[Posted: March 11, 2016—9:30 AM EST] Global equity markets are generally higher this morning. The EuroStoxx 50 is trading higher by 3.5% from the last close. In Asia, the MSCI Asia Apex 50 traded higher by 1.3% from the prior close. Chinese markets are mixed, with the Shanghai composite up 0.2% and the Shenzhen index down 0.2%. U.S. equity futures are signaling a higher opening from the previous close. With 98.6% of the S&P 500 companies having reported, the Q4 adjusted earnings stand at $29.81, higher than the $28.95 forecast. Of the 493 companies that have reported, 69.3% beat expectations while 19.5% fell short.

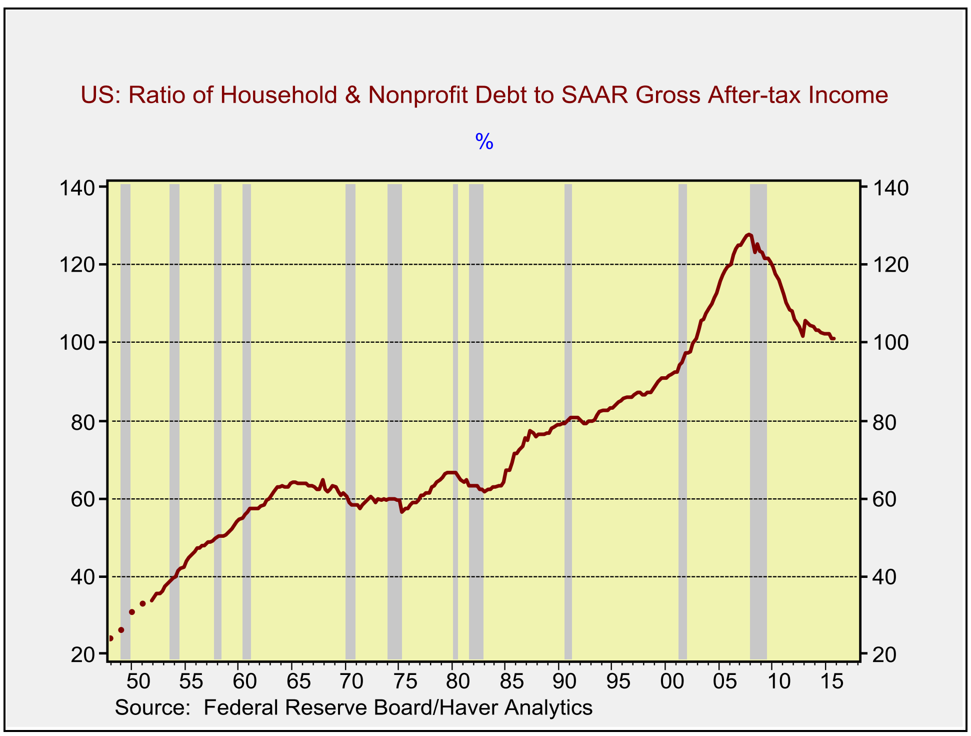
After yesterday's wild ride, risk-on has returned this morning. Equities and the dollar are higher, while Treasuries and gold are lower. Yesterday, the ECB far exceeded expectations with its stimulus package. All was going according to plan after the announcement—the dollar rose, equities were higher—and then ECB President Draghi took the air out of the room by offering forward guidance that suggested yesterday's move would be the last of the stimulus. Within minutes, the favorable trends reversed. However, this morning, we are seeing a return to positive sentiment. We suspect Draghi really meant to infer that he believes the plan unveiled yesterday will be enough to reach the bank's inflation target and additional stimulus won't be necessary. However, Draghi has shown he will continue to do "whatever it takes" and we suspect that he will do more if inflation fails to rise.

We are watching the USD against the JPY and EUR. Given the drop into negative rates, one would have expected further weakness in the latter two, but so far both have held up rather well. Although the emerging market currencies may have further to decline, we may have seen the bottom on the EUR and JPY. If so, further stimulus from the BOJ and ECB will likely fail to generate an uptick in growth.

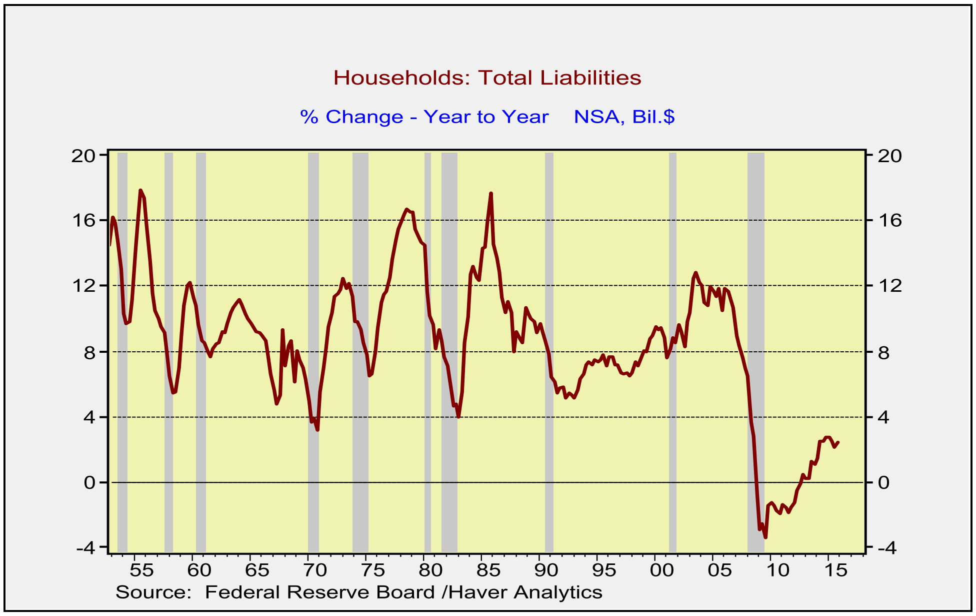
There were a couple of news items of note out of China. First, February bank loans came in weaker than forecast, at CNY 727 billion, well below the CNY 1.2 trillion forecast. Given that January loans were CNY 2.5 trillion, some pullback was expected, but the drop was larger than forecast. With the recent cut in reserve requirements, we would expect loan growth to remain elevated. The second item is that financial authorities are considering a policy to allow banks to swap deteriorating loans for equity. There has been no official confirmation of the report and few details (a trial balloon, most likely). However, media reports suggest that state-owned enterprises (SOEs) in overbuilt industries would be the likely targets. On its face, this won't do much. Banks have to assign a 100% risk/capital weighting to loans, which rises to 250% once a loan begins to deteriorate. Publicly traded equities require a weighting of 290% and unlisted equities require 370%. The only way this makes sense is if the banks take the equity and then are allowed to sell it to new buyers (likely at a much lower price). This may be a way for the government to shift ownership of these firms to the public, but it would also require giving up control of these entities. We expect to see some hopeful comments in the media supporting the swap, but most likely it won't be a big deal.

Oil prices are lifting this morning on reports from the IEA that suggest oil prices may have bottomed. The OECD group says that falling output from both OPEC and non-OPEC producers will lead to lower supplies. However, the IEA does not expect much relief on inventories, meaning that prices may have bottomed but a big rally might not be on tap. We note that meetings with Russia and OPEC leaders to freeze output have not been held; in fact, they cannot agree on a place or time. Additionally, Iran has indicated it won't freeze production until it regains its lost market share. We doubt OPEC will make any significant reductions in output until the Saudis decide they want to boost prices. Although the Saudis' financial position is deteriorating, they still have the wherewithal to deal with weaker oil prices compared to their competitors.

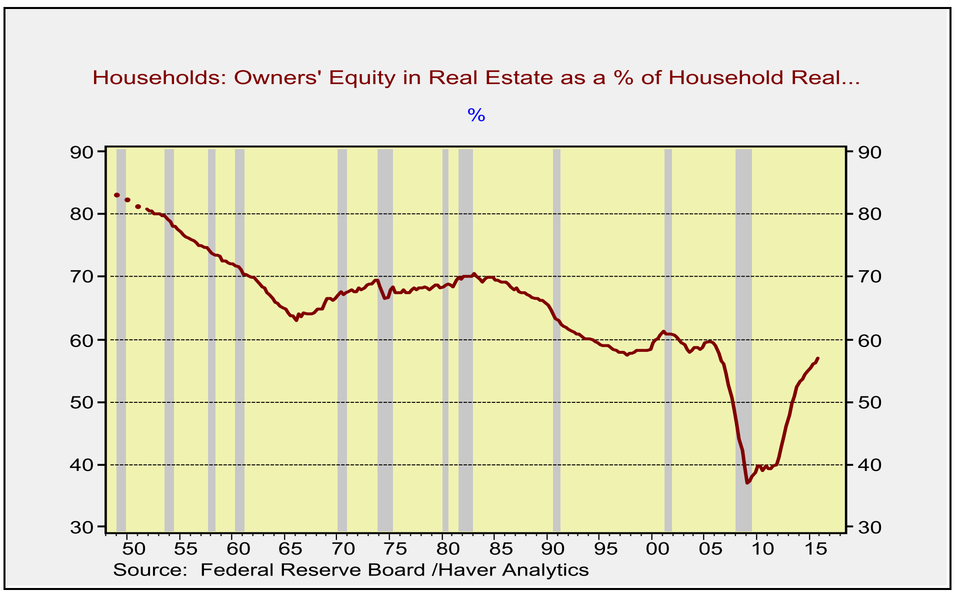
Yesterday, the Fed released its Financial Accounts for the United States for Q4. Formerly known as the "Flow of Funds" report, it offers deep insight into U.S. financial conditions for government, businesses and households. Here are a few highlights:



Deleveraging has pretty much stopped. Household debt is now 101.14% of after-tax income, up modestly from 101.09% in Q3. Households are not adding debt much faster than income, but it does appear that debt reduction is clearly ending. In the near term, this is bullish for the economy as rising consumption is key to stronger growth.

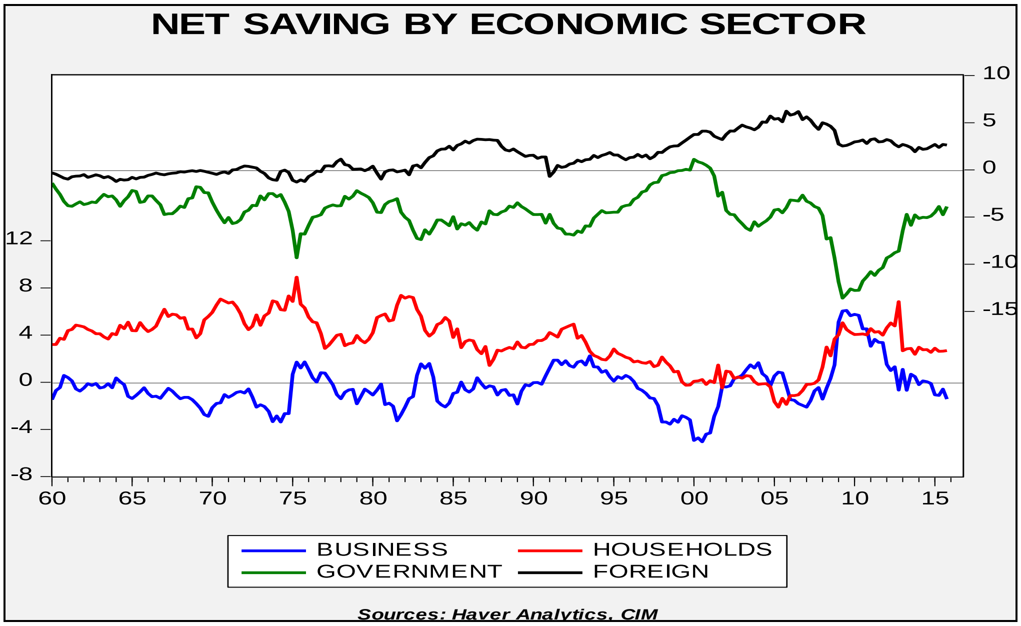


As this chart shows, debt growth is rising modestly but remains well below historical growth levels. The lack of deleveraging is due, in part, to sluggish income growth.



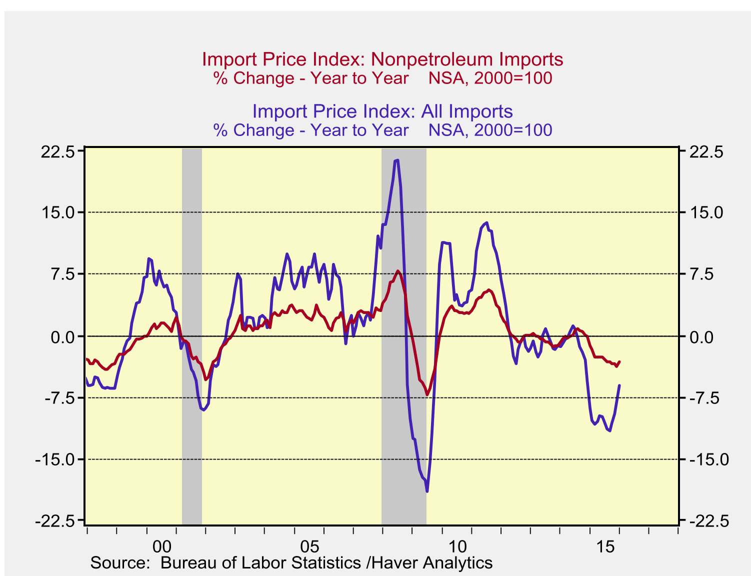
Homeowners equity in real estate creeped higher, to 56.9%in Q4 from 56.3% in Q3. We believe that when this percentage reaches 60%, homeowners will feel that they are back to a comfortable level of equity and spending will likely rise.

Finally, net saving by sector continues to slowly move in a favorable direction. Businesses continue to dissave, which is good for the economy. Business saving has two detrimental effects. First, if businesses are net savers, they are not investing their excess which usually means the economy is soft. Second, a business sector with excess saving can invest without using the financial markets to vet the investment decision. Thus, in a healthy economy, the business sector should be a net borrower most of the time. Household saving rose modestly by 5 bps, government reduced its dissaving by 86 bps and the foreign sector (the mirror image of the current account deficit) reduced its saving by 7 bps.



U.S. Economic Releases

Import prices fell 0.3% in February, better than the 0.7% forecast. Prices excluding food and fuel rose 0.1% from the month before, the first gain since May 2014. Imported petroleum prices fell 4.0%, while food prices fell 2.0%.



The chart above shows the annual change in overall import prices and core prices. Annually, headline import prices fell 6.1%, while core prices fell 2.5%. We are seeing a slight uptrend in import prices.

There are no other economic releases scheduled for the rest of the day.

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	New yuan loans (CNY)	m/m	Feb	726.6 bn	2,510.0 bn	1,200 bn	**	Equity bearish, bond bullish
	Money supply M2	y/y	Feb	13.3%	14.0%	13.7%	**	Equity bearish, bond bullish
India	Industrial production	y/y	Jan	-1.5%	-1.2%	-0.5%	***	Equity bearish, bond bullish
EUROPE								
Germany	CPI	y/y	Feb	0.0%	0.0%	0.0%	***	Equity and bond neutral
Italy	Industrial production	m/m	Jan	1.9%	-0.6%	0.7%	***	Equity bullish, bond bearish
Russia	Trade balance (RUB)	m/m	Jan	7.9 bn	11.0 bn	10.2 bn	**	Equity bearish, bond bullish
AMERICAS								
Canada	Unemployment rate	m/m	Feb	7.3%	7.2%	7.2%	***	Equity bearish, 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)	63	64	-1	Down
3-mo T-bill yield (bps)	31	31	0	Neutral
TED spread (bps)	32	33	-1	Down
U.S. Libor/OIS spread (bps)	41	40	1	Up
10-yr T-note (%)	1.93	1.93	0.00	Neutral
Euribor/OIS spread (bps)	-23	-22	-1	Down
EUR/USD 3-mo swap (bps)	23	21	2	Up
Currencies	**Direction**			
dollar	up			Rising
euro	down			Falling
yen	down			Falling
franc	down			Falling

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	$ 40.73	$ 40.05	1.70%	Speculation of production cuts
WTI	$ 38.76	$ 37.84	2.43%	
Natural gas	$ 1.84	$ 1.79	3.02%	
Crack spread	$ 18.96	$ 19.48	-2.63%	
12-mo strip crack	$ 14.12	$ 14.37	-1.73%	
Ethanol rack	$ 1.51	$ 1.51	0.27%	
Metals				
Gold	$ 1,264.36	$ 1,272.25	-0.62%	Higher dollar, risk markets rebounding
Silver	$ 15.56	$ 15.60	-0.27%	
Copper contract	$ 224.30	$ 222.00	1.04%	Risk markets rebounding
Grains				
Corn contract	$ 363.25	$ 362.75	0.14%	
Wheat contract	$ 476.50	$ 477.00	-0.10%	Oversupply concerns
Soybeans contract	$ 892.75	$ 889.25	0.39%	
Shipping				
Baltic Dry Freight	384	376	8	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)	3.9	3.2	0.7	
Gasoline (mb)	-4.5	-1.5	-3.0	
Distillates (mb)	-1.1	0.3	-1.4	
Refinery run rates (%)	0.8%	0.0%	0.8%	
Natural gas (bcf)	-57	-58.0	1.0	

Weather

The 6-10 and 8-14 day forecasts indicate warmer and wetter than normal weather for the eastern half of the country, with the western half receiving cooler and drier weather.

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.

March 11, 2016

One of the most surprising markets since the turn of the century has been long duration Treasuries. After a long bull market in bonds that ran from the early 1980s into the late 1990s, the general belief was that valuations were unattractive and it was difficult to see how further gains were possible.

This chart shows the long-term Treasury yield composite. It peaked in Q3 1981 and has steadily declined since then. Long duration yields are mostly a function of the rate of fed funds and inflation expectations. By 2000, it was generally felt that inflation wouldn't fall much further since policy rates were already rather low. However, long duration rates continued to decline after 2000. Inflation remained contained and foreign inflows, prompted by current account recycling in the emerging market economies,[1] kept buying strong for bonds. Since the end of the 2008 financial crisis, economic growth has remained lackluster and monetary policy has been historically accommodative. With no signs of inflation on the horizon, long-dated bonds have seen low yields persist.

Despite these conditions, the consensus forecast for yields has mostly been calling for a bear market in bonds.

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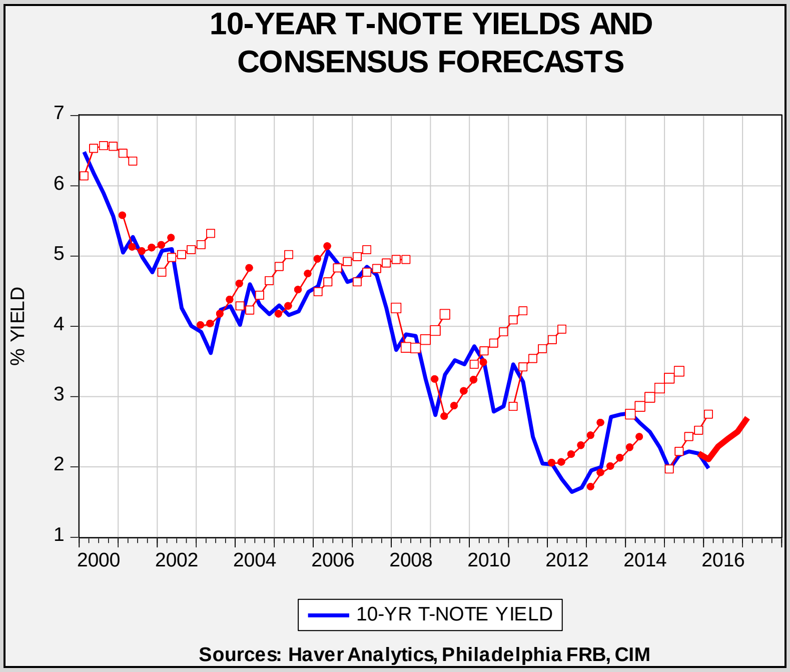
[1] Emerging economies have historically run current account surpluses due to export-led growth. A dollar-denominated current account surplus usually gets reinvested in dollar-denominated low-risk assets, such as Treasuries and other bonds, which supports the demand for these instruments.



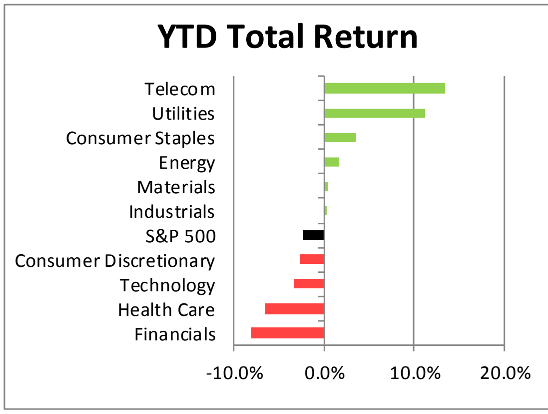
This chart shows the 10-year T-note yield along with the consensus forecast for that yield over the next six quarters from the Philadelphia Federal Reserve Bank's Professional Forecasters' survey, starting in the year 2000. Each forecast line is for the first quarter of the given year. The ones that "missed" are shown as open blocks, while the ones that looked mostly "right" are solid circles. There have been 16 forecasts; we judge that 10 have been wrong. Actually, what is remarkable isn't that the forecasts have mostly missed, but that all the misses have been in the same direction, in forecasting much higher rates.

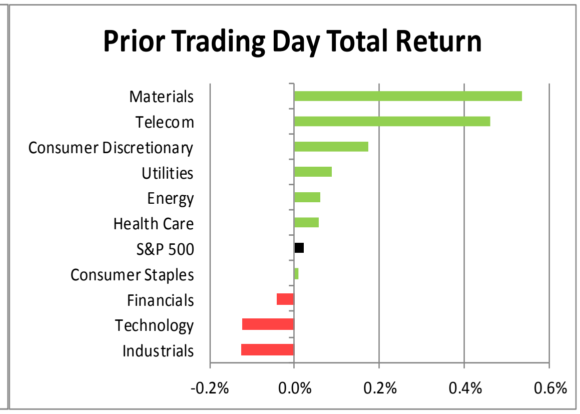
The persistent bias in expecting higher yields raises serious questions about the mindset and methodology of the forecasters. About the only way one can argue for higher yields is to expect that either inflation is going to rise or monetary policy is going to tighten significantly. We don't expect either to occur. Low inflation has global roots. The world is awash in excess capacity and technology is exposing more industries to foreign competition. In addition, excess capacity and technology are weighing on U.S. economic growth and keeping wage growth in check, which should discourage the Federal Reserve from raising rates too quickly. Despite evidence to the contrary, forecasters seem to be unable to capture these conditions in their models.

Despite persistently bearish consensus forecasts, we remain favorable toward longer duration assets. We suspect the professional forecasters surveyed are assuming an economy that no longer exists. Long-term rates may rise dramatically at some point. If, for example, trade policy becomes protectionist, we could have a rebound in inflation that would prompt higher long-term rates. If the FOMC lifts policy rates rapidly we could also see a similar result. However, our duration bias remains in place until such policy changes actually emerge.

Data Section

U.S. Equity Markets – (as of 3/10/2016 close)

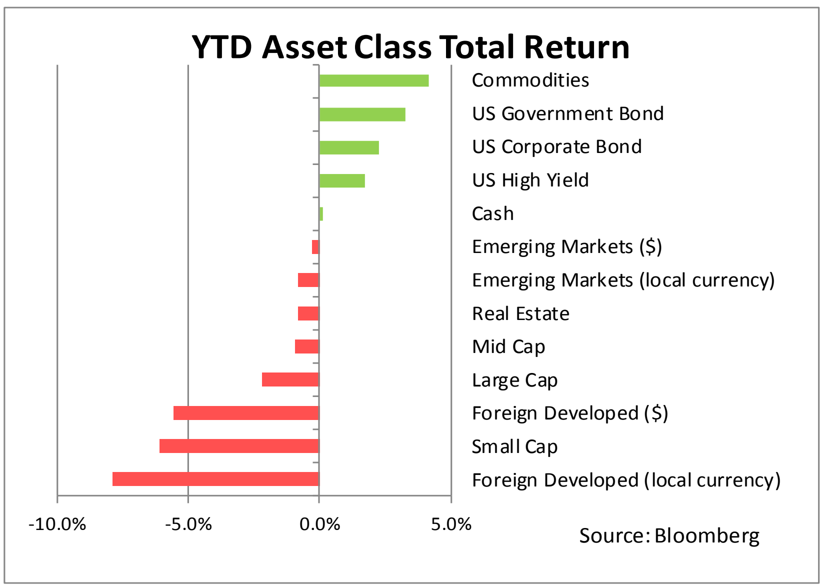




(Source: Bloomberg)

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 3/10/2016 close)

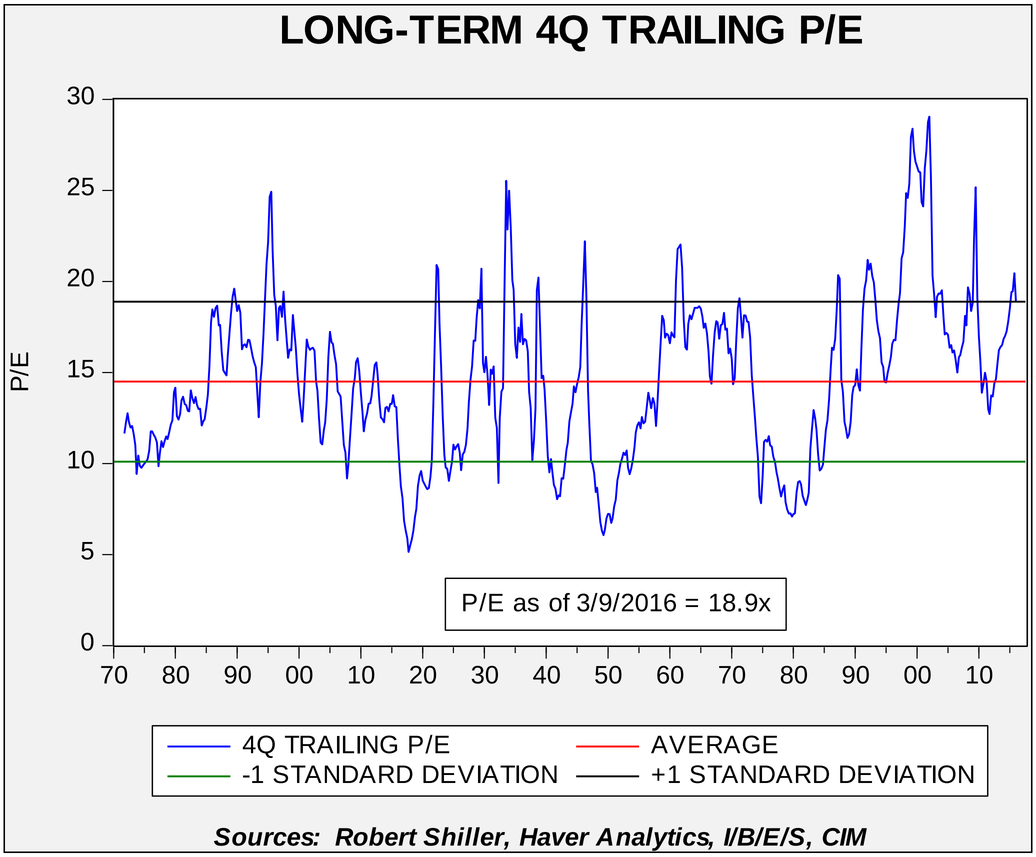


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

March 10, 2016



Based on our methodology,[2] the current P/E is 18.9x, up 0.1x from last week. Continued declines in earnings expectations and a stronger equity market are keeping the P/E elevated.

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.

[2] 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 (Q2 and Q3) and two estimates (Q4 and Q1). 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.