Confluence Investment Management

Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: July 21, 2015—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading down 0.2% from the last close. In Asia, the MSCI Asia Apex 50 rose 0.7% from the prior close. U.S. equity futures are signaling a lower opening from the previous close. With 13.6% of the S&P 500 companies having reported Q2 earnings, the actual plus projected adjusted EPS is $29.15, above the $28.70 forecast. Of the 68 companies that have reported, 72.1% had positive earnings surprises, while 22.1% had negative earnings surprises.

After a busy news cycle for the past few weeks, news flow is very quiet this morning. Gold prices are getting a bounce this morning. If levels hold for a few days, it probably means a short-term bottom has probably formed and yesterday represented a "wash out", a capitulation of gold bulls. However, if selling returns, what we are seeing today is a modest short covering rally that will simply bring in new selling. We are leaning toward the latter and expect further weakness to develop.

The biggest news today is that President Obama is expected to nominate Kathryn Dominguez to the Fed's Board of Governors. We have recently updated our Monetary Policy Monitor multimedia presentation and show a chart where we note that two vacancies exist on the Board of Governors. The president has already nominated Allen Landon to the Board. Landon is an expert on community banks, the most popular sector of the financial system in Washington (after all, who doesn't like local banks—its like not appreciating George Bailey). Dominguez is a professor at the University of Michigan and considered an expert on international capital markets. She will be less attractive of a candidate for Congress (the constituency of foreign capital markets is rather small) but she appears to be a very capable candidate.

It appears that the Senate Banking Committee, led by Richard Shelby (R-AL), was not willing to schedule confirmation meetings until candidates for both vacancies were nominated. Although any confirmation process is grueling, these candidates appear to be non-controversial and will likely make it through the process. Once appointed, Governors are permanent members of the FOMC and vote on policy at every meeting. History suggests they tend to follow the Chairman in their voting pattern and rarely dissent. If this pattern continues (and we see no reason to expect otherwise) the composition of the FOMC and the full leadership of the Fed will become more dovish. If these two seats are filled, it will be the first time the Board has been at full strength since August 2013.

U.S. Economic Releases

There are no releases scheduled before we go to print, but for the rest of today, at 10:00 EDT the industrial production and capacity utilization revisions will be released.

Foreign Economic News

We monitor numerous global economic indicators on a continuous basis. The most significant international news that was released overnight is outlined below. Not all releases are equally significant, thus we have created a star rating to convey to our readers the importance of the various indicators. The rating column below is a three-star scale of importance, with one star being the least important and three stars being the most important. We note that these ratings do change over time as economic circumstances change. Additionally, for ease of reading, we have also color-coded the market impact section, with red indicating a concerning development, yellow indicating an emerging trend that we are following closely for possible complications and green indicating neutral conditions. We will add a paragraph below if any development merits further explanation.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
China	Foreign direct investment	y/y	Jun	0.7%	7.8%	0.5%	**	Equity bullish, bond bearish
Japan	LEI	m/m	May	106.2	106.2		**	Equity and bond neutral
	Coincident indicator	m/m	May	109.0	109.2		**	Equity bearish, bond bullish
EUROPE								
Switzerland	Trade balance (CHF)	m/m	Jun	3.6 bn	3.4 bn	2.5 bn	**	Equity bearish, bond bullish
	Exports	m/m	Jun	-0.9%	1.1%		**	Equity bearish, bond bullish
	Imports	m/m	Jun	2.2%	-1.2%		**	Equity bearish, bond bullish
	M3 money supply	y/y	Jun	2.1%	1.5%		**	Equity bullish, bond bearish

Financial Markets

The table below highlights some of the indicators that we follow on a daily basis. Again, the color coding is similar to the foreign news description above. We will add a paragraph below if a certain move merits further explanation.

	Today	Prior	Change	Trend
3-mo Libor yield (bps)	29	29	0	Neutral
3-mo T-bill yield (bps)	2	2	0	Neutral
TED spread (bps)	27	27	0	Neutral
U.S. Libor/OIS spread (bps)	12	12	0	Neutral
10-yr T-note (%)	2.39	2.37	0.02	Widening
Euribor/OIS spread (bps)	11	11	0	Neutral
EUR/USD 3-mo swap (bps)	21	21	0	Neutral
Currencies	**Direction**			
dollar	down			Rising
euro	up			Falling
yen	down			Falling
franc	up			Falling

Commodity Markets

The commodity section below shows some of the commodity prices and their change from the prior trading day, with commentary on the cause of the change highlighted in the last column.

	Price	Prior	Change	Cause/ Trend
Energy markets				
Brent	$ 56.63	$ 56.65	-0.04%	Persistent global surplus
WTI	$ 50.13	$ 50.15	-0.04%	
Natural gas	$ 2.86	$ 2.82	1.31%	
Crack spread	$ 26.59	$ 27.07	-1.75%	
12-mo strip crack	$ 18.97	$ 19.27	-1.59%	
Ethanol rack	$ 1.74	$ 1.75	-0.27%	
Metals				
Gold	$ 1,105.77	$ 1,096.50	0.85%	Rebound after yesterday's losses
Silver	$ 14.80	$ 14.71	0.61%	
Copper contract	$ 249.25	$ 248.15	0.44%	
Grains				
Corn contract	$ 416.50	$ 416.00	0.12%	
Wheat contract	$ 533.00	$ 532.75	0.05%	Better than expected export inspections
Soybeans contract	$ 1,005.50	$ 999.50	0.60%	
Shipping				
Baltic Dry Freight	1067	1048	19	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.2		
Gasoline (mb)		0.8		
Distillates (mb)		1.7		
Refinery run rates (%)		0.0%		

Weather

The 6-10 and the 8-14 day forecasts call for warmer and drier than normal conditions for the majority of the country. There is no tropical activity to report.

Weekly Asset Allocation Commentary

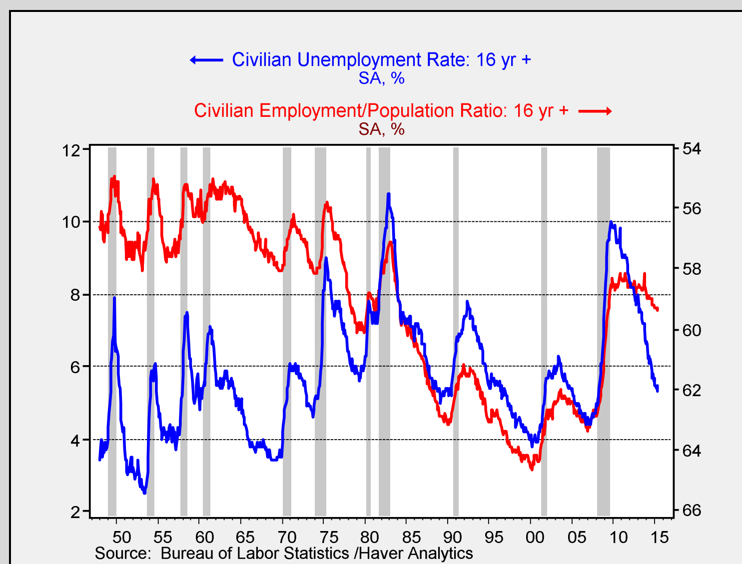
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. This year, we will start reporting asset allocation thoughts on a weekly basis, updating the piece every Friday. We hope you find this new addition useful.

July 17, 2015

Economic slack is a key issue for conducting monetary policy. Economic theory suggests that inflation rises when aggregate demand increases high enough to constrain supply, or deplete productive slack in the economy. Thus, policymakers use economic slack measures in determining monetary policy. If policymakers keep stimulative policy in place once slack has been diminished, they run the risk of building inflation pressures. However, if stimulus is withdrawn before slack is sufficiently reduced, the best outcome is stagnant growth and the worst is recession.

The traditional way of measuring economic slack is to look at the current level of real GDP relative to potential GDP. The latter is measured by calculating the level of unemployment, labor force growth, labor productivity and capital utilization. Unfortunately, these components of potential GDP are not directly observable and, in the end, such calculations are "best estimates" and fraught with error. In addition, all the inputs are subject to revision and so such calculations, even if reasonably accurate, may contain significant lags. In light of these issues, policymakers and economists have tended to focus on labor market measures that are available with greater frequency, which are more fluid than industrial capacity or productivity measures.

The unemployment rate has been a reasonably good measure of labor market slack. However, there have been two major changes in the postwar period that have affected the labor markets: 1) the baby boomers entering the workforce, and 2) the social change of female employment. These two factors caused a surge in labor supply that led to a period of discontinuity in the 1970s. By the 1980s, these factors had been mostly absorbed by the labor market.

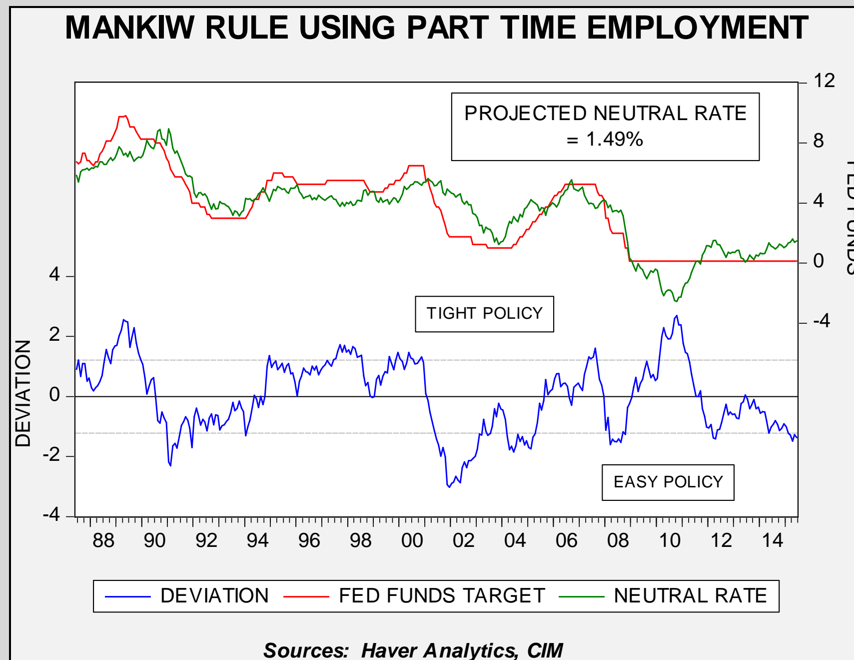


The chart above shows the unemployment rate (blue line, left scale) and the employment/population ratio (red line, right scale, inverted). Until the mid-1970s, the employment/population ratio rarely rose to around 58%. This is because the majority of baby boomers were still children and fewer women worked. For example, from 1950 to 1964, on average, only 34.4% of women aged 16 or older were employed. Currently, that ratio is 53.8% and it peaked at 58.0% in 2000. Initially, as women joined the workforce and baby boomers came of age, the unemployment rate rose but, over time, labor markets adjusted. From 1980 until 2011, the unemployment rate and the employment/population ratio moved closely together.

Since 2011, as we have documented before, these measures began to diverge. Why this divergence has occurred is up for debate, but the consensus among economists is that much of this difference is because of baby boomer retirement. Although we have doubts that this factor alone can explain the divergence, the fact that policymakers probably do hold this position is more important. This leads us to the second major change, the flexibility of the labor force, which is partly due to changes in technology and partly due to changes in health care laws, resulting in the increasing prevalence of part-time employment. Chairman Yellen is said to monitor the level of part-time workers for economic reasons as a percentage of the labor force. These are workers who would prefer full-time work but can't find such positions.

This chart shows the percentage of part-time workers for economic reasons compared to the labor force. In general, long expansions tend to reduce this number. However, the current expansion has been underway for six years; in the last expansion, this percentage was just under 3% by the six-year mark. As the chart shows, this indicator rose to 6% during the Great Financial Crisis but has been steadily falling. A reading under 4% would suggest an improving labor force. In general, a reading under 3% tends to trigger faster wage growth.

To compare this measure to the level of the policy rate, we replace the unemployment rate with the part-time for economic reasons rate in the Mankiw Rule. The Mankiw Rule is a simplified version of the Taylor Rule, which estimates the neutral policy rate for monetary policy. The latter uses actual to potential GDP to measure economic slack. The former uses the unemployment rate to determine the same measure. In the model below, we replace the unemployment rate with the level of part-time workers for economic reasons as a percentage of the labor force.

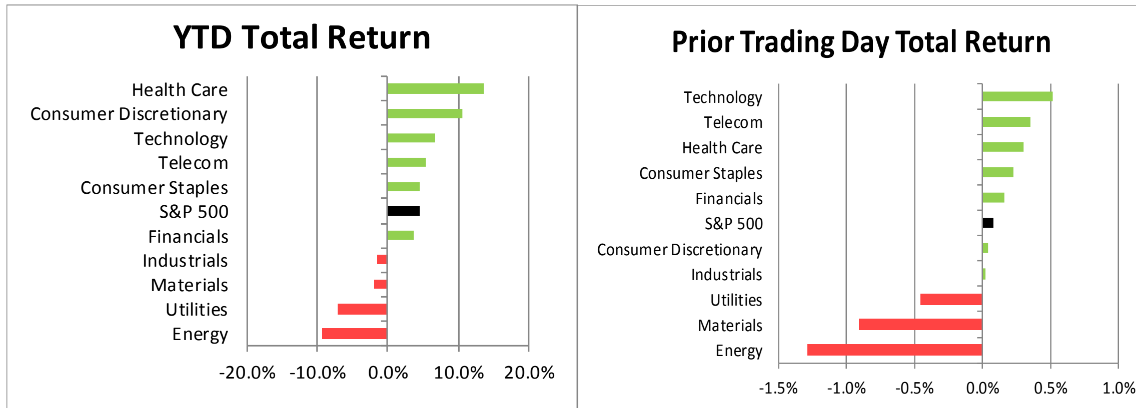


The results show that monetary policy is currently accommodative. According to this model, the neutral rate would be 1.50%. Although we doubt the FOMC will move rates quickly to this level, it is consistent with the "dots" projection for the end of 2016. The model suggests that every 1% improvement in the part-time employment for economic reasons as a percentage of the labor force adds about 116 bps to the neutral policy rate. Thus, the rapid decline in this labor market measure, plus the fact that the FOMC appears to be behind the curve, is probably prompting more aggressive moves to raise rates by policymakers. Consequently, we are leaning toward the first rate hike likely occurring in September.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

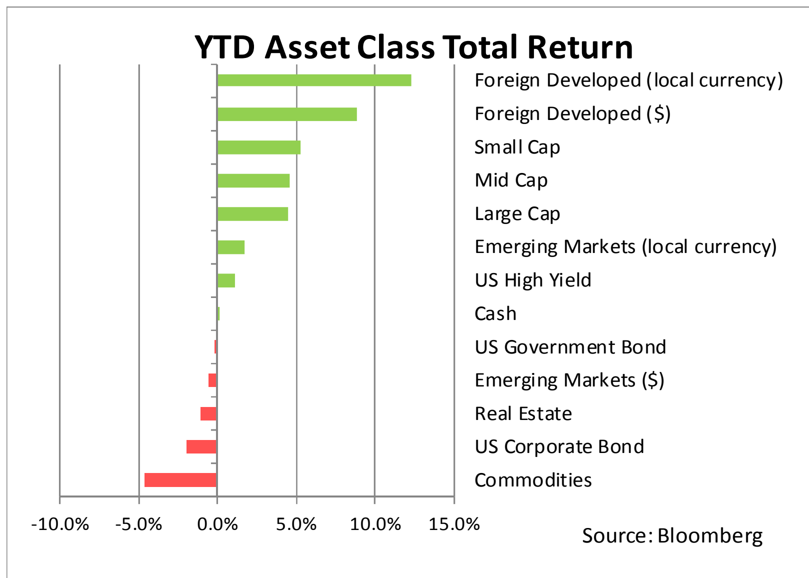
U.S. Equity Markets – (as of 7/20/2015 close)



(Source: Bloomberg)

These S&P 500 and sector return charts are designed to provide the reader with an easy overview of the year-to-date and prior trading day total return. The sectors are ranked by total return, with green indicating positive and red indicating negative return, along with the overall S&P 500 in black.

Asset Class Performance – (as of 7/20/2015 close)

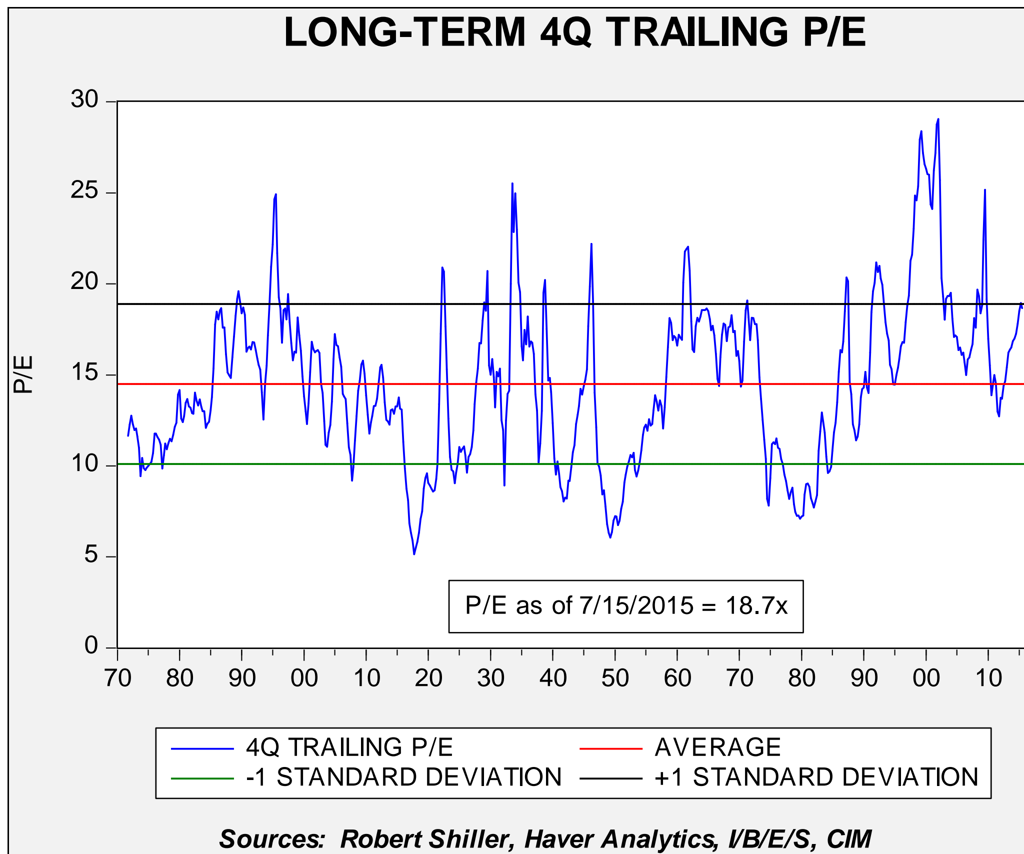


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

Asset classes are defined as follows: Large Cap (S&P 500 Index), Mid Cap (S&P 400 Index), Small Cap (Russell 2000 Index), Foreign Developed (MSCI EAFE (USD and local currency) Index), Real Estate (FTSE NAREIT Index), Emerging Markets (MSCI Emerging Markets (USD and local currency) Index), Cash (iShares Short Treasury Bond ETF), U.S. Corporate Bond (iShares iBoxx $ Investment Grade Corporate Bond ETF), U.S. Government Bond (iShares 7-10 Year Treasury Bond ETF), U.S. High Yield (iShares iBoxx $ High Yield Corporate Bond ETF), Commodities (Dow Jones-UBS Commodity Index).

P/E Update

July 16, 2015



The above chart offers a running snapshot of the S&P 500 P/E in a long-term historical context. We are using a specific measurement process, similar to *Value Line*, which combines earnings estimates and actual data. We use an adjusted operating earnings number going back to 1870 (we adjust as-reported earnings to operating earnings through a regression process until 1988), and actual operating earnings after 1988. For the current and last quarter, we use the I/B/E/S estimates which are updated regularly throughout the quarter; currently, the four-quarter earnings sum includes two actual (Q4 and Q1) and two estimates (Q2 and Q3). We take the S&P average for the quarter and divide by the rolling four-quarter sum of earnings to calculate the P/E. This methodology isn't perfect (it will tend to inflate the P/E on a trailing basis and deflate it on a forward basis), but it will also smooth the data and avoid P/E volatility caused by unusual market activity (through the average price process). Why this process? Given the constraints of the long-term data series, this is the best way to create a very long-term dataset for P/E ratios.

Based on our methodology, the current P/E is 18.7x, up 0.1x from last week. The rise is mostly due to stronger equity prices.

This report was prepared by Bill O'Grady and Kaisa Stucke of Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change. This is not a solicitation or an offer to buy or sell any security.