By Bill O'Grady and Thomas Wash

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 27, 2018—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed up 1.2% from the prior close. Chinese markets were higher, with the Shanghai composite up 0.2% and the Shenzhen index up 0.3%. U.S. equity index futures are signaling a lower open. With 227 companies having reported, the S&P 500 Q1 earnings stand at $37.64, higher than the $36.49 forecast for the quarter. The forecast reflects an 18.4% increase from Q1 2017 earnings. Thus far this quarter, 80.2% of the companies reported earnings above forecast, while 13.2% reported earnings below forecast.

It's a busy Friday. Here is what we are watching:

Korean leaders meet: In a historic event, the leaders of North and South Korea met and Kim Jong-un became the first DPRK leader to visit the South since the war. The two leaders vowed to work on denuclearization (with a strong dose of strategic ambiguity) and promised to actually draft a peace accord, which would officially end the Korean conflict. Currently, the armistice that ended the war is in place but a formal peace has never been negotiated. The symbolic importance of this meeting should not be underestimated. It is an important development; not too long ago we were preparing for war.

However, what it means in the end remains in doubt. One issue to remember is that Koreans, in general, would prefer to reduce outside influence. The peninsula is valuable land; throughout history, China and Japan have controlled the area to project power. The U.S. also has an interest. A potential outcome is one that enhances the independence of both Koreas at the expense of China, Japan and the U.S. The next big event is the U.S./North Korea summit.

The other big meeting: Overshadowed, but in many ways just as important, is the meeting today between Chairman Xi and PM Modi in Wuhan, in the Hubei province of China. Relations between the two countries have been tense recently. There was a flare-up on the northern border several months ago over disputed boundary areas. India is concerned about rising Chinese investment in its arch-rival Pakistan and is also worried about the one belt, one road (OBR) project that seems to be engulfing the region. India is facing a difficult path. If it joins the OBR, it will receive welcome investment and likely gain access to China's growing consumer market but it will also become a Chinese satellite. Unfortunately, India does not have a strong enough military or economy to hold out against being surrounded by Chinese allies (purchased with investment from OBR).

Under normal circumstances, India would ally with the U.S. Geopolitically, this would be a win/win for both nations. India's position in the region would be a potential barrier to the OBR and would allow the U.S. to threaten Chinese expansion. But, the U.S. is in withdrawal mode and Washington may not be reliable. India's historical default position is non-alignment. It was one of the founders of the Non-Aligned Movement and thus would prefer to not team up with either China or the U.S. Unfortunately, for Modi, remaining non-aligned is probably not an option. Even if India resists China's "charms," it will face a growing threat from Pakistan which will be fueled by Chinese investment. And, India's neighbors are increasingly acquiescing to Chinese OBR pressure. We doubt a resolution will come from this meeting today but the pressure on India is rising.

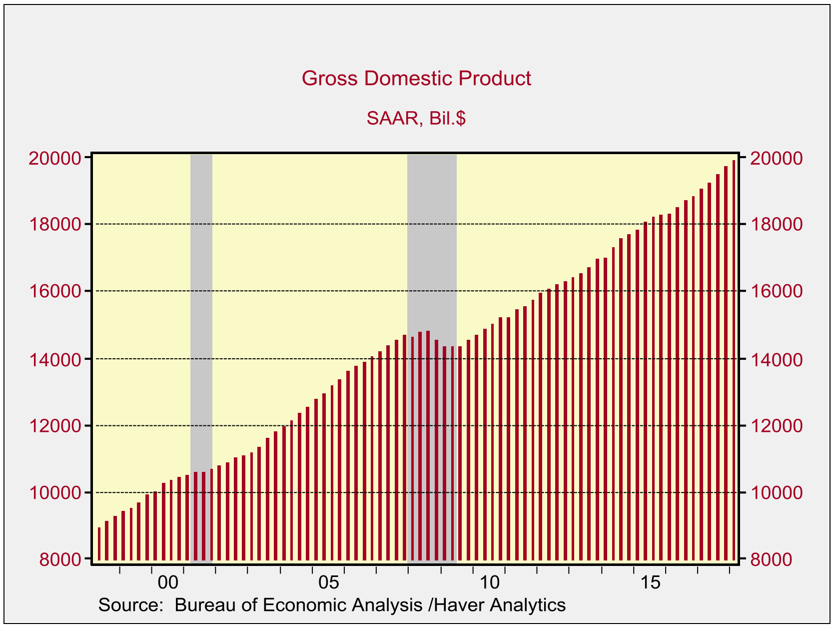
And yet another meeting: President Trump and Chancellor Merkel meet today in Washington. Unlike Macron, Merkel does not have a warm personal relationship with President Trump so we would expect a businesslike meeting. Criticism of Germany's trade surplus is likely.

A portrait of discontent: A recent Pew poll[1] shows that the political divide is hardening. Democrats have traditionally preferred officials who compromise. We believe that's because Democrats generally see government as a force for good and thus want to see government work, which entails compromise. The majority of Republicans oppose compromise. However, this recent polling suggests the majority of Democrats now oppose compromise, a significant hardening of position that will make it very difficult to govern under conditions of gridlock. But, the most significant finding was that two-thirds of Americans believe their side "loses" more than it "wins" in politics. Some of this is probably due to a hardening of partisanship; getting partial wins when you think you should get everything you want seems like a "loss." But, the most likely reason for this finding is that Americans seem to believe the entire system doesn't work for them and thus whomever is in office won't lead to a "win." This would explain the attraction of rogue candidates like Obama and Trump. Our contention is that the voters in 2008 who favored Obama thought they were getting Sanders. The disappointment was palpable and if the GOP had not run the poster child of the establishment in 2012 then Obama would have been a one-term president. We would not be at all surprised to see the Democrats repeat the "Romney error" in 2020.

U.S. Economic Releases

The first reading of Q1 GDP came in above expectations at 2.3% compared to the forecast of 2.0%. Personal consumption came in line with expectations, rising 1.1% from the prior quarter. Core PCE came in line with expectations, rising 2.5% from the prior quarter. The GDP price index came in below expectations, rising 2.0% from the prior quarter compared to the forecast of 2.2%.

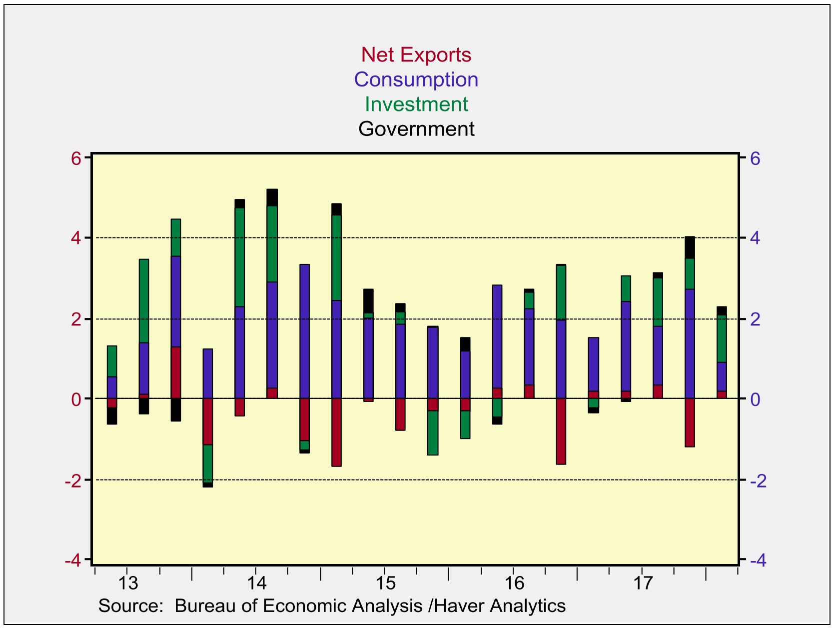
[1] http://www.pewresearch.org/fact-tank/2018/04/26/key-findings-on-americans-views-of-the-u-s-political-system-and-democracy/?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top-stories



The chart above shows historical GDP. As of right now, GDP continues to grow at a solid pace.

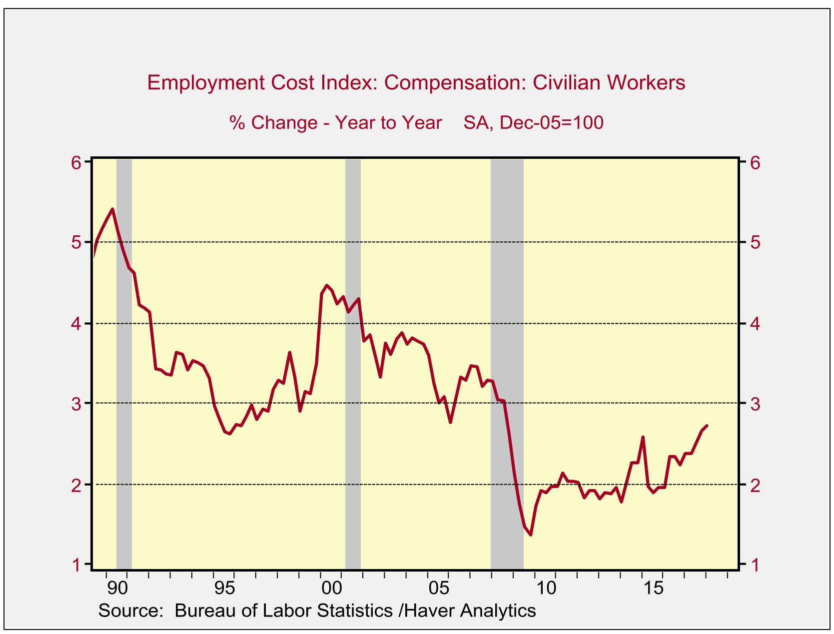
	Q1 2018 First Reading	Q4 2017 First Reading	Difference
GDP	2.3%	2.9%	-0.6%
Consumption	0.7%	2.8%	-2.1%
Investment	1.2%	0.8%	0.4%
Inventories	0.4%	-0.5%	0.9%
Net Exports	0.2%	-1.2%	1.4%
Government	0.2%	0.5%	-0.3%

The table above shows the contributions to GDP. The growth in GDP is largely due to an increase in investment in Q1, but some of it did come from inventory growth. It is worth noting that this was the desired effect of the tax cuts passed in December, although it would be surprising to see the impact this quickly.



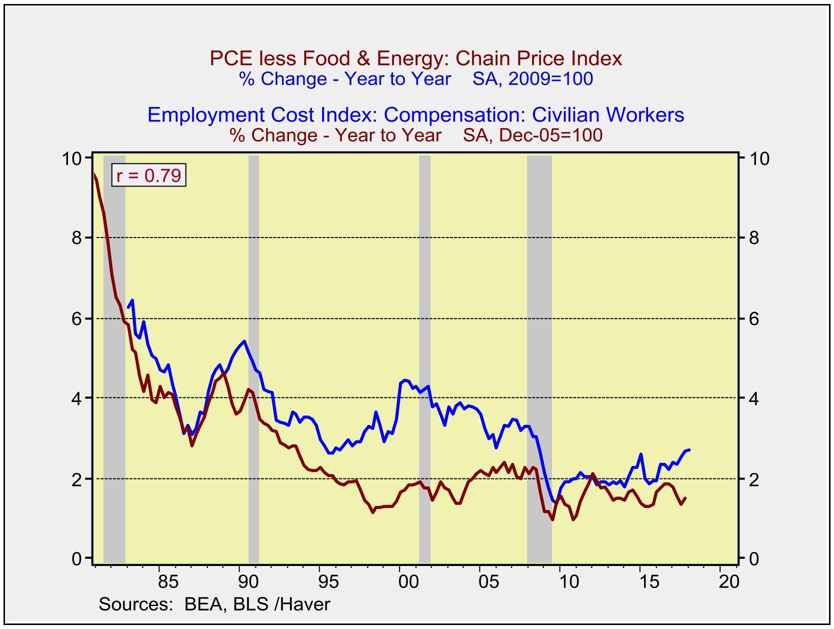
This chart shows the contributions graphically. Investments were a major positive for GDP in Q1.

The employment cost index for Q1 came in above expectations, rising 0.8% from the prior quarter compared to the forecast of 0.6%.



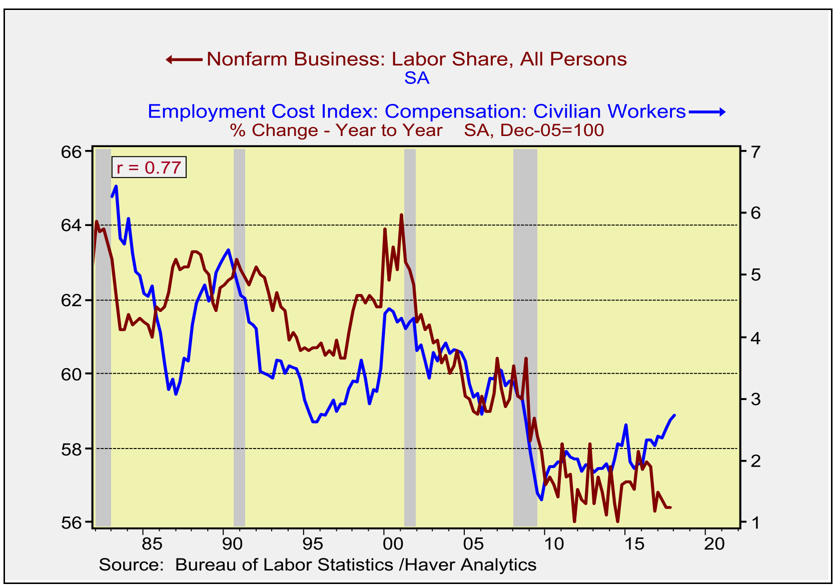
The chart above shows the year-over-year change of the employment cost index, which rose 2.7% from the prior year. Since the financial crisis, the ECI has been relatively weak, remaining below its historical average of 3.0% for over a decade. An ECI approaching its historical average would confirm that the labor market is tightening.

Rising wages raises fears of higher inflation.



This chart shows there is a solid correlation between the yearly change in the core PCE and the yearly change in the ECI. However, since 1995, the correlation has fallen to 32%.

Instead, rising wages will more likely pressure margins.



The chart above shows the ECI and the labor share. The two are positively correlated and the correlation has increased to 84% since 1995. Essentially, if a business is faced with rising employment costs, it can either (a) raise prices, (b) make labor-substituting investment, or (c) give up margin. In a globalized world, option (a) is very hard and (b) takes time. Thus, rising labor costs are, most likely, going to result in tighter margins. That effect won't be immediately obvious because of the tax cut, but, once that boost passes, rising labor costs will likely pressure profit margins.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	U. of Michigan Sentiment	m/m	apr	98.0	97.8	**
10:00	U. of Michigan Current Conditions	m/m	apr	106.2	115.0	**
10:00	U. of Michigan Expectations	m/m	apr		86.8	**
10:00	U. of Michigan 1 yr Inflation	m/m	apr		2.7%	***
10:00	U. of Michigan 5-10 Yr Inflation	m/m	apr		2.4%	**
Fed speakers or events						
	No speakers or events scheduled					

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	Industrial Profits	m/m	mar	3.1%	10.8%		**	Equity and bond neutral
Japan	Jobless-To-Applicant Ratio	m/m	apr	1.59	1.58	1.59	**	Equity and bond neutral
	Jobless Rate	m/m	apr	2.5%	2.5%	2.5%	***	Equity and bond neutral
	Tokyo CPI	y/y	apr	0.5%	1.0%	0.8%	***	Equity bearish, bond bullish
	Tokyo CPI Ex-Fresh Food	y/y	apr	0.6%	0.8%	0.8%	***	Equity bearish, bond bullish
	Industrial Production	y/y	mar	2.2%	1.6%	2.0%	***	Equity bullish, bond bearish
Australia	PPI	y/y	1q	0.5%	0.6%		**	Equity and bond neutral
New Zealand	ANZ Consumer Confidence	y/y	apr	120.5	128.0		***	Equity and bond neutral
	Trade Balance	y/y	mar	-86 mn	217 mn	275 bn	**	Equity bearish, bond bullish
EUROPE								
Eurozone	Economic Confidence	m/m	may	112.7	112.6	112.0	**	Equity and bond neutral
	Business Climate Indicator	m/m	apr	1.35	1.34	1.28	**	Equity and bond neutral
	Industrial Confidence	m/m	apr	7.1	6.4	5.8	**	Equity bullish, bond bearish
	Service Confidence	m/m	apr	14.9	16.3	15.9	**	Equity bearish, bond bullish
	Consumer Confidence	m/m	apr	0.4	0.4	-0.1	***	Equity bullish, bond bearish
France	GDP	y/y	1q	2.1%	2.5%	2.3%	***	Equity and bond neutral
	PPI	y/y	mar	2.5%	1.5%		**	Equity and bond neutral
	CPI EU Harmonized	y/y	apr	1.8%	1.7%	1.7%	***	Equity bullish, bond bearish
	CPI	y/y	apr	1.6%	1.6%	1.6%	***	Equity and bond neutral
	Consumer Spending	y/y	apr	2.3%	1.9%	2.5%	***	Equity and bond neutral
Germany	Unemployment Change	m/m	apr	-7k	-19k	-15k	**	Equity and bond neutral
	Unemployment Rate	m/m	apr	5.3%	5.3%	5.3%	***	Equity and bond neutral
Italy	PPI	y/y	apr	2.4%	1.8%		**	Equity and bond neutral
	Hourly Wages	y/y	mar	1.0%	0.7%		***	Equity and bond neutral
U.K.	Nationwide House Px	y/y	apr	2.6%	2.1%	2.7%	**	Equity and bond neutral
	Index of Services	m/m	feb	-0.2%	0.2%	0.1%	**	Equity bearish, bond bullish
	GDP	y/y	1q	1.2%	1.4%	1.4%	***	Equity and bond neutral
AMERICAS								
Mexico	Unemployment Rate	y/y	mar	3.2%	3.3%	3.3%	***	Equity and bond neutral
Brazil	PPI manufacturing	y/y	mar	5.7%	4.7%		**	Equity and bond neutral
	Total Oustanding Loans	m/m	mar	3.082 tn	3.062 tn		**	Equity and bond neutral
Canada	CFIB Business Barometer	m/m	apr	56.6	60.7		**	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)	237	236	1	Up
3-mo T-bill yield (bps)	178	178	0	Neutral
TED spread (bps)	59	58	1	Neutral
U.S. Libor/OIS spread (bps)	183	182	1	Up
10-yr T-note (%)	2.97	2.98	-0.01	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	10	10	0	Down
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	down			Up
pound	down			Up
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
BOJ Policy Balance Rate	0.000%	0.000%	0.000%	On forecast
BOJ 10-yr Yield Target	-0.100%	-0.100%	-0.100%	On forecast
ECB Main Refinancing Rate	0.000%	0.000%	0.000%	On forecast
ECB Marginal Lending Facility Rate	0.250%	0.250%	0.250%	On forecast
ECB Deposit Facility Rate	-0.400%	-0.400%	-0.400%	On forecast

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	$74.59	$74.74	-0.20%	
WTI	$67.99	$68.19	-0.29%	
Natural Gas	$2.81	$2.84	-1.16%	
Crack Spread	$21.24	$21.06	0.86%	
12-mo strip crack	$19.51	$19.44	0.40%	
Ethanol rack	$1.58	$1.58	-0.04%	
Metals				
Gold	$1,319.88	$1,316.80	0.23%	
Silver	$16.53	$16.52	0.06%	
Copper contract	$307.75	$313.80	-1.93%	
Grains				
Corn contract	$ 396.25	$ 395.25	0.25%	
Wheat contract	$ 492.25	$ 489.50	0.56%	
Soybeans contract	$ 1,036.00	$ 1,039.50	-0.34%	
Shipping				
Baltic Dry Freight	1375	1376	-1	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	2.2	-2.3	4.4	
Gasoline (mb)	0.8	-2.0	2.8	
Distillates (mb)	-2.6	-1.5	-1.2	
Refinery run rates (%)	-1.60%	-0.10%	-1.50%	
Natural gas (bcf)	-18.0	-9.0	-9.0	

Weather

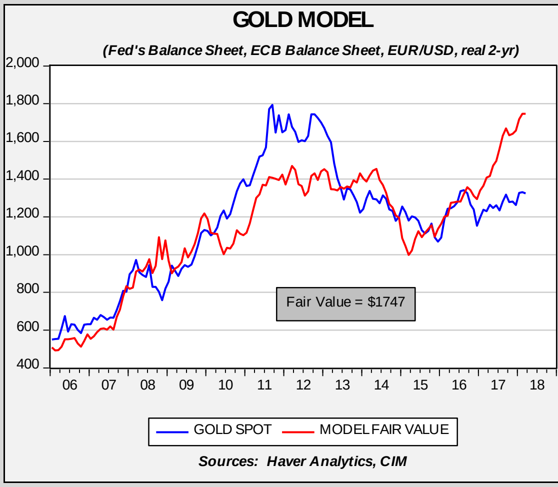
The 6-10 and 8-14 day forecasts continue to signal warmer to normal temperatures for most of the country, with cooler temperatures in the mountain regions. Precipitation is expected for the eastern region.

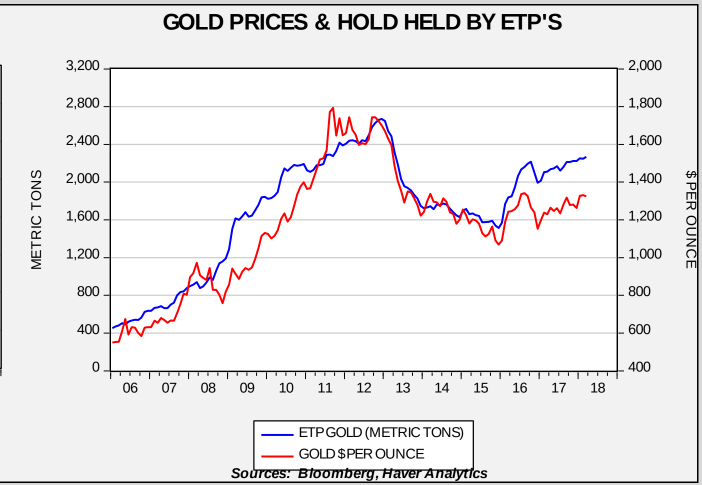
Asset Allocation Weekly Comment

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 27, 2018

In our recent rebalance, the Asset Allocation Committee added a position in gold. There were two reasons behind the decision. First, we estimate that gold prices are undervalued compared to relevant fundamental factors.





The chart on the left is our gold valuation model. It uses the balance sheets of the Federal Reserve and the European Central Bank, the EUR/USD exchange rate and inflation-adjusted two-year Treasury yields. The model currently indicates gold prices are deeply undervalued. Much of this undervaluation is probably due to expectations of balance sheet contraction and higher real yields.[2] For example, if the Fed's balance sheet was cut to $3.0 trillion from the current $4.4 trillion, the fair value would drop to 1585.73 (assuming the other variables remain unchanged). In other words, it appears the financial markets are discounting a more bearish turn in fundamentals than is probably likely.

The chart on the right shows the price of gold relative to the holdings of gold by exchange-traded products (ETPs). The price of gold tends to track the holdings of ETPs with two periods of divergence. Gold prices tended to track higher in both periods.

Second, gold is a flight-to-safety asset. During periods of turmoil, investors will often shift to safety assets. With the potential for a geopolitical event rising in the coming months, the committee has concluded that allocating some of the portfolio to gold is prudent. Here are some of the potential events:

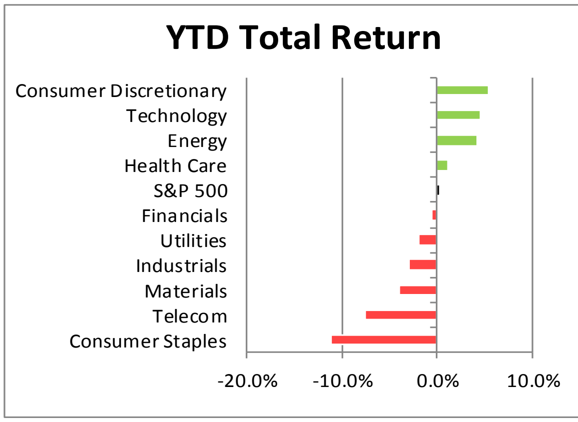
[2] Note that from 2010 into 2012, the model indicated that gold was overvalued. This was likely due to the market overestimating the degree of balance sheet expansion.

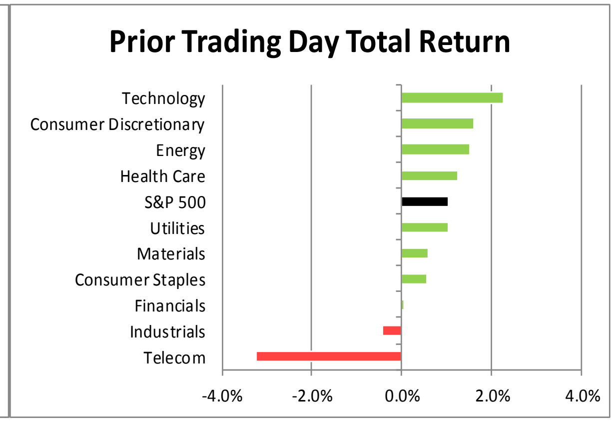
1. North Korea: If talks between Kim Jong-un and President Trump go awry, the chances for war in the Far East rise significantly. We view these talks as “make or break”; if they fail, it is hard to see a path forward that doesn’t result in conflict.
2. Iran: The Trump administration’s policies toward Iran are hardening. If the Obama-era nuclear deal is scotched and new sanctions are imposed, we expect Iran to move toward a nuclear weapon which increases the odds of a conflict.
3. China: Trade tensions with China are rising. A full blown trade war will tend to boost inflation and if the Federal Reserve is constrained in responding due to political pressure then gold will be an attractive response.

For these reasons, we have added gold to the portfolio. We will continue to monitor market conditions to address future risks.

Data Section

U.S. Equity Markets – (as of 4/26/2018 close)

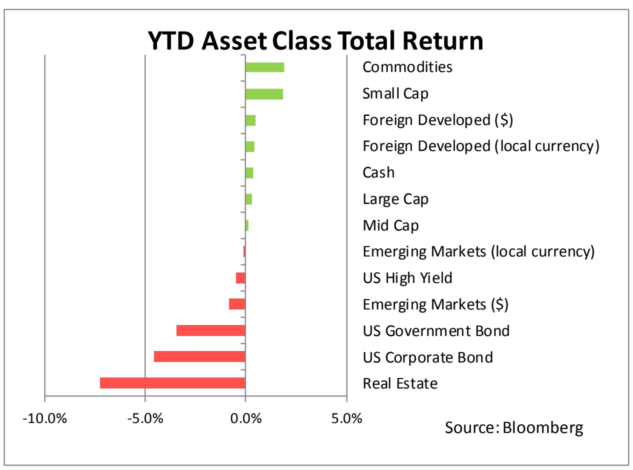




(Source: Bloomberg)

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 4/26/2018 close)

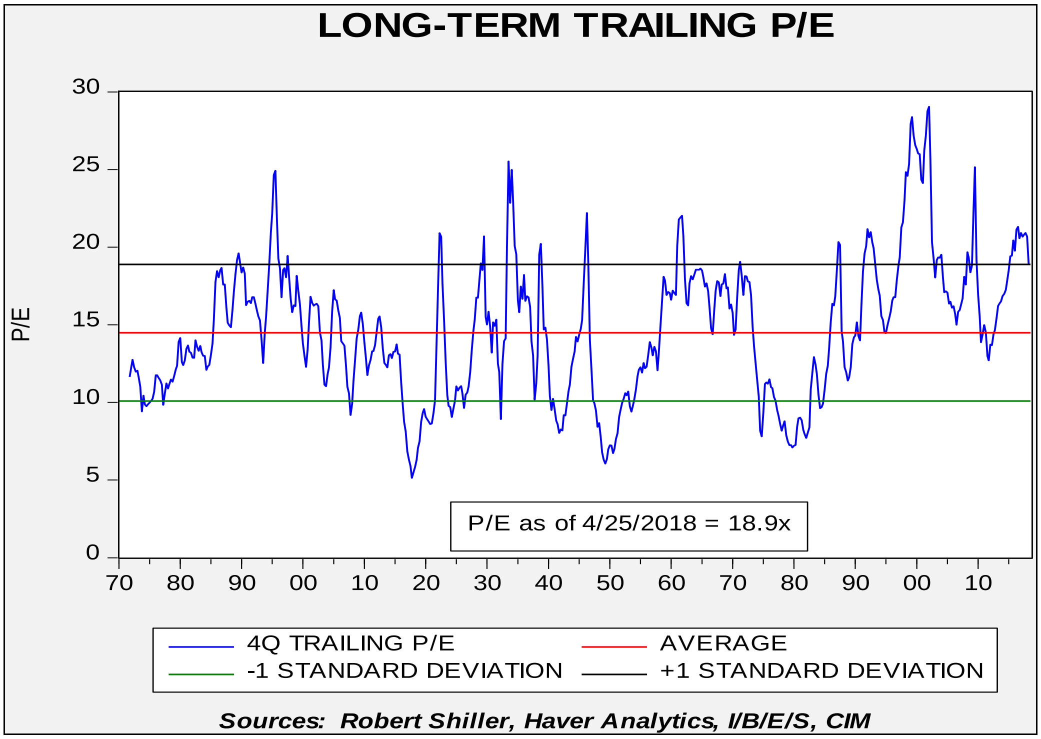


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 26, 2018



Based on our methodology,[3] the current P/E is 18.9x, unchanged from last week.

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.

[3] 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.