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 18, 2018—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed unchanged from the prior close. Chinese markets were up, with the Shanghai composite up 1.2% and the Shenzhen index up 0.3%. U.S. equity index futures are signaling a higher open. With 460 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, 79.1% of the companies reported earnings above forecast, while 14.6% reported earnings below forecast.

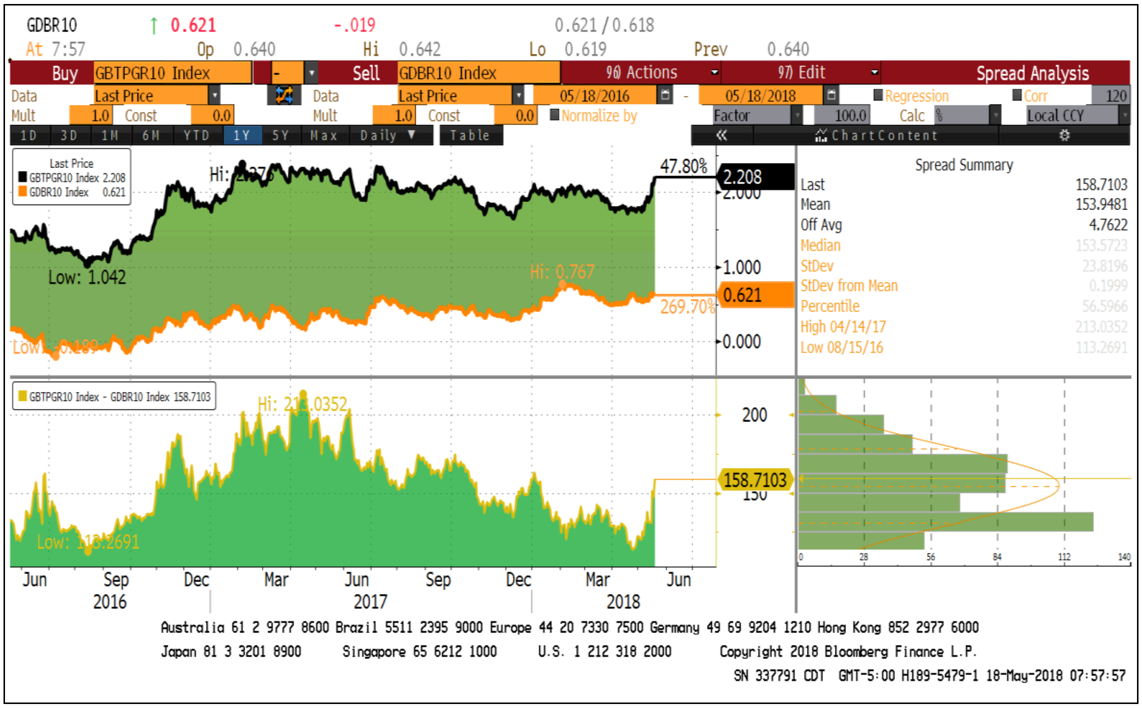
Happy Friday! Financial markets are mostly flat this morning. This is what we are watching:

Italy: The *FT*[1] is reporting that the Five-Star Movement and the League have reached a deal to form a government, although the prime minister post has not been settled. We would expect a compromise candidate, a figurehead, to emerge at some point for this role. The final deal does remove the talk of a return to "pre-Maastricht" and calls on the Italian bonds held by the ECB to not count against debt/GDP calculations. But, the agreement calls for both tax cuts and increased spending which will almost certainly lead to fiscal deficits that will run afoul of Eurozone rules.

What really caught our attention, however, was the government's proposal to issue "mini-BoT," which are short-term, small denomination sovereign bills. Denominated in euros, they are designed to be "tax anticipation notes." Cash-strapped governments have issued such instruments; California did so eight years ago.[2] ***Still, previous notes were electronic entry; Italy plans to use its lottery presses to print these BoT, which makes them bearer bonds and potentially a parallel currency.*** Now, as one would expect, the coalition is downplaying this potential, indicating that no entity will be required to accept BoT. But, if the government follows through on this plan, it is a major threat to the Eurozone. It should be noted that the former Greek FM Yanis Varoufakis proposed similar instruments in 2015. In fact, the Five-Star and League negotiators consulted with Syriza on how to structure these instruments, yet even the radical Varoufakis wouldn't go so far as to issue printed bearer bills. It isn't hard to envision how these notes, issued at a discount to face value (say, €90 with a face value of €100), would fall to even deeper discounts as more are issued. Essentially, the BoT will potentially become a

[1] https://www.ft.com/content/e0cd0f22-5a7c-11e8-bdb7-f6677d2e1ce8
[2] https://www.municipalbondstoday.com/tag/california-revenue-anticipation-notes/

way for Italy to expand its fiscal debt in a quasi-currency. This coalition is turning into a significant threat to the Eurozone.



(Source: Bloomberg)

This chart shows the level and spread between German and Italian 10-year sovereigns. What is notable is that German yields have been steady to lower since the run up in Italian yields. We would expect Italian capital flight to develop and usually Germany is the first stop. We are also not seeing any unusual behavior in the Swiss franc. Perhaps investors are waiting for the PM to be appointed before deciding a populist threat in the Eurozone's third largest economy is meaningful.

In the short run, the problems in Italy are bearish for the euro. But, if we get a north/south split, the euro becomes the new D-mark and a new southern euro becomes the new lira/drachma. The euro soars, while the southern euro depreciates. That may be the final outcome but getting there could easily mean a period of euro weakness.

Trade: There were two items on trade. First, there are reports that China will offer $200 bn in trade concessions.[3] Essentially, China will offer to increase its imports from the U.S. if the Trump administration relaxes the technology trade restrictions. Implied is the idea that Beijing will help in the negotiations with North Korea. The president now finds himself facing a problem often seen with his predecessors; the U.S. has multiple goals and has to "thread the needle" to meet all of them. And, in reality, it is usually impossible to get everything you want.

[3] https://www.nytimes.com/2018/05/17/us/politics/china-trade-trump-concessions.html?hp&action=click&pgtype=Homepage&clickSource=story-heading&module=first-column-region&region=top-news&WT.nav=top-news

China's desire to expand and develop its tech industry seems paramount and it is willing to promise to buy grain,[4] natural gas and perhaps even oil to narrow the trade deficit if it will allow Beijing to maintain access to U.S. intellectual property. The problem is, of course, that this runs at cross-purposes to the U.S. goal to maintain tech supremacy. In addition, the buying China does with the U.S. means that other nations, e.g., Brazil, Argentina, Australia and perhaps Iran, will see their exports to China fall. Second, it appears that the NAFTA negotiations have failed. It isn't clear if the administration will simply leave the treaty or if it will remain in limbo as talks drag on.

Venezuela: Elections will be held on Sunday; there is little doubt to the outcome.[5] President Maduro will likely win. Real opposition candidates have been prevented from running. Only two independent candidates share the ballot with Maduro and they won't likely win more votes than Maduro unless powerful people in the ruling class have decided Maduro needs to go. If the expected occurs, most governments have already indicated they don't recognize this election as legitimate which could mean new sanctions are imposed. If we get a surprise and Maduro is forced out, outside governments will have to decide whether this illegitimate election is now legitimate. Our expectation is that Maduro wins and Venezuelan oil supplies are further reduced.

U.S. Economic Releases

There are no economic releases or Fed events scheduled for the rest of the day.

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.

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[4] https://www.wsj.com/articles/china-drops-probe-into-u-s-sorghum-shipments-1526629000

[5] https://www.ft.com/content/edd6c4a0-5906-11e8-b8b2-d6ceb45fa9d0?emailId=5afe55bf3305f4000487e5a5&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
Japan	National CPI	m/m	apr	0.6%	1.1%	0.7%	***	Equity bearish, bond bullish
	National CPI ex Fresh Food	m/m	apr	0.7%	0.9%	0.8%	***	Equity bearish, bond bullish
	Natinoal CPI ex Fresh Food, Energy	m/m	apr	0.4%	0.5%	0.4%	***	Equity and bond neutral
EUROPE								
Eurozone	ECB Current Account Balance	m/m	mar	32.0 bn	35.1 bn		**	Equity and bond neutral
	Current Account Balance	m/m	mar	40.6 bn	22.7 bn		**	Equity and bond neutral
	Trade Balance	m/m	mar	21.2 bn	21.0 bn	21.0 bn	**	Equity bullish, bond bearish
Germany	Wholesale Price Index	m/m	apr	1.4%	1.2%		**	Equity and bond neutral
	PPI	m/m	apr	2.0%	1.9%	1.8%	**	Equity bullish, bond bearish
Italy	Current Account Balance	m/m	mar	3.408 bn	0.839 bn		**	Equity bullish, bond bearish
Russia	Gold and Forex Reserve	m/m	may	457.7 bn	458.4 bn		*	Equity and bond neutral
	Money Supply Narrow	m/m	may	9.96 tn	9.88 tn		*	Equity and bond neutral
AMERICAS								
Canada	International Securities Transactions	m/m	mar	6.15 bn	3.96 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)	233	232	1	Up
3-mo T-bill yield (bps)	187	187	0	Neutral
TED spread (bps)	46	45	1	Neutral
U.S. Libor/OIS spread (bps)	189	189	0	Up
10-yr T-note (%)	3.10	3.11	-0.01	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	6	5	1	Down
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	down			Up
pound	down			Up
franc	up			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Overnight Rate	7.500%	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	$79.61	$79.30	0.39%	
WTI	$71.55	$71.49	0.08%	
Natural Gas	$2.86	$2.86	-0.07%	
Crack Spread	$23.62	$23.25	1.59%	
12-mo strip crack	$21.79	$21.57	1.03%	
Ethanol rack	$1.57	$1.58	-0.08%	
Metals				
Gold	$1,287.44	$1,290.79	-0.26%	
Silver	$16.41	$16.43	-0.12%	
Copper contract	$306.65	$308.90	-0.73%	
Grains				
Corn contract	$ 400.50	$ 395.25	1.33%	
Wheat contract	$ 505.25	$ 497.50	1.56%	
Soybeans contract	$ 1,004.75	$ 995.00	0.98%	
Shipping				
Baltic Dry Freight	1305	1403	-98	
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)	105.0	107.0	-2.0	

Weather

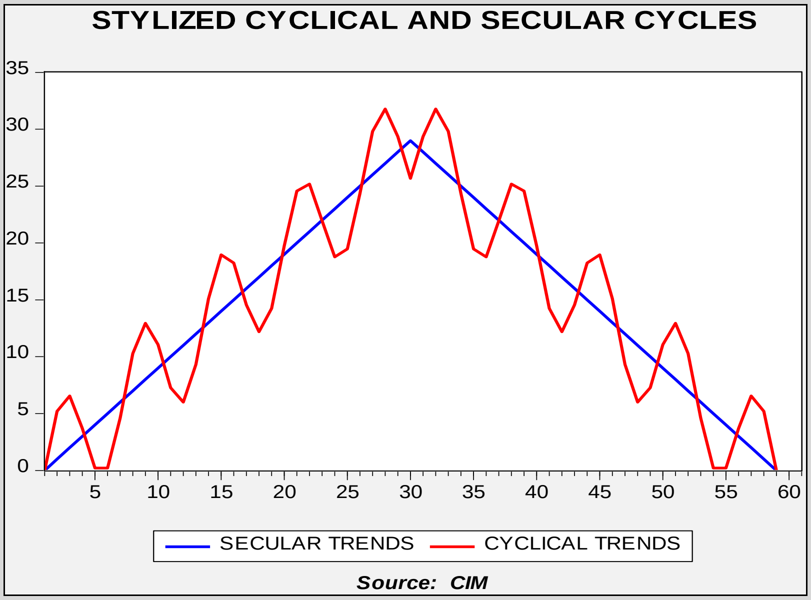
The 6-10 and 8-14 day forecasts continue to signal warmer to normal temperatures for most of the country. Precipitation is expected for most of the country.

<u>Asset Allocation Weekly Comment</u>

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 18, 2018

In our asset allocation process, we focus on cyclical trends; that doesn't mean we pay no attention to secular trends but it isn't our primary emphasis. The lack of clarity around what these terms mean can lead to confusion. And so, over the next few weeks, we will examine the difference between the two trends and how we address them in our asset allocation process.



This chart shows a stylized example of cyclical and secular cycles. It's simply for illustration purposes, but it does express the general view of how we view markets. In reality, cyclical trends are not this smooth or regular, but rather often exhibit varying length and amplitude. Secular trends are not necessarily constant either. But, in general, as we will look at in the coming weeks, financial and commodity markets exhibit both trends.

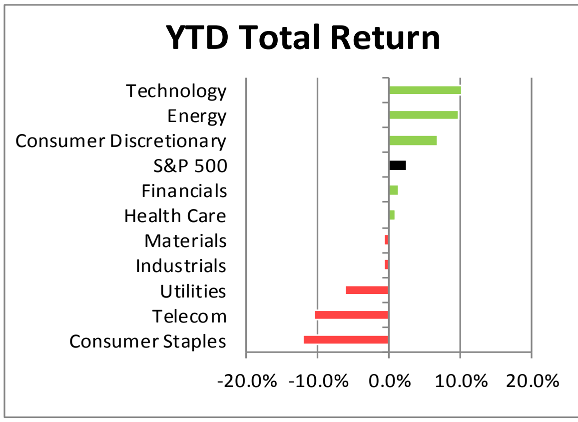
Depending on the market, cyclical trends tend to run three to 10 years. It is the most important trend in our asset allocation process. The business cycle is the primary factor in our analysis. The business cycle is the normal tendency for the economy to move from expansion to decline, recession, recovery and back to expansion. This cycle clearly affects financial and commodity markets. Financial market conditions, monetary and fiscal policy and geopolitical events are all important contributors to cyclical trends as well.

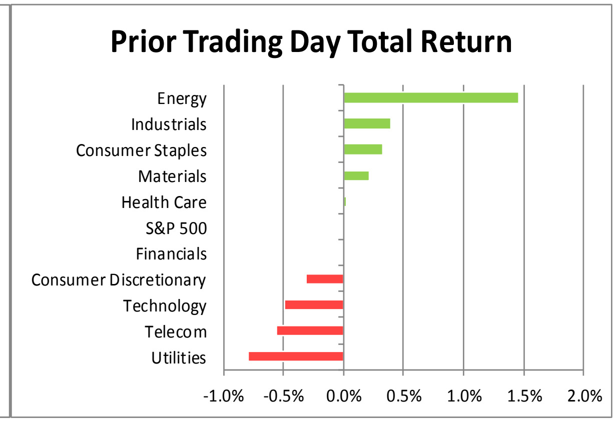
On the other hand, secular trends can last generations. These trends tend to be driven by societal factors. For example, public attitudes toward the balance between efficiency and equality are critical as these are affected by regulatory and tax policy. Long-term geopolitical stability is mostly a factor of hegemony; if a superpower vacuum is developing or a new hegemon is emerging, secular trends can adjust. What makes secular trends important is that because they last a long time, they become part of the background, leading investors to assume that these trends never change. And so, in the early part of a reversal in secular trends, actual market performance can vary widely from what is expected. The other factor that matters in secular trends is that, unlike our stylized model, they don't always clearly shift, causing a degree of uncertainty as to whether the change actually occurred. Only with the hindsight of history can we definitively know when and if the secular change happened. Still, we pay attention to secular trends because, at inflection points, the impact on financial and commodity markets can be significant.

Therefore, over the next few weeks, we will examine the cyclical and secular trends in commodity, equity and debt markets. In general, this analysis will offer insights into our allocation process, discussing the important cyclical elements of each asset class along with the potential impact of a change in secular trends.

Data Section

U.S. Equity Markets – (as of 5/17/2018 close)

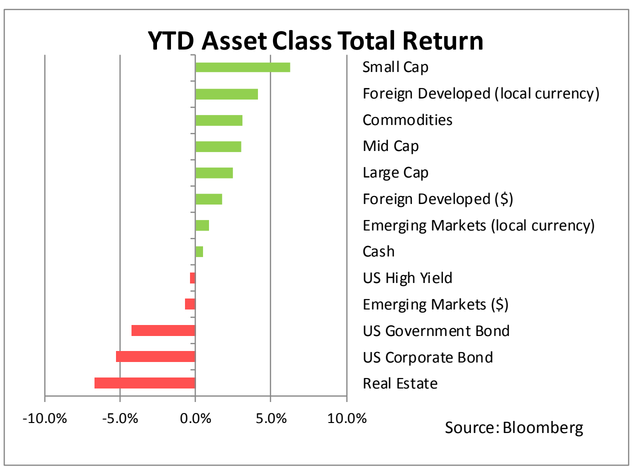




(Source: Bloomberg)

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 5/17/2018 close)

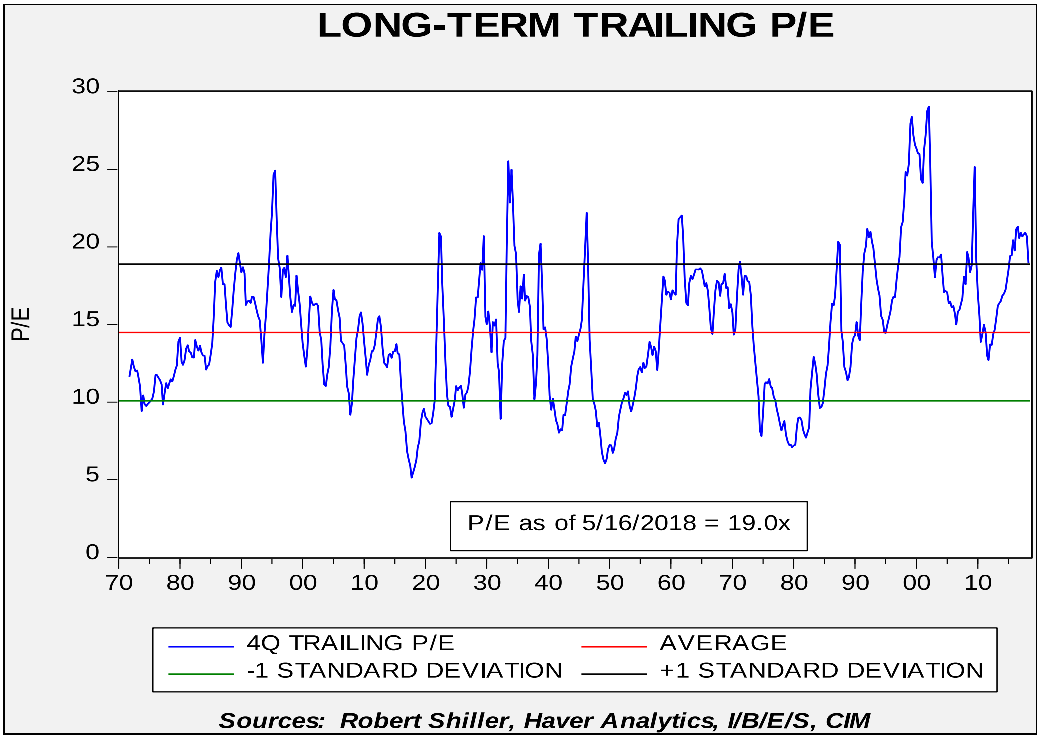


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.