

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, 2019—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 1.5% 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 1.4% and the Shenzhen index down 2.4%. U.S. equity index futures are signaling a lower open. With 464 companies having reported, the S&P 500 Q4 earnings stand at \$39.38, higher than the \$37.29 forecast for the quarter. The forecast reflects a 2.0% decrease from Q1 2018 earnings. Thus far this quarter, 75.4% of the companies reported earnings above forecast, while 18.5% reported earnings below forecast.

Good morning! U.S. equity futures are modestly lower this morning. There is a lot of news to digest this morning. Here is what we are watching:

Trade wars: There is little evidence that the trade situation in China is improving. If anything, conditions are worsening. Here is what we are seeing:

1. The trade negotiations are turning from a mere discussion of tariffs and the trade deficit to a direct attack on [China's tech sector](#). As we have noted in the past, China's economy is in the midst of transitioning from a high-growth/low-cost manufacturer to a moderate-growth, mature economy. Like virtually all nations that have developed since the industrial revolution, China has developed by expanding investment and has now reached the point in its development where it has excess capacity. It needs to address that excess capacity through a combination of methods: (a) finding new markets for this production, (b) writing down the value of this investment to make it profitable for a new buyer, and (c) transforming the old investment capital into new higher value-added capital. It is mostly trying to deploy options (a) and (c); the former is through the belt and road project, a modern form of 19th century imperialism, and the latter through the China 2025 project, where it wants to dominate the tech sector. The U.S. is trying to prevent either method; if China is forced to deploy option (b) then it can either take the American sub-option, which is also affectionately known as the "Great Depression," or the Japan sub-option, which means 30+ years of stagnation. Needless to say, China is resisting. [Preventing China from dominating tech seems to be rapidly evolving into the thrust of U.S. policy](#). *If this is truly the goal of U.S. policy, relations between the U.S. and China will be forever changed.* Consequently, the trade talks, though they still matter, may not give the financial markets the boost that a deal would have given us just a few weeks ago.

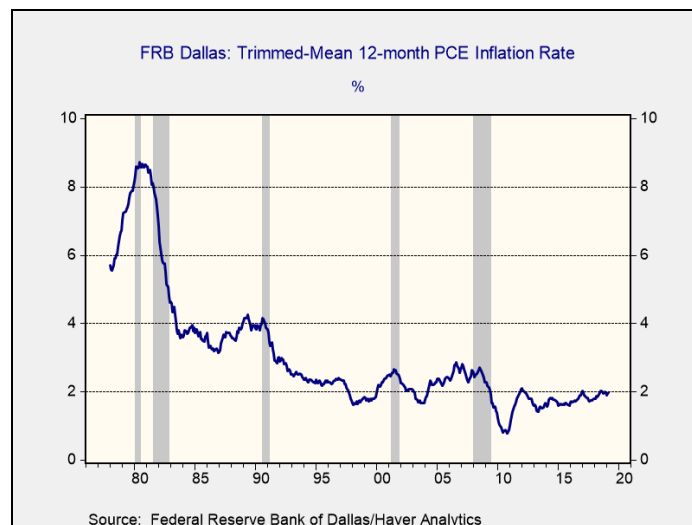
2. We are starting to see other [developed nations fall in line](#) with U.S. tech policy regarding China. Initially, it looked like other nations were defying Washington; however, [that defiance has waned](#). It is possible that continued [bad behavior by Chinese tech firms](#) has changed sentiment. This adds to the argument that we are seeing a fundamental shift. Essentially, since Deng, American policy has been to foster China's economic development, assuming that increased development would eventually lead to democratization and acceptance of the U.S. global order. That idea was steadily fraying under Obama but it's dead under Trump.
3. We fear [financial markets are misreading the situation with China](#). Faith in the "Trump put" remains high. The assumption is that Trump will cave to China if financial markets buckle and accept a trade agreement, lifting risk assets. However, financial markets may be missing the fact that there is [strong bipartisan support for opposing China](#). It appears [blue collar workers are very supportive](#) of Trump's China policy.
4. China may be misreading the U.S. and President Trump's situations as well. Yesterday, we saw scheduled infrastructure talks canceled in anger as the president ended them due to Speaker Pelosi's comment that the White House was engaged in a "cover up." Although we view this as normal political sniping, it could have wider implications if Beijing views the cycle of investigations and lawsuits as evidence that Trump is under pressure and needs a trade deal. In fact, that assumption may be completely wrong; given the support the president gets from his tough stance on China, he may need that support more than a deal...unless the economy tanks. And, that may have more to do with the FOMC (see below) than the China trade deal. In fact, Trump may hold even tighter to his hardening position on China with the leading Democratic Party candidate [downplaying the Chinese threat](#).
5. China appears to be dusting off a ploy it first unveiled in 2010—using its [dominant position in rare earths as negotiation leverage](#). Rare earth minerals are [critical components of modern technology](#), including not just smartphones but also green energy and missile guidance systems. To some extent, the term "rare" is a misnomer. The minerals are actually accessible in most of the world, but the production is extraordinarily "dirty," causing serious environmental problems in mining. Because China doesn't have strong environmental regulations or a tort bar, China became the leader in rare earth production because it was willing to bear the environmental costs internally. The U.S. and others could restart rare earths production but, given our environmental restrictions, the costs of these minerals would increase.
6. Meanwhile, the U.S. is continuing to build pressure on China in other ways, such as [sailing U.S. Navy vessels through the Taiwan Strait](#).

The bottom line is that the likelihood is falling for a trade deal at next month's G-20 meeting. Although President Trump's mercurial nature could lead to a surprise agreement, in reality, China and the U.S. are now strategic competitors. While it's possible the two nations could eventually accommodate each other, that sentiment suggests a level of optimism we struggle to share. In the immediate situation, financial markets continue to cling to hope that this will all pass. That hope is becoming increasingly difficult to maintain.

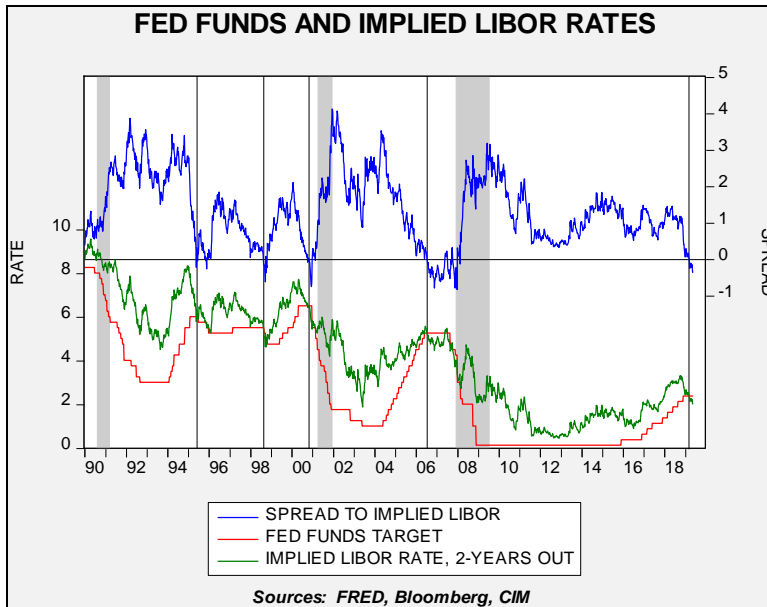
Gaming trade: Trade restrictions have been around for centuries and producers and consumers have worked on ways to evade them. A [prominent American protein producer](#) has apparently figured out a way to evade Chinese trade sanctions.

Gaming tech: Drivers for the various ride-sharing companies have developed a new tactic to force up their pay. At large airports, [all the contractors coordinate to shut off their apps](#), leading the algorithms to assume there is a shortage of drivers. This leads to surge pricing, allowing the drivers to increase their pay.

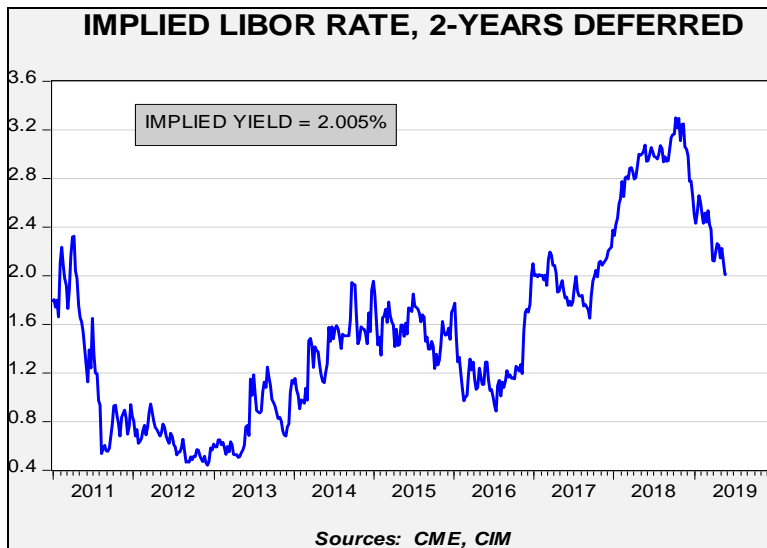
Fed minutes: Overall, the minutes were a bit hawkish, more reflecting Chair Powell’s press conference comments about transitory inflation than leaning toward a rate cut. There were comments expressing concern that continued low inflation might lead to lower inflation expectations, with the term “several” being used. But, the general tenor is that current low inflation is an aberration and won’t be maintained. One reason for this position is based on the Dallas FRB Trimmed Mean PCE. The “trimmed mean” process essentially throws out the most extreme component readings of the PCE that could be skewing the data. Their yearly reading does show stable prices.



At the same time, it does not suggest a decline in inflation that would strengthen the need to cut rates. In looking at the extreme distributions, 26.7% of the PCE components indicated monthly price changes in excess of 26.7% annualized. Price changes from zero to 2% were around 14%. Overall, this distribution would suggest caution on being overly worried about disinflation. The minutes suggest a Fed on hold, with a “few” members pressing for tightening, but the financial markets are leaning even more heavily toward a rate cut.



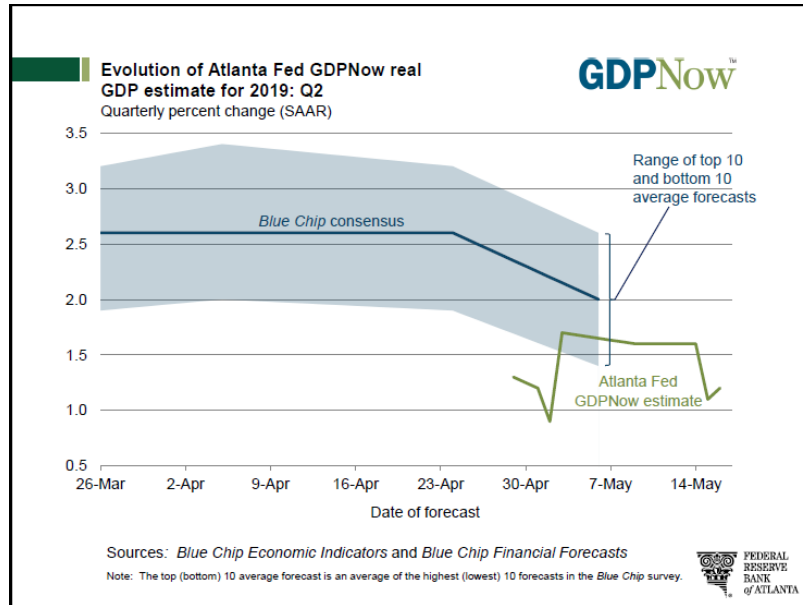
This chart shows the two-year deferred implied LIBOR rate from the Eurodollar futures market and fed funds. The upper line shows the spread. The relationship has been remarkably accurate in signaling when policymakers should end tightening cycles. We inverted these rates in late March; the implied LIBOR rate is now down to 2.01% (see chart below), suggesting monetary policy is too tight. [That is not the message the FOMC is sending](#), which is increasing the risk of a policy error.



The end of May: It finally looks like the [end for PM May is coming](#). [Andrea Leadsom resigned from her cabinet position yesterday](#), indicating she could no longer support the PM's Brexit plan. Tory MPs [are furious with May's flirtations with Labour](#) by offering a customs union and hinting at supporting a second referendum. At the same time, the Brexit Party looks like it will win the majority of EU Parliament seats, a further blow to May. Internal Tory party leadership is

expected to meet with May in the coming days and will likely press her to step down. All this political turmoil has been [bearish for the GBP](#).

Weaker economy: The Atlanta FRB GDPNow forecast is signaling GDP for Q2 at 1.2%, a significant slowdown from Q1 3.2% growth. Here is the forecast chart.



And the contributions.

Atlanta Fed GDPNow estimates for 2019: Q2, contributions to growth

Date	Major Releases	GDP	PCE	Equip- ment	Intell. prop. prod.	Nonres. struct.	Resid. inves.	Govt.	Net exports	CPI ¹
29-Apr	Initial nowcast	1.3	2.22	0.29	0.31	-0.01	-0.14	0.15	-0.01	-1.56
1-May	ISM Manuf., Construction spending	1.2	2.18	0.27	0.31	0.01	-0.13	0.15	0.00	-1.58
2-May	M3-2 Manufacturing, Auto sales	0.9	1.95	0.14	0.31	0.01	-0.14	0.15	0.00	-1.52
3-May	Employment situation, Adv. Econ. Indicators, ISM Nonmanufact. Index	1.7	2.08	0.17	0.32	0.03	-0.08	0.16	0.02	-1.02
9-May	Producer Price Index	1.6	2.13	0.17	0.32	0.03	-0.08	0.15	-0.02	-1.12
10-May	CPI, Monthly Treasury Statement	1.6	2.13	0.17	0.31	0.03	-0.08	0.14	-0.02	-1.12
14-May	Import/Export prices	1.6	2.13	0.17	0.31	0.03	-0.08	0.14	-0.02	-1.12
15-May	Retail trade, Industrial production	1.1	1.99	0.06	0.31	-0.03	-0.21	0.14	0.02	-1.19
16-May	Housing starts	1.2	2.00	0.06	0.31	-0.03	-0.14	0.14	0.02	-1.19
Maximum forecast of real GDP growth										
3-May	Employment situation, Adv. Econ. Indicators, ISM Nonmanufact. Index	1.7	2.08	0.17	0.32	0.03	-0.08	0.16	0.02	-1.02
Minimum forecast of real GDP growth										
2-May	M3-2 Manufacturing, Auto sales	0.9	1.95	0.14	0.31	0.01	-0.14	0.15	0.00	-1.52

Note: CPII is "change in private inventories." All numbers are percentage-point contributions to GDP growth (SAAR). The table does not necessarily include all estimates for the quarter; see tab "ContribHistory" in the [online excel file](#) for the entire history.

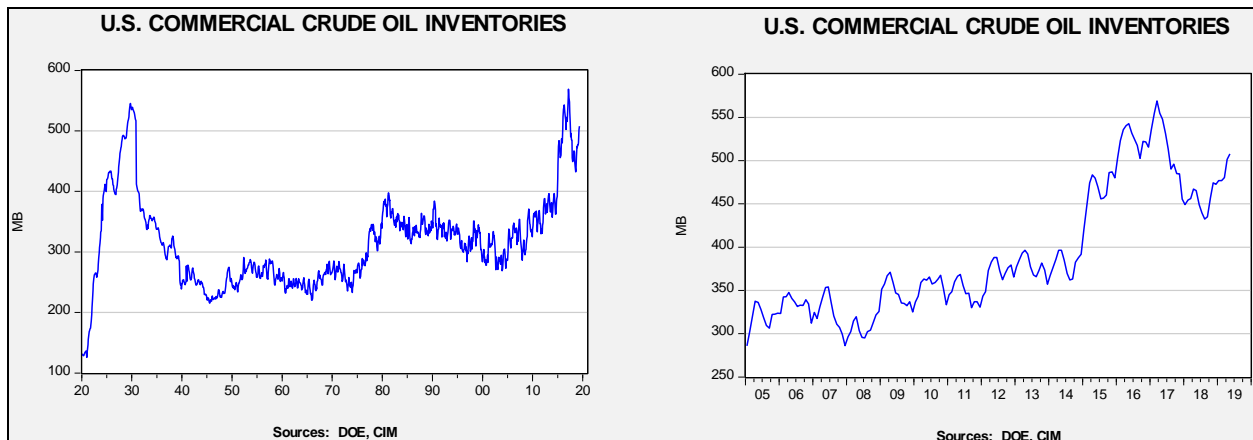
The largest drag on growth is inventory liquidation, which accounted for 65 bps of growth in Q1.

Those pesky Russians: Russian warplanes were buzzing the coast of Alaska earlier this week; two incidents were reported that led the [U.S. to intercept](#) in both cases. The Russians sent two

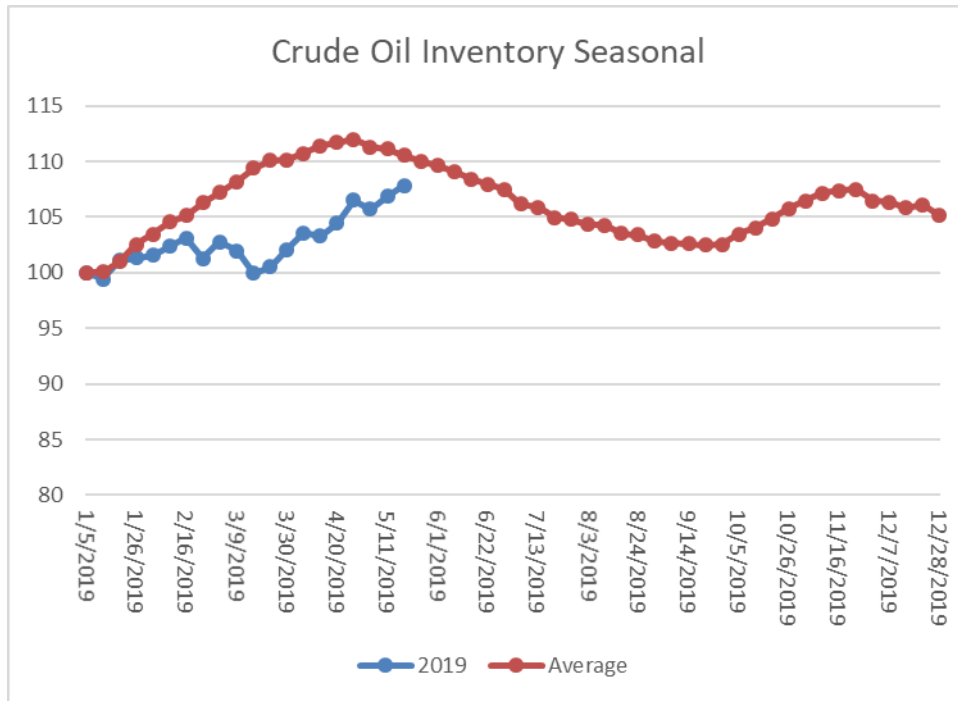
[Tu-95 bombers](#) and two [Su-35 fighter](#) escorts. The Tu-95 is a Cold War-era large turboprop bomber; it is essentially Russia's answer to the B-52. The bomber is a lumbering aircraft; although it can act as a platform for cruise missiles, its ability as a bomber is minor due to its large size and low speed. But, it is a perfect aircraft to send a message as one can't miss it in the air. However, it isn't obvious what that message is except to signal that Russia isn't afraid to make provocative acts.

Foreign political news: EU parliamentary elections begin today. We covered them in [detail in yesterday's report](#). [Election disputes in Indonesia led to riots](#) yesterday. It is hard to see how Joko Widodo could have won by fraud given the size of his win, but the loser, Prabowo Subianto, protested the outcome and apparently triggered the response. We continue to wait to see how the incumbent responds. In India, as expected, [Narendra Modi has returned to power in a landslide](#).

Energy update: Crude oil inventories rose 4.7 mb last week compared to the forecast drop of 1.9 mb. There was a 1.1 mb draw of the SPR, meaning the actual build was closer to 3.6 mb.

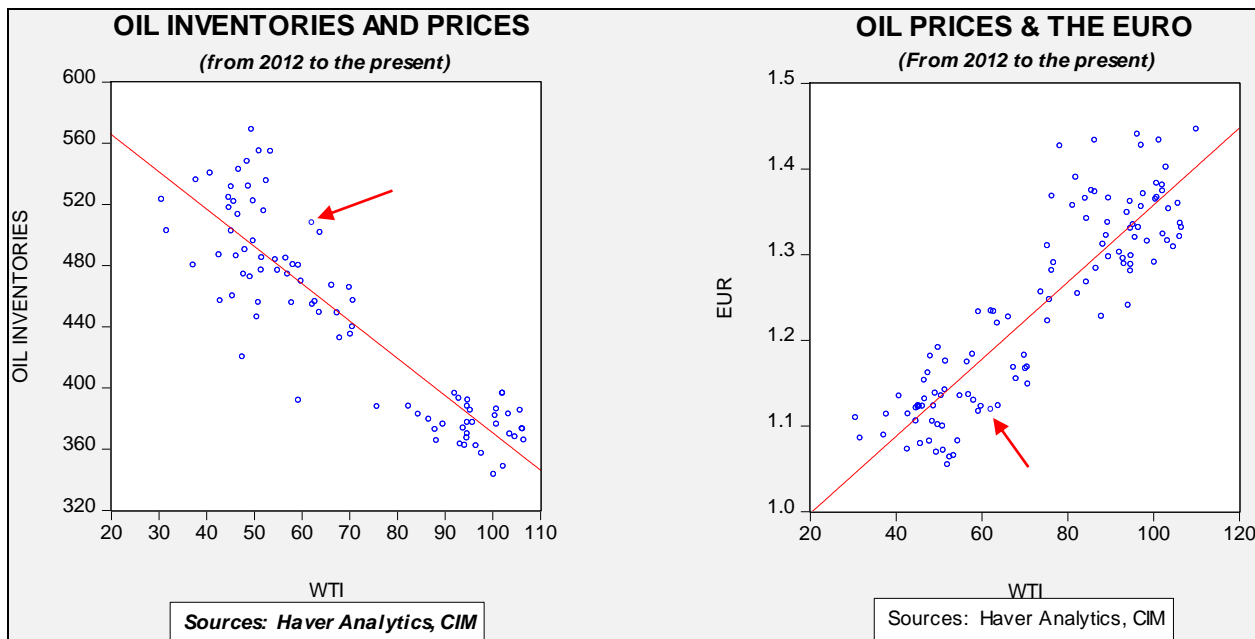


In the details, refining activity unexpectedly fell 0.6% compared to the 0.5% increase forecast. Estimated U.S. production rose slightly by 0.1 mbpd to 12.2 mbpd. Crude oil imports fell 0.7 mbpd, while exports fell 0.4 mbpd.



(Sources: DOE, CIM)

This is the seasonal pattern chart for commercial crude oil inventories. We are now well within the spring/summer withdrawal season so the continued build is bearish for prices. The seasonal pattern remains below normal but the gap is closing rapidly.

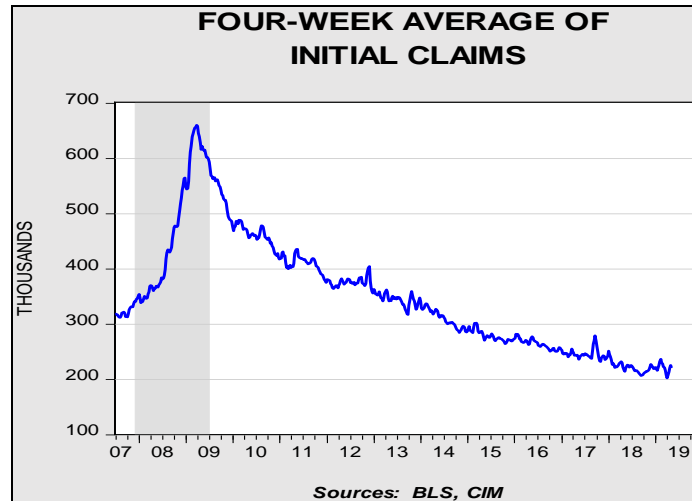


Based on oil inventories alone, fair value for crude oil is \$49.10. Based on the EUR, fair value is \$51.24. Using both independent variables, a more complete way of looking at the data, fair value is \$49.45. Geopolitical risks are adding nearly \$13 per barrel to crude oil prices. Although

the geopolitical risks are formidable, this spread is unusually wide and raises the odds of a deeper price correction in the coming weeks, assuming that inventories remain elevated and the dollar remains strong. Of course, this rich price is due to geopolitical risks; Iran has been using [covert actions](#) in response to U.S. sanctions, and the [U.S. is considering boosting its troop presence](#) in the Persian Gulf.

U.S. Economic Releases

Initial jobless claims came in below expectations at 211k compared to the forecast of 215k.



The chart above shows the four-week moving average for initial claims. The four-week moving average fell from 225.00k to 220.25k.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Consumer Comfort	m/m	may			**
9:45	Bloomberg Economic Expectations	m/m	may			**
9:45	Markit US Manufacturing PMI	m/m	may			**
9:45	Markit US Services PMI	m/m	may			**
9:45	Markit US Composite PMI	m/m	may			**
10:00	Existing Home Sales	m/m	apr	675k	692k	**
10:00	Existing Home Sales	m/m	apr	-2.5%	4.5%	**
10:00	Kansas City Manf. Activity	m/m	may	6	5	**
Fed speakers or events						
EST	Speaker or event	District or position				
13:00	Robert Kaplan Speaks on Panel	President of the Federal Reserve Bank of Dallas				
13:00	Mary Daly Speaks on Panel	President of the Federal Reserve Bank of San Francisco				
13:00	Raphael Bostic Speaks on Panel	President of the Federal Reserve Bank of Atlanta				

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	Japan buying foreign bonds	m/m	may	¥1355.7 bn	¥20.8 bn		*	Equity and bond neutral
	Japan buying foreign stocks	m/m	may	¥241.7 bn	¥123.8 bn		*	Equity and bond neutral
	Foreign buying Japan bonds	m/m	may	-¥194.9 bn	¥553.5 bn		*	Equity and bond neutral
	Foreign buying Japan stocks	m/m	may	-¥58.0 bn	¥282.5 bn		*	Equity and bond neutral
	Nikkei Japan PMI Mfg	m/m	may	49.6	50.2		**	Equity and bond bearish
	Machine tool orders	m/m	apr	-33.4%	-33.4%		*	Equity and bond bearish
Australia	CBA Australia PMI Mfg	w/w	may	51.1	50.9		**	Equity bullish, bond bearish
	CBA Australia PMI Services	y/y	apr	52.3	50.1		**	Equity bullish, bond bearish
	CBA Australia PMI Composite	y/y	mar	52.2	50.0		**	Equity bullish, bond bearish
EUROPE								
Eurozone	Markit Eurozone Manufacturing PMI	m/m	may	47.7	47.9	48.1	**	Equity and bond bearish
	Markit Eurozone Services PMI	m/m	may	52.5	52.8	53.0	**	Equity and bond neutral
	Markit Eurozone Composite PMI	m/m	may	51.6	51.5	51.7	**	Equity and bond neutral
Germany	GDP	y/y	1q	0.7%	0.7%	0.7%	***	Equity and bond neutral
	Markit Germany Manufacturing	m/m	may	44.3	44.4	44.8	**	Equity and bond neutral
	Markit Germany Services	m/m	may	55.0	55.7	55.4	**	Equity and bond neutral
	Markit Germany Composite	m/m	may	52.4	52.0	52.2	**	Equity and bond neutral
France	Business Confidence	m/m	may	106	105	105	**	Equity and bond neutral
	Manufacturing Confidence	m/m	mar	104	101	101	**	Equity and bond neutral
	Production Outlook Indicator	m/m	may	4	-2	-2	**	Equity and bond neutral
	Own-Company Production	m/m	may	13	9		**	Equity and bond neutral
	Markit France Manufacturing	m/m	mar	50.6	50.0	50.0	**	Equity bullish, bond bearish
	Markit France Services	m/m	may	51.7	50.5	50.8	**	Equity bullish, bond bearish
Switzerland	Markit France Composite	m/m	may	51.3	50.1	50.3	**	Equity bullish, bond bearish
	Industry & Construction Output	q/q	1q	3.7%	3.8%		**	Equity and bond neutral
Russia	Industrial Output	q/q	1q	4.3%	5.1%	-0.3%	**	Equity and bond neutral
	Industrial Production	y/y	apr	4.9%	1.2%	2.0%	***	Equity bullish, bond bearish
AMERICAS								
Mexico	Retail Sales	m/m	mar	1.6%	1.8%	1.8%	**	Equity and bond neutral
Canada	Retail Sales	m/m	mar	1.1%	0.8%	1.2%	**	Equity and bond neutral
	Retail Sales ex Auto	m/m	mar	1.7%	0.6%	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)	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	up			Neutral
euro	down			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	\$69.91	\$70.99	-1.52%	Bearish API Report
WTI	\$60.46	\$61.42	-1.56%	
Natural Gas	\$2.55	\$2.54	0.35%	
Crack Spread	\$22.44	\$22.34	0.44%	
12-mo strip crack	\$18.45	\$18.51	-0.34%	
Ethanol rack	\$1.49	\$1.49	-0.29%	
Metals				
Gold	\$1,277.22	\$1,273.34	0.30%	
Silver	\$14.48	\$14.44	0.25%	
Copper contract	\$266.10	\$267.80	-0.63%	
Grains				
Corn contract	\$ 396.25	\$ 394.50	0.44%	
Wheat contract	\$ 477.50	\$ 472.75	1.00%	
Soybeans contract	\$ 826.75	\$ 828.50	-0.21%	
Shipping				
Baltic Dry Freight	1059	1049	10	
DOE inventory report				
	Actual	Expected	Difference	
Crude (mb)	4.7	-1.9	6.6	
Gasoline (mb)	3.7	-1.0	4.7	
Distillates (mb)	0.8	-0.6	1.4	
Refinery run rates (%)	-0.60%	0.50%	-1.10%	
Natural gas (bcf)		103.0		

Weather

The 6-10 and 8-14 day forecasts show cooler temps for most of the country, with warmer temps in the southeastern and northwestern regions. Precipitation is expected for most of the country. The tropical season has started early; [Andrea](#) formed south of Bermuda. It has already been downgraded to a depression but it starts the hurricane season well before the traditional June 1 date.

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.

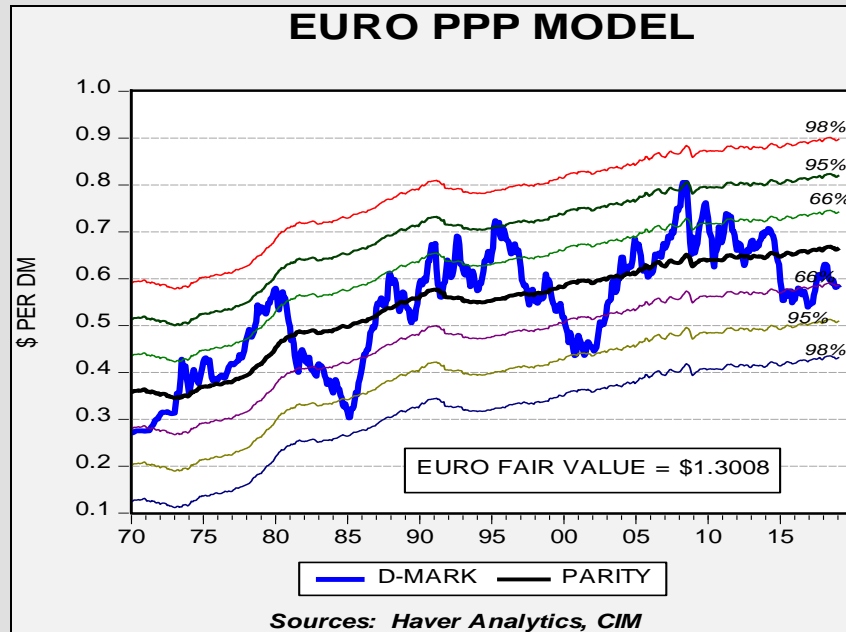
May 17, 2019

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:

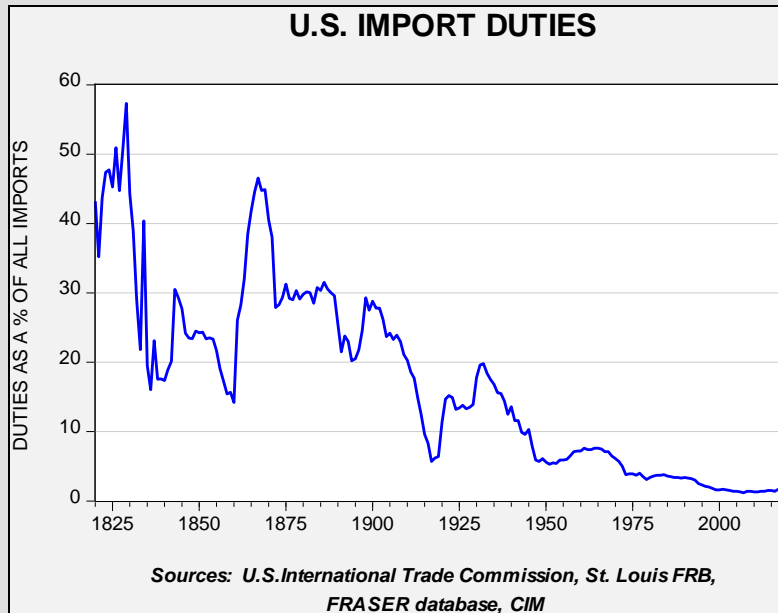
¹ Or, said another way, “markets can stay stupid longer than you can stay solvent.”



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.



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

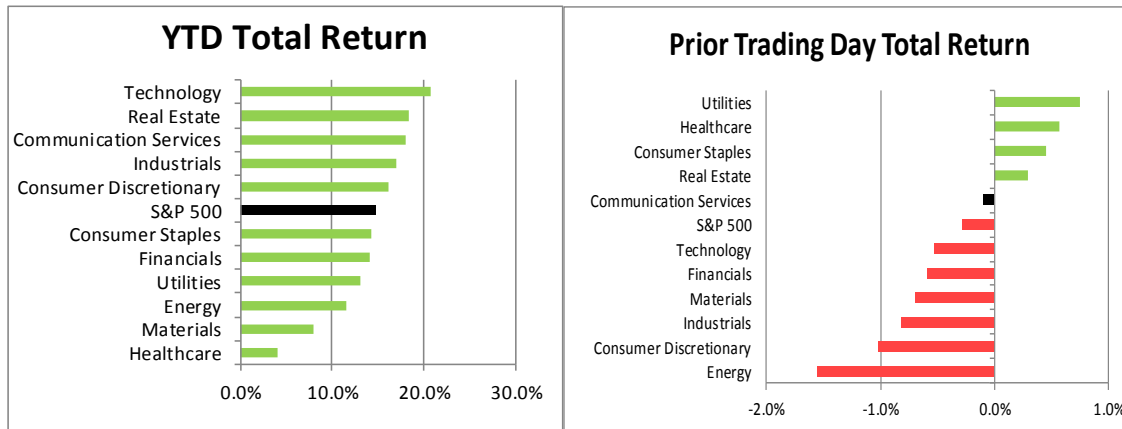
If the administration continues down this path of using tariffs on a widespread basis, our position on future dollar weakness has to be reconsidered. Although the tariff policy may not last once Trump leaves office, one cannot necessarily assume that to be the case. Of course, the U.S. could act against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

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

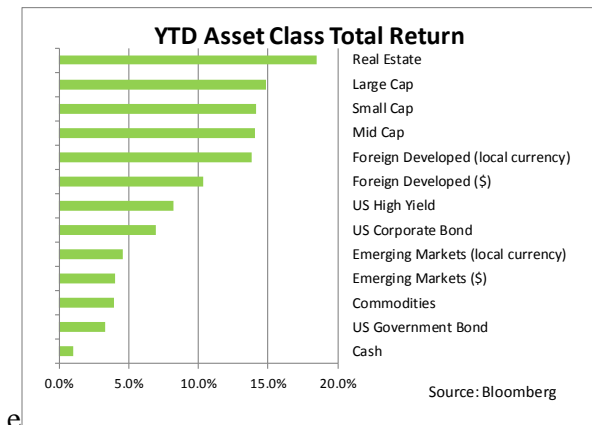
U.S. Equity Markets – (as of 5/22/2019 close)



(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 5/22/2019 close)

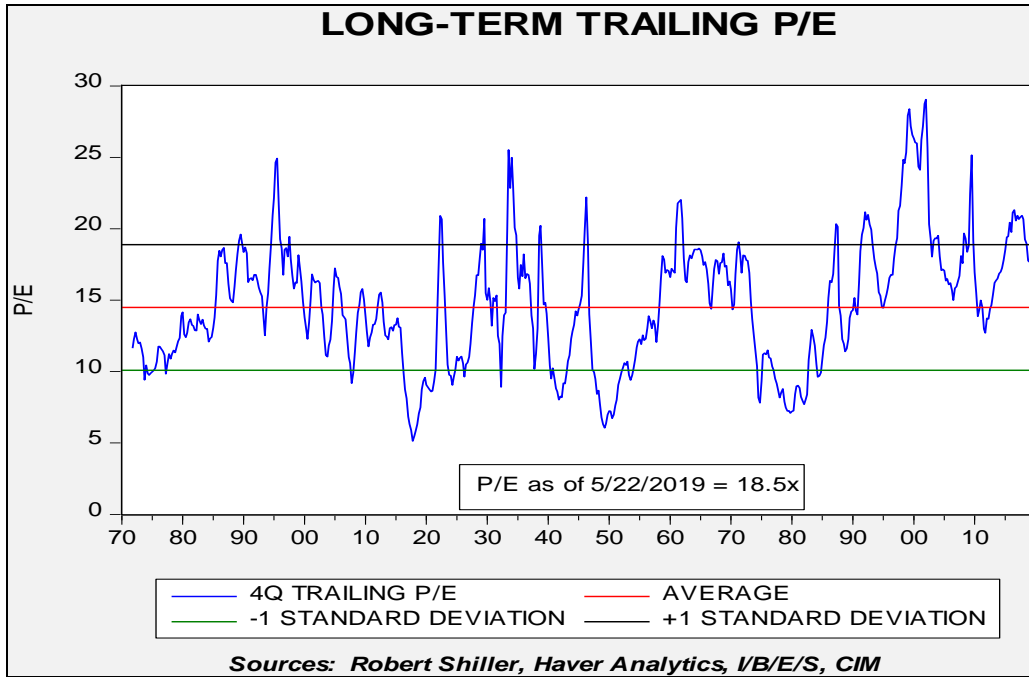


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 23, 2019



Based on our methodology,² the current P/E is 18.5x, down 0.1x from last week. Improved earnings and lower index values caused the contraction.

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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.