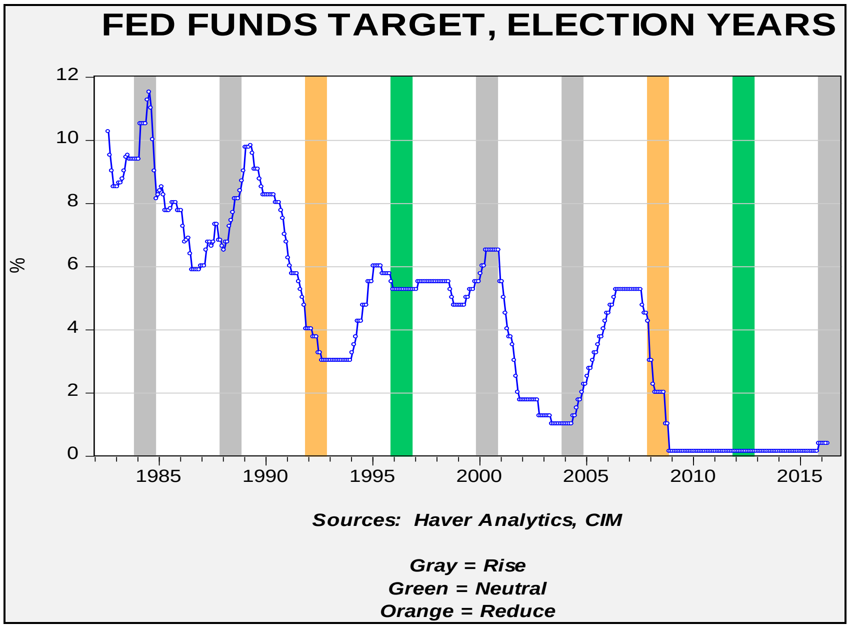
Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: June 15, 2016—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is trading higher by 1.6% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 0.6% from the prior close. Chinese markets were also higher, with the Shanghai composite trading up 1.6% and the Shenzhen index higher by 3.1%. U.S. equity futures are signaling a higher 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.

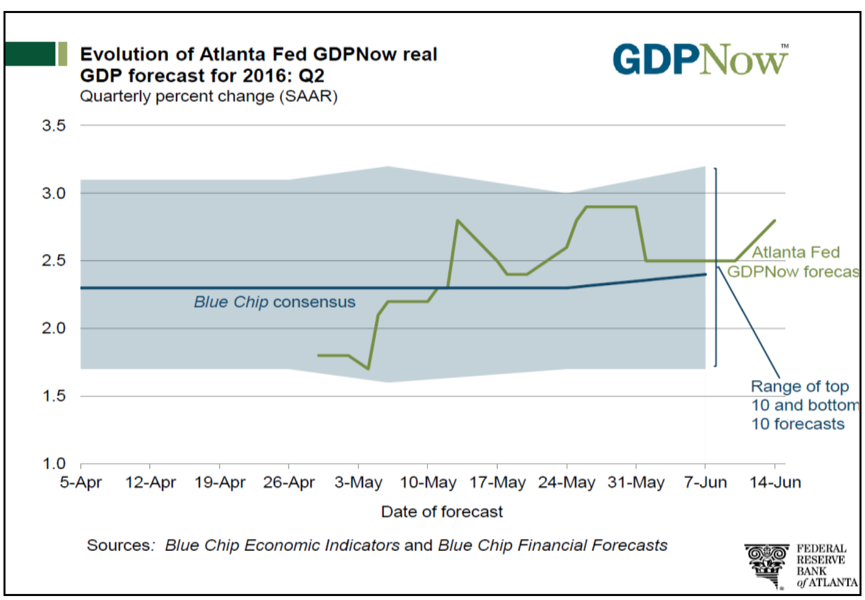
BREAKING NEWS: Nigeria announced it is moving toward a market driven exchange rate policy, likely taking steps toward allowing its currency, the naira, to float. Although the Central Bank of Nigeria has allowed more flexible exchange rates recently, allowing a full float will likely lead to a much weaker currency. This action will boost inflation and import prices but will make the domestic oil industry more competitive as it pays its workers in a depreciating currency but sells oil in dollars. To a great extent, this news reflects the tensions caused by lower oil prices.

It's Fed Day! After six weeks of waiting and a swing in the employment data, the current fed funds futures expectations put the odds of a rate hike today at virtually zero and only 17.6% for July. This outcome is probably too low for the Fed's liking. Although we believe Chairwoman Yellen is generally dovish, she will likely be uncomfortable with this degree of certainty in the markets and will try to inject a bit of worry. Thus, we expect a more hawkish tone to the statement, data expectations and "dots" from the FOMC. At the same time, with Brexit and what will likely be a political circus through autumn, we believe that if the Fed doesn't hike in July, it probably won't move again until December.



Nevertheless, the Fed has hiked rates during election years despite general market beliefs that the central bank would stay neutral. This chart shows that since 1984, or nine election cycles, the Fed has raised rates in five, cut rates in two and stayed neutral in two. On the other hand, these were fairly standard elections between two establishment candidates. It isn't farfetched to expect Democrats to complain that rate hikes could toss the election to Donald Trump. Of course, it could work the other way as well, that not cutting rates is a boost to the Democrats if the economy needs it. Given the degree of vitriol, it would take a very compelling reason for the Fed to raise rates once campaigning escalates later this summer.

Another potential reason for today's Fed meeting to have a hawkish tilt is that Q2, despite the employment data, looks like it will be rather strong.



The Atlanta FRB's GDPNow report is projecting a 2.8% Q2 GDP number. This report is above the Blue Chip Consensus and approaching the upper bound of that forecasting groups expectations. In looking at the contributions to growth, virtually all the expansion is coming from personal consumption.

Atlanta Fed GDPNow forecasts for 2016: Q2, contributions to growth

Date	Major Releases	GDP	PCE	Equip-ment	Intell. prop. prod.	Nonres. struct.	Resid. inves.	Govt.	Net exports	CIPI
29-Apr	Initial nowcast	1.8	1.90	0.03	0.11	-0.17	0.08	0.17	-0.01	-0.27
17-May	Housing starts, CPI, Indust. Prod.	2.5	2.45	0.17	0.11	-0.08	0.09	0.22	-0.04	-0.39
18-May	M3 Manufact. (Benchmark Revision)	2.4	2.45	0.15	0.11	-0.08	0.09	0.22	-0.04	-0.53
20-May	Existing home sales	2.4	2.45	0.15	0.11	-0.08	0.13	0.22	-0.04	-0.53
24-May	New home sales/construct. costs	2.6	2.45	0.15	0.11	-0.08	0.28	0.22	-0.04	-0.54
25-May	Advance intl goods trade	2.8	2.46	0.16	0.11	-0.08	0.28	0.22	0.16	-0.54
26-May	Advance durable manufacturing	2.9	2.46	0.18	0.11	-0.07	0.28	0.22	0.16	-0.46
31-May	GDP (May 27), Personal Income/PCE	2.9	2.49	0.03	0.09	-0.07	0.28	0.21	0.30	-0.39
1-Jun	Constr. spending, ISM Manufacturing	2.5	2.42	0.00	0.09	-0.18	0.15	0.07	0.31	-0.39
2-Jun	Auto sales, ISM Nonmanuf. (Weds)	2.5	2.39	0.00	0.09	-0.18	0.15	0.07	0.32	-0.36
3-Jun	Employ, Intl tr, M3 Man, ISM Nonman	2.5	2.37	0.04	0.10	-0.18	0.14	0.06	0.23	-0.27
9-Jun	Wholesale trade	2.5	2.37	0.04	0.10	-0.18	0.14	0.06	0.23	-0.23
10-Jun	Monthly Treasury Statement	2.5	2.37	0.04	0.10	-0.18	0.14	0.02	0.23	-0.23
14-Jun	Retail trade, Import/export prices	2.8	2.69	0.04	0.10	-0.18	0.09	0.02	0.31	-0.28
Maximum forecast of real GDP growth										
31-May	GDP (May 27), Personal Income/PCE	2.9	2.49	0.03	0.09	-0.07	0.28	0.21	0.30	-0.39
Minimum forecast of real GDP growth										
29-Apr	Initial nowcast	1.8	1.90	0.03	0.11	-0.17	0.08	0.17	-0.01	-0.27

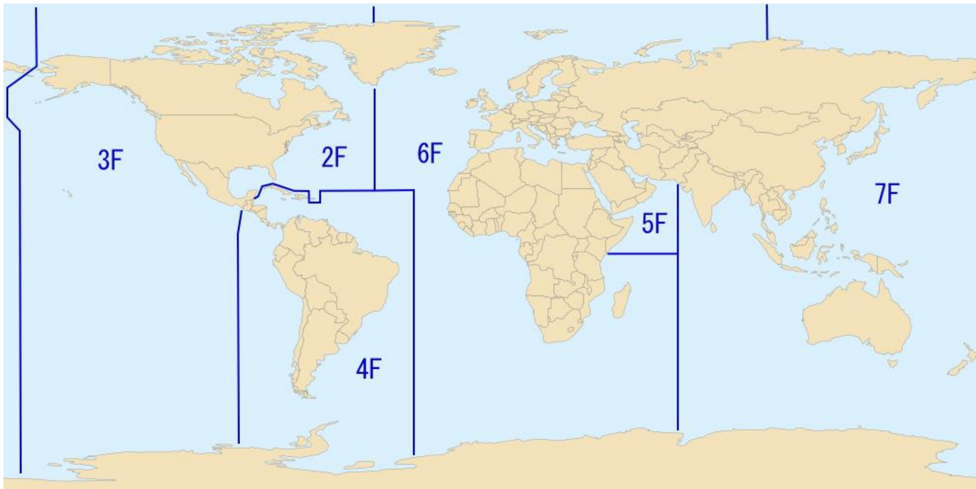
Note: CIPI is "change in private inventories." All numbers are percentage point contributions to GDP growth (SAAR).
Table does not include all forecasts for the quarter; see tab "ContribHistory" in online excel file for entire history.

FEDERAL RESERVE BANK of ATLANTA

Of the 2.8% projection, 2.7% is coming from consumption. Investment spending is negative, mostly due to a drop in inventories. Net exports are showing an impressive recovery while government continues to disappoint. The bottom line: the market's expectations are too dovish at this point and even if the FOMC doesn't want to raise rates until December, it will try to inject a degree of uncertainty into the markets.

MSCI denied the inclusion of China's A shares into its indices, which was something of a surprise. MSCI rightly pointed out that the Chinese government still has an excessive degree of involvement in the markets and capital controls make it difficult for foreign investors to pull their investments quickly. The group did say China will be considered for inclusion in 2017. This decision is a blow of sorts to the Xi regime as it seems to like international recognition for its development.

Although this development hasn't been noted widely in the news, the U.S. Navy announced it is moving vessels from the Third Fleet, based in San Diego, to the waters in the East and South China seas. As the map below shows, the Third Fleet's normal area of operations is mostly around the U.S. Apparently, the Obama administration wants to beef up U.S. presence in the Seventh Fleet's area of operation to counter increasing Chinese belligerence. This shift suggests growing tensions with China.



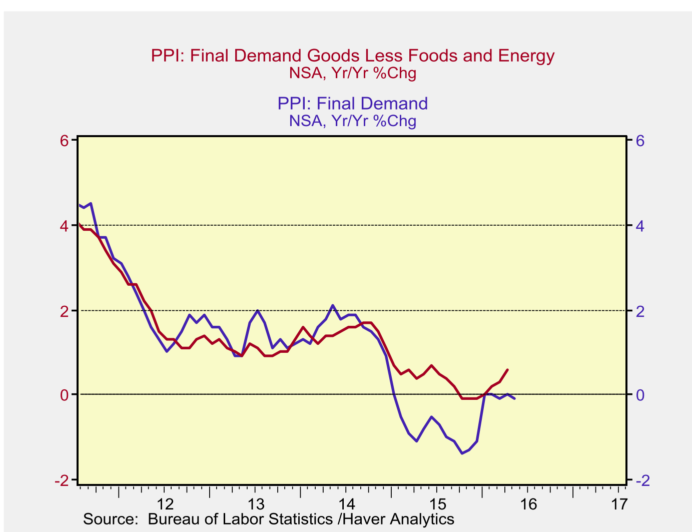
(Source: Google)

This map shows the areas of operation for six of the seven U.S. Navy Fleets. The First Fleet, which has no designation on this map, was designated as the Third Fleet in 1973. There is also a Tenth Fleet, which is in charge of Cyber Command.

U.S. Economic Releases

Industrial production came in weaker than forecast, falling 0.4% in May compared to the 0.2% decline forecast. Capacity utilization also disappointed, falling to 74.9% from 75.3% the month before and below the 75.2% level forecast.

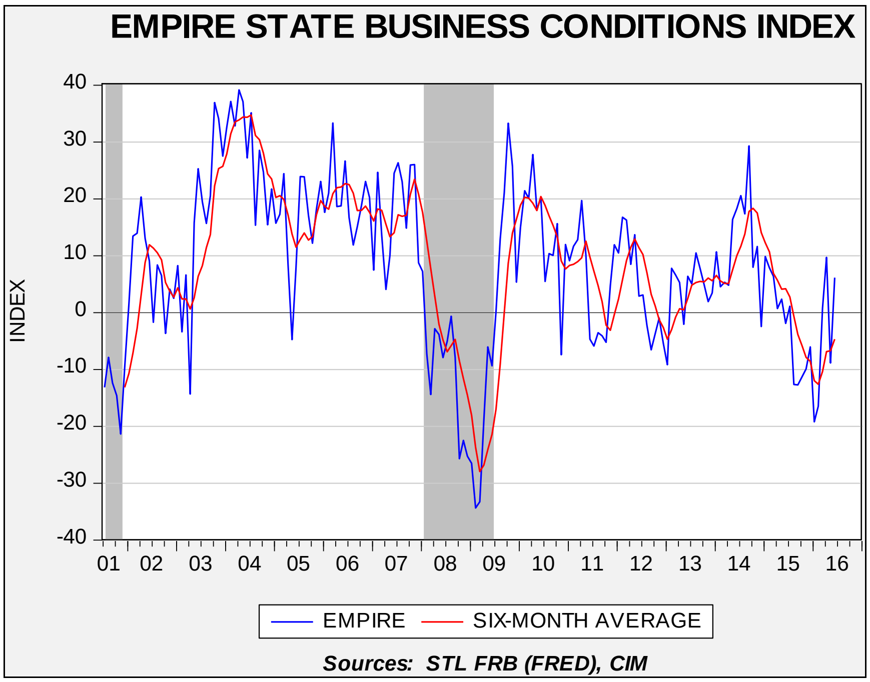
PPI rose 0.4% in May, more than the 0.3% increase forecast. Core producer prices rose 0.3%, also higher than the 0.1% increase forecast. Price increases were the strongest in energy and food sectors.



The chart above shows the annual change in the headline and core PPI. Annually, headline prices fell 0.1%, on forecast, while core prices rose 1.2%, more than the 1.0% expected.

Mortgage applications fell 2.4% for the most recent reporting week, with purchases down 4.9% and refinancing down 0.7%. Purchases are in their seasonally strong period, but data can be lumpy week to week. This week's decline followed a strong week.

Empire manufacturing came in better than forecast in June, rising to 6.0 from -9.0 the month before. Forecasts were calling for a level of -4.9. Conditions are improving for New York manufacturing.



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

Economic releases						
EST	Indicator			Expected	Prior	Rating
4:00	Total net TIC flows	m/m	Apr		-$98.3 bn	**
4:00	Net long-term TIC flows	m/m	Apr		$78.1 bn	**
Fed speakers or events						
EST	Speaker or event	District or position				
2:00	FOMC rate decision					
2:00	Summary of FOMC's economic projections					
2:30	Janet Yellen press conference	Fed Chairwoman				

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	Money supply M2	y/y	May	11.8%	12.8%	12.5%	**	Equity bearish, bond bullish
	New yuan loans (CNY)	m/m	May	985.5 bn	555.6 bn	750.0 bn	**	Equity bullish, bond bearish
Japan	Machine tool orders	y/y	May	-24.7%	-25.0%		*	Equity and bond neutral
EUROPE								
Eurozone	Trade balance	m/m	Apr	€28.0 bn	€23.7 bn	€21.5 bn	**	Equity bullish, bond bearish
France	CPI	y/y	May	0.0%	-0.1%	-0.1%	***	Equity bullish, bond bearish
U.K.	Unemployment rate	q/q	Apr	5.0%	5.1%	5.1%	***	Equity bullish, bond bearish
Russia	GDP	y/y	Q1	-1.2%	-1.2%	-1.2%	***	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)	65	66	-1	Down
3-mo T-bill yield (bps)	27	26	1	Up
TED spread (bps)	38	39	-1	Down
U.S. Libor/OIS spread (bps)	40	39	1	Up
10-yr T-note (%)	1.62	1.61	0.01	Widening
Euribor/OIS spread (bps)	-26	-26	0	Neutral
EUR/USD 3-mo swap (bps)	37	37	0	Neutral
Currencies	Direction			
dollar	down			Up
euro	up			Down
yen	down			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	$ 48.88	$ 49.83	-1.91%	API inventory report showed rising domestic stockpiles
WTI	$ 47.80	$ 48.49	-1.42%	
Natural gas	$ 2.61	$ 2.60	0.31%	Hot weather
Crack spread	$ 14.35	$ 15.13	-5.20%	
12-mo strip crack	$ 12.72	$ 13.13	-3.11%	
Ethanol rack	$ 1.83	$ 1.83	0.22%	
Metals				
Gold	$ 1,283.08	$ 1,285.72	-0.21%	Profit taking
Silver	$ 17.46	$ 17.39	0.38%	
Copper contract	$ 211.25	$ 204.05	3.53%	Falling Chinese stockpiles
Grains				
Corn contract	$ 443.50	$ 441.75	0.40%	
Wheat contract	$ 502.00	$ 497.75	0.85%	
Soybeans contract	$ 1,154.50	$ 1,149.25	0.46%	
Shipping				
Baltic Dry Freight	608	609	-1	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.1		
Gasoline (mb)		-0.4		
Distillates (mb)		0.0		
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

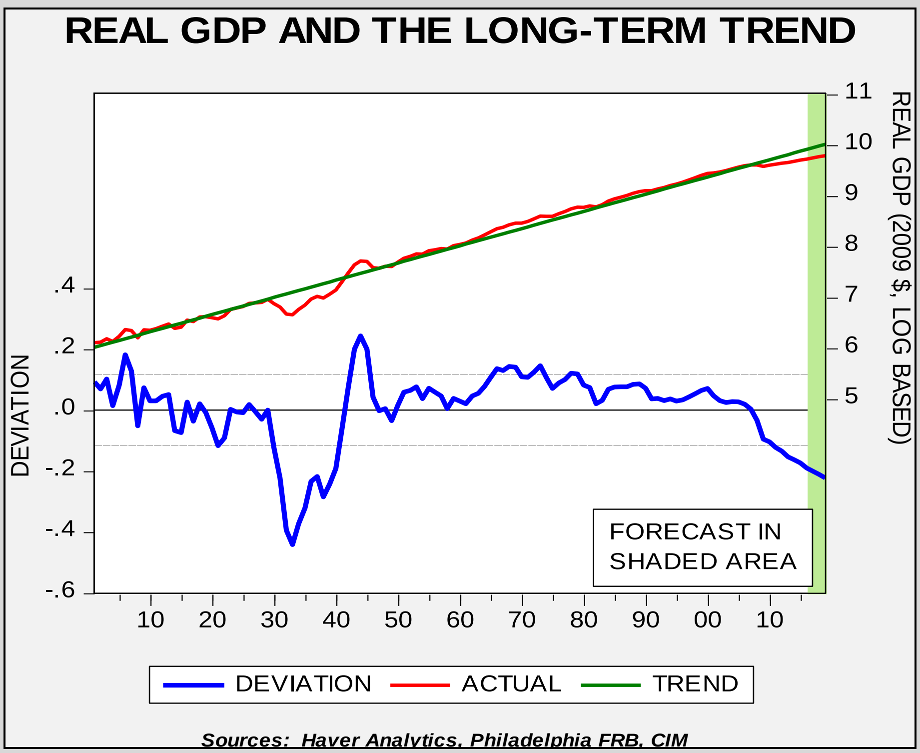
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

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.

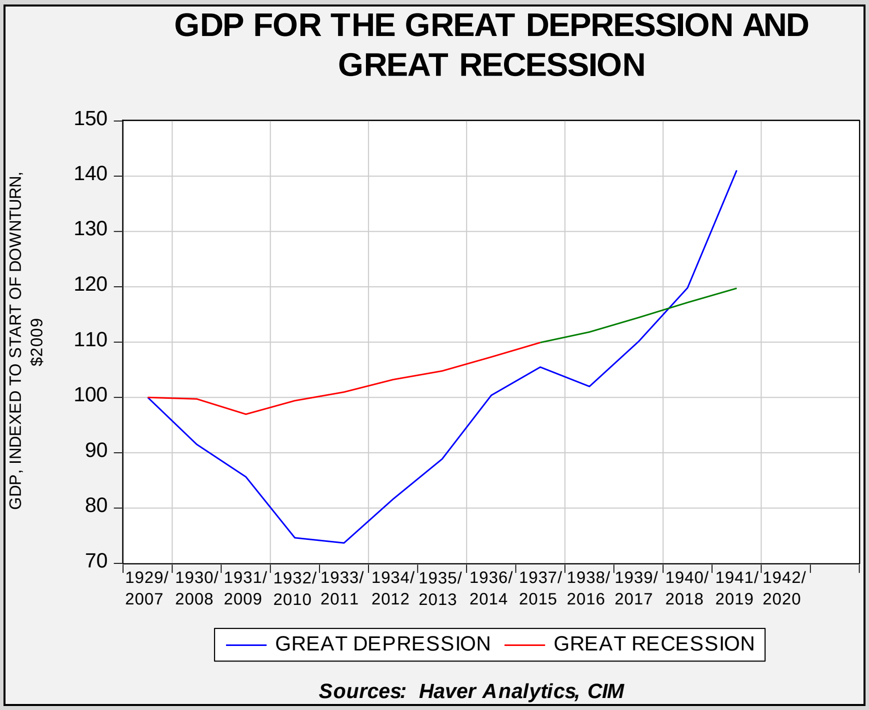
However, this does not mean that longer term cycles are not important. We view these longer term cycles as the overall market environment. These factors include the geopolitical environment (especially related to the U.S. superpower role), inflation policy (which tends to last decades), debt cycles (which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

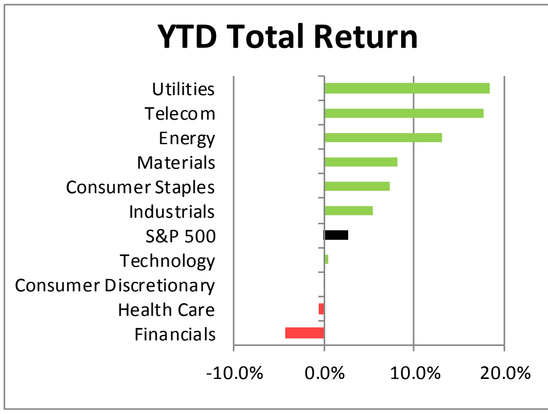


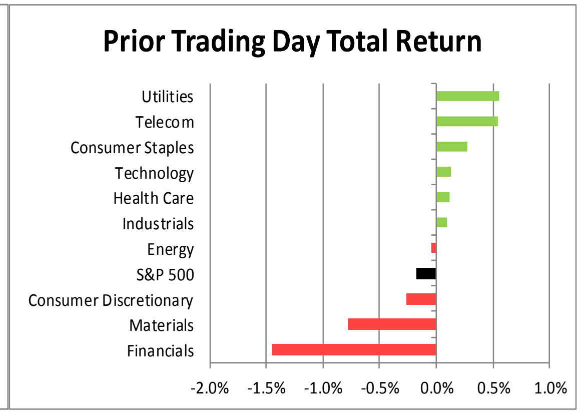
On this chart, we have indexed the level of real GDP beginning in 1929 and 2007. In the Great Depression (shown as the blue line), GDP dropped by nearly 25% at the trough; in the Great Recession, the decline was a little over 3% (with the actual data shown in red, and the forecast in green). However, 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 6/14/2016 close)

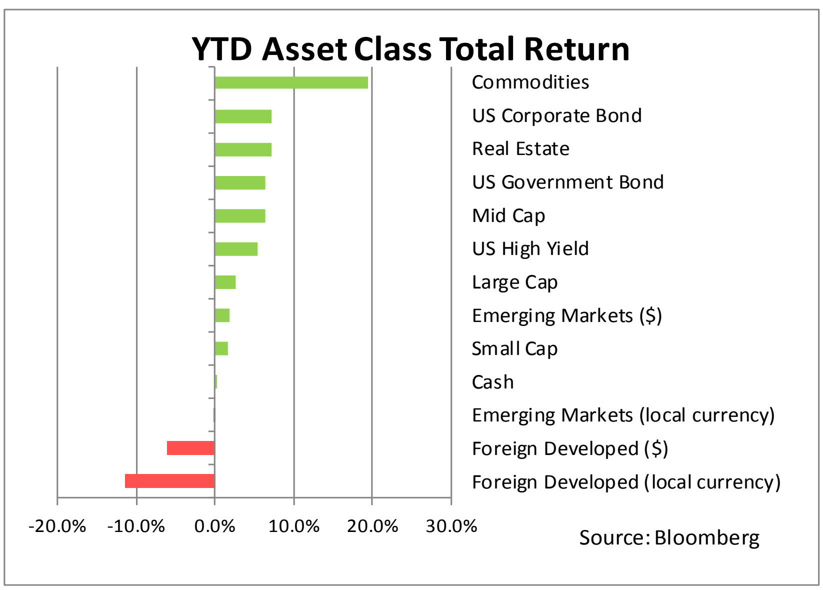




(Source: Bloomberg)

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 6/14/2016 close)

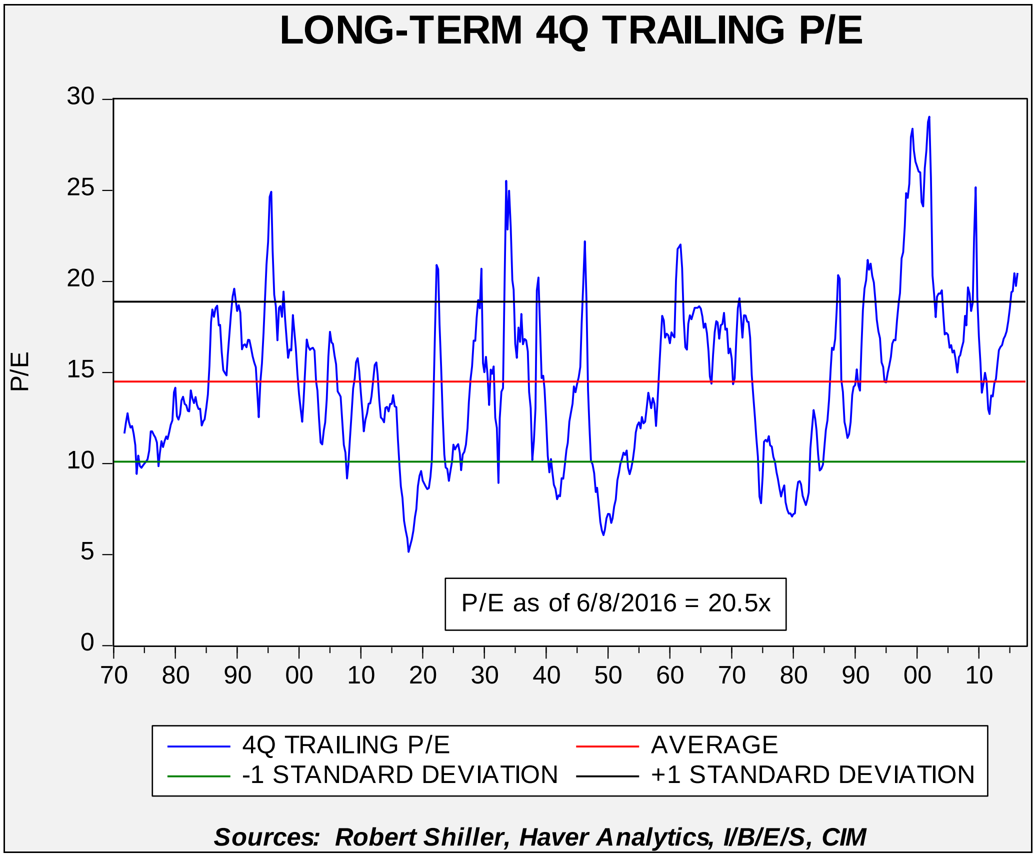


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.