# Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

**[Posted: Aug 3, 2016—9:30 AM EDT]** Global equity markets are mostly lower this morning. The EuroStoxx 50 is trading down 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.4% from the prior close. Chinese markets were higher, with the Shanghai composite up 0.2% and the Shenzhen index trading higher by 0.4%. U.S. equity futures are signaling a modestly lower opening from the previous close. With 367 companies having reported, the S&P 500 Q2 earnings stand at $29.38, higher than the $28.38 forecast for the quarter. The forecast reflects a 5.4% decline from Q2 2015 earnings. Thus far this quarter, 72.5% of the companies reported earnings above forecast, while 16.5% reported earnings below forecast.

In the wake of the BOJ and Abe disappointment yesterday, we have been observing a steady backup of long duration yields. So far, this isn't anything too serious, but the market narrative behind it is important. There is a growing concern that BOJ monetary policy may have reached its limits. In terms of rate adjustment and QE, it probably has. Once a central bank becomes the dominant buyer of the entire yield curve, sovereign debt probably ceases to be a market and the central bank becomes the sole determinant of all rates, not just short-term ones. According to reports, BOJ Governor Kuroda is starting to receive pushback from some board members, suggesting that he will struggle to expand the balance sheet further.

However, it is probably a mistake to limit the possibility of policy to merely QE and rates. There are other policy tools available but the ones left are controversial. The first option, which we have discussed at great length, is helicopter money. However, this policy would require fiscal authorities to work directly with the central bank to accomplish anything. If the government is too timid with fiscal expansion, the impact of direct financing of fiscal spending is potentially minor. The second would be aggressive devaluation; imagine QE with foreign bonds. The goal here would be to drive down one's exchange rate to boost exports and constrain imports. Such "beggar thy neighbor" policies, seen in the 1930s, are considered inappropriate now but, if conditions deteriorate enough, consideration of such actions cannot be discounted. The problem with this policy tool is that it is dependent on foreigners to acquiesce to the policy, which is unlikely. Trade retaliation and capital controls would be potential responses.

One common element to both of these controversial measures is that there will almost certainly be strong opposition from central bank policymakers. The possibility that a government could propose massive fiscal expansion only to see the central bank balk on funding it directly is a real possibility. This is why we took note of a Bloomberg article reporting that Kozo Yamamoto has joined Abe's cabinet as Minister of Regional Revitalization. Yamamoto is a strong advocate of radical measures to combat Japan's secular stagnation and one of his ideas is to strip the BOJ of its policy independence. Last year, Yamamoto was quoted as worrying that the BOJ was wavering on its commitment to monetary stimulus and Governor Kuroda might be contending with "a den of conspirators."

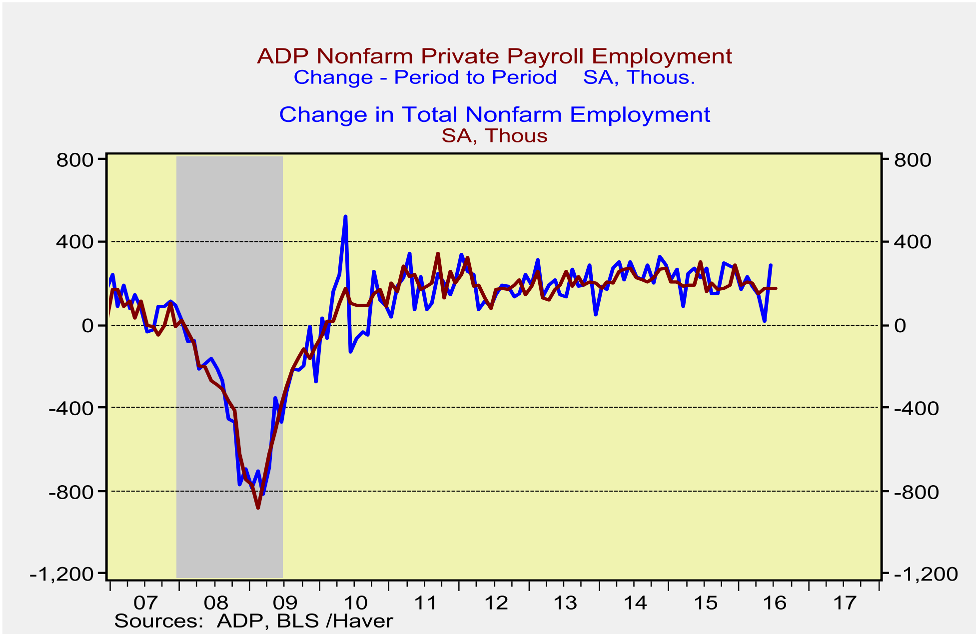
Central bank independence has not always been considered best practice. The Federal Reserve didn't become independent until the 1951 Treasury Accord. The BOJ didn't become independent until 1998. On the one hand, there is an argument to be made that it makes sense for a central bank to coordinate policy with the fiscal arm of the government to make it more effective. If fiscal spending and monetary policy work at cross purposes, it can make fiscal stimulus less effective or lead to ineffective inflation control. On the other hand, since fiscal policy is affected by politics, central bank independence is put in place to act as a bulwark against inflation. Simply put, if the goal is inflation control, central bank independence is a key component. If the goal is reflation and the escape of secular stagnation, central bank independence is a hindrance.

Giving Yamamoto a stronger voice could lead the BOJ to simply become the funding arm of fiscal spending. Another news item we noted last night was that North Korea launched a ballistic missile that landed near Japan. It isn't hard to imagine a massive defense spending expansion, funded directly by the BOJ, which is under the supervision of the Ministry of Finance. So, we would caution that the idea that central bankers are out of tools may not be true. Yes, further measures would require fiscal coordination but that could be accomplished. The key issue is that we have, over the past 36 years, built a policy consensus that is designed to keep inflation under control. Brexit, Trump, Sanders and perhaps Yamamoto all suggest that this policy consensus may be coming to a close. If that is the case, rising inflation somewhere in the medium term is increasingly likely.

**U.S. Economic Releases**

Weekly mortgage applications fell 3.5%, with purchases down 2.4% and refinancing down 4.2%. The average 30-year mortgage rate fell 2 bps to 3.67%.

The ADP private employment report showed a rise in non-farm payrolls of 179k compared to expectations of 170k.




This chart shows the monthly change in the BLS private non-farm payroll report along with the ADP report. The ADP report has been acting more like a trend indicator and a slowdown compared to last month would be likely if that pattern continues. Current expectations call for a private payroll change of +170k.

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

| Economic releases | | | | | | |
|---|---|---|---|---|---|---|
| EDT | Indicator | | | Expected | Prior | Rating |
| 9:45 | Markit Services PMI | m/m | Jul | 51 | 50.9 | ** |
| | Markit Composite PMI | m/m | Jul | | 51.5 | * |
| 10:00 | ISM Non-Maufacturing | m/m | Jul | 55.9 | 56.5 | ** |
| Fed speakers or events | | | | | | |
| EST | Speaker or event | District or position | | | | |
| 3:00 | Kashkari | Minneapolis 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 | | | | | | | | |
| Australia | Services PMI (AiG) | m/m | Jul | 53.9 | 51.3 | | * | Equity bullish, bond bearish |
| China | Services PMI (Caixin) | m/m | Jul | 51.7 | 52.7 | | ** | Equity bearish, bond bullish |
| | Composite PMI (Caixin) | m/m | Jul | 51.9 | 50.3 | | ** | Equity bullish, bond bearish |
| India | Services PMI (Nikkei) | m/m | Jul | 51.9 | 50.3 | | ** | Equity bullish, bond bearish |
| | Composite PMI (Nikkei) | m/m | Jul | 52.4 | 51.1 | | ** | Equity bullish, bond bearish |
| Japan | Services PMI (Nikkei) | m/m | Jul | 50.4 | 49.4 | | ** | Equity bullish, bond bearish |
| | Composite PMI (Nikkei) | m/m | Jul | 50.1 | 49.0 | | ** | Equity bullish, bond bearish |
| EUROPE | | | | | | | | |
| Eurozone | Services PMI (Markit) | m/m | Jul | 52.9 | 52.7 | 52.7 | ** | Equity bullish, bond bearish |
| | Composite PMI (Markit) | m/m | Jul | 53.2 | 52.9 | 52.9 | ** | Equity bullish, bond bearish |
| | Retail Sales | y/y | Jun | 1.6% | 1.6% | 1.8% | ** | Equity and bond neutral |
| France | Services PMI (Markit) | m/m | Jul | 50.5 | 50.3 | 50.3 | ** | Equity and bond neutral |
| | Composite PMI (Markit) | m/m | Jul | 50.1 | 50.0 | 50.0 | ** | Equity and bond neutral |
| Germany | Services PMI (Markit) | m/m | Jul | 54.4 | 54.6 | 54.6 | ** | Equity and bond neutral |
| | Composite PMI (Markit) | m/m | Jul | 55.3 | 55.3 | 55.3 | ** | Equity and bond neutral |
| Italy | Services PMI (Markit) | m/m | Jul | 52.0 | 51.9 | 51.0 | ** | Equity and bond neutral |
| | Composite PMI (Markit) | m/m | Jul | 52.2 | 52.6 | 52.4 | ** | Equity and bond neutral |
| U.K. | Services PMI (Markit) | m/m | Jul | 47.4 | 47.4 | 47.4 | ** | Equity and bond neutral |
| | Composite PMI (Markit) | m/m | Jul | 47.5 | 47.7 | 47.7 | ** | Equity and bond neutral |
| Russia | Services PMI (Markit) | m/m | Jul | 55.0 | 53.8 | 52.9 | ** | Equity bullish, bond bearish |
| | Composite PMI (Markit) | m/m | Jul | 53.5 | 53.5 | | ** | 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)** | 76 | 76 | 0 | Up |
| **3-mo T-bill yield (bps)** | 28 | 27 | 1 | Down |
| **TED spread (bps)** | 48 | 49 | -1 | Widening |
| **U.S. Libor/OIS spread (bps)** | 42 | 41 | 1 | Neutral |
| **10-yr T-note (%)** | 1.54 | 1.56 | -0.02 | Up |
| **Euribor/OIS spread (bps)** | -30 | -30 | 0 | Neutral |
| **EUR/USD 3-mo swap (bps)** | 49 | 47 | 2 | Down |
| **Currencies** | **Direction** | | | |
| dollar | up | | | Neutral |
| 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 | $42.03 | $41.80 | 0.55% | Neutral API data |
| WTI | $39.74 | $39.51 | 0.58% | |
| Natural Gas | $2.75 | $2.73 | 0.51% | |
| Crack Spread | $14.52 | $14.84 | -2.18% | |
| 12-mo strip crack | $12.40 | $12.52 | -0.94% | |
| Ethanol rack | $1.56 | $1.57 | -0.58% | |
| **Metals** | | | | |
| Gold | $1,364.53 | $1,363.57 | 0.07% | |
| Silver | $20.62 | $20.62 | -0.02% | |
| Copper contract | $219.30 | $220.90 | -0.72% | |
| **Grains** | | | | |
| Corn contract | $ 335.75 | $ 334.00 | 0.52% | |
| Wheat contract | $ 404.50 | $ 401.25 | 0.81% | |
| Soybeans contract | $ 964.75 | $ 953.00 | 1.23% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 645 | 650 | -5 | |
| **DOE inventory report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | | -1.8 | | |
| Gasoline (mb) | | -0.7 | | |
| Distillates (mb) | | -0.7 | | |
| Refinery run rates (%) | | 0.0% | | |
| Natural gas (bcf) | | 5.0 | | |

## Weather

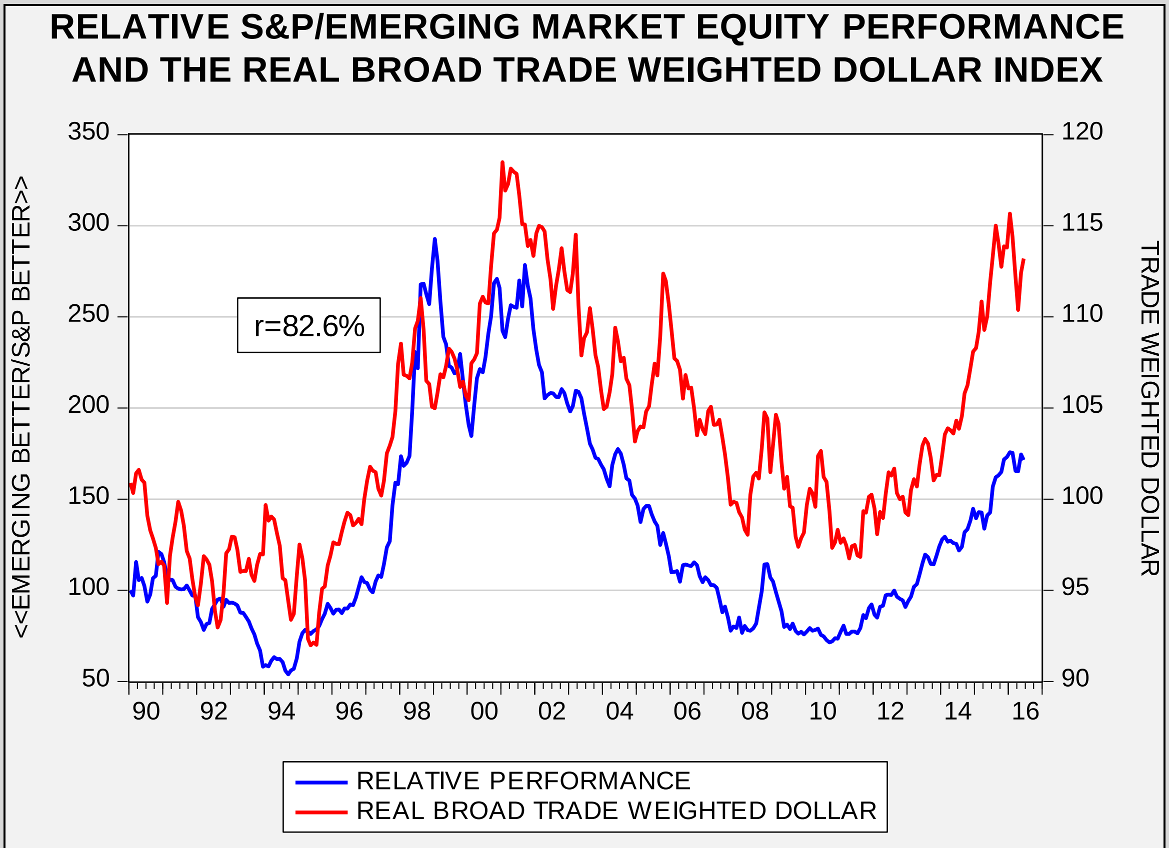
The 6-10 and 8-14 day forecasts call for warmer than normal temperatures for the majority of the country, with some cooler than normal weather for parts of the West Coast. Greater than normal precipitation is forecast for parts of the Southeast, Great Lakes and Southwest regions. A strong tropical wave has formed south of Hispaniola and is expected to reach the Cayman Islands tomorrow. It has a high probability of developing into a tropical depression over the next 48 hours. At present, it has a small chance of affecting oil and gas production and flows, although there is the potential that it could affect Mexican production later this week.

**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.*

July 29, 2016

In the most recent rebalance of our Asset Allocation portfolios, we maintained an allocation to emerging market equities in the Aggressive Growth portfolio. As we have noted in the past, there is a positive relationship between the dollar's exchange rate and the relative performance of developed market equities and emerging market equities.



*Sources: Haver Analytics, CIM*

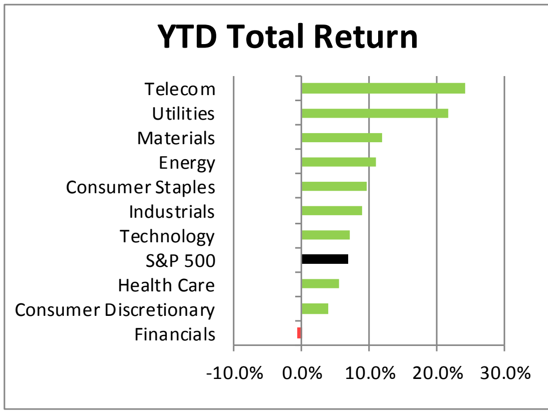
This chart shows the relative performance of the S&P 500 and the MSCI emerging market index (denominated in dollars). A rising blue line on the chart signals stronger S&P performance relative to emerging markets and vice versa. Using the JPM dollar index, we note the dollar bottomed in late 2011. As the dollar appreciated, the S&P began to consistently outperform emerging markets.

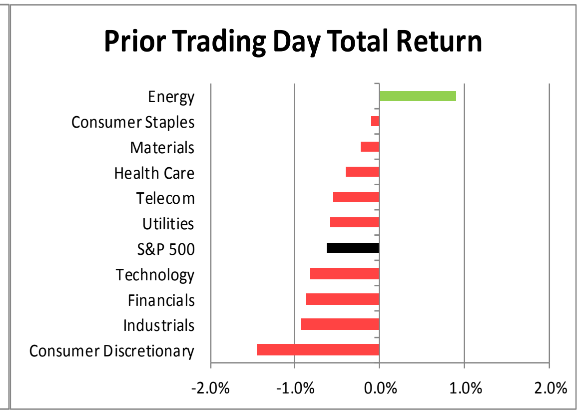
The most important factor boosting the dollar was monetary policy divergence. The Federal Reserve ended its balance sheet expansion in December 2014. It raised its policy rate in December 2015. This tightening occurred while the European Central Bank (ECB) and the Bank of Japan (BOJ) both continued to implement aggressively accommodative policies. The dollar's strength clearly accelerated in the 2014-15 period, although the rally has stalled this year. We believe the stall has occurred because of uncertainty surrounding U.S. monetary policy. Initially, the FOMC signaled four rate hikes this year. Currently, fed funds futures are suggesting no rate hikes this year and perhaps only one hike next year. If this does become the path of policy, the dollar bull market may be coming to a close unless the ECB and BOJ become even more aggressive in policy easing. If we are reaching the point where further accommodation isn't possible, a stronger dollar is less likely and thus, emerging market equities become attractive given their recent relative weakness.

However, due to the uncertainty over the direction of policy, as noted above, the asset allocation committee has judged emerging market equities as only appropriate for aggressive investors. If the FOMC tightens policy sooner or to a greater degree than expected, developed markets could begin to sharply outperform emerging markets again. Given that market expectations are leaning heavily toward steady Fed policy, there is the potential for a bearish surprise for the emerging equity sector. Thus, in our judgement, only the most risk tolerant investors should be considering emerging market equities at this time.

**<u>Data Section</u>**

**U.S. Equity Markets** – (as of 8/2/2016 close)

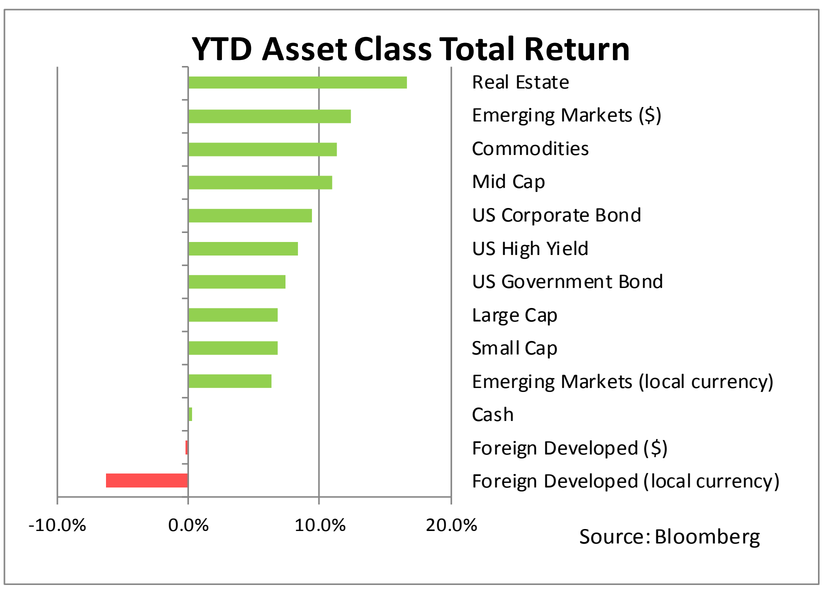



(Source: Bloomberg)

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 8/2/2016 close)

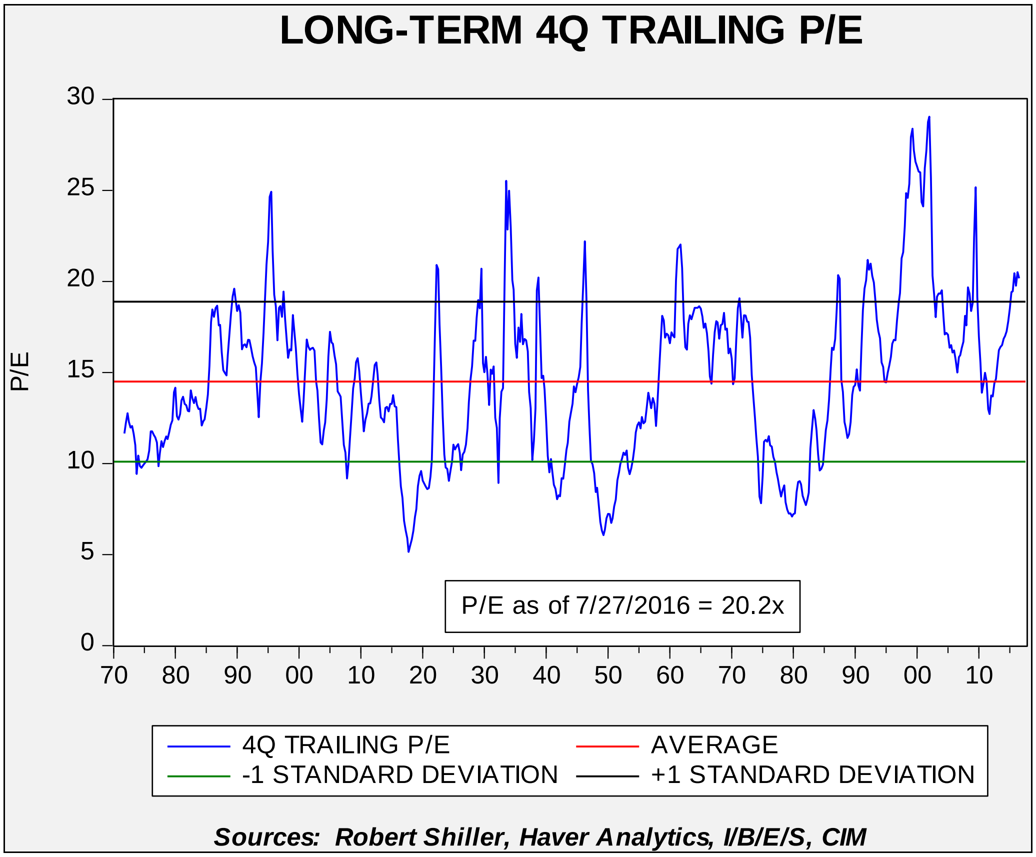



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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**

July 28, 2016




Based on our methodology,[1] the current P/E is 20.2x, up 0.1x. The rise is mostly due to a rising S&P 500.

*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 (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.