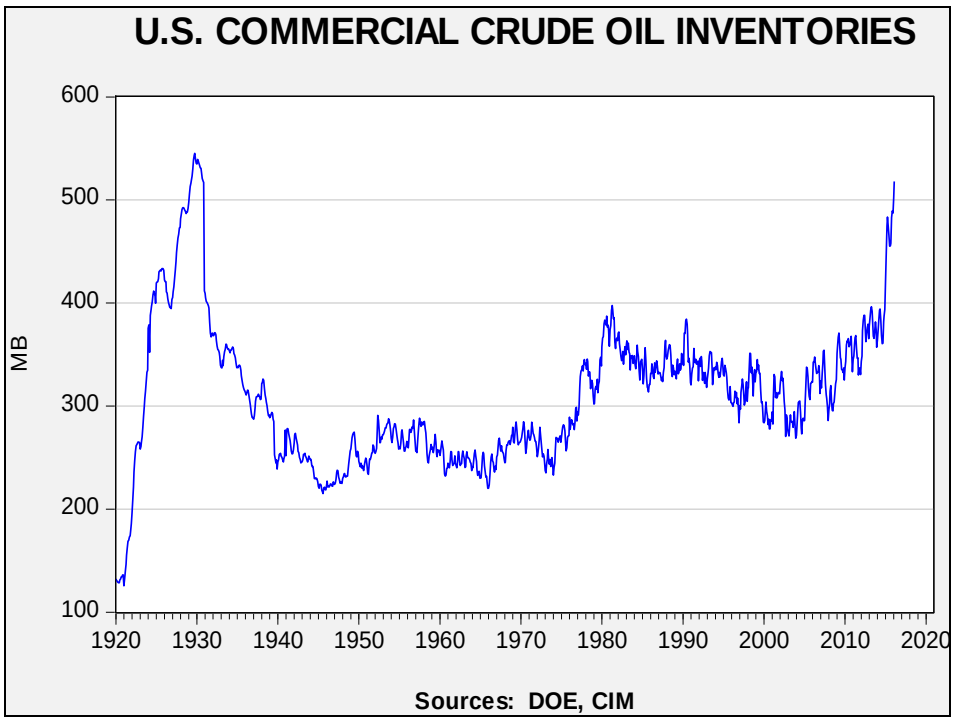
Daily Comment

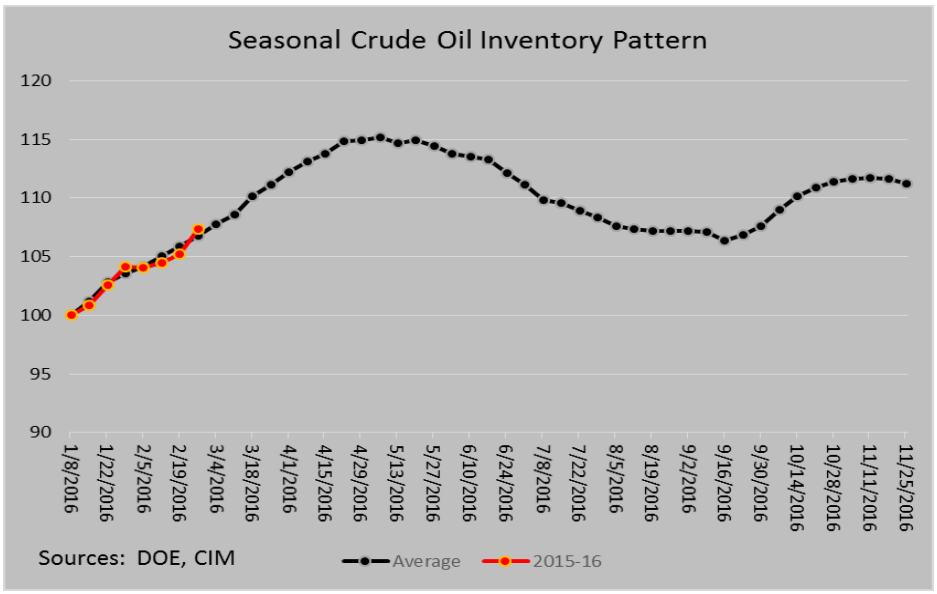
By Bill O'Grady & Kaisa Stucke, CFA

[Posted: March 3, 2016—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is trading lower by 0.6% from the last close. In Asia, the MSCI Asia Apex 50 traded higher by 1.0% from the prior close. Chinese markets are also mixed, with the Shanghai composite up 0.3% and the Shenzhen index down 0.1%. U.S. equity futures are signaling a lower opening from the previous close. With 97.2% of the S&P 500 companies having reported, the Q4 adjusted earnings stand at $29.80, higher than the $28.95 forecast. Of the 486 companies that have reported, 69.2% beat expectations while 19.5% fell short.

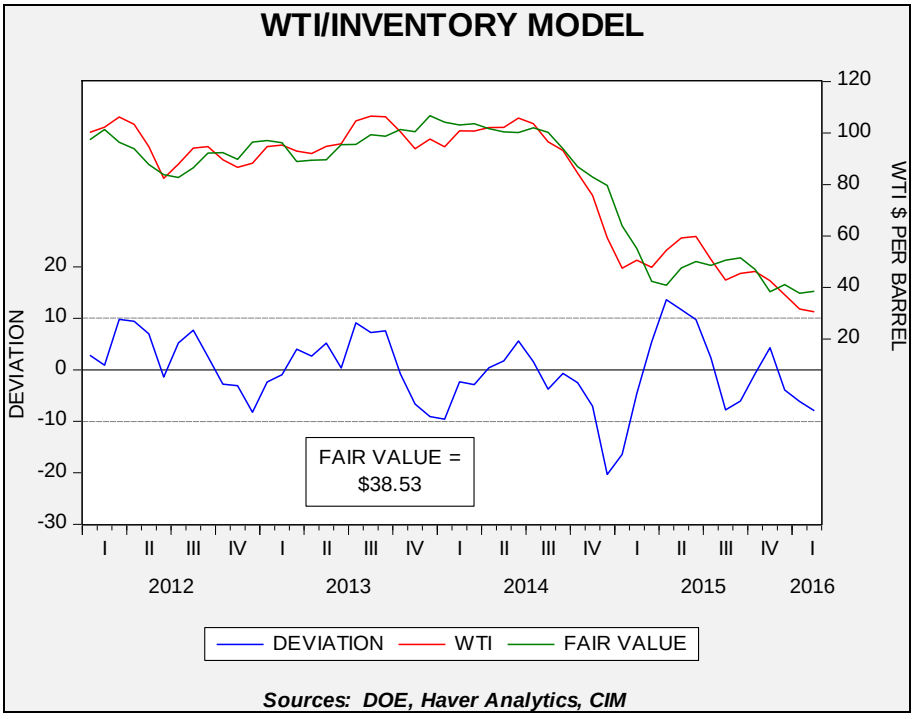
U.S. commercial crude oil inventories jumped 10.4 mb for the week ending 2/26, well above forecast. Current stockpiles remain at 80+ year highs. We are only 21 mb below the all-time high and there is a very good chance we will make a new high in the coming weeks.



The below chart shows the current build compared to the five-year average on an indexed basis. As the chart indicates, the current build is running close to normal. If we continue to track the average, we will see stockpiles peak at 555.8 mb, a new high.



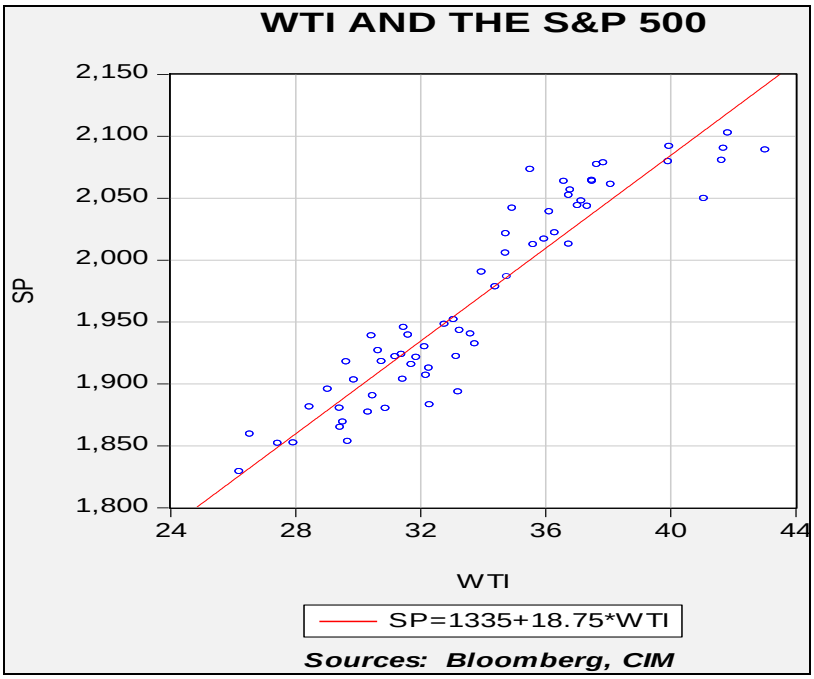
Oil prices rose yesterday despite the massive inventory overhang. This is probably because current prices are below where the combination of the dollar and inventories suggest they should be.



Our oil price model, which uses commercial crude oil inventories and the EUR exchange rate, puts fair value at $38.53. Thus, the market is a bit cheap here. Assuming we do reach the expected seasonal peak, fair value would be $31.62, so we are not necessarily out of the woods yet on oil. If the European Central Bank presses the EUR lower at next week's meeting, oil could come under further pressure.

Market action is clearly supportive; rallying in the face of such bearish data is at least a short-term signal that oil has bottomed. Nevertheless, we still have to make it through the rest of the injection season. The good news is that we probably have seen the lows in oil.

The relationship between oil and U.S. equities has been rather tight. Looking at the relationship since the last OPEC meeting, the two series are correlated at the 93.9% level.

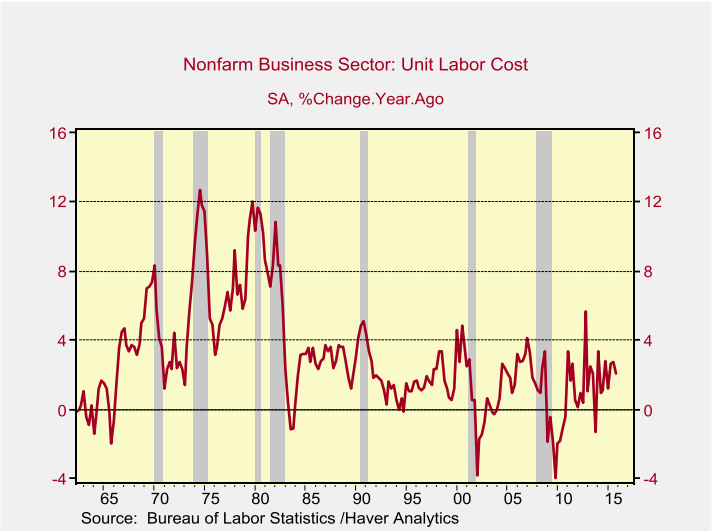


Although one cannot necessarily derive causality from correlation, market behavior seems to suggest that oil prices drive equity values. The relationship is currently quite strong; the regression suggests that every dollar change in oil prices leads to a change in the S&P 500 of 18.75 points. Thus, if we get to our current fair value price, the S&P 500 would be 2,057, assuming the above relationship holds. Of course, as noted above, we still have eight weeks of storage accumulation in front of us, which will likely pressure oil prices. The fact that we are currently below fair value is likely due to expectations of rising storage. If we reach the expected level of storage, the fair value level for the S&P 500 would be 1,928, based on the oil price/equity relationship.

The wild card in all this rests with the ECB. If the ECB expands monetary stimulus and leads the EUR lower, the fair value for oil will decline as well. The other critically important caveat is that short-term relationships in markets come and go; this one will as well. If the FOMC returns to hawkishness (as intimated yesterday by San Francisco FRB President Williams) the oil/equity relationship could break down. However, for now, it appears that any equity rallies depend on rising oil prices.

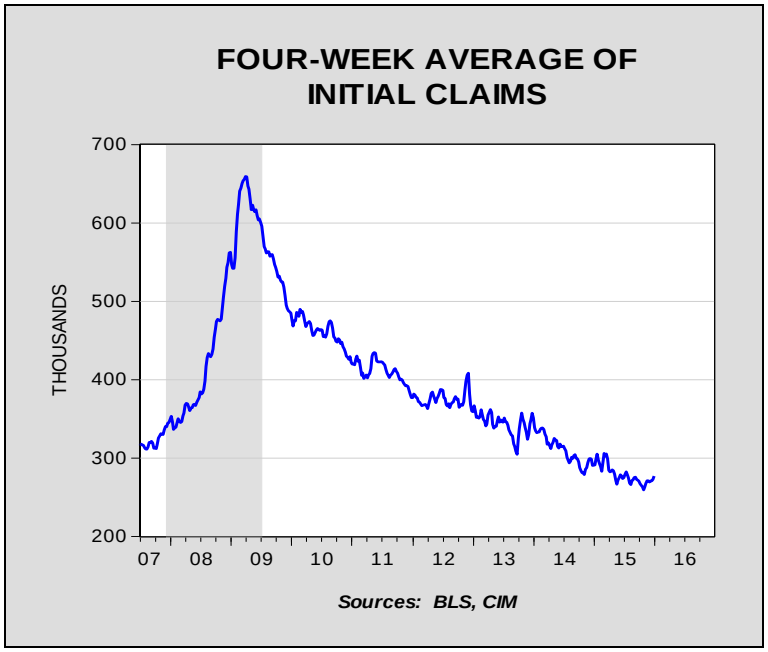
U.S. Economic Releases

Non-farm productivity declined 2.2% in Q4 compared to the 2.9% decline forecast. Unit labor costs increased 3.3%, less than the 4.3% forecast.



The chart above shows the annual change in unit labor costs, adjusted for productivity. Although labor costs were weaker than forecast in February, the general trend is increasing.

Initial claims disappointed, rising 6k to 278k compared to the 270k forecast. Despite the higher claims, the overall labor market is improving solidly. The four-week average, a more stable measure, actually fell 2k to 270k, still close to historic lows.



The chart above shows the four-week average. The claims data does not point to a deterioration in the labor market.

Challenger job cuts increased 21.8% in February from the year before compared to the 41.6% increase in January. This report indicates the number of corporate layoffs, but does not necessarily show current conditions as this number shows announced layoffs, which does not mean increased joblessness in the near term.

The table below shows the releases scheduled for the rest of the day.

Economic releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Services PMI	m/m	Feb	50.0	49.8	*
9:45	Manufacturing PMI	m/m	Feb		50.1	*
10:00	ISM non-manufacturing composite	m/m	Feb	53.1	53.5	**
10:00	Factory orders	m/m	Jan	2.1%	-2.9%	**
10:00	Durable goods orders	m/m	Jan		4.9%	**
Fed Speakers and Events						
EST	**Speaker or event**	**District or position**				
10:45	Kaplan	Dallas				

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								
Australia	Trade balance (AUD)	m/m	Jan	-2.9 bn	-3.5 bn	-3.2 bn	*	Equity bullish, bond bearish
China	Services PMI (Caixin)	m/m	Feb	51.2	52.4		*	Equity bearish, bond bullish
	Composite PMI (Caixin)	m/m	Feb	49.4	50.1		*	Equity bearish, bond bullish
India	Services PMI (Nikkei)	m/m	Feb	51.4	54.3		*	Equity bearish, bond bullish
	Composite PMI (Nikkei)	m/m	Feb	51.2	53.3		*	Equity bearish, bond bullish
Japan	Services PMI (Nikkei)	m/m	Feb	51.2	52.4		*	Equity bearish, bond bullish
	Composite PMI (Nikkei)	m/m	Feb	51.0	52.6		*	Equity bearish, bond bullish
EUROPE								
Eurozone	Services PMI (Markit)	m/m	Feb	53.3	53.0	53.0	*	Equity bullish, bond bearish
	Composite PMI (Markit)	m/m	Feb	53.0	52.7	52.7	*	Equity bullish, bond bearish
	Retail sales	m/m	Jan	0.4%	0.6%	0.1%	**	Equity bullish, bond bearish
France	Services PMI (Markit)	m/m	Feb	49.2	49.8	49.8	*	Equity bearish, bond bullish
	Composite PMI (Markit)	m/m	Feb	49.3	49.8	49.8	*	Equity bearish, bond bullish
	Unemployment rate	m/m	Jan	10.3%	10.4%	10.5%	***	Equity bullish, bond bearish
U.K.	Services PMI (Markit)	m/m	Feb	52.7	55.6	55.1	*	Equity bearish, bond bullish
	Composite PMI (Markit)	m/m	Feb	52.8	56.2	55.7	*	Equity bearish, bond bullish
Russia	Services PMI (Markit)	m/m	Feb	50.9	47.1		*	Equity bullish, bond bearish
	Composite PMI (Markit)	m/m	Feb	50.6	48.4		*	Equity bullish, bond bearish
AMERICAS								
Brazil	Services PMI (Markit)	m/m	Feb	36.9	44.4		*	Equity bearish, bond bullish
	Composite PMI (Markit)	m/m	Feb	39.0	45.1		*	Equity bearish, bond bullish
	GDP	y/y	Feb	-5.9%	-4.5%	-6.0%	***	Equity and bond neutral

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)	63	63	0	Neutral
3-mo T-bill yield (bps)	28	29	-1	Down
TED spread (bps)	35	34	1	Up
U.S. Libor/OIS spread (bps)	42	42	0	Neutral
10-yr T-note (%)	1.85	1.84	0.01	Up
Euribor/OIS spread (bps)	-21	-21	0	Neutral
EUR/USD 3-mo swap (bps)	31	31	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	$ 36.73	$ 36.93	-0.54%	Domestic crude inventories increased more than expected
WTI	$ 34.49	$ 34.66	-0.49%	
Natural gas	$ 1.65	$ 1.68	-1.73%	Warmer weather forecast
Crack spread	$ 17.38	$ 17.53	-0.86%	
12-mo strip crack	$ 12.92	$ 12.92	0.02%	
Ethanol rack	$ 1.50	$ 1.50	-0.15%	
Metals				
Gold	$ 1,241.88	$ 1,239.98	0.15%	Lower dollar
Silver	$ 14.97	$ 14.95	0.19%	
Copper contract	$ 218.95	$ 218.10	0.39%	Speculation of further Chinese easing
Grains				
Corn contract	$ 357.00	$ 356.25	0.21%	
Wheat contract	$ 454.00	$ 450.25	0.83%	Dry weather forecast in the Black Sea region
Soybeans contract	$ 863.75	$ 861.50	0.26%	
Shipping				
Baltic Dry Freight	335	332	3	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)	10.3	2.5	7.8	
Gasoline (mb)	-1.5	-1.1	-0.4	
Distillates (mb)	2.9	-1.0	3.9	
Refinery run rates (%)	1.0%	-0.3%	0.0	
Natural gas (bcf)		-40.0		

Weather

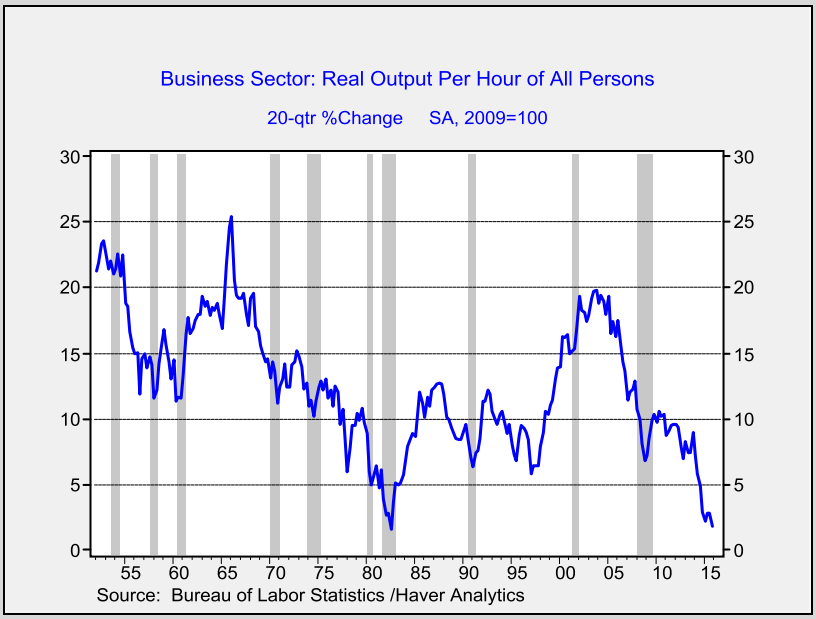
The 6-10 and 8-14 day forecasts indicate warmer and wetter than normal weather for the majority of the country.

Weekly Asset Allocation Commentary

Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

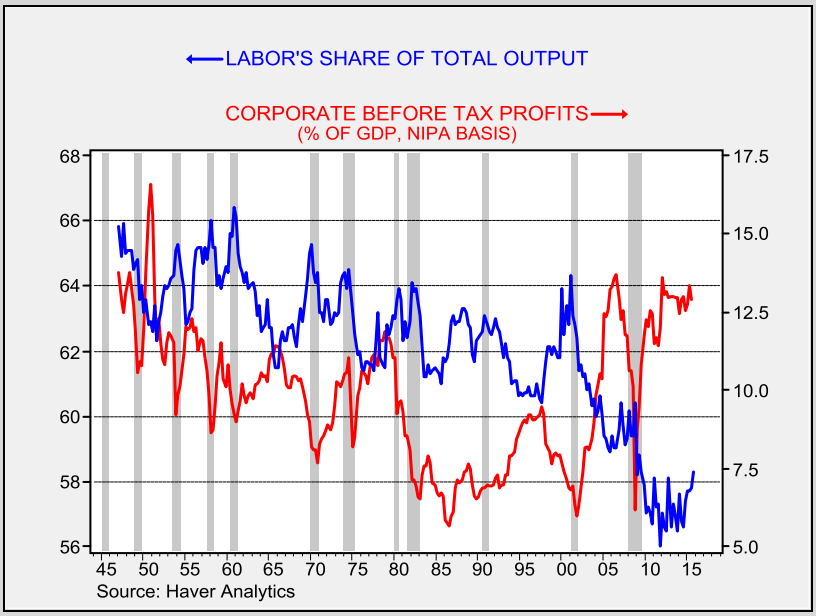
February 26, 2016

One of the more troubling issues of the economy is the lack of productivity growth.

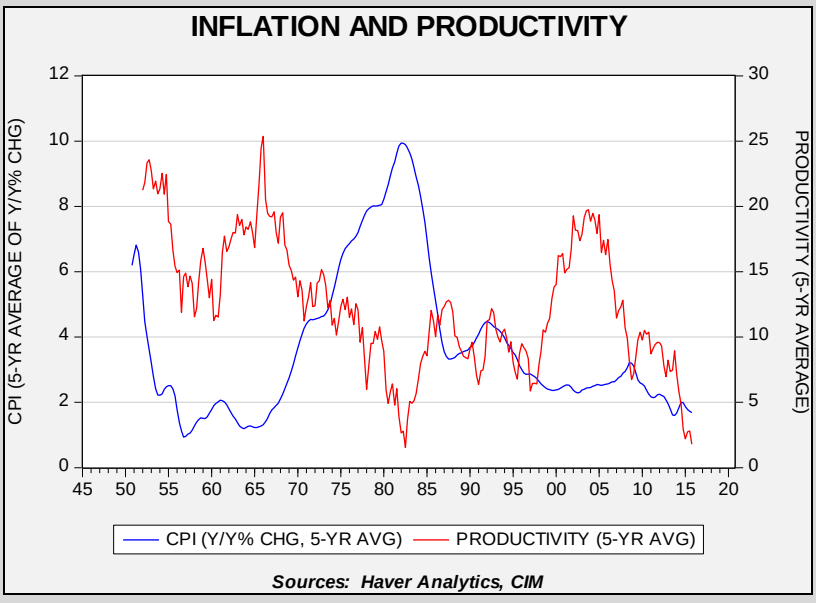


This chart shows the five-year average of yearly productivity. Note that productivity has steadily declined since the recent peak in 2005, falling to levels last seen in the early 1980s. Productivity tends to be the lifeblood of the economy. It measures the output of the economy for the amount of hours worked. When it is low, it means that more workers are needed to grow the economy at the same pace.

Another way of thinking about productivity is that it acts as the "grease" between the competing interests of labor and capital. If productivity is rising, both labor and capital can see their relative shares of total output rise. However, if productivity is flat, it is difficult for either capital or labor to see their positions improve; in effect, it becomes a fight over a static pie.



In the high productivity years of the 1960s, both labor and capital were able to maintain relatively high shares. However, in the 1970s into the early 1980s, when productivity declined, labor maintained its share at the expense of capital. The cost to society was high inflation.



This chart overlays the five-year change in productivity with the five-year average of the yearly change in CPI. Note that the decline in productivity from 1965 to 1982 led to sharply higher inflation. Firms tried to maintain profit margins by raising prices to offset inflation-adjusted wages.

One of the concerns about weak productivity growth is that it could lead to inflation. However, thus far, the decline in productivity has mostly been shouldered by labor as seen by the decline in

labor's share of output. Recent wage gains raise the possibility that labor markets are tight enough to allow workers to gain share; if productivity fails to increase, profit margins will very likely fall.

Why is productivity lower? That is a puzzle economists are trying to solve. Unlike the 1970s, when government regulation and high levels of unionization were blamed for slow productivity, at least on a relative basis, regulation remains lax. Our worry is that economic growth is too slow to fully utilize the economy's productive capacity.[1] If this is the case, the government should boost spending to absorb some of this excess capacity. However, if there is some other reason behind sluggish productivity,[2] the spending may not have much impact.

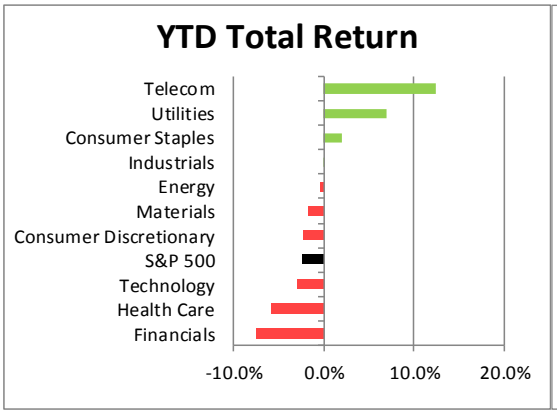
The other concern is that the pressure on labor's share of productivity is probably a factor in the popularity of Donald Trump and Sen. Sanders. The squeeze that labor is facing is being exacerbated by the drop in productivity. If labor is able to use the political system to change the terms of distribution it would probably have two effects. It would lower profit margins and likely lift inflation, which would both be negative for equities. The productivity issue is one we are watching closely. If it fails to recover, equity markets are vulnerable to further weakness.

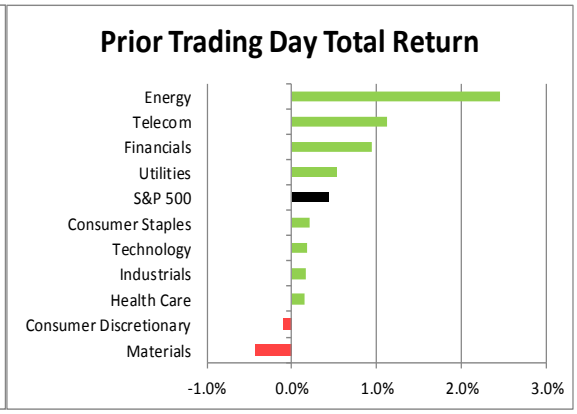
[1] Examples of this phenomenon would be underemployment (college grads working as baristas) or firms shutting down production lines due to lack of demand but still being required to keep machines maintained and the factory lights on.

[2] For example, there could be problems in the housing markets that prevent the most productive workers from moving to where the jobs are.

Data Section

U.S. Equity Markets – (as of 3/2/2016 close)

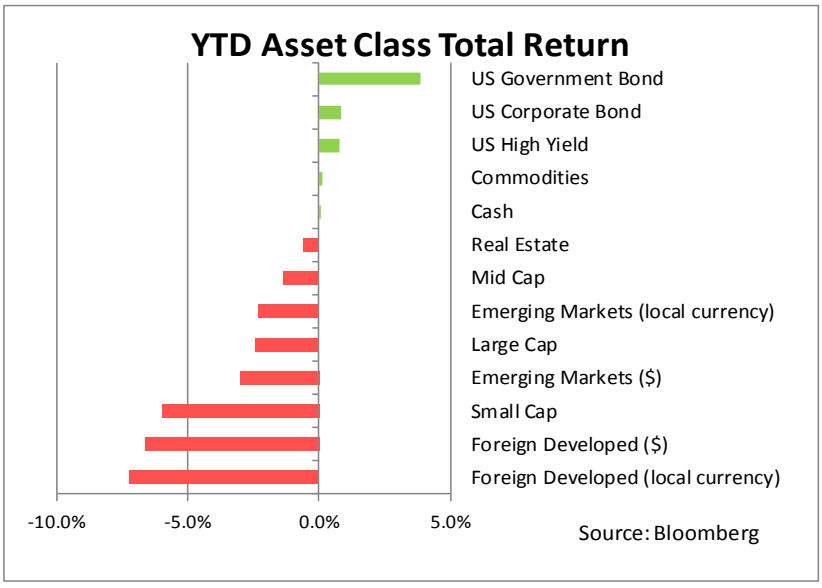




(Source: Bloomberg)

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 3/2/2016 close)

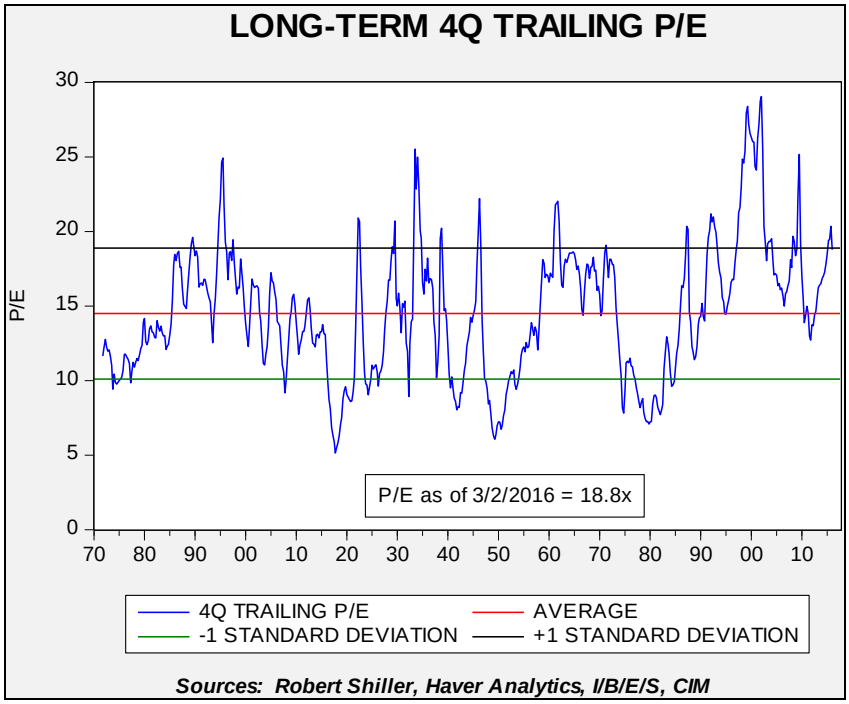


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

March 3, 2016



Based on our methodology,[3] the current P/E is 18.8x, up 1.2x from last week. The jump is due to a situation that has developed in recent quarters in which the Bloomberg numbers are significantly higher than the official data we receive from Haver Analytics. This situation has previously occurred during periods of weak economic growth. Haver releases an earnings number once 95% of the companies of the S&P 500 have reported and these may be adjusted in the coming weeks. For now, earnings have come in much weaker than expected. Based off the Haver numbers for 2015, operating earnings for the year were $100.89; as reported, $87.07.

[3] 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 (Q2 and Q3) and two estimates (Q4 and Q1). 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.