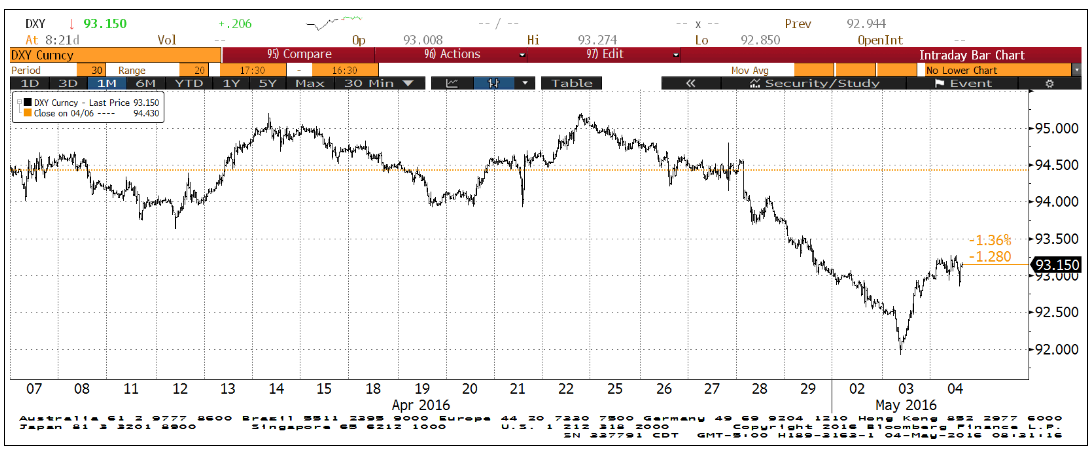
Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: May 4, 2016—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is trading down 0.9% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 1.0% from the prior close. Chinese markets are trading lower to sideways from the prior close, with the Shanghai composite down 0.1% and the Shenzhen index moving sideways. U.S. equity futures are signaling a lower opening from the previous close. With 72.2% of the S&P 500 companies having reported, Q1 float-adjusted earnings stand at $26.70, more than the $26.66 forecast. Of the 361 companies that have reported, 73.7% had positive earnings surprises, while 19.9% had negative earnings surprises.

We will keep our opening comments short as quite a few economic indicators were released this morning. Risk markets are trading lower this morning, with equities lower globally and Treasuries trading higher. As the earnings season continues, equity fundamentals have not changed much, thus the pullback in equities is more a function of profit taking and the fact that positive factors that could drive the market higher have already been discounted.



(Source: Bloomberg)

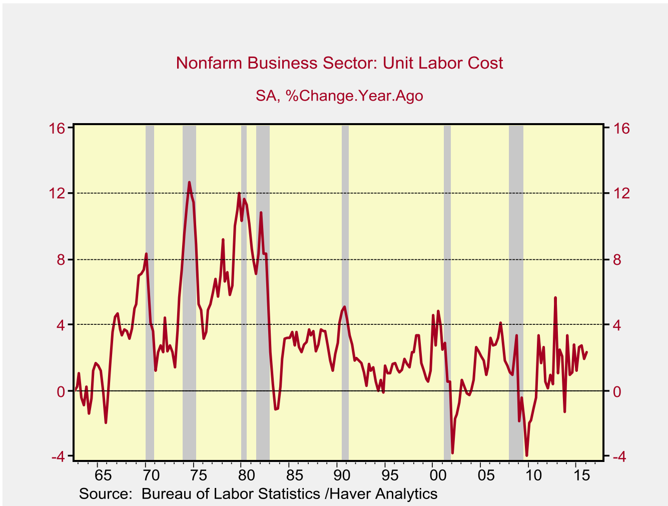
As the chart above indicates, the dollar rebounded yesterday afternoon and maintained its strength overnight. This is likely due to weak Chinese manufacturing data released earlier in the week as well as indications from Fed speakers that the June FOMC meeting should be considered "live," meaning that we could see a hike from that meeting. Currently, the markets peg the likelihood of a June hike essentially at zero.

Trump became the presumptive Republican presidential nominee yesterday as Cruz quit the race after Trump won a resounding victory in Indiana. Yesterday's win is almost certain to allow Trump to gather the 1,237 delegates needed for an outright nomination victory. On the

Democratic side, Sanders won Indiana with 52.5% of the votes. Despite the unexpected loss in Indiana, Clinton is likely to receive the delegates needed for an outright nomination win.

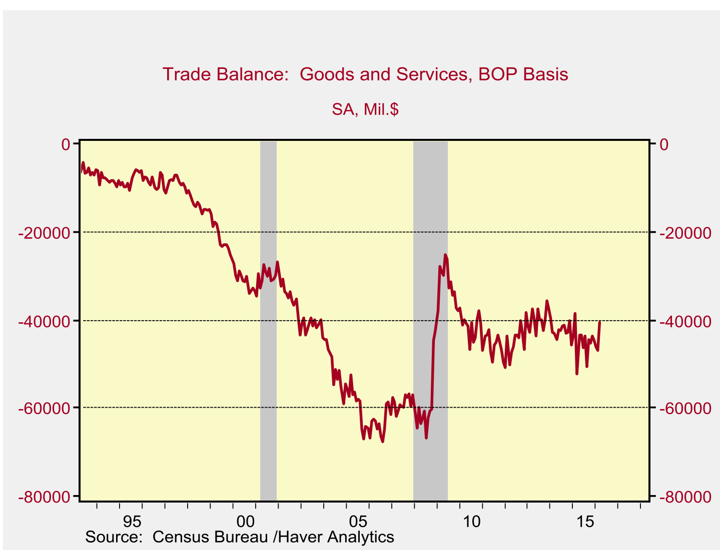
U.S. Economic Releases

Q1 non-farm productivity fell 1.0% from the month before, better than the 1.3% decline forecast. This is the second consecutive monthly decline. Unit labor costs gained 4.1%, better than the 3.3% increase forecast.



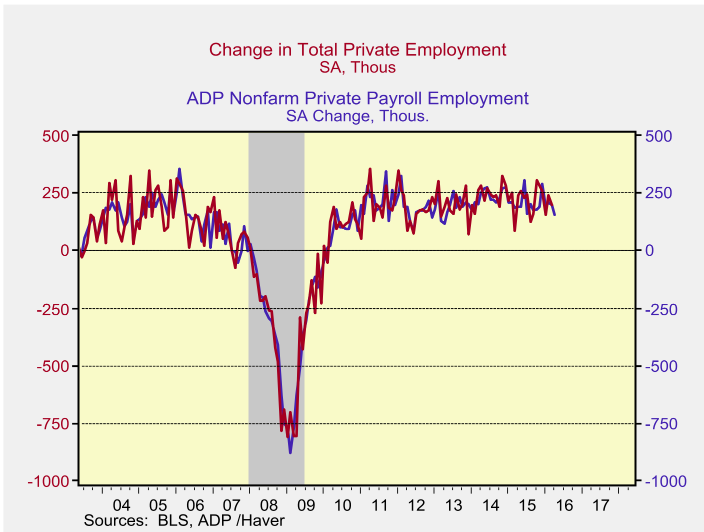
The chart above shows the annual change in unit labor costs, which have been rising over the past year. Labor costs have risen as companies have added workers in anticipation of strengthening demand, even as current global demand has remained tepid.

The trade deficit for March narrowed to $40.4 bn from a deficit of $47.0 bn the month before, better than the $41.2 bn deficit forecast.



The chart above shows the total level of the trade balance. We have seen a narrowing deficit as imports fell 3.6% from the month before, with exports also falling 0.9%. Import weakness was broad-based, with all categories declining. Consumer goods and food/beverages imports were the weakest. Exports were also generally weak, with only capital goods and services showing gains from the month before.

ADP employment rose less than forecast for April, rising 156k compared to the 195k increase forecast. All the gains came from the service-producing sector as the goods-producing sector actually lost jobs.



The chart above shows the ADP non-farm private payroll change and the change in private employment. The pace of ADP job gains has slowed, with April's number showing the smallest gain since April 2013, signaling slowing employment gains. This reading means that we may also see a weaker private employment number.

Mortgage applications fell 3.4% for the most recent reporting week, with purchases down 0.1% and refinancing down 5.5%. We are heading into a strong sales season, but the weekly numbers may be volatile during the spring months. Refinancing activity fell as the 30-year rate rose 2 bps to 3.87%.

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

Economic releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Services PMI	m/m	Apr	52.1	52.1	*
9:45	Composite PMI	m/m	Apr		51.7	*
10:00	ISM non-manufacturing PMI	m/m	Apr	54.8	54.5	*
10:00	Factory orders	m/m	Mar	0.6%	-1.7%	**
10:00	Durable goods orders	m/m	Mar	0.8%	0.8%	**
Fed speakers of events						
EST	**Speaker or event**	**District or position**				
6:30	Kashkari	Minneapolis 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								
India	Services PMI (Nikkei)	m/m	Apr	53.7	54.3		*	Equity bearish, bond bullish
	Composite PMI (Nikkei)	m/m	Apr	52.8	54.3		*	Equity bearish, bond bullish
EUROPE								
Eurozone	Services PMI (Nikkei)	m/m	Apr	53.1	53.2	53.2	*	Equity and bond neutral
	Composite PMI (Nikkei)	m/m	Apr	53.0	53.0	53.0	*	Equity and bond neutral
	Retail sales	m/m	Mar	-0.5%	0.3%	-0.1%	**	Equity bearish, bond bullish
France	Services PMI (Nikkei)	m/m	Apr	50.6	50.8	50.8	*	Equity and bond neutral
	Composite PMI (Nikkei)	m/m	Apr	50.2	50.5	50.5	*	Equity and bond neutral
	Trade balance	m/m	Mar	-€4.4 bn	-€5.1 bn	-€4.2 bn	**	Equity and bond neutral
Germany	Services PMI (Nikkei)	m/m	Apr	54.5	54.6	54.6	*	Equity and bond neutral
	Composite PMI (Nikkei)	m/m	Apr	53.6	53.8	53.8	*	Equity and bond neutral
Italy	Services PMI (Nikkei)	m/m	Apr	52.1	51.2	51.9	*	Equity bullish, bond bearish
	Composite PMI (Nikkei)	m/m	Apr	53.1	52.4		*	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)	64	64	0	Neutral
3-mo T-bill yield (bps)	20	20	0	Neutral
TED spread (bps)	44	44	0	Neutral
U.S. Libor/OIS spread (bps)	39	39	0	Neutral
10-yr T-note (%)	1.78	1.80	-0.02	Narrowing
Euribor/OIS spread (bps)	-25	-25	0	Neutral
EUR/USD 3-mo swap (bps)	24	24	0	Neutral
Currencies	**Direction**			
dollar	up			Falling
euro	down			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	$ 45.36	$ 44.97	0.87%	
WTI	$ 43.99	$ 43.65	0.78%	
Natural gas	$ 2.13	$ 2.09	2.01%	
Crack spread	$ 17.71	$ 17.30	2.37%	
12-mo strip crack	$ 13.92	$ 13.64	2.05%	
Ethanol rack	$ 1.67	$ 1.68	-0.26%	
Metals				
Gold	$ 1,286.99	$ 1,286.50	0.04%	Investment demand
Silver	$ 17.41	$ 17.43	-0.11%	
Copper contract	$ 220.25	$ 221.90	-0.74%	Demand concern
Grains				
Corn contract	$ 377.50	$ 379.75	-0.59%	
Wheat contract	$ 471.25	$ 470.75	0.11%	
Soybeans contract	$ 1,026.75	$ 1,030.00	-0.32%	
Shipping				
Baltic Dry Freight	682	703	-21	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)		0.6		
Gasoline (mb)		-0.5		
Distillates (mb)		0.0		
Refinery run rates (%)		0.3%		
Natural gas (bcf)		67.0		

Weather

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

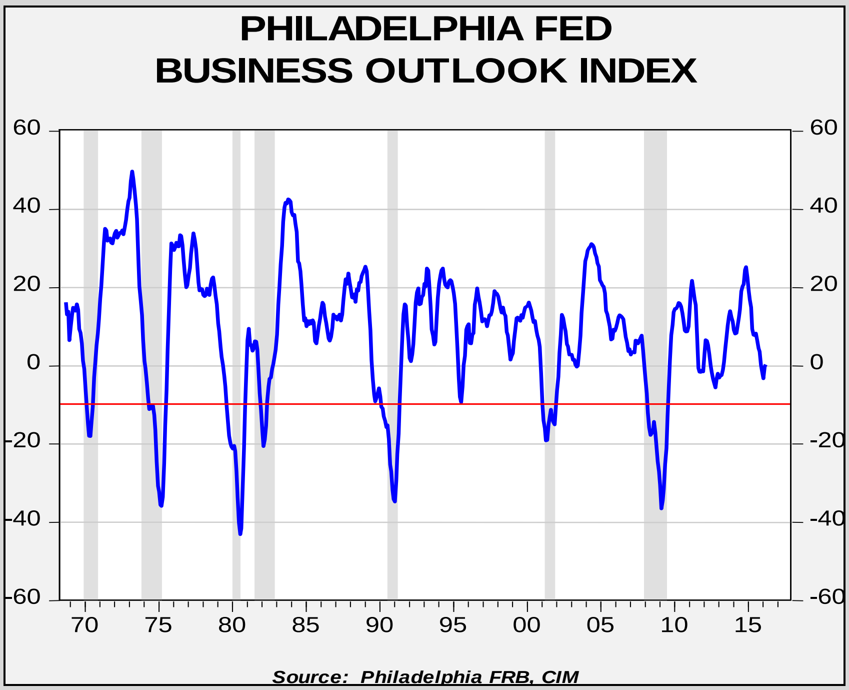
Weekly Asset Allocation Commentary

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.

April 29, 2016

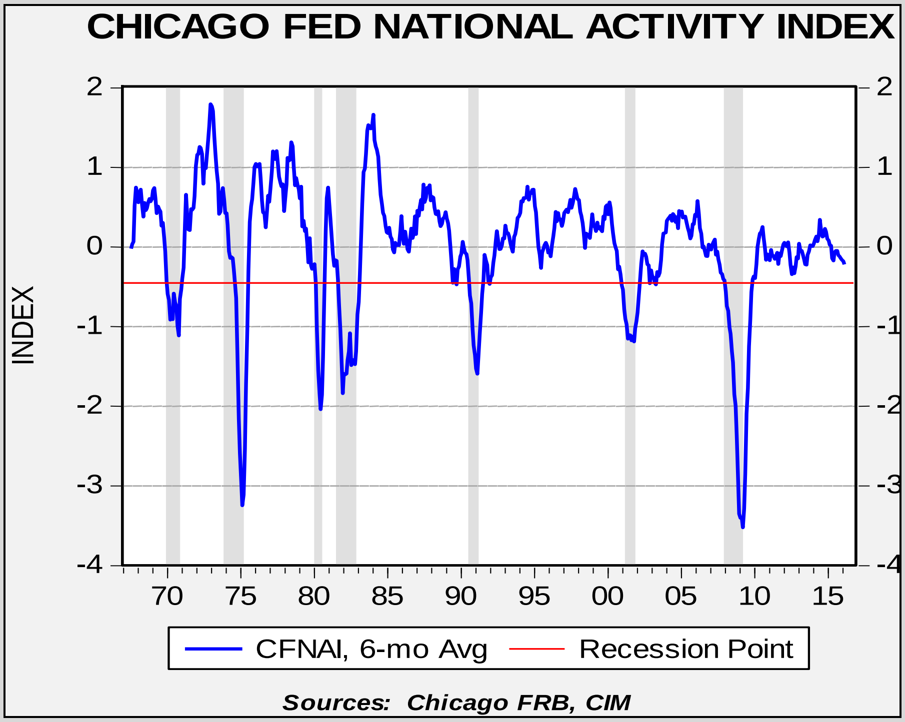
We recently completed our quarterly rebalancing process in our asset allocation models. One of our key assumptions is that the economy will avoid recession but growth will remain sluggish. Recently, two reliable recession indicators, one from the Philadelphia FRB and the other from the Chicago FRB, have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

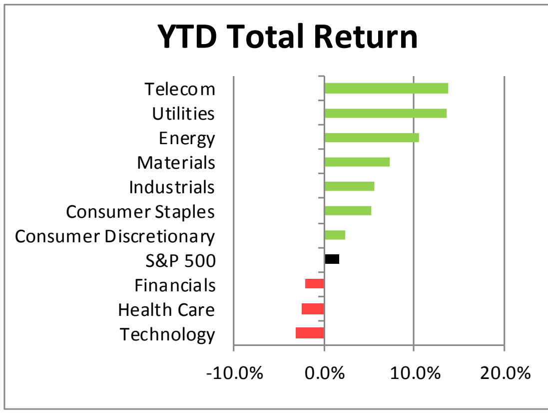
We expect the economy to continue on this path. Until household debt falls to more manageable levels, consumption will likely remain sluggish which will tend to weigh on the economy. This forecast for the economy means that:

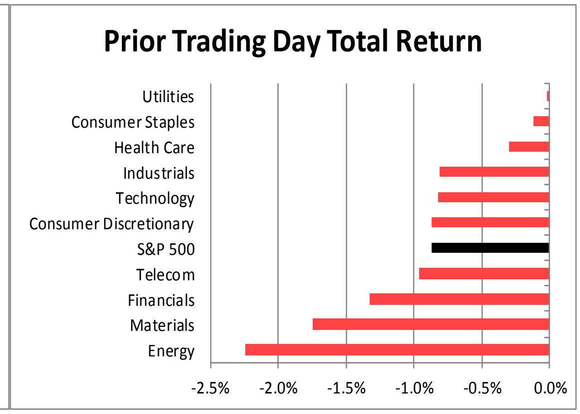
1. Inflation should remain low;
2. The risk in long-duration interest rate instruments is low;
3. Monetary policy should remain accommodative, even with the Federal Reserve moving on a tightening path;
4. Equity markets can support a higher than normal P/E.

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 5/3/2016 close)

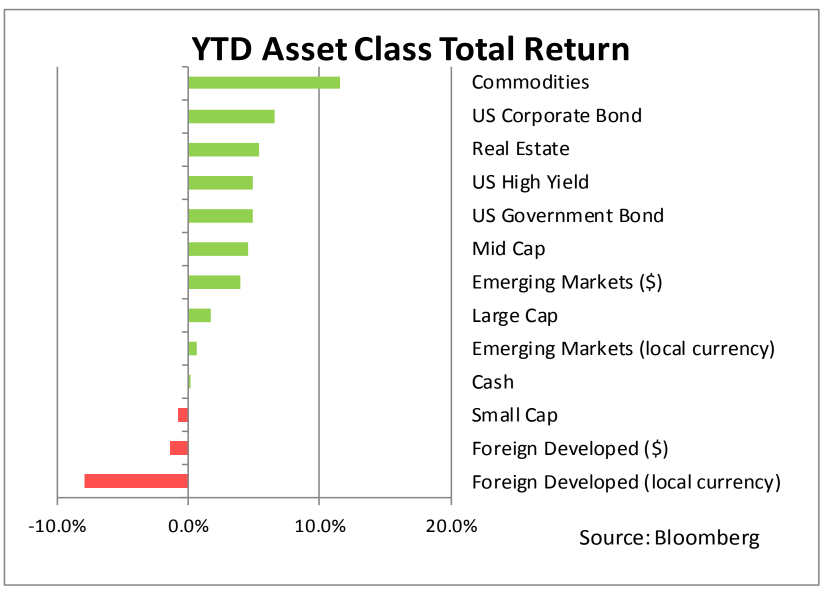




(Source: Bloomberg)

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 5/3/2016 close)

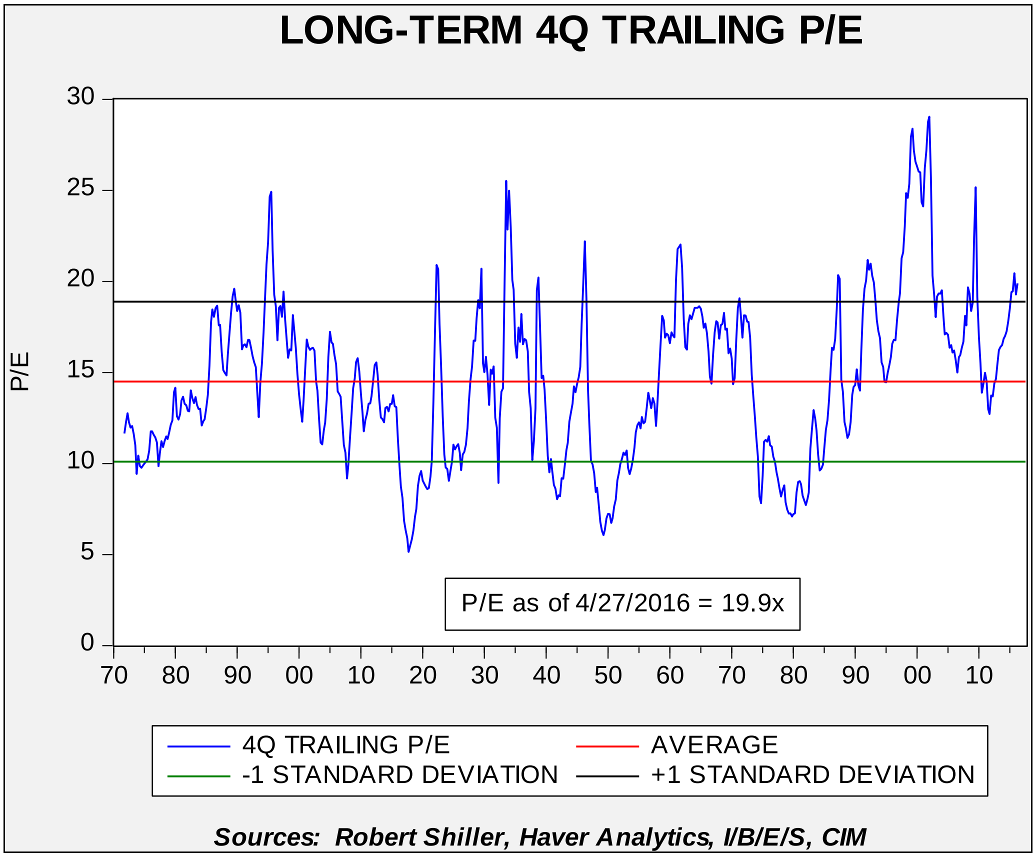


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[1] 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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[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.