Confluence INVESTMENT MANAGEMENT

Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: August 26, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading sideways from the last close. In Asia, the MSCI Asia Apex 50 also closed generally unchanged from the prior close. Chinese markets were modestly higher, with the Shanghai composite up 0.1% and the Shenzhen index trading higher by 0.2%. U.S. equity futures are signaling a lower opening from the previous close. With 493 companies having reported, the S&P 500 Q2 earnings stand at $29.47, higher than the $28.38 forecast for the quarter. The forecast reflects a 5.4% decline from Q2 2015 earnings. Thus far this quarter, 72.1% of companies reported earnings above forecast, while 17.3% reported earnings below forecast.

Market movement this morning is eerily quiet. The change in currencies is small, energy is roughly unchanged as are Treasuries. The lack of activity in front of Yellen's remarks (which formally begin at 10:00 EDT) suggests that (a) the markets are mostly "squared" in front of the speech, meaning traders are not leaning in either direction, or (b) they have decided on a stance (dovish) and are vulnerable to a hawkish surprise. We lean toward the latter. On the other hand, we doubt her talk will be hawkish. In fact, we doubt it will say much at all about the current situation. We expect her speech to mostly focus on operating monetary policy in a low nominal interest rate environment. In other words, when the economy does slip into recession, the FOMC probably won't be able to cut rates significantly. If this is the case, how will policymakers stimulate growth? We expect the Yellen paper to offer ZIRP, forward guidance and QE. NIRP will be mentioned but likely only as a last resort.

If our projection is correct, how will the markets react? Since we have seen rate hike expectations creeping higher on the back of recent FOMC member comments, Yellen's comments will be seen as neutral to dovish. That outcome will be modestly bearish for the dollar, bullish for gold and commodities and supportive for equities and Treasuries.

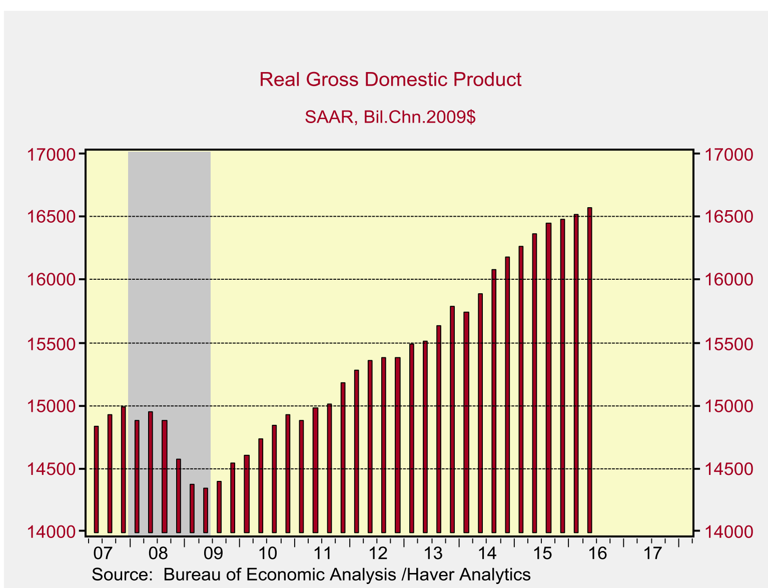
In other news, the Saudi energy minister, Khalid al-Falih, indicated today that the talk of a production freeze isn't a big deal and added that the market is moving toward balance without outside intervention. This would seem to be a bid to temper expectations for next month's meeting. Iran told Reuters that it would be willing to help stabilize oil prices as long as OPEC members allow Iran to gain market share…which is, of course, silly. Saudi oil policy, by design, is to gain and keep market share. The only way Iran can gain market share while allowing Saudi Arabia to achieve its production goals is if the other OPEC members cut output. That might occur but it won't be due to policy—it would be due, most likely, to geopolitical events, e.g., a civil implosion in Venezuela. Since that isn't much of a policy, we suspect the OPEC meeting won't be able to maintain prices on its own. In fact, we note that the Saudis are planning to sell a dollar based bond soon. It might be that the kingdom is trying to prop up oil prices in front of that bond sale, which will bear watching.

We are also continuing to monitor rising naval threats to shipping in the Persian Gulf. Iranian vessels, operated by the Iranian Republican Guard Corp (as opposed to the tiny, official Iranian navy), have been playing "chicken" with U.S. warships. Over the past few days, the U.S. has fired warning shots at these vessels that were making threatening passes at U.S. ships. Iran appears to be increasing tensions in this area—the question is why? Gillian Tett of the *FT* has an op-ed today where she notes how the lack of clarity surrounding the DOJ's treatment of foreign banks operating in Iran has led most foreign banks to shun Iranian business. Although the Obama administration has formally lifted the ban, there are other U.S. laws, such as counter-terrorism regulations, that might potentially snare foreign banks. Thus, the lifting of sanctions after the nuclear deal has not led to massive investment in Iran. It is not out of the question that Iran is expressing its frustration with U.S. policy through these naval acts. We should note that U.S. banks continue to be prohibited from doing business in Iran.

Finally, the Brazilian Senate has begun its impeachment trial against President Dilma Rousseff. To impeach the president, two-thirds of the 81 senators must vote to remove her from office. If the vote passes, VP Temer will be elevated to president and hold office until Rousseff's term ends in 2018. Brazilian financial markets have rallied on expectations that Temer will be more business friendly than the leftist Rousseff, but we note that Temer is beset by low approval ratings and personal corruption. If the impeachment vote fails, we would anticipate market disappointment. However, even if it passes, as expected, the left will likely become obstructionist and Temer's own shortcomings could weaken Brazilian financial markets.

U.S. Economic Releases

The second revision of Q2 GDP growth came in on forecast at 1.1%, revised lower from the 1.2% increase reported previously. Private consumption was the strongest area, with net exports also showing modestly positive growth. Private investment and government consumption both detracted from growth.

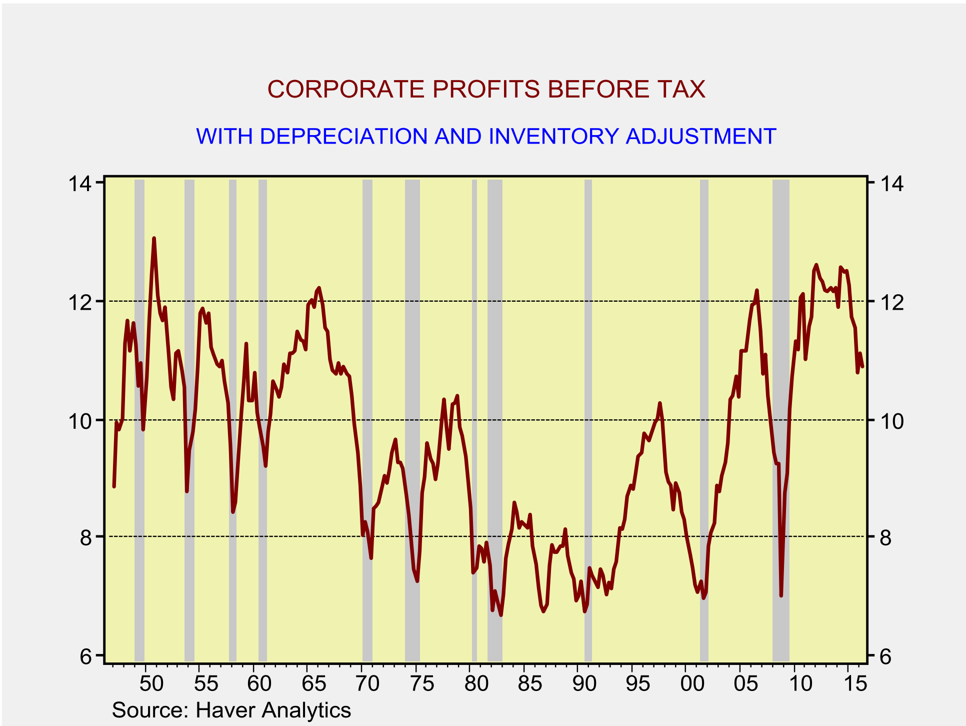


The chart above shows GDP levels. The economy is continuing to expand.

	Q2 2016 second revision	Q2 2016 advance report	Difference
GDP	1.1%	1.2%	-0.1%
Consumption	2.9%	2.8%	0.1%
Investment	-1.7%	-1.7%	0.0%
Inventories	-1.3%	-1.2%	-0.1%
Net Exports	0.1%	0.2%	-0.1%
Government	-0.3%	-0.2%	-0.1%

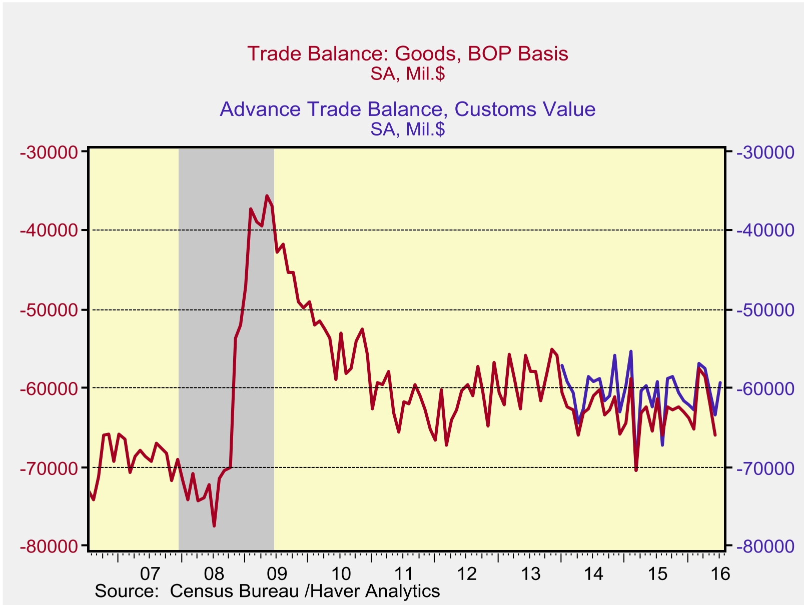
The chart above shows the contribution to GDP from the four major segments of the economy, plus the change in inventories. Consumption continues to underlie the overall growth.

Corporate profits data is released with the second revision to Q2 GDP growth and it reveals a weakening profit environment. Corporate profits fell 1.2% from the quarter before. Profit margins are getting squeezed as wages slowly increase.



The chart above shows corporate profits as a percentage of GDP.

The advance goods trade deficit came in narrower than forecast, falling to $59.3 bn in July from $64.5 bn the month before. Exports rose 2.4% in July, while imports fell 1.3%. Export strength came from food/beverages trading, while import weakness was broad-based.



The chart above shows the absolute level of the trade balance alongside the longer term data series. In general, the trade balance has been moving sideways over the past five years.

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	**University of Michigan sentiment**	m/m	Aug	90.8	90.4	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
10:00	Yellen speech at Jackson Hole	Fed Chairwoman				

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	CPI	y/y	Jul	-0.4%	-0.4%	-0.4%	***	Equity and bond neutral
EUROPE								
Eurozone	M3 money supply	y/y	Jul	4.8%	5.0%	5.0%	**	Equity bearish, bond bullish
France	GDP	y/y	Q2	1.4%	1.4%	1.4%	***	Equity and bond neutral
	Consumer confidence	m/m	Aug	97.0	96.0	96.0	**	Equity bullish, bond bullish
Germany	Consumer confidence (GfK)	m/m	Sep	10.2	10.0	10.0	**	Equity bullish, bond bullish
U.K.	GDP	y/y	Q2	2.2%	2.2%	2.2%	***	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	83	0	Neutral
3-mo T-bill yield (bps)	31	32	-1	Down
TED spread (bps)	52	51	1	Widening
U.S. Libor/OIS spread (bps)	44	45	-1	Down
10-yr T-note (%)	1.56	1.57	-0.01	Narrowing
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	39	39	0	Neutral
Currencies	Direction			
dollar	down			Down
euro	up			Neutral
yen	up			Up
pound	up			Down
franc	up			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	$49.53	$49.67	-0.28%	Awaiting Yellen speech
WTI	$47.26	$47.33	-0.15%	
Natural Gas	$2.80	$2.85	-1.69%	
Crack Spread	$13.59	$13.86	-1.91%	
12-mo strip crack	$13.69	$13.92	-1.64%	
Ethanol rack	$1.58	$1.58	-0.13%	
Metals				
Gold	$1,329.15	$1,321.97	0.54%	
Silver	$18.74	$18.55	1.01%	
Copper contract	$208.90	$208.30	0.29%	Possible monetary loosening in China
Grains				
Corn contract	$ 332.50	$ 332.00	0.15%	
Wheat contract	$ 423.50	$ 423.75	-0.06%	
Soybeans contract	$ 977.75	$ 975.50	0.23%	
Shipping				
Baltic Dry Freight	718	706	12	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	2.5	0.5	-2.0	
Gasoline (mb)	0.0	-1.3	-1.3	
Distillates (mb)	0.1	0.1	0.0	
Refinery run rates (%)	-1.0%	-0.6%	0.4%	
Natural gas (bcf)	11.0	17.0	6.0	

Weather

The 6-10 and 8-14 day forecasts are calling for warmer conditions for the eastern two-thirds of the country. Precipitation is forecast in the north and the east. Tropical Storm Gaston continues to move northwest from its current location in the central Atlantic. TS Gaston is expected to slow as it moves over cooler waters. A small area of disturbed weather has formed in the Gulf of Mexico, with a low chance of becoming a cyclone over the next two days. Another small low-pressure area has moved over Cuba and is heading toward Florida. This activity also has a low chance of becoming a cyclone over the next two 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

As we noted last week, equity markets are trading at the upper end of the range defined by the relationship between the Federal Reserve's balance sheet and equities. To some extent, the level of the relationship is somewhat less important than what the expanded balance sheet signals, which is that monetary policy remains accommodative. In our AAW from June 24, 2016, we discussed St. Louis FRB President Jim Bullard's paper on monetary regimes. Bullard is projecting only one rate hike of 25 to 50 bps over the next two years unless economic conditions change, a position for which he has taken some criticism. However, we note that a recent paper by San Francisco FRB President Williams suggests that the neutral real interest rate has probably declined to near zero, meaning that if inflation is 2%, the target rate for fed funds that would be neither stimulative nor restrictive would be 2% as well. To stimulate growth, the policy rate would need to be below 2%, suggesting little room to raise rates. Although various U.S. central bank officials keep suggesting that every meeting is "live," meaning a rate change could occur, the reality is that there appears to be a distinct intellectual trend toward the idea that the slow growth the economy is facing is more than just temporary headwinds. In fact, Ben Bernanke recently blogged that the FOMC does appear to be shifting its perspective on the economy in a dovish direction.[1]

There is increasing attention on fiscal policy. We note that both presidential candidates are calling for increases in infrastructure spending. Our review of economic literature shows little consensus on the multiplier effect of government investment spending; there is no doubt, however, that the state of U.S. roads would be improved by repairs. On the other hand, it isn't obvious what sort of investment the government could make that would equate to the building of the interstate highway system or the dam building of the Great Depression. If the Federal Reserve and the government coordinated stimulus through direct funding ("helicopter money"), the effect could be substantial, although its most important impact might be in currency depreciation.[2]

What this all means is that the financial markets, which have been projecting significantly less tightening than the "dots" chart has been signaling, are probably correct. Interest rates will likely remain low and the terminal rate will probably come nowhere close to what we saw prior to the 2008 Financial Crisis. This situation puts policymakers in a difficult position. In both the U.S. and in Europe, there is great reluctance for fiscal expansion. Most of the policymakers came of age during the high inflation years of the 1970s and early 1980s and are quite skeptical of government spending. If a recession were to develop, the Federal Reserve would find itself at the zero bound rather quickly. At that point, all monetary policy could offer is either QE4 or

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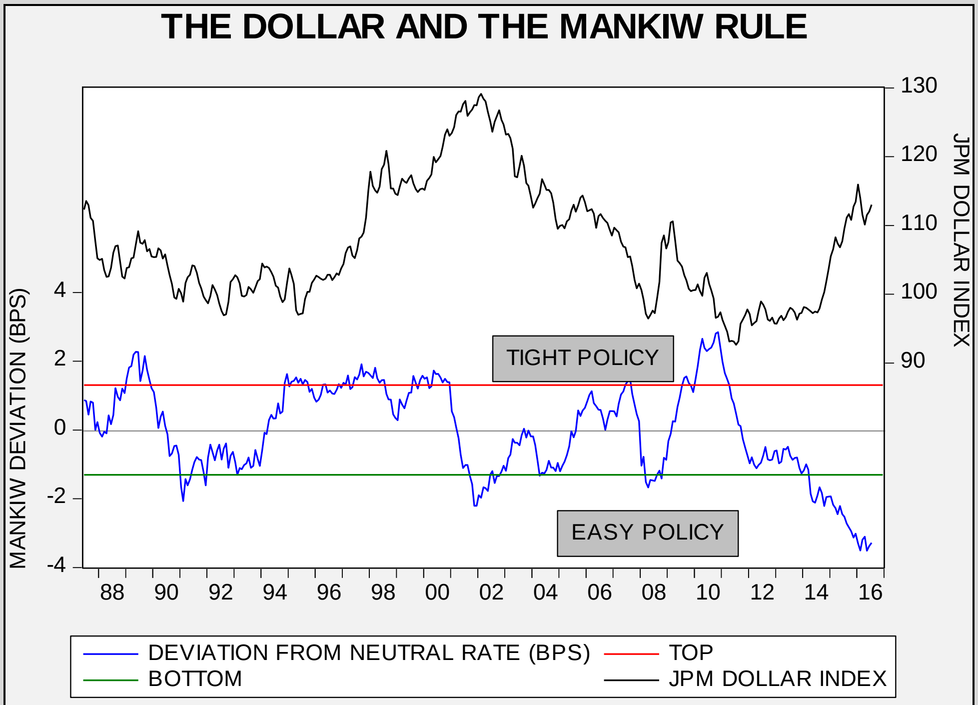
[1] https://www.brookings.edu/blog/ben-bernanke/2016/08/08/the-feds-shifting-perspective-on-the-economy-and-its-implications-for-monetary-policy/

[2] See WGR: The Geopolitics of Helicopter Money, Part I (5/2/16), Part II (5/9/16), and Part III (5/16/16).

negative nominal rates. The former might help equities but foreign experience with negative nominal rates has been quite disappointing.

So far, policymakers in the major economies have avoided competitive currency depreciation. However, a move to such policies will become increasingly tempting as other tools fail to deliver growth. This was the pattern seen during the 1930s.



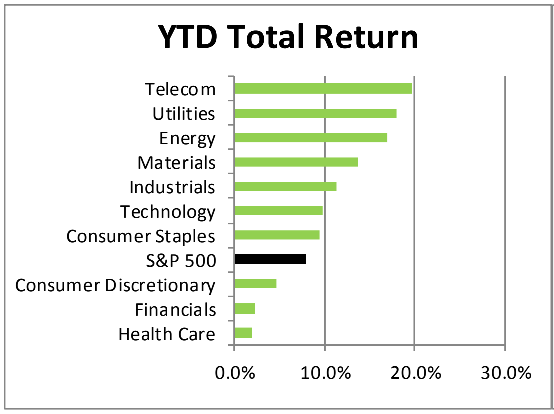
Sources: Haver Analytics, CIM

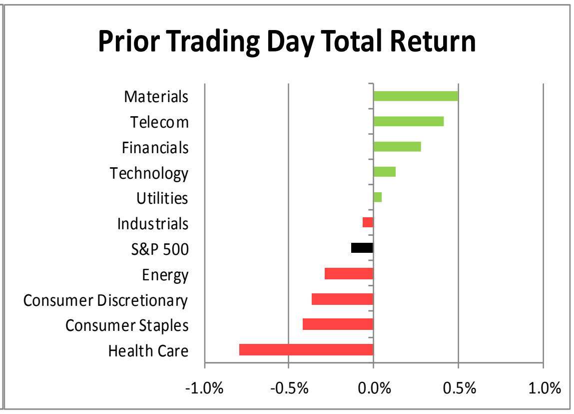
This chart shows the deviation from the Mankiw Rule model, using core CPI and the unemployment rate along with the dollar index. In the past, the FOMC paid little attention to the dollar in setting policy. However, commentary from the Fed minutes suggests "international" concerns are being discussed at length. We suspect that the dollar (using the JPM effective exchange rate as a proxy) would need to fall before the FOMC would consider raising rates.

This means that, despite protests to the contrary, the FOMC probably won't raise rates for a while unless (a) the dollar weakens, (b) core inflation unexpectedly rises, or (c) unemployment falls further. The risk of a rate hike is that it would push the dollar higher and tighten policy more than the FOMC would want. This puts the Fed in something of a quandary. They would like to have a higher rate in place, if for nothing more than to give them room to lower rates into the next downturn. However, due to the uncertainty surrounding the reaction of the dollar, we expect monetary policy to remain on hold into 2017, assuming the three conditions noted at the top of this paragraph don't arise. If that is the case, equity values should remain supported.

Data Section

U.S. Equity Markets – (as of 8/25/2016 close)

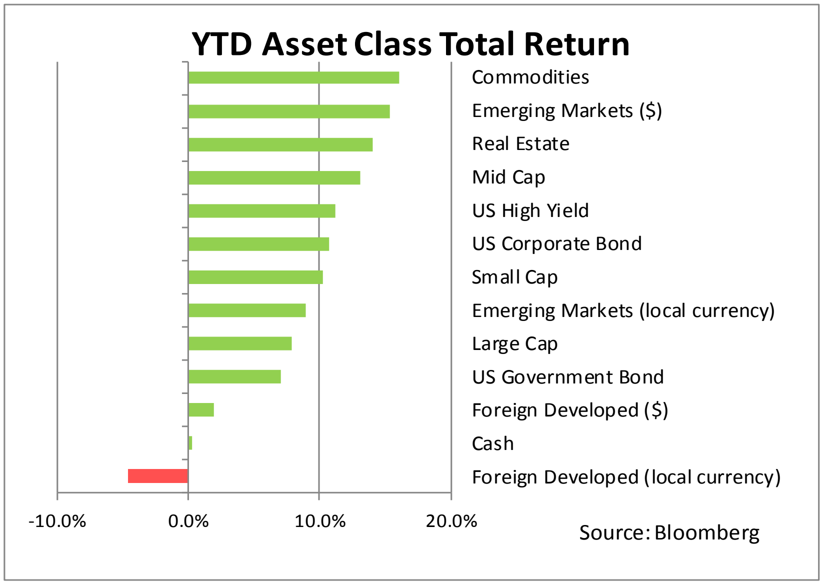




(Source: Bloomberg)

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 8/25/2016 close)

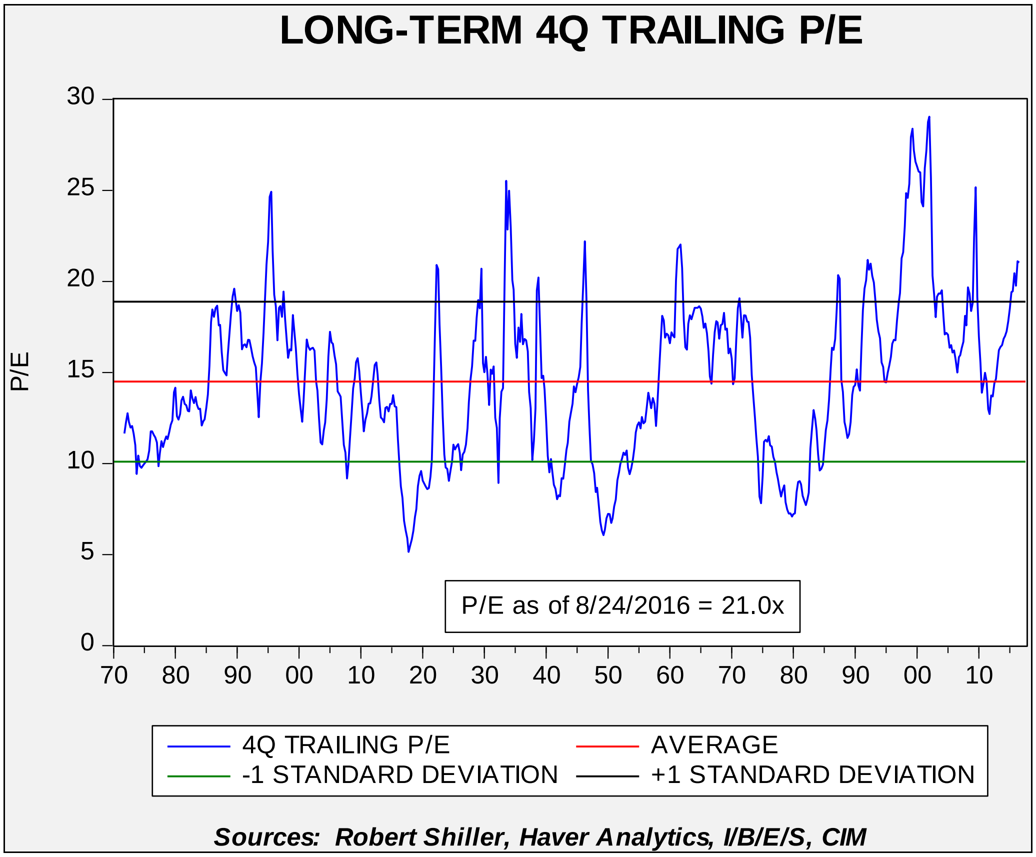


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 25, 2016



Based on our methodology,[3] the current P/E is 21.0x, unchanged from last 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 (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.