Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

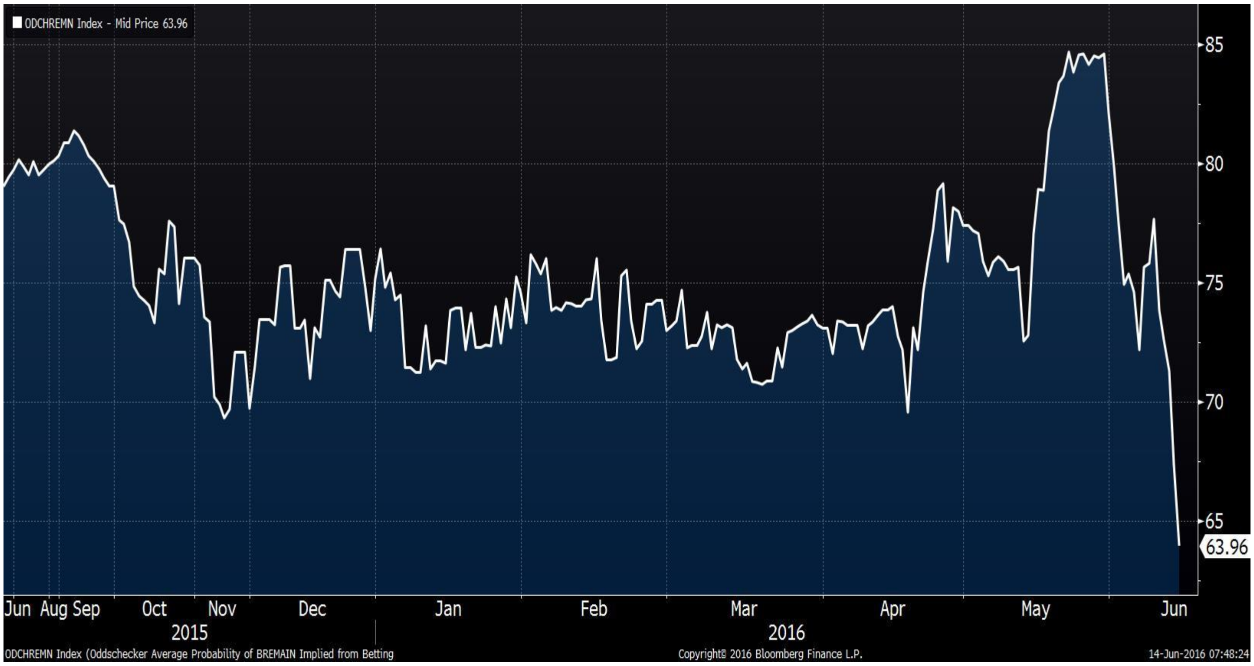
[Posted: June 14, 2016—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is trading lower by 1.3% from the last close. In Asia, the MSCI Asia Apex 50 closed lower by 0.3% from the prior close. Chinese markets were actually higher, with the Shanghai composite trading up 0.3% and the Shenzhen index higher by 0.3%. 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.

Risk markets remain soft this morning in the wake of the German 10-year yield dipping under zero.

(Source: Bloomberg)

It is historic enough that we now have the German yield curve below zero going out 10 years. A total of 75% of German bonds now carry a negative yield and 50% yield below -40 bps. The -40 bps level is important because the ECB can't legally buy bonds with a yield below that level. Thus the continued decline in German yields is making QE in Europe increasingly difficult, forcing the ECB to purchase riskier credits. Perhaps just as important is that U.S. 10-year T-note yields have dipped under 1.60% this morning, reaching a low yield of 1.57%.

The other big news is Brexit. The *Sun* newspaper, with the highest circulation in the U.K., has come out in favor of leaving the EU. Although the actual impact of this news is probably less than it would have been a decade ago, it does add to evidence of a surge toward leaving the EU.



(Source: Bloomberg)

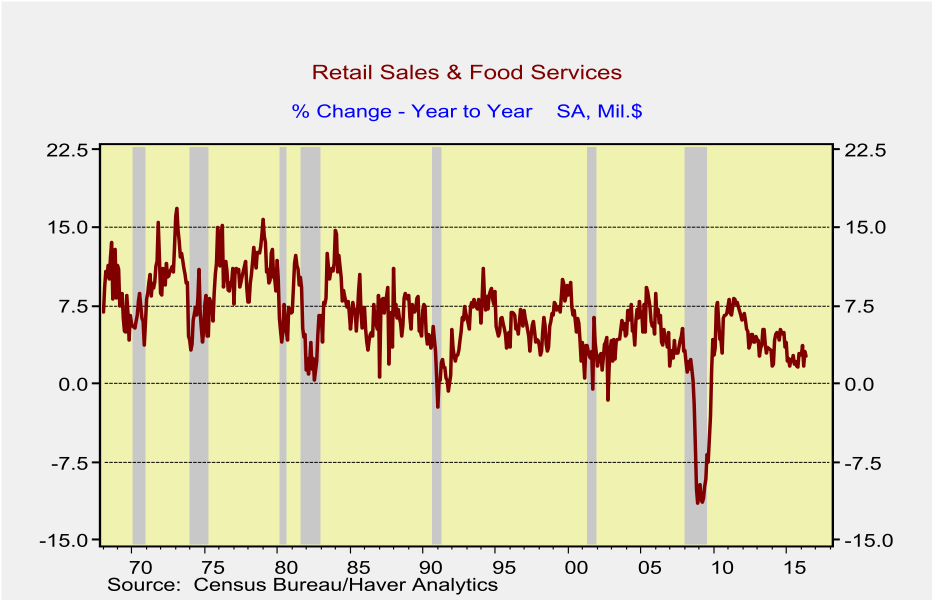
This chart shows a Bloomberg calculation of the average of betting sites on the question of staying in the EU. At the beginning of the month, odds makers' betting pools showed a clear bias toward Bremain as the betting flows suggested the U.K. would not vote to leave the EU. Although the odds still favor that position, there has been a definitive shift since early June. Next week's WGR will examine the Brexit issue from the context of the viability of the EU project.

Finally, the *FT* is reporting that, since last August, China has spent $470 bn supporting the CNY. The onshore rate has been inching down recently despite persistent central bank support. Recent comments suggest China will not allow a free float of the CNY; usually, that means depreciation, but due to fears of capital flight, the most likely outcome is a gradual slide in the exchange rate. On a related note, the MSCI is nearing a decision to allow onshore (A shares) equities into its emerging market basket. Based on the lack of openness in the Chinese financial markets, it is hard to justify adding additional Chinese exposure to the emerging indices. On the other hand, given China's size, it will be difficult to keep the onshore shares out indefinitely. We suspect they will get added in a measured fashion starting later this year.

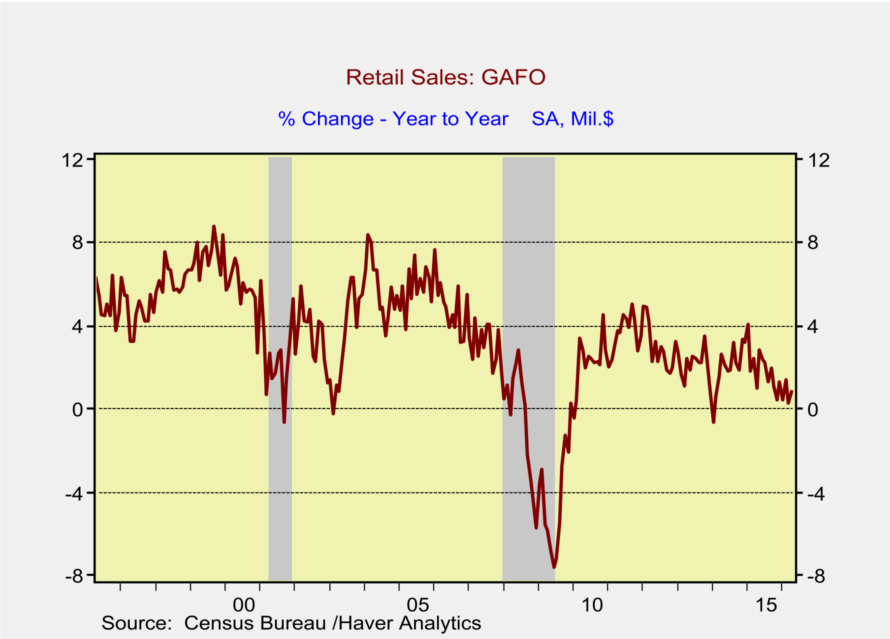
U.S. Economic Releases

Retail sales for May came in better than forecast, rising 0.5% compared to expectations of a 0.3% rise. Excluding auto purchases, sales rose 0.4%, on forecast, and excluding autos and gasoline stations, sales rose 0.3%, also on forecast.

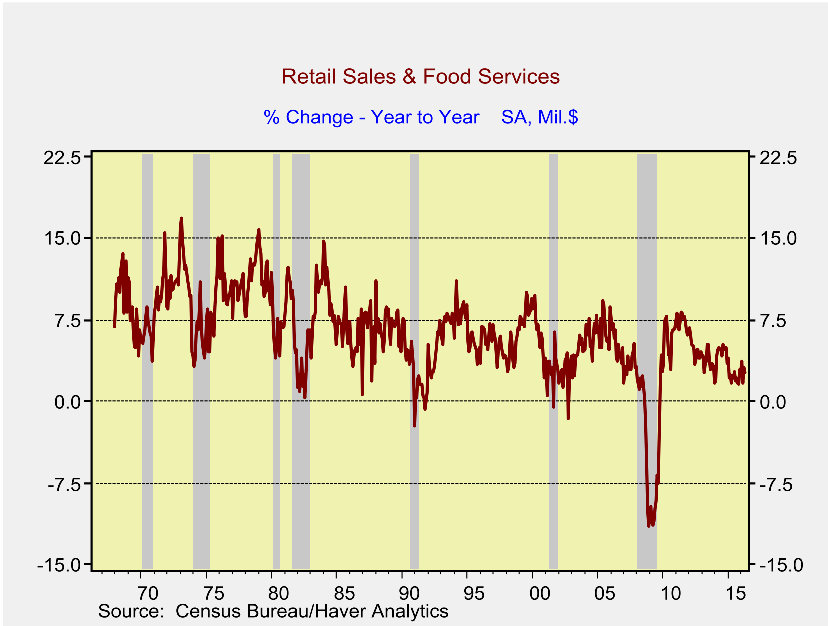
Over the past year, overall retail sales are up 2.6%.



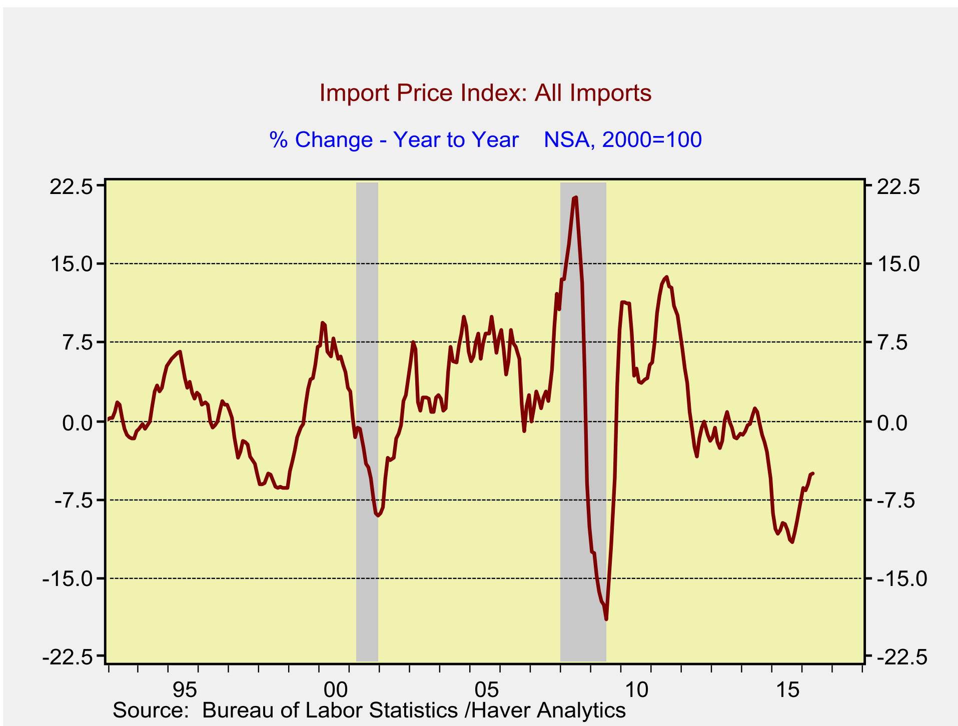
The control group sales, which correlates rather well with GDP consumption is up only 0.8% from last year.



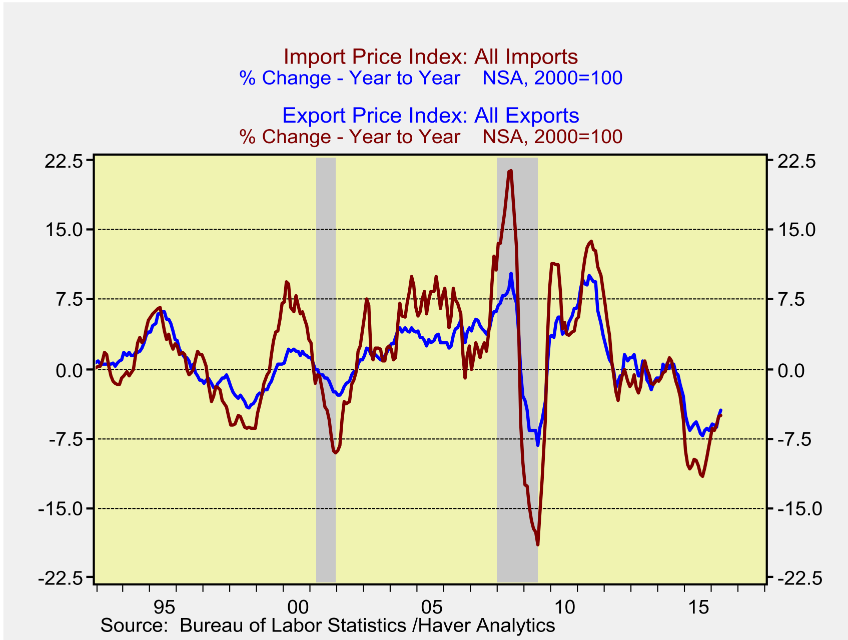
Resturant sales remain rather strong.



Import prices for May rose 1.4% from last year, well above the 0.7% consensus. However, on a yearly basis, import prices remain a deflationary drag.



Terms of trade, the difference between export prices and import prices, was mostly flat. Terms of trade had been improving for most of last year as the stronger dollar depressed import prices more than export prices.



Small business optimism came in a bit better than forecast for May, at 93.8 compared to expectations of 93.6%.

On balance, the economic data today was generally supportive for the economy. It is difficult to imagine a recession with rising retail sales. However, there was nothing in any of the reports that would sway economic policy in either direction.

The chart below indicates economic releases scheduled for the rest of the day.

Economic releases						
EST	Indicator			Expected	Prior	Rating
10:00	Business inventories	m/m	Apr	0.2%	0.4%	**

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	Manpower survey	q/q	Q3	2.0%	5.0%		*	Equity and bond neutral
India	CPI	y/y	May	5.8%	5.5%	5.6%	***	Equity and bond neutral
	Manpower survey	q/q	Q3	36.0%	39.0%		*	Equity and bond neutral
	Wholesale prices	y/y	May	0.8%	0.3%	0.5%	*	Equity and bond neutral
Japan	Industrial production	y/y	Apr	-3.3%	-3.5%		***	Equity bearish, bond bullish
	Capacity utilization	m/m	Apr	-1.0%	3.2%		**	Equity bearish, bond bullish
EUROPE								
Eurozone	Industrial production	y/y	Apr	2.0%	0.2%	1.4%	***	Equity bullish, bond bearish
Italy	CPI	y/y	May	-0.3%	-0.3%	-0.3%	***	Equity and bond neutral
U.K.	CPI	y/y	May	0.3%	0.3%	0.4%	***	Equity and bond neutral
AMERICAS								
Brazil	Retail sales	y/y	Apr	-6.7%	-5.7%	-6.6%	**	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)	26	26	0	Neutral
TED spread (bps)	40	39	1	Up
U.S. Libor/OIS spread (bps)	38	39	-1	Down
10-yr T-note (%)	1.57	1.61	-0.04	Narrowing
Euribor/OIS spread (bps)	-26	-26	0	Neutral
EUR/USD 3-mo swap (bps)	36	32	4	Up
Currencies	**Direction**			
dollar	up			Up
euro	down			Down
yen	up			Up
franc	up			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	$ 49.64	$ 50.35	-1.41%	Profit taking
WTI	$ 48.18	$ 48.88	-1.43%	
Natural gas	$ 2.59	$ 2.59	0.31%	
Crack spread	$ 15.20	$ 15.34	-0.90%	
12-mo strip crack	$ 13.15	$ 13.17	-0.20%	
Ethanol rack	$ 1.82	$ 1.82	0.30%	
Metals				
Gold	$ 1,289.44	$ 1,283.86	0.43%	Investment demand
Silver	$ 17.48	$ 17.45	0.17%	
Copper contract	$ 204.05	$ 205.35	-0.63%	Rising inventories
Grains				
Corn contract	$ 433.00	$ 435.50	-0.57%	Crop rating better than expected
Wheat contract	$ 490.50	$ 491.25	-0.15%	
Soybeans contract	$ 1,150.00	$ 1,159.00	-0.78%	
Shipping				
Baltic Dry Freight	609	610	-1	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.1		
Gasoline (mb)		-0.7		
Distillates (mb)		-0.1		
Refinery run rates (%)		0.4%		
Natural gas (bcf)		66.0		

Weather

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

Weekly Asset Allocation Commentary

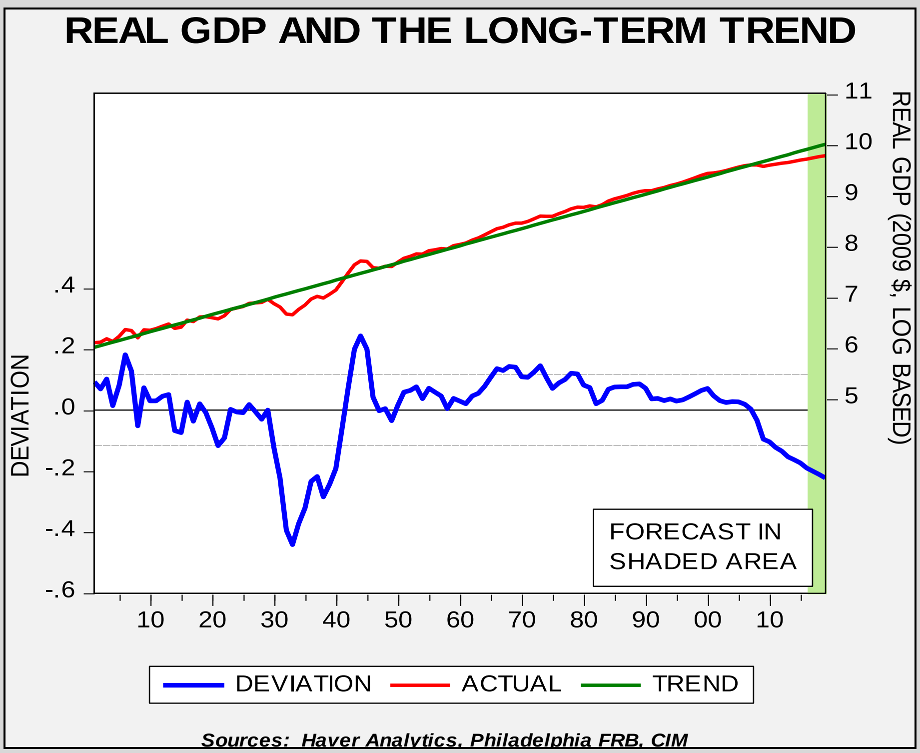
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

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.

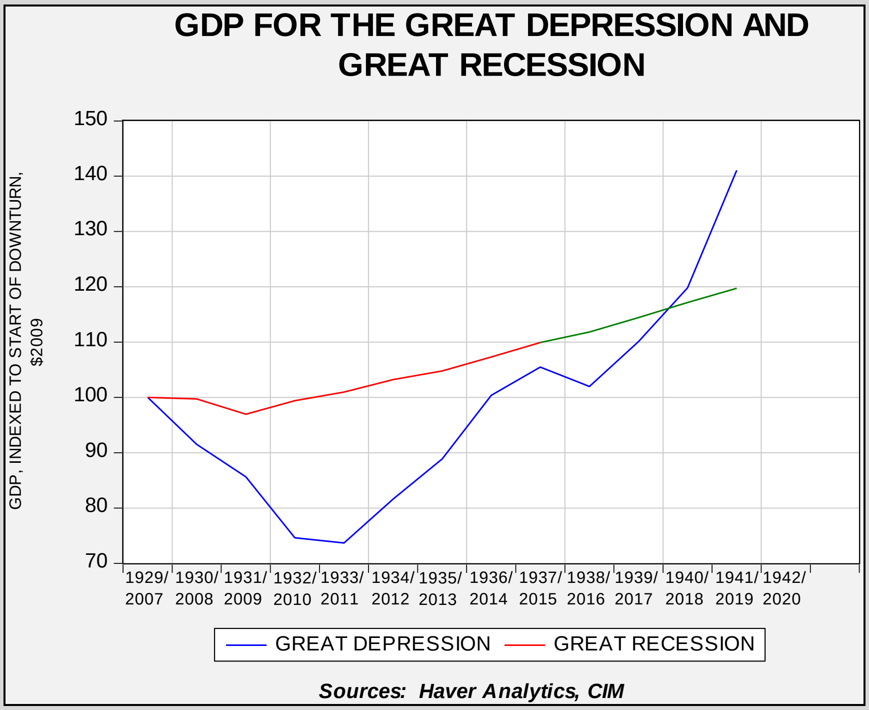
However, this does not mean that longer term cycles are not important. We view these longer term cycles as the overall market environment. These factors include the geopolitical environment (especially related to the U.S. superpower role), inflation policy (which tends to last decades), debt cycles (which 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.



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.

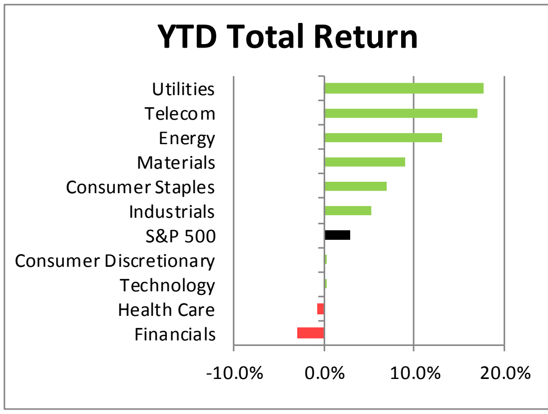


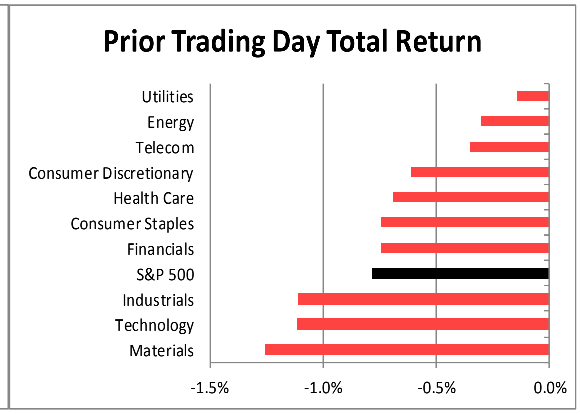
On this chart, we have indexed the level of real GDP beginning in 1929 and 2007. In the Great Depression (shown as the blue line), GDP dropped by nearly 25% at the trough; in the Great Recession, the decline was a little over 3% (with the actual data shown in red, and the forecast in green). However, 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.

<u>Data Section</u>

U.S. Equity Markets – (as of 6/13/2016 close)

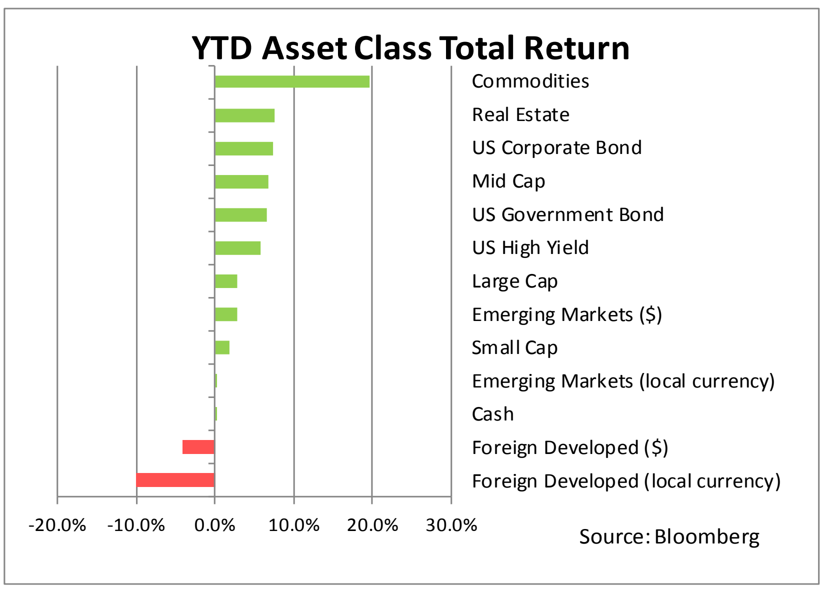




(Source: Bloomberg)

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 6/13/2016 close)

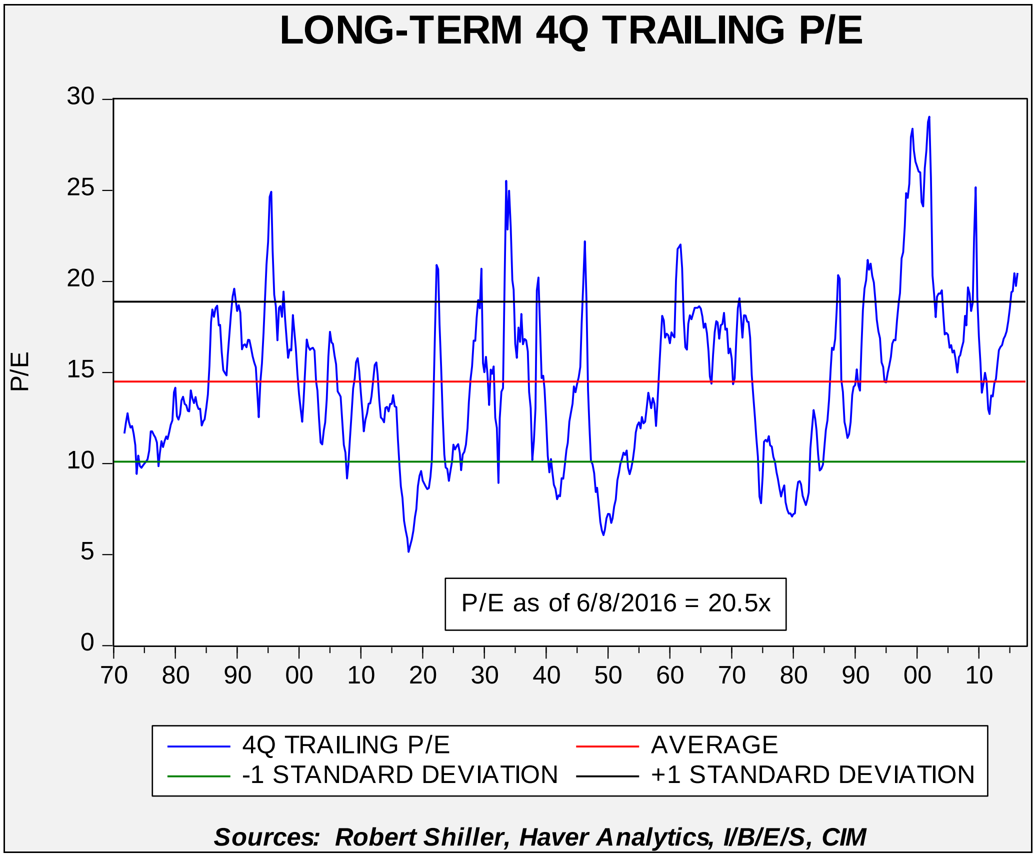


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.