Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: May 16, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is lower by 0.6% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 0.3% from the prior close. Chinese markets are also higher, with the Shanghai composite trading up by 0.8% and the Shenzhen index higher by 1.7%. U.S. equity futures are signaling a sideways opening from the previous close. With 91.6% of the S&P 500 companies having reported, Q1 float-adjusted earnings stand at $26.70, more than the $26.66 forecast. Of the 458 companies that have reported, 71.8% had positive earnings surprises, while 21.0% had negative earnings surprises.

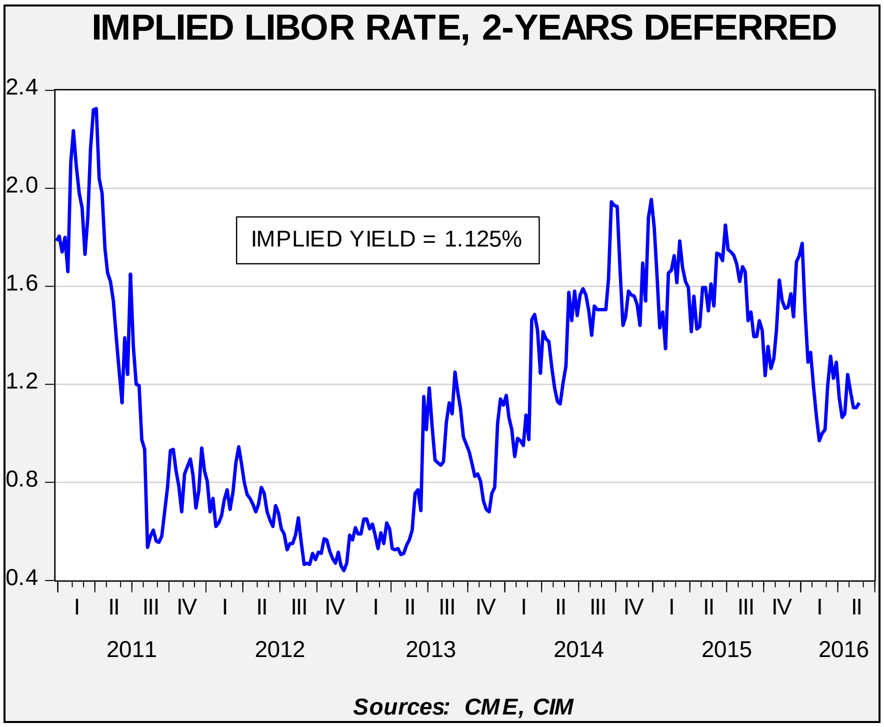
Oil prices are surging this morning as short-term outages dominate the news. Conflict in the Delta region of Nigeria has reduced production by 0.6 mbpd. Although Canadian production does appear to be returning, the recent outages will likely lead to inventory declines in the U.S. for at least the next couple of weeks. As we have noted, the seasonal withdrawal period for crude oil is about to start and we will likely see the supply situation improve over the summer. At the same time, the current price has already discounted a drop of about 50 mb in U.S. commercial crude oil stockpiles, so the supply situation will have to improve even more to see prices continue to lift.

Unfortunately for oil, and for other markets as well, there is a lurking danger. Despite numerous comments from regional FRB presidents suggesting that a rate hike could occur in June, fed funds futures put the odds of a hike at 4%. At the same time, we are seeing the yield curve continue to flatten.

(Source: Bloomberg)

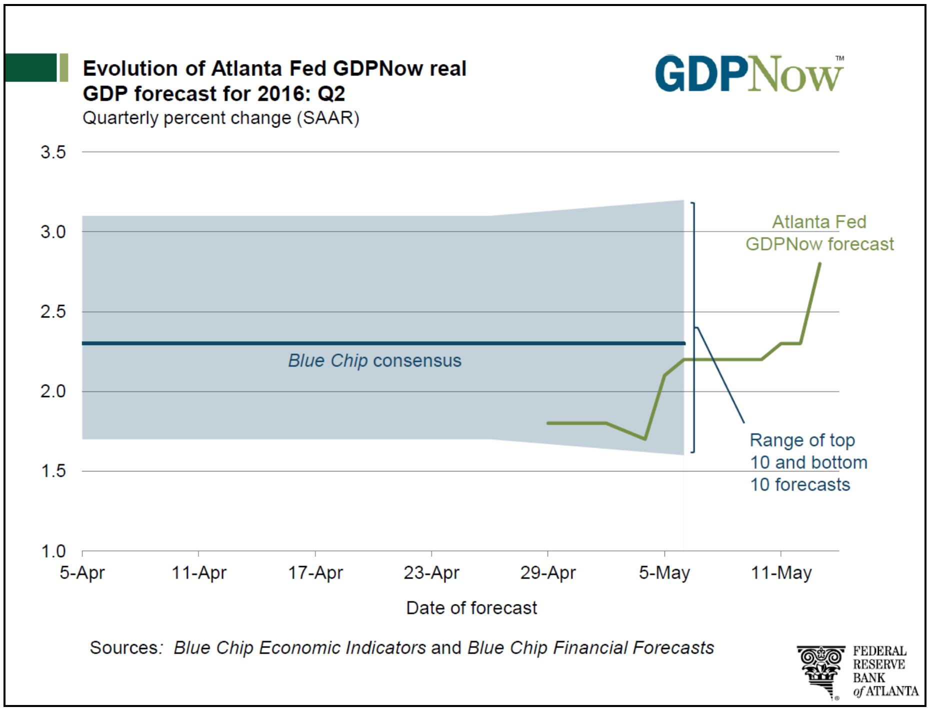
This chart shows the two-year to 10-year T-note spread, which hit its narrowest point since late 2007. Although we have 95 bps to go to invert the curve (a near certain signal of recession), the narrowing is a worry. Most of the narrowing is coming from the long end of the curve, which is likely benefitting from foreign inflows; with much of Europe and all of Japan sporting negative sovereign yields, the U.S. looks pretty attractive on a relative basis.

The implied two-year LIBOR rate has not moved significantly higher, which tends to indicate that the markets expect a low terminal policy rate.



Here is where our worry lies. When five-star doves like Chicago FRB President Evans and Boston FRB President Rosengren argue that the financial markets are underestimating the odds of a rate hike, it suggests that support for stable policy is weakening. In general, we assume that three dissenters among the voting members of the FOMC are akin to a no-confidence vote for the chair. At this point, among the 10 voters, Bullard (St. Louis), George (KC) and Mester (Cleveland) would probably support a rate hike. If Rosengren, usually a reliable dove, is leaning toward a hike, you could potentially have four dissenters. Among the permanent voters, only Fischer would probably prefer to tighten, although we don't see him voting against the chair. Still, there is enough uncertainty to seriously question the 4% likelihood of a hike that is currently being discounted by fed funds futures.

The GDPNow data from the Atlanta FRB is suggesting a rather robust jump in Q2 growth, especially in relation to Q1.



Here are the component changes.

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
2-May	Constr. spending, ISM Manufacturing	1.8	1.76	-0.03	0.10	-0.10	0.14	0.15	0.01	-0.24
4-May	Intl. trade, M3 Manuf., ISM Nonman.	1.7	1.75	-0.08	0.10	-0.10	0.14	0.15	0.00	-0.29
5-May	Auto sales, ISM Nonmanuf. (Weds)	2.1	1.98	0.07	0.11	-0.09	0.18	0.14	-0.01	-0.26
6-May	Employment situation	2.2	2.06	0.11	0.11	-0.08	0.22	0.11	-0.03	-0.29
10-May	Wholesale trade	2.2	2.06	0.11	0.11	-0.08	0.22	0.11	-0.03	-0.34
11-May	Monthly Treasury Statement	2.3	2.06	0.11	0.11	-0.08	0.22	0.22	-0.03	-0.34
12-May	Import/export prices	2.3	2.06	0.11	0.11	-0.08	0.22	0.22	-0.02	-0.34
13-May	Retail trade	2.8	2.51	0.11	0.11	-0.08	0.19	0.22	-0.02	-0.24

ote: CIPI is "change in private inventories." All numbers are percentage point contributions to GDP growth (SAAR).

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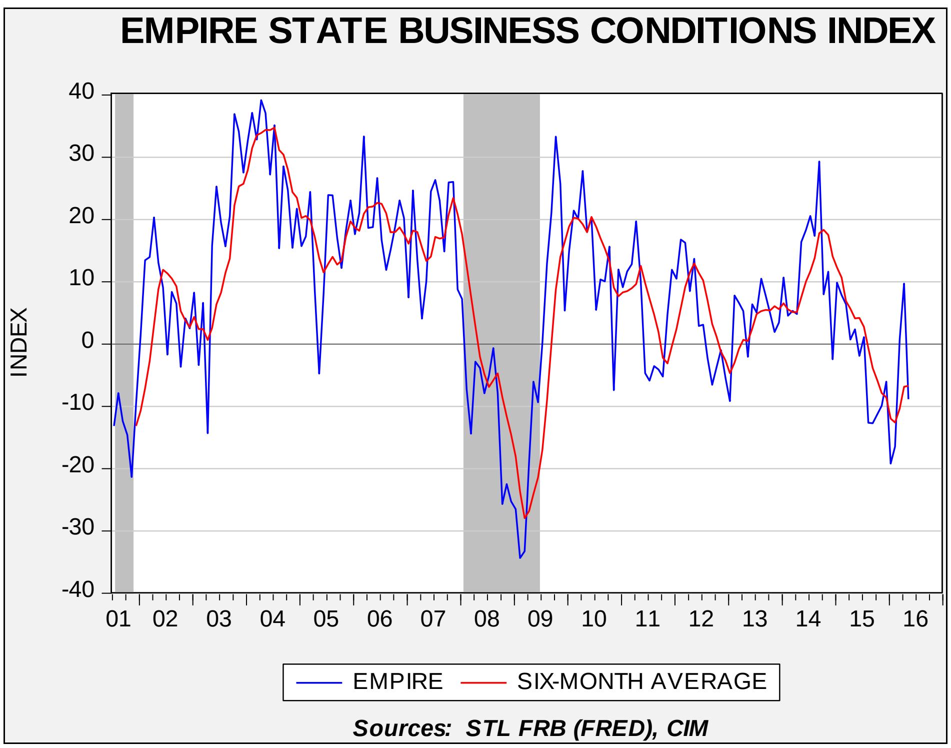
Of the 100 bps rise since the initial forecast, 61 bps are coming from consumption alone, which was reflected in the recent retail sales report. Of the remaining 39 bps, residential investment, adding 11 bps, accounts for over a quarter of the rest.

The case for standing pat is strong. International developments remain a worry (today's China data is adding to worries) and U.S. industrial data is soft (see today's Empire State report). On the other hand, all our Mankiw model variations support a rate hike. The dollar, which was much stronger, has retreated, giving the Fed room to hike. The real worry is that a rate hike would be a complete surprise to the financial markets and unnecessarily raise market volatility.

This discussion brings us back to oil…if the Fed unexpectedly raises rates and the dollar rallies (which would be highly likely), oil prices are vulnerable to a pullback. That doesn't mean a collapse to the sub-$30s lows, but perhaps a drop into the low $40s or high $30s. It also means the dollar would strengthen and emerging markets would be vulnerable to a pullback.

U.S. Economic Releases

Empire manufacturing came in well below expectations for May, falling to- 9.02 from +9.56 the month before compared to the +6.50 forecast. Conditions have deteriorated for New York state manufacturers due to current weak global demand and the relatively strong dollar.



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

Economic releases						
EST	Indicator			Expected	Prior	Rating
10:00	NAHB housing market index	m/m	May	59.0	58.0	*
4:00	Total TIC flows	m/m	Mar		$33.5 bn	**
4:00	Net long-term TIC flows	m/m	Mar		$72.0 bn	**
Fed speakers of events						
EST	Speaker or event	District or position				
7:00	Kashkari	Minneapolis 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								
China	Industrial production	y/y	Apr	6.0%	5.8%	6.5%	***	Equity bearish, bond bullish
	Retail sales	y/y	Apr	10.1%	10.5%	10.6%	**	Equity bearish, bond bullish
	Fixed asset investment	y/y	Apr	10.5%	10.7%	11.0%	**	Equity bearish, bond bullish
Japan	PPI	y/y	Apr	-4.2%	-3.8%	-3.7%	**	Equity bearish, bond bullish
	Machine tool orders	y/y	Apr	-26.4%	-21.2%		**	Equity bearish, bond bullish

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	Neutral
3-mo T-bill yield (bps)	27	26	1	Up
TED spread (bps)	36	36	0	Neutral
U.S. Libor/OIS spread (bps)	39	38	1	Up
10-yr T-note (%)	1.73	1.70	0.03	Widening
Euribor/OIS spread (bps)	-26	-26	0	Neutral
EUR/USD 3-mo swap (bps)	23	24	-1	Down
Currencies	**Direction**			
dollar	down			Falling
euro	up			Rising
yen	down			Rising
franc	down			Rising

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	$ 48.87	$ 47.83	2.17%	Demand to outpace production
WTI	$ 47.24	$ 46.21	2.23%	
Natural gas	$ 2.06	$ 2.10	-1.62%	Warmer weather
Crack spread	$ 17.98	$ 17.90	0.40%	
12-mo strip crack	$ 14.18	$ 14.12	0.45%	
Ethanol rack	$ 1.69	$ 1.69	0.04%	
Metals				
Gold	$ 1,287.38	$ 1,273.45	1.09%	Investment demand
Silver	$ 17.36	$ 17.11	1.47%	
Copper contract	$ 208.10	$ 207.40	0.34%	
Grains				
Corn contract	$ 388.25	$ 390.75	-0.64%	Supplies likely to improve
Wheat contract	$ 475.25	$ 474.75	0.11%	
Soybeans contract	$ 1,063.00	$ 1,065.00	-0.19%	U.S. likely to plant more soybeans
Shipping				
Baltic Dry Freight	600	579	21	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)	-3.4	-0.1	-3.3	
Gasoline (mb)	-1.2	-0.5	-0.7	
Distillates (mb)	-1.6	-0.7	-0.9	
Refinery run rates (%)	-0.6%	0.5%	-1.1%	
Natural gas (bcf)	56	58.0	-2.0	

Weather

The 6-10 and 8-14 day forecasts are calling for warmer than normal conditions for the eastern two-thirds of the country. Precipitation is forecast for the majority of the country.

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 13, 2016

With Donald Trump and Hillary Clinton becoming the presumptive nominees for the Republican and Democratic Parties, respectively, this week's Asset Allocation Weekly will offer some of our initial thoughts on this election cycle. We will offer more in-depth analysis in the coming months but these highlights express our starting points about the candidates and the election.

This election is shaping up to be establishment versus populist: As we discussed in our three-part series on the election in the spring of 2014,[1] we noted a rising trend of populism in the U.S. that could lead to a populist candidate and president. Donald Trump is running as a classic "traitor to his class" by supporting populist positions such as anti-globalization (anti-immigration, anti-trade) and support for middle-class entitlements (Social Security, Medicare, Disability). These positions are in direct opposition to the establishment's positions on free trade, open immigration and entitlement reform. Sen. Clinton finds herself as the establishment candidate, which has been well exposed in her primary campaign against Sen. Sanders. In Europe, both the right- and left-wing establishments tend to coalesce around one establishment figure to fend off a populist challenge. If we see a similar pattern in the U.S. (which we would expect), look for talk about a third-party "real conservative" challenger to dissipate soon. Otherwise, if a third-party establishment figure runs, it will simply split the vote and allow Trump to win easily. Instead, we look for the right-wing establishment to either stay home or vote for Sen. Clinton. In any case, unlike in most elections, there will be major differences between the candidates which will probably lead to historic voter turnout.

Domestic Policy: If you liked the last eight years, you should vote for Sen. Clinton**.** She is running a campaign similar to what a vice president runs when he is trying to succeed a sitting two-term president. Although this didn't appear to be her initial plan, the surprising performance of Sen. Sanders has forced her to defend President Obama's policies to frame her opponent as being too radical and she has used Sanders's criticism of President Obama to suggest that he is denigrating the current Democratic Party president. This means she really can't run on a domestic policy platform that aims to fix all that has gone wrong and allows Mr. Trump to claim that current conditions are bad and that a new policy stance, which he would provide, would make things better. Since many Americans claim things are bad,[2] it makes Sen. Clinton's position difficult to defend.

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[1] See WGRs: 2016, Part 1 (3/31/2014); 2016, Part 2 (4/14/2014); and 2016, Part 3 (4/21/2014).

[2] On average, 66% of those polled think the country is going in the "wrong direction," see: http://www.realclearpolitics.com/epolls/other/direction_of_country-902.html.

This election will likely be determined by Sen. Sander's supporters: In 2014, Ralph Nader published a book titled *Unstoppable*.[3] In the book, he argues that populists on both the left and right have a common cause around which to unify and overthrow the political establishment. As we noted in our aforementioned WGRs, the establishment supports deregulation, globalization and the unfettered introduction of new technology. Although these policies are very successful in bringing down inflation through supply side efficiency, they have the effect of holding down wage growth that harms most populist households.[4] Nader acknowledges that there are major disagreements between left- and right-wing populists on social issues. However, on economic issues, the differences are significantly less and the two sides could find common ground. If Sanders's voters decide that Donald Trump can improve their economic situation and swing toward him, he has a solid chance for victory. If Trump can, at a minimum, discourage Sanders's supporters from voting for Sen. Clinton, he will improve his odds of winning. Although we doubt Ralph Nader had Donald Trump in mind when he penned his book, Trump may be best positioned to bring Nader's coalition of populists together. This may be even more evident in foreign policy (see below).

Foreign policy is about be flipped: Sen. Clinton is hawkish; she supported the invasion of Iraq, a much heavier military presence in Syria and the overthrow of Muammar Gaddafi. Using Walter Russell Mead's archetypes,[5] Sen. Clinton is a Wilsonian. She believes that the U.S. is a source of good in the world and that using military force is legitimate in order to protect the weak or support goals like democracy in the world. Trump is a Jacksonian; this archetype can be belligerent but only if the national honor is besmirched. Trump has indicated that we will give up our superpower duties[6] by forcing European and Asian allies to pay for their own defense. At the same time, he is promising a major boost in military spending to ensure that "nobody messes with us," a classic Jacksonian position. On the one hand, Trump promises that we won't be drawn into wars to protect others; on the other, he would likely order the U.S. Navy to shoot on sight any Russian warplanes buzzing around U.S. vessels. The differences between Trump and Clinton offer an unusual shift for voters; neoconservatives who currently are part of the GOP will be inclined to vote for Clinton, while those who oppose U.S. hegemony will tend to find Trump's "America First" message appealing. In terms of foreign policy, Sanders's supporters have much more in common with Trump than Clinton.

The debates could be historic: Trump has proven to be an effective debater, a brawler that tends to force opponents to operate at a base level. For example, Sen. Rubio ended up in a verbal sparring match more suitable for a middle school; however, Trump operates well in such situations while most politicians don't. Rubio didn't…and neither did Governor Bush. Sen. Clinton has a wonkish grasp of policy that will far exceed Trump's knowledge. But, if he forces her into his "alley," the results could be devastating. The debates could be the most watched television outside the Super Bowl and may swing the campaign.

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[3] Nader, R. (2014). *Unstoppable: The Emerging Left-Right Alliance to Dismantle the Corporate State*. New York, NY: Nation Books.

[4] We define the differences between populists and establishment in the aforementioned WGRs.

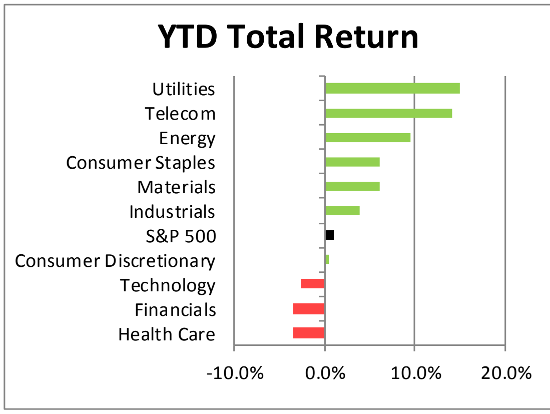
[5] See WGR, 4/4/2016, The Archetypes of American Foreign Policy: A Reprise.

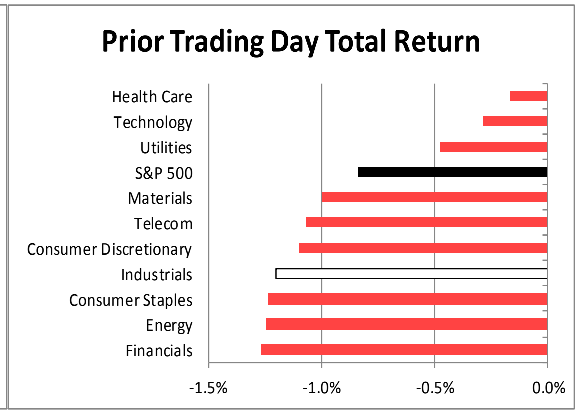
[6] See WGR, 4/11/16, Intergenerational Forgetfulness.

Next week, we will discuss the market impact of a Trump presidency and the asset allocation measures we would likely consider. The following week, we will examine a Clinton presidency and perform the same drill.

Data Section

U.S. Equity Markets – (as of 5/13/2016 close)

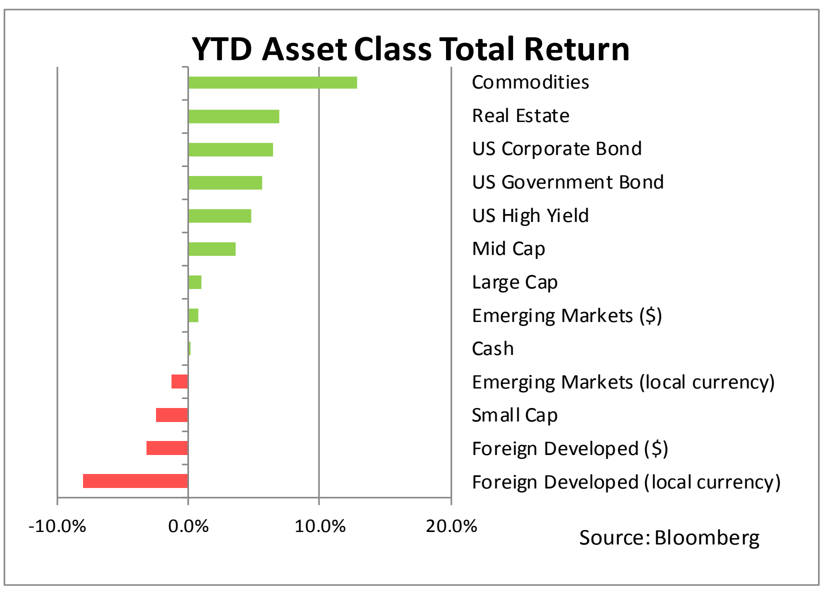




(Source: Bloomberg)

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 5/13/2016 close)

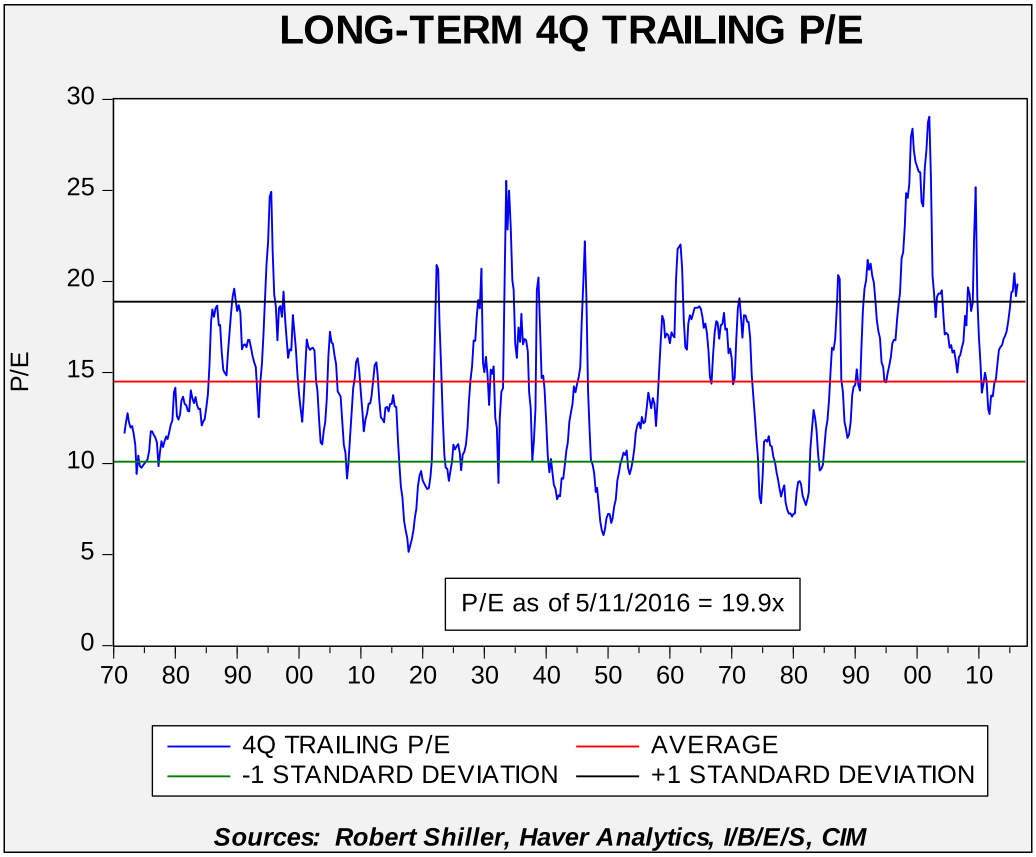


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

May 12, 2016



Based on our methodology,[7] the current P/E is 19.9x, down 0.1x from last week. The P/E eased due to a rise in earnings.

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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[7] 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.