Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: July 28, 2016—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is trading down 0.6% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.2% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.1% and the Shenzhen index trading lower by 0.2%. U.S. equity futures are signaling a modestly lower opening from the previous close. With 232 companies having reported, the S&P 500 Q2 earnings stand at $29.31, higher than the $28.38 forecast for the quarter. The forecast reflects a 5.4% decline from Q2 2015 earnings. Thus far this quarter, 74.6% of the companies reported earnings above forecast, while 14.7% reported earnings below forecast.

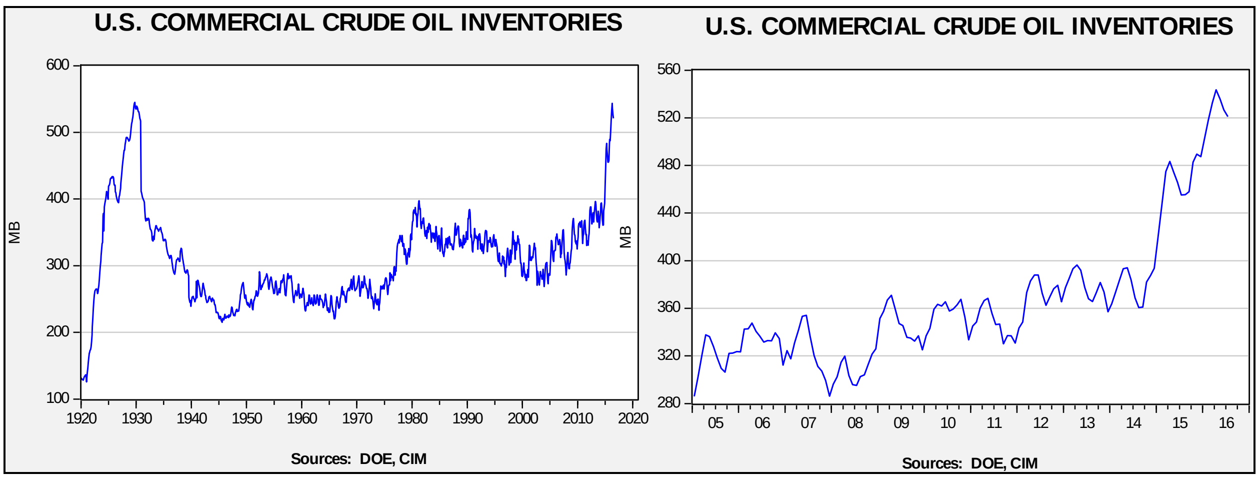
The FOMC statement was generally as expected. The committee acknowledged the economy improved from their last meeting. Labor markets are better and household spending is robust. On the other hand, business investment remains sluggish. Overall, the FOMC indicates that "near-term risks to the economic outlook have diminished." Yet, the language suggesting that policymakers are in no rush to raise rates remains in place. The statement, for example, did not signal that risks to the economy were "nearly balanced" as some feared. KC Fed President George dissented, resuming her lonely assault on policy stability. But, overall, there were few surprises. We would view the statement as consistent with an outside chance of one hike this year, and more likely, no rate adjustments until 2017. Simply put, if the Fed wanted to prepare the markets for a rate hike, this statement failed in the goal, leading us to conclude that was not their aim.

Market action would suggest that the financial markets were primed for a more hawkish stance from the FOMC. In the hours after the statement, the dollar has weakened significantly and long-duration Treasuries rallied. Although STL Fed President Bullard has been roundly criticized for his regime model of monetary policy, the actual behavior of the Fed is very consistent with his model. He has faced criticism because his theory implies that policymakers are anticipatory except when regimes change; at that point, monetary policy would shift to a new focus (e.g., from controlling inflation to stabilizing the financial system) which would require a period of adjustment where the Fed would be behind the curve until the new regime is implemented. This is an unpopular view of policy; the preferred view is one where the focus of policy never changes. However, if one actually looks at how policy is conducted, it does pass through periods of goal adjustments, or regimes. The reason this is unpopular is that it adds another layer of risk to the financial markets. If, for example, the Fed switched to a regime of getting to 8% annual M2 growth instead of targeting inflation, interest rate volatility could soar. And yet, this was exactly Volcker's monetary policy regime.

The BOJ decision is expected tomorrow. As we noted yesterday, PM Abe unveiled a ¥28 trillion fiscal package that included new spending and loan guarantees. The latter isn't all that important because money is nearly free in Japan and so a project that needs a guarantee might be difficult to do anyway. The focus, then, is on how much new spending is included. Bloomberg reports today that it's about a quarter of the total package, or ¥7 trillion. The unknown is the time frame for that spending. If it is spread out over several years, the immediate impact is less. From the BOJ tomorrow, we would not expect an announcement of helicopter money but would expect an expansion of QE.

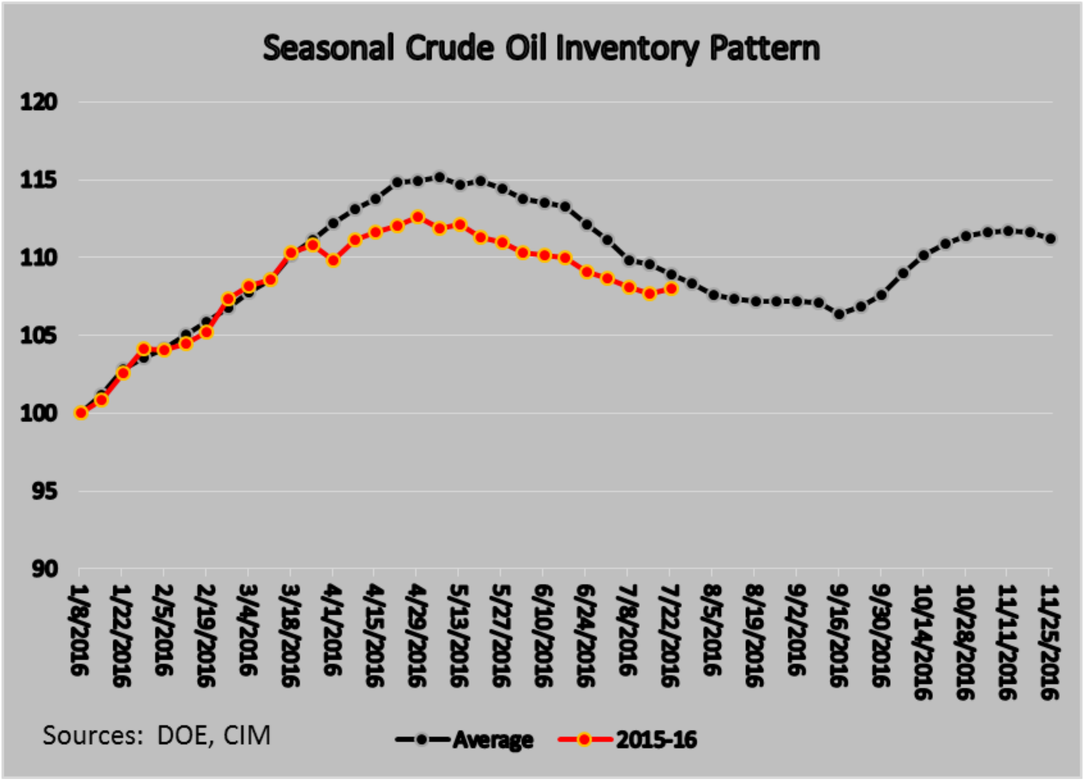
Meanwhile, in Europe, EU Commission President Juncker appointed Michel Barnier to negotiate Britain's exit from the EU. This appointment raised alarm in London; Barnier is considered anti-finance. He has supported regulatory measure, which has been unpopular in London, including broker bonus caps. Quotes surrounding his appointment include "I can't see how it could be worse" and "It's incredibly provocative. This is Juncker's revenge on Britain". We still believe that Chancellor Merkel is the ultimate decision maker on Brexit and initial meetings between the German leader and PM May appeared cordial. But the French are taking a hard line, in part to scare off the Le Pen's National Front party, and are likely behind Barnier's appointment. This decision could make things worse in terms of Brexit.

The U.S. crude oil inventories rose 1.6 mb, a bearish surprise. Market expectations called for a 2.0 mb draw.

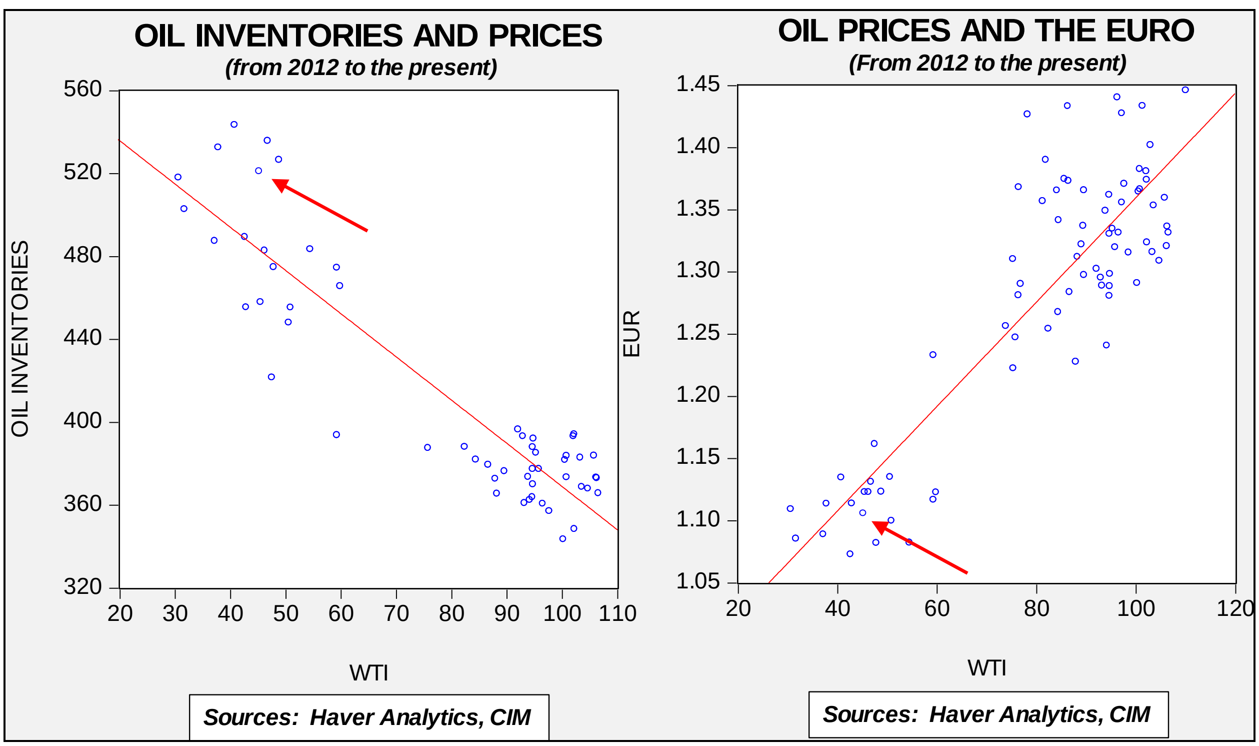


This chart shows current crude oil inventories, both over the long term and the last decade. We are starting to see inventories decline but normal levels would be below 400 mb, some 130 mb lower than now.

Inventory levels have been running below seasonal norms although the divergence has been narrowing. It narrowed significantly this week. We are in a period of the year where crude oil stockpiles tend fall at an increasing pace; in fact, in August, declines slow markedly. We note this week that refinery utilization fell 0.8%. Given the overhang in gasoline inventories, which rose 0.5 mb compared to expectations of a 0.2 mb rise, further declines in refinery utilization could lead to additional increases in oil stockpiles.



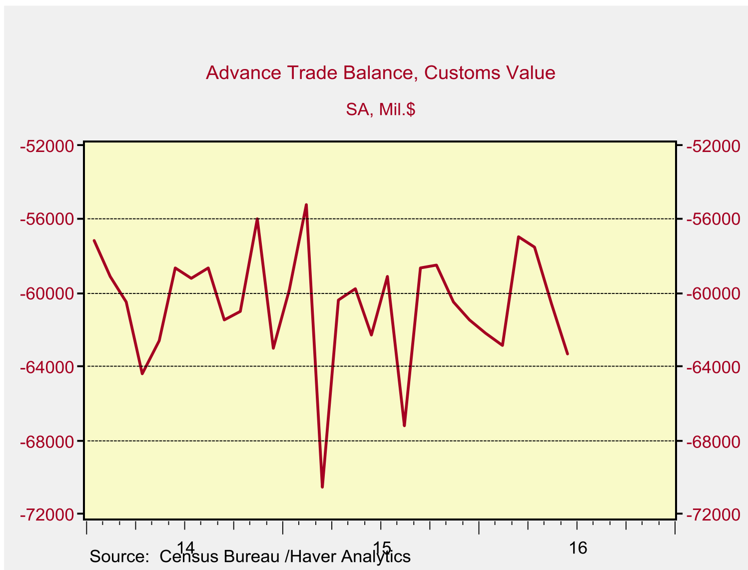
It is important to remember that the dollar is playing a bigger role in determining oil prices.



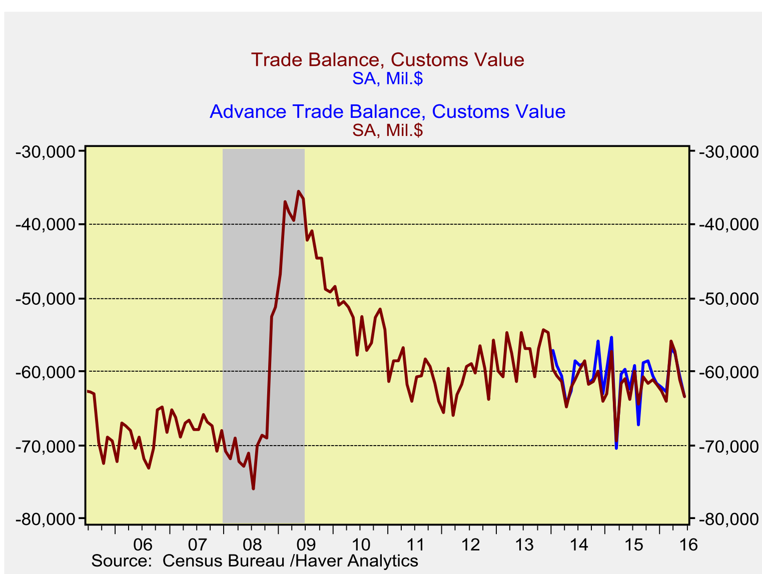
Based on inventories alone, oil prices are profoundly overvalued with the fair value price of $35.99. Meanwhile, the EUR/WTI model generates a fair value of $45.92. Together (which is a more sound methodology) fair value is $40.34, meaning that current prices are a bit rich although valuations are improving.

U.S. Economic Releases

The June advance trade deficit widened to $63.3 bn from $61.1 bn the month before, showing a wider deficit than the $61.0 bn forecast. Most of the widening of the deficit came from the increased imports of industrial supplies and consumer goods.

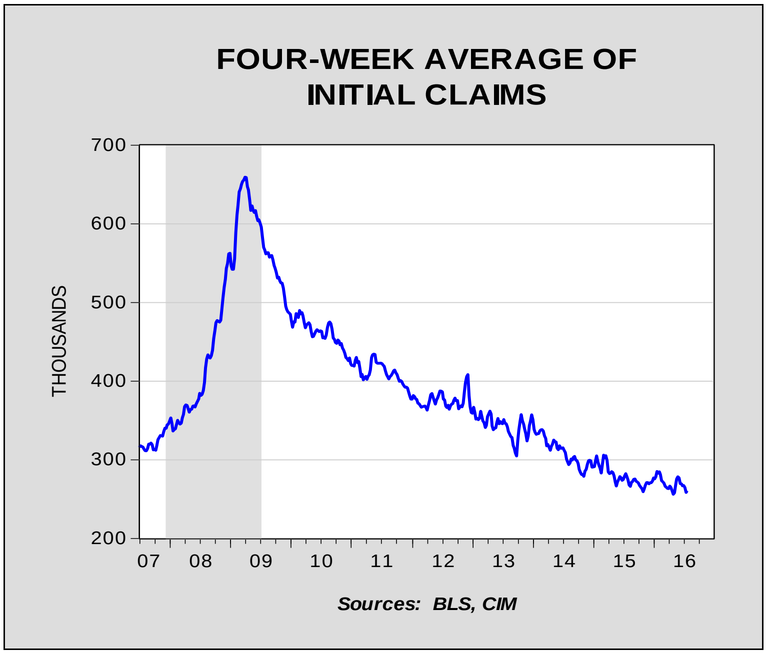


The chart above shows the level of the advance trade balance. Since this is a new data series from the Census Bureau, let's compare it to the longer data series.



The chart below shows the longer trade balance data as well as the advance trade report. Based on the widening of the advance trade deficit, we would also expect the Balance of Payments (BOP) basis trade deficit to widen.

Initial claims rose 14k to 266k level, higher than the 262k level forecast. Although we saw an increase in the level of claims, the number has stayed low as companies are reluctant to lay workers off in expectation of a pick-up in end demand.



The chart above shows the four-week average of claims. The average fell 1k to 257k. The low levels of claims are consistent with a generally steady labor market.

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

Economic releases						
EST	Indicator			Expected	Prior	Rating
11:00	Kansas City Fed manufacturing activity	m/m	Jul	4.0	2.0	**

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	Economic confidence	m/m	Jul	104.6	104.4	103.5	**	Equity bullish, bond bullish
	Business climate indicator	m/m	Jul	0.4	0.2	0.2	**	Equity bullish, bond bullish
	Industrial confidence	m/m	Jul	-2.4	-2.8	-3.3	**	Equity and bond neutral
	Services confidence	m/m	Jul	11.1	10.9	10.3	**	Equity bullish, bond bullish
	Consumer confidence	m/m	Jul	-7.9	-7.9	-7.9	**	Equity and bond neutral
Germany	CPI	y/y	Jul	0.4%	0.3%	0.3%	***	Equity bullish, bond bullish
Italy	Hourly wages	y/y	Jun	0.2%	0.0%		**	Equity bullish, bond bullish
U.K.	House prices	y/y	Jul	5.2%	5.1%	4.5%	**	Equity bullish, 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)	74	73	1	Up
3-mo T-bill yield (bps)	27	28	-1	Down
TED spread (bps)	48	46	2	Up
U.S. Libor/OIS spread (bps)	42	41	1	Up
10-yr T-note (%)	1.53	1.50	0.03	Widening
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	52	51	1	Up
Currencies	Direction			
dollar	down			Neutral
euro	up			Neutral
yen	up			Up
franc	up			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	$43.48	$43.47	0.02%	
WTI	$42.12	$41.92	0.48%	
Natural Gas	$2.67	$2.66	0.26%	
Crack Spread	$13.75	$13.48	1.97%	
12-mo strip crack	$12.23	$12.15	0.67%	
Ethanol rack	$1.61	$1.62	-0.42%	
Metals				
Gold	$1,345.65	$1,340.08	0.42%	Lower dollar
Silver	$20.48	$20.37	0.55%	
Copper contract	$221.65	$218.50	1.44%	
Grains				
Corn contract	$ 343.50	$ 343.00	0.15%	
Wheat contract	$ 419.25	$ 414.75	1.08%	Severe rain damage to French crop
Soybeans contract	$ 990.00	$ 986.00	0.41%	
Shipping				
Baltic Dry Freight	679	696	-17	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	1.7	-2.0	3.7	
Gasoline (mb)	0.5	0.2	0.3	
Distillates (mb)	-0.8	0.7	-1.5	
Refinery run rates (%)	-0.8%	-0.2%	-0.6%	
Natural gas (bcf)		26.0		

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 small disturbance has formed off the coast of Africa, with a medium chance of developing into a cyclone over the next 48 hours.

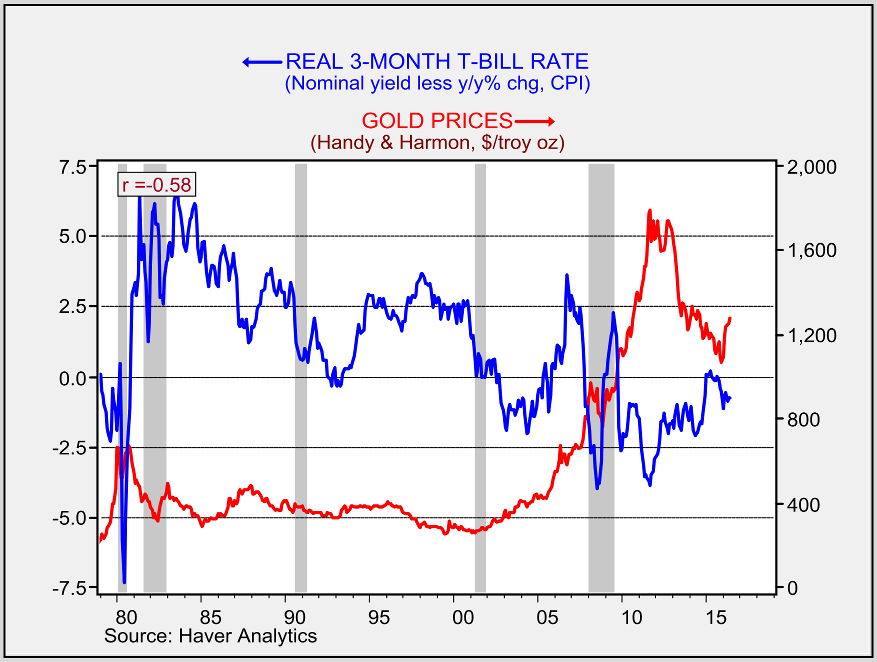
Weekly Asset Allocation Commentary

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 22, 2016

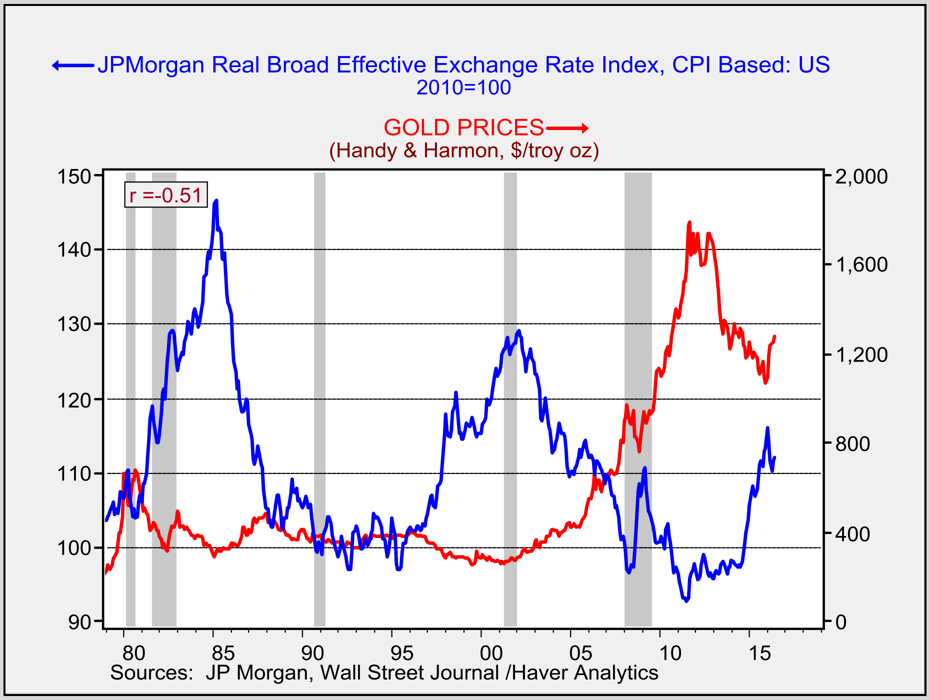
In the most recent rebalance of our Asset Allocation portfolios, we introduced positions in gold. Although the yellow metal is classified as a commodity, we view it more as a currency, admittedly one that is not backed by liabilities. National fiat currencies are generally created in the credit process and are backed by the trust imbedded in the nation's debt. Currencies have three roles: medium of exchange, unit of account and store of value. Gold does not act as a medium of exchange in a modern economy. But, it can be used as a unit of account and it mostly excels as a store of value.

Because it isn't liability backed, the opportunity cost of holding gold is essentially equivalent to inflation-adjusted interest rates. If one holds gold in lieu of short-term debt, the lost opportunity is the interest earned after inflation. History does suggest that there is an inverse correlation between real interest rates and gold.



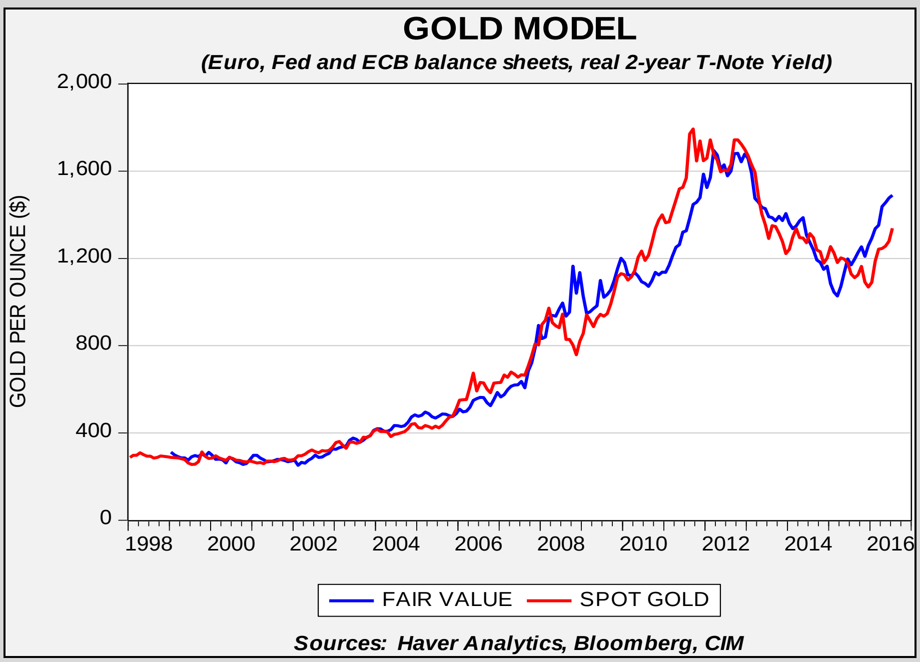
This chart shows real T-bill rates and the price of gold. Note that gold prices have increased as real rates have become persistently negative.

The other factor that affects gold is the dollar. Since gold is priced in dollars, a rising greenback makes gold prices more expensive to foreign buyers. Since a stronger dollar is often associated with rising U.S. interest rates, a stronger dollar tends to be bearish for gold.



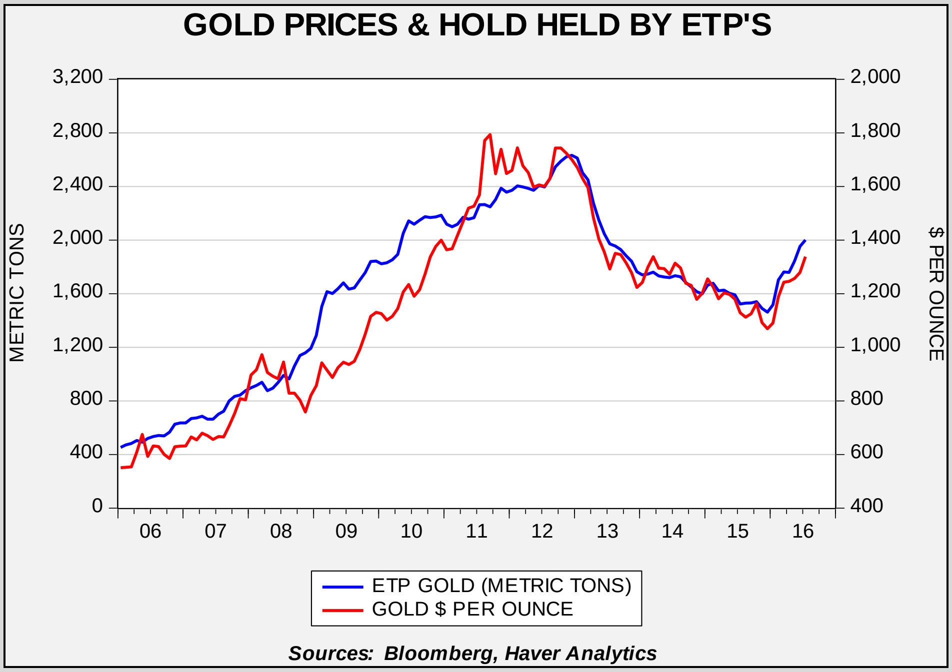
This chart shows gold prices and the JPM real effective dollar index. Note that since 2000, the dollar's swings have affected gold prices. In fact, since 2000, the correlation is -87%.

Since inflation, interest rates and exchange rates affect gold prices, we have created a model of the relationship.



The model uses the EUR/USD exchange rate, inflation adjusted two-year T-note yields and the balance sheets of the European Central Bank (ECB) and the Federal Reserve. Including the latter two variables generally accounts for investor expectations of future inflation and interest rates. The current fair value for gold, based on this model, is $1,489.26, suggesting that current prices, though elevated, are not overvalued.

Finally, investors have been putting money into gold through exchange-traded products.

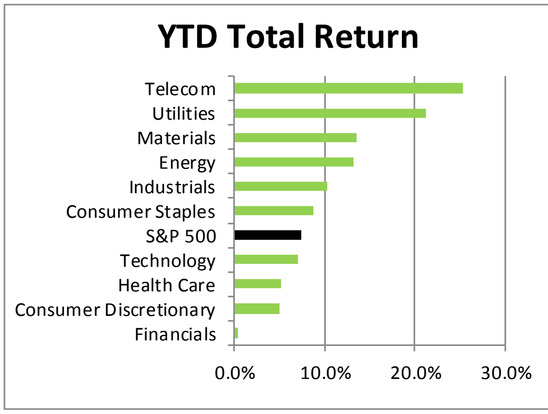


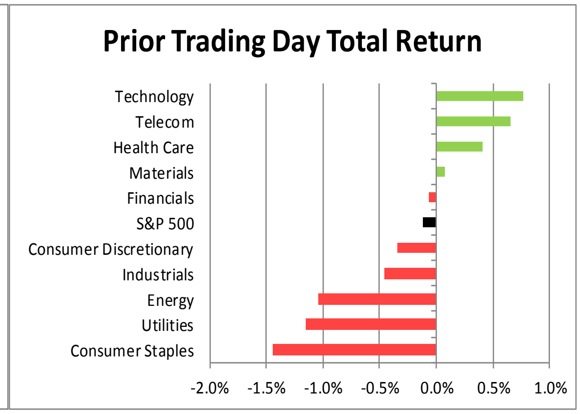
This chart looks at the metric tons of gold held by ETFs, ETNs and grantor trusts compared to the price of gold. As one would expect, the two are closely linked, correlating at nearly 95%. Since the beginning of the year, investors have been increasing their exposure to gold through these products. With the FOMC on hold and additional policy stimulus expected due to Brexit, investors are seeking the safety of gold.

Due to our view that gold is attractively valued and that conditions should favor the yellow metal, as noted above, we added gold to our allocations this quarter. We expect that conditions should favor gold in the upcoming quarters.

Data Section

U.S. Equity Markets – (as of 7/27/2016 close)

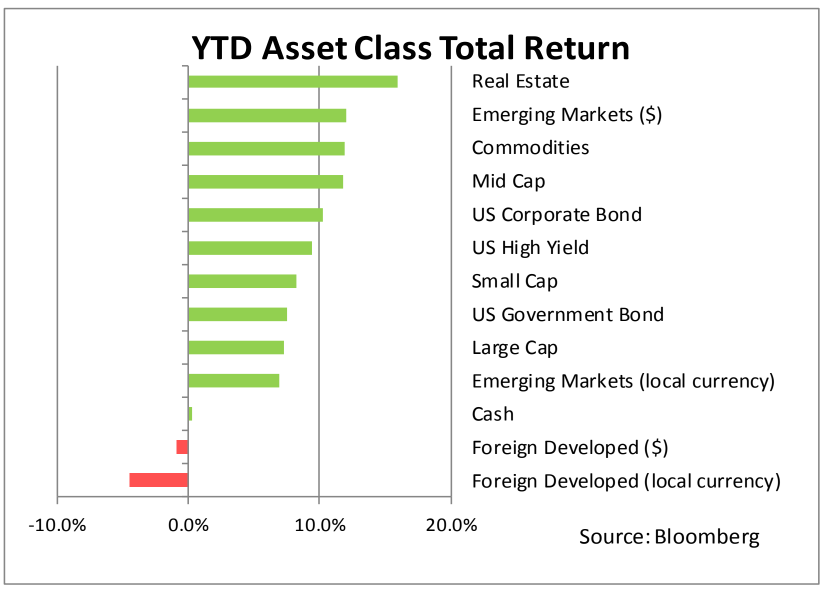




(Source: Bloomberg)

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 7/27/2016 close)

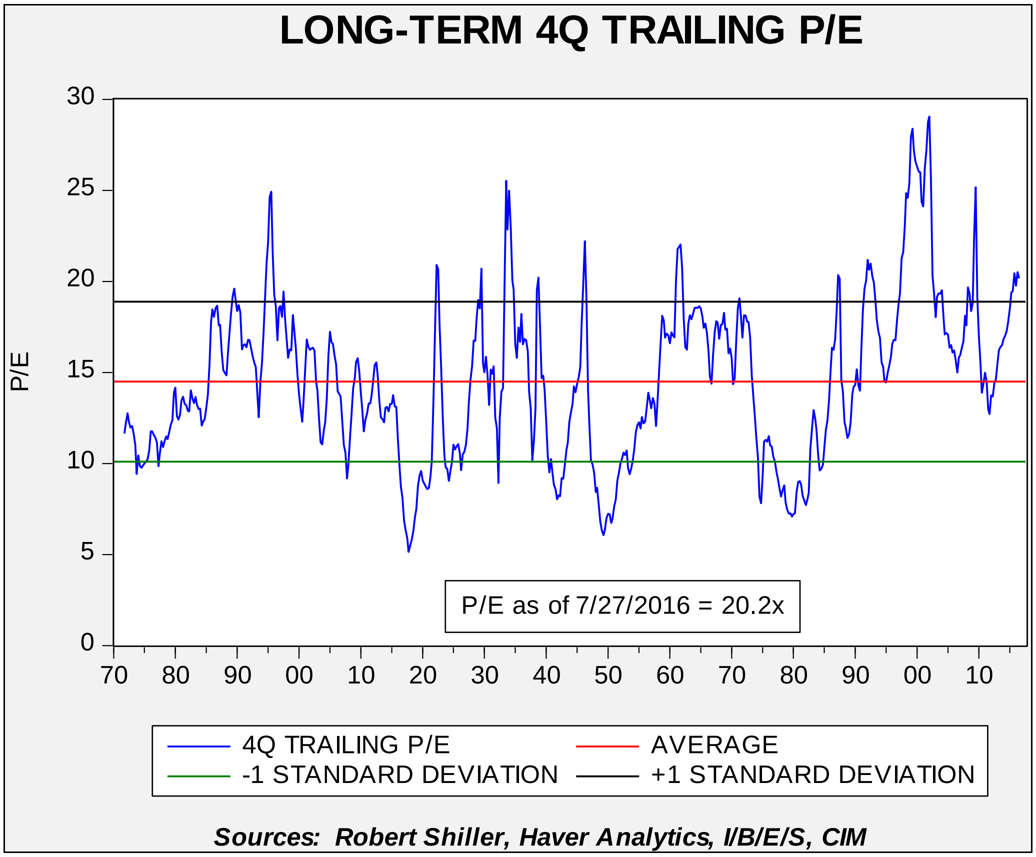


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.