Confluence INVESTMENT MANAGEMENT

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 9, 2019—9:30 AM EDT] Global equity markets are generally mixed this morning. The EuroStoxx 50 is unchanged from the last close. In Asia, the MSCI Asia Apex 50 was up 0.3% from the prior close. Chinese markets were mixed, with the Shanghai composite down 0.2% and the Shenzhen index up 0.7%. U.S. equity index futures are signaling a flat open.

It's a very quiet morning in front of Brexit deadlines. The only economic news of note was weak Chinese car sales (-12.7% in March). Here is what we are watching:

BREAKING NEWS: Italy reduces its GDP forecast to 0.1% from 1.0% this year. This action will increase its deficit/GDP ratio. The IMF lowered its world GDP growth forecast for 2019 to 3.3% from 3.5%, which was a bigger decline than forecast.

Brexit: PM May is on the continent to ask for an extension.[1] She wants to stay in the EU until the end of May. There are some in the EU that want to give her a flexible extension[2] for a year, but allow the U.K. to leave sooner if a deal is reached. May is reluctant to accept a long delay as it will be seen by Tory Brexit supporters as a delay with no end.[3] Meanwhile, talks between May and Corbyn[4] continue on the idea of a customs union with the EU.[5] A customs union has its own problems (it would prevent the U.K. from striking deals on tariffs with the rest of the world, for example), but, politically, it would only pass with a subset of MP votes from Labour and the Conservatives. This could split both parties and lead to a political realignment. Another complicating issue is that if the U.K. stays past mid-May it will need to participate in EU elections, which is something the hardline Brexit supporters loathe.[6]

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[1] https://www.ft.com/content/d10acc5a-59e5-11e9-939a-341f5ada9d40?emailId=5cac0f7c5f28c30004fe9f16&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22 and https://www.reuters.com/article/us-britain-eu/theresa-may-to-ask-merkel-and-macron-for-brexit-delay-idUSKCN1RK2HP?il=0

[2] https://www.politico.eu/pro/brexit-flextension-plan-gains-traction/

[3] https://www.ft.com/content/1c92be22-59fe-11e9-939a-341f5ada9d40?emailId=5cac0f7c5f28c30004fe9f16&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

[4] https://www.nytimes.com/2019/04/08/world/europe/brexit-corbyn-theresa-may-compromise.html?emc=edit_MBE_p_20190409&nl=morning-briefing&nlid=5677267tion%3DtopNews&section=topNews&te=1

[5] https://www.ft.com/content/48dcc7f8-5a07-11e9-939a-341f5ada9d40?emailId=5cac0f7c5f28c30004fe9f16&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

[6] https://www.ft.com/content/0fed22d0-5a20-11e9-939a-341f5ada9d40?emailId=5cac0f7c5f28c30004fe9f16&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

There are probably four potential outcomes this week. The most likely is a short delay with promises of extensions. We doubt a workable deal can emerge from Parliament and we don't expect the EU to force the U.K. out of the EU.[7] A long delay is the second most likely result. But, in any case, a hard Brexit is the least likely outcome, which is reflected in the financial markets. The GBP remains steady despite all the uncertainty.

China/EU summit: Meetings between the two sides begin tomorrow. Talks have taken on an air of urgency as the EU has become increasingly hostile toward Beijing. We suspect European leaders are seeing two major threats from China. First, China is using its Belt and Road project to divide Europe. Italy's recent decision to sign a memo of understanding highlights this risk. Second, China is moving up the value chain and ruthlessly using state power to dominate industries and using direct purchases of European companies to favor Chinese supply chains.[8] China is framing the dispute as the EU following Washington's lead,[9] but the reality is that Europe has discovered China is becoming a geopolitical rival to the U.S. and it has no good response.

EU tariffs? The Trump administration is considering $11 bn in tariffs on EU goods.[10] This proposal is partly in response to a WTO ruling that EU aircraft subsidies harmed U.S. interests.[11]

Oil news: India is delaying its purchases of Iranian oil, awaiting U.S. decisions on sanctions waivers.[12] Frackers are using production methods that boost production quickly but also dissipate wells rapidly. This is leading to faster depletion rates and excess output of associated natural gas.[13] The faster depletion rates mean drilling must continue at a rapid pace just to keep production steady. If investment begins to decline, oil supplies could tighten further and support oil prices.

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[7] https://www.washingtonpost.com/world/europe/this-is-a-pivotal-week-for-brexit-here-are-four-ways-it-could-end/2019/04/08/05c94490-5a03-11e9-98d4-844088d135f2_story.html?utm_term=.99b05fc2dabf&wpisrc=nl_todayworld&wpmm=1

[8] https://www.foreignaffairs.com/articles/china/2019-04-03/why-europe-getting-tough-china and https://www.politico.eu/blogs/the-coming-wars/2019/04/how-europe-learned-to-fear-china/?utm_source=POLITICO.EU&utm_campaign=e0900b0c22-EMAIL_CAMPAIGN_2019_04_09_04_40&utm_medium=email&utm_term=0_10959edeb5-e0900b0c22-190334489

[9] https://www.politico.eu/article/chinas-envoy-to-europe-washington-is-getting-between-us/?utm_source=POLITICO.EU&utm_campaign=e0900b0c22-EMAIL_CAMPAIGN_2019_04_09_04_40&utm_medium=email&utm_term=0_10959edeb5-e0900b0c22-190334489

[10] https://finance.yahoo.com/news/us-floats-tariffs-11bn-eu-products-061755773.html

[11] https://www.ft.com/content/c381615a-5a55-11e9-9dde-7aedca0a081a?emailId=5cac0f7c5f28c30004fe9f16&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22 and https://www.wsj.com/articles/u-s-to-impose-tariffs-on-11-billion-of-eu-goods-11554770493?mod=hp_lead_pos4

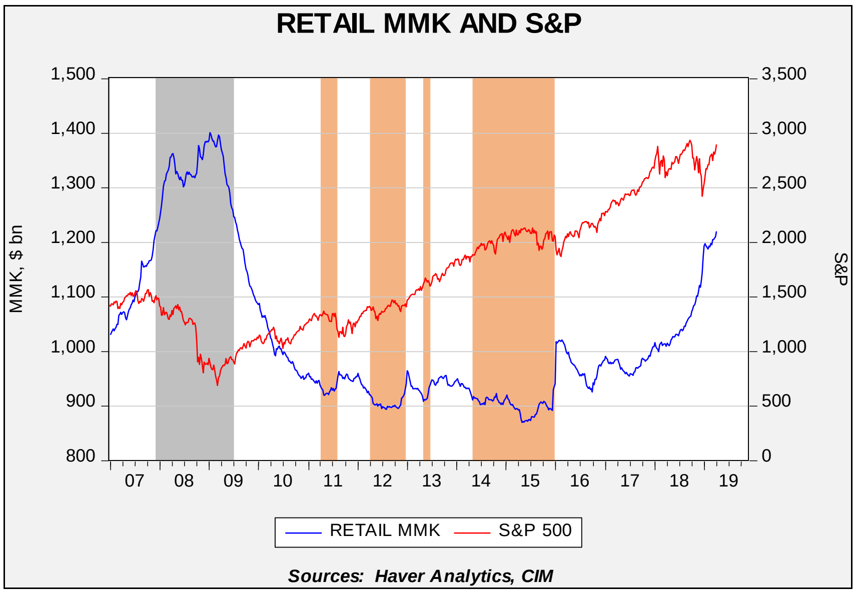
[12] https://www.reuters.com/article/us-usa-iran-india/india-delays-may-order-for-iran-oil-awaits-clarity-on-sanctions-waiver-sources-idUSKCN1RL0PB

[13] https://www.wsj.com/articles/frackers-chasing-fast-oil-output-are-on-a-treadmill-11554721202?mod=itp_wsj&ru=yahoo

China v. bitcoin: Chinese officials are considering banning bitcoin mining.[14] China is the world's largest producer of technology designed to mine bitcoins but the National Development and Reform Commission (NDRC) argued that the mining itself is wasteful and should not be permitted. We have wondered for a while why China would permit such activities; bitcoin has become the vehicle of choice for criminal activity and would be a currency outside of state control. The position of the NDRC would seem to be more consistent with the degree of social and political control the Xi government supports.

Tech regulation: The U.K. is considering a measure that would penalize social media firms for allowing harmful content to be posted on their platforms.[15] Although the rules would only apply to the U.K., they could become the basis for regulation in other countries. If it becomes law, it would force the social media platforms to more systematically police its user-posted content and dramatically increase its cost of doing business. The U.K. regulation could be part of more regulatory actions in other nations.[16]

Chart *du jour* (plus one): Although equity values continue to trend higher, retail investors are still shying away from stocks.



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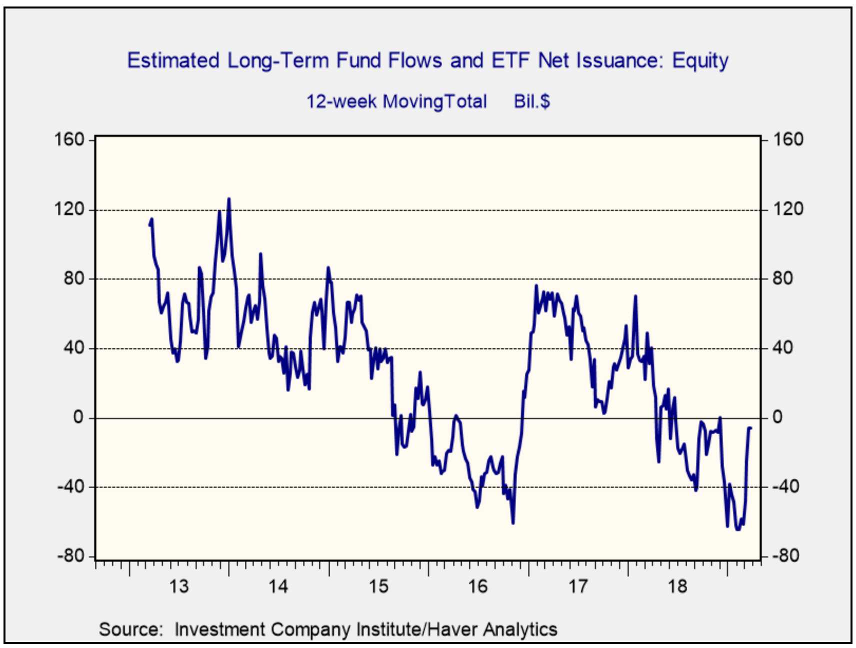
[14] https://www.reuters.com/article/us-china-cryptocurrency/china-says-it-wants-to-eliminate-bitcoin-mining-idUSKCN1RL0C4

[15] https://www.washingtonpost.com/technology/2019/04/07/uk-unveils-sweeping-plan-penalize-facebook-google-harmful-online-content/?utm_term=.86f84f2d7dd3&wpisrc=nl_daily202&wpmm=1 and https://www.nytimes.com/2019/04/07/business/britain-internet-regulations.html?emc=edit_MBE_p_20190409&nl=morning-briefing&nlid=5677267ion%3DwhatElse&section=whatElse&te=1

[16] https://www.axios.com/scoop-senators-target-the-ways-the-web-tricks-you-1554761685-0d393953-967d-4362-954d-08bcf5ad27c3.html?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top

This chart shows the S&P 500 with retail money market funds as measured by ICI. In 2007, money market funds rose rapidly as the real estate crisis unfolded. This area, shown in gray, coincided with market weakness. The decline in money market funds coincided with the beginning of the current bull market. We have also placed orange areas on the chart that show periods when money market fund levels fell below $920 bn. Equities tended to stall during these times. Since mid-2017, we have seen a steady rise in money market funds and levels rose above $1.0 trillion in early 2018, which also ushered in a period of broad consolidation. The pattern in retail money market funds is similar to what was seen during the panic in 2005-08.

The recent rally in equities does not appear to be supported by falling retail money market levels.[17] Company buybacks are thought to be supporting equities.[18] Still, without the return of retail investors, it is difficult to see how this rally could extend much further. We note that flows into equities in the form of mutual funds and ETFs have been mostly negative since the middle of last year.



Note that flows were negative in 2016 but reversed rapidly as the Fed delayed policy tightening. If we see a similar pattern this year, a challenge of 3000 on the S&P is quite possible.

U.S. Economic Releases

NFIB Small Business Optimism came in below expectations at 101.8 compared to the forecast of 102.0.

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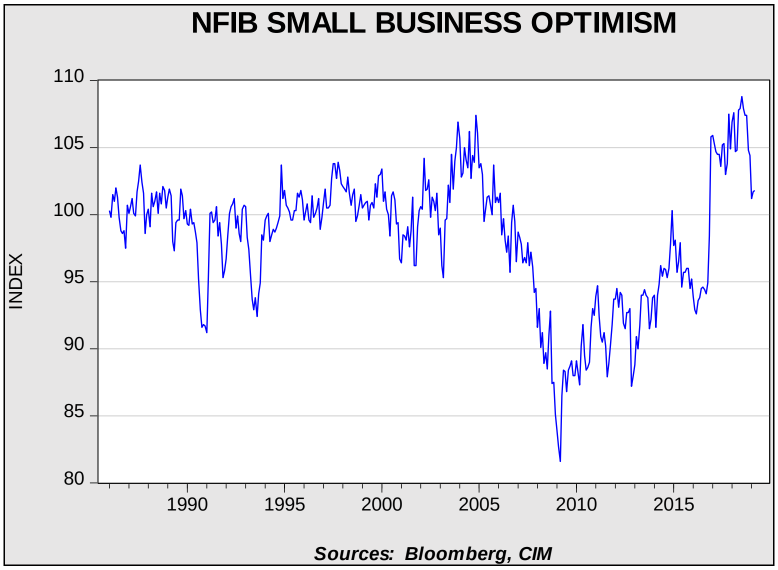
17 https://www.axios.com/newsletters/axios-markets-3dc392f3-edf6-46fe-9177-4688f4bb2f8b.html (see #3)
18 https://www.axios.com/newsletters/axios-markets-89a6d4f2-bb17-4d1d-8922-860c0a0da999.html?chunk=0#story0



The chart above shows the level of small business optimism. The latest reading suggests that small business optimism has fallen sharply since President Trump's inauguration in 2017. The primary concerns weighing on small businesses appear to be the ability to raise selling prices and find qualified workers. In our opinion, the two problems may be related to wages. It is possible that owners may be reluctant to raise wages high enough to attract more qualified workers due to fears that they will not be able to push the costs onto consumers. If this is true, we expect small businesses to prefer policies that boost export potential or limit competition from abroad. Therefore, we could see a sharp rebound in small business optimism if the trade agreement between the U.S. and China achieves either of these two aims.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	JOLTS Job Openings	m/m	feb	7550	7581	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
17:00	Randal Quarles speaks on Bank Regulation	U.S. Federal Reserve Vice Chairman for Supervision				
18:45	Richard Clarida speaks at Fed Listens Events in Minneapolis	Vice Chairman of Board of Governors of Federal Reserve				

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								
Australia	ANZ Roy Morgan Weekly Consumption	w/w	apr	113.2	114.7		**	Equity and bond neutral
	Home Loans	m/m	feb	0.8%	-1.2%	0.5%	**	Equity bullish, bond bearish
	Owner-Occupier Loan Value	m/m	feb	3.4%	-1.3%	1.0%	**	Equity bullish, bond bearish
	Investment Lending	m/m	feb	0.9%	-4.1%	-1.0%	**	Equity bullish, bond bearish
New Zealand	ANZ Truckometer Heavy	m/m	mar	-2.0%	0.4%		*	Equity and bond neutral
EUROPE								
Italy	Retail Sales	m/m	feb	0.1%	0.5%	-0.2%	**	Equity bullish, bond bearish
UK	BRC Sales Like-For-Like	y/y	mar	-1.1%	-0.1%	-0.8%	*	Equity and bond bearish
Switzerland	Unemployment Rate	m/m	mar	2.4%	2.4%	2.4%	***	Equity and bond neutral
AMERICAS								
Mexico	Gross Fixed Investment	m/m	jan	1.6%	-6.8%	-0.4%	**	Equity bullish, bond bearish
Canada	Housing Starts	m/m	mar	192.5k	173.2k	196.0k	***	Equity and bond neutral
	Building Permits	m/m	feb	-5.7%	-5.5%	2.0%	***	Equity and bond bearish
Brazil	Trade Balance Weekly	m/m	apr	$2.326 bn	$0.913 bn		**	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)	259	259	0	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	241	-1	Up
10-yr T-note (%)	2.52	2.52	0.00	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	19	17	2	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Up
yen	up			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	$71.09	$71.10	-0.01%	
WTI	$64.48	$64.40	0.12%	
Natural Gas	$2.71	$2.71	0.11%	
Crack Spread	$20.42	$20.07	1.75%	
12-mo strip crack	$17.15	$17.08	0.41%	
Ethanol rack	$1.47	$1.47	-0.12%	
Metals				
Gold	$1,301.89	$1,297.48	0.34%	
Silver	$15.28	$15.25	0.20%	
Copper contract	$294.95	$293.20	0.60%	
Grains				
Corn contract	$ 359.25	$ 360.00	-0.21%	
Wheat contract	$ 458.25	$ 465.25	-1.50%	
Soybeans contract	$ 898.50	$ 898.75	-0.03%	
Shipping				
Baltic Dry Freight	714	711	3	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.5		
Gasoline (mb)		-2.0		
Distillates (mb)		-1.5		
Refinery run rates (%)		1.00%		

Weather

The 6-10 and 8-14 day forecasts shows cooler temps for most of the country. Precipitation is expected for most of the country.

Asset Allocation Weekly

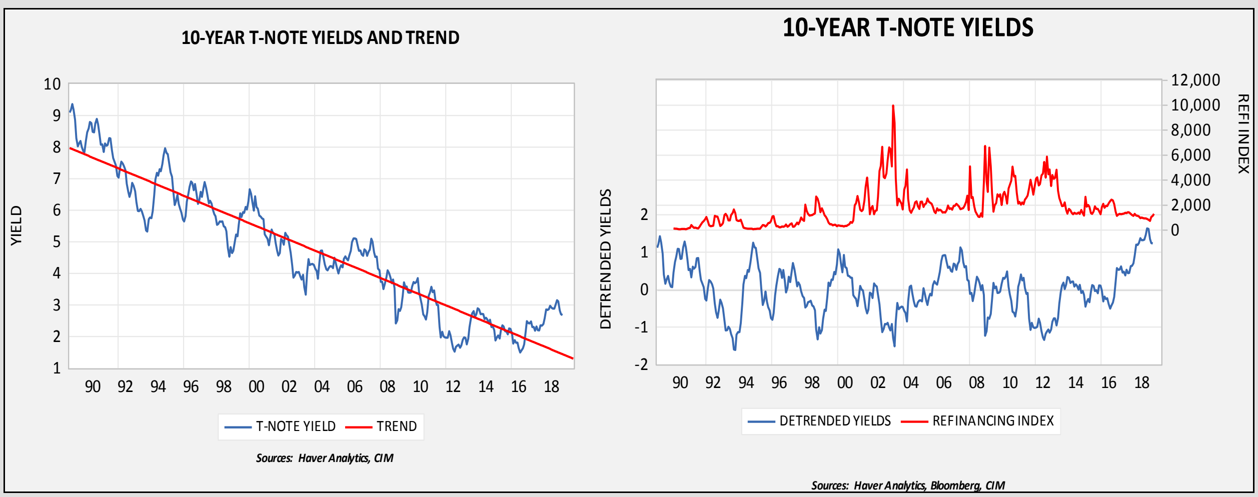
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

April 5, 2019

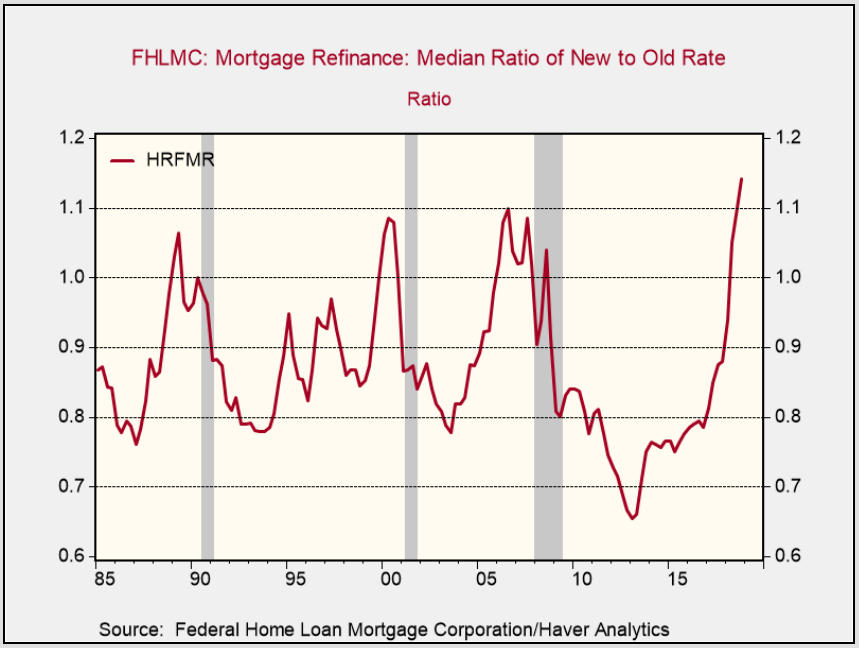
Mortgage-backed securities have rather odd characteristics compared to Treasuries. At their most basic level, mortgages are bonds—prices are inversely related to yields. The pricing on mortgages assumes a certain level of refinancing activity. However, when yields rise, expected mortgage duration tends to extend because mortgage holders are less likely to refinance. When yields fall, expected duration shortens as mortgage holders replace their existing mortgages with new ones at lower rates. Usually, mortgage bonds tend to act like options; they act "normal" within a certain range of yields, but duration adjustments occur if yields change above a given range.

Some bond fund managers are required to maintain a given duration level. If the manager is holding mortgages and refinancing activity rises then the fund's duration could shorten. This would require the manager to take steps to re-extend duration. A fast way to accomplish this goal would be to buy long-duration Treasury futures. These instruments are liquid and generally have a set duration.

In general, refinancing tends to take place when interest rates fall below the level of the current mortgage, taking closing costs into account.



The chart on the left shows the 10-year T-note yield; we have regressed a time trend through the data. Clearly, yields have been on a downward path since 1990. The chart on the right shows the 10-year T-note yield less trend on the lower line and the mortgage refinancing index on the upper line. Evidently, refinancing activity tends to rise when rates are below trend. Since 2016, the steady rise in rates relative to trend has depressed refinancing. However, we have seen a lift in refinancing recently. On the one hand, the dip in rates doesn't look like enough to overcome closing costs. On the other hand, paying a higher rate on a new mortgage may be the only way a homeowner can capture price appreciation.



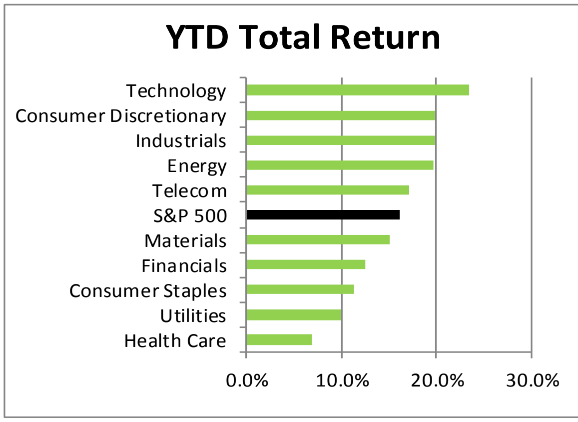
This chart shows the ratio of the new rate to the old rate. When the old rate is higher than the new rate, the ratio is less than 1.0. Note that this ratio is now at a new record high. Essentially, buyers are refinancing at a less advantageous rate to extract home equity.

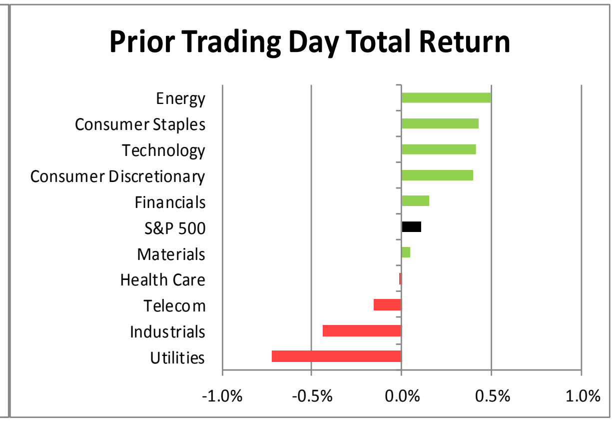
We suspect the most important factors of the recent bond rally have been changes in monetary policy expectations and reduced inflation fears. But, the rise in refinancing has likely played a role as well. We doubt that the attractiveness of locking in a higher mortgage rate will continue indefinitely, therefore this bullish factor should dissipate in the coming weeks.

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 4/8/2019 close)

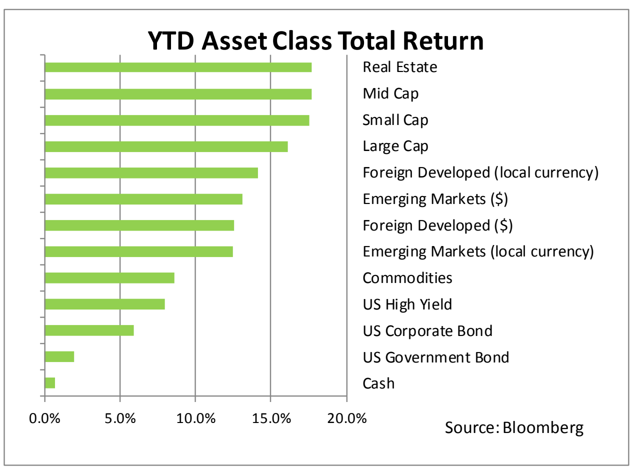




(Source: Bloomberg)

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 4/8/2019 close)

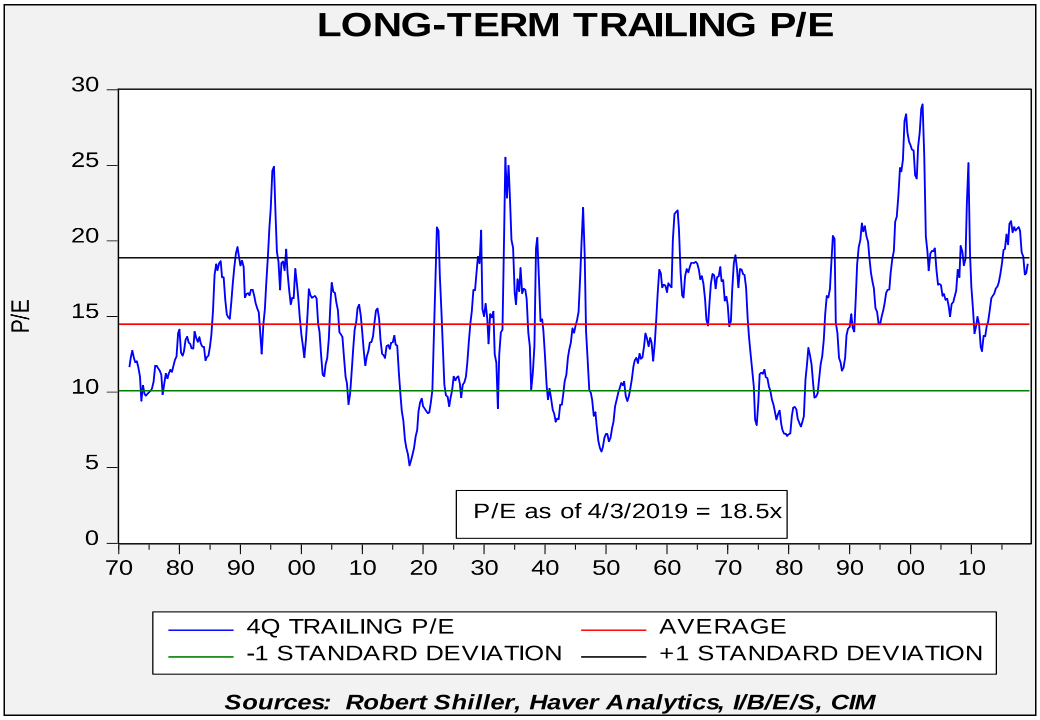


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

April 4, 2019



Based on our methodology,[19] the current P/E is 18.5x, up from 17.8x last week. With the beginning of Q2, we have adjusted the four-quarter moving total and the average value for the S&P. The jump in the multiple is mostly due to the recent rise in the index.

[19] 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 and Q4) and two estimates (Q1 and 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.