Daily Comment

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: July 11, 2018—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 1.1% from the last close. In Asia, the MSCI Asia Apex 50 closed down 1.1% from the prior close. Chinese markets were down, with the Shanghai composite down 1.8% and the Shenzhen index also down 2.0%. U.S. equity index futures are signaling a lower open. With 21 companies having reported, the S&P 500 Q2 earnings stand at $39.16, lower than the $39.20 forecast for the quarter. The forecast reflects a 19.9% increase from Q2 2017 earnings. Thus far this quarter, 90.5% of the companies reported earnings above forecast, while 4.8% reported earnings below forecast.

Equity markets are lower due to concerns of global trade tensions. Below are the issues that we are paying close attention to today:

NATO summit: In the opening hours of the NATO summit, President Trump sparked controversy by criticizing Germany's relationship with Russia and its unwillingness to increase spending on defense. In a meeting with NATO Secretary General Jens Stoltenberg, President Trump accused Germany of being held captive by Russia due to its support of the Nord Stream 2 gas pipeline it is constructing with Russia. In the past, the construction of the pipeline was criticized as undermining U.S. efforts to punish Russia for its annexation of the Crimea as it would make it easier for Russia to cut off Ukraine's gas supply by siphoning the gas that is bound for the EU. Germany has been pressed to secure the deal due to its strict renewable energy goals which prompted it to close its coal and nuclear plants despite criticisms that the country is putting its own national interests above the European alliance. Although the timing and manner of the president's comments were a bit odd, they were not all that surprising. That being said, his comments will further feed speculation that he prefers closer ties with Russia over Europe.

Oil supply: During the NATO summit, Secretary of State Mike Pompeo set up meetings with NATO members to assist them in finding alternatives to Iranian oil. Last month, the U.S. requested that all countries stop purchasing Iranian oil before November 4 as a way to force Iran to end its nuclear program. Since the request has been made, countries have struggled to find alternative sources due to unrest in both Libya and Venezuela as well as OPEC's inability to come to an agreement to significantly increase oil production. As a result, there is growing speculation that the U.S. may be forced to push back the deadline or offer sanction waivers to certain countries. Recent developments in Libya may ease some of those concerns but at this point it is unclear – today, ports in eastern Libya were able to resume shipments after the state energy producer regained control of the terminals. We will continue to monitor that situation.

Chinese Middle East Police: Yesterday, Chinese President Xi Jinping told members of the Arab League that China would like to "become the keeper of peace and stability" within the region. In addition, China pledged $25 billion in loans and aid to Middle Eastern countries as part of its Belt and Road infrastructure initiative. China's push to boost economic and security ties is likely due to its desire to become less dependent on the West for its exports, increase its access to natural resources and build additional military bases throughout the world. Currently, the Belt and Road initiative covers two-thirds of the world's population and involves three-quarters of its energy resources.[1]

New tariffs: Yesterday, President Trump initiated the process of imposing additional tariffs on $200 billion of Chinese goods. The response was over China's decision to impose tariffs on $34 billion of American exports. The market reacted negatively to the news; as a result, Chinese equities and renminbi have fallen. According to the June Federal Reserve minutes, rising trade tensions have deterred businesses from making future investments. We will continue to monitor this situation.

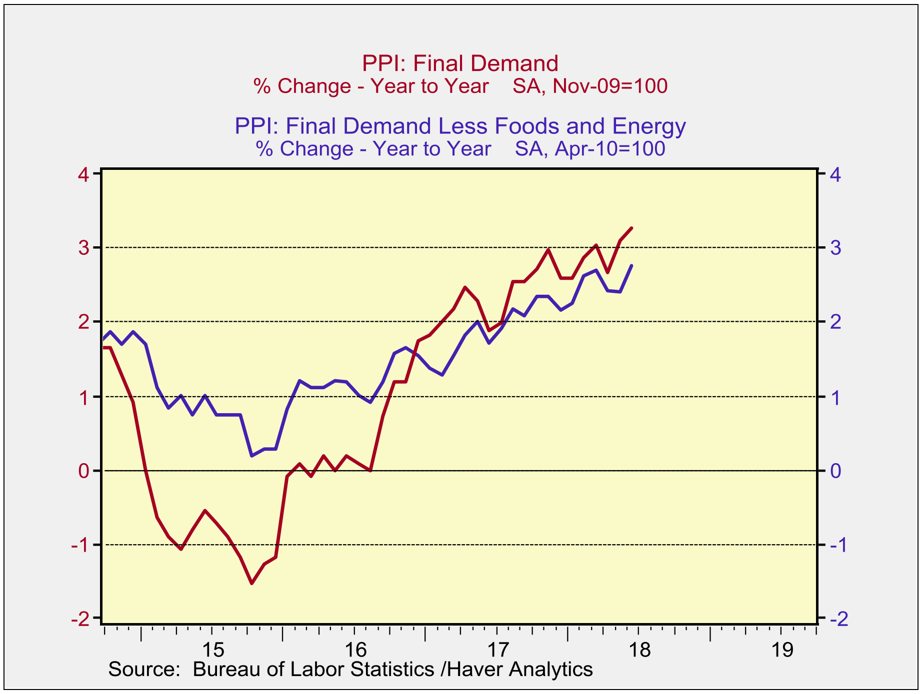
(Source: Bloomberg)

U.S. Economic Releases

MBA mortgage applications rose 2.5% from the prior week. Purchases rose 6.5% from the prior week, while refinancing fell 3.8%. The average 30-year fixed rate fell by 3 bps from 4.79% to 4.76%.

PPI final demand came in above expectations, rising 0.3% from the prior month compared to the forecast rise of 0.2%. PPI excluding food and energy was above expectations, rising 0.3% from the prior month compared to the forecast of 0.2%. Core PPI came in above expectations, rising 0.3% from the prior month compared to the forecast of 0.2%.

[1] https://worldview.stratfor.com/article/how-development-finance-changing-geopolitics



The chart above shows the relationship between PPI final demand and PPI excluding food and energy. Annually, headline PPI and PPI excluding food and energy rose 3.3% and 2.8%, respectively. We note the relationship of PPI to CPI isn't all that strong so the impact on consumer inflation is not significant.

There were no other economic releases prior to the publication of this report. The table below lists the economic releases published for the rest of the day.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Wholesale Trade Sales	m/m	may	0.5%	0.8%	**
10:00	Wholesale Inventories	m/m	may	0.5%	0.5%	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
12:15	Patrick Harker Speaks at Rocky Mountain Economic Summit	President of the Federal Reserve Bank of Philadelphia				

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	PPI	m/m	jun	2.8%	2.7%	2.8%	**	Equity and bond neutral
	Core Machine Orders	m/m	may	16.5%	9.6%	10.9%	**	Equity bullish, bond bearish
	Tertiary Industry Index	m/m	may	0.1%	1.0%	-0.3%	**	Equity bullish, bond bearish
Australia	Westpac Consumer Confidence	m/m	jul	3.9%	0.3%		**	Equity bullish, bond bearish
	Home Loans	y/y	may	1.1%	-1.4%	-2.0%	**	Equity bullish, bond bearish
	Investment Lending	m/m	may	-0.1%	-0.9%		**	Equity and bond neutral
	Owner-Occupier Loan Value	m/m	may	0.7%	0.2%		**	Equity bullish, bond bearish
EUROPE								
Russia	Current Account Balance	q/q	2q	22.300 bn	30.827 bn	27.675 bn	**	Equity bearish, bond bullish
AMERICAS								
Mexico	Nominal Wages	y/y	jun	5.6%	5.7%		**	Equity and bond neutral
	International Reserves Weekly	w/w	jul	$173.362 bn	$173.211 bn		**	Equity and bond neutral
Canada	Housing Starts	m/m	jun	248.1k	195.6k	210.0k	**	Equity bullish, bond bearish
	Building Permits	m/m	may	4.7%	0.0%	-4.6%	**	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)	233	233	0	Up
3-mo T-bill yield (bps)	193	194	-1	Neutral
TED spread (bps)	41	40	1	Neutral
U.S. Libor/OIS spread (bps)	196	195	1	Up
10-yr T-note (%)	2.84	2.85	-0.01	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	2	2	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**	
Bank of Canada Rate Decision		1.250%	1.500%	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	$77.17	$78.86	-2.14%	Supply Optimism
WTI	$73.66	$74.11	-0.61%	
Natural Gas	$2.79	$2.79	0.11%	
Crack Spread	$16.46	$17.48	-5.87%	
12-mo strip crack	$19.45	$20.20	-3.73%	
Ethanol rack	$1.58	$1.58	-0.16%	
Metals				
Gold	$1,250.30	$1,255.54	-0.42%	
Silver	$15.93	$16.06	-0.80%	
Copper contract	$276.35	$283.95	-2.68%	
Grains				
Corn contract	$ 356.75	$ 360.75	-1.11%	
Wheat contract	$ 484.75	$ 492.00	-1.47%	
Soybeans contract	$ 856.25	$ 871.50	-1.75%	
Shipping				
Baltic Dry Freight	1555	1609	-54	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.9		
Gasoline (mb)		-1.0		
Distillates (mb)		1.0		
Refinery run rates (%)		0.10%		
Natural gas (bcf)		56.0		

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. Tropical Storm Chris has developed into a hurricane and is expected to move northward and away from the eastern coastline.

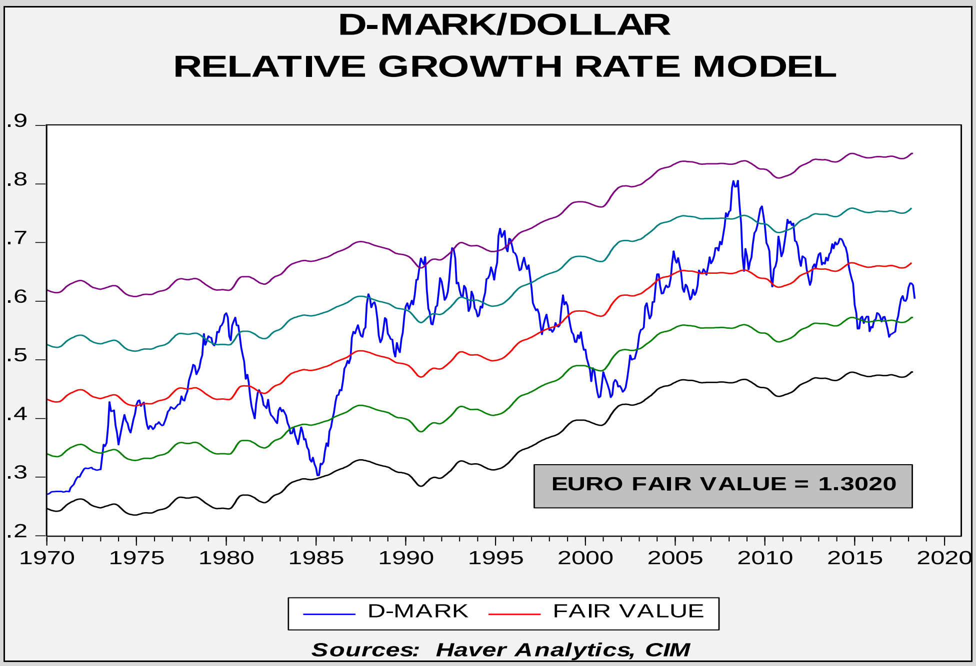
Asset Allocation Weekly Comment

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.

July 6, 2018

Over the past quarter, emerging market equities have weakened; the primary culprit was a strengthening dollar, although concerns about softer non-U.S. growth likely played a role as well. The dollar's strength appears to be caused by one of two factors. The first possibility is interest rate differentials, which are partly due to the differences in economic growth. The second possibility is that the potential of a trade conflict, which would likely reduce the global supply of dollars, is leading to the appreciation of the greenback.

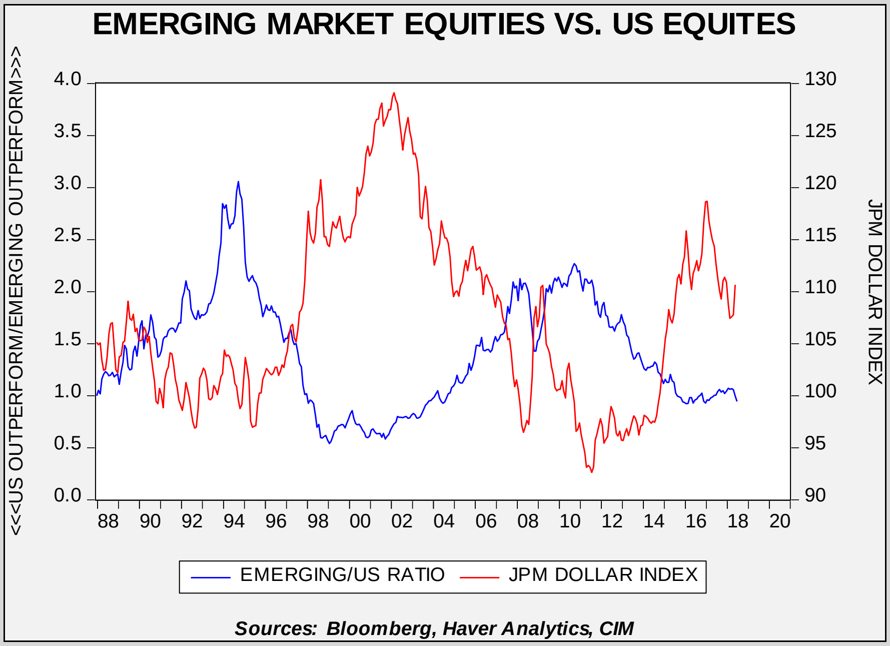
The problem is that relative growth rates suggest the dollar is still somewhat overvalued.



This chart shows a model using the OECD's leading indicators for Germany and the U.S. Converting the estimated D-mark forecast to euros indicates a fair value of $1.3020. Since relative growth rates drive the interest rate differences, it suggests it is less likely that interest rate differences are pushing the dollar higher. In other words, it is obvious that U.S. interest rates exceed European rates but the exchange rate has already adjusted. At the same time, if the financial markets expect further monetary policy tightening from the Federal Reserve, the elevated value of the dollar might be justified.

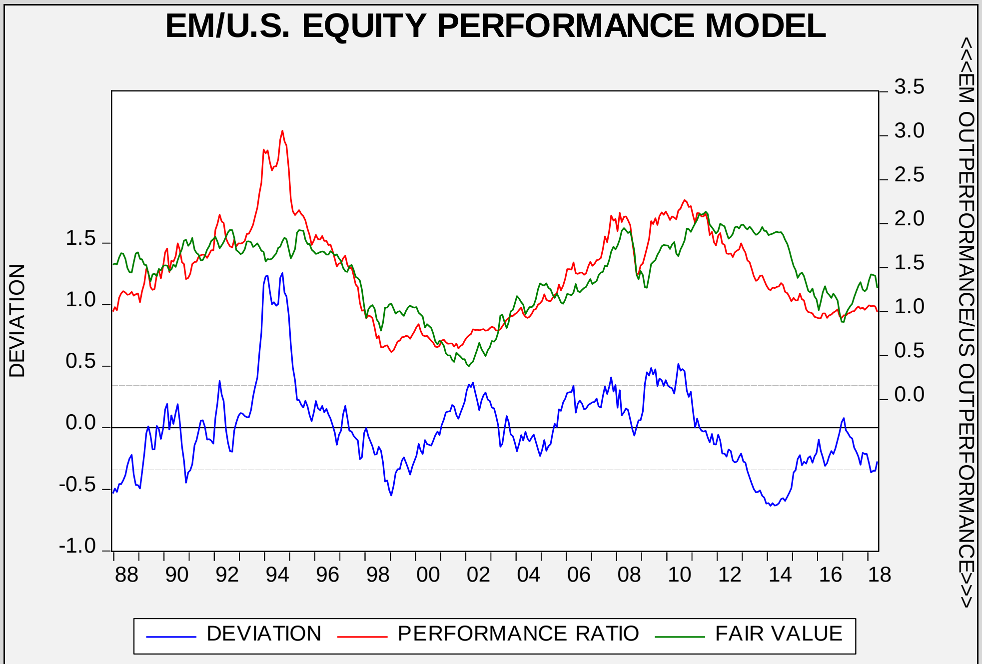
On the other hand, the impact of trade restrictions is different. The U.S. has built a global trading system that was designed for steady declines in trade impediments. From GATT to the WTO, the U.S. has fostered this system by consistently lowering tariffs and allowing nations to run trade surpluses with the U.S. This wasn't a flaw in the system; a reserve currency in a fiat currency regime essentially forces the U.S. to supply dollars to the world to facilitate trade. The persistent trade deficit does impose costs on the U.S. economy but American political leadership, up until now, was willing to absorb those costs to maintain American hegemony.

At this juncture, it is unclear if the administration intends to completely upend the postwar trading system or if its actions are designed to improve America's bargaining position. Either outcome is possible. If it turns out that the former is the goal, the dollar is likely to continue to appreciate, perhaps reaching historic highs. If the latter is the goal, then the dollar may be vulnerable to a pullback.



This chart shows the relative performance of U.S. equities and emerging market equities; a rising blue line indicates emerging equities are outperforming emerging market equities. The red line shows the JPM dollar index; the two series are inversely correlated at the 77.5% level, which means a stronger dollar leads to U.S. outperformance. That finding is consistent with what has occurred over the past quarter.

However, there is evidence to suggest the recent U.S. outperformance is excessive. The chart below shows a regression model of the relative performance of equities with the dollar index as the explanatory variable. The lower line in the chart show shows the deviation from fair value. Since 2010, emerging markets have generally underperformed relative to the dollar. This could be due to a general avoidance of risk since the Great Financial Crisis but current levels are nearly a full standard error below fair value.



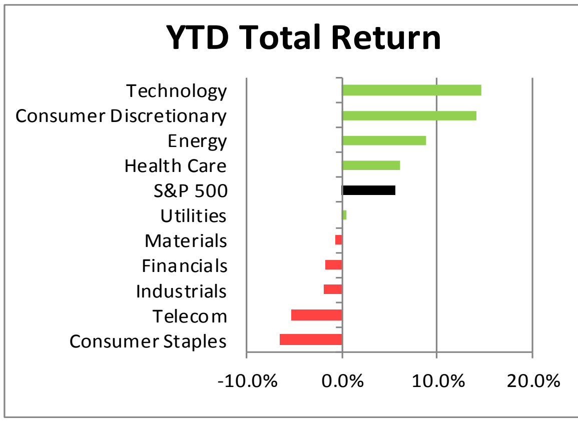
Sources: Bloomberg, Haver Analytics, CIM

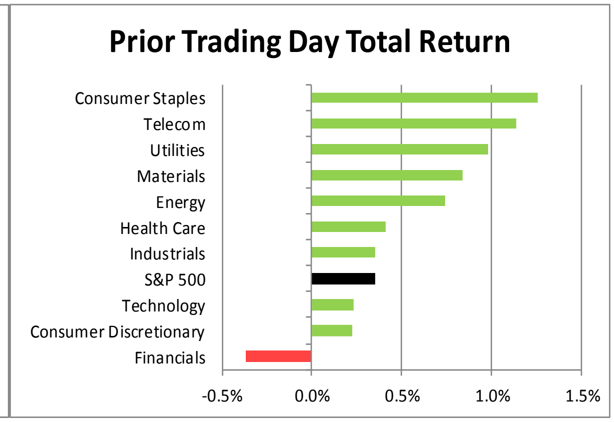
This analysis suggests that emerging markets are undervalued even in the face of recent dollar strength. If the dollar pulls back, either because the Trump trade policy is posturing or the FOMC signals some moderation in its tightening path, emerging markets could recover. In any case, they are attractive at current levels, although recovery will likely need a sign of policy restraint either on trade or the monetary front.

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 7/10/2018 close)

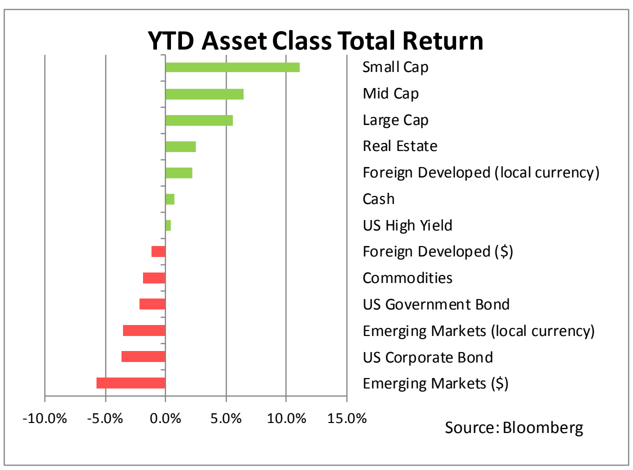




(Source: Bloomberg)

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 7/10/2018 close)

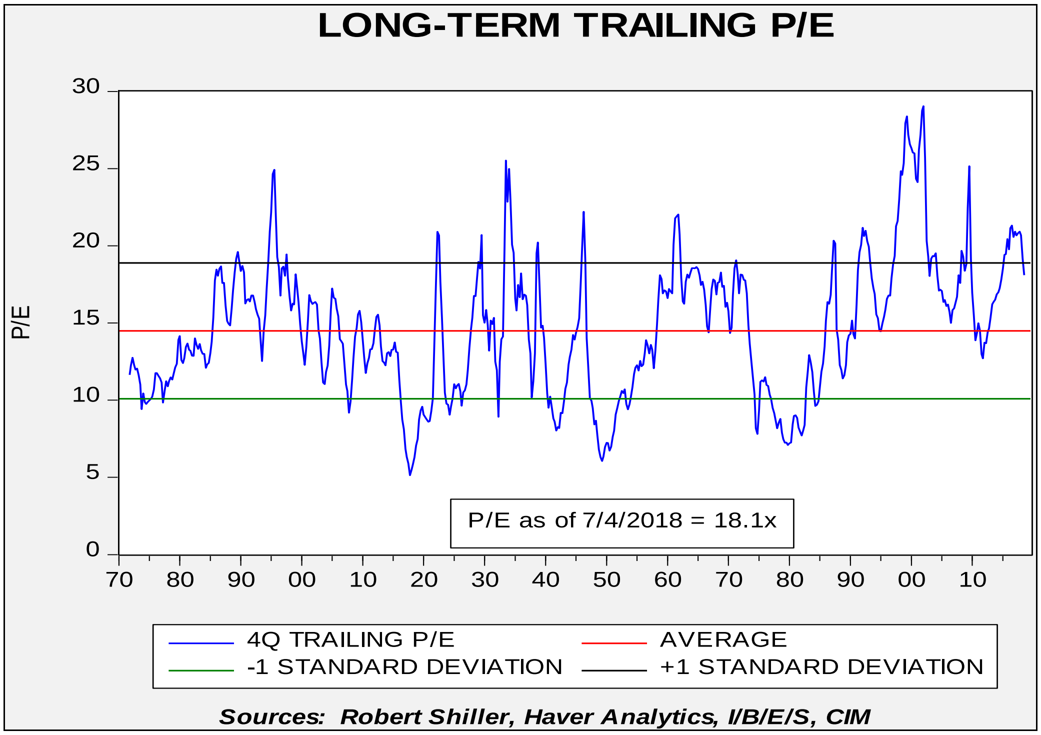


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

July 5, 2018



Based on our methodology,[2] the current P/E is 18.1, down 1.1x from last week. As we move into Q3, the impact of rising earnings is depressing the 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.

[2] 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 three actual quarters (Q4 and Q1) and two estimates (Q2 and Q3). 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.