# Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

**[Posted: October 20, 2014—9:30 AM EDT]** Global equity markets are mixed this morning. The EuroStoxx 50 is trading lower by 1.5% from last week's close. In Asia, the MSCI Asia Apex 50 was higher by 1.1% from the prior close. U.S. equity futures are signaling a lower opening. With 16.2% of the S&P 500 companies reporting, actual plus projected earnings are $29.25 on a float-adjusted basis. This is below the $30.02 forecast. Of the 81 companies that have reported, 69.1% beat estimates while 17.3% were below forecast.

After St. Louis Fed President Bullard surprised the markets last week by hinting that QE might be extended, the FOMC, almost as a group, quashed the idea. The *WSJ*'s "Fed Whisperer," Jon Hilsenrath, indicated in today's paper that the majority of members intend to end QE this month and use the policy rate as the primary tool for guiding the economy. Bullard's statement was a surprise because it was out of character. Bullard has leaned toward the hawkish side during his tenure at the FOMC, so his statement caught the markets by surprise. However, the general consensus on the FOMC seems to be that QE has outlived its usefulness and that the policy rate is a more effective tool for conducting monetary policy. In the media, it was interesting to see that there was virtually no support for Bullard's position even among prominent doves, like Boston Fed President Rosengren.

Thus, QE will likely end this month but we expect the pace and timing of the first fed funds rise to be later and slower than the "dots" chart would suggest. Global growth concerns will likely force the Fed to hew a cautious path to removing stimulus; in general, we are expecting that the tightening of rates will be at a pace gradual enough to keep policy leaning stimulative. By moving slowly, the Fed can watch the global economy and avoid the position of backtracking (cutting rates quickly after raising them).

Other than that development, there wasn't much other news. IS is struggling in Syria but making gains in the Anbar province in Iraq. The new Iraqi government named a Shiite to the key role of interior minister. This move will weaken efforts to reduce sectarianism in Iraq and further move the country to devolution. European nations are submitting their 2015 budgets to the EU. Germany has offered a balanced budget which is raising serious concerns about the future of the Eurozone. Essentially, for the Eurozone to work, Germany must play the role at the continental level that the U.S. does on a global scale. Namely, Germany must become the Eurozone's importer of last resort and regional growth engine. As long as Germany runs austerity, it will drag the Eurozone into a version of its own policies. This factor will weigh further on Eurozone growth and depress global economic prospects.

**U.S. Economic Releases**

There are no releases scheduled before we go to print, but for the rest of today, at 10:00 EDT, Fed Governor Powell will give a speech, followed by Fed Governor Tarullo at 12:00.

**Foreign Economic News**

In Asia, Japan's August LEI rose 0.4% from the year before, while the coincidence indicator fell 0.2% from the month before.

In Europe, the Eurozone August current account surplus narrowed to EUR 18.9 bn from EUR 21.6 bn the month before. Germany's September PPI fell 1.0% annually, on forecast. Italy's August industrial sales rose 0.4% monthly, while industrial orders rose 1.5%.

**Financial Markets**

In the financial markets, three-month Libor yields were stable at 23 bps and three-month T-bill yields fell 1 bp to 2 bps, widening the TED spread to 21 bps. The U.S. Libor/OIS spread was unchanged at 14 bps. The 10-year Treasury yield rose 3 bps to 2.21%. The Euribor/OIS spread was stable at 9 bps and the EUR/USD three-month swap spread widened 1 bp to 11 bps. The dollar is lower along with the yen.

**Commodity Markets**

Commodity markets are mixed this morning. Crude futures are mixed, with Brent lower but WTI higher. Speculation is increasing that OPEC will cut production targets as its producers need higher prices. The nearby crack spread stands at $14.36, up $0.84 from the prior trading day, while the 12-month strip crack spread was $17.34, up $0.35 from last night. The ethanol rack prices rose four cents to $1.94. Precious metals are trading higher on the lower dollar. Industrial metals are lower on expectations of slowing Chinese demand. Grains are lower on harvest pressures. The Baltic Dry Freight index was 944, higher by 14 points from the prior trading day.

**Weather**

The 6-10 and 8-14 day forecasts call for warmer than normal weather for most of the country. Dry conditions are forecast for the short end of the forecasting period, while precipitation is forecast for the Midwest in the longer run.

A low pressure area has formed in the southwestern corner of the GOM, with a medium chance of becoming a cyclone over the next two days. This development could have the potential to disturb the production and transportation of oil in the Gulf. Another small low pressure area has formed off the coast of Africa. This activity has a low chance of becoming a cyclone over the next two days.

**Weekly Asset Allocation Commentary**

*Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. This year, we will start reporting asset allocation thoughts on a weekly basis, updating the piece every Friday. We hope you find this new addition useful.*

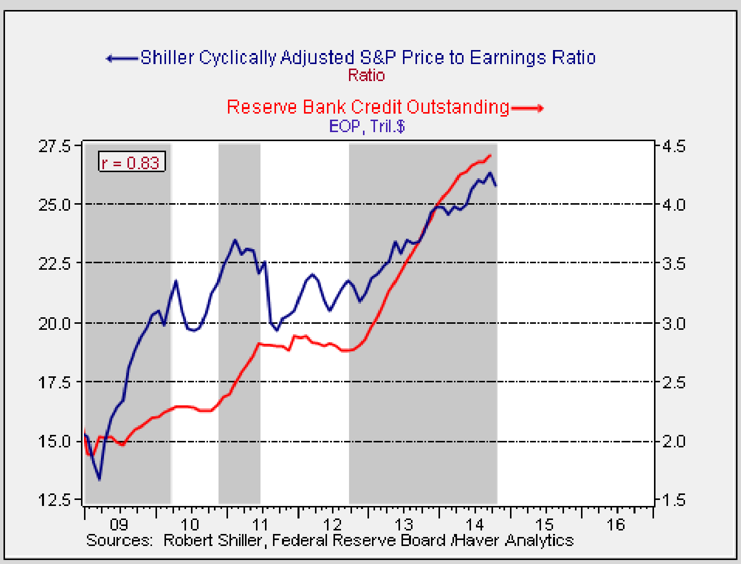
October 17, 2014

One of the most significant unknown factors for the coming months is the impact of the end of quantitative easing (QE) on equity markets. We have shown, on numerous occasions, that there has been a tight correlation between the S&P 500 and the size of the Federal Reserve's balance sheet since 2009. Thus, it would stand to reason that if the correlation holds then the end of QE will, at least, be a headwind for equities.

However, one of the concerns about this relationship is the causality between the size of the Fed's balance and the S&P. One of the problems with correlation is that it doesn't necessarily indicate causality. We know the two variables move together; from that relationship alone, we cannot ascertain which variable is the cause and which variable is the effect. In addition, the two may move together but the relationship exists because some other variable is the causal factor (the so-called "omitted variable" problem in logic and statistics).

It isn't obvious how excess bank reserves, which are created by QE, lift equity prices. After all, the reserves seem to remain safely on bank balance sheets; there is little evidence to suggest that they have directly found their way into the equity markets. It is possible that QE has led to lower interest rates which encouraged investors to move funds into equities in search of higher yields. However, as we have also shown in the past, 10-year Treasury yields actually rise during periods of QE. Thus, the zero interest rate policy (ZIRP) may have had a bigger impact.

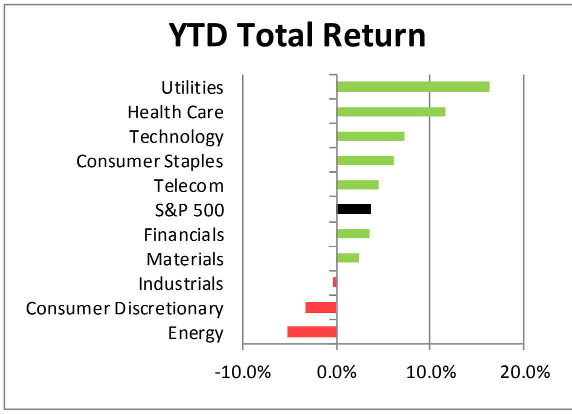
However, it is possible that QE raised investor sentiment by proving to investors that the FOMC had additional policy measures available even though the fed funds target was effectively zero. If this were true, we should see a positive correlation between periods of QE and the market's price/earnings ratio, which is a measure of investor sentiment.

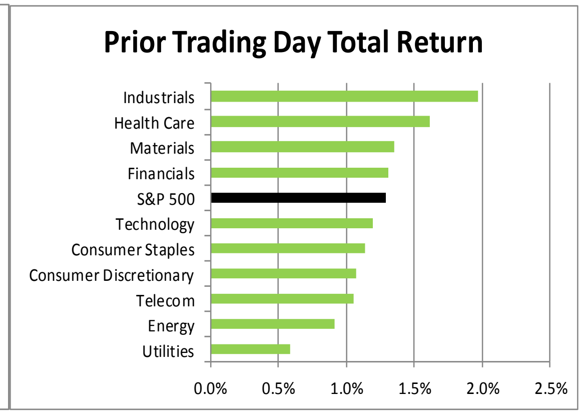


In fact, that is exactly what we observe. The above chart shows the Shiller Cyclically-Adjusted P/E and the Federal Reserve balance sheet. We have shaded areas on the chart that represent periods of QE. Note that the P/E rose during QE phases. This chart suggests that the positive relationship between the Fed's balance sheet and the S&P 500 is probably due to an expanding P/E. And so, as QE comes to a close, we should expect the P/E to cease expanding, which means that further index appreciation will need to rely more on earnings. Since margins are already rather stretched, we may be looking at a rather modest year for equities in 2015.

## Data Section

**U.S. Equity Markets** – (as of 10/17/2014 close)

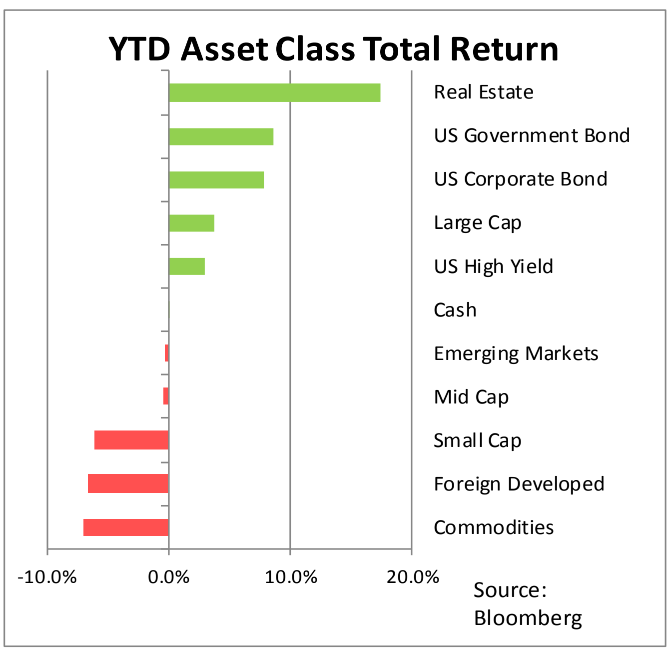



(Source: Bloomberg)

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 10/17/2014 close)

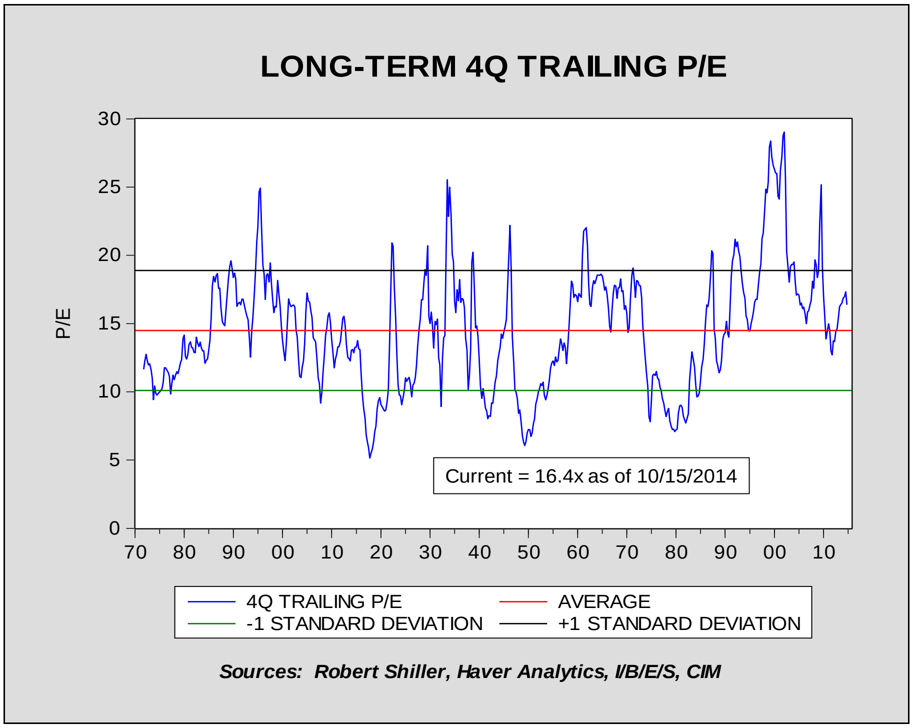



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 EAFA Index), Real Estate (FTSE NAREIT Index), Emerging Markets (MSCI Emerging Markets 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**

October 16, 2014




One of the new features we have added to the Daily Comment this year is the above chart, which 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; for example, the current four-quarter earnings sum includes two actual (Q1 and Q2) and two estimates (Q3 and Q4). 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.

This week we begin adding Q4. Based on our methodology, the current P/E is 16.4x, down from the last reading of 16.6x. The recent weakness in equities caused the P/E to decline, while Q4 earnings are also forecast to be substantially stronger than Q3 earnings. Over time, we expect Q4 estimates to be revised downward.

*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.*