Daily Comment

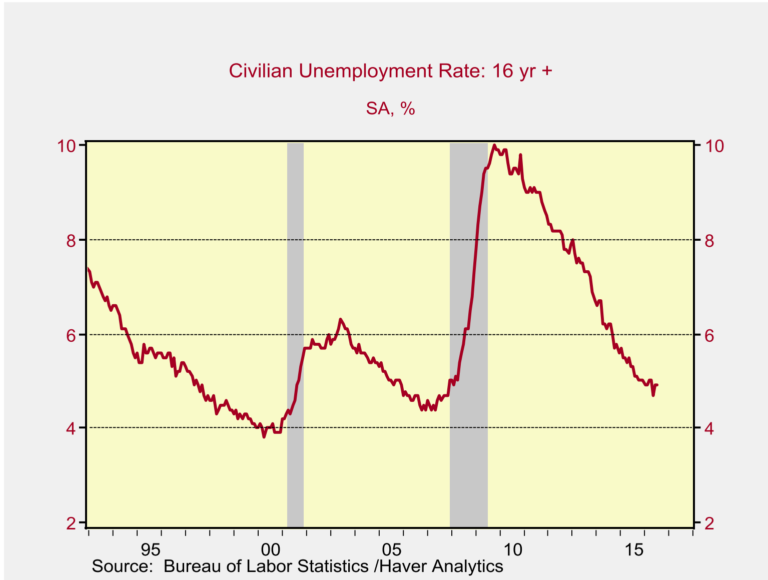
By Bill O'Grady & Kaisa Stucke, CFA

[Posted: August 30, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading higher by 0.9% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 0.7% from the prior close. Chinese markets were also modestly higher, with the Shanghai composite up 0.2% and the Shenzhen index trading higher by 0.1%. 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. 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.

Fed Vice Chairman Stanley Fischer gave an interview on Bloomberg TV this morning indicating that although a September rate hike is data-dependent, the likelihood of a move has increased. This comes after Fischer's interview last week, which was also generally considered hawkish. Following the two Fischer interviews over the past week, the market is now pegging a September hike at 36% likelihood, up from 24% a week ago.

Fischer pointed to this Friday's employment report as one of the main data points that the Fed uses to measure economic health. He said that the U.S. economy is close to full employment, despite the slowing pace of the expansion, as the "problem is largely about productivity growth, something which is very hard to control by policymakers. It depends enormously on what private individuals are doing at their companies, and it's very slow at the moment." Still, he expects technology to boost productivity growth in the future.

Expectations for Friday's employment report are calling for an improvement in the unemployment rate, which is forecast to improve to 4.8% from 4.9% in July. The chart below shows the unemployment rate, which has improved steadily since the end of the recession.

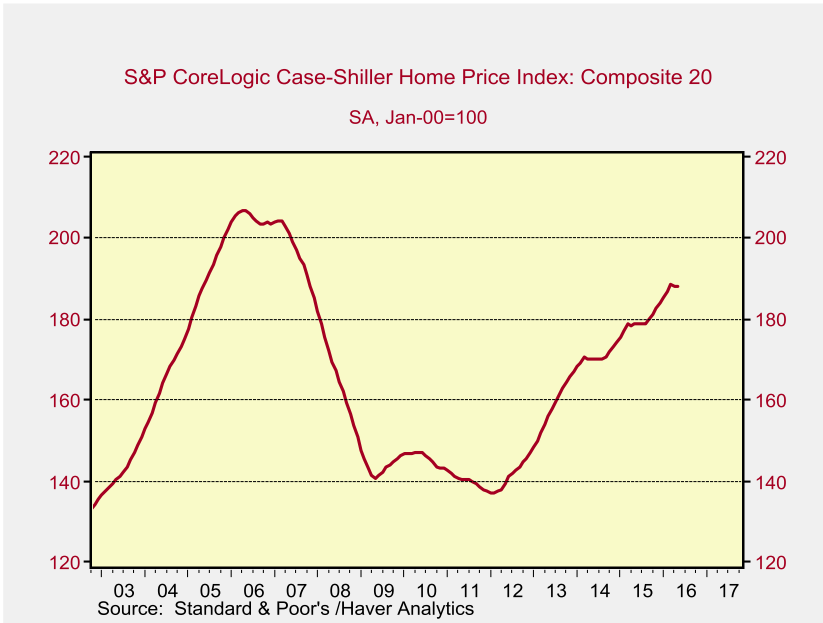


At the same time, earnings growth is forecast to remain slow, rising 0.2% in August. Additionally, the rate of part-time workers for economic reasons (shown in the chart below), one of Yellen's favorite measures of labor market health, has seen some deterioration this year.

Thus, although a September hike remains a one-in-three possibility, it is looking more likely than previously perceived by the market. Still, a September hike would be risky ahead of the elections and Chair Yellen's Jackson Hole interview was considered mildly dovish, so it is not clear whether she would support a hike this fall.

U.S. Economic Releases

The S&P CoreLogic Case-Shiller 20-city composite came in roughly on forecast, falling 0.07% from the month before compared to the 0.10% decline forecast. Annually, home prices in the 20-city composite increased 5.13%, close to the 5.10% increase forecast.



The chart above shoes the Case-Shiller 20-city composite index. Prices declined modestly, breaking the uptrend that has been in place since the beginning of the year.

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	Consumer confidence	m/m	Aug	97.0	97.3	**

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	Unemployment rate	m/m	Jul	3.0%	3.1%	3.1%	***	Equity bullish, bond bullish
	Retail sales	y/y	Jul	-0.2%	-1.3%	-0.9%	**	Equity and bond neutral
EUROPE								
Eurozone	Economic sentiment	m/m	Aug	103.5	104.5	104.1	**	Equity bearish, bond bullish
	Business climate indicator	m/m	Aug	0.0	0.4	0.4	**	Equity bearish, bond bullish
	Industrial confidence	m/m	Aug	-4.4	-2.6	-2.7	**	Equity bearish, bond bullish
	Consumer confidence	m/m	Aug	-8.5	-8.5	-8.5	**	Equity and bond neutral
Germany	CPI	y/y	Aug	0.4%	0.4%	0.5%	***	Equity and bond neutral
Italy	Retail sales	m/m	Jun	0.2%	0.3%	-0.2%	**	Equity bullish, bond bullish
U.K.	Money supply M4	y/y	Jul	3.9%	3.6%		**	Equity bullish, bond bullish
Switzerland	KOF LEI	m/m	Aug	99.8	103.5	102.0	**	Equity bearish, bond bullish
AMERICAS								
Brazil	Unemployment rate	m/m	Jul	11.6%	11.3%	11.5%	***	Equity bearish, bond bullish

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)	32	31	1	Up
TED spread (bps)	51	52	-1	Down
U.S. Libor/OIS spread (bps)	46	45	1	Up
10-yr T-note (%)	1.57	1.56	0.01	Widening
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	40	42	-2	Down
Currencies	Direction			
dollar	up			Up
euro	down			Neutral
yen	down			Down
pound	down			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	$49.54	$49.26	0.57%	Domestic gasoline inventories expected to fall
WTI	$47.35	$46.98	0.79%	
Natural Gas	$2.92	$2.90	0.66%	
Crack Spread	$12.86	$13.11	-1.91%	
12-mo strip crack	$13.52	$13.57	-0.37%	
Ethanol rack	$1.57	$1.57	-0.08%	
Metals				
Gold	$1,321.20	$1,323.38	-0.16%	Higher dollar, Fed outlook
Silver	$18.80	$18.88	-0.39%	
Copper contract	$208.20	$207.90	0.14%	Emerging markets rebound
Grains				
Corn contract	$ 321.00	$ 320.75	0.08%	
Wheat contract	$ 399.25	$ 397.00	0.57%	
Soybeans contract	$ 964.25	$ 964.25	0.00%	
Shipping				
Baltic Dry Freight	720	718	2	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.0		
Gasoline (mb)		-1.3		
Distillates (mb)		0.0		
Refinery run rates (%)		-0.7%		
Natural gas (bcf)		38.0		

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 west. Hurricane Gaston is expected to slow as it moves over cooler waters and dissipate by the end of the week. Tropical Depression Nine is in the southeast corner of the GOM and is expected to turn north and make landfall in Florida. Another small disturbance is in the northwest corner of the GOM. This activity has a low chance of becoming a cyclone over the next two days. Tropical Depression Eight is moving along the Eastern Seaboard.

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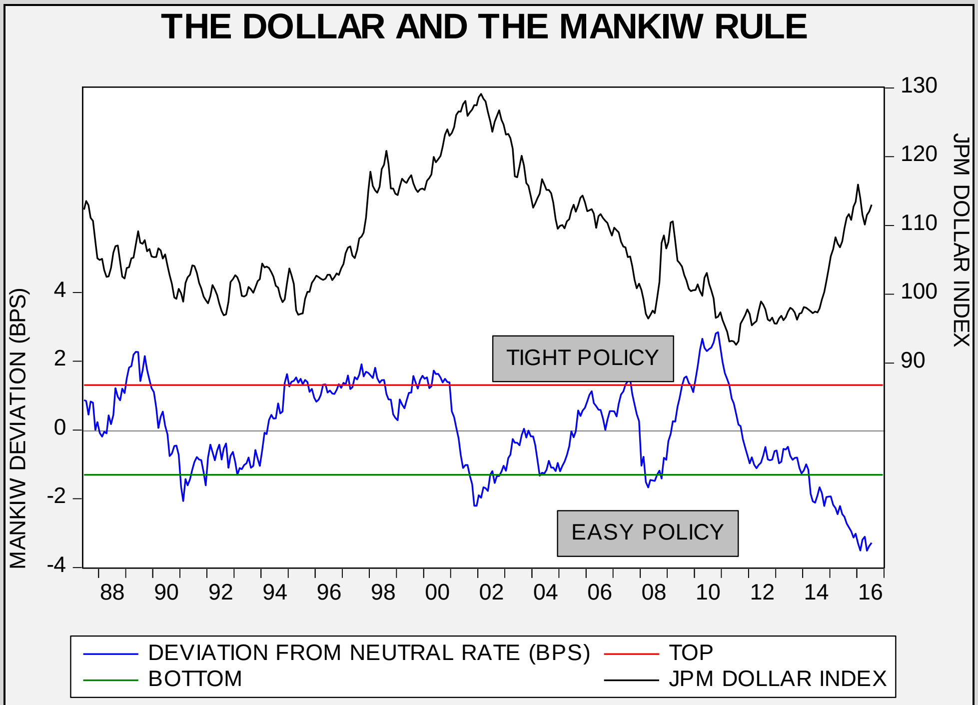
[1] https://www.brookings.edu/blog/ben-bernanke/2016/08/08/the-feds-shifting-perspective-on-the-economy-and-its-implications-for-monetary-policy/

[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.



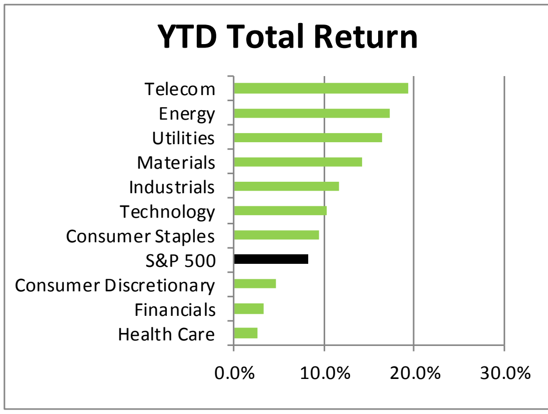
Sources: Haver Analytics, CIM

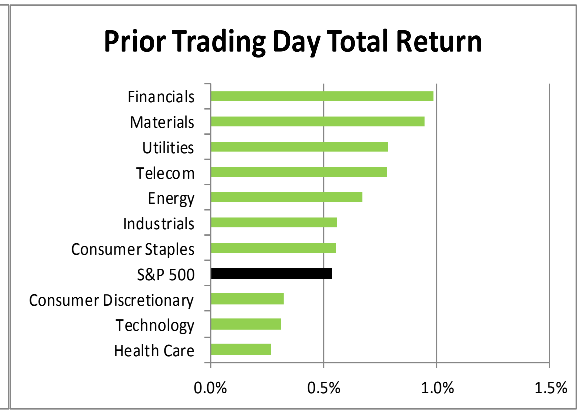
This chart shows the deviation from the Mankiw Rule model, using core CPI and the unemployment rate along with the dollar index. In the past, the FOMC paid little attention to the dollar in setting policy. However, commentary from the Fed minutes suggests "international" concerns are being discussed 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 8/29/2016 close)

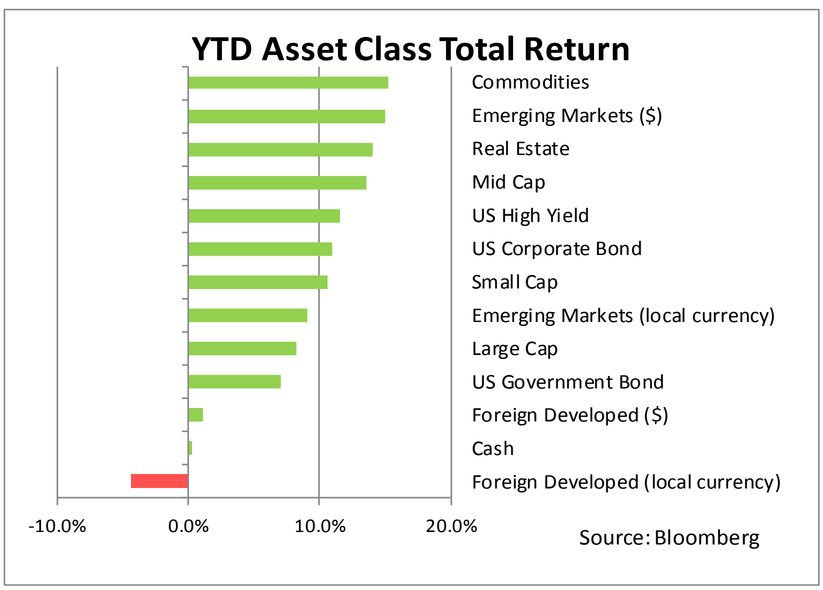




(Source: Bloomberg)

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 8/29/2016 close)

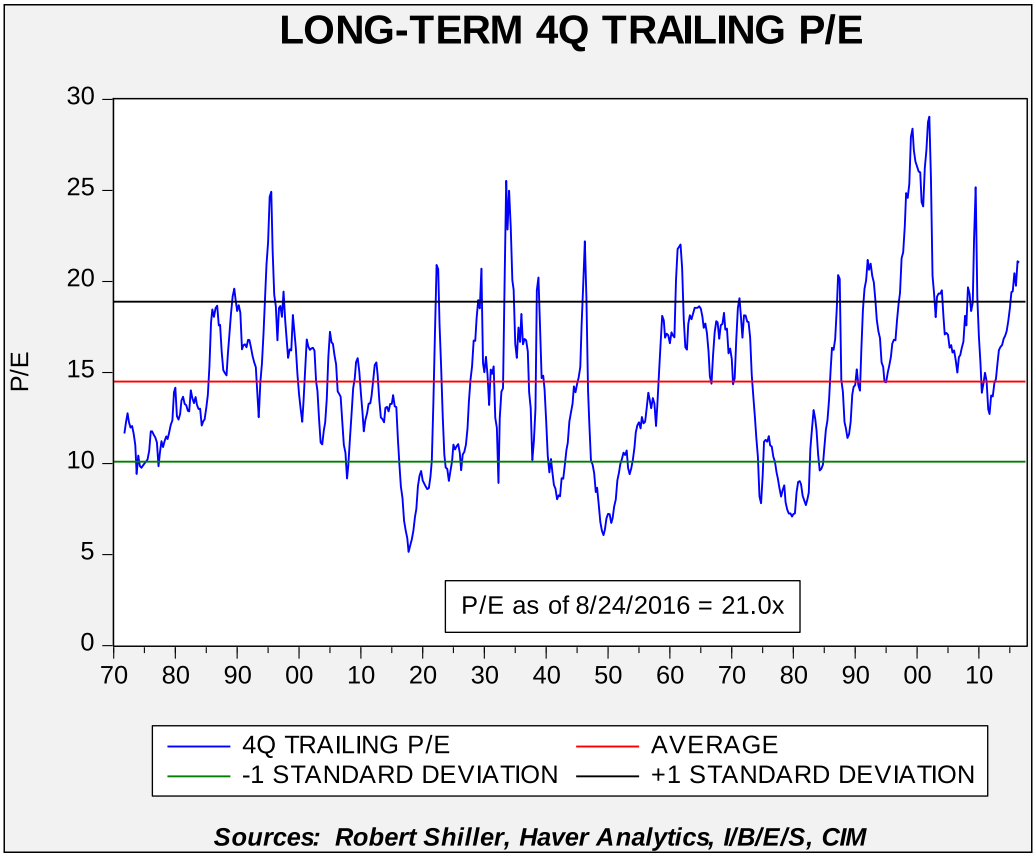


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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[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.