Daily Comment

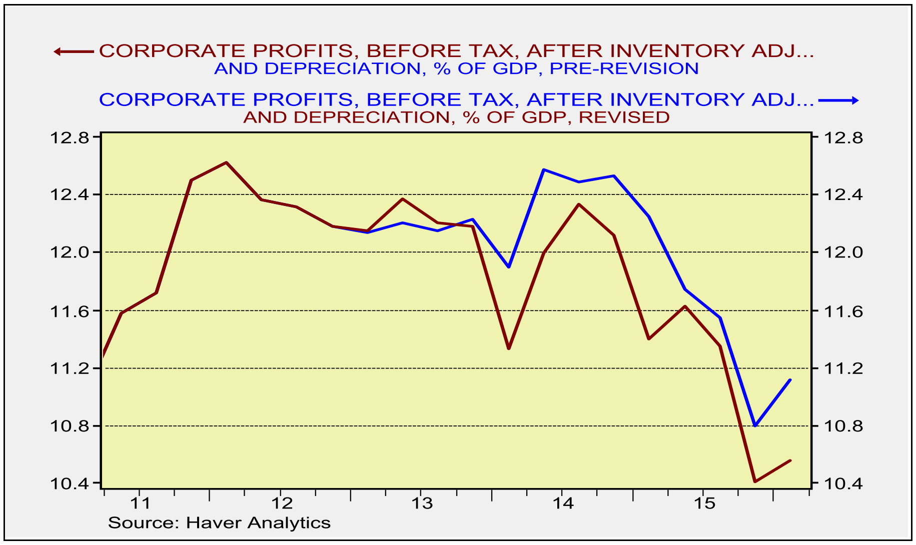
By Bill O'Grady & Kaisa Stucke, CFA

[Posted: Aug 1, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading down 0.6% from the last close. In Asia, the MSCI Asia Apex 50 closed up 1.6% from the prior close. Chinese markets were sharply lower, with the Shanghai composite down 0.9% and the Shenzhen index trading lower by 1.5%. Concerns about a regulatory crackdown on wealth management products are being blamed for the weakness. U.S. equity futures are signaling a steady opening from the previous close. With 318 companies having reported, the S&P 500 Q2 earnings stand at $29.25, higher than the $28.38 forecast for the quarter. The forecast reflects a 5.4% decline from Q2 2015 earnings. Thus far this quarter, 72.9% of the companies reported earnings above forecast, while 15.5% reported earnings below forecast.

It's global PMI day today. As we note below, most of the data came in around expectations. Australia was unusually robust while the U.K. was rather weak. Overall, the data suggests a global economy that is mostly steady.

We had two fed officials speak over the weekend, Dallas FRB President Kaplan and NY FRB President Dudley. Kaplan was mostly hawkish, suggesting that September was a live meeting, but also expressed the need for "patience." Dudley, on the other hand, spent most of his time talking about the problems the economy faces. Despite these comments, financial markets continue to project a slow path for tightening; for now, the market doesn't have the probability of an increase greater than 50% until the June 2017 meeting (based on the fed funds futures).

One item we neglected to mention with last week's GDP benchmark revisions is that corporate profits, after inventory adjustments and depreciation, were revised higher. As the chart below shows, profits were stronger than originally reported, which is supportive for the equity markets.



U.S. Economic Releases

There were no economic releases before we went to press this morning. The table below shows other releases or Fed speakers scheduled for the rest of the day.

Economic releases							
EDT	Indicator			Expected	Prior	Rating
8:45	Manufacturing PMI (Markit)	m/m	Jul	52.9	52.9	***
9:00	Manufacturing PMI (ISM)	m/m	Jul	53.0	53.2	***
9:00	Construction Spending	m/m	Jun	0.5%	-0.8%	**
Fed speakers or events						
EST	Speaker or event	District or position				
5:15	Kaplan	Dallas FRB President				

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	AIG Manufacturing Indes	m/m	Jul	56.4	51.8		**	Equity bullish, bond bullish
	New Home Sales	m/m	Jun	8.2%	-4.4%		*	Equity bullish, bond bullish
China	Manufacturing PMI (official)	m/m	Jul	49.9	50.0	50.0	***	Equity and bond neutral
	Services PMI (official)	m/m	Jul	53.9	53.7		**	Equity and bond neutral
	Manufacturing PMI (Caixin)	m/m	Jul	50.6	48.6	48.8	**	Equity bullish, bond bullish
India	Manufacturing PMI (Nikkei)	m/m	Jul	51.8	51.7		***	Equity and bond neutral
	Eight Infrastructure Industries	m/m	Jun	5.2%	2.8%		*	Equity bullish, bond bullish
Japan	Manufacturing PMI (Nikkei)	m/m	Jul	49.3	49.0		***	Equity and bond neutral
	Housing Starts	y/y	Jun	-2.5%	9.8%	-2.7%	**	Equity and bond neutral
	Construction Orders	y/y	Jun	-2.4%	34.5%		*	Equity and bond neutral
	Vehicle sales	y/y	Jul	-0.2%	3.0%		**	Equity bearish, bond bullish
EUROPE								
Eurozone	Manufacturing PMI (Markit)	m/m	Jul	52.0	51.9	51.9	***	Equity and bond neutral
France	Manufacturing PMI (Markit)	m/m	Jul	48.6	48.6	48.6	***	Equity and bond neutral
Germany	Manufacturing PMI (Markit)	m/m	Jul	53.8	53.7	53.7	***	Equity and bond neutral
Italy	Manufacturing PMI (Markit)	m/m	Jul	51.2	53.5	52.5	***	Equity and bond neutral
U.K.	Manufacturing PMI (Markit)	m/m	Jul	48.2	49.1	49.1	***	Equity bearish, bond bullish
Russia	Manufacturing PMI (Markit)	m/m	Jul	49.5	51.5	51.0	***	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)	76	76	0	Up
3-mo T-bill yield (bps)	27	25	2	Down
TED spread (bps)	49	50	-1	Widening
U.S. Libor/OIS spread (bps)	41	41	0	Neutral
10-yr T-note (%)	1.50	1.45	0.05	Neutral
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	47	47	0	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	neutral			Neutral
yen	neutral			Up
franc	up			Neutral

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	Explanation
Energy Markets				
Brent	$43.05	$43.53	-1.10%	Higher than expected domestic inventories
WTI	$41.18	$41.60	-1.01%	
Natural Gas	$2.85	$2.88	-0.90%	
Crack Spread	$13.69	$13.65	0.31%	
12-mo strip crack	$12.09	$12.14	-0.37%	
Ethanol rack	$1.59	$1.59	0.00%	
Metals				
Gold	$1,348.35	$1,351.28	-0.22%	
Silver	$20.46	$20.34	0.60%	
Copper contract	$223.05	$222.15	0.41%	
Grains				
Corn contract	$ 340.00	$ 342.75	-0.80%	
Wheat contract	$ 410.00	$ 407.75	0.55%	Severe rain damage to French crop
Soybeans contract	$ 984.25	$ 1,003.00	-1.87%	Favorable crop weather
Shipping				
Baltic Dry Freight	656	665	-9	

Weather

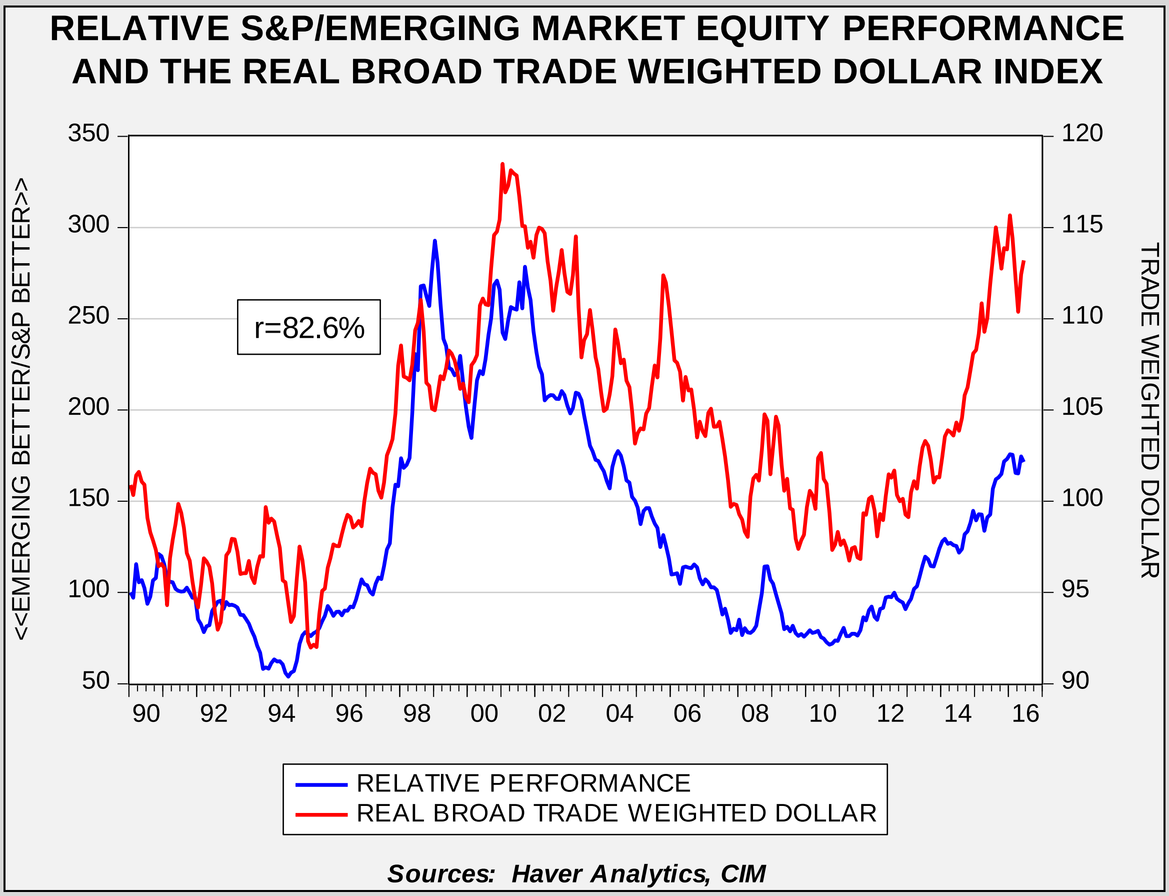
The 6-10 and 8-14 day forecasts call for warmer than normal temperatures for the majority of the country, with some cooler than normal weather for parts of the West Coast. Greater than normal precipitation is forecast for parts of the Southeast, Great Lakes and Southwest regions. A strong tropical wave has formed south of Hispaniola and is expected to reach the Cayman Islands tomorrow. It has a high probability of developing into a tropical depression over the next 48 hours. At present, it has a small chance of affecting oil and gas production and flows, although there is the potential that it could affect Mexican production later this week.

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.

July 29, 2016

In the most recent rebalance of our Asset Allocation portfolios, we maintained an allocation to emerging market equities in the Aggressive Growth portfolio. As we have noted in the past, there is a positive relationship between the dollar's exchange rate and the relative performance of developed market equities and emerging market equities.



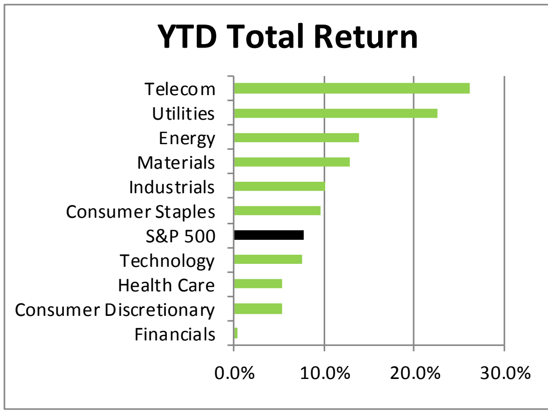
This chart shows the relative performance of the S&P 500 and the MSCI emerging market index (denominated in dollars). A rising blue line on the chart signals stronger S&P performance relative to emerging markets and vice versa. Using the JPM dollar index, we note the dollar bottomed in late 2011. As the dollar appreciated, the S&P began to consistently outperform emerging markets.

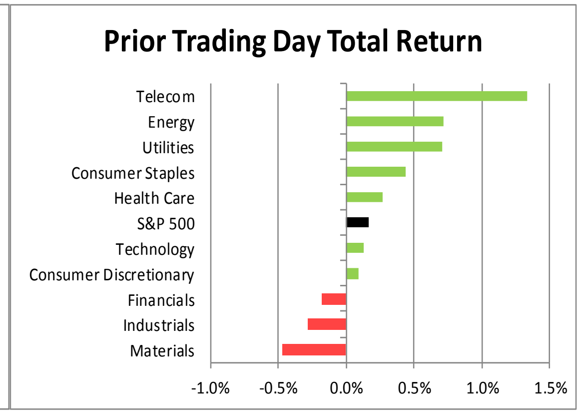
The most important factor boosting the dollar was monetary policy divergence. The Federal Reserve ended its balance sheet expansion in December 2014. It raised its policy rate in December 2015. This tightening occurred while the European Central Bank (ECB) and the Bank of Japan (BOJ) both continued to implement aggressively accommodative policies. The dollar's strength clearly accelerated in the 2014-15 period, although the rally has stalled this year. We believe the stall has occurred because of uncertainty surrounding U.S. monetary policy. Initially, the FOMC signaled four rate hikes this year. Currently, fed funds futures are suggesting no rate hikes this year and perhaps only one hike next year. If this does become the path of policy, the dollar bull market may be coming to a close unless the ECB and BOJ become even more aggressive in policy easing. If we are reaching the point where further accommodation isn't possible, a stronger dollar is less likely and thus, emerging market equities become attractive given their recent relative weakness.

However, due to the uncertainty over the direction of policy, as noted above, the asset allocation committee has judged emerging market equities as only appropriate for aggressive investors. If the FOMC tightens policy sooner or to a greater degree than expected, developed markets could begin to sharply outperform emerging markets again. Given that market expectations are leaning heavily toward steady Fed policy, there is the potential for a bearish surprise for the emerging equity sector. Thus, in our judgement, only the most risk tolerant investors should be considering emerging market equities at this time.

Data Section

U.S. Equity Markets – (as of 7/29/2016 close)

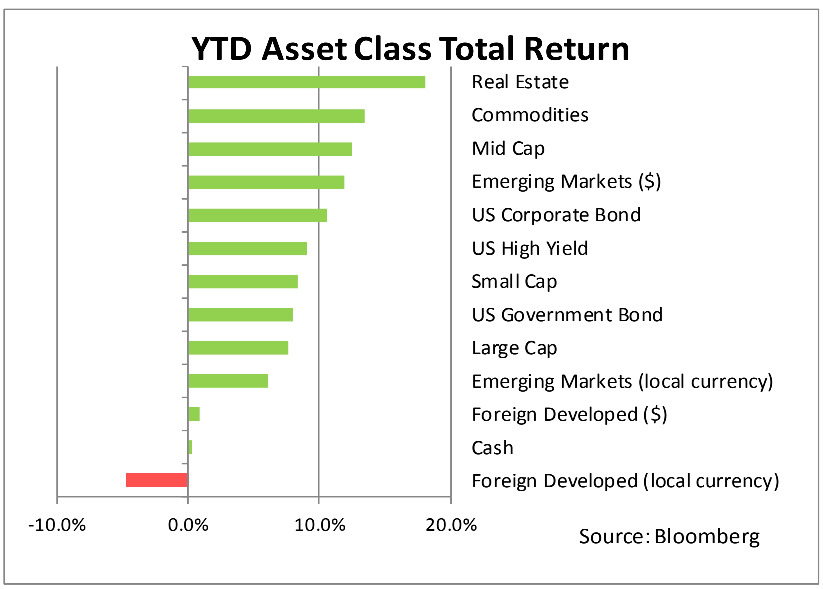




(Source: Bloomberg)

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 7/29/2016 close)

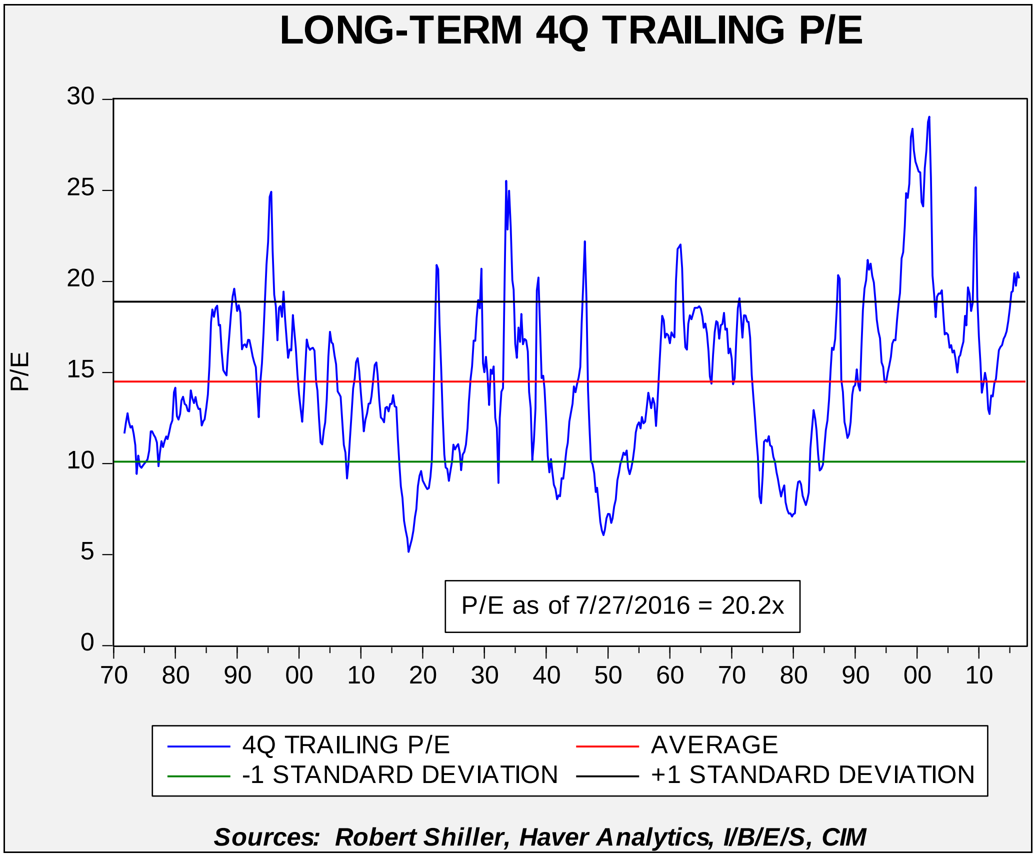


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

July 28, 2016



Based on our methodology,[1] the current P/E is 20.2x, up 0.1x. The rise is mostly due to a rising S&P 500.

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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[1] 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 estimate (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.