Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: July 20, 2016—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is trading higher by 0.9% from the last close. In Asia, the MSCI Asia Apex 50 closed up by 0.2% from the prior close. Chinese markets were mixed, with the Shanghai composite trading down 0.3% and the Shenzhen index higher by 0.1%. U.S. equity futures are signaling a higher opening from the previous close. With 61 companies having reported, the S&P 500 Q2 earnings stand at $28.91, 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, 67.2% of the companies reported earnings above forecast, while 21.3% reported earnings below forecast.

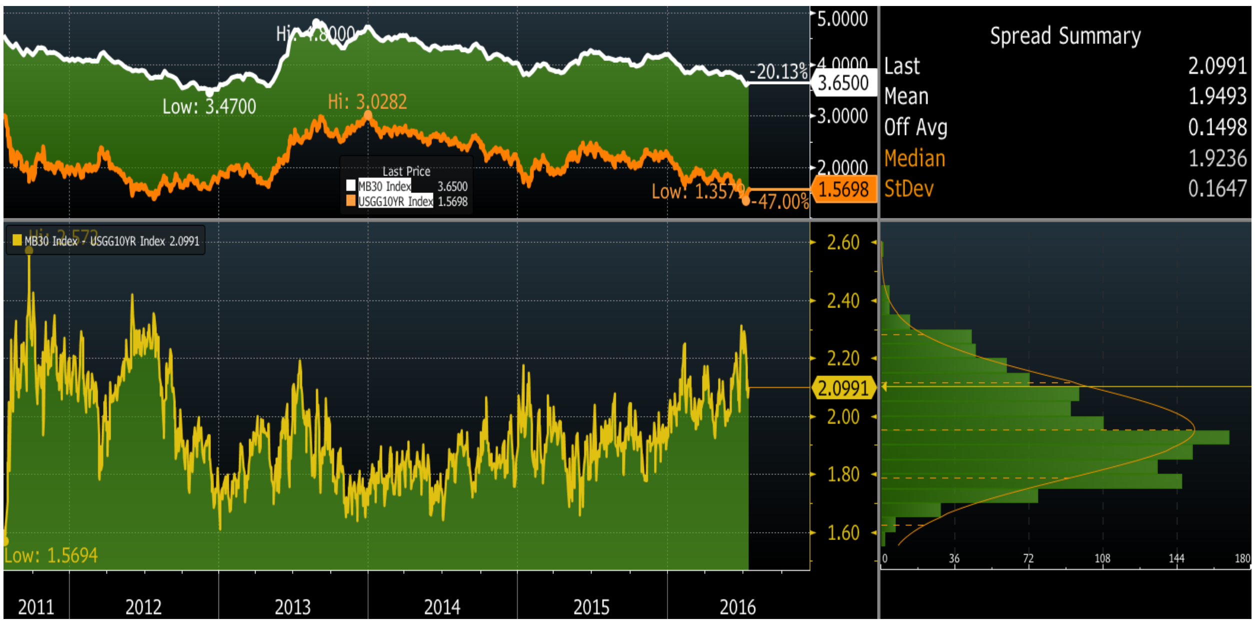
Market commentary is starting to suggest that the FOMC may be heading toward a rate hike later this year. Since the Brexit event is now behind us and the U.S. economy has stabilized, if the Fed wants to return to a tightening mode, it could. However, the markets themselves don't believe it is going to occur. The fed funds futures market doesn't signal a greater than 50% probability of a rate increase until the March 2017 meeting and, even then, the odds are only 53.1%. By next June, the odds reach 64.3%. If the FOMC moves more quickly, this would come as a surprise to the financial markets. If sentiment toward tightening increases, we would expect some weakness to emerge in equities. Fixed income would likely experience a flattening yield curve and the dollar would probably rally, which would be bearish for commodities. We doubt the FOMC moves rates this year. The level of political turmoil is high, the economy isn't robust and inflation remains contained. However, the lack of policy consensus on the FOMC does suggest that a return to a more hawkish rhetoric from the U.S. central bank would not be a shock.

Reuters is reporting that a survey of Chinese sales managers confirms the economy is growing but suggests the growth rate is only about 50% of the official rate. The Sales Manager Index for July came in at 51.7, up from 51.6; the group that conducts the survey, World Economics, suggests that China is growing around 3.3% based on its data.

The *WSJ* is reporting that Saudi Arabia is drawing down inventories in order to meet domestic demand. The kingdom estimates its maximum production capacity at 12.5 mbpd and current production is pegged at 10.3 mbpd. There is some controversy surrounding the capacity number. This level is not verified by outside sources so there is some doubt the kingdom can actually achieve this level of production. In addition, there is some question as to why Saudi Arabia doesn't just raise output to meet domestic demand and maintain export levels. Reports suggest it would need to raise output by 0.3 mbpd to meet domestic demand, but it is possible the kingdom fears that an increase of that magnitude would signal a renewed market share war and send prices lower. Another possibility is that the marginal production is more expensive than the cost of the oil in storage, thus it's a decision based on relative costs. It should be noted that Saudi Arabian oil inventories are 289 mb, down from 324 mb from last October. There is still ample oil in storage, so there is little chance that the Saudis will allow global supplies to tighten due to the lack of storage. Overall, we still believe the guiding principle of Saudi oil policy is market share and the decision to boost output or use inventories is probably more a function of relative cost. On the other hand, the behavior suggests the kingdom is comfortable with current prices.

U.S. Economic Releases

Mortgage applications fell 1.3% for the most recent reporting week, with purchases down 2.0% and refinancing down 0.9%. Purchases have been somewhat low in July, especially for a period that is usually seasonally strong. Refinancing activity declined as mortgage rates rose, with the 30-year mortgage rate rising 5 bps to 3.65%.



(Source: Bloomberg)

This chart shows the 30-year mortgage rate against the 10-year T-note. The spread (lower chart) has been widening this year as mortgage suppliers have been increasing margins. The current mortgage rate is 15 bps higher than its five-year average, suggesting that rates are running a bit higher than the overall market rate.

There are no other releases or Fed speakers scheduled for the rest of the day.

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
EUROPE								
Eurozone	Current account	m/m	May	€30.8 bn	€36.4 bn		**	Equity and bond neutral
Germany	PPI	y/y	Jun	-2.2%	-2.7%	-2.4%	**	Equity bearish, bond bullish
Italy	Current account	m/m	May	€3.2 bn	€4.7 bn		**	Equity and bond neutral
U.K.	Unemployment rate	m/m	May	4.9%	5.0%	5.0%	***	Equity bullish, bond bullish
Switzerland	ZEW survey of expectations	m/m	Jul	5.9	19.4		**	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)	70	69	1	Up
3-mo T-bill yield (bps)	31	31	0	Neutral
TED spread (bps)	39	38	1	Up
U.S. Libor/OIS spread (bps)	41	41	0	Neutral
10-yr T-note (%)	1.56	1.55	0.01	Widening
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	48	48	0	Neutral
Currencies	**Direction**			
dollar	unch			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	$46.74	$46.66	0.17%	Domestic inventories forecast to decline
WTI	$44.54	$44.65	-0.25%	
Natural Gas	$2.69	$2.73	-1.32%	Profit taking
Crack Spread	$13.16	$13.25	-0.66%	High gasoline inventories
12-mo strip crack	$12.01	$12.14	-1.10%	
Ethanol rack	$1.71	$1.71	-0.45%	
Metals				
Gold	$1,319.25	$1,332.01	-0.96%	Falling investment demand
Silver	$19.55	$19.91	-1.82%	
Copper contract	$223.25	$226.30	-1.35%	Chinese copper output rose
Grains				
Corn contract	$ 349.75	$ 348.50	0.36%	
Wheat contract	$ 420.75	$ 418.00	0.66%	Wet weather in Europe
Soybeans contract	$ 1,024.50	$ 1,027.75	-0.32%	Weather concerns ease for soybeans
Shipping				
Baltic Dry Freight	746	748	-2	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.3		
Gasoline (mb)		-0.2		
Distillates (mb)		1.0		
Refinery run rates (%)		0.1%		
Natural gas (bcf)		42.0		

Weather

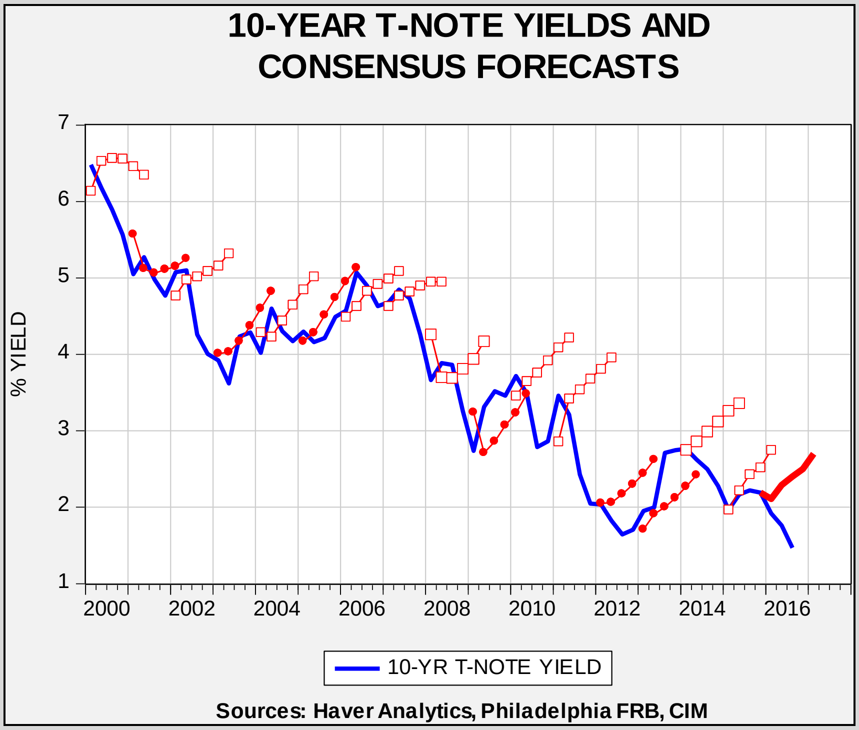
The 6-10 and 8-14 day forecasts call for warmer and drier than normal temperatures for the majority of the country, with some rain forecast for the East Coast. The tropics are quiet today.

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 15, 2016

Since the recovery began, we have consistently favored duration in fixed income. Our position has been that growth would remain sluggish in the developed world and global overcapacity would keep inflation contained. The consensus of strategists and economists didn't support our position.



This chart shows the path of the 10-year T-note yield along with the forecast at the beginning of each year from the Philadelphia FRB Professional Forecasters Survey. The open boxes indicate when the forecasts were incorrect; the solid circles indicate correct forecasts. We are on the 17th forecast; so far, 10 have been wrong and, barring a strong jump in yields similar to 2012, the forecasters will be incorrect this year as well.

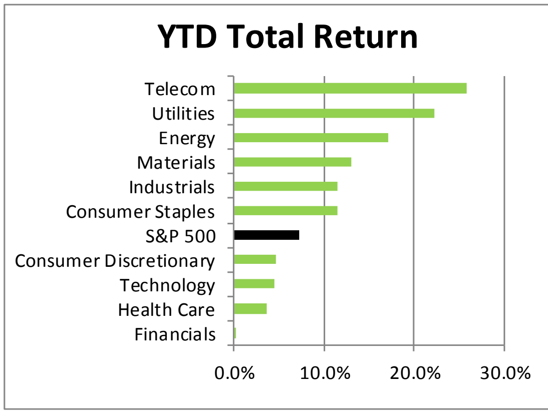
In general, the persistently incorrect forecasts are likely due to the consensus opinion that the economy, inflation and markets will normalize over some time frame. Instead, since the turn of the century, inflation has steadily declined and, in the aftermath of the financial crisis, economic growth has been persistently low. Accordingly, financial markets and global economies have been operating in a "new normal" rather than a return to the 1990s normal.

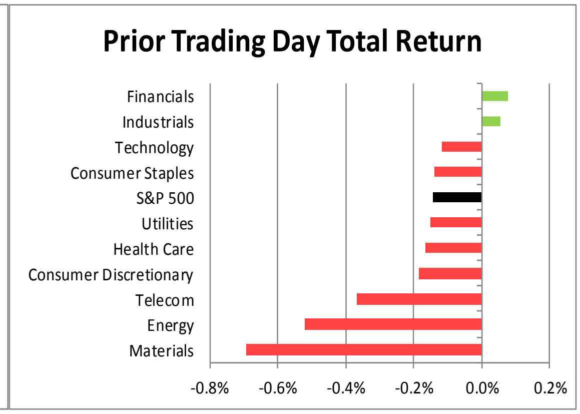
Although our position on fixed income has been correct, we are watchful for conditions that would reverse this long-term downtrend in yields. Inflation trends often have a political element. One of the key tradeoffs society makes is between equality and efficiency.[1] When society is leaning toward the latter, bonds will tend to do well because inflation will be controlled. If equality is demanded, the risk levels of bonds rise. Thus, we are carefully watching Brexit, Bernie Sanders and Donald Trump. These are all manifestations of a potential trend toward equality that would likely be expressed by re-regulation and deglobalization of the economy. If these trends, and others, gain traction, the potential for rising inflation and interest rates would increase. For now, we continue to favor long duration assets. Given the high level of binary risks looming (the process of the U.K. leaving the EU, November U.S. elections, the Italian referendum on government reform and its banking problems), long duration Treasuries offer some protection against bearish events, as the Brexit situation showed. But, we are closely monitoring economic and political conditions for a change in the secular trend in bonds.

[1] For a discussion on efficiency and equality cycles, see our recent WGR: Post-Brexit (7/11/16).

Data Section

U.S. Equity Markets – (as of 7/19/2016 close)

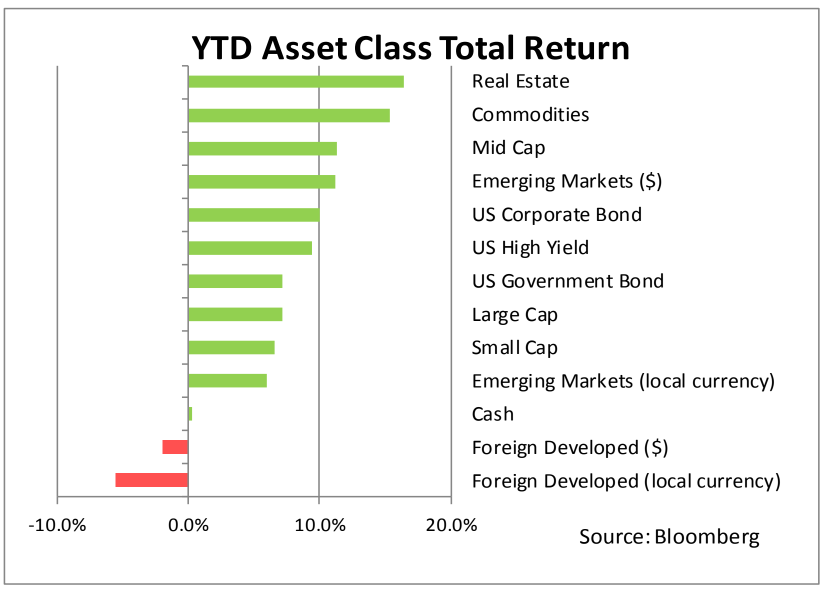




(Source: Bloomberg)

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 7/19/2016 close)

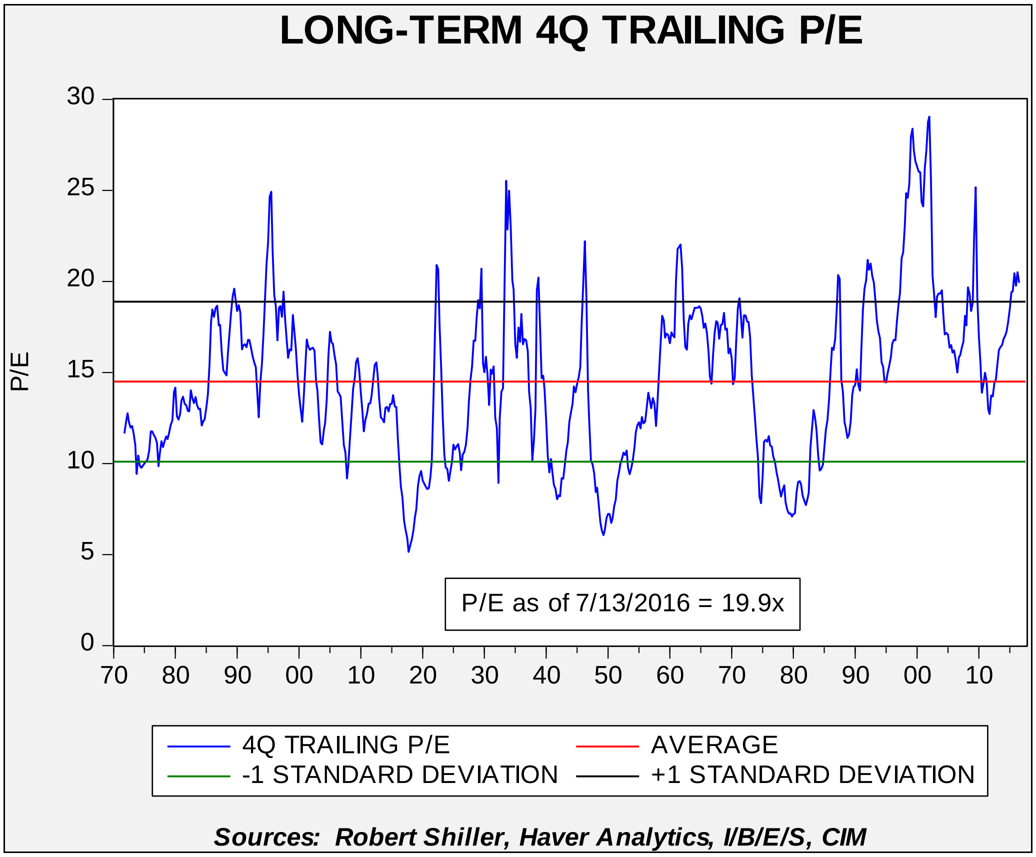


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 14, 2016



Based on our methodology,[2] the current P/E is 19.9x, up 0.2x. 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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[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.