Daily Comment

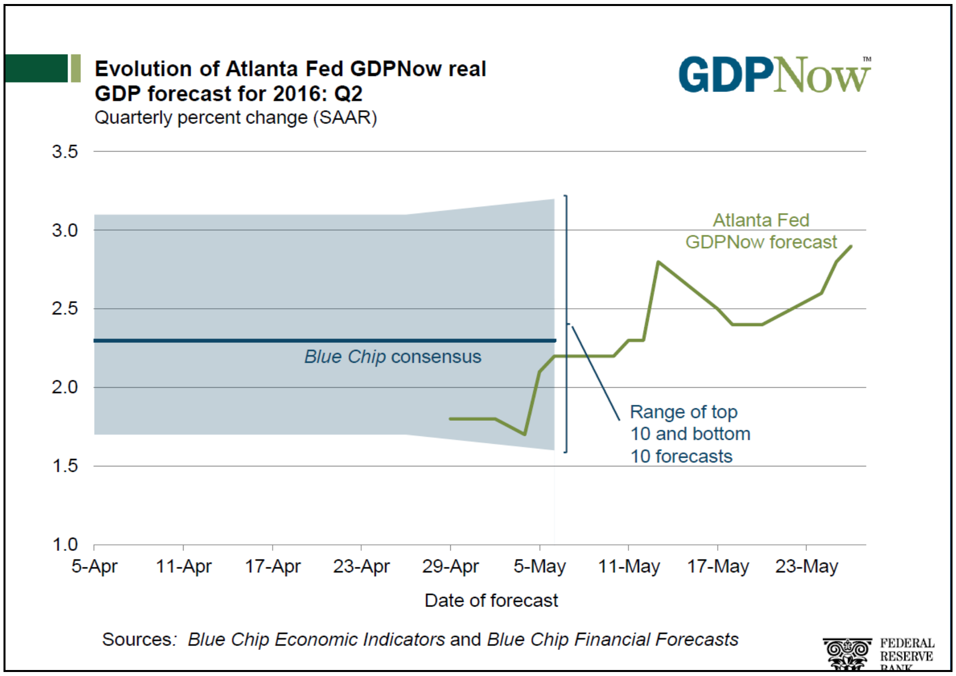
By Bill O'Grady & Kaisa Stucke, CFA

[Posted: May 27, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading higher by 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 1.0% from the prior close. Chinese markets fell, with the Shanghai composite trading down 0.1% and the Shenzhen index lower by 0.1%. U.S. equity futures are signaling a higher opening from the previous close. With 96.2% of the S&P 500 companies having reported, Q1 float-adjusted earnings stand at $26.77, more than the $26.66 forecast. Of the 481 companies that have reported, 72.1% had positive earnings surprises, while 20.2% had negative earnings surprises.

As noted below, Chair Yellen speaks later this morning. This talk has been long awaited; however, we don't expect too much. In our opinion, Yellen remains dovish and would likely prefer not to move rates this year. However, she does need to maintain control of the FOMC and so she occasionally has to acquiesce to rate hikes. We look for a move of 25 bps in either June or July, which will probably be the last one for the year. The market's reaction to the anticipated hike has been quite controlled so far. There has been an uptick in the two-year T-note yield, but not as high as we saw in December, and the dollar has rallied, but we haven't revisited the recent highs. Those reactions suggest that the markets are not projecting a summer move to trigger a series of future rate hikes. To some extent, this is what the Fed has been trying to communicate; policy would only tighten gradually. While this is good news in the short term, the policy seems strikingly similar to what the Fed tried to accomplish with its tightening cycle that ran from 2004 to 2006. That cycle, on its face, didn't cause the major market disruption that it needed to cause. By not causing significant pain, risky leveraging behavior continued which culminated in the 2008 Great Financial Crisis. So, bottom line, we don't expect Yellen to say much and she will likely not dispel rate hike expectations for this summer. Since this outcome is probably discounted, if we are correct, market action should be minor (especially in front of a long holiday weekend in the U.S.).

The G-7 communiqué probably disappointed the host nation, Japan. PM Abe was trying to suggest that the world economy faces similar risk issues as seen in 2008. The other six members of the group clearly disagreed. We suspect Abe will use his outlook expressed at this meeting to deploy fiscal stimulation with the hope that the action will depreciate the JPY. He would have likely preferred G-7 support but we expect him to move without it.

For those calling for a rate hike, the Atlanta FRB GDPNow forecast suggests strong support.



The current forecast is up to 2.9% compared to the consensus forecast of 2.4% and the initial forecast of 1.8%. The contributions to GDP are clearly coming from consumption, which accounts for 2.46% of the 2.90%. Residential investment is adding 28 bps (up from 8 bps in late April) and net exports is actually a positive contributor. The primary drags on growth are inventory liquidation and commercial building.

Atlanta Fed GDPNow forecasts for 2016: Q2, growth rates and changes

Date	Major Releases	GDP	PCE	Equip-ment	Intell. prop. prod.	Nonres. struct.	Resid. inves.	Govt.	Exports	Imports	Change in net exp.	Change in CIPI
29-Apr	Initial nowcast	1.8	2.8	0.6	2.6	-6.3	2.1	0.9	2.7	2.2	-1	-11
2-May	Constr. spending, ISM Manufacturing	1.8	2.6	-0.6	2.6	-3.9	3.9	0.8	2.3	1.9	0	-10
4-May	Intl. trade, M3 Manufacturing	1.7	2.6	-1.4	2.6	-3.9	4.0	0.8	2.4	2.0	0	-12
5-May	Auto sales, ISM Nonmanuf. (Weds)	2.1	2.9	1.2	2.6	-3.5	5.1	0.8	2.7	2.3	-1	-11
6-May	Employment situation	2.2	3.0	1.9	2.8	-3.2	6.1	0.6	2.9	2.6	-2	-12
10-May	Wholesale trade	2.2	3.0	1.9	2.8	-3.2	6.0	0.6	2.9	2.6	-2	-14
11-May	Monthly Treasury Statement	2.3	3.0	1.9	2.8	-3.2	6.0	1.2	2.9	2.6	-2	-14
12-May	Import/export prices	2.3	3.0	1.9	2.8	-3.2	6.0	1.2	2.9	2.5	-1	-14
13-May	Retail trade	2.8	3.7	1.9	2.8	-3.2	5.3	1.2	2.9	2.5	-2	-10
17-May	Housing starts, CPI, Indust. Prod.	2.5	3.6	2.9	2.8	-2.9	2.5	1.2	3.3	3.0	-2	-16
18-May	M3 Manufact. (Benchmark Revision)	2.4	3.6	2.6	2.8	-2.9	2.5	1.2	3.3	3.0	-2	-22
20-May	Existing home sales	2.4	3.6	2.6	2.8	-2.9	3.6	1.2	3.3	3.0	-2	-22
24-May	New home sales/construction costs	2.6	3.6	2.6	2.8	-2.9	7.9	1.2	3.3	3.0	-2	-22
25-May	Advance intl goods trade	2.8	3.6	2.7	2.8	-2.8	7.9	1.2	3.8	2.0	7	-22
26-May	Advance durable manufacturing	2.9	3.6	3.2	2.8	-2.8	7.9	1.2	3.8	2.0	7	-19

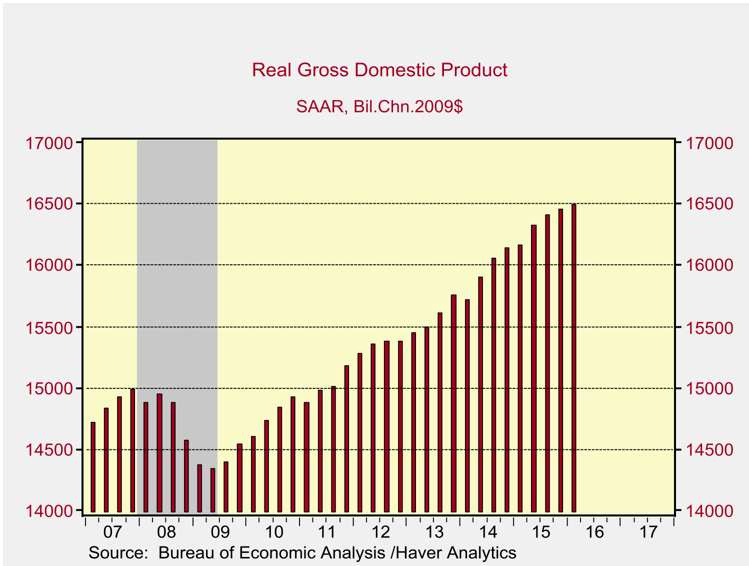
Note: CIPI is "change in private inventories". Changes in net exports and CIPI are both in billions of 2009 dollars (SAAR). All other numbers are quarterly percent changes (SAAR).

FEDERAL RESERVE BANK

Overall, this forecast will increase the odds of a summer rate increase by the FOMC.

U.S. Economic Releases

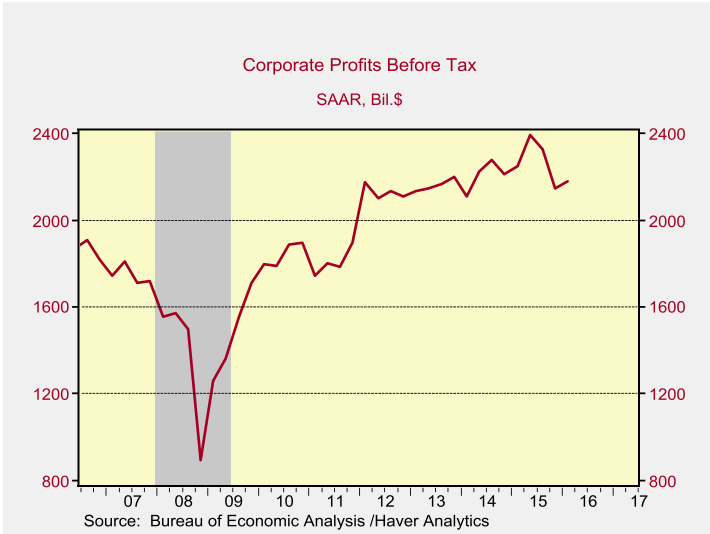
The second look at Q1 GDP came in close to expectations, rising 0.8% annualized compared to the 0.9% increase forecast. Most of the strength came from private investment growth and an improvement in net exports. Private consumption came in weaker than forecast, rising 1.9% compared to the 2.1% growth expected. The chart below shows the level of GDP over the past ten years. The economy is still expanding.



The table below shows the contribution to growth from the four major sectors of the economy, plus inventories. Private investment added 0.2% to growth, and inventory growth added 0.1% as inventory growth was revised to be less negative than previously estimated.

	Q1 2016 second revision	Q1 2016 advance report	Difference
GDP	0.8%	0.5%	0.3%
Consumption	1.3%	1.3%	0.0%
Investment	-0.5%	-0.6%	0.2%
Inventories	-0.2%	-0.3%	0.1%
Net Exports	-0.2%	-0.3%	0.1%
Government	0.2%	0.2%	0.0%

With the second revision of GDP, we also get the corporate profit numbers. Corporate profits improved in Q1, showing positive quarterly growth after two consecutive negative changes. The chart below shows the level of corporate profits as a percentage of GDP.



Despite the second revision to GDP showing generally positive and stable trends, equities traded modestly lower following the release. We suspect that the better than expected numbers will be interpreted to raise the likelihood of a hike this summer, leading to slight equity weakness.

The table below shows the economic releases or Fed speakers scheduled for the rest of the day.

Economic releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	University of Michigan sentiment	m/m	May	95.4	95.8	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
1:15	Yellen	Fed Chairwoman				

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	Industrial profits	y/y	Apr	4.2%	11.1%		**	Equity bearish, bond bullish
India	CPI	y/y	Apr	-0.3%	-0.1%	-0.4%	***	Equity and bond neutral
EUROPE								
France	Consumer confidence	m/m	May	98.0	94.0	95.0	**	Equity bullish, bond bearish
Italy	Consumer confidence	m/m	May	112.7	114.1	114.5	**	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)	67	67	0	Neutral
3-mo T-bill yield (bps)	29	29	0	Neutral
TED spread (bps)	38	38	0	Neutral
U.S. Libor/OIS spread (bps)	46	45	1	Up
10-yr T-note (%)	1.83	1.83	0.00	Neutral
Euribor/OIS spread (bps)	-26	-26	0	Neutral
EUR/USD 3-mo swap (bps)	29	28	1	Up
Currencies	Direction			
dollar	up			up
euro	down			down
yen	up			down
franc	down			down

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	$ 48.93	$ 49.59	-1.33%	Canadian crude supply returns
WTI	$ 48.99	$ 49.48	-0.99%	
Natural gas	$ 2.11	$ 2.15	-1.86%	
Crack spread	$ 17.19	$ 17.15	0.20%	
12-mo strip crack	$ 13.81	$ 13.82	-0.06%	
Ethanol rack	$ 1.80	$ 1.79	0.30%	
Metals				
Gold	$ 1,220.28	$ 1,219.80	0.04%	
Silver	$ 16.29	$ 16.33	-0.20%	
Copper contract	$ 211.85	$ 210.25	0.76%	Growth optimism
Grains				
Corn contract	$ 408.25	$ 408.25	0.00%	
Wheat contract	$ 480.00	$ 481.25	-0.26%	
Soybeans contract	$ 1,078.75	$ 1,079.75	-0.09%	
Shipping				
Baltic Dry Freight	601	605	-4	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)	-4.2	-1.6	-2.6	
Gasoline (mb)	2	-1.3	3.3	
Distillates (mb)	-1.3	-1.1	-0.2	
Refinery run rates (%)	-0.8%	0.5%	-1.3%	
Natural gas (bcf)	71.0	69.0	2.0	

Weather

The 6-10 and 8-14 day forecasts are calling for warmer than normal conditions for the coasts, with the middle of the country expected to receive colder than normal temperatures. Precipitation is forecast for the eastern half of the country.

Weekly Asset Allocation Commentary

Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

May 27, 2016

As promised, this week we will discuss how President Clinton's policies would likely affect the financial markets. It should be noted that, unlike Mr. Trump, Sen. Clinton has published most of her policy positions. However, there have been apparent shifts in her policy positions as Clinton adjusts her campaign to react to changes in the election environment.

Sen. Clinton's campaign is similar to that of a succeeding vice president: In 2008, when Clinton ran against Barack Obama, she framed him as an ephemeral dreamer who lacked the necessary experience to accomplish much. Early in her 2016 campaign, she appeared to be distancing herself from the president. For example, President Obama has characterized his foreign policy as "don't do stupid s*@t." Clinton suggested that this sentiment wasn't a working foreign policy stance for the world's superpower. Her comment raised expectations that she would triangulate a position different from Obama and her GOP opponent.

However, as it became apparent that she faced a legitimate primary threat from Sen. Sanders, Clinton, in an effort to secure the African American voter block, has completely embraced President Obama and has framed Sanders's calls for new policies as a repudiation of Obama's legacy. This position has been very effective in securing African American votes and has also given her an edge in closed primaries, taking advantage of Obama's popularity with most Democrats. However, in open primaries, which allow independents to vote, and in areas with white voters, Sen. Clinton has underperformed Sen. Sanders. While tying her fate to President Obama's legacy has been mostly effective in winning the nomination,[1] Clinton's positioning as essentially the third term of the Obama administration is a risky general election strategy as she will face the debate line, "if you liked the last eight years, you should vote for Hillary."[2]

What can we expect from a Clinton administration?

Foreign Policy: This is one of the few areas where we would expect a Clinton government to differ significantly from the outgoing administration. Clinton is much more hawkish than Obama and her positions are in direct opposition to the apparent populist mood of the nation. During her time as secretary of state, she often favored a more hawkish foreign policy than the president, pushing for greater military involvement in the world. Although she isn't a neoconservative, she is about as close to one as this group can hope for among the remaining

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[1] Although one could argue that she has barely been able to beat an elderly socialist.

[2] It should be noted that Gov. Reagan used a similar line against President Carter in a debate; some historians have argued that this phrase turned the election for Reagan.

candidates. In terms of Meade's archetypes, she is Wilsonian. Thus, we would not be surprised to see neoconservatives, who usually vote Republican, drift toward Sen. Clinton.

Domestic Policy: As noted above, she is proposing nothing more than maintaining and defending the Obama policy legacy. That policy means preserving Obamacare, holding tax rates at current levels or perhaps raising them modestly on the very wealthy, and expanding on the regulatory legacy started by President Obama.

Trade Policy: On trade, Clinton has generally supported free trade agreements. She was originally in favor of the Trans-Pacific Partnership (TPP) before she turned against it. We seriously doubt she actually opposes either this agreement or the Transatlantic Trade and Investment Partnership (TTIP), but given the rising unpopularity of such agreements and the fact that both Sen. Sanders and Mr. Trump have made opposition to trade a major plank of their platforms, Clinton has been forced to tack left on this issue. We think there is a chance that President Obama will try to get the TPP passed before he leaves office; in fact, he may accomplish this during the "lame duck" session after the November elections. Although a President-elect Clinton would officially oppose this tactic, in reality, we suspect she would privately support it.

Immigration: The Democratic Party and, by extension, Sen. Clinton have generally supported easing restrictions on immigration and want to create a "path to citizenship" for illegal aliens living in the U.S. This position will alienate her with white, working-class voters, perhaps putting swing states like Ohio and Pennsylvania in play, but could help Clinton wrest Arizona and Georgia from GOP hands.

Defense: We would expect Clinton to have a better relationship with the military than President Obama. In fact, it would not be a surprise if she asked Ash Carter, the current secretary of defense, to stay on in her administration. Given her foreign policy stance, the military would likely be utilized more often in her government.

Fiscal Policy: Clinton would likely run an orthodox fiscal policy with a modest tilt toward raising taxes.

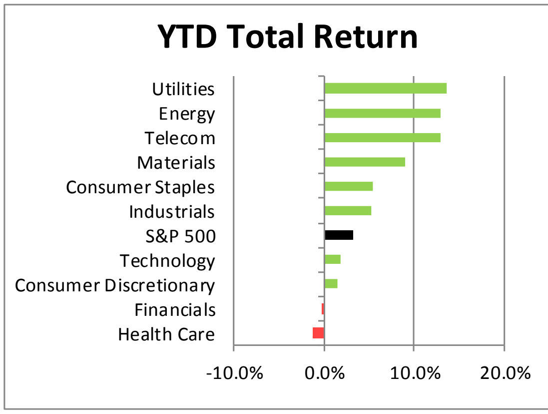
Environmental Policy: Her policies will likely follow in the trends established by President Obama. We would not expect anything as radical as Sen. Sanders's bid to end fracking. At the same time, her policies won't revive coal and we would expect a steadily tightening regulatory environment for oil and gas producers.

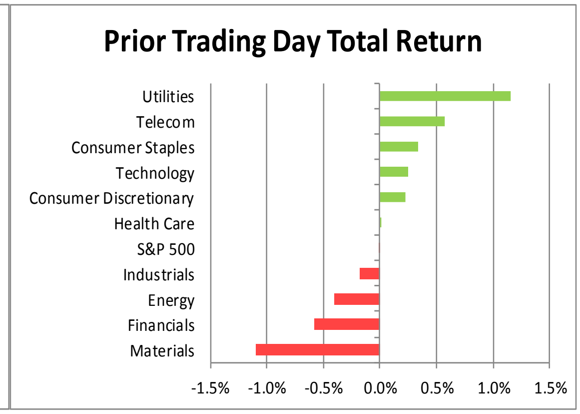
The market impact from a Clinton presidency would be negligible. Not only is she a solid member of the political establishment, but because she is running a campaign similar to a succeeding vice president, she will have virtually no political capital to bring "change" after gaining office. Thus, the slow growth, low inflation economic environment would likely continue. If markets fear a Trump presidency is likely and financial markets weaken into the election due to these fears, then a strong relief rally may ensue from a Clinton presidency, which is about the most notable market impact that would occur.

In our asset allocation views, we have consistently held that inflation would remain low; we have tended to favor longer duration in fixed income and generally supported equities. A Clinton presidency would maintain the status quo. We would continue to closely monitor the evolution of populism in the U.S., which threatens the current low inflation environment, but we would not expect Clinton to support a populist agenda. ***Bottom line: a Clinton presidency is a status quo outcome.***

Data Section

U.S. Equity Markets – (as of 5/26/2016 close)

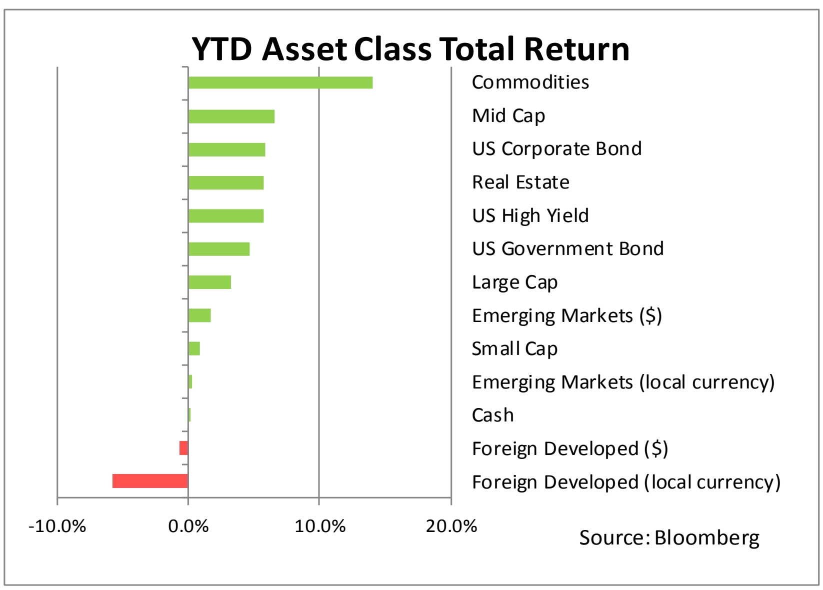




(Source: Bloomberg)

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 5/26/2016 close)

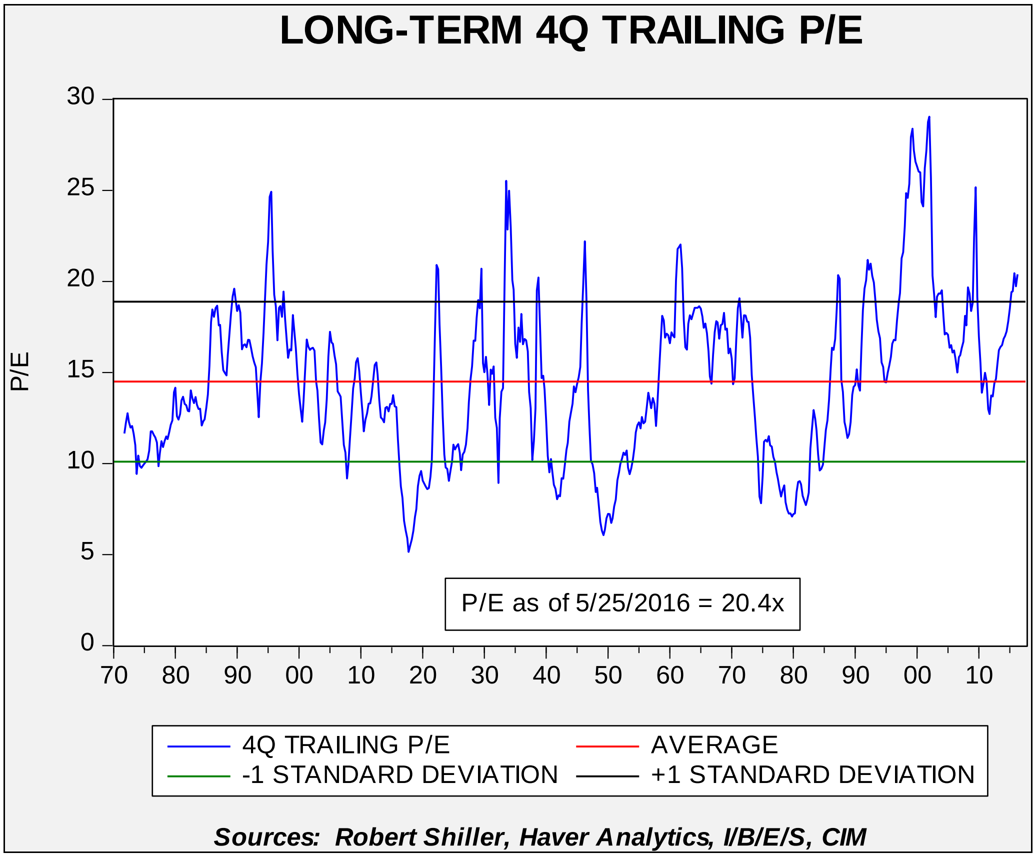


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 26, 2016



Based on our methodology,[3] the current P/E is 20.4x, up 0.5x from last week. The P/E rose mostly due to higher equity values.

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.

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[3] 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.