Daily Comment

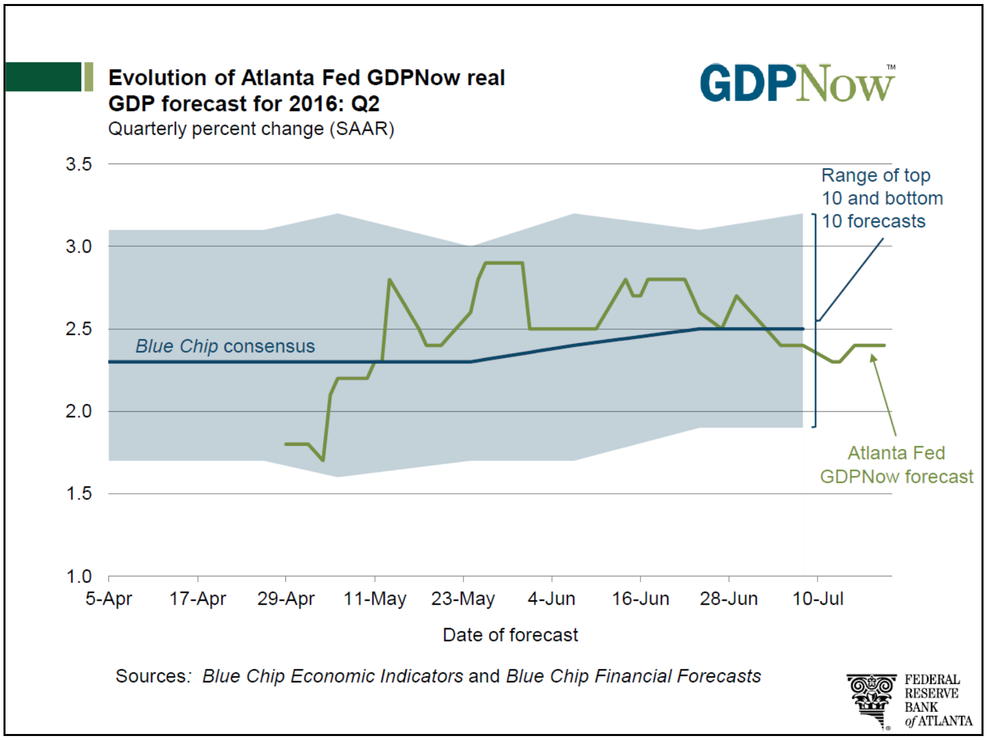
By Bill O'Grady & Kaisa Stucke, CFA

[Posted: July 26, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading sideways from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.6% from the prior close. Chinese markets were also higher, with the Shanghai composite up 1.1% and the Shenzhen index trading higher by 1.3%. U.S. equity futures are signaling a modestly lower opening from the previous close. With 134 companies having reported, the S&P 500 Q2 earnings stand at $29.06, higher than the $28.38 forecast for the quarter. The forecast reflects a 5.4% decline from Q2 2015 earnings. Thus far this quarter, 70.9% of the companies reported earnings above forecast, while 15.7% reported earnings below forecast.

The FOMC meeting begins today and concludes tomorrow. As we noted yesterday, we expect the Fed to try to inject expectations of potential tightening. We also expect the FOMC to fail on this goal. The financial markets are quite sure the Fed won't move until next year. We note that the *NYT* has a feature article on Governor Brainard, one of the most dovish members of the FOMC. The article discusses her Democratic Party leanings (she has donated $2,700 to the Clinton campaign, the largest donation an individual can make) and her focus on global economic conditions in setting U.S. monetary policy. The Fed's mandate from Congress is to focus on the U.S. economy. However, given the U.S. superpower role, the singular focus on the domestic economy is probably inappropriate. For better or worse, the U.S. is the world's central bank. Given global conditions, the Fed should remain on the sidelines.

We are seeing the JPY much stronger this morning after the Japanese media reported that PM Abe is likely to propose a ¥6 trillion fiscal package, well below the ¥20 trillion suggested earlier this week. However, it should be noted that the higher numbers were somewhat overstated in that many were simply loan guarantees. Since Japan has negative sovereign rates, loan guarantees are rather silly. The proposal being discussed today appears to be real spending over a two-year time frame. Although this spending is not small, the reaction from financial markets is a clear signal that more is required to "move the needle."

On Friday, the first look at Q2 GDP will be released. We do note that there will be benchmark revisions to the data which could affect how the numbers come in relative to expectations. The latest data from the Atlanta FRB showed the following:



This GDP tracker puts growth at +2.4%.

Atlanta Fed GDPNow forecasts for 2016: Q2, contributions to growth

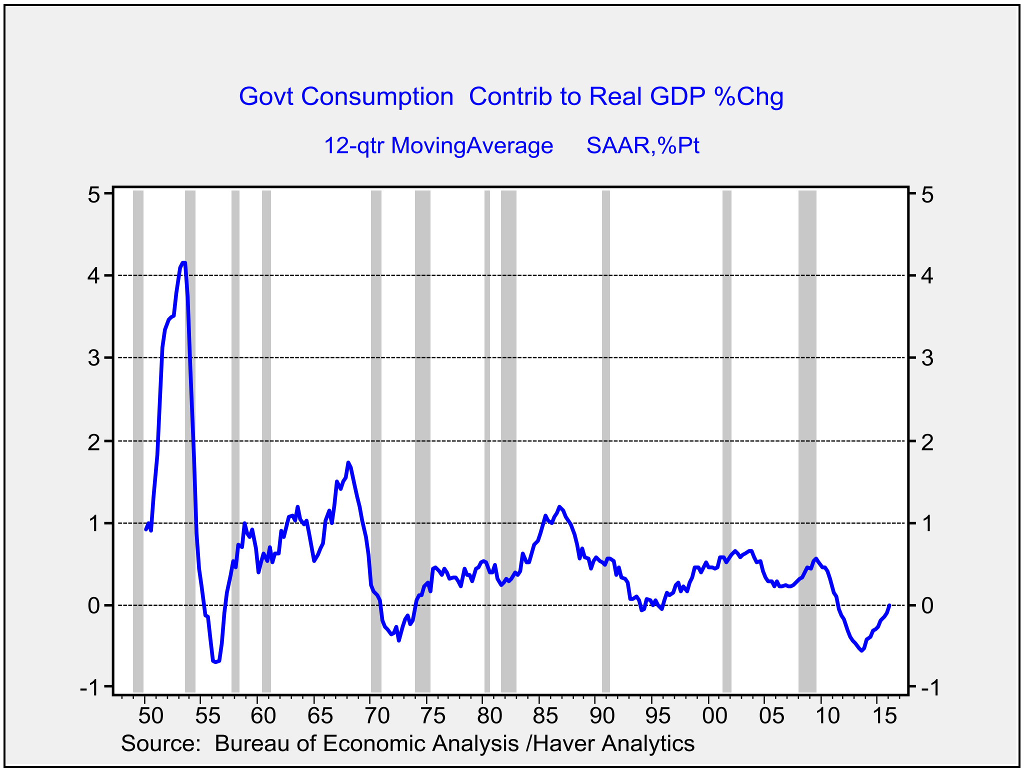
Date	Major Releases	GDP	PCE	Equip-ment	Intell. prop. prod.	Nonres. struct.	Resid. inves.	Govt.	Net exports	CIPI
29-Apr	Initial nowcast	1.8	1.90	0.03	0.11	-0.17	0.08	0.17	-0.01	-0.27
31-May	GDP (May 27), Personal Income/PCE	2.9	2.49	0.03	0.09	-0.07	0.28	0.21	0.30	-0.39
22-Jun	Existing home sales	2.8	2.77	0.01	0.10	-0.20	0.13	0.02	0.32	-0.41
23-Jun	New home sales/construct. costs	2.7	2.77	0.01	0.10	-0.20	0.06	0.01	0.32	-0.41
24-Jun	Advance durable manufacturing	2.6	2.77	0.04	0.10	-0.20	0.06	0.01	0.32	-0.53
27-Jun	Advance intl. trade (goods)	2.5	2.77	0.04	0.10	-0.20	0.06	0.01	0.25	-0.53
29-Jun	GDP (Jun 28), Personal Income/PCE	2.7	2.95	-0.07	0.15	-0.20	0.06	0.01	0.26	-0.52
1-Jul	Constr. spending, ISM Manufacturing	2.6	3.03	-0.03	0.15	-0.11	-0.14	-0.07	0.24	-0.51
5-Jul	Auto sales, M3 Manufacturing	2.4	2.93	-0.13	0.15	-0.11	-0.14	-0.07	0.25	-0.47
6-Jul	Foreign trade, ISM Nonmanufacturing	2.4	2.94	-0.07	0.15	-0.11	-0.13	-0.07	0.15	-0.47
8-Jul	Employment situation	2.4	2.94	-0.08	0.16	-0.11	-0.14	-0.05	0.15	-0.50
12-Jul	Wholesale trade	2.3	2.94	-0.08	0.16	-0.11	-0.14	-0.05	0.15	-0.55
13-Jul	Imp./Exp. prices, Treasury statement	2.3	2.94	-0.08	0.16	-0.11	-0.14	-0.09	0.17	-0.55
15-Jul	Retail trade, Industrial production	2.4	3.04	-0.07	0.16	-0.10	-0.12	-0.09	0.17	-0.57
19-Jul	Housing starts	2.4	3.04	-0.07	0.16	-0.10	-0.12	-0.09	0.17	-0.57
Maximum forecast of real GDP growth										
31-May	GDP (May 27), Personal Income/PCE	2.9	2.49	0.03	0.09	-0.07	0.28	0.21	0.30	-0.39
Minimum forecast of real GDP growth										
29-Apr	Initial nowcast	1.8	1.90	0.03	0.11	-0.17	0.08	0.17	-0.01	-0.27

Note: CIPI is "change in private inventories." All numbers are percentage point contributions to GDP growth (SAAR). Table does not include all forecasts for the quarter; see tab "ContribHistory" in online excel file for entire history.

FEDERAL RESERVE BANK of ATLANTA

The above table shows contributions to the overall growth number. The data suggest that household consumption is the source of nearly all growth in the economy, adding just over 3%. The biggest drag on growth is inventory reduction, which is peeling nearly 60 bps off of growth

(CIPI on the above table). That is something of a "bad news/good news" situation as inventory rebuilding will tend to support growth in future quarters. Net exports added modestly, although if one observes the trends in the data, the contribution from net exports fell as consumption improved over the quarter. This is consistent with theory; as consumption rises, some growth is lost to foreigners. It is also disconcerting that the government sector remains a drag on the economy, a persistent problem in this recovery and expansion.



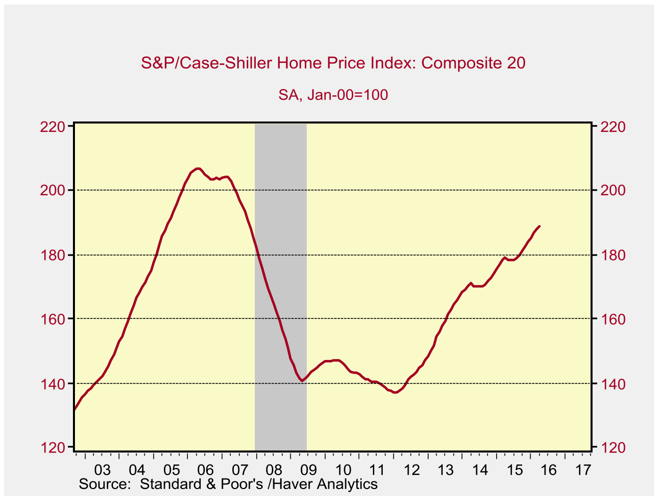
This chart shows the three-year average of the contribution to GDP growth coming from government. Since 1950, the trend contribution from government tends to run between 50 to 100 bps. There were three periods prior to the current one when the government contribution was negative. All three of these periods occurred during post-war demobilizations. The current weakness, occurring during wars in Iraq and Afghanistan, suggests that other spending on infrastructure, education, etc. has been severely constrained. It is important to note that only spending on goods and services by the government affects GDP directly in the GDP data. Transfer payments, such as Social Security, Medicare, etc., are not counted as government consumption. That spending shows up in consumption as households spend these transfers.

Both candidates for president are promising higher fiscal spending. Although we have serious concerns about the potential return on investment (nicer airports and more roads probably won't boost productivity), at least the spending will lift GDP growth. Overall, we would expect the proposed fiscal policy boosts to lift growth by 50 to 100 bps most quarters.

So, overall, we are looking for a recovery in the data on Friday. The revisions do add an element of uncertainty to the data. However, we feel safe in saying that the data will be an improvement over Q1.

U.S. Economic Releases

The Case-Shiller 20-city price index declined 0.1% during the month of May, weaker than the 0.1% increase forecast. Annually, home prices rose 5.2%, also weaker than the 5.5% increase expected.



The chart above shows the annual change in the 20-city composite. Although May data was discouraging, the overall trend in housing prices is improving. This report follows the release of June existing home sales, which improved in June. Thus, we could also see an improvement in the Case-Shiller home prices in June, which will be released in a month.

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

Economic releases						
EST	Indicator			Expected	Prior	Rating
9:45	Services PMI	m/m	Jul	52.0	51.4	*
9:45	Composite PMI	m/m	Jul		51.2	*
10:00	Consumer confidence	m/m	Jul	95.5	98.0	**
10:00	Richmond Fed manufacturing	m/m	Jul	-5.0	-7.0	**
10:00	New home sales	m/m	Jun	1.6%	-6.0%	**
Fed speakers or events						
EST	Speaker or event	District or position				
	Fed meeting					

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								
Japan	PPI services	y/y	May	0.2%	0.2%	0.1%	*	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)	72	71	1	Up
3-mo T-bill yield (bps)	30	28	2	Up
TED spread (bps)	42	43	-1	Down
U.S. Libor/OIS spread (bps)	42	41	1	Up
10-yr T-note (%)	1.56	1.57	-0.01	Narrowing
Euribor/OIS spread (bps)	-30	-30	0	Neutral
EUR/USD 3-mo swap (bps)	54	50	4	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	down			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	$44.40	$44.72	-0.72%	High stockpiles
WTI	$42.63	$43.13	-1.16%	
Natural Gas	$2.71	$2.75	-1.35%	
Crack Spread	$13.09	$13.11	-0.19%	High gasoline inventories
12-mo strip crack	$11.92	$11.97	-0.39%	
Ethanol rack	$1.63	$1.63	-0.14%	
Metals				
Gold	$1,320.60	$1,315.60	0.38%	Awaiting Fed meeting, BOE official hints at stimulus
Silver	$19.67	$19.56	0.55%	
Copper contract	$221.20	$221.70	-0.23%	Global supply increases
Grains				
Corn contract	$ 339.00	$ 341.25	-0.66%	
Wheat contract	$ 422.25	$ 429.00	-1.57%	Profit taking
Soybeans contract	$ 968.25	$ 966.25	0.21%	
Shipping				
Baltic Dry Freight	709	718	-9	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.4		
Gasoline (mb)		0.0		
Distillates (mb)		0.7		
Refinery run rates (%)		-0.2%		
Natural gas (bcf)		29.0		

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 East, Great Lakes and Southwest regions. The tropics are quiet today.

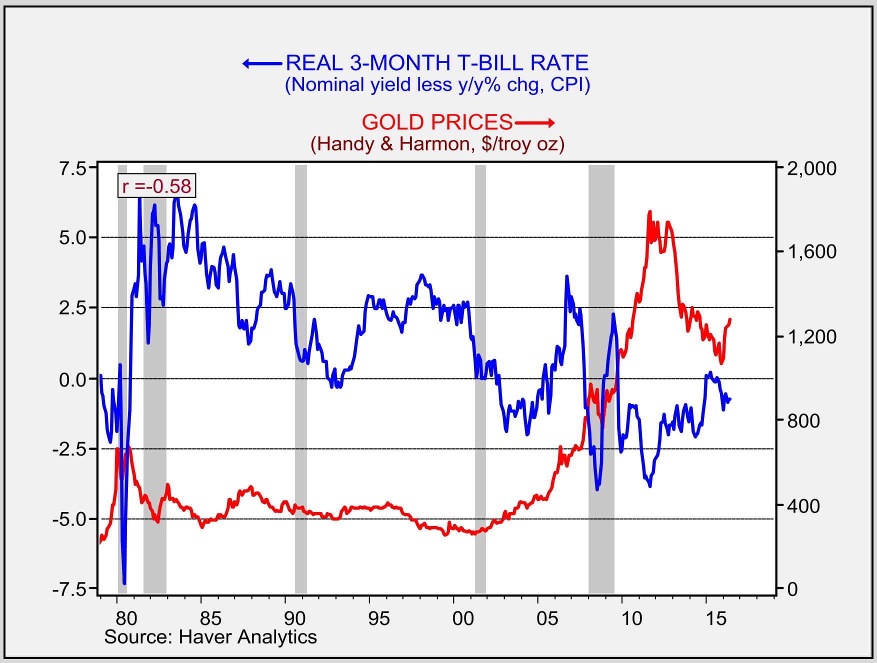
Weekly Asset Allocation Commentary

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 22, 2016

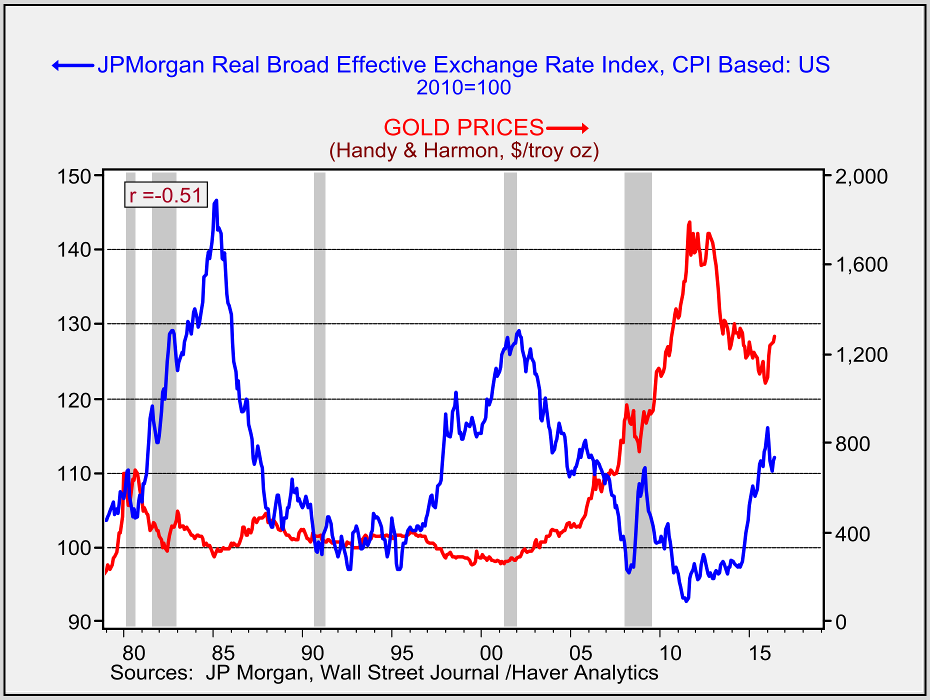
In the most recent rebalance of our Asset Allocation portfolios, we introduced positions in gold. Although the yellow metal is classified as a commodity, we view it more as a currency, admittedly one that is not backed by liabilities. National fiat currencies are generally created in the credit process and are backed by the trust imbedded in the nation's debt. Currencies have three roles: medium of exchange, unit of account and store of value. Gold does not act as a medium of exchange in a modern economy. But, it can be used as a unit of account and it mostly excels as a store of value.

Because it isn't liability backed, the opportunity cost of holding gold is essentially equivalent to inflation-adjusted interest rates. If one holds gold in lieu of short-term debt, the lost opportunity is the interest earned after inflation. History does suggest that there is an inverse correlation between real interest rates and gold.



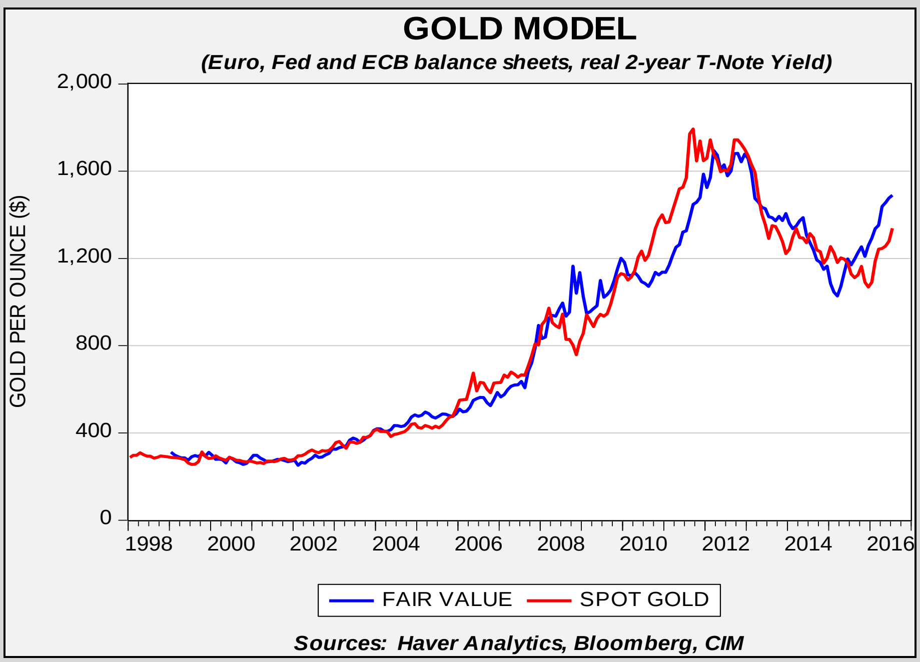
This chart shows real T-bill rates and the price of gold. Note that gold prices have increased as real rates have become persistently negative.

The other factor that affects gold is the dollar. Since gold is priced in dollars, a rising greenback makes gold prices more expensive to foreign buyers. Since a stronger dollar is often associated with rising U.S. interest rates, a stronger dollar tends to be bearish for gold.



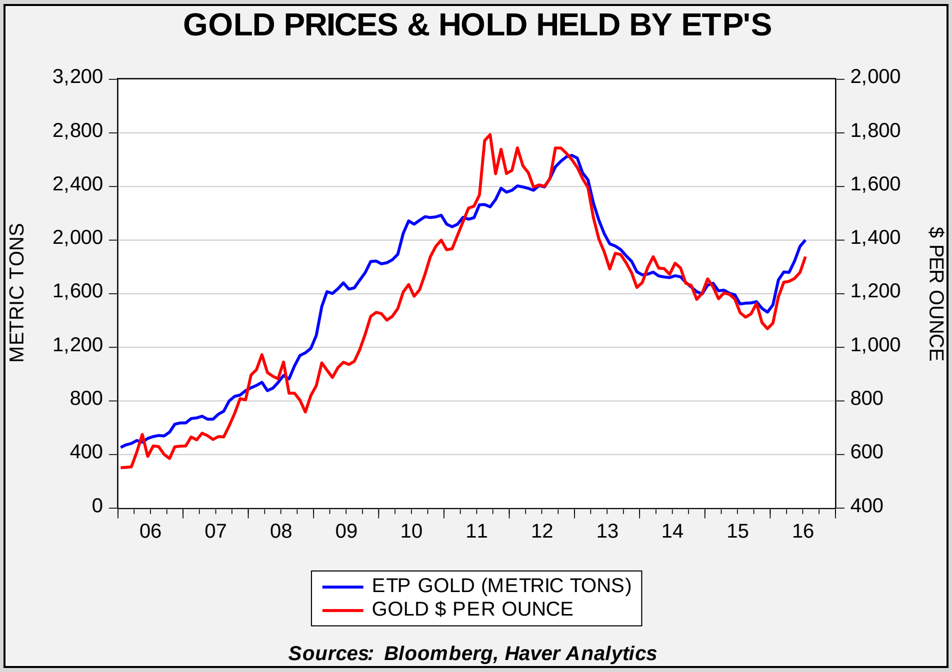
This chart shows gold prices and the JPM real effective dollar index. Note that since 2000, the dollar's swings have affected gold prices. In fact, since 2000, the correlation is -87%.

Since inflation, interest rates and exchange rates affect gold prices, we have created a model of the relationship.



The model uses the EUR/USD exchange rate, inflation adjusted two-year T-note yields and the balance sheets of the European Central Bank (ECB) and the Federal Reserve. Including the latter two variables generally accounts for investor expectations of future inflation and interest rates. The current fair value for gold, based on this model, is $1,489.26, suggesting that current prices, though elevated, are not overvalued.

Finally, investors have been putting money into gold through exchange-traded products.

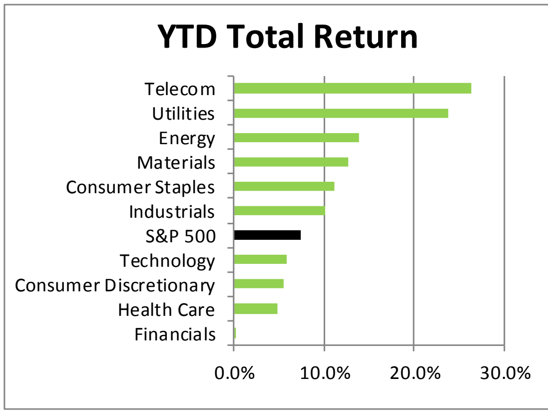


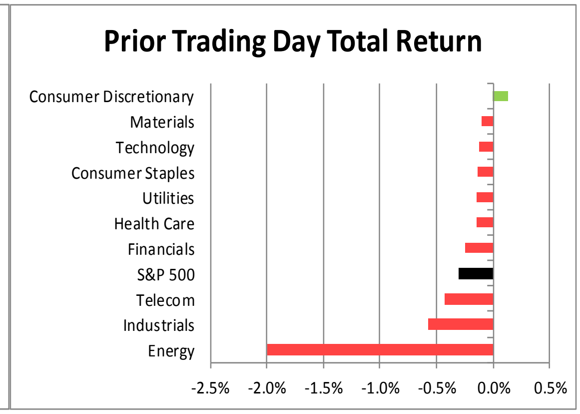
This chart looks at the metric tons of gold held by ETFs, ETNs and grantor trusts compared to the price of gold. As one would expect, the two are closely linked, correlating at nearly 95%. Since the beginning of the year, investors have been increasing their exposure to gold through these products. With the FOMC on hold and additional policy stimulus expected due to Brexit, investors are seeking the safety of gold.

Due to our view that gold is attractively valued and that conditions should favor the yellow metal, as noted above, we added gold to our allocations this quarter. We expect that conditions should favor gold in the upcoming quarters.

Data Section

U.S. Equity Markets – (as of 7/25/2016 close)

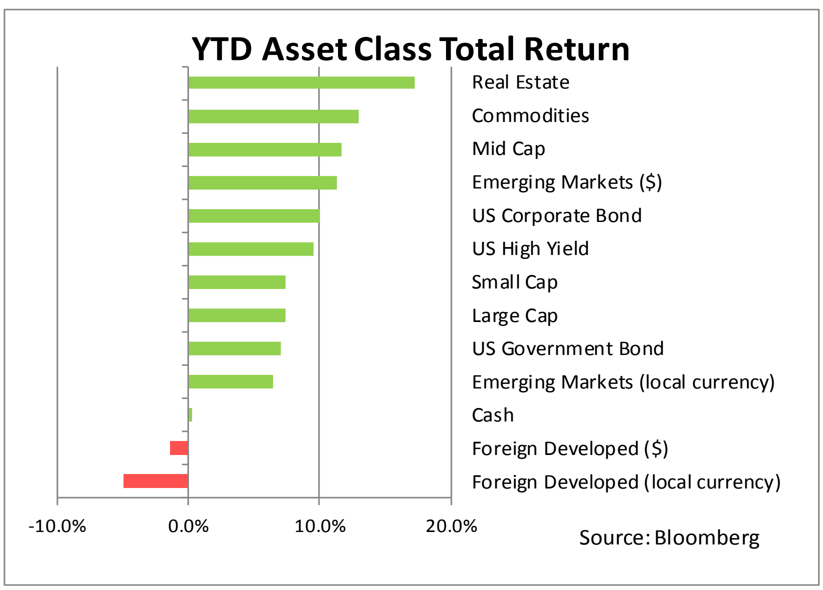




(Source: Bloomberg)

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 7/25/2016 close)



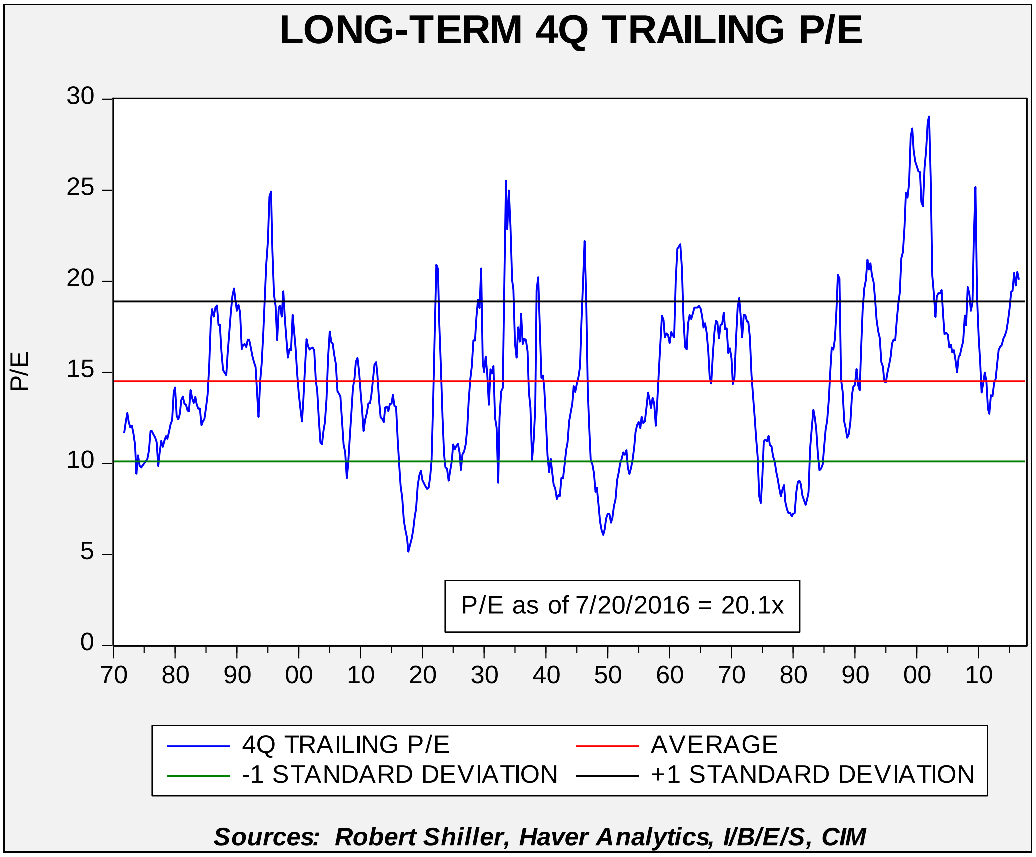
Source: Bloomberg

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 21, 2016



Based on our methodology,[1] the current P/E is 20.1x, up 0.3x. 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.

---

[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.