Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: September 15, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading lower by 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 0.2% from the prior close. Chinese markets were closed today. U.S. equity futures are signaling a higher opening from the previous close.

The big overnight news was the BOE's decision to hold rates and bond-buying steady, which was expected. The committee vote was 9-0 in favor of the current policy. The bank did indicate, however, that it was still on course to lower rates later this year and this news caused a modest selloff in the GBP. Although the British economy didn't collapse as some feared it would after Brexit, we believe the longer term situation is still rather negative in the wake of the referendum.

In other news, Italy's PM Renzi says he will announce the date for the upcoming referendum on government restructuring on September 26. This restructuring is seen as a "make or break" moment for Italy. The referendum would streamline the Italian government by reducing the power of the upper house and allowing policy to be more easily implemented. Renzi, who was not elected to the PM post, says he will resign if the referendum fails. The fear is that if the referendum does not pass, populist forces that may support Italy's exit from the Eurozone could become ascendant.

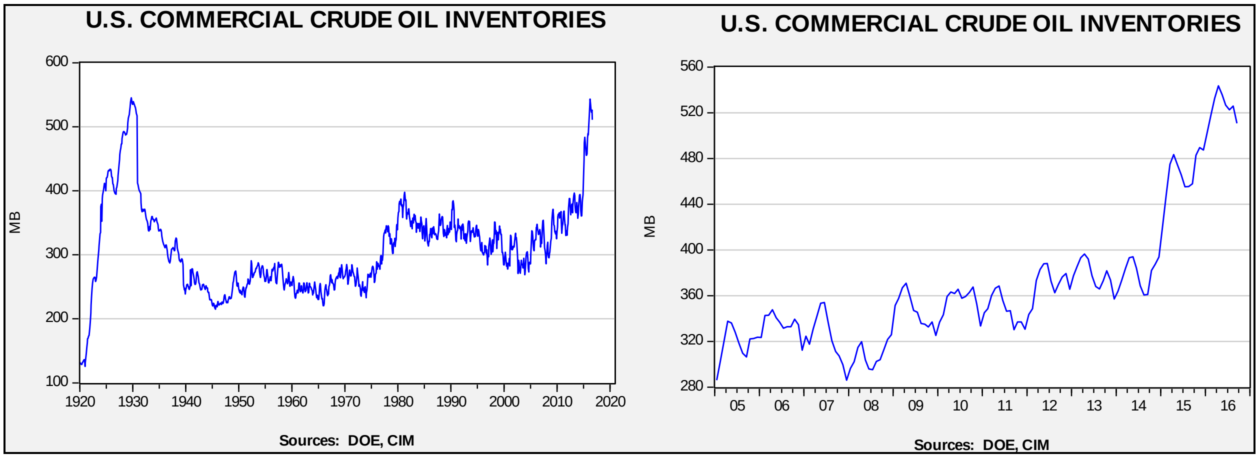
We note that EU President Jean-Claude Juncker gave a talk yesterday in which he admitted that the EU is facing an "existential crisis," suggesting there is little common ground between members and governments are facing nationalist and populist threats that undermine European unity. From Brexit to the weakening of Chancellor Merkel's party in recent elections, Europe is likely facing a crisis.

The U.S. pivot to Asia took a couple of hits this week. First, the mercurial president of the Philippines, Rodrigo Duterte,[1] said today that "China is now in power, and they have military superiority in the region." Duterte announced the end of joint U.S./Philippine naval patrols in the South China Sea and expelled U.S. forces from Mindanao, an island region of the country. U.S./Thai relations have become strained after the Obama administration criticized the current military leadership that has controlled Thailand since the 2014 coup. In retaliation, Thailand announced it will buy three submarines from China. Meanwhile, China is showing investment on Laos and is working to improve relations with the new Myanmar government. Although one does not want to jump to conclusions, this information seems to be signaling that some of South Asia's governments are seeing China as the new regional power and are beginning to accommodate the Middle Kingdom. We suspect they would prefer U.S. hegemony but fear that

[1] Duterte recently referred to President Obama in crude and derogatory terms.

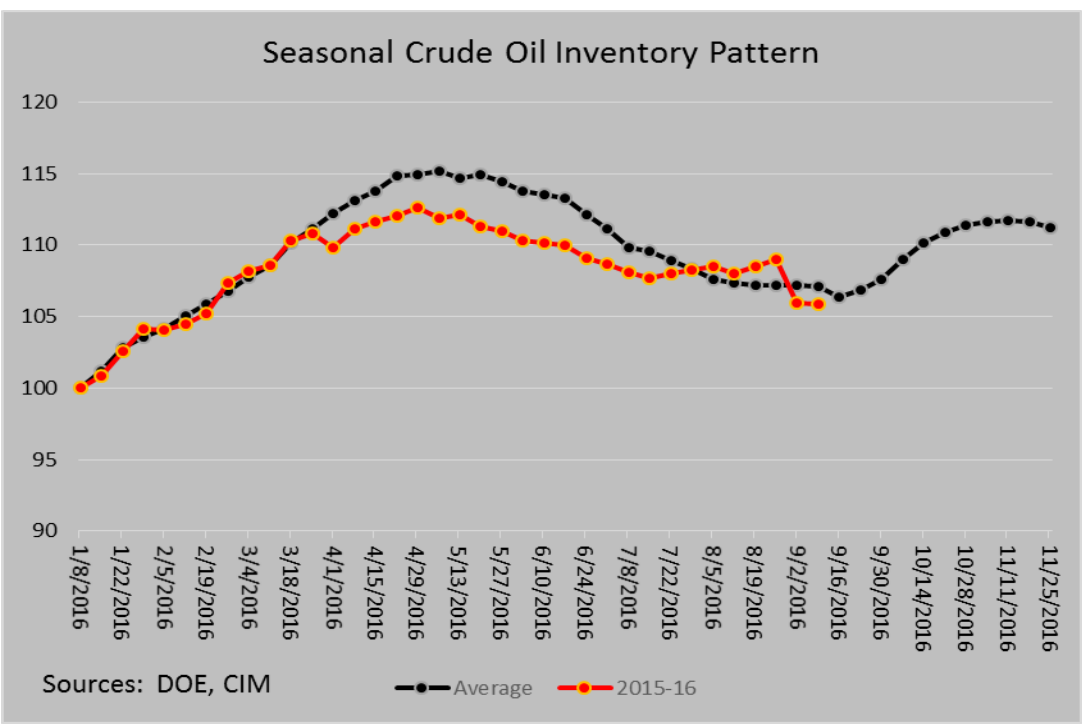
America is giving up on its superpower role. Thus, these nations are simply preparing for a new environment.

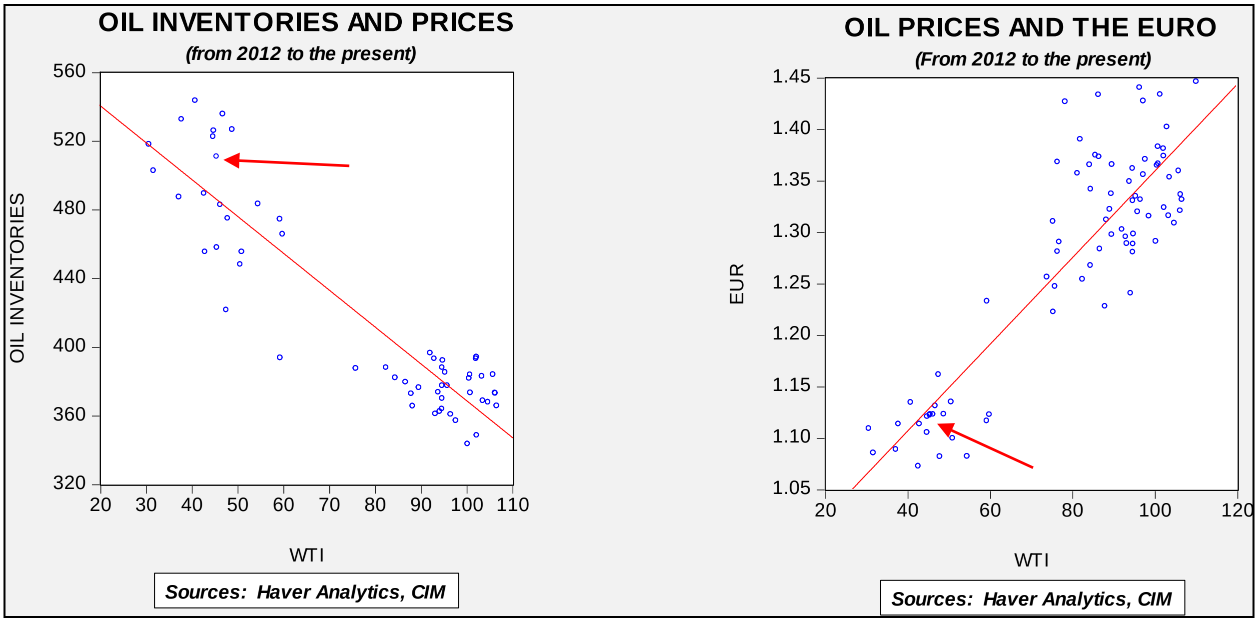
U.S. crude oil inventories fell 0.6 mb compared to market expectations of a 2.8 mb build.



This chart shows current crude oil inventories, both over the long term and the last decade. We saw a huge 14.5 mb draw in crude stocks the previous week, which was mostly due to import disruptions caused by tropical storms. About half of the oil imports returned to the market last week. We would expect a rebound next week as imports normalize.

The unexpected drop in storage has put inventories below the normal seasonal trend. Again, we would expect that drop to be reversed in the coming weeks.

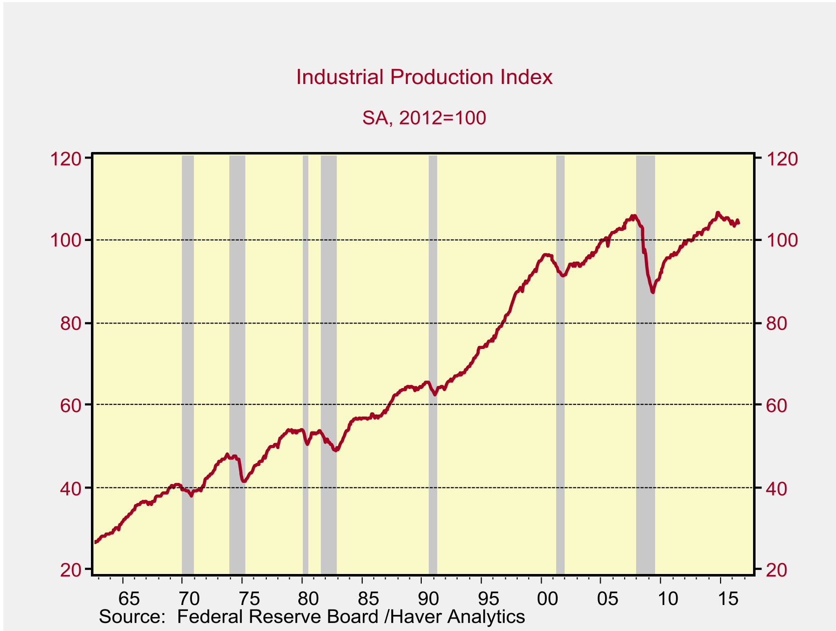




Based on inventories alone, oil prices are overvalued with the fair value price of $41.07. Meanwhile, the EUR/WTI model generates a fair value of $49.30. Together (which is a more sound methodology), fair value is $44.67, meaning that current prices are a bit cheap. Although the market has put great hope on an OPEC deal next month, the plan looks to be more like jawboning the market higher. For now, oil prices are mostly marking time before OPEC meets on the 26th. We were somewhat surprised that oil prices fell off of yesterday's unexpected draw, but expectations of rising inventories in the wake of the aforementioned drawdown are likely the reason. In addition, reports yesterday that oil loadings will begin soon in two troubled areas, Libya and Nigeria, are also bearish factors.

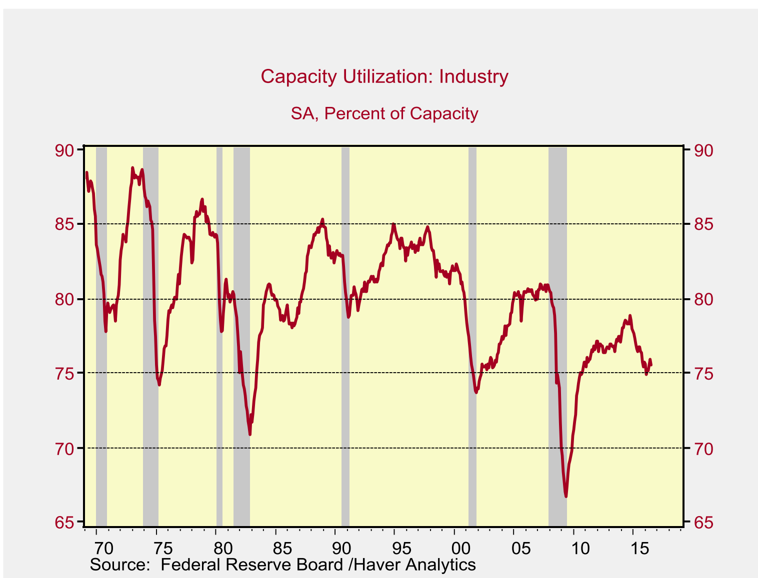
U.S. Economic Releases

Industrial production came in weaker than forecast, falling 0.4% in August compared to the 0.2% decline expected. Additionally, July gains were revised slightly lower to 0.6% from the 0.7% previously reported.



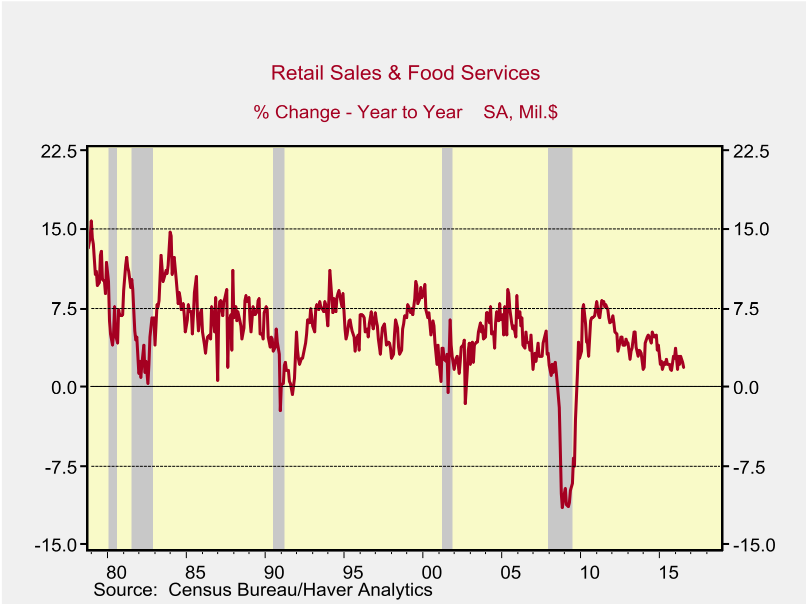
The chart above shows the industrial production index, which has been generally trending lower to sideways over the past two years.

Capacity utilization also fell to 75.5% from 75.9%, weaker than the 75.7% expected.



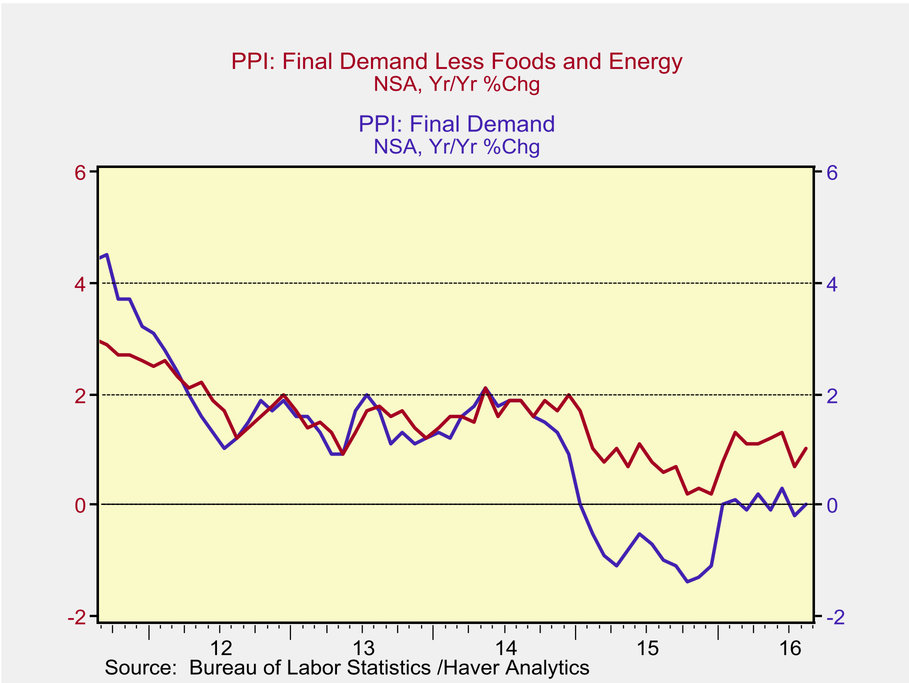
The chart above shows the level of capacity utilization. Capacity remains ample.

Retail sales came in weaker than forecast for August, falling 0.3% from the month before compared to the 0.1% decline expected. Sales excluding autos fell 0.1%, also weaker than the 0.2% increase forecast. Sales excluding autos and gas were also weak, falling 0.1% compared to the 0.3% increase forecast. The weakest sales came from motor vehicle, building materials, sporting goods and gasoline station sales. The strongest gains came from restaurant, food/beverage and clothing sales.



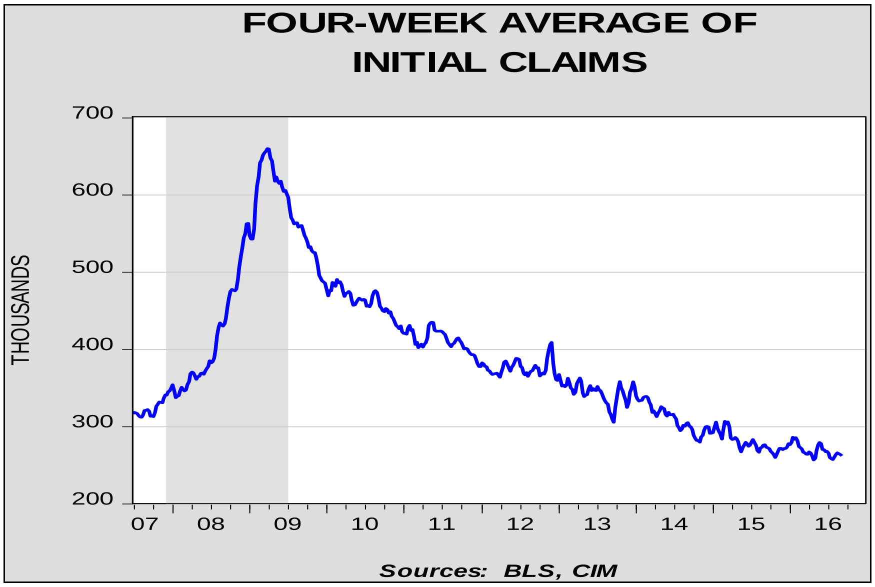
The chart above shows the annual change in retail sales. In general, the pace of gains has been slowing recently.

Producer prices remained unchanged in August, weaker than the 0.1% increase forecast. PPI excluding food, energy and trade rose 0.3% for the month, more than the 0.1% increase forecast.



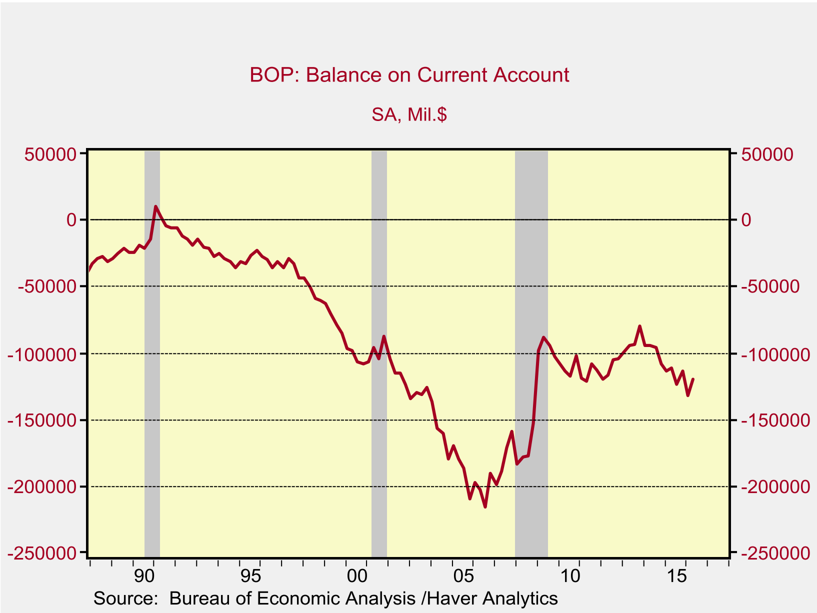
The chart above shows the annual change in producer prices. Annually, the headline prices remained unchanged, less than the 0.1% increase forecast.

Initial claims rose 1k to 260k compared to the 265k level forecast. Claims remain near four-decade lows.



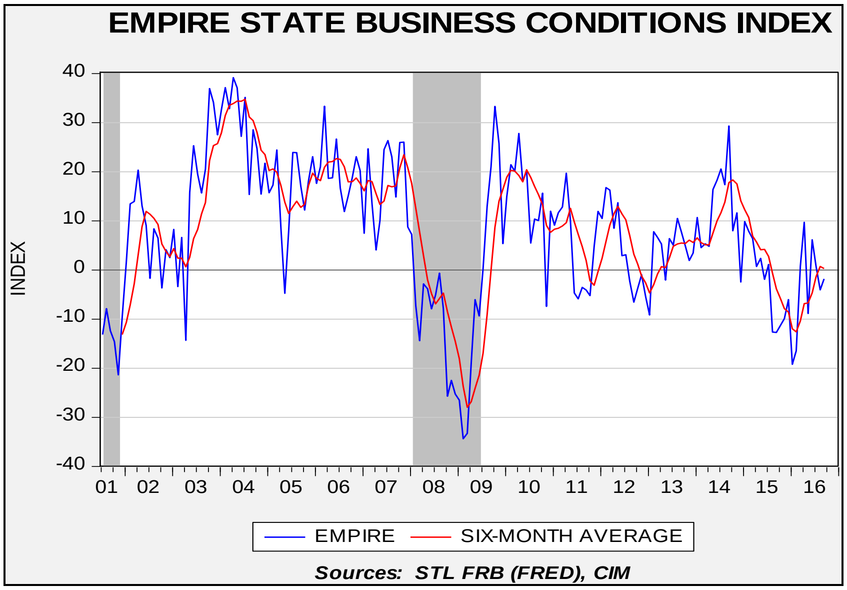
The chart above shows the four-week average of claims, which remained unchanged at 261k.

The current account deficit for Q2 narrowed to $119.9 bn from $131.8 bn the quarter before, narrower than the $121.0 bn deficit forecast.



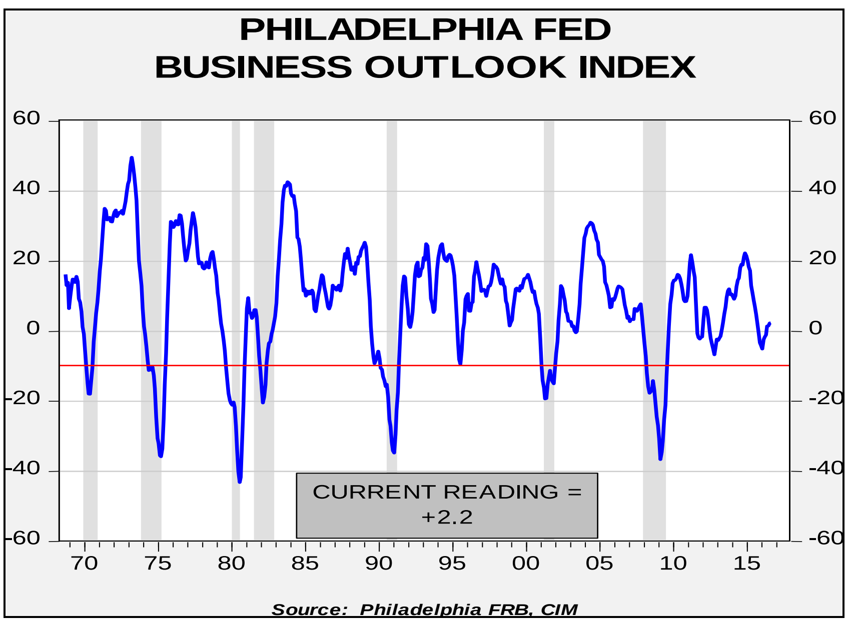
The chart above shows the level of the current account balance. Over the past two years, the deficit has widened, although it has been choppy since the beginning of the year.

The Empire State manufacturing index for September came in weaker than forecast, at -1.99 compared to estimates of -1.00.



The six-month moving average has recovered to zero, consistent with weak growth but no recession.

The Philadelphia FRB business outlook index for September came in much better than forecast, at 12.8 compared to expectations of 1.0.



We smooth this data with a six-month average as well. Although the data did come in better than expected, the smoothed data shows a reading just above zero. Again, this is consistent with a slow growth, low inflation, non-recessionary economy.

The table below shows the releases and Fed speakers scheduled for the rest of the day.

Economic releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Business inventories	m/m	Jul	0.1%	0.2%	**

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								
Australia	Unemployment rate	m/m	Aug	5.6%	5.7%	5.7%	***	Equity bullish, bond bearish
India	Trade balance	m/m	Aug	-$7.7 bn	-$7.8 bn	-$7.0 bn	**	Equity and bond neutral
	Imports	y/y	Aug	-14.1%	-19.0%		**	Equity and bond neutral
	Exports	y/y	Aug	-0.3%	-6.8%		**	Equity and bond neutral
EUROPE								
Eurozone	Trade balance	m/m	Jul	€20.0 bn	€23.8 bn	€22.0 bn	**	Equity bearish, bond bullish
	CPI	y/y	Aug	0.2%	0.2%	0.2%	***	Equity and bond neutral

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)	85	86	-1	Down
3-mo T-bill yield (bps)	29	32	-3	Down
TED spread (bps)	57	54	3	Up
U.S. Libor/OIS spread (bps)	44	44	0	Neutral
10-yr T-note (%)	1.68	1.70	-0.02	Narrowing
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	29	29	0	Neutral
Currencies	**Direction**			
dollar	up			Up
euro	up			Neutral
yen	down			Down
pound	down			Down
franc	up			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of England rate	0.25%	0.25%	0.25%	On forecast

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	$46.26	$45.85	0.89%	Domestic inventories expected to fall
WTI	$43.89	$43.58	0.71%	
Natural Gas	$2.89	$2.89	0.07%	
Crack Spread	$14.43	$13.89	3.95%	
12-mo strip crack	$13.91	$13.65	1.88%	
Ethanol rack	$1.64	$1.64	-0.10%	
Metals				
Gold	$1,323.32	$1,322.94	0.03%	Higher dollar
Silver	$19.06	$18.96	0.54%	
Copper contract	$214.95	$215.50	-0.26%	Demand concerns
Grains				
Corn contract	$ 331.75	$ 331.75	0.00%	
Wheat contract	$ 404.00	$ 403.00	0.25%	
Soybeans contract	$ 946.00	$ 942.75	0.34%	
Shipping				
Baltic Dry Freight	756	796	-40	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-0.6	2.8	3.4	
Gasoline (mb)	0.6	-0.6	-1.2	
Distillates (mb)	4.6	1.3	-3.3	
Refinery run rates (%)	-0.8%	-0.4%	0.4%	
Natural gas (bcf)		58.9		

Weather

The 6-10 and 8-14 day forecasts are calling for warmer conditions for all of the country. Precipitation is forecast for the eastern half of the country. Tropical Storm Julia made landfall in Georgia and is expected to slow as it moves inland. Tropical Storm Ian is located in the mid-Atlantic and is expected to slow as it moves north. Tropical Depression Twelve has formed off the coast of Africa. This development has a high chance of becoming a cyclone over the next two days. A small low pressure area has formed in the Gulf of Mexico. This development has a low chance of becoming a cyclone over the next two days. We note that the average peak in tropical storm development is September 10, so we should see fewer storms as the weeks pass.

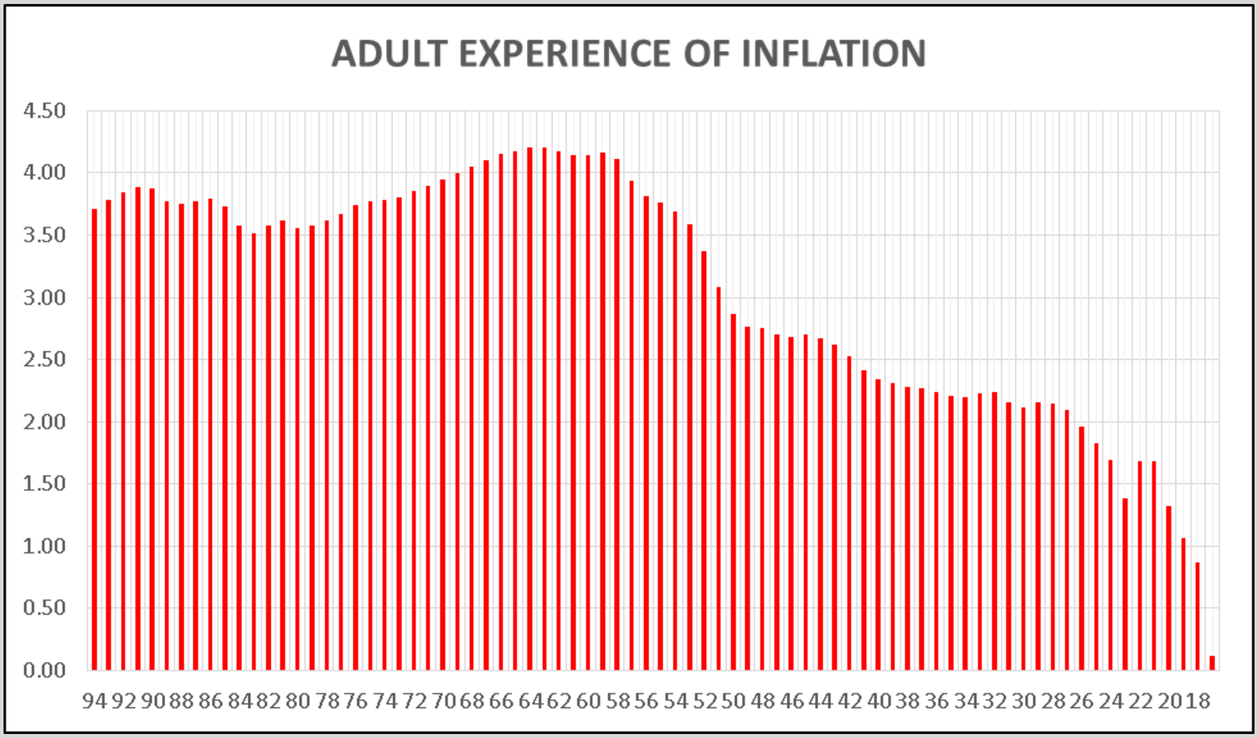
Asset Allocation Weekly Comment

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.

September 9, 2016

Milton Friedman postulated that inflation expectations are established through a lifetime of experience. To some extent, the issue of inflation expectations is similar to other market gauges in our lives, such as the level of financial markets, interest rates and home prices. What we have experienced is considered as "normal" in our lives. Behavioral economists call this anchoring; it's where we believe levels "should be" based on our experience.

To get a feeling for this, we calculated the adult experience of inflation, looking at ages 16 to 94.



(Sources: Haver Analytics, CIM)

We have presented the "lifetime" experience of inflation on several occasions in the past. However, on this chart, we omit the data related to the first 16 years of an individual's life on the assumption that children are less aware of inflation than adults. The difference is interesting. Essentially, Americans with the highest experience of inflation are in their late 50s and early 60s. By age 50, which is 34 years of inflation experience, the average inflation experience falls below 3%. And, by age 26, the average falls under 2%.

It makes sense that current policymakers are concerned about inflation. Vice Chairman Stanley Fischer is 73, while the youngest member of the FOMC, Neil Kashkari, is 43.[2] The allocation of hawks and doves doesn't seem to follow an age pattern. In fact, the most important factor to determine policy stance is permanent voting members versus rotating voter members. The NY FRB president and the five governors, all permanent voting members, are moderates to doves. All the hawks are other regional FRB presidents who are rotating voters. But, the fact that the "dots" chart mostly shows high future rate levels does suggest that nearly all the FOMC members expect some degree of normalization. This is consistent with the adult inflation experience for the ages of the members.

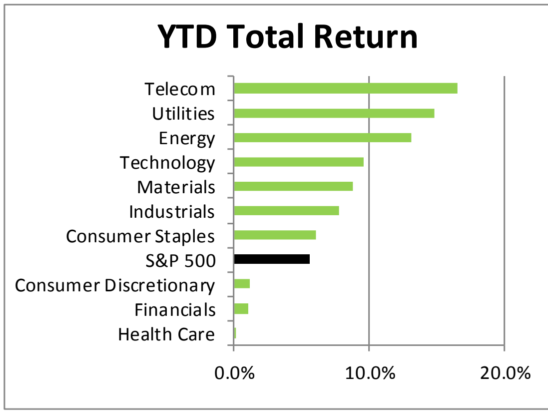
The other factor this chart highlights is the expectations of investors. Older investors are likely more concerned about inflation because they have experienced it. As time wears on, the odds of inflation-inducing policy become lower because fears of it should decline. However, we would not expect this to become an issue for at least another decade. Thus, fears of rising long-term rates and duration risk are probably overestimated, for now.

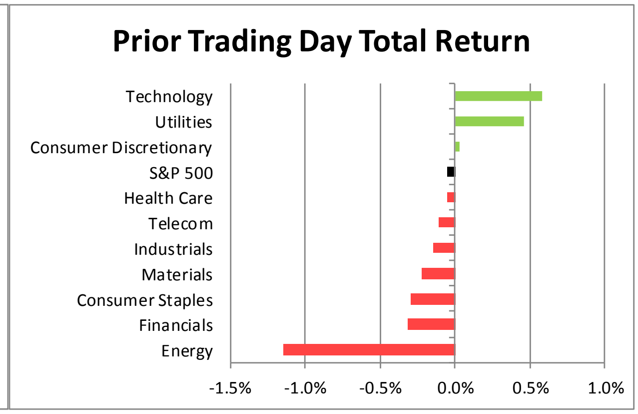
Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors 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.

[2] The current age breakdown for FOMC voting and alternate members is as follows: ages 40-44: 1 member, ages 45-49: 0 members, ages 50-54: 3 members, ages 55-59: 5 members, ages 60-64: 4 members, ages 65-69: 0 members, ages 70-74: 2 members.

Data Section

U.S. Equity Markets – (as of 9/14/2016 close)

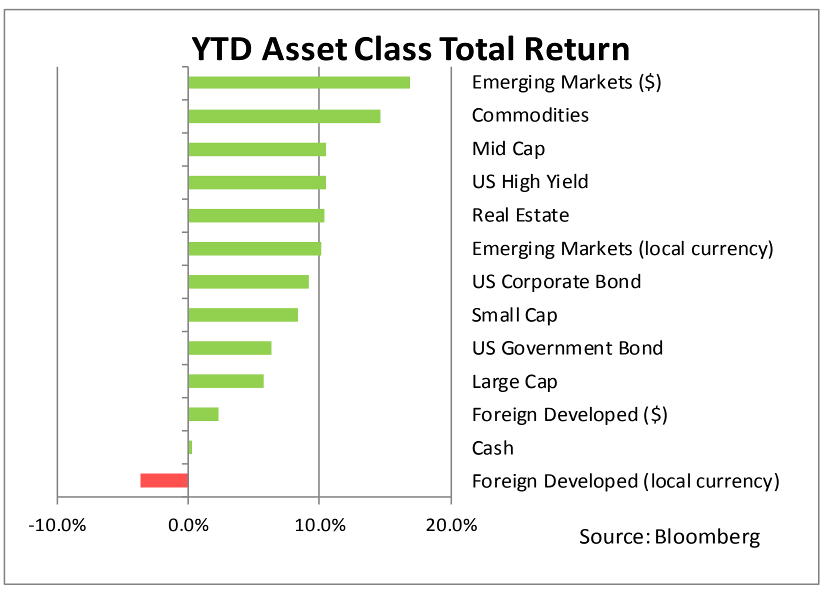




(Source: Bloomberg)

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 9/14/2016 close)

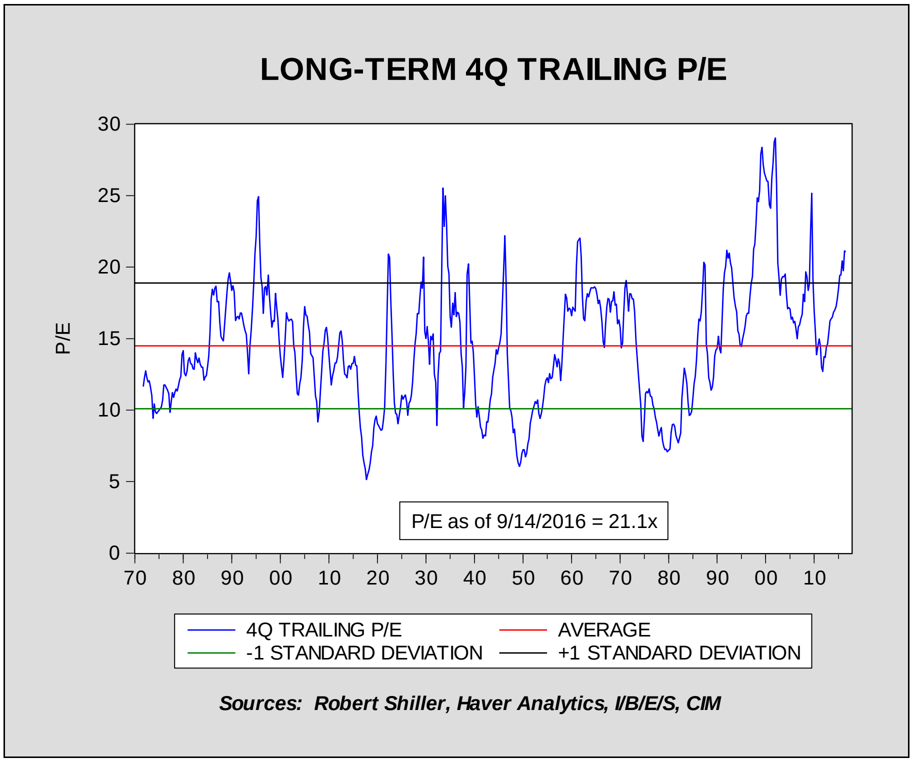


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

September 15, 2016



Based on our methodology,[3] the current P/E is 21.1x, up 0.6x from last week. As we adjust from Thomson-Reuters to S&P data for earnings, the latter number is lower, which is leading to the higher 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.

[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 (Q4 and Q1) and two estimate (Q2 and Q3). 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.