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: March 6, 2018—9:30 AM EST] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.7% from the last close. In Asia, the MSCI Asia Apex 50 closed up 2.5% from the prior close. Chinese markets were higher, with the Shanghai composite up 1.0% and the Shenzhen index up 1.2%. U.S. equity index futures are signaling a higher open.

Risk markets are higher this morning, building on yesterday's afternoon recovery. Here is what we are watching this morning:

Trade wars—the establishment strikes back: They don't call it the establishment for nothing. The GOP establishment playbook—tax cuts, open trade, deregulation—has always been a less than perfect fit for a president with populist leanings. This was a worry in the president's first year but it has generally been accepted that the president mostly tweets like a populist but governs like the establishment. That conclusion is facing a strong challenge from Trump's anti-trade policies. While some were working on tax cuts, parts of the administration were working on trade impediments and retaliation. Commerce Secretary Ross was working on trade actions on metals and against China, and tough NAFTA negotiations were ongoing. But, the president's announcement of across-the-board tariffs on steel and aluminum were mostly unexpected, at least in terms of timing.

However, after the initial shock, the GOP establishment is pushing back. First, Gary Cohn, Director of the National Economic Council, is assembling a summit meeting where companies adversely affected by the proposed tariffs can inform the president and the administration of the negative effects of the action. Second, House Speaker Ryan has also openly warned against the tariffs and hinted that the House may create legislation to reduce the president's ability to implement trade actions. We suspect that some sort of "deal" will be cut; the president can't lose face by not getting anything on this issue, but the across-the-board nature of the proposed tariffs can be scaled back to the point where they don't significantly affect trade. In other words, the goal will be to give the president enough to let him claim a win but not so much as to actually affect trade. ***Hopes that this will be the outcome are probably why equities rallied yesterday and are higher this morning.***

Unfortunately, this trade debacle doesn't address the real issue, which is the management of the reserve currency. The U.S. benefits greatly from running a trade deficit; we get a plethora of goods and services from the world that contain inflation and improve our efficiency. In return for goods and services, we give foreigners Treasuries, which are cheap to produce! This only works for us because there is a natural demand for dollars as foreigners use dollars to conduct trade with other nations who trust dollars over local currencies. However, the process of providing the reserve currency, a key element in our program to win the Cold War, creates distortions in our economy that are unhealthy. Our financial system is very large and our sales and logistics systems are overly large as well (to handle foreign investment when foreigners with dollars don't spend them right away and need to invest in dollar assets). And, we struggle to create enough buying power for all the imports the world wants to sell us; our answer from 1980 to 2008 was to allow a massive expansion of household debt. Much of this was due to the fact that sectors of our economy have been severely harmed by trade and as a result these workers no longer have the wages to buy the imports the world wants to sell to us. The Great Financial Crisis showed that our ability to lift debt has reached its natural limit. The nation definitely needs a new course on trade and the dollar. Widespread protectionism probably isn't the answer but what we have now isn't working. One thought would be to penalize nations with high current account surpluses with automatic trade penalties.

North Korean thaw: North and South Korea have agreed to hold direct talks next month and Pyongyang indicated it would be willing to abandon its nuclear program in return for security guarantees. At first glance, this is difficult to believe but it actually does make sense. Since the "axis of evil" speech, North Korea has had to assume that America's policy goal is regime change. Thus, having weapons to prevent such an outcome is a reasonable step on its part. However, none of this is new. What has changed is the realization by the two Koreas that none of their allies are really looking out for the interests of either one. The talk of war to prevent North Korea from acquiring nukes essentially showed that Washington is willing to sacrifice South Korea to protect the U.S. In other words, a conventional war with North Korea would devastate South Korea but leave the U.S. untouched. At the same time, cool relations between Pyongyang and Beijing suggest that China would probably not oppose regime change in North Korea if the resulting new government is generally friendly to China's interests. Therefore, the incentive for North and South Korea to negotiate their own peace makes sense. If North Korea can (a) get a working deal with South Korea to improve and modernize its economy, and (b) get the U.S. to stop threatening regime change by negotiating a security deal for nukes, it's probably worth it. This recent progress also shows that Kim Jong-un is apparently unconcerned about shifting the nuclear policy, which probably means that any opposition to his rule has been eliminated.

Update on National People's Congress: China's National People's Congress (NPC), the state legislature of China, is holding its meetings. Although it is the most powerful body in China on paper, in practice, it's a "rubber stamp" for the Communist Party of China (CPC). Yesterday, the NPC agreed to a 6.5% GDP growth target. What's important about this decision is that it was made at all. China can achieve any GDP number it wants; the key driver is debt. If China is serious about deleveraging, the first step we would expect to see is a reduction or elimination of the growth target. This number is too high to lower debt. Although we still believe that Xi's actions to extend his rule will eventually lead to a period of deleveraging, this decision suggests it won't occur in 2018. This target also suggests that the CPC is still uncomfortable with allowing growth to slow. Marxism has been thoroughly discredited and, in its place, the CPC promises high growth. The CPC needs a new goal other than growth for legitimacy and thus this 6.5% growth goal for 2018 suggests it hasn't found a new one yet.

U.S. Economic Releases

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

Economic Releases							
EDT	Indicator			Expected	Prior	Rating
10:00	Factory Orders	m/m	feb	-1.4%	1.7%	**
10:00	Factory Orders ex Trans	m/m	feb		0.7%	**
10:00	Durable Goods Orders	m/m	feb	-3.6%	-3.7%	**
10:00	Durable Goods Orders ex Transportation	m/m	feb		-0.3%	**
10:00	Cap Goods Orders Nondef Ex Air	m/m	feb		-0.2%	**
10:00	Cap Goods Ship Nondef Ex Air	m/m	feb		0.1%	**
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								
Australia	ANZ Roy Morgan Weekly Consumption	w/w	feb	119.0	117.9		**	Equity and bond neutral
	BoP Current Account Balance	q/q	feb	-A$14.0 bn	-A$9.1 bn	-A$12.2 bn	**	Equity bearish, bond bullish
	Retail Sales	m/m	feb	0.1%	-0.5%	0.4%	**	Equity bearish, bond bullish
EUROPE								
Eurozone	Markit Eurozone Retail	m/m	feb	52.3	50.8		**	Equity bullish, bond bearish
France	Markit France Retail	m/m	feb	51.8	51.0		**	Equity and bond neutral
Germany	Markit Germany Construction	m/m	feb	52.7	59.8		**	Equity and bond neutral
	Markit Germany Retail PMI	m/m	feb	53.8	53.0		**	Equity and bond neutral
Italy	Markit Italy Retail PMI	m/m	feb	50.4	47.3		**	Equity bullish, bond bearish
Switzerland	CPI	y/y	feb	0.6%	0.7%	0.6%	***	Equity and bond neutral
	CPI EU Harmonized	y/y	feb	0.5%	0.8%		***	Equity and bond neutral
AMERICAS								
Canada	Bloomber Nanos Confidence	m/m	mar	57.7	58.2		**	Equity and bond neutral
Brazil	Markit Brazil PMI Composite	m/m	feb	53.1	50.7		**	Equity bullish, bond bearish
	Markit Brazil PMI Services	q/q	feb	52.7	50.0		**	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)	203	202	1	Up
3-mo T-bill yield (bps)	163	164	-1	Neutral
TED spread (bps)	40	39	1	Neutral
U.S. Libor/OIS spread (bps)	163	163	0	Up
10-yr T-note (%)	2.90	2.88	0.02	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	30	33	-3	Down
Currencies	**Direction**			
dollar	down			Down
euro	up			Up
yen	down			Up
pound	up			Up
franc	up			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBA Cash Rate Target		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	$66.02	$65.54	0.73%	Pessimism about US Oil Supply
WTI	$63.10	$62.57	0.85%	
Natural Gas	$2.71	$2.70	0.37%	
Crack Spread	$17.88	$18.16	-1.54%	
12-mo strip crack	$17.00	$17.07	-0.41%	
Ethanol rack	$1.54	$1.54	0.06%	
Metals				
Gold	$1,327.40	$1,320.11	0.55%	Weaker Dollar
Silver	$16.62	$16.43	1.15%	
Copper contract	$316.45	$312.80	1.17%	
Grains				
Corn contract	$ 387.00	$ 387.25	-0.06%	
Wheat contract	$ 503.75	$ 509.25	-1.08%	
Soybeans contract	$ 1,076.75	$ 1,077.50	-0.07%	
Shipping				
Baltic Dry Freight	1210	1207	3	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.5		
Gasoline (mb)		1.8		
Distillates (mb)		-0.8		
Refinery run rates (%)		-0.30%		

Weather

The 6-10 and 8-14 day forecasts continue to signal colder than normal temperatures for most of the country, with warmer temperatures in the central region of the country.

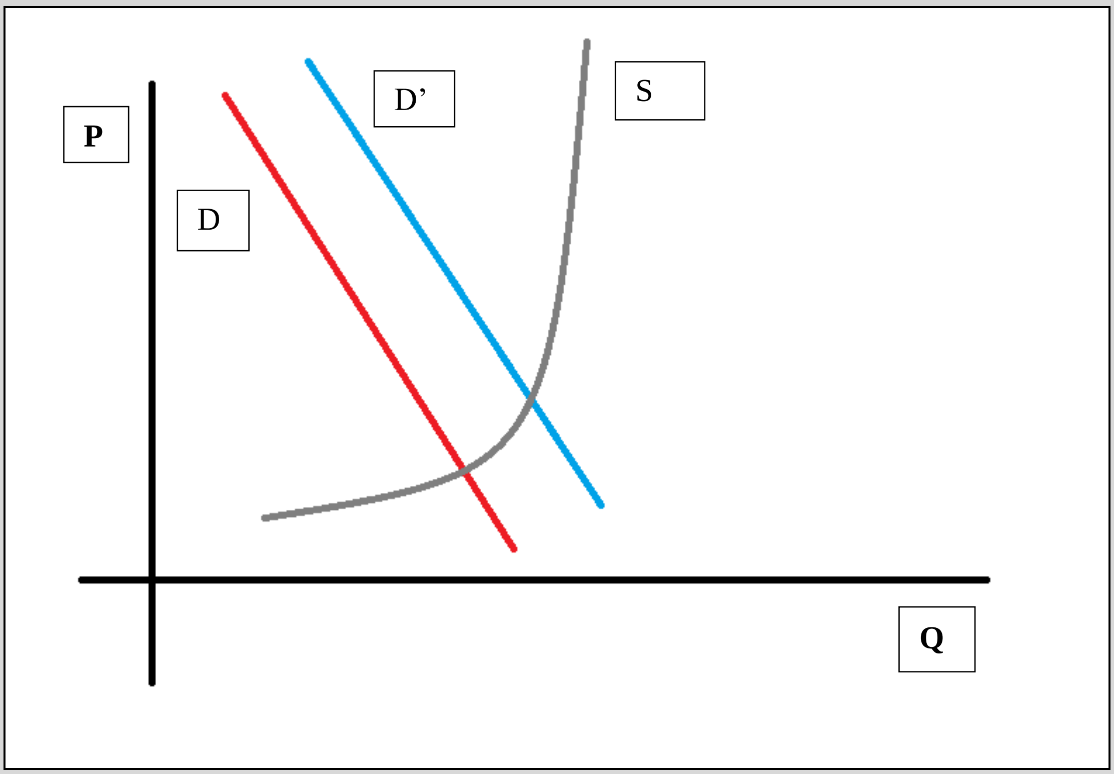
Asset Allocation Weekly Comment

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.

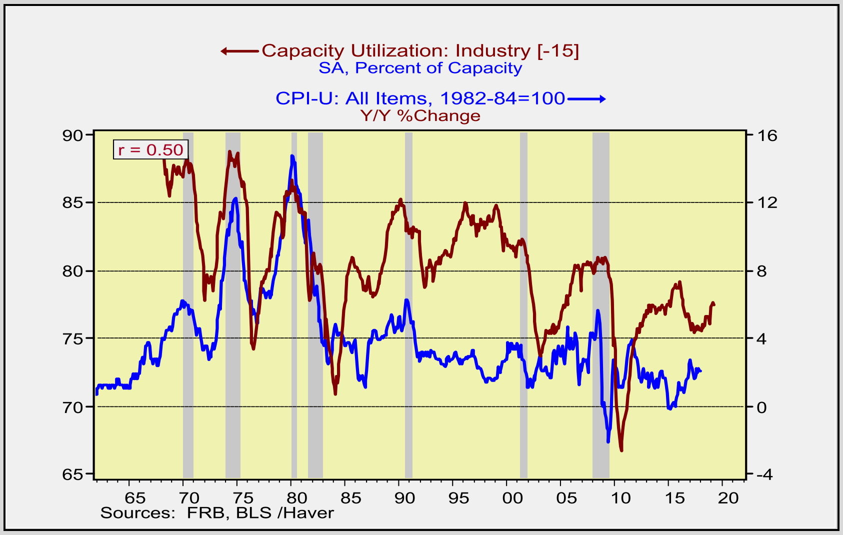
March 2, 2018

The recent rise in long-duration yields has been partially blamed on rising inflation expectations. Although this reason is a possible explanation, the reality is that it's more likely the fixed income markets are simply adjusting to a faster pace of policy tightening. In this report, we examine the differences between cyclical and secular trends in inflation.

Cyclical trends in inflation are driven by available slack in the economy. In purely theoretical terms, it's based on the slope of the aggregate supply curve. As available capacity is depleted, additional demand intersects supply when the slope of the supply curve is becoming increasingly vertical.

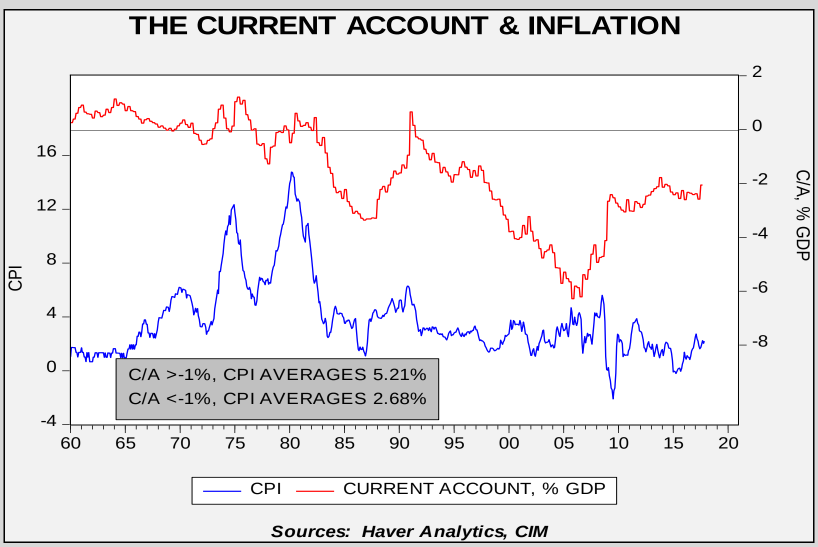


This stylized drawing shows that as demand rises from D to D', the quantity supplied rises but so do price levels. Obviously, the slope of the supply curve is critical. Policies designed to increase the supply side of the market will tend to bring more output with less inflation. Cyclical inflation is a function of movements along an existing aggregate supply curve, which is fixed in the short run. In the long run, the supply curve can expand or contract; the former leads to lower inflation at all levels of demand and the latter leads to higher levels of inflation at all levels.



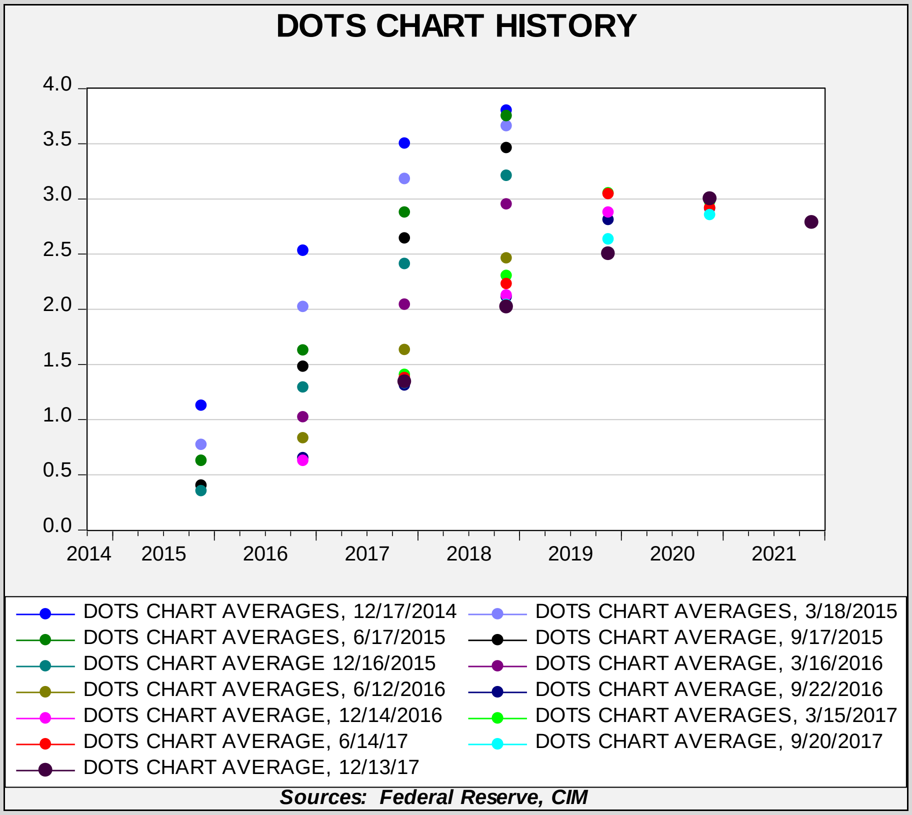
This chart shows the relationship between the yearly change in inflation and capacity utilization; the latter leads inflation by five quarters. Note that in the 1970s into the early 1980s, high levels of capacity utilization were consistent with very high levels of inflation. If the relationship between inflation and capacity utilization that existed in 1972-82 had been maintained, the current level of utilization would have generated inflation of 4.5%, reaching 5.3% by early 2019. But, clearly, the relationship has changed.

We believe the key elements of structural inflation are trade and regulation. An economy open to trade can tap excess capacity globally, and one that is deregulated can rapidly introduce new techniques and technology to improve productivity. The upside to this these policies is lower inflation at each level of aggregate demand; the downside is usually higher levels of inequality.



This chart shows the current account with inflation. Inflation fell dramatically as the current account deficit rose from the early 1980s forward.

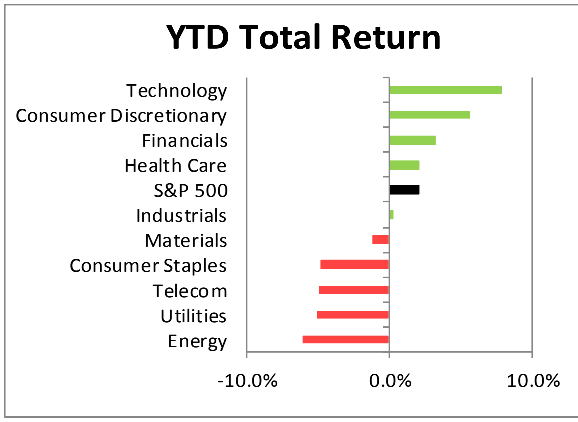
The recent lift in long-term interest rates appears to be due to a re-evaluation of monetary policy expectations. The FOMC's dots chart has consistently expected normalization in three to four years' time. However, slow growth and low inflation have persistently pushed off that actual tightening into the ever distant future. The chart below shows the average of the FOMC members' dots for future year-end fed funds rates. For example, in December 2014, the committee expected the terminal rate in 2018 to be 3.75%. Note how that rate for the end of 2018 steadily declined until last December's average of just over 2%, or two hikes this year. We expect three increases are more likely.

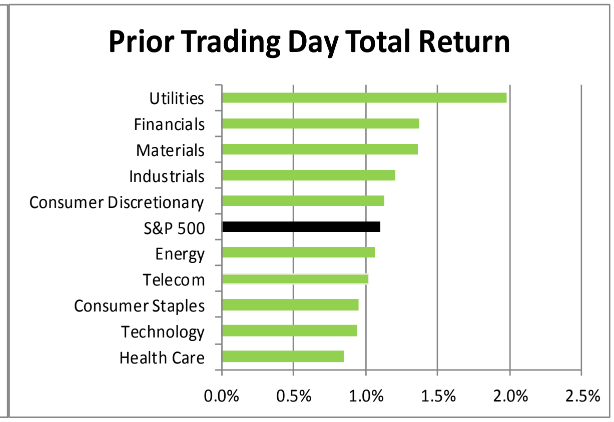


Although our base case is that secular inflation factors remain unchanged, we are watching trade policy very closely. If the president makes good on his promises to restrict imports, the potential is there for at least a significant secular inflation scare. So far, there has been more rhetoric than action but that may change in the coming year. The FOMC would face a dilemma if inflation expectations were to become "unanchored." Do they move up the fed funds target with enough vigor to offset the rise in inflation caused by the leftward shift of the aggregate supply curve and likely face a "tweet storm" from the White House, or do they acquiesce to the negative change in aggregate supply and allow inflation fears to return in earnest? Hopefully, Chair Powell won't face that difficult choice but, if he does, the potential for market disruption would be high

Data Section

U.S. Equity Markets – (as of 3/5/2018 close)

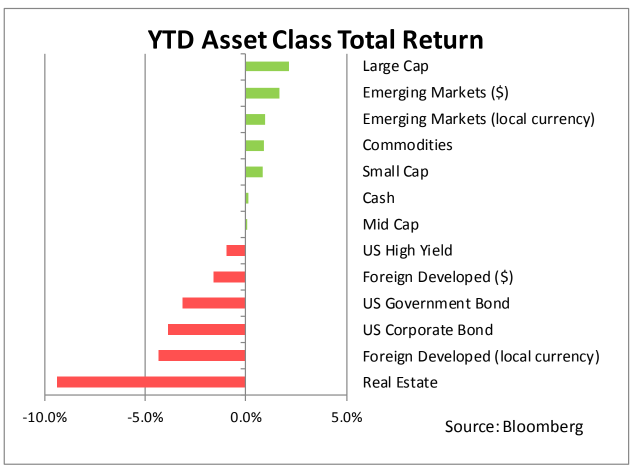




(Source: Bloomberg)

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 3/5/2018 close)

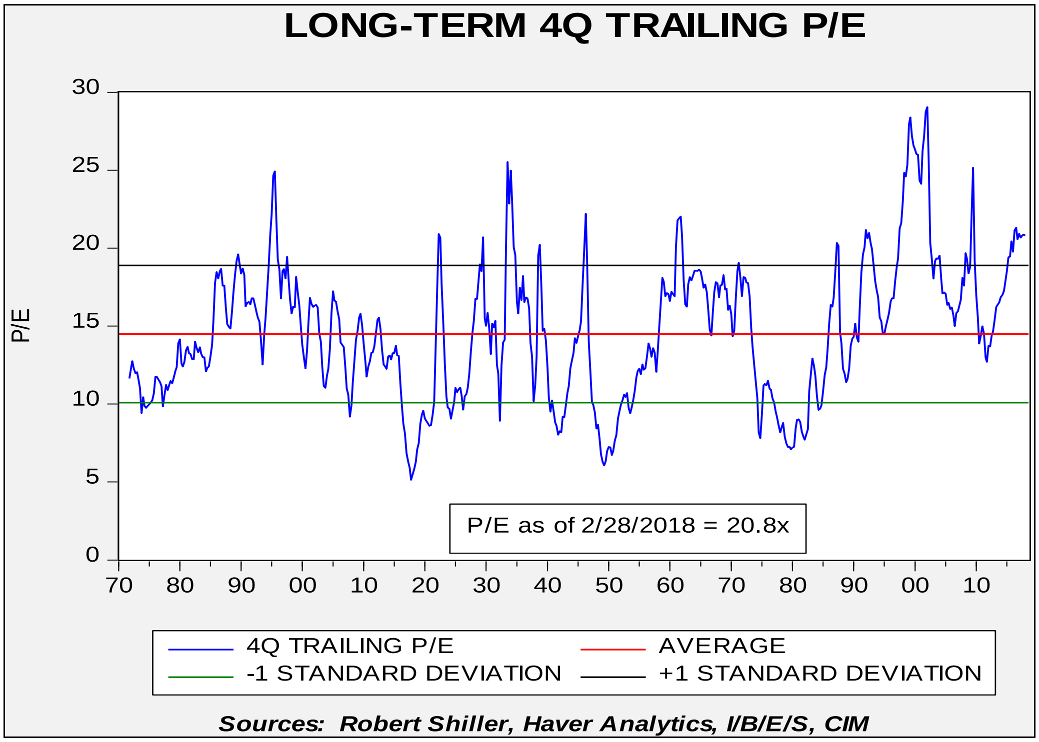


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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).

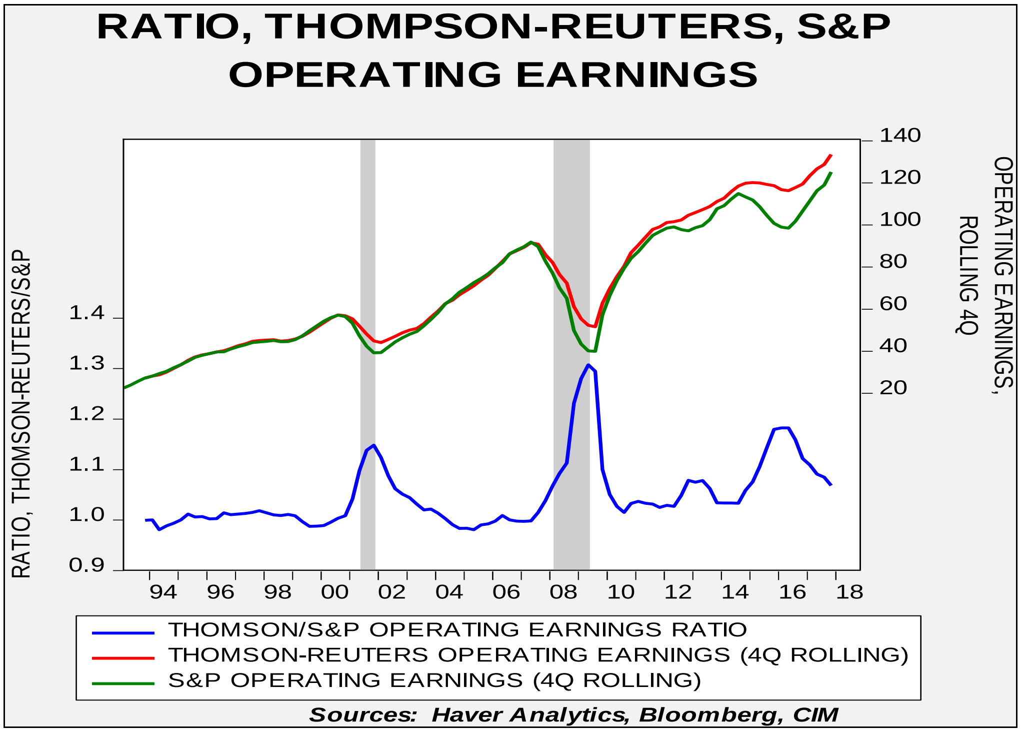
P/E Update

March 1, 2018



Based on our methodology,[1] the current P/E is 20.8, up 0.3x from last week. The rise in the P/E is due to switching to S&P operating earnings for Q4 instead of Thomson/Reuters. The chart on the next page shows that the Thomson/Reuters operating earnings data has tended to outpace the S&P operating number during this bull market. As the chart below shows, the gap between the two measures has continued to narrow as the S&P operating earnings calculation lags the Thomson/Reuters number by 6.7%.

[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 (Q2, Q3 and Q4) and one estimate (Q1). 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.



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.