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: May 14, 2018—9:30 AM EDT] Global equity markets are generally mixed this morning. The EuroStoxx 50 is down 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.5% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.3% and the Shenzhen index down 0.1%. U.S. equity index futures are signaling a higher open. With 454 companies having reported, the S&P 500 Q1 earnings stand at $38.90, higher than the $36.49 forecast for the quarter. The forecast reflects an 18.4% increase from Q1 2017 earnings. Thus far this quarter, 78.9% of the companies reported earnings above forecast, while 14.8% reported earnings below forecast.

Happy Monday! Here is what we are watching this morning:

ZTE relief? In a surprise announcement, President Trump tweeted that he is seeking some sort of relief for the embattled company. ZTE (ZTCOF, 2.26, delayed) is under a rather harsh penalty from the Commerce Department for breaking Iranian sanctions. Under U.S. rules, the company would not be able to access U.S. components for its devices. According to reports,[1] President Trump was contacted by Chairman Xi who asked for help on this issue. This action does appear contrary to the general direction of trade policy toward China but is probably also part of the administration's broader negotiating stance. In other words, the president may be using ZTE relief to accomplish other parts of his trade agenda. We note that a high-level Chinese trade delegation is arriving in Washington on Friday, led by Vice Premier Liu He, a key member of Xi's governing team.

This event highlights an element of this administration's behavior. Simply put, the president's negotiating style is personal and improvisational. He doesn't over prepare and likes flexibility. This characteristic makes for great risk but also has the potential for breakthroughs. The North Korean negotiations are a case in point. It may turn out that the talks with Kim end up as a disaster, leading to war. At the same time, they might also lead to a new relationship and dramatic lessening of tensions. Previous administrations have been very cautious in their dealings with Pyongyang and have gotten nowhere. It is possible that Trump's negotiating style is what is needed to move the discussion forward.

[1] https://www.wsj.com/articles/trump-in-tweet-says-working-with-chinese-president-xi-to-keep-zte-in-business-1526225831 ; https://www.washingtonpost.com/news/the-switch/wp/2018/05/13/trump-pledges-to-help-chinese-phone-maker-zte-get-back-into-business/?utm_term=.deb75d6f11f8

A similar trend may develop on trade. The bellicose tone may morph into a workable trade deal that improves the global financial system and extends this business cycle. It could also devolve into a trade war. It is clear that Trump has gotten the world's attention. But, it is hard to know exactly what the result of these talks will be at their conclusion. For financial markets, this is really hard because part of the markets' role to discount the future. The future is always uncertain but when a negotiator vacillates between war and peace, it increases the difficulty. However, if Trump is offering Xi an "olive branch" on ZTE and it reduces trade tensions, it will be bullish for risk assets. In order for Trump to do that, he will likely need a high-visibility "deliverable" to bolster his political fortunes.

Iran: Iranian officials are visiting nations that still remain in the nuclear deal.[2] For now, it looks like the non-U.S. participants will remain in the agreement, although they will likely face the threat of secondary sanctions from the U.S.; National Security Advisor Bolton suggested this in the Sunday talk shows.[3] For now, we expect the deal to hold but, eventually, Iranian hardliners will use the rupture to retake control of the government and at least threaten to restart uranium enrichment. In the short run, oil prices have benefited from the risk of a decline in Iranian supplies. Those supplies are probably not at risk for the moment. We do note that China has opened an oil futures contract denominated in CNY. Reports indicate that volume has increased in light of the sanctions.[4] Although transacting in CNY will reduce the risk of dollar-based sanctions, it also reduces the value of Iranian oil as the CNY isn't broadly convertible and China limits foreign ownership of Chinese financial assets, a key element of the reserve currency system. Thus, Iran would be limited to buying Chinese goods and services. Still, one of the rules of sanctions is that the more nations that participate in the sanctions effort, the better they work and thus, if the U.S. stands alone, the impact of sanctions is lessened.

Italian government: According to reports, the two major populist blocs, the Five-Star Movement and the League, are making progress toward forming a government. Although the key sticking point, the prime minister position, hasn't been resolved, they have put together a policy platform that includes a basic national income for the poor, a reversal of pension reforms and a flat tax of 15%. Although the fiscal plan may meet the technical constraints of the Eurozone, it clearly doesn't meet the spirit of structural reforms that the Eurozone has been asking of Italy. A populist Italy will eventually threaten the fiscal rules of the Eurozone and, unlike Greece, Italy's economy is large enough to threaten the integrity of the single currency bloc. European equities have eased on the news while probably supporting modest EUR appreciation this morning.

Indonesia terror attack: It appears a set of bombings in Indonesia was executed by a family that had recently returned from Syria, reportedly[5] with ties to an Islamic State group. Two Christian churches were targeted. There have been fears among counterterrorism experts that the

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[2] https://www.rferl.org/a/iran-china-russia-nuclear-deal-zarif-trump/29223723.html?wpisrc=nl_todayworld&wpmm=1
[3] https://www.reuters.com/article/us-iran-nuclear-rouhani/rouhani-says-iran-may-remain-part-of-nuclear-accord-idUSKCN1IE0BY ; https://www.politico.com/story/2018/05/13/bolton-pompeo-trump-iran-sanctions-584206
[4] https://www.reuters.com/article/us-iran-nuclear-china-oil/chinas-crude-oil-futures-boom-amid-looming-iran-sanctions-idUSKCN1IF0SD
[5] http://www.bbc.com/news/world-asia-44101070?wpisrc=nl_todayworld&wpmm=1

demise of Islamic State would lead to its followers spreading into other parts of the world and carrying out attacks in their new countries. There was also an attack in Paris,[6] a knifing that may have been inspired by Islamic State, although the ties are not as clear as the Indonesian incident.

Iraqi elections: Although results are preliminary, it appears the radical cleric Moqtada al-Sadr was the winner of parliamentary elections over the weekend. Turnout was very low, around 45%, which may have contributed to his win. Results suggest his party won 54 out of 329 seats, which means he will need to build a coalition in order to govern. The expected winner, current PM Haider al-Abadi, came in third. Al-Sadr is an interesting candidate because he is considered an Iraqi nationalist—he opposes both the U.S. and Iran. Although a Shiite cleric, his relations with Iran are mixed and we suspect Tehran is not happy about his win as it will complicate relations between the two countries.

Hawkish Mester: Cleveland FRB President Mester indicated that better growth likely means she will support more rate hikes than she has in the past. She is a voter this year and this stance increases the odds of four hikes this year.

U.S. Economic Releases

The table below shows the Fed events scheduled for the rest of the day.

Economic Releases		
No economic releases today		
Fed speakers or events		
EST	**Speaker or event**	**District or position**
9:40	James Bullard Speaks in Washington	President of the Federal Reserve Bank of St. Louis

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.

[6] https://www.washingtonpost.com/world/europe/paris-police-respond-to-knife-attack-media-report-2-dead/2018/05/12/8fdf41e6-5623-11e8-a6d4-ca1d035642ce_story.html?utm_term=.2bb6f41e6179&wpisrc=nl_todayworld&wpmm=1

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
Japan	PPI	y/y	apr	2.0%	2.1%	2.0%	**	Equity and bond neutral
	Loans & Discounts Corp	y/y	apr	1.9%	2.2%		**	Equity and bond neutral
	Machine Tool Orders	y/y	apr	22.0%	28.1%		*	Equity and bond neutral
India	Wholesale Prices	y/y	apr	3.2%	2.5%	2.9%	**	Equity bullish, bond bearish
	CPI	y/y	apr	4.6%	4.3%	4.4%	***	Equity bullish, bond bearish
Australia	Credit Card Purchases	y/y	mar	A$26.6 bn	A$25.3 bn		**	Equity bullish, bond bearish
	Credit Card Balances	m/m	mar	A$52.5 bn	A$52.7 bn		**	Equity and bond neutral
New Zealand	Performance Services Index	y/y	apr	55.9	58.8		**	Equity and bond neutral
EUROPE								
Switzerland	Total Sight Deposits	m/m	may	576.2 bn	575.9 bn		*	Equity and bond neutral
	Domestic Sight Deposits	m/m	may	472.8 bn	473.8 bn		*	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)	234	236	-2	Up
3-mo T-bill yield (bps)	186	187	-1	Neutral
TED spread (bps)	48	49	-1	Neutral
U.S. Libor/OIS spread (bps)	187	187	0	Up
10-yr T-note (%)	2.98	2.97	0.01	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	1	2	-1	Down
Currencies	**Direction**			
dollar	up			Down
euro	up			Up
yen	down			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	$77.37	$77.12	0.32%	
WTI	$70.82	$70.70	0.17%	
Natural Gas	$2.82	$2.81	0.36%	
Crack Spread	$21.51	$21.65	-0.61%	
12-mo strip crack	$19.83	$19.82	0.02%	
Ethanol rack	$1.57	$1.57	-0.14%	
Metals				
Gold	$1,319.59	$1,319.30	0.02%	
Silver	$16.63	$16.67	-0.21%	
Copper contract	$308.75	$311.15	-0.77%	
Grains				
Corn contract	$ 395.00	$ 396.50	-0.38%	
Wheat contract	$ 493.50	$ 498.75	-1.05%	
Soybeans contract	$ 1,005.50	$ 1,003.25	0.22%	
Shipping				
Baltic Dry Freight	1472	1453	19	

Weather

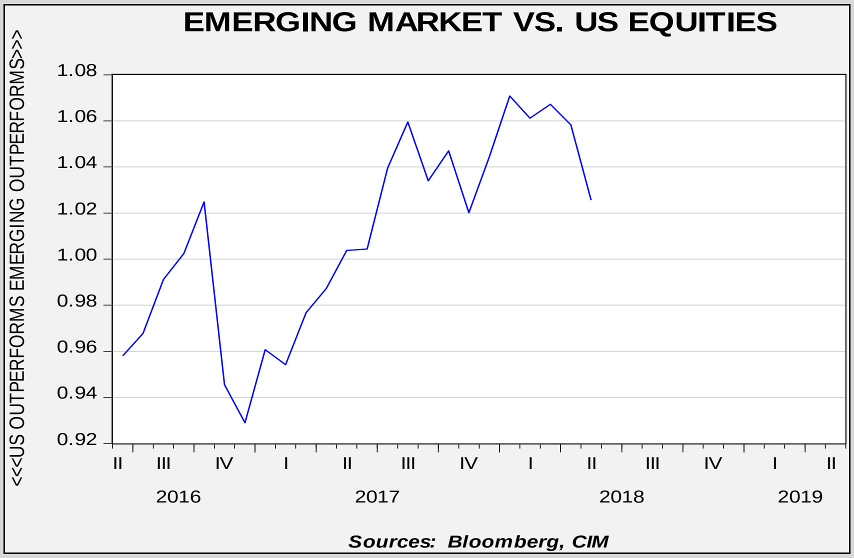
The 6-10 and 8-14 day forecasts continue to signal warmer to normal temperatures for most of the country. Precipitation is expected for most of the country.

Asset Allocation Weekly Comment

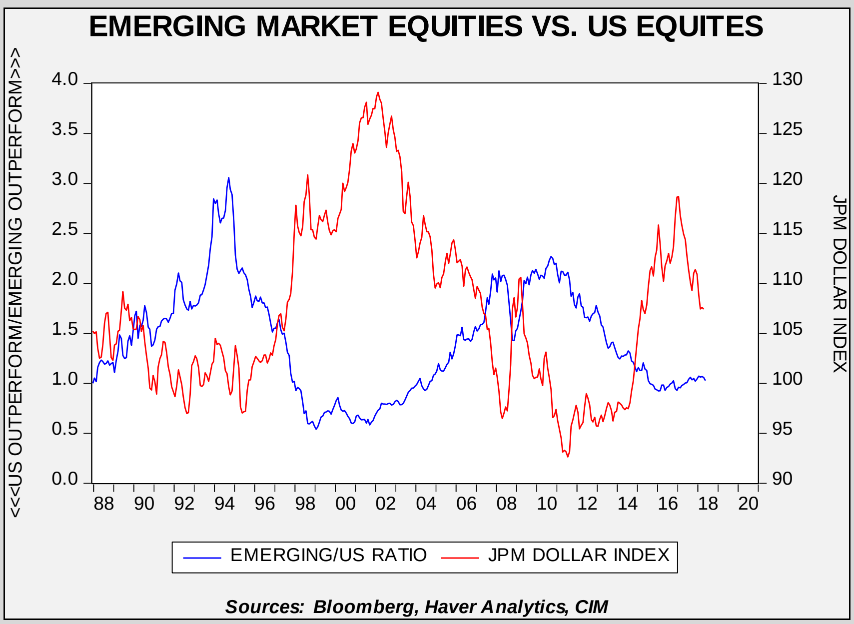
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

May 11, 2018

Recently, U.S. equities have outperformed emerging market equities.

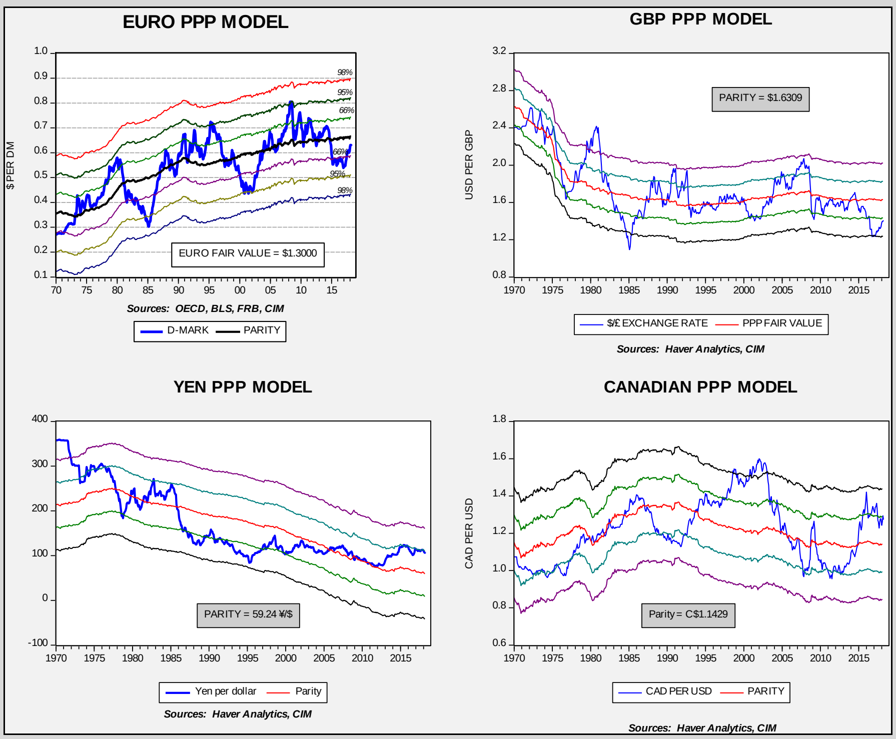


The chart above shows the relative performance of emerging market equities against U.S. equities. A rising line indicates that foreign equities are outperforming. Questions are being raised as to whether this recent decline is the end of what has been a strong relative uptrend in emerging equities that began near the end of 2016.



The above chart shows the same relative performance ratio along with the JPM dollar index. In general, emerging equities tend to trade opposite the dollar. In the past few weeks, the dollar has rallied after peaking in early 2017. We suspect this has mostly been a short-covering rally (surveys suggest market participants have been leaning heavily against the greenback), although there has been concern that interest rate differentials may be supporting the dollar as well.

Our basic valuation model for exchange rates is purchasing power parity, which assumes that exchange rates offset price differences between countries. In general, nations with higher inflation tend to have weaker exchange rates to equalize prices. The model is not perfect; not all goods are tradeable and trade regulations can interfere with the ability of floating exchange rates to generate "the law of one price." However, the historical record does suggest that when exchange rates deviate significantly from the fair value generated by the parity calculation, it is more probable that the trend will reverse over time. Currently the major exchange rates are running below parity.

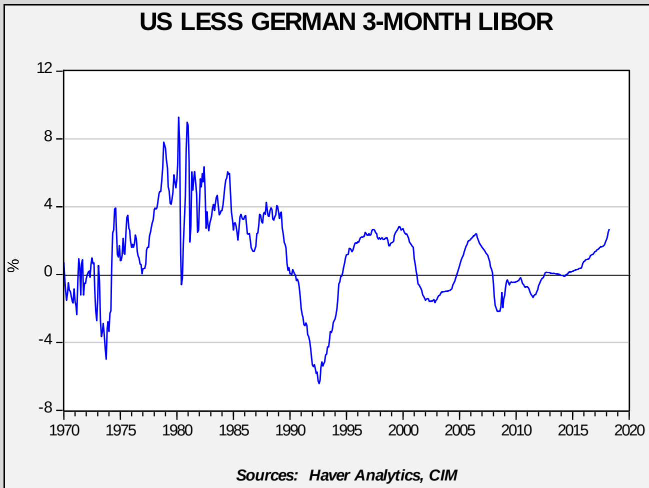


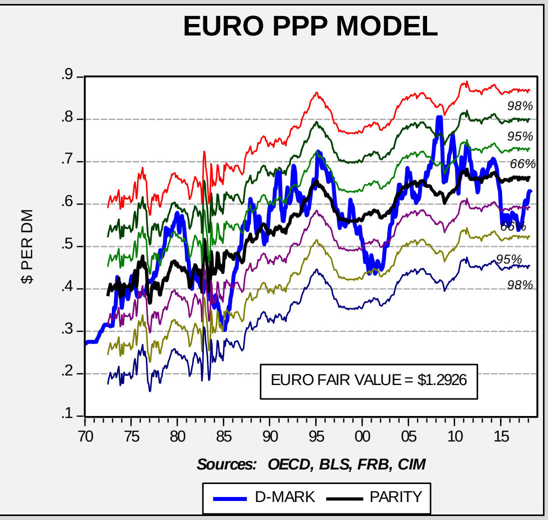
These four charts show the parity models for the D-mark (a proxy for the euro), the British pound, Japanese yen and Canadian dollar. All are, or have recently, been a standard error or more from fair value. This would suggest the dollar has more room to decline.

What about the widening interest rate differential? After all, the FOMC is tightening policy faster than the rest of the world. Although interest rate differentials affecting exchange rates makes intuitive sense, the small gains one can make from the differences in interest rates can be easily swamped by exchange rate moves. And, high interest rates alone are not necessarily signals of strength; recently, Argentina raised overnight rates to 40% to support the peso.[7] Such

[7] http://www.bbc.com/news/business-44001450

policy actions belie the notion that high interest rates automatically make a currency attractive. Still, between nations of similar credit characteristics, all else held equal, the nation with the higher interest rates would likely see a higher exchange rate.





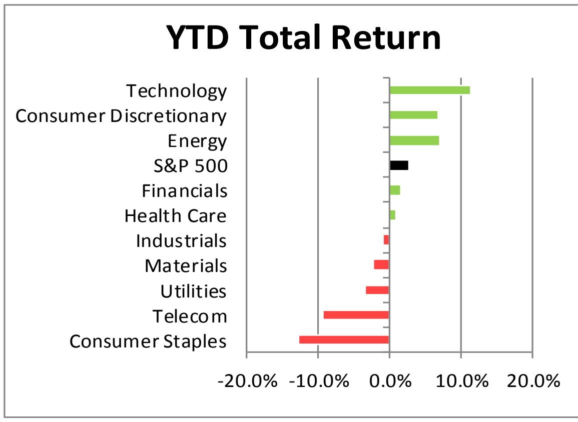
Adding the interest rate differential with a 30-month lag suggests the impact of interest rates isn't all that significant. Due to the lag, the differences in interest rates will tend to offer support to the dollar but, by far, the impact of relative inflation is more robust. Thus, if inflation in the U.S. does rise relative to German inflation, the impact of higher rates will be lessened.

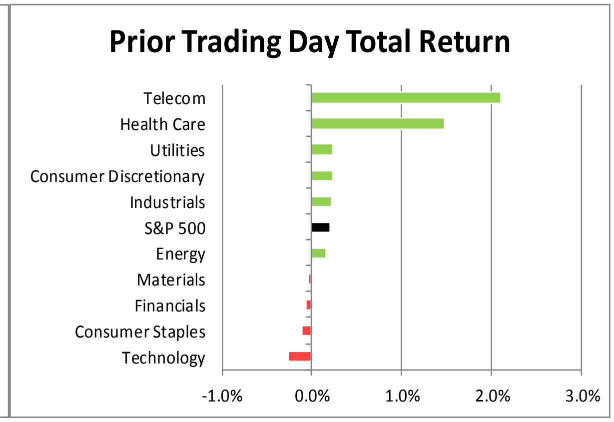
In conclusion, the recent rally in the dollar and pullback in emerging markets does bear watching, but the underlying fundamentals still support the emerging market allocation. Thus, without ample evidence to suggest otherwise, we expect emerging market equities to recover from recent weakness.

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 5/11/2018 close)

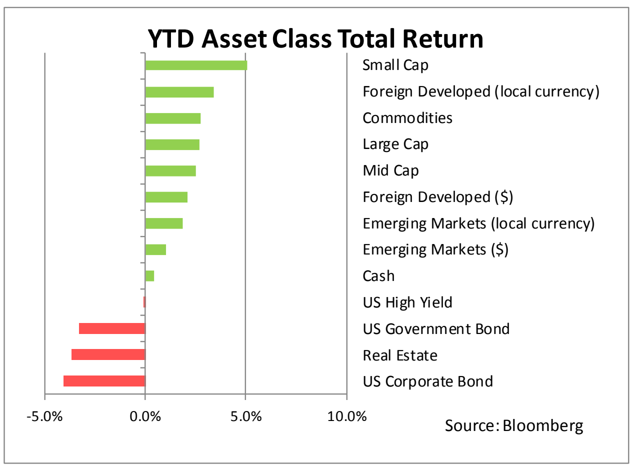




(Source: Bloomberg)

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 5/11/2018 close)

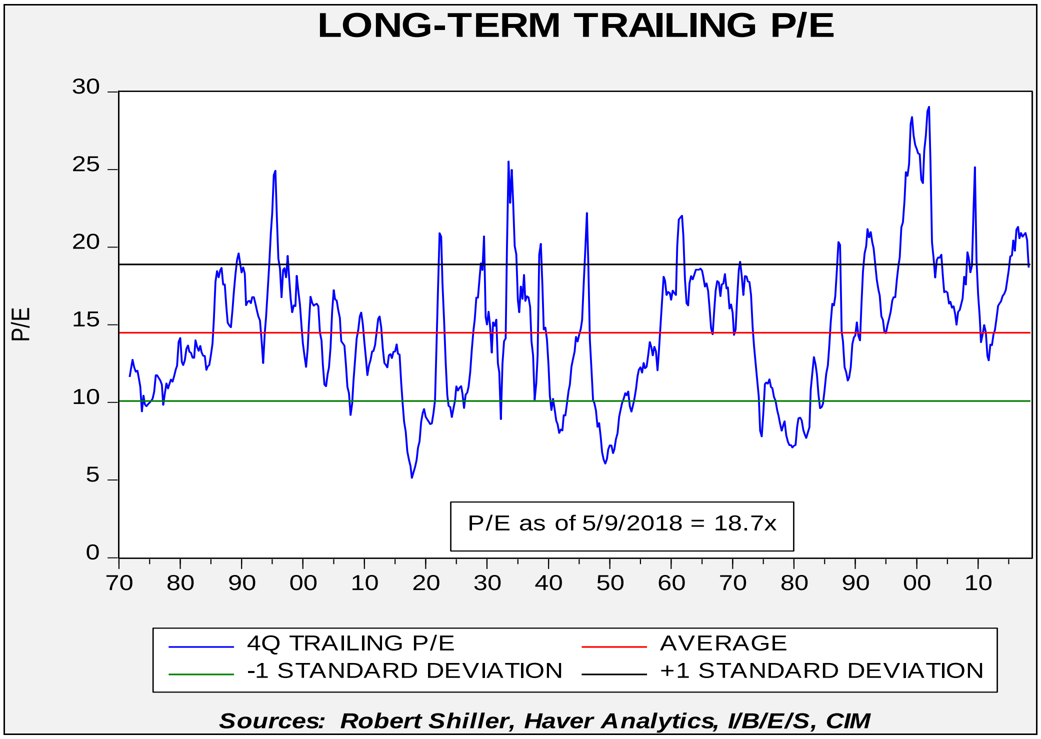


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 10, 2018



Based on our methodology,[8] the current P/E is 18.7x, down 0.1x from last week. The decline was due to rising earnings.

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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[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 two 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.