Daily Comment

By Bill O'Grady and Thomas Wash

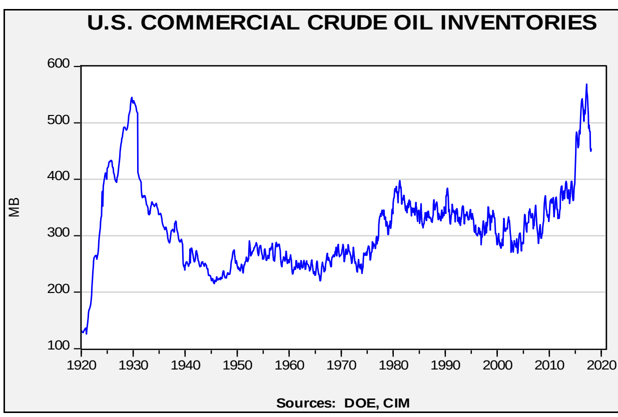
Looking for something to read? See our Reading List; these books, separated by category, are ones we find interesting and insightful. We will be adding to the list over time.

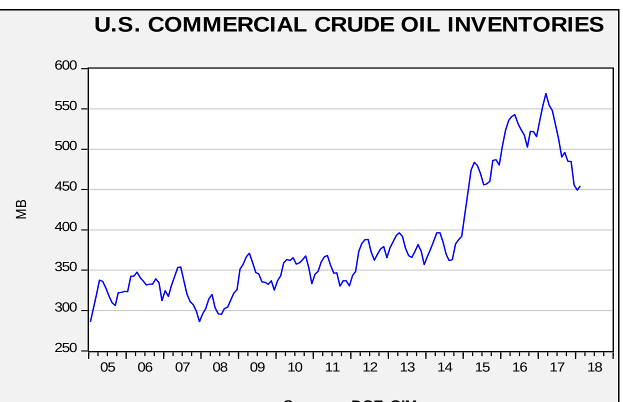
[Posted: March 1, 2018—9:30 AM EST] Global equity markets are generally mixed this morning. The EuroStoxx 50 is down 1.0% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.3% from the prior close. Chinese markets were higher, with the Shanghai composite up 0.4% and the Shenzhen index up 1.2%. U.S. equity index futures are signaling a lower open. With 470 companies having reported, the S&P 500 Q4 earnings stand at $36.15, higher than the $34.84 forecast for the quarter. The forecast reflects a 10.7% increase from Q4 2016 earnings and a 4.2% increase from Q3 2017. Thus far this quarter, 74.0% of the companies reported earnings above forecast, while 17.4% reported earnings below forecast.

Risk assets are coming under pressure this morning as equities struggle. Here is what we are watching today:

Powell, Part 2: Chair Powell testifies before the Senate Banking Committee today. Usually, the second testimony is not closely watched; after all, we have already seen the formal testimony and Q&A either a day or two before and accordingly there shouldn't be much new information. However, we have seen instances when a Fed chair, concerned that the financial markets misunderstood the earlier message, attempts to adjust market expectations. Thus, if Powell didn't intend to signal that a fourth hike is possible this year, look for him to make a point that inflation remains under control despite economic strength. He can make this case fairly easily with the Fed's preferred measure of inflation, core PCE, remaining below target (see discussion below).

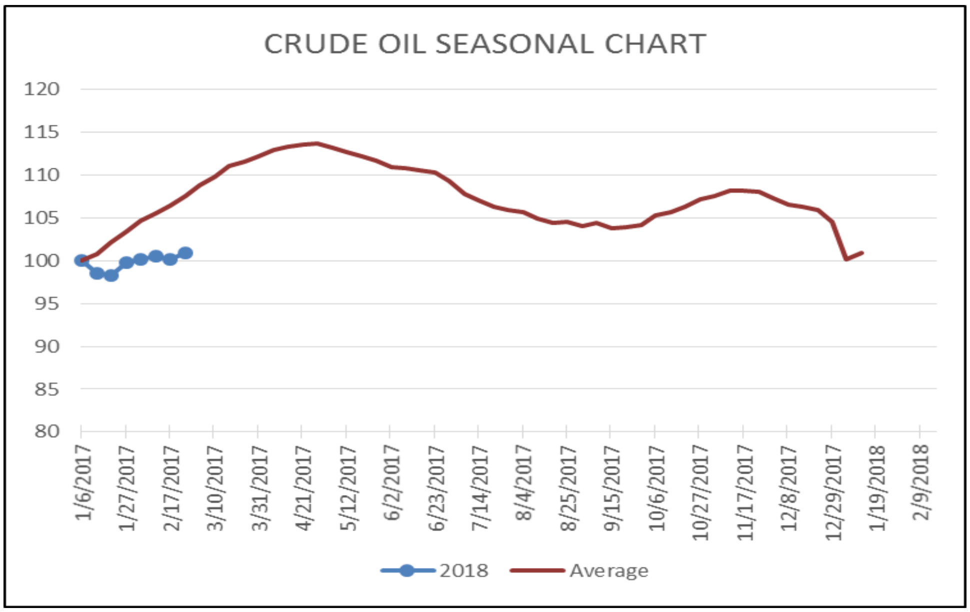
Energy recap: U.S. crude oil inventories rose 3.0 mb compared to market expectations of a 2.0 mb build.



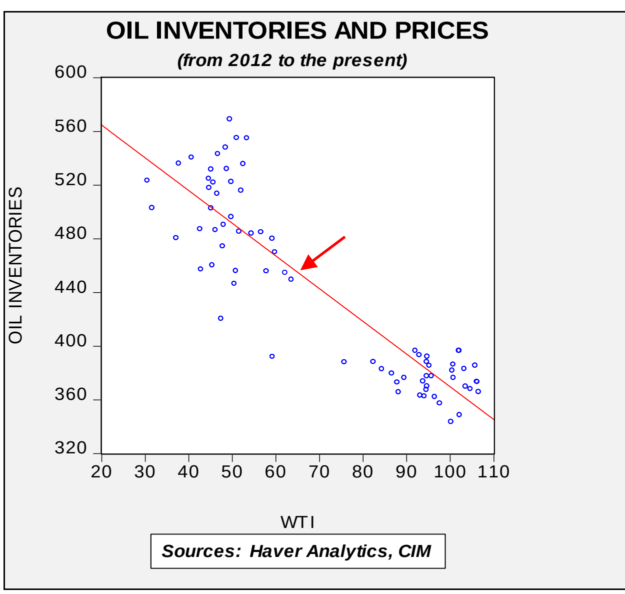


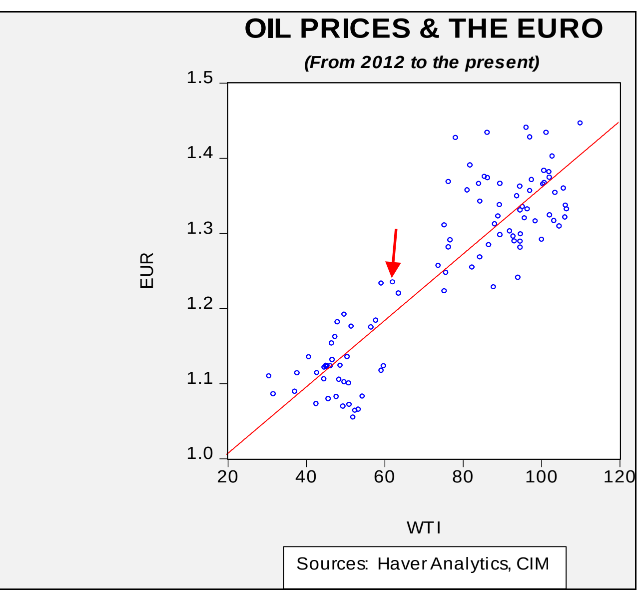
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but have declined significantly since last March. We would consider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

As the seasonal chart below shows, inventories are usually rising this time of year. What we are seeing is very bullish—the usual seasonal build in stockpiles isn't occurring this year. The longer this continues, the more fundamentally bullish this becomes; thus, even with the higher than expected build this week, it is important to realize that the change in stockpiles is well below where it should be.



(Source: DOE, CIM)

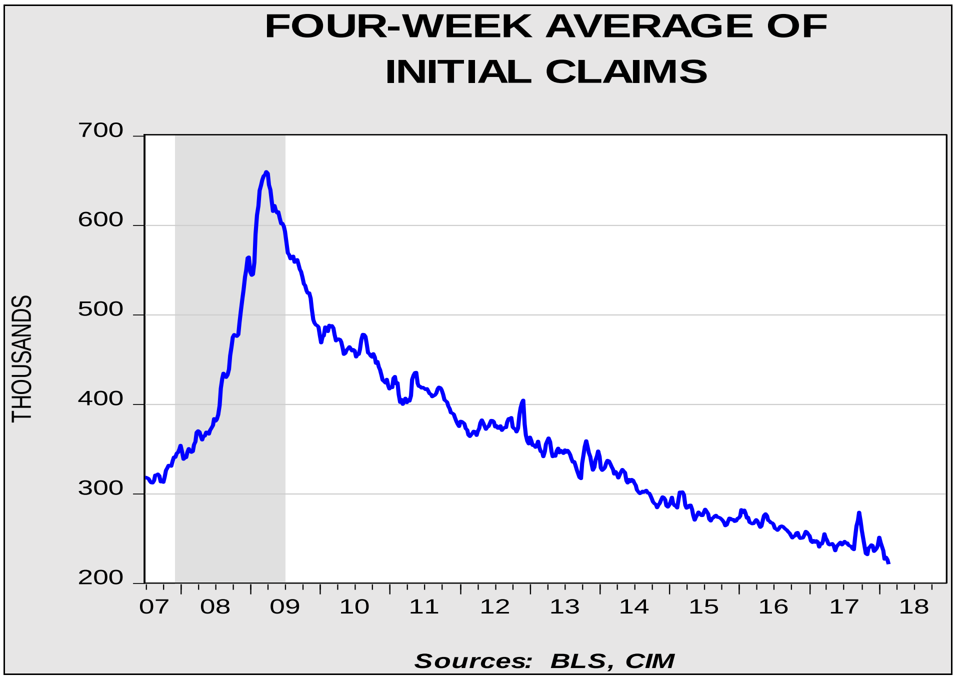




Based on inventories alone, oil prices are undervalued with the fair value price of $66.37. Meanwhile, the EUR/WTI model generates a fair value of $75.32. Together (which is a more sound methodology), fair value is $72.55, meaning that current prices are below fair value.

U.S. Economic Releases

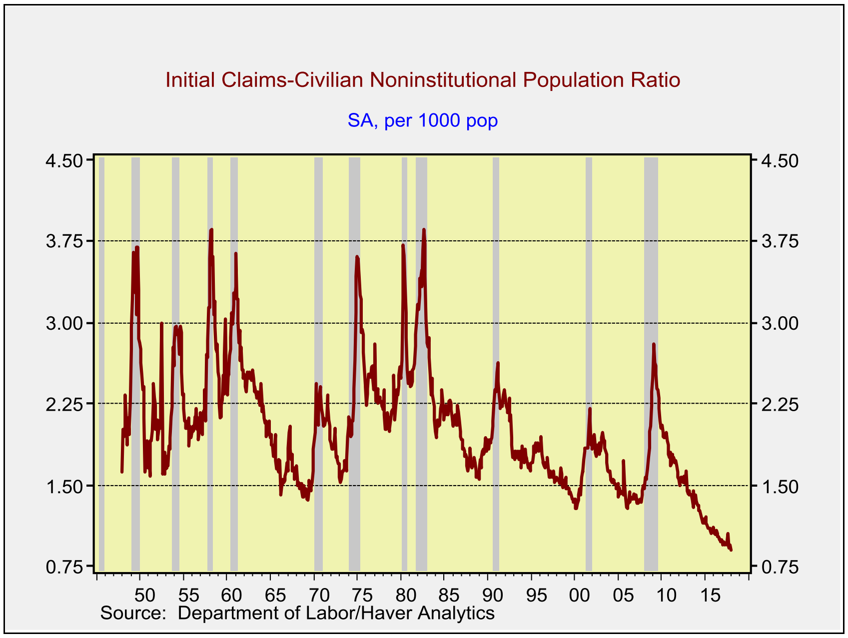
Initial jobless claims came in below expectations at 210k compared to the forecast of 225k. The prior week's report was revised downward from 222k to 220k.



The chart above shows the four-week moving average of initial jobless claims. The four-week moving average fell from 225.5 to 220.5. This is the lowest level of claims since 1969.

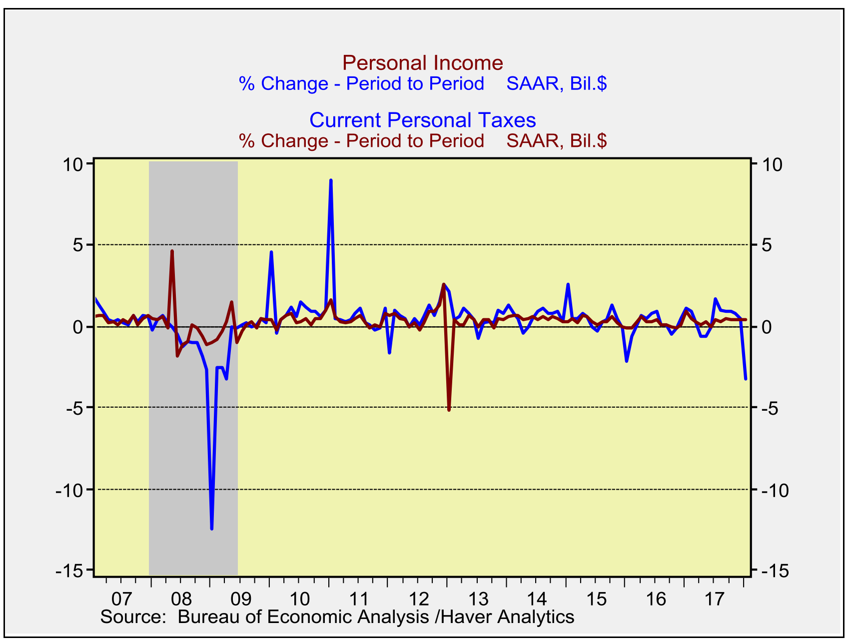
To get further perspective, the level of unemployment insurance claims per 1,000 persons of the civilian non-institutional population hit an all-time low last month. As the chart below shows, there is less than one claim for unemployment insurance per each 1,000 members of the non-institutional population. The denominator includes all Americans over the age of 16 who are not (a) in the military on active duty, or (b) in prison. Given this most recent reading on claims, we would expect this ratio to make a new low. This number below is rather astounding—it suggests very little labor slack and, at the same time, very little "churn." In other words, workers seem to be staying where they are and firms seem willing to keep them around. One reason why churn seems low and wages under control despite the low level of slack is industry concentration.[1]

[1] https://mobile.nytimes.com/2018/02/28/opinion/corporate-america-suppressing-wages.html?action=click&pgtype=Homepage&clickSource=story-heading&module=opinion-c-col-left-region%C2%AEion=opinion-c-col-left-region&WT.nav=opinion-c-col-left-region&referer=https://t.co/VrglBfu3uk?amp=1



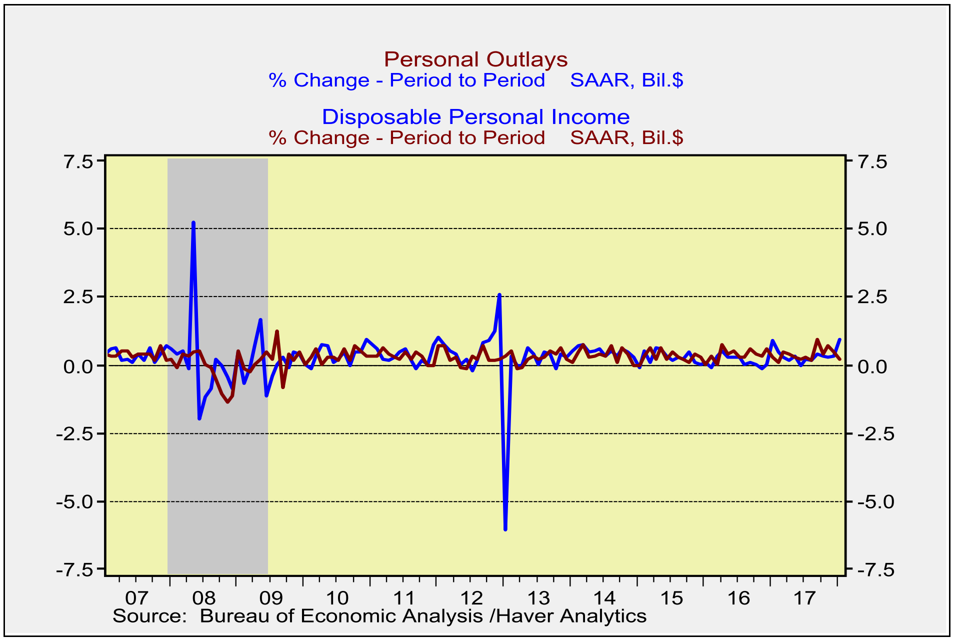
Personal income came in above expectations, rising 0.4% from the prior month compared to the forecast of 0.3%. Personal spending came in line with expectations, rising 0.2% from the prior month. Real personal spending came in line with expectations, falling 0.1% from the prior month. The prior report's gain was revised downward from 0.3% to 0.2%.

The impact of the tax cut does appear in the data.

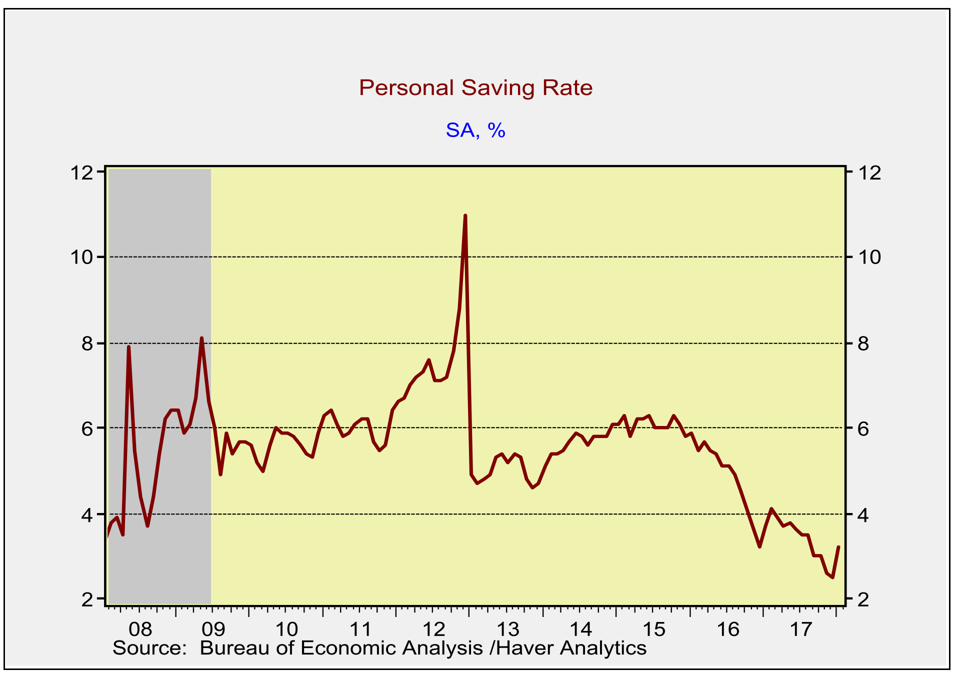


This chart shows the monthly change in overall personal income and the change in taxes paid. Note the sharp drop in taxes paid; it fell 3.3% from December.

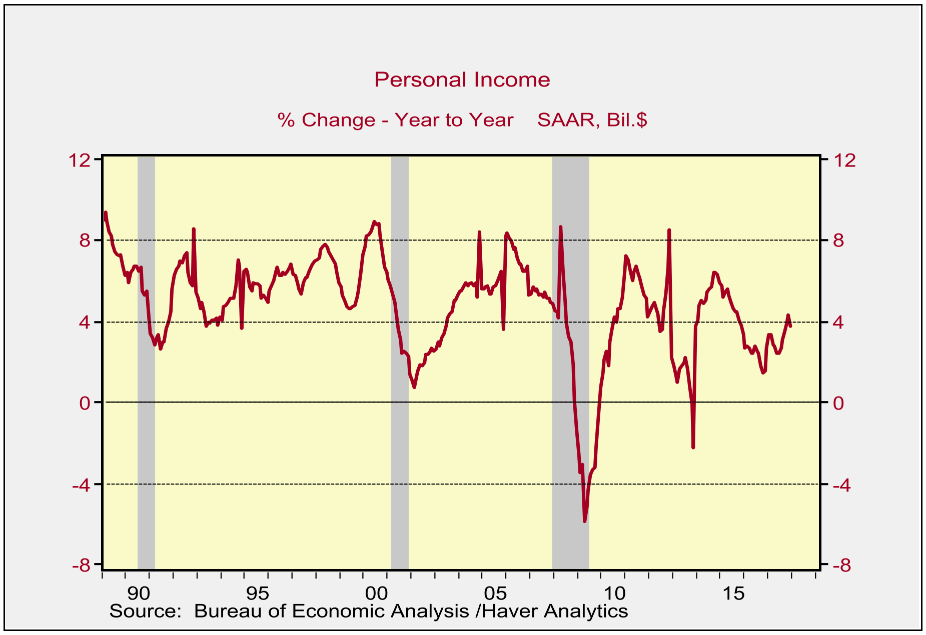
After-tax income rose 0.9% but spending rose a mere 0.2%.



These changes lifted the savings rate.

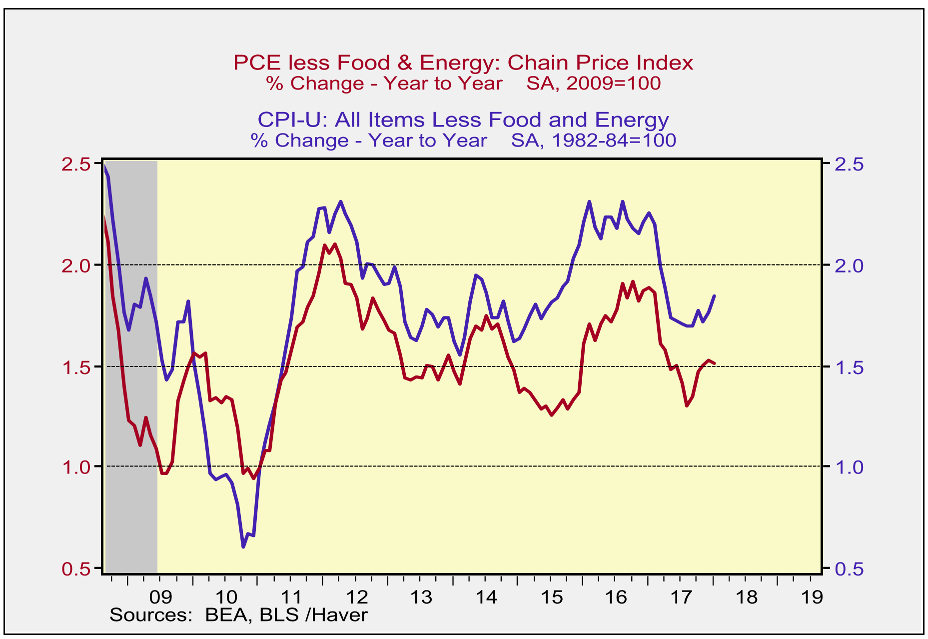


We would expect increased spending in the coming months as households begin to adjust to lower taxes. However, for now, it appears that most of the tax cut has been saved.



The chart above shows the year-over-year change in personal income.

The PCE deflator was in line with expectations, rising 0.4% from the prior month. Core PCE was also in line with expectations, rising 0.3% from the prior month.



The chart above shows the year-over-year change in core PCE and core CPI. Annual core PCE and core CPI rose 1.5% and 1.8%, respectively. Relatively low inflation still remains a puzzle for policymakers. Tomorrow's Asset Allocation Weekly Comment will have some thoughts on the inflation issue.

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		56.6	**
9:45	Markit US Manufacturing PMI	m/m	feb	55.9	55.9	**
10:00	Construction Spending	m/m	jan	0.3%	0.2%	**
10:00	ISM Manufacturing	m/m	feb	58.7	59.1	**
10:00	ISM Prices Paid	m/m	feb		54.2	**
10:00	ISM New Orders	m/m	feb	70.0	72.7	**
10:00	ISM Employment	m/m	feb		65.4	**
	Wards Total Vehicle Sales	m/m	jan	13.30 mn	13.10 mn	**
	Wards Domestic Vehicle Sales	m/m	jan	17.20 mn	17.07 mn	**
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	y/y	feb	¥201.3 bn	-¥553.1 bn		*	Equity and bond neutral
	Japan buying foreign stocks	y/y	feb	¥45.0 bn	-¥587.1 bn		*	Equity and bond neutral
	Foreign buying Japan bonds	y/y	feb	¥20.6 bn	-¥789.5 bn		*	Equity and bond neutral
	Foreign buying Japan stocks	y/y	feb	-¥53.6 bn	¥127.1 bn		*	Equity and bond neutral
	Capital Spending	m/m	4q	4.3%	4.2%	3.0%	**	Equity bullish, bond bearish
	Capital Spending ex Software	m/m	4q	4.7%	4.3%	2.7%	**	Equity bullish, bond bearish
	Nikkei Japan PMI	m/m	feb	54.1	54.0		**	Equity and bond neutral
India	GDP	m/m	4q	7.2%	6.3%	7.0%	***	Equity bullish, bond bearish
New Zealand	ANZ Job Advertisements	m/m	feb	-1.2%	3.1%		**	Equity and bond neutral
	Terms of Trade Index	q/q	4q	0.8%	0.7%	0.5%	**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Manufacturing	y/y	feb	58.6	58.5	58.5	**	Equity bullish, bond bearish
	Unemployment rate	y/y	feb	8.6%	8.7%	8.6%	***	Equity and bond neutral
Italy	Markit/ADACI Italy Manufacturing	y/y	feb	56.8	59.0	58.0	**	Equity and bond neutral
	Unemployment rate	y/y	jan	11.1%	10.8%	10.8%	***	Equity bearish, bond bullish
	GDP	y/y	2017	1.5%	0.9%	1.5%	***	Equity and bond neutral
	Deficit to GDP	y/y	2017	1.9%	2.4%		***	Equity and bond neutral
Germany	Markit/BME Germany Manufacturing	m/m	feb	60.6	60.3	60.3	**	Equity and bond neutral
France	Markit France Manufacturing PMI	m/m	feb	55.9	56.1	56.1	**	Equity and bond neutral
U.K.	Markit UK PMI Manufacturing	m/m	feb	55.2	55.3	55.0	**	Equity and bond neutral
Switzerland	GDP	q/q	4q	0.6%	0.6%	0.5%	***	Equity and bond neutral
Russia	Markit Russia PMI Manufacturing	m/m	feb	50.2	52.1	52.0	**	Equity and bond neutral
AMERICAS								
Brazil	GDP	q/q	4q	0.1%	0.1%	0.3%	**	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)	201	198	3	Up
3-mo T-bill yield (bps)	161	163	-2	Neutral
TED spread (bps)	39	36	3	Neutral
U.S. Libor/OIS spread (bps)	162	161	1	Up
10-yr T-note (%)	2.83	2.86	-0.03	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	37	34	3	Down
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	up			Up
pound	down			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	$64.20	$64.73	-0.82%	Bearish EIA report
WTI	$61.24	$61.64	-0.65%	
Natural Gas	$2.65	$2.67	-0.75%	
Crack Spread	$18.86	$18.90	-0.20%	
12-mo strip crack	$17.60	$17.69	-0.51%	
Ethanol rack	$1.54	$1.54	-0.05%	
Metals				
Gold	$1,306.96	$1,318.31	-0.86%	Stronger dollar
Silver	$16.25	$16.42	-1.01%	
Copper contract	$311.15	$313.25	-0.67%	
Grains				
Corn contract	$ 379.75	$ 382.00	-0.59%	
Wheat contract	$ 490.00	$ 495.00	-1.01%	
Soybeans contract	$ 1,052.75	$ 1,055.50	-0.26%	
Shipping				
Baltic Dry Freight	1192	1188	4	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	3.0	2.0	1.0	
Gasoline (mb)	2.5	1.0	1.5	
Distillates (mb)	-1.0	-0.9	-0.1	
Refinery run rates (%)	-0.30%	-0.30%	0.0%	
Natural gas (bcf)		-69.0		

Weather

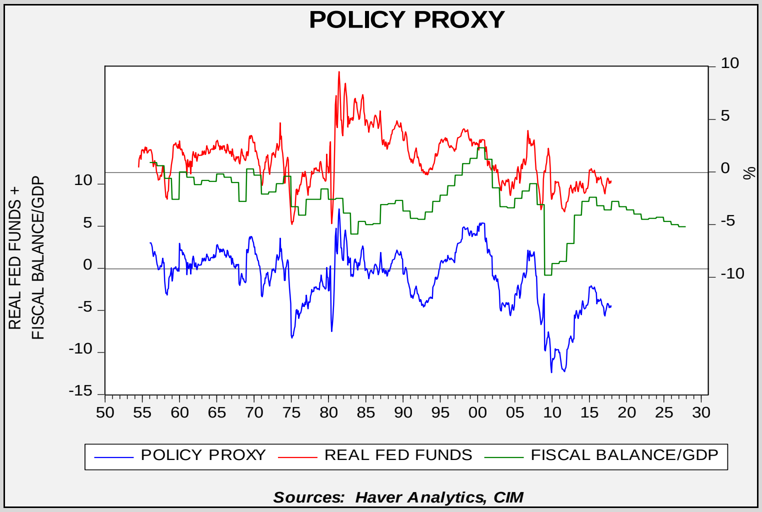
The 6-10 and 8-14 day forecasts continue to signal colder than normal temperatures for much of the nation.

Asset Allocation Weekly Comment

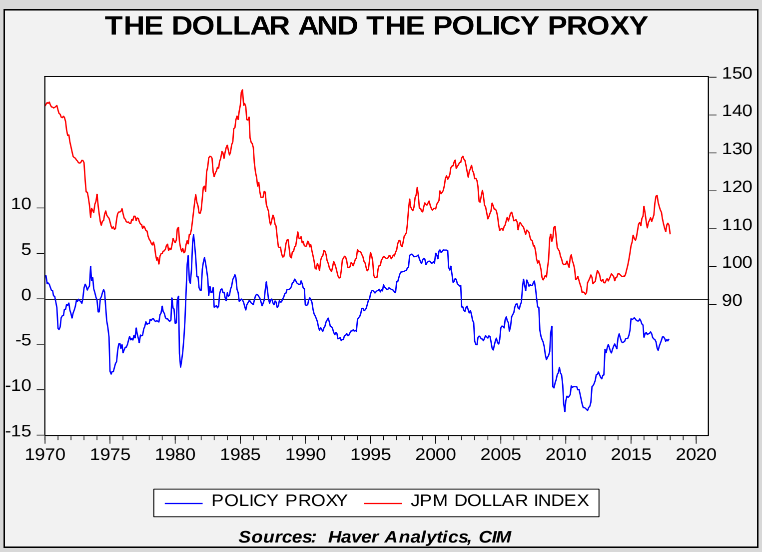
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

February 23, 2018

Last week, we discussed the impact of the growing fiscal deficit on the economy and markets. We did note that fiscal deficits have tended to weaken the dollar. This week, we want to expand on that analysis. To start, we note that fiscal policy does not operate in a vacuum. To measure the combined effect of monetary and fiscal policies, we added real fed funds (fed funds less yearly change in CPI) and the fiscal deficit as a percentage of GDP to create a policy proxy variable. Real fed funds offset the impact of inflation and scaling the fiscal account to GDP shows the relative effect of fiscal policy.



The lower line of the chart is the sum of the upper two lines on the chart. The thesis is that policy is stimulative when the lower line is rising.



This chart shows the policy proxy with the JPM dollar index. The pattern seems to be that the dollar appreciates when policy tightens with at least a two- or three-year lag. The "Volcker dollar" rally in the early 1980s was due to the combination of very high interest rates and rising fiscal deficits. The dollar bull market from 1995 to 2002 was due to the combination of rather tight monetary and fiscal policies. The most recent bull market, surprisingly, was tight fiscal policy (especially in light of the sluggish economy) and rather easy monetary policy.

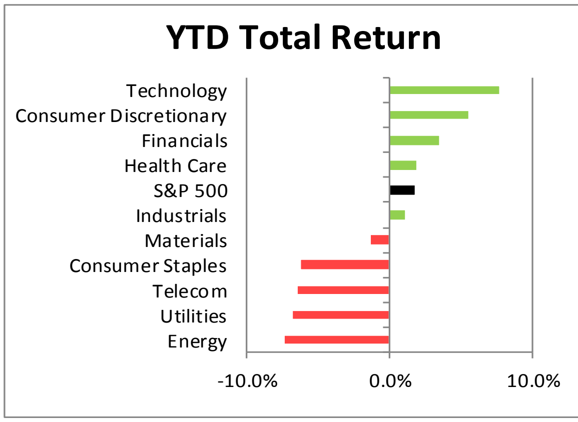
The first chart shows the Congressional Budget Office's estimate for the future deficit. If the FOMC does not significantly tighten monetary policy in the coming months, it looks like the dollar could come under pressure. Obviously, if we were to get a repeat of Chair Volcker's monetary policy, we would be bullish on the greenback. However, we strongly doubt monetary policy will be that tight. After all, real fed funds approached 10% in 1991. And, if the economy were to weaken, the fiscal deficit would widen more than expected due to the automatic spending that comes from higher unemployment insurance and other income support and the lower revenue for falling tax receipts.

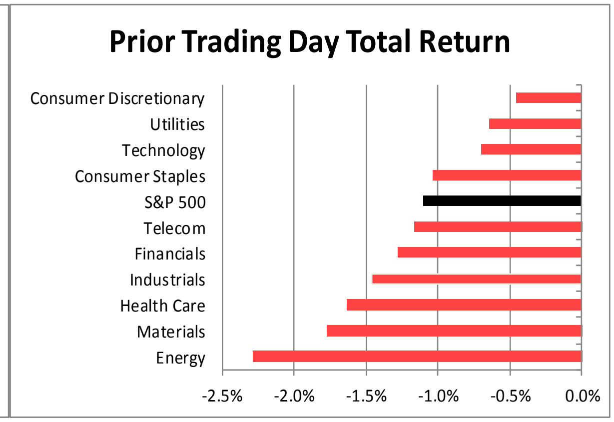
Given the dollar's current parity overvaluation, as we discussed earlier this month,[2] the current fiscal expansion and continued accommodative monetary policy have the potential to exacerbate the weakening dollar. A weak dollar is bullish for foreign equities and commodities, and usually boosts large capitalization stocks relative to small capitalization stocks. The policy proxy is also suggesting steady headwinds for the dollar in the coming years. Given how rarely changes occur in fiscal policy, we don't expect major changes on that front anytime soon. Although monetary policy will likely tighten, it will take significant increases in the fed funds target to offset the overvaluation noted in the parity analysis discussed in an earlier report and the widening fiscal deficit. Thus, we look for dollar weakness to be a factor this year and into 2019.

[2] See Asset Allocation Weekly, 2/2/18.

<u>Data Section</u>

U.S. Equity Markets – (as of 2/28/2018 close)

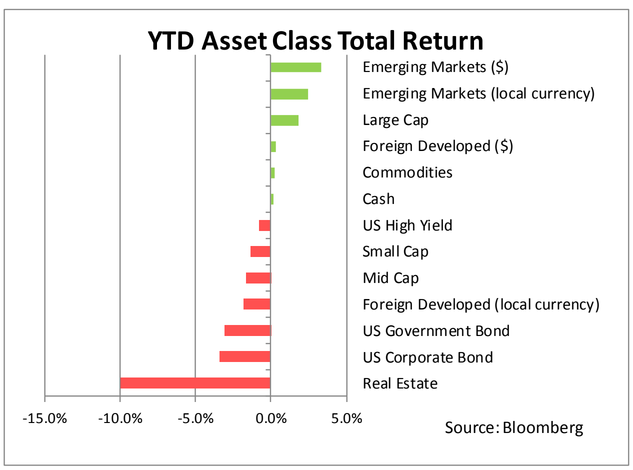




(Source: Bloomberg)

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 2/28/2018 close)

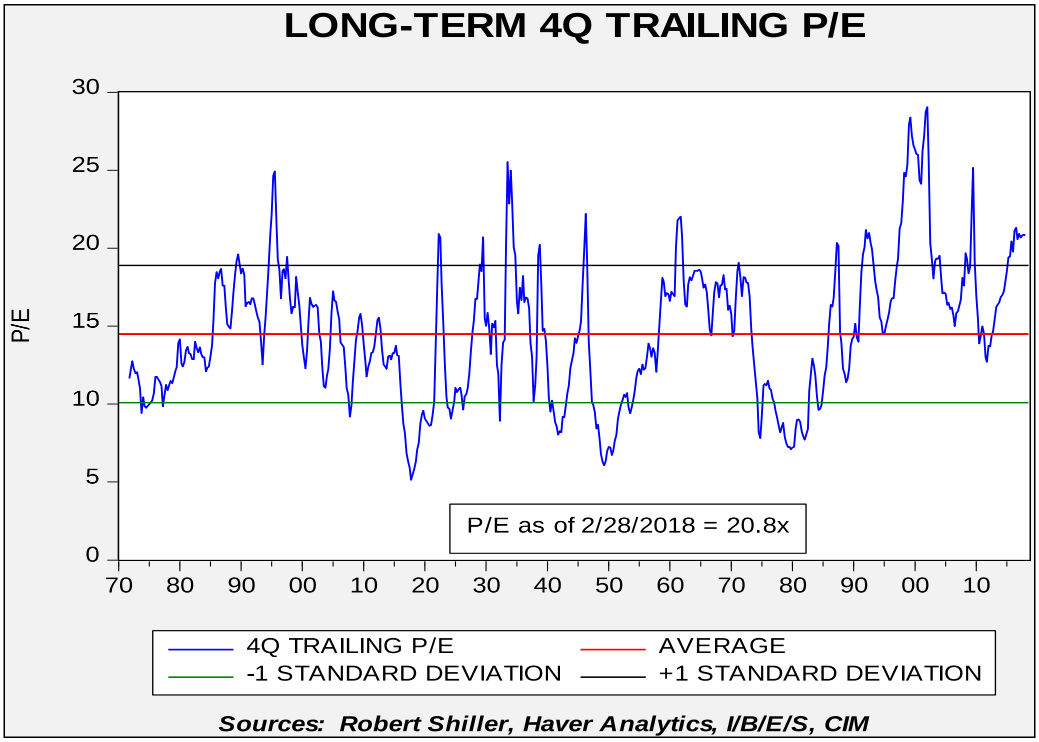


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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).

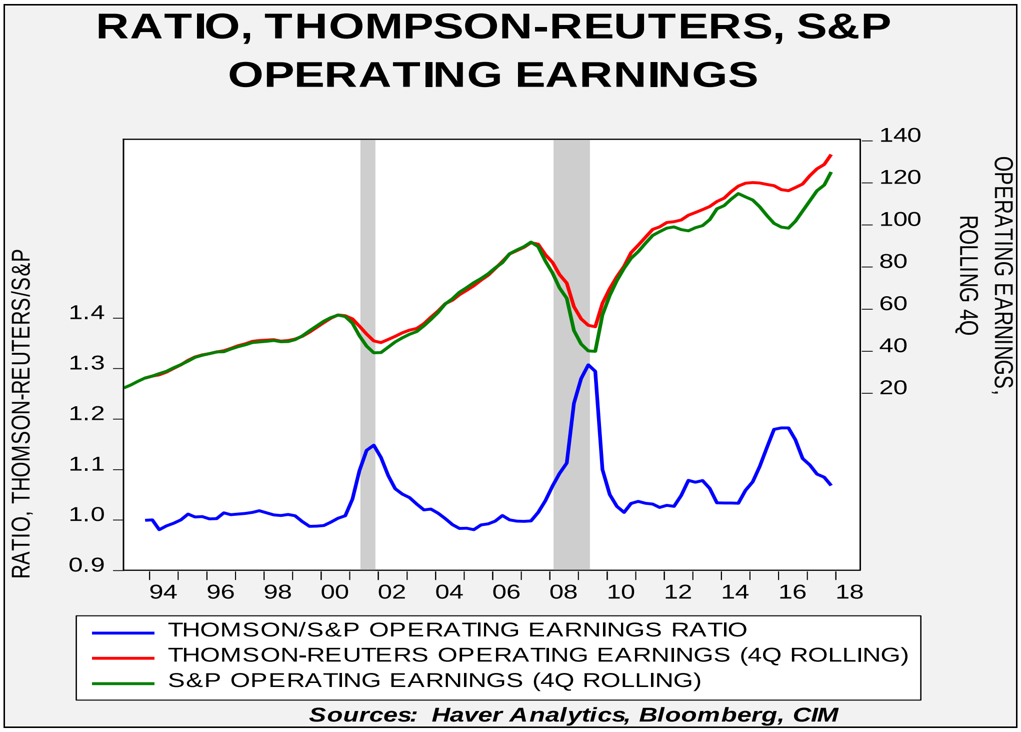
P/E Update

March 1, 2018



Based on our methodology,[3] the current P/E is 20.8, up 0.3x from last week. The rise in the P/E is due to switching to S&P operating earnings for Q4 instead of Thomson/Reuters. The chart on the next page shows that the Thomson/Reuters operating earnings data has tended to outpace the S&P operating number during this bull market. As the chart below shows, the gap between the two measures has continued to narrow as the S&P operating earnings calculation lags the Thomson/Reuters number by 6.7%.

[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.



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.