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 22, 2018—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.4% from the prior close. Chinese markets were mixed, with the Shanghai composite unchanged and the Shenzhen index up 0.4%. 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.

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

The problem of priorities: There is a stock scene in most action movies where the hero is surrounded by bad guys but, inexplicably, they attack one at a time. The hero fends them off, showing he can defeat a group aligned against him…assuming they don't all attack at once. When one runs for president, it seems there is an assumption that the world behaves like an action movie. In real life, the "bad guys" ("issues") don't take turns. They come at the POTUS all at once. President Trump is dealing with the multiplicity of issues and performing triage. Here are the evolving issues:

1. **North Korea has become the most important item on the agenda.**[1] President Trump is running the risk his predecessor had with Iran; he may want a deal more than the other party. If the president can reach a substantive agreement with North Korea, it would be historic, something none of his predecessors have been able to pull off. The lure of this achievement may be overtaking the real possibilities of an agreement. It's critical for both parties to know exactly what they want. The U.S. should press for an ***elimination of the nuclear risk to the United States***. Anything beyond that is a mere plus. Note that we didn't say "denuclearization." That may come over time, but if there is anything Kim wants to avoid it's the fate of Muammar Gaddafi. He will keep some form of a nuclear threat for that reason alone. What the U.S. should try to accomplish is an end to the delivery mechanism to the U.S. North Korea should want sanctions relief and an eventual peace treaty that will foster economic development. This outcome may be

[1] https://apnews.com/f2e5aa3856b44b4b823064834dfb819d

achievable, but if John Bolton[2] has hijacked the president's policy on North Korea then the summit could end up in a stand-off, with the next logical step being war.

2. **Focusing on North Korea means that trade negotiations with China are less important.** China is willing to give the impression of a trade win to the White House; for example, today China announced a large reduction in car tariffs, to 15% from 25%.[3] There were non-binding promises for more imports, mostly grain and energy. The ZTE (ZTCOF, $2.26, 4/26/18) situation is getting resolved with a less rigorous U.S. response.[4] The president has put Treasury Secretary Mnuchin in charge of the China negotiations, sidelining hardliners such as Peter Navarro. Steve Bannon criticized Mnuchin's trade negotiations as a "giveaway."[5] In reality, we think the president wants to hew a hard line toward China on trade but he cannot have a trade war with China and a historic agreement with North Korea at the same time because China could scuttle U.S. negotiations with Kim. China, so far, is the winner on trade; its key goal remains intact, which is to maintain the industrial policy toward becoming a tech powerhouse.

3. **What about Iran?** Secretary of State Pompeo outlined U.S. goals with Iran. Essentially, the U.S. wants Iran to end its nuclear program permanently, stop developing missile technology and withdraw its influence across the Middle East. As one would expect, the response from Iran has been less than open.[6] Agreeing to this proposal would be tantamount to unilateral surrender and, in fact, would essentially require regime change.[7] The Iranian Revolution was not just about Iran but about spreading Shiite theocracy throughout the region. The U.S. goal may be regime change. If so, this could be setting the preconditions for war. However, there is another item to consider. If the Iranian leadership actually withdraws, a power vacuum would develop in Syria and Iraq. It is unclear who would fill it. At first glance, it would seem that any replacement for Iran would be better for the U.S. However, the last "vacuum filler" was Islamic State.

For now, North Korea is the #1 priority. That means the U.S. will go easy on China and will probably not move beyond rhetoric on Iran. But, once the North Korean situation is resolved, attention will need to shift to other priorities. Our guess is that Iran becomes next "in the barrel." If true, that should underpin oil prices.

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[2] https://www.washingtonpost.com/world/asia_pacific/whos-to-blame-for-the-hiccup-in-north-korea-talks-south-koreans-say-bolton/2018/05/21/f5099324-5cdf-11e8-8c93-8cf33c21da8d_story.html?utm_term=.895661ce1c71

[3] https://www.ft.com/content/dbda0d5c-5d89-11e8-9334-2218e7146b04

[4] https://www.wsj.com/articles/u-s-china-agree-on-broad-outline-to-settle-zte-controversy-1526959695

[5] https://www.bloomberg.com/news/articles/2018-05-21/steve-bannon-condemns-mnuchin-s-trade-truce-as-china-giveaway (paywall)

[6] https://www.ft.com/content/972765b8-5cfa-11e8-9334-2218e7146b04?emailId=5b039e04f872430004412604&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

[7] https://www.ft.com/content/2b97380a-5d63-11e8-9334-2218e7146b04?emailId=5b039e04f872430004412604&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

Zuckerberg in Brussels[8]: The Facebook (FB, 184.49) CEO will go to Brussels to discuss his company as Europe prepares to unleash its new regulations on privacy, known as General Data Protection Regulation (GDPR), which appears to restrict social media's ability to track user behavior. We expect Zuckerberg to offer investment and promises to do better[9] but, in reality, GDPR potentially could seriously harm the business model of social media[10] by reducing the amount of data that can be collected and sold to advertisers.

U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below shows the economic releases scheduled for the rest of the day.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Richmond Fed Manufacturing Index	m/m	may	10	-3	**
Fed speakers or events						
No speakers or events scheduled						

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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[8] https://www.ft.com/content/cd745340-5d47-11e8-ad91-e01af256df68?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

[9] https://www.politico.eu/pro/mark-zuckerberg-hearing-eu-european-union-brussels-cambridge-analytica-antonio-tajani/?utm_source=POLITICO.EU&utm_campaign=db3d564eca-EMAIL_CAMPAIGN_2018_05_21&utm_medium=email&utm_term=0_10959edeb5-db3d564eca-190334489

[10] https://www.politico.eu/article/gdpr-survival-guide-europe-privacy-data-protection-general-data-protection-regulation-may-25-facebook/?utm_source=POLITICO.EU&utm_campaign=f3892c4dc9-EMAIL_CAMPAIGN_2018_05_22&utm_medium=email&utm_term=0_10959edeb5-f3892c4dc9-190334489

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
Japan	Supermarket Sales	y/y	apr	-1.2%	-0.1%		**	Equity bearish, bond bullish
Australia	ANZ Roy Morgan Weekly Consumption	m/m	may	121.6	120.8		*	Equity and bond neutral
EUROPE								
U.K.	Public Finances	y/y	apr	-9.7 bn	0.5 bn		**	Equity bearish, bond bullish
	Central Government	y/y	apr	-6.1 bn	19.9 bn		**	Equity bearish, bond bullish
	Public Sector Net Borrowing	m/m	apr	6.2 bn	-0.3 bn	7.1 bn	**	Equity and bond neutral
	PSNB ex Net Borrowing	m/m	apr	7.8 bn	1.3 bn	8.5 bn	**	Equity and bond neutral
	CBI Trends Total Orders	m/m	may	-3	4	2	**	Equity bearish, bond bullish
	CBI Trends Selling Prices	m/m	may	19	18	18	**	Equity bullish, bond bearish
Switzerland	Money Supply M3	y/y	apr	3.3%	3.3%		**	Equity and bond neutral
	Total Sight Deposits	m/m	may	576.4 bn	576.2 bn		*	Equity and bond neutral
	Domestic Sight Deposits	m/m	may	470.4 bn	472.8 bn		*	Equity and bond neutral
Russia	PPI	y/y	apr	7.5%	4.8%	6.4%	**	Equity bearish, bond bullish
AMERICAS								
Brazil	CNI Industrial Confidence	y/y	may	55.5	56.7		**	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)	187	186	1	Neutral
TED spread (bps)	46	48	-2	Neutral
U.S. Libor/OIS spread (bps)	190	189	1	Up
10-yr T-note (%)	3.06	3.06	0.00	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	9	9	0	Down
Currencies	**Direction**			
dollar	down			Down
euro	up			Up
yen	up			Up
pound	up			Up
franc	up			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	$79.48	$79.22	0.33%	
WTI	$72.42	$72.24	0.25%	
Natural Gas	$2.84	$2.81	0.96%	
Crack Spread	$22.61	$22.78	-0.72%	
12-mo strip crack	$21.21	$21.28	-0.33%	
Ethanol rack	$1.59	$1.58	0.37%	
Metals				
Gold	$1,294.26	$1,292.60	0.13%	
Silver	$16.59	$16.51	0.46%	
Copper contract	$312.25	$309.85	0.77%	
Grains				
Corn contract	$ 405.00	$ 402.75	0.56%	
Wheat contract	$ 515.25	$ 507.25	1.58%	
Soybeans contract	$ 1,028.00	$ 1,025.25	0.27%	
Shipping				
Baltic Dry Freight	1239	1273	-34	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.0		
Gasoline (mb)		-1.8		
Distillates (mb)		-1.0		
Refinery run rates (%)		0.30%		

Weather

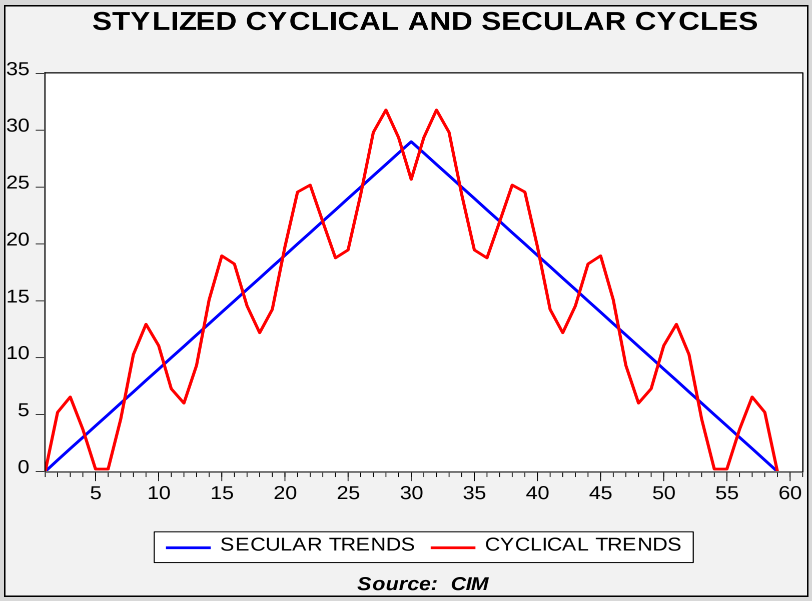
The 6-10 and 8-14 day forecasts continue to signal warmer to normal temperatures for most of the country. Precipitation is expected for most of the country.

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.

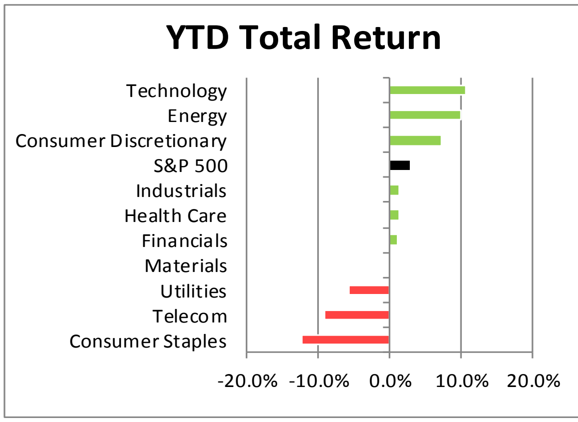
Depending on the market, cyclical trends tend to run three to 10 years. It is the most important trend in our asset allocation process. The business cycle is the primary factor in our analysis. The business cycle is the normal tendency for the economy to move from expansion to decline, recession, recovery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

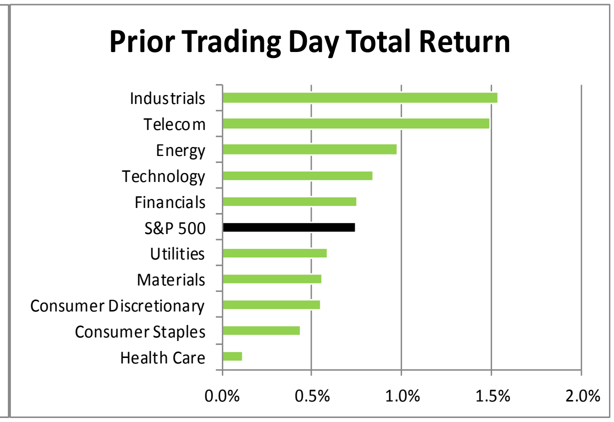
On the other hand, secular trends can last generations. These trends tend to be driven by societal factors. For example, public attitudes toward the balance between efficiency and equality are critical as these are affected by regulatory and tax policy. Long-term geopolitical stability is mostly a factor 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 5/21/2018 close)

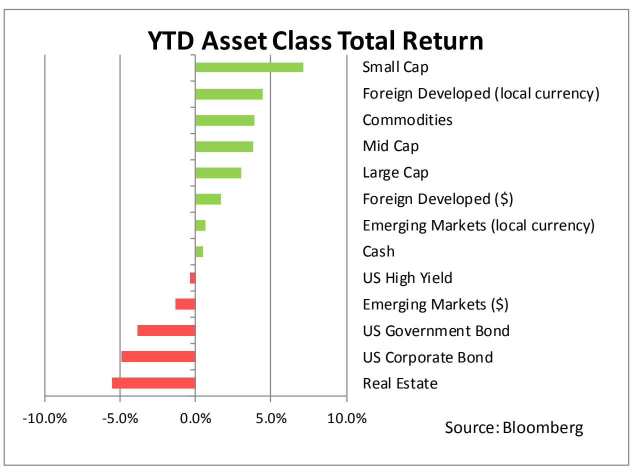




(Source: Bloomberg)

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 5/21/2018 close)

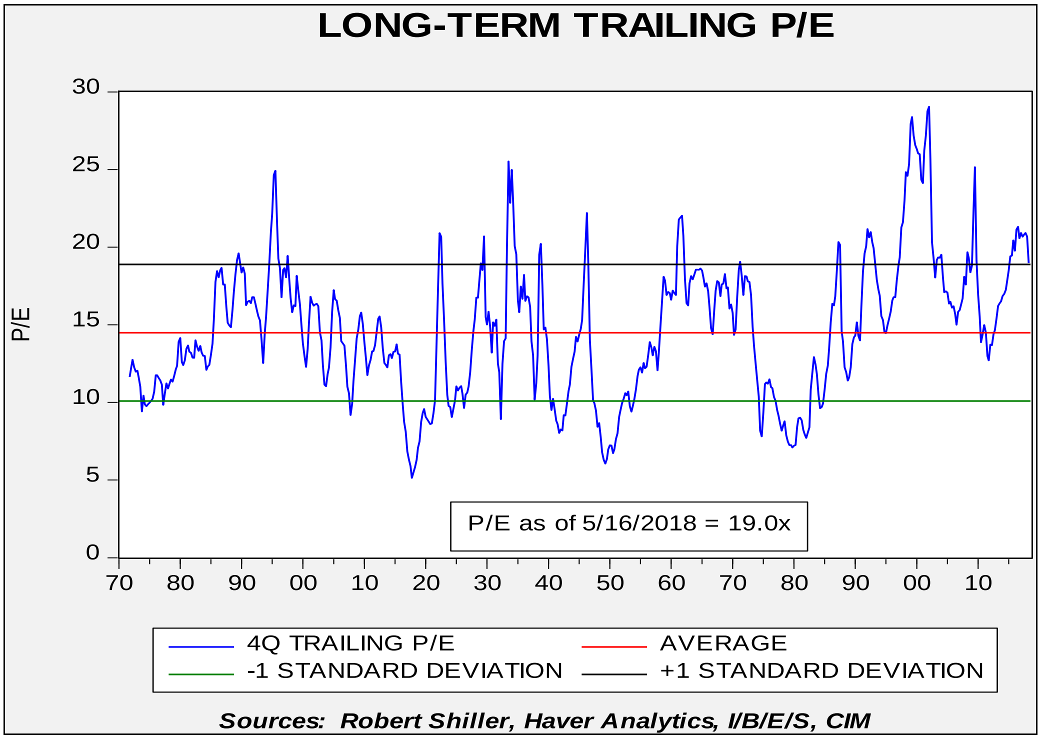


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[11] 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.

[11] 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.