INVESTMENT MANAGEMENT

Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

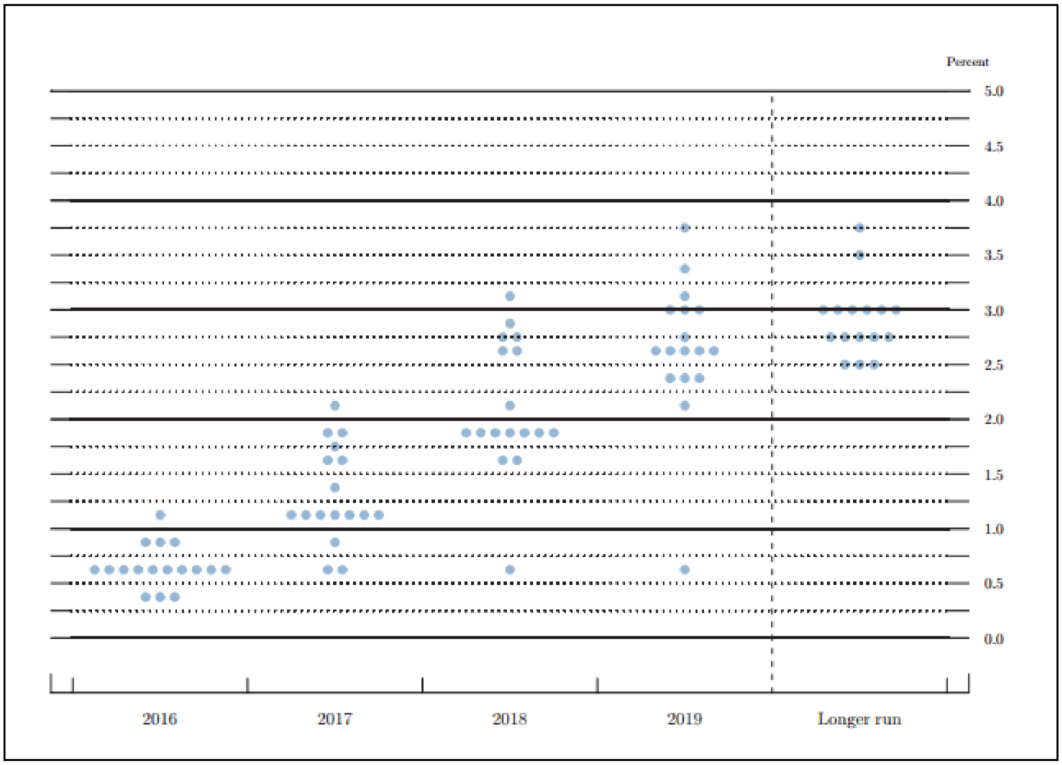
[Posted: September 22, 2016—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is trading higher by 2.5% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 1.2% from the prior close. Chinese markets were higher, with the Shanghai composite moving up 0.5% and the Shenzhen index higher by 0.6%. U.S. equity futures are signaling a higher opening from the previous close.

As expected, the Fed did not raise rates yesterday. Risk markets rallied following the release and are higher again this morning as investors focus on the more dovish aspects of the release. A key sentence was added to the FOMC statement, which read, "The Committee judges that the case for an increase in the federal funds rate has strengthened but decided, for the time being, to wait for further evidence of continued progress toward its objectives." Although it is hard to define what the Fed means by "for the time being," the likelihood of a hike has increased for December, with market expectations for December at 61% last night and 59% this morning. The Fed is signaling that the decision is still data-dependent and the committee is ready to raise rates if conditions improve further.

There were three items of note regarding the FOMC decision to maintain rates at the current level:

1. The prepared statement was hawkish, at least for the near term. The language for growth was upgraded, and now states that "economic activity has picked up from the modest pace seen in the first half of this year." The Fed perceives that the labor market is healing and inflation levels are moving closer to the Fed's target, and near-term risks to the economy appear "roughly balanced." In June, the committee indicated that the near-term risks to the economy had "diminished." Within the statement, business fixed investment was pointed out as an area that could use improvement and, during the Q&A, Yellen also said that the Fed is keeping an eye on international growth. Additionally, the presidential election is adding another measure of uncertainty. The prepared remarks basically said that although the Fed could have raised rates this time, it decided to wait to do so until it sees confirmation of a strengthening trend.

2. The dots chart was more dovish as members tapered their expectations for the path of rate increases. Three participants look for no hikes this year compared to zero participants in June. The chart below shows the dots. Participant expectations for increases have moderated from prior data. As a result, we have seen a modest flattening of the yield curve as short-term yields remained roughly unchanged, but the intermediate and longer term durations reacted to the more dovish dots.



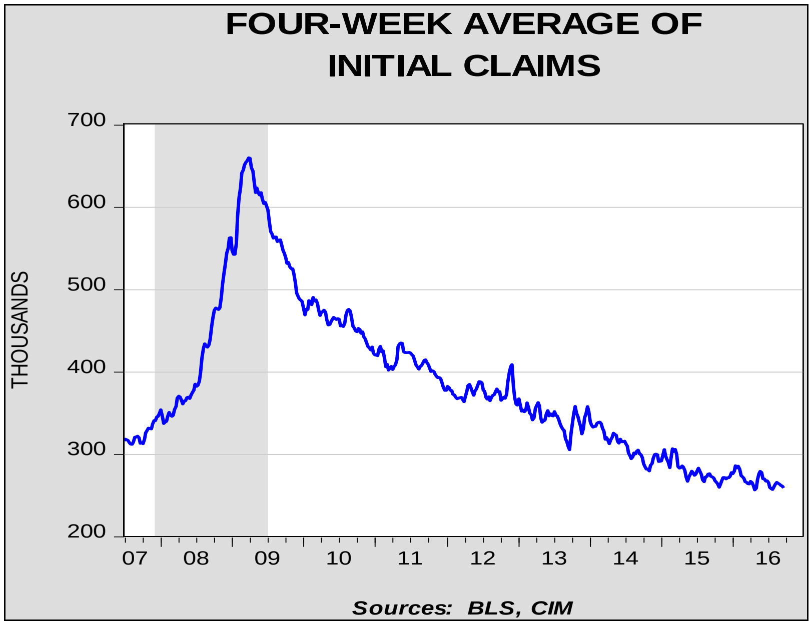
(Source: Federal Reserve)

3. The vote was 7-3, with George, Mester and Rosengren dissenting. All three dissenters called for a September hike. We note that for such a collegial FOMC, three dissenters is actually quite a lot. All three dissenters were regional Fed presidents, rather than FOMC governors, as it is more common for regional presidents to have divergent views. The past two FOMC chairs have generally aimed to maintain as much unity as possible, especially amongst the governors. Divergent opinions are healthy in maintaining a well-rounded debate, but the increasing number of dissenters calling for an increase also means that it is more likely.

Markets have reached a calm following the Fed's decision. Most risk markets are trading higher as the Fed and other central bank decisions are in the rear-view mirror, thus removing short-term uncertainty.

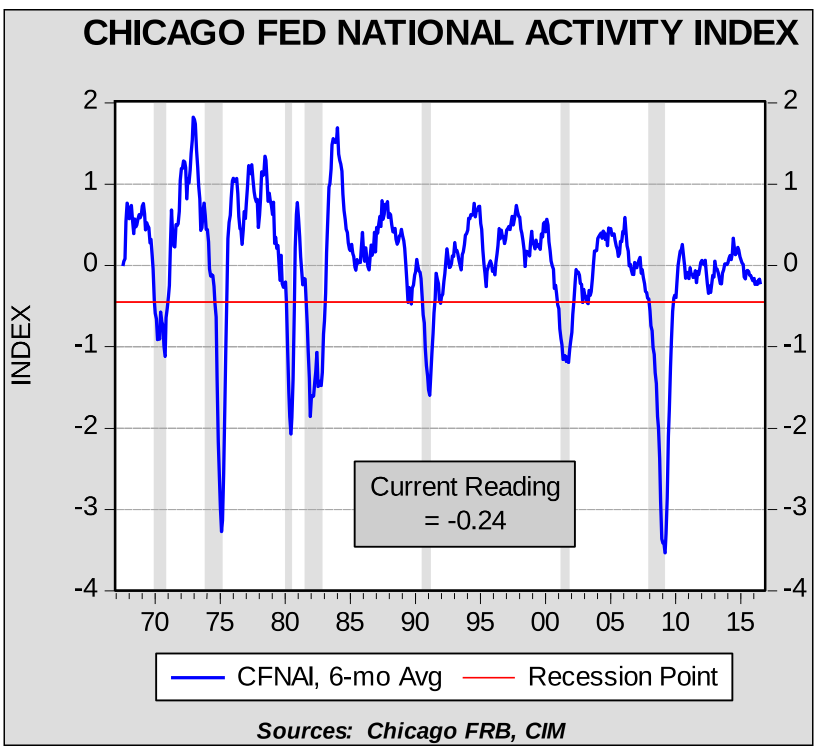
U.S. Economic Releases

Initial claims fell 8k to 252k, better than the 261k expected. Although this low level was reached in April of this year, the last time claims were this low was in 1969. We have stayed below the 300k level since March 2015.



The chart above shows the four-week average of claims, which have remained near their recent lows. The average fell 2k to 259k.

The Chicago Fed National Activity Index disappointed in August, falling to -0.55 from +0.24 compared to the +0.15 expected. A positive reading indicates that the economy is growing above its long-term trend, while a negative reading indicates below-trend growth. The current reading signals weakening, below-trend growth.



The chart above shows the six-month average of the index, which fell to -0.24 from -0.18 the month before. Although circumstances have deteriorated, the metric does not indicate a recession (recession line is in red on the chart).

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

Economic releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Existing home sales	m/m	Aug	1.1%	-3.2%	**
10:00	LEI	m/m	Aug	0.0%	0.4%	**
11:00	Kansas City Fed manufacturing activity	m/m	Sep	-3.0	-4.0	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
1:00	Lockhart	Atlanta 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, 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
EUROPE								
France	Business Confidence	y/y	sep	102	101	101	**	Equity and bond neutral
	Manufacturing Confidence	y/y	sep	103	101	101	**	Equity and bond neutral
UK	CBI Trends Total Orders	y/y	sep	-5	-5	-5	*	Equity and bond neutral
	CBI Trends Selling Prices	y/y	Sep	10	5	8	*	Equity and bond neutral
Russia	Gold and Forex Reserve	y/y	sep	396.6 bn	399.6 bn		**	Equity bearish, bond bullish
AMERICAS								
Brazil	Industrial Production	y/y	May	-7.8%	-7.2%	-7.8%	***	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)	87	86	1	Up
3-mo T-bill yield (bps)	19	20	-1	Down
TED spread (bps)	68	66	2	Up
U.S. Libor/OIS spread (bps)	43	43	0	Neutral
10-yr T-note (%)	1.65	1.65	0.00	Neutral
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	34	30	4	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	down			Neutral
pound	up			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	$47.50	$46.83	1.43%	Inventory fell further than expected, moving up with equity markets
WTI	$46.17	$44.05	4.81%	
Natural Gas	$3.06	$3.06	0.20%	
Crack Spread	$12.73	$13.07	-2.56%	
12-mo strip crack	$13.55	$13.70	-1.13%	
Ethanol rack	$1.65	$1.64	0.29%	
Metals				
Gold	$1,336.99	$1,335.17	0.14%	FOMC decision to not raise rates
Silver	$19.95	$19.84	0.54%	
Copper contract	$219.35	$215.50	1.79%	Equity market strength
Grains				
Corn contract	$ 339.25	$ 340.00	-0.22%	
Wheat contract	$ 408.00	$ 407.75	0.06%	
Soybeans contract	$ 979.00	$ 975.50	0.36%	
Shipping				
Baltic Dry Freight	903	865	38	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-6.2	3.4	-9.6	
Gasoline (mb)	-3.2	-1.3	-1.9	
Distillates (mb)	2.2	0.0	2.2	
Refinery run rates (%)	-0.2%	-0.7%	0.5%	
Natural gas (bcf)		57.4		

Weather

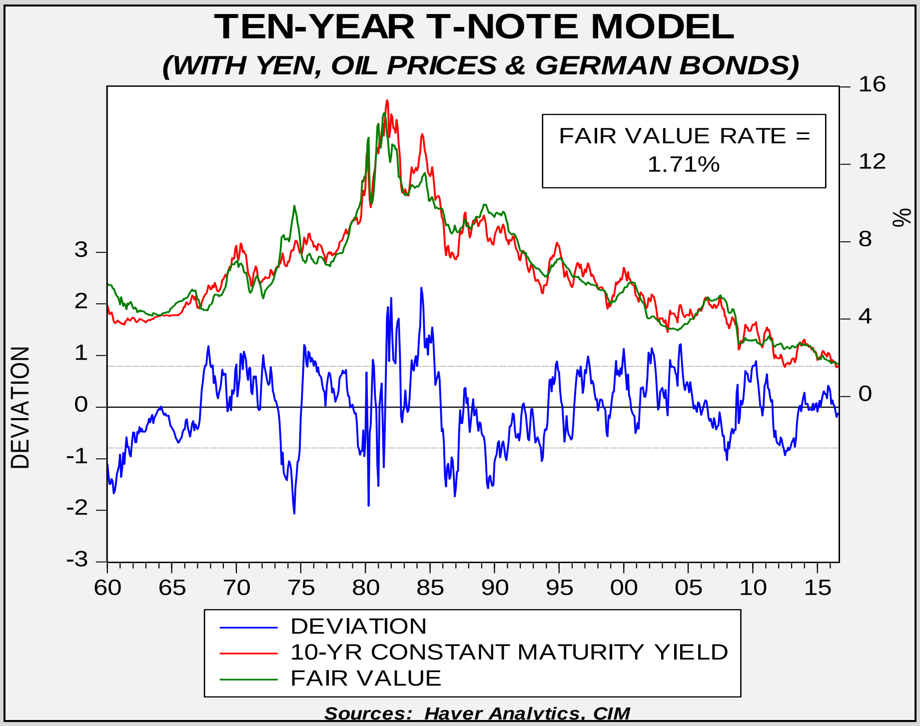
The 6-10 and 8-14 day forecasts are calling for warmer conditions for most of the country, except parts of the western region. Precipitation is forecast for the middle of the country. Tropical Depression Karl has slowed and moved slightly northwest. TD Karl is expected to dissipate by Sunday. Tropical Storm Lisa remained in the mid-Atlantic, but is expected to calm as it turns north. 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.

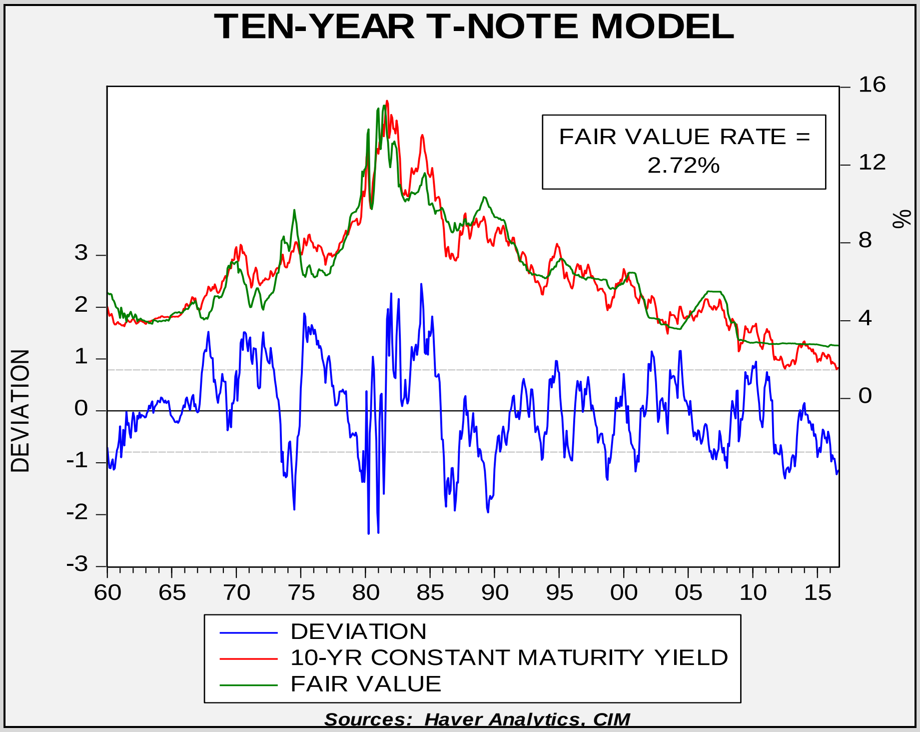
September 16, 2016

Since the beginning of September, 10-year T-note yields have risen from a low of 1.52% to a high of 1.75%. This backup in yields is as issue we are monitoring carefully because we have favored long-duration assets for some time. We analyze long-dated interest rates by starting with a fair value assessment of the 10-year T-note yield.



This is our full T-note model. It uses the effective fed funds rate, the 15-year average of inflation (a proxy for inflation expectations), the yen/dollar exchange rate, oil prices and the yield on German bonds. The current fair value rate is 1.71%, suggesting that the long end is a bit overvalued at current yields. A hike of 25 bps in the effective fed funds rate would raise the fair value yield to 1.88%, assuming no change in the other variables. Thus, the recent rise in yields is due, in part, to concerns about the potential for tightening monetary policy.

Deeper examination shows that foreign factors are keeping yields low. Eliminating the yen/dollar exchange rate, oil prices (which are set globally) and German bond yields creates a model using only domestic factors. Namely, using just inflation expectations and fed funds boosts the fair value by 100 bps.



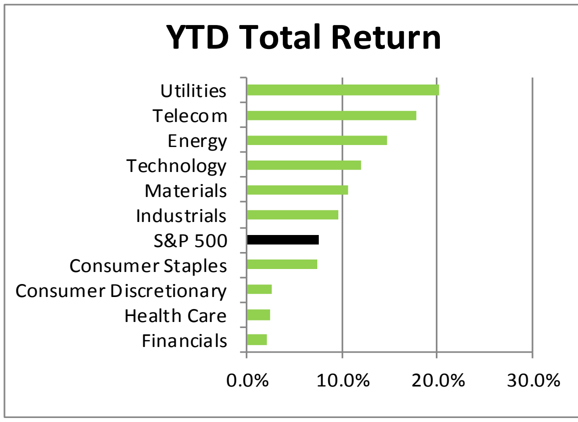
By focusing on domestic factors, the 10-year T-note is deeply overvalued. In fact, a comparison of the models shows that international factors have played a key role in lowering yields over the past two years.

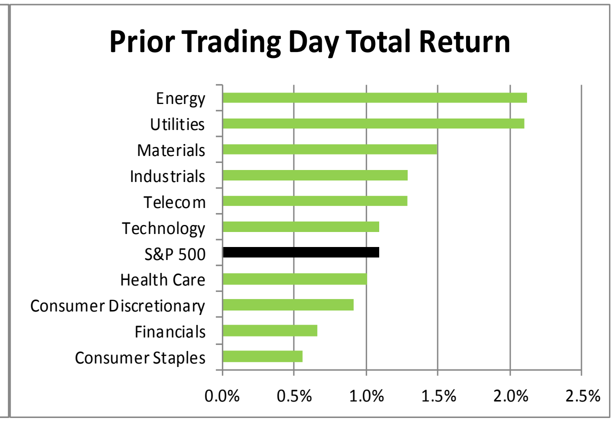
As we assess the prospects for the three international variables, we expect oil prices will likely be rangebound. Over the next year, we look for the average price of oil to hold around $50 per barrel. In the near term, however, seasonal factors will likely weigh on oil prices and support lower T-note yields. Barring helicopter money in Japan, the JPY will likely drift higher against the dollar which will also bring lower T-note yields. The key factor will probably be German yields. German yields ticked higher after the ECB refused to adjust policy last week. But, worries about the upcoming Italian referendum, expected to be held as early as October, and the rising likelihood that the ECB will eventually boost stimulus should lower German bond yields. Thus, for now, we believe the case for long-duration fixed income remains in place.

Longer term, we continue to closely monitor the expansion of populism. Populist policies will tend to eventually lift inflation and will most likely end the long decline in interest rates. For now, the establishment continues to hold sway but we would expect that somewhere in the next four to eight years, or perhaps sooner, inflation will return and we will need to position portfolios for such an environment.

Data Section

U.S. Equity Markets – (as of 9/21/2016 close)

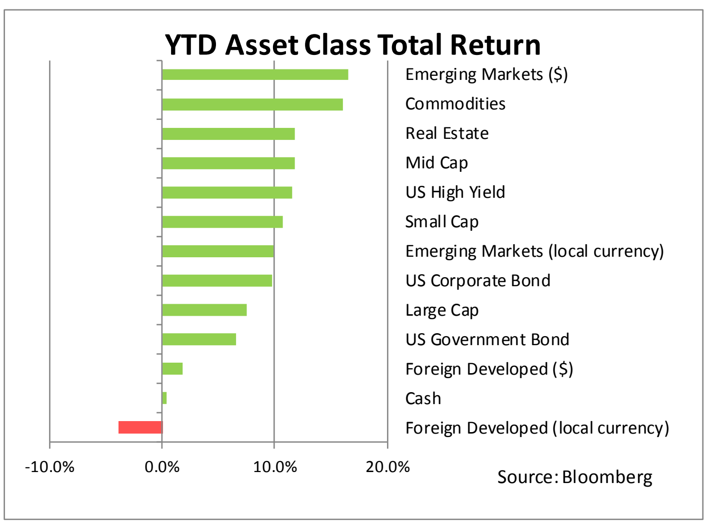




(Source: Bloomberg)

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 9/21/2016 close)

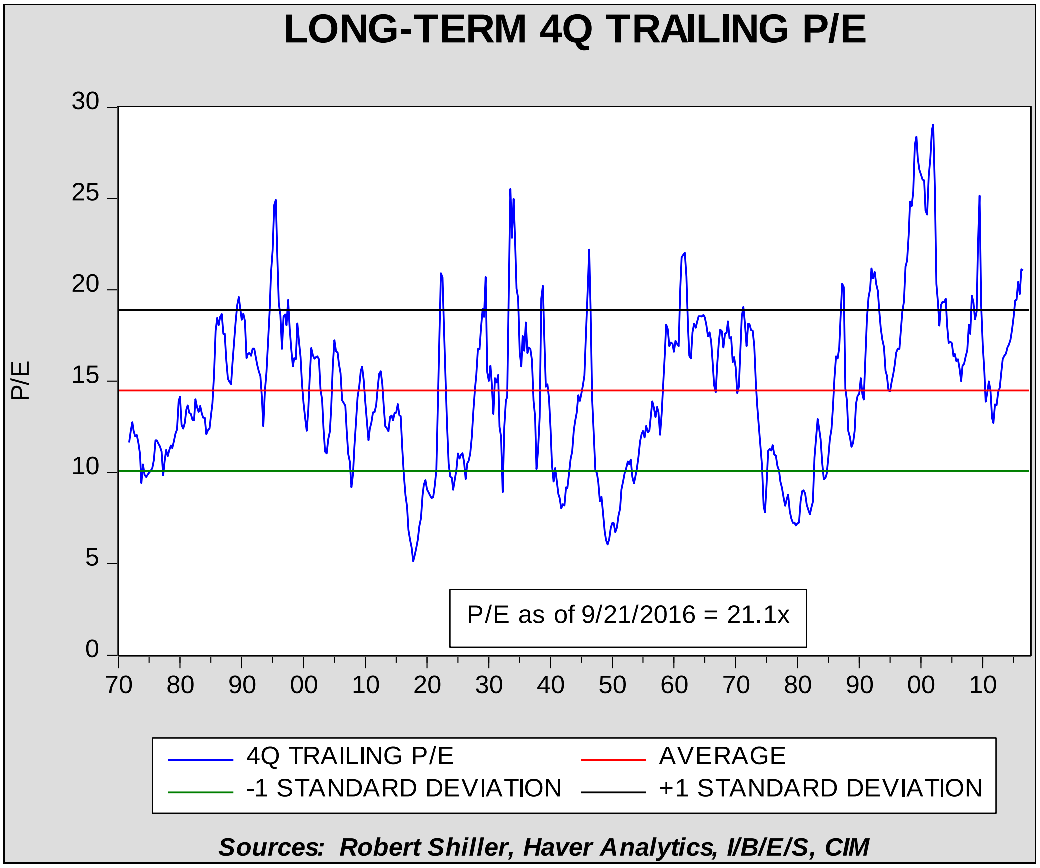


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 22, 2016



Based on our methodology,[1] 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.

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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 (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.