Daily Comment

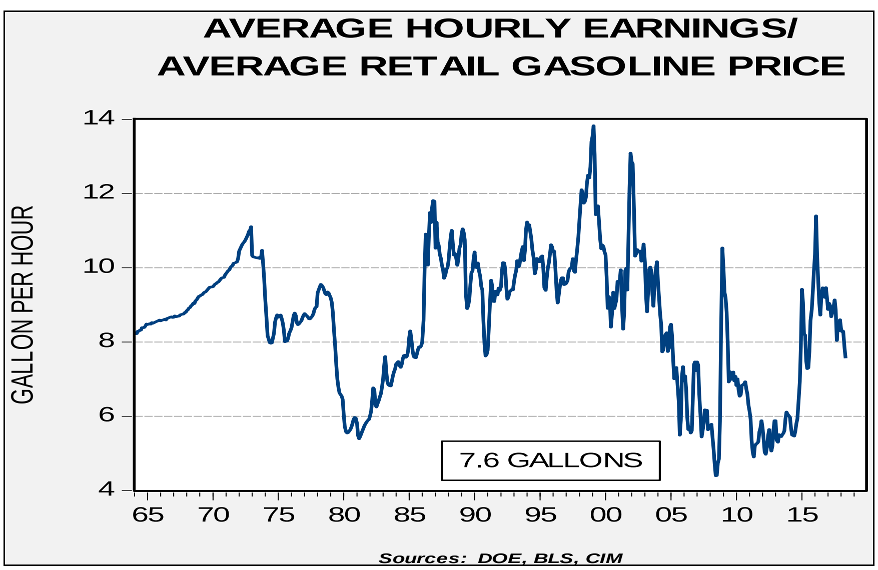
By Bill O'Grady and Thomas Wash

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 5, 2018—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.8% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.3% from the prior close. Chinese markets were up, with the Shanghai composite up 0.7% and the Shenzhen index up 1.7%. U.S. equity index futures are signaling a higher open.

Good morning—Happy National Moonshine Day![1] Here is what we are watching this morning:

Oil and OPEC: The Trump administration has quietly asked OPEC[2] to boost oil output by 1.0 mbpd in a bid to lower oil prices and, as a result, gasoline prices. Undoubtedly we will hear how this move is "unprecedented" from some of the media but it isn't all that unusual. Oil prices are a very important variable to the economy and administrations have often guided prices. During the 1986 oil collapse, Vice President Bush nudged the Saudis into cutting output to lift prices to save the U.S. oil industry.[3] Other presidents have boosted or reduced oil prices by adding or subtracting inventory out of the Strategic Petroleum Reserve.



[1] https://www.economist.com/the-economist-explains/2018/06/05/why-america-still-has-dry-counties
[2] https://www.bloomberg.com/news/articles/2018-06-05/u-s-said-to-ask-opec-for-1-million-barrel-a-day-oil-output-hike
[3] Yergin, D. (1991). *The Prize: The Epic Quest for Oil, Money and Power*. New York, New York: Simon & Schuster. (pp. 756-758.)

The above chart shows how many gallons of gasoline a non-supervisory worker can buy for an hour's worth of work. Currently, it is 7.6 gallons, which is a bit below the average of 8.5 gallons. Although not at an extreme, the direction is worrisome and thus the administration's move to bring down oil prices, and thus gasoline prices, makes sense.

We expect Russia to support the increased output, whereas Saudi Arabia will be more inclined to make a symbolic increase of 300 kbpd. Russia will probably win out. In any case, our analysis has been indicating that prices were running a bit above fair value, based on inventories and the dollar. Still, these cuts may do nothing more than arrest prices around the $60 per barrel level. Venezuelan[4] output will continue to fall and we also look for lower Iranian production. There is also the potential for output disruptions in Iraq due to political uncertainty there after recent elections. We have probably been seeing weaker oil prices on fears that OPEC would try to make up some of the lost output. Now that the news is out, we would not be surprised to see prices stabilize.

Iran and uranium: Although Iran has been careful not to take actions that would directly break the nuclear agreement, the country is signaling it will take actions that will be seen as hostile. Ayatollah Khamenei indicated today that his nation is prepared to increase uranium enrichment if the deal is ended.[5] The head of Iran's Atomic Energy Organization, Ali Akbar Salehi, indicated today that Iran will begin building advanced centrifuges in light of recent developments.[6] Rising tensions with Iran are a bullish factor for oil prices.

Italy: The new government is now in place.[7] The EU is waiting to see how Euroskeptic the new government will be in practice. There is evidence that the EU is quietly punishing Italy for its behavior; the ECB has reduced its purchases of Italian bonds, although the ECB has disputed the idea that there is any ulterior motive. Instead, the ECB says the change in buying is technical in nature.[8]

Unwinding of the postwar order: A persistent theme in our geopolitical research has been the case that the U.S. is souring on the costs of the hegemonic role and wants to reduce its global involvement. A tempest of comments have emerged overnight after the U.S. ambassador to Germany, Richard Grenell, made comments supporting right-wing nationalist movements in the EU.[9] Although Grenell denied the intention to directly support parties in Europe, the U.S. has a

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[4] https://www.washingtonpost.com/world/national-security/pompeo-urges-kicking-venezuela-from-oas-and-more-sanctions/2018/06/04/32fbba1e-6806-11e8-bea7-c8eb28bc52b1_story.html?utm_term=.9918b3513f82&wpisrc=nl_todayworld&wpmm=1

[5] https://www.reuters.com/article/us-usa-election-opioids/voters-in-opioid-plagued-districts-demand-solutions-from-candidates-idUSKCN1J11BE?il=0&wpisrc=nl_todayworld&wpmm=1

[6] https://www.reuters.com/article/us-iran-nuclear/iran-to-start-building-advanced-centrifuges-salehi-idUSKCN1J113Q

[7] https://www.ft.com/content/01cae2cc-68b4-11e8-b6eb-4acfcfb08c11

[8] https://www.ft.com/content/8a688786-67f8-11e8-8cf3-0c230fa67aec?utm_source=POLITICO.EU&utm_campaign=9a915e1a62-EMAIL_CAMPAIGN_2018_06_04_04_11&utm_medium=email&utm_term=0_10959edeb5-9a915e1a62-190334489

[9] https://www.ft.com/content/60bfc106-67df-11e8-8cf3-0c230fa67aec?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56 and https://www.washingtonpost.com/news/world/wp/2018/06/04/trumps-envoy-to-germany-

long history of trying to shape European politics. One of the goals of the Marshall Plan was to undermine communist parties in Europe after WWII. However, the trend in place appears rather clear. The U.S. has been pulling back from its hegemonic obligations since the Obama administration because the American people have concluded the costs exceed the benefits. We disagree with this idea, but 73 years without a mass mobilization war will tend to skew the cost/benefit calculation for Americans.

That doesn't necessarily mean the U.S. goes full isolationist.[10] Instead, the U.S. is trying to change the rules of conduct, which means forcing allies in frozen conflict zones (Europe, Middle East, Far East) to play a more active (and costly) role in their own defense and no longer easily supplying dollars to global markets through U.S. unemployment. However, managing this change is hard because (a) if nations in the conflict zones pay for their own defense, they will also very easily want a much greater say in how security is executed (which may not be in U.S. interests), and (b) without U.S. open trade policy, globalization has probably peaked. It should be noted that the right-wing establishment is funding a "counter-reformation" to these trade changes.[11] However, we suspect they are on the wrong side of the trend.

Bank of India—HELP! The Bank of India has asked the Fed to slow its policy tightening after emerging markets have seen growing pressure.[12] Although we understand the bank's concern, history shows that the Fed doesn't pay too much attention to foreign economies until a crisis develops of sufficient magnitude that it affects the U.S. economy in a significant way. We do note the National Association of Business Economists is warning that the likelihood of recession will be elevated in 2020, mostly due to the negative impact of trade.[13]

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
9:45	Markit US Services PMI	m/m	may	55.7	55.7	**
9:45	Markit US Composite PMI	m/m	may		55.7	**
10:00	JOLTS Job Openings	m/m	apr	6350	6550	**
10:00	ISM Non-Manf. Composite	m/m	may	57.6	57.6	**
Fed speakers or events						
No speakers or events scheduled						

wants-to-empower-conservatives-but-he-doesnt-appear-to-mean-merkel/?utm_term=.f6a0a5af4e95&wpisrc=nl_todayworld&wpmm=1

10 https://www.reuters.com/article/us-usa-taiwan-military-exclusive/exclusive-at-delicate-moment-u-s-weighs-warship-passage-through-taiwan-strait-idUSKCN1J030R

11 https://www.reuters.com/article/us-usa-trade-koch/free-trade-puts-republican-megadonors-on-collision-course-with-trump-idUSKCN1J02C0

12 https://www.ft.com/content/a572d6fa-680f-11e8-8cf3-0c230fa67aec?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

13 https://abcnews.go.com/Business/wireStory/business-economists-worry-recession-2020-55625966

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 Composite	m/m	may	52.3	52.3		**	Equity and bond neutral
	Caixin China PMI Services	m/m	may	52.9	52.9	52.9	**	Equity and bond neutral
Japan	Household Spending	m/m	apr	-1.3%	-0.7%	0.8%	**	Equity bearish, bond bullish
	Nikkei Japan PMI Services	m/m	may	51.0	52.5		**	Equity and bond neutral
	Nikkei Japan PMI Composite	m/m	may	51.7	53.1		**	Equity and bond neutral
India	Nikkei India PMI Services	m/m	may	49.6	51.4		**	Equity bearish, bond bullish
	Nikkei India PMI Composite	m/m	may	50.4	51.9		**	Equity bearish, bond bullish
Australia	AiG Perf of Services Index	m/m	may	59.0	55.2		**	Equity bullish, bond bearish
	CBA Australia PMI Services	m/m	may	55.9	55.2		**	Equity and bond neutral
	CBA Australia PMI Composite	m/m	may	55.6	55.3		**	Equity and bond neutral
	ANZ Roy Morgan Weekly Consumption	m/m	jun	116.5	117.7		**	Equity and bond neutral
	BoP Current Account Balance	q/q	1q	-A$10.5 bn	-A$14.0 bn	-A$9.9 bn	**	Equity bearish, bond bullish
	Net Exports of GDP	q/q	1q	0.30	-0.50	0.50	**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Services	m/m	may	53.8	53.9	53.9	**	Equity and bond neutral
	Markit Eurozone Composite	m/m	may	54.1	54.1	54.1	**	Equity and bond neutral
	Retail Sales	y/y	may	1.7%	0.8%	1.7%	**	Equity and bond neutral
France	Budget Balance	ytd	apr	-54.3 bn	-33.1 bn		**	Equity bearish, bond bullish
	Markit France Services	m/m	may	54.3	54.3	54.3	**	Equity and bond neutral
	Markit France Composite	m/m	may	54.2	54.5	54.5	**	Equity and bond neutral
Germany	Markit Germany Services	m/m	may	52.1	52.1	52.1	**	Equity and bond neutral
	Markit/BME Germany Composite	m/m	may	53.4	53.1	53.1	**	Equity and bond neutral
Italy	Markit/ADACI Italy Services	m/m	may	53.1	52.6	53.0	**	Equity and bond neutral
	Markit/ADACI Italy Composite	m/m	may	52.9	52.9	52.8	**	Equity and bond neutral
U.K.	Markit/CIPS UK Services	m/m	may	54.0	52.8	53.0	**	Equity and bond neutral
	Markit/CIPS UK Composite	m/m	may	54.5	53.2	53.4	**	Equity and bond neutral
AMERICAS								
Mexico	Leading Indicators	m/m	may	-0.02	-0.02		**	Equity and bond neutral
Canada	Bloomberg Nanos Confidence	m/m	jun	57.5	57.2		**	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)	190	190	0	Neutral
TED spread (bps)	42	42	0	Neutral
U.S. Libor/OIS spread (bps)	191	191	0	Up
10-yr T-note (%)	2.92	2.94	-0.02	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	8	11	-3	Down
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	up			Up
pound	up			Up
franc	flat			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBA Casht Target Rate	1.500%	1.500%	1.500%	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	$74.08	$75.29	-1.61%	OPEC Speculation
WTI	$64.38	$64.75	-0.57%	
Natural Gas	$2.92	$2.93	-0.44%	
Crack Spread	$23.90	$24.81	-3.68%	
12-mo strip crack	$22.00	$22.87	-3.83%	
Ethanol rack	$1.60	$1.61	-0.25%	
Metals				
Gold	$1,290.78	$1,292.02	-0.10%	
Silver	$16.38	$16.42	-0.22%	
Copper contract	$314.85	$313.45	0.45%	
Grains				
Corn contract	$ 382.50	$ 380.75	0.46%	
Wheat contract	$ 512.00	$ 505.25	1.34%	
Soybeans contract	$ 1,001.75	$ 1,001.75	0.00%	
Shipping				
Baltic Dry Freight	1193	1156	37	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.0		
Gasoline (mb)		0.5		
Distillates (mb)		1.1		
Refinery run rates (%)		0.40%		

Weather

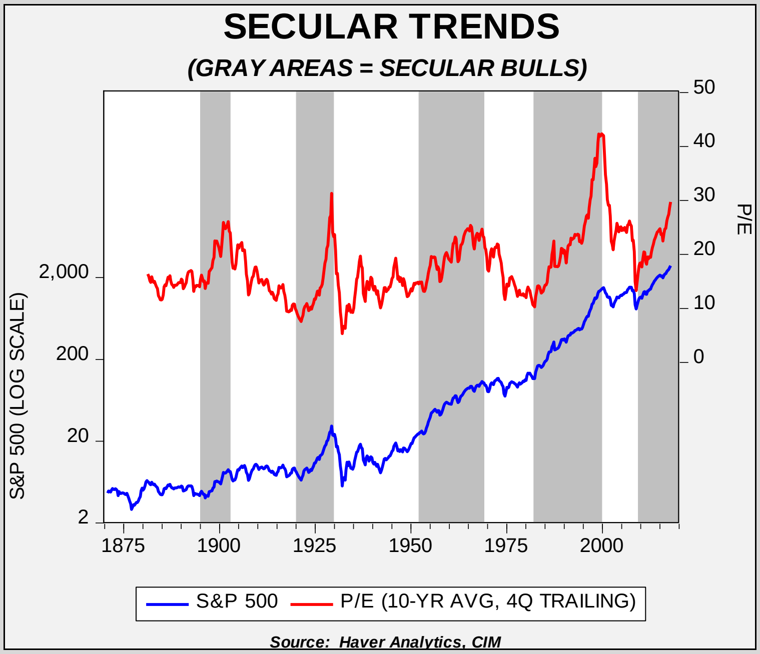
The 6-10 and 8-14 day forecasts continue to signal warmer to normal temperatures for most of the country. There are no tropical storms expected over the next 48 hours.

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.[14] 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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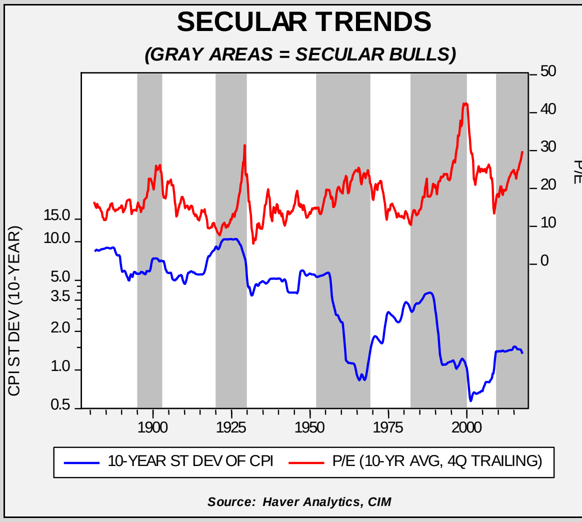
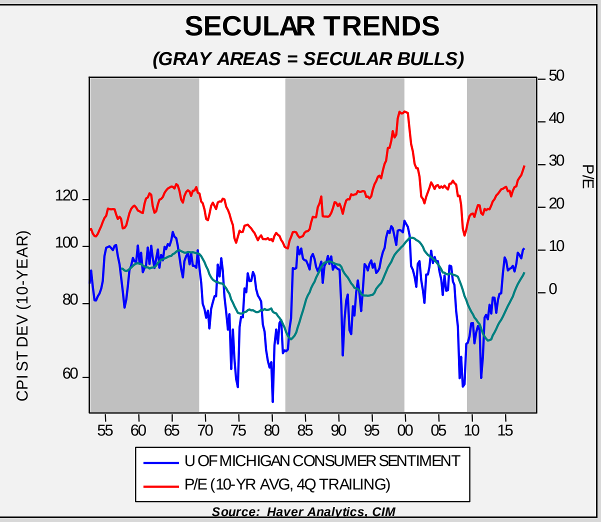
[14] The 10-year P/E is calculated by the 10-year average of nominal earnings divided by the current value of the S&P 500. The multiple is similar to the Shiller P/E except that the latter deflates both by CPI.





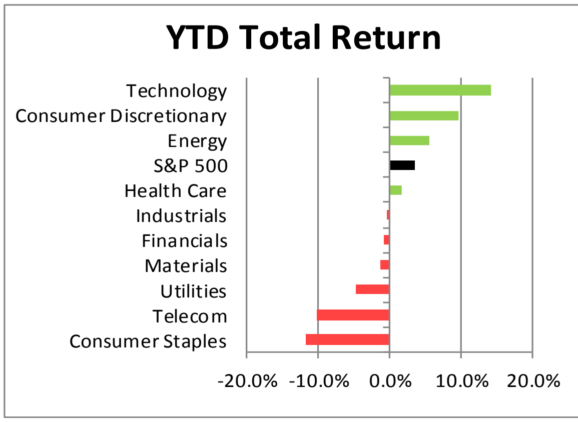
The chart on the left shows the aforementioned P/E with the 10-year rolling standard deviation of inflation. Secular trends are shaded in gray. Although not a perfect indicator, in general, rising inflation volatility tends to coincide with a lower P/E. With all financial assets, inflation is an important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

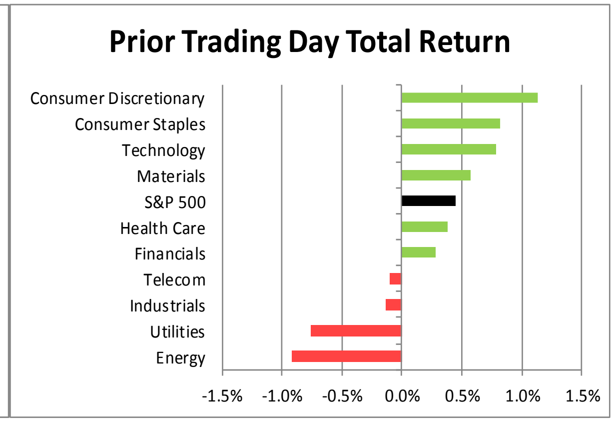
There is an old saying that "bond investors don't build hospital wings." In other words, equities are the best way to build wealth. At the same time, investing in equities requires optimism about the future. War, civil unrest, social disruption and geopolitical uncertainty should make citizens reluctant 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 6/4/2018 close)

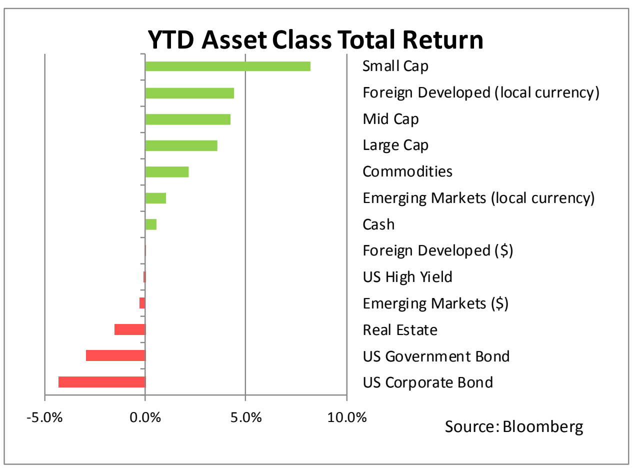




(Source: Bloomberg)

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 6/4/2018 close)

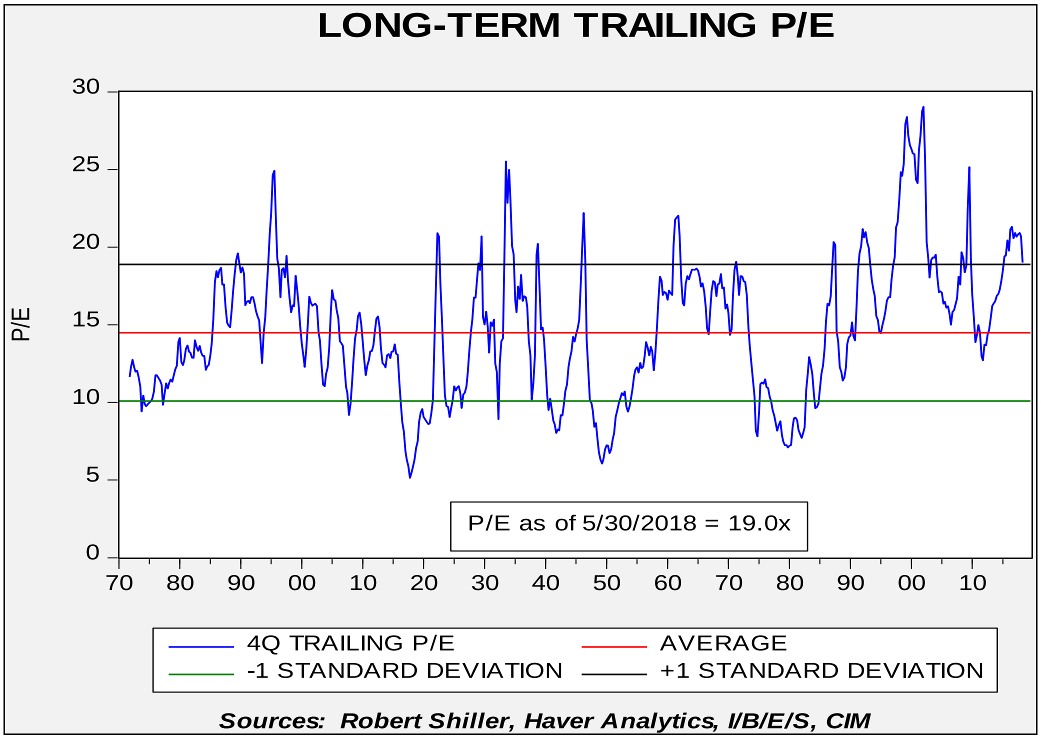


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[15] the current P/E is 19.0x, 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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[15] 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.