Confluence Investment Management

Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: April 28, 2016—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is trading down 1.8% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 0.3% from the prior close. Chinese markets also closed lower, with the Shanghai composite down 0.3% and the Shenzhen index lower by 0.1%. U.S. equity futures are signaling a lower opening from the previous close. With 45.6% of the S&P 500 companies having reported, Q1 float-adjusted earnings stand at $26.44, lower than the $26.66 forecast. Of the 228 companies that have reported, 76.8% had positive earnings surprises, while 15.8% had negative earnings surprises.

The market-making news overnight was that the BOJ announced no new policy measures at its meeting. Although this was mostly anticipated, there were hopes that Governor Kuroda would offer at least some support for the economy. Instead, he suggested he is taking a "wait and see" approach to see if NIRP and other measures begin to bear fruit. Clearly, the financial markets were disappointed.

First, the Nikkei:

(Source: Bloomberg)

This is a three-day, three-minute chart of the major Japanese stock index. The market broke hard on the news.

The JPY soared:

(Source: Bloomberg)

The currency jumped 3% from Tuesday's close.

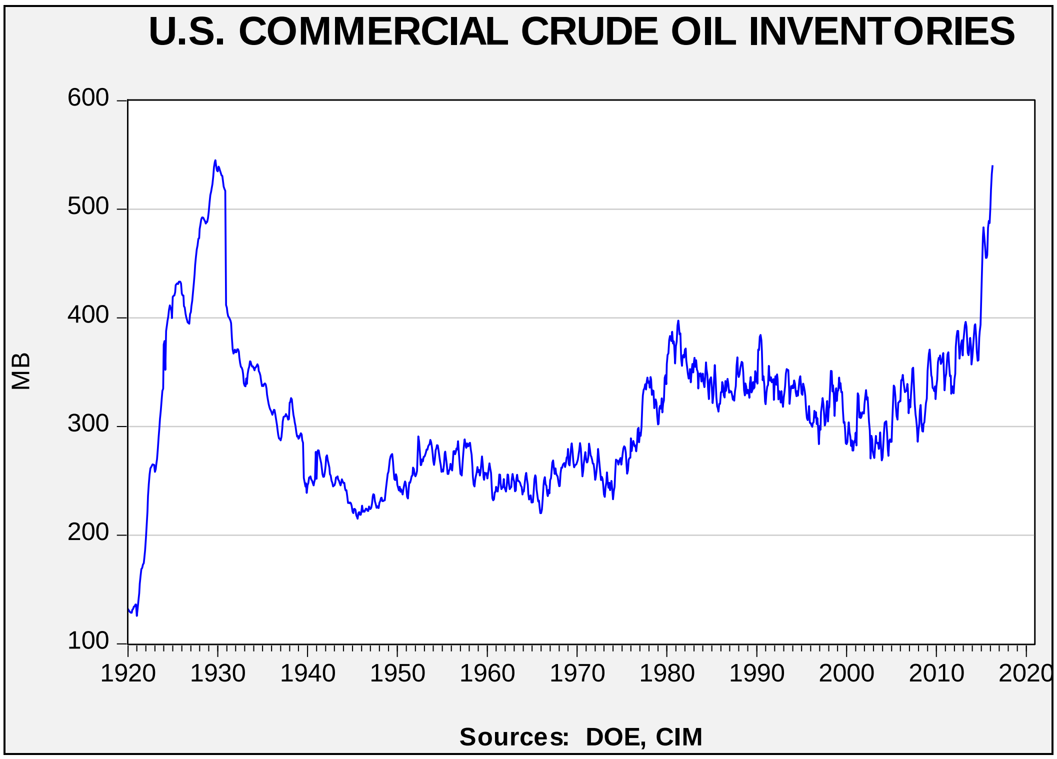
There is much speculation on why Kuroda didn't act. Some are arguing that he is trying to press PM Abe into doing more with fiscal policy; by dragging his feet on more monetary stimulus, he is putting pressure on the government to act. Although this may be the case, history shows that when monetary policy officials try to pressure elected officials, the latter usually win. That's because, even with central bank independence, a central banker gets his mandate from some elected official. The other possibility is that Kuroda may be wondering if monetary policy is reaching its limit. The impact of NIRP has been mixed at best. Although rates have declined, the appreciation of the JPY has mitigated much of the positive bounce from falling rates. The BOJ may be at a point where the last remaining policy tool is direct debt monetization ("helicopter money"), which probably can't be implemented without government support.

The FOMC statement didn't contain any serious surprises. The committee noted that the labor market has shown improvement but the overall economy looks sluggish. About the only serious surprise was that the comment about global economic and financial developments posing risks was dropped from the statement. This may not mean much; later in the statement, it was noted that developments overseas will be "closely monitored." KC FRB President George dissented, as expected.

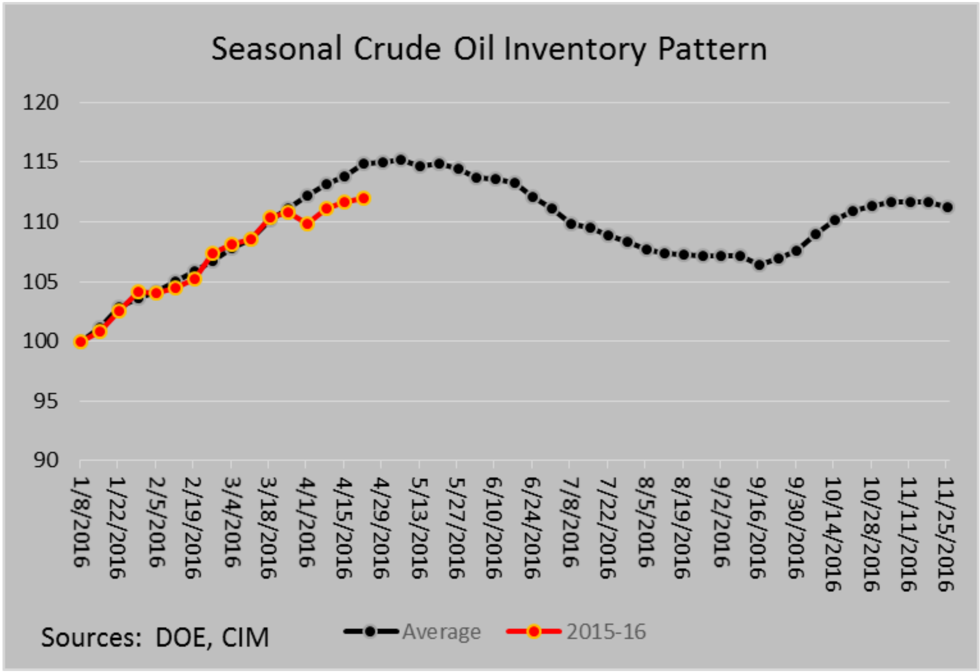
We have speculated that the Fed may be using a de facto currency target as part of its policy mix. Although this would never be admitted in public (it's outside the Fed's policy mandate), it is impossible to argue for steady policy using virtually all the permutations of the Phillips Curve that we monitor. Perhaps dropping the foreign risk statement is an indication that the Fed is comfortable with a 110ish JPY/USD and a 1.1300ish EUR/USD. Or, this may be reading too much into a short statement. Although pundits continue to suggest that the statement allows for a June hike, we doubt that will occur.

Oil prices continue to rally, exhibiting the characteristics of a bull market. For the past two weeks, any bearish news has been met with buying, suggesting there is money on the sidelines looking to take advantage of pullbacks to establish long positions. The market bounced back from a very bearish meeting in Doha and held gains after the API reported a stock draw that was contradicted by the official data from the DOE.

Inventory levels remain historically high.



However, inventories are clearly lagging the usual seasonal pattern.

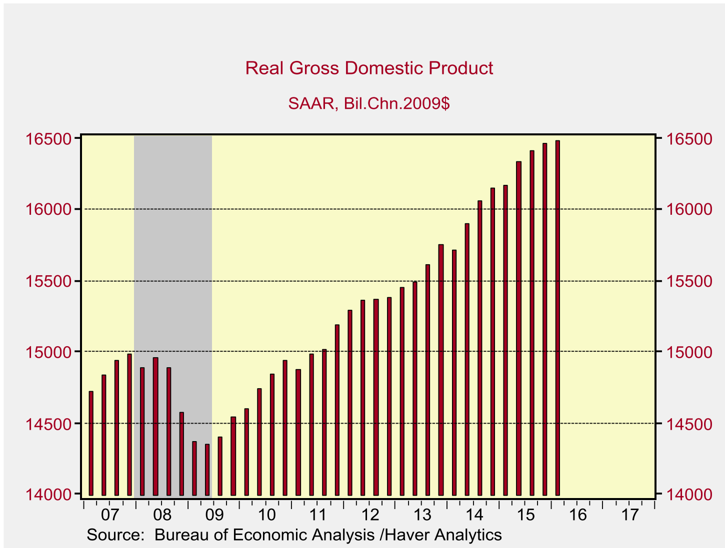


On average, we are near the seasonal peak and should begin to see stock draws going forward as the summer vacation season gets underway. Based on current inventory levels and the EUR, the average monthly price for WTI (which is currently $40.61) is a bit overvalued; our model puts the fair value price at $38.84. However, the current price is rich. Assuming a stable EUR, the current price of around $45.25 is consistent with inventory levels of 502 mb, implying a stock draw of nearly 40 mb, or about 7.0% from current levels. Assuming the last data point represents the peak week, a normal seasonal storage decline puts the low at 500.5 mb by the third week of September, which calculates to a fair value price of $45.25 per barrel. Essentially, the market has already discounted a lot of bullish news and further price strength could lead us into overvalued territory unless stock draws are much more than normal. This isn't to say we are bearish, but we wouldn't be surprised to see a flat market develop in the coming weeks.

Finally, it appears that Greece is becoming a problem yet again. Greek PM Tsipras has been requesting a summit meeting with Eurozone officials, asking for an easing of terms to receive promised aid. Donald Tusk, the current president of the European Council (which represents the 28 nations of the Eurozone), has only agreed to a meeting of finance ministers, who generally cannot change terms to an existing arrangement. Greece faces a €3.5 bn loan payment in July and it doesn't look like it will be able to make it. In addition, Tsipras is struggling to make other reforms demanded by creditors. Although this situation should be manageable, problems could escalate as we head into the Brexit vote in mid-June and new Spanish elections in late June, the outcomes of which could reduce the policy "bandwidth" available. Thus, we may be heading into a series of Eurozone issues as summer nears.

U.S. Economic Releases

The first look at Q1 GDP came in weaker than forecast, with GDP rising 0.5%, less than the 0.7% increase forecast. The chart below shows the absolute level of quarterly GDP. The economy is still expanding, but at a much slower pace.

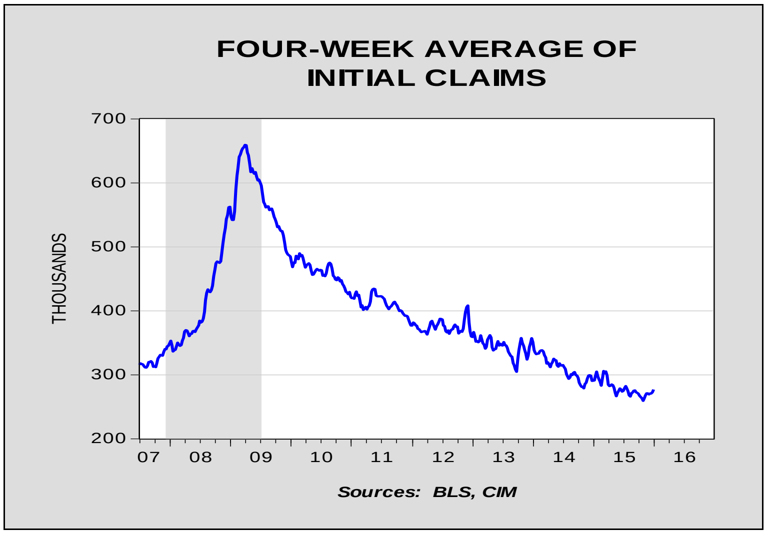


Consumption grew at a slower pace, while business investment and trade declined. Government consumption rose on increased spending by local and state governments.

	Q1 2016	Q4 2015	Difference
GDP	0.5%	1.4%	-0.9%
Consumption	1.3%	1.7%	-0.4%
Investment	-0.6%	-0.2%	-0.4%
Inventories	-0.3%	-0.2%	-0.1%
Net Exports	-0.3%	-0.1%	-0.2%
Government	0.2%	0.0%	0.2%

The chart above shows contributions to the change in GDP from the four major sectors, plus inventories. All sectors, except for government spending, weakened from the quarter before. Other indicators have signaled a slight improvement in personal consumption, so we may see consumption revised over the next two Q1 GDP revisions. Business investment was down due to weak global demand and falling oil prices. Net exports were also down due to weak global demand and the stronger dollar.

Initial claims came in lower than forecast, rising 9k to 257k, better than the 259k level forecast. The labor market seems to be holding up well as businesses maintain their workforce.



The chart above shows the four-week average of claims, a more stable measure of labor market health. The average fell 1k to 256k.

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	Kansas City Fed manufacturing activity	m/m	Apr		-6.0	**

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	Unemployment rate	m/m	Mar	3.2%	3.3%	3.3%	***	Equity bullish, bond bearish
	CPI	y/y	Mar	-0.1%	0.3%	0.0%	***	Equity bearish, bond bullish
	Industrial production	y/y	Mar	0.1%	-1.2%	-1.6%	***	Equity bullish, bond bearish
	Retail sales	y/y	Mar	-1.1%	0.4%	-1.4%	**	Equity and bond neutral
EUROPE								
Eurozone	Economic confidence	m/m	Apr	103.9	103.0	103.4	**	Equity bullish, bond bearish
	Industrial confidence	m/m	Apr	-3.7	-4.2	-4.0	**	Equity and bond neutral
	Consumer confidence	m/m	Apr	-9.3	-9.3	-9.3	**	Equity and bond neutral
	Business climate indicator	m/m	Apr	0.1	0.1	0.1	**	Equity and bond neutral
Germany	CPI	y/y	Apr	0.1%	0.3%	0.1%	***	Equity and bond neutral
U.K.	House prices	y/y	Apr	4.9%	5.7%	5.0%	**	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)	23	23	0	Neutral
TED spread (bps)	41	40	1	Up
U.S. Libor/OIS spread (bps)	39	38	1	Up
10-yr T-note (%)	1.85	1.85	0.00	Neutral
Euribor/OIS spread (bps)	-25	-25	0	Neutral
EUR/USD 3-mo swap (bps)	21	22	-1	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	$ 47.18	$ 47.18	0.00%	Refinery run rates falling
WTI	$ 45.28	$ 45.33	-0.11%	
Natural gas	$ 2.10	$ 2.15	-2.42%	Warmer weather
Crack spread	$ 18.35	$ 18.69	-1.79%	
12-mo strip crack	$ 14.15	$ 14.30	-1.05%	
Ethanol rack	$ 1.69	$ 1.70	-0.06%	
Metals				
Gold	$ 1,257.64	$ 1,245.83	0.95%	Lower dollar
Silver	$ 17.37	$ 17.24	0.74%	
Copper contract	$ 222.30	$ 222.45	-0.07%	Expectation of falling Chinese demand
Grains				
Corn contract	$ 384.50	$ 384.75	-0.06%	
Wheat contract	$ 486.25	$ 483.50	0.57%	Demand accelerates
Soybeans contract	$ 1,025.25	$ 1,028.50	-0.32%	Weather turns more favorable to soybeans
Shipping				
Baltic Dry Freight	715	704	11	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)	2.0	1.4	0.6	
Gasoline (mb)	1.6	-1.0	2.6	
Distillates (mb)	-1.7	-0.7	-1.0	
Refinery run rates (%)	-1.3%	0.4%	-1.7%	
Natural gas (bcf)		69.0		

Weather

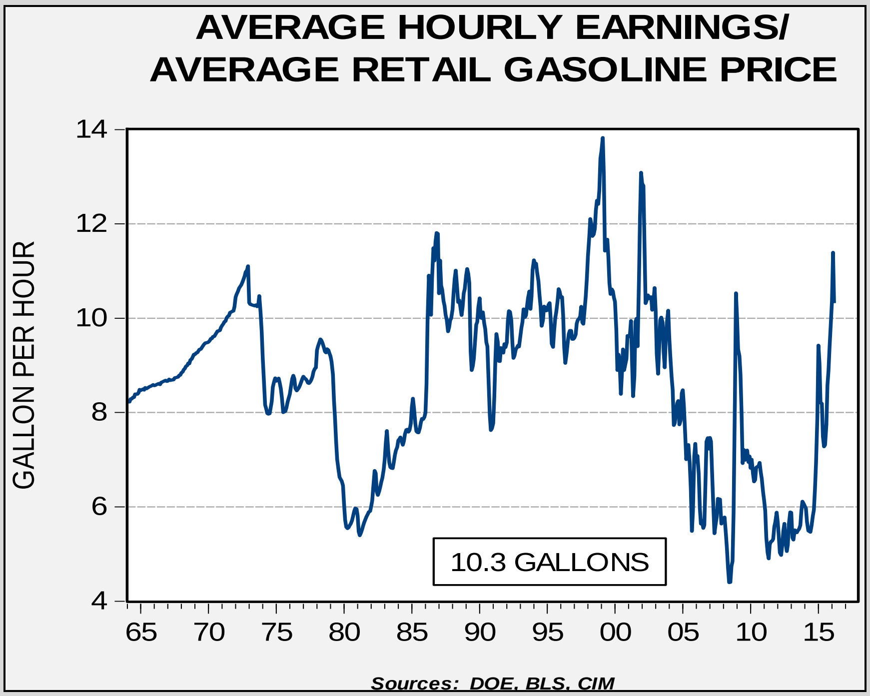
The 6-10 and 8-14 day forecasts are calling for cooler than normal conditions in the east and south. Precipitation is forecast for the northwestern region.

Weekly Asset Allocation Commentary

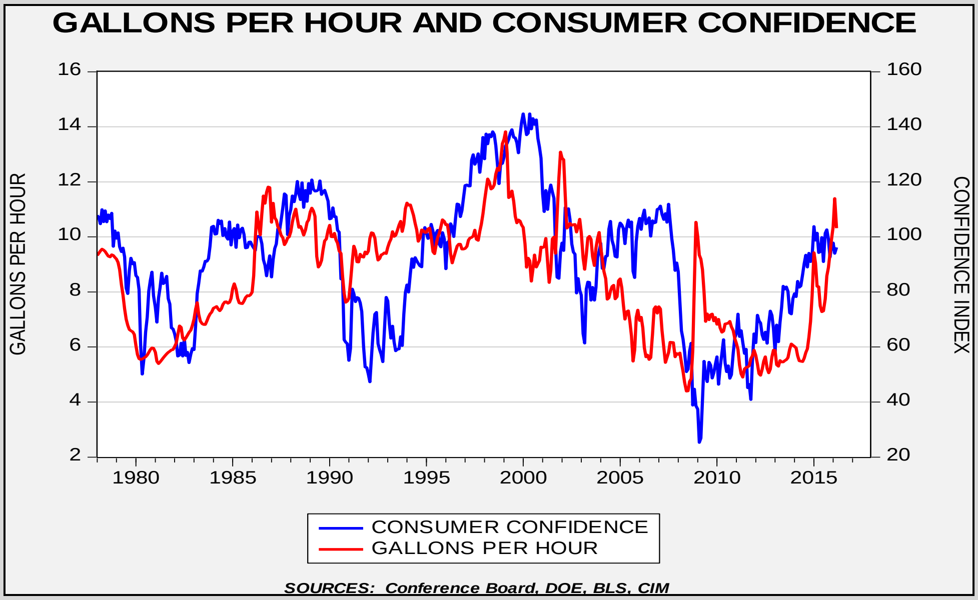
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

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.

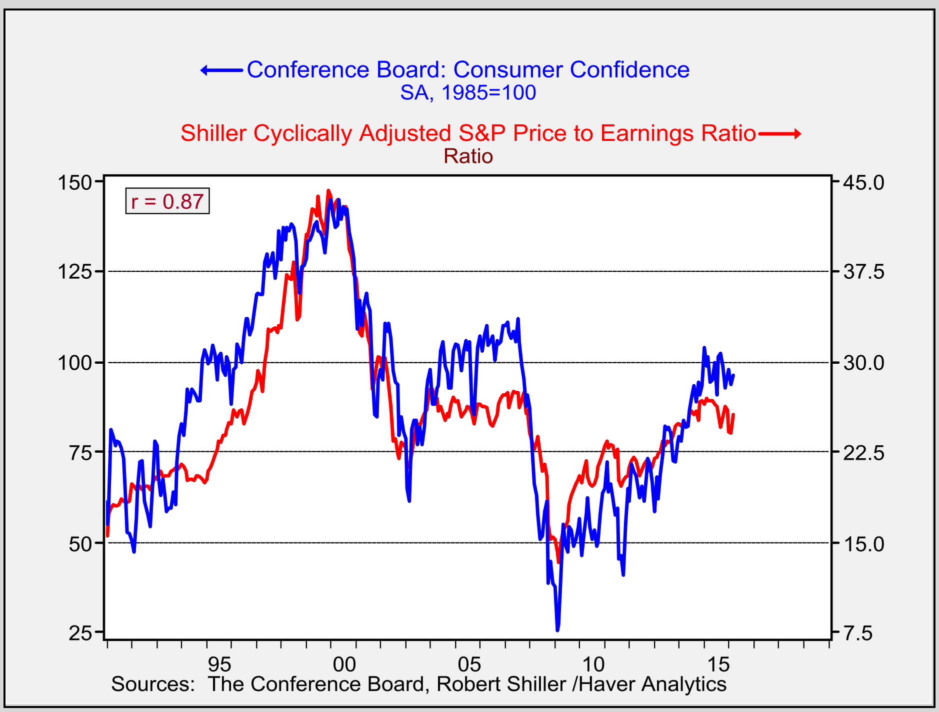


This chart shows how many gallons of gasoline a person can buy with one hour of non-supervisory average wage. This ratio not only takes into account the price of gasoline but also the effect of wage growth. Since 1964, the average worker has been able to buy 8.6 gallons of gasoline for an hour's wage.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

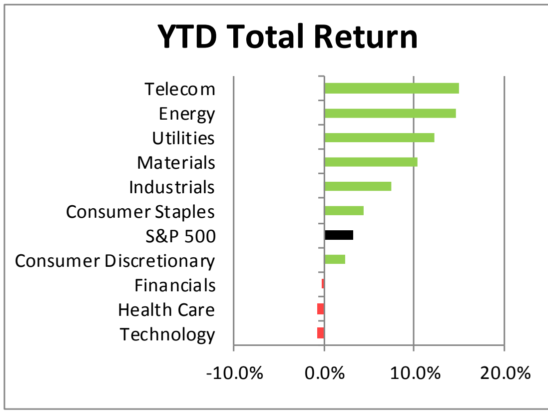


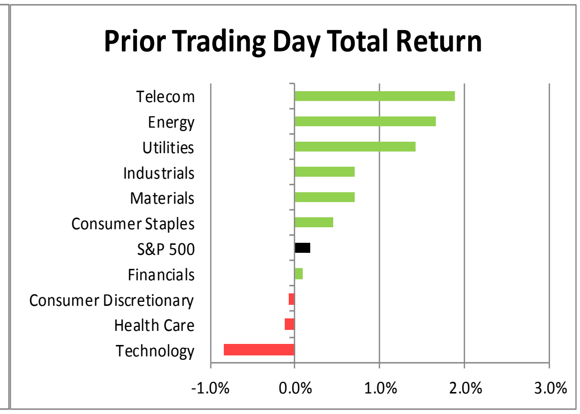
This chart shows the Shiller P/E and consumer confidence. The two series correlate at the 87% level. It does seem that rising consumer confidence tends to reflect a degree of investor confidence as well. Therefore, to the extent that lower gasoline prices and tightening labor markets boost consumer confidence,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

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

U.S. Equity Markets – (as of 4/27/2016 close)

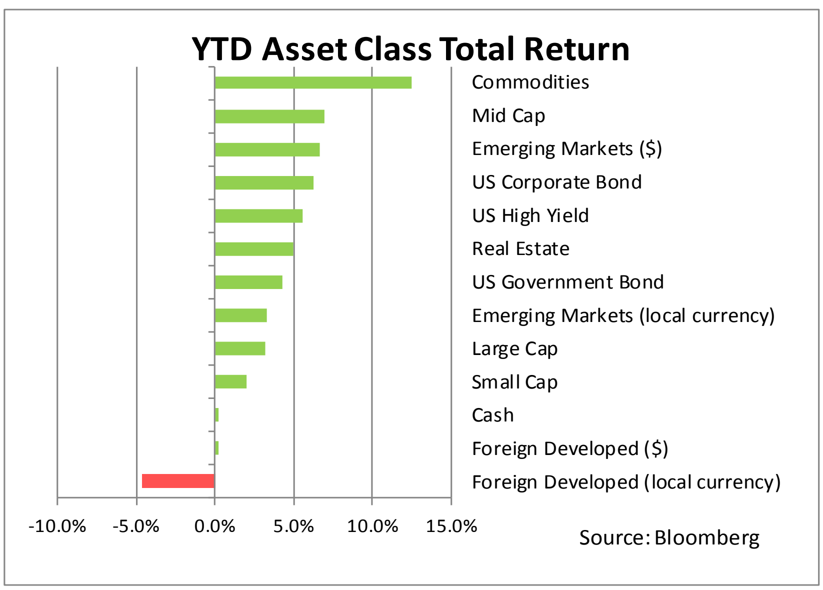




(Source: Bloomberg)

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 4/27/2016 close)

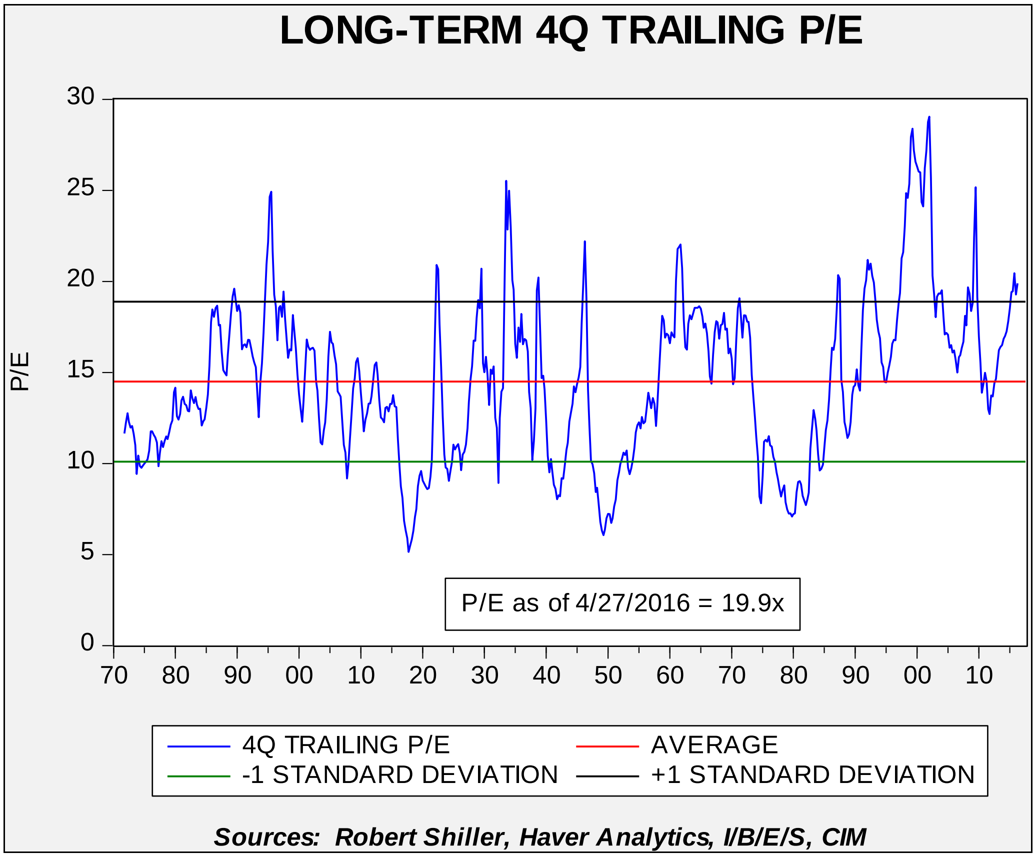


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 28, 2016



Based on our methodology,[1] the current P/E is 19.9x, 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.