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 21, 2018—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.4% from the prior close. Chinese markets were up, with the Shanghai composite up 0.6% and the Shenzhen index up 1.1%. U.S. equity index futures are signaling a higher open. With 464 companies having reported, the S&P 500 Q1 earnings stand at $38.92, 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 14.9% reported earnings below forecast.

Happy Monday! There was a lot of weekend news. Let's dig in:

Trade war postponed: Yesterday, Treasury Secretary Mnuchin announced that China and the U.S. have postponed any trade actions while talks continue on the structure of the trading relationship. Equity prices rose, the dollar moved higher and grain prices jumped. Grains are up on relief that corn, sorghum and soybeans won't be targeted by China for retaliation.[1] It doesn't appear that anything has been resolved; the reason for the delay in trade action may be due to the next item.

Does Trump have a bandwidth issue? All presidents find that the office is complicated; pulling on one thread leads to issues somewhere else. The upcoming summit with North Korea has become increasingly fraught with risk. Earlier, it looked like the path to the summit was going smoothly. Talks between the North and South appeared warm. Kim had hinted at denuclearization. Then, last week, North Korea turned hostile, indicating it would never trade away its nukes. It's unclear what prompted the change. It may be due to John Bolton's appointment as national security director as he has held hardline positions against North Korea (and many other countries as well). We note that Kim visited Beijing just before the turn in tone; it may be that China urged Pyongyang to turn hostile to give China leverage in trade talks. That might explain the "time out" on trade noted above.

The president has pressed the DOJ to open an investigation into the FBI's actions during the 2016 election. The administration is trying to negotiate a trade deal with China. NAFTA talks appear stalled. The president seems to want a historic summit with North Korea. There is the Iran issue. And Venezuela, too. Needless to say, there are a lot of "plates spinning." We

[1] An additional factor supporting grain prices is that the Midwest continues to receive heavy rainfall, which has slowed fieldwork and may result in less acreage being planted.

suspect the trade postponement with China is due, in part, to having so many policy actions underway.

We note the media is viewing the China postponement as a "climb down."[2] That take is probably unfair but the administration did raise hopes for sectors of the economy that want trade protection. Backing away disappoints those sectors. In addition, there is obvious confusion on the part of the negotiations. China is using its usual playbook—it is promising to buy lots of raw materials (grains, LNG, oil) but does not want to give in at all on technology. There have been discussions about a $200 bn reduction in the deficit with China, but no nation has indicated it will change policy to reduce the trade imbalance.

Often, in the financial media, one will hear offhand comments like, "The U.S. runs a trade deficit because we under save." Although true on its face, it makes it sound as if it's all the fault of spendthrift Americans. These commentators don't seem to get that in a world with open trade a nation that purposely creates policies to generate saving over investment will lead to trade deficits elsewhere.[3] The only way to stop that from happening is to (a) change the saving/investment policy in high trade surplus nations, or (b) enact trade barriers. Until we trade with Martians, the world cannot run a trade surplus since one nation's surplus, by definition, becomes another nation's trade deficit. This condition is exacerbated by the dollar's reserve status as nations are willing to run trade surpluses with the U.S. to acquire dollars.[4] If the U.S. really wants to end the trade deficit, policies designed to boost saving should be implemented. These would include higher interest rates, a weak dollar policy, consumption taxes and a weaker social safety net. However, if the U.S. did this, the world economy would implode. The absence of a global hegemon was a major cause of the Great Depression.[5]

Will the EU prompt a sanctions war? Reuters[6] is reporting that the EU is considering direct sovereign transfers to Iran to pay for oil exports. Individual companies are uncomfortable with violating American sanctions because they want access to the U.S. financial system. The EU is taking the position that the administration won't prevent a whole country from accessing the U.S. financial system. Although we tend to agree with the EU that the U.S. probably would not go after countries, the damage that this action would do to transatlantic relations would be significant. Relations have been strained before but if Europe decides to "go it alone" it could lead to a "thaw" in another frozen conflict area. At the same time, there are reports that the EU, Russia and China are working on a new agreement that would address U.S. concerns over Iran's

[2] https://www.washingtonpost.com/news/wonk/wp/2018/05/20/china-is-winning-trumps-trade-war/?utm_term=.39d94a9fc198 and https://www.ft.com/content/fdf48df2-5c46-11e8-9334-2218e7146b04 (Interesting to note is that Chinese media commentators are just as critical of Chinese trade negotiators, feeling they were also weak.)

[3] The best analysis of this issue comes from Michael Pettis. Pettis, M. (2013). *The Great Rebalancing: Trade, Conflict, and the Perilous Road Ahead for the World Economy*. Princeton, NJ: Princeton University Press.

[4] To put it another way, we get stuff for T-bills.

[5] Kindleberger, C. (1986). *The World in Depression, 1929-1939* (2nd ed.). Berkeley, CA: University of California Press.

[6] https://www.cnbc.com/2018/05/18/eu-considers-iran-central-bank-transfers-to-beat-us-sanctions.html

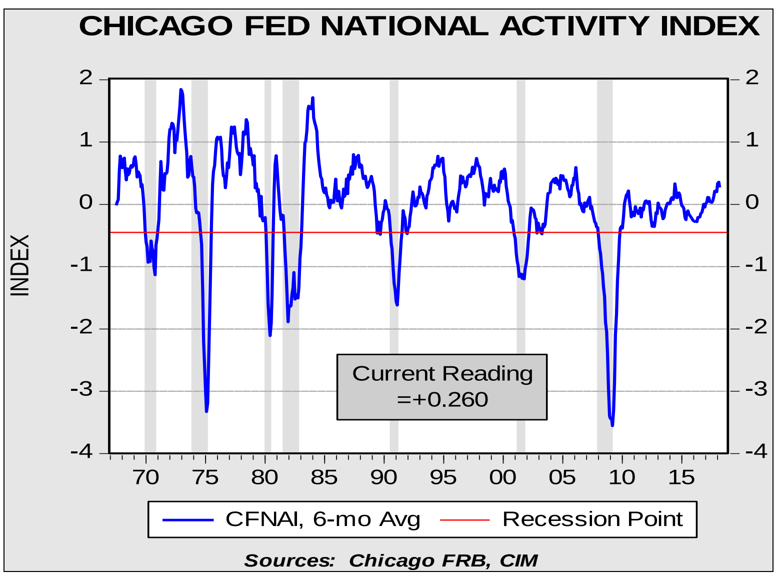
missile program and its support of proxy groups in the region.[7] Thus, the EU threat may be part of the bargaining process.

Italian politics: Reports indicate that Giuseppe Conte, a 54-year-old law professor, is likely to be nominated as Italy's next prime minister. He is a little known figure, which is the usual ploy when coalition partners don't really agree on a candidate. If Italy's president agrees to Conte, we will be watching to see how the key ministries are distributed in the new government.

Maduro wins[8]: This is not really news as his victory was widely expected. The turnout was very low, only 48%; the last election had an 80% turnout. Some pundits noted that letting one of the other independent candidates win would have been a savvy policy. Most of the world has refused to recognize this election as legitimate and there are expectations of further sanctions on Venezuela. Letting another candidate win would have made new sanctions less likely. Since Maduro clearly didn't feel secure enough to take that path, we expect further action against Venezuela. If the U.S. embargos Venezuelan oil imports, oil prices will likely move higher.

U.S. Economic Releases

The April Chicago FRB National Activity Index came in above expectations at 0.34 compared to the forecast of 0.30. The prior report was revised upward from 0.10 to 0.32.



The current smoothed reading is 0.26 and is clearly rising. The index is constructed to show trend growth at zero, thus a reading above zero shows above-trend growth. Casual observation would suggest this expansion has seen very modest growth, with much of the time spent below zero. However, that trend does appear to be improving.

[7] https://www.reuters.com/article/us-iran-nuclear-meeting/europe-china-russia-discussing-new-deal-for-iran-newspaper-idUSKCN1IL016
[8] https://www.ft.com/content/23bdde0a-5ca4-11e8-9334-2218e7146b04?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

There are no other 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.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
China	FX Net Settlement- Clients	y/y	apr	92.4 bn	-16.5 bn		**	Equity and bond neutral
Japan	Trade Balance	m/m	apr	¥550.0 bn	¥797.3 bn	¥440.0 bn	**	Equity and bond neutral
	Tokyo Condominium Sales	m/m	apr	-14.6%	6.1%		*	Equity bearish, bond bullish
	Convernience Store Sales	y/y	apr	0.7%	1.3%		**	Equity and bond neutral
New Zealand	Net Migration	m/m	apr	4930	5480		*	Equity and bond neutral
	Retail Sale Ex Inflation	q/q	1q	0.1%	1.7%	1.0%	**	Equity bearish, bond bullish
	Credit Card Spending	m/m	apr	0.6%	1.0%		*	Equity and bond neutral
EUROPE								
U.K.	Rightmove House Price	y/y	may	0.8%	0.4%		**	Equity bullish, bond bearish
Russia	Industrial Production	y/y	apr	1.3%	1.0%	1.2%	***	Equity bullish, bond bearish
AMERICAS								
Canada	Retail Sales	m/m	mar	0.6%	0.4%	0.3%	**	Equity and bond neutral
	Retail Sales ex Auto Fuel	y/y	mar	-0.2%	0.0%	0.5%	**	Equity bearish, bond bullish
	CPI	y/y	apr	2.2%	2.3%	2.3%	***	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	233	0	Up
3-mo T-bill yield (bps)	186	186	0	Neutral
TED spread (bps)	47	48	-1	Neutral
U.S. Libor/OIS spread (bps)	190	189	1	Up
10-yr T-note (%)	3.07	3.06	0.01	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	9	7	2	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	$78.44	$78.51	-0.09%	
WTI	$71.46	$71.28	0.25%	
Natural Gas	$2.82	$2.85	-0.88%	
Crack Spread	$22.72	$22.90	-0.79%	
12-mo strip crack	$21.18	$21.34	-0.74%	
Ethanol rack	$1.57	$1.57	-0.06%	
Metals				
Gold	$1,285.33	$1,293.04	-0.60%	
Silver	$16.39	$16.44	-0.31%	
Copper contract	$310.00	$306.35	1.19%	
Grains				
Corn contract	$ 405.25	$ 402.50	0.68%	
Wheat contract	$ 520.75	$ 518.25	0.48%	
Soybeans contract	$ 1,016.75	$ 998.50	1.83%	
Shipping				
Baltic Dry Freight	1273	1305	-32	

Weather

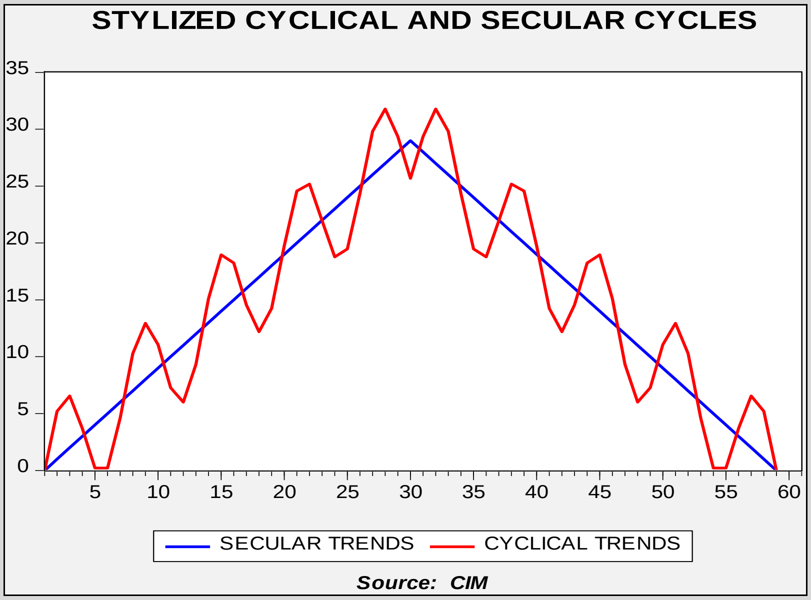
The 6-10 and 8-14 day forecasts continue to signal warmer to normal temperatures for most of the country. Precipitation is expected for most of the country.

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 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.

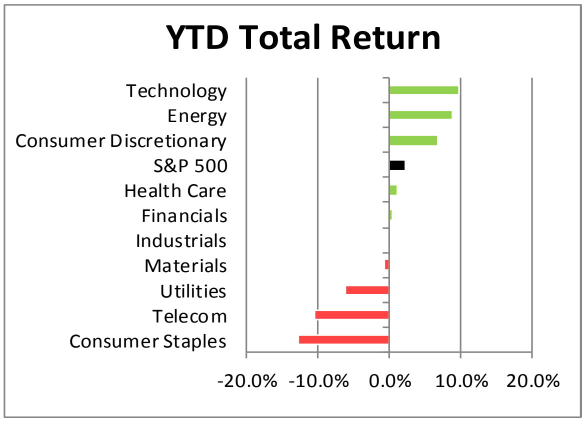
Depending on the market, cyclical trends tend to run three to 10 years. It is the most important trend in our asset allocation process. The business cycle is the primary factor in our analysis. The business cycle is the normal tendency for the economy to move from expansion to decline, recession, recovery 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.

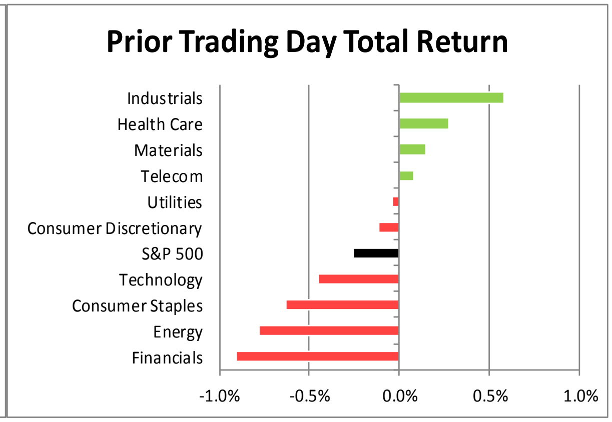
On the other hand, secular trends can last generations. These trends tend to be driven by societal factors. For example, public attitudes toward the balance between efficiency and equality are critical as these are affected by regulatory and tax policy. Long-term geopolitical stability is mostly a factor 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 5/18/2018 close)

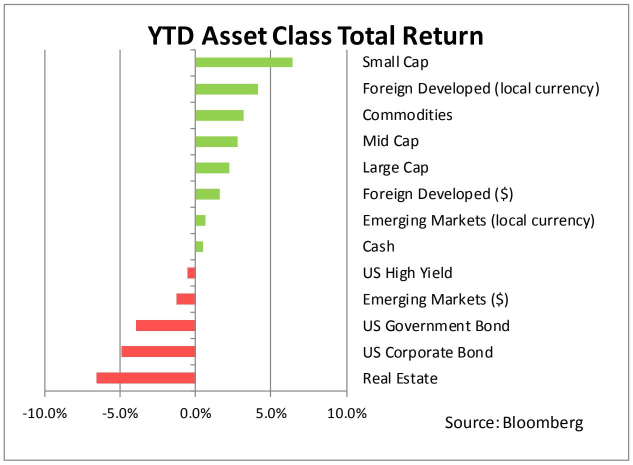




(Source: Bloomberg)

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 5/18/2018 close)

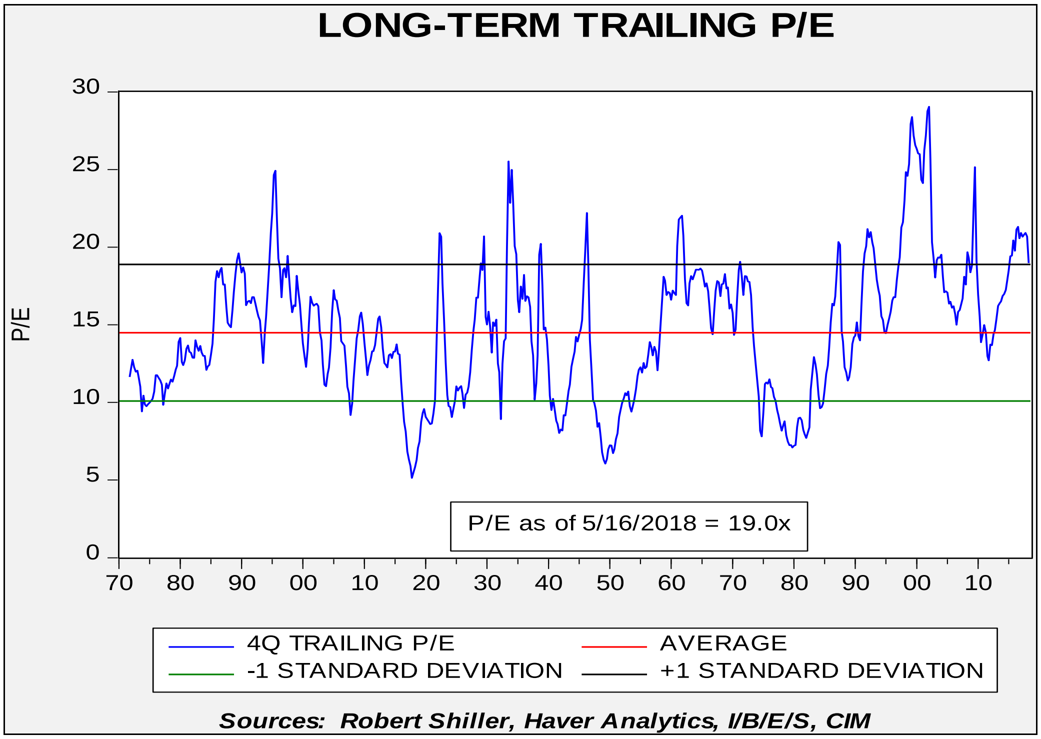


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[9] 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.

[9] 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.