Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: May 3, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading down 1.8% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 1.6% from the prior close. Chinese markets are higher after being closed yesterday, with the Shanghai composite up 1.9% and the Shenzhen index higher by 2.9%. U.S. equity futures are signaling a lower opening from the previous close. With 64.0% of the S&P 500 companies having reported, Q1 float-adjusted earnings stand at $26.67, just over the $26.66 forecast. Of the 320 companies that have reported, 74.0% had positive earnings surprises, while 19.1% had negative earnings surprises.

After a rally in risk assets yesterday, we are seeing a reversal this morning. Although China's official PMI data came in a bit soft (see below), we suspect the real story continues to come from the forex markets. Overnight, the Reserve Bank of Australia (RBA), the country's central bank, surprised the markets by cutting its policy rate to a record low of 1.75%. A Bloomberg survey showed that 12 economists out of the 27 polled had forecast a cut in rates. The bank cited low inflation as the reason. We have our doubts.

This chart shows the market's reaction to the rate cut. The AUD is quoted in USD per AUD, meaning the higher the reading the stronger the AUD. Note the sharp decline in light of the unexpected rate action by the RBA.

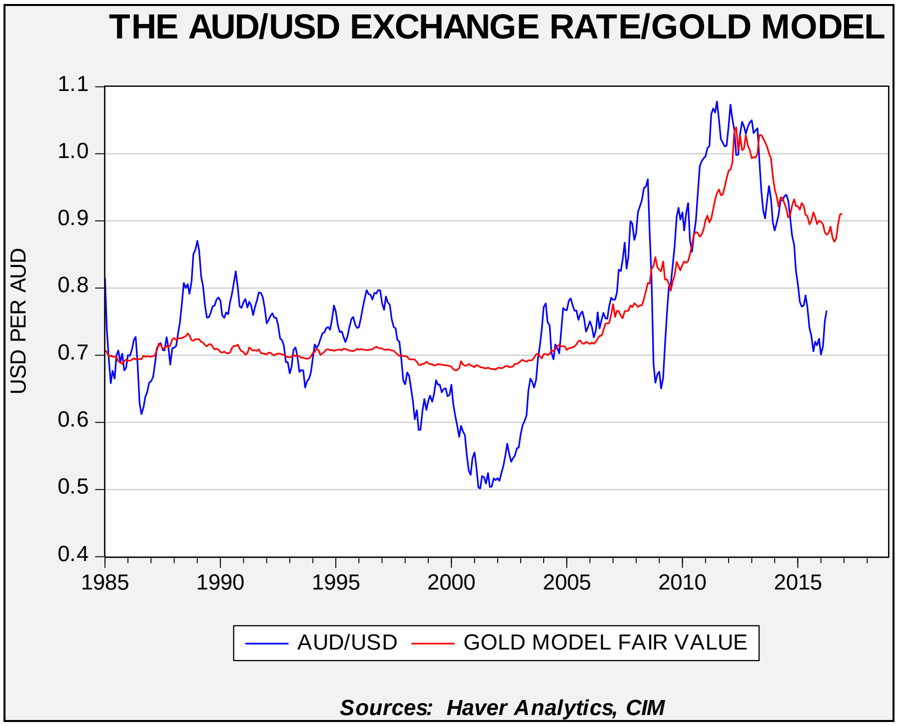
(Source: Bloomberg)

Here is a longer term look at the data.

(Source: Bloomberg)

This is a five-year chart of the USD/AUD exchange rate. The AUD fell sharply as commodity prices began to decline in 2014. During China's stronger growth period into mid-2013, the AUD traded above $1.00. It slipped under 70 cents in Q3 2015 and has been bouncing around 70 cents until recently, when the currency began to appreciate.

We are coming to the position that no central bank or financial authority on planet Earth wants a stronger currency. Every nation is trying to engage in some sort of accommodative policy and an appreciating currency tends to undermine those efforts. The AUD has bounced, in part, due to Chinese stimulus. In fact, there is a positive relationship (r=76.7%) between gold and the AUD (with gold leading the currency by about eight months), and so this may be a move by the RBA to preempt further appreciation.



Although deviations this wide are not unprecedented, history suggests that such deviations tend to get corrected by an appreciating AUD. The recent rally in gold (seen by the late rise in the red line) makes the bullish case for the AUD even stronger. We suspect that Australian authorities do not want a stronger currency and thus are taking steps to weaken it by cutting rates.

If our thesis is correct, we should see the Eurozone and Japan take steps to address the recent strength in the EUR and JPY. Reuters reported yesterday that BOJ Governor Kuroda expressed concern about JPY strength, which was given as a reason for yesterday's strength. We note today that comments out of Japan suggest that NIRP is very unpopular, meaning the BOJ may be forced into other stimulus measures, which might include even bigger QE, currency intervention (very controversial) or considerations of "monetary financing of fiscal spending," or "helicopter money" in the vernacular.[1] We look for ECB President Draghi to react to recent EUR strength as well. Additionally, it appears to us that the Fed won't really move rates higher without assurances that tightening policy won't lead to a much stronger dollar…which it undoubtedly will. All of this means that easy policies will remain in place everywhere and currency depreciation may be the only tool left that will measurably lead to stronger growth. However, as the 1930s showed, everyone cannot have a weaker currency.

U.S. Economic Releases

There are no releases scheduled before we go to print. The chart below shows the economic releases or Fed speakers scheduled for the rest of the day.

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[1] See this week's WGR and the following two weeks' WGRs.

Economic releases						
EST	Indicator			Expected	Prior	Rating
9:45	ISM New York	m/m	Apr		50.4	*
10:00	IBD/TIPP Economic Optimism	m/m	May	46.5	46.3	**
	Wards Domestic Vehicle Sales	m/m	Apr	13.4 mn	13.0 mn	**
Fed speakers of events						
EST	Speaker or event	District or position				
10:30	Mester	Cleveland FRB President				
2:00	Williams	San Francisco FRB President				
7:00	Lockhart	Atlanta 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	Manufacturing PMI (Caixin)	m/m	Apr	49.4	49.7	49.8	**	Equity bearish, bond bullish
India	Manufacturing PMI (Nikkei)	m/m	Apr	50.5	52.4		**	Equity and bond neutral
EUROPE								
Eurozone	PPI	y/y	Mar	-4.2%	-4.2%	-4.3%	**	Equity and bond neutral
U.K.	Manufacturing PMI (Markit)	m/m	Apr	49.2	50.7	51.2	**	Equity bearish, bond bullish
Switzerland	Consumer confidence	m/m	Apr	-15.0	-14.0	-11.0	**	Equity bearish, bond bullish
AMERICAS								
Brazil	Industrial production	y/y	Mar	-11.4%	-9.8%	-10.8%	***	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)	64	64	0	Neutral
3-mo T-bill yield (bps)	20	21	-1	Down
TED spread (bps)	44	42	2	Up
U.S. Libor/OIS spread (bps)	39	39	0	Neutral
10-yr T-note (%)	1.80	1.87	-0.07	Narrowing
Euribor/OIS spread (bps)	-25	-25	0	Neutral
EUR/USD 3-mo swap (bps)	24	22	2	Up
Currencies	**Direction**			
dollar	down			Falling
euro	up			Rising
yen	up			Rising
franc	up			Rising
Central Bank Action	**Current**	**Prior**	**Expected**	
Australia key rate	1.75%	2.00%	2.00%	Loosening

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	$ 45.49	$ 45.83	-0.74%	Awaiting weekly inventory data
WTI	$ 44.33	$ 44.78	-1.00%	
Natural gas	$ 2.08	$ 2.04	1.91%	
Crack spread	$ 17.23	$ 17.96	-4.05%	
12-mo strip crack	$ 13.72	$ 14.08	-2.51%	
Ethanol rack	$ 1.69	$ 1.69	-0.25%	
Metals				
Gold	$ 1,298.05	$ 1,291.55	0.50%	Lower dollar
Silver	$ 17.59	$ 17.55	0.24%	
Copper contract	$ 224.00	$ 226.65	-1.17%	Caixin China manufacturing data weaker than expected
Grains				
Corn contract	$ 391.75	$ 391.75	0.00%	
Wheat contract	$ 489.00	$ 487.75	0.26%	
Soybeans contract	$ 1,049.50	$ 1,043.75	0.55%	Strong global demand
Shipping				
Baltic Dry Freight	703	710	-7	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)		0.2		
Gasoline (mb)		-0.6		
Distillates (mb)		0.0		
Refinery run rates (%)		0.4%		
Natural gas (bcf)		70.0		

Weather

The 6-10 and 8-14 day forecasts are calling for warmer than normal conditions for the northern half of the country. Precipitation is forecast for the middle of the country.

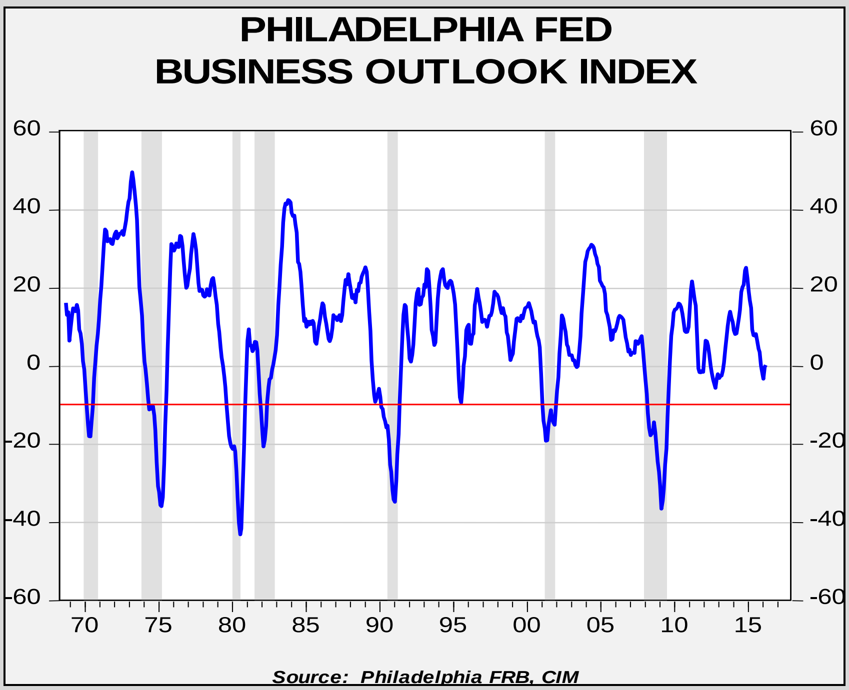
Weekly Asset Allocation Commentary

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.

April 29, 2016

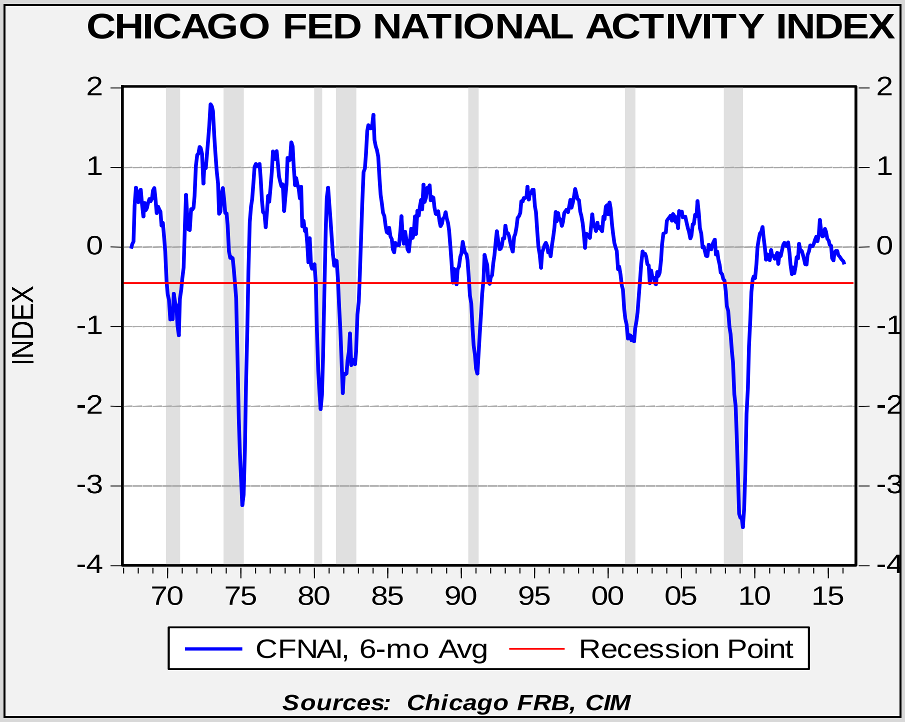
We recently completed our quarterly rebalancing process in our asset allocation models. One of our key assumptions is that the economy will avoid recession but growth will remain sluggish. Recently, two reliable recession indicators, one from the Philadelphia FRB and the other from the Chicago FRB, have confirmed our expectations.

First, shown below is the Philadelphia FRB's manufacturing index, which is a survey of manufacturing firms in the Northeast:



This index signals below-trend growth with a reading below zero, and indicates a recession with a reading under -10. We smooth the data with a six-month moving average. The current reading is +0.08, suggesting, at best, growth is at trend. Note that the readings have been rather weak in this recovery. In fact, the average index value (on a six-month average basis) for this recovery is the second lowest on record, with only the recovery between the 1980 and 1981-82 recessions being slower.

The Chicago FRB National Activity Index, which is a broad-based compilation of national economic indicators, shows a similar pattern.



Similar to the Philadelphia FRB manufacturing index, a reading below zero indicates below-trend growth. The data clearly shows the economy is weak but not recessionary.

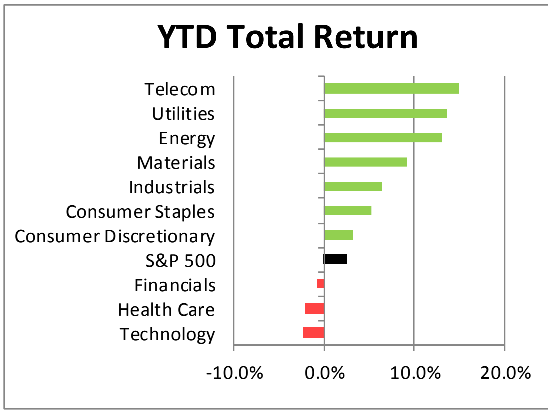
We expect the economy to continue on this path. Until household debt falls to more manageable levels, consumption will likely remain sluggish which will tend to weigh on the economy. This forecast for the economy means that:

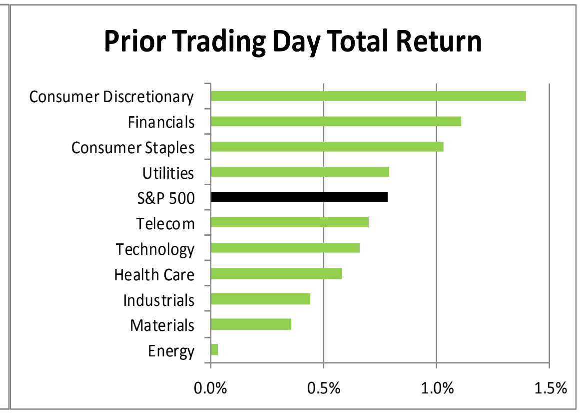
1. Inflation should remain low;
2. The risk in long-duration interest rate instruments is low;
3. Monetary policy should remain accommodative, even with the Federal Reserve moving on a tightening path;
4. Equity markets can support a higher than normal P/E.

These expectations have been incorporated into our asset allocation models. A shift to either recession or faster economic growth would require adjustments but, at this juncture, neither appears likely. Until a shift in stance occurs, our current allocations will likely remain in place.

Data Section

U.S. Equity Markets – (as of 5/2/2016 close)

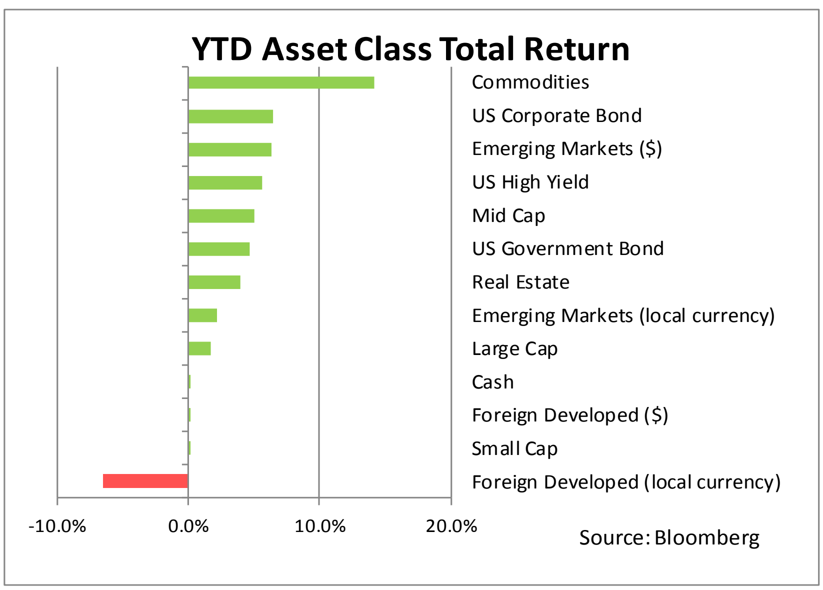




(Source: Bloomberg)

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 5/2/2016 close)

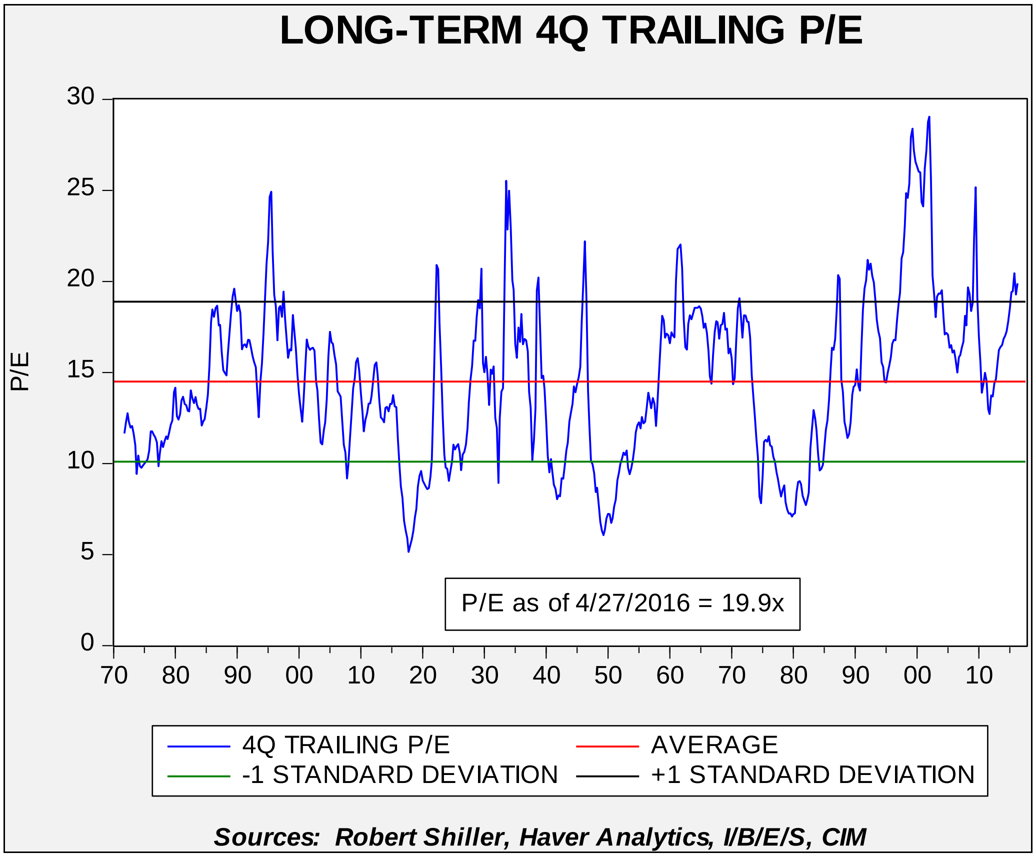


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

April 28, 2016



Based on our methodology,[2] the current P/E is 19.9x, up 0.1x from last week. The P/E rose due to rising equity price levels.

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 (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.