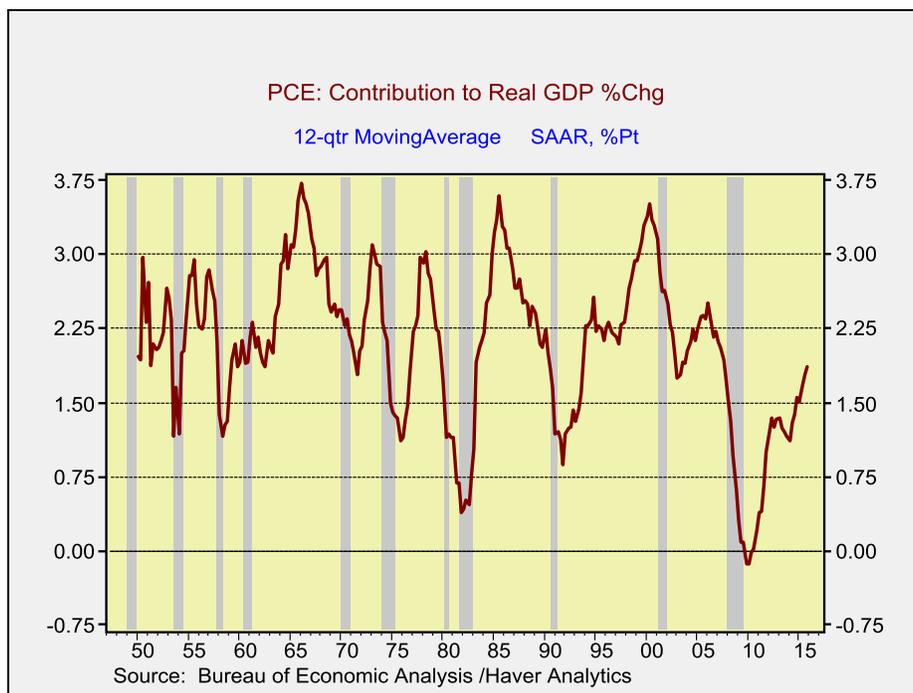
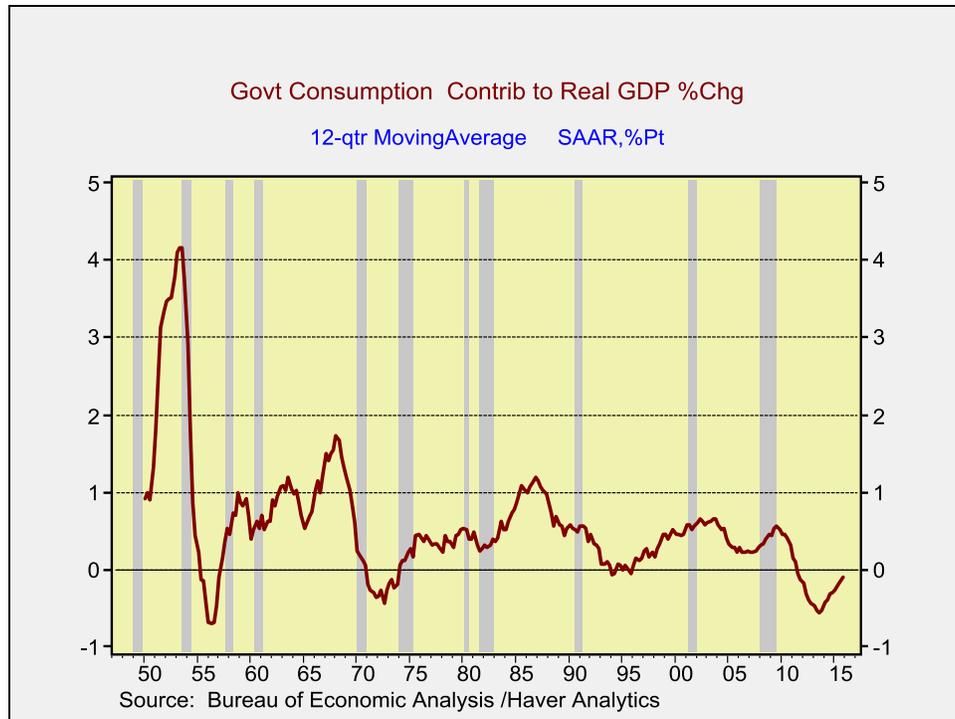


[Posted: March 28, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The European markets and Hong Kong are closed. In Asia, the MSCI Asia Apex 50 traded sideways from the prior close. Chinese markets were lower, with the Shanghai composite down 0.7% and the Shenzhen index off 0.6%. U.S. equity futures are signaling a higher opening from the previous close.

Trading was quiet overnight. Hong Kong and European markets are closed for Easter Monday, which limited market activity. On Good Friday, the Commerce Department issued the GDP report for Q4 (see below). In addition to our usual coverage, we want to highlight a couple of important charts from this report.

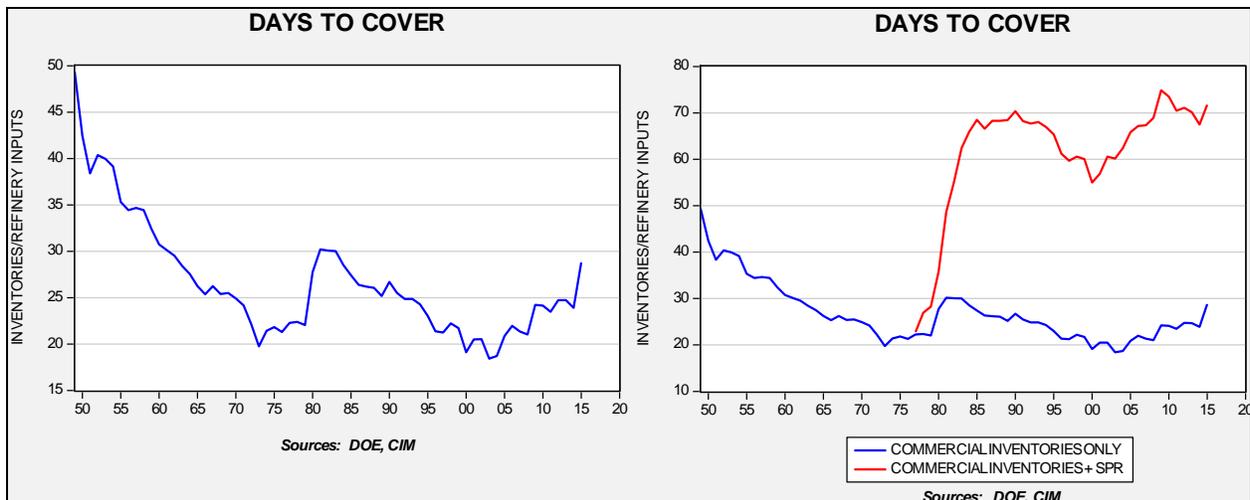


This chart shows the 12-quarter moving average of the contribution from consumption. As the chart shows, consumption collapsed during the Great Financial Crisis but has since rebounded sharply. Note that no recession has ever occurred with the measure rising. Improving consumption is probably the most favorable data on the economy.



Perhaps the second most positive development for the economy is that government is almost no longer a drag on the economy. Now, in an age of deficits and fights over the fiscal budget, suggesting that the lack of government spending is acting as a drag on the economy seems illogical. However, we note that in the GDP calculation, government’s contribution to the economy is what government spends on “stuff”—bridges, tanks, roads, etc. That discretionary part of the budget has been dramatically squeezed in this business cycle, meaning the government has subtracted from growth at its fastest pace since the demobilization from the Korean War. However, as state and local government budgets improve, spending is also improving, adding to GDP.

We have been getting a number of questions about our coverage of oil inventories. Due to the attention on oil prices and their tight correlation to equities, we have been regularly updating the oil inventory data in this report; we have been mostly focusing on the seasonal pattern in oil stockpiles. However, a number of readers have correctly noted that because demand is higher today, current inventory levels nearing the highs set in the 1930s is really not a fair comparison. This is true. So, to address these comments, we have created the two charts shown below.



To measure the level of inventory to demand, we divide oil inventories by the amount of crude oil that is used by refineries. That measure tells us how many days of inventory exist at the current refinery run rate. The chart on the left looks at commercial crude oil inventories only. Unfortunately, the DOE data only goes back to 1949, so we can't capture the days to cover from the 1930s, but it is fairly clear that current inventory levels are not excessively high by this measure. In fact, inventories are only approaching the levels seen during the early 1980s when oil companies were hoarding oil due to the Iran-Iraq War.

However, there is another element to the story. In 1977, President Carter began filling the Strategic Petroleum Reserve (SPR) as part of an international effort to create an emergency supply buffer to counteract future supply disruptions from the Middle East or elsewhere. The actual availability of the SPR is always an issue—defining what constitutes a real emergency is difficult. On the other hand, the existence of the SPR probably does have some impact on storage management; before the SPR, commercial firms had to have large enough supply buffers to counteract events that might reduce supply. Once the government took over this role, firms were no longer required to keep storage on hand for emergencies. Thus, the right-hand chart is probably a more accurate snapshot of how much oil is available. Interestingly enough, the right hand chart tells us that the current level of stockpiles, relative to refinery operations, isn't all that unusual.

Our analysis suggests that commercial crude oil stocks are more critical to oil prices than the SPR, although we have done work that suggests adjustments to the Strategic Reserve have an impact on prices. For example, in the fall of 1990, President George H.W. Bush ordered a test withdrawal from the SPR to see if it could be used in the case of war in Iraq. The very announcement coincided with the peak in prices (although we did see a new panic high on the day the air war started that was very short lived). In addition, his son's policy of filling the reserve during his term likely boosted oil prices as well.

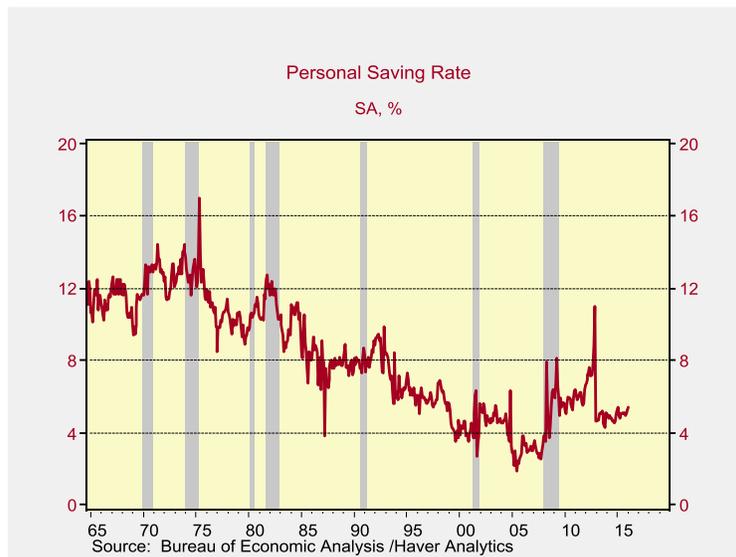
The bottom line is that when the SPR is included, oil stocks are ample and the rise in commercial inventories, which are unencumbered by policy, has an even greater impact. Simply put, a major recovery in oil prices, barring a geopolitical event, needs a reduction in the inventory overhang.

U.S. Economic Releases

Personal income came in better than forecast, rising 0.2% from the month before compared to the 0.1% increase expected. Personal spending rose 0.1%, on forecast. The chart below shows the annual change in income and expenditures.

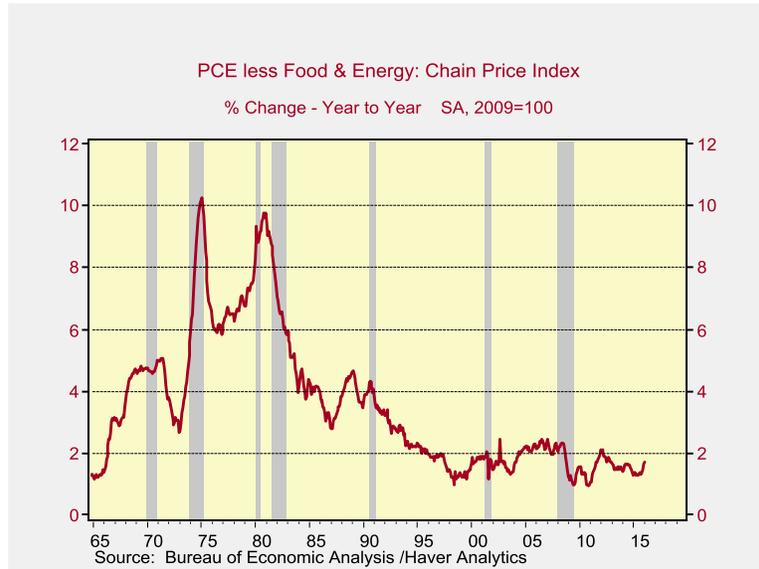


The personal savings rate continued to move higher, rising to 5.4% from 5.3% the month before.

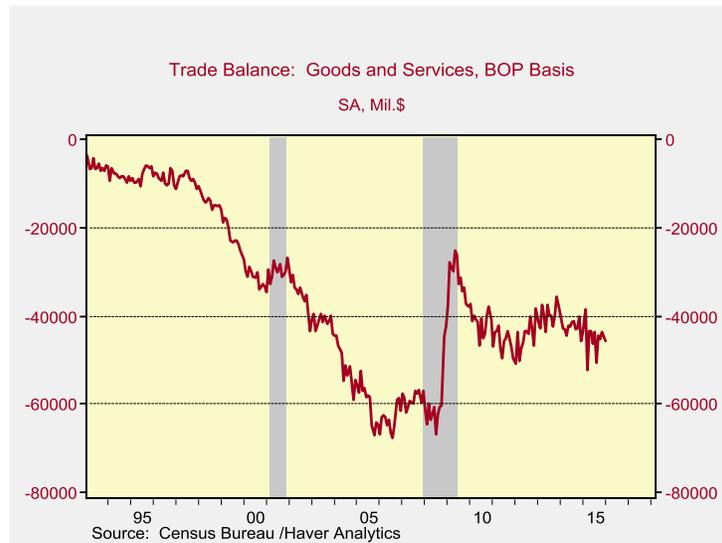


PCE rose 1.0% annually, on forecast, while the core PCE, the Fed's favorite measure of inflation, rose 1.7% annually, slightly less than the 1.8% forecast. The chart below shows the annual change in the core PCE, the pace of which has accelerated recently. Historically, the Fed

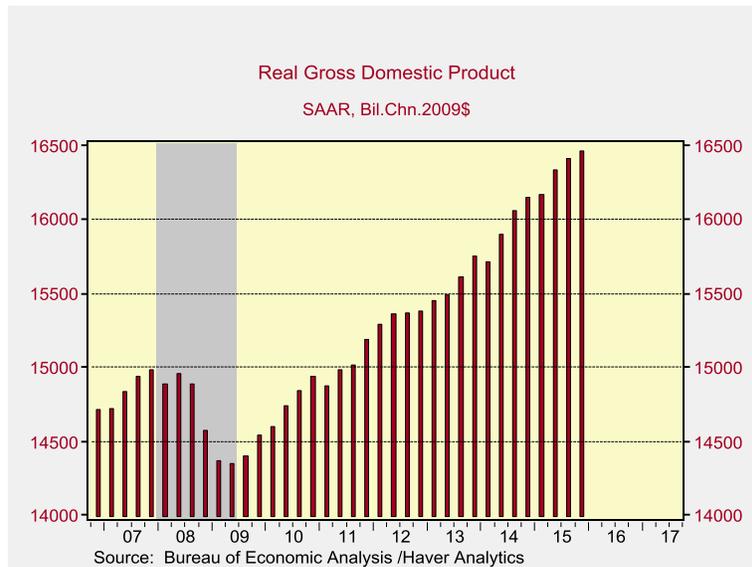
has tightened monetary policy when the rate has exceeded 2.0% and loosened when the rate has been below 2.0%.



The February trade deficit widened unexpectedly to \$62.9 bn from \$62.4 bn the month before, wider than the \$62.2 bn expected. Exports rose 2.0% from the month before, while imports rose 1.6%. The chart below shows the level of the trade balance.



On Friday, the third revision to Q4 GDP was released and it came in stronger than expected, rising 1.4% annually compared to the 1.0% increase forecast. It also compares well with the prior estimate of a 1.0% rise. The chart below shows the level of GDP, which continues to expand.



Most of the strength came from an upward revision in consumption, while private investment was modestly weaker due to weaker inventory growth. Net exports were revised to have a less negative effect on GDP, while government spending remained roughly unchanged. The chart below shows the contributions to GDP from the four major sectors of the economy, plus inventory change.

	Q4 Third	Q4 Second	Q4 First	Difference
GDP	1.4%	1.0%	0.7%	0.4%
Consumption	1.7%	1.4%	1.5%	0.3%
Investment	-0.2%	-0.1%	-0.4%	-0.1%
Inventories	-0.2%	-0.1%	-0.5%	-0.1%
Net Exports	-0.1%	-0.3%	-0.5%	0.2%
Government	0.0%	0.0%	0.1%	0.0%

Overall, consumption remains the strongest factor, a trend which we could see continuing given the improving labor market.

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	Pending home sales	m/m	Feb	1.2%	-2.5%	*
10:30	Dallas Fed manufacturing activity	m/m	Mar	-25.8	-31.8	*

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								
Japan	CPI	y/y	Feb	0.3%	0.0%	0.3%	***	Equity and bond neutral
	LEI	m/m	Jan	101.8	101.4		**	Equity bullish, bond bearish
	Coincident indicator	m/m	Jan	113.5	113.8		**	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	63	0	Neutral
3-mo T-bill yield (bps)	28	28	0	Neutral
TED spread (bps)	35	35	0	Neutral
U.S. Libor/OIS spread (bps)	40	40	0	Neutral
10-yr T-note (%)	1.90	1.90	0.00	Neutral
Euribor/OIS spread (bps)	-24	-24	0	Neutral
EUR/USD 3-mo swap (bps)	22	22	0	Neutral
Currencies	Direction			
dollar	down			Falling
euro	up			Rising
yen	down			Rising
franc	down			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
Energy markets				
Brent	\$ 40.59	\$ 40.44	0.37%	Domestic rig count declined
WTI	\$ 39.82	\$ 39.46	0.91%	
Natural gas	\$ 1.77	\$ 1.81	-1.83%	Mild weather
Crack spread	\$ 19.32	\$ 19.31	0.05%	
12-mo strip crack	\$ 14.23	\$ 14.34	-0.77%	
Ethanol rack	\$ 1.53	\$ 1.53	0.00%	
Metals				
Gold	\$ 1,219.97	\$ 1,217.05	0.24%	Lower dollar
Silver	\$ 15.27	\$ 15.18	0.59%	
Copper contract	\$ 223.25	\$ 222.90	0.16%	
Grains				
Corn contract	\$ 368.50	\$ 370.00	-0.41%	
Wheat contract	\$ 464.75	\$ 463.00	0.38%	Domestic planting declining
Soybeans contract	\$ 910.25	\$ 910.50	-0.03%	
Shipping				
Baltic Dry Freight	406	401	5	
DOE inventory report expectations of weekly change				
	Actual	Expected	Difference	
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)	21	22.0	-1.0	

Weather

The 6-10 and 8-14 day forecasts are calling for warmer than normal temperatures for the western half of the country and cooler than normal conditions for the eastern half. Precipitation is forecast for most of the Great Lakes region and parts of the middle of the country.

Weekly Asset Allocation Commentary

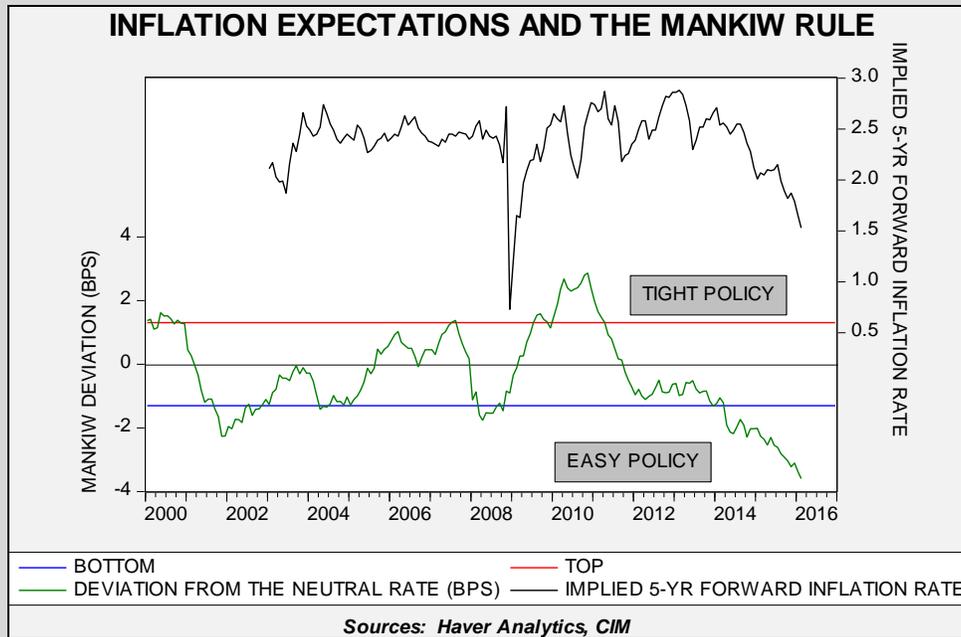
Confluence Investment Management offers various asset allocation products which are managed using “top down,” or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

March 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.

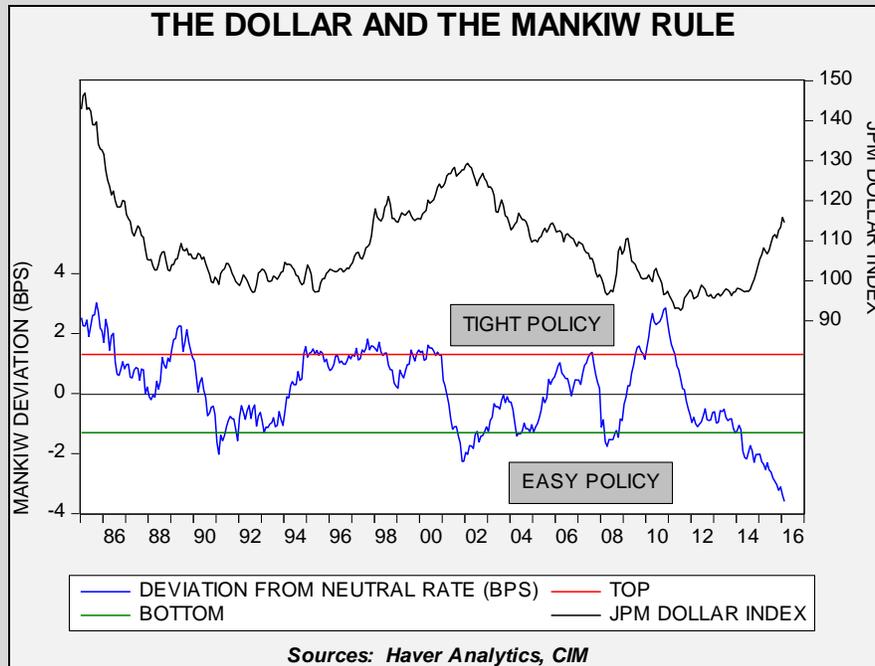
There are two factors that may explain why the FOMC left rates steady. The first is that inflation expectations may be depressed enough to allay fears that monetary policy is too easy. The second is that the dollar has been strong enough to help contain inflation. Let’s look at the first factor:



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.



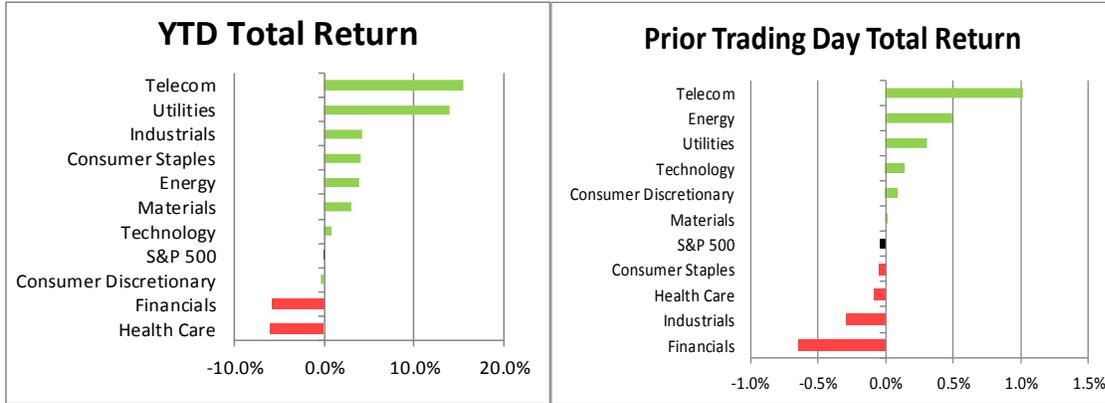
The upper line on this chart shows the JP Morgan real dollar index, which takes into account trade relations and relative inflation rates. The dollar’s strong appreciation that began in the summer of 2014 coincides with the Fed allowing its policy stance to become excessively accommodative, based on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

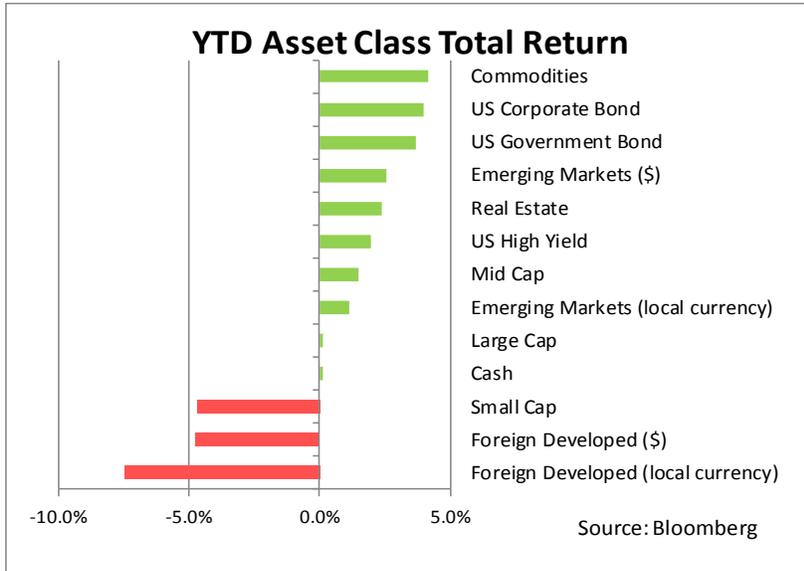
U.S. Equity Markets – (as of 3/24/2016 close)



(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 3/24/2016 close)



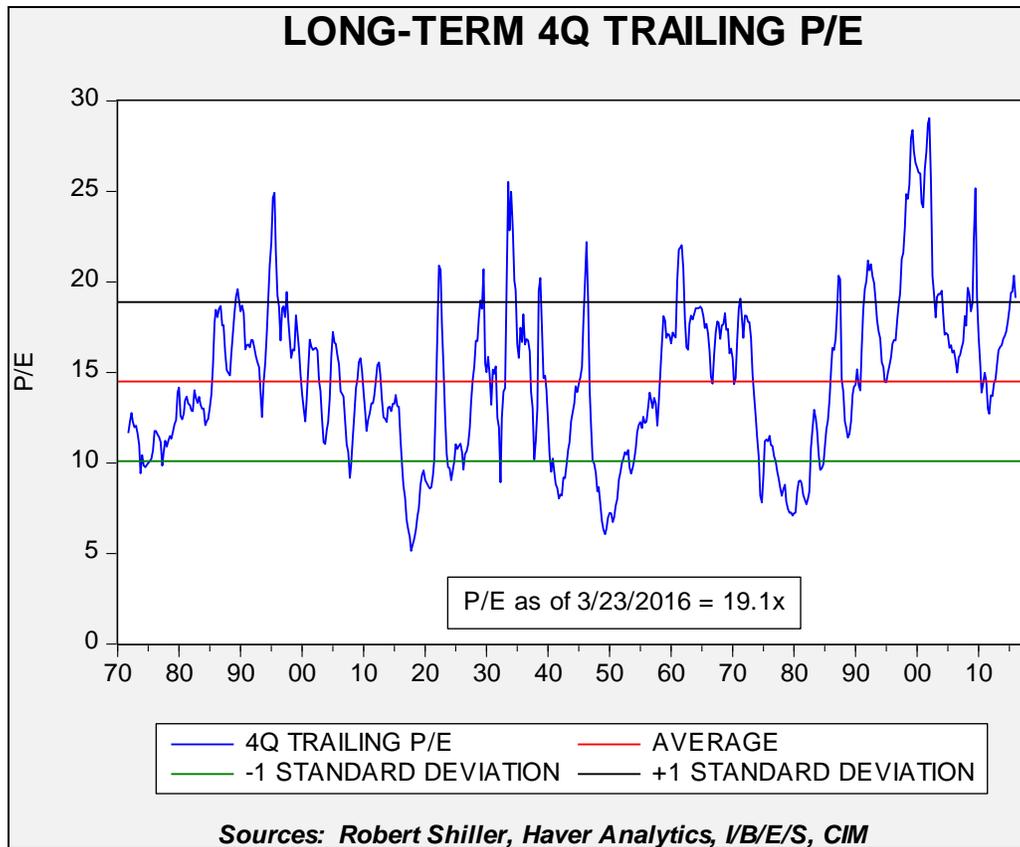
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,¹ 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.

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 (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.