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 29, 2018—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 1.3% from the last close. In Asia, the MSCI Asia Apex 50 closed up 1.6% from the prior close. Chinese markets were up, with the Shanghai composite up 2.2% and the Shenzhen index up 3.3%. U.S. equity index futures are signaling a higher open.

Happy Friday and good riddance to Q2! It's looking like a risk-on day. Lots of news today. Let's dig in:

EU summit: A deal was struck on immigration and refugees in a nearly all-night session.[1] The agreement says that seaborne migrants will be placed into processing centers in the EU itself. These centers will sort out who are legitimate asylum seekers from those who are just migrating. Nations will ***voluntarily*** establish these centers with support from the broader EU (read: Germany). There are promises that enough money will be allocated to encourage border nations (read: Italy) to set up these centers. Although the deal is being hailed (the EUR jumped on the news), in reality, no nation has yet agreed to actually establish such "controlled centers" and it also isn't clear which nations will take the immigrants once they are accepted. Merkel was able to get language put in place that requires the initial nation to keep tabs on the new immigrants to ensure they don't move across borders. It isn't at all obvious how this can be executed under Schengen rules, which allow EU member citizens to freely move about the continent. Merkel needed this element to quell the internal political threat from Bavaria.

Although Italy, Poland, Hungary and the Czech Republic are governed by populists, the agendas differ. Italy wants refugees dispersed around the EU to relieve the burden on Italy, a frontline state. Under EU rules, Italy is responsible for the migrants if they land on Italian soil. Poland, Hungary and the Czech Republic resisted any plans that would force them to take refugees. Essentially, no deal was reached other than to establish the processing centers. The bottom line: it wasn't the worst outcome but, in reality, little was accomplished. The EU remains in trouble on this issue.

U.S. ditching the WTO? Axios[2] is reporting that President Trump is indicating a desire to leave the WTO. So far, no one in his administration, as best we can tell, is supportive of this action.

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[1] https://www.ft.com/content/4831b0c8-7b52-11e8-bc55-50daf11b720d

[2] https://www.axios.com/trump-threat-withdraw-wto-world-trade-organization-f6ca180e-47d6-42aa-a3a3-f3228e97d715.html

In reality, the U.S. is crippling the WTO by refusing to approve appellate judges that handle trade dispute appeals. In September, an appellate judge is expected to retire and once he does so the body won't have a quorum, therefore disputes cannot be appealed.[3] So, by continuing to veto judges, the administration is effectively rendering the WTO into irrelevance. However, the optics of the U.S. actually leaving the WTO would send an unmistakable sign that the postwar order, built on U.S. hegemony, is over. One of the president's strengths is "political theater." He knows how important visual symbolism is; the summit with North Korea is a good example. Leaving the WTO would be part of that as well. If the U.S exits the WTO, look for the dollar to rise and pressure on foreign equities to escalate as well.

Mexican elections: Mexico will hold elections on Sunday. Barring an epic political surprise, Lopez Obrador, otherwise known as AMLO, will be the next president of the country. Mexican voters are angry. Corruption is rife, security is lacking due to narco-terrorism and the economy is struggling due to concerns around NAFTA and the weak peso. AMLO is making broad promises to clean up corruption and improve the economy. In addition, Mexicans want a leader who will stand up to the verbal assaults coming from Washington. We view him as a populist in the model of Lula in Brazil, not Chavez in Venezuela. Although his election is well anticipated and should have already been discounted by the financial markets, his actual election could put further pressure on Mexican financial assets.

Central bank notes: A couple of items. Chair Powell will testify before Congress on July 17.[4] Boston FRB President Rosengren, who for most of his career has been a dove, is signaling support for two more rate hikes this year.[5] Today's core PCE number, hitting 2%, supports higher rates. The ECB is considering some form of "operation twist" to keep long rates low,[6] which would be supportive for lower rates here.

Iran: Japan and India[7] are indicating they will reduce oil imports from Iran, which is boosting oil prices (mostly Brent) this morning. The administration finds itself at cross-purposes. It wants lower oil prices (thus the tweet storms against OPEC), but it is also sanctioning Iran, which is bullish for oil.

Banning cryptocurrencies: The U.S. government has apparently realized that cryptocurrencies could be a way for excessive and perhaps illegal campaign contributions.[8] Mostly untraceable, cryptocurrencies could come into a campaign and be spent without a traceable record. The Secret Service has apparently warned Congress to this threat.

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[3] https://www.politico.eu/article/wto-donald-trump-protectionism-brussels-fears-trump-wants-the-wto-to-fail/

[4] https://www.wsj.com/articles/powell-to-testify-before-senate-on-july-17-1530237985?mod=hp_listb_pos1

[5] https://www.wsj.com/articles/boston-feds-rosengren-says-its-time-to-take-away-monetary-policy-punch-bowl-1530192388

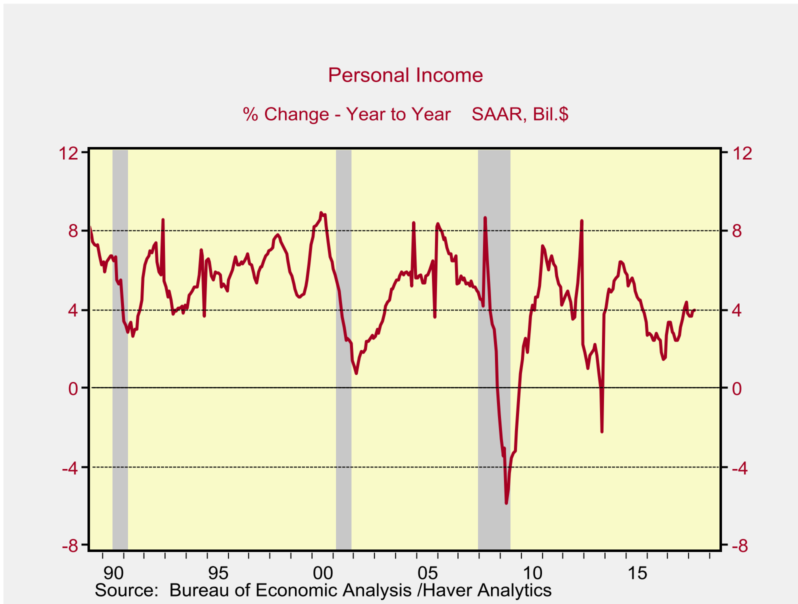
[6] https://www.reuters.com/article/us-ecb-policy/ecb-mulls-small-twist-to-keep-borrowing-costs-low-sources-idUSKBN1JP0XX

[7] https://www.reuters.com/article/us-india-iran-oil-exclusive/exclusive-india-preparing-for-cut-in-oil-imports-from-iran-sources-idUSKBN1JO18L

[8] https://www.ccn.com/congress-should-take-action-against-privacy-coins-secret-service-official/

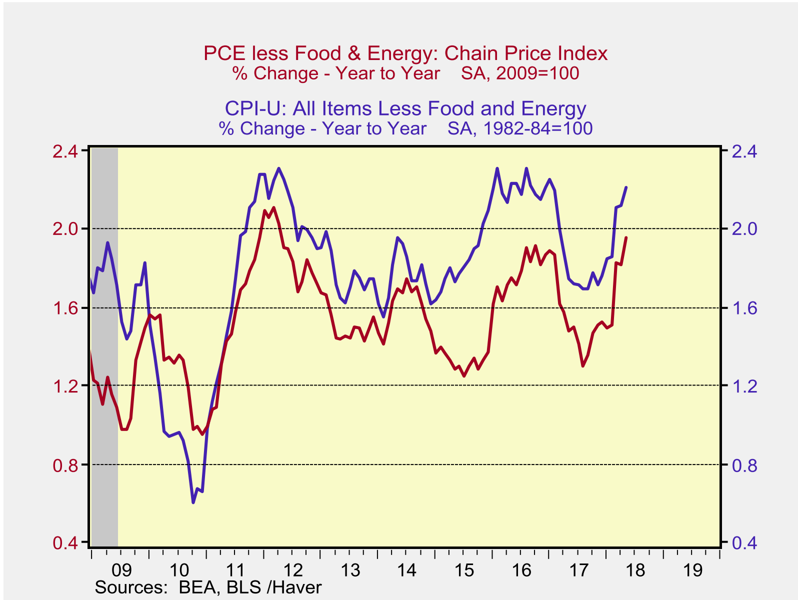
U.S. Economic Releases

Personal income was in line with expectations, rising 0.4% from the prior month. The prior report's gain was revised downward from 0.3% to 0.2%. Personal spending came in below expectations, rising 0.2% from the prior month compared to the forecast of 0.4%. The prior report's gain was revised upward from 0.5% to 0.6%. Real personal spending came in below expectations, remaining unchanged from the prior month compared to the forecast of 0.2%. The prior report's gain was revised from 0.4% to 0.6%.



The chart above shows the year-over-year change in personal income. Personal income rose 3.9% from the prior year.

The PCE deflator was in line with expectations, rising 0.2% from the prior month. Core PCE was also in line with expectations, also rising 0.2% from the prior month.



The chart above shows the year-over-year change in core PCE and core CPI. Annual core PCE and core CPI rose 2.0% and 2.2%, respectively.[9]

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Chicago Purchasing Manager	m/m	jun	60.0	62.7	**
10:00	U. of Michigan Sentiment	m/m	jun	99.0	99.3	***
10:00	U. of Michigan Current Conditions	m/m	jun		117.9	**
10:00	U. of Michigan Expectations	m/m	jun		87.4	**
10:00	U. of Michigan 1 yr Inflation	m/m	jun		2.9%	**
10:00	U. of Michigan 5-10 Yr Inflation	m/m	jun		2.6%	**
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.

[9] Note on the chart that the core PCE isn't quite at 2.0%. That's because it's really 1.955% but the media is rounding it up to 2.0%.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
Japan	Job-To-Applicant Ratio	m/m	jun	1.60	1.59	1.59	***	Equity bullish, bond bearish
	Jobless Rate	m/m	jun	2.2%	2.5%	2.5%	***	Equity bullish, bond bearish
	Tokyo CPI	m/m	jun	0.6%	0.4%	0.4%	***	Equity bullish, bond bearish
	Tokyo CPI ex Food	m/m	jul	0.7%	0.5%	0.6%	***	Equity bullish, bond bearish
	Industrial Production	m/m	jun	4.2%	2.6%	3.5%	***	Equity bullish, bond bearish
	Housing Starts	m/m	may	1.3%	0.3%	-5.7%	**	Equity bullish, bond bearish
	Construction Orders	y/y	may	-18.7%	4.0%		**	Equity and bond neutral
Australia	Private Sector Credit	y/y	may	4.8%	5.1%	5.0%	**	Equity and bond neutral
New Zealand	ANZ Consumer Confidence	m/m	jun	-0.8%	0.4%		**	Equity and bond neutral
	Building Permits	m/m	may	7.1%	-3.7%		**	Equity and bond neutral
EUROPE								
Eurozone	CPI Core	y/y	may	1.0%	1.0%	1.1%	***	Equity and bond neutral
	CPI Estimate	m/m	may	2.0%	1.9%	2.0%	***	Equity and bond neutral
Germany	Retail Sales	y/y	may	-1.6%	1.2%	1.9%	**	Equity bearish, bond bullish
	Import Price Index	m/m	may	3.2%	0.6%	2.4%	**	Equity bullish, bond bearish
France	PPI	y/y	may	2.9%	2.3%		**	Equity and bond neutral
	Consumer Spending	m/m	may	-0.2%	0.2%	0.1%	**	Equity bearish, bond bullish
	CPI	y/y	jun	2.1%	2.0%	2.1%	***	Equity and bond neutral
U.K.	GDP	m/m	1q	1.2%	1.2%	1.2%	***	Equity and bond neutral
	Current Account Balance	q/q	1q	-17.7 bn	-18.4 bn	-17.9 bn	**	Equity and bond neutral
	Total Business Investment	m/m	1q	2.0%	2.0%	2.0%	**	Equity and bond neutral
Switzerland	KOF LEI	m/m	jun	101.7	100.0	99.7	**	Equity bullish, bond bearish
AMERICAS								
Mexico	CFIB Business Barometer	y/y	may	62.2	62.5		**	Equity and bond neutral
Brazil	Central Government Budget Balance	m/m	may	-11.0 bn	7.2 bn	-10.2 bn	**	Equity bearish, bond bullish

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)	188	188	0	Neutral
TED spread (bps)	46	45	1	Neutral
U.S. Libor/OIS spread (bps)	194	194	0	Up
10-yr T-note (%)	2.84	2.84	0.00	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	6	7	-1	Down
Currencies	**Direction**			
dollar	down			Down
euro	up			Up
yen	down			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	$78.77	$77.85	1.18%	Supply Concerns
WTI	$73.29	$73.45	-0.22%	
Natural Gas	$2.94	$2.94	-0.17%	
Crack Spread	$16.94	$16.01	5.83%	
12-mo strip crack	$19.50	$18.93	3.01%	
Ethanol rack	$1.58	$1.58	-0.06%	
Metals				
Gold	$1,250.95	$1,248.25	0.22%	
Silver	$16.04	$16.00	0.22%	
Copper contract	$297.85	$297.15	0.24%	
Grains				
Corn contract	$ 368.75	$ 366.00	0.75%	
Wheat contract	$ 488.25	$ 483.50	0.98%	
Soybeans contract	$ 885.50	$ 883.50	0.23%	
Shipping				
Baltic Dry Freight	1329	1309	20	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-9.9	-2.5	-7.4	
Gasoline (mb)	1.2	1.0	0.2	
Distillates (mb)	0.0	1.5	-1.5	
Refinery run rates (%)	0.80%	0.10%	0.0	
Natural gas (bcf)	72.0	73.0	-1.0	

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.

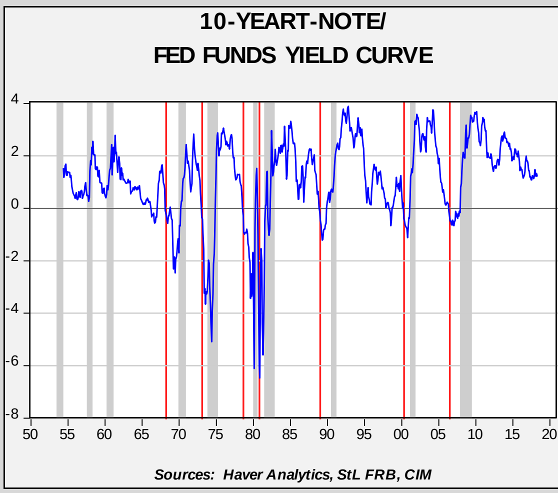
Asset Allocation Weekly Comment

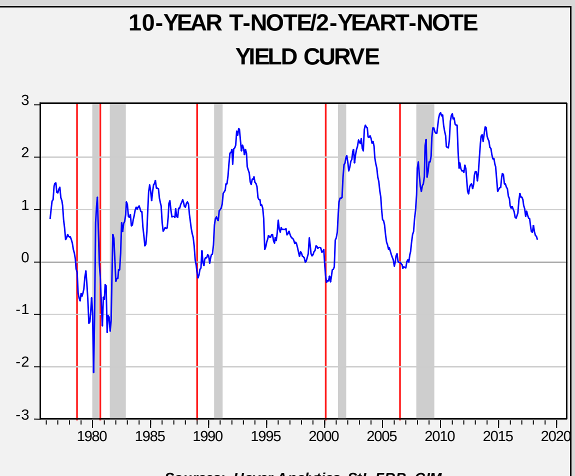
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

June 29, 2018

With the recent narrowing of the yield curve, we have been receiving a number of questions about the impact of inversion. Defined, yield curve inversion is when short-duration interest rates rise above long-duration interest rates. The yield curve is arguably the single best indicator of recession. Therefore, with various calculations of the yield curve narrowing, we want to examine the impact of inversion.

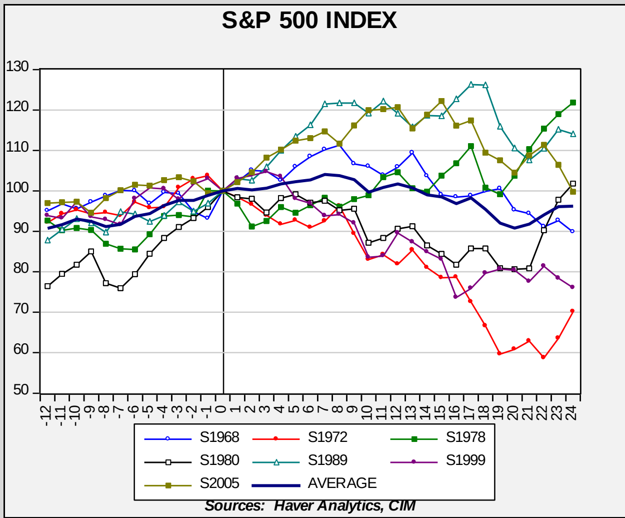
The first problem one confronts during this analysis is defining which rate spread constitutes the most appropriate yield curve to monitor. The Conference Board, in its calculation of leading economic indicators, uses the 10-year T-note yield less fed funds. This spread compares a market yield (the 10-year T-note) with a policy rate (fed funds); given that the latter is mostly in control of the Federal Reserve, this measure of the yield curve is the clearest indication of policy intentions. In other words, when the FOMC allows the policy rate to exceed long-duration yields, it clearly believes that the threat of inflation outweighs the potential costs of recession. The problem with this yield curve is that one part of it is directly under the control of policymakers and thus can be manipulated. The other popular measure is the 10-year T-note less the two-year T-note. Because the rates are mostly set by the market, this spread represents the market's estimate of the potential of recession.

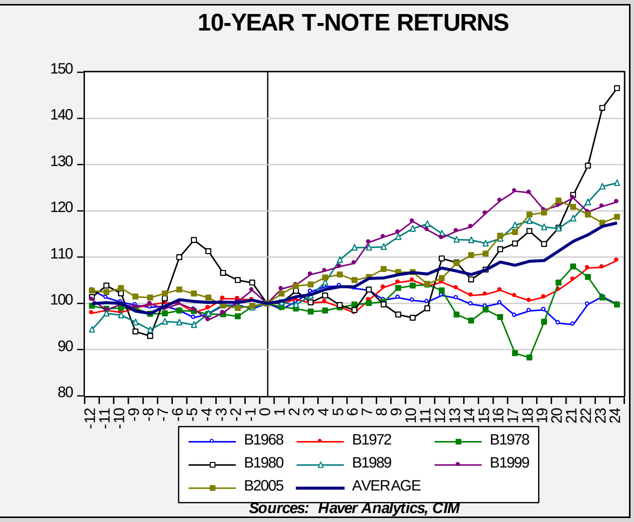




The above graphs show both of the aforementioned yield curves. Recessions are shown by gray bars; the red vertical lines indicate the month of yield curve inversion prior to a recession. We have a longer history for fed funds compared to the two-year T-note, but the results are similar. The fed funds version inverts, on average, 14 months before the onset of recession. The shortest lead was nine months, while the longest was 20 months. For the two-year T-note version, the average from inversion to recession was 15 months, with the shortest lead at 10 months and the longest at 18 months. The fed funds version did produce two false positives, in 1966 and 1998, while the two-year T-note version had one, in 2006. But, as business cycle indicators go, either version of the yield curve is very reliable and gives sufficient warning.

So, if the yield curve inverts, what should investors do?



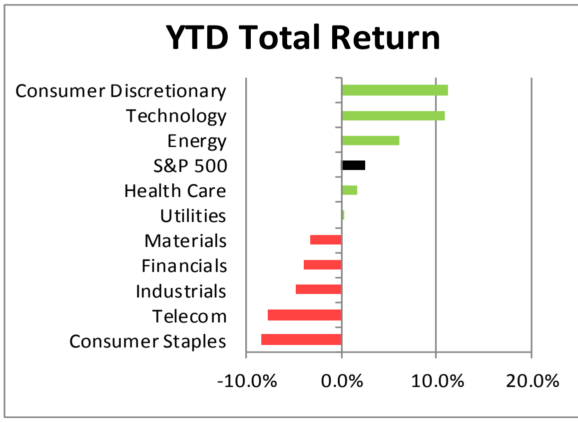


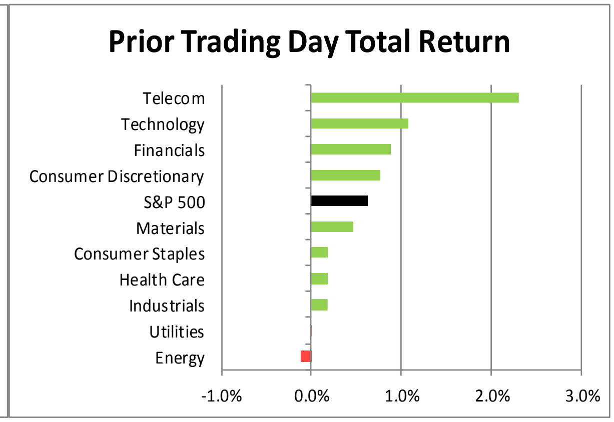
These two charts show equities (the S&P 500) and long-duration bonds (10-year T-notes total return index), indexed to the yield curve inversion (shown as a vertical line on the chart). We looked at the data 12 months before the inversion and 24 months after the inversion. We also calculated the average for the seven events. The data show that these financial markets don't always treat inversions as bearish. Under low inflation conditions, long-duration interest rates tend to perform well. Equities decline about 10% or less after inversion the majority of the time; however, in three cases, they actually continued to rise. Furthermore, during the 2005 inversion the real bear market didn't start until two years after the yield curve turned negative.

We are paying very close attention to the yield curve but it should be noted that it may take a few months before equity markets peak even after inversion takes place. Thus, investors should not necessarily exit equities but should be prepared to reduce exposure. On the other hand, inversion is a reasonably reliable signal that extending duration in fixed income should be considered.

Data Section

U.S. Equity Markets – (as of 6/28/2018 close)

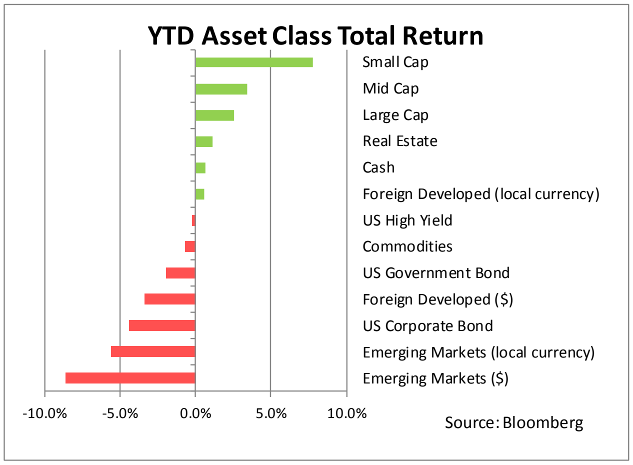




(Source: Bloomberg)

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 6/28/2018 close)

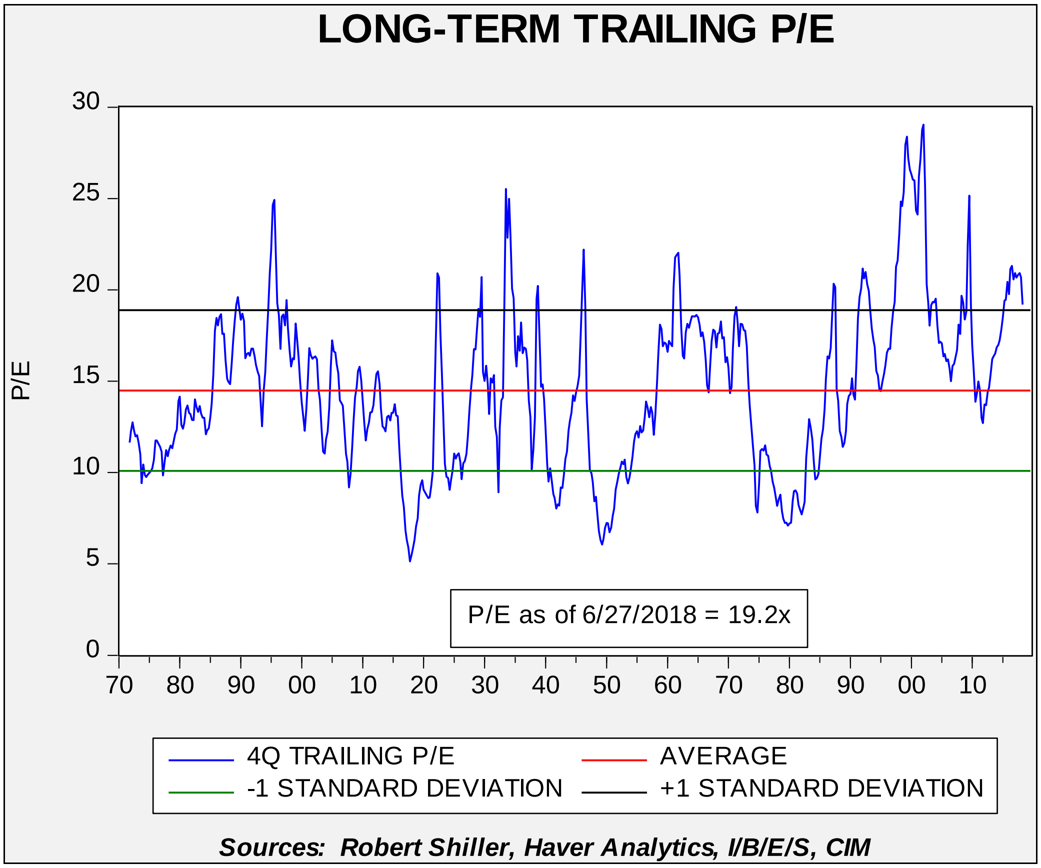


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 28, 2018



Based on our methodology,[10] 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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[10] 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.