Confluence INVESTMENT MANAGEMENT

Daily Comment

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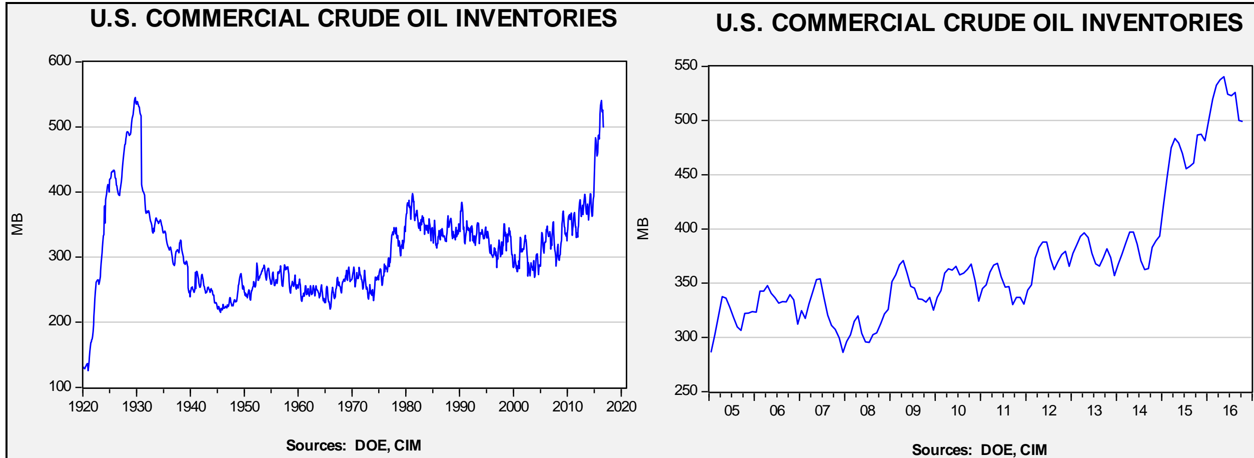
and Thomas Wash

[Posted: October 27, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading sideways from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 0.8% from the prior close. Chinese markets were down, with the Shanghai composite down 0.1% and the Shenzhen index down 0.1%. U.S. equity futures are signaling a higher opening. With 214 companies having reported, the S&P 500 Q3 earnings stand at $30.65, higher than the $29.62 forecast for the quarter. The forecast reflects a 2.0% decline from Q3 2015 earnings. Thus far this quarter, 75.2% of the companies reported earnings above forecast, while 18.7% reported earnings below forecast.

Belgian political leaders were able to overcome Walloon's opposition to the free trade deal with Canada and so, at the deadline, it looks like the agreement will be approved, assuming none of the other 27 nations decide to oppose the deal, too. Most of the opposition to the agreement with Canada is due to the creation of an arbitration body that would adjudicate regulatory differences between trading partners. For example, if a Canadian farmer wanted to sell GMO grain to a buyer in the EU in a nation that banned GMO grain, in theory, this panel could overrule the local law. The possibility that local regulations could be nullified by a foreign nation has become a major problem for not only this deal, but TPP and TTIP as well. We would not be surprised to see another member of the EU oppose this trade deal before it is signed. If it does pass, it may be the last one for a while unless President Obama is able to push TPP through during the lame duck session after the November elections.

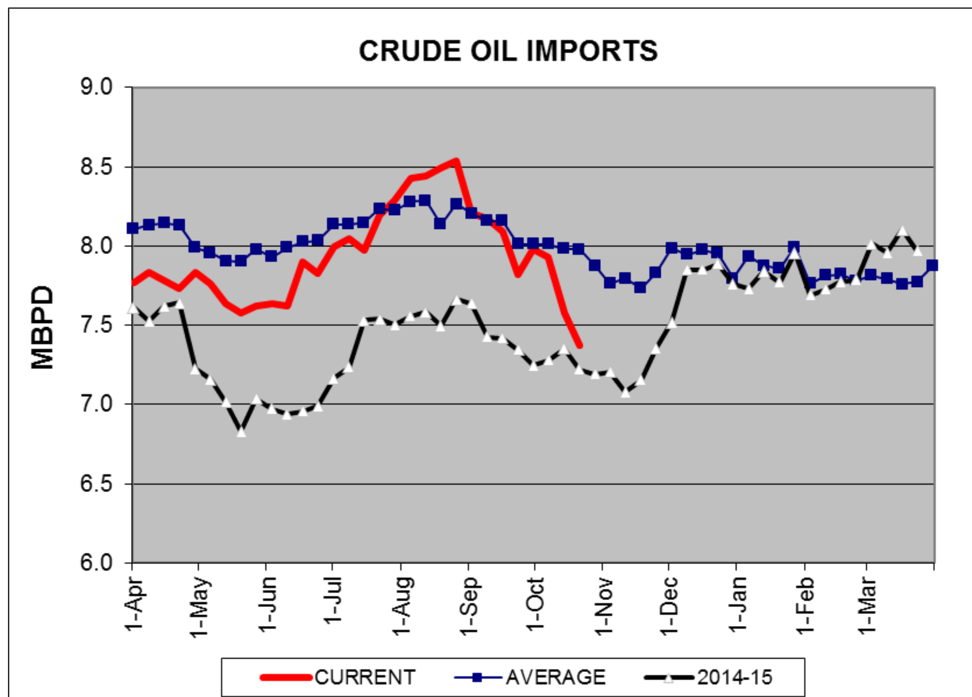
On a side note, there have been reports that a Russian naval battle group, which includes Russia's lone aircraft carrier, the decrepit RFS *Admiral Kuznetsov*, was denied a port of call at the Spanish Port of Ceuta. The Russian Navy wanted to use the port for refueling; NATO pressured Spain to deny access and Russia has apparently decided to withdraw its request. This move by Spain and Europe is a bit of a surprise as it shows an unexpected degree of unanimity for NATO against Russia. We will see if the Russian battle group can actually make it to Syria where it is expected that the RFS *Kuznetsov* will conduct air sorties against Syrian rebels.

U.S. crude oil inventories fell 0.6 mb compared to market expectations which called for a 1.3 mb build.



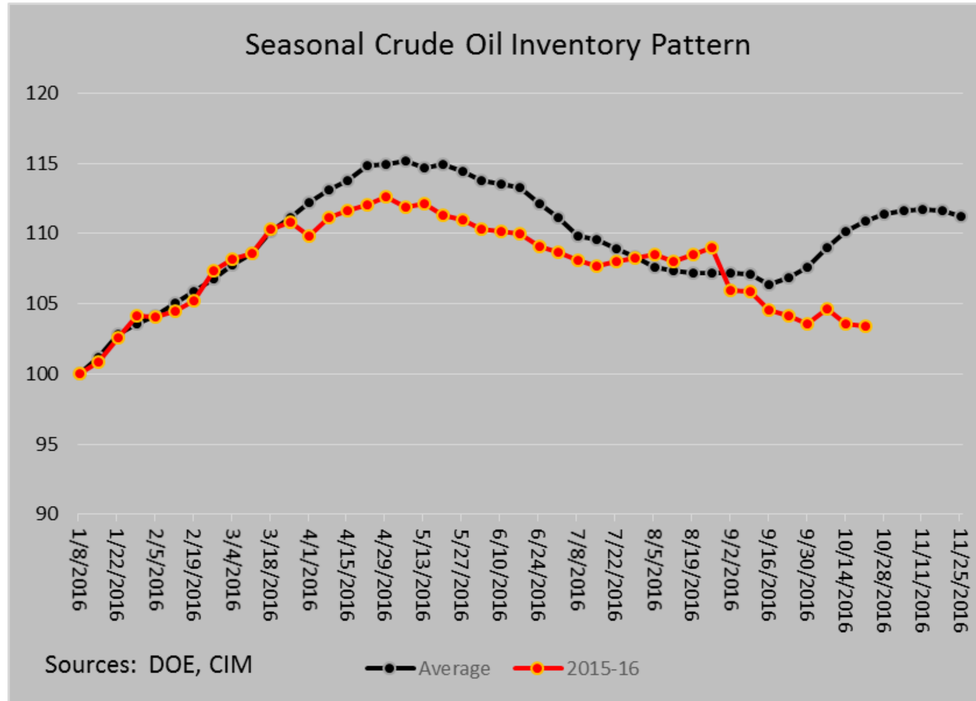
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart below shows, seasonally, we should see inventories rise as refineries undergo maintenance. But, even with the drop in refinery operations, inventories have steadily declined.

As the chart below shows, imports have declined sharply. Some of this is probably due to tropical storms which have affected shipping into the Gulf of Mexico. It is notable that Mexican and Venezuelan exports were down sharply last week. If this is the case, we may see a rebound as the tropical season comes to a close (the official end of hurricane season is Halloween).



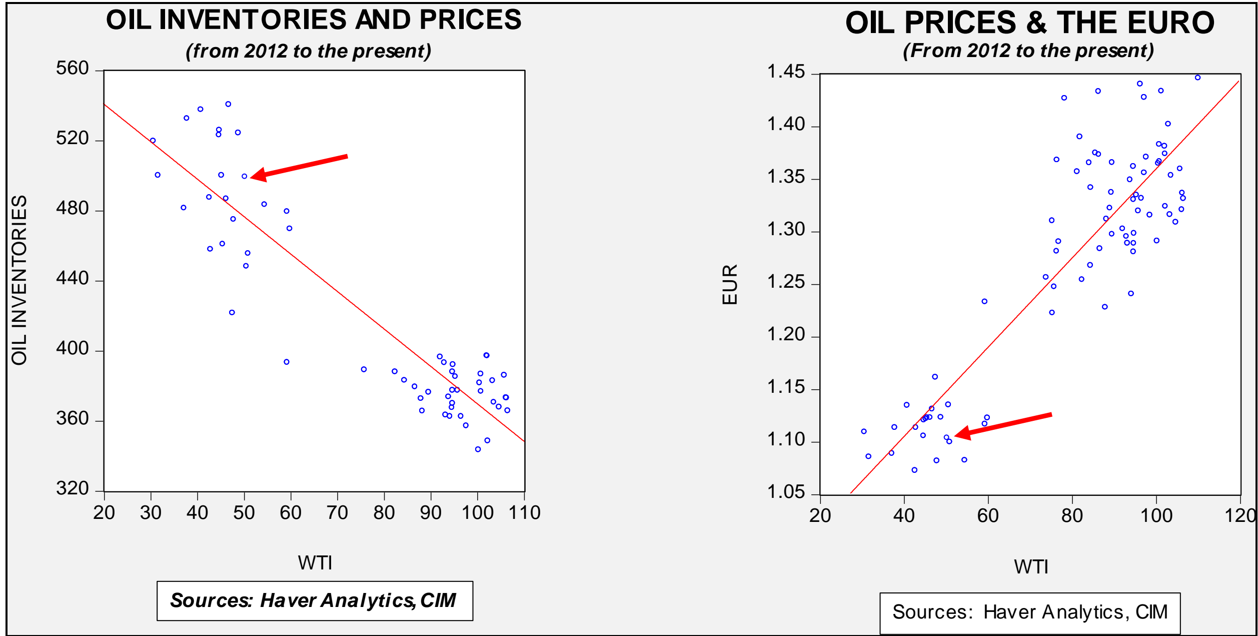
(Source: DOE, CIM)

As the chart below shows, the drop in imports has led to a contra-seasonal draw in oil inventories. If stocks don't rise in the coming weeks, it would be supportive for crude oil prices. However, if the drop in imports is due to hurricane season, we should see a rebound in inventories over the next few weeks.



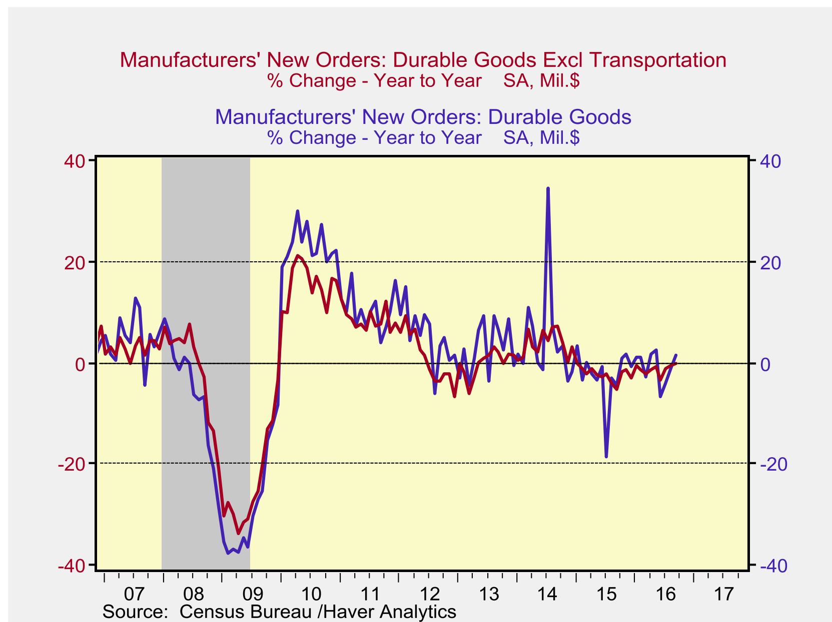
Based on inventories alone, oil prices are overvalued with the fair value price of $45.72. Meanwhile, the EUR/WTI model generates a fair value of $45.24. Together (which is a more sound methodology), fair value is $43.62, meaning that current prices are above fair value.[1] Most likely, the divergence from fair value is due to hopes of an OPEC deal that would boost prices. We are surprised to see oil hold its gains in the face of a rising dollar. The best explanation is that OPEC has engineered this price strength. However, this means that the oil market is quite vulnerable to any disappointment from the cartel.

[1] It also suggests some collinearity issues, in that the two independent variables applied together yield a lower price than what each generates separately. In fact, oil inventories and the euro are inversely correlated at -72.0% since 2012. Thus, the dollar's recent strength usually occurs with rising oil inventories. However, so far, this hasn't occurred, likely for the reasons noted above.



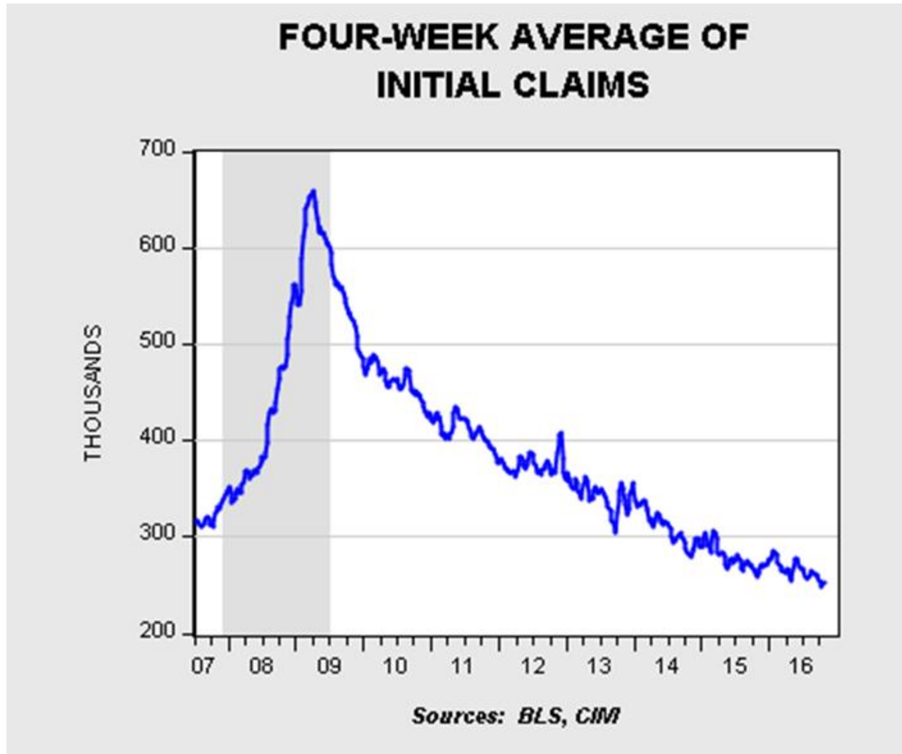
U.S. Economic Releases

September durable goods were lower by 0.1% from the month before compared to the zero growth forecast. The prior month's gains were revised lower to 0.3% from the 0.1% previously reported. Orders excluding transportation rose 0.4% in line with forecasts. Non-defense capital goods orders excluding airplane orders, a proxy for planned business investment, declined -1.2%, worse than the -0.1% decline forecast. At the same time, shipments of the same non-defense capital goods ex-air increased 0.3%, matching the 0.1% increase forecast.



The chart above shows the annual change in headline durable goods orders and orders excluding transportation. Annually, the trend remains weak but it has improved from the month before. Annually, new orders rose 1.0%, shipments fell 0.5%, inventories declined 1.7% and unfilled orders fell 1.7%.

This week, initial jobless claims were 258k, slightly above the forecast of 256k. The previous week's report was revised upward from 260k to 261k.



The chart above shows the four-week moving average of initial jobless claims. There seems to be an overall decline in jobless claims which suggests a strengthening labor market.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Consumer Comfort	y/y	oct		41.3	**
9:00	Pending Home Sales	y/y	oct	4.0%	4.0%	**
11:00	Kansas City Fed Manufactuing Activity	y/y	sep	3	6	**

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, which indicates the effect on the foreign market. Red indicates a concerning development, yellow indicates an emerging trend that we are following closely for possible complications and green indicates 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	Swift Global Payments	y/y	sep	2.0%	1.9%		**	Equity and bond neutral
	Industrial Profits	y/y	sep	7.7%	19.5%		**	Equity bearish, bond bullish
New Zealand	Trade Balance	y/y	sep	-1.436 bn	-1.265 bn	-1.145 bn	**	Equity bearish, bond bullish
	Exports	y/y	sep	3.47 bn	3.39	3.53	**	Equity bearish, bond bullish
	Imports	y/y	sep	4.9 bn	4.65	4.68	**	Equity bearish, bond bullish
Australia	Imports	y/y	3Q	-1.0%	-1.0%	-0.8%	**	Equity and bond neutral
	Exports	y/y	3Q	3.5%	1.4%	2.0%	**	Equity bullish, bond bearish
EUROPE								
Eurozone	M3 Money Supply	y/y	sep	5.0%	5.1%	5.1%	**	Equity and bond neutral
Italy	Economic Sentiment	y/y	oct	102.4	101		*	Equity bullish, bond bearish
	Manufacturing Confidence	y/y	oct	103	101.9	102.2	**	Equity bullish, bond bearish
	Consumer Confidence	y/y	oct	108	108.7	108.6	**	Equity and bond neutral
	Hourly Wages	y/y	sep	0.6%	0.6%		**	Equity and bond neutral
Switzerland	UBS Consumption Indicator	y/y	sep	1.59	1.53		**	Equity and bond neutral
AMERICAS								
Brazil	National Unemployment Rate	y/y	sep	11.8%	11.8%	11.9%	**	Equity and bond neutral
	Total Outstanding Loans	y/y	sep	94.77	91.808 bn	95.014 bn	**	Equity and bond neutral
Canada	CFIB Business Barometer	y/y	oct	57.7	59		**	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)	89	88	1	Up
3-mo T-bill yield (bps)	31	32	-1	Down
TED spread (bps)	58	56	2	Up
U.S. Libor/OIS spread (bps)	50	50	0	Neutral
10-yr T-note (%)	1.82	1.79	0	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	46	43	3	Up
Currencies	**Direction**			
dollar	down			Up
euro	up			Down
yen	down			Down
pound	down			Down
franc	up			Down

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	Explanation
Energy Markets				
Brent	$50.28	$49.98	0.60%	
WTI	$49.33	$49.18	0.31%	
Natural Gas	$2.74	$2.73	0.26%	
Crack Spread	$14.08	$13.96	0.85%	
12-mo strip crack	$15.47	$15.48	-0.08%	
Ethanol rack	$1.74	$1.74	0.13%	
Metals				
Gold	$1,268.52	$1,267.10	0.11%	
Silver	$17.67	$17.63	0.26%	
Copper contract	$216.00	$214.55	0.68%	
Grains				
Corn contract	$ 357.00	$ 354.00	0.85%	Price taking
Wheat contract	$ 415.75	$ 411.50	1.03%	
Soybeans contract	$ 1,025.75	$ 1,021.00	0.47%	
Shipping				
Baltic Dry Freight	802	813	-11	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-0.6	1.3	-1.9	
Gasoline (mb)	-2.0	-1	-1.0	
Distillates (mb)	-3.4	-1.5	-1.9	
Refinery run rates (%)	0.6%	0.6%	0.0	
Natural gas (bcf)	73.00	75.00	-2.0	

Weather

The 6-10 and 8-14 day forecasts are calling for warmer conditions for most of the country. Precipitation is forecast for the Midwest and western regions.

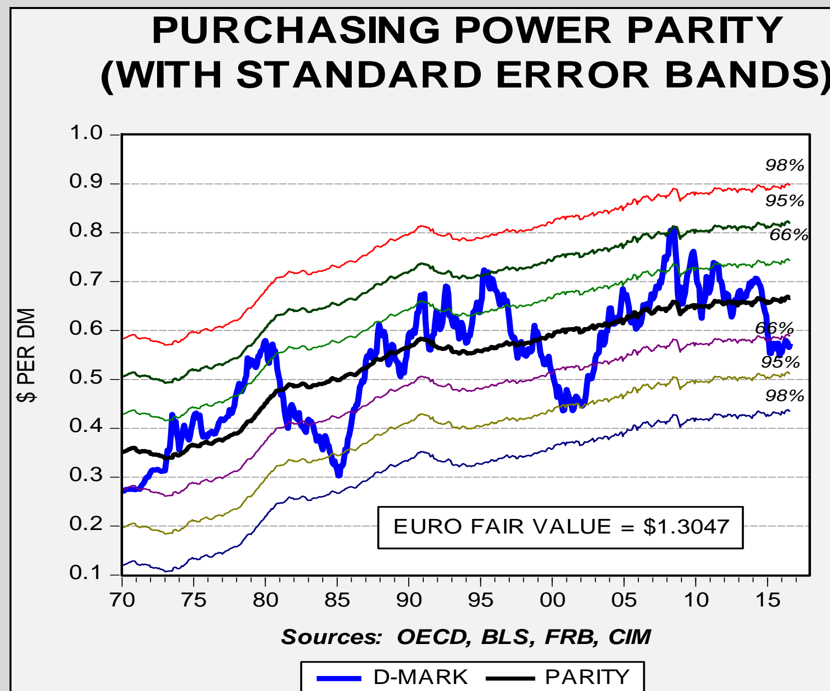
Asset Allocation Weekly Comment

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.

October 21, 2016

The dollar has been strengthening over the past few weeks; we believe much of this appreciation is due to expectations of tighter monetary policy. Fed funds futures suggest that there is a 60+% chance of a rate hike at the December FOMC meeting. Although the FOMC is divided and there are prominent doves that oppose any tightening, the consensus on the committee seems to be leaning toward a 25 bps increase. However, we also suspect that the next hike (following December) will be delayed for several months. In other words, to placate the doves on the FOMC, Chair Yellen will need to promise a very slow path; to satisfy the hawks, she will need to raise rates in December.

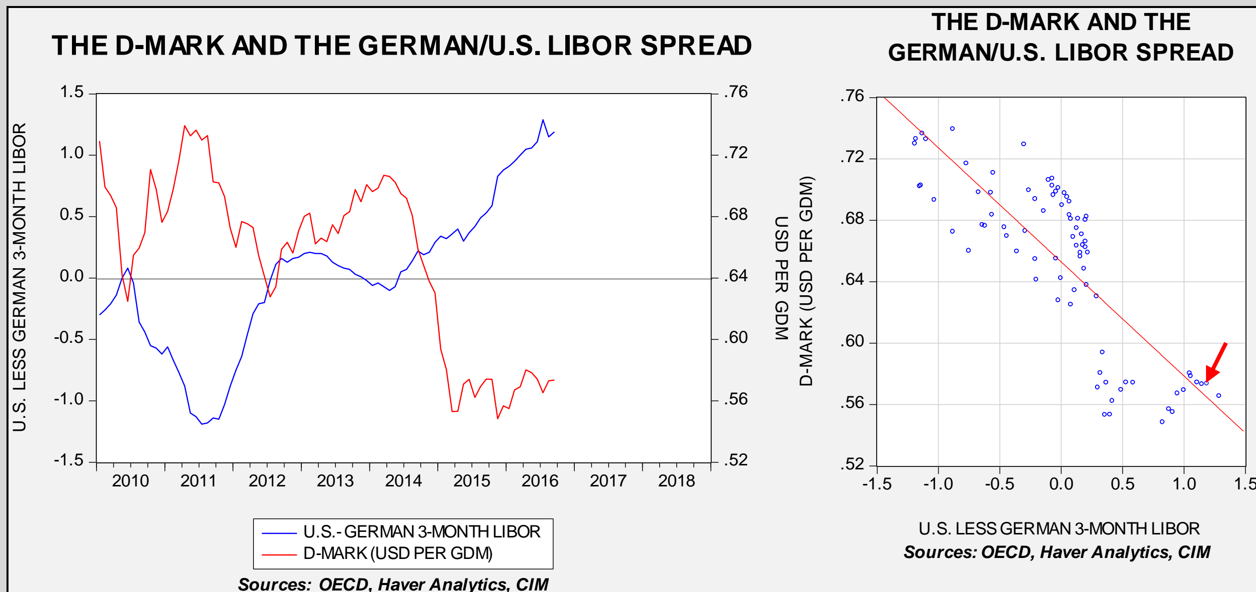
There are at least four different ways to value currencies—relative inflation, relative interest rates, trade performance and relative productivity. As a general rule, if any of the four performed consistently, the other three wouldn't exist. Of the four, relative inflation, so-called "purchasing power parity," is the oldest. Although most of the time it doesn't give strong signals, it does tend to indicate when a currency pair is at an extreme.



This chart shows the purchasing power parity relationship between the dollar and the D-mark. We use the legacy German currency and calculate its currency value based on its conversion rate at the time the euro was introduced. We do this for two reasons; first, we have a consistent inflation history with Germany, and second, Germany is the dominant economy in the Eurozone,

meaning the comparison with Germany is likely representative for the leading nations in the Eurozone. In our opinion, parity models are only useful at extremes. When the relationship becomes more than one standard error from parity, it tends to signal a problem with valuation. Currently, the dollar is overvalued by more than one standard error. There have only been two other periods when the dollar was stronger based on this measure. And, we note that this degree of overvaluation has been in place since January 2015, indicating it has been overvalued for a rather long time.

It appears that this deviation from fair value is due to divergent monetary policy. The spread between German and U.S. three-month LIBOR rates has widened in favor of the U.S.



These charts show the same data in two forms, a simple line graph and a scatter plot. In 2014, as the markets began to discount future FOMC tightening, the LIBOR rate began to rise modestly. At the same time, German rates fell sharply as the ECB tried to address deflation and weak economic growth; in fact, German three-month LIBOR remains in negative territory.

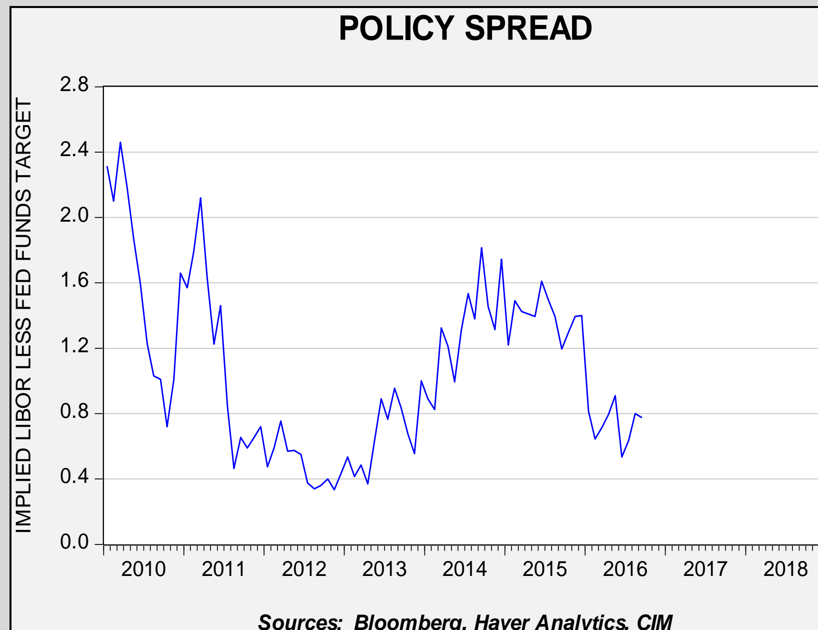
Although interest rate differentials are favoring the U.S., it is interesting to note that the explanatory power of interest rate differentials in the purchasing power parity model is modest at best. In other words, in relation to the past 36 years, the current spread in interest rates should not be having this degree of impact. The current spread is having an expanded impact mostly due to the current level of low rates.[2]

Complicating matters is that the U.S. three-month LIBOR rate has been rising due to changes in U.S. money market regulation. There has been a sustained exodus of liquidity out of institutional prime money market funds and this has led to higher three-month LIBOR rates. We doubt this

[2] Since 1970, the average spread between the U.S. and Germany is 69 bps, suggesting the current spread of 119 bps is rather wide. However the standard deviation is 235 bps, meaning the current spread is within the normal range.

level of LIBOR will be sustained over time, and so the U.S. side of the interest rate spread should ease. In addition, German LIBOR rates have been negative for the past few months. We doubt the ECB will maintain negative rates much longer and instead use QE for monetary stimulus. Thus, we would expect the spread to narrow in the coming weeks.

In addition, there has been a marked change in market expectations toward FOMC monetary policy.



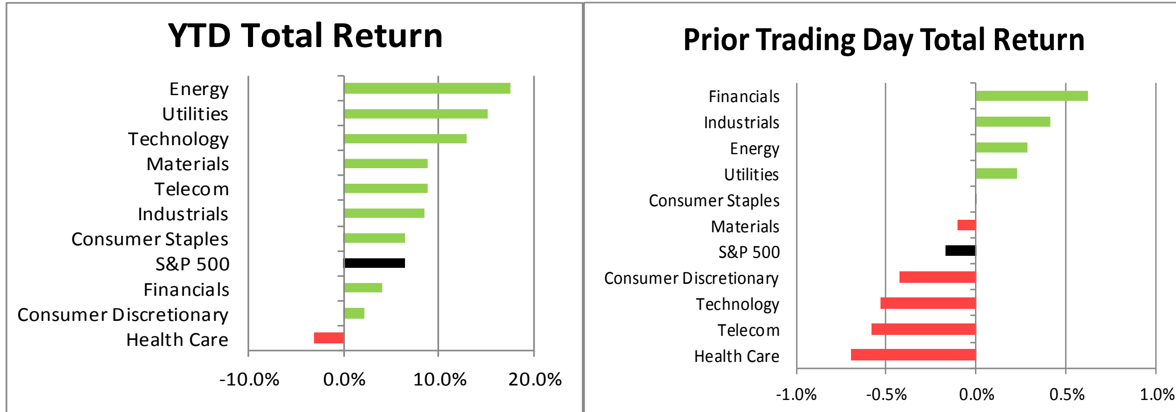
This chart shows the spread between the fed funds target and the two-year deferred Eurodollar futures contract. The latter shows the market's projection for future three-month LIBOR rates. For much of the past two years, Eurodollar futures were projecting a terminal rate for fed funds of 1.50%; that has now declined to around 75 bps. Simply put, the financial markets expect perhaps one or two more rate hikes over the next two years. If this is all we get, we would expect the rate differentials between Germany and the U.S. to steadily contract.

It is worth noting that the current strength of the dollar appears based on the policy spread in 2014-15. If so, once the market adjusts to a lower terminal fed funds target, we would expect some dollar weakness to develop. In the second half of next year, a USD/EUR of 1.25 (a USD/DMK of 0.6410) would be likely. A weaker dollar would be supportive for equities and commodities and bearish for debt and foreign equity markets, although this weakness would be partially offset by stronger foreign currencies. In addition, emerging equities usually strengthen relative to developed markets when the dollar weakens. Thus, in our asset allocation models, we have been slowly adding commodities and emerging equities to portfolios. If the dollar weakens in 2017, we would likely build on these initial positions.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

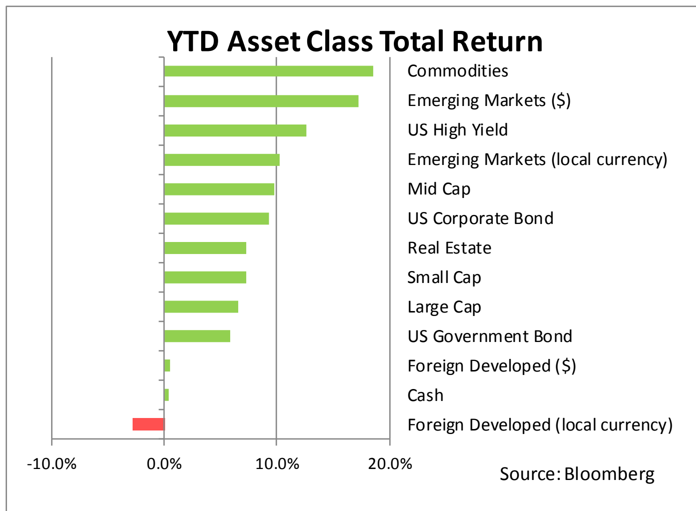
U.S. Equity Markets – (as of 10/26/2016 close)



(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 10/26/2016 close)

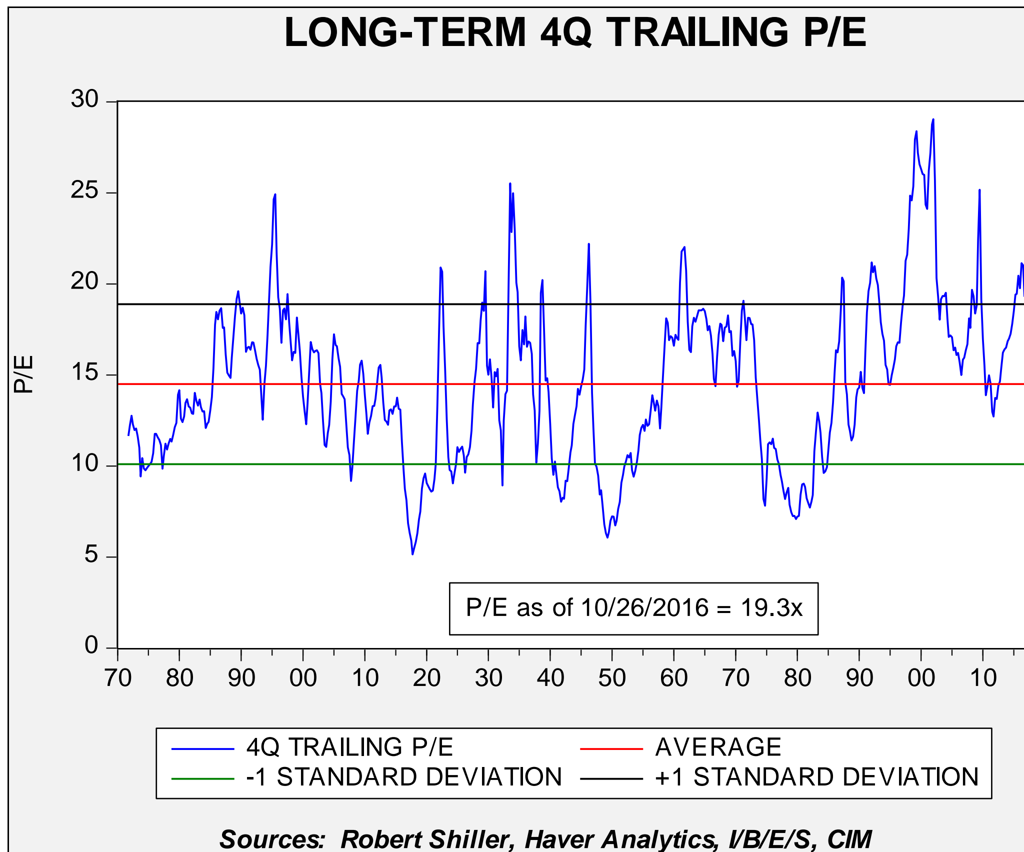


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

October 27, 2016



Based on our methodology,[3] the current P/E is 19.3x, down 0.1x from last week. Better earnings reports are the cause of the decline in the P/E.

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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[3] 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 (Q1 and Q2) and two estimates (Q3 and Q4). 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.