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 15, 2019—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 1.2% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.6% from the prior close. Chinese markets were higher, with the Shanghai composite up 1.0% and the Shenzhen index up 1.4%. U.S. equity index futures are signaling a higher open.

Happy Ides of March Friday! The National Party Congress (NPC) ended in China and New Zealand is reeling from a mass shooting. U.S. equity futures are higher. Here is what we are watching this morning:

The National Party Congress: Unlike previous events, this one was relatively quiet. Three items emerged. First, China will return to stimulus, with an increase of 0.8% of GDP in off-budget bond issuance for infrastructure spending. Although tax cuts have captured the headlines, they are mostly a head fake as spending cuts elsewhere in the budget will tend to offset them. There could also be some easing of bank reserve requirements.[1] The stimulus is not all that great but should be enough to stabilize growth. Second, there was much talk about changes in industrial policy, including little mention of the Belt and Road Initiative or China 2025. But, the policies still remain in place. Second, a leveling of the playing field for foreign firms was announced to great fanfare[2] but, in reality, such laws are not terribly meaningful in a nation where "rule of law" really means "do what the Party says." The law is mostly there to help bring a trade deal with the U.S. Third, although there has been some easing of property controls in cities, the national level policy remains restrained. There had been hopes for change. Overall, the NPC will support China's economic growth and likely increase the odds of a trade deal with the U.S., but it won't lead to an economic boom.

Fed next week: The FOMC will meet next week. Although no action on rates is expected, we will be watching for two signals. First, it is quite possible that the FOMC will indicate it will be on hold for most of this year. Although the usual commentary on data dependency should remain, financial markets are signaling to policymakers that the fed funds should not increase this year. We will be watching to see if the dots plot reflects this. Second, the markets will be looking to see if the FOMC signals anything on the balance sheet. There is growing speculation

[1] https://uk.reuters.com/article/us-china-parliament-economy/china-premier-says-can-use-interest-rates-other-policy-steps-to-help-economy-idUKKCN1QW09Y
[2] https://www.scmp.com/economy/china-economy/article/3001780/china-approves-new-foreign-investment-law-designed-level

that the Fed will target a level between $3.8 trillion to $3.5 trillion.[3] If the FOMC does signal no rate hikes this year and a higher terminal number for the balance sheet, then equities will take this news as supportive.

North Korea: In the aftermath of the recent summit, it appears North Korea may be moving back to a more hostile stance.[4] Relations between the U.S. and North Korea are complicated. It appears to us that Kim Jong-un thought he could get a lot from the U.S. and give up little; President Trump clearly figured this out and walked out of talks. Pyongyang probably wants to pull the U.S. back into talks and thus is using threats to accomplish this outcome. However, we note the recent comments about restarting warhead and missile tests didn't come from Kim but from other officials. We would expect Kim to write another letter or two to Trump to try to get another round of talks. In addition, a turn toward hostility would be a help to China, who may offer to help out for some easing of trade tensions.

Tehran to Baghdad: Iranian President Rouhani visited Iraq this week, his first state visit to his neighbor. The visit appears to be designed to undermine U.S. sanctions.[5] Given the degree of influence that Iran has in Iraq, we expect Iraq to offer a "leaky border" for smuggling. What was interesting about Rouhani's visit was that the Iranian president was given a rare audience with Iraq's leading religious authority, the Grand Ayatollah Ali Sistani.[6] Sistani has always been a political moderate; he does not ascribe to Iran's "rule of the clerics" model developed by Ayatollah Khomeini, preferring the traditional quietist[7] position of the Shiites. Sistani opposes Iran's paramilitary influence in Iraq and apparently noted this in his conversation with Rouhani. The meeting will lift Rouhani's position in Iran among moderates and will likely tighten relations between the two governments.

Brexit: So, now what? The next step is yet another vote on PM May's exit plan. Although this seems like a futile exercise[8] to have another vote after the plan has failed miserably twice, it may actually pass on a third turn.[9] First, May's minority partner, the DUP in Northern Ireland, is coming under significant pressure from the Northern Irish business community to avoid a hard border and that may mean accepting the backstop and May's plan.[10] Second, the EU is

---

[3] https://www.reuters.com/article/us-funds-pimco/fed-could-soon-announce-plan-to-stop-shrinking-balance-sheet-pimco-idUSKCN1QV2WB

[4] https://www.reuters.com/article/us-northkorea-usa/north-korea-may-suspend-nuclear-talks-with-gangster-like-u-s-diplomat-idUSKCN1QW0C9?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top

[5] https://www.washingtonpost.com/world/irans-rouhani-in-iraq-for-historic-visit-to-offset-us-sanctions/2019/03/11/24c6e88b-eb40-4da1-b091-c4eb64c0fce3_story.html?utm_term=.a056337ce629&wpisrc=nl_todayworld&wpmm=1

[6] https://www.washingtonpost.com/world/by-granting-rare-audience-iraqs-grand-ayatollah-sends-message-to-washington-and-tehran/2019/03/13/9a624870-4506-11e9-94ab-d2dda3c0df52_story.html?utm_term=.329425d52887&wpisrc=nl_todayworld&wpmm=1

[7] https://en.wikipedia.org/wiki/Political_quietism_in_Islam

[8] https://www.youtube.com/watch?v=UijhbHvxWrA

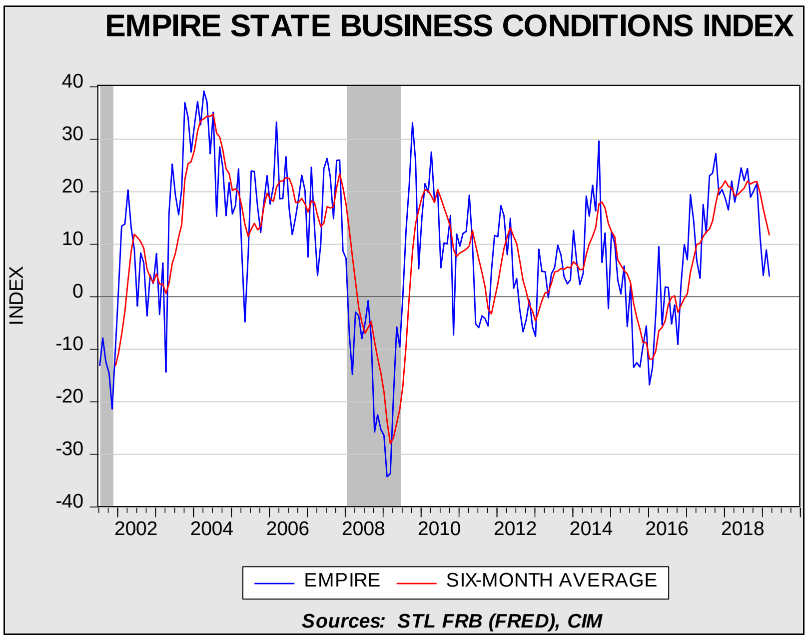
[9] https://www.youtube.com/watch?v=zMRrNY0pxfM

[10] https://www.ft.com/content/43ec8b9e-466a-11e9-a965-23d669740bfb?utm_source=POLITICO.EU&utm_campaign=154de0543d-

indicating that the only way it will agree to an extension is if there is a second referendum. The Brexiteers are uncomfortable taking a chance on another vote, which might end up with a return to the EU.[11] Third, it appears that the European Research Group, the collection of Tory MPs who support Brexit, is splitting. The group, which numbers around 90, only has a core of about 20 MPs. There are reports that the pragmatists in the group are having second thoughts about careening into a hard Brexit and may end up favoring May's deal.[12] And, finally, Labour is facing dissention in its own ranks[13] and may actually lose an election, based on recent polling.[14] Labour leader Jeremy Corbyn has been pining to bring down the government and have an election, but if Corbyn can't hold his party together then they might simply vote for May's plan to avoid another referendum or a hard Brexit. If May's plan passes, look for the GBP to rally.

U.S. Economic Releases

Empire manufacturing came in below expectations at 3.7 compared to the forecast of 10.0.



The chart above shows the six-month moving average of the Empire State Business Conditions Index. Currently, the six-month moving average is 11.5.

EMAIL_CAMPAIGN_2019_03_15_06_44&utm_medium=email&utm_term=0_10959edeb5-154de0543d-190334489

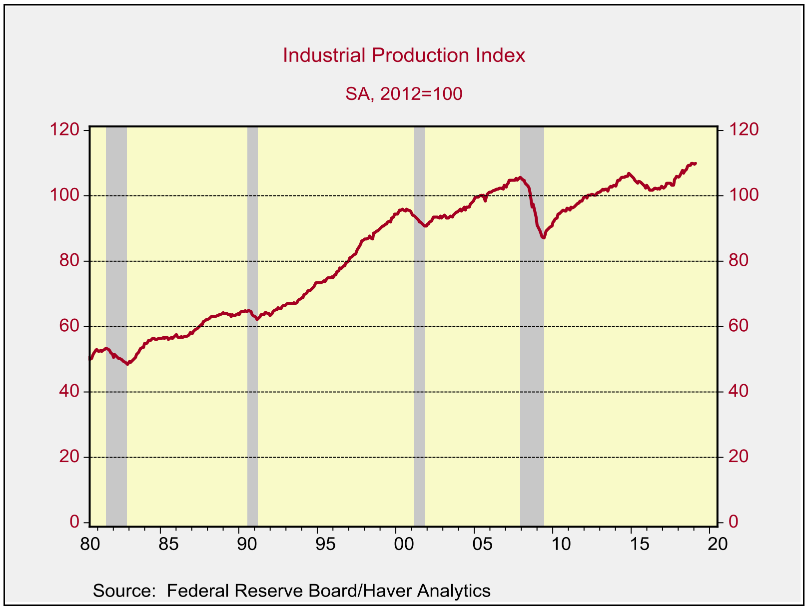
11 https://www.thetimes.co.uk/edition/news/eu-will-agree-to-extra-time-if-there-is-a-second-brexit-referendum-z6td8nvd7?utm_source=POLITICO.EU&utm_campaign=154de0543d-EMAIL_CAMPAIGN_2019_03_15_06_44&utm_medium=email&utm_term=0_10959edeb5-154de0543d-190334489

12 https://www.ft.com/content/300a59e4-465b-11e9-b168-96a37d002cd3?emailId=5c8aeeb0cc534f000485fbec&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

13 https://www.telegraph.co.uk/politics/2019/03/14/mps-reject-second-referendum-labour-frontbencher-quits-partys/

14 https://www.theguardian.com/politics/2019/feb/02/labour-slumps-in-polls-as-tories-open-biggest-lead-since-general-election

Industrial production for February came in weaker than forecast, rising 0.1% from the prior month compared to the forecast gain of 0.4%. The prior report's loss was revised downward from 0.6% to 0.4%. Capacity utilization was 78.2%, below the 78.5% expected.



The chart above shows the Industrial Production Index. The current reading is 109.7, the highest on record.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	JOLTS Job Openings	m/m	jan	7225	7335	**
10:00	U. of Michigan Sentiment	m/m	mar	95.6	93.8	**
10:00	U. of Michigan Current Conditions	m/m	mar	112.0	108.5	**
10:00	U. of Michigan Expectations	m/m	mar	88.1	84.4	**
10:00	U. of Michigan 1 yr Inflation	m/m	mar		2.6%	**
10:00	U. of Michigan 5-10 Yr Inflation	m/m	mar		2.3%	**
15:00	Total Net TIC Flows	m/m	jan		-$48.3 bn	**
15:00	Net Long-Term TIC Flows	m/m	jan		-$33.1 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								
China	New Home Prices	y/y	feb	0.5%	0.6%		**	Equity and bond neutral
	Foreign Direct Investment	y/y	feb	6.6%	4.8%		**	Equity and bond neutral
India	Wholesale Prices	y/y	feb	2.9%	2.8%	2.8%	**	Equity bearish, bond bullish
New Zealand	BusinessNZ Manufacturing PMI	m/m	feb	53.7	53.1		**	Equity and bond neutral
	Net Migration	m/m	jan	6300	5080		**	Equity and bond neutral
EUROPE								
Eurozone	CPI	m/m	feb	1.5%	1.5%	1.5%	***	Equity and bond neutral
	CPI Core	m/m	feb	1.0%	1.0%	1.0%	***	Equity and bond neutral
	EU27 New Car Registratoins	m/m	feb	-1.0%	-4.6%		*	Equity and bond neutral
Germany	Wholesale Price Index	m/m	feb	1.6%	1.1%		**	Equity and bond neutral
Italy	Industry Sales	y/y	jan	0.6%	-7.3%		**	Equity and bond neutral
	Industry Orders	y/y	jan	1.8%	-1.8%		**	Equity and bond neutral
	General Government Debt	m/m	jan	2.358 tn	2.317 tn		**	Equity and bond neutral
	CPI EU Harmonized	y/y	feb	1.1%	1.2%	1.2%	***	Equity and bond neutral
Russia	Money Supply Narrow Def	m/m	mar	10.300 tn	10.170 tn		**	Equity and bond neutral
AMERICAS								
Canada	New Housing Price Index	y/y	jan	-0.1%	0.0%	0.0%	***	Equity and bond bearish
Brazil	Retail Sales	y/y	jan	1.9%	0.6%	1.0%	***	Equity bullish, bond bearish
	Retail Sales Broad	y/y	jan	3.5%	1.8%	2.3%	**	Equity bullish, bond bearish

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)	261	259	2	Up
3-mo T-bill yield (bps)	239	239	0	Neutral
TED spread (bps)	22	20	2	Neutral
U.S. Libor/OIS spread (bps)	241	241	0	Up
10-yr T-note (%)	2.63	2.63	0.00	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	10	9	1	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Up
yen	down			Neutral
pound	up			Neutral
franc	flat			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
BOJ Policy Balance Rate	-0.100%	-0.100%	-0.100%	On forecast
BOJ 10-yr Yield Target	0.000%	0.000%	0.000%	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	$67.01	$67.23	-0.33%	
WTI	$58.61	$58.61	0.00%	
Natural Gas	$2.84	$2.86	-0.60%	
Crack Spread	$20.58	$20.94	-1.69%	
12-mo strip crack	$16.86	$17.07	-1.25%	
Ethanol rack	$1.45	$1.44	0.32%	
Metals				
Gold	$1,304.02	$1,296.17	0.61%	
Silver	$15.39	$15.19	1.32%	
Copper contract	$290.75	$289.15	0.55%	
Grains				
Corn contract	$ 370.50	$ 370.25	0.07%	
Wheat contract	$ 451.50	$ 452.75	-0.28%	
Soybeans contract	$ 900.25	$ 898.50	0.19%	
Shipping				
Baltic Dry Freight	677	654	23	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-3.9	3.0	-6.9	
Gasoline (mb)	-4.6	-3.0	-1.6	
Distillates (mb)	0.4	-2.0	2.4	
Refinery run rates (%)	0.10%	0.50%	-0.40%	
Natural gas (bcf)	-204.0	-212.0	8.0	

Weather

The 6-10 and 8-14 day forecasts show cooler temperatures for most of the country. Precipitation is expected for the western half of the country.

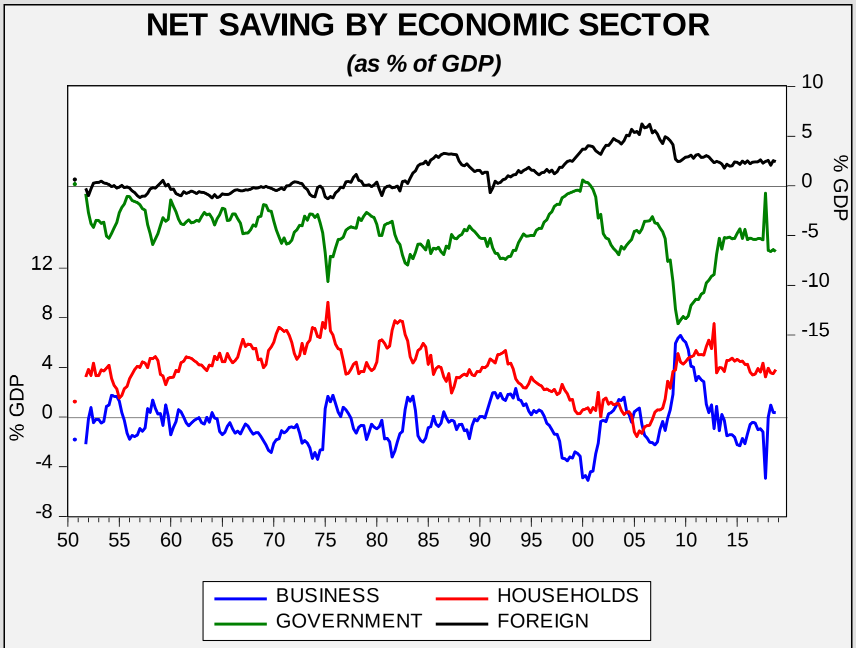
Asset Allocation Weekly Comment

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 15, 2019

The Financial Accounts of the United States, formerly known as the Flow of Funds Report, was released last week. It is a plethora of information about the state of the economy. Below we discuss the charts we find most noteworthy.

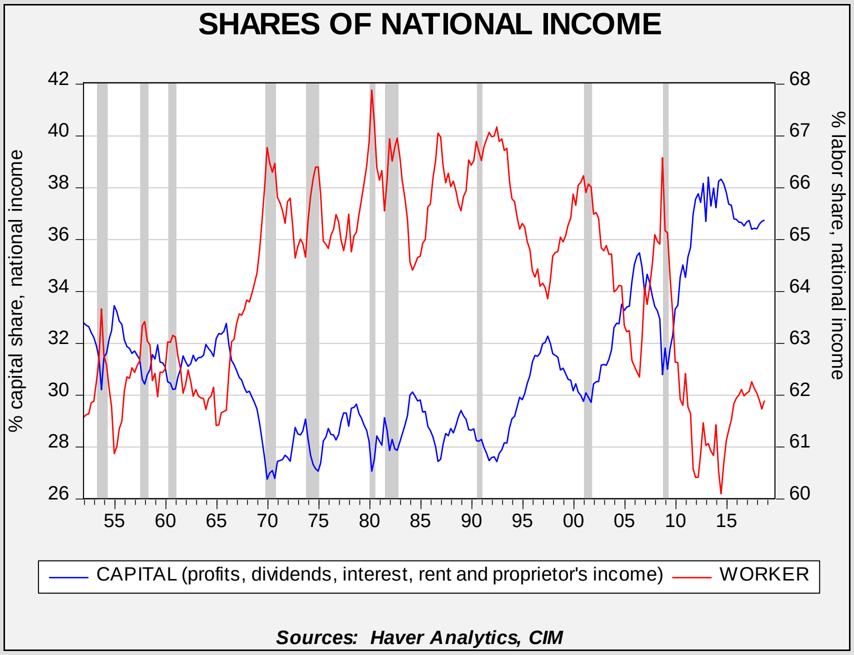
First, here is the saving balance by sector.



Sources: Haver Analytics, CIM

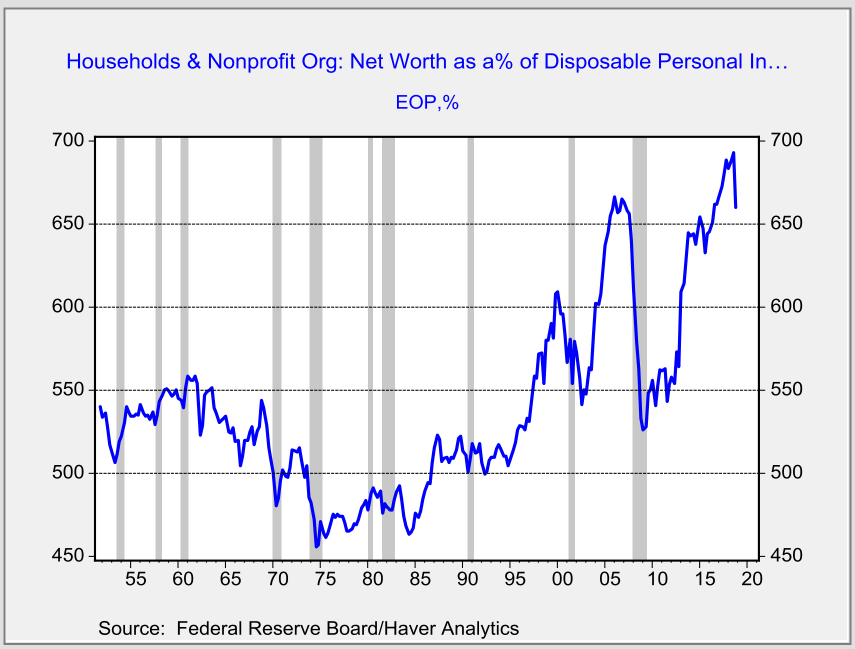
The tax cut has led to an increase in business saving and a wider fiscal deficit. Household and foreign saving was essentially unchanged. We are watching to see if the administration's trade policy reduces the trade deficit; if it does, then foreign saving, the inverse of the trade deficit, will decline and require higher saving from the other three sectors to offset that saving decline.

Second, the share of national income going to capital and labor were mostly stable.



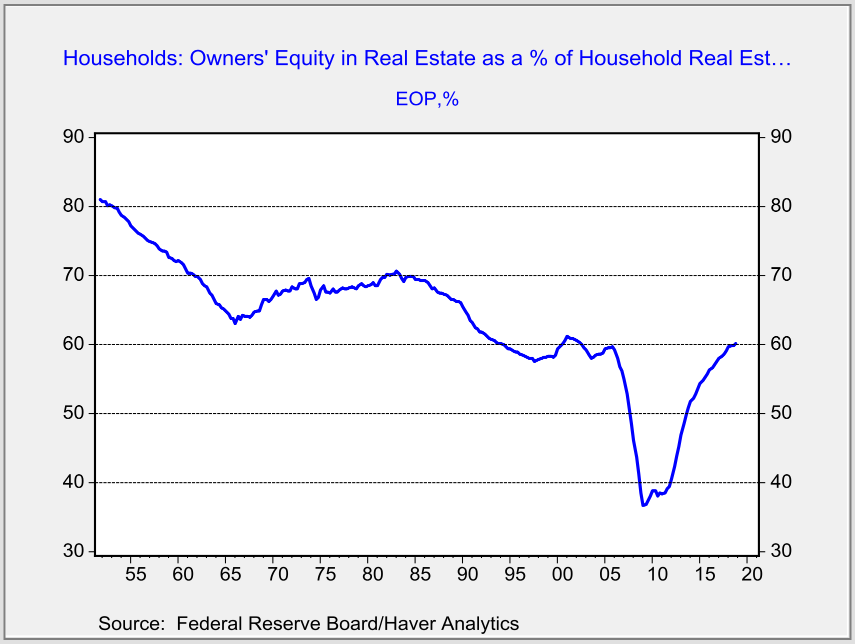
Since the end of communism in the early 1990s, capital has been taking a steadily larger share of national income. In each expansion, the capital share has made a higher peak.

Third, the drop in equity markets adversely affected household net worth.

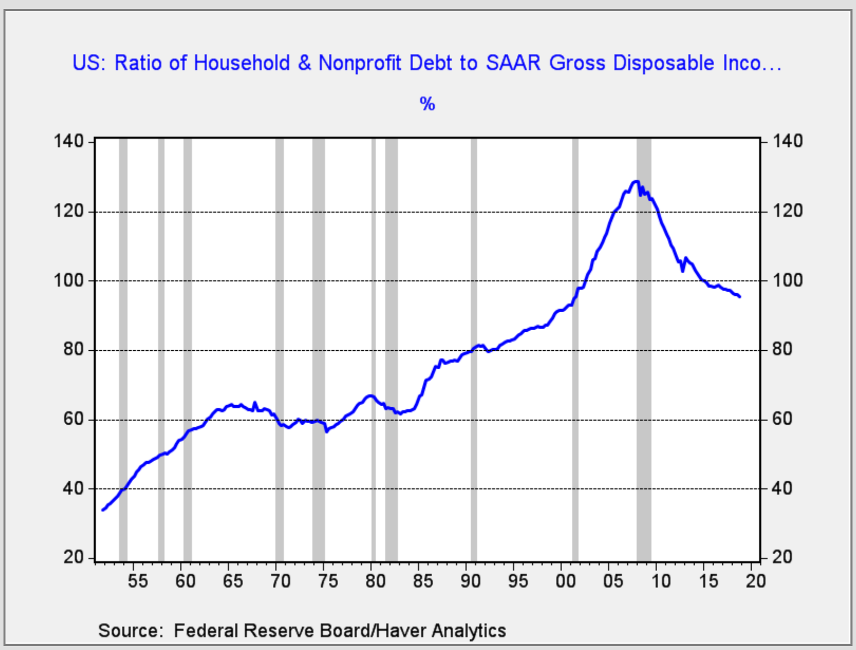


Net worth relative to after-tax income took a dive in Q4; the recent recovery in equity markets should reverse this dip, but we do note that in previous cycles such declines tended to signal that the business cycle was coming to a close.

Fourth, owners' equity in real estate finally reached 60%, a level which we consider normal. This was the level the market was at pre-1995, when the government eased the rules on home ownership. During the real estate crisis, equity plunged as falling home prices collided with excessive mortgage debt. From a financial perspective, this suggests the residential real estate market has overcome the trauma of the Great Financial Crisis.[15]



Finally, household deleveraging is continuing, although the pace has slowed.



---

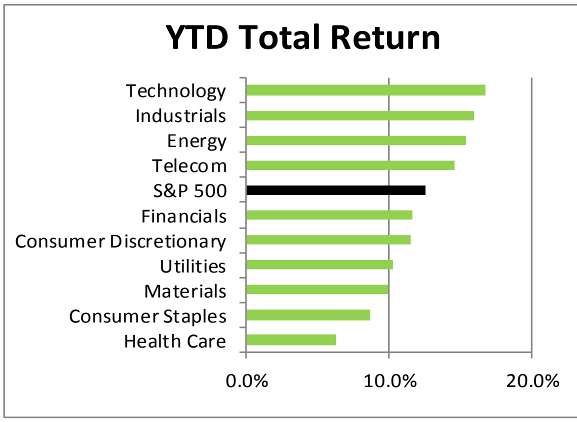
[15] This is only true for the financial system. Many communities are still struggling with the aftermath of the crisis.

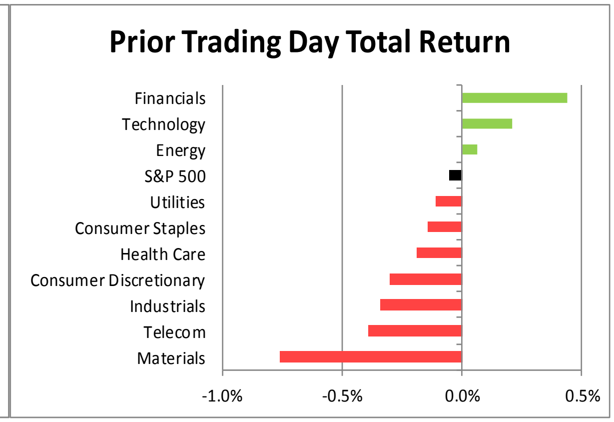
This chart shows household debt as a percentage of after-tax income. From the early 1980s into 2005, household debt rose steadily. The Great Financial Crisis led households to lower their debt levels relative to income. Although there is no generally accepted level that signals when deleveraging has been achieved (we would prefer around 80%), the continued decline is both good and bad. It is good because the reduction in debt is supportive for household balance sheets. However, growth will tend to be slower during periods of deleveraging.

Overall, the report does show the tax bill affected business saving and government dissaving. The recent market decline was reflected in the slide in household net worth. Capital is still gaining on labor; the housing market is now on a more solid footing compared to a decade ago. And, household balance sheets are improving. Overall, we view the report as consistent with steady, slow growth.

Data Section

U.S. Equity Markets – (as of 3/14/2019 close)

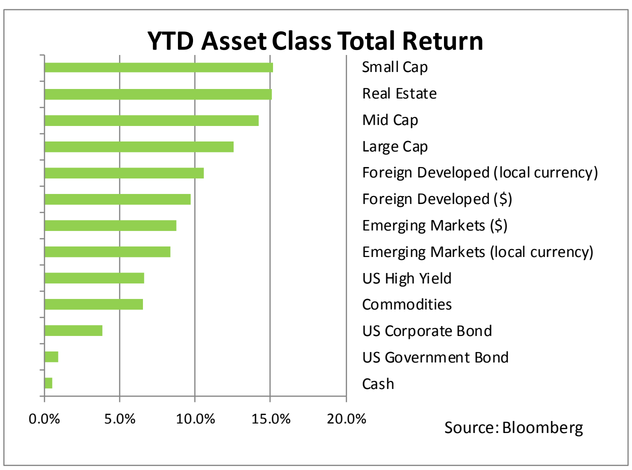




(Source: Bloomberg)

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 3/14/2019 close)

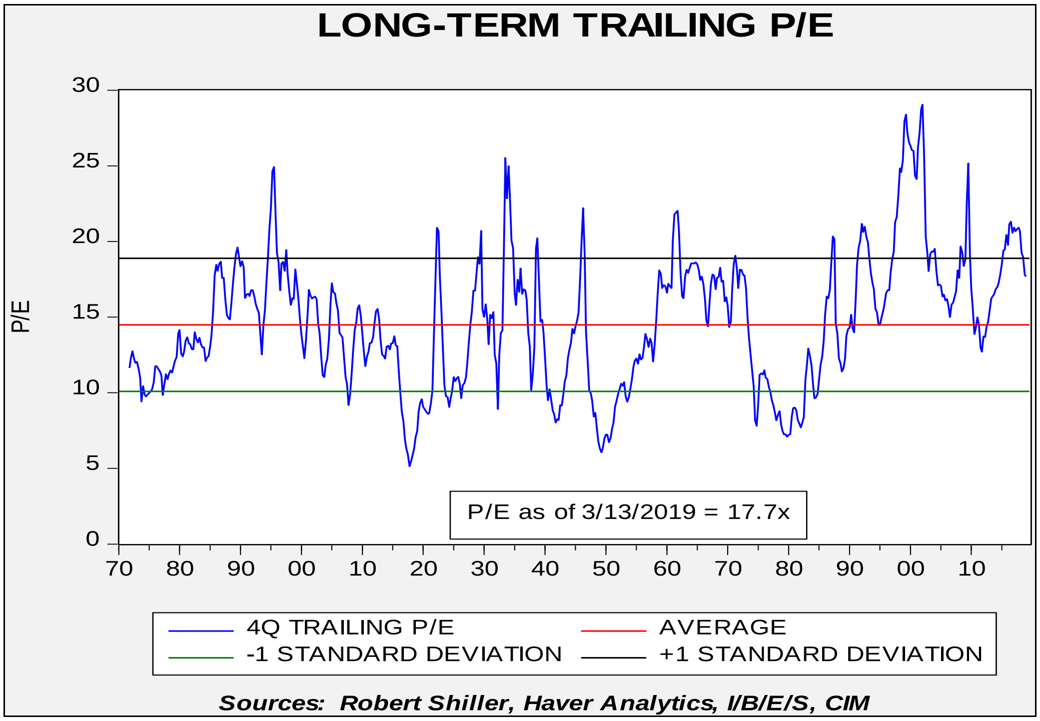


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 14, 2019



Based on our methodology,[16] the current P/E is 17.7x, up 0.2x from last week. The rise in the P/E was due to declining earnings estimates.

[16] 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.