Daily Comment

By Bill O'Grady, Kaisa Stucke, and Thomas Wash

[Posted: June 12, 2017—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 1.0% from the last close. In Asia, the MSCI Asia Apex 50 closed down 1.4% from the prior close. Chinese markets were mixed, with the Shanghai composite down 0.6% and the Shenzhen index up 1.1%. U.S. equity index futures are signaling a lower open.

The global political situation remains fluid. In France, President Macron won an apparent smashing victory in the first round of parliamentary elections, winning nearly 32% of the vote and faring much better than the conservative parties, which captured around 20%. The National Front picked up 14% of the vote and the Socialists polled in the single digits. The second round of elections will be held on June 18 when the En Marche Party is expected to capture 400 to 440 seats out of 577 seats. This is an impressive victory for a new party. The vote will give this new party and Macron a dominating hold on the legislature. Macron is promising to implement what can be best characterized as a neo-liberal policy, intending to lower taxes and end the 35-hour workweek. France never really adopted neo-liberal policies during the Reagan-Thatcher period so it would be a major change if they are implemented. On the other hand, Macron wants to create an EU fiscal mandate, which will surely be opposed by the Germans. All in all, Macron will have domestic political support.

While France appears to be moving to the right, the U.K. seems to be leaning toward unreconstructed socialism. Jeremy Corbyn pines to renationalize various industries that were privatized under Thatcher and initially nationalized by Labour after WWII. Although the Tories did win the majority of seats in the last election, they will struggle to form a government and the odds of another election soon are rising. After last week's embarrassing loss, there is growing speculation that Theresa May will be forced to step down from her post as party leader while the Tories try to regather themselves. David Davis, the minister overseeing Brexit, has stated that Brexit negotiations will not start on June 19 as planned but will likely take place sometime next week.

We are seeing a penchant for newness as there are high levels of discord across Western societies. We have seen the rise of hard-left and hard-right parties, but what has been consistent across the West is a willingness by voters to try something new. Corbyn and Trump are calling for different policies but are clearly outside the mainstream. These persons become attractive because voters are desperate for something new, hence why France decided to go with a very young president and a new party promising neo-liberal, market-friendly policies. So far, financial markets are handling these divergences without major problems, although one could argue that currency and fixed income markets have moved while equities continue to mostly ignore political discord. We don't know if this can last indefinitely, but it is clearly in place now.

In the Middle East, Qatar is still looking for a diplomatic solution to the blockade formed by Saudi Arabia. Qatar has been accused of funding terrorism, a claim that it has vehemently denied. SOS Tillerson has called for a de-escalation of the blockade, stating that it is hindering U.S. military operations within the region as well as being wrong on "humanitarian" grounds. It is worth noting that Qatar hosts the largest U.S. military base in the Middle East. As such, the Pentagon has also weighed in, stating that the blockade does not currently hinder its operations but rather its ability to plan for longer term military operations within the region. Alongside SOS Tillerson's calls for de-escalation, Trump has issued a statement praising the blockade as possibly leading to the end of terrorism. Trump's conflicting viewpoints from members of his administration have become somewhat routine. That being said, the Trump administration's inability to formulate a coherent foreign policy could lead to the U.S. losing clout around the world.

U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below shows the economic releases scheduled for the rest of the day.

Economic Releases							
EDT	Indicator			Expected	Prior	Rating
10:00	Monthly Budget Statement	m/m	may	-$87.0 bn	-$52.5 bn	**
Fed speakers or events						
No speakers or events scheduled						

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, which indicates the effect on the foreign market. Red indicates a concerning development, yellow indicates an emerging trend that we are following closely for possible complications and green indicates 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	Machine Orders	y/y	apr	-3.1%	1.4%	0.5%	**	Equity bearish, bond bullish
	PPI	y/y	apr	2.1%	2.1%	2.2%	**	Equity and bond neutral
India	CPI	y/y	may	2.2%	3.0%	2.4%	***	Equity and bond neutral
New Zealand	Card Spending Retail	m/m	may	-0.4%	1.1%	0.2%	**	Equity bearish, bond bullish
	Card Spending Total	m/m	may	-0.2%	0.5%		**	Equity and bond neutral
EUROPE								
France	Bank of France Business Sentiment	m/m	may	105	104	105	**	Equity and bond neutral
Italy	Industrial Production	y/y	apr	1.0%	2.8%	2.5%	***	Equity bearish, bond bullish
Switzerland	Total Sight Deposits	m/m	apr	576.4 bn	576.1 bn		*	Equity and bond neutral
	Domestic Sight Deposits	y/y	1q	476.2 bn	480.3 bn		*	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)	124	123	1	Up
3-mo T-bill yield (bps)	98	98	0	Neutral
TED spread (bps)	26	25	1	Neutral
U.S. Libor/OIS spread (bps)	114	114	0	Up
10-yr T-note (%)	2.21	2.20	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Down
EUR/USD 3-mo swap (bps)	34	34	0	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Down
yen	up			Down
pound	down			Neutral
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	$48.94	$48.15	1.64%	Short Covering
WTI	$46.51	$45.83	1.48%	
Natural Gas	$3.05	$3.04	0.20%	
Crack Spread	$16.34	$16.25	0.55%	
12-mo strip crack	$14.39	$14.27	0.86%	
Ethanol rack	$1.67	$1.67	0.04%	
Metals				
Gold	$1,269.33	$1,266.76	0.20%	Weaker dollar
Silver	$17.15	$17.21	-0.33%	
Copper contract	$263.35	$264.95	-0.60%	
Grains				
Corn contract	$ 383.25	$ 387.75	-1.16%	
Wheat contract	$ 439.50	$ 445.75	-1.40%	
Soybeans contract	$ 937.75	$ 941.50	-0.40%	
Shipping				
Baltic Dry Freight	849	824	25	

Weather

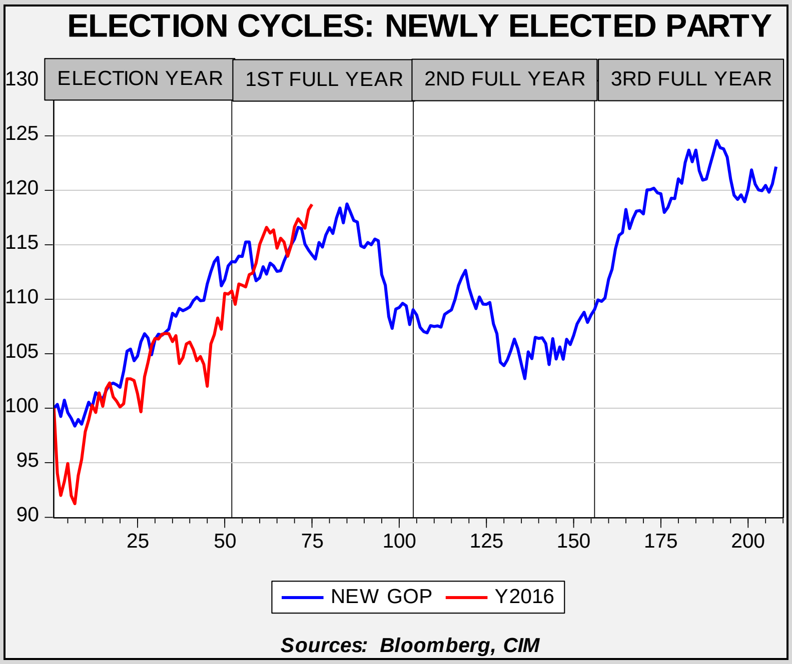
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. Precipitation is expected for most of the eastern region.

<u>Asset Allocation Weekly Comment</u>

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.

June 9, 2017

We have been monitoring the S&P 500 performance relative to new GOP administrations. Based on the historical pattern, the market has reached the average peak level a few weeks early.



This chart shows the performance of the S&P 500 on a weekly close basis, indexed to the first Friday of the first trading week in the year of the election. We have averaged the first four years of a new GOP president. So far, this cycle's equity market has generally, though not perfectly, followed the average. Based on that pattern, the current level of the market is around the usual peak. Clearly, this election cycle could be different, but the average does suggest we could be poised for a period of weakness.

So, what might cause a pullback? Here are a few candidates:

A debt ceiling crisis: The Treasury indicates that the government may begin to shut down as early as August if the debt ceiling isn't lifted. With the GOP controlling Congress and the White House, raising the debt limit should be perfunctory. However, there are rumblings that the Freedom Caucus will demand spending cuts to agree to any debt limit increases. The Democrats, after watching President Obama deal with two government shutdowns and the sequester over the debt limit, are in no mood to work with the administration and may force the congressional leadership to deal with the Freedom Caucus. If another debt limit crisis triggers a new government shutdown and raises fears of a potential downgrade of Treasury debt, a pullback in equities would likely result.

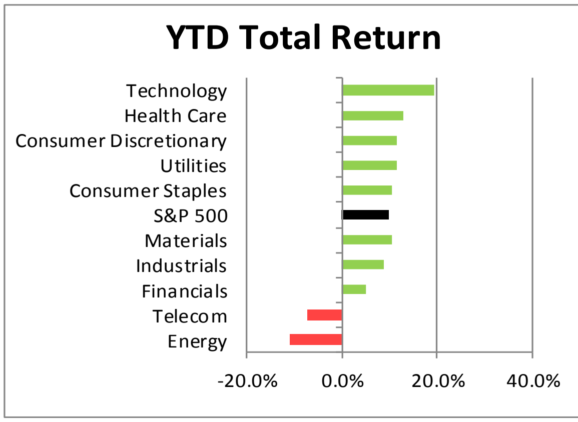
Winds of war on the Korean Peninsula: The U.S. will have three carrier groups in the East China Sea in the coming weeks. Although we doubt the Trump administration wants a war with North Korea, the U.S. is putting enough assets in the region to go to war if it so decides. A full-scale attack on North Korea would be a bloody affair; the Hermit Kingdom has been preparing for such an attack for years and even if its nuclear program isn't ready to deliver a weapon, its conventional forces will wreak havoc on the South. Even a hint of a conflict will likely prompt a pullback in risk assets.

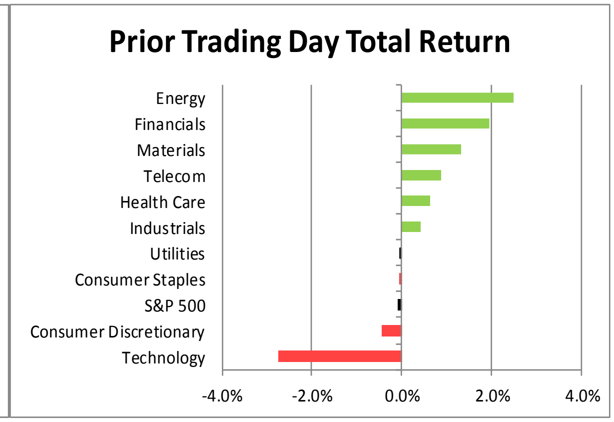
Monetary policy worries: The FOMC appears driven to raise the fed funds target rate. As we have noted before, there is a good deal of uncertainty surrounding the degree of slack that remains in the economy. The FOMC appears to be leaning toward the notion that the economy is getting close to capacity and further declines in unemployment will surely lead to inflation rising over target. Although financial markets didn't react well to the rate hike in December 2015, the subsequent increases have occurred without incident. Telegraphing the increases has reduced the risk to rate hikes but the odds of overtightening will increase if the Federal Reserve has miscalculated the level of slack in the economy. This potential concern, coupled with plans to begin reducing the size of the balance sheet later this year, could begin to undermine market sentiment.

We want to note that the average decline shown on the above graph is not a numerical forecast; we tend to view the direction as a more important indicator than level. It suggests that a period of equity market weakness is a growing possibility later this summer. What we don't see, at least so far, is evidence of anything more than a pullback. Recessions tend to be the primary factors that lead to bear markets. The economy is doing just fine; the yield curve hasn't inverted, the ISM manufacturing index is comfortably above 50 and there hasn't been any evidence in the labor markets to suggest a drop in economic growth. Thus, we may see a weak summer for stocks but nothing that would lead us to take a defensive position in the equity markets. Instead, a pullback will likely create an opportunity for investors.

Data Section

U.S. Equity Markets – (as of 6/9/2017 close)

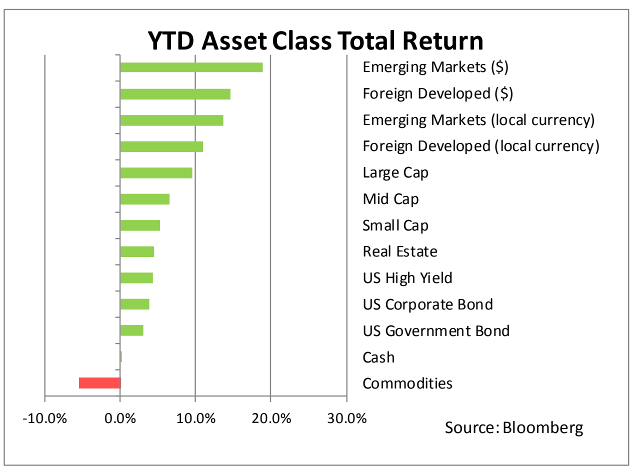




(Source: Bloomberg)

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. Sectors are ranked by total return; green indicating positive and red indicating negative return, along with the overall S&P 500 in black.

Asset Class Performance – (as of 6/9/2017 close)

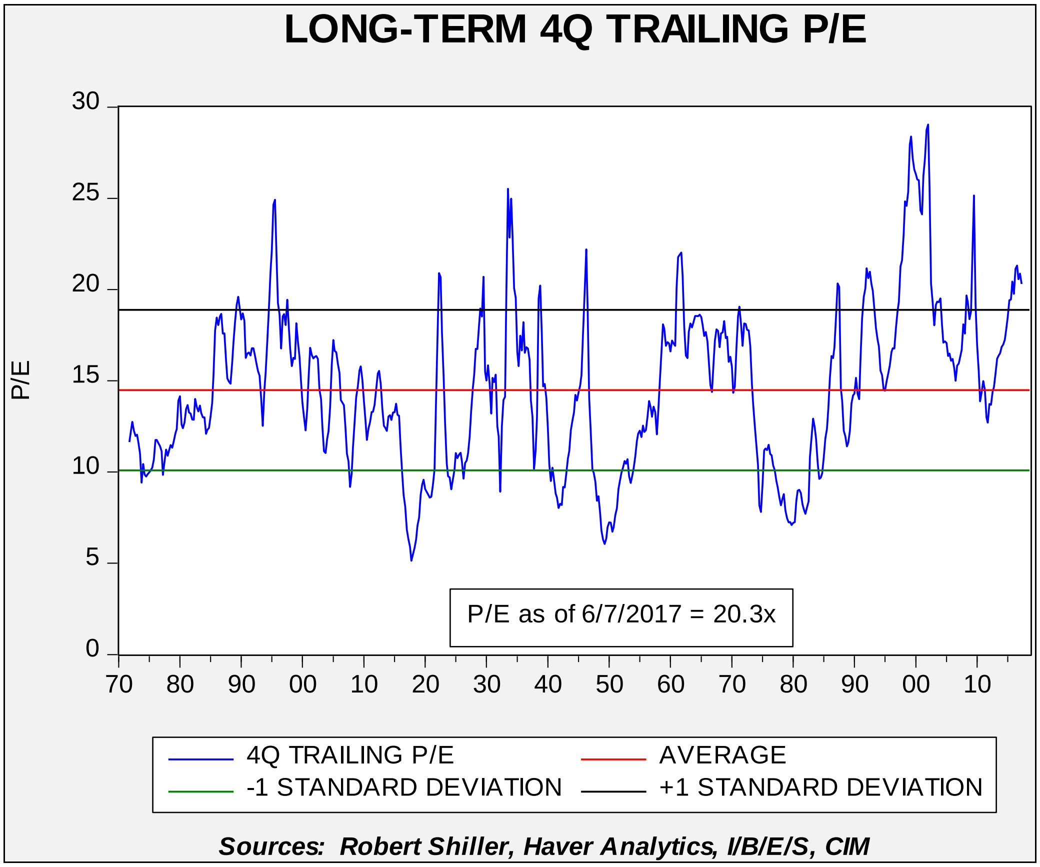


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 (Bloomberg total return Commodity Index).

P/E Update

June 8, 2017



Based on our methodology,[1] the current P/E is 20.3x, unchanged from last week.

This report was prepared by 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 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 quarters (Q3, Q4 and Q1) and 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.