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, 2019—9:30 AM EDT] Global equity markets are generally mixed this morning. The EuroStoxx 50 is up 0.1% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.2% 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 459 companies having reported, the S&P 500 Q4 earnings stand at $39.43, higher than the $37.29 forecast for the quarter. The forecast reflects a 2.0% decrease from Q1 2018 earnings. Thus far this quarter, 75.6% of the companies reported earnings above forecast, while 18.1% reported earnings below forecast.

(N.B. We are making a modest change today in this report. Instead of footnoting links to news items, we are moving to using hyperlinks. To see the linked story, simply click the underlined and highlighted item in the report. This is a more "modern" way of linking and will make our reports less cluttered.)

Good morning! U.S. equity futures are modestly lower this morning. The Fed minutes are out later today and trade tensions remain elevated. Brexit looks a mess and EU Parliamentary elections are coming. Here are the details:

BREAKING: Russian aircraft, for the second day, have threatened U.S. airspace, leading American warplanes to intercept. We will have more on this tomorrow.

Fed minutes: We will be watching for any insight into the committee's thinking on the nature of inflation. Members have indicated at least some degree of dissention as to whether the current low inflation is due to structural issues or if, as Chair Powell stressed in his post-meeting press conference, current low inflation is due to "transitory factors." Our take is that it's probably more permanent, but we don't vote on the committee! Although the minutes are heavily edited, look for words that suggest any sort of numbers, such as "some" or "a few" or "most." If the minutes suggest the permanent inflation group appears to be larger, it might mean a dovish tilt.

Tech trade war: Positions on both sides are hardening. The Trump administration is considering blacklisting Chinese surveillance technology firms, which would prevent them from purchasing U.S. technology. This action would further escalate tensions. The Chinese appear to be "digging in" as well; Chairman Xi told his people to prepare for difficult times, relating the current situation to Mao's "Long March." American firms operating in China report increasing difficulties, including rising costs and increased regulatory scrutiny. A rising number are looking to relocate, with Southeast Asia and Mexico as the most favored destinations. The growing trade conflict increases the risk of global recession.

EU parliamentary elections: We analyze and comment on domestic and foreign politics on a regular basis. That being said, we haven't been overly enthusiastic about delving into the upcoming parliamentary elections. The rules are devilishly complicated and it has never been clear to us how powerful the body actually is. Often, the EU Parliament vote is a protest action against the established domestic governments. However, with all that being said, the elections are looming and this is what you need to know:

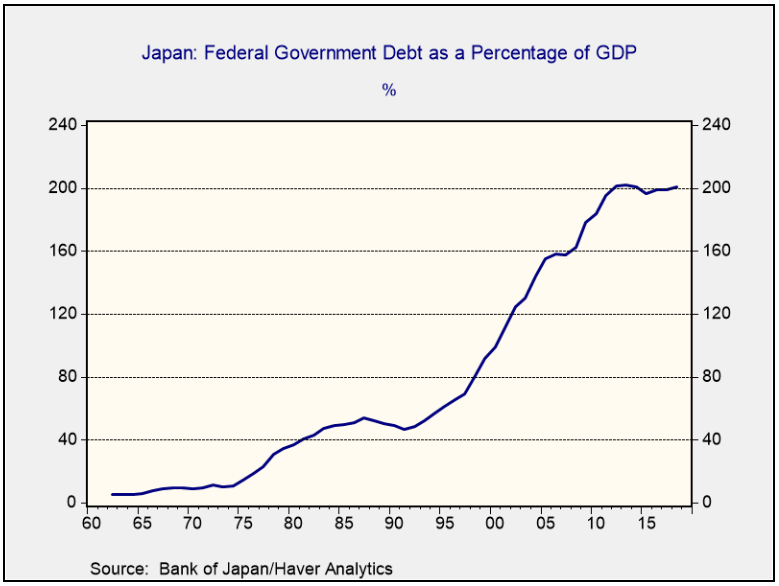
1. What does the EU Parliament do? It passes EU wide laws, supervises the European Commission (EC) and oversees the EU budget, which is currently around €145 bn.
2. This vote will replace Jean-Claude Juncker, the outgoing president of the EC.
3. The body has 751 seats and more than 350 mm EU voters can participate in the election. It is the only chance EU citizens have to directly vote on EU matters.
4. The U.K. will participate in this vote but, if the country leaves the EU as planned, its 73 seats will be allocated in the following manner—27 will be distributed among 14 nations deemed to be "underrepresented" and the rest will be held in reserve for new members.
5. In the voting, national parties within EU countries organize with like-minded members in other nations. Polling suggests the fringes are gaining ground and the center-left and center-right parties are losing power. Right-wing populist parties are especially gaining ground. Although the centrist parties will probably still have the largest bloc, they will need to add coalition partners from the populist-leaning parties. The populists want an autarkic trade policy and stronger actions against immigration. The Schengen policy of free movement might be restricted.
6. Although Germany and France will remain the heavyweights in the EU, especially if the U.K. departs, the ability of these two nations to determine the path of EU policy will be adversely affected if the populists gain influence in the EU Parliament. That might mean trade negotiations with the U.S. will become more difficult and it likely increases the odds of a trade rupture with the U.S. It might make a trade deal with the U.K. after Brexit more difficult as well. It may also have an impact on relations with Turkey. The populist opposition to immigration will give Ankara the ability to upset EU relations by merely allowing Middle East refugees transit across its territory to Europe.

Overall, we don't expect an immediate market impact, regardless of the outcome (which is why we haven't had much to say before now). The EU moves slowly by design. But, over time, it could change economic and regulatory policy and increase dissention in Europe. The more power the populists receive, the greater the odds of an eventual EU/Eurozone breakup. Again, this isn't anything we expect in the next few years, but by 2025 we could be seeing clear signs of trouble.

Brexit: PM May is offering a fourth vote for her plan and has suggested she will allow a second referendum vote by Parliament. The response has been overwhelmingly negative. It appears that PM May tried to lean toward supporting Labour's ideas for a Brexit deal, which has infuriated the hardline Tory members but failed to woo the opposition. The GBP has held up rather well, edging lower but not breaking down. The real risk to the currency is probably a Corbyn government, not Brexit. May probably won't survive another month and the polling suggests Boris Johnson will be the next Tory PM. Johnson is a bit of a rogue but has tended to lean toward a hard Brexit. If Johnson pushes the country toward a hard Brexit, we would not be shocked to see new general elections. Overall, the political trends are not favoring the GBP, but nothing looks catastrophic…yet.

Debt limits: It looks like we are actually close to getting a budget deal. If so, the potential for autumn drama will be reduced.

Japan consumption tax: Japan's fiscal situation is famously bad.



Its government debt/GDP is over 200%; for years, bond vigilantes have been shorting JGBs because "someday, this has to lead to inflation and falling bond prices." The trade has been so spectacularly bad it has become known as the "widow maker." Japan, like most nations that developed after WWII, used export promotion to constrain consumption, boost saving and use the saving for investment. That works very well until a certain level of development is achieved. Then, the economy needs to (a) shift to consumption instead of exports to drive growth, and (b) use various methods to deal with the inevitable malinvestment that develops from subsidizing investment. Japan has essentially done neither and has suffered through 30 years of stagnation. A holdover from this policy is the reliance on consumption taxes to raise fiscal revenue. This is harebrained—the last thing the overburdened household sector needs is more taxes. But, because policy inertia is so strong, the country continues to look at raising consumption taxes to address the aforementioned deficit. Under Abe, the government has tended to back away from planned hikes and we expect them to continue that policy. But, the recent surge in GDP may undermine the short-term political argument for postponing the hike and thus the odds may have increased for it to go through. If it does, we would look for a cyclical downturn in the economy. The BOJ is warning it will consider further easing measures if the tax boost is enacted.

U.S. Economic Releases

MBA mortgage applications rose 2.4% from the prior week. Purchases fell 2.0% from the prior week, while refinancing rose 8.3%. The average 30-year fixed rate fell by 7 bps from 4.40% to 4.33%.

The table below lists the Fed events scheduled for the rest of the day.

Economic Releases		
No economic releases today		
Fed speakers or events		
EST	**Speaker or event**	**District or position**
10:00	James Bullard Speaks in Washington	President of the Federal Reserve Bank of St. Louis
10:10	John Williams speaks to Bronx Bankers Breakfast	President of the Federal Reserve Bank of San Francisco
14:00	FOMC Meeting Minutes	Federal Reserve Board

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								
Japan	Trade Balance	m/m	apr	¥0.060 bn	¥528.5 bn	¥232.5 bn	**	Equity bearish, bond bullish
	Core Machine Orders	y/y	mar	-0.7%	-5.5%	-3.4%	**	Equity bearish, bond bullish
Australia	Westpac Leading Index	w/w	may	-0.1%	0.2%		**	Equity and bond neutral
	Skilled Vacancies	y/y	apr	-1.6%	-1.5%		**	Equity and bond neutral
	Construction Work Done	y/y	mar	-1.9%	-3.1%	0.0%	**	Equity and bond bearish
New Zealand	Retail Sales Ex Inflation	q/q	1q	0.7%	1.7%	0.6%	**	Equity and bond neutral
EUROPE								
Eurozone	Consumer Confidence	m/m	may	-6.5	-7.9	-7.7	***	Equity and bond neutral
UK	CPI	y/y	apr	2.1%	1.9%	2.2%	***	Equity and bond neutral
	CPI core	m/m	apr	1.8%	1.8%	1.9%	***	Equity and bond neutral
	RPI	y/y	apr	3.0%	2.4%	2.8%	**	Equity bullish, bond bearish
	PPI Output	y/y	apr	2.1%	2.4%	2.3%	**	Equity and bond neutral
	PPI Input	m/m	apr	3.8%	3.7%	4.5%	**	Equity and bond neutral
	House Price Index	m/m	mar	1.4%	0.6%	1.0%	**	Equity bullish, bond bearish
	PSNB ex Banking Groups	m/m	apr	5.8 bn	1.7 bn	5.9 bn	*	Equity and bond neutral
AMERICAS								
Mexico	Internation Reserves Weekly	m/m	may	$177.091 bn	$176.924 bn		**	Equity bullish, bond bearish
Canada	Bloomberg Nanos Confidence	m/m	mar	55.1	54.7		**	Equity bullish, bond bearish

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)	252	252	0	Up
3-mo T-bill yield (bps)	232	233	-1	Neutral
TED spread (bps)	20	20	0	Neutral
U.S. Libor/OIS spread (bps)	238	238	0	Up
10-yr T-note (%)	2.43	2.43	0.00	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	17	17	0	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	flat			Up
yen	up			Neutral
pound	down			Neutral
franc	flat			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	$71.83	$72.18	-0.48%	
WTI	$62.56	$63.13	-0.90%	
Natural Gas	$2.62	$2.61	0.23%	
Crack Spread	$21.98	$21.95	0.14%	
12-mo strip crack	$18.30	$18.37	-0.41%	
Ethanol rack	$1.50	$1.49	0.33%	
Metals				
Gold	$1,273.98	$1,274.68	-0.05%	
Silver	$14.45	$14.45	-0.03%	
Copper contract	$269.30	$271.50	-0.81%	
Grains				
Corn contract	$ 389.25	$ 394.25	-1.27%	
Wheat contract	$ 471.25	$ 478.75	-1.57%	
Soybeans contract	$ 824.50	$ 822.00	0.30%	
Shipping				
Baltic Dry Freight	1049	1041	8	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.9		
Gasoline (mb)		-1.0		
Distillates (mb)		-0.6		
Refinery run rates (%)		0.50%		
Natural gas (bcf)		103.0		

Weather

The 6-10 and 8-14 day forecasts show cooler temps for the western half of the country, with warmer temps for the rest of the country. Precipitation is expected for most of the country.

Asset Allocation Weekly

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.

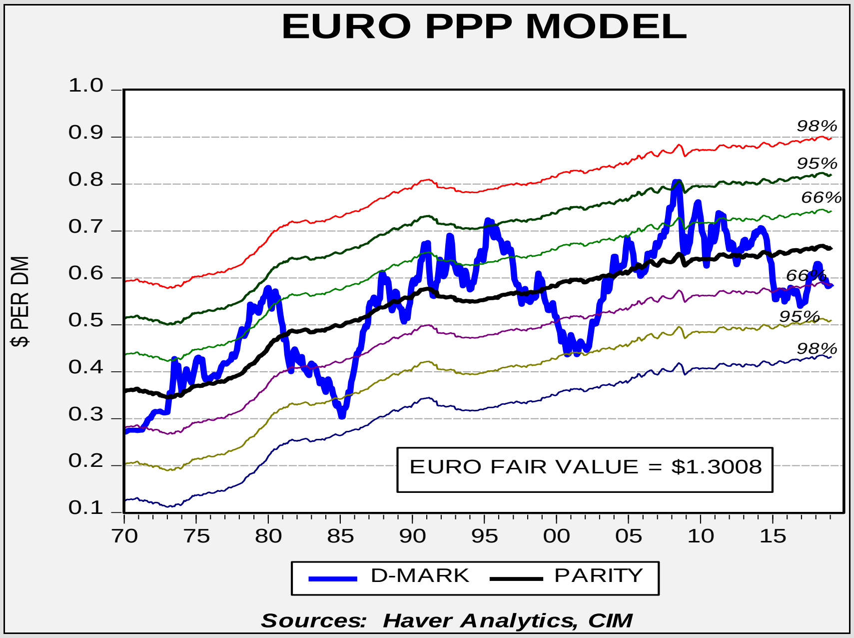
May 17, 2019

Foreign exchange economics has become something of a backwater in economic theory. There are four predominant valuation methodologies; if one were any good, the others wouldn't exist! The four are purchasing power parity, real equilibrium theory, interest rate differentials and productivity equalization (unit labor cost equalization). The general idea is that under flexible exchange rates, currency values adjust to eliminate differences between nations. The oldest of the four is purchasing power parity, which assumes exchange rates move to equalize prices across nations. Real equilibrium theory suggests the exchange rate adjusts to equalize real current account differences. Interest rate differentials suggest the exchange rate adjusts to equalize interest rates, and productivity equalization normalizes unit labor costs (labor costs adjusted for productivity) across nations.

In practice, the macro data used to calculate fair value for exchange rate models is usually not granular enough to capture differences between nations. For example, with purchasing power parity, all goods and services in an inflation index are not tradeable and so these non-traded products cannot be adjusted via exchange rates. And so, all the models tend to be useful only at extremes. In other words, wide deviations from calculated fair value can offer useful signals, but, like all valuation models in finance, they are not helpful for timing.[1] At the same time, long-term investors can find value in such models in that they do signal when a relationship is cheap or rich. This is helpful but only if (a) the investor is truly patient, and (b) something significant hasn't changed.

Our favorite model is purchasing power parity because long-term inflation histories are usually easy to access and, theoretically, inflation is a very important variable. As we have been noting for some time, the dollar is expensive based on these models. For example:

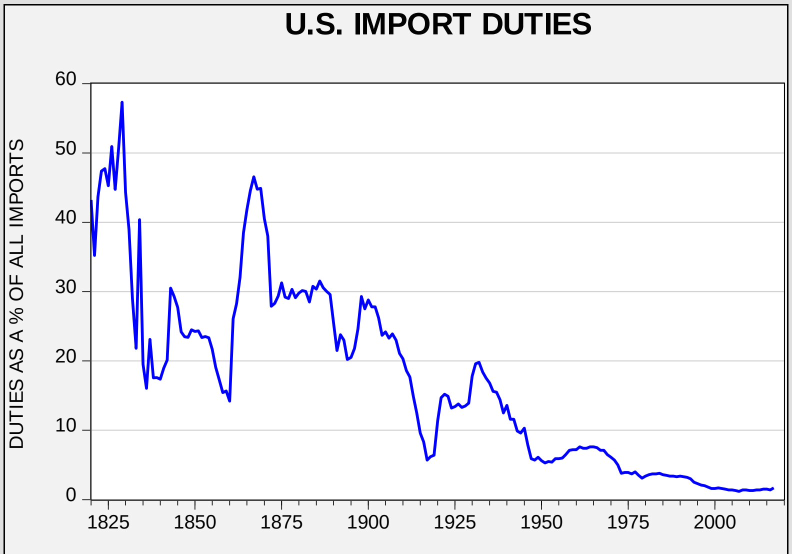
[1] Or, said another way, "markets can stay stupid longer than you can stay solvent."



This is a parity model for the EUR, using German inflation against U.S. inflation. The fair value exchange rate is $1.3008 compared to the current rate of $1.1200. This deviation from fair value, which in historical ranges is where reversals usually occur, has led to the belief that, at some point, the dollar will weaken. The model also suggests that once a reversal occurs it is common that the exchange relationship will overshoot. Thus, a turn in the exchange rate is an important event; in markets, for U.S. investors, foreign stocks and commodities are two areas where one can historically find outperformance.

But, the Trump administration has moved to the use of tariffs to combat persistent trade deficits. The use of tariffs had fallen out of favor, in part because the U.S. fostered open trade, and because tariffs tend to be less effective under flexible exchange rates. Why? Because the nation targeted by tariffs can simply allow its currency to weaken, offsetting the price effect of the tariff. For example, if China is a target for tariffs, the expected response would be CNY depreciation.

This chart shows how tariffs have become less of a factor.



Sources: U.S.International Trade Commission, St. Louis FRB, FRASER database, CIM

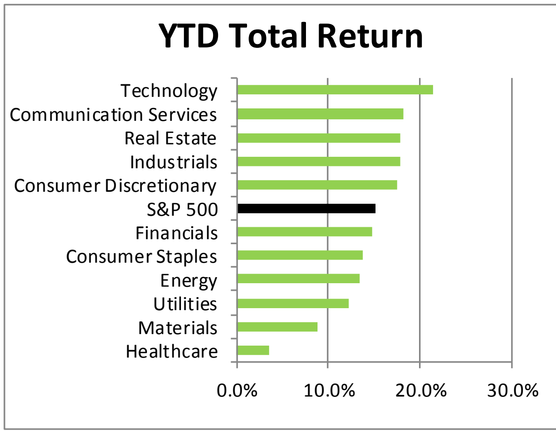
As the chart shows, after the 1920s, the U.S. has steadily abandoned tariffs…until now.

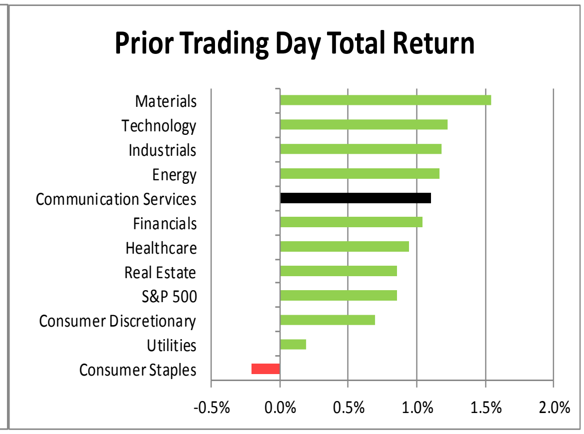
If the administration continues down this path of using tariffs on a widespread basis, our position on future dollar weakness has to be reconsidered. Although the tariff policy may not last once Trump leaves office, one cannot necessarily assume that to be the case. Of course, the U.S. could act against depreciation too, but that might prove difficult to stop.

At some point, we expect the administration (or some future administration) to realize that tariffs are a poor tool for reducing the trade deficit. Currency weakness is more effective but the most effective method is capital controls. The reason the U.S. runs persistent trade deficits is because the dollar is the reserve currency. If the U.S. denied access to the U.S. capital markets, then foreigners would have less reason to engage in policies to promote exports. Would there be collateral damage from such policies? Yes, but we may be approaching a point where Americans are willing to accept those side effects in order to reduce inequality and lift domestic wages.

Data Section

U.S. Equity Markets – (as of 5/21/2019 close)

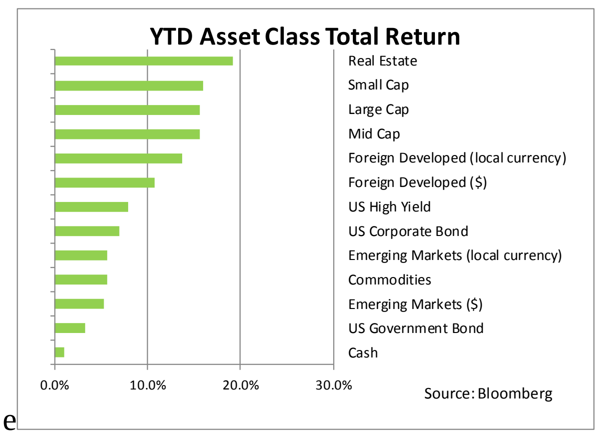




(Source: Bloomberg)

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. These charts represent the new sectors following the 2018 sector reconfiguration.

Asset Class Performance – (as of 5/21/2019 close)



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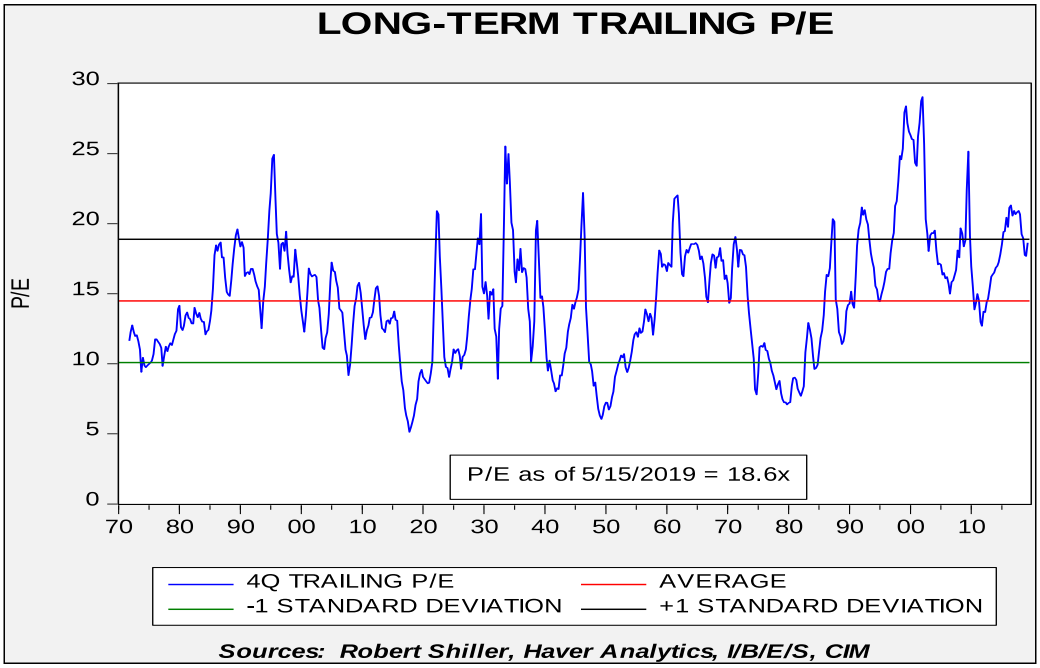
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 16, 2019



Based on our methodology,[2] the current P/E is 18.6x, unchanged from last week.

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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[2] 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 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.