Confluence Investment Management

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 23, 2018—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 1.6% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.5% from the prior close. Chinese markets were down, with the Shanghai composite down 1.4% and the Shenzhen index down 1.1%. U.S. equity index futures are signaling a lower 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.

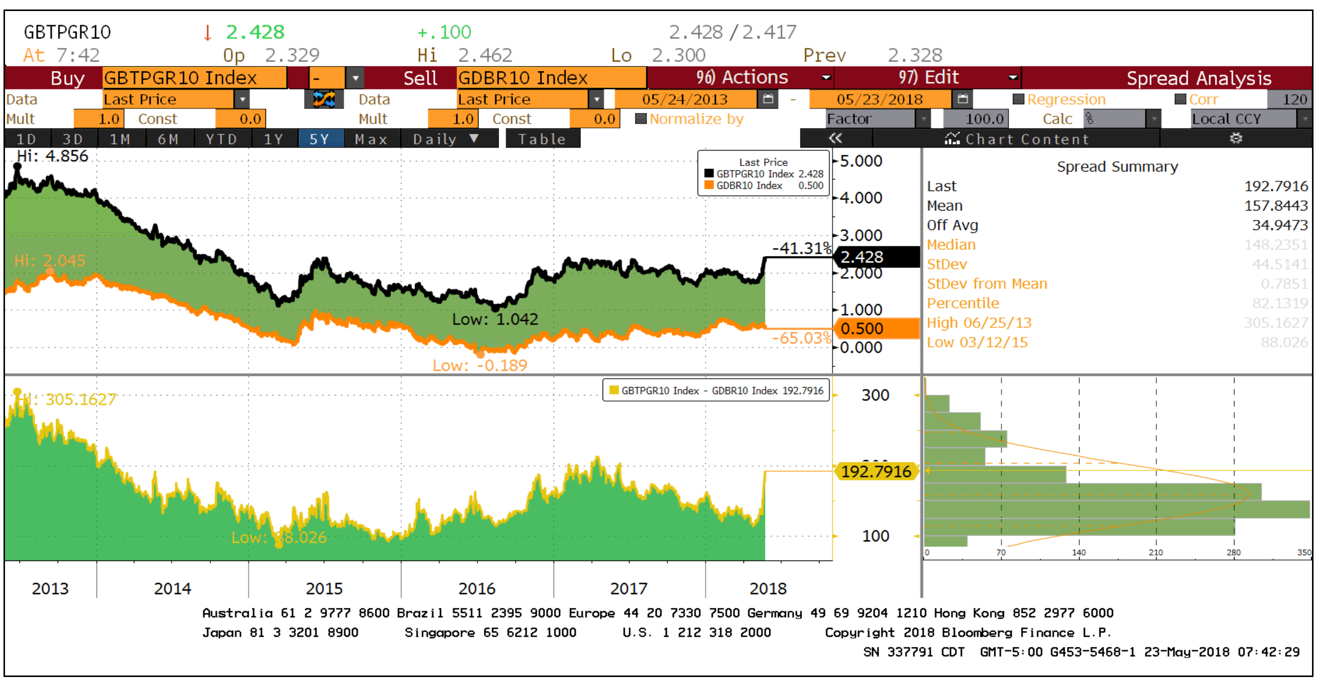
It's looking a bit ugly out there this morning for risk assets. Equities and most commodities are lower, while gold, Treasuries and the JPY are higher. This is a classic pattern of flight to safety buying. Here is what we are watching:

Twin crises: Turkey and Italy are the primary problem areas this morning. Turkey is facing a full-blown currency crisis.

(Source: Bloomberg)

The above is a three-decade chart of the TRY/USD exchange rate in terms of lira per dollar. We are not only making new lows but making them in rapid fashion. The drop in the TRY is a classic example of why leaders shouldn't undermine the independence of the central bank. The textbook response to this sort of decline is a massive increase in short-term interest rates. This action increases the cost of shorting (the short has to borrow in the shorted currency) and usually arrests the decline. However, President Erdogan is strongly opposed to interest rate increases so we have a showdown between the financial markets and the president. Compounding the problem is that the Turkish private sector has borrowed in foreign currencies, meaning the drop in the TRY is rapidly escalating the cost of debt service. S&P[1] is threatening a downgrade. Turkey is holding national elections on June 24. Erdogan is hoping to solidify his political position to change the nature of the presidency, boosting the executive's power. A currency crisis that triggers a debt crisis won't help Erdogan's popularity.

Meanwhile, the travails of Italy continue. The Five-Star Movement and the League are close to forming a government but have hit two snags. First, their candidate for PM, Giuseppe Conte, a politically unknown law professor, appears to have either lied about or inflated his accomplishments on his resume.[2] Second, the coalition is recommending Paolo Savona for finance minister, an avowed Euroskeptic.[3] President Mattarella, who must approve any government, is not comfortable with either choice for PM or FM. Italian credit markets are showing signs of stress. First, sovereign interest rates are rising.



(Source: Bloomberg)

[1] https://www.reuters.com/article/us-turkey-ratings-s-p/turkeys-woes-could-quickly-sour-governments-finances-sp-idUSKCN1IN1WB
[2] https://www.cnbc.com/2018/05/23/conte-italy-populists-face-setback-on-their-new-leader.html
[3] https://www.ft.com/content/360dc63a-5dd3-11e8-9334-2218e7146b04

This chart shows the Italian vs. German 10-year sovereigns. The spread is widening out rapidly; what is worrisome is that while Italian yields are rising, German yields are declining (albeit modestly). This suggests we may be seeing capital flight out of Italy into German paper. Second, Italian bank bonds, especially those with elevated levels of non-performing loans, are coming under pressure.[4]

OPEC: Oil prices slipped yesterday afternoon on reports that OPEC may boost output to offset declines in Venezuelan production.[5] The cartel probably does not want to see the U.S. gain market share due to Venezuela's woes. If it actually occurs, we don't see this change in OPEC as necessarily bearish but it will tend to cap some of the recent enthusiasm. Oil prices have mostly ignored the recent rise in the dollar, but eventually the stronger greenback will tend to adversely affect oil prices.

Facebook (FB, 183.80): Mark Zuckerberg was given kudos for coming to testify in Europe; that's where the praise ended. The apology was more in the vein of, "I'm sorry you were upset," and it was apparent that the company has no interest in changing its advertising-driven business model. At this point, social media's greatest threat comes from Europe.

U.S. Economic Releases

MBA mortgage applications fell 2.6% from the prior week. Purchases and refinancing fell 2.0% and 3.7%, respectively. The average 30-year fixed rate mortgage rose by 9 bps to 4.86% from 4.77%.

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	Markit Manufacturing PMI	m/m	may	56.5	56.5	**
9:45	Markit Services PMI	m/m	may	55.0	54.6	**
9:45	Markit Composite PMI	m/m	may		54.9	**
10:00	New Home Sales	m/m	apr	680k	694k	**
10:00	New Home Sales	m/m	apr	-2.1%	4.0%	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
14:00	FOMC Meeting Minutes	Federal Reserve Board				
14:15	Neel Kashkari speaks about Housing and Finance	President of the Federal Reserve Bank of Minneapolis				

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

[4] https://www.ft.com/content/0ed87bcc-5e6f-11e8-9334-2218e7146b04
[5] https://www.reuters.com/article/us-global-oil/oil-dips-as-market-eyes-possible-easing-of-opec-supply-curbs-idUSKCN1IO01M?il=0

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	Nikkei Japan PMI Mfg	m/m	may	52.5	53.8		**	Equity and bond neutral
	All Industry Activity Index	m/m	mar	0.0%	0.4%	0.1%	**	Equity bearish, bond bullish
	Nationwide Dept Sales	y/y	apr	0.7%	0.1%		**	Equity bullish, bond bearish
	Tokyo Dept Store Sales	y/y	apr	1.9%	0.1%		**	Equity bullish, bond bearish
Australia	Westpac Leanding Index	m/m	apr	0.2%	-0.2%		**	Equity and bond neutral
	Skilled Vacancies	m/m	apr	-0.5%	0.9%		**	Equity and bond neutral
	Construction Work Done	q/q	1q	0.2%	-19.4%	1.3%	**	Equity bearish, bond bullish
EUROPE								
Eurozone	Markit Eurozone Manufacturing	m/m	may	55.5	56.2	56.1	**	Equity and bond neutral
	Markit Eurozone Services	m/m	may	53.9	54.7	54.7	**	Equity and bond neutral
	Markit Eurozone Composite	m/m	may	54.1	55.1	55.1	**	Equity and bond neutral
France	Markit France Manufacturing	m/m	may	55.1	53.8	53.7	**	Equity bullish, bond bearish
	Markit France Services	m/m	may	54.3	57.4	57.2	**	Equity and bond neutral
	Markit France Composite	m/m	may	54.5	56.9	56.8	**	Equity and bond neutral
	ILO Unemployment Rate	q/q	1q	9.2%	8.9%	8.8%	***	Equity bearish, bond bullish
Germany	Markit/BME Germany Manufacturing	m/m	may	56.8	58.1	57.9	*	Equity and bond neutral
	Markit Germany Services	m/m	may	52.1	53.0	53.0	*	Equity and bond neutral
	Markit/BME Germany Composite	y/y	may	53.1	54.6	54.6	**	Equity and bond neutral
U.K.	CPI core	q/q	apr	2.4%	2.3%	2.2%	***	Equity bullish, bond bearish
	RPI	y/y	apr	3.4%	3.3%	3.4%	**	Equity and bond neutral
	PPI Input	y/y	apr	5.3%	2.4%	1.0%	**	Equity bullish, bond bearish
	PPI Output	y/y	apr	2.7%	2.2%	2.3%	***	Equity bullish, bond bearish
	House Price Index	y/y	mar	4.2%	4.4%	4.4%	**	Equity and bond neutral
	CBI Retailing Reported Sales	y/y	may	11	-2	5	**	Equity bullish, bond bearish
	CBI Total Dist. Reported Sales	y/y	may	17	6		**	Equity bullish, bond bearish
Russia	Unemployment Rate	m/m	apr	2.4%	2.0%	2.4%	***	Equity and bond neutral
AMERICAS								
Mexico	Retail Sales	y/y	mar	1.2%	1.2%	0.1%	**	Equity and bond neutral
Canada	Wholesale Trade Sales	m/m	mar	1.1%	-0.8%	0.9%	**	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)	233	233	0	Up
3-mo T-bill yield (bps)	189	189	0	Neutral
TED spread (bps)	44	44	0	Neutral
U.S. Libor/OIS spread (bps)	190	190	0	Up
10-yr T-note (%)	3.01	3.06	-0.05	Up
Euribor/OIS spread (bps)	-32	-33	1	Neutral
EUR/USD 3-mo swap (bps)	14	11	3	Down
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	down			Up
pound	down			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	$78.98	$79.57	-0.74%	Bearish API report
WTI	$71.80	$72.20	-0.55%	
Natural Gas	$2.91	$2.91	0.00%	
Crack Spread	$22.74	$23.06	-1.40%	
12-mo strip crack	$21.46	$21.79	-1.51%	
Ethanol rack	$1.59	$1.59	0.18%	
Metals				
Gold	$1,297.16	$1,291.14	0.47%	
Silver	$16.55	$16.55	0.02%	
Copper contract	$306.25	$313.20	-2.22%	
Grains				
Corn contract	$ 404.25	$ 404.75	-0.12%	
Wheat contract	$ 518.75	$ 521.50	-0.53%	
Soybeans contract	$ 1,032.75	$ 1,030.50	0.22%	
Shipping				
Baltic Dry Freight	1199	1239	-40	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.0		
Gasoline (mb)		-1.8		
Distillates (mb)		-1.0		
Refinery run rates (%)		0.30%		
Natural gas (bcf)		96.0		

Weather

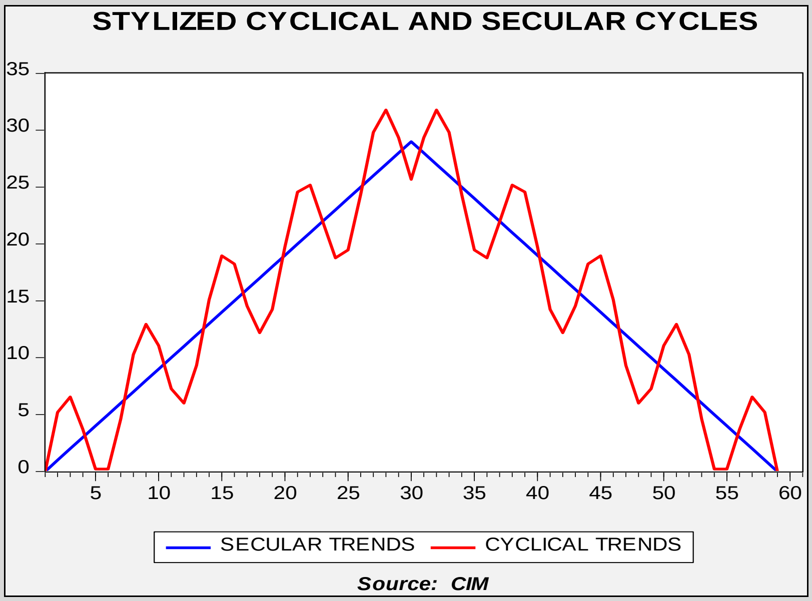
The 6-10 and 8-14 day forecasts continue to signal warmer to normal temperatures for most of the country. Precipitation is expected for most of the country.

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 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.

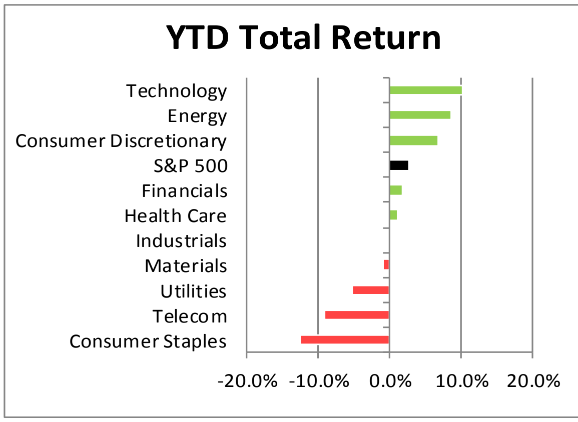
Depending on the market, cyclical trends tend to run three to 10 years. It is the most important trend in our asset allocation process. The business cycle is the primary factor in our analysis. The business cycle is the normal tendency for the economy to move from expansion to decline, recession, recovery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

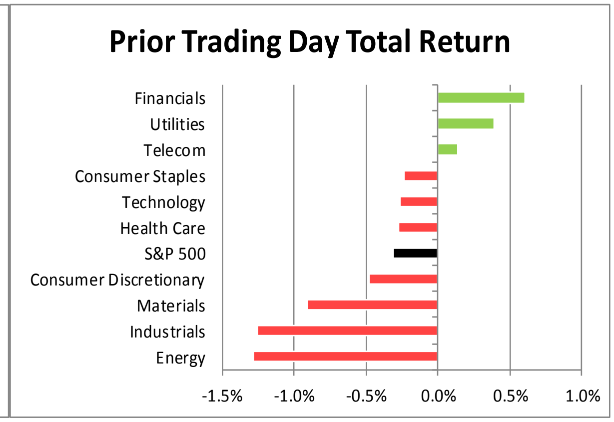
On the other hand, secular trends can last generations. These trends tend to be driven by societal factors. For example, public attitudes toward the balance between efficiency and equality are critical as these are affected by regulatory and tax policy. Long-term geopolitical stability is mostly a factor 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 5/22/2018 close)

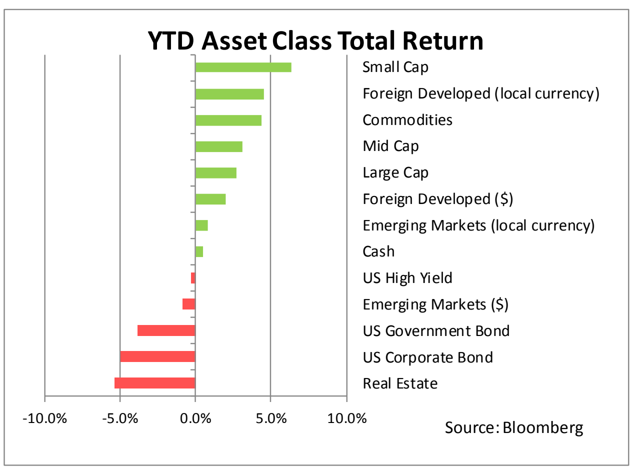




(Source: Bloomberg)

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 5/22/2018 close)

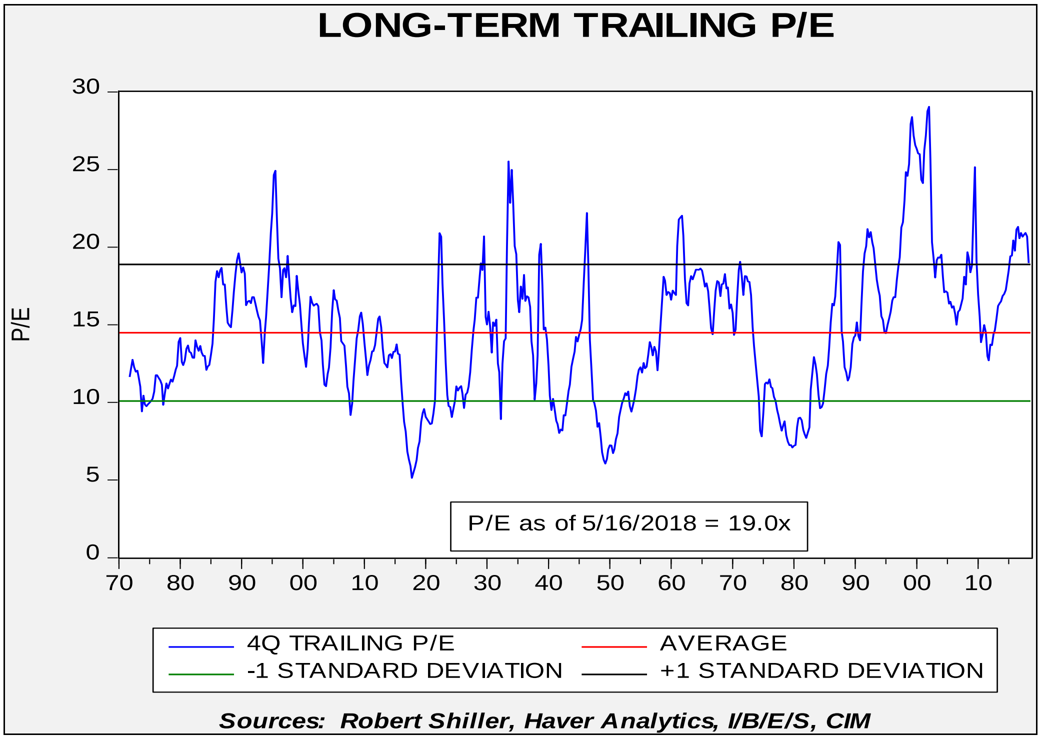


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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[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.