# *Daily Comment*

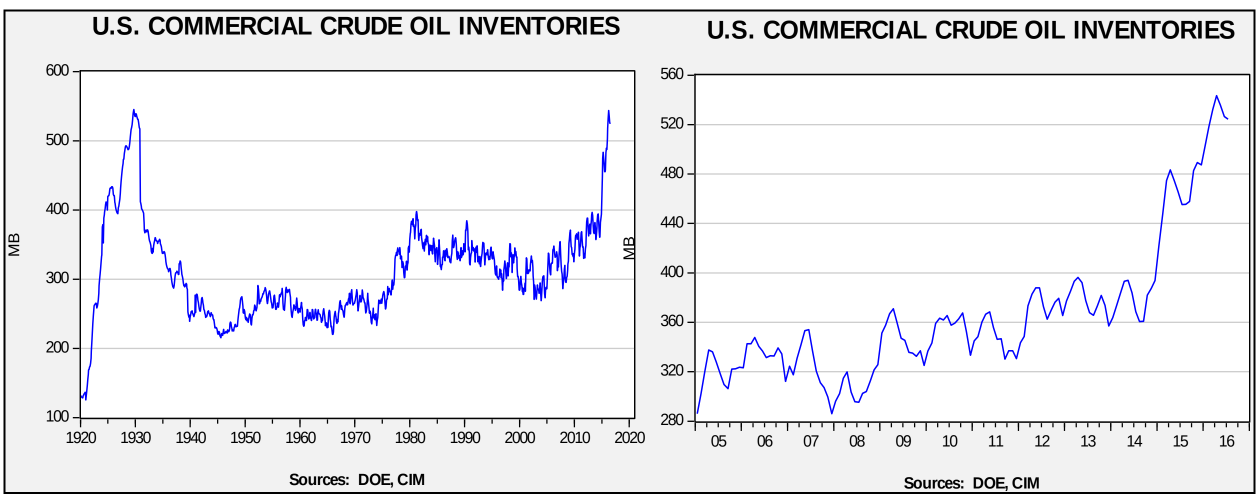
**By Bill O'Grady & Kaisa Stucke, CFA**

**[Posted: July 8, 2016—9:30 AM EDT]** Global equity markets are mixed this morning. The EuroStoxx 50 is trading higher by 1.3% from the last close. In Asia, the MSCI Asia Apex 50 closed down by 0.4% from the prior close. Chinese markets were lower, with the Shanghai composite trading lower by 1.0% and the Shenzhen index down 0.1%. U.S. equity futures are signaling a higher opening from the previous close.

We discuss the labor market data in more detail below but the initial response is that the Bureau of Labor Statistics (BLS) seems to have lost its way. We saw a massive jump in June non-farm payrolls by 287k with a net revision of -6k, reversing the 11k rise (revised downward) in May. The household survey indicated a significant recovery in the labor force, up 414k after seeing an over 800k drop in the labor force in April and May. However, employment in the household survey only rose by 67k, leading to a 0.2% jump in the unemployment rate to 4.9%. Wage growth came in below forecast, up 2.6% from last year. Given the volatility of the monthly data, it would seem that one should be smoothing the numbers with three-month averages at a minimum.

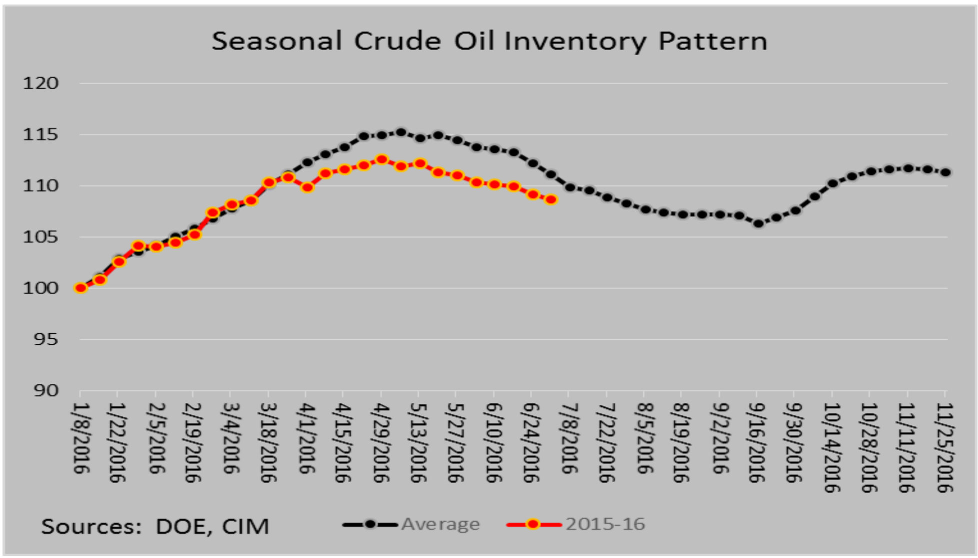
Market reaction is reasonably predictable after the data—equities and the dollar rallied, while Treasuries and gold declined. We doubt this data will change the policy stance of the FOMC. The June data will quell any worries about an immediate recession, which is good news. However, the inconsistencies between the surveys make it difficult to determine how strong the labor markets are at the moment. On balance, though, we would call the report supportive for the economy.

U.S. crude oil inventories fell less than forecast, dipping 2.2 mb versus estimates of a 2.4 mb decline.

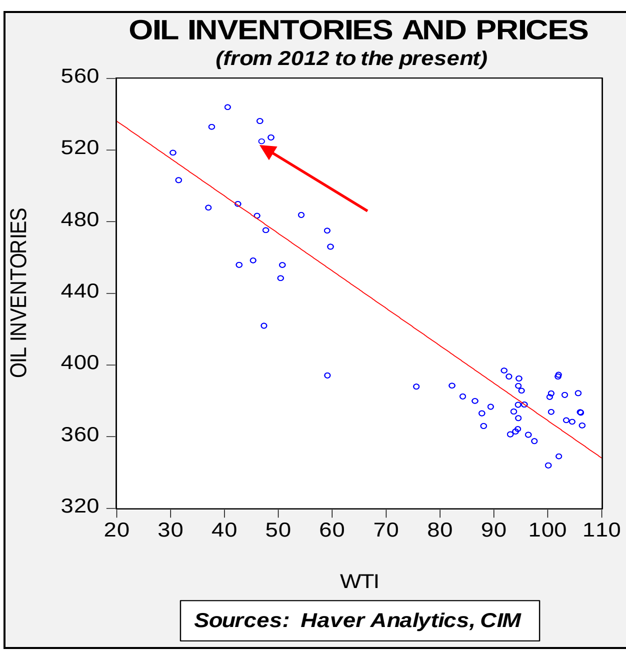


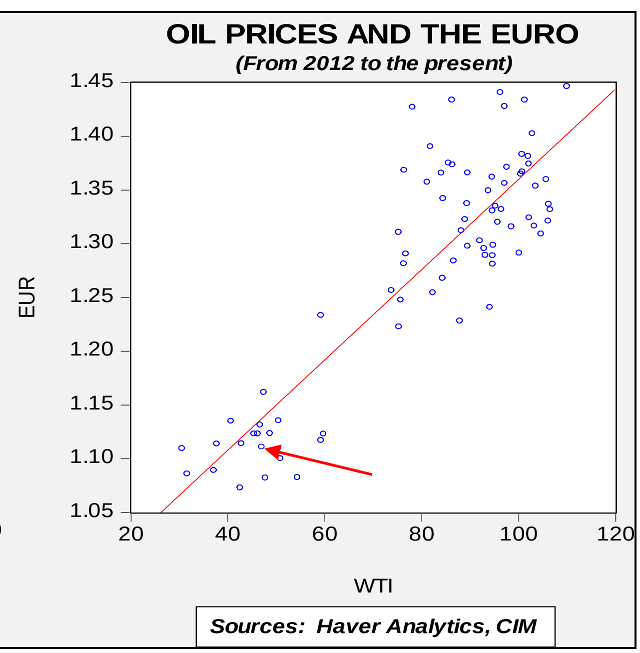
The above chart shows current crude oil inventories, both over the long term and the last decade. We are starting to see inventories decline, but normal levels would be below 400 mb, some 130 mb lower than now.

So, obviously, 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.




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

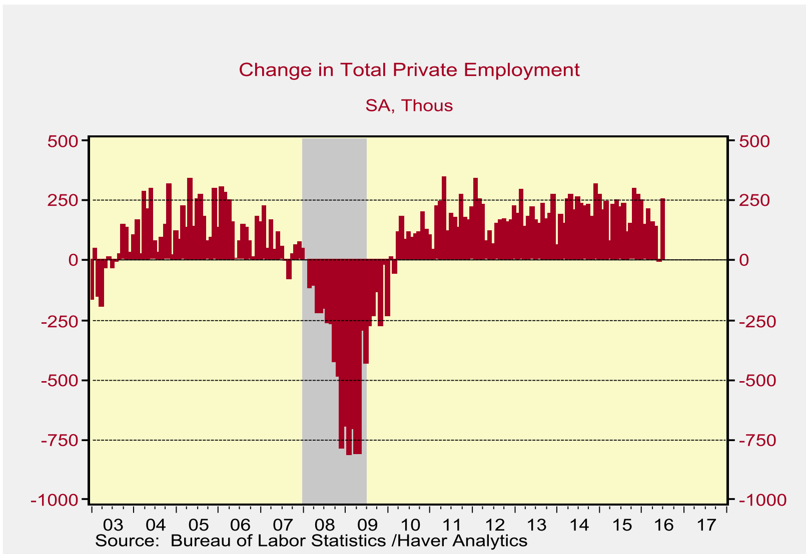


Based on inventories alone, oil prices are profoundly overvalued with the fair value price of $34.98. Meanwhile, the EUR/WTI model generates a fair value of $47.07. Together (which is a more sound methodology), fair value is $40.80, meaning that current prices are a bit rich.

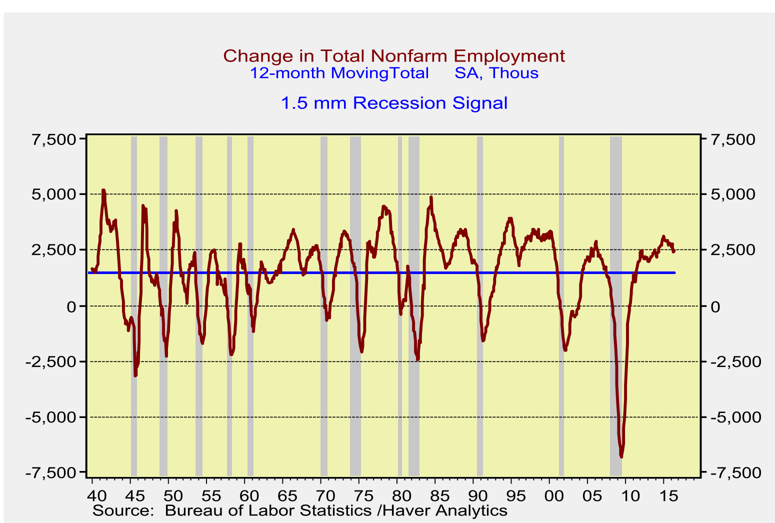
**U.S. Economic Releases**

June payrolls came in much stronger than forecast, rising 287k compared to the 180k forecast. May's payrolls were revised lower to 11k from 38k. Private payrolls rose by 265k in June, also much stronger than the 170k forecast. The chart below shows the change in payrolls.

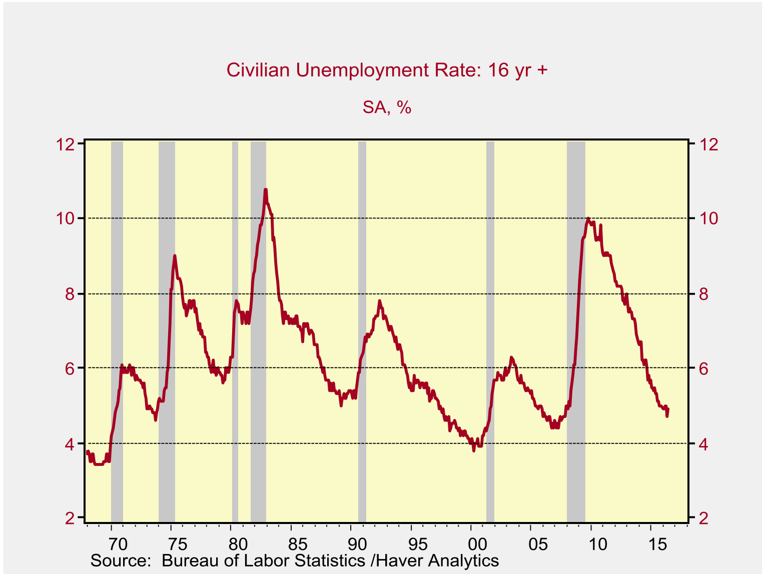



The unemployment rate rose to 4.9% from 4.7% previously, higher than the 4.8% forecast. The chart below shows the unemployment rate, which increased as more people entered the labor force. The labor force grew by 414k, while employment rose by 67k.

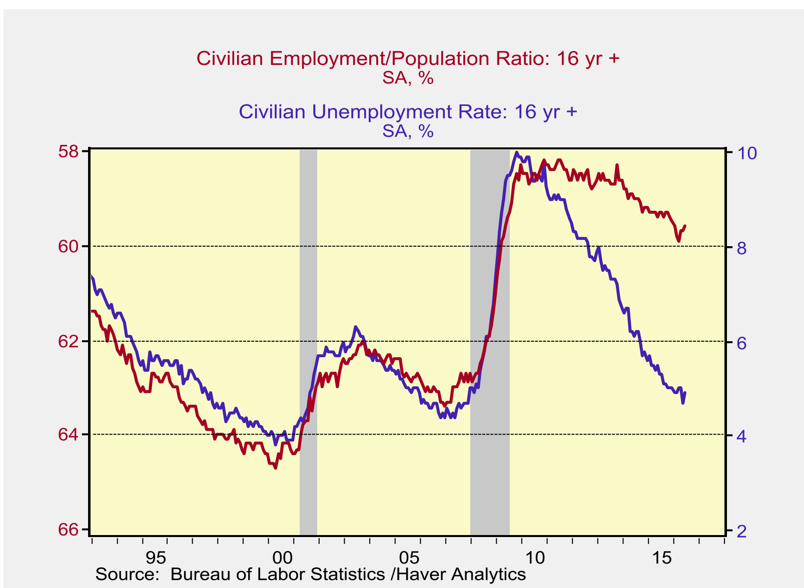
Using a 12-month rolling total of non-farm payrolls, the expansion remains on track.



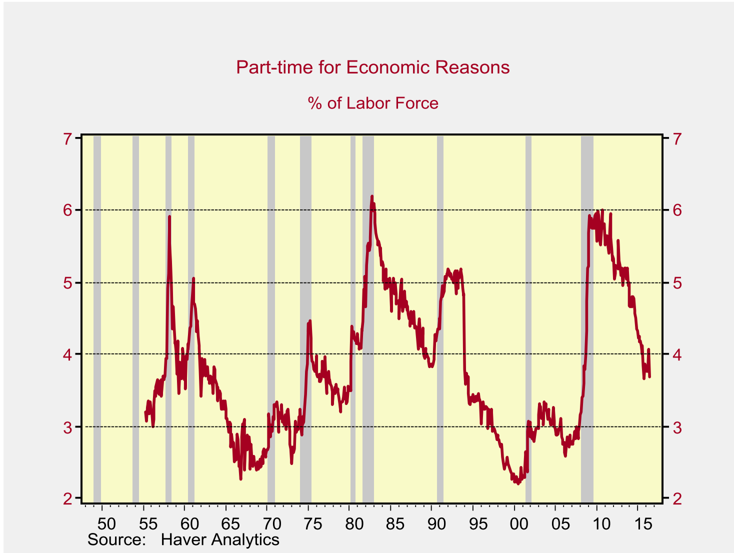
Yearly cumulative payrolls are up 2.45 mm jobs, comfortably above the recession level of 1.5 mm. This number rose 100k over the past month.



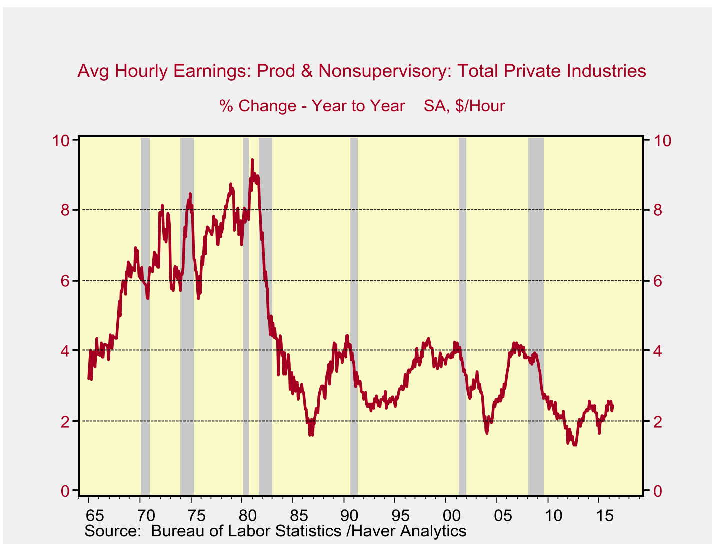

The labor force participation rate rose modestly to 62.7% from 62.6% in the prior month. At the same time, the employment/population ratio fell to 59.6% from 59.7%. The chart below shows the employment/population ratio (on an inverse scale) and the unemployment rate. Historically, these two metrics have moved together but have diverged significantly since the end of the crisis.



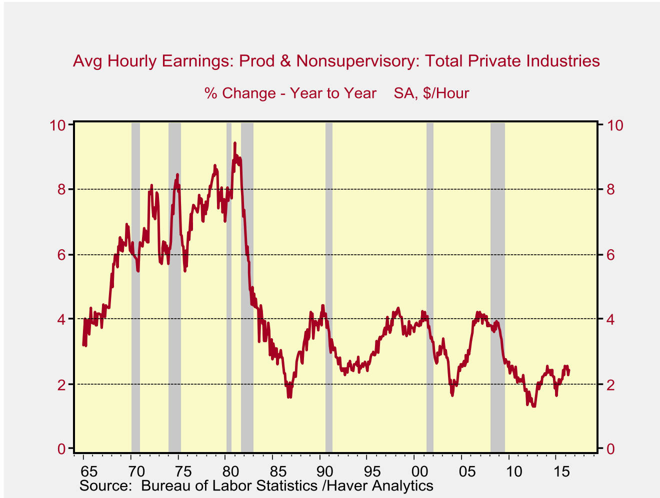

The rate of people working part-time for economic reasons, one of Yellen's favorite labor market measures, fell to 3.7% from 4.1%. This number includes those who are currently working part-time, would like to be employed full-time, but have been unable to find full-time positions.




Average hourly earnings rose 0.1% from the month before, less than the 0.2% increase forecast. As shown in the chart below, annual earnings rose 2.6%, also less than the 2.7% increase expected.




Duration of unemployment lengthened to 27.7 weeks from 26.7 weeks previously.




Overall, the better than expected payrolls numbers are supporting risk markets and the expanding labor force is a positive trend, although more people looking for work will keep the unemployment rate from falling.

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

| **Economic releases** | | | | | | |
|---|---|---|---|---|---|---|
| **EST** | **Indicator** | | | **Expected** | **Prior** | **Rating** |
| **3:00** | Consumer credit | m/m | May | $16.0 bn | $16.0 bn | ** |

**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** | | | | | | | | |
| **Japan** | Trade balance | m/m | May | ¥1.4 tn | ¥1.6 tn | ¥1.5 tn | ** | Equity and bond neutral |
| | Current account balance | m/m | May | ¥40.0 bn | ¥697.1 bn | ¥56.0 bn | ** | Equity bearish, bond bullish |
| | Labor cash earnmings | y/y | May | -0.2% | 0.0% | 0.5% | * | Equity bearish, bond bullish |
| | Eco watchers survey current | m/m | Jun | 41.2 | 43.0 | 43.1 | ** | Equity bearish, bond bullish |
| | Eco watchers survey outlook | m/m | Jun | 41.5 | 47.3 | 46.7 | ** | Equity bearish, bond bullish |
| **EUROPE** | | | | | | | | |
| **Eurozone** | Industrial production | m/m | May | -0.5% | 1.2% | -0.5% | *** | Equity and bond neutral |
| **Germany** | Trade balance | m/m | May | €21.0 bn | €25.7 bn | €23.5 bn | ** | Equity bearish, bond bullish |
| | Current account balance | m/m | May | €17.5 bn | €28.4 bn | €24.6 bn | ** | Equity bearish, bond bullish |
| **U.K.** | Trade balance | m/m | May | -£2.3 bn | -£2.0 bn | -£3.6 bn | ** | Equity and bond neutral |
| **Switzerland** | Unemployment rate | y/y | Jun | 3.3% | 3.3% | 3.5% | *** | Equity bullish, bond bearish |

## 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)** | 66 | 66 | 0 | Neutral |
| **3-mo T-bill yield (bps)** | 27 | 28 | -1 | Down |
| **TED spread (bps)** | 39 | 37 | 2 | Up |
| **U.S. Libor/OIS spread (bps)** | 38 | 38 | 0 | Neutral |
| **10-yr T-note (%)** | 1.39 | 1.39 | 0.00 | Neutral |
| **Euribor/OIS spread (bps)** | -29 | -29 | 0 | Neutral |
| **EUR/USD 3-mo swap (bps)** | 43 | 44 | -1 | 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 | $46.71 | $46.40 | 0.67% | Labor report surprising to the upside |
| WTI | $45.46 | $45.14 | 0.71% | |
| Natural Gas | $2.79 | $2.78 | 0.61% | |
| Crack Spread | $12.58 | $12.78 | -1.53% | |
| 12-mo strip crack | $12.03 | $12.12 | -0.69% | |
| Ethanol rack | $1.75 | $1.75 | -0.15% | |
| **Metals** | | | | |
| Gold | $1,356.18 | $1,360.45 | -0.31% | Labor data |
| Silver | $19.61 | $19.69 | -0.41% | |
| Copper contract | $212.80 | $212.35 | 0.21% | |
| **Grains** | | | | |
| Corn contract | $ 348.75 | $ 341.75 | 2.05% | World production forecast cut |
| Wheat contract | $ 428.75 | $ 425.50 | 0.76% | |
| Soybeans contract | $ 1,043.00 | $ 1,024.75 | 1.78% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 699 | 694 | 5 | |
| **DOE inventory report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | -2.2 | -2.1 | -0.1 | |
| Gasoline (mb) | -0.1 | -0.3 | 0.2 | |
| Distillates (mb) | -1.6 | 0.1 | -1.7 | |
| Refinery run rates (%) | -0.5% | 0.3% | -0.8% | |
| Natural gas (bcf) | 39.0 | 42.0 | -3.0 | |

## Weather

The 6-10 and 8-14 day forecasts call for warmer than normal temperatures for the eastern two-thirds of the country. Heavier than normal rain is projected for parts of the eastern region and the upper Midwest. The tropics are quiet today.

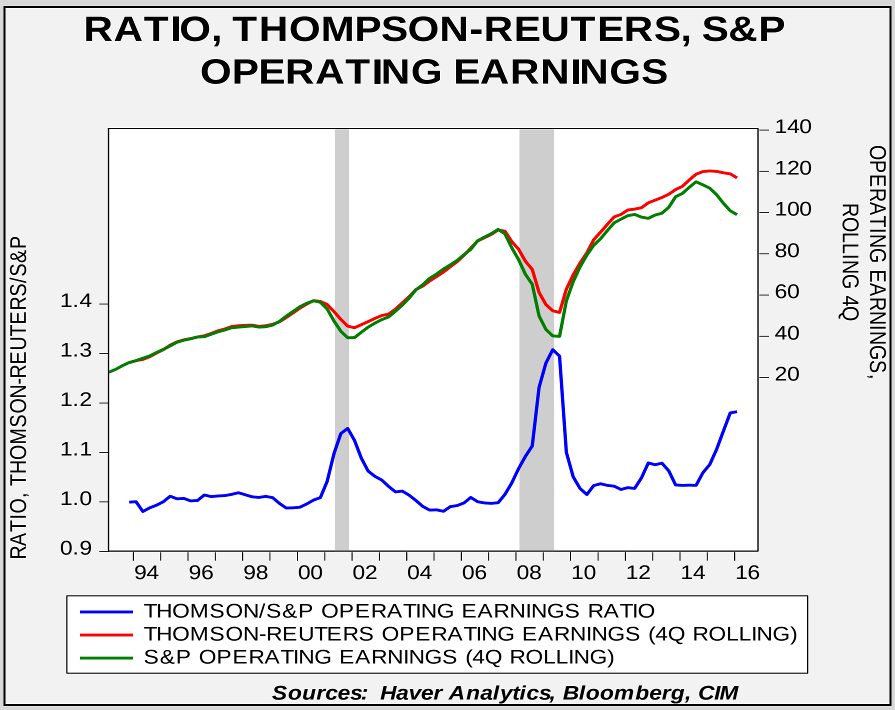
## Weekly Asset Allocation Commentary

*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 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.

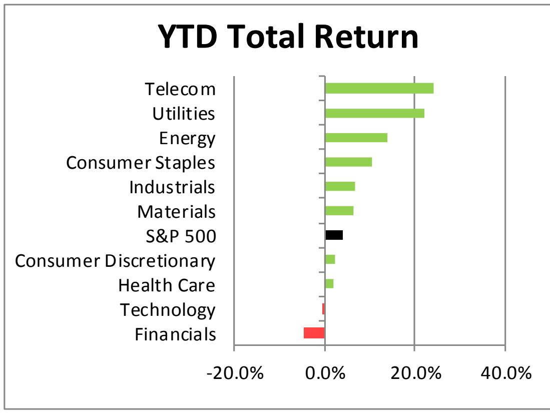
There are two issues to examine. First, it is apparent that the Thomson-Reuters numbers are usually higher than the S&P data; there are only 22 out of 90 quarters where the S&P number was higher and the average spread was only 50 cents per share. According to analyst reports, Thomson-Reuters "fits" its 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.

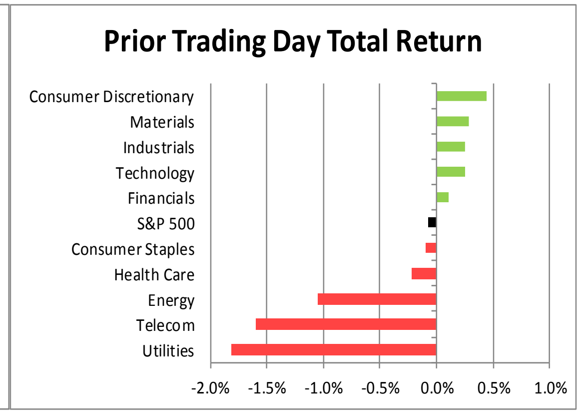
Which is the more accurate number? Frankly, like so many other situations in life, it depends. At this part of the business cycle, the S&P number is probably more informative. In previous cycles, S&P's weaker earnings were an indicator of an impending change in the business cycle. That's why the current 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 7/7/2016 close)

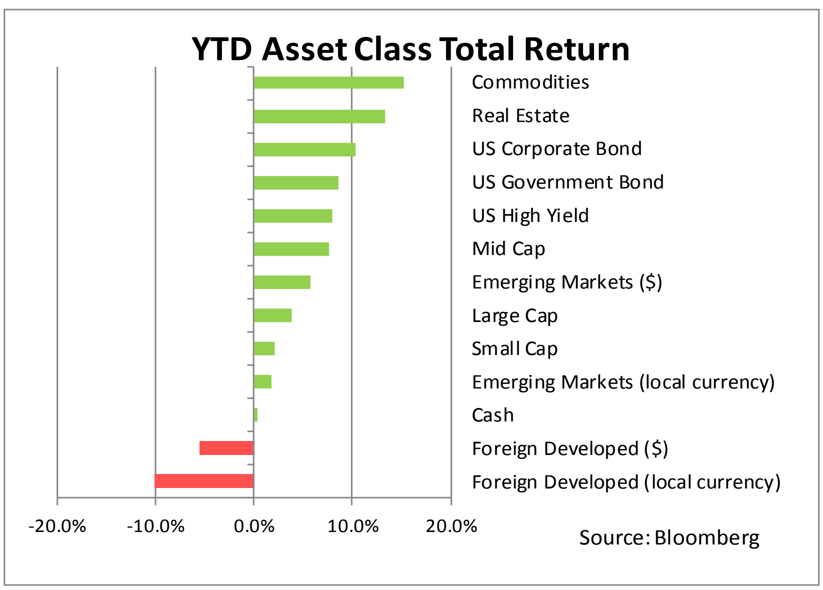



(Source: Bloomberg)

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 7/7/2016 close)

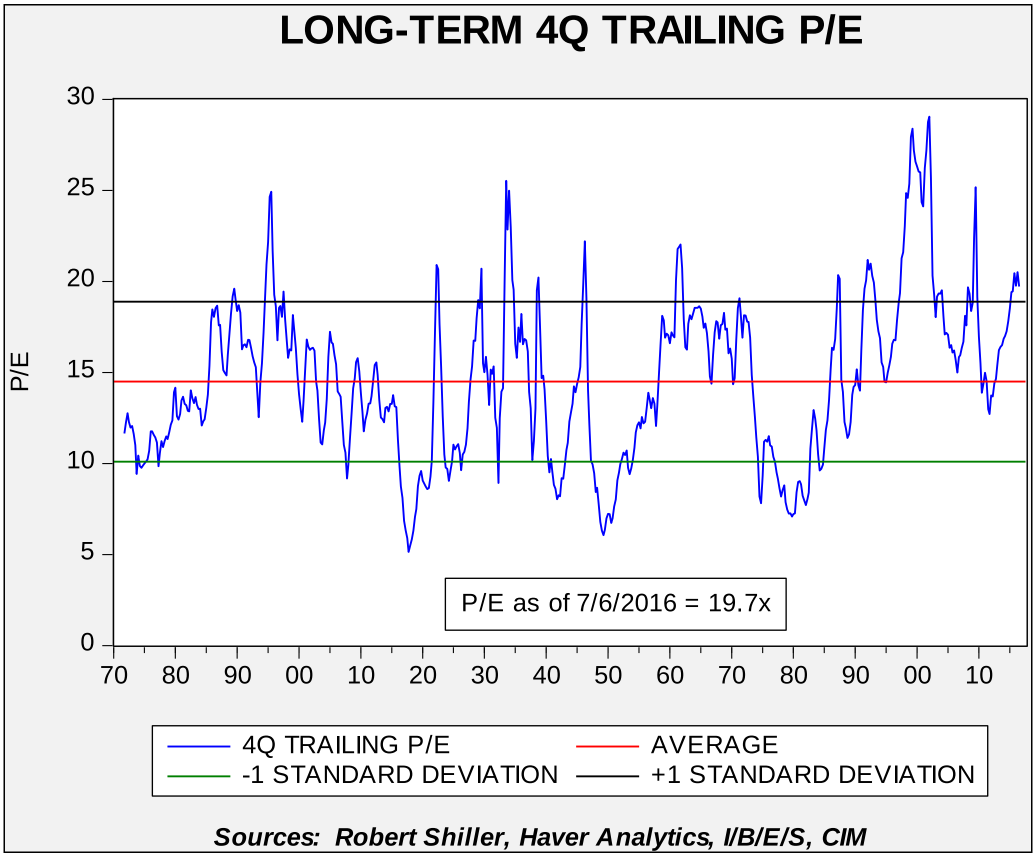



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.*

[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.