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 15, 2018—9:30 AM EDT] Global equity markets are generally mixed this morning. The EuroStoxx 50 is unchanged from the last close. In Asia, the MSCI Asia Apex 50 closed down 1.5% from the prior close. Chinese markets were up, with the Shanghai composite up 0.6% and the Shenzhen index up 0.9%. U.S. equity index futures are signaling a lower open. With 455 companies having reported, the S&P 500 Q1 earnings stand at $38.91, 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 14.7% reported earnings below forecast.

Risk markets are under some pressure this morning. Here is what we are watching this morning:

Clarida to the Hill: Richard Clarida, Columbia University economist and Global Strategic Advisor for PIMCO, testifies before the Senate Banking Committee on his way to a confirmation vote. Michelle Bowman, a Kansas banking regulator, will join him today in this endeavor. Clarida is up for the position of vice chair and, given Chair Powell's lack of academic experience, the vice chair position will be of great importance. We view Clarida as a moderate on policy and expect him to be easily confirmed. Bowman will fill the role reserved for community banks; this position routinely votes with the leadership. Filling out the FOMC is important. Meanwhile, Marvin Goodfriend's nomination remains in limbo; we doubt he can get confirmed and expect the administration to eventually find a replacement.

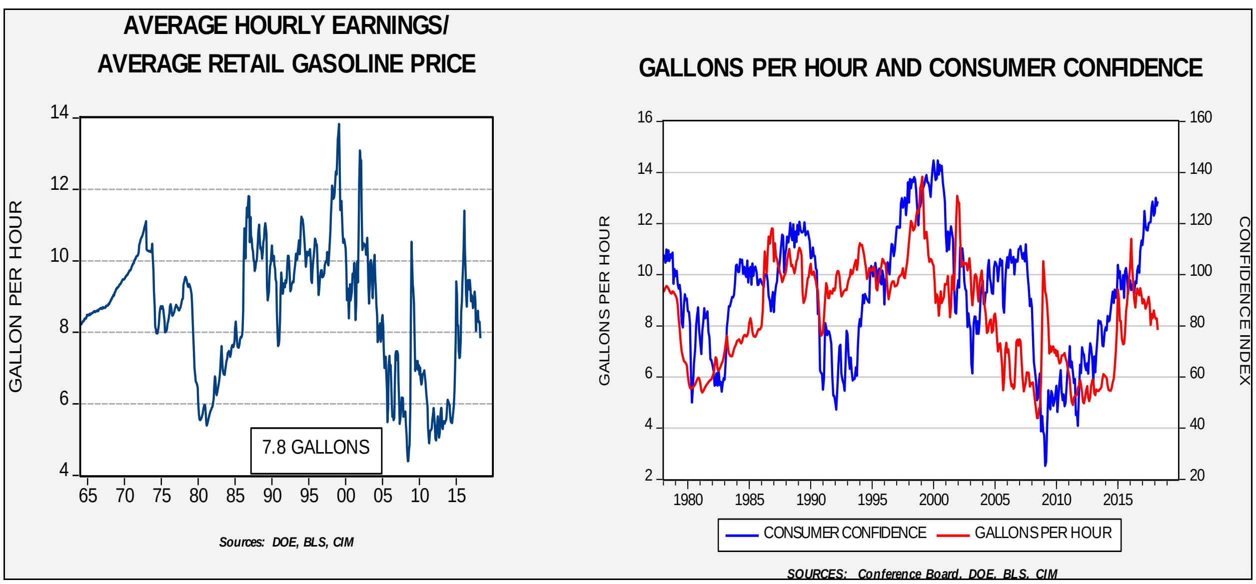
Today in trade: Every day seems to bring new information on trade. Today's trends indicate that NAFTA talks, so far, are not progressing fast enough to meet the May 17th (Thursday) deadline. But, it's probably too soon to declare negotiations "dead" because Washington seems to only accomplish things when deadlines loom. The president is trying to navigate the ZTE (ZTCOF, $2.26, delayed) issue. It appears the White House may be trading ZTE for grain tariffs, backing down on punishing ZTE in return for China not raising tariffs on grain.[1] There are suggestions that the China hawks may be losing influence[2]; specifically, it appears that Wilbur Ross may have acted rashly to punish ZTE. Although ZTE acted improperly, the punishment Ross approved was probably overly harsh and prompted the White House to walk it back. If this is the case, Treasury Secretary Mnuchin is likely becoming a more important influence on trade. If so, we could see a moderating tone on the trade war front.

[1] https://www.wsj.com/articles/u-s-china-discussing-deal-on-zte-agricultural-tariffs-1526313679
[2] https://www.politico.com/story/2018/05/14/ross-trump-china-trade-commerce-539279

Italian populists granted an extension: The Five-Star and League parties asked the Italian president for more time to form a government and the extension was granted. The policy platform does appear to be coming together but the sticking point is the prime minister. Neither party has enough power to press for its own party leader so they are trying to find a compromise candidate that both parties can live with. The possibility of a populist party is putting some pressure on the EUR.

Venezuelan woes: As the state oil company, PDVSA, defaults on bonds, creditors are taking steps to seize assets outside the country. In an especially crippling move, ConocoPhillips (COP, 69.59) has seized Caribbean tank farms and related export facilities owned by PDVSA.[3] ConocoPhillips won a court ruling against PDVSA for assets nationalized in Venezuela. There are reports of oil tankers owned by the company being seized by creditors.[4] The bottom line here is that PDVSA may find itself unable to export product and crude oil because creditors may seize the asset before it can reach its destination. Supply disruption from Venezuela may become a bigger issue than Iran for oil supplies.

Summer and gasoline: One of the ways we measure the impact of the price of gasoline is to compare it to the average hourly wage for non-supervisory workers.

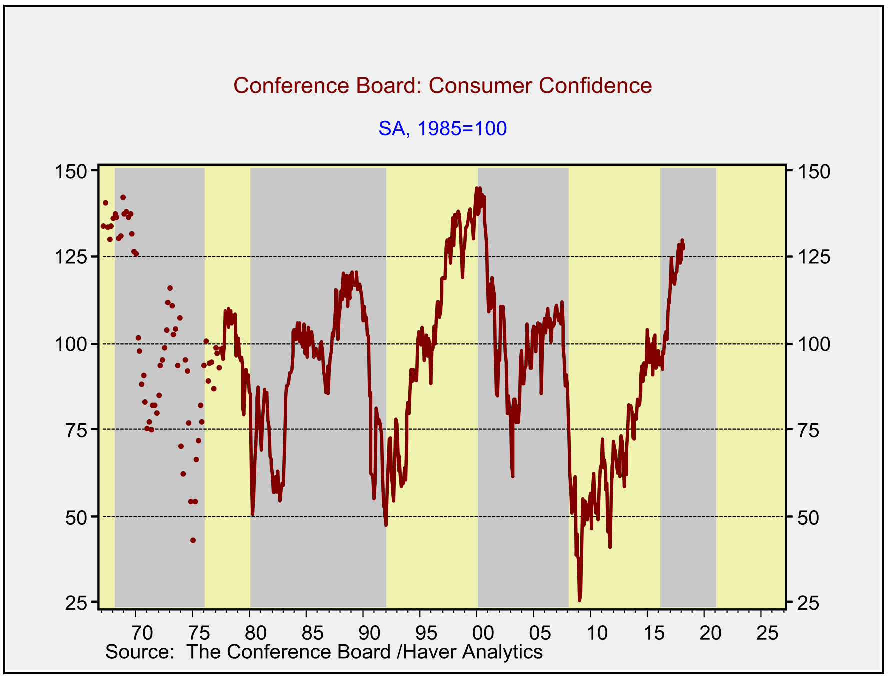


The chart on the left shows how many gallons of gasoline the average worker can purchase with an hour's worth of work. Thus, the larger the number the more beneficial it is to the worker. The long-term average is about 8.6 gallons per hour. We recently fell below 8.0 gallons, suggesting gasoline prices are getting a bit lofty. The chart on the right compares the aforementioned ratio to consumer confidence. It's not a perfect fit but, in general, a high ratio correlates with high consumer confidence. The recent decline in the ratio is diverging from the

[3] https://oilprice.com/Energy/Energy-General/ConocoPhillips-Moves-To-Seize-Venezuelan-Oil-Assets.html
[4] https://www.ft.com/content/fd86ae66-5504-11e8-b24e-cad6aa67e23e?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

current high levels of consumer confidence. There was a similar pattern around the turn of the century that eventually led to a drop in confidence.

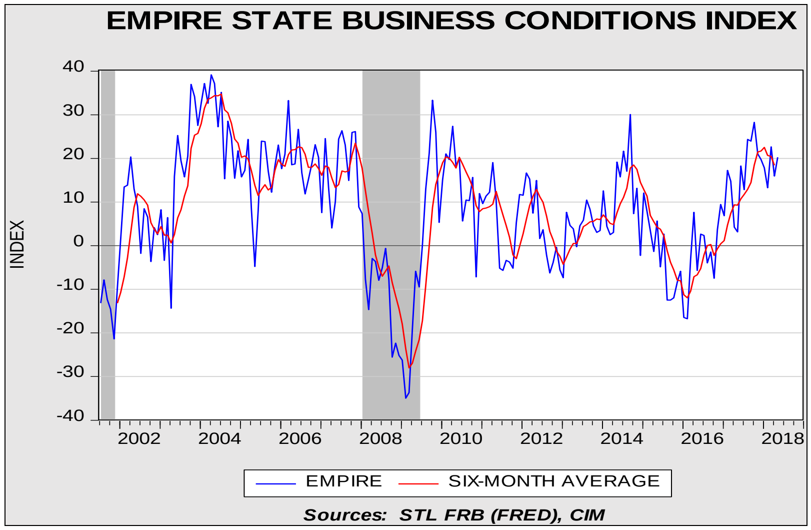
The impact of confidence on the economy is mixed. It sometimes coincides with stronger retail sales but other times diverges.[5] However, it does appear that confidence affects voting behavior. The chart below shows presidential parties, with gray showing Republican presidents. The relationship isn't perfect, but we note that confidence declined in the early 1990s and in 2007, leading to changes in power. Interestingly enough, confidence was mostly elevated at the end of Clinton's term as well as Obama's, but neither saw his party hold onto power. We note recently that the president criticized OPEC for keeping oil prices high. He may be worried that rising summer gasoline prices might undermine his popularity and hurt the GOP in the midterms. If oil gets to $80 per barrel or higher, we would not be shocked to see a large SPR release in a bid to ease prices.



U.S. Economic Releases

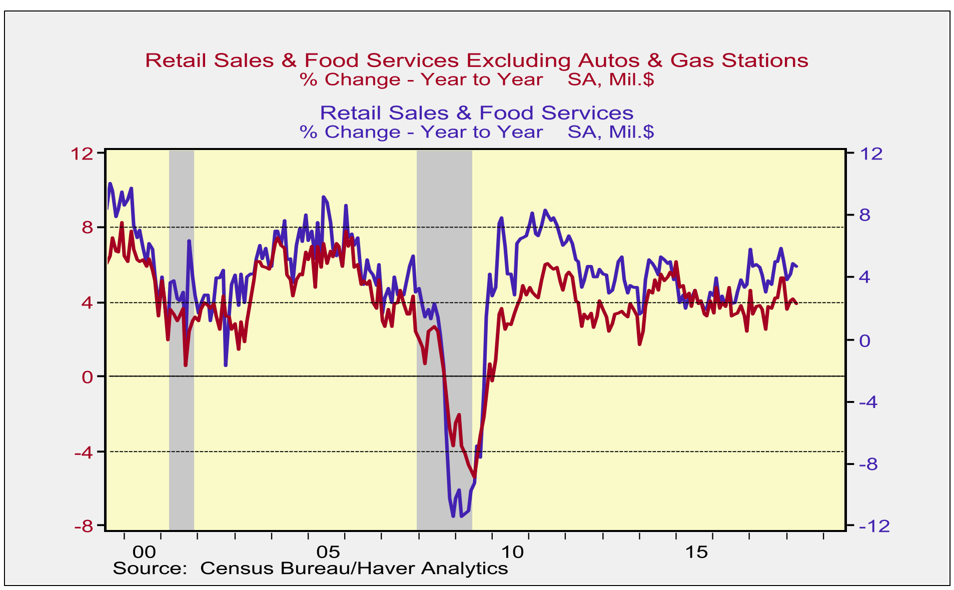
Empire manufacturing came in above expectations at 20.1 compared to the forecast of 15.0.

[5] The correlation between the yearly change in the control group of retail sales and consumer confidence is only +32%.



The chart above shows the six-month moving average of the Empire State Business Conditions Index.

Retail sales advance came in line with expectations, rising 0.3% from the prior month. The prior month's report was revised upward from 0.6% to 0.8%. Retail sales ex-auto came in below expectations, rising 0.3% from the prior month compared to the forecast of 0.5%. The prior report's gain was revised upward from 0.2% to 0.4%. Retail sales ex-auto and gas came in below expectations, rising 0.3% from the prior month compared to the forecast of 0.4%. The prior month's report was revised upward from 0.3% to 0.4%. The retail sales control group came in line with expectations, rising 0.4% from the prior month. The prior month's report was revised upward from 0.4% to 0.5%.



The chart above shows the year-over-year change in retail sales and core retail sales.

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	Business Inventories	m/m	mar	0.1%	0.6%	**
10:00	NAHB Housing Market Index	m/m	may	69	69	**
16:00	Total Net TIC Flows	m/m	apr		$44.7 bn	**
16:00	Net Long-term Tix Flows	m/m	apr		$49.0 bn	**
Fed speakers or events						
EST	Speaker or event	District or position				
10:00	Fed Nominees Clarida and Bowman Testify before Senate	Federal Reserve Nominees				
13:00	John Williams Speaks at Hoover Institution	President of the Federal Reserve Bank of San Francisco				

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	Surveyed Jobless Rate	y/y	apr	4.9%	5.1%		***	Equity and bond neutral
	Retail Sales	y/y	apr	9.4%	10.1%	10.0%	***	Equity bearish, bond bullish
	Industrial Production	y/y	apr	7.0%	6.0%	6.4%	***	Equity bullish, bond bearish
	Fixed Asset Ex Rural	y/y	apr	7.0%	7.5%	7.4%	**	Equity and bond neutral
Japan	Teritary Industry Index	y/y	mar	-0.3%	0.0%	-0.2%	**	Equity bearish, bond bullish
Australia	ANZ Roy Morgan Weekly Consumption	y/y	mar	120.8	119.6		**	Equity and bond neutral
EUROPE								
Eurozone	Industrial Production	m/m	may	0.5%	-0.8%	0.7%	***	Equity bearish, bond bullish
	GDP	m/m	1q	0.4%	0.4%	0.4%	***	Equity and bond neutral
	ZEW Survey Expectations	m/m	may	2.4	1.9		**	Equity and bond neutral
Germany	GDP	q/q	1q	0.3%	0.6%	0.4%	***	Equity bearish, bond bullish
	ZEW Survey Current Situations	m/m	apr	87.4	87.9	85.5	**	Equity and bond neutral
	ZEW Survey Expectations	m/m	apr	-8.2	-8.2	-8.2	**	Equity and bond neutral
France	Wages	q/q	1q	0.7%	0.2%		***	Equity bullish, bond bearish
	CPI EU Harmonized	m/m	apr	0.2%	0.1%	0.1%	***	Equity bullish, bond bearish
	CPI	m/m	apr	0.2%	0.1%	0.1%	*	Equity bullish, bond bearish
	Private Sector Payrolls	q/q	1q	0.3%	0.4%	0.4%	**	Equity and bond neutral
Switzerland	Producer & Import Prices	m/m	apr	0.4%	-0.2%		**	Equity and bond neutral
AMERICAS								
Brazil	Trade Balance Weekly	m/m	may	$1.896 bn	$1.209 bn		**	Equity bullish, bond bearish
Canada	Teranet/National Bank HPI	m/m	apr	0.2%	0.0%		**	Equity and bond neutral
	Bloomberg Nanos Confidence	y/y	mar	58.2	58.0		***	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)	187	188	-1	Neutral
TED spread (bps)	47	48	-1	Neutral
U.S. Libor/OIS spread (bps)	188	188	0	Up
10-yr T-note (%)	3.02	3.00	0.02	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	6	3	3	Down
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	down			Up
pound	down			Up
franc	down			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	$79.14	$78.23	1.16%	Uncertainty in the Middle East
WTI	$71.59	$70.96	0.89%	
Natural Gas	$2.83	$2.84	-0.32%	
Crack Spread	$22.13	$22.14	-0.03%	
12-mo strip crack	$20.38	$20.30	0.41%	
Ethanol rack	$1.58	$1.58	0.06%	
Metals				
Gold	$1,307.90	$1,313.50	-0.43%	
Silver	$16.41	$16.52	-0.71%	
Copper contract	$309.75	$309.30	0.15%	
Grains				
Corn contract	$ 398.75	$ 396.50	0.57%	
Wheat contract	$ 493.75	$ 491.25	0.51%	
Soybeans contract	$ 1,019.25	$ 1,017.75	0.15%	
Shipping				
Baltic Dry Freight	1476	1472	4	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.5		
Gasoline (mb)		-1.5		
Distillates (mb)		-1.9		
Refinery run rates (%)		0.70%		

Weather

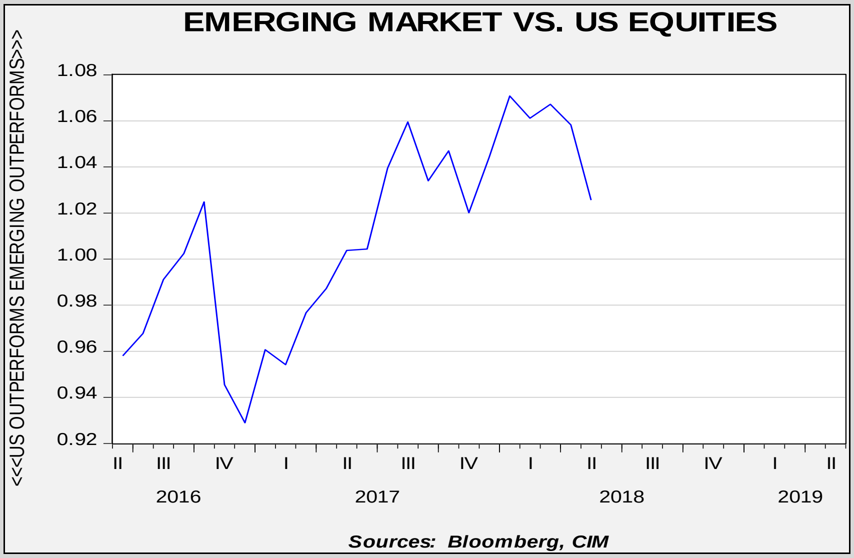
The 6-10 and 8-14 day forecasts continue to signal warmer to normal temperatures for most of the country. Precipitation is expected for most of the country.

Asset Allocation Weekly Comment

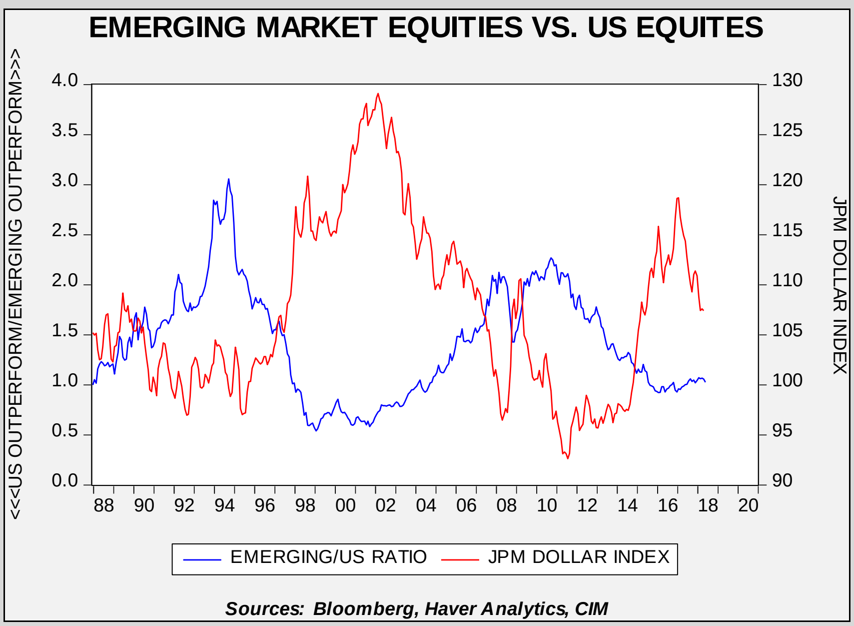
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

May 11, 2018

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

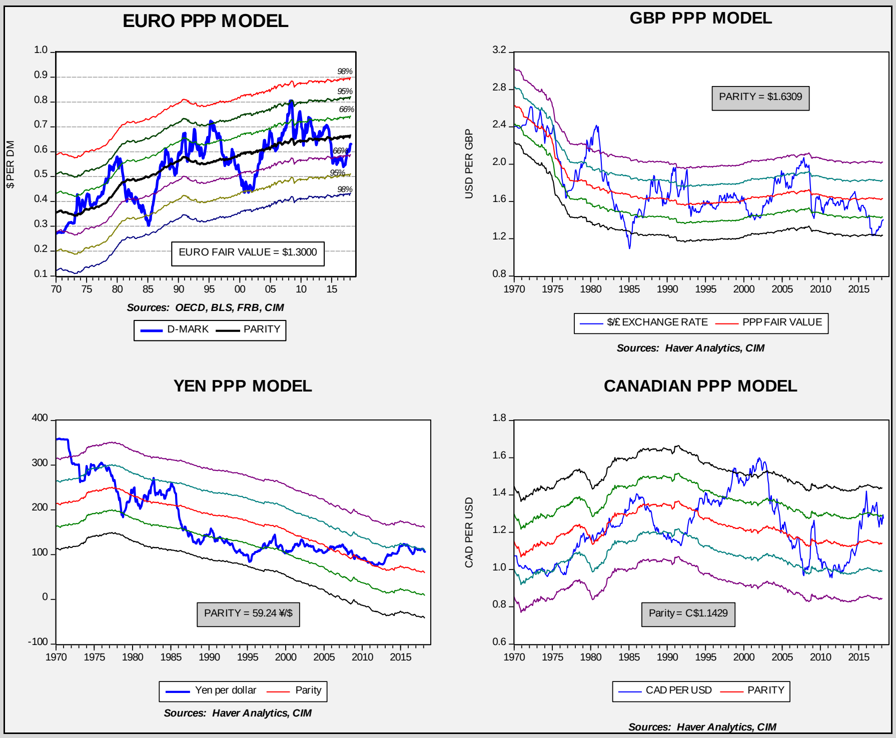


The chart above shows the relative performance of emerging market equities against U.S. equities. A rising line indicates that foreign equities are outperforming. Questions are being raised as to whether this recent decline is the end of what has been a strong relative uptrend in emerging equities that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

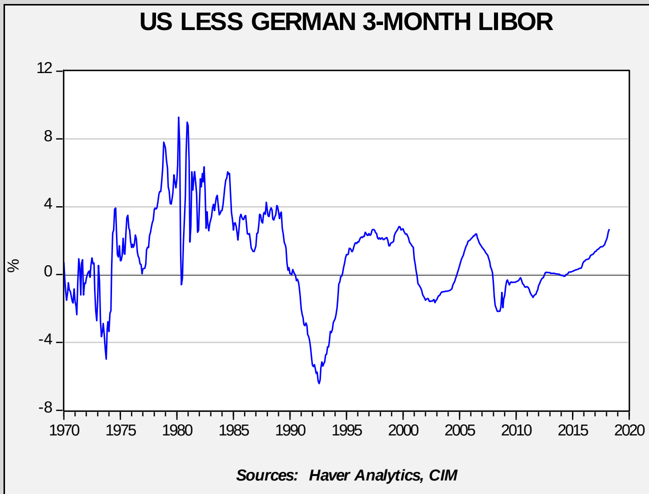


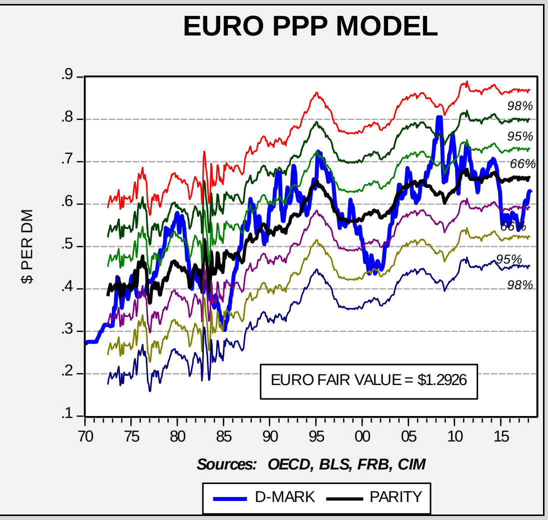
These four charts show the parity models for the D-mark (a proxy for the euro), the British pound, Japanese yen and Canadian dollar. All are, or have recently, been a standard error or more from fair value. This would suggest the dollar has more room to decline.

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.[6] Such

[6] 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.



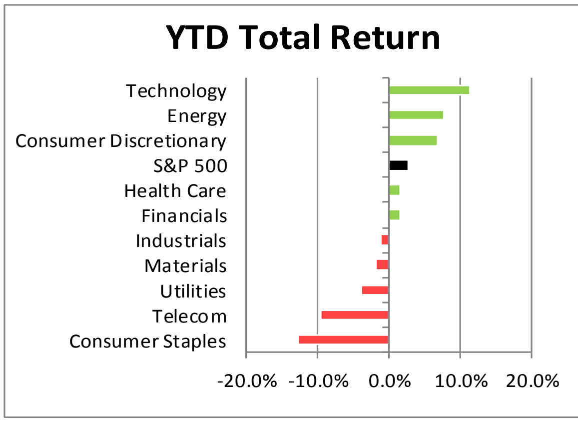


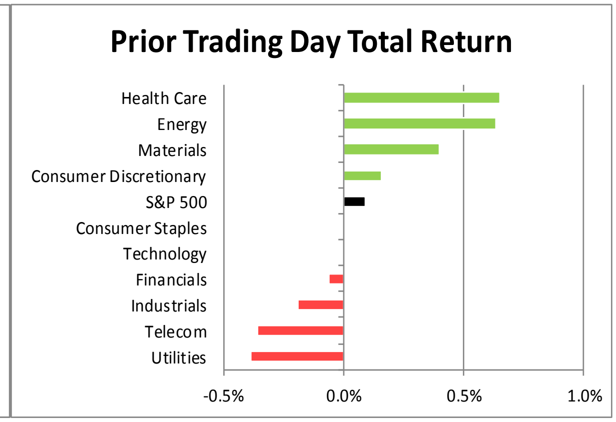
Adding the interest rate differential with a 30-month lag suggests the impact of interest rates isn't all that significant. Due to the lag, the differences in interest rates will tend to offer support to the dollar but, by far, the impact of relative inflation is more robust. Thus, if inflation in the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

Data Section

U.S. Equity Markets – (as of 5/14/2018 close)

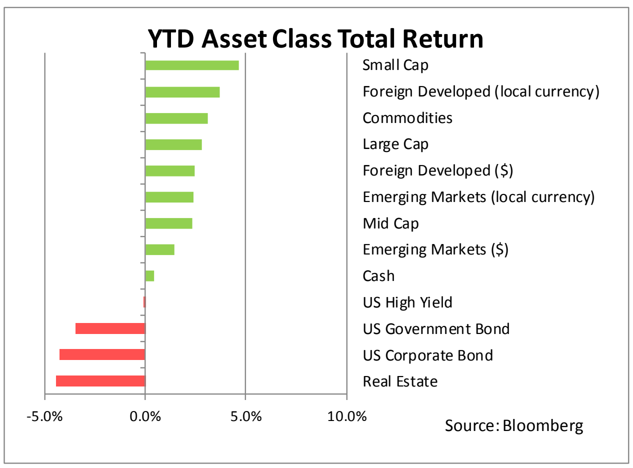




(Source: Bloomberg)

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 5/14/2018 close)

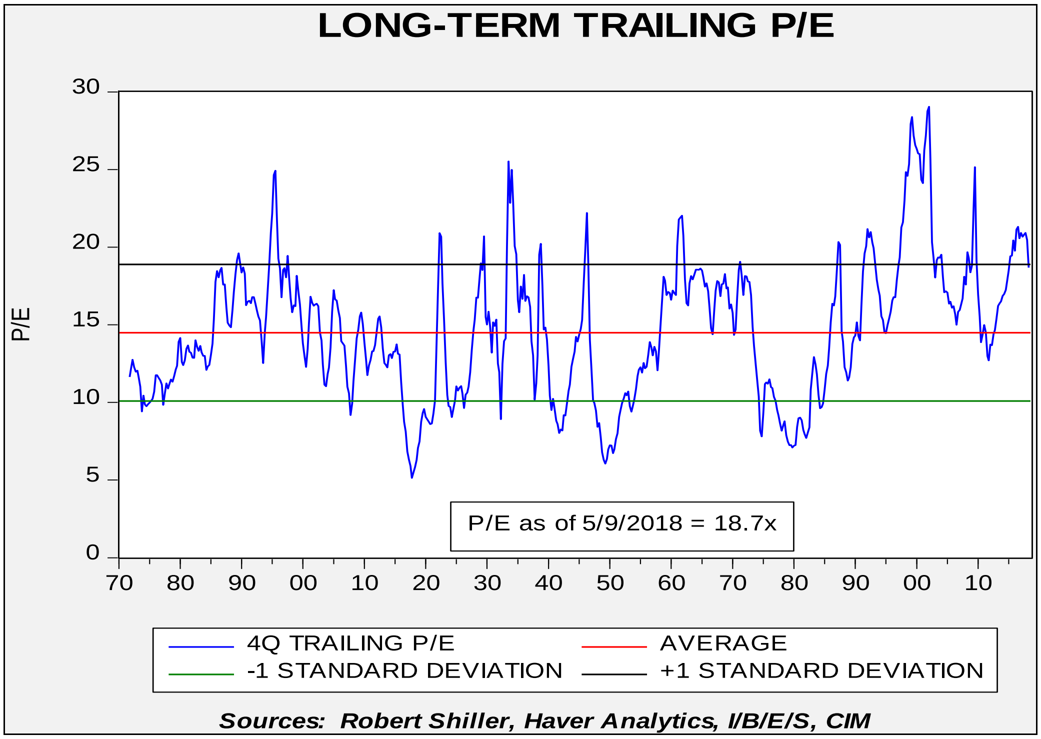


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[7] 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.

[7] 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.