

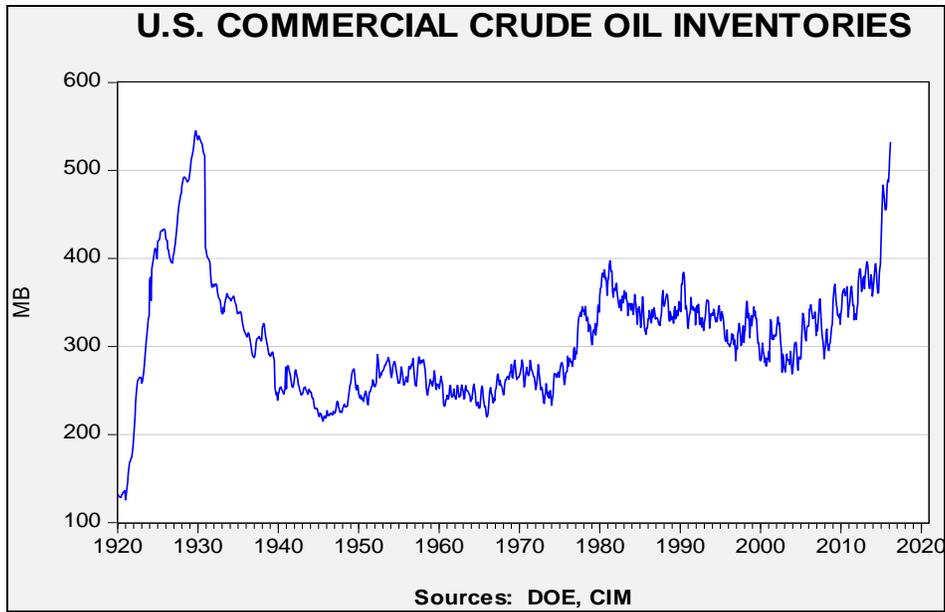
**[Posted: March 24, 2016—9:30 AM EDT]** Global equity markets are mostly lower this morning. The EuroStoxx 50 is trading down 1.5% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 0.2% from the prior close as well. Chinese markets were lower, with the Shanghai composite down 1.6% and the Shenzhen index off 1.4%. U.S. equity futures are signaling a lower opening from the previous close.

As noted below, St. Louis FRB President Bullard has joined a chorus of other regional presidents pushing back against the dovish tone from the last Fed meeting. The change in Fed behavior is discussed in this week's Asset Allocation Comment, published below on page 7. As these comments ripple through the market, we are seeing the recent rally fade in commodities, foreign currencies and equities.

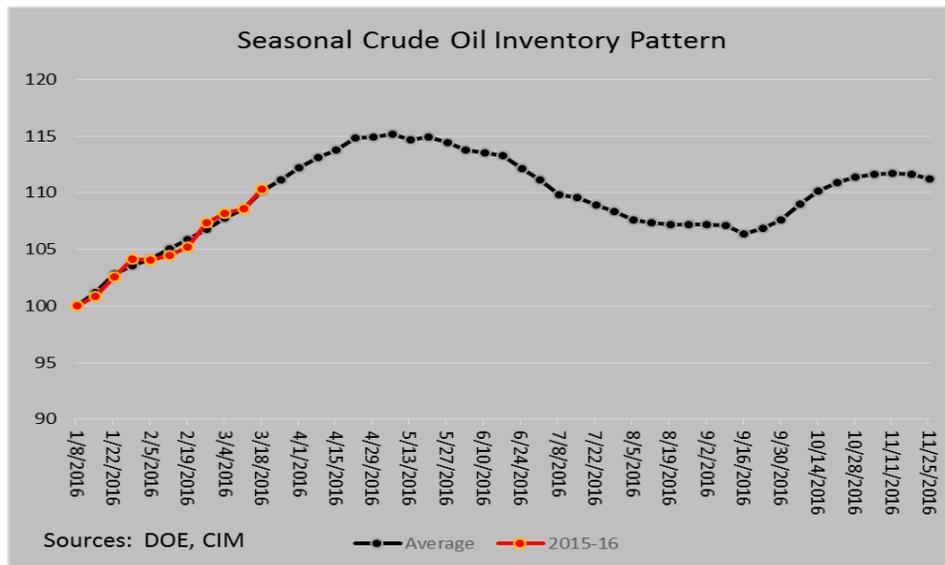
What is becoming evident is that the paths of several markets are increasingly dependent on U.S. monetary policy. The tone out of the March meeting was clearly bullish. However, subsequent speeches have also made it known that this dovish position isn't universally shared. We do believe that Yellen is probably fending off the Phillips Curve adherents on the committee by using inflation expectations and dollar strength to argue against further tightening. The dots plot suggesting two rate hikes this year is probably about right, but the financial and commodity markets are taking the position that monetary policy will be consistently accommodative. For that to happen, Chairman Yellen is going to need to keep control of the committee against rising opposition to policy accommodation. If she loses the battle, equities and commodities are at risk, whereas the dollar and Treasuries should benefit. In general, it is usually safe to side with the chairman; however, it should also be noted that she probably can't hold her position with three dissents on any policy decision.

At present, it would not be a stretch to see Bullard, George, Williams and Mester press for a rate hike in April. If they hold off, that concession probably only comes with a promise to raise rates in June. Only George has shown she will consistently dissent. Growing opposition to dovish policy could make Yellen's job much tougher in the coming months and create choppier markets.

Oil prices fell yesterday as inventories rose well above expectations.

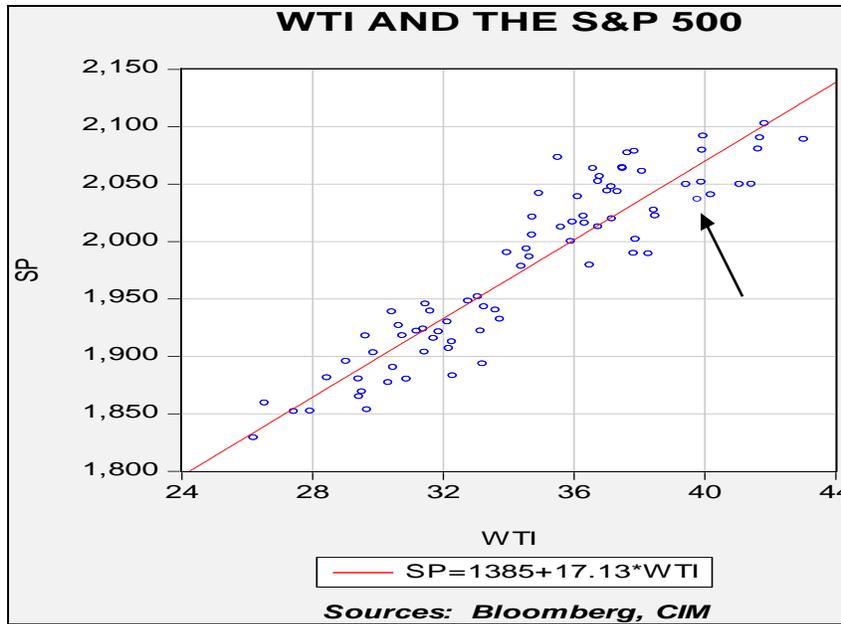


Current stockpiles are 532.5 mb, only about 12 mb below the all-time high set in October 1929. Based on seasonal patterns, we would expect that oil record to be broken before the end of next month.



This chart indexes current storage levels compared to the past five-year average. By the middle of next month, the injection season will come to a close. If we assume that the EUR/USD exchange rate remains in the \$1.11 neighborhood, a return to the low \$30s on crude oil is possible. However, by late summer, a return to the low \$40s would be expected. To some extent, we view the crude oil market as a bit ahead of itself, but the bearish seasonal situation is almost over.

The relationship between oil prices and equities remains very tight.



The current pair of oil prices and the S&P 500 are noted with an arrow. The current level of the equity index is a bit below the linear regression line, suggesting the market is a bit cheap. If this relationship holds, a trip to the low \$30s in crude oil will likely result in an S&P between 1,900 and 1,950.

### U.S. Economic Releases

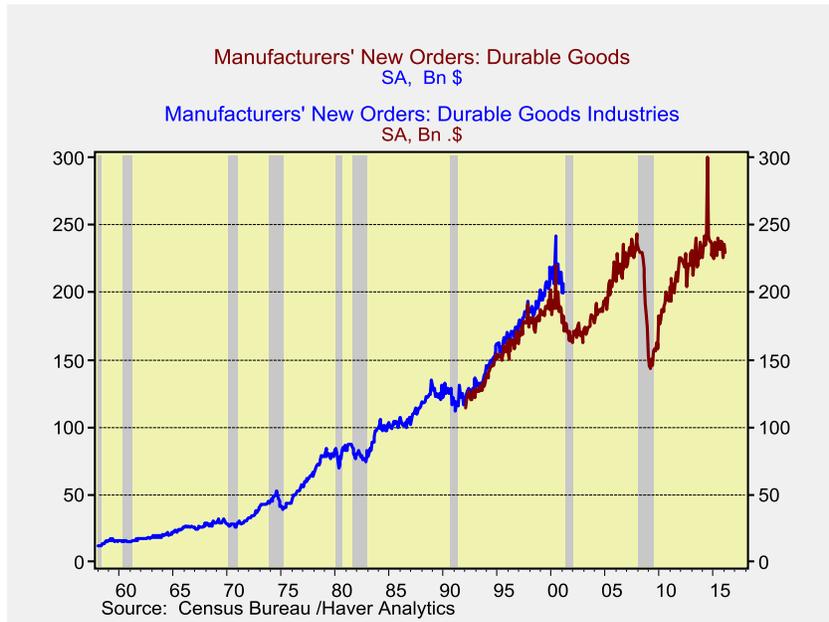
Weekly initial claims came in a bit lower than forecast, at 265k, lower than the 269k forecast. The four-week average of claims is 259.75k, up 0.25k from last week.



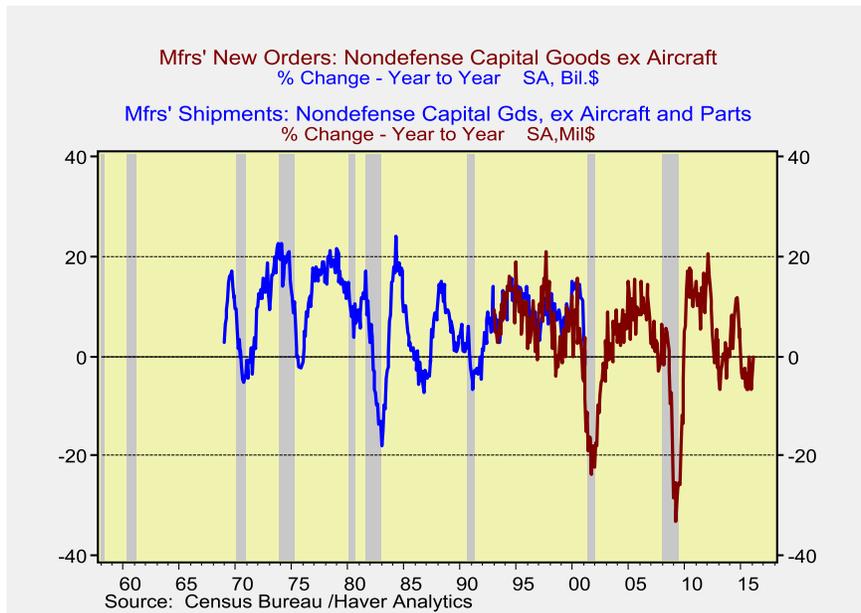
Claims are rising modestly but remain well below 300k, the level that tends to signal tight labor markets.

February durable goods orders fell 2.8% compared to January, a bit better than the 3.0% decline forecast. Capital goods orders excluding aircraft and defense orders fell 1.8%, much weaker than the 0.5% decline expected. The latter number is a good proxy for investment orders, suggesting sluggish economic activity.

This chart shows the level of overall durable goods orders, overlapping the older SIC code data with the newer classification of NAICS



This chart looks at the yearly change in non-defense capital goods orders excluding aircraft. In general, the most recent data confirms an economy struggling with sluggish industrial growth.



Overall, the orders data is bearish for risk-on assets and bullish for risk-off assets.

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

Economic releases						
EST	Indicator			Expected	Prior	Rating
10:00	KC FRB Manufacturing activity	m/m	March		-12	*

St. Louis FRB President Bullard gave a talk in NY this morning that was rather hawkish. Bullard is a voter this year, and seems to be leaning toward a rate hike perhaps as early as next month. This news is weighing on equities and commodities, while lifting the dollar and long duration Treasuries.

## 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
<b>ASIA-PACIFIC</b>								
China	S.W.I.F.T CNY payments	m/m	Feb	1.8%	2.5%		*	Equity and bond neutral
<b>EUROPE</b>								
France	Business Confidence	m/m	Mar	100.0	100.0	101.0	*	Equity and bond neutral
Germany	Import Prices	y/y	Feb	-0.6%	-1.5%	-0.2%	**	Equity bearish, bond bullish
Switzerland	ZEW economic expectations survey	m/m	Mar	2.5	-5.9		**	Equity bullish, bond bearish
Italy	Industrial orders	y/y	Jan	0.1%	1.5%		*	Equity bearish, bond bullish
	Retail sales	y/y	Jan	-0.8%	0.7%		**	Equity bearish, bond bullish
U.K.	Retail sales	y/y%	Feb	3.8%	5.2%	3.9%	**	Equity and bond neutral
<b>AMERICAS</b>								
Brazil	Unemployment rate	m/m	Jan	9.5%	9.0%	9.3%	*	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	62	1	Neutral
3-mo T-bill yield (bps)	29	30	-1	Down
TED spread (bps)	34	33	1	Neutral
U.S. Libor/OIS spread (bps)	40	39	1	Neutral
10-yr T-note (%)	1.87	1.88	-0.01	Up
Euribor/OIS spread (bps)	-24	-24	0	Neutral
EUR/USD 3-mo swap (bps)	21	20	1	Neutral
<b>Currencies</b>	<b>Direction</b>			
dollar	up			Falling
euro	down			Rising
yen	down			Rising
franc	flat			Rising

## 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
<b>Energy markets</b>				
Brent	\$ 39.74	\$ 40.47	-1.80%	Bearish DOE data
WTI	\$ 38.98	\$ 39.79	-2.04%	
Natural gas	\$ 1.79	\$ 1.79	-0.45%	Mild weather/expected inventory build
Crack spread	\$ 19.08	\$ 18.76	1.71%	Falling gasoline stockpiles
12-mo strip crack	\$ 13.93	\$ 13.74	1.41%	
Ethanol rack	\$ 1.53	\$ 1.52	0.41%	
<b>Metals</b>				
Gold	\$ 1,220.94	\$ 1,220.11	0.07%	
Silver	\$ 15.30	\$ 15.25	0.30%	
Copper contract	\$ 222.05	\$ 223.55	-0.67%	
<b>Grains</b>				
Corn contract	\$ 368.00	\$ 368.50	-0.14%	
Wheat contract	\$ 461.75	\$ 463.00	-0.27%	
Soybeans contract	\$ 902.00	\$ 905.25	-0.36%	
<b>Shipping</b>				
Baltic Dry Freight	401	398	3	
<b>DOE inventory report expectations of weekly change</b>				
	<b>Actual</b>	<b>Expected</b>	<b>Difference</b>	
Crude (mb)	9.4	4.0	5.4	
Gasoline (mb)	-4.6	-2.2	-2.4	
Distillates (mb)	0.9	-0.7	-1.6	
Refinery run rates (%)	-0.6%	0.3%	-0.9%	
Natural gas (bcf)		22.0		

## Weather

The 6-10 and 8-14 day forecasts are calling for warmer than normal temperatures for the coasts and cooler than normal conditions for the nation's midsection. Precipitation is forecast for most of the country, the notable exception being the Pacific Northwest.

## **Weekly Asset Allocation Commentary**

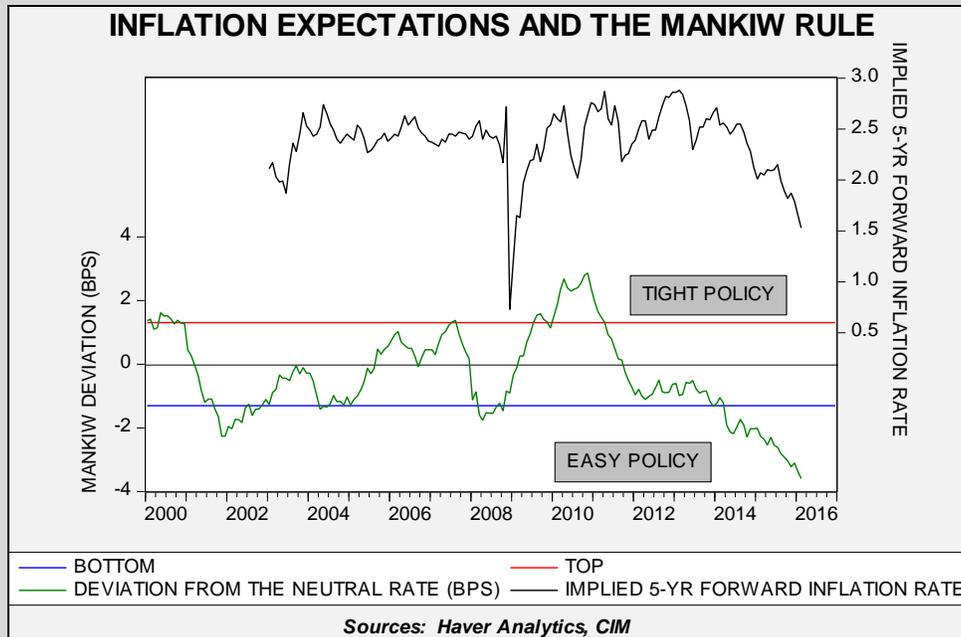
*Confluence Investment Management offers various asset allocation products which are managed using “top down,” or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.*

March 24, 2016

The recent FOMC meeting yielded a dovish surprise. Despite rising core inflation and a rather robust labor market, the Fed not only kept rates unchanged but issued a dovish statement. In the most clear-cut signal it can make, short of easing, the committee lowered its forecasts for rate hikes this year from four to two. Based on the Phillips Curve-related models, such as the Taylor or Mankiw Rules, even in the most dovish constructions, the Fed is behind the curve. So, why did the Fed frame such a permissive argument for maintaining steady policy?

The Federal Reserve’s Congressional mandate is to use monetary policy to support full employment and controlled inflation. This mandate fits into the theoretical construct of the Phillips Curve, which argues that there is a tradeoff between employment and inflation. If the level of employment exceeds the natural level of “full employment,” then resources become stretched and inflation develops. Although the underlying thesis is logical, in practice, other factors can affect inflation. For example, in a nation open to foreign trade and a deregulated economic environment, reaching the natural level of full employment may simply cause an increase in imports or investment in labor-saving technology. If this is the case, the Fed may be able to allow employment to exceed estimates of full employment because other factors may prevent inflation from becoming a problem.

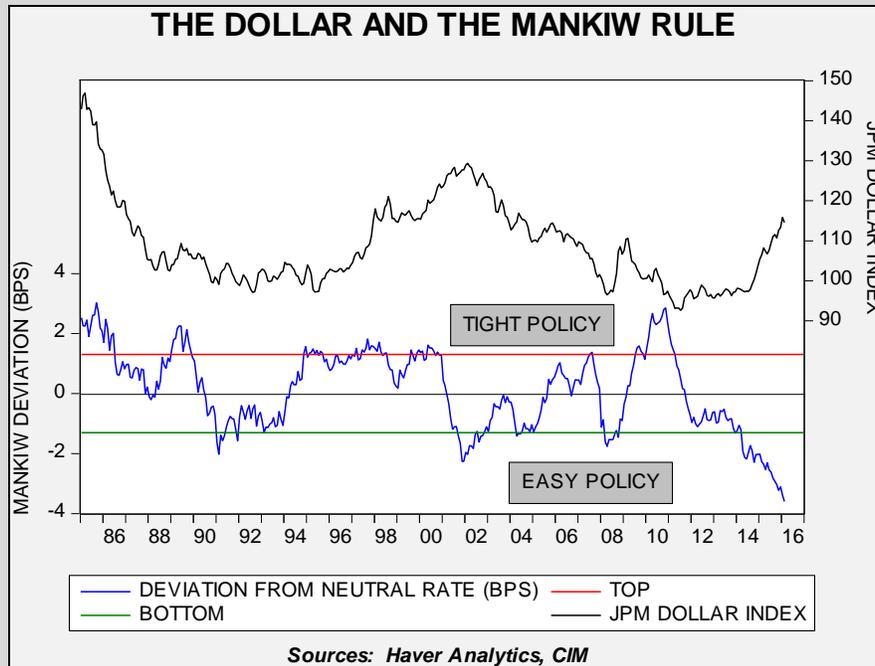
There are two factors that may explain why the FOMC left rates steady. The first is that inflation expectations may be depressed enough to allay fears that monetary policy is too easy. The second is that the dollar has been strong enough to help contain inflation. Let’s look at the first factor:



The upper line shows the five-year implied inflation rate from the TIPS market. Note that last summer the implied inflation rate fell below 2% and has been falling at a rather precipitous rate. Although the Fed has an inflation mandate, in reality, the central bank’s primary job is to manage inflation expectations. If inflation expectations become elevated enough, firms and households begin to anticipate inflation and work to protect their spending from rising prices. The very act of protecting their purchasing power leads to higher inflation because buyers rush to build inventories before prices rise in the future, pushing up demand and, likely, price levels. In addition, fears of rising inflation can lead to high debt accumulation as debtors expect to repay their loans with “cheaper” dollars. Excessively low inflation expectations can also be dangerous because they encourage purchasers to wait to buy until absolutely necessary. It also can discourage borrowing for fear that the debt will be repaid with more “expensive” dollars. The Fed has concluded the best inflation rate is near 2%, which is high enough to support buying and borrowing, but not so low that it encourages delaying purchases or borrowing.

The lower line on the chart shows the deviation of the Mankiw Rule model using core CPI and the unemployment rate in its calculation. The deviation line shows whether policy is tight or easy. Currently, policy is quite easy; however, comments from Fed officials expressing concern about falling inflation expectations probably contributed to the decision to project fewer rate hikes this year. As inflation expectations began to trend lower, the Fed’s policy stance became easier. In other words, it appears that the drop in inflation expectations influenced the FOMC to keep policy easy despite a stronger labor market.

The second factor, the dollar, appears to have played a role as well. In the statement, the FOMC expressed concern about “international developments.” These issues are best observed in the exchange rate. The strong dollar has dampened net exports and a case can be made that the U.S. central bank has been willing to maintain an easy policy stance, at least from the perspective of the Phillips Curve, due to the dollar’s strength.



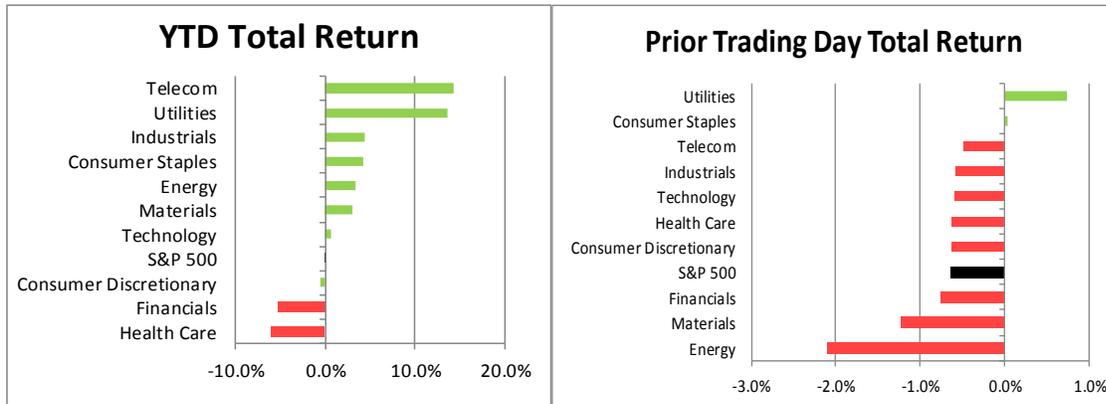
The upper line on this chart shows the JP Morgan real dollar index, which takes into account trade relations and relative inflation rates. The dollar’s strong appreciation that began in the summer of 2014 coincides with the Fed allowing its policy stance to become excessively accommodative, based on the Mankiw Rule.

If our analysis is correct, monetary policy is likely to remain supportive assuming inflation doesn’t become excessive, inflation expectations remain depressed and the dollar stays strong. Confirmation of supportive monetary policy has already boosted equity values and stalled the dollar’s rise, which has boosted commodity prices as well. However, given that foreign central banks are taking aggressive steps to ease, including the introduction of negative policy rates, the dollar might appreciate in the future. The uncertainty surrounding inflation expectations and exchange rates will likely keep monetary policy steady into summer.

*Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.*

**Data Section**

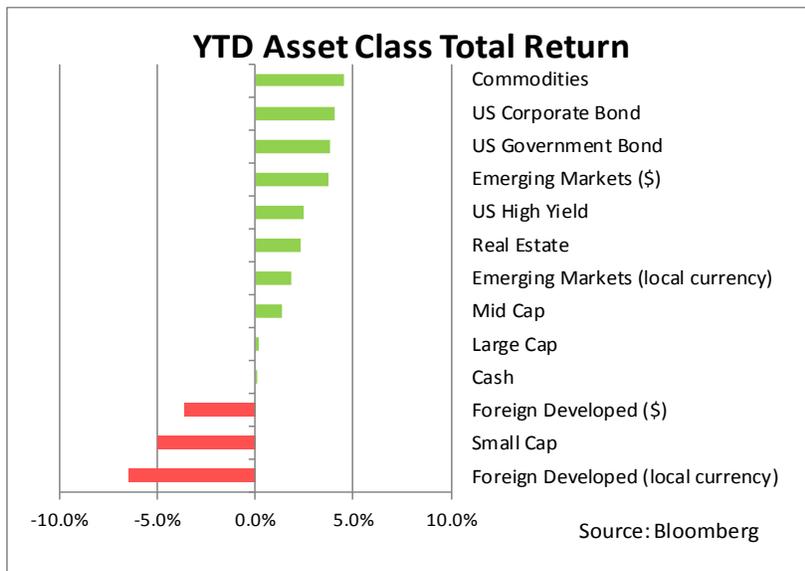
**U.S. Equity Markets – (as of 3/23/2016 close)**



(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 3/23/2016 close)**



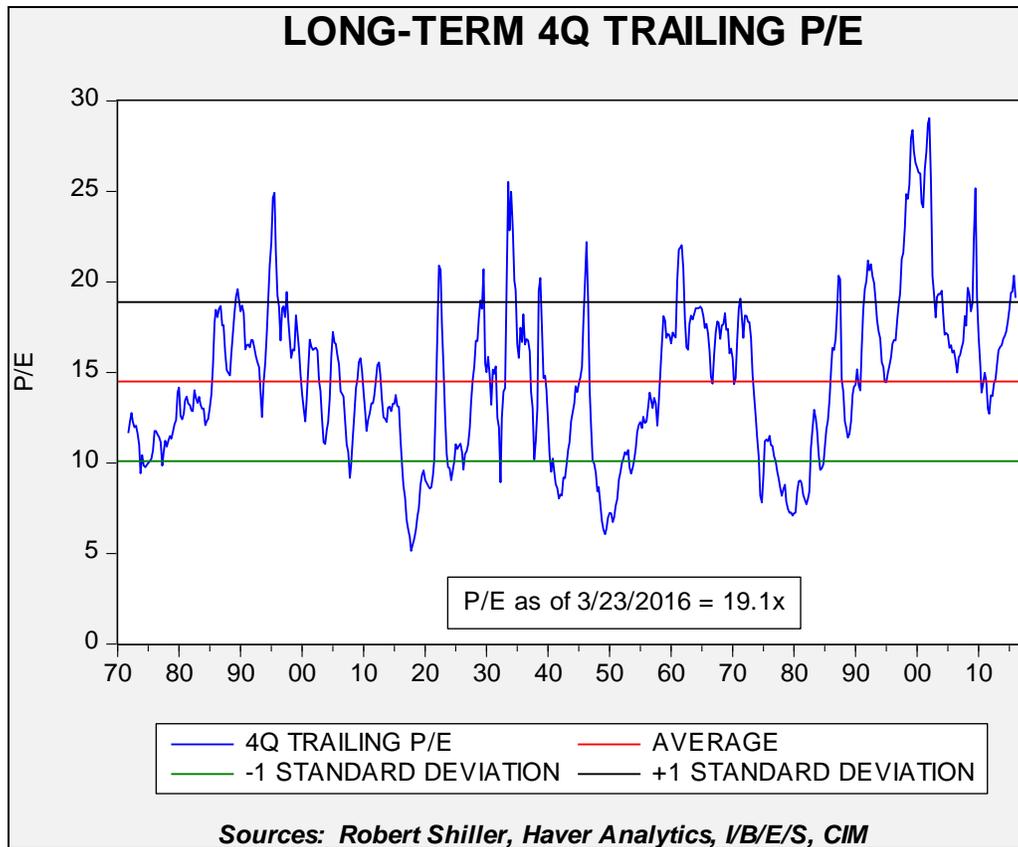
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 24, 2016



Based on our methodology,<sup>1</sup> the current P/E is 19.1x, up 0.2x from last week. Continued declines in earnings expectations and a stronger equity market, supported by a dovish FOMC, 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.*

<sup>1</sup> 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.