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 6, 2018—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.7% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.3% from the prior close. Chinese markets are closed for the Ching Ming Festival. U.S. equity index futures are signaling a lower open.

Happy employment day! We cover the data in detail below but the quick take is that it was much weaker than expected. Payrolls came in well below forecast and the unemployment rate held steady compared to an expected small decline. The data should be taken with caution because the parade of winter storms that hit the Northeast last month probably affected the report. The other major issue is, again, trade. Here is what we are watching this morning:

Tit for tat: Last night, President Trump suggested another $100 bn of new tariffs on China because of its reaction to the first salvo. The usual market response developed; equity futures slid while gold and Treasuries rallied. However, the reaction was not as pronounced compared to earlier periods. It appears the financial markets are steadily adjusting to the president's social media messages and beginning to focus more on the endpoint than the tweet. The situation with China remains fluid and there is still the probability of a trade war. But, there is also the potential for the outcome we have seen with NAFTA as it seems the U.S., Canada and Mexico are nearing an agreement. When the discussions began, it looked like the treaty was in deep trouble. Now, it looks like all the rhetoric was a negotiating stance.

It is still important to remember that China has taken advantage of the U.S. and the West during its development. This isn't anything new. Export promotion has become the development model of choice since the end of WWII. The basic recipe is to implement policies that curtail consumption and boost investment. These policies include an undervalued exchange rate, import restrictions, easy corporate borrowing and intellectual property theft. The program works if the global superpower tolerates it. The U.S. did tolerate this behavior during the Cold War, although there were occasional pushbacks (the Plaza Accord, "voluntary" Japanese vehicle import restrictions, etc.). However, every nation that deploys the model reaches a point of development where it no longer works. First, other nations begin to retaliate against the trade surpluses. Second, debt levels usually become untenable. There are essentially four paths to transition away from export promotion. The first is to boost household consumption by reducing saving. This approach can create a debt crisis; in the U.S., resolving this crisis was called "anyone, anyone, the great, Great, Depression."[1] In Japan, it has led to 30 years of stagnation. The second

[1] https://www.youtube.com/watch?v=uhiCFdWeQfA

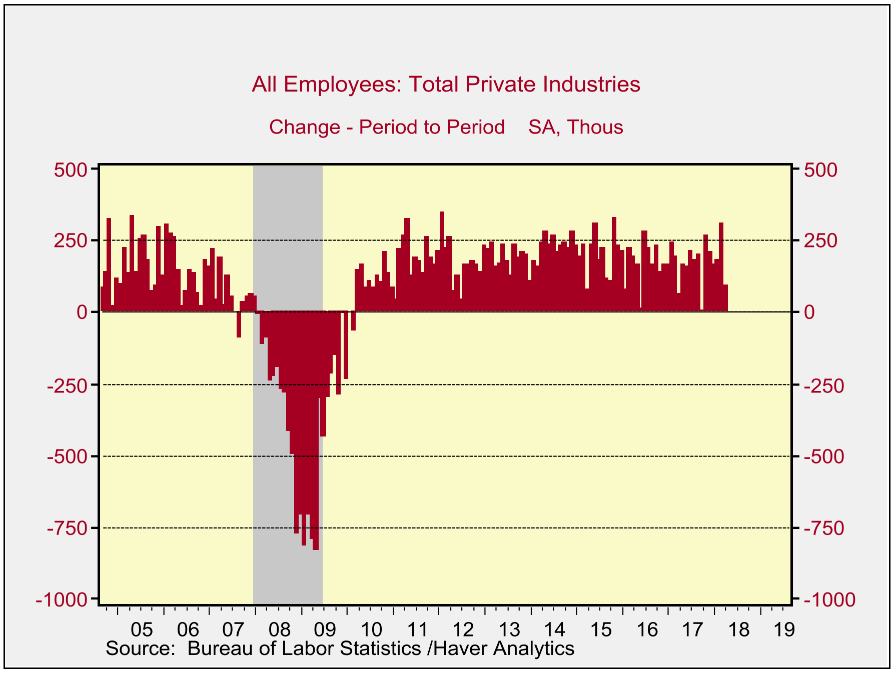
path is war. War allows the nation to redirect its excess capacity to the war effort instead of exports. The winner destroys the export capacity of his enemy and can keep export promotion policies in place, perhaps even gaining colonies (see below). The third path is to raise the value chain. The excess capacity is transformed into higher value goods. Germany has used this path since the 1980s and the China 2025 plan looks like a similar plan. The fourth path is colonization, where colonies are forced to absorb the excess production caused by malinvestment. The U.K. used this system with its commonwealths, Germany is using it now with the Eurozone and China hopes to use the same method with the "one belt, one road" program. China knows it is at a critical point where it needs to transition its economy. Chairman Xi has amassed enough power to give him the wherewithal to make these difficult changes.

To some extent, U.S. goals of reducing its trade deficit with China are consistent with China's goals of restructuring its economy. However, China won't simply accept U.S. trade impediments as they are seen as a form of attack on its sovereignty. Encouraging a stronger CNY and dictating global trade rules, as TTP would have done, would have been a better path. Thus, we have the risk of a trade war, but such a conflict is still avoidable.

Oil tariffs? There are growing fears that China will put tariffs or quotas on U.S. crude oil exports. Tariffs might occur, but they would likely be ineffective. U.S. oil exports to China are rising but are still only about 300 kpbd as of January. Nevertheless, if China raises the cost of U.S. oil exports, other nations will fill the U.S. market share. But, since oil is mostly fungible, the flows will change but U.S. exports should remain the same. For example, let's say Saudi Arabia fills the U.S. market share. Unless the Saudis increase output and violate their OPEC quota, they will reduce oil sales to some other customer and the U.S. will likely fill that gap. The same thing could happen with soybeans. China needs commodities, and selectively slapping tariffs on U.S. commodity exports will have an effect on flows but not necessarily on overall exports.

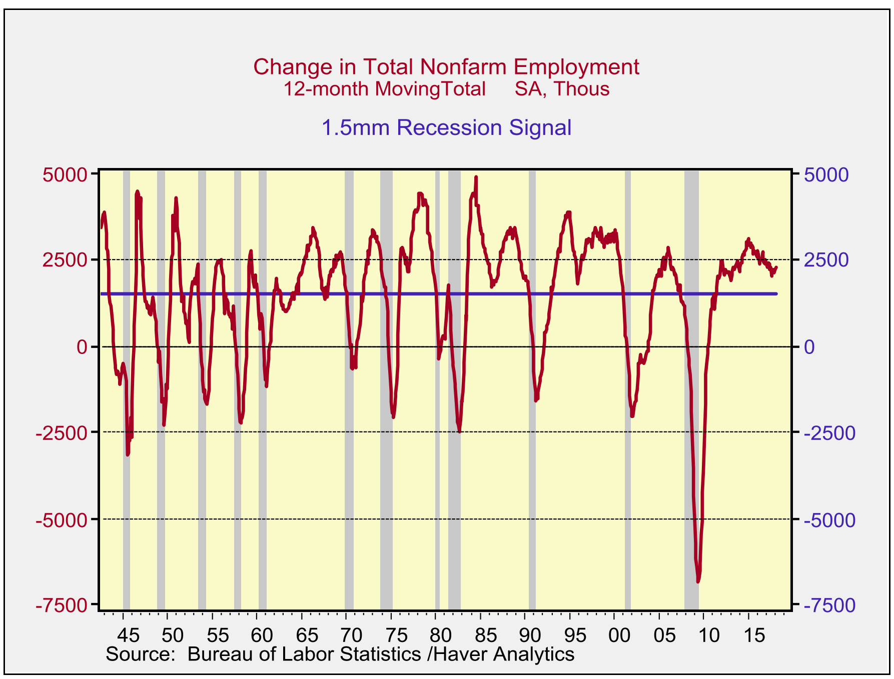
U.S. Economic Releases

The change in non-farm payrolls for March came in below expectations at 103k compared to the forecast of 185k. The prior report was revised upward from 313k to 326k. The change in private payrolls came in below expectations at 102k compared to the forecast of 188k. The prior report was revised upward from 287k to 320k. The change in manufacturing payrolls was in line with expectations at 22k.

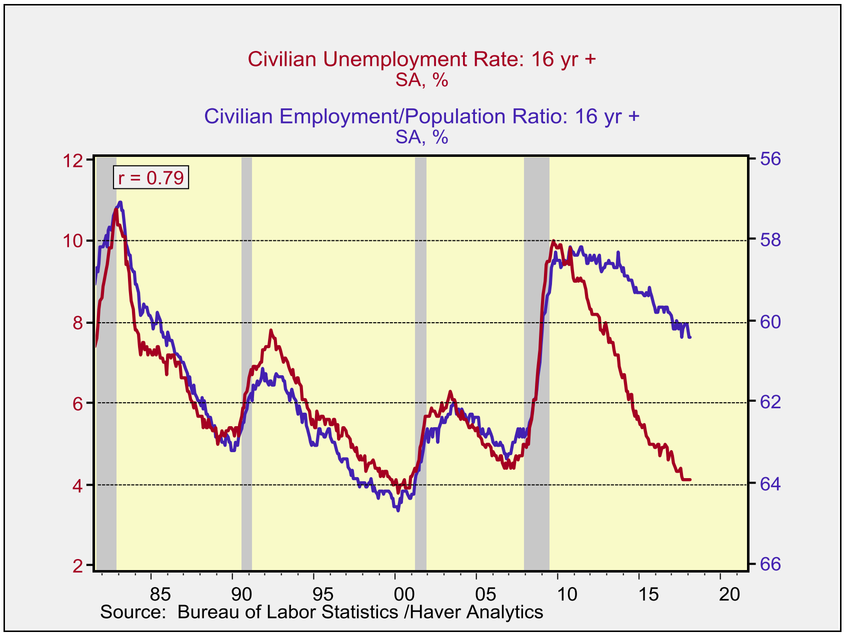


The chart above shows the change in total private employment. This chart suggests the economic expansion continues.

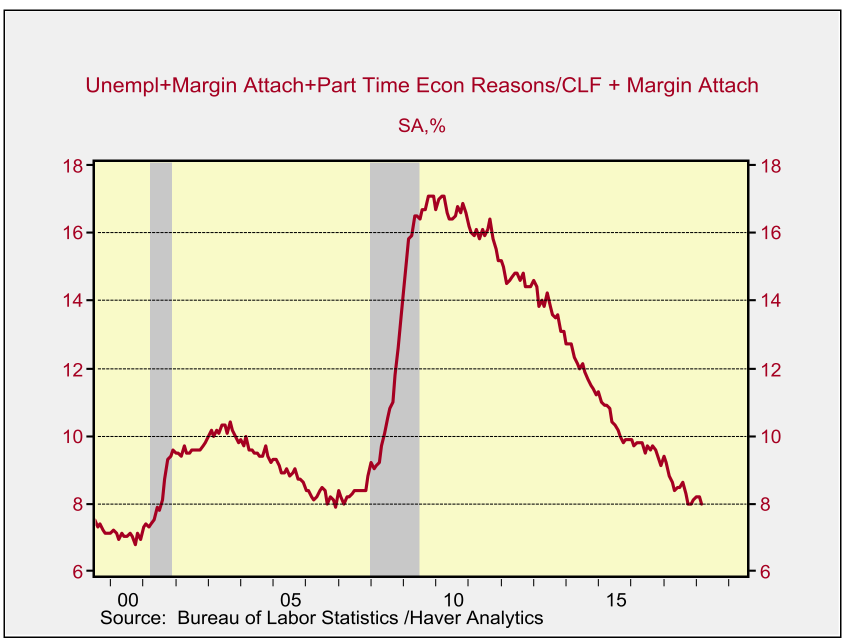
The chart below shows the 12-month moving total of the change in non-farm payrolls; a dip under 1.5 mm signals recession.



The unemployment rate came in above expectations at 4.1% compared to the forecast of 4.0%. The labor force participation rate was 62.9%, a small dip from the previous month, while the U-6 unemployment rate fell 20 bps from 8.2% to 8.0%.

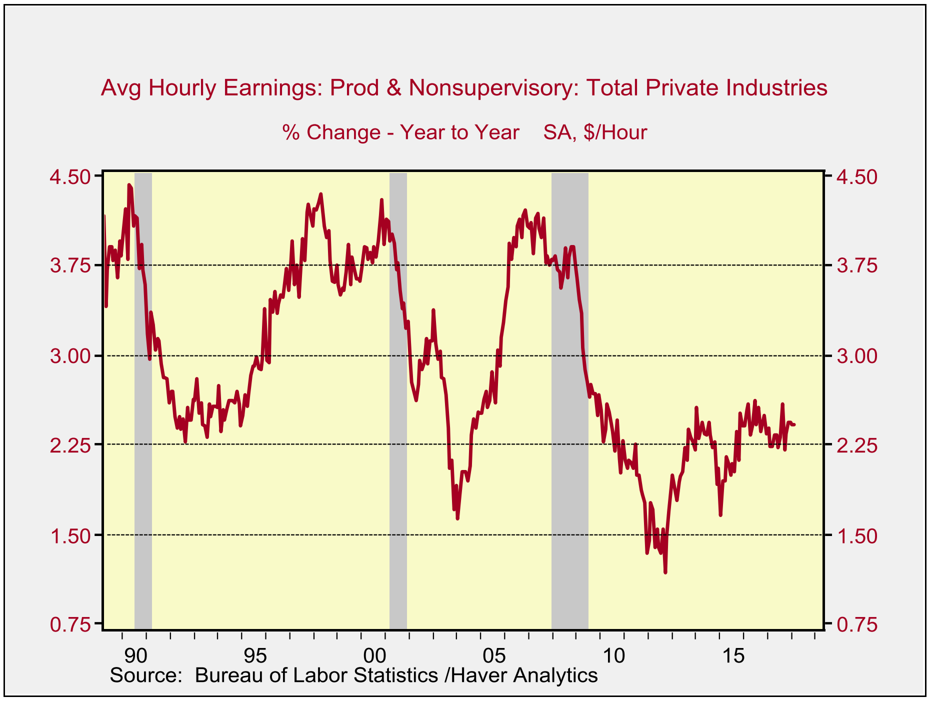


The chart above shows the relationship between the unemployment rate and the employment/population ratio. The divergence of the two variables has been one of the defining factors of this recovery and argues that labor market slack still remains.



The chart above shows the underemployment rate, also referred to as the U-6 rate. This is a broader measure of unemployment and it's showing a tightening labor situation.

Average hourly earnings for all workers came in line with expectations, rising 0.3% from the prior year. The chart below shows the yearly change in overall wages for non-supervisory and production workers.



As mentioned, this chart shows the yearly growth in hourly earnings for production and non-supervisory workers. On an annual basis, wage growth for production and non-supervisory employees rose 2.4%, in line with the prior month. Wage growth remains subdued even with the historically low unemployment rate.

Overall, this report would tend to ease the need for the FOMC to aggressively move on rates. However, given the likelihood that weather dampened the report, we would expect the Fed to look beyond today's numbers. We may get some insight into the Fed's thinking later today when Chair Powell speaks.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
15:00	Consumer Credit	m/m	feb	$15.500 bn	$13.906 bn	**
Fed speakers or events						
EST	Speaker or event	District or position				
13:30	Jerome Powell to Give Speech on Economic Outlook	Chairman of Board of Governors of Federal Reserve				
16:00	John Williams speaks on Economic Outlook	President of the Federal Reserve Bank of San Francisco				

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	Household Spending	m/m	mar	0.1%	2.0%	0.4%	**	Equity bearish, bond bullish
	Official Reserve Assets	m/m	mar	$1.268 tn	$1.262 tn		**	Equity and bond neutral
	Labor Cash Earnings	m/m	mar	1.3%	0.7%	0.5%	**	Equity bullish, bond bearish
	Real Cash Earnings	m/m	mar	-0.5%	-0.9%	-1.2%	**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Retail	m/m	mar	50.1	52.3		**	Equity and bond neutral
France	Trade Balance	m/m	mar	-5.186 bn	-5.560 bn	-5.313 bn	**	Equity and bond neutral
	Current Account Balance	m/m	feb	-2.000 bn	-1.600 bn		**	Equity bearish, bond bullish
	Budget Balance	m/m	feb	-28.500 bn	-10.800 bn		**	Equity bearish, bond bullish
	Markit France Retail PMI	m/m	mar	50.0	51.8		**	Equity and bond neutral
Italy	Markit Italy Retail PMI	m/m	mar	48.0	50.4		**	Equity bearish, bond bullish
Germany	Markit Germany Retail PMI	m/m	mar	51.5	53.8		**	Equity and bond neutral
U.K.	Unit Labor Costs	y/y	4q	2.1%	1.3%		**	Equity and bond neutral
Swutzerland	Foreign Currency Reserves	m/m	mar	737.8 bn	732.8 bn	735.8 bn	**	Equity and bond neutral
AMERICAS								
Mexico	Consumer Confidence	m/m	mar	82.5	82.0	84.6	***	Equity bearish, bond bullish
	Gross Fixed Investment	m/m	jan	4.1%	-0.4%	3.5%	***	Equity bullish, bond bearish
Canada	International Merchandise Trade	m/m	feb	-2.69 bn	-1.91 bn	-2.10 bn	**	Equity and bond neutral
Brazil	CNI Consumer Confidence	m/m	mar	101.9	102.7		***	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)	232	232	0	Up
3-mo T-bill yield (bps)	168	168	0	Neutral
TED spread (bps)	65	64	1	Neutral
U.S. Libor/OIS spread (bps)	175	174	1	Up
10-yr T-note (%)	2.82	2.83	-0.01	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	9	10	-1	Down
Currencies	**Direction**			
dollar	down			Down
euro	flat			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	$67.95	$68.33	-0.56%	
WTI	$63.12	$63.54	-0.66%	
Natural Gas	$2.71	$2.68	1.31%	
Crack Spread	$19.59	$19.62	-0.13%	
12-mo strip crack	$17.93	$17.96	-0.14%	
Ethanol rack	$1.53	$1.53	0.08%	
Metals				
Gold	$1,324.09	$1,326.57	-0.19%	
Silver	$16.31	$16.44	-0.81%	
Copper contract	$303.40	$307.45	-1.32%	
Grains				
Corn contract	$ 385.00	$ 389.50	-1.16%	
Wheat contract	$ 459.50	$ 464.75	-1.13%	
Soybeans contract	$ 1,011.75	$ 1,031.25	-1.89%	
Shipping				
Baltic Dry Freight	953	977	-24	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-4.6	2.0	-6.6	
Gasoline (mb)	-1.1	-1.5	0.4	
Distillates (mb)	0.5	-1.5	2.0	
Refinery run rates (%)	0.70%	0.40%	0.30%	
Natural gas (bcf)	-29.0	-27.0	-2.0	

Weather

The 6-10 and 8-14 day forecasts continue to signal colder than normal temperatures for the northern region, with warmer temperatures for the rest of the country. 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.

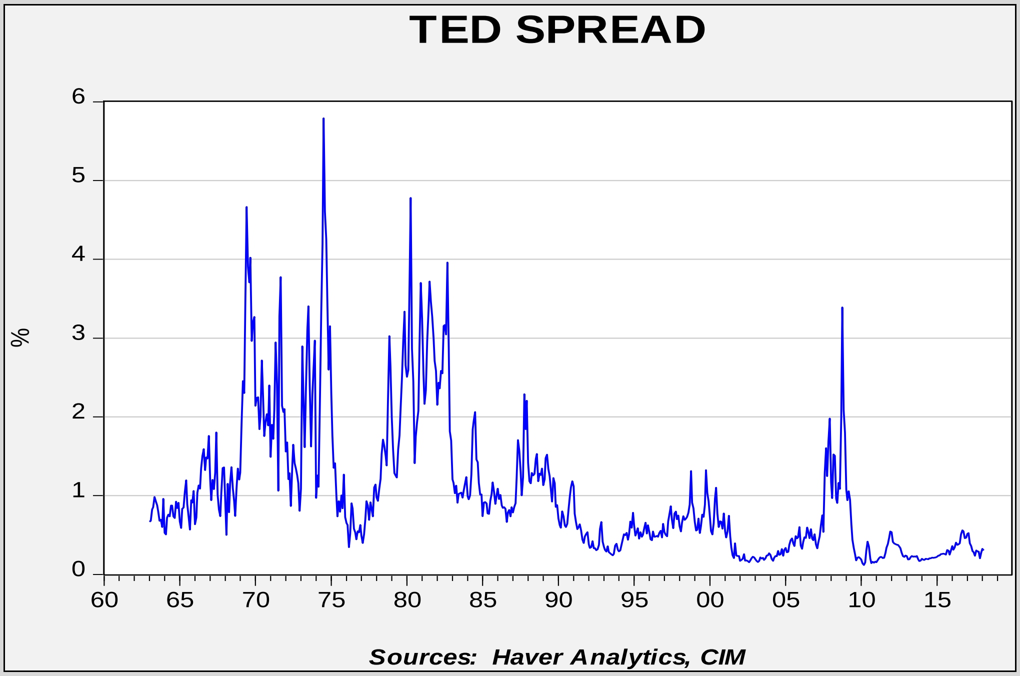
April 6, 2018

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.

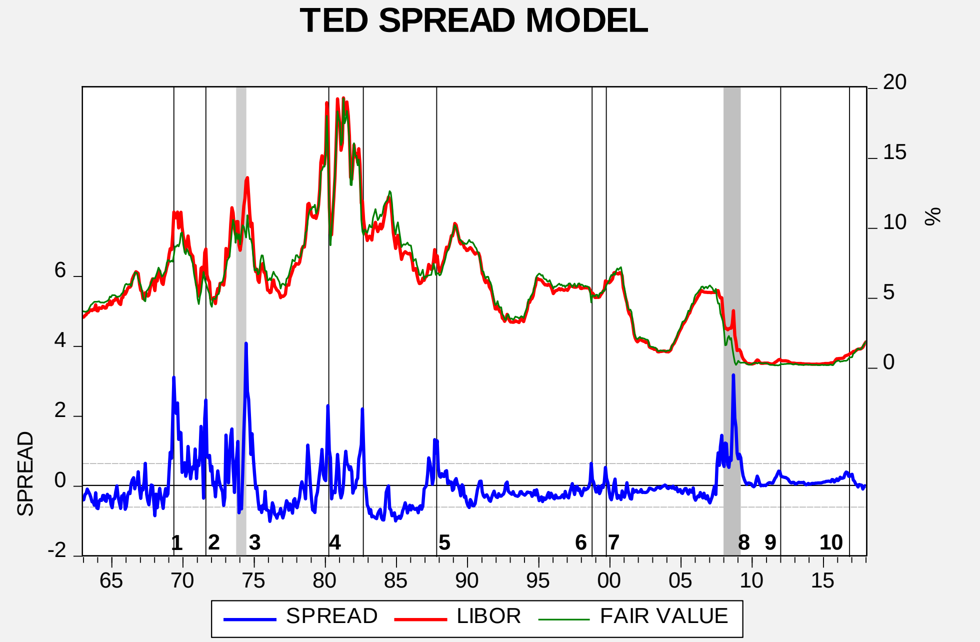
The other component is the flight-to-quality spread. Because Eurodollars are not government-guaranteed and do not have direct support of a central bank, investors flock to T-bills and shun Eurodollars during periods of stress. This widens the TED spread.

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.

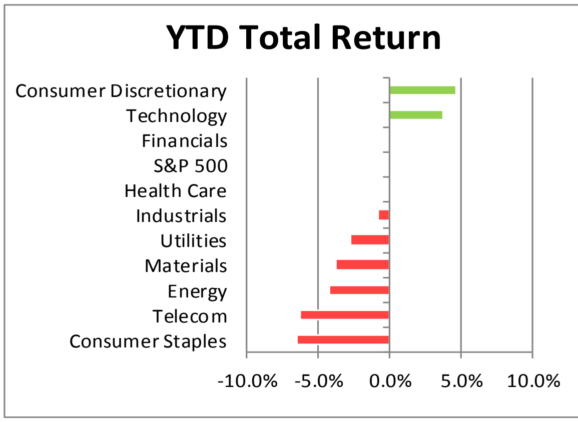


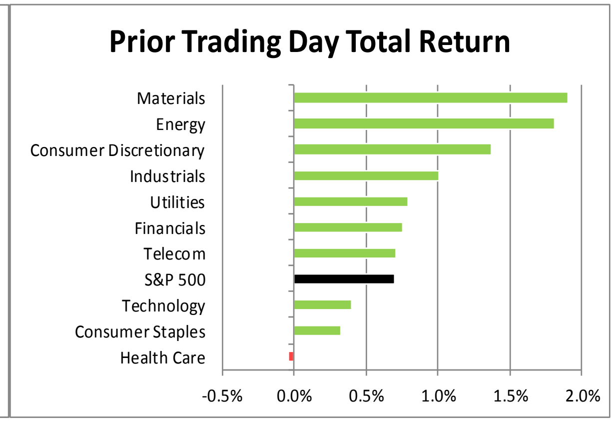
1 = Penn Central Bankruptcy; 2 = Bretton Woods Rescinded; 3= Arab Oil Embargo, Watergate
4 = Iran-Iraq War, Hostage Crisis; 5= Market Crash; 6 = LTCM Crisis;
7 = Asian Economic Crisis; 8= Great Financial Crisis; 9 = Eurozone Crisi, U.S. Debt Downgrade;
10 = 2016 Election
Sources: Haver Analytics, CIM

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 4/5/2018 close)

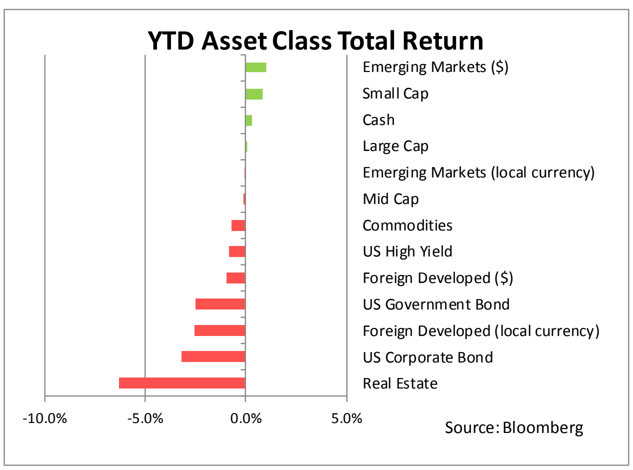




(Source: Bloomberg)

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 4/5/2018 close)

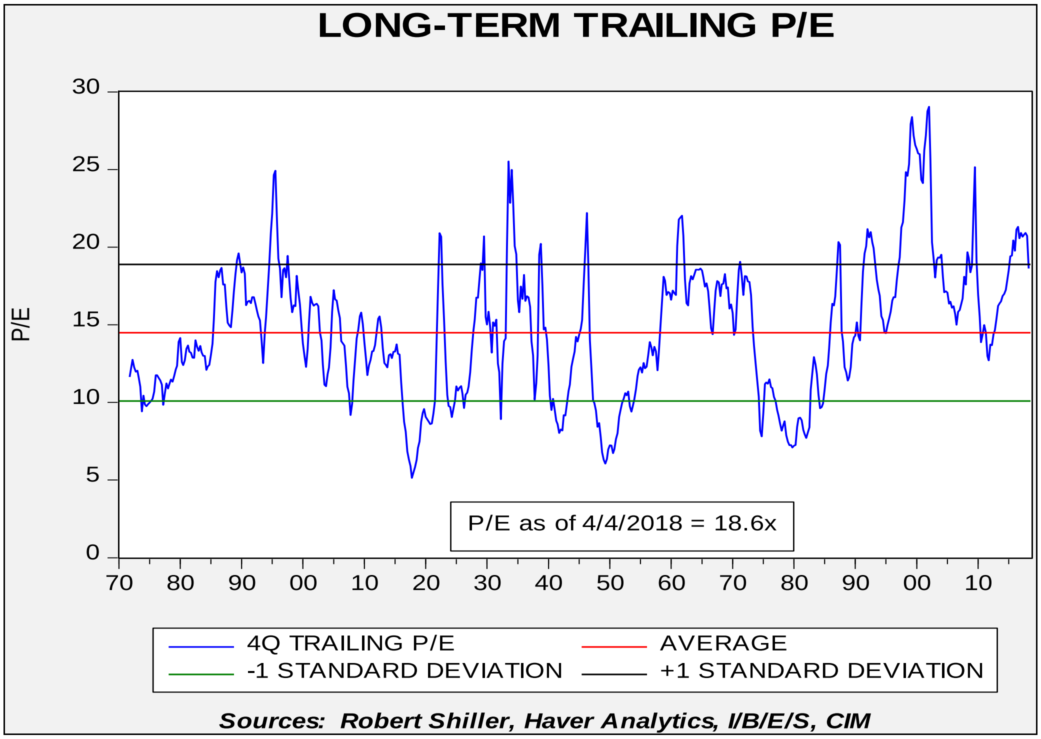


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.