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: March 11, 2019—9:30 AM EST] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.3% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.6% from the prior close. Chinese markets were higher, with the Shanghai composite up 1.9% and the Shenzhen index up 3.9%. U.S. equity index futures are signaling a higher open.

Equity futures are mostly higher this morning, although Dow futures are lower on the Ethiopian airlines crash.[1] Here is what we are watching this morning:

Chinese trade: It appears the trade summit between China and the U.S. will likely be delayed, probably into April.[2] There was some movement on the enforcement mechanism. China is uncomfortable with giving the U.S. unilateral power to decide whether China is violating the terms of the agreement, but would be willing to accept a joint plan.[3] China has also indicated it won't engage in competitive devaluations,[4] most likely because any threat of a weaker CNY would trigger capital flight. We still expect the Trump administration to make a deal with China as a failure of talks would harm the president's reelection campaign.[5]

Meanwhile, we note that China's exports appear to be rebounding this month.[6] There is evidence that China's economy is starting to benefit from recent stimulus measures.[7]

Brexit: It's decision week for Brexit. There are three votes this week. The first occurs tomorrow on May's exit deal. Although her administration has been negotiating with the EU, there has been no discernable progress made.[8] Thus, we are assuming her plan will go down in

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[1] https://www.washingtonpost.com/world/ethiopian-airlines-flight-bound-for-nairobi-crashes-with-157-on-board/2019/03/10/0be5826c-4310-11e9-90f0-0ccfeec87a61_story.html?noredirect=on&utm_term=.1847abc5605e&wpisrc=nl_todayworld&wpmm=1
[2] https://www.wsj.com/articles/u-s-china-trade-deal-isnt-imminent-ambassador-branstad-says-11552031163 and https://www.ft.com/content/e089b6de-42b4-11e9-b168-96a37d002cd3
[3] https://www.nytimes.com/2019/03/09/business/china-trade-talks-trump.html?action=click&module=Latest&pgtype=Homepage
[4] https://www.wsj.com/articles/u-s-china-near-currency-deal-beijing-vows-not-to-devalue-yuan-to-help-exports-11552204378
[5] https://www.bloomberg.com/news/articles/2019-03-08/trump-says-china-deal-will-mean-very-big-spike-for-markets
[6] https://www.scmp.com/economy/china-economy/article/2189454/china-exports-rebound-strongly-early-march-after-februarys-20
[7] https://www.ft.com/content/c085c2e4-4235-11e9-b168-96a37d002cd3
[8] https://www.ft.com/content/dceee028-43ca-11e9-a965-23d669740bfb

defeat again. The following day Parliament will vote on whether it wants a "no-deal" Brexit. That will likely also be defeated as few MPs want to be seen as supporting the chaos that a fast, hard break would bring. On Thursday, assuming our assessment of Tuesday's and Wednesday's votes are correct, Parliament should vote to ask for an extension.[9] Although it would appear logical that they should vote for an extension, stranger things have happened.

It does look like PM May's remarkable run could be coming to a close.[10] Although she has suffered historic losses in Parliament, she has hung on to power, in part, because no one else has any better ideas on how to proceed. However, the Tories are concluding that the party needs a new leader to negotiate trade arrangements with the EU. From our vantage point, we don't see a leader in the Conservatives who will have any easier of a time concluding Brexit.

Meanwhile, the BOE has ordered banks to triple their "easy to sell" asset buffers on fears of a hard Brexit.[11] Businesses are in varied states of preparation.[12] So far, the GBP has held its value on the belief that a hard Brexit will be avoided. We suspect this supposition is true, but there remains a chance that Britain stumbles into a crisis.

Venezuela blackouts: Venezuela suffered massive power outages over the weekend[13] that are continuing into this workweek.[14] The Maduro government has accused outsiders of sabotage, but the most likely reason is the ineptitude of the regime. Protests against the government continue despite the blackout,[15] but it increasingly appears that the opposition cannot swing the military to its side. Thus, the slow-motion collapse continues.[16]

Saudi oil cuts extended into April: Saudi sale intentions for next month are signaling that oil production cuts will continue, which is supportive for oil prices.[17]

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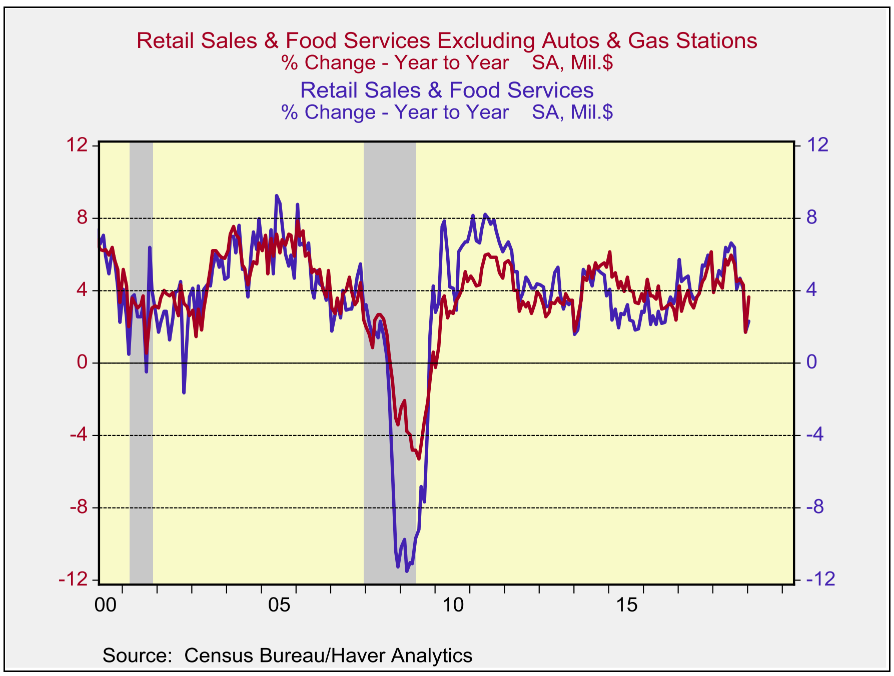
[9] https://www.nytimes.com/2019/03/08/world/europe/brexit-uk-may-endless.html?emc=edit_mbe_20190311&nl=morning-briefing-europe&nlid=567726720190311&te=1
[10] https://www.ft.com/content/618ad20c-4316-11e9-a965-23d669740bfb?emailId=5c85da12a114dd0004a40895&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22
[11] https://www.ft.com/content/7450737a-4356-11e9-b168-96a37d002cd3?emailId=5c85da12a114dd0004a40895&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22
[12] https://www.washingtonpost.com/world/europe/will-brexit-happen-when-and-how-the-uncertainty-is-maddening-for-business/2019/03/09/900525fe-3468-11e9-8375-e3dcf6b68558_story.html?utm_term=.48613f282d57&wpisrc=nl_todayworld&wpmm=1
[13] https://www.washingtonpost.com/world/the_americas/rotting-food-and-endangered-patients-how-venezuelans-are-faring-during-continuing-nationwide-power-outages/2019/03/10/137e14a2-4343-11e9-94ab-d2dda3c0df52_story.html?utm_term=.2b67fedfc403&wpisrc=nl_todayworld&wpmm=1
[14] https://www.ft.com/content/65940e9a-3c6d-11e9-b72b-2c7f526ca5d0
[15] https://www.washingtonpost.com/world/the_americas/demonstrators-jam-venezuela-anti-government-protest-despite-blackout/2019/03/09/75c328c0-404e-11e9-85ad-779ef05fd9d8_story.html?utm_term=.eb167a5fa2a4&wpisrc=nl_todayworld&wpmm=1
[16] https://www.washingtonpost.com/opinions/2019/03/10/venezuela-is-truly-verge-collapse/?utm_term=.ab11763ea5f8
[17] https://www.bloomberg.com/news/articles/2019-03-11/saudi-arabia-is-said-to-extend-deep-oil-output-cuts-into-april

Indian elections begin mid-April: The world's largest democracy will begin elections on April 11. Six subsequent elections will be held over the next five weeks, ending on May 19 with final results due on May 23.[18]

U.S. Economic Releases

Advance retail sales for January came in above expectations, rising 0.2% from the prior month compared to the forecast of unchanged. The prior month's loss of 1.8% was revised downward to -2.1%. Retail sales ex-auto came in above expectations, rising 0.9% from the prior month compared to the forecast gain of 0.3%. The prior month's loss was revised downward from 1.8% to -2.1%. Retail sales ex-auto and gasoline came in above expectations, rising 1.2% from the prior month compared to the forecast rise of 0.6%. The prior month's loss was revised downward from -1.4% to -1.6%. The retail sales control group came in above expectations, rising 1.1% from the prior month compared to the forecast gain of 0.6%. The prior month's loss was revised from -1.7% to -2.3%.



The chart above shows the year-over-year change in retail sales and core retail sales. Annually, retail sales and core retail sales rose 2.3% and 3.6%, respectively.

The data confirms that December retail sales were weak; this data will almost certainly lead to downward revisions to Q4 GDP, but it does suggest consumption may be OK in Q1.

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

[18] https://www.washingtonpost.com/world/india-elections-to-launch-on-april-11-unfold-in-seven-stages/2019/03/10/8b94916e-4320-11e9-9726-50f151ab44b9_story.html?noredirect=on&utm_term=.9cac09849a42&wpisrc=nl_todayworld&wpmm=1

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Business Inventories	m/m	dec	0.6%	-0.1%	**
Fed speakers or events						
EST	Speaker or event	District or position				
19:00	Jerome Powell Welcome Remarks at Conference	Chairman of Board of Governors of Federal Reserve				

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	Money Stock M2	y/y	feb	2.4%	2.4%	2.4%	*	Equity and bond neutral
	Money Stock M3	y/y	feb	2.1%	2.1%	2.1%	*	Equity and bond neutral
	Machine Tool Orders	y/y	feb	-29.3%	-18.8%		**	Equity and bond bearish
New Zealand	Card Spending Retail	m/m	feb	0.9%	1.8%	0.3%	**	Equity bullish, bond bearish
	Card Spending Total	m/m	feb	0.1%	2.0%		**	Equity and bond neutral
EUROPE								
Germany	Industrial Production	m/m	jan	-3.3%	-3.9%	-3.2%	***	Equity and bond neutral
	Trade Balance	m/m	jan	14.5 bn	13.9 bn	15.2 bn	**	Equity and bond neutral
	Current Account Balance	m/m	jan	18.3 bn	21.0 bn	18.0	**	Equity and bond neutral
	Labor Cost	q/q	4q	2.0%	2.7%		***	Equity and bond neutral
Switzerland	Total Sight Deposits	m/m	mar	576.1 bn	576.4 bn		*	Equity and bond neutral
	Domestic Sight Deposits	m/m	mar	487.6 bn	491.4 bn		*	Equity and bond neutral
AMERICAS								
Mexico	Gross Fixed Investment	m/m	feb	-6.8%	-3.2%	-4.9%	***	Equity and bond bearish
	Nominal Wages	m/m	feb	6.0%	5.2%		***	Equity and bond neutral
Canada	Housing Starts	m/m	feb	173.2k	208.0k	205.0k	***	Equity and bond bearish
	Net Change in Employment	m/m	feb	55.9k	66.8k	1.2k	***	Equity bullish, bond bearish
	Unemployment Rate	m/m	feb	5.8%	5.8%	5.8%	***	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)	260	260	0	Up
3-mo T-bill yield (bps)	239	240	-1	Neutral
TED spread (bps)	20	20	0	Neutral
U.S. Libor/OIS spread (bps)	241	241	0	Up
10-yr T-note (%)	2.65	2.63	0.02	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	12	11	1	Down
Currencies	**Direction**			
dollar	flat			Neutral
euro	up			Up
yen	down			Neutral
pound	flat			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	$66.20	$65.74	0.70%	Saudi possibly extending cuts
WTI	$56.43	$56.07	0.64%	
Natural Gas	$2.79	$2.87	-2.69%	
Crack Spread	$22.41	$22.34	0.32%	
12-mo strip crack	$18.13	$18.08	0.26%	
Ethanol rack	$1.42	$1.43	-0.22%	
Metals				
Gold	$1,294.63	$1,298.30	-0.28%	
Silver	$15.30	$15.34	-0.25%	
Copper contract	$289.95	$289.35	0.21%	
Grains				
Corn contract	$ 365.25	$ 364.25	0.27%	
Wheat contract	$ 438.50	$ 439.50	-0.23%	
Soybeans contract	$ 895.25	$ 895.75	-0.06%	
Shipping				
Baltic Dry Freight	649	657	-8	

Weather

The 6-10 and 8-14 day forecasts show cooler temperatures for most of the country, with warmer temps on the West Coast.

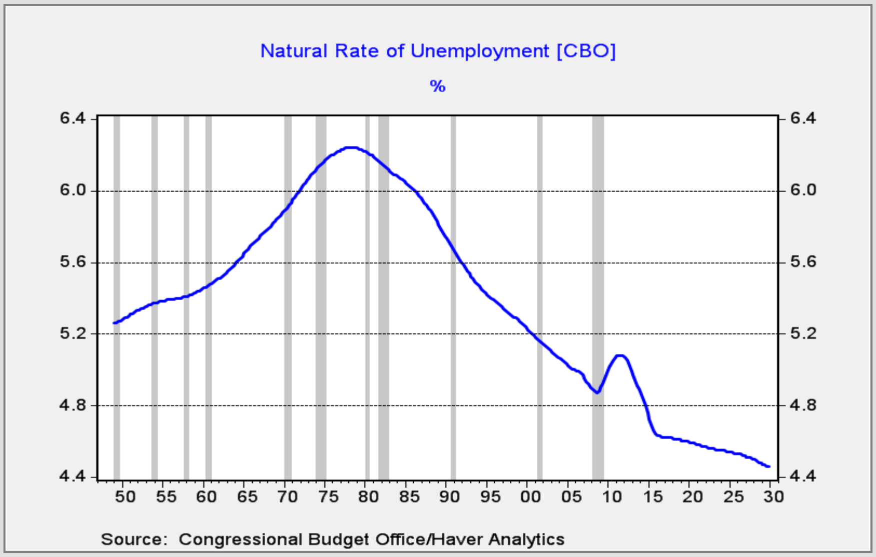
<u>Asset Allocation Weekly Comment</u>

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.

March 8, 2019

The Federal Reserve is experiencing a crisis of sorts. For years, policymakers have used the Phillips Curve as a guide to policy. The Phillips Curve postulates that there is a tradeoff between inflation and unemployment. Essentially, to quell inflation policymakers need to raise rates to create unemployment. The basic idea is that unemployment represents capacity; when the unemployment rate falls below some level, sometimes called the "natural rate of unemployment," capacity constraints develop and inflation rises. Theory has developed around the Phillips Curve. For example, the Non-Accelerating Inflationary Rate of Unemployment (NAIRU) suggests an equilibrium unemployment rate; inflation falls above this rate, and inflation rises below this rate.

However, if NAIRU is natural, it doesn't appear to be stable.



This chart shows the natural rate of unemployment, calculated by the Congressional Budget Office. As is evident, it has increased and declined over time.

The lack of inflation given the low level of unemployment has led the FOMC to consider if another model might work better. If the reaction of the economy to low unemployment has changed, then policymakers may need to keep rates lower for longer to avoid the risk of raising rates too soon or too much. Doing either could needlessly shorten a business cycle. If inflation reacts more slowly to falling capacity, it might make sense to use a different way to adjust the policy rate to inflation. Currently, the FOMC uses a 2% target on core PCE inflation. In other words, based on the yearly change in the core PCE index, the FOMC attempts to keep inflation around a yearly 2% change. Although the Fed attempts to suggest 2% isn't a ceiling, it is generally treated as one by the financial markets.

Of the current 17 members of the FOMC, nine are Ph.D. economists. Of that group, five have advocated for a reexamination of inflation policy. None of the non-Ph.D. members have advocated for a change. Thus, the drive to make a change appears to be coming from the "technical" side of the shop. At present, there are three ideas being explored to address the inflation policy issue.

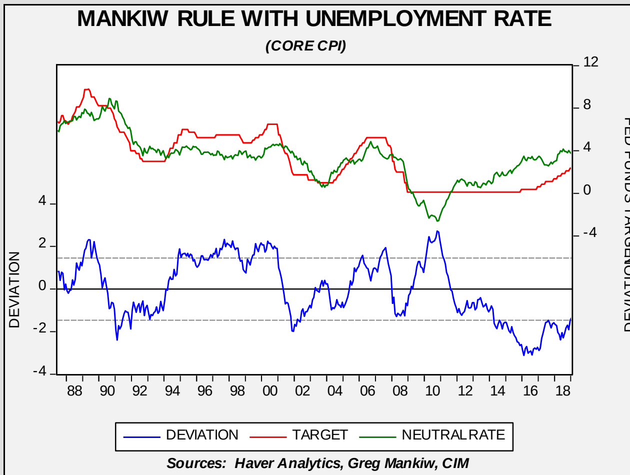
1. **Raise the inflation target:** The official inflation target is relatively new. Although the Fed privately agreed to an inflation target in 1996, Chair Greenspan insisted it was to be kept secret.[19] It wasn't until 2012 that the FOMC made the 2% target official.[20] The working definition of inflation control is a rate low and stable enough that inflation concerns are not part of the economic process. In other words, if I am buying something, I neither accelerate the purchase (a reaction to higher expected prices) nor wait (a reaction to lower expected prices). If the interest rate that creates equilibrium has fallen, one way to achieve that rate, on a real basis, is to simply tolerate higher inflation.
2. **Use a moving average of the yearly change in inflation:** The use of the core rate, the rate excluding food and energy, is designed to smooth out the changes that can be triggered by weather or geopolitical events. However, even items outside of food and energy can be affected by short-term events. Changes in tax rates at the state and local level can raise prices for a short time. In the past, price wars in mobile phone plans led to lower core prices. If the goal is to control inflation over the medium term, a smoothed series might make more sense.[21]
3. **Target the level of prices, not the rate of change:** The FOMC uses the core PCE deflator as its policy tool. Instead of aiming for a 2% rate of change, the committee could target a level instead. That way, if price levels were above trend for an extended period, monetary policy would be tightened until the index falls back to trend. In the case of price levels being below trend, the Fed may move slowly to raise rates until prices return to trend. The advantage of this model is that the FOMC would not have to react to a simple jump in prices after a period of low prices.

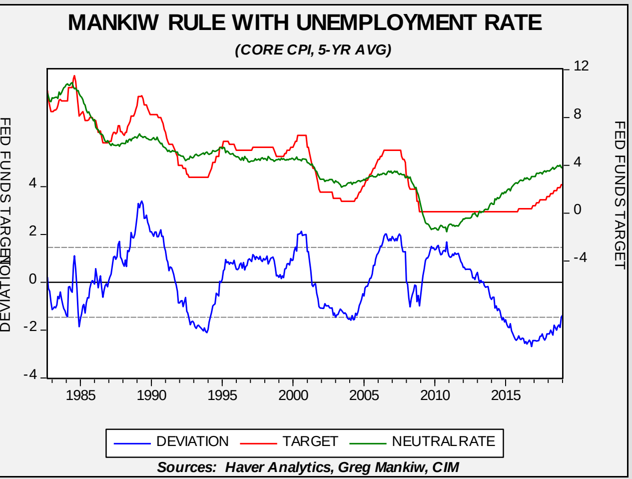
All three options have pluses and minuses. Raising the inflation target is the easiest to understand. But, there is concern that if the target appears flexible then inflation expectations could become unanchored. The risk is that once the target is changed, the Fed could find itself facing political pressure to keep rates steady or cut them even with rising inflation to suit short-term political goals. Moving average models will reduce the likelihood that the Fed would react quickly to inflation impulses and make the policy rate steadier. However, by design, moving averages will tend to delay easing and tightening. In the present circumstance, it appears attractive but it will tend to slow rate reductions going into an easing cycle. Targeting the level of price is attractive in that it takes previous price levels into account, but it will be hard to explain to the public how it works and what to expect. And, the calculated trend can be sensitive

[19] https://economia.icaew.com/opinion/april-2015/the-federal-reserves-battle-with-price-stability
[20] https://www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf
[21] The Bank of England has a sort of smoothing process where it targets a 2% rate with a 1% variance. If inflation rises or falls outside this band, the bank must explain to the Exchequer why this occurred and what it will do about it. Thus, if the variance is due to a one-off situation, the bank may do nothing.

to initial conditions. In other words, if you start your model in a high inflation period, it can affect the deviation from trend.

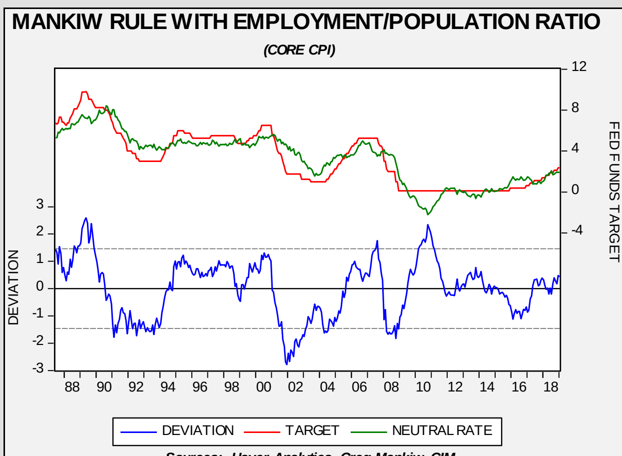
Here is one potential view of the second option.

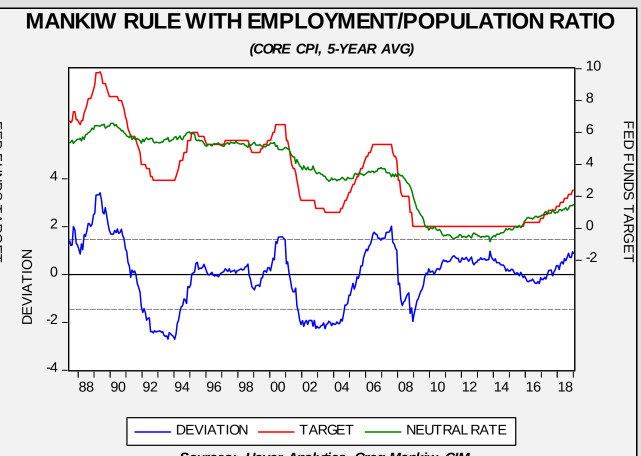




Using the Mankiw Rule (which uses core CPI instead of core PCE), we take a five-year average of inflation on the model shown on the right. The model on the right has better performance; during the 1990s, it did a better job of informing policymakers that rate changes were unnecessary and would have told the Bernanke Fed that policy was too tight going into the 2007-09 recession. Interestingly enough, both versions suggest the Fed is currently too easy.

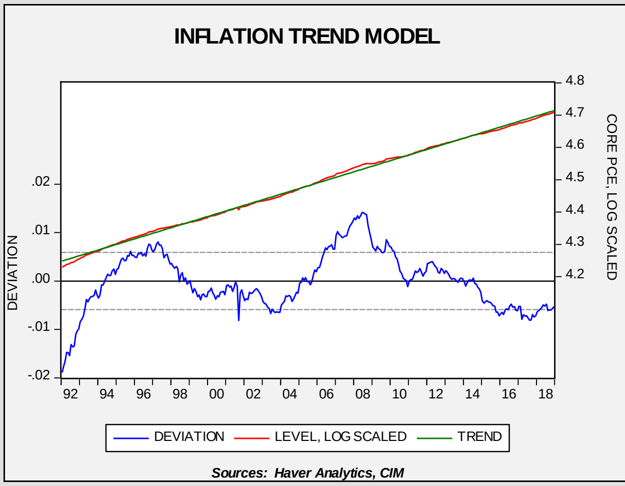
Here is another view using the employment/population ratio as a proxy for capacity.

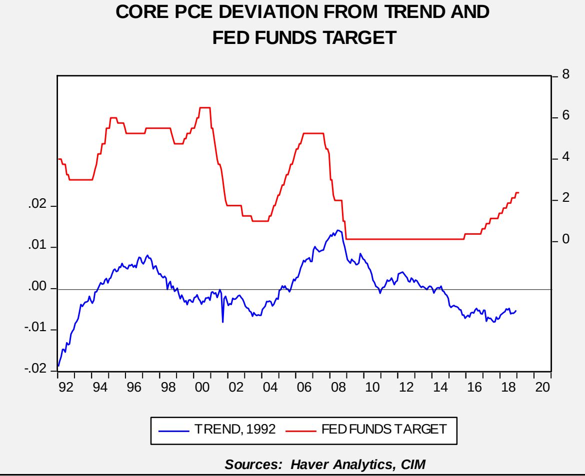




The moving average model gave clearer signals; it would have told policymakers to ease sooner in 2001 (a recession year) and would have signaled to the Bernanke Fed to begin easing sooner than it did before the 2007-09 recession. Both suggest the neutral rate is below the current rate but the moving average model suggests policy is tighter than the unadjusted inflation model. ***Essentially, these views show that the real issue remains the measure of slack, but adjusting the inflation indicator might mitigate the uncertainty surrounding the capacity issue.***

Here is one potential view of the third option.



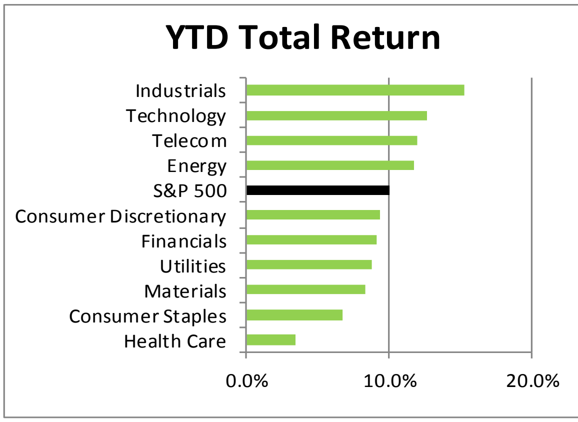


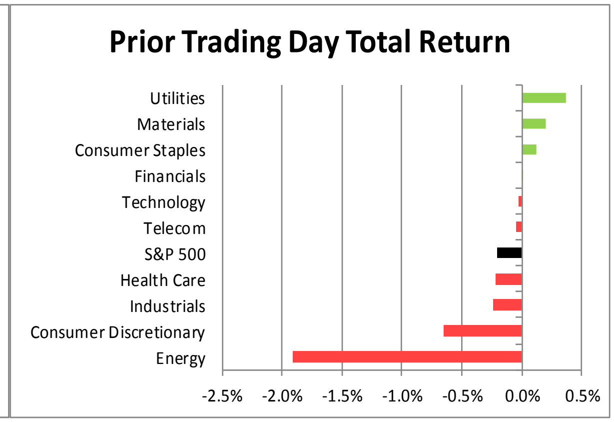
The chart on the left shows the core PCE index, log transformed, regressed against a time trend. In general, price levels vary to trend. The chart on the right compares the detrended index to the fed funds target. Note that the cycles in policy tended to move with price levels ***except for the current one***. This model would have kept the FOMC from tightening at all in this cycle.

Under current conditions, this reassessment of inflation policy will likely lead to an end of tightening. Essentially, the considered adjustments will probably discourage further rate hikes by reducing the policy level of inflation. However, this assessment still depends on the proper measure of slack in the economy, which, so far, has not been resolved by the FOMC. Nevertheless, we think the proper assessment of this change is dovish for policy.

Data Section

U.S. Equity Markets – (as of 3/8/2019 close)

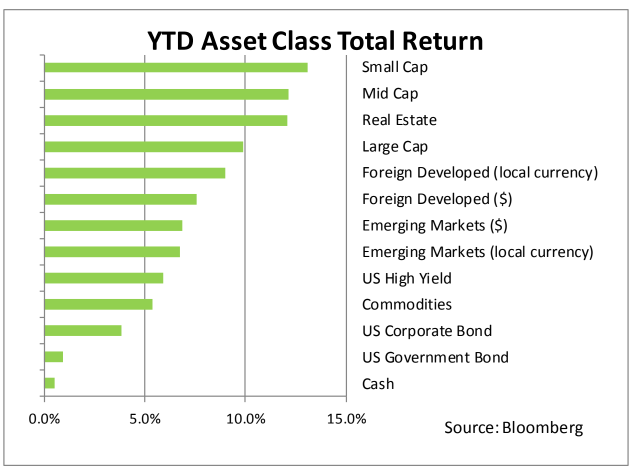




(Source: Bloomberg)

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 3/8/2019 close)

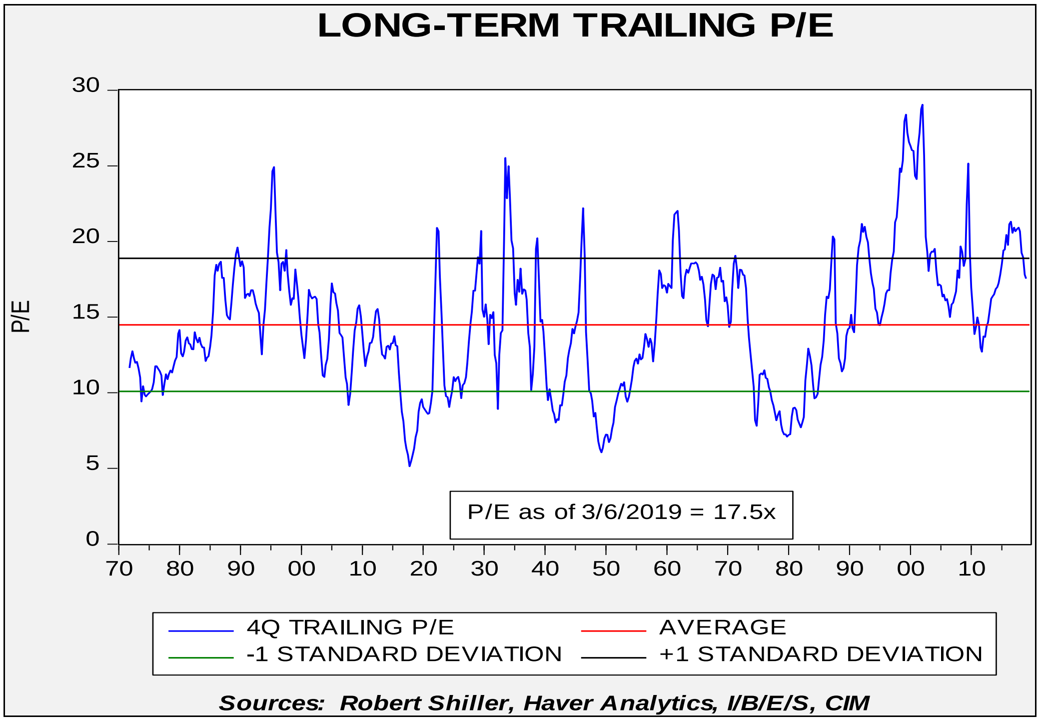


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

March 7, 2019



Based on our methodology,[22] the current P/E is 17.5x, up 0.7x from last week. The rise in the P/E is due to getting the official quarterly earnings data from S&P, which tends to be about 6.5% to 7.0% less than the I/B/E/S estimates.

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[22] 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 three actual quarters (Q2, Q3 and Q4) and one estimate (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 long-term dataset for P/E ratios.