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 1, 2018—9:30 AM EDT] Global equity markets are generally mixed this morning. The EuroStoxx 50 is up 1.5% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.5% from the prior close. Chinese markets were down, with the Shanghai composite down 0.7% and the Shenzhen index down 1.2%. U.S. equity index futures are signaling a higher open.

Happy employment day! We cover the data in detail below but the quick snapshot is that the numbers are showing clear and increasing evidence of a tightening labor market. The unemployment rate dipped to 3.8% (out to three digits, it was 3.755%), payrolls exceeded expectations and earnings ticked up to 2.7%. The data all support further policy tightening by the FOMC and thus the initial market reaction is a bit bearish for equities, dollar bullish and bearish for bonds.

A side note: The *WP*[1] is reporting that President Trump appeared to break protocol in a tweet that read, "Looking forward to seeing the employment numbers at 8:30 this morning," about 69 minutes before the release. Given that the numbers were very strong, it would appear the president tipped off the financial markets to the data. The White House gets the numbers about a day before they are officially released (news media gets it a bit in advance as well—that's why they can write stories on the data so quickly), but previous presidents hadn't commented on the reports before the official release. Here is why this matters: financial markets are like poker players, all looking for a "tell." Finding something that gives one advance information is highly prized. For the markets, if next month he doesn't signal anything, will the financial markets then assume the data is weak? Or, if the president knows it's weak and tries to preempt the information by discrediting it in advance, will that lead to early sell-offs? This act has added another layer of uncertainty surrounding this report; we will be watching next month for clues to the numbers.

Italy gets a government: President Mattarella approved a coalition government of populist parties, the two main groups being the Five-Star Movement and the League. The new PM is Giuseppe Conte, with Giovanni Tria, a professor of political economy, as finance minister. It was the finance mandate that led the president to scuttle an earlier configuration. Paolo Savona, the Euroskeptic, will be the minister for EU affairs (that should be interesting). The coalition's

[1] https://www.washingtonpost.com/news/business/wp/2018/06/01/trump-breaks-protocol-sends-markets-a-clear-signal-on-jobs-report-before-numbers-are-released/?utm_term=.9f2569a198e7

fiscal plans are estimated[2] to cost about 6% to 7% of GDP. If those plans are acted upon, it will lead to a confrontation with the EU (read: Germany). The financial markets are taking this outcome as better than new elections but it isn't a good outcome for financial markets. At the same time, the two major coalition parties barely won 50% of the vote and this may end up being a short-lived government anyway.

Rajoy out: This morning, Mariano Rajoy lost the no-confidence vote and was replaced by socialist party (PSOE) leader Pedro Sanchez. Upon accepting the position, Sanchez promised to keep the budget plan of the previous administration as well as open up dialogue with secessionists in Catalonia. Even though PSOE does not support secession, the group has historically been open to making concessions to appease Catalonia. That being said, Sanchez's legitimacy has been questioned by political rivals Cuidadanos and PP because he doesn't have the backing of the people; he lost the previous two elections. Sanchez's party currently holds 84 seats in parliament, making it unclear how long his administration will last. In the event of an election, the party we will pay close attention to is Ciudadanos, which will likely pose a challenge to the establishment parties PSOE and PP.

The problem with trade policy: The private sector in capitalist economies are remarkably flexible. It is part of the reason capitalism triumphed over communism. Capitalist economies react better to change; production methods, supply chains, customers, etc. can all be adjusted to maximize profits, sales or whatever the business is trying to accomplish. Businesses constantly complain about regulation, for example. For the most part, however, history shows that industries do manage to adjust.

But, this system functions only if conditions are reasonably stable. Rapidly changing price levels, regulations that vary on a whim or the perception of a wide range of potential outcomes can freeze managers into a position where it becomes difficult to make long-term plans. How does one invest when conditions are rapidly changing? Only with great difficulty.

Herein lies the problem with the administration's trade policy. It is becoming difficult to tell what future trade arrangements will emerge. If the aluminum tariffs are going to remain in place, a consumer should probably build stockpiles to protect against future price increases…unless the policy changes for some other reason. And, what should a company do if it finds itself as the target of trade retaliation? Invest in lobbying to try to reverse the policy? Woo foreign governments to change their minds?

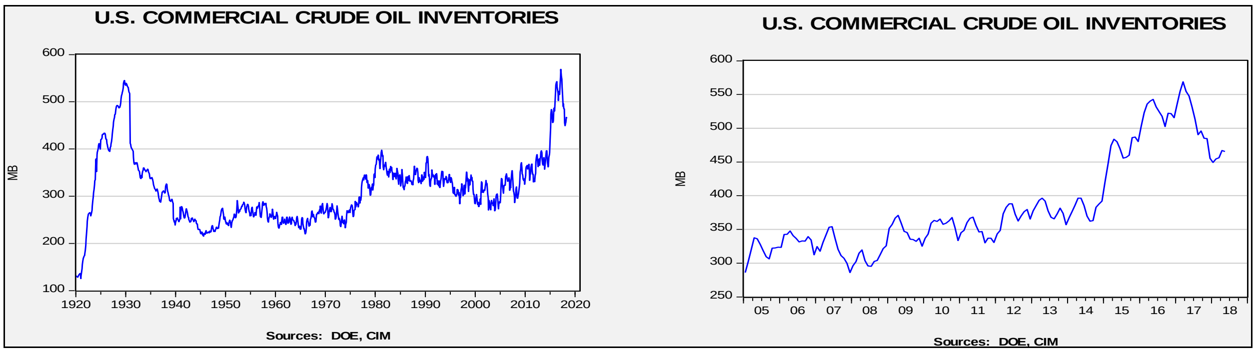
The U.S. has engaged in a reserve currency system that brings costs and benefits. The beneficiaries are most consumers (we get lots of imports that keep prices down) and the financial system (foreigners need U.S. dollar assets to hold their reserves until needed). The reserve currency is also a source of influence; Iranian sanctions were successful, in part, because other nations feared the loss of access to the U.S. banking system. The costs were borne by those working in import-competing industries. The dollar/reserve policy has been partly responsible

[2] https://www.politico.eu/article/silvia-merler-italy-politics-populists-program-violates-all-eu-and-domestic-fiscal-rules/?utm_source=POLITICO.EU&utm_campaign=982742a3a1-EMAIL_CAMPAIGN_2018_06_01_04_26&utm_medium=email&utm_term=0_10959edeb5-982742a3a1-190334489

for rising inequality. The U.S. has every right to change the rules of the game to help those adversely affected by the policy.

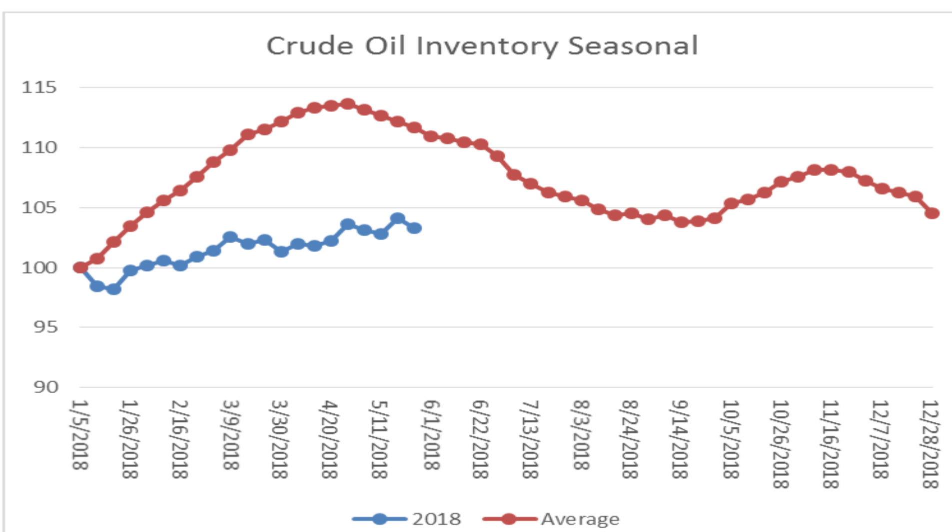
However, the dollar/reserve system is deeply imbedded in how the global economy functions and changing it requires careful adjustments to avoid causing an unexpected crisis. Moving fast and breaking things raises the risks of an unforeseen consequence that will tend to make investors cautious; this will likely play out in the equity markets in the form of multiple contraction.

Energy recap: U.S. crude oil inventories fell 3.6 mb compared to market expectations of a 0.9 mb draw.

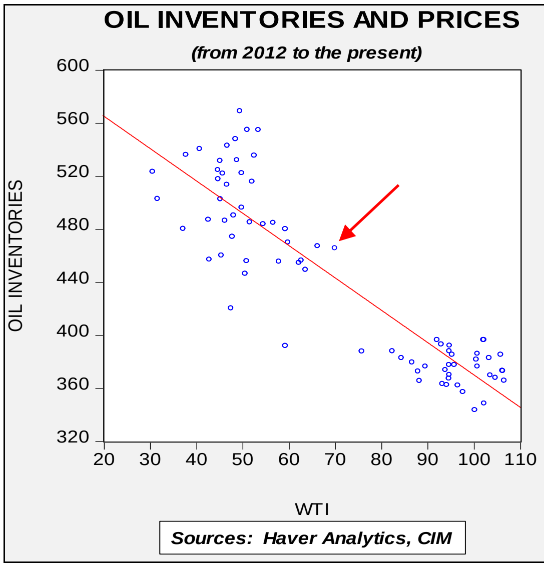


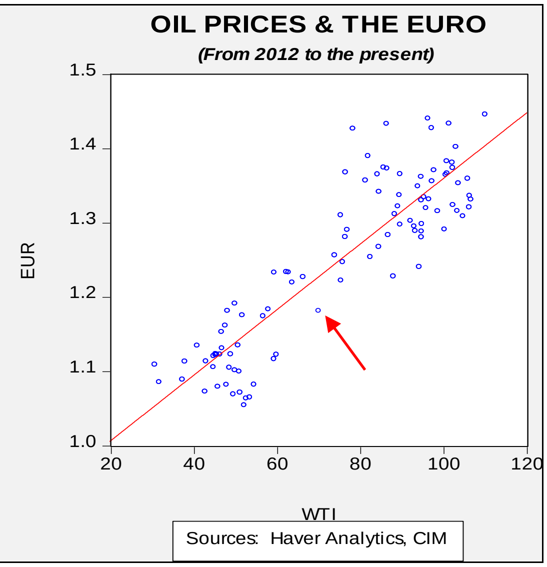
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but have declined significantly since last March. We would consider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

As the seasonal chart below shows, inventories are usually starting their seasonal decline this time of year. This week's decline is consistent with that pattern. We expect steady stock withdrawals from now until mid-September. If we follow the normal seasonal draw in stockpiles, crude oil inventories will decline to approximately 426 mb by September.



(Source: DOE, CIM)





Based on inventories alone, oil prices are overvalued with the fair value price of $62.88. Meanwhile, the EUR/WTI model generates a fair value of $63.52. Together (which is a more sound methodology), fair value is $62.92, meaning that current prices are above fair value even with the recent pullback. The stronger dollar is putting downside pressure on oil prices, which is only partially being offset by falling stockpiles. Although we don't expect a bear market to emerge (there is probably too much geopolitical risk for a decline below $50 per barrel), prices did get a bit ahead of themselves and some consolidation would be normal.

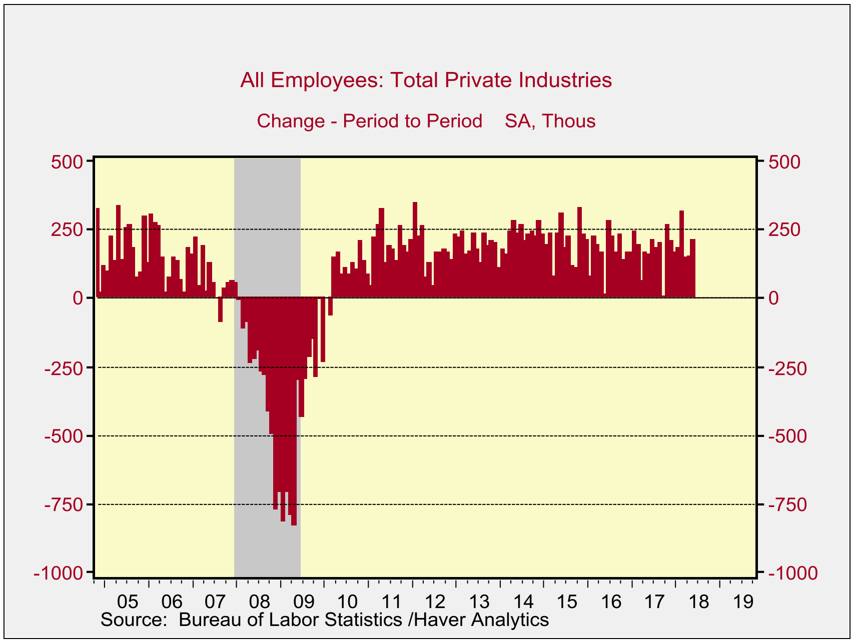
Assad threatens U.S. forces in Syria: Recent comments from Syrian President Assad are an example of the level of geopolitical risk we are seeing. Yesterday, he warned that his government would "wage war" to expel U.S. troops from northeastern Syria if negotiations for withdrawal fail.[3] U.S. troops have supported the Kurds who have established control in parts of Syria. Assad's comments are really ill-advised. President Trump has already indicated he wants to leave Syria. At the same time, Trump is a Jacksonian; besmirch his honor and he will react harshly. Even threatening to attack U.S. troops could lead the president to react harshly. Assad appears to be overconfident; if he simply keeps quiet, it is likely the U.S. will exit without fanfare. It should be noted that without Russian and Iranian support, Assad would likely be out of power. We doubt either of his supporters would countenance a direct attack on U.S. troops. But, if conditions suddenly escalate, it increases the chances of a geopolitical event in the Middle East and could support oil prices if it spreads.

U.S. Economic Releases

The change in non-farm payrolls for April came in above expectations at 223k compared to the forecast of 190k. The prior report was revised downward from 164k to 159k. The change in private payrolls came in above expectations at 218k compared to the forecast of 190k. The prior

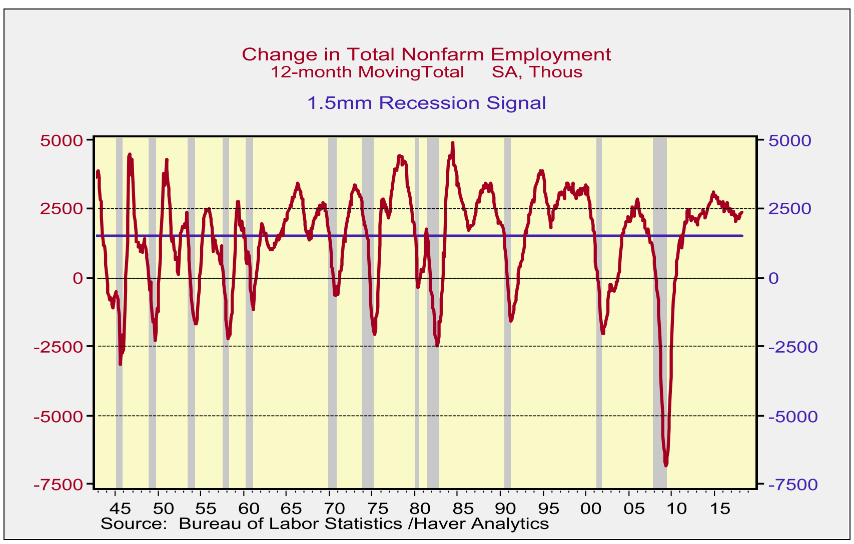
[3] https://www.washingtonpost.com/world/middle_east/assad-threatens-to-expel-us-troops-from-syria-by-force/2018/05/31/e4ba8400-64d3-11e8-81ca-bb14593acaa6_story.html?utm_term=.f48f971744b4&wpisrc=nl_todayworld&wpmm=1

report was revised downward from 168k to 162k. The change in manufacturing payrolls was below expectations at 18k compared to the forecast of 20k.

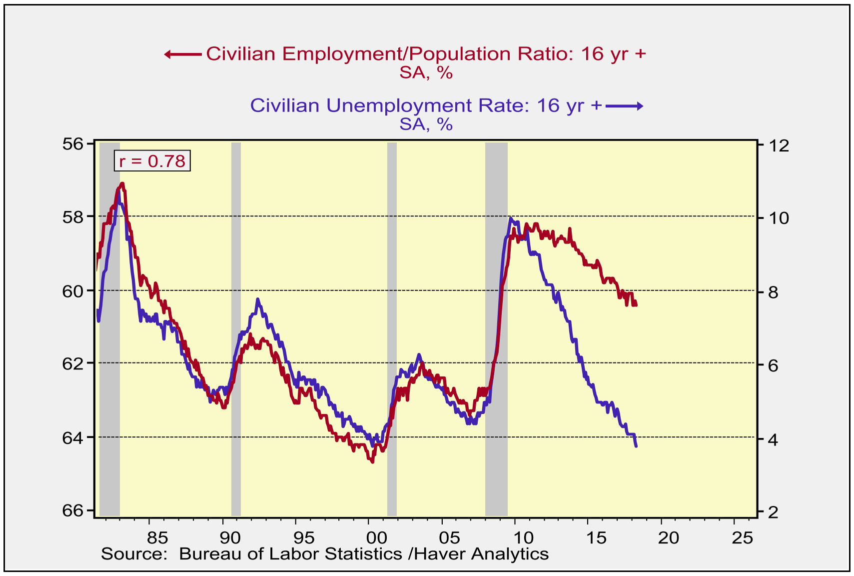


The chart above shows the change in total private employment. This chart suggests the economic expansion continues.

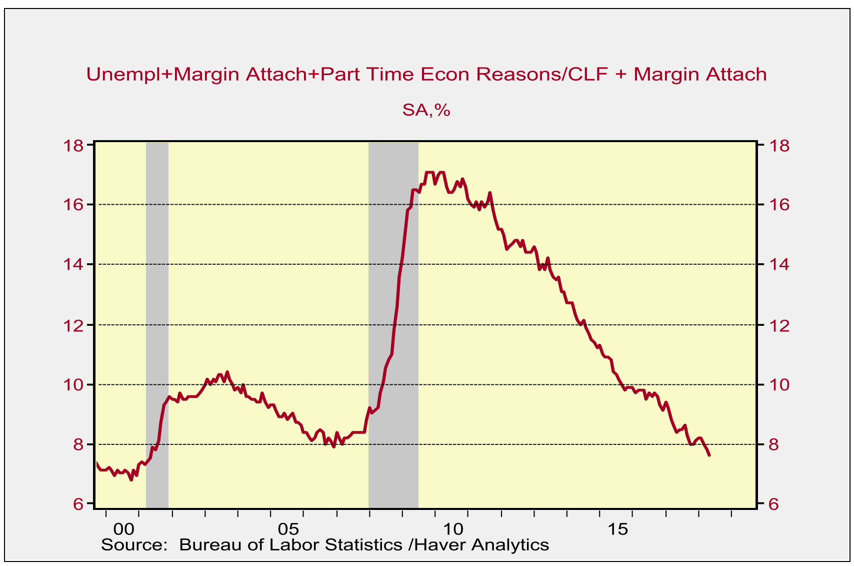
The chart below shows the 12-month moving total of the change in non-farm payrolls; a dip under 1.5 mm signals recession.



The unemployment rate came in below expectations at 3.8% compared to the forecast of 3.9%. The labor force participation rate was 62.7%, a small dip from the previous month, while the U-6 unemployment rate fell 20 bps from 7.8% to 7.6%.

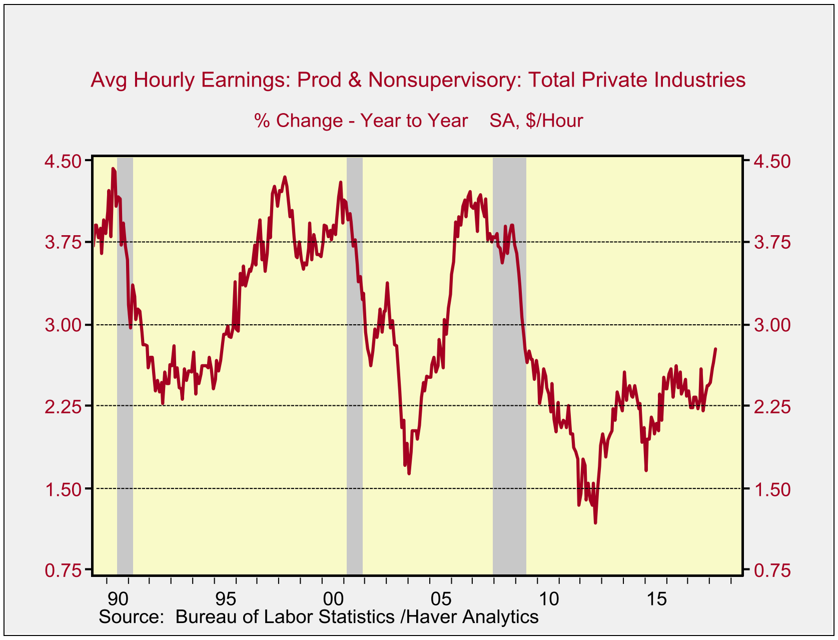


The chart above shows the relationship between the unemployment rate and the employment/population ratio. The divergence of the two variables has been one of the defining factors of this recovery and argues that labor market slack still remains. However, some of that slack is diminishing.



The chart above shows the underemployment rate, also referred to as the U-6 rate. This is a broader measure of unemployment and it's showing a tightening labor situation.

Average hourly earnings for all workers came in above expectations, rising 0.3% from the prior month. The chart below shows the yearly change in overall wages for non-supervisory and production workers.



As mentioned, this chart shows the yearly growth in hourly earnings for production and non-supervisory workers. On an annual basis, wage growth for production and non-supervisory employees rose 2.8%, at last showing signs of acceleration.

Overall, this report is showing an accelerating tightening of the labor markets. This trend will likely embolden the FOMC to continue raising rates; the risk of Fed overshoot is increasing but we are not at a critical stage yet.

The table below lists the economic releases and Fed events scheduled for the rest of the day.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Markit US Manufacturing PMI	m/m	may	56.6	56.6	**
10:00	Construction Spending	m/m	apr	0.8%	-1.7%	**
10:00	ISM Manufacturing	m/m	may	58.2	57.3	**
10:00	ISM Prices Paid	m/m	may		54.2	**
10:00	ISM New Orders	m/m	may	78.0	79.3	**
10:00	ISM Employment	m/m	may		61.2	**
	Wards Total Vehicle Sales	m/m	may	16.70 mn	17.07 mn	**
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								
China	Caixin China PMI Mfg	y/y	may	51.1	51.1	51.2	**	Equity and bond neutral
Japan	Capital Spending	m/m	may	3.4%	4.3%	3.1%	**	Equity bullish, bond bearish
	Capital Spending ex Software	m/m	apr	2.1%	4.7%	3.8%	**	Equity bearish, bond bullish
	Company Profits	m/m	may	0.2%	0.9%	-3.6%	**	Equity bullish, bond bearish
	Company Sales	m/m	may	3.2%	5.9%		**	Equity and bond neutral
	Nikkei Japan PMI Mfg	m/m	may	52.8	52.5		**	Equity and bond neutral
India	Nikkei India PMI Mfg	m/m	may	51.2	51.6		**	Equity and bond neutral
Australia	AiG Perf of Manufacturing Index	m/m	may	57.5	58.3		**	Equity and bond neutral
	CBA Australia PMI Mfg	m/m	may	53.2	55.5		**	Equity and bond neutral
	Corelogic House Px	m/m	may	-0.2%	-0.3%		**	Equity and bond neutral
	Commodity Index SDR	y/y	may	3.6%	-1.4%		**	Equity and bond neutral
New Zealand	ANZ Consumer Confidence	m/m	may	0.4%	-5.9%		**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Manufacturing	m/m	may	55.5	55.5	55.5	**	Equity and bond neutral
Germany	Markit/BME Germany Manufacturing	m/m	may	56.9	56.8	56.8	**	Equity and bond neutral
France	Markit France Manufacturing	m/m	may	54.4	55.1	55.1	**	Equity and bond neutral
Italy	Markit/ADACI Italy Manufacturing	m/m	may	52.7	53.5	53.0	**	Equity and bond neutral
	GDP	y/y	may	1.4%	1.4%	1.4%	***	Equity and bond neutral
U.K.	Markit UK PMI Manufacturing	m/m	may	54.4	53.9	53.5	**	Equity bullish, bond bearish
Switzerland	PMI Manufacturing	m/m	may	62.4	63.6	62.5	**	Equity and bond neutral
Russia	Markit Russia PMI Manufacturing	m/m	may	49.8	51.3	51.1	**	Equity bearish, bond bullish
AMERICAS								
Mexico	Net Outstanding Loans	m/m	apr	4.128 tn	4.077 tn		**	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)	230	231	-1	Up
3-mo T-bill yield (bps)	186	187	-1	Neutral
TED spread (bps)	44	44	0	Neutral
U.S. Libor/OIS spread (bps)	189	189	0	Up
10-yr T-note (%)	2.89	2.86	0.03	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	12	11	1	Down
Currencies	**Direction**			
dollar	down			Down
euro	up			Up
yen	up			Up
pound	up			Up
franc	up			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Canada Rate Decision	1.250%	1.250%	1.250%	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	$77.87	$77.56	0.40%	
WTI	$66.49	$67.04	-0.82%	
Natural Gas	$2.96	$2.95	0.14%	
Crack Spread	$25.23	$24.32	3.73%	
12-mo strip crack	$23.94	$23.20	3.19%	
Ethanol rack	$1.61	$1.61	0.03%	
Metals				
Gold	$1,298.31	$1,298.51	-0.02%	
Silver	$16.43	$16.43	0.03%	
Copper contract	$307.30	$306.50	0.26%	
Grains				
Corn contract	$ 395.00	$ 394.00	0.25%	
Wheat contract	$ 520.25	$ 526.25	-1.14%	
Soybeans contract	$ 1,023.50	$ 1,018.50	0.49%	
Shipping				
Baltic Dry Freight	1090	1042	48	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-3.6	-0.9	-2.7	
Gasoline (mb)	0.5	-0.9	1.4	
Distillates (mb)	0.6	-1.4	2.0	
Refinery run rates (%)	2.10%	0.60%	1.5%	
Natural gas (bcf)	96.0	102.0	-6.0	

Weather

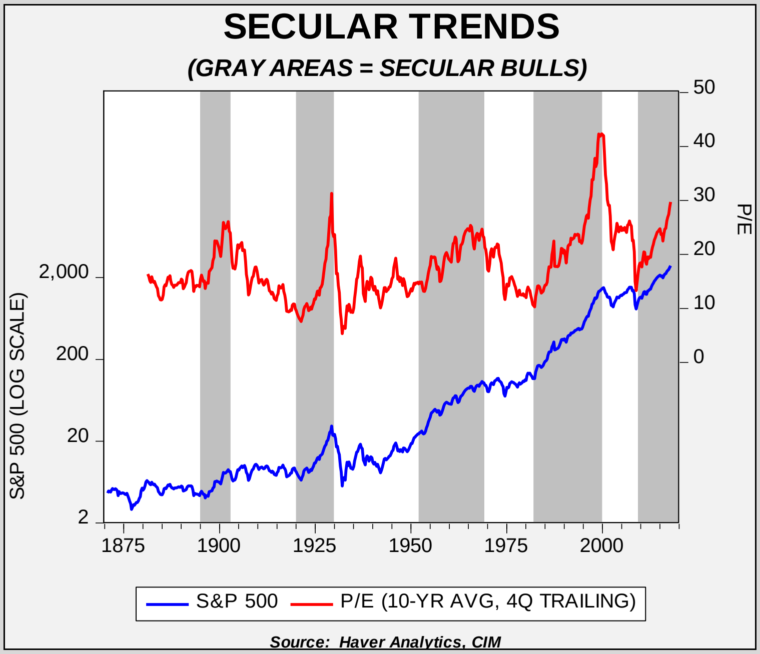
The 6-10 and 8-14 day forecasts continue to signal warmer to normal temperatures for most of the country, with cooler temps on the East Coast. There are no tropical storms expected over the next 48 hours.

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 1, 2018

Last week, we discussed secular cycles in the Treasury market. This week we will discuss equities. The rule for secular cycles in equities is rather simple: the price/earnings (P/E) is the critical factor. In general, profits tend to rise over time. Driving the secular trend in equity markets is what investors are willing to pay for those earnings.



This chart shows the S&P 500 on the lower line (log-scaled) with the 10-year P/E on the upper line.[4] Secular bull markets are shown in gray. What generates the secular trend is the multiple. When the P/E is rising (and the 10-year P/E generally shows the underlying trend in the multiple), equity values tend to rise as well. Secular bear markets are characterized by flat to falling P/Es.

So, the key question is, "What drives the multiple?" Most variables that are important are also complicated and the P/E is, too. In general, the multiple is a sentiment indicator—it measures how optimistic equity investors are about future prospects. Our analysis suggests that inflation plays a role as does general sentiment.

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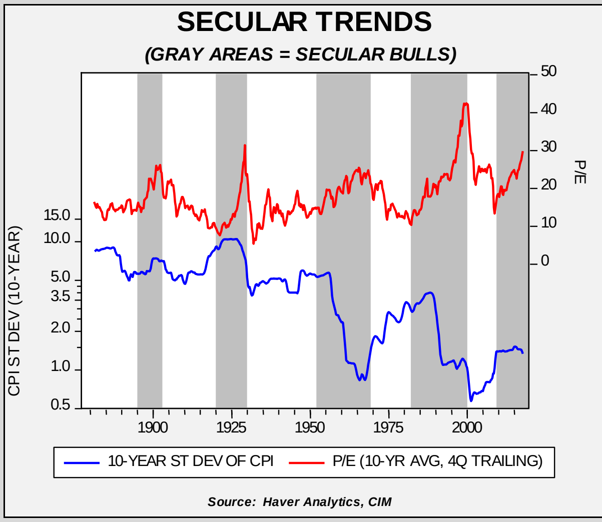
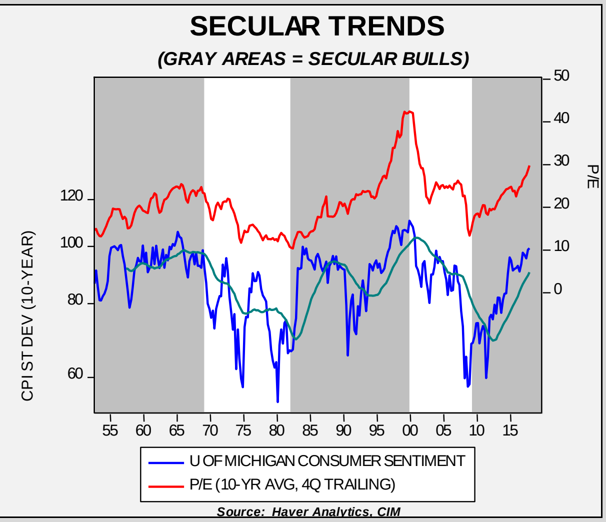
[4] The 10-year P/E is calculated by the 10-year average of nominal earnings divided by the current value of the S&P 500. The multiple is similar to the Shiller P/E except that the latter deflates both by CPI.





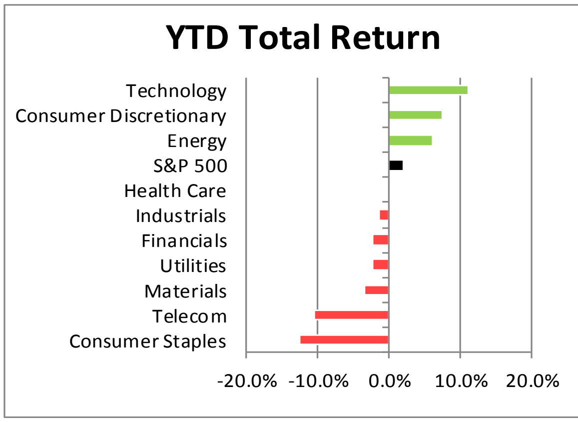
The chart on the left shows the aforementioned P/E with the 10-year rolling standard deviation of inflation. Secular trends are shaded in gray. Although not a perfect indicator, in general, rising inflation volatility tends to coincide with a lower P/E. With all financial assets, inflation is an important variable. Investors have balance sheets; in a way, inflation is the return on real assets so fears of rising inflation, expressed with rising volatility, should discourage investment in financial assets. The chart on the right shows consumer sentiment. Although the data is rather limited compared to inflation, it does show that periods of falling sentiment tend to coincide with P/E contraction.

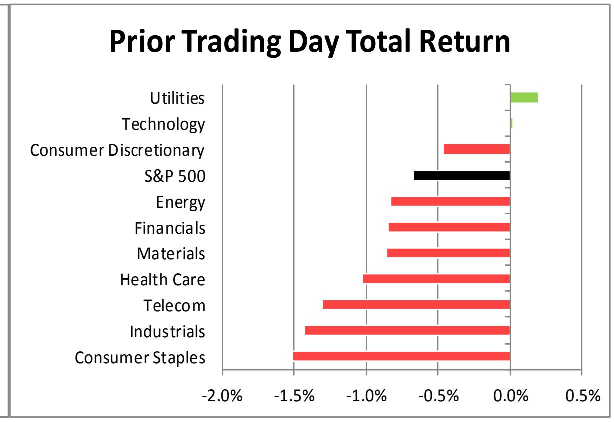
There is an old saying that "bond investors don't build hospital wings." In other words, equities are the best way to build wealth. At the same time, investing in equities requires optimism about the future. War, civil unrest, social disruption and geopolitical uncertainty should make citizens reluctant to invest. For example, the end of the Cold War was likely a contributing factor to the steep rise in the P/E during 1995-2000. Perhaps the relief that the Great Financial Crisis didn't trigger another Great Depression boosted the P/E after 2008.

Our view on secular trends in equities is based on two factors—what is inflation doing and how do people feel? Rising inflation and increasing volatility of price levels will tend to reduce investor optimism. The perception of how society is doing will affect sentiment. Inflation can be easily measured, while sentiment is more of an observational "call." At present, the secular bull market appears intact but under threat from two directions. First, if populism gains traction then inflation will likely follow. Second, the high level of political partisanship could eventually affect consumer sentiment. If these trends gain strength, we may be entering into a new secular bear market in equities. That would mean a period of steady to declining multiples. Investors can still make positive gains in equities in such an environment, but passive investing tends to struggle during secular bear markets.

Data Section

U.S. Equity Markets – (as of 5/31/2018 close)

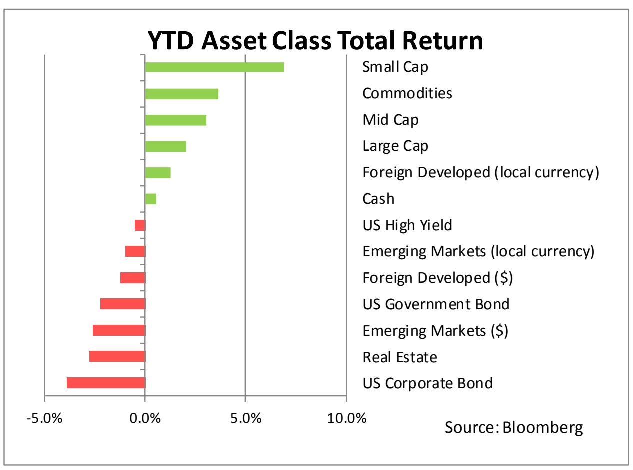




(Source: Bloomberg)

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 5/31/2018 close)

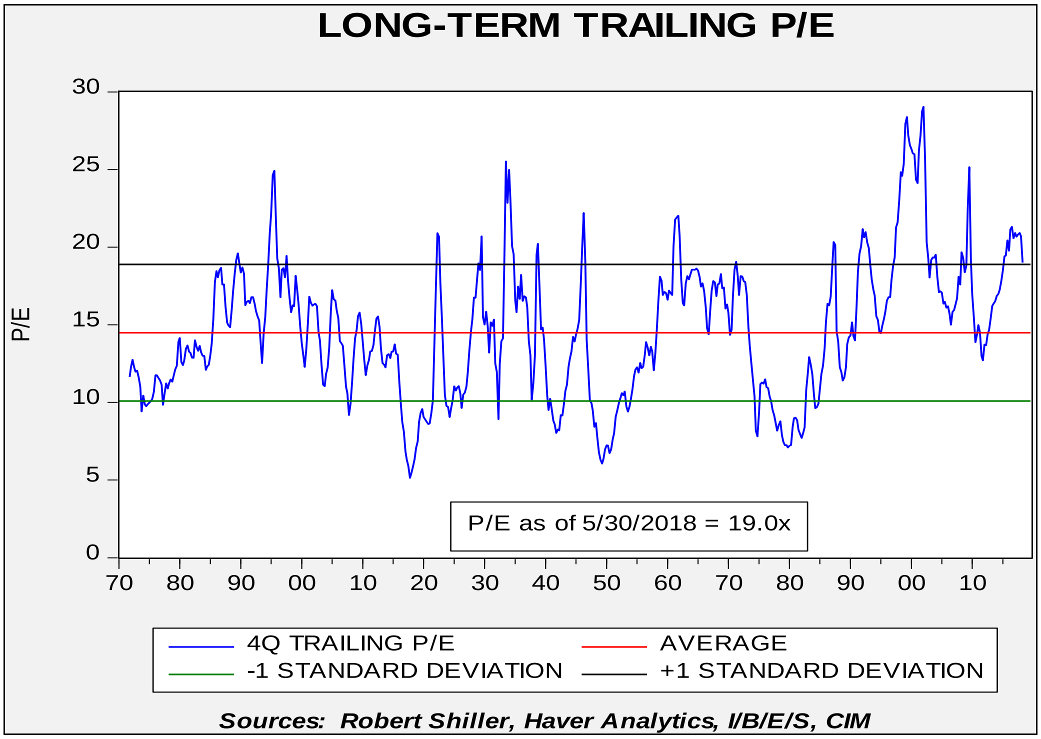


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

May 31, 2018



Based on our methodology,[5] the current P/E is 19.0x, unchanged from last week.

[5] 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.