Confluence Investment Management

Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: July 1, 2016—9:30 AM EDT] Global equity markets are modestly higher this morning. The EuroStoxx 50 is trading higher by 0.6% from the last close. In Asia, the MSCI Asia Apex 50 closed up by 0.7% from the prior close. Chinese markets were mixed, with the Shanghai composite trading up by 0.1% and the Shenzhen index down by 0.2%. U.S. equity futures are signaling a mostly steady opening from the previous close. Given that this is the beginning of a three-day weekend in the U.S., we expect a quiet trade today.

It's global PMI day! We have recorded the overseas numbers below. Overall, Europe came in strong, while Asia was mostly neutral to negative. Although the European numbers were positive, they may be dampened post-Brexit.

After BOE Governor Carney promised further monetary accommodation yesterday, financial markets rose strongly, showing that, even after eight years of easy global monetary policy, central bankers talking about policy support still has an impact. We note that the U.S. 10-year T-note is challenging 1.40% this morning. In fact, we are seeing the most curious of trading patterns—gold and Treasuries are rallying with equities. It's almost as if investors are engaging in a barbell approach, simultaneously acquiring equities and safety instruments. We maintain that the key indicator will remain in the forex markets. Currency depreciation will likely be the unspoken tool of choice to stimulate economic growth, which means, of course, that the best way to grow is by absorbing the aggregate demand of other nations. So far, the currency markets are mostly steady as all the central banks continue to maintain policy accommodation. We have achieved a balance of sorts, although the GBP's weakness could eventually trigger instability.

In Europe, we continue to monitor the situation in Britain; today, there is nothing significant to report but there was a surprising development in Austria. In May, the Green Party presidential candidate fended off a challenge from the far-right Freedom Party, winning by a narrow vote. For the first time since 1945, Austrian courts have ruled that there were enough voting irregularities to require another runoff election. Thus, in September or October, another round of elections will be held. According to reports, Norbert Hofer, the Freedom Party candidate, was winning by a small margin before postal ballots were counted. The postal votes swung the election but the Freedom Party charged that there were questionable practices in certifying these ballots. The courts agreed. Under normal circumstances, this news wouldn't be that important. However, in the currently charged atmosphere in Europe, the possibility of a far-right government in a significant European nation raises concerns. The fact that a re-vote is necessary in a modern economy raises serious questions. This vote may occur nearly simultaneous to the Italian government restructuring referendum, which may turn out to be a proxy vote on EU and Eurozone membership.

Finally, we are watching with great interest comments from Sen. Warren (D-MA), who seems to be turning her populist aim toward the tech giants. In a recent speech, she raised the question about industry concentration in the tech sector, arguing that the tech giants seem to be preventing small firms from threatening the large ones with creative destruction. This condition has been noted by others; a recent book[1] discussed how the technology industry's business model is based on monopoly and market domination. The so-called "unicorns" have little value to investors unless they can completely dominate their industries and thus have the potential to earn monopoly profits.

In some respects, it's remarkable to us that this hasn't attracted attention sooner. The technology giants have sometimes acted in manners that would make a trust operator of the late 19th century blush. However, unlike the monopolists of old, these tech dominators do not use their vast market power to raise prices, for the most part. Instead, they seem to use their market power to depress wages. The usual way that monopoly power catches the attention of regulators is by high and steadily rising prices; these new monopolies maintain profit margins by keeping labor power depressed.

The fact that Warren is turning her sights on this industry is something that we will be watching in the coming months. If this trend continues, it will suggest a significant new turn in populism, away from the relatively easy target of banks to a more complicated target of technology.

U.S. Economic Releases

There are no economic releases before the market opens this morning. The table below shows the rest of today's data releases and notable Fed speakers.

Economic releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Markit US Manufacturing PMI	m/m	Jun	51.2	51.4	***
10:00	Construction spending	m/m	May	0.6%	-1.8%	**
10:00	ISM manufacturing PMI	m/m	Jun	51.3	51.3	***
10:00	ISM manufacturing PMI (new orders)	m/m	Jun	55.9	55.7	**
all day	Vehicles sales	m/m	Jun	17.3 mm	17.4 mm	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
10:00	Mester	Cleveland 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

[1] Rushkoff, D. (2016). *Throwing Rocks at the Google Bus*. New York, NY: Random House.

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 index	m/m	Jun	51.8	51.0		**	Equity bullish, bond bearish
	Corelogic Home Prices	m/m	Jun	0.5%	1.6%		*	Equity bearish, bond bullish
	Commodity price index	y/y	Jun	-9.9%	-10.0%		***	Equity bearish, bond bullish
China	Manufacturing PMI (large enterprises)	m/m	Jun	50.0	50.1	50.0	***	Equity and bond neutral
	Caixin Man. PMI (small/mid enterprises)	m/m	Jun	48.6	49.2	49.2	***	Equity bearish, bond bullish
	Services PMI (large enterprises)	m/m	May	53.7	53.1		**	Equity bullish, bond bearish
Japan	Unemployment rate	m/m	May	3.2%	3.2%	3.2%	***	Equity and bond neutral
	Household spending	m/m	May	-1.1%	-0.4%	-1.1%	**	Equity and bond neutral
	CPI	y/y	May	-0.4%	-0.3%	-0.5%	***	Equity and bond neutral
	CPI Core	y/y	May	0.8%	0.9%	0.8%	***	Equity and bond neutral
	Tankan (large Man.)	m/m	Q2	6.0	6.0	4.0	***	Equity and bond neutral
	Tankan (large services)	m/m	Q2	19.0	22.0	19.0	***	Equity and bond neutral
	Nikkei Man. PMI	m/m	Jun	48.1	47.8		***	Equity and bond neutral
	Vehicle sales	y/y	Jun	3.0%	6.6%		**	Equity bearish, bond bullish
	Consumer Confidence	m/m	Jun	41.8	40.9	41.1	*	Equity and bond neutral
India	Nikkei India Man. PMI	m/m	Jun	51.7	50.7		***	Equity bullish, bond bearish
EUROPE								
Eurozone	Markit Man. PMI	m/m	Jun	52.8	52.6	52.6	***	Equity and bond neutral
	Unemployment rate	m/m	May	10.1%	10.2%	10.1%	**	Equity and bond neutral
Germany	Markit Man. PMI	m/m	Jun	54.5	54.4	54.4	***	Equity bullish, bond bearish
UK	Markit Man. PMI	m/m	Jun	52.1	50.1	50.1	***	Equity bullish, bond bearish
France	Markit Man. PMI	m/m	Jun	48.3	47.9	47.9	***	Equity bullish, bond bearish
Italy	Markit Man. PMI	m/m	Jun	53.5	52.4	52.4	***	Equity bullish, bond bearish
	Unemployment rate	m/m	May	11.5%	11.7%	11.7%	**	Equity bullish, bond bearish
Switzerland	PMI Man.	m/m	Jun	51.6	55.8	55.3	***	Equity bearish, bond bullish
	Real Retail Sales	y/y	May	-1.6%	-1.9%		**	Equity and bond neutral
Russia	Markit Man. PMI	m/m	Jun	51.5	49.6	50.0	***	Equity bullish, bond bearish
AMERICAS								
Mexico	IMEF Man. PMI	m/m	Jun	47.5	51.9	52.1	*	Equity bullish, bond bullish
	IMEF Services PMI	m/m	May	47.8	51.3	51.4	*	Equity bullish, bond bearish
Brazil	Industrial Production	y/y	May	-7.8%	-7.2%	-7.8%	***	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)	65	63	2	Down
3-mo T-bill yield (bps)	25	26	-1	Down
TED spread (bps)	40	37	3	Up
U.S. Libor/OIS spread (bps)	37	37	0	Down
10-yr T-note (%)	1.43	1.47	-0.04	Down
Euribor/OIS spread (bps)	-29	-28	-1	Neutral
EUR/USD 3-mo swap (bps)	38	40	-2	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	up			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	49.58	49.71	-0.13	
WTI	48.20	48.33	-0.13	
Natural Gas	2.90	2.92	-0.02	
Crack Spread	13.96	14.55	-0.59	
12-mo strip crack	12.54	12.67	-0.13	
Ethanol rack	1.79	1.78	0.00	
Metals				
Gold	$1,334.24	$1,321.90	12.34	Flight to safety
Silver	$19.20	$18.71	0.48	
Copper contract	$218.15	$219.55	-1.40	
Grains				
Corn contract	$ 364.00	$ 365.50	-0.41%	Bearish acres planted report
Wheat contract	$ 439.75	$ 445.50	-1.29%	
Soybeans contract	$ 1,144.25	$ 1,153.25	-0.78%	
Shipping				
Baltic Dry Freight	660	640	20	

	Actual	Expected	Difference
Crude (mb)	-4.0	-2.5	-1.5
Gasoline (mb)	1.4	-0.3	1.7
Distillates (mb)	-1.8	0.6	-2.4
Refinery run rates (%)	1.7%	0.5%	1.2%
Natural gas (bcf)	37.0	46.0	-9.0

Weather

The 6-10 and 8-14 day forecasts clearly indicate that summer is coming back with a vengeance. Only the Pacific Northwest is expected to be cooler than normal. Heavier than normal rain is projected for the Great Lakes region. 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 1, 2016

The Brexit situation is dominating the financial news, and rightly so—such events are unusual and their outcomes are usually uncertain. As part of our asset allocation process, we examine these types of issues and adjust our portfolios to account for them.

Although our process is cyclical, meaning we pay particular attention to the business cycle and its effect on markets and asset classes, there are factors that affect markets that go well beyond the business cycle. Examples of such factors are demographics, inflation and growth policies, political coalitions, superpower dynamics, etc. These influences have been background factors for the past several business cycles; when these background factors change, it can cause unexpected outcomes to financial markets that appear to be reactions beyond normal. For example, the 2008 Financial Crisis was much worse than generally expected because the expansion of household debt, which had underpinned economic growth for nearly three decades and allowed the implementation of low inflation policies to coexist with acceptable economic growth, suddenly reached a point of unsustainability. This was one of the primary reasons why what started out as a normal recession evolved into a massive contraction. Household deleveraging continues to weigh on economic growth and, until the issue is addressed, will likely remain a damper on growth.

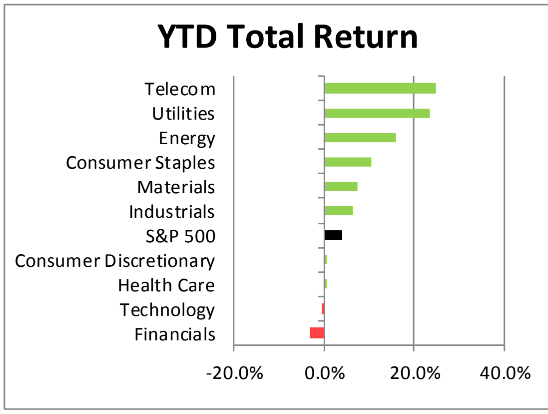
Brexit is part of another longer term political trend we have been discussing for several years. We have been concerned that the U.S. is steadily relinquishing its superpower role. The superpower provides key global public goods, mainly global security and the reserve currency. The former requires a large military and heavy defense spending, while the latter means the nation is the global importer of last resort and must continually provide its currency to the world through trade deficits. No superpower reigns indefinitely but history has shown that periods between superpowers tend to be difficult. The lack of global leadership brings a surge of nationalism, leading to wars and economic dislocation.

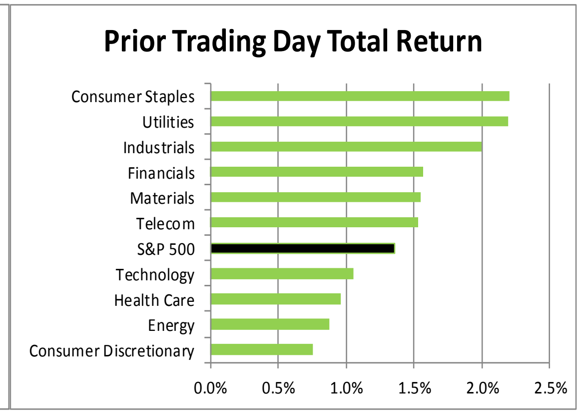
The Brexit vote was an emotional appeal to British nationalism. It could very well bring a resurgence of Scottish nationalism and may lead to the end of the United Kingdom. Similar movements in other parts of Europe are based on nationalism as well. In part, the campaigns of Donald Trump and Bernie Sanders are a rejection of the establishment project of globalization and deregulation. After all, Trump's campaign slogans of "Make America Great Again" and "America First" are appeals to nationalism.

What does this mean for asset allocation? The twin policies of globalization and deregulation have been key background factors that have supported financial markets. After the Berlin Wall fell, this policy pair was dubbed "the Washington Consensus," which became the blueprint for how the world economy should work. That policy consensus appears to be breaking down mostly because it requires a global hegemon to enforce the consensus. The ill-advised Middle East wars and the unsustainable weaknesses of the Washington Consensus (which required excessive debt to compensate for the lack of income growth) have now called into question the entire policy project. If the Washington Consensus fails and nations retreat into nationalism, inflation and global unrest will almost certainly follow. Rising inflation would favor stocks and cash over bonds. In addition, virtually everything we know about foreign investing has occurred with the U.S. playing the hegemon role. If the U.S. no longer fully provides the public goods that come with being the superpower, foreign investing faces a new and difficult future with greater uncertainty. Much of our asset allocation process is determining the interplay of shorter term and longer term factors. The Brexit situation is another factor in that process.

Data Section

U.S. Equity Markets – (as of 6/30/2016 close)

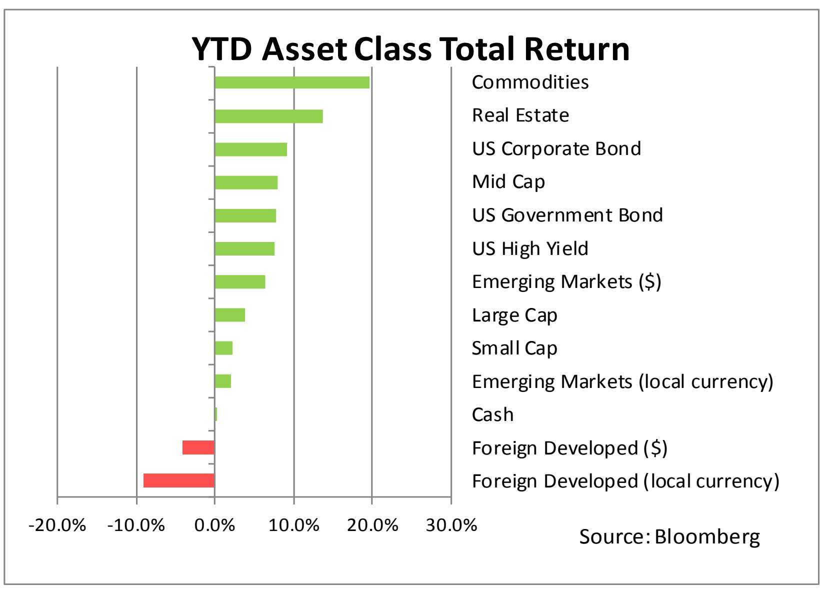




(Source: Bloomberg)

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 6/30/2016 close)

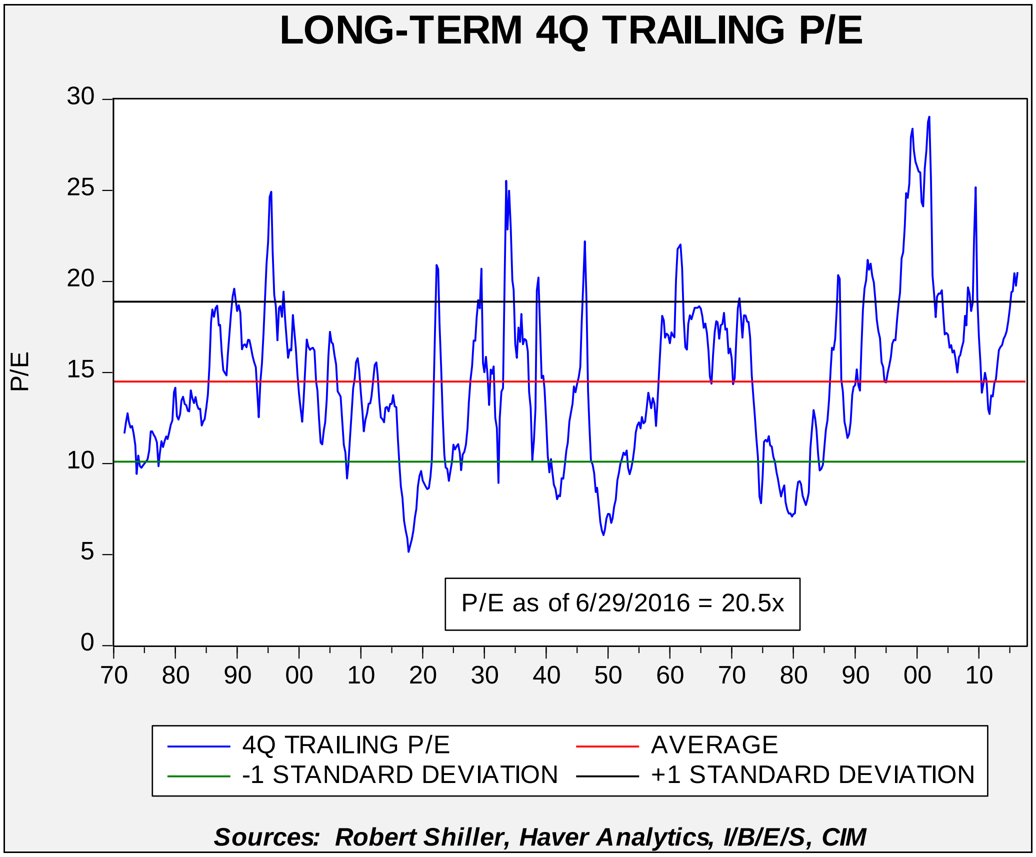


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

June 30, 2016



Based on our methodology,[2] the current P/E is 20.5x, steady from last week

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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[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 three actual (Q3, Q4 and Q1) and one estimate (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.