

*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: May 7, 2019—9:30 AM EDT]** Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.8% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.4% from the prior close. Chinese markets were up, with the Shanghai composite up 0.7% and the Shenzhen index up 1.6%. U.S. equity index futures are signaling a lower open. With 400 companies having reported, the S&P 500 Q4 earnings stand at \$39.40, higher than the \$37.29 forecast for the quarter. The forecast reflects a 2.0% decrease from Q1 2018 earnings. Thus far this quarter, 76.3% of the companies reported earnings above forecast, while 17.3% reported earnings below forecast.

Trade tensions remain. Parsing the Iran threat. Here is what we are watching:

**Trade turmoil:** So, is the tariff threat real or a bluff? Equity markets decided yesterday that it was more the latter than the former.<sup>1</sup> This morning, equity markets seem less convinced. This is what we know:

1. The U.S. is calling out China for reneging on previous agreements.<sup>2</sup> Lighthizer appears to have taken the lead in talks with China, edging out Treasury Secretary Mnuchin. Lighthizer, as we have noted before, is a hardliner on trade. He was instrumental in getting Japan to agree to “voluntary” auto export reductions in the late 1980s and is known as a relentless negotiator. Although President Trump seems to really want a deal, he trusts Lighthizer and the change in course likely reflects that the president agrees with his trade negotiator that China was trying to pull a fast one. It’s also important to remember that for Lighthizer these talks are perhaps his last chance to fundamentally change the U.S./China trade relationship to favor America, much like he did with the U.S./Japan relationship. Thus, he is less concerned about China’s “feelings” and the 2020 elections. It had appeared Trump was leaning toward Mnuchin and against Lighthizer so a deal could get done, but Lighthizer may have appealed to Trump’s “inner Jackson” and convinced the president that a hardline position was justified. But, come what may, Lighthizer’s goal doesn’t necessarily coincide with the president’s in all areas.

<sup>1</sup> <https://www.ft.com/content/c55a12f6-6ff4-11e9-bbfb-5c68069fbd15?emailId=5cd0fd378585b10004f43b27&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22>

<sup>2</sup> <https://www.ft.com/content/ea07e70e-7044-11e9-bbfb-5c68069fbd15?emailId=5cd0fd378585b10004f43b27&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22> and [https://www.washingtonpost.com/business/economy/trump-administration-accuses-chinese-officials-of-reneging-on-earlier-commitments-in-trade-talks/2019/05/06/808e91f4-7037-11e9-8be0-ca575670e91c\\_story.html?utm\\_term=.3020cae82078](https://www.washingtonpost.com/business/economy/trump-administration-accuses-chinese-officials-of-reneging-on-earlier-commitments-in-trade-talks/2019/05/06/808e91f4-7037-11e9-8be0-ca575670e91c_story.html?utm_term=.3020cae82078)

If Trump decides to follow Lighthizer, a rupture in U.S./China trade relations is much more likely.

2. So far, China's response has been measured. Vice Premier Liu will come to Washington, but not until Thursday and will leave the next day. He was originally scheduled to arrive on Wednesday and stay until Saturday.<sup>3</sup> Although the visit does avoid a complete rupture, it is hard to see how we can avoid the tariff increase.
3. Both sides may have overplayed their positions. The White House is basking in historically low interest rates and surprisingly strong GDP, while China is coming off a successful OBR meeting and better economic data.<sup>4</sup> Wars often start because the participants overestimate their own positions and underestimate their opponents.
4. China may have concluded that continuing to negotiate was a better outcome because elections in 2020 would likely force the U.S. to capitulate. Lighthizer likely sniffed out this position and may have recommended that the president renew the tariff threat.<sup>5</sup>
5. It is possible the White House believes that an increase in trade tensions might prompt the FOMC to cut rates. Although we are not sure that would occur, a breakdown in talks would likely weaken sentiment and may lead the Fed to ease. Thus, the president may think he has the Fed at his back if things go south.
6. Financial markets continue to expect a deal to be finalized. There is good reason to expect that outcome. But, it isn't certain and there could be an equity correction looming if trade talks fail.<sup>6</sup>

**Iran:** According to reports, the U.S. received credible intelligence that Iran was planning to attack U.S. assets in the Middle East.<sup>7</sup> The U.S. response is something of a half measure. If the U.S. was really going to war with Iran, we would see three carrier groups in the region, not one. At the same time, the CVN *Abraham Lincoln* is a formidable asset and will get Iran's attention. We suspect Iran has "fired up" Hamas and Islamic Jihad to attack Israel, leading to the recent missile strikes.<sup>8</sup> Iran's problem is that the reduced U.S. exposure in the Middle East has led to a quiet alliance between the Arab states and Israel. Iran, under sanctions, is finding it difficult to respond to this pressure. Its "softest" target is Iraq, but it already has influence there anyway. Syria is a less reliable party because of Russian influence. Therefore, the desire to strike back at the Sunni Arab states makes sense. It should be noted that if Iran does "something" (e.g., cyberattack on Saudi Arabia, etc.), then the only real targets for U.S. warplanes are in Iran itself.

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<sup>3</sup> <https://finance.yahoo.com/news/china-says-vice-premier-liu-063138953.html>

<sup>4</sup> [https://www.wsj.com/articles/lighthizer-says-china-renegeing-on-trade-talk-commitments-11557176867?mod=hp\\_lead\\_pos1](https://www.wsj.com/articles/lighthizer-says-china-renegeing-on-trade-talk-commitments-11557176867?mod=hp_lead_pos1)

<sup>5</sup> <https://www.scmp.com/news/china/diplomacy/article/3009163/chinese-vice-premier-liu-he-go-washington-trade-talks>

<sup>6</sup> <https://www.nytimes.com/2019/05/06/business/china-trump-trade-economy-markets.html>

<sup>7</sup> <https://www.axios.com/israel-warned-trump-of-possible-iran-plot-bolton-34f25563-c3f3-41ee-a653-9d96b4541984.html> and [https://www.washingtonpost.com/world/national-security/as-tensions-with-us-rise-iran-threatens-to-curtailed-cooperation-in-the-nuclear-deal/2019/05/06/e38e29b6-7034-11e9-9f06-5fc2ee80027a\\_story.html?utm\\_term=.5bdfddf71b78&wpisrc=nl\\_todayworld&wpm=1](https://www.washingtonpost.com/world/national-security/as-tensions-with-us-rise-iran-threatens-to-curtailed-cooperation-in-the-nuclear-deal/2019/05/06/e38e29b6-7034-11e9-9f06-5fc2ee80027a_story.html?utm_term=.5bdfddf71b78&wpisrc=nl_todayworld&wpm=1)

<sup>8</sup> [https://www.washingtonpost.com/world/middle-east/israel-and-gaza-militants-agree-to-cease-fire-after-weekend-of-violence/2019/05/06/255f9b6a-6f89-11e9-9f06-5fc2ee80027a\\_story.html?utm\\_term=.6959fc91ff75&wpisrc=nl\\_todayworld&wpm=1](https://www.washingtonpost.com/world/middle-east/israel-and-gaza-militants-agree-to-cease-fire-after-weekend-of-violence/2019/05/06/255f9b6a-6f89-11e9-9f06-5fc2ee80027a_story.html?utm_term=.6959fc91ff75&wpisrc=nl_todayworld&wpm=1)

Thus, the chances of escalation are probably increasing. However, it still is not obvious that Iran will act in such a way that makes it obvious Iran is the perpetrator. Iran is a master of the covert.

**Turkey:** President Erdogan’s party has forced a new municipal election in Istanbul.<sup>9</sup> The initial vote was allegedly corrupt. We have no doubt that, compared to Western standards, the election process was probably open to question. However, our reading of the process suggests there was nothing all that unusual in last month’s local elections. New elections will be held on June 23.<sup>10</sup> It appears Erdogan is unwilling to accept adverse results and that is unnerving foreign investors.<sup>11</sup> The TRY has weakened on the news; however, our position is that the currency has already discounted significant bad news.

**Brexit:** Although there is hope that May and Corbyn can put together a coalition to approve a customs union, this outcome may not have staying power. It appears that even if a deal is made we are probably still looking at either a new referendum<sup>12</sup> or new general elections.<sup>13</sup> It isn’t clear that a new referendum will offer any more clarity and the second outcome probably either leads to a Corbyn government (and market panic) or Johnson (panic, but less so). Stay tuned...

**Fed governors:** Senate GOP leaders are putting together a list of potential governor candidates for the White House to avoid a repeat of the Stephen Moore/Herman Cain situation.<sup>14</sup> Although this makes sense, the candidates offered will likely be hard money policy hawks, exactly the opposite of what the president wants. So, we expect no short-term resolution on this issue.

## U.S. Economic Releases

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	JOLTS Job Openings	m/m	mar	7350	7087	**
15:00	Consumer Credit	m/m	mar	\$16.000 bn	\$15.188 bn	**
Fed speakers or events						
11:35	Randal Quarles Takes Part in FSB Roundtables	U.S. Federal Reserve Vice Chairman for Supervision				

<sup>9</sup> [https://www.washingtonpost.com/world/turkish-election-board-orders-new-vote-for-istanbul-mayor-after-ruling-party-loss/2019/05/06/3e22c8c2-701d-11e9-9331-30bc5836f48e\\_story.html?utm\\_term=.03a6516a8820&wpisrc=nl\\_todayworld&wpmm=1](https://www.washingtonpost.com/world/turkish-election-board-orders-new-vote-for-istanbul-mayor-after-ruling-party-loss/2019/05/06/3e22c8c2-701d-11e9-9331-30bc5836f48e_story.html?utm_term=.03a6516a8820&wpisrc=nl_todayworld&wpmm=1) and

[https://www.nytimes.com/2019/05/06/world/europe/turkey-istanbul-mayor-election.html?emc=edit\\_MBE\\_p\\_20190507&nl=morning-briefing&nlid=5677267tion%3DtopNews&section=topNews&te=1](https://www.nytimes.com/2019/05/06/world/europe/turkey-istanbul-mayor-election.html?emc=edit_MBE_p_20190507&nl=morning-briefing&nlid=5677267tion%3DtopNews&section=topNews&te=1)

<sup>10</sup> [https://www.politico.eu/article/turkish-authorities-cancel-istanbul-mayoral-election/?utm\\_source=POLITICO.EU&utm\\_campaign=d782f561bf-EMAIL\\_CAMPAIGN\\_2019\\_05\\_07\\_04\\_55&utm\\_medium=email&utm\\_term=0\\_10959edeb5-d782f561bf-190334489](https://www.politico.eu/article/turkish-authorities-cancel-istanbul-mayoral-election/?utm_source=POLITICO.EU&utm_campaign=d782f561bf-EMAIL_CAMPAIGN_2019_05_07_04_55&utm_medium=email&utm_term=0_10959edeb5-d782f561bf-190334489)

<sup>11</sup> <https://www.ft.com/content/c9fc455e-701c-11e9-bf5c-6eeb837566c5?emailId=5cd0fd378585b10004f43b27&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22>

<sup>12</sup> <https://www.ft.com/content/47d955b0-6fdd-11e9-bbfb-5c68069fbd15?emailId=5cd0fd378585b10004f43b27&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22>

<sup>13</sup> <https://www.ft.com/content/543d8a74-6ff1-11e9-bf5c-6eeb837566c5?emailId=5cd0fd378585b10004f43b27&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22>

<sup>14</sup> <https://www.ft.com/content/36ce59a6-704a-11e9-bf5c-6eeb837566c5>

## 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
<b>ASIA-PACIFIC</b>								
China	Foreign Reserves	m/m	apr	\$3.095 bn	\$3.099 bn	\$3.100 bn	*	Equity and bond neutral
Japan	Vehicle Sales	y/y	apr	2.5%	-4.7%		*	Equity and bond neutral
Australia	AiG Performance of Construction Index	m/m	apr	42.6	45.6		**	Equity and bond neutral
	ANZ Roy Morgan Weekly Consumption	m/m	may	117.3	117.6		**	Equity and bond neutral
	Trade Balance	m/m	apr	A\$4.949 bn	A\$4.801 bn	A\$4.480 bn	**	Equity bullish, bond bearish
	Retail Sales	m/m	mar	0.3%	0.8%	0.2%	**	Equity and bond neutral
New Zealand	2Yr Inflation Expectation	y/y	2q	2.0%	2.0%		**	Equity and bond neutral
<b>EUROPE</b>								
Germany	Factory Orders	y/y	apr	52.8	52.5	52.5	**	Equity and bond neutral
	Markit Germany Construction	y/y	apr	51.5	51.3	51.3	**	Equity and bond neutral
France	Trade Balance	m/m	mar	-5.324 bn	-4.002 bn	-4.500 bn	**	Equity bearish, bond bullish
	Current Account Balance	m/m	mar	-1.300 bn	-0.800 bn		**	Equity bearish, bond bullish
UK	New Car Registrations	m/m	apr	-4.1%	-3.4%		**	Equity and bond bearish
Switzerland	UBS Real Estate Bubble Index	q/q	1q	0.83	0.87		**	Equity and bond neutral
	Foreign Currency Reserves	m/m	apr	771.6 bn	756.0 bn	758.3 bn	**	Equity and bond neutral
<b>AMERICAS</b>								
Mexico	Consumer Confidence Index	m/m	apr	110.9	112.7	113.2	***	Equity and bond neutral
Canada	Bloomberg Nanos Confidence	m/m	may	54.9	54.9		**	Equity and bond neutral
Brazil	Markit Brazil PMI Services	m/m	apr	49.9	52.7		**	Equity and bond bearish
	Markit Brazil PMI Composite	m/m	apr	50.6	53.1		**	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
<b>3-mo Libor yield (bps)</b>	256	257	-1	Up
<b>3-mo T-bill yield (bps)</b>	236	237	-1	Neutral
<b>TED spread (bps)</b>	20	20	0	Neutral
<b>U.S. Libor/OIS spread (bps)</b>	239	239	0	Up
<b>10-yr T-note (%)</b>	2.47	2.47	0.00	Neutral
<b>Euribor/OIS spread (bps)</b>	-31	-31	0	Neutral
<b>EUR/USD 3-mo swap (bps)</b>	17	19	-2	Down
<b>Currencies</b>	<b>Direction</b>			
dollar	up			Neutral
euro	flat			Up
yen	up			Neutral
pound	down			Neutral
franc	down			Neutral
<b>Central Bank Action</b>	<b>Current</b>	<b>Prior</b>	<b>Expected</b>	
RBA Official Cash Rate	1.500%	1.500%	1.250%	Above Forecast
RBNZ Official Cash Rate		1.750%	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
<b>Energy Markets</b>				
Brent	\$70.36	\$71.24	-1.24%	Trade Concerns
WTI	\$61.64	\$62.25	-0.98%	
Natural Gas	\$2.53	\$2.52	0.12%	
Crack Spread	\$21.88	\$22.57	-3.08%	
12-mo strip crack	\$18.22	\$18.73	-2.72%	
Ethanol rack	\$1.45	\$1.45	-0.17%	
<b>Metals</b>				
Gold	\$1,280.17	\$1,281.10	-0.07%	
Silver	\$14.83	\$14.90	-0.50%	
Copper contract	\$278.60	\$282.95	-1.54%	
<b>Grains</b>				
Corn contract	\$ 364.00	\$ 364.25	-0.07%	
Wheat contract	\$ 432.75	\$ 437.25	-1.03%	
Soybeans contract	\$ 829.50	\$ 830.25	-0.09%	
<b>Shipping</b>				
Baltic Dry Freight	985	1032	-47	
<b>DOE inventory report</b>				
	<b>Actual</b>	<b>Expected</b>	<b>Difference</b>	
Crude (mb)		2.5		
Gasoline (mb)		-1.0		
Distillates (mb)		-0.5		
Refinery run rates (%)		-0.90%		

## Weather

The 6-10 and 8-14 day forecasts show cooler temps for most of the country, with warmer temps in the northwestern regions. 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 3, 2019

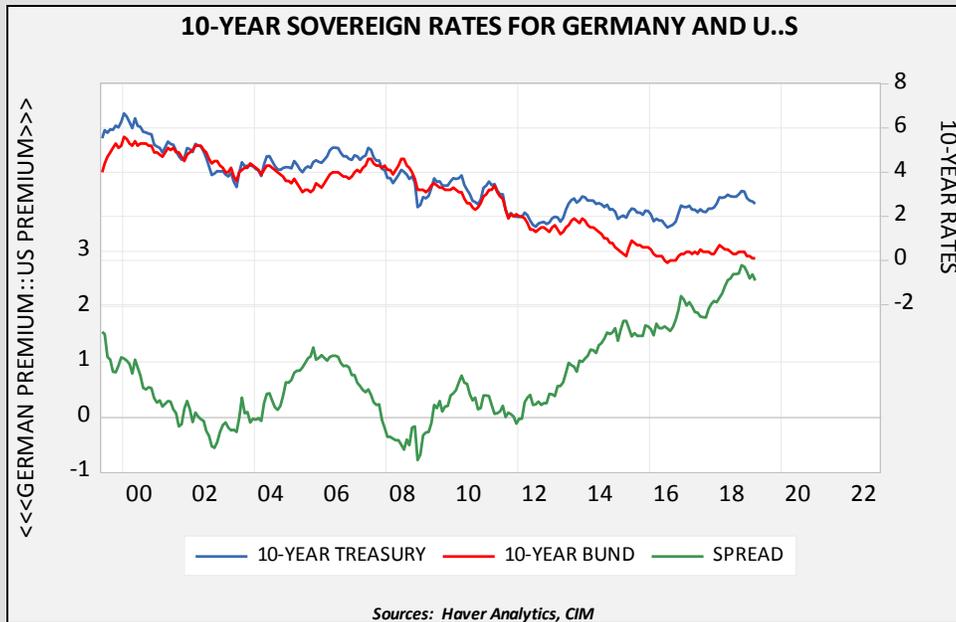
Covered interest rate parity is a basic concept that, at its heart, says all interest rates are equal after hedging exchange rate risk. It is one of the theories in finance that is beyond dispute—it works as long as capital markets are open (free of capital controls) and short-term money markets are liquid. In general, if foreign interest rates are higher than domestic rates, the forward exchange rate will trade at a premium high enough to absorb the interest rate difference. Here is a simple example:

		1-yr rate	
<b>foreign rate</b>		5.00%	
<b>domestic</b>		2.50%	
<b>spread</b>		2.50%	
		spot	forward
<b>dollar</b>		1.0000	1.0000
<b>euro</b>		1.0000	1.0250

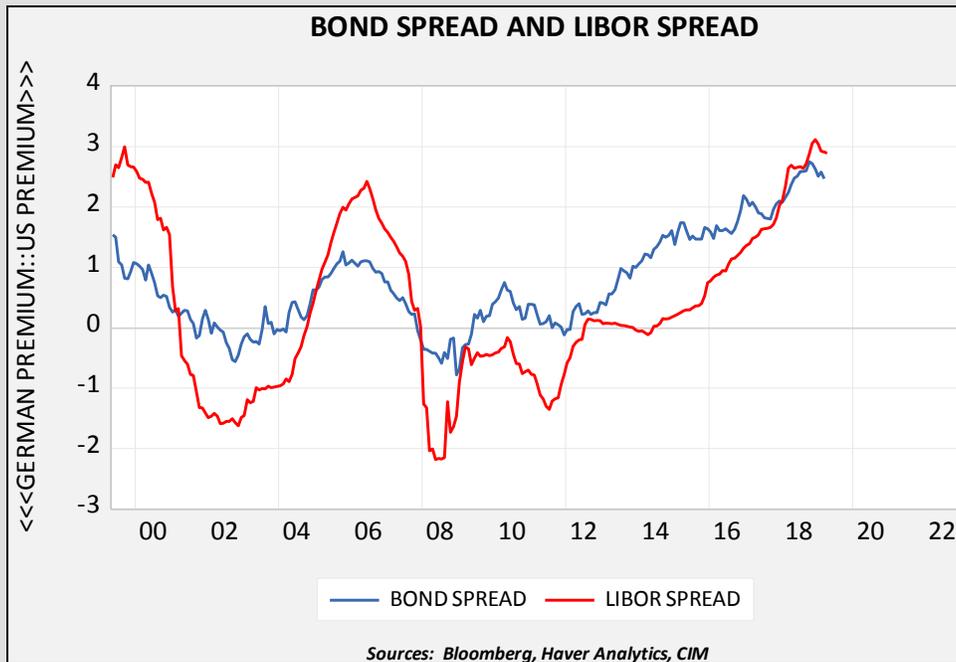
In our example, one-year interest rates in the Eurozone are 5.00% compared to U.S. rates at 2.50%. If the forward rates were equal, a U.S. investor could exchange dollars for euros, invest at the 2.50% spread and hedge the currency risk, earning a risk-free extra 2.50% compared to dollar-based interest rates. However, in the process of doing so, the forward rate on euros would be bid up to 1.0250, which eliminates any arbitrage opportunities. A U.S. investor should be indifferent to either investing in the U.S. at 2.5% or in the Eurozone at 5%, at 1.025 \$/€ one-year forward exchange rate. In a year, if nothing changes, that euro purchased at 1.025 will be at 1.00, eliminating the entire interest rate spread.

However, this doesn't necessarily mean that hedging opportunities don't exist. An investor could decide to buy into longer duration fixed income abroad and roll the hedge periodically. Using the above example, an investor could buy a foreign bond and hedge each year, selling the bond if the hedging costs become excessive.

The current spread between U.S. and German 10-year sovereigns clearly favors the U.S. German yields are around zero and U.S. yields remain significantly higher even though U.S. yields have declined. Thus, it would seem that German investors would have an incentive to buy longer dated Treasuries.

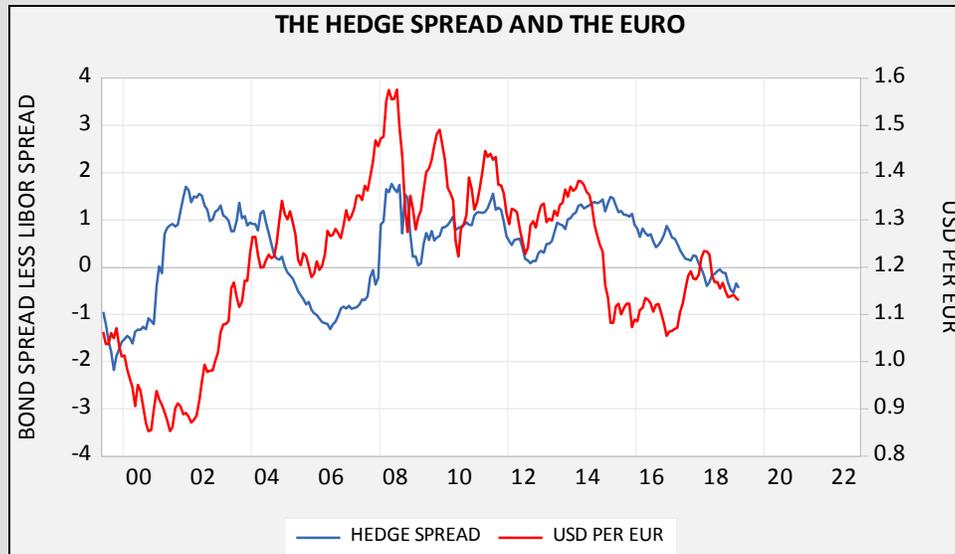


However, for a German investor to make this investment, he would have to either accept the currency risk or attempt to hedge the risk. As shown above, the short-term rate spread determines the currency forward discount/premium relationship.



This chart shows the 10-year sovereign spread and the three-month LIBOR spread. When the bond spread exceeds the LIBOR spread, the bond spread exceeds the cost of hedging. Even with a very wide sovereign spread, a foreign investor cannot, under current conditions, profitably hedge the currency risk.

This has led foreign bond investors to (a) accept U.S. credit risk by purchasing corporate bonds and hedging the exchange rate risk, or (b) accept the currency risk by leaving the transaction unhedged. However, that situation is less than ideal and may discourage foreign investors from investing in U.S. fixed income markets.

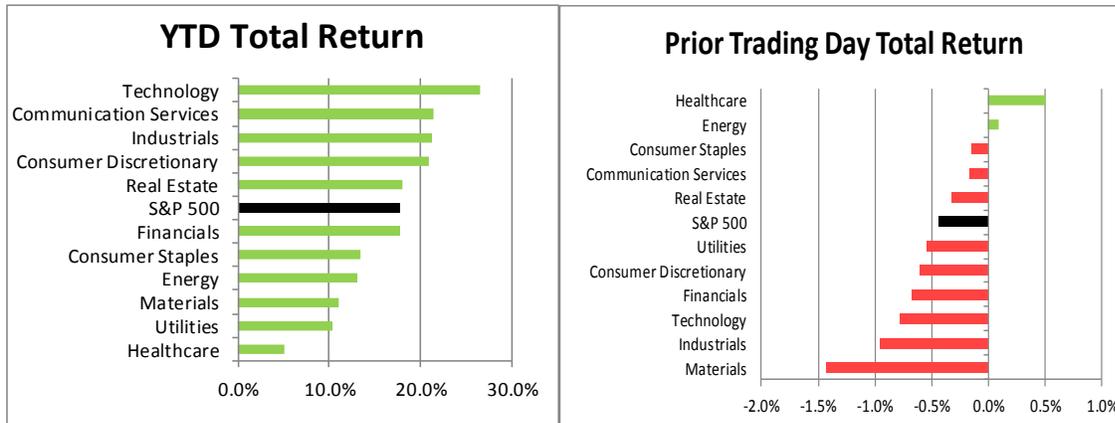


Although the hedge relationship with regard to the euro isn't overly strong, there is a modest tendency for the currency to strengthen against the dollar when the hedge spread is negative. Clearly, there are other factors that affect exchange rates beyond mere interest rate differences. Although the euro has been weakening recently, it hasn't declined significantly despite unusually wide sovereign spreads; the likely culprit is the cost of hedging. If the U.S. yield curve were to steepen, perhaps with policy easing, the window for hedging might reopen and, paradoxically, could lead to a stronger dollar.

*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**

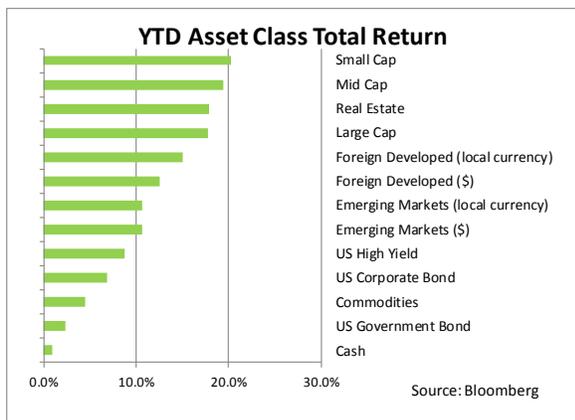
**U.S. Equity Markets – (as of 5/6/2019 close)**



(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 5/6/2019 close)**

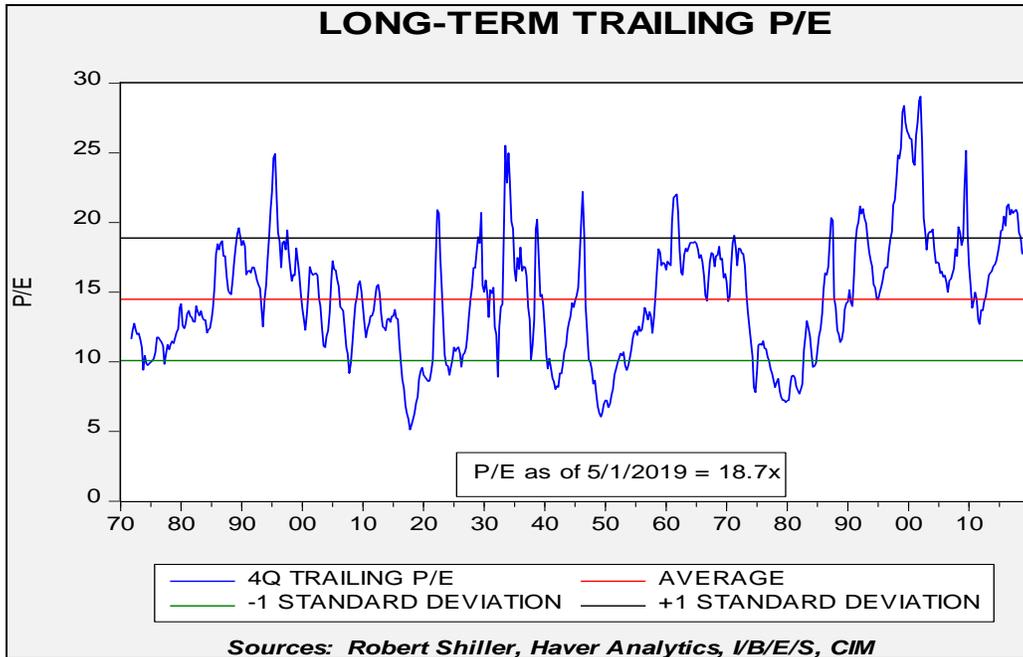


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 2, 2019



Based on our methodology,<sup>15</sup> the current P/E is 18.7x, 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.*

<sup>15</sup> 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 and Q4) and two estimates (Q1 and 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.