Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: May 31, 2016—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading lower by 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed higher by 0.7% from the prior close. Chinese markets closed higher, with the Shanghai composite trading up 3.3% and the Shenzhen index up by 4.1%. U.S. equity futures are signaling a higher opening from the previous close. With 98.2% of the S&P 500 companies having reported, Q1 float-adjusted earnings stand at $26.79, more than the $26.66 forecast. Of the 491 companies that have reported, 72.3% had positive earnings surprises, while 20.2% had negative earnings surprises.

Chinese equities rose sharply overnight as MSCI takes another look at adding this country's equities to its emerging market indices. In one sense, the exclusion of China's equities in these key equity indices is hard to justify. After all, China is an important country; its GDP is the second largest in the world and it has provided the bulk of global growth for most of this century. However, index officials are concerned about the degree of government intervention in China's securities markets. China has put obstacles in the way of short selling. Currently, companies can, nearly without notice, suspend trading of their shares. According to media reports, MSCI is worried about this practice. It should be noted that Bloomberg is reporting a surge in short selling against the FTSE China A50 index, which trades in Hong Kong and has fewer short selling restrictions. We suspect the Xi government would like to see MSCI add Chinese equities to its indices as a sign the country is becoming developed. At the same time, the Chinese government has become increasingly uncomfortable with allowing financial markets to set prices. Although such sentiments are part of every Chinese policy plan, in practice, China seems to like market pricing until prices do something the government doesn't like. Then, it reverts back to intervention. The recent behavior of the CNY is a clear example of China's policy toward markets. The PBOC supported letting the CNY float in a wider range until it looked like a weaker currency was triggering capital flight. Since then, the PBOC has simply set the exchange rate. We expect MSCI to add China to its indices; after all, the company makes money from licensing, and excluding China from its indices makes those products less attractive. Unfortunately, if China is added, the indices will become affected by Chinese government's actions.

Another trend we are noting is that the bitcoin exchange rate is steadily rising and the uptrend is accelerating.

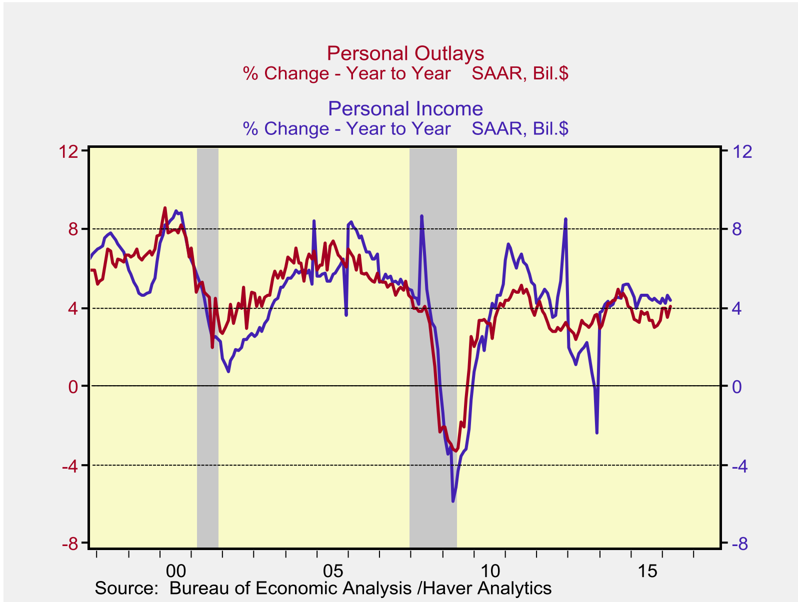
(Source: Bloomberg)

This chart shows the level of bitcoin in USD. After the 2013 spike, the cryptocurrency's value steadily dropped into early 2015 and was mostly range bound until last autumn when prices began to rise. Over the past couple of days, we have seen a surge in value. Bloomberg, quoting the website bitcoincharts.com, notes that 90% of bitcoin trading is coming from China. We suspect Chinese investors are using the currency as one avenue for capital flight. Given the cryptocurrency's anonymous structure, it is attractive to investors and others trying to keep their assets invisible to governments. The recent spike in bitcoin may be a signal of growing financial system problems in China.

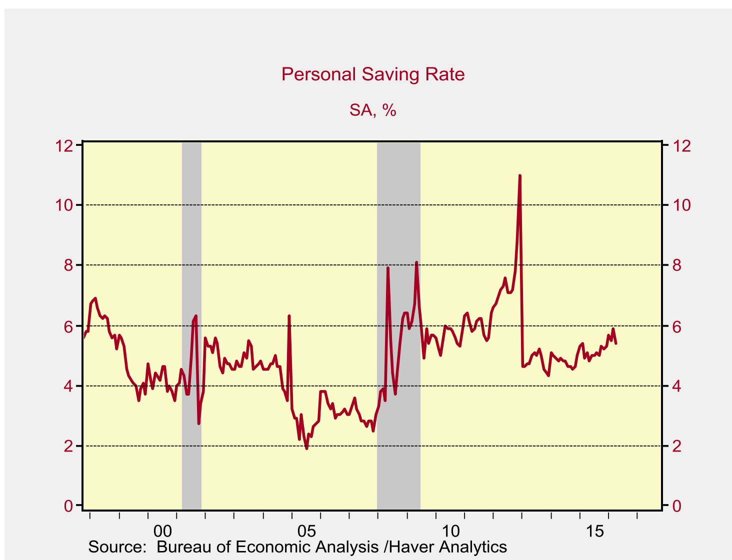
Yesterday, the JPY weakened considerably and it is steady this morning. Now that the G-7 meeting is out of the way, we look for Japan to take steps to strengthen its economy via fiscal and monetary expansion. We expect a fiscal stimulus package of at least 1% of GDP. It will likely include actual spending and a delay of a VAT increase. On monetary policy, about the only avenue left would be to expand QE as NIRP hasn't worked as expected.

U.S. Economic Releases

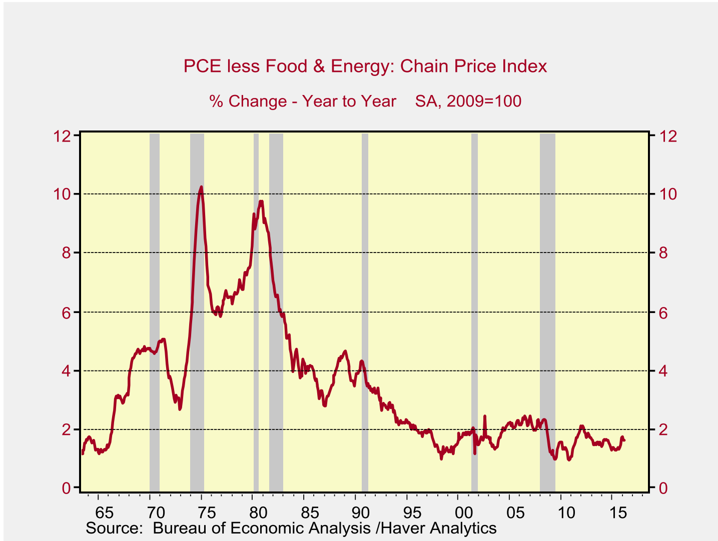
Personal income rose 0.4% in April, on forecast, while personal spending rose 1.0%, better than the 0.7% forecast. The chart below shows the annual change in incomes and spending. The savings rate declined with incomes up less than spending.



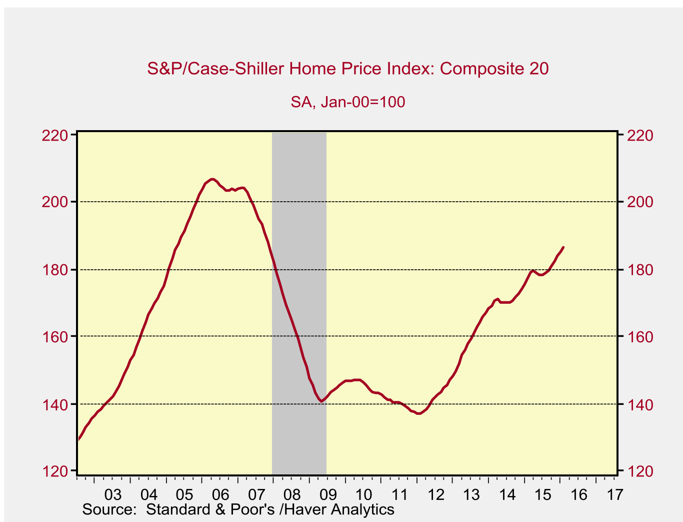
The chart below shows the personal savings rate, which fell to 5.4% from 5.9% the month before. Consumers seem to feel more confident as payroll numbers have remained strong and wages are gradually picking up.



One of the Fed's favorite inflation measures, the core PCE, rose 1.6% annually, on forecast, while the overall PCE rose 1.1%, also on forecast.



The Case-Shiller 20-city housing price composite rose 0.9% from the month before, better than the 0.8% increase forecast. The chart below shows the overall home price index, which has been moving up uninterrupted since last year.



The largest positive price contributions came from San Francisco, Los Angeles, Seattle and Chicago, while the largest negative price contributions came from Miami, Detroit, Portland and Minneapolis.

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	Chicago purchasing manager index	m/m	May	50.5	50.4	**
10:00	Consumer confidence	m/m	May	96.1	94.2	**
10:30	Dallas Fed manufacturing activity	m/m	May	-8.0	-13.9	*

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	GDP	y/y	Q1	7.9%	7.2%	7.5%	***	Equity bullish, bond bearish
Japan	Unemployment rate	m/m	Apr	3.2%	3.2%	3.2%	***	Equity and bond neutral
	Industrial production	y/y	Apr	-3.5%	0.2%	-5.0%	***	Equity and bond neutral
	Retail sales	y/y	Apr	-0.8%	-1.0%	-1.2%	**	Equity and bond neutral
EUROPE								
Eurozone	Unemployment rate	m/m	Apr	10.2%	10.2%	10.2%	***	Equity and bond neutral
	CPI	y/y	May	0.8%	0.7%	0.8%	***	Equity and bond neutral
France	GDP	y/y	Q1	1.4%	1.3%	1.3%	***	Equity bullish, bond bearish
	CPI	y/y	May	-0.1%	-0.2%	-0.1%	***	Equity and bond neutral
	PPI	y/y	Apr	-4.1%	-3.9%		**	Equity bearish, bond bullish
Germany	CPI	y/y	May	0.1%	-0.1%	0.1%	***	Equity and bond neutral
	Retail sales	y/y	Apr	2.3%	0.6%	1.7%	**	Equity bullish, bond bearish
AMERICAS								
Canada	GDP	y/y	Mar	1.1%	1.4%	1.4%	***	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)	67	67	0	Neutral
3-mo T-bill yield (bps)	31	31	0	Neutral
TED spread (bps)	37	37	0	Neutral
U.S. Libor/OIS spread (bps)	47	47	0	Neutral
10-yr T-note (%)	1.88	1.85	0.03	Widening
Euribor/OIS spread (bps)	-26	-26	0	Neutral
EUR/USD 3-mo swap (bps)	29	29	0	Neutral
Currencies	**Direction**			
dollar	up			up
euro	up			down
yen	up			down
franc	down			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	$ 49.54	$ 49.76	-0.44%	Awaiting the OPEC meeting
WTI	$ 49.56	$ 49.33	0.47%	
Natural gas	$ 2.21	$ 2.17	1.84%	
Crack spread	$ 17.07	$ 17.58	-2.91%	
12-mo strip crack	$ 13.76	$ 14.16	-2.81%	
Ethanol rack	$ 1.80	$ 1.80	0.00%	
Metals				
Gold	$ 1,209.90	$ 1,204.95	0.41%	
Silver	$ 16.01	$ 15.99	0.13%	
Copper contract	$ 210.35	$ 211.40	-0.50%	Stronger dollar
Grains				
Corn contract	$ 411.25	$ 412.75	-0.36%	
Wheat contract	$ 478.25	$ 481.50	-0.67%	More favorable weather
Soybeans contract	$ 1,090.50	$ 1,086.50	0.37%	
Shipping				
Baltic Dry Freight	606	601	5	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)	-4.2	-1.6	-2.6	
Gasoline (mb)	2	-1.3	3.3	
Distillates (mb)	-1.3	-1.1	-0.2	
Refinery run rates (%)	-0.8%	0.5%	-1.3%	
Natural gas (bcf)	71.0	69.0	2.0	

Weather

The 6-10 and 8-14 day forecasts are calling for warmer than normal conditions for the western half of the country and the Southeast. Precipitation is forecast for the coasts.

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.

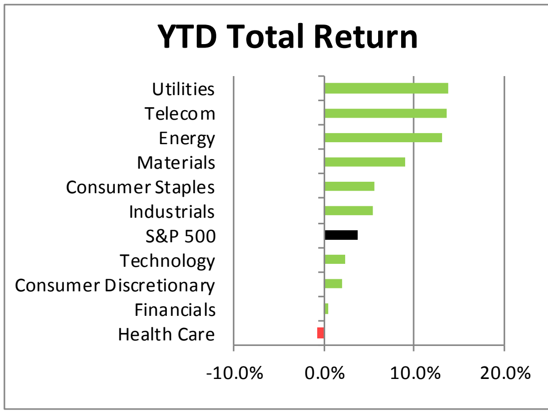
Environmental Policy: Her policies will likely follow in the trends established by President Obama. We would not expect anything as radical as Sen. Sanders's bid to end fracking. At the same time, her policies won't revive coal and we would expect a steadily tightening regulatory environment for oil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

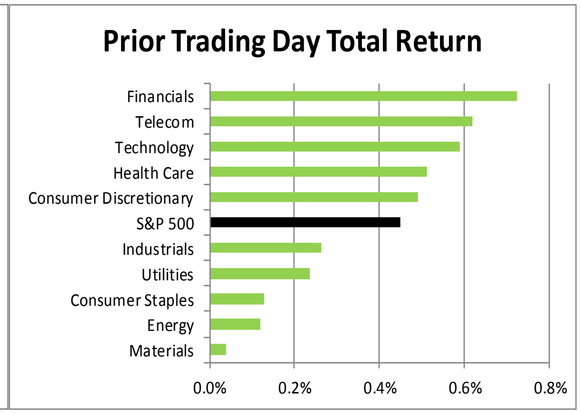
The market impact from a Clinton presidency would be negligible. Not only is she a solid member of the political establishment, but because she is running a campaign similar to a succeeding vice president, she will have virtually no political capital to bring "change" after gaining office. Thus, the 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.***

Data Section

U.S. Equity Markets – (as of 5/27/2016 close)

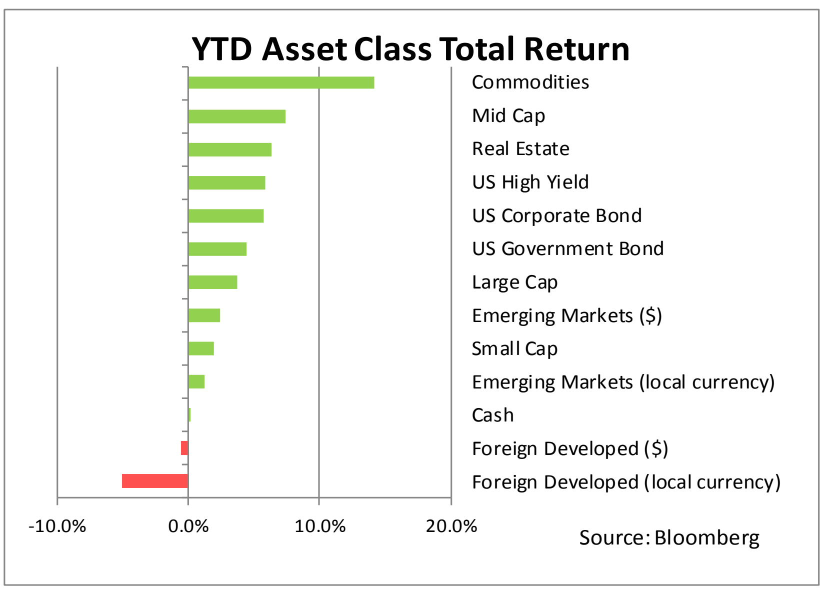




(Source: Bloomberg)

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 5/27/2016 close)

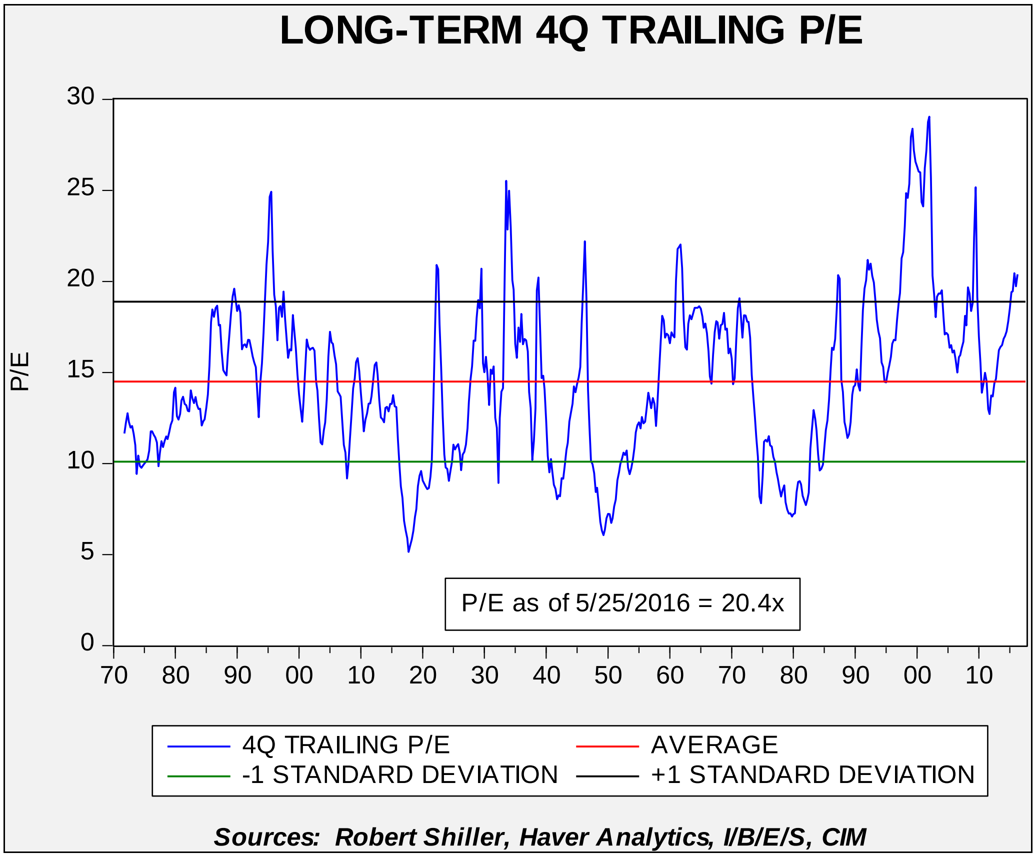


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 26, 2016



Based on our methodology,[3] the current P/E is 20.4x, up 0.5x from last week. The P/E rose mostly 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.

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[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.