Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: March 30, 2016—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is trading up 1.7% from the last close. In Asia, the MSCI Asia Apex 50 closed up 2.3% from the prior close. Chinese markets were also higher, with the Shanghai composite up 2.8% and the Shenzhen index higher by 3.6%. U.S. equity futures are signaling a higher opening from the previous close.

Risk markets surged globally yesterday as Fed Chair Yellen re-confirmed the central bank's intention to move rates up slowly, citing weak global growth. This was exactly the kind of reconciliatory signal that the markets were looking for after several FRB presidents had voiced their support for moving rates higher, possibly as soon as next month's meeting. Clearly, the market likes a unified and clear message from the Fed's leadership.

Risk markets jumped following her presentation, with the S&P 500 swinging to a positive change for the year.

(Source: Bloomberg)

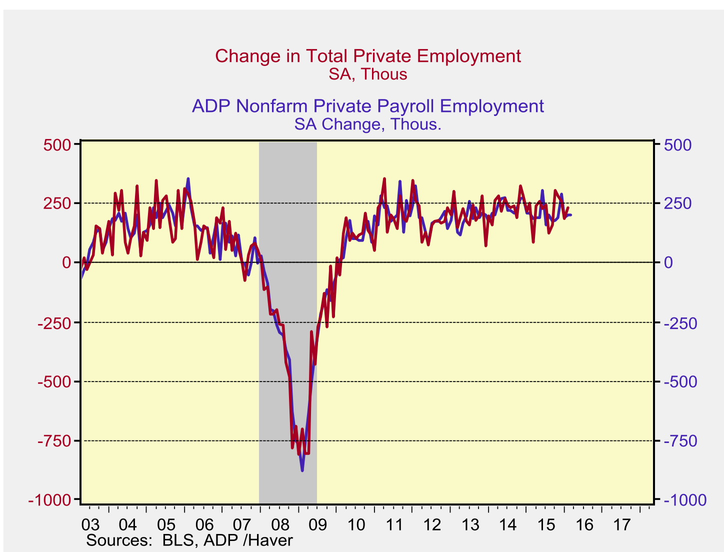
Additionally, the dollar plunged almost the moment she started speaking.

(Source: Bloomberg)

Market expectations for a rate hike were dampened, with futures now showing a zero percent chance of a rate hike next month, a 28% chance of a hike by June, and a 54% likelihood of an increase by November.

U.S. Economic Releases

ADP employment change came in slightly stronger than forecast, rising 200k compared to the 195k expected.



The chart above shows the ADP employment change and non-farm private employment, which is due to be released on Friday. The better than expected ADP reading could mean that the payrolls data will also surprise to the upside. Current expectations call for a 205k increase in private payrolls.

Mortgage applications fell 1.0% for the most recent reporting week, with purchases up 2.1% and refinancing down 3.3%. We are entering a strong sales season which has supported purchases, while a slight pick-up in rates from the recent lows has hampered refinancing activity.

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

Economic releases				
Fed Speakers and Events				
EST	**Speaker or event**	**District or position**		
1:00	Evans	Chicago FRB President		

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	Consumer sentiment (Westpac-MNI)	m/m	Mar	118.1	111.3		**	Equity bullish, bond bearish
Japan	Industrial production	m/m	Feb	-6.2%	3.7%	-5.9%	***	Equity bearish, bond bullish
	Vehicle production	m/m	Feb	-6.9%	-5.8%		**	Equity bearish, bond bullish
	Small business confidence	m/m	Mar	48.8	47.9	49.0	**	Equity and bond neutral
EUROPE								
Eurozone	Economic confidence	m/m	Mar	103.0	103.9	103.8	**	Equity bearish, bond bullish
	Consumer confidence	m/m	Mar	-9.7	-9.7	-9.7	**	Equity and bond neutral
	Business climate indicator	m/m	Mar	0.1	0.1	0.1	*	Equity and bond neutral
	Industrial confidence	m/m	Mar	-4.2	-4.1	-4.3	**	Equity and bond neutral
	Services confidence	m/m	Mar	9.6	10.8	10.8	*	Equity bearish, bond bullish
Germany	CPI	y/y	Mar	0.3%	0.0%	0.1%	***	Equity bullish, bond bearish
Switzerland	LEI	m/m	Mar	102.5	102.6	102.0	**	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)	21	22	-1	Down
TED spread (bps)	42	41	1	Up
U.S. Libor/OIS spread (bps)	38	38	0	Neutral
10-yr T-note (%)	1.82	1.80	0.02	Widening
Euribor/OIS spread (bps)	-24	-24	0	Neutral
EUR/USD 3-mo swap (bps)	23	23	0	Neutral
Currencies	**Direction**			
dollar	down			Falling
euro	up			Rising
yen	up			Rising
franc	up			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	$ 39.56	$ 39.14	1.07%	Yellen signals gradual rate movement
WTI	$ 38.76	$ 38.28	1.25%	
Natural gas	$ 2.01	$ 1.98	1.21%	Moving higher with crude oil
Crack spread	$ 19.21	$ 19.53	-1.61%	
12-mo strip crack	$ 14.00	$ 14.24	-1.66%	
Ethanol rack	$ 1.55	$ 1.55	0.25%	
Metals				
Gold	$ 1,234.38	$ 1,242.20	-0.63%	Risk markets rising, investor confidence boosted
Silver	$ 15.33	$ 15.36	-0.20%	
Copper contract	$ 220.25	$ 221.40	-0.52%	High Chinese stockpiles could mean lower future demand
Grains				
Corn contract	$ 372.75	$ 373.00	-0.07%	
Wheat contract	$ 475.50	$ 476.75	-0.26%	Favorable crop development weather in Europe
Soybeans contract	$ 915.25	$ 916.00	-0.08%	
Shipping				
Baltic Dry Freight	409	406	3	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.8		
Gasoline (mb)		-2.2		
Distillates (mb)		-0.3		
Refinery run rates (%)		-0.1%		
Natural gas (bcf)		-21.0		

Weather

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

Weekly Asset Allocation Commentary

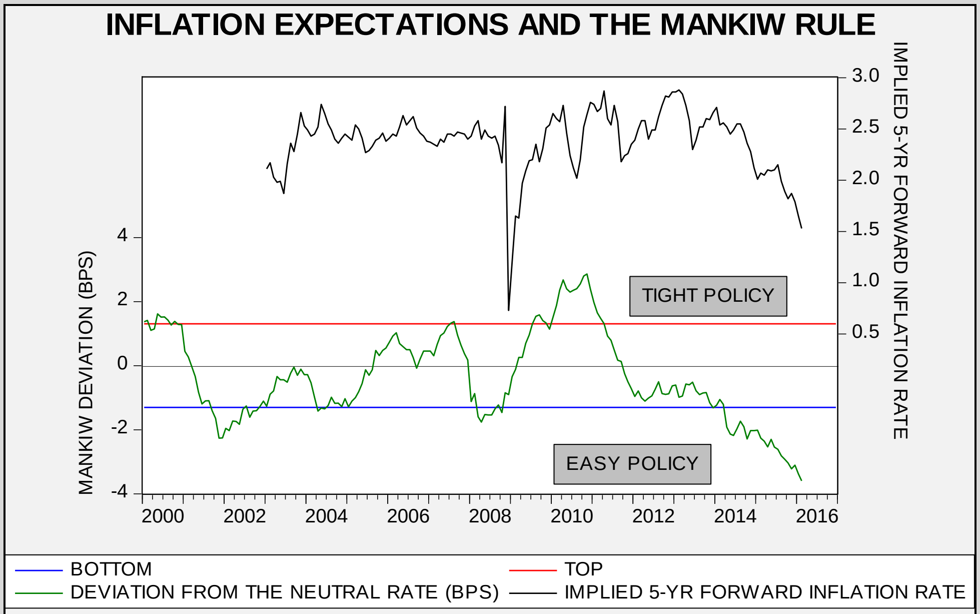
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

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:

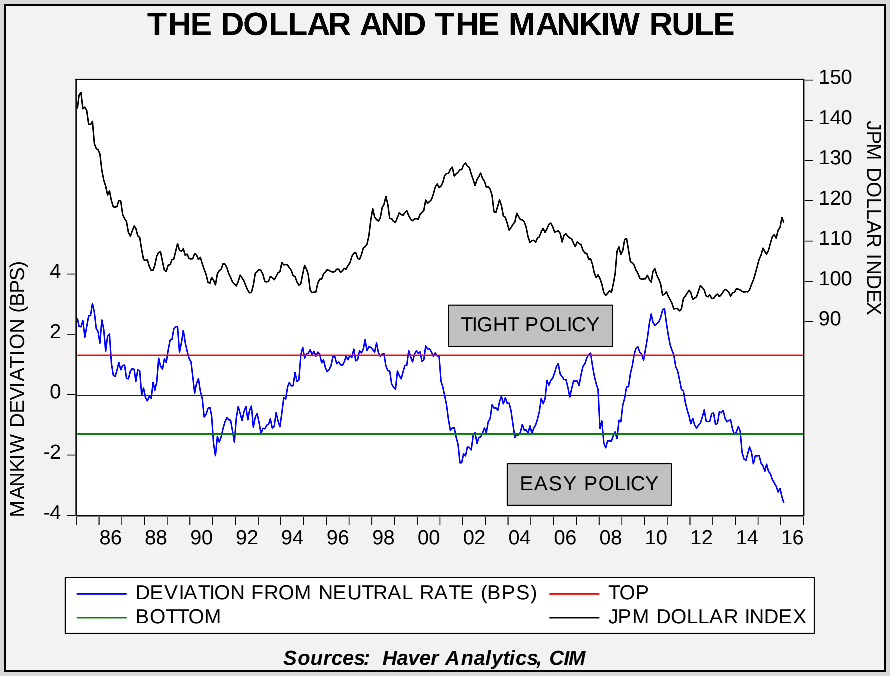


Sources: Haver Analytics, CIM

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.

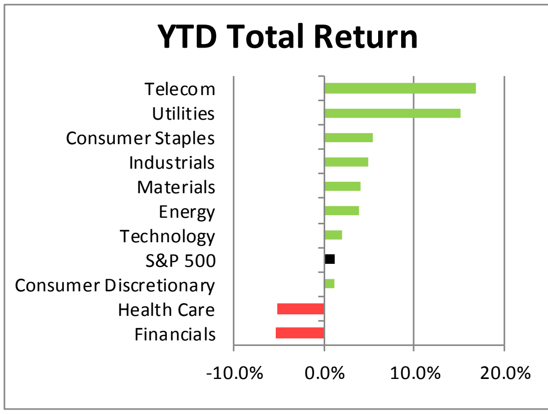


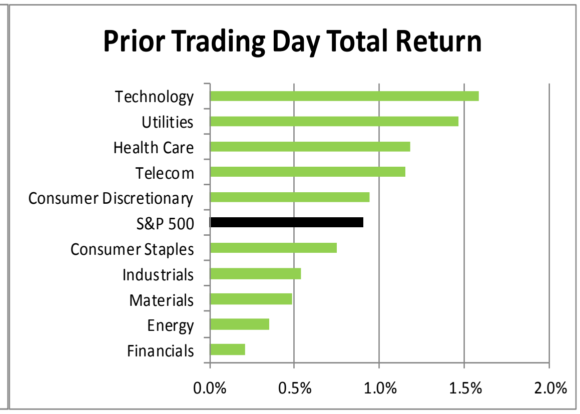
The upper line on this chart shows the JP Morgan real dollar index, which takes into account trade relations and relative inflation rates. The dollar's strong appreciation that began in the summer of 2014 coincides with the Fed allowing its policy stance to become excessively accommodative, based on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

Data Section

U.S. Equity Markets – (as of 3/29/2016 close)

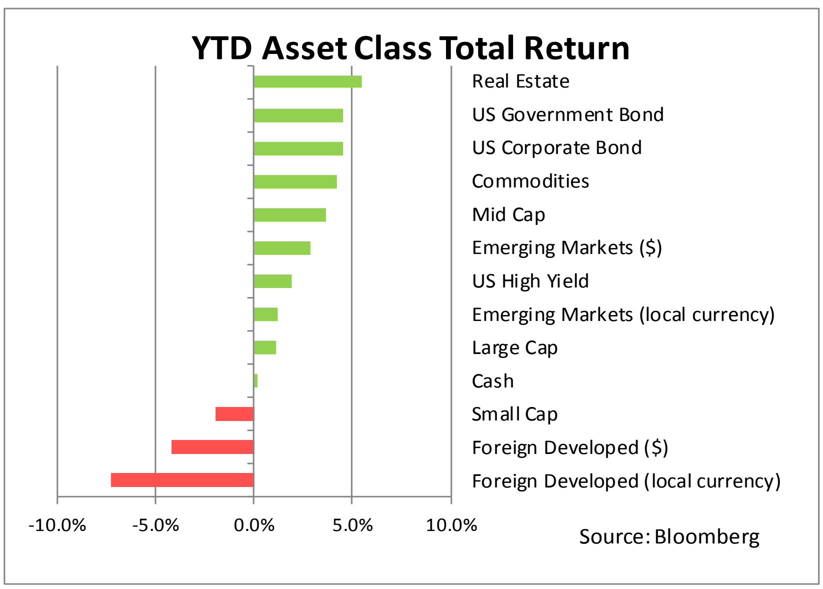




(Source: Bloomberg)

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 3/29/2016 close)

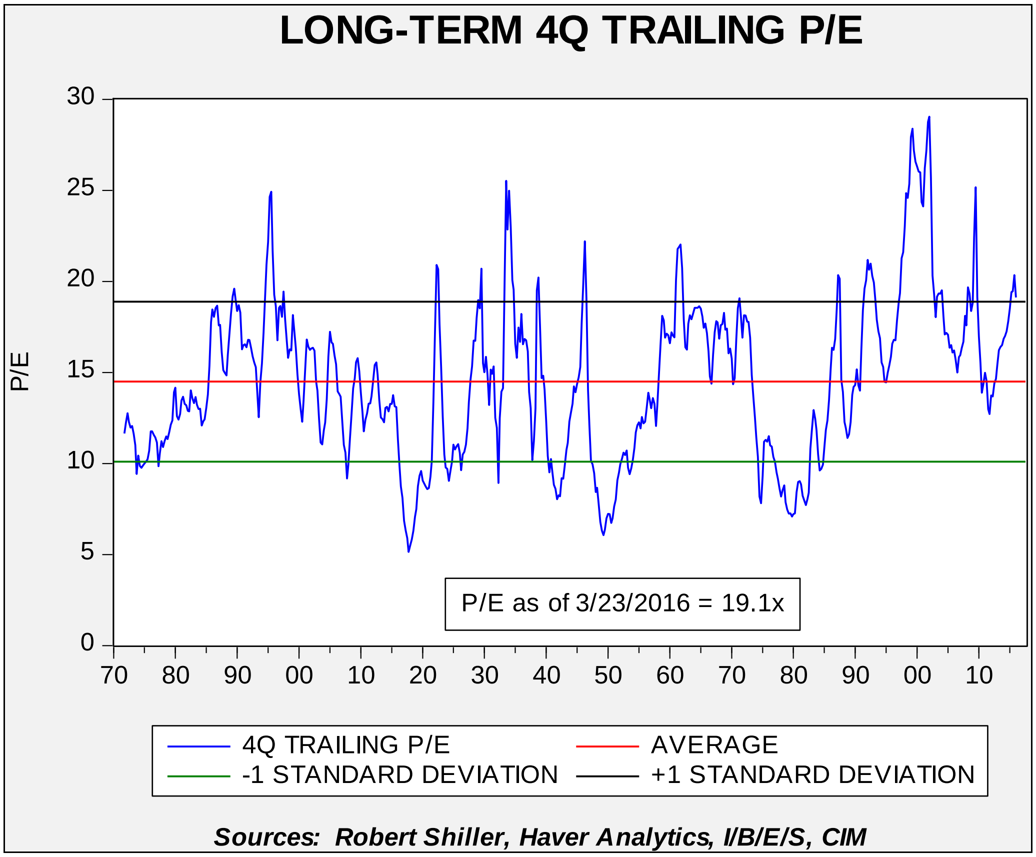


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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[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.