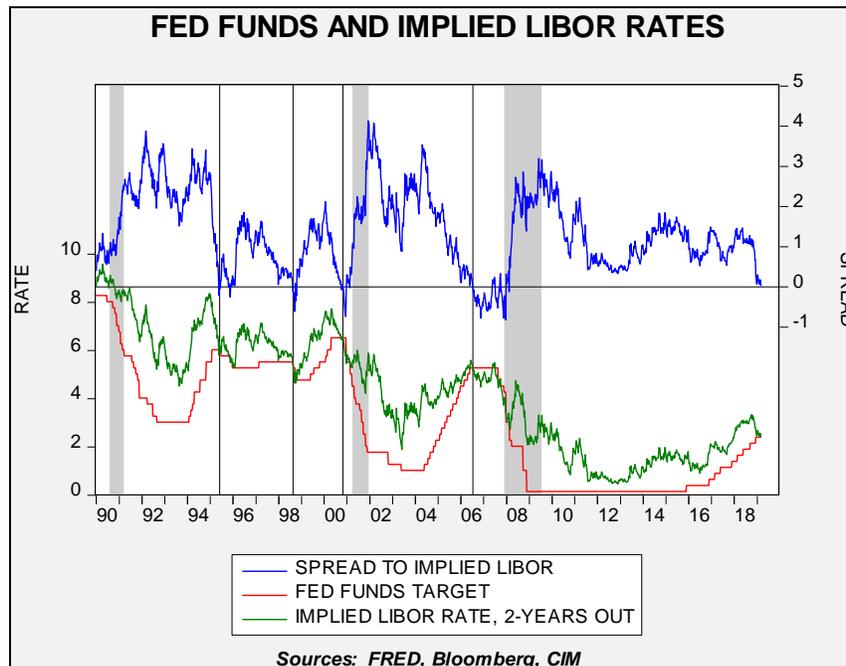


Looking for something to read? See our [Reading List](#); these books, separated by category, are ones we find interesting and insightful. We will be adding to the list over time.

[Posted: March 18, 2019—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is unchanged from the last close. In Asia, the MSCI Asia Apex 50 was up 0.9% from the prior close. Chinese markets were higher, with the Shanghai composite up 2.5% and the Shenzhen index up 2.7%. U.S. equity index futures are signaling a higher open.

It’s a modest risk-on day on this Monday in late winter. Here is what we are watching this morning:

Fed meeting: As noted last week, the FOMC meets this week. Although there are hopes that the Fed may set the terminal level for the balance sheet,¹ this action may not occur at this meeting. The dot plot will be watched carefully to see if the FOMC is taking a dovish turn.² Meanwhile, financial markets are clearly signaling that the Fed is on hold.



¹ <https://www.wsj.com/articles/federal-reserve-rate-projections-could-show-greater-confidence-in-extended-pause-11552820400>

² <https://www.wsj.com/articles/fed-officials-wrestle-with-a-dot-plot-dilemma-11552901401>

This chart shows the fed funds target with the implied three-month LIBOR rate on the two-year deferred Eurodollar futures market. Historically, this rate has coincided with policy actions. We have placed vertical lines where this spread between the target and the implied rate inverts. The Greenspan Fed tended to cut rates when the spread inverted. The Bernanke Fed did stop raising rates once the inversion occurred, but didn't cut; this lack of action probably contributed to the 2007-09 recession. The spread is currently sitting at zero. The financial markets are not signaling a rate cut but they are clearly indicating that further tightening will increase the odds of a policy mistake.

OPEC+: OPEC and Russia are meeting in Baku to discuss oil policy. This morning, the OPEC minister, Khalid al-Falih, suggested that inventories are still too high (we would agree) and that production cuts should remain in place.³ Oil prices have moved higher on the news. However, Russia has been more cautious about cuts and future talks.⁴ The sticking point seems to be around extending the cuts into H2. It appears the cartel and Russia will likely defer that decision until May.

Trade talks: It looks like China and U.S. trade negotiators are hitting the most difficult elements of the negotiations because we are starting to hear reports suggesting longer delays in a summit.⁵ The latest out of China is that a meeting might not occur until June. Apparently, the U.S. is considering keeping the threat of tariffs in place to ensure Chinese compliance to the agreement.⁶ Not only will China probably not accept such a deal, but the continued threat of sanctions will affect U.S. domestic company behavior. That is, the mere threat of trade sanctions will affect how American companies behave. If the trade talks fail, it would have an adverse effect on U.S. equities as the stock market has mostly discounted an easing in trade tensions.

Yellow Vest unrest: The Yellow Vests returned to France over the weekend and targeted areas of elite wealth in violent riots.⁷ In some respects, the numbers in the protests are falling but the protests themselves are becoming increasingly destructive. The Macron government continues to condemn the protests but it looks like its plan to deal with them is to simply wait out the movement.⁸

³ <https://www.reuters.com/article/us-oil-opec-falih/saudi-falih-optimistic-on-continued-commitment-to-opec-oil-supply-cut-idUSKCN1QY09C>

⁴ <https://www.reuters.com/article/us-oil-opec-novak/russias-novak-says-talks-needed-in-may-to-decide-opec-next-steps-idUSKCN1QY008?il=0> and https://www.wsj.com/articles/opec-russia-deepen-oil-output-cuts-but-disagree-on-their-duration-11552860517?mod=hp_listc_pos3

⁵ <https://www.scmp.com/news/china/diplomacy/article/3001943/trump-xi-meeting-end-trade-war-may-be-put-back-june-sources>

⁶ <https://www.nytimes.com/2019/03/17/business/trade-war-china-tariffs.html?action=click&module=Top%20Stories&pgtype=Homepage>

⁷ https://www.nytimes.com/2019/03/16/world/europe/france-yellow-vests-protest.html?emc=edit_mbe_20190318&nl=morning-briefing-europe&nid=567726720190318&te=1

⁸ https://www.politico.eu/article/french-politicians-condemn-violent-street-clashes-in-paris-yellow-jackets/?utm_source=POLITICO.EU&utm_campaign=3bf9274f14-

[EMAIL_CAMPAIGN_2019_03_18_05_49&utm_medium=email&utm_term=0_10959edeb5-3bf9274f14-190334489](mailto:EMAIL_CAMPAIGN_2019_03_18_05_49?utm_medium=email&utm_term=0_10959edeb5-3bf9274f14-190334489)

Brexit: Political machinations continue in Britain and the EU. PM May could delay another vote on her exit proposal until next week, which would put it very close to the exit date. May is pressing the junior partner in her coalition, the DUP, to support her exit plan.⁹ The EU is indicating that the U.K. can extend the deadline to July 1 and not participate in May's EU Parliamentary elections.¹⁰ Otherwise, the U.K. would be required to participate in the vote, which is not the EU's preference. EU officials fear British participation would bolster the populist cause.

But, the most interesting insight on the issue may be a recent election in Fall River, MA, of all places.¹¹ The mayor of the town, Jasiel Correia, was accused of defrauding investors, including some local residents, in a marketing app scheme. Because of his alleged transgressions, the town mustered enough signatures to trigger a recall vote. Correia, who denies any wrongdoing, was decisively voted out of office. He received 38% support, or 4,911 votes; obviously, 62% of the electorate opposed him. Thus, the recall effort was successful and he was removed from office.

However, the good citizens of Fall River needed a mayor if the recall effort was successful so they held a second ballot simultaneously with the first. Correia boldly ran for mayor against four other candidates. In the second ballot, he received about the same level of support but because of the multiplicity of candidates he won the mayoral race. So, on the same day, Correia was ousted and elected to office.

So, how did this happen? The Fall River vote highlights a weakness in voting. Voting as a decision process is only effective if the choices are clear. Otherwise, voting can lead to indeterminate outcomes. That is why many nations use a run-off vote after an initial voting round to clarify choices. Other political entities have tested rank choice voting,¹² where voters list their preferences if there are multiple candidates. This weighted preference method tends to be better for situations of multiple candidates or voting decisions.

The Brexit referendum was poorly constructed. The way the vote was perceived was either the status quo or something different. Voters who were unhappy with their economic or social condition opted to leave. But, the leave decision is actually quite complicated because what that looks like was never fully expressed. In recent voting, Parliament has told us that it doesn't like May's plan, but it doesn't want a hard break either. Much like the Fall River vote, British voters opted for one outcome, to leave, but there probably isn't a majority for any other outcome. In Fall River, voters paradoxically voted to remove and elect the same man on the same day. With Brexit, voters opted to exit the EU but with no clear preference for what comes next.

⁹ <https://www.ft.com/content/449be1d0-4899-11e9-bbc9-6917dce3dc62?emailId=5c8f15f2584aeb00046099a6&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22> and <https://www.ft.com/content/4a10a60e-48b3-11e9-bbc9-6917dce3dc62?emailId=5c8f15f2584aeb00046099a6&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22>

¹⁰ https://www.politico.eu/article/document-brexit-by-july-1-unless-uk-votes-in-eu-election/?utm_source=POLITICO.EU&utm_campaign=3bf9274f14-EMAIL_CAMPAIGN_2019_03_18_05_49&utm_medium=email&utm_term=0_10959edeb5-3bf9274f14-190334489 and <https://www.ft.com/content/030dce3c-4749-11e9-a965-23d669740bfb>

¹¹ <https://www.nytimes.com/2019/03/16/world/europe/brexit-referendums.html>

¹² <https://www.fairvote.org/rcv#where-is-ranked-choice-voting-used>

Perhaps PM May’s plan, after all, is the best there is to offer. It won’t garner a preference of the majority but it may be the best outcome that can be negotiated. If a new referendum is held, a rank choice vote may at least reveal a plurality that the British people and the EU can live with.

An interesting twist on bitcoin: Bitcoin has become popular in nations with capital controls or currencies in collapse due to hyperinflation. Venezuela has both conditions. Another coincidence is that Venezuela has cheap electricity due to hydropower. Bitcoin mining absorbs a tremendous amount of electricity. As a result, despite the government’s effort to prevent the use of bitcoin, which included the creation of its own cryptocurrency, Venezuelans have tried to produce bitcoin in a bid to create a store of value. The recent power outage has created a crisis in bitcoin mining, which led to a 40% decline in volume.¹³

The Cheollima Civil Defense: A group¹⁴ by this name infiltrated the North Korean Embassy in Madrid during the Trump/Kim summit in Vietnam. The shadowy group, which wants to oust the Kim regime, briefly took control of the embassy and got away with a treasure trove of confidential information. We will continue to monitor this group going forward.

U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below lists the economic releases scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	NAHB Housing Market Index	m/m	mar	63	62	**
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.

¹³ <https://bitcoinist.com/bitcoin-trading-plummets-in-venezuela-blackout-as-government-struggles-to-pay-money-printers/>

¹⁴ https://www.washingtonpost.com/world/national-security/a-shadowy-group-trying-to-overthrow-kim-jong-un-raided-a-north-korean-embassy-in-broad-daylight/2019/03/15/ae4208a4-c451-4886-b608-f5ac1f182d3d_story.html?utm_term=.babdc8624b28

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
China	FX Net Settlement- Clients CNY	y/y	feb	-102.3 bn	103.1 bn		**	Equity and bond neutral
Japan	Trade Balance	y/y	feb	¥0.339 bn	-¥1.415 tn		**	Equity bullish, bond bearish
	Tokyo Condominium Sales	y/y	feb	-6.7%	-1.8%		**	Equity and bond bearish
	Industrial Production	y/y	jan	0.3%	0.0%		**	Equity and bond neutral
	Capacity Utilization	m/m	jan	-4.7%	-1.9%		**	Equity and bond bearish
India	Trade Balance	m/m	feb	-\$9.595 bn	-\$14.725 bn	-\$13.700 bn	**	Equity bullish, bond bearish
New Zealand	Performance Services Index	m/m	feb	53.8	56.3		**	Equity and bond neutral
	Non Resident Bond Holdings	m/m	feb	55.2%	54.1%		**	Equity bullish, bond bearish
EUROPE								
Eurozone	Trade Balance	m/m	jan	17.0 bn	15.6 bn	15.0 bn	**	Equity bullish, bond bearish
UK	Rightmove House Prices	y/y	mar	-0.8%	0.2%		*	Equity and bond neutral
Switzerland	Total Sight Deposits	m/m	mar	576.0 bn	576.1 bn		*	Equity and bond neutral
	Domestic Sight Deposits	m/m	mar	488.6 bn	487.6 bn		*	Equity and bond neutral
AMERICAS								
Canada	Manufacturing Sales	y/y	jan	1.0%	-1.3%	0.4%	**	Equity bullish, bond bearish
	Existing Home Sales	y/y	jan	-9.1%	3.6%	-4.0%	**	Equity and bond bearish
Brazil	FGV Inflation IGP-10	y/y	mar	2.1%	-0.2%	1.8%	***	Equity bearish, bond bullish

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)	263	261	2	Up
3-mo T-bill yield (bps)	239	239	0	Neutral
TED spread (bps)	24	22	2	Neutral
U.S. Libor/OIS spread (bps)	240	240	0	Up
10-yr T-note (%)	2.59	2.59	0.00	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	8	8	0	Down
Currencies	Direction			
dollar	down			Neutral
euro	up			Up
yen	flat			Neutral
pound	down			Neutral
franc	up			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	\$67.22	\$67.16	0.09%	
WTI	\$58.46	\$58.52	-0.10%	
Natural Gas	\$2.78	\$2.80	-0.57%	
Crack Spread	\$21.04	\$20.86	0.89%	
12-mo strip crack	\$16.95	\$16.87	0.47%	
Ethanol rack	\$1.46	\$1.45	0.38%	
Metals				
Gold	\$1,305.84	\$1,302.40	0.26%	
Silver	\$15.36	\$15.29	0.45%	
Copper contract	\$292.70	\$290.60	0.72%	
Grains				
Corn contract	\$ 373.50	\$ 373.25	0.07%	
Wheat contract	\$ 458.25	\$ 462.25	-0.87%	
Soybeans contract	\$ 906.25	\$ 909.25	-0.33%	
Shipping				
Baltic Dry Freight	730	677	53	

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.

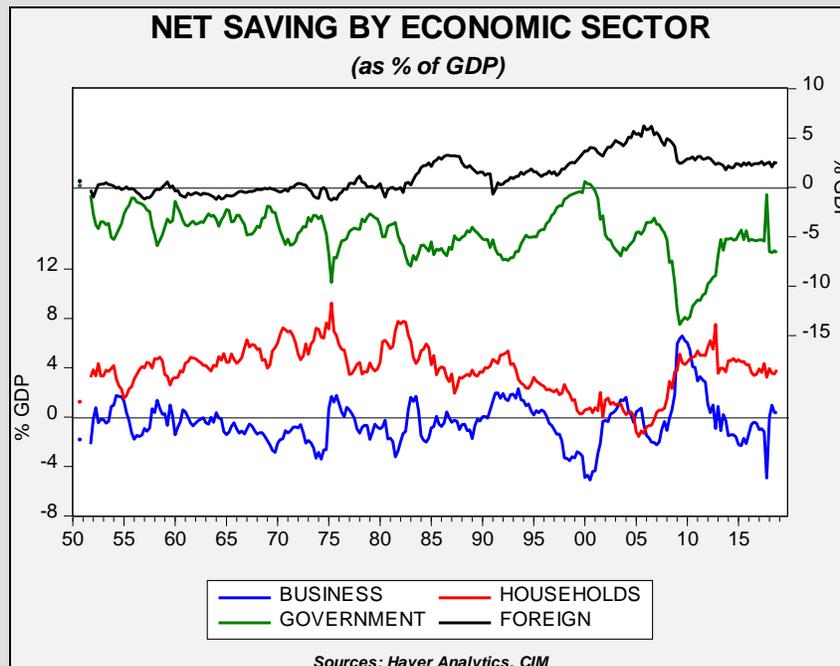
Asset Allocation Weekly Comment

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

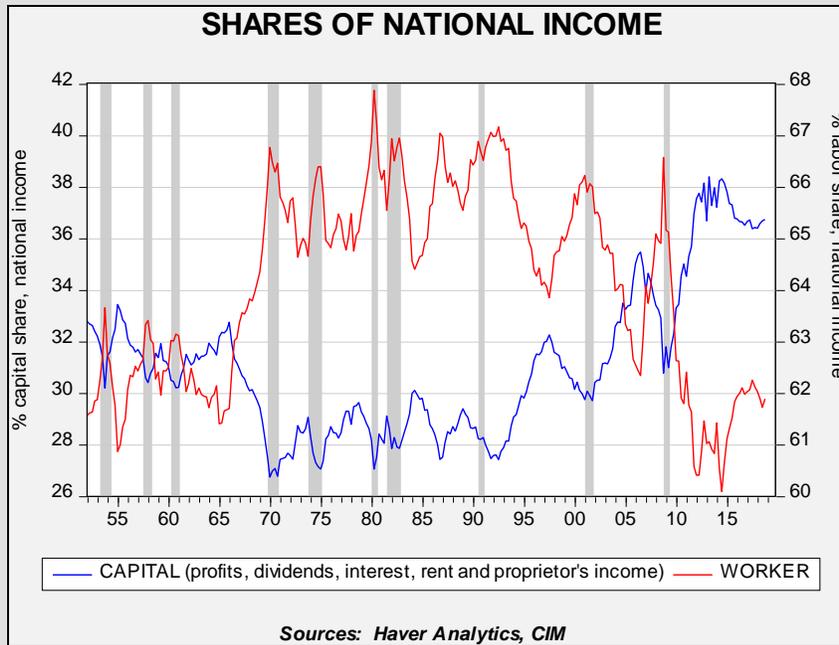
The Financial Accounts of the United States, formerly known as the Flow of Funds Report, was released last week. It is a plethora of information about the state of the economy. Below we discuss the charts we find most noteworthy.

First, here is the saving balance by sector.



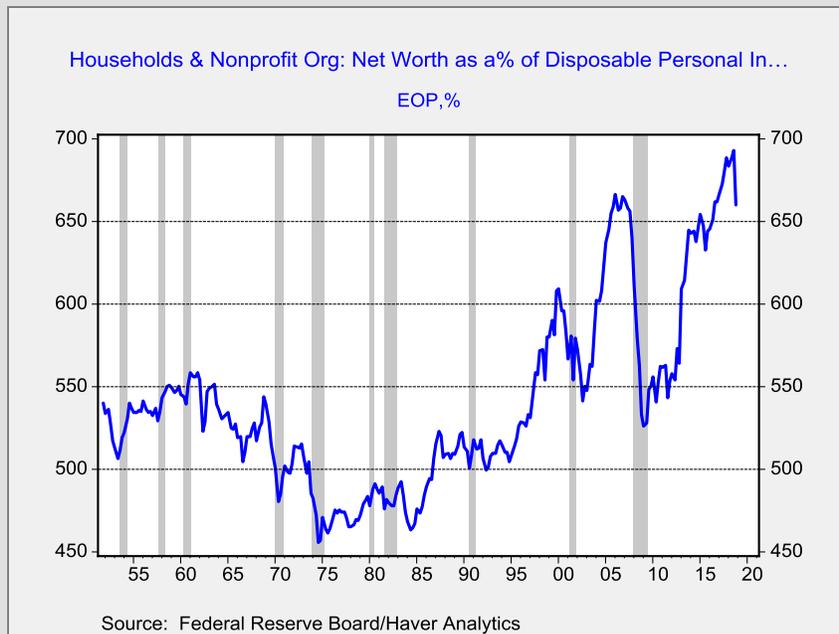
The tax cut has led to an increase in business saving and a wider fiscal deficit. Household and foreign saving was essentially unchanged. We are watching to see if the administration’s trade policy reduces the trade deficit; if it does, then foreign saving, the inverse of the trade deficit, will decline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



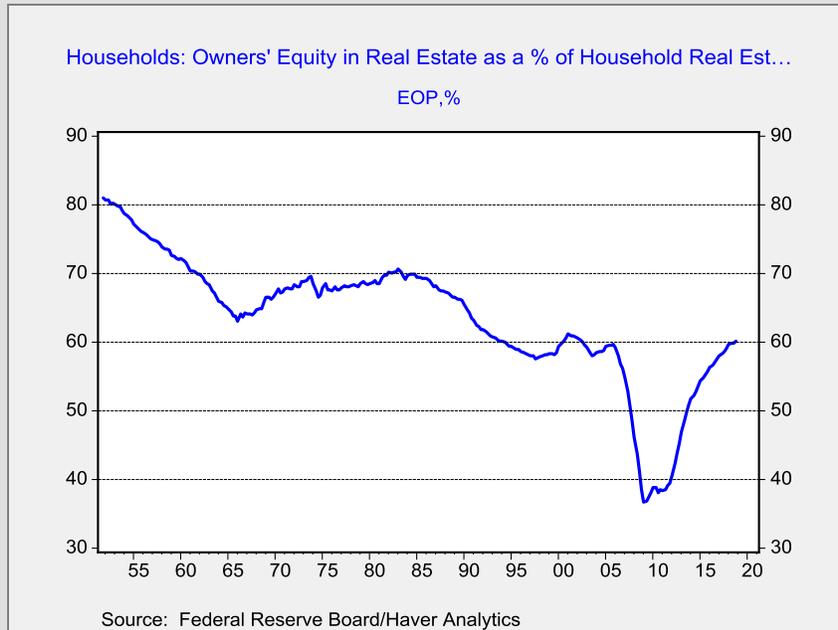
Since the end of communism in the early 1990s, capital has been taking a steadily larger share of national income. In each expansion, the capital share has made a higher peak.

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

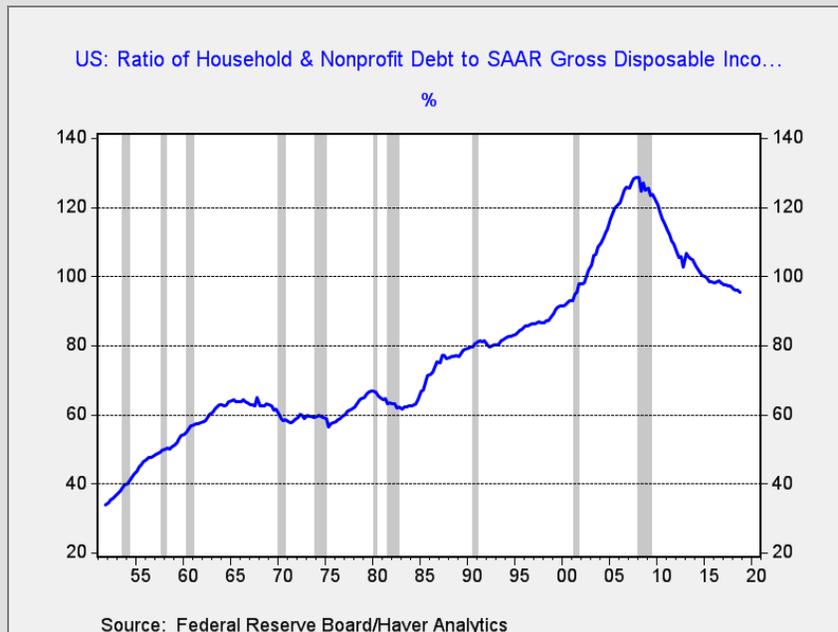


Net worth relative to after-tax income took a dive in Q4; the recent recovery in equity markets should reverse this dip, but we do note that in previous cycles such declines tended to signal that the business cycle was coming to a close.

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.

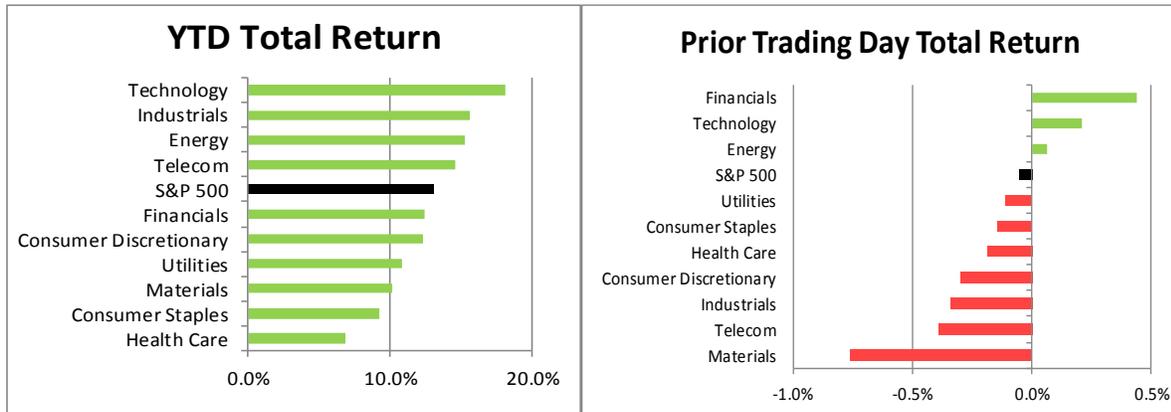
This chart shows household debt as a percentage of after-tax income. From the early 1980s into 2005, household debt rose steadily. The Great Financial Crisis led households to lower their debt levels relative to income. Although there is no generally accepted level that signals when deleveraging has 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.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

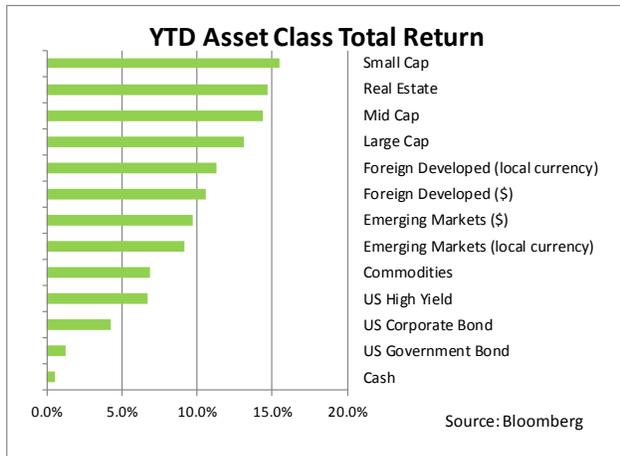
U.S. Equity Markets – (as of 3/15/2019 close)



(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 3/15/2019 close)



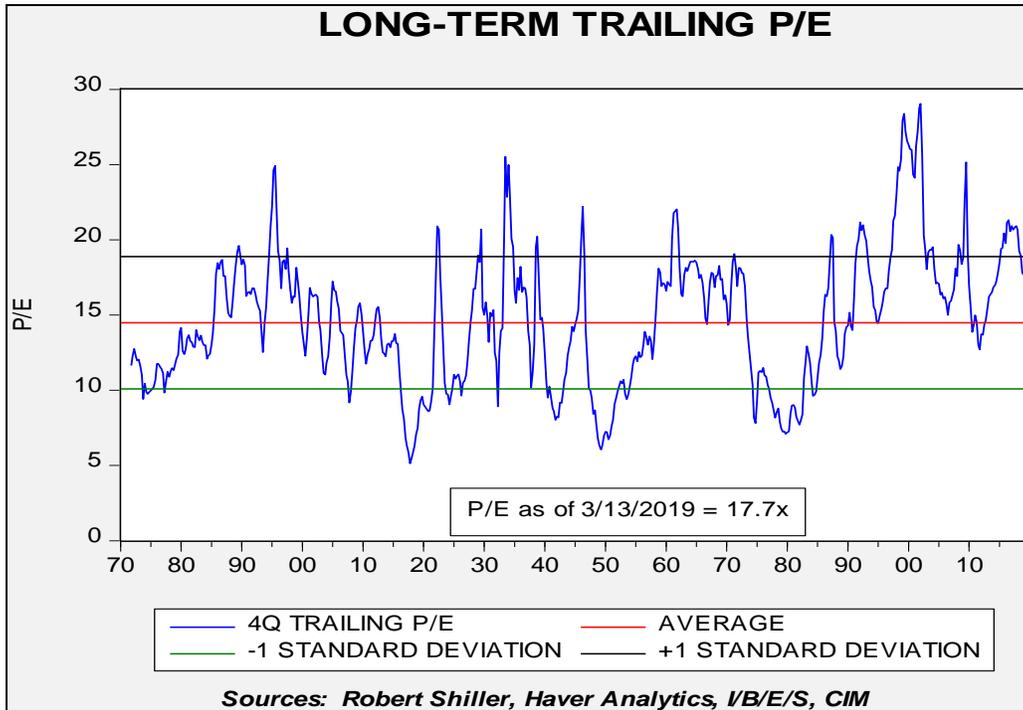
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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.

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.