By Bill O'Grady and Thomas Wash

[Posted: February 15, 2018—9:30 AM EST] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.8% from the last close. In Asia, the MSCI Asia Apex 50 closed up 1.5% from the prior close. Chinese markets are closed due to the Lunar New Year holiday. U.S. equity index futures are signaling a higher open. With 362 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, 76.2% 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.*

It's Chinese New Year's Eve, the year of the dog! The Chinese New Year is tomorrow so Chinese financial markets are closed today and will remain so until the 21st. This will slow Asian trading for the next week. Here is what we are watching this morning:

Cyprus trouble: Last week, on Feb. 9th, Turkish naval vessels blocked an Italian ship contracted by Italy's oil firm Eni ($33.85) that was planning to explore for natural gas around the island nation. In response, Italy has dispatched a naval frigate to the area, although the Italians have indicated their vessel is under orders not to engage with the Turkish military ships.

Cyprus's population is roughly 25% Turkish and 75% Greek. Both groups have vied for control of the island, which is geopolitically important in that the holder of that island could project naval power into the Levant and block shipping from the Black Sea. The British held Cyprus as a colony until 1960. During the colonial period, as was often the case, the British gave the minority Turks extensive rights. This was a common ploy by European colonists—they would offer strong support to minority groups in a colony, making them dependent on the colonial power. This practice made managing the colony easier since the minority group was dependent and usually didn't have enough power to manage independence. At independence, the British wrote a constitution that gave the Turkish Cypriots extensive minority rights. It was a recipe for discord and, by 1963, the island was embroiled in a low-level civil war. The Johnson administration was able to prevent the war from escalating but only by supporting a U.N. peacekeeping mission that essentially partitioned the island. In 1974, a coup ousted the Greek Cypriot president and the junta planned to forcibly merge the island. Turkey invaded the northern Turkish zone to prevent unification and declared (an almost universally unrecognized) Turkish Republic of Cyprus in the northern zone. It has remained divided ever since.

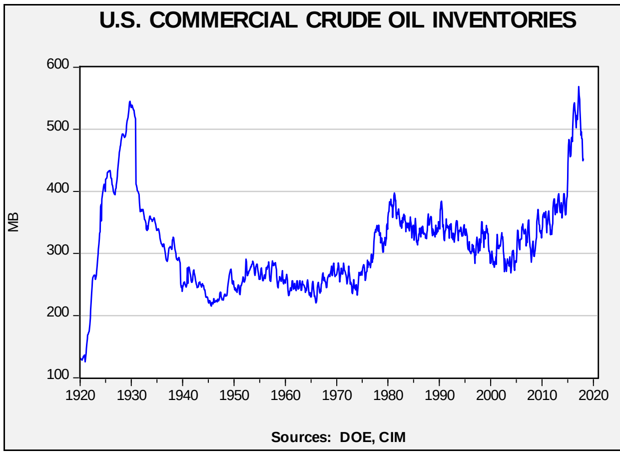
What triggered the current dust-up was that the Greek Cyprus government, which is generally recognized as the legitimate government of the island, licensed blocs offshore for energy exploration as it appears there could be significant natural gas deposits around Cyprus. However, most of these blocs sit in an area that Turkey has claimed as under its control, even though this area is on the southern end of the island. However, no other nation in the world, save Turkey, recognizes the Turkish Republic of Cyprus and thus the exclusive zones claimed by this republic are also unrecognized.

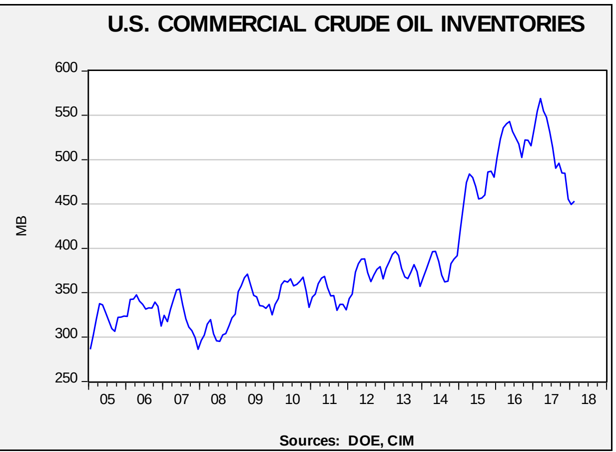
At present, we don't expect this situation to escalate. Europe appears unable to conduct war without the U.S. and we don't see the Trump administration getting involved. In addition, Turkey has significant leverage over the EU; if sufficiently angered, Turkey would release a flood of refugees into Europe. The last wave has had significant political ramifications and another would likely exacerbate those problems. At the same time, Turkey has its hands full managing its southern border with what was once Syria and northern Iraq. It can't really deal with a full-scale naval battle in the Mediterranean. We see this spat as jockeying for position in negotiations, with the prize being the control of natural gas reserves. At the same time, the chances that this situation escalates, while remote, are higher than normal because the U.S. has created a global power vacuum by its steady withdrawal from the world. Russia, for example, could tip the scales in either direction; supporting Italy might give Moscow an ally to attain EU sanctions relief, while cozying up to Turkey could help it project power in the Middle East. We believe this event is an example of what we will see more of for the foreseeable future.

The JPY: Japan's Finance Minister Aso indicated overnight that the recent strength of the JPY is not a major concern, opening the Japanese currency to further appreciation. Reuters[1] is reporting that Governor Kuroda, who we recently noted is likely to get a rare second term as head of the BOJ, may face a less cooperative group of deputy governors at the central bank. Overall, we expect the BOJ to allow for steady appreciation of the JPY as long as it doesn't accelerate. Openly calling for a weaker currency runs the risk of antagonizing the Trump administration, and Japan would prefer good relations with Washington while it is dealing with significant tensions on the Korean Peninsula and with China.

Energy recap: U.S. crude oil inventories rose 1.8 mb compared to market expectations of a 3.0 mb build.

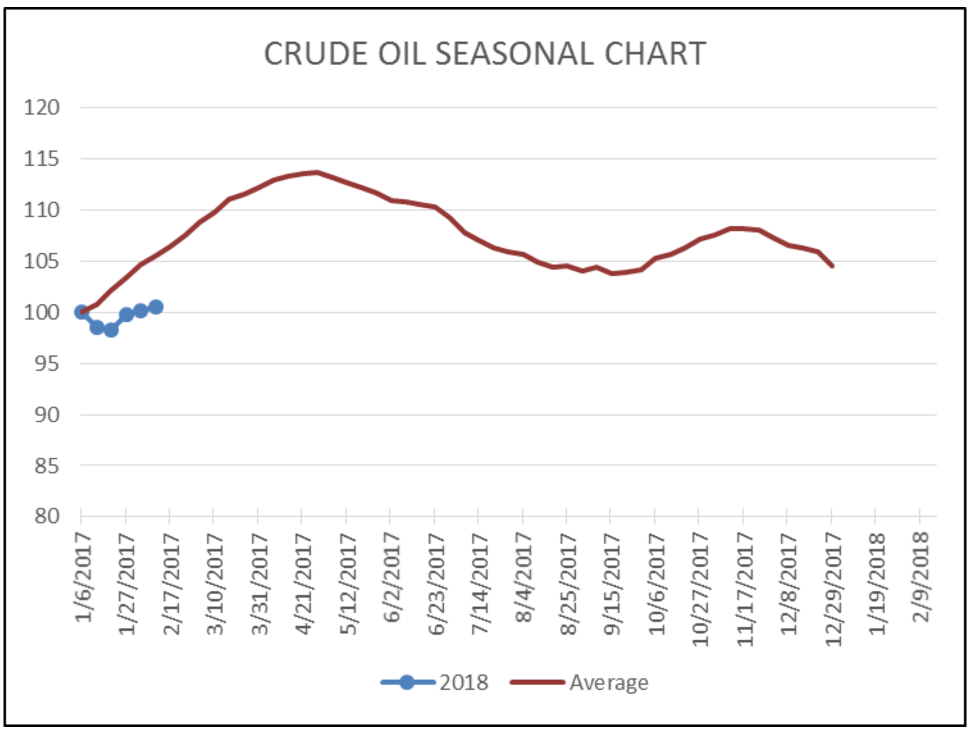
[1] https://www.reuters.com/article/us-japan-economy-boj/choice-of-deputies-may-complicate-kurodas-job-at-the-boj-helm-idUSKCN1FZ0WT





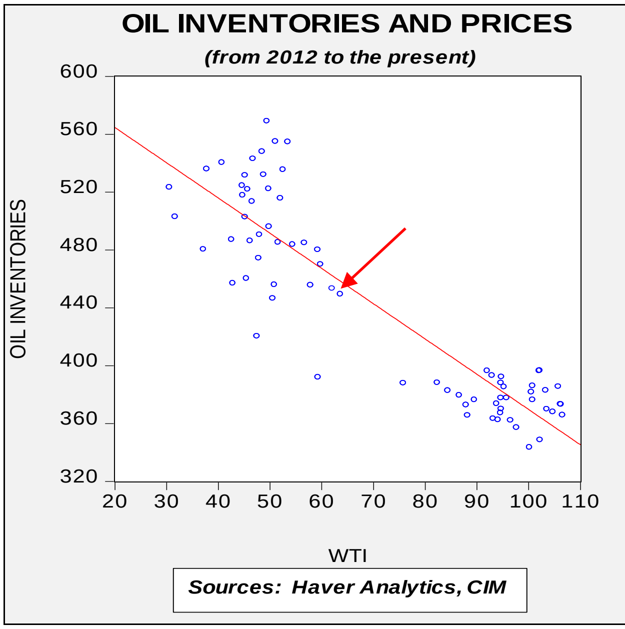
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but have declined significantly since last March. We would consider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

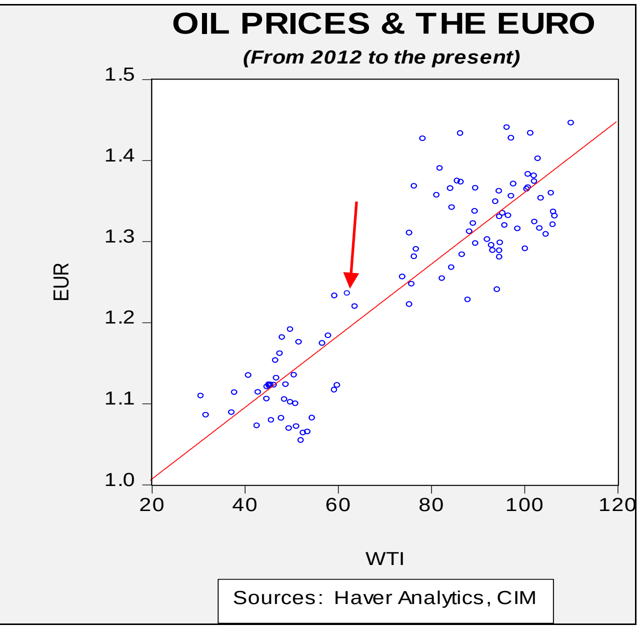
As the seasonal chart below shows, inventories are usually rising this time of year. We are seeing increasing inventories but they are running well below the usual seasonal levels.



(Source: DOE, CIM)

This chart shows how inventories are growing more slowly than normal. We still have almost three more months before the seasonal inventory build ends, but this slow pace is bullish for oil prices.

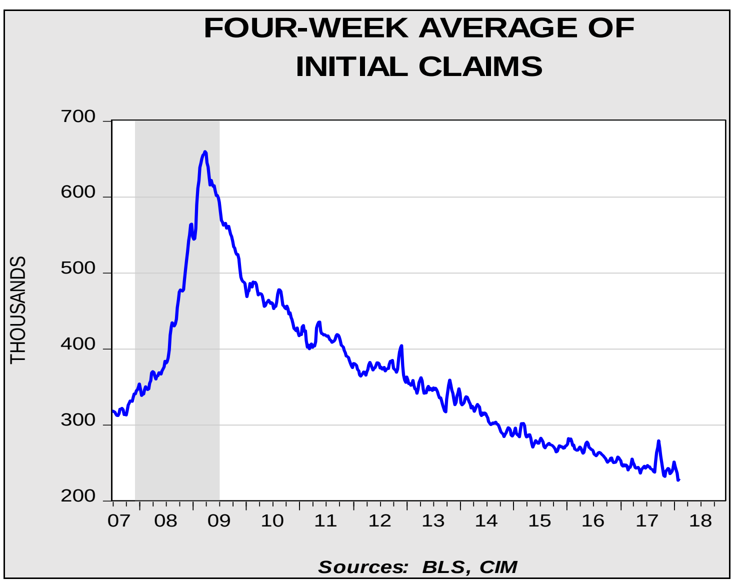




Based on inventories alone, oil prices are undervalued with the fair value price of $66.83. Meanwhile, the EUR/WTI model generates a fair value of $75.61. Together (which is a more sound methodology), fair value is $72.90, meaning that current prices are below fair value. We view the recent sell-off as overdone and expect prices to recover unless the inventory build accelerates.

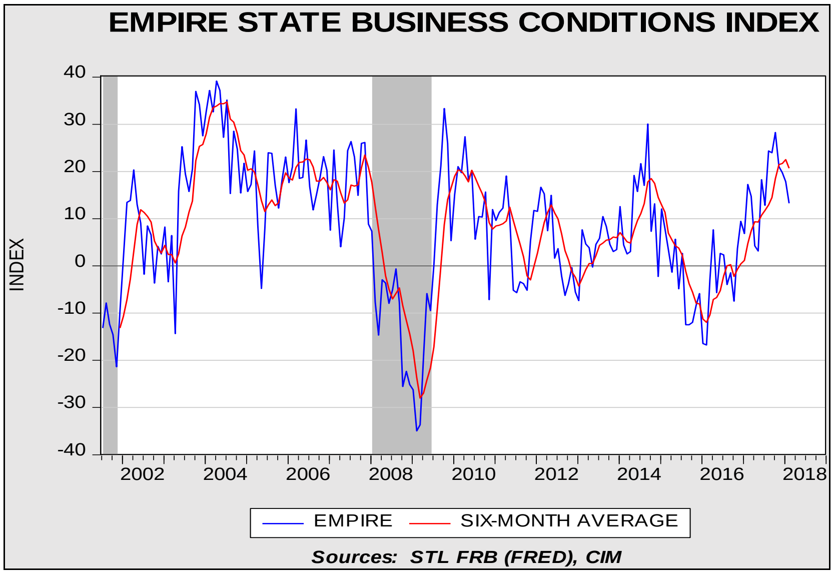
U.S. Economic Releases

Initial jobless claims came in above expectations at 230k compared to the forecast of 228k.



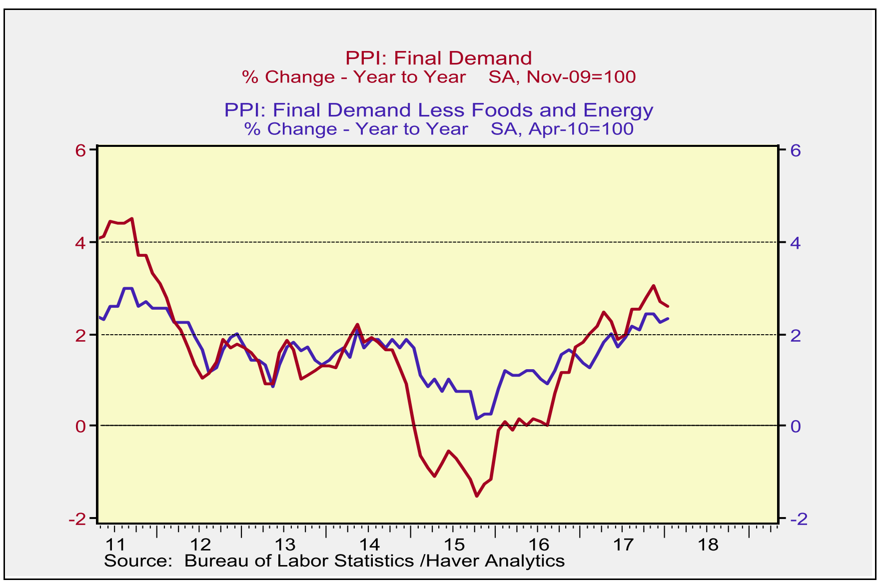
The chart above shows the four-week moving average of initial jobless claims. The four-week moving average rose from 226k to 228.5k.

Empire manufacturing came in below expectations at 13.1 compared to the forecast of 18.0. The prior month's report was revised upward from 18.0 to 19.6



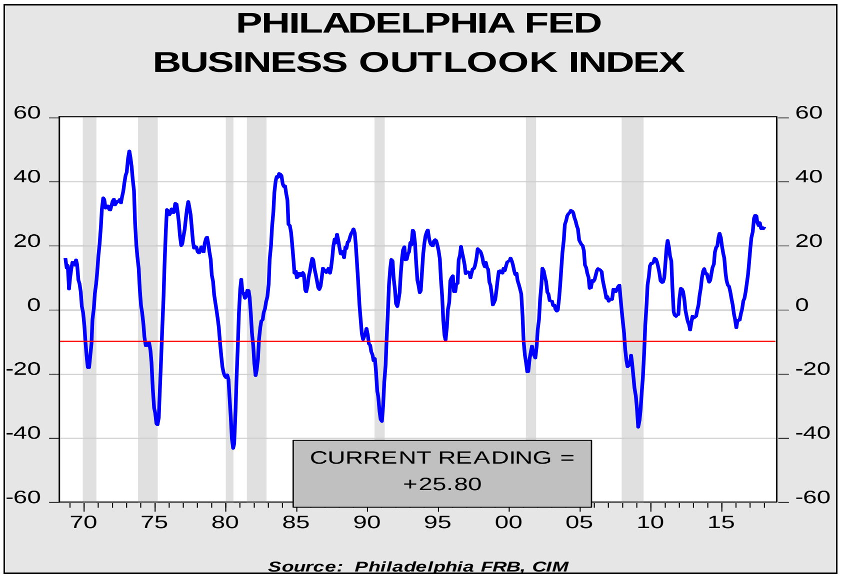
The chart above shows the six-month moving average of the Empire State Business Conditions Index**.**

PPI final demand came in line with expectations, rising 0.4% from the prior month. PPI excluding food and energy rose 0.4% from the prior month compared to the forecast gain of 0.2%. Core PPI came in above expectations, also rising 0.4% from the prior month compared to the forecast of 0.2%.



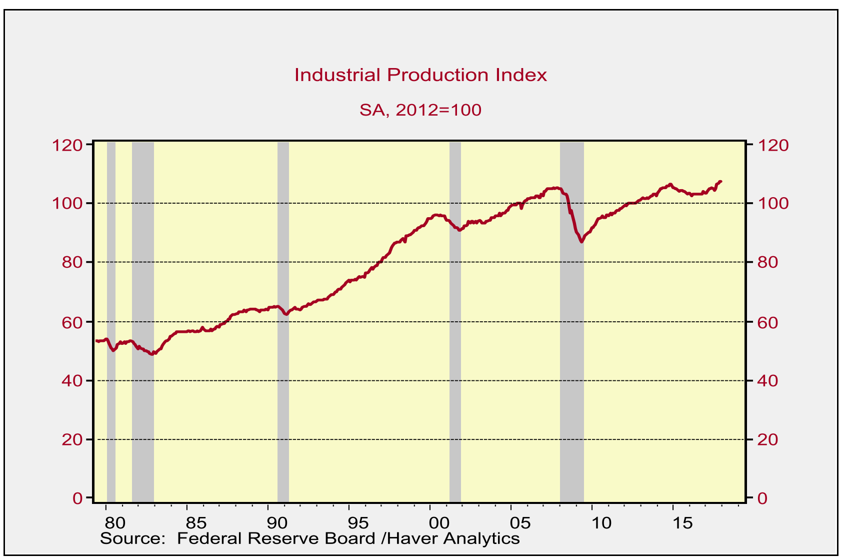
The chart above shows the relationship between PPI final demand and PPI excluding food and energy. Annually, headline PPI and PPI excluding food and energy rose 2.6% and 2.3%, respectively. We note the relationship of PPI to CPI isn't all that strong so the impact on consumer inflation is not significant.

The Philadelphia Fed Business Outlook came in above expectations at 25.8 compared to the forecast of 21.8.



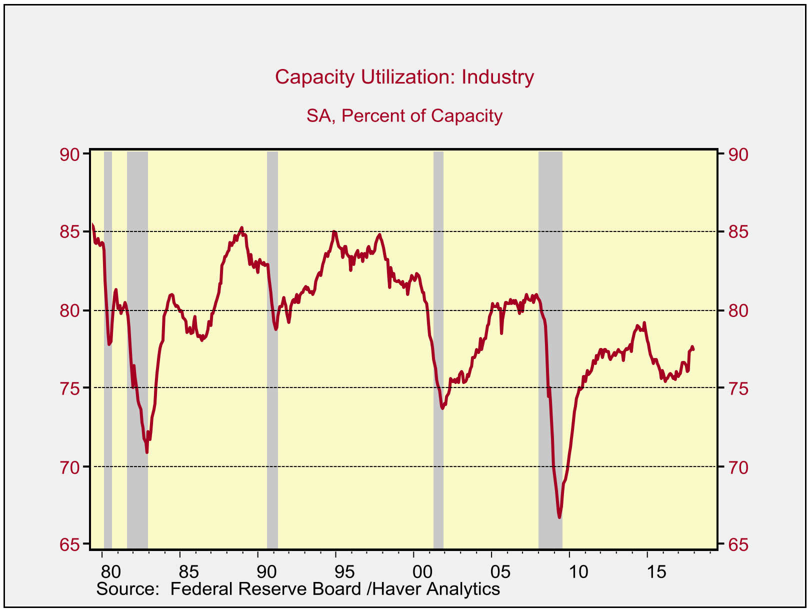
In the chart, we smooth the data with a six-month average. Although this is a sentiment number, it suggests strong confidence in the Philadelphia FRB district.

January industrial production fell by 0.1% compared to forecasts of a 0.2% rise. The prior month's report was revised downward from 0.9% to 0.4%.



The chart above shows the level of industrial production. The current reading is 107.2.

Capacity utilization came in above expectations at 77.5% compared to a forecast of 78.0%, but the prior month was revised downward from 77.9% to 77.7%.



The chart above shows the level of capacity utilization.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	NAHB Housing Market Index	m/m	jan	72.0	72.0	**
16:00	Total Net TIC Flows	m/m	jan		$33.8 bn	**
16:00	Net Long-Term TIC Flows	m/m	jan		$57.5 bn	**
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								
Japan	Core Machine Orders	m/m	dec	-11.9%	5.7%	-2.0%	**	Equity and bond neutral
	Industrial Production	m/m	dec	2.9%	2.7%		***	Equity and bond neutral
	Capacity utilization	m/m	dec	2.8%	0.0%		**	Equity and bond neutral
India	Trade Balance	m/m	jan	-$16.298 bn	-$14.880 bn	-$13.000 bn	**	Equity bearish, bond bullish
Australia	Employment Change	m/m	jan	16.0k	34.7k	15.0k	**	Equity and bond neutral
	Unemployment Rate	m/m	jan	5.5%	5.5%	5.5%	***	Equity and bond neutral
New Zealand	REINZ House Sales	y/y	jan	2.7%	-10%		**	Equity and bond neutral
EUROPE								
Eurozone	Trade Balance	q/q	dec	23.8 bn	22.5 bn	22.3 bn	**	Equity and bond neutral
	EU27 New Car Registration	q/q	jan	7.1%	-4.9%		**	Equity and bond neutral
France	ILO Unemployment Rate	y/y	4q	8.9%	9.7%	9.5%	***	Equity bullish, bond bearish
	Mainland Unemployment Change	y/y	4q	-205k	62k		***	Equity and bond neutral
Italy	Trade Balance	y/y	jan	5.253 bn	4.83 bn		**	Equity bullish, bond bearish
	General Government Budget	y/y	jan	2.256 tn	2.275 tn		**	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)	184	183	1	Up
3-mo T-bill yield (bps)	154	155	-1	Neutral
TED spread (bps)	30	28	2	Neutral
U.S. Libor/OIS spread (bps)	158	157	1	Up
10-yr T-note (%)	2.93	2.90	0.03	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	34	31	3	Down
Currencies	**Direction**			
dollar	down			Down
euro	up			Up
yen	up			Neutral
pound	up			Neutral
franc	up			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBA FX Transactions Market	A$529 mn	A$1279 mn		On forecast
RBA FX Transactions Government	-A$634 mn	-A$1358 mn		On forecast
RBA FX Transactions	-A$2646 mn	A$2319 mn		On forecast

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	$63.86	$64.36	-0.78%	
WTI	$60.43	$60.60	-0.28%	
Natural Gas	$2.55	$2.59	-1.28%	
Crack Spread	$13.65	$13.75	-0.67%	
12-mo strip crack	$17.06	$17.12	-0.39%	
Ethanol rack	$1.51	$1.50	0.64%	
Metals				
Gold	$1,349.73	$1,350.73	-0.07%	
Silver	$16.83	$16.86	-0.20%	
Copper contract	$322.50	$323.60	-0.34%	
Grains				
Corn contract	$ 367.50	$ 367.25	0.07%	
Wheat contract	$ 469.00	$ 469.25	-0.05%	
Soybeans contract	$ 1,029.50	$ 1,027.75	0.17%	
Shipping				
Baltic Dry Freight	1095	1114	-19	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	1.8	3.0	-1.2	
Gasoline (mb)	3.6	1.6	2.0	
Distillates (mb)	-0.5	0.0	-0.5	
Refinery run rates (%)	-2.70%	-1.00%	-1.7%	
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 eastern region.

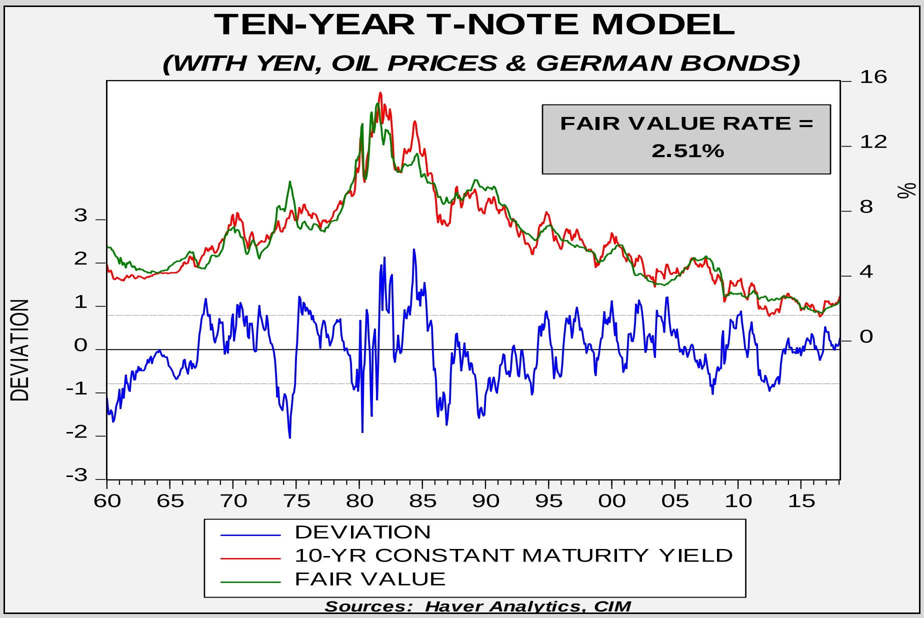
Asset Allocation Weekly Comment

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.

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.

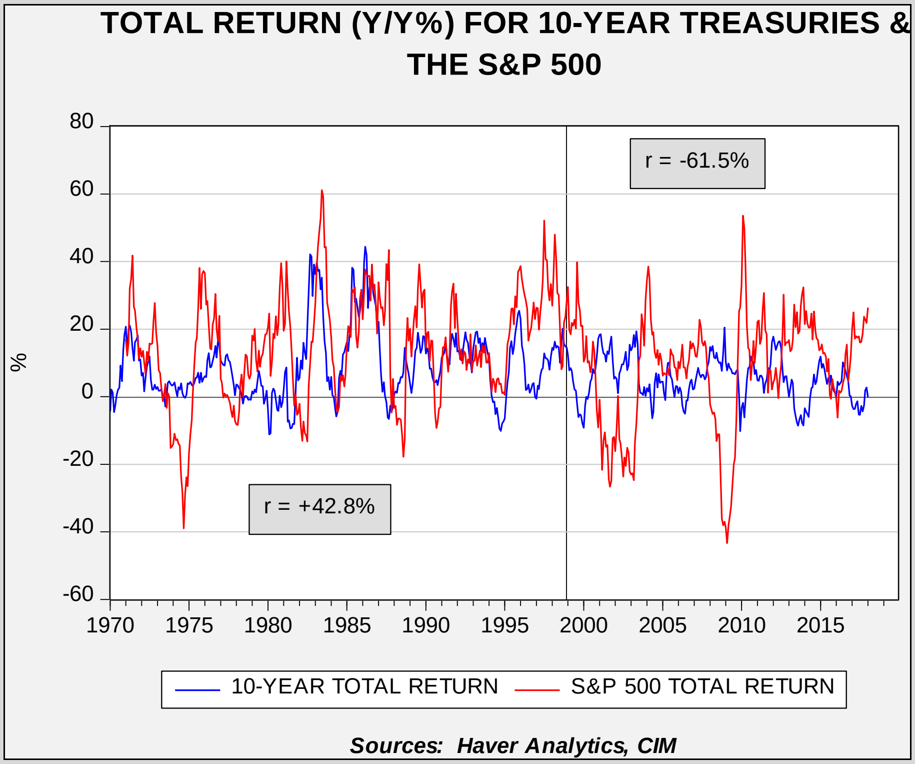
Here is our updated 10-year T-note model.



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.

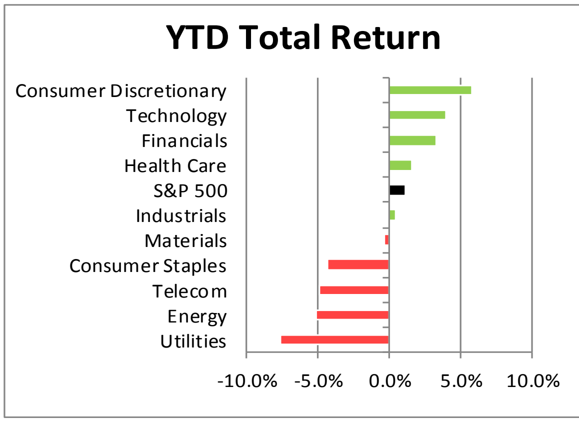
One other factor worth mentioning is that bond and stock prices have been positively correlated recently. Under these circumstances, the effectiveness of bonds as a portfolio diversification tool is reduced.

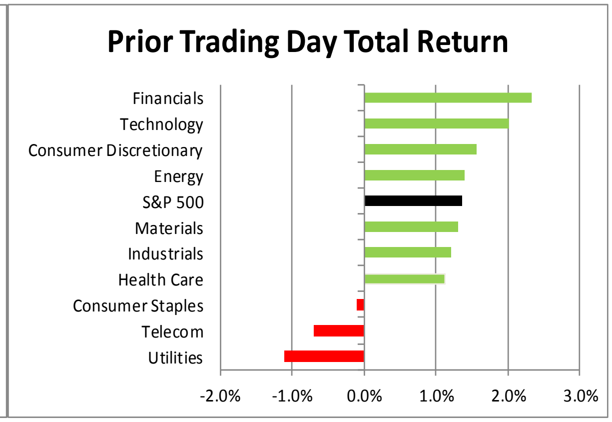


It's interesting that the returns were positively correlated from 1970 to 1998. What caused the reversal? Most likely it's a function of the steady decline in interest rates from their high peak in the early 1980s to normal levels by the late 1990s. In other words, falling yields were the norm during 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 2/14/2018 close)

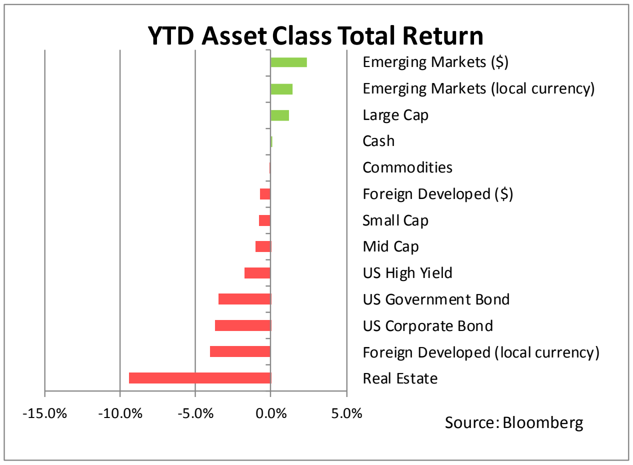




(Source: Bloomberg)

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 2/14/2018 close)

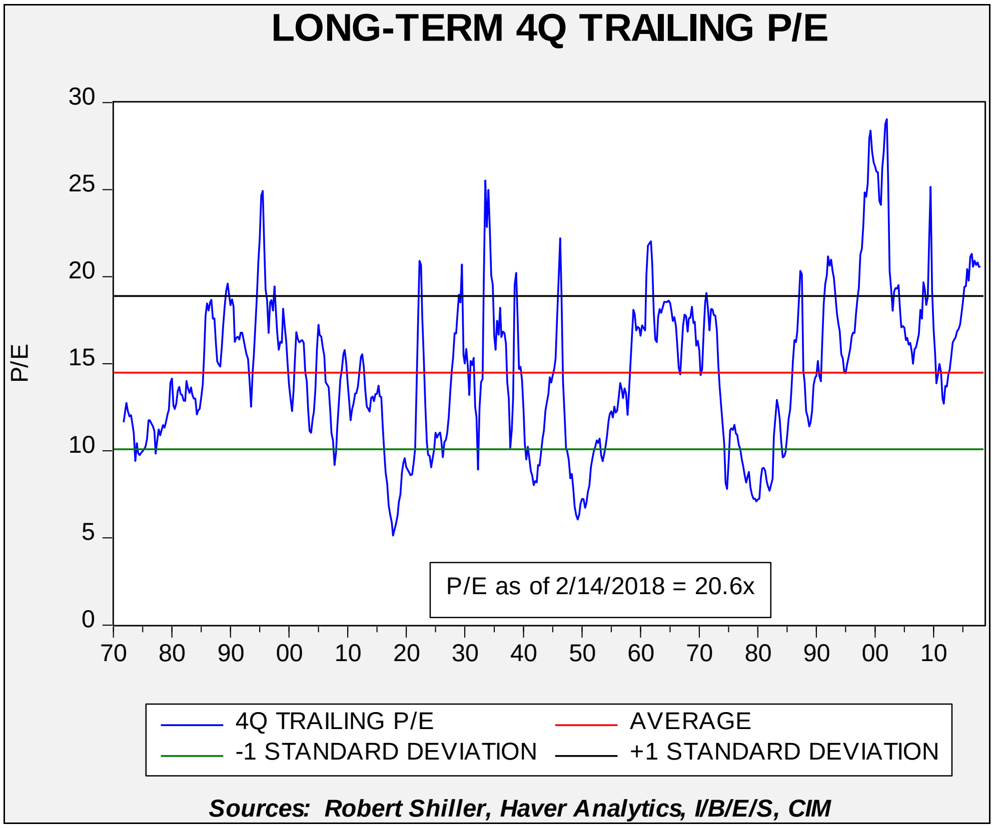


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 15, 2018



Based on our methodology,[2] the current P/E is 20.6, down 0.2x from last week. Rising earnings and falling equity prices led to the modest decline in the multiple.

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[2] 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.