Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: August 21, 2015—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 1.1% from the last close. In Asia, the MSCI Asia Apex 50 was down 2.4% from the prior close. Chinese markets slipped, with the Shanghai composite down 4.3% and the Shenzhen index down 5.4% as well. U.S. equity futures are signaling a lower opening from the previous close. With 96.0% of the S&P 500 companies having reported Q2 earnings, the actual plus projected adjusted EPS is $30.01, above the $28.70 forecast. Of the 480 companies that have reported, 68.5% had positive earnings surprises, while 21.7% had negative earnings surprises.

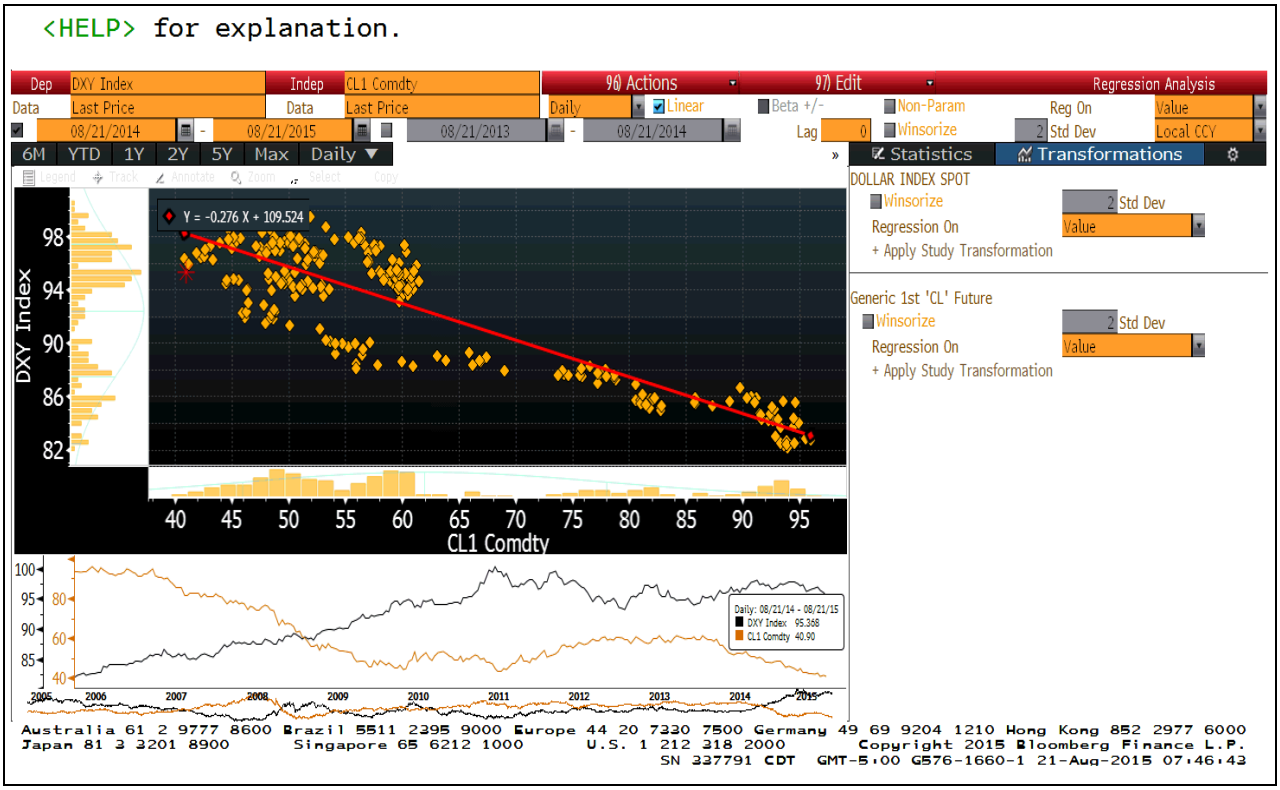
Yesterday was difficult for equities. Technically, we broke the low end of the recent trading range.

(Source: Bloomberg)

The white support line had been in place since early February and was tested three times. The next level of support is around the 1990-1980 area. Basis the September futures and taking the overnight low into account, we are down 5.5% from the mid-July highs, which is still a rather modest decline in terms of market volatility. Most of the weakness is coming from worries over China, although jitters about FRB monetary policy is likely a contributing factor.

What spooked the market overnight was the weakness seen in China's PMI data (see below). China's economy continues to slow despite a myriad of measures to bolster prices. There is a growing impression that policymakers in China are struggling to support the economy and may simply need to allow the economy to slow in order to facilitate restructuring. The Shanghai composite is nearing the 3500 level, where most traders believe the government will directly support stocks. If this level is tested and broken without a response from the Xi regime, we could easily see larger declines. While China's economy is clearly slowing, we do note that Europe and Japan's PMI data was actually strong and suggests the rest of the world is not doing all that badly.

One of the more interesting features of this week's market action has been that the dollar has turned lower. Currency traders are concluding the FOMC won't move on rates next month (we would disagree) and that has sent the dollar lower. For most of the year, there has been a strong inverse relationship between oil prices and the dollar. So far, the dollar's weakness hasn't translated into better oil prices.



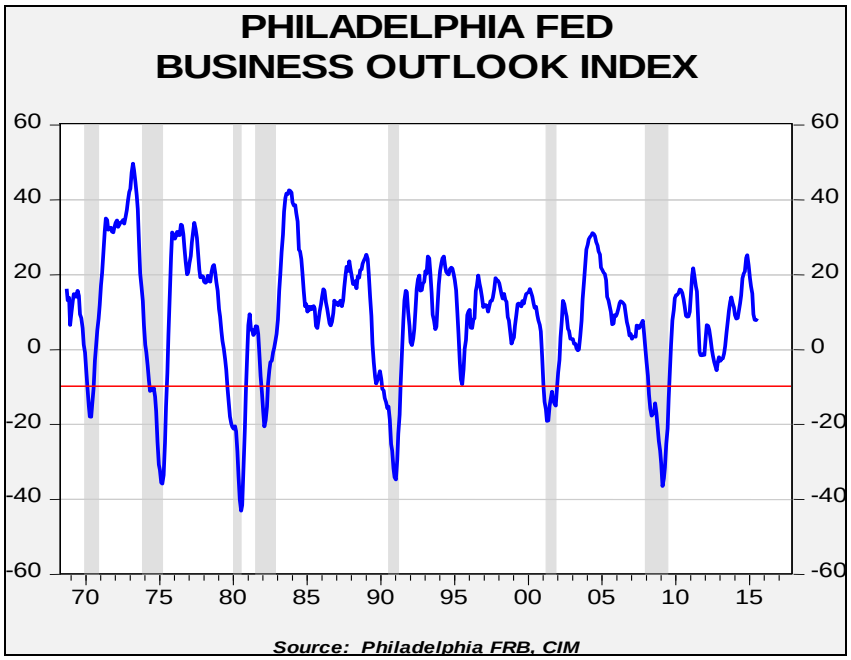
(Source: Bloomberg)

This chart shows a regression of oil prices and the dollar index over the past year. On the left side of the regression, there is a red star that shows yesterday's close for both oil and the dollar. The regression suggests that the current oil prices are justified with a dollar index of 98.0. To be consistent with recent behavior, a dollar index of 95.5 indicates oil prices in the mid-$50s. That doesn't mean that oil prices are poised to rally, but it does suggest the current price has discounted a lot of bad news in the short run.

Finally, one issue we will be watching this weekend is the growing tensions on the Korean peninsula. Although the recent skirmishes are not all that intense compared to North Korean attacks on South Korean navy vessels in the past, three conditions are different this time around. First, these attacks are occurring on the demilitarized zone where tensions are always elevated. Second, South Korea has implemented a more hostile stance toward North Korean aggression, which increases the odds of unexpected escalation. Third, Kim Jong un is still establishing his power base which may mean he needs to look really tough to maintain credibility with the North Korean leadership. The consensus is that nothing bad is going to happen. This means that if conditions worsen, markets will not be prepared.

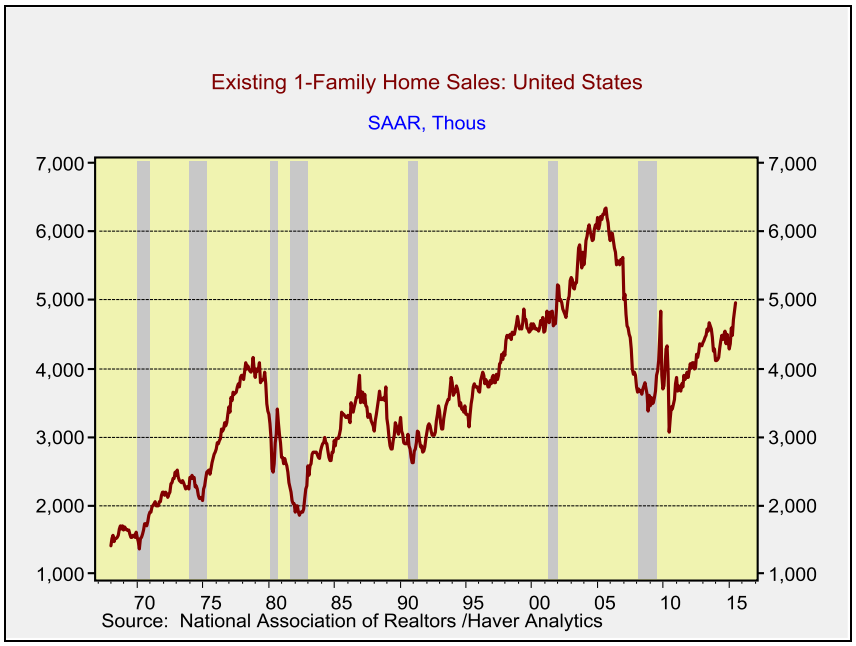
U.S. Economic Releases

Yesterday's Philadelphia FRB August business outlook index came in a bit better than forecast, at 8.3 compared to a reading of 6.5.



This chart shows the aforementioned index, smoothed with a six-month moving average. Although any reading under zero is a cause for concern, in the history of the index a reading under -10 (again, on a smoothed basis) has been a clear signal of recession. At present, the index is signaling that the economy is doing reasonably well.

Existing home sales for July were also released yesterday, with sales coming in at 5.59 mm units for all existing homes, better than the 5.43 mm expected. Single-family sales are also improving.



Compared to last year, single-family sales are up 11.0%.

For the rest of the day, at 9:45 EDT, the August Markit manufacturing PMI data will be released, with a 53.8 reading expected. Next week is the Jackson Hole meeting, a gathering hosted by the KC FRB. Often, major policy speeches and directions are revealed at this meeting. This year, major figures are not attending; Yellen, for example, will miss. However, we do note that Vice Chairman Fischer will talk on August 29 and could signal the future near term direction for policy. There are no speakers scheduled today.

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, with red indicating a concerning development, yellow indicating an emerging trend that we are following closely for possible complications and green indicating neutral conditions. We will add a paragraph below if any development merits further explanation.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
China	Caixin PMI manufacturing	m/m	Aug	47.1	47.8	48.2	***	Equity bearish, bond bullish
Japan	Nikkei PMI manufacturing	m/m	Aug	51.9	51.2		***	Equity bullish, bond bearish
EUROPE								
Eurozone	Markit PMI manufacturing	m/m	Aug	52.4	52.4	52.2	***	Equity bullish, bond bearish
	Markit PMI services	m/m	Aug	54.3	54.0	54.0	**	Equity bullish, bond bearish
	Markit PMI composite	m/m	Aug	54.1	53.9	53.7	**	Equity bullish, bond bearish
France	Markit PMI manufacturing	m/m	Aug	48.6	49.6	49.7	***	Equity bearish, bond bullish
	Markit PMI services	m/m	Aug	51.8	52.0	52.0	**	Equity bearish, bond bullish
	Markit PMI composite	m/m	Aug	51.3	51.5		**	Equity bearish, bond bullish
Germany	Markit PMI manufacturing	m/m	Aug	53.2	51.8	51.6	***	Equity bullish, bond bearish
	Markit PMI services	m/m	Aug	53.6	53.8	53.7	**	Equity bullish, bond bearish
	Markit PMI composite	m/m	Aug	54.0	53.7	53.6	**	Equity bullish, bond bearish
	Consumer confidence	m/m	Sep	9.9	10.1	10.1	**	Equity and bond neutral
Switzerland	M3	y/y	Jul	1.9%	2.1%		*	Equity and bond neutral
AMERICAS								
Brazil	Inflation	y/y	Aug	9.6%	9.3%	9.6%	***	Equity and bond neutral
Canada	Retail sales	m/m	Jun	0.6%	1.0%	0.2%	**	Equity bullish, bond bearish
	CPI	y/y	Jul	1.3%	1.0%	1.3%	***	Equity and bond neutral
	CPI Core	y/y	Jul	2.4%	2.3%	2.4%	***	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)	33	33	0	Neutral
3-mo T-bill yield (bps)	1	2	-1	Down
TED spread (bps)	32	32	0	Widening
U.S. Libor/OIS spread (bps)	14	14	0	Neutral
10-yr T-note (%)	2.07	2.07	0.00	Down
Euribor/OIS spread (bps)	10	10	0	Neutral
EUR/USD 3-mo swap (bps)	18	19	-1	Neutral
Currencies	**Direction**			
dollar	down			Rising
euro	up			Falling
yen	up			Falling
franc	up			Falling

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	Cause/ Trend
Energy markets				
Brent	$ 46.01	$ 46.62	-1.31%	Supply glut persists
WTI	$ 40.95	$ 41.32	-0.90%	
Natural gas	$ 2.71	$ 2.76	-1.67%	
Crack spread	$ 18.10	$ 18.78	-3.59%	Summer driving season nears end
12-mo strip crack	$ 16.90	$ 17.28	-2.23%	
Ethanol rack	$ 1.70	$ 1.70	-0.05%	
Metals				
Gold	$ 1,155.99	$ 1,152.20	0.33%	Global equity weakness
Silver	$ 15.47	$ 15.57	-0.65%	
Copper contract	$ 230.10	$ 231.75	-0.71%	China weakness
Grains				
Corn contract	$ 383.00	$ 382.50	0.13%	
Wheat contract	$ 506.75	$ 511.25	-0.88%	
Soybeans contract	$ 901.25	$ 907.25	-0.66%	
Shipping				
Baltic Dry Freight	1014	1031	-17	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)	2.6	-0.8	3.4	
Gasoline (mb)	-2.7	-1.5	-1.2	
Distillates (mb)	0.6	1.5	-0.9	
Refinery run rates (%)	-1.0%	-0.5%	0.0	
Natural gas (bcf)	55.0	59.0	-4.0	

Weather

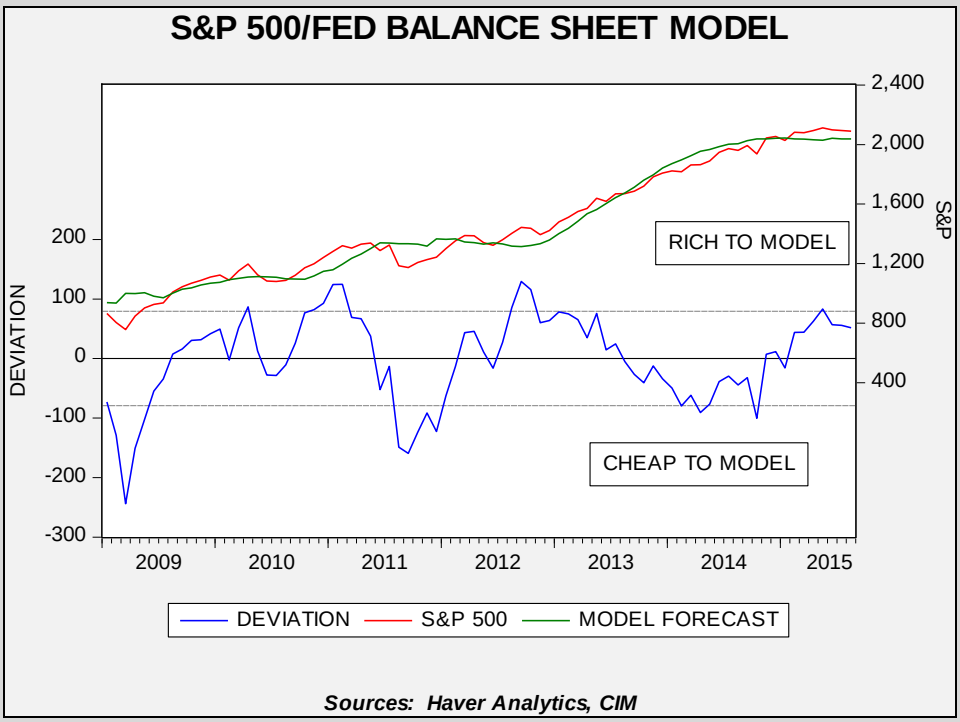
The 6-10 and 8-14 day forecasts indicate a cooling trend for the West and a warming trend for the areas east of the Rockies. Dry conditions are expected for all regions but the Pacific Northwest. This forecast is bullish for natural gas and supportive for grain. Hurricane Danny, currently spinning in the mid-Atlantic, is expected to hit the Leeward and Virgin Islands by Monday, Puerto Rico by Tuesday and Hispaniola on Wednesday. At this point, we would not expect it to affect energy production or flows. We are entering the most active season for tropical activity, which usually peaks on September 10.

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.

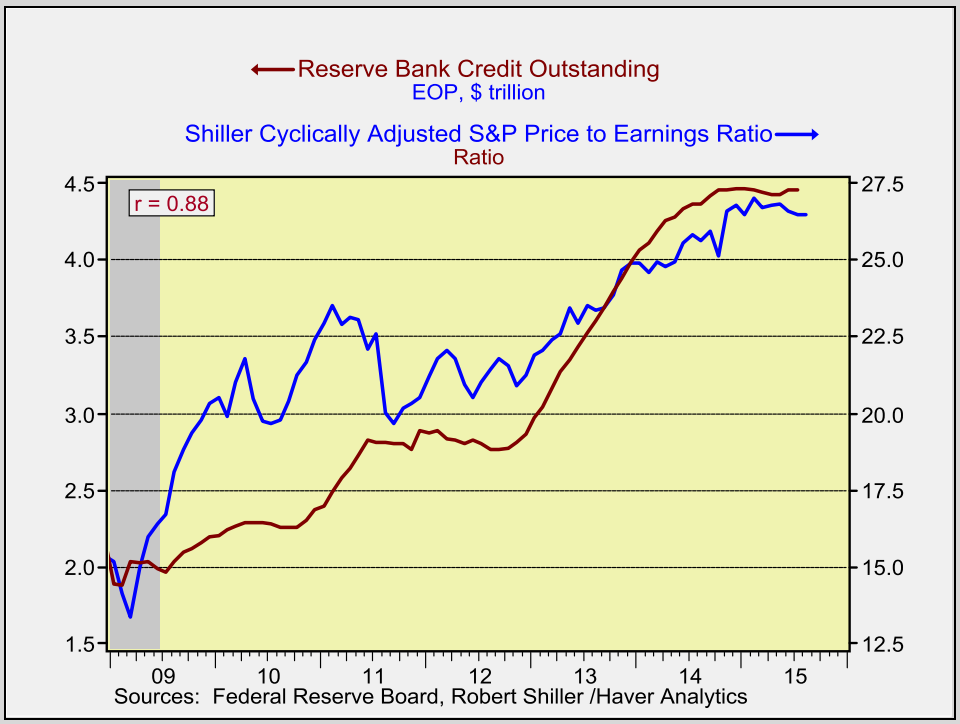
August 21, 2015

The S&P 500 has been mostly rangebound this year. That outcome is consistent with the relationship between the Federal Reserve's (FRB) balance sheet and the S&P 500 index.



This chart shows a model that uses the size of the FRB's balance sheet to the S&P price index. Since the recession ended in June 2009, the correlation of these two variables is 98.4%. Of course, correlation and causality are not the same thing. The financial world is littered with spurious correlations that suddenly fail to hold; this one could fall into the same category at some point. What bridges the difference between causality and correlation is theory. If one can explain why two variables move in some fashion it makes the case stronger that the correlation does imply some degree of causality.

We don't know exactly why the size of the FRB's balance sheet seems to drive equity markets. Our best assessment is that the size of the balance sheet boosts investor confidence.

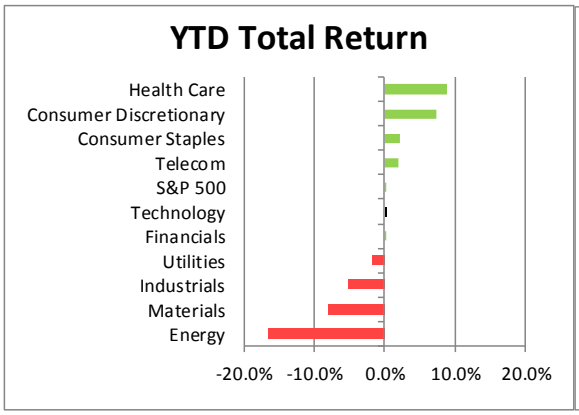


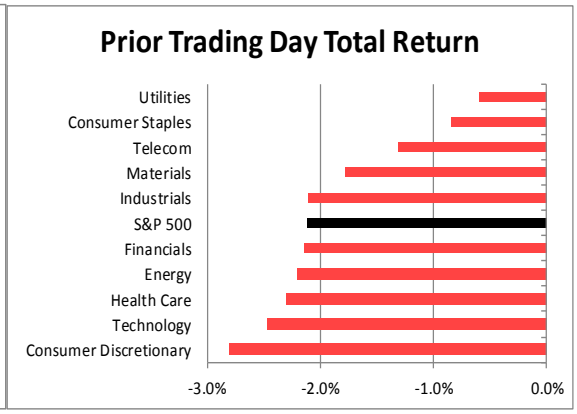
This chart shows the relationship between the FRB's balance sheet and the Shiller Cyclically Adjusted P/E ratio for the S&P 500. The two series are also highly correlated, at 88%. In general, we believe that the size of the balance sheet signals the degree of commitment the Federal Open Market Committee (FOMC) has to policy accommodation. Note that as the growth of the balance sheet has slowed, the CAPE has tended to flatten.

Currently, the above model is trading above fair value, which is 2038.00 for the S&P 500. A decline to the low end of the valuation range would put the index at 1963.50. Even though the fed funds target may be increased soon, we doubt it would trigger a major selloff unless the FOMC signals a robust tightening cycle is about to start. We do not expect such an outcome. A pullback to the lower end of the valuation range would not be pleasant but would not be a major pullback, either. Our baseline position is that recessions trigger bear markets and the primary culprit for a compression of the business cycle would be overly aggressive monetary policy tightening. Since we don't expect that outcome, a rangebound market is the most likely outcome.

Data Section

U.S. Equity Markets – (as of 8/20/2015 close)

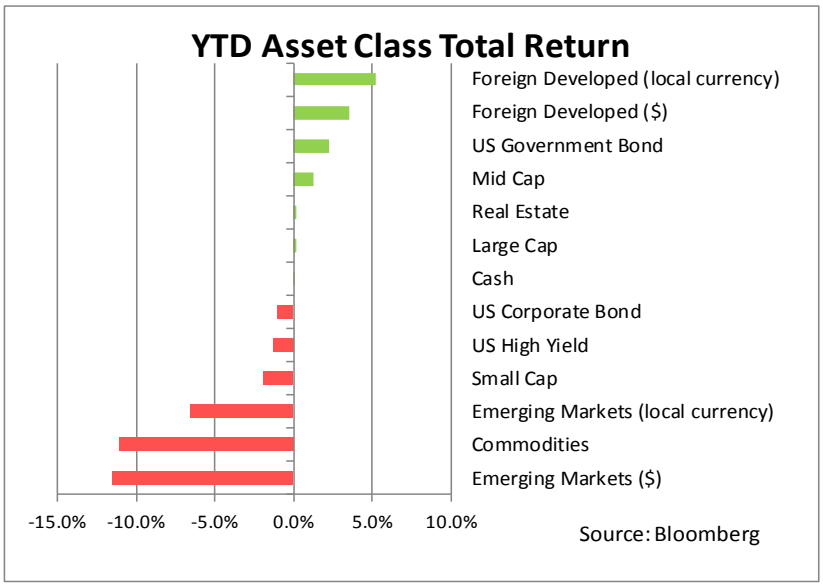




(Source: Bloomberg)

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 8/20/2015 close)

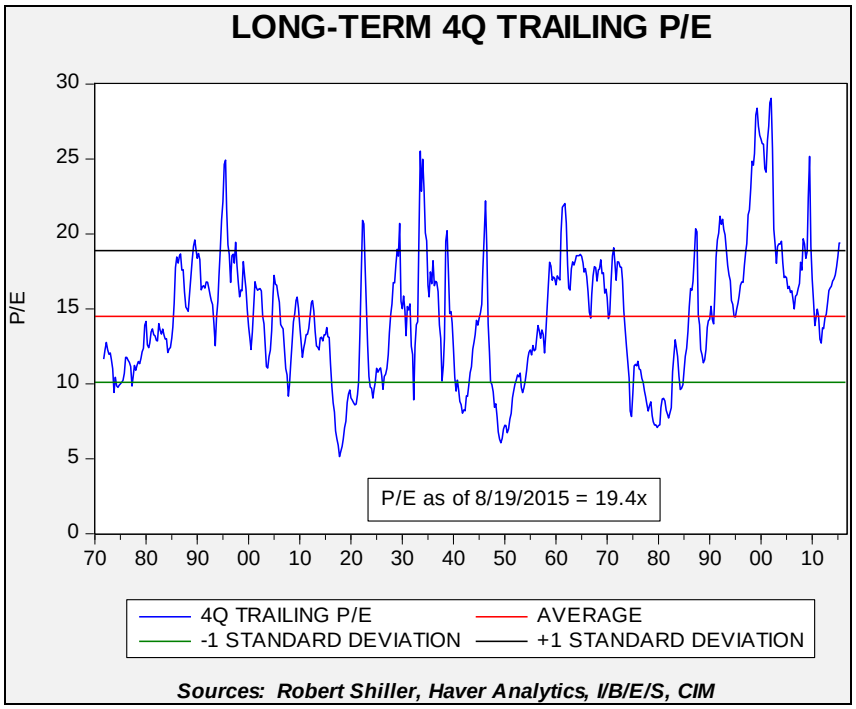


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

August 20, 2015



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 estimates (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.

Based on our methodology, the current P/E is 19.4x, up 0.1x from last week. The P/E remains very elevated on a historical basis. High valuations probably explain the sluggish market performance this year.

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.