Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

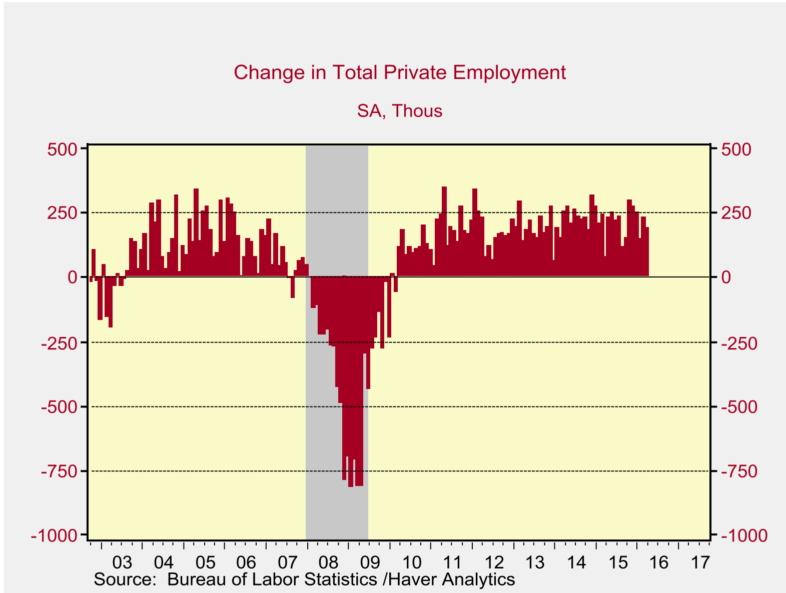
[Posted: April 1, 2016—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is trading down 2.6% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 1.6% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.2% and the Shenzhen index lower by 0.6%. U.S. equity futures are signaling a lower opening from the previous close.

Happy employment day! We will go into much more detail below, but we are seeing solid improvement in the labor market. Most importantly, the labor force is finally starting to expand; in fact, the unemployment rate rose this month in a good way as the labor force expanded faster than employment. We have also seen a rise in wage growth, although it still remains soft. The market is taking the data as hawkish, leading to higher interest rates today and a stronger dollar.

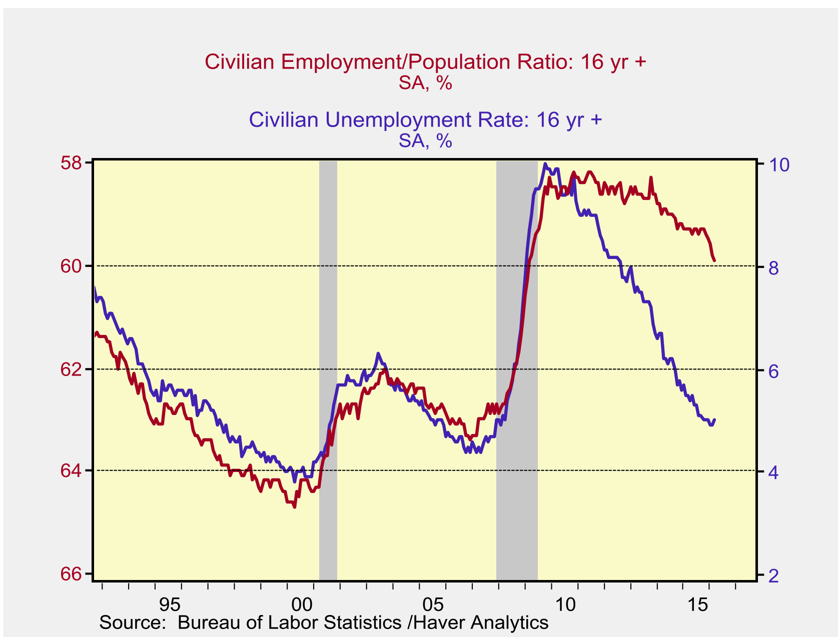
There were two overseas developments of note overnight. First, China's PMI data (see below) came in better than forecast, with the Caixin PMI number reaching 49.7, the highest report in 13 months. The official report hit 50.2, above the 50 expansion line and a nine-month high. Although some of this may be due to the timing of the New Year's holiday, it does appear that stimulus measures are starting to have an impact, which is a good sign. Second, Saudi Arabia's Deputy Crown Prince Salman conducted a long interview with Bloomberg overnight. The primary short run news is that the kingdom does not intend to freeze oil output unless Iran does as well. This scotches hopes that OPEC + Russia were on the brink of a production deal; oil prices have fallen as a result. Salman also suggested that the kingdom would only sell 5% or less of Saudi Aramco and would create a massive $2.0 trillion sovereign wealth fund to support the kingdom's efforts. Although the value of the wealth fund appears massive, in fact, it looks like Saudi Arabia will simply put Saudi Aramco in the fund which will become the bulk of its assets. The most important takeaway from the interview is that Saudi Arabia is in no hurry to support an oil price recovery.

U.S. Economic Releases

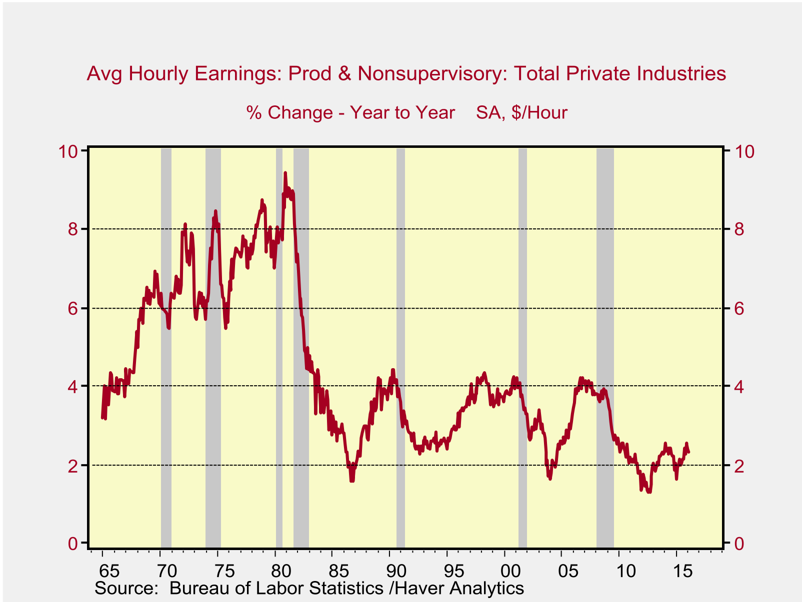
March non-farm payrolls came in better than expected, rising 215k compared to the 205k forecast. At the same time, the unemployment rate rose to 5.0% from 4.9% previously, also higher than the 4.9% increase forecast. The increase was due to an expansion of the labor force in excess of jobs created as improving labor market conditions attract previously discouraged workers. Wages were higher than forecast, rising 0.3% from the month before compared to the 0.2% increase forecast.



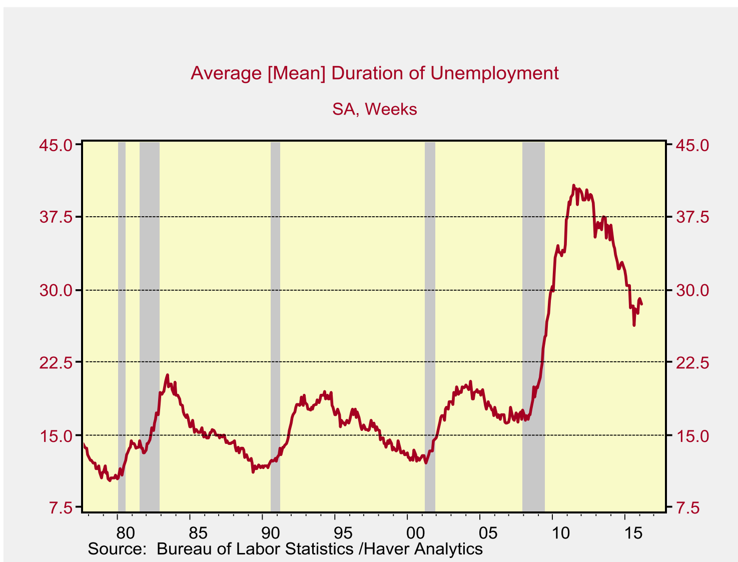
The chart above shows the change in non-farm private payrolls. Gains in payrolls have been solid recently, indicating an improving labor market.



The chart above shows the unemployment rate and the employment/population ratio (on an inverse scale). The two metrics are starting to close the gap after diverging significantly since the end of the recession. The employment/population ratio improved to 59.9% from 59.8% previously.



The chart above shows the annual change in the average hourly earnings, which were better than forecast, rising 2.3% compared to the 2.2% expected.



The chart above shows the average duration of unemployment, which improved to 28.4 weeks from 29.0 weeks previously.

The chart above shows the rate of part-time workers for economic reasons, one of Yellen's favorite measures. The rate remained unchanged at 3.8%, but has generally improved after reaching a high of 5.9% in 2009.

Overall, the market took the employment report as a hawkish signal, with the dollar higher and equities and bond yields higher.

The table below shows the economic releases and Fed speakers scheduled for the rest of the day.

Economic releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Manufacturing PMI (Markit)	m/m	Mar	51.5	51.4	**
10:00	ISM manufacturing	m/m	Mar	51.0	49.5	**
10:00	University of Michigan sentiment	m/m	Mar	90.5	90.0	**
10:00	Construction spending	m/m	Feb	0.1%	1.5%	*
Fed Speakers and Events						
EST	**Speaker or event**	**District or position**				
12:00	Mester	Cleveland FRB President				

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	Mar	50.2	49.0	49.4	**	Equity bullish, bond bearish
	Manufacturing PMI (Caixin)	m/m	Mar	53.8	52.7		**	Equity bullish, bond bearish
	Non-manufacturing PMI	m/m	Mar	49.7	48.0	48.3	*	Equity bullish, bond bearish
Japan	Manufacturing PMI (Nikkei)	m/m	Mar	49.1	49.1		**	Equity and bond neutral
	Tankan large manufacturing index	q/q	Q1	6.0	12.0	8.0	*	Equity bearish, bond bullish
	Tankan large non-manufacturing index	q/q	Q1	22.0	25.0	24.0	*	Equity bearish, bond bullish
	Tankan small manufacturing index	q/q	Q1	-4.0	0.0	-2.0	*	Equity bearish, bond bullish
EUROPE								
Eurozone	Manufacturing PMI (Markit)	m/m	Mar	51.6	51.4	51.4	**	Equity bullish, bond bearish
France	Manufacturing PMI (Markit)	m/m	Mar	49.6	49.6	49.6	**	Equity and bond neutral
Germany	Manufacturing PMI (Markit)	m/m	Mar	50.7	50.4	50.4	**	Equity bullish, bond bearish
Italy	Manufacturing PMI (Markit)	m/m	Mar	53.5	52.2	52.5	**	Equity bullish, bond bearish
	Unemployment rate	m/m	Feb	11.7%	11.6%	11.5%	***	Equity bearish, bond bullish
U.K.	Manufacturing PMI (Markit)	m/m	Mar	51.0	50.8	51.2	**	Equity and bond neutral
Switzerland	Manufacturing PMI	m/m	Mar	53.2	51.6	51.1	**	Equity bullish, bond bearish
	Retail sales	m/m	Feb	-0.2%	-0.1%		**	Equity bearish, bond bullish
Russia	Manufacturing PMI (Markit)	m/m	Mar	48.3	49.3	49.5	**	Equity bearish, bond bullish
AMERICAS								
Brazil	Industrial production	m/m	Feb	-2.5%	-2.5%	0.4%	***	Equity bearish, bond bullish

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)	20	20	0	Neutral
TED spread (bps)	43	43	0	Neutral
U.S. Libor/OIS spread (bps)	38	38	0	Neutral
10-yr T-note (%)	1.78	1.77	0.01	Widening
Euribor/OIS spread (bps)	-24	-24	0	Neutral
EUR/USD 3-mo swap (bps)	24	25	-1	Down
Currencies	**Direction**			
dollar	up			Falling
euro	down			Rising
yen	up			Rising
franc	up			Rising

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	$ 39.41	$ 40.33	-2.28%	Ample global supplies
WTI	$ 37.44	$ 38.34	-2.35%	
Natural gas	$ 1.97	$ 1.96	0.66%	
Crack spread	$ 18.74	$ 18.77	-0.12%	
12-mo strip crack	$ 13.47	$ 13.54	-0.50%	
Ethanol rack	$ 1.56	$ 1.57	-0.12%	
Metals				
Gold	$ 1,232.11	$ 1,232.75	-0.05%	Falling on the employment report
Silver	$ 15.38	$ 15.44	-0.40%	
Copper contract	$ 218.25	$ 218.30	-0.02%	China manufacturing improves
Grains				
Corn contract	$ 349.25	$ 351.50	-0.64%	Increased domestic planting
Wheat contract	$ 469.75	$ 473.50	-0.79%	
Soybeans contract	$ 914.00	$ 910.75	0.36%	
Shipping				
Baltic Dry Freight	429	414	15	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)	2.3	2.8	-0.5	
Gasoline (mb)	-2.5	-2.2	-0.3	
Distillates (mb)	-1.1	-0.3	-0.8	
Refinery run rates (%)	2.0%	-0.1%	2.1%	
Natural gas (bcf)	-25	-24.0	-1.0	

Weather

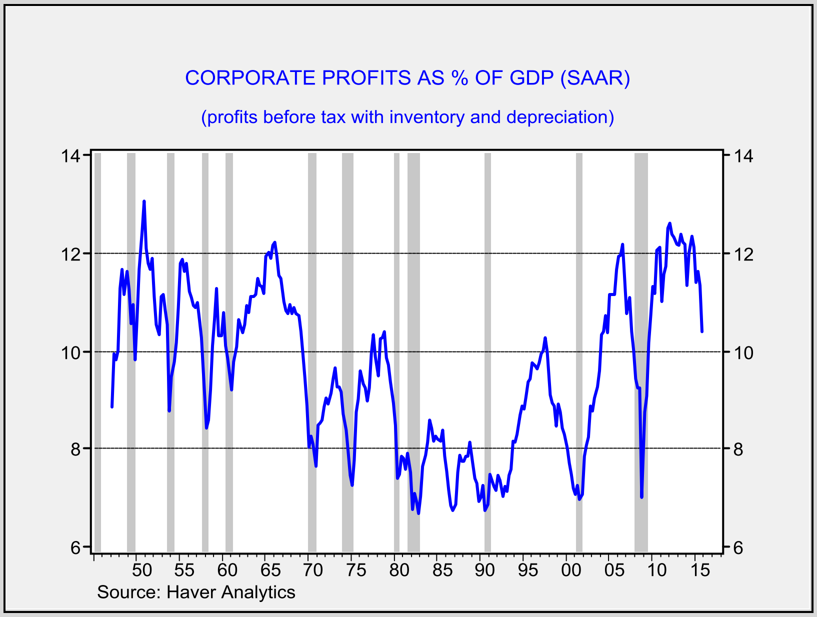
The 6-10 and 8-14 day forecasts are calling for warmer than normal temperatures for the western two-thirds of the country and cooler than normal conditions for the eastern third. Precipitation is forecast for most of the Northeast and the Southwest.

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.

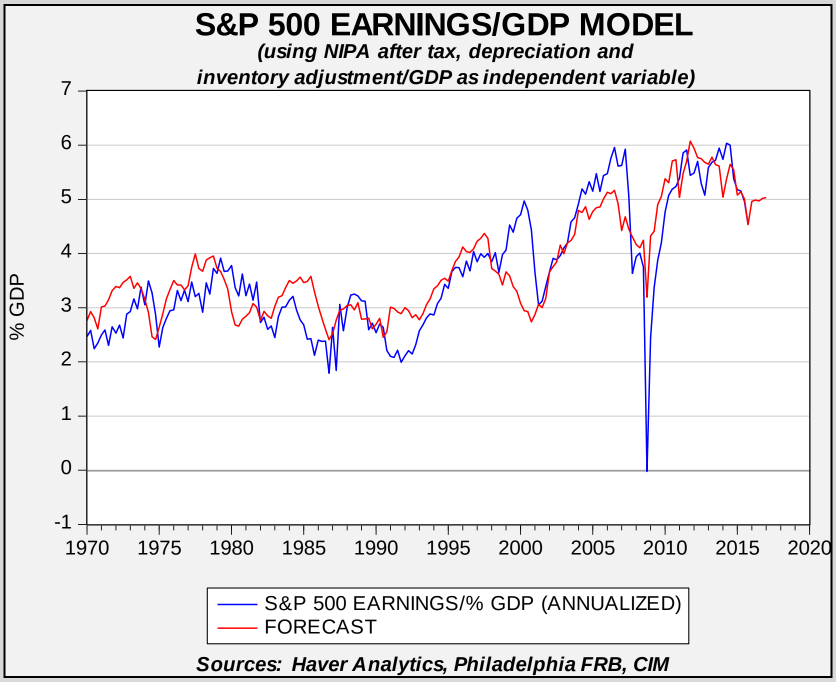
April 1, 2016

In the most recent GDP report, corporate profits plunged.



The overall decline in profits was $153 bn in Q4, although some of this drop was due to an $83 bn settlement that BP had with the government over the 2010 Gulf of Mexico oil spill. We have been noting for some time that profit margins have been eroding. This data tends to confirm that concern.

In our earnings forecast, we use a similar number from the National Income and Products Accounts (NIPA) that is similar to the above profits report except that it includes corporate taxes as well.



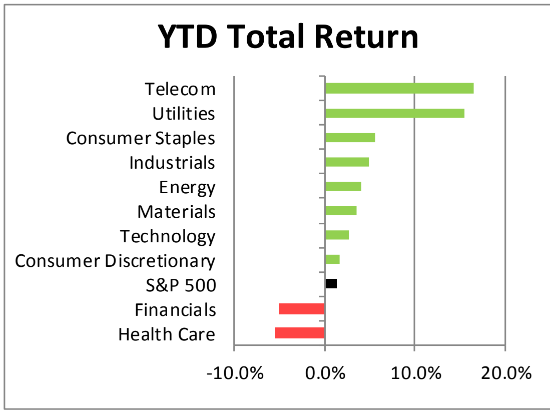
This chart shows the relationship between S&P 500 earnings as a percentage of GDP and the NIPA corporate profits after tax, depreciation and inventory adjustment. We include this variable in a larger model that we use to project S&P earnings compared to GDP. For the most part, the two series tend to track each other rather closely. Periods when S&P earnings greatly exceed the NIPA numbers tend to signal that such divergences are not sustainable and they are resolved by a drop in S&P earnings. Such divergences are evident in 1980, 2000 and 2007. Fortunately, the two readings are not currently diverging.

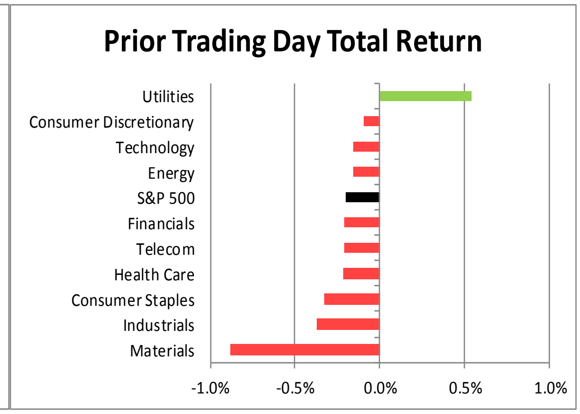
Using the NIPA profits and GDP forecasts from the Philadelphia FRB, the relationship suggests that profits will recover in 2016. In our latest update to our 2016 outlook, we reduced our earnings for the year mostly due to margin contraction.[1] The most recent GDP data generally confirms this trend. Overall, we are looking for a mostly flat year for the equity markets due to sluggish economic growth and mostly flat margins. At the same time, we do not expect a recession this year, which should prevent a major pullback in equities.

[1] See 2016: An Update.

Data Section

U.S. Equity Markets – (as of 3/31/2016 close)

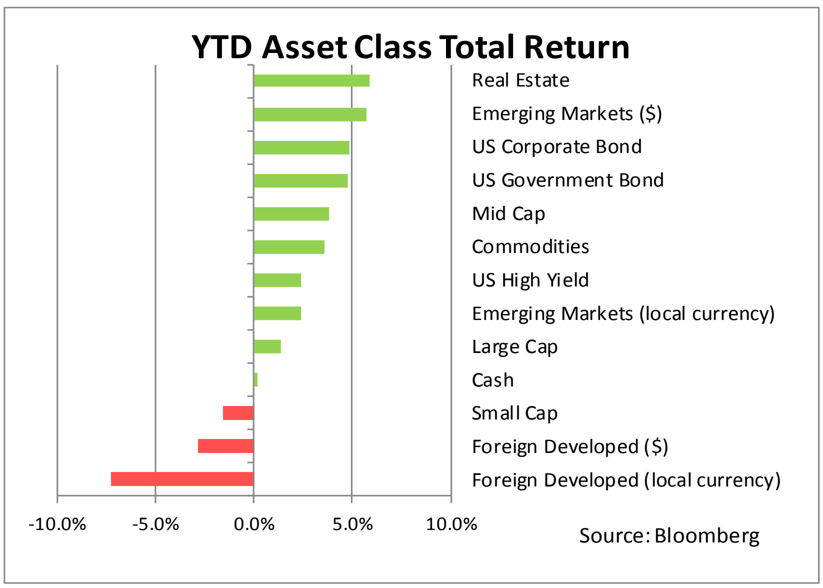




(Source: Bloomberg)

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 3/31/2016 close)

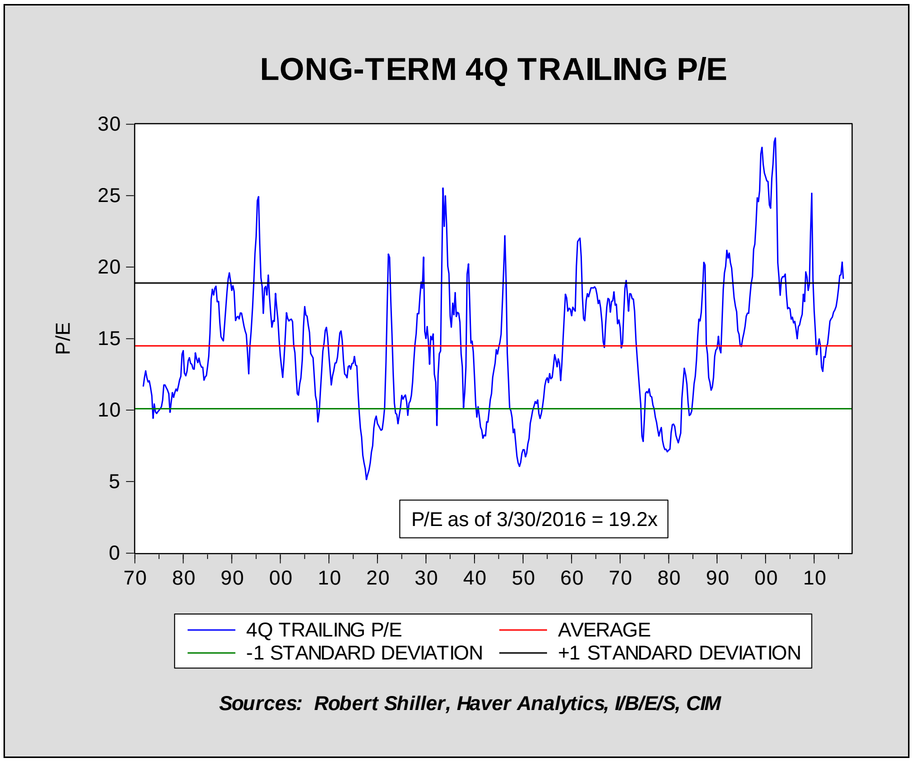


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 31, 2016



Based on our methodology,[2] the current P/E is 19.2x, up 0.1x from last week. Continued declines in earnings expectations and a stronger equity market, are keeping the P/E elevated.

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.

[2] 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.