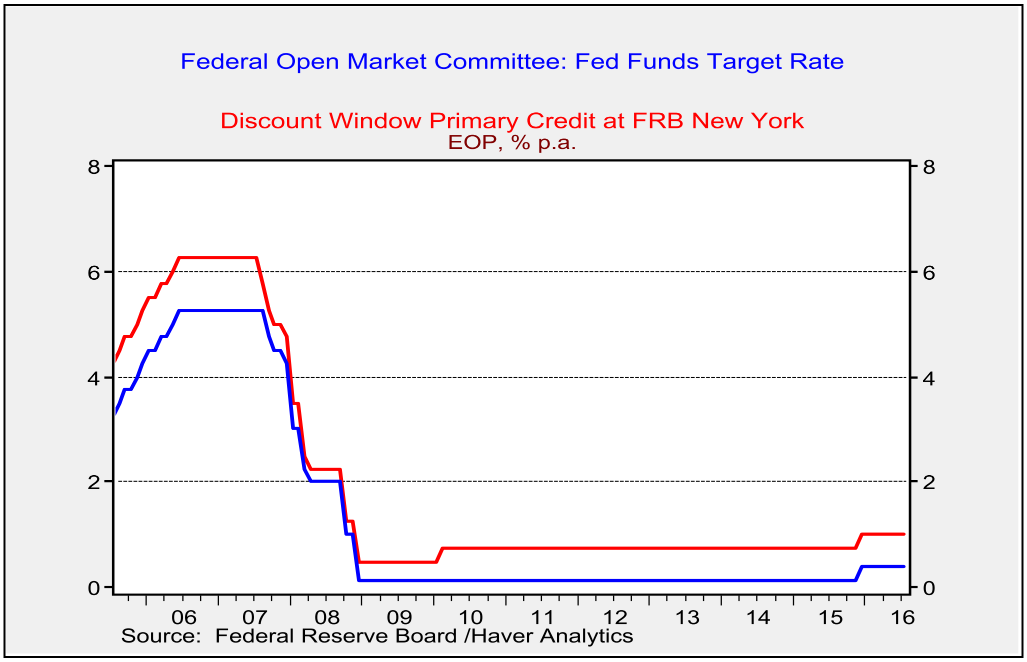
Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: August 24, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading higher by 0.8% from the last close. In Asia, the MSCI Asia Apex 50 closed down by 0.7% from the prior close. Chinese markets were mixed, with the Shanghai composite down 0.1% and the Shenzhen index trading higher by 0.3%. U.S. equity futures are signaling a higher opening from the previous close. With 482 companies having reported, the S&P 500 Q2 earnings stand at $29.45, higher than the $28.38 forecast for the quarter. The forecast reflects a 5.4% decline from Q2 2015 earnings. Thus far this quarter, 72.3% of companies reported earnings above forecast, while 17.0% reported earnings below forecast.

Late summer doldrums are upon us. Financial markets are quiet; the VIX is falling as investor fears dissipate. About the only concern out there is Fed policy. As we noted yesterday, Chair Yellen speaks on Friday. She is not taking questions and her topic is on the toolbox the central bank has to operate policy. Although there is ample room to become restrictive by raising rates, the concern is what will the Fed do if the economy rolls over? With the policy rate just off zero, the Fed would hit ZIRP in short order. A recent paper from the FOMC's staff economists suggests that the U.S. central bank will resume QE and forward guidance if it needs to stimulate but will likely avoid negative interest rates. We doubt Chair Yellen will deviate much from this script. Broader questions about long-term growth and inflation prospects will probably be dealt with in only the broadest of terms. The Fed could consider changing its inflation target, as San Francisco FRB President Williams suggested last week, but we would expect Yellen to intimate that although this is a possible response, it carries risk and would only be done after ample consideration.

There was some interesting news on the FOMC front in the minutes that we missed in earlier comments. Eight of the 12 regional banks requested a discount rate hike. It should be noted that the nature of the discount rate changed in 2002. Prior to the regulatory change, the discount rate was lower than fed funds. The former was designed as an emergency rate for a bank in trouble; banks that were OK simply used fed funds. There was a stigma attached to borrowing at the discount window as it signaled the bank was in trouble. Thus, it was decided that the discount rate would be used as a penalty rate to give banks incentives to use fed funds. With the banking system drowning in excess reserves, the need to borrow at the discount window is low. However, the fact that eight regional banks voted to lift the rate does suggest growing sentiment among the presidents to lift the fed funds target. Yellen may be forced to allow a hike sooner than we (and the market) have been anticipating. We note that there were nine votes to raise the discount rate at the November FOMC meeting last year, and the rate hike occurred at the next meeting.



Finally, on a geopolitical note, Turkish armored units have crossed the border into Syria, supported by Turkish and U.S. air assets. Ostensibly, the attack is on IS but it does appear that the operation is also designed to push Kurdish elements out of the area. At the same time, the area around al-Hasakah has been ceded to the Kurds. According to the *NYT*, the Assad government has declared a ceasefire with the Kurds in this northeastern region of Syria. The regions are indicated by the boxes below.

(Source: Google)

We suspect the Obama administration is coordinating with Turkey against some Kurdish elements as a way to maintain relations with Erdogan. Also of note, *Stars and Stripes* is reporting that Turkey is "open" to allowing Russian warplanes to operate from Incirlik air base, the same base the U.S. has used for years for Middle East operations. It should be noted that some 50 U.S. nuclear warheads are on this airbase. Although it isn't getting much press, Russian influence in the Middle East is growing and Turkey is becoming a less reliable U.S. ally.

U.S. Economic Releases

Mortgage applications fell 2.1% for the most recent reporting week, with purchases down 0.3% and refinancing down 3.2%. We are entering a seasonally slow home sales period as many buyers try to complete the purchase before the school year begins. Refinancing activity was weak as the 30-year refinancing rate rose 3 bps to 3.67%.

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

Economic releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Existing home sales	m/m	Jul	-1.1%	1.1%	**

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	LEI	m/m	Jun	99.2	98.4		**	Equity and bond neutral
	Coincident index	m/m	Jun	111.1	110.5		**	Equity bullish, bond bearish
EUROPE								
Germany	GDP	y/y	Q2	3.1%	3.1%	3.1%	***	Equity and bond neutral
AMERICAS								
Brazil	CPI	y/y	Aug	9.0%	8.9%	9.0%	***	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)	83	82	1	Up
3-mo T-bill yield (bps)	31	30	1	Up
TED spread (bps)	52	52	0	Neutral
U.S. Libor/OIS spread (bps)	43	43	0	Neutral
10-yr T-note (%)	1.55	1.55	0.00	Neutral
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	41	39	2	Up
Currencies	**Direction**			
dollar	up			Down
euro	down			Neutral
yen	down			Up
pound	up			Down
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	$49.32	$49.96	-1.28%	Domestic inventories expected to rise
WTI	$47.18	$48.10	-1.91%	
Natural Gas	$2.77	$2.76	0.43%	
Crack Spread	$13.56	$12.91	5.08%	
12-mo strip crack	$13.65	$13.44	1.51%	
Ethanol rack	$1.59	$1.59	-0.23%	
Metals				
Gold	$1,329.83	$1,337.56	-0.58%	Higher dollar, awaiting Yellen speech on Friday
Silver	$18.83	$18.82	0.05%	
Copper contract	$211.10	$212.60	-0.71%	Ample global inventories
Grains				
Corn contract	$ 335.75	$ 337.25	-0.44%	
Wheat contract	$ 426.00	$ 427.50	-0.35%	Oversupply concerns
Soybeans contract	$ 1,007.50	$ 1,013.50	-0.59%	
Shipping				
Baltic Dry Freight	692	687	5	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		0.5		
Gasoline (mb)		-1.3		
Distillates (mb)		0.1		
Refinery run rates (%)		-0.6%		
Natural gas (bcf)		21.0		

Weather

The 6-10 and 8-14 day forecasts are calling for warmer and wetter than forecast conditions for the eastern two-thirds of the country. A broad low-pressure area has moved over the Leeward Islands and is heading toward the Bahamas and Puerto Rico. This activity has a high chance of becoming a cyclone over the next two days, but it is not expected to enter the Gulf of Mexico. Tropical Storm Gaston continues moving northwest from its current location in the central Atlantic. TS Gaston is expected to slow as it moves over cooler waters.

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.

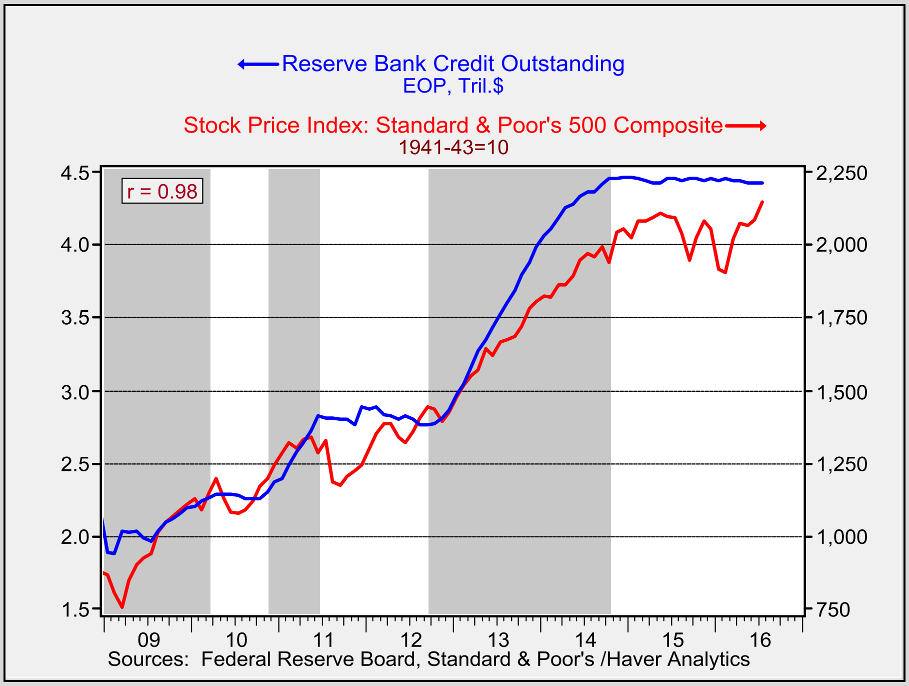
(Source: Bloomberg)

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.

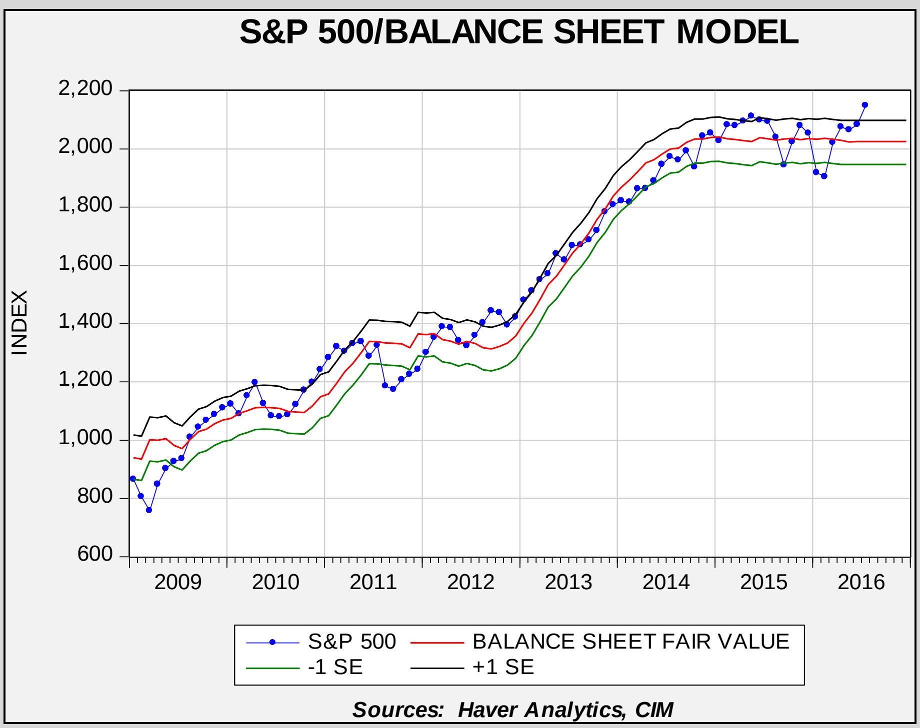
One of our more reliable indicators during this cyclical bull market has been the relationship between the S&P 500 and the Federal Reserve's balance sheet.

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



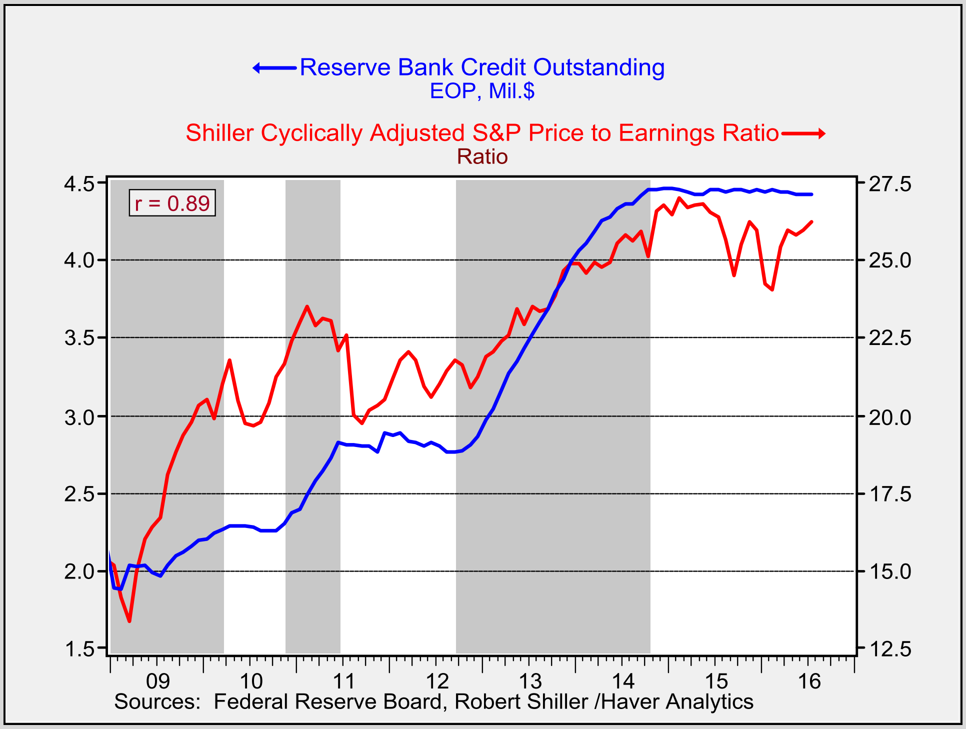
This chart shows the size of the Fed's balance sheet along with the S&P 500 Index. Periods of quantitative easing (QE) are shown in gray. Note that since the recovery began in 2009, equity values tended to rise during and in anticipation of a balance sheet expansion and move sideways during periods where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

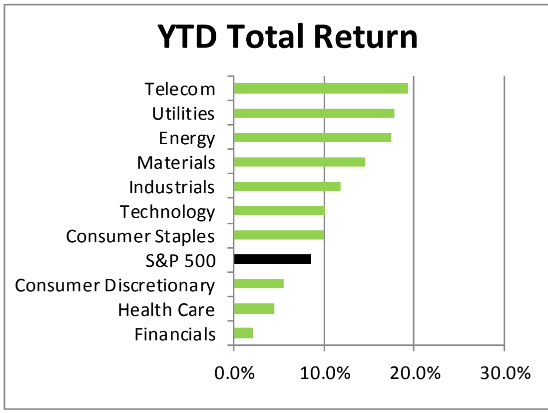
However, the third possibility does remain—there are new factors that are boosting equities. We note the equity markets rallied on Friday's strong employment data. However, the historical record on the relationship of employment and equities is mixed. Clearly, an improving labor market signals that a 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.

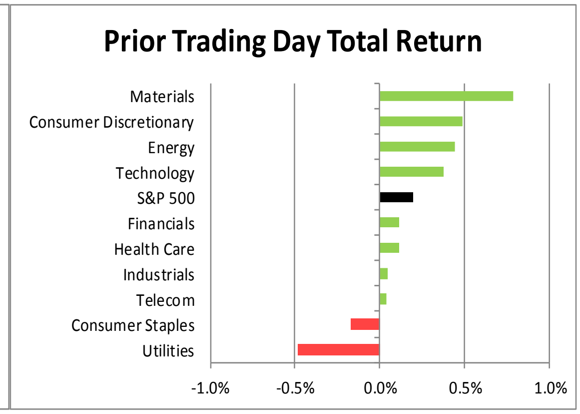
However, these favorable conditions may not last. Therefore, our base case is that equities are fully valued but a correction may not be imminent.

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 8/23/2016 close)

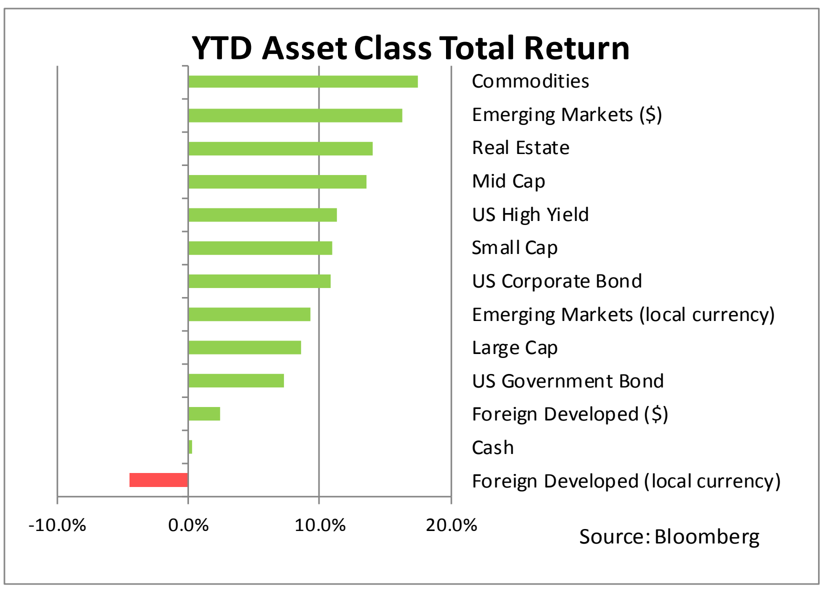




(Source: Bloomberg)

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 8/23/2016 close)

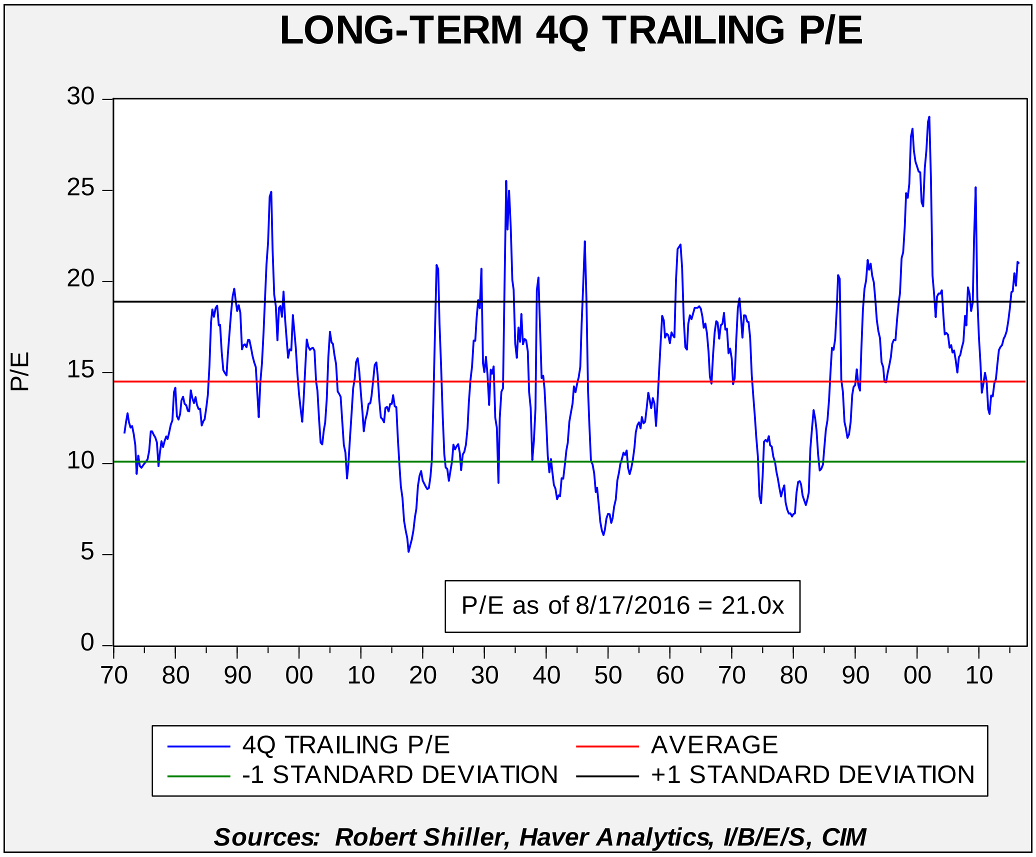


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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



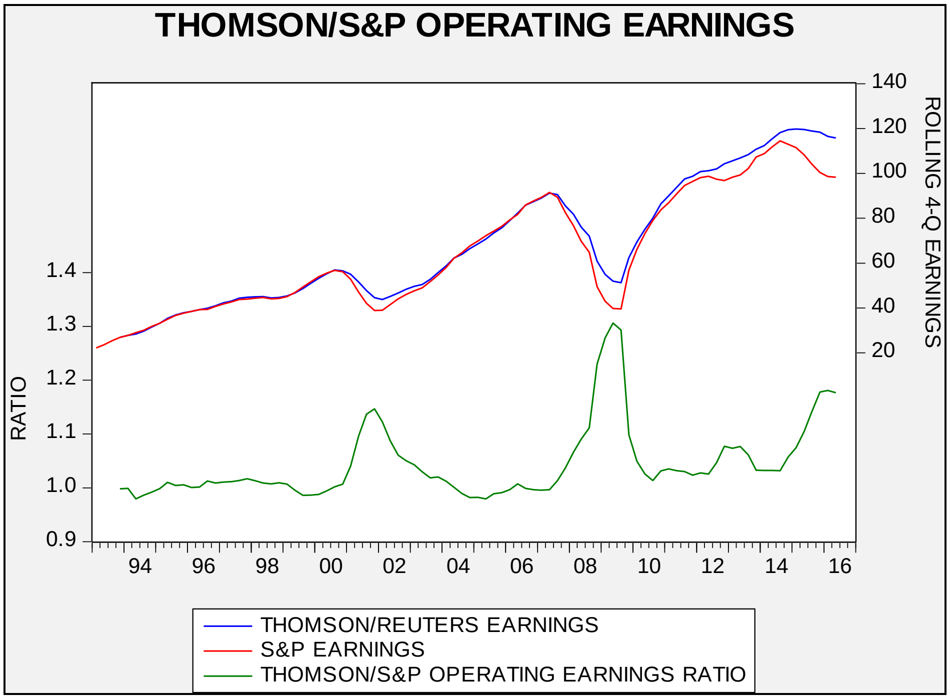
Based on our methodology,[2] the current P/E is 21.0x, up 0.6x from last week.

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.