Confluence INVESTMENT MANAGEMENT

Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: September 23, 2016—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is trading lower by 0.6% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 0.1% from the prior close. Chinese markets were lower, with the Shanghai composite moving down 0.3% and the Shenzhen index lower by 0.5%. U.S. equity futures are signaling a higher opening from the previous close.

This morning's big news comes from OPEC, where Reuters is reporting that Saudi Arabia offered a production cut *if* Iran would freeze production. We do not know how much the kingdom has offered to reduce its output, but Iran did tell Russian media that it would need Saudi Arabia to "slash" its production. Current Saudi production is 10.6 mbpd, near record highs, while Iranian output is 3.6 mbpd. Iran has indicated it wants to raise output to 4.0 mbpd; we believe that will probably be close to its sustainable output level.

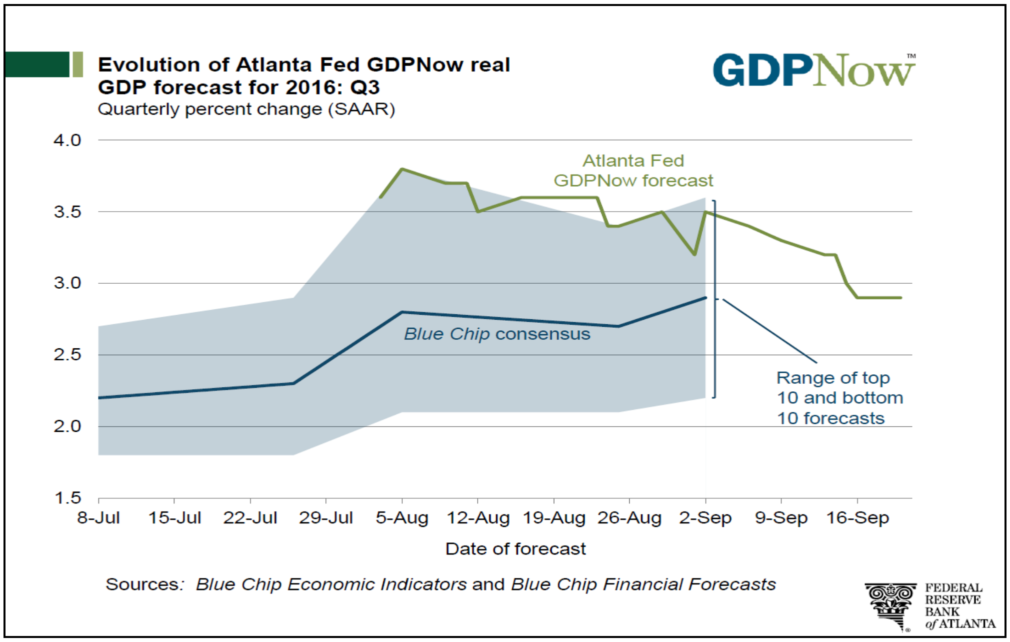
Although we obviously don't have all the details, we can develop a reasonable set of deal parameters. We suspect Saudi Arabia wants to see Iran hold production at current levels and will not grant it the additional 0.4 mbpd of market share. Iran would probably want Saudi Arabia to cut output by more than 0.4 mbpd. We doubt the kingdom would meet this demand. We note that about 0.8 mbpd has come to global markets due to production recoveries in Nigeria and Libya, and from new output by Russia. A Saudi/Iranian agreement would force both to cede market share, something we doubt either would be comfortable doing.

So, what is Saudi Arabia doing? It is quite possible that it is trying to shift the blame for weak prices to Iran. If the kingdom offers a token cut, less than 0.4 mbpd, Iran will almost certainly reject a freeze. The Saudis will say that they did "try" to work out a deal with Iran but, due to Iranian intransigence, it failed. If no deal emerges, oil prices will likely ease toward the $40 per barrel level. However, we don't expect prices to fall much below $40 in a worst case scenario.

The FOMC's decision has been well discussed but we do want to offer a reflection on the growing dissention developing at the FOMC. Three presidents dissented from the steady policy decision, while three "dots" suggest no rate hike this year. There have only been five other instances in the past three decades when we had three dissents. If a rate hike does occur, it is possible that we will have three dissents again; however, we suspect that at least two of those calling for no change this year are governors, probably Brainard and Tarullo. The last time we have two governor dissents was in 1993.

Fed chairs try to maintain a consensus; large numbers of dissents raise fears in the financial markets of policy instability. So far, the financial markets have taken the policy signals as supportive as the dots chart continues to show a steady slide in the terminal rate for the fed funds target. Given the softening data recently, even a December hike isn't certain.

Here is the latest Q3 GDP estimate from the Atlanta FRB.



From the September peak, the estimate has dropped 0.55%.

Atlanta Fed GDPNow forecasts for 2016: Q3, contributions to growth

Date	Major Releases	GDP	PCE	Equip-ment	Intell. prop. prod.	Nonres. struct.	Resid. inves.	Govt.	Net exports	CIPI
3-Aug	Initial nowcast	3.6	2.50	0.33	0.16	-0.14	0.01	0.31	-0.44	0.90
23-Aug	New home sales/prices/const. costs	3.6	2.41	0.43	0.16	-0.09	0.04	0.32	-0.45	0.75
24-Aug	Existing-home sales	3.4	2.41	0.43	0.16	-0.09	-0.10	0.32	-0.45	0.75
25-Aug	Advance durable manufacturing	3.4	2.41	0.37	0.16	-0.09	-0.10	0.32	-0.45	0.78
29-Aug	Pers. Inc./PCE, GDP/Adv. Econ. Ind.	3.5	2.59	0.31	0.22	-0.09	-0.10	0.32	-0.42	0.65
1-Sep	Construction spending, ISM Manuf.	3.2	2.35	0.20	0.22	0.20	-0.21	0.21	-0.38	0.64
2-Sep	Employ. Sit., Foreign trade, M3 Manuf.	3.5	2.43	0.19	0.22	0.20	-0.19	0.23	-0.16	0.57
6-Sep	ISM Nonmanuf., Light vehicle sales	3.4	2.31	0.11	0.22	0.20	-0.20	0.23	-0.15	0.62
9-Sep	Wholesale trade	3.3	2.31	0.11	0.22	0.20	-0.20	0.23	-0.15	0.57
13-Sep	Monthly Treasury Statement	3.2	2.31	0.11	0.22	0.20	-0.20	0.15	-0.15	0.57
14-Sep	Import/Export prices	3.2	2.31	0.11	0.22	0.20	-0.20	0.15	-0.14	0.57
15-Sep	Retail trade, Industrial production	3.0	2.12	0.09	0.22	0.20	-0.25	0.15	-0.13	0.61
16-Sep	Consumer Price Index	2.9	2.04	0.09	0.22	0.21	-0.25	0.15	-0.13	0.61
20-Sep	Housing starts	2.9	2.04	0.09	0.22	0.21	-0.25	0.15	-0.13	0.61
Maximum forecast of real GDP growth										
5-Aug	Employment situation, Foreign trade	3.8	2.53	0.40	0.16	-0.13	0.02	0.34	-0.45	0.93
Minimum forecast of real GDP growth										
20-Sep	Housing starts	2.9	2.04	0.09	0.22	0.21	-0.25	0.15	-0.13	0.61

Note: CIPI is "change in private inventories." All numbers are percentage point contributions to GDP growth (SAAR). Table does not necessarily include all forecasts for the quarter; see tab "ContribHistory" in online excel file for entire history.

FEDERAL RESERVE BANK of ATLANTA

Looking at the data, since September 2, 39 bps of the 55 bps drop have come from lower consumption estimates, 11 bps have come from lower investment and 8 bps have come from lower government spending, while net exports have added 3 bps. Overall, Q3 growth looks ok, but the momentum is slowing; election worries could make Q4 data soften further. In this environment, if Yellen does want to raise rates with a divided Fed, she will likely be unable to sway the doves on the board. Rising dissent will, at some point, become a risk factor for the financial markets.

U.S. Economic Releases

There are no releases scheduled before we go to print. The table below indicates the economic 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	Sep	52.0	52.0	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
12:00	Harker, Mester, Lockhart	Philadelphia, Cleveland, Atlanta FRB Presidents				
12:30	Kaplan	Dallas 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	GDP	y/y	Q2	-0.1%	0%	0%	***	Equity bearish, bond bullish
	Markit France Services PMI	m/m	sep	54.1	52.3	52.0	*	Equity and bond neutral
	Markit France Manufacturing	m/m	sep	49.5	48.3	48.5	*	Equity and bond neutral
	Markit France Composite PMI	m/m	sep	53.3	51.9	51.8	*	Equity and bond neutral
Germany	Markit France Services PMI	m/m	sep	50.6	51.7	52.7	*	Equity and bond neutral
	Markit France Manufacturing	m/m	sep	54.3	53.6	53.1	*	Equity and bond neutral
	Markit France Composite PMI	m/m	Sep	52.7	53.3	53.6	*	Equity and bond neutral
Russia	Money Supply Narrow	y/y	jul	8.76t	8.65 tn		**	Equity bearish, bond bullish
AMERICAS								
Canada	CPI	y/y	aug	1.1%	1.3%	1.4%	***	Equity bearish, bond bullish
	Retail Sales	m/m	jul	-0.1%	-0.1%	0.1%	**	Equity and bond neutral
Brazil	CPI	m/m	sep	0.18%	0.27%	0.24%	***	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)	86	87	-1	down
3-mo T-bill yield (bps)	17	17	0	Neutral
TED spread (bps)	69	70	-1	down
U.S. Libor/OIS spread (bps)	43	43	0	Neutral
10-yr T-note (%)	1.62	1.62	0	Neutral
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	33	34	-1	down
Currencies	**Direction**			
dollar	up			Neutral
euro	up			Neutral
yen	up			Neutral
pound	down			Down
franc	down			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	$47.71	$47.65	0.13%	OPEC discussing production freeze
WTI	$46.15	$44.05	4.77%	
Natural Gas	$3.02	$2.99	0.84%	
Crack Spread	$12.75	$12.82	-0.52%	
12-mo strip crack	$13.61	$13.64	-0.21%	
Ethanol rack	$1.66	$1.65	0.43%	
Metals				
Gold	$1,338.86	$1,337.07	0.13%	FOMC decision to not raise rates
Silver	$19.87	$19.87	0.00%	
Copper contract	$219.40	$219.45	-0.02%	
Grains				
Corn contract	$ 334.00	$ 336.75	-0.82%	Harvest pressure
Wheat contract	$ 403.25	$ 405.50	-0.55%	
Soybeans contract	$ 967.25	$ 976.50	-0.95%	
Shipping				
Baltic Dry Freight	937	903	34	
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)	52.0	57.4	-5.4	

Weather

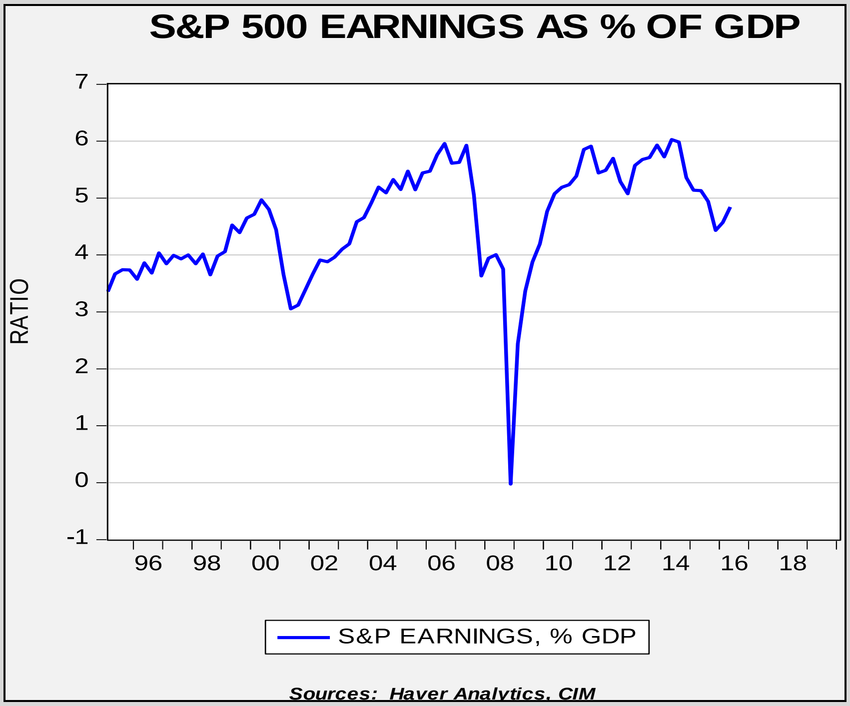
The 6-10 and 8-14 day forecasts are calling for warmer conditions for most of the country, except parts of the western region. Precipitation is forecast for the middle of the country. Tropical Depression Karl has slowed and moved slightly northwest. TD Karl is expected to dissipate by Monday. Tropical 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 23, 2016

Profit margins are off their highs but have started to improve.

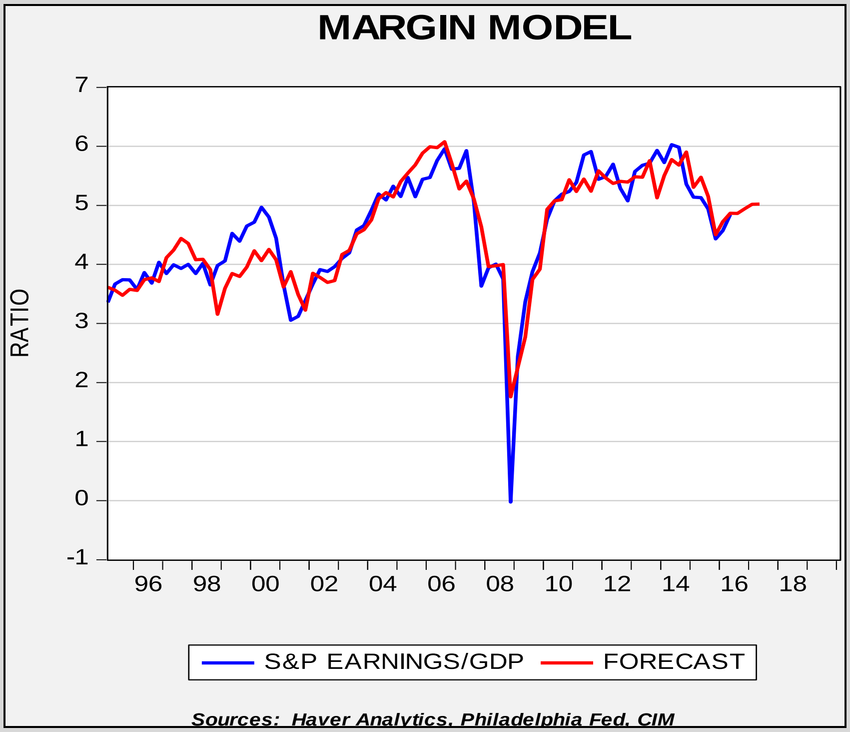


This chart takes total S&P 500 operating earnings as a percentage of GDP. Excluding the financial crisis, operating earnings have been running between 5% and 6% of GDP for most of the past decade and a half. In the middle of last year, this percentage fell below 5% and has remained below that threshold for the past four quarters. Falling energy prices appear to be the culprit for the drop in margins.

We have a model for this series that is critical to our forecasts for S&P earnings. It includes unit labor costs, net exports as a percentage of GDP, LIBOR, fed funds, national income accounts profits as a percentage of GDP, a national corporate cash flow estimate from the Financial Accounts of the U.S.,[1] the EUR/USD exchange rate and oil prices. Based on these variables (and the forecasts coming from the Philadelphia FRB's Survey of Professional Forecasters), we estimate S&P 500 earnings as a percentage of GDP.

Here is our updated model.

[1] Also known as the Flow of Funds report.



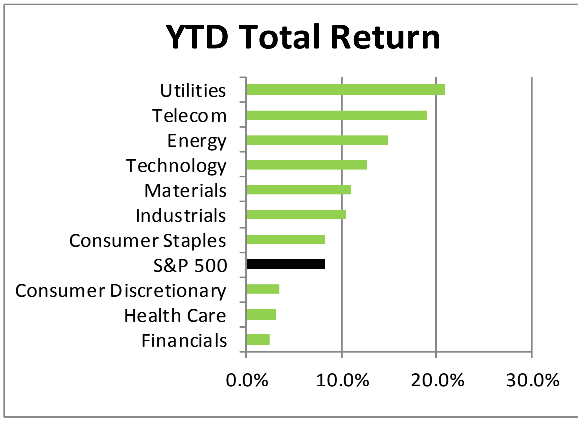
By Q1 2017, margins should rise back to 5%. Given the current divisor, S&P earnings for this year are expected at $107.09, and $113.89 for 2017.[2] These are much lower than what is being discussed in the financial press, mostly due to the wide divergence between Thomson-Reuters and S&P's earnings numbers.[3]

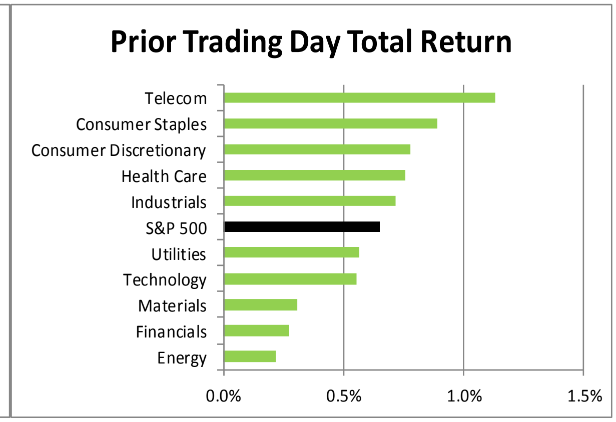
The key to the forecast is that the dollar will gradually weaken as the terminal rate is lowered for fed funds and as oil prices recover to $52 by mid-2017. If the dollar unexpectedly strengthens, which would also lower oil prices, we would need to adjust our forecasts lower. Of course, this also means that earnings will exceed our current estimates if the dollar weakens more than we expect (EUR/USD > $1.14) and/or oil prices rise more than forecast. The actual recovery in margins is a welcome sign for earnings, although we believe that most of this good news is already reflected in current prices. However, the good news is that, barring a recession, we should avoid a major market correction.

[2] This change reduces our estimate for 2016 from $107.82, but increases our forecast for 2017 from $109.32.
[3] We analyzed this issue in the AAW from 7/15/2016.

Data Section

U.S. Equity Markets – (as of 9/22/2016 close)

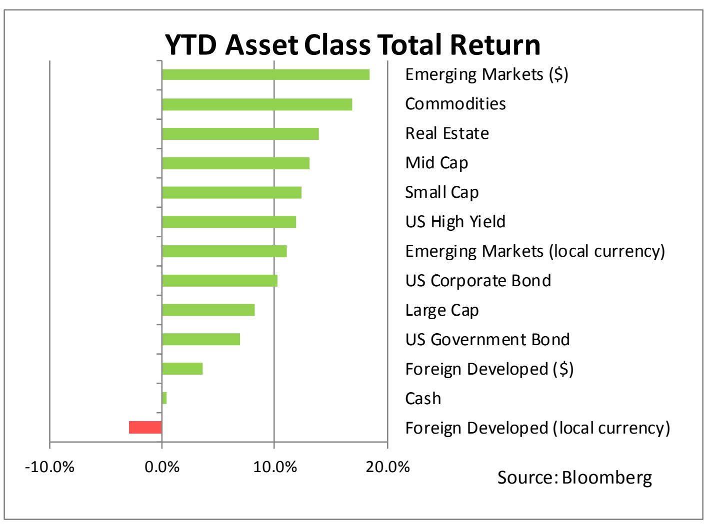




(Source: Bloomberg)

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 9/22/2016 close)

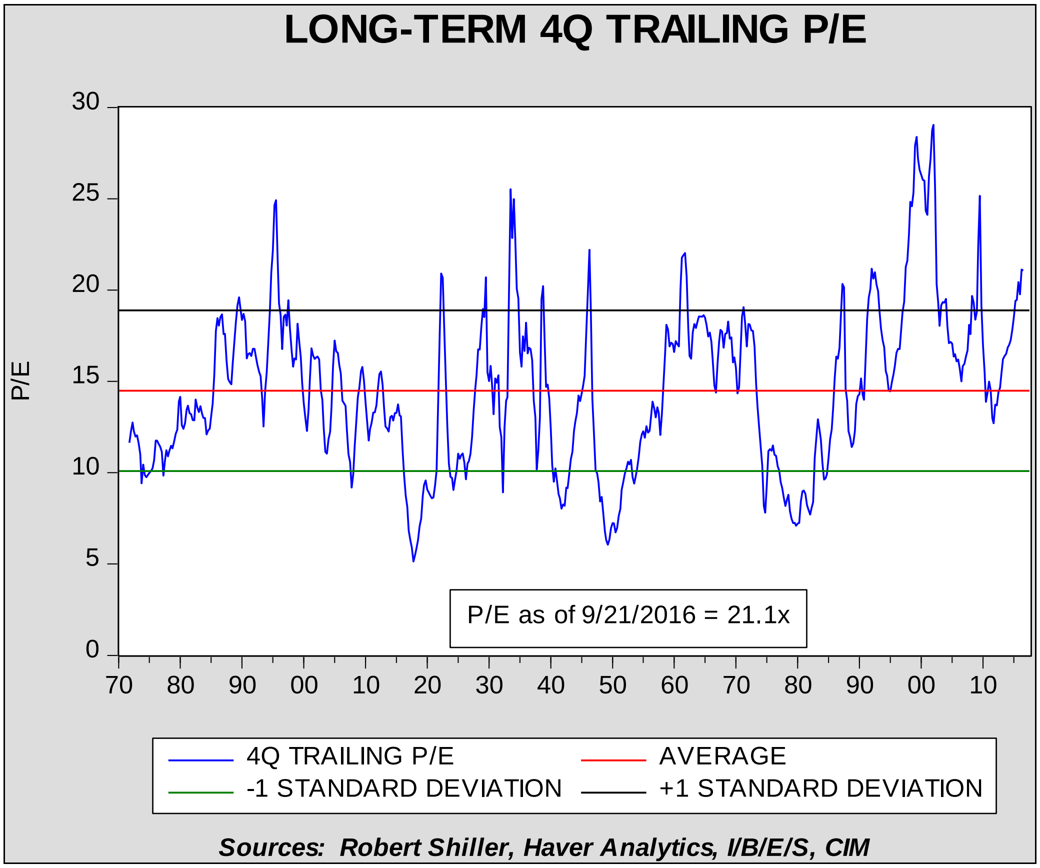


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[4] 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.

---

[4] 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.