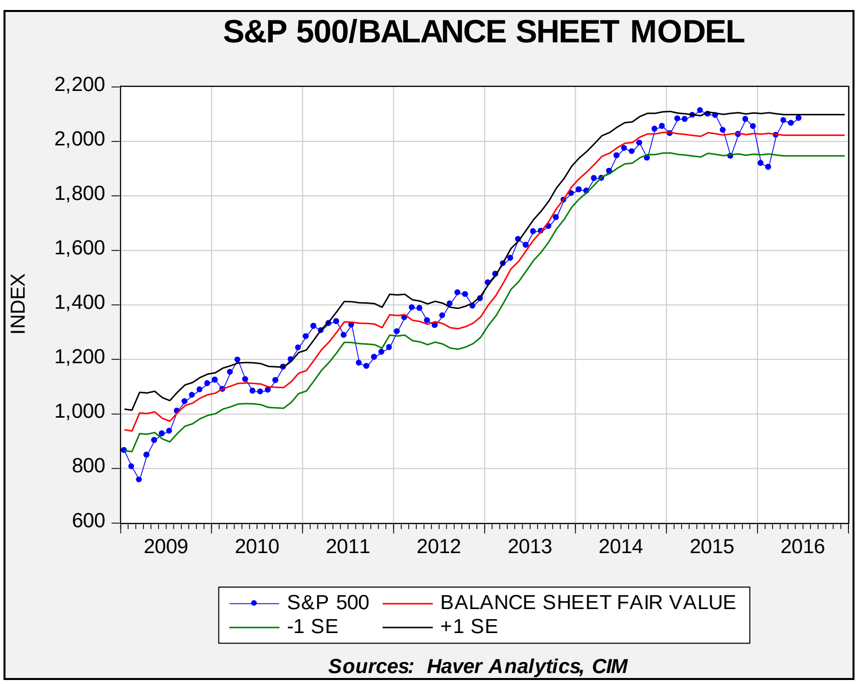
Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: July 12, 2016—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is trading higher by 1.6% from the last close. In Asia, the MSCI Asia Apex 50 closed up by 0.9% from the prior close. Chinese markets were also higher, with the Shanghai composite trading higher by 1.8% and the Shenzhen index up 1.2%. U.S. equity futures are signaling a higher opening from the previous close. With 24 companies having reported, the S&P 500 Q2 earnings stand at $28.65, higher than the $28.38 forecast for the quarter. The forecast reflects a 5.4% decline from Q2 2015 in the consensus estimates. Thus far this quarter, 62.5% of the companies reported earnings above forecast, while 20.8% reported earnings below forecast.

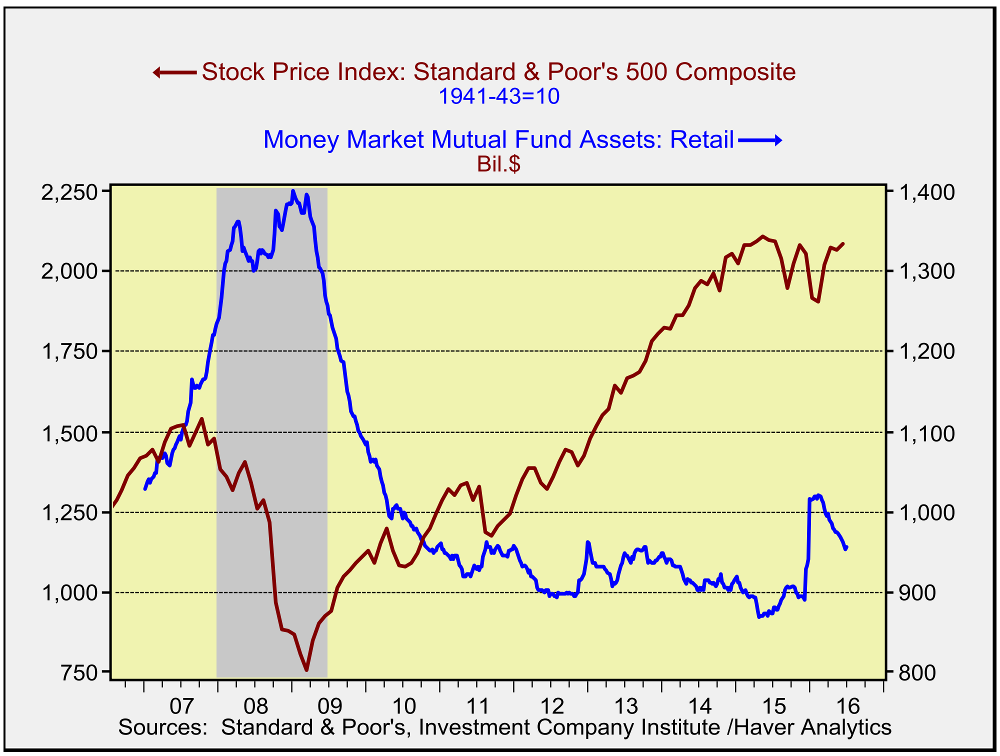
The most important news for investors is that, despite everything, equity markets around the world are gaining strength. This improvement is coming despite slowing earnings growth, sluggish economic activity, Brexit, an adverse ruling against China on its maritime claims, U.S. elections, etc. Why the strength? Most likely the same reason that has lifted equities all along—supportive monetary policy.



This chart models the S&P 500 (monthly average) against the Fed's balance sheet. Since the recovery began, the U.S. equity markets have closely tracked the size of the Fed's balance sheet. Since the FOMC has ended its expansion of the balance sheet, the market has mostly moved in a sideways trading range. We are starting to see a modest breakout, but it would not be a surprise if equities fade a bit from here.

On the other hand, the combination of Brexit and unstable employment data has removed almost any chance of FOMC tightening. We do expect some brave talk about "September being on the table" and the like, but the financial markets don't believe it for a minute. With the potential for turmoil this autumn tied to the U.S. elections, we doubt the Fed will have any desire to inject itself into that debate. At the same time, it looks like Abenomics 2.0 is about to be unleashed; this version will be more fiscal in nature but will rely on the BOJ to fund the expansion. The ECB should remain accommodative and the BOE is expected to cut rates tomorrow. In addition, the PBOC is supporting the Chinese economy, too. Overall, the central banks appear to be in accommodation mode, which is bullish for risk assets across the board. In the U.S., two major fears for equities have been eliminated as uncertainty eases around Brexit due to Theresa May's win and the Fed remains on the sidelines due to uncertainty surrounding employment.

All this points to the potential of a "melt up." With low bond yields and zero to negative rates on cash, equities remain attractive, at least on a relative basis.



This chart shows the level of retail money market funds held along with the S&P 500. In general, since 2011, the base level of money market funds held runs between \$900 to \$950 bn. During market pullbacks, cash accumulates (the direction of causality cannot be determined—in other words, does raising cash weaken stocks or do weaker stocks lead to higher cash levels as investors sell?); as cash is redeployed, equities recover. Current cash levels are above the upper end of the recent range, suggesting that there is ample liquidity available to propel equities higher in the short run.

The longer term danger of a stronger stock market is that it's doubtful it can be supported by robust earnings growth. As this week's AAW discusses below, even the veracity of earnings is in question due to the divergence between Thomson-Reuters and Standard & Poor's earnings numbers. If earnings don't keep up, the rally will come from multiple expansion. Low interest rates support multiple expansion but it also means that equities could become "priced to perfection." Thus, we are in rally mode now but we are worried it will be difficult to sustain over time.

U.S. Economic Releases

June small business optimism rose more than expected to 94.5 from 93.8 the month before. Forecasts were calling for a level of 93.9.

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

Economic releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Wholesale inventories	m/m	May	0.2%	0.6%	*
10:00	JOLTS job openings	m/m	May	5650.0	5788.0	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
5:30	Kashkari	Minneapolis FRB President				
9:30	Mester	Cleveland 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								
China	Foreign direct investment	y/y	Jun	9.7%	-1.0%	0.8%	**	Equity bullish, bond bearish
India	CPI	y/y	Jun	5.8%	5.8%	5.8%	***	Equity and bond neutral
	Industrial production	y/y	May	1.2%	-1.3%	-0.3%	***	Equity bullish, bond bearish
Japan	PPI	y/y	Jun	-4.2%	-4.3%	-4.2%	**	Equity and bond neutral
EUROPE								
Germany	CPI	y/y	Jun	0.3%	0.3%	0.3%	***	Equity and bond neutral
	Wholesale price index	y/y	Jun	-1.5%	-2.3%		*	Equity and bond neutral
AMERICAS								
Brazil	Retail sales	y/y	May	-9.0%	-6.9%	-6.3%	**	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)	67	66	1	Up
3-mo T-bill yield (bps)	29	28	1	Up
TED spread (bps)	38	38	0	Neutral
U.S. Libor/OIS spread (bps)	39	39	0	Neutral
10-yr T-note (%)	1.48	1.43	0.05	Widening
Euribor/OIS spread (bps)	-29	-29	0	Neutral
EUR/USD 3-mo swap (bps)	43	43	0	Neutral
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	down			Up
franc	unch			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	$47.67	$46.25	3.07%	Nigeria outages, lower dollar
WTI	$45.98	$44.76	2.73%	
Natural Gas	$2.74	$2.70	1.30%	Hot weather forecast
Crack Spread	$14.13	$13.81	2.31%	
12-mo strip crack	$12.67	$12.51	1.23%	
Ethanol rack	$1.75	$1.75	-0.09%	
Metals				
Gold	$1,345.64	$1,355.40	-0.72%	Investment demand falling
Silver	$20.23	$20.28	-0.26%	
Copper contract	$218.55	$214.75	1.77%	Demand expected to rise
Grains				
Corn contract	$ 347.50	$ 348.25	-0.22%	
Wheat contract	$ 429.00	$ 430.50	-0.35%	
Soybeans contract	$ 1,055.50	$ 1,055.00	0.05%	
Shipping				
Baltic Dry Freight	704	703	1	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.3		
Gasoline (mb)		-1.1		
Distillates (mb)		0.2		
Refinery run rates (%)		0.3%		
Natural gas (bcf)		53.0		

Weather

The 6-10 and 8-14 day forecasts call for warmer than normal temperatures for the majority of the country, except for the Northwest. Most of the country is expected to receive lighter than normal precipitation, although parts of the Midwest and Northwest are forecast to receive some rain. The tropics are quiet today.

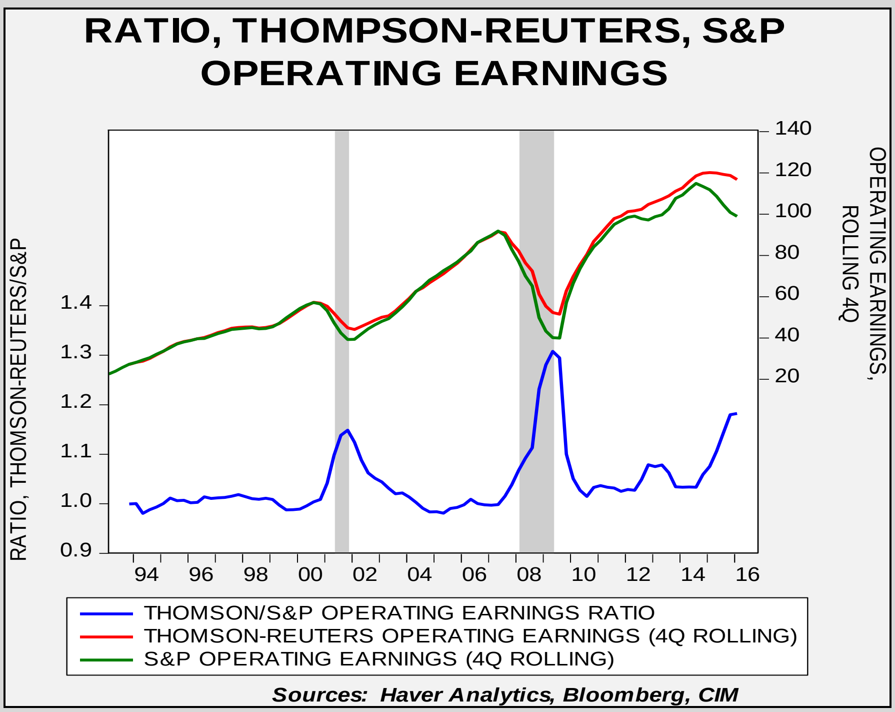
Weekly Asset Allocation Commentary

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 8, 2016

One of the great characteristics about working in financial services is that there are always surprises. Recently, we came across a situation in the S&P earnings data that we had not noticed before. It is well known that earnings have two variations—as reported and operating. As reported earnings include all costs. Thus, the cost of shutting down a factory or an adverse legal judgement reduces earnings. However, it could be argued that these costs are nonrecurring and don't accurately reflect the costs of the ongoing business. Operating earnings exclude nonrecurring expenses.

What surprised us is that there are at least two sources for operating earnings, Standard and Poor's and Thomson-Reuters. At times, the two series diverge.



This chart shows the two operating earnings series along with the ratio of the two numbers on the bottom of the chart. About 28% of the time, the ratio is 1.05 or greater, indicating that the Thomson-Reuters operating earnings numbers are about 5% higher than the S&P operating earnings report.

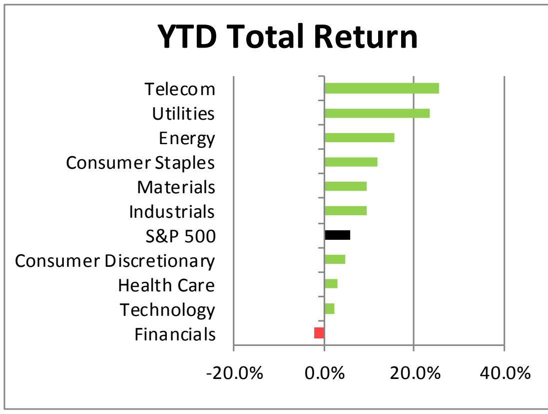
There are two issues to examine. First, it is apparent that the Thomson-Reuters numbers are usually higher than the S&P data; there are only 22 out of 90 quarters where the S&P number was higher and the average spread was only 50 cents per share. According to analyst reports, Thomson-Reuters "fits" its series to more closely match analyst estimates (which its I/B/E/S division gathers). Although neither series purports to be GAAP, most likely, the Thomson-Reuters series is less adherent than S&P. Thus, any P/E calculated off the Thompson-Reuters data will tend to be understated. The second issue, and perhaps the more important one, is the signal being sent by the divergence of the two series. On the above chart, we have included vertical gray bars indicating recessions; note that when the two series diverge by 10% (1.10 on the above chart), the economy is in recession. Thus, the current divergence is a concern. There are several other business cycle indicators that suggest the economy is not in a downturn, but this indicator is clearly flashing a warning sign.

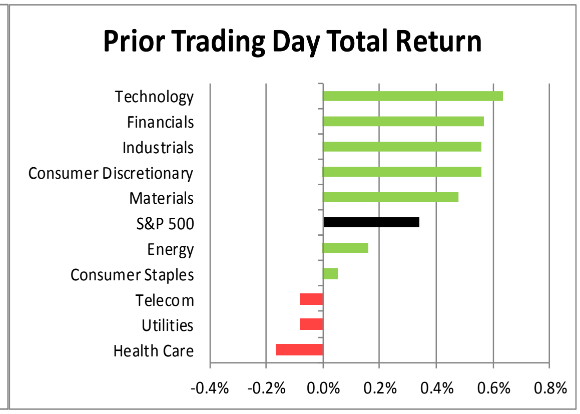
Which is the more accurate number? Frankly, like so many other situations in life, it depends. At this part of the business cycle, the S&P number is probably more informative. In previous cycles, S&P's weaker earnings were an indicator of an impending change in the business cycle. That's why the current divergence is a warning sign. On the other hand, the Thomson-Reuters numbers are a more accurate representation of operating earnings during the recovery from recession. Note on the above chart that the S&P earnings numbers tend to "catch up" with the Thomson-Reuters numbers as the recovery begins.

The P/E chart later in this report (page 12), which we update weekly, uses the S&P operating earnings data for historical earnings data. The expectations data comes from I/B/E/S, so it comes ultimately from Thomson-Reuters. This means our P/E may be somewhat understated, although not nearly as much as a pure forward-looking number would suggest using the Thomson-Reuters data. Given where we are in the business cycle, the S&P numbers are probably a better reflection of operating earnings, meaning the forward P/E may be offering investors false comfort.

Data Section

U.S. Equity Markets – (as of 7/11/2016 close)

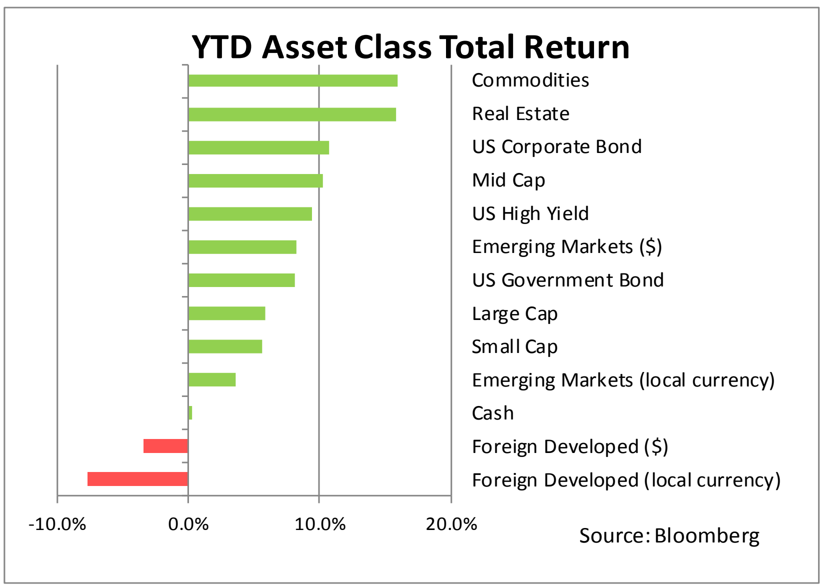




(Source: Bloomberg)

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 7/11/2016 close)

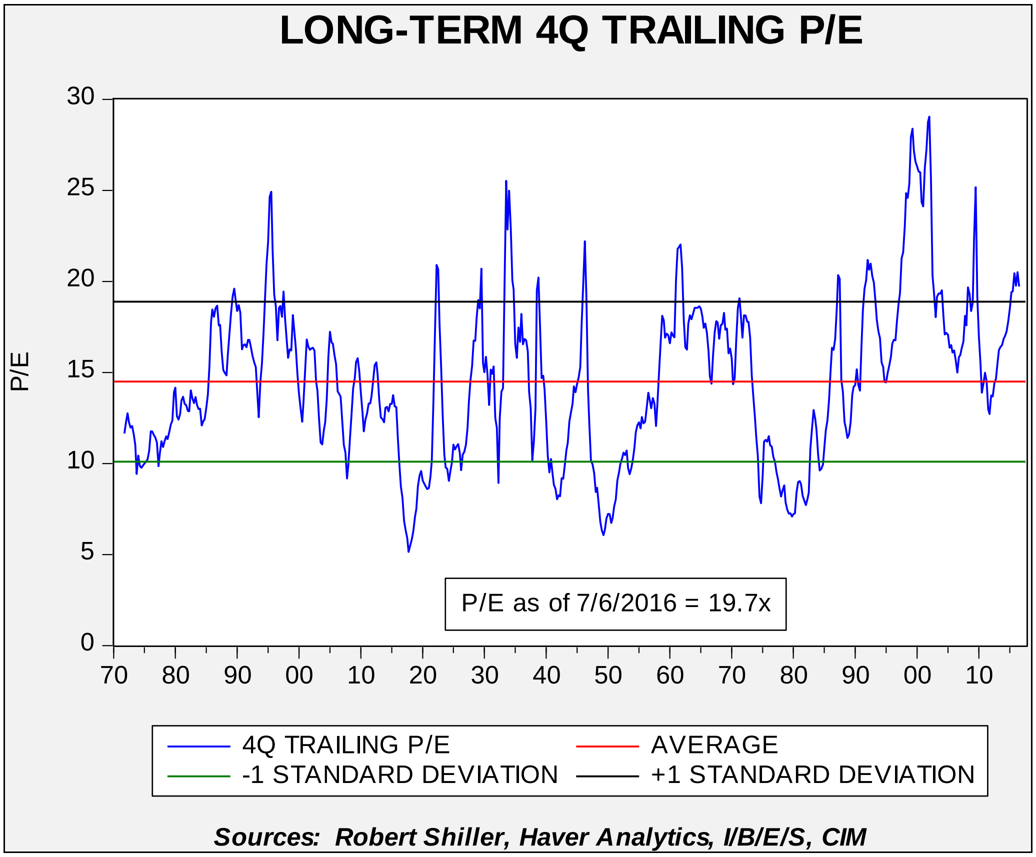


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 8, 2016



Based on our methodology,[1] the current P/E is 19.7x, down 0.8x. This drop reflects the adjustment of moving to Q3.

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.