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: June 19, 2018—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 1.2% from the last close. In Asia, the MSCI Asia Apex 50 closed down 2.1% from the prior close. Chinese markets were down, with the Shanghai composite down 3.8% and the Shenzhen index down 5.8%. U.S. equity index futures are signaling a lower open.

It's looking like a "tough Tuesday." Risk-off is clearly evident—Treasuries, the yen and the dollar are higher, while gold is flat and equities, especially emerging markets, are under pressure. Oil and commodities are lower as well. Here's the story:

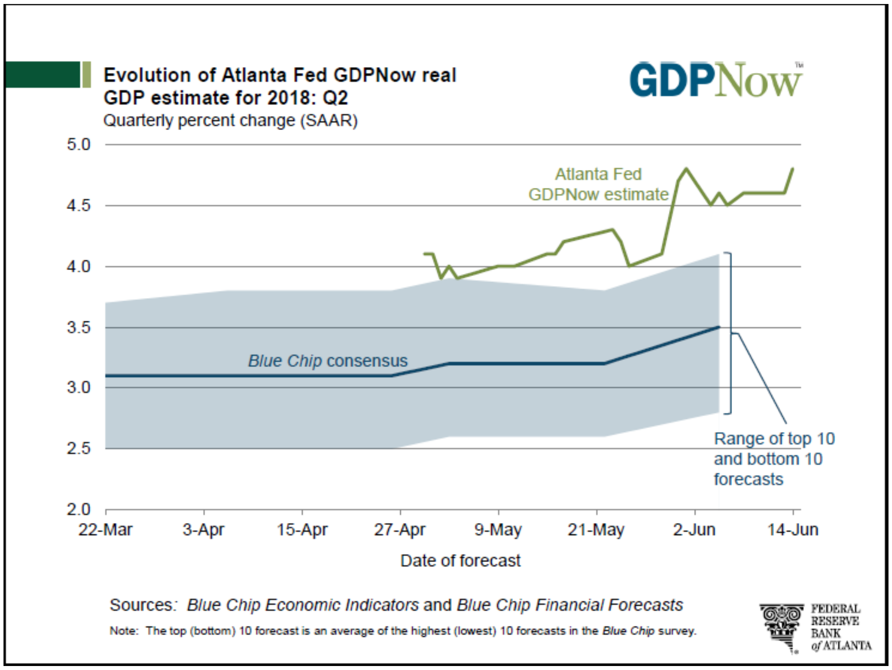
Trade: President Trump has threatened[1] an additional $200 bn in tariffs on Chinese imports; China has vowed to retaliate in kind. At the same time, the Senate voted overwhelmingly to reinstate the penalties on the Chinese tech company ZTE (SHE: 000063, CNY 20.54).

What makes analyzing this brewing trade war so difficult is that we really haven't had anything like this since the 1930s. Under U.S. leadership, tariffs have been steadily declining since the end of WWII. Even though there has been the occasional trade spat, such as the "voluntary" auto export restrictions in the late 1980s, a broad-based trade war is something that probably no living analysts remember. The Smoot-Hawley Tariffs were passed in 1930. A 30-year-old analyst at that time would be about 118 years old. Accordingly, there probably isn't anyone out there with actual adult experience of rapidly rising tariffs.

So, if this continues to escalate, what happens? In our opinion, the most likely development is higher inflation. The steady decline in inflation that began in the early 1980s was mostly due to supply-side reforms. Globalization and deregulation led the way to improving efficiencies and reducing labor costs. Although the latter remains in place, a trade war will obviously undermine globalization. That development would lead to less efficiency and higher prices. However, other than the trend, significant uncertainties still remain. First, if markets remain deregulated, meaning the new introduction of technology will continue unabated, then rising labor costs will be partially blunted by increasing automation. Second, the Federal Reserve can keep inflation expectations anchored by proving its independence and raising rates high enough to maintain low inflation expectations, even at the risk of recession. If these two factors remain in place, inflation probably remains relatively tame.

[1] https://www.ft.com/content/acd48414-7360-11e8-aa31-31da4279a601?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

Market behavior suggests investors believe these two factors will remain in place. If investors believed otherwise, we would be seeing a rise in long-duration yields. In fact, the opposite is occurring; bond yields are falling, suggesting the financial markets believe the risk of recession is higher than the risk of reflation. Interestingly enough, there is nothing in the data to suggest a recession is on the horizon. For example, the Atlanta FRB's running estimate of Q2 GDP is now +4.8%.



Here is the evolution of the data by estimated contribution to growth.

Atlanta Fed GDPNow estimates for 2018: Q2, contributions to growth

Date	Major Releases	GDP	PCE	Equip-ment	Intell. prop. prod.	Nonres. struct.	Resid. inves.	Govt.	Net exports	CIPI
30-Apr	Initial nowcast	4.1	2.26	0.52	0.18	0.09	0.14	0.09	0.18	0.62
16-May	Housing starts, Industrial production	4.1	2.16	0.51	0.19	0.16	0.13	0.10	0.17	0.72
17-May	M3 Manufacturing (revision)	4.2	2.16	0.50	0.19	0.16	0.13	0.10	0.17	0.84
23-May	New-home sales/prices/costs	4.3	2.16	0.50	0.19	0.16	0.21	0.10	0.16	0.84
24-May	Existing-home sales	4.2	2.16	0.50	0.19	0.16	0.04	0.10	0.17	0.84
25-May	Advance durable manufacturing	4.0	2.16	0.48	0.19	0.16	0.04	0.10	0.17	0.75
29-May	Retail/wholesale trd. revisions (5/25)	4.1	2.23	0.48	0.19	0.16	0.03	0.10	0.17	0.76
31-May	Adv. Econ. Indicators/GDP (5/30), Personal Inc., NIPA underlying detail	4.7	2.36	0.31	0.26	0.17	0.03	0.10	0.43	1.00
1-Jun	Employment sit., ISM Manufacturing, Construction spending	4.8	2.44	0.35	0.26	0.21	0.07	0.07	0.42	1.01
4-Jun	M3 Manufacturing, Auto sales	4.5	2.26	0.25	0.26	0.21	0.07	0.07	0.42	0.99
5-Jun	ISM Nonmanufacturing Index	4.6	2.27	0.25	0.26	0.21	0.08	0.07	0.42	0.99
6-Jun	International trade	4.5	2.33	0.23	0.26	0.21	0.08	0.07	0.31	0.99
8-Jun	Wholesale trade	4.6	2.33	0.23	0.26	0.21	0.08	0.07	0.31	1.06
12-Jun	CPI, Monthly Treasury Statement	4.6	2.33	0.23	0.26	0.21	0.06	0.15	0.31	1.07
13-Jun	Producer Price Index	4.6	2.33	0.23	0.26	0.22	0.06	0.15	0.31	1.03
14-Jun	Retail trade, Import/Export prices	4.8	2.50	0.23	0.26	0.22	0.06	0.15	0.36	1.04
Maximum forecast of real GDP growth										
1-Jun	Employment sit., ISM Manufacturing, Construction spending	4.8	2.44	0.35	0.26	0.21	0.07	0.07	0.42	1.01
Minimum forecast of real GDP growth										
4-May	Employment situation	3.9	2.08	0.48	0.19	0.15	0.09	0.08	0.19	0.67

Note: CIPI is "change in private inventories." All numbers are percentage-point contributions to GDP growth (SAAR). The table does not necessarily include all estimates for the quarter; see tab "ContribHistory" in the online excel file for the entire history.

FEDERAL RESERVE BANK of ATLANTA

Virtually all sectors are additive to growth, including net exports, which is surprising given how U.S. growth is outpacing most of our trading partners. As one would expect, consumption is robust, accounting for more than half of the growth estimate. There is nothing in this data to suggest an imminent slowing.

The dollar's strength is a drag on equities, especially large caps and foreign equities. The dollar's rally is based on two trends. First, the divergence on monetary policy is dollar supportive. Historically, the record on interest rate differentials is decidedly mixed but, for now, the tightening Fed is bullish for the greenback. Second, assuming the dollar remains the preferred reserve currency, restrictions on imports, the primary way the world acquires dollars, act as a reduction on the global dollar supply. As a result, tariffs are dollar bullish until nations decide to use another currency for reserves. At present, there is no real alternative to the dollar so we should assume the threat of tariffs will be dollar bullish. A tariff-driven dollar bull market would be unprecedented in post-WWII history.

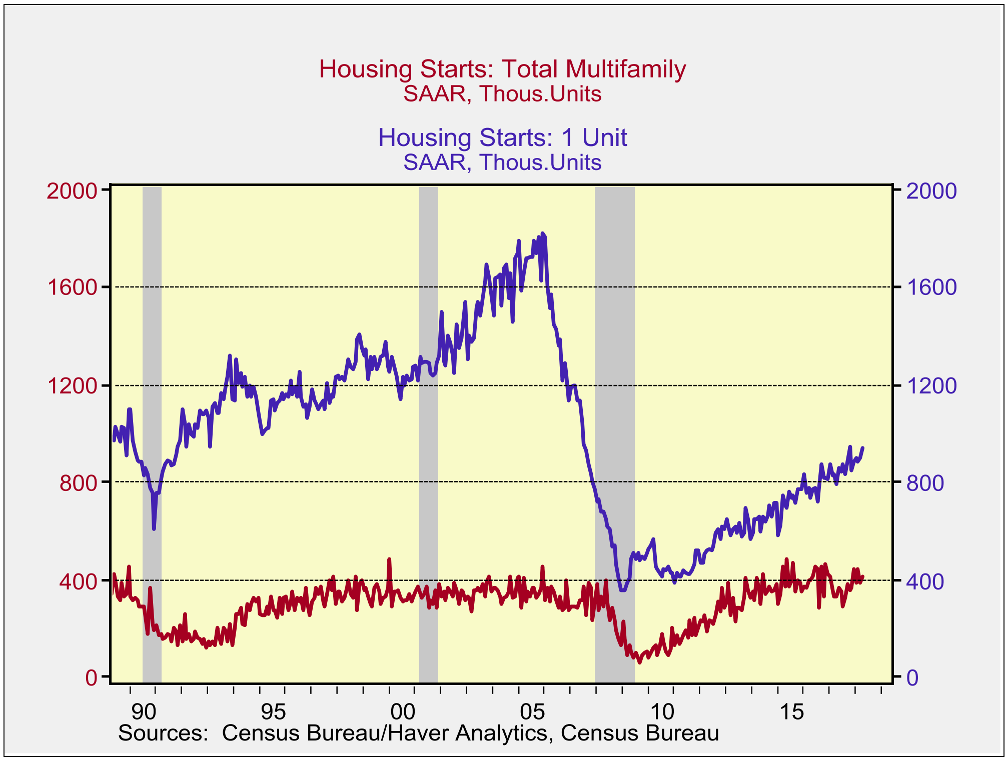
The other key issue to watch is the Fed's independence. If the economy begins to weaken, the White House will likely put pressure on Chair Powell to lower rates quickly. We note the two-year deferred Eurodollar futures implied yield is holding around 3.00%, suggesting the market does not expect more than four more rate hikes. If there were serious inflation fears, we would expect that implied rate to move higher. That hasn't happened, which is further evidence that the financial markets don't expect this recent growth spurt to last. The consensus also expects the FOMC to keep inflation expectations anchored.

The other factor that makes this situation so fluid and difficult is that the White House doesn't appear to have a clearly detailed plan in place. In other words, it's hard to know what would constitute a victory. There have been a parade of comments in the financial media suggesting these announcements are mere posturing and that a trade war isn't likely. Perhaps that is the case. However, Treasury Secretary Mnuchin seems to have disappeared and the president seems to have taken over trade policy. If victory requires foreign nations to admit they were wrong and simply accept tariffs, then that probably isn't going to happen. Although the EU, Canada or Mexico might eventually offer the president a symbolic win, we can't see China doing that.

There remain numerous positive factors. As noted above, economic growth remains strong. Earnings are great. Consumer and business sentiment remain elevated. Household cash is rising, which could fuel equity buying. Simply put, there are clear positive factors that could fuel an equity rally. But, the high uncertainty surrounding a trade war is offsetting these bullish factors. If these bullish factors begin to fade, increasing financial stress is likely.

U.S. Economic Releases

Housing starts came in above expectations at 1,350k compared to the forecast of 1,311k on an annualized basis. The prior month's report was revised downward from 1,287k to 1,286k. The monthly change in housing starts came in above expectations, rising 5.0% compared to the forecast gain of 1.9%. The prior report's loss was revised downward from 3.7% to 3.1%. Building permits came in below expectations at 1,301k compared to the forecast of 1,350k. The prior month's report was revised upward by 12k from 1,352k to 1,364k. The monthly change in building permits came in below expectations, falling 4.6% from the prior month compared to the forecast loss of 1.0%. The prior report's loss was revised from 1.8% to 0.9%.



The chart above shows the level of multi-family and single-family housing starts. Multi-family starts have risen 7.5%, while single-units rose 18.3% from the prior year. Housing starts on an annual basis rose 18.2% in the Northeast, 22.6% in the South, 13.7% in the West and 12.2% in the Midwest.

There are no economic releases or Fed events scheduled for the rest of the day.

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	ANZ Roy Morgan Weekly Consumption	w/w	may	122.1	123.0		**	Equity and bond neutral
	House Price Index	y/y	1q	-0.7%	1.0%	-1.0%	**	Equity and bond neutral
China	FX Net Settlement	m/m	may	143.3 bn	92.4 bn		**	Equity bullish, bond bearish
EUROPE								
Eurozone	ECB Current Account	m/m	apr	28.4 bn	32.0 bn		**	Equity and bond neutral
	Current Account Balance	m/m	apr	26.2 bn	40.6 bn		**	Equity and bond neutral
Italy	Current Account Balance	m/m	apr	3.0 bn	3.4 bn		*	Equity and bond neutral
Russia	GDP	y/y	1q	1.3%	1.3%	1.3%	***	Equity and bond neutral
	Industrial Production	y/y	may	3.7%	1.3%	0.9%	***	Equity bullish, bond bearish
AMERICAS								
Canada	Bloomberg Nanos Confidence	m/m	jun	57.1	57.3		**	Equity and bond neutral
Brazil	Trade Balance Weekly	m/m	jun	$1.970 bn	$0.581 bn		**	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)	189	189	0	Neutral
TED spread (bps)	44	44	0	Neutral
U.S. Libor/OIS spread (bps)	191	192	-1	Up
10-yr T-note (%)	2.88	2.92	-0.04	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	6	8	-2	Down
Currencies	**Direction**			
dollar	flat			Down
euro	down			Up
yen	up			Up
pound	down			Up
franc	flat			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	$74.84	$75.34	-0.66%	
WTI	$64.87	$65.85	-1.49%	
Natural Gas	$2.94	$2.95	-0.54%	
Crack Spread	$21.66	$21.52	0.63%	
12-mo strip crack	$21.05	$20.92	0.59%	
Ethanol rack	$1.58	$1.58	-0.15%	
Metals				
Gold	$1,275.10	$1,278.32	-0.25%	
Silver	$16.30	$16.47	-1.07%	
Copper contract	$308.35	$312.90	-1.45%	
Grains				
Corn contract	$ 369.50	$ 377.25	-2.05%	
Wheat contract	$ 492.75	$ 501.50	-1.74%	
Soybeans contract	$ 908.75	$ 931.50	-2.44%	
Shipping				
Baltic Dry Freight	1442	1445	-3	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.0		
Gasoline (mb)		-1.0		
Distillates (mb)		-1.0		
Refinery run rates (%)		0.05%		

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. There are no tropical storms 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.

June 15, 2018

The last topic in our series on secular trends is the dollar. It is arguable as to whether or not exchange rates are actually an asset class. In our asset allocation, we don't treat it as one. On the other hand, the behavior of the dollar affects most of the other asset classes. There is a clear inverse correlation between the dollar and commodities. Since most commodities are priced in dollars, a weaker dollar is a price cut for non-dollar buyers. The increase in demand will usually lead to higher prices for commodities when the dollar dips. Foreign equities to U.S. investors are directly affected by the dollar's exchange value. In general, foreign equities tend to outperform during periods of dollar weakness because, for a dollar-domiciled investor, appreciating foreign currencies act as a tailwind for foreign assets. Of course, if foreign currencies become too strong, it adversely affects the foreign economy and can become too much of a good thing. Even domestic equities are affected. A weaker dollar tends to support large cap stocks relative to small caps because the latter are less globalized. And, an excessively weak dollar can foster tighter monetary policy as a very strong dollar can prompt the Federal Reserve to ease credit.

The dollar is the nexus of most foreign exchange transactions. Although there is a market for cross rates in the major currencies, most transactions are into and out of dollars. That way dealers don't have to make markets in thousands of currency permutations. Because of the widespread use of the U.S. dollar, it is the global reserve currency; when nations accumulate foreign reserves, the currency of choice is mostly the greenback. About 63% of official foreign reserves are in dollars, with the next closest competitor, the euro, at 20%.[2] The dollar represents 88% of all forex turnover.[3] Thus, the dollar's exchange rate against various currencies deviates from classic textbook valuation measures because there is a natural demand for transaction and reserve purposes.

However, even with that caveat, some opinion on the direction of the dollar is critical because, as noted above, it affects numerous markets. In our observation, the dollar's path tends to be driven by "flavor of the month" factors. During various periods, markets focus on the trade deficit, relative productivity, interest rate differentials and monetary policy divergences, to name a few. In other words, there hasn't be a consistent variable that has affected the dollar's exchange rate in all markets. Here are the variables we use when examining the greenback.

First, history shows a cycle to the dollar.

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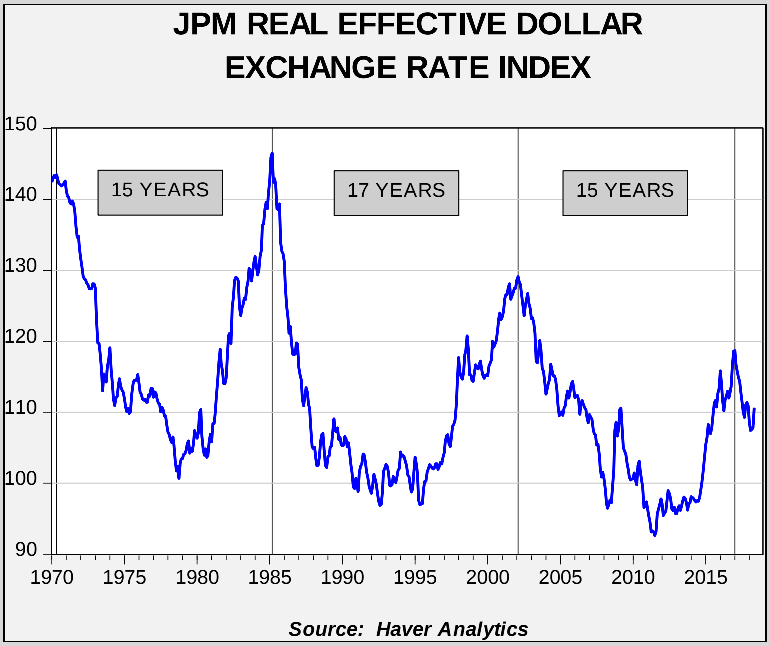
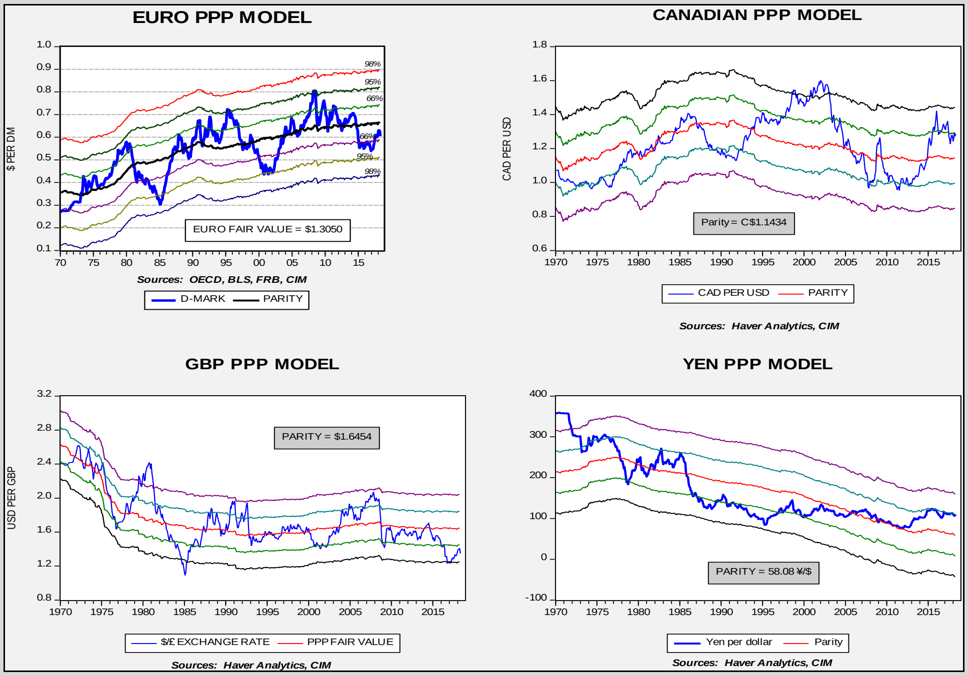
[2] https://en.wikipedia.org/wiki/Reserve_currency
[3] https://www.bis.org/statistics/d11_3.pdf



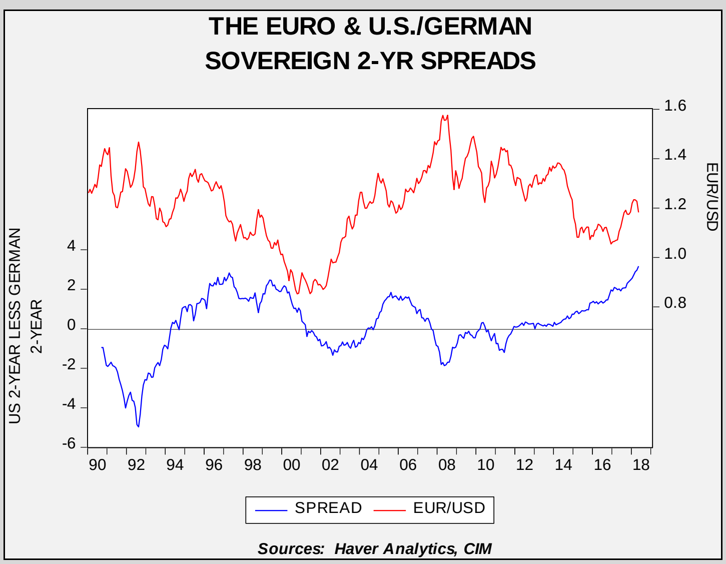
To measure the general value of the dollar, we use the JP Morgan real effective dollar index, which adjusts the dollar for relative inflation and trade. We note that the dollar tends to peak about every 15 to 17 years. There is always a danger in such observations…it's a bit of the correlation/causality problem. Just because something has followed a pattern for a long time doesn't mean it will do so in the future. This cycle does "rhyme" with relative growth; the dollar tends to strengthen when U.S. economic growth exceeds the rest of the world. However, the important market takeaway from this chart for long-term investors is that exchange rates probably don't matter if one holds a position for around 15 years. And, dollar bear markets tend to last longer than dollar bull markets.

Second, for long-term valuation purposes, we use purchasing power parity. This theory of currency valuation argues that exchange rates should adjust to equalize prices across countries. A nation with higher price levels should have a weaker currency, which would equalize the prices of a lower inflation country.



This chart shows the calculation of parity for four currencies, the euro, yen, Canadian dollar and British pound. Deviations from the model's fair value forecast are wide but, at extremes, the model does suggest reversals are more likely. Currently, the dollar is richly valued compared to these four currencies.

What about other models? Relative growth between Europe and the U.S. yields a similar fair value. Interest rate differentials clearly favor the greenback but the relationship isn't all that strong either.

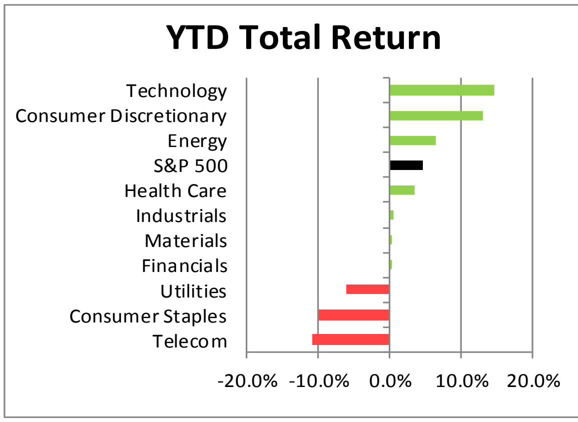


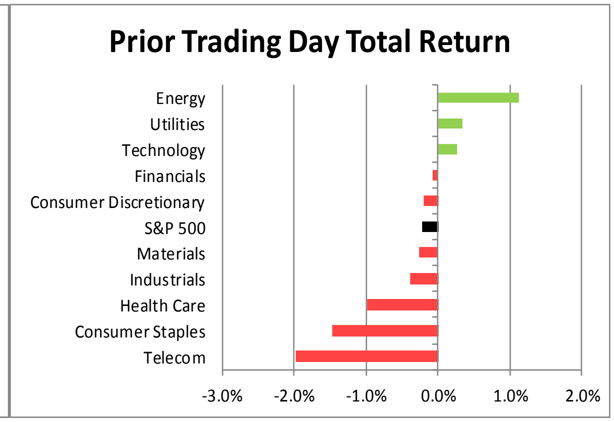
This chart shows the spread between U.S. and German two-year sovereigns and the EUR/USD exchange rate. Although the rate spread is historically wide, in the last tightening cycle in 2004-06 the dollar faded shortly after the tightening cycle ended.

Perhaps the most important issue facing the dollar is the future of American hegemony. If the world loses faith in the dollar's reserve value, we would expect a profound bear market to develop. At this point, there is no obvious rival to the dollar. However, one of the reasons no rival exists is that no other nation with a reasonably attractive currency is willing to run persistent trade deficits. The Trump administration is trying to adjust or reverse America's importer of last resort role which is part of being the reserve currency provider. If the U.S. puts up trade barriers, we would expect the dollar to appreciate as long as reserve demand remains. But, if the world decides the U.S. is no longer a reliable provider of the reserve currency, even if no obvious replacement exists, the dollar will almost certainly decline. Reserve currency changes don't occur very often; we have only had two reserve currencies over the past two centuries, the British pound from 1815 to 1920 and the U.S. dollar from 1920 to the present. With events that occur so rarely, it is difficult to determine the path of the greenback but it does appear we are moving into an era of significant change. This is a factor we will be closely monitoring in the coming months and years.

Data Section

U.S. Equity Markets – (as of 6/18/2018 close)

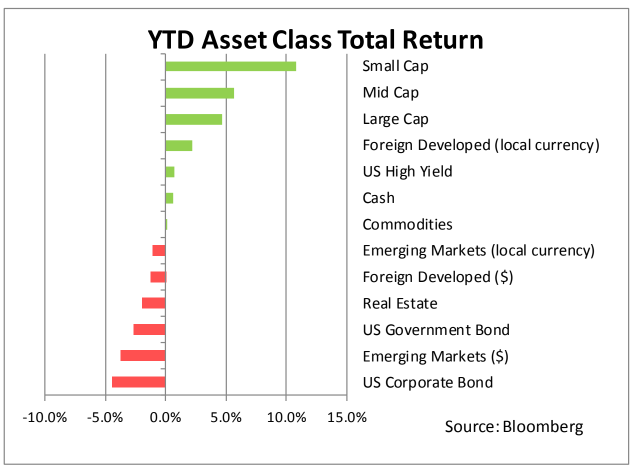




(Source: Bloomberg)

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 6/18/2018 close)

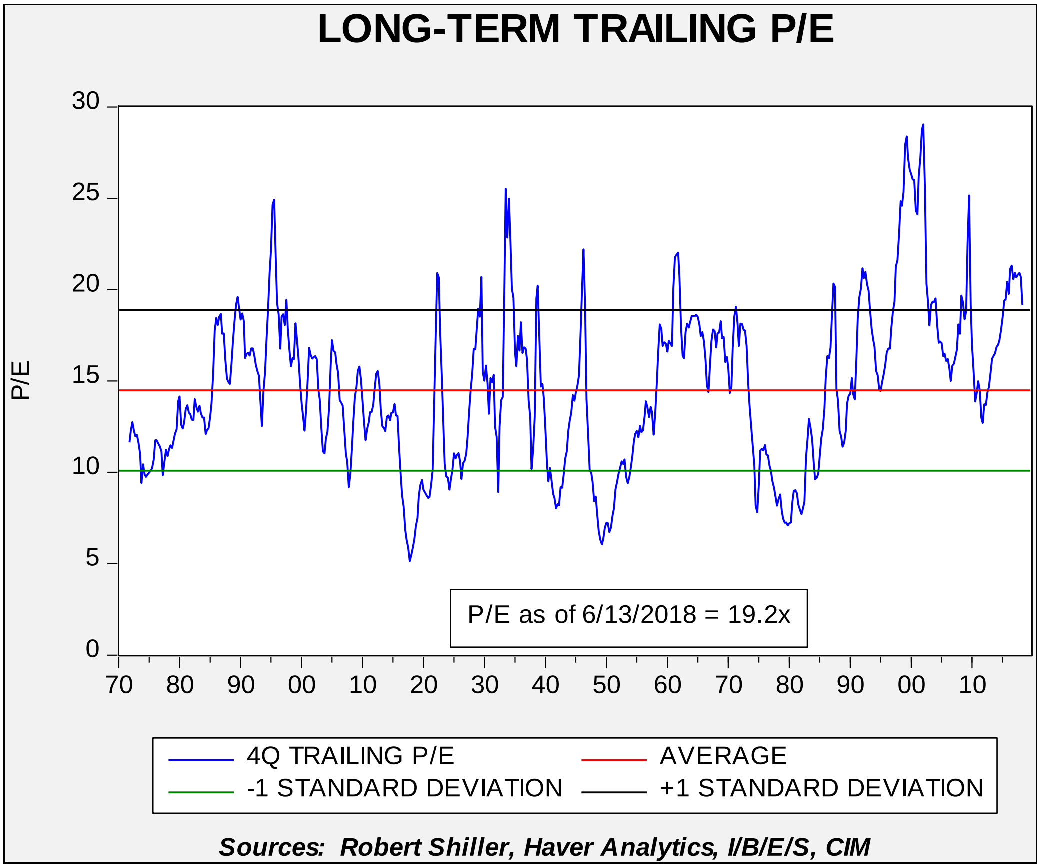


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

June 14, 2018



Based on our methodology,[4] the current P/E is 19.2x, up 0.1x from last week. The increase was due to a rising S&P index.

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] 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 (Q3, Q4 and Q1) and one estimate Q2). 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.