Looking for something to read? See our Reading List; these books, separated by category, are ones we find interesting and insightful. We will be adding to the list over time.

[Posted: April 18, 2018—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed up 1.0% from the prior close. Chinese markets were higher, with the Shanghai composite up 0.8% and the Shenzhen index up 1.1%. U.S. equity index futures are signaling a higher open. With 48 companies having reported, the S&P 500 Q1 earnings stand at $36.47, lower than the $36.49 forecast for the quarter. The forecast reflects an 18.4% increase from Q1 2017 earnings. Thus far this quarter, 79.2% of the companies reported earnings above forecast, while 12.5% reported earnings below forecast.

Equity markets are quietly ticking higher. Earnings remain strong. Although there wasn't much market news, there was a great deal of other news. Here is what we are watching:

Pompeo to Pyongyang: Over Easter, CIA Director and SOS nominee Mike Pompeo was dispatched to North Korea and met directly with Kim Jong-un. The meeting was confirmed by the president in an early morning tweet. With the breakdown at the State Department under Tillerson, the White House has been using the intelligence channel to communicate with Pyongyang. Reports indicate the CIA has been the conduit of backchannel talks with officials at the Reconnaissance General Bureau, the North Korean version of the CIA. The president has also given his "blessing" to North and South Korea to begin peace talks.

There has been some discussion about the idea of denuclearization. This has the potential to be an area of "strategic ambiguity," where two parties say the same thing but mean something entirely different. For the U.S., it is generally assumed that denuclearization means North Korea gives up its nuclear program. For North Korea, the term means the U.S. and North Korea no longer threaten each other directly and U.S. troops leave South Korea. Most analysts have considered the North Korean position a non-starter for the U.S. Those American troops on the Korean Peninsula are part of U.S. power projection in the region. However, that analysis may be misreading the president's core position on foreign policy. In terms of foreign policy, Trump is Jacksonian.[1] That means he rejects the burdens of hegemony; foreign policy is mostly based on honor. In this light, the Syrian policy is perfectly clear—the use of chemical weapons is a direct affront to the president and American honor but there is no need for the U.S. to shape policy in the region because it's none of our business. Thus, the White House might be perfectly fine with the withdrawal of U.S. troops from South Korea in exchange for an end to North Korea's ICBM

[1] For background, see WGRs, American Foreign Policy: A Review, Part I (10/3/16) and Part II (10/10/16)

program. In other words, the Far East would still be threatened by North Korea's nuclear program but the U.S. would not.[2]

There are two other items that are part of these meetings. First, it is notable that Pompeo met with Kim over Easter, which was just after Kim met with Xi in Beijing. The timing would suggest Washington and Beijing are vying for the attention of the "young general." Second, Pompeo is struggling with Senate confirmation. The announcement that he is in the midst of sensitive talks with North Korea will probably be enough to encourage the senators to approve him so as not to disrupt negotiations.

China and telecom: The U.S. is limiting the ability of ZTE (ZTE: CNY 31.31) to use American technology for seven years. The White House has been complaining about China's confiscation of U.S. intellectual property and thus has decided to punish one of the few truly international Chinese telecom companies.[3] ZTE also engaged in business with nations under U.S. trade restrictions. Huawei Technologies (SHE: CNY, 7.20) announced it will refocus on existing markets due to difficulty in doing business in the U.S.[4] Although there has been much focus on tariffs and commodities, the real battle is in technology, where the U.S. is opposing China's attempts to establish high-tech dominance.

Is Clarida more dovish than we thought? *Barron's*[5] offers analysis suggesting the president's nominee for vice chair may be more dovish and less conventional than at first glance. We will have more on this idea in the coming days but we have been concerned the president would lean dovish in picking Fed officials and may berate the central bank for rate hikes at some point. In other words, relations between the Fed and the White House could eventually become Nixonian, which would mean higher inflation, lower nominal yields and a weaker dollar.

IMF and growth: The IMF is forecasting 3.9% GDP growth for this year, the strongest year since 2011. The group noted that the global economy is in a widespread expansion, but did warn that a trade war could undermine the current good times.

Nickel prices jump: Nickel prices are higher this morning on fears that new sanctions on Russian nickel producers could restrict supplies.

U.S. Economic Releases

MBA mortgage applications rose 4.9% from the prior week. Purchases and refinancing rose 6.1% and 3.5%, respectively. The average 30-year fixed rate remained unchanged from the prior week at 4.7%.

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[2] The meetings with PM Abe must have been awkward in light of the Pompeo news.
[3] https://www.nytimes.com/2018/04/16/technology/chinese-tech-company-blocked-from-buying-american-components.html
[4] https://www.wsj.com/articles/huawei-looks-to-existing-markets-as-tech-becomes-target-in-u-s-china-trade-spat-1523966693
[5] https://www.barrons.com/articles/reading-richard-clarida-hawk-or-dove-1523929538

The table below shows the Fed events scheduled for the rest of the day.

Economic Releases		
	No economic releases today	
Fed speakers or events		
EST	**Speaker or event**	**District or position**
14:00	US Federal Reserve Releases Beige Book	Members of the Board of Governors
15:15	Randal Quarles Testify Before House Financial Services	U.S. Federal Reserve Vice Chairman for Supervision
16:15	William Dudley Speaks on US Economic Outlook	President of the Federal Reserve Bank of New York

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, which indicates the effect on the foreign market. Red indicates a concerning development, yellow indicates an emerging trend that we are following closely for possible complications and green indicates 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	New Home Prices	m/m	mar	0.4%	0.3%		***	Equity and bond neutral
Japan	Trade Balance	m/m	mar	¥797.3 bn	¥3.4 bn	¥499.2 bn	**	Equity bullish, bond bearish
Australia	Westpac Leading Index	m/m	mar	-0.2%	0.3%		**	Equity bearish, bond bullish
	Skilled Vacancies	m/m	mar	0.9%	0.6%		**	Equity and bond neutral
EUROPE								
Eurozone	Construction Output	m/m	apr	-0.5%	-2.2%		**	Equity and bond neutral
	CPI	y/y	apr	1.3%	1.4%	1.4%	***	Equity and bond neutral
	CPI Core	y/y	apr	1.0%	1.0%	1.0%	***	Equity and bond neutral
Italy	Industrial Sales	m/m	feb	3.4%	5.3%		***	Equity and bond neutral
	Industrial Orders	m/m	feb	3.4%	9.6%		**	Equity and bond neutral
U.K.	CPI Core	y/y	mar	2.3%	2.4%	2.5%	***	Equity bearish, bond bullish
	RPI	y/y	mar	3.3%	3.6%	3.5%	**	Equity bearish, bond bullish
	PPI Input	y/y	mar	4.2%	3.4%	4.3%	**	Equity and bond neutral
	PPI Output	m/m	mar	2.4%	2.6%	2.5%	**	Equity and bond neutral
	House Price Index	y/y	mar	4.4%	4.9%	4.7%	**	Equity bearish, bond bullish
Russia	PPI	m/m	mar	4.8%	5.7%	6.2%	**	Equity bearish, bond bullish
AMERICAS								
Canada	International Securities Transactions	m/m	feb	3.96 bn	5.68 bn		**	Equity and bond neutral
	Manufacturing Sales	m/m	feb	1.9%	-1.0%	0.8%	**	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)	236	235	1	Up
3-mo T-bill yield (bps)	175	175	0	Neutral
TED spread (bps)	60	60	0	Neutral
U.S. Libor/OIS spread (bps)	178	178	0	Up
10-yr T-note (%)	2.84	2.83	0.01	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	5	5	0	Down
Currencies	**Direction**			
dollar	up			Down
euro	up			Up
yen	down			Up
pound	down			Up
franc	down			Neutral

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	Explanation
Energy Markets				
Brent	$72.50	$71.58	1.29%	Bullish API Report
WTI	$67.47	$66.52	1.43%	
Natural Gas	$2.76	$2.74	0.66%	
Crack Spread	$19.35	$19.43	-0.41%	
12-mo strip crack	$18.22	$18.18	0.18%	
Ethanol rack	$1.57	$1.57	0.12%	
Metals				
Gold	$1,348.88	$1,347.52	0.10%	
Silver	$16.93	$16.78	0.89%	
Copper contract	$316.55	$310.30	2.01%	
Grains				
Corn contract	$ 389.75	$ 389.25	0.13%	
Wheat contract	$ 484.50	$ 481.50	0.62%	
Soybeans contract	$ 1,057.00	$ 1,057.25	-0.02%	
Shipping				
Baltic Dry Freight	1052	1025	27	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-0.6		
Gasoline (mb)		0.5		
Distillates (mb)		-0.4		
Refinery run rates (%)		0.10%		
Natural gas (bcf)		-23.0		

Weather

The 6-10 and 8-14 day forecasts continue to signal colder than normal temperatures for most of the country, with warmer temperatures in the western regions. Precipitation is expected for most of the East Coast.

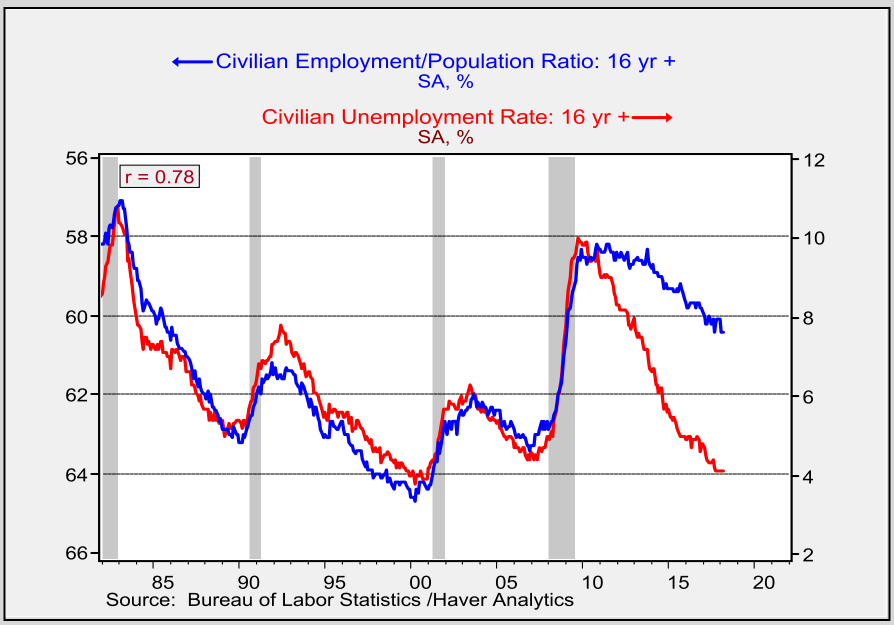
<u>Asset Allocation Weekly Comment</u>

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.

April 13, 2018

One of the great unknowns in this recovery and expansion is the proper measure of economic slack. Although it's a term that is rather easy to understand in the abstract, actually defining it is difficult. The Congressional Budget Office (CBO) produces an estimate of potential GDP but it is, at best, a rough measure based on population growth, estimates of productivity and capital stock. The famous "Taylor Rule[6]" uses the difference between actual and potential GDP in its calculation of the neutral policy rate. However, due to the uncertainty surrounding potential GDP, Greg Mankiw, an economics professor at Harvard and Chair of Economic Advisors under President Bush, offered another version of the Taylor Rule, which we call the "Mankiw Rule." The Mankiw Rule substitutes the unemployment rate less the non-accelerating inflation rate of unemployment (NAIRU). In other words, Mankiw proposes the labor markets are a better measure of slack.

The primary attraction of the Mankiw Rule for policymakers is that it fits well with the FOMC's other working model, the Phillips Curve, which postulates that there is an inverse relationship between the unemployment rate and inflation. The Mankiw Rule's primary flaw is that NAIRU isn't directly observable (although the CBO calculates it as well). It also has a secondary flaw, which is that the unemployment rate may not be the best measure of slack in the labor markets.

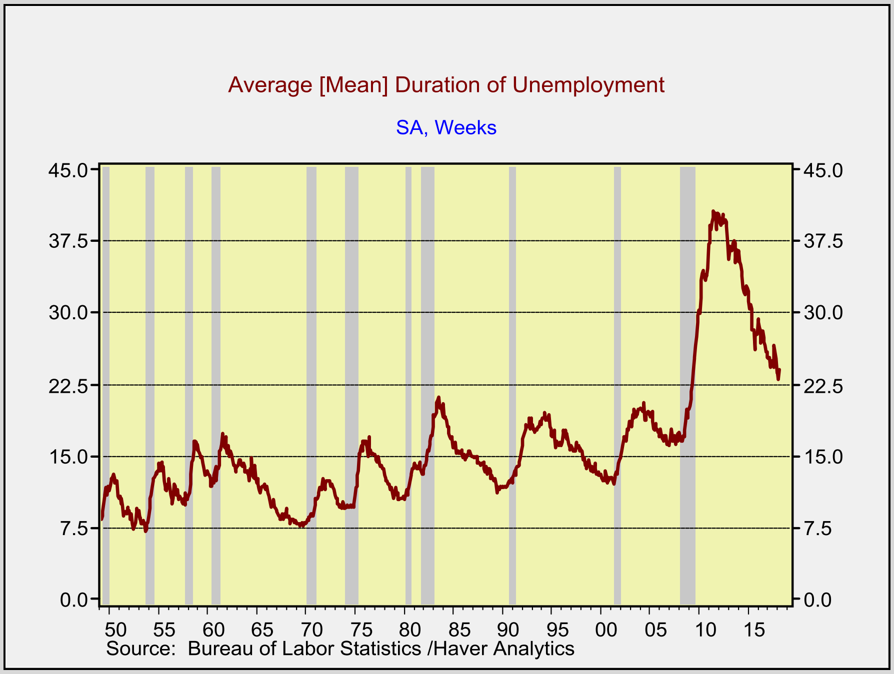


This chart shows the relationship between the unemployment rate and the employment/ population ratio (inverted scale). From 1980 to 2010, the two series correlated at 94%. But, the relationship has broken down in this recovery and expansion.

[6] Neutral nominal policy rate = neutral real rate + 0.5(actual vs. target inflation) + 0.5(real GDP - real potential GDP)

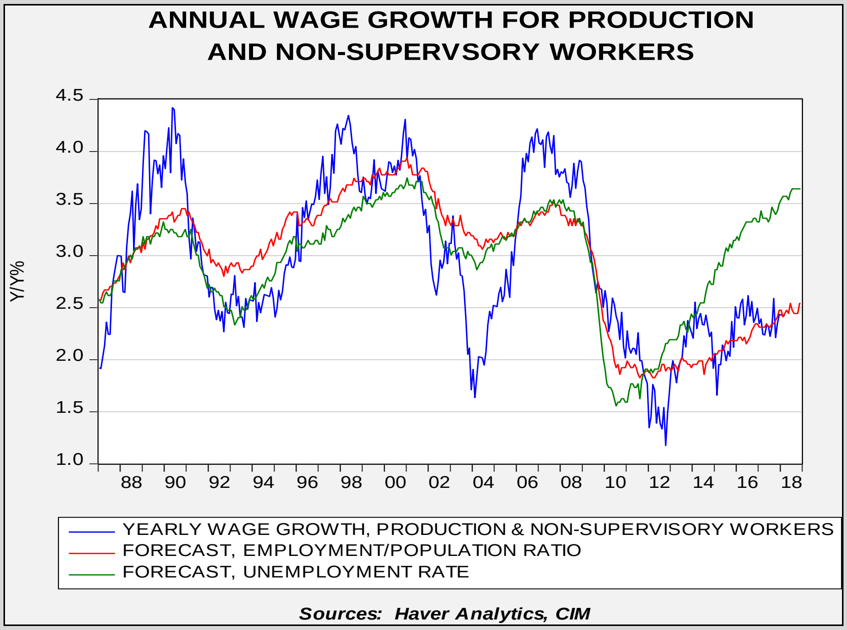
The problem for policymakers is determining which of these two series for the labor market best measures slack. The unemployment rate is at levels that would usually be considered full employment, which would suggest that monetary policy should be tightening rapidly. On the other hand, the employment/population ratio indicates ample slack in the labor market, which would argue for slow tightening at best.

The general consensus among economists is that the employment/population ratio is depressed due to baby boom retirements and structural unemployment caused by globalization and automation. Thus, these workers are not really available for hiring. The high level of long-term unemployment would tend to bolster that position.



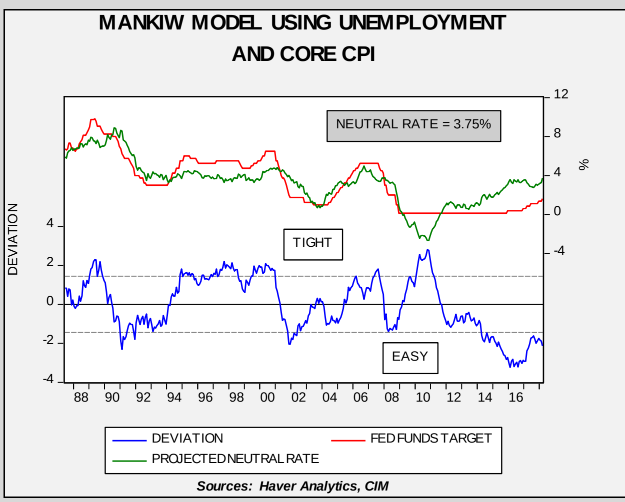
This chart shows the average duration of unemployment. Previous cycle highs were generally around 21 weeks; during expansions the trough is usually around 12 weeks, although the cycle low exceeded 15 weeks in the last expansion. In the Great Financial Crisis, the average duration peaked at 40.7 weeks and remains elevated, but it has been declining. The existence of long-term unemployment does support the idea that the unemployment rate is probably a more accurate measure of slack as the gap shown in the first chart is due to structural unemployment and baby boom retirements.

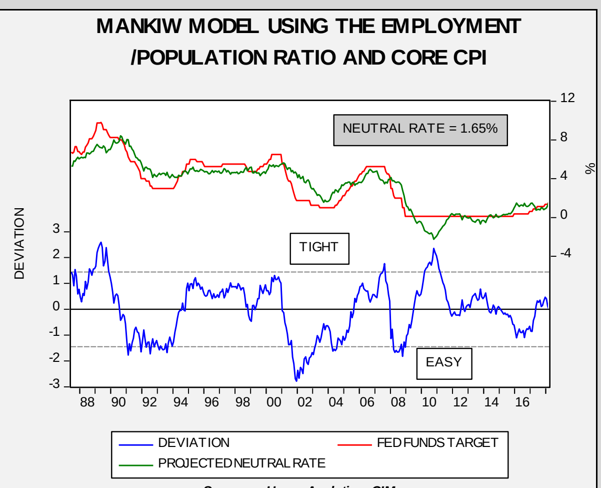
However, if slack is disappearing, it should be showing up in wages. Thus, comparing the two measures of slack to wage growth should really be the ultimate determinant of which measure is best for policymakers. In this regard, the employment/population ratio has outperformed recently.



This chart shows the forecast of annual wage growth for production and non-supervisory workers using the unemployment rate in one model and the employment/population ratio in the other. Until 2012, neither model was clearly superior to the other. However, since 2014, the employment/population ratio has been clearly superior. Both independent variables tend to lead wages by nine months. The employment/population ratio predicts that wage growth for this broad segment of workers should remain around 2.5% through the end of this year.

Our primary concern about monetary policy is determining the likelihood of a mistake that would lead to excessive tightening and raise the odds of a recession. Studying the two variations of the Mankiw model, one that uses the unemployment rate and another that uses the employment/population ratio, should offer insights into the chances of a policy error.



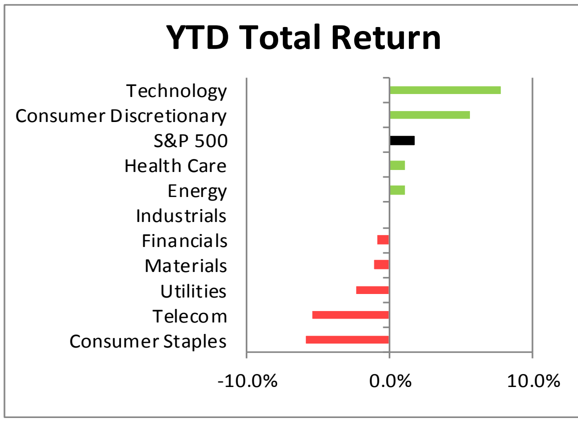


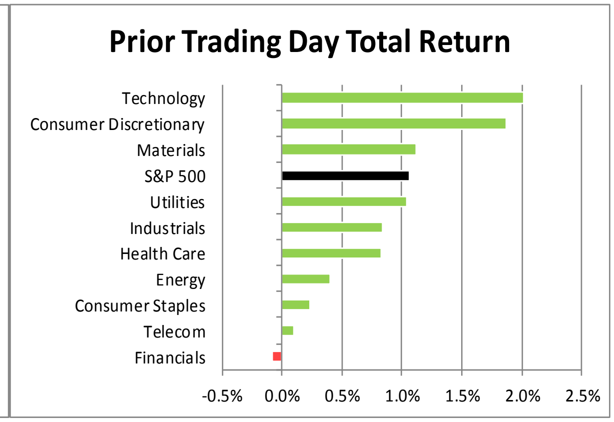
This chart shows the two models. The unemployment rate model suggests the FOMC is woefully behind the curve and needs to raise rates aggressively. The employment/population ratio model suggests the FOMC has achieved policy neutrality and should only raise rates further with evidence of rising inflation. The Fed dots chart average indicates the fed funds target will reach 2.25% by year's end, or two more rate hikes this year. If all variables remain stable, the unemployment rate model will still signal that policy is accommodative. The employment/population ratio will not reach restrictive until rates reach 2.75%, which would be one standard error above the forecast. The estimates from the dots chart suggest that scenario would happen in 2019, when another three hikes are expected.

Our analysis of comments from members of the FOMC suggests that policymakers believe the unemployment rate is the proper measure of slack. Thus, the odds of a policy mistake are increasing. However, the calculation of the employment/population ratio suggests we aren't there quite yet. Thus, it is probably too soon to become overly defensive in portfolios based on the domestic economy and monetary policy alone. There may be other reasons (geopolitical and political) to be cautious but, for now, our Asset Allocation Committee remains optimist about risk assets.

Data Section

U.S. Equity Markets – (as of 4/17/2018 close)

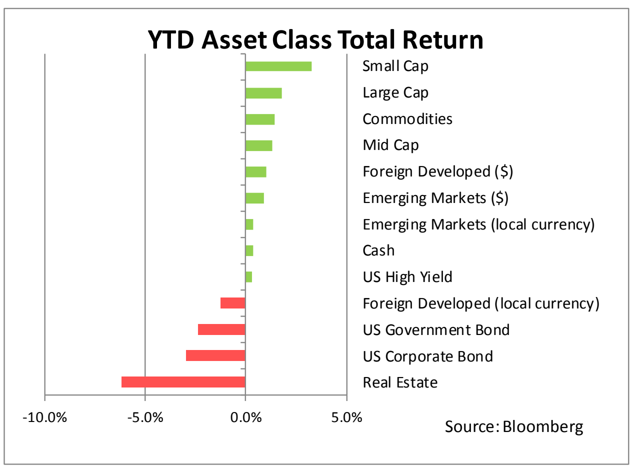




(Source: Bloomberg)

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. Sectors are ranked by total return; green indicating positive and red indicating negative return, along with the overall S&P 500 in black.

Asset Class Performance – (as of 4/17/2018 close)

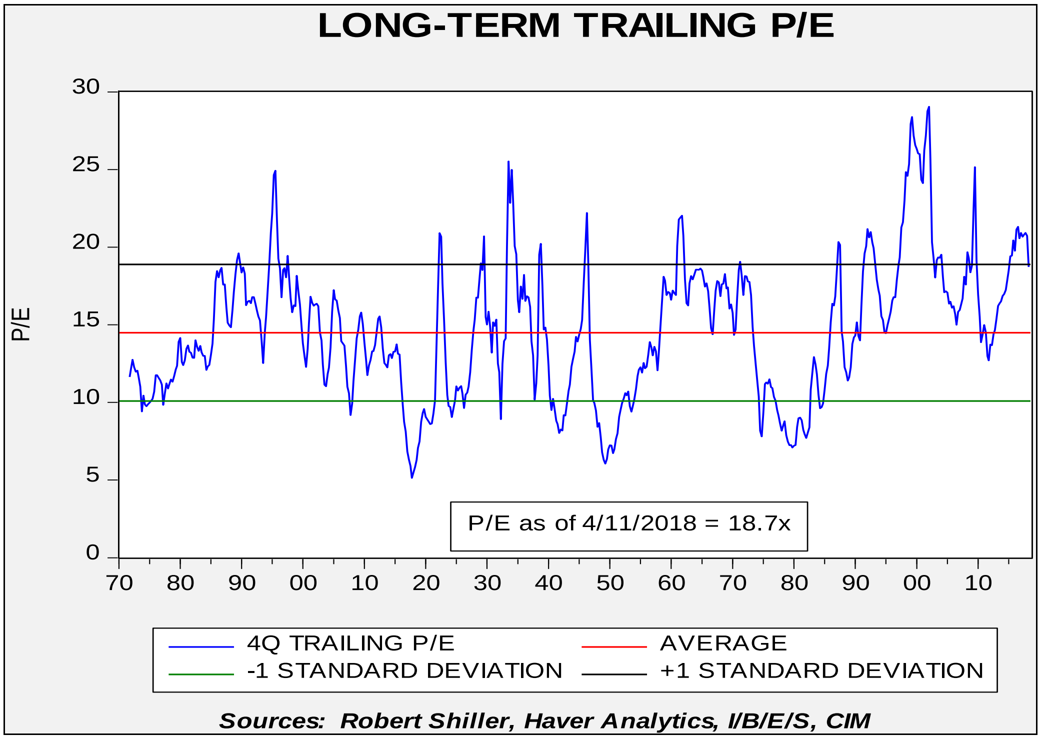


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 (Bloomberg total return Commodity Index).

P/E Update

April 12, 2018



Based on our methodology,[7] the current P/E is 18.7, up 0.1x from last week. The modest rise in the multiple is due to higher equity prices.

This report was prepared by 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.

[7] This 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 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 quarters (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 long-term dataset for P/E ratios.