

[Posted: June 2, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading lower by 0.1% 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 1.0%. U.S. equity futures are signaling a lower opening from the previous close. With 98.6% of the S&P 500 companies having reported, Q1 float-adjusted earnings stand at \$26.79, more than the \$26.66 forecast. Of the 493 companies that have reported, 72.4% had positive earnings surprises, while 20.1% had negative earnings surprises.

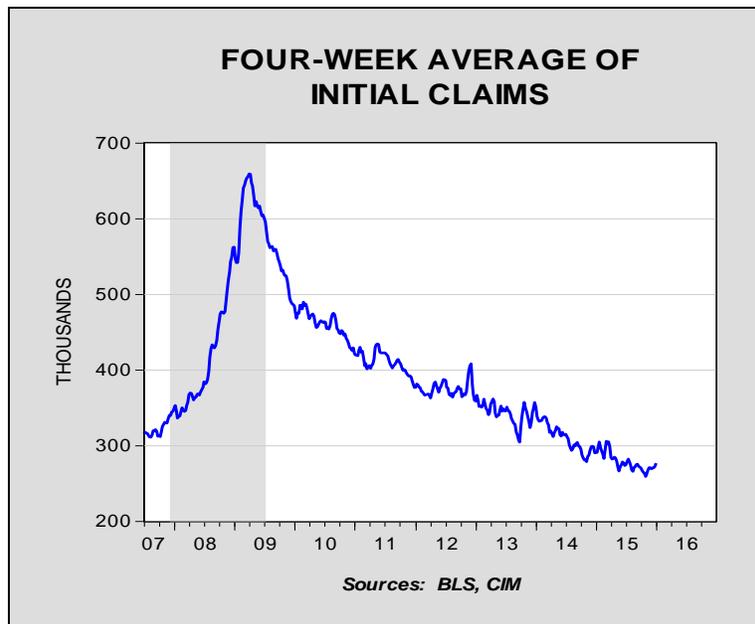
At the time of this writing, ECB President Mario Draghi is holding his press conference. The ECB did give the markets a modest surprise by announcing it will begin buying corporate bonds almost immediately. Policy will remain easy. The EUR has weakened during his comments.

At the Geneva OPEC meeting, Saudi Arabia has apparently offered a cartel-wide production target. This proposal is seen as an attempt by the kingdom to improve relations with the rest of the cartel. Iran has flatly rejected the offer, wanting individual quotas to return. Iran's plan is not going to happen; we expect that Saudi Arabia wants to fill any gaps that develop from civil disorder in various cartel nations. Individual quotas would make grabbing this market share more difficult. According to most recent comments, OPEC was unable to agree on an output target. The other item on the cartel's agenda is to appoint a new general secretary. The odds-on favorite is Mohammed Barkindo, the former head of Nigeria's state oil company. If a general secretary isn't appointed, it will be taken as further evidence that the OPEC cartel is dysfunctional and would be modestly bearish for crude oil prices.

Finally, we look for a fairly quiet trade today in front of tomorrow's employment data. The current Bloomberg consensus calls for a 160k rise in non-farm payrolls and a 4.9% unemployment rate, which would be down 0.1%. Wage growth is expected to rise 2.5% over the past year. One key uncertainty surrounding the data is the telecommunications strike, which probably reduced payrolls by 30k. These workers have returned to work but were still on strike during mid-May when the surveys were conducted. If we get a 160k number despite the strike, it would suggest that the June data will be significantly stronger. Simply put, a weak number does not necessarily mean the FOMC won't move in June, but a strong number will almost certainly dictate a rate hike. The ADP data (see below) suggests a good number but it isn't clear how ADP handled the strike.

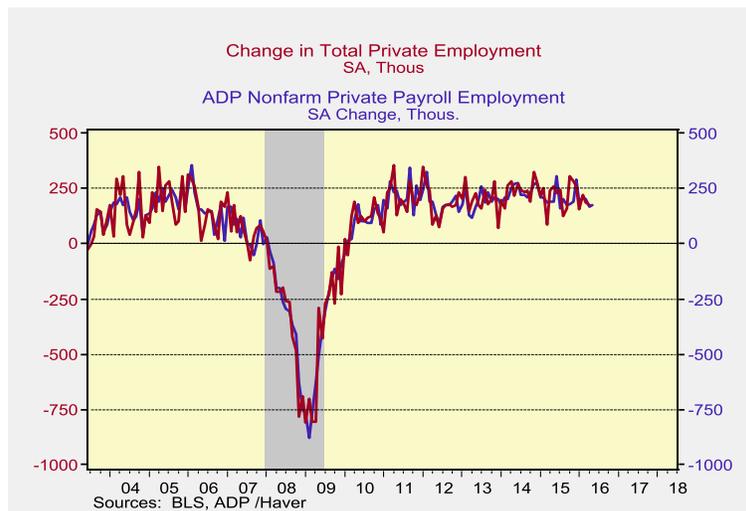
U.S. Economic Releases

Initial claims fell 1k to 267k, better than the 270k level forecast. Claims are improving after a hiccup in May.



The chart above shows the four-week average of claims, a more stable measure. The average fell 2k to 267k, staying below the 300k level for over a year.

ADP employment came in right on forecast, rising 173k in May. This follows a 166k gain in April. The chart below shows the ADP private payroll change and the change in total private employment. The two measures are highly correlated and we would expect today's improvement in ADP to also lead to better employment numbers tomorrow.



The Challenger job cuts index fell 26.5% in May, indicating a decreased number of planned job cuts. This reading is an improvement from the 5.8% increase in April.

The table below shows the economic releases or Fed speakers scheduled for the rest of the day.

Economic releases						
EST	Indicator			Expected	Prior	Rating
9:45	ISM New York	m/m	May		42.0	*

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	Manufacturing PMI (Nikkei)	m/m	May	50.7	50.5		**	Equity bullish, bond bearish
Japan	Consumer confidence	m/m	May	40.9	40.8	40.1	**	Equity and bond neutral
EUROPE								
Eurozone	PPI	y/y	Apr	-4.4%	-4.1%	-4.1%	**	Equity bearish, bond bullish
France	Manufacturing PMI (Markit)	m/m	May	48.4	48.3		**	Equity and bond neutral
AMERICAS								
Brazil	Industrial production	y/y	Apr	-7.2%	-11.5%	-8.7%	***	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)	69	67	2	Up
3-mo T-bill yield (bps)	29	29	0	Neutral
TED spread (bps)	40	39	1	Up
U.S. Libor/OIS spread (bps)	46	46	0	Neutral
10-yr T-note (%)	1.83	1.84	-0.01	Narrowing
Euribor/OIS spread (bps)	-26	-26	0	Neutral
EUR/USD 3-mo swap (bps)	34	31	3	Up
Currencies	Direction			
dollar	down			Up
euro	up			Down
yen	up			Down
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	\$ 49.79	\$ 49.72	0.14%	Awaiting OPEC meeting outcome
WTI	\$ 48.95	\$ 49.01	-0.12%	
Natural gas	\$ 2.37	\$ 2.38	-0.34%	
Crack spread	\$ 17.85	\$ 17.20	3.74%	
12-mo strip crack	\$ 14.17	\$ 13.84	2.41%	
Ethanol rack	\$ 1.80	\$ 1.80	-0.06%	
Metals				
Gold	\$ 1,215.09	\$ 1,212.98	0.17%	Lower dollar
Silver	\$ 15.98	\$ 15.96	0.12%	
Copper contract	\$ 206.50	\$ 207.30	-0.39%	Expectations of slowing Chinese growth
Grains				
Corn contract	\$ 414.00	\$ 413.75	0.06%	
Wheat contract	\$ 475.50	\$ 473.75	0.37%	Rains threatening European wheat crop
Soybeans contract	\$ 1,108.25	\$ 1,099.75	0.77%	
Shipping				
Baltic Dry Freight	612	612	0	
DOE inventory report expectations of weekly change				
	Actual	Expected	Difference	
Crude (mb)		-2.7		
Gasoline (mb)		-0.5		
Distillates (mb)		-1.0		
Refinery run rates (%)		0.7%		
Natural gas (bcf)		83.0		

Weather

The 6-10 and 8-14 day forecasts are calling for warmer than normal conditions for most of the country, except for the Northeast. Precipitation is forecast for the west coast.

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.

May 27, 2016

As promised, this week we will discuss how President Clinton’s policies would likely affect the financial markets. It should be noted that, unlike Mr. Trump, Sen. Clinton has published most of her policy positions. However, there have been apparent shifts in her policy positions as Clinton adjusts her campaign to react to changes in the election environment.

Sen. Clinton’s campaign is similar to that of a succeeding vice president: In 2008, when Clinton ran against Barack Obama, she framed him as an ephemeral dreamer who lacked the necessary experience to accomplish much. Early in her 2016 campaign, she appeared to be distancing herself from the president. For example, President Obama has characterized his foreign policy as “don’t do stupid s*@t.” Clinton suggested that this sentiment wasn’t a working foreign policy stance for the world’s superpower. Her comment raised expectations that she would triangulate a position different from Obama and her GOP opponent.

However, as it became apparent that she faced a legitimate primary threat from Sen. Sanders, Clinton, in an effort to secure the African American voter block, has completely embraced President Obama and has framed Sanders’s calls for new policies as a repudiation of Obama’s legacy. This position has been very effective in securing African American votes and has also given her an edge in closed primaries, taking advantage of Obama’s popularity with most Democrats. However, in open primaries, which allow independents to vote, and in areas with white voters, Sen. Clinton has underperformed Sen. Sanders. While tying her fate to President Obama’s legacy has been mostly effective in winning the nomination,¹ Clinton’s positioning as essentially the third term of the Obama administration is a risky general election strategy as she will face the debate line, “if you liked the last eight years, you should vote for Hillary.”²

What can we expect from a Clinton administration?

Foreign Policy: This is one of the few areas where we would expect a Clinton government to differ significantly from the outgoing administration. Clinton is much more hawkish than Obama and her positions are in direct opposition to the apparent populist mood of the nation. During her time as secretary of state, she often favored a more hawkish foreign policy than the president, pushing for greater military involvement in the world. Although she isn’t a neoconservative, she is about as close to one as this group can hope for among the remaining

¹ Although one could argue that she has barely been able to beat an elderly socialist.

² It should be noted that Gov. Reagan used a similar line against President Carter in a debate; some historians have argued that this phrase turned the election for Reagan.

candidates. In terms of Meade's archetypes, she is Wilsonian. Thus, we would not be surprised to see neoconservatives, who usually vote Republican, drift toward Sen. Clinton.

Domestic Policy: As noted above, she is proposing nothing more than maintaining and defending the Obama policy legacy. That policy means preserving Obamacare, holding tax rates at current levels or perhaps raising them modestly on the very wealthy, and expanding on the regulatory legacy started by President Obama.

Trade Policy: On trade, Clinton has generally supported free trade agreements. She was originally in favor of the Trans-Pacific Partnership (TPP) before she turned against it. We seriously doubt she actually opposes either this agreement or the Transatlantic Trade and Investment Partnership (TTIP), but given the rising unpopularity of such agreements and the fact that both Sen. Sanders and Mr. Trump have made opposition to trade a major plank of their platforms, Clinton has been forced to tack left on this issue. We think there is a chance that President Obama will try to get the TPP passed before he leaves office; in fact, he may accomplish this during the "lame duck" session after the November elections. Although a President-elect Clinton would officially oppose this tactic, in reality, we suspect she would privately support it.

Immigration: The Democratic Party and, by extension, Sen. Clinton have generally supported easing restrictions on immigration and want to create a "path to citizenship" for illegal aliens living in the U.S. This position will alienate her with white, working-class voters, perhaps putting swing states like Ohio and Pennsylvania in play, but could help Clinton wrest Arizona and Georgia from GOP hands.

Defense: We would expect Clinton to have a better relationship with the military than President Obama. In fact, it would not be a surprise if she asked Ash Carter, the current secretary of defense, to stay on in her administration. Given her foreign policy stance, the military would likely be utilized more often in her government.

Fiscal Policy: Clinton would likely run an orthodox fiscal policy with a modest tilt toward raising taxes.

Environmental Policy: Her policies will likely follow in the trends established by President Obama. We would not expect anything as radical as Sen. Sanders's bid to end fracking. At the same time, her policies won't revive coal and we would expect a steadily tightening regulatory environment for oil and gas producers.

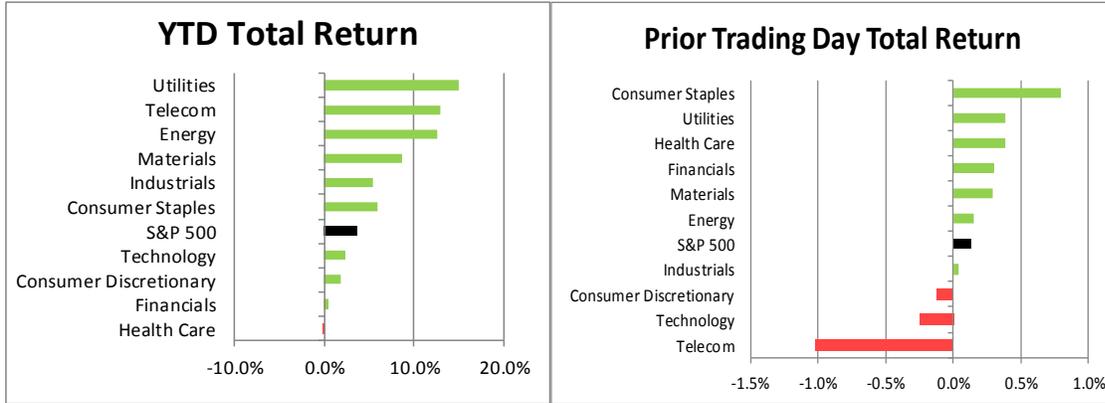
The market impact from a Clinton presidency would be negligible. Not only is she a solid member of the political establishment, but because she is running a campaign similar to a succeeding vice president, she will have virtually no political capital to bring "change" after gaining office. Thus, the slow growth, low inflation economic environment would likely continue. If markets fear a Trump presidency is likely and financial markets weaken into the election due to these fears, then a strong relief rally may ensue from a Clinton presidency, which is about the most notable market impact that would occur.

In our asset allocation views, we have consistently held that inflation would remain low; we have tended to favor longer duration in fixed income and generally supported equities. A Clinton presidency would maintain the status quo. We would continue to closely monitor the evolution of populism in the U.S., which threatens the current low inflation environment, but we would not expect Clinton to support a populist agenda. ***Bottom line: a Clinton presidency is a status quo outcome.***

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

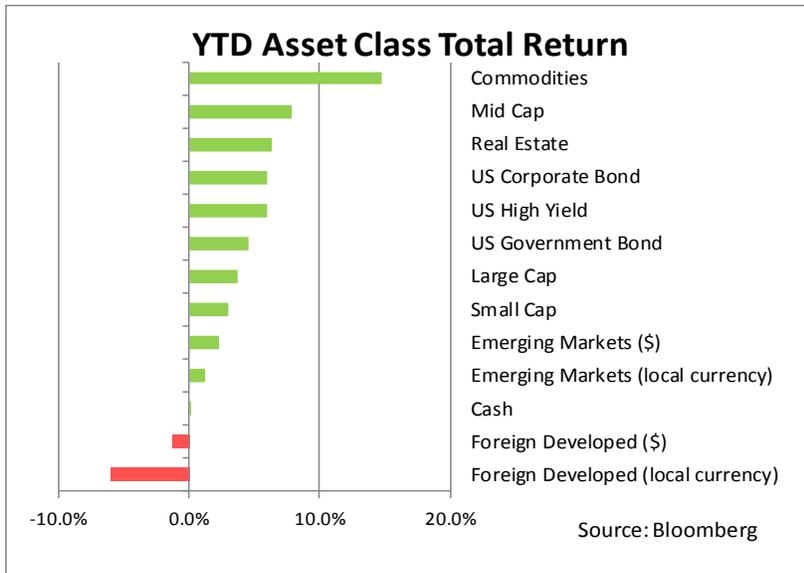
U.S. Equity Markets – (as of 6/1/2016 close)



(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 6/1/2016 close)



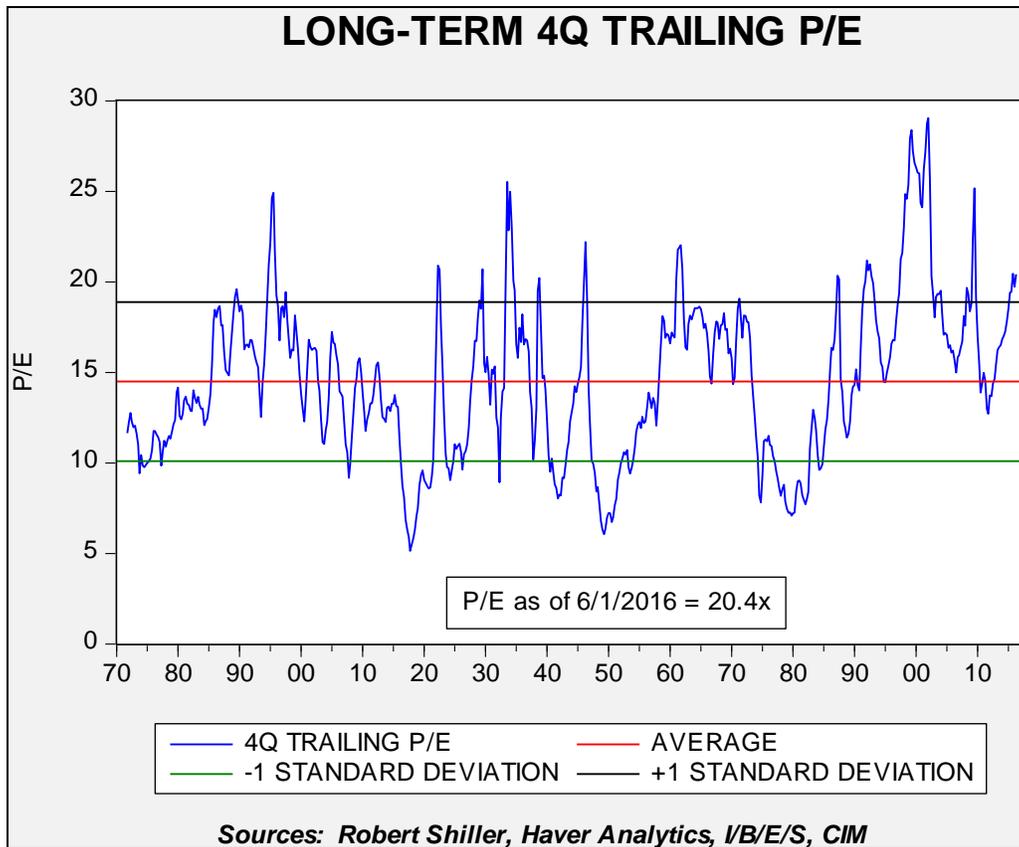
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 2, 2016



Based on our methodology,³ the current P/E is 20.4x, unchanged from last week. The P/E remains elevated due to higher equity values.

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.

³ 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 two actual (Q3 and Q4) and two estimates (Q1 and 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.