Daily Comment

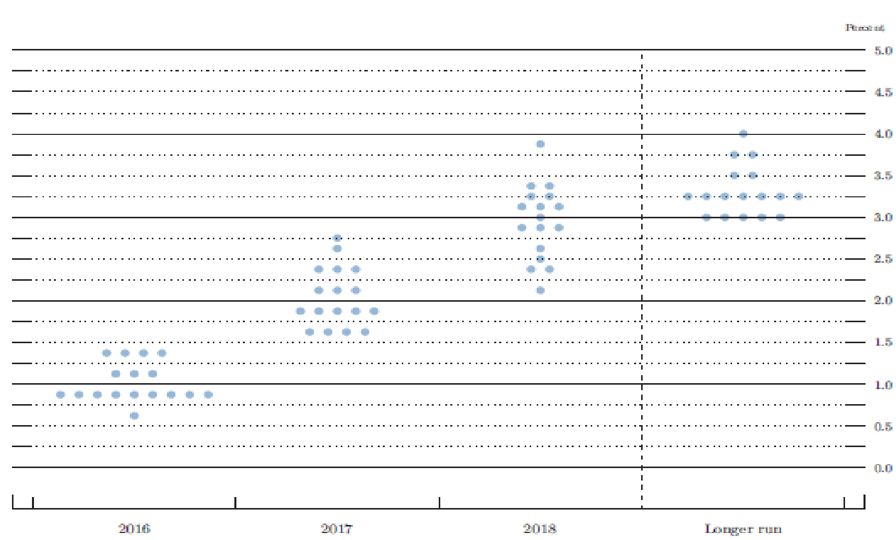
By Bill O'Grady & Kaisa Stucke, CFA

[Posted: March 17, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading lower by 1.6% from the last close. In Asia, the MSCI Asia Apex 50 traded up 1.9% from the prior close. Chinese markets are also higher, with the Shanghai composite up 1.2% 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.

Before we dive into the Fed and oil prices this morning, there are a couple of geopolitical items worth noting. First, Brazil is facing massive civil unrest this morning after wiretaps revealed that President Rousseff offered to appoint former President Luiz Inacio Lula de Silva as Chief of Staff in a bid to avoid his prosecution. A minister is immune from prosecution. Second, there was an outbreak of violence on the Sinai Peninsula today as insurgents attacked an Egyptian military base in Rafah and there were reports of other smaller attacks as well. Egypt faces numerous insurgent groups in Sinai, including IS.

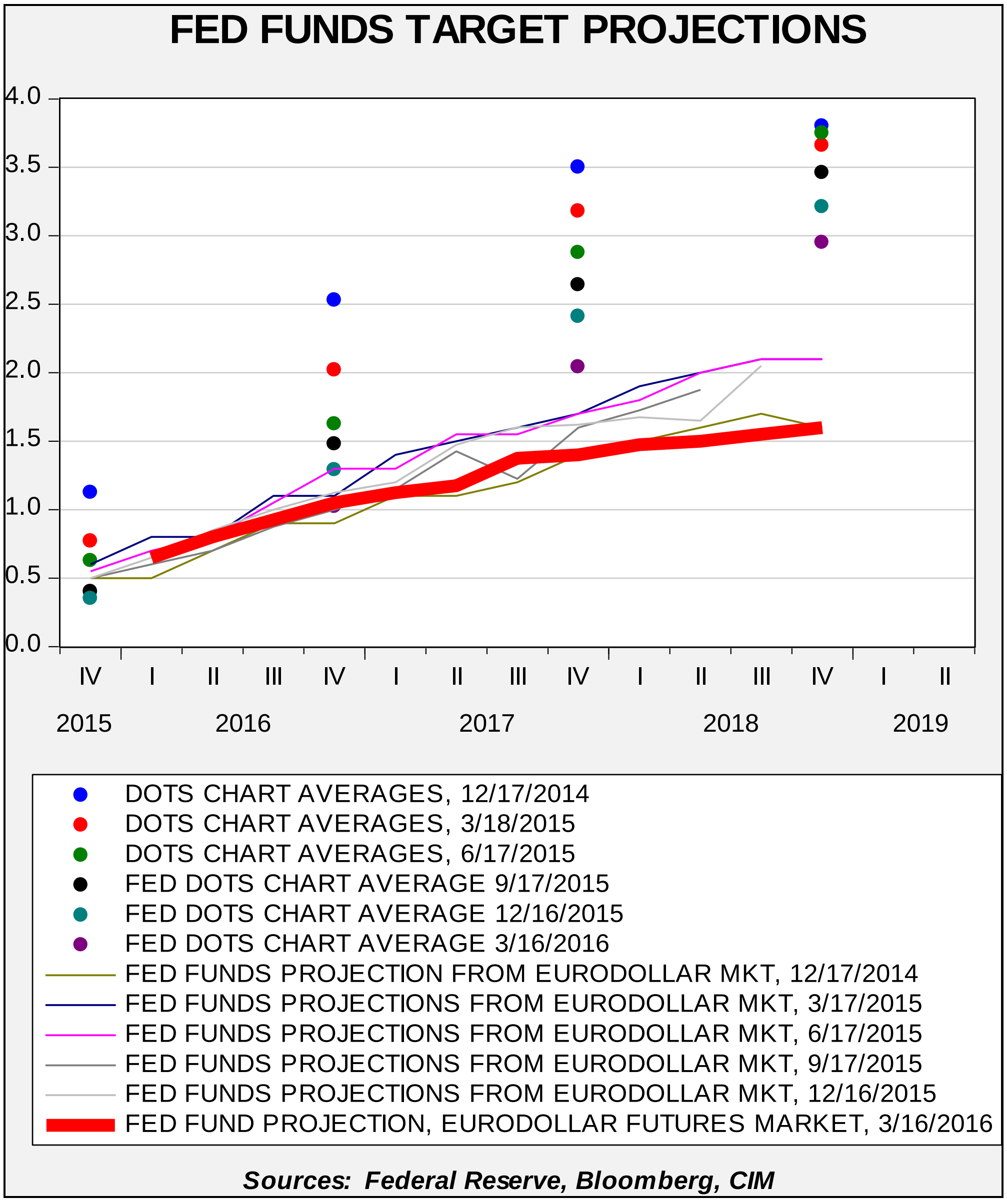
The FOMC came out with a dovish report. As expected, the Fed left rates unchanged and KC FRB President George dissented from the decision. From there, however, the FOMC changed its stance on policy as shown by the dovish dots chart projections.

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



(Source: Federal Reserve)

The bulk of the votes are around 0.875% for this year. One voter is actually at 0.625%, putting only one hike on the agenda. The average is 1.02%, meaning that two tightening moves are forecast.

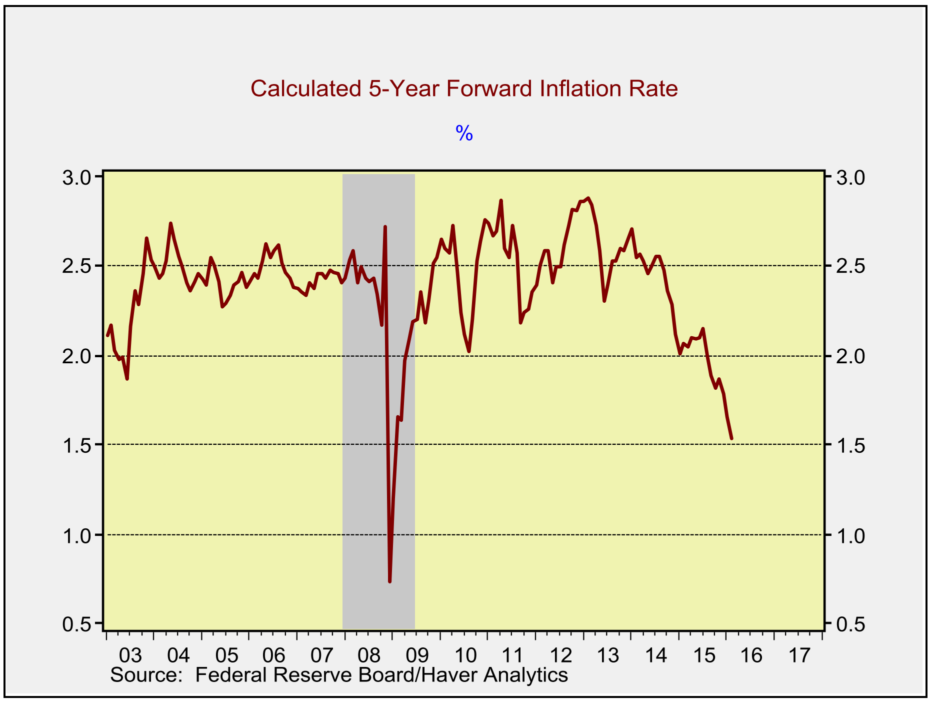


This chart shows the progression of the dots average compared to the market's projection for policy, derived from the Eurodollar futures market. The progression shows that the FOMC is steadily reducing its expectations for the terminal rate. In fact, the average dot for this meeting is dead on expectations of the Eurodollar futures market, meaning the FOMC has moved its forecast year-end rate to what has already been discounted by the financial markets. The Fed is still looking to move rates higher in the more distant years but, as the dots progression shows, it is highly likely that these expectations will probably fall as well…at least, that's been the trend over the past several years.

We were surprised by the dovish stance of the Fed. As we noted yesterday, inflation is clearly picking up and any Phillips Curve-based model suggests that monetary policy is getting behind the curve. As we discussed yesterday, we were worried that Yellen would "tee up" a tightening for June. Not only did that not happen, but the Fed actually uncorked a dovish statement. What led to this decision? We believe it is one of three factors:

The FOMC has decided the Phillips Curve is no longer relevant. This has been the position of Governor Brainard and Chicago FRB President Evans. Although this is possible, recent comments from Vice Chairman Fischer suggest that he has not been swayed by this argument.

The FOMC still believes in the Phillips Curve, but is worried about inflation expectations. Expectations have been falling for some time, and lifting the policy rate into declining inflation expectations means that policy is being tightened even more than simply an increase in rates.



This chart shows the five-year forward implied inflation rate using the Treasury TIPS. From 2003 through 2014, the average expected inflation rate was 2.42%. Over the past two years, it has declined to an average of 1.94% and, as the chart shows, it is falling rapidly. One implied goal of Fed policy is to "anchor" inflation expectations. In the 1970s, as expectations ratcheted higher, it became harder to control inflation because the very act of expecting higher inflation induced behaviors that exacerbated it. Thus, consumers would buy today fearing prices would be higher tomorrow, and businesses held more inventory because it rose in value with inflation and inventory accumulation acted to boost demand. The Fed's worry is that in an environment of falling expectations, you get the opposite behavior. Households delay purchases because prices are not expected to rise appreciably or, perhaps, may even decline. Businesses do everything they can to not hold stockpiles. It appears that the FOMC will be reluctant to lift rates as long as inflation expectations are weakening.

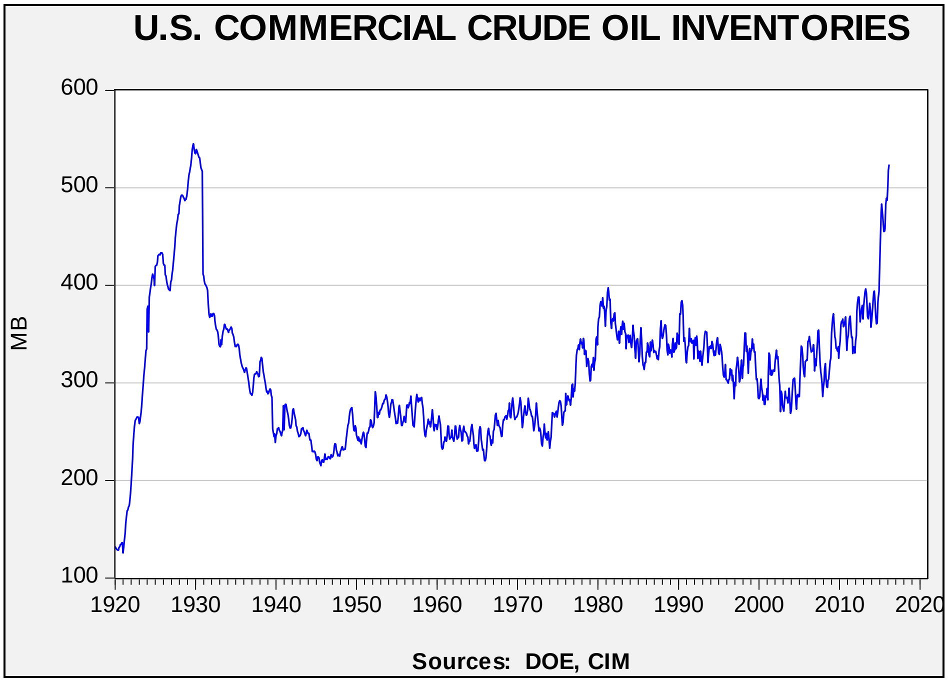
The FOMC is reacting to foreign developments, especially actions recently taken over the past few weeks by the ECB and BOJ to engage in additional stimulus. We were most struck by the market reaction in the dollar and gold, with the former plunging and the latter rising sharply. Although there isn't much history of the FOMC paying close attention to the dollar and international events except in extreme cases, it is starting to look like the Fed is viewing the behavior of foreign central banks as a form of easing. Of course, that only occurs if the dollar strengthens, which it didn't do yesterday.

There are some commentators arguing that some sort of deal to support the dollar came out of the last G-20 meeting. We strongly doubt this was the case. Instead, we believe both the BOJ and ECB eased policy with the aim of weakening their currencies. The lack of reactions in the JPY and EUR and failures to weaken after they eased, and the reaction to the Fed, suggests to us that something more like a "currency war" is underway. Negative interest rate policy's (NIRP) primary stimulative effect comes from a weaker currency. If the dollar continues to depreciate, it will be interesting to see how the BOJ and ECB will react. If our narrative is correct, we can expect to see further aggressive easing by these central banks.

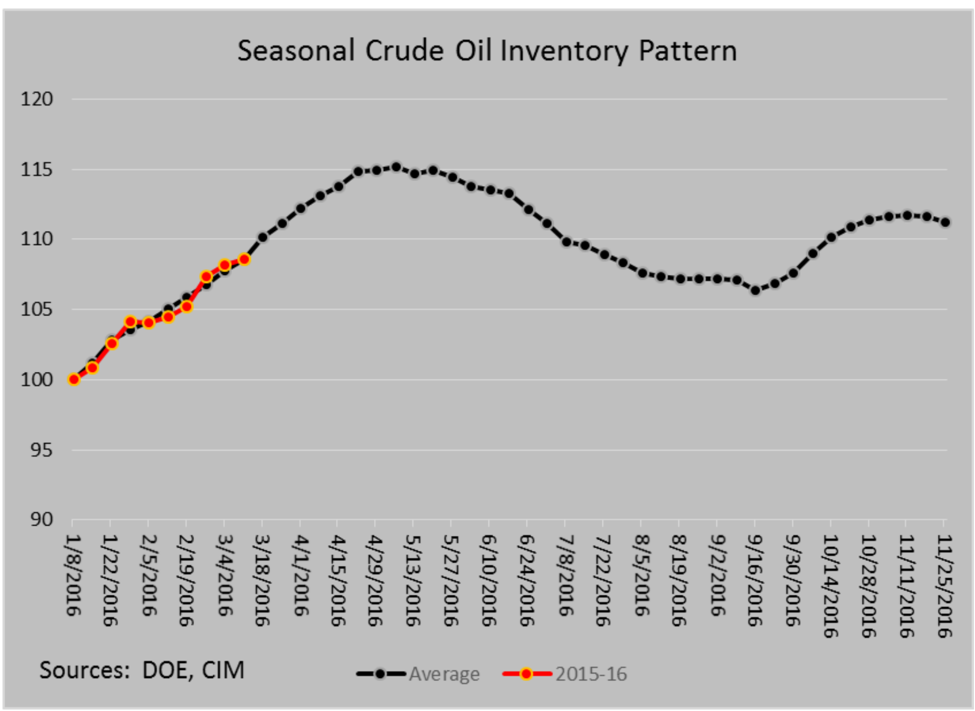
We note the Fed didn't offer a "balance of risks" assessment, which avoided exposing the divisions on the committee. Thus, we expect that the second and third points are probably the keys. Inflation expectations are a concern. Although labor markets are clearly improving, the lack of wage growth suggests something isn't working right. The annual wage-setting season in Japan has been very disappointing for PM Abe in that wage increases are almost non-existent and NIRP is being blamed for the lack of labor bargaining power. There is probably some legitimate fear among the committee members that perhaps the lack of inflation expectations (see above) is bleeding into the wage-setting process in the U.S. Foreign developments could be weighing on the committee as well. The expected divergence in policy led to a much stronger dollar that clearly dampened Q4 economic growth. By not raising rates and by lowering the trajectory of tightening, the retreat of the dollar is good news for the U.S. economy. However, as we discussed above, the negative reaction of developed market equities to the Fed's decision shows how sensitive these markets have become to currency values.

So, the big winners from yesterday are commodities, emerging markets, foreign currencies, domestic equities and U.S. fixed income. Losers look like the dollar and developed market equities.

This discussion takes us to the oil market. Oil prices jumped yesterday, in part due to a lower than expected build in crude oil inventories but also due to the aforementioned dovish Fed statement.



Inventories remain historically high. Assuming the usual seasonal pattern continues, we should end up with stockpiles of around 555 mb by the end of next month.

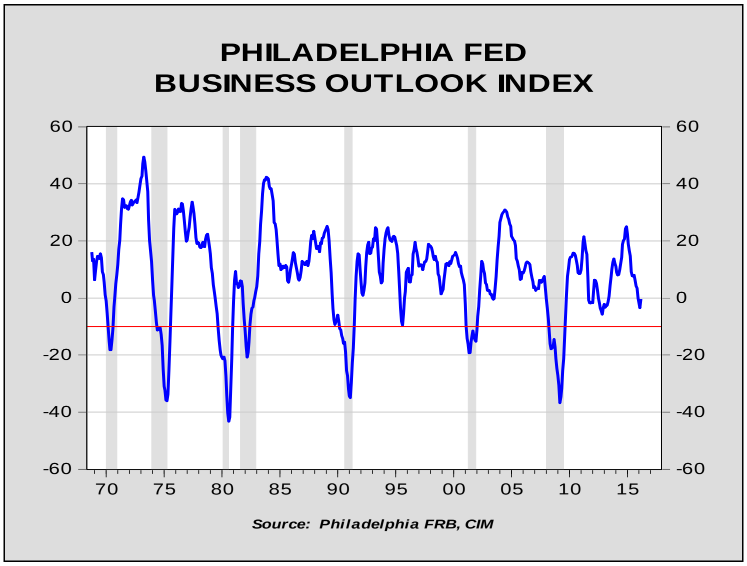


As this chart shows, we have about another six weeks before inventories peak. Based on current oil inventories and the euro, fair value for crude oil is $36.70 per barrel. Thus, current prices are a bit overvalued. Assuming we continue to see normal seasonal builds, fair value by the end of

April will be $31.02. To justify current oil prices with the expected peak in stockpiles, the euro will need to strengthen to $1.155, which isn't out of the question in light of the Fed's behavior.

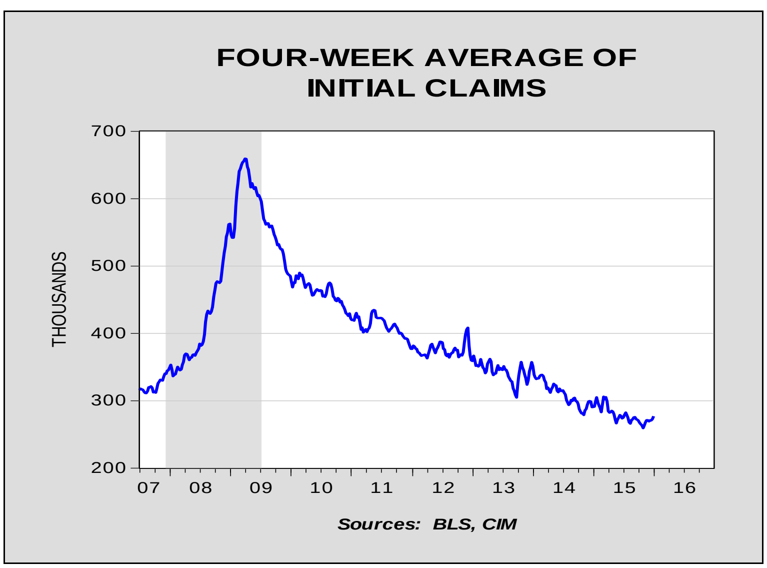
U.S. Economic Releases

The March Philadelphia Fed business outlook indicator rebounded unexpectedly, rising to +12.4 from -2.8 the month before, also much stronger than the -1.5 level forecast.



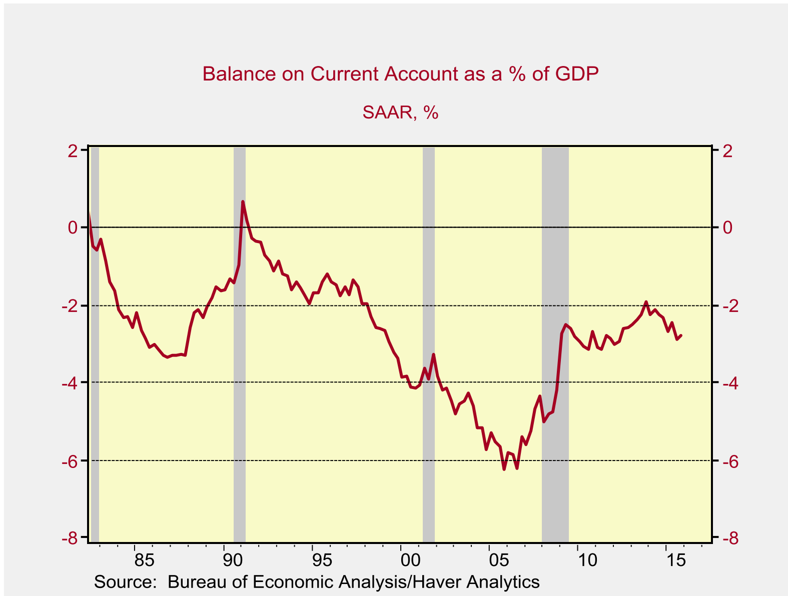
The chart above shows the six-month average of the index, which improved to -0.4 in March from -3.4 the month before. This uptick in the index indicates an improvement in conditions, but we will follow the index's future moves closely to make sure the improvement is sustained.

Initial claims came in better than forecast, rising 7k to 265k compared to the 268k level forecast. The labor market is improving, with companies retaining workers to meet final demand.



The chart above shows the four-week average of claims, a more stable measure. The average actually rose 1k to 268k, but remains near recent lows.

The current account deficit came in at $125.3 bn in Q4, wider than the $118.0 bn deficit expected, but narrowing from the $129.9 bn level in January.



The chart above shows the current account balance as a percentage of GDP. The ratio has taken a break recently from the general uptrend due to the stronger dollar.

The chart below shows the economic releases scheduled for the rest of the day.

Economic releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	LEI	m/m	Feb	0.2%	-0.2%	*
10:00	JOLTS job openings	m/m	Jan	92.2	91.7	*

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								
Australia	Unemployment rate	m/m	Feb	5.8%	6.0%	6.0%	***	Equity bullish, bond bearish
China	Foreign Direct Investment	y/y	Feb	1.8%	3.2%	1.7%	**	Equity bullish, bond bearish
Japan	Trade balance	m/m	Feb	¥166.1 bn	¥73.2 bn	¥235.0 bn	**	Equity and bond neutral
	Exports	y/y	Feb	-4.0%	-12.9%	-3.0%	**	Equity bearish, bond bullish
	Imports	y/y	Feb	-14.2%	-18.0%	-15.8%	**	Equity bullish, bond bearish
EUROPE								
Eurozone	CPI	y/y	Feb	-0.2%	-0.2%	-0.2%	***	Equity and bond neutral
	Trade balance	m/m	Jan	€21.2 bn	€22.5 bn	€19.5 bn	**	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)	64	64	0	Neutral
3-mo T-bill yield (bps)	28	29	-1	Down
TED spread (bps)	37	35	2	Up
U.S. Libor/OIS spread (bps)	38	38	0	Neutral
10-yr T-note (%)	1.89	1.91	-0.02	Narrowing
Euribor/OIS spread (bps)	-23	-23	0	Neutral
EUR/USD 3-mo swap (bps)	20	19	1	Up
Currencies	**Direction**			
dollar	down			Rising
euro	up			Falling
yen	up			Falling
franc	up			Falling
Central Bank Action	**Current**	**Prior**	**Expected**	
BOE bank rate	0.50%	0.50%	0.50%	On forecast
BOE asset purchase target	£375 bn	£375 bn	£375 bn	On forecast
Swiss LIBOR lower target rate	-1.25%	-1.25%	-1.25%	On forecast
Swiss LIBOR upper target rate	-0.25%	-0.25%	-0.25%	On forecast
Swiss sight deposit rate	-0.75%	-0.75%	-0.75%	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	$ 40.52	$ 40.33	0.47%	Domestic crude stockpiles rise less than expected
WTI	$ 38.75	$ 38.46	0.75%	
Natural gas	$ 1.88	$ 1.87	0.48%	
Crack spread	$ 17.94	$ 18.49	-2.97%	
12-mo strip crack	$ 13.40	$ 13.74	-2.44%	
Ethanol rack	$ 1.53	$ 1.52	0.10%	
Metals				
Gold	$ 1,264.52	$ 1,262.57	0.15%	Lower dollar
Silver	$ 15.68	$ 15.62	0.37%	
Copper contract	$ 227.50	$ 223.40	1.84%	Lower dollar
Grains				
Corn contract	$ 370.00	$ 368.25	0.48%	
Wheat contract	$ 475.00	$ 470.75	0.90%	
Soybeans contract	$ 901.00	$ 894.50	0.73%	
Shipping				
Baltic Dry Freight	393	396	-3	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)	1.3	3.2	-1.9	
Gasoline (mb)	-0.7	-2.5	1.8	
Distillates (mb)	-1.1	-0.6	-0.5	
Refinery run rates (%)	-0.1%	0.0%	-0.1%	
Natural gas (bcf)		-5.0		

Weather

The 6-10 and 8-14 day forecasts are calling for warmer and wetter than normal temperatures for the majority of the country.

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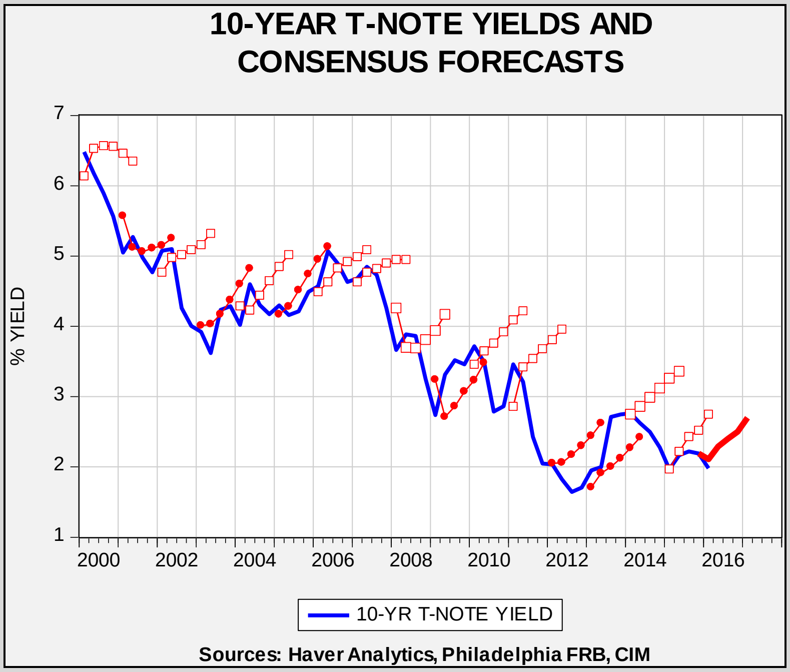
[1] Emerging economies have historically run current account surpluses due to export-led growth. A dollar-denominated current account surplus usually gets reinvested in dollar-denominated low-risk assets, such as Treasuries and other bonds, which supports the demand for these instruments.



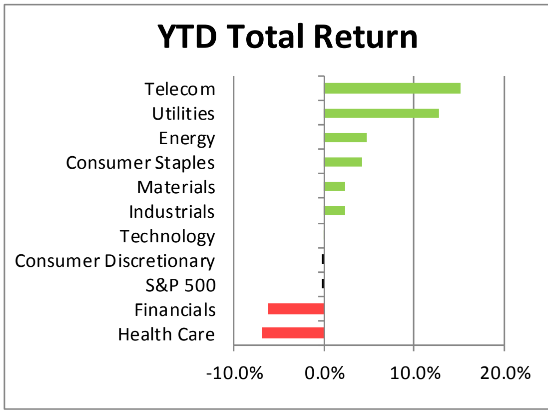
This chart shows the 10-year T-note yield along with the consensus forecast for that yield over the next six quarters from the Philadelphia Federal Reserve Bank's Professional Forecasters' survey, starting in the year 2000. Each forecast line is for the first quarter of the given year. The ones that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

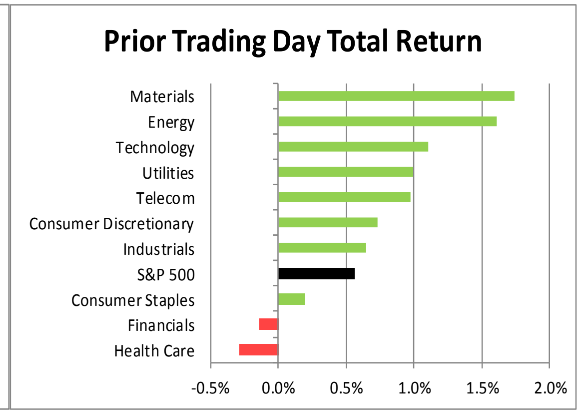
The persistent bias in expecting higher yields raises serious questions about the mindset and methodology of the forecasters. About the only way one can argue for higher yields is to expect that either inflation is going to rise or monetary policy is going to tighten significantly. We don't expect either 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 3/16/2016 close)

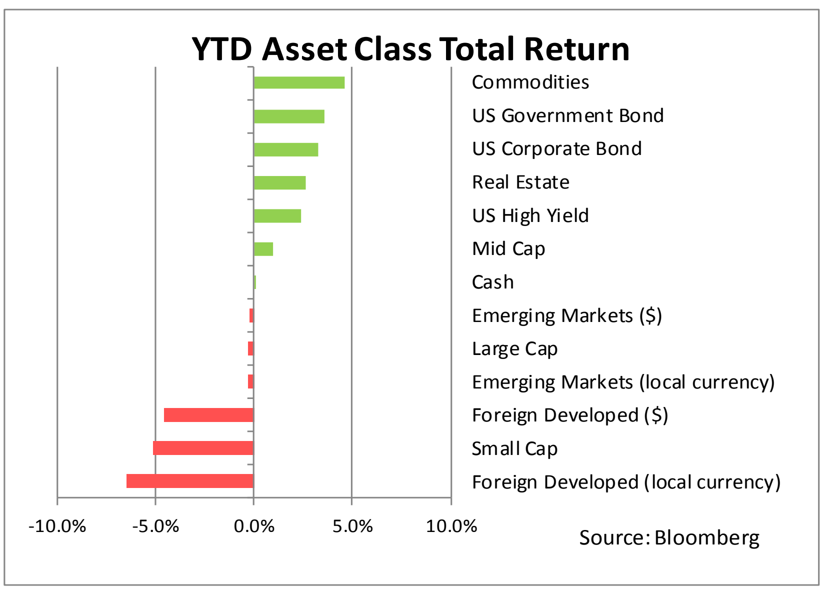




(Source: Bloomberg)

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 3/16/2016 close)

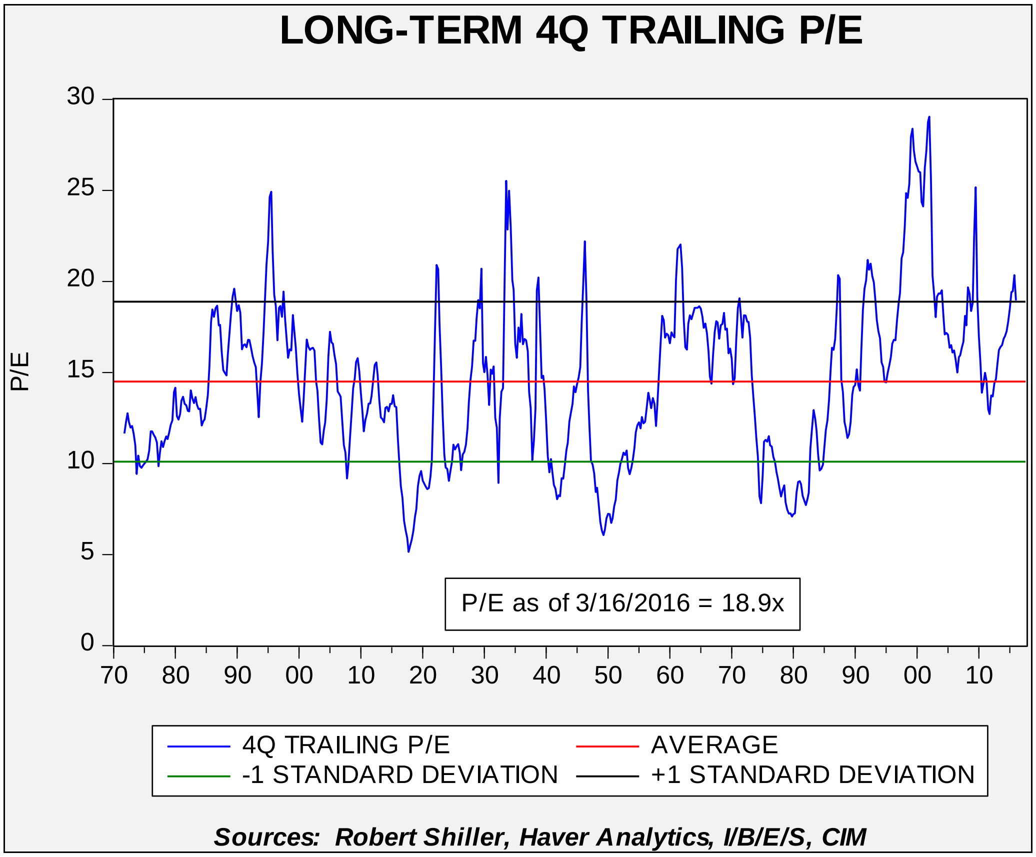


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 17, 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.