Confluence INVESTMENT MANAGEMENT

Daily Comment

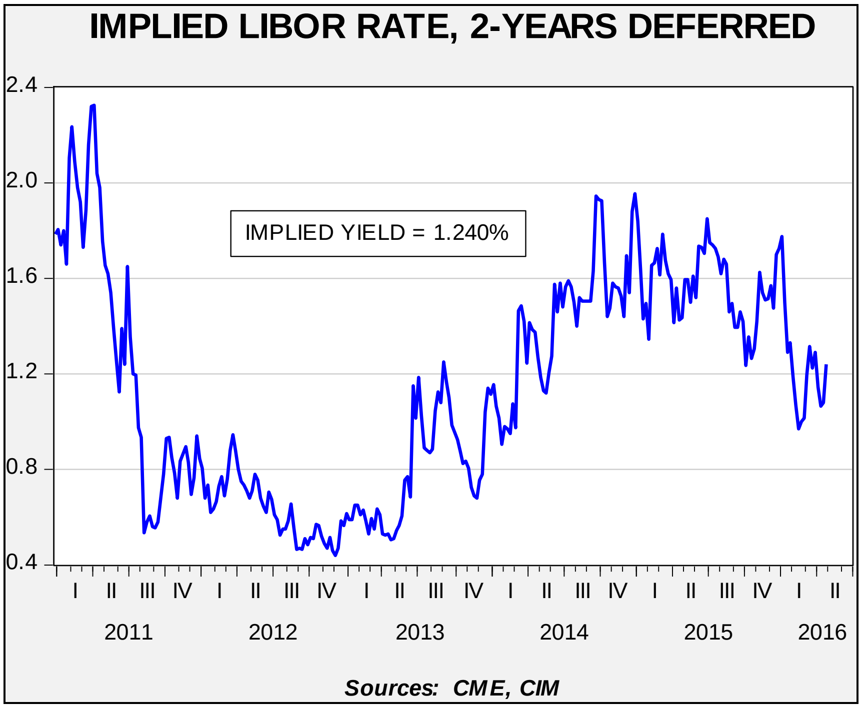
By Bill O'Grady & Kaisa Stucke, CFA

[Posted: April 25, 2016—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is trading down 0.9% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 0.6% from the prior close. Chinese markets also closed lower, with the Shanghai composite down 0.4% and the Shenzhen index lower by 0.4%. U.S. equity futures are signaling a lower opening from the previous close. With 26.4% of the S&P 500 companies having reported, Q1 float-adjusted earnings stand at $26.35, lower than the $26.66 forecast. Of the 132 companies that have reported, 76.5% had positive earnings surprises, while 14.4% had negative earnings surprises.

It was a remarkably quiet weekend and that pattern has continued into this morning. Risk markets are easing this morning in what looks more like tactical profit taking. The BOJ and Fed both meet this week, with the former finishing its meeting on Thursday and the latter on Wednesday. Neither is expected to do very much; the BOJ is expected to keep all its measures on hold, although it may ease its bank lending facilities to copy the ECB, which allows banks to borrow from the central bank at a negative rate. Meanwhile, we don't expect much at all from the FOMC. The focus will be on the June meeting, which could yield a rate hike except that the meeting will coincide with the Brexit vote which may keep the Fed on hold.

One interesting note came from a Bloomberg report that the BOJ now holds 52% of Japan's equity ETF. Part of the BOJ's QE allows it to buy equities in the form of ETF. In the short run, for investors, this direct support for equities is clearly bullish. On the other hand, it does create two risks. First, the central bank's capital could be at risk if equities turn lower, and second, there is always the fear that the BOJ will, at some point, sell the ETF positions. What makes the second point tricky is that the selling probably won't occur for the usual reasons an investor liquidates a position, e.g., valuation, but will occur for other reasons, which could include political considerations. In fact, once purchased, it is hard to see how the BOJ will ever be able to liquidate its equity holdings.

As we head into the FOMC meeting this week, it is worth noting that market expectations remain very low.



This chart shows the implied three-month LIBOR yield two years deferred. Although the rate has lifted off its recent lows, it remains below the range set from mid-2014 into Q3 2015. Essentially, the markets believe that the terminal rate for the policy rate will be lower than previously expected.

Finally, a few geopolitical comments are in order. President Obama indicated that he will add 250 Special Operations troops to combat IS. The president is in Europe, currently visiting Germany. His tour through Britain was divisive, infuriating those who support Brexit and heartening those who want to remain in the EU. The president also met with Chancellor Merkel; it appears those meetings were more cordial, although we do note that the president suggested the chancellor is "on the right side of history" in the immigration and refugee debate, a point that many Germans would dispute.

In Saudi Arabia, King Salman has approved the economic restructuring proposed by his son, the deputy crown prince. The program will include the partial sale of the state oil company, Saudi Aramco, but more importantly it calls for austerity that will reduce the fiscal breakeven oil price to $66.70 from $94.80 last year (both numbers calculated by the IMF). The fiscal austerity suggests the kingdom is digging in for oil prices to stay low for a longer period of time. We also note that Bloomberg is reporting Saudi Aramco has increased the capacity of its Shaybah field by 0.25 mbpd to 1.0 mbpd, keeping the nation's productive capacity at 12.0 mbpd. There have been hints that the Saudis may lift output as U.S. production declines in a bid to capture market share.

U.S. Economic Releases

There are no releases scheduled before we go to print. 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	New home sales	m/m	Mar	1.6%	2.0%	**
10:30	Dallas Fed manufacturing activity index	m/m	Apr	-10.0	-13.6	**

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	LEI	m/m	Feb	96.8	99.8		**	Equity bearish, bond bullish
	Coincident indicator	m/m	Feb	110.7	110.3		**	Equity bullish, bond bearish
EUROPE								
Germany	IFO business climate	m/m	Apr	106.6	106.7	107.1	*	Equity bearish, bond bullish
	IFO current assessment	m/m	Apr	113.2	113.8	113.8	*	Equity bearish, bond bullish
	IFO expectations	m/m	Apr	100.4	100.0	100.9	*	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)	64	64	0	Neutral
3-mo T-bill yield (bps)	23	23	0	Neutral
TED spread (bps)	41	41	0	Neutral
U.S. Libor/OIS spread (bps)	39	39	0	Neutral
10-yr T-note (%)	1.89	1.89	0.00	Neutral
Euribor/OIS spread (bps)	-25	-25	0	Neutral
EUR/USD 3-mo swap (bps)	23	23	0	Neutral
Currencies	**Direction**			
dollar	down			Falling
euro	up			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	$ 45.42	$ 45.11	0.69%	Lower dollar
WTI	$ 43.89	$ 43.73	0.37%	
Natural gas	$ 2.10	$ 2.14	-1.78%	Warmer weather
Crack spread	$ 18.03	$ 18.07	-0.20%	
12-mo strip crack	$ 14.06	$ 14.03	0.21%	
Ethanol rack	$ 1.69	$ 1.69	0.00%	
Metals				
Gold	$ 1,235.80	$ 1,233.03	0.22%	Lower dollar
Silver	$ 17.02	$ 16.97	0.30%	
Copper contract	$ 227.15	$ 226.85	0.13%	
Grains				
Corn contract	$ 377.00	$ 375.50	0.40%	Drought in Brazil
Wheat contract	$ 473.25	$ 474.00	-0.16%	
Soybeans contract	$ 991.50	$ 996.25	-0.48%	
Shipping				
Baltic Dry Freight	688	670	18	
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%		

Weather

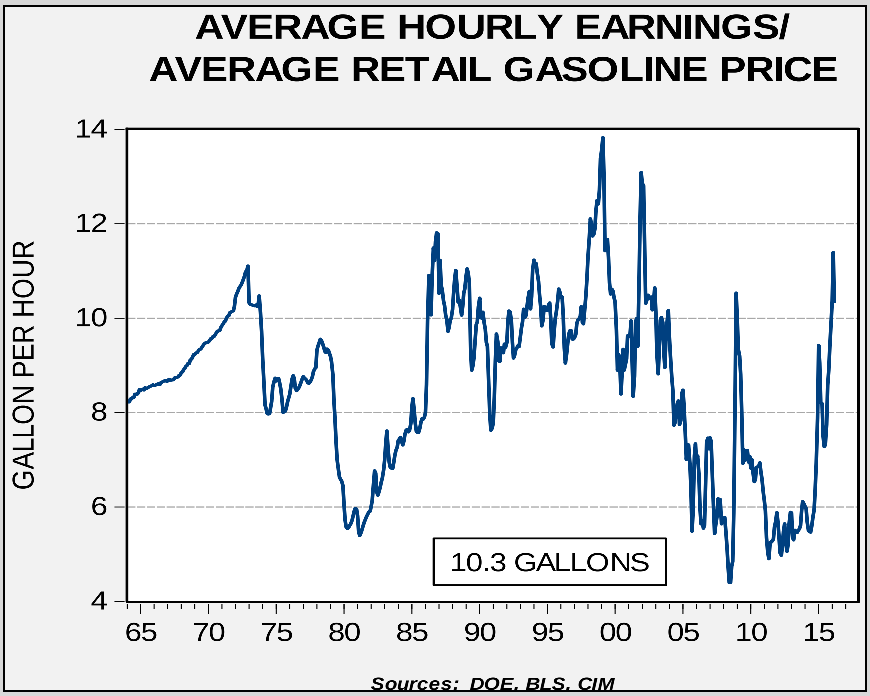
The 6-10 and 8-14 day forecasts are calling for warmer than normal conditions for the western and southeastern regions. Precipitation is forecast for the majority of the country.

Weekly Asset Allocation Commentary

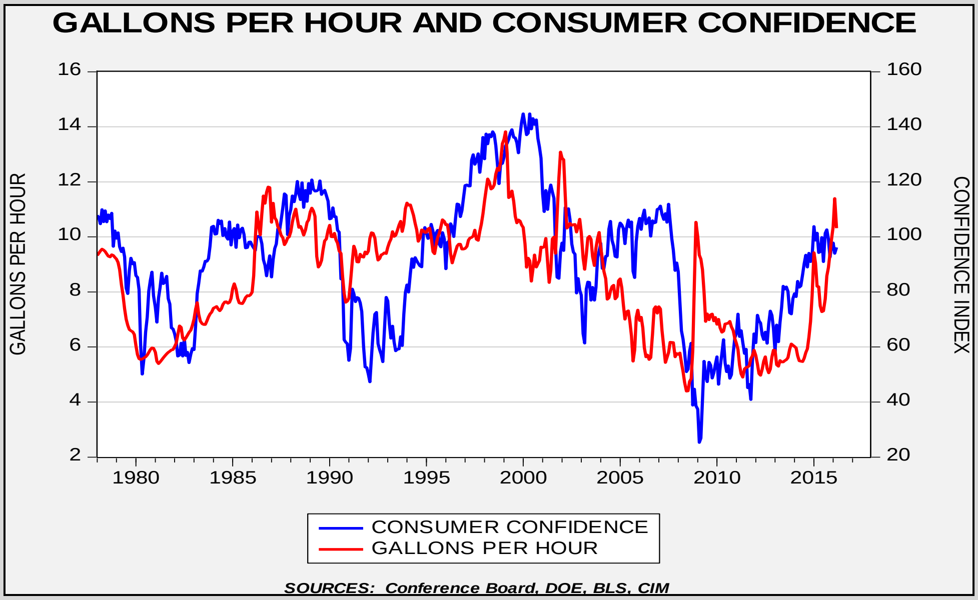
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

April 22, 2016

Although it is a widely held assertion that lower gasoline prices will lead to stronger consumption, this correlation has been mostly absent following the most recent decline in fuel prices. We suspect that household deleveraging has tended to weaken the expected impact of lower gasoline prices. However, there does appear to be a strong relationship between consumer confidence and gasoline prices.

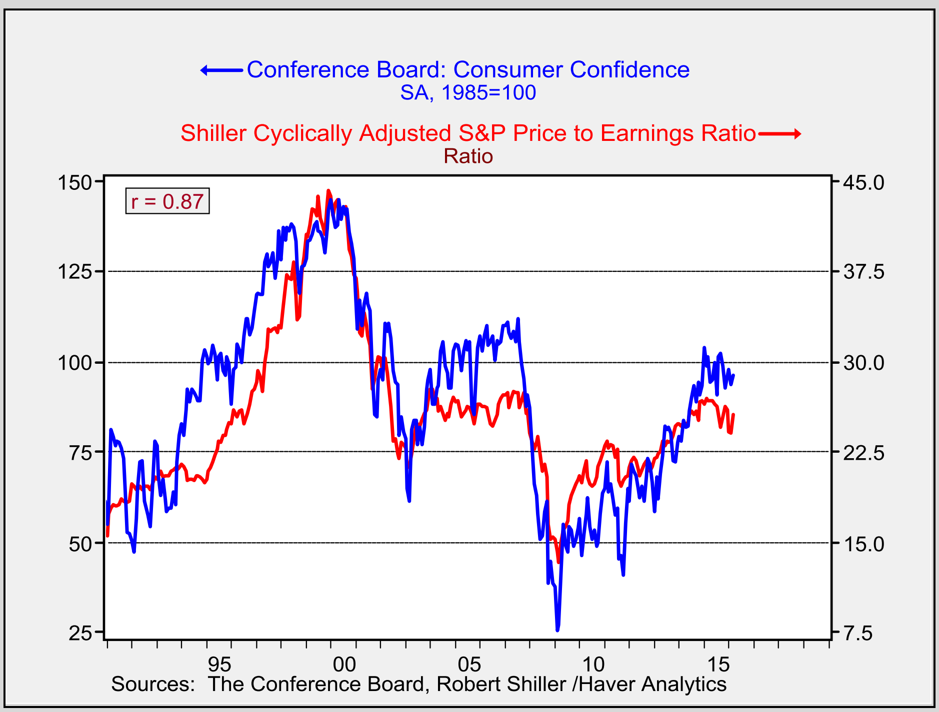


This chart shows how many gallons of gasoline a person can buy with one hour of non-supervisory average wage. This ratio not only takes into account the price of gasoline but also the effect of wage growth. Since 1964, the average worker has been able to buy 8.6 gallons of gasoline for an hour's wage. Periods of high oil prices are evident on the chart; the two OPEC oil shocks in the 1970s into the early 1980s and the high oil prices from 2003 to 2014 are obvious.



The relationship between gallons per hourly wage and consumer confidence is fairly clear, although there are some periods where the two diverge. Generally speaking, two variables, the previously described ratio of wages and gasoline prices, along with the unemployment rate, do a reasonably good job of explaining the trends in consumer confidence.

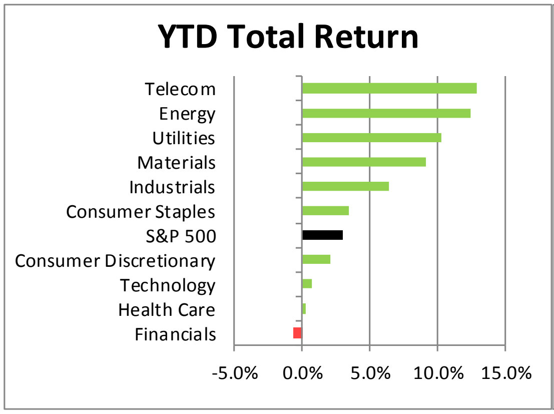
Consumer confidence isn't a great predictor of consumption or retail sales. However, since 1990, it has had a good fit with the trend in price/earnings multiples.

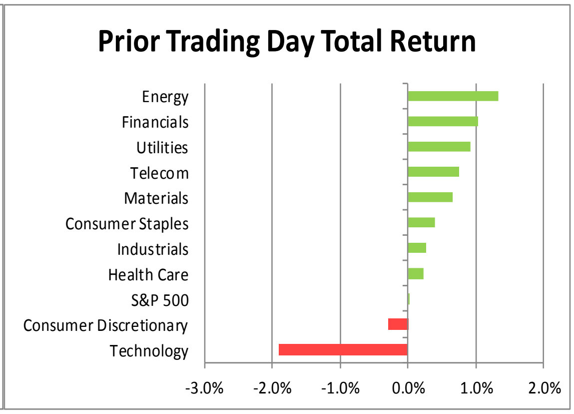


This chart shows the Shiller P/E and consumer confidence. The two series correlate at the 87% level. It does seem that rising consumer confidence tends to reflect a degree of investor confidence as well. Therefore, to the extent that lower gasoline prices and tightening labor markets boost consumer confidence, it is also reflected in multiple expansion, which is supportive for equity markets.

Data Section

U.S. Equity Markets – (as of 4/22/2016 close)

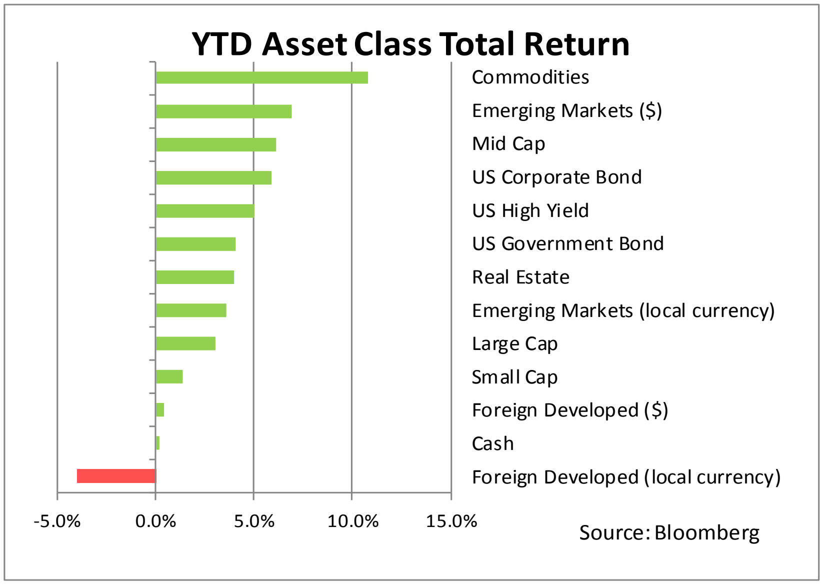




(Source: Bloomberg)

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 4/22/2016 close)

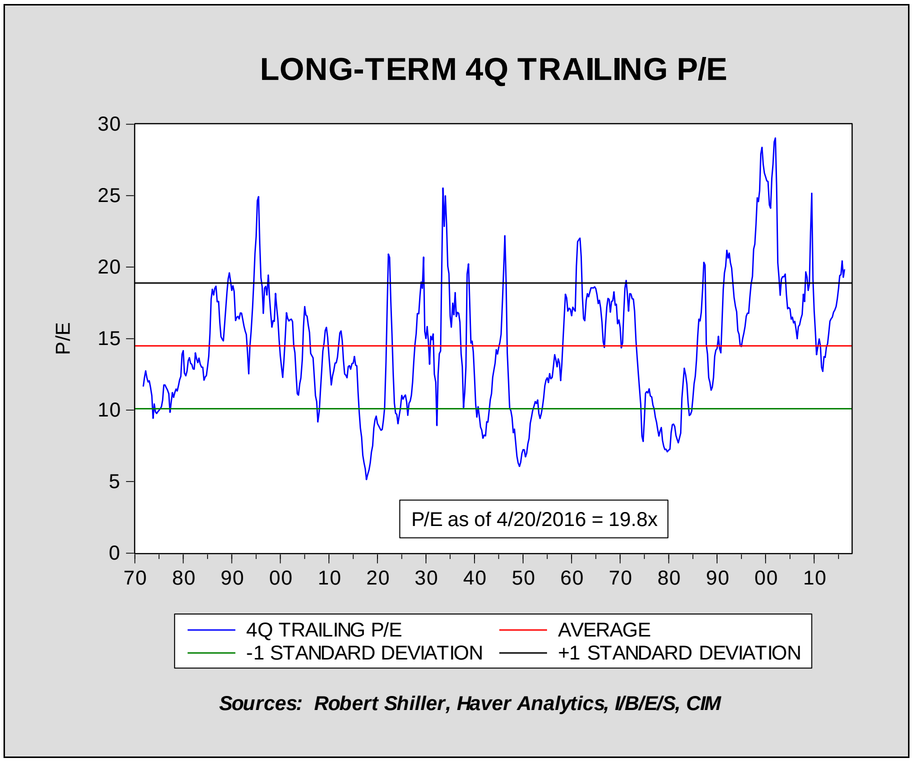


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 21, 2016



Based on our methodology,[1] the current P/E is 19.8x, up 0.1x from last week. The P/E rose due to rising equity price levels.

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.