Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: August 22, 2016—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is trading lower by 0.5% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 0.4% from the prior close. Chinese markets were also down, with the Shanghai composite off 0.8% and the Shenzhen index trading lower by 1.3%. U.S. equity futures are signaling a lower opening from the previous close. With 480 companies having reported, the S&P 500 Q2 earnings stand at $29.44, higher than the $28.38 forecast for the quarter. The forecast reflects a 5.4% decline from Q2 2015 earnings. Thus far this quarter, 72.2% of companies reported earnings above forecast, while 17.1% reported earnings below forecast.

There are two items of note this morning. First, talk coming from the FOMC is that of two minds. On the one hand, several members are taking great pains to suggest that all meetings are "live." Today's weakness in equities and dollar strength is being attributed to comments from Vice Chair Fischer who said the economy is "…close to our targets" for raising rates further. Fischer appears to be in the camp that believes recent economic sluggishness is not a permanent feature but a series of temporary headwinds. This position is different than what we have heard from the San Francisco and St. Louis FRB presidents, who have suggested that sluggish growth may be more persistent and that the FOMC may need to have a much lower terminal rate target or tolerate higher than 2% inflation.

Chair Yellen will speak later this week at Jackson Hole, WY, at the annual gathering sponsored by the KC FRB. The markets do not expect Fischer and Yellen to contradict each other; if Fischer's comments are hawkish, the fear is that Yellen will reflect similar sentiments on Friday.

We do note that *WSJ* Fed whisperer Jon Hilsenrath has an article today in which he admits his earlier opposition to raising the inflation target was probably wrong. Raising the inflation target solidifies the "lower for longer" position but it also assumes that central banks can control inflation, which we think is incorrect. The intersection of aggregate supply and demand sets inflation. Monetary policy tends to affect aggregate demand but only if banks circulate the reserves (which they have not done). In a globalized and deregulated world, aggregate supply is ample, leading to a mostly flat supply curve, meaning that the economy can take lots of stimulus before price levels start to rise. That is why we have been watching the populist uprising in the West; if anything could upend the current regime of globalization and deregulation, it would be nationalism and populism. But, as long as centrists continue to control government, the current regime will probably stay in place.

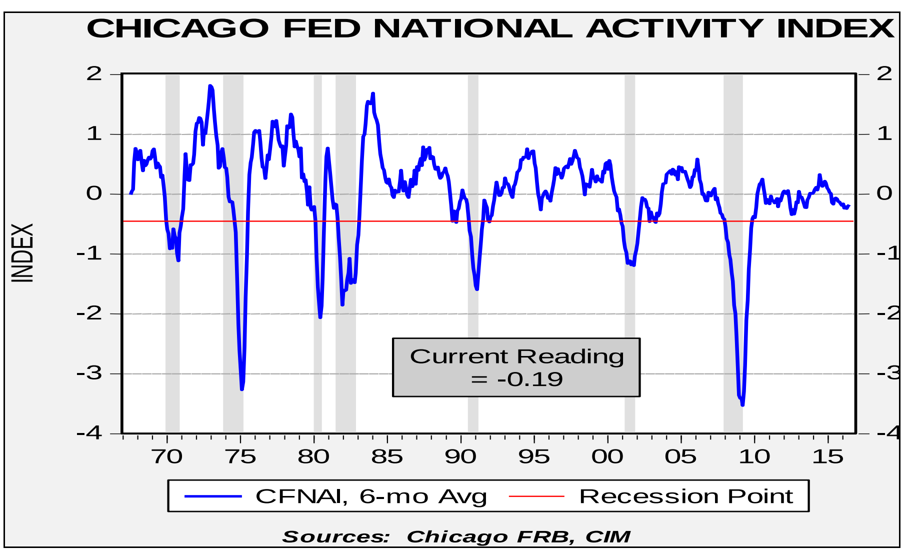
To some extent, the FOMC probably wants to inject a bit of uncertainty into the financial markets. This is a fool's errand—financial markets are calling the Fed's bluff and we doubt the FOMC will raise rates because of an elevated P/E. Thus, even if they do raise rates, we would expect a parade of Fed speakers to make it clear that a hike at one meeting doesn't necessarily signal a series of hikes. This gets us to the "two minds" problem. On the one hand, the Fed would like to raise rates a bit; on the other hand, it's becoming clear that more members are buying into the secular stagnation idea, which means the terminal rate will be lower.

In foreign central bank news, the Reserve Bank of India announced its new governor. He is Urjit Patel, a former Yale economist who spent time at the IMF in the early 1990s. He replaces Raghuram Rajan, who had fallen out of favor with the Modi regime. Patel is said to be an inflation hawk, so we don't expect much change in policy. We also note that BOJ Governor Kuroda said over the weekend that there is "sufficient chance" of further easing at the next policy meeting. It is unclear how much more could be done, absent of direct fiscal financing.

Second, we are seeing lower oil prices this morning. The latest commitment of traders' data confirms that the rally over the past two weeks has been nothing more than massive short covering. In Nigeria, the rebel group that has cut the nation's output by about a third has agreed to a ceasefire and is "ready for dialogue." We suspect that the government will have to pay off these rebels in order to lift output; that was the strategy of the former government. In addition, Iraq has announced a deal with the Kurds to lift Iraqi oil exports by 5% in the next few days. The Northern Iraqi Oil Company owns the oil but uses pipelines that move through Kurdish territory. There was a payment dispute but that has apparently been resolved. Finally, Reuters is reporting that Chinese refiners are boosting exports to record levels. Diesel exports are up 182% from last year and gasoline shipments are up 145%. We expect to see oil prices ease back toward recent lows in the coming weeks as the summer driving season in the U.S. comes to a close.

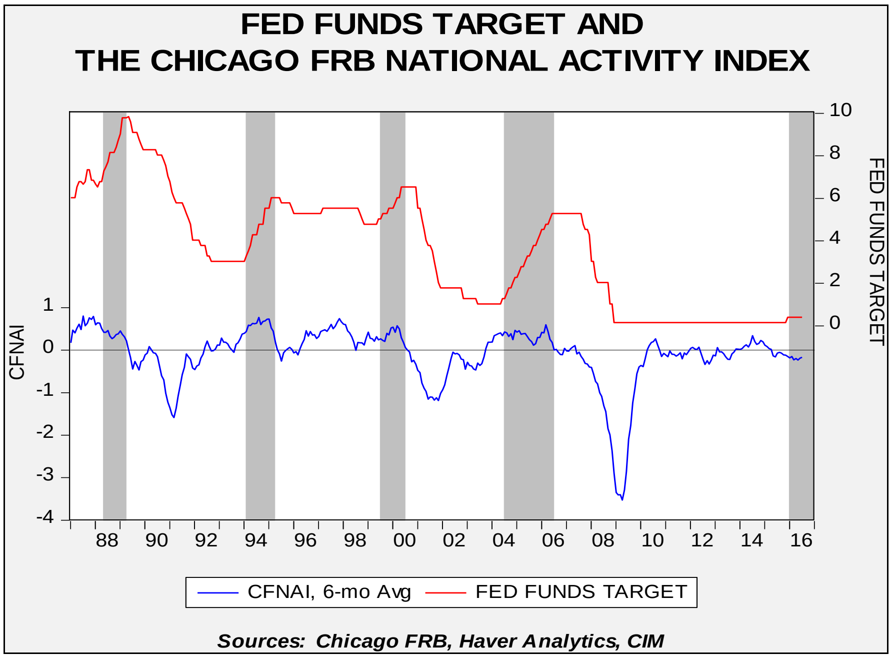
U.S. Economic Releases

The Chicago FRB National Activity Index came in stronger than forecast but was offset by revisions. The index for July was 0.27, higher than the 0.20 forecast, but June was revised lower to 0.05 from 0.16.



We prefer to smooth the raw data with a six-month moving average. The data are consistent with what we have been seeing for some time—the economy is continuing to exhibit below-trend growth but does remain above recession levels.

This index is one of our favorite indicators because it is monthly and broad based. Although Fed members continue to talk about tightening, the usual behavior between the Chicago FRB National Activity Index and monetary policy would suggest they should do nothing.



In the previous four tightening cycles, the index was well above zero when rate increases began. The only way rate hikes can be justified now, based on this relationship, is if the policy rate is too low even accounting for current economic weakness.

There are no other releases or Fed speakers scheduled for today.

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	Department store sales	y/y	Jul	-0.1%	-3.5%		**	Equity bullish, bond bearish
	Convenience store sales	y/y	Jul	0.3%	0.8%		*	Equity bullish, bond bearish
EUROPE								
Switzerland	M3	y/y	Jul	2.7%	2.5%		*	Equity and bond neutral
AMERICAS								
Canada	Wholesale trade	m/m	Jun	0.7%	1.9%	0.1%	**	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)	82	81	1	Up
3-mo T-bill yield (bps)	30	30	0	Neutral
TED spread (bps)	52	51	1	Widening
U.S. Libor/OIS spread (bps)	43	42	1	Neutral
10-yr T-note (%)	1.58	1.58	0.00	Up
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	37	37	0	Down
Currencies	Direction			
dollar	up			Down
euro	down			Neutral
yen	down			Up
franc	down			Neutral

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	Explanation
Energy Markets				
Brent	$49.44	$50.88	-2.83%	Rising Nigerian, Iraqi exports
WTI	$47.26	$48.52	-2.60%	
Natural Gas	$2.66	$2.58	2.75%	
Crack Spread	$14.89	$15.12	-1.48%	
12-mo strip crack	$13.34	$13.54	-1.43%	
Ethanol rack	$1.59	$1.59	0.00%	
Metals				
Gold	$1,335.40	$1,341.47	-0.45%	Higher dollar, tighter Fed policy
Silver	$18.91	$19.31	-2.08%	Higher dollar, tighter Fed policy
Copper contract	$215.05	$217.75	-1.24%	
Grains				
Corn contract	$ 342.25	$ 343.75	-0.44%	
Wheat contract	$ 440.50	$ 444.75	-0.96%	Eastern European harvest is coming in strong
Soybeans contract	$ 1,006.75	$ 1,004.50	0.22%	
Shipping				
Baltic Dry Freight	683	682	1	

Weather

The 6-10 day forecast is calling for warmer and drier than normal temperatures for the East Coast, with the 8-14 day projecting normal temps for the nation's midsection and hot weather for both coasts. Precipitation is expected in the Midwest as well. Tropical Depression Fiona has moved into the mid-Atlantic but remains "remarkably resilient." It is not expected to affect anything but open Atlantic shipping. This activity is expected to slow as it moves northwest. There are two disturbances between 10° and 5° latitude which could become depressions in the next few days.

Asset Allocation Weekly Comment

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.

August 19, 2016

U.S. equity markets are showing impressive strength.

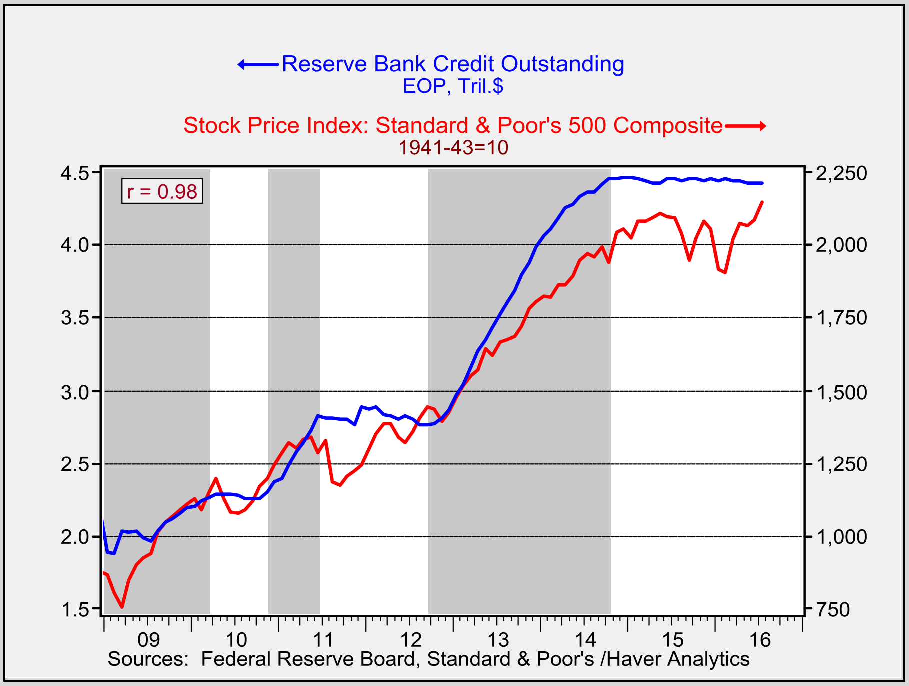
(Source: Bloomberg)

This chart shows the S&P 500 Index along with the 200-day moving average. The white horizontal line shows recent highs; note that the S&P 500 has recently moved above these highs. Technically, this is a "breakout" and suggests the market will likely move higher.

Still, this rally has occurred with slowing earnings growth. Although S&P 500 operating earnings are coming in better than expected, they are still down about 2% from last year.[1] Rising equity prices with falling earnings implies a rising P/E (confirmed below). Without an increase in future earnings, equity markets are becoming increasingly pricey.

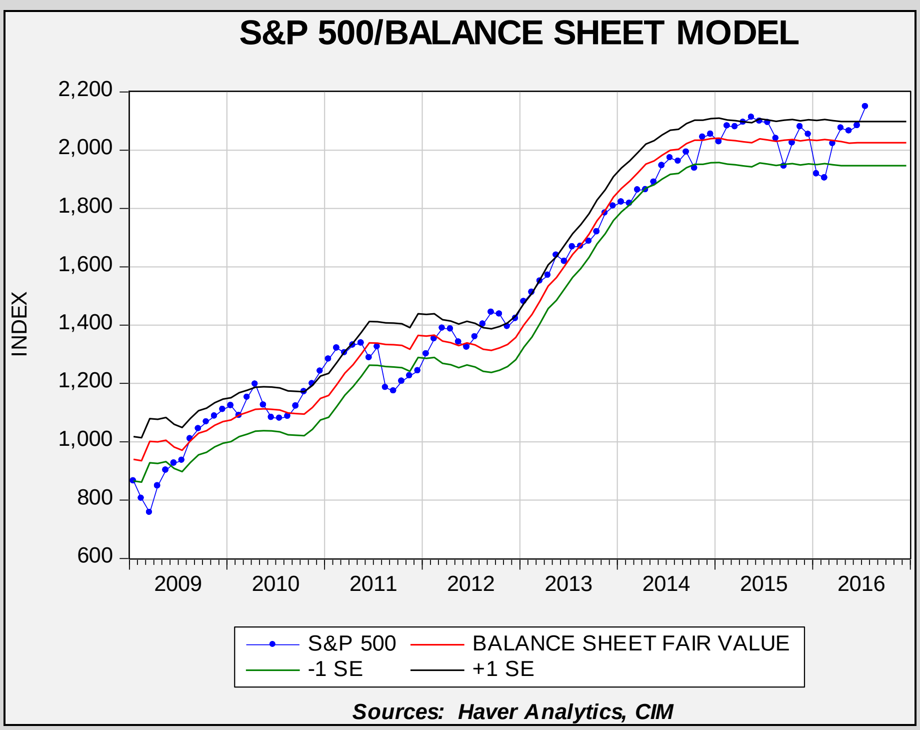
One of our more reliable indicators during this cyclical bull market has been the relationship between the S&P 500 and the Federal Reserve's balance sheet.

[1] Using Thompson-Reuters' calculation of operating earnings.



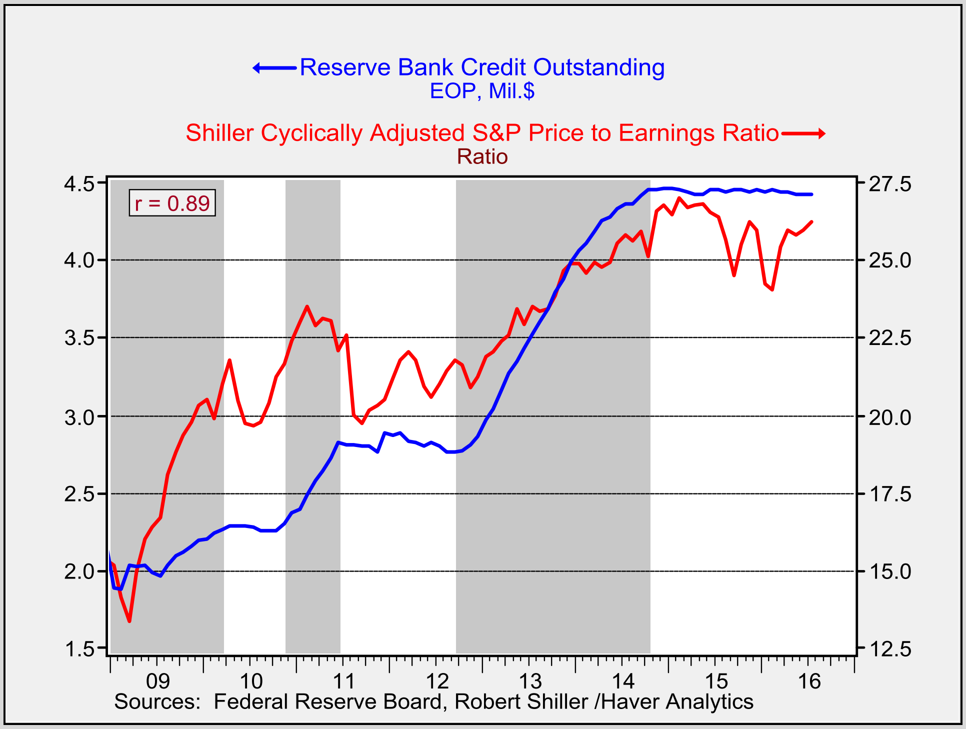
This chart shows the size of the Fed's balance sheet along with the S&P 500 Index. Periods of quantitative easing (QE) are shown in gray. Note that since the recovery began in 2009, equity values tended to rise during and in anticipation of a balance sheet expansion and move sideways during periods where the balance sheet remained steady.

This chart shows a regression of the relationship.



This chart shows the fair value for the S&P 500, based on the Fed's balance sheet, along with standard error bands. Over the past seven years, the upper standard error band has been a signal that markets are overvalued; dips to the lower standard error bank suggest a more favorably valued equity market.

We are currently well above one standard error which raises three possibilities. The first is that equities are overvalued and primed for a pullback (fair value is 2,025 and the lower standard error line is 1,947). The second is that the relationship was always spurious and the recent rise is uncorrelated. The third is that there are other variables that are now more important which can justify the recent rise. We disagree with the second possibility because the relationship between the Fed's balance sheet and the Shiller P/E is also quite strong, suggesting that unconventional monetary policy boosted investor sentiment and supported a higher P/E.



This chart shows the relationship of P/E ratios and the balance sheet; note that the P/E rises sharply during periods of QE. We believe this relationship offers support for the notion that unconventional monetary policy lifted investor sentiment and P/E ratios remained steady in its absence.

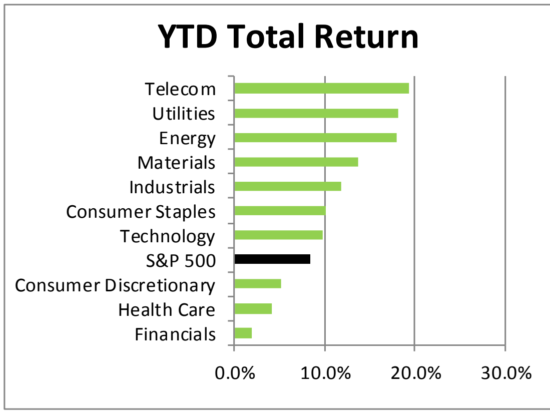
However, the third possibility does remain—there are new factors that are boosting equities. We note the equity markets rallied on Friday's strong employment data. However, the historical record on the relationship of employment and equities is mixed. Clearly, an improving labor market signals that a recession isn't imminent. But, when the labor market becomes very strong, it often triggers tighter monetary policy. At present, the financial markets do not expect tighter policy until December at the earliest. Thus, at least in the short run, the equity markets may be in a "sweet spot" where better growth may lift top line revenues without triggering tighter policy.

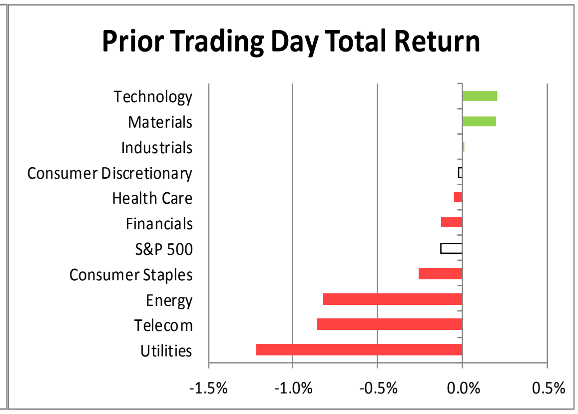
However, these favorable conditions may not last. Therefore, our base case is that equities are fully valued but a correction may not be imminent.

At the same time, equities are not cheap and could be vulnerable to exogenous issues, such as the U.S. presidential elections and terrorism. As a result, we would not be surprised to see a modest correction in the coming months but, as long as a recession is avoided (which we expect), a major pullback isn't likely.

Data Section

U.S. Equity Markets – (as of 8/19/2016 close)

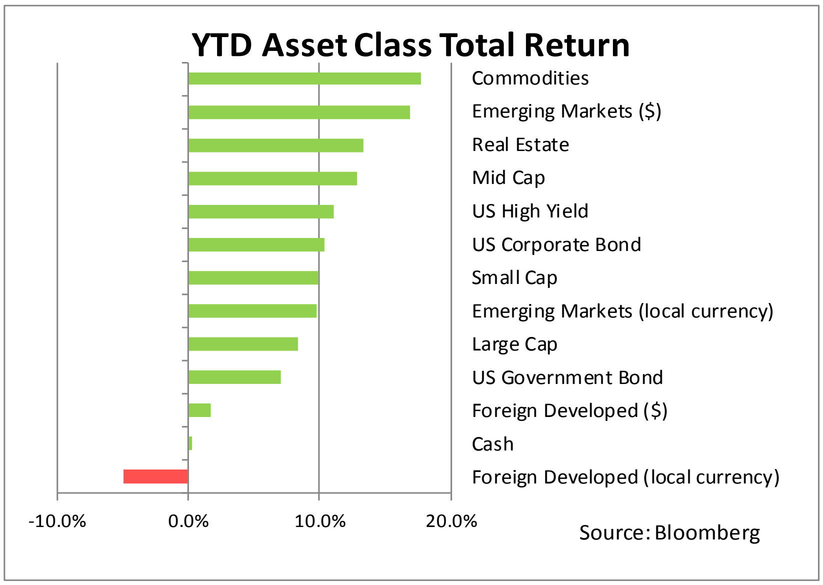




(Source: Bloomberg)

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 8/19/2016 close)

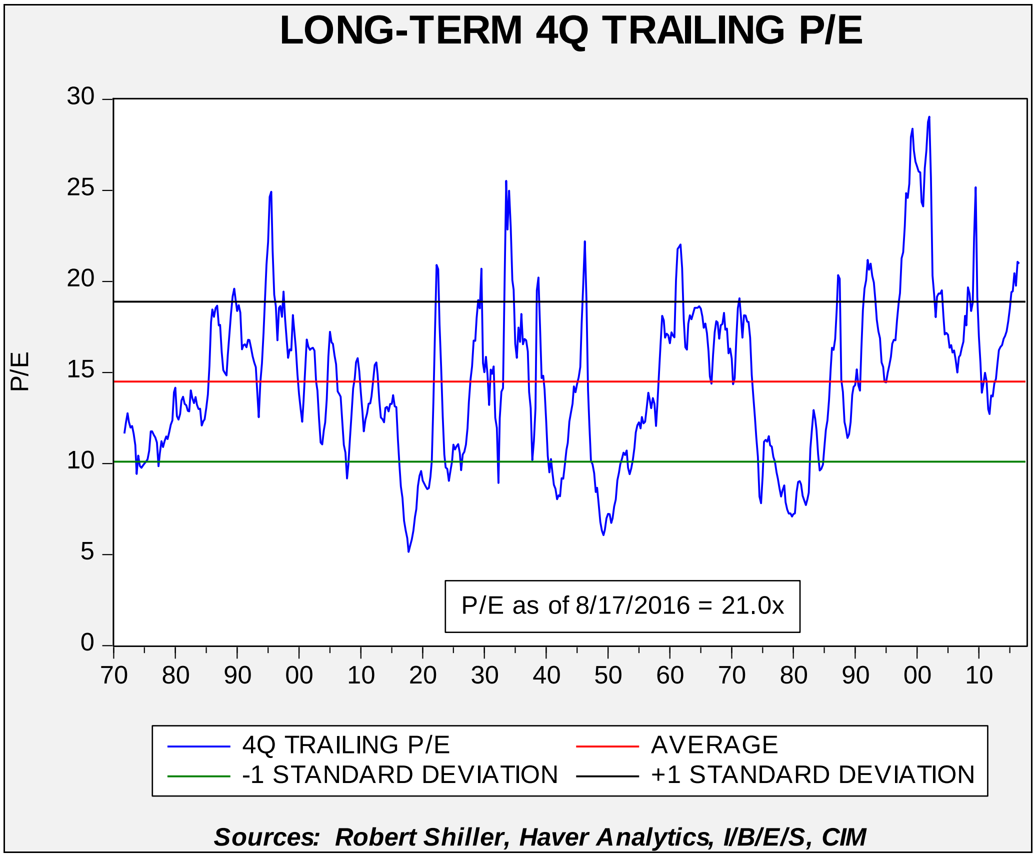


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

August 18, 2016

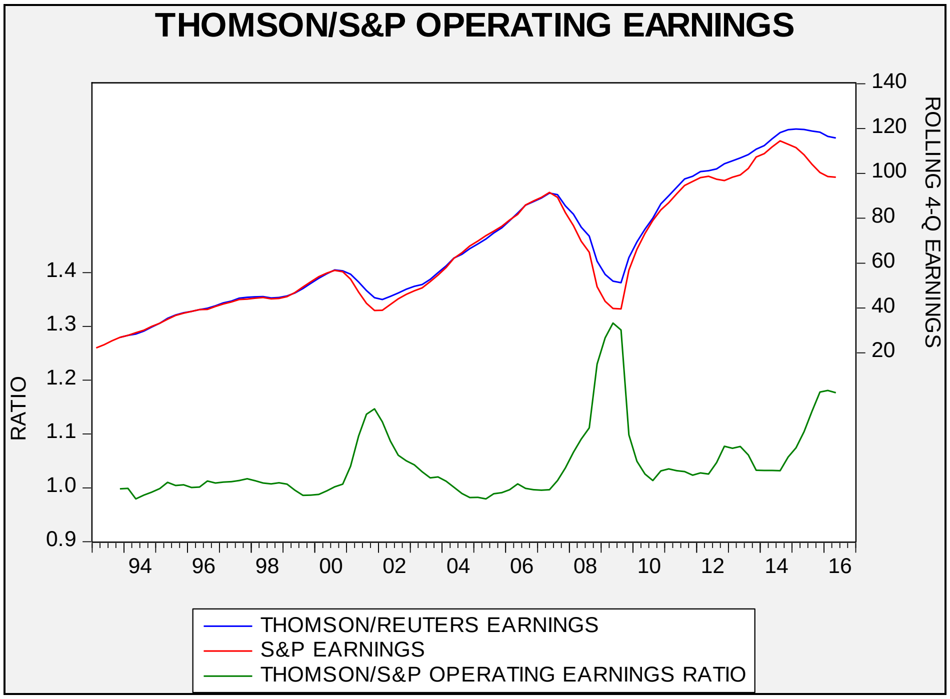


Based on our methodology,[2] the current P/E is 21.0x, up 0.6x from last week.

Every week we update the rolling P/E for the S&P 500. Our source for the history of operating earnings comes from S&P. However, Thomson/Reuters also provides operating earnings data and I/B/E/S earnings estimates also come for the same source. As noted in the footnote below, we calculate the P/E using history and expectations. Once the number of companies reporting

[2] 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 (Q4 and Q1) and two estimate (Q2 and Q3). 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.

exceeds 90%, Haver Analytics, our primary data aggregator, provides an estimate for the latest quarter from S&P. This has resulted in a sharp jump in the P/E to 21.0x because we are now including two quarters of actuals and one quarter of estimates from S&P and one quarter of estimates from I/B/E/S. As we noted earlier this year in an AAW, we are seeing a sharp divergence between these two data sources.



Most of the time, the two series track closely but they usually diverge during recessions or periods of economic stress. The lower line on this chart shows the current ratio between the two, which is quite elevated. This is something of a warning sign for equities; in the past, a ratio this high tended to signal a significant pullback in equities. On a rolling four-quarter basis, through Q2, Thomson-Reuters reports earnings of $115.76; S&P reports $98.36. We tend to trust S&P more but the common discussion in the financial media uses Thomson-Reuters. Investors should be aware of the current divergence. It does appear that the two series eventually equalize and most of the movement comes from the S&P source. However, in the two prior periods when the ratio was this elevated, the improvement also came with a bear market in stocks.

The bottom line is that the strength we are seeing in equities is mostly coming from multiple expansion and using Thomson-Reuters' data may underestimate the degree of reliance on multiple growth. As long as Fed policy remains accommodative, the likelihood of equity weakness is low, but it also suggests that conditions are becoming increasingly vulnerable to modest changes in policy.

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.