Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: May 11, 2016—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is higher by 1.1% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 0.5% from the prior close. Chinese markets are actually mixed, with the Shanghai composite higher by 1.1% and the Shenzhen index lower by 0.6%. U.S. equity futures are signaling a lower opening from the previous close. With 89.8% of the S&P 500 companies having reported, Q1 float-adjusted earnings stand at $26.70, more than the $26.66 forecast. Of the 449 companies that have reported, 72.2% had positive earnings surprises, while 20.7% had negative earnings surprises.

As noted above, global equity markets are lower this morning in a quiet trade. There wasn't much news overnight and the trade looks like it is taking a breather today after a strong day in the U.S. yesterday.

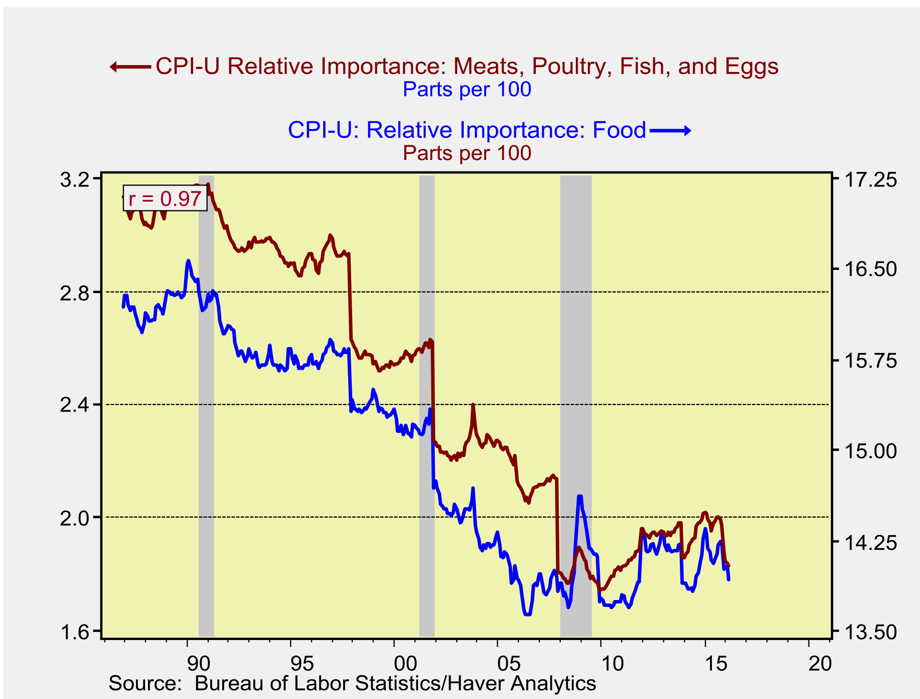
One market that had a strong day yesterday was soybeans.

(Source: Bloomberg)

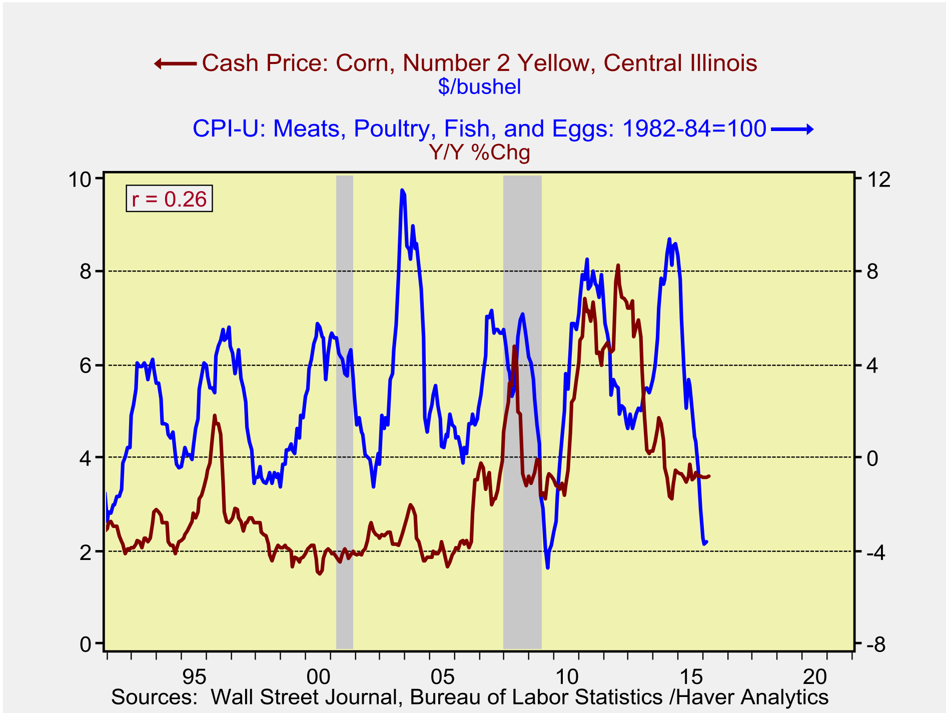
This chart shows the nearest soybean contract over the past three years. Prices have been edging higher since mid-March. A combination of factors has affected soybeans. First, Brazil has been experiencing dry conditions. Worries about the Brazilian crop, coupled with rising political turmoil (the Brazilian Senate votes today on impeachment proceedings—we expect them to vote to start an impeachment trial with the news coming out this evening), have raised worries about soybean supplies. Then, flooding in Argentina has raised fears that some of the crop will be lost. Although analysts always assume normal weather, there is an elevated chance of drought in the U.S. this summer if a La Niña develops. Yesterday, the USDA estimated that global soybean inventories will decline 8.1% this year and end the season at 68.2 metric tons (mt), which is well below analyst estimates of 72.9 mt. Corn inventories were also forecast lower than analyst estimates, at 1.8 billion bushels, but due to increased planted acreage the market expects a record U.S. harvest for corn this year. Of course, if the weather fails to cooperate, that record crop won't materialize.

Rising grain prices tend to eventually show up in rising food prices as corn and soybean meal are key inputs. Although the relative importance of food to the U.S. household budget is relatively low, studies have shown that lower income households tend to spend more on food than their wealthier counterparts. Thus, rising food, especially meat prices, could become an election issue by November.

First, this chart shows the relative importance of food and meat to the CPI.



Second, meat prices have declined after years of strong growth (see chart below). Meat prices are also affected by drought; we have seen a sharp drop in the cattle herd in recent years, although reports indicate that the herd is building again. A rise in corn and soybean meal prices should filter into higher meat and egg prices later this year.



U.S. Economic Releases

Mortgage applications rose 0.4% for the most recent reporting week, with purchases up 0.4% and refinancing up 0.5% from the week before. Purchases are picking up heading into the seasonally strong period, while refinancing activity rose as rates declined. The 30-year mortgage rate fell 5 bps to 3.82%.

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

Economic releases						
EST	Indicator			Expected	Prior	Rating
2:00	Monthly budget statement	m/m	Apr	$107.0 bn	$156.7 bn	*

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	Consumer confidence	m/m	May	103.2	95.1		**	Equity bullish, bond bearish
Japan	LEI	m/m	Mar	98.4	96.8	96.3	**	Equity bullish, bond bearish
	Coincident indicator	m/m	Mar	111.2	110.7	111.2	**	Equity and bond neutral
EUROPE								
U.K.	Industrial production	y/y	Mar	-0.2%	0.1%	-0.4%	***	Equity and bond neutral
AMERICAS								
Brazil	Retail sales	y/y	Mar	-5.7%	-4.2%	-4.7%	**	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)	25	24	1	Up
TED spread (bps)	38	39	-1	Down
U.S. Libor/OIS spread (bps)	38	38	0	Neutral
10-yr T-note (%)	1.76	1.76	0.00	Neutral
Euribor/OIS spread (bps)	-26	-26	0	Neutral
EUR/USD 3-mo swap (bps)	22	23	-1	Down
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	$ 46.05	$ 45.52	1.16%	Nigerian supply disruptions
WTI	$ 44.91	$ 44.66	0.56%	
Natural gas	$ 2.16	$ 2.16	0.28%	
Crack spread	$ 16.13	$ 15.67	2.99%	
12-mo strip crack	$ 12.94	$ 12.69	2.01%	
Ethanol rack	$ 1.67	$ 1.67	0.22%	
Metals				
Gold	$ 1,278.41	$ 1,265.84	0.99%	Increasing investment demand and lower dollar
Silver	$ 17.53	$ 17.12	2.40%	
Copper contract	$ 212.45	$ 209.25	1.53%	Expectation of falling global supply
Grains				
Corn contract	$ 380.50	$ 381.00	-0.13%	
Wheat contract	$ 462.25	$ 461.25	0.22%	
Soybeans contract	$ 1,085.75	$ 1,084.00	0.16%	Unfavorable weather in South America
Shipping				
Baltic Dry Freight	594	616	-22	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)		-0.1		
Gasoline (mb)		-0.5		
Distillates (mb)		-0.7		
Refinery run rates (%)		0.5%		
Natural gas (bcf)		60.0		

Weather

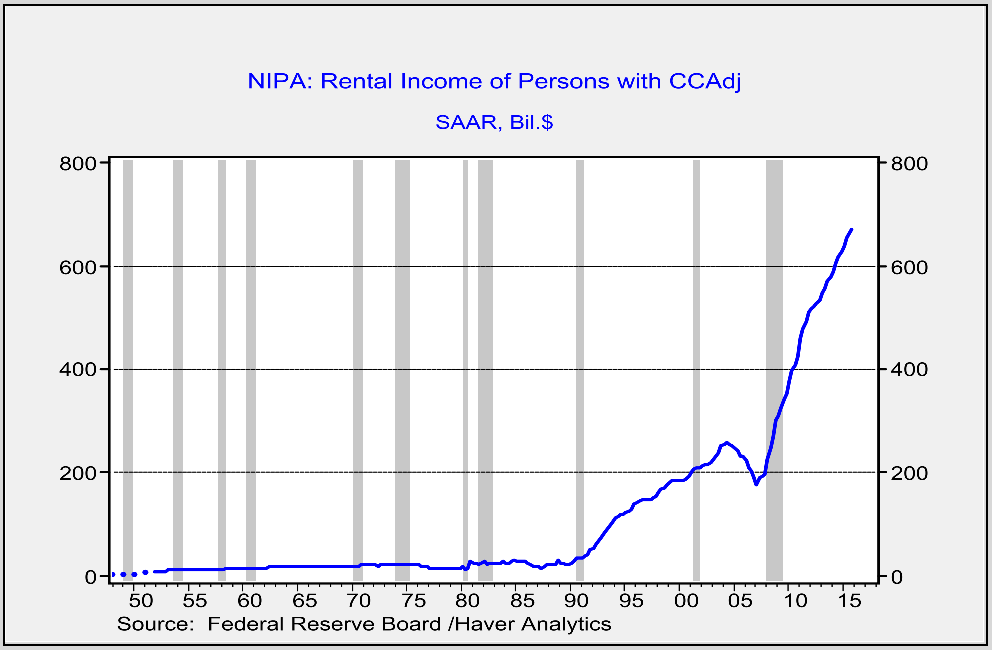
The 6-10 day forecast is calling for cooler than normal conditions for the Northeast and the Great Lakes region, while the 8-14 day forecast is calling for cooler than normal temps for the Northwest. Precipitation is forecast for the majority of the country.

Weekly Asset Allocation Commentary

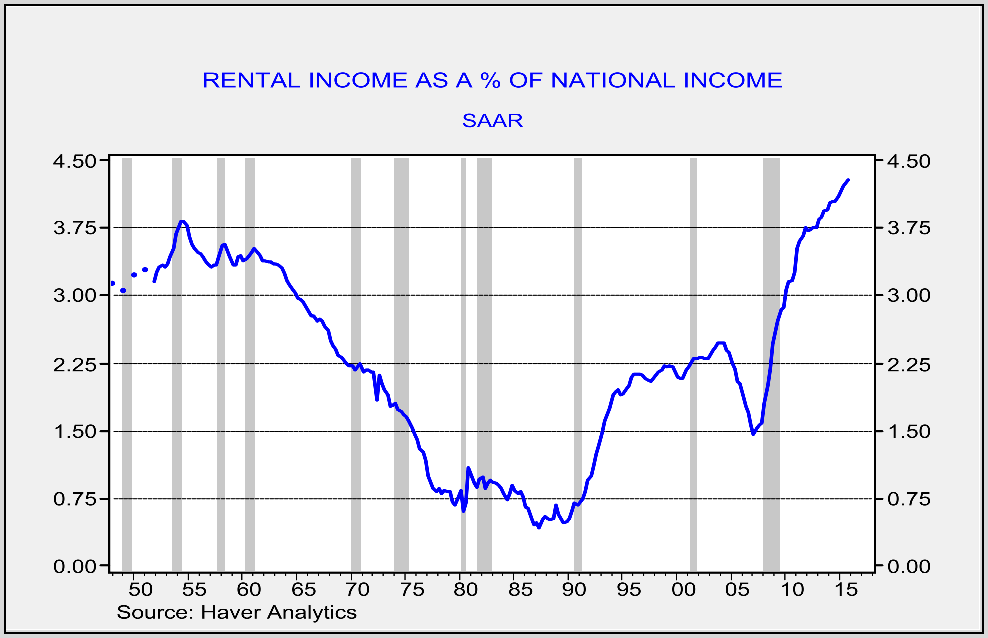
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

May 6, 2016

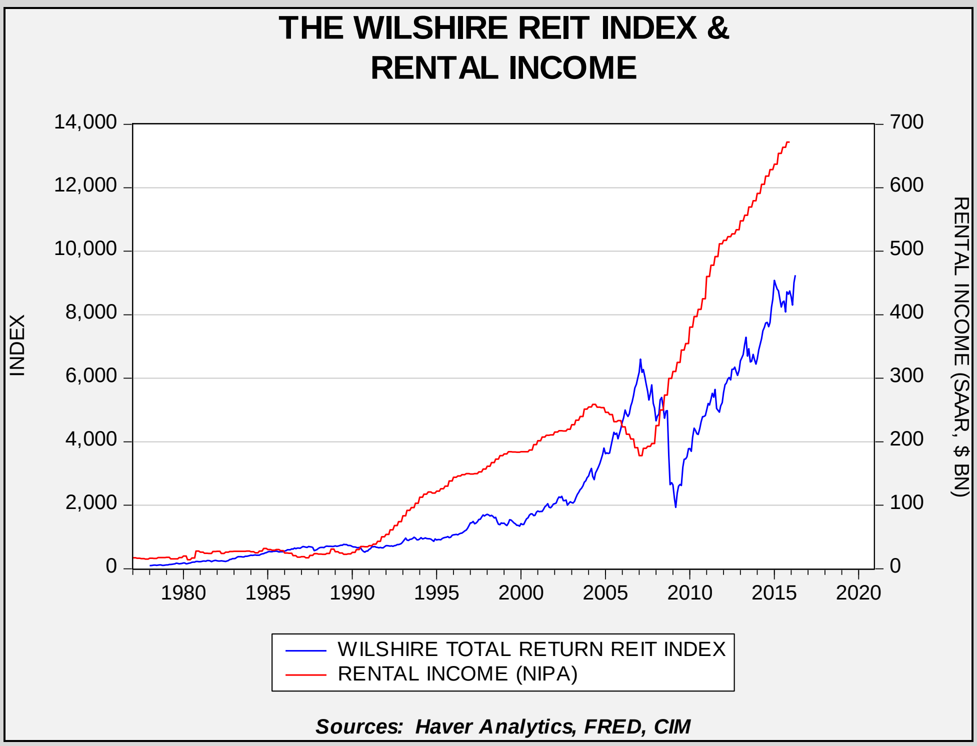
In our latest adjustment to the asset allocation portfolios, we added to the REIT positions in three of the four models. One of the reasons we remain friendly to this asset class has been the steady increase in rental income.



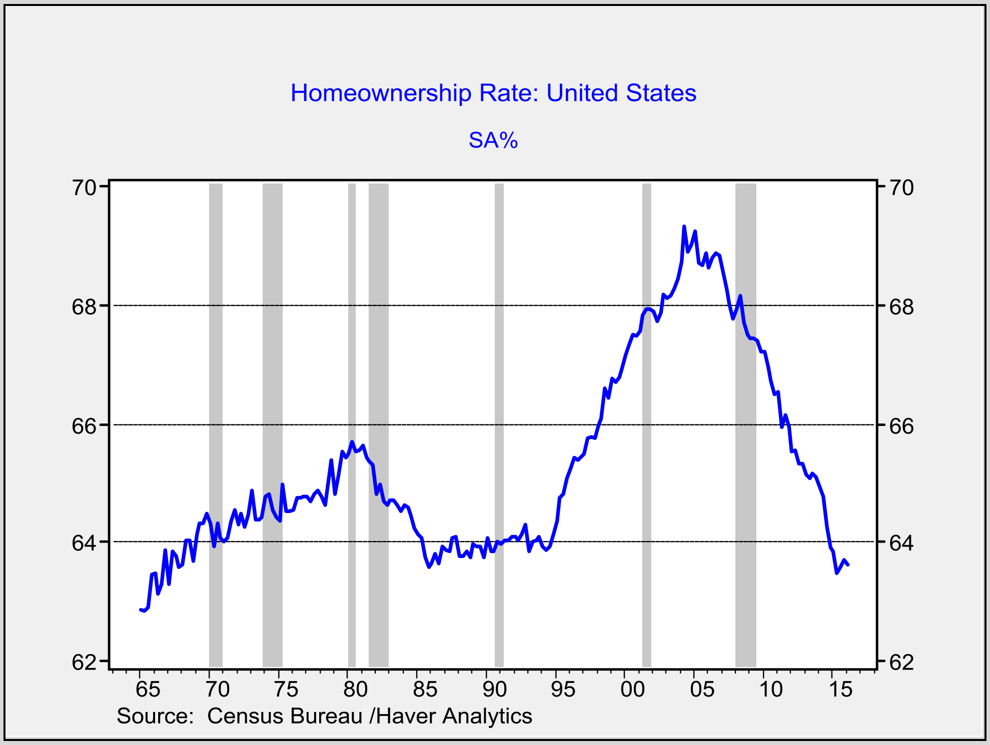
This chart shows rental income from the National Income and Product Accounts (NIPA). Note that rental income has been rising at a very fast pace since the housing crisis. In fact, as a percentage of national income, rents are at a postwar high, exceeding 4.25%.



In general, history shows that rising rental income tends to support rising REIT values.



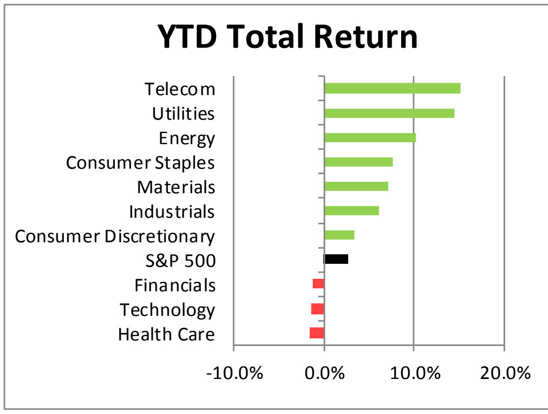
A major reason rental income is rising is due to falling homeownership rates.

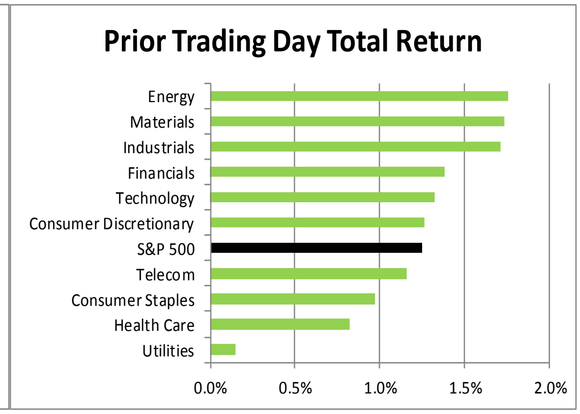


The rate of homeownership peaked at 69.3% in Q2 2004 and, in the wake of the housing crisis, suffered a precipitous decline. Although we have reached a level where we believe stabilization is likely, we doubt this level will rise anytime soon. And so, rental income should remain elevated until enough new apartments are constructed to depress rents. So far, that hasn't happened, although there has been an increase in multi-family construction. We will continue to closely monitor rental income as a key input into our REIT allocations.

<u>Data Section</u>

U.S. Equity Markets – (as of 5/10/2016 close)

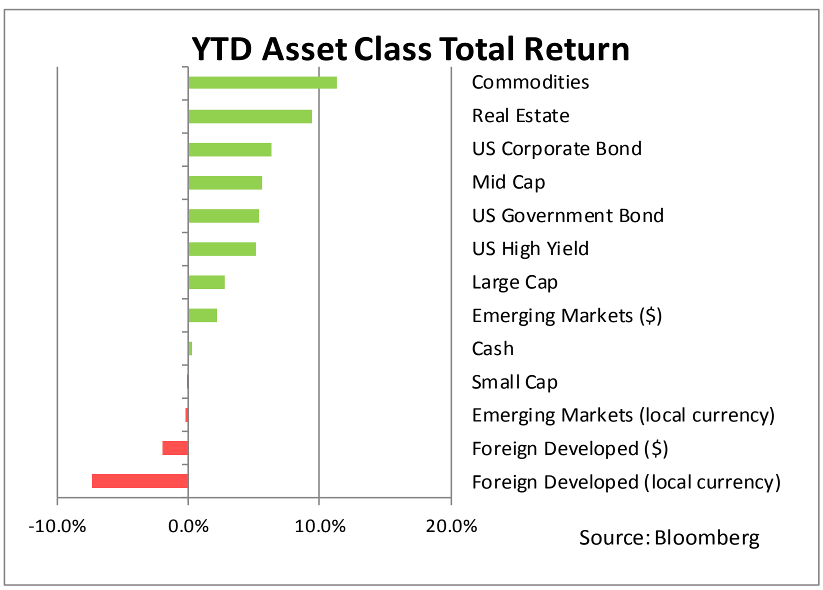




(Source: Bloomberg)

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 5/10/2016 close)

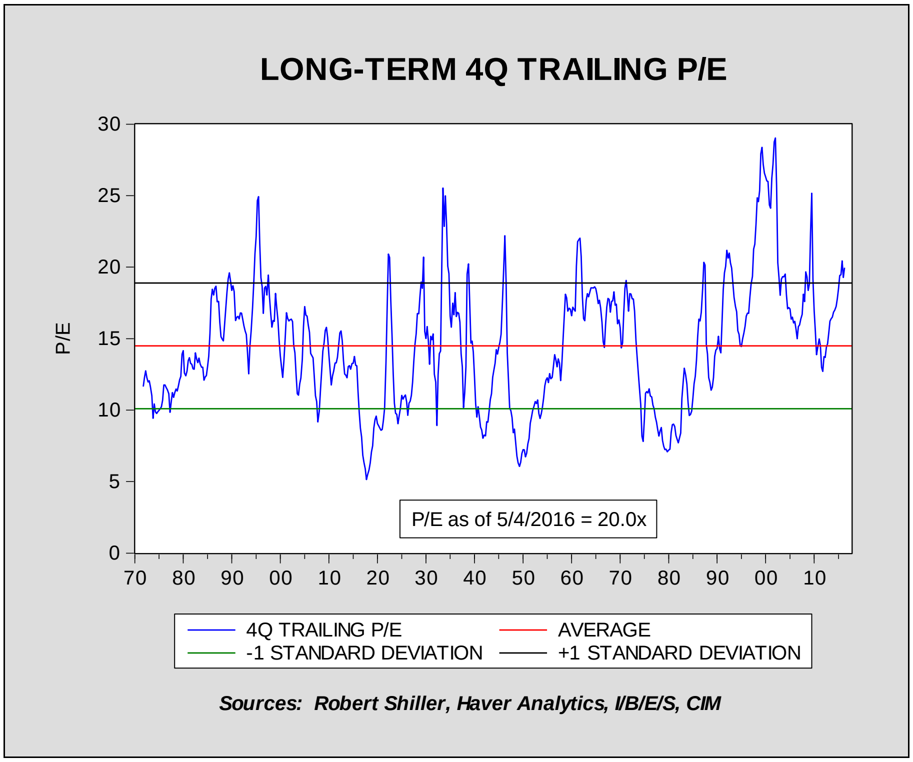


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

May 5, 2016



Based on our methodology,[1] the current P/E is 20.0x, up 0.1x from last week. The P/E rose due to falling earnings.

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 (Q3 and Q4) and two estimates (Q1 and Q2). 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.