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 9, 2018—9:30 AM EDT] Global equity markets are 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 2.5% and the Shenzhen index also up 2.5%. U.S. equity index futures are signaling a higher open.

Happy Monday! It looks like a risk-on day so far, with Treasury prices lower and equities higher. The dollar is a bit soft which has lifted metals prices. The lack of comment from the White House about trade appears to be helping equity markets. Here is what we are watching:

BREAKING NEWS: Boris Johnson, the U.K. foreign minister, has resigned. Below we discuss the earlier resignation of David Davis. Johnson's resignation is far more serious as he could mount a leadership challenge to PM May. The GBP is falling on the news.

North Korea disappointment: SoS Pompeo was in North Korea over the weekend and his visit didn't go very well.[1] The U.S. wanted to begin talks on North Korea dismantling its nuclear program, but North Korea wanted "goodies" before even beginning to talk about denuclearization. North Korea called the U.S. "gangsters," criticizing U.S. negotiating tactics.[2] For anyone who has watched North Korea since the fall of the Soviet Union, this behavior isn't a surprise. North Korea's negotiating stance has been mostly "Lucy with the football."[3] The West thinks it has a promise from Pyongyang but finds out that either the promise was broken or that the North Koreans never intended to take such actions and the West's disappointment is merely a misunderstanding.

North Korea isn't going to give up its nukes. It may be willing to have the IAEA count some of them and it may be willing to split the U.S. alliance in the Far East by restricting its missiles to ones that cannot reach the U.S. But, complete denuclearization is a demand that is unlikely to be

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[1] https://www.ft.com/content/721ba908-8286-11e8-96dd-fa565ec55929?emailId=5b42e658f885cc00043968c4&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

[2] https://www.washingtonpost.com/world/pompeo-pushes-back-against-north-koreas-gangster-like-criticism/2018/07/08/a6261b3e-825e-11e8-9200-b4dee4fb4e28_story.html?utm_term=.db990966f032&wpisrc=nl_todayworld&wpmm=1 and https://www.theatlantic.com/international/archive/2018/07/america-north-korea-nuclear/564620/?wpmm=1&wpisrc=nl_todayworld and https://www.nytimes.com/2018/07/07/world/asia/mike-pompeo-north-korea-pyongyang.html?hp&action=click&pgtype=Homepage&clickSource=story-heading&module=first-column-region&region=top-news&WT.nav=top-news

[3] https://www.youtube.com/watch?v=055wFyO6gag

met. The real question is the reaction from the White House. If President Trump concludes he's been "played" then we could move quickly from summits and handshakes to war. Although we haven't seen any movement yet, we would not be shocked to see a rapid escalation in tensions. On the other hand, the White House will tend to react based on commentary from the right-leaning media. The fact that John Bolton is inside the government removes a prominent pundit voice that would have been harshly critical of the summit and would have likely pushed for a hard line after the Pompeo visit.[4] In addition, the potential negative impact of this news is lessened due to the expected announcement of the president's selection for the Supreme Court, which will occur later tonight.

May moves to soft Brexit: PM May took her cabinet out to her summer place in Chequers last Friday and appeared to move her advisors to her vision of Brexit,[5] which is mostly a series of measures designed to limit the impact of leaving the EU on the U.K. economy. Initially, it appeared May had earned unanimous approval, winning over the hard Brexit members of her cabinet. However, last night David Davis,[6] the minister in charge of the EU exit, resigned. Dominic Raab has taken Davis's ministry. Davis is hoping his sacrifice will prevent any further concessions to the EU, while May is hoping his departure from the cabinet will give her more freedom to act. We expect Davis to agitate for a hard Brexit now that he is out of the cabinet; our read is that support for Brexit has waned a bit and Davis may not have all that much sway. The GBP took the resignation well, suggesting the markets believe May will not only survive but negotiate a soft Brexit, which would be favorable for the pound.

Japan returning to nuclear power? After the Fukushima disaster, Japan pulled back from nuclear electric power. Public sentiment turned sharply against it. However, Japan faces another policy goal, energy security.[7] The Trump administration's actions against Iran[8] have made it clear that the island nation is vulnerable to energy flow disruptions. If Japan returns to nuclear power, it could give a boost to a moribund uranium industry.

President Trump to Europe: As we noted last week, the president is traveling to the U.K., attending the NATO summit and visiting with Russian President Putin. We have been discussing this upcoming meeting for the past few reports. Fears among Europeans are elevated; President Trump has been critical of the alliance and has been pressing the EU to boost defense spending. We will be watching to see how the president deals with our EU allies this week.

Energy recap: As we noted last week, the DOE weekly energy data was delayed. As promised, we are publishing our recap in today's comment due to the delay.

U.S. crude oil inventories rose 1.2 mb compared to market expectations of a 5.0 mb draw.

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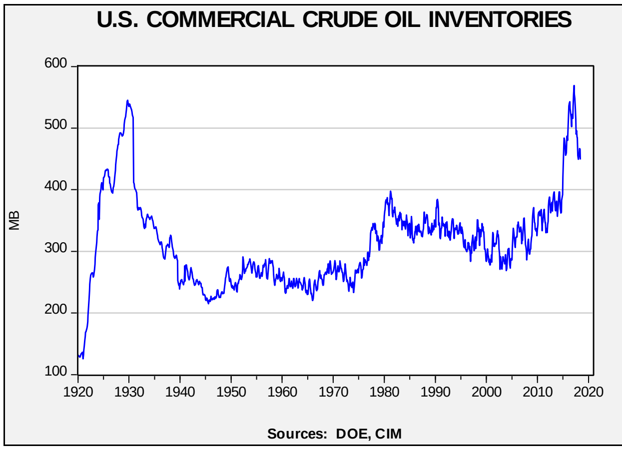
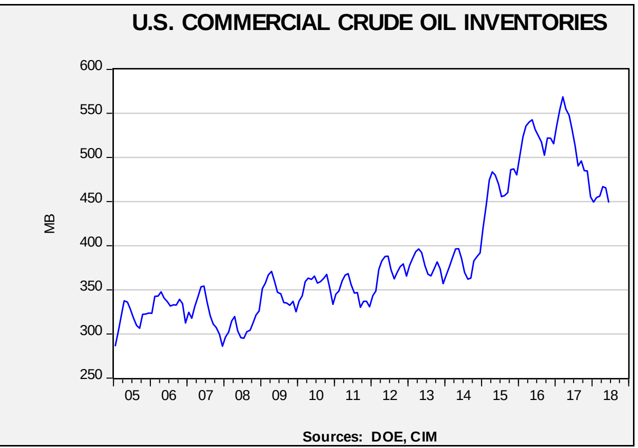
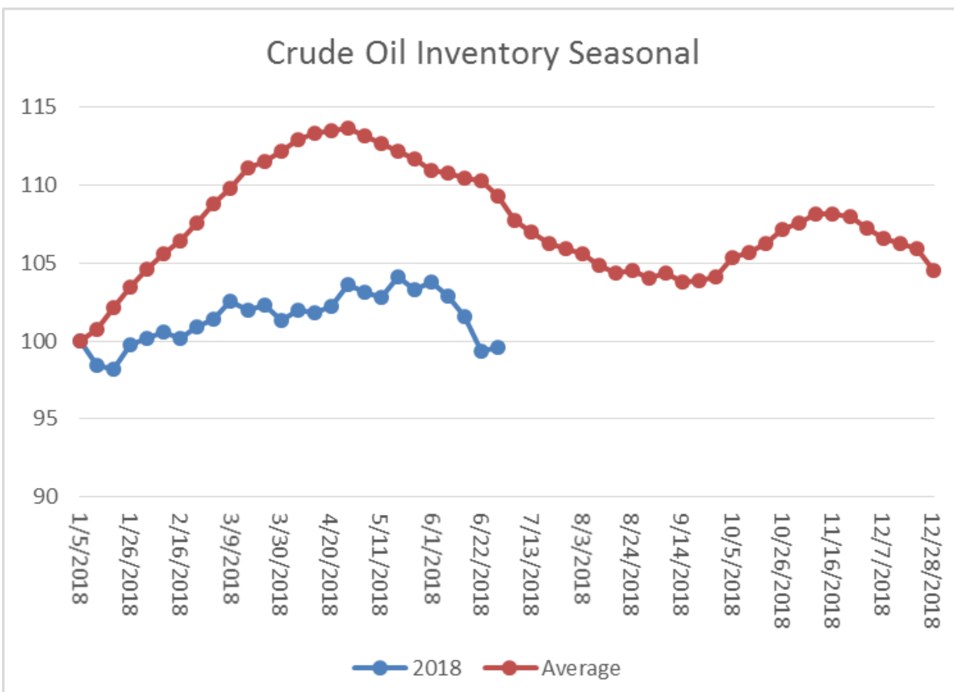
[4] http://quotes.yourdictionary.com/author/quote/570850
[5] https://www.ft.com/content/aeb53c82-82ac-11e8-96dd-fa565ec55929
[6] https://www.ft.com/content/fef0e51c-8300-11e8-96dd-fa565ec55929
[7] https://www.ft.com/content/66c37158-801a-11e8-bc55-50daf11b720d?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56
[8] https://www.reuters.com/article/us-iran-nuclear/iran-calls-for-eu-help-as-shipping-giant-pulls-out-for-fear-of-u-s-sanctions-idUSKBN1JX0NQ?feedType=RSS&feedName=worldNews



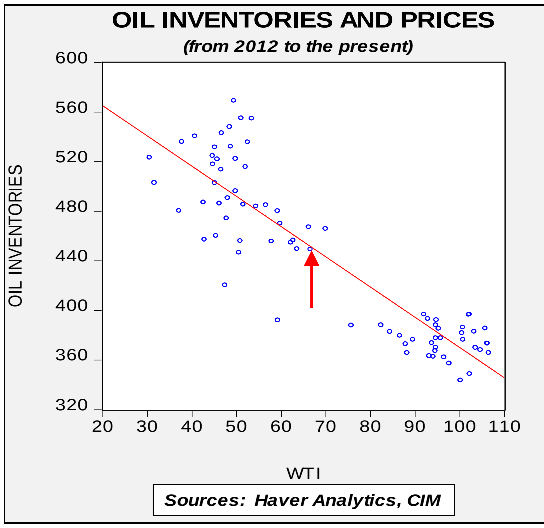


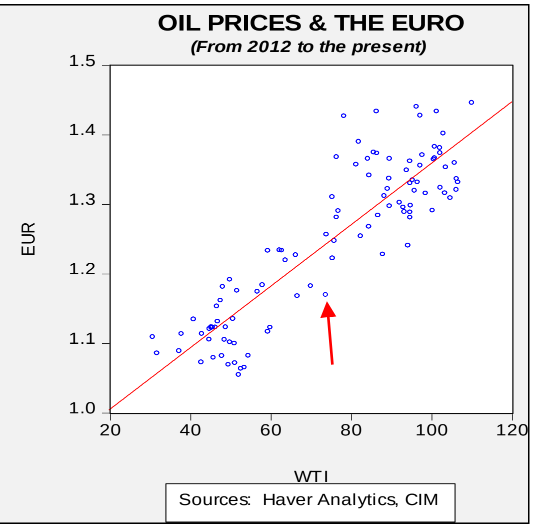
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but have declined significantly since March 2017. We would consider the overhang closed if stocks fall under 400 mb.

As the seasonal chart below shows, inventories are well into the seasonal withdrawal period. This week's increase in stocks was unusual, but some adjustment was not a huge shock given last week's rather large decline. If the usual seasonal pattern plays out, mid-September inventories will be 411 mb.



(Source: DOE, CIM)





Based on inventories alone, oil prices are near the fair value price of $68.31. Meanwhile, the EUR/WTI model generates a fair value of $61.24. Together (which is a more sound methodology), fair value is $62.80, meaning that current prices are above fair value. Currently, the oil market is dealing with divergent fundamental factors. Falling oil inventories are fundamentally bullish but the stronger dollar is a bearish factor. The action to suppress Iranian oil exports has boosted oil prices, but the rapid decline in oil inventories over the past week is very supportive for prices. It should be noted that a 410 mb number by September would put the oil inventory/WTI model in the high $70s per barrel. Although dollar strength could dampen that price action, oil prices should remain elevated. At the same time, refinery utilization remains above 97.0%. We will be reaching a point in the near future where domestic oil consumption growth will peak for the summer season, although we expect the level to remain elevated.

U.S. Economic Releases

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
15:00	Consumer Credit	m/m	jun	$12.000 bn	$9.262 bn	**
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	BoP Current Account Balance	m/m	may	¥1.938 tn	¥1.845 tn	¥1.266 tn	**	Equity bullish, bond bearish
	Trade Balance BoP Basis	m/m	may	-¥0.304 tn	¥0.573 tn	-¥483.1 bn	**	Equity bullish, bond bearish
	Bankruptcies	m/m	jun	-2.3%	-4.4%		**	Equity and bond neutral
	Eco Watchers Survey Current Situation	m/m	may	48.1	47.1	48.1	**	Equity and bond neutral
	Eco Watchers Survey Outlook	m/m	may	50.0	49.2	50.1	**	Equity and bond neutral
EUROPE								
Germany	Trade Balance	m/m	may	19.7 bn	20.4 bn	20.2 bn	**	Equity and bond neutral
	Current Account Balance	m/m	may	12.6 bn	22.7 bn	19.8 bn	**	Equity and bond neutral
France	Bank of France Industry Sentiment	m/m	may	101	100	100	**	Equity and bond neutral
Eurozone	Sentix Investor Confidence	m/m	jul	12.1	9.3	9.0	**	Equity bullish, bond bearish
Switzerland	Unemployment Rate	y/y	jun	2.4%	2.4%	2.3%	***	Equity and bond neutral
Russia	CPI	y/y	jun	2.3%	2.4%	2.2%	***	Equity and bond neutral
AMERICAS								
Brazil	IBGE Inflation IPCA	y/y	jun	4.4%	2.9%	4.4%	***	Equity and bond neutral
Canada	Unemployment Rate	m/m	jun	6.0%	5.8%	5.8%	***	Equity bullish, bond bearish
	Net Change in Employment	m/m	jun	31.8k	-7.5k	20.0k	**	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	234	-1	Up
3-mo T-bill yield (bps)	191	191	0	Neutral
TED spread (bps)	43	43	0	Neutral
U.S. Libor/OIS spread (bps)	195	195	0	Up
10-yr T-note (%)	2.85	2.82	0.03	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	6	6	0	Down
Currencies	**Direction**			
dollar	down			Down
euro	up			Up
yen	up			Up
pound	up			Up
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	$77.78	$77.11	0.87%	
WTI	$73.79	$73.80	-0.01%	
Natural Gas	$2.84	$2.86	-0.59%	
Crack Spread	$16.60	$15.59	6.46%	
12-mo strip crack	$19.70	$19.18	2.72%	
Ethanol rack	$1.59	$1.58	0.15%	
Metals				
Gold	$1,265.79	$1,255.48	0.82%	
Silver	$16.21	$16.05	0.99%	
Copper contract	$285.25	$282.40	1.01%	
Grains				
Corn contract	$ 369.00	$ 373.00	-1.07%	
Wheat contract	$ 509.25	$ 515.25	-1.16%	
Soybeans contract	$ 884.25	$ 894.50	-1.15%	
Shipping				
Baltic Dry Freight	1622	1612	10	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	1.2	-5.0	6.2	
Gasoline (mb)	-1.5	-0.5	-1.0	
Distillates (mb)	0.1	-0.5	0.6	
Refinery run rates (%)	-0.40%	0.05%	-0.5%	
Natural gas (bcf)	78.0	77.0	1.0	

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. Tropical Storm Chris has developed in the Atlantic along the eastern coast near the Carolinas. It is expected to move northward and away from the coast.

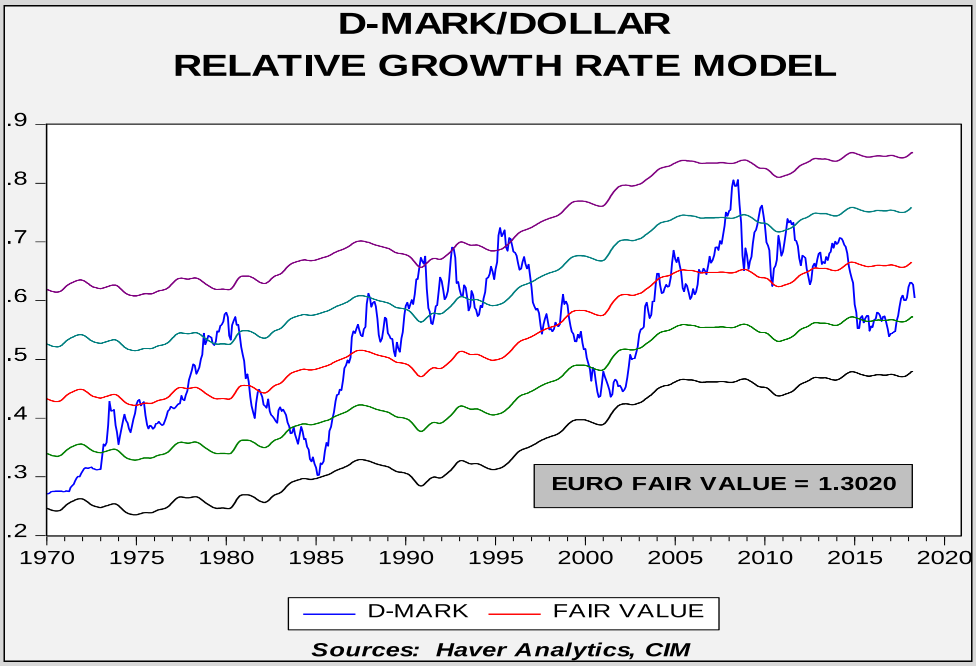
Asset Allocation Weekly Comment

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.

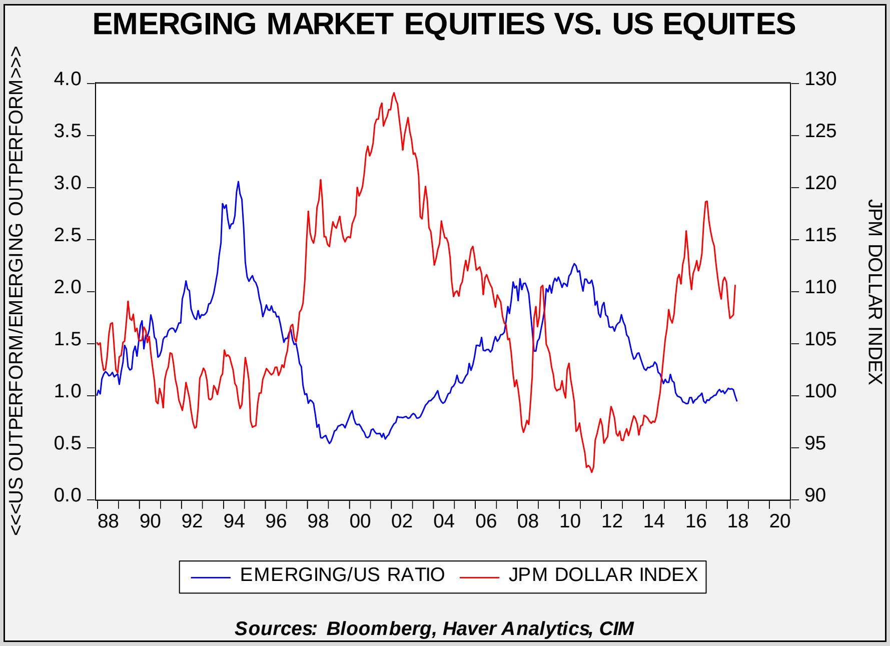
The problem is that relative growth rates suggest the dollar is still somewhat overvalued.



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.

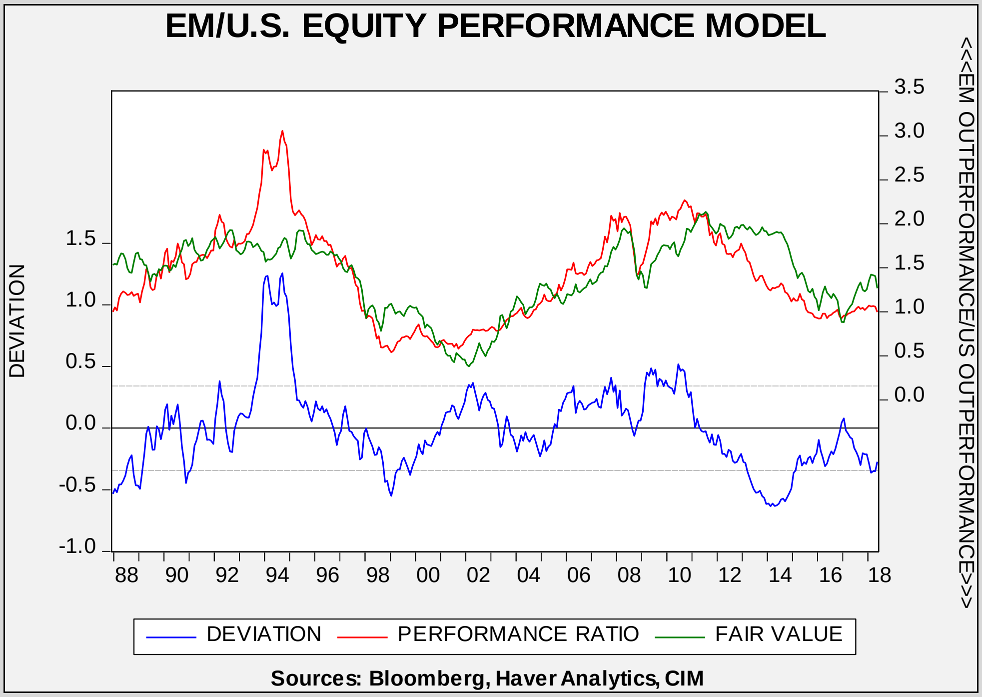
On the other hand, the impact of trade restrictions is different. The U.S. has built a global trading system that was designed for steady declines in trade impediments. From GATT to the WTO, the U.S. has fostered this system by consistently lowering tariffs and allowing nations to run trade surpluses 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.

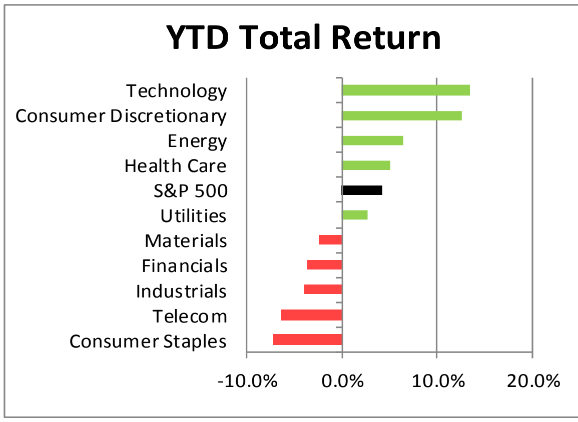


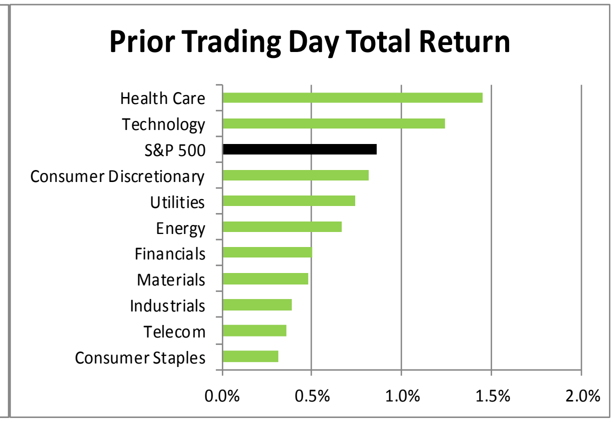
This analysis suggests that emerging markets are undervalued even in the face of recent dollar strength. If the dollar pulls back, either because the Trump trade policy is posturing or the FOMC signals some moderation in its tightening path, emerging markets could recover. In any case, they are attractive 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 7/6/2018 close)

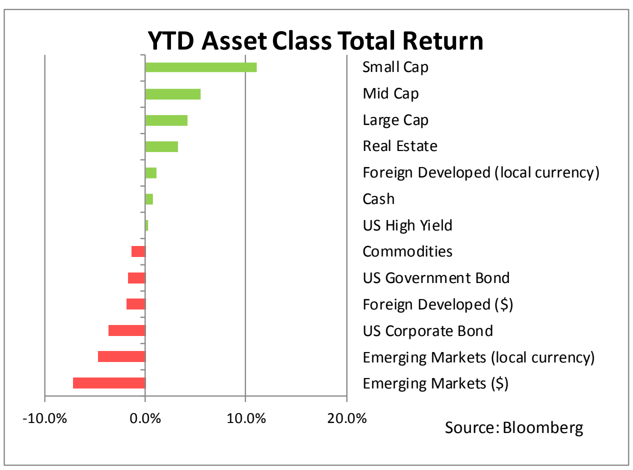




(Source: Bloomberg)

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 7/6/2018 close)

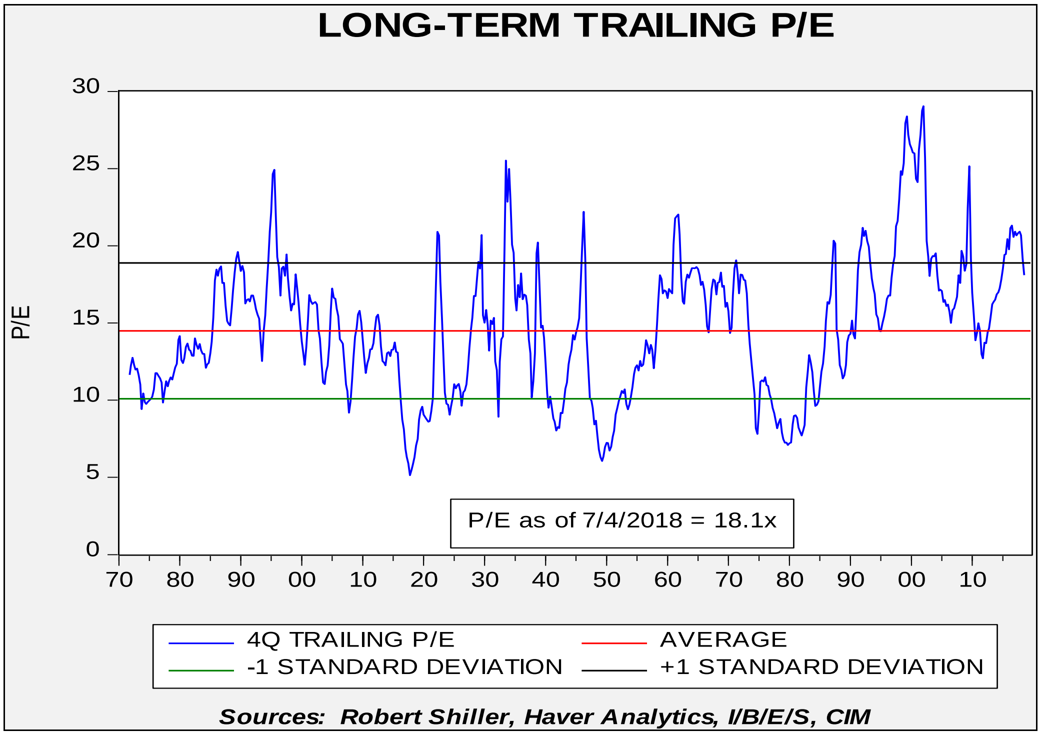


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[9] 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.

[9] 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.