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 22, 2019—9:30 AM EDT] Global equity markets are generally mixed this morning. The EuroStoxx 50 is up 0.6% from the last close. In Asia, the MSCI Asia Apex 50 was unchanged from the prior close. Chinese markets were lower, with the Shanghai composite down 1.7% and the Shenzhen index down 1.5%. U.S. equity index futures are signaling a lower open. With 46 companies having reported, the S&P 500 Q4 earnings stand at $37.31, higher than the $37.29 forecast for the quarter. The forecast reflects a 2.0% decrease from Q1 2018 earnings. Thus far this quarter, 89.1% of the companies reported earnings above forecast, while 10.1% reported earnings below forecast.

Happy Easter Monday! Most of Europe is closed today, along with a few Asian markets (Australia, New Zealand). It's also Earth Day. There was a horrific terror event Easter Sunday against Christians in Sri Lanka.[1] Here is what we are watching:

Oil: The Trump administration is signaling that there will be no more import waivers granted on Iranian oil.[2] This decision was something of a surprise. Although SoS Pompeo and National Security Director Bolton supported this hardline stance, the president was reluctant to take this step for fear of higher oil prices.[3] In response, oil prices have jumped on the news. In other Iranian news, the Supreme Leader Khamenei announced the replacement of the commander of the Iranian Republican Guard Corps (IRCG). Gen. Hossein Salami was elevated to the post, while Gen. Mohammad Ali Jafari was removed.[4] Salami is considered a hardliner (in a rather hardline group), so this move does suggest Iran is preparing for a more hostile environment.

Iran is the proximate cause for today's lift but we have noted that overall geopolitical risk is adding around $10 to $12 per barrel to the price of oil; the current price is well above what the dollar and oil inventories would suggest. In Libya, the Trump administration shifted course with

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1 https://www.nytimes.com/2019/04/21/world/asia/sri-lanka-bombings.html?emc=edit_MBE_p_20190422&nl=morning-briefing&nlid=5677267tion%3DtopNews&section=topNews&te=1

2 https://www.wsj.com/articles/u-s-to-end-iran-oil-waivers-to-drive-tehrans-exports-to-zero-11555898664?mod=hp_lead_pos2

3 https://www.reuters.com/article/us-global-oil/oil-prices-jump-more-than-2-percent-as-u-s-set-to-end-iran-import-sanction-waivers-idUSKCN1RY00J?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosmarkets&stream=business

4 https://www.nytimes.com/2019/04/21/world/middleeast/iran-revolutionary-guards-leader.html?emc=edit_MBE_p_20190422&nl=morning-briefing&nlid=5677267ion%3DwhatElse&section=whatElse&te=1

regard to political leadership, offering a full endorsement of Khalifa Hifter.[5] Hifter, a former Libyan general under Khaddaffi who broke with the late Libyan leader, offers a secular leadership option for the country. It isn't clear if the endorsement will lead to overt support, such as equipment and funding. So far, Hifter has been less than impressive on the battlefield.[6] If the conflict escalates, the potential for further supply disruption is high.

Venezuela remains problematic. Electricity outages, trade restrictions and sanctions continue to weigh on production. There are reports that the Russians are helping Caracas evade sanctions.[7] Although this action might support an increase in Venezuelan supplies, we doubt the U.S. will allow this evasion to continue indefinitely.

Although we remain bullish on oil prices, we are at the point where the primary bullish factor is geopolitical. We are probably approaching a crux where it will be difficult for prices to sustain these levels without either (a) a continued flow of news that signals further supply disruptions, or (b) improving fundamentals (falling inventories or dollar weakness).

A funny guy wins in Ukraine: The voters in Ukraine have spoken with a landslide victory[8] for Volodymyr Zelensky, defeating incumbent president Petro Poroshenko. Zelensky has no political experience—in fact, he played a political leader on a Ukrainian TV show.[9] Zelensky is a comedian by trade and his victory is another indication of the anti-incumbent mood of electorates and the desire for something "different" across the West. It is unclear how well Zelensky will govern a difficult nation in an unsettled geopolitical environment, but voters in Ukraine were apparently willing to take the chance.

China: Reports that Chinese leaders are more focused on reform and less on boosting growth led to a slump in Chinese equities today.[10] According to reports, in a review of the Q1 economy, the 25-member Politburo congratulated themselves for navigating the trade conflict with the U.S. and signaled that Chinese policy will continue to focus on reform and show less concern toward excessive growth.[11] The need for economic restructuring is nothing new; China is in the midst of the difficult shift from investment-led growth to consumer-led growth. When the U.S. went

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5 https://www.nytimes.com/2019/04/19/world/middleeast/trump-libya-khalifa-hifter.html?searchResultPosition=12

6 https://www.nytimes.com/reuters/2019/04/21/world/africa/21reuters-libya-security.html?searchResultPosition=2

7 https://www.reuters.com/article/us-venezuela-politics-rosneft-exclusive/exclusive-venezuela-skirts-u-s-sanctions-by-funneling-oil-sales-via-russia-idUSKCN1RU2A4?feedType=RSS&feedName=businessNews

8 https://www.nytimes.com/2019/04/21/world/europe/ukraine-elections-zelenskiy.html?emc=edit_MBE_p_20190422&nl=morning-briefing&nlid=5677267tion%3DtopNews&section=topNews&te=1

9 https://www.washingtonpost.com/world/as-ukraine-votes-in-presidential-runoff-a-comedian-looks-to-unseat-the-incumbent/2019/04/21/b7d69a38-603f-11e9-bf24-db4b9fb62aa2_story.html?utm_term=.c9eb055e69cf&wpisrc=nl_todayworld&wpmm=1

10 https://www.reuters.com/article/china-stocks-close/china-stocks-fall-most-in-nearly-4-weeks-on-worries-beijing-may-slow-policy-easing-idUSZZN2RKA00

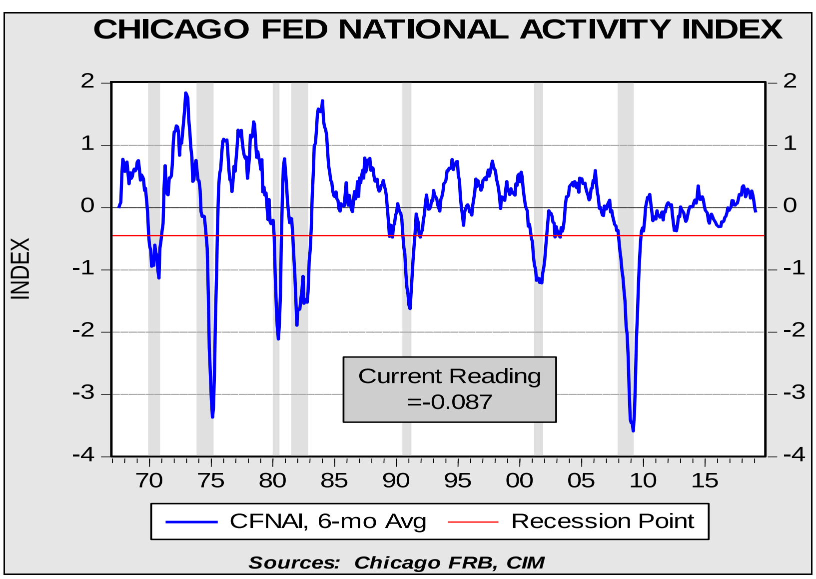
11 https://www.scmp.com/economy/china-economy/article/3006951/china-leaders-vow-reform-not-stimulate-economy-trade-deal-us?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosmarkets&stream=business

through this process, we suffered the Great Depression. Japan is still struggling to make this adjustment which began in 1990 and has led to nearly three decades of stagnation. In practice, Chinese leaders have tended to start the process of reform, which will lead to slower growth and falling debt, but upon seeing weaker growth the leadership has panicked and boosted spending and debt. Chinese financial markets have enjoyed a rally on expectations that Chinese leaders have "blinked" again in the face of slowing growth. Today's news suggests that reform remains on the agenda; our position is that the CPC is not confident enough to allow growth to decline and thus the continued pattern of "reform, panic, stimulus, reform" will continue. But, we do acknowledge that there will be a point when China's debt capacity will be reached and it will be impossible for them to continue this process. We don't think we are close yet, but the signal that the endgame is approaching will be when China taps foreign capital markets for loans. That has started but isn't at a huge level…yet.

The dollar: In a survey of conference calls on Q1 earnings, the largest area of company concern is dollar strength, with the second being increasing labor costs.[12] So far, the Treasury has maintained a strong dollar policy, not supporting steps to weaken the dollar. At some point, we do expect a reversal of this policy and industry opposition to dollar strength could be a factor that brings about this policy shift.

U.S. Economic Releases

The Chicago Fed National Activity Index came in worse than expectations at -0.15 compared to the forecast of -0.10. The prior report's loss was revised upward from 0.29 to 0.31. The chart below shows the data; we smooth it with a six-month moving average. The average fell sharply from the prior month but remains well above the recession indicator. This index, which is a broad-based monitor of the economy, suggests the U.S. economy is growing a bit below its long-run trend and is starting to lose momentum.



[12] https://insight.factset.com/fx-and-wages-cited-as-top-negative-impacts-by-sp-500-companies-on-q1-earnings-calls?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosmarkets&stream=business

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Existing Homes	m/m	apr	5.30 mn	5.51 mn	**
10:00	Existing Homes	m/m	apr	-3.8%	11.8%	***
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	Japan Convenience Same Store Sales	y/y	mar	0.0%	2.0%		**	Equity bearish, bond bullish
EUROPE								
Italy	Consumer Confidence	m/m	apr	110.5	111.2	111.3	***	Equity bearish, bond bullish
	Manufacturing Confidence	m/m	apr	100.6	100.8	100.9	**	Equity and bond neutral
	Economic Sentiment	m/m	apr	98.7	99.2		**	Equity bearish, bond bullish
Russia	Money Supply Narrow Def	y/y	apr	10.27 tn	10.16 tn		**	Equity and bond neutral
AMERICAS								
Canada	Retail Sales	m/m	feb	0.8%	-0.3%	0.4%	**	Equity bullish, bond bearish
	Retail Sales ex Auto	y/y	feb	0.6%	0.1%	0.2%	***	Equity bullish, bond bearish
Brazil	PPI manufacturing	m/m	feb	7.8%	7.8%		**	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)	258	259	-1	Up
3-mo T-bill yield (bps)	237	237	0	Neutral
TED spread (bps)	21	22	-1	Neutral
U.S. Libor/OIS spread (bps)	242	242	0	Up
10-yr T-note (%)	2.56	2.56	0.00	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	18	18	0	Down
Currencies	**Direction**			
dollar	flat			Neutral
euro	flat			Up
yen	flat			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	$73.69	$71.97	2.39%	Iran Oil Waivers Speculation
WTI	$65.29	$64.00	2.02%	
Natural Gas	$2.51	$2.49	0.72%	
Crack Spread	$23.20	$22.98	0.94%	
12-mo strip crack	$18.62	$18.46	0.89%	
Ethanol rack	$1.47	$1.47	0.03%	
Metals				
Gold	$1,279.01	$1,275.52	0.27%	
Silver	$15.05	$15.03	0.11%	
Copper contract	$291.25	$292.65	-0.48%	
Grains				
Corn contract	$ 365.00	$ 367.25	-0.61%	
Wheat contract	$ 442.75	$ 448.25	-1.23%	
Soybeans contract	$ 892.50	$ 894.25	-0.20%	
Shipping				
Baltic Dry Freight	790	767	23	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-1.4	2.0	-3.4	
Gasoline (mb)	-1.2	-2.6	1.4	
Distillates (mb)	-0.4	-1.0	0.6	
Refinery run rates (%)	0.20%	0.95%	-0.75%	
Natural gas (bcf)	92.0	88.0	4.0	

Weather

The 6-10 and 8-14 day forecasts show warmer temps for most of the country, with cooler temps in the northern regions. Precipitation is expected for most of the country.

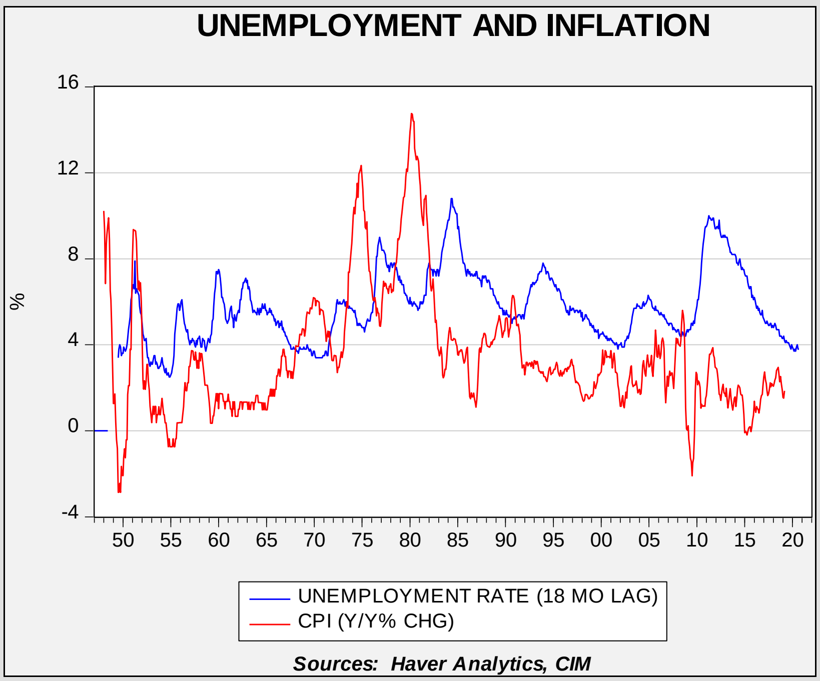
Asset Allocation Weekly

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 18, 2019

Why is inflation so low? The persistence of low inflation, despite the long expansion and the decline in unemployment, continues to befuddle policymakers. Standard economic theory suggests there is an inverse relationship between inflation and unemployment. When the unemployment rate is low, firms should be experiencing reduced excess capacity. As capacity is constrained, supply bottlenecks would be expected to develop which would eventually result in inflation.

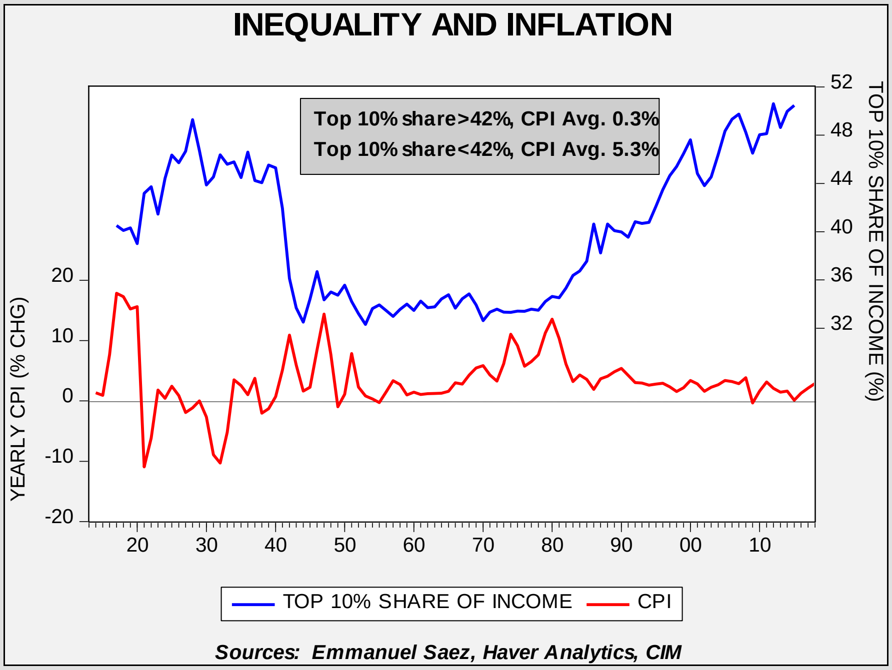
Although the unemployment/inflation theory makes sense, it doesn't work all that well in real life.



This chart shows the level of unemployment, with an 18-month lag, compared to the yearly change in CPI. In the 1960s, it did appear there was a tradeoff; when unemployment fell, inflation rose 18 months later. However, even during this period, the data relationship was merely directional as sub-4% unemployment led to 6% CPI. In the mid-1970s, 4.5% unemployment led to CPI in excess of 12%. Since the early 1980s, CPI has rarely moved above 4%, and in the current environment sub-4% unemployment has not yet triggered a notable inflation problem.

It turns out inflation is rather complicated. Expectations play a major role; if households and businesses expect rising inflation, they take steps to protect themselves that exacerbate the inflation impulse. Both sectors will build inventory levels, effectively changing their balance sheet allocation from financial instruments to real goods. This action can lift the demand for goods and can trigger inflation.

There also appears to be at least two long-term factors that affect inflation. Inequality seems to have an impact.



History shows that lower degrees of inequality are correlated with higher levels of inflation. We think there are two factors that cause this outcome. First, policies designed to expand supply, deregulation and globalization, tend to improve the efficiency of the economy at the expense of higher inequality. Outsourcing and automation make production more efficient but also reduce the demand for domestic labor. Simply put, one person's efficiency is another person's pink slip. Second, CPI is designed to measure prices based on an average household's consumption patterns. With rising inequality, lower decile households may have less income to spend on basic items, making it difficult for firms to pass along price increases on such goods. On the other hand, under conditions of inequality, prices on luxury items are likely to be priced higher simply because there is more spending power available.[13]

However, it is likely that the most potent reason inflation has stayed low is because of excess capacity in the economy. Measuring excess capacity is profoundly difficult because it is something of a moving target. A simple way is to regress long-term GDP against trend; the assumption is that the trend is a reasonable proxy for capacity.

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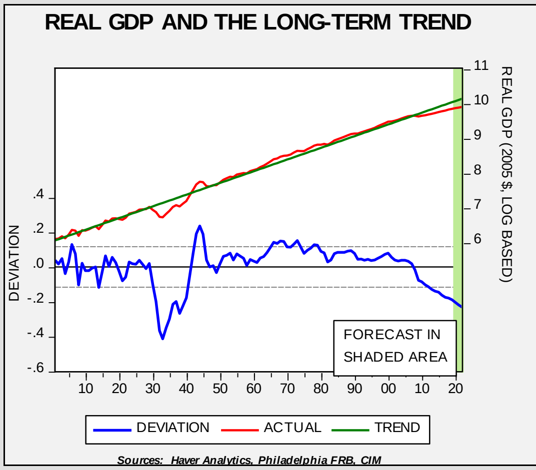
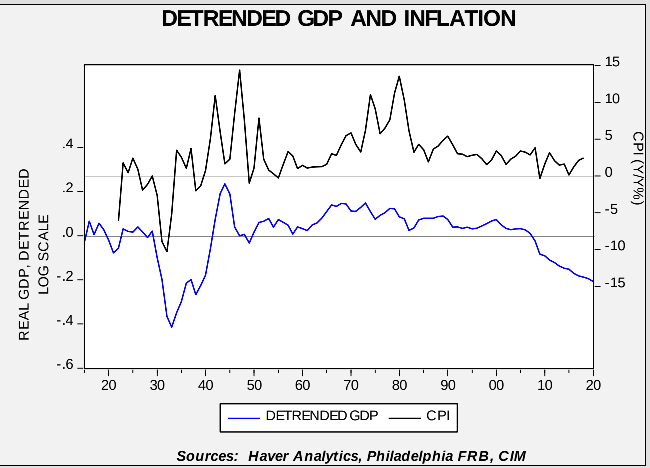
[13] https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2016/03/household-expenditures-and-income



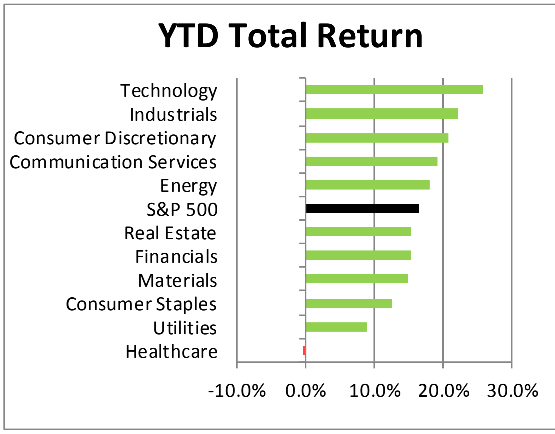


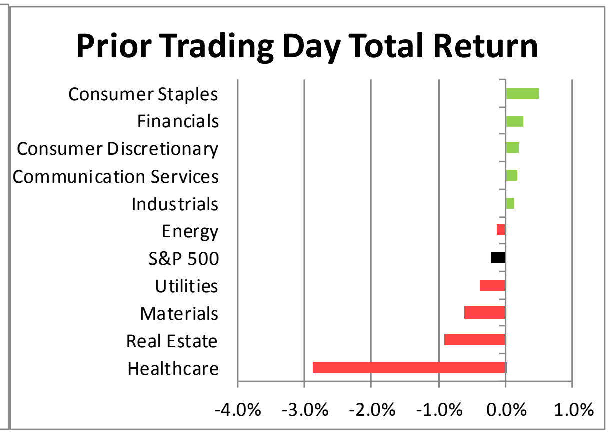
The chart on the left is real GDP, log-transformed with a time trend regressed through it. The lower line is the deviation from trend. We are currently in a period where GDP is well below trend. The only other period that exhibited such a negative deviation from trend was the Great Depression. The chart on the right shows the GDP deviation line compared to CPI. Note that inflation tends to be low during periods of below-trend GDP. For the overall time frame (1921-2018), CPI averages 2.8%. When GDP is above trend, inflation averages 3.8%; when GDP is below trend, CPI averages 0.4%.

This trend analysis could mean that it may take several years before inflation pressures become notable if policymakers become aggressive with stimulation (i.e., keeping monetary policy accommodative while lifting fiscal policy). It also means the Federal Reserve can probably avoid raising rates for a considerable period.

Data Section

U.S. Equity Markets – (as of 4/18/2019 close)

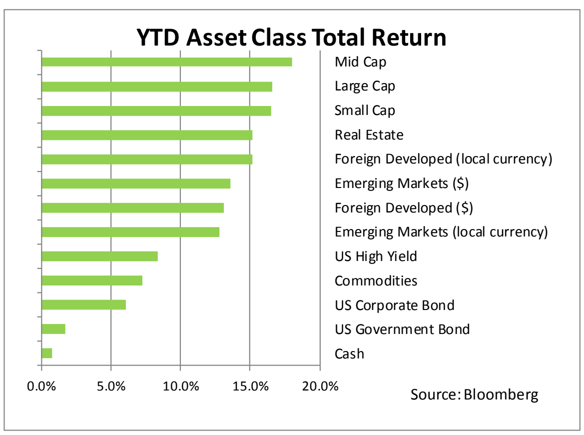




(Source: Bloomberg)

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 4/18/2019 close)

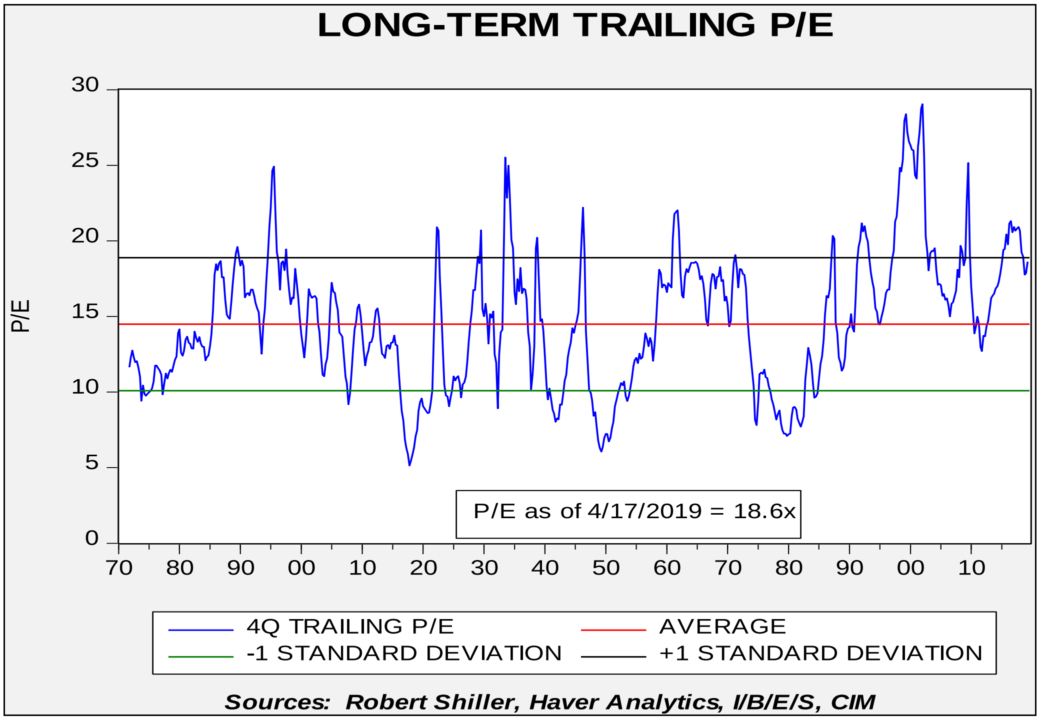


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 18, 2019



Based on our methodology,[14] the current P/E is 18.6x, 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.

[14] 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.