Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: July 18, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading lower by 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed up by 0.4% from the prior close. Chinese markets were lower, with the Shanghai composite trading down 0.4% and the Shenzhen index lower by 0.5%. U.S. equity futures are signaling a modestly higher opening from the previous close. With 36 companies having reported, the S&P 500 Q2 earnings stand at $28.70, 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, 66.7% of the companies reported earnings above forecast, while 19.4% reported earnings below forecast.

The big weekend news was the failed coup in Turkey. Late Friday, news began to emerge of unusual troop movements within the country. By evening, it was clear that a full-blown coup attempt was underway. President Erdogan issued a statement to his followers via FaceTime to resist the coup plotters. Although the gesture seemed rather pathetic at the time, the action does appear to have turned the tide against the coup. By nightfall in the West, it had become apparent that the coup plotters had failed, although bloodshed continued for several hours. Once Erdogan flew to Istanbul, the government was in control of the situation.

These charts show the reaction within the Turkish financial markets.

(Source: Bloomberg)

This chart shows the TRY/USD exchange rate on an inverted scale. Note that the Turkish lira plunged on the news but has regained about half of its losses.

Turkish equities show a similar pattern.

(Source: Bloomberg)

This is a six-month daily candlestick chart. Note that equities had been rallying into the event. They have sold off hard today and are trading near the lows. Even though the coup failed, it is unclear how far Erdogan will go in reaction to the coup. This will be a topic of an upcoming WGR. Nevertheless, the point is that the dragnet appears unusually wide; in fact, if the conspiracy was as wide as the arrests indicate, it is unfathomable how operational secrecy was maintained. It appears that Erdogan is going to use this event to eliminate as many opponents as possible. If a widespread purge follows the coup, it won't be good for Turkish financial assets.

The other quiet event that occurred in the wake of the Turkish coup was that the PBOC used the cover of events to further depreciate the CNY.

(Source: Bloomberg)

This chart shows the CNY/USD exchange rate, inverted, over the past year. After last August's devaluation, China has been following a "stair step" approach to depreciate its currency, with periods of pushing the rate lower followed by consolidation. It is becoming clear that China is trying to use a weaker currency to stimulate its economy. This action will tend to export deflation to the rest of the world and is supportive of further declines in long-term interest rates.

Overall, the failed coup's broader market impact appears rather modest but it does highlight the underlying risks of emerging market investing. The bigger market impact may be felt in the aftermath of the coup as the purge has the potential to turn Turkey into an authoritarian regime. Its relationship with NATO and its role in stabilizing the Middle East are now under question.

U.S. Economic Releases

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	NAHB Housing Market Index	m/m	July	60.0	60.0	**
10:00	Net TIC flows	m/m	May		80.4	**

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								
India	Import prices	y/y	Jun	-7.3%	-13.2%		**	Equity and bond neutral
	Export prices	y/y	Jun	1.3%	-0.8%		**	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)	69	68	1	Neutral
3-mo T-bill yield (bps)	30	30	0	Neutral
TED spread (bps)	39	38	1	Neutral
U.S. Libor/OIS spread (bps)	40	40	0	Neutral
10-yr T-note (%)	1.58	1.55	0.03	Widening
Euribor/OIS spread (bps)	-29	-30	1	Down
EUR/USD 3-mo swap (bps)	50	48	2	Neutral
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	down			Up
franc	down			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	$47.09	$47.61	-1.09%	Supply worries, no Turkey disruption
WTI	$45.49	$45.95	-1.00%	
Natural Gas	$2.76	$2.76	0.00%	Hot weather forecast
Crack Spread	$13.09	$13.43	-2.56%	High gasoline inventories
12-mo strip crack	$12.10	$12.27	-1.40%	
Ethanol rack	$1.73	$1.73	0.00%	
Metals				
Gold	$1,327.42	$1,337.45	-0.75%	Investment demand falls
Silver	$19.86	$20.23	-1.87%	
Copper contract	$221.10	$223.35	-1.01%	
Grains				
Corn contract	$ 358.25	$ 358.25	0.00%	
Wheat contract	$ 427.00	$ 424.75	0.53%	
Soybeans contract	$ 1,043.75	$ 1,057.25	-1.28%	Weather concerns ease for soybeans
Shipping				
Baltic Dry Freight	745	738	7	

Weather

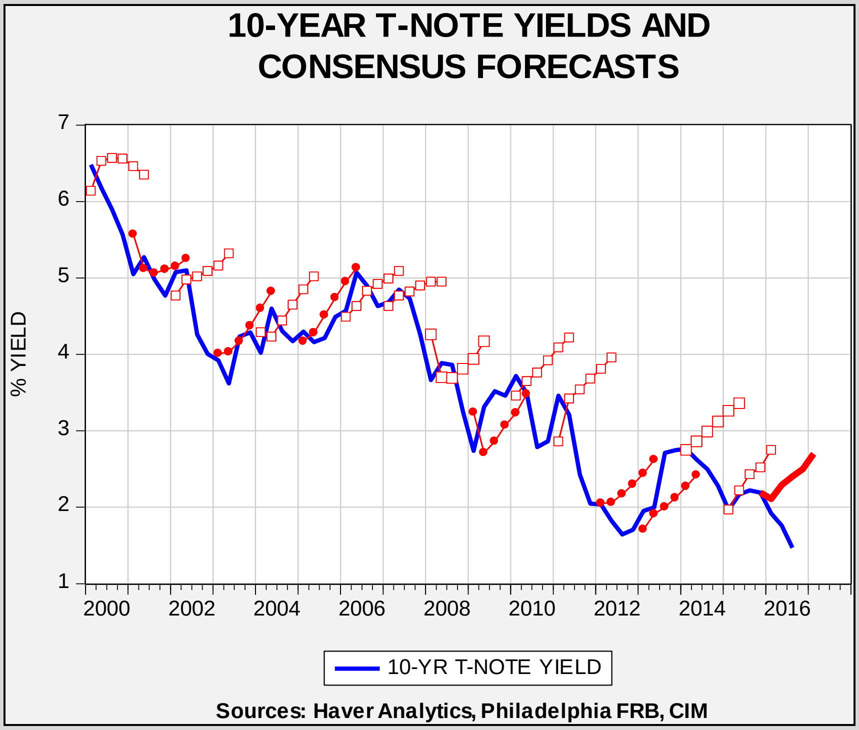
The 6-10 and 8-14 day forecasts call for warmer and drier than normal temperatures for the majority of the country. The tropics are quiet today.

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.

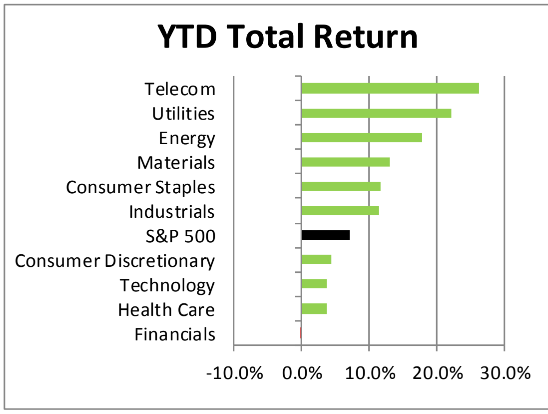
In general, the persistently incorrect forecasts are likely due to the consensus opinion that the economy, inflation and markets will normalize over some time frame. Instead, since the turn of the century, inflation has steadily declined and, in the aftermath of the financial crisis, economic growth 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.

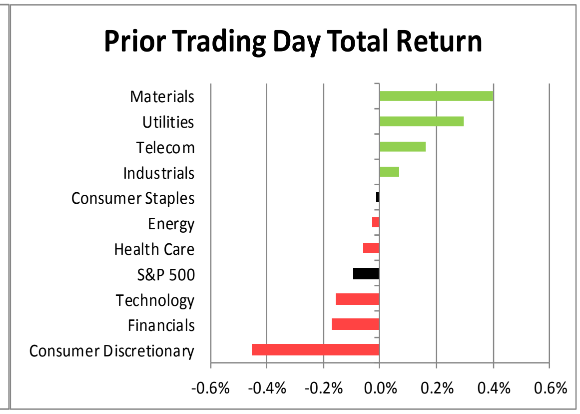
Although our position on fixed income has been correct, we are watchful for conditions that would reverse this long-term downtrend in yields. Inflation trends often have a political element. One of the key tradeoffs society makes is between equality and efficiency.[1] When society is leaning toward the 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.

[1] 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 7/15/2016 close)

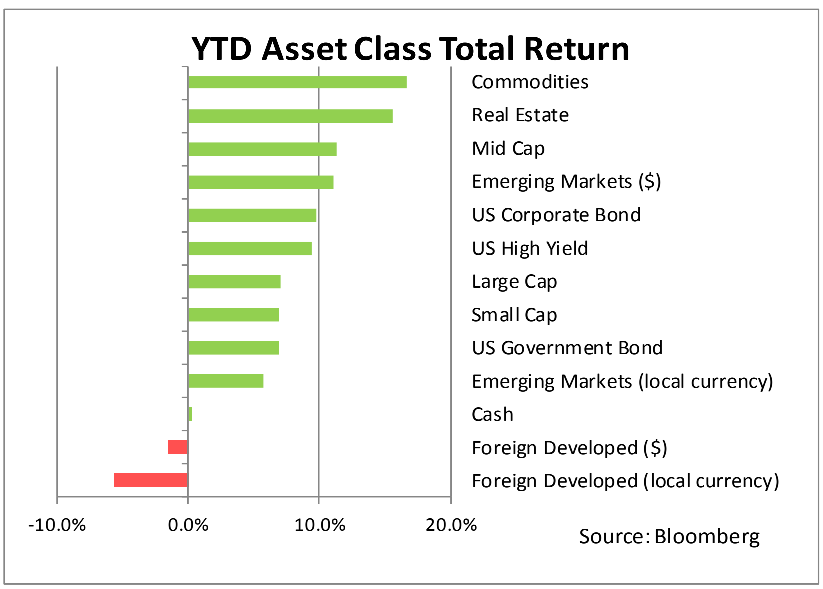




(Source: Bloomberg)

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 7/15/2016 close)

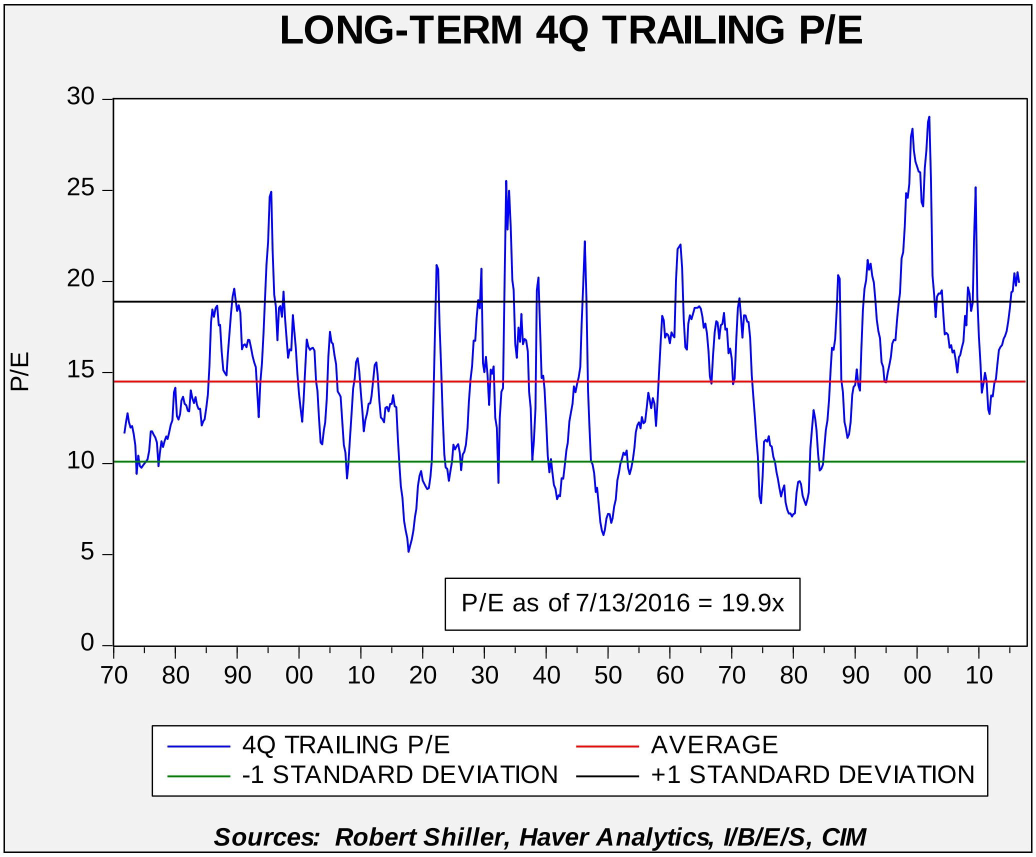


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[2] 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.

---

[2] 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.