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 25, 2018—9:30 AM EDT] Global equity markets are generally mixed this morning. The EuroStoxx 50 is down 0.3% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.7% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.1% and the Shenzhen index down 0.1%. U.S. equity index futures are signaling a lower open. With 110 companies having reported, the S&P 500 Q2 earnings are above expectations at $39.76 compared to the $39.20 forecast for the quarter. The forecast reflects a 19.9% increase from Q2 2017 earnings. Thus far this quarter, 86.4% of the companies reported earnings above forecast, while 6.4% reported earnings below forecast.

Markets are quiet this morning, typical for mid-summer. Here is what we are watching:

Juncker to the White House: The president of the EU Commission, Jean-Claude Juncker, visits the White House today.[1] It is expected he will offer the U.S. some sort of narrow trade pact on industrial goods and autos. We suspect this meeting will probably end in failure; the auto trade is too important for Germany to give up much and it isn't obvious what would appease the president. Juncker has made it clear that the EU will retaliate if the U.S. implements tariffs, most likely against agriculture.

The crux of the trade issue: The biggest issue emerging from the trade issue is that the president's goal is unclear. He appears to view trade from a mercantilist perspective—surpluses are wins, deficits are losses. Although economic theory discredited this viewpoint about 250 years ago, it still remains a common belief among most people. So, how does a mercantilist win? The goal would seem to either be opening foreign markets to U.S. exports or restricting imports, or some combination of these policies. The president has concluded, it seems, that the only lever he really controls is import restrictions. If we are correct in this assessment, the tariff war will almost certainly escalate. The end result will be increased employment and higher inflation in the trade deficit nations, and lower employment and lower inflation in the trade surplus nations.

How this policy plays out politically is complicated. First, the microeconomic impact is quite difficult to parse. Some sectors of the economy are simultaneously benefiting and being harmed. They are facing less import competition for their finished goods, for example, but higher input costs. Over time, these price effects will lead to production adjustments but it could cause

[1] https://www.nytimes.com/2018/07/24/business/juncker-trump-trade-europe-autos.html?emc=edit_mbe_20180725&nl=morning-briefing-europe&nlid=567726720180725&te=1

political fallout as we head into mid-terms. Second, we are seeing the GOP establishment tentatively push back against Trump's trade policy[2]; as we noted in the last two WGRs,[3] the class interests of the establishment benefit from free trade so it isn't a huge surprise that the center-right is finding their voice against protectionism. Our read is that support for free trade has been waning for some time, although recent polls have shown increasing Democrat Party support for free trade. This change is consistent with the idea that the GOP is steadily taking on a constituency of nationalist, working-class voters while the Democrats are becoming the party of globalist elites.

Another problem starting to emerge from the trade tensions is that Chinese investors are apparently liquidating commercial real estate holdings in the U.S.[4] Some of these sales appear to be tied to pressure from the Xi government to curtail potential capital flight. The loss of Chinese investment could be a negative factor for real estate, especially in the coastal regions.

May takes control of Brexit: PM May has taken direct control of the Brexit negotiating team,[5] transferring about 50 staff members from the Department for Exiting the EU. That department's role will be downgraded to focusing on preparing the domestic U.K. for Brexit. May has been forced to deal with high levels of dissent within her government on this issue and has apparently concluded that she is better off streamlining the process. Most likely, those "hard" Brexit supporters will see this as an attempt to silence their dissent.[6] We suspect this is the case. However, if May can pull this off, the odds of a "soft" Brexit will increase.

Cyberwar worries: The Department of Homeland Security warns that Russian hackers[7] have penetrated the control rooms of U.S. utilities. Although the utilities were thought to be safe because they were "air gapped" from the internet, the hackers used portals created by trusted vendors and used those vulnerabilities to access the control rooms. This development is a major threat because it could cause extended blackouts which would seriously undermine domestic security.

Israel downs jets: The Israel Defense Force has indicated it shot down a Syrian military jet that entered the airspace over the Golan Heights. Israel and Russia are in negotiations to secure Israel's borders; Israel wants the Russians to create a large buffer zone that will keep Hezbollah and Iran from being able to attack Israel with missiles. Russia has, so far, been unable to create a plan that Israel accepts. The Syrian incursion could be a signal that Israel is taking a hardline stance on its border. Although we don't expect a flare-up, this could be a new conflict zone if Russia is unable to stabilize the region.

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[2] https://www.politico.com/story/2018/07/24/trump-farmers-bailout-reaction-republicans-congress-737517

[3] See WGRs, Reflections on Politics and Populism: Part I (7/16/18), and Part II (7/23/18)

[4] https://www.wsj.com/articles/chinese-real-estate-investors-retreat-from-u-s-as-political-pressure-mounts-1532437934

[5] https://www.ft.com/content/2bf327ec-8f44-11e8-bb8f-a6a2f7bca546?emailId=5b58005a4f1aa40004f6ef35&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

[6] https://www.ft.com/content/d523ad9a-8f63-11e8-bb8f-a6a2f7bca546?emailId=5b58005a4f1aa40004f6ef35&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

[7] https://www.wsj.com/articles/russian-hackers-reach-u-s-utility-control-rooms-homeland-security-officials-say-1532388110

North Korea: Although North Korea has been accused of not taking steps to denuclearize, we are starting to see some movement on the promised dismantling of a missile launch facility. The group 38 North reports there is evidence that Pyongyang is taking concrete steps to decommission the facility.[8] It is always difficult to determine what exactly is happening in North Korea, but the evidence supports that the regime is making an effort, at least at this facility, to move toward some sort of agreement.[9]

It's bad in Venezuela: How bad is it? It's so bad that the IMF is projecting inflation could reach 1,000,000% this year.[10] It's so bad that the government can't afford to print banknotes of sufficient denomination and is just putting "money" electronically into bank accounts. Interestingly enough, this hyperinflation event is only the 23rd worst in modern history. The worst case was Hungary post-WWII, which saw prices double every 15 hours. Still, some of the anecdotal reports are stunning; a kilogram of chicken (2.2 lbs) costs 3.3 mm bolivars last week, a bargain compared to the current price of 4.2 mm bolivars. The collapse of the economy is leading to a significant brain drain.[11] Those with skills are leaving the country for better opportunities elsewhere. Oil production fell below 2.0 mbpd last year; in the late 1990s, the country produced about 3.3 mbpd. To a great extent, recent increases in output by the OPEC cartel are designed to offset the production declines by Venezuela.

NAFTA: Earlier this week, we reported that AMLO, the president-elect of Mexico, wrote a letter to President Trump calling for good relations between the two nations and offering to complete a renegotiation of NAFTA. President Trump has responded in a similar fashion, which may improve the chances of an agreement.[12]

Taiwan: China has been pressing U.S. airlines to stop calling Taiwan "Taiwan" as Beijing sees the island as a breakaway province that will eventually "return to the fold." The agreement about "one China" that Nixon and Carter approved was really a bit of strategic ambiguity; both China and the U.S. said there was "one China" but the U.S. held that Taiwan could remain independent indefinitely. The Obama administration shied away from selling Taiwan large military systems because it felt such sales only angered China. Instead, the doctrine was that Taiwan should make a defense of the island that would increase the costs of invasion to the point where China would simply not want to bear the cost.[13] However, as relations between the Trump

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[8] https://www.38north.org/2018/07/sohae072318/

[9] https://www.ft.com/content/881897c0-8eed-11e8-b639-7680cedcc421?emailId=5b56a5635931240004dafefd&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

[10] https://www.washingtonpost.com/world/venezuelas-inflation-rate-may-hit-1000000-percent-yes-1-million/2018/07/24/90d59086-8f4a-11e8-ae59-01880eac5f1d_story.html?utm_term=.c3e1ad920fb2&wpisrc=nl_todayworld&wpmm=1

[11] https://www.washingtonpost.com/world/the_americas/a-historic-exodus-is-leaving-venezuela-without-teachers-doctors-and-electricians/2018/06/03/8c6587a8-62d7-11e8-81ca-bb14593acaa6_story.html?utm_term=.b2678473638c&wpisrc=nl_todayworld&wpmm=1

[12] https://www.reuters.com/article/us-pacific-alliance-mexico/trump-mexico-expect-progress-in-stalled-nafta-talks-idUSKBN1KD25Y

[13] https://www.washingtonpost.com/news/global-opinions/wp/2018/07/23/the-u-s-makes-a-new-push-to-bolster-taiwans-military-defenses-china-wont-like-it/?utm_term=.d34d715ca1b3&wpisrc=nl_todayworld&wpmm=1

administration and China have deteriorated, the U.S. is now considering arms sales of greater capabilities. This action will obviously anger the Chinese but it is an area where the U.S. does have some leverage.

U.S. Economic Releases

MBA mortgage applications fell 0.2% from the prior week. Purchases fell 1.0% from prior week, while refinancing rose 0.9%. The average 30-year fixed rate remains unchanged from the prior week at 4.77%.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	New Home Sales	m/m	jun	668k	689k	**
10:00	New Home Sales	m/m	jun	-3.1%	6.7%	**
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								
Australia	Skilled Vacancies	m/m	jun	-1.0%	-0.9%		**	Equity and bond neutral
	CPI	m/m	2q	0.4%	0.4%	0.5%	***	Equity and bond neutral
New Zealand	Trade Balance	m/m	jun	-0.113 bn	0.294 bn	0.200 bn	**	Equity bearish, bond bullish
	Exports	m/m	jun	4.91 bn	5.42 bn	5.06 bn	**	Equity and bond neutral
	Imports	y/y	jun	5.02 bn	5.12 bn	4.92 bn	**	Equity and bond neutral
EUROPE								
Eurozone	M3 Money Supply	m/m	jun	4.4%	4.0%	4.0%	**	Equity and bond neutral
France	PPI	m/m	jul	0.1%	0.6%		**	Equity and bond neutral
	Total Jobseekers	m/m	jul	3440.5k	3435.9 k		**	Equity and bond neutral
Germany	IFO Business Climate	m/m	jul	101.7	101.8	101.5	**	Equity and bond neutral
	IFO Expectations	m/m	jul	98.2	98.6	98.3	**	Equity and bond neutral
	IFO Current Assessment	m/m	jul	105.3	105.1	104.9	**	Equity bullish, bond bearish
U.K.	UK Financing Loans for Housing	m/m	jun	40541	39244	39000	**	Equity and bond neutral
	CBI Retailing Reported Sales	m/m	jul	20	32	15	**	Equity and bond neutral
	CBI Total Dist. Reported Sales	m/m	jul	25	18		**	Equity and bond neutral
Switzerland	Credit Suisse Survey Expectations	m/m	jul	-4.0	8.0		**	Equity bearish, bond bullish
AMERICAS								
Mexico	Bi-Weekly Core CPI	m/m	jul	0.2%	0.1%	0.2%	***	Equity and bond neutral
Brazil	FGV Consumer Confidence	y/y	jul	84.2	82.1		***	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	234	0	Up
3-mo T-bill yield (bps)	196	195	1	Neutral
TED spread (bps)	38	39	-1	Neutral
U.S. Libor/OIS spread (bps)	200	200	0	Up
10-yr T-note (%)	2.94	2.95	-0.01	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	4	4	0	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	up			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	$73.75	$73.44	0.42%	
WTI	$68.42	$68.52	-0.15%	
Natural Gas	$2.75	$2.73	0.48%	
Crack Spread	$19.73	$19.05	3.56%	
12-mo strip crack	$20.13	$19.74	1.98%	
Ethanol rack	$1.57	$1.57	-0.20%	
Metals				
Gold	$1,231.15	$1,224.52	0.54%	
Silver	$15.57	$15.47	0.70%	
Copper contract	$280.30	$281.05	-0.27%	
Grains				
Corn contract	$ 369.50	$ 366.00	0.96%	
Wheat contract	$ 522.00	$ 510.25	2.30%	
Soybeans contract	$ 870.25	$ 873.25	-0.34%	
Shipping				
Baltic Dry Freight	1774	1718	56	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.1		
Gasoline (mb)		-1.2		
Distillates (mb)		0.6		
Refinery run rates (%)		1.00%		
Natural gas (bcf)		46.0		

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 for the eastern half of the country. There are no tropical disturbances expected over the next 48 hours.

Asset Allocation Weekly Comment

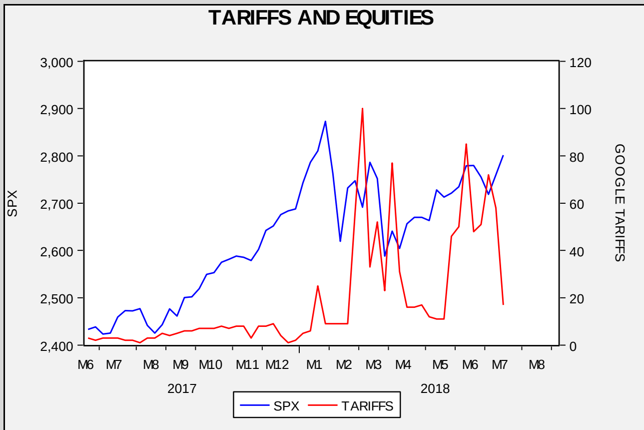
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

July 20, 2018

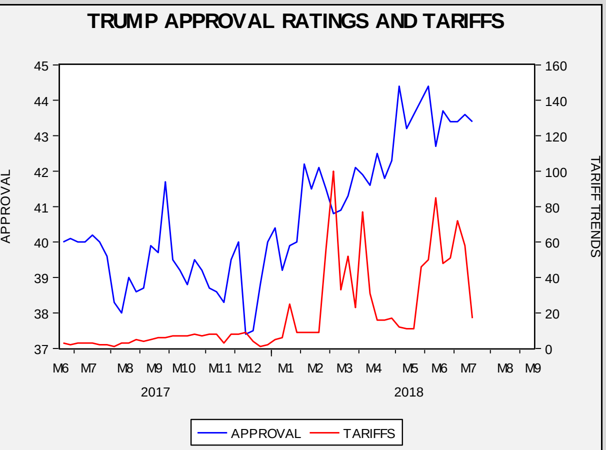
Although earnings are rising, equity markets have been range-bound since February.

(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.



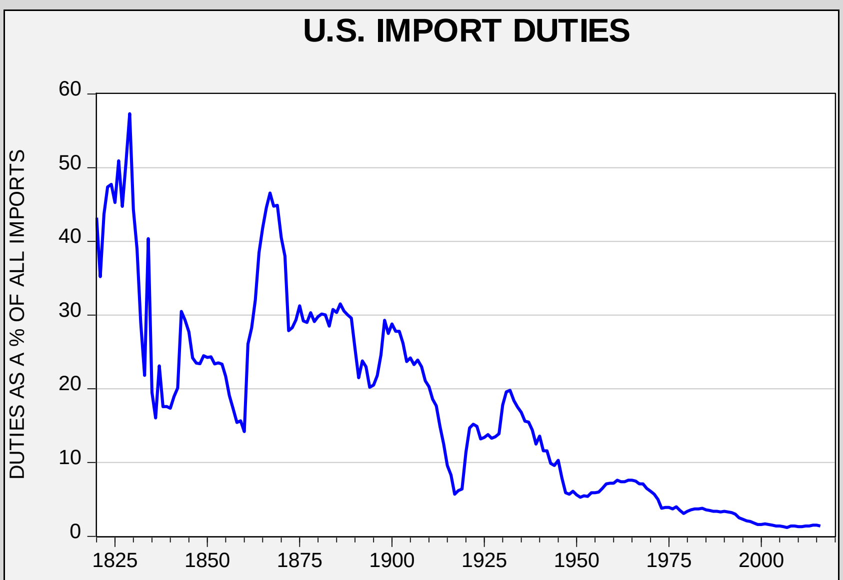
Sources: Bloomberg, Google, CIM



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.



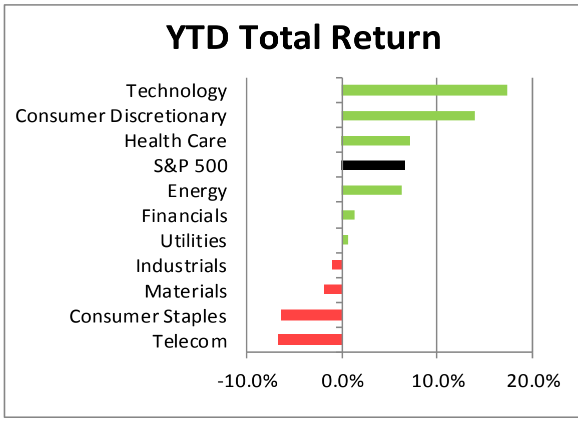
Sources: U.S.International Trade Commission, St. Louis FRB, FRASER database, CIM

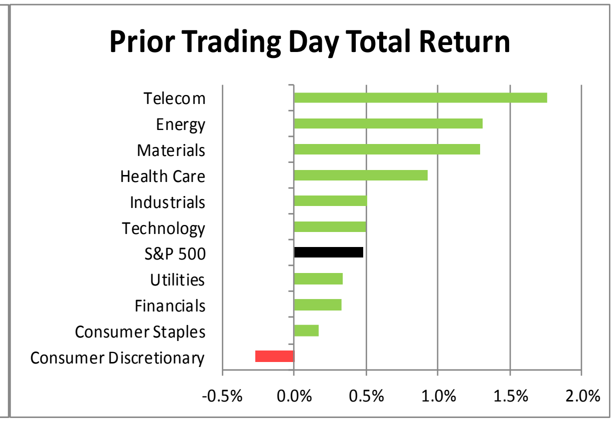
This chart shows the level of duties as a percentage of all imports. The U.S. was a high tariff nation, although tariffs did decline steadily until 1917. Tariff rates rose sharply after WWI into the early 1930s, culminating in the Smoot-Hawley Tariffs of 1930. Since then, tariff rates have steadily declined 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.

Data Section

U.S. Equity Markets – (as of 7/24/2018 close)

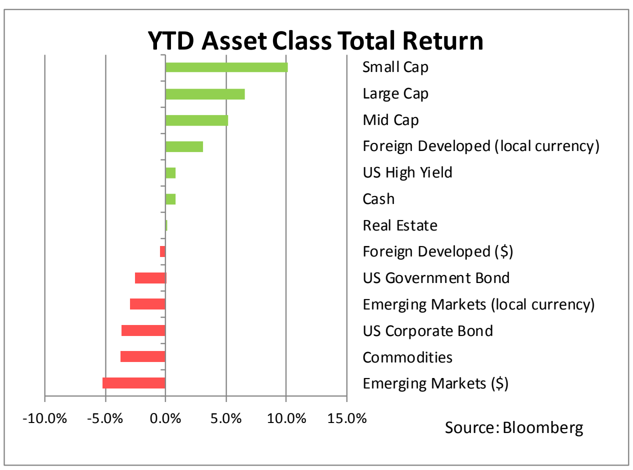




(Source: Bloomberg)

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 7/24/2018 close)

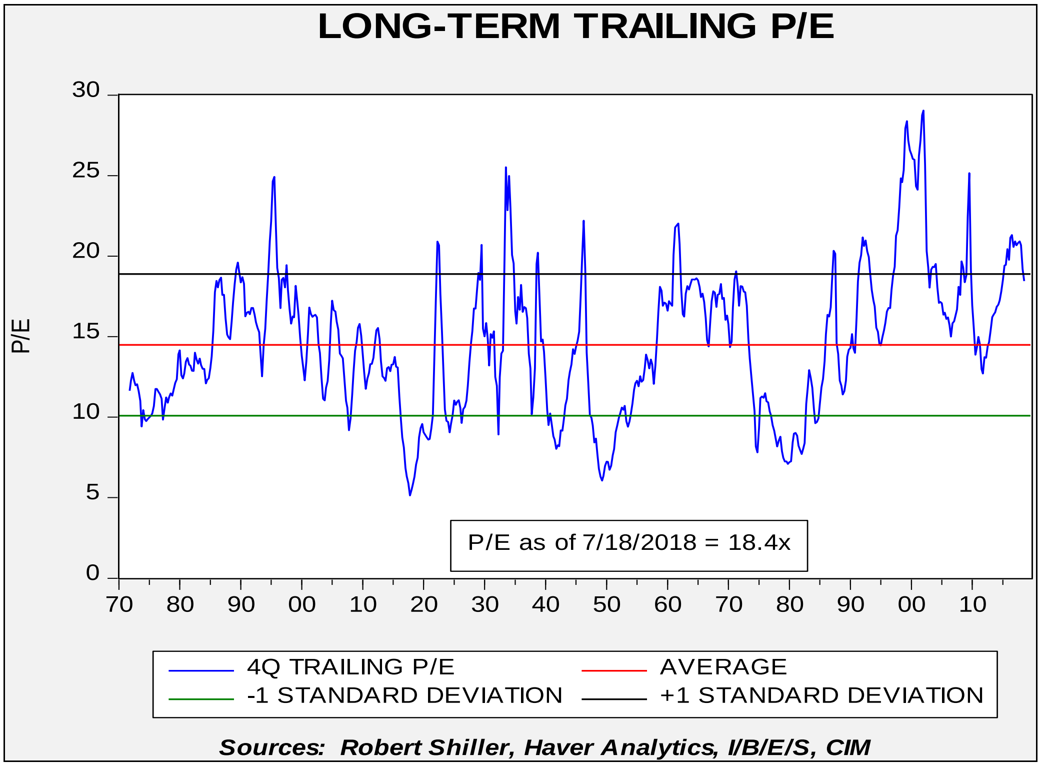


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

July 19, 2018



Based on our methodology,[14] 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.

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.

[14] 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.