Confluence INVESTMENT MANAGEMENT

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 16, 2018—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.1% from the prior close. Chinese markets were down, with the Shanghai composite down 0.7% and the Shenzhen index down 0.4%. U.S. equity index futures are signaling a lower open. With 456 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.

It's mid-week! Here is what we are watching this morning:

A DPRK snag? Yesterday afternoon, the Kim regime turned hostile, calling off talks with South Korea and threatening to cancel the summit meeting with President Trump. There is a lot of uncertainty around this sudden change in tone. However, here are some of our observations. First, the Kims are famous for erratic behavior. George Friedman of *Geopolitical Futures* used to call North Korean policy "ferocious, weak and crazy." In other words, the regime projected itself as strong (better not mess with us), weak (we are small fry, why bother) and crazy (don't provoke us, we might do anything). Kim's actions are consistent with his father and grandfather's behavior. Second, Kim gets more from this summit with Trump than anyone—he gets to put his nation on the world stage with the preeminent superpower. Thus, we doubt he will walk away. But, it makes sense that he would try to shape the talks before they begin. So, indicating that denuclearization ≠ unilateral nuclear disarmament is important for North Korea.[1] NSC Director Bolton has suggested that North Korea will follow the Libyan model, which is an unfortunate parallel, not one that Kim would adopt. North Korea wants "goodies" for each step in the denuclearization process. It does not want immediate denuclearization. Three, it's important not to underestimate the impact of China; Beijing would prefer the status quo, so it may be giving Kim incentives to walk away from the summit. However, our take is that Kim and Moon are really trying to make the Koreas independent. If so, Kim wants to use the U.S. to distance himself from China. We suspect Xi understands this goal and is probably trying to thwart it. We will be looking for any change in China's trade with North Korea.

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[1] https://www.ft.com/content/cb6413ce-588d-11e8-bdb7-f6677d2e1ce8?emailId=5afbaa115c5dad00042d6753&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22 and https://www.nytimes.com/2018/05/15/world/asia/north-korea-postpones-talks.html?emc=edit_mbe_20180516&nl=morning-briefing-europe&nlid=567726720180516&te=1

For financial markets, there are two issues within this story. First, does a hot war develop? Second, how do the talks with North Korea affect U.S./Chinese trade relations? Unless these two issues are affected, the North Korean situation won't have a dramatic impact on the financial markets.

Tensions at the FOMC? Reuters[2] is reporting that a dispute is developing over the issue of "R*Star," which is otherwise known as the natural rate of interest. It also describes what we often refer to as the "neutral rate." It's the rate of interest that is neither stimulative nor restrictive. The concept was first described by Knut Wicksell and suggests that the economy could overheat if policymakers set a rate below the R*Star, while a rate set above could trigger a recession. R*Star is not directly observable; economists attempt to estimate it based on a number of methods. The Phillips Curve is one attempt to determine this rate. Others try to do it through combinations of long-term productivity and labor force growth. The dispute is over how to define R*Star. John Williams, recently appointed as president of the NY FRB, argues that slow productivity and labor force growth have led to a structural decline in R*Star, meaning the FOMC may be close to the peak of its rate cycle. Randy Quarles, a Fed governor, has postulated the economy has a much faster growth potential and thus should have a higher rate. In some respects, this is a normal "fight" within the Fed, one between hawks and doves. The difference here is the arena—economists are fighting over R*Star.

On a related note, those who prepared Richard Clarida and Michelle Bowman for their hearings likely raised a glass last evening because the take on their confirmation testimonies was "boring." If one is preparing a nominee, boring is the goal. Although Clarida didn't offer us much in his testimony, he did indicate discomfort with QE and seemed to suggest he might not have supported the later versions of the program. As we have noted in the past, we suspect a generation of young economists will write their dissertations on QE and its impact. Simply put, we really don't know what it did. Our position is that the effect was mostly psychological. It convinced the public that the zero bound was not a barrier for further policy support. However, the liquidity injected seemed to sit harmlessly (and ineffectively) on bank balance sheets as excess reserves, so the real impact was probably limited. However, if the Fed forgoes QE, its only recourse at the zero bound is negative nominal interest rates.

Italy: There were a couple of bombshells that emerged from the coalition talks. First, a draft version of the coalition agreement sketched out a plan that would effectively return Italy to the pre-Maastricht world of a steadily depreciating lira.[3] Although the plan does not call for Italy to leave the Eurozone, it wants to be freed from fiscal constraints. Before joining the Eurozone, Italy maintained its economic growth through steady depreciation of the lira and expansive fiscal spending. Joining the Eurozone did lead to lower interest rates but restricted fiscal flexibility; economic growth in Italy has suffered ever since.

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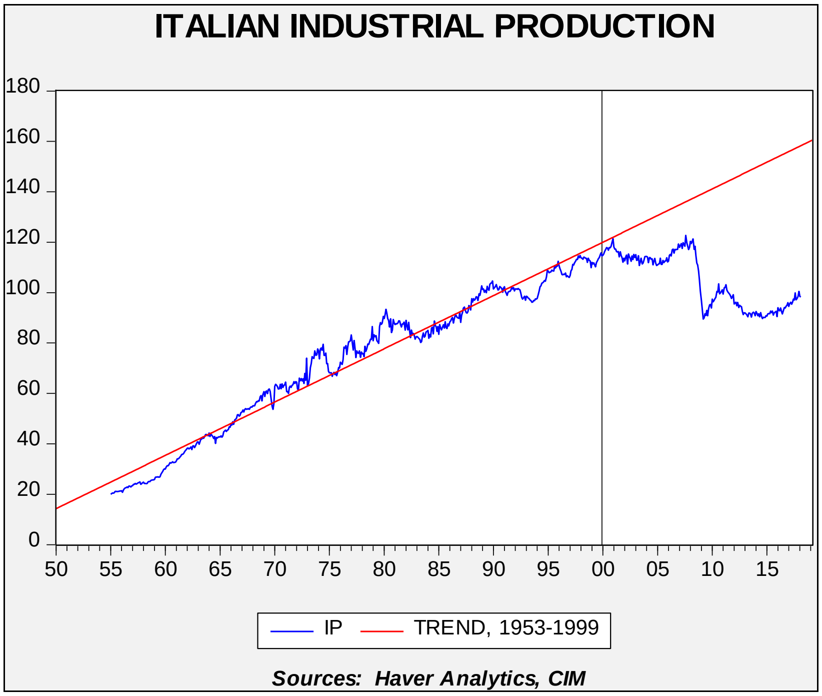
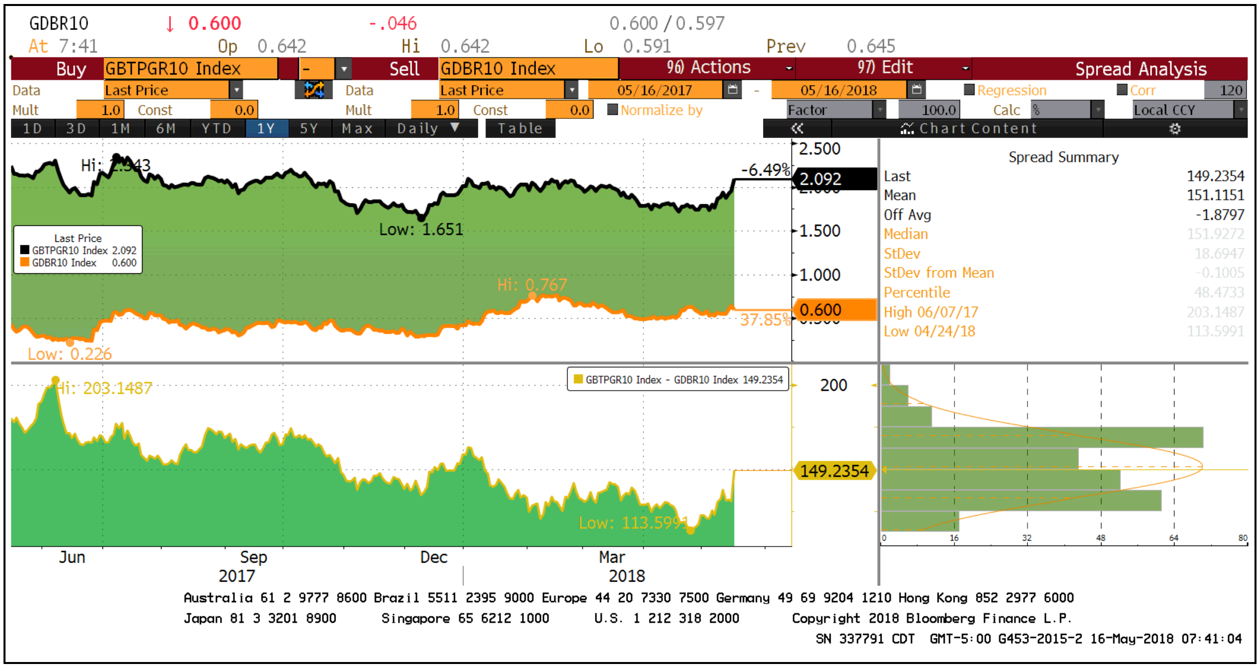
[2] https://www.reuters.com/article/us-usa-fed-nominees/at-top-of-fed-a-dispute-on-policy-picks-up-steam-idUSKCN1IG257

[3] https://www.ft.com/content/890ba3f4-588b-11e8-bdb7-f6677d2e1ce8



This chart shows Italian industrial production from 1953 to the present. Note that production rose steadily until Italy officially joined the single currency in 2000. Since then, production has stagnated. We don't disagree with the populist coalition—joining the Eurozone was a mistake. The question is how does Italy fix this issue? There are two paths. The first is a dramatic restructure of the Italian economy, similar to the labor market reforms in Germany (Hartz reforms) that occurred in the last decade. Politically, this is probably impossible. The second path is to leave the Eurozone. We have always suspected this would be the eventual outcome. The political trends suggest that exit is a growing possibility.

Another bombshell was that the potential coalition wants the ECB to cancel €250 bn of Italian government debt held on the ECB's balance sheet. This would probably be illegal under Eurozone rules, which prevents direct fiscal funding by the ECB. This report has sent Italian yields rising.



(Source: Bloomberg)

This chart shows German and Italian 10-year sovereigns. Note the spike in the spread.

Italian polls still indicate the majority of citizens want to remain in the Eurozone.[4] However, it is tied with Greece with the most against the Eurozone and the lowest actual support. The coalition probably doesn't have the support to exit the Eurozone yet. But, if Germany and the EU try to thwart Italy's attempt to expand fiscally, we would not be surprised to see a swing toward favoring an exit (and we would also expect increasing capital flight to protect against just that outcome).

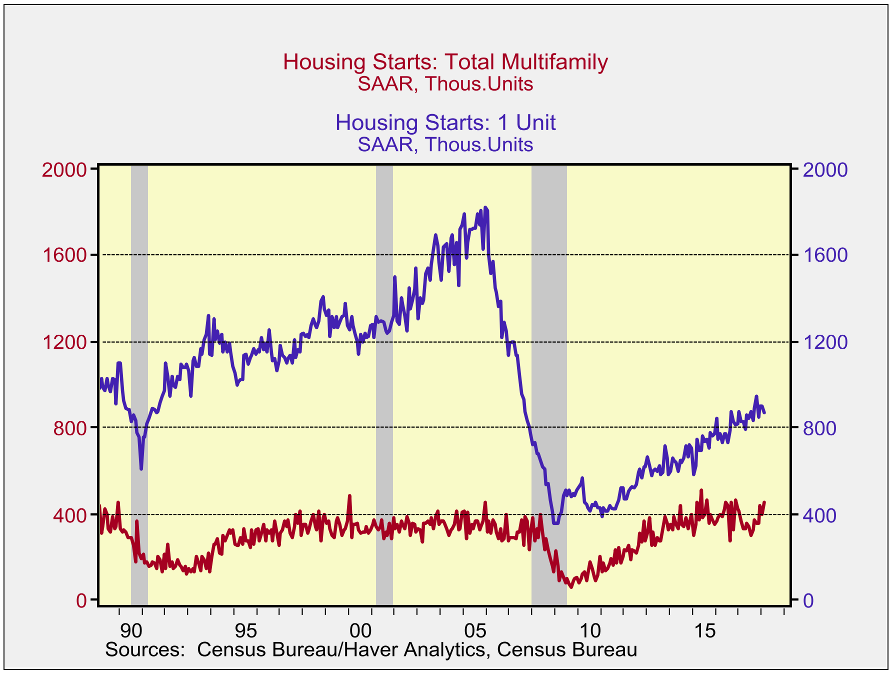
Would Italy's departure from the Eurozone be the end of the single currency? Although losing Italy would be significant, we suspect that it would likely lead to a two-currency bloc. It would be easy to make the case that Spain, Greece, Portugal, Italy and perhaps some of the Eastern European nations could join a currency bloc, while the Northern Europeans keep the euro. That scenario would probably lead to a much stronger EUR, while the southern bloc, by design, would depreciate. The key nation in this scenario is France. France should probably be in the southern bloc but it would want to stay linked to Germany. This outcome isn't imminent but, as history shows, a process like this can go quite quickly once it starts.

U.S. Economic Releases

MBA mortgage applications fell 2.7% from prior week. Purchases and refinancing fell 2.1% and 3.8%, respectively. The average 30-year fixed rate dropped by 1 bp from 4.78% to 4.77%.

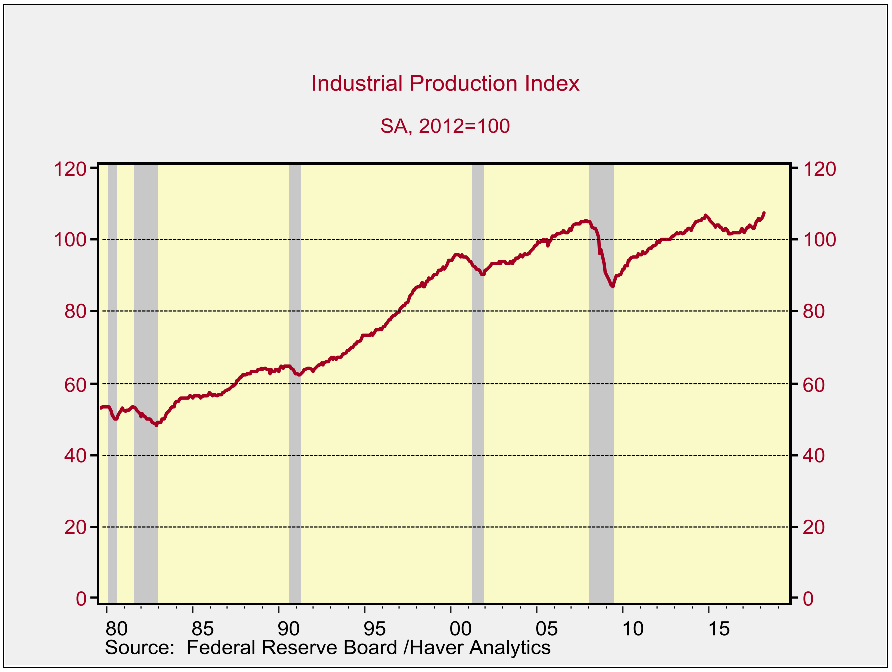
[4] https://www.ft.com/content/eb6bcbee-57e8-11e8-bdb7-f6677d2e1ce8

Housing starts came in below expectations at 1,287k compared to the forecast of 1,310k on an annualized basis. The prior month's report was revised upward from 1,319k to 1,336k. The monthly change in housing starts came in below expectations, falling 3.7% compared to the forecast loss of 0.7%. The prior report's gain was revised upward from 1.9% to 3.6%. Building permits came in above expectations at 1,352k compared to the forecast of 1,350k. The prior month's report was revised upward by 23k from 1,354k to 1,377k. The monthly change in building permits came in above expectations, falling 1.8% from the prior month compared to the forecast loss of 2.1%. The prior report's gain was revised upward from 2.5% to 4.1%.



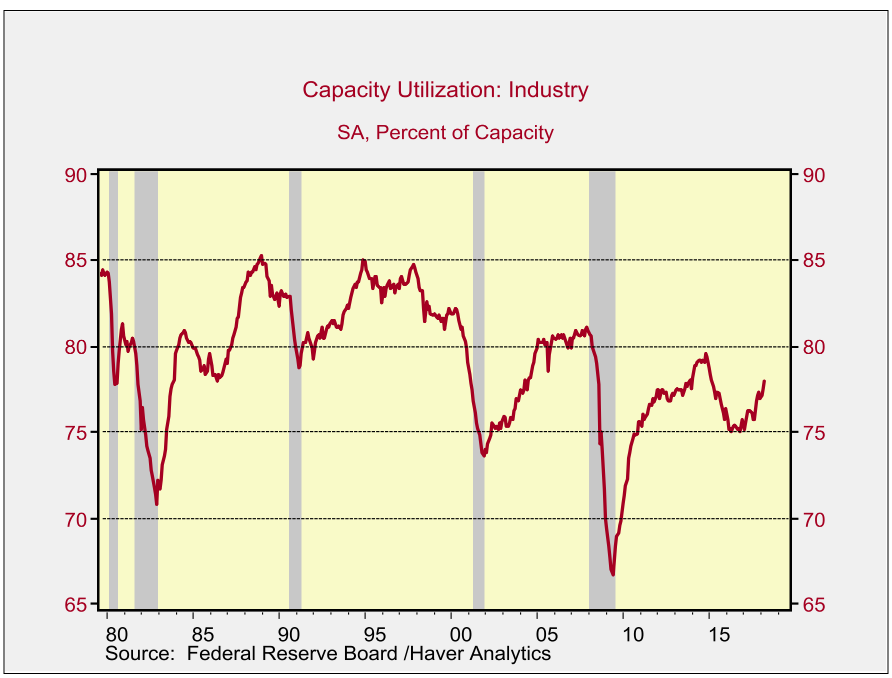
The chart above shows the level of multi-family and single-family housing starts. Multi-family starts have risen 18.7%, while single-units rose 7.2% from the prior year. Housing starts on an annual basis rose 34.1% in the Northeast, 16.3% in the South and 12.0% in the West, but fell 18.4% in the Midwest.

April industrial production came in above expectations, rising 0.7% from the prior month compared to the forecast gain of 0.6%. The prior month's gain was revised upward from 0.5% to 0.7%.



The chart above shows the level of industrial production. The current reading is 107.3, which is a new cycle high for this expansion.

Capacity utilization came in slightly below expectations at 78.0% compared to the forecast of 78.6%, and the prior month was revised downward from 78.0% to 77.6%.



The chart above shows the level of capacity utilization.

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	Mortgage Delinquencies	q/q	1q		5.2%	**
10:00	MBA Mortgage Foreclosures	q/q	1q		1.2%	**
Fed speakers or events						
EST	Speaker or event	District or position				
17:30	James Bullard Speaks to Media	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.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
China	New Home Prices	m/m	apr	0.6%	0.4%		**	Equity and bond neutral
Japan	GDP	q/q	1q	-0.2%	0.0%	0.4%	***	Equity bearish, bond bullish
	Capacity Utilization	m/m	mar	0.5%	1.3%		***	Equity and bond neutral
	Industrial Production	y/y	mar	2.4%	2.2%		***	Equity and bond neutral
India	Trade Balance	y/y	apr	-$13.716 bn	-$13.691 bn	-$15.000 bn	**	Equity bullish, bond bearish
Australia	Westpac Consumer Confidence	m/m	may	-0.6%	-0.6%		**	Equity and bond neutral
	Wage Price	y/y	mar	2.1%	2.1%	2.1%	**	Equity and bond neutral
New Zealand	Non Resident Bond Holdings	m/m	apr	59.8%	59.0%		**	Equity bullish, bond bearish
EUROPE								
Eurozone	CPI core	m/m	apr	0.7%	0.7%	0.7%	***	Equity and bond neutral
	CPI	m/m	apr	1.2%	1.3%	1.2%	***	Equity and bond neutral
Germany	CPI	m/m	apr	0.0%	0.0%	0.0%	***	Equity and bond neutral
	CPI EU Harmonized	m/m	apr	-0.1%	-0.1%	-0.1%	***	Equity and bond neutral
Italy	Industrial Sales	m/m	mar	0.8%	0.5%		**	Equity bullish, bond bearish
	Industrial Orders	m/m	mar	0.5%	-0.6%		**	Equity and bond neutral
	CPI EU Harmonized	m/m	apr	0.6%	0.6%	0.6%	***	Equity and bond neutral
AMERICAS								
Brazil	Trade Balance Weekly	m/m	may	$1.896 bn	$1.209 bn		**	Equity bullish, bond bearish
Canada	Existing Home Sales	m/m	apr	-2.9%	1.3%	0.4%	**	Equity bearish, bond bullish

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)	233	234	-1	Up
3-mo T-bill yield (bps)	187	187	0	Neutral
TED spread (bps)	46	47	-1	Neutral
U.S. Libor/OIS spread (bps)	189	188	1	Up
10-yr T-note (%)	3.08	3.07	0.01	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	8	8	0	Down
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	up			Up
pound	down			Up
franc	flat			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Overnight Rate		7.500%	7.500%	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	$77.94	$78.43	-0.62%	Bearish IEA report
WTI	$71.19	$71.31	-0.17%	
Natural Gas	$2.83	$2.84	-0.18%	
Crack Spread	$21.88	$21.91	-0.13%	
12-mo strip crack	$20.37	$20.41	-0.20%	
Ethanol rack	$1.58	$1.58	0.13%	
Metals				
Gold	$1,286.82	$1,290.53	-0.29%	
Silver	$16.22	$16.27	-0.31%	
Copper contract	$306.55	$305.60	0.31%	
Grains				
Corn contract	$ 403.75	$ 402.25	0.37%	
Wheat contract	$ 496.50	$ 493.50	0.61%	
Soybeans contract	$ 1,013.50	$ 1,018.75	-0.52%	
Shipping				
Baltic Dry Freight	1468	1476	-8	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.5		
Gasoline (mb)		-1.5		
Distillates (mb)		-1.9		
Refinery run rates (%)		0.70%		
Natural gas (bcf)		107.0		

Weather

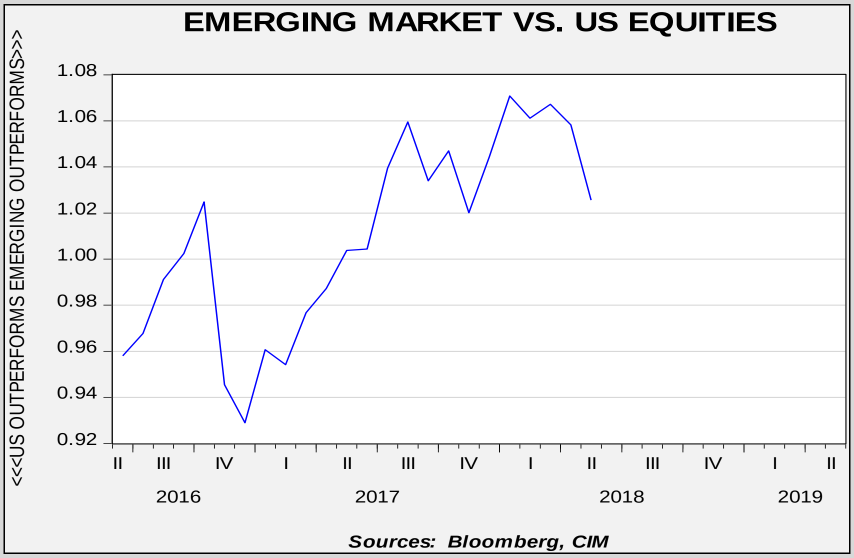
The 6-10 and 8-14 day forecasts continue to signal warmer to normal temperatures for most of the country. Precipitation is expected for most of the country.

Asset Allocation Weekly Comment

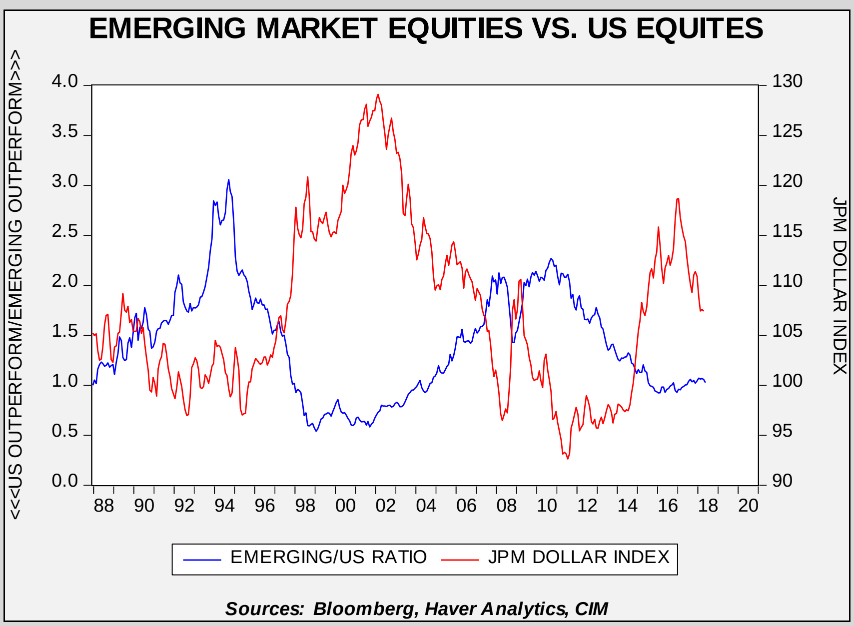
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

May 11, 2018

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

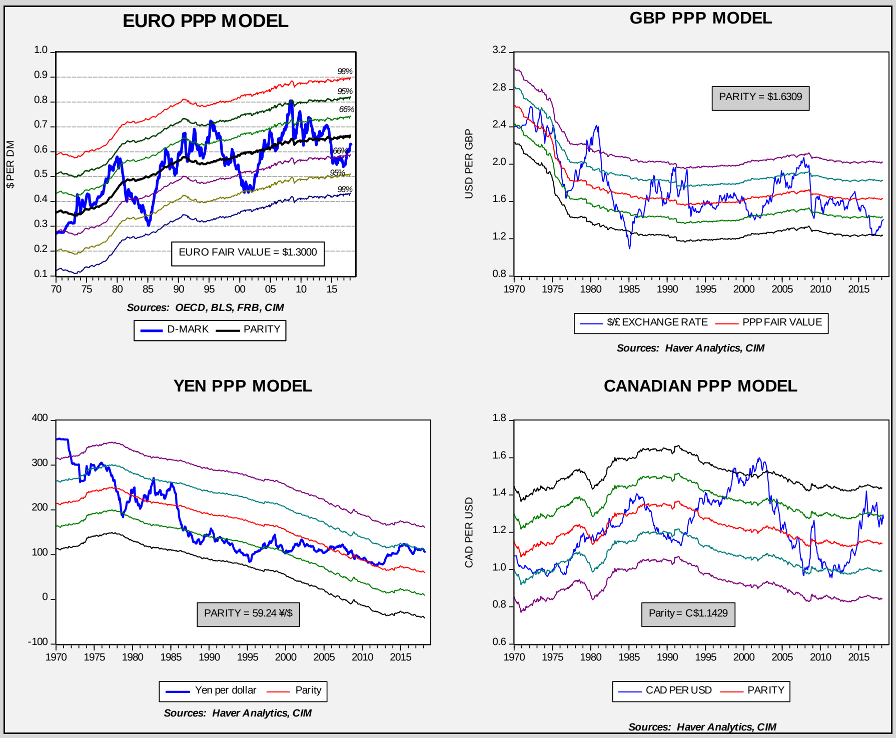


The chart above shows the relative performance of emerging market equities against U.S. equities. A rising line indicates that foreign equities are outperforming. Questions are being raised as to whether this recent decline is the end of what has been a strong relative uptrend in emerging equities that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

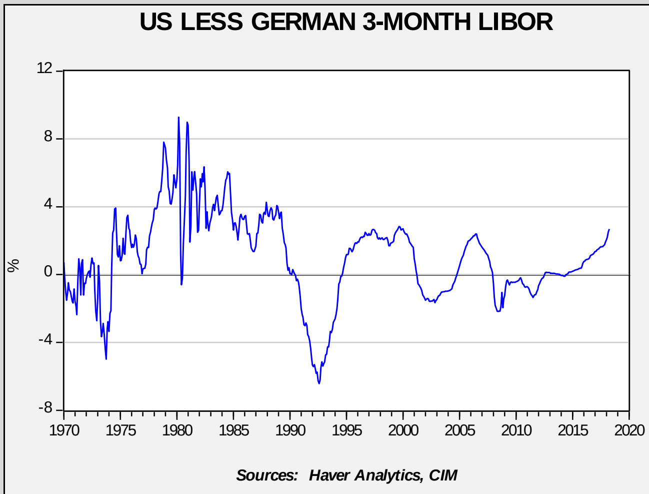


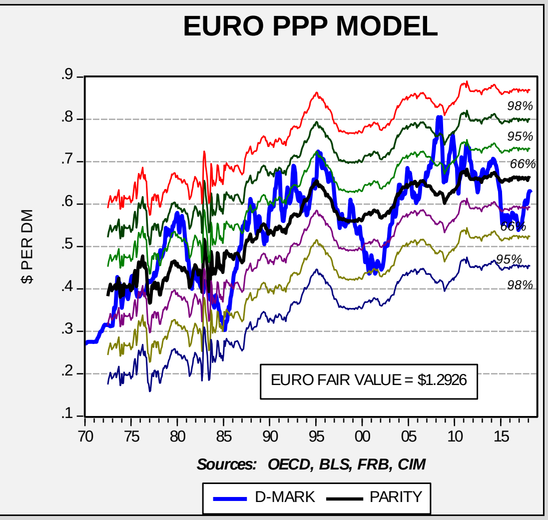
These four charts show the parity models for the D-mark (a proxy for the euro), the British pound, Japanese yen and Canadian dollar. All are, or have recently, been a standard error or more from fair value. This would suggest the dollar has more room to decline.

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.[5] Such

[5] 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.



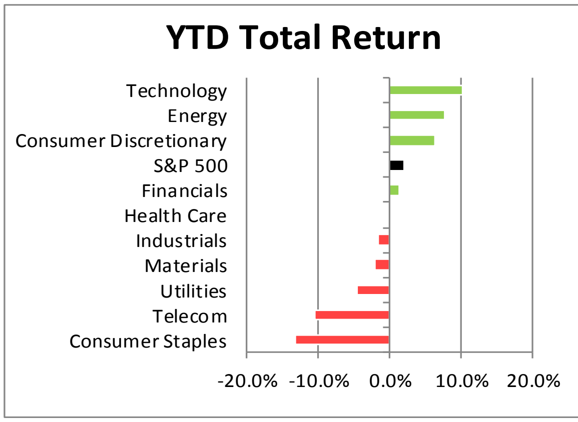


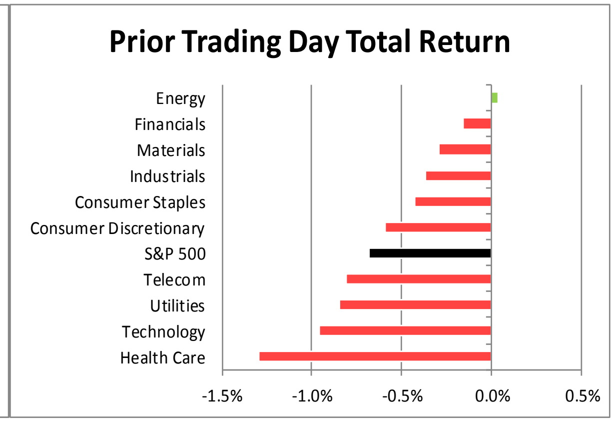
Adding the interest rate differential with a 30-month lag suggests the impact of interest rates isn't all that significant. Due to the lag, the differences in interest rates will tend to offer support to the dollar but, by far, the impact of relative inflation is more robust. Thus, if inflation in the 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 5/15/2018 close)

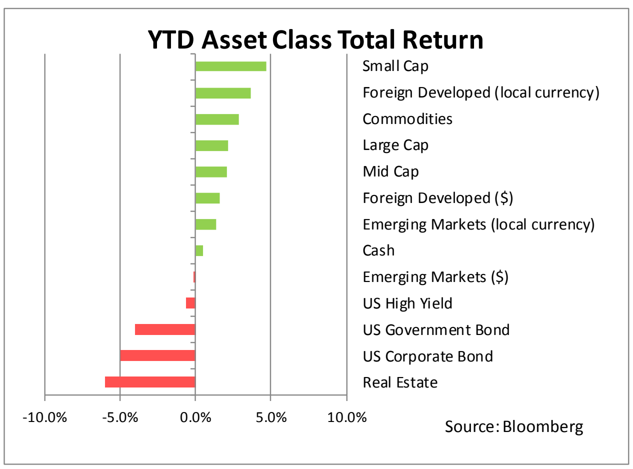




(Source: Bloomberg)

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 5/15/2018 close)

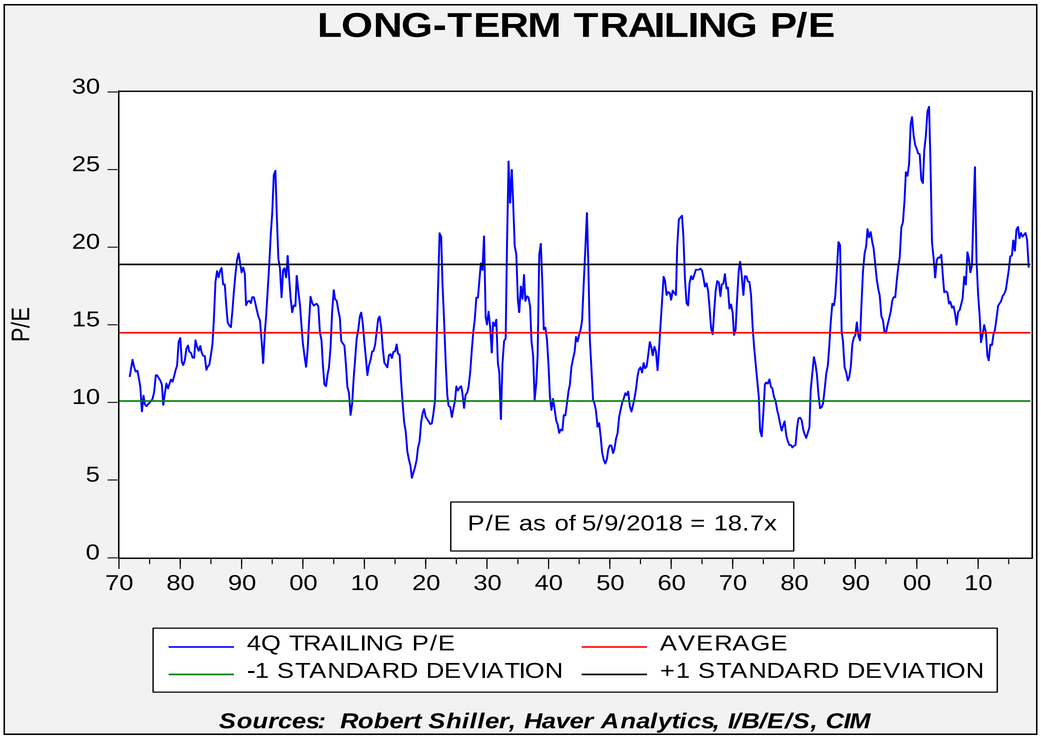


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[6] 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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[6] 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.