By Bill O'Grady & Kaisa Stucke, CFA

[Posted: July 19, 2016—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is trading lower by 0.9% from the last close. In Asia, the MSCI Asia Apex 50 closed down by 0.4% from the prior close. Chinese markets were mixed, with the Shanghai composite trading down 0.2% and the Shenzhen index higher by 0.3%. U.S. equity futures are signaling a lower opening from the previous close. With 44 companies having reported, the S&P 500 Q2 earnings stand at $28.76, 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, 65.9% of the companies reported earnings above forecast, while 20.5% reported earnings below forecast.

Financial and commodity markets are very quiet this morning as the summer doldrums are starting to become evident. However, three news items did catch our attention and are worthy of comment:

GOP Platform calls for a return to Glass-Steagall: The Glass-Steagall Act separated commercial from investment banking, preventing the creation of universal banks that can perform both services.[1] Although political platforms have become rather inconsequential in recent years, this addition is something of a shocker. Breaking up the banks' commercial and investment banking operations would significantly change the landscape of the current industry. Acquisitions of broker-dealers would become more difficult without the large balance sheets of the commercial banks. Although most universal banks have struggled with the cross-selling concept, it remains a significant goal and potentially lucrative source of revenue. We suspect this is a ploy by the GOP to capture the Sanders voters, who tend to believe that Clinton supports the large banks in their current form. Simply put, if the GOP is on the side of attacking the large banks, it's hard to see where they will find support.

The Bundesbank drops a bombshell: The Bundesbank, usually the stanch supporter of creditor interests, recently proposed reforms to improve Europe's response to future fiscal crises. First, the German central bank wants to broaden the European Stability Mechanism's (ESM) mandate to a Eurozone fiscal authority, a role currently being met by the European Commission, the IMF and the ECB (otherwise known as the "troika"). Currently, the ESM acts as a Eurozone IMF, helping countries with fiscal problems with liquidity. The Bundesbank wants the ESM to become this fiscal monitoring body which would assess economic prospects, debt sustainability

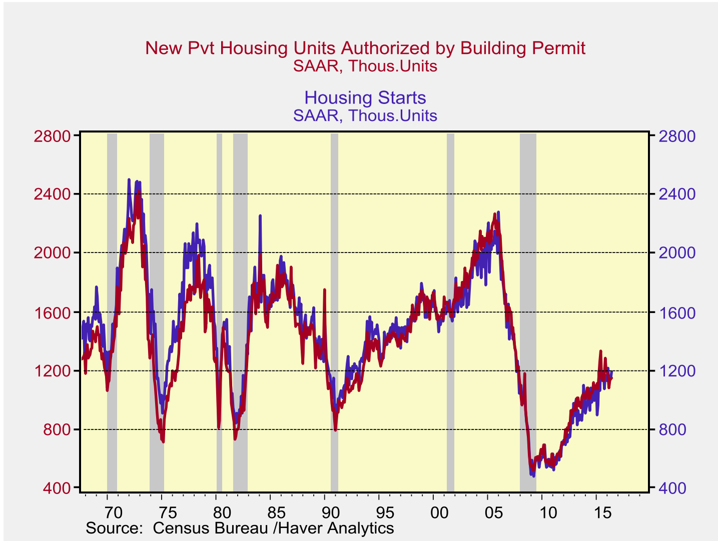
[1] The Glass-Steagall Act did not necessarily restrict interstate branch banking. These laws were covered by the 1927 McFadden Act and the 1956 Bank Holding Company Act. Restrictions on branch and interstate banking were completely repealed by the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. Interstate banking dramatically increases the ability of banks to grow, and limiting geographic scope would be the next step toward reducing bank power.

and the financial needs of nations with fiscal problems. The ESM would also oversee aid programs, replacing the troika. The second part is the surprise. The Bundesbank wants newly issued sovereigns to contain clauses that would automatically extend maturities once a nation accepts ESM assistance ***without triggering a credit event***. This proposal has serious ramifications if adopted. First, it renders credit default swaps (CDS) worthless, as extending maturities is a remedy for default. By allowing that to occur without a credit event, which is the trigger for a CDS, investors would have no protection from a credit event. Second, this action would be a forced "bail-in" by a nation's creditors. Third, the risk profile of Eurozone government debt would change dramatically; suddenly, a two-year note could become a 10-year one by a keystroke. Investors would, assuming rationality, start shunning sovereigns issued by weaker nations, driving up their yields. It is also quite possible that the ECB might avoid buying them in QE operations…or, it might not avoid them, which would support the bailout. The creditworthiness of the G-7, or perhaps most of the G-20, sovereign debt is generally not called into question; the Bundesbank's proposal may be the slippery slope to a form of built-in debt repudiation. The fact that this is even being considered shows how strange conditions have become.

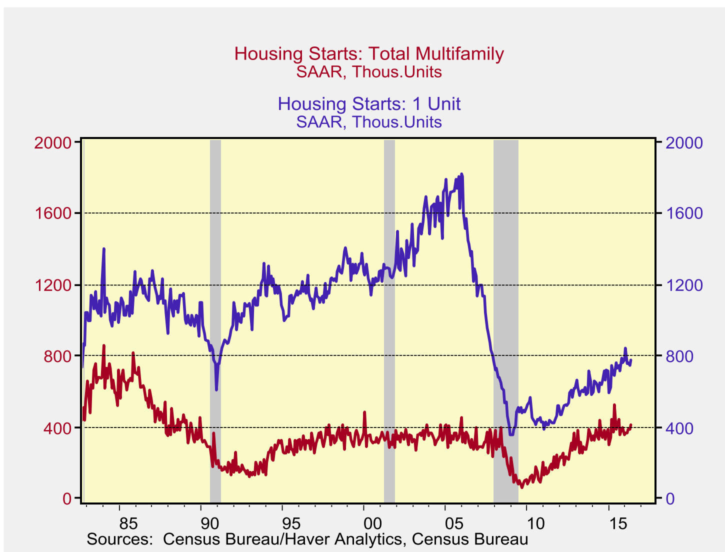
China's newest export: One of the concerns we have about China is its debt capacity, which is broadly defined as the ability of an entity to issue debt relative to the growth the new debt generates. There is ample evidence to suggest that the effectiveness of Chinese debt is waning; it appears that ever higher levels of new debt are necessary to bring smaller increments of growth. That situation is a concern. The other concern is that, with debt effectiveness waning, how will China be able to sell new debt without resorting to steadily higher interest rates? The answer appears to be by selling debt to overseas buyers. Bloomberg reports that debt from Special Purpose Vehicles, which are bonds used to fund municipal and provincial building projects, is finding its way into overseas portfolios. It is unclear what currency this paper is denominated in; we suspect CNY, although we can't always be sure. In a yield-starved world, this paper is yielding 4.9%; one can imagine the sales pitch, "muni paper from China…they won't default…stable currency, see the long-term chart…nice yield!" If China decides to tap the international markets, it can likely expand its debt even further, even if the economic effects are small. After all, if the economic impact is modestly positive and the default risk resides with foreigners, the political risks are small. *Caveat emptor!*

U.S. Economic Releases

Housing starts rose 4.8% in June, much better than the 0.2% increase forecast. Starts increased to 1,189k from 1,135k the month before. Permits were also modestly better than forecast in June, rising 1.5% compared to the 1.2% increase forecast. Permits stand at 1,153k, up from 1,136k the month before.



The chart above shows starts and permits levels. Both have rebounded strongly since the 2008 recession, but have moved somewhat sideways over the past year.



The chart above shows single-family and multi-family starts. Last month, both increased, with single-family starts up 4.4% and multi-family starts up 5.4%. However, single-family gains have far outpaced multi-family gains over the past year, with single-family starts up 13.4% and multi-family starts down 22.0% from the levels of a year ago. Multi-family starts have led the housing rebound since the recession, but this pattern has reversed since multi-family starts achieved their post-recession high in September 2015.

There are no other releases or Fed speakers scheduled for the rest of the day.

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
EUROPE								
Eurozone	ZEW survey of expectations	m/m	Jul	-14.7	20.2		**	Equity bearish, bond bullish
Germany	ZEW survey of expectations	m/m	Jul	-6.8	19.2	9.0	**	Equity bearish, bond bullish
	ZEW survey of current situation	m/m	Jul	49.8	54.5	51.8	**	Equity and bond neutral
U.K.	CPI	y/y	Jun	0.5%	0.3%	0.4%	***	Equity bullish, 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)	69	68	1	Up
3-mo T-bill yield (bps)	30	30	0	Neutral
TED spread (bps)	39	38	1	Up
U.S. Libor/OIS spread (bps)	40	40	0	Neutral
10-yr T-note (%)	1.55	1.58	-0.03	Narrowing
Euribor/OIS spread (bps)	-30	-29	-1	Down
EUR/USD 3-mo swap (bps)	48	49	-1	Down
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	$47.28	$46.96	0.68%	Nigeria outages continue, domestic inventories forecast to decline
WTI	$45.49	$45.24	0.55%	
Natural Gas	$2.77	$2.72	1.69%	Hot weather forecast
Crack Spread	$13.10	$12.89	1.60%	High gasoline inventories
12-mo strip crack	$12.09	$12.00	0.76%	
Ethanol rack	$1.72	$1.72	0.02%	
Metals				
Gold	$1,332.31	$1,328.85	0.26%	
Silver	$19.98	$20.05	-0.38%	
Copper contract	$225.10	$223.70	0.63%	
Grains				
Corn contract	$ 356.75	$ 363.25	-1.79%	Good crop conditions
Wheat contract	$ 424.00	$ 429.50	-1.28%	
Soybeans contract	$ 1,052.25	$ 1,066.25	-1.31%	Weather concerns ease for soybeans
Shipping				
Baltic Dry Freight	748	745	3	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.3		
Gasoline (mb)		-0.6		
Distillates (mb)		0.9		
Refinery run rates (%)		0.2%		
Natural gas (bcf)		43.0		

Weather

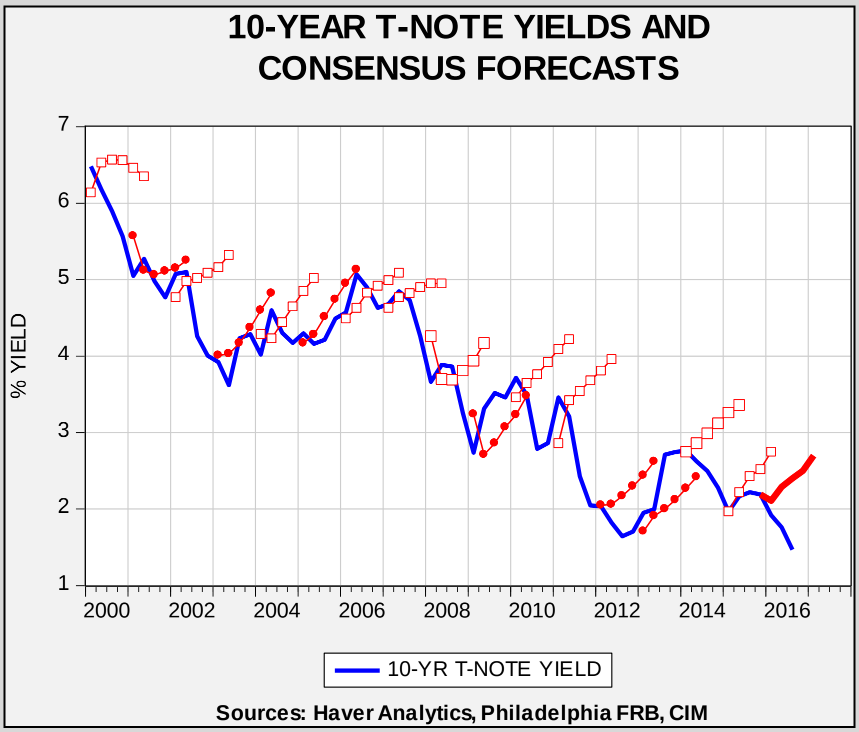
The 6-10 and 8-14 day forecasts call for warmer and drier than normal temperatures for the majority of the country, with some rain forecast for the East Coast. The tropics are quiet today.

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.

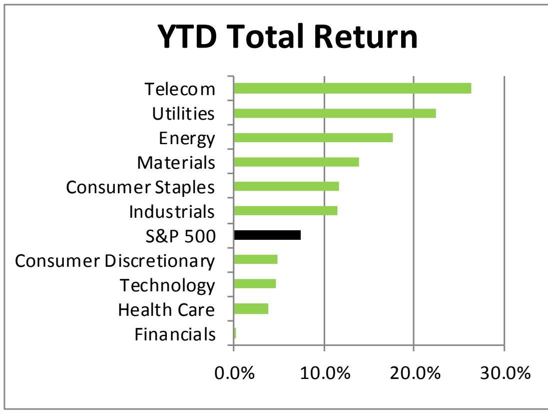
In general, the persistently incorrect forecasts are likely due to the consensus opinion that the economy, inflation and markets will normalize over some time frame. Instead, since the turn of the century, inflation has steadily declined and, in the aftermath of the financial crisis, economic growth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

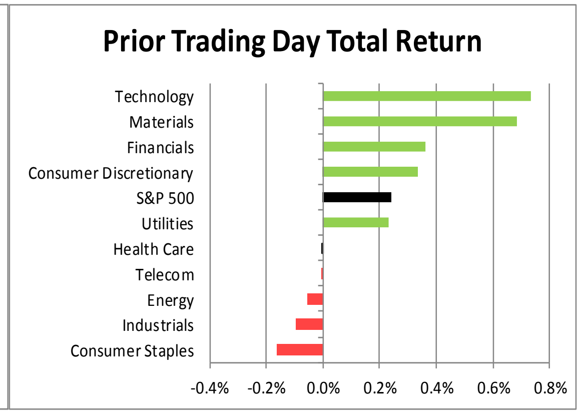
Although our position on fixed income has been correct, we are watchful for conditions that would reverse this long-term downtrend in yields. Inflation trends often have a political element. One of the key tradeoffs society makes is between equality and efficiency.[2] When society is leaning toward the 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 7/18/2016 close)

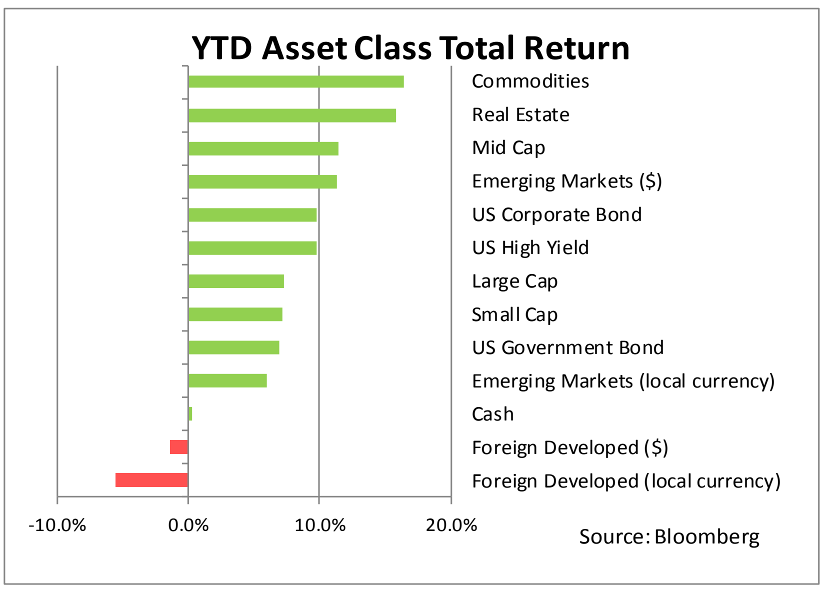




(Source: Bloomberg)

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 7/18/2016 close)

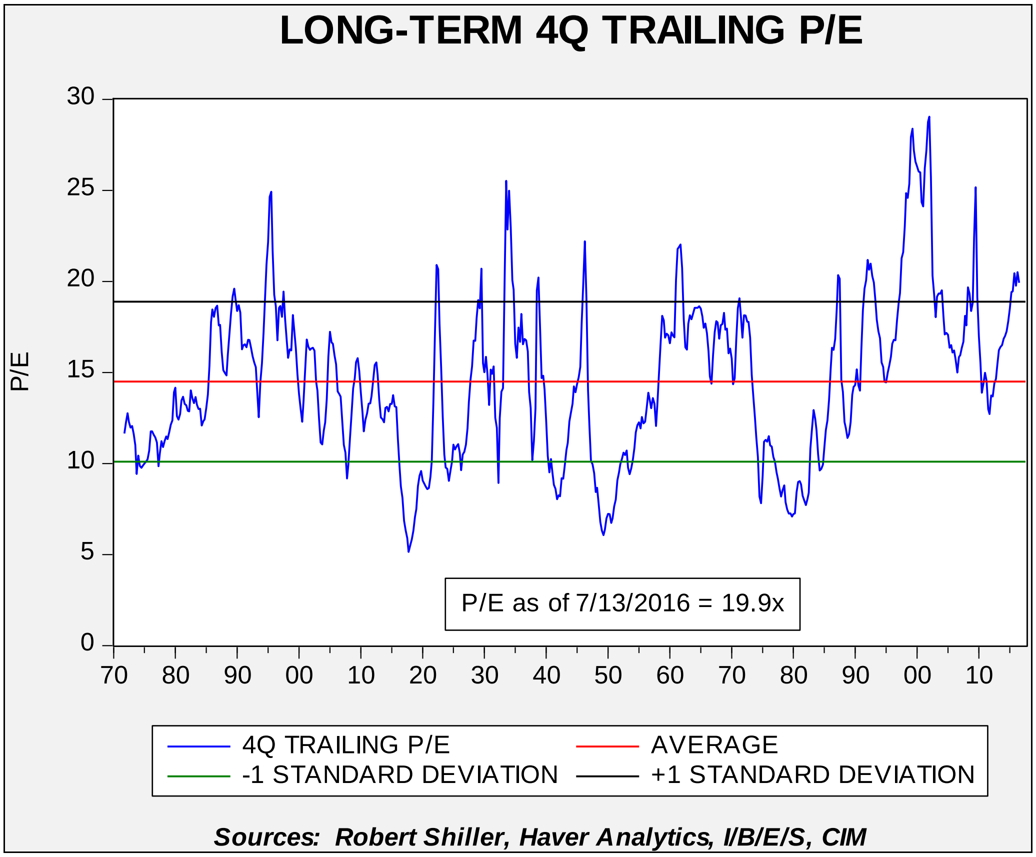


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.