By Bill O'Grady and Thomas Wash

[Posted: February 16, 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 1.4% 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 387 companies having reported, the S&P 500 Q4 earnings stand at $36.11, 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, 76.0% of the companies reported earnings above forecast, while 15.5% 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.*

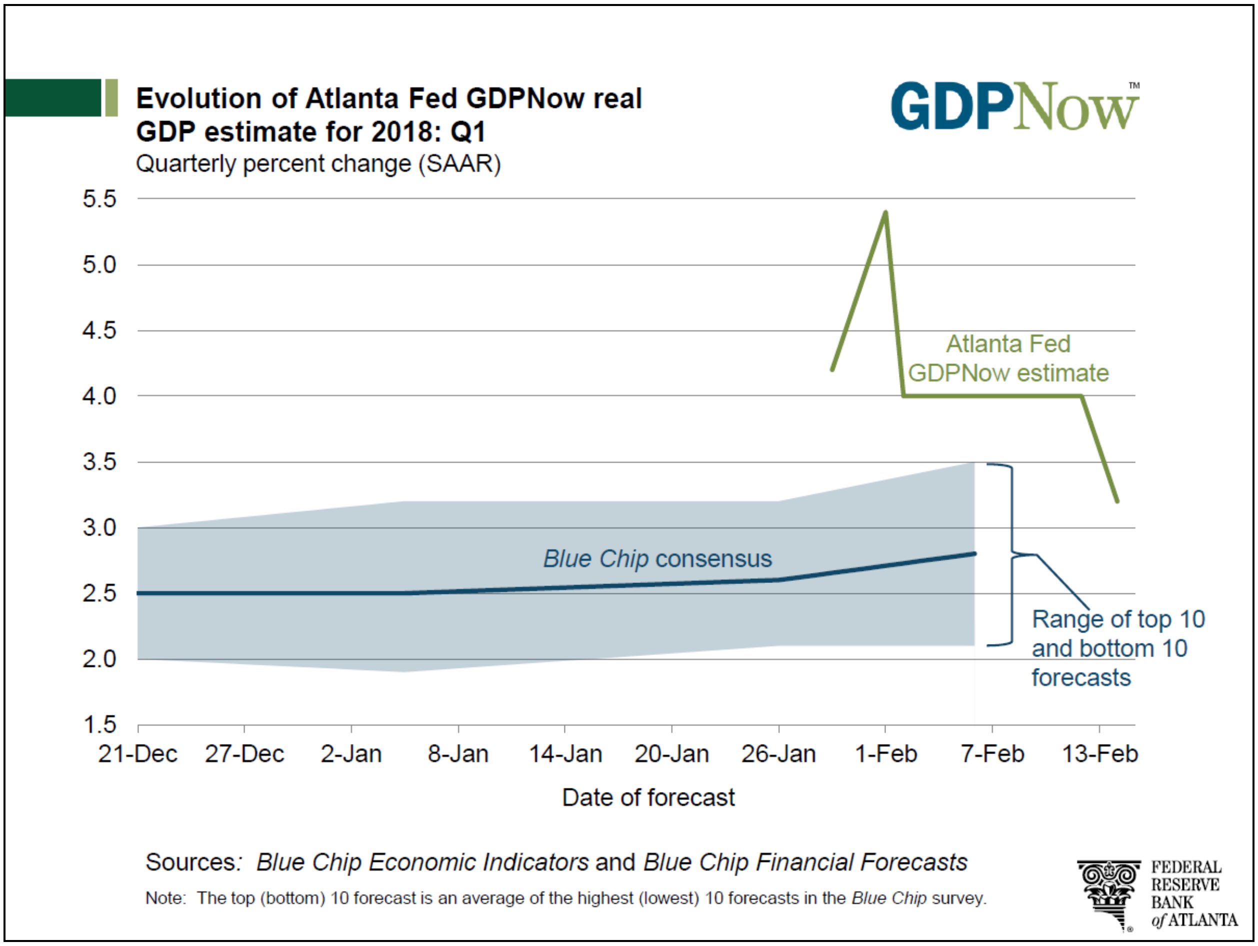
It looks like we are having a pause day after a strong week for equities and foreign exchange and steadily rising interest rates. Equity futures have turned to unchanged, while the dollar and Treasuries are higher. However, market moves are fairly benign. The Chinese New Year is today; as we mentioned yesterday, Chinese markets will be closed into next week and several other Asian markets were closed as well. Here is what we are watching today:

Tariff hikes in India: PM Modi has been promoting a "Make in India" policy that has been something of a disappointment. In response, earlier this week, his government announced duty increases on a wide range of products. India's development has deviated from the rest of Asia. From Japan in the 1960s to China in the 1980s, the path to development was based on building a manufacturing base through mercantilism. Policies were designed to stifle domestic consumption through non-existent safety nets, consumption taxes and an undervalued exchange rate. As long as the U.S. was willing to play the role of importer of last resort, a function tied closely to providing the reserve currency, the development model worked quite well.

India did not follow that model. Instead, Indian policy following its independence was essentially autarky. The country didn't trade much and built quasi-public national champions that dominated domestic markets. The model followed the British Labour Party policies after WWII (and advocated today by Jeremy Corbyn). This policy led to high inflation and slow growth. As India began to develop, it had more success in services and developed a sophisticated trade in financial, medical and technology services. However, manufacturing lagged in part due to the aforementioned autarkic policies. To build mass employment, India needs manufacturing to expand. Modi has tried to build India's manufacturing with apparently little success. We are not at all surprised to see India move in the direction of increasing duties;

this is part of the mercantilist policy mix that has worked well for others. However, conditions that made that policy mix successful have and are changing. The U.S. is becoming increasingly unwilling to play the importer of last resort role and could retaliate against India's actions. It is possible that India's manufacturing base never rivals China, Japan, et al. because it is missing a key element—a willing buyer.

Growth estimates come down: The Atlanta FRB has released its GDPNow estimate for Q1 GDP. As the chart below shows, it was initially quite elevated but has declined rather sharply.



GDP is expected to rise 3.2% in Q1, which is still quite robust but well below the nearly 5.5% rate estimated earlier this month. The culprits for slower growth are weakening consumption and investment.

Atlanta Fed GDPNow estimates for 2018: Q1, contributions to growth

Date	Major Releases	GDP	PCE	Equip-ment	Intell. prop. prod.	Nonres. struct.	Resid. inves.	Govt.	Net exports	CIPI
29-Jan	Initial nowcast	4.2	2.18	0.62	0.23	0.04	-0.01	0.17	-0.29	1.23
1-Feb	ISM Manufact., Construction spending	5.4	2.80	0.92	0.23	0.13	0.23	0.17	-0.36	1.25
2-Feb	Employment, M3 Manuf., Auto sales	4.0	2.05	0.48	0.22	0.08	0.03	0.17	-0.29	1.25
5-Feb	ISM Nonmanufacturing Index	4.0	2.08	0.49	0.22	0.08	0.05	0.17	-0.29	1.25
6-Feb	International trade	4.0	2.07	0.52	0.22	0.08	0.05	0.17	-0.33	1.25
9-Feb	Wholesale trade	4.0	2.07	0.52	0.22	0.08	0.05	0.17	-0.33	1.24
12-Feb	Monthly Treasury Statement	4.0	2.07	0.52	0.22	0.08	0.05	0.17	-0.33	1.24
14-Feb	Retail trade, Consumer Price Index	3.2	1.42	0.51	0.22	0.08	-0.02	0.17	-0.33	1.21
Maximum forecast of real GDP growth										
1-Feb	ISM Manufact., Construction spending	5.4	2.80	0.92	0.23	0.13	0.23	0.17	-0.36	1.25
Minimum forecast of real GDP growth										
14-Feb	Retail trade, Consumer Price Index	3.2	1.42	0.51	0.22	0.08	-0.02	0.17	-0.33	1.21

Note: CIPI is "change in private inventories." All numbers are percentage-point contributions to GDP growth (SAAR). The table does not necessarily include all estimates for the quarter; see tab "ContribHistory" in the online excel file for the entire history.

FEDERAL RESERVE BANK *of* ATLANTA

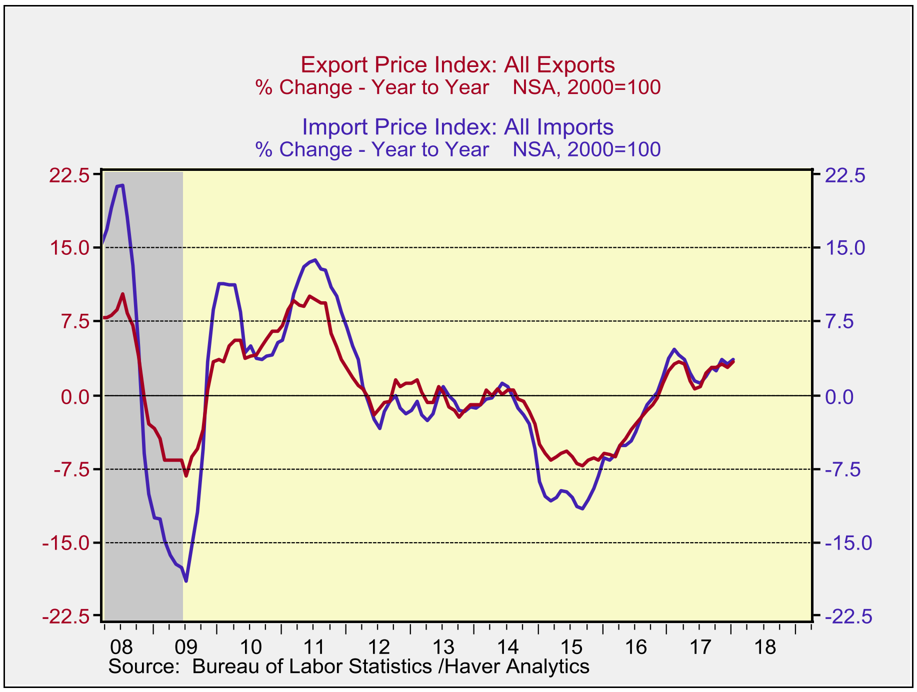
The recent retail sales and CPI data have shaved 60 bps from GDP and weaker residential investment was responsible for the rest of the decline. Net exports have become an increasing drag on growth; we expect the net export sector's drag on growth to rise as the data flows the rest of the quarter.

Rising stress: We closely monitor a number of stress indices. The two we rely on most come from the FRBs of Chicago and St. Louis. The former has a longer history while the latter tends to be more sensitive and thus give earlier (but more noisy) signals. The St. Louis FRB Stress Index jumped last week.

This is a decade graph of the two series. Note that the St. Louis number rose sharply last week. Both numbers remain below zero, which indicates that stress really isn't a concern at this point. However, if it continues to rise, it will signal broader problems in the financial markets.

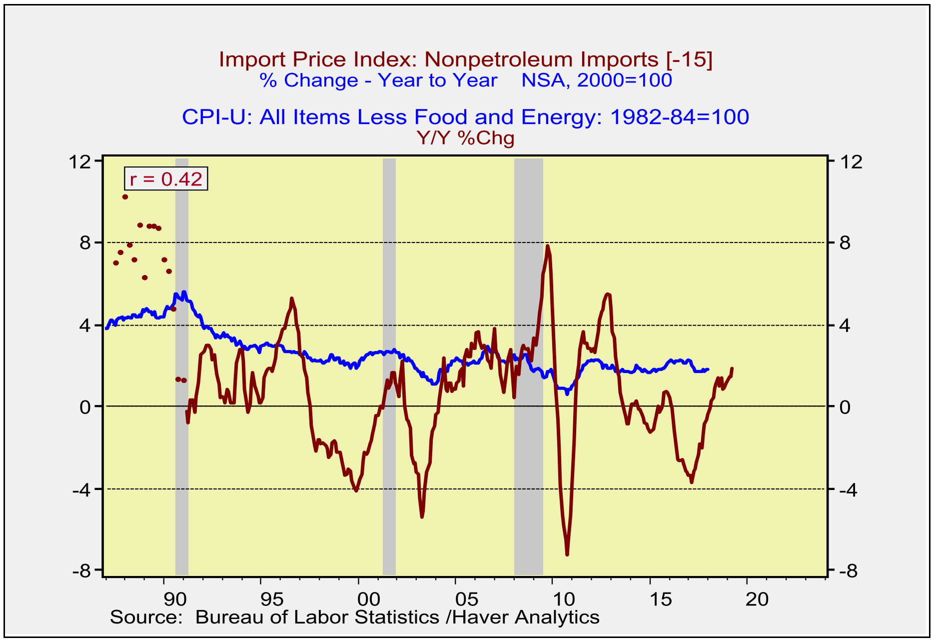
U.S. Economic Releases

The import price index came in above expectations, rising 1.0% from the prior month compared to the forecast gain of 0.6%. The prior month's gain was revised up from 0.1% to 0.2%. The import price index excluding petroleum came in above expectations, rising 0.5% from the prior month compared to the forecast rise of 0.1%. The export price index came in above expectations, rising 0.8% from the prior month compared to the forecast rise of 0.3%.

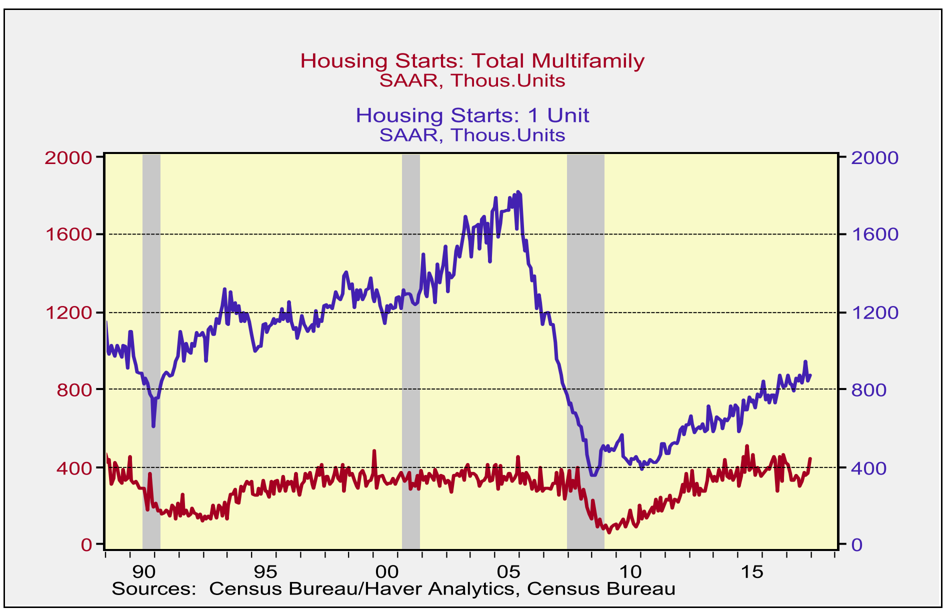


The chart above shows the year-over-year change in the import price index and export price index. The import price and export price indexes rose 3.6% and 3.4%, respectively.

The combination of dollar weakness and fiscal policy that likely will need to attract foreign saving means that higher import prices could cause inflation to rise. There is some evidence that import prices affect core CPI but the impact has a rather long lag. The chart below shows the yearly change in non-petroleum import prices and core CPI. The highest correlation is shown with import prices leading core CPI by five quarters. Thus, we would expect some modest upward pressure from import prices in the coming months but doubt it will have a major impact on inflation.



Housing starts came in above expectations at 1,326k compared to the forecast of 1,234k on an annualized basis. The prior month's report was revised upward to 1,209k from 1,192k. The monthly change in housing starts came in above expectations, rising 9.7% compared to the forecast gain of 3.5%. The prior report's loss was revised downward from 8.2% to 6.9%. Building permits came in above expectations at 1,396k compared to the forecast of 1,300k. The prior month's report was revised downward by 2k from 1,302k to 1,300k. The monthly change in building permits came in above expectations, rising 7.4% compared to the forecast of unchanged from the prior month. The prior report's loss was revised upward from 0.1% to 0.2%.



The chart above shows the level of multi-family and single-family housing starts. Multi-family starts have risen 6.7%, while single-units rose 7.6% from the prior year. Housing starts fell in the East by 3.4% and 19.8% in the Midwest, while housing starts in the South and West rose by 25.7% and 70.1%, respectively. The regional patterns were probably affected by weather. Wintery and cold weather likely slowed building in the Midwest and East, while mild weather boosted activity in the South and West. We will be watching starts closely in the coming months to see the impact of higher interest rates on real estate.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	U. of Michigan Sentiment	m/m	feb	95.4	95.7	***
10:00	U. of Michigan Current Conditions	m/m	feb	111.1	110.5	**
10:00	U. of Michigan Expectations	m/m	feb	87.2	86.3	**
10:00	U. of Michigan 1 yr Inflation	m/m	feb		2.7%	**
10:00	U. of Michigan 5-10 Yr Inflation	m/m	feb		2.5%	**
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	Japan buying foreign bonds	m/m	feb	-¥973.2 bn	-¥866.6 bn		*	Equity and bond neutral
	Japan buying foreign stocks	m/m	feb	-¥44.8 bn	¥466.5 bn		*	Equity and bond neutral
	Foreign buying Japan bonds	m/m	feb	¥41.7 bn	-¥353.1 bn		*	Equity and bond neutral
	Foreign buying Japan stocks	m/m	feb	-¥429.5 bn	-¥126.7 bn		*	Equity and bond neutral
New Zealand	BusinessNZ Manufacturing PMI	m/m	jan	55.6	51.2		**	Equity bullish, bond bearish
	Non Resident Bond Holdings	m/m	jan	60.0%	61.1%		**	Equity and bond neutral
EUROPE								
Germany	Wholesale Price Index	m/m	jan	0.9%	-0.3%		**	Equity bullish, bond bearish
Russia	Industrial Production	q/q	jan	2.9%	-1.5%	-0.5%	***	Equity bullish, bond bearish
	Gold and Forex Reserve	y/y	feb	447.4 bn	449.8 bn		*	Equity and bond neutral
U.K.	Retail Sales ex Auto	y/y	jan	1.5%	1.3%	2.4%	**	Equity bearish, bond bullish
	Retail Sales inc Auto	y/y	jan	1.6%	1.4%	2.5%	**	Equity bearish, bond bullish
AMERICAS								
Canada	Existing Home Sales	m/m	jan	-14.5%	4.5%		**	Equity and bond neutral
Brazil	Trade Balance Weekly	y/y	feb	$2.590 bn	$0.041 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)	185	184	1	Up
3-mo T-bill yield (bps)	156	157	-1	Neutral
TED spread (bps)	29	27	2	Neutral
U.S. Libor/OIS spread (bps)	158	158	0	Up
10-yr T-note (%)	2.89	2.91	-0.02	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	31	32	-1	Down
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	down			Neutral
pound	down			Neutral
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	$64.61	$64.33	0.44%	
WTI	$61.56	$61.34	0.36%	
Natural Gas	$2.56	$2.58	-0.93%	
Crack Spread	$13.58	$13.75	-1.17%	
12-mo strip crack	$17.15	$17.30	-0.89%	
Ethanol rack	$1.53	$1.52	0.58%	
Metals				
Gold	$1,357.56	$1,353.67	0.29%	
Silver	$16.83	$16.87	-0.22%	
Copper contract	$327.95	$326.45	0.46%	
Grains				
Corn contract	$ 375.00	$ 375.50	-0.13%	
Wheat contract	$ 475.00	$ 475.25	-0.05%	
Soybeans contract	$ 1,034.50	$ 1,035.00	-0.05%	
Shipping				
Baltic Dry Freight	1089	1095	-6	
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)	-194.0	-191.0	-3.0	

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 16, 2018

Do fiscal deficits matter? This is one of the more polarizing topics in economics. The recent tax bill and budget agreement will increase the deficit, which has led to all sorts of worries and claims. Here are a few observations:

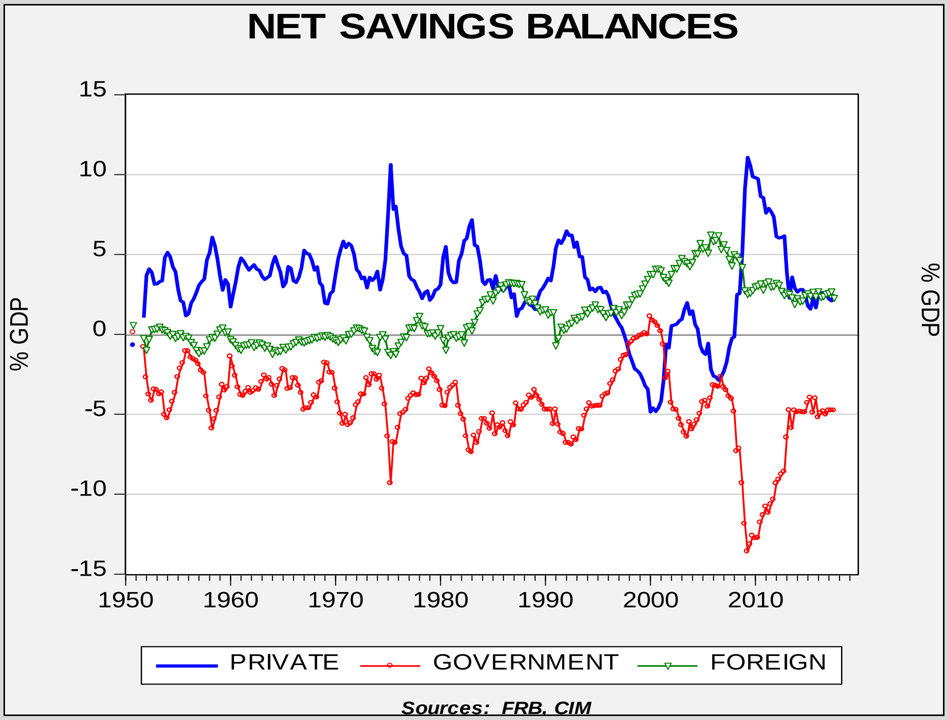
1. Politically, deficits matter to the party out of power. Protesting against deficits are one of the few ways a party out of power can restrain the party in power. Thus, the party in power tends to ignore deficits because it doesn't want to be restrained. In addition, there is always a fear that borrowing capacity could become constrained, so by the time the party out of power regains a majority, it will be stuck with implementing austerity. Each party believes there are some types of public expenditures that are good for their own sake and should be paid for even if the deficit increases. Although a generalization, Republicans tend to support defense spending and tax cuts; Democrats tend to support health care and social spending. Thus, what angers each side about the other side's priorities is that they view their own priorities as sacred and the others' as buying votes.
2. The economic impact is complicated and dependent upon market and economic conditions. One of the most common mistakes people make in terms of the deficit is the error of composition. This is a classic logic error where one postulates that what is true on a small scale is also true on a large scale. Thus, it's common for politicians[1] to note that a household can't borrow money to unsustainable levels and neither can the government. However, there is a big difference between a government and a household. First, the former can use force to collect revenue to service debt (if you don't pay your taxes, the government can use coercion), and second, the government prints the currency used to pay the debt. If households could use force to service their debt and print money, they would be like the government and thus could borrow much more.
3. The major issue with deficits is spending priorities. The government of a developing nation should run deficits to build out infrastructure because the return on the investment will likely exceed the cost. In wartime, borrowing money to fund the war effort makes sense because the state will cease to exist if the nation loses the war. Education is arguably a good public investment, as is domestic security. One would expect strong debates about how much of these public[2] or quasi-public goods should be provided. The

[1] Usually the party out of power, but not always. There are a few political figures that are consistently opposed to deficits and government debt regardless of whether or not their party is in control of Congress.

[2] In public finance, a public good is a good that cannot be easily excluded and is non-rivalrous, meaning that it is either provided to all or none. Fire protection cannot be easily segregated, for example. In theory, one could argue that the fire department should only put out fires from households that pay their "fire bill." In reality, it is probably impossible to allow one house to burn down and not adversely affect neighboring homes who did pay their fees. Police services, libraries, etc. are examples of pure public goods. If the government or a non-profit

reality is that it's difficult to estimate the value of public investment and spending, and arguments over these issues will be perpetual.

Do deficits matter? Yes, but not in the simple form that pundits suggest. When the government spends more money than it takes in from taxes, that saving has to be acquired from the other major sectors of the economy, the private sector (households and businesses) or the foreign sector (through the trade account).



Private saving balance = (business revenue less business investment) + (household saving less consumption)

Public saving balance = (taxes less government spending and transfers)

Foreign saving balance = inverse of the current account

The above chart shows the three sectors of the saving balance; it's a macroeconomic identity, meaning that it will always equal zero. Thus, when the government deficit expands, it must be

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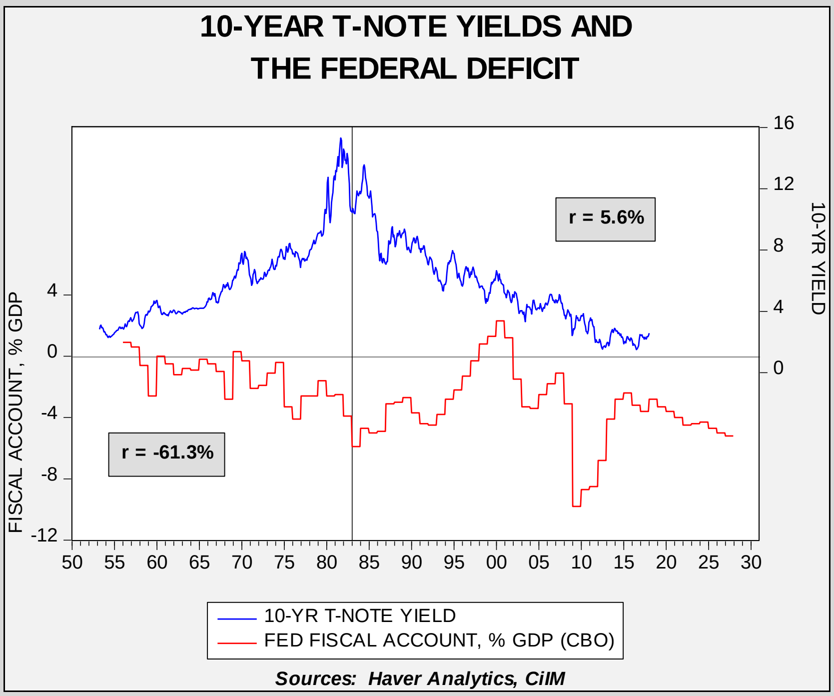
entity doesn't provide the good, no private sector firm will provide it because it cannot ensure it will get paid (getting back to the government's ability to use coercion to collect taxes). Quasi-public goods are goods that can be provided by the private sector but is sometimes provided in less quantities than considered optimal. If households don't earn enough to provide for the wellbeing of a family, a quasi-public good would be public assistance. The private sector does provide food and shelter but it may not produce enough to be a feasible option for a low income household.

funded by saving created by either the foreign sector or the private sector. When the government runs a surplus, it depletes private sector saving or reduces foreign inflows.

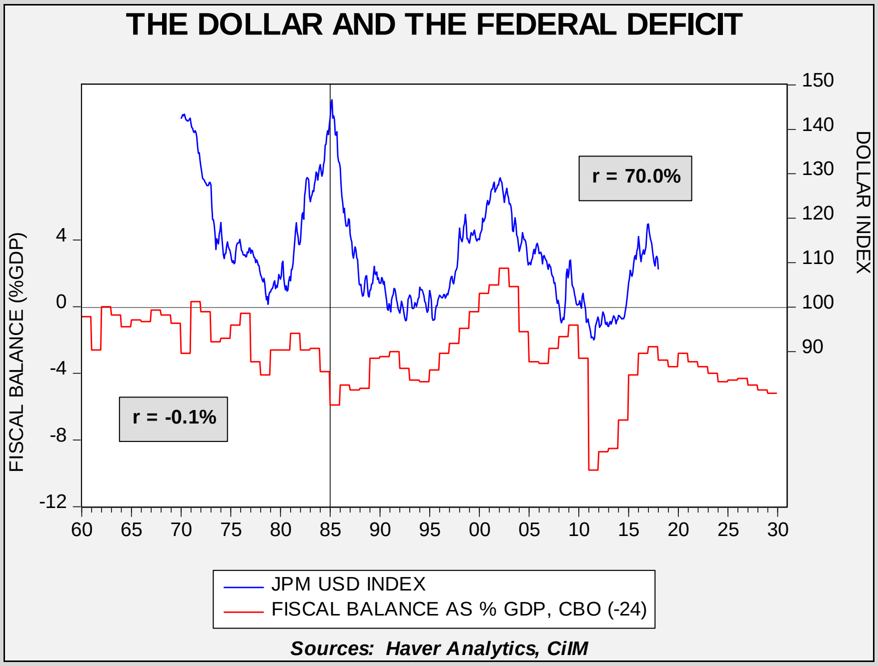
The impact on the economy depends on the return from government spending relative to the return from the private sector or the foreign sector. If public spending has a higher rate of return than investment in the private sector, then fiscal deficits are reasonable. However, this calculation is extraordinarily difficult. Think of the rate of return on the Strategic Petroleum Reserve; if the world experiences a major war in the Middle East and oil rises to $150 per barrel, the investment when oil was cheaper would almost certainly be positive. The same would be true for peacetime defense spending when war breaks out. However, outside of dire situations and under shorter time frames, private sector investment probably has a higher rate of return.

Our concern is the market impact. The classic fear is that deficits trigger inflation and higher interest rates. The theory is that if the government runs a deficit, the private sector will offset it, which will require a drop in consumption and crowd out private investment. The drop in consumption is usually facilitated by higher prices and the contraction of investment would usually constrain output and lift inflation as well. The data actually shows that higher deficits did seem to boost interest rates from the late 1950s into the early 1980s; however, the relationship became uncorrelated thereafter.



Since 1983, long-duration Treasury rates have steadily declined despite the trend in the deficit. In comparison to the first graph, what changed in 1983 was the expanding current account deficit, which brought in another source of saving to fund the fiscal deficit.

One area that will likely be affected is the dollar. The dollar was mostly uncorrelated with the fiscal balance until the peak of the "Volcker dollar" in 1985. However, since then, with a two-year lag, the fiscal account correlates directly with the dollar at a level of 70%. A fiscal surplus tends to be dollar bullish, while a widening deficit is dollar bearish.

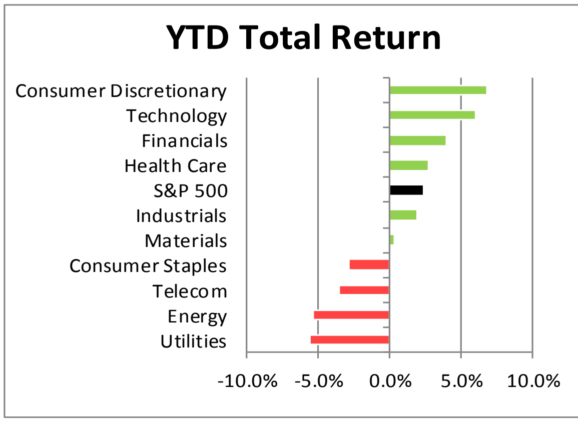


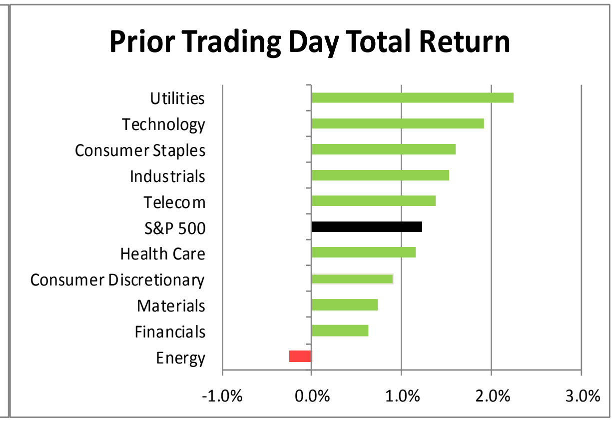
We believe this occurs because of the dollar's reserve status. There is a constant demand for dollars on world markets to facilitate trade. A wider fiscal deficit makes more dollars available for world markets; rising supply tends to weaken the dollar's price, the exchange rate. On the other hand, a fiscal surplus (or narrower deficit) means the supply of dollars is less, boosting the exchange rate.

Although it is possible that a weaker dollar could lift prices, the evidence is scant; foreign countries use exports for growth and to lower unemployment in their nations. As a result, they tend to accept margin compression rather than give up market share through higher prices. Accordingly, we think the preponderance of the evidence suggests the expanding fiscal deficit will be dollar bearish and supportive for foreign assets.

Data Section

U.S. Equity Markets – (as of 2/15/2018 close)

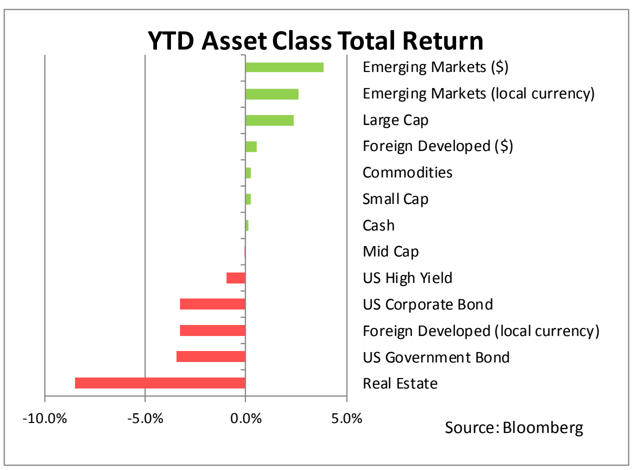




(Source: Bloomberg)

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 2/15/2018 close)

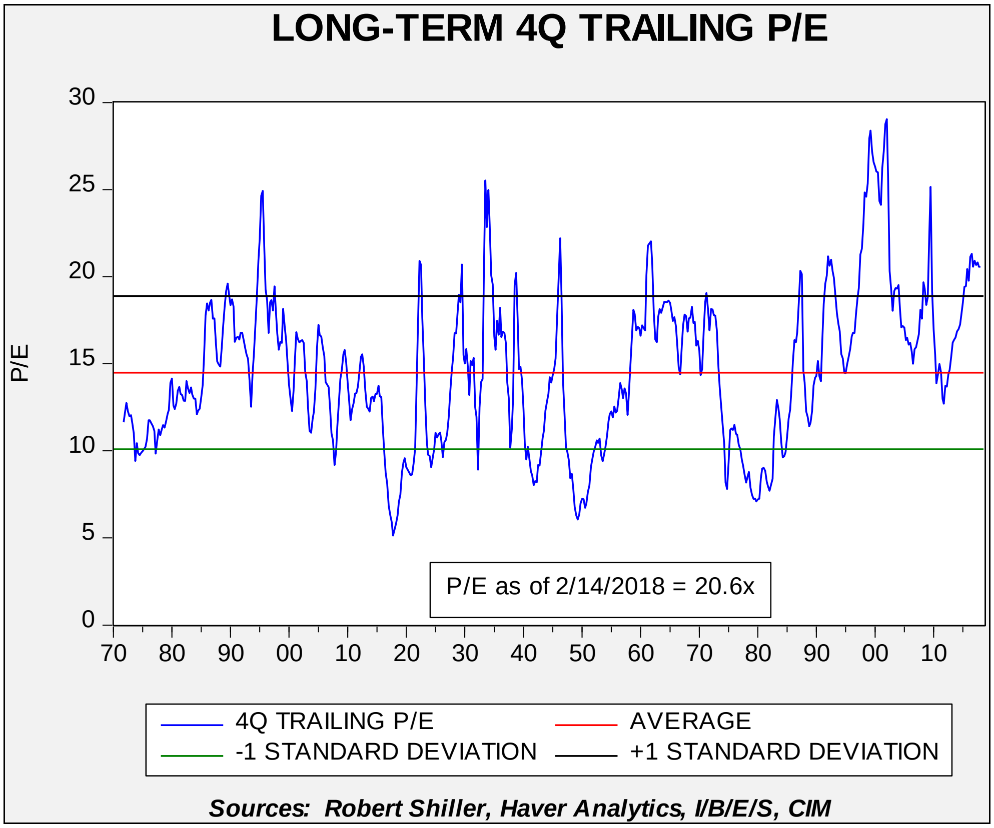


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[3] 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.

[3] 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.