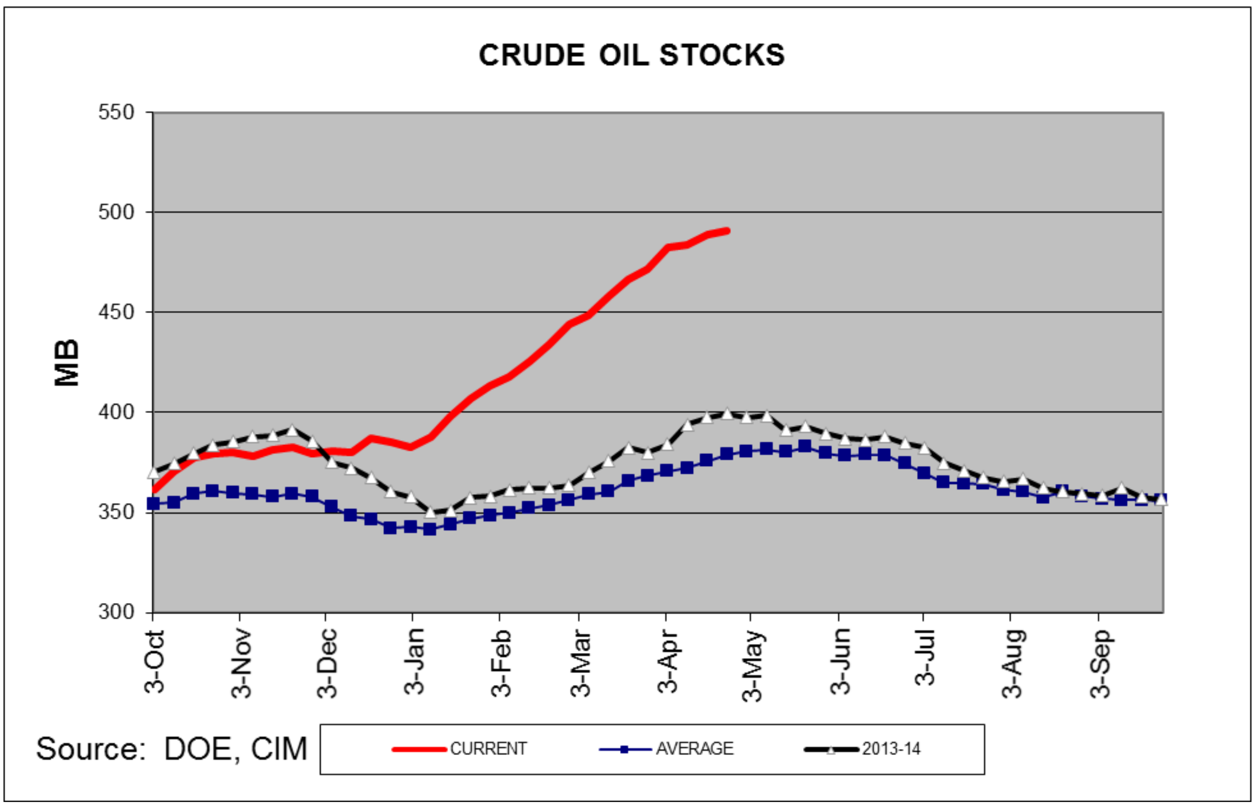
Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: May 5, 2015—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is trading down 0.2% from the last close. In Asia, the MSCI Asia Apex 50 was down 1.0% from the prior close. U.S. equity futures are signaling a lower opening from the previous close. With 75.4% of the S&P 500 companies reporting, actual plus projected earnings are $28.46 on a float-adjusted basis. This is above the $27.48 forecast. Of the 377 companies that have reported, 68.4% beat estimates, while 21.5% were below forecast.

There are three big news items this morning.

The breakout in oil prices: WTI broke above $60 per barrel this morning, prompting technical buying. News surrounding the breakout is scarce; the only headline is that Saudi Arabia has left its pricing to customers unchanged. Over the past few months, the market has taken Saudi pricing activity as informative, which it really isn't. Production is what matters. If Saudi Arabia can produce over 10 mbpd and the market price rises at the same time, the kingdom will not fight that outcome. However, it won't reduce output to support prices.



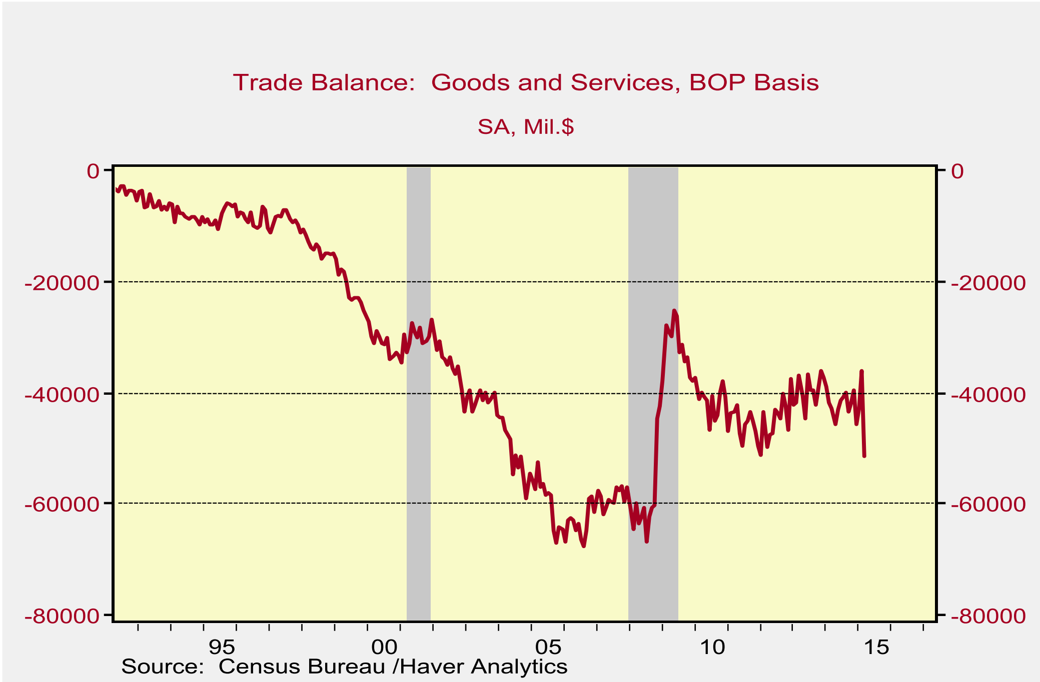
The most supportive factor for oil prices is that inventories are poised for their seasonal decline. The above chart shows current U.S. commercial crude oil inventories along with last year's data and the five-year average. Current inventories are 111.9 mb higher than average; in fact, this is the highest level of crude oil inventories since the 1930s. Note that seasonally, starting in a week or so, crude oil inventories usually decline. The ramping up of the summer driving season lifts refining demand and inventories fall. Based on our inventory/price model, this morning's price of around $60.40 is discounting a 38 mb decline in crude oil inventories by autumn. Although a normal decline is around 25 mb, a larger decline isn't impossible. In fact, stockpiles fell by about that much last year. However, this analysis does suggest that the market has already discounted a large drop in supplies. If inventories don't fall at this pace, oil prices could retreat in the coming weeks.

The IMF warning: Today's lead story in the *FT* reports the IMF is warning the EU that Greece's debt situation is worsening and that write-offs are probably necessary. The IMF is forecasting that Greece will now run a primary ***deficit*** this year when a surplus was initially forecast. This means that its debt/GDP ratio will rise, worsening the situation. The problem now is that most Greek debt is in official hands, mostly held by the ECB and the Eurozone national central banks, meaning that these bondholders will take losses which they are loath to accept. In fact, write-offs may force these banks to be recapitalized. This situation is tricky because national central banks don't print their own currencies, meaning the nations' taxpayers will be on the hook for effectively bailing out Greece. The IMF note is a warning shot for the EU; simply put, if the Tsipras government doesn't cave soon, the rest of the EU may simply decide to force out Greece. In the short run, it is a better solution than asking taxpayers to pay higher taxes in order to fund Greece's debt. However, once a nation is forced out of the Eurozone, no one knows for sure how the financial markets will react.

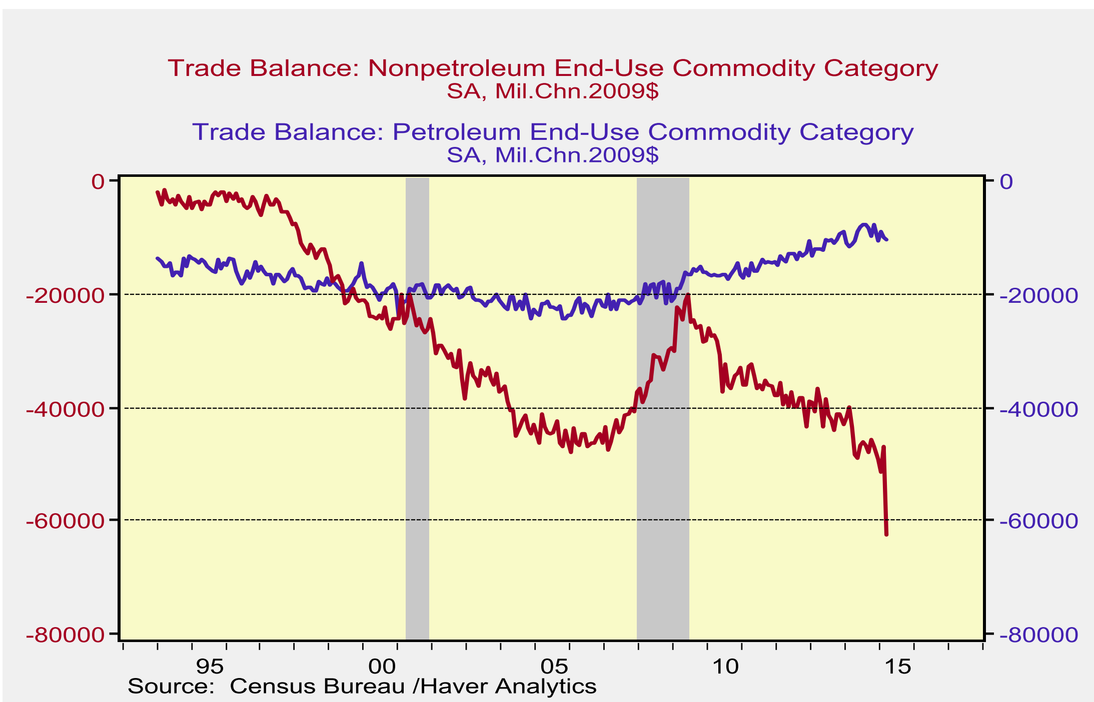
Pullback in China: The major equity indices fell between 2.7% to just over 4.0% on reports that Chinese authorities are tightening margin rules. This pullback shows how sensitive the Chinese market is to rule changes that might slow the flow of liquidity into its extended markets. Over the past few weeks, such pullbacks didn't last as investors saw the declines as buying opportunities. We will be watching to see if the pattern continues after this event or if the government is intending to ease the pace of equity strength.

U.S. Economic Releases

The trade deficit in March reached its highest level in more than six years as ports on the West Coast re-opened, causing imports to surge. The trade deficit widened to $51.4 bn from $35.9 bn the month before, much wider than the $41.7 bn forecast.



The chart above shows the total trade balance. The deficit reached levels last seen in 2008. We would expect deficit levels to normalize from this point as the port re-openings will not have a lasting effect. However, domestic demand could strengthen on the back of emerging wage growth, which would support import growth.



The chart above shows the trade balance in petroleum products (blue) and non-petroleum products (red). Increasing domestic energy production has actually narrowed the petroleum product deficit. In fact, the value of petroleum imports was the lowest since 2004. At the same time, the non-petroleum product deficit has widened, with the widening overall trade deficit almost entirely due to the non-petroleum trade deficit.

For the rest of the day, at 9:45 EDT, the April Markit composite PMI (no forecast) and services PMI (forecast at 57.8 vs. 57.4 prior month) will be released. At 10:00, the May IBD/TIPP economic optimism indicator will be published, with a forecast level of 50.0, down from 51.3 the month before. Also at 10:00, the April ISM non-manufacturing composite will be published, with a forecast level of 56.0, down from 56.5 the month before.

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								
Australia	Trade balance (AUD)	m/m	Mar	-1.3 bn	-1.6 bn	-1.0 bn	**	Equity bearish, bond bullish
EUROPE								
Eurozone	PPI	y/y	Mar	-2.3%	-2.8%	-2.3%	**	Equity and bond neutral
Russia	Manufacturing PMI	m/m	Apr	48.9	48.1	48.3	***	Equity bullish, bond bearish

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)	1	1	0	Neutral
TED spread (bps)	27	27	0	Neutral
U.S. Libor/OIS spread (bps)	14	14	0	Neutral
10-yr T-note (%)	2.14	2.14	0.00	Neutral
Euribor/OIS spread (bps)	10	10	0	Neutral
EUR/USD 3-mo swap (bps)	21	20	1	Up
Currencies	**Direction**			
dollar	up			Rising
euro	down			Falling
yen	down			Falling
franc	up			Falling
Central Bank Action	**Current**	**Prior**	**Expected**	
Royal Bank of Australia cash rate	2.00%	2.25%	2.00%	

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	$ 67.33	$ 66.45	1.32%	U.S. production expected to fall
WTI	$ 59.89	$ 58.93	1.63%	
Natural gas	$ 2.80	$ 2.82	-0.67%	
Crack spread	$ 25.64	$ 25.72	-0.32%	
12-mo strip crack	$ 19.38	$ 19.35	0.17%	
Ethanol rack	$ 1.77	$ 1.78	-0.17%	
Metals				
Gold	$ 1,190.88	$ 1,188.33	0.21%	
Silver	$ 16.50	$ 16.41	0.53%	
Copper contract	$ 292.45	$ 292.05	0.14%	Production expected to slow
Grains				
Corn contract	$ 357.50	$ 361.25	-1.04%	Rains in the U.S.
Wheat contract	$ 468.25	$ 472.75	-0.95%	
Soybeans contract	$ 976.75	$ 976.25	0.05%	
Shipping				
Baltic Dry Freight	587	591	-4	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)		0.7		
Gasoline (mb)		0.2		
Distillates (mb)		-0.1		
Refinery run rates (%)		0.6%		
Natural gas (bcf)		75		

Weather

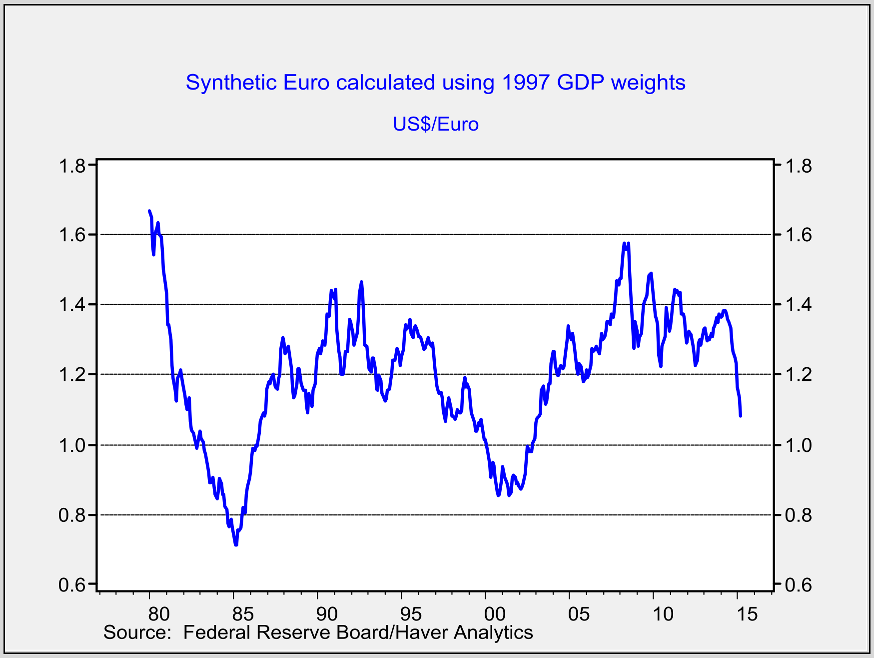
The 6-10 and the 8-14 day forecasts call for cooler than normal conditions for the middle of the country. Precipitation is forecast for most of the country.

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 1, 2015

The appreciation of the dollar has been a key factor that has affected financial markets and the economy.



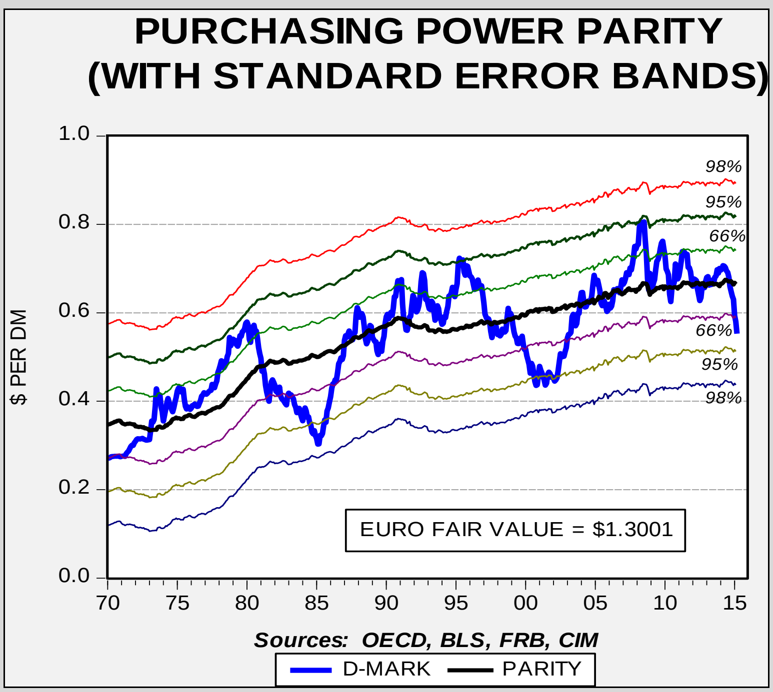
This chart shows the euro (EUR) and U.S. dollar (USD) exchange rate. Haver Analytics has created a synthetic exchange rate to approximate how the single European currency would have traded if it had existed from 1980 (the EUR officially started in January 1999). On the above chart, the average exchange rate over the past 35 years has been 1.1960. A casual perusal of the chart suggests that, most of the time, the EUR trades at 1.200 or higher against the USD; statistically, that occurs about 55% of the time. In fact, 75% of the time, the EUR/USD exchange rate is above the current level of approximately 1.080. Thus, the current exchange rate is relatively rare.

As the chart shows, dollar bull markets are somewhat infrequent occurrences. When they do occur, they tend to be driven by unusual events. The 1980-85 bull market was driven by FOMC monetary policy. Chairman Volcker allowed interest rates to reach unusually high levels to break inflation psychology which led foreign investors to move funds to the U.S. to take advantage of the elevated interest rates. The 1995-2002 bull market was driven mostly by strong U.S. productivity growth. The rise in American productivity, in part driven by deregulation and in part caused by the drop in military spending (which forced technology workers to leave the defense sector for the private sector), led to a tech boom that boosted the dollar.

The current bull market is mostly due to policy divergence. The FOMC has ended QE and is preparing the markets for high policy rates. The rest of the world is moving in the opposite direction—the ECB, BOJ and PBOC are all lowering rates and, in the case of the first two, engaging in aggressive QE.

However, these facts are now well known and beg the question, "has the forex market fully discounted these divergences in policy?" Since we don't know with certainty the path of policy, either here or abroad, it is hard to know if the dollar has more appreciation in front of it or if it is already overvalued. However, there is another way of addressing this issue, which entails establishing a "fair value" for the dollar by other means.

In general, there are several different ways to assess currency valuation. Of course, if any of them worked well, there would only be one! The method that has the longest history is purchasing power parity, which measures the value of currencies relative to inflation. The idea is that if inflation is higher in a country compared to another one, the exchange rate will adjust to ensure that prices will be equal in both countries. Otherwise, there would be trade arbitrage opportunities to exploit. The theory suggests that the nation with higher inflation will have a weaker exchange rate. Although it isn't perfect, purchasing power parity may be the best long-term method of exchange rate valuation.



This chart shows the calculation of purchasing power parity between the U.S. and Germany. We use Germany for two reasons; first, we have a longer exchange rate and inflation history with Germany compared to the Eurozone, and second, by virtue of being the largest economy in

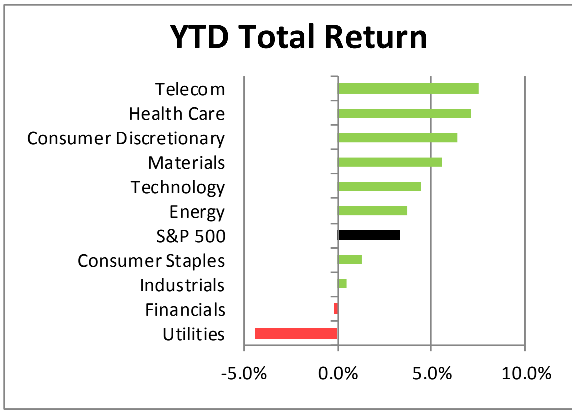
Europe, its parity values likely offer the best overall reflection for Europe in general. Clearly, the exchange rate often deviates rather far from fair value. However, it is worth noticing that during dollar bear markets, the peak tends to occur at the second standard error line, which should only occur about 5% of the time. In dollar bull markets, the dollar tends to appreciate a bit beyond the second standard error line. Although there are no guarantees, it would be consistent with history to see an appreciation to at least the second standard error line.

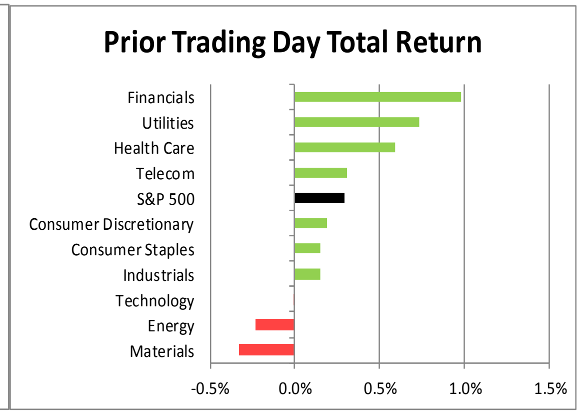
The current estimated parity value, based on the relative inflation rates between the U.S. and Germany, is 0.6647 (DM/USD 1.500). Given the conversion rate of DM to EUR, the EUR parity value would be 1.300. By this measure, the dollar is overvalued; however, as in the prior two bull markets, circumstances other than relative inflation rates led to the dollar's appreciation and the deviation from parity. The second standard error level would be a EUR/USD of 1.000. This calculation suggests the dollar may struggle to move higher once that level is achieved.

In our asset allocation, we have avoided foreign investing, in part, because the dollar's appreciation acts as a headwind for the U.S. investor. However, the closer the EUR/USD exchange rate comes to the second standard error level, the headwind becomes less of an issue. That doesn't necessarily mean the committee will decide to add European or other foreign equities to the portfolio, but it does suggest that one of the concerns that led the committee to avoid the foreign equity asset class will have diminished.

Data Section

U.S. Equity Markets – (as of 5/4/2015 close)

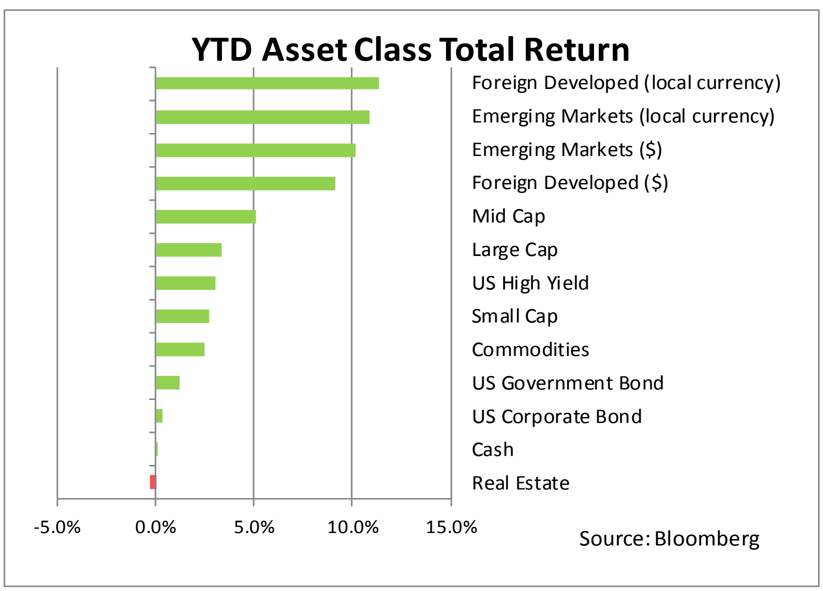




(Source: Bloomberg)

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 5/4/2015 close)

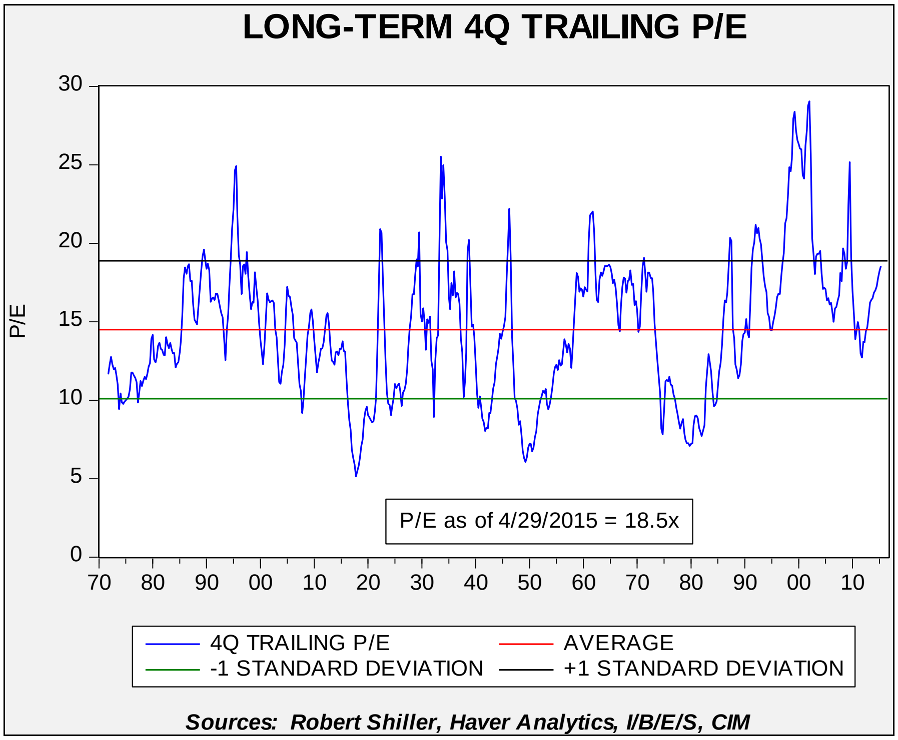


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

April 30, 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 18.5x, steady with the last reading. The P/E level remains below overvalued levels of 19.0x. However, valuations are becoming quite stretched, which probably explains this year's rather lackluster market performance.

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.