Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: July 21, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading higher by 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed up by 0.4% from the prior close. Chinese markets were also higher, with the Shanghai composite trading up 0.4% and the Shenzhen index higher by 0.1%. U.S. equity futures are signaling a lower opening from the previous close. With 82 companies having reported, the S&P 500 Q2 earnings stand at $29.05, 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, 68.3% of the companies reported earnings above forecast, while 19.5% reported earnings below forecast.

The JPY rose strongly overnight after media reports quoted BOJ Governor Kuroda as saying that helicopter money was not being considered and would never be implemented. This comment came as a surprise as the financial markets have been steadily discounting some sort of action from the Japanese central bank. We have seen the JPY retreat after it was discovered that the comments are about a month old. Still, there are reports carried by both Reuters and Bloomberg raising concerns from BOJ officials that the BOJ may be reaching the point where its unconventional policies are no longer able to boost growth. The BOJ holds its official meeting on July 29.

On the fiscal side, Japan's PM Abe is hinting at a ¥20 trillion ($108 bn) package, which is massive. However, the actual fiscal thrust could be much less, closer to ¥3 trillion ($28 bn). How does this work? Much of the package isn't direct spending but special loans offered to the private sector for special projects. Given that the Japanese financial system has ample liquidity, it isn't obvious that these loans are even necessary. It should be noted that many of these projects are multi-year in nature, which dilutes the impact in the short run.

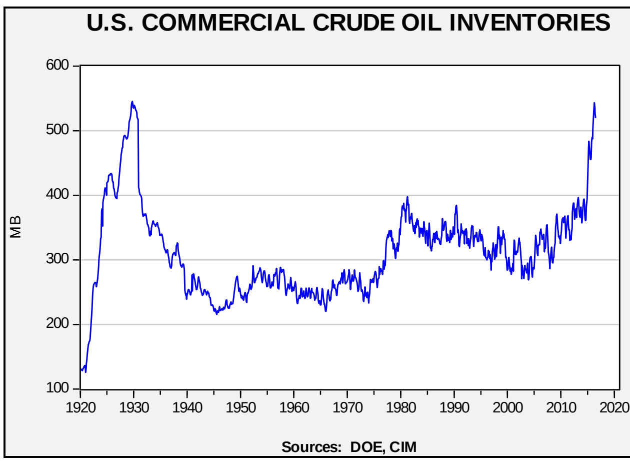
We still believe that direct financing of fiscal spending will eventually occur and will most likely occur in Japan first. However, it may not happen this summer. If Abe and Kuroda disappoint, the recent rally seen in Japanese equities and the weakness in the JPY may not be sustained.

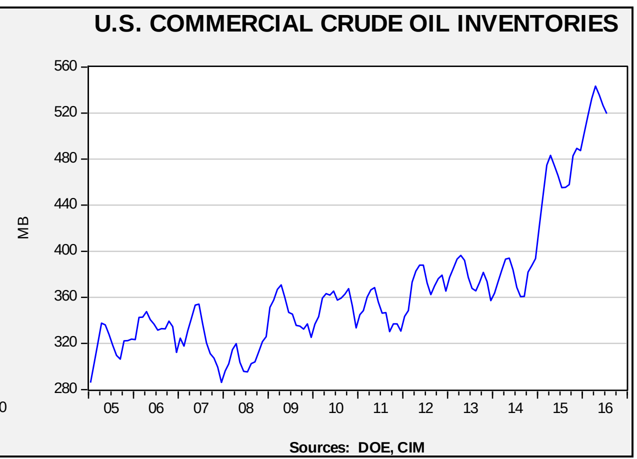
ECB President Mario Draghi is holding his press conference after the bank made no changes to policy. The markets initially took the bank's action as modestly hawkish as the EUR rallied before and early on Draghi's comments. Draghi has hinted that a stimulus boost might be considered in September. This comment reversed gains in the EUR, leaving it unchanged as the U.S. equity markets open.

The GOP is holding its convention. Unlike conventions in recent years, this one is clearly not tightly managed. Although the chattering classes are uncomfortable with the surprises and the lack of control, we suspect this issue isn't a big deal for the public. In fact, the lack of a followed script makes it more interesting to watch and may be boosting ratings. After all, we don't expect any surprises when the other party meets so there is little reason to watch. In today's *NYT*, Donald Trump suggested that, under his administration, the U.S. may not move automatically on an Article 5 event, the part that says that an attack on one member is considered an attack on all. It is known as the "collective security" article. In NATO's own documents, it is considered a "cornerstone of the Alliance."[1] Instead, Trump suggested that U.S. support may be contingent on how much a member contributes to NATO defense. In other words, he is offering a warning that "free riding" the U.S. may be very costly.

If this stance were to become the policy of the next government, it would raise significant fears among NATO members. After all, an important part of Europe's recovery from WWII was the ability to steer away from defense spending toward social spending because the former became less important due to U.S. defense spending. Trump is signaling that the behavior of the superpower will change significantly if he becomes president. We would note that this position would probably be endorsed by Sen. Sanders if he did not know the author of the statement.

The U.S. crude oil inventories fell a bit more than forecast, dipping 2.3 mb versus estimates of a 1.3 mb decline.

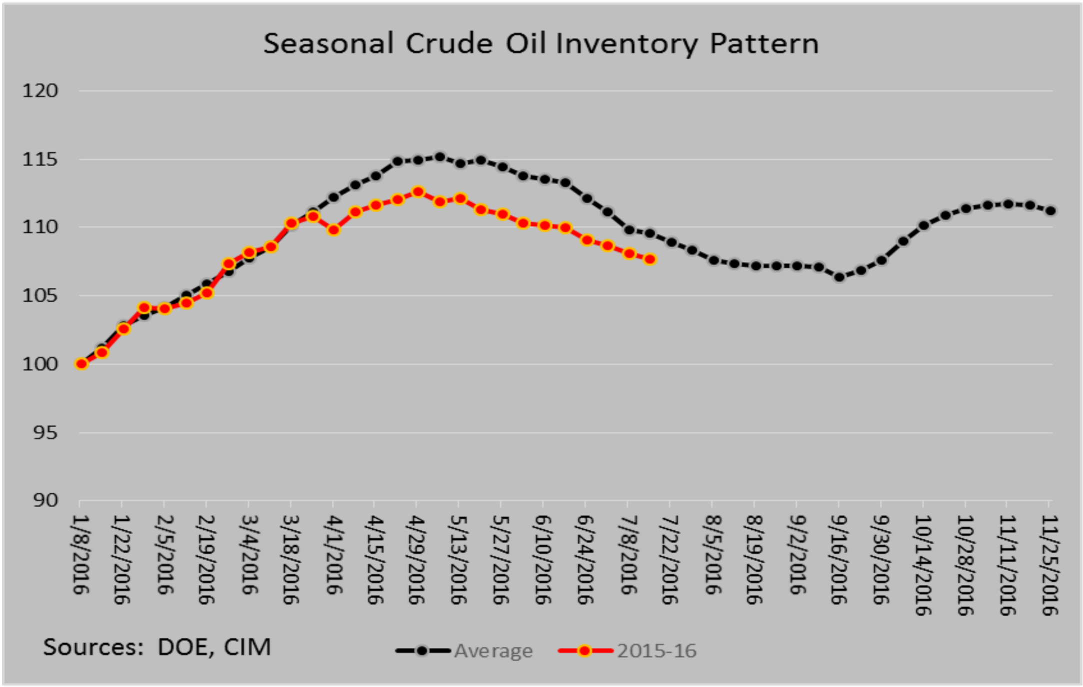




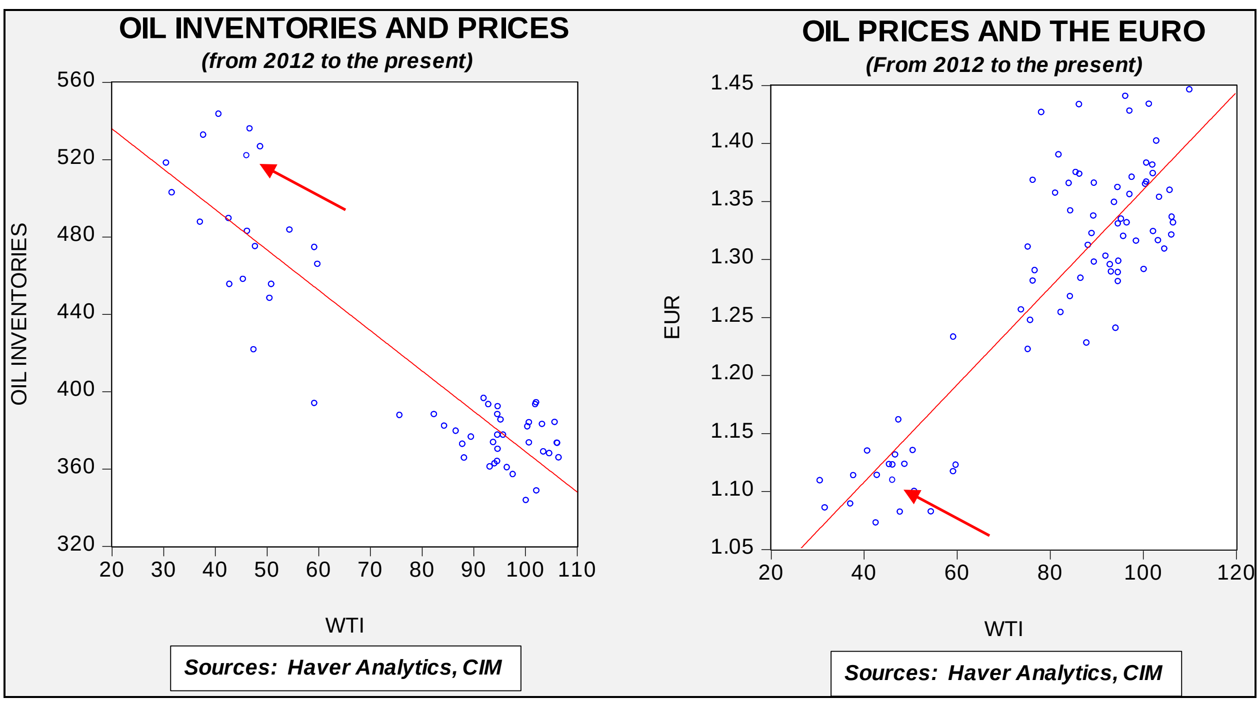
This chart shows current crude oil inventories, both over the long term and the last decade. We are starting to see inventories decline, but normal levels would be below 400 mb, some 130 mb lower than now.

Inventories remain elevated. Inventories have been lagging the usual seasonal pattern. We are in a period of the year when crude oil stockpiles tend to fall at an increasing pace. The pace of declines will slow in the coming weeks as we are halfway through the summer driving season.

[1] http://www.nato.int/cps/en/natohq/topics_110496.htm



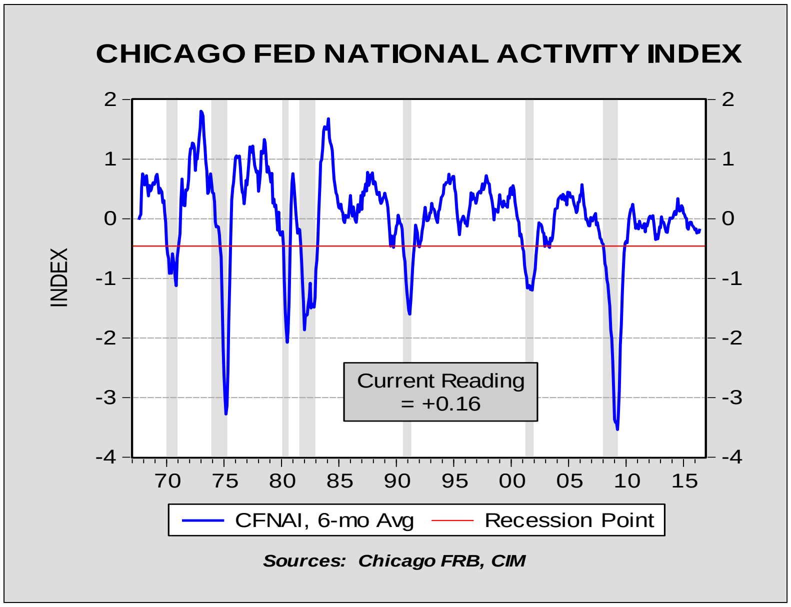
It is important to remember that the dollar is playing a bigger role in determining oil prices.



Based on inventories alone, oil prices are profoundly overvalued, with a fair value price of $36.62. Meanwhile, the EUR/WTI model generates a fair value of $46.33. Together (which is a more sound methodology), fair value is $40.85, meaning that current prices are a bit rich.

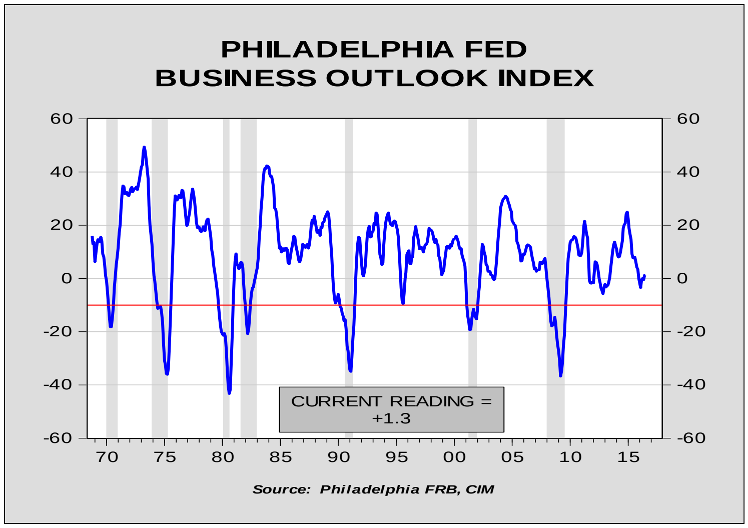
U.S. Economic Releases

The Chicago Fed National Activity Index came in better than expected in June, rising to +0.16 from -0.56 the month before. Expectations were calling for a level of -0.20. The index is designed such that a positive reading indicates economic growth above its long-term average, while a negative reading indicates economic growth below its long-term average. The current positive reading indicates improving economic growth.



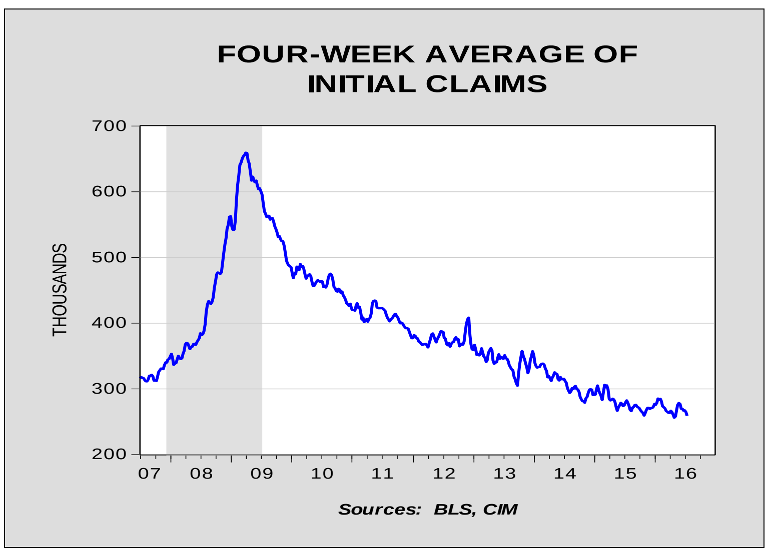
The chart above shows the six-month average of the index, a more stable measure of economic health. The average improved modestly to -0.17 from -0.23 in May. Although the average remains in negative territory, it is still above the recession point (as indicated by the red line on the chart).

At the same time, the Philadelphia Fed business outlook indicator came in weaker than forecast for July, falling to -2.9 from +4.7 the month before. Forecasts were calling for a +4.5 reading. Weakness was broad-based, with inventories, number of employees and the average workweek all in negative territory. New orders component, an indicator of future economic activity, improved significantly, rising to +11.8 from -3.0 the month before.



The chart above shows the six-month average of the Philly Fed index. The average improved modestly to +1.3 from +1.2 the month before. It remains well above the recession line, indicated in red.

Jobless claims fell to a three-month low, falling 1k to 253k, much better than the 265k forecast.



The chart above shows the four-week average of claims, which fell 1k to 258k. The labor market remains steady as companies are retaining workers in anticipation of a Q3 pick-up in demand.

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

Economic releases						
EST	Indicator			Expected	Prior	Rating
10:00	Existing home sales	m/m	Jun	-0.9%	1.8%	**
10:00	LEI	m/m	Jun	0.2%	-0.2%	**

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	Business confidence	q/q	Q2	2.0	4.0		**	Equity and bond neutral
China	Global payments (CNY)	m/m	Jun	1.7%	1.9%		**	Equity and bond neutral
Japan	Machine tool orders	y/y	Jun	-0.5%	-1.3%		**	Equity and bond neutral
EUROPE								
France	Business confidence	m/m	Jul	102.0	100.0	99.0	**	Equity bullish, bond bullish
	Manufacturing confidence	m/m	Jul	103.0	102.0	101.0	**	Equity bullish, bond bullish
	Production outlook indicator	m/m	Jul	3.0	1.0		**	Equity bullish, bond bullish
	Overall demand- Business Demand	m/m	Jul	12.0	10.0		**	Equity bullish, bond bullish
U.K.	Retail sales	m/m	Jun	-0.9%	0.9%	-0.6%	**	Equity bearish, bond bullish
Switzerland	Trade balance (SNB)	m/m	Jun	3.6 bn	3.8 bn		**	Equity and bond neutral
	Exports (real)	m/m	Jun	-3.3%	-1.0%		**	Equity bearish, bond bullish
	Imports (real)	m/m	Jun	-4.0%	-0.6%		**	Equity bullish, bond bullish
	M3 money supply	y/y	Jun	2.5%	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)	70	70	0	Neutral
3-mo T-bill yield (bps)	31	32	-1	Down
TED spread (bps)	39	38	1	Up
U.S. Libor/OIS spread (bps)	41	41	0	Neutral
10-yr T-note (%)	1.60	1.58	0.02	Widening
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	50	48	2	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	up			Up
franc	up			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
ECB main refinancing rate	0.00%	0.00%	0.00%	On forecast
ECB deposit facility rate	-0.40%	-0.40%	-0.40%	On forecast
ECB marginal lending facility	0.25%	0.25%	0.25%	On forecast
ECB asset purchase target	€80 bn	€80 bn	€80 bn	On forecast

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	$46.86	$47.17	-0.66%	Domestic gasoline stocks climbed, taking the total of crude and refined fuels to a record high
WTI	$45.51	$45.75	-0.52%	
Natural Gas	$2.67	$2.66	0.56%	Hot weather
Crack Spread	$12.75	$12.73	0.11%	High gasoline inventories
12-mo strip crack	$11.92	$11.98	-0.45%	
Ethanol rack	$1.67	$1.69	-0.91%	
Metals				
Gold	$1,321.55	$1,316.06	0.42%	Investment demand
Silver	$19.41	$19.41	-0.01%	
Copper contract	$225.85	$225.40	0.20%	
Grains				
Corn contract	$ 345.75	$ 344.25	0.44%	
Wheat contract	$ 414.75	$ 413.00	0.42%	Wet weather in Europe
Soybeans contract	$ 1,019.75	$ 1,009.00	1.07%	Weather concerns ease for soybeans
Shipping				
Baltic Dry Freight	736	746	-10	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.3	-1.3	-1.0	
Gasoline (mb)	0.9	-0.2	1.1	
Distillates (mb)	-0.2	1.0	-1.2	
Refinery run rates (%)	0.9%	0.1%	0.8%	
Natural gas (bcf)		40.0		

Weather

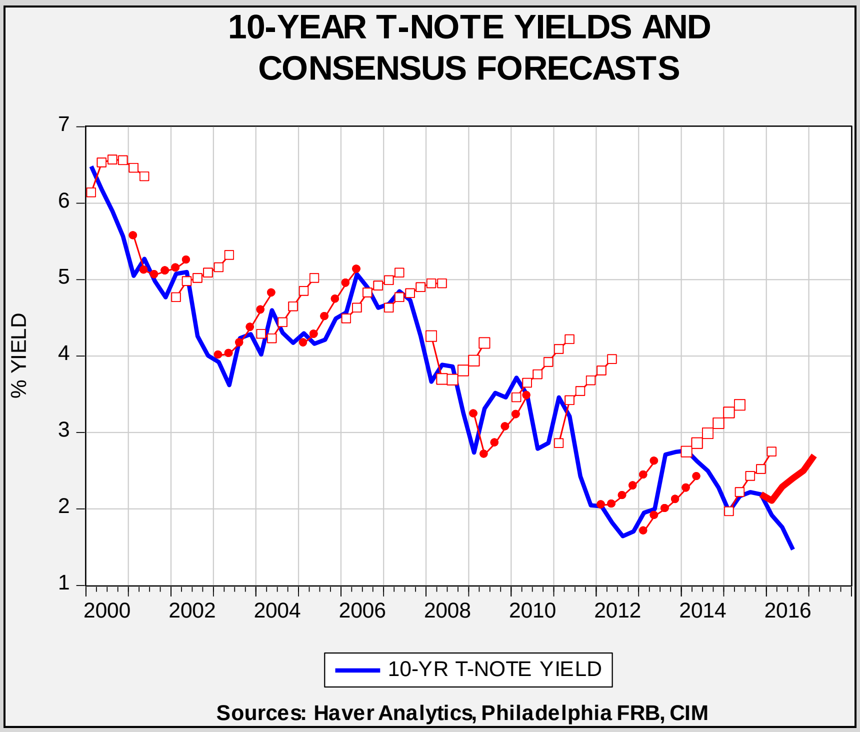
The 6-10 and 8-14 day forecasts call for warmer and drier than normal temperatures for the majority of the country, with some rain forecast for parts of the East and the Midwest. The tropics are quiet today.

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.

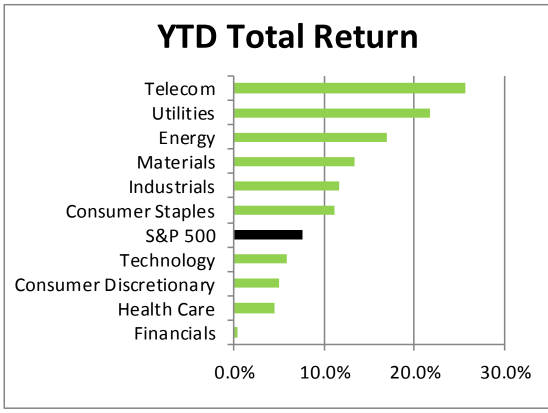
In general, the persistently incorrect forecasts are likely due to the consensus opinion that the economy, inflation and markets will normalize over some time frame. Instead, since the turn of the century, inflation has steadily declined and, in the aftermath of the financial crisis, economic growth 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.

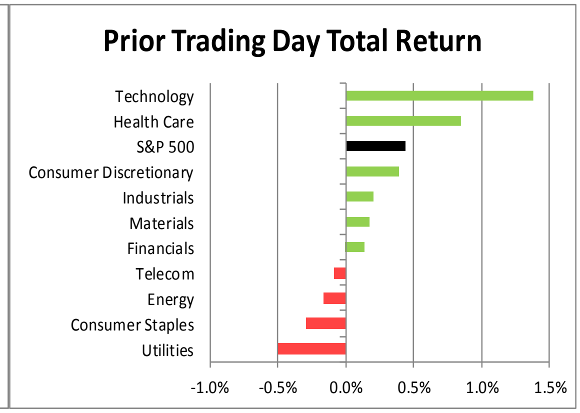
Although our position on fixed income has been correct, we are watchful for conditions that would reverse this long-term downtrend in yields. Inflation trends often have a political element. One of the key tradeoffs society makes is between equality and efficiency.[2] When society is leaning toward the 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.

[2] 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 7/20/2016 close)

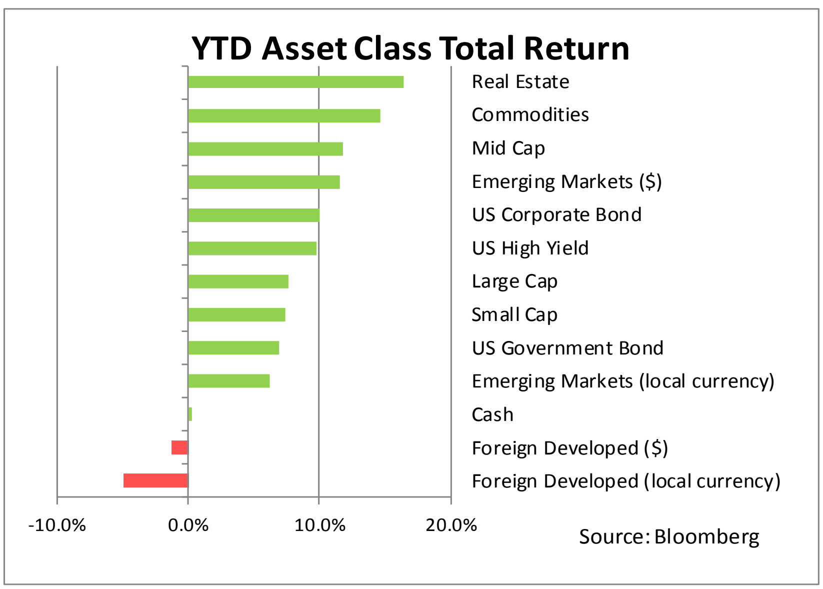




(Source: Bloomberg)

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 7/20/2016 close)

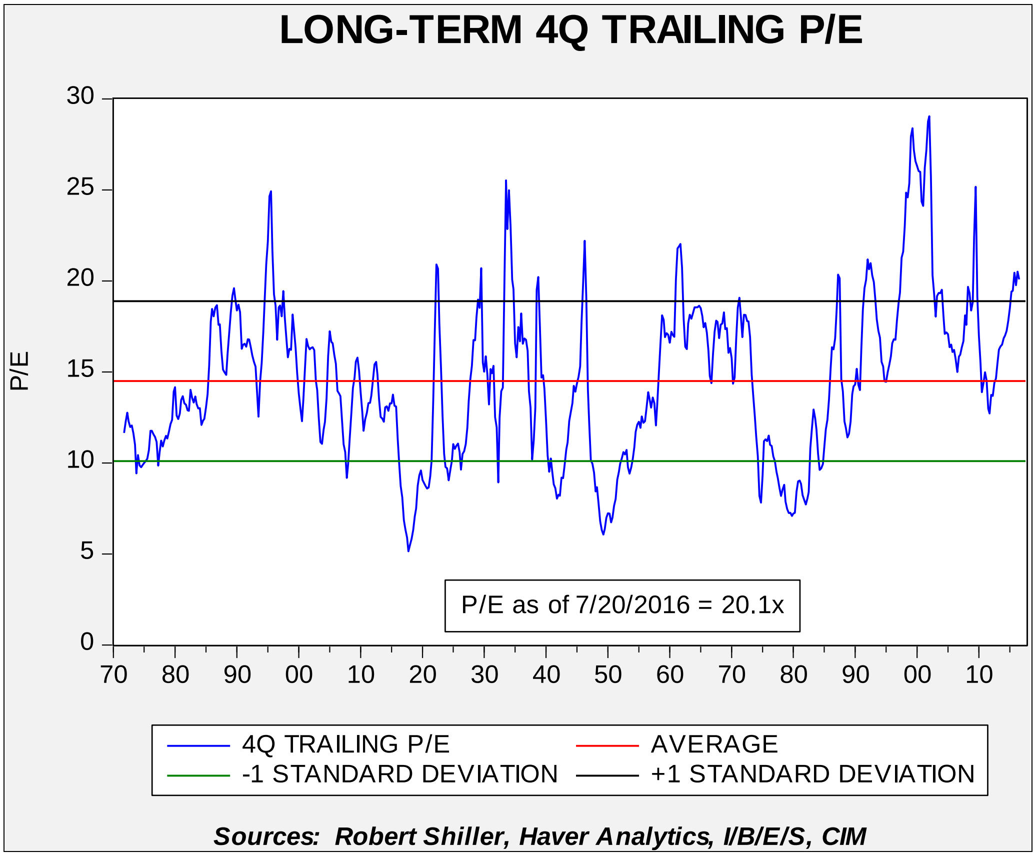


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 21, 2016



Based on our methodology,[3] the current P/E is 20.1x, up 0.3x. 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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[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.