Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: May 9, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is higher by 1.31% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 0.4% from the prior close. Chinese markets are trading lower from the prior close, with the Shanghai composite down 2.8% and the Shenzhen index lower by 3.7%. U.S. equity futures are signaling a higher opening from the previous close. With 87.4% of the S&P 500 companies having reported, Q1 float-adjusted earnings stand at $26.86, more than the $26.66 forecast. Of the 400 companies that have reported, 72.3% had positive earnings surprises, while 20.6% had negative earnings surprises.

There were five major news items over the weekend:

Saudi Oil Minister al-Naimi sacked: Al-Naimi, who has been oil minister since 1995, was unceremoniously fired over the weekend, replaced with another Saudi Aramco official, Khalid al-Falih. Al-Naimi was considered a good administrator and was the *de facto* head of OPEC. At 80 years old, he has hinted at stepping down for some time but the fact that he was fired, and not allowed to resign, sends a signal that the new king and his effective regent, DCP Salman, are putting their own stamp on the country. At the Doha meeting, al-Naimi appeared prepared to agree to a production freeze, only to be overruled at the last minute by the DCP, who insisted that Iran also freeze output, which was sure to kill any deals. Although the official stance of the kingdom is that this move will not lead to new policies, we suspect that al-Naimi was willing to engage in jawboning to lift oil prices. Our position is that the Saudi policy of gaining market share was not necessarily targeted at the U.S. but at Russia and Iran, which pose geopolitical threats to the kingdom. By firing al-Naimi, the DCP is making it clear that the goal of Saudi oil policy is to undermine the Iranian and Russian economies. After all, a freeze would have likely led to higher oil prices even in the absence of real change because it held the promise of future cooperation. We strongly suspect that the new minister has heard loud and clear that the kingdom's policy is to hurt Iran and, to a lesser extent, Russia. Thus, we view the change as potentially bearish for oil prices.

Fed officials talking about hikes: NY FRB President Dudley suggested after the employment report that the FOMC is on path for two hikes this year. St. Louis FRB President Bullard says he is "open" to a June hike and Boston FRB President Rosengren (an avowed dove) has been saying that the financial markets are underestimating the Fed's likelihood of raising rates. Atlanta FRB President Lockhart says he is "on the fence" for June. Meanwhile, the fed funds futures put the odds of a June hike at 4.0% and don't get to 50% odds until February 2017. As we have noted before, based on the Phillips Curve relationship, the FOMC is well behind the curve in any iteration. We have noted that there is a chance that Chair Yellen is using the dollar as her policy target. Waiting for dollar weakness before raising rates would make sense. However, given the comments coming out of the rest of the FOMC, there is little evidence anyone else is buying into this policy. We doubt the Fed moves in June; the *WSJ*'s Jon Hilsenrath also suggested this idea today. But the noise surrounding a hike may be there to build some degree of uncertainty into the financial markets.

Greece is becoming dicey: Despite demonstrations against the measures, PM Tsipras did get the Greek parliament to agree to reform pensions and raise taxes yesterday, but the IMF is making more comments indicating that the body may not agree to further bailout measures without debt relief. Debt relief is an anathema to Germany, which fears that others may ask for similar support. Meanwhile, surveys across Europe indicate that the Brexit vote may trigger similar referendums in other nations as well. Another Greek debt crisis could trigger even more problems in the EU and Eurozone and could put pressure on the EUR, which would not be welcome in the U.S.

Alberta fires: Forest fires in Alberta have reportedly cut tar sands oil production by 1.0 mbpd, although it does appear the fires will mostly miss the oil-producing regions. However, the workers tend to live in Fort McMurray, so it isn't clear how the oil companies will function even after there is no fire danger. Oil markets were initially higher on the news but have given back some of their gains.

Chinese trade data: Exports in April fell 1.8% and imports fell more than forecast (down 10.9%). Key commodity imports declined; oil imports were down 7.2% (in volume terms), iron ore fell 4.7% and copper imports dropped 23.8%. Meanwhile, a major Chinese newspaper carried a full page ad warning about growing debt and non-performing loans.

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.

Economic releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Labor market conditions index	m/m	Apr	-1.0	-2.1	*
Fed speakers of events						
EST	**Speaker or event**	**District or position**				
1:00	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								
China	Foreign Reserves	m/m	Apr	$3.2 bn	$3.2 bn	$3.2 bn	**	Equity and bond neutral
	Trade balance	m/m	Apr	$45.6 bn	$29.9 bn	$40.0 bn	**	Equity bullish, bond bearish
	Exports	y/y	Apr	-1.8%	11.5%	0.0%	**	Equity bearish, bond bullish
	Imports	y/y	Apr	-10.9%	-7.6%	-4.0%	**	Equity bullish, bond bearish
Japan	Consumer confidence	m/m	Apr	40.8	41.7	40.7	**	Equity bullish, bond bearish
EUROPE								
Eurozone	Sentix investor confidence	m/m	May	6.2	5.7	6.0	*	Equity bullish, bond bearish
Germany	Factory orders	m/m	Mar	1.9%	-0.8%	0.6%	**	Equity bullish, bond bearish
U.K.	House prices	m/m	Apr	-0.8%	2.2%	-0.3%	**	Equity bearish, bond bullish
Switzerland	CPI	y/y	Apr	-0.4%	-0.9%	-0.7%	***	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)	19	19	0	Neutral
TED spread (bps)	44	44	0	Neutral
U.S. Libor/OIS spread (bps)	38	39	-1	Down
10-yr T-note (%)	1.77	1.78	-0.01	Narrowing
Euribor/OIS spread (bps)	-26	-26	0	Neutral
EUR/USD 3-mo swap (bps)	23	24	-1	Down
Currencies	**Direction**			
dollar	up			Falling
euro	up			Rising
yen	down			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	$ 45.17	$ 45.37	-0.44%	Canadian production falls due to the wildfire
WTI	$ 44.65	$ 44.66	-0.02%	
Natural gas	$ 2.11	$ 2.10	0.19%	
Crack spread	$ 15.64	$ 15.96	-2.01%	
12-mo strip crack	$ 12.54	$ 12.74	-1.54%	
Ethanol rack	$ 1.66	$ 1.66	0.00%	
Metals				
Gold	$ 1,272.62	$ 1,288.99	-1.27%	Stronger dollar
Silver	$ 17.24	$ 17.47	-1.33%	
Copper contract	$ 211.80	$ 215.40	-1.67%	China demand concerns
Grains				
Corn contract	$ 378.25	$ 377.50	0.20%	
Wheat contract	$ 465.50	$ 463.75	0.38%	
Soybeans contract	$ 1,035.75	$ 1,034.75	0.10%	
Shipping				
Baltic Dry Freight	631	642	-11	

Weather

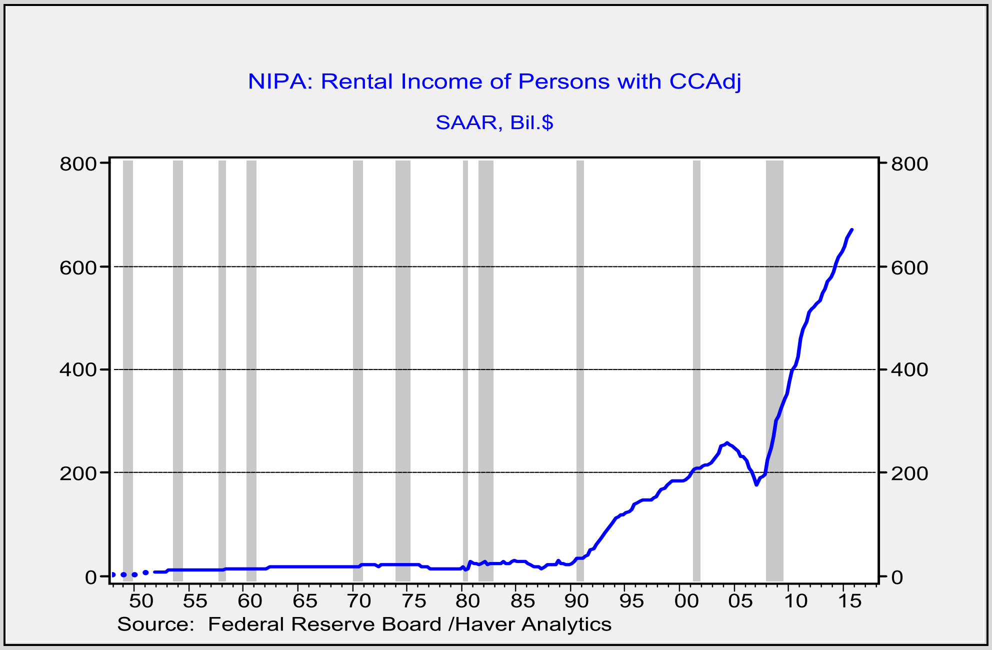
The 6-10 and 8-14 day forecasts are calling for warmer than normal conditions for the West and the South. Precipitation is forecast for the majority of the country.

Weekly Asset Allocation Commentary

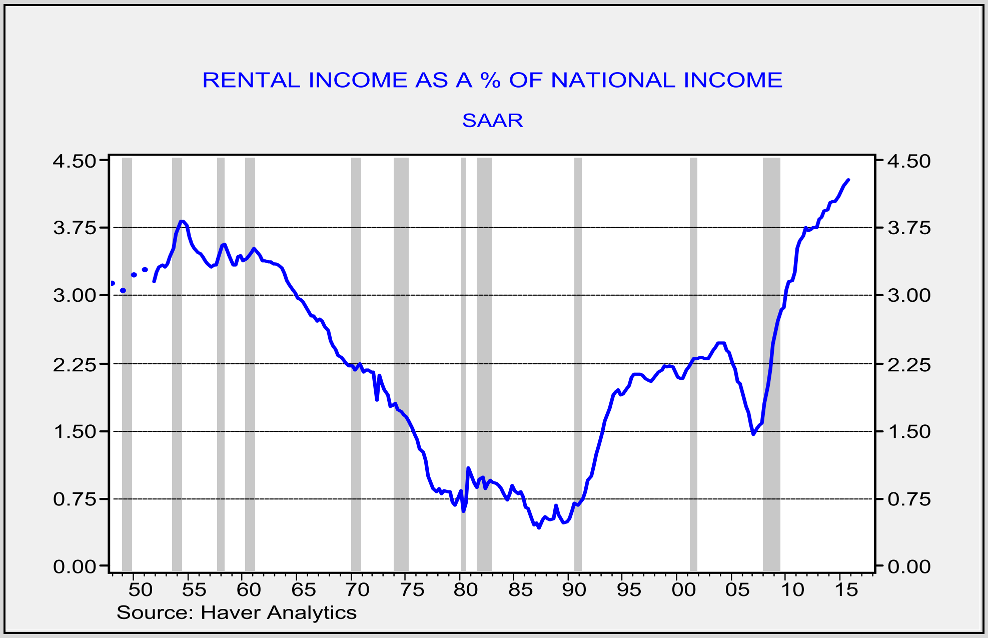
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

May 6, 2016

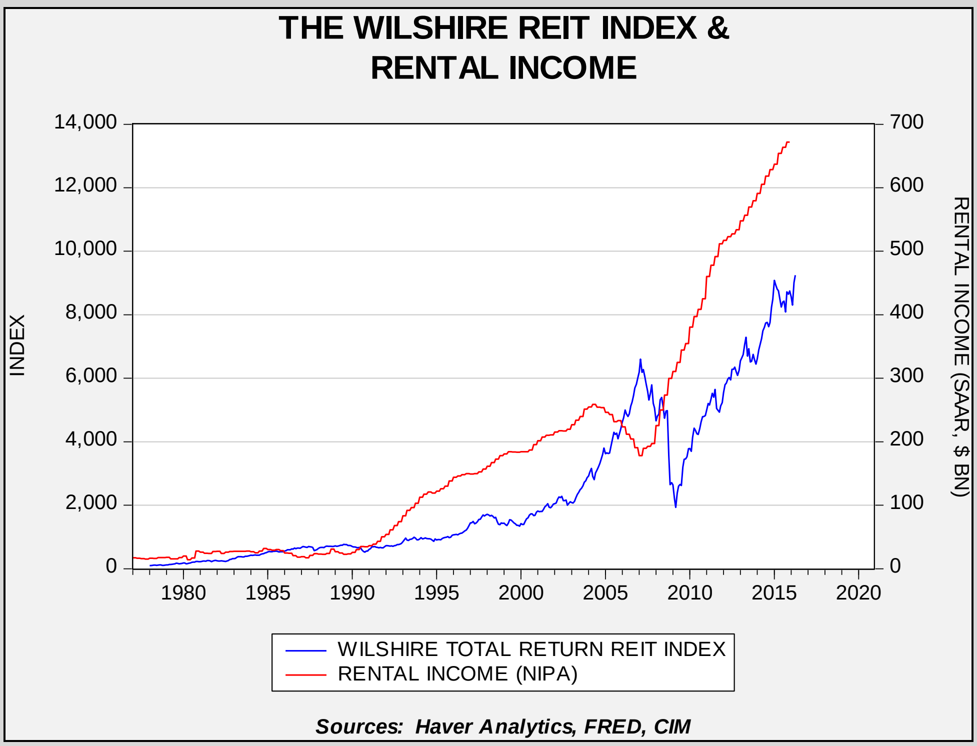
In our latest adjustment to the asset allocation portfolios, we added to the REIT positions in three of the four models. One of the reasons we remain friendly to this asset class has been the steady increase in rental income.



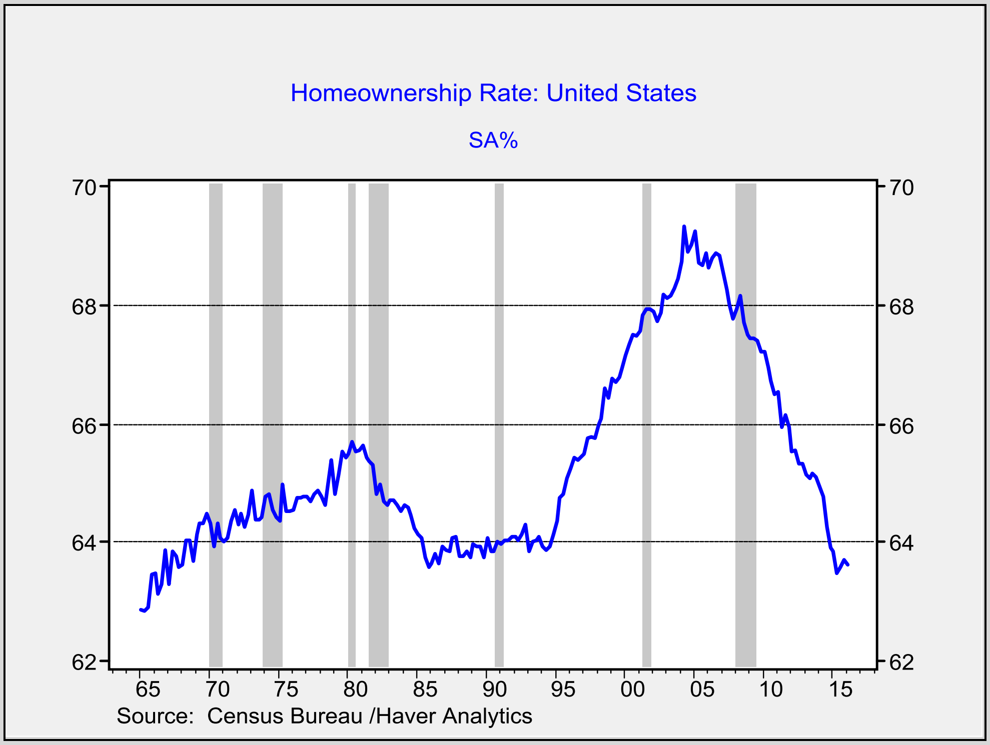
This chart shows rental income from the National Income and Product Accounts (NIPA). Note that rental income has been rising at a very fast pace since the housing crisis. In fact, as a percentage of national income, rents are at a postwar high, exceeding 4.25%.



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



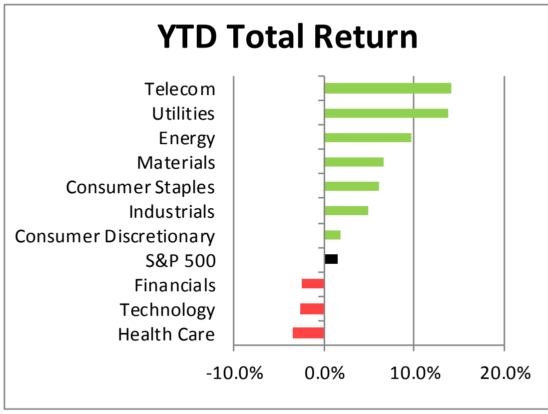
A major reason rental income is rising is due to falling homeownership rates.

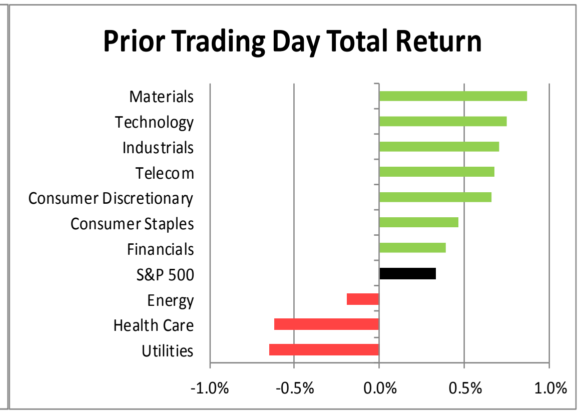


The rate of homeownership peaked at 69.3% in Q2 2004 and, in the wake of the housing crisis, suffered a precipitous decline. Although we have reached a level where we believe stabilization is likely, we doubt this level will rise anytime soon. And so, rental income should remain elevated until enough 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.

Data Section

U.S. Equity Markets – (as of 5/6/2016 close)

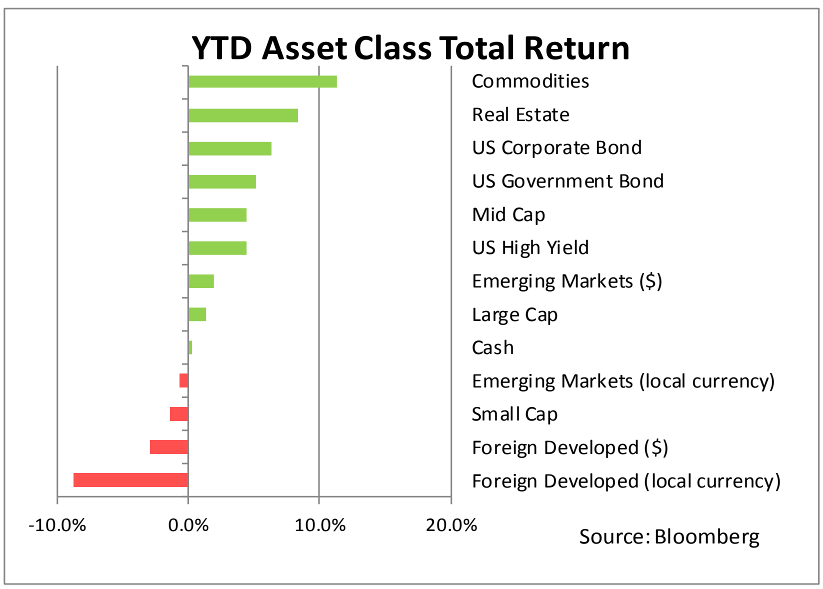




(Source: Bloomberg)

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 5/6/2016 close)

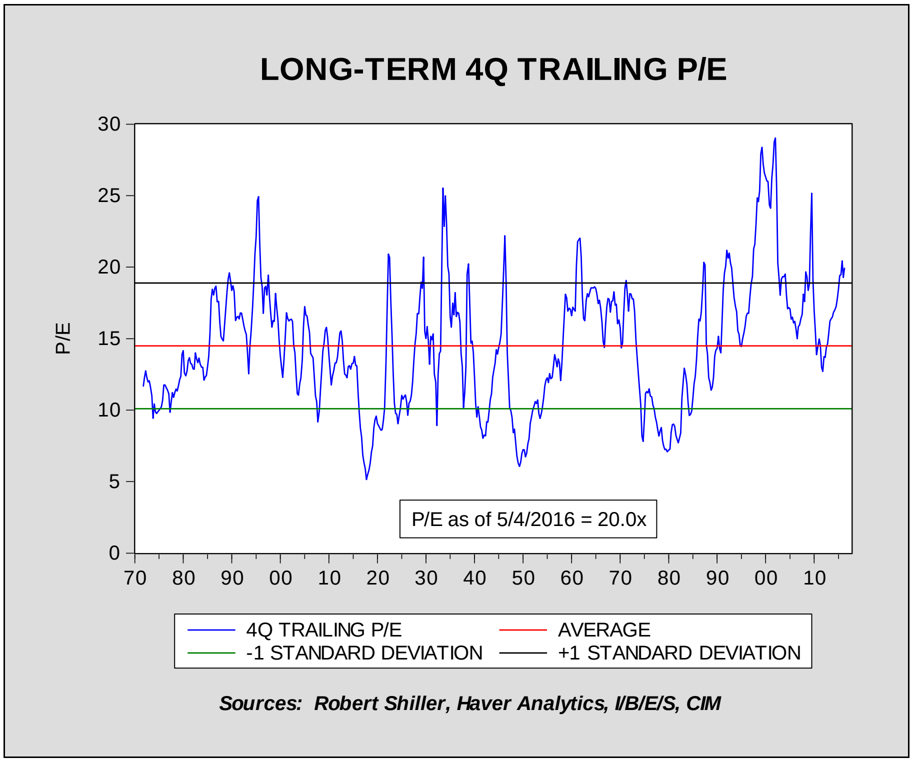


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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.