Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: April 4, 2016—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is trading up 1.0% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 0.2% from the prior close. Chinese markets were closed today. U.S. equity futures are signaling a higher opening from the previous close.

There wasn't too much market news overnight as several Asian markets were closed for holiday. However, there were several major news splashes from WikiLeaks, one of which published a massive database from the offshore law firm Mossack Fonseca. A German newspaper, *Süddeutsche Zeitung*, obtained the data from anonymous sources and shared them with the International Consortium of Investigative Journalists (ICIJ). The firm was involved in creating offshore tax shields; its base of operations is in Panama (which is why you are seeing these referred to as the "Panama Papers"), but it has 600 employees working in 42 countries. The client list is quite impressive and includes the current president of Argentina, the PM of Iceland (who is facing a no-confidence vote due to the revelations), the King and the Crown Prince of Saudi Arabia, and the president of Ukraine, among others. The list revealed that family members and friends of various leaders also used the firm's services. Azerbaijan's first family were clients, as were some childhood friends of Vladmir Putin; even U.K. PM Cameron's dad used the firm.[1] This leak will cause some consternation in a number of countries and could undermine some governments. The aforementioned Iceland appears to the first on the list but others are likely.

The other interesting WikiLeaks report is that it appears the IMF is putting strong pressure on Eurozone governments to give debt relief to Greece. According to several reports, the IMF is pressing for a Greek default and is threatening to withdraw from negotiations. Germany has insisted on IMF participation in part to offer an international imprimatur for enforcing austerity on Greece. The negotiations on the last bailout are not complete and this news has raised anger in Athens that the IMF may use brinkmanship to force the EU to give Greece debt concessions. The risk is that the EU refuses and Greece is faced with another financial crisis. Given that Greece is the front line for the refugee crisis as well, the country is feeling a bit abandoned by the EU. This leak won't help.

With China's growth peaking, one of the questions we are asked occasionally is, "Who is the next China?" In the late 1980s, we were asked who the "next Japan" would be; it turned out to be, in fact, China. *Business Insider* reports that India is likely the next low cost/high growth manufacturing giant on the horizon. In terms of oil, India is now the third largest consumer,

[1]https://panamapapers.icij.org/the_power_players/?utm_source=Sailthru&utm_medium=email&utm_campaign=New%20Campaign&utm_term=%2AMideast%20Brief

surpassing Japan recently (trailing the U.S. and China). India has been frustrating to watch; shackled by the post-WWII British Labor Party socialist model, regulations have slowed development. There was great hope that PM Modi would be the Thatcher/Reagan of India. So far, he has been the Modi of India. However, even without a "big bang" there has been steady improvement. With India's oil demand rising, the country is considering the creation of a strategic reserve, which would boost global demand and offer some support for prices. According to reports, India is considering a 90 mb reserve. It has also changed foreign investment rules to streamline investment into India's energy sector. Given the current low oil price environment, it would make good sense for India to consider building inventory capacity. Although this decision, by itself, won't fix the global oversupply problem, it is a good sign that demand is starting to react to low prices.

U.S. Economic Releases

There are no releases scheduled before we go to print. The table below shows the economic releases and Fed speakers scheduled for the rest of the day.

Economic releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	ISM New York	m/m	Mar	54.1	53.6	*
10:00	Labor market conditions index	m/m	Mar	1.5	-2.4	*
10:00	Factory orders	m/m	Feb	-1.7%	1.6%	**
10:00	Durable goods orders	m/m	Feb	-2.8%	-2.8%	**
Fed Speakers and Events						
EST	**Speaker or event**	**District or position**				
9:45	Rosengren	Boston FRB President				
7:00	Kashkari	Minneapolis FRB President				

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								
India	Manufacturing PMI (Nikkei)	m/m	Mar	52.4	51.1		**	Equity bullish, bond bearish
Japan	Vehicle sales	y/y	Mar	-3.2%	-4.6%		**	Equity and bond neutral
	Monetary base	y/y	Mar	¥375.7 tn	¥358.8 tn		*	Equity bullish, bond bearish
EUROPE								
Eurozone	Unemployment rate	m/m	Feb	10.3%	10.4%	10.3%	***	Equity and bond neutral
	PPI	y/y	Feb	-4.2%	-3.0%	-4.0%	**	Equity bearish, bond bullish
	Investor confidence	m/m	Feb	5.7	5.5	7.0	**	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	22	0	Neutral
TED spread (bps)	41	41	0	Neutral
U.S. Libor/OIS spread (bps)	38	38	0	Neutral
10-yr T-note (%)	1.78	1.77	0.01	Widening
Euribor/OIS spread (bps)	-25	-24	-1	Down
EUR/USD 3-mo swap (bps)	23	24	-1	Down
Currencies	**Direction**			
dollar	unch			Falling
euro	down			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	$ 38.78	$ 38.67	0.28%	Ample global supplies
WTI	$ 36.96	$ 36.79	0.46%	
Natural gas	$ 2.01	$ 1.96	2.91%	Domestic rig count falls to the lowest since 1987
Crack spread	$ 18.48	$ 18.30	1.00%	
12-mo strip crack	$ 13.33	$ 13.10	1.81%	
Ethanol rack	$ 1.57	$ 1.57	0.00%	
Metals				
Gold	$ 1,220.67	$ 1,222.60	-0.16%	Stronger domestic economic growth
Silver	$ 15.02	$ 15.05	-0.20%	
Copper contract	$ 215.90	$ 216.30	-0.18%	Supplies remain high
Grains				
Corn contract	$ 350.75	$ 354.00	-0.92%	Increased domestic planting
Wheat contract	$ 472.75	$ 475.75	-0.63%	
Soybeans contract	$ 920.00	$ 918.25	0.19%	Falling domestic planting
Shipping				
Baltic Dry Freight	450	429	21	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)	2.3	2.8	-0.5	
Gasoline (mb)	-2.5	-2.2	-0.3	
Distillates (mb)	-1.1	-0.3	-0.8	
Refinery run rates (%)	2.0%	-0.1%	2.1%	
Natural gas (bcf)	-25	-24.0	-1.0	

Weather

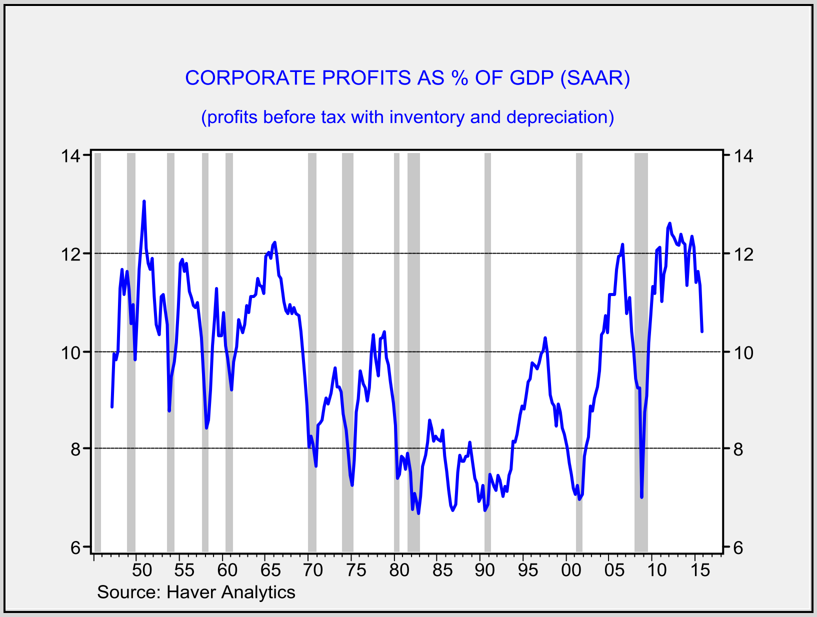
The 6-10 and 8-14 day forecasts are calling for warmer than normal temperatures for the western half of the country and cooler than normal conditions for the eastern half. Precipitation is forecast for most of the country.

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.

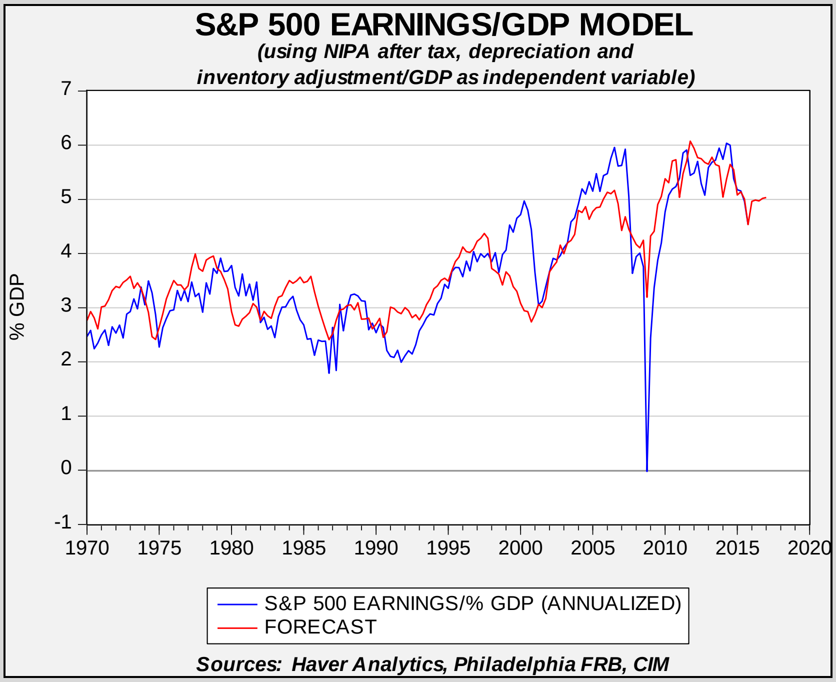
April 1, 2016

In the most recent GDP report, corporate profits plunged.



The overall decline in profits was $153 bn in Q4, although some of this drop was due to an $83 bn settlement that BP had with the government over the 2010 Gulf of Mexico oil spill. We have been noting for some time that profit margins have been eroding. This data tends to confirm that concern.

In our earnings forecast, we use a similar number from the National Income and Products Accounts (NIPA) that is similar to the above profits report except that it includes corporate taxes as well.



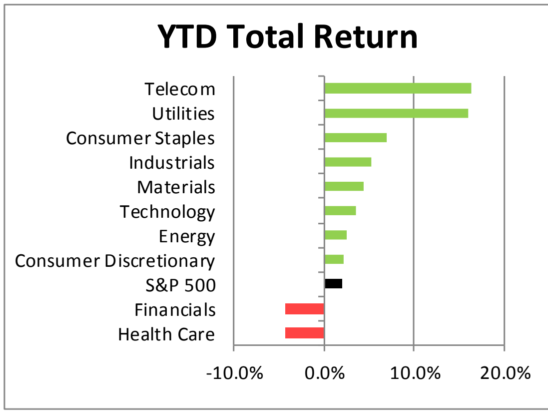
This chart shows the relationship between S&P 500 earnings as a percentage of GDP and the NIPA corporate profits after tax, depreciation and inventory adjustment. We include this variable in a larger model that we use to project S&P earnings compared to GDP. For the most part, the two series tend to track each other rather closely. Periods when S&P earnings greatly exceed the NIPA numbers tend to signal that such divergences are not sustainable and they are resolved by a drop in S&P earnings. Such divergences are evident in 1980, 2000 and 2007. Fortunately, the two readings are not currently diverging.

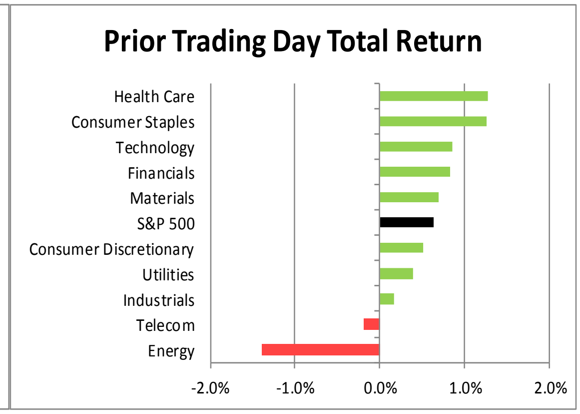
Using the NIPA profits and GDP forecasts from the Philadelphia FRB, the relationship suggests that profits will recover in 2016. In our latest update to our 2016 outlook, we reduced our earnings for the year mostly due to margin contraction.[2] The most recent GDP data generally confirms this trend. Overall, we are looking for a mostly flat year for the equity markets due to sluggish economic growth and mostly flat margins. At the same time, we do not expect a recession this year, which should prevent a major pullback in equities.

[2] See 2016: An Update.

Data Section

U.S. Equity Markets – (as of 4/1/2016 close)

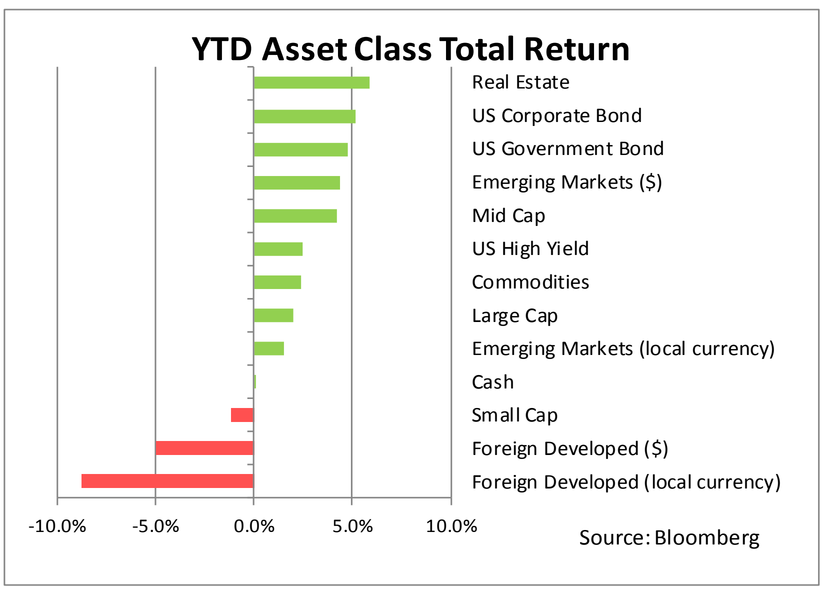




(Source: Bloomberg)

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 4/1/2016 close)

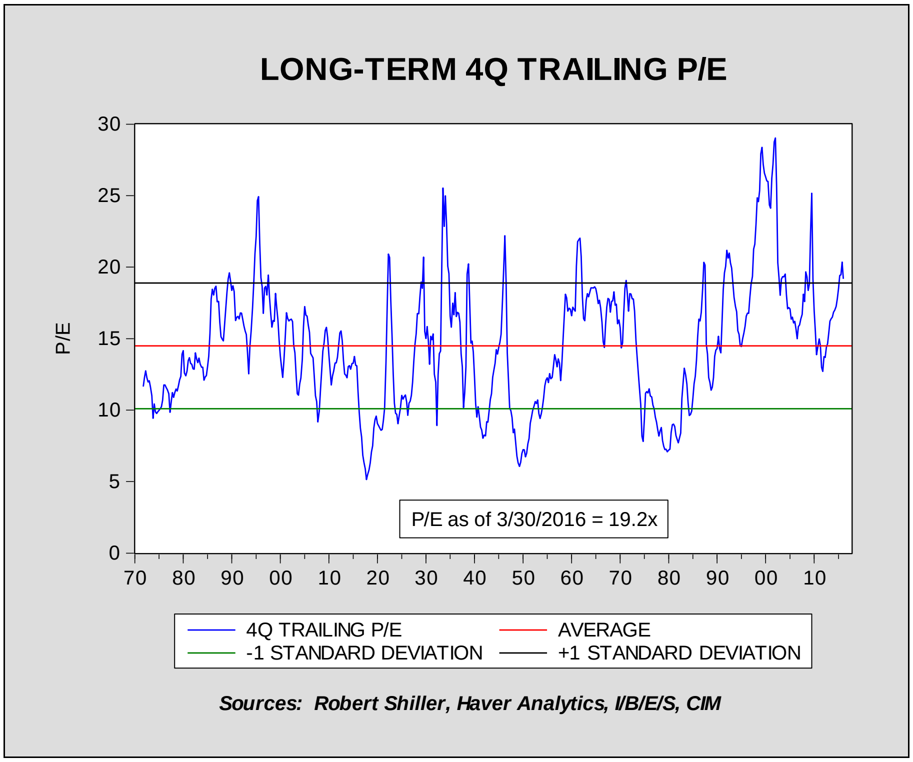


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

March 31, 2016



Based on our methodology,[3] the current P/E is 19.2x, up 0.1x from last week. Continued declines in earnings expectations and a stronger equity market, are keeping the P/E elevated.

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