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.

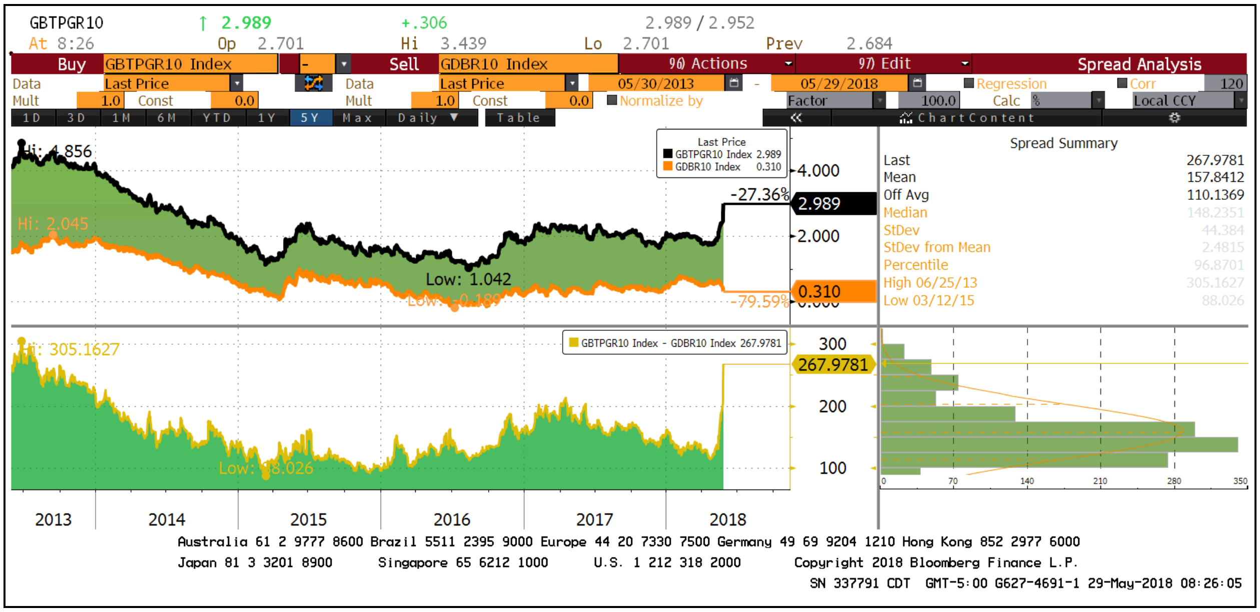
[Posted: May 29, 2018—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 1.6% from the last close. In Asia, the MSCI Asia Apex 50 closed down 1.0% from the prior close. Chinese markets were down, with the Shanghai composite down 0.5% and the Shenzhen index down 1.1%. U.S. equity index futures are signaling a lower open. With 485 companies having reported, the S&P 500 Q1 earnings stand at $38.95, higher than the $36.49 forecast for the quarter. The forecast reflects an 18.4% increase from Q1 2017 earnings. Thus far this quarter, 78.6% of the companies reported earnings above forecast, while 15.3% reported earnings below forecast.

It's clearly another "risk off" morning—equities are lower around the world, the dollar, yen and Treasury prices are up, and most other currencies are lower. Europe is the culprit. Here is the story:

The Italian job: Over the Memorial Day weekend, Italy's president, Sergio Mattarella, refused to allow a populist coalition of the Five-Star Movement and the League to form a government.[1] The sticking point was the group's decision to name Paolo Savona as finance minister. Savona is deeply skeptical of the Eurozone and would likely press for Italy to exit the single currency. So, Mattarella scuttled the negotiations and instead appointed Carlo Cottarelli as a caretaker PM. Cottarelli is an anathema to the populists; he is a former IMF official and represents everything the populist coalition detests.

Italian bond yields continue to rise on the news.

[1] https://www.ft.com/content/f495fc3a-6283-11e8-90c2-9563a0613e56?emailId=5b0cd171da224c00049b3d0f&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22



(Source: Bloomberg)

Perhaps what is most impressive isn't the spike in Italian yields but the drop in German Bund yields, which are now down to 31 bps from mid-60 bps before the crisis. The drop in German yields is a clear indication of capital flight, most likely from Italy.

The disgruntled coalition has called for Mattarella's impeachment and there are reports that demonstrations and strikes are possible.[2] Assuming Cottarelli cannot form a government (and it is highly probable he won't be able to), elections are likely to be scheduled for September. This election could be pivotal for the future of the Eurozone and the euro. Up until this point, the Italian parties have not really campaigned on leaving the single currency. The populist parties, instead, planned on flouting fiscal restrictions, daring the EU to stop them. However, the September poll is shaping up to be about Italy's status in the Eurozone. Most polls show a slim majority support for continued membership in the Eurozone; only about 55% support the single currency, the second lowest of any Eurozone nation. Only Cyprus is marginally lower. Still, that means the majority of Italians still support remaining in the Eurozone. Thus, if the election does become a referendum on the single currency, the populists may not win. At the same time, the centrist parties are in deep disarray and may not be able to form a government anyway. Thus, the risks are unusually elevated that the September vote leads to a radical outcome.

What we find most interesting about the Italian situation is that Italy has created the "Nader coalition" of populist right and left wings.[3] Nader's vision is that the economic goals of the right- and left-wing populists are close enough to build a dominant political coalition. Nader wrote his book for U.S. voters; however, to date, a Trump/Sanders coalition looks like a low probability event. Italy may be closer to Nader's idea; interestingly enough, the policy mix of

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[2] https://www.reuters.com/article/us-italy-politics/italys-league-leader-dismisses-talk-of-presidents-impeachment-idUSKCN1IT0GK

[3] Nader, R. (2014). *Unstoppable: The Emerging Left-Right Alliance to Dismantle the Corporate State*. New York, NY: Nation Books.

lower taxes, immigration restrictions and a basic national income doesn't fit with any degree of fiscal restraint. Perhaps the secret to the Nader coalition is to jettison fiscal control.

Although purchasing power parity clearly favors the euro over the dollar, the potential for a bust-up of the Eurozone will hang as a major threat to the single currency and consequently weigh on the exchange rate. Of course, the worst case scenario rests on a significant populist win in September, which may not happen. Although Italy's debt/GDP ratio is a whopping 132%, most of that debt is held domestically…in euros. If the Italian government leaves the Eurozone and tries to change the debt currency to the "new lira" instead of euros, the backlash would be significant. Our read is that most Italians like the external governor that Eurozone membership provides but oppose the fiscal constraints. Leaving the Eurozone would almost certainly be painful for Italian savers; thus, if the September vote becomes a referendum on remaining in the Eurozone, we suspect the populists will fail to form a government. But, the vote will be close and any casual observation of Italy's economic performance since joining the Eurozone makes it clear that Italy will be better off outside the Eurozone once the painful adjustment process is complete. Getting to that "promised land," however, requires a great deal of disruption that no one wants in the short run.

Spain, too: PM Rajoy faces a confidence vote on Friday. Rajoy's center-right government has faced a series of scandals that have undermined sentiment. If the vote goes against Rajoy, the odds of new elections increase. Additional European political turmoil adds to concerns about the euro.

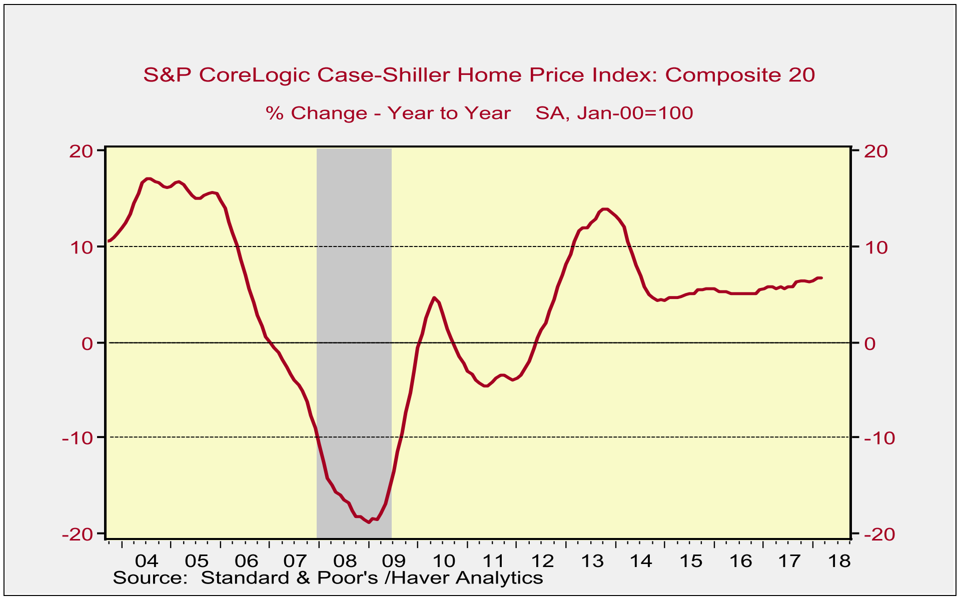
North Korea dialogue: After postponing talks, North and South Korea have moved aggressively to support negotiations. The leaders of the two Koreas have met[4] and envoys from both the U.S. and North Korea are meeting; in fact, a high-ranking North Korean official, Kim Yong Chol,[5] has arrived in New York for discussions. Although the Trump/Kim summit isn't officially on, in reality, there are indications that talks are likely.

China trade: Breaking at the time of this writing, the Trump administration indicated it would proceed with tariff plans against China.[6] Given that negotiations continue, we see this as mostly posturing rather than signaling action.

U.S. Economic Releases

The S&P CoreLogic CS 20-City Home Price Index came in above expectations at 6.39% compared to the forecast rise of 6.35% from the prior year. The prior report was revised from 6.76% to 6.80%. The S&P CoreLogic CS U.S. Home Price Index rose by 6.53% from the prior year. The prior report was revised upward from 6.34% to 6.51%.

[4] https://www.reuters.com/article/us-northkorea-missiles/south-korea-calls-for-more-impromptu-talks-with-north-korea-as-u-s-seeks-to-revive-summit-idUSKCN1IT0JK
[5] https://www.cnn.com/2018/05/29/asia/kim-yong-chol-united-states-intl/index.html
[6] https://www.nytimes.com/2018/05/29/business/white-house-moves-ahead-with-tough-trade-measures-on-china.html



The chart above shows the year-over-year change in the S&P CoreLogic CS 20-City Home Price Index. The HPI continues to remain steady near 6.0%. The rise in prices is likely due to a lack of supply as housing starts continue to remain below the long-term average.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Conference Board Consumer Confidence	m/m	may	128.0	128.7	***
10:00	Conference Board Present Situation	m/m	may		159.6	**
10:00	Conference Board Expectations	m/m	may		108.1	**
10:00	Dallas Fed Manf. Activity	m/m	may	23.0	21.8	**
Fed speakers or events						
No speakers or events scheduled						

Foreign Economic News

We monitor numerous global economic indicators on a continuous basis. The most significant international news that was released overnight is outlined below. Not all releases are equally significant, thus we have created a star rating to convey to our readers the importance of the various indicators. The rating column below is a three-star scale of importance, with one star being the least important and three stars being the most important. We note that these ratings do change over time as economic circumstances change. Additionally, for ease of reading, we have also color-coded the market impact section, which indicates the effect on the foreign market. Red indicates a concerning development, yellow indicates an emerging trend that we are following closely for possible complications and green indicates neutral conditions. We will add a paragraph below if any development merits further explanation.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
Japan	Job-To-Applicant Ratio	m/m	apr	1.59	1.59	1.60	***	Equity and bond neutral
	Jobless Rate	m/m	apr	2.5%	2.5%	2.5%	***	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	m/m	may	117.7	121.6		*	Equity and bond neutral
EUROPE								
Eurozone	M3 Money Supply	m/m	may	3.9%	3.7%	3.9%	**	Equity and bond neutral
France	Consumer Confidence Index	m/m	may	113.7	117.1	116.5	***	Equity and bond neutral
Italy	Manufacturing Confidence	m/m	may	107.7	107.7	107.0	**	Equity and bond neutral
	Consumer Confidence Index	m/m	may	113.7	117.1	116.5	**	Equity and bond neutral
	Economic Sentiment	m/m	may	104.7	105.1		***	Equity and bond neutral
Switzerland	Exports Real	q/q	1q	0.0%	0.6%		**	Equity and bond neutral
	Imports Real	q/q	1q	-0.4%	3.9%		**	Equity and bond neutral
	Swiss Watch Exports	q/q	1q	13.8%	4.8%		**	Equity bullish, bond bearish
AMERICAS								
Mexico	Unemployment Rate	y/y	apr	3.4%	3.2%	3.3%	***	Equity bearish, bond bullish
Brazil	FGV Inflation IGPM	y/y	may	4.3%	1.9%	4.1%	***	Equity and bond neutral

Financial Markets

The table below highlights some of the indicators that we follow on a daily basis. Again, the color coding is similar to the foreign news description above. We will add a paragraph below if a certain move merits further explanation.

	Today	Prior	Change	Trend
3-mo Libor yield (bps)	232	232	0	Up
3-mo T-bill yield (bps)	185	186	-1	Neutral
TED spread (bps)	47	46	1	Neutral
U.S. Libor/OIS spread (bps)	187	188	-1	Up
10-yr T-note (%)	2.86	2.93	-0.07	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	22	17	5	Down
Currencies	Direction			
dollar	up			Down
euro	down			Up
yen	up			Up
pound	down			Up
franc	down			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	$75.76	$75.30	0.61%	
WTI	$66.93	$67.88	-1.40%	
Natural Gas	$2.95	$2.94	0.24%	
Crack Spread	$23.89	$23.80	0.39%	
12-mo strip crack	$22.24	$22.18	0.31%	
Ethanol rack	$1.61	$1.61	0.00%	
Metals				
Gold	$1,303.42	$1,299.04	0.34%	
Silver	$16.43	$16.47	-0.26%	
Copper contract	$307.90	$307.75	0.05%	
Grains				
Corn contract	$ 408.25	$ 406.00	0.55%	
Wheat contract	$ 551.75	$ 543.00	1.61%	
Soybeans contract	$ 1,046.00	$ 1,041.50	0.43%	
Shipping				
Baltic Dry Freight	1077	1109	-32	

Weather

The 6-10 and 8-14 day forecasts continue to signal warmer to normal temperatures for most of the country, with cooler temps on the East Coast. Precipitation is expected for the Mid-Atlantic region. Surprisingly, the tropical season started earlier than normal. We usually begin hurricane coverage on June 1, but Alberto made landfall on the Florida peninsula over the weekend. It wasn't a major storm but it does signal the beginning of hurricane season. In the wake of Alberto, there is nothing else forecast for the next few days.

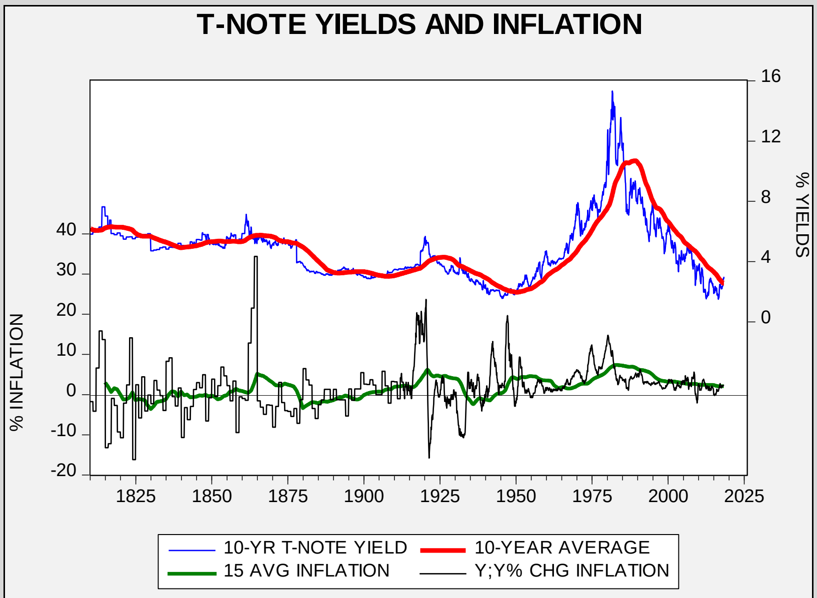
Asset Allocation Weekly Comment

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.[7] Thus, secular trends can abruptly change if underlying conditions adjust significantly.

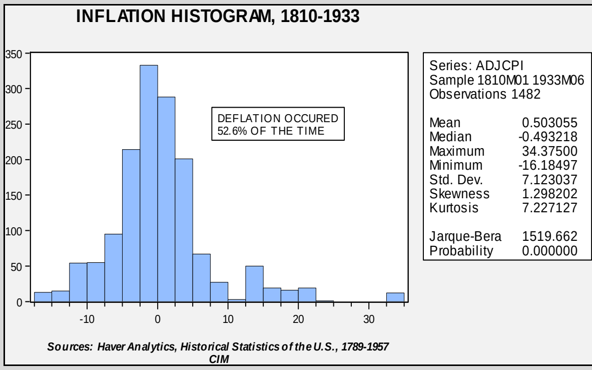


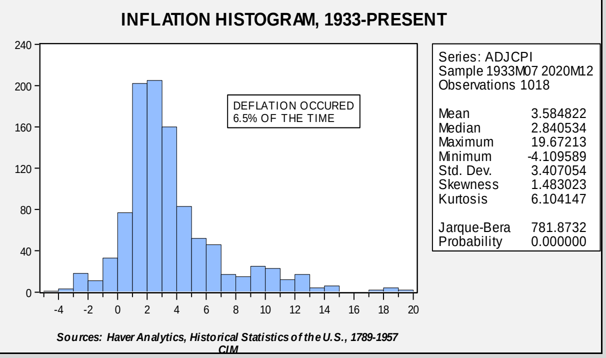
Sources: Haver Analytics, Historical Statistics of the United States, 1793-1957, CIM

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.

[7] 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.

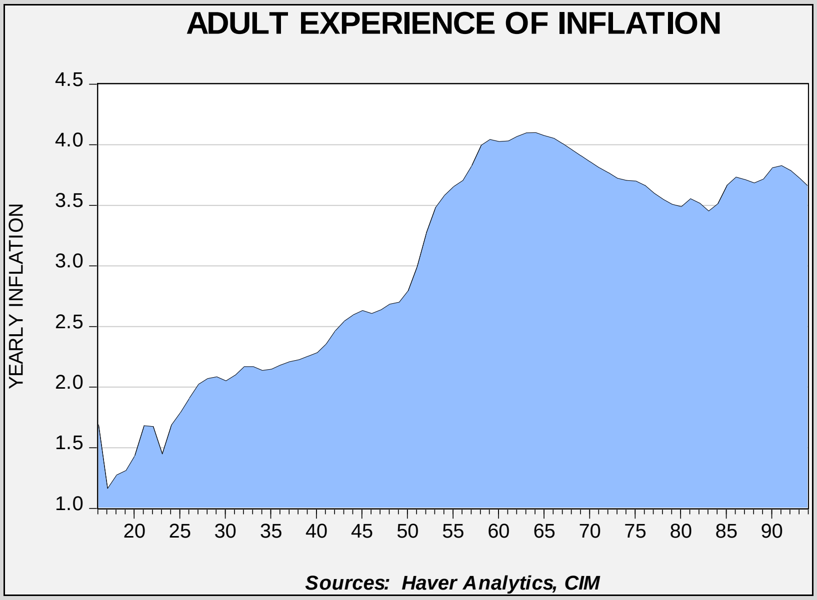
It would be reasonable to assume that longer duration yields would be rather low during the period when deflation was common. In fact, they averaged 4.6% in the years from 1810 to 1933. Yields remained low during the Great Depression, and, during WWII, the Treasury forced the Federal Reserve to keep 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.



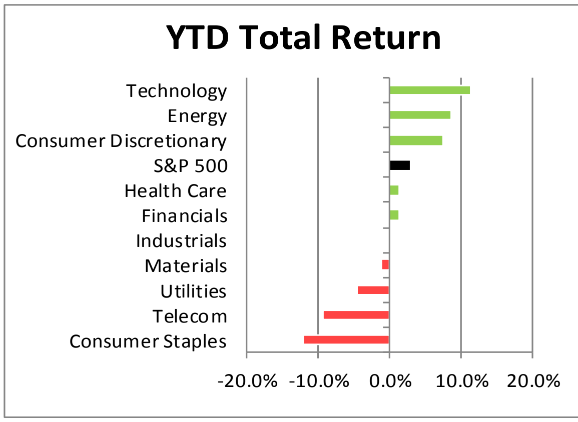
This chart shows the adult experience of inflation, starting with age 16. The current 64-year-olds have experienced the highest average adult inflation, at 4.1%. Note that the experience of inflation declines rapidly for the current age cohort in their 50s. Over time, the area of the graph will shift 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.

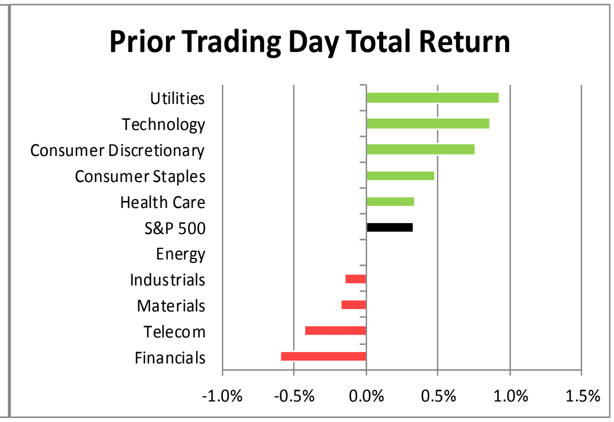
If inflation fears are triggered, we could see a bear market in bonds develop characterized by rapid spikes in long-term interest rates that choke off growth and lead to less stable financial markets and shorter business cycles. This is not our base case. However, the particular demographic pattern could 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 5/25/2018 close)

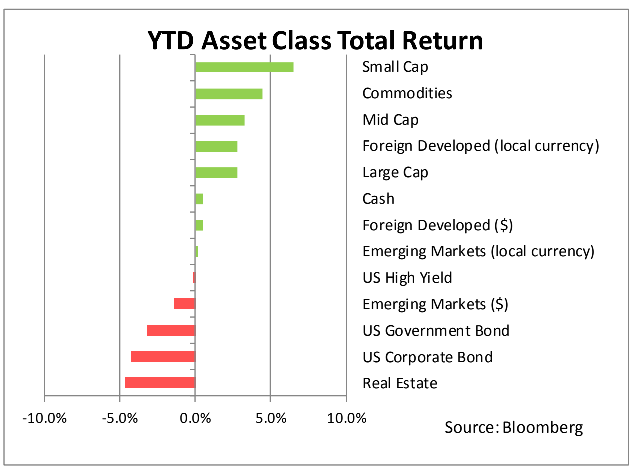




(Source: Bloomberg)

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 5/25/2018 close)

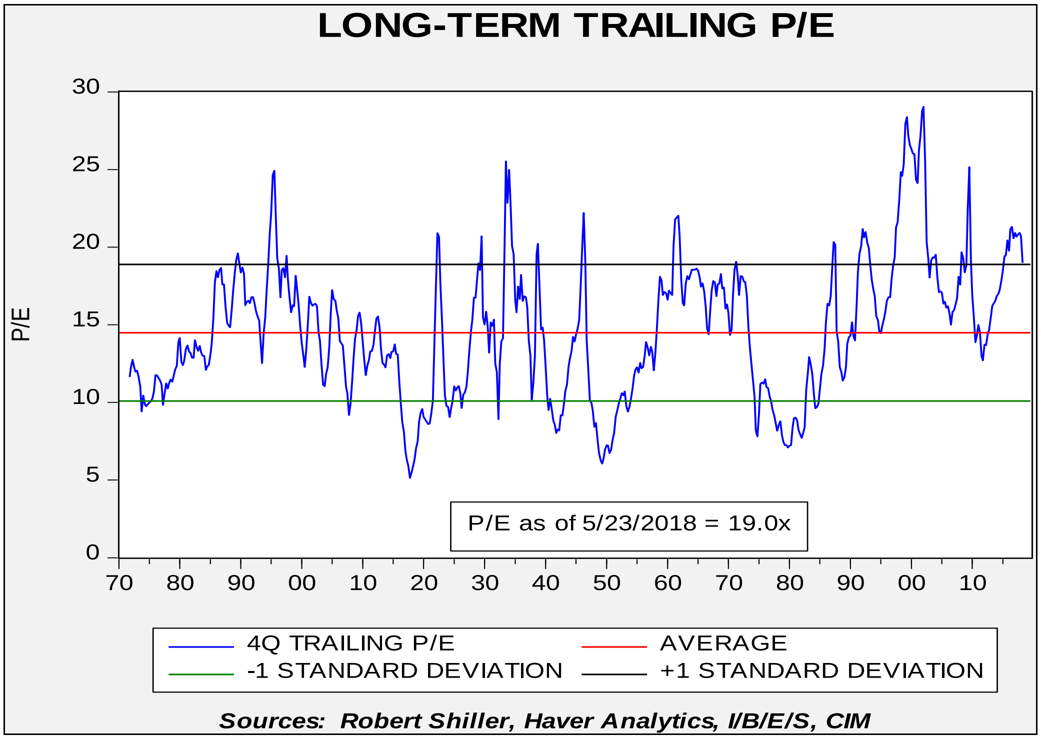


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[8] 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.

[8] 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.