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 2, 2019—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.3% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.4% from the prior close. Chinese markets were higher, with the Shanghai composite up 0.2% and the Shenzhen index up 0.1%. U.S. equity index futures are signaling a higher open.

Markets are quiet after a strong rally yesterday. Here is what we are watching this morning:

Turkey fallout: The stunning losses in local elections have put President Erdogan on notice—the economy is suffering and he needs to address the problem. Addressing a weakening economy with rising inflation will be challenging. The weak currency will help in the economy's recovery but Turkey is probably looking at a year of falling real wages and stagnant growth. The temptation to use temporary measures to lift growth will be high.[1] Although the elections reflect economic turmoil, for the most part, it looks to us like the financial markets have mostly discounted the bad news; simply put, the elections are a lagging indicator.

Brexit: Parliament voted on four measures for Brexit and rejected all of them.[2] It is becoming apparent that all of the ideas for leaving without disruption mean the U.K. will remain tied to the EU with less influence than it has now. The customs union, which lost by a mere three votes, doesn't really solve anything. Such a union keeps the U.K. in the EU's trade bloc on tariffs but not on product standards. Thus, there would still be a border problem in Ireland. Essentially, Britain is rapidly realizing that it must either (a) leave suddenly and completely, suffering an immediate economic shock in return for full independence, or (b) call the whole thing off. There really isn't any middle ground.

The other trend that is becoming apparent is that May can either (a) stop Brexit by cobbling together a coalition of Remain-supporting MPs in Parliament at the cost of marginalizing the Tory Party, or (b) hold the Tories together but suffer a hard Brexit. We think she leans toward the second option. Our position has been that no government wants a hard break, and that is probably true, but a hard break may be considered a better option than eternal Labour Party dominance.

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[1] https://www.ft.com/content/6ca1d484-546d-11e9-91f9-b6515a54c5b1?emailId=5ca2d4f0341b100004e47892&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

[2] https://www.nytimes.com/2019/04/01/world/europe/uk-parliament-soft-brexit-may.html?emc=edit_fd_20190402&nl=&nlid=567726720190402&te=1

Bouteflika out: The president of Algeria, Abdelaziz Bouteflika, will leave office on April 28.[3] It is unclear who will replace him. Although there is no evidence that Algerian energy production has been affected, the chances of a disruption are rising.

Fed conference: The Fed will hold a monetary policy conference in Chicago June 4-5; ideas about policy, including inflation targeting, policy transparency and employment, will be on the agenda.[4] As we discussed recently,[5] the Fed is investigating its inflation target, considering if it should be trying to target a level or average change in inflation. The Chicago meeting will likely overshadow the August Jackson Hole meeting this year.

September fiscal cliff? The Treasury will hit a hard debt limit by September. At that point, the debt ceiling will need to be raised. Congress has already begun work on a deal but both houses are closely watching the White House, which is making noise about a wholesale rewrite of recent budget deals. Although it isn't uncommon for these arrangements to go down to the wire, the looming election year will play a role.[6] Thus, we will continue to monitor this issue but would not be surprised to see a crisis develop in late Q3.

U.S. Economic Releases

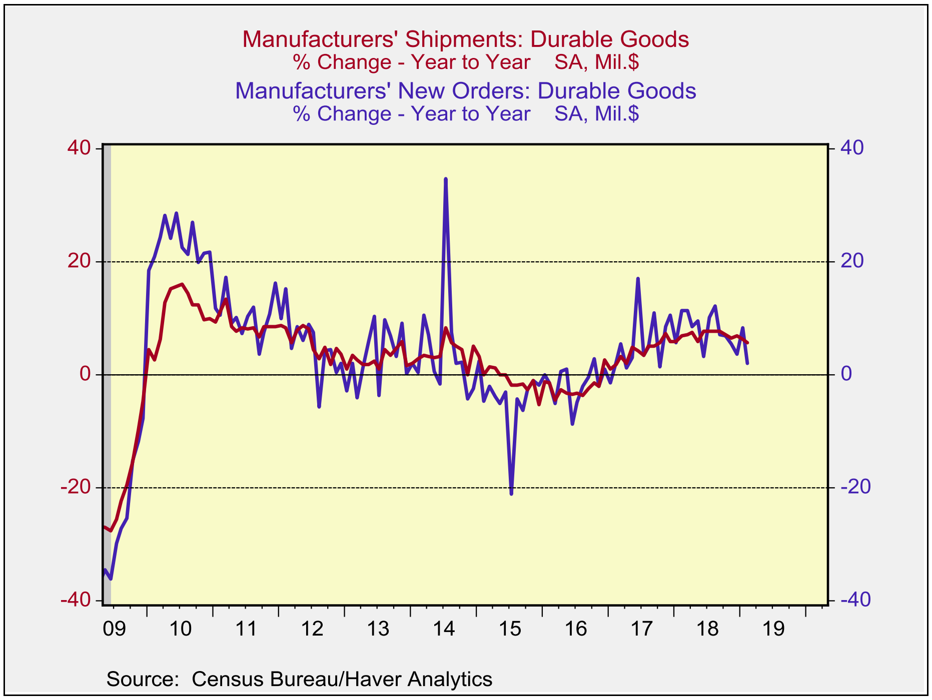
February durable goods orders came in better than expectations, falling 1.6% from the prior month compared to the forecast loss of 1.8%. Durables ex-transportation came in line with expectations, rising 0.1% from the prior month. The prior report's loss was revised downward from 0.2% to 0.1%. Capital goods orders non-defense ex-air were below expectations, falling 0.1% from the prior month compared to the forecast gain of 0.1%. The prior report's gain was revised from 0.8% to 0.9%. Capital goods shipments non-defense ex-air came in above expectations, remaining unchanged from the prior month compared to the forecast loss of 0.1%.

[3] https://www.bbc.com/news/world-africa-47776725?utm_source=POLITICO.EU&utm_campaign=647364b043-EMAIL_CAMPAIGN_2019_04_02_04_47&utm_medium=email&utm_term=0_10959edeb5-647364b043-190334489

[4] https://www.reuters.com/article/us-usa-fed-conference/fed-sets-agenda-for-chicago-framework-conference-in-june-idUSKCN1RD351

[5] See Confluence Asset Allocation Weekly (3/8/2019).

[6] https://www.politico.com/story/2019/04/02/congress-spending-budget-shutdown-1244283



This chart shows the annual change in new durable goods orders and shipments. Annually, new orders rose by 1.8%, shipments rose by 5.5%, unfilled orders rose by 3.5% and inventories rose by 4.8%.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
	Ward Total Vehicle Sales	m/m	mar	16.80 mn	16.56	**
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	Monetary Base	y/y	mar	3.8%	4.6%		**	Equity and bond neutral
	Monetary Base End of period	y/y	mar	¥506.3 tn	¥497.3 tn		**	Equity and bond neutral
India	Eight Infrastructure Industries	m/m	feb	2.1%	1.8%		**	Equity and bond neutral
	Nikkei India PMI Mfg	m/m	mar	52.6	54.3		**	Equity and bond neutral
Australia	Commodity Index SDR	m/m	mar	11.0%	9.1%		**	Equity and bond neutral
	ANZ Roy Morgan Weekly Consumption	w/w	mar	114.7	111.8		**	Equity and bond neutral
	Building Approvals	m/m	feb	-12.5%	-28.6%	-27.0%	**	Equity and bond neutral
EUROPE								
Eurozone	PPI	y/y	feb	3.0%	3.0%	3.1%	**	Equity and bond neutral
UK	Markit/CIPS UK Construction	m/m	mar	49.7	49.5	49.8	**	Equity bearish, bond bullish
Switzerland	CPI	m/m	mar	0.5%	0.4%	0.4%	***	Equity bearish, bond bullish
	CPI EU Harmonized	m/m	mar	0.3%	0.3%	0.2%	***	Equity bearish, bond bullish
	CPI Core	m/m	mar	0.5%	0.4%	0.4%	***	Equity bearish, bond bullish
Russia	GDP	y/y	4q	2.7%	1.5%	2.2%	***	Equity bullish, bond bearish
AMERICAS								
Mexico	Markit Mexico PMI Mfg	y/y	mar	49.8	52.6		**	Equity bearish, bond bullish
	IMEF Non-Manufacturing Index	m/m	mar	51.2	50.7	51.7	**	Equity and bond neutral
	IMEF Manufacturing Index	m/m	mar	50.2	54.3	52.0	**	Equity and bond neutral
Brazil	Markit Brazil PMI Manufacturing	m/m	mar	52.8	53.4		**	Equity and bond neutral
	Trade Balance Monthly	m/m	mar	$4.990 bn	$3.673 bn	$5.350 bn	**	Equity and bond neutral
Canada	MLI Leading Indicator	m/m	feb	0.0%	0.0%		**	Equity and bond neutral
	Markit Canada Manufacturing	m/m	mar	50.5	52.6		**	Equity and bond neutral
	Bloomberg Nanos Confidence	w/w	mar	55.4	55.4		**	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)	236	236	0	Neutral
TED spread (bps)	24	23	1	Neutral
U.S. Libor/OIS spread (bps)	240	240	0	Up
10-yr T-note (%)	2.48	2.50	-0.02	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	13	14	-1	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	flat			Up
yen	up			Neutral
pound	down			Neutral
franc	up			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBA Cash Rate Target	1.500%	1.500%	1.500%	On forecast

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	$69.17	$69.01	0.23%	
WTI	$62.00	$61.59	0.67%	
Natural Gas	$2.70	$2.71	-0.15%	
Crack Spread	$19.32	$19.38	-0.30%	
12-mo strip crack	$16.61	$16.61	-0.01%	
Ethanol rack	$1.49	$1.49	-0.01%	
Metals				
Gold	$1,289.66	$1,287.72	0.15%	
Silver	$15.05	$15.11	-0.36%	
Copper contract	$291.30	$292.45	-0.39%	
Grains				
Corn contract	$ 361.75	$ 361.75	0.00%	
Wheat contract	$ 460.25	$ 462.75	-0.54%	
Soybeans contract	$ 898.75	$ 895.50	0.36%	
Shipping				
Baltic Dry Freight	685	689	-4	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-0.9		
Gasoline (mb)		-2.0		
Distillates (mb)		-0.6		
Refinery run rates (%)		1.00%		

Weather

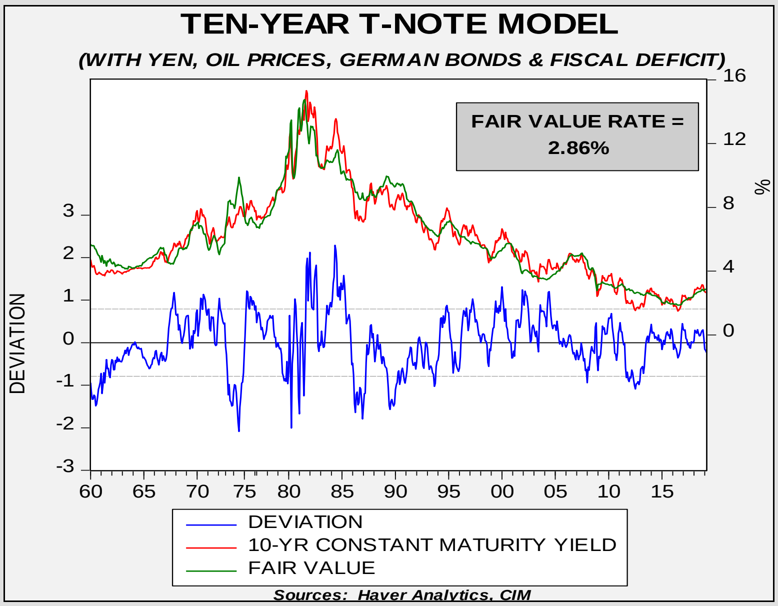
The 6-10 and 8-14 day forecasts show warmer temperatures for the country. Precipitation is expected for most of the country.

Asset Allocation Weekly

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,[7] 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%.[8] 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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[7] We use a 15-year moving average of the yearly change in inflation for inflation expectations.
[8] 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.[9] 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%.

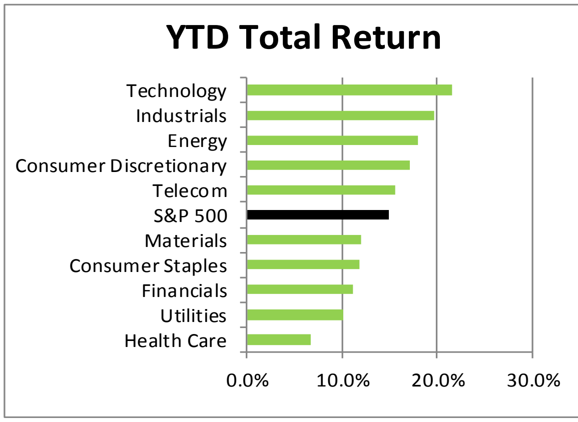
It is quite possible that falling inflation expectations and forecasts of easier monetary policy can justify the current 10-year yields. The risk is that the FOMC keeps policy steady and inflation eventually surprises to the upside. Thus, we would not see the current environment as conducive for extending duration.

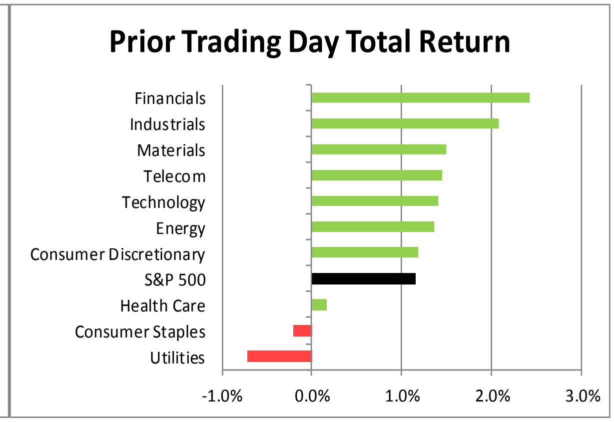
Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors 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.

[9] 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 4/1/2019 close)

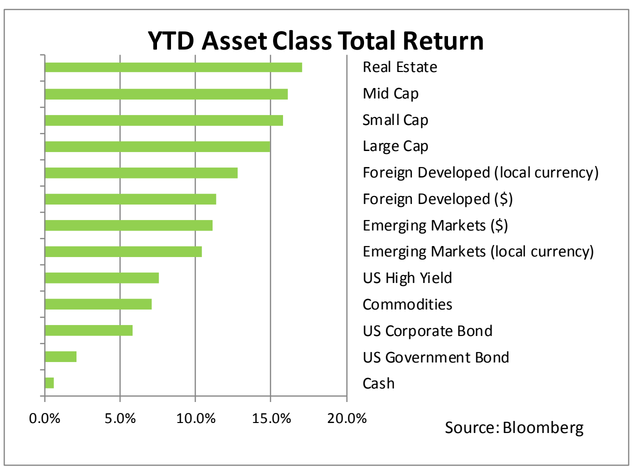




(Source: Bloomberg)

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.

Asset Class Performance – (as of 4/1/2019 close)

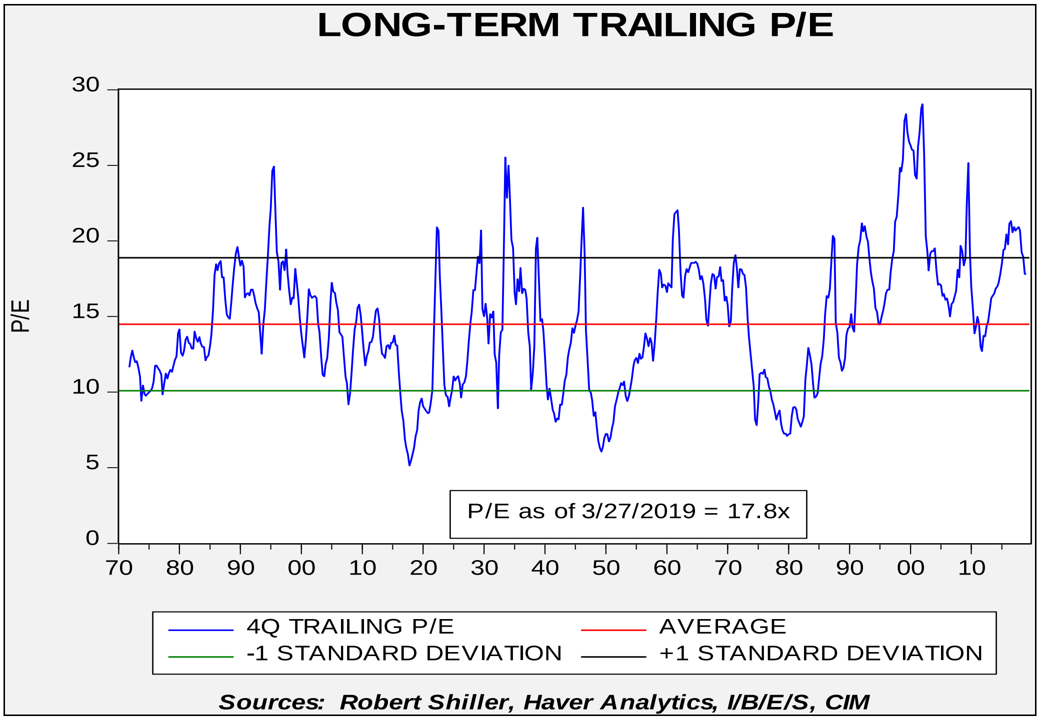


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

March 28, 2019



Based on our methodology,[10] the current P/E is 17.8x, 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.

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[10] 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.