

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, 2019—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.5% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.8% from the prior close. Chinese markets were down, with the Shanghai composite down 1.0% and the Shenzhen index down 1.4%. U.S. equity index futures are signaling a higher open.

Good morning! It's the 30th anniversary of the Tiananmen Square crackdown. President Trump's visit to the U.K. continues today. We are seeing a bit of risk-on this morning as equities make a modest recovery. Here is what we are watching today:

Fed meets in Chicago: The [Federal Reserve is holding a conference in Chicago today and tomorrow](#) to discuss the inflation target. Members of the FOMC have expressed concerns for some time about the target and how it is interpreted by the market. For the most part, it has evolved into a 2% ceiling on price changes; although this target is clearly workable, the Fed wants to avoid, at all costs, being boxed in to a policy that it might not want to adopt. This has always been the argument against rules-based policy. For years, economists have argued that the Fed could put policy on a sort of autopilot where the model would generate the "correct" policy rate depending on whether a certain combination of factors exist. The benefits of such a program would be certainty; we would always know what the policy rate would be going forward. The downside is that unexpected conditions could develop that were not in place when the model was created and force policymakers into rate adjustments that may be inappropriate.

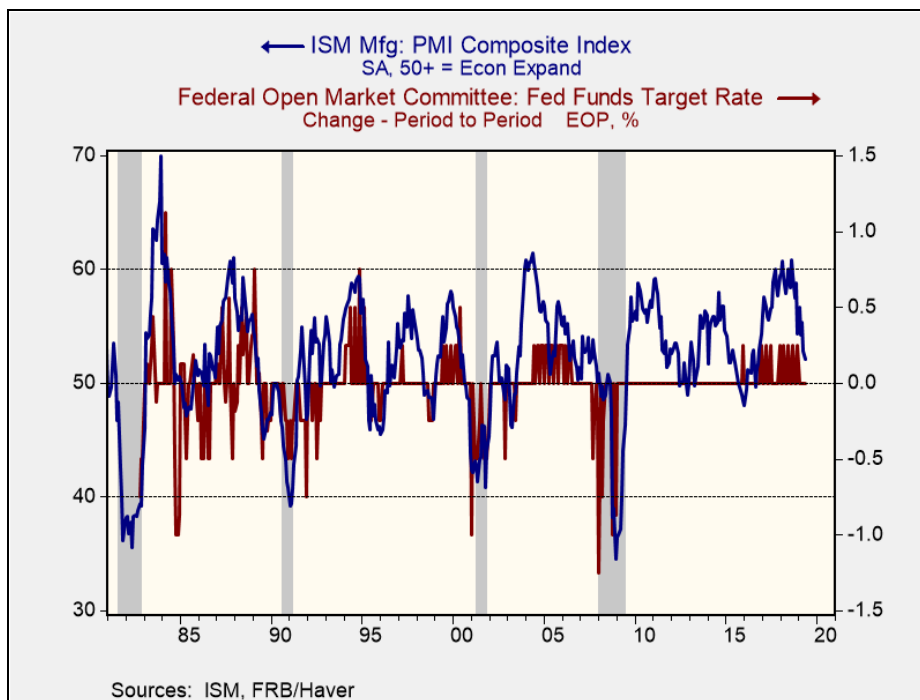
Policymakers have become increasingly concerned that the perception of the 2% ceiling on inflation may not be appropriate and are considering making changes to the inflation bogey to give themselves more flexibility. [There are several potential adjustments being considered](#). We suspect that none will be decided upon at this meeting but the groundwork will likely be laid for an adjustment. The bottom line is that the Fed wants an inflation target that is less rigid but still provides a guideline for the markets to follow.

Weakening global growth: We are seeing reports from the [transportation sector](#) suggesting the global economy is coming under pressure. Additionally, the [global PMI index](#) has dipped under the 50 expansion line. Weaker global growth will add to pressure on U.S. policymakers to ease.

Tightening fiscal policy? The U.S. has been engaging in fiscal stimulus, but there are two issues that could reverse this policy. First, the debt ceiling issue will return by September and [automatic spending cuts](#) will be enforced if a deal can't be reached. Second, although the full effects are difficult to determine, tariffs are, essentially, a form of consumption tax and [raising](#)

[them is an act of fiscal tightening](#). Tightening fiscal policy may force the FOMC to start cutting rates.

Bullard and rate cuts: [St. Louis FRB President Bullard](#) chased a short-term rally in equities when he suggested the FOMC may need to cut rates soon. We rate Bullard a level 5 dove in our rating system (1 = most hawkish, 5 = most dovish), so his stance isn't a shocker. However, we suspect his position probably isn't the consensus on the FOMC. One reason why is that the ISM Manufacturing Index is still in expansion mode.



This chart looks at the ISM Manufacturing Index and the monthly change in the fed funds target. Since 1983, a period of 403 months, the FOMC has cut rates when the ISM index was above 50 in 21 occasions. We do note there were a series of cuts that began in August 2007 even though the ISM was safely above 50. The trigger for these cuts came from a sharp deterioration in financial conditions in Q3 2007. In the absence of a drop in financial conditions, which are currently benign, the FOMC will likely need to see more economic weakness to trigger rate reductions.

More on tech: [Tech shares took a beating yesterday](#), with the Technology sector SPDR (XLK, 70.63) falling 1.8%. It does appear that a bipartisan move to regulate the large firms in the sector, [including anti-trust actions](#), is progressing. Although it is [unclear how this will play out](#), and it will likely take years to fully develop, the regulatory move will distract these firms and likely have an adverse impact on their performance.

Mexico: There are a number of cross-currents affecting the situation with Mexico. First, Mexico is creating multiple responses to the tariff threat. It has [threatened retaliation](#), although the impact of any [retaliation will be disproportionate](#) to the damage the U.S. can inflict on Mexico.

There are also indications that [Mexico is starting its own crackdown](#) against illegal migration, but the [government has indicated](#) it will [not grant Mexican asylum](#) to Central Americans moving into the country. Second, Mexico is trying to negotiate a deal that might prevent the tariffs from being implemented. Third, there is an [apparent effort](#) by Congress to take back some of its trade authority by blocking the president's proposed tariffs on Mexico. Congress has mostly given up its role in shaping trade policy after making a hash out of it in the 1920s in a bill known as the Smoot-Hawley Tariff. However, the administration's strategy of [using tariffs as its main foreign policy tool](#) appears to be stirring a congressional response. If Congress limits the White House's ability to unilaterally act on tariffs, this policy tool may not be as easy to implement going forward.

Trouble for Maduro: Venezuelan President Maduro has suffered another blow as Russia begins to pull advisors out of the country. The defense firm [Rostec](#), which was training Venezuelan security forces, has decided to reduce the number of trainers, mostly [because the country can't afford to pay them](#) anymore. This news not only shows the degree of economic deterioration in Venezuela, but it also highlights the transactional nature of Russian foreign policy. Essentially, Russia can't afford to support all its allies and we suspect the costs of supporting operations in Ukraine and Syria are affecting Moscow's ability to remain involved in Caracas.

A threat to the CPC: There are reports that the [Chinese middle class is becoming worried about the trade war](#) with the U.S. The message from leadership is to prepare for hard times, which isn't what those who have put together some savings want to hear. Online reports suggest some households are considering diversifying out of the CNY into other foreign currencies or perhaps precious metals. These Chinese citizens don't threaten the regime as much as students would (no less on the [30th anniversary](#) of the Tiananmen Square crackdown) by calling for democracy or mobilizing against the regime, but they are an economic threat. The potential for capital flight exists as does a simple "hunkering down" in spending that would weaken consumption.

Odds and ends: It appears the SPD will continue to be part of the [German coalition government](#), easing fears of snap elections. [China is warning its citizens](#) that the U.S. isn't a safe place to travel. China also appears to be [stockpiling soybeans](#), an indication that it is preparing for a long trade dispute with the U.S. Inventory accumulation will be part of deglobalization as the world moves from "just-in-time" to "just-in-case" logistics. Kevin Hassett fired off a [parting shot](#), arguing that tariffs and deficits are bad for the U.S. economy. Hassett is leaving his post as head of the CEA and is not a candidate for Fed governor. The EU is close to [making a decision](#) on Italy's punishment for ignoring fiscal and debt rules. The Italian PM has [threatened to quit](#) over internal squabbling over this issue.

U.S. Economic Releases

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

Economic Releases							
EDT	Indicator				Expected	Prior	Rating
10:00	Factory Orders	m/m	apr		-1.0%	1.9%	***
10:00	Factory Orders ex Trans	m/m	apr			0.8%	**
10:00	Durable Goods Orders	m/m	apr			-2.1%	**
10:00	Durable Goods Orders ex Transportation	m/m	apr			0.0%	**
10:00	Cap Goods Orders Nondef Ex Air	m/m	apr			-0.9%	**
10:00	Cap Goods Ship Nondef Ex Air	m/m	apr			0.0%	**
Fed speakers or events							
	Speaker or event	District or position					
13:45	Lael Brainard Moderates Panel at Chicago Fed Conference	Member of the Board of Governors					

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	Vehicle Sales	y/y	may	4.8%	2.5%		**	Equity and bond neutral
	Monetary Base	y/y	may	3.6%	3.1%		**	Equity and bond neutral
India	Nikkei India PMI Mfg	m/m	may	52.7	51.8		**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	m/m	jun	116.9	118.6		*	Equity and bond neutral
	BoP Current Account Balance	q/q	1q	-A\$2.900 bn	-A\$7.200 bn	-A\$2.900 bn	***	Equity and bond neutral
	Net Exports of GDP	q/q	1q	0.2%	0.2%	0.2%	***	Equity and bond neutral
	Retail Sales	m/m	apr	-0.1%	0.3%	0.2%	**	Equity and bond bearish
New Zealand	Terms of Trade Index	q/q	1q	1.0%	-3.0%	0.5%	**	Equity and bond neutral
EUROPE								
Eurozone	Unemployment Rate	m/m	apr	7.6%	7.7%	7.7%	***	Equity bullish, bond bearish
	CPI core	y/y	may	0.8%	1.3%	0.9%	***	Equity bullish, bond bearish
	CPI Estimate	y/y	may	1.2%	1.7%	1.3%	***	Equity bullish, bond bearish
Italy	Unemployment Rate	y/y	apr	10.2%	10.2%	10.3%	***	Equity and bond neutral
France	Budget Balance	ytd	apr	-67.2 bn	-40.7 bn		**	Equity and bond bearish
UK	BRC Sales Like-For-Like	y/y	may	-3.0%	3.7%	0.8%	*	Equity and bond bearish
	Markit/CIPS UK Construction	m/m	may	48.6	50.5	50.6	**	Equity and bond bearish
AMERICAS								
Mexico	Markit Mexico PMI Mfg	m/m	may	50.0	50.1		**	Equity and bond neutral
	IMEF Non-Manufacturing Index	m/m	mar	49.4	52.4	51.5	**	Equity and bond bearish
	IMEF Manufacturing Index	m/m	may	49.4	52.0	51.5	**	Equity and bond bearish
Canada	MLI Leading Indicator	m/m	apr	0.4%	0.2%		**	Equity and bond neutral
	Markit Canada Manufacturing	y/y	may	49.1	49.7		**	Equity and bond neutral
	Bloomberg Nanos Confidence	y/y	apr	55.5	55.7		***	Equity and bond neutral
Brazil	Markit Brazil PMI Manufacturing	m/m	may	50.2	51.5		**	Equity and bond neutral
	CNI Capacity Utilization	m/m	apr	77.8%	76.5%		***	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)	250	252	-2	Up
3-mo T-bill yield (bps)	228	228	0	Neutral
TED spread (bps)	22	24	-2	Neutral
U.S. Libor/OIS spread (bps)	230	227	3	Up
10-yr T-note (%)	2.10	2.07	0.03	Neutral
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	13	14	-1	Down
Currencies	Direction			
dollar	down			Neutral
euro	up			Up
yen	up			Neutral
pound	flat			Neutral
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	\$60.50	\$61.28	-1.27%	Trade Tensions
WTI	\$52.65	\$53.25	-1.13%	
Natural Gas	\$2.42	\$2.40	0.50%	
Crack Spread	\$20.39	\$20.86	-2.28%	
12-mo strip crack	\$16.91	\$17.22	-1.78%	
Ethanol rack	\$1.61	\$1.61	0.27%	
Metals				
Gold	\$1,327.12	\$1,325.31	0.14%	
Silver	\$14.72	\$14.79	-0.43%	
Copper contract	\$264.90	\$265.00	-0.04%	
Grains				
Corn contract	\$ 430.00	\$ 424.25	1.36%	
Wheat contract	\$ 513.75	\$ 519.75	-1.15%	
Soybeans contract	\$ 887.50	\$ 879.00	0.97%	
Shipping				
Baltic Dry Freight	1103	1096	7	
DOE inventory report				
	Actual	Expected	Difference	
Crude (mb)		-1.8		
Gasoline (mb)		1.0		
Distillates (mb)		0.0		
Refinery run rates (%)		0.55%		

Weather

The 6-10 and 8-14 day forecasts show cooler to normal temps for most of the country, with warmers temps in the Southeast and West Coast. Precipitation is expected for most of the country.

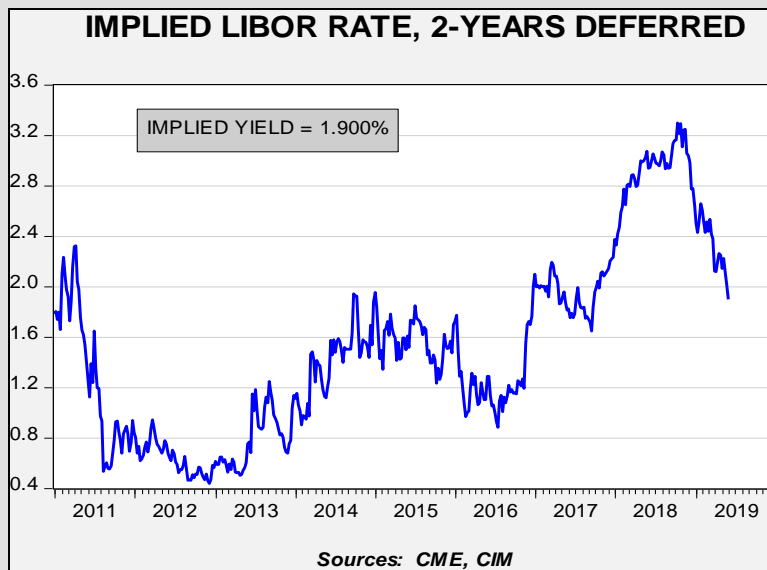
Asset Allocation Weekly

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.

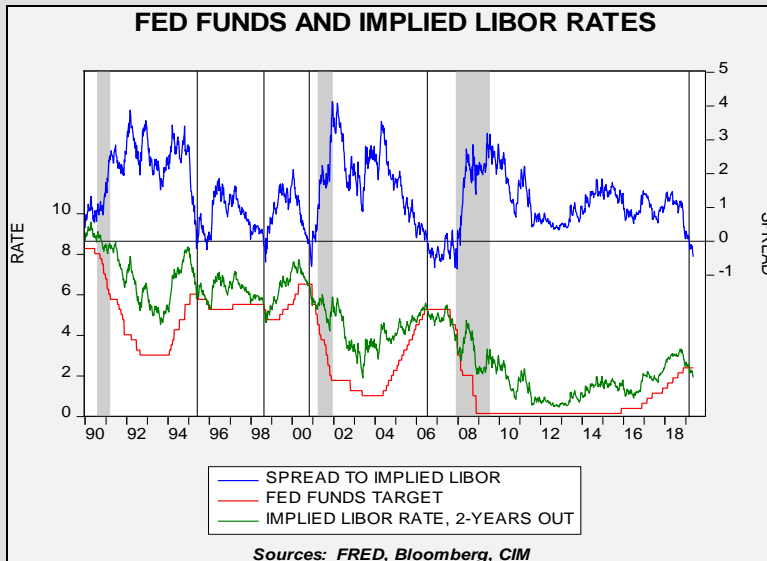
May 31, 2019

There are three factors that tend to cause recessions—inventory misadjustments, policy errors and geopolitical events. The first in the series has become less of a factor over time. Inventory management has improved dramatically since the end of WWII, and excess inventory leading to falling output has become less of an issue. Therefore, we tend to focus on the latter two factors. Since fiscal policy changes tend to occur more slowly, monetary policy is where we spend most of our efforts. With regard to geopolitical events, we write a weekly report on that issue.

Monetary policy is facing a serious signaling problem. One of the signals we use for monetary policy is the implied LIBOR rate from the two-year deferred Eurodollar futures. That rate is an indication of what the financial markets are thinking. As we will show below, it has generally been a good indicator for when policy tightening should stop. The implied LIBOR rate has declined significantly.

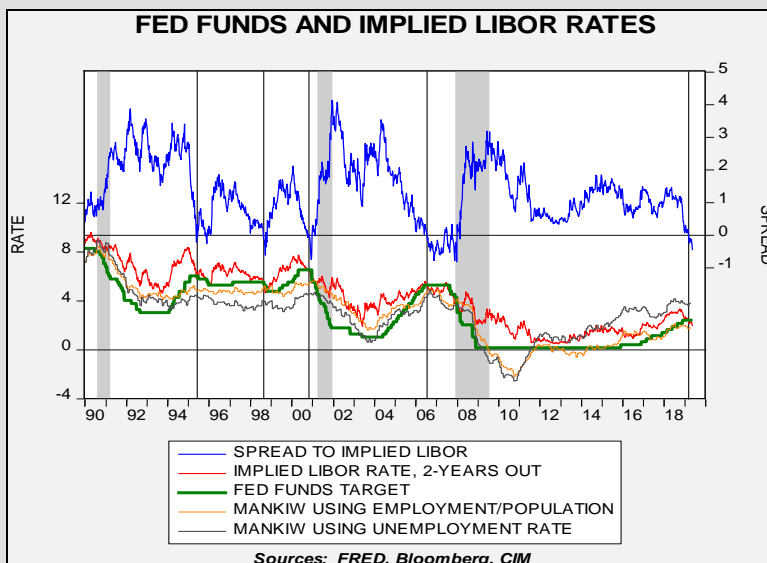


Since peaking at 3.30% last October, the rate has declined to 1.90%, a drop of 140 bps.



The lower lines show the implied LIBOR rate with the fed funds target. Note that the FOMC has tended to stop raising rates when the spread inverts. During the Greenspan years, easing tended to follow shortly after inversion. The Bernanke Fed did stop raising rates after inversion but didn't ease, which may have contributed to the severity of the 2007-09 recession.

To compare how the financial market signs compare to economic signals, we have overlaid the fed funds target/deferred LIBOR rate with two of the Mankiw Rule variations, one using core CPI and the unemployment rate and the other using core CPI and the employment/population ratio. The Mankiw Rule is a simplified version of the Taylor Rule, which estimates the fed funds rate based upon core inflation and GDP relative to potential GDP. Because potential GDP isn't directly observable, Mankiw's original research replaced GDP with the unemployment rate. We have created our own variations as well (not shown).



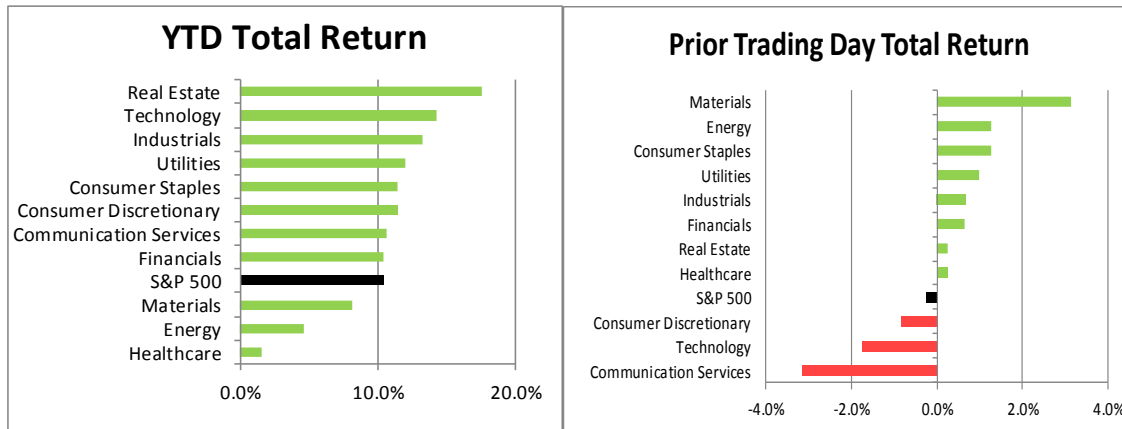
The lower lines on the chart show the implied LIBOR rate, with the fed funds target and the two aforementioned estimated Mankiw Rule rates. Aside from the Mankiw Rule variation using the unemployment rate, all other variations are suggesting the Fed should be cutting rates. However, in each of the prior inversion events (shown by the vertical lines on the above chart), the estimates for the fed funds target from the Mankiw Rule variations were below the target rates.

This has been a consistent issue during this expansion; essentially, it has been difficult to determine the degree of slack in the economy. Fortunately for policymakers, this problem of estimating slack has not been a serious issue until recently. Given the current divergence in signals, the most likely outcome is for the FOMC to maintain a steady posture. The lack of a clear signal between the financial markets and the interest rate markets increases the odds of a policy mistake. Although the FOMC's official stance is neutral, we suspect the next move will be to lower the policy rate.

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

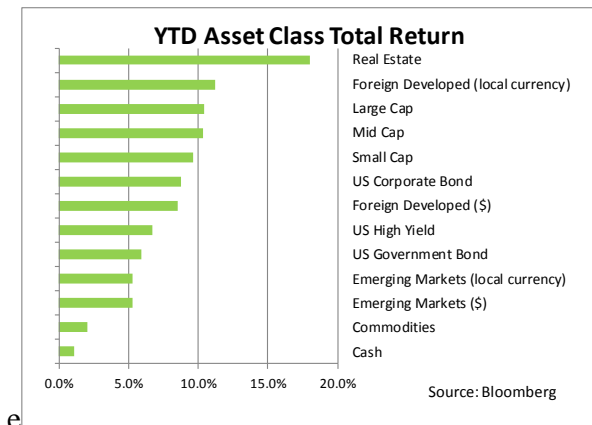
U.S. Equity Markets – (as of 6/3/2019 close)



(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. These charts represent the new sectors following the 2018 sector reconfiguration.

Asset Class Performance – (as of 6/3/2019 close)

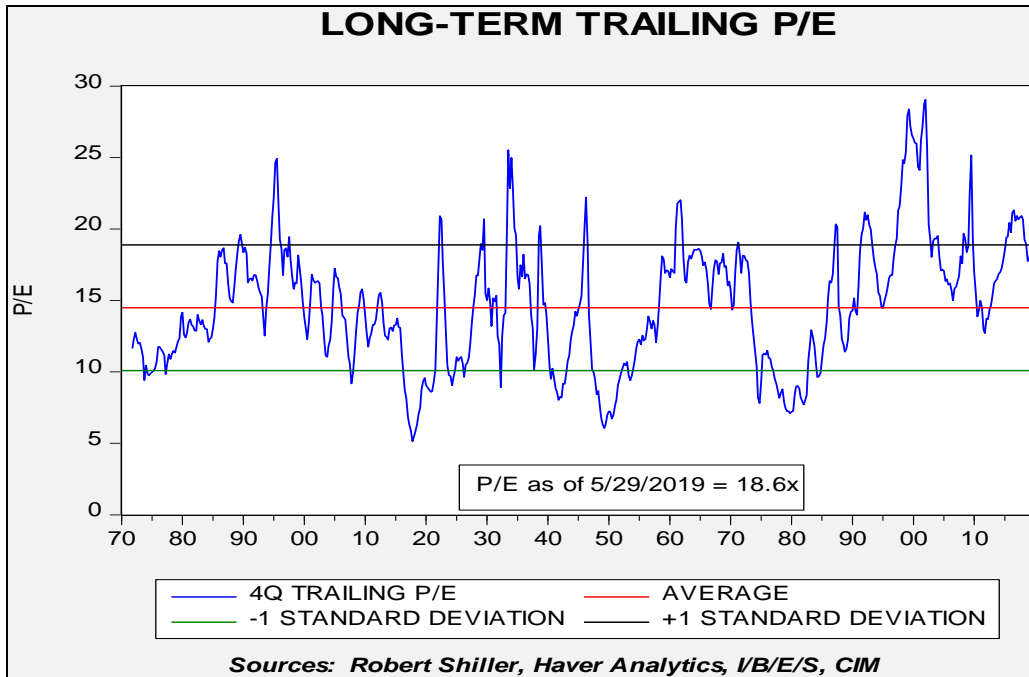


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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, 2019



Based on our methodology,¹ the current P/E is 18.6x, up 0.1x from last week. We have updated Q1 earnings to be consistent with S&P instead of Thomson/Reuters. That transition accounted for the modest rise in the P/E despite weak equity prices.

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.

¹ 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.