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: April 1, 2019—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.7% from the last close. In Asia, the MSCI Asia Apex 50 was up 1.3% from the prior close. Chinese markets were higher, with the Shanghai composite up 2.6% and the Shenzhen index up 3.6%. U.S. equity index futures are signaling a higher open.

It's the beginning of Q2 and April Fools' Day. Equities are up around the world. Here is what we are watching this morning:

China better, but elsewhere struggles: China's manufacturing PMI data came in better than forecast;[1] the Caixin number for March was 50.8, exceeding expectations around 50.0, and the official PMI reading was 50.5 compared to 49.2. A lift in export orders accounted for much of the rise. Although the improvement offered investors some relief in what has been a steady diet of weaker data, the fact that export orders drove the numbers raises fears they won't be sustained. In contrast, the Eurozone data was soft, with manufacturing PMI falling to 47.5 in March, the weakest level in almost six years. Meanwhile, in Japan, the Tankan business survey fell to a two-year low. The data from large companies was even worse, falling to a more than six-year low.

Weekend elections: There were three elections of note over the weekend. In Turkey, the economic recession led to local government losses for Erdogan's AKP, including the capital Ankara and Istanbul.[2] Although these elections don't threaten Erdogan's power, the results show rising discontent in Turkey and thus it would behoove the leadership to boost the economy. In Ukraine, a comedian, Vladimir Zelenskiy, won the first round of presidential elections, capturing about 30% of the vote. The election sets the stage for a run-off between Zelenskiy and the incumbent president Poroshenko, which will be held in two to three weeks.[3] And, in the second

[1] https://www.wsj.com/articles/china-factory-activity-rebounded-strongly-in-march-11554002297?mod=hp_lead_pos3

[2] https://www.reuters.com/article/us-turkey-election/erdogan-loses-hold-over-turkish-capital-istanbul-disputed-idUSKCN1RD130?utm_source=POLITICO.EU&utm_campaign=cd12771421-EMAIL_CAMPAIGN_2019_04_01_04_45&utm_medium=email&utm_term=0_10959edeb5-cd12771421-190334489 and https://www.washingtonpost.com/world/erdogan-faces-challenge-in-local-elections-as-turkeys-economy-struggles/2019/03/31/3794c56c-539b-11e9-a047-748657a0a9d1_story.html?utm_term=.4ce76201fd52&wpisrc=nl_todayworld&wpmm=1

[3] https://www.politico.eu/article/no-joke-comedian-vladimir-zelenskiy-to-win-first-round-in-ukraines-presidential-election-against-petro-poroshenko/?utm_source=POLITICO.EU&utm_campaign=cd12771421-EMAIL_CAMPAIGN_2019_04_01_04_45&utm_medium=email&utm_term=0_10959edeb5-cd12771421-190334489

round of voting in Slovakia, Zuzana Caputova won handily, 58.4% to 41.6% over Maros Sefcovic.[4] Slovakia has suffered through a series of high-profile assassinations of journalists; Caputova is seen as a reformer.[5]

Brexit: One could be forgiven for thinking Brexit has become something like the movie *Groundhog Day*, where the lead character keeps reliving the same day over and over again. There are plans for a fourth vote on May's ill-fated plan.[6] Also on tap is another round of indicative votes. So far, all Parliament has been able to do is express what it doesn't want but hasn't been able to determine what it does want. The upcoming votes range from May's plan, to a custom's union, a hard exit and other points in between.[7] So far, the GBP is taking all this in stride, which suggests the financial markets do not expect a hard exit.

Closing the southern border? The White House is threatening to close the southern border in response to an influx of migrants.[8] It isn't clear if the U.S. will carry out the threat but, if it does, it will disrupt trade between the U.S. and Mexico. The goal of the Trump administration is for the Mexican government to stop Central American migrants from coming to the U.S. border.

The White House and the Fed: White House officials are calling for an immediate 50 bps cut in interest rates.[9] One of the most dovish members of the FOMC, Minneapolis FRB President Kashkari, doesn't go that far, suggesting a pause is the best policy.[10] However, the steady pressure from the White House is having the effect of a policy easing, at least so far. The risk is that if the economy were to pick up and inflation pressures rise, markets would view pressure from the administration less favorably. But, for now, executive branch officials pressing for easier policy isn't adversely affecting financial markets.

Secondary sanctions: The U.S. is considering sanctions on non-U.S. companies conducting business with Venezuela. So far, the U.S. has not sanctioned companies that have ties to PDVSA,[11] the Venezuelan state oil company. If the U.S. were to take this step, it would further reduce Venezuela's sales from oil.

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[4] https://volby.sme.sk/prezidentske-volby/2019/vysledky?utm_source=POLITICO.EU&utm_campaign=cd12771421-EMAIL_CAMPAIGN_2019_04_01_04_45&utm_medium=email&utm_term=0_10959edeb5-cd12771421-190334489
[5] https://www.politico.eu/article/jan-kuciak-gorilla-slovakia-journalist-dead-darkest-day/?utm_source=POLITICO.EU&utm_campaign=cd12771421-EMAIL_CAMPAIGN_2019_04_01_04_45&utm_medium=email&utm_term=0_10959edeb5-cd12771421-190334489
[6] https://www.ft.com/content/c20c79ae-5384-11e9-a3db-1fe89bedc16e?emailId=5ca1834e1d4b6b000456c867&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22
[7] https://www.politico.eu/article/uks-brexit-options-explained/?utm_source=POLITICO.EU&utm_campaign=cd12771421-EMAIL_CAMPAIGN_2019_04_01_04_45&utm_medium=email&utm_term=0_10959edeb5-cd12771421-190334489
[8] https://www.nytimes.com/2019/03/31/us/politics/trump-mulvaney-border-close-mexico.html?emc=edit_fd_20190401&nl=&nlid=567726720190401&te=1
[9] https://www.reuters.com/article/us-usa-fed-trump/white-house-calls-for-fed-to-reverse-u-s-rate-hikes-idUSKCN1RA2MB
[10] https://www.wsj.com/articles/feds-kashkari-says-it-isnt-time-to-cut-rates-11554111001?mod=newsviewer_click
[11] https://www.reuters.com/article/us-venezuela-politics-bolton-exclusive/exclusive-trump-eyeing-stepped-up-venezuela-sanctions-for-foreign-companies-bolton-idUSKCN1RA2F0

U.S. Economic Releases

Advance retail sales for February came in below expectations, falling 0.2% from the prior month compared to the forecast rise of 0.2%. The prior month's gain of 0.2% was revised upward to 0.7%. Retail sales ex-auto came in below expectations, falling 0.4% from the prior month compared to the forecast gain of 0.3%. The prior month's gain was revised upward from 0.9% to 1.4%. Retail sales ex-auto and gasoline came in below expectations, falling 0.6% from the prior month compared to the forecast rise of 0.3%. The prior month's gain was revised upward from 1.2% to 1.7%. The retail sales control group came in below expectations, falling 0.2% from the prior month compared to the forecast gain of 1.1%. The prior month's gain was revised from 1.1% to 1.7%.

Source: Census Bureau/Haver Analytics

The chart above shows the year-over-year change in retail sales and core retail sales. Annually, retail sales and core retail sales rose 2.2% and 2.9%, respectively.

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

Economic Releases					Expected	Prior	Rating
EDT	**Indicator**				**Expected**	**Prior**	**Rating**
9:45	Markit US Manufacturing PMI	m/m	mar		52.5	52.5	**
10:00	ISM Manufacturing	m/m	mar		54.5	54.2	**
10:00	ISM Employment	m/m	mar			52.3	**
10:00	ISM Prices Paid	m/m	mar		52.5	49.4	**
10:00	ISM New Orders	m/m	mar			55.5	**
10:00	Construction Spending	m/m	feb		-0.1%	1.3%	**
10:00	Business Inventories	m/m	jan		0.5%	0.6%	**
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								
China	Composite PMI	m/m	mar	54.0	52.4		**	Equity bullish, bond bearish
	Non-manufacturing PMI	m/m	mar	54.8	54.3	54.4	**	Equity bullish, bond bearish
	Manufacturing PMI	m/m	mar	50.5	49.2	49.6	**	Equity bullish, bond bearish
Japan	Tankan Large Mfg Index	y/y	feb	12	19	13	**	Equity bearish, bond bullish
	Tankan Large Mfg Outlook	y/y	feb	8	15	12	**	Equity bearish, bond bullish
	Tankan Large Non-Mfg Index	ytd	mar	21	24	22	**	Equity bearish, bond bullish
	Tankan Large Non-Mfg Outlook	m/m	mar	20	20	20	**	Equity and bond neutral
	Nikkei Japan PMI Mfg	m/m	mar	49.2	48.9		**	Equity and bond neutral
Australia	AiG Performance of Mfg Index	m/m	mar	51.0	54.0		**	Equity and bond neutral
	Melbourne Institute Inflation	m/m	mar	52.0	52.0		**	Equity and bond neutral
	NAB Business Conditions	m/m	mar	7	4		**	Equity bullish, bond bearish
	NAB Business Confidence	m/m	mar	0	2		**	Equity and bond neutral
EUROPE								
Eurozone	Unemployment Rate	m/m	feb	7.8%	7.8%	7.8%	***	Equity and bond neutral
	CPI Core	m/m	mar	0.8%	1.0%	0.9%	***	Equity and bond neutral
	CPI Estimate	m/m	mar	1.4%	1.5%	1.5%	***	Equity and bond neutral
Italy	Unemployment Rate	m/m	feb	10.7%	10.5%	10.5%	***	Equity and bond neutral
	Markit/ADACI Italy Manufacturing	m/m	mar	47.4	47.7	47.5	**	Equity and bond neutral
France	Markit France Manufacturing	y/y	mar	49.7	49.8	49.8	**	Equity and bond neutral
Germany	Markit/BME Germany Manufacturing	y/y	mar	44.1	44.7	44.7	**	Equity and bond bearish
UK	Markit UK PMI Manufacturing	m/m	mar	55.1	52.0	51.2	**	Equity and bond neutral
Russia	Makir Russia Manufacturing	m/m	mar	52.8	50.1	50.5	**	Equity bullish, bond bearish
Switzerland	Retail Sales Real	y/y	feb	-0.2%	-0.4%	-0.4%	**	Equity and bond neutral
	PMI Manufacturing	m/m	mar	50.3	55.4	53.6	**	Equity bearish, bond bullish
AMERICAS								
Mexico	Net Outstanding Loans	y/y	feb	4.475 tn	4.441 tn		**	Equity and bond neutral
	Budget Balance	ytd	feb	-27.6 bn	-42.7 bn		**	Equity and bond neutral
Canada	GDP	y/y	feb	1.6%	1.1%	1.3%	**	Equity bullish, bond bearish
Brazil	National Unemployment Rate	m/m	feb	12.4%	12.0%	12.5%	**	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)	260	259	1	Up
3-mo T-bill yield (bps)	235	234	1	Neutral
TED spread (bps)	25	25	0	Neutral
U.S. Libor/OIS spread (bps)	240	240	0	Up
10-yr T-note (%)	2.44	2.41	0.03	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	14	13	1	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Up
yen	down			Neutral
pound	up			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	$68.67	$67.58	1.61%	Global Growth Optimism
WTI	$60.87	$60.14	1.21%	
Natural Gas	$2.68	$2.66	0.53%	
Crack Spread	$20.05	$20.07	-0.06%	
12-mo strip crack	$16.97	$16.84	0.76%	
Ethanol rack	$1.49	$1.49	-0.18%	
Metals				
Gold	$1,290.97	$1,292.38	-0.11%	
Silver	$15.09	$15.12	-0.16%	
Copper contract	$294.85	$293.60	0.43%	
Grains				
Corn contract	$ 359.50	$ 356.50	0.84%	
Wheat contract	$ 459.25	$ 457.75	0.33%	
Soybeans contract	$ 888.50	$ 884.25	0.48%	
Shipping				
Baltic Dry Freight	689	692	-3	

Weather

The 6-10 and 8-14 day forecasts show warmer temperatures for 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.

March 29, 2019

Long-dated Treasury bonds have enjoyed a strong rally in recent weeks. Fears about future U.S. economic growth, falling global economic growth and a reversal in monetary policy expectations have all conspired to lower yields. The question now is whether or not yields have fallen more than is justified by the fundamental factors.
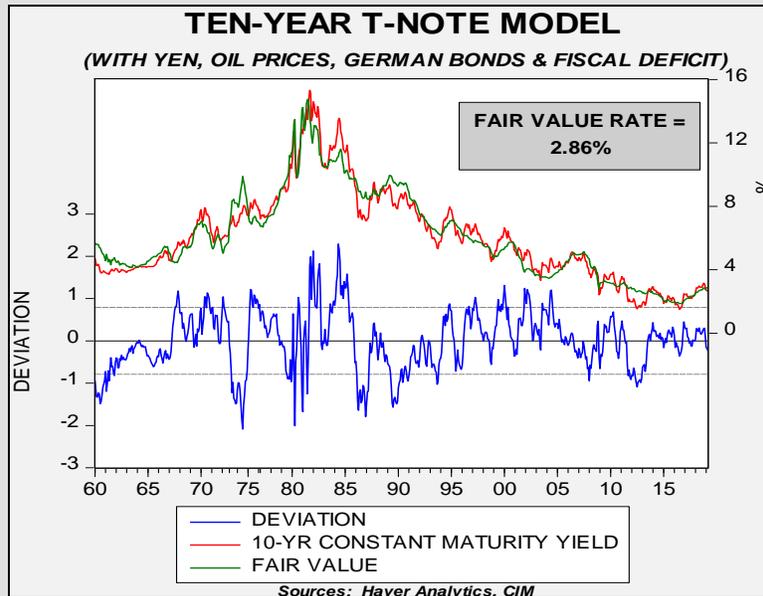
This is our model of the 10-year T-note yield. Independent variables in the model include fed funds, an inflation proxy,[12] the yen/dollar exchange rate, German 10-year yields, WTI oil prices and the fiscal deficit as a percentage of GDP. The standard error line is 70 bps; thus, at current fair value, the 10-year T-note yield would be "rich" around 2.15%.

In general, the first two variables have the most explanatory power. The current yield is well below the fair value of 2.86%.[13] One way to account for the decline in yields would be if the market was projecting easier monetary policy. Leaving the rest of the independent variables unchanged, to reach a 2.40% 10-year T-note yield would require fed funds of about 1.50%, or a 100 bps reduction from current levels. Since such a cut is unlikely in the near term, it is arguable that the 10-year yield has overshot to the downside.

However, another possibility is that inflation expectations are falling. Inflation expectations have a powerful effect on long-dated debt yields. Our current inflation proxy puts inflation at 2.10%. To achieve current yields, inflation expectations would need to fall to 1.41%. Although

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[12] We use a 15-year moving average of the yearly change in inflation for inflation expectations.
[13] We use monthly averages in the above model; thus, the March yield is 2.63%. The April yield will be much less.

inflation expectations are not directly observable, we assume such expectations are slow to change.[14] Thus, it would be unlikely that a drop in inflation expectations alone would account for the recent decline. However, inflation expectations falling to 1.8% and fed funds at 2.00% would bring yields close to 1.40%.
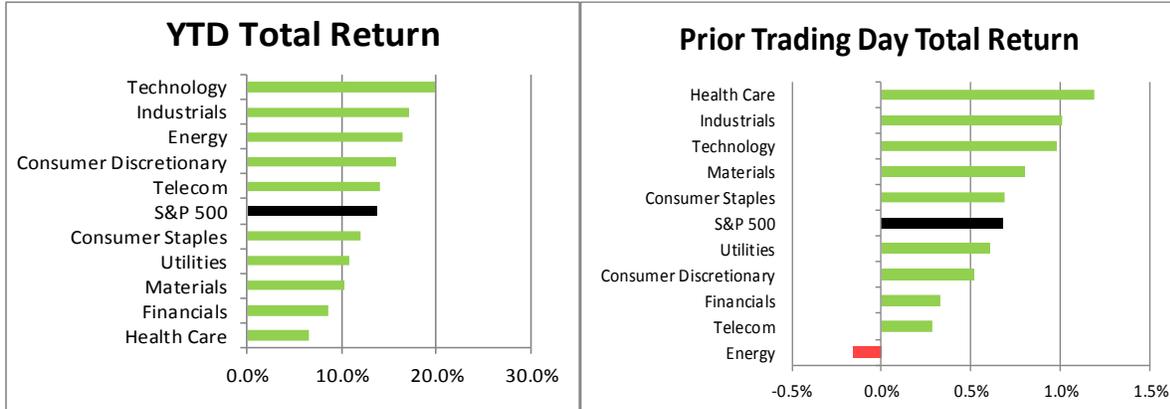
It is quite possible that falling inflation expectations and forecasts of easier monetary policy can justify the current 10-year yields. The risk is that the FOMC keeps policy steady and inflation eventually surprises to the upside. Thus, we would not see the current environment as conducive for extending duration.

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[14] Milton Friedman assumed such expectations were built over a long period of time, perhaps two decades or more.

Data Section

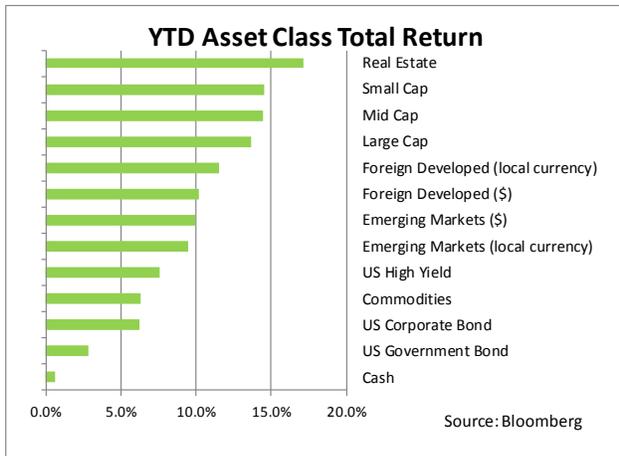**U.S. Equity Markets** – (as of 3/29/2019 close)

YTD Total Return

Sector	
Technology	
Industrials	
Energy	
Consumer Discretionary	
Telecom	
S&P 500	
Consumer Staples	
Utilities	
Materials	
Financials	
Health Care	

Axis: 0.0%, 10.0%, 20.0%, 30.0%

Prior Trading Day Total Return

Sector	
Health Care	
Industrials	
Technology	
Materials	
Consumer Staples	
S&P 500	
Utilities	
Consumer Discretionary	
Financials	
Telecom	
Energy	

Axis: -0.5%, 0.0%, 0.5%, 1.0%, 1.5%

(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 3/29/2019 close)

YTD Asset Class Total Return

Asset Class	
Real Estate	
Small Cap	
Mid Cap	
Large Cap	
Foreign Developed (local currency)	
Foreign Developed ($)	
Emerging Markets ($)	
Emerging Markets (local currency)	
US High Yield	
Commodities	
US Corporate Bond	
US Government Bond	
Cash	

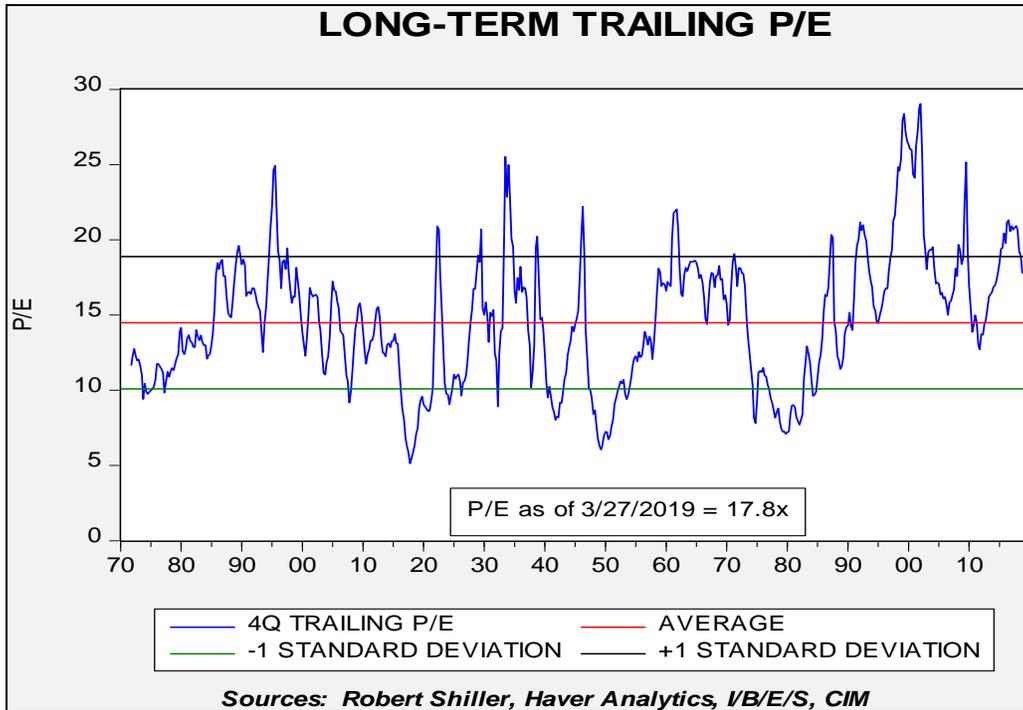Axis: 0.0%, 5.0%, 10.0%, 15.0%, 20.0%

Source: Bloomberg

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

March 28, 2019

LONG-TERM TRAILING P/E

P/E as of 3/27/2019 = 17.8x

Legend:
— 4Q TRAILING P/E — AVERAGE
— -1 STANDARD DEVIATION — +1 STANDARD DEVIATION

Sources: Robert Shiller, Haver Analytics, I/B/E/S, CIM

Based on our methodology,[15] the current P/E is 17.8x, unchanged from last week.

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[15] 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 (Q2, Q3 and Q4) and one estimate (Q1). 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.