Daily Comment

By Bill O'Grady and Thomas Wash

[Posted: February 14, 2018—9:30 AM EST] 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 1.6% from the prior close. Chinese markets were up, with the Shanghai composite up 0.5% and the Shenzhen index up 0.5%. U.S. equity index futures are signaling a higher open. With 349 companies having reported, the S&P 500 Q4 earnings stand at $36.02, higher than the $34.84 forecast for the quarter. The forecast reflects a 10.7% increase from Q4 2016 earnings and a 4.2% increase from Q3 2017. Thus far this quarter, 76.8% of the companies reported earnings above forecast, while 14.6% reported earnings below forecast.

Looking for something to read? In our travels we are often asked about books we recommend. As a result, we have created [The Reading List]. The list is a group of books, separated by category, that we believe are interesting and insightful. Each book on the list has an associated review to help you decide if you want to read it. We will be adding to the list over time. Books marked with a "" are ones we consider classics and come highly recommended.*

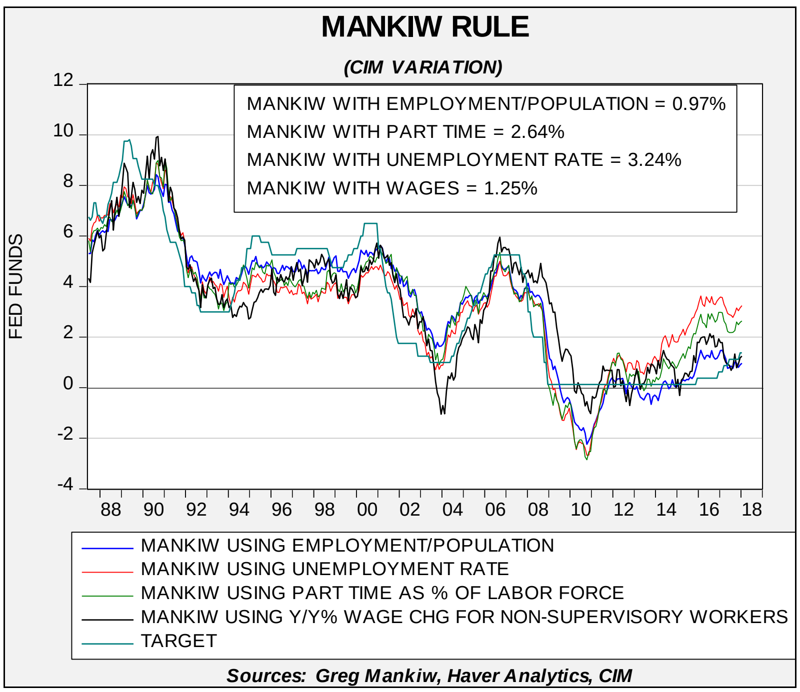
We are seeing a sharp flip in financial markets following a higher than expected print in CPI (see below). Here is what we are watching:

Is Netanyahu in trouble? The Israeli police have recommended that Israel's PM, Benjamin Netanyahu, be indicted for the crimes of bribery and fraud. Although the PM says he will fight the charges, they do appear serious and may derail his political career. From here, the attorney general must decide if the evidence supporting the recommendation is solid enough to proceed with the indictment. We expect this process to take several months but, during that time, it will act as a cloud over Israeli politics.

Zuma faces a no-confidence vote: South African President Zuma is facing a showdown in the legislature in the form of a no-confidence vote. Zuma has so far refused to leave office despite being ordered to do so by his party, the African National Congress. Zuma has tried to negotiate an exit that would last several months but his party wants him out. He faces serious corruption charges and could face years of costly litigation if he leaves the presidency. Thus, we suspect he is trying to make a deal to leave office in return for some sort of amnesty. The no-confidence vote could force him from office perhaps as soon as tomorrow. Zuma's departure is bullish for the ZAR and precious metals.

Mester for vice chair? Cleveland FRB President Loretta Mester is apparently under consideration for the vice chair position on the Board of Governors. We rate Mester as a hawk (we put her at a "2" on our 1 to 5 scale, with 1 being most hawkish). Although the president promised to shake up the Fed, his selections thus far have been rather conventional and this one would also fit into that characterization. The White House has indicated the president is not close to filling this position and it is clear more candidates are being considered.

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.



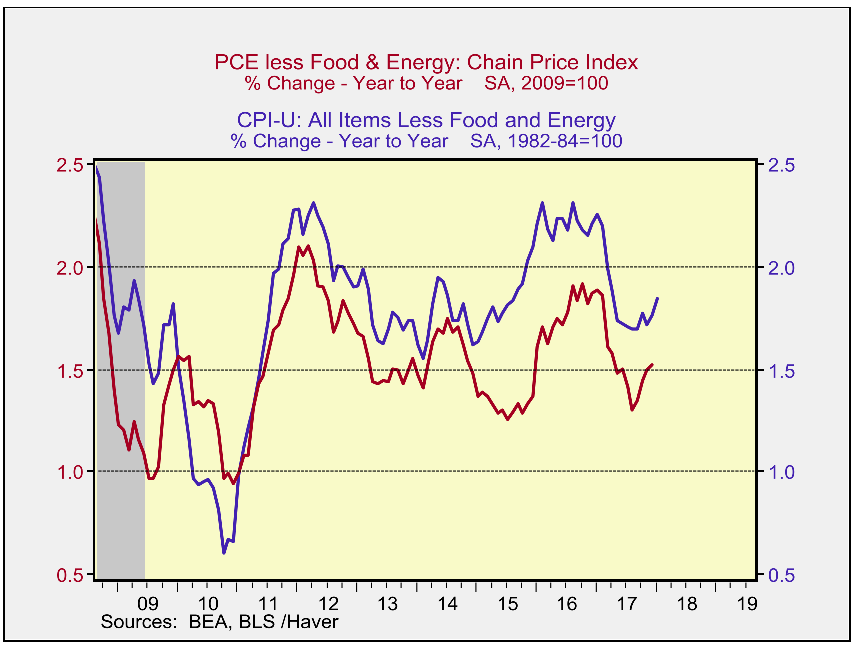
Using the unemployment rate, the neutral rate is now 3.24%. Using the employment/population ratio, the neutral rate is 0.97%. Using involuntary part-time employment, the neutral rate is 2.64%. Using wage growth for non-supervisory workers, the neutral rate is 1.25%. The rise in core CPI has lifted the various neutral estimates higher but, as we have seen for several months, two of these measures of slack suggest the FOMC has achieved rate neutrality, while two suggest the FOMC is well behind the curve. We still expect the FOMC to mostly split the difference and end up between 2.25% to 2.50% for the target at the end of this year. However, the rise in inflation does increase the odds that the hawks on the FOMC will push for continued rate hikes into 2019; in other words, we may see a repeat of the 2004-06 tightening cycle with steady increases in the fed funds target, perhaps with hikes occurring at meetings lacking a press conference.

The CPI data is clearly bearish for equities, as shown by the quick and sharp reversal from higher to lower in this morning's futures trade. The usual impact of higher inflation is to lower the P/E multiple, which occurs as interest rates rise. We are also seeing the dollar lift, although we doubt that can be sustained given the headwinds the fiscal deficit will cause…unless the FOMC finds its "inner Volcker." We wouldn't count on that. In fact, if monetary tightening worries begin to weigh on equities, expect the president to go "full Nixon" and tweet against Fed tightening. Instead of Volcker, think Arthur Burns.

U.S. Economic Releases

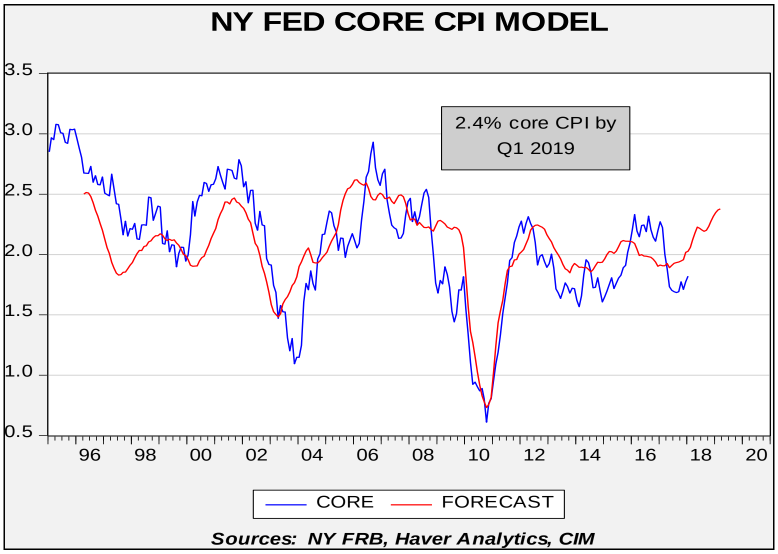
Mortgage applications fell by 4.1% from the prior week. Purchases and refinancing fell by 5.9% and 1.9%, respectively. The average 30-year fixed rate rose 7 bps from 4.50% to 4.57%.

CPI came in above expectations, rising 0.5% from the prior month compared to the forecast of 0.3%. The prior month's report was revised upward from 0.1% to 0.2%. Core CPI came in above expectations, rising 0.3% from the prior month compared to the forecast of 0.2%. The prior report was revised downward from 0.3% to 0.2%.



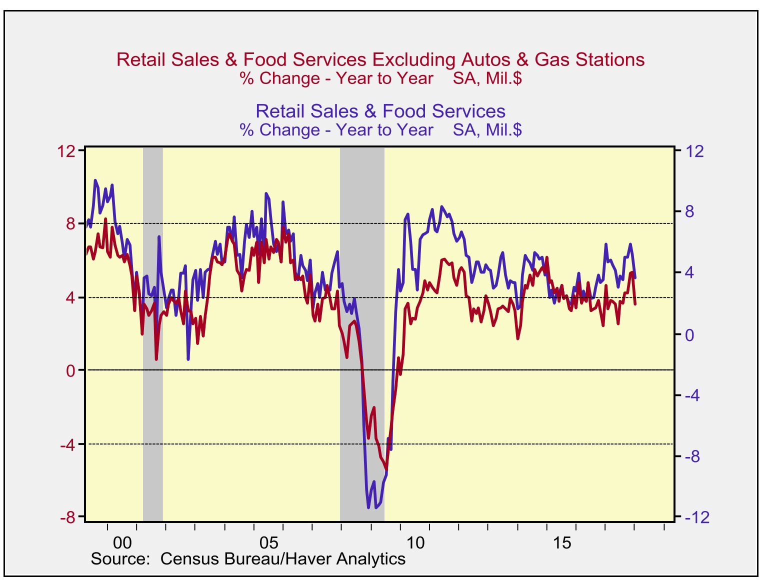
The chart above shows the year-over-year change in core CPI and core PCE. Core CPI rose 1.8% from the prior year. It is worth noting that although CPI is the most commonly used inflation gauge, the Fed's preferred measure is the PCE.

We expect core CPI to continue to rise this year, but we would not anticipate an outsized increase.



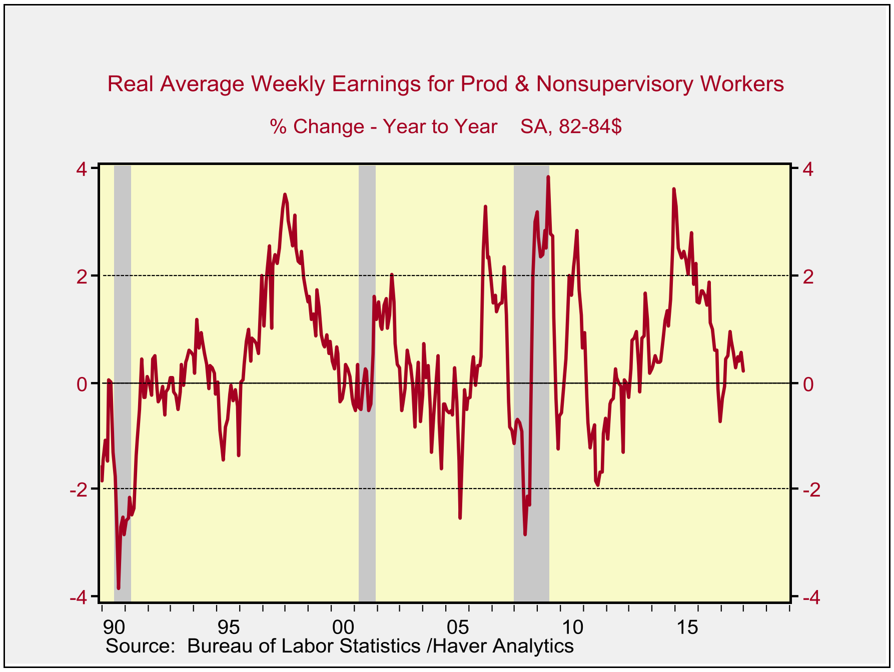
This model uses the New York FRB inflation gauge, an index that uses various inputs to forecast inflation. Compared to the core rate, it is suggesting upward pressure this year, but a rise to only about 2.4% in early next year. That level will put upward pressure on interest rates but should not trigger a crisis response.

Retail sales advance came in below expectations, falling 0.3% from the prior month compared to the forecast gain of 0.2%. Retail sales ex-auto came in weak as well, remaining unchanged from the prior month compared to the forecast gain of 0.5%; the prior month's gain was revised downward from 0.4% to 0.1%. Retail sales ex-auto and gas were below expectations, falling 0.2% from the prior month compared to the forecast gain of 0.3%. The retails sales control group came in below expectations, remaining unchanged from the prior month compared to the forecast of 0.4%. The prior month's gain was revised downward from 0.3% to -0.2%.



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

Real average weekly earnings rose by 0.4% from the prior year, while real average hourly earnings also rose by 0.8% from the prior year.



The chart above shows the year-over-year change in real average weekly earnings for production and non-supervisory workers, which rose 0.2% from the prior year.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Business Inventories	m/m	dec	0.3%	0.4%	**
Fed speakers or events						
No speakers or events scheduled						

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	Foreign Direct Investment	y/y	jan	0.3%	-9.2%		**	Equity and bond neutral
Japan	GDP Annualized	q/q	4q	0.5%	2.5%	1.0%	***	Equity bearish, bond bullish
	Tokyo Condominium Sales	m/m	jan	39.7%	-7.5%		*	Equity and bond neutral
Australia	Westpac Consumer Conference Index	m/m	feb	102.7	105.1		**	Equity and bond neutral
New Zealand	Food Prices	m/m	jan	1.2%	-0.8%		***	Equity and bond neutral
EUROPE								
Eurozone	Industial Production	q/q	4q	0.4%	1.0%	0.1%	***	Equity bullish, bond bearish
	GDP	y/y	4q	2.7%	2.7%	2.7%	***	Equity and bond neutral
Italy	GDP	y/y	4q	1.6%	1.7%	1.7%	***	Equity and bond neutral
Germany	GDP	q/q	4q	0.6%	0.8%	0.6%	***	Equity and bond neutral
	CPI	y/y	jan	1.6%	1.6%	1.6%	***	Equity and bond neutral
AMERICAS								
Mexico	International Weekly Reserves	y/y	feb	$172.797 bn	$172.991 bn		*	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)	183	182	1	Up
3-mo T-bill yield (bps)	157	156	1	Neutral
TED spread (bps)	27	26	1	Neutral
U.S. Libor/OIS spread (bps)	156	155	1	Up
10-yr T-note (%)	2.82	2.83	-0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	33	32	1	Down
Currencies	**Direction**			
dollar	down			Down
euro	flat			Up
yen	up			Neutral
pound	down			Neutral
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	$62.49	$62.72	-0.37%	
WTI	$58.79	$59.19	-0.68%	
Natural Gas	$2.57	$2.59	-0.89%	
Crack Spread	$13.55	$13.72	-1.19%	
12-mo strip crack	$17.13	$17.20	-0.38%	
Ethanol rack	$1.49	$1.49	-0.05%	
Metals				
Gold	$1,331.62	$1,329.55	0.16%	Weaker Dollar
Silver	$16.62	$16.58	0.25%	
Copper contract	$316.40	$316.25	0.05%	
Grains				
Corn contract	$ 366.50	$ 367.00	-0.14%	
Wheat contract	$ 474.00	$ 476.00	-0.42%	
Soybeans contract	$ 1,001.25	$ 1,001.75	-0.05%	
Shipping				
Baltic Dry Freight	1123	1125	-2	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.0		
Gasoline (mb)		1.6		
Distillates (mb)		0.0		
Refinery run rates (%)		-1.00%		
Natural gas (bcf)		-191.0		

Weather

The 6-10 and 8-14 day forecasts call for warmer temperatures for the eastern region, with cooler to normal temperatures for the rest of the country. Precipitation is expected for most of the country.

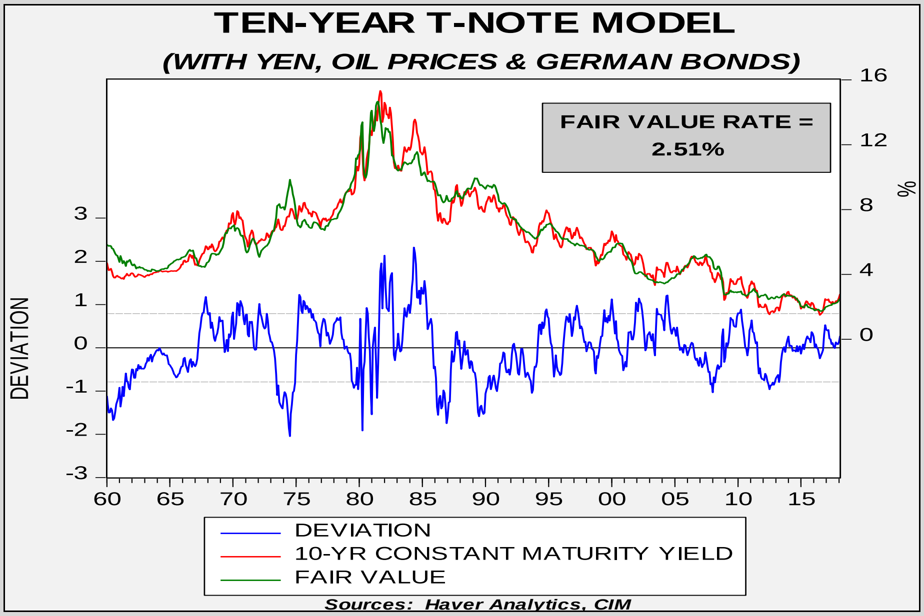
Asset Allocation Weekly Comment

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.

February 9, 2018

The continued rise in long-term interest rates is clearly grabbing the attention of financial markets. Stronger than expected wage growth was the proximate cause of the recent lift in yields. Although overall wages rose 2.9%, wages for production and non-supervisory workers grew only 2.4%. Still, it is clear that fears of inflation stemming from an accelerating economy and concerns about monetary policy tightening are leading to rising interest rates.

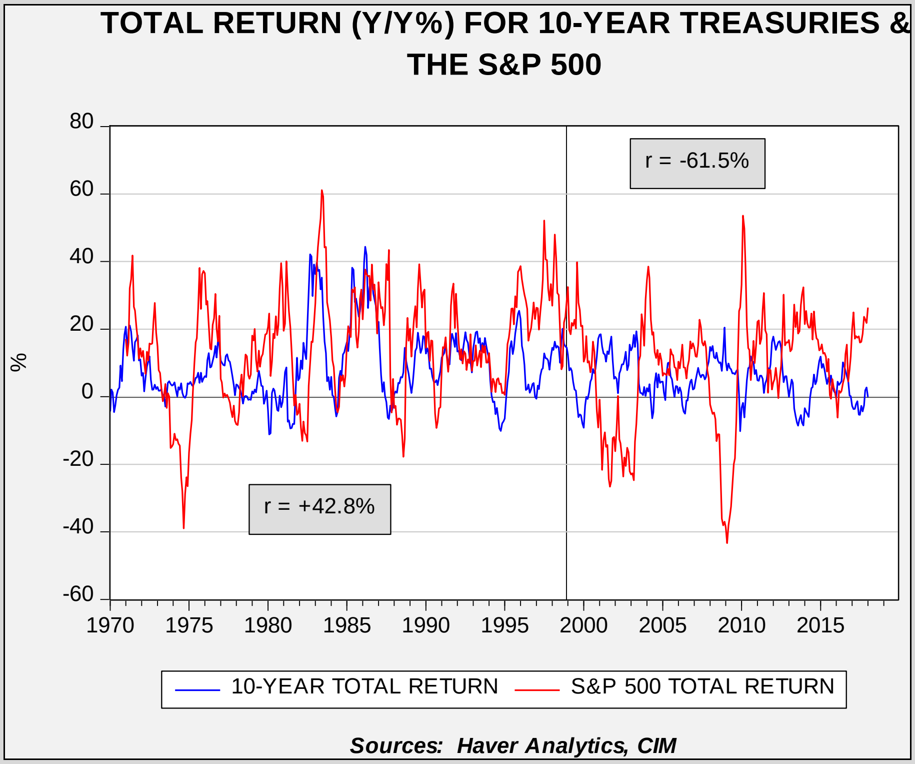
Here is our updated 10-year T-note model.



The model's core variables are fed funds and the 15-year moving average of inflation, which we use as a proxy for inflation expectations. The other three variables are the yen, oil prices and German long-duration sovereign yields. The current yield on the 10-year T-note, which is in the 2.80% range, is running above fair value. The standard error for this model, shown on the lower part of the graph as the parallel lines running along the midpoint of the standard error, is ±70 bps. Thus, reaching a level that would signal excessively high yields would be 3.20%.

Complicating this case is the fact that the FOMC is expected to raise rates at least three times this year, and perhaps four, German yields are rising and oil prices have increased as well. To project the potential lift in yields, we made some projections. Assuming the FOMC moves the upper end of the target rate to 2.25%, with nothing else changing, fair value for the 10-year T-note will reach 2.825%. The recent lift in 10-year T-note yields appears to be mostly discounting tighter monetary policy. If oil prices reach $75 per barrel, the fair value yield would hit 2.90%, and if German yields rise to 1.00%, we would see 2.95%. This suggests to us that a reasonable projection of variables likely takes us to a 3.00% 10-year T-note in the coming months. In other words, it appears the 10-year T-note yield is mostly about discounting tighter monetary policy.

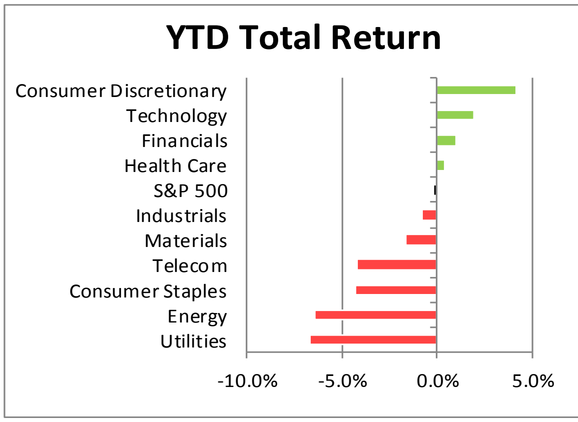
One other factor worth mentioning is that bond and stock prices have been positively correlated recently. Under these circumstances, the effectiveness of bonds as a portfolio diversification tool is reduced.

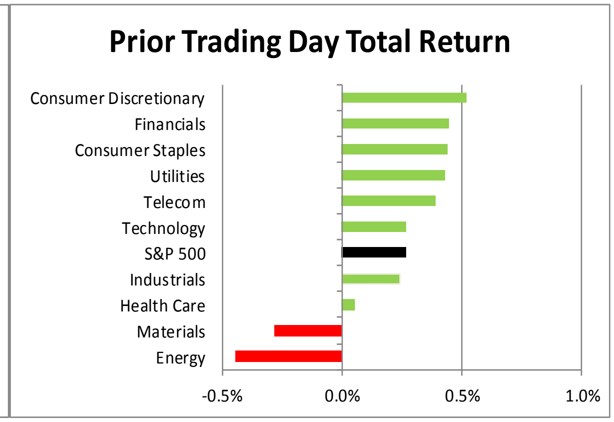


It's interesting that the returns were positively correlated from 1970 to 1998. What caused the reversal? Most likely it's a function of the steady decline in interest rates from their high peak in the early 1980s to normal levels by the late 1990s. In other words, falling yields were the norm during that two-decade period and, as rates fell, it supported rising P/E multiples. After rates normalized by the end of the 1990s, the ordinary inverse relationship between equities and bond prices emerged. Although the short-term price action between bonds and equities is a concern, we doubt it will be maintained. Since the shift in the correlation occurred in the late 1990s, we have seen two periods when the one-year rolling correlation became positive, 2007 and 2015. Neither event lasted very long nor did it undermine the longer term diversification that longer duration bonds offered. We suspect the current positively correlated event is due to an overbought correction in equities and a bond market discounting tighter monetary policy (as noted above). Thus, we view this as a temporary event.

Data Section

U.S. Equity Markets – (as of 2/13/2018 close)

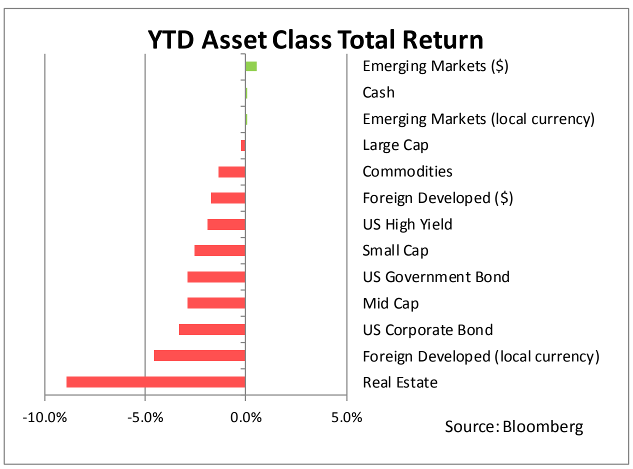




(Source: Bloomberg)

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 2/13/2018 close)

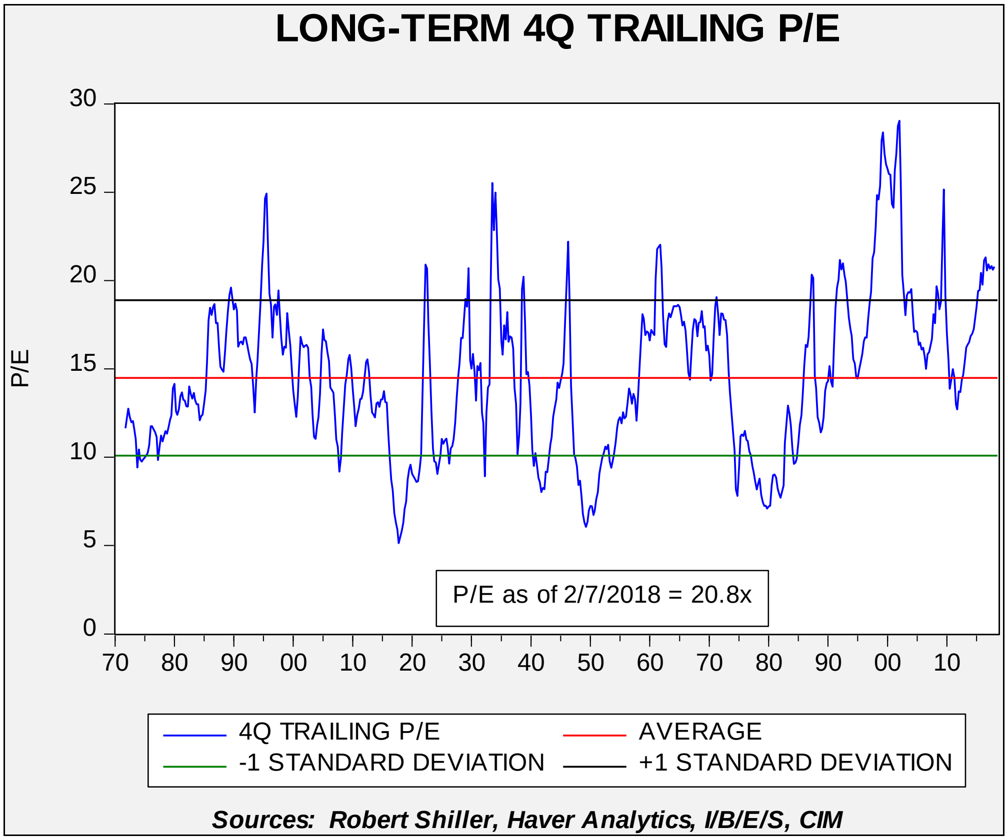


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

February 8, 2018



Based on our methodology,[1] the current P/E is 20.8, down 0.2x from last week. Rising earnings and falling equity prices led to the modest decline in the multiple.

This report was prepared by Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change. This is not a solicitation or an offer to buy or sell any security.

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[1] The above 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 (Q2 and Q3) and two estimates (Q4 and Q1). 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 very long-term dataset for P/E ratios.