By Bill O'Grady & Kaisa Stucke, CFA

[Posted: September 1, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading higher by 0.9% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 0.3% from the prior close. Chinese markets were also lower, with the Shanghai composite down 0.7% and the Shenzhen index lower by 0.8%. U.S. equity futures are signaling a higher opening from the previous close.

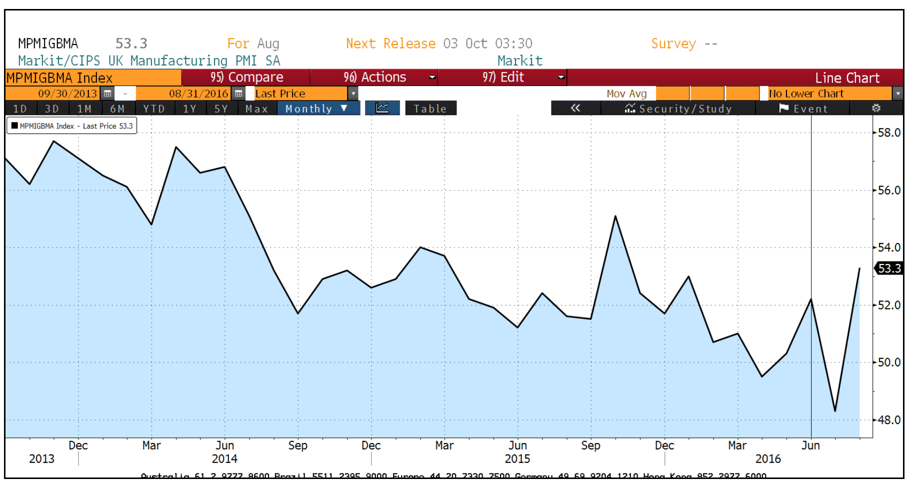
It's global manufacturing PMI day (see Foreign Economic News section for full data table). China's official PMI came in better than expected, crossing into expansionary territory with a reading above 50. At the same time, China's Caixin PMI reading came in slightly below expectations but remained right at 50, indicating expectations of neutral growth (no expansion or contraction). Below is the historical chart for the two Chinese PMIs. In general, the official PMI tends to be more stable, while the Caixin has produced lower readings for the country's manufacturing. The good news is that although the Caixin reading showed a generally contracting manufacturing sector for most of last year, both gauges show a manufacturing rebound over the past two months.

(Source: Bloomberg)

The yuan advanced for the fifth day on relatively strong PMI data, but also on speculation that the PBOC has been supporting the currency ahead of the G-20 meeting. The chart below shows the one-year move in the yuan. Although the currency has weakened since the end of last year, speculation is that the central bank does not want the currency to weaken further from its current level ahead of the G-20 meeting. However, the policy is likely to change later in September.

(Source: Bloomberg)

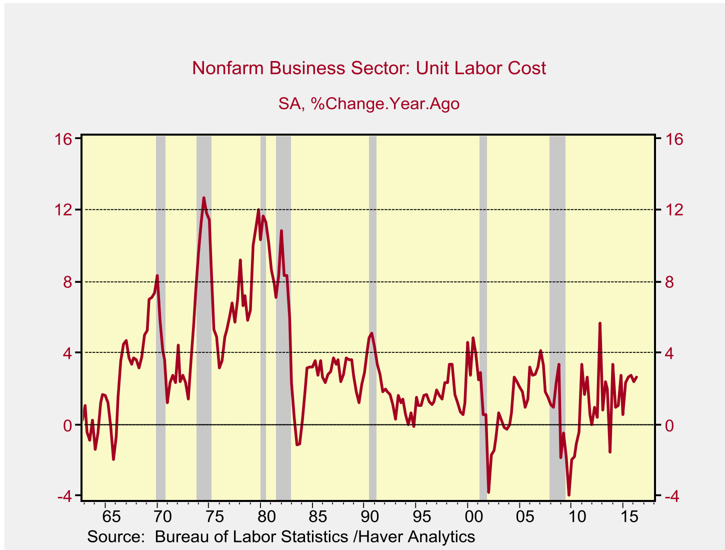
The U.K. also saw a strong rebound in its manufacturing PMI in August following a relatively weak reading in July. The stronger than expected PMI reading helps dissipate post-Brexit worries and indicates that the country can grow even amidst the prospect of leaving the EU. We have drawn a vertical line on the chart below at the Brexit vote date. The subsequent PMI reading in July had plunged to a contractionary level of 48.3, but rebounded strongly to 53.3 in August.



(Source: Bloomberg)

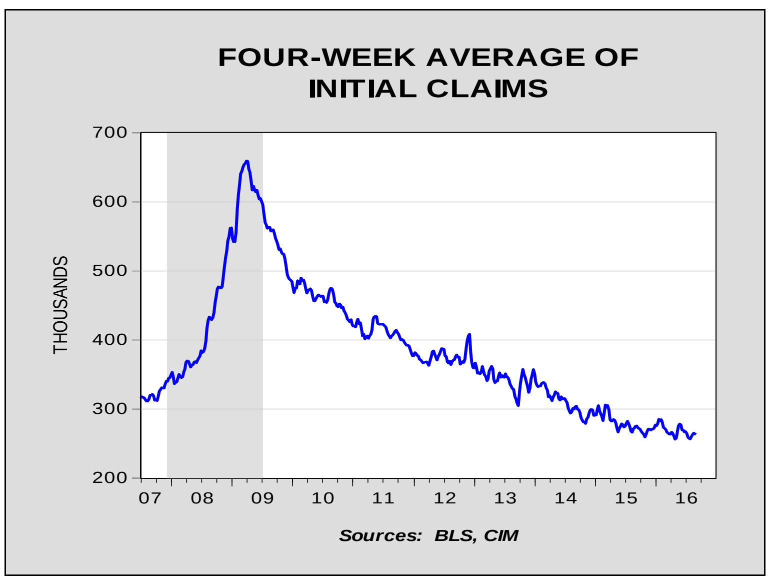
U.S. Economic Releases

Nonfarm productivity fell 0.6% in Q2, on forecast. Unit labor costs rose 4.3%, much higher than the 2.1% forecast.



The chart above shows the yearly change in unit labor costs, which increased 2.6% annually. We are starting to see a modest acceleration of wage growth.

Initial claims came in a little better than forecast, rising 2k to 263k compared to the 265k forecast. Claims have remained below 300k since March 2015.



The chart above shows the four-week average of claims, which declined 1k to 263k. The labor market is looking healthy from a claims standpoint.

The Challenger job cuts index fell 21.8% from the year before. The index measures the number of announced job cuts by employers, which is a proxy for future layoffs but does not necessarily indicate the state of current layoffs. Still, the large decline in planned layoffs adds to evidence of a strengthening labor market.

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

Economic releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Manufacturing PMI (Markit)	m/m	Aug	52.1	52.1	**
10:00	ISM manufacturing	m/m	Aug	52.0	52.6	**
10:00	Construction spending	m/m	Jul	0.5%	-0.6%	*
TBD	Wards domestic vehicle sales	m/m	Aug	13.5 m	13.8 m	**
TBD	Wards total vehicle sales	m/m	Aug	17.2 m	17.8 m	**
Fed speakers or events						
EST	Speaker or event	District or position				
12:25	Mester	Cleveland 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 (official)	m/m	Aug	50.4	49.9	49.8	**	Equity bullish, bond bullish
	Manufacturing PMI (Caixin)	m/m	Aug	50.0	50.6	50.1	**	Equity and bond neutral
	Non-manufacturing PMI	m/m	Aug	53.5	53.9		*	Equity bullish, bond bullish
India	Manufacturing PMI (Nikkei)	m/m	Aug	52.6	51.8		**	Equity bullish, bond bullish
Japan	Manufacturing PMI (Nikkei)	m/m	Aug	49.5	49.6		**	Equity bearish, bond bullish
	Vehicle sales	y/y	Aug	5.7%	-0.2%		**	Equity bullish, bond bullish
EUROPE								
Eurozone	Manufacturing PMI (Markit)	m/m	Aug	51.7	51.8	51.8	**	Equity and bond neutral
France	Manufacturing PMI (Markit)	m/m	Aug	48.3	48.5	48.5	**	Equity bearish, bond bullish
Germany	Manufacturing PMI (Markit)	m/m	Aug	53.6	53.6	53.6	**	Equity and bond neutral
Italy	Manufacturing PMI (Markit)	m/m	Aug	49.8	51.2	51.2	**	Equity bearish, bond bullish
U.K.	Manufacturing PMI (Markit)	m/m	Aug	53.3	48.3	49.0	**	Equity bullish, bond bullish
Switzerland	Manufacturing PMI (Markit)	m/m	Aug	51.0	50.1	50.6	**	Equity bullish, bond bullish
	Retail sales	m/m	Jul	-2.2%	-3.5%		**	Equity bearish, bond bullish
Russia	Manufacturing PMI (Markit)	m/m	Aug	50.8	49.5	50.1	**	Equity bullish, 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)	84	83	1	Up
3-mo T-bill yield (bps)	33	33	0	Neutral
TED spread (bps)	52	51	1	Up
U.S. Libor/OIS spread (bps)	46	46	0	Neutral
10-yr T-note (%)	1.59	1.58	0.01	Widening
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	42	40	2	Up
Currencies	**Direction**			
dollar	up			Up
euro	down			Neutral
yen	down			Down
pound	up			Down
franc	down			Neutral

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	$46.78	$46.89	-0.23%	Ample global supplies
WTI	$44.63	$44.70	-0.16%	
Natural Gas	$2.87	$2.89	-0.62%	
Crack Spread	$12.35	$12.60	-1.94%	
12-mo strip crack	$13.29	$13.41	-0.92%	
Ethanol rack	$1.56	$1.56	-0.12%	
Metals				
Gold	$1,306.07	$1,308.97	-0.22%	Fed outlook
Silver	$18.65	$18.66	-0.03%	
Copper contract	$208.60	$207.75	0.41%	Possible Chile supply disruption, but ample global supplies remain
Grains				
Corn contract	$ 318.25	$ 315.50	0.87%	
Wheat contract	$ 394.00	$ 388.25	1.48%	
Soybeans contract	$ 946.50	$ 943.00	0.37%	
Shipping				
Baltic Dry Freight	711	715	-4	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	2.3	0.8	1.5	
Gasoline (mb)	-0.7	-1.0	0.3	
Distillates (mb)	1.5	-0.2	1.7	
Refinery run rates (%)	0.3%	-0.6%	0.9%	
Natural gas (bcf)		42.0		

Weather

The 6-10 and 8-14 day forecasts are calling for warmer conditions for the eastern two-thirds of the country. Precipitation is forecast for the middle of the country. Hurricane Gaston is moving east from its current location in the mid-Atlantic. Tropical Storm Hermine is moving northeast from its current location in the eastern Gulf of Mexico. TS Hermine is expected to make landfall in Florida tomorrow and become an East Coast storm. The remnants of Tropical Depression Eight are moving along the Eastern Seaboard and are expected to slow as they move north.

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.

August 19, 2016

As we noted last week, equity markets are trading at the upper end of the range defined by the relationship between the Federal Reserve's balance sheet and equities. To some extent, the level of the relationship is somewhat less important than what the expanded balance sheet signals, which is that monetary policy remains accommodative. In our AAW from June 24, 2016, we discussed St. Louis FRB President Jim Bullard's paper on monetary regimes. Bullard is projecting only one rate hike of 25 to 50 bps over the next two years unless economic conditions change, a position for which he has taken some criticism. However, we note that a recent paper by San Francisco FRB President Williams suggests that the neutral real interest rate has probably declined to near zero, meaning that if inflation is 2%, the target rate for fed funds that would be neither stimulative nor restrictive would be 2% as well. To stimulate growth, the policy rate would need to be below 2%, suggesting little room to raise rates. Although various U.S. central bank officials keep suggesting that every meeting is "live," meaning a rate change could occur, the reality is that there appears to be a distinct intellectual trend toward the idea that the slow growth the economy is facing is more than just temporary headwinds. In fact, Ben Bernanke recently blogged that the FOMC does appear to be shifting its perspective on the economy in a dovish direction.[1]

There is increasing attention on fiscal policy. We note that both presidential candidates are calling for increases in infrastructure spending. Our review of economic literature shows little consensus on the multiplier effect of government investment spending; there is no doubt, however, that the state of U.S. roads would be improved by repairs. On the other hand, it isn't obvious what sort of investment the government could make that would equate to the building of the interstate highway system or the dam building of the Great Depression. If the Federal Reserve and the government coordinated stimulus through direct funding ("helicopter money"), the effect could be substantial, although its most important impact might be in currency depreciation.[2]

What this all means is that the financial markets, which have been projecting significantly less tightening than the "dots" chart has been signaling, are probably correct. Interest rates will likely remain low and the terminal rate will probably come nowhere close to what we saw prior to the 2008 Financial Crisis. This situation puts policymakers in a difficult position. In both the U.S. and in Europe, there is great reluctance for fiscal expansion. Most of the policymakers came of age during the high inflation years of the 1970s and early 1980s and are quite skeptical of government spending. If a recession were to develop, the Federal Reserve would find itself at the zero bound rather quickly. At that point, all monetary policy could offer is either QE4 or

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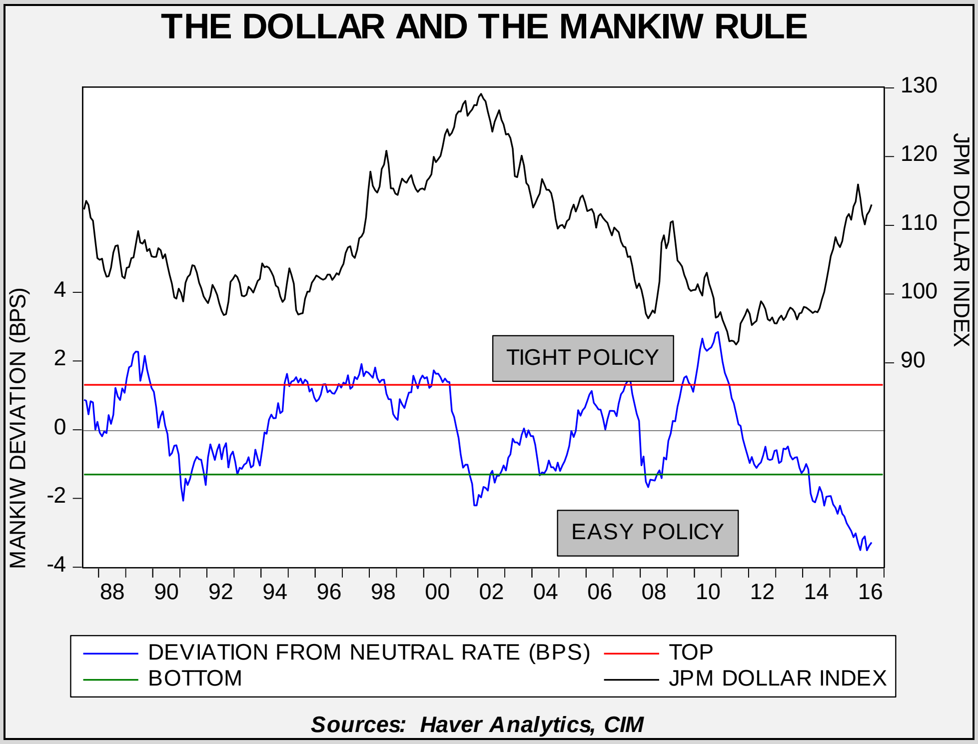
[1] https://www.brookings.edu/blog/ben-bernanke/2016/08/08/the-feds-shifting-perspective-on-the-economy-and-its-implications-for-monetary-policy/

[2] See WGR: The Geopolitics of Helicopter Money, Part I (5/2/16), Part II (5/9/16), and Part III (5/16/16).

negative nominal rates. The former might help equities but foreign experience with negative nominal rates has been quite disappointing.

So far, policymakers in the major economies have avoided competitive currency depreciation. However, a move to such policies will become increasingly tempting as other tools fail to deliver growth. This was the pattern seen during the 1930s.

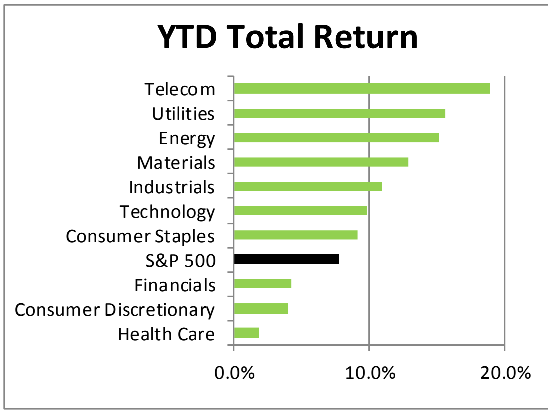


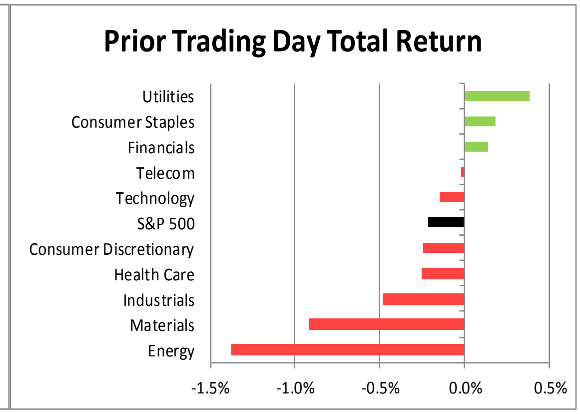
This chart shows the deviation from the Mankiw Rule model, using core CPI and the unemployment rate along with the dollar index. In the past, the FOMC paid little attention to the dollar in setting policy. However, commentary from the Fed minutes suggests "international" concerns are being discussed at length. We suspect that the dollar (using the JPM effective exchange rate as a proxy) would need to fall before the FOMC would consider raising rates.

This means that, despite protests to the contrary, the FOMC probably won't raise rates for a while unless (a) the dollar weakens, (b) core inflation unexpectedly rises, or (c) unemployment falls further. The risk of a rate hike is that it would push the dollar higher and tighten policy more than the FOMC would want. This puts the Fed in something of a quandary. They would like to have a higher rate in place, if for nothing more than to give them room to lower rates into the next downturn. However, due to the uncertainty surrounding the reaction of the dollar, we expect monetary policy to remain on hold into 2017, assuming the three conditions noted at the top of this paragraph don't arise. If that is the case, equity values should remain supported.

Data Section

U.S. Equity Markets – (as of 8/31/2016 close)

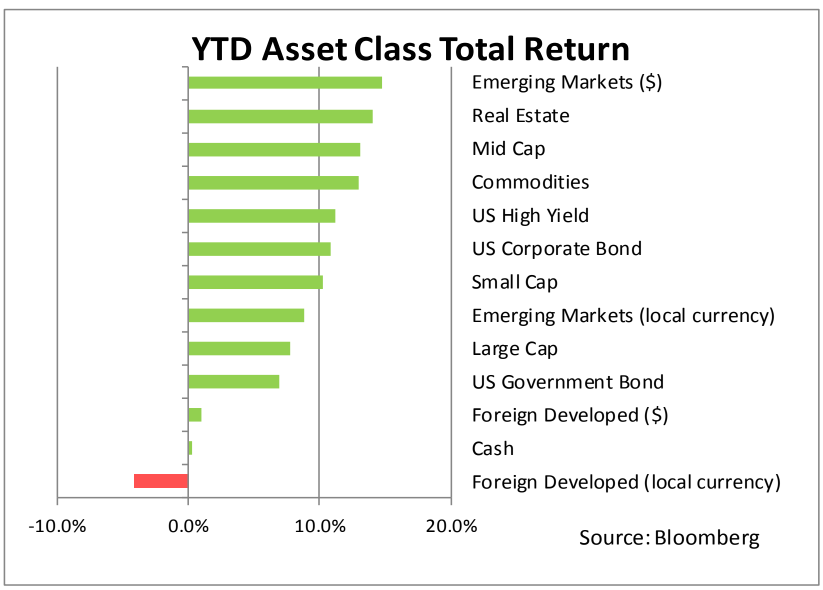




(Source: Bloomberg)

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 8/31/2016 close)

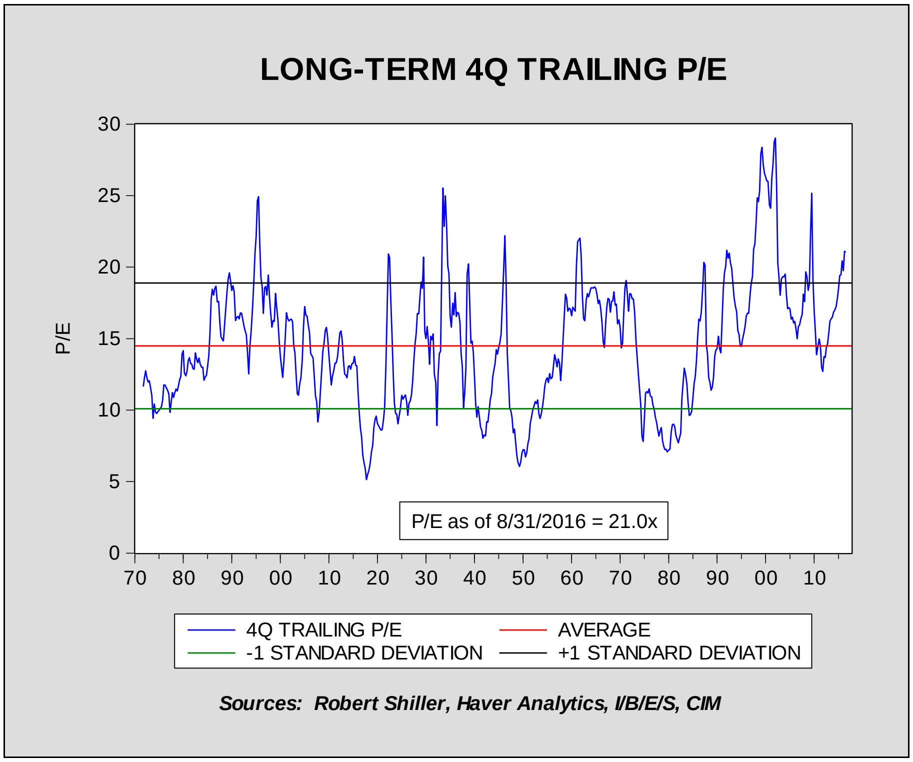


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 1, 2016



Based on our methodology,[3] the current P/E is 21.0x, unchanged from last week.

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.