Daily Comment

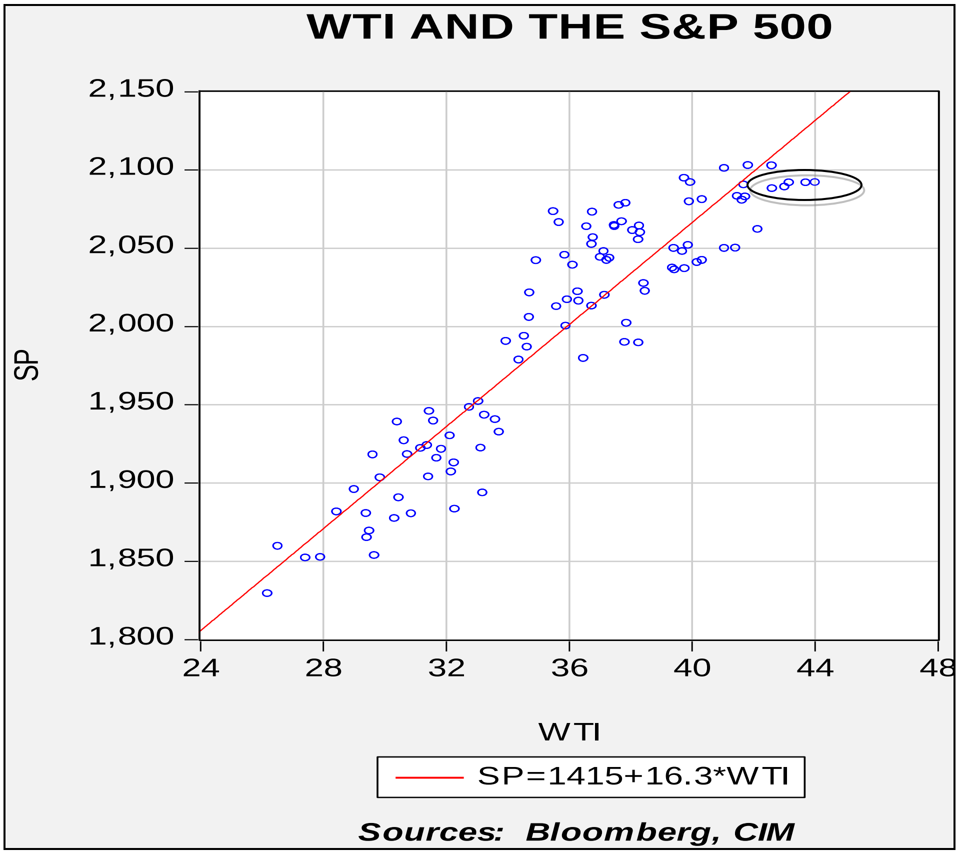
By Bill O'Grady & Kaisa Stucke, CFA

[Posted: April 27, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading up 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 0.2% from the prior close. Chinese markets also closed lower, with the Shanghai composite down 0.4% and the Shenzhen index lower by 0.3%. U.S. equity futures are signaling a sideways opening from the previous close. With 36.8% of the S&P 500 companies having reported, Q1 float-adjusted earnings stand at $26.38, lower than the $26.66 forecast. Of the 184 companies that have reported, 75.0% had positive earnings surprises, while 16.3% had negative earnings surprises.

It's FOMC Day! As we noted earlier this week, we don't expect any major news today. The key focus will be on the idea of "balance of risks." The Fed often puts a note in the statement about the balance of risks. In general, it leans toward inflation, recession or balanced. If inflation is a concern, the committee is likely leaning toward rate hikes. If recession is a concern, the Fed is likely moving to ease. If it's balanced, assuming the Fed is at the neutral rate, no change in policy would be expected. However, the key to this issue is the neutral policy rate. As we have demonstrated using the Mankiw Rule, if the Fed is relying on the Phillips Curve to determine the neutral rate then it is well behind the curve and needs to be raising rates. Thus, if risks are said to be "balanced," this would suggest rate hikes will be coming soon. However, if the committee is looking at other factors for policy guidance, such as the dollar, then it may feel it is already at a neutral rate (the Fed's behavior could arguably suggest this) and calling risks balanced should have little effect on the markets. Overall, we suspect the financial markets would be spooked by the Fed describing the current risk environment as "balanced" and we would likely see selling develop in risk assets.

The BOJ meets tomorrow. Again, nothing is expected here either, except that the JPY strength is hurting the bank's attempts to boost the economy. Although we don't expect much at this meeting, we would not be surprised to see a good bit of "oral intervention" in a bid to weaken the JPY by promising to take more aggressive steps to boost the economy.

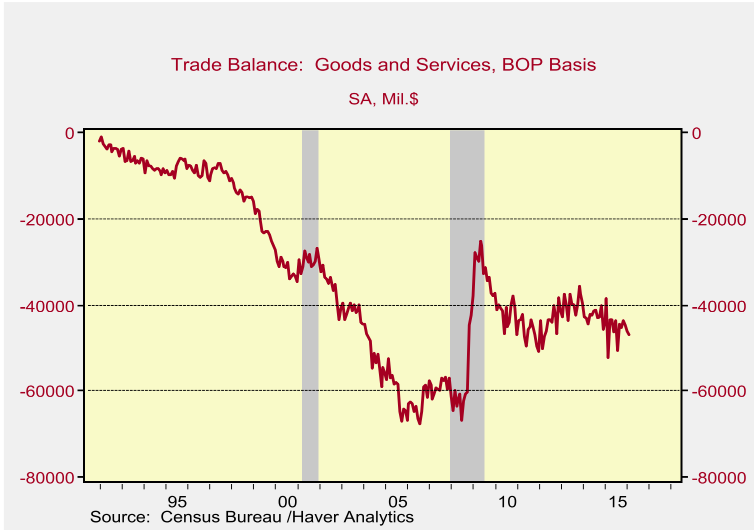
Oil prices, basis WTI, broke above $45 per barrel this morning after the American Petroleum Institute (API) said oil inventories fell last week. The API data are not the official numbers; those will be released by the DOE at 10:30 EDT. In general, the two data sets tend to track each other but have, on occasion, diverged, so the government data will need to confirm yesterday's API data in order to hold current levels. We will have more analysis on the oil data tomorrow. However, it is interesting to note that the tight correlation between oil and the S&P 500 is breaking down somewhat.



Based on the regression line, the S&P 500's fair value to the current level of oil prices is 2,132. Although the current dispersion is within the normal range of the regression line, the values from the last few days, shown within the oval above, may be an early indication that oil and the equity market may be starting to delink.

U.S. Economic Releases

The advance report on goods trade balance showed a shrinking trade deficit, mostly due to falling imports. The March trade deficit narrowed to \$56.9 bn from \$62.9 bn the month before, narrower than the \$62.8 bn forecast. Exports fell 1.1% from the month before, while imports fell 4.3%. Export declines were broad-based, with only exports of capital goods and other goods rising from the month before. Consumer goods exports were particularly weak on weak global demand. Import weakness was also broad-based, with consumer goods imports falling strongly.



The chart above shows the trade balance. The trend over the past year has been a widening trade balance.

Mortgage applications fell 4.1% for the most recent reporting week, with purchases down 2.4% and refinancing down 5.0%. Purchases are entering their seasonally strong period, so we would expect sales to strengthen over the coming weeks even as they remain lumpy week-to-week. Refinancing fell as the 30-year rate rose 2 bps to 3.85%. We note that lending standards have tightened while mortgage rates have remained at reasonable levels.

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	Pending home sales	m/m	Mar	0.5%	3.5%	**
Fed speakers of events						
EST	**Speaker or event**	**District or position**				
2:00	FOMC rate decision					

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	CPI	y/y	Q1	1.3%	1.7%	1.7%	***	Equity bearish, bond bullish
China	Industrial profits	y/y	Mar	11.1%	-4.7%		***	Equity bullish, bond bearish
	Consumer confidence (Westpac-MNI)	m/m	Apr	117.8	118.1		**	Equity bearish, bond bullish
Japan	Small business confidence	m/m	Apr	47.8	48.8	48.5	**	Equity bearish, bond bullish
EUROPE								
Eurozone	Money supply M3	y/y	Mar	5.0%	4.9%	5.0%	**	Equity and bond neutral
France	Consumer confidence	m/m	Apr	94.0	94.0	95.0	**	Equity bearish, bond bullish
Germany	Consumer confidence	m/m	May	9.7	9.4	9.4	**	Equity bullish, bond bearish
	Import price index	y/y	Mar	-5.9%	-5.7%	-6.2%	**	Equity and bond neutral
U.K.	GDP	y/y	Q1	2.1%	2.1%	2.0%	***	Equity bullish, bond bearish
Switzerland	UBS consumption indicator	m/m	Mar	1.51	1.45		**	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)	63	64	-1	Down
3-mo T-bill yield (bps)	25	24	1	Up
TED spread (bps)	39	39	0	Neutral
U.S. Libor/OIS spread (bps)	39	39	0	Neutral
10-yr T-note (%)	1.90	1.93	-0.03	Narrowing
Euribor/OIS spread (bps)	-25	-25	0	Neutral
EUR/USD 3-mo swap (bps)	22	24	-2	Down
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	$ 46.73	$ 45.74	2.16%	API inventory data shows domestic inventories falling
WTI	$ 45.01	$ 44.04	2.20%	
Natural gas	$ 2.03	$ 2.03	-0.30%	Warmer weather
Crack spread	$ 18.71	$ 18.93	-1.13%	
12-mo strip crack	$ 14.36	$ 14.46	-0.66%	
Ethanol rack	$ 1.70	$ 1.70	0.09%	
Metals				
Gold	$ 1,250.35	$ 1,243.40	0.56%	Awaiting Fed decision, lower dollar
Silver	$ 17.37	$ 17.16	1.21%	
Copper contract	$ 223.80	$ 224.65	-0.38%	Chinese consumer sentiment falling
Grains				
Corn contract	$ 387.00	$ 387.25	-0.06%	
Wheat contract	$ 485.75	$ 487.75	-0.41%	
Soybeans contract	$ 1,024.25	$ 1,027.25	-0.29%	Weather turns more favorable to soybeans
Shipping				
Baltic Dry Freight	704	690	14	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.4		
Gasoline (mb)		-1.0		
Distillates (mb)		-0.7		
Refinery run rates (%)		0.4%		
Natural gas (bcf)		70.0		

Weather

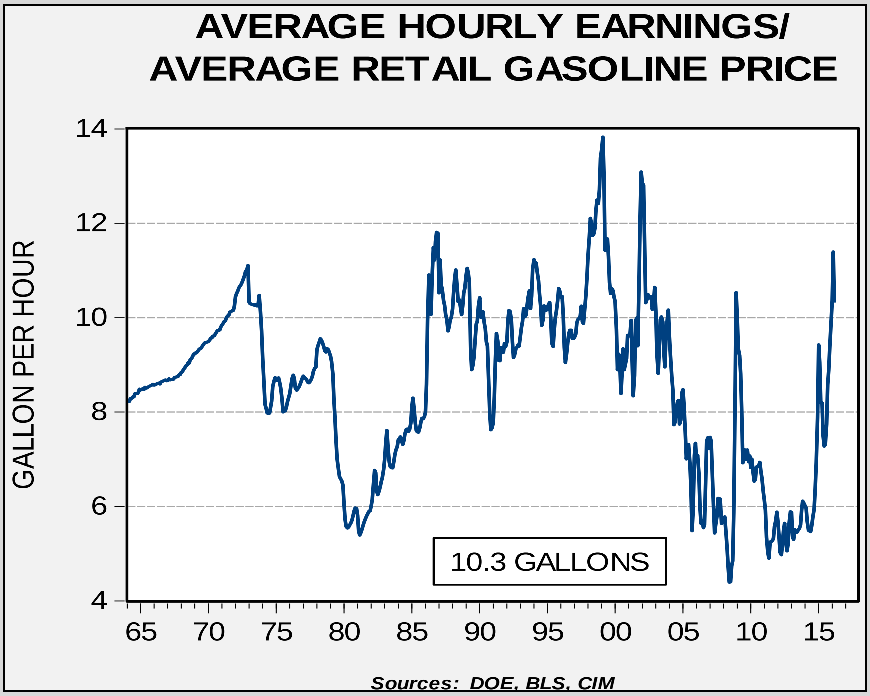
The 6-10 and 8-14 day forecasts are calling for cooler than normal conditions for the south and southeast. Precipitation is forecast for the coasts.

Weekly Asset Allocation Commentary

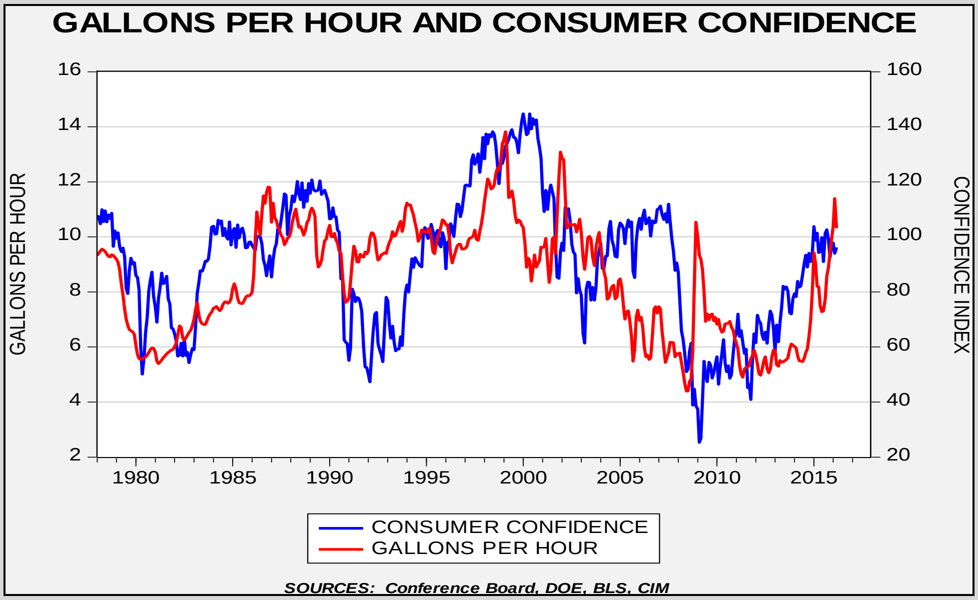
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

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.

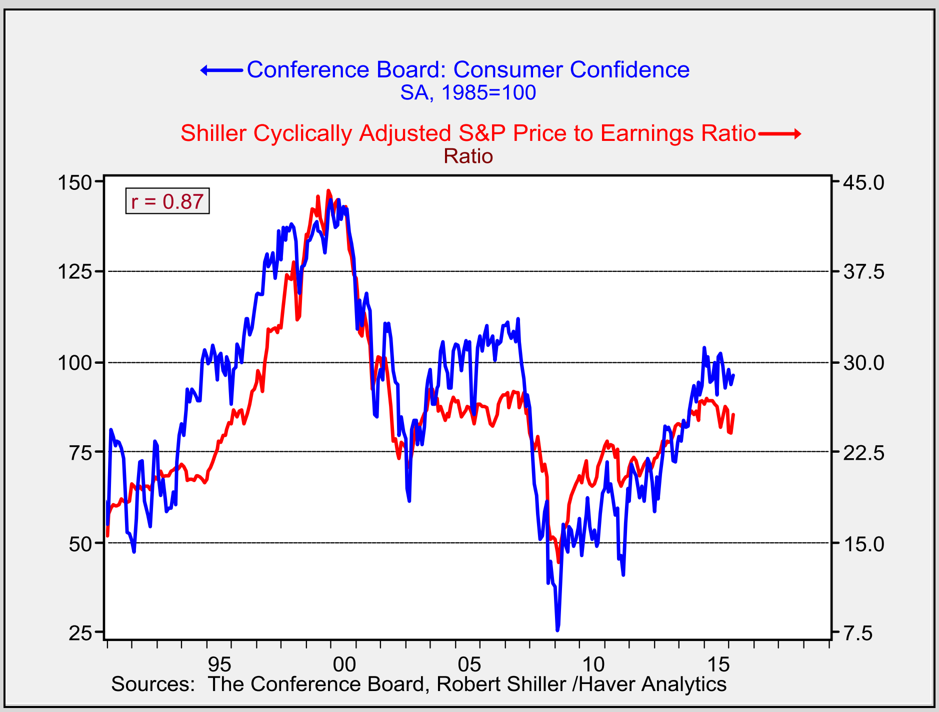


This chart shows how many gallons of gasoline a person can buy with one hour of non-supervisory average wage. This ratio not only takes into account the price of gasoline but also the effect of wage growth. Since 1964, the average worker has been able to buy 8.6 gallons of gasoline for an hour's wage. 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.

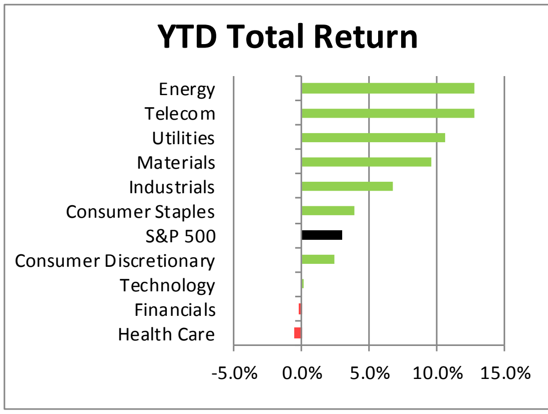
Consumer confidence isn't a great predictor of consumption or retail sales. However, since 1990, it has had a good fit with the trend in price/earnings multiples.

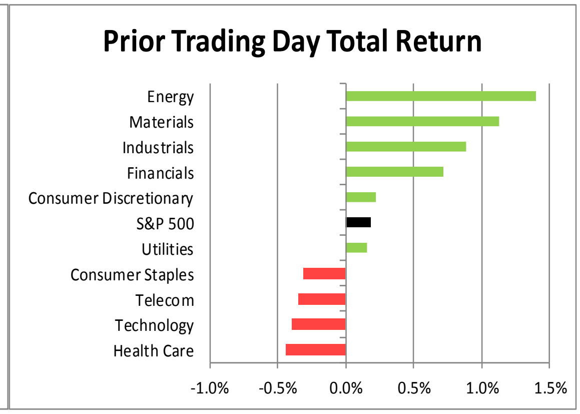


This chart shows the Shiller P/E and consumer confidence. The two series correlate at the 87% level. It does seem that rising consumer confidence tends to reflect a degree of investor confidence as well. Therefore, to the extent that lower gasoline prices and tightening labor markets boost consumer confidence,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

Data Section

U.S. Equity Markets – (as of 4/26/2016 close)

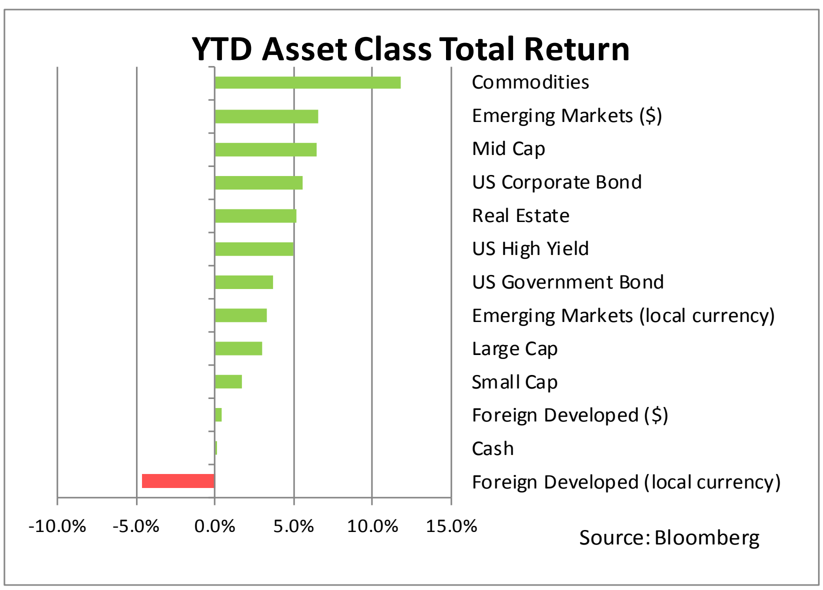




(Source: Bloomberg)

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 4/26/2016 close)

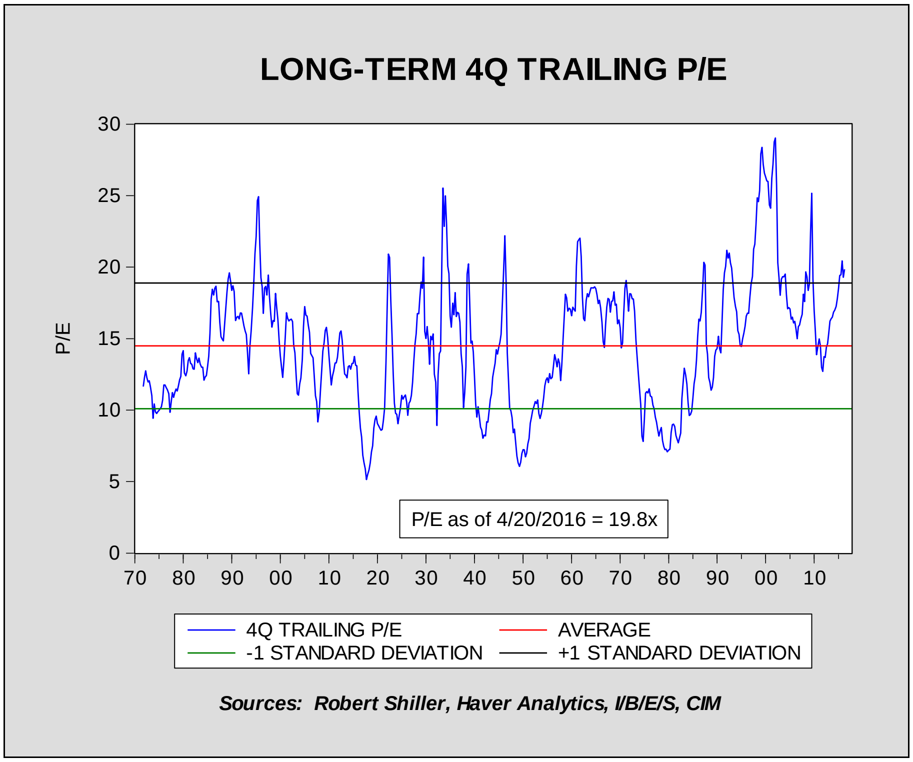


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.