Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: April 29, 2016—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is trading down 1.6% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 1.4% from the prior close. Chinese markets closed lower to sideways, with the Shanghai composite down 0.3% and the Shenzhen index closing unchanged. U.S. equity futures are signaling a lower opening from the previous close. With 57.8% of the S&P 500 companies having reported, Q1 float-adjusted earnings stand at $26.65, just under the $26.66 forecast. Of the 289 companies that have reported, 74.2% had positive earnings surprises, while 18.1% had negative earnings surprises.

The primary feature of today's financial markets is dollar weakness.

(Source: Bloomberg)

This chart shows the CME dollar index, which is comprised of about 56% EUR and correlates at nearly +80% with the EUR/USD exchange rate. The dollar began to rally in mid-2014 as the U.S. economy began to improve and Fed policy stimulus began to wane. At the same time, weaker Japanese and Eurozone inflation led to increased policy stimulus by the BOJ and ECB, leading to a dollar bull market. The dollar has been consolidating after peaking in March of last year. Recent weakness is putting the index at the support line experienced over the past year and a break below this support line would likely prompt technical selling.

Although it is difficult to prove, we have been suggesting the Fed is using the dollar as a policy target. After all, by any measure of the Phillips Curve, the FOMC should be raising rates at least twice this year if one believes the employment/population ratio is the best reflection of the labor markets, and should be moving aggressively if the unemployment rate is the best reflection. Since the Fed doesn't seem to be using the Phillips Curve, it has to be focusing on something and the dollar is a plausible alternative. We note today's *WSJ* has an op-ed from Kevin Warsh, former Fed governor, speculating as we are that the FOMC is targeting the dollar for policy purposes. Of course, the key unknown is what exchange rates the Chair has in mind for raising rates but if we break support, we might find out in rapid fashion.

The editorial pages in most major news outlets are reacting to the growing likelihood that Donald Trump will be the GOP candidate for president. There is much discussion about his recent foreign policy address, which we would view as mostly Jacksonian in nature. In other words, isolationist with a very strong military. The key campaign slogan is "America First," likely an inadvertent reference to an earlier America First movement that was dead set against participating in WWII. Many pundits are treating the earlier version with derision, tying it to its now discredited chief spokesman Charles Lindbergh. However, it should be noted that, at its peak, it had 880k paying members, including future presidents John Kennedy and Gerald Ford, future Supreme Court Justice Potter Stewart, Sargent Shriver, General Wood of Sears-Roebuck, the publisher of the Daily News, Joe Patterson and the publisher of the Chicago Tribune, Robert McCormick. Walt Disney and Frank Lloyd Wright were also members. Simply put, the America First movement wasn't a den of kooks…it has a rich history that was only discredited after the U.S. abandoned isolationism and accepted the burden of global hegemony.

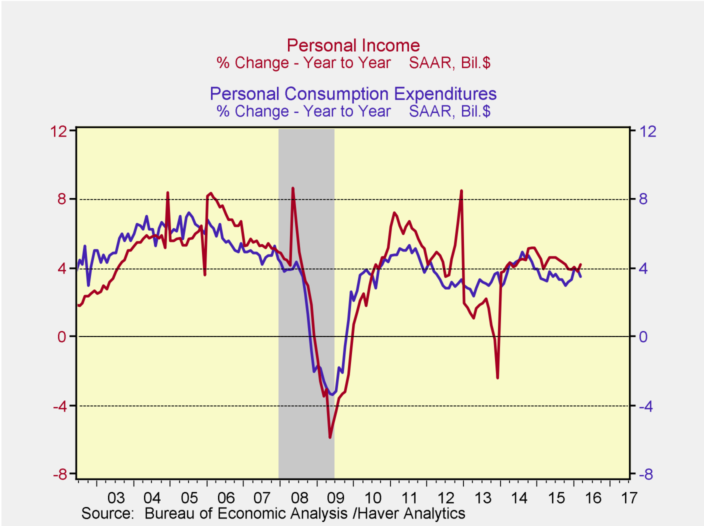
We believe that the wave is turning. Due to intergenerational forgetfulness, today's Americans are keenly aware of the costs of hegemony but have taken the benefits for granted. It isn't just Trump who is touting a return to isolationism. Rand Paul represents a similar strain and Sen. Sanders's foreign policy wouldn't be much different. Sen. Clinton represents the neo-conservative Wilsonian vision of America keeping the world safe, which is probably a fading position.

What is interesting to us is while the American media is fixated on Trump, it is failing to notice a growing degree of anti-Americanism in Europe. This is most evident in the strong opposition to the Trans-Atlantic Trade and Investment Partnership (TTIP) in Germany. The TTIP is the European version of the Trans-Pacific Partnership, which has been tentatively approved. Essentially, these are free trade zones that would become the new trade framework for the world. In Germany, support for TTIP is down to 17%, compared to 55% just two years ago. Given that Germany is an exporting power, it seems rather odd it would oppose an expansion of trade. However, in today's *FT*, Stefan Wagstyl argues that Germany's opposition is rooted in growing anti-Americanism and anti-globalism. Perhaps the Germans and other Europeans are also suffering from intergenerational forgetfulness, concluding that they can handle a resurgent and belligerent Russia without U.S. support.

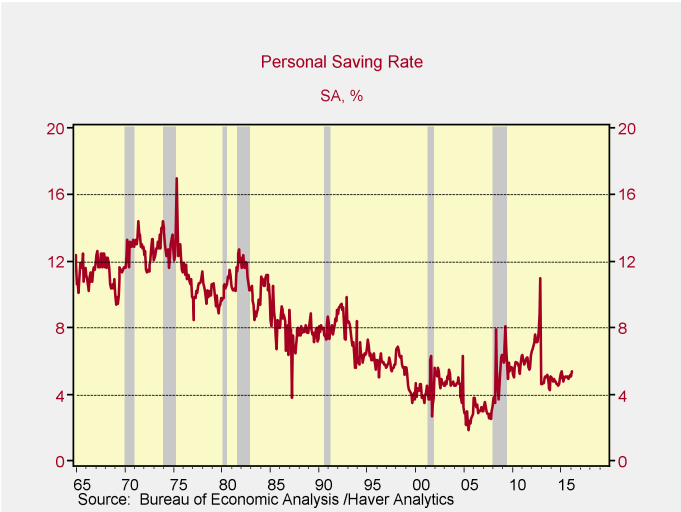
Finally, the *NYT* reports that there are growing voices calling for a partition of Iraq. We have suspected this would be the eventual outcome from the minute U.S. troops entered the country in 2003. Iraq was never a natural nation. Instead, it was an artificial construct created by British and French diplomats primarily for the purpose of colonial control. The only way such a nation could be held together was either by outside force or internal authoritarianism. In the absence of either, there seems little reason for current borders to be maintained. The problem is that a threepart Iraq will be difficult to defend from outside powers, and so partitioning will likely lead to a battle for territory between Iran, Saudi Arabia and Turkey.

U.S. Economic Releases

March personal income rose more than forecast, increasing 0.4% from the month before, compared to the 0.3% expected. At the same time, personal spending came in lower than forecast, rising 0.1%, compared to the 0.2% increase forecast. The chart below shows the annual change in personal income and outlays.

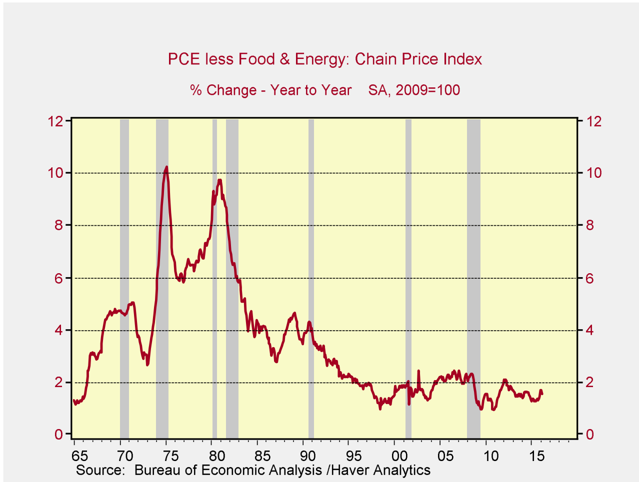


As households earned more and spent less in March, the personal savings rate rose to 5.4% from 5.1% the month before. That's the highest level of savings since February of last year.



The overall PCE deflator rose 0.1% annually, on forecast. Core PCE deflator, the FOMC's favorite measure of inflation, rose 1.6% annually, on forecast. The Fed's target core PCE is

2.0% and historically, the Fed has tightened credit when the rate exceeds 2.0% and loosened credit when the rate has been below 2.0%.



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	University of Michigan sentiment	m/m	Apr	90.0	89.7	**

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	PPI	y/y	Q1	1.2%	1.9%		**	Equity and bond neutral
Japan	CPI	y/y	Mar	1.1%	1.1%	1.0%	***	Equity bullish, bond bearish
	Housing starts	y/y	Mar	8.4%	7.8%	-0.6%	**	Equity bullish, bond bearish
EUROPE								
Eurozone	Unemployment rate	m/m	Mar	10.2%	10.4%	10.3%	***	Equity bullish, bond bearish
	GDP	y/y	Q1	1.6%	1.6%	1.4%	***	Equity bullish, bond bearish
	CPI	y/y	Apr	-0.2%	0.0%	-0.1%	***	Equity bearish, bond bullish
	CPI core	m/m	Apr	0.8%	1.0%	0.9%	***	Equity bearish, bond bullish
France	GDP	y/y	Q1	1.3%	1.4%	1.0%	***	Equity bullish, bond bearish
	CPI	y/y	Apr	-0.2%	-0.1%	-0.1%	***	Equity bearish, bond bullish
	PPI	y/y	Mar	-4.0%	-4.2%		**	Equity and bond neutral
Germany	Retail sales	m/m	Mar	-1.1%	0.0%	0.4%	**	Equity bearish, bond bullish
Switzerland	LEI	m/m	Apr	102.7	102.8	102.5	**	Equity bullish, bond bearish
Russia	Manufacturing PMI	m/m	Apr	48.0	49.3	48.9	**	Equity bearish, bond bullish
AMERICAS								
Canada	GDP	y/y	Feb	1.5%	1.6%	1.5%	***	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)	64	63	1	Up
3-mo T-bill yield (bps)	20	21	-1	Down
TED spread (bps)	44	43	1	Up
U.S. Libor/OIS spread (bps)	38	39	-1	Down
10-yr T-note (%)	1.87	1.83	0.04	Widening
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
Central Bank Action	Current	Prior	Expected	
Russia key rate	11.00%	11.00%	11.00%	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	$ 48.26	$ 48.14	0.25%	Refinery run rates falling
WTI	$ 46.47	$ 46.03	0.96%	
Natural gas	$ 2.09	$ 2.08	0.38%	
Crack spread	$ 18.34	$ 18.78	-2.34%	
12-mo strip crack	$ 14.19	$ 14.47	-1.96%	
Ethanol rack	$ 1.69	$ 1.69	-0.04%	
Metals				
Gold	$ 1,275.85	$ 1,266.26	0.76%	Lower dollar
Silver	$ 17.75	$ 17.55	1.09%	
Copper contract	$ 227.75	$ 223.15	2.06%	Lower dollar
Grains				
Corn contract	$ 394.50	$ 391.25	0.83%	
Wheat contract	$ 487.25	$ 485.50	0.36%	Demand accelerates
Soybeans contract	$ 1,028.75	$ 1,027.50	0.12%	
Shipping				
Baltic Dry Freight	710	715	-5	
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)	73	69.0	4.0	

Weather

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

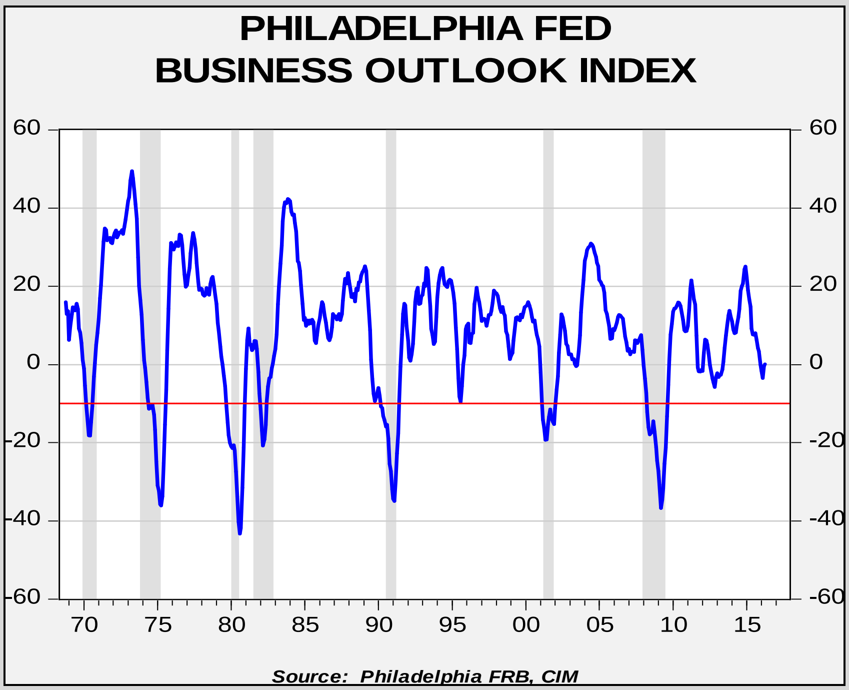
Weekly Asset Allocation Commentary

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 29, 2016

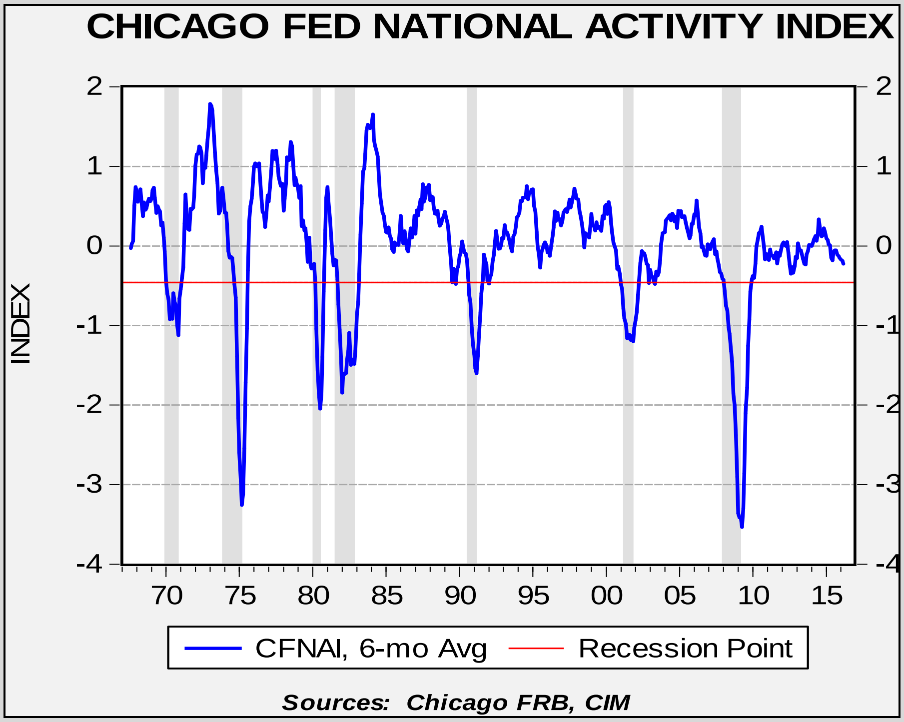
We recently completed our quarterly rebalancing process in our asset allocation models. One of our key assumptions is that the economy will avoid recession but growth will remain sluggish. Recently, two reliable recession indicators, one from the Philadelphia FRB and the other from the Chicago FRB, have confirmed our expectations.

First, shown below is the Philadelphia FRB's manufacturing index, which is a survey of manufacturing firms in the Northeast:



This index signals below-trend growth with a reading below zero, and indicates a recession with a reading under -10. We smooth the data with a six-month moving average. The current reading is +0.08, suggesting, at best, growth is at trend. Note that the readings have been rather weak in this recovery. In fact, the average index value (on a six-month average basis) for this recovery is the second lowest on record, with only the recovery between the 1980 and 1981-82 recessions being slower.

The Chicago FRB National Activity Index, which is a broad-based compilation of national economic indicators, shows a similar pattern.



Similar to the Philadelphia FRB manufacturing index, a reading below zero indicates below-trend growth. The data clearly shows the economy is weak but not recessionary.

We expect the economy to continue on this path. Until household debt falls to more manageable levels, consumption will likely remain sluggish which will tend to weigh on the economy. This forecast for the economy means that:

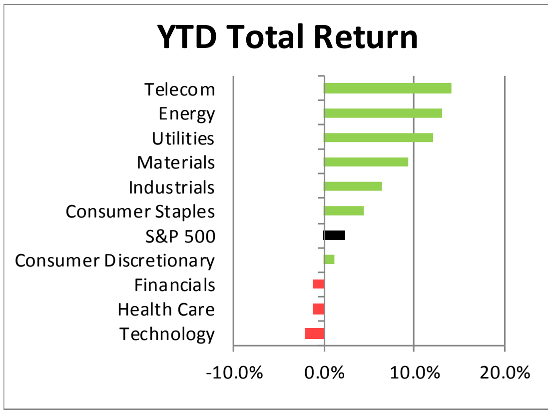
1. Inflation should remain low;
2. The risk in long-duration interest rate instruments is low;
3. Monetary policy should remain accommodative, even with the Federal Reserve moving on a tightening path;
4. Equity markets can support a higher than normal P/E.

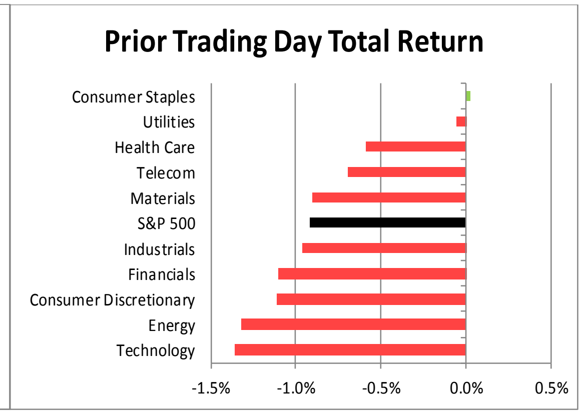
These expectations have been incorporated into our asset allocation models. A shift to either recession or faster economic growth would require adjustments but, at this juncture, neither appears likely. Until a shift in stance occurs, our current allocations will likely remain in place.

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 4/28/2016 close)

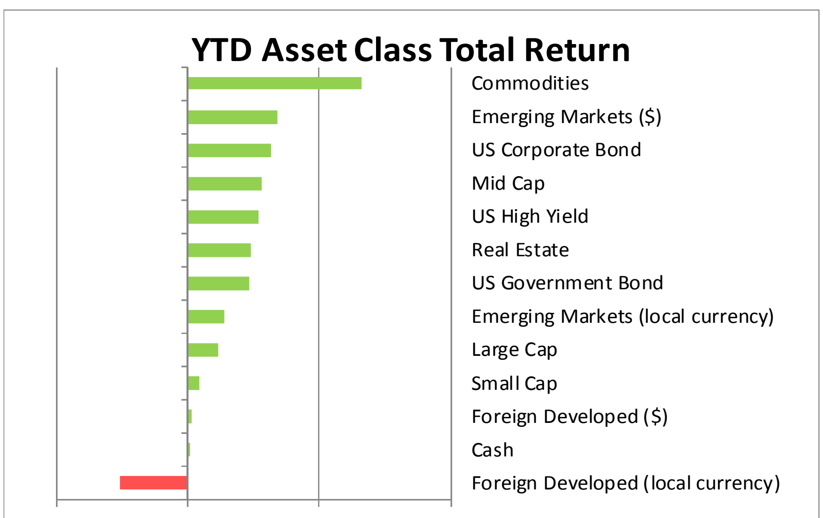




(Source: Bloomberg)

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 4/28/2016 close)



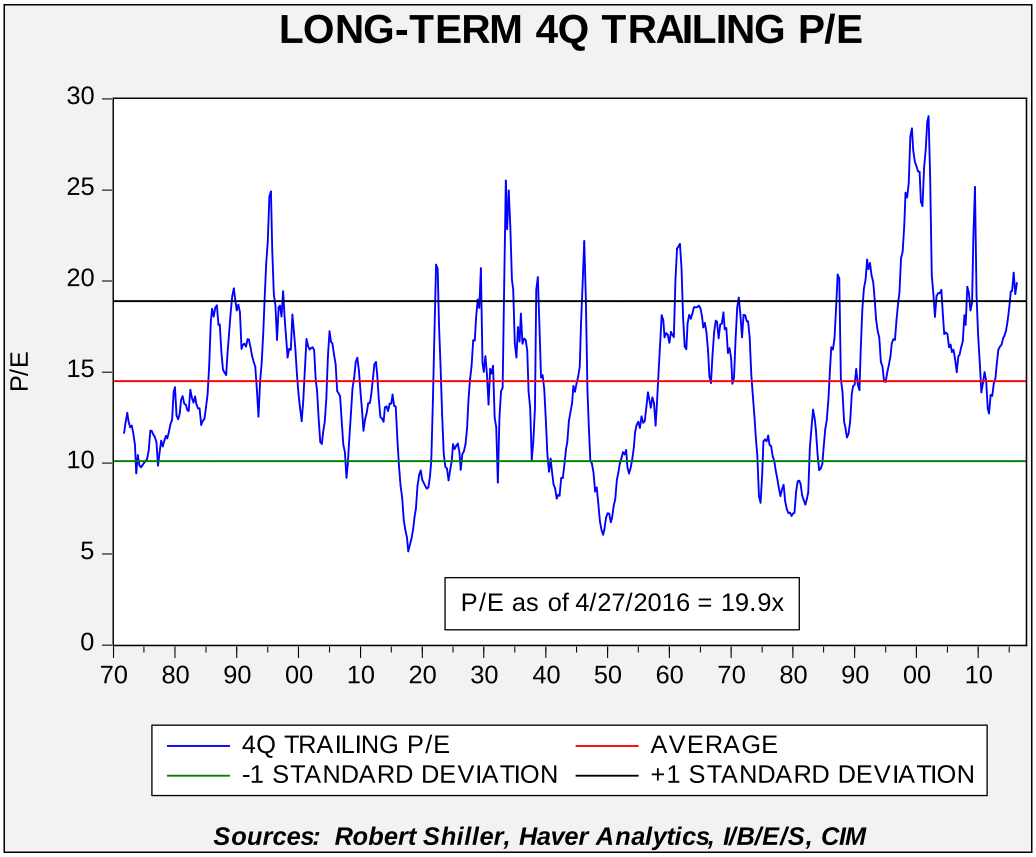
Source: Bloomberg

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.

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[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.