Confluence Investment Management

Daily Comment

By Bill O'Grady and Thomas Wash

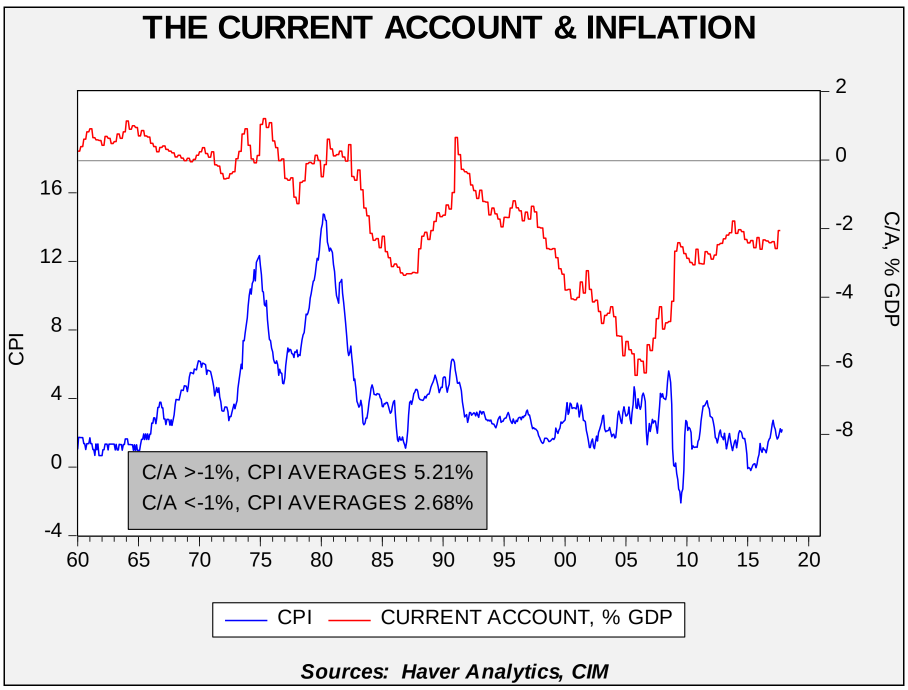
[Posted: January 25, 2018—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.2% from the prior close. Chinese markets were down, with the Shanghai composite down 0.3% and the Shenzhen index down 0.4%. U.S. equity index futures are signaling a higher open. With 88 companies having reported, the S&P 500 Q4 earnings stand at $35.07, 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, 79.5% of the companies reported earnings above forecast, while 11.4% reported earnings below forecast.

The president arrived in Davos this morning and will give the keynote speech tomorrow, and the ECB met today. Here is what we are watching:

The ECB: The ECB made no monetary policy changes, as expected. In his press conference, ECB President Draghi didn't veer from anything he has said before. Interestingly enough, this was taken as hawkish. The dollar slumped, the EUR jumped, European and U.S. bond yields rose and European equities dipped. It does appear the financial markets were expecting a dovish statement or press conference and the aforementioned market action developed when it became evident that wasn't coming.

Another side of protectionism: Discussions of trade policy tend to be based on academic theory. The theoretical structure is fairly simple—mercantilism, the policy of forcing a trade surplus, will eventually lead to inflation in the nation running the surplus. This theory goes back to David Hume (1711-1776). The theory of competitive advantage was developed by David Ricardo (1772-1823). Perhaps one of the most misunderstood parts is trade macroeconomics, which shows that changes in trade are tied to changes in public, private and foreign saving. Another area that is generally underestimated is the effect of the dollar's role as the reserve currency. ***The U.S. gets to play by trade rules that no other nation gets to use.*** Other nations need dollars to conduct trade; they don't have an interest in accumulating balances in the Vietnamese dong and will thus try to conduct trade with Vietnam in dollars. In addition, consumption represents 70% of U.S. GDP and America acts as the global importer of last resort. If a normal nation puts trade barriers in place, import prices quickly rise as the supply contracts. On the other hand, if the U.S. puts trade impediments in place, the foreign nation facing these restrictions ***still needs dollars***. Thus, they may decide to absorb the costs of the tariff by cutting prices. In addition, the firms affected still want access to the large, open American market, which may mean directly sourcing production in the U.S. to avoid losing access to the American market. Interestingly enough, building productive capacity in the U.S. appears to be part of the adjustment process on the recently announced tariffs on washing machines.[1] South Korean firms have indicated they will hike prices to account for the tariff but they also announced they have built productive capacity in the U.S.

There are numerous reasons why foreign nations want to export to the U.S. One reason is to acquire dollars. Another is to use American consumers to build their industrial base. Others want to boost domestic employment. Moving productive capacity to the U.S. does undermine these goals. However, it is also an acknowledgement that there are limits to what the U.S. will tolerate; after all, foreign nations do create structures to suppress domestic consumption and wages and undervalue their exchange rates to sell to the U.S. These policies adversely affect some sectors of the U.S. economy, especially manufacturing.[2] One way nations can pacify American policymakers is to move production to the U.S. During the 1980s, after President Reagan negotiated "voluntary" auto export restraints with Japan, Japanese automakers built car plants in the U.S. Although President Trump's trade threats could have significant effects on America's superpower role and global growth, foreign nations can blunt the impact by moving production into the U.S. And, in fact, that should be the administration's goal. Although some members do see the trade deficit itself as a problem, in reality, nearly all elected officials in a democracy are most focused on job creation. If foreign companies shift production to the U.S. in a bid to reduce protectionist pressures, this would be a major win for the president. That isn't to say there won't be an impact on inflation. Reducing competitive pressures from foreigners (which is also affected by a weaker dollar) will tend to lift domestic prices.



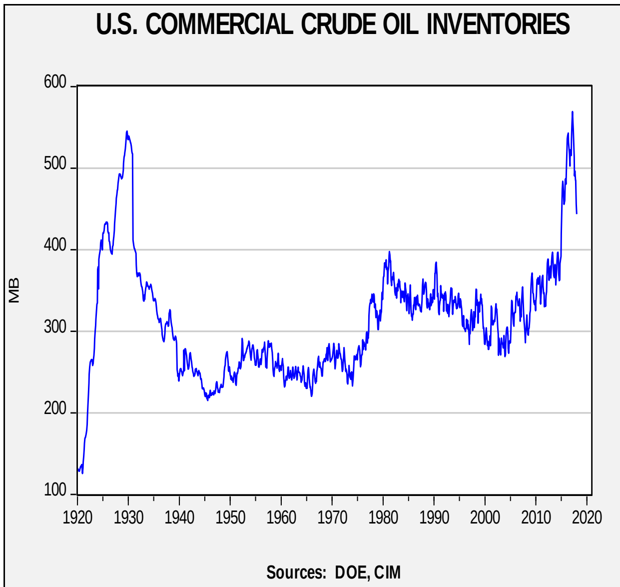
[1] https://www.reuters.com/article/us-lg-elec-tariffs/south-koreas-lg-to-hike-washer-prices-in-u-s-after-tariffs-idUSKBN1FD2Z9

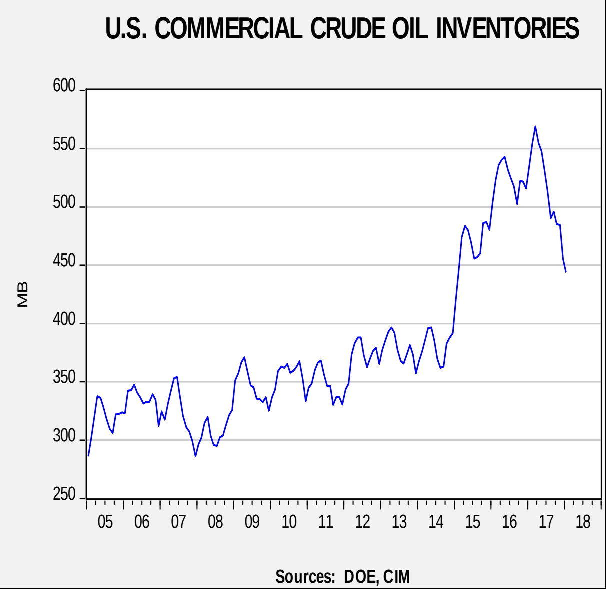
[2] Interestingly enough, it boosts other sectors, such as finance, which recycles foreign saving into dollar assets.

This chart shows the current account as a percentage of GDP and CPI. As the chart shows, a wider current account deficit is consistent with lower inflation.

The bottom line is that if the administration's trade policies lead to an influx of direct foreign investment and jobs in those facilities (which may not hire that many people, based on the degree of automation in these new factories), it could boost U.S. growth and improve the president's approval rating. If this is the outcome, it will probably be a net positive for the U.S. and help, at least partially, rebalance the costs of hegemony.

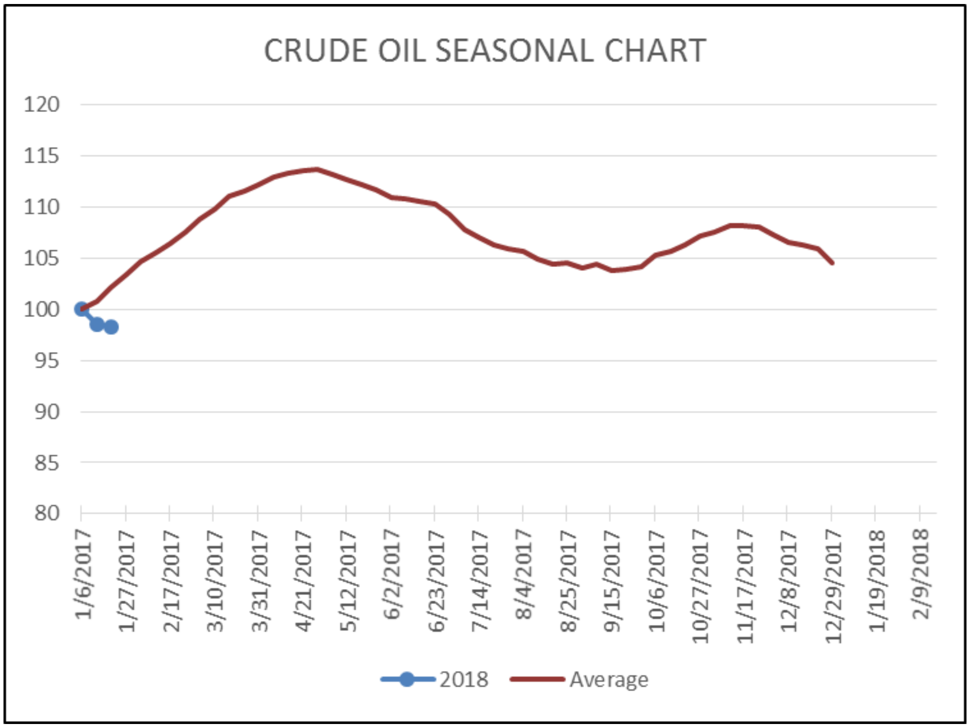
Energy recap: U.S. crude oil inventories fell 1.1 mb compared to market expectations of a 2.3 mb draw.



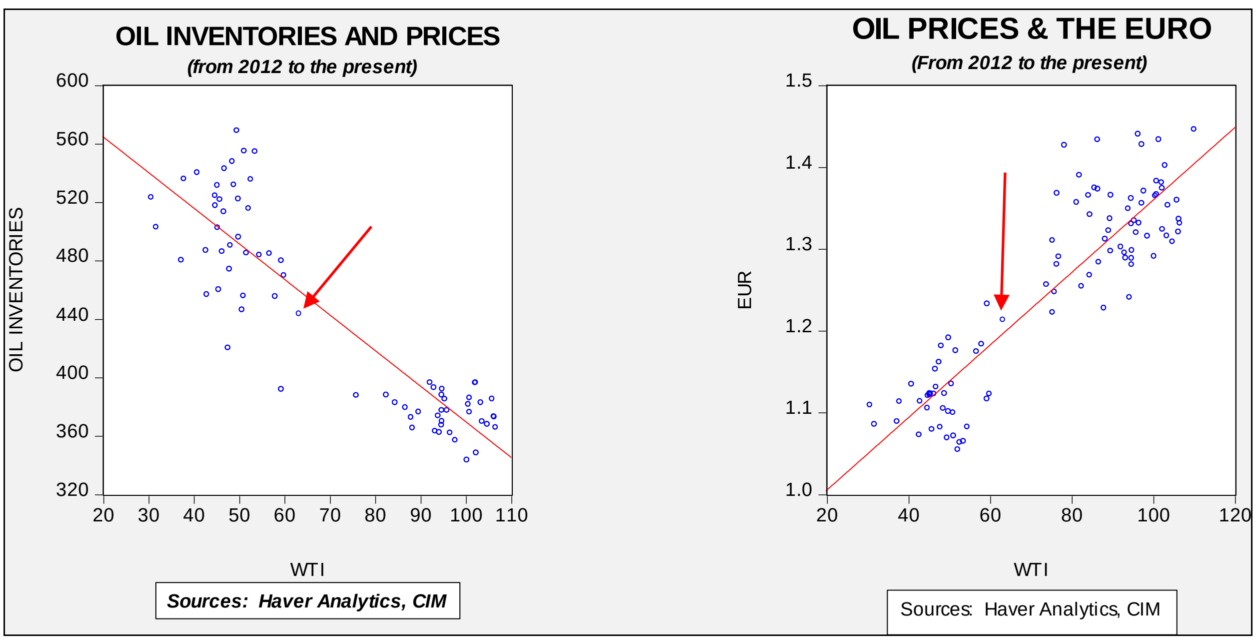


This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but have declined significantly since last March, by over 120 mb. This decline doesn't take into account the withdrawal from the SPR, which added an additional 31 mb to supply. Taking the SPR into account, inventories fell a whopping 152 mb.

As the seasonal chart below shows, inventories fell this week. We are at the beginning of the Q1 seasonal build season. The fact that oil inventories fell again this week is quite bullish. If this pattern continues we could see stockpiles drop below 400 mb later this year, which would be at the high end of normal.



(Source: DOE, CIM)

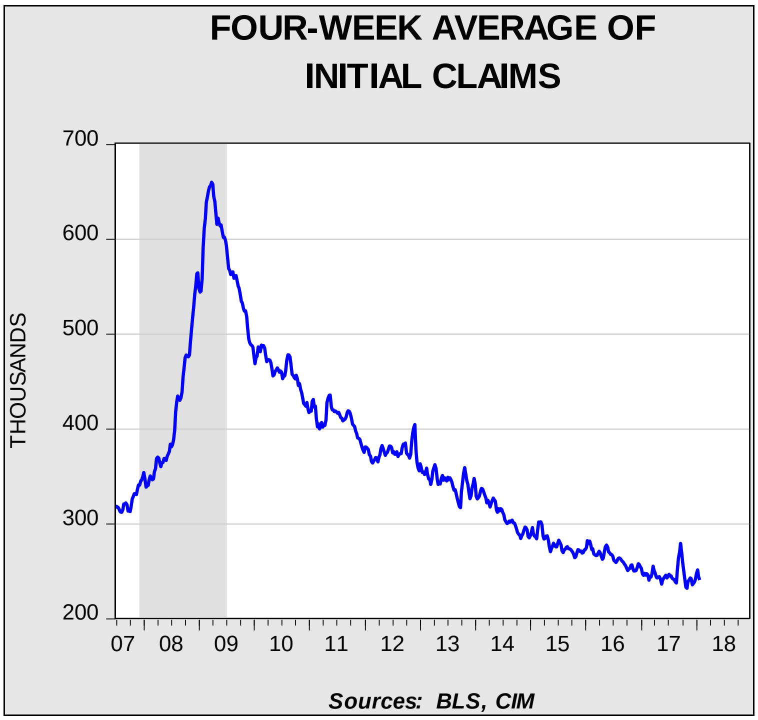


Based on inventories alone, oil prices are undervalued with the fair value price of $69.95. Meanwhile, the EUR/WTI model generates a fair value of $70.91. Together (which is a more sound methodology), fair value is $70.59, meaning that current prices, while elevated, are below fair value. The weak dollar and falling oil inventories are bullish for oil prices and suggest there is more upside, especially if inventories fail to rise in their normal seasonal fashion.

The Saudi Oil Minister suggested in an interview at Davos yesterday that the IPO for Saudi Aramco may not occur this year unless conditions are favorable. There is a general belief (which we agree with) that Saudi oil policy will be designed to boost oil prices into the IPO. Once the offering is made, we would not be surprised to see OPEC try to regain market share which would weigh on oil prices. If the IPO is delayed, it is bullish for oil prices.

U.S. Economic Releases

Initial jobless claims came in below expectations at 233k compared to the forecast of 235k. The previous report was revised downward from 220k to 216k.



The chart above shows the four-week moving average of initial jobless claims. The four-week moving average dropped from 243.5k to 240.0k.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomber Consumer Comfort	m/m	jan		53.8	**
10:00	New Home Sales	m/m	dec	675k	733k	**
10:00	New Home Sales	m/m	dec	-7.9%	17.5%	**
10:00	Leading Indec	m/m	dec	0.5%	0.4%	**
11:00	Kansas City Fed Manf. Activity	m/m	jan	14	14	**
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	Japan buying foreign bonds	m/m	jan	¥953.5 bn	¥953.5 bn		*	Equity and bond neutral
	Japan buying foreign stocks	m/m	jan	¥379.8 bn	¥89.2 bn		*	Equity and bond neutral
	Foreign buying Japan bonds	m/m	jan	-413.4 bn	¥86.8 bn		*	Equity and bond neutral
	Foreign buying Japan stocks	m/m	jan	-148.2 bn	¥468.7 bn		*	Equity and bond neutral
	Supermarket Sales	m/m	dec	0.9%	-0.6%		**	Equity and bond neutral
New Zealand	CPI	y/y	4q	1.6%	0.5%	0.4%	***	Equity bullish, bond bearish
EUROPE								
Germany	GfK Consumer Confidence	m/m	jan	11.0	10.8	10.8	**	Equity bullish, bond bearish
	IFO Business Climate	m/m	jan	117.6	117.2	117.0	**	Equity bullish, bond bearish
	IFO Expectations	m/m	jan	108.4	109.5	109.3	**	Equity and bond neutral
	IFO Current Assessment	m/m	jan	127.7	125.4	125.3	**	Equity bullish, bond bearish
Italy	Industrial Sales	y/y	nov	5.1%	6.0%		**	Equity and bond neutral
	Industrial Orders	y/y	nov	8.9%	12.5%		**	Equity and bond neutral
UK	UK Finance Loan for Housing	m/m	dec	36115	39507	39800	**	Equity and bond neutral
	CBI Retailing Reported Sales	m/m	jan	12	20	13	**	Equity and bond neutral
	CBI Total Dist. Reported Sales	m/m	jan	14	24		**	Equity and bond neutral
Russia	PPI	y/y	dec	8.4%	8.0%	7.7%	**	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)	175	174	1	Up
3-mo T-bill yield (bps)	141	141	0	Neutral
TED spread (bps)	34	33	1	Neutral
U.S. Libor/OIS spread (bps)	152	151	1	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)	25	24	1	Down
Currencies	**Direction**			
dollar	down			Down
euro	flat			Up
yen	up			Neutral
pound	up			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
ECB Main Refinancing Rate	0.000%	0.000%	0.000%	On forecast
ECB Marginal Lending Facility	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	$70.83	$70.53	0.43%	
WTI	$66.09	$65.61	0.73%	
Natural Gas	$3.52	$3.51	0.26%	
Crack Spread	$17.03	$17.36	-1.93%	
12-mo strip crack	$19.40	$19.68	-1.41%	
Ethanol rack	$1.42	$1.42	0.20%	
Metals				
Gold	$1,358.96	$1,358.46	0.04%	
Silver	$17.53	$17.55	-0.14%	
Copper contract	$323.50	$322.85	0.20%	
Grains				
Corn contract	$ 357.00	$ 356.50	0.14%	
Wheat contract	$ 434.75	$ 433.00	0.40%	
Soybeans contract	$ 994.50	$ 992.25	0.23%	
Shipping				
Baltic Dry Freight	1200	1157	43	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-1.1	-2.3	1.2	
Gasoline (mb)	3.1	2.1	1.0	
Distillates (mb)	0.6	-1.3	1.9	
Refinery run rates (%)	-2.10%	-1.00%	-1.10%	
Natural gas (bcf)		-268.0		

Weather

The 6-10 and 8-14 day forecasts call for warmer temperatures on both coasts, with cooler to normal temperatures for the rest of the country. Precipitation is expected for most of the country.

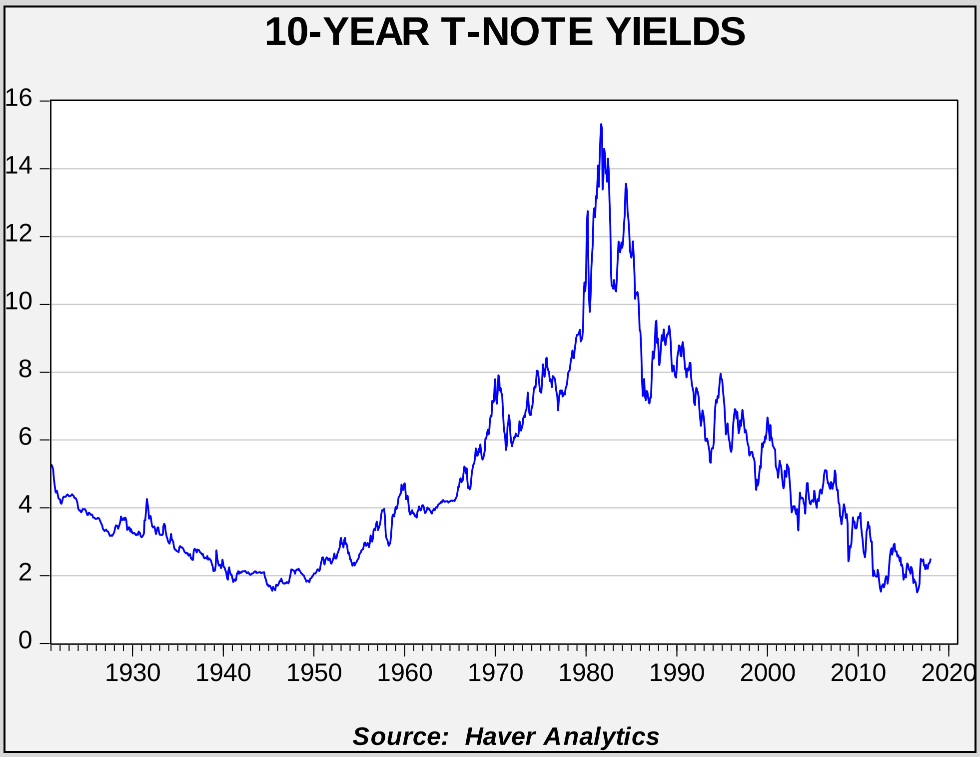
Asset Allocation Weekly Comment

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.

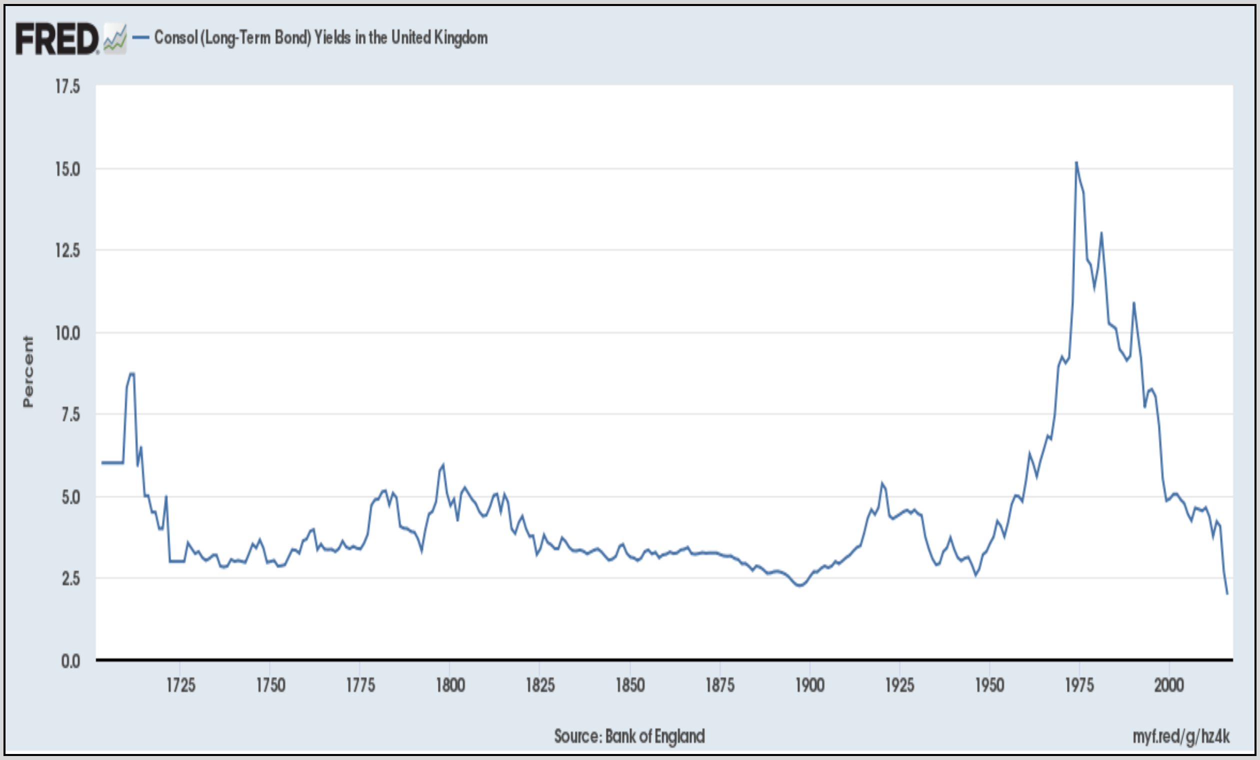
January 19, 2018

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.

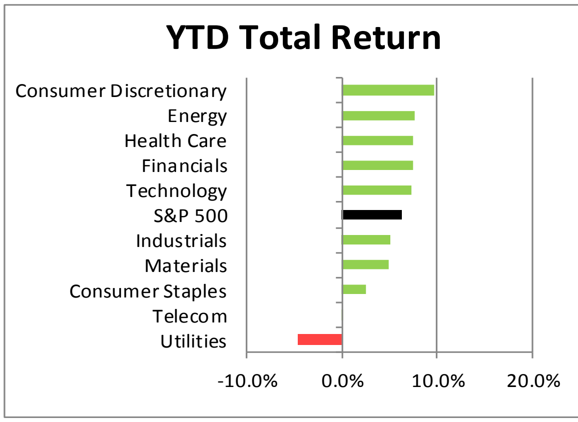
What makes the current period interesting is that the baby boomers are unusually sensitive to inflation fears because most of them spent their formative years during the high-inflation period of the 1970s. Thus, any signs of inflation, regardless of how minor, tend to lead to "discomfort" in the fixed 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.

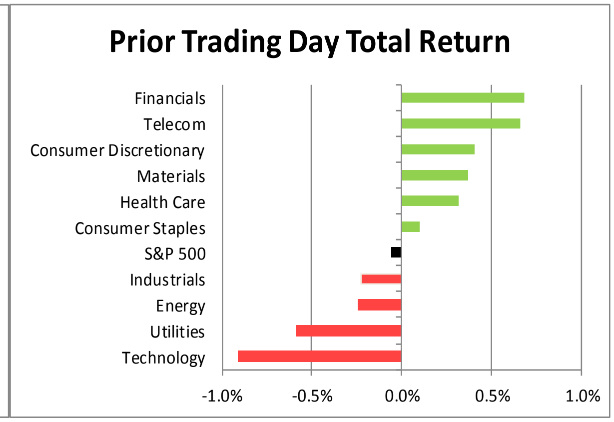
So, what does an investor do in the meantime? We look for gradually rising rates over time. The policies of neoliberalism, which supported globalization and deregulation,[3] successfully ended the high inflation period of the 1970s. We are likely in the early stages of a retreat from neoliberalism. The 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.

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

Data Section

U.S. Equity Markets – (as of 1/24/2018 close)

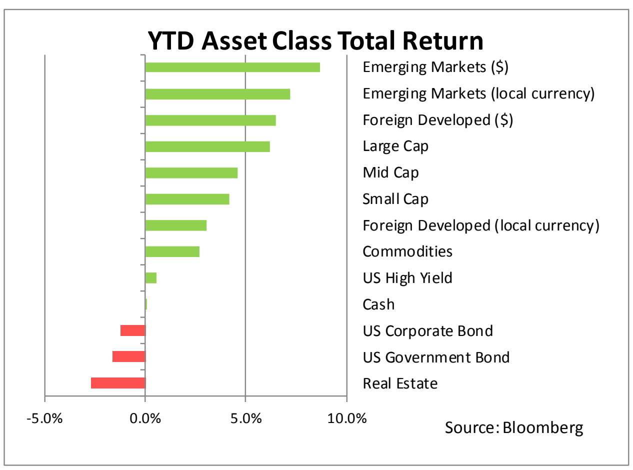




(Source: Bloomberg)

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 1/24/2018 close)

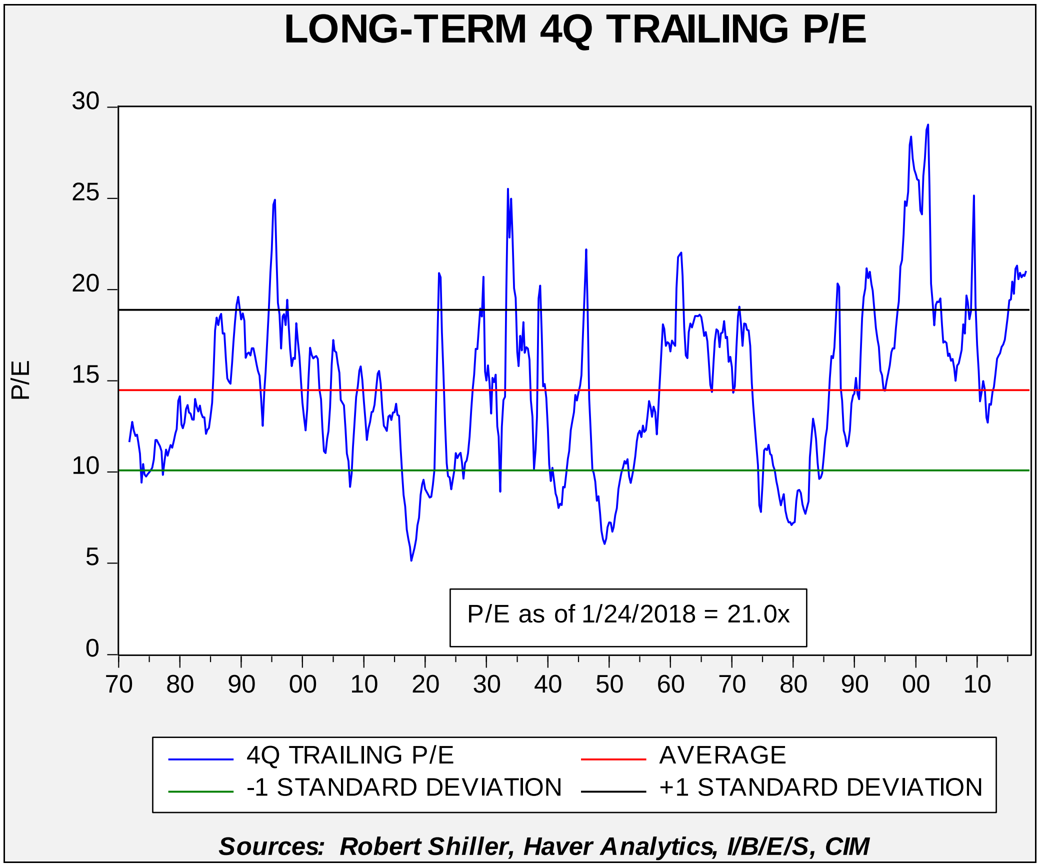


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 25, 2018



Based on our methodology,[4] the current P/E is 21.0x, up 0.1x from the last report. The rise in the S&P index led to the modest rise in the P/E multiple.

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.

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[4] 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.