Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: April 20, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading up 1.3% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 0.7% from the prior close. Chinese markets also closed lower, with the Shanghai composite down 2.3% and the Shenzhen index lower by 4.4%. U.S. equity futures are signaling a higher opening from the previous close, erasing overnight losses. With 12.0% of the S&P 500 companies having reported, Q1 float-adjusted earnings stand at $26.31, lower than the $26.66 forecast. Of the 60 companies that have reported, 76.7% had positive earnings surprises, while 13.3% had negative earnings surprises.

Chinese risk markets traded lower overnight as Chinese officials indicated that the People's Bank of China (PBOC) is likely to reduce stimulus over the coming year due to improving economic data. While the PBOC has not released an official statement, at least two government sources have hinted at the stimulus deceleration. Late last night, a PBOC official said that the central bank will balance the need for continued economic growth support with the risks that additional stimulus could pose—especially the over-leveraging of the corporate sector. At the same time, the PBOC injected the most funds into the economy in two months in anticipation of a seasonal cash squeeze, auctioning $38.7 bn of seven-day reverse-repo agreements. The chart below shows the volume of seven-day reverse repos auctioned since the beginning of the year. Even though liquidity should improve as a result of the cash injections, the impending maturation of medium-term lending facility loans, tax bills and payments of required reserves will drain more than the injected amount from the economy.

(Source: Bloomberg)

In other news, crude fell overnight as the Kuwaiti workers' strike came to an end. This should boost production, adding to ample global supplies. On the political front, Trump and Clinton won the New York state primaries, leading the two front-runners to re-assert their positions as their parties' possible nominees.

U.S. Economic Releases

Mortgage applications rose 1.3% for the most recent reporting week, with purchases down 0.5% and refinancing up 2.6%. The 30-year mortgage rate rose by 1 bp to 3.83%.

The chart below shows the economic releases or Fed speakers scheduled for the rest of the day.

Economic releases						
EST	Indicator			Expected	Prior	Rating
10:00	Existing home sales	m/m	Mar	5.28 mn	5.08 mn	**

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								
Japan	Trade balance	m/m	Mar	¥276.5 bn	¥150.4 bn	¥450.0 bn	**	Equity bearish, bond bullish
	Exports	y/y	Mar	-6.8%	-4.0%	-7.0%	**	Equity and bond neutral
	Imports	y/y	Mar	-14.9%	-14.2%	-16.6%	**	Equity and bond neutral
EUROPE								
Germany	PPI	y/y	Mar	-3.1%	-3.0%	-2.9%	**	Equity bearish, bond bullish
U.K.	Unemployment rate	m/m	Feb	5.1%	5.1%	5.1%	***	Equity and bond neutral
Switzerland	ZEW survey expectations	m/m	Apr	11.5	2.5		*	Equity bullish, bond bearish
AMERICAS								
Brazil	Unemployment rate	m/m	Feb	10.2%	9.5%	10.1%	***	Equity and bond neutral
	Consumer inflation (IPCA)	y/y	Apr	9.3%	10.0%	9.3%	***	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)	22	21	1	Up
TED spread (bps)	42	43	-1	Down
U.S. Libor/OIS spread (bps)	38	38	0	Neutral
10-yr T-note (%)	1.78	1.79	-0.01	Narrowing
Euribor/OIS spread (bps)	-25	-25	0	Neutral
EUR/USD 3-mo swap (bps)	23	22	1	Up
Currencies	**Direction**			
dollar	up			Falling
euro	down			Rising
yen	up			Rising
franc	down			Rising
Central Bank Action	**Current**	**Prior**	**Expected**	
Turkish benchmark rate	7.50%	7.50%	7.50%	On forecast
Turkish overnight lending rate	10.00%	10.50%	10.00%	On forecast

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	$ 43.48	$ 44.03	-1.25%	Kuwaiti oil workers' strike ends
WTI	$ 40.34	$ 41.08	-1.80%	
Natural gas	$ 2.12	$ 2.09	1.53%	
Crack spread	$ 18.44	$ 18.04	2.18%	
12-mo strip crack	$ 13.86	$ 13.63	1.69%	
Ethanol rack	$ 1.70	$ 1.70	0.01%	
Metals				
Gold	$ 1,250.48	$ 1,250.19	0.02%	Lower dollar
Silver	$ 17.10	$ 16.94	0.97%	
Copper contract	$ 223.00	$ 223.15	-0.07%	Chinese demand concerns
Grains				
Corn contract	$ 391.50	$ 389.50	0.51%	Drought in South America is hurting yields
Wheat contract	$ 497.25	$ 494.25	0.61%	Canadian planting falls
Soybeans contract	$ 991.00	$ 994.75	-0.38%	
Shipping				
Baltic Dry Freight	671	659	12	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.3		
Gasoline (mb)		-1.5		
Distillates (mb)		-0.1		
Refinery run rates (%)		-0.1%		
Natural gas (bcf)		3.0		

Weather

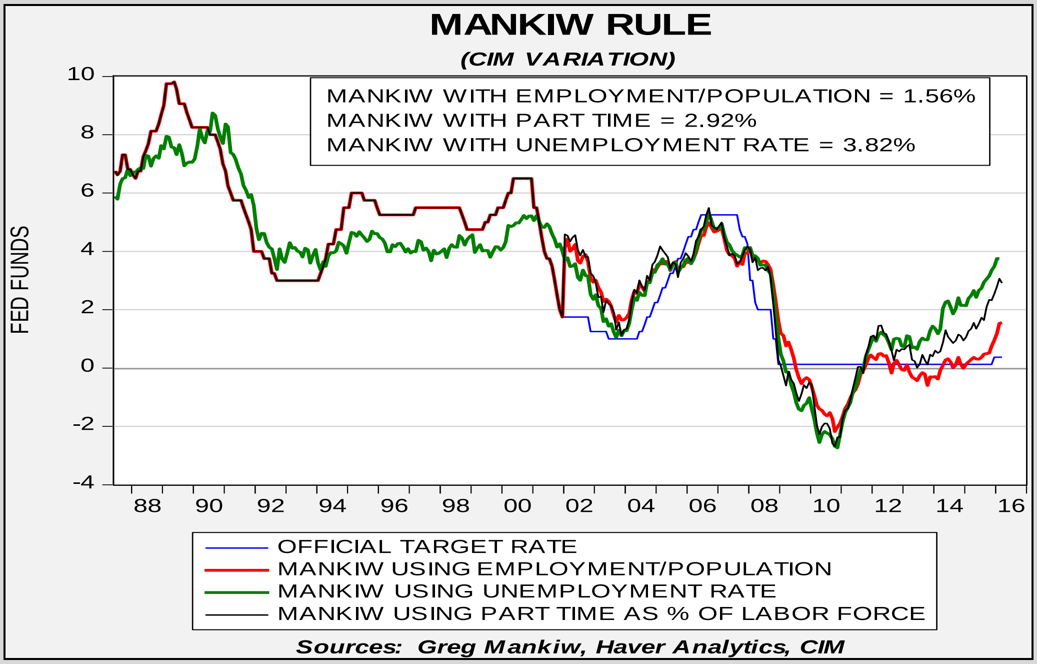
The 6-10 and 8-14 day forecasts are calling for warmer and wetter than normal conditions for the majority of the country. Parts of the Northeast and Southwest are forecast to receive cooler than normal temperatures.

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 15, 2016

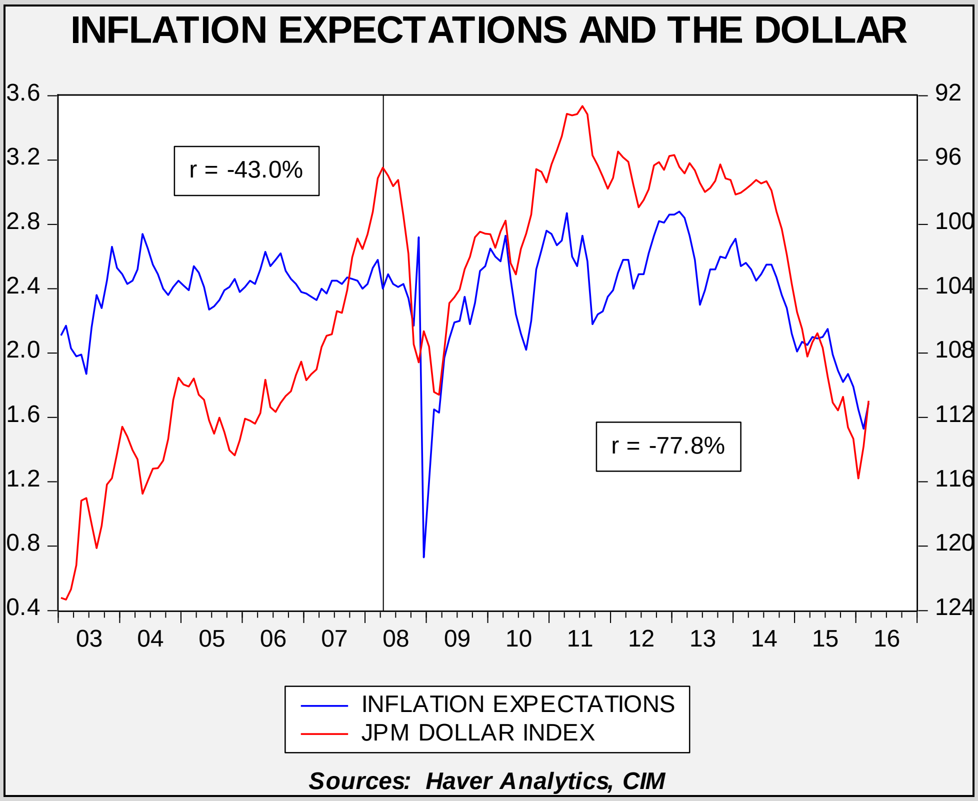
It is becoming apparent that the FOMC is using something other than the Phillips Curve to manage monetary policy. The Phillips Curve postulates that there is a tradeoff between inflation and the labor markets. Economists have developed models based on the Phillips Curve to determine what interest rate target the FOMC "should" implement.



The Mankiw Rule is one of these models that have been developed. It attempts to determine the neutral rate for fed funds, which is a rate that is neither accommodative nor stimulative. Mankiw's model is a variation of the Taylor Rule. The latter measures the neutral rate using core CPI and the difference between GDP and potential GDP, which is an estimate of slack in the economy. Potential GDP, however, cannot be directly observed, only estimated. To overcome this problem with potential GDP, Mankiw used the unemployment rate as a proxy for economic slack. We have created three versions of the Mankiw rule by using three different variables as measures of slack, one that follows the original construction using the unemployment rate, a second using the employment/population ratio and a third using involuntary part-time workers as a percentage of the total labor force.

Using the unemployment rate, the neutral rate is now up to 3.82%. Using the employment/population ratio, the neutral rate is 1.56%, and using involuntary part-time employment, the model generates a neutral rate estimate of 2.92%. In all cases, there is no reason why the FOMC shouldn't be raising rates now; even the most dovish iteration of the Mankiw Rule, the one using the employment/population ratio, suggests the FOMC is at least 100 bps too easy.

So, if the Fed isn't using the Phillips Curve, what are policymakers focusing on? "International developments" are often offered in official documents (minutes and statements) and in press interviews as the reason for caution in raising rates. In addition, the declines seen in inflation expectations from the TIPS spread have been cited for keeping the target policy rate steady.

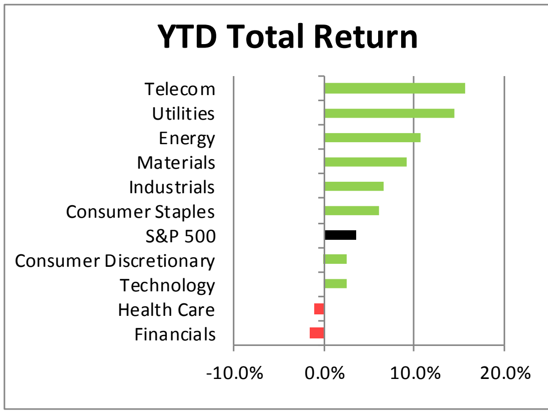


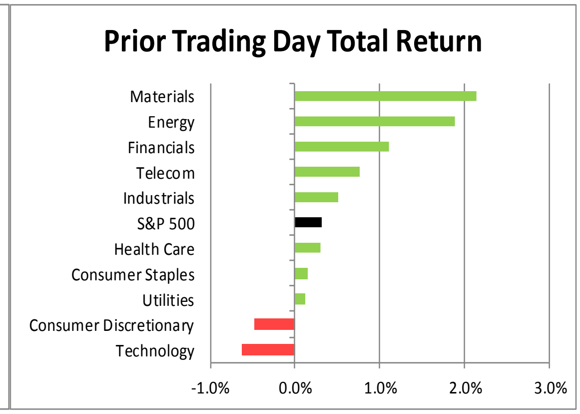
This chart shows the relationship between five-year forward inflation expectations and the JPM dollar index (right scale, inverted). The data suggest that the FOMC could be keeping rates steady because of dollar strength. However, since exchange rate policy is outside the purview of the Federal Reserve (that policy mandate is given to the Treasury), the central bank cannot come out and directly say it is guiding the exchange rate lower to change inflation expectations. Given that the dollar's rally since 2014 has been mostly due to divergent monetary policy between the U.S. and the rest of the developed world, a less aggressive FOMC will likely lead to a weaker dollar.

Although we cannot know for sure whether our thesis is correct, we would argue that rates should be increasing if the FOMC is using the Phillips Curve as a guide for policy. It is possible that a dollar index of 104 would put inflation expectations close to 2.4%, which is about the mid-range of values for inflation expectations from 2010 through 2014. That would generate a €/$ exchange rate of approximately 1.23. We strongly doubt the ECB would welcome that degree of strength and would probably react by implementing additional stimulus. Thus, a "race to the bottom" in terms of policy could be the outcome. In the coming weeks, we will be watching to see if the dollar has replaced the Phillips Curve for guiding policy, or if the majority of FOMC members will pressure Fed Chair Yellen into raising rates. For now, we expect the path of rate hikes to be slower than the Mankiw Rule would suggest.

Data Section

U.S. Equity Markets – (as of 4/19/2016 close)

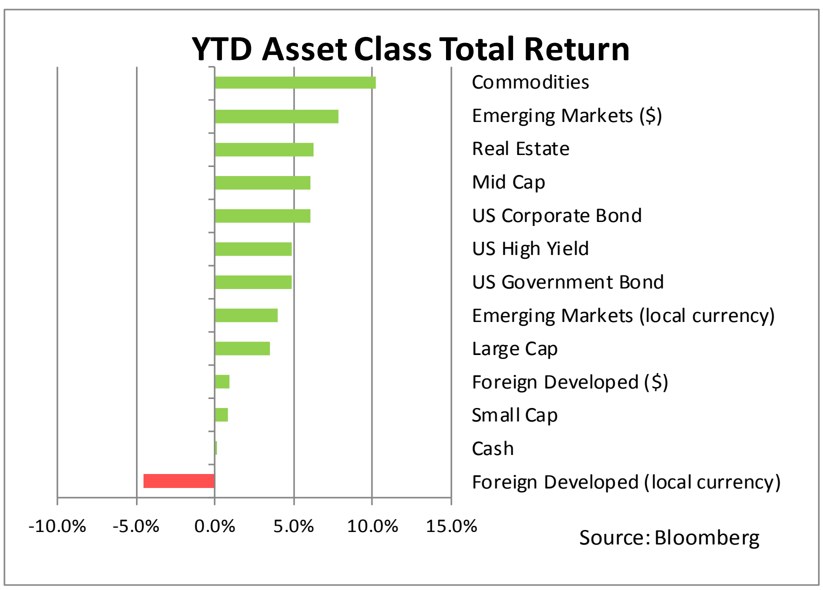




(Source: Bloomberg)

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 4/19/2016 close)

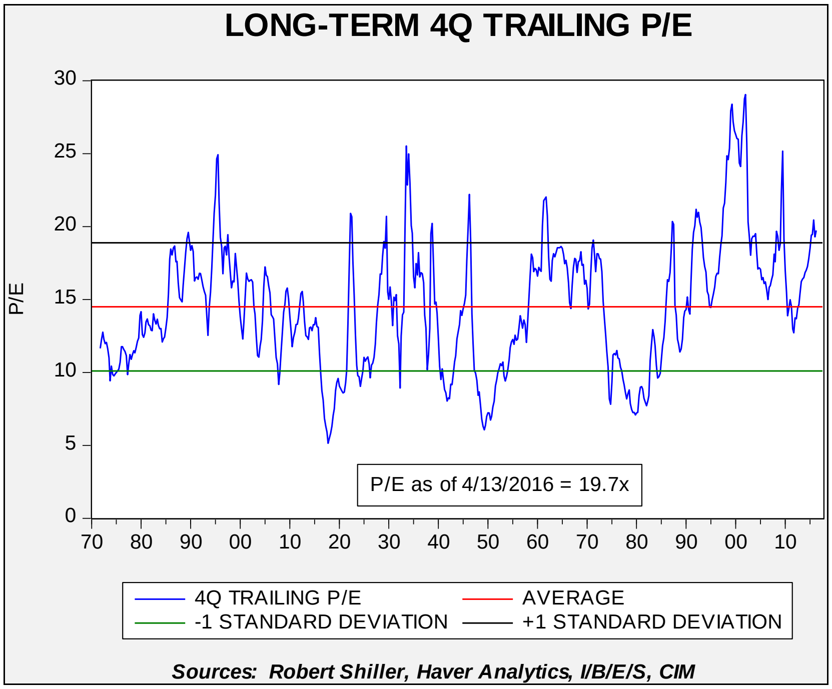


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

April 14, 2016



Based on our methodology,[1] the current P/E is 19.7x, down 0.1x from last week. The P/E remains elevated but is coming down due to expectations of rising 2016 earnings.

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.

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