Confluence INVESTMENT MANAGEMENT

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 23, 2018—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.4% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.2% from the prior close. Chinese markets were up, with the Shanghai composite up 1.1% and the Shenzhen index up 0.5%. U.S. equity index futures are signaling a lower open. With 87 companies having reported, the S&P 500 Q2 earnings are above expectations at $39.52 compared to the $39.20 forecast for the quarter. The forecast reflects a 19.9% increase from Q2 2017 earnings. Thus far this quarter, 89.7% of the companies reported earnings above forecast, while 4.6% reported earnings below forecast.

Although it was a quiet weekend, we have had a busy morning. Here is what we are watching:

Iran: There was media sniping this morning, which appears to have started in Iran. First, President Rouhani of Iran warned the U.S. not to escalate tensions with his country, suggesting that a confrontation would lead to the "mother of all wars." He also indicated that the U.S. could not stop Iran from exporting its oil.[1] This statement is, obviously, incorrect. Although Iran has often threatened to shut down the Strait of Hormuz, which is perhaps the most important oil shipping chokepoint in the world, the U.S. could actually close off Iranian shipping and exports through financial sanctions and the U.S. Navy's ability to implement a blockade. President Trump reacted through social media, sending out an all-caps response late last night.

> To Iranian President Rouhani: NEVER, EVER THREATEN THE UNITED STATES AGAIN OR YOU WILL SUFFER CONSEQUENCES THE LIKES OF WHICH FEW THROUGHOUT HISTORY HAVE EVER SUFFERED BEFORE. WE ARE NO LONGER A COUNTRY THAT WILL STAND FOR YOUR DEMENTED WORDS OF VIOLENCE & DEATH. BE CAUTIOUS![2]

This escalation appears to have been prompted by comments from SoS Pompeo, who described Iran's leaders as the "mafia" and promised to back Iranians unhappy with their government.[3] Pompeo reiterated the U.S. goal of lowering Iran's exports to "as close to zero as possible" by

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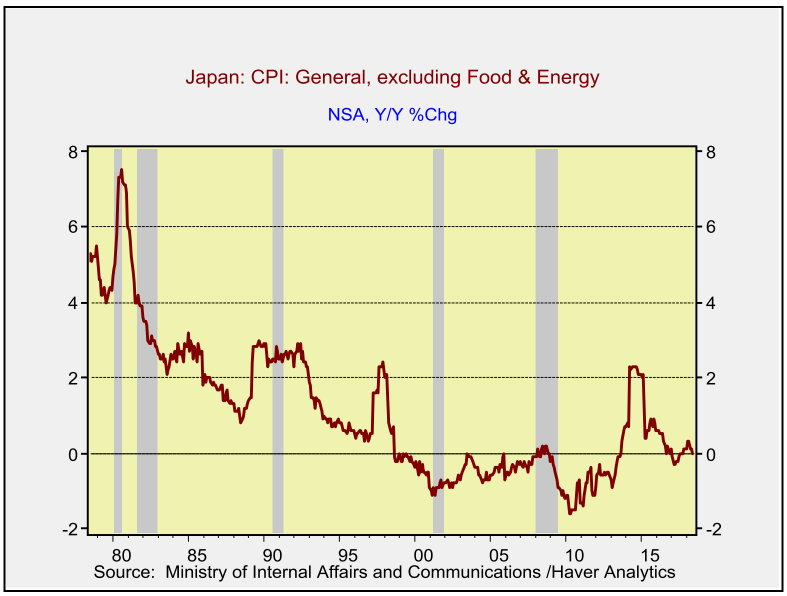
[1] https://www.aljazeera.com/news/2018/07/play-lion-tail-rouhani-warns-trump-180722162909627.html
[2] https://www.ft.com/content/14e607ac-8e29-11e8-b639-7680cedcc421?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56
[3] https://uk.reuters.com/article/uk-usa-iran-pompeo/pompeo-assails-irans-leaders-compares-them-to-mafia-idUKKBN1KD04E?il=0&utm_source=POLITICO.EU&utm_campaign=5a3b984308-EMAIL_CAMPAIGN_2018_07_23_04_38&utm_medium=email&utm_term=0_10959edeb5-5a3b984308-190334489

November 4. While it is obvious this administration is taking a hostile line toward Iran, Pompeo's comments about supporting anti-government elements in Iran are probably a mistake. There has been rising unrest in Iran due to the deteriorating economy. But, the elements opposing the mullahs in Iran may not necessarily be pro-U.S. By indicating the U.S. would aid such groups, they are immediately tainted as not being loyal to Iran. This is a mistake that is common for Western governments; regime change may not necessarily make conditions better or empower a new, Western-friendly government.

The comments appear to have lifted oil prices. However, prices are also higher on reports that some North Sea oil platforms have been hit with a 24-hour strike.[4]

Change at the BOJ? We did see a jump in Japan's 10-year government yields overnight on fears of tightening monetary policy. The Bank of Japan continues to struggle with policy. The central bank continues to see inflation below its 2% target with little evidence it's rising.

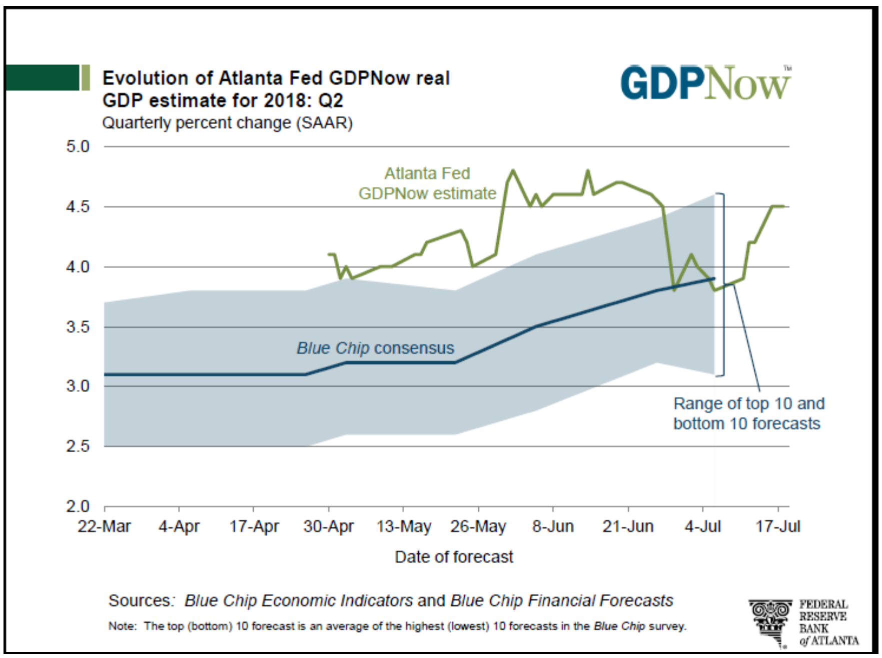


This chart shows Japan's core CPI (y/y% change). Although we did see a jump in 2014, that was due to a hike in consumption taxes. Currently, the inflation rate is zero. At the same time, zero interest rates are distorting the economy and undermining how the financial system functions. What does the BOJ need to do? The best outcome it could achieve would be to steepen the yield curve, which would help the financial system. Currently, the BOJ pegs the 10-year rate at zero. There is talk that it may allow the 10-year rate to become more volatile, but the risk to this policy is that it further confirms the low inflation policy and lifts the JPY. The central bank meets next week; we suspect these "leaks" are really trial balloons, and the market's reaction thus far (rising 10-year yields and a stronger JPY) will support the doves on the board to leave policy unchanged.

[4] https://www.reuters.com/article/us-total-strike-north-sea/totals-north-sea-oil-platforms-hit-by-24-hour-strike-idUSKBN1KD144

Trade: Trade issues continue unabated. SoT Mnuchin was at the G-20 over the weekend in Argentina. By all accounts, not much changed. The Trump administration continues to press for bilateral trade agreements and the rest of the world doesn't want anything to change.[5] Mnuchin added to the president's recent currency comments about foreign nations depreciating their currencies for trade advantage.[6] It should be remembered that Mnuchin made weak dollar comments at Davos earlier this year. On Wednesday, the president of the EU Commission, Jean-Claude Juncker, will meet with President Trump in a bid to forestall auto tariffs.[7] We would not be surprised to see some sort of deal on autos; it appears President Trump is rather isolated even within his own administration on this issue.[8] However, we do offer one note of warning: U.S. light trucks enjoy 25% tariffs which date back to the Johnson administration (the "chicken tax"[9]). If that gets negotiated away, it would likely be a major negative factor for U.S. automakers.

Q2 GDP: The latest reading from the Atlanta FRB's continuous forecast for GDP is suggesting a robust quarter.



The current estimate is for a 4.5% quarter. In looking at the contributions to growth, consumption, net exports and inventories account for about 3.3% of that growth. Government spending is adding 57 bps. New investment is the remainder. Such growth bolsters the Fed's case for higher interest rates.

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[5] https://www.ft.com/content/cbe1f2e2-8dc3-11e8-bb8f-a6a2f7bca546?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

[6] https://www.ft.com/content/97105928-8db4-11e8-b639-7680cedcc421?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

[7] https://www.ft.com/content/7fe120f0-8d8e-11e8-b639-7680cedcc421?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

[8] https://www.politico.com/story/2018/07/22/trump-foreign-car-tariffs-juncker-735555

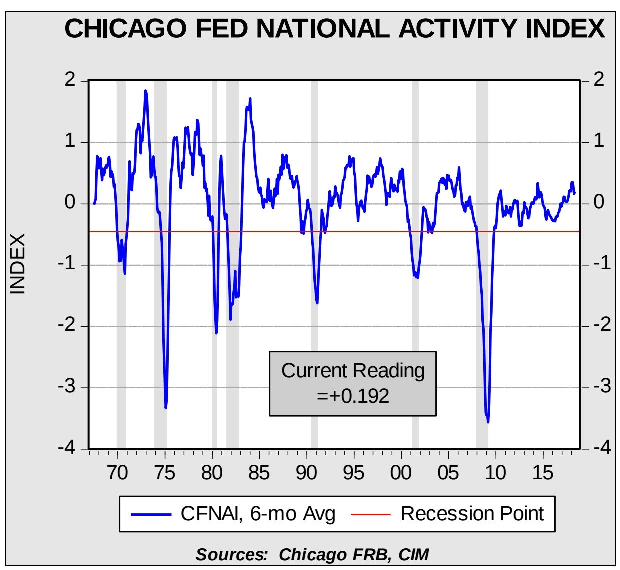
[9] https://en.wikipedia.org/wiki/Chicken_tax

AMLO—let's make a deal! The president-elect of Mexico penned a letter[10] to President Trump indicating he is ready to "start a new stage of U.S.-Mexico relations" and wants to conclude the renegotiation of NAFTA. Although there have been worries about deteriorating relations due to AMLO's nationalist stance, it does appear he is trying to work with the U.S. If the Trump administration responds positively, it could be supportive for Mexican financial markets.

Meat Mountain:[11] Although macroeconomic theory highlights the inflationary impact of trade impediments, the reality is somewhat more complicated. Yes, the combination of higher import prices and the loss of efficiencies that come from trade is inflationary. However, there is the short-run effect that exporters, whose markets become closed in retaliation, find themselves sitting on rising inventories. Eventually, these inventories are worked off and production is cut to adapt to lower demand. However, this can lead to "fire sale" prices during the adjustment process. It appears U.S. exports of meats are facing trade impediments and inventories are rising. This will eventually lead to lower meat prices in the U.S. (although this is dependent upon the competitive structure of the grocery and restaurant markets; some of this price decline could show up as better margins in those industries). Declining meat prices, while not as important to consumer confidence as energy, could be a popular event as we head into the mid-term elections.

U.S. Economic Releases

The Chicago Fed National Activity Index came in above expectations at +0.43 compared to the forecast of +0.25. The prior month's report was revised downward from -0.15 to -0.45.



The current smoothed reading is +0.192. The index is constructed to show trend growth at zero, thus a reading above zero shows above-trend growth. Casual observation would suggest this expansion has seen very modest growth, with much of the time spent below zero.

[10] https://www.wsj.com/articles/in-letter-to-trump-mexicos-president-elect-seeks-common-path-1532285296
[11] https://www.wsj.com/articles/meat-piles-up-as-production-grows-and-exports-slow-1532268000

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Existing Home Sales	m/m	jun	5.45 mn	5.43 mn	**
10:00	Existing Home Sales	m/m	jun	0.2%	-0.4%	**
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
EUROPE								
Switzerland	M3 Money stock	y/y	jun	2.4%	2.9%		*	Equity and bond neutral
	Total Sight Deposits	m/m	Jun	576.4 bn	576.1 bn		*	Equity and bond neutral
	Domestic Sight Deposits	m/m	Jun	474.2 bn	473.0 bn		*	Equity and bond neutral
AMERICAS								
Canada	Wholesale trade	m/m	may	1.2%	0.1%	0.7%	**	Equity bullish, bond bearish
Mexico	CPI	y/y	jun	2.5%	2.2%	2.3%	***	Equity bearish, bond bearish
	CPI Core	y/y	jun	1.9%	1.9%	1.9%	***	Equity and bond neutral
Brazil	Industrial confidence	m/m	jun	50.2	49.6		**	Equity bullish, bond bearish
	Bloomberg Nanos Confidence	m/m	jul	54.2	54.5		**	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)	234	235	-1	Up
3-mo T-bill yield (bps)	193	194	-1	Neutral
TED spread (bps)	41	41	0	Neutral
U.S. Libor/OIS spread (bps)	199	199	0	Up
10-yr T-note (%)	2.88	2.89	-0.01	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	4	2	2	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	down			Neutral
yen	up			Neutral
pound	up			Neutral
franc	up			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	$74.26	$73.07	1.63%	Rising tensions between US-Iran
WTI	$69.14	$68.26	1.29%	
Natural Gas	$2.73	$2.76	-0.94%	
Crack Spread	$18.56	$18.23	1.78%	
12-mo strip crack	$19.61	$19.27	1.74%	
Ethanol rack	$1.57	$1.57	0.13%	
Metals				
Gold	$1,224.51	$1,222.97	0.13%	
Silver	$15.35	$15.32	0.25%	
Copper contract	$272.65	$269.55	1.15%	
Grains				
Corn contract	$ 367.50	$ 365.00	0.68%	
Wheat contract	$ 508.50	$ 504.25	0.84%	
Soybeans contract	$ 867.25	$ 861.50	0.67%	
Shipping				
Baltic Dry Freight	1657	1688	-31	

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for the West Coast and Southwest, with the rest of the country getting a break from the summer heat. Precipitation is expected in the eastern and southern regions. There are no tropical disturbances expected over the next 48 hours.

Asset Allocation Weekly Comment

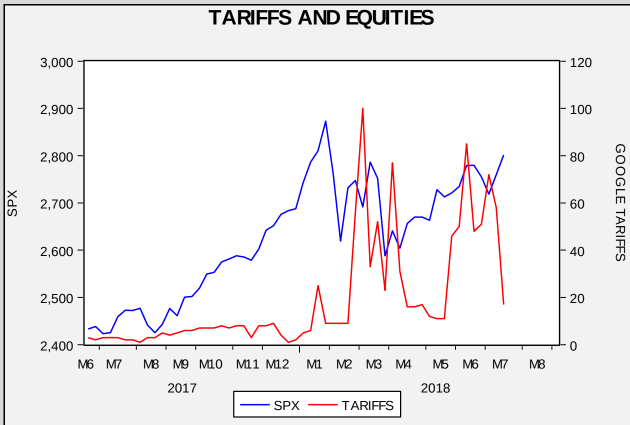
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

July 20, 2018

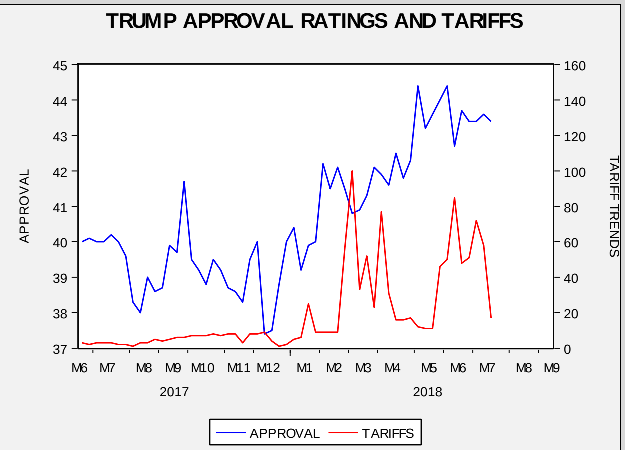
Although earnings are rising, equity markets have been range-bound since February.

(Source: Bloomberg)

This chart shows the S&P 500; after peaking around 2870, prices have been in a range roughly from 2600 to 2800. Although monetary policy tightening is partly to blame, the Fed was lifting rates during the period when the market was making new highs. Instead, it appears the market reversal was caused by the threat of trade impediments.



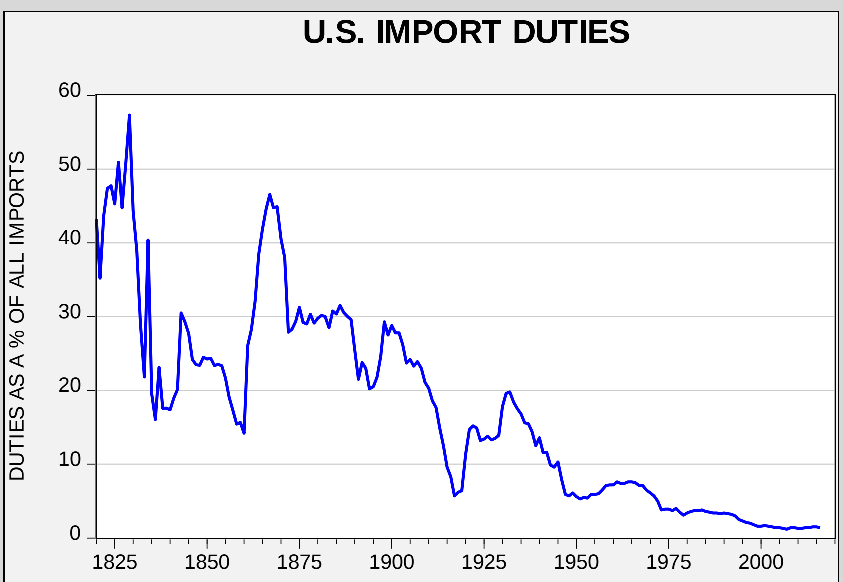
Sources: Bloomberg, Google, CIM



Sources: Real Clear Politics, Google, CIM

The chart on the left shows the S&P 500 and the number of times Google Trends reports the popularity of the word "tariff," with 100 being most popular and zero being no reports of the word getting used. Note that when tariff chatter started to rise, the uptrend in equities stalled. The chart on the right shows President Trump's approval ratings and the same Google Trends data. Approval ratings bottomed in December, about the time the tax bill passed. Approval ratings began to rise with the onset of tariff mentions. Note that as tariff mentions have declined recently the president's trend in approval ratings has stalled and equities (on the left chart) have started to rally. Although the correlations are not perfect, overall, when remarks about tariffs are elevated, equities decline and the president's approval ratings rise. Thus, it would make sense for the president to keep pushing on tariffs as it's improving his political situation.

A major issue with trade policy is how the market discounts a turn to protectionism. That is mostly because we haven't seen U.S. protectionism as official policy since the 1920s.



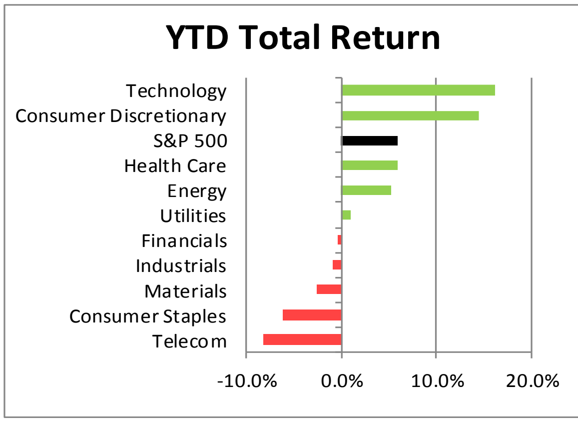
Sources: U.S.International Trade Commission, St. Louis FRB, FRASER database, CIM

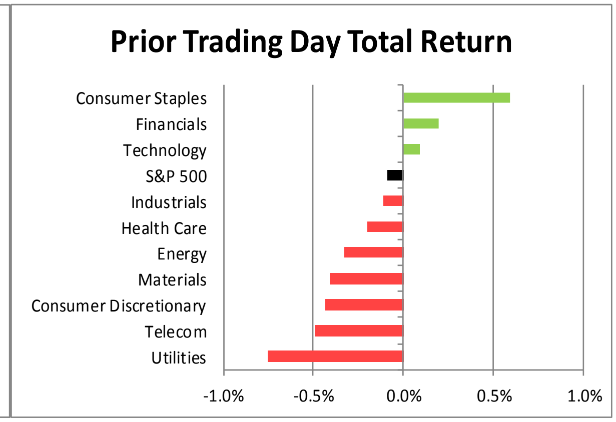
This chart shows the level of duties as a percentage of all imports. The U.S. was a high tariff nation, although tariffs did decline steadily until 1917. Tariff rates rose sharply after WWI into the early 1930s, culminating in the Smoot-Hawley Tariffs of 1930. Since then, tariff rates have steadily declined to the current low level of 1.4%. Simply put, there is no market analyst alive today who was an adult working in the markets the last time we had a major increase in tariff rates. And, if they were, it's important to remember that this was under the gold standard so no one really has any experience in how a trade conflict will affect the world economy and financial markets in a floating fiat currency environment. All we can rely on is theory.

Our expectation is that tariffs will act as a supply constraint on dollars, which would be expected to be dollar bullish. However, as noted above, there is no reasonable way to indicate how much the dollar would rise because there isn't a historical precedent to compare. So far, the financial markets appear to believe that the administration's tariff threats are designed to prompt negotiations for more favorable trade terms. Thus, the dollar's direction has been more a function of U.S. monetary policy—as the Fed continues to tighten the dollar has moved higher. However, if sentiment toward trade turns from mere posturing to deglobalization, the dollar could move significantly higher. A much stronger dollar would be very bearish for emerging markets and commodities and also a negative factor for developed markets as well. It would be bullish for Treasuries and small cap equities.

<u>Data Section</u>

U.S. Equity Markets – (as of 7/20/2018 close)

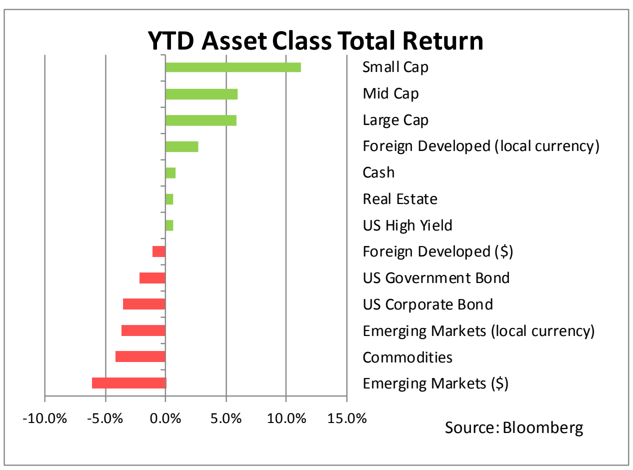




(Source: Bloomberg)

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 7/20/2018 close)

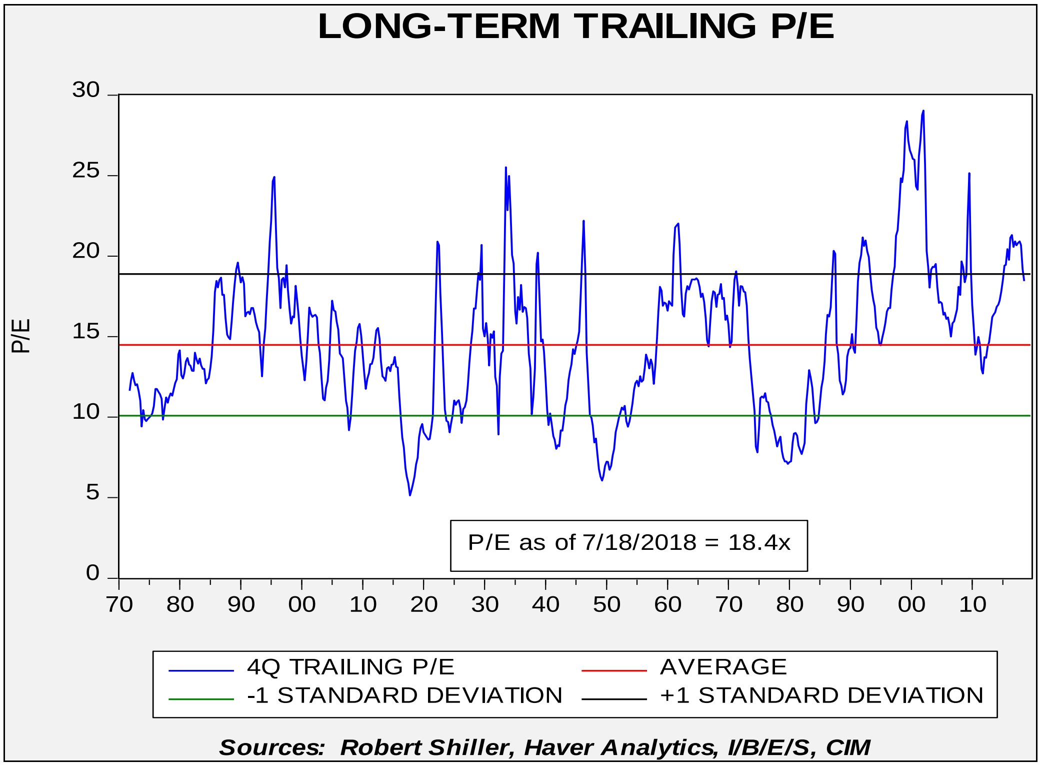


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 19, 2018



Based on our methodology,[12] the current P/E is 18.4, up 0.1x from last week. The rise in the S&P 500 outweighed the rise in earnings, which led to a higher P/E.

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[12] 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.