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 12, 2019—9:30 AM EDT] Global equity markets are generally mixed this morning. The EuroStoxx 50 is down 0.3% from the last close. In Asia, the MSCI Asia Apex 50 was up 1.4% from the prior close. Chinese markets were higher, with the Shanghai composite up 1.1% and the Shenzhen index up 1.7%. U.S. equity index futures are signaling a lower open.

U.S. equity futures are flat this morning after a strong run yesterday. Here is what we are watching this morning:

Brexit: In an 11th hour attempt to seal a deal,[1] PM May and EU Commissioner Juncker offered statements to clarify and ease the Irish backstop issue. Although May suggested that she had secured "legally binding" assurances that the U.K. would not be forever trapped in the backstop, Geoffrey Cox, her attorney general, disagreed.[2] In reality, if Juncker had offered something new it would have needed ratification from the 26 other members of the EU; since he didn't ask, these "assurances" were not a real change. Cox's decision is probably a deal killer. If Cox would have agreed with May's description, his approval might have swayed Tory Brexiteers. But, his assessment likely means that when the vote on May's plan is held at 7:00 GMT (3:00 pm EDT) it will almost certainly be defeated. That sets up tomorrow's vote, which will determine whether or not there can be a hard Brexit. We expect hard Brexit to be defeated, which means a delay in Brexit is coming; the exit could be delayed for up to a year.

When the May/Juncker agreement was announced, the GBP rallied strongly. It has given up nearly all of its gains.

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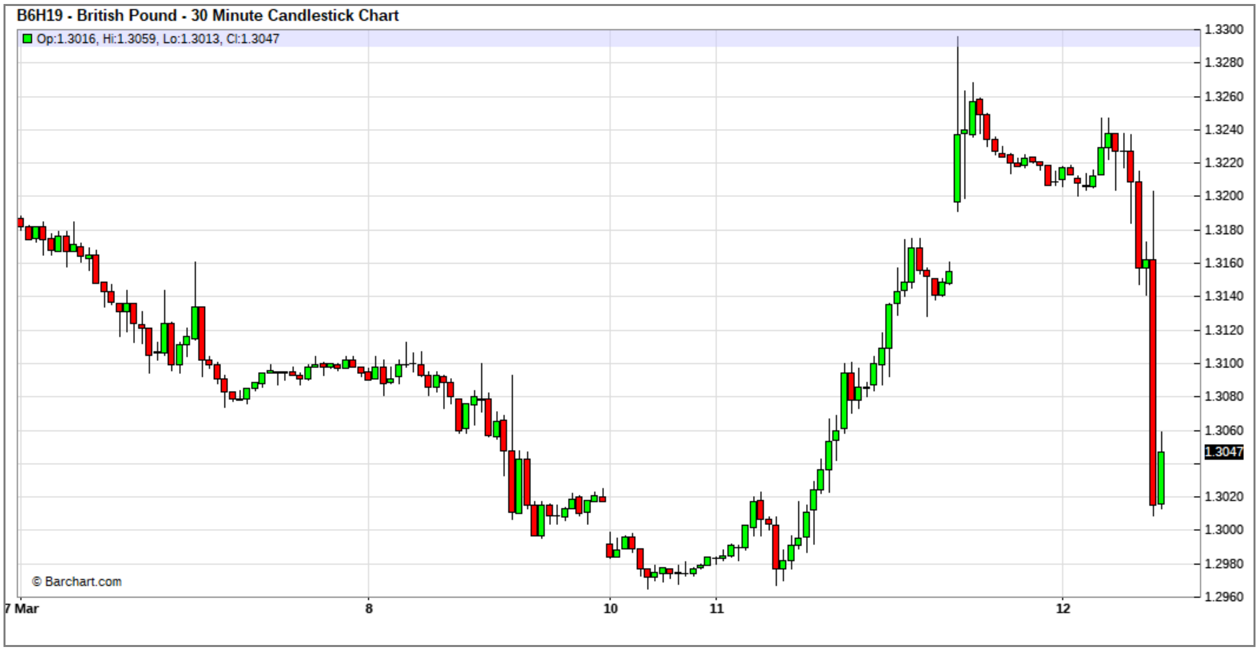
[1] https://www.washingtonpost.com/world/europe/in-a-big-week-for-brexit-parliament-will-vote-on-theresa-mays-deal-and-possibly-a-delay/2019/03/11/52d3f5d4-4403-11e9-94ab-d2dda3c0df52_story.html?utm_term=.fc13b814458f&wpisrc=nl_todayworld&wpmm=1
[2] https://www.ft.com/content/bbb893a6-44b8-11e9-b168-96a37d002cd3



(Source: Barchart)

A customs workers' strike in France, protesting the lack of French preparation for Brexit, could be a sign of how chaotic a hard Brexit would be.[3] Trucks are reportedly backed up for miles. Current arrangements allow for the seamless movement of goods. After Brexit, cargos will need to be inspected.

Venezuela blackouts: The blackouts in Venezuela are continuing with no clear end in sight.[4] The U.S. is pulling all of its embassy staff from the country.[5] The persistent power outages are affecting oil production and exports.[6] There are unconfirmed reports that oil production may have fallen to 0.5 mbpd; for world markets, the lack of exports means that Venezuela is no longer contributing to global supply. Oil prices moved higher on the news.

Bouteflika's presidency nears its end: Algerian president Abdelaziz Bouteflika has postponed the April 18 elections and has indicated he won't stand for a fifth term.[7] Algeria has been hit with protests against the president, who is 82 years old and incapacitated from a stroke. It appears a caretaker government will take control of his administration until new elections are held. Bouteflika has been in office since 1999. The fact that it appears there will be a peaceful transition of power is remarkable and modestly bearish for oil prices (although Venezuela's news is probably a more important factor).

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[3] https://www.nytimes.com/2019/03/11/world/europe/france-border-protest-brexit.html?emc=edit_mbe_20190312&nl=morning-briefing-europe&nlid=567726720190312&te=1
[4] https://www.nytimes.com/2019/03/11/world/americas/venzuela-blackout-maduro.html?emc=edit_mbe_20190312&nl=morning-briefing-europe&nlid=567726720190312&te=1
[5] https://www.wsj.com/articles/u-s-to-withdraw-remaining-embassy-staff-families-from-venezuela-11552370940
[6] https://oilprice.com/Geopolitics/South-America/Blackout-Shuts-Down-Venezuelas-Oil-Exports.html
[7] https://www.nytimes.com/2019/03/11/world/africa/algeria-president-election.html?emc=edit_mbe_20190312&nl=morning-briefing-europe&nlid=567726720190312&te=1

Chinese trade: Chinese Vice Premier Liu discussed the text of a trade agreement with USTR Lighthizer yesterday evening.[8] Although there is no date for a Xi-Trump trade summit, the fact that these two high-ranking officials are talking is a good sign that there are attempts at progress.

New York tax: State and city officials are considering a "pied-à-terre" tax[9] on second homes in New York City. The city is a destination for the wealthy to purchase apartments and homes that are not their primary residence. The tax would apply to non-primary homes worth $5.0 mm or more. What makes this tax interesting to us is that New York residential real estate has been attractive to foreign capital flight for years. It is unclear if the tax will be enough to deter these funds to other venues, but other cities that are also areas for capital flight, such as London, may be watching to see if the city remains a destination for capital flight after the tax is enacted.

Populism v. establishment: Since the election, we have characterized the Trump presidency as a battle between the populists and the establishment. Trump shrewdly determined that populists, especially the right-wing variety, had perceived themselves as being shunted aside. By running as an anti-global Jacksonian, he was able to capture that vote. At the same time, Trump also catered to the right-wing establishment. In governing, Trump mostly acted as an establishment figure, at least on domestic economic policy, until January 2018. After the tax bill passed, Trump's policies of trade impediments and border security were pure right-wing populism.

However, on foreign policy, Trump has been more consistently populist. The establishment supports America as hegemon, which means the U.S. acts to bring global security and provides the reserve currency. In the latter role, the U.S. is open to trade and willingly accepts a trade deficit. It also remains open to immigration, which provides the capital-owning class an expanding (and compliant) labor force. Trump has put up trade barriers and moved U.S. trade policy to a bilateral stance, which virtually guarantees that the U.S. will dominate every trade relationship (at the cost of undermining U.S. security projection). Trump has also moved to restrict immigration.

The right-wing establishment has an uneasy relationship with Trump. Although it clearly supports the tax cuts and aggressive deregulation, it would prefer the U.S. maintain the superpower role and have relaxed immigration policy. The *WP* is reporting that, in a discussion with VP Pence, former VP Dick Cheney accused Trump of running a foreign policy similar to his predecessor, Barack Obama.[10] In terms of substance, Cheney is closer to being accurate. Trump's unilateral decision to leave Syria is reminiscent of Obama's hasty retreat from Iraq. Obama's "pivot to Asia" required a reduction in resources to the Middle East. One of the common mistakes made in the current environment is to analyze politics from the traditional right/left, Republican/ Democrat or conservative/liberal viewpoints, but the real underlying trend, in our view, is populist/establishment. And, it isn't just a U.S. issue. Europe is being

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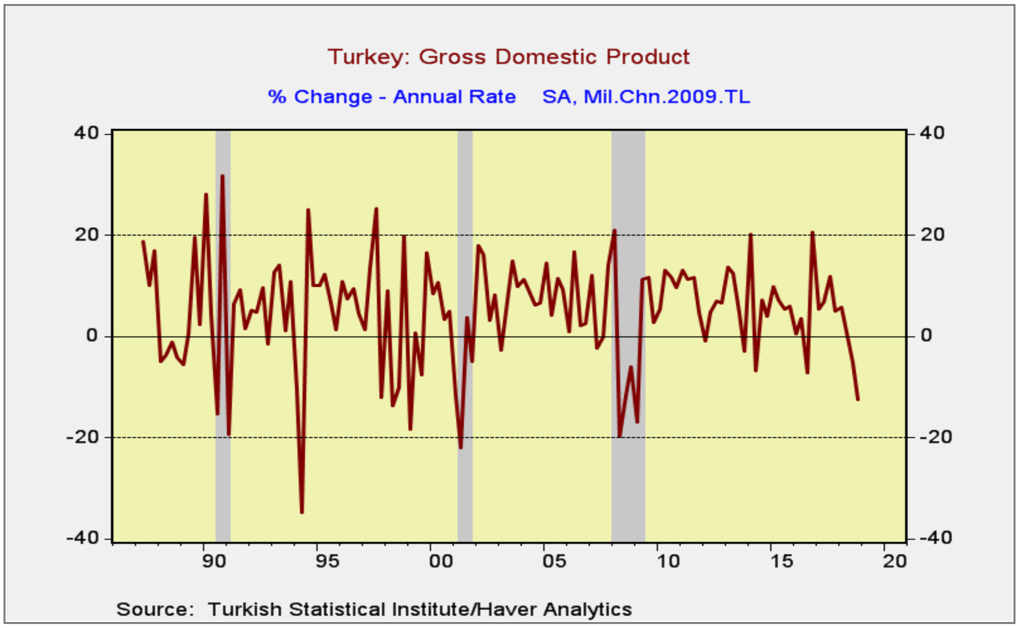
[8] https://www.scmp.com/news/china/diplomacy/article/3001162/chinese-vice-premier-liu-he-discusses-trade-deal-text-us

[9] https://www.nytimes.com/2019/03/11/nyregion/mta-subways-pied-a-terre-tax.html?action=click&module=Top%20Stories&pgtype=Homepage

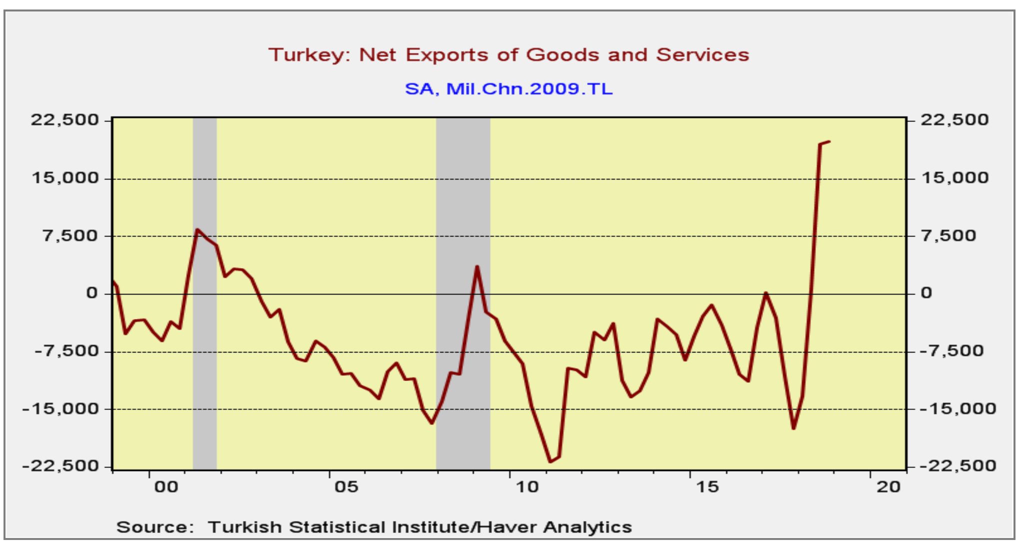
[10] https://www.washingtonpost.com/politics/former-vice-president-cheney-challenges-pence-on-trumps-foreign-policy/2019/03/11/ecddbff6-4436-11e9-aaf8-4512a6fe3439_story.html?utm_term=.f2b69fdea40d&wpisrc=nl_todayworld&wpmm=1

riven by similar trends. The noted exchange between Cheney and Pence is an interesting example of the populist/establishment divide.

Turkey slips into a downturn: Last year's currency crisis in Turkey has weighed on growth and finally taken GDP into negative territory for the second consecutive quarter, which is considered a "rule of thumb" definition of recession.

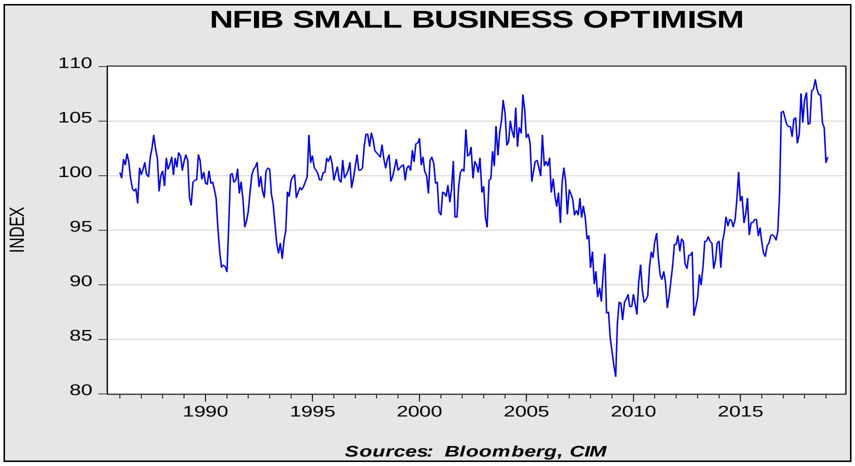


However, it wasn't all bad news. The drop in the TRY has led to a significant improvement in net exports, which will, over time, support the economy's recovery. The improvement in trade confirms that a floating exchange rate is a powerful tool to combat a downturn.



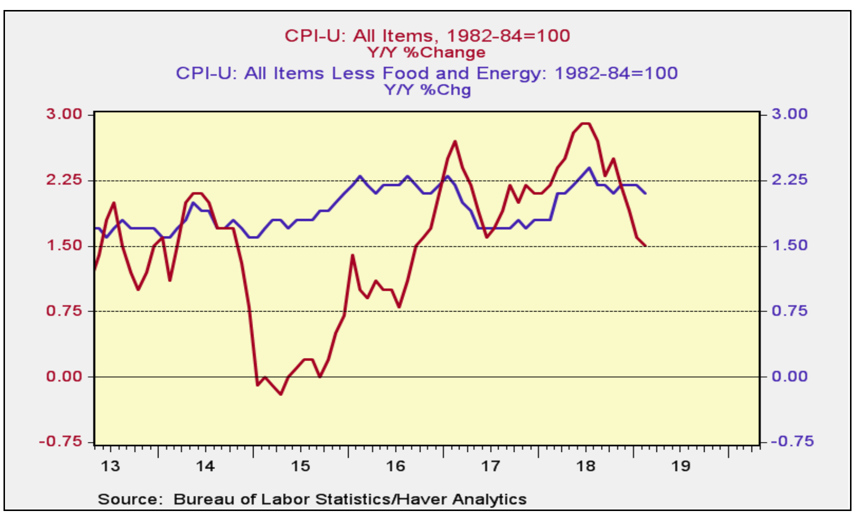
U.S. Economic Releases

NFIB small business optimism came in below expectations at 101.7 compared to the forecast of 102.5.



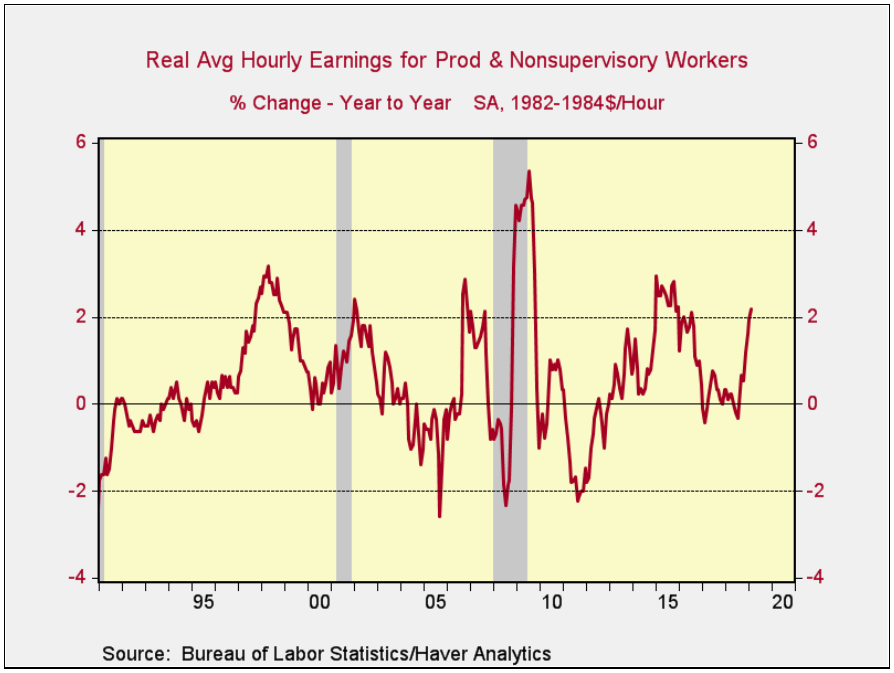
The chart above shows the level of small business optimism. After a five-month losing streak, small business optimism rebounded modestly in February. The increased sentiment is largely due to a small boost in the economic outlook following the conclusion of the government shutdown. In addition, the survey provided some background on the weak payroll numbers. The survey showed that 16% of the firms surveyed stated that they plan to hire; this is a six-month low. We believe the reluctance to hire can be partially attributed to the global slowdown. A global slowdown is generally bullish for the dollar, which hurts U.S. exports as a result. Firms might wait until global growth picks up before agreeing to take on more workers.

CPI came in line with expectations, rising 0.2% from the prior month. Core CPI also came in below expectations, rising 0.1% from the prior month compared to the forecast of 0.2%.



The chart above shows the year-over-year change in headline CPI and core CPI. Headline CPI and core CPI rose 1.5% and 2.1%, respectively. The drop in CPI is largely due to a drop in the price of gasoline, which fell 9.1% from the prior year.

Real average weekly earnings rose by 1.6% from the prior year, while real average hourly earnings rose 1.9% from the prior year for all workers and 2.2% for non-supervisory workers.



The chart above shows real average hourly earnings for production and nonsupervisory workers. Although the rise in earnings suggests the labor market is starting to tighten, we do not expect the Fed to change its stance on monetary policy. However, this rise in real earnings should support improved consumption in the coming months.

There are no other domestic releases or Fed events scheduled for the rest of the day.

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	Manpower Survey	q/q	2q	6.0%	10.0%		**	Equity and bond neutral
Japan	Machine Tool Orders	y/y	feb	-29.3%	-18.8%		**	Equity and bond bearish
	BSI Large All Industry	y/y	1q	-1.7	4.3		**	Equity and bond bearish
	BSI Large Manufacturing	y/y	1q	-7.3	5.5		**	Equity and bond bearish
	Manpower Survey	m/m	2q	27.0	27.0		**	Equity and bond neutral
India	Manpower Survey	q/q	2q	13.0%	12.0%		**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	m/m	mar	109.5	114.8		**	Equity and bond neutral
	Manpower Survey	m/m	2q	10.0%	14.0%		**	Equity and bond neutral
	NAB Business Conditions	m/m	4q	4	7		**	Equity and bond neutral
	NAB Business Confidence	m/m	jan	2	4		**	Equity and bond neutral
	Home Loans	m/m	jan	-1.2%	-8.2%	-2.0%	**	Equity and bond bearish
	Investment Lending	m/m	jan	-4.1%	-4.6%	-1.5%	**	Equity and bond bearish
New Zealand	ANZ Truckometer Heavy	m/m	feb	0.9%	1.8%	0.3%	**	Equity bullish, bond bearish
EUROPE								
France	Total Payrolls	m/m	4q	0.2%	0.1%	0.1%	***	Equity and bond neutral
	Private Sector Payrolls	m/m	4q	0.3%	0.1%	0.1%	***	Equity bullish, bond bearish
UK	Trade Balance	m/m	jan	-3.825 bn	-3.229 bn	-3.500 bn	**	Equity and bond neutral
	Industrial Production	y/y	jan	-0.9%	-0.9%	-1.3%	***	Equity and bond neutral
	Manufacturing Production	y/y	jan	-1.1%	-2.1%	-1.9%	***	Equity and bond neutral
	GDP	m/m	jan	0.5%	-0.4%	0.2%	***	Equity bullish, bond bearish
AMERICAS								
Canada	Bloomberg Nanos Confidence	m/m	mar	55.5	55.0		**	Equity and bond neutral
Brazil	Vehicle Sales Anfavea	m/m	feb	198641	199794		***	Equity and bond neutral
	Vehicle Production	m/m	feb	257233	196767		***	Equity and bond neutral
	Vehicle Exports Anfavea	m/m	feb	40510	25034		***	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	$67.15	$66.58	0.86%	Saudi possibly extending cuts
WTI	$57.29	$56.79	0.88%	
Natural Gas	$2.76	$2.77	-0.32%	
Crack Spread	$22.07	$22.26	-0.88%	
12-mo strip crack	$17.93	$18.06	-0.71%	
Ethanol rack	$1.42	$1.42	-0.18%	
Metals				
Gold	$1,295.99	$1,293.35	0.20%	
Silver	$15.41	$15.31	0.67%	
Copper contract	$293.40	$290.10	1.14%	
Grains				
Corn contract	$ 363.50	$ 362.00	0.41%	
Wheat contract	$ 432.25	$ 428.50	0.88%	
Soybeans contract	$ 891.00	$ 890.00	0.11%	
Shipping				
Baltic Dry Freight	645	649	-4	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.0		
Gasoline (mb)		-3.0		
Distillates (mb)		-2.0		
Refinery run rates (%)		0.50%		

Weather

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

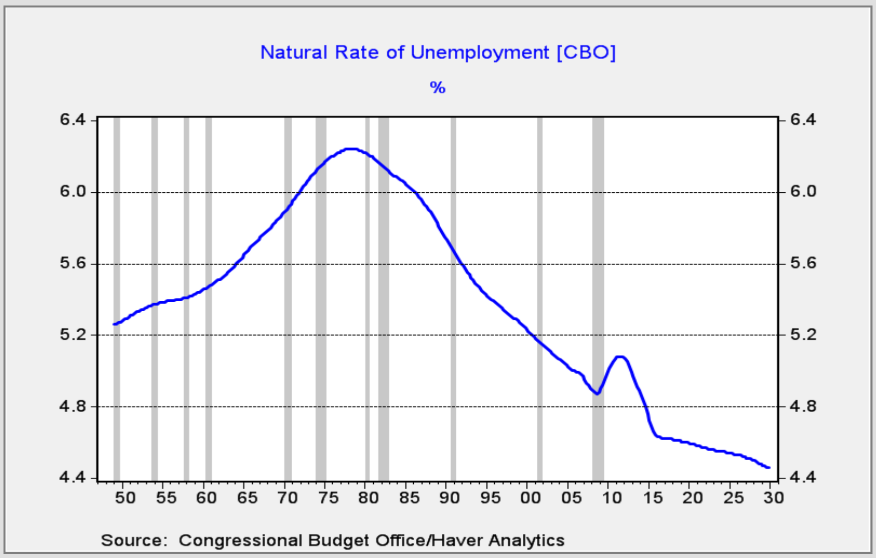
Asset Allocation Weekly Comment

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.

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.

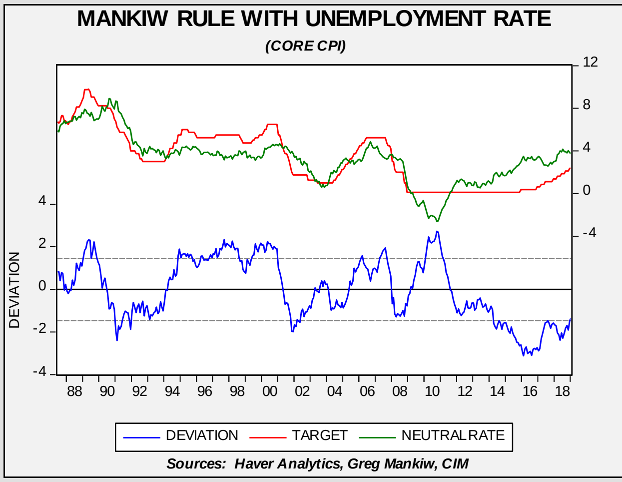
1. **Raise the inflation target:** The official inflation target is relatively new. Although the Fed privately agreed to an inflation target in 1996, Chair Greenspan insisted it was to be kept secret.[11] It wasn't until 2012 that the FOMC made the 2% target official.[12] The working definition of inflation 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.[13]
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.

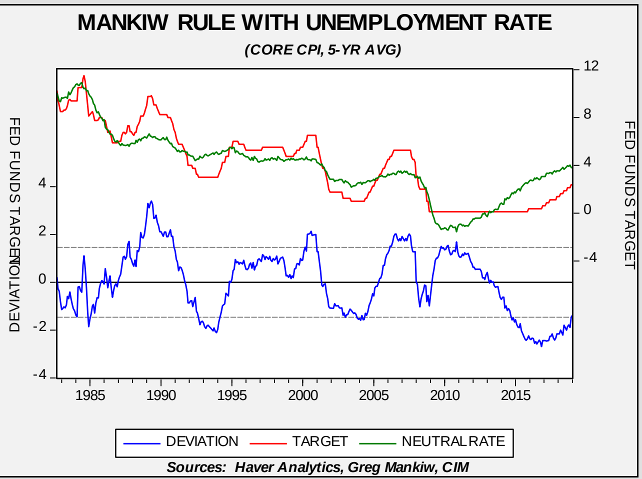
All three options have pluses and minuses. Raising the inflation target is the easiest to understand. But, there is concern that if the target appears flexible then inflation expectations could become unanchored. The risk is that once the target is changed, the Fed could find itself facing political 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

[11] https://economia.icaew.com/opinion/april-2015/the-federal-reserves-battle-with-price-stability
[12] https://www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf
[13] 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.

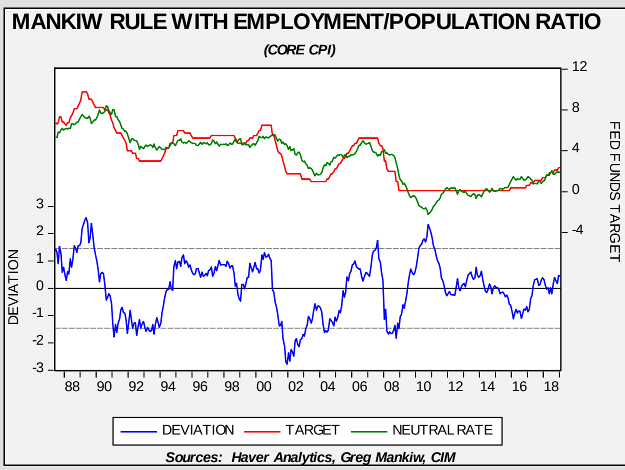
Here is one potential view of the second option.

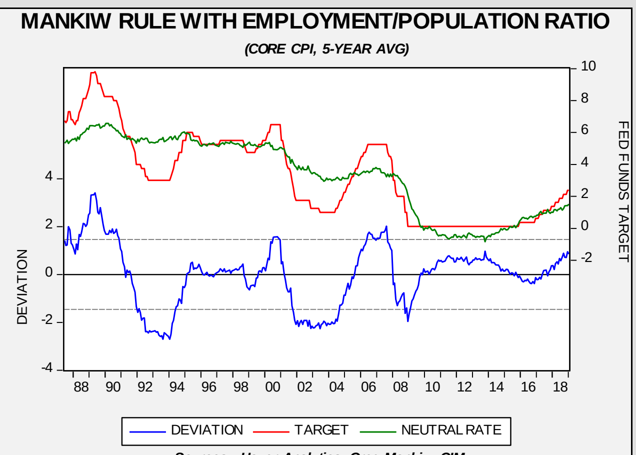




Using the Mankiw Rule (which uses core CPI instead of core PCE), we take a five-year average of inflation on the model shown on the right. The model on the right has better performance; during the 1990s, it did a better job of informing policymakers that rate changes were unnecessary and would have told 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.

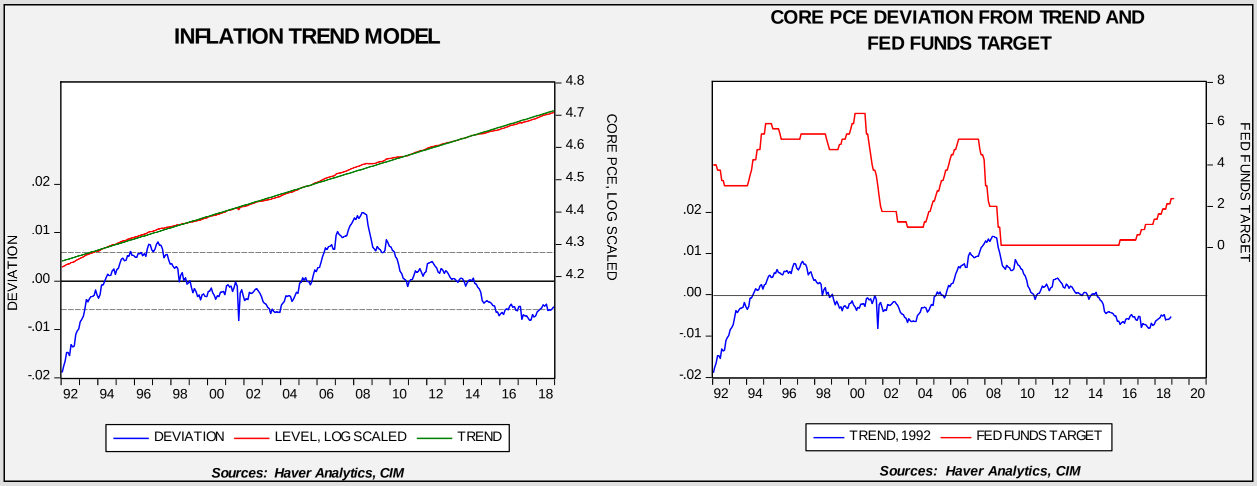
Here is another view using the employment/population ratio as a proxy for capacity.





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.

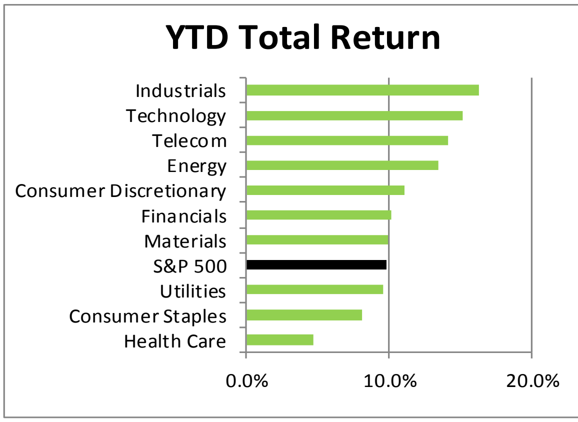


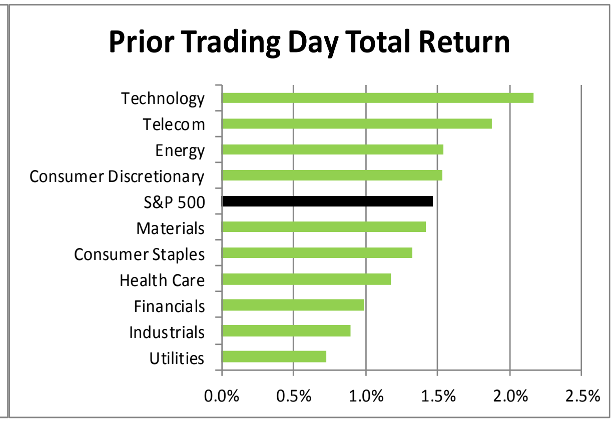
The chart on the left shows the core PCE index, log transformed, regressed against a time trend. In general, price levels vary to trend. The chart on the right compares the detrended index to the fed funds target. Note that the cycles in policy tended to move with price levels ***except for the current 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 3/11/2019 close)

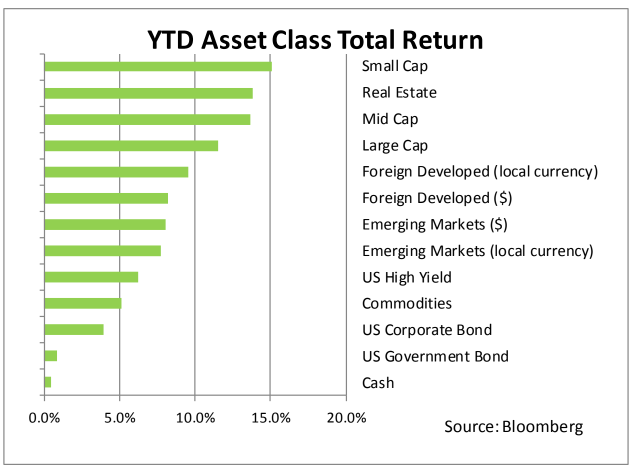




(Source: Bloomberg)

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 3/11/2019 close)

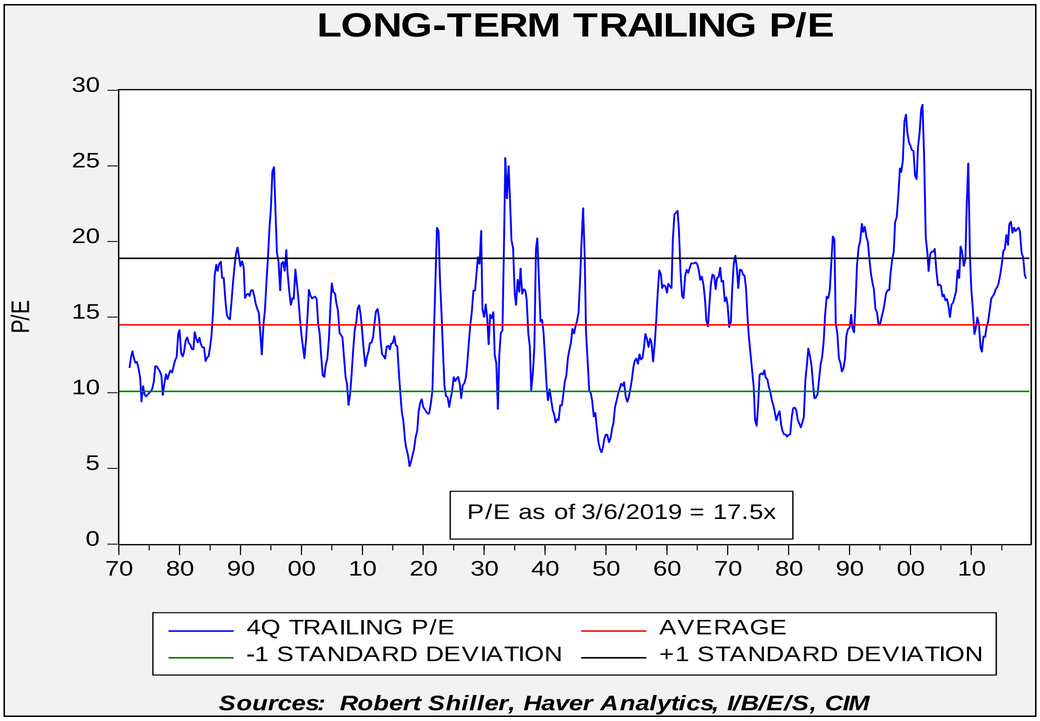


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[14] 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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[14] 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.