Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: June 7, 2016—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is trading higher by 1.3% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 1.7% from the prior close. Chinese markets were also higher, with the Shanghai composite trading up 0.1% and the Shenzhen index lower by 0.3%. U.S. equity futures are signaling a higher opening from the previous close. With 98.8% of the S&P 500 companies having reported, Q1 float-adjusted earnings stand at $26.79, more than the $26.66 forecast. Of the 494 companies that have reported, 72.5% had positive earnings surprises, while 20.0% had negative earnings surprises.

Chair Yellen's speech yesterday was about as we expected; she didn't say too much and did work hard to give her and the FOMC ample space to raise or not raise rates. She did paint a view of the economy that was reasonably upbeat but also noted a series of concerns that she was watching. Overall, the tone really hasn't changed—the Fed wants to move rates higher but is being very cautious. The good news is that the financial markets took the comments in stride and we are seeing stronger equity markets again this morning.

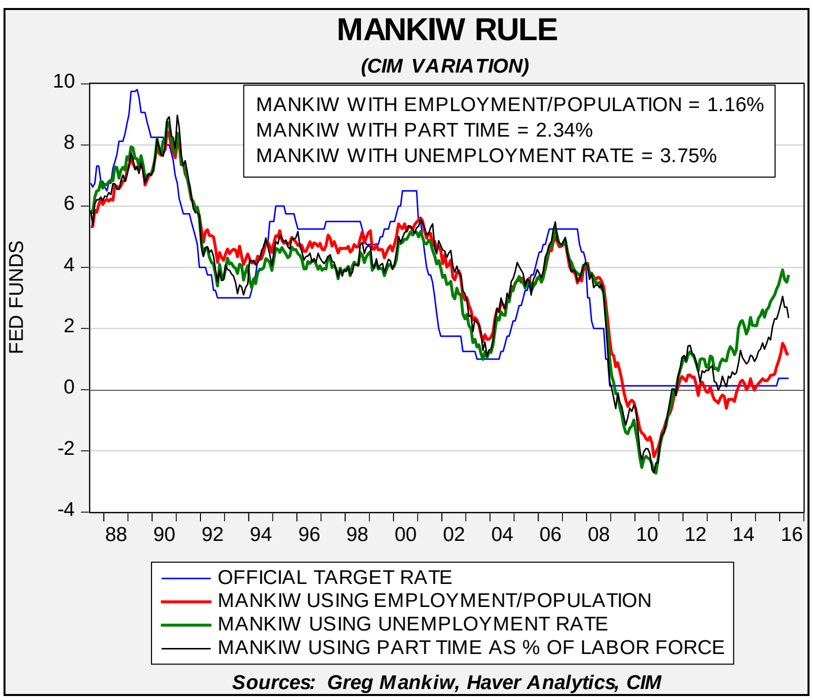
Of course, part of the reason the financial markets are better this morning is that we have seen a dovish shift in the fed funds futures. There is now a 0% chance of a rate hike later this month and the markets don't have the odds of a hike exceeding 50% until the December meeting. We are not sure this degree of dovishness is reasonable in light of yesterday's talk. On the other hand, given how volatile this year's election season could be, it is really hard to fathom the Fed injecting itself into that mess by changing policy in autumn. Thus, we tend to agree that, barring some inflation shock, July is probably the last chance to change policy before the election cycle goes into full swing. And, we doubt the data will improve that much in such a short amount of time to trigger a rate change.

China's foreign reserves dipped by $28 bn to $3.19 trillion last month. That was near expectations. The stronger dollar weighed on China's reserves, in that any reserves held in JPY or EUR reduced the dollar level of reserves. The key takeaway is that China has managed to stabilize its currency without spending a lot out of reserves to stabilize it. Thus, this is good news for China.

The U.S. and China are holding semiannual talks at the U.S.-China Strategic and Economic Dialogue meetings this week. Treasury Secretary Lew suggested yesterday that China needed to reduce its industrial capacity because its production of industrial metals was overwhelming global markets. China pushed back today, suggesting that the U.S. and the world cheered China's expansion of capacity after the 2008 downturn as a way to boost global growth. We suspect that the leaders of both nations are posturing. China knows it needs to reduce its capacity; it doesn't know how do to that without causing unemployment. One trip through the

U.S. rust belt makes it evident just how painful reducing capacity is in real life. Chinese officials are grappling with the political and social fallout from cutting capacity and certainly don't want it to look like the U.S. is pressing China to make such painful moves. On the other hand, China's pattern has been to talk about doing the right things but avoiding the pain once the policy change starts. The U.S. fear is that China is more likely to maintain the capacity and keep dumping goods on global markets, leading to global deflation. We tend to expect that dumping is the more likely outcome and trade barriers are the most likely response.

With last week's employment data, we can tentatively update our versions of the Mankiw rule model. This model attempts to determine the neutral rate for fed funds, which is a rate that is neither accommodative nor stimulative. Mankiw's model is a variation of the Taylor Rule. The latter measures the neutral rate by core CPI and the difference between GDP and potential GDP, which is an estimate of slack in the economy. The latter number cannot be directly observed, only estimated. To overcome the problem of potential GDP, Mankiw used the unemployment rate as a proxy for economic slack. We have created three versions of the rule, one that follows the original construction by using the unemployment rate, a second that uses the employment/population ratio and a third using involuntary part-time workers as a percent of the total labor force as a measure of slack.

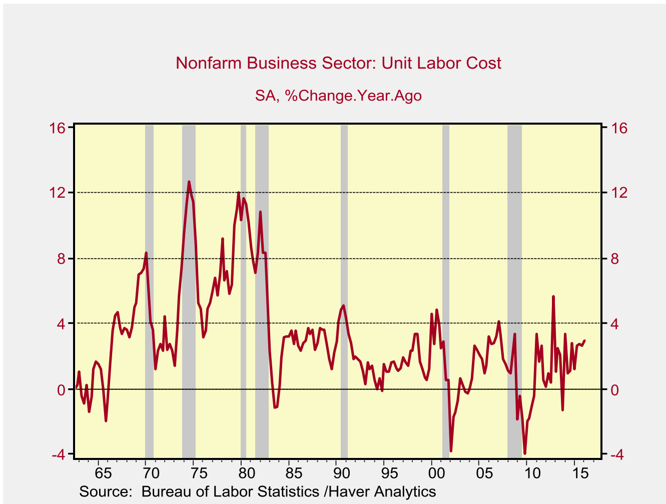


Using the unemployment rate, the neutral rate is now up to 3.75%, suggesting the FOMC is well behind the curve. Using the employment/population ratio, the neutral rate is 1.16%, indicating that, even using the most dovish variation, the FOMC needs at least a 75 to 100 bps rate hike to achieve neutral policy. And finally, using involuntary part-time employment, the neutral rate is

2.34%. Although these neutral rate estimates are well above the current target, it is important to note that two of the three have declined in this most recent calculation.

U.S. Economic Releases

Nonfarm productivity for Q1 fell 0.6%, on forecast. This follows a 1.0% decline in Q4 2015. Unit labor costs, which are adjusted for productivity, rose 4.5% (q/q%, annualized), more than the 4.0% increase forecast. This follows a 4.1% gain in unit labor costs in Q4.



As the chart above indicates, unit labor costs have been rising. This could lead to a narrowing of margins, as the trend in rising labor costs is likely to continue in the strengthening labor market environment.

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

Economic releases						
EST	Indicator			Expected	Prior	Rating
10:00	IBD/TIPP Economic Optimism	m/m	Jun	48.2	48.7	**
3:00	Consumer Credit	m/m	Apr	$18.0 bn	$29.7 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								
China	Foreign reserves	m/m	May	$3191.7 bn	$3219.7 bn	$3200.0 bn	**	Equity and bond neutral
Japan	LEI	m/m	Apr	100.5	99.3	100.7	**	Equity and bond neutral
	Coincidence index	m/m	Apr	112.2	111.1	112.7	**	Equity and bond neutral
EUROPE								
Eurozone	GDP	y/y	Q1	1.7%	1.5%	1.5%	***	Equity bullish, bond bearish
France	Trade balance	m/m	Apr	-€5.2 bn	-€4.2 bn	-€4.5 bn	**	Equity bearish, bond bullish
	Current account balance	m/m	Apr	-€2.8 bn	-€1.9 bn		**	Equity bearish, bond bullish
Germany	Industrial production	y/y	Apr	1.2%	0.4%	1.0%	***	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)	68	68	0	Neutral
3-mo T-bill yield (bps)	27	26	1	Up
TED spread (bps)	42	42	0	Neutral
U.S. Libor/OIS spread (bps)	40	40	0	Neutral
10-yr T-note (%)	1.72	1.74	-0.02	Narrowing
Euribor/OIS spread (bps)	-26	-26	0	Neutral
EUR/USD 3-mo swap (bps)	32	31	1	Up
Currencies	**Direction**			
dollar	up			Up
euro	up			Down
yen	down			Down
franc	up			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Australia Cash Rate Target	1.75%	1.75%	1.75%	On forecast
Royal Bank of India Repo Rate	6.50%	6.50%	6.50%	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	Cause/ Trend
Energy markets				
Brent	$ 51.08	$ 50.55	1.05%	Expectations of falling supplies
WTI	$ 50.16	$ 49.69	0.95%	
Natural gas	$ 2.42	$ 2.47	-1.74%	
Crack spread	$ 15.84	$ 15.84	0.03%	
12-mo strip crack	$ 13.33	$ 13.25	0.61%	
Ethanol rack	$ 1.82	$ 1.82	0.43%	
Metals				
Gold	$ 1,237.90	$ 1,245.34	-0.60%	Yellen's indication of openness to hikes
Silver	$ 16.31	$ 16.48	-1.01%	
Copper contract	$ 205.90	$ 211.75	-2.76%	Ample global supplies
Grains				
Corn contract	$ 425.25	$ 427.25	-0.47%	Profit taking
Wheat contract	$ 504.50	$ 507.50	-0.59%	
Soybeans contract	$ 1,146.00	$ 1,138.25	0.68%	
Shipping				
Baltic Dry Freight	607	610	-3	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.3		
Gasoline (mb)		-1.1		
Distillates (mb)		-0.5		
Refinery run rates (%)		0.5%		
Natural gas (bcf)		80.0		

Weather

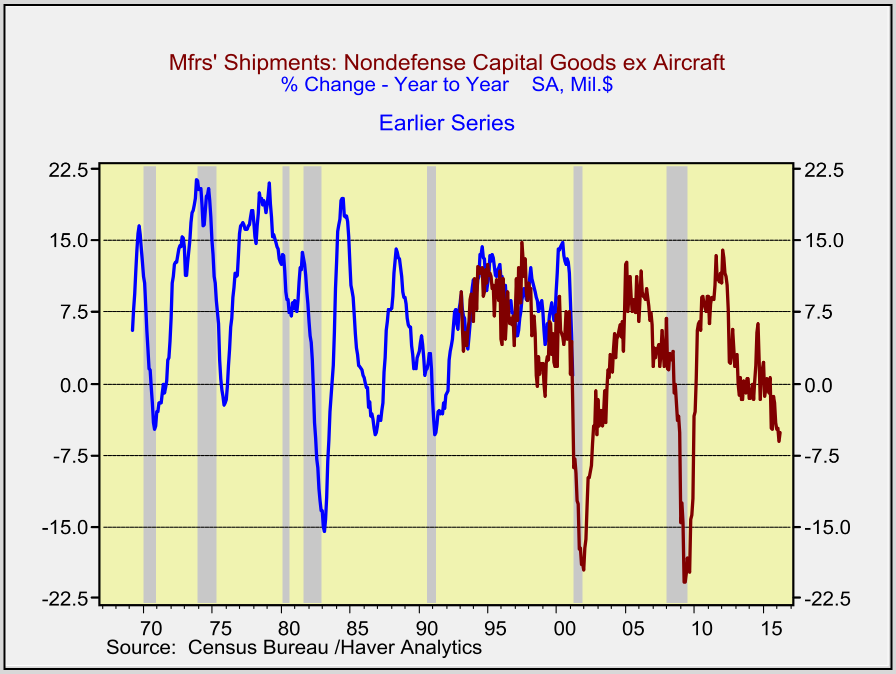
The 6-10 and 8-14 day forecasts are calling for warmer than normal conditions for majority of the country. Dry conditions are expected for the Northeast and the Southwest. Tropical Storm Colin left the Gulf of Mexico and is skimming the coast of the Carolinas.

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.

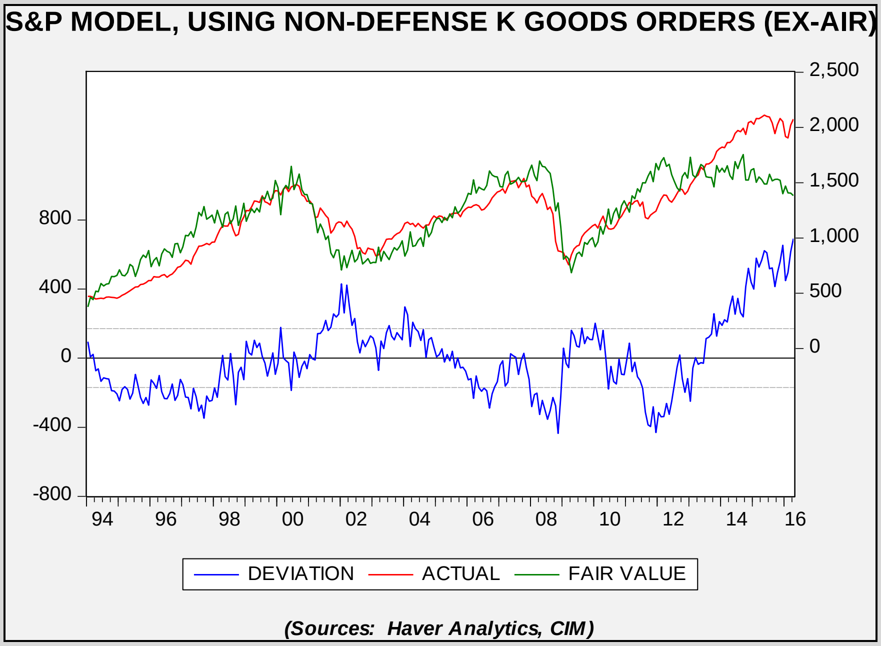
June 3, 2016

The prolonged weakness seen in capital spending is a concern for the economy and equity markets.



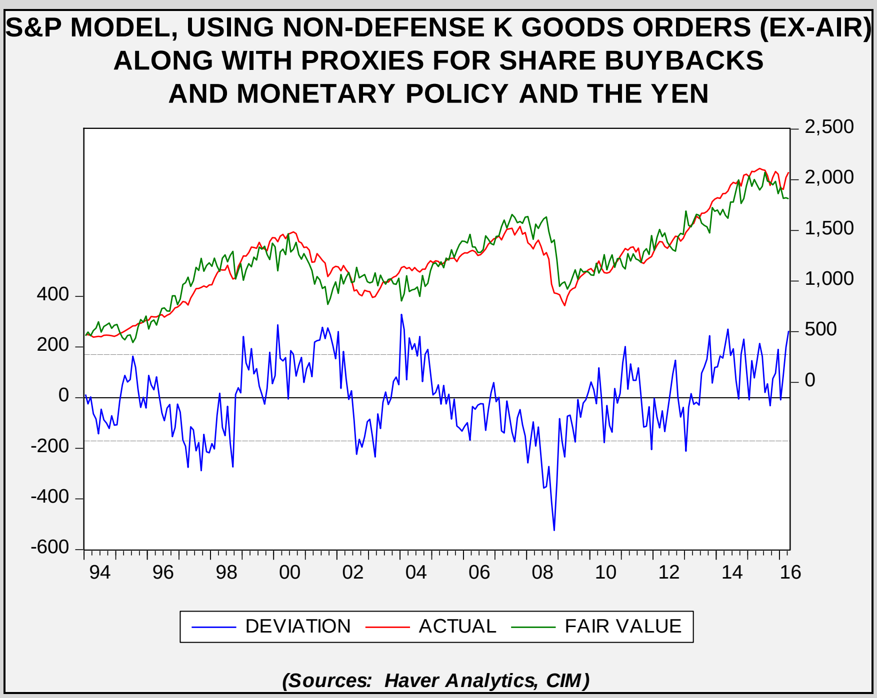
This chart shows the yearly change in the three-month smoothed non-defense capital goods orders excluding aircraft. The Census Bureau changed how it calculates this series in 1992; we have overlapped the yearly change in the earlier series. In general, a negative reading is a concern. It isn't a certain signal of recession, and in some downturns it becomes weak late in the cycle, but, in any case, a persistent negative reading does suggest economic weakness. The only other time the yearly change in this number was this negative without being associated with a recession was in 1987.

Taking this data from 1992 and regressing it against the S&P 500 suggests an overvalued equity market.



This chart shows the results of regressing non-defense capital goods orders, excluding aircraft, against the S&P 500. The orders data closely fit this equity index until around 2012. Based on this study, fair value is around 1383.

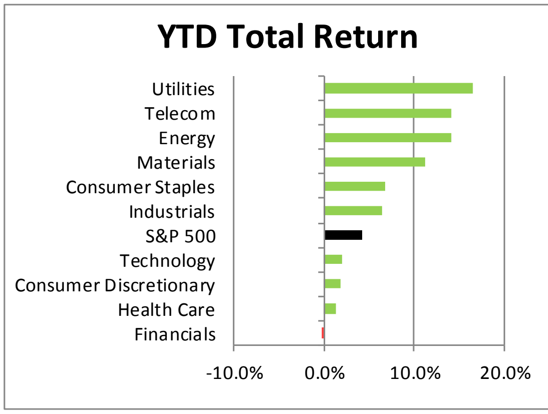
So, what is causing this divergence? We suspect monetary policy, the dollar and corporate behavior are affecting the equity market. Adding a proxy for buybacks and monetary policy, along with the yen's exchange rate, reduces the degree of overvaluation.

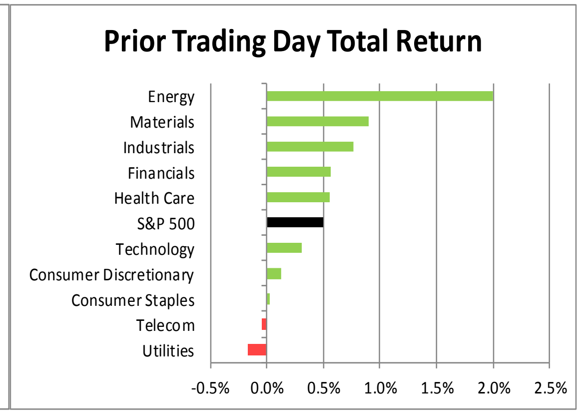


Adding these proxies increases fair value to 1811, significantly reducing the degree of overvaluation. This is still well below the current market, but it does show how equity markets have become dependent on accommodative monetary policy, dollar strength and share buybacks. Without stronger corporate economic growth—which will boost the demand for investment goods—monetary policy tightening, regulation to reduce buybacks or a stronger yen could put pressure on equity markets. We remain supportive of equity markets, although we are only looking for single-digit gains, at best, due to current valuation levels.

Data Section

U.S. Equity Markets – (as of 6/6/2016 close)

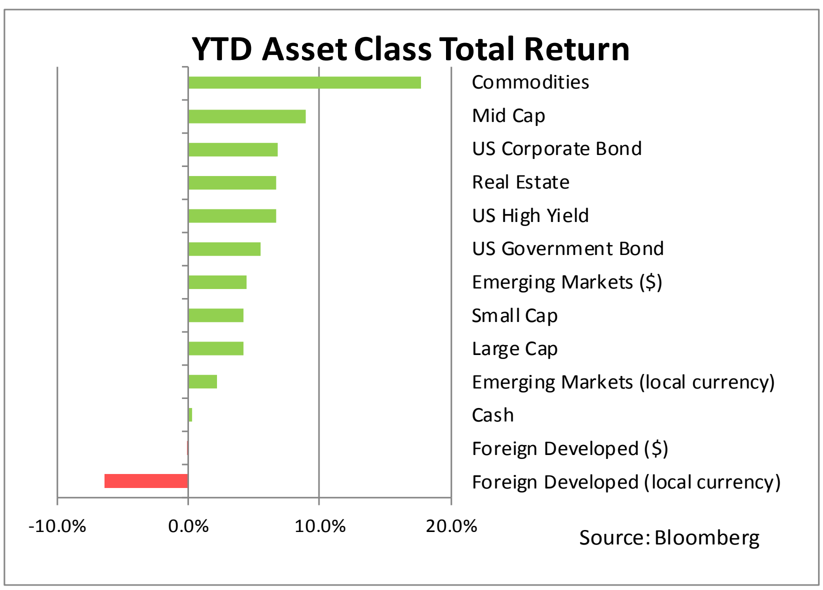




(Source: Bloomberg)

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 6/6/2016 close)

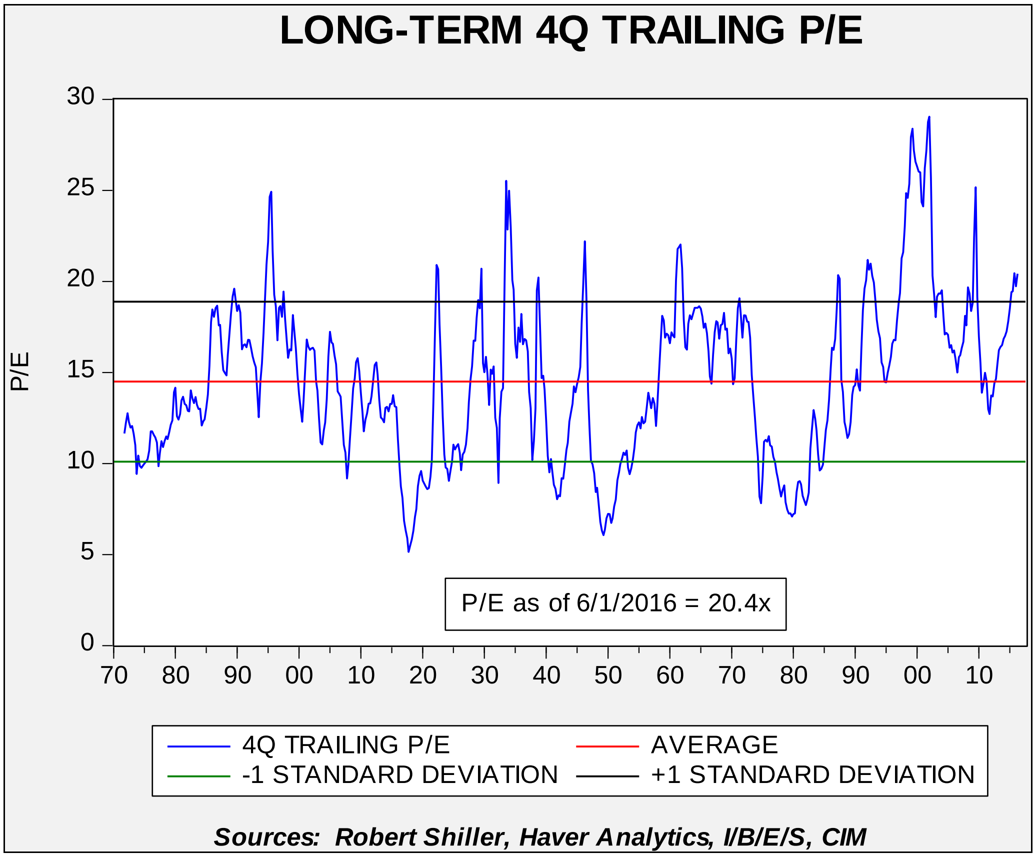


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

June 2, 2016



Based on our methodology,[1] the current P/E is 20.4x, unchanged from last week. The P/E remains elevated due to higher equity values.

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 (Q3 and Q4) and two estimates (Q1 and Q2). 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.