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.

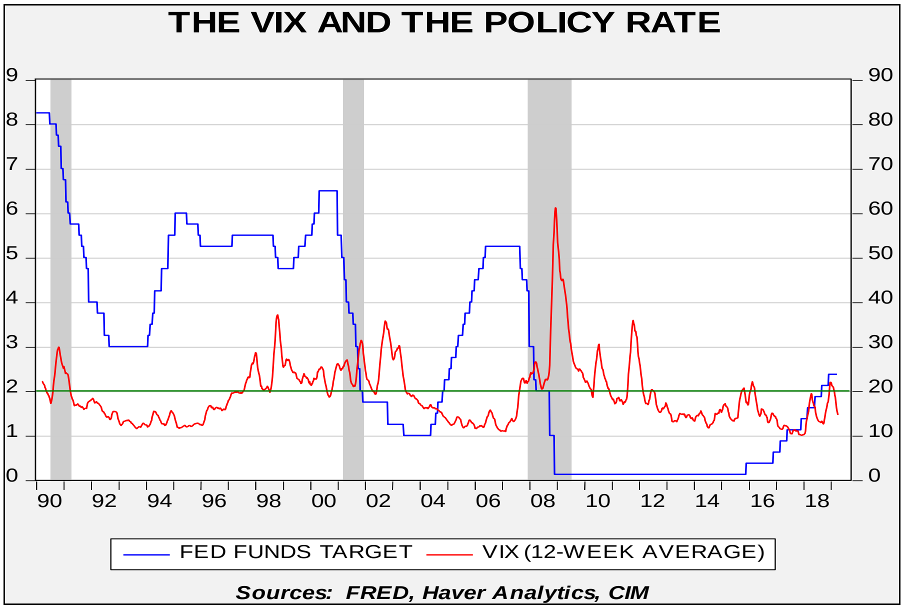
[Posted: April 16, 2019—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.2% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.8% from the prior close. Chinese markets were higher, with the Shanghai composite up 2.4% and the Shenzhen index up 2.1%. U.S. equity index futures are signaling a flat open. With 29 companies having reported, the S&P 500 Q4 earnings stand at $37.42, higher than the $37.29 forecast for the quarter. The forecast reflects a 2.0% decrease from Q1 2018 earnings. Thus far this quarter, 19.1% of the companies reported earnings above forecast, while 36.4% reported earnings below forecast.

Equities are trending higher in a quiet trade. Media is focused on the tragic Notre Dame fire. Here is what we are watching:

Fed talk: Chicago FRB President Evans and Boston FRB President Rosengren (both voters this year) made essentially dovish statements on monetary policy. Both suggested that inflation should be allowed to move above the 2% target since it has been below target for an extended period.[1] For most of their tenures, both were considered to lean dovish on policy. However, in recent years, both had become more hawkish, citing worries about easy policy causing distortions in the financial markets. Governor Brainard has made similar indications. Although there is theoretical support for such a policy stance (Hyman Minsky would be supportive), in practice, it's pretty difficult to pull off. Imagine a Fed chair going to Congress and admitting the Fed raised rates to trigger a correction in stocks because the central bank ascertained that the P/E was too high. At the same time, we have showed that the Fed might consider equity volatility in setting policy.[2]

[1] https://www.reuters.com/article/us-usa-fed-evans/fed-should-communicate-comfort-with-slightly-higher-inflation-evans-idUSKCN1RR1U9 and https://www.wsj.com/articles/fed-official-is-open-to-adopting-an-inflation-target-range-11555372800?mod=hp_major_pos10

[2] See Asset Allocation Weekly (1/11/2019)



Since the early 1990s the Fed has tended to tighten when the Vix is below 20 (on a 12-week moving average basis). The only time the Fed raised rates with an elevated Vix was in the late 1990s. We note that Greenspan waited for the Vix to fall below 20 before raising rates and Yellen started raising rates after the Vix had been below 20 for a long period of time, only to stop when the Vix spiked. The recent pause is consistent with the rising Vix, although we would note that the Vix has been declining and if it continues we would expect pressure from Rosengren, Evans and Brainard for a rate hike. That's why dovish comments from the Boston and Chicago FRB leaders are important and likely lifting the market today.

Trade talk: The EU and Japan are engaging in trade talks with the U.S. The EU's discussions look like a stall tactic; the Europeans want to conclude talks by year's end. By then, the U.S. presidential election process will be in full swing and EU officials know the White House will want to have talks wrapped up so the president can concentrate on reelection. We also note that the EU refuses to open up negotiations on agriculture and wants to avoid specific measures on autos. We doubt that U.S. negotiators will tolerate these limits.[3] We also note that the EU is considering separate tariffs on U.S. exports, up to €20 bn, if the U.S. penalizes the EU over aircraft subsidies.[4] Two takeaways—first, the EU plans to "slow walk" broader negotiations with hopes that either elections or a new government will relieve trade pressure, and second, the potential for a trade conflict may be falling with China but it may be rising with the EU. The market impact would be the same—bad for risk assets. Meanwhile, trade negotiations with Japan began yesterday.[5] Japan wants to separate talks on goods and services from forex; we suspect Japan is quite pleased with the current level of the JPY and does not want it to strengthen toward parity, which is estimated to be around ¥60.

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[3] https://www.reuters.com/article/us-usa-trade-eu/eu-says-it-is-ready-to-launch-u-s-trade-talks-but-without-agriculture-idUSKCN1RR0OZ
[4] https://www.ft.com/content/79691cea-5d37-11e9-9dde-7aedca0a081a?fbclid=IwAR0hkTgjsq6fnOxtJip7O-hLNnNl8Ubqf6NgkGOY-r46gTz43AUbgcrPQ58
[5] https://www.reuters.com/article/us-usa-trade-japan/japan-and-us-hold-frank-and-good-trade-talks-economy-minister-idUSKCN1RR2GC

Shadow lending tightening: In the financial system, there are traditional banks and "shadow" banks. Both do lending but the latter do not take in deposits.[6] Essentially, lenders make money on the spread; either on a time spread, by borrowing short and lending long, or on credit, by borrowing low-risk liabilities and lending to riskier assets. Traditional banks are regulated, whereas shadow banks are generally not. At the same time, shadow banks don't have access to the Fed's discount window, where banks can tap funds in times of stress. Thus, shadow lenders have two significant risks. The first is that the flow of funding, essentially the short-term money markets (repo, for example), freezes up; this risk is heightened due to the lack of access to the Fed window. The second is that loans stop performing. With regard to the latter, some notable shadow lenders announced they are taking steps to reduce loan exposure on fears of economic weakness.[7] Paradoxically, these actions can accelerate the trend toward a downturn because even if borrowing costs fall to the shadow banks reluctance to lend can end up weakening economic growth.

A political microcosm: One of the reasons we track U.K. politics is because it often offers insight into American politics. The commonality of language and support for free markets (both nations are considered "Anglo-Saxon" by continental Europe) are likely the reasons for the similarities. Brexit has been interesting to watch because it isn't directly represented by a person. Instead, it is an idea. When a person represents an idea, the concept itself can get muddled; a voter may oppose the policy of a political figure but like his image and thus continue to support him (it can work the other way, too). This notion relates to what American pundits refer to as the "beer test"—would a voter like to have a beer with this person.

Brexit relieves us of the personality factor. Large political parties strive to be a "big tent"; they want to avoid clear ideological boundaries and instead project rather amorphous values. Within political parties, there are ideologs that try to force the parties to pure positions. The leadership of large parties try to avoid this development and keep the focus on personalities because they see that as the best way to gather a larger swath of votes.

With Brexit, the personality factor is reduced and in its place are two difference visions of state and the future. Leavers want a singular U.K. that is provincial and nationalist; Remainers have a more cosmopolitan view of the world, one that has close ties to the EU. Recent polling shows that the electorate is breaking down, about evenly, between leave and remain. Regardless of who wins, the loser will be a significant minority, one that feels its vision for the country has been lost. For example, among Labour supporters in the poorer parts of Britain, there has been a shift to the Conservatives, who are seen as leavers. Meanwhile, Tories in London who support remaining are shifting allegiance to Labour.[8]

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[6] Most believe that traditional banks lend out deposits but, in reality, they are not much different than shadow banks in that they don't really need deposits to make loans. https://www.zerohedge.com/contributed/2014-03-20/bank-england-admits-loans-come-first-%E2%80%A6-and-deposits-follow

[7] https://www.reuters.com/article/us-usa-economy-online-lenders-focus/worried-a-recession-is-coming-u-s-online-lenders-reduce-risk-idUSKCN1RR0BB?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosmarkets&stream=business

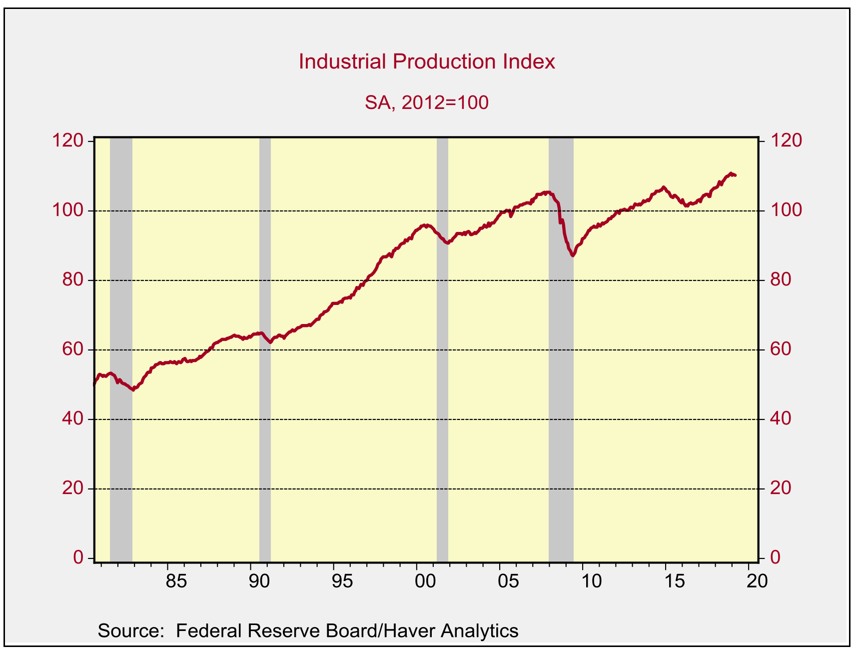
[8] https://www.politico.eu/article/brexit-culture-war-in-numbers-exclusive-poll/?utm_source=POLITICO.EU&utm_campaign=809df01d25-EMAIL_CAMPAIGN_2019_04_16_04_58&utm_medium=email&utm_term=0_10959edeb5-809df01d25-190334489

Brexit likely represents a reconfiguration of the two parties; Labour could become the party of the educated and moneyed class (of course, for this to happen Corbyn has to go) and the Tories could become the party of the lower working classes, sprinkled with old-line traditional nationalists from old money. A similar mixing is likely occurring in the U.S., with the GOP rapidly becoming the party of the working class and the Democrats becoming the party of educated technocrats and Greens.

For this reason, we continue to monitor the path of Brexit not so much because of what the British exit or non-exit means but for the potential harbinger of political changes in the U.S. We do expect that if the U.K. leaves, the short-run impact will be difficult, but in the long run it probably makes sense to go because we doubt the EU will last for another decade. Thus, leaving early will probably be a benefit. But, as noted, Brexit reflects political division that are becoming clearer in the U.S. What is uncertain is how the political landscape will look in the future as these divisions are resolved.

U.S. Economic Releases

Industrial production for March came in weaker than forecast, falling 0.1% from the prior month compared to the forecast gain of 0.2%. Capacity utilization was 78.8%, below the 79.2% expected.



The chart above shows the Industrial Production Index. The current reading is 110.2, just below last month's 110.3.

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	NAHB Housing Market Index	m/m	apr	63	62	**

Fed speakers or events		
EST	**Speaker or event**	**District or position**
14:00	Robert Kaplan Speaks at Community Forum in NYC	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	New Home Prices	m/m	mar	0.6%	0.5%		***	Equity and bond neutral
Japan	Tertiary Industry Index	m/m	mar	-0.6%	0.4%	-0.2%	***	Equity and bond bearish
India	Wholesale Prices	y/y	mar	3.2%	2.9%	3.2%	**	Equity and bond neutral
	Trade Balance	m/m	mar	-$10.890 bn	-$9.595 bn	-$9.713 bn	**	Equity bearish, bond bullish
Australia	ANZ Roy Morgan Weekly Consumption	m/m	apr	115.3	113.2		**	Equity and bond neutral
New Zealand	Non Resident Bond Holdings	m/m	mar	55.6%	55.2%		**	Equity and bond neutral
EUROPE								
Eurozone	Construction Output	m/m	feb	5.2%	-1.4%		**	Equity bullish, bond bearish
	ZEW Survey Expectations	y/y	apr	4.5	-2.5		**	Equity bullish, bond bearish
Germany	ZEW Survey Expectations	y/y	apr	3.1	0.5	-3.6	**	Equity bullish, bond bearish
	ZEW Survey Current Situation	y/y	apr	5.5	11.1	8.5	**	Equity bearish, bond bullish
UK	Claimant Count Rate	y/y	mar	3.0%	2.9%		***	Equity and bond neutral
	Jobless Claims Change	y/y	feb	28.3k	27.0k		***	Equity and bond neutral
	ILO Unemployment Rate 3mths	y/y	feb	3.9%	3.9%	3.9%	***	Equity and bond neutral
	Employment Change	m/m	feb	179k	222k	181k	**	Equity and bond neutral
Switzerland	Real Estate Index Family Homes	q/q	1q	469.0	468.5		***	Equity and bond neutral
Russia	Industrial Production	y/y	mar	1.2%	4.1%	2.8%	**	Equity bearish, bond bullish
AMERICAS								
Mexico	Formal Job Creation Total	y/y	mar	48.5k	126.0k		**	Equity bearish, bond bullish
Canada	Existing Home Sales	y/y	feb	3.8%	2.1%	4.0%	**	Equity and bond neutral
	Bloomber Nanos Confidence	m/m	feb	55.8	55.5		**	Equity and bond neutral
	BoC Overall Business Outlook	q/q	1q	-0.6	2.2		**	Equity and bond neutral
	BoC Senior Loan Officer Survey	q/q	1q	-2.7	-16.0		***	Equity and bond neutral
	BoC Business Outlook Future	q/q	1q	6.00	-1.00		***	Equity bullish, bond bearish

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	260	0	Up
3-mo T-bill yield (bps)	236	236	0	Neutral
TED spread (bps)	25	24	1	Neutral
U.S. Libor/OIS spread (bps)	241	241	0	Up
10-yr T-note (%)	2.57	2.56	0.01	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	16	16	0	Down
Currencies	**Direction**			
dollar	flat			Neutral
euro	flat			Up
yen	up			Neutral
pound	flat			Neutral
franc	down			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	$71.16	$71.18	-0.03%	
WTI	$63.45	$63.40	0.08%	
Natural Gas	$2.59	$2.59	0.04%	
Crack Spread	$21.38	$21.68	-1.35%	
12-mo strip crack	$17.67	$17.87	-1.10%	
Ethanol rack	$1.47	$1.47	-0.07%	
Metals				
Gold	$1,283.96	$1,287.95	-0.31%	
Silver	$14.94	$15.00	-0.38%	
Copper contract	$293.50	$293.50	0.00%	
Grains				
Corn contract	$ 370.00	$ 371.50	-0.40%	
Wheat contract	$ 458.50	$ 463.25	-1.03%	
Soybeans contract	$ 910.50	$ 912.50	-0.22%	
Shipping				
Baltic Dry Freight	738	726	12	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.0		
Gasoline (mb)		-2.6		
Distillates (mb)		-1.0		
Refinery run rates (%)		0.95%		

Weather

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

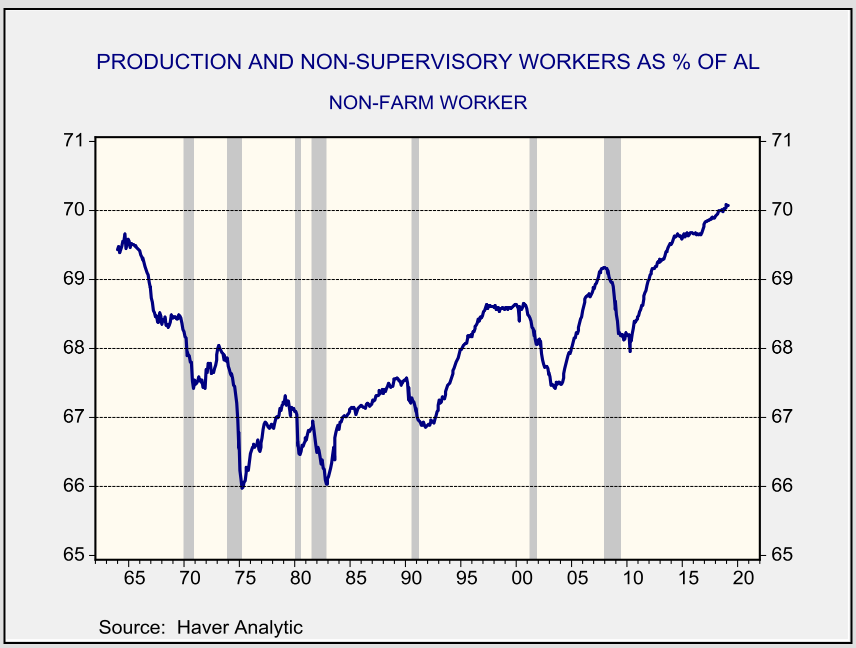
Asset Allocation Weekly

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 12, 2019

The employment data is closely watched by financial markets; although the data isn't necessarily a leading indicator for the economy, it is probably the most important from a political and social perspective. Weak employment data is a worry for political incumbents and concerning to policymakers. However, beyond the headline data, there are usually interesting trends worth noting. In this week's report, we will examine two trends that have longer term implications.

Career paths were part of corporate culture three decades ago. Large companies often had junior executive programs, where promising young talent was brought to the firm and would follow a rotation of positions in numerous departments before finding a permanent home. In other situations, college graduates would join a company and follow a path of positions of increasing responsibility. However, over the years, outsourcing jobs overseas and increasing industry concentration[9] have probably reduced the number of entry level professional positions in the U.S. This chart shows the percentage of production and non-supervisory workers compared to total non-farm employment.

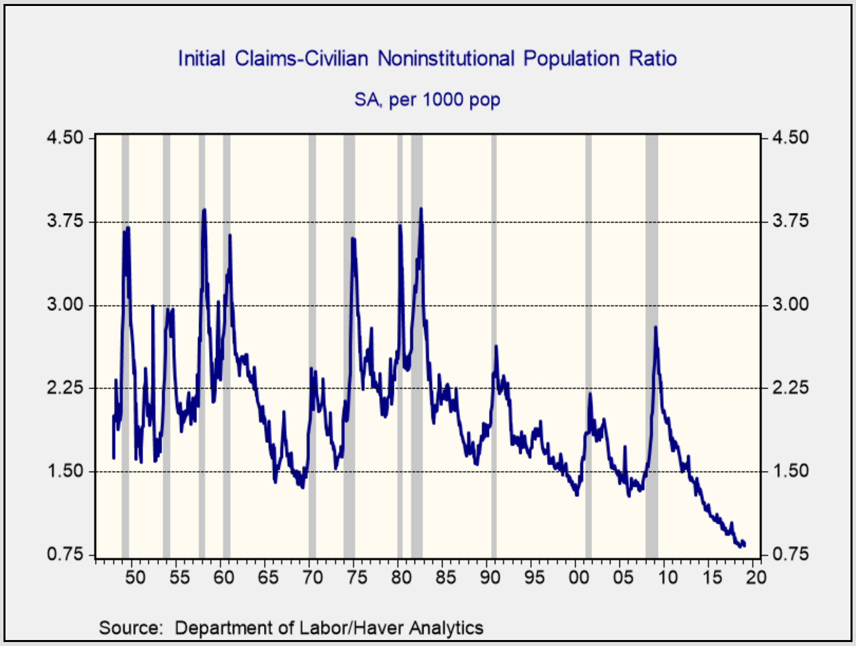


In the 1970s, this percentage declined to a low of 66%. However, since the early 1980s, the percentage has steadily increased in each business cycle. This data suggests that an increasing number of jobs are non-management positions. We suspect that college graduates are being forced to accept non-management positions as fewer of them are available for an increasing

[9] https://finance.eller.arizona.edu/sites/finance/files/grullon_11.4.16.pdf

number of graduates. Such disappointment has the potential to cause social unrest. At the same time, reversing industry concentration would tend to boost the number of management jobs in the economy (every firm needs HR, finance, etc.). Thus, support for anti-trust actions could become more popular.

Second, initial claims, on a weekly basis, fell to 40-year lows recently. However, the weekly data is "noisy" and can be affected by floating holidays and weather. Another way of looking at claims is to scale to the civilian non-institutional population. This data is at historic lows.

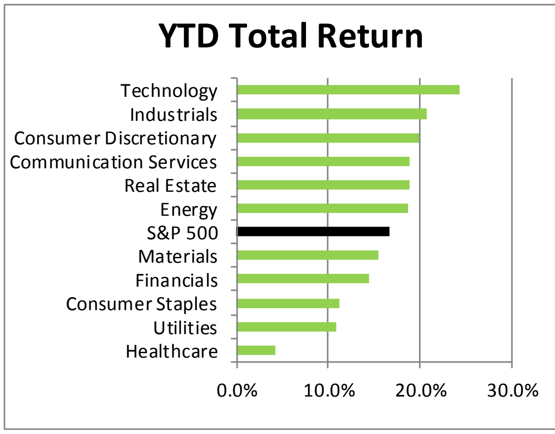


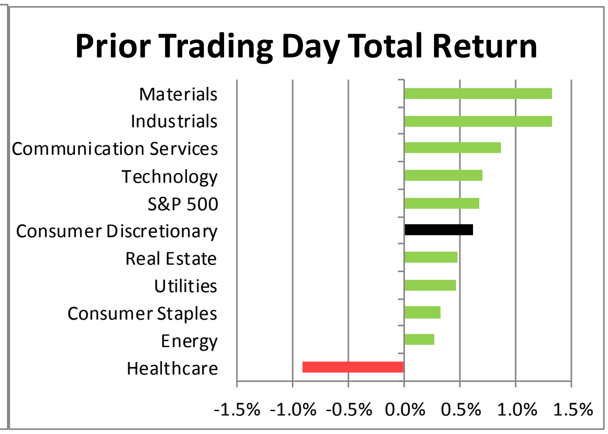
This low level of claims is likely due, in part, to firms holding on to workers because of tight labor conditions. A rising number of retirees will lift the non-working civilian non-institutional population but fewer workers will tend to depress claims. In any case, this level of claims compared to the population is remarkably low and would argue that wages should rise.

Overall, these two charts offer insights into longer term issues in the labor market. They won't have an immediate effect on financial markets, but both signal potential for further disruption.

Data Section

U.S. Equity Markets – (as of 4/15/2019 close)

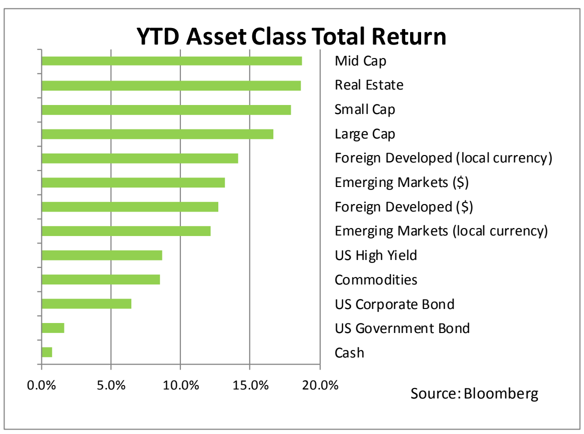




(Source: Bloomberg)

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. These charts represent the new sectors following the 2018 sector reconfiguration.

Asset Class Performance – (as of 4/15/2019 close)

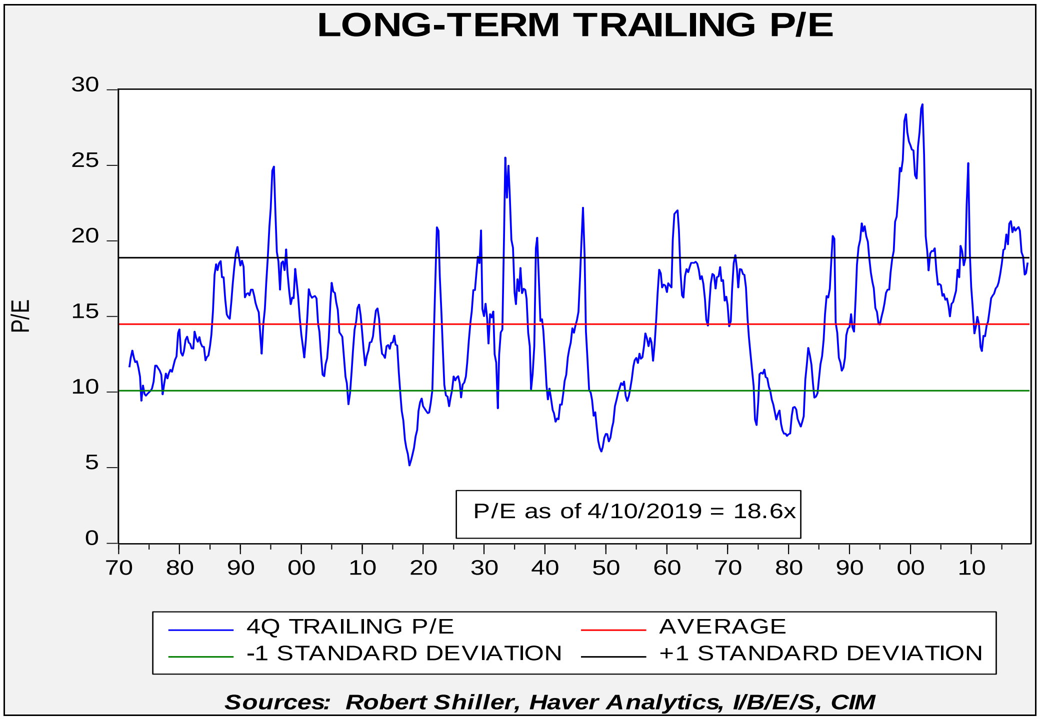


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[10] 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.

[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 (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.