Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: May 14, 2015—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is trading up 0.7% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.2% from the prior close. U.S. equity futures are signaling a higher opening from the previous close. With 91.8% of the S&P 500 companies reporting, actual plus projected earnings are $28.64 on a float-adjusted basis. This is above the $27.48 forecast. Of the 459 companies that have reported, 67.7% beat estimates, while 22.3% were below forecast.

Equity markets are trading quietly higher this morning, bonds are rallying a bit and the dollar continues to tumble. There was some interesting news overnight. Here is what caught our attention:

The president gets a trade deal after all. President Obama, in a rarely displayed bit of political savvy, brought numerous lawmakers to the White House, lectured them for an hour and a half and then released to the press who was with him. In other words, he "named names," which put pressure on the senators to facilitate the deal. It looks like he got most of what he wanted. The fast track authority will likely get passed. Offensive measures, such as the currency manipulation part, will go to the president as separate bills that will be vetoed. This will give the senators political cover ("I voted for protections but the president vetoed them.") and give the president what he wants, which is a clear path to TPP approval. The real fight that led to yesterday's defeat was a show of force between Reid and McConnell. Now that they have had their political theater, it looks like things will move forward. It should be noted that the establishment wants these trade agreements to pass and are likely putting pressure on lawmakers, in the form of threats to withhold campaign donations, to push for passage.

IS #2 killed? Iraqi military sources are saying that the ranking #2 member of IS was killed in an airstrike. The Pentagon won't confirm but the Iraqis claim they have pictures to prove it. If true, it would mean the leadership of IS is hurting; the leader, Abu al-Baghdadi, is said to be recovering from severe wounds and may be partially paralyzed. The loss of two key leaders will put pressure on the group.

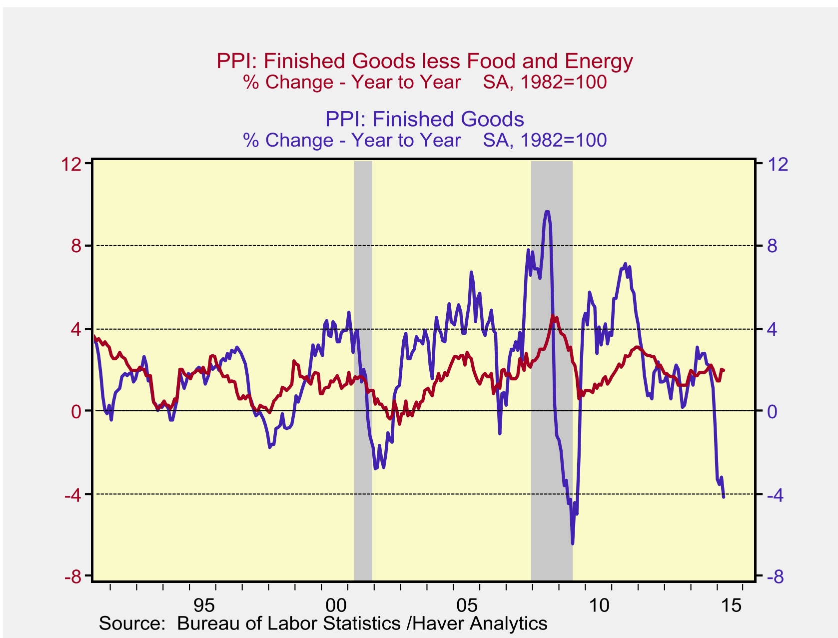
Saudis take market share. The lead story in today's *FT* contains claims from Saudi Arabia that it is producing record levels of crude oil and associated liquids, and touting that investment is falling in North America due to lower prices. The Saudis are trying to reclaim market share. However, today's *WSJ* reports that U.S. companies are preparing to bring rigs back on line in light of the recent recovery in oil prices. We remain very cautious about oil prices at current levels, especially given the high levels of storage. A more natural price range is probably $45 to $50.

An el niño? The Australian Bureau of Meteorology has issued a forecast of a moderate to strong el niño this year. This condition is due to changes in water temperatures in the Pacific and has widespread effects on commodity prices. Wheat crops in Australia are usually adversely affected by drought. It tends to help U.S. crops as normal temps occur. Atlantic hurricanes are often less frequent. Rice supplies are often reduced due to drought as well.

A pivot to Asia? Sources indicate that the U.S. is planning on basing a B-1 squadron and other intelligence gathering groups in Australia. Moving such key facilities to Australia does suggest that the long awaited pivot may actually be happening. In a related story, Bloomberg is reporting that the U.S. may more aggressively patrol the South China Sea to figure out what China's recent moves to build artificial islands are really all about. This issue bears watching and will be a topic of future a WGR.

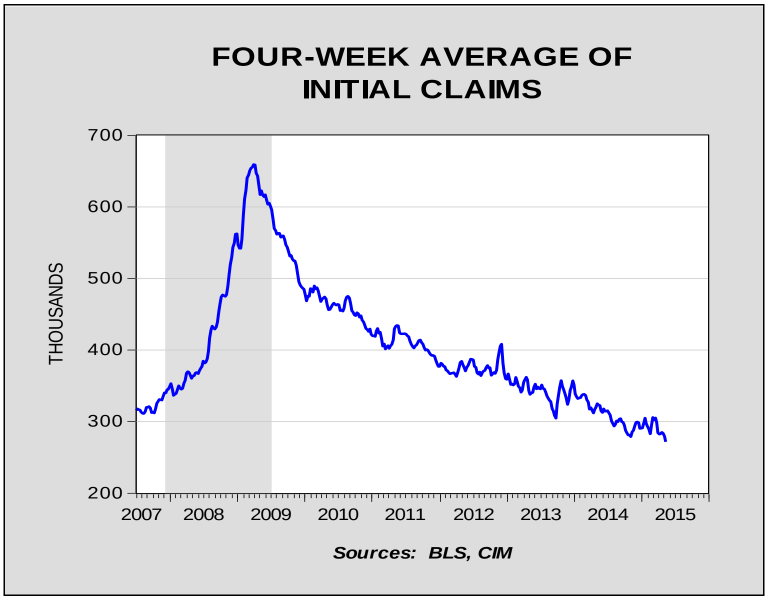
U.S. Economic Releases

PPI fell 0.4% in April from the month before, much weaker than the 0.1% increase forecast. The core PPI also fell 0.2%, weaker than the 0.1% increase forecast. Price weakness was widespread, with all but one category of final demand prices declining. The largest declines were seen in energy, food and trade prices.



The chart above shows the annual change in the overall and core PPI. Annually, the headline producer prices are down 1.3% compared to the 0.8% decline forecast, while the core producer prices are up 0.7% compared to the 0.8% increase forecast. In the annual data, oil is the main reason for price weakness.

Initial claims fell 1k to 264k, better than the 273k forecast. This marks the continuation of below 300k readings for the tenth consecutive week.



The chart above shows the four-week average of claims, a more stable measure of labor market health. The average fell 8k to 272k, the lowest reading since before the recession.

For the rest of the day, at 10:00 EDT, we will get factory orders revisions.

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								
India	Wholesale price	y/y	Apr	-2.7%	-2.3%	-2.3%	*	Equity bullish, bond bearish
Japan	Money supply M3	y/y	Apr	3.0%	3.0%	3.0%	**	Equity and bond neutral
	Machine tool orders	y/y	Apr	10.4%	14.9%		*	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)	28	28	0	Neutral
3-mo T-bill yield (bps)	2	2	0	Neutral
TED spread (bps)	26	26	0	Neutral
U.S. Libor/OIS spread (bps)	14	14	0	Neutral
10-yr T-note (%)	2.25	2.28	-0.03	Narrowing
Euribor/OIS spread (bps)	10	10	0	Neutral
EUR/USD 3-mo swap (bps)	19	19	0	Neutral
Currencies	**Direction**			
dollar	down			Rising
euro	up			Falling
yen	down			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.

Futures	Price	Prior	Change	Cause/ Trend
Energy markets				
Brent	$ 67.08	$ 66.81	0.40%	Domestic supply drop
WTI	$ 60.51	$ 60.50	0.02%	
Natural gas	$ 2.92	$ 2.94	-0.65%	
Crack spread	$ 25.50	$ 24.71	3.21%	
12-mo strip crack	$ 19.51	$ 19.11	2.10%	
Ethanol rack	$ 1.80	$ 1.80	-0.05%	
Metals				
Gold	$ 1,218.94	$ 1,215.75	0.26%	Lower dollar
Silver	$ 17.37	$ 17.12	1.43%	
Copper contract	$ 292.30	$ 292.90	-0.20%	Chinese copper output increases
Grains				
Corn contract	$ 365.75	$ 362.25	0.97%	
Wheat contract	$ 489.25	$ 481.50	1.61%	Excessive rains in the U.S.
Soybeans contract	$ 961.25	$ 957.25	0.42%	
Shipping				
Baltic Dry Freight	634	589	45	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.2	0.0	-2.2	
Gasoline (mb)	-1.1	0.0	-1.1	
Distillates (mb)	-2.5	0.8	-3.3	
Refinery run rates (%)	-1.8%	0.5%	0.0	
Natural gas (bcf)		114		

Weather

The 6-10 and the 8-14 day forecasts call for warmer than normal conditions for the eastern half of the country, with wetter than normal conditions for most of the country. There is no tropical activity to report this morning.

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.

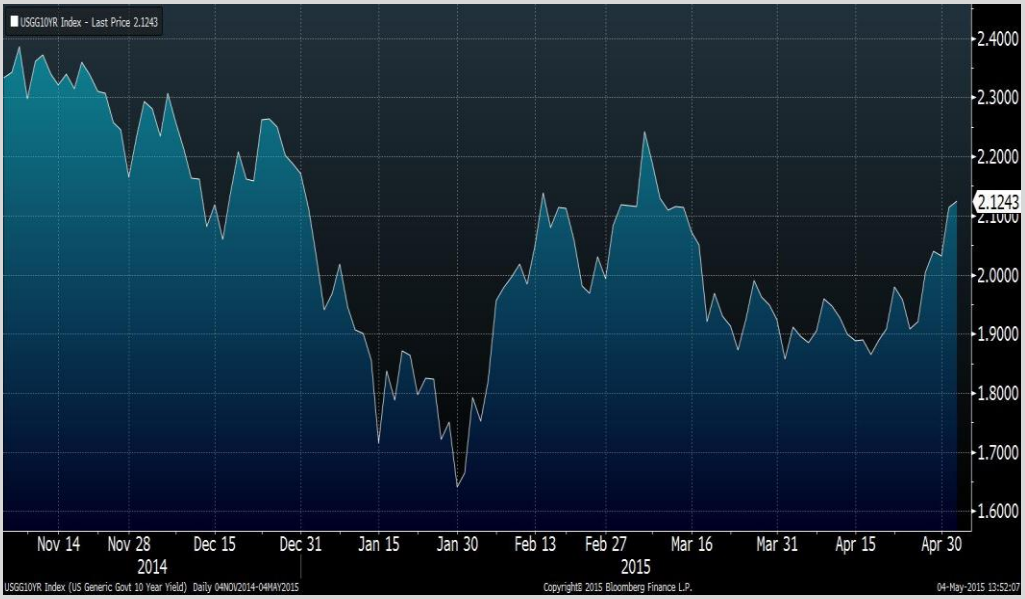
May 8, 2015

Since mid-April, German long-term sovereign yields have risen sharply.

(Source: Bloomberg)

This chart, from Bloomberg, shows the yield on a generic 10-year German government bond. Yields have spiked after dipping under 10 bps last month. Two factors seem to be behind the rise. First, there is widespread belief that Greece will acquiesce to EU demands and maintain austerity, avoiding default and an exit from the Eurozone. With confidence rising that the Eurozone will avoid a "Lehman moment," the demand for safety, exemplified by German debt, is waning. Second, some high-profile bond managers have argued that German bonds are an "easy short." Although the position is defendable, we offer two caveats. First, we have seen similar recommendations about shorting Japanese bonds on the notion that Japanese long-dated yields would eventually rise. This trade has become known as the "widow maker" because it hasn't worked for over 15 years. Second, several European nations have experienced negative nominal yields, including Germany. This recent experience of negative nominal yields means that the zero bound may not hold. In other words, it is quite possible that yields could fall below zero if growth or inflation declines. Part of the argument for shorting low yielding bonds is that yields are zero bound. If the zero bound theory no longer holds, the short position may be more risky than it looks.

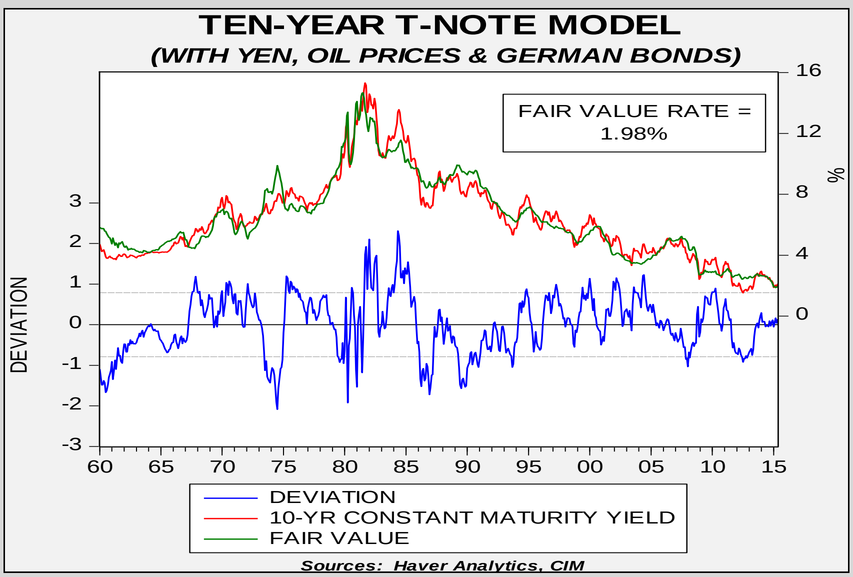
The rise in German yields has led to a similar, but less dramatic, increase in U.S. yields.



(Source: Bloomberg)

Since mid-April, U.S. 10-year T-note yields have increased from just below 1.88% to 2.12%. Given that the rise in the U.S. coincides with the aforementioned lift in German yields, we suspect they are related.

In a broader context, current U.S. 10-year T-note yields are in line with fundamental factors.

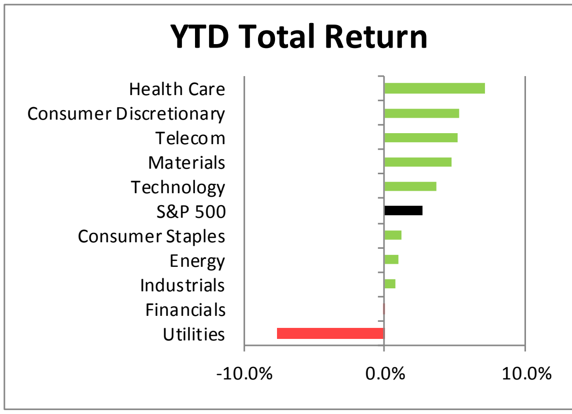


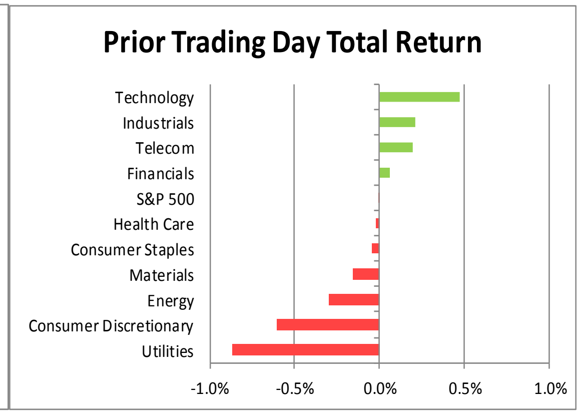
This is our long-term 10-year T-note yield model. It has five independent variables, including fed funds, the 15-year trend in inflation (a proxy for inflation expectations), the yen exchange rate, oil prices and German bond yields. The current fair value rate is 1.98%; the upper end of the standard error band would be around 2.75%, meaning that yields would need to rise significantly before the market would become undervalued.

We continue to maintain a bias toward duration risk in our asset allocation portfolios. The most significant risk to this position, at least in the short run, is tighter monetary policy. The model suggests that for every 100 bps increase in fed funds, the fair value rate on 10-year T-notes increases by 37 bps. If the FOMC raises the fed funds target to 50 bps by year-end, a fairly aggressive position, and all other independent variables remain steady, the fair value yield would rise by 19 bps to 2.17%. Overall, we expect U.S. long-term interest rates to remain mostly steady.

Data Section

U.S. Equity Markets – (as of 5/13/2015 close)

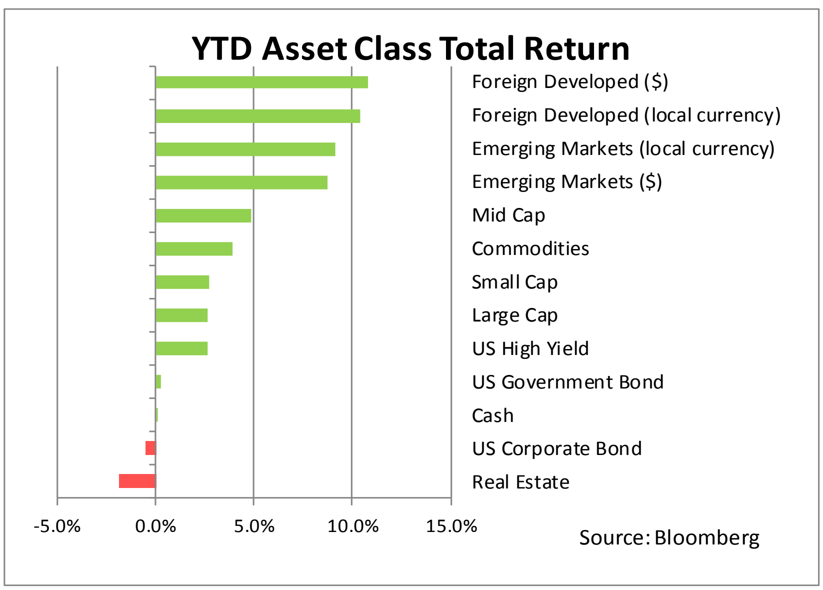




(Source: Bloomberg)

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 5/13/2015 close)

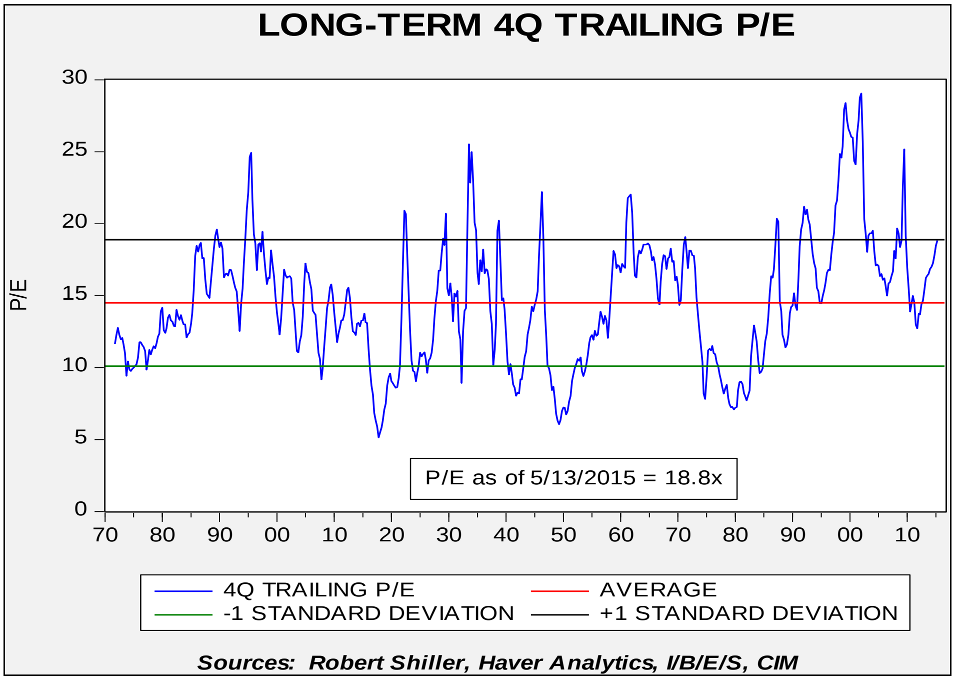


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

May 14, 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 (Q3 and Q4) and two estimates (Q1 and Q2). 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 18.8x, +0.3x from the last reading and just below overvalued levels of 19.0x. The earnings numbers for both Q1 and Q2 fell this week. For Q1, we have shifted to the Haver Analytics forecast from I/B/E/S since we now have over 90% of the S&P reporting. Overall, earnings are weak, in part due to lower earnings from energy and in part due to rising wage costs. Valuations are becoming quite stretched, which probably explains this year's rather sluggish market performance. Breaking into overvalued areas doesn't necessarily mean a pullback is imminent, but it does raise concerns that the market is expensive.

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.