Confluence Investment Management

Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: November 25, 2015—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is trading higher by 1.1% from the last close. In Asia, the MSCI Asia Apex 50 was lower by 0.1% from the prior close. Chinese equities are actually higher, with the Shanghai composite up 0.9% and the Shenzhen index up 1.9%. U.S. equity futures are signaling a higher opening from the previous close. With 98.0% of the S&P 500 companies having reported, the Q3 2015 earnings[1] stand at $29.80, above the I/B/E/S forecast of $29.35. Of the 490 companies that have reported, 69.5% beat estimates while 21.9% fell short.

We have a lot of economic releases this morning, so we will keep our opening comments short. In general, the data released this morning indicates a generally improving economic environment.

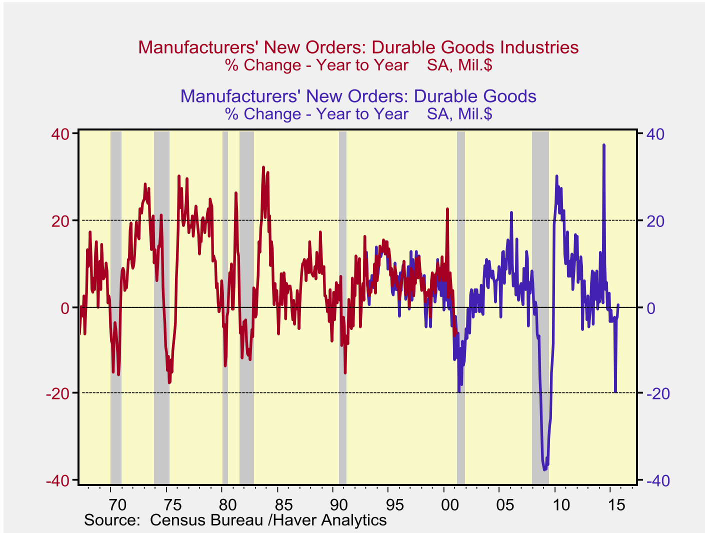
Domestic and European equities rebounded this morning as focus shifts from geopolitical tensions to the ECB and Fed monetary policy, as well as the improving domestic economic data. The ECB is scheduled to meet next week. ECB Vice President Vitor Constâncio signaled in an interview yesterday that risks are increasing for the European economy, leading to speculation that the ECB may approve additional stimulus.

Tensions over the downing of the Russian warplane calmed somewhat overnight. Russian President Putin said that his country "will have to respond" to any future air incidents, but also suggested that Russia is not currently planning military retaliation against Turkey. At the same time, Turkish President Erdogan said that his country is not planning on "escalating this issue" but that Turkey would protect its airspace. We believe this specific incident will not cause further escalation of military conflict, but tensions will remain elevated between the two countries.

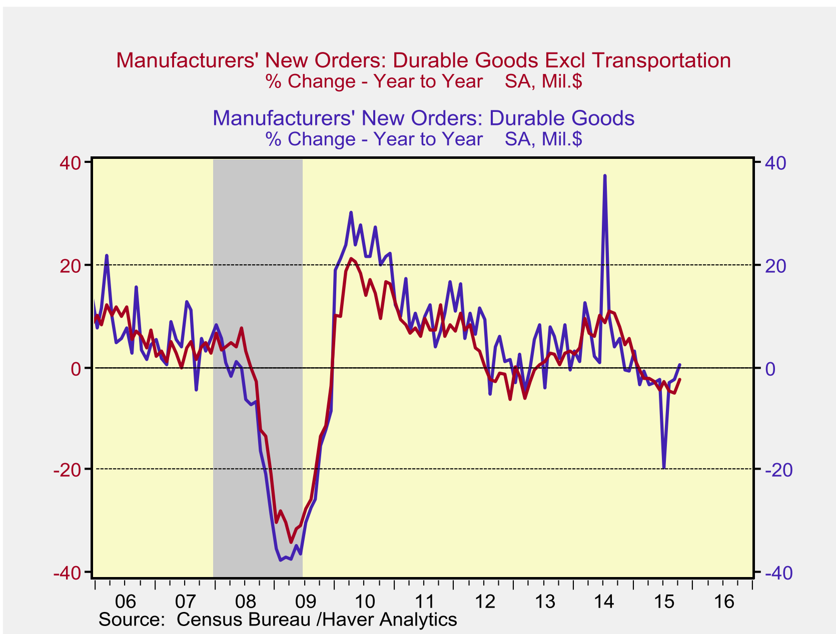
U.S. Economic Releases

Durable goods orders came in better than forecast, with orders for business equipment showing considerable strength. Durable goods orders rose 3.0% in October compared to expectations of a 1.7% increase. Revised September orders showed a 0.8% decline from the 1.2% decline. Orders excluding transportation increased 0.5% compared to the forecast increase of 0.3%. Non-defense capital goods orders excluding aircraft orders, a good measure of business investment, rose 1.3%, much better than the 0.2% increase forecast.

[1] We report the earnings based on the Bloomberg adjusted EPS, which may differ from the earnings reported by the S&P due to adjustment factors. The current I/B/E/S forecast is calling for a yearly earnings decline of 3.9% and a decline of 2.2% from Q2 2015 earnings of $30.00.

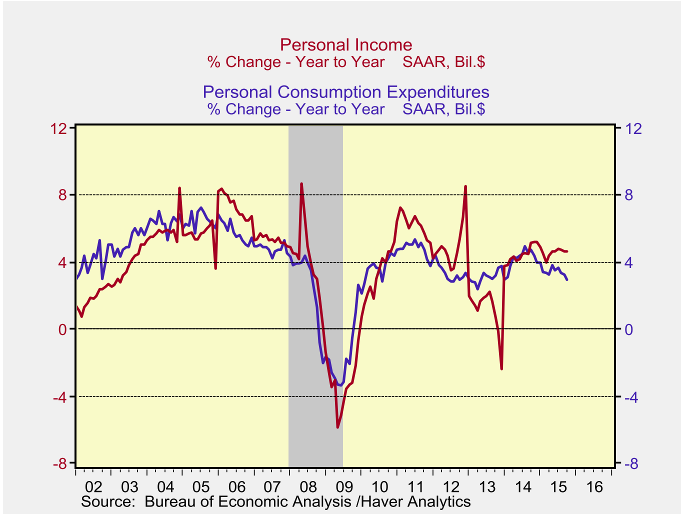


This chart shows the yearly change in durable goods orders. The steep decline last year was due to cuts seen in the energy sector and declines in defense spending, but we are slowly recovering from these shocks.

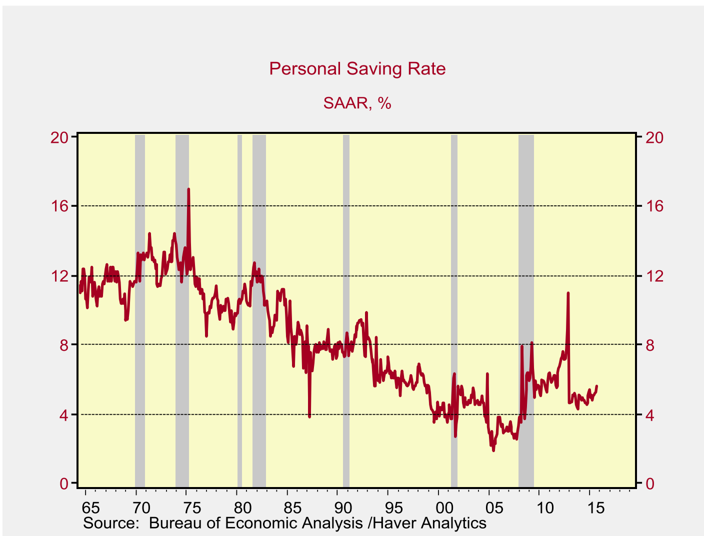


The chart above shows the annual change in the overall durable goods orders and orders excluding transportation. Transportation orders are notoriously volatile, but both metrics show improvement.

October personal income rose 0.4% from the month before, on forecast. Personal spending rose 0.1%, less than the 0.3% increase forecast. The core PCE deflator rose 1.3% annually, slightly below the forecast increase of 1.4%.

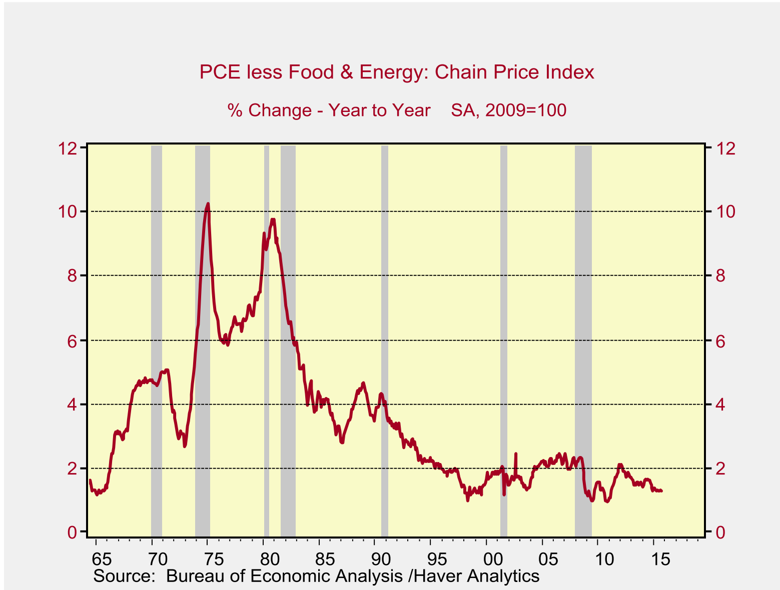


The chart above shows the annual change in personal income and consumption. Spending has lagged incomes as consumers are saving the windfall from lower gasoline prices.



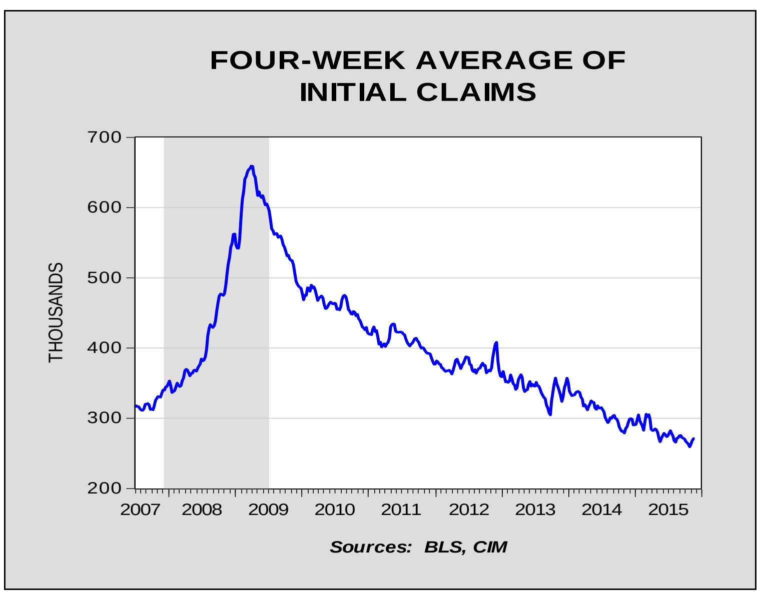
The chart above shows the personal savings rate, which rose to 5.6% from 5.3%.

Finally, the core PCE deflator, the FOMC's favorite inflation measure, rose 1.3% from last year, steady with September's rise.



The Fed has tended to employ monetary stimulus when the rate is below 2% and increase rates when this inflation measure exceeds 2.5%. Although labor market conditions have improved, rising inflation does not seem to be on the horizon. The Fed may tighten monetary policy preemptively, even in the absence of higher inflation.

Initial claims came in better than expected, falling 12k to 260k, well below the 270k forecast. Claims remain near their four-decade lows and have remained below the 300k level since March of this year.



The chart above shows the four-week average of claims, a more stable measure of labor market health. We are still seeing an improving trend as companies maintain the size of their workforce in anticipation of strengthening end-demand.

Mortgage applications fell 3.2% for the most recent reporting week, with purchases down 0.5% and refinancing down 4.8%. The 30-year mortgage rate fell 4 bps to 4.14%.

For the rest of the day, at 9:45 EST, the November Markit services and composite PMIs will be released. At 10:00, the October new home sales report will be released, with a forecast monthly change of 6.8%. Also at 10:00, the University of Michigan sentiment indicator will be released, with a forecast level of 93.1, unchanged from 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								
China	Consumer sentiment	m/m	Nov	113.1	109.7		**	Equity bullish, bond bearish
Japan	LEI	m/m	Sep	101.6	101.4		**	Equity bullish, bond bearish
	Coincidence index	m/m	Sep	112.3	111.9		**	Equity bullish, bond bearish
	Small business confidence	m/m	Nov	49.9	48.7		**	Equity bullish, bond bearish
EUROPE								
France	Consumer confidence	m/m	Nov	76.7	75.7		**	Equity bullish, bond bearish
Italy	Industrial orders	m/m	Sep	-2.0%	-5.2%		**	Equity bullish, bond bearish
	Retail sales	m/m	Sep	-0.1%	0.2%	0.5%	**	Equity bearish, bond bullish
AMERICAS								
Brazil	Consumer confidence	m/m	Nov	8.9%	8.7%	8.9%	**	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)	39	38	1	Up
3-mo T-bill yield (bps)	16	16	0	Neutral
TED spread (bps)	24	22	2	Up
U.S. Libor/OIS spread (bps)	29	28	1	Up
10-yr T-note (%)	2.23	2.24	-0.01	Narrowing
Euribor/OIS spread (bps)	-10	-10	0	Neutral
EUR/USD 3-mo swap (bps)	46	48	-2	Down
Currencies	**Direction**			
dollar	up			Rising
euro	down			Falling
yen	down			Falling
franc	down			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	$ 45.22	$ 46.12	-1.95%	Pull-back after yesterday's rally
WTI	$ 42.14	$ 42.87	-1.70%	
Natural gas	$ 2.18	$ 2.20	-1.14%	
Crack spread	$ 14.55	$ 15.08	-3.46%	
12-mo strip crack	$ 15.27	$ 15.54	-1.71%	
Ethanol rack	$ 1.63	$ 1.63	0.01%	
Metals				
Gold	$ 1,073.01	$ 1,075.65	-0.25%	Focus returns to U.S. rate outlook
Silver	$ 14.12	$ 14.20	-0.55%	
Copper contract	$ 204.35	$ 206.90	-1.23%	Chinese demand expected to fall
Grains				
Corn contract	$ 371.25	$ 369.50	0.47%	
Wheat contract	$ 489.50	$ 488.50	0.20%	
Soybeans contract	$ 864.50	$ 863.75	0.09%	
Shipping				
Baltic Dry Freight	528	516	12	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.2		
Gasoline (mb)		0.3		
Distillates (mb)		-0.4		
Refinery run rates (%)		0.3%		
Natural gas (bcf)		6.0		

Weather

The 6-10 and 8-14 day forecasts call for warmer than normal temps for the majority of the country, except for parts of the East Coast. Precipitation is forecast for the eastern and southern regions.

Weekly Asset Allocation Commentary

Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. This year, we have started reporting asset allocation thoughts on a weekly basis, updating the section every Friday.

Last month, we published our Asset Allocation Quarterly report for Q4 2015, which can be found on our website. Sign up for the "Asset Allocation Quarterly" email list to receive future editions by email.

November 20, 2015

In our asset allocation process, we pay attention to geopolitical conditions and market trends rather than focus on individual events. Given the recent terrorist attacks on Paris, we look back at the effects on the markets of previous terror events. We find that terrorist acts tend to only have short-term effects on the markets. Additionally, it appears that the more these acts are repeated, the less effect they have.

Event Date	Index	Pre-event Close	Post-event Close	Decline	Days to Low	Days to Pre-event Close	Close 30 Days Post-event
9/11/2001	**S&P 500**	1092.54	965.8	-11.6%	8	23	1089.9
3/11/2004	**IBEX 35**	8292.9	7699.1	-7.2%	3	20	8293.6
7/7/2005	**FTSE 100**	5229.6	5158.3	-1.4%	1	2	5292.7

(Sources: Bloomberg, CIM)

This table shows three events—the al Qaeda attacks on New York and Washington in 2001, the Madrid rail station bombing in 2004 and the London subway and bus bombings in 2005. The table reflects the following information: the day of the event, the specific national index, the index's close the day prior to the event, the post-event closing low and the percentage decline, the number of weekdays to that low, the number of days to exceed the closing level the day before the event and the level after 30 trading days. As the table shows, the market impact of each event has been steadily lessening.

In general, when the initial event is a surprise, it has a more significant impact. As similar events follow, especially if they are coming from similar groups, the impact seems to decline. That makes sense; markets are discounting vehicles. Financial markets especially are quite efficient in handicapping the future impact of a certain event and the more of these situations the market sees, the better it can discount the incident.

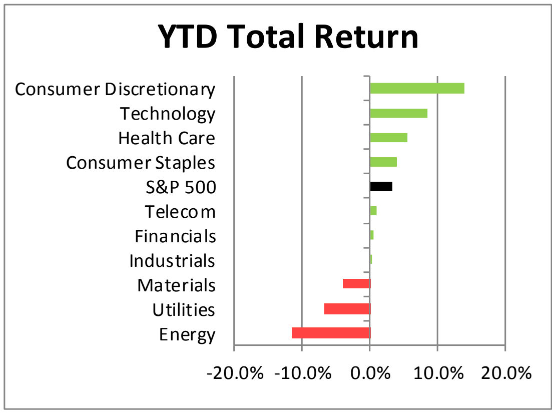
On the other hand, changes in long-term trends that cannot be easily defined can be harder for markets to discount. The slow change in reserve currency status, a gradual improvement in investor confidence or a change in how policy is executed can lead markets to struggle to adjust. For example, Milton Friedman noted that investor inflation expectations are formed over long periods of time, as long as two decades. Thus, bond yields remained elevated during the 1980s even though inflation was retreating quickly.

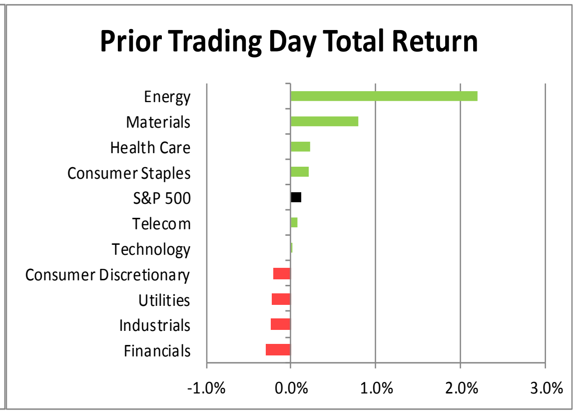
Long-term geopolitical changes work in a similar fashion. We believe the U.S. is steadily retreating from its global hegemon role. There are a number of reasons why this is occurring. First, the superpower role was not a natural position for a republic that mostly rejected imperialism. The U.S. reluctantly accepted the task to prevent communism from dominating the world. Second, once the Cold War ended, the primary reason for accepting the role faded and American foreign policy has struggled to build a new narrative to justify the costs of hegemony to the American people. Thus far, the inability to create a consistent foreign policy that lasts beyond a single administration has led Americans to question the costs of stabilizing the world and providing global financial and economic support. If the U.S. decides to no longer continue that role, the impact on financial markets, in the long run, will be profound.

Therefore, in our asset allocation, we don't focus on particular geopolitical events but pay close attention to developing trends and their impact on economic growth, inflation and stability. This is why, for the past several quarters, we have avoided international exposure in all but the most aggressive accounts; we believe that the risks in these markets are rising because of a long-term change in American policy.

Data Section

U.S. Equity Markets – (as of 11/24/2015 close)

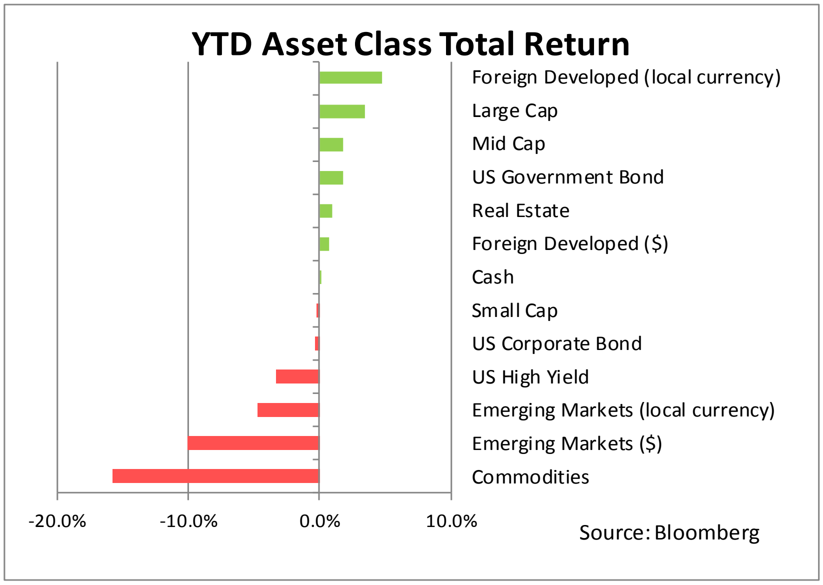




(Source: Bloomberg)

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 11/24/2015 close)

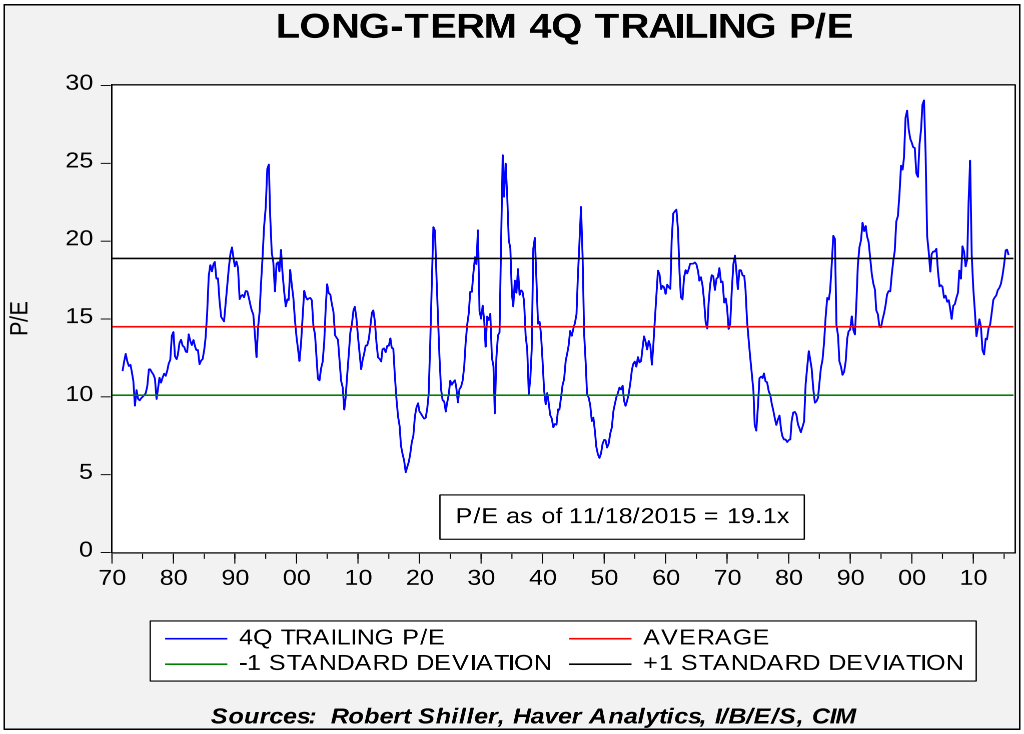


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

November 19, 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 (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.

Based on our methodology, the current P/E is 19.1x, up 0.8x from last week. Why such a jump? We use I/B/E/S estimates for Q3 until 90% of the index's companies report. At that point, our primary data provider, Haver Analytics, provides an earnings number. The difference is rather large—I/B/E/S is still indicating earnings at $29.75 for Q3, whereas Haver has the number at $25.44. We tend to see these sort of discrepancies when earnings momentum declines.

Is this a worry? Yes. However, we do expect earnings to recover next year as energy companies adjust to lower oil prices and the economy continues to grow. Still, expanded P/Es will tend to limit next year's market potential. We discuss this in much more detail in our 2016 outlook, which we will publish soon.

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.