Confluence Investment Management

Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: July 15, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading lower by 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed up by 0.7% from the prior close. Chinese markets were lower to sideways, with the Shanghai composite trading roughly unchanged and the Shenzhen index lower by 0.3%. U.S. equity futures are signaling a modestly higher opening from the previous close. With 32 companies having reported, the S&P 500 Q2 earnings stand at $28.67, higher than the $28.38 forecast for the quarter. The forecast reflects a 5.4% decline from Q2 2015 in the consensus estimates. Thus far this quarter, 65.6% of the companies reported earnings above forecast, while 21.9% reported earnings below forecast.

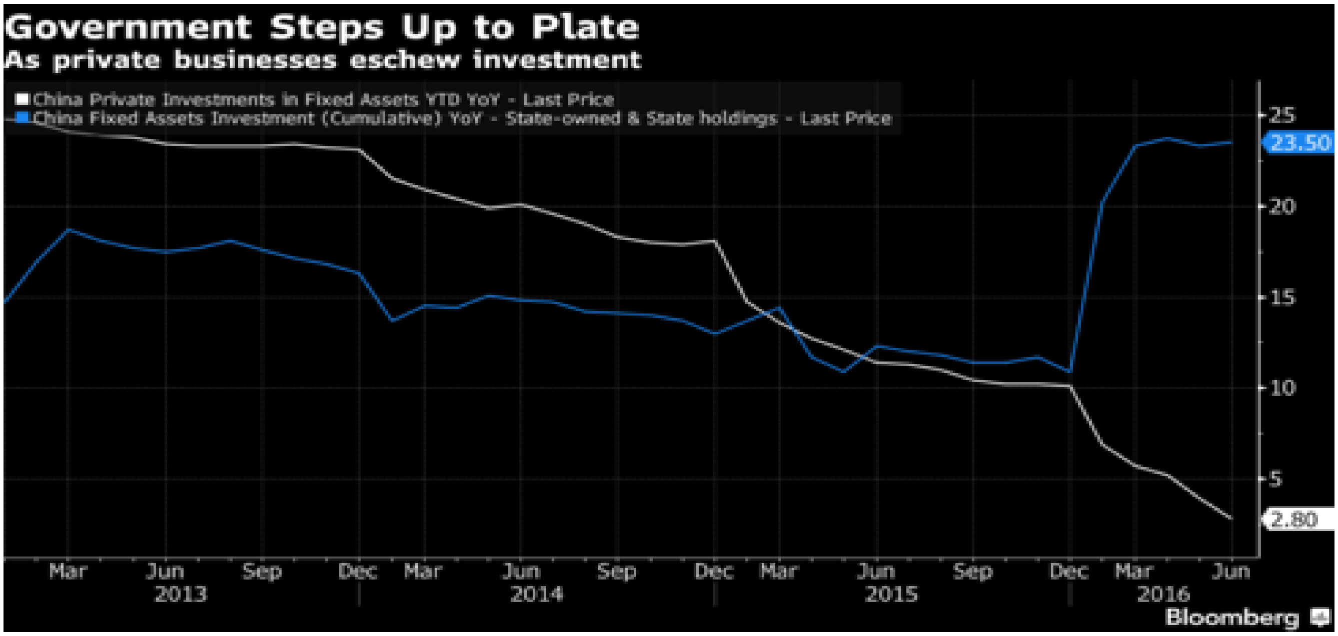
There were two major news items overnight, the Nice terrorist attack and China's GDP. News reports indicate that there were 84 deaths from a terrorist attack in Nice, France. The attacker, identified as Mohamed Lahouaiej Bouhlel, a French passport holder of Tunisian descent, used a 19 tonne truck to drive into a crowd celebrating Bastille Day on the French Riviera. Not too much is known about the assailant; he appears to be a petty criminal but was not on any terrorist watch lists. There have been reports that IS has been actively recruiting criminals of Middle Eastern origin living in Europe. These recruits are often not overtly religious but seem attracted to the violent nature of IS.[1] Neighbors of Bouhlel report that he did not appear religious. He was married with three children but, according to reports, his marriage was estranged. President Hollande asked the French legislature to extend the state of emergency for three more months; it was due to expire.

Terror attacks such as these are nearly impossible to stop. Normal reasoning would look for patterns, trying to create a profile that might inform when the next attack may be coming. However, that doesn't seem to work; after all, if small-time criminals can suddenly turn into terrorists, there is no clear way to figure out the difference. The longer this goes on the more likely it is that the public will demand protection, which may mean that anyone with a certain religious background with a criminal record will come under increased scrutiny and surveillance, at a minimum. The increase in fear will almost certainly have a political effect; we will be watching closely to see if Le Pen's National Front poll numbers improve in the coming weeks. On the other hand, the financial markets have become so inured to these events that there is scant evidence of an effect on todays' trade.

---

[1] https://www.washingtonpost.com/world/national-security/new-isis-recruits-have-deep-criminal-roots/2016/03/23/89b2e590-f12e-11e5-a61f-e9c95c06edca_story.html

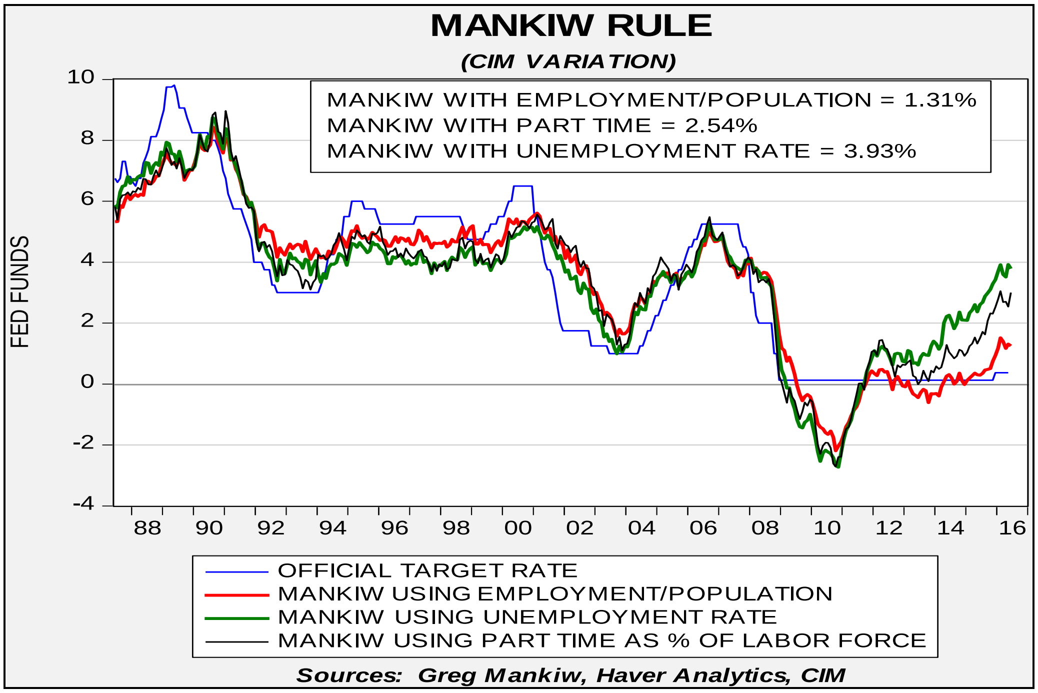
China's Q2 GDP rose 6.7% from last year, a bit better than the 6.6% expected. The data is (not surprisingly) in line with government growth targets. The rise in credit has lifted GDP at the risk of increasing non-performing loans in the future.



(Source: Bloomberg)

This chart shows that private investment continues to fall; essentially, the government was able to meet its goals by boosting public investment. Property investment is up 6.1% YTD compared to the same period last year. It is unclear if another rise in real estate activity is a good long-term plan. The good news of the data is that the Chinese economy isn't in imminent danger. The bad news is that it is likely creating future debt problems that could be serious in order to avoid problems now.

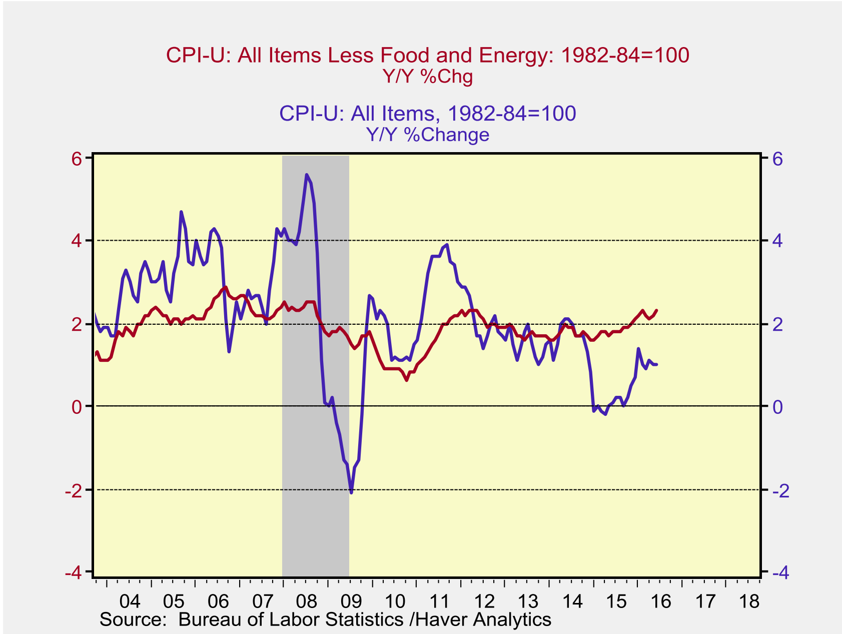
With the release of CPI data, we can tentatively update our versions of the Mankiw rule model. This model attempts to determine the neutral rate for fed funds, which is a rate that is neither accommodative nor stimulative. Mankiw's model is a variation of the Taylor Rule. The latter measures the neutral rate using core CPI and the difference between GDP and potential GDP, which is an estimate of slack in the economy. Potential GDP cannot be directly observed, only estimated. To overcome this problem with potential GDP, Mankiw used the unemployment rate as a proxy for economic slack. We have created three versions of the rule, one that follows the original construction by using the unemployment rate as a measure of slack, a second that uses the employment/population ratio and a third using involuntary part-time workers as a percentage of the total labor force.



Using the unemployment rate, the neutral rate is now up to 3.93%, suggesting the FOMC is well behind the curve. Using the employment/population ratio, the neutral rate is 1.31%, indicating that, even using the most dovish variation, the FOMC needs a rate hike of at least 75 to 100 bps to achieve neutral policy. Finally, using involuntary part-time employment, the neutral rate is 2.54%. Currently, fed funds futures place the odds of a September hike at 21%. A probability in excess of 50% isn't seen until June 2017. We had three Fed speakers yesterday; none suggested a rate was required in the near term. With the immediate impact of Brexit mostly out of the way and no policy tightening on the horizon, there is clear evidence of improving investor confidence. The next two events of consequence are the Italian referendum on government reform in October and the November U.S. elections. In the wake of Brexit, we would expect EU officials to give some ground to Italy; we note that the new head of Italy's largest bank, UniCredit (UCG, €2.18), called for a "more lenient stance" on bank support from the EU. Although the risk of a President Trump is, in our opinion, probably higher than polls suggest, it is still nothing more than a coin flip. Essentially, the biggest risk we identified in our 2016 outlook, a policy mistake by the FOMC, is becoming less likely, at least in terms of tightening too much and too often. On the other hand, we may be facing the other risk, which is that stable policy triggers financial market exuberance.

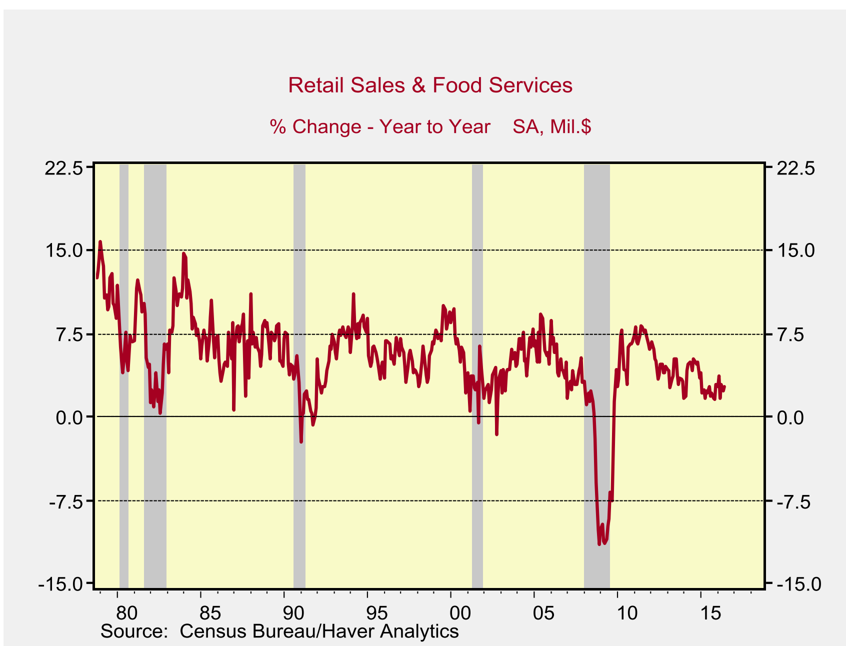
U.S. Economic Releases

Consumer prices increased 0.2% in June, less than the 0.3% increase forecast. Core prices rose 0.2% from the month before, on forecast. Energy prices increased by the most, rising 1.3% for the month. Rent price increases were also strong, rising 0.3%. Prices of apparel and food/beverages declined.



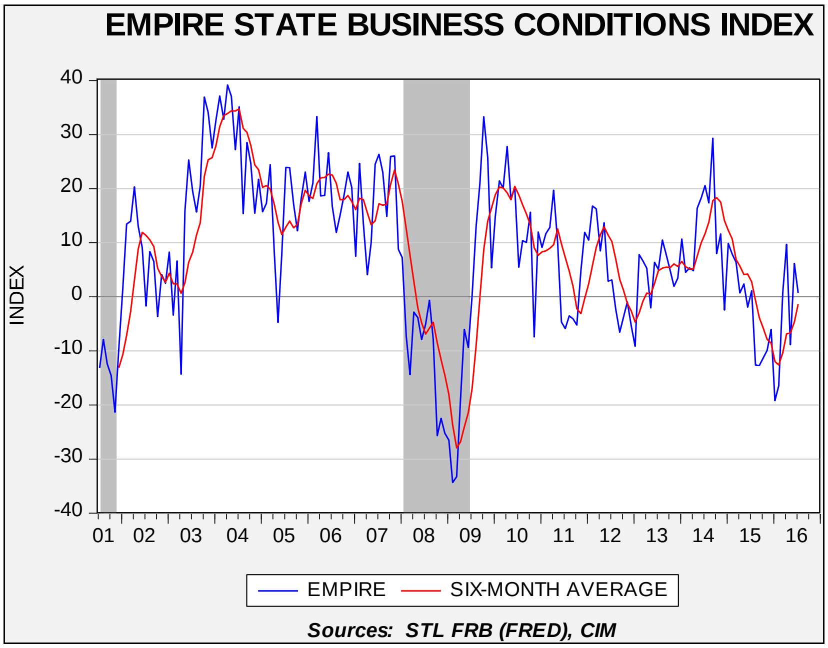
The chart above shows the annual change in the headline and core prices. Annually, headline prices rose 1.0%, modestly less than the 1.1% increase forecast, while core prices rose 2.3%, slightly more than the 2.2% increase expected.

Retail sales came in much stronger than forecast in June, rising 0.6% compared to the 0.1% increase expected. May's sales increases were revised lower to a 0.2% increase from the 0.5% increase reported earlier. Sales strength was broad based, with sales excluding autos rising 0.7% for the month, more than the 0.4% forecast, and sales excluding autos and gas rising 0.7%, also more than the 0.3% increase expected.



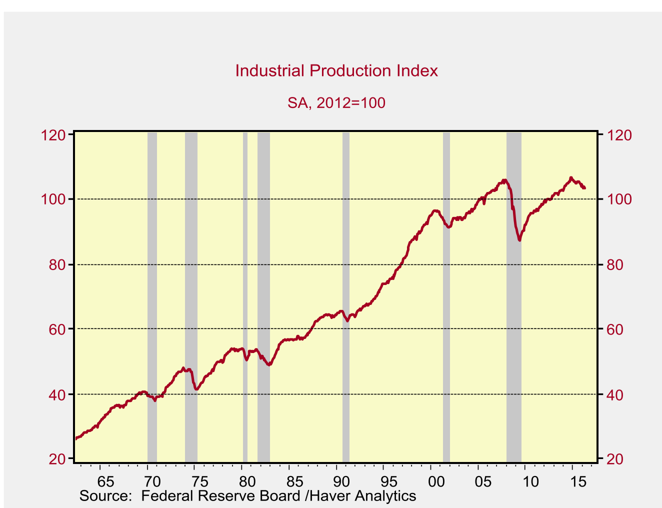
The chart above shows the annual change in retail sales, which are up 2.7%.

Empire manufacturing came in weaker than forecast in July, coming in at 0.6 from the 6.0 rise the month before. Expectations were calling for a level of 5.0.

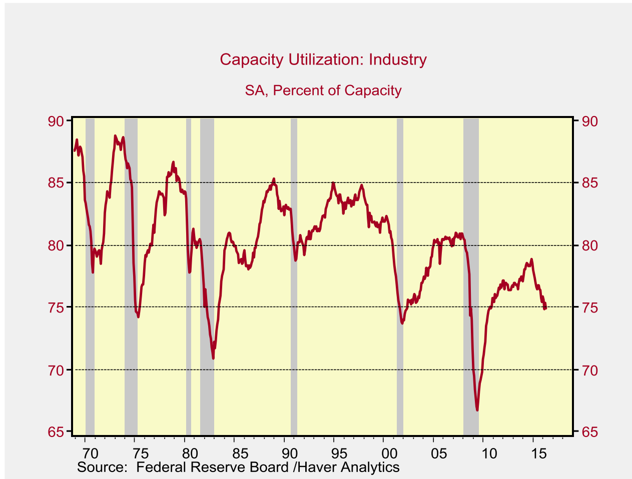


Real average weekly wages rose 1.2% from the year before, picking up modestly from the 1.1% increase the week before.

Industrial production came in stronger than forecast for June, rising 0.6% compared to the 0.3% increase forecast. The chart below shows the industrial production index, which has weakened over the past two years on soft global demand and the stronger dollar.



Capacity utilization was also stronger than expected, rising to 75.4% from 74.9% during the prior month and higher than the 75.1% increase forecast.



Overall, today's data was encouraging. Equities moved higher after the releases, while bonds and gold moved lower.

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

Economic releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Business inventories	m/m	May	0.1%	0.1%	**
10:00	University of Michigan sentiment	m/m	Jul	93.3	93.5	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
1:00	Williams	San Francisco FRB President				
1:15	Kashkari	Minneapolis 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	Unemployment rate	m/m	Jun	5.8%	5.7%	5.8%	***	Equity and bond neutral
	New motor vehicles sales	y/y	Jun	2.1%	1.8%		**	Equity bullish, bond bearish
India	Wholesale prices	y/y	Jun	1.6%	0.8%	1.2%	*	Equity bullish, bond bearish
EUROPE								
U.K.	Producer and import prices	y/y	Jun	-1.0%	-1.2%	-1.0%	**	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)	67	67	0	Neutral
3-mo T-bill yield (bps)	30	30	0	Neutral
TED spread (bps)	37	37	0	Neutral
U.S. Libor/OIS spread (bps)	40	39	1	Neutral
10-yr T-note (%)	1.52	1.48	0.04	Widening
Euribor/OIS spread (bps)	-30	-29	-1	Down
EUR/USD 3-mo swap (bps)	43	43	0	Neutral
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	up			Up
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of England rate	0.50%	0.50%	0.25%	Unchanged
BOE asset purchase target	£375 bn	£375 bn	£375 bn	On forecast

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	$47.23	$46.26	2.10%	Stockpiles decline more than expected, lower dollar
WTI	$45.57	$44.75	1.83%	
Natural Gas	$2.76	$2.74	0.95%	Hot weather forecast
Crack Spread	$13.69	$13.18	3.89%	
12-mo strip crack	$12.56	$12.24	2.61%	
Ethanol rack	$1.75	$1.75	-0.07%	
Metals				
Gold	$1,325.98	$1,342.64	-1.24%	Investment demand falls
Silver	$20.18	$20.36	-0.86%	
Copper contract	$224.35	$224.00	0.16%	Short covering
Grains				
Corn contract	$ 372.50	$ 362.00	2.90%	
Wheat contract	$ 447.25	$ 439.75	1.71%	Hot weather expected in Russia
Soybeans contract	$ 1,121.75	$ 1,105.25	1.49%	Hot weather in the U.S. threatens crop development
Shipping				
Baltic Dry Freight	726	711	15	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.5	-2.3	-0.2	
Gasoline (mb)	1.2	-1.0	2.2	
Distillates (mb)	4.1	-0.1	4.2	
Refinery run rates (%)	-0.2%	0.3%	0.0	
Natural gas (bcf)	64.0	61.0	3.0	

Weather

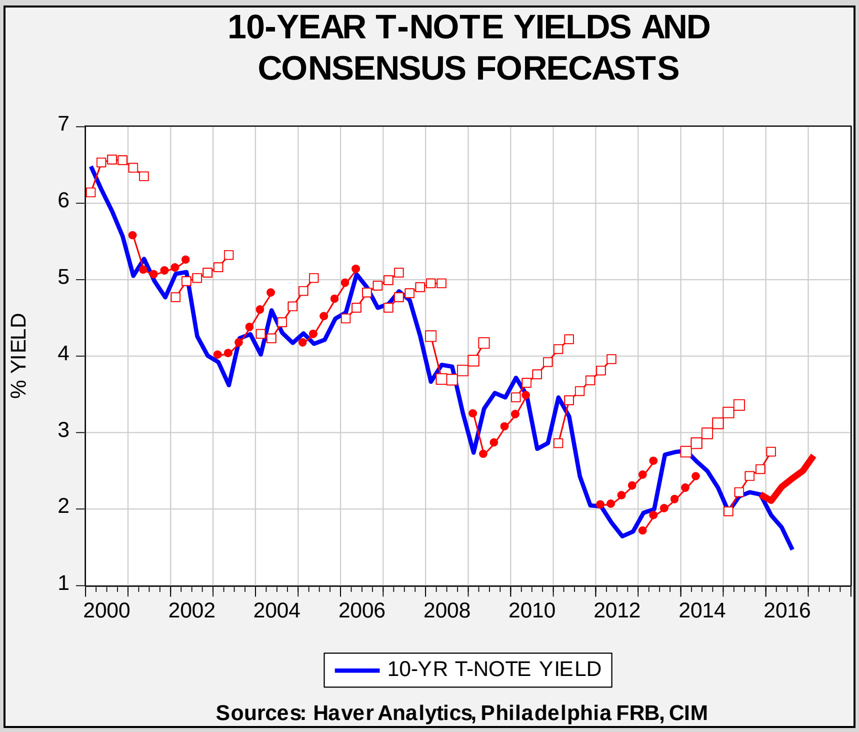
The 6-10 and 8-14 day forecasts call for warmer than normal temperatures for the majority of the country, except for the Northwest. Most of the country is expected to receive lighter than normal precipitation. The tropics are quiet today.

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 15, 2016

Since the recovery began, we have consistently favored duration in fixed income. Our position has been that growth would remain sluggish in the developed world and global overcapacity would keep inflation contained. The consensus of strategists and economists didn't support our position.



This chart shows the path of the 10-year T-note yield along with the forecast at the beginning of each year from the Philadelphia FRB Professional Forecasters Survey. The open boxes indicate when the forecasts were incorrect; the solid circles indicate correct forecasts. We are on the 17th forecast; so far, 10 have been wrong and, barring a strong jump in yields similar to 2012, the forecasters will be incorrect this year as well.

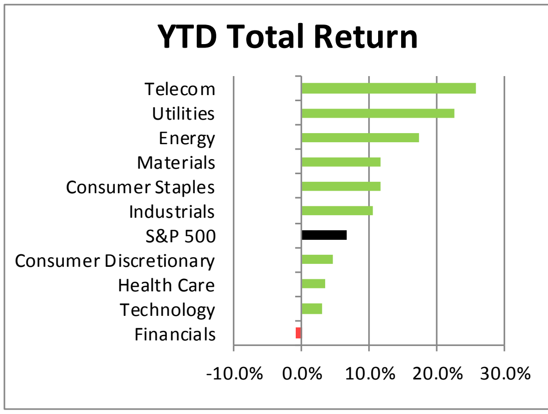
In general, the persistently incorrect forecasts are likely due to the consensus opinion that the economy, inflation and markets will normalize over some time frame. Instead, since the turn of the century, inflation has steadily declined and, in the aftermath of the financial crisis, economic growth has been persistently low. Accordingly, financial markets and global economies have been operating in a "new normal" rather than a return to the 1990s normal.

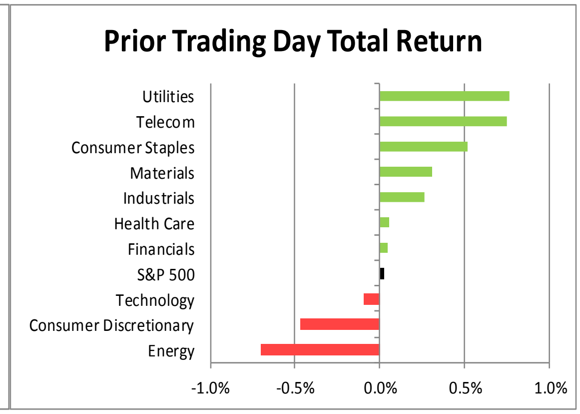
Although our position on fixed income has been correct, we are watchful for conditions that would reverse this long-term downtrend in yields. Inflation trends often have a political element. One of the key tradeoffs society makes is between equality and efficiency.[2] When society is leaning toward the latter, bonds will tend to do well because inflation will be controlled. If equality is demanded, the risk levels of bonds rise. Thus, we are carefully watching Brexit, Bernie Sanders and Donald Trump. These are all manifestations of a potential trend toward equality that would likely be expressed by re-regulation and deglobalization of the economy. If these trends, and others, gain traction, the potential for rising inflation and interest rates would increase. For now, we continue to favor long duration assets. Given the high level of binary risks looming (the process of the U.K. leaving the EU, November U.S. elections, the Italian referendum on government reform and its banking problems), long duration Treasuries offer some protection against bearish events, as the Brexit situation showed. But, we are closely monitoring economic and political conditions for a change in the secular trend in bonds.

[2] For a discussion on efficiency and equality cycles, see our recent WGR: Post-Brexit (7/11/16).

Data Section

U.S. Equity Markets – (as of 7/14/2016 close)

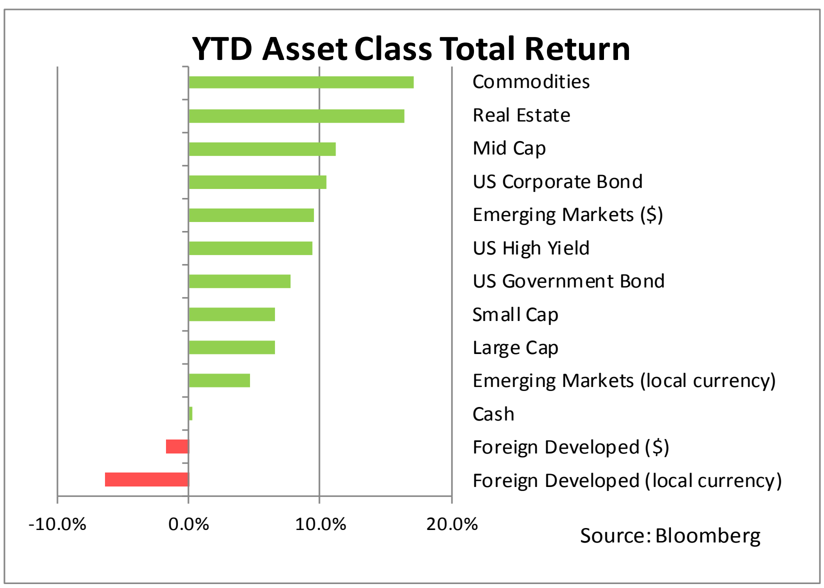




(Source: Bloomberg)

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 7/14/2016 close)

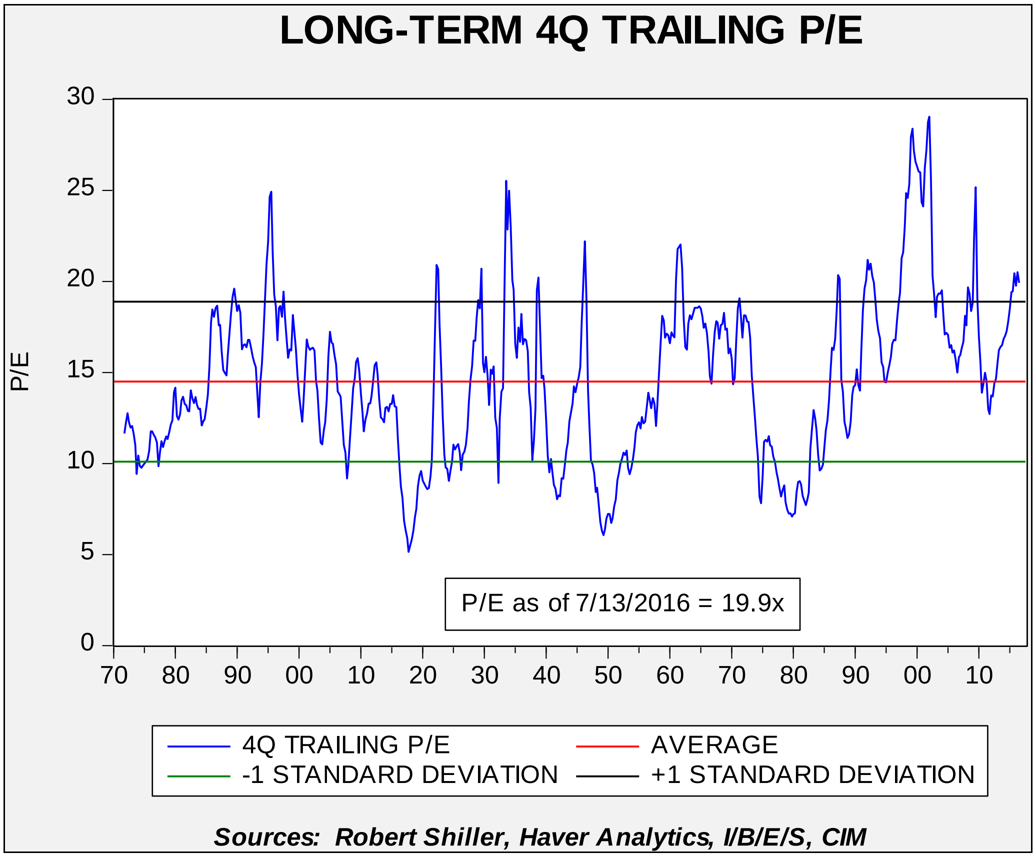


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 14, 2016



Based on our methodology,[3] the current P/E is 19.9x, up 0.2x. 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.

---

[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 (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.