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 20, 2018—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed down 1.6% from the prior close. Chinese markets were lower, with the Shanghai composite down 1.5% and the Shenzhen index down 2.0%. U.S. equity index futures are signaling a higher open. With 74 companies having reported, the S&P 500 Q1 earnings stand at $36.60, higher than the $36.49 forecast for the quarter. The forecast reflects an 18.4% increase from Q1 2017 earnings. Thus far this quarter, 78.4% of the companies reported earnings above forecast, while 12.2% reported earnings below forecast.

It was a mostly quiet overnight session. Here is what we are watching this morning:

Policy talk boosts greenback: Dovish comments from the ECB and BOE have lifted the dollar this morning. The ECB is considering delaying the path of tapering due to recent economic weakness and BOE Governor Carney made similar statements as well. We have been bearish the dollar based on valuation issues; using inflation parity, the dollar remains overvalued, although the degree of overvaluation has been reduced. Monetary policy, under conditions of overvaluation, is usually not all that important. However, the dollar has been range-bound in recent months and we suspect that condition will remain in place for a few more weeks before the dollar's decline resumes.

Trump and OPEC: The president tweeted this morning that OPEC is "at it again" artificially boosting prices. Oil prices dropped sharply on his comments. He argued that there are "record amounts of oil all over the place." This is clearly wrong. As we detailed yesterday, oil inventories are well off their peak and we have not seen the usual seasonal build in stockpiles that typically occurs in the first four months of the year. The president suggested "this will not be accepted." There are two things the president could do to bring down oil prices. First, he could authorize a release of oil from the Strategic Petroleum Reserve (SPR). Although the government plans to sell oil out of the reserve in the coming years for budgetary reasons, there is still ample oil available in the reserve. This action would be improper—the SPR is designed for emergencies, not for guiding prices. However, other presidents have used the reserve in this way; President Clinton did so in the late 1990s (although officially this release was related to heating oil). The second action he could take would be to recommend legislation to stop oil exports. This would lower U.S. oil prices relative to the world and give OPEC + Russia what it really wants, which is an end to the supply threat from shale oil. We remain bullish oil; the president could affect oil supplies but, in reality, this morning's tweeting is simply jawboning.

However, politically, his comments make sense; high gasoline prices are never popular with the public and calling out OPEC is one way to react to higher gasoline prices.

In related news, Saudi Arabia and Russia will begin talks over the weekend "on sending a signal on what they will do beyond next year."[1] Saudi Arabia needs Brent around $75 per barrel to meet its fiscal obligations. Russia can balance its budget with $53 oil. The two must decide if they will continue their program to reduce supplies or begin to retake market share. Although we are bullish crude oil, any news that OPEC is boosting supplies will be bearish for prices, at least in the short term. Longer term, if the Iran deal ends or the conflict in Syria spreads, oil prices would likely rise.

North Korea: Media reports indicate that North Korea will not have preconditions for upcoming talks. Although there is concern about strategic ambiguity (the U.S. and the DPRK say the same thing but mean something different), it does appear that Kim wants a deal of some sort. The talks are a high-stakes gamble. If negotiations are successful they could bring peace to a troubled part of the world and give President Trump an historic breakthrough. If they fail, it's hard to see how war doesn't follow.

U.S. Economic Releases

There are no economic releases or Fed events scheduled for the rest of the day.

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	National CPI	y/y	mar	1.1%	1.5%	1.1%	***	Equity and bond neutral
	National CPI ex Fresh Food	y/y	mar	0.9%	1.0%	0.9%	***	Equity and bond neutral
	National CPI ex Fresh Food, Energy	y/y	mar	0.5%	0.5%	0.5%	***	Equity and bond neutral
	Tertiary Industry Index	m/m	feb	0.0%	-0.6%	0.0%	**	Equity and bond neutral
	Nationwide Department Sales	y/y	mar	0.1%	-0.9%		**	Equity and bond neutral
	Tokyo Department Sales	y/y	mar	0.1%	0.6%		**	Equity and bond neutral
	Convenience Store Sales	y/y	mar	1.3%	0.3%		**	Equity and bond neutral
EUROPE								
Germany	PPI	y/y	mar	1.9%	1.8%	2.0%	**	Equity and bond neutral
Russia	Gold and Forex Reserve	m/m	apr	462.4 bn	458.9 bn		**	Equity and bond neutral
	Money Supply Narrow Def	m/m	apr	9.840 tn	9.640 tn		**	Equity and bond neutral
AMERICAS								
Brazil	CNI Industrial Confidence	m/m	apr	56.7	59.0		**	Equity and bond neutral

[1] https://www.wsj.com/articles/an-oil-deal-between-saudi-and-russia-worked-now-what-1524130200

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)	236	236	0	Up
3-mo T-bill yield (bps)	178	178	0	Neutral
TED spread (bps)	58	57	1	Neutral
U.S. Libor/OIS spread (bps)	179	179	0	Up
10-yr T-note (%)	2.91	2.91	0.00	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	7	5	2	Down
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	down			Up
pound	down			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	$73.60	$73.78	-0.24%	
WTI	$68.12	$68.29	-0.25%	
Natural Gas	$2.67	$2.66	0.49%	
Crack Spread	$19.57	$19.41	0.81%	
12-mo strip crack	$18.37	$18.40	-0.12%	
Ethanol rack	$1.60	$1.60	0.23%	
Metals				
Gold	$1,342.17	$1,345.53	-0.25%	
Silver	$17.15	$17.25	-0.57%	
Copper contract	$315.95	$315.40	0.17%	
Grains				
Corn contract	$ 388.75	$ 391.00	-0.58%	
Wheat contract	$ 482.50	$ 490.75	-1.68%	
Soybeans contract	$ 1,041.75	$ 1,049.00	-0.69%	
Shipping				
Baltic Dry Freight	1201	1124	77	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-1.1	-0.6	-0.5	
Gasoline (mb)	-3.0	0.5	-3.4	
Distillates (mb)	-3.1	-0.4	-2.7	
Refinery run rates (%)	-1.10%	0.10%	-1.20%	
Natural gas (bcf)	-36.0	-23.0	-13.0	

Weather

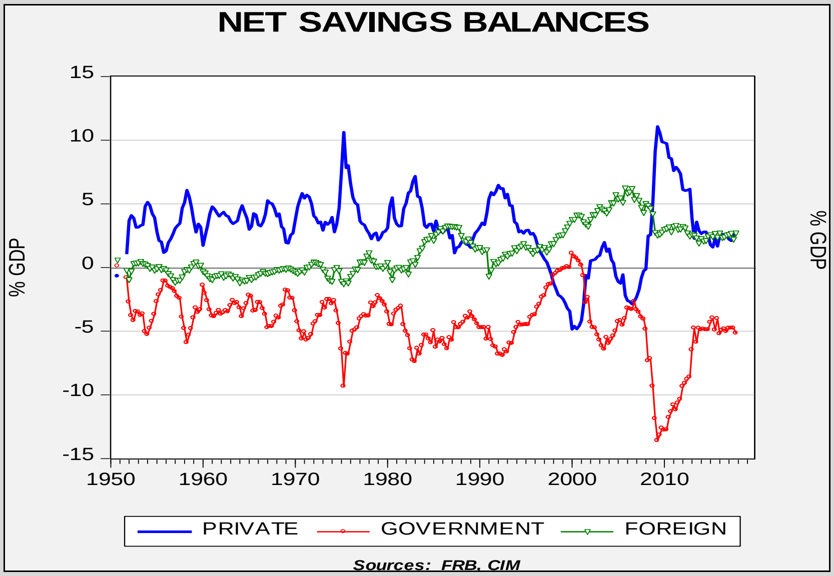
The 6-10 and 8-14 day forecasts continue to signal warm to normal temperatures for most of the country, with cooler temperatures in the mid-Atlantic region.

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 20, 2018

The Trump administration has made it a key policy goal to reduce the trade deficit. The reasoning is that reducing the trade deficit will boost jobs in areas that have been adversely affected by foreign competition. Although this might be true (trade is very complicated), the risk is that trade restrictions will likely result in higher inflation.

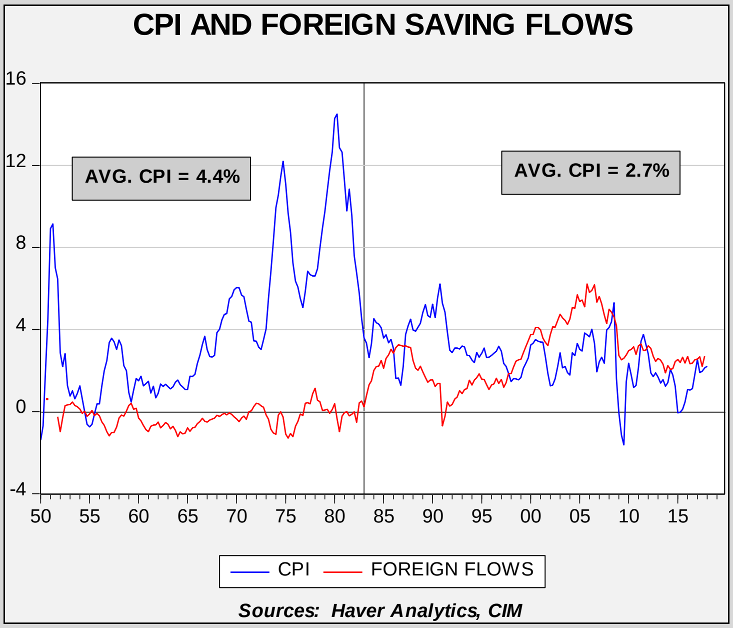


This chart shows net savings balances. These are macroeconomic identities, which, like a balance sheet, total to zero. However, how they reach zero is interesting. Usually, government dissaving (more commonly called a fiscal deficit) is offset by the combination of private and public sector saving. Foreign saving is the inverse of the current account; when a nation accumulates foreign saving, it is running a trade deficit. Private sector saving comes from the household and business sectors. For the former, it's the difference between income and consumption. For the latter, it's the net of revenue after investment. Thus, for the entire private sector, net saving is saving less investment.

Since the early 1980s, foreign saving has become a nearly permanent fixture. Most pundits argue that the U.S. must "attract" foreign saving due to the fiscal deficit. However, the direction of causality can be difficult to trace. For instance, under conditions of free trade, if a foreign nation purposely builds excess saving, that excess saving will become a trade surplus and the rest of the world must absorb that excess production (saving). If trade barriers exist, that excess saving is transformed into domestic investment, either by inventory accumulation or increased investment spending.

Because the U.S. is the provider of the reserve currency, it is the most likely target of foreign saving. Note that in the late 1990s, the U.S. ran fiscal surpluses with rising foreign saving inflows. There was a plunge in private saving, mostly due to business dissaving. Some of that increased investment was due to Y2K spending but some ended up bidding up existing asset prices (the tech bubble was partly a beneficiary). Ben Bernanke referred to a global "savings glut" in the last decade that is seen in the foreign inflows.

President Trump wants to reduce the trade deficit; if he is successful, he will also reduce foreign saving to the U.S. With the fiscal deficit rising, the private sector will be required to make up the difference. That can either come from falling consumption relative to income or falling investment relative to business saving. Falling consumption usually comes from either increases in inflation (which reduces real spending) or unemployment. Although reducing the trade deficit may benefit specific sectors of the economy, in reality, there are downsides to the policy.

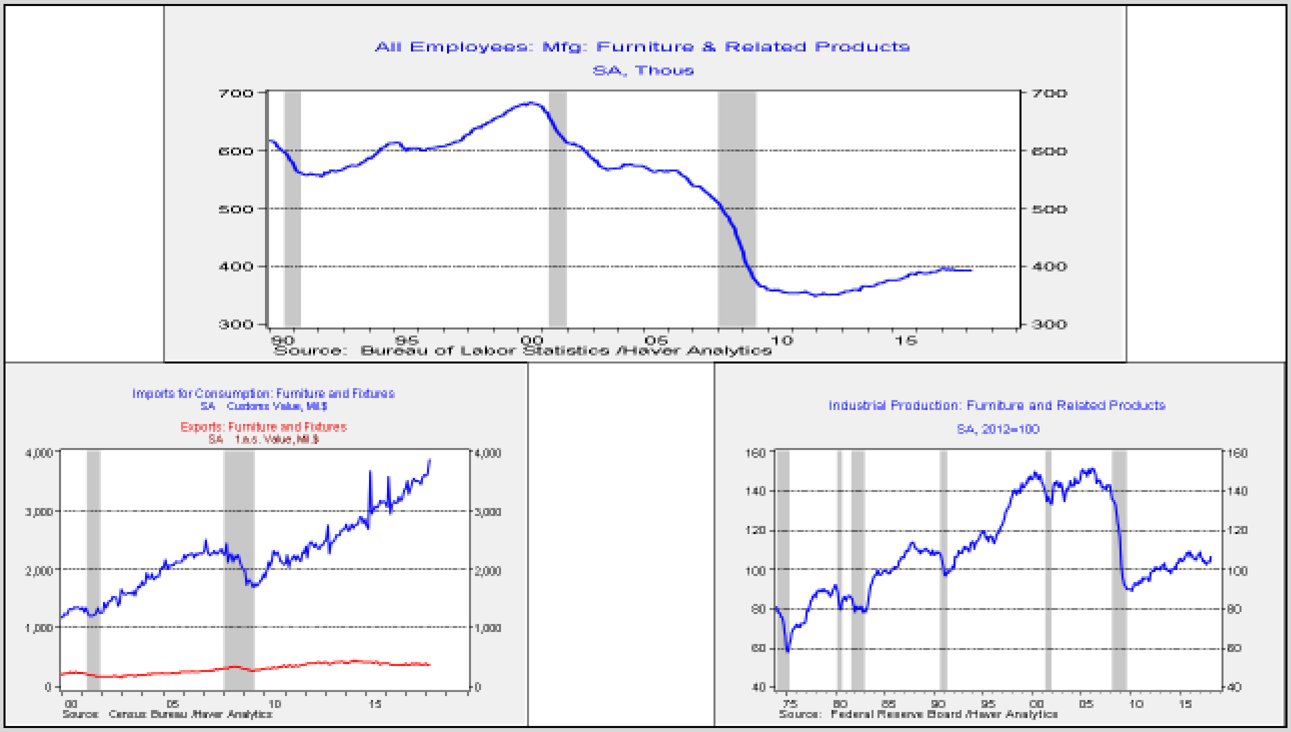


This chart shows the yearly change in CPI with foreign saving into the U.S. We have placed a vertical line on the chart, beginning in 1983, when foreign saving increased. During the period of small trade deficits (low for negative foreign saving), inflation averaged 4.4%. The onset of foreign saving has reduced inflation significantly.

The U.S. benefits from foreign saving inflows. It keeps inflation low and allows the U.S. to run fiscal deficits that would not be possible for other nations. For the most part, foreign nations accept this tradeoff to acquire the dollar for reserve purposes. The cost to the U.S. economy is that the trade is clearly unfair; foreign nations purposely build saving through policies designed to boost household saving. These include an undervalued exchange rate, consumption taxes, an inadequate or non-existent social safety net, tariffs and quotas. In one sense, if a foreign nation wants to deprive its citizens of goods and services and force them to save,[2] then the U.S. should

[2] Something the U.S. did during wartime with rationing.

accept their “generosity” and repay them with Treasuries. However, there are negative effects for some sectors of the economy that compete with imports.

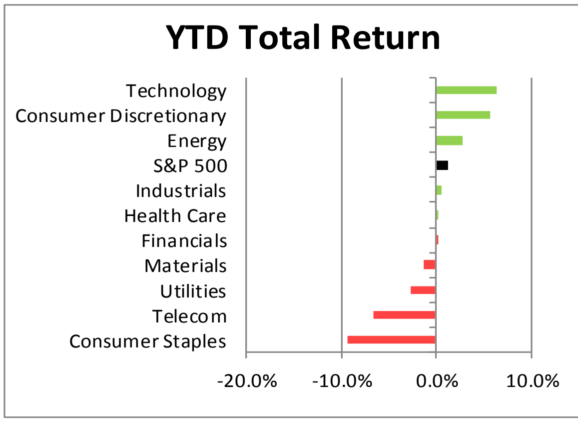


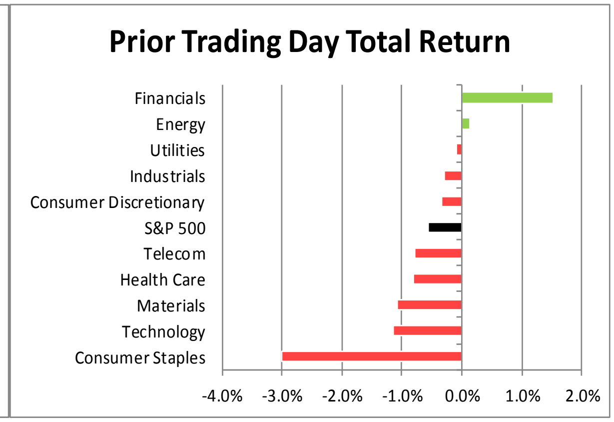
These charts show the U.S. furniture industry. The upper chart is employment. It has fallen by more than a third from the peak. The lower left-hand chart shows imports and exports (with the former rising rapidly) and the lower right-hand chart shows industrial output for furniture, which fell sharply during the last recession but has failed to recover anywhere near the previous peak. Clearly, this industry has been harmed by imports.

The trade issue is really a matter of who bears the burden of trade adjustment. Tariffs mean consumers bear the costs via higher prices. Subsidies mean taxpayers bear the burden. In the absence of either, the workers and owners in the U.S. bear the burden. However, in a macroeconomic sense, acts that raise the cost of imports will tend to bring higher inflation. If that becomes the favored policy, investors will face rising interest rates and falling P/E multiples. Thus, we continue to closely watch the president’s trade policy to for widespread effects and the impact on price levels.

Data Section

U.S. Equity Markets – (as of 4/19/2018 close)

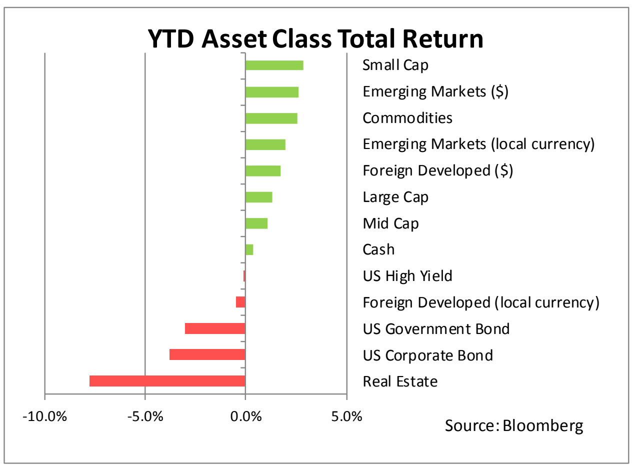




(Source: Bloomberg)

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 4/19/2018 close)

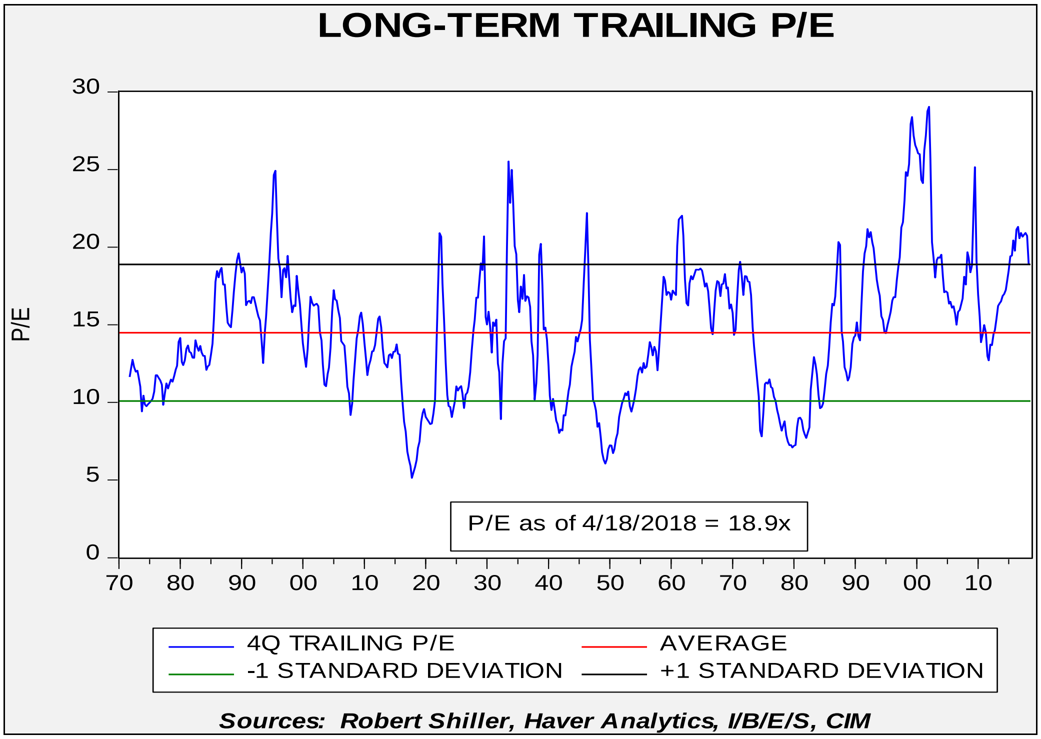


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 19, 2018



Based on our methodology,[3] the current P/E is 18.7, up 0.2x from last week. The modest rise in the multiple is due to higher equity prices.

[3] 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.