Confluence INVESTMENT MANAGEMENT

Daily Comment

By Bill O'Grady & Kaisa Stucke, CFA

[Posted: June 29, 2015—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is trading down 3.8% from the last close. In Asia, the MSCI Asia Apex 50 was down 2.5% from the prior close. U.S. equity futures are signaling a lower opening from the previous close.

Greece: Risk markets slumped around the world, while Treasuries and German bunds rose after Greek PM Tsipras called a referendum, essentially calling off any further negotiations until the referendum is held. Greece also imposed capital controls, closing banks until July 6th, the day after the referendum. With negotiations called off, both Merkel and Hollande have signaled that their countries have reached their limits of being able to offer Greece any further concessions after Tsipras's surprise decision to call a referendum. Politically, it makes sense for the EU leadership not to offer concessions to a populist government ahead of a referendum that will decide whether or not the country will stay in the Eurozone and the EU. Greek polls indicate that the majority of voters would like to stay in the EU. So, EU leaders are counting on voters to vote "yes" on remaining in the Eurozone, which would sweep the Tsipras government from office and maintain Greece within the Eurozone.

We note that the referendum is not a vote over whether the country should stay in the EU, but rather the question being asked of voters is actually if they will approve a complex set of proposals for austerity in return for EU bailout funding. In general, Greek voters do not vote in favor of austerity measures, but the odds of austerity being approved in order to stay in the union are increasing. We would expect for Tsipras to present a "no austerity" vote as a way to persuade the EU to grant Greece funding either way. Although EU leaders would like to see the Eurozone remain intact, they believe that the risks have been reduced sufficiently so as not to cause widespread contagion in the Eurozone. For their part, EU leaders are signaling to Greece that this referendum is not just a vote on austerity measures, but also a vote on its future membership in the Eurozone.

China: Chinese stocks continued their downtrend, despite the PBOC's move to cut its one-year lending rate as this move struck many market participants as desperate. Additionally, rumors are emerging that regulators are considering suspending initial public offerings to stabilize the stock market.

U.S. Economic Releases

There are no releases scheduled before we go to print, but for the rest of the day, at 10:00 EDT, the May pending home sales will be released, with a forecast monthly increase of 1.2%. At 10:30, the June Dallas Fed manufacturing activity index will be released, with a forecast level of -16.0, strengthening from the -20.8 level the month before.

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 profits	y/y	May	0.6%	2.6%		**	Equity bearish, bond bullish
Japan	Retail sales	m/m	May	1.7%	0.3%	1.0%	**	Equity bullish, bond bearish
	Industrial production	y/y	May	-4.0%	0.1%	-2.3%	***	Equity bearish, bond bullish
EUROPE								
Eurozone	Economic confidence	m/m	Jun	103.5	103.8	103.8	**	Equity bearish, bond bullish
	Business climate indicator	m/m	Jun	0.1	0.3	0.3	**	Equity bearish, bond bullish
	Industrial confidence	m/m	Jun	-3.4	-3.0	-3.0	**	Equity bearish, bond bullish
	Services confidence	m/m	Jun	7.9	7.9	8.0	**	Equity bearish, bond bullish
	Consumer confidence	m/m	Jun	-5.6	-5.6	-5.6	**	Equity and bond neutral
Germany	CPI	y/y	Jun	0.3%	0.5%	0.7%	***	Equity bearish, bond bullish
U.K.	M4 money supply	y/y	May	0.7%	0.1%		**	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	0	0	Neutral
TED spread (bps)	29	28	1	Up
U.S. Libor/OIS spread (bps)	14	14	0	Neutral
10-yr T-note (%)	2.35	2.47	-0.12	Narrowing
Euribor/OIS spread (bps)	11	10	1	Up
EUR/USD 3-mo swap (bps)	23	20	3	Up
Currencies	**Direction**			
dollar	up			Rising
euro	down			Falling
yen	up			Falling
franc	up			Falling
Central Bank Action	**Current**	**Prior**	**Expected**	
Chinese one-year lending rate	4.85%	5.10%		Loosening

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	$ 61.68	$ 63.26	-2.50%	Greek uncertainty
WTI	$ 58.25	$ 59.63	-2.31%	
Natural gas	$ 2.78	$ 2.77	0.47%	
Crack spread	$ 23.20	$ 22.98	0.95%	
12-mo strip crack	$ 17.72	$ 17.56	0.87%	
Ethanol rack	$ 1.74	$ 1.73	0.49%	
Metals				
Gold	$ 1,178.78	$ 1,175.52	0.28%	Investment demand
Silver	$ 15.84	$ 15.81	0.19%	
Copper contract	$ 262.40	$ 263.55	-0.44%	Chinese growth uncertainty
Grains				
Corn contract	$ 397.00	$ 392.50	1.15%	El Nino threat re-emerges
Wheat contract	$ 573.00	$ 568.00	0.88%	
Soybeans contract	$ 983.75	$ 986.00	-0.23%	
Shipping				
Baltic Dry Freight	823	829	-6	

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.

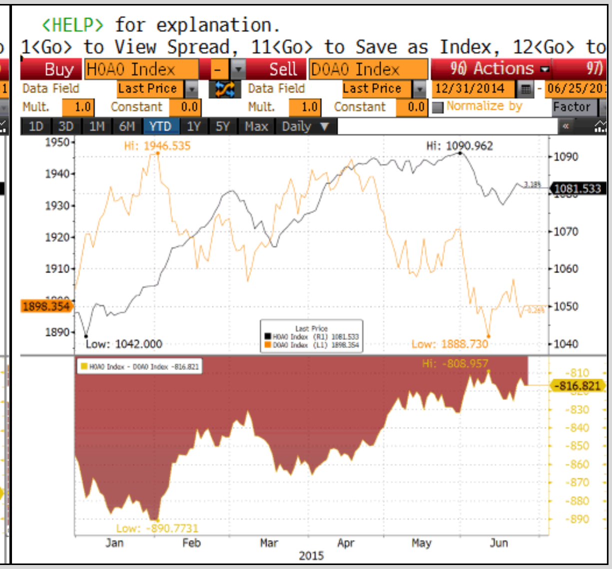
June 26, 2015

High yield bonds prices were volatile in the second half of last year, but have been steadier thus far in 2015. Over the past few years, rising crude oil output from domestic shale production and the energy industry's significant use of debt financing created an outsized energy sector representation in the speculative grade bond market. So, when crude oil prices collapsed in 2014, most energy sector bonds declined in price, lowering returns across the entire speculative grade bond asset class.

Since last December, the speculative grade bond market has been improving. We note that energy is still a large portion of the market and if oil prices decline we could see further weakness. However, thus far, defaults have not escalated and we expect them to remain relatively low as long as the broader economy continues to grow. More recently, speculative grade bonds have faced pricing pressure from a different source—tighter Fed policy. Interest rates are higher in most sectors in anticipation of the Fed raising short-term rates. Although challenges exist for speculative grade bonds, and returns may be lower going forward, speculative grade bonds can still play a constructive role where income is an objective.

Speculative grade bonds combine the characteristics of both fixed income and equity, so they tend to be more volatile than traditional fixed income as they are affected by the economic cycle, but less volatile than equities. The higher yield profile of this asset class can offer some protection against increased volatility. The current yield of more than 5% looks attractive, especially compared to the low rates offered by higher grade bonds and the near-zero yields offered by international developed market bonds. But like most other asset classes, speculative grade bond valuations have moved higher over the past several quarters, a trend that indicates future returns are likely to moderate.

The charts on the next page show the year-to-date performance of the Merrill Lynch High Yield Index against the S&P 500 on the left and against the Merrill Lynch Domestic Master Index on the right. As shown in the charts, the high yield market is more correlated with equities than investment grade bonds.



In our investment process we tend to look at the health of the underlying companies' financial profiles to determine the relative attractiveness of an asset class. Earnings have strengthened in the current, steadily improving economic environment, which will likely help maintain relatively low default rates.

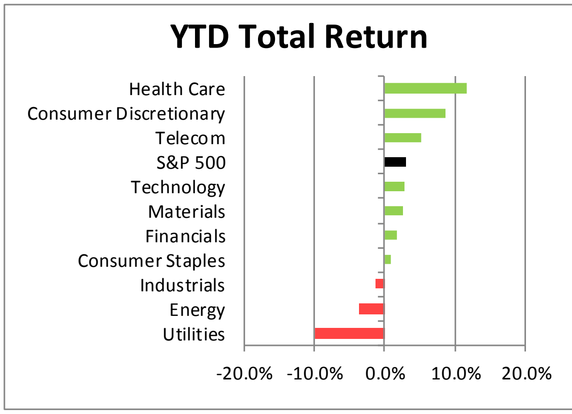
Historically, high yield bonds have performed well in a rising rate environment. In both the 2004 and 1994 tightening cycles, high yield outperformed higher grade bonds. Additionally, rate hikes are likely to be gradual and well-telegraphed, removing some risk to the high yield market.

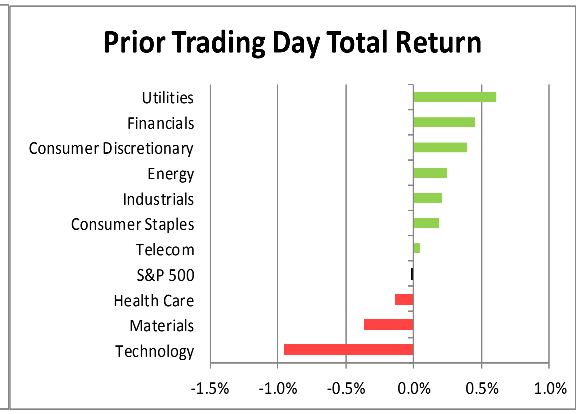
The high yield spread, the premium that investors require for holding the additional credit risk instruments, is currently around 3.0%. When this spread widens, stress has increased and investors are requiring a larger yield spread for taking on the risk. The wider spread can also represent an attractive return potential, especially if economic conditions are expected to improve. The current spread is around its mid-range, meaning the high yield return and risk potential is trading at fair value.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

U.S. Equity Markets – (as of 6/26/2015 close)

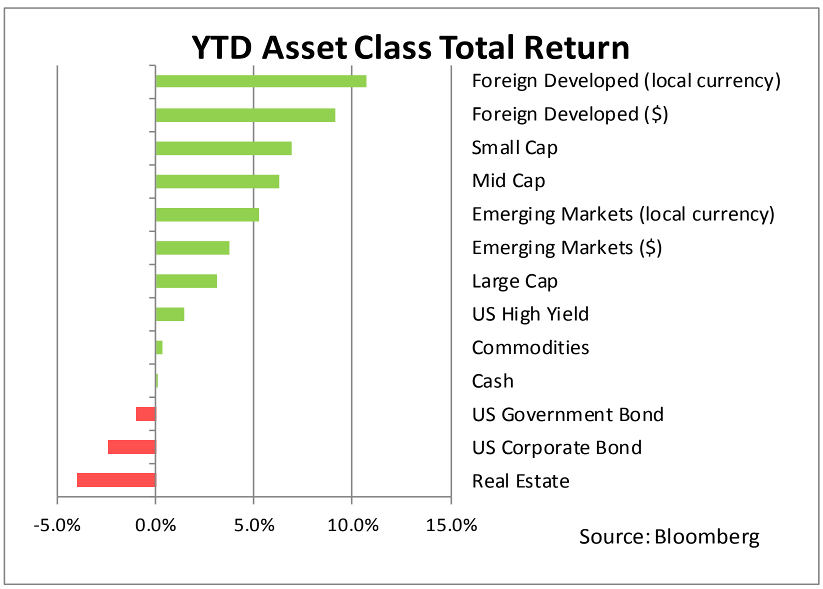




(Source: Bloomberg)

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 6/26/2015 close)

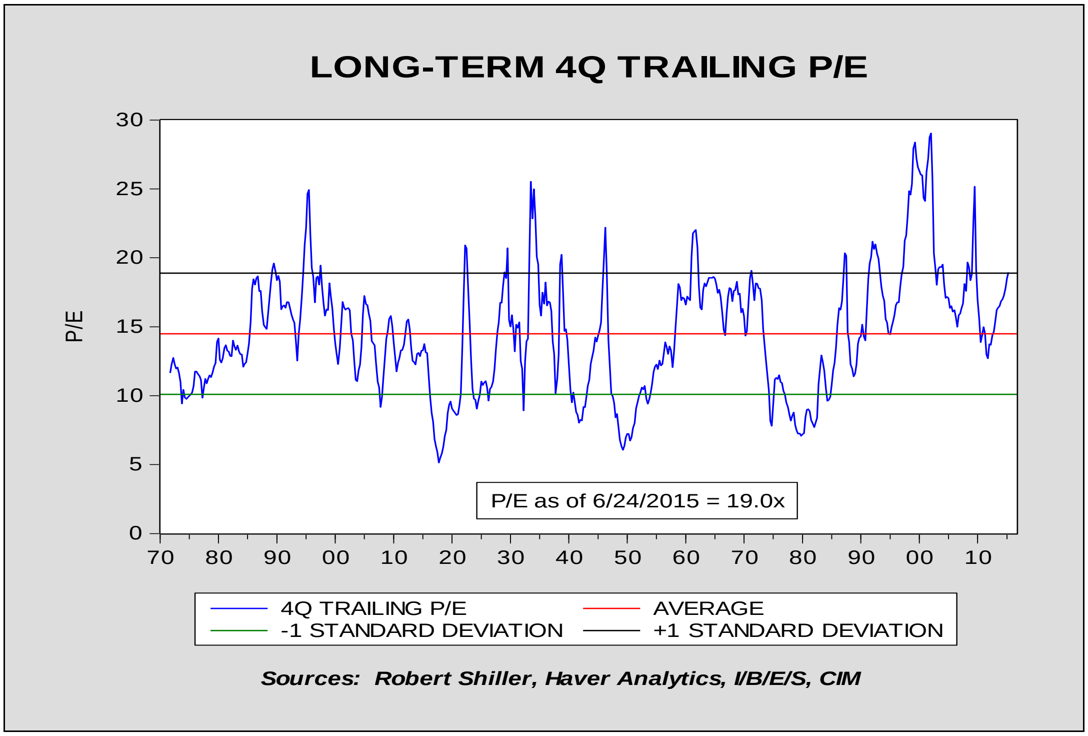


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

June 25, 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 (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.

Based on our methodology, the current P/E is 19.0x, up from 18.9x last week. Overall, earnings are weak, in part due to lower earnings from energy and in part due to rising wage costs. Valuations are becoming quite stretched, which probably explains this year's rather sluggish market performance.