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 11, 2018—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.6% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.5% from the prior close. Chinese markets were higher, with the Shanghai composite up 0.6% and the Shenzhen index up 0.5%. U.S. equity index futures are signaling a lower open.

It's risk-off today; risk markets are lower on a swirl of issues that are weighing on sentiment. Here is what we are watching:

Action on Syria: The president tweeted this morning, warning Syria and Russia that the U.S. is preparing an attack on Syria for its recent use of chemical weapons. There are several known/unknowns with this action. First, what will be the scope of the attack? We see four potential outcomes. It could be a mere symbolic attack like the one seen last year, where a salvo of cruise missiles hit various targets. That event didn't deter the Assad regime then and it won't do so now. The attack could also be broadened to strike chemical weapons dumps. Such attacks do increase the risk of collateral damage, including triggering weapon spillage and inadvertent casualties of Iranian or Russian soldiers. Third, the attacks could be broadened even further to include not just existing weapons but also production facilities. This type of strike would increase the chances of collateral damage. Lastly, the U.S. and its allies could directly attack Syrian military assets, including bases, aircraft, artillery, etc. Collateral risks escalate with this option, but it would clearly get Assad's attention.

The second "known/unknown" is the potential counter-response. What will Russia or Iran do in response to a U.S. and allied attack? Would Iran attack the Gulf States if they participate in airstrikes? Would Iran target oil facilities? Would we see a cyberattack in response? Essentially, there are growing risks here, especially with a White House that contains more belligerent advisors than when a similar attack occurred last year.

We are looking for a broader attack and it may take a week to 10 days before the full event unfolds. There are no aircraft carriers in theater at present. Although there are significant U.S. military assets already in the region, if it is going to be an expanded attack we would expect at least one carrier group to be moved into position. The CVN *Theodore Roosevelt* is in Singapore and could be in range within a week or so. We also expect some participation from France, although it appears the U.K. has decided not to engage. This event will offer insight into John Bolton's influence; although regarded as an unabashed hawk, the role of the National Security Advisor is to offer the president options and advice. The potential for escalation is elevated and may take some time to resolve. Oil and gold are the greatest beneficiaries of this news.

Threats against Mueller: The media is rampant with reports that the White House is considering firing Special Counsel Mueller and it believes it has the legal authority to do so. The consensus of legal opinion is that he doesn't; only the Attorney General can do that and the current holder of that office has recused himself from the Russia investigation so the deputy has that role. If the president doesn't have the authority, we could see the spectacle of the "Saturday night massacre," when Nixon ordered his AG Elliot Richardson to fire Archibald Cox. Richardson refused so Nixon fired him. Nixon then ordered Deputy AG Ruckelshaus to fire Cox; the deputy refused and was fired as well. Nixon next ordered Solicitor General Bork to execute the firing, and a reluctant Bork did fire Cox (which probably prevented Bork from sitting on the Supreme Court). Firing Mueller would get messy because it veers into the somewhat vague boundaries of constitutional power. Usually, Congress sees such actions as interfering with its oversight of the executive branch and reacts. As long as Congress is in the hands of the GOP, Trump might get away with removing Mueller. However, Trump runs two risks. First, Congress has historically reacted against the usurpation of its executive branch oversight and may turn on the president. It's important to note that most of the GOP leadership is establishment, not populist, and would not be overly opposed to quashing populism. The establishment has gotten its tax cuts and may view the president's actions as taking the party into areas where the elite would prefer to avoid. Second, nothing would fire up the opposition more than removing Mueller. The odds of the House flipping to the Democrats would be elevated (we note reports that Speaker Ryan is not seeking re-election), and removing Mueller would even put the Senate into play. For markets, such turmoil would undermine sentiment; it would be negative for equities and probably bearish for the dollar as well.

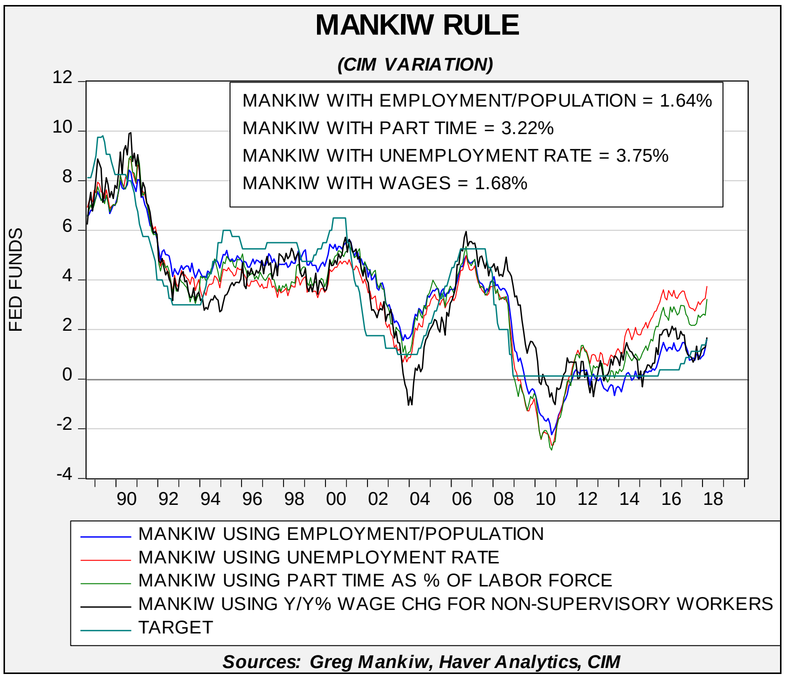
Russian sanctions: Expanded sanctions on Russian figures close to President Putin have boosted aluminum prices as the Russian firm Rusal (486:HKG, HKD, 2.06) has been hit by sanctions. U.S. regulators are warning British banks that their relations with Russian oligarchs could put them at risk. The ruble is weakening and the small, but not zero, potential that Russian oil firms could come under scrutiny is probably helping oil prices this morning.

Facebook (FB, 165.04): CEO Zuckerberg generally held his own yesterday mostly because most of the questioners were completely ignorant of how not only social media works, but the internet in general.[1] Only Ron Johnson (R-WI) nailed it when he asked Zuckerberg if his company should pay users for their data. This is really the crux of the matter. If social media is merely a constant focus group for advertisers, they should pay us for our time. We don't expect this train of thought to go anywhere.

Something of note: For the first time since the end of WWII, the Japanese Defense Force has created a contingent of marines. The Japanese military has avoided such forces because they were seen as offensive units and its pacifist constitution outlawed such actions, therefore marines were seen as unnecessary. Apparently, due to China's growing threat and fears of likely U.S. disengagement, Japan has concluded it needs an amphibious force to protect its various island chains from encroachment.

[1] It was a bit like Dave Letterman's comments about having a "twitter machine." https://mashable.com/2009/12/09/david-letterman-tweet/#.LThK4_1UkqQ

Fed policy: With the release of the CPI data we can update the Mankiw models. The Mankiw rule models attempt to determine the neutral rate for fed funds, which is a rate that is neither accommodative nor stimulative. Mankiw's model is a variation of the Taylor Rule. The latter measures the neutral rate using core CPI and the difference between GDP and potential GDP, which is an estimate of slack in the economy. Potential GDP cannot be directly observed, only estimated. To overcome this problem with potential GDP, Mankiw used the unemployment rate as a proxy for economic slack. We have created four versions of the rule, one that follows the original construction by using the unemployment rate as a measure of slack, a second that uses the employment/population ratio, a third using involuntary part-time workers as a percentage of the total labor force and a fourth using yearly wage growth for non-supervisory workers.

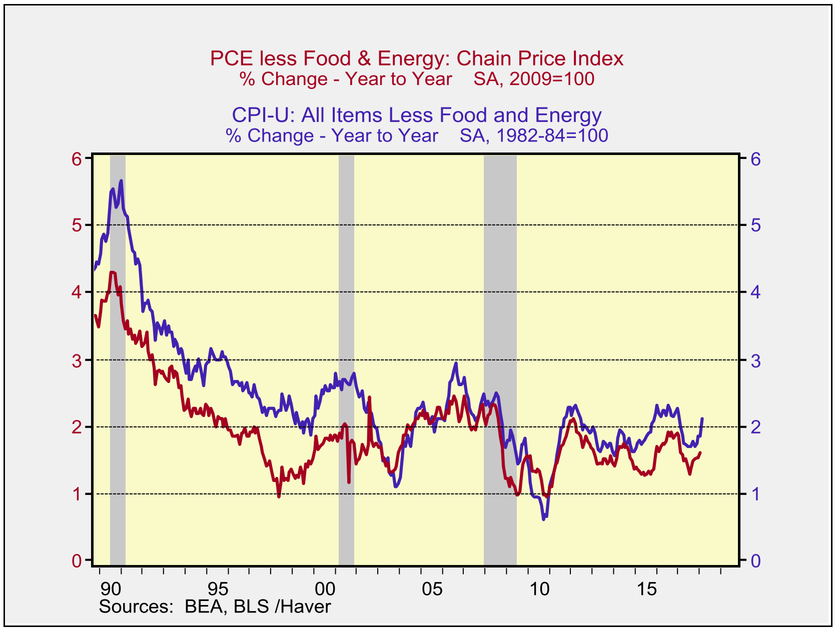


Using the unemployment rate, the neutral rate is now 3.75%, up from 3.26%. Using the employment/population ratio, the neutral rate is 1.68%, up from 1.25%. Using involuntary part-time employment, the neutral rate is 3.22%, up from 2.58%. Using wage growth for non-supervisory workers, the neutral rate is 1.67%, up from 1.28%. The rise in core inflation, due in part to last year's roll-off of mobile phone plan prices, has led to a significant upward lift in the Mankiw rule neutral rate estimates for all variations of the model. If anything, this will increase the determination of the FOMC to continue on its path to hike rates. We may get some insight from this afternoon's minutes but, overall, it is reasonable to expect three more hikes this year.

U.S. Economic Releases

MBA mortgage applications fell 1.9% from the prior week. In addition, purchases and refinancing fell 2.0% and 1.7%, respectively. The average 30-year fixed rate mortgage rose by 3 bps from 4.66% to 4.69%.

CPI came in below expectations, falling 0.1% from the prior month compared to the forecast of unchanged. Core CPI was also in line expectations, rising 0.2% from the prior month.



The chart above shows the year-over-year change in core CPI and core PCE. Core CPI rose 2.4% from the prior year. Despite concerns over inflation, price levels remain fairly steady. It is worth noting that although CPI is the most commonly used inflation gauge, the Fed's preferred measure is the PCE.

Real average weekly earnings rose by 0.9% from the prior year, while real average hourly earnings rose by 0.4% from the prior year.

The chart above shows real average hourly earnings. Real wage pressures remain mostly steady.

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

Economic Releases						
14:00	Monthly Budget Statement	m/m	mar	$186.0 bn	-$215.2 bn	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
14:00	FOMC Meeting Minutes	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	PPI	y/y	mar	3.1%	3.7%	3.3%	**	Equity bearish, bond bullish
	CPI	y/y	mar	2.1%	2.9%	2.6%	***	Equity bearish, bond bullish
Japan	Core Machine Orders	y/y	feb	2.4%	2.9%	0.0%	**	Equity and bond neutral
	PPI	y/y	mar	2.1%	2.5%	2.0%	**	Equity and bond neutral
Australia	Westpac Consumer Confidence	m/m	apr	102.4	103.0		***	Equity and bond neutral
New Zealand	ANZ Truckometer Heavy	m/m	mar	-0.3%	-2.5%		**	Equity and bond neutral
EUROPE								
France	Bank of France Industry Sentiment	m/m	mar	103	105	104	**	Equity and bond neutral
Italy	Retail Sales	m/m	feb	-0.6%	-0.8%	0.6%	**	Equity bearish, bond bullish
U.K.	Trade Balance	m/m	feb	-965	-3074	-2600	**	Equity and bond neutral
	Industrial Production	y/y	feb	2.2%	1.6%	2.9%	**	Equity bearish, bond bullish
	Manufacturing Production	y/y	feb	2.5%	2.7%	3.3%	**	Equity bearish, bond bullish
	NIESR GDP Estimate	q/q	mar	0.2%	0.3%	0.3%	**	Equity and bond neutral
Russia	Current Account Balance	q/q	1q	28.800 bn	13.698 bn	29.500 bn	**	Equity and bond neutral
AMERICAS								
Mexico	Nominal Wages	y/y	mar	5.4%	5.6%		**	Equity and bond neutral
Canada	Housing Starts	m/m	mar	225.2k	229.7k	216.8k	***	Equity bullish, bond bearish
	Building Permits	m/m	feb	-2.6%	5.6%	-1.3%	**	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)	234	234	0	Up
3-mo T-bill yield (bps)	170	169	1	Neutral
TED spread (bps)	64	64	0	Neutral
U.S. Libor/OIS spread (bps)	175	175	0	Up
10-yr T-note (%)	2.76	2.80	-0.04	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	4	4	0	Down
Currencies	**Direction**			
dollar	down			Down
euro	up			Up
yen	up			Up
pound	flat			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	$71.74	$71.04	0.99%	Uncertainty in the Middleeast
WTI	$66.23	$65.51	1.10%	
Natural Gas	$2.65	$2.66	-0.30%	
Crack Spread	$19.96	$20.54	-2.86%	
12-mo strip crack	$18.66	$18.90	-1.26%	
Ethanol rack	$1.55	$1.55	0.03%	
Metals				
Gold	$1,350.72	$1,339.64	0.83%	
Silver	$16.63	$16.58	0.32%	
Copper contract	$313.55	$313.70	-0.05%	
Grains				
Corn contract	$ 398.50	$ 397.75	0.19%	
Wheat contract	$ 505.25	$ 508.50	-0.64%	
Soybeans contract	$ 1,067.75	$ 1,060.25	0.71%	
Shipping				
Baltic Dry Freight	974	952	22	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.4		
Gasoline (mb)		-1.1		
Distillates (mb)		-0.3		
Refinery run rates (%)		0.10%		
Natural gas (bcf)		-12.0		

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.

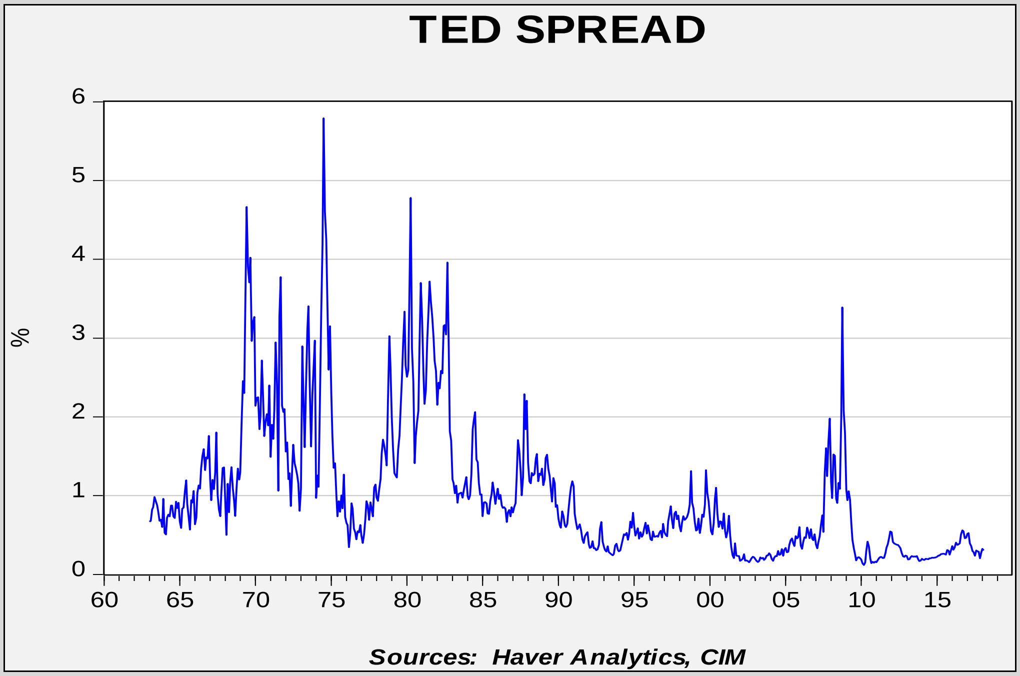
April 6, 2018

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.

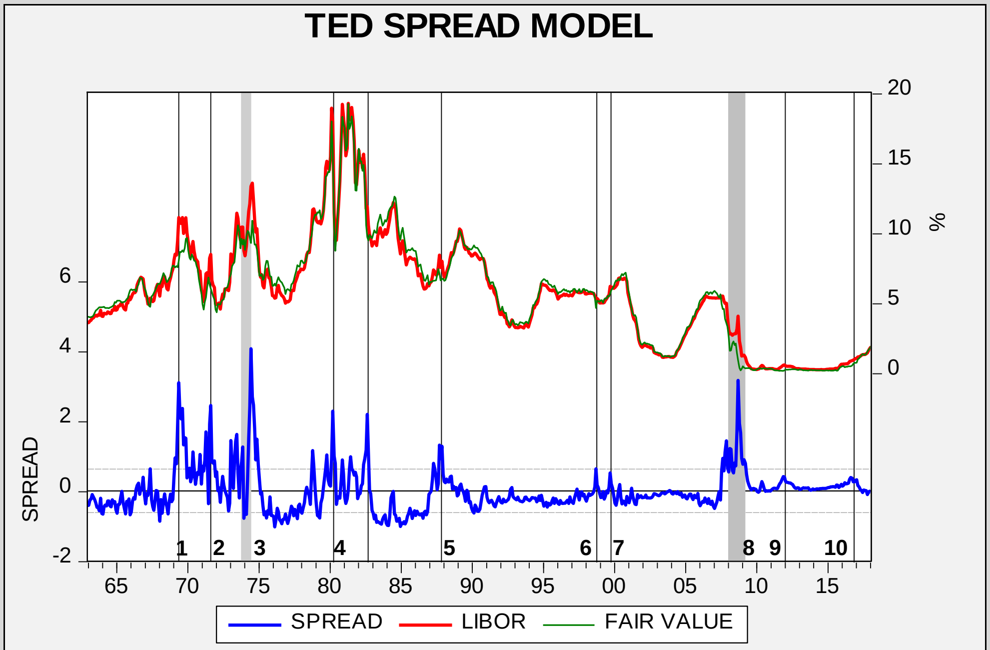
The other component is the flight-to-quality spread. Because Eurodollars are not government-guaranteed and do not have direct support of a central bank, investors flock to T-bills and shun Eurodollars during periods of stress. This widens the TED spread.

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.

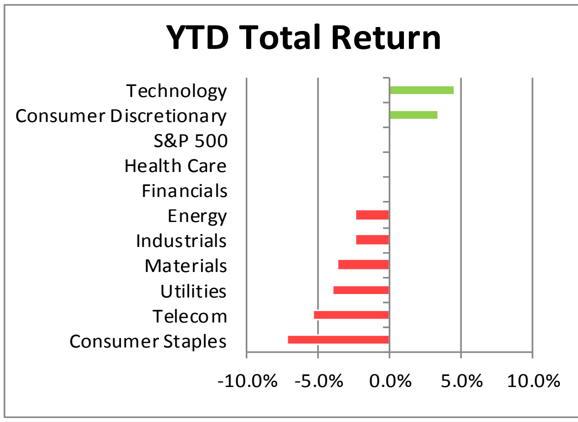


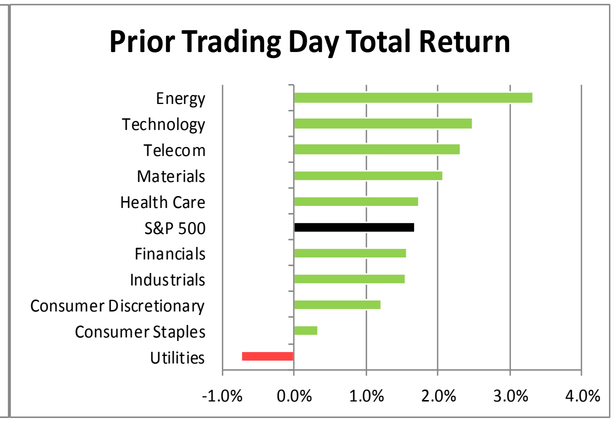
1 = Penn Central Bankruptcy; 2 = Bretton Woods Rescinded; 3= Arab Oil Embargo, Watergate
4 = Iran-Iraq War, Hostage Crisis; 5= Market Crash; 6 = LTCM Crisis;
7 = Asian Economic Crisis; 8= Great Financial Crisis; 9 = Eurozone Crisi, U.S. Debt Downgrade;
10 = 2016 Election
Sources: Haver Analytics, CIM

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.

Data Section

U.S. Equity Markets – (as of 4/10/2018 close)

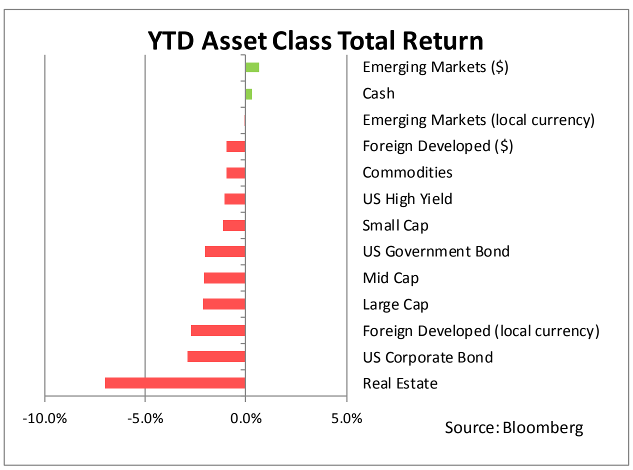




(Source: Bloomberg)

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 4/10/2018 close)

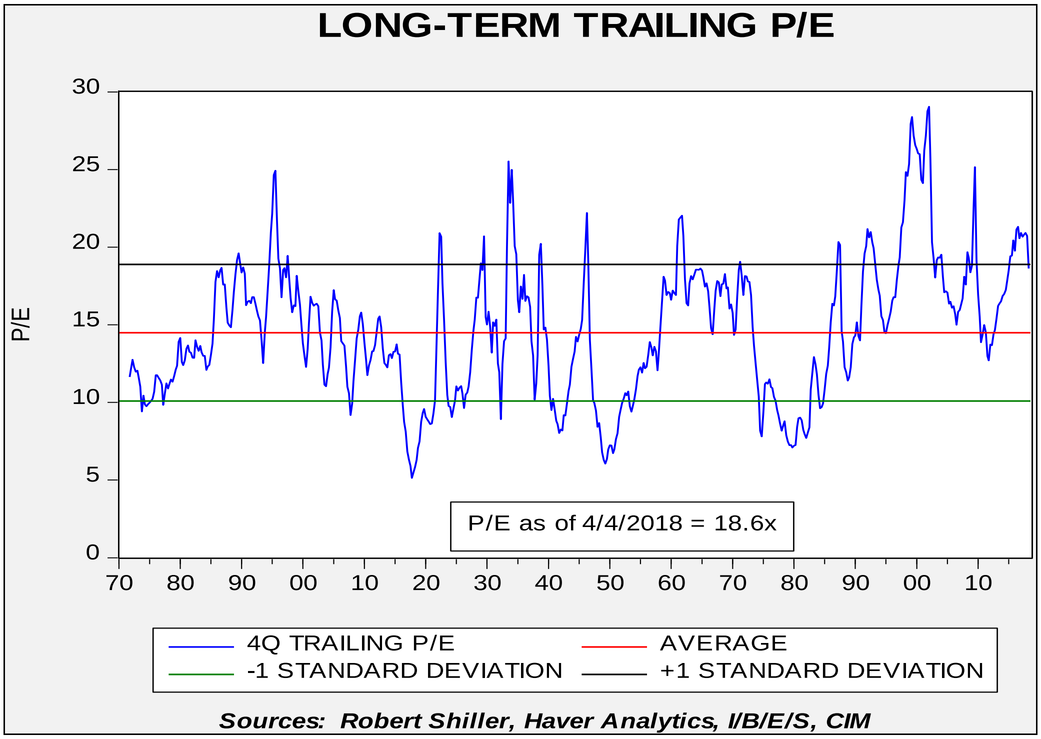


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[2] 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.

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[2] 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.