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 4, 2018—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.5% from the last close. In Asia, the MSCI Asia Apex 50 closed up 1.5% from the prior close. Chinese markets were up, with the Shanghai composite up 0.5% and the Shenzhen index up 0.1%. U.S. equity index futures are signaling a higher open.

Happy Monday! Equities are ticking higher this morning, walking up a wall of worry. Here is what we are watching this morning:

Trade friction: A couple of weekends ago, Treasury Secretary Mnuchin declared a ceasefire on trade. It didn't last very long. Over the weekend, meetings with Commerce Secretary Ross and Chinese officials ended on a frosty note.[1] No joint communiqué was released and China indicated it would respond with retaliatory action if the U.S. places tariffs on Chinese imports. Some of the issue here is that China thought it had secured a "time out" from the treasury secretary; turns out that wasn't the case.

Meanwhile, Treasury Secretary Mnuchin faced a hostile group of allies at the G-7 meeting. The weekend pre-meeting with finance ministers ended with a public split between the U.S. and the rest of the group.[2] The leaders meet in Quebec this weekend and all indications are that this will be a difficult meeting.

Here is the basic issue. At the end of WWII, the U.S. created a hegemonic structure that was unique to world history. Instead of creating colonies that would be forced to run trade deficits with the host nation, the U.S. fostered a global trading system that virtually guaranteed the U.S. would run trade deficits. When Nixon closed the gold window, foreign nations shifted from a dollar/gold standard to a dollar/Treasury standard rather than adjust their economies. Since the U.S. can create Treasuries rather cheaply and with no feasible limit, there was little foreign constraint on U.S. debt growth or the size of the trade deficit. In return for this generosity, the U.S. demanded the nations in the American trade orbit submit to U.S. foreign policy goals.

This was a Cold War strategy. It was designed to create a unified free world and it worked. There were serious downsides, however. Foreign nations structured their economies to generate

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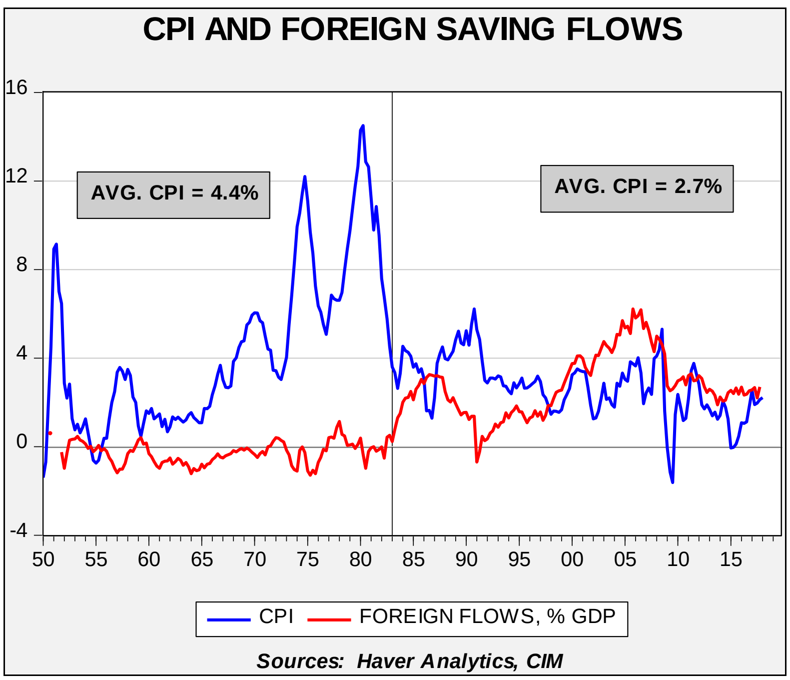
[1] https://www.ft.com/content/26efcf88-670e-11e8-b6eb-4acfcfb08c11?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56 and https://www.nytimes.com/2018/06/03/world/asia/us-china-trade.html
[2] https://www.ft.com/content/7b5fab1e-66c9-11e8-8cf3-0c230fa67aec?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56 and https://www.wsj.com/articles/global-trade-tensions-intensify-1528070538

trade surpluses that would lead to unemployment in the U.S. If we use the saving identity from macroeconomics, (M-X) = (I-S) + (G-Tx), trade surpluses are created by excessive public or private saving (S>I, X>M) or (Tx>G, X>M). The U.S., being open to trade, must absorb the excess saving in the form of a trade deficit, which is seen domestically as either a deficit in private saving or, more commonly, a fiscal deficit. This is why the common comment often heard in the financial media that the U.S. "must attract foreign saving" isn't really accurate. If that were the case, U.S. interest rates would need to rise to attract the funds. In fact, U.S. rates remain quite low.

This trade arrangement is a vestige of the Cold War.[3] The U.S. has every right to call for a new arrangement. This change will be very painful for the rest of the world as it will force a restructuring on those economies. Imagine Germany having to reduce its saving, as an example. There are no stone tables anywhere saying that the U.S. must act to absorb the world savings. However, this doesn't mean that there won't be costs of adjustment to the U.S., too. First, foreign nations will be less beholden to the U.S. if they no longer rely on American consumption to absorb their excess production. Thus, it would not be a shock to see the alliance system the U.S. built during the Cold War collapse. And, second, it will almost certainly cause higher U.S. inflation.



This chart shows the relationship between foreign saving flows (the inverse of the current account deficit) and CPI. Since inflows have increased, inflation has declined. This is part of the impact of globalization.

[3] https://www.washingtonpost.com/business/economy/trump-thinks-hes-saving-trade-the-rest-of-the-world-thinks-hes-blowing-it-up/2018/06/02/27afa736-6678-11e8-a768-ed043e33f1dc_story.html?utm_term=.69f5d08211fa

Is there a more effective way of prompting this change? We doubt negotiations would work. A good example is China, which shows no interest in changing its policies and simply wants to promise to buy more soybeans. That isn't reform, that's a bribe. The border adjustment tax would have been a good tool for this change. Another would be to use the self-adjustment mechanism from the gold standard—force the dollar to depreciate. Under the gold standard, a nation running a large trade surplus would accumulate gold and face inflation, while the deficit nation would have the opposite problem. The changes in prices would naturally lead to a reversal of trade flows. The large foreign reserve surplus nations are (or have done so in the past) purposely preventing their currencies from appreciating buy purchasing dollars (Treasuries). The U.S. could counter that action by aggressively buying foreign assets.

Politically, though, the trade war makes more sense. The average American better understands tariffs rather than exchange rates. President Trump's approval ratings have been steadily rising since the policy focus shifted from taxes to trade. With mid-terms looming, we don't see any reason why the White House would change tack.

Merkel on the EU: French President Macron has pushed for an expansion of powers for the EU. Chancellor Merkel offered her position[4] which is far less ambitious and more or less solidifies the existing fiscal rules. Merkel is trying to show she isn't a roadblock to further European integration but she won't permit an expansion that occurs on the back of German economic credibility.

Slovenia goes populist: In weekend elections, the Slovenian Democratic Party (SDS) took 25% of the vote, giving the anti-immigrant party 25 of the 90 elected seats. Although the dominant party, it will be a while before a government is formed as most of the other parties dislike the SDS.[5]

Kim fires senior military officials[6]: As the summit with President Trump approaches, Kim Jong-un reportedly replaced three senior military officials. Although it is always difficult to know for sure what is going on in the Hermit Kingdom, there are strong suspicions that these military officials may have opposed Kim's upcoming meeting with Trump and the potential thaw with the U.S. On the one hand, removing these officials just prior to a historic summit may indicate that he is facing significant internal dissent and thus if the meeting doesn't go well it could lead to political instability in North Korea. At the same time, taking this action before a major summit does indicate that Kim probably intends to press for a change in policy and will not brook potential opposition.

The employment report: We have received some questions about our non-farm payroll recession indicator, which shows that recessions tend to follow when the 12-month rolling total

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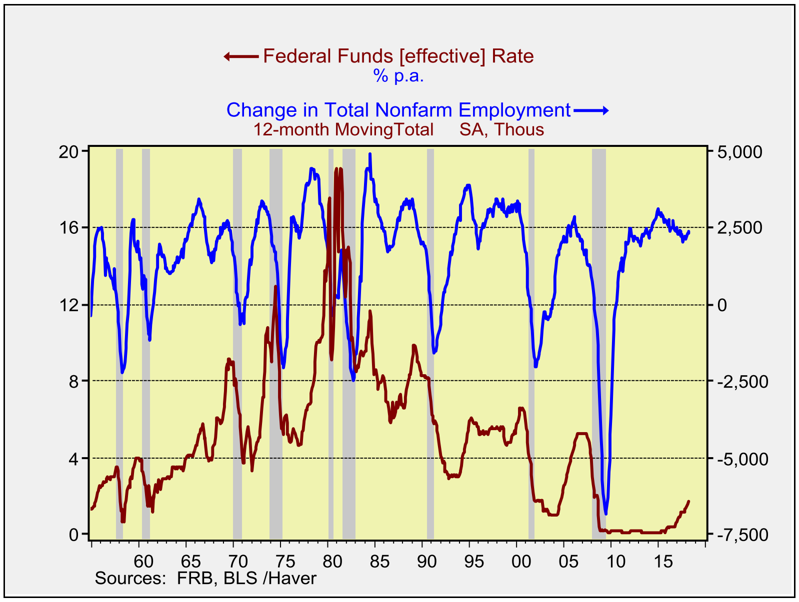
[4] https://www.ft.com/content/0b0bd67a-6706-11e8-8cf3-0c230fa67aec?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

[5] https://www.politico.eu/article/anti-immigration-sds-party-wins-slovenian-election-janez-jansa-miro-cerar/?utm_source=POLITICO.EU&utm_campaign=63318497f2-EMAIL_CAMPAIGN_2018_06_04_04_42&utm_medium=email&utm_term=0_10959edeb5-63318497f2-190334489

[6] https://www.reuters.com/article/us-northkorea-usa-military/north-koreas-top-three-military-officials-replaced-u-s-official-says-idUSKCN1IZ0XY

of payroll changes falls below 1.5 mm. There is some confusion on causality; the real culprit that causes recession is the FOMC. As the labor markets tighten, the Fed raises rates and the increase in rates is the real reason recessions occur. The drop below 1.5 mm signals when the Fed has overtightened.



U.S. Economic Releases

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

Economic Releases							
EDT	Indicator			Expected	Prior	Rating
10:00	Factory Orders	m/m	apr	-0.5%	1.6%	**
10:00	Factory Orders ex Trans	m/m	apr		0.3%	**
10:00	Durable Goods Orders	m/m	apr		-1.7%	**
10:00	Durable Goods Orders ex Transportation	m/m	apr		0.9%	**
10:00	Cap Goods Orders Nondef Ex Air	m/m	apr		1.0%	**
10:00	Cap Goods Ship Nondef Ex Air	m/m	apr		0.8%	**
Fed speakers or events						
No speakers or events scheduled						

Foreign Economic News

We monitor numerous global economic indicators on a continuous basis. The most significant international news that was released overnight is outlined below. Not all releases are equally significant, thus we have created a star rating to convey to our readers the importance of the various indicators. The rating column below is a three-star scale of importance, with one star being the least important and three stars being the most important. We note that these ratings do change over time as economic circumstances change. Additionally, for ease of reading, we have also color-coded the market impact section, which indicates the effect on the foreign market. Red indicates a concerning development, yellow indicates an emerging trend that we are following closely for possible complications and green indicates neutral conditions. We will add a paragraph below if any development merits further explanation.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
Japan	Monetary Base	m/m	may	8.1%	7.8%		**	Equity and bond neutral
	Monetary Base End of Period	m/m	may	¥492.6 bn	¥498.3 tn	¥492.9 tn	**	Equity and bond neutral
Australia	Melbourne Institute Inflation	m/m	may	0.0%	0.5%		**	Equity and bond neutral
	Inventories	m/m	may	0.7%	0.2%	0.0%	**	Equity bullish, bond bearish
	Company Operating Profits	m/m	may	5.9%	2.2%	3.0%	**	Equity bullish, bond bearish
	ANZ Job Advertisements	m/m	may	1.5%	-0.2%		**	Equity and bond neutral
	Retail Sales	m/m	may	0.4%	0.0%	0.3%	**	Equity bullish, bond bearish
EUROPE								
Eurozone	Sentix Investor Confidence	m/m	may	9.3	19.2	18.5	**	Equity bearish, bond bullish
	PPI	m/m	may	2.0%	0.1%	0.2%	**	Equity bullish, bond bearish
U.K.	Markit/CIPS UK Construction	m/m	may	52.5	52.5	52.0	**	Equity bullish, bond bearish
Switzerland	Total Sight Deposits	m/m	may	576.5 bn	576.6 bn		*	Equity and bond neutral
	Domestic Sight Deposits	m/m	may	467.3 bn	466.3 bn		*	Equity and bond neutral
AMERICAS								
Mexico	Markit Mexico PMI Mfg	m/m	may	51.0	51.6		**	Equity and bond neutral
	IMEF Non-Manufacturing Index	m/m	may	51.1	52.4	52.6	**	Equity and bond neutral
	IMEF Manufacturing Index	m/m	may	51.0	51.7	52.0	**	Equity and bond neutral
Canada	Markit Canada Manufacturing PMI	m/m	may	56.2	55.5		**	Equity bullish, bond bearish
Brazil	Markit Brazil PMI Manufacturing	m/m	may	50.7	52.3		**	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)	232	232	0	Up
3-mo T-bill yield (bps)	187	187	0	Neutral
TED spread (bps)	45	45	0	Neutral
U.S. Libor/OIS spread (bps)	190	190	0	Up
10-yr T-note (%)	2.91	2.90	0.01	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	10	13	-3	Down
Currencies	**Direction**			
dollar	down			Down
euro	up			Up
yen	up			Up
pound	up			Up
franc	up			Neutral

Commodity Markets

The commodity section below shows some of the commodity prices and their change from the prior trading day, with commentary on the cause of the change highlighted in the last column.

	Price	Prior	Change	Explanation
Energy Markets				
Brent	$75.93	$76.79	-1.12%	OPEC Speculation
WTI	$65.46	$65.81	-0.53%	
Natural Gas	$2.97	$2.96	0.41%	
Crack Spread	$24.25	$24.54	-1.17%	
12-mo strip crack	$22.83	$23.13	-1.29%	
Ethanol rack	$1.61	$1.61	-0.04%	
Metals				
Gold	$1,294.93	$1,293.40	0.12%	
Silver	$16.45	$16.41	0.23%	
Copper contract	$311.70	$309.85	0.60%	
Grains				
Corn contract	$ 387.50	$ 391.50	-1.02%	
Wheat contract	$ 514.50	$ 523.25	-1.67%	
Soybeans contract	$ 1,010.75	$ 1,021.25	-1.03%	
Shipping				
Baltic Dry Freight	1156	1090	66	

Weather

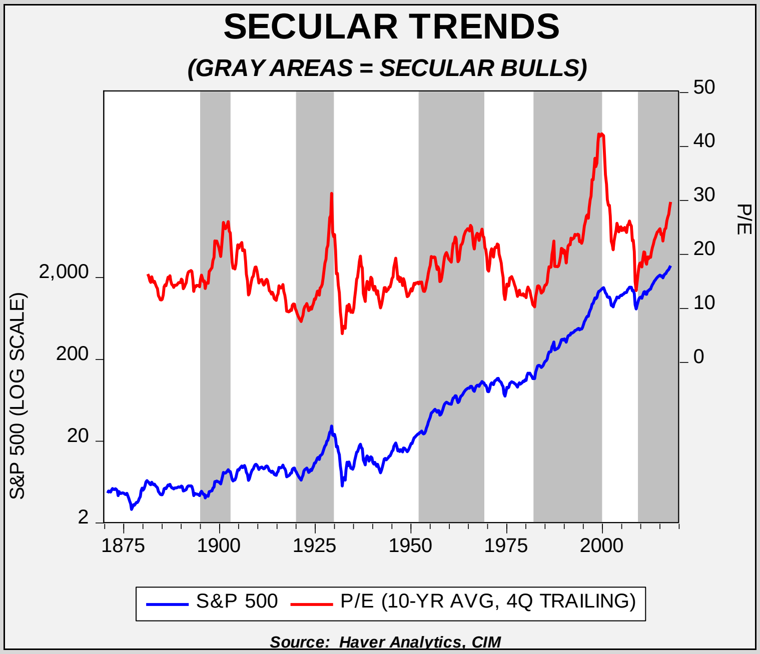
The 6-10 and 8-14 day forecasts continue to signal warmer to normal temperatures for most of the country. There are no tropical storms expected over the next 48 hours.

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 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.[7] 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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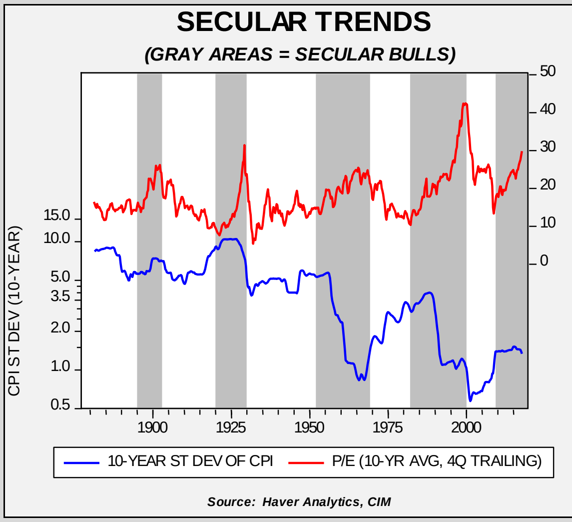
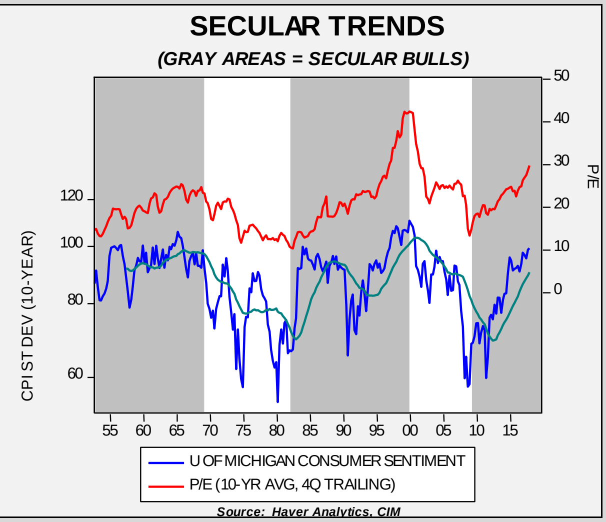
[7] The 10-year P/E is calculated by the 10-year average of nominal earnings divided by the current value of the S&P 500. The multiple is similar to the Shiller P/E except that the latter deflates both by CPI.





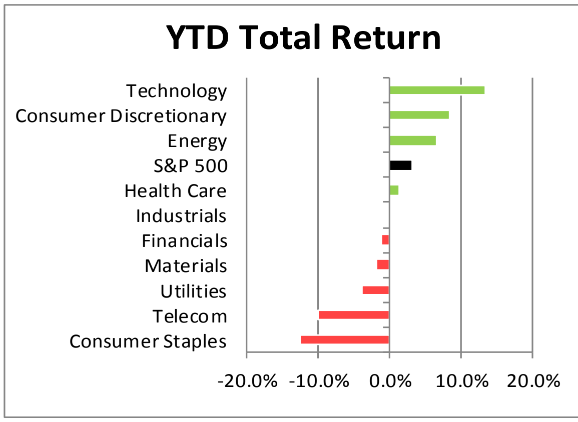
The chart on the left shows the aforementioned P/E with the 10-year rolling standard deviation of inflation. Secular trends are shaded in gray. Although not a perfect indicator, in general, rising inflation volatility tends to coincide with a lower P/E. With all financial assets, inflation is an important 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.

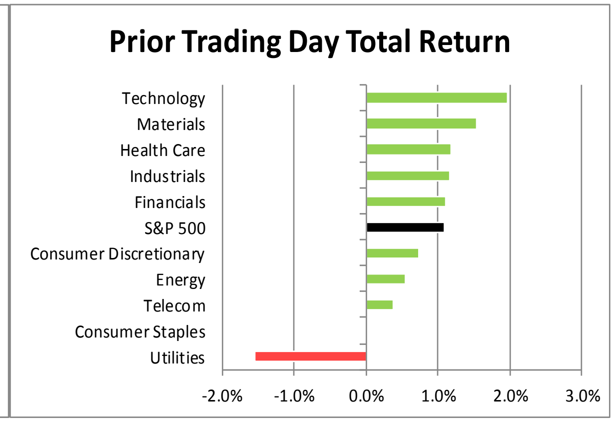
There is an old saying that "bond investors don't build hospital wings." In other words, equities are the best way to build wealth. At the same time, investing in equities requires optimism about the future. War, civil unrest, social disruption and geopolitical uncertainty should make citizens reluctant 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 6/1/2018 close)

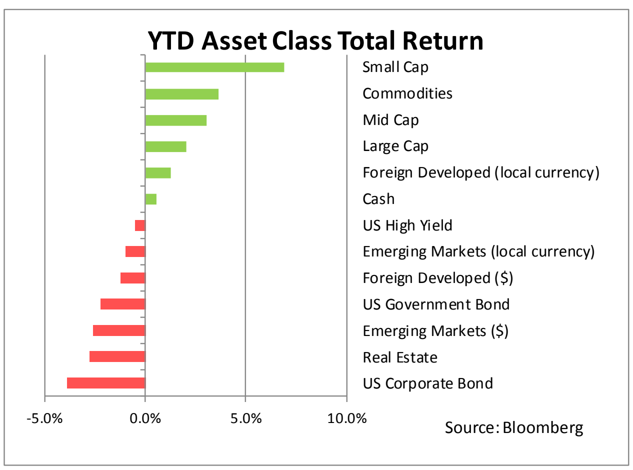




(Source: Bloomberg)

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 6/1/2018 close)

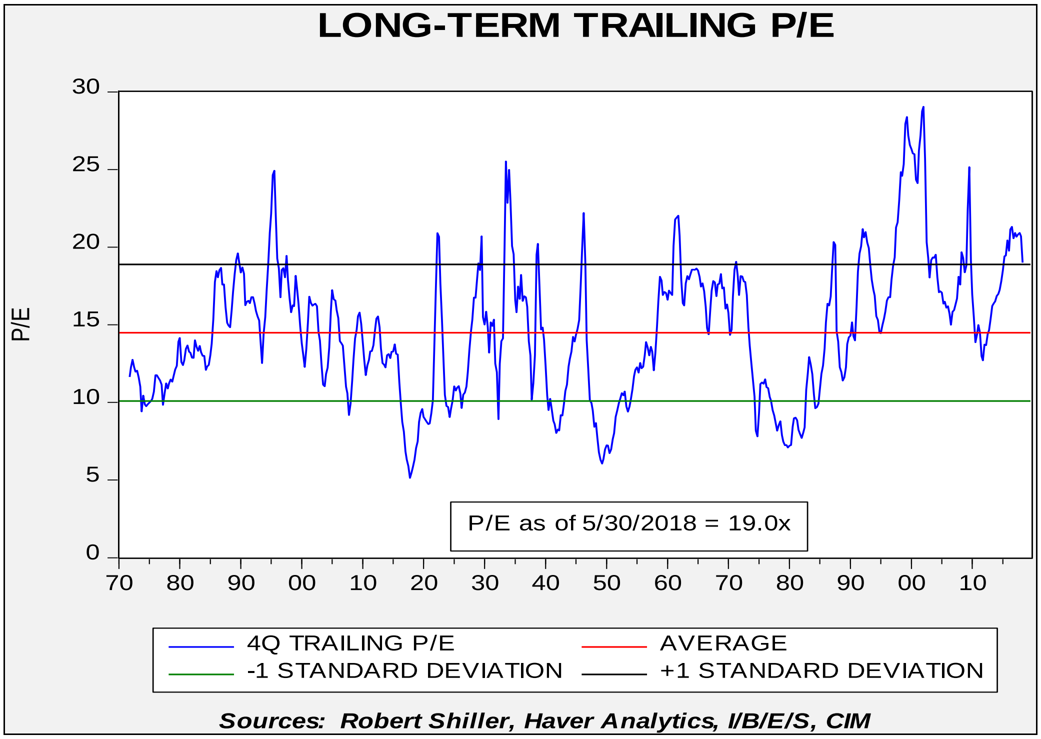


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[8] the current P/E is 19.0x, unchanged from last week.

[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.