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 11, 2019—9:30 AM EDT] Global equity markets are generally mixed this morning. The EuroStoxx 50 is up 0.4% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.6% from the prior close. Chinese markets were lower, with the Shanghai composite down 1.6% and the Shenzhen index down 2.2%. U.S. equity index futures are signaling a higher open.

Lots of news this morning. Here is what we are watching:

Assange arrested: The Ecuadorian government has removed Julian Assange's asylum status and he has been arrested in London.[1] We expect him to eventually be extradited to the U.S.[2] Assange is a controversial figure; Wikileaks has exposed all sorts of confidential information that governments would prefer to keep secret. His leaks seemed to take a partisan direction in the 2016 election. Thus, he has lots of enemies. It will be interesting to see how he gets prosecuted.

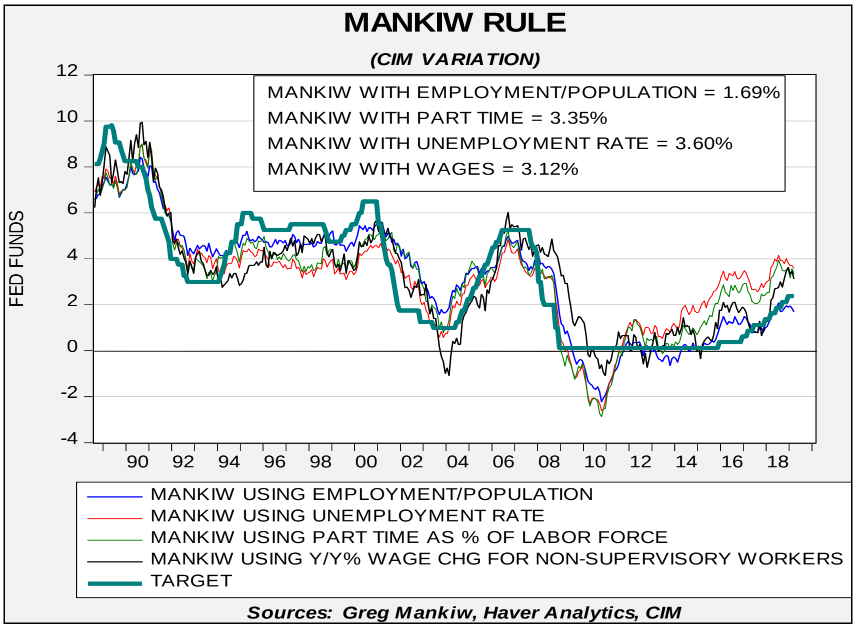
Central banks: Yesterday, the ECB and the Fed[3] gave us essentially dovish signals. As we noted yesterday, the ECB told the markets it has other tools to support the Eurozone economy. The Fed strongly suggested that policy would be on hold for the rest of the year. In our 2019 Outlook, we named a monetary policy error as one of the four risks facing the financial markets. It appears we can assume that this risk has been eliminated.

Mankiw Rule update: The Taylor Rule is designed to calculate the neutral policy rate given core inflation and the measure of slack in the economy. John Taylor measured slack using the difference between actual GDP and potential GDP. The Taylor Rule assumes that the Fed should have an inflation target in its policy and should try to generate enough economic activity to maintain an economy near full utilization. The rule will generate an estimate of the neutral policy rate; in theory, if the current fed funds target is below the calculated rate then the central bank should raise rates. Greg Mankiw, a former chair of the Council of Economic Advisers in

[1] https://apnews.com/53b9db6a174742168622f66749a61c4c?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top
[2] https://www.washingtonpost.com/world/europe/wikileakss-julian-assange-evicted-from-ecuador-embassy-in-london/2019/04/11/1bd87b58-8f5f-11e8-ae59-01880eac5f1d_story.html?utm_term=.41778ebdded4&wpisrc=nl_politics&wpmm=1
[3] https://www.ft.com/content/ac3cfa72-5bae-11e9-9dde-7aedca0a081a?emailId=5caec3df0f7aa7000439d880&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

the Bush White House and current Harvard professor, developed a similar measure that substitutes the unemployment rate for the difficult-to-observe potential GDP measure.

We have taken the original Mankiw rule and created three other variations. Specifically, our models use core CPI and either the unemployment rate, the employment/population ratio, involuntary part-time employment or yearly wage growth for non-supervisory workers. All four compare inflation and some measure of slack. Here is the most recent data:



This month, all the models are showing a drop in the estimated target rate. Three of the models would still suggest the FOMC is behind the curve and needs to be increasing the policy rate. However, the employment /population ratio implies a rather high level of slack in the economy and would suggest the Fed has already lifted rates more than necessary. Given the uncertainty in the economy, coupled with political pressure, we expect the FOMC to remain on the sidelines.

Brexit: As has been the case during this whole event, the extension was a compromise. Macron wanted a very short extension as did PM May. Most of the EU wanted to extend the deadline up to a year. They split the difference, with the deadline being moved to October 31 (we suspect the irony was lost on the participants).[4] The U.K. will participate in European elections, although the EMPs won't necessarily stay very long.

So, the good news is that, just maybe, we won't have to talk about Brexit every day for a while. Still, the whole process (or lack thereof) has been painful to watch and perhaps all of it has missed the real issue. Those of us who live in democracies have become habituated to the notion

[4] https://www.washingtonpost.com/world/europe/theresa-may-heads-to-decisive-eu-summit-to-beg-for-more-time-before-britain-brexits/2019/04/10/1b342ffa-5622-11e9-aa83-504f086bf5d6_story.html?utm_term=.f1e45d2e1d77&wpisrc=nl_todayworld&wpmm=1 and https://www.nytimes.com/2019/04/10/world/europe/uk-eu-brexit-extension.html

that compromise is possible on every point of contention.[5] To some extent, that is what makes democracy work. The American founders created a divided government that would foster compromise. But, there are some issues for which compromise probably isn't possible. Slavery turned out to be one; that was resolved through war. The two-state solution in Israel probably isn't workable because both parties claim the same land as theirs. With Brexit, there really isn't a workable middle ground. All the solutions that avoid a hard break put the U.K. in a less advantageous position than it would have been by simply remaining within the EU. So, the real decision is to either stay or leave abruptly. From an economic standpoint, it is hard to see how the U.K. will be better off with a hard break, but socially and politically it might be. It is natural for politicians to try to find a middling solution that would give most of the benefits of being in the EU, while satisfying those who want to leave. However, that natural inclination is probably not bringing us closer to a resolution. Polls suggest the U.K. public is closely divided on leaving.[6] This problem may lead to another referendum but, even if the results are reversed, the British public will remain divided. From a market perspective, in the short run, staying in the EU is the better option. In the long run, it isn't as clear cut; if Germany doesn't accept the role of regional hegemon and start absorbing EU domestic demand (in the form of a trade deficit), then the EU could devolve and therefore leaving early might have its advantages.

In light of this news, the financial markets are mostly unchanged. The EU does one thing really well—it delays hard decisions. It would not surprise us to see another delay around Halloween. So, the financial markets are assuming the status quo continues. It's probably the right call.

Trade news: There are reports that the U.S. and China are planning to create enforcement offices to monitor any trade agreements.[7] Although this doesn't eliminate all the potential sticking points, it does resolve an important one.

Cain in trouble: Although the Trump administration hasn't completed the vetting process for Herman Cain's nomination for the Fed, Senators Romney (R-UT), Murkowski (R-AK) and Gardner (R-CO) have announced they won't support his nomination. Assuming all Democrats oppose his nomination, the loss of one more Republican will doom his chances. Interestingly enough, the controversy surrounding Cain has reduced opposition to Stephen Moore. If Cain fails, we would not be surprised to see Larry Kudlow get the nod.

Dalai Lama hospitalized: The Dalai Lama is in a New Delhi hospital with a chest infection.[8] Although his condition is considered good, the news does raise questions about his succession. The CPC has always considered the Dalai Lama a threat because he represents a power that the

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[5] https://www.bloomberg.com/opinion/articles/2019-04-03/brexit-in-the-end-the-u-k-s-choice-will-be-stay-or-go?cmpid=BBD041019_AUT&utm_medium=email&utm_source=newsletter&utm_term=190410&utm_campaign=authers

[6] https://www.telegraph.co.uk/politics/2019/04/08/exclusive-britons-split-middle-no-deal-no-brexit-telegraph-poll/

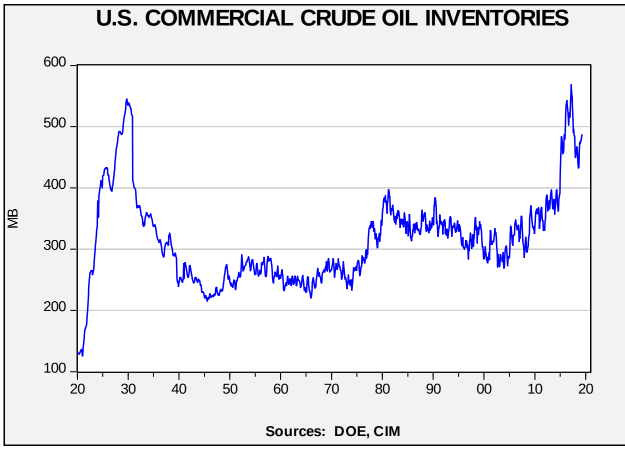
[7] https://www.ft.com/content/4a2ae4e4-5bcb-11e9-9dde-7aedca0a081a?emailId=5caec3df0f7aa7000439d880&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22&list=intlhomepage

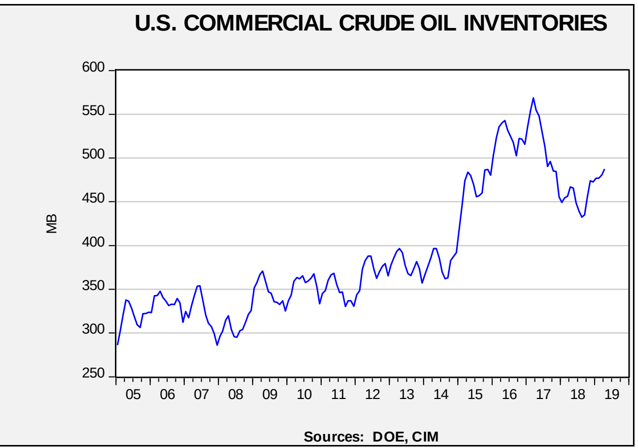
[8] https://www.reuters.com/article/us-china-tibet-dalai-lama/dalai-lama-83-hospitalized-with-chest-infection-idUSKCN1RL2EW

party can't control. China has consistently indicated it wants to approve the next Dalai Lama, which means the Buddhist designation process would be subsumed under the Chinese state.[9]

Australian elections: Australia will hold elections on May 18.[10] Current polls suggest that Labor is favored 53% to 47% in a two-party race, but the Liberal-National Coalition (conservative incumbent government) holds a small lead in a multi-party race.[11]

Energy update: Crude oil inventories rose 7.0 mb last week compared to the forecast rise of 2.5 mb.





In the details, refining activity rose 1.1%, near expectations. Estimated U.S. production was unchanged at 12.2 mbpd. Crude oil imports fell 0.2 mbpd, while exports fell 0.4 mbpd.

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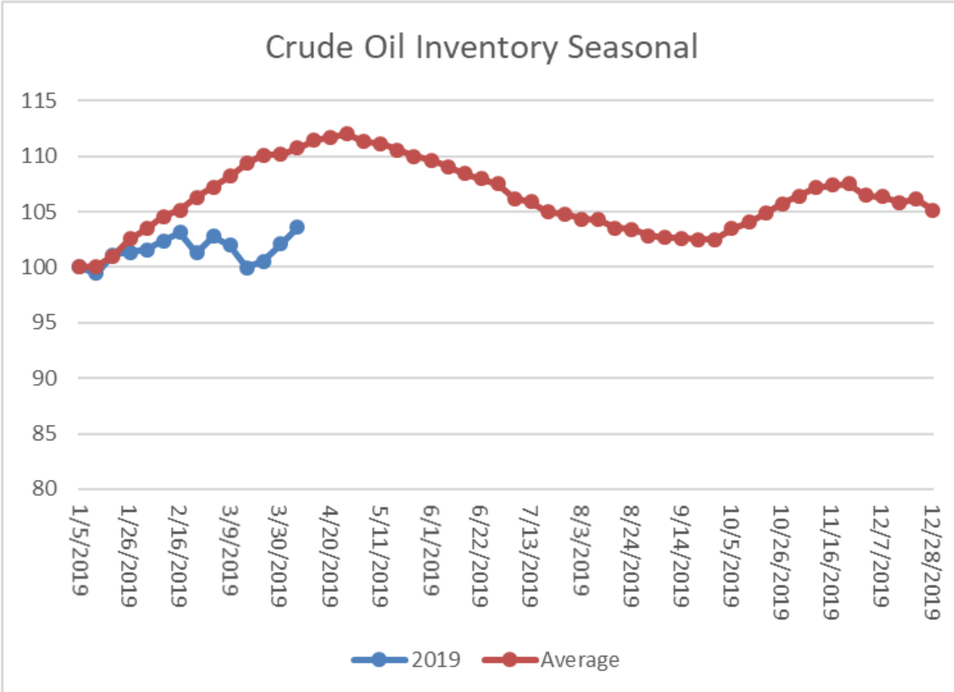
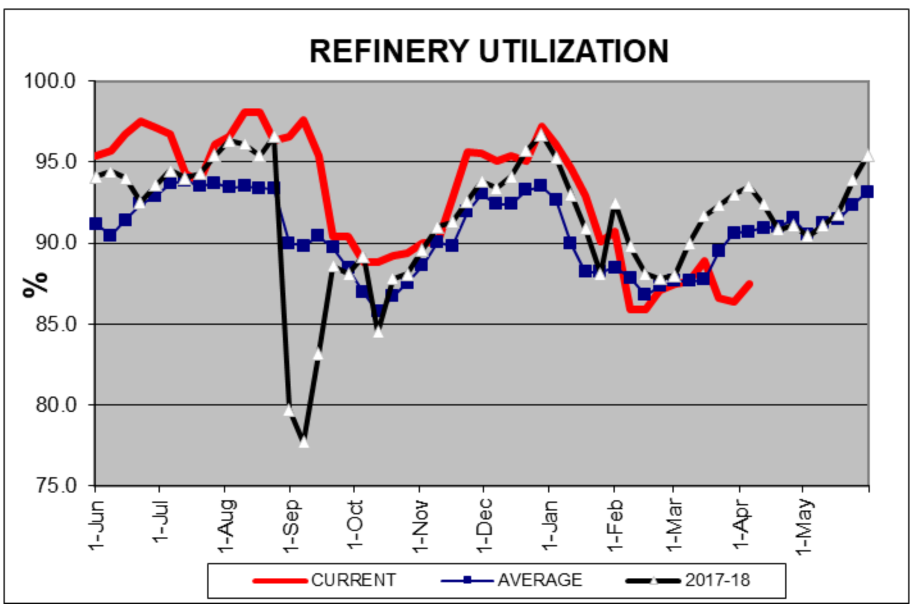
[9] https://www.ndtv.com/world-news/china-says-dalai-lamas-successor-must-have-its-approval-2020939
[10] https://www.ft.com/content/0967dfa6-5b9a-11e9-939a-341f5ada9d40?emailId=5caec3df0f7aa7000439d880&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22
[11] https://en.wikipedia.org/wiki/Opinion_polling_for_the_2019_Australian_federal_election



(Sources: DOE, CIM)

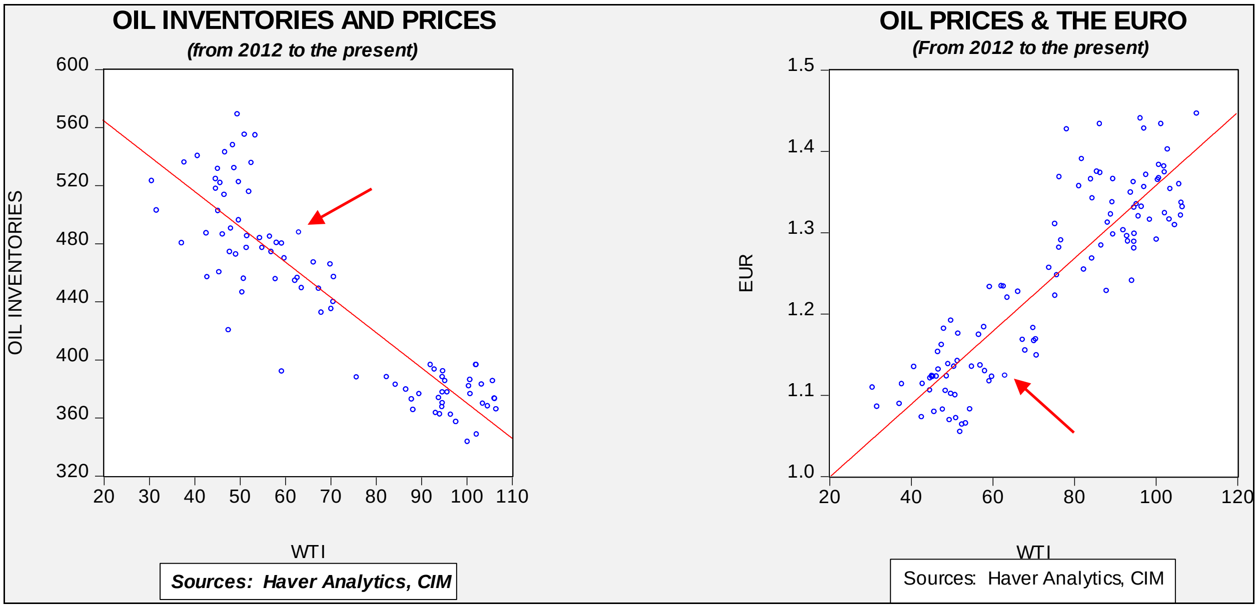
This is the seasonal pattern chart for commercial crude oil inventories. We are nearing the end of the spring build season and will probably not achieve average, although the gap has narrowed significantly over the next two weeks.

Refinery activity is still lagging average.



(Sources: DOE, CIM)

Usually by this week we are seeing utilization above 90%. Given the 7.2 mb decline in gasoline stocks, we would look for rising utilization in the coming weeks.

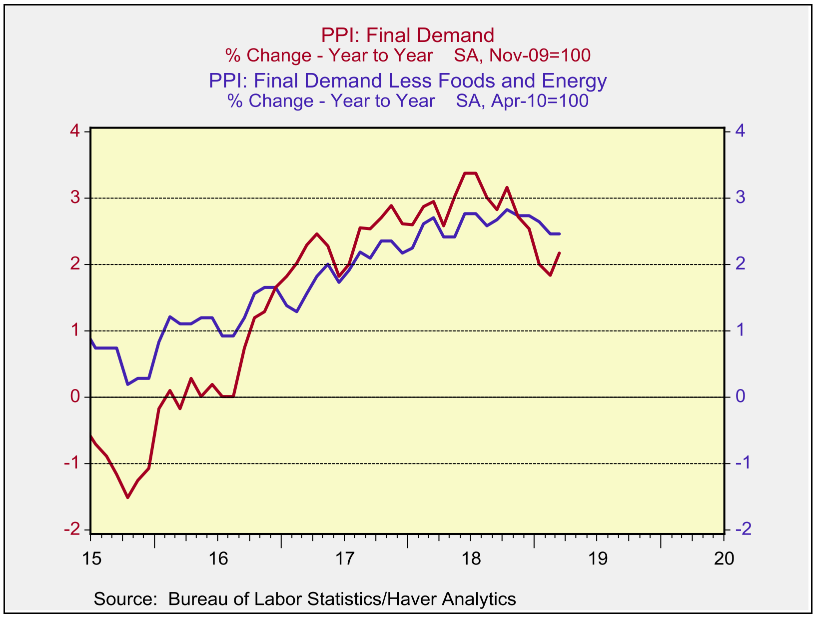


Based on oil inventories alone, fair value for crude oil is $55.33. Based on the EUR, fair value is $51.99. Using both independent variables, a more complete way of looking at the data, fair value is $52.27. Current prices are running well above fair value. Geopolitical risks, including the unrest in Libya, continued problems in Iraq, falling Venezuelan output[12] and the upcoming decision on Iranian oil export waivers, are lifting prices. However, our data does suggest the markets are getting a bit rich, so evidence that any of these situations are improving will likely lead to a pullback in prices.

U.S. Economic Releases

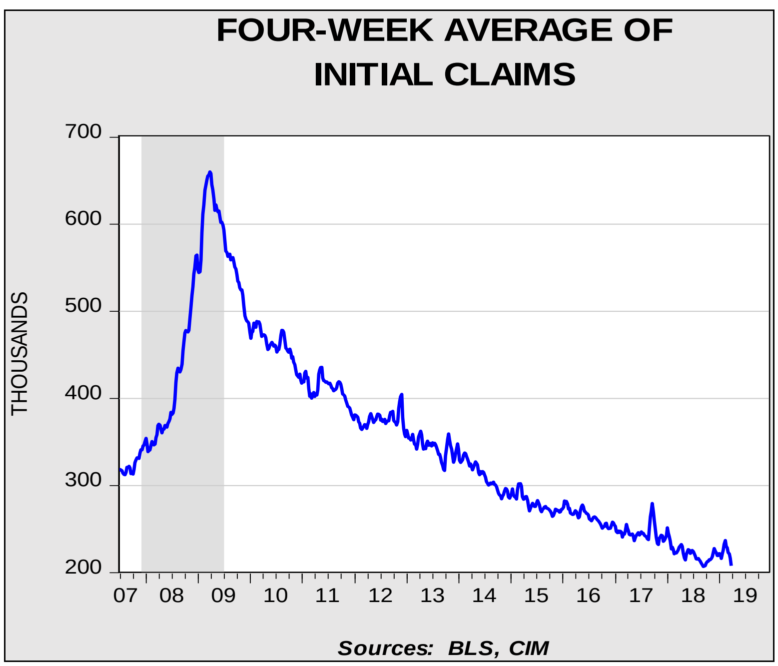
PPI final demand came in above expectations, rising 0.6% from the prior month compared to the forecast gain of 0.3%. PPI excluding food and energy also came in above expectations, rising 0.3% from the prior month compared to the forecast of 0.2%. Core PPI, which excludes food, energy and trade services, came in below expectations, remaining unchanged from the prior month compared to the forecast of 0.2%.

[12] https://www.reuters.com/article/us-iea-oil/venezuela-oil-output-plummets-to-870000-bpd-on-outages-sanctions-iea-idUSKCN1RN0QY?il=0



The chart above shows the year-over-year change in headline PPI and core PPI, which rose 2.2% and 2.0%, respectively.

Initial jobless claims came in below expectations at 196k compared to the forecast of 210k. The prior report was revised upward from 202k to 204k. This is the first time that weekly claims have been below 200k since November 1969.



The chart above shows the four-week moving average for initial claims. The four-week moving average fell from 215.5k to 207.0k.

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	Bloomberg Consumer Comfort	m/m	apr		58.9	**
Fed speakers or events						
EST	Speaker or event	District or position				
14:00	Neel Kashkari speaks on wages and policy	President of Federal Reserve Bank of Minneapolis				
16:00	Michelle Bowman Speaks on Community Banking	Federal Reserve Board				

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	CPI	y/y	mar	2.3%	1.5%	2.3%	***	Equity and bond neutral
	PPI	y/y	mar	0.4%	0.1%	0.4%	**	Equity and bond neutral
Japan	Money stock M2	y/y	mar	2.4%	2.4%	2.4%	**	Equity and bond neutral
	Money stock M3	y/y	mar	2.1%	2.1%	2.1%	**	Equity and bond neutral
	Japan buying foreign bonds	y/y	mar	-¥1.753 tn	¥1.244 tn		*	Equity and bond neutral
	Japan buying foreign stocks	m/m	mar	¥0.104 tn	¥0.062 tn		*	Equity and bond neutral
	Foreign buying Japan bonds	m/m	mar	¥0.874 tn	¥1.571 tn		*	Equity and bond neutral
	Foreign buying Japan stocks	m/m	mar	¥1.464 tn	¥0.439 tn		*	Equity and bond neutral
	Tokyo Average Office Vacancies	m/m	feb	1.78	1.78		**	Equity and bond neutral
Australia	Consumer Inflation Expectations	m/m	apr	3.9%	4.1%		***	Equity and bond neutral
New Zealand	Food Prices	m/m	mar	0.5%	0.4%		***	Equity and bond neutral
EUROPE								
Germany	CPI	y/y	mar	1.3%	1.3%	1.3%	***	Equity and bond neutral
	CPI EU Harmonized	y/y	mar	1.4%	1.4%	1.4%	***	Equity and bond neutral
France	CPI	y/y	mar	1.1%	1.1%	1.1%	***	Equity and bond neutral
	CPI EU Harmonized	y/y	mar	1.3%	1.3%	1.3%	***	Equity and bond neutral
AMERICAS								
Mexico	Nominal Wages	y/y	mar	6.5%	6.0%		***	Equity and bond neutral
	ANTAD Same-Store Sales	y/y	mar	0.6%	3.3%		**	Equity and bond neutral
Brazil	IBGE Inflation IPCA	y/y	mar	4.6%	3.9%	4.5%	***	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)	258	258	0	Up
3-mo T-bill yield (bps)	236	237	-1	Neutral
TED spread (bps)	22	22	0	Neutral
U.S. Libor/OIS spread (bps)	241	240	1	Up
10-yr T-note (%)	2.48	2.47	0.01	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	14	13	1	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	flat			Up
yen	down			Neutral
pound	flat			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	$71.14	$71.73	-0.82%	Bearish IEA Report
WTI	$64.05	$64.61	-0.87%	
Natural Gas	$2.71	$2.70	0.30%	
Crack Spread	$22.16	$22.33	-0.77%	
12-mo strip crack	$18.00	$18.05	-0.28%	
Ethanol rack	$1.46	$1.46	-0.12%	
Metals				
Gold	$1,301.28	$1,307.99	-0.51%	
Silver	$15.10	$15.24	-0.94%	
Copper contract	$291.20	$292.55	-0.46%	
Grains				
Corn contract	$ 371.00	$ 370.75	0.07%	
Wheat contract	$ 464.00	$ 461.50	0.54%	
Soybeans contract	$ 901.50	$ 902.00	-0.06%	
Shipping				
Baltic Dry Freight	734	725	9	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	7.0	2.5	4.5	
Gasoline (mb)	-7.7	-2.0	-5.7	
Distillates (mb)	-0.1	-1.5	1.4	
Refinery run rates (%)	1.10%	1.00%	0.10%	
Natural gas (bcf)		33.0		

Weather

The 6-10 and 8-14 day forecasts shows cooler temps for most of the country, with warmer temps on the two coasts. Precipitation is expected for most of the country. A major winter storm is dumping prodigious amounts of snow across the northern plains. This will likely delay corn planting and increase flooding in the Midwest and southern river systems.

Asset Allocation Weekly

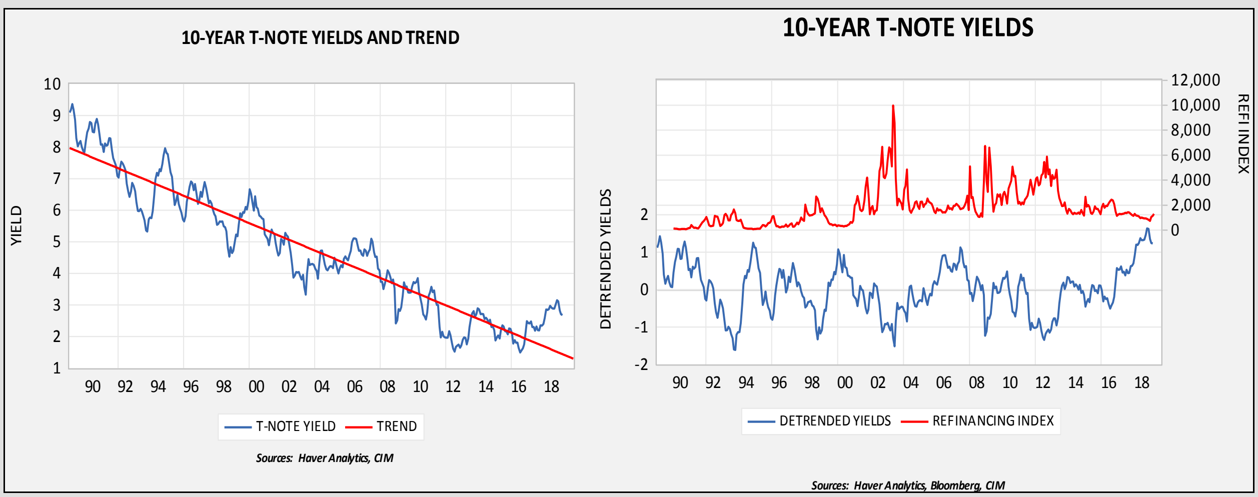
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

April 5, 2019

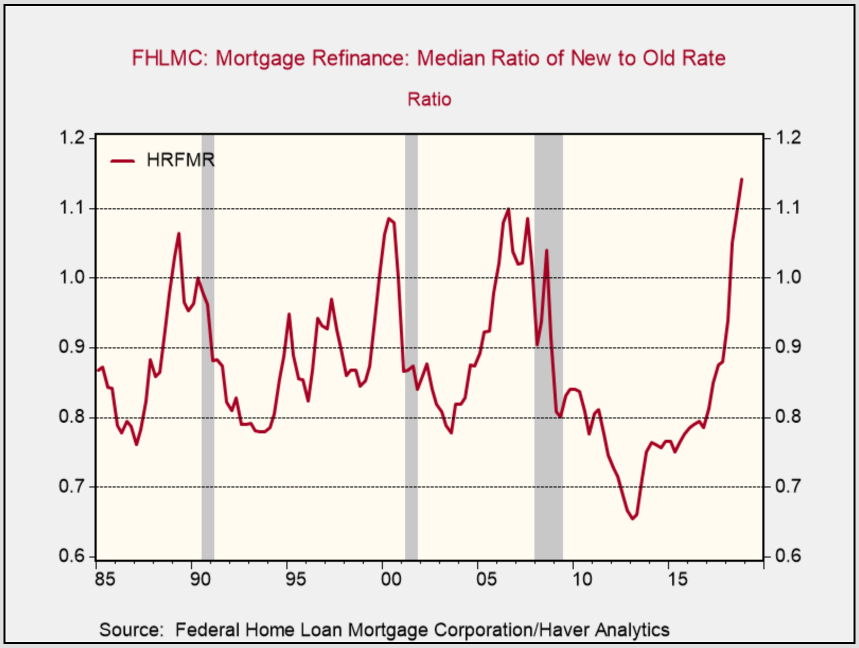
Mortgage-backed securities have rather odd characteristics compared to Treasuries. At their most basic level, mortgages are bonds—prices are inversely related to yields. The pricing on mortgages assumes a certain level of refinancing activity. However, when yields rise, expected mortgage duration tends 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.

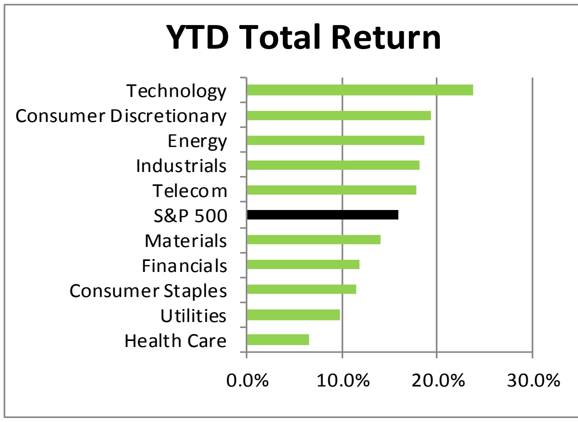


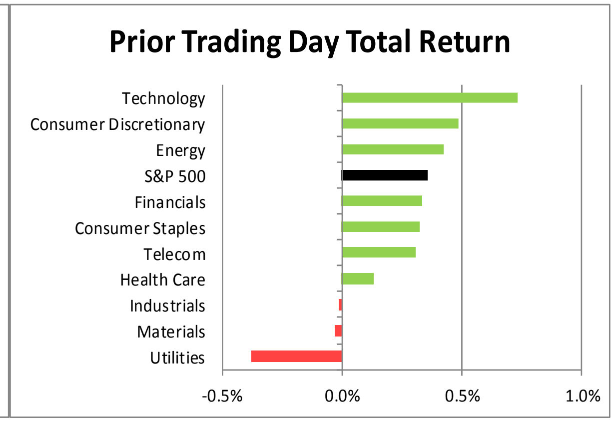
This chart shows the ratio of the new rate to the old rate. When the old rate is higher than the new rate, the ratio is less than 1.0. Note that this ratio is now at a new record high. Essentially, buyers are refinancing at a less advantageous rate to extract home equity.

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.

Data Section

U.S. Equity Markets – (as of 4/10/2019 close)

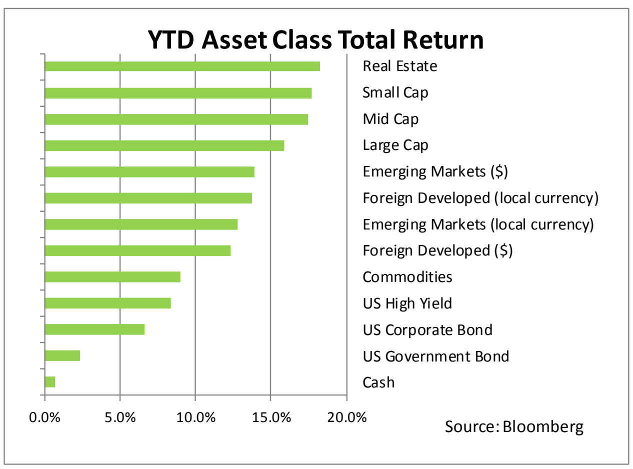




(Source: Bloomberg)

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 4/10/2019 close)

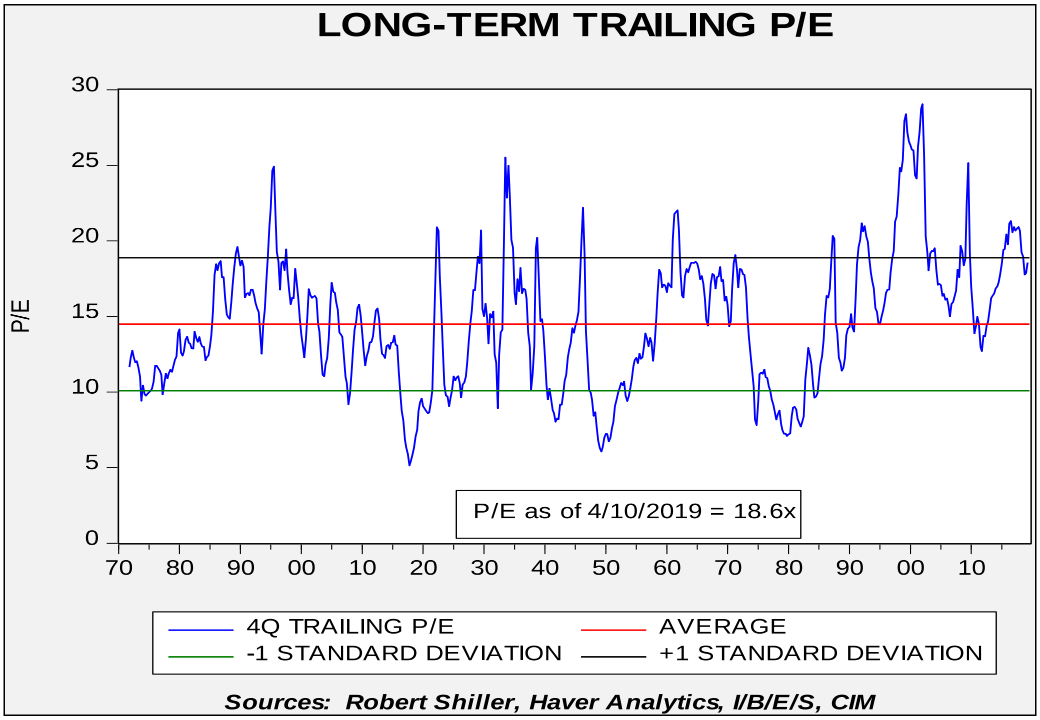


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 11, 2019



Based on our methodology,[13] the current P/E is 18.6x, up 0.1x from last week. The increase in the multiple is mostly due to the recent rise in the index.

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.

[13] 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.