Confluence INVESTMENT MANAGEMENT

Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: March 14, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading higher by 0.7% from the last close. In Asia, the MSCI Asia Apex 50 traded higher by 1.1% from the prior close. Chinese markets are also higher, with the Shanghai composite up 1.8% and the Shenzhen index up 3.6%. U.S. equity futures are signaling a lower 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.

Markets are trending higher leading into a busy week. Here are a few highlights as most of the U.S. shifts to the dreaded Daylight Savings Time:

Three central banks meet this week: The FOMC meets this week. This meeting is one of the four that includes a press conference and an updated dots chart. No change in policy is expected, although the recent lift in equities and the weaker dollar have started to shift the market narrative back to tightening. We expect the following from the meeting, which will conclude tomorrow:

1. No change in rates.
2. One dissent, coming from KC FRB President George.
3. A downward revision in the dots chart but rates still higher than market expectations.
4. A narrative that is reasonably upbeat on the economy.

The BOJ and BOE also meet this week. The former is not expected to make any changes in policy despite the disappointing reaction after the bank introduced its negative interest rate policy (NIRP). It appears that some dissention between the Abe government and the BOJ is brewing. The government wants the central bank to be more aggressive while the BOJ seems worried that NIRP could backfire and policymakers appear somewhat stumped on what to do next. Meanwhile, the BOE isn't expected to do anything as Britain is in the throes of Brexit, which might require the BOE to aggressively support the economy if the U.K. leaves the EU.

Egypt devalues: Although the move wasn't a huge surprise, it will lift inflation in Egypt and could add instability to an already volatile region.

(Source: Bloomberg)

This chart shows the EGP (Egyptian pound) per dollar. We have inverted the scale such that a decline in the chart (a higher number) actually indicates a weaker EGP. This is a big drop and may trigger other nations in the region to consider devaluations of their own. At the same time, the move was well anticipated. The black market rate is reportedly around 9.6 so we cannot rule out another devaluation.

China's economy and financial markets: Although the headline data was disappointing (see below), the actual numbers are probably a bit better than the reports would suggest. Industrial production came in weaker than expected; however, the entire drop in growth was due to a slide in tobacco output, which may be due to adverse weather. Electricity production rose, which is a good proxy for economic growth. Meanwhile, the new head of financial market supervision hinted at equity market support. As we noted last week, China may create a loan/equity swap facility that would allow banks to swap deteriorating debt for equity. This is potentially a good move depending on how the deals are priced. Overall, a better Chinese economy would be bullish for emerging markets and commodities.

Politics: There are crucial primaries in the U.S. tomorrow. Donald Trump is currently expected to win Illinois, Florida and Missouri, but lose to Kasich in Ohio, based on betting data from Predictit. If this is the outcome, it will most likely mean that Trump will have the largest number of delegates at the Cleveland convention but not a majority. Then, we will see if the GOP establishment can maintain control over the political system or not. Over the weekend, violence erupted at Trump rallies and there is concern that this could spread to other candidates as well. Meanwhile, in Germany, Chancellor Merkel's coalition lost two out of three state elections yesterday. Most concerning, the Alternative for Germany (AfD) made gains in all three states, building its base as a leading opposition party. The AfD is a right-wing, anti-immigration party and has been making gains due to the refugee turmoil.

U.S. Economic Releases

There are no economic releases or Fed speakers scheduled for today.

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	Industrial production	y/y	Feb	5.4%	6.1%	5.6%	***	Equity bearish, bond bullish
	Retail sales	y/y	Feb	10.2%	10.7%	11.0%	**	Equity bearish, bond bullish
	Fixed asset investment	y/y	Feb	10.2%	10.0%	9.3%	**	Equity bullish, bond bearish
India	CPI	y/y	Jan	5.2%	5.7%	5.5%	***	Equity bullish, bond bearish
EUROPE								
Eurozone	Industrial production	y/y	Jan	2.8%	-0.1%	1.6%	***	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)	63	63	0	Neutral
3-mo T-bill yield (bps)	32	31	1	Up
TED spread (bps)	32	32	0	Neutral
U.S. Libor/OIS spread (bps)	41	41	0	Neutral
10-yr T-note (%)	1.96	1.98	-0.02	Narrowing
Euribor/OIS spread (bps)	-23	-23	0	Neutral
EUR/USD 3-mo swap (bps)	24	22	2	Up
Currencies	**Direction**			
dollar	up			Rising
euro	down			Falling
yen	up			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	$ 39.24	$ 40.39	-2.85%	Iran refuses to join production freeze initiative
WTI	$ 37.54	$ 38.50	-2.49%	
Natural gas	$ 1.79	$ 1.82	-1.81%	
Crack spread	$ 18.76	$ 18.99	-1.22%	
12-mo strip crack	$ 13.78	$ 13.98	-1.48%	
Ethanol rack	$ 1.51	$ 1.51	0.00%	
Metals				
Gold	$ 1,256.61	$ 1,249.45	0.57%	
Silver	$ 15.68	$ 15.49	1.24%	
Copper contract	$ 225.00	$ 224.10	0.40%	China investment data
Grains				
Corn contract	$ 366.50	$ 365.00	0.41%	
Wheat contract	$ 475.25	$ 475.75	-0.11%	Oversupply concerns
Soybeans contract	$ 892.75	$ 895.75	-0.33%	
Shipping				
Baltic Dry Freight	388	384	4	

Weather

The 6-10 day forecast is calling for warmer than normal temperatures for the coasts, while the 8-14 day forecast indicates warmer than normal weather for the majority of the country. Precipitation is forecast for the East Coast.

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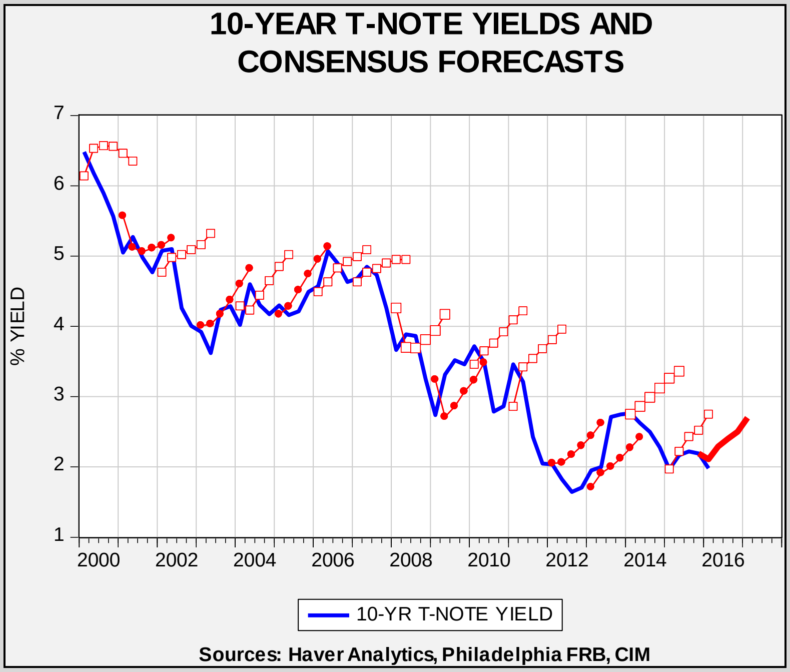
[1] Emerging economies have historically run current account surpluses due to export-led growth. A dollar-denominated current account surplus usually gets reinvested in dollar-denominated low-risk assets, such as Treasuries and other bonds, which supports the demand for these instruments.



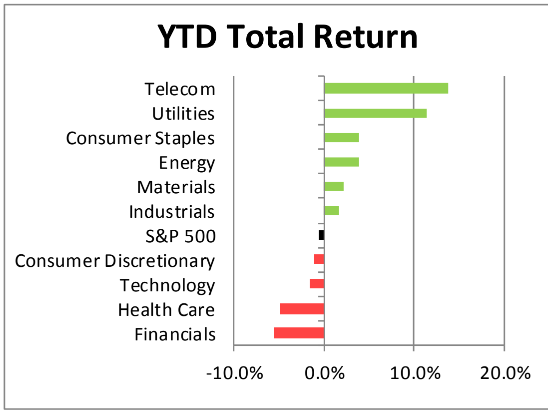
This chart shows the 10-year T-note yield along with the consensus forecast for that yield over the next six quarters from the Philadelphia Federal Reserve Bank's Professional Forecasters' survey, starting in the year 2000. Each forecast line is for the first quarter of the given year. The ones that "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.

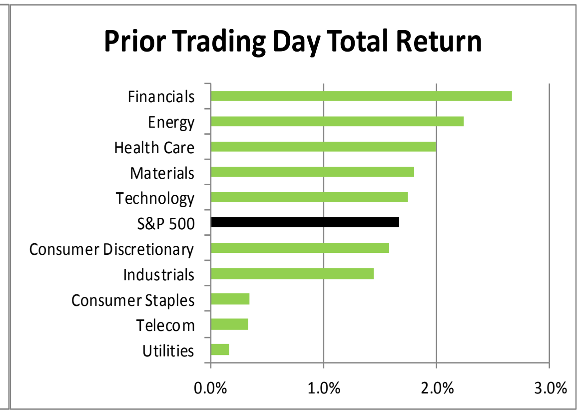
The persistent bias in expecting higher yields raises serious questions about the mindset and methodology of the forecasters. About the only way one can argue for higher yields is to expect that either inflation is going to rise or monetary policy is going to tighten significantly. We don't expect either 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 3/11/2016 close)

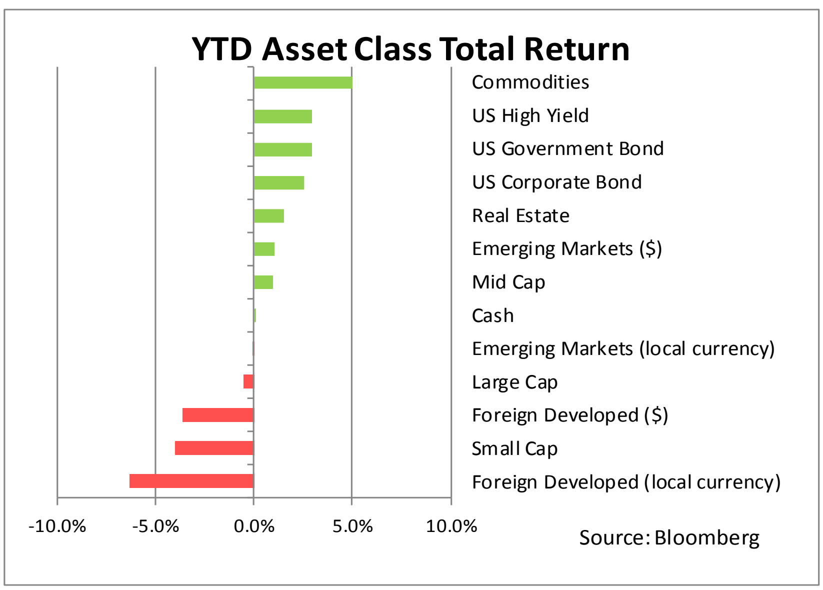




(Source: Bloomberg)

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 3/11/2016 close)

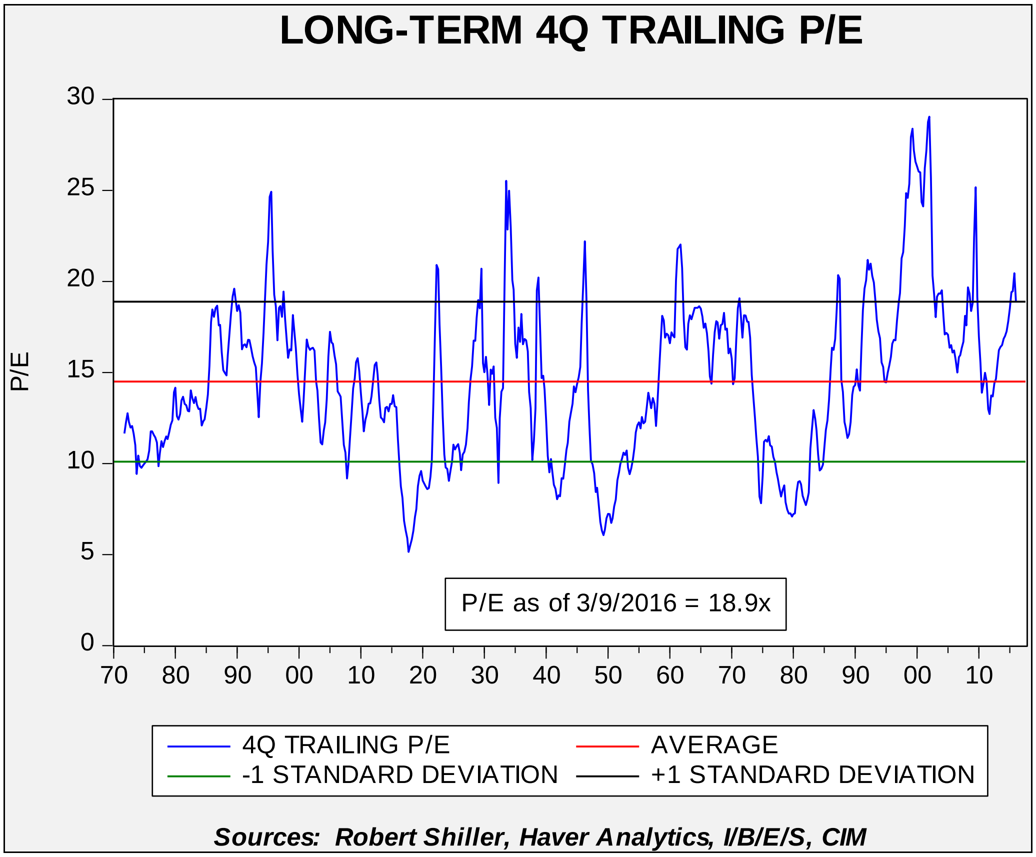


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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[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.