Confluence INVESTMENT MANAGEMENT

Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: May 18, 2016—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is trading lower by 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed down by 1.2% from the prior close. Chinese markets are also lower, with the Shanghai composite trading down by 1.3% and the Shenzhen index lower by 2.7%. U.S. equity futures are signaling a lower opening from the previous close. With 92.2% of the S&P 500 companies having reported, Q1 float-adjusted earnings stand at $26.72, more than the $26.66 forecast. Of the 461 companies that have reported, 72.0% had positive earnings surprises, while 20.8% had negative earnings surprises.

There are two items of interest this morning, which are linked. First, worries about the Fed moving rates higher are starting to rise. Fed funds futures are now projecting a 12% chance of a hike in June. Although this level remains low, it is up from 4% a week ago. Comments from San Francisco FRB President Williams and Atlanta FRB President Lockhart indicating that two hikes are in the pipeline for this year hit the market yesterday afternoon. It should be noted that neither of these two regional presidents are voters this year. Tomorrow, NY FRB President Dudley and Vice Chair Fischer, who are permanent voters, will speak. Dudley has been reliably dovish but Fischer is another matter. At heart, Fischer appears to back a Phillips Curve-influenced view of the world and thus should lean toward raising rates. Fischer's stance will likely be the deciding factor at the June meeting because it will be hard for Chair Yellen to offset his weight on the committee if he swings his vote for a rate hike.

We are starting to see the markets react.

(Source: Bloomberg)

This chart shows the yield on the two-year Treasury. It has been steadily rising after falling from late April into early May. This rate is consistent with a fed funds target of 50 bps, implying that the market is building expectations of a rate move. As noted below, the Fed minutes are out later today, which may give us some color on the odds of a hike next month.

Although all the financial markets will be affected by a tightening of Fed policy, exchange rates may be the most sensitive. Since the last G-20 meeting three months ago, there has been speculation that a deal was put in place to stabilize currencies. According to this narrative, China did not want to see a stronger CNY so it prevailed upon the U.S. to back away from tightening talk. This led to a weaker dollar and the CNY stabilized because the CNY is mostly pegged to the greenback. At the same time, both the ECB and the BOJ refrained from further aggressive easing measures, leading to some dollar weakness against both currencies. The weaker dollar helped gold but really supported oil, easing credit conditions in the U.S. and helping China stabilize. The losers? Europe and Japan, especially the latter. The BOJ and the Ministry of Finance have been making rumblings about pushing fiscal policy in Japan, which, given the degree of QE, might be monetary financing of fiscal spending (which we discussed over the past three weeks in the WGR).[1] If the Fed really wants to raise rates, the dollar's retreat gives Yellen room to move. At the G-7 meeting this weekend, where China won't participate, we may see this "gentleman's agreement" on forex break down. If so, the JPY and EUR could weaken, emerging markets will be at risk and commodity prices would likely retreat.

Finally, a poll this morning suggests 55% of U.K. voters favor remaining in the EU. This gave the GBP a lift.

(Source: Bloomberg)

This is a one-day chart of the £/$ exchange rate; when news of the poll broke, the GBP rallied strongly. If the polls lean toward remaining as we move into the FOMC meeting next month, the

[1] See WGRS, The Geopolitics of Helicopter Money: Part 1 (5/2/16); Part 2 (5/9/16); and Part 3 (5/16/16).

committee may assume the U.K. will stay and this situation would increase the odds of a rate hike.

U.S. Economic Releases

Mortgage applications fell 1.6% for the most recent reporting week, with purchases down 5.8% and refinancing up 1.4%. Unfavorable weather in parts of the country kept purchases low, while unchanged mortgage rates supported refinancing activity. The 30-year rate remained unchanged at 3.82%.

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

Economic releases		
Fed speakers of events		
EST	**Speaker or event**	**District or position**
2:00	FOMC Apr 27-28 meeting minutes	

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	Property price increases (new residential apartments)	m/m	Apr	65 out of 70 cities	62 out of 70 cities		**	Equity and bond neutral
	Property price declines (new residential apartments)	m/m	Apr	5 out of 70 cities	8 out of 70 cities		**	Equity and bond neutral
	Property price unchanged (new residential apartments)	m/m	Apr	0 out of 70 cities	0 out of 70 cities		**	Equity and bond neutral
Japan	GDP	y/y	Q1	1.7%	-1.7%	0.3%	***	Equity bullish, bond bearish
EUROPE								
Eurozone	CPI	y/y	Apr	-0.2%	-0.2%	-0.2%	***	Equity and bond neutral
U.K.	Unemployment rate	m/m	Mar	5.1%	5.1%	5.1%	***	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)	63	63	0	Neutral
3-mo T-bill yield (bps)	30	28	2	Up
TED spread (bps)	33	35	-2	Down
U.S. Libor/OIS spread (bps)	41	40	1	Up
10-yr T-note (%)	1.78	1.77	0.01	Widening
Euribor/OIS spread (bps)	-26	-26	0	Neutral
EUR/USD 3-mo swap (bps)	23	23	0	Neutral
Currencies	**Direction**			
dollar	up			Falling
euro	down			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	$ 49.14	$ 49.28	-0.28%	Ample supply despite production disruptions
WTI	$ 48.35	$ 48.31	0.08%	
Natural gas	$ 2.01	$ 2.05	-1.71%	Warmer weather
Crack spread	$ 17.83	$ 17.99	-0.87%	
12-mo strip crack	$ 13.87	$ 13.95	-0.62%	
Ethanol rack	$ 1.72	$ 1.71	0.50%	
Metals				
Gold	$ 1,274.13	$ 1,278.95	-0.38%	Fed officials indicating rising rate hike likelihoods
Silver	$ 17.03	$ 17.25	-1.25%	
Copper contract	$ 205.65	$ 208.90	-1.56%	Chinese growth concerns
Grains				
Corn contract	$ 396.25	$ 397.00	-0.19%	Supplies likely to improve
Wheat contract	$ 480.25	$ 481.75	-0.31%	
Soybeans contract	$ 1,072.75	$ 1,080.25	-0.69%	
Shipping				
Baltic Dry Freight	643	613	30	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.1		
Gasoline (mb)		-0.9		
Distillates (mb)		-0.8		
Refinery run rates (%)		0.8%		
Natural gas (bcf)		76.0		

Weather

The 6-10 and 8-14 day forecasts are calling for warmer than normal conditions for the eastern half 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,[2] 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,[3] it makes Sen. Clinton's position difficult to defend.

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[2] See WGRs: 2016, Part 1 (3/31/2014); 2016, Part 2 (4/14/2014); and 2016, Part 3 (4/21/2014).
[3] 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*.[4] 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.[5] 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,[6] 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[7] 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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[4] Nader, R. (2014). *Unstoppable: The Emerging Left-Right Alliance to Dismantle the Corporate State*. New York, NY: Nation Books.

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

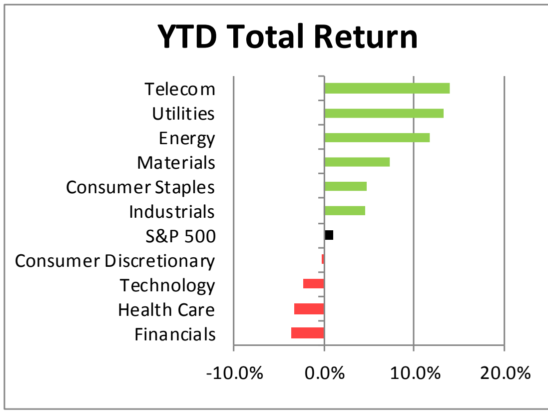
[6] See WGR, 4/4/2016, The Archetypes of American Foreign Policy: A Reprise.

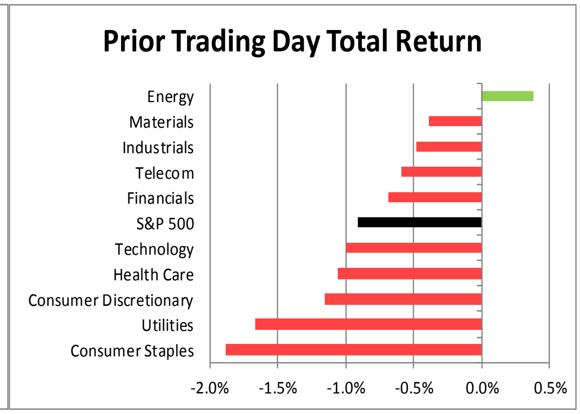
[7] See WGR, 4/11/16, Intergenerational Forgetfulness.

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 5/17/2016 close)

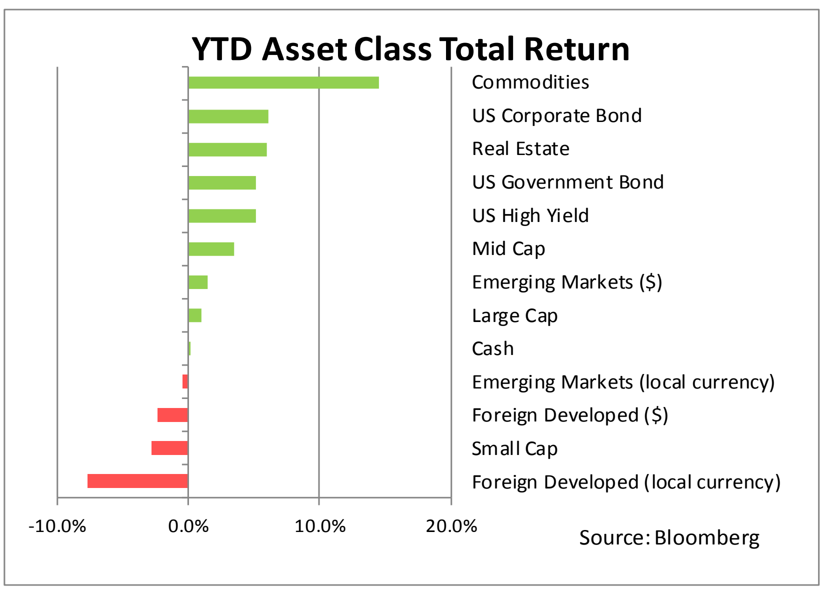




(Source: Bloomberg)

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 5/17/2016 close)

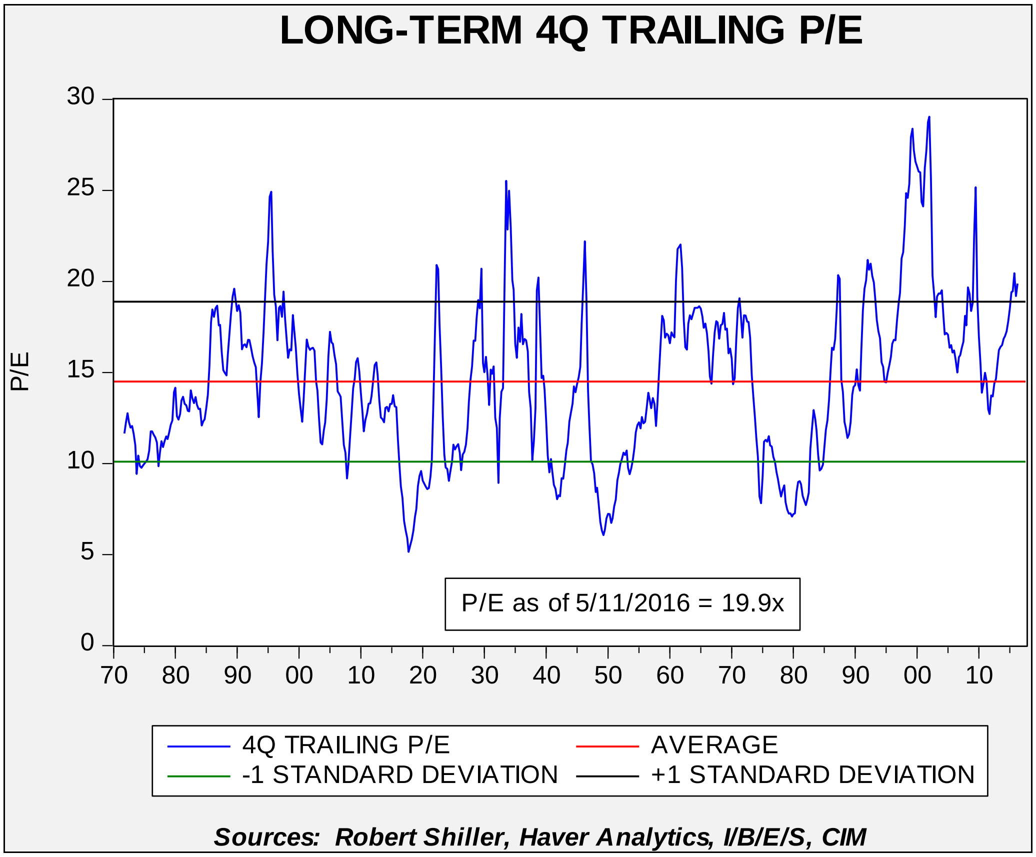


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[8] 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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[8] 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.