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 15, 2018—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.2% from the prior close. Chinese markets were mixed, with the Shanghai composite unchanged and the Shenzhen index down 0.2%. U.S. equity index futures are signaling a higher open.

It's the Ides of March! Be careful out there. Markets were very quiet overnight. Here is what we are watching:

Trump 2.0: As expected, Larry Kudlow is replacing Gary Cohn as NEC director. This should be a somewhat market supportive appointment. Kudlow isn't an economic heavyweight; he doesn't have a degree in the subject and his claim to fame is mostly as a supply side pundit. On the plus side, he is a skilled media spokesman and will improve the profile of the administration, whereas Cohn could be a bit stiff in front of the cameras. Kudlow will be in his element. We doubt he will push back too hard against the president's policies but we do expect him to frame the policies as pro-growth and pro-market. Contorting trade impediments into being pro-growth and pro-market will be a feat but, if anyone can do it, Larry is the best candidate. He has already come out in favor of a "strong dollar" in a public statement; the forex markets ignored his comments. Kudlow likely assumes the strong dollar of the early 1980s was due to supply side economic policies. We doubt they played a major role; a more important part was played by Paul Volcker's tight money policies. But, returning to allowing the markets to set exchange rates is a better policy stance than Treasury Secretary Mnuchin's comments at Davos.

There are reports[1] that the president is preparing to replace more of his cabinet and aides, including Chief of Staff Kelly, National Security Director McMaster and AG Sessions. Financial markets have not reacted well to previous departures, although we expect the impact will decline over time. As we noted yesterday, this is a normal pattern that presidents follow. They usually attract strong characters in the first year but by the time their first four years end presidents tend to surrounded themselves with people who can execute the president's plans, not comment on the plans themselves.

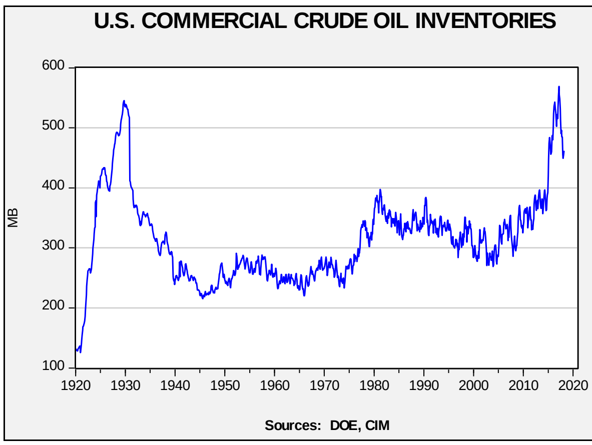
Russia and Britain: We are still awaiting Russia's official response but the commentary has been denial and contempt. Russia is trying to portray itself as a great power and actions like

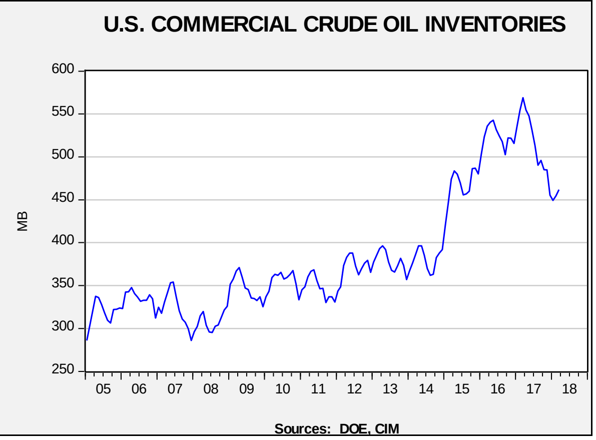
[1] https://www.vanityfair.com/news/2018/03/trump-swinging-the-axe-at-tillerson-mcmaster-sessions-jared-and-ivanka

executing old double agents are part of that narrative. The U.S., Germany and France have joined the chorus demanding that Russia accept responsibility for the attack, although we note it hasn't been a universal position. In France, a spokesman suggested Britain's proof of Russian involvement is "fantasy politics." However, the Macron government did later indicate that it believes the British claims of Russian involvement. In the U.K., Labour leader Corbyn refused to endorse May's claim of Russian responsibility, reminding British voters what a "PM Corbyn" would look like. We don't think diplomatic expulsions will make much difference and we don't expect major sanctions to follow. Sadly, the lack of an effective response will only embolden Putin to take more aggressive steps.

Abe's woes continue: The land scandal that has ensnared Finance Minister Aso is expanding. If Aso and perhaps Abe either ordered or knew documents were altered, it could bring down his government. The end of Abe would likely end Abenomics as well. We would expect a "knee-jerk" rally in the JPY and a weaker Nikkei.

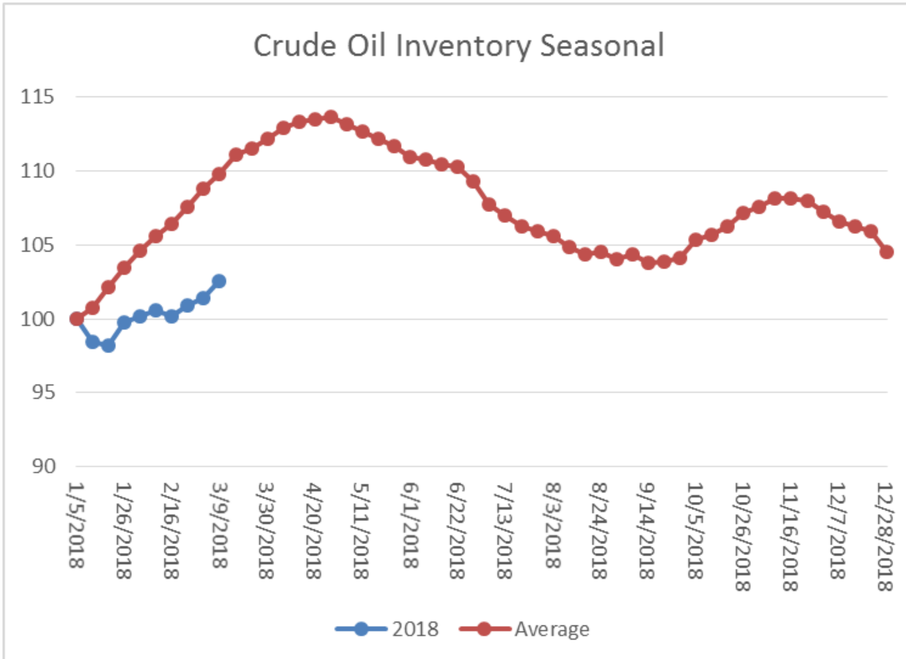
Energy recap: U.S. crude oil inventories rose 5.0 mb compared to market expectations of a 1.9 mb build.



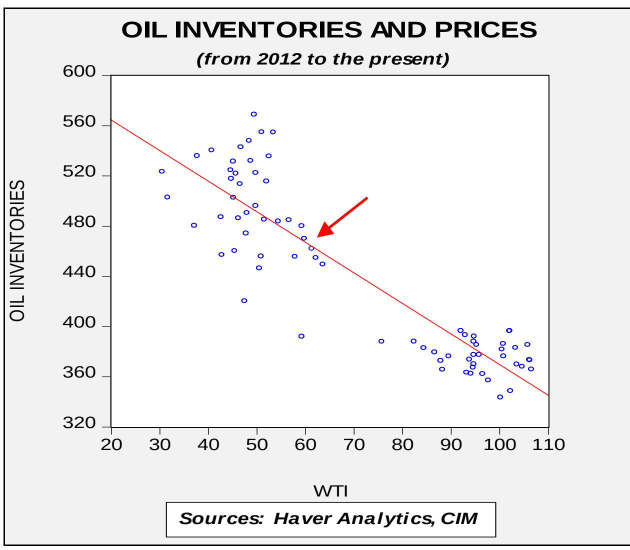


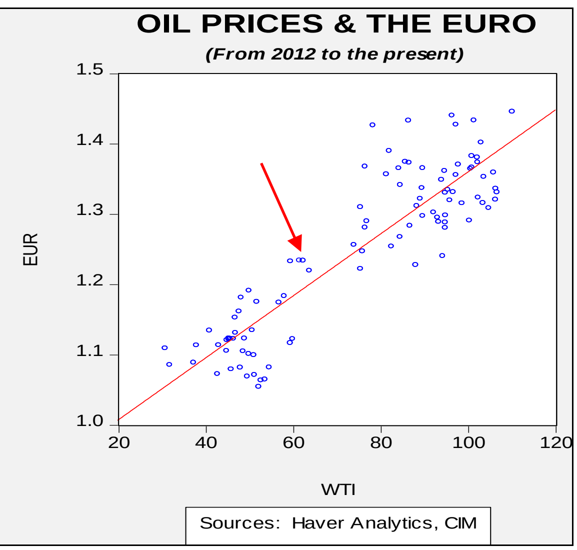
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but have declined significantly since last March. We would consider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

As the seasonal chart below shows, inventories are usually rising this time of year. This week's rise was more in line with a normal increase in oil inventories during late winter into spring. If this pattern continues, oil prices may come under further pressure in the short run, although it still appears to us that prices are undervalued.



(Source: DOE, CIM)



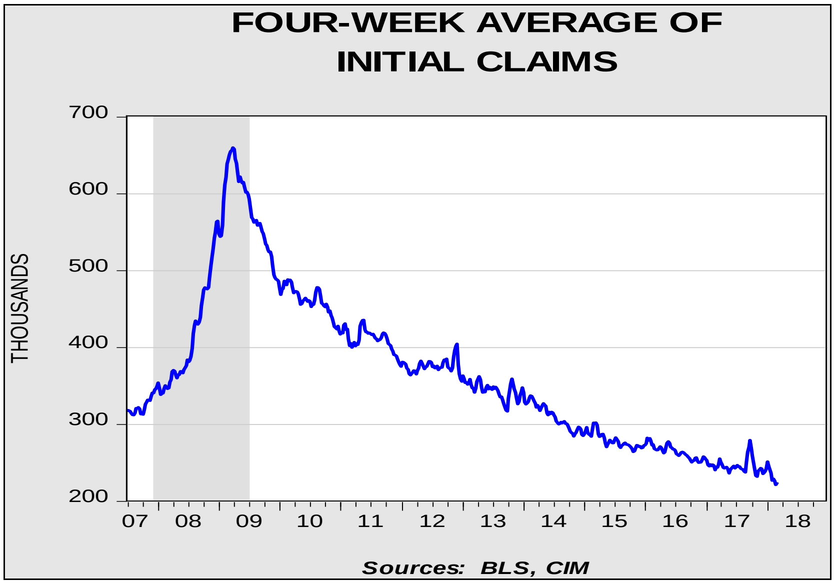


Based on inventories alone, oil prices are undervalued with the fair value price of $63.90. Meanwhile, the EUR/WTI model generates a fair value of $75.13. Together (which is a more sound methodology), fair value is $71.45, meaning that current prices are below fair value. Oil prices have been struggling on fears that U.S. production is going to overwhelm OPEC supply cuts. Earlier this week, we published our Quarterly Energy Comment[2] looking at the rapid rise in production without a commensurate increase in rig counts. We wonder if that production level can be maintained without an increase in resources. If not, oil prices should move higher once seasonal pressures dissipate.

[2] See Quarterly Energy Comment, 3/13/18

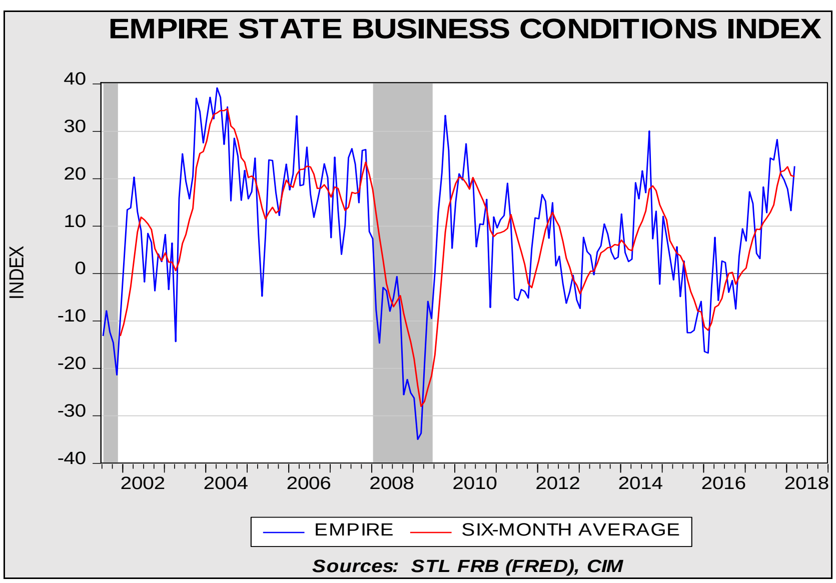
U.S. Economic Releases

Initial jobless claims came in below expectations at 226k compared to the forecast of 228k. The prior report was revised downward from 231k to 230k.



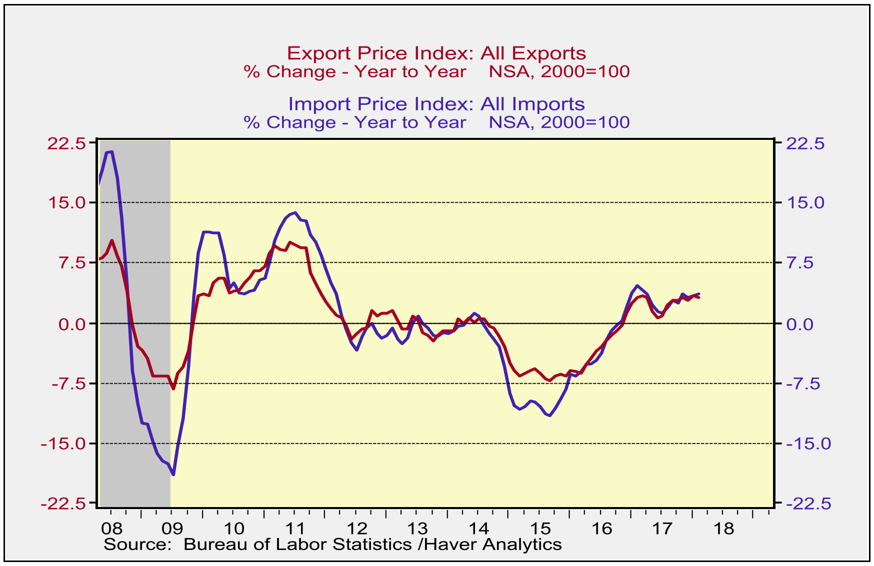
The chart above shows the four-week moving average of initial jobless claims. The four-week moving average fell from 222.25k to 221.50k.

Empire manufacturing came in above expectations at 22.5 compared to the forecast of 15.0.



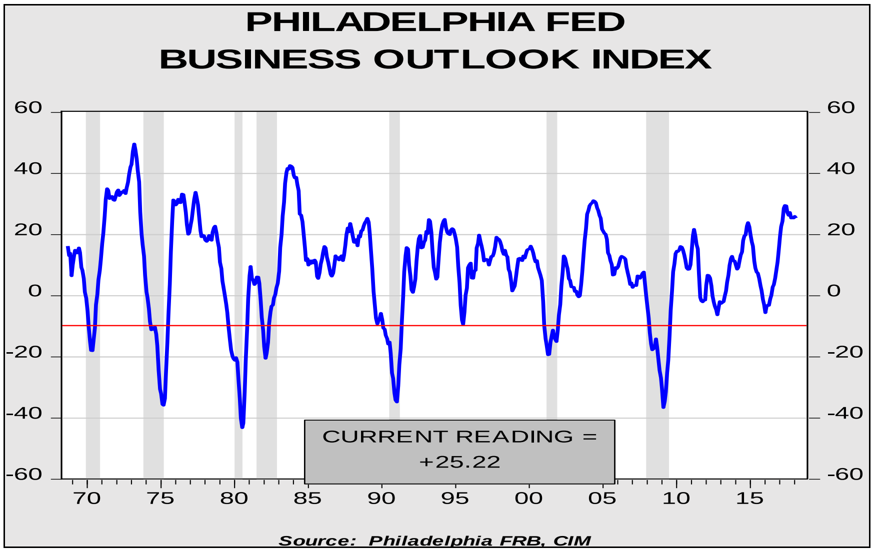
The chart above shows the six-month moving average of the Empire State Business Conditions Index.

The import price index came in above expectations, rising 0.4% from the prior month compared to the forecast gain of 0.2%. The prior month's gain was revised downward from 1.0% to 0.8%. The import price index excluding petroleum came in above expectations, rising 0.5% from the prior month compared to the forecast rise of 0.3%. The export price index came in below expectations, rising 0.2% 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 3.5% and 3.3%, respectively.

The Philadelphia Fed Business Outlook came in below expectations at 22.3 compared to the forecast of 23.0.



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

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Consumer Comfort	m/m	feb		56.8	**
9:45	NAHB Housing Market Index	m/m	mar	72	72	**
16:00	Total Net TIC Flows	m/m	jan		-$119.3 bn	**
10:00	Net Long-Term TIC Flows	m/m	jan		$27.3 bn	**
Fed speakers or events						
No speakers or events scheduled						

Foreign Economic News

We monitor numerous global economic indicators on a continuous basis. The most significant international news that was released overnight is outlined below. Not all releases are equally significant, thus we have created a star rating to convey to our readers the importance of the various indicators. The rating column below is a three-star scale of importance, with one star being the least important and three stars being the most important. We note that these ratings do change over time as economic circumstances change. Additionally, for ease of reading, we have also color-coded the market impact section, which indicates the effect on the foreign market. Red indicates a concerning development, yellow indicates an emerging trend that we are following closely for possible complications and green indicates neutral conditions. We will add a paragraph below if any development merits further explanation.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
Japan	Japan buying foreign bonds	m/m	mar	¥1.091 tn	-¥1.189 tn		*	Equity and bond neutral
	Japan buying foreign stocks	m/m	mar	-¥0.023 tn	¥0.202 tn		*	Equity and bond neutral
	Foreign buying Japan bonds	m/m	mar	¥0.486 tn	¥1.265 tn		*	Equity and bond neutral
	Foreign buying Japan stocks	m/m	mar	-¥0.433 tn	-¥0.463 tn		*	Equity and bond neutral
	Tokyo Condiminium Sales	y/y	feb	7.8%	39.7%		**	Equity and bond neutral
Australia	Consumer Inflation Expectations	y/y	mar	3.7%	3.6%		***	Equity and bond neutral
New Zealand	GDP	y/y	4q	2.9%	2.7%	3.1%	***	Equity bearish, bond bullish
EUROPE								
Eurozone	EU27 New Car Registration	y/y	feb	4.3%	7.1%		*	Equity and bond neutral
France	CPI EU Harmonized	y/y	feb	1.3%	1.3%	1.3%	***	Equity and bond neutral
	CPI	y/y	feb	1.2%	1.2%	1.2%	***	Equity and bond neutral
Italy	General Government Debt	m/m	jan	2.280 tn	2.256 tn		**	Equity and bond neutral
Switzerland	Producer and Import Prices	m/m	feb	2.3%	1.8%		**	Equity and bond neutral
AMERICAS								
Canada	Teranet/National Bank HPI	y/y	jan	7.5%	8.7%		**	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)	212	211	1	Up
3-mo T-bill yield (bps)	172	172	0	Neutral
TED spread (bps)	40	39	1	Neutral
U.S. Libor/OIS spread (bps)	168	167	1	Up
10-yr T-note (%)	2.81	2.82	-0.01	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	32	31	1	Down
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	up			Up
pound	down			Up
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBA FX Transactions Market	A$310 mn	A$529 mn		On forecast
RBA FX Transactions Government	-A$438 mn	-A$634 mn		On forecast
RBA FX Transactions Other	-A$259 mn	A$2646 mn		On forecast
SNB Sight Deposits Interest Rates	-0.750%	-0.750%	-0.750%	On forecast
SNB 3-Month Libor Lower Target	-1.250%	-1.250%	-1.250%	On forecast
SNB 3-Month Libor Lower Target	-0.250%	-0.250%	-0.250%	On forecast

Commodity Markets

The commodity section below shows some of the commodity prices and their change from the prior trading day, with commentary on the cause of the change highlighted in the last column.

	Price	Prior	Change	Explanation
Energy Markets				
Brent	$65.10	$64.89	0.32%	
WTI	$61.29	$60.96	0.54%	
Natural Gas	$2.75	$2.73	0.51%	
Crack Spread	$18.97	$19.34	-1.92%	
12-mo strip crack	$17.31	$17.54	-1.31%	
Ethanol rack	$1.56	$1.56	0.03%	
Metals				
Gold	$1,321.94	$1,324.85	-0.22%	
Silver	$16.49	$16.55	-0.35%	
Copper contract	$313.75	$315.85	-0.66%	
Grains				
Corn contract	$ 389.75	$ 388.75	0.26%	
Wheat contract	$ 490.50	$ 488.75	0.36%	
Soybeans contract	$ 1,039.25	$ 1,032.25	0.68%	
Shipping				
Baltic Dry Freight	1169	1179	-10	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	5.0	2.5	2.5	
Gasoline (mb)	-6.3	-1.1	-5.2	
Distillates (mb)	-4.4	-1.7	-2.7	
Refinery run rates (%)	2.00%	-0.30%	2.3%	
Natural gas (bcf)		-98.0		

Weather

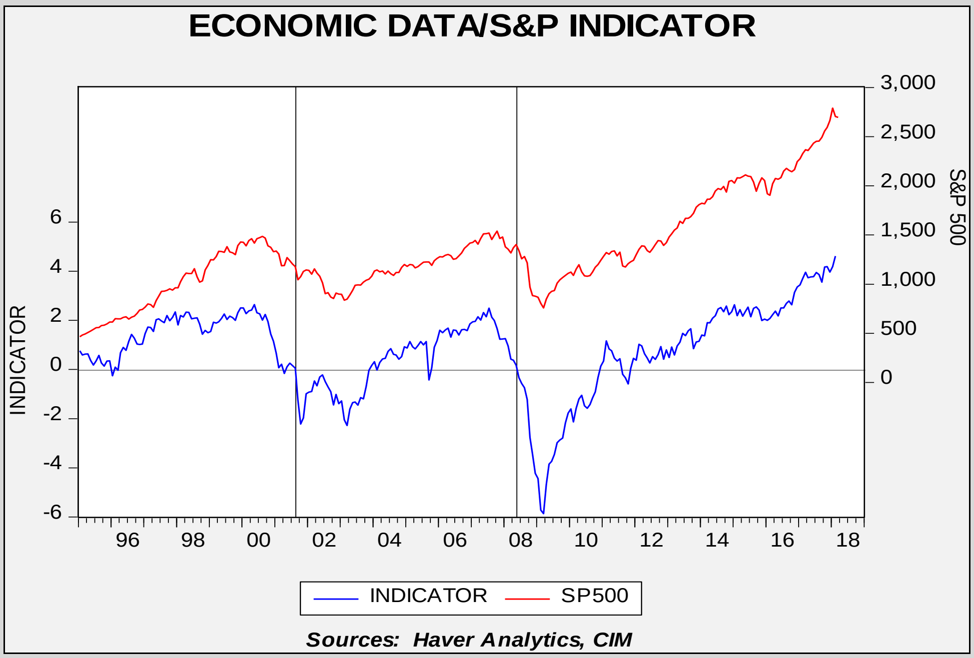
The 6-10 and 8-14 day forecasts continue to signal colder than normal temperatures for most of the country. Precipitation is expected for most of the country.

Asset Allocation Weekly Comment

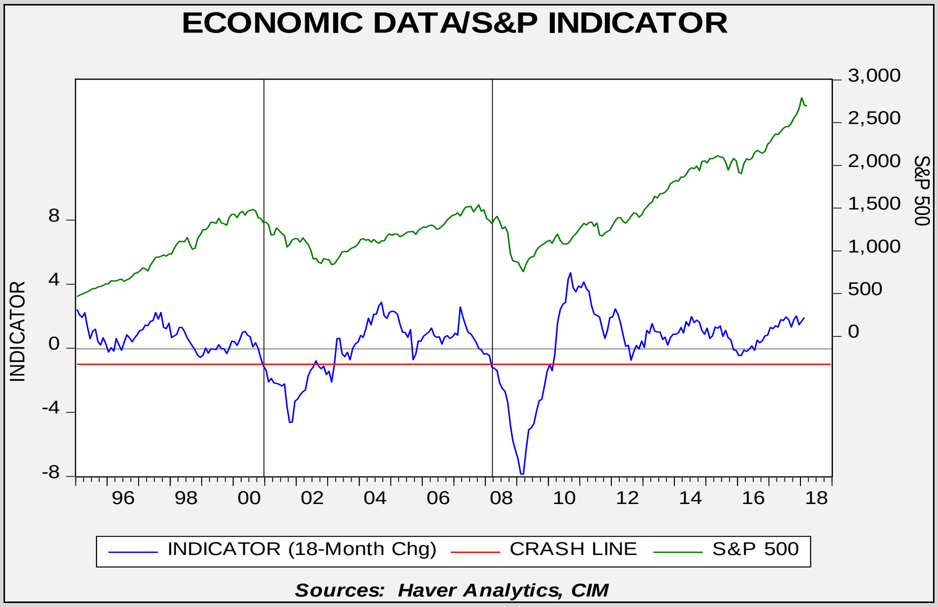
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

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.



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.

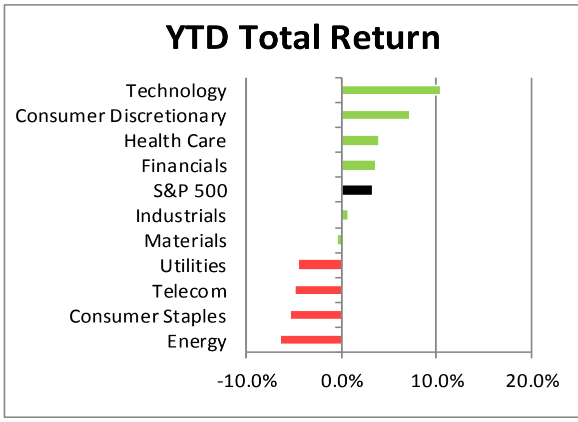


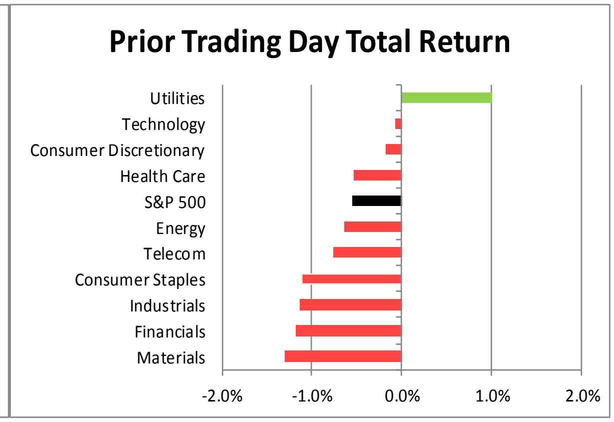
To make the indicator more sensitive, we took the 18-month change and put the signal threshold at -1.0. This provided an earlier bearish signal and also eliminated the false positives that the zero threshold generated. Notwithstanding, we will pay close attention when the 18-month change approaches zero.

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.

<u>Data Section</u>

U.S. Equity Markets – (as of 3/14/2018 close)

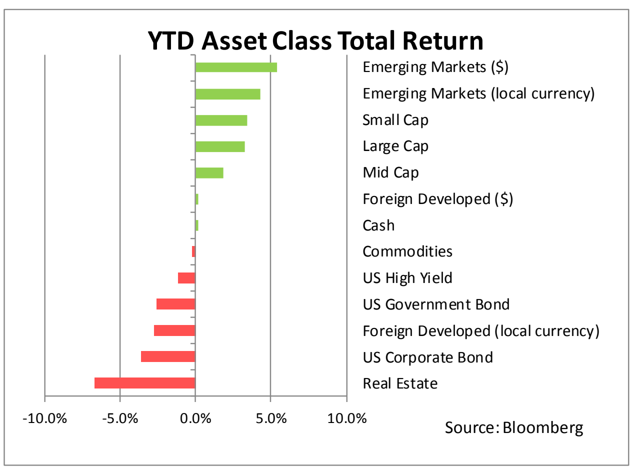




(Source: Bloomberg)

These S&P 500 and sector return charts are designed to provide the reader with an easy overview of the year-to-date and prior trading day total return. Sectors are ranked by total return; green indicating positive and red indicating negative return, along with the overall S&P 500 in black.

Asset Class Performance – (as of 3/14/2018 close)

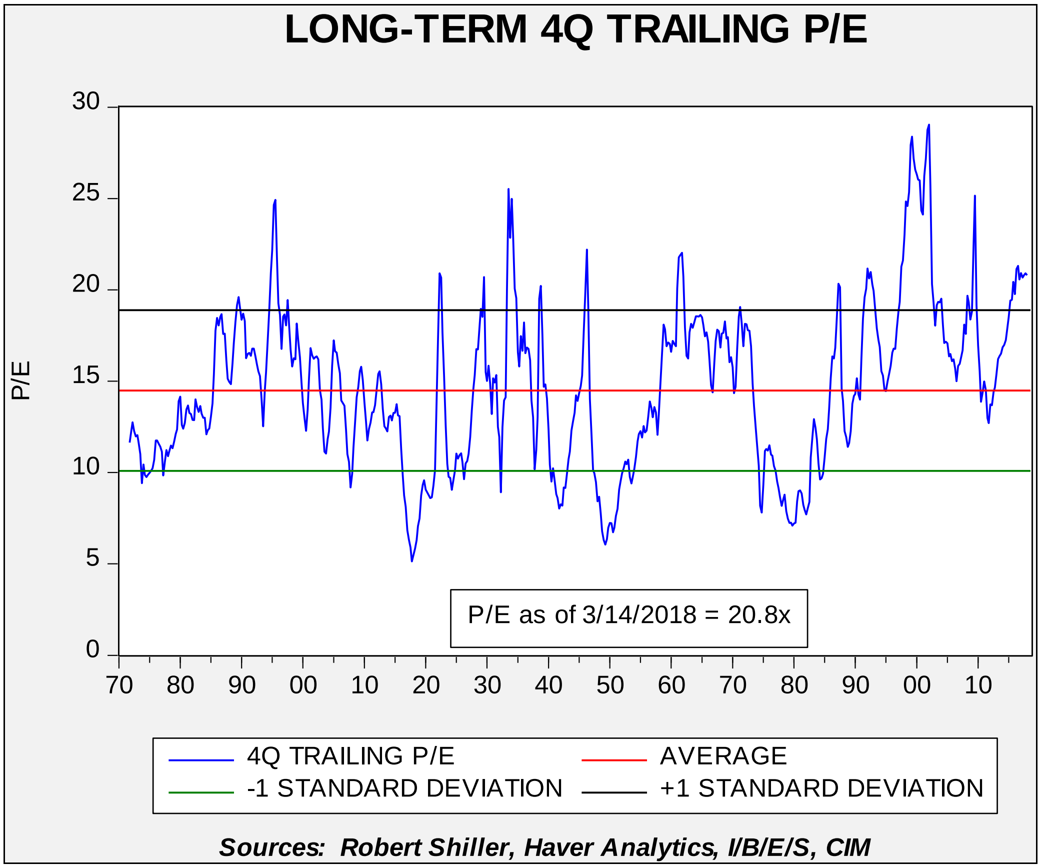


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

Asset classes are defined as follows: Large Cap (S&P 500 Index), Mid Cap (S&P 400 Index), Small Cap (Russell 2000 Index), Foreign Developed (MSCI EAFE (USD and local currency) Index), Real Estate (FTSE NAREIT Index), Emerging Markets (MSCI Emerging Markets (USD and local currency) Index), Cash (iShares Short Treasury Bond ETF), U.S. Corporate Bond (iShares iBoxx $ Investment Grade Corporate Bond ETF), U.S. Government Bond (iShares 7-10 Year Treasury Bond ETF), U.S. High Yield (iShares iBoxx $ High Yield Corporate Bond ETF), Commodities (Bloomberg total return Commodity Index).

P/E Update

March 15, 2018



Based on our methodology,[3] 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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[3] 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.