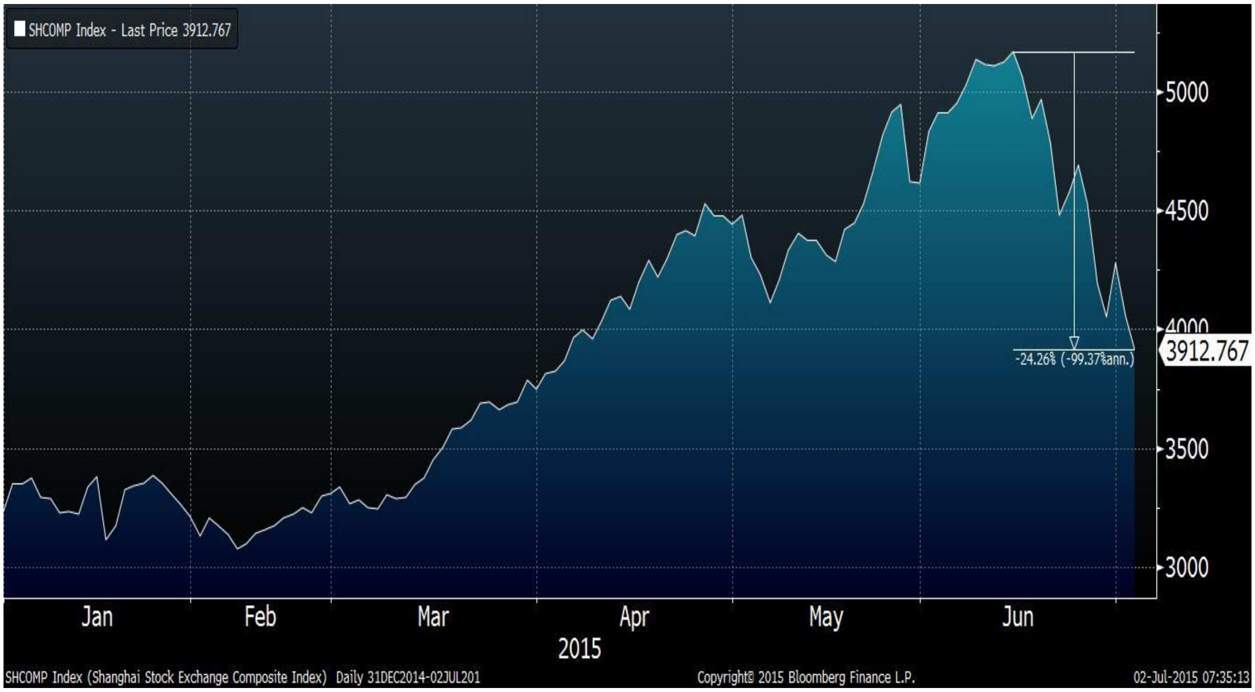
By Bill O'Grady & Kaisa Stucke, CFA

[Posted: July 2, 2015—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is trading down 0.1% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.1% from the prior close. U.S. equity futures are signaling a higher opening from the previous close.

The big news this morning is a rather soft employment report, which we will detail below. Two other important items of note:

Greece: Positions have hardened as the Sunday vote looms. Although recent polling shows the vote is too close to call, it appears to us that momentum is favoring the "yes" vote, which should spell the end of the Syriza coalition. If we are correct on this call, and the Greeks vote to stay in the Eurozone at the cost of continued austerity, then the current government is essentially doomed. New elections will certainly follow with the most likely outcome being a national unity government of the center-left and center-right. Look for the EU (read: Germany) to shower the new government with support. European equity markets should take this outcome as positive. The EUR probably rallies modestly, although a Grexit might actually be more bullish as it would cut out a weak nation from the basket. As a side note, today's *NYT* has a good piece on the "brain drain" occurring in Greece due to the financial crisis there. Given the poor prospects for the country, Greece will likely become a country where the educated and ambitious leave and the economy becomes dependent on private remittances from Greek expats sending money home.

China: Despite several measures to prop up Chinese equities, the stock market continues to tumble. The government is proposing actions to ease margin lending restrictions, including lowering the ratio of assets to loans and offering a longer "trigger" before margin calls are required. These measures smack of desperation which is probably why they aren't helping.

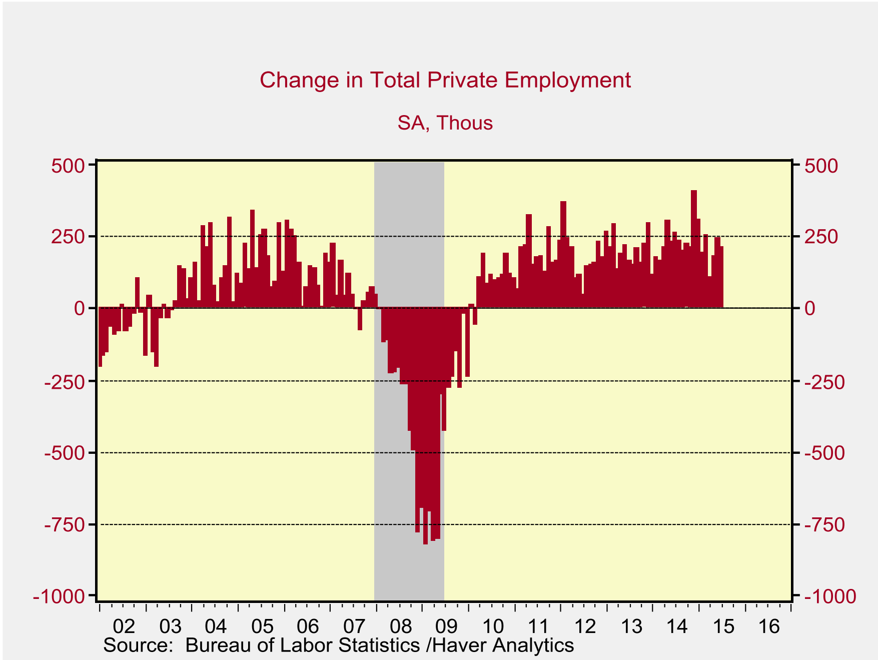


(Source: Bloomberg)

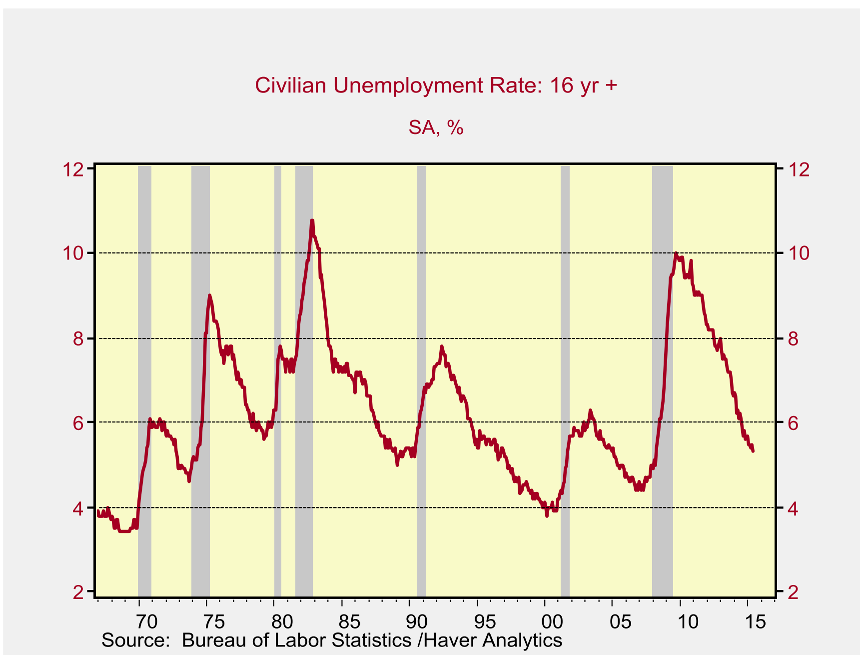
This chart shows the closing level of the Shanghai Composite. Since its closing peak two weeks ago, the index is off over 24%. The smaller capitalization indexes have suffered even greater losses. The rise and subsequent fall in equities is something of a warning for Chinese financial officials that deregulating financial markets is a tricky affair; it also shows the undeveloped state of China's financial markets. Although it is always dangerous within China to take the side opposite of the PBOC and the CPC, it does look like the "love affair" that Chinese investors had with stocks was maybe little more than a "spring fling."

U.S. Economic Releases

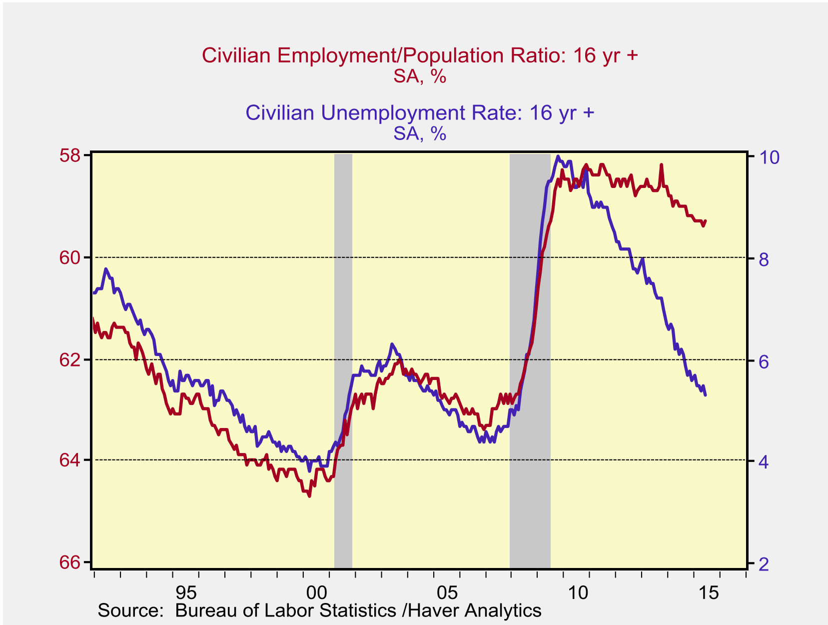
The employment and payroll reports came in weaker than expected overall. June payrolls came in at 223k compared to the 233k forecast. May numbers were revised significantly lower to 254k from 280k. All the hiring came from the private sector, with private payrolls up 223k, close to the 225k forecast. Although the unemployment rate fell more than expected, falling to 5.3% from 5.5%, the employment report revealed an overall soft labor market. The labor force shrank, the participation rate fell and employment also declined. Wage growth was unchanged from the month before, less than expected.



The chart above shows the change in private payrolls. Overall, payrolls are rising on expectations of end-demand improvement.



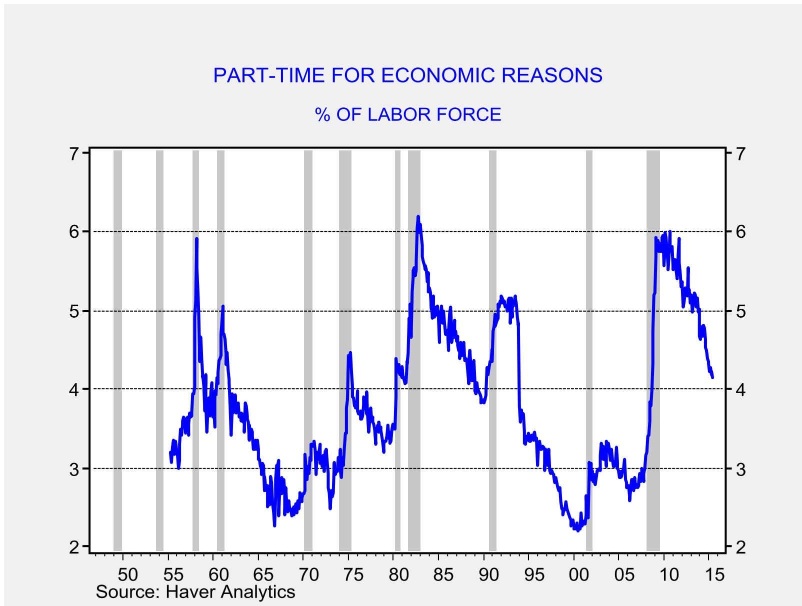
The chart above shows the unemployment rate, which improved to 5.3% from 5.5%, also better than the 5.4% forecast. However, the details of the employment report reveal that employment actually fell by 56k, while the labor force shrank 432k, lowering the unemployment rate on the back of numbers that are not exactly encouraging. In other words, the decline in unemployment was mostly due to a decrease in the size of the labor force.



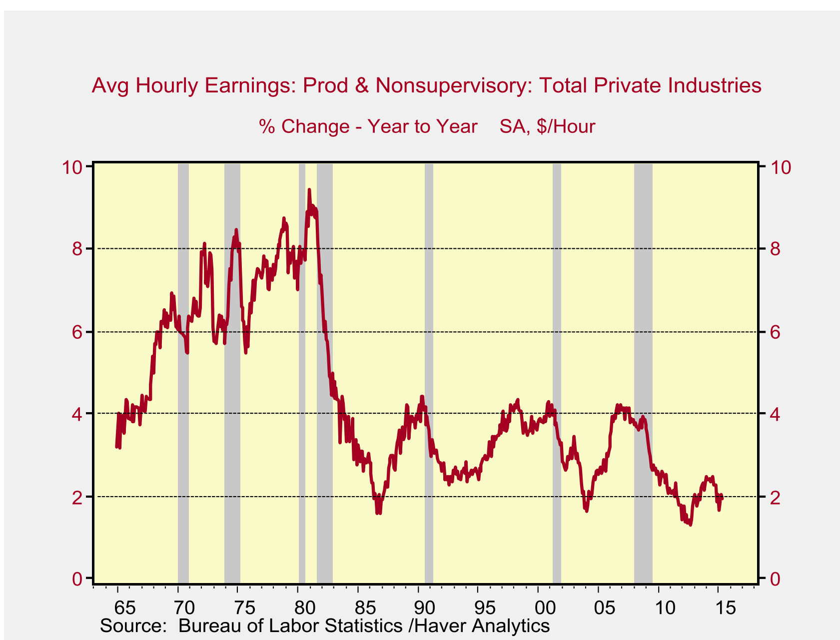
The chart above shows the unemployment rate and the employment/population ratio (on an inverted scale). Prior to the 2008 recession, these two metrics moved closely together. However, since the recession, the two readings have diverged. June's numbers took the readings further apart. We suspect that the divergence is due to skills mismatches and other structural labor market issues.

The chart above shows the average duration of unemployment, which fell to 28.1 weeks from 30.7 weeks.

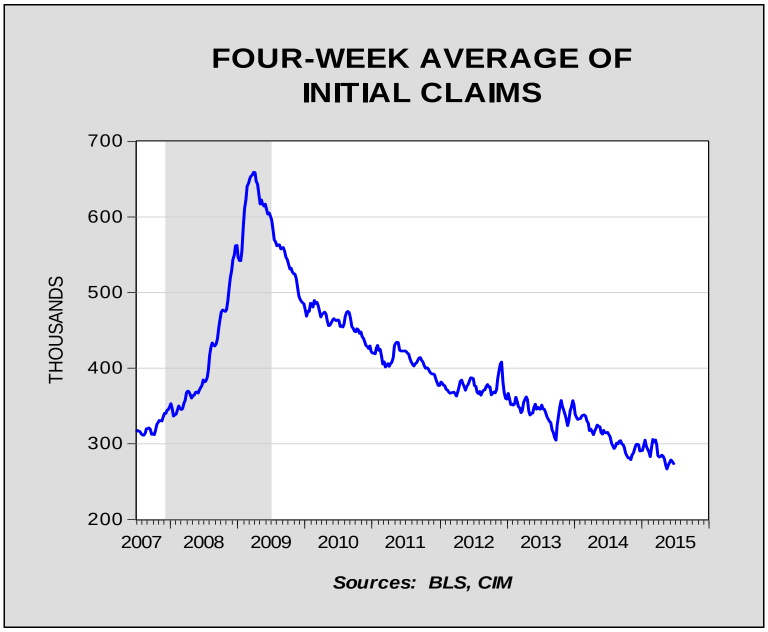
The number of part-time workers who would prefer full-time work fell to 4.1% in June from 4.2% in May. This number is closely watched by Chairman Yellen as a measure of labor market slack. A reading under 4% would generally signal a "normal" labor market, so this number is getting close to suggesting a better labor situation.



At the same time, wages growth has been weak. The chart below shows the annual change in wages, which fell to 1.9% from 2.0% the month before.



The jobless claims were also released this morning. Claims rose 10k to 281k compared to the 270k forecast.



The chart above shows the four-week average of claims. The average is still trending downward and companies are maintaining their workforce.

For the most part, today's labor market data was disappointing. The data was neutral for equities, bullish for debt and bearish for the dollar.

For the rest of the day, at 9:45 EDT, the June ISM New York report will be released. At 10:00, the May factory orders report will be published, with a forecast monthly decline of -0.5%.

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	Trade balance (AUD)	m/m	May	-2.8 bn	-4.1 bn	-2.2 bn	**	Equity bearish, bond bullish
India	Manufacturing PMI	m/m	Jun	51.3	52.6		***	Equity bearish, bond bullish
Japan	Monetary base	y/y	Jun	34.2%	35.6%		**	Equity bearish, bond bullish
EUROPE								
Eurozone	PPI	y/y	May	-2.0%	-2.1%	-2.0%	**	Equity and bond neutral
AMERICAS								
Brazil	Industrial production	y/y	May	-8.8%	-7.8%	-10.0%	***	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)	28	28	0	Neutral
3-mo T-bill yield (bps)	0	2	-2	Down
TED spread (bps)	28	27	1	Up
U.S. Libor/OIS spread (bps)	14	13	1	Up
10-yr T-note (%)	2.37	2.42	-0.05	Widening
Euribor/OIS spread (bps)	11	10	1	Up
EUR/USD 3-mo swap (bps)	21	21	0	Neutral
Currencies	**Direction**			
dollar	up			Rising
euro	up			Falling
yen	down			Falling
franc	down			Falling

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	$ 62.49	$ 62.01	0.77%	General optimism
WTI	$ 57.07	$ 56.96	0.19%	
Natural gas	$ 2.82	$ 2.78	1.47%	Gas demand rising on hot weather in Europe
Crack spread	$ 25.89	$ 25.42	1.84%	
12-mo strip crack	$ 19.14	$ 18.98	0.83%	
Ethanol rack	$ 1.79	$ 1.79	0.32%	
Metals				
Gold	$ 1,159.97	$ 1,168.79	-0.75%	
Silver	$ 15.56	$ 15.58	-0.17%	
Copper contract	$ 262.65	$ 263.05	-0.15%	
Grains				
Corn contract	$ 423.25	$ 422.50	0.18%	
Wheat contract	$ 583.00	$ 588.50	-0.93%	
Soybeans contract	$ 1,031.25	$ 1,029.50	0.17%	
Shipping				
Baltic Dry Freight	794	800	-6	
DOE inventory report expectations of weekly change				
	Actual	**Expected**	**Difference**	
Crude (mb)	2.4	-1.7	4.1	
Gasoline (mb)	-1.8	0.2	-2.0	
Distillates (mb)	0.4	1.3	-0.9	
Refinery run rates (%)	1.0%	0.2%	0.8%	
Natural gas (bcf)		72		

Weather

The 6-10 and the 8-14 day forecasts call for cooler and rainier than normal conditions for the middle of the country, with the coasts seeing warmer temps. There is no tropical activity to report.

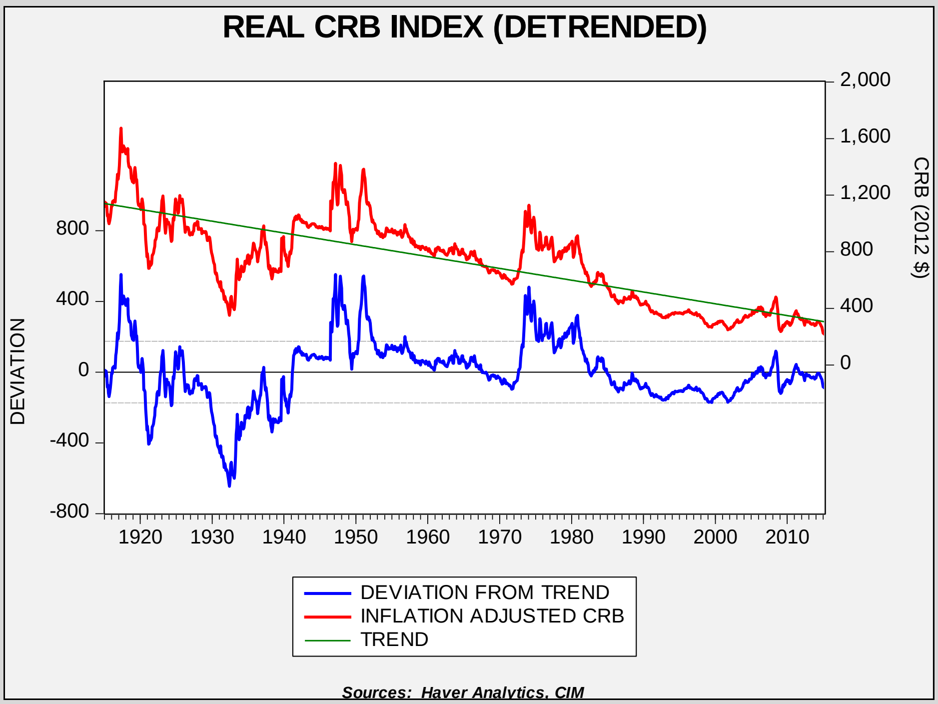
Weekly Asset Allocation Commentary

Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. This year, we will start reporting asset allocation thoughts on a weekly basis, updating the piece every Friday. We hope you find this new addition useful.

July 2, 2015

Most asset allocation models use three broad asset classes—cash, equities and fixed income. Within these broad classes, there are numerous categories for investment. For example, within equities, there are market sectors (utilities, consumer staples, etc.), capitalizations (mid-caps, small caps) or international (developed markets and emerging markets). In fixed income, the two major differentiation choices are duration and credit risk.

In addition to these traditional asset classes, we also consider commodities in our allocation portfolios. To some extent, commodities are an opportunistic asset class.



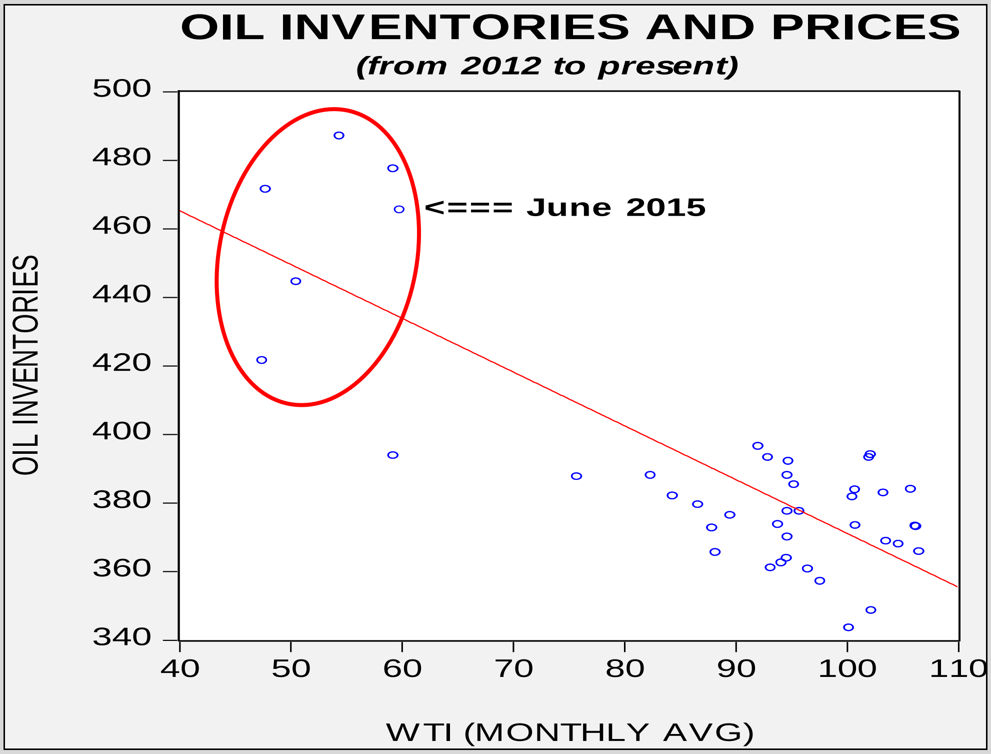
This chart shows the inflation-adjusted Commodity Research Bureau's (CRB) index of commodity prices, beginning in 1915. In the long run, commodity prices have tended to decline compared to consumer inflation. That's why the trend line has been on a steady decline over the past century. This is one of the key reasons capitalism has been the most successful method of organizing economic activity. Over time, businesses and households are given incentives to more efficiently produce and consume commodities; thus, commodity prices tend to fall compared to consumer prices, meaning that households can spend their money on other things.

However, just because this downtrend exists doesn't mean there are not periods when commodity prices do rise relative to overall prices and an allocation to commodities lifts portfolio returns. The deviation line on the chart shows periods which have lasted from five to fifteen years when commodity prices exceeded trend, which is to say they rose faster than consumer prices. In general, these periods tended to occur during periods of war and currency instability. Simply put, during periods of geopolitical and/or financial instability, commodity prices tend to rise above trend. The reasons? First, wars tend to consume enormous amounts of commodities which lift their demand. Second, during war, normal supply chains are disrupted which leads to hoarding, driving prices higher. Third, during periods of financial instability, businesses and households will use commodities as forms of savings. When inflation-adjusted interest rates are negative, there is an incentive to directly hold inventory instead of cash; the former is holding its value better than the latter.

The most recent bull market in commodities, which began in late 1999, was historically unusual in that neither war nor financial instability played a major role. Instead, the primary driver of this rally was emerging market economic growth, mostly coming from China. As China's economy has slowed, commodity prices have eased. Since we expect China's economic growth to remain sluggish, commodity prices will likely remain weak as well.

However, just because broad-based commodity prices remain weak, there may be occasional opportunities in various sectors of the asset class. Generally speaking, precious metals and oil can move somewhat independently of broader commodities. Gold is more of a contra-currency and has historically tended to rally in periods of fear as investors use the yellow metal as an ultimate safety asset. Such instances often occur during periods of weak economic growth, which tend to depress overall commodity prices. Oil prices can also be resilient during periods of commodity weakness because the oil market has usually operated under cartel conditions. The cartel operates by keeping some production off the market, which raises prices above their market clearing rate; at the same time, this excess capacity buffer also acts as a price stabilizer. When production interruptions occur, the cartel will bring this excess production to market to take advantage of rising prices, stabilizing the market.

The current cartel, OPEC, is trying to expand its market share. Thus, it is holding less capacity offline, which is a bearish factor and has caused prices to fall from $100 to $50 per barrel over the past year. However, there is some evidence to suggest that oil prices are starting to stabilize.



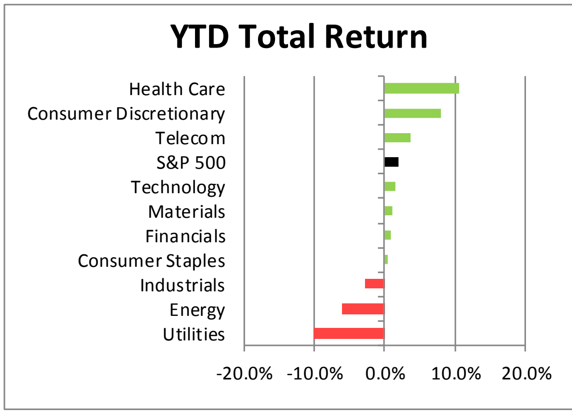
(Source: Haver Analytics, DOE, CIM)

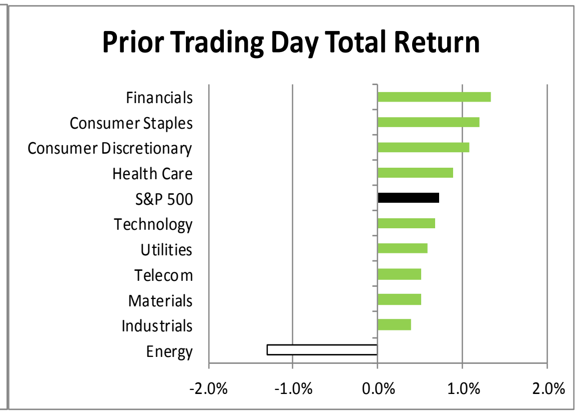
This chart shows a scatterplot of U.S. commercial crude oil inventories and West Texas Intermediate (WTI) oil prices. Last winter, oil inventories reached their highest levels since the early 1930s. However, rising demand, falling imports and declining North American production have been reducing the glut of inventory seen earlier this year. The current level of stocks is still consistent with prices around $40 per barrel, but as the dots within the oval in the chart show, the overhang is easing. Seasonally, crude oil inventories tend to decline in the summer as refineries boost output to meet vacation driving demand. This demand tends to slow by mid-August as schools resume classes. But, it does suggest that the market will probably settle around $50 per barrel by autumn.

At this point, outside of the diversification that commodities provide (commodities tend to be less correlated to traditional asset classes), it is probably too early to be considering commodity positions. However, circumstances may provide an opportunity in oil in the coming months as prices stabilize. Of course, if OPEC decides to reverse its goal of expanding market share, oil prices could rise rapidly. We don't expect this to occur in the short run, but would expect OPEC to take this step at some point in the future.

<u>Data Section</u>

U.S. Equity Markets – (as of 7/1/2015 close)

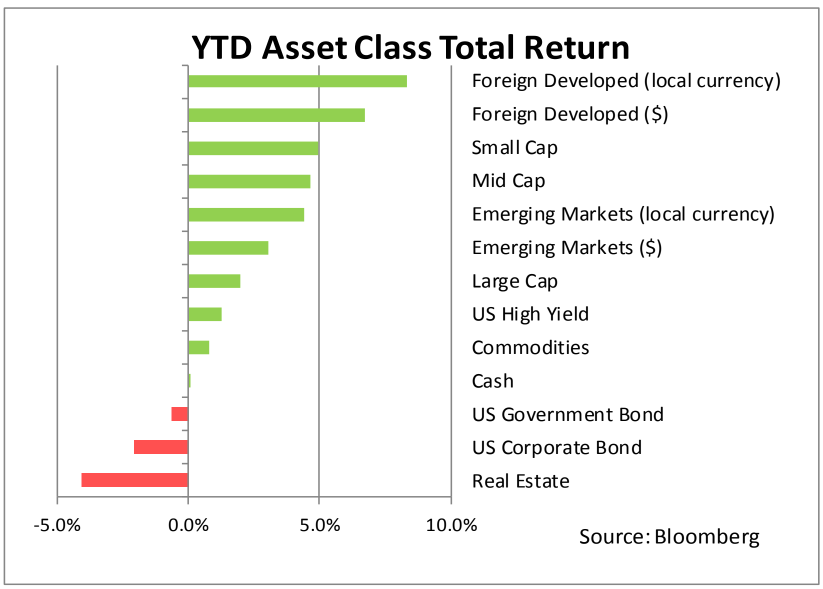




(Source: Bloomberg)

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 7/1/2015 close)

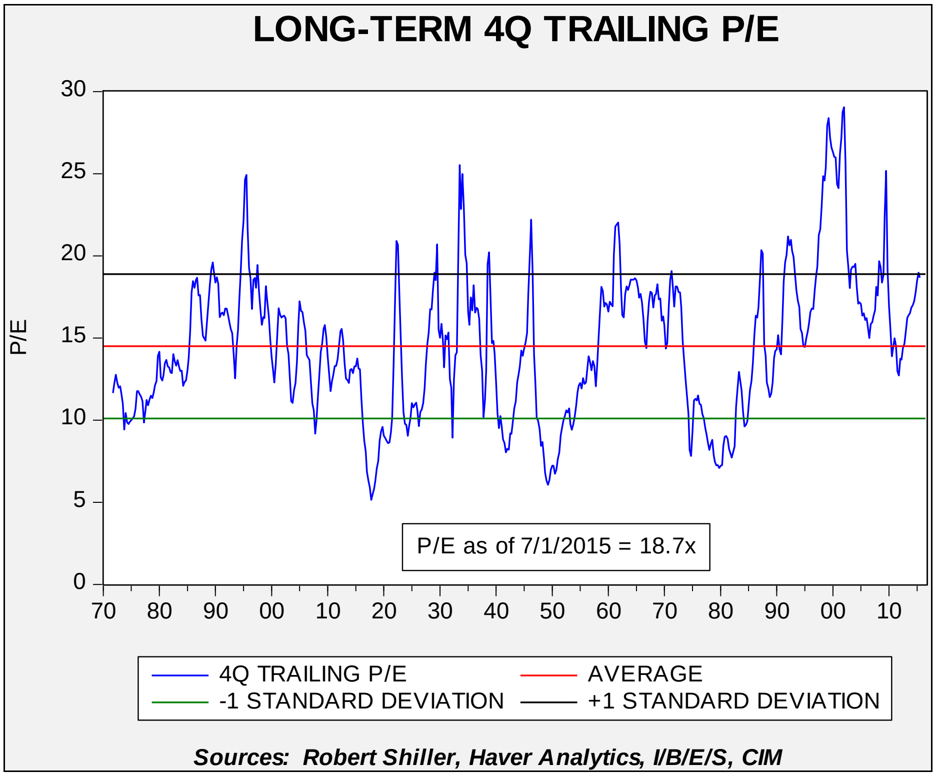


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

July 2, 2015



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 (Q4 and Q1) and two estimates (Q2 and Q3). 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.

Based on our methodology, the current P/E is 18.7x, down from 19.0x last week. The decline is entirely due to the onset of Q3 and the addition of earnings estimates for the current quarter. The usual pattern is for these estimates to decline over the quarter; assuming the S&P 500 remains near current levels, we would anticipate the P/E to rise in the coming weeks.

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.