

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 17, 2018—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is up 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.3% from the prior close. Chinese markets were down, with the Shanghai composite down 0.5% and the Shenzhen index down 0.5%. U.S. equity index futures are signaling a lower open. With 457 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, 79.0% of the companies reported earnings above forecast, while 14.7% reported earnings below forecast.

Financial markets are quiet this morning. This is what we are watching:

More in Italy: Governments are powerful but not omnipotent. When financial markets turn on a country, it can force unwelcome policy changes. The populists in Italy are finding this out the hard way. As we noted yesterday, Italian sovereign yields rose sharply. Markets have offered little relief today as 10-year Italian sovereigns hit a high yield this morning of 2.15%; on May 4, the yield troughed at 1.71%. It should be noted that this 44 bps rise in rates has occurred without any tightening from the ECB. We did get some clarification on the debt write-down; the coalition doesn't necessarily want the debt written off but wants any bonds held by the ECB as part of QE to not be counted in the debt/GDP calculation,¹ which, of course, is essentially the same thing. The leader of the League, Matteo Salvini, complained about market "blackmail."² Although the populists have, to some extent, toned down their rhetoric about the Eurozone (they have dropped earlier calls for a referendum, for example), the coalition is proposing increases in fiscal spending that will break Eurozone rules. The coalition seems to be daring the Eurozone to sanction them; unlike Greece, Italy is a large economy and the populist leaders seem to be willing to force a showdown. If the coalition forms and does increase government spending, Germany's reaction will be key. We doubt Germany will tolerate Italy's actions and will press the Eurozone and the ECB to punish Italy. Although we have been bullish the EUR, for parity reasons, an internal fight will likely be bearish in the short to intermediate term.

Our long-term view has always been that the Eurozone was unsustainable; the single currency was not an economic policy but instead done for political goals, namely, to contain Germany.

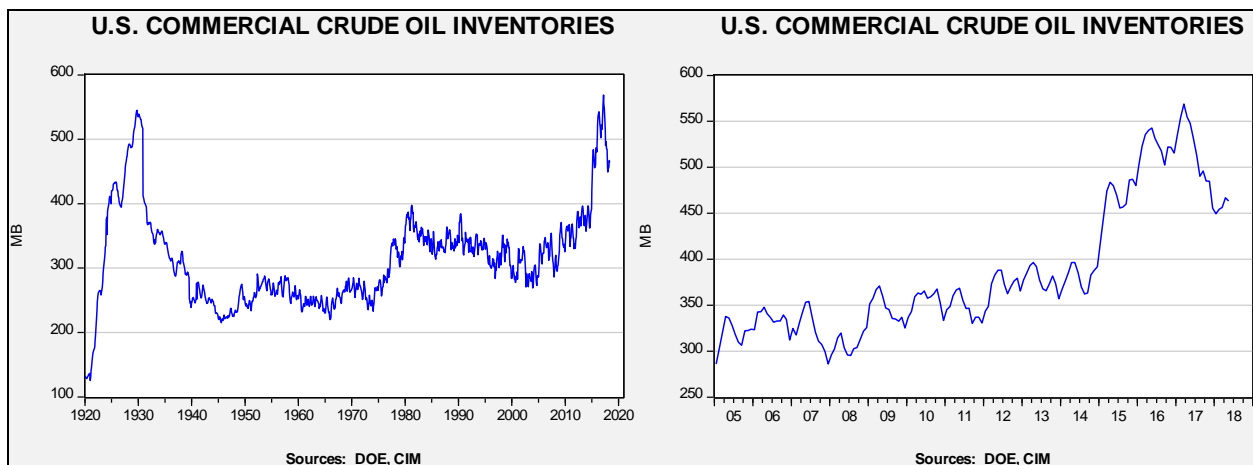
¹ https://video.repubblica.it/economia-e-finanza/governo-borghi-lega-nessuna-richiesta-di-condono-debito-i-mercati-non-conoscono-l-economia/304980/305610?ref=RHPPLF-BH-I0-C8-P1-S1.8-T2&utm_source=POLITICO.EU&utm_campaign=1671a38515-EMAIL_CAMPAIGN_2018_05_16&utm_medium=email&utm_term=0_10959edeb5-1671a38515-190334489

² <https://www.ft.com/content/0dcc8412-591f-11e8-bdb7-f6677d2e1ce8>

The real fight is whether Germany's or some other European nation's vision dominates. The story of Europe since 1870 has been all about the German problem. Germany is the strongest power in Europe but not strong enough to fully dominate it. In the long run, we expect the Eurozone to split into workable economic units, with the north and south creating their own currencies. As we noted yesterday, the "known/unknown" is which group France joins.

No NAFTA³ today: Today is the deadline for NAFTA talks but it doesn't look like a deal is in the offing. The deadline is somewhat artificial—negotiations can continue. However, in order to put the bill through under the complicated Fast Track Promotion Authority, which passes trade bills on an "up or down" vote without amendments, Speaker Ryan needs to put the bill into place today. In addition, exemptions for the steel and aluminum tariffs for Mexico and Canada end on June 1; it is hard to argue for an extension without a NAFTA deal. And, Mexican elections loom on July 1 and polls continue to show that Orbador still holds a dominating lead. He is a populist and negotiating a NAFTA deal under his government might not be possible. A breakup of NAFTA would be very disruptive to all three economies.

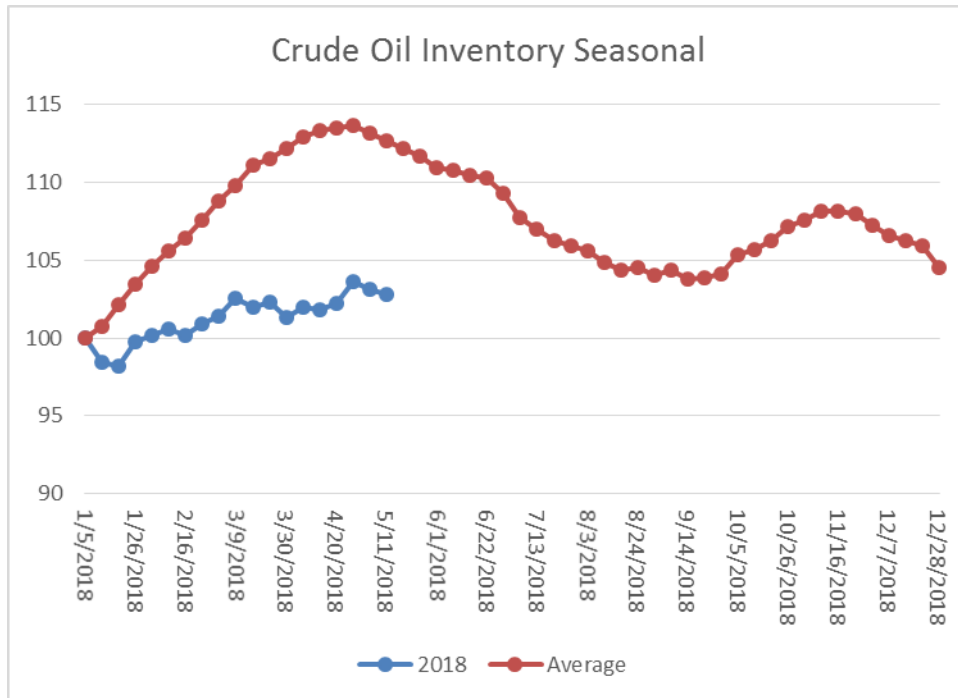
Energy recap: U.S. crude oil inventories fell 1.4 mb compared to market expectations of a 1.5 mb draw.



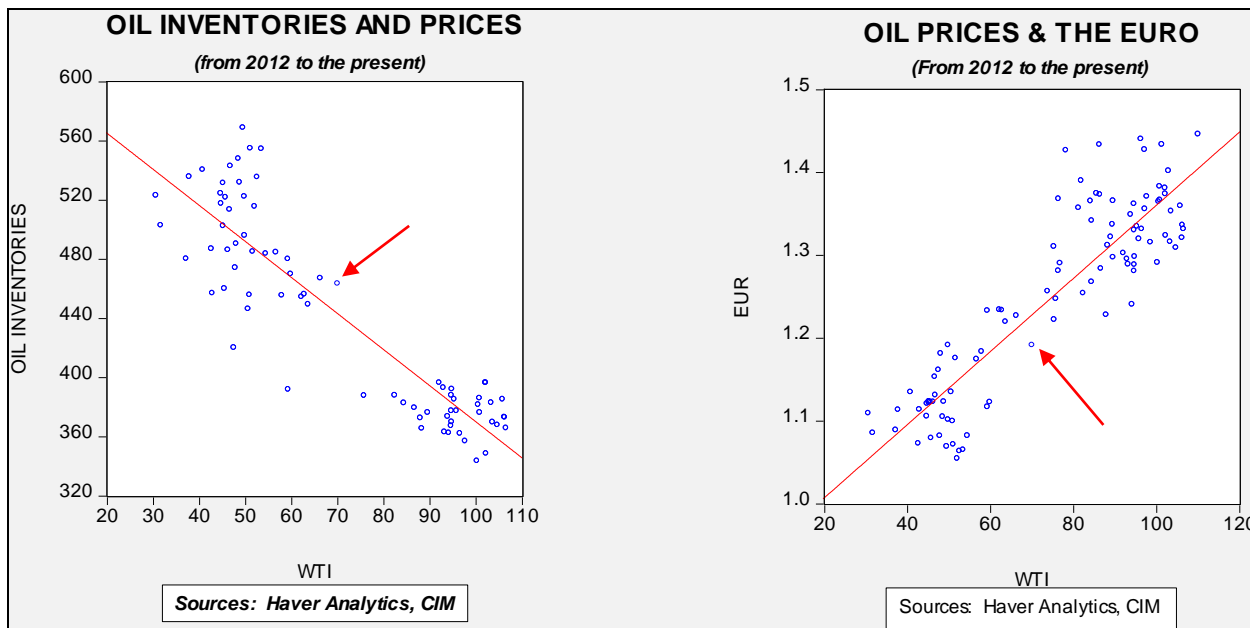
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but have declined significantly since last March. We would consider the overhang closed if stocks fall under 400 mb.

As the seasonal chart below shows, inventories are usually rising this time of year. This week's decline is consistent with the onset of seasonal patterns. We expect steady stock withdrawals from now into mid-September. If we follow the normal seasonal draw in stockpiles, by September, crude oil inventories will decline to approximately 424 mb.

³ <https://www.politico.com/story/2018/05/16/nafta-trade-deal-delay-547034>



(Source: DOE, CIM)

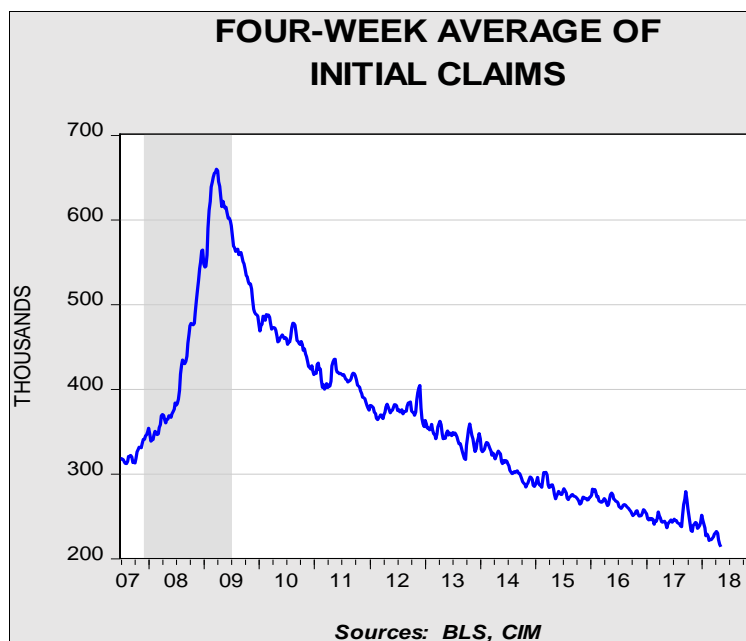


Based on inventories alone, oil prices are overvalued with the fair value price of \$63.55. Meanwhile, the EUR/WTI model generates a fair value of \$65.68. Together (which is a more sound methodology), fair value is \$64.68, meaning that current prices are above fair value. The combination of a stronger dollar and the peak of seasonal inventories has weakened our fair value calculations. However, we do expect the dollar to weaken in the coming months and oil inventories to decline based on seasonal factors. Using the oil inventory scatterplot, a reading of 424 on oil inventories would generate oil prices in the high \$70s to low \$80s range. At present,

we have no reason to believe that inventories won't follow their usual path so the case for higher oil prices remains, barring a seasonal divergence that increases supply or a sharp rise in the dollar. We note today that Total (TOT, (ADR) 63.21) warned it will likely pull out of Iran unless it can be guaranteed sanctions relief.⁴ The French oil company is the largest foreign investor in Iran's energy sector. If it does pull out, it would represent a significant blow to Iran and signal that, despite all the brave talk, Europe will be beholden to the American sanctions regime. Issues like this, plus the Venezuelan elections on Sunday, are a major reason why oil prices are running in front of where the dollar and inventories suggest they should be. In other words, the observed risk premium is reasonable.

U.S. Economic Releases

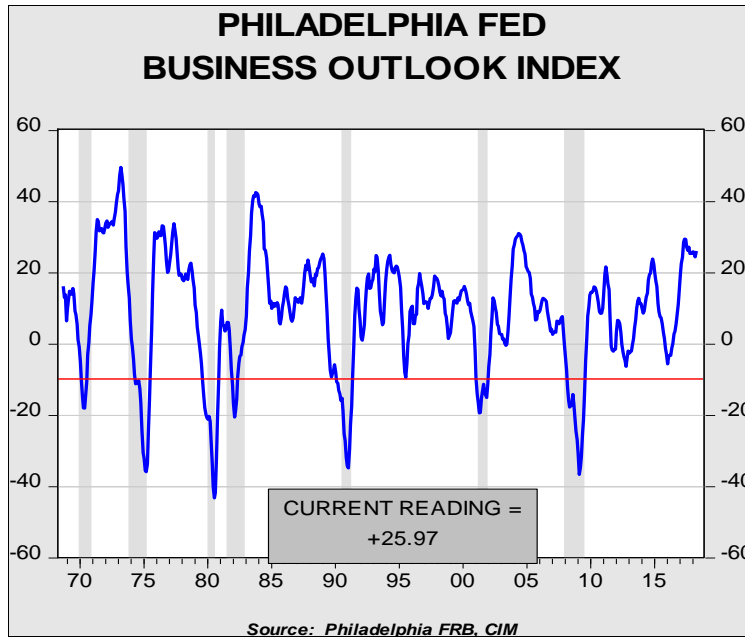
Initial jobless claims came in above expectations at 222k compared to the forecast of 215k.



The chart above shows the four-week moving average of initial jobless claims. The four-week moving average fell 3.75k to 213.25k.

The Philadelphia Fed Business Outlook came in above expectations at 34.4 compared to the forecast of 21.0.

⁴ <https://www.ft.com/content/723155ce-591d-11e8-bdb7-f6677d2e1ce8?emailId=5afd0450da2c1e000444e8f0&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22>



In the chart, we smooth the data with a six-month average. Although this is a sentiment number, it suggests strong confidence in the Philadelphia FRB district.

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

Economic Releases							
EDT	Indicator			Expected	Prior	Rating	
9:45	Bloomberg Economic Expectations	m/m	may		52.5	**	
9:45	Bloomberg Consumer Comfort	m/m	may		55.8	***	
10:00	Leading Index	m/m	apr	0.4%	0.3%	**	
Fed speakers or events							
EST	Speaker or event	District or position					
10:45	Neel Kashkari Speaks at Moderated Q&A in Minneapolis	President of the Federal Reserve Bank of Minneapolis					
13:30	Robert Kaplan Speaks at Moderated Q&A	President of the Federal Reserve Bank of Dallas					

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	Foreign Direct Investment	y/y	apr	-1.1%	0.4%		**	Equity and bond neutral
Japan	Housing Loans	q/q	1q	2.7%	2.9%		**	Equity and bond neutral
	Core Machine Orders	m/m	mar	-2.5%	2.4%	0.3%	**	Equity bearish, bond bullish
	Japan buying foreign bonds	m/m	may	¥827.0 bn	-¥363.7 bn		*	Equity and bond neutral
	Japan buying foreign stocks	m/m	may	¥258.5 bn	¥23.8 bn		*	Equity and bond neutral
	Foreign buying Japan bonds	m/m	may	¥238.5 bn	-¥15.4 bn		*	Equity and bond neutral
	Foreign buying Japan stocks	m/m	may	¥126.3 bn	-¥0.3 bn		*	Equity and bond neutral
Australia	Employment Change	m/m	apr	22.6k	4.9k	20.0k	***	Equity bullish, bond bearish
	Unemployment Rate	y/y	apr	5.6%	5.5%	5.5%	***	Equity and bond neutral
	Consumer Inflation Expectations	m/m	may	3.7%	3.6%		***	Equity and bond neutral
New Zealand	PPI Output	q/q	1q	0.2%	1.0%		**	Equity bearish, bond bullish
	PPI Input	q/q	1q	0.6%	0.9%		**	Equity bearish, bond bullish
EUROPE								
Eurozone	EU27 New Car Registration	m/m	apr	9.6%	-5.3%		**	Equity and bond neutral
	Construction Output	y/y	mar	0.8%	0.4%		**	Equity and bond neutral
Eurozone	Trade Balance Total	m/m	mar	0.698 bn	1.130 bn		**	Equity bearish, bond bullish
AMERICAS								
Brazil	Economic Activity	y/y	mar	-0.7%	0.9%	-0.3%	***	Equity bearish, bond bullish
Canada	Manufacturing Sales	m/m	mar	1.4%	1.9%	0.9%	**	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)	232	233	-1	Up
3-mo T-bill yield (bps)	187	187	0	Neutral
TED spread (bps)	46	46	0	Neutral
U.S. Libor/OIS spread (bps)	189	189	0	Up
10-yr T-note (%)	3.10	3.10	0.00	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	7	7	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
Selic Rate	6.500%	6.500%	6.250%	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	\$79.98	\$79.28	0.88%	
WTI	\$72.21	\$71.49	1.01%	
Natural Gas	\$2.81	\$2.82	-0.21%	
Crack Spread	\$23.18	\$23.28	-0.43%	
12-mo strip crack	\$21.36	\$21.30	0.26%	
Ethanol rack	\$1.58	\$1.58	-0.11%	
Metals				
Gold	\$1,289.01	\$1,290.73	-0.13%	
Silver	\$16.42	\$16.38	0.23%	
Copper contract	\$308.95	\$307.05	0.62%	
Grains				
Corn contract	\$ 401.50	\$ 399.25	0.56%	
Wheat contract	\$ 504.50	\$ 494.25	2.07%	
Soybeans contract	\$ 1,006.00	\$ 999.75	0.63%	
Shipping				
Baltic Dry Freight	1403	1468	-65	
DOE inventory report				
	Actual	Expected	Difference	
Crude (mb)	-1.4	-1.5	0.1	
Gasoline (mb)	-3.8	-1.5	-2.3	
Distillates (mb)	-0.9	-1.9	1.0	
Refinery run rates (%)	0.70%	0.70%	0.00%	
Natural gas (bcf)		107.0		

Weather

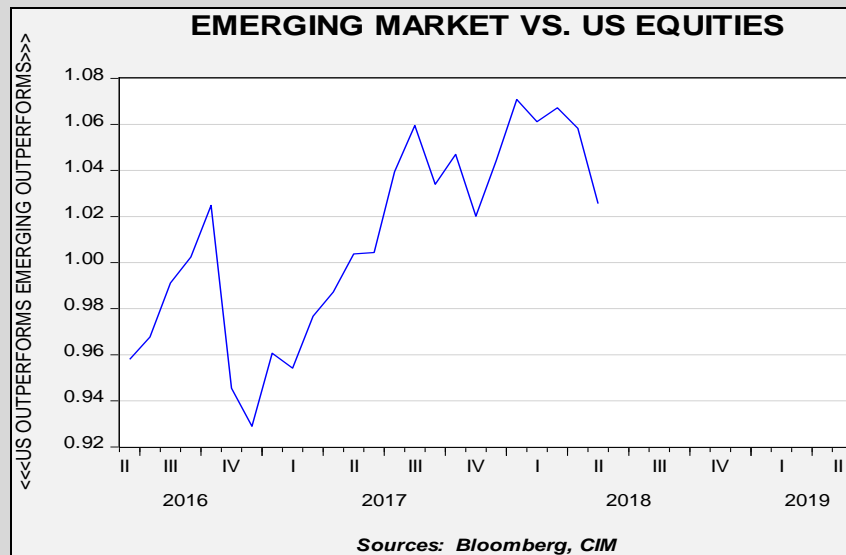
The 6-10 and 8-14 day forecasts continue to signal warmer to normal temperatures for most of the country. Precipitation is expected for most of the country.

Asset Allocation Weekly Comment

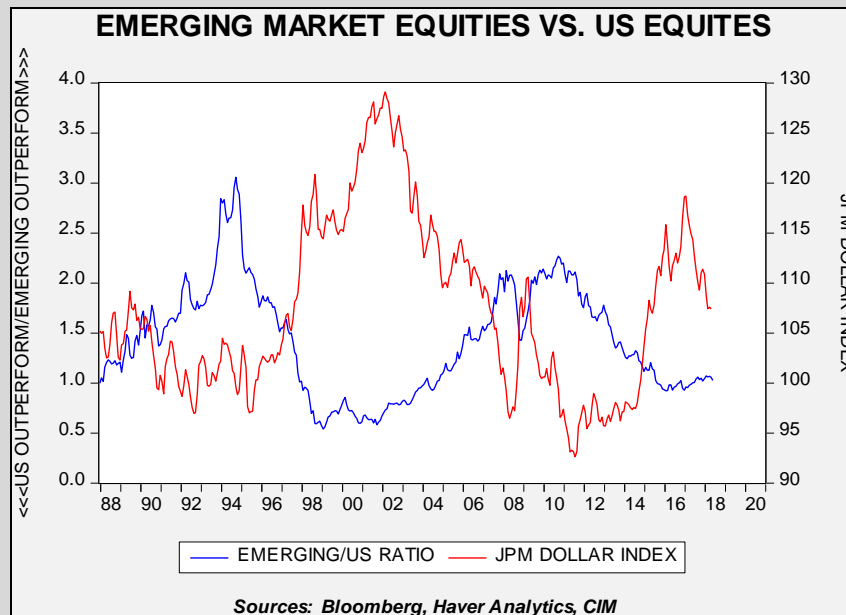
Confluence Investment Management offers various asset allocation products which are managed using “top down,” or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

May 11, 2018

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

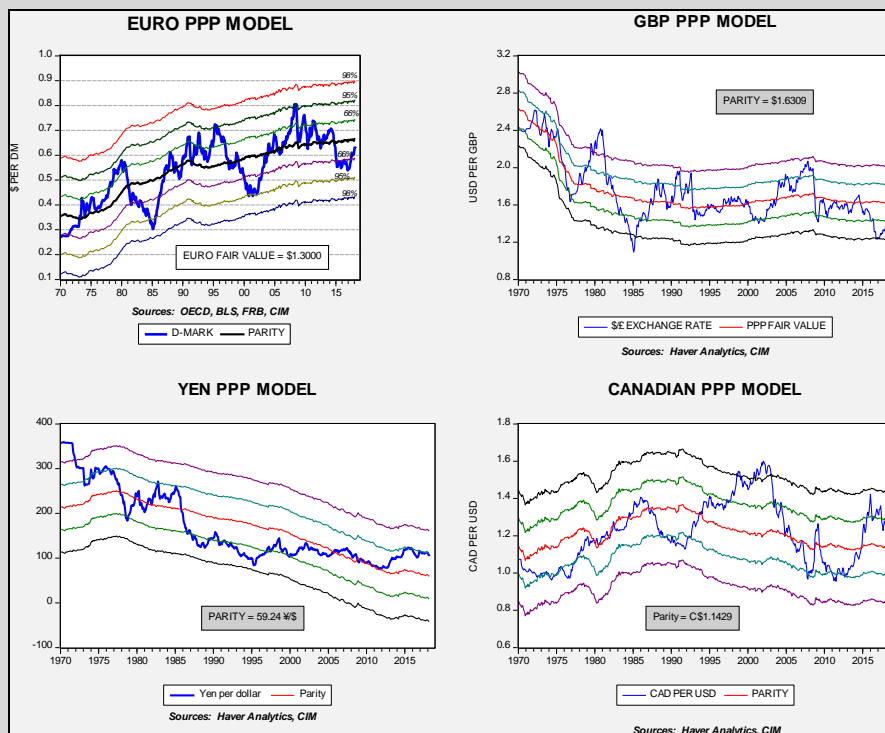


The chart above shows the relative performance of emerging market equities against U.S. equities. A rising line indicates that foreign equities are outperforming. Questions are being raised as to whether this recent decline is the end of what has been a strong relative uptrend in emerging equities that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

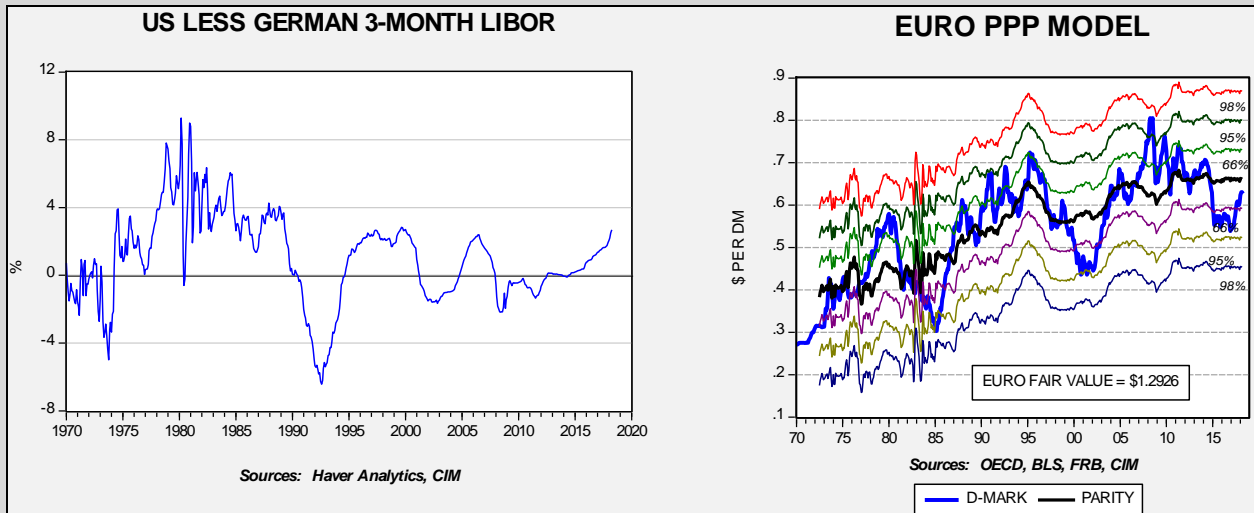


These four charts show the parity models for the D-mark (a proxy for the euro), the British pound, Japanese yen and Canadian dollar. All are, or have recently, been a standard error or more from fair value. This would suggest the dollar has more room to decline.

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.



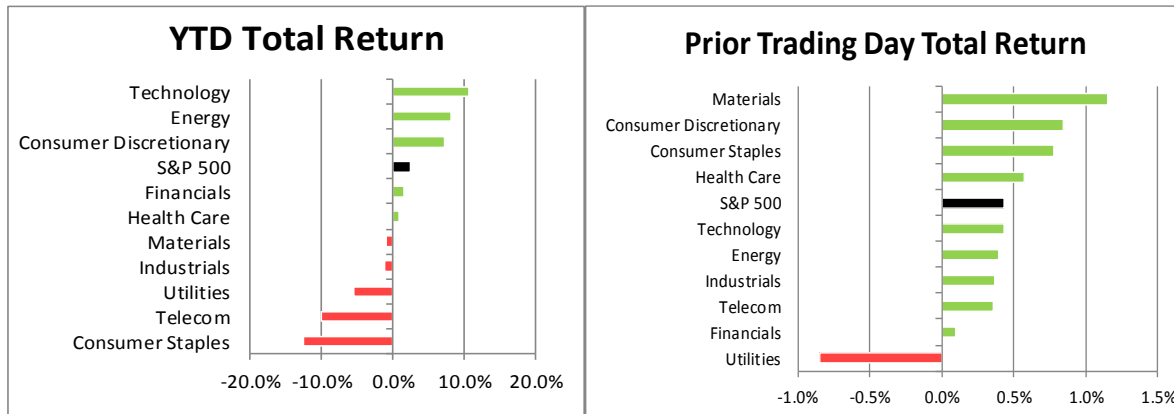
Adding the interest rate differential with a 30-month lag suggests the impact of interest rates isn't all that significant. Due to the lag, the differences in interest rates will tend to offer support to the dollar but, by far, the impact of relative inflation is more robust. Thus, if inflation in the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

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

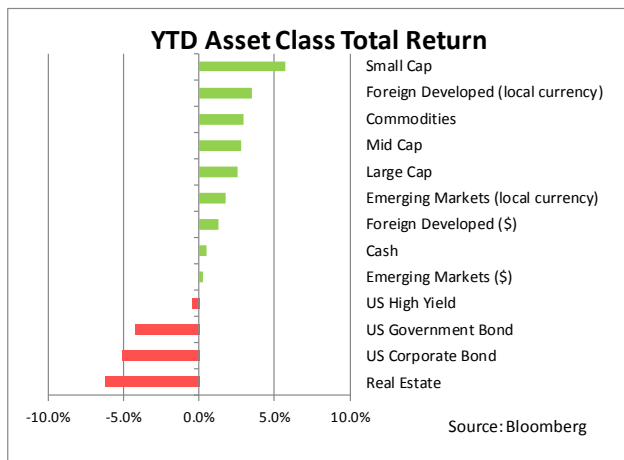
U.S. Equity Markets – (as of 5/16/2018 close)



(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 5/16/2018 close)



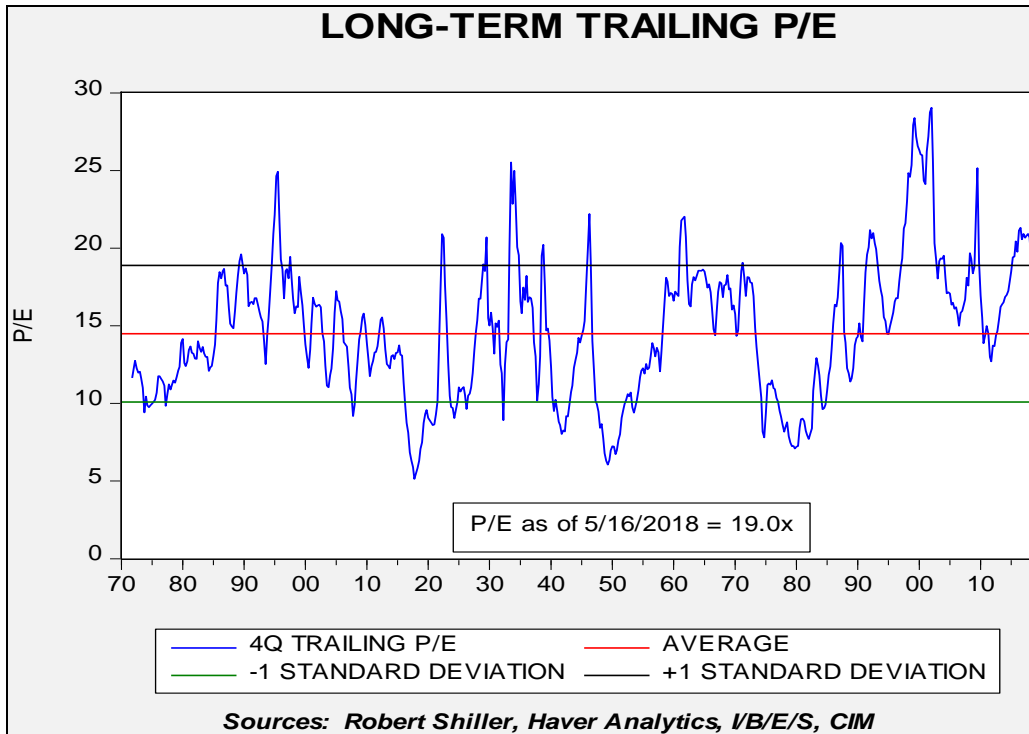
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 17, 2018



Based on our methodology,⁶ the current P/E is 19.0x, up 0.3x from last week. The rise was due to the usual shift from Thomson/Reuters to S&P's calculation of operating 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.

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 three actual quarters (Q3, Q4 and Q1) and one estimate 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.