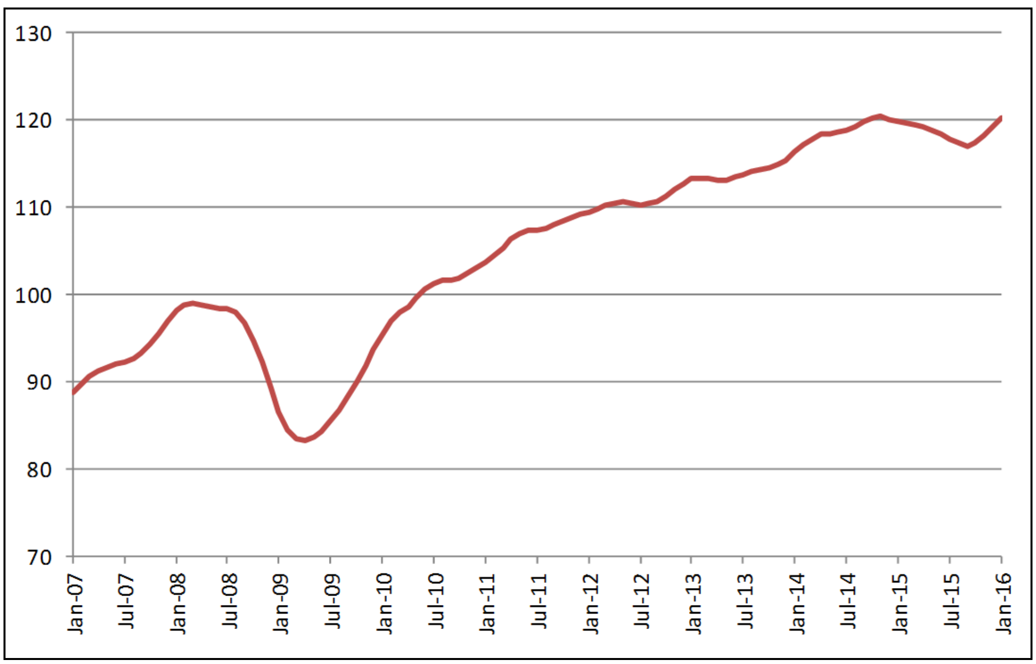
Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: April 8, 2016—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is trading up 1.4% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 0.2% from the prior close. Chinese markets were actually lower, with the Shanghai composite down 0.8% and the Shenzhen index also lower by 0.8%. U.S. equity futures are signaling a higher opening from the previous close.

The WTO released its global trade data for 2015 yesterday along with its forecasts for this year and next. The sum of imports and exports rose 2.8% last year and is expected to rise at the same pace this year, rising to 3.6% in 2017. The WTO noted that the past five years have been the slowest trade expansion in the postwar world. Although trade volumes rose 2.8%, the value of trade plunged 13% due to the dollar's strength. Container shipping volumes were flat last year.



(Source: WTO)

This chart shows container traffic on a volume basis. This indicator peaked in mid-2014 and recovered to its old highs at the end of last year.

Rank	Exporters	Value	Share	Annual % change	Rank	Importers	Value	Share	Annual % change
1	China	2275	13.8	-2.9	1	United States	2308	13.8	-4.3
2	United States	1505	9.1	-7.1	2	China	1682	10.0	-14.2
3	Germany	1329	8.1	-11.0	3	Germany	1050	6.3	-13.0
4	Japan	625	3.8	-9.5	4	Japan	648	3.9	-20.2
5	Netherlands	567	3.4	-15.7	5	United Kingdom	626	3.7	-9.4
6	Korea, Republic of	527	3.2	-8.0	6	France	573	3.4	-15.4
7	Hong Kong, China	511	3.1	-2.6	7	Hong Kong, China	559	3.3	-6.9
	- domestic exports	13	0.1	-16.2		- retained imports	134	0.8	-10.7
	- re-exports	498	3.0	-2.2					
8	France	506	3.1	-12.8	8	Netherlands	506	3.0	-14.2
9	United Kingdom	460	2.8	-8.9	9	Korea, Republic of	436	2.6	-16.9
10	Italy	459	2.8	-13.4	10	Canada a	436	2.6	-9.1
11	Canada	408	2.5	-14.0	11	Italy	409	2.4	-13.8
12	Belgium	398	2.4	-15.7	12	Mexico	405	2.4	-1.5
13	Mexico	381	2.3	-4.1	13	India	392	2.3	-15.3
14	Singapore	351	2.1	-14.5	14	Belgium	375	2.2	-17.5
	- domestic exports	174	1.1	-19.6					
	- re-exports	177	1.1	-8.7					
15	Russian Federation	340	2.1	-31.6	15	Spain	309	1.8	-13.8
16	Switzerland b	290	1.8	-6.9	16	Singapore	297	1.8	-19.0
						- retained imports c	120	0.7	-30.5
17	Chinese Taipei	285	1.7	-10.8	17	Switzerland b	252	1.5	-8.7
18	Spain	282	1.7	-13.2	18	Chinese Taipei	238	1.4	-15.7
19	India	267	1.6	-17.2	19	United Arab Emirates d	230	1.4	-8.0
20	United Arab Emirates d	265	1.6	-29.3	20	Australia	208	1.2	-12.0
21	Thailand	214	1.3	-5.8	21	Turkey	207	1.2	-14.4
22	Saudi Arabia, Kingdom of	202	1.2	-41.1	22	Thailand	203	1.2	-11.0
23	Malaysia	200	1.2	-14.6	23	Russian Federation a	194	1.2	-37.0
24	Poland	198	1.2	-10.0	24	Poland	193	1.1	-13.9
25	Brazil	191	1.2	-15.1	25	Brazil	179	1.1	-25.2
26	Australia	188	1.1	-21.9	26	Malaysia	176	1.0	-15.7
27	Viet Nam	162	1.0	7.9	27	Saudi Arabia, Kingdom of d	172	1.0	-0.9
28	Czech Republic	158	1.0	-9.7	28	Viet Nam	166	1.0	12.3
29	Austria	152	0.9	-14.5	29	Austria	155	0.9	-14.7
30	Indonesia	150	0.9	-14.8	30	Indonesia	143	0.9	-19.9
	Total of above e	**13848**	**84.0**	-		**Total of above e**	**13126**	**78.3**	-
	World e	**16482**	**100.0**	**-13.2**		**World e**	**16766**	**100.0**	**-12.2**

(Source: WTO)

This table shows the world's largest importers and exporters. Note the growth declines seen across the board. On the export side, only Vietnam showed positive growth and none of the 30 largest importers increased last year. The world's largest exporter remains China, with a 13.8% share of total exports; its exports fell 2.9% last year. The U.S. is the second largest (a cautionary note for the political class, which is becoming increasingly protectionist), but U.S. exports fell over 7% last year. Germany, the world's third largest exporter, saw the value of its exports decline by 11.0%. Also note that oil exporters suffered massive declines, with Saudi Arabia falling 41.1% and Russia off 31.6%. On the import side, the U.S. remains the world's largest importer, with a 13.8% share; the value of U.S. imports fell 4.3%.

The drop in trade is partially due to the strong dollar but that isn't the whole story. We suspect two factors are at work. First, slow U.S. economic growth is dampening global trade. Because of America's reserve currency status, the U.S. is the global importer of last resort. Deleveraging and weak economic activity is reducing America's ability to fulfill that role, leading to weaker trade. Second, without American leadership on trade, the world is slipping into mercantilism and "beggar thy neighbor" trade policies. This development not only weakens global economic growth, but it makes the world a more dangerous place. Nations that trade can still go to war with each other (the world was quite integrated before WWI), but trade does make the idea of conflict between trading powers more costly. Falling trade leads to a scramble to capture aggregate demand from other nations and fosters protectionism.

In that light, the Japanese finance minister warned that the JPY is strengthening too quickly and fear of intervention has eased some of the currency's strength today. We are leaning toward the idea that Chairwoman Yellen is using the dollar as a policy indicator, which is really bad news for the ECB and BOJ. This is a development we will be monitoring in the coming weeks (and which we discussed at length in yesterday's comment).

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**
10:00	Wholesale inventories	m/m	Feb	-0.2%	0.2%	**
Fed Speakers and Events						
EST	**Speaker or event**	**District or position**				
8:30	Dudley	New York 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								
Japan	Consumer confidence	m/m	Mar	41.7	40.1	40.5	**	Equity bullish, bond bearish
	Eco watchers survey current	m/m	Mar	45.4	44.6	45.5	*	Equity and bond neutral
	Eco watchers survey outlook	m/m	Mar	46.7	48.2	48.3	*	Equity bearish, bond bullish
EUROPE								
France	Industrial production	m/m	Feb	-1.0%	1.0%	-0.4%	***	Equity bearish, bond bullish
	Business sentiment	m/m	Mar	99.0	98.0	98.0	**	Equity bullish, bond bearish
Germany	Trade balance	m/m	Feb	€20.3 bn	€13.4 bn	€18.0 bn	**	Equity bullish, bond bearish
	Exports	m/m	Feb	1.3%	-0.6%	0.5%	**	Equity bullish, bond bearish
	Imports	m/m	Feb	0.4%	1.3%	-0.3%	**	Equity bearish, bond bullish
	Current account balance	m/m	Feb	€20.0 bn	€14.3 bn	€16.5 bn	**	Equity bullish, bond bearish
U.K.	Industrial production	m/m	Feb	-0.3%	0.2%	0.1%	***	Equity bearish, bond bullish
Switzerland	Unemployment rate	m/m	Mar	3.5%	3.4%	3.5%	***	Equity and bond neutral
	CPI	y/y	Mar	-0.9%	-0.8%	-0.9%	***	Equity and bond neutral
AMERICAS								
Canada	Unemployment rate	m/m	Mar	7.1%	7.3%	7.3%	***	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	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	37	1	Up
10-yr T-note (%)	1.73	1.69	0.04	Widening
Euribor/OIS spread (bps)	-25	-25	0	Neutral
EUR/USD 3-mo swap (bps)	22	21	1	Up
Currencies	**Direction**			
dollar	up			Falling
euro	down			Rising
yen	down			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	$ 40.96	$ 39.43	3.88%	Focus returns to production cut talks
WTI	$ 38.87	$ 37.26	4.32%	
Natural gas	$ 2.01	$ 2.02	-0.59%	Warmer weather
Crack spread	$ 17.49	$ 17.17	1.87%	
12-mo strip crack	$ 13.03	$ 12.75	2.20%	
Ethanol rack	$ 1.63	$ 1.62	0.27%	
Metals				
Gold	$ 1,232.59	$ 1,240.45	-0.63%	Equities rally, gold demand falls
Silver	$ 15.20	$ 15.22	-0.16%	
Copper contract	$ 208.10	$ 207.65	0.22%	
Grains				
Corn contract	$ 361.50	$ 361.50	0.00%	
Wheat contract	$ 460.00	$ 457.00	0.66%	
Soybeans contract	$ 906.25	$ 904.50	0.19%	
Shipping				
Baltic Dry Freight	517	500	17	
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)	12	8.0	4.0	

Weather

The 6-10 and 8-14 day forecasts are calling for warmer than normal temperatures to spread from the northwest to encompass the majority of the country. Precipitation is forecast for the western two-thirds 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 8, 2016

One of our key investment decisions in terms of asset allocation has been to avoid emerging markets. There are primarily two reasons for this call.

First, as the U.S. pulls back from its superpower position, the emerging world, which tends to be more dependent on exports for economic development, faces two significant risks.

1) Their geopolitical position becomes more tenuous because the U.S. is less likely to "keep the peace" in the world.

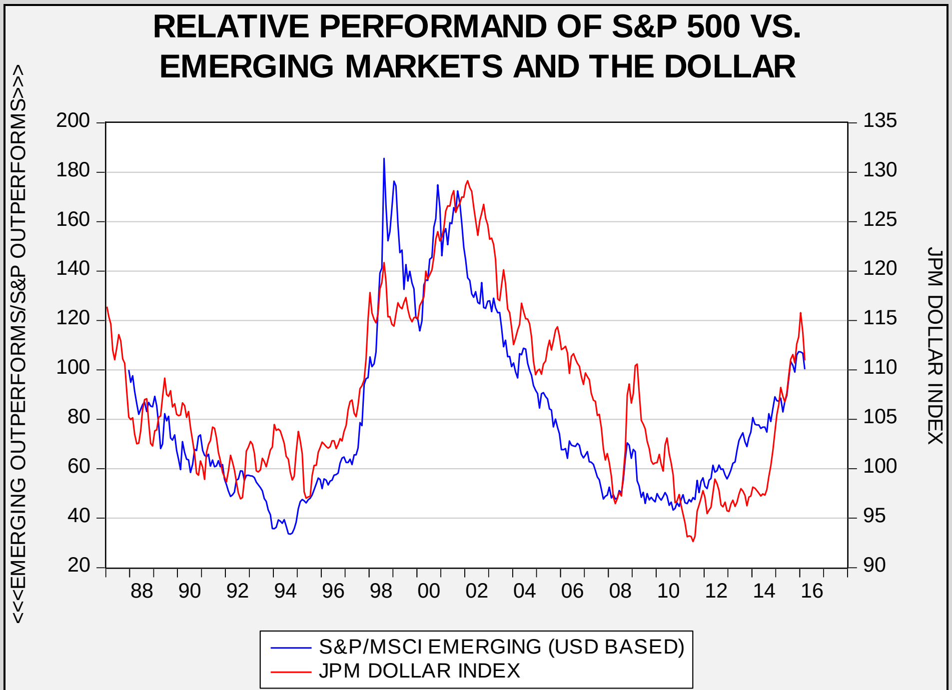
2) The American role of providing the reserve currency and acting as a consumer of last resort for emerging economy exports is at risk. Since the end of WWII, export promotion has been the most successful economic development model. This model only works if there is an importer of last resort. By providing the reserve currency, the U.S. has played that role. If America stops acting as the primary purchaser of exports, the export promotion model collapses.

Second, a stronger dollar weighs on the relative performance of emerging markets to a dollar-based investor. Again, there are two reasons for this outcome.

1) Many emerging market economies are commodity producers and a strong dollar tends to dampen demand for commodities because they are priced in dollars. A stronger dollar raises the price of commodities for all non-dollar consumers, thus lowering total demand.

2) Emerging economies often borrow in dollars because the interest rate is lower. As long as the dollar doesn't appreciate, the debt service cost on these dollar loans is lower. However, a stronger dollar will tend to lift debt service costs which hurt emerging economy growth and raise the risk of financial problems.

The dollar has been strengthening since 2014 due to the divergence of monetary policy between the Federal Reserve (Fed) and other central banks. The Fed was very aggressive in easing after the 2008-09 recession, not only keeping rates at zero but implementing three rounds of quantitative easing. The other major central banks tended to lag U.S. efforts. However, in late 2013, the Fed began to taper its additions to the balance sheet and last December the FOMC raised rates for the first time since 2006. This change in policy, coincident with other central banks becoming more aggressive in their policy accommodation, led to a stronger dollar.



Sources: Haver Analytics, Bloomberg, CIM

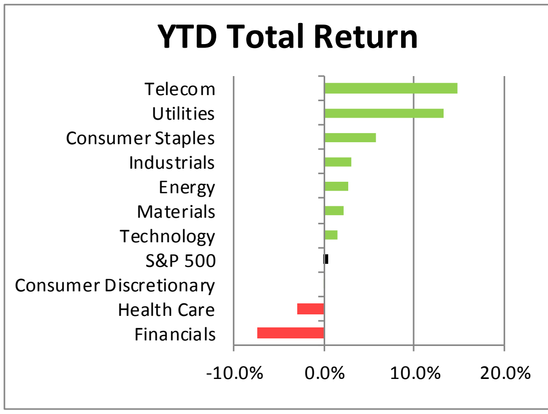
This chart shows the relative index performance of the S&P and the MSCI Emerging Market Index. When the blue line on the chart is rising, the S&P 500 is outperforming emerging markets and vice versa. The JPM dollar index is directly correlated with the relative performance of these equity indices at the 86% level. As we noted above, a stronger dollar tends to weigh on emerging market equity performance.

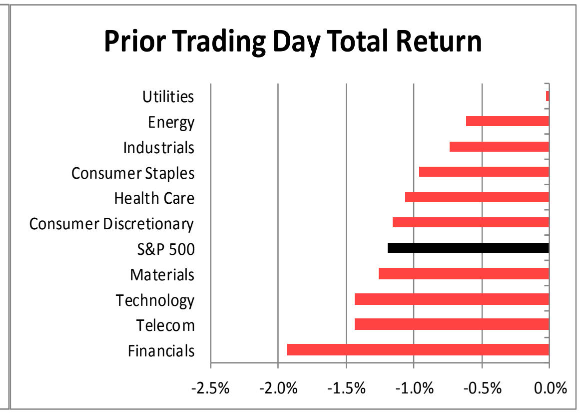
Interestingly, the dollar fell sharply last month. There is growing evidence that Fed Chairwoman Yellen is keeping policy easier than the Phillips Curve would justify; one of the factors she seems to be targeting is the dollar. It is clear that the strong dollar has weighed on net exports and the industrial sector, pressuring U.S. economic growth lower. If the Fed decides to guide the dollar lower, emerging markets will look more attractive.

The key issue for our investment committee is whether these trends are durable enough for a cyclical allocation. The longer term outlook for emerging markets is still problematic if America's foreign policy trends remain in place. That will be part of our decision process in upcoming allocation meetings.

Data Section

U.S. Equity Markets – (as of 4/7/2016 close)

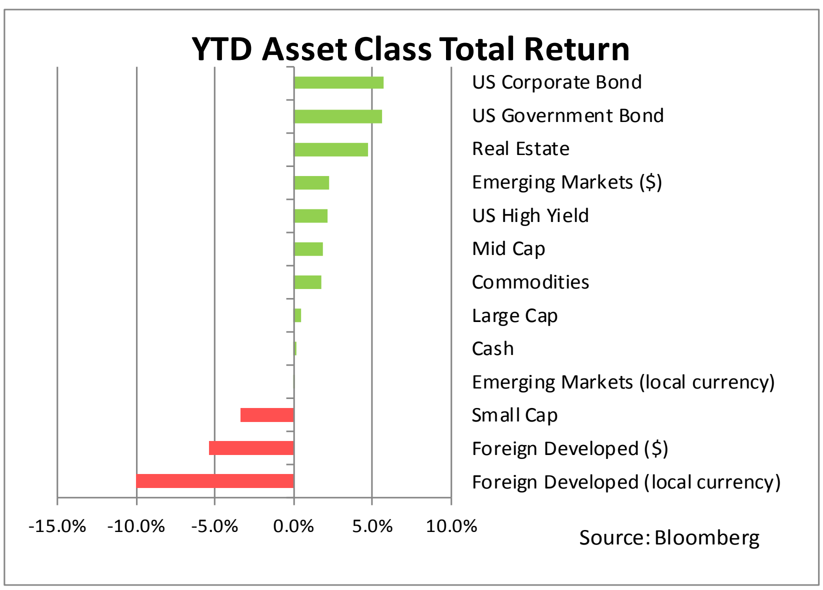




(Source: Bloomberg)

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 4/7/2016 close)

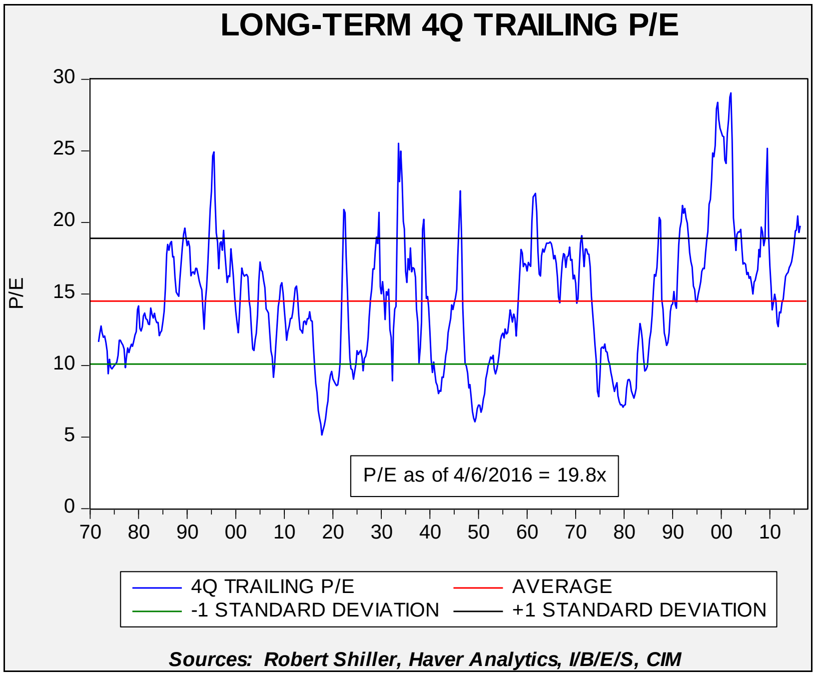


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[1] 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.

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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.