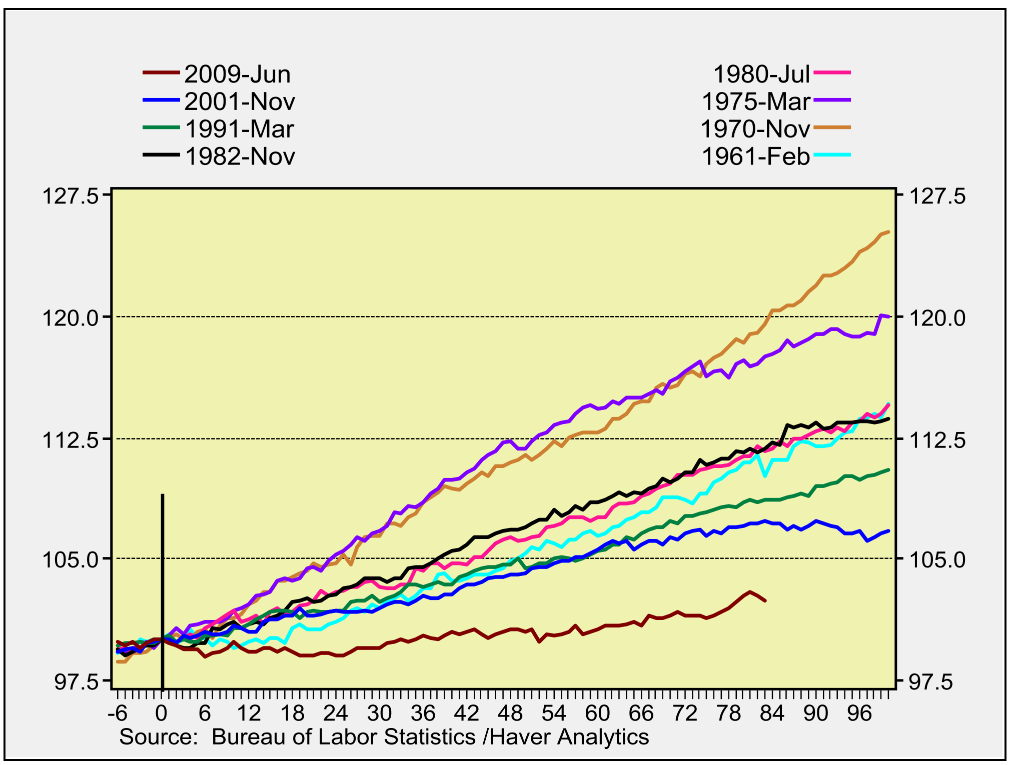
By Bill O'Grady & Kaisa Stucke, CFA

[Posted: July 7, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading higher by 0.8% from the last close. In Asia, the MSCI Asia Apex 50 closed up by 1.2% from the prior close. Chinese markets were roughly unchanged, with both the Shanghai and the Shenzhen indices trading sideways. U.S. equity futures are signaling a lower opening from the previous close.

Financial markets are attempting to stabilize in front of tomorrow's employment data. We did get the ADP data (see below), which came in above forecast and rather strong compared to last month. Current expectations call for a 180k rise in payrolls and a 4.8% unemployment rate (+0.1%). We tend to believe that the May data was an anomaly and non-farm payroll growth between 150k and 200k is the norm. If the U.S. is unable to growth the labor force (or, to put it another way, raise the participation rate), then we are running up against labor market constraints and payroll growth should weaken. But, we doubt that is the case. The lack of labor force growth is complicated, a combination of skills mismatches, less mobile labor force and aging baby boomers.



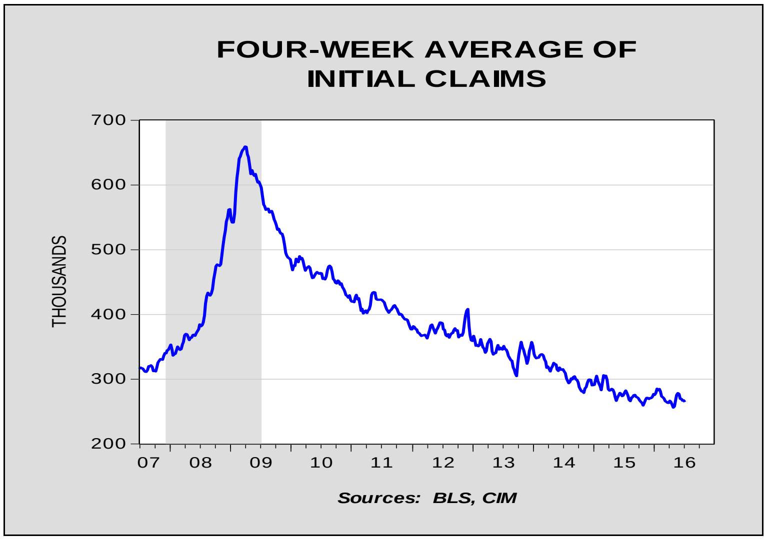
This chart shows the cyclical expansion of the labor force or the past eight business cycles, indexed to the end of each recession. As the chart shows, this is the slowest expansion of the labor force over these eight business cycles.

In Europe, starting with the U.K., the Conservatives have narrowed their choices for David Cameron's successor to Home Secretary Theresa May and Energy Minister Andrea Leadsom. Michael Gove was eliminated after this cycle of voting. Of the two, Leadsom is the most supportive of Brexit. Current betting pools indicate that May will be the most likely winner, although the actual vote among Tories won't be held until September. If May remains the frontrunner, it increases the likelihood that the U.K. exit will be amicable and, in fact, might not occur. Meanwhile, in Italy, talks between the EU and Italian authorities over the banking situation have stalled over government involvement in the bailout. The EU wants creditors to be the first line of defense for bank recapitalization rather than governments. The problem is that, in Italy, the banks have sold bonds to households that appear to be viewed as forms of deposits. It is estimated that households own about a third of Italian bank debt securities. The EU rules are designed to protect taxpayers from bank bailouts and force creditors to carry the bulk of the risk. However, in Italy, this isn't much different than having depositors bear the risk of a bank failure. If the bonds take a hit it could easily create conditions for a bank run. The *FT* is reporting that the populist Five Star party is surging in the polls. The latest polls show support for Five Star at 30.6%, exceeding the governing PD party support of 29.8%. In January, the PD led by six points. PM Renzi is holding a referendum on streamlining the structure of government in October. If the vote fails, we expect the Renzi government to fall. At present, the odds of such a rupture are rising. Finally, Reuters is reporting that about a third of Eurozone sovereign bonds are ineligible for QE because they yield less than the -0.4% deposit rate set by the ECB. Brexit has exacerbated this problem; before the vote, about 22% were ineligible. The *WSJ* reports that QE has reduced the availability of sovereign bonds to the financial system. Without risk-free bonds for collateral, QE inadvertently undermines the operations of the shadow banking system, reducing the availability of credit.

The FOMC minutes didn't tell us much other than the members were dealing with such uncertainty that they all agreed not to make any changes. If we get a rebound in the employment data tomorrow, expect to see the markets rebuild at least some possibility of rate hikes. That result would be dollar bullish and Treasury bearish.

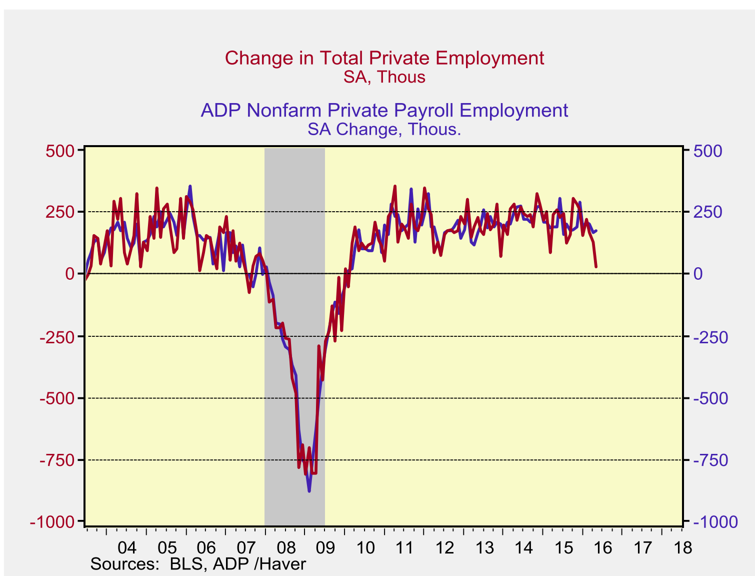
U.S. Economic Releases

Initial claims came in better than expected, falling 16k to 254k compared to the 269k forecast. Claims have remained below 300k for over a year.



The chart above shows the four-week average of claims, a more stable measure of claims, which fell by 2k to 265k. As the chart indicates, we continue to see a slow improvement in the labor markets.

ADP employment came in better than expected in June, rising 172k compared to the 160k increase expected.



The chart above shows the ADP non-farm private employment and the change in total private employment. The two metrics generally correlate and today's better than expected ADP numbers could mean that we might see a positive surprise in the employment report due out this Friday. Note that, in the past, when the BLS data has diverged sharply to the downside it tends to rise to the ADP data and not the other way around. Thus, a number near expectations tomorrow would be more likely.

The Challenger job cuts index fell 14.1% in June, following a 26.5% decline in May. The declines indicate that planned layoffs have fallen over the past two months.

There are no other data releases or notable Fed speakers scheduled for today.

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								
China	Foreign reserves	m/m	Jun	$3.2 bn	$3.2 bn	$3.2 bn	**	Equity and bond neutral
Japan	LEI	m/m	May	100.0	100.0	100.0	*	Equity and bond neutral
	Coincident index	m/m	May	110.5	112.0	110.3	*	Equity bullish, bond bearish
EUROPE								
France	Trade balance	m/m	May	-€2.8 bn	-€4.8 bn	-€4.9 bn	**	Equity bullish, bond bearish
	Current account balance	m/m	May	-€0.3 bn	-€2.1 bn		**	Equity bullish, bond bearish
Germany	Industrial production	y/y	May	-0.4%	0.8%	1.5%	***	Equity bearish, bond bullish
U.K.	Industrial production	y/y	May	1.4%	2.2%	0.5%	***	Equity bullish, bond bearish
Switzerland	CPI	y/y	Jun	-0.4%	-0.4%	-0.5%	***	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)	66	66	0	Neutral
3-mo T-bill yield (bps)	27	27	0	Neutral
TED spread (bps)	39	39	0	Neutral
U.S. Libor/OIS spread (bps)	38	38	0	Neutral
10-yr T-note (%)	1.39	1.37	0.02	Widening
Euribor/OIS spread (bps)	-29	-29	0	Neutral
EUR/USD 3-mo swap (bps)	43	44	-1	Down
Currencies	**Direction**			
dollar	up			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	$49.27	$48.80	0.96%	Expectations for a decline in stockpiles
WTI	$47.90	$47.43	0.99%	
Natural Gas	$2.83	$2.79	1.65%	
Crack Spread	$13.96	$13.29	5.09%	
12-mo strip crack	$12.74	$12.37	2.99%	
Ethanol rack	$1.76	$1.76	-0.30%	
Metals				
Gold	$1,364.16	$1,363.78	0.03%	Investment demand
Silver	$19.95	$20.09	-0.71%	
Copper contract	$214.80	$215.35	-0.26%	Demand concerns
Grains				
Corn contract	$ 350.50	$ 341.50	2.64%	World production forecast cut
Wheat contract	$ 434.50	$ 428.50	1.40%	
Soybeans contract	$ 1,066.50	$ 1,073.25	-0.63%	
Shipping				
Baltic Dry Freight	694	692	2	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.1		
Gasoline (mb)		-0.3		
Distillates (mb)		0.1		
Refinery run rates (%)		0.3%		
Natural gas (bcf)		42.0		

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.

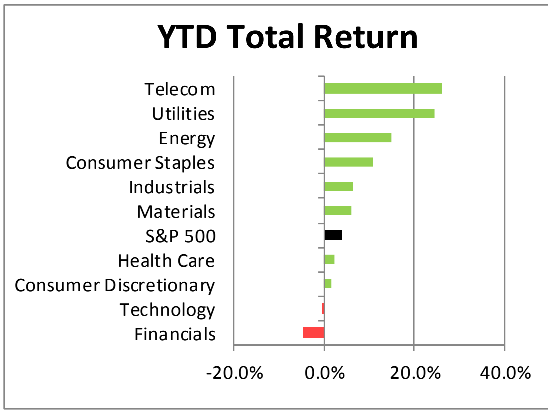
Brexit is part of another longer term political trend we have been discussing for several years. We have been concerned that the U.S. is steadily relinquishing its superpower role. The superpower provides key global public goods, mainly global security and the reserve currency. The former requires a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

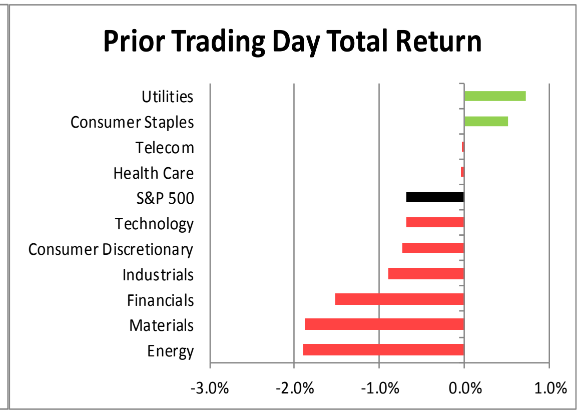
The Brexit vote was an emotional appeal to British nationalism. It could very well bring a resurgence of Scottish nationalism and may lead to the end of the United Kingdom. Similar movements in other parts of Europe are based on nationalism as well. In part, the campaigns of Donald Trump and Bernie Sanders 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 7/6/2016 close)

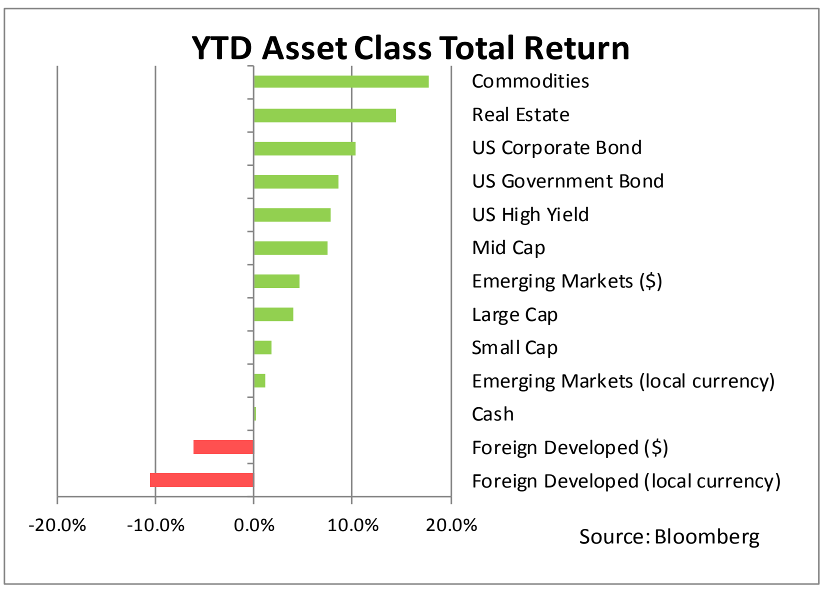




(Source: Bloomberg)

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 7/6/2016 close)

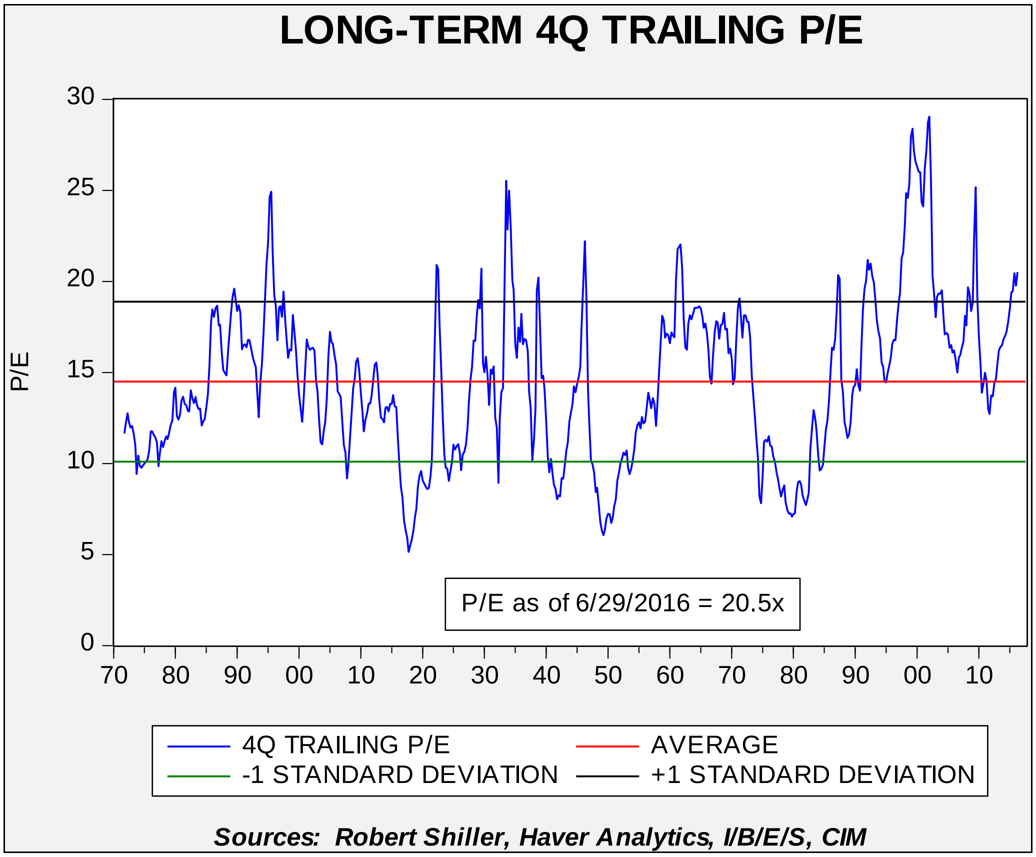


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 **(due to the Fourth of July holiday, this chart will be updated tomorrow)**



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.