Confluence Investment Management

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 13, 2018—9:30 AM EDT] Global equity markets are generally mixed this morning. The EuroStoxx 50 is up 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.8% from the prior close. Chinese markets were lower, with the Shanghai composite down 0.5% and the Shenzhen index down 0.7%. U.S. equity index futures are signaling a higher open.

CPI came in on forecast. Financial markets were fearing faster inflation and so we are seeing the dollar ease and equities rally on the news. Here is what we are watching this morning:

NEC Chair: Shahira Knight has signaled she doesn't want the job, and Chris Liddell didn't move the president. Instead, Larry Kudlow has emerged as the front-runner. Kudlow has become a well-known television personality, positioned as a defender of free markets and low taxes. He has an undergrad degree in history from the University of Rochester and did begin a master's program at the Princeton Woodrow Wilson School of Public and International Affairs but left before completing his degree. According to reports, the president is impressed with how he handles himself on television. Kudlow, if appointed (and until he is announced and seated nothing is certain), will be a relief to the financial markets. Although we still expect the president to lean toward trade protection, Kudlow will act as a counterpoint to that sentiment.

Tillerson out: Rex Tillerson, the former Exxon (XOM, 75.24) CEO, is out as Secretary of State and will be replaced by CIA Director Pompeo. This isn't a huge shock; Tillerson has never really gotten along with the president and was expected to leave sometime this year. We will be watching to see who gets the CIA position. Tom Cotton, the GOP senator from Arkansas, is a likely candidate. Pompeo will require Senate approval but that shouldn't be a major issue.

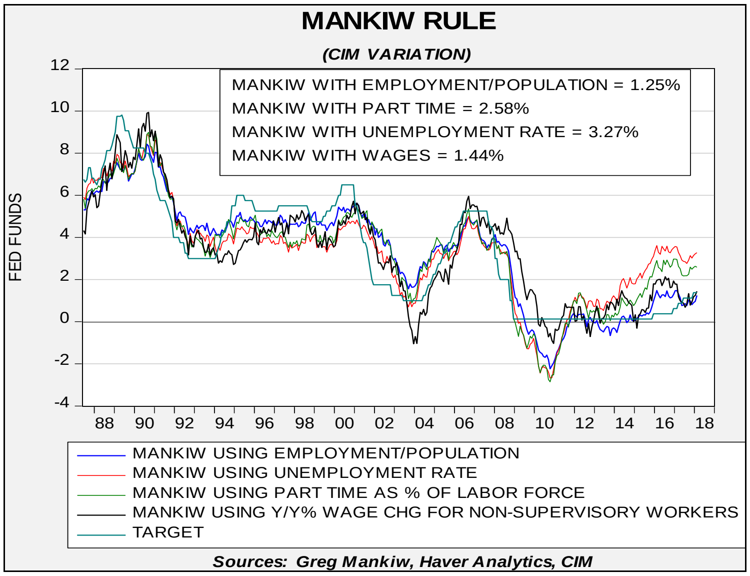
48 hours: PM May has accused the Russian government of involvement in the recent assassination attempt of a former Russian spy in the U.K. Although the Putin regime has denied the report, it should be noted that the nerve agent used was Novichok, a Soviet-era nerve agent said to be 10x more powerful than VX. The use of such a weapon makes it almost certain that the Russian government, in some fashion, was involved. It is possible that this was a rogue operation, but we doubt that is the case. First, this is another brazen act by Russia to intimidate its critics that live in the U.K. Britain has become a haven of sorts for Russian capital flight and discontented Russians. This isn't the first attack; a former Russian security member was killed with Polonium in 2006, and other Russians and fellow travelers, either critical of Putin or thought to be involved in money laundering, have also died under suspicious circumstances.[1] The use of a military-class nerve agent that was only formulated in Russia suggests that whoever was involved was not concerned about plausible deniability. Second, PM May is clearly angry, giving Russia 48 hours to explain itself. The Russians have denied involvement, as one would expect. Britain has been trying to generate international support but, so far, the Trump administration has been mostly quiet outside of Tillerson's indication of likely Russian involvement (see above). At the same time, most other NATO states have also remained mostly quiet. We expect some diplomatic expulsions and U.K. sanctions on Russia, but major sanctions won't be possible without international support.

Broadcom (AVGO, 262.84) and Qualcomm (QCOM, 62.81): The White House has stepped into this proposed merger and quashed it on national security grounds. At first glance, this reasoning looks tortured; Broadcom is based in Singapore, a nation that is no national security threat to the U.S. However, Qualcomm has made a major R&D investment in 5G technology and it was feared that the merger would undermine that investment and give the lead in the next generation of wireless to China's Huawei (CNY, 7.71). It appears the administration may be taking the position that high tech is a key military industry and the U.S. intends to prevent foreign firms from owning these key assets. In other words, globalization is starting to be curtailed as industries are going to become off limits to foreign buyers.

Slovakia in turmoil: Slovakia's government is teetering on collapse after a journalist working on tax evasion and corruption was assassinated in a gangland fashion. For good measure, the killers also shot and killed the journalist's fiancée. The attack was so blatant that it has triggered mass protests in the country and it appears new elections may be coming.

Fed policy: With the release of the CPI data we can update the Mankiw models. The Mankiw rule models attempt to determine the neutral rate for fed funds, which is a rate that is neither accommodative nor stimulative. Mankiw's model is a variation of the Taylor Rule. The latter measures the neutral rate using core CPI and the difference between GDP and potential GDP, which is an estimate of slack in the economy. Potential GDP cannot be directly observed, only estimated. To overcome this problem, Mankiw used the unemployment rate as a proxy for economic slack. We have created four versions of the rule, one that follows the original construction by using the unemployment rate as a measure of slack, a second that uses the employment/population ratio, a third using involuntary part-time workers as a percentage of the total labor force and a fourth using yearly wage growth for non-supervisory workers.

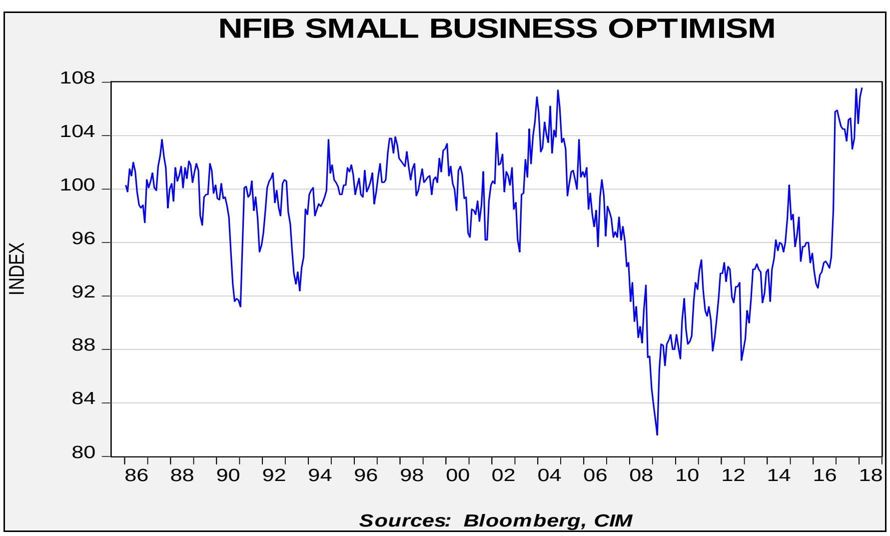
[1] https://www.buzzfeed.com/heidiblake/from-russia-with-blood-14-suspected-hits-on-british-soil?utm_term=.pkzDdmmwZr#.ygJqyRRv8a



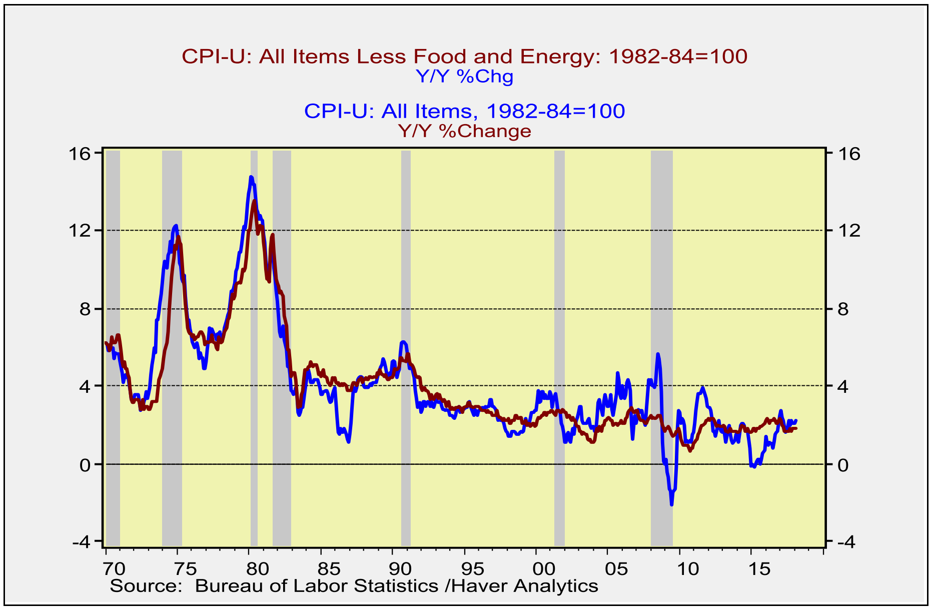
Using the unemployment rate, the neutral rate is now 3.27%. Using the employment/population ratio, the neutral rate is 1.25%, a 28 bps rise over last month. Using involuntary part-time employment, the neutral rate is 2.58%. Using wage growth for non-supervisory workers, the neutral rate is 1.44%, a 19 bps rise over last month. Although inflation remains steady, the sharp improvement in the employment/population ratio and the modest rise in wages suggest that some of the slack is leaving the labor market. However, the differences are still very wide between the wage growth and employment/population ratio variations compared to involuntary part-time employment and the unemployment rate. If the FOMC is using the former two variations, policy is essentially neutral. Overall, the CPI data does not suggest anything unusual in price levels and thus, monetary policy will likely continue to tighten on its current cautious path.

U.S. Economic Releases

NFIB small business optimism came in above expectations at 107.6 compared to the forecast of 107.1.

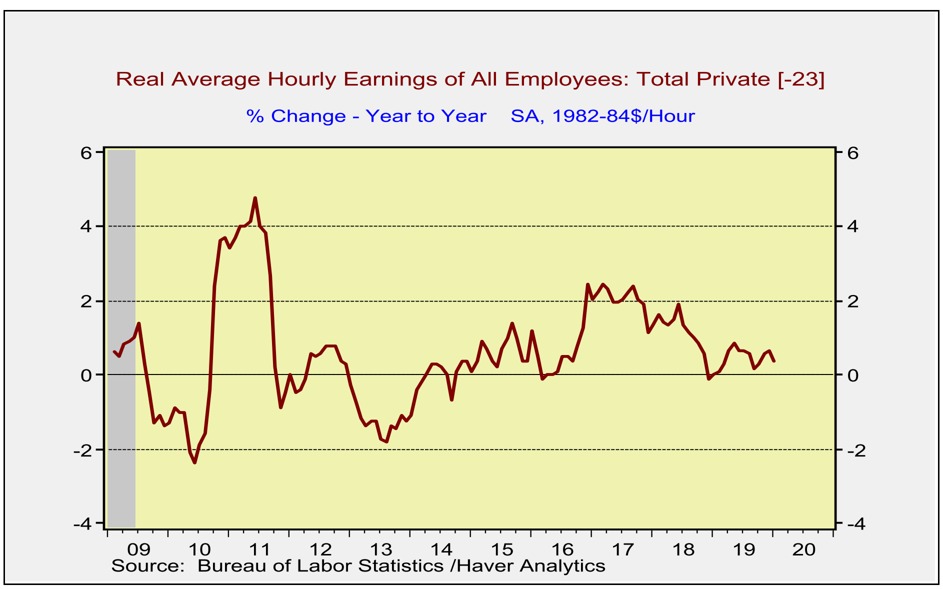


CPI came in on expectations, rising 0.2% from the prior month. Core CPI was also in line with forecasts, up 0.2% from the prior month.



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

Real average weekly earnings rose by 0.6% from the prior year, while real average hourly earnings rose by 0.4% from the prior year.



The chart above shows real average hourly earnings. Real wage pressures remain mostly steady.

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	BSI Large All Industry	q/q	1q	3.3	6.2		**	Equity and bond neutral
	BSI Large All Manufacturing	q/q	1q	2.9	9.7		**	Equity and bond neutral
	Machine Tools	y/y	feb	39.5%	48.8%		**	Equity and bond neutral
Australia	Credit Card Purchases	y/y	jan	A$26.5 bn	A$27.9 bn		**	Equity and bond neutral
	Credit Card Balances	y/y	jan	A$51.6 bn	A$52.9 bn		**	Equity and bond neutral
EUROPE								
Switzerland	Total Sight Deposits	m/m	mar	575.9 bn	576.0 bn		**	Equity and bond neutral
	Domestic Sight Deposits	m/m	mar	464.3 bn	458.3 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)	209	207	2	Up
3-mo T-bill yield (bps)	164	164	0	Neutral
TED spread (bps)	45	44	1	Neutral
U.S. Libor/OIS spread (bps)	165	165	0	Up
10-yr T-note (%)	2.89	2.89	0.00	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	28	29	-1	Down
Currencies	**Direction**			
dollar	down			Down
euro	flat			Up
yen	up			Up
pound	up			Up
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	$64.88	$64.95	-0.11%	
WTI	$61.34	$61.36	-0.03%	
Natural Gas	$2.81	$2.78	1.01%	
Crack Spread	$17.63	$17.78	-0.82%	
12-mo strip crack	$16.76	$16.87	-0.65%	
Ethanol rack	$1.55	$1.55	0.10%	
Metals				
Gold	$1,318.66	$1,323.10	-0.34%	
Silver	$16.51	$16.53	-0.14%	
Copper contract	$312.75	$312.40	0.11%	
Grains				
Corn contract	$ 391.50	$ 390.75	0.19%	
Wheat contract	$ 493.25	$ 490.75	0.51%	
Soybeans contract	$ 1,044.00	$ 1,041.00	0.29%	
Shipping				
Baltic Dry Freight	1192	1201	-9	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.9		
Gasoline (mb)		-0.3		
Distillates (mb)		-1.2		
Refinery run rates (%)		-0.08%		

Weather

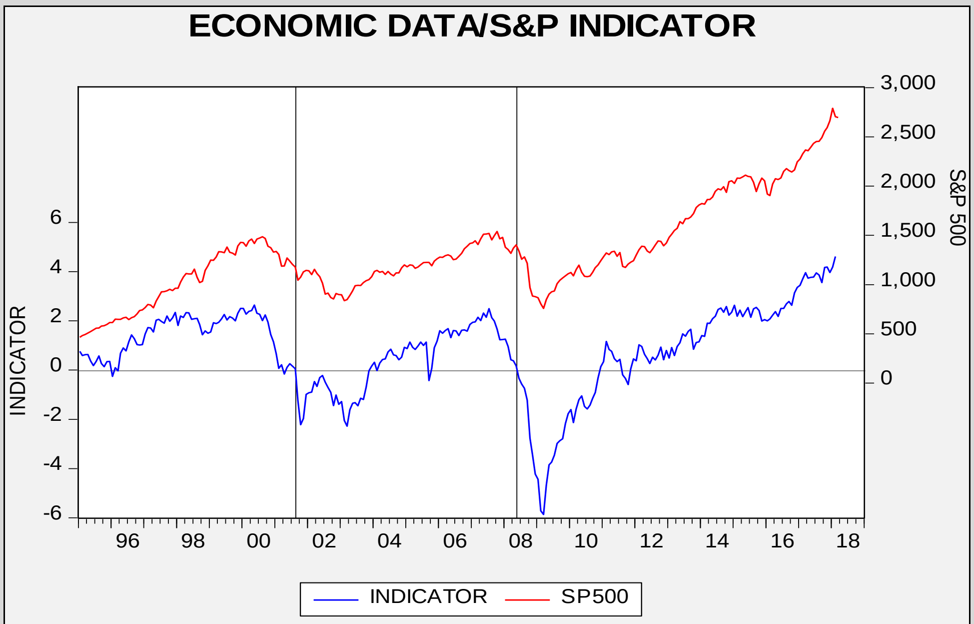
The 6-10 and 8-14 day forecasts continue to signal colder than normal temperatures for most of the country, with warmer temperatures in the eastern region of the country. Precipitation is expected for most of the country.

Asset Allocation Weekly Comment

Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

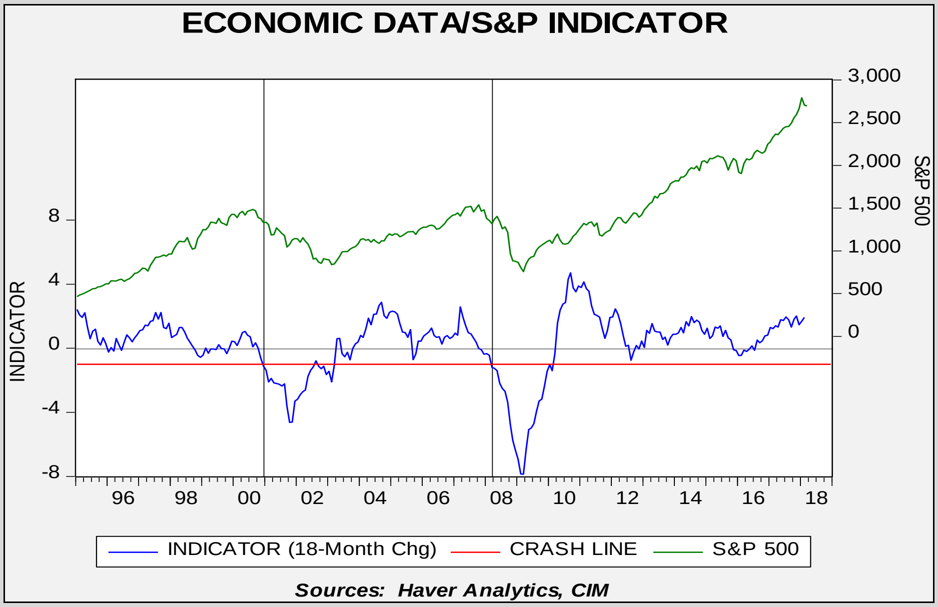
March 9, 2018

Last year, we introduced an indicator of the basic health of the economy and added it to the many charts we monitor in gauging market conditions. The indicator is constructed with commodity prices, initial claims and consumer confidence. The thesis behind this indicator is that these three components should offer a simple and clear picture of the economy; in other words, rising initial claims coupled with falling commodity prices and consumer confidence is a warning that a downturn may be imminent. The opposite condition should support further economic recovery.



Sources: Haver Analytics, CIM

This chart shows the results of the indicator and the S&P 500 since 1995. We have placed vertical lines at certain points when the indicator falls below zero. Although it works fairly well as a signal that equities are turning lower, there is a lag. In other words, by the time this indicator suggests the economy is in trouble, the recession is likely near or underway and the equity markets have already begun their decline.

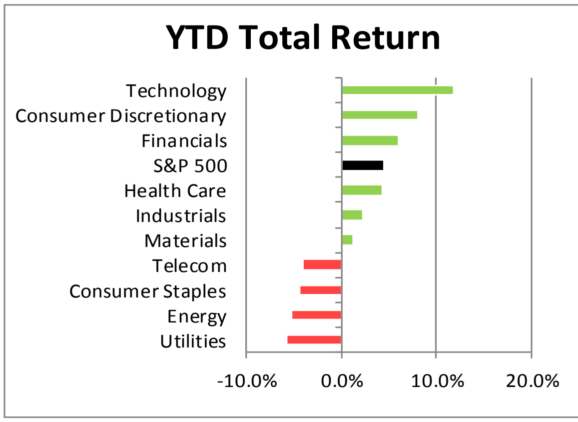


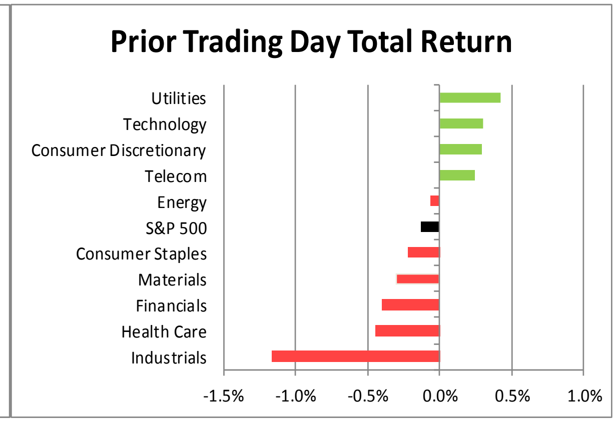
To make the indicator more sensitive, we took the 18-month change and put the signal threshold at -1.0. This provided an earlier bearish signal and also eliminated the false positives that the zero threshold generated. Notwithstanding, we will pay close attention when the 18-month change approaches zero.

What does the indicator say now? The economy is healthy and currently supportive for equity markets. Future market performance is likely to be more affected by the P/E multiple rather than earnings, which are dependent on economic growth. The P/E is mostly a function of interest rates and inflation, although there is also an element of sentiment to the ratio. For now, we expect the multiple to remain elevated but the risk of contraction will grow over time, especially if inflation worries increase. We will have more to say on this issue in the coming weeks.

Data Section

U.S. Equity Markets – (as of 3/12/2018 close)

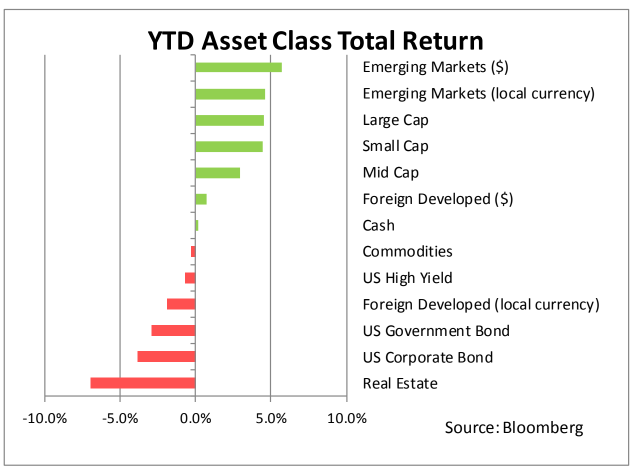




(Source: Bloomberg)

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 3/12/2018 close)

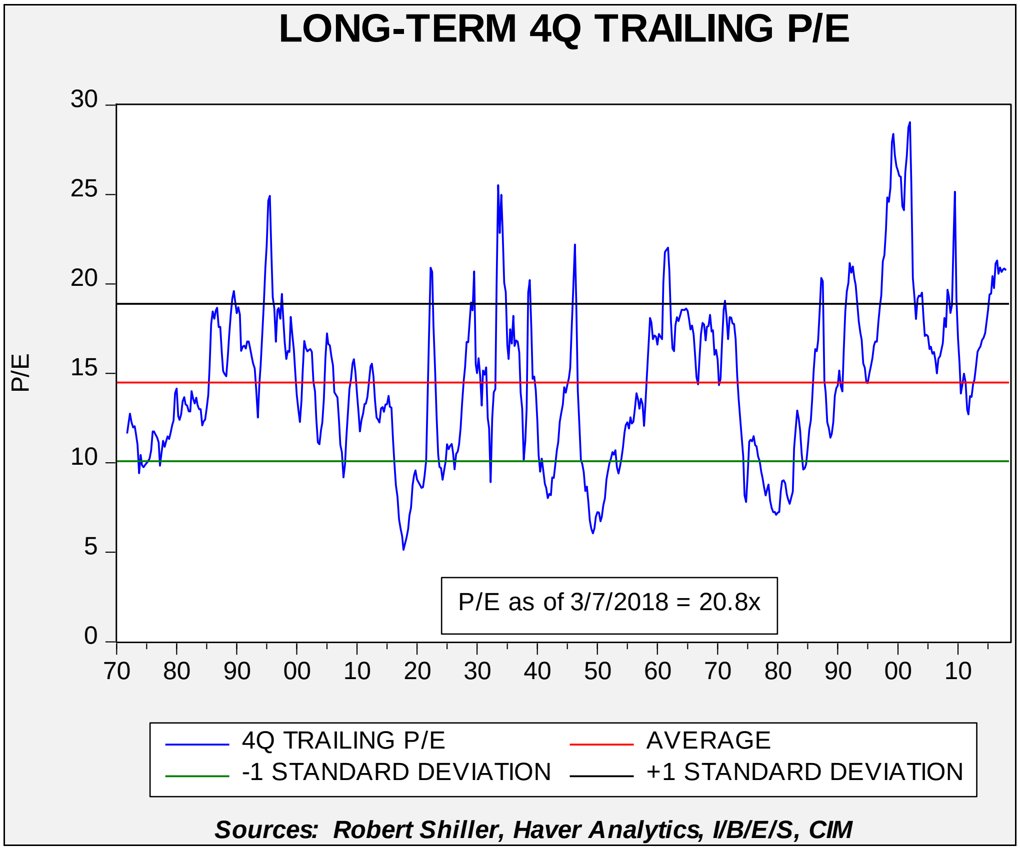


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

March 8, 2018



Based on our methodology,[2] the current P/E is 20.8, unchanged from last week. Earnings remain strong but the S&P remains elevated for the quarter, even with the recent correction.

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

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[2] 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.