Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: June 13, 2016—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is trading lower by 1.4% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 2.3% from the prior close. Chinese markets were also lower, with the Shanghai composite trading down 3.2% and the Shenzhen index lower by 4.8%. U.S. equity futures are signaling a lower opening from the previous close. With 99.4% of the S&P 500 companies having reported, Q1 float-adjusted earnings stand at $26.80, more than the $26.66 forecast. Of the 496 companies that have reported, 72.4% had positive earnings surprises, while 20.1% had negative earnings surprises.

Week of meetings: the Federal Reserve, BOJ, BOE and SNB all meet this week. None are expected to change policy, although if one might, the BOJ would be the most likely. The JPY has been on a tear and the Abe government would like to reverse that trend. About the only tool available to the BOJ would be to increase the amount of QE, which might happen. Although the best tool for the BOJ would be the expansion of its balance sheet by purchasing U.S. Treasuries, this would be seen as a hostile currency event, making it unlikely, at least for now.

Of course, the big issue is the Brexit vote, which will be held on June 23. Polls are all over the place, but we note that the PredictIt betting market puts the odds of leaving at 42%. Although the leave odds have been rising, they are still comfortably under 50%. We suspect that the race may tighten a bit from here but, in general, most separation votes (Scotland, Quebec) end up failing and we suspect this one will as well. For us, the Brexit vote is very useful because it reflects the nationalism fueling the Trump campaign. If the U.K. votes to exit, it may show that the cosmopolitan position of the political elites in Europe and the U.S. is eroding. If the betting line is correct, we may be setting up for a decent rally in the GBP and risk assets in general.

On the topic of the Fed, we don't expect any rate movement this week. To trigger a July hike, the June employment data will have to show that the May numbers were an anomaly and labor market conditions aren't deteriorating. If the July data are not all that robust, the next hike will be pushed into year's end. Yes, the Fed can raise rates in an election year but it raises political heat on the committee when it does so and this election cycle will be so divisive that we doubt the Fed will have any desire to inject itself into that turmoil.

China released a series of data over the weekend. In general, most of the numbers came in either near or a bit below forecast, suggesting a degree of stabilization in China. However, one number did come in surprisingly weak—foreign direct investment. Foreign direct investment is when a foreigner either buys or builds something in a nation, as compared to portfolio investment, which is the purchase of securities by a foreigner. The drop may be simply one month's issue but losing foreign direct investment may be a sign that foreigners are becoming less comfortable with the social and political stability of China.

U.S. Economic Releases

There are no releases or 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	Industrial production	y/y	May	6.0%	6.0%	6.0%	***	Equity and bond neutral
	Foreign direct investment	y/y	May	-1.0%	6.0%	5.0%	**	Equity bearish, bond bullish
	Fixed asset investment	y/y	May	9.6%	10.5%	10.5%	**	Equity bearish, bond bullish
	Retail sales	y/y	May	10.0%	10.1%	10.1%	**	Equity and bond neutral
India	CPI	y/y	May	5.8%	5.5%	5.6%	***	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)	24	24	0	Neutral
TED spread (bps)	42	41	1	Up
U.S. Libor/OIS spread (bps)	39	39	0	Neutral
10-yr T-note (%)	1.64	1.64	0.00	Neutral
Euribor/OIS spread (bps)	-26	-26	0	Neutral
EUR/USD 3-mo swap (bps)	33	30	3	Up
Currencies	Direction			
dollar	down			Up
euro	up			Down
yen	up			Up
franc	down			Down

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	Cause/ Trend
Energy markets				
Brent	$ 50.04	$ 50.54	-0.99%	Expectations of rising domestic production
WTI	$ 48.54	$ 49.07	-1.08%	
Natural gas	$ 2.61	$ 2.56	1.96%	
Crack spread	$ 15.61	$ 15.82	-1.37%	
12-mo strip crack	$ 13.20	$ 13.42	-1.65%	
Ethanol rack	$ 1.80	$ 1.80	0.00%	
Metals				
Gold	$ 1,285.46	$ 1,274.24	0.88%	Investment demand
Silver	$ 17.38	$ 17.33	0.28%	
Copper contract	$ 204.55	$ 203.05	0.74%	
Grains				
Corn contract	$ 434.00	$ 423.00	2.60%	South American adverse weather
Wheat contract	$ 500.00	$ 495.00	1.01%	
Soybeans contract	$ 1,178.50	$ 1,162.75	1.35%	
Shipping				
Baltic Dry Freight	610	611	-1	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)	-3.2	-3.1	-0.1	
Gasoline (mb)	1.0	-1.3	2.3	
Distillates (mb)	1.8	-0.5	2.3	
Refinery run rates (%)	1.1%	0.5%	0.6%	
Natural gas (bcf)	65.0	77.0	-12.0	

Weather

The 6-10 and 8-14 day forecasts are calling for hotter and drier than normal conditions for majority of the country. There is no tropical activity to report.

Weekly Asset Allocation Commentary

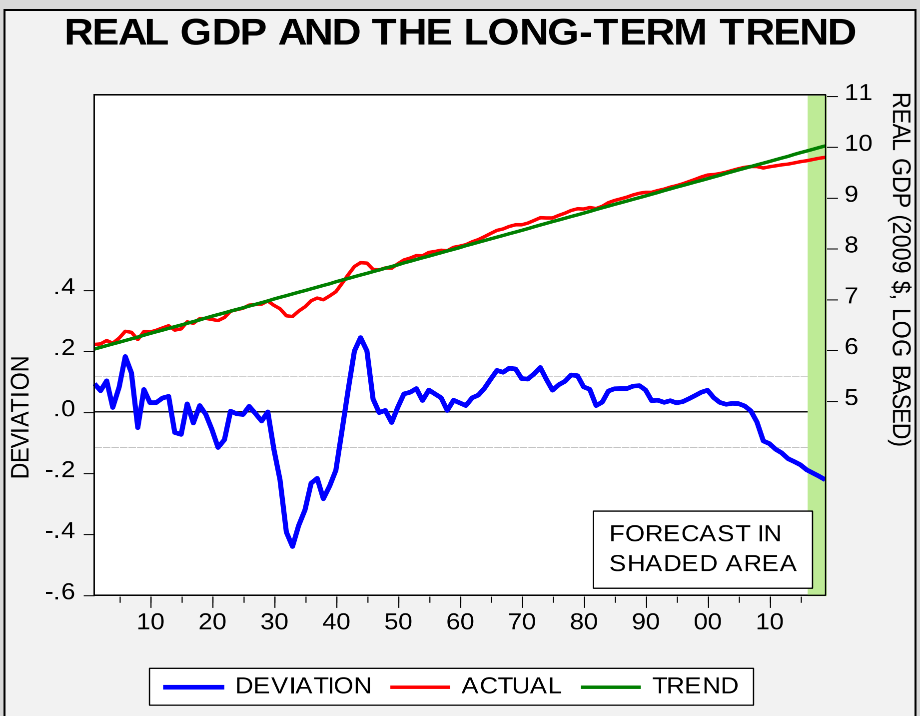
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

June 10, 2016

In our asset allocation process, we focus on cyclical trends—trends that tend to have three- to five-year time horizons. Two examples of these sorts of trends are the business cycle and the monetary policy cycle. Although both cycles can last longer or less than three to five years, in general, these types of trends have an impact on market activity and distinguish our process from strategic models, which tend to focus on very long-term cycles. We believe that ignoring the cyclical trends can lead to short- to medium-term losses that can be avoided by taking shorter term factors into account.

However, this does not mean that longer term cycles are not important. We view these longer term cycles as the overall market environment. These factors include the geopolitical environment (especially related to the U.S. superpower role), inflation policy (which tends to last decades), debt cycles (which also have a long life span), and secular economic growth cycles (which tend to be affected by productivity, technology, demographics and debt). Although the inflection points in these long-term cycles tend to occur infrequently, perhaps once or twice in a lifetime, they have significant effects on short-term cycles when they do occur.

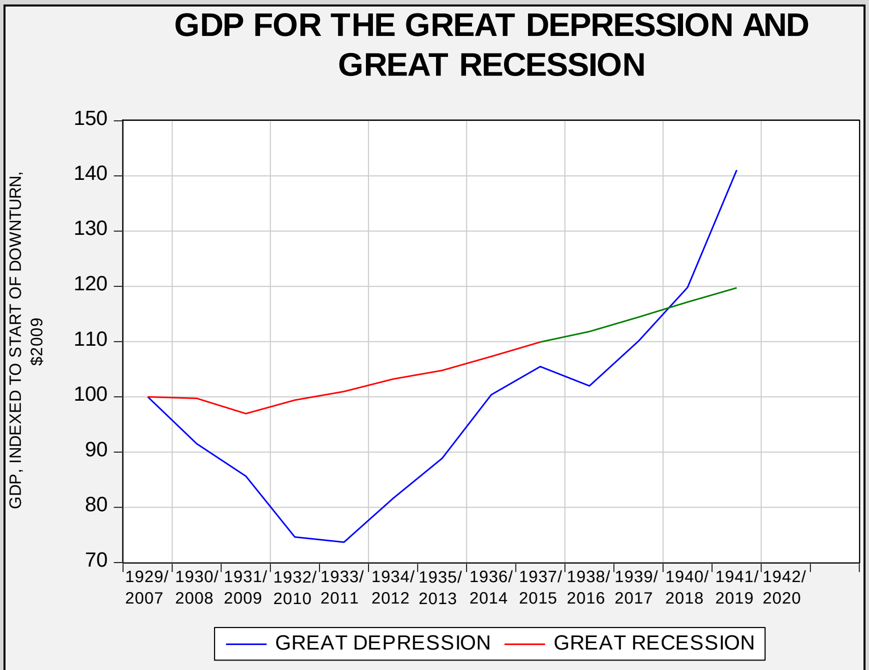
We continue to monitor the long-term economic growth cycle.



Sources: Haver Analytics, Philadelphia FRB, CIM

This chart shows GDP from 1901 and includes consensus forecasts for 2016 through 2019, using the Philadelphia FRB Survey of Professional Forecasters. The key line is on the lower end of the chart showing the deviation from trend. There are two periods that show a sharp negative deviation from trend, the Great Depression and the Great Recession. In the Great Depression, the economy fell sharply but staged a strong recovery into the war years, with the exception of a pullback during the 1937 recession. In the current downturn, the decline is much shallower, but, assuming the consensus forecast is correct, there is no strong recovery in the offing. In other words, it is quite possible we have exchanged a deep, but shorter, economic decline for one that is shallower but interminable.

Here is another way of looking at the data.



Sources: Haver Analytics, CIM

On this chart, we have indexed the level of real GDP beginning in 1929 and 2007. In the Great Depression (shown as the blue line), GDP dropped by nearly 25% at the trough; in the Great Recession, the decline was a little over 3% (with the actual data shown in red, and the forecast in green). However, the recovery from the Great Depression was quite strong, exceeding the previous peak by 1936 and, had the Roosevelt administration not derailed the improvement through an ill-advised fiscal tightening in 1937, the economy would have likely gathered even more momentum. Meanwhile, if the Philadelphia FRB Survey of Professional Forecasters is accurate, by 2018, the recovery from the Great Depression will exceed the current cycle. Of course, mobilization for WWII partly explains the expansion. But, what it probably also shows is that if the current economy is ever going to recover to trend, it will likely take a large fiscal shock, such as a major war, to bring that about.

In the current environment, we don't expect a major fiscal expansion to occur, although we note that given the populist tone of the current election cycle, deficit reduction doesn't appear to be a major political factor. Still, as the second chart shows, we are rapidly approaching the point where the current period of weak growth will extend past the period of the Great Depression. In our asset allocation process, we have assumed that growth will remain lackluster, meaning that interest rates and inflation would stay low. We continue to closely monitor the economic and political environment for evidence that subpar growth will be addressed by more radical measures. But, thus far, there isn't much evidence to suggest that significant change is in the offing. Therefore, until we see signs of a change in the policy environment, we expect the current cyclical and secular trends to remain in place.

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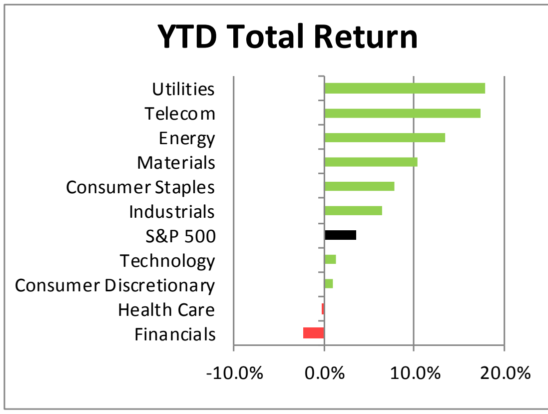
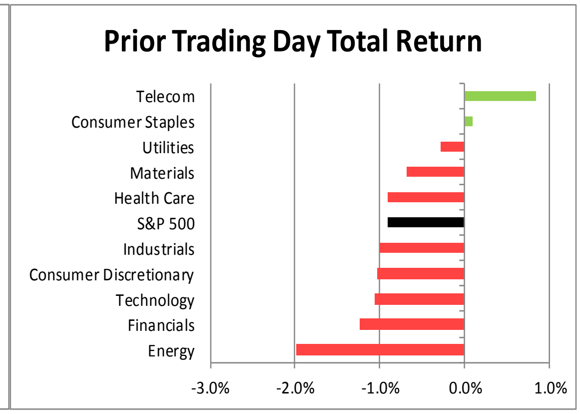
Data Section

U.S. Equity Markets – (as of 6/10/2016 close)

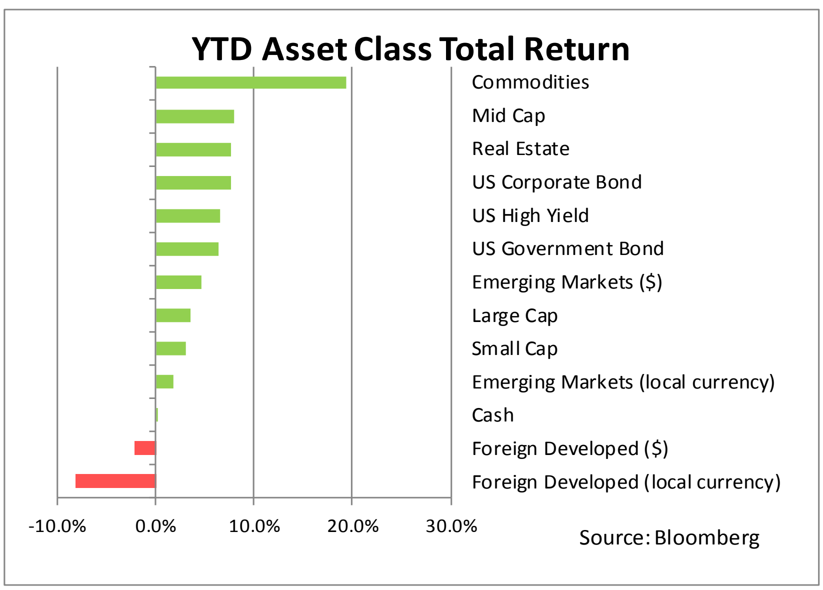




(Source: Bloomberg)

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 6/10/2016 close)

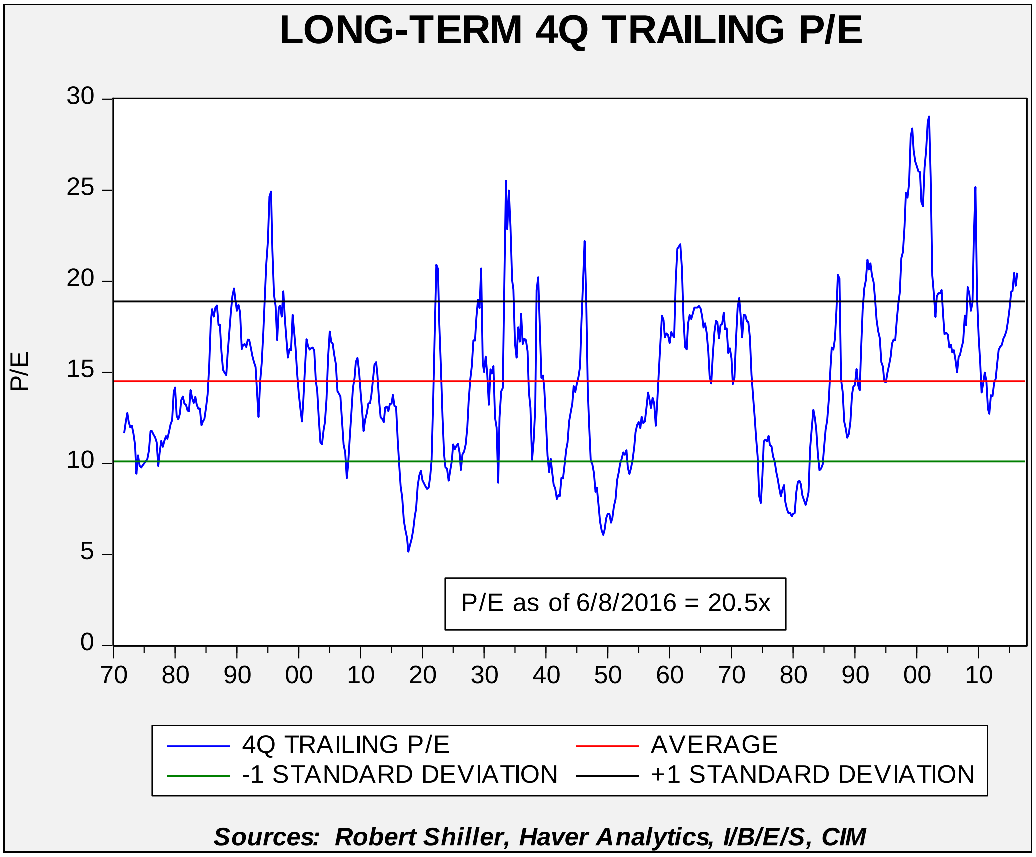


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 9, 2016



Based on our methodology,[1] the current P/E is 20.5x, up 0.1x from last week. The rise in equities with mostly steady earnings data led to the continued upward lift in the P/E.

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.