Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: July 6, 2016—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is trading lower by 1.8% from the last close. In Asia, the MSCI Asia Apex 50 closed down by 1.6% from the prior close. Chinese markets were actually higher, with the Shanghai composite trading up by 0.4% and the Shenzhen index higher by 0.4%. U.S. equity futures are signaling a lower opening from the previous close.

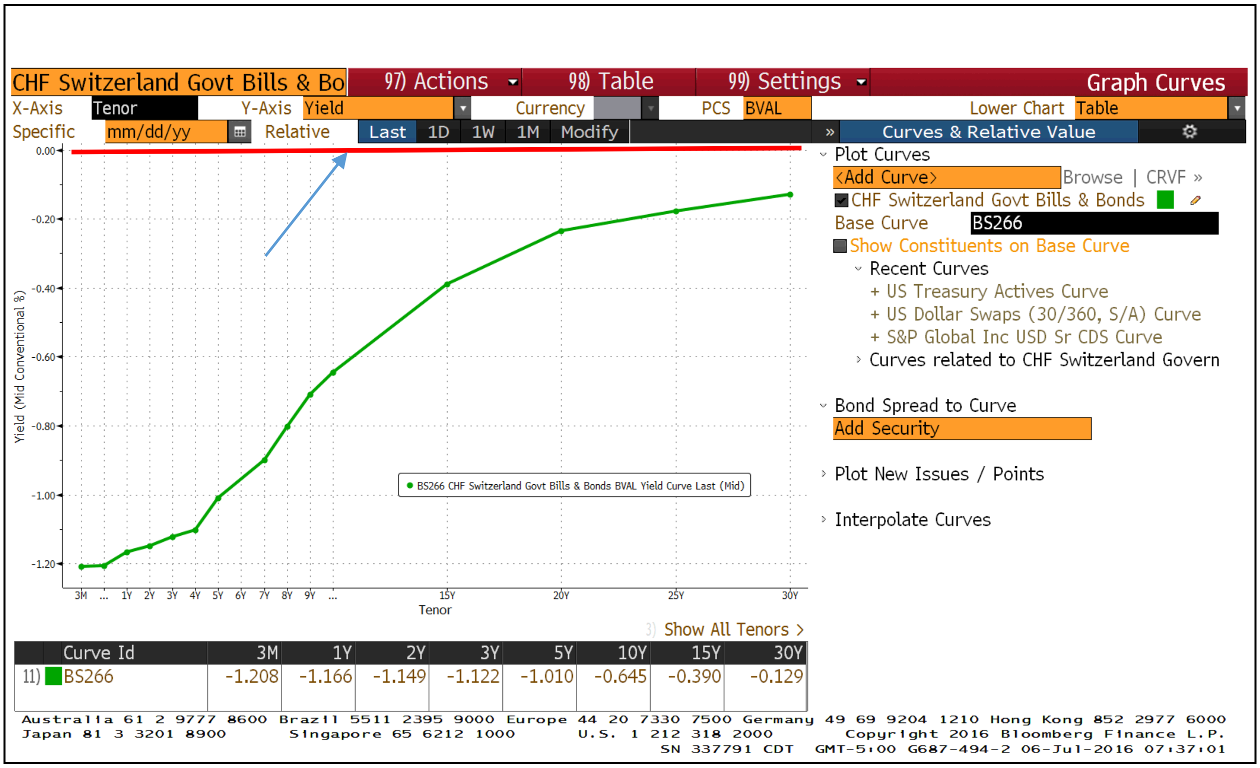
It's more of the same this morning. The GBP has declined under $1.30, worries are present about Italian banks becoming a systemic risk and we continue to see the relentless decline in sovereign yields. China is continuing its "stealth" depreciation. Here are a few charts of note:

First, Italian bank shares continue to tumble.

(Source: Bloomberg)

This chart shows an index of Italian banks. Shares are testing the lows seen during the 2012 Eurozone crisis. The key conflict is that Italian banks are sitting on €360 bn of non-performing loans (NPLs). Under normal circumstances, in a nation that prints its own currency, the banking crisis could be averted by the government borrowing money to either create a functioning "bad bank" to buy the NPLs or directly recapitalize the banking system. If the lira still existed, the exchange value would be tumbling but the banking system would be safe. However, the Bank of Italy can't produce euros. This doesn't necessarily mean that the Italian government can't issue euro debt to address its banks, but it will run afoul of EU rules regarding government debt issuance if it does. It would not be a huge surprise to see yields on Italian sovereigns rise, although that hasn't been the case recently. Since Brexit, Italian 10-year yields have fallen from 1.50% to near 1.20%. The odds of a conflict between the EU (read: Germany) and Italy over a bank bailout are rising and that risk is clearly weighing on Eurozone sentiment and Italian banks.

Here's a chart for historical reference:



(Source: Bloomberg)

This chart shows the Swiss sovereign yield curve. We have placed a solid red line at zero (noted with an arrow). The entire Swiss yield curve is now below zero. There isn't much more to say on this issue, other than this must reflect deflation threats and weak global growth.

The GBP remains under pressure.

(Source: Bloomberg)

This shows the pound has dipped under $1.30 (although chartists will note that this candlestick chart's entry for today may be signaling a "hammer," which occurs with a short body at the upper end of the bar with a long "stalk," mimicking a hammer, supposedly to hammer out a bottom).

Perhaps of greater interest is the continued softening of the CNY.

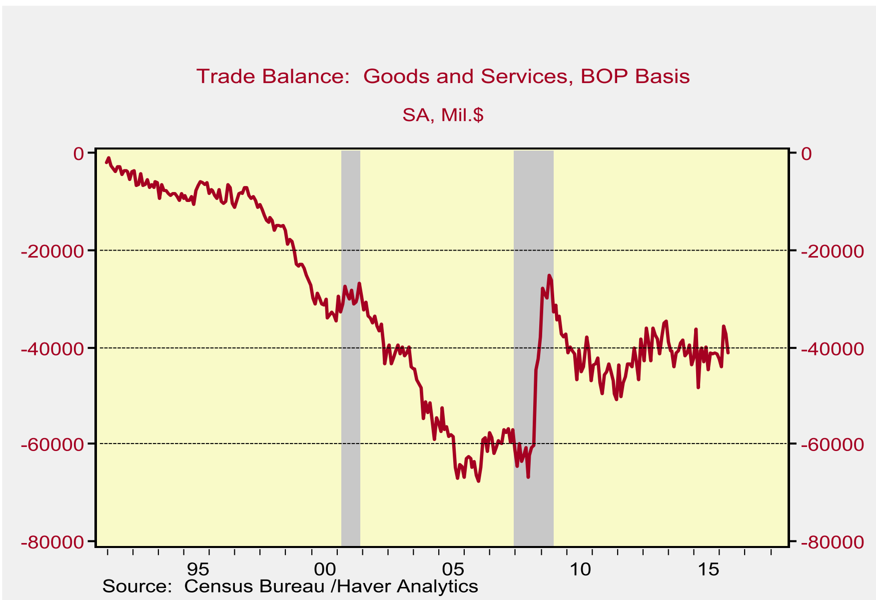
(Source: Bloomberg)

It is becoming increasingly clear that the PBOC is using global turmoil to reduce the value of the CNY. This drop will make Chinese exports more competitive and put greater deflationary pressures into the global economy.

All in all, today is more of the same. However, the trends in place are not giving positive signals for global growth.

U.S. Economic Releases

The May trade deficit widened more than forecast, coming in at $41.1 bn compared to the $40.0 bn level expected. April showed a deficit of $40.0 bn. Exports fell 0.2%, while imports rose 1.6%, which led to the widening of the deficit. The petroleum trade balance actually improved, while the deficit of goods widened. Exports of automotive, capital and consumer goods were weak, while food/beverage exports showed its second consecutive month of strength. Exports of aircrafts and parts were particularly weak. At the same time, imports of industrial supplies and consumer goods were particularly strong.



The chart above shows the level of trade balance. After a steep narrowing of the balance earlier in the year, we have seen two months of deficit widening.

Mortgage applications rose 14.2% for the most recent reporting week, with purchases up 4.3% and refinancing up 20.8%. Refinancing activity was boosted by the fall in rates. The 30-year mortgage rate fell 9 bps to 3.66%.

The table below shows the rest of today's data releases and notable Fed speakers.

Economic releases						
EST	Indicator			Expected	Prior	Rating
9:45	Services PMI (Markit)	m/m	Jun	51.3	51.3	*
9:45	Composite PMI (Markit)	m/m	Jun		51.2	*
10:00	ISM non-manufacturing composite	m/m	Jun	53.3	52.9	*
Fed speakers or events						
EST	Speaker or event	District or position				
9:00	Tarullo	Fed Governor				
2:00	Fed minutes from the June 14-15 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
EUROPE								
Germany	Factory orders	m/m	May	0.0%	-1.9%	1.0%	**	Equity bearish, bond bullish
U.K.	New car registrations	y/y	Jun	-0.8%	2.5%		**	Equity bearish, 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)	66	65	1	Up
3-mo T-bill yield (bps)	27	26	1	Up
TED spread (bps)	39	40	-1	Down
U.S. Libor/OIS spread (bps)	38	38	0	Neutral
10-yr T-note (%)	1.33	1.38	-0.05	Narrowing
Euribor/OIS spread (bps)	-29	-29	0	Neutral
EUR/USD 3-mo swap (bps)	49	40	9	Up
Currencies	Direction			
dollar	down			Neutral
euro	up			Neutral
yen	up			Up
franc	up			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	$47.31	$47.96	-1.36%	Awaiting inventory data
WTI	$46.06	$46.60	-1.16%	
Natural Gas	$2.72	$2.76	-1.63%	
Crack Spread	$12.84	$13.64	-5.89%	
12-mo strip crack	$11.97	$12.47	-3.98%	
Ethanol rack	$1.77	$1.78	-0.35%	
Metals				
Gold	$1,371.38	$1,356.45	1.10%	Investment demand
Silver	$20.23	$19.94	1.48%	
Copper contract	$213.50	$218.35	-2.22%	Demand concerns
Grains				
Corn contract	$ 344.50	$ 350.75	-1.78%	
Wheat contract	$ 427.25	$ 433.50	-1.44%	
Soybeans contract	$ 1,057.50	$ 1,077.25	-1.83%	
Shipping				
Baltic Dry Freight	692	688	4	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.4		
Gasoline (mb)		-0.5		
Distillates (mb)		-0.2		
Refinery run rates (%)		0.3%		
Natural gas (bcf)		40.0		

Weather

The 6-10 and 8-14 day forecasts call for warmer than normal temperatures for the eastern two-thirds of the country. Heavier than normal rain is projected for parts of the eastern region and the upper Midwest. 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.

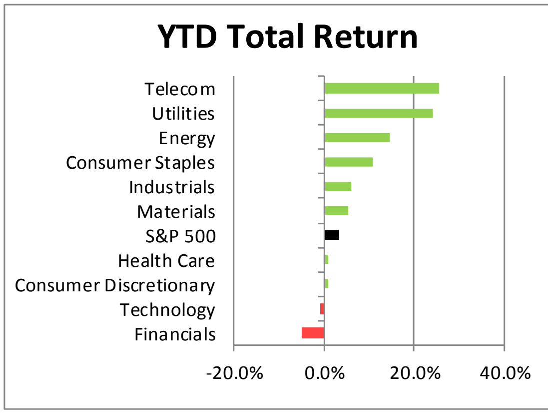
Brexit is part of another longer term political trend we have been discussing for several years. We have been concerned that the U.S. is steadily relinquishing its superpower role. The superpower provides key global public goods, mainly global security and the reserve currency. The former requires a 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.

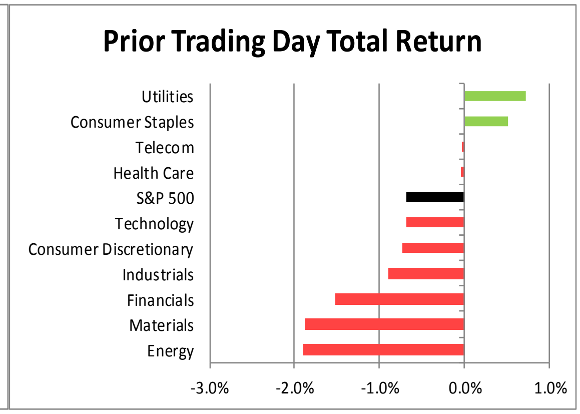
The Brexit vote was an emotional appeal to British nationalism. It could very well bring a resurgence of Scottish nationalism and may lead to the end of the United Kingdom. Similar movements in other parts of Europe are based on nationalism as well. In part, the campaigns of Donald Trump and Bernie Sanders 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 7/5/2016 close)

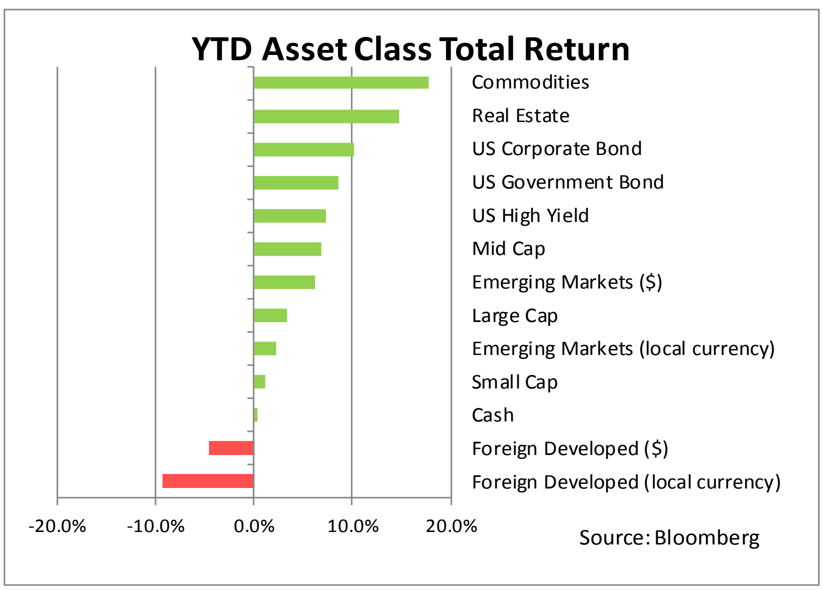




(Source: Bloomberg)

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 7/5/2016 close)

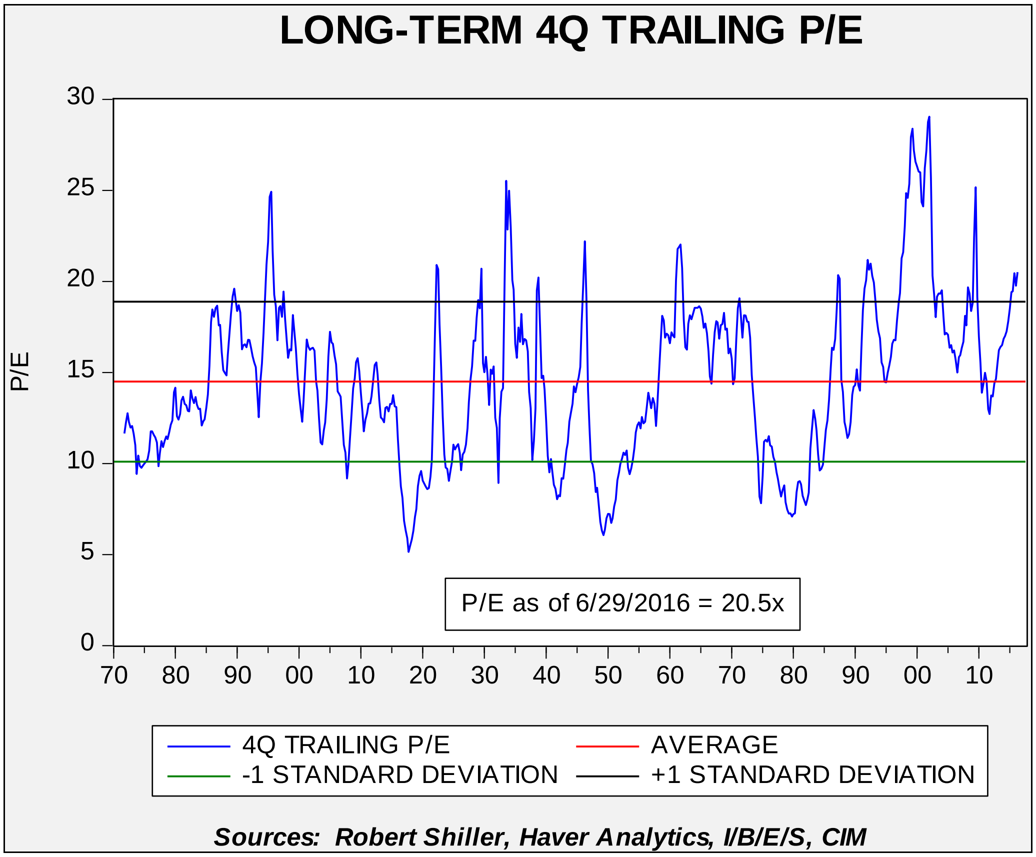


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[1] 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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[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 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.