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 16, 2018—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.8% from the prior close. Chinese markets were lower, with the Shanghai composite down 1.5% and the Shenzhen index down 0.5%. U.S. equity index futures are signaling a higher open. With 30 companies having reported, the S&P 500 Q1 earnings stand at $36.29, lower than the $36.49 forecast for the quarter. The forecast reflects an 18.4% increase from Q1 2017 earnings. Thus far this quarter, 73.3% of the companies reported earnings above forecast, while 16.7% reported earnings below forecast.

It's relief Monday! There was an attack on Syria but it was quite limited. Equities have moved higher, Treasury yields have lifted, oil prices have dipped and the dollar is lower. This is what we are watching this morning:

Parsing Syria: Late Friday, the U.S., U.K. and France launched a missile and bombing raid on three suspected chemical weapons sites in Syria. Although it appears damage to the facilities was extensive, there was no leakage or any reports of casualties. This suggests that Syria fully anticipated what targets would be hit and evacuated the facilities. Russia was essentially warned to ensure no Russian personnel would be harmed. The strikes were calculated to show American resolve against chemical weapons without expanding the conflict or threatening the Assad regime. Although B-1 bombers did use the Qatar facilities in the attack, there was no evidence of direct Gulf State participation.

What can we take away from this action? First, we think Trump's recent comments about leaving Syria are where his preference lies. The reaction of some right-wing populist commentators was interesting as there was strong condemnation of the attacks. Right-wing populists are opposed to American hegemony and want an end to the inconsequential wars that accompany that position. This group represents the president's core supporters and he will be conscious of their opposition. Thus, we would not be surprised to hear him return to the withdrawal position soon. Second, the action will not deter Assad from his goal, which is to retake all the territory lost. He may stop using chemical weapons to achieve this aim but attacking Syria for using chemical weapons but allowing his military to use indiscriminate bombing, i.e., attacking civilian areas and hospitals, is just as bad. Why does the U.S. tolerate the latter but respond to the former? There are probably a couple of reasons: (a) chemical weapons are weapons of mass destruction and the U.S. wants to restrict other nations from having them because they reduce America's ability to project power, and (b) President Obama didn't enforce the red line on this issue and President Trump is something of the "anti-Obama" in terms of policy. In other words, he perceives that his base reviles Obama and thus does not want to do anything that smacks of a similar policy.

Additionally, the president really does want to end American hegemony. We believe this process began with the last administration and continues with this one. The majority of Americans appear to have tired of the role and don't see any reason, in light of the end of the Cold War, to maintain America's superpower role. A recent *Washington Post* article[1] notes the president wanted Europe to "handle the Ukraine problem." Actually, the policy of demilitarizing Europe and taking over its security was deliberate—Europeans don't get along (just look at how they handled the Greek debt problem) and have been the fount of two world wars. Letting Europeans handle security problems will lead to a rearming of Europe and, a generation from now, an environment for conflict. President Obama concluded that the U.S. could not afford to maintain stability in three regions (Europe, Middle East and Far East) and therefore prepared to remove American influence in the Middle East by allowing Iran to become the regional hegemon. Trump's election put that plan aside but its replacement is a free-for-all. Leaving the Middle East may be necessary but the fallout could be difficult. The refugee crisis in Europe is partly due to this withdrawal and, at some point, we would expect a disruption of oil flows.

The U.S. has announced further sanctions on Russian firms, those involved in Syria's chemical weapons industry. Expect much consternation but no real change in circumstances.

So, the worst outcome for the markets, which would have been Russian casualties, Iranian attacks on Gulf State oil facilities and a wider conflict, did not and probably will not occur. The result has led to weaker oil prices, higher Treasury yields, dollar weakness and stronger equities. The good news is that a broader war with deep U.S. involvement isn't likely. The bad news is that the Middle East will devolve, bringing further instability.

The currency dog: Sherlock Holmes, in the short story *Silver Blaze*, talked about the absence of an expected outcome. In the story, there was a house abduction and the "dog didn't bark." One of the oddities of the Trump administration has to do with the dollar. At Davos, Treasury Secretary Mnuchin noted that a weaker dollar would support America's trade policy aims. The president quickly scotched the idea of dollar weakness for that goal. However, pressing dollar weakness looks like a policy that a president intent on reducing the trade deficit should support. Over the weekend, we learned that the Treasury won't name several nations,[2] including China, as "currency manipulators." Naming China with this designation was part of Trump's campaign, so the reluctance is something of a surprise.

We suspect the president, always conscious of the visibility of his actions, wants tariffs for the dramatic effect. That way he can show his base something clear he is doing to punish trade miscreants in ways they can see. On the other hand, the border adjustment tax, which was part of the tax reform discussion but jettisoned, and a weaker dollar would have likely been more

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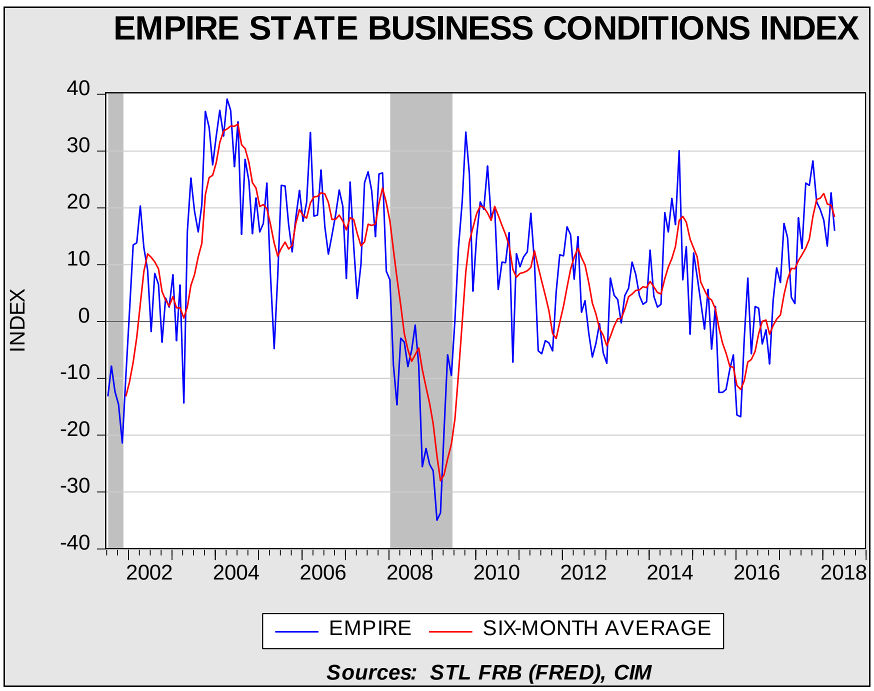
[1] https://www.washingtonpost.com/world/national-security/trump-a-reluctant-hawk-has-battled-his-top-aides-on-russia-and-lost/2018/04/15/a91e850a-3f1b-11e8-974f-aacd97698cef_story.html?utm_term=.dcfd4031c578&wpisrc=nl_politics&wpmm=1
[2] https://www.nytimes.com/2018/04/13/us/politics/trump-china-currency-manipulator.html

effective than tariffs in reducing the trade deficit. However, using these tools to affect trade is complicated and takes time. The president appears to have made the decision that visibility is worth more than potential effectiveness.

Nevertheless, we note with interest a tweet from the president this morning that said, "Russia and China are playing the Currency Devaluation game as the U.S. keeps raising interest rates. Not acceptable!" Two issues are contained in this statement. First, the president seems to have discovered that a weaker currency can offset the effects of tariffs, and second, this may be a shot across the bow to the Powell Fed that the White House is becoming uncomfortable with tighter monetary policy. Will the president soon discover the benefits of a weaker dollar? We will be watching to see if more comes of this; if it does, the dollar will likely weaken.

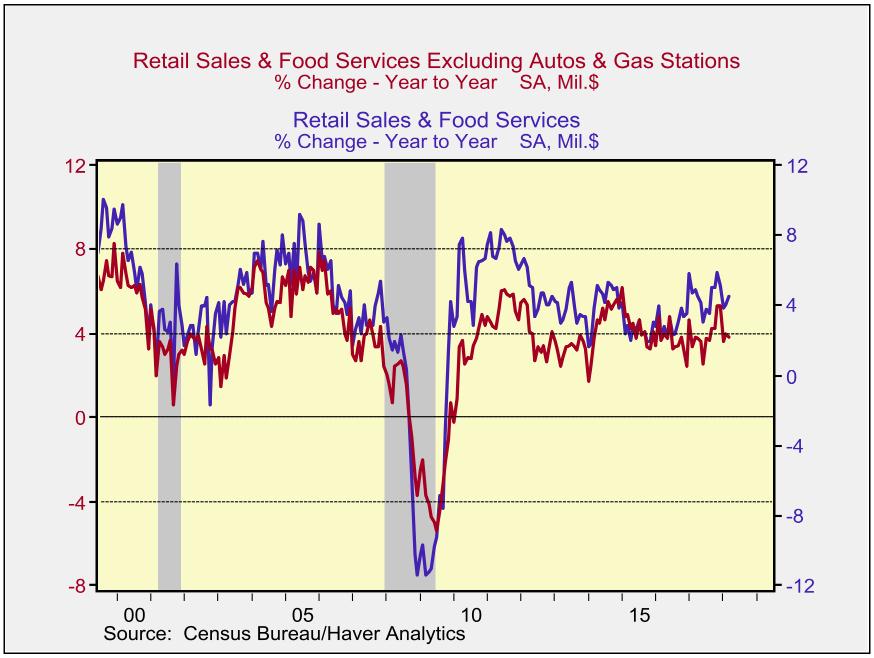
U.S. Economic Releases

Empire manufacturing came in below expectations at 15.8 compared to the forecast of 18.4.



The chart above shows the six-month moving average of the Empire State Business Conditions Index.

Retail sales advance came in above expectations, rising 0.6% from the prior month compared to the forecast gain of 0.4%. Retail sales ex-auto came in line with expectations, rising 0.2% from the prior month. Retail sales ex-auto and gas came in below expectations, rising 0.3% from the prior month compared to the forecast of 0.4%. The retail sales control group came in line with expectations, rising 0.4% from the prior month.



The chart above shows the year-over-year change in retail sales and core retail sales.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Business Inventories	m/m	feb	0.6%	0.6%	**
10:00	NAHB Housing Market Index	m/m	apr	70	70	**
16:00	Total Net TIC Flows	m/m	feb		$119.7 bn	**
16:00	Net Long-term TIC Flows	m/m	feb		$62.1 bn	**
Fed speakers or events						
EST	Speaker or event	District or position				
12:00	Robert Kaplan at International Economic Forum	President of the Federal Reserve Bank of Dallas				
12:00	Neel Kashkari speaks Too Big to Fail in Washington	President of Federal Reserve Bank of Minneapolis				
13:15	Raphael Bostic Speaks on the Economy and Rural Markets	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	Tokyo Condominium Sales	y/y	mar	6.1%	7.8%		**	Equity and bond neutral
India	Wholesale Prices	y/y	mar	2.5%	2.5%	2.5%	**	Equity and bond neutral
New Zealand	Performance Services Index	m/m	mar	58.8	55.0		**	Equity bullish, bond bearish
	Food Prices	m/m	mar	1.0%	-0.5%		***	Equity bullish, bond bearish
EUROPE								
Germany	Wholesale Price Index	m/m	mar	0.0%	-0.3%		**	Equity and bond neutral
U.K.	Rightmove House Price	m/m	apr	1.6%	1.5%		**	Equity and bond neutral
Swutzerland	Producer and Import Prices	m/m	mar	-0.2%	0.3%		**	Equity and bond neutral
	Total Sights Deposits	m/m	mar	575.1 bn	574.9 bn		*	Equity and bond neutral
	Deposits Sight Deposits	m/m	apr	466.2 bn	465.4 bn		*	Equity and bond neutral
AMERICAS								
Canada	Existing Home Sales	m/m	mar	1.3%	-6.5%		**	Equity and bond neutral
Brazil	Economic Activity	y/y	feb	0.7%	3.0%	0.8%	**	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)	235	235	0	Up
3-mo T-bill yield (bps)	172	172	0	Neutral
TED spread (bps)	63	63	0	Neutral
U.S. Libor/OIS spread (bps)	177	177	0	Up
10-yr T-note (%)	2.86	2.83	0.03	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	8	9	-1	Down
Currencies	**Direction**			
dollar	up			Down
euro	up			Up
yen	up			Up
pound	up			Up
franc	up			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	$71.81	$72.58	-1.06%	
WTI	$66.68	$67.39	-1.05%	
Natural Gas	$2.76	$2.74	0.88%	
Crack Spread	$19.64	$19.84	-1.00%	
12-mo strip crack	$18.36	$18.59	-1.24%	
Ethanol rack	$1.57	$1.57	-0.10%	
Metals				
Gold	$1,342.67	$1,346.20	-0.26%	
Silver	$16.59	$16.66	-0.37%	
Copper contract	$307.70	$307.10	0.20%	
Grains				
Corn contract	$ 393.00	$ 394.50	-0.38%	
Wheat contract	$ 485.00	$ 489.25	-0.87%	
Soybeans contract	$ 1,065.75	$ 1,065.00	0.07%	
Shipping				
Baltic Dry Freight	1014	993	21	

Weather

The 6-10 and 8-14 day forecasts continue to signal colder than normal temperatures for most of the country, with warmer temperatures in the western regions. Precipitation is expected for most of the East Coast.

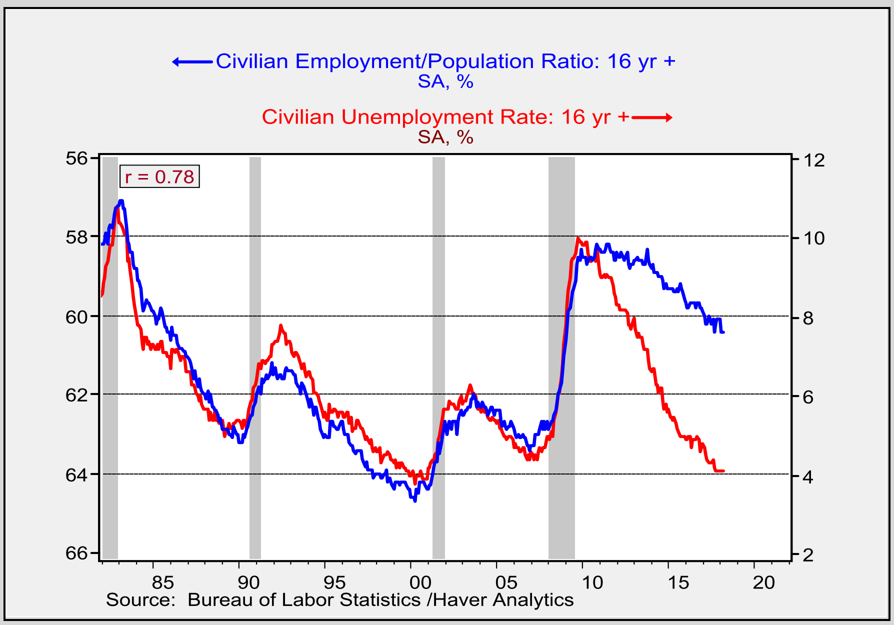
Asset Allocation Weekly Comment

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 13, 2018

One of the great unknowns in this recovery and expansion is the proper measure of economic slack. Although it's a term that is rather easy to understand in the abstract, actually defining it is difficult. The Congressional Budget Office (CBO) produces an estimate of potential GDP but it is, at best, a rough measure based on population growth, estimates of productivity and capital stock. The famous "Taylor Rule[3]" uses the difference between actual and potential GDP in its calculation of the neutral policy rate. However, due to the uncertainty surrounding potential GDP, Greg Mankiw, an economics professor at Harvard and Chair of Economic Advisors under President Bush, offered another version of the Taylor Rule, which we call the "Mankiw Rule." The Mankiw Rule substitutes the unemployment rate less the non-accelerating inflation rate of unemployment (NAIRU). In other words, Mankiw proposes the labor markets are a better measure of slack.

The primary attraction of the Mankiw Rule for policymakers is that it fits well with the FOMC's other working model, the Phillips Curve, which postulates that there is an inverse relationship between the unemployment rate and inflation. The Mankiw Rule's primary flaw is that NAIRU isn't directly observable (although the CBO calculates it as well). It also has a secondary flaw, which is that the unemployment rate may not be the best measure of slack in the labor markets.



This chart shows the relationship between the unemployment rate and the employment/ population ratio (inverted scale). From 1980 to 2010, the two series correlated at 94%. But, the relationship has broken down in this recovery and expansion.

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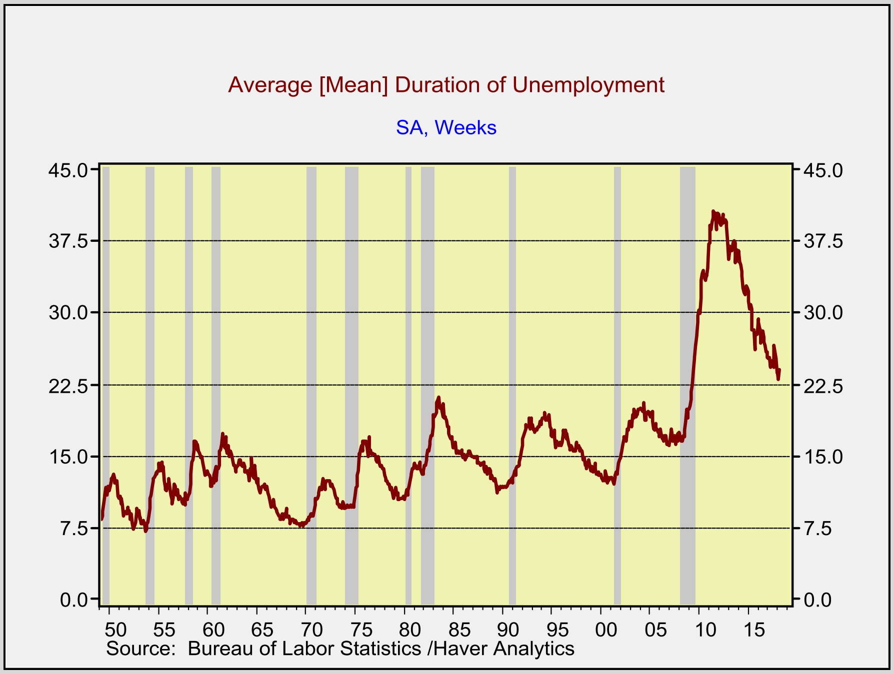
[3] Neutral nominal policy rate = neutral real rate + 0.5(actual vs. target inflation) + 0.5(real GDP - real potential GDP)

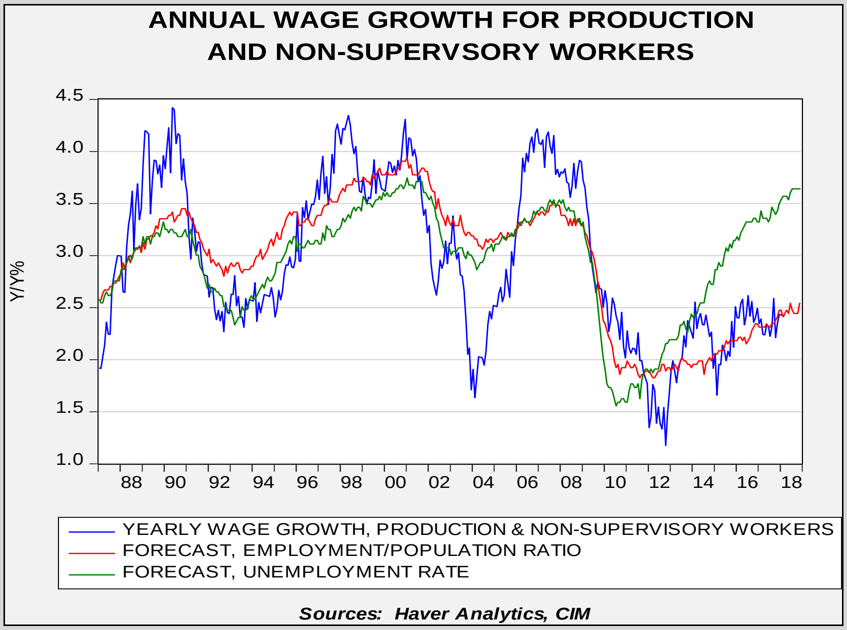
The problem for policymakers is determining which of these two series for the labor market best measures slack. The unemployment rate is at levels that would usually be considered full employment, which would suggest that monetary policy should be tightening rapidly. On the other hand, the employment/population ratio indicates ample slack in the labor market, which would argue for slow tightening at best.

The general consensus among economists is that the employment/population ratio is depressed due to baby boom retirements and structural unemployment caused by globalization and automation. Thus, these workers are not really available for hiring. The high level of long-term unemployment would tend to bolster that position.



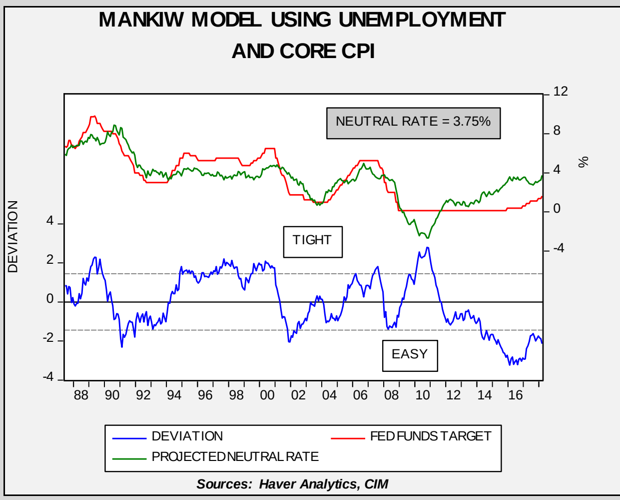
This chart shows the average duration of unemployment. Previous cycle highs were generally around 21 weeks; during expansions the trough is usually around 12 weeks, although the cycle low exceeded 15 weeks in the last expansion. In the Great Financial Crisis, the average duration peaked at 40.7 weeks and remains elevated, but it has been declining. The existence of long-term unemployment does support the idea that the unemployment rate is probably a more accurate measure of slack as the gap shown in the first chart is due to structural unemployment and baby boom retirements.

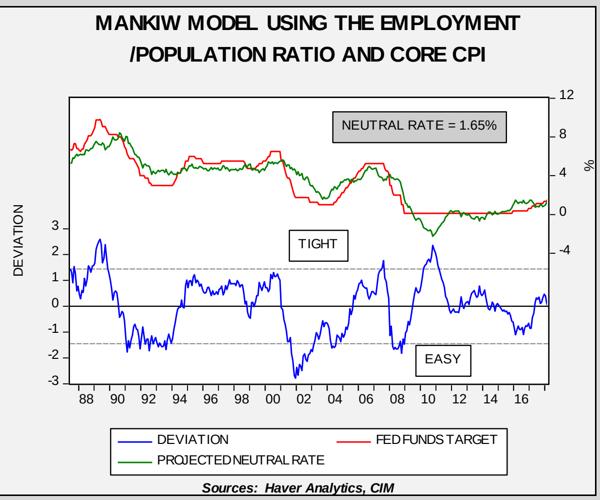
However, if slack is disappearing, it should be showing up in wages. Thus, comparing the two measures of slack to wage growth should really be the ultimate determinant of which measure is best for policymakers. In this regard, the employment/population ratio has outperformed recently.



This chart shows the forecast of annual wage growth for production and non-supervisory workers using the unemployment rate in one model and the employment/population ratio in the other. Until 2012, neither model was clearly superior to the other. However, since 2014, the employment/population ratio has been clearly superior. Both independent variables tend to lead wages by nine months. The employment/population ratio predicts that wage growth for this broad segment of workers should remain around 2.5% through the end of this year.

Our primary concern about monetary policy is determining the likelihood of a mistake that would lead to excessive tightening and raise the odds of a recession. Studying the two variations of the Mankiw model, one that uses the unemployment rate and another that uses the employment/population ratio, should offer insights into the chances of a policy error.



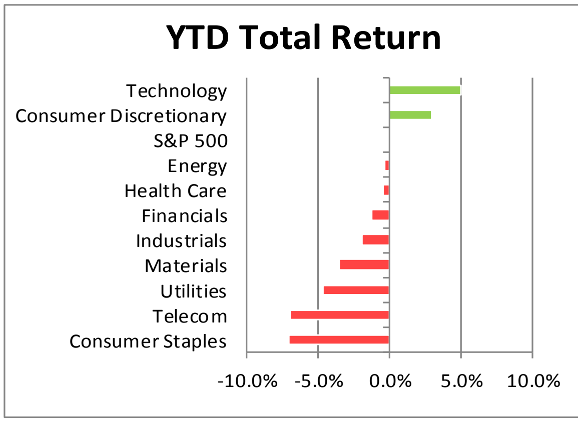


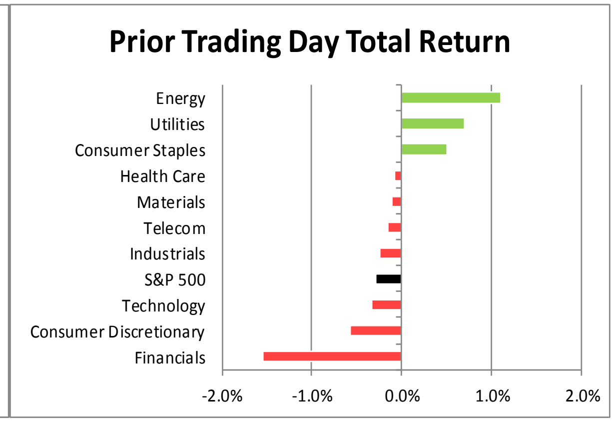
This chart shows the two models. The unemployment rate model suggests the FOMC is woefully behind the curve and needs to raise rates aggressively. The employment/population ratio model suggests the FOMC has achieved policy neutrality and should only raise rates further with evidence of rising inflation. The Fed dots chart average indicates the fed funds target will reach 2.25% by year's end, or two more rate hikes this year. If all variables remain stable, the unemployment rate model will still signal that policy is accommodative. The employment/population ratio will not reach restrictive until rates reach 2.75%, which would be one standard error above the forecast. The estimates from the dots chart suggest that scenario would happen in 2019, when another three hikes are expected.

Our analysis of comments from members of the FOMC suggests that policymakers believe the unemployment rate is the proper measure of slack. Thus, the odds of a policy mistake are increasing. However, the calculation of the employment/population ratio suggests we aren't there quite yet. Thus, it is probably too soon to become overly defensive in portfolios based on the domestic economy and monetary policy alone. There may be other reasons (geopolitical and political) to be cautious but, for now, our Asset Allocation Committee remains optimist about risk assets.

Data Section

U.S. Equity Markets – (as of 4/13/2018 close)

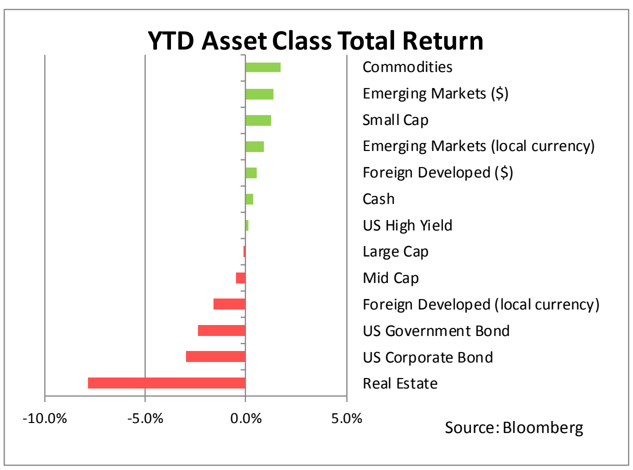




(Source: Bloomberg)

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 4/13/2018 close)

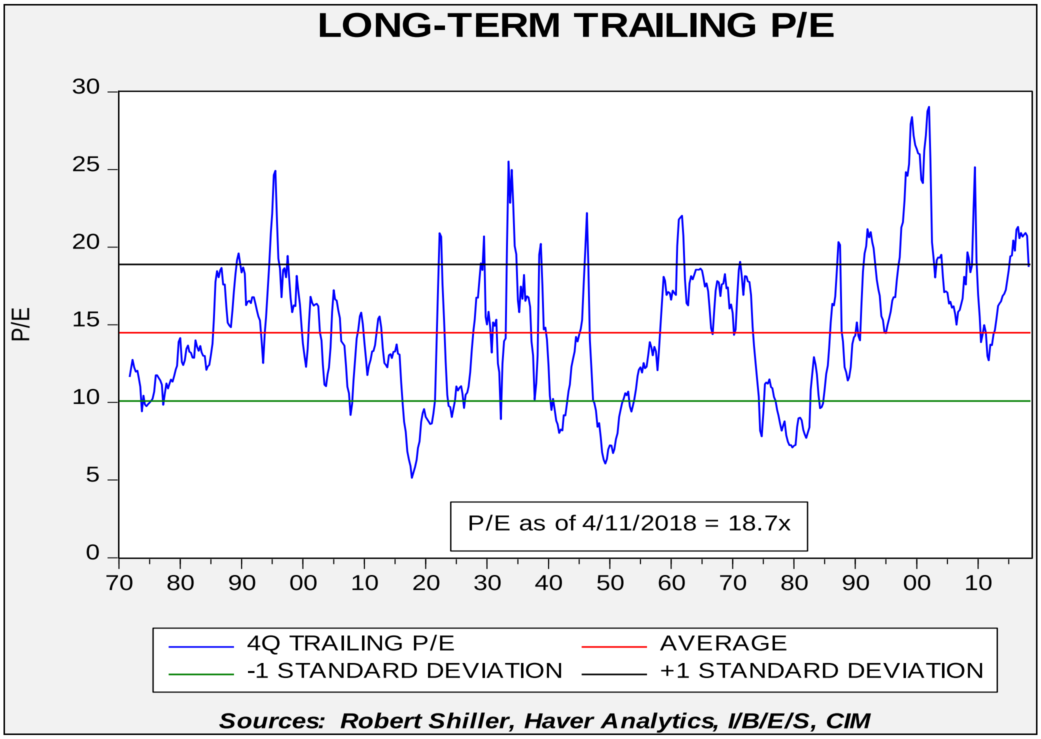


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[4] 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.

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[4] 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.