Daily Comment

By Bill O'Grady and Thomas Wash

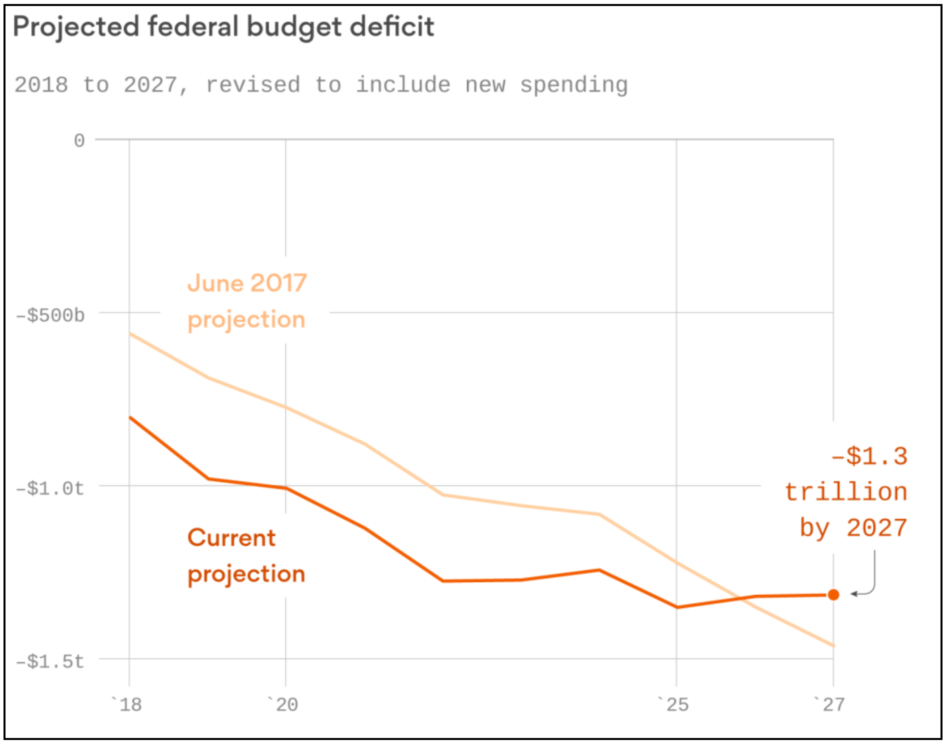
Looking for something to read? See our Reading List; these books, separated by category, are ones we find interesting and insightful. We will be adding to the list over time.

[Posted: April 10, 2018—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.5% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.8% from the prior close. Chinese markets were higher, with the Shanghai composite up 1.7% and the Shenzhen index up 0.5%. U.S. equity index futures are signaling a higher open.

Risk-on is the order of the day. Here's what's driving it:

Xi talks: Chairman Xi spoke at the Boao Forum yesterday evening and made promises to open China's market to foreign investment and lower export impediments. He indicated that auto tariffs will be lowered. The tone was conciliatory and would offer the Trump administration a path to de-escalate trade tensions. We have seen a steady escalation of tensions since January which has clearly spooked risk assets. Trade tensions are a major element of those concerns (the FOMC is the other). However, a word of caution is needed. Xi was rather vague in his comments. In fact, there isn't much new here from his speech in Davos in 2017. Xi's goal appears to be two-fold. First, he wants to lower the "temperature" on trade and offer President Trump a face-saving path to lower tensions. Offering to lower car tariffs is a clear but minor concession that Trump could take to declare victory and smooth relations. Since the Trump administration hasn't really offered what it wants to accomplish with trade, he could declare the autos as sufficient. There was a second element to Xi's speech. China's view is that it wants to be considered a rival superpower to the U.S. and end America's unipolar moment. Thus, he wants to offer China as an alternative to the U.S. and is portraying China as the defender of free trade. This is preposterous; China may be a rising superpower but it doesn't engage in free trade at all. Not only does it interfere with exports, but its financial system is mostly closed and therefore its currency can't be used for reserve purposes. If one runs a trade surplus with China and holds CNY as a result, it's difficult to invest those CNY in the Chinese financial system in an asset like U.S. Treasuries. So, the bottom line is that the speech was mostly fluff but the fact that he at least tried to lower trade tensions is being well received by financial markets.

The deficit: Yesterday, the CBO released its new deficit estimates, taking into account the tax reform act and the recent spending package. The results:

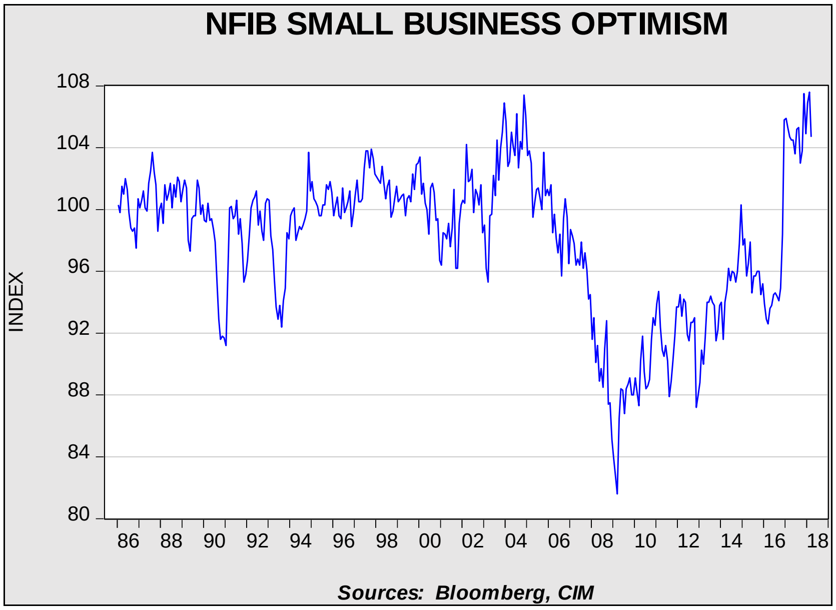


(Source: Axios)

Clearly, the deficit is going to rise. Here is the key point—either the deficit is going to expand growth beyond capacity and lead to higher inflation, or it is going to lead to a wider trade deficit, or some combination of the two. The deficit, all else held equal, will shift the aggregate demand curve outward from the origin. The intersection with aggregate supply determines the level of output and the price level. In a closed economy, this usually leads to higher levels of inflation and higher nominal interest rates. But, in an open economy, the excess consumption usually leads to increased imports and a wider trade deficit. The trade deficit outcome is dependent upon (a) global capacity—if it is insufficent then import prices will rise, leading to inflation, and (b) the exchange rate and the willingness of foreigners to hold the financial assets of the deficit nation. For example, when Venezuela runs a fiscal deficit, no one will hold its bonds and the result is higher inflation. The U.S., a the provider of the reserve currency, is uniquely able to run fiscal deficits and rely on foreign saving to partially fund it. However, if American policy is determined to reduce the trade deficit while simulateously expanding fiscally, the result will be higher inflation.

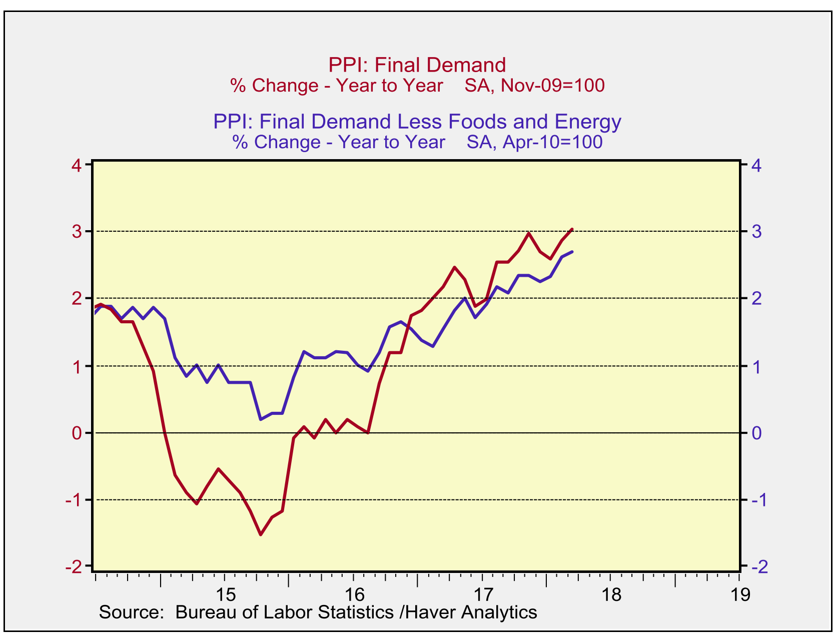
U.S. Economic Releases

NFIB small business optimism came in below expectations at 104.7 compared to the forecast of 107.0.



Small business optimism fell slightly from the prior month but still remains elevated above historical norms. The drop in optimism is likely due to possible ramifications of the U.S. engaging in a trade war with China.

PPI final demand came in above expectations, rising 0.3% from the prior month compared to the forecast rise of 0.1%. PPI excluding food and energy came in above expectations, rising 0.3% from the prior month compared to the forecast of 0.2%. Core PPI also came in above expectations, rising 0.4% from the prior month compared to the forecast of 0.2%.



The chart above shows the relationship between PPI final demand and PPI excluding food and energy. Annually, headline PPI and PPI excluding food and energy rose 3.0% and 2.7%, respectively. We note the relationship of PPI to CPI isn't all that strong so the impact on consumer inflation is not significant.

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

Economic Releases						
10:00	Wholesale Trade Sales	m/m	feb	0.1%	-1.1%	***
10:00	Wholesale Inventories	m/m	feb	0.8%	1.1%	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
18:30	Raphael Bostic Speaks on Economic Outlook	President of the Federal Reserve Bank of Atlanta				

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	Machine Tool Orders	m/m	mar	28.1%	39.5%		*	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	m/m	mar	115.1	115.5		**	Equity and bond neutral
	NAB Business Conditions	y/y	mar	14	21		**	Equity and bond neutral
	NAB Business Confidence	m/m	mar	7	9		***	Equity and bond neutral
EUROPE								
France	Industrial Production	m/m	feb	4.0%	1.2%	4.3%	***	Equity and bond neutral
	Manufacturing Production	m/m	feb	2.4%	3.3%	4.3%	**	Equity bearish, bond bullish
Italy	Industrial Production	m/m	feb	2.5%	4.0%	4.7%	***	Equity bearish, bond bullish
U.K.	BRC Sales Like-for-Like	y/y	mar	1.4%	0.6%	-0.3%	*	Equity bullish, bond bearish
AMERICAS								
Mexico	CPI	y/y	mar	5.0%	5.3%	5.1%	***	Equity and bond neutral
	Vehicle Exports AMIA	m/m	mar	327955	275980		*	Equity and bond neutral
	Vehicle Production AMIA	m/m	mar	331109	328362		*	Equity and bond neutral
Canada	Bloomberg Nanos Confidence	m/m	apr	57.8	56.8		***	Equity and bond neutral
	BoC Business Outlook Future	m/m	1q	16.00	8.00		**	Equity and bond neutral
	BoC Senior Loan Officer Survey	m/m	1q	-5.2	-6.4		**	Equity and bond neutral
	BoC Overall Business Outlook	m/m	1q	2.0	2.5		**	Equity and bond neutral
Brazil	Trade Balance Weekly	w/w	apr	$1.461 bn	$1.131 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)	234	233	1	Up
3-mo T-bill yield (bps)	170	169	1	Neutral
TED spread (bps)	63	64	-1	Neutral
U.S. Libor/OIS spread (bps)	175	175	0	Up
10-yr T-note (%)	2.79	2.78	0.01	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	5	4	1	Down
Currencies	**Direction**			
dollar	down			Down
euro	flat			Up
yen	down			Up
pound	up			Up
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	$69.51	$68.65	1.25%	Speculation from Saudi Arabia
WTI	$64.21	$63.42	1.25%	
Natural Gas	$2.70	$2.69	0.26%	
Crack Spread	$20.04	$20.09	-0.26%	
12-mo strip crack	$18.28	$18.29	-0.05%	
Ethanol rack	$1.55	$1.55	0.29%	
Metals				
Gold	$1,336.38	$1,336.35	0.00%	
Silver	$16.50	$16.50	0.06%	
Copper contract	$310.10	$307.70	0.78%	
Grains				
Corn contract	$ 398.25	$ 399.00	-0.19%	
Wheat contract	$ 487.00	$ 490.75	-0.76%	
Soybeans contract	$ 1,061.00	$ 1,057.50	0.33%	
Shipping				
Baltic Dry Freight	952	948	4	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.4		
Gasoline (mb)		-1.1		
Distillates (mb)		-0.3		
Refinery run rates (%)		0.10%		

Weather

The 6-10 and 8-14 day forecasts continue to signal colder than normal temperatures. Precipitation is expected for most of the country.

Asset Allocation Weekly Comment

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.

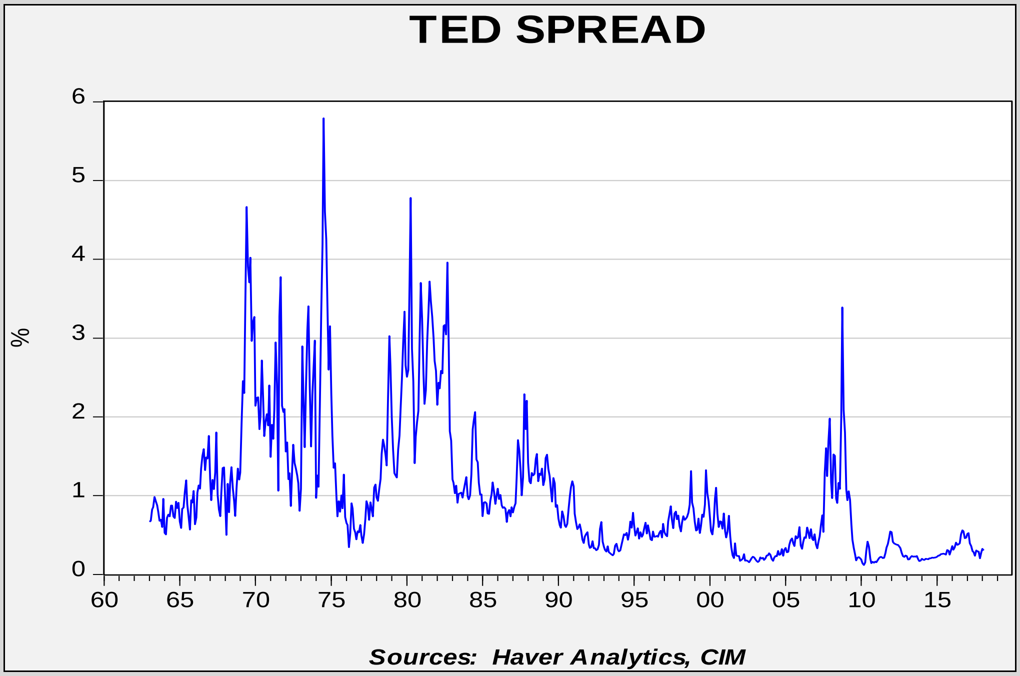
April 6, 2018

Recently, the three-month T-bill/Eurodollar spread (TED spread) has widened, raising concerns about financial stability. In this report, we will offer a primer on the spread and discuss its recent rise.

The TED spread has two components; it's a direction-of-rate spread and a flight-to-quality spread. Eurodollars (also known as LIBOR) represent dollar borrowing that is not government-guaranteed. It originally began when Europe accumulated dollars during the 1960s as part of Bretton Woods and the dollar's reserve status. As Europe ran trade surpluses with the U.S., they acquired dollars which they wanted to lend to earn interest. At the time, U.S. interest rates were governed by "Regulation Q," which set deposit rates for U.S. banks. During periods of tight monetary policy, U.S. borrowers could find European dollar lenders willing to lend those dollars at a premium to domestic interest rates. Thus, if banks found themselves unable to borrow from the Federal Reserve, they could use the Eurodollar market to acquire liquidity. However, unlike the domestic market, Eurodollars offered no lender of last resort protections and thus carried premium interest rates. Under normal circumstances, the yield premium was around 20%. So, if domestic dollar borrowing rates were set at 5%, Eurodollars yielded 6%. Obviously, if domestic rates doubled, to 10%, Eurodollars yielded 12%. This pattern explains the TED spread's direction-of-rate element; during a rising rate market, speculators would short Eurodollars and go long T-bills, profiting from a widening spread. In a falling rate market, the reverse position would be implemented.

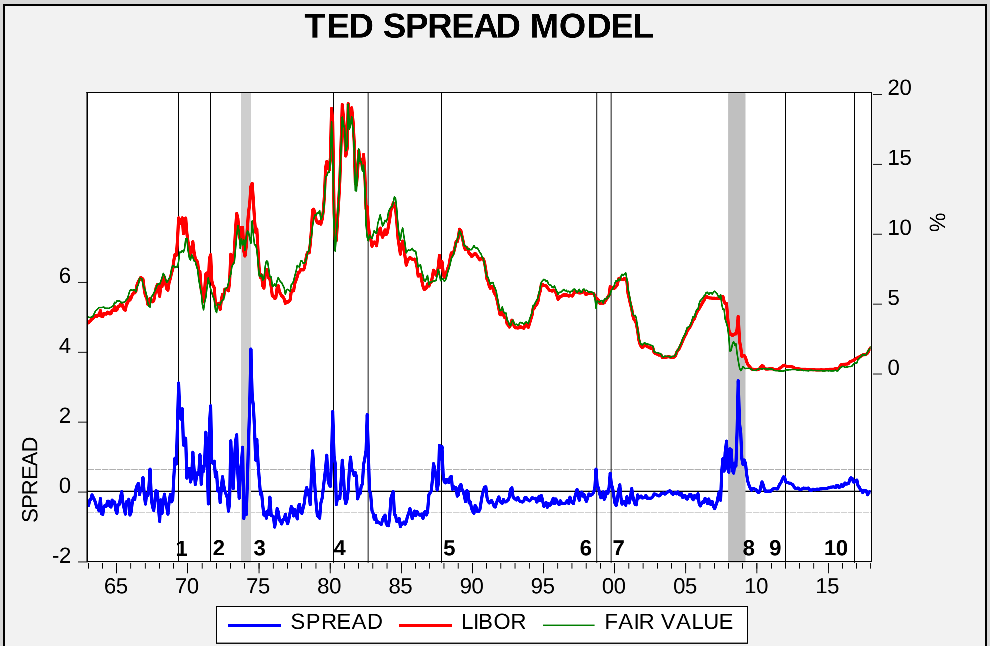
The other component is the flight-to-quality spread. Because Eurodollars are not government-guaranteed and do not have direct support of a central bank, investors flock to T-bills and shun Eurodollars during periods of stress. This widens the TED spread.

This chart shows the long-term TED spread.



As the chart shows, there was a great deal of volatility in the spread. As we will discuss below, this was partly due to flight-to-quality incidents along with volatile monetary policy. Under Chair Volcker, the Federal Reserve targeted the money supply instead of fed funds which led to rate volatility. Spread volatility declined as interest rates fell and the Federal Reserve returned to fed funds targeting. In addition, the end of Regulation Q in 1986 ended the government's practice of setting maximum deposit rates. This increased the government-guaranteed rate and essentially narrowed the spread.

To separate the direction of interest rate effects from the flight-to-quality factors in the spread, we regressed the Eurodollar (LIBOR) rate by the T-bill rate with a variable to account for Regulation Q. This chart shows the results of that model.



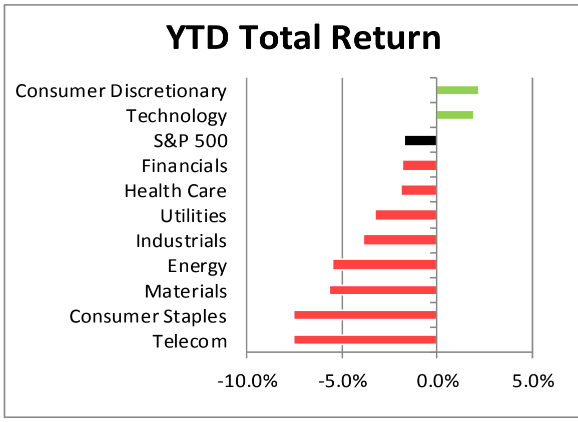
1 = Penn Central Bankruptcy; 2 = Bretton Woods Rescinded; 3= Arab Oil Embargo, Watergate
4 = Iran-Iraq War, Hostage Crisis; 5= Market Crash; 6 = LTCM Crisis;
7 = Asian Economic Crisis; 8= Great Financial Crisis; 9 = Eurozone Crisi, U.S. Debt Downgrade;
10 = 2016 Election
Sources: Haver Analytics, CIM

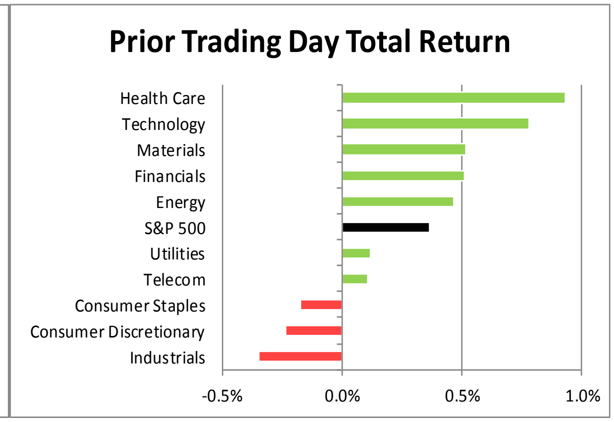
The lower line on the chart shows the deviation in Eurodollar interest rates relative to T-bill rates. A widening spread is represented by a rising lower line. Clearly, financial, political and geopolitical events can widen the spread; we have marked the important ones. The current spread is essentially at fair value, suggesting the widening of the TED spread isn't due to any sort of financial crisis but is entirely due to rising yields. In other words, the widening of the TED spread is consistent with increasing interest rates and, so far, does not indicate significant financial stress.

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 4/9/2018 close)

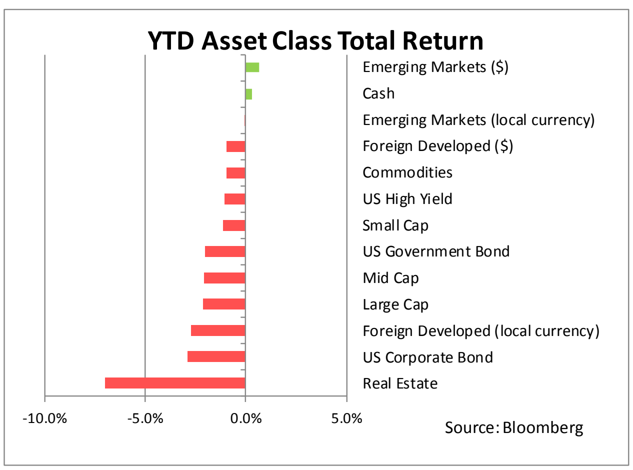




(Source: Bloomberg)

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 4/9/2018 close)

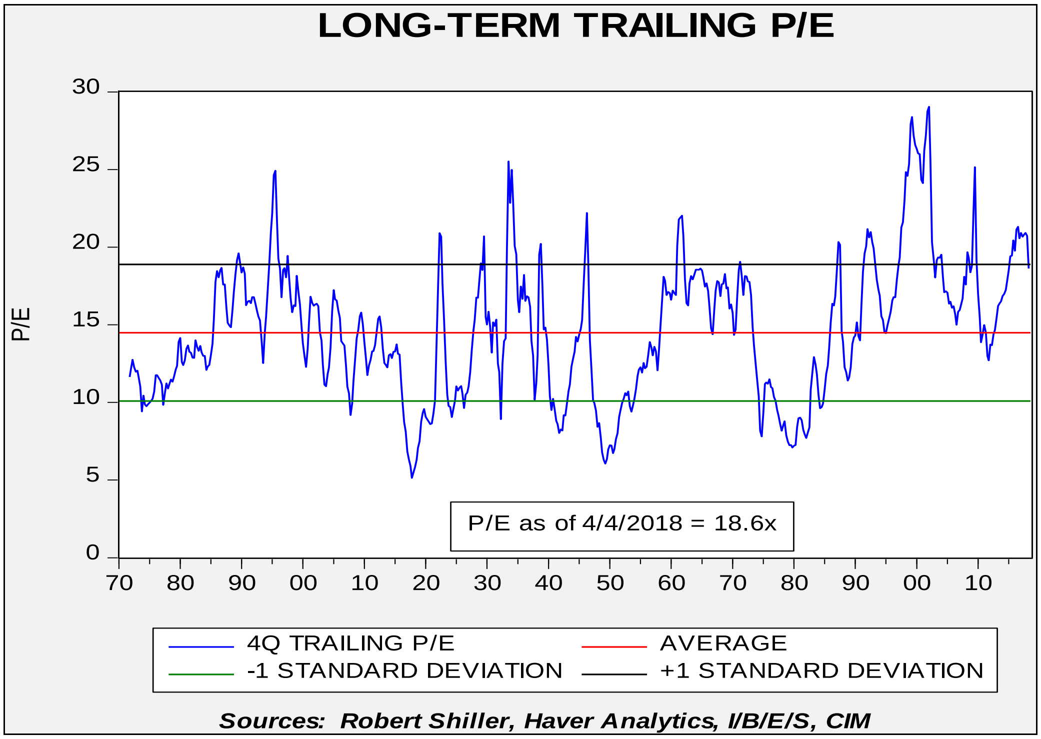


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 5, 2018



Based on our methodology,[1] the current P/E is 18.6, down 2.0x from last week. With the new quarter, we are calculating earnings with the new quarter's estimate which reflects the estimated impact of the tax law. Stronger earnings coupled with weaker equity prices account for the sharp drop in the multiple.

[1] 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 two 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.