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 25, 2018—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is unchanged from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.1% from the prior close. Chinese markets were down, with the Shanghai composite down 0.4% and the Shenzhen index down 0.9%. U.S. equity index futures are signaling a lower open. With 480 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, 78.5% of the companies reported earnings above forecast, while 15.2% reported earnings below forecast.

Happy Friday! Here is what we are watching this morning:

Capping oil prices: On the eve of the first summer holiday, gasoline prices are becoming an issue. The recent rise in crude oil prices has taken gasoline higher. Although higher gasoline prices are a natural consequence of higher crude prices, perhaps no other price has greater visibility and political impact. The president has tweeted against high oil prices in the recent past and now the issue is starting to have some political implications.[1]

There have been three reasons behind the recent rise in oil prices. First, OPEC + Russian output discipline has been solid. We believe Saudi Arabia has held production steady to support its IPO of Saudi Aramco, which we expect sometime next year. Second, supply was curtailed further by falling output from Venezuela. The potential for additional sanctions on Iran has boosted bullish sentiment. Third, the dollar was weak for most of last year; most of the time, there is an inverse correlation between the dollar and oil. The weaker dollar acted as a bullish factor for oil prices.

These factors have been reversing. OPEC has enjoyed the rise in prices but has been disappointed with the loss of market share caused by the surge in U.S. shale production. It does not want to cede market share indefinitely. Consequently, the cartel is looking to boost production.[2] Second, the dollar has been rising, mostly due to expectations of tighter monetary policy. We note that the dollar is still expensive on a parity basis and history suggests rising deficits will pressure the dollar going forward. Thus, we don't expect the dollar to rise over the

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[1] https://www.politico.com/story/2018/05/25/trumps-gas-prices-midterms-570916

[2] https://uk.reuters.com/article/us-global-oil/oil-prices-fall-as-opec-and-russia-weigh-output-boost-idUKKCN1IQ03C?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosgenerate&stream=top

long run but, until the FOMC is set to "pause," the dollar will tend to be underpinned by policy divergence.

The political fallout should not be underestimated. President Trump has two policy levers at his disposal to bring down gasoline prices. First, he can release oil from the Strategic Petroleum Reserve. Although this oil is held for emergencies, in fact, previous presidents have tapped it to curb price increases. Second, he can use his "tweet" bully pulpit to pressure OPEC into raising production. Given that the Saudis have been actively trying to cultivate good relations with the president, it looks like this is the direction the kingdom wants to go in anyway.

We have been bullish on oil prices for several months. Given the above factors, a more neutral position is probably warranted. That doesn't mean oil prices are heading to the basement. Geopolitical risk remains elevated and we expect U.S. refiners to ramp up output for the summer driving season. But, a pullback into the low $60s would not be a huge shock.

No summit: We were surprised by the president's decision to walk away from the summit with North Korea but we do agree that Beijing was likely behind the breakup. China has been afraid the U.S. would make an ally out of North Korea and, given the Koreas' almost natural opposition to China, Chairman Xi had reasonable concerns that Kim could be turned. Thus, he moved to ease sanctions on North Korea and we saw a near about-face in North Korea's rhetoric. The White House made some unforced errors, too. John Bolton's talk of the "Libya model" was a mistake, although it is also probable that Bolton wasn't thrilled with the summit anyway.

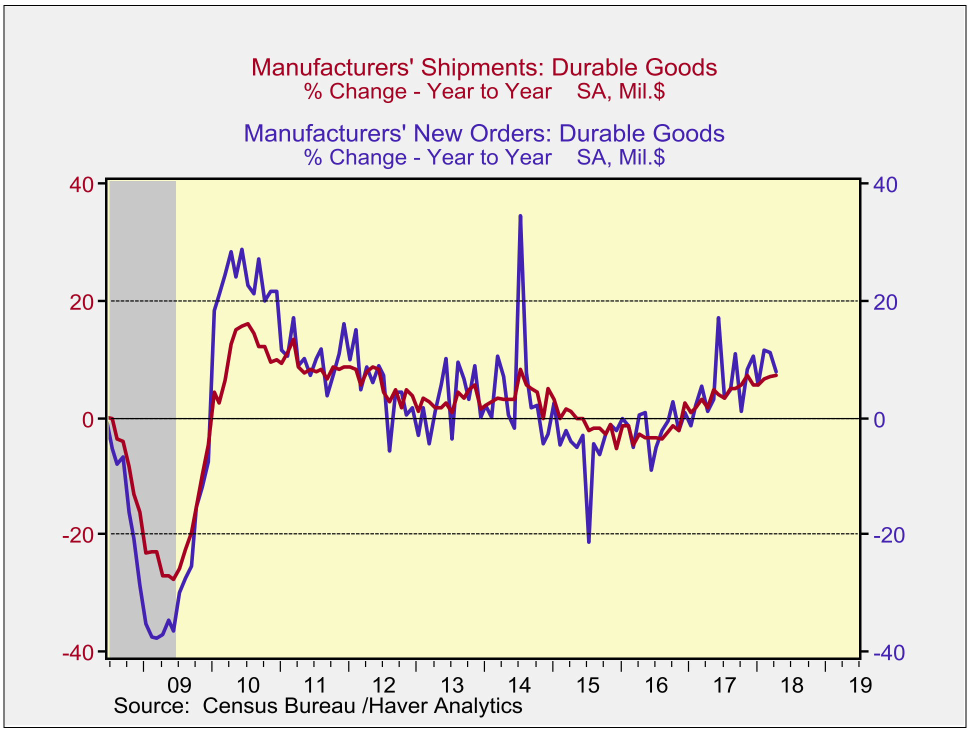
The key issue is, "now what?" We see two consequences from the summit's cancellation. First, trade negotiations with China will likely become hostile again. It appeared the White House was pulling its punches in trade talks with China, likely hoping Beijing would assist the U.S. in negotiations with North Korea. Now that the summit is canceled, we would expect the Navarro/Lighthizer hardline wing to return to the forefront. Second, the risk of military action against North Korea will likely increase in the coming weeks. If it occurs, it will tend to lift flight to safety assets.

Backdoor bonds: The EU is working on a proposal to create "sovereign bond-backed securities" (SBBS), which would create a securitized bond composed of the government debt of the various EU nations. The stated reason for the creation of these instruments is to create a bond that European banks could buy in lieu of their national government bonds and reduce the odds of the "doom loop" that occurs during crises. However, this probably isn't the real issue. One of the reasons the EUR can't compete with the USD for reserves is that there is no single sovereign bond that is backed by the full faith and credit of the Eurozone. Thus, if a nation wants to hold EUR as reserves, it has to pick a single country bond to invest in. That reduces the attractiveness of the EUR. Creating a securitized debt instrument with "all" the bonds in the Eurozone could be a substitute for the lack of a Eurobond (defined as a single full faith and credit instrument).

The Germans saw through the ruse. Germany's finance minister, Olaf Scholz, slammed the plan, correctly pointing out that if such a securitized instrument was viable the private sector would have already created it. Germany has vehemently opposed any attempt to mutualize Eurozone debt, worried that higher spending nations (read: Italy) would borrow heavily against the credit of Germany and force the Germans to fund Italy's spending in the case of a crisis. This little dust up tells us that the mandarins within the EU still pine for a unified Eurobond.

U.S. Economic Releases

April durable goods came in below expectations, falling 1.7% from the prior month compared to the forecast loss of 1.3%. The prior report's gain was revised from 2.6% to 2.7%. Durables ex-transportation came in above expectations, rising 0.9% from the prior month compared to the forecast gain of 0.5%. The prior report's gain of 0.1% was revised to 0.4%. Capital goods orders non-defense ex-air came in above expectations, rising 1.0% from the prior month compared to the forecast gain of 0.7%. The prior month's loss of 0.9% was revised to 0.4%. Capital goods shipments non-defense ex-air came in above expectations, rising 0.8% from the prior month compared to the forecast rise of 0.4%. The prior report's loss of 0.8% was revised to 0.7%.



The chart above shows the annual change in new durable goods orders and shipments. Annually, new orders rose by 7.8%, shipments rose by 7.3%, unfilled orders rose by 3.7% and inventories rose by 4.9%.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	U. of Michigan Sentiment	m/m	may	98.8	98.8	***
10:00	U. of Michigan Current Conditions	m/m	may	98.6	113.3	**
10:00	U. of Michigan Expectations	m/m	may		89.5	**
10:00	U. of Michigan 1 yr Inflation	m/m	may		2.8%	**
10:00	U. of Michigan 5-10 Yr Inflation	m/m	may		2.5%	**

Fed speakers or events		
EST	Speaker or event	District or position
11:45	Raphael Bostic Speaks at Dallas Fed	President of the Federal Reserve Bank of Atlanta
11:45	Charles Evans Speaks Speaks at Dallas Fed	President of the Federal Reserve Bank of Chicago
11:45	Robert Kaplan Speaks at Dallas Fed	President of the Federal Reserve Bank of Dallas

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	Tokyo CPI	m/m	may	0.4%	0.5%	0.5%	***	Equity bearish, bond bullish
	Tokyo CPI ex Fresh Food	m/m	may	0.5%	0.6%	0.6%	***	Equity bearish, bond bullish
	Tokyo CPI ex Fresh Food, Energy	m/m	may	0.2%	0.3%	0.3%	***	Equity bearish, bond bullish
EUROPE								
Germany	IFO business climate	m/m	may	102.2	102.1	102.0	**	Equity and bond neutral
	IFO expectations	m/m	may	98.5	98.7	98.5	**	Equity and bond neutral
	IFO current assessment	m/m	may	106.0	105.7	105.5	**	Equity bullish, bond bearish
U.K.	GDP	y/y	1q	1.2%	1.2%	1.2%	***	Equity and bond neutral
	Private Consumption	q/q	1q	0.2%	0.3%	0.1%	***	Equity and bond neutral
	Government Spending	q/q	1q	0.5%	0.4%	0.3%	***	Equity bullish, bond bearish
	Gross Fixed Investment	q/q	1q	0.9%	1.1%	-0.2%	***	Equity bullish, bond bearish
AMERICAS								
Mexico	Bi-Weekly CPI	y/y	may	4.5%	4.4%	4.4%	***	Equity and bond neutral
Brazil	Current Account Balance	m/m	apr	$0.620 bn	$1.200 bn	$0.798 bn	**	Equity bearish, bond bullish
	Foreign Direct Investment	m/m	apr	$2.618 bn	$6.539 bn	$3.000 bn	**	Equity bearish, bond bullish

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	47	0	Neutral
U.S. Libor/OIS spread (bps)	189	189	0	Up
10-yr T-note (%)	2.96	2.98	-0.02	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	17	13	4	Down
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	down			Up
pound	down			Up
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	$76.88	$78.79	-2.42%	Saudi Minister Boosts Optimism
WTI	$69.18	$70.71	-2.16%	
Natural Gas	$2.95	$2.94	0.31%	
Crack Spread	$22.96	$23.36	-1.67%	
12-mo strip crack	$21.60	$22.02	-1.93%	
Ethanol rack	$1.61	$1.61	0.05%	
Metals				
Gold	$1,305.29	$1,304.63	0.05%	
Silver	$16.69	$16.67	0.13%	
Copper contract	$310.10	$309.60	0.16%	
Grains				
Corn contract	$ 405.50	$ 404.25	0.31%	
Wheat contract	$ 536.50	$ 530.25	1.18%	
Soybeans contract	$ 1,041.25	$ 1,035.75	0.53%	
Shipping				
Baltic Dry Freight	1109	1162	-53	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	5.8	-2.0	7.8	
Gasoline (mb)	1.9	-1.8	3.6	
Distillates (mb)	-1.0	-1.0	0.0	
Refinery run rates (%)	0.70%	0.30%	0.40%	
Natural gas (bcf)	91.0	96.0	-5.0	

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.

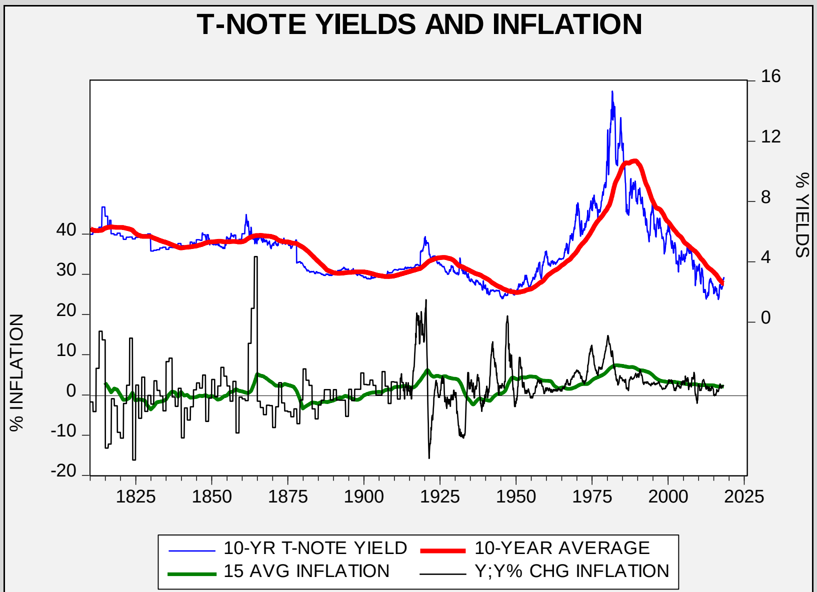
Asset Allocation Weekly Comment

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 25, 2018

Last week we discussed the general idea of secular versus cyclical trends. This week we will look at these concepts with regard to longer duration fixed income.

The goal of theory is always to simplify. Theorizing is all about taking complex phenomena and reducing it to basic elements that can guide us in estimating the future. However, as Albert Einstein noted, "Everything should be made as simple as possible, but not simpler." The yield on sovereign debt instruments should be a function of the policy rate and inflation expectations. The longer the duration of the instrument, the more important inflation expectations are to the yield. However, specific historical conditions do count. For example, a nation's credit risk can change over time; government borrowing behavior can play a role. Even geopolitical risks can matter; Tsarist bonds traded at 95 rubles to par of 100 in late 1914, only to have the debt later repudiated by the Bolsheviks.[3] Thus, secular trends can abruptly change if underlying conditions adjust significantly.



Sources: Haver Analytics, Historical Statistics of the United States, 1793-1957, CIM

This chart looks at inflation trends and the yield on 10-year T-notes. For inflation, we use CPI from 1915 to the present; the data prior is the General Price Index. Although not perfectly equivalent, the two indices do give general insight into inflation. We have added a 10-year average of yields and a 15-year average of inflation to highlight the trends in the data.

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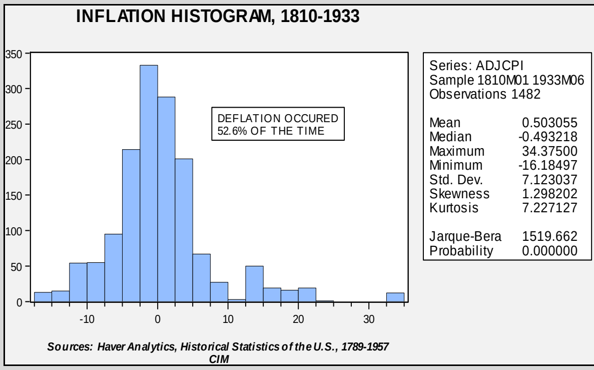
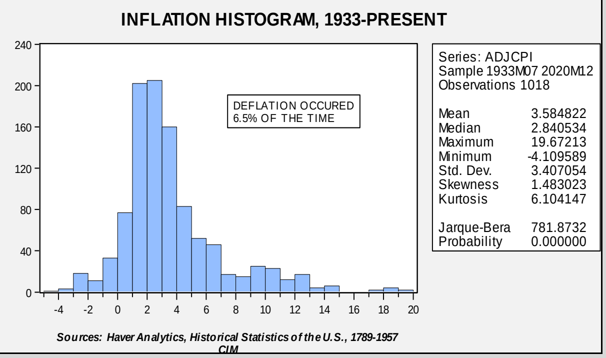
[3] http://www.helsinki.fi/iehc2006/papers1/Oosterli.pdf, page 34.

Inflation behavior until the 1930s was rather erratic. This was because the U.S. was on the gold standard and the money supply was partly driven by mining activity and partly driven by industrial activity. In other words, deflation is highly likely if the money supply is fixed while output is rising rapidly (as was the case during the industrial revolution).





These charts show the behavior of our inflation series; the chart on the left shows the dispersion during the years 1810 until June 1933, when President Roosevelt ended the ability of citizens to hold gold. The average inflation rate over this time frame was a mere 0.5%; however, range was wide. Note that the highest rate recorded was 34.4% during the Civil War and the lowest was 16.2% during a downturn after there was a lull in public investment. During this period, deflation occurred almost 53% of the time. After June 1933, the average inflation rate rose to 3.6% but the range narrowed significantly, from 19.7% after WWII to a low of -4.1% during the 1936-37 recession. Deflation only occurred 6.5% of the time after Roosevelt ended the gold standard. Economists discovered that people have an asymmetric response to inflation and deflation—rising prices tend to spur buying which supports growth, while deflation can lead consumers to stop buying in anticipation of even lower future prices.

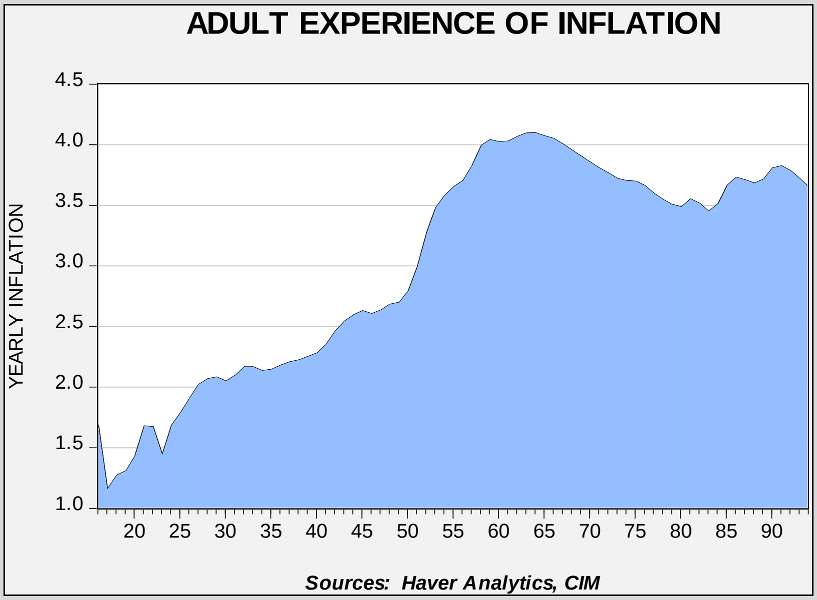
It would be reasonable to assume that longer duration yields would be rather low during the period when deflation was common. In fact, they averaged 4.6% in the years from 1810 to 1933. Yields remained low during the Great Depression, and, during WWII, the Treasury forced the Federal Reserve to keep rates low to reduce borrowing costs. Thus, the “modern era” really begins in March 1951 with the Federal Reserve-Treasury accord. That pact allowed the Federal Reserve to set interest rates based on economic conditions. In theory, central bank independence is generally thought to lead to better inflation control. In the absence of an external restraint on money creation, i.e., gold, central bank independence should create conditions of better inflation control. However, from the 1950s into the early 1980s, the Federal Reserve raised short term interest rates to try to quell steadily rising inflation. Since the policy rate acts as an anchor for longer duration instruments, T-note yields rose during this period. The average yield on T-notes from March 1951 to the present is 5.1%. However, as the above charts show, long-duration rates steadily rose until the early 1970s and then rose rapidly with each business cycle until peaking in late 1981. By the late 1970s, policymakers were moving aggressively to contain inflation through strict monetary policy, deregulation and globalization. Those policies triggered a secular bull market in bonds that continues to this day.

We believe this bull market in bonds is likely nearing an end. Populism is becoming an increasingly potent force throughout the West. In general, populism usually leads to re-

regulation and deglobalization. These factors should, over time, lead to steadily rising inflation and bond yields.

Our base case is that we will likely see a gradual increase in yields over the next 10 to 20 years. We do not expect that increase to be sudden, but do look for higher high yield and higher low yield in each business cycle. The asset allocation committee believes this situation can be managed with a modest shortening of duration and the use of "ladders" using target-date exchange-traded products.

However, as part of our scenario planning, there is the possibility that we may see discrete jumps instead of a gradual increase in interest rates. This is due to the generational experience of inflation.



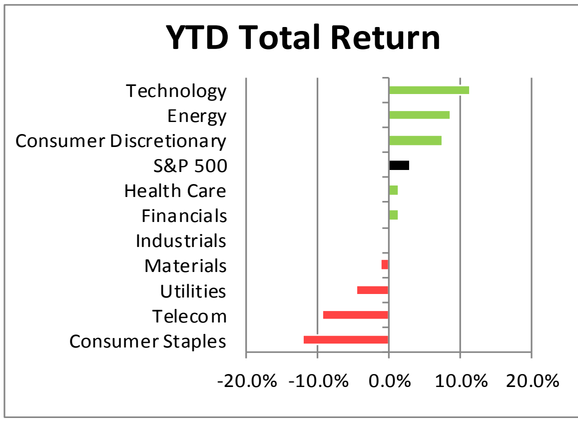
This chart shows the adult experience of inflation, starting with age 16. The current 64-year-olds have experienced the highest average adult inflation, at 4.1%. Note that the experience of inflation declines rapidly for the current age cohort in their 50s. Over time, the area of the graph will shift to the right, meaning that society's memory of the high inflation years will gradually diminish. However, that isn't the case now; a significant cohort remembers inflation and, if populist policies expand quicker than we expect, the baby boom generation could react strongly and trigger inflation fears.

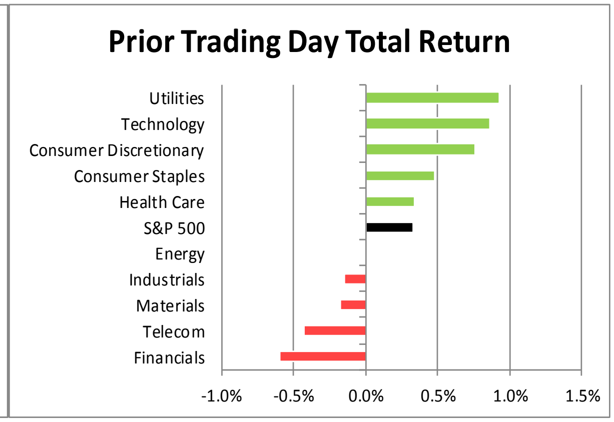
If inflation fears are triggered, we could see a bear market in bonds develop characterized by rapid spikes in long-term interest rates that choke off growth and lead to less stable financial markets and shorter business cycles. This is not our base case. However, the particular demographic pattern could lead to this outcome, which we will monitor closely.

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 5/24/2018 close)

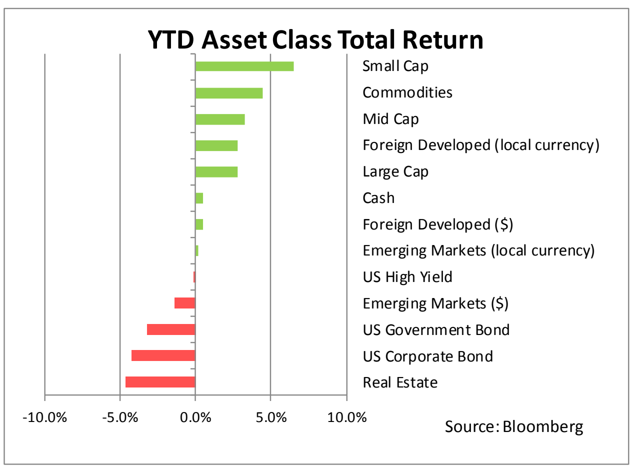




(Source: Bloomberg)

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 5/24/2018 close)

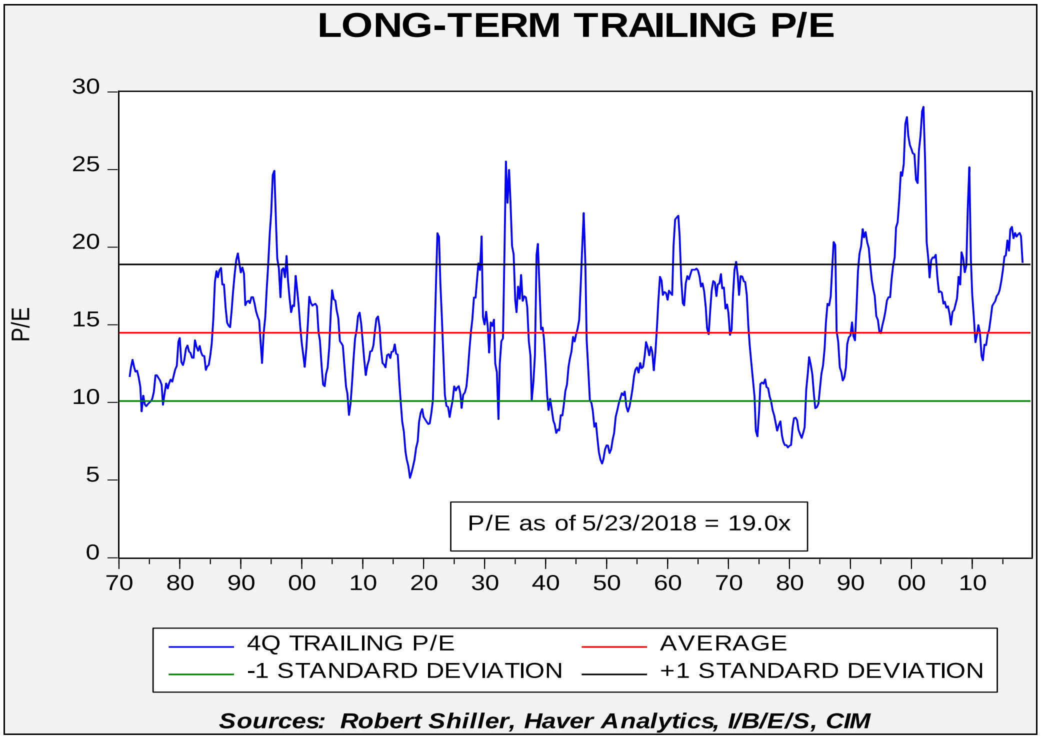


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 24, 2018



Based on our methodology,[4] the current P/E is 19.0x, 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.

[4] 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.