Confluence INVESTMENT MANAGEMENT

Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: September 26, 2016—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is trading lower by 1.7% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 1.2% from the prior close. Chinese markets were lower, with the Shanghai composite moving down 1.8% and the Shenzhen index lower by 2.1%. U.S. equity futures are also signaling a lower opening.

It was a quiet weekend. The only major news of note was that Jeremy Corbyn was elected as the leader of the Labour Party by nearly 62% of party members.[1] Most political pundits are predicting the Labour Party is doomed to the political wilderness until it gives up on this charge to the left. Perhaps; however, like Brexit, the Trump/Sanders phenomenon, the AfD in Germany and the National Front in France, this news is a clear signal of the rise of populism. Those left behind by globalization, deregulation and the rapid introduction of new technology have had enough. Up until the financial crisis, rising debt and distraction from social issues kept populists on both the right and left pacified. Deleveraging and weak growth have ended the populists' tolerance. As a result, populists across the West are trying to grow their influence, which could mean a reversal of the supply-side policies of the past 35 years.

It is with this background that the U.S. holds its first presidential debate this evening. There has been much ink spilled on the ramifications of this debate. Debates are always interesting because they are unscripted; unusual things can happen. However, the impact is probably overstated as core supporters are rarely swayed by debates. When a debate occurs between two establishment figures, likeability is probably the best trait to project. Al Gore's irritating sighing in response to George W. Bush's answers did him serious harm. This election is unusual because it is between a populist and an establishment candidate. Essentially, Clinton offers continuity while Trump promises change. Thus, much like the Reagan/Carter debates, this election may simply come down to how you fared over the past eight years. If the years went well for you, Clinton is your candidate. If they didn't, either Trump or one of the other party candidates might be your preference.

So far, we don't think the financial markets have discounted a Trump presidency. If Trump even remotely projects a modicum of presidential aura, it will be a success. If he doesn't make a hash out of his performance tonight, we may see some weakness develop in equities. On the other hand, Clinton needs to goad Trump into looking a bit crazy, or "non-presidential."

Finally, OPEC is meeting over the next three days. There is growing hope that the cartel will come to some sort of output agreement. Although we doubt it will happen at this meeting, the outlines of a deal are starting to take shape. Saudi Arabia will probably cut production to Q1

[1] For background on Corbyn, see WGR, Meet Jeremy Corbyn, 9/21/2015.

levels, around 10.2 mbpd, if Iran agrees to keep output at current levels, somewhere between 3.6 to 3.8 mbpd. The other Gulf States will probably contribute an additional 0.4 mbpd. This agreement likely isn't enough to stimulate a recovery much above $50, but it will implement a floor around $40 per barrel. As prices stabilize, we would expect U.S. production to stabilize and recover. In addition, the Russians will not only keep production elevated, but they will try to grab market share. So, the good news is that OPEC is probably creating a sustainable price floor but little else. However, that may be enough to lift energy sentiment.

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
10:00	New home sales	m/m	Aug	-8.3%	12.4%	**
10:30	Dallas Fed manufacturing activity	m/m	Aug	-2.5	-6.2	**
Fed speakers or events						
EST	Speaker or event	District or position				
11:45	Tarullo	Fed Governor				
1:30	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
ASIA-PACIFIC								
Japan	Leading Index CI	y/y	Jul	100	100		**	Equity and bond neutral
	Coincident Index	y/y	Jul	112.1	112.8		**	Equity and bond neutral
EUROPE								
Germany	IFO Business Climate	m/m	sep	109.5	106.2	106.3	*	Equity bullish, bond bearish
	IFO Current Assessment	m/m	sep	114.7	112.8	112.9	*	Equity bullish, bond bearish
Italy	Retails Sales	y/y	jul	-0.3%	0.2%	0.0	**	Equity bearish, bond bullish
UK	BBA Loans for House Purchase	y/y	aug	36997	37662	37100	*	Equity and bond neutral
Switzerland	Total Sight Deposits	m/m	Sep	517.2 bn	516.7 bn		*	Equity and bond neutral
	Domestic Sight Deposits	y/y	aug	444.6 bn	438.7 bn		**	Equity and bond neutral
Brazil	Federal Debt Total	y/y	jul	2.97 tn	2.96 tn		**	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)	17	17	0	Neutral
TED spread (bps)	69	69	0	Neutral
U.S. Libor/OIS spread (bps)	43	43	0	Neutral
10-yr T-note (%)	1.60	1.62	0	Neutral
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	35	33	2	up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	up			Neutral
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	$46.56	$45.89	1.46%	OPEC discussing production freeze
WTI	$45.04	$44.48	1.26%	
Natural Gas	$2.98	$2.96	0.81%	
Crack Spread	$13.50	$13.33	1.30%	
12-mo strip crack	$13.69	$13.66	0.23%	
Ethanol rack	$1.66	$1.66	0.00%	
Metals				
Gold	$1,337.83	$1,337.56	0.02%	Growing pessimism about global markets
Silver	$19.51	$19.69	-0.89%	
Copper contract	$218.55	$220.10	-0.70%	
Grains				
Corn contract	$ 334.25	$ 336.50	-0.67%	Harvest pressure
Wheat contract	$ 403.75	$ 404.75	-0.25%	
Soybeans contract	$ 954.25	$ 955.00	-0.08%	
Shipping				
Baltic Dry Freight	941	937	4	

Weather

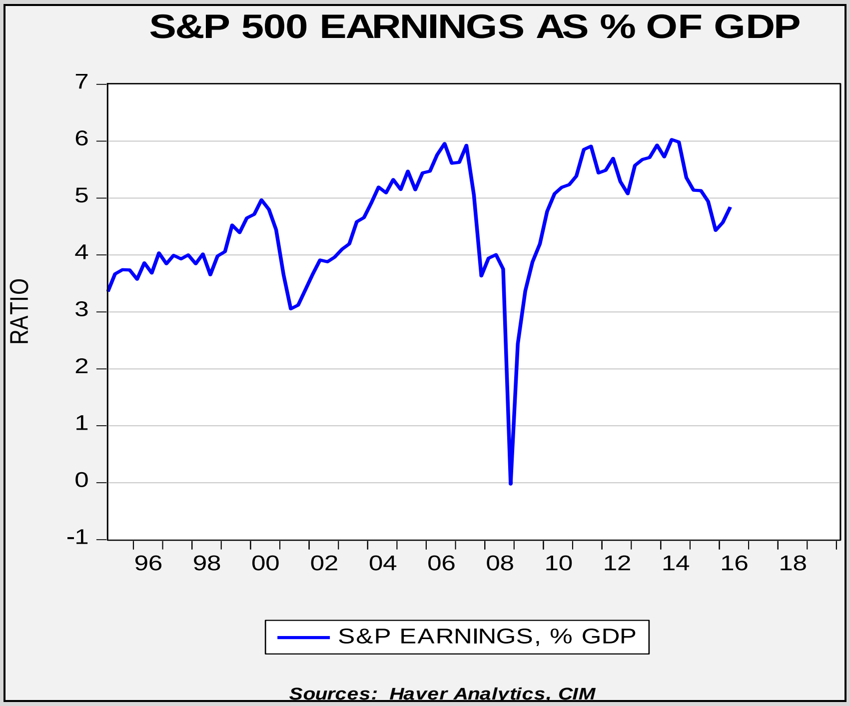
The 6-10 and 8-14 day forecasts are calling for warmer conditions for most of the country, except parts of the western region. Precipitation is forecast for the western half of the country. Tropical Depressions Karl and Lisa have dissipated; however, there are a couple of possible cyclone formations in the Atlantic. 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.,[2] 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.

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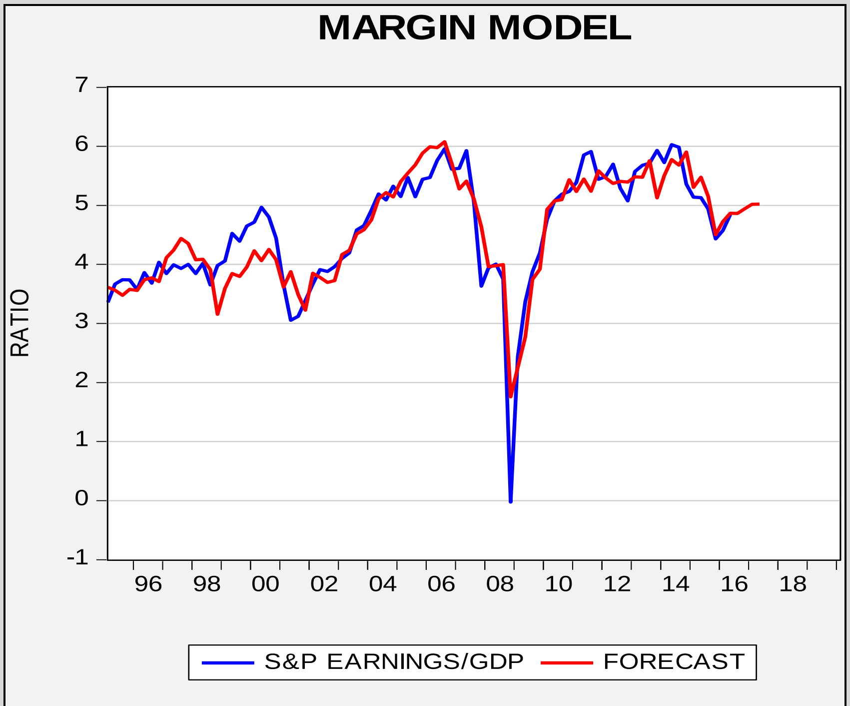
[2] Also known as the Flow of Funds report.



Sources: Haver Analytics, Philadelphia Fed, CIM

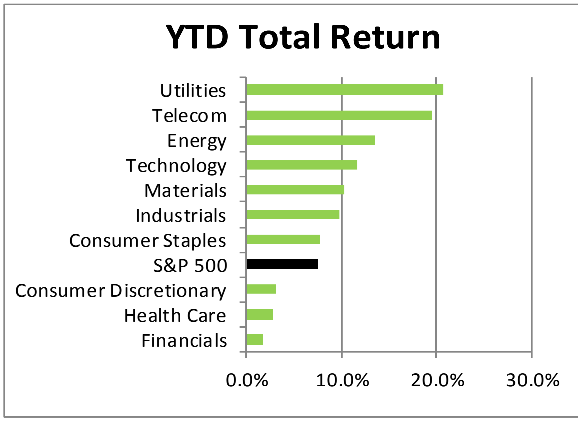
By Q1 2017, margins should rise back to 5%. Given the current divisor, S&P earnings for this year are expected at $107.09, and $113.89 for 2017.[3] These are much lower than what is being discussed in the financial press, mostly due to the wide divergence between Thomson-Reuters and S&P's earnings numbers.[4]

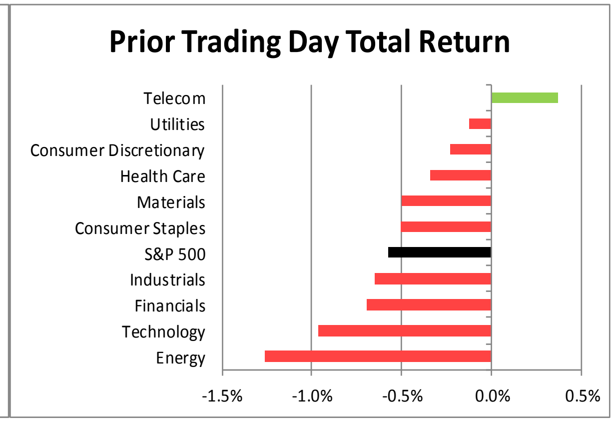
The key to the forecast is that the dollar will gradually weaken as the terminal rate is lowered for fed funds and as oil prices recover to $52 by mid-2017. If the dollar unexpectedly strengthens, which would also lower oil prices, we would need to adjust our forecasts lower. Of course, this also means 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.

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

Data Section

U.S. Equity Markets – (as of 9/23/2016 close)

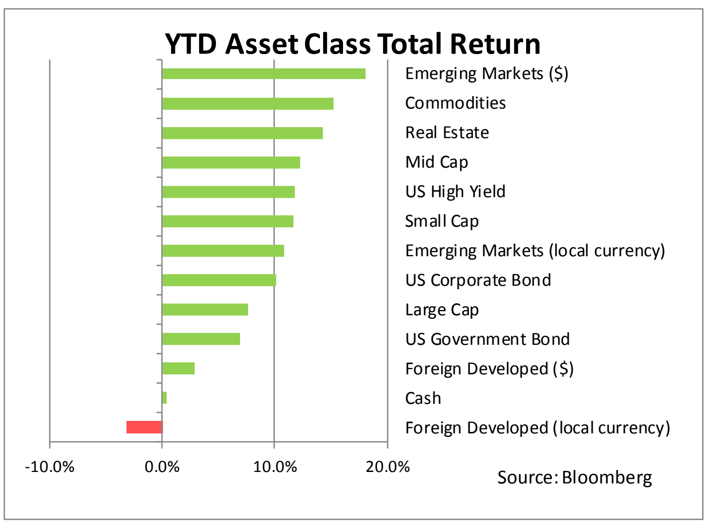




(Source: Bloomberg)

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 9/23/2016 close)

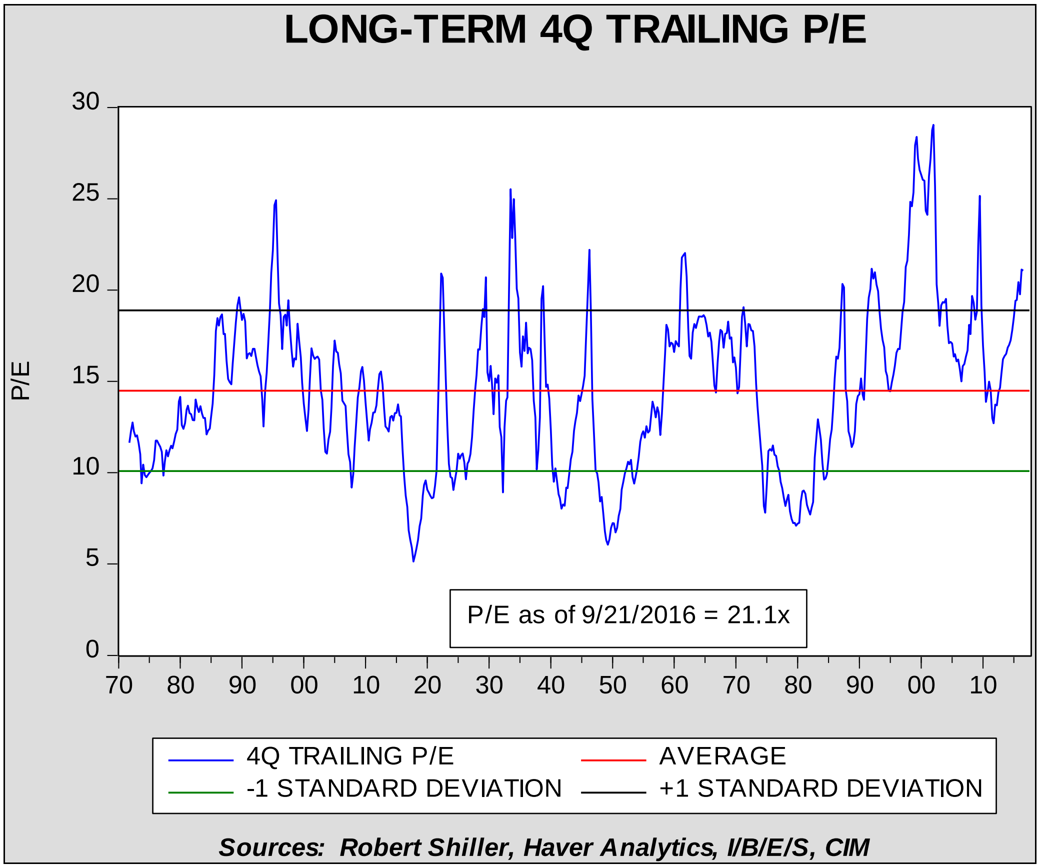


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[5] 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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[5] 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.