Confluence Investment Management

# *Daily Comment*

**By Bill O'Grady & Kaisa Stucke, CFA**

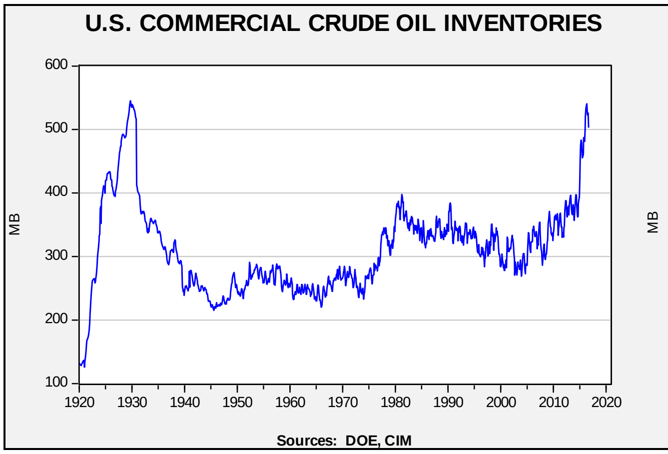
**[Posted: September 29, 2016—9:30 AM EDT]** Global equity markets are mixed this morning. The EuroStoxx 50 is trading higher by 0.6% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 0.6% from the prior close. Chinese markets were also higher, with the Shanghai composite moving up 0.4% and the Shenzhen index higher by 0.4%. U.S. equity futures are signaling a lower opening following this morning's economic releases.

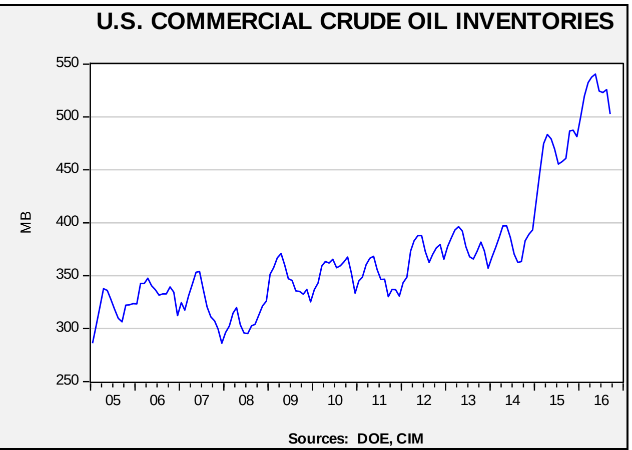
Oil prices jumped yesterday on an announcement that OPEC had arrived at a deal to cut production. This was mostly unexpected (we didn't expect it). According to early reports, the cartel agreed to cut output by 0.7 mbpd, which included a 0.4 mbpd cut by Saudi Arabia and a cap on Iranian production at 3.7 mbpd. That agreement would put cartel output at 32.5 mbpd. As the day wore on, however, the deal was clearly less than advertised. First, there isn't really an agreement. OPEC won't actually detail production quotas until the November 30th meeting. The latter commentary suggested that cuts could be in a range between 0.7 mbpd and 0.2 mbpd. The former is impressive; the latter is mostly a rounding error. Later comments from the Iranians indicated they will not "have" to freeze output, which we read as "won't."

There are other questions. Why would the Saudis raise the risk of social unrest by announcing a 20% salary cut for government workers, along with subsidy cuts of up to 15% for housing, if they knew they were going to work out a deal with OPEC to lift prices? Will Saudi civil servants, who represent about 66% of all employed Saudis, go along with less income when they know that the kingdom has a deal to lift oil prices? What prompted the kingdom to cave into Iran's demands? Given recent history, giving in to Iran would suggest that conditions have deteriorated more than the financial data would suggest, or the Saudi princes have rebelled against Deputy Crown Prince Salman and demanded higher oil prices and more revenue. This seems like a major policy reversal that has come without comment from the DCP. Finally, the Russians got off without cutting output!

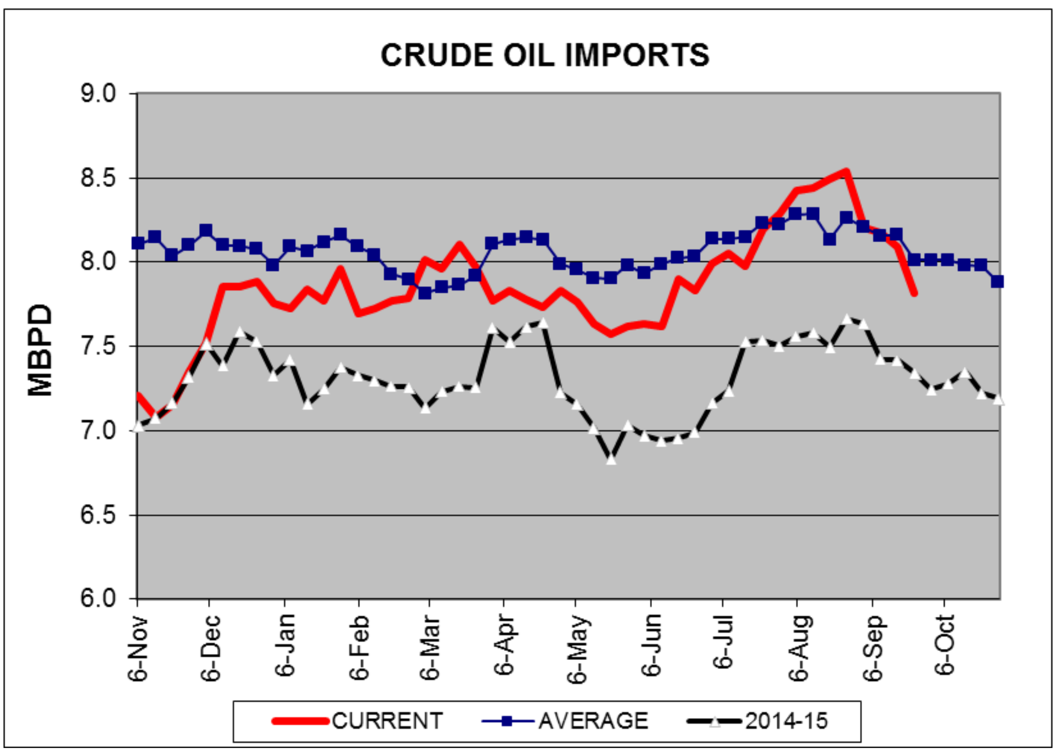
The sharp rise in prices yesterday had all the look of short covering. OPEC did buy itself some time before it has to make a deal, but a meaningful agreement still looks like a long shot. Thus, we would be surprised to see much follow through from yesterday. At the same time, the potential for an agreement will put a floor under prices, meaning that the $40 to $42 price zone (WTI) will probably become a base for the market. Why? Because OPEC appears to be working to resume its market-balancing role. It still isn't clear whether the cartel is fully behind this resumption and it doesn't answer the long-term question for oil producers, which is the value of future reserves. If regulation turns oil into coal in 20 years, why would anyone wait to produce instead of doing so now?

U.S. crude oil inventories fell 1.9 mb compared to market expectations of a 2.4 mb build.

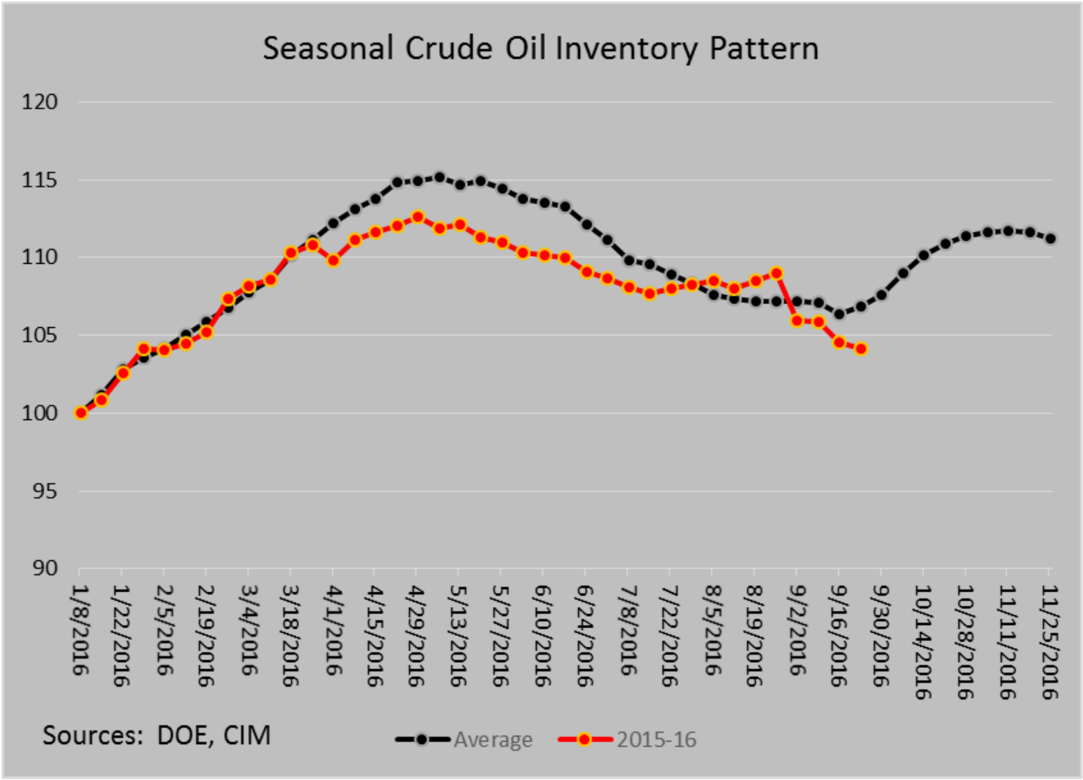


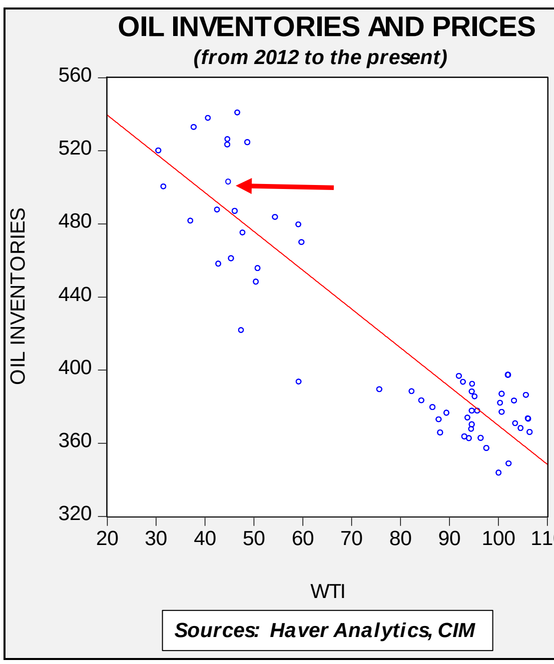

This chart shows current crude oil inventories, both over the long term and the last decade. For the past three weeks we have seen a steady decline in stockpiles. As the chart below shows, seasonally, we should see inventories rise as refineries begin their maintenance period. However, we have seen a sharp drop in oil imports which have exceeded seasonal norms. Some of that decline was due to tropical disruptions but the drop is clearly noticeable.

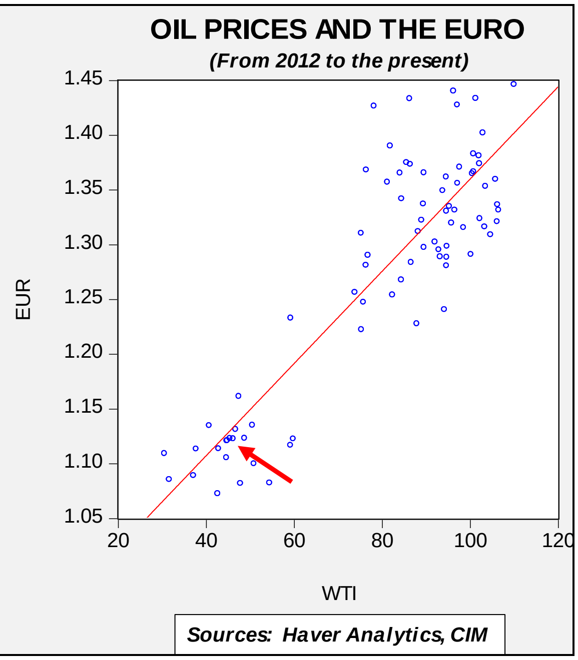



If this trend continues, it would be bullish for WTI. The seasonal pattern suggests at least a leveling off of import flows and a build in stockpiles.




Based on inventories alone, oil prices are overvalued with the fair value price of $45.66. Meanwhile, the EUR/WTI model generates a fair value of $49.07. Together (which is a more sound methodology), fair value is $44.17, meaning that current prices are close to fair value.



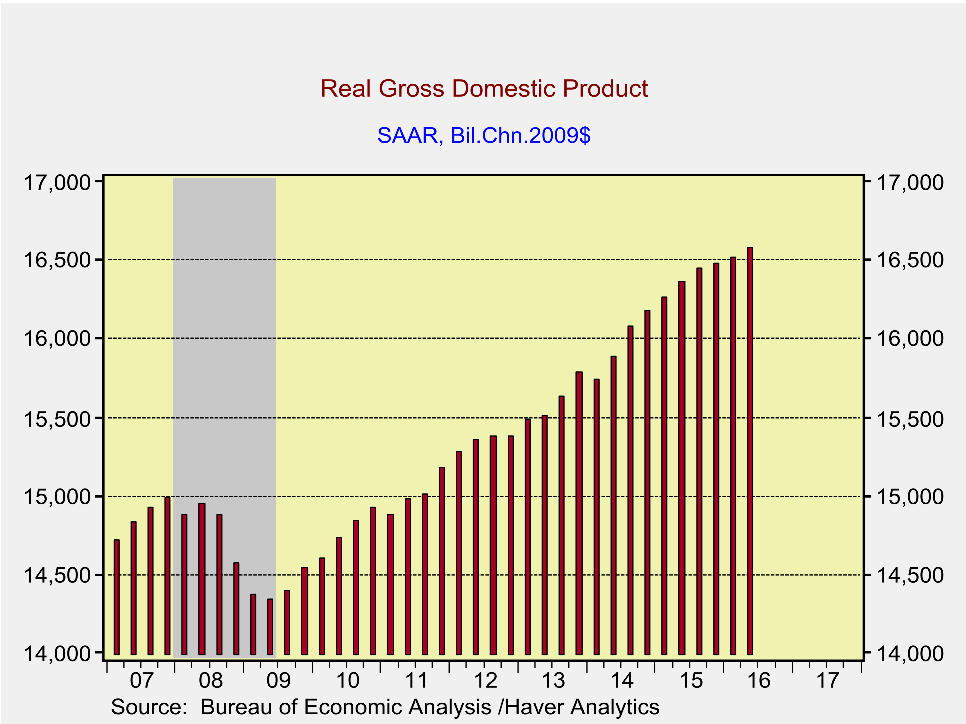
## U.S. Economic Releases

The last revision to Q2 GDP was released, coming in a bit stronger than expected at +1.4% compared to expectations of a 1.3% rise. This table shows the contribution to the overall growth number.

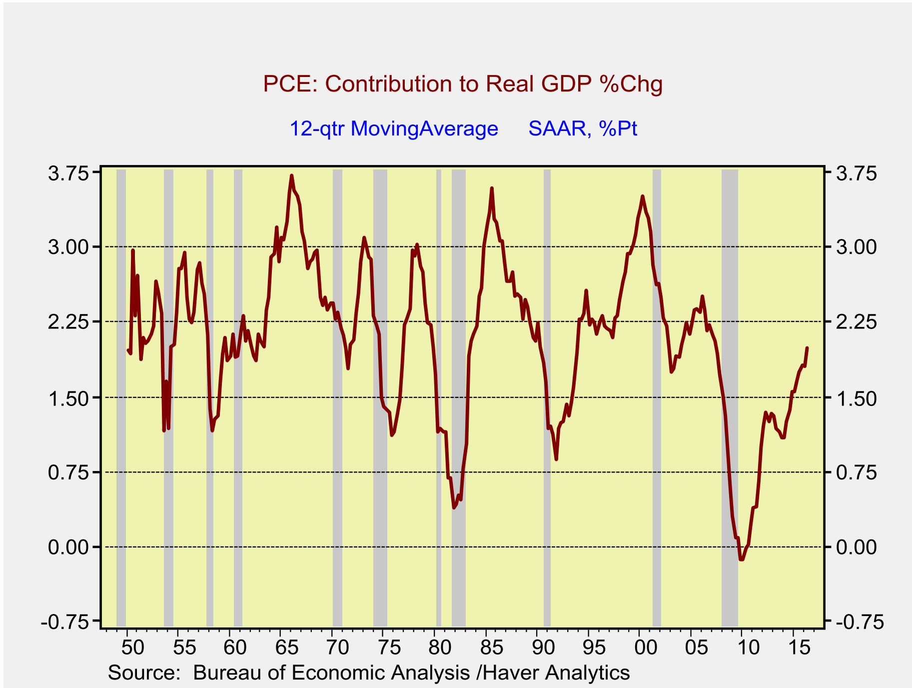
| | Current | 1st rev | Advance | curr-1st |
|---|---|---|---|---|
| GDP | 1.4 | 1.1 | 1.2 | 0.3 |
| Consumption | 2.83 | 2.94 | 2.88 | -0.11 |
| Investment | -1.68 | -1.67 | -1.34 | -0.01 |
| inventory | -1.16 | -1.26 | -1.16 | 0.1 |
| Net exports | -1.05 | -1.14 | -1.23 | 0.09 |
| Government | -0.04 | -0.04 | -0.03 | 0 |

Investment and net exports remain a serious drag on growth, although inventory liquidation accounted for almost 70% of the drop in investment. Expectations from the Atlanta FRB suggest that inventories will add about 60 bps to Q3 growth, which is currently expected at 2.8%.

Here are some of the relevant charts:

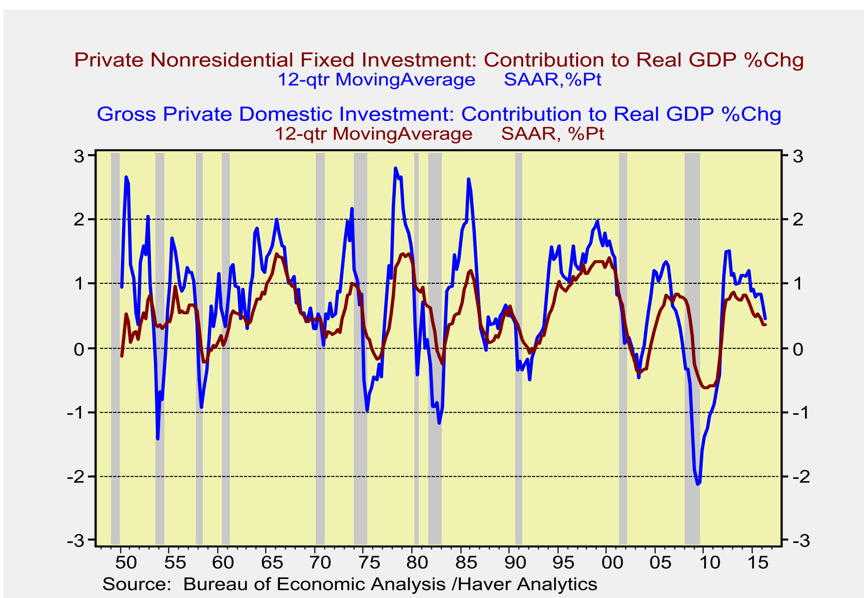



This shows the level of real GDP; the expansion continues.

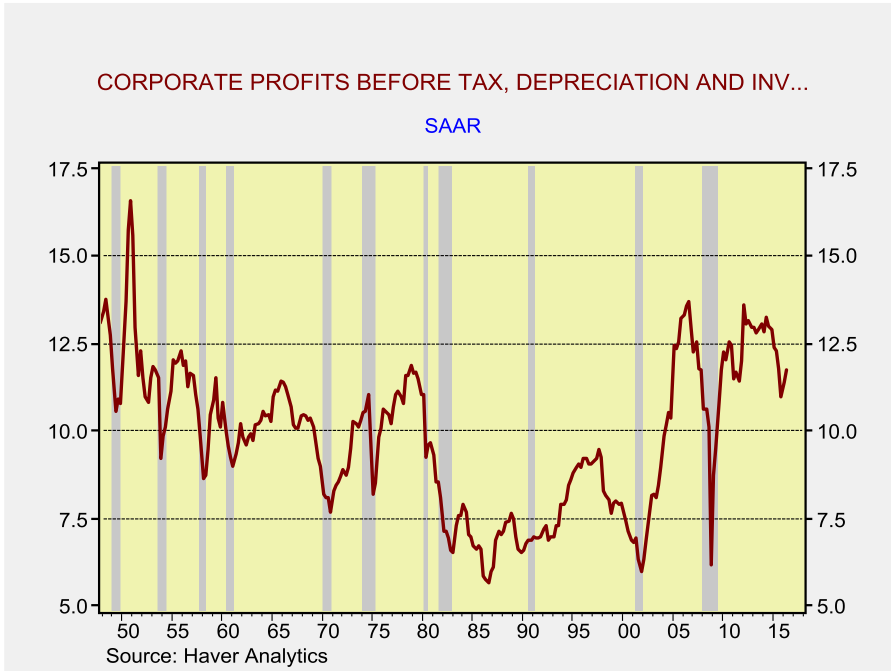



This chart shows the rolling three-year average contribution to GDP coming from consumption. As the data show, consumption is recovering quite well and is the primary support to economic growth.

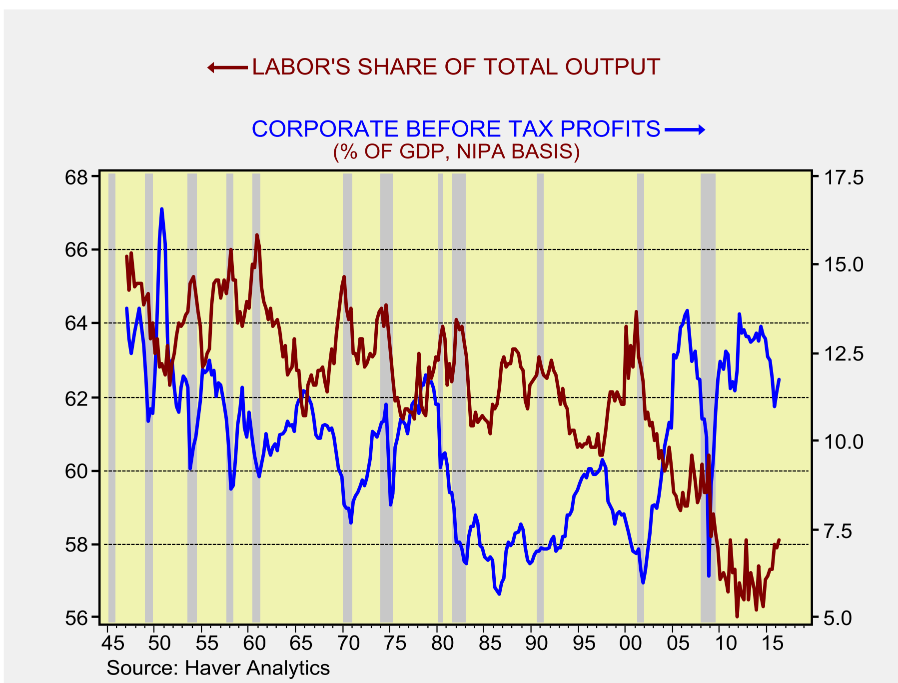
On the other hand, investment remains sluggish.




This chart shows the same measure as above; investment's contribution is currently minimal and the trend is falling.

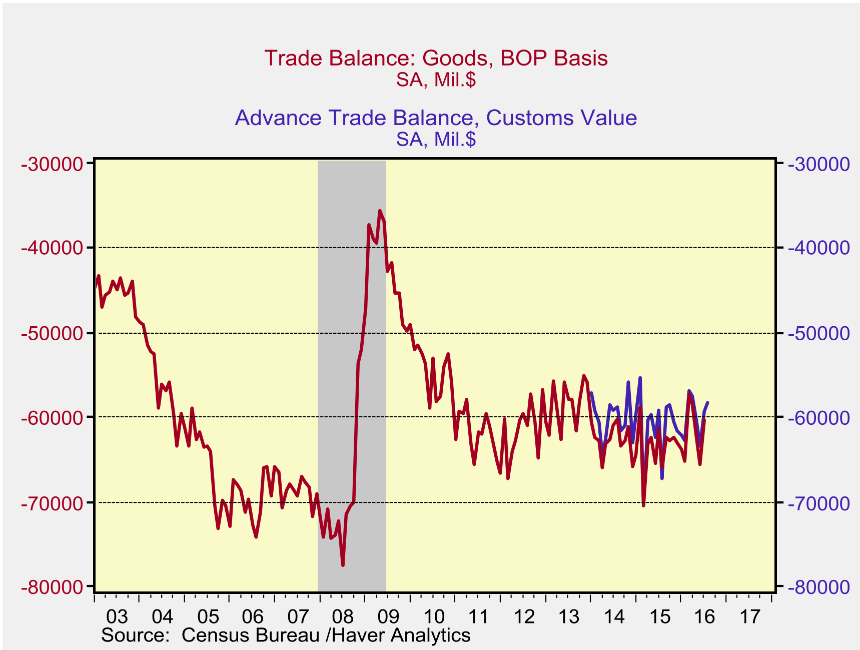



Profit margins are showing signs of recovery.



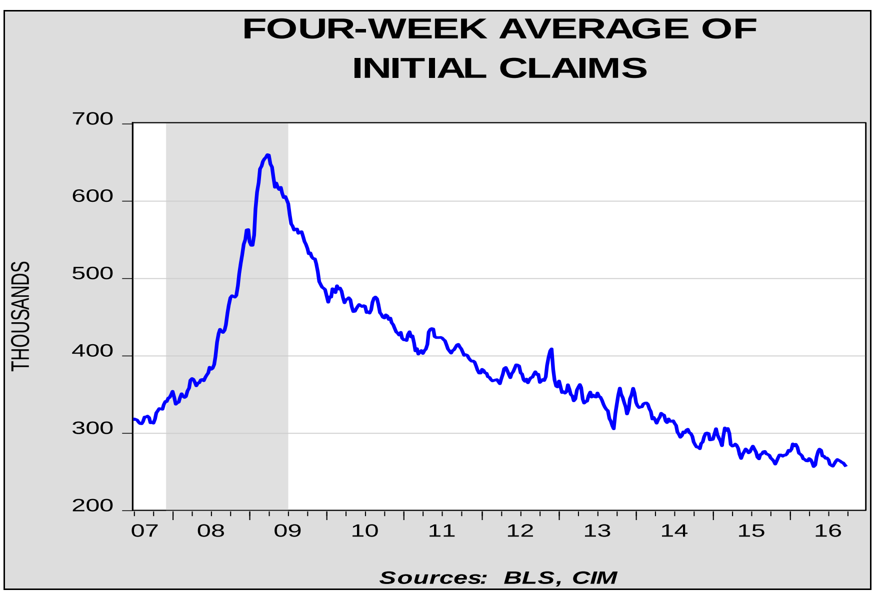

The margin improvement has slowed the recovery in labor's share; the low level of labor's share is partly behind the rise of populism in the political sphere.

The August advance trade deficit came in narrower than forecast, coming in at $58.4 bn compared to the forecast of $62.2 bn. This level is about even with July's trade deficit of $58.8 bn. Exports rose 0.7% for the month, while imports rose 0.3%.




The chart above shows the level of the trade balance. Over the past three years, the trade deficit has mostly moved sideways.

Initial claims rose 3k to 254k compared to the 260k forecast. Claims have remained near their recent lows as companies are holding onto their workforce in anticipation of improving demand. Claims have stayed below 300k since March 2015.



The chart above shows the four-week average, which fell 2k to 256k.

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

| EDT | Indicator | | | Expected | Prior | Rating |
|---|---|---|---|---|---|---|
| 8:30 | Pending Home Sales | y/y | Aug | 2.6% | -2.2% | ** |
| Fed speakers or events | | | | | | |
| EST | Speaker or event | District or position | | | | |
| 10:00 | Powell | Fed Governor | | | | |
| 2:00 | Kashkari | Minneapolis FRB President | | | | |
| 4:00 | Yellen | Fed Chairwoman | | | | |

## 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 | | | | | | | | |
| Eurozone | Economic Confidence | y/y | sep | 104.9 | 103.5 | 103.5 | ** | Equity bullish, bond bullish |
| | Consumer Confidence | y/y | sep | -8.2 | -8.3 | -8.4 | ** | Equity bearish, bond bullish |
| Germany | CPI Saxony | y/y | Sep | 0.7% | 0.5% | | *** | Equity bullish, bond bullish |
| | Unemployment Claims Rate | y/y | Sep | 6.1% | 6.1% | 6.1% | ** | Equity bullish, bond bullish |
| UK | M4 Money Supply | y/y | sep | 5.4% | 3.9% | | ** | Equity bullish, bond bullish |
| | Mortgage Approvals | y/y | sep | 60.1 k | 60.9 k | 60.2 k | * | Equity bullish, bond bullish |
| | Net Lending Sec. on Dwellings | m/m | Sep | 2.9 bn | 2.7 bn | 2.6 bn | * | Equity and bond neutral |
| AMERICAS | | | | | | | | |
| Canada | CFIB Business Barometer | y/y | sep | 59 | 59.8 | | ** | Equity and bond neutral |
| Brazil | FGV Inflation IGPM | y/y | sep | 10.7% | 11.5% | 10.7% | *** | 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)** | 85 | 85 | 0 | Neutral |
| **3-mo T-bill yield (bps)** | 26 | 27 | -1 | Down |
| **TED spread (bps)** | 60 | 58 | 2 | Up |
| **U.S. Libor/OIS spread (bps)** | 43 | 43 | 0 | Neutral |
| **10-yr T-note (%)** | 1.58 | 1.57 | 0 | Neutral |
| **Euribor/OIS spread (bps)** | -30 | -30 | 0 | Neutral |
| **EUR/USD 3-mo swap (bps)** | 50 | 42 | 8 | Neutral |
| **Currencies** | **Direction** | | | |
| dollar | up | | | Neutral |
| euro | down | | | Neutral |
| yen | down | | | 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 | $48.36 | $48.69 | -0.68% | Saudi Arabia agrees to output freeze |
| WTI | $46.93 | $47.05 | -0.26% | |
| Natural Gas | $3.01 | $3.00 | 0.33% | |
| Crack Spread | $13.73 | $14.17 | -3.10% | |
| 12-mo strip crack | $14.05 | $14.30 | -1.78% | |
| Ethanol rack | $1.67 | $1.67 | -0.06% | |
| **Metals** | | | | |
| Gold | $1,320.95 | $1,321.54 | -0.04% | Profit taking, higher dollar |
| Silver | $19.08 | $19.19 | -0.60% | |
| Copper contract | $219.15 | $218.75 | 0.18% | |
| **Grains** | | | | |
| Corn contract | $ 333.00 | $ 329.25 | 1.14% | Increase commodity prices in general |
| Wheat contract | $ 405.75 | $ 403.25 | 0.62% | |
| Soybeans contract | $ 954.25 | $ 945.50 | 0.93% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 912 | 930 | -18 | |
| **DOE inventory report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | -1.9 | 2.4 | -4.3 | |
| Gasoline (mb) | 2.0 | -0.4 | 2.4 | |
| Distillates (mb) | -1.9 | 0.8 | -2.7 | |
| Refinery run rates (%) | -1.9% | -0.5% | -1.4% | |
| Natural gas (bcf) | | 54.6 | | |

## Weather

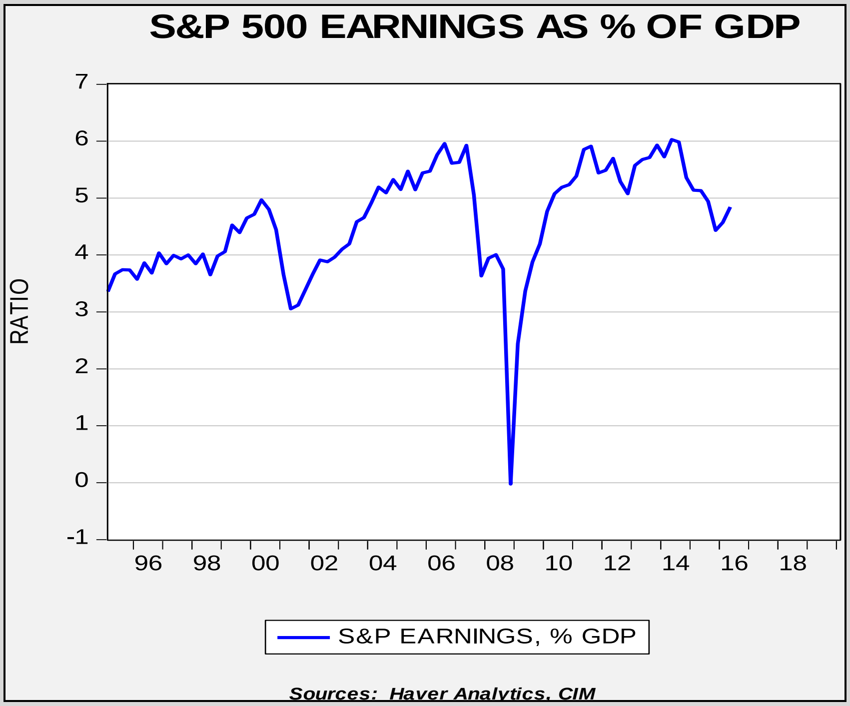
The 6-10 and 8-14 day forecasts are calling for warmer conditions for most of the country, except parts of the western region. Precipitation is forecast for most of the country. Tropical Storm Matthew is located in the central Caribbean and is expected to slow as it turns north. TS Matthew is not expected to enter the GOM. 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.

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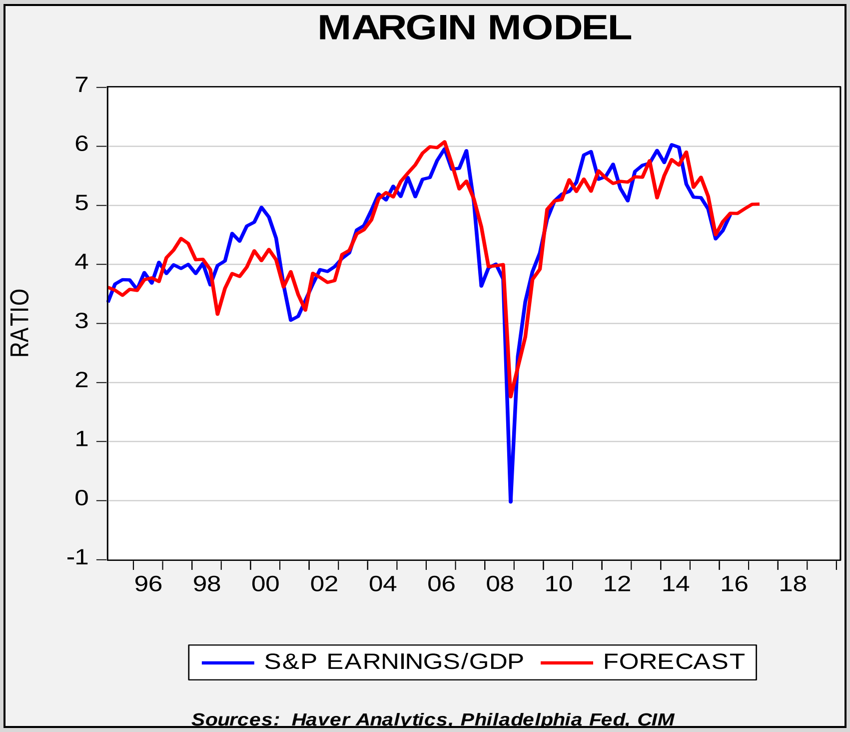
[1] Also known as the Flow of Funds report.




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]

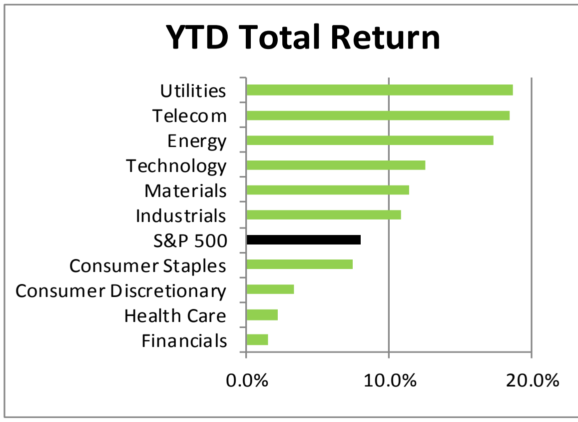
The key to the forecast is that the dollar will gradually weaken as the terminal rate is lowered for fed funds and as oil prices recover to $52 by mid-2017. If the dollar unexpectedly strengthens, which would also lower oil prices, we would need to adjust our forecasts lower. Of course, this also means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

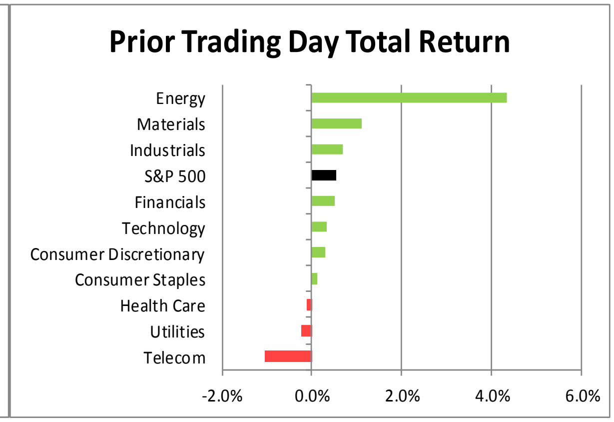


[2] This change reduces our estimate for 2016 from $107.82, but increases our forecast for 2017 from $109.32.
[3] We analyzed this issue in the AAW from 7/15/2016.

## Data Section

**U.S. Equity Markets** – (as of 9/28/2016 close)

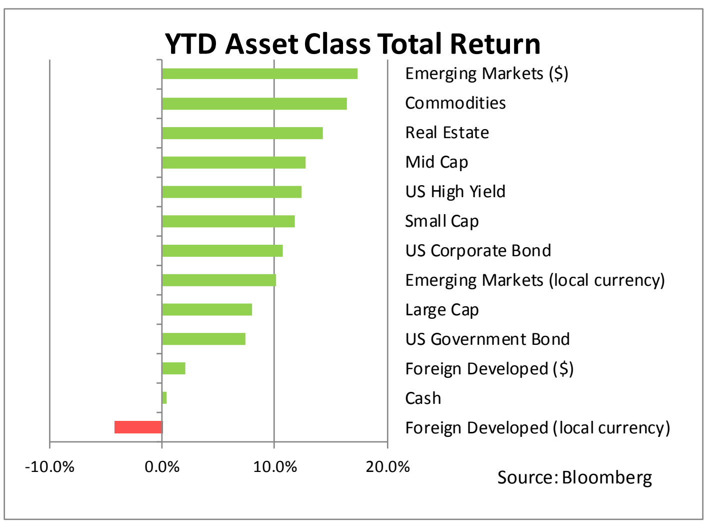



(Source: Bloomberg)

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 9/28/2016 close)

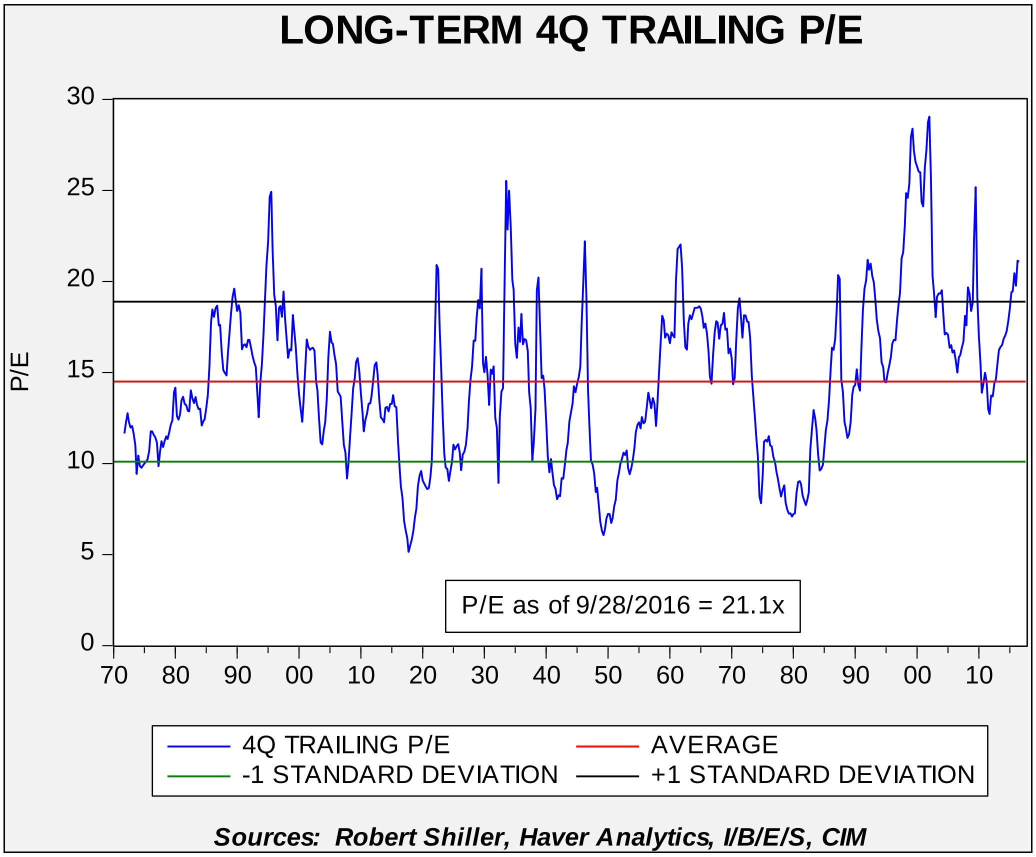



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 29, 2016




Based on our methodology,[4] the current P/E is 21.1x, 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.*

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[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.