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 12, 2018—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.5% from the prior close. Chinese markets were lower, with the Shanghai composite down 0.9% and the Shenzhen index down 0.6%. U.S. equity index futures are signaling a higher open. With 24 companies having reported, the S&P 500 Q1 earnings stand at $36.22, lower than the $36.49 forecast for the quarter. The forecast reflects an 18.4% increase from Q1 2017 earnings. Thus far this quarter, 70.8% of the companies reported earnings above forecast, while 20.8% reported earnings below forecast.

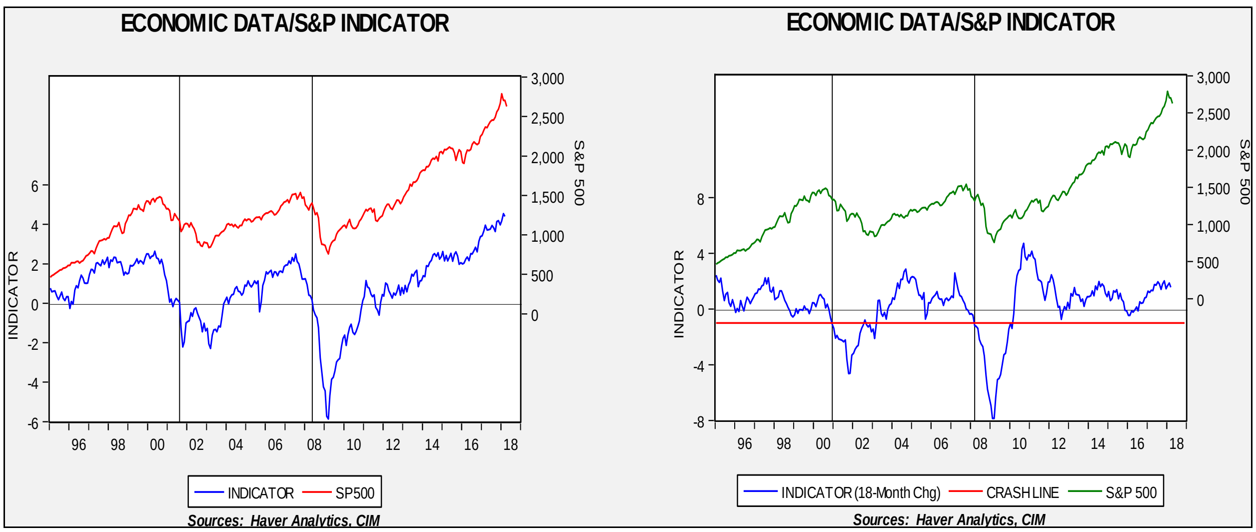
It was a fairly quiet overnight session; the dollar reversed some of yesterday's losses and equities are modestly higher. This is what we are watching:

Ryan's departure: Soon after last November's elections, we framed the forthcoming political battle as "Ryan vs. Bannon." Now, both are gone. Bannon was banished from the White House last summer and Speaker Ryan confirmed what had been rumored for some time that he isn't going to run again. Last November, our position was that President Trump wasn't necessarily fully formed as a political figure and that the establishment (Ryan) and the populists (Bannon) were trying to get control of the president's agenda. Both figures are now gone because the president has established his political persona. Trump isn't as populist as Bannon had hoped—it's important to remember that Bannon wanted to raise the highest marginal tax rate on households above 40% while cutting rates to lower income households. Trump is too much within the establishment to sponsor that idea. At the same time, trade policy, the growing fiscal deficits and Trump's continued support for universal social spending (Social Security, Medicare) has made it clear to Ryan that his style of conservatism is no longer ascendant. Thus, there is no reason for Ryan to remain as Speaker.

As we have noted before, our two-party system is really a form of forced coalitions and there are periods when the coalition groups within the parties are in flux. This is one of those moments. We don't know for sure where all the various groups will eventually align but we strongly suspect that groups we currently think of as Republicans or Democrats won't be the same in 10 years.

A walk back: Yesterday, President Trump caused quite a stir by suggesting an attack on Syria was imminent and warning Russia that missiles were coming. This was something of a mistake; the military always prefers an element of surprise and tweeting about an incoming attack is counterproductive. So, this morning, the president reintroduced an element of surprise by suggesting an attack may not happen at all (very unlikely) or will occur at some unknown date. There are two things we are watching. We expect an escalation from last year's limited cruise missile strike which means (a) the U.S. needs more military assets in theater, and (b) the U.S. would prefer allies involved in this action. The U.K. is considering joining the U.S. and we would expect France, which has long-standing ties to Syria, to also participate. We would also anticipate at least some token participation by the Gulf Kingdoms. On the first point, the U.S.S. *Harry S. Truman* has left port in Norfolk after extensive maintenance and training for the Fifth Fleet's Area of Operations, which includes the Middle East. Assuming it can reach the Mediterranean in 10-14 days, we suspect nothing major will happen before then. Second, it will take some time to gather allies and coordinate a plan. Thus, we still expect a military strike but not imminently.

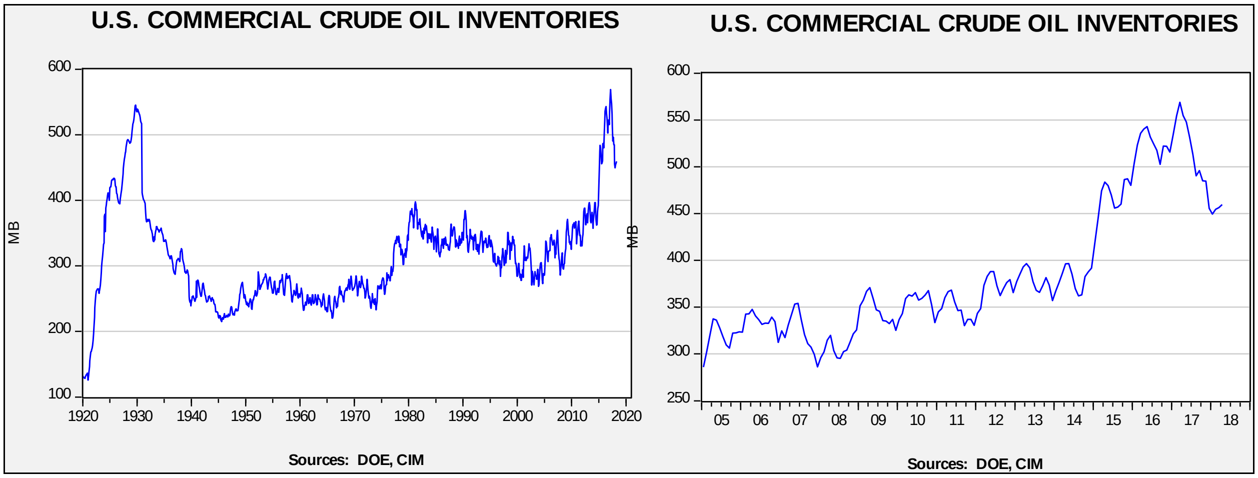
A comment on equities: Whenever we have a period of equity market weakness, there are always concerns that equities are signaling economic weakness and a bear market is in the offing. Our economic data indicator, which uses initial claims, commodity prices and consumer confidence, would suggest we are in a period of correction and consolidation but does not indicate an ensuing bear market.



The chart on the left shows the S&P 500 with our economic data indicator. The indicator is constructed by normalizing the aforementioned economic data and creating an index. The left chart shows the raw index; when it crosses zero, it indicates economic weakness and signals further weakness in equities. However, it is somewhat "slow"; to correct this deficiency, we use the 18-month change in the indicator and the warning signal is when it crosses the red line, shown on the right chart. This gives an earlier warning but avoids the false positives of a mere zero crossing. As the charts indicate, there is no obvious danger coming from the high frequency data.

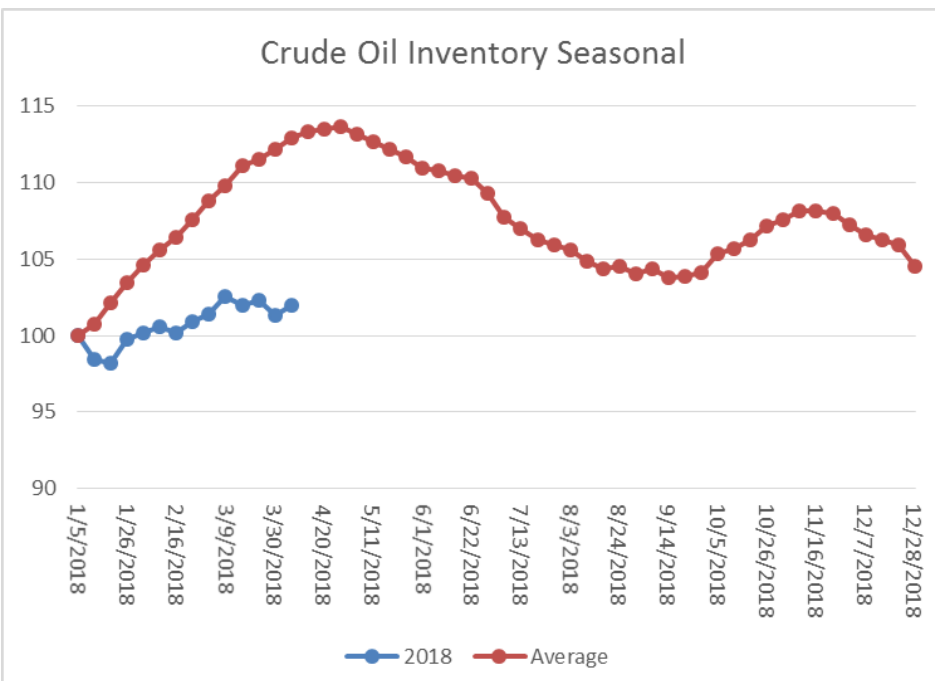
There are two caveats. First, there is the usual "past performance doesn't guarantee future performance" warning. The second is that this is an economic model and should not be expected to signal warnings for geopolitical or political crises.

Energy recap: U.S. crude oil inventories rose 3.3 mb compared to market expectations of a 1.3 mb draw.

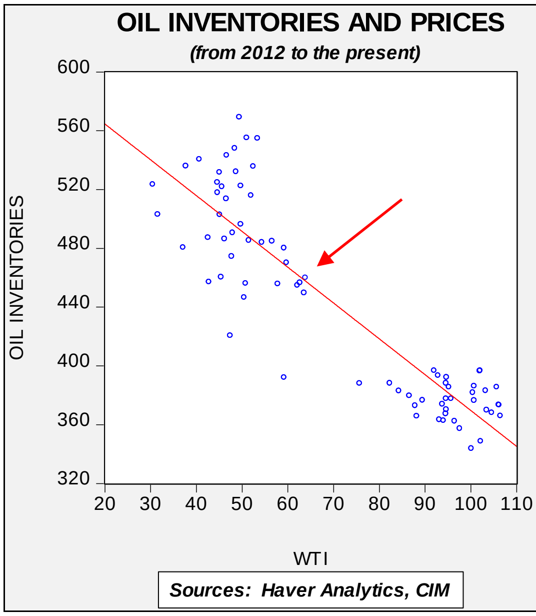


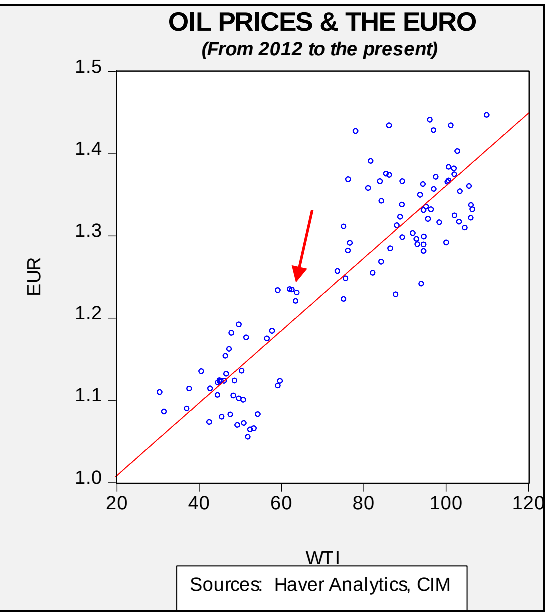
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but have declined significantly since last March. We would consider the overhang closed if stocks fall under 400 mb.

As the seasonal chart below shows, inventories are usually rising this time of year. This week's rise in stockpiles is normal. Every week that fails to show a build on the seasonal pattern is a week where the seasonal factors become less bearish. Although there is still time for stockpiles to rise, it will be virtually impossible for inventories to reach their seasonal norms.



(Source: DOE, CIM)

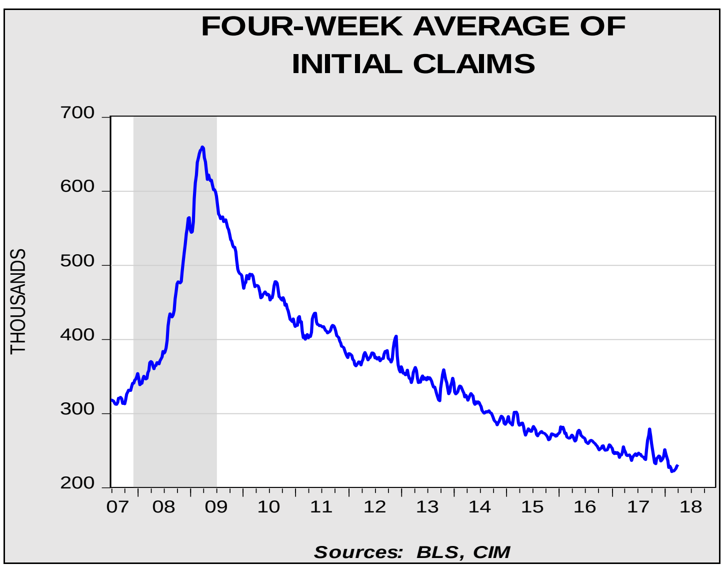




Based on inventories alone, oil prices are undervalued with the fair value price of $64.54. Meanwhile, the EUR/WTI model generates a fair value of $74.08. Together (which is a more sound methodology), fair value is $70.92, meaning that current prices are below fair value. Oil prices have been rising on geopolitical tensions but it should be noted that current inventory levels are supportive, as is the weak dollar. If tensions remain high, the seasonal "flip" that will occur by early May will add to potential market strength.

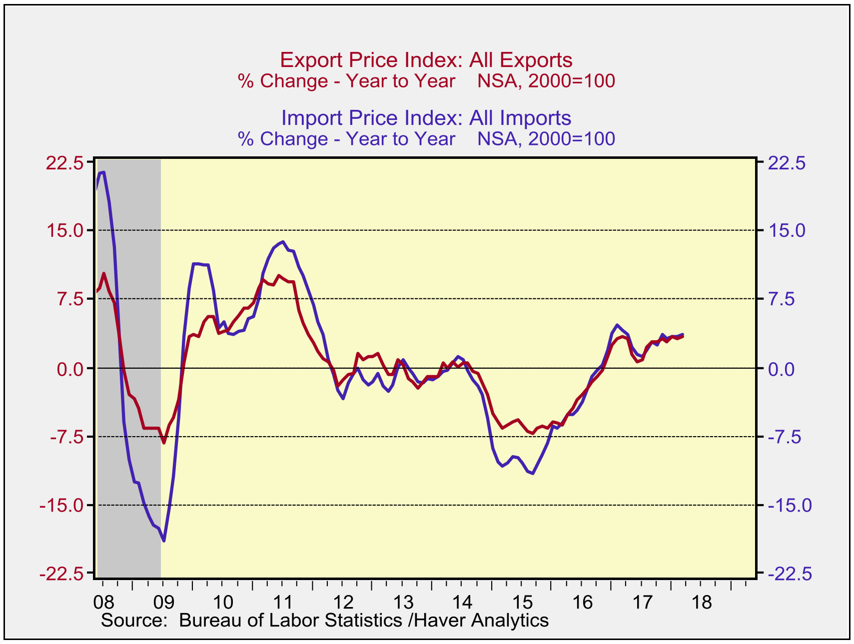
U.S. Economic Releases

Initial jobless claims came in worse than expectations at 233k compared to the forecast of 230k.



The chart above shows the four-week moving average of initial jobless claims. The four-week moving average rose 1.75k to 230.00k.

The import price index came in below expectations, remaining unchanged from the prior month compared to the forecast gain of 0.1%. The prior month's gain was revised downward from 0.4% to 0.3%. The import price index excluding petroleum came in below expectations, rising 0.1% from the prior month compared to the forecast rise of 0.2%. The export price index came in above expectations, rising 0.3% from the prior month compared to the forecast rise of 0.2%.



The chart above shows the year-over-year change in the import price index and export price index. The import price and export price indexes rose 3.6% and 3.4%, respectively.

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								
Japan	Japan buying foreign bonds	y/y	mar	-¥609.4 bn	-¥774.3 bn		*	Equity and bond neutral
	Japan buying foreign stocks	y/y	mar	¥149.3 bn	¥173.1 bn		*	Equity and bond neutral
	Foreign buying Japan bonds	y/y	feb	¥818.9 bn	¥268.9 bn		*	Equity and bond neutral
	Foreign buying Japan stocks	y/y	mar	¥332.9 bn	¥228.8 bn		*	Equity and bond neutral
India	CPI	m/m	mar	4.3%	4.4%	4.1%	***	Equity and bond neutral
	Industrial Production	m/m	feb	7.1%	7.5%	6.8%	***	Equity bullish, bond bearish
Australia	Consumer Inflation Expectation	y/y	apr	3.6%	3.7%		**	Equity and bond neutral
	Home Loan	m/m	feb	-0.2%	-1.1%	-0.4%	**	Equity bearish, bond bullish
	Investment Lending	m/m	feb	0.5%	1.1%		**	Equity and bond neutral
	Owner-Occupier Loan Value	m/m	feb	1.3%	0.5%		**	Equity and bond neutral
	Credit Card Purchases	m/m	feb	A$25.3 bn	A$26.6 bn		**	Equity and bond neutral
	Credit Card Balances	q/q	feb	A$52.7 bn	A$51.6 bn		**	Equity and bond neutral
New Zealand	Card Spending Retail	y/y	mar	1.0%	-0.3%	0.5%	**	Equity bullish, bond bearish
	Card Spending Total	m/m	mar	0.7%	0.1%		**	Equity and bond neutral
EUROPE								
Eurozone	Industrial Production	m/m	mar	-0.8%	-1.0%	0.1%	**	Equity bearish, bond bullish
France	CPI	y/y	mar	1.6%	1.5%	1.5%	**	Equity bullish, bond bearish
	CPI EU Harmonized	m/m	mar	1.7%	1.7%	1.7%	**	Equity and bond neutral
Russia	Trade Balance	y/y	feb	12.2 bn	17.0 bn	13.5 bn	**	Equity bearish, bond bullish
AMERICAS								
Mexico	Industrial Production	y/y	feb	0.7%	0.9%	1.2%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	feb	0.9%	1.7%	2.9%	***	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)	169	169	0	Neutral
TED spread (bps)	65	64	1	Neutral
U.S. Libor/OIS spread (bps)	177	176	1	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)	9	5	4	Down
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	down			Up
pound	up			Up
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	$71.85	$72.06	-0.29%	
WTI	$66.69	$66.82	-0.19%	
Natural Gas	$2.66	$2.68	-0.56%	
Crack Spread	$20.06	$20.37	-1.54%	
12-mo strip crack	$18.68	$18.92	-1.24%	
Ethanol rack	$1.57	$1.56	0.37%	
Metals				
Gold	$1,345.98	$1,353.38	-0.55%	Stronger Dollar
Silver	$16.64	$16.68	-0.25%	
Copper contract	$304.90	$311.70	-2.18%	
Grains				
Corn contract	$ 394.00	$ 395.75	-0.44%	
Wheat contract	$ 494.75	$ 504.25	-1.88%	
Soybeans contract	$ 1,061.00	$ 1,058.75	0.21%	
Shipping				
Baltic Dry Freight	979	974	5	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	3.3	-1.4	4.7	
Gasoline (mb)	0.5	-1.1	1.5	
Distillates (mb)	-1.0	-0.3	-0.8	
Refinery run rates (%)	0.50%	0.10%	0.40%	
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.

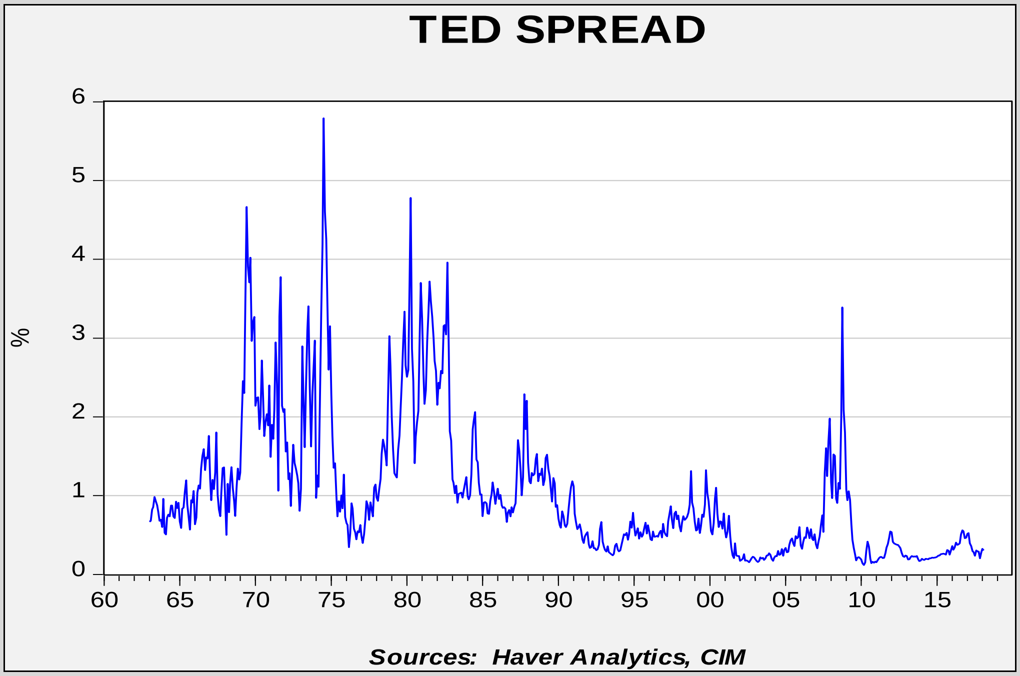
April 6, 2018

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.

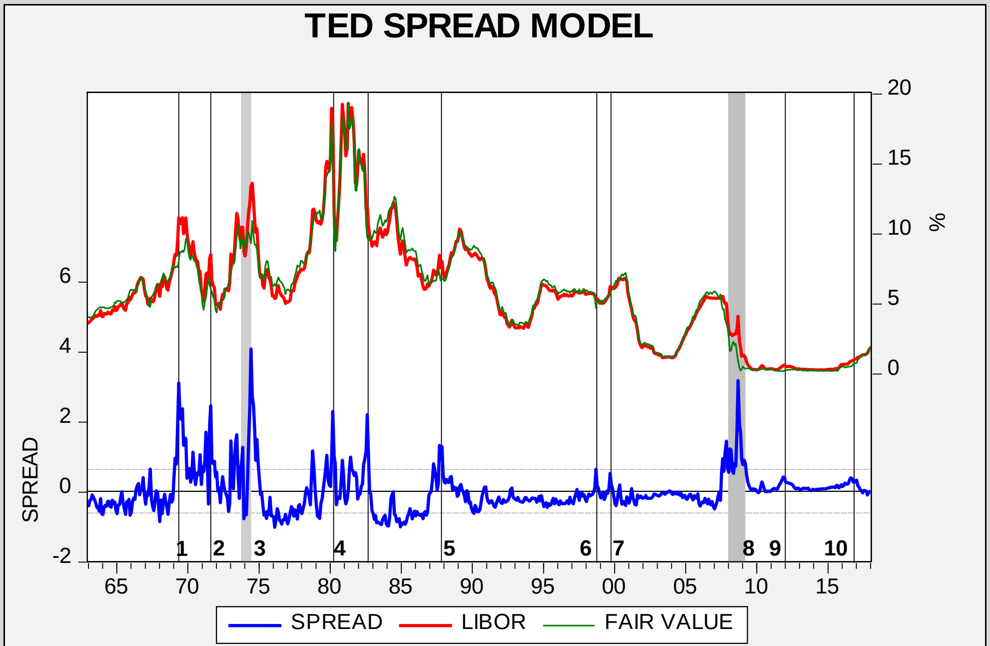
The other component is the flight-to-quality spread. Because Eurodollars are not government-guaranteed and do not have direct support of a central bank, investors flock to T-bills and shun Eurodollars during periods of stress. This widens the TED spread.

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.

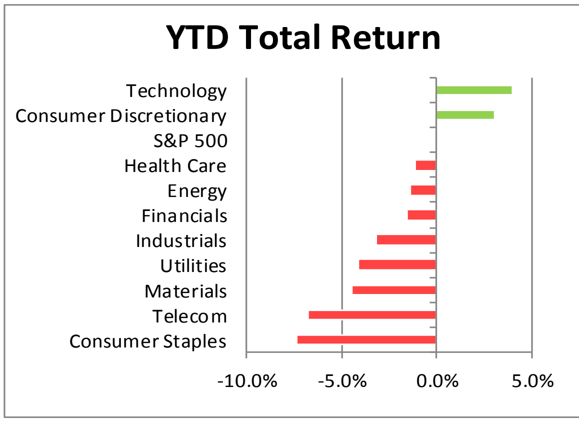


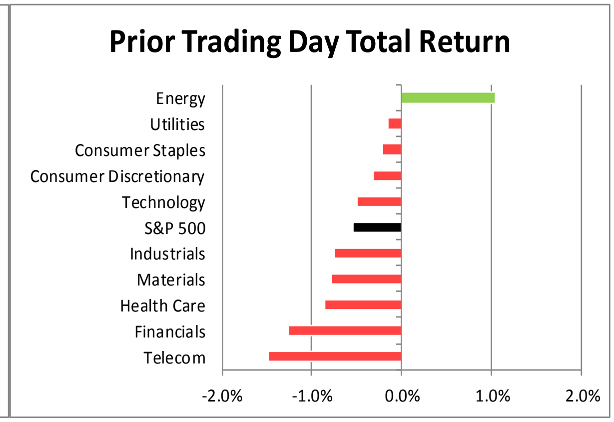
1 = Penn Central Bankruptcy; 2 = Bretton Woods Rescinded; 3= Arab Oil Embargo, Watergate
4 = Iran-Iraq War, Hostage Crisis; 5= Market Crash; 6 = LTCM Crisis;
7 = Asian Economic Crisis; 8= Great Financial Crisis; 9 = Eurozone Crisi, U.S. Debt Downgrade;
10 = 2016 Election
Sources: Haver Analytics, CIM

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 4/11/2018 close)

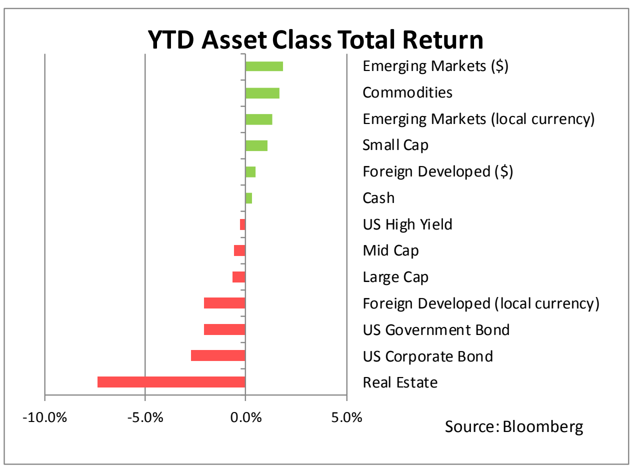




(Source: Bloomberg)

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 4/11/2018 close)

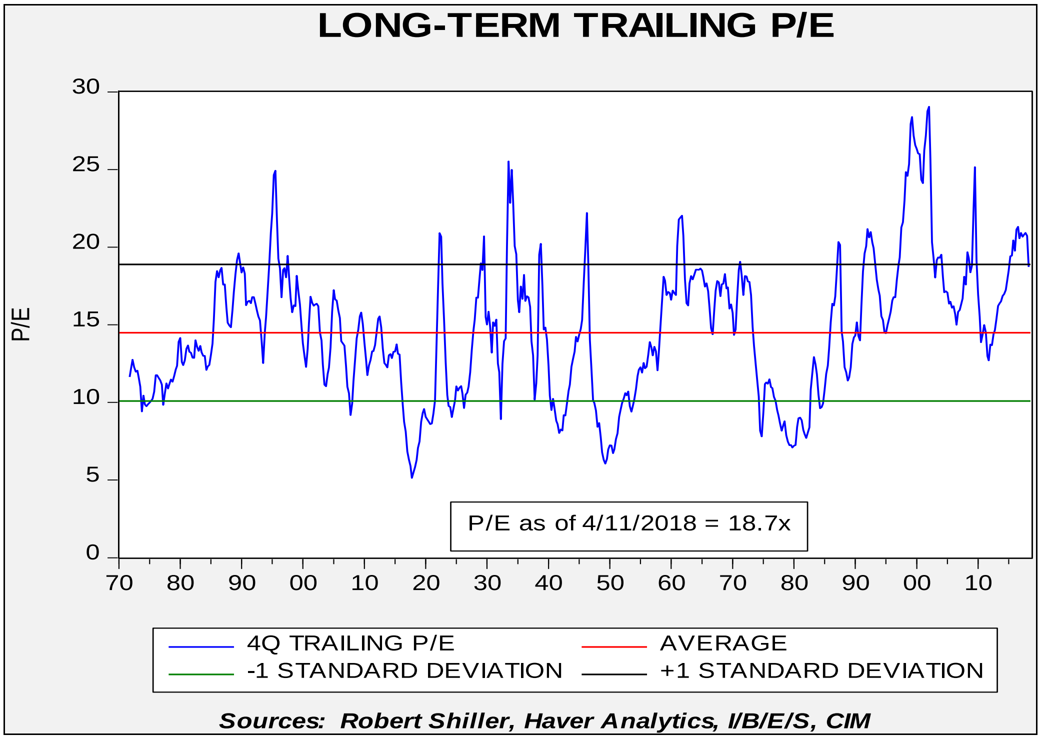


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 12, 2018



Based on our methodology,[1] the current P/E is 18.7, up 0.1x from last week. The modest rise in the multiple is due to higher equity prices.

[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.