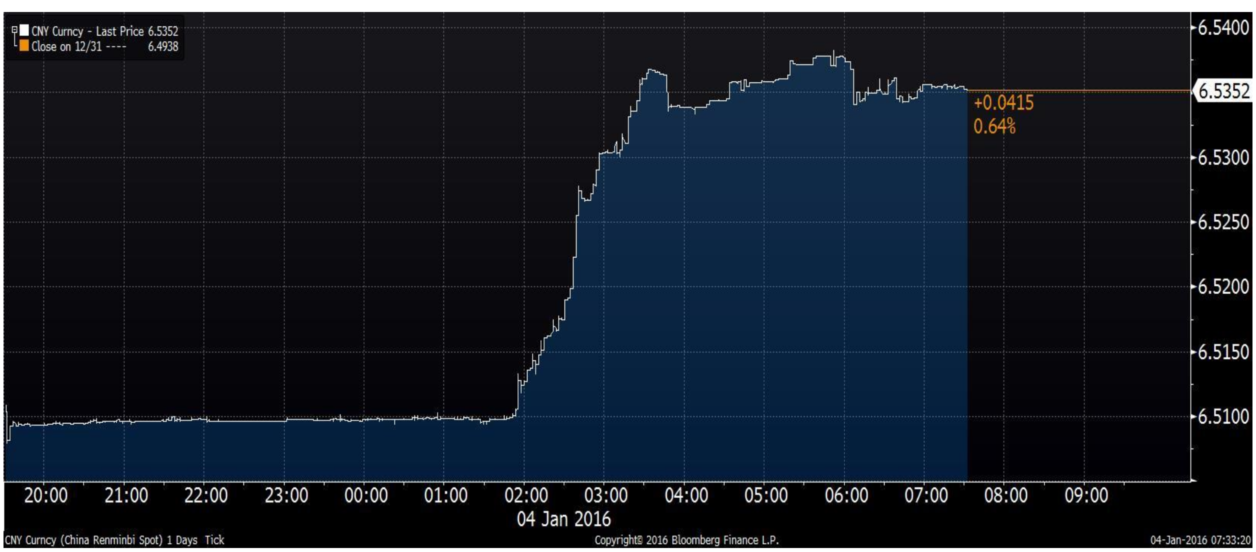
Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: January 4, 2016—9:30 AM EST] Global equity markets are lower this morning. The EuroStoxx 50 is trading lower by 2.9% from the last close. In Asia, the MSCI Asia Apex 50 was down 3.1% from the prior close. Chinese equities were much lower, with the Shanghai composite down 6.9% and the Shenzhen index down 8.2%. U.S. equity futures are signaling a lower opening from the previous close.

The first trading day of the year is starting off with a thud. Global equity markets are lower, despite the rally in oil, and "risk-on" assets are rallying. We are seeing stronger Treasuries and developed market sovereigns, and the JPY is up. There are two reasons behind the slide in "risk-off" assets. First, China's equity market plunged after manufacturing PMI data came in below 50 (see below). Although the data was in line with expectations, it should be noted that this is the official PMI report; two other independent surveys have closed recently and these had been signaling even more weakness than the official number. Continued worries about China's economy led to further equity selling. New trading limits in China likely exacerbated the problem. Trading was halted once equities fell 7%; trading limits, sometimes called "circuit breakers," are used in many markets, including here in the U.S. However, within these markets, an active options market exists which can give an indication of what the underlying market would be doing if the limits were not in place. Since no such market exists in China, traders are left with guessing what the true value of equities should be. That uncertainty probably made things worse. Further weakness in the CNY also exacerbated market fears.



(Source: Bloomberg)

The chart above shows the intraday CNY/USD chart; a rising number means more CNY to buy a dollar, or a weaker Chinese currency. Evidently, the CNY slid overnight. For perspective, below is a longer term chart.

(Source: Bloomberg)

It is becoming clear that the PBOC is allowing the CNY to depreciate. After the devaluation shock in August 2015 led to selloffs in equities around the world, Chinese monetary authorities stabilized the CNY until mid-November but have since allowed the Chinese currency to steadily weaken. A weaker CNY will tend to weigh on commodities and emerging market equities.

The second factor affecting "risk-off" assets came out of the Middle East. Over the long New Year's weekend, Saudi Arabia performed a mass execution of 47 convicted criminals. It appears the majority of those executed were jihadist radicals. Their crimes included apostasy, attacks on Saudi security personnel and conspiracies to attack the financial system and embassies in the kingdom. The aggressiveness of this act makes clear that the kingdom faces a very serious internal threat to security, coming from Sunni jihadists that believe the royal family is corrupt and illegitimate. Although in the West we fret about jihadist terrorism, there is almost no likelihood that this threat could undermine any government in Western Europe or North America. Is it a threat to citizens? No doubt. However, as the past several years have shown, violent behavior can come from domestic, non-sectarian sources as well. Security officials are burdened with protecting us from numerous threats. However, none rise to the level at which they could lead to a new government.

That isn't the case for the Saudi royal family. Part of its ruling legitimacy comes from the family's alliance with Wahhabi clerics, and the Sunni jihadists, from al Qaeda to Islamic State, are suggesting that this alliance is not justified and that the royal family is not worthy of its power due to its lack of piety. Osama bin Laden's opposition to the Saudi government was born when King Fahd invited the U.S. military into the kingdom to defend it from Saddam Hussein during Operation Desert Shield in 1990. If the Saudi population concludes that the jihadists are correct and the royal family is illegitimate, then a revolution may develop. This is why the government's decision to reduce subject support by cutting subsidies and raising prices is particularly risky; for reference, the late King Abdullah expanded spending in response to the Arab Spring.

However, there is a broader signal from these executions as well. One of the unfortunate Saudis executed was a renowned Shiite cleric, Sheikh Nimr al-Nimr. Al-Nimr was strongly critical of Saudi discrimination of Shiites and led protests against the government. He was arrested several times, the last in 2012 when he was reportedly involved in a shootout with security officials (it should be noted that most of the charges against al-Nimr were based on his views, not from this incident). He was wounded during this episode, accused of inciting unrest and sentenced to death in 2014.

The Saudi government is sending clear signals by executing al-Nimr. First, the fact that he was executed with mostly Sunni prisoners indicates that the royal family is signaling that being a Shiite arguing for equal treatment is on par with errant Sunni jihadism. The official Saudi position seems to be that it views both IS's deviant version of Sunni Islam and Shiite Islam as equal threats. In other words, the message being sent is that Iran and IS are both true threats to stability in the region, and Saudi Arabia is prepared to attack both.

This means, of course, that the Saudis will not be party to any peace negotiation that allows Assad to remain in power or offers IS a role in the region, and it won't agree to Iran being part of negotiations, either. This stance will make it almost impossible for the U.S. or any other outside power to bring any sort of negotiated settlement to fruition. In other words, absent a change in Saudi policy (or its government) we are facing perpetual conflict in the region.

These executions also signal that the kingdom is now prepared to escalate the situation. The widespread protests and official condemnations, along with the attack on the Saudi embassy in Tehran, could not have come as a surprise to the Saudi government. The executions were, in our opinion, an aggressive act designed to show Saudi resolve and to increase regional tensions. In light of the attack on the Saudi embassy, the kingdom has expelled Iran's ambassador to Saudi Arabia and has officially broken off diplomatic relations. It appears the gloves are coming off.

What does this mean for markets? Oil prices initially rose sharply on the news but have fallen from their earlier opening highs. The fact that oil prices are not higher shows the degree of bearish market fundamentals. At the same time, we still expect Iran to begin exporting oil sometime in Q1, which will tend to weigh on prices. However, if the risk of broader conflict rises, oil prices will rise, along with other "risk-off" assets, such as Treasuries, the JPY and perhaps gold. We will continue to closely monitor events in the region, but it appears the Saudi action increases risks across a number of markets.

U.S. Economic Releases

Each year we make improvements to our commentary. This year, we are using a chart to list U.S. economic releases and Fed speakers that will occur after we publish. We will still print charts on the 8:30 EST data.

Economic releases						
EST	Indicator			Expected	Prior	Rating
9:45	Markit PMI	m/m	Dec	51.1	51.3	***
10:00	Construction spending	m/m	Nov	0.6%	1.0%	*
10:00	ISM manufacturing	m/m	Nov	49.0	48.6	**
10:00	ISM prices paid	m/m	Nov	35.5	35.5	**
Fed Speakers						
EST	Speaker	District				
5:30 PM	Williams	San Francisco				

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	Manufacturing PMI	m/m	Dec	49.7	49.6	49.8	***	Equity bearish, bond bullish
	Non-manufacturing PMI	m/m	Dec	54.4	53.6		**	Equity bullish, bond bearish
	Manufacturing PMI (Caixin)	m/m	Dec	48.2	48.6	48.9	***	Equity bearish, bond bullish
India	Manufacturing PMI (Nikkei)	m/m	Dec	49.1	50.3		***	Equity bearish, bond bullish
Japan	Manufacturing PMI (Nikkei)	m/m	Dec	52.6	52.5		***	Equity bullish, bond bearish
EUROPE								
Eurozone	Manufacturing PMI	m/m	Dec	53.2	53.1	53.1	***	Equity bullish, bond bearish
France	Manufacturing PMI	m/m	Dec	51.4	51.6	51.6	***	Equity bearish, bond bullish
Germany	Manufacturing PMI	m/m	Dec	47.8	50.5		***	Equity bearish, bond bullish
	CPI	y/y	Dec	0.3%	0.4%	0.6%	***	Equity bearish, bond bullish
Italy	Manufacturing PMI	m/m	Dec	55.6	54.9	54.9	***	Equity bullish, bond bearish
U.K.	Manufacturing PMI	m/m	Dec	51.9	52.5	52.8	***	Equity bearish, bond bullish
Russia	Manufacturing PMI	m/m	Dec	48.7	50.1	49.5	***	Equity bearish, bond bullish
	Services PMI	m/m	Dec	47.8	49.8	48.3	**	Equity bearish, bond bullish
	Composite PMI	m/m	Dec	47.8	50.5		**	Equity bearish, bond bullish
AMERICAS								
Brazil	Manufacturing PMI	m/m	Dec	45.6	43.8		***	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)	61	61	0	Neutral
3-mo T-bill yield (bps)	17	16	1	Up
TED spread (bps)	44	45	-1	Down
U.S. Libor/OIS spread (bps)	39	39	0	Neutral
10-yr T-note (%)	2.23	2.27	-0.04	Down
Euribor/OIS spread (bps)	-13	-13	0	Neutral
EUR/USD 3-mo swap (bps)	21	19	2	Down
Currencies	**Direction**			
dollar	down			Rising
euro	down			Falling
yen	up			Falling
franc	down			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	$ 38.26	$ 37.28	2.63%	Saudi Arabia cuts ties with Iran, adding to geopolitical tension
WTI	$ 37.74	$ 37.04	1.89%	
Natural gas	$ 2.31	$ 2.34	-1.03%	
Crack spread	$ 14.82	$ 14.28	3.72%	
12-mo strip crack	$ 15.44	$ 15.09	2.30%	
Ethanol rack	$ 1.56	$ 1.56	0.00%	
Metals				
Gold	$ 1,077.44	$ 1,061.10	1.54%	Geopolitical tensions
Silver	$ 14.18	$ 13.82	2.64%	
Copper contract	$ 209.20	$ 213.50	-2.01%	Weak China data
Grains				
Corn contract	$ 357.75	$ 358.75	-0.28%	
Wheat contract	$ 469.00	$ 470.00	-0.21%	
Soybeans contract	$ 859.50	$ 864.25	-0.55%	
Shipping				
Baltic Dry Freight	478	475	3	

Weather

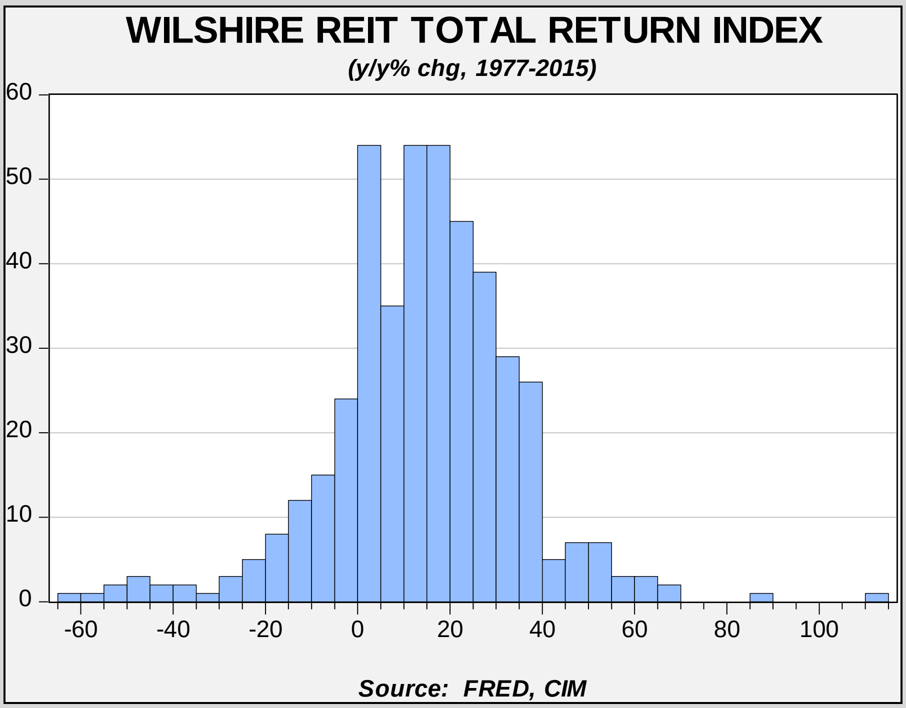
The 6-10 and 8-14 day forecasts indicate colder than normal weather for the middle of the country, with the west receiving heavier than normal precipitation.

Weekly Asset Allocation Commentary

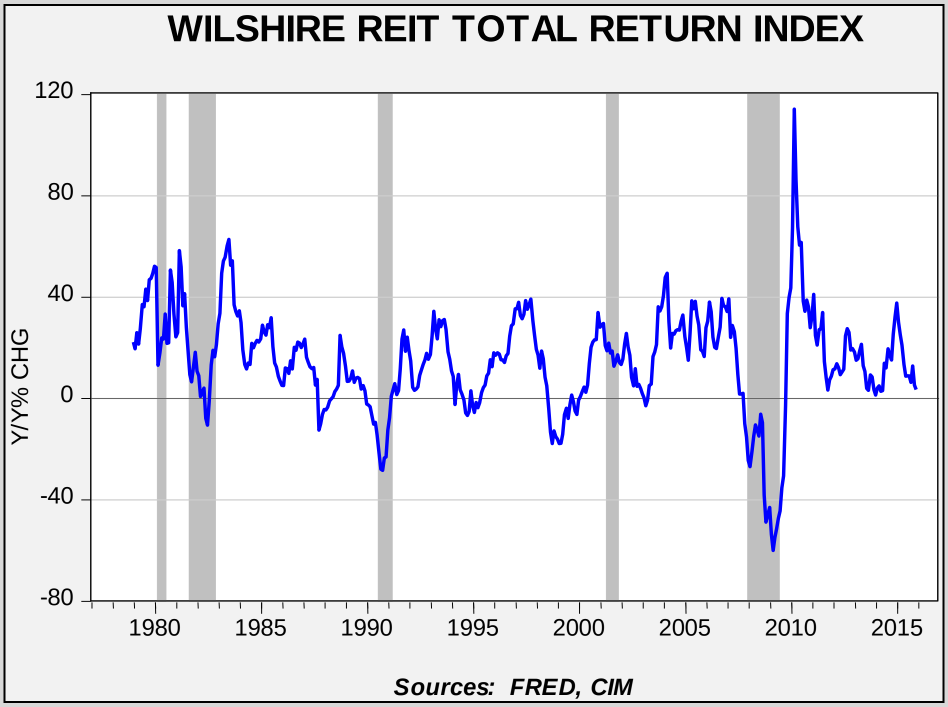
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. This year, we have started reporting asset allocation thoughts on a weekly basis, updating the section every Friday.

December 31, 2015

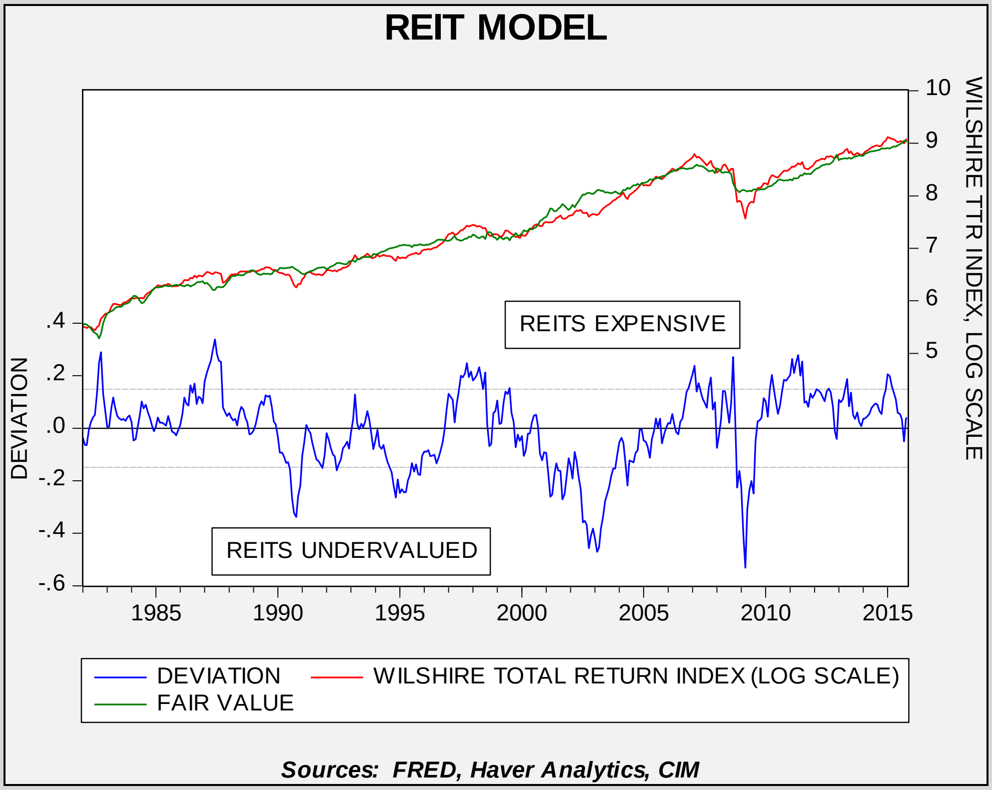
Real estate investment trusts (REITs) are one of the asset classes we use in our asset allocation portfolios. The investment has characteristics of both equity and debt. The investment is equity because the trust shares represent fractional ownership of income-producing real estate. At the same time, their relatively high yield means the trust shares are highly sensitive to interest rates like a fixed income instrument. However, because rents tend to rise with both stronger economies and inflation, the investment can offer some protection in a rising rate environment. Because of their equity characteristics, REITs tend to be sensitive to the economic cycle.



This chart shows the yearly return profile of the Wilshire REITs total return market index. The average return is 14.6% over this time frame with a 20.4% standard deviation. The distribution has a kurtosis of 5.5, meaning the distribution isn't normal but "peaked" around the mean. For investors, this means that most of the monthly returns on an annual basis are around the mean, but when they deviate from the mean, the differences tend to be large.



This is a chart showing the yearly change in the total return index, another way of looking at the data in the first chart. Over the life of the index, which began in 1977, there have been five recessions. In three of those five periods, the index recorded negative returns, consistent with its equity-like characteristics. It also had a negative period coincident with the 1987 stock market crash. In 1994-95, REITs were weak as tighter monetary policy hurt fixed income returns along with the market turmoil in 1998 tied to the LTCM Crisis, the Asian Economic Crisis and the Russian Debt Default. This chart indicates that REITs are sensitive to the business cycle, rising interest rates and any sort of financial crisis that would raise credit concerns.

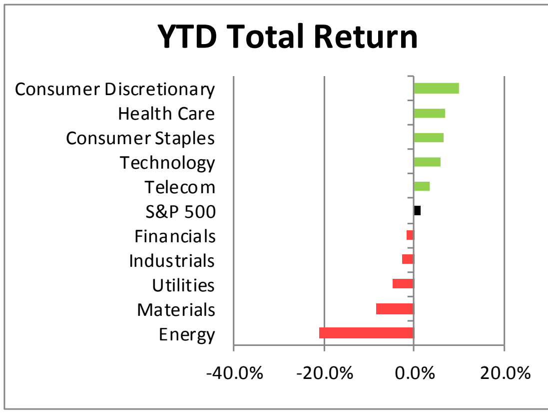


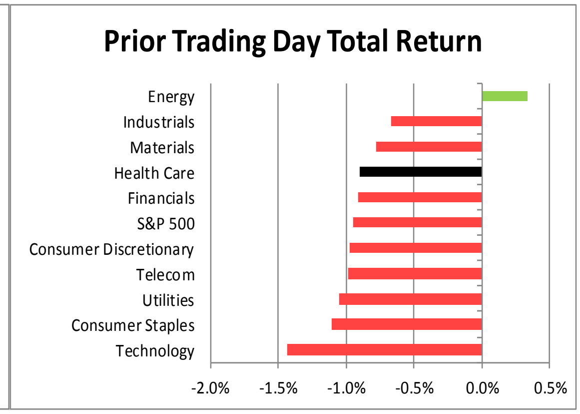
This chart shows a pricing model for the Wilshire REIT Total Return Index. It uses the coincident indicator, the 10-year T-note yield, the Shiller CAPE, and the Chicago FRB Financial Conditions Index. The deviation line shows us that the periods above zero (57.3% of the time) are higher than below zero (42.7% of the time). However, the periods of undervaluation tend to be deeper than the degree of overvaluation. In general, of the four variables, the coincident index, equity valuation and financial conditions are the most powerful. Essentially, when equities are very strong with a rising P/E, REITs tend to be less attractive. Recessions are negative for the performance of REITs and rising financial stress is also a concern.

Our model currently suggests that REITs are about fairly valued, coming off a period of rather high valuation last year. We are monitoring the economy and financial conditions closely; however, at present, we do not expect a major negative event for REITs in the near future. As we noted in our 2016 Outlook, if the Federal Reserve makes a policy mistake, and either boosts financial stress or triggers an economic downturn, the Asset Allocation Committee will need to consider reducing our exposure to this asset class.

Data Section

U.S. Equity Markets – (as of 12/31/2015 close)

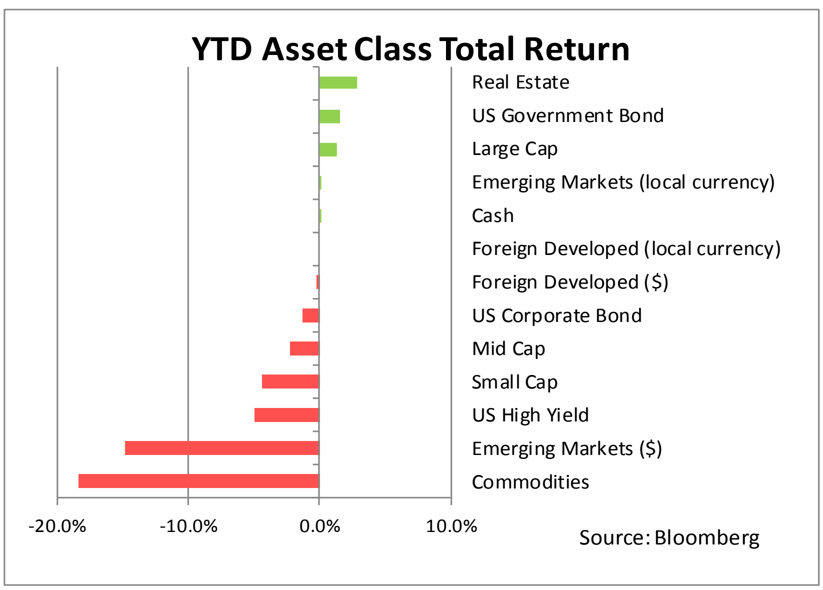




(Source: Bloomberg)

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 12/31/2015 close)

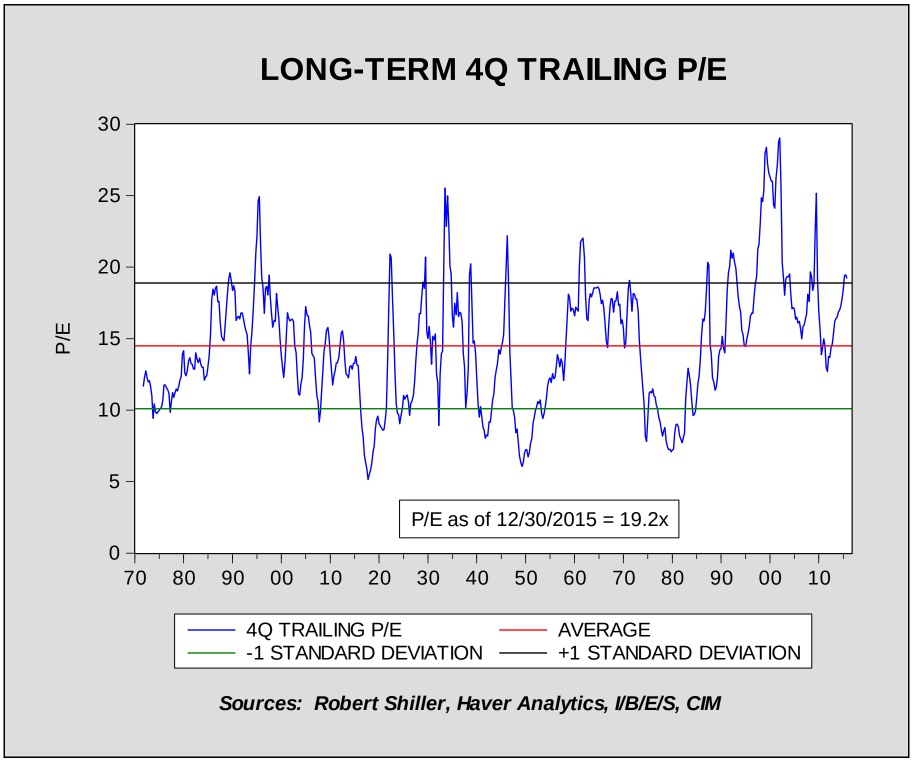


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

December 31, 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 three actual (Q1, Q2 and Q3) and one estimate (Q4). 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 19.2x, unchanged from last week. The multiple remains elevated but has stabilized.

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.