Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: June 24, 2016—9:30 AM EDT] Global equity markets are sharply lower this morning. The EuroStoxx 50 is trading lower by 9.0% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 0.3% from the prior close. Chinese markets were lower, with the Shanghai composite trading down 1.3% and the Shenzhen index down by 0.8%. U.S. equity futures are signaling a sharply lower opening from the previous close.

In a major shock, U.K. voters chose to exit the EU in yesterday's referendum. The vote, which ran roughly 52/48 in favor of Brexit, defied polls and, for the first time in our experience, the betting pools as well. In the U.K., this is the second straight polling miss; pollsters also missed the Labour loss in the last elections. As expected, PM Cameron, who promised a referendum to quell a backbencher revolt, resigned. His political ploy clearly backfired. One half of our macro team, Kaisa, is in London this week. The mood on the ground there is calm, but confused. Many voters felt that they did not have enough details to make an informed decision. The turnout for the referendum was the highest in any U.K. election since 1992. England and Wales voted strongly in favor of leaving, while Scotland and Northern Ireland voted for remaining in the EU.

It will take some months to completely determine what this historic vote means, but here are our initial thoughts:

Financial and commodity markets: As one would expect, market volatility is historic. Part of the reason for the massive volatility is that the markets were surprised by the outcome. With polls mostly leaning toward remain going into the vote, we had seen a rather impressive rally in the GBP and global equities over the past few days. So, with the unexpected outcome, reverse market action is accentuated. Flight to safety instruments have all rallied strongly. Treasury yields plunged across the board, with the 10-year T-note dipping under 1.50%. Perhaps even more shocking, the two-year T-note fell over 20 bps, approaching the 56 bps level. This T-note is very sensitive to Fed policy and the plunge in yield suggests that no tightening will occur for the rest of the year and perhaps longer. The JPY penetrated the 100 ¥/$ rate and it appears the BOJ did intervene to prevent further strength. Gold prices have soared, with the nearby futures price hitting $1,362.60, a rise of nearly $100 per ounce. The rise in gold occurred despite a strong dollar. On the flip side, global equities are all lower, with most major markets off around 7%. Bank stocks were especially vulnerable, with most dropping double digits. Outside of gold, most commodity prices are lower, with oil down over $3.00 per barrel at the lows. The GBP fell below $1.3300.

In the ensuing hours, we have seen markets stabilize and, in most cases, they have lifted off their worst levels of the overnight session. However, thus far, we haven't seen anything that would suggest a recovery is in the offing. Going into 2016, there were two major concerns, Fed tightening and Brexit. The first concern is now off the board, but the second, unfortunately, has occurred. The BOE has already indicated it will take steps to stabilize markets but there will be limits to what it can do. Usually, major market dislocations such as this one tend to create buying opportunities; we suspect this one will as well, but it will take a few days to sort out where we go forward.

The question of Europe: The EU and the U.K. will begin the process of splitting up. The official process creates a two-year period where negotiations take place for exit. Thus, nothing happens immediately. We suspect EU officials have two goals; first, they want to quell panic, and second, they want to greatly punish the U.K. for its actions to make it abundantly clear to the remaining members of the EU that exiting isn't a viable option. Already, EU officials have indicated that there will be no further concessions made to the U.K. Unfortunately for the EU, the populist trend appears to be gaining strength and other nations in the EU are going to consider an exit. Already, Geert Wilders, a right-wing populist political leader in the Netherlands, applauded the British outcome and suggested his nation should consider a referendum as well. Scottish leaders have indicated that Scotland will be exploring its options, which may include devolution.

An EU without the U.K. will become more German-centric. France will struggle to dilute German dominance. As we noted in last week's WGR, the entire EU project is now in question. The goal of the EU was to offer peace and prosperity as an alternative to nationalism. When the Soviet Union was a threat and the U.S. was willing to fund European security, the EU worked reasonably well. But, absent the communist peril, with the U.S. less interested in Europe and with prosperity lagging for the masses, nationalism is gaining strength. Although we don't expect Europe to become a threat to global security for the foreseeable future, one cannot fully discount history. Simply put, we have seen two world wars spawned by European nationalism. If it returns, it is reasonable to expect that this threat will return. Again, this isn't an immediate concern but the risks will rise over the next two decades.

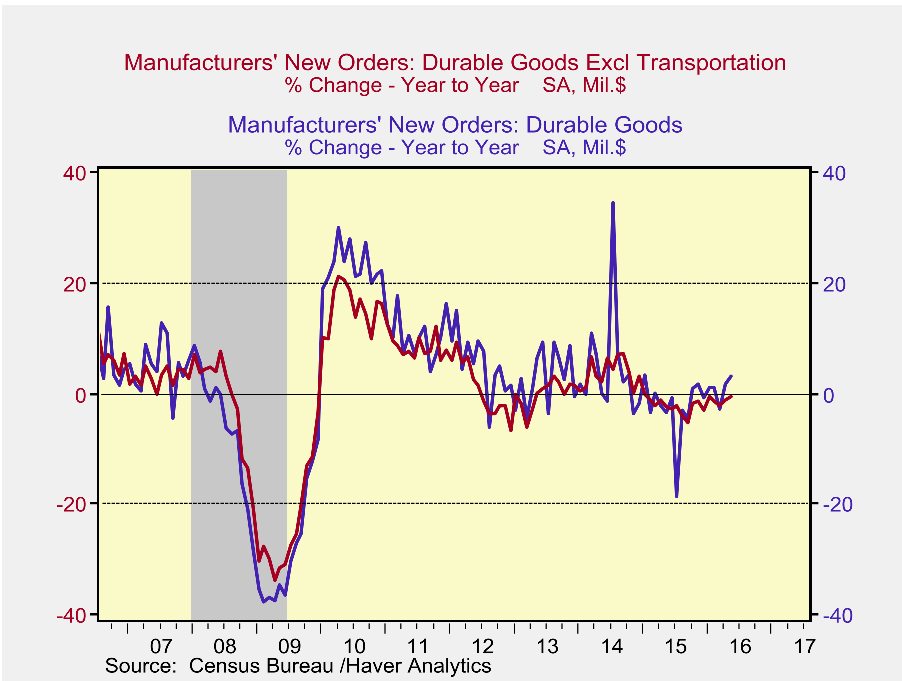
The growing threat of populism: We have been discussing this issue for some time. Sluggish economic growth and widening income inequality has led to a growing backlash against globalization and deregulation. Numerous right- and left-wing populist movements have been rising in Europe and the remarkable primary campaigns of Donald Trump and Bernie Sanders show that similar sentiment is occurring here as well. At heart, populism is anti-globalization and, at some point, will also push for protective regulation. Such policies threaten price stability and, if implemented, will lead to inflation.

The fact that the polls and betting pools in the U.K. completely missed this outcome suggests that populism is growing. Think of it this way: although there were no official exit polls in the referendum, there were a couple private ones that were calling for remain to win 52/48. So, how does this happen? Assuming that there was a random sample, the only explanation is that responders probably lied to poll takers. In other words, people may say they deplore populist positions, but in the voting booth they are voting for populism. If we are correct, it means that pollsters and the elites are greatly underestimating the strength of populism. The European establishment has been left looking very much like the Republican establishment in the wake of Trump's primary campaign: befuddled and completely wrong about the public's passions. It also means that the polls here may be underestimating the impact of the Trump general election campaign. Historians may pinpoint yesterday's referendum as the turning point where globalization began its retreat.

We will have more on this issue in the coming weeks. For now, expect markets to remain under pressure. **We would not expect this event to trigger a recession in the U.S.**, but we are confident that U.S. monetary policy will not tighten further this year.

U.S. Economic Releases

Durable goods orders came in weaker than expected in May, falling 2.2% for the month compared to the 0.5% decline expected. Orders excluding transportation also disappointed, falling 0.3% compared to the 0.1% increase expected. Nondefense capital goods orders excluding aircraft orders, a proxy for planned business investment, fell 0.7% from the month before, also lower than the 0.4% increase expected.



The chart above shows the annual change in the headline orders and orders excluding transportation. Annually, the headline orders are still trending higher despite the slowing pace of growth. Orders excluding transportation are still below zero from their level a year ago, but they are improving.

The table below shows the rest of today's data and notable Fed speakers.

Economic releases						
EST	Indicator			Expected	Prior	Rating
10:00	University of Michigan sentiment	m/m	June	94.1	94.3	**

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
EUROPE								
France	GDP	y/y	Q1	1.3%	1.4%	1.4%	***	Equity bearish, bond bullish
Germany	IFO busines climate	m/m	Jun	108.7	107.8	107.4	**	Equity bullish, bond bearish
	IFO current assessment	m/m	Jun	114.5	114.2	114.0	**	Equity bullish, bond bearish
	IFO expectations	m/m	Jun	103.1	101.7	101.2	**	Equity bullish, bond bearish

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)	64	64	0	Neutral
3-mo T-bill yield (bps)	23	28	-5	Down
TED spread (bps)	41	36	5	Up
U.S. Libor/OIS spread (bps)	34	39	-5	Down
10-yr T-note (%)	1.52	1.75	-0.23	Narrowing
Euribor/OIS spread (bps)	-27	-27	0	Neutral
EUR/USD 3-mo swap (bps)	60	36	24	Up
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	up			Up
franc	down			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	Cause/ Trend
Energy markets				
Brent	$ 48.36	$ 50.91	-5.01%	Brexit vote affecting risk markets
WTI	$ 47.71	$ 50.11	-4.79%	
Natural gas	$ 2.67	$ 2.70	-1.22%	
Crack spread	$ 16.02	$ 16.46	-2.67%	
12-mo strip crack	$ 13.38	$ 13.62	-1.81%	
Ethanol rack	$ 1.78	$ 1.78	-0.22%	
Metals				
Gold	$ 1,322.40	$ 1,256.84	5.22%	Investment demand
Silver	$ 17.96	$ 17.29	3.88%	
Copper contract	$ 211.50	$ 216.55	-2.33%	
Grains				
Corn contract	$ 384.75	$ 392.50	-1.97%	Trading down with equity markets
Wheat contract	$ 460.00	$ 465.75	-1.23%	
Soybeans contract	$ 1,087.00	$ 1,101.50	-1.32%	
Shipping				
Baltic Dry Freight	596	585	11	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)	-0.9	-1.5	0.6	
Gasoline (mb)	0.6	-1.0	1.6	
Distillates (mb)	0.1	1.0	-0.9	
Refinery run rates (%)	1.1%	0.6%	0.0	
Natural gas (bcf)	62.0	60.0	2.0	

Weather

The 6-10 and 8-14 day forecasts are calling for hotter and drier than normal conditions for the West, while the mid-central states will enjoy below-normal temperatures. There is a tropical disturbance near the coast of Belize; if it moves away from land, the National Hurricane Center estimates a 10% chance of development.

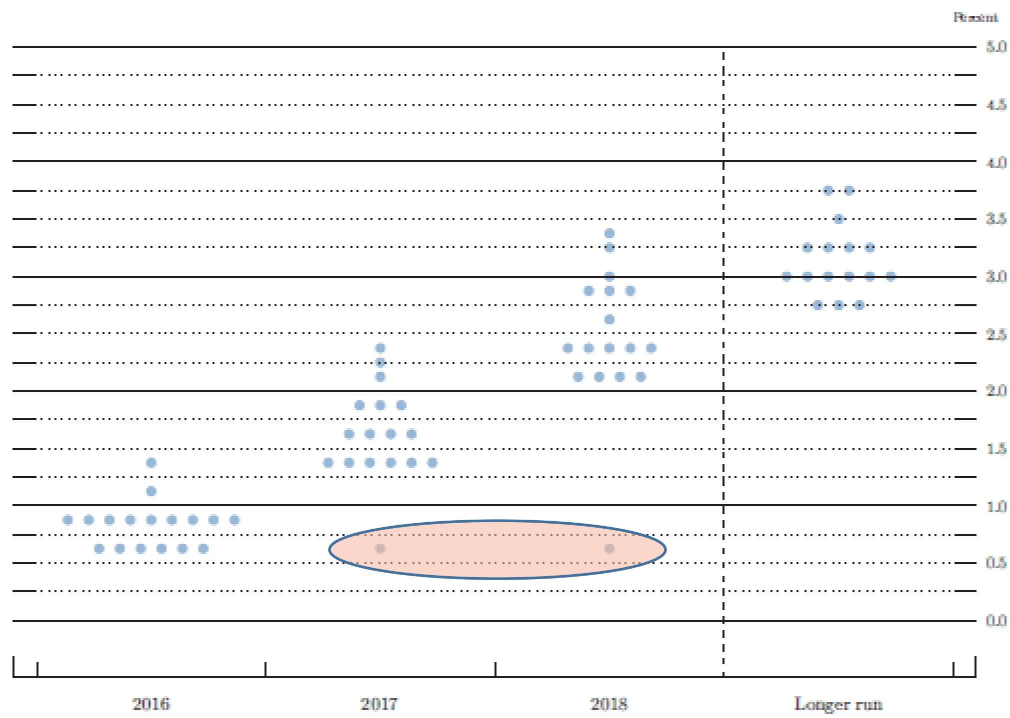
Weekly Asset Allocation Commentary

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 24, 2016

Last week, St. Louis FRB President Bullard issued a position paper that represents a significant departure from what has been standard policy at the Federal Reserve. Our first hint that something had changed was noticed in the dots chart. First, there were two dots that indicated no change in policy in 2017 and 2018. Second, there were only 16 forecasts for the "longer run." The unexpectedly low dots, shown below in the oval, were initially thought to be attributed to the known dovish members of the committee, such as Governor Brainard or Chicago FRB President Evans. However, as part of the aforementioned paper, St. Louis FRB President Bullard "outed" himself as the lower dots.

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



Bullard argues that instead of viewing the economy as having a long-term structural equilibrium, there are a series of medium- to long-term "regimes." These regimes, although not necessarily permanent, are persistent, and thus monetary 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 assumes 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 premiums on safe assets, fixed income returns will be low, as will interest rates. He also assumes no recession on the horizon.

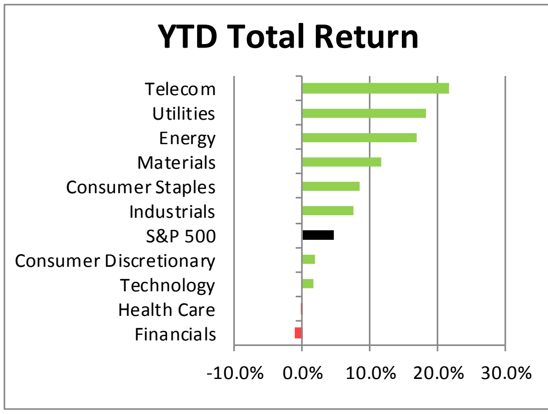
What does this mean? Assuming the current regime stays in place, Bullard believes that the proper fed funds rate is 63 bps, suggesting a target range of 50-75 bps for fed funds, or a single rate hike for the next two years. ***By design, if policymakers adopt the Bullard model, monetary policy will no longer be anticipatory, but will be adaptive to condition changes with a lag.*** 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 moniker given to Chairman Greenspan.

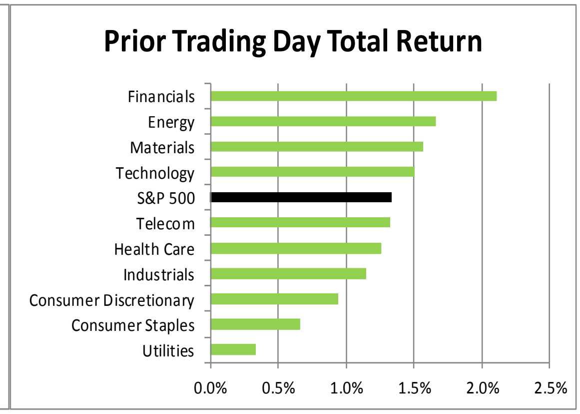
The problem with Bullard's policy model will be at the point of regime change—when regimes change, the Fed will be playing catch up to the new regime which will probably require aggressive moves. Understanding the new regime during its transition will take time. On the other hand, Bullard's program will 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).

We would expect heated debates on Bullard's position. First, it undermines the whole Taylor Rule/Phillips Curve model narrative. This model is one of the important tools the FOMC uses in setting policy. Bullard's notion of regimes could allow for the Taylor Rule to be used but would likely argue that its parameters would change based upon regime conditions. Second, by design, when regimes change, major adjustments in interest rates are likely. The Fed seems to want to avoid major moves, although this is probably impossible in practice. Third, losing the oracle image carries risks in that there would be constant speculation on whether or not the current regime is in danger of ending. If markets become convinced that the parameters of policy are fluid, it would add another layer of uncertainty. For a FOMC that prizes transparency, this move would be difficult. Finally, the dots chart becomes irrelevant because it can only be trusted as long as the current regime is maintained. We will be watching carefully to see how much support Bullard receives for his position. We suspect he will be mostly alone. However, if Bullard's position gains traction, the fixation on the Fed should wane over time which is probably a healthy long-term development.

Data Section

U.S. Equity Markets – (as of 6/23/2016 close)

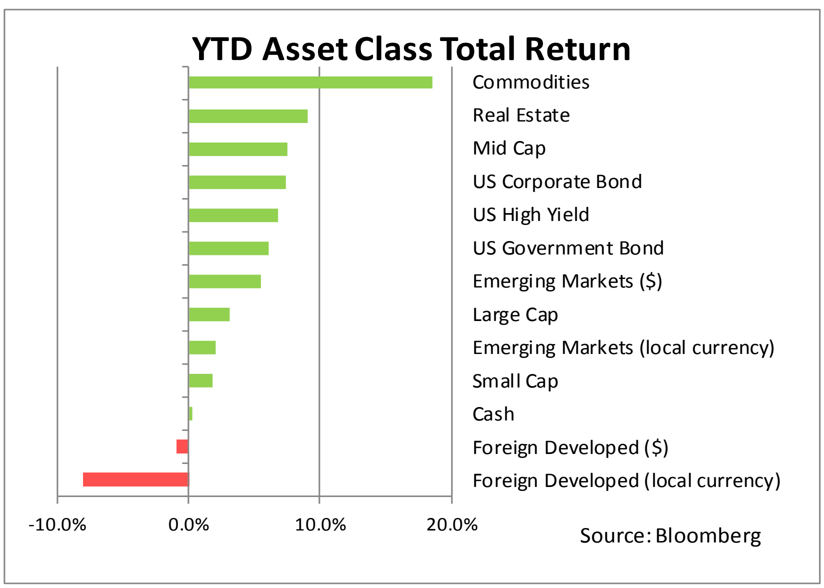




(Source: Bloomberg)

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 6/23/2016 close)

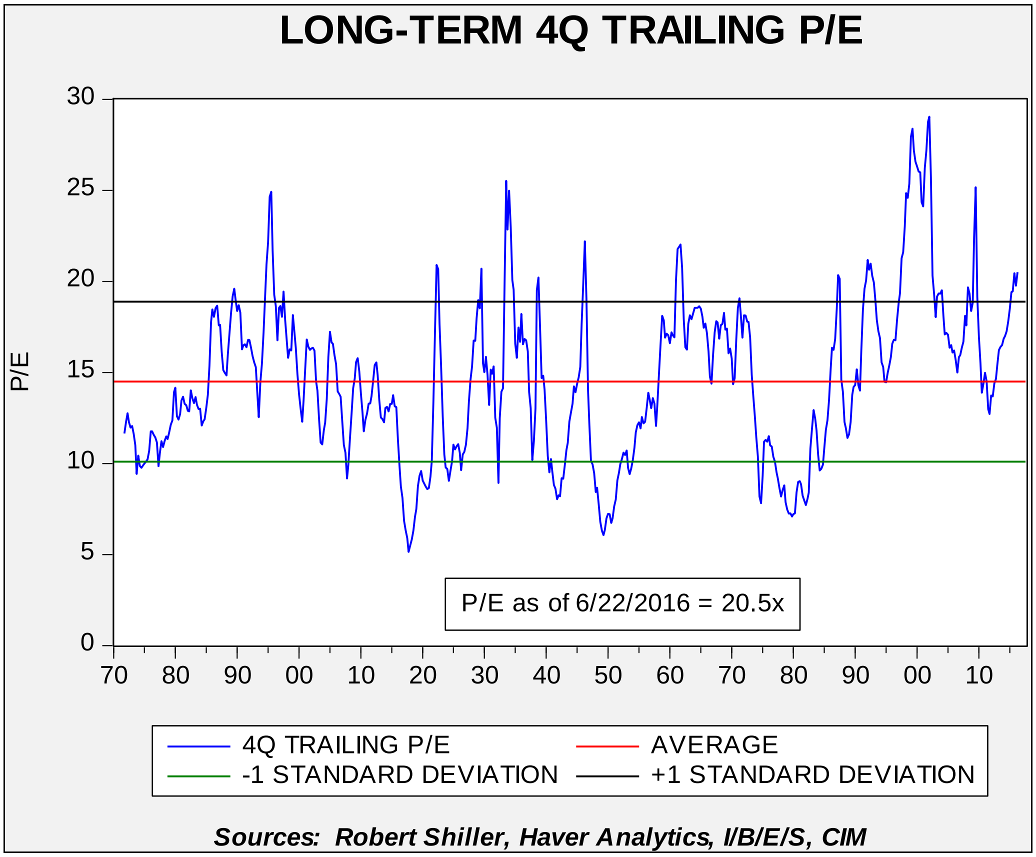


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 23, 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.