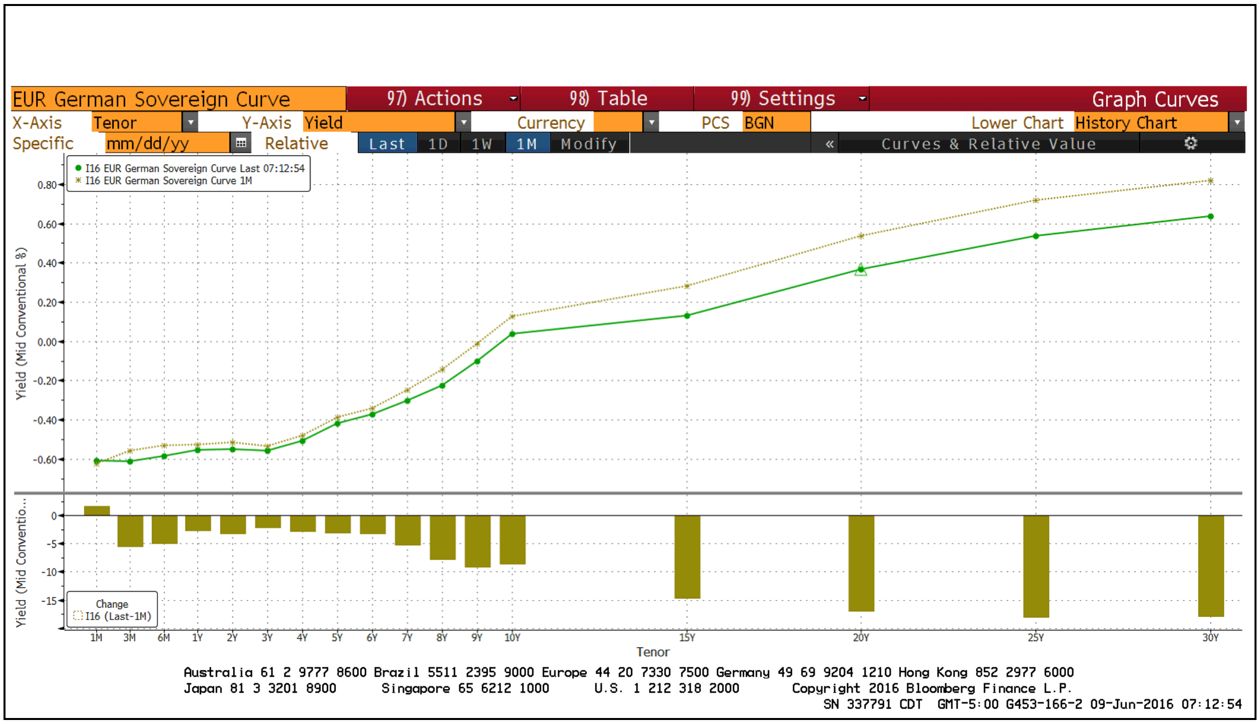
By Bill O'Grady & Kaisa Stucke, CFA

[Posted: June 9, 2016—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is trading lower by 1.0% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 0.1% from the prior close. Chinese markets were also lower, with the Shanghai composite trading down 0.3% and the Shenzhen index lower by 0.3%. U.S. equity futures are signaling a lower opening from the previous close. With 99.2% of the S&P 500 companies having reported, Q1 float-adjusted earnings stand at $26.80, more than the $26.66 forecast. Of the 496 companies that have reported, 72.6% had positive earnings surprises, while 20.0% had negative earnings surprises.

Signs of a growing rebellion against negative interest rate policies (NIRP) were evident this morning. The front page story in today's *FT* is "Negative Rates Stir Mutiny with Bank Threats to put Cash in Vaults." The report indicates that major banks in Europe and Japan are pushing back against NIRP. Commerzbank (CRZBY, $8.31) is considering a plan to hold cash in vaults rather than pay a negative rate to the ECB. With the phasing out of the €500 note, this process would be more difficult, but the threat does show the limits of NIRP. The Bank of Tokyo-Mitsubishi UFJ, part of the Mitsubishi UFJ Financial Group (MTU, $5.01), is deliberating a plan to relinquish its primary dealer role for JGB. If the bank leaves, it will be the first in Japan to walk away from this position. For the most part, the move by Mitsubishi is symbolic; the BOJ is buying up most of the government's new issuance of JGB anyway. However, the action is a very public display of displeasure with BOJ policy.

NIRP acts as a tax on excess liquidity. The idea is that by implementing negative rates, banks will be spurred to lend. However, if the problem of excess reserves is due to the lack of loan demand, and not to the reluctance of bankers to lend, NIRP simply acts to reduce bank profitability. Textbook economics suggests that a zero-bound exists; once interest rates turn negative, there is a nominal positive return from cash and the financial system will simply suffer disintermediation, meaning that households and businesses will simply hold cash.

That isn't what we are actually seeing at present. It is estimated that $10.4 trillion of sovereign debt around the world is now carrying a negative yield. German sovereign yields are negative to almost a decade and it is expected that we could see a negative yield on the Bund soon.



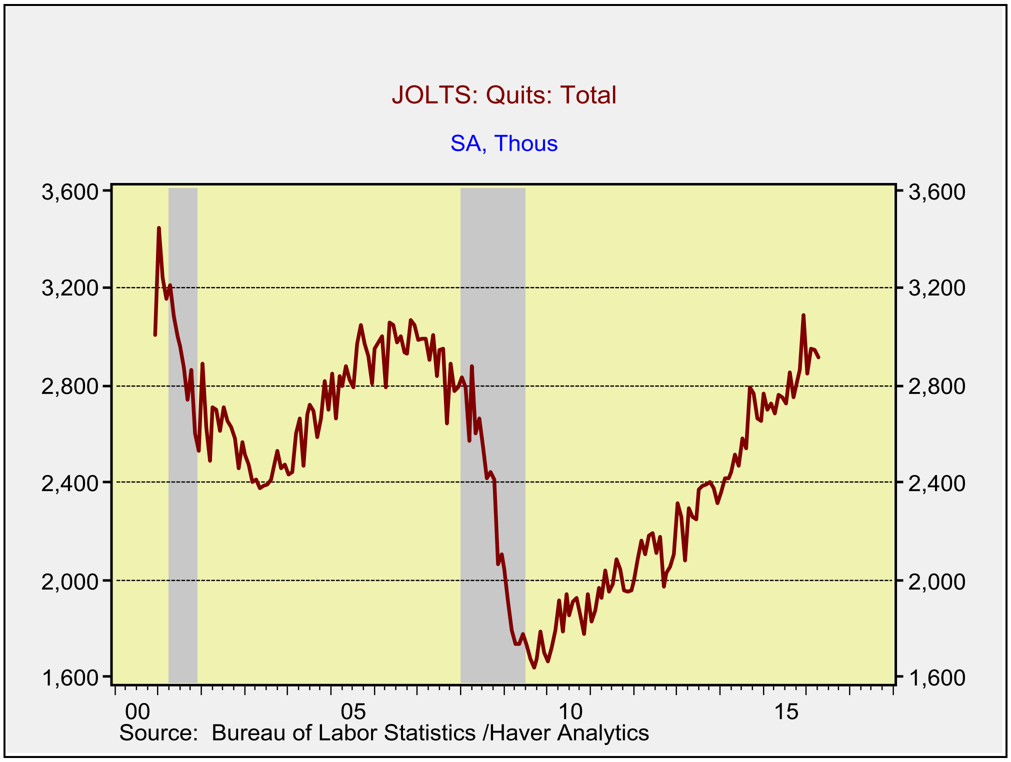
(Source: Bloomberg)

This chart shows the German sovereign yield curve for today and a month ago. The German 10-year yield is currently at 4 bps and yields up to nearly a 10-year term are anchored below zero. The combination of flight to safety, the lack of bonds for the ECB to conduct QE and the lack of an alternative are leading to negative rates. Falling overseas yields have pushed longer duration Treasury rates lower in sympathy.

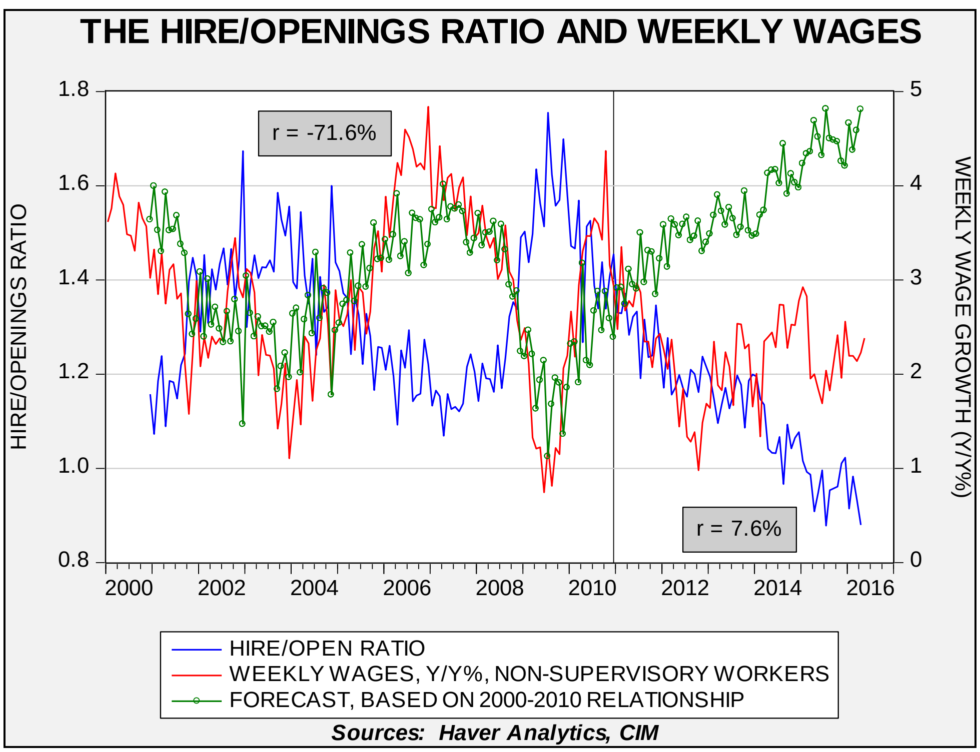
Finally, on the topic of central banks, the Bank of Korea surprised global financial markets with an unexpected 25 bps cut to 1.25% for its base lending rate. The unanimous decision was based on slowing export growth, weak domestic growth and corporate restructuring.

In the aftermath of last Friday's employment report, the JOLTS numbers, released yesterday at 10:00 EDT, became more closely watched than usual. This isn't to say this report isn't considered important, but it has a limited history (it started in 2000) and there are a lot of numbers in the report that can be difficult to interpret. The headline number showed job openings were higher than expected, coming in at 5.788 mm, up 118k from March, and above the survey level of 5.675 mm. On the other hand, hires came in at 5.092 mm, down 198k.

Quit rates, which tend to show increasing worker confidence, held at pre-recession levels.



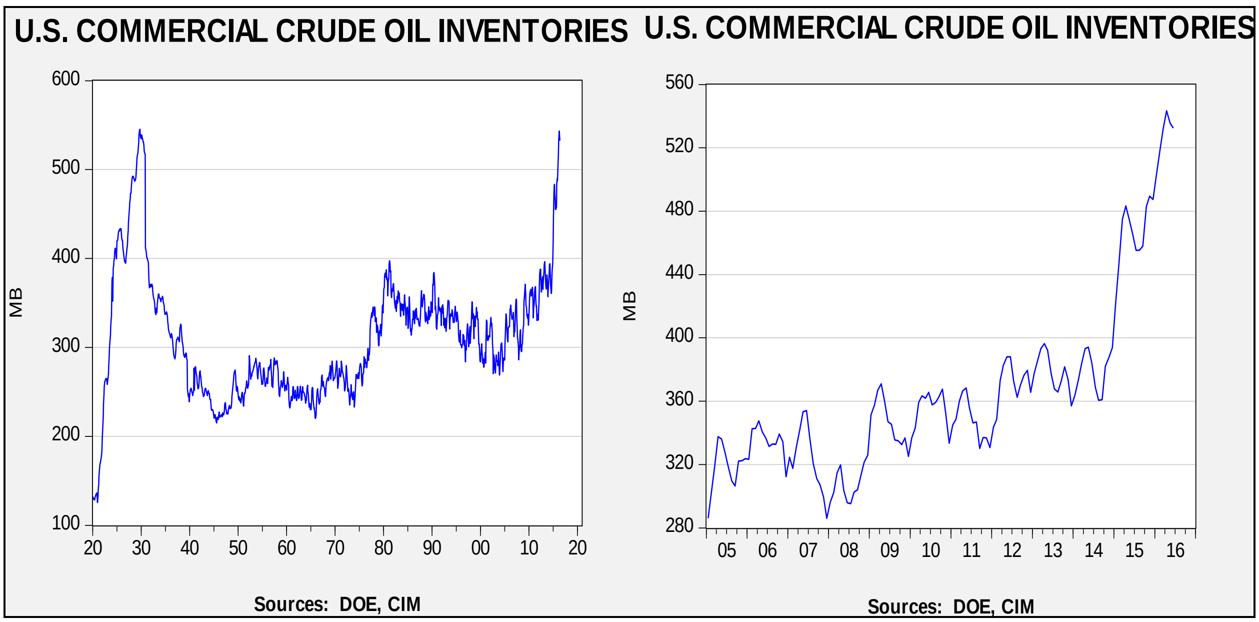
The relationship that caught our interest was between the hire/openings ratio and weekly wage growth.



This chart shows the ratio of hires to job openings. The ratio is very low, which means that there are many more openings than hires. In the 2000-10 period, the relationship between the yearly change in wage growth for non-supervisory workers was fairly tight, at -71.6%. However, from 2011 to the present, the relationship has become virtually uncorrelated (and the sign reversed). The green line on the chart shows the forecast from a regression where we use the hire/openings ratio to explain wage growth, based on the 2000-10 period. If the relationship between these two variables had been maintained, wage growth would be approaching 5% instead of the 2.4% rise we are currently experiencing.

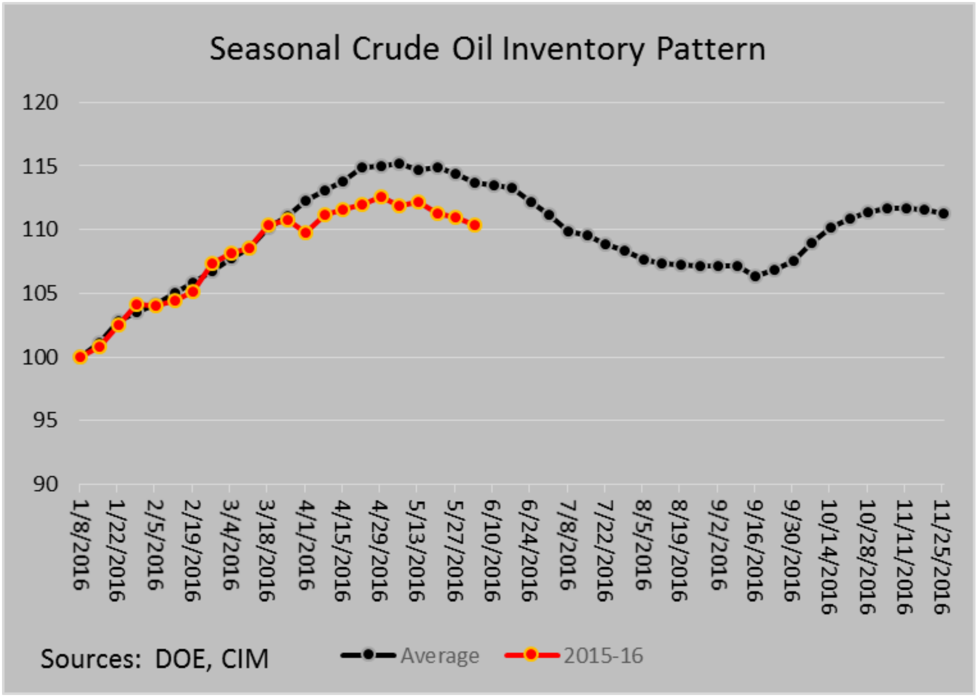
This divergence is a reflection of the changes we have seen in the labor market; the low level of the employment/population ratio and the participation rate coincide with this chart. This chart does explain the fears of the FOMC; the members appear worried that, at some point, wage growth will "catch up" due to the tight labor markets. If, on the other hand, the labor markets have permanently changed and we are not going back to the pre-2010 situation, wage growth will remain stagnant even with a plethora of job openings compared to hires. And that will mean that inflation should remain under control and the need to raise rates will be less.

The U.S. crude oil inventories fell mostly in line with expectations; stockpiles fell 3.2 mb to 532.5 mb compared to estimates of a 3.3 mb decline.

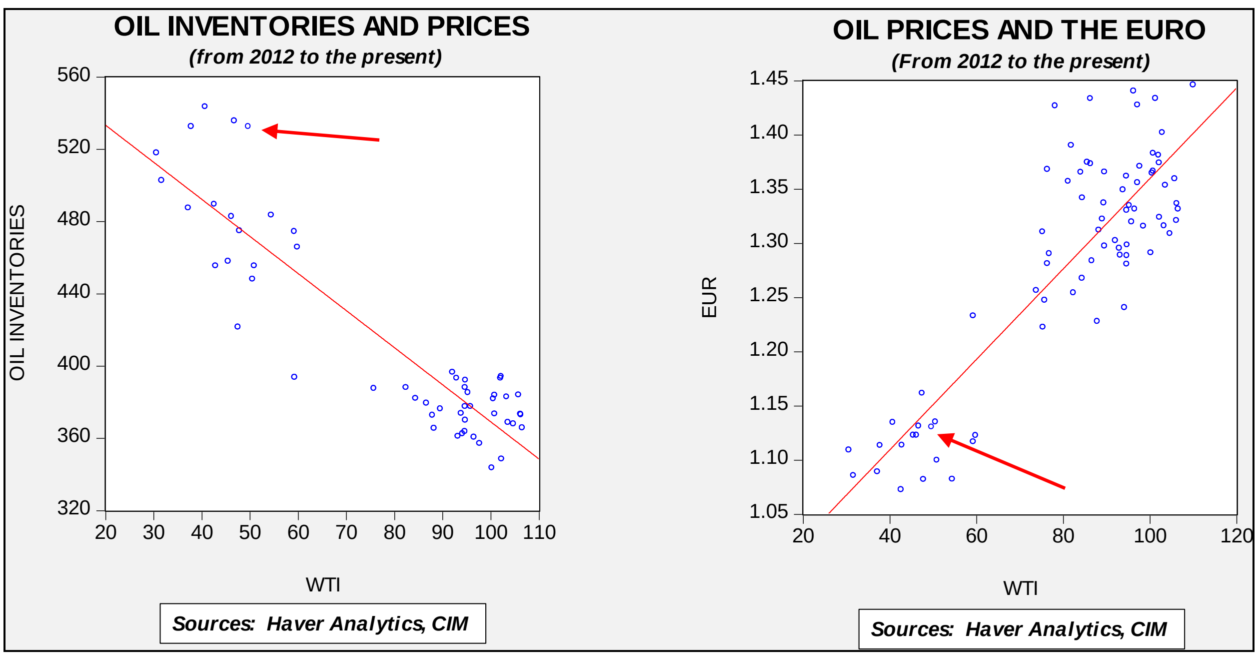


This chart shows current crude oil inventories, both over the long-term and the last decade. We are starting to see inventories decline but normal levels would be below 400 mb, some 130 mb lower than now.

So, obviously, inventories remain elevated. But, inventories are lagging the usual seasonal pattern and we are clearly on a declining path. We are running about a month ahead of the normal seasonal decline.



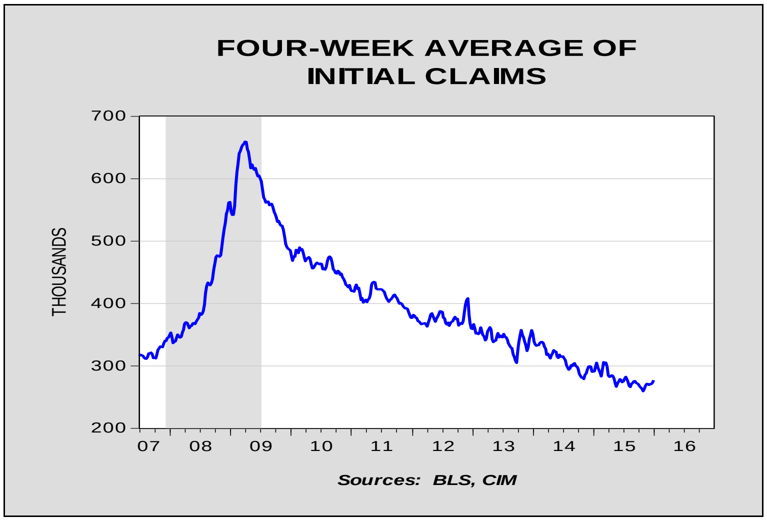
It is important to remember that the dollar is playing a bigger role in determining oil prices.



Based on inventories alone, oil prices are profoundly overvalued with the fair value price of \$31.01. Meanwhile, the EUR/WTI model generates a fair value of \$49.67, close to current values. Together (which is a more sound methodology), fair value is \$42.25, meaning that current prices are a bit rich. For those interested in oil, the Fed is arguably more important than the DOE inventories for the future of oil prices, and the recent weak employment data was a bullish event for oil prices in that it put bearish pressure on the dollar. The market is putting the odds of a July rate hike at 18%; if the employment data for June show that the May data was an anomaly, it could be bearish for oil prices.

U.S. Economic Releases

Initial claims came in better than expected, indicating a healing labor market. Claims fell 4k to 264k, better than the 270k forecast.



The chart above shows the four-week average of claims, which has trended slightly higher recently, but remains near the recent lows. Last week, the average fell 7k to 270k.

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	Wholesale inventories	m/m	Apr	0.1%	0.1%	*
12:00	Household change in net worth	q/q	Q1		$1637 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	CPI	y/y	May	2.0%	2.3%	2.2%	***	Equity and bond neutral
	PPI	y/y	May	-2.8%	-3.4%	-3.2%	**	Equity bullish, bond bearish
Japan	Eco watchers survey current	m/m	May	43.0	43.5	43.4	**	Equity bearish, bond bullish
	Eco watchers survey expectation	m/m	May	47.3	45.5	45.9	**	Equity bearish, bond bullish
EUROPE								
Germany	Trade balance	m/m	Apr	€25.6 bn	€26.2 bn	€22.8 bn	**	Equity bullish, bond bearish
	Current account balance	m/m	Apr	€28.8 bn	€29.9 bn	€21.0 bn	**	Equity bullish, bond bearish
	Exports	m/m	Apr	0.0%	1.9%	-0.8%	**	Equity bullish, bond bearish
	Imports	m/m	Apr	-0.2%	-2.3%	1.3%	**	Equity bullish, bond bearish
Italy	Unemployment rate	q/q	Q1	11.6%	11.6%	11.6%	***	Equity and bond neutral
U.K.	Trade balance	m/m	Apr	-£10.5 bn	-£10.6 bn	-£11.1 bn	**	Equity bullish, bond bearish
Switzerland	Unemployment rate	m/m	May	3.5%	3.5%	3.5%	***	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)	66	66	0	Neutral
3-mo T-bill yield (bps)	23	23	0	Neutral
TED spread (bps)	43	43	0	Neutral
U.S. Libor/OIS spread (bps)	40	40	0	Neutral
10-yr T-note (%)	1.67	1.70	-0.03	Narrowing
Euribor/OIS spread (bps)	-26	-26	0	Neutral
EUR/USD 3-mo swap (bps)	30	29	1	Up
Currencies	Direction			
dollar	up			Up
euro	down			Down
yen	up			Down
franc	down			Down

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	$ 51.74	$ 52.51	-1.47%	Higher dollar
WTI	$ 50.50	$ 51.23	-1.42%	
Natural gas	$ 2.47	$ 2.47	0.08%	
Crack spread	$ 15.98	$ 16.11	-0.84%	
12-mo strip crack	$ 13.39	$ 13.56	-1.25%	
Ethanol rack	$ 1.81	$ 1.82	-0.06%	
Metals				
Gold	$ 1,260.39	$ 1,262.80	-0.19%	Higher dollar
Silver	$ 17.00	$ 17.04	-0.23%	
Copper contract	$ 202.25	$ 206.15	-1.89%	Profit taking
Grains				
Corn contract	$ 426.25	$ 431.25	-1.16%	
Wheat contract	$ 512.50	$ 519.50	-1.35%	
Soybeans contract	$ 1,147.75	$ 1,150.25	-0.22%	Rains in the U.S. favorablew to crop development
Shipping				
Baltic Dry Freight	610	606	4	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)	-3.2	-3.1	-0.1	
Gasoline (mb)	1.0	-1.3	2.3	
Distillates (mb)	1.8	-0.5	2.3	
Refinery run rates (%)	1.1%	0.5%	0.6%	
Natural gas (bcf)		77.0		

Weather

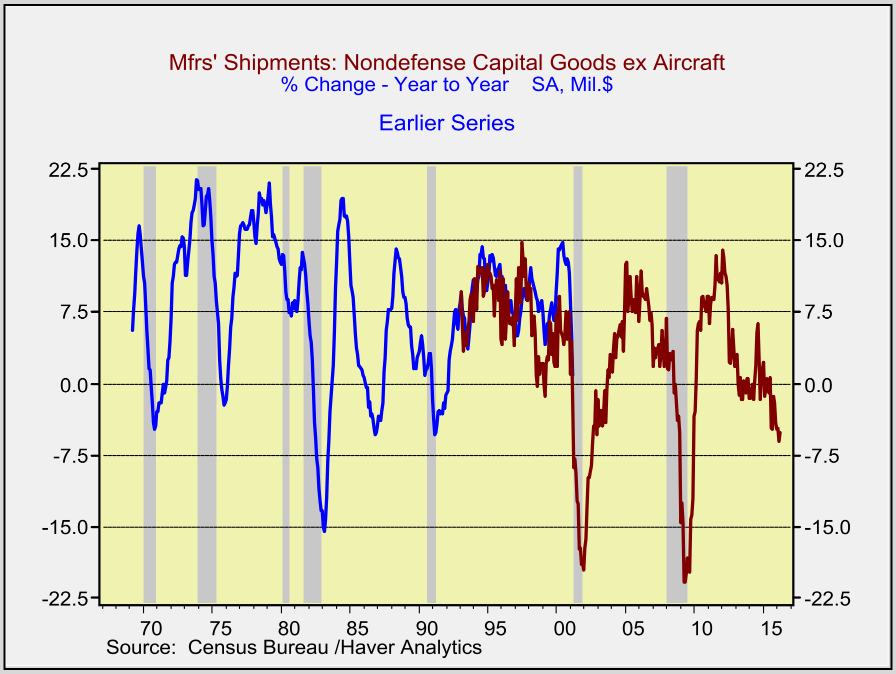
The 6-10 and 8-14 day forecasts are calling for warmer than normal conditions for most of the country, with the West Coast receiving cooler temps. Dry conditions are expected for the Northeast and the Midwest. There is no tropical activity to report.

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.

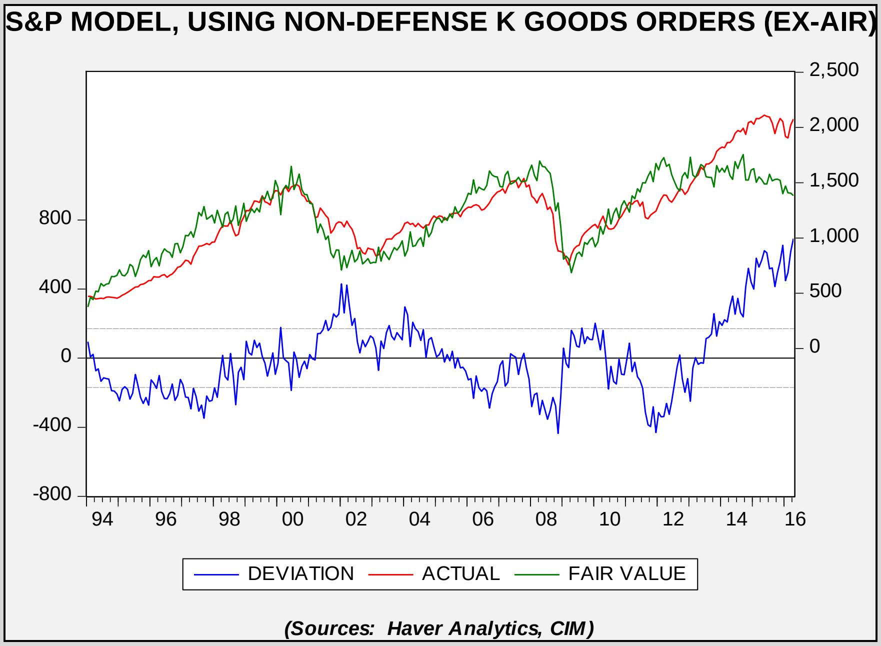
June 3, 2016

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



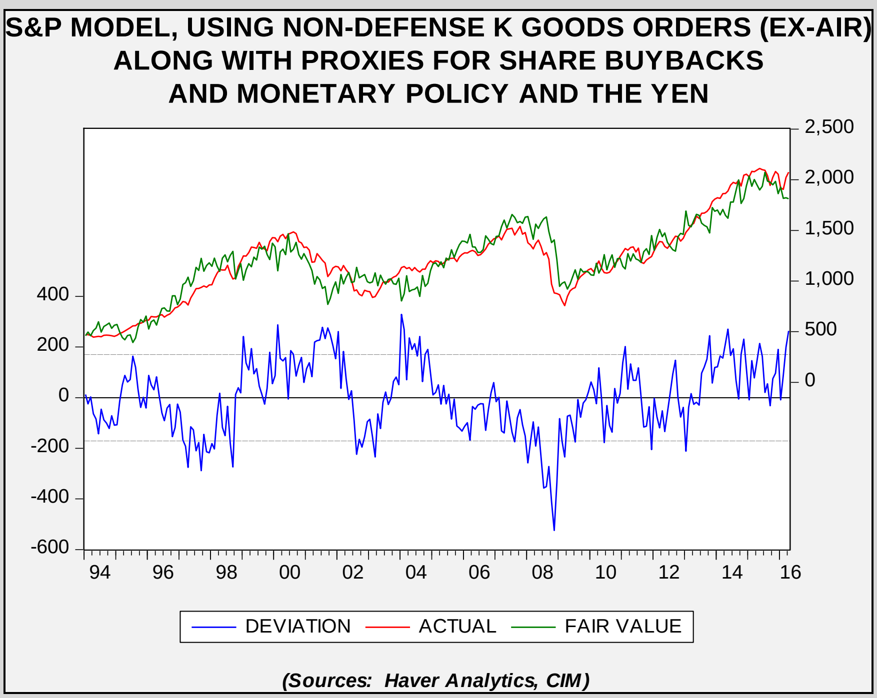
This chart shows the yearly change in the three-month smoothed non-defense capital goods orders excluding aircraft. The Census Bureau changed how it calculates this series in 1992; we have overlapped the yearly change in the earlier series. In general, a negative reading is a concern. It isn't a certain 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.

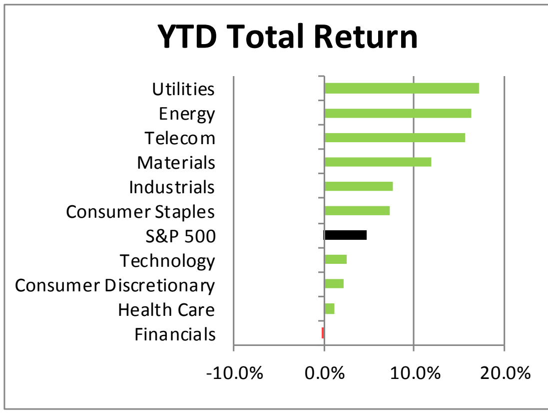
So, what is causing this divergence? We suspect monetary policy, the dollar and corporate behavior are affecting the equity market. Adding a proxy for buybacks and monetary policy, along with the yen's exchange rate, reduces the degree of overvaluation.

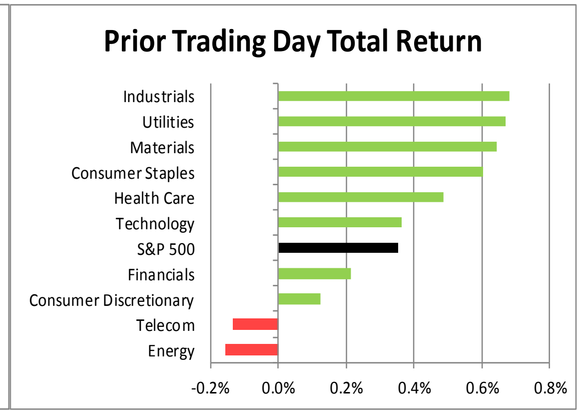


Adding these proxies increases fair value to 1811, significantly reducing the degree of overvaluation. This is still well below the current market, but it does show how equity markets have become dependent on accommodative monetary policy, dollar strength and share buybacks. Without stronger corporate 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 6/8/2016 close)

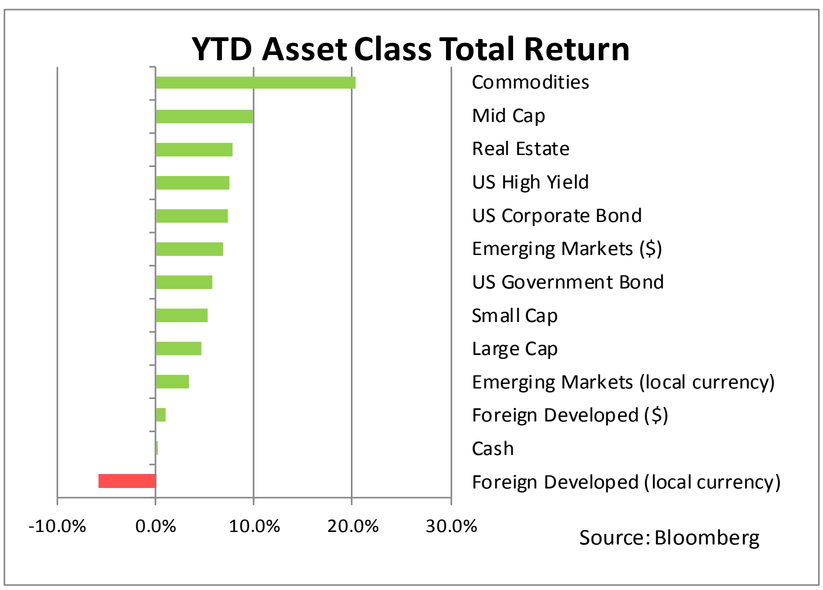




(Source: Bloomberg)

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 6/8/2016 close)

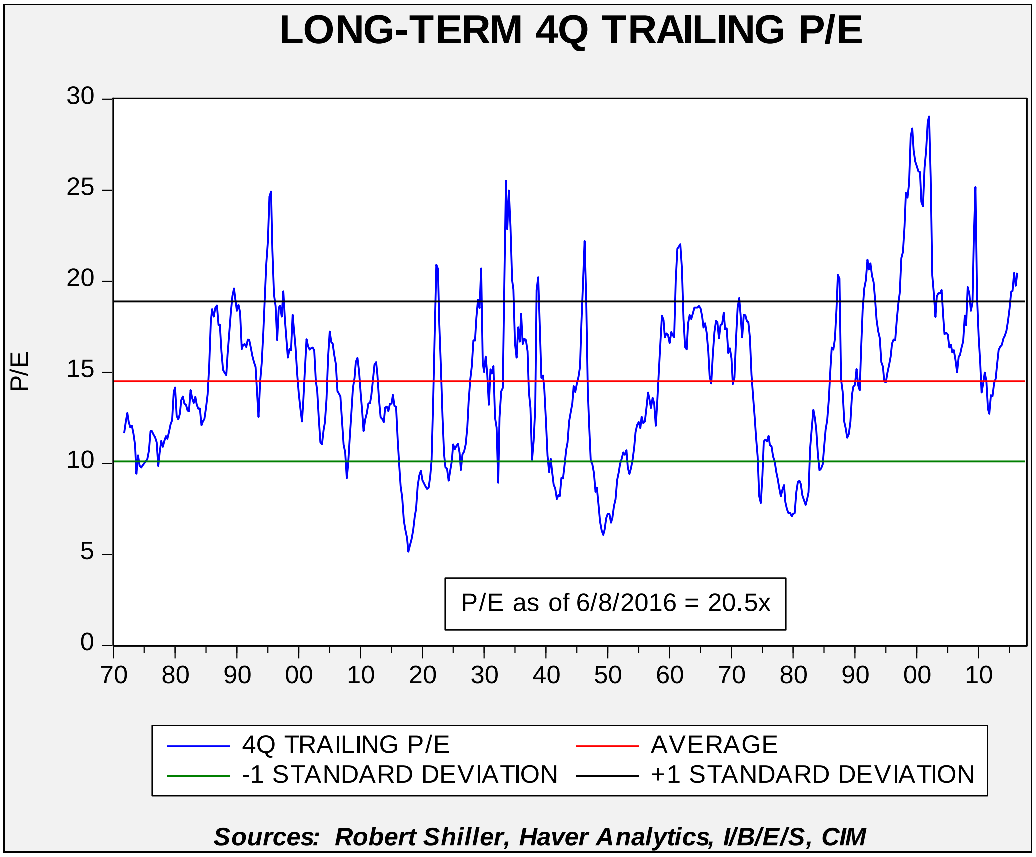


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 20.5x, up 0.1x from last week. The rise in equities with mostly steady earnings data led to the continued upward lift in the P/E.

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.