By Bill O'Grady and Thomas Wash

[Posted: January 23, 2018—9:30 AM EST] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed up 1.3% from the prior close. Chinese markets were up, with the Shanghai composite up 1.3% and the Shenzhen index up 0.4%. U.S. equity index futures are signaling a lower open. With 55 companies having reported, the S&P 500 Q4 earnings stand at $35.00, higher than the $34.84 forecast for the quarter. The forecast reflects a 10.7% increase from Q4 2016 earnings and a 4.2% increase from Q3 2017. Thus far this quarter, 78.2% of the companies reported earnings above forecast, while 10.9% reported earnings below forecast.

After all the news from yesterday, markets are fairly quiet this morning. This is what we are watching today:

The shutdown ends: And it ends with mostly a whimper. Democrat Party leaders essentially ended the shutdown with a promise for a vote on DACA and an extension of CHIP. The populist wing of the party is furious; the GOP is spiking the football. However, it's not as dire as it looks for the Democrats or as great for the Republicans. First, funding was only extended until February 8. We can then do this all over again. On DACA, the Senate might pass a bill that offers a path to citizenship but it isn't obvious if the House will pass something and it's anyone's guess if the president would sign it. Second, this was only a battle; the real war is the debt ceiling issue, which will likely come up by early April. That could lead to a more serious crisis. The trade that would avert a crisis is DACA in return for more defense spending, but the GOP now believes the Democrats will cave on DACA so they will be less likely to negotiate. If the left-wing populists push establishment Democrats hard enough, we may have a debt ceiling impasse in a couple of months.

So, what are our takeaways from the shutdown? First, Democrats really can't do government shutdowns because, at heart, they like government and view it as a force for good. Republicans view government as a necessary evil, a testament to the fallen nature of humans. For Democrats, shutting down the government is a repudiation of something they hold dear; for Republicans, it's "time off." Second, although there is great handwringing about immigrants, in reality, neither party is willing to deplete significant political capital for them. Remember, President Obama could have done something about immigration in his first two years when he had a veto-proof majority in the Senate. Instead, he used his political capital on the ACA. The Democratic leadership knows they will still carry the majority of Latino voters in November and beyond. Thus, the leadership isn't compelled to move heaven and earth for their issues. Third, for markets, the takeaway is to mostly ignore Washington. That could make April an issue.

President to Davos: With the shutdown ended, we expect the president to make his way to Switzerland later in the week. Expect an "America First" speech and some comments about trade (see next).

Trade action: After running as a protectionist and promising to take steps to reduce the trade deficit, the Trump administration finally acted yesterday by putting tariffs on solar panels and washing machines. Solar panels and cells will face a 30% tariff and washing machines could face up to a 50% duty. The actual impact will be complicated. For manufacturers in the U.S., this action is a cause for celebration. However, this only works if foreign manufacturers don't cut prices further. In the past, when the U.S. has put temporary duties on imports, foreign manufacturers have usually responded in two ways. First, they cut prices further. Since the duties were put in place to offset foreign government subsidies, the government could simply give more support. It's important to remember that for foreign governments the exports are designed to boost employment and gain foreign reserves. The companies involved may not actually care about profits. Second, if additional government support isn't likely and the firm wants to maintain profit margins, it may simply move the production to another nation—that approach may not work in this case (it appears the duties are not specific to a country but to the product). What is also missing is that manufacturing, especially for solar panels, is only part of the business. There are an estimated 260k jobs in the solar electricity industry; about 40k are in manufacturing, with the bulk in sales, support and installation. Overall, the solar industry views the final outcome as better than expected; a 35% duty was the consensus and 50% was possible. And, the duties decline every year for the next four years. Thus, as trade actions go, this was not overly punitive. However, given the specificity of this action, it may not be indicative of future trade policies.

Yield action: BOJ Governor Kuroda indicated this morning that his central bank is not abandoning QE or policy accommodation. In the wake of his comments, global long-duration sovereign yields declined. We didn't really expect Kuroda to say anything different but there has been growing speculation that the BOJ was going to follow the ECB in tightening policy. We note that over $14 trillion of global government bonds carried a negative yield in early 2016. That number has fallen to $9.6 trillion.

The lesson of UKIP: The U.K. papers[1] are carrying reports about the steady decline of the U.K. Independence Party, the party of Nigel Farage, who was a driving force behind Brexit. Farage stepped down from party leadership last year and his successor is failing to hold the party together. Essentially, movements usually don't last; their ideas are co-opted by mainstream parties and shift the political discussion. In one sense, UKIP was successful beyond all measure; whole groups of people in the country that had been ignored by the two main political parties found a voice in UKIP. But, now that these citizens have found their voice, they will have more power by being part of the Tories or Labour.

A troubling decline: The U.N. reports that foreign direct investment (FDI) fell 16% in 2017, the second consecutive year of decline. The "Greenfield" project, investment that creates new plant

[1] https://www.ft.com/content/cff64e3c-ff84-11e7-9650-9c0ad2d7c5b5?emailId=5a66a827f3e8d400040bd1d0&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

and equipment, fell 32% to $571 bn, a 14-year low. It's hard to tell if the drop was due to fears of increased protectionism, government interference or part of an overall decline in investment activity, but falling FDI does suggest globalization is in retreat and could eventually lead to higher inflation.

U.S. Economic Releases

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Richmond Fed Manufacturing Index	m/m	jan	19	20	**
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								
Japan	All Industry Activity Index	m/m	nov	1.0%	0.3%	0.8%	***	Equity bullish, bond bearish
	Nationwide Dept Sales	m/m	dec	-0.6%	2.2%		**	Equity and bond neutral
	Tokyo Dept Store Sales	y/y	dec	0.9%	3.8%		**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	w/w	jan	119.4	123.5		**	Equity and bond neutral
New Zealand	Perfomance Services Index	m/m	dec	56.0	56.4		**	Equity and bond neutral
EUROPE								
Eurozone	ZEW Survey Expectations	m/m	jan	31.8	29.0		**	Equity and bond neutral
Germany	ZEW Current Situations	m/m	jan	95.2	89.3	89.6	**	Equity bullish, bond bearish
	ZEW Survey Expectations	m/m	jan	20.4	17.4	17.7	**	Equity bullish, bond bearish
U.K.	PSNB ex Banking Groups	m/m	dec	2.6 bn	8.7 bn	5.0 bn	**	Equity and bond neutral
	CBI Trends Total Orders	m/m	jan	14	17	12	**	Equity and bond neutral
	CBI Trends Selling Prices	m/m	jan	40	23		**	Equity and bond neutral
	CBI Business Optimism	m/m	jan	13	-11		**	Equity and bond neutral
AMERICAS								
Mexico	Unemployment Rate	m/m	dec	3.4%	3.5%	3.5%	***	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)	174	174	0	Up
3-mo T-bill yield (bps)	141	140	1	Neutral
TED spread (bps)	34	34	0	Neutral
U.S. Libor/OIS spread (bps)	150	150	0	Up
10-yr T-note (%)	2.63	2.65	-0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	29	28	1	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Up
yen	up			Neutral
pound	down			Neutral
franc	flat			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
BOJ Policy Balance Rate	-0.100%	-0.100%	-0.100%	On forecast
BOJ 10-yr Yield Target	0.000%	0.000%	0.000%	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	$69.33	$69.03	0.43%	
WTI	$63.82	$63.57	0.39%	
Natural Gas	$3.30	$3.22	2.48%	Colder Weather
Crack Spread	$17.97	$17.84	0.72%	
12-mo strip crack	$19.76	$19.74	0.09%	
Ethanol rack	$1.41	$1.41	-0.04%	
Metals				
Gold	$1,336.20	$1,333.92	0.17%	
Silver	$16.95	$17.02	-0.38%	
Copper contract	$313.85	$319.85	-1.88%	
Grains				
Corn contract	$ 351.50	$ 352.00	-0.14%	
Wheat contract	$ 423.75	$ 425.75	-0.47%	
Soybeans contract	$ 986.75	$ 984.25	0.25%	
Shipping				
Baltic Dry Freight	1129	1125	4	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.3		
Gasoline (mb)		2.1		
Distillates (mb)		-1.3		
Refinery run rates (%)		-1.00%		

Weather

The 6-10 and 8-14 day forecasts call for warmer to normal temperatures for most of the country. Precipitation is expected for most of the country.

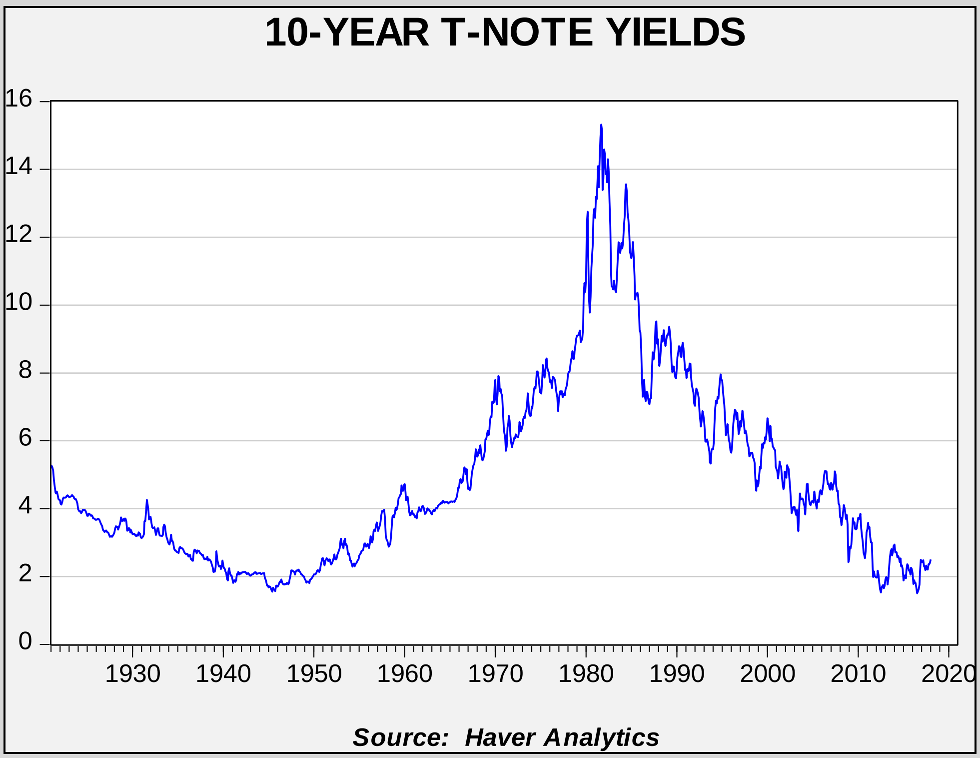
Asset Allocation Weekly Comment

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.

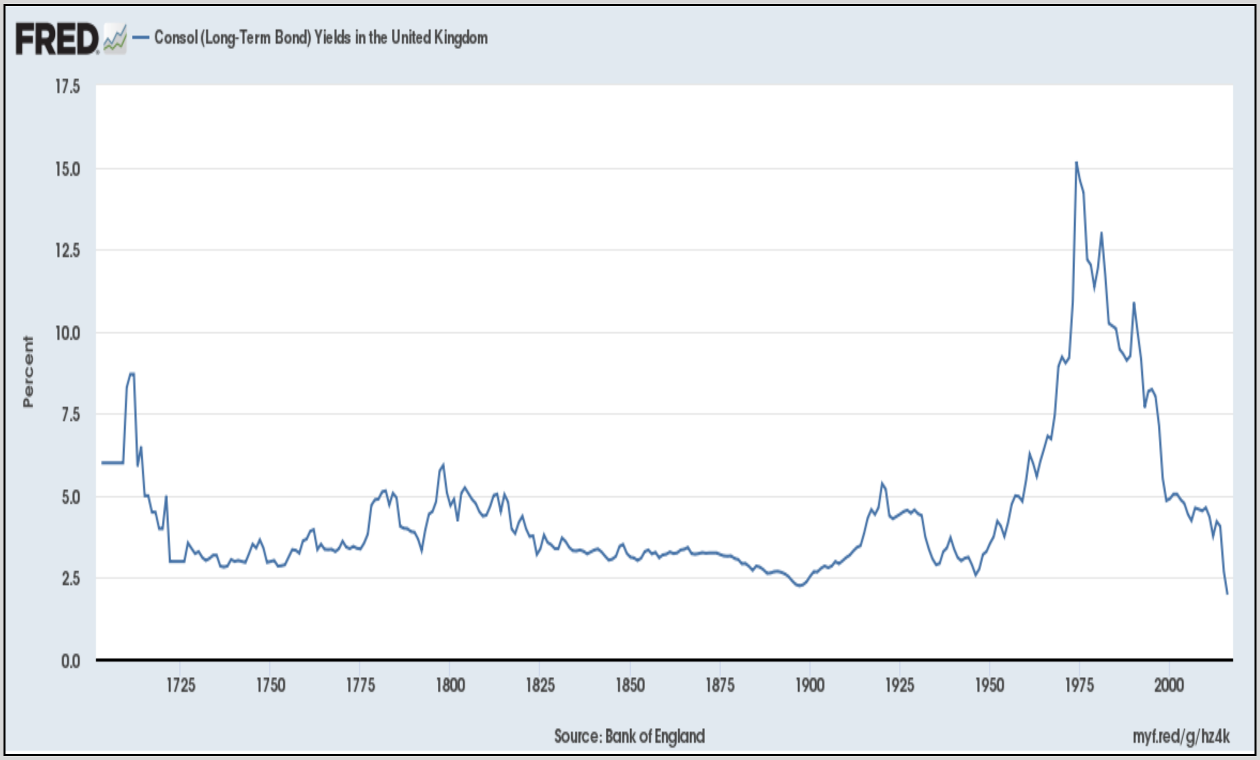
January 19, 2018

Since the beginning of the year, long-term interest rates have moved higher. The constant maturity 10-year Treasury yield ended 2017 at 2.40%. That yield climbed to 2.60% in January, which is above our recently released 2018 Outlook forecast. We are not adjusting our forecast quite yet because the driving factor behind our forecast was continued flattening of the yield curve. However, if the curve doesn't flatten further, we will need to revisit that forecast.

The recent rise in yields has led several commentators to declare a new bear market in bonds had developed. We sort of agree with this statement; we believe a secular bear market in bonds began in 2016 and we will likely see gradually rising rates for the foreseeable future. However, the key word is "gradually." The last secular bear market in bonds began in 1945 and took over two decades to become a serious problem for financial markets.



This chart shows the 10-year T-note yield from 1921 to the present. In 1945, yields made their secular low and gradually rose into the early 1980s. Note the gradual ascent of yields for the first couple decades. It wasn't until yields rose above 5% in the late 1960s that rising rates began to have an adverse impact on financial markets. Of course, when one is talking about secular cycles that last three to four decades, the last experience may not be indicative of what the current secular bear market will look like. Fortunately, the Bank of England has maintained long-term databases of British interest rates and can offer us some insights into long-term cycles. The chart below shows the interest rate of British Consols beginning in 1701. These instruments were bonds without a maturity; essentially, they were very long-duration instruments. Note that bull and bear markets tended to last a very long time and, in fact, the British bond bear market after WWII was impressive in terms of rate increases but rather normal in terms of length.



Why do secular cycles in bonds last so long? For the most part, secular cycles in long-duration interest rates are driven by inflation expectations. Rising inflation undermines the real value of interest return; investors, stung by inflation, will demand ever higher yields for protection. When policy changes to corral inflation, it takes some time before investors "forget" their unpleasant experiences and accept a lower interest rate. After a long period of low inflation, investors are "fooled" by rising inflation, at least at its early stages. This underestimation in inflation leads to falling real returns and prompts demand for rising rates.

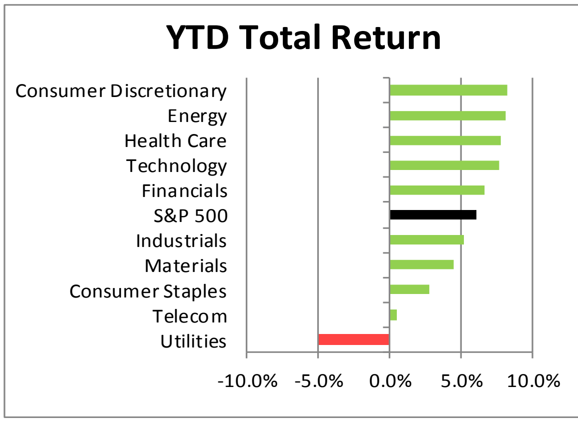
What makes the current period interesting is that the baby boomers are unusually sensitive to inflation fears because most of them spent their formative years during the high-inflation period of the 1970s. Thus, any signs of inflation, regardless of how minor, tend to lead to "discomfort" in the fixed income markets. The existence and current prominence of the baby boom generation will likely keep long-duration rates from rising very much in the coming years. The oldest boomer is 72 this year, while the youngest is 54. Clearly, over the next two decades, the memory of 1970s inflation will fade and the subsequent generations will be much more likely to be fooled by inflation and will be slow to demand higher yields. This fact will probably lead to the final stages of the bond bear market, which will be rather painful for investors.

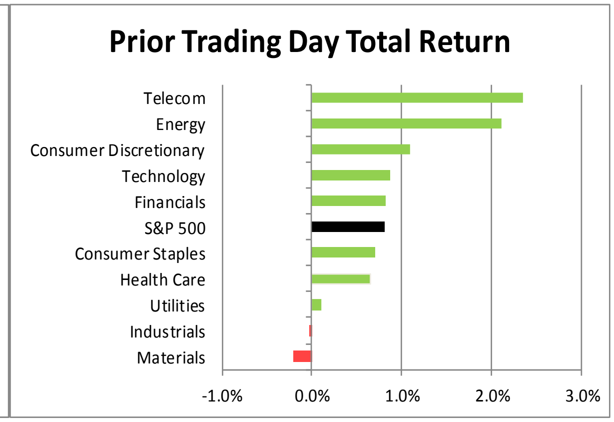
So, what does an investor do in the meantime? We look for gradually rising rates over time. The policies of neoliberalism, which supported globalization and deregulation,[2] successfully ended the high inflation period of the 1970s. We are likely in the early stages of a retreat from neoliberalism. The rise of populism in the West is partly due to citizens becoming acutely aware of the costs of neoliberalism (high level of inequality and job insecurity) without being aware of its benefits (low inflation, long business expansions). Although it will take some time, tolerance of higher inflation will likely increase. Investors have two strategies for such an environment. First, corporate credit tends to do better in the early stages of a secular bear market because gradually rising prices reduce credit risk as firms find it easier to pass along higher prices. Second, bond laddering, the purchase of instruments at various points of the yield curve, offers some defense from rising rates. As time passes, the duration of a laddered portfolio falls, reducing rate risk. As the nearest instrument matures, the investor buys a longer term instrument and the process repeats. We are currently deploying both strategies in our fixed income allocations.

[2] We define deregulation as the unfettered implementation of new technology and methods on the economy.

Data Section

U.S. Equity Markets – (as of 1/22/2018 close)

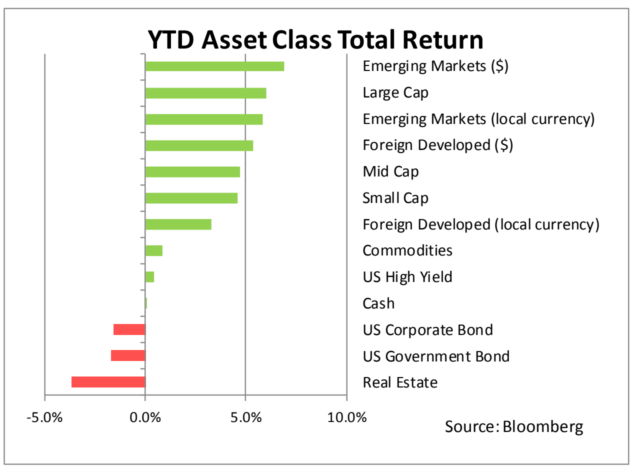




(Source: Bloomberg)

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 1/22/2018 close)

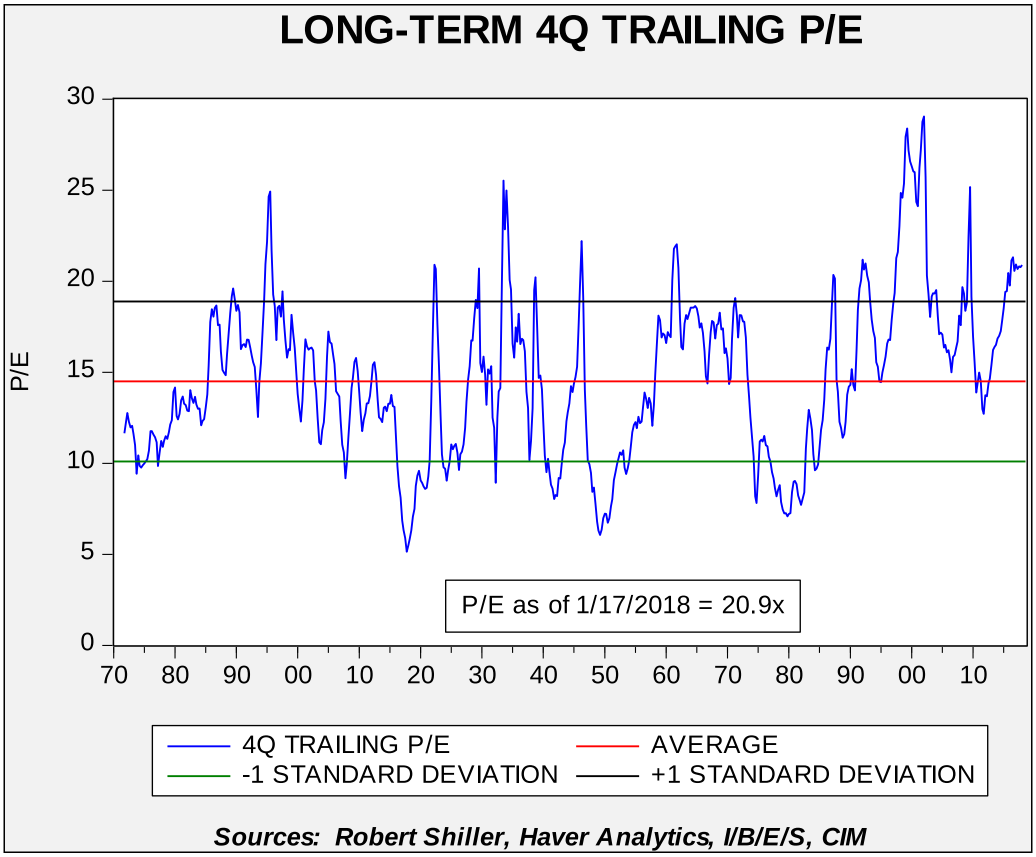


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

January 18, 2018



Based on our methodology,[3] the current P/E is 20.9x, down 0.5x from the last report. Although the S&P is rising, upward revisions to 2018 Q1 earnings led to the drop in the multiple.

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