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 31, 2018—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.9% from the prior close. Chinese markets were up, with the Shanghai composite up 1.8% and the Shenzhen index up 1.8%. U.S. equity index futures are signaling a higher open.

It's the last day of May! Markets are mostly steady, the dollar is a bit weaker and Treasuries are seeing a modest bump in yields. Here is what we are watching this morning:

Italian populists try to form a government: Italy's president has given the populists more time to form a government,[1] but the League's leader, Matteo Salvini, has been reluctant to finish the deal, likely hoping that his party's standing would improve with new elections. Hopes that new elections could be avoided sparked a strong rally in Italian bonds and a pullback in flight to safety instruments, such as the yen and U.S. Treasuries. It seems a bit odd that the formation of a populist government is preferred to new elections, but the fear of new elections is that they will turn into a referendum on the Eurozone and Italians will decide to leave.

In reality, the populist coalition in Italy is rather unusual and may not survive. We have dubbed it a "Nader coalition" of left- and right-wing populists. Why is this rare? It's a bit like the Tea Party and Occupy forming a government in the U.S. Nader's argument is that both populist wings share similar goals on economic policy and thus should subsume their social differences to improve their economic conditions. History shows that a more durable coalition is when a center party aligns with a populist party, with the former giving enough economic "goodies" to the populists to keep them together. Franklin Roosevelt's center-left coalition with the white working class lasted from the 1930s into the mid-1960s.

If the populists do form a government, we doubt it will last long. The League's base is in northern Italy, which is industrial and economically successful. The Five-Star Movement is based in economically depressed southern Italy. That's why you see a policy mix that includes tax cuts, anti-immigration and basic national income. The only way such a policy mix works is if the EU simply stops enforcing fiscal rules. However, the financial markets will pressure Italy if such policies are adopted. If we get new elections, look for fear to pressure financial markets but, in reality, new elections are probably necessary and we don't see Italy leaving the Eurozone in the short run. In fact, about the only way Italy exits the Eurozone is if Five-Star dominates the government.

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[1] https://www.ft.com/content/91937214-63d4-11e8-90c2-9563a0613e56

Trade war looming? The deadline for steel and aluminum tariff exemptions is tomorrow and there is every indication that the Trump administration is moving to implement some form of tariffs, although a short-term waiver is possible. If trade actions are taken, we expect the U.S. to implement quotas on imports, with tariffs applied once the imports exceed the quota level. The real worry is retaliation. We would expect all nations adversely affected to apply their own trade retaliation. Expect the retaliation to be targeted to politically sensitive areas of the economy, including agriculture, bourbon and motorcycles. The tariff threat could also kill this weekend's scheduled talks between Commerce Secretary Ross and Chinese officials.

Rajoy in trouble: The formal debate to hold a confidence vote on the current Spanish government begins today. Rajoy might survive even though his support is weak because of party rivalry; voting Rajoy out puts the Socialists in power, which the center-left parties don't want. We expect the eventual outcome to be new elections. Although political turmoil is a bearish factor for confidence assets, this problem is more normal. What is going on in Spain is all about domestic issues, while Italy affects the foundation of the Eurozone. Thus, we would not expect Spain to turn into a Eurozone crisis.

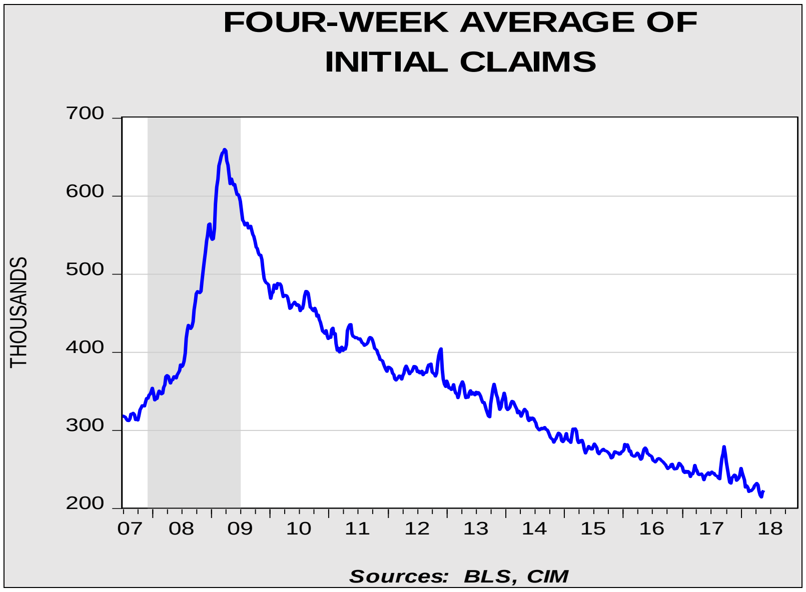
A hawk flies away: The BOE's Monetary Policy Committee bid adieu to Ian McCafferty and announced that Jonathan Haskel will be joining the group. McCafferty has been a recent dissenter to steady policy, voting to raise rates. It is unclear how Haskel will vote. He is an economics professor and specialist in productivity and growth measurement. Most likely, the committee has become a bit more dovish.

The OECD boosts growth forecasts: The OECD is forecasting global GDP to rise 3.8% this year, up from its last forecast of 3.5%, mostly due to stronger U.S. growth. Although the strong dollar's impact on emerging markets was noted as a risk factor, the group remains optimistic about the near term.

U.S. Economic Releases

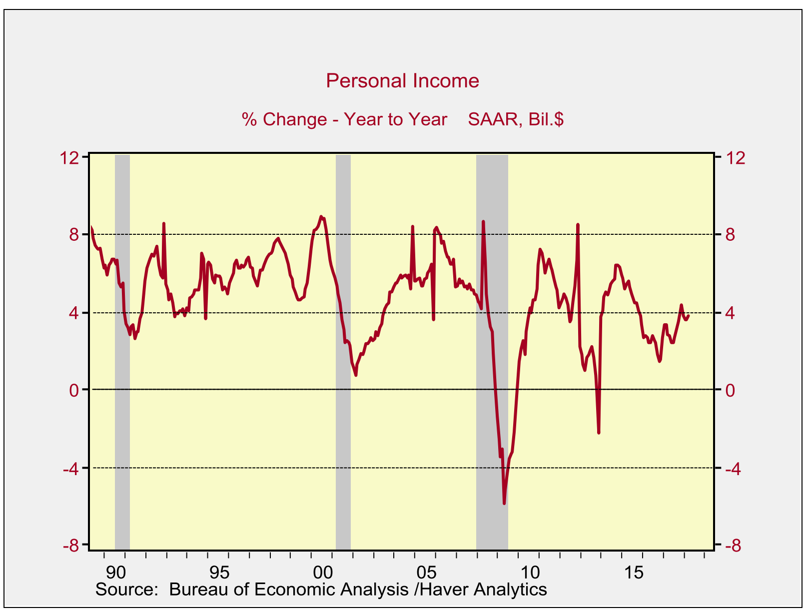
The May Challenger job cuts report fell by 4.8% from the prior year. The index measures the number of announced job cuts by employers, which is a proxy for future layoffs but does not necessarily indicate the state of current layoffs

Initial jobless claims came in below expectations at 221k compared to the forecast of 228k.



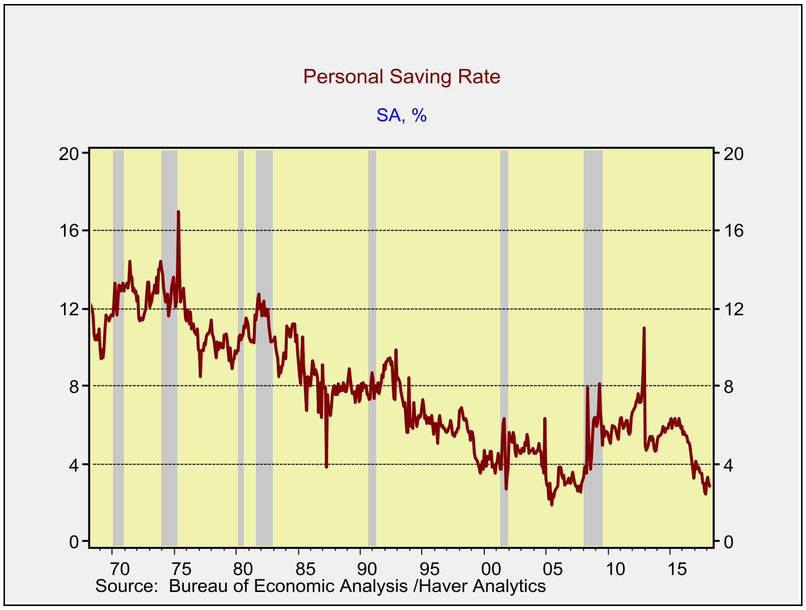
The chart above shows the four-week moving average for initial jobless claims. The four-week moving average rose from 219.75k to 222.25k

Personal income was in line with expectations, rising 0.3% from the prior month. The prior report's gain was revised downward from 0.3% to 0.2%. Personal spending came in above expectations, rising 0.6% from the prior month compared to the forecast of 0.4%. The prior report's gain was revised upward from 0.4% to 0.5%. Real personal spending came in above expectations, rising 0.4% from the prior month compared to the forecast of 0.2%. The prior report's gain was revised from 0.4% to 0.6%.



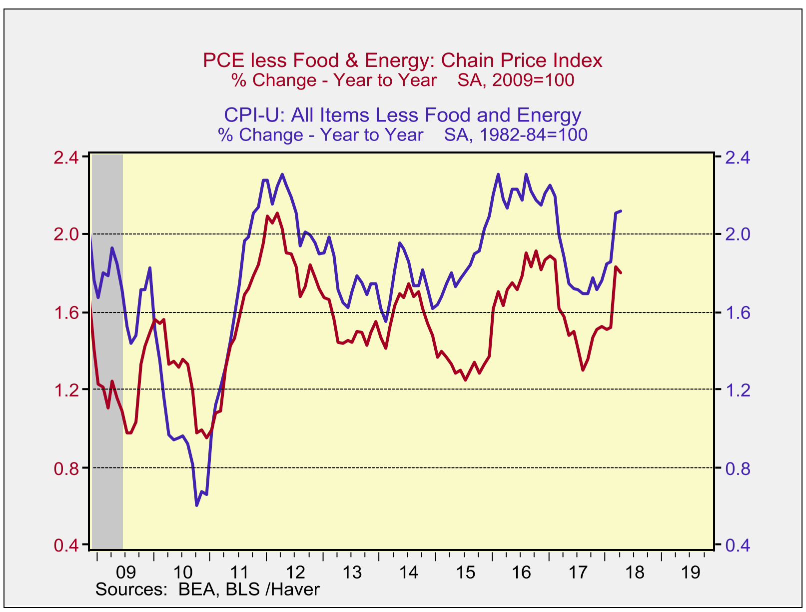
The chart above shows the year-over-year change in personal income. Personal income rose 3.8% from the prior year.

The rise in spending above income lowered the saving rate.



Household saving relative to after-tax income is down to 2.8%, near levels seen in 2005. It will become increasingly difficult for consumption to continue to rise unless incomes start to increase at a faster pace. Saving has reached a point where further declines to support consumption are unlikely.

The PCE deflator came in line with expectations, rising 0.2% from the prior month. Core PCE came in above expectations, rising 0.2% from the prior month compared to the forecast of 0.1%.



The chart above shows the year-over-year change in core PCE and core CPI. Annual core PCE and core CPI rose 1.8% and 2.1%, respectively.

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	Chicago Purchasing Manager	m/m	may	58.3	57.6	**
9:45	Bloomberg Consumer Comfort	m/m	may		55.2	***
10:00	Pending Home Sales	m/m	apr	0.4%	0.4%	**
10:00	Pending Home Sales	m/m	apr		-4.4%	**
Fed speakers or events						
EST	Speaker or event	District or position				
12:30	Raphael Bostic Speaks at Dallas Fed	President of the Federal Reserve Bank of Atlanta				
13:00	Lael Brainard Speaks in Cambridge, Massachusetts	Member of the Board of Governors				
20:30	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								
China	Non-manufacturing PMI	y/y	may	54.9	54.8	54.8	**	Equity and bond neutral
	Manufacturing PMI	m/m	may	51.9	51.4	51.4	**	Equity bullish, bond bearish
	Swift Global Payments	m/m	apr	1.7%	1.6%		**	Equity and bond neutral
	Composite PMI	m/m	may	54.6	54.1		**	Equity and bond neutral
Japan	Industrial Production	m/m	may	2.5%	2.4%	3.6%	***	Equity bearish, bond bullish
	Japan buying foreign bonds	m/m	may	-¥717.0 bn	¥948.9 bn		**	Equity and bond neutral
	Japan buying foreign stocks	m/m	may	¥255.8 bn	¥165.8 bn		**	Equity and bond neutral
	Foreign buying Japan bonds	m/m	may	-¥216.7 bn	-¥150.9 bn		**	Equity and bond neutral
	Foreign buying Japan stocks	m/m	may	-¥380.0 bn	¥99.1 bn		**	Equity and bond neutral
India	GDP	y/y	1q	6.7%	6.6%	6.7%	***	Equity and bond neutral
Australia	Private Capital Expenditure	q/q	1q	0.4%	-0.2%	1.0%	*	Equity and bond neutral
	Private Sector Credit	y/y	apr	5.1%	5.1%	5.0%	*	Equity and bond neutral
EUROPE								
Eurozone	Unemployment Rate	m/m	may	8.5%	8.5%	8.4%	***	Equity and bond neutral
	CPI Core	m/m	may	1.1%	0.7%	1.0%	***	Equity bullish, bond bearish
	CPI Estimate	m/m	may	1.9%	1.2%	1.6%	***	Equity bullish, bond bearish
France	PPI	m/m	may	-0.7%	0.4%		**	Equity and bond neutral
	CPI EU Harmonized	y/y	may	2.3%	1.8%	2.1%	***	Equity bullish, bond bearish
	CPI	y/y	apr	2.0%	1.6%	1.9%	***	Equity bullish, bond bearish
Italy	Unemployment Rate	m/m	apr	11.2%	11.0%	10.9%	***	Equity bearish, bond bullish
	CPI EU Harmonized	m/m	may	0.4%	0.5%	0.2%	***	Equity and bond neutral
	CPI NIC inc. Tobacco	y/y	may	0.4%	0.5%	0.8%	***	Equity bearish, bond bullish
AMERICAS								
Mexico	Budget Balance	ytd	apr	5.8 bn	-91.9 bn		**	Equity and bond neutral
Brazil	GDP	y/y	apr	1.2%	2.1%	1.3%	***	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)	231	232	-1	Up
3-mo T-bill yield (bps)	188	188	0	Neutral
TED spread (bps)	43	44	-1	Neutral
U.S. Libor/OIS spread (bps)	188	186	2	Up
10-yr T-note (%)	2.84	2.78	0.06	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	13	19	-6	Down
Currencies	**Direction**			
dollar	down			Down
euro	up			Up
yen	up			Up
pound	up			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	$77.65	$75.39	3.00%	OPEC Production Pessimism
WTI	$68.33	$66.73	2.40%	
Natural Gas	$2.88	$2.90	-0.72%	
Crack Spread	$23.93	$23.64	1.24%	
12-mo strip crack	$22.75	$22.13	2.77%	
Ethanol rack	$1.61	$1.61	0.02%	
Metals				
Gold	$1,302.17	$1,298.77	0.26%	
Silver	$16.51	$16.37	0.86%	
Copper contract	$307.05	$306.25	0.26%	
Grains				
Corn contract	$ 393.50	$ 400.00	-1.63%	
Wheat contract	$ 522.00	$ 536.50	-2.70%	
Soybeans contract	$ 1,023.00	$ 1,030.50	-0.73%	
Shipping				
Baltic Dry Freight	1057	1077	-20	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-0.9		
Gasoline (mb)		-0.9		
Distillates (mb)		-1.4		
Refinery run rates (%)		0.60%		
Natural gas (bcf)		102.0		

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. There are no tropical storms expected over the next 48 hours.

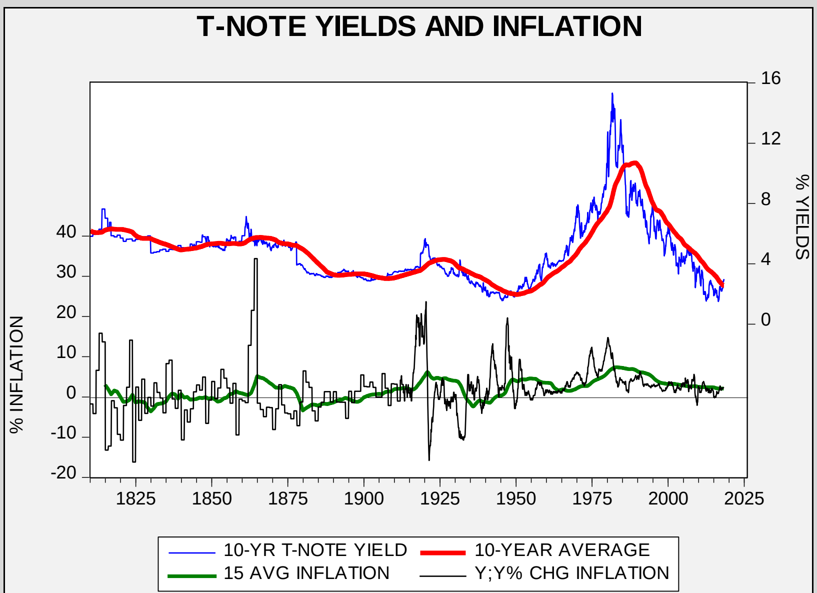
Asset Allocation Weekly Comment

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.[2] 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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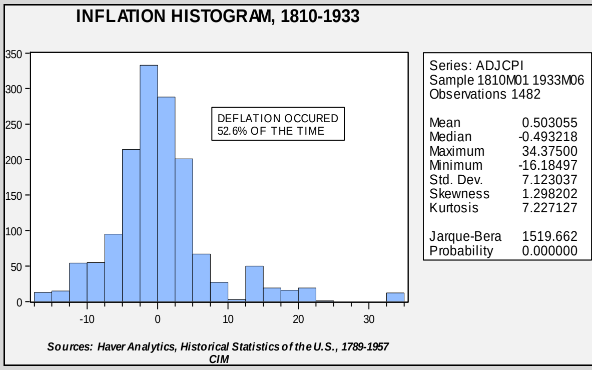
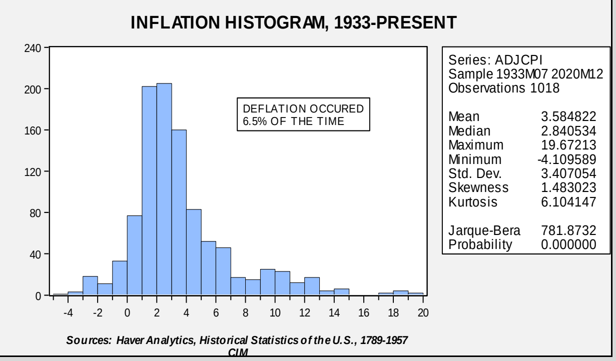
[2] http://www.helsinki.fi/iehc2006/papers1/Oosterli.pdf, page 34.

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.

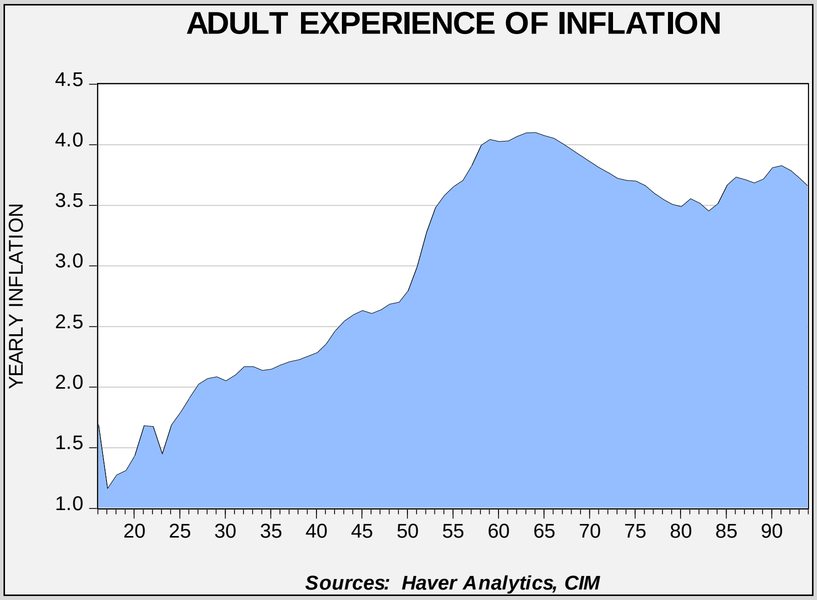
It would be reasonable to assume that longer duration yields would be rather low during the period when deflation was common. In fact, they averaged 4.6% in the years from 1810 to 1933. Yields remained low during the Great Depression, and, during WWII, the Treasury forced the Federal Reserve to keep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

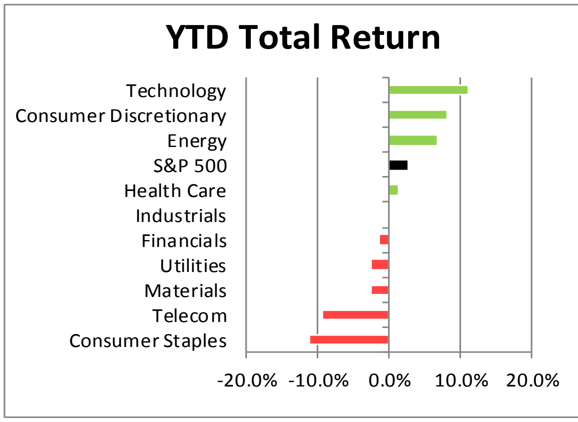


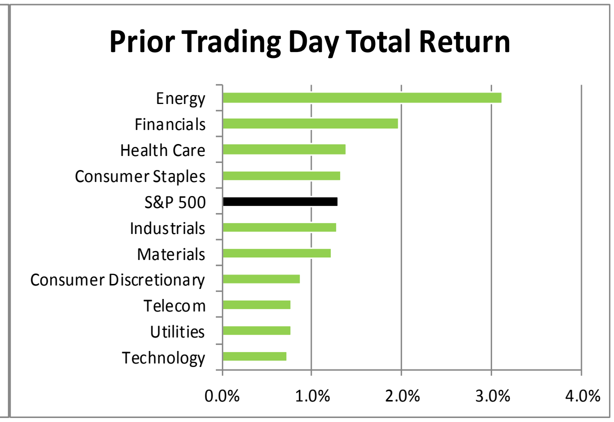
This chart shows the adult experience of inflation, starting with age 16. The current 64-year-olds have experienced the highest average adult inflation, at 4.1%. Note that the experience of inflation declines rapidly for the current age cohort in their 50s. Over time, the area of the graph will shift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

Data Section

U.S. Equity Markets – (as of 5/30/2018 close)

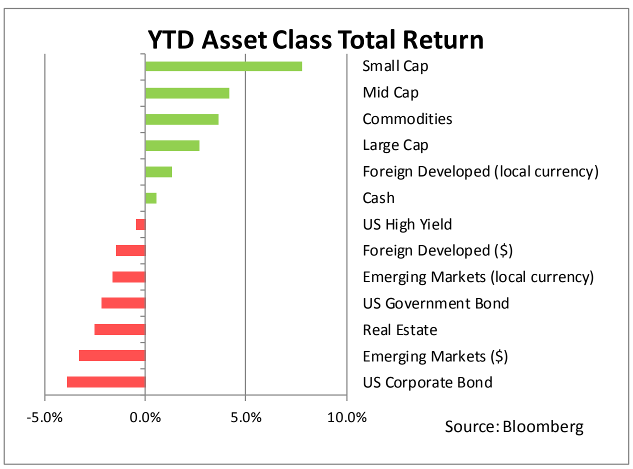




(Source: Bloomberg)

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 5/30/2018 close)

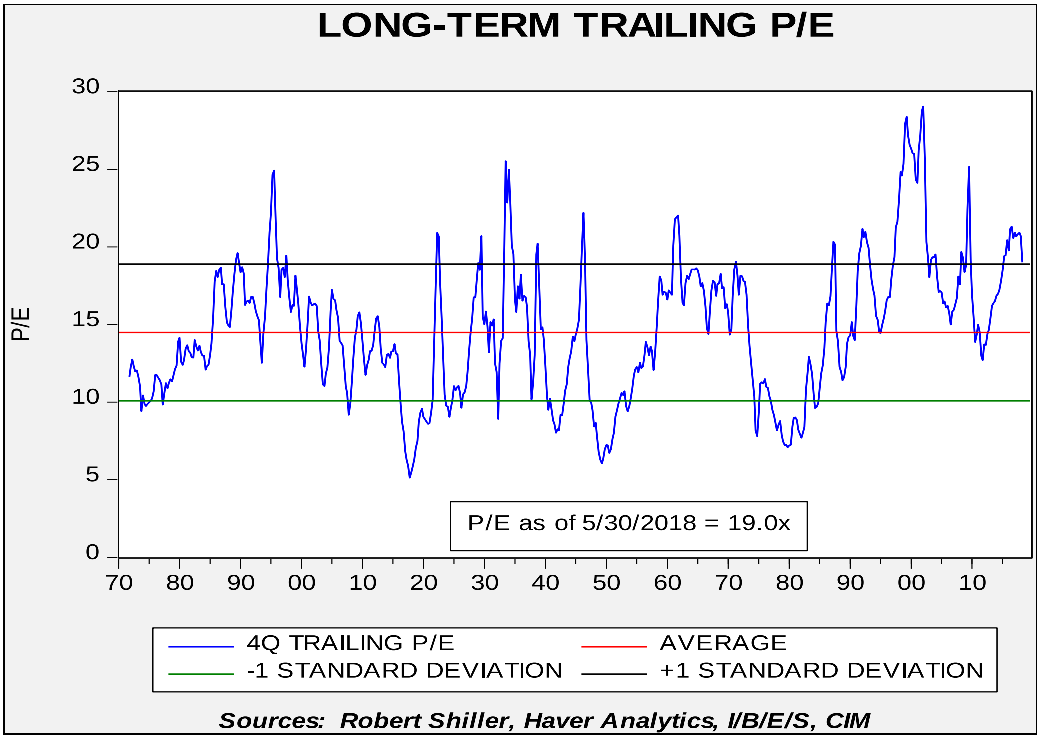


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 31, 2018



Based on our methodology,[3] the current P/E is 19.0x, unchanged from last week.

[3] 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.