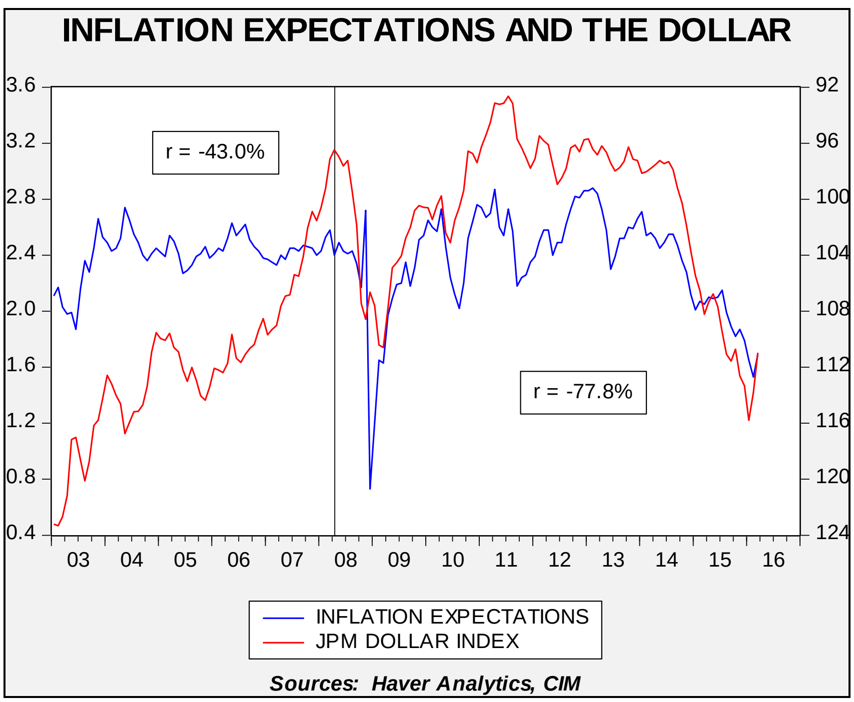
Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

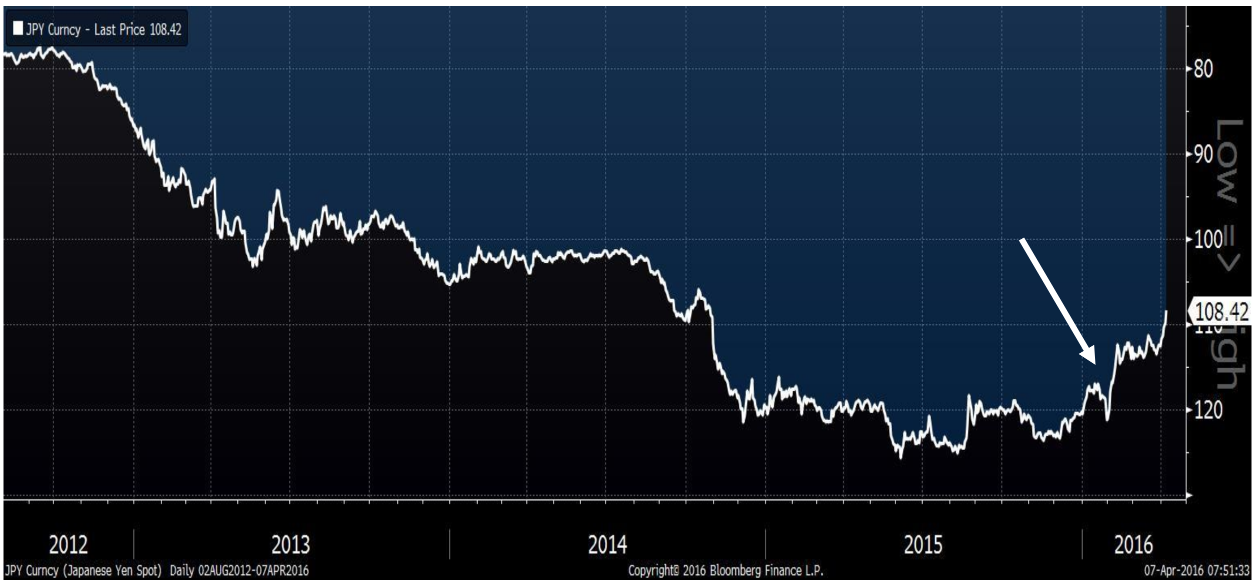
[Posted: April 7, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading down 0.6% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 0.2% from the prior close. Chinese markets were lower, with the Shanghai composite down 1.4% and the Shenzhen index lower by 1.6%. U.S. equity futures are signaling a lower opening from the previous close.

Yesterday's FOMC minutes generally confirmed what we have been hearing from committee members over the past few weeks, namely, that international concerns are worrying members and keeping policy steady. Of the 17 members on the committee, eight viewed the risks to be shifting toward slower growth, while six saw the risks as balanced between slower growth and inflation. Eleven members expected inflation to trend lower. These numbers suggest a dovish bias, so it seems unlikely that the Fed will move to raise rates this month. This chart actually captures two of the risks mentioned by Fed members recently, international developments and the weakness in market inflation projections.



This chart shows the five-year forward inflation expectations from the TIPS spread and the JPM dollar index (on an inverted scale). Since early 2008, the correlation between these two series is 77.8%; essentially, the dollar appears to be driving inflation expectations. Although we would never expect the Fed to openly target the dollar for policy purposes, in fact, weakening the dollar is probably the best remaining tool in the Fed's policy toolbox. Unfortunately for the FOMC, there are two problems with this policy. First, the exchange rate is not its policy mandate; the Treasury is in charge of exchange rate policy even though it has no tools to affect the exchange rate. Thus, targeting the dollar is not part of the Fed's Congressional mandate and could create legal trouble if it becomes an official policy goal.[1] Second, an open policy to weaken the dollar could trigger a currency war reminiscent of the 1930s. Still, if the Fed is successful in weakening the dollar (see below for more on this topic), it will reduce policy stimulus for the rest of the world, especially in Europe and developed Asia.

The JPY has strengthened considerably in recent weeks despite the BOJ's foray into negative interest rates (NIRP). The impotence of BOJ policy suggests that Fed policy is the primary driver of exchange rates in the current environment. First, a look at the JPY/USD exchange rate:



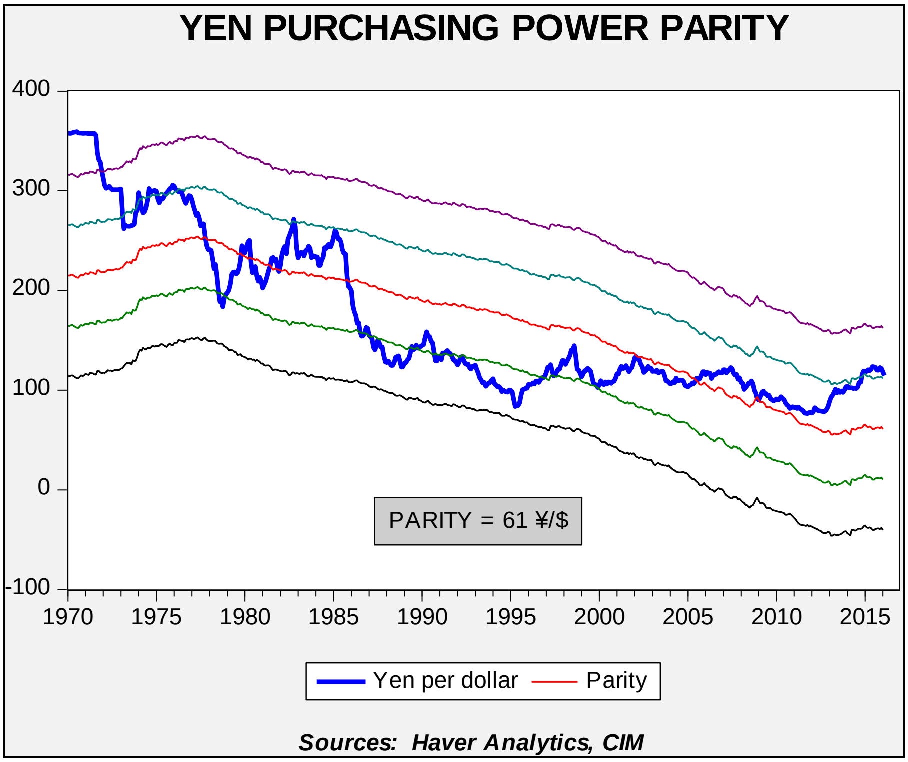
(Source: Bloomberg)

This shows the exchange rate in JPY per USD on an inverted scale. PM Abe took office in late 2012 and began Abenomics, which was a set of policies designed to boost Japanese economic growth and inflation. One of the primary tools was currency weakness. The JPY weakened in two phases, falling initially from 78 ¥/$ to over 100 ¥/$, and then, after additional stimulus, the currency took another leg down in 2014. The latter drop was more likely due to a strengthening U.S. economy and expectations of the end of Fed monetary accommodation. In January of this year, when the BOJ announced NIRP, the currency weakened (see arrow) but that drop failed to hold. Since then, the JPY has steadily strengthened. This is profoundly bad news for the Japanese economy. The forex markets are going to force some sort of reaction from the Abe government but its most effective tool, intervention, will be very controversial given that we believe the FOMC is deliberately trying to weaken the dollar. What makes it even worse is that

[1] It should be noted that other central banks do have a forex mandate. The ECB is given the task of currency stability (although to date that hasn't been defined), and the Hong Kong monetary authority's only real job is to maintain the USD/HKD peg.

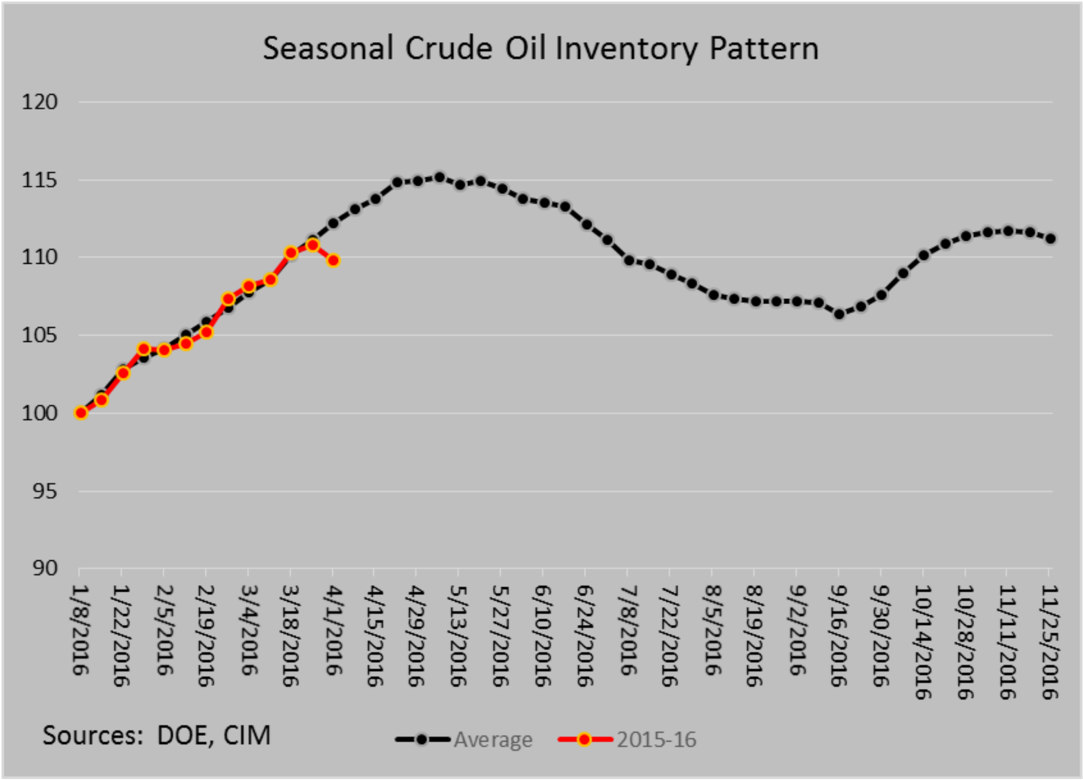
such a move would become political fodder for the U.S. presidential primary candidates who are leaning against globalization.

Overall, the JPY could have a lot further to strengthen.



This chart shows a purchasing power parity valuation mode of the JPY/USD, which uses the ratio of inflation rates to value the exchange rate. The theory suggests the economy with lower inflation should have a stronger exchange rate. Because Japan is deflating, the parity rate is much stronger than the current exchange rate; in fact, at current rates, the JPY is a full standard error weaker than forecast. Although we don't expect the Abe government to allow the JPY to continue to strengthen without a fight, the general undervalued nature of the JPY may make it difficult to prevent the strengthening trend from continuing unless the Fed moves to tighten soon.

We had a surprise draw in crude oil stocks yesterday which was clearly bullish for crude oil. A decline this time of year is unusual and may portend a lower seasonal peak. However, Bloomberg is reporting that there are pipeline problems affecting Canadian exports to the U.S. which led to the unexpected draw in stockpiles. If the problems are fixed this week, we will likely see a surge in imports next week to make up for this week's draw. This is probably why oil prices have not been able to follow through this morning.

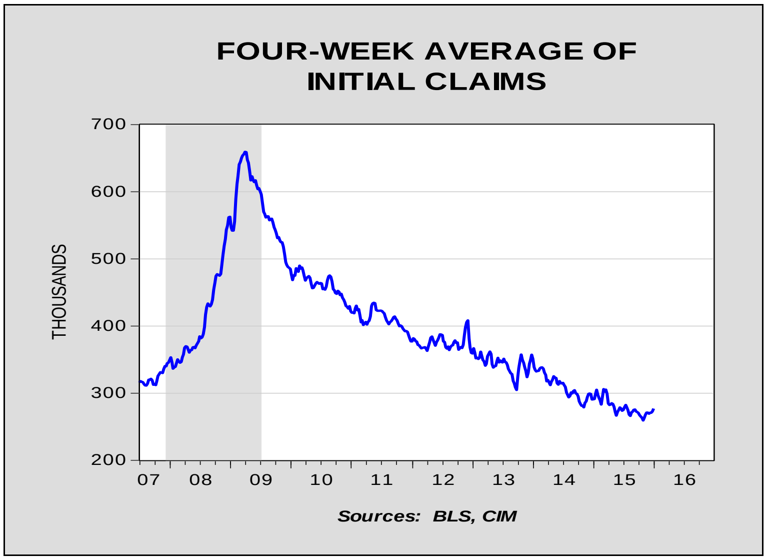


China's forex reserves rose $10 bn in March, rising to $3.213 bn. Although this is a positive number on its face as it suggests that capital fight might be easing, the market reaction has been rather modest. We will probably need to see a couple of months of reserve stability before we can declare that the PBOC has successfully contained the seeming panic of capital outflows.

Finally, the ripple effects from the Panama Wikileaks disclosures continue to mount. Iceland's government has been rocked by the revelations, with the PM resigning and the finance minister coming under fire. Britain's PM is catching flack for his family's use of offshore accounts and the U.S. Treasury is apparently looking into whether the account violates sanctions against Russia. President Putin apparently has it figured out—the leaks are a Western plot to undermine the Russian state. On the topic of Russia, the *FT* is reporting that Putin is forming a National Guard that will be completely under his control. The belief is that this body will be mostly for civil order, suggesting Putin is becoming worried about rising protests against his regime as the economy stumbles.

U.S. Economic Releases

Initial claims fell 9k to 267k, better than the 270k level forecast. Although the general trend in claims has been moving up recently, claims remain at healthy levels consistent with a healing labor market.



The chart above shows the four-week average of claims, which rose 4k to 267k. Claims still remain near their recent lows.

The table below shows the economic releases and Fed speakers scheduled for the rest of the day.

Economic releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
3:00	Consumer credit	m/m	Feb	$14.9 bn	$10.5 bn	**
Fed Speakers and Events						
EST	**Speaker or event**	**District or position**				
5:30	Yellen	Fed Chair				
9:15	George	Kansas City 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								
China	Foreign reserves	m/m	Mar	$3212.6 bn	$3202.3 bn	$3196.0 bn	**	Equity and bond neutral
EUROPE								
France	Trade balance	m/m	Feb	-€5.2 bn	-€3.9 bn	-€3.7 bn	**	Equity bearish, bond bullish
	Current account balance	m/m	Feb	-€3.9 bn	-€2.2 bn		**	Equity bearish, bond bullish
U.K.	House prices	y/y	Mar	10.1%	9.7%	9.5%	**	Equity bullish, bond bearish
	Unit labor costs	y/y	Q4	1.3%	1.7%	1.9%	**	Equity bearish, bond bullish
AMERICAS								
Brazil	General inflation	y/y	Mar	11.1%	11.9%	11.1%	***	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)	22	23	-1	Down
TED spread (bps)	41	40	1	Up
U.S. Libor/OIS spread (bps)	38	38	0	Neutral
10-yr T-note (%)	1.73	1.76	-0.03	Narrowing
Euribor/OIS spread (bps)	-25	-25	0	Neutral
EUR/USD 3-mo swap (bps)	21	21	0	Neutral
Currencies	**Direction**			
dollar	up			Falling
euro	down			Rising
yen	up			Rising
franc	down			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	$ 39.56	$ 39.84	-0.70%	Profit taking
WTI	$ 37.48	$ 37.75	-0.72%	
Natural gas	$ 1.95	$ 1.91	1.83%	Rig count falls
Crack spread	$ 17.42	$ 17.27	0.92%	
12-mo strip crack	$ 12.79	$ 12.76	0.21%	
Ethanol rack	$ 1.62	$ 1.61	0.42%	
Metals				
Gold	$ 1,238.74	$ 1,222.47	1.33%	Investment demand
Silver	$ 15.24	$ 15.07	1.09%	
Copper contract	$ 209.75	$ 214.35	-2.15%	Global demand worries
Grains				
Corn contract	$ 358.75	$ 358.00	0.21%	China outlines plan to cut planting acreage
Wheat contract	$ 461.75	$ 463.00	-0.27%	
Soybeans contract	$ 908.00	$ 908.00	0.00%	
Shipping				
Baltic Dry Freight	500	487	13	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)	-4.9	3.0	-7.9	
Gasoline (mb)	1.4	-1.3	2.7	
Distillates (mb)	1.8	-0.8	2.6	
Refinery run rates (%)	1.0%	0.3%	0.7%	
Natural gas (bcf)		8.0		

Weather

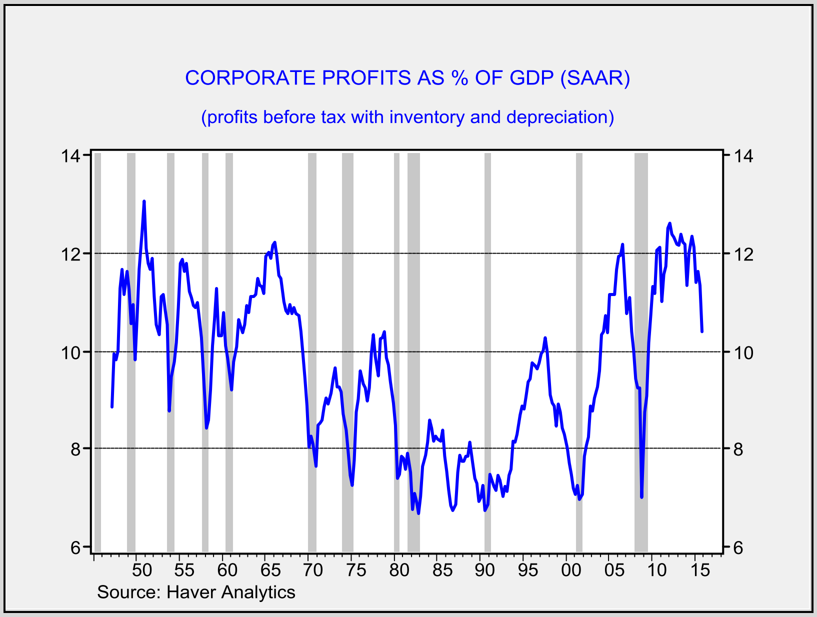
The 6-10 and 8-14 day forecasts are calling for warmer than normal temperatures for the Northwest and the Southeast. Precipitation is forecast for most of the country.

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.

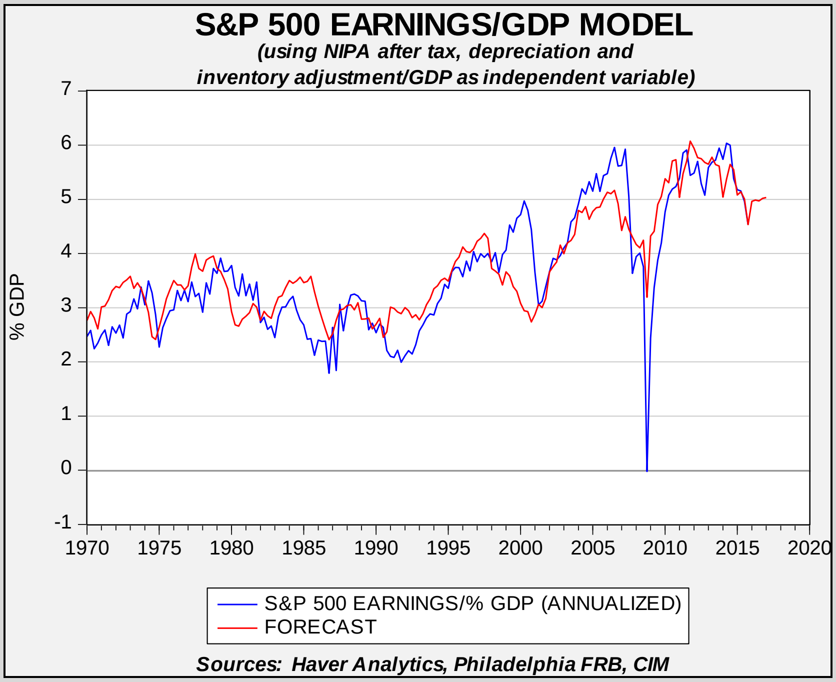
April 1, 2016

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.



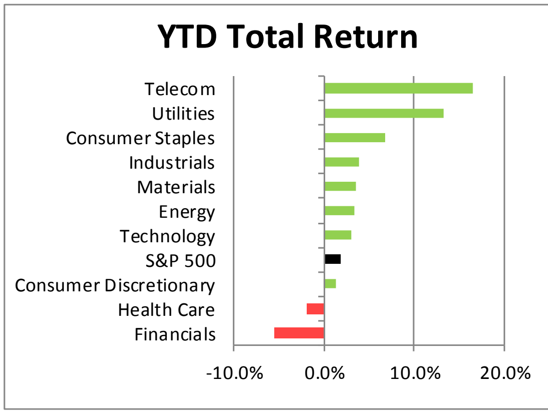
This chart shows the relationship between S&P 500 earnings as a percentage of GDP and the NIPA corporate profits after tax, depreciation and inventory adjustment. We include this variable in a larger model that we use to project S&P earnings compared to GDP. For the most part, the two series tend to 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.

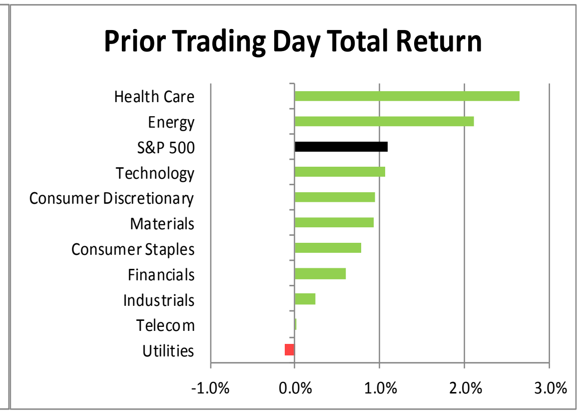
Using the NIPA profits and GDP forecasts from the Philadelphia FRB, the relationship suggests that profits will recover in 2016. In our latest update to our 2016 outlook, we reduced our earnings for the year mostly due to margin contraction.[2] The most recent GDP data generally confirms this trend. 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 4/6/2016 close)

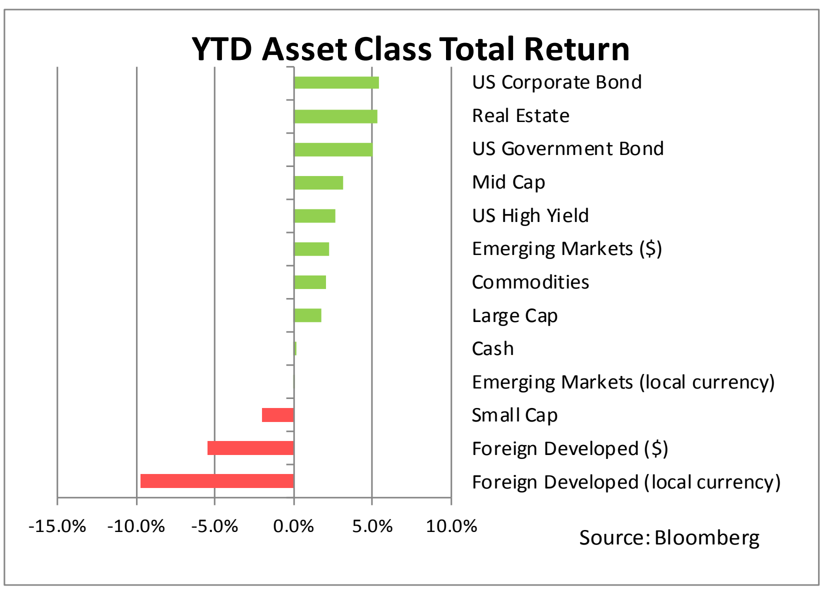




(Source: Bloomberg)

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 4/6/2016 close)

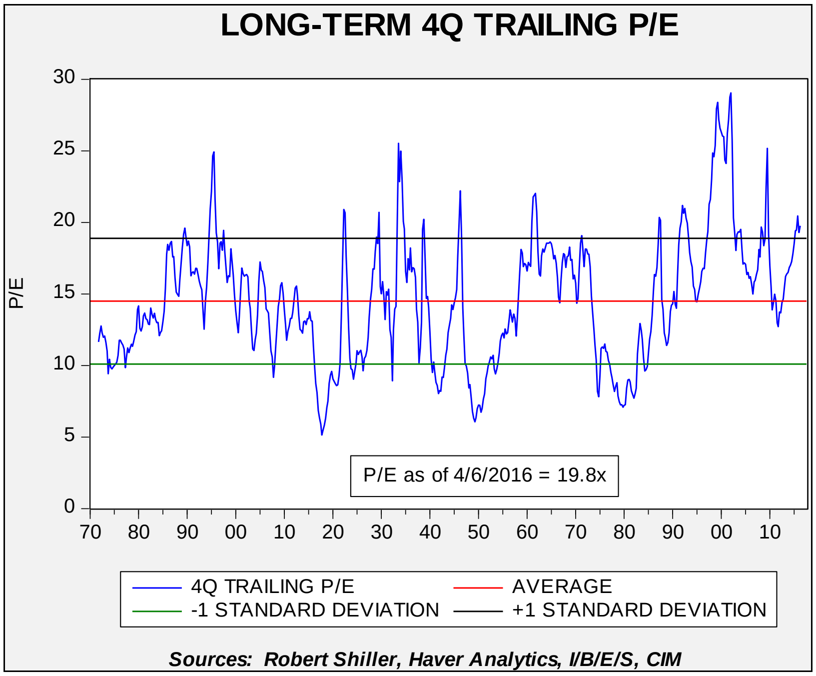


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 7, 2016



Based on our methodology,[3] the current P/E is 19.8x. This is the first reading for Q2 and it is elevated. Earnings season will kick off next week.

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.

[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 (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.