Confluence INVESTMENT MANAGEMENT

Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

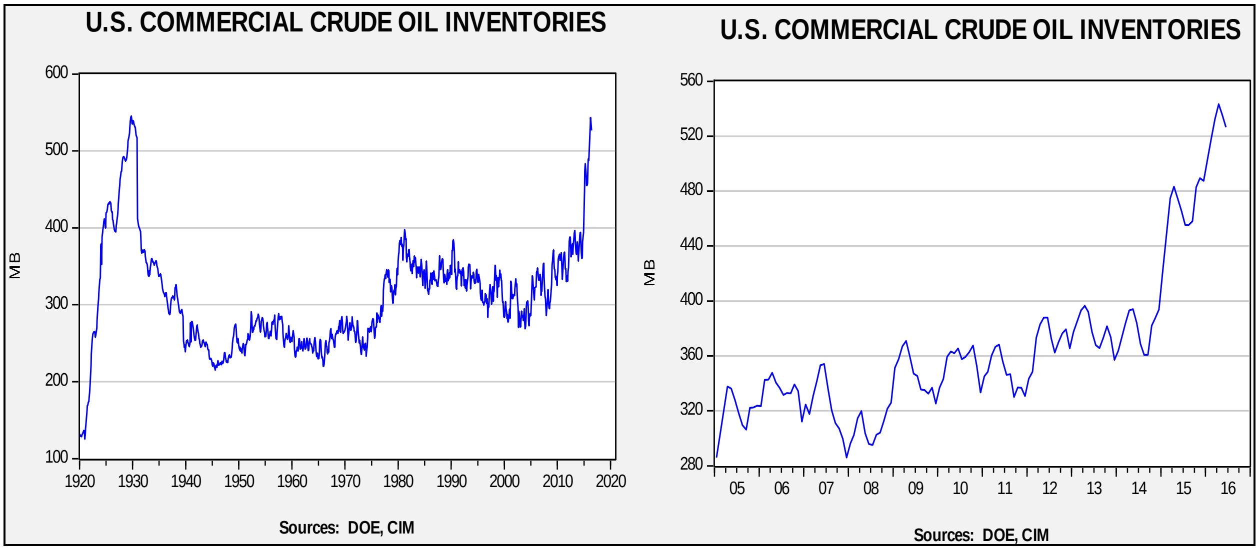
[Posted: June 30, 2016—9:30 AM EDT] Global equity markets are rising again this morning, although the pace of gains is slowing. The EuroStoxx 50 is trading higher by 0.6% from the last close. In Asia, the MSCI Asia Apex 50 closed up by 1.7% from the prior close. Chinese markets were steady, with the Shanghai composite trading down 0.1% and the Shenzhen index up by 0.1%. U.S. equity futures are signaling a steady opening from the previous close. We shut the books on Q2 at the close today, marking the halfway point of the calendar year.

The big shock overnight came from a surpise announcement by former London Mayor Boris Johnson, who withdrew from the race for the PM job in the U.K. after a withering attack from an (now probably former) ally, Michael Gove. This withdrawal adds to uncertainty surrounding the U.K. government. Although Mr. Gove is running for PM, the leading candidate is Theresa May, the Home Secretary.[1] May supported the remain campaign, but did say today that "Brexit means Brexit." She opposes another referendum. Meanwhile, the Labour Party continues to self-destruct as the Shadow PM, Corbyn, refuses to step down despite a no-confidence vote. Today's *FT* is full of stories suggesting the EU is going to make it difficult for the U.K. in order to set an example for others. George Soros, speaking to the EU Parliament, offered a dire warning about the impact of Brexit, suggesting it has unleashed a financial crisis similar to 2008.

The other big news came from mixed messages out of China regarding the CNY. Reuters is reporting that, according to unnamed sources, the PBOC is willing to allow the currency to depreciate 6.8% (the degree of precision is worth noting). The report suggested that as long as the decline in the currency is within expectations and managable, its preferred policy is a weaker currency. The primary risk to China is that fears of depreciation could turn into a rout as it fosters capital flight. It appears that the PBOC is trying to create a situation where the CNY can weaken without repercussions. After the story was published, the PBOC tried to quash it, saying it has no intention to promote trade competitiveness through currency depreciation. We suspect the PBOC wants to quietly weaken the CNY, but stories that offer targets are dangerous because financial markets have a tendency to immediately move toward the target level quickly which can become difficult to control.

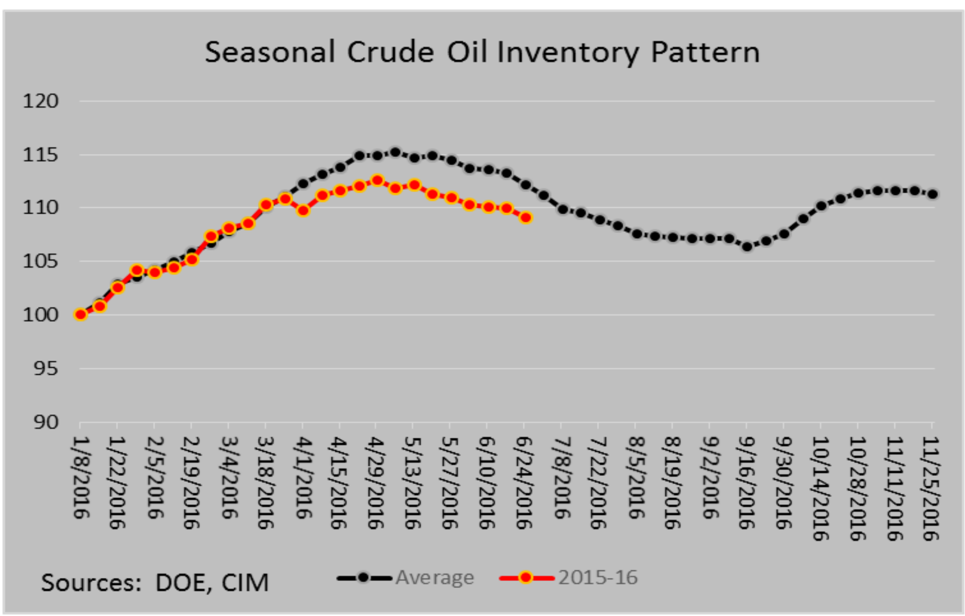
With yesterday's DOE report, we can update the oil situation. U.S. crude oil inventories fell more than forecast, dipping 4.0 mb versus estimates of a 2.5 mb decline.

[1] In the U.K, the Home Secretary has the mandate of internal affairs for the country. This role includes overseeing MI-5, roughly the U.S. equivalent of the FBI.

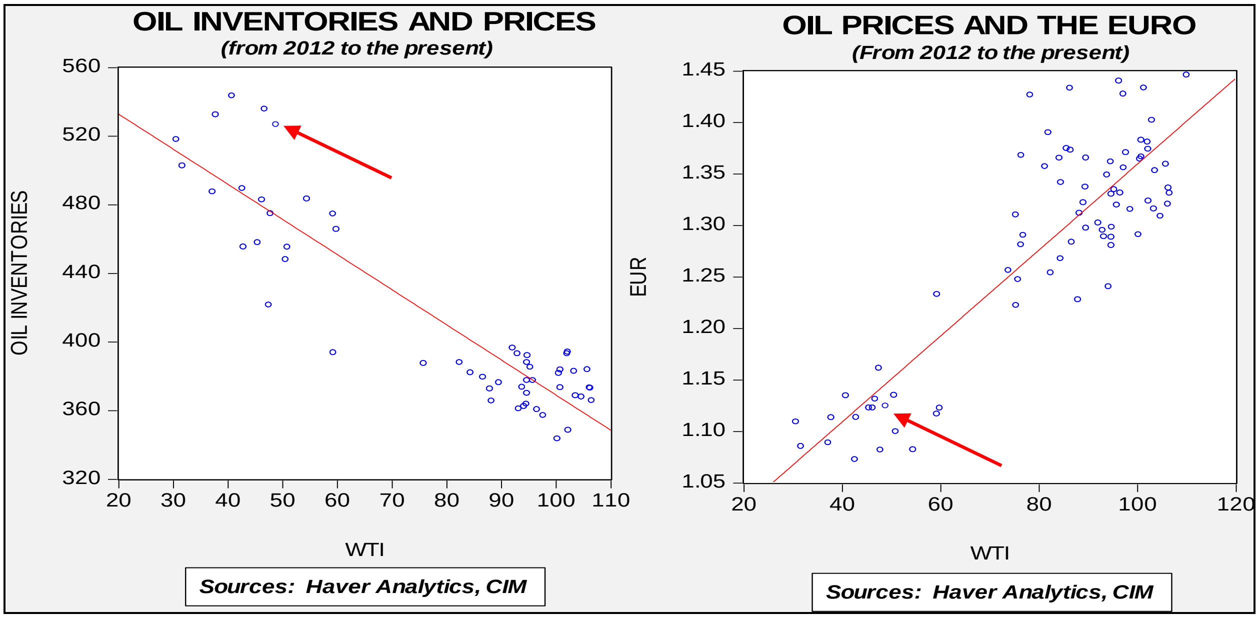


This chart shows current crude oil inventories, both over the long term and the last decade. We are starting to see inventories decline but normal levels would be below 400 mb, some 130 mb lower than now.

So, obviously, inventories remain elevated. Inventories have been lagging the usual seasonal pattern. We are in a period of the year when crude oil stockpiles tend to fall at an increasing pace. The pace of declines will slow after Independence Day but we should have at least a couple of weeks with large draws in stocks.



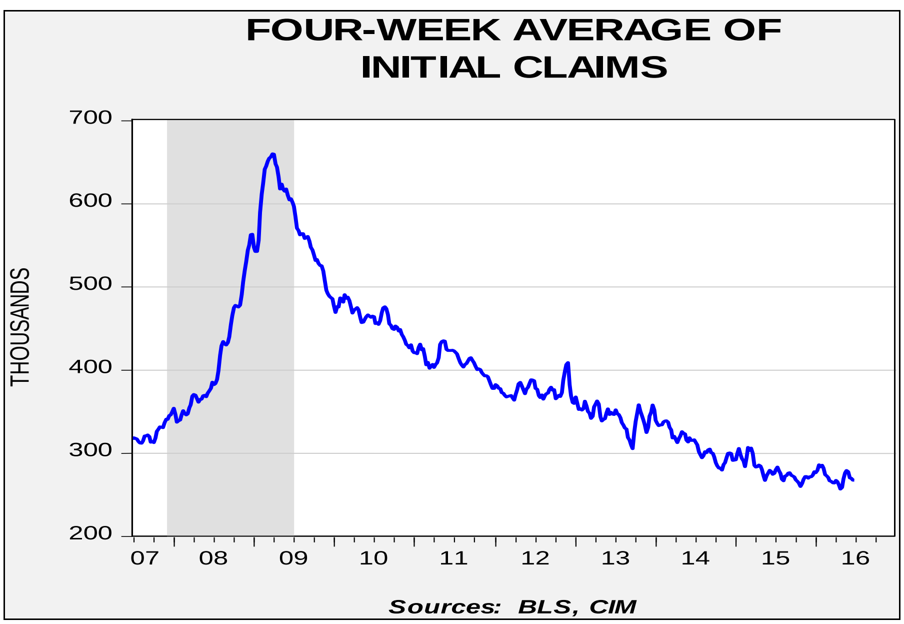
It is important to remember that the dollar is playing a bigger role in determining oil prices.



Based on inventories alone, oil prices are profoundly overvalued, with the fair value price of $32.99. Meanwhile, the EUR/WTI model generates a fair value of $50.32. Together (which is a more sound methodology), fair value is $42.06, meaning that current prices are a bit rich. The recent turmoil with Brexit did put downward pressure on oil prices, but the improvement in sentiment has allowed oil prices to recover some of their losses.

U.S. Economic Releases

Initial claims came in near forecast, at 268k compared to expectations of 267k. The four-week average of claims is 266.75k, unchanged from the prior week.



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

Economic releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Chicago PMI	m/m	Jun	51.0	49.3	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
14:15	Bullard	St. Louis FRB President				

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								
Australia	Private Sector Credit	y/y	May	6.5%	6.7%	6.7%	**	Equity and bond neutral
China	Current Account	q/q	Q1	$39.3 bn	$48.1 bn		*	Equity and bond neutral
Japan	Housing starts	y/y	May	9.8%	9.0%	4.8%	**	Equity bullish, bond bearish
EUROPE								
Eurozone	CPI	y/y	Jun	0.1%	-0.1%	0.0%	**	Equity and bond neutral
	Consumer Confidence	m/m	Jun	0.9%	0.8%	0.8%	**	Equity and bond neutral
Germany	Retail sales	y/y	May	0.9%	-0.9%	0.6%	**	Equity bullish, bond bearish
	Unemployment rate	m/m	Jun	6.1%	6.1%	6.1%	***	Equity and bond neutral
UK	GDP	y/y	Q1	2.0%	2.0%	2.0%	***	Equity and bond neutral
	Current Account	q/q	Q1	-32.6	-32.7	-28.0	**	Equity and bond neutral
France	PPI	y/y	May	-3.5%	-4.1%		*	Equity and bond neutral
	CPI	y/y	Jun	0.3%	0.1%	0.3%	**	Equity bullish, bond bearish
	Consumer spending	y/y	May	2.2%	2.5%	2.5%	*	Equity and bond neutral
Italy	CPI	y/y	Jun	-0.3%	-0.3%	-0.2%	**	Equity and bond neutral
	PPI	y/y	May	-4.2%	-4.5%		**	Equity bearish, bond bullish
Switzerland	Leading indicator	m/m	Jun	102.4	102.9	102.6	*	Equity bullish, bond bearish
AMERICAS								
Canada	GDP	y/y	Apr	1.5%	1.1%	1.4%	***	Equity bullish, bond bullish
	Industrial prices	m/m	May	6.7%	0.7%	5.0%	**	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)	63	63	0	Down
3-mo T-bill yield (bps)	25	26	-1	Down
TED spread (bps)	39	37	2	Up
U.S. Libor/OIS spread (bps)	37	38	-1	Down
10-yr T-note (%)	1.50	1.52	-0.02	Down
Euribor/OIS spread (bps)	-28	-28	0	Neutral
EUR/USD 3-mo swap (bps)	39	40	-1	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	down			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.

	Today	Prior	Change	Trend
3-mo Libor yield (bps)	63	63	0	Down
3-mo T-bill yield (bps)	25	26	-1	Down
TED spread (bps)	39	37	2	Up
U.S. Libor/OIS spread (	37	38	-1	Down
10-yr T-note (%)	1.50	1.52	-0.02	Down
Euribor/OIS spread (b	-28	-28	0	Neutral
EUR/USD 3-mo swap (	39	40	-1	Up
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	down			Up
franc	down			Neutral
Corn contract	$ 379.50	$ 377.75	0.46%	Hot weather returns
Wheat contract	$ 446.50	$ 444.50	0.45%	
Soybeans contract	$ 1,114.50	$ 1,112.50	0.18%	
Shipping				
Baltic Dry Freight	627	616	11	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)	-4.0	-2.5	-1.5	
Gasoline (mb)	1.4	-0.3	1.7	
Distillates (mb)	-1.8	0.6	-2.4	
Refinery run rates (%)	1.7%	0.5%	1.2%	
Natural gas (bcf)		46.0		

Weather

The 6-10 and 8-14 day forecasts clearly indicate that summer is coming back with a vengeance. Only the Pacific Northwest is expected to be cooler than normal. Heavier than normal rain is projected for the Great Lakes region. The tropics are quiet today.

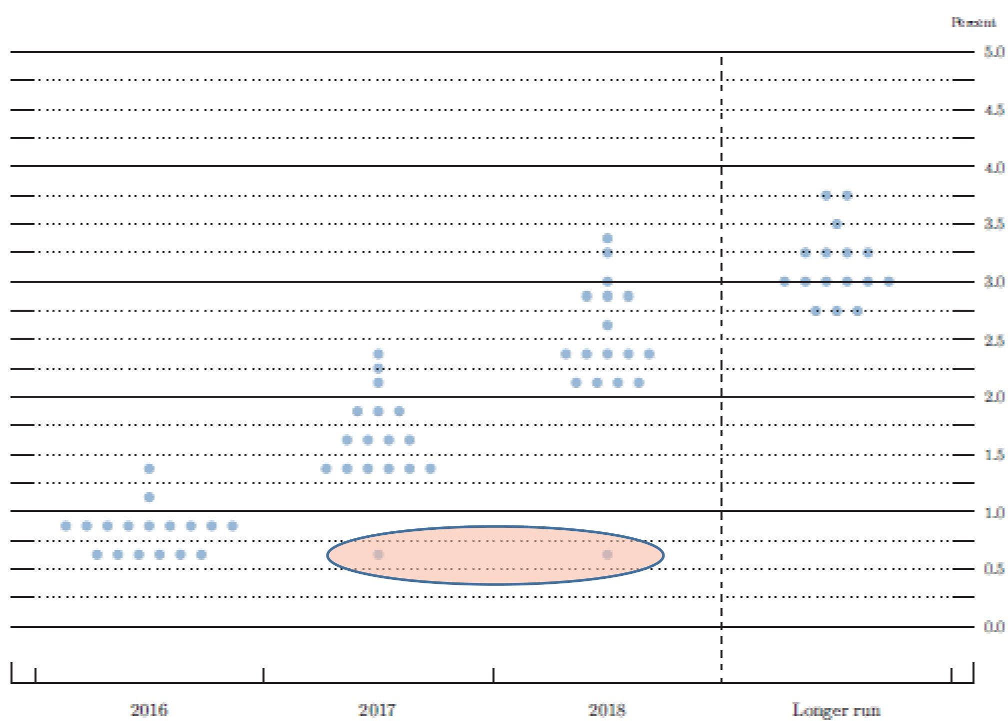
Weekly Asset Allocation Commentary

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.

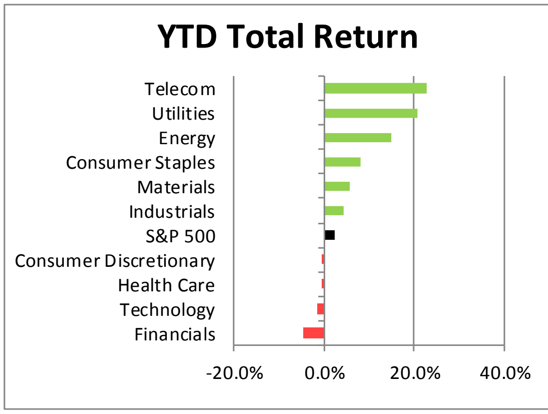
What does this mean? Assuming the current regime stays in place, Bullard believes that the proper fed funds rate is 63 bps, suggesting a target range of 50-75 bps for fed funds, or a single rate hike for the next two years. ***By design, if policymakers adopt the Bullard model, monetary policy will no 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.

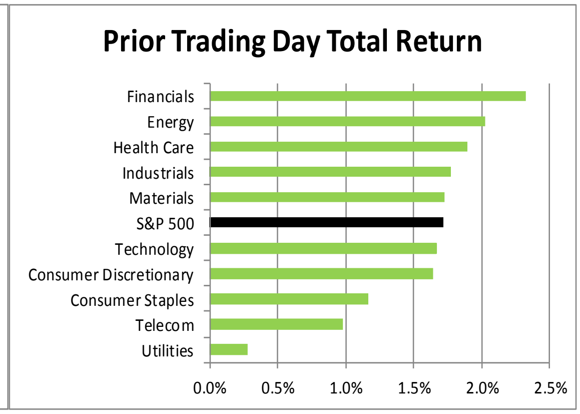
The problem with Bullard's policy model will be at the point of regime change—when regimes change, the Fed will be playing catch up to the new regime which will probably require aggressive moves. Understanding the new regime during its transition will take time. On the other hand, Bullard's program will 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 6/29/2016 close)

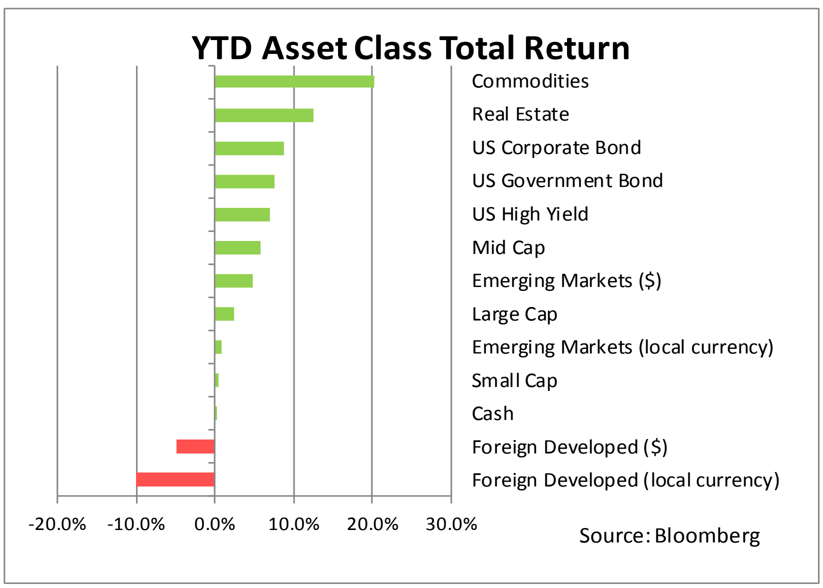




(Source: Bloomberg)

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 6/29/2016 close)

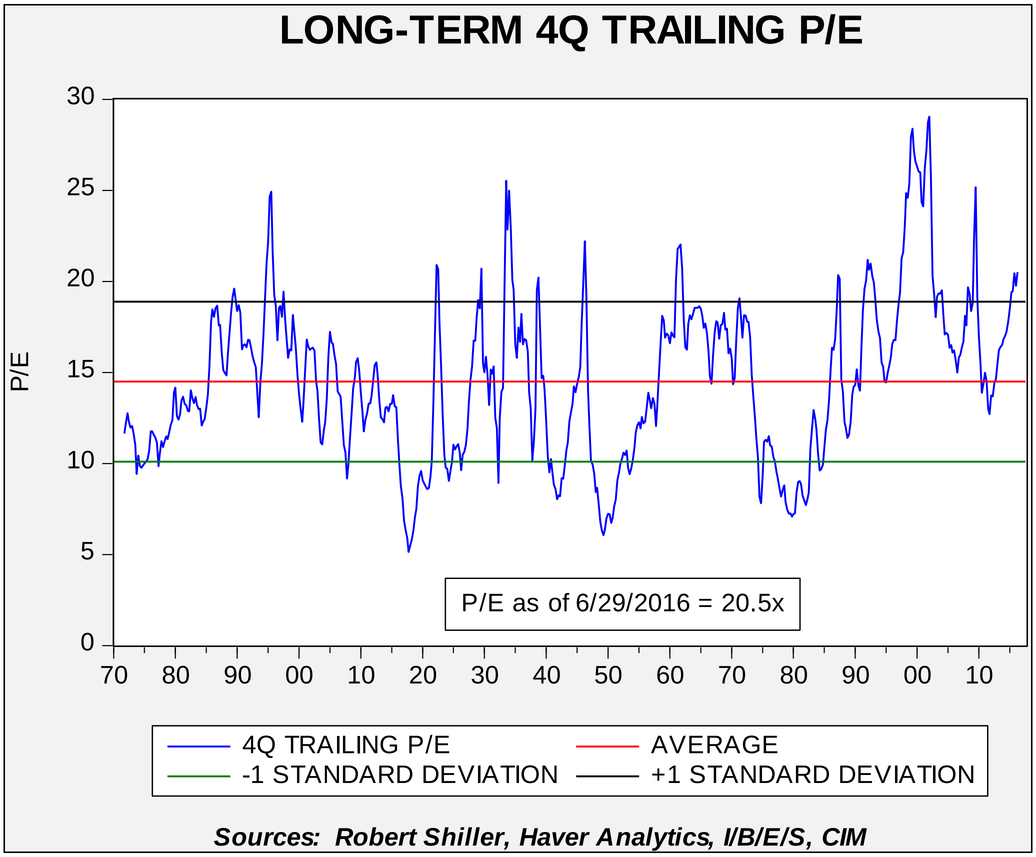


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 30, 2016



Based on our methodology,[2] 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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[2] 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.