Confluence INVESTMENT MANAGEMENT

Daily Comment

By Bill O'Grady and Thomas Wash

Looking for something to read? See our Reading List; these books, separated by category, are ones we find interesting and insightful. We will be adding to the list over time. ***We added a few new titles recently!***

[Posted: June 27, 2018—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is up 0.7% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.9% from the prior close. Chinese markets were down, with the Shanghai composite down 1.1% and the Shenzhen index down 1.3%. U.S. equity index futures are signaling a lower open.

Here we are at mid-week. Financial markets are recovering this morning after a difficult overnight session. Here is what we are watching:

Softening on trade? Around 7:35 AM EDT, the White House[1] announced it would not create a new regime to scrutinize Chinese investments and instead will use the current foreign investment apparatus, the Committee on Foreign Investment in the U.S. (CFIUS) to analyze Chinese investments. Risk markets have recovered on this news, likely for a couple of reasons. First, going this route means China isn't necessarily being targeted specifically, which does tone down tensions. Second, using CFIUS appears to confirm Treasury Secretary Mnuchin's position that all nations are being watched for intellectual property theft, not just China. This notion refutes comments from Peter Navarro, which followed Mnuchin's aforementioned comments by saying that no nations other than China were being investigated.

There is other evidence of softening. Chairman Xi has instructed the Chinese media[2] to stop talking about "China 2025," the controversial program to essentially move China up the value chain. Using CFIUS and China backing away from at least talking about China 2025 are positive developments. On the other hand, CFIUS can still effectively block Chinese investment. And, we doubt Xi will give up on China 2025. Given the nearly constant shifting positions of the White House, investors are clearly looking for some kind of sign that will accurately predict the future path of policy. However, that clear path isn't likely to emerge anytime soon. Instead, financial markets are starting to look like the shoe scene from the Monty Python movie *Life of Brian*,[3] desperately searching for some indication in a cacophony of policy actions.

Meanwhile, China is clearly taking steps to protect itself from rising trade tensions. As we noted yesterday, the PBOC cut reserve requirements. There is talk of China subsidizing firms targeted

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1 https://www.ft.com/content/a819ec8a-79f4-11e8-8e67-1e1a0846c475
2 https://www.politico.com/story/2018/06/26/beijing-made-in-china-2025-trump-trade-651852
3 https://www.youtube.com/watch?v=Ka9mfZbTFbk

for tariffs.[4] We are also seeing financial authorities accepting a weaker CNY.[5] As the chart below shows, the CNY had been appreciating from early 2017 until recently but the depreciation has accelerated over the past few days. As we have noted before, the Trump administration appears to tolerate currency manipulation, unwilling to purposely jawbone the dollar lower to improve the U.S. trade situation. We expect other nations to follow similar currency policies as a way to offset the impact of tariffs. But, the bottom line is that policy-induced volatility is here to stay; from the president's perspective, uncertainty is a feature of his administration, not a bug.

(Source: Bloomberg)

Iran sanctions: Oil prices surged yesterday after the White House warned allies that they should be prepared to cut oil imports from Iran to zero by November.[6] Although this action was anticipated, the deadline was much quicker than expected. Iran exports around 2.2 mbpd; we don't expect all imports to end (China will likely continue to buy Iranian oil, roughly 0.7 mbpd), but a reasonable expectation is that Iran's oil exports will fall to around 1.0 mbpd. Saudi Arabia can absorb this lost oil but its spare capacity would fall to around 1.0 mbpd, leaving the world dangerously close to no slack in the oil markets. Current oil prices are elevated relative to inventories and the dollar, and this geopolitical threat is keeping oil prices elevated. The rial remains weak.[7]

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[4] https://www.reuters.com/article/us-china-trade-usa/china-should-take-self-defense-measures-in-trade-war-global-times-idUSKBN1JN01G

[5] http://www.scmp.com/business/banking-finance/article/2152669/yuan-drops-through-660-level-beijing-signals-it-favours

[6] https://www.washingtonpost.com/world/national-security/us-pushes-allies-to-cut-oil-imports-from-iran-as-sanctions-loom/2018/06/26/c1d20e78-794f-11e8-aeee-4d04c8ac6158_story.html?utm_term=.4e682cb86412&wpisrc=nl_todayworld&wpmm=1

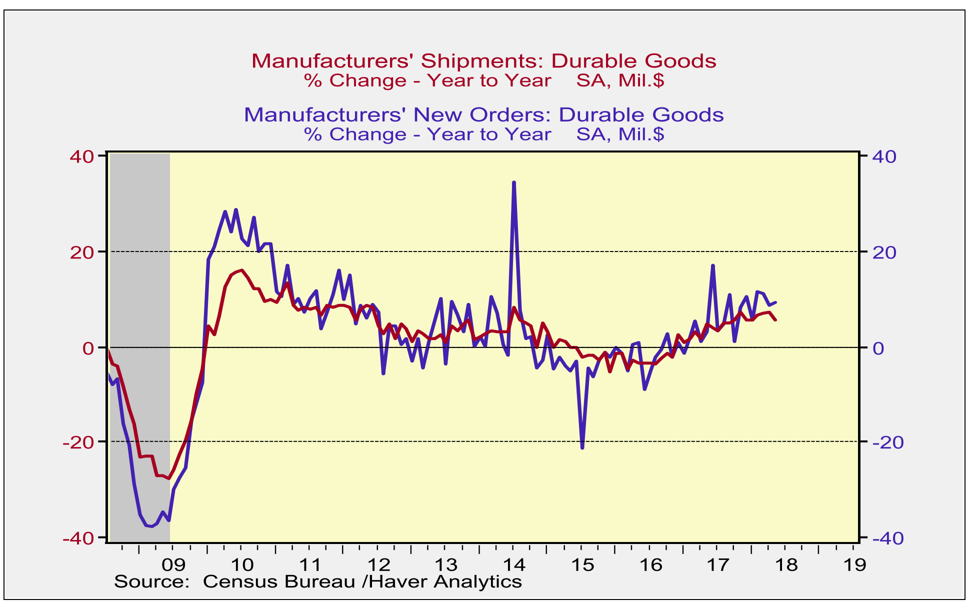
[7] https://www.reuters.com/article/us-iran-economy-rial/iran-rial-plunges-to-new-lows-as-us-sanctions-loom-idUSKBN1JK0HZ?wpisrc=nl_todayworld&wpmm=1

About last night: There were a series of primaries last night and the net takeaway is that the political situation is becoming increasingly populist. The headline shocker was from New York's 14th district, where Alexandria Ocasio-Cortez defeated Joe Crowley, a representative with nearly two decades of experience. Crowley hadn't faced a primary challenge since 2004. There was talk that Crowley could mount a leadership challenge to Nancy Pelosi (D-CA). His money advantage was 10-1. Ocasio-Cortez ran on a progressive platform, calling for a federal jobs guarantee and the abolition of ICE. We view this outcome as similar to David Brat's win over Eric Cantor in 2014. The populists on both sides (right- and left-wing) are gathering strength and establishment voters are increasingly being faced with candidates who want equality policies that will, at some point, lead to lower returns to capital and rising inflation.

U.S. Economic Releases

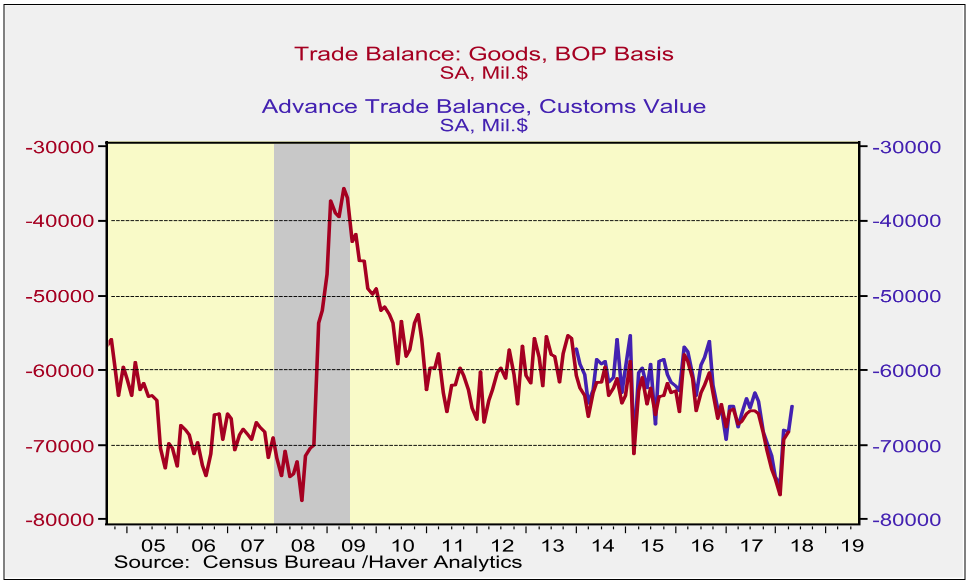
MBA mortgage applications fell 4.9% from the prior week. Purchases and refinancing fell 5.9% and 3.5%, respectively. The average 30-year fixed rate rose by 1 bp from 4.83% to 4.84%.

May durable goods came in above expectations, falling 0.6% from the prior month compared to the forecast loss of 1.0%. The prior report's loss was revised from 1.6% to 1.0%. Durables ex-transportation came in below expectations, falling 0.3% from the prior month compared to the forecast gain of 0.5%. The prior report's gain of 0.9% was revised to 1.9%. Capital goods orders non-defense ex-air came in below expectations, falling 0.2% from the prior month compared to the forecast gain of 0.5%. The prior month's gain of 1.0% was revised to 2.3%. Capital goods shipments non-defense ex-air came in below expectations, falling 0.1% from the prior month compared to the forecast rise of 0.3%. The prior report's gain of 0.9% was revised to 1.0%.



The chart above shows the annual change in new durable goods orders and shipments. Annually, new orders rose by 9.2%, shipments rose by 5.6%, unfilled orders rose by 4.6% and inventories rose by 5.1%.

The advance goods trade deficit came in narrower than expected at $64.6 bn compared to the forecast of $69.0 bn. The prior report's deficit was revised from $68.2 bn to $67.3 bn. Wholesale inventories came in above expectations, rising 0.5% from the prior month compared to the forecast gain of 0.2%. Retail inventories rose 0.4% from the prior month.



The chart above shows the trade balance of goods and the advance trade balance. The unexpected narrowing of the trade deficit was caused by rising U.S. exports. What appears to be happening is that foreign buyers are building inventory in advance of the imposition of tariffs.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Pending Home Sales	m/m	may	0.5%	-1.3%	**
10:00	Pending Home Sales	y/y	may		0.4%	**
Fed speakers or events						
EST	Speaker or event	District or position				
11:00	Randal Quarles Speaks at Bank Regulation	U.S. Federal Reserve Vice Chairman for Supervision				
12:15	Eric Rosengren Speaks on Ethics and Economics	President of the Federal Reserve Bank of Boston				

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	Industrial Profits	m/m	may	21.1%	21.9%		**	Equity and bond neutral
New Zealand	Trade Balance	m/m	may	0.294 mn	0.263 mn	0.100 mn	**	Equity bullish, bond bearish
	ANZ Activity Outlook	m/m	jun	9.4	13.6		**	Equity and bond neutral
	ANZ Business Outlook	m/m	jun	-39.0	-27.2		**	Equity bearish, bond bullish
EUROPE								
Eurozone	M3 Money Supply	y/y	may	4.0%	3.9%	3.8%	**	Equity bullish, bond bearish
Italy	Consumer Confidence Index	m/m	may	116.2	113.7	113.3	***	Equity bullish, bond bearish
	Economic Sentiment	m/m	may	105.4	104.7		***	Equity and bond neutral
	Manufacturing Confidence	m/m	may	106.9	107.7	107.0	**	Equity and bond neutral
	PPI	m/m	may	2.7%	1.4%		**	Equity bullish, bond bearish
France	Consumer Confidence	m/m	jun	97	100	100	***	Equity and bond neutral
U.K.	Nationwide House Px	m/m	jun	0.5%	-0.2%	0.2%	**	Equity and bond neutral
	CBI Retailing Reported Sales	m/m	may	32	11	10	*	Equity bullish, bond bearish
	CBI Total Dist. Reported Sales	m/m	may	18	17		*	Equity bullish, bond bearish
Switzerland	Credit Suisse Survey Expectations	m/m	jun	8.0	28.0		**	Equity and bond neutral
AMERICAS								
Mexico	Unemployment Rate	y/y	may	3.2%	3.4%	3.4%	***	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)	234	234	0	Up
3-mo T-bill yield (bps)	189	189	0	Neutral
TED spread (bps)	45	45	0	Neutral
U.S. Libor/OIS spread (bps)	193	193	0	Up
10-yr T-note (%)	2.84	2.88	-0.04	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	6	5	1	Down
Currencies	Direction			
dollar	up			Down
euro	down			Up
yen	down			Up
pound	down			Up
franc	down			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	$76.90	$76.31	0.77%	Supply Concerns
WTI	$70.99	$70.53	0.65%	
Natural Gas	$2.98	$2.94	1.46%	
Crack Spread	$17.21	$16.91	1.74%	
12-mo strip crack	$19.26	$18.82	2.33%	
Ethanol rack	$1.58	$1.58	0.06%	
Metals				
Gold	$1,256.73	$1,259.04	-0.18%	
Silver	$16.18	$16.30	-0.73%	
Copper contract	$299.75	$301.55	-0.60%	
Grains				
Corn contract	$ 375.25	$ 373.25	0.54%	
Wheat contract	$ 488.25	$ 483.00	1.09%	
Soybeans contract	$ 892.25	$ 887.50	0.54%	
Shipping				
Baltic Dry Freight	1323	1333	-10	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.5		
Gasoline (mb)		1.0		
Distillates (mb)		1.5		
Refinery run rates (%)		0.10%		
Natural gas (bcf)		73.0		

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps in Washington and the surrounding states. 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.

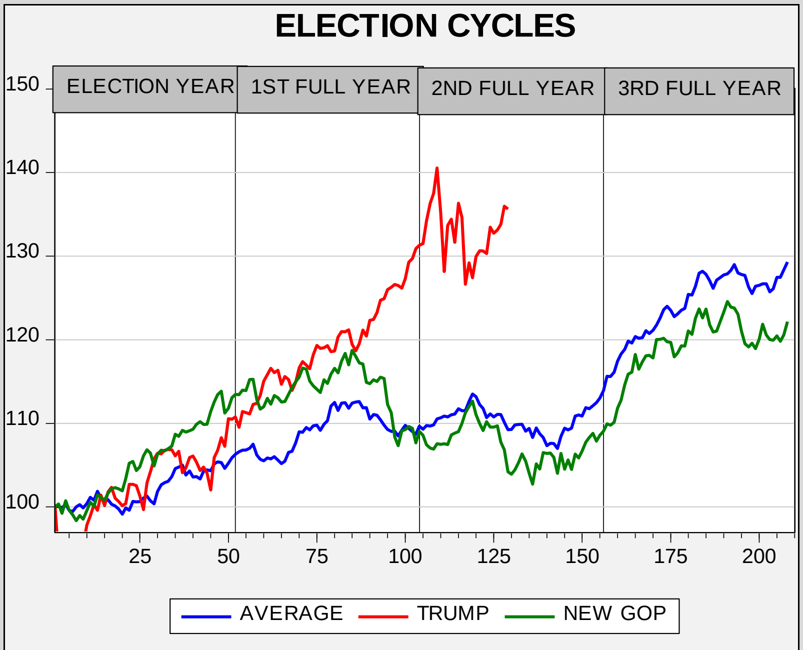
June 22, 2018

Cycle studies are common in analyzing markets. Such studies can be quite useful in some markets that are affected by seasonal factors, such as commodities. We all know it gets cold in the winter and rains in the spring, and measuring the timing of when market participants discount these events can offer insights into market behavior. In general, the more regular and reliable the factors are that cause the cyclicality, the more trustworthy the analysis. Seasonal cycles tend to be consistent and thus are heavily used in commodity analysis. Of course, once a pattern has been discovered, traders attempt to position in front of the expected price cycle. Commodity analysts will note that price patterns still work but they often start sooner.

Human cycles tend to be much less reliable. Usually, these cycles occur because of the structure of regulation; one example is tax selling, which sometimes weakens equity prices in late Q3. It doesn't always work because (a) tax laws change, or (b) sometimes investors don't have a lot of losses to "harvest." Market research is full of examples that "used to work." Often, once analysts notice a cycle, there is a temptation to publish it, in part for reputational enhancement. However, publishing makes the cycle better known and will often render it useless.

Elections in democracies create cycles with some degree of regularity. In the U.S., elections are not called, as is common in a parliamentary system, but occur on schedule. Policymakers are aware of elections and want to manipulate the economy in ways that improve their chances of re-election. For example, presidents have an incentive to implement painful policies during the first two years of their term with the hopes of an economic rebound in the last two years. That pattern usually means the mid-terms hurt the party of the president. At the same time, a president is at the peak of his political capital at inauguration. That capital erodes with time and thus if one is going to do something "big" the best chance is in the first 18 months of the presidency. By around May of the second year, the initial political capital is mostly exhausted, meaning little new accomplishments are enacted. In the third year, the president tries to implement policies that support growth to increase the chances of re-election and Congress often participates for the same reason.

To measure these effects, we created a database using the Friday close of the S&P 500, beginning in 1928. We indexed each four-year cycle at the beginning of the election year. Thus, we ended up with 22 cycles, excluding the current one, which began in 2016. Here is what the patterns indicate:



Sources: Bloomberg, CIM

The blue line on the chart shows the long-term average of all cycles. The green line shows the pattern for a newly elected Republican president and the red line shows the current administration. The pattern suggests that equities tend to favor the GOP, at least for the first 18 months of the cycle. The two average lines converge by Q4 of the first full year. The second full year tends to be the most disappointing for equities, on average, although a strong rally from the mid-terms into the year prior to the next election usually develops.

President Trump's first term was closely tracking an average new Republican president until it became clear that the tax law changes were going to pass. This led equities to rise sharply. However, in the aftermath of the tax changes, equities have moved sideways, which is consistent with the second full-year pattern but, in this particular case, from a much higher level. The usual pattern could be indicating one of two outcomes. First, equities will likely struggle into Q4 and then stage their usual third-year rally. Or, second, we have already had the "Trump bull market" and the rest of his first term will be "churn," leaving us about where we would be without the tax-driven lift in markets.

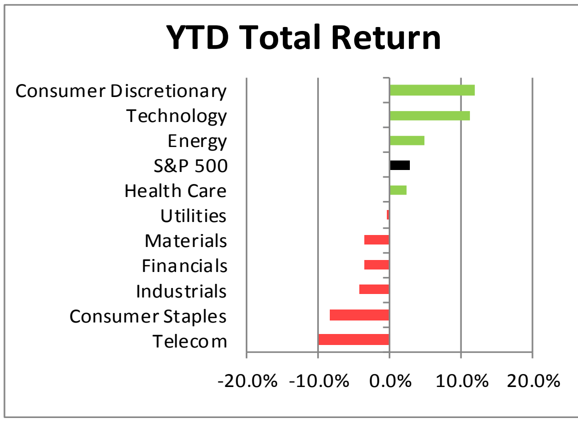
Although either scenario is possible, we tend to expect the first is more likely. There is little evidence that the economy is near recession, which is the primary cause of cyclical bear markets. While earnings growth will likely slow next year, the tax law changes should keep the level of earnings elevated. In fact, the recent weak performance in equities is due to multiple contraction, most likely due to fears surrounding trade conflicts. If the administration can resolve these issues without serious incident, it would bolster the case for a rally next year. On the other hand, if trade issues escalate, the second scenario is more likely, which would be no major pullback in equities but a long-term sideways market.

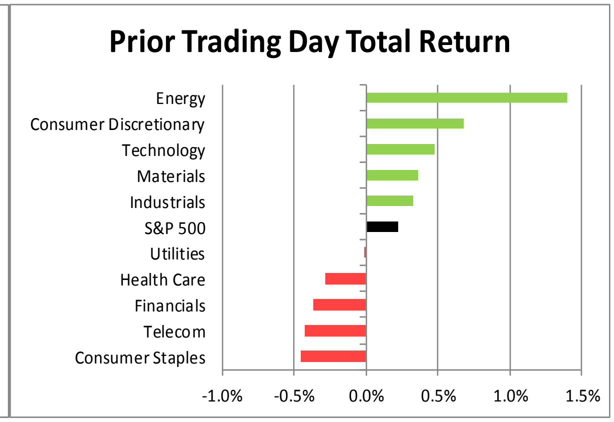
Clearly, other factors will play a role and these cyclical studies are not definitive. Nevertheless, they do offer some insight into the normal policy cycle, which the current presidency was tracking until November. For now, we consider a trade war the most near-term serious threat to equities.

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 6/26/2018 close)

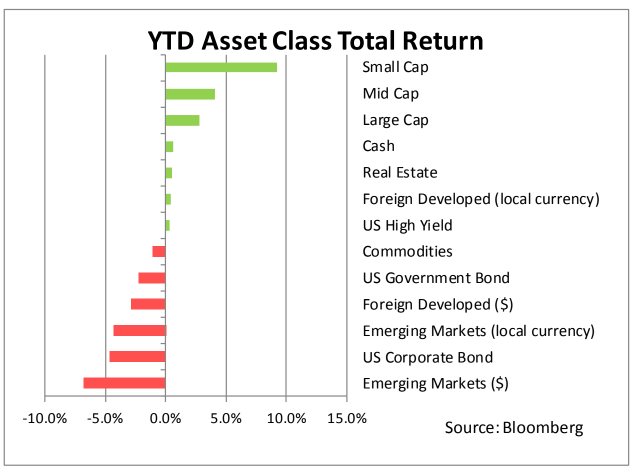




(Source: Bloomberg)

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 6/26/2018 close)

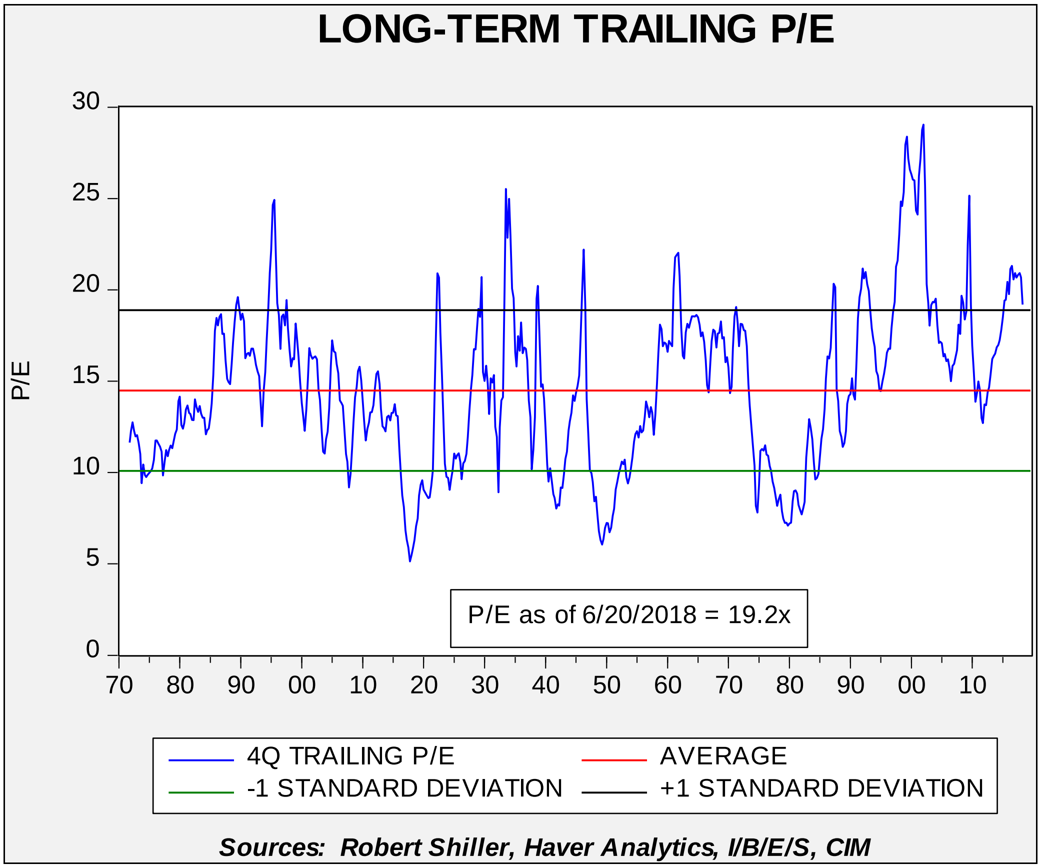


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 21, 2018



Based on our methodology,[8] the current P/E is 19.2x, unchanged from last week.

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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[8] 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.