Daily Comment

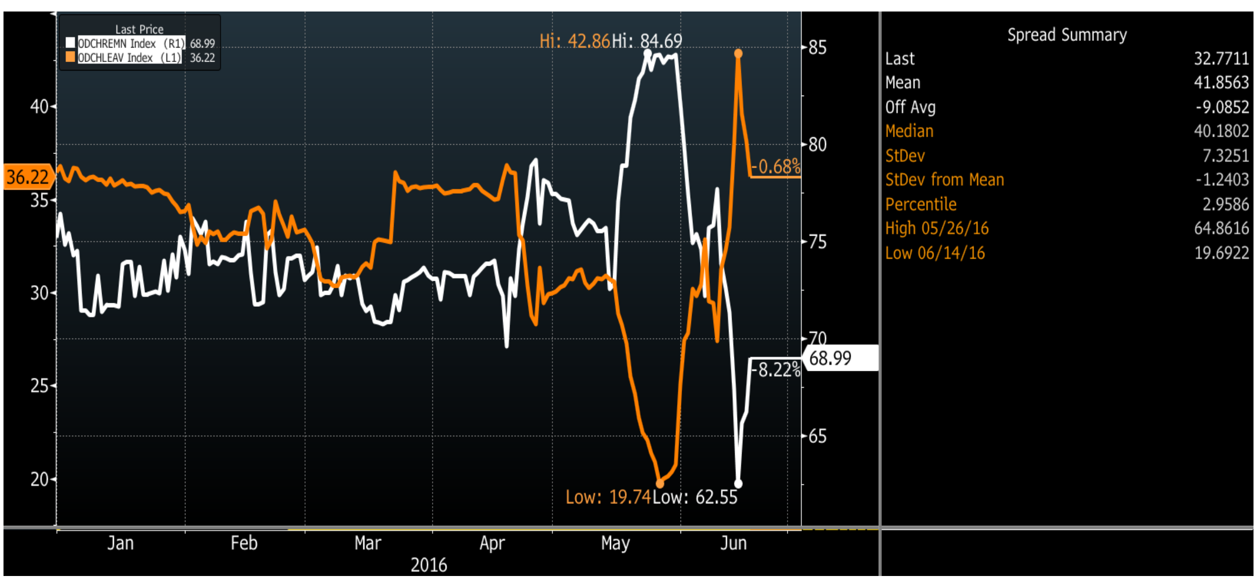
By Bill O'Grady & Kaisa Stucke, CFA

[Posted: June 17, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading higher by 1.2% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 0.4% from the prior close. Chinese markets were also higher, with the Shanghai composite trading up 0.4% and the Shenzhen index higher by 0.8%. U.S. equity futures are signaling a lower opening from the previous close. With 99.8% of the S&P 500 companies having reported, Q1 float-adjusted earnings stand at $26.80, more than the $26.66 forecast. Of the 499 companies that have reported, 72.3% had positive earnings surprises, while 20.2% had negative earnings surprises.

There are three big stories today.

Jo Cox, martyr: MP Jo Cox was brutally assassinated yesterday while campaigning for the "remain" vote in Leeds, England yesterday. A Labor MP and a rising star in the party, she was attacked while leaving a meeting with constituents. According to British media, Thomas Mair has been accused of the murder and is in custody. The Southern Poverty Law Center reports that Mair is a supporter of the National Alliance, a neo-Nazi organization based in the U.S. Media reports suggest his support may not have extended beyond purchasing printed materials from the group. Mair's brother claims Thomas has a history of mental illness.

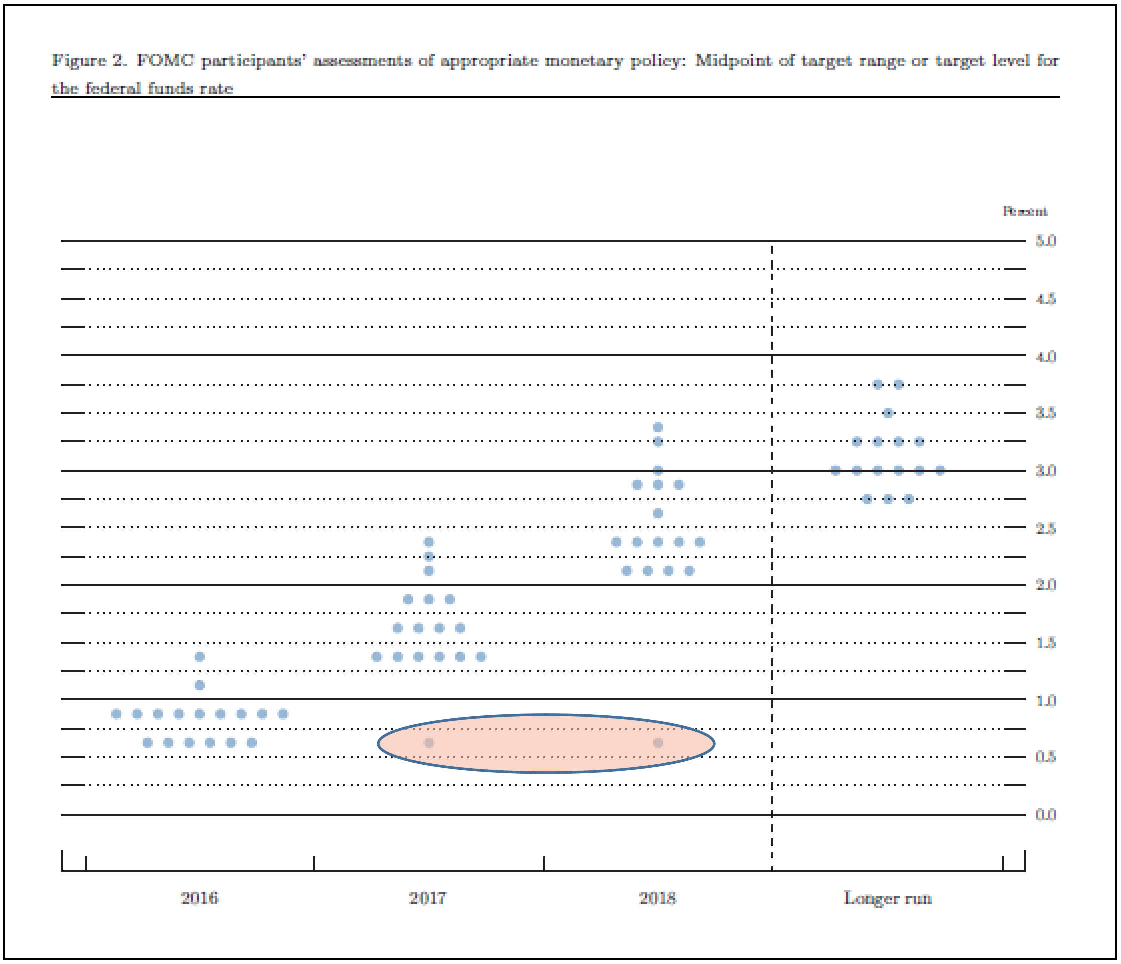
In the wake of this attack, both sides have suspended their campaigns. There are no post-assassination polls. However, markets never sleep and the betting pools show a decided drop in Brexit support.



(Source: Bloomberg)

The white line shows "Bremain" betting, which bounced to nearly 69% after falling to a low of 62.5%. The orange line, the "Brexit" bet, has clearly declined, falling from nearly 45% to 36%. Although we won't know with certainty for a week, the tragedy clearly broke the Brexit momentum and we suspect this may shock U.K. voters into voting to stay in the EU simply because the Brexit campaign will probably not be able to rid itself from this assassination. If we are correct, risk markets should get a relief rally after the vote; in fact, it may begin in anticipation of a Bremain victory.

Bullard outs himself: Yesterday, we noted that there was a stray dot on the Fed's dot chart that was clearly an outlier. We assumed it was one of the well-known doves. We were wrong. To recap, here is the chart:



The red oval contains two dots that show no further rate increases after this year. In a paper released today, STL FRB President Bullard revealed his dots were the ones in the oval and his paper explained his position. The summary of his thoughts are simple, but profound. Instead of viewing the economy as having a long-term structural equilibrium, Bullard argues that there are a series of medium- to long-term "regimes." These regimes, although not necessarily permanent, are persistent and thus policy should be shaped to the regime and not some theoretical equilibrium. The other important point is ***that regimes themselves are not forecastable***. In other words, Bullard will assume a regime in place will stay in place until there is clear evidence of change. The current regime is characterized by real GDP growth of about 2%, unemployment around the current level of 4.7% and inflation in the area of 2% (using the Dallas FRB trimmed mean CPI). This implies that productivity will likely remain low and, due primarily to abnormally large liquidity premium on safe assets, fixed income returns will be low, as will interest rates. He also assumes no recession on the horizon.

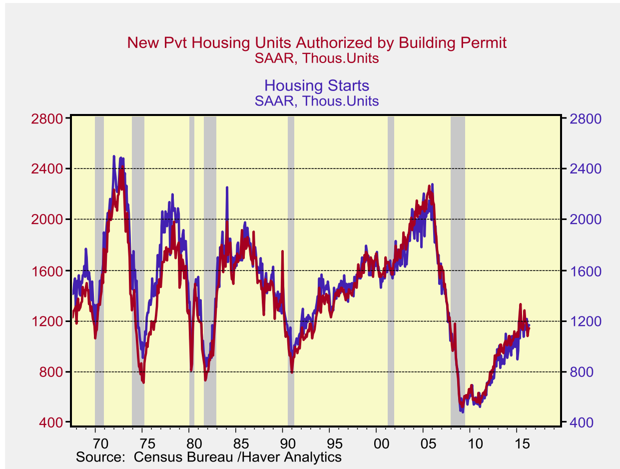
What does this mean? Assuming this regime stays in place, Bullard believes that the proper fed funds rate is 63 bps, suggesting a target range of 50-75 bps for fed funds. ***By design, if policymakers adopt the Bullard model, monetary policy will no longer be anticipatory, but will always lag its goals.*** This is probably a more honest approach to policy but one we suspect will be rejected by the other 16 members of the FOMC or any future governors (there are two unfilled seats on the FOMC). Why? Because adopting this policy will undermine the "oracle" image that the Fed tries to project. In other words, there will be no more "maestros." The problem for Bullard's policy model will be at the point of regime change—when regimes change, the Fed will be playing "catch up" to the new regime which will probably require aggressive moves. Understanding the new regime when an old one is going away will take time. On the other hand, Bullard's program will end much of the speculation on policy; note that Bullard's dots mostly follow the Eurodollar futures market. In effect, the financial markets will likely set rates (which they really do anyway).

Expect a heated debate on Bullard's paper. Although the Fed may press against his model, in practice, his scheme is really how it tends to behave. If adopted, it will tend to change the narratives around monetary policy and make them less confusing.

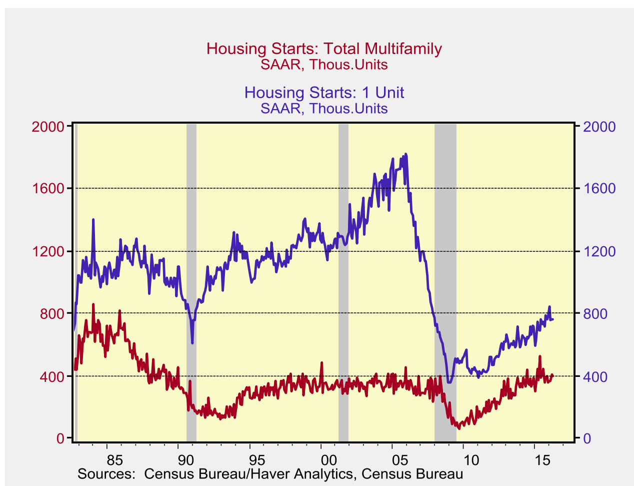
Japan's cries for help: Japanese policymakers are calling for G-7 assistance in halting the JPY's strength. FM Taro Aso remarked today that he was deeply concerned about the "one-sided, rapid and speculative" currency moves and hinted at intervention. We doubt Japan will get much sympathy from the rest of the group but that may not stop Japan from intervention. Unfortunately, in the absence of joint intervention, simply buying currency to weaken the JPY won't have a lasting impact unless it is tied to other policies, e.g., "helicopter money." Still, Japan is warning the financial markets that it is ready to act.

U.S. Economic Releases

Housing starts fell 0.3% in the month of May compared to the 1.9% decline forecast. Permits rose 0.7%, below the 1.3% increase forecast.



The chart above shows the long-term trend in the level of starts and permits. Both have generally trended sideways over the past year, although we have seen some very strong monthly data in starts over the same time period.



The chart above shows the level of single- and multi-family starts. Single-family starts rose 0.3% in May to 764k, while multi-family starts fell 1.2% to 400k. We have seen a general pick-up in single-family homes as the labor market improves and wages start to rise.

There are no other releases scheduled for the rest of the day.

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								
India	Current account balance	m/m	Q1	-$0.3 bn	-$7.1 bn	-$1.8 bn	**	Equity bullish, bond bearish
EUROPE								
Eurozone	Current account balance	m/m	Q1	€36.2 bn	€26.3 bn		**	Equity bullish, bond bearish
	Labor costs	y/y	Q1	1.7%	1.3%		**	Equity bullish, bond bearish
France	Wages	q/q	Q1	0.5%	0.5%	0.5%	**	Equity and bond neutral
AMERICAS								
Canada	CPI	y/y	May	1.5%	1.7%	1.6%	***	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	65	1	Up
3-mo T-bill yield (bps)	25	25	0	Neutral
TED spread (bps)	41	40	1	Up
U.S. Libor/OIS spread (bps)	38	38	0	Neutral
10-yr T-note (%)	1.59	1.58	0.01	Widening
Euribor/OIS spread (bps)	-26	-26	0	Neutral
EUR/USD 3-mo swap (bps)	37	39	-2	Down
Currencies	**Direction**			
dollar	down			Up
euro	up			Down
yen	down			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	$ 48.50	$ 47.19	2.78%	Lower dollar
WTI	$ 47.32	$ 46.21	2.40%	
Natural gas	$ 2.58	$ 2.58	0.08%	Hot weather
Crack spread	$ 15.30	$ 14.74	3.79%	
12-mo strip crack	$ 13.16	$ 12.82	2.67%	
Ethanol rack	$ 1.81	$ 1.82	-0.28%	
Metals				
Gold	$ 1,289.47	$ 1,278.43	0.86%	Lower dollar
Silver	$ 17.44	$ 17.19	1.41%	
Copper contract	$ 205.75	$ 204.80	0.46%	
Grains				
Corn contract	$ 434.00	$ 430.50	0.81%	
Wheat contract	$ 490.50	$ 484.75	1.19%	
Soybeans contract	$ 1,133.75	$ 1,119.25	1.30%	
Shipping				
Baltic Dry Freight	598	604	-6	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)	-0.9	-2.1	1.2	
Gasoline (mb)	-2.6	-0.4	-2.2	
Distillates (mb)	-0.8	0.0	-0.8	
Refinery run rates (%)	-0.7%	0.4%	-1.1%	
Natural gas (bcf)	69.0	66.0	3.0	

Weather

The 6-10 and 8-14 day forecasts are calling for hotter and drier than normal conditions for the majority of the country, except for parts of the eastern region. There is a small low-pressure area in the Gulf of Mexico, but this development has a low chance of becoming a cyclone over the next two days.

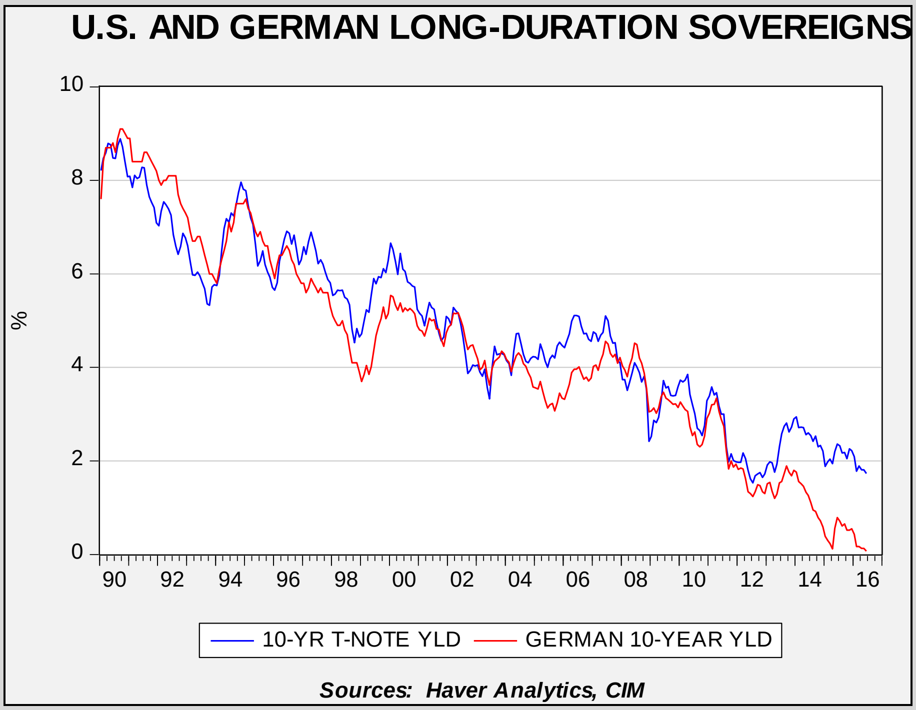
Weekly Asset Allocation Commentary

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 17, 2016

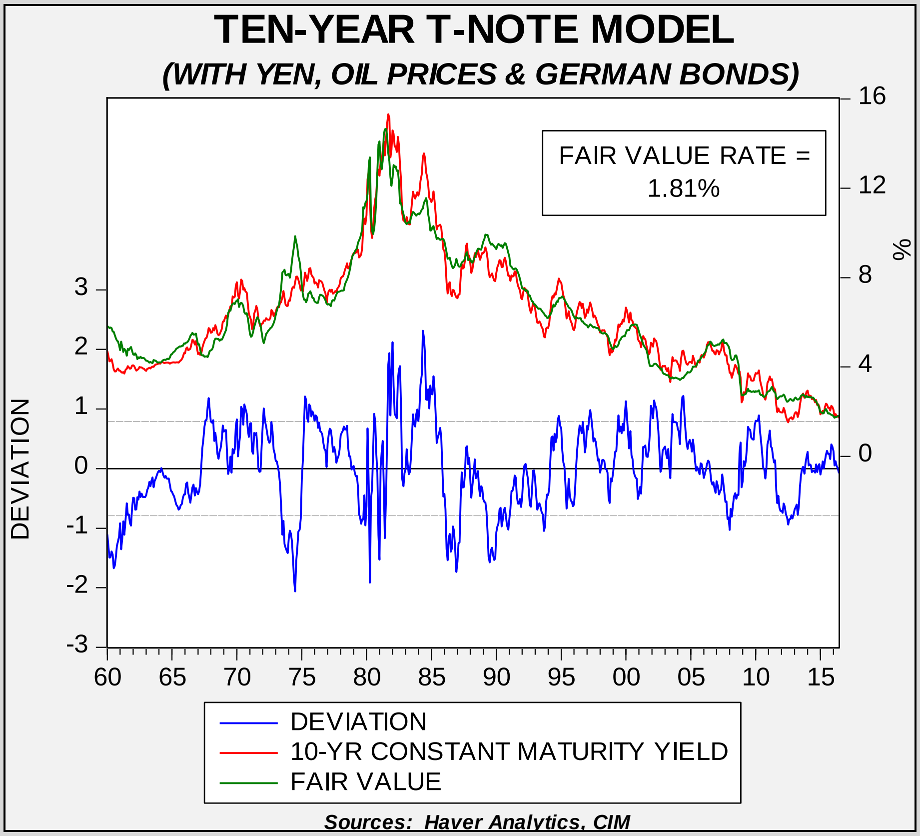
Our asset allocation process has generally favored longer duration fixed income instruments. We have expected inflation to remain low due to continued globalization and deregulation. Over time, low inflation brings low long-term interest rates. In recent weeks, domestic long-term interest rates have declined significantly. Although this isn't a huge surprise to us, the factors behind the decline are worth examining.

Currently, the biggest factor affecting U.S. interest rates is probably the drop in international yields.



This chart shows U.S. and German 10-year sovereign yields since 1990. The current spread is very wide; German yields have recently dipped below zero. Why are German yields declining? In part, low Eurozone inflation is to blame. Despite aggressively accommodative monetary policy from the ECB, inflation remains very low. Second, the ECB is conducting quantitative easing (QE) and has extended its purchases to include corporate bonds. Given that German bonds are the preferred choice for European investors seeking safety, the lack of available bonds for QE has pushed German yields to historically low levels.

However, it should be noted that other factors are not quite so bullish for U.S. Treasuries.

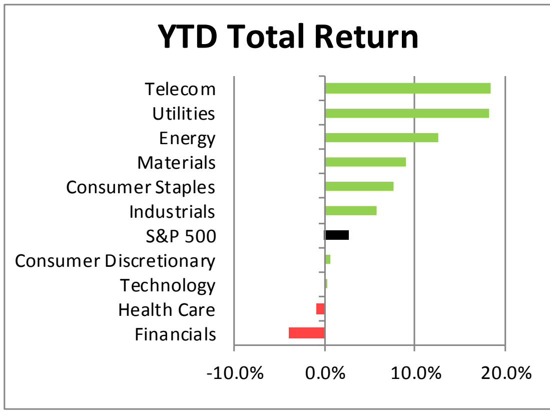


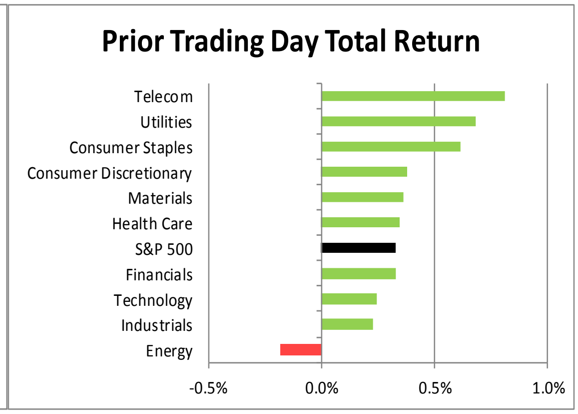
This chart shows our basic 10-year T-note yield model. It uses fed funds, an inflation trend proxy, oil prices, the yen's exchange rate and German sovereign yields. The lift in fed funds and higher oil prices are factors that raise the fair value yield and so, the current fair value yield is a bit higher than the current yield.

This model suggests that the fixed income markets may be overestimating the impact of falling overseas interest rates. That doesn't necessarily mean that our fixed income strategy will change significantly. At present, although the yield is somewhat overvalued, it isn't so low as to signal an overvalued market. The lower line on the graph, which shows the deviation between fair value and current yields, is just a bit below that level. Based on current fundamentals, the 10-year T-note would become overvalued at a yield of 1.10%. Thus, barring some significant change in the data, there is no reason to adjust our current allocation position.

Data Section

U.S. Equity Markets – (as of 6/16/2016 close)

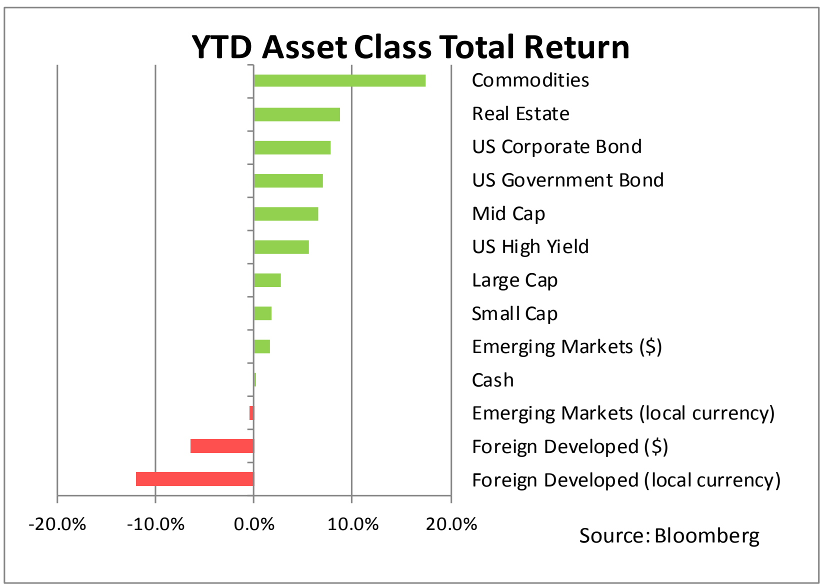




(Source: Bloomberg)

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 6/16/2016 close)

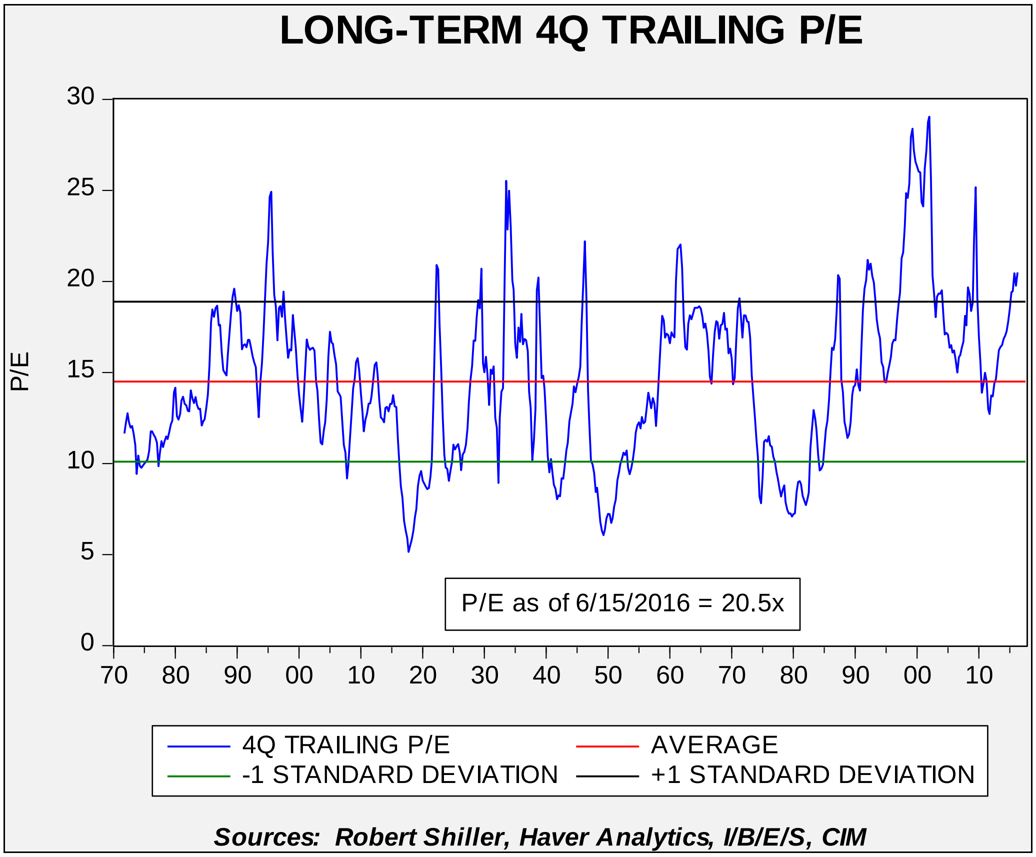


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 16, 2016



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.