Daily Comment

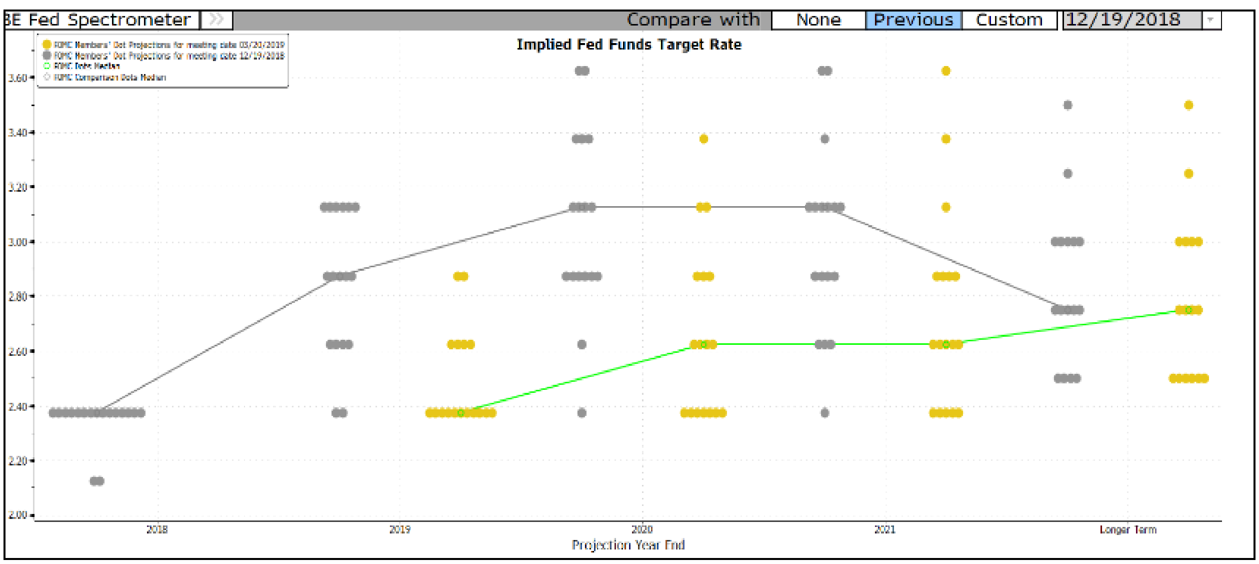
By Bill O'Grady and Thomas Wash

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 21, 2019—9:30 AM EDT] Global equity markets are generally mixed this morning. The EuroStoxx 50 is unchanged from the last close. In Asia, the MSCI Asia Apex 50 was up 0.1% from the prior close. Chinese markets were up, with the Shanghai composite up 0.4% and the Shenzhen index up 0.8%. U.S. equity index futures are signaling a lower open.

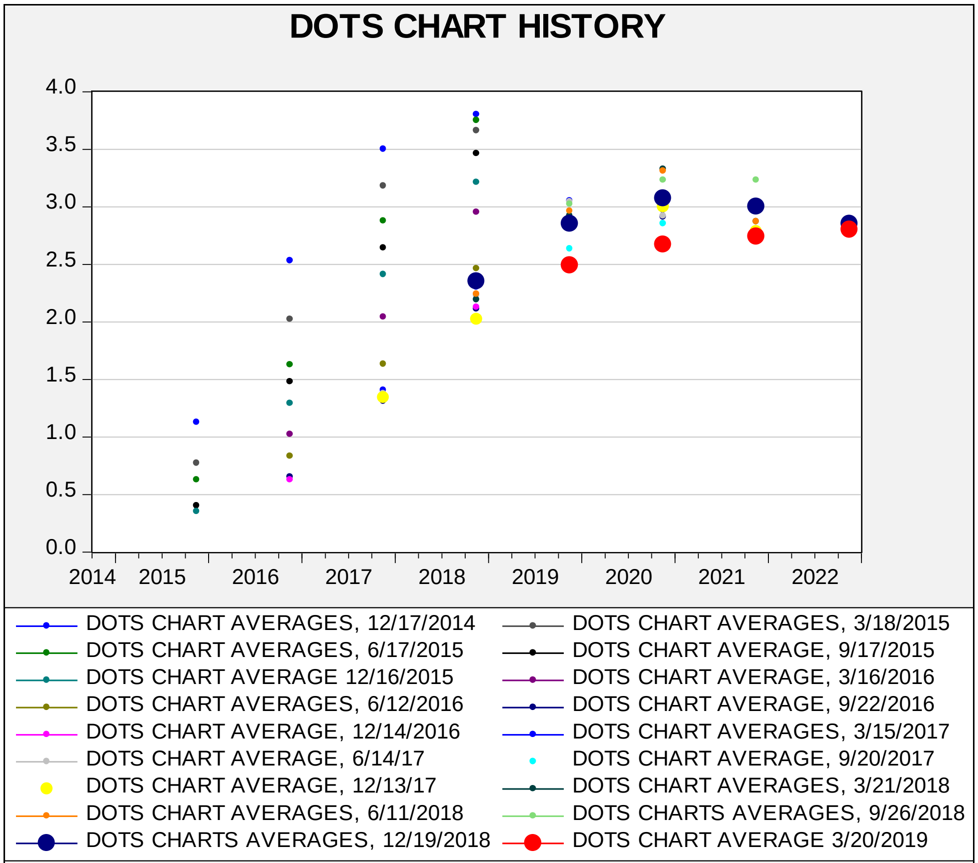
Bond yields continue to decline while equities come under pressure. Here is what we are watching this morning:

The FOMC: A dovish outcome was expected and the Fed delivered. First, the dots plot was lowered, projecting no rate changes this year and only one more rate increase next year. On the chart below, December is in gray and March is in yellow with a green line.



(Sources: Federal Reserve, CIM)

Here is another way of looking at the evolution of the dots. On the chart below, the December meeting is shown as large dark blue dots and yesterday's meeting is in red. Note the significant decline in projections. The history of the dots makes very clear that the FOMC thought a normal recovery would develop and support a return to "normal" fed funds levels. Continued low inflation has prevented the FOMC from moving the target rate higher.



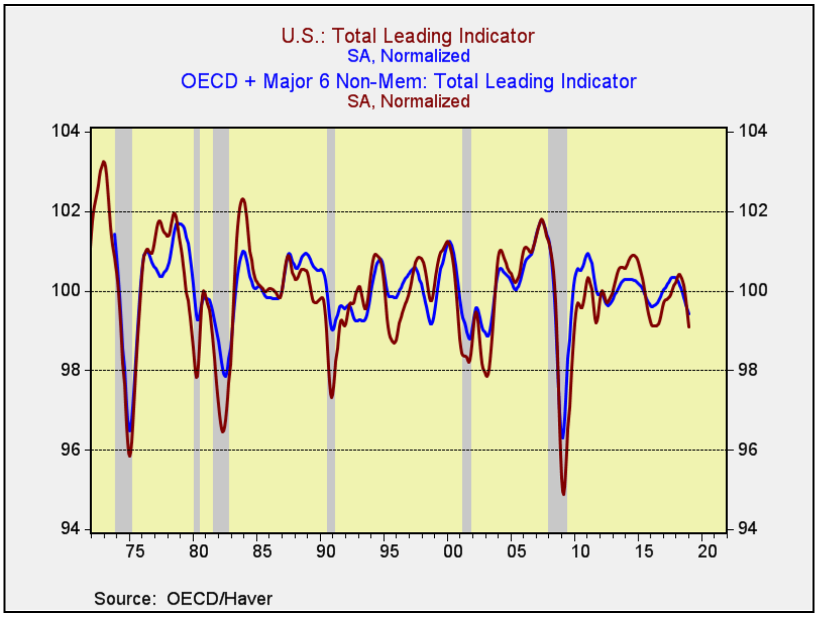
Sources: Federal Reserve, CIM

Second, in the statement, the FOMC acknowledged the slowdown in growth and low inflation. The economic expectation data showed that the committee is forecasting GDP less than 2% for the foreseeable future with controlled inflation. In general, there is no reason to lift rates.

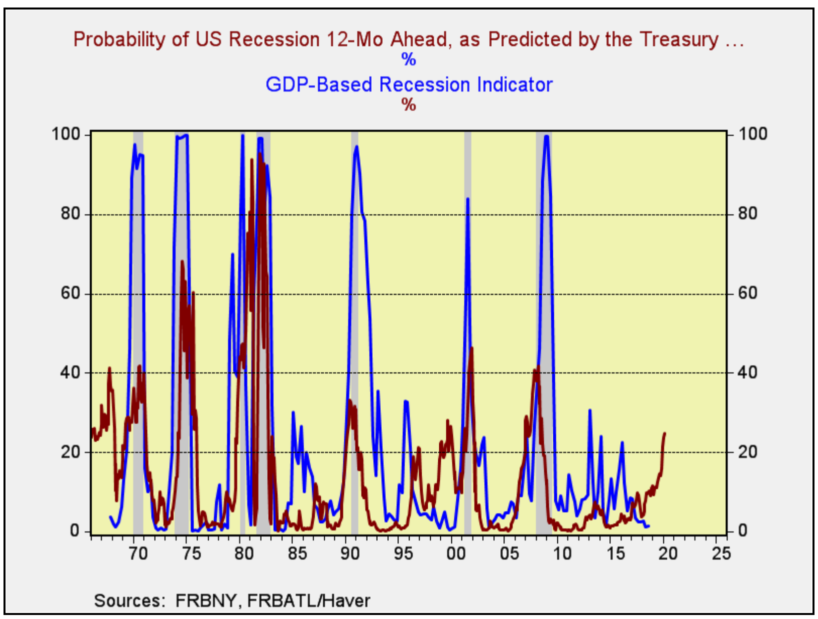
And third, the Fed will likely end QT in September. Again, we view this change as mostly psychological but, in the bigger scheme of things, reducing the balance sheet was unnecessary. Simply holding it steady would have reduced its impact over time (e.g., its share of GDP would have declined), so QT was, to some extent, a kind of "unforced error."

Although equities rallied initially, the lift failed to hold as financials suffered. Long-duration bond yields fell and the dollar weakened as well. To a great extent, equity markets had already discounted more dovish policy. However, without a steepening yield curve and dollar weakness, a major lift in stocks will require a pop in earnings.

There has been some discussion by financial pundits that the Powell Fed is caving into the financial markets but the move in policy may have more to do with fears of an economic downturn. We note that the OECD's broad leading indicator and the U.S. leading indicator are showing signs of weakness.



And, comparing the NY FRB yield curve-based recession indicator with the Atlanta FRB GDP recession indicator warns of trouble ahead.



The NY Fed indicator gives us a year lead; any reading above 20 is a cause for concern. The two combined indictors are rather powerful. This tells us that the U.S. needs to steepen the yield curve if the U.S. is going to avoid a recession. And, history shows the normal way to have this occur is for policy to ease. The expectation of one more hike in 2020 from the dots plot suggests the FOMC isn't quite ready to lower rates.

From our perspective, the continued rally in long-duration Treasuries is a concern. If investors were concerned about inflation, the dovish Fed policy change would have caused higher long-term rates. The fact that long rates are continuing to decline suggests no inflation fear and greater worries about weaker economic growth.

Brexit: We realize this topic is really getting old but the drama is unending. It's pretty clear there is no consensus in Parliament. PM May's plan all along was to eliminate other alternatives and have a vote on her deal or a hard Brexit. It appears she will now get her wish. The EU has made it clear that it will grant a short extension to the Article 50 deadline only to give U.K. MPs more time to vote on May's plan.[1] Otherwise, it's a long delay or hard Brexit. May is wagering that the hard Brexit supporters will prefer her deal to a long delay.[2] However, there is an element within the Tory Party that would welcome a hard Brexit.[3] Their position seems to be that the expectations of a sudden break are dire but the outcome probably won't be as bad as expected and thus a hard Brexit would end up being ok.[4] In addition, the hard Brexit supporters have tended to believe the EU will blink. Then again, it appears to us that the EU is better prepared and has more to benefit from a hard break than the British supporters realize. The hard Brexit supporters also believe that the U.K. can quickly make free trade deals with other nations, including the U.S. They will likely be shocked at how hard a bargain the U.S. will drive; we doubt U.S. negotiators would tolerate any restrictions on American agriculture, for example.

We still think the odds favor some outcome that avoids a sudden break. But, it is also clear that this outcome won't occur until the last minute and the odds of stumbling into a crisis are rising.

Auto tariffs: The Commerce Department has submitted its report to the president on auto tariffs; this triggered a 90-day review period where the president can decide if he wants to implement them. So far, the White House has refused to distribute the findings despite requests from Congress.[5] The concept of auto tariffs are generally panned among his advisors, with the exception of Peter Navarro. The problem is that the auto industry is deeply globalized; tariffs by the U.S. will invite retaliation and could very well paralyze the industry and lead to a sharp downturn in industrial activity. The auto tariffs are especially critical to EU/U.S. trade talks.[6] Although we still expect the administration to make a short-term deal with China and avoid a significant disruption, the EU talks could become the next trade-related disruptive event.

Energy update: Crude oil inventories fell 9.6 mb last week compared to the forecast rise of 2.0 mb.

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[1] https://www.ft.com/content/971250a4-4ae0-11e9-8b7f-d49067e0f50d?emailId=5c931623bcd2b90004d98730&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22 and https://www.nytimes.com/2019/03/20/world/europe/theresa-may-brexit-european-union.html?emc=edit_mbe_20190321&nl=morning-briefing-europe&nlid=567726720190321&te=1

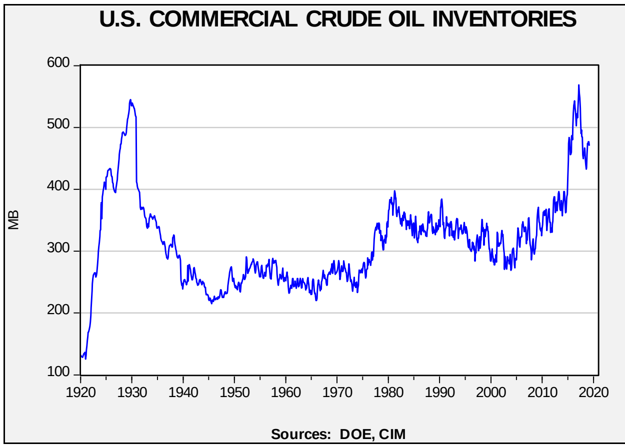
[2] https://www.reuters.com/article/us-britain-eu-deal/may-has-a-good-shot-of-getting-brexit-deal-approved-next-week-uk-junior-minister-idUSKCN1R20OF

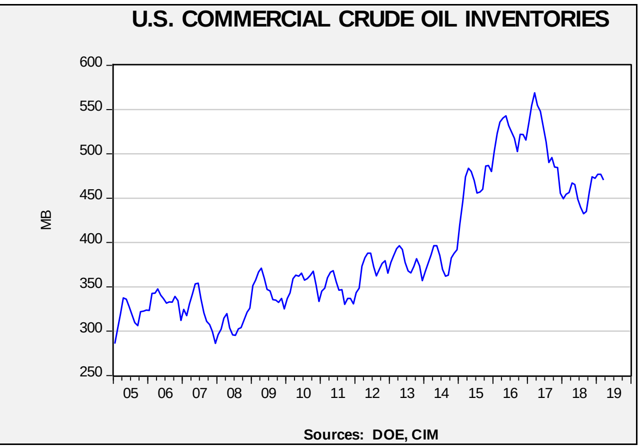
[3] https://www.ft.com/content/3d6f76da-4b1c-11e9-8b7f-d49067e0f50d?emailId=5c931623bcd2b90004d98730&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

[4] https://www.ft.com/content/1376ce46-4b2b-11e9-8b7f-d49067e0f50d?emailId=5c931623bcd2b90004d98730&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

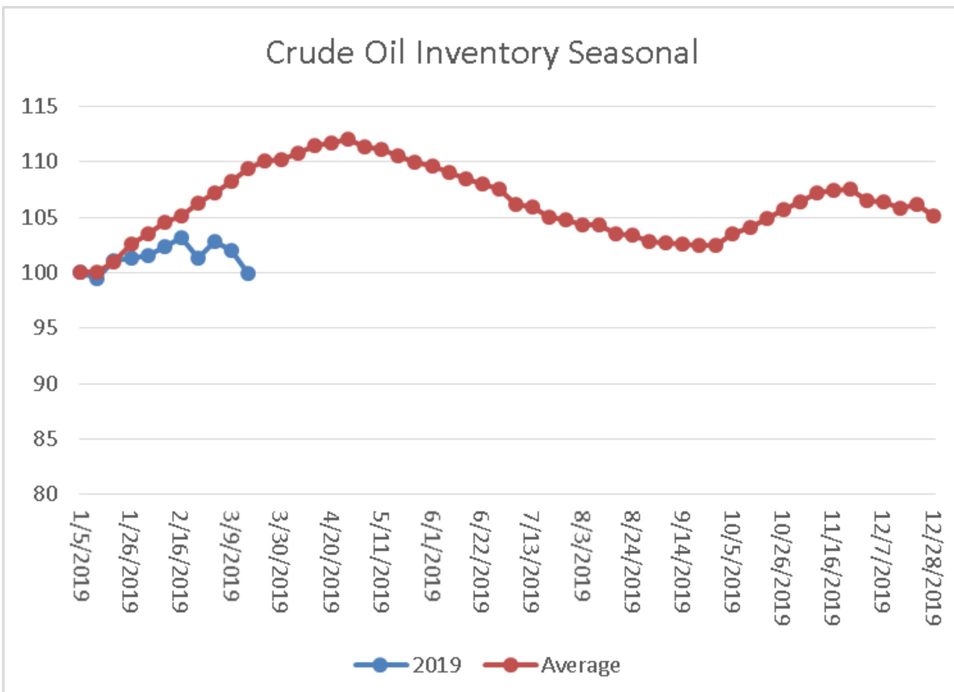
[5] https://www.politico.com/story/2019/03/20/trump-tariffs-automobiles-commerce-1228344

[6] https://www.cnn.com/2019/03/20/politics/eu-talks-trump-tariffs/index.html



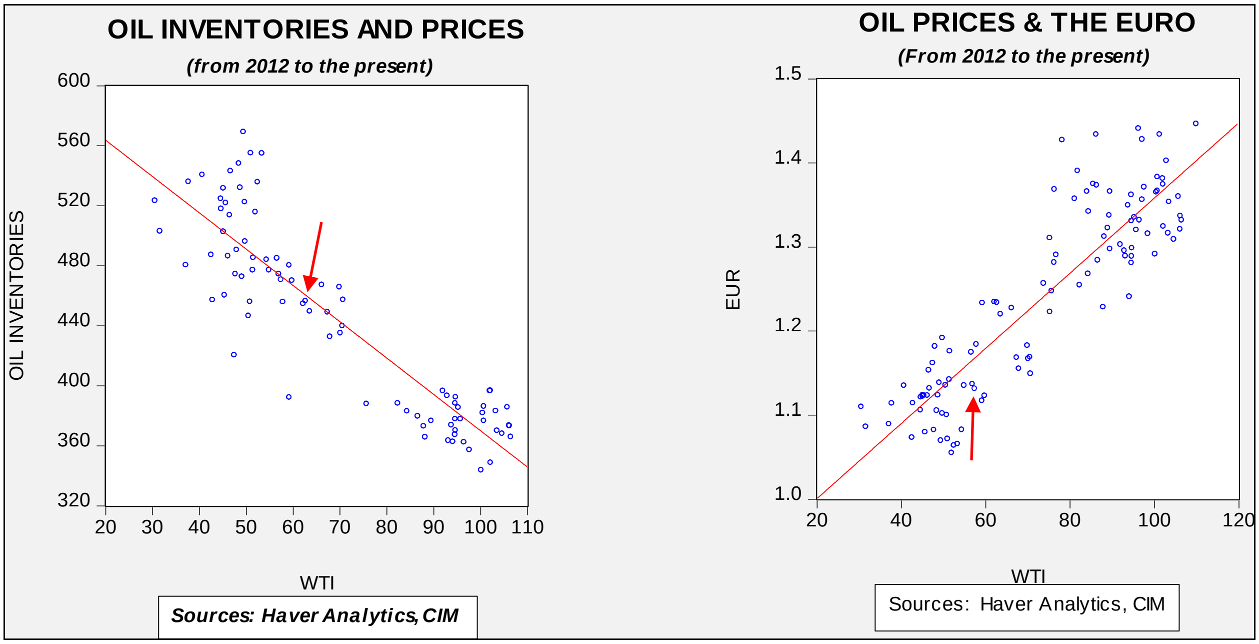


In the details, refining activity rose 1.3% as winter maintenance steadily ends. Estimated U.S. production rose 0.1 mbpd to 12.1 mbpd. Crude oil imports rose 0.2 mbpd, while exports rose 0.9 mbpd.



(Sources: DOE, CIM)

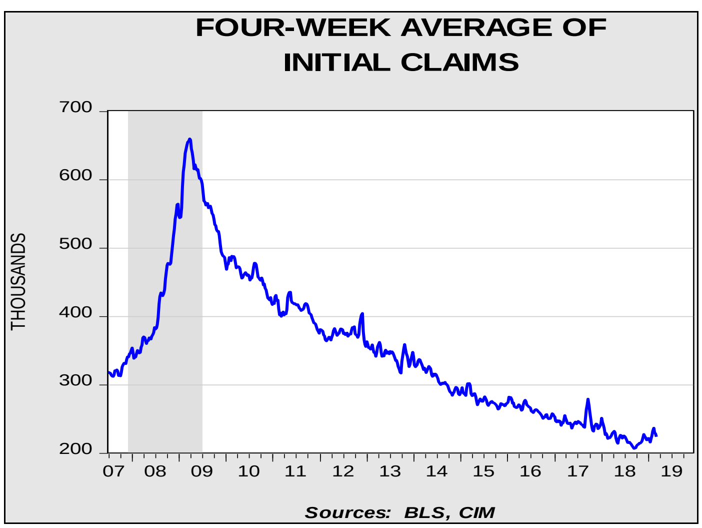
This is the seasonal pattern chart for commercial crude oil inventories. We would expect to see a steady increase in inventory levels that will peak in early May; the pattern coincides with refinery maintenance. The continued decline puts the market further behind the storage injection curve and is bullish.



Based on oil inventories alone, fair value for crude oil is $60.78. Based on the EUR, fair value is $53.37. Using both independent variables, a more complete way of looking at the data, fair value is $55.25. We are seeing widening fair value readings on the two individual models, with oil stocks very supportive for prices while the dollar is not. The Fed news could weaken the dollar which could lift oil prices as well. Although we may see a push over $60 in the near term, a sustained rally will probably need some dollar weakness to maintain the rise.

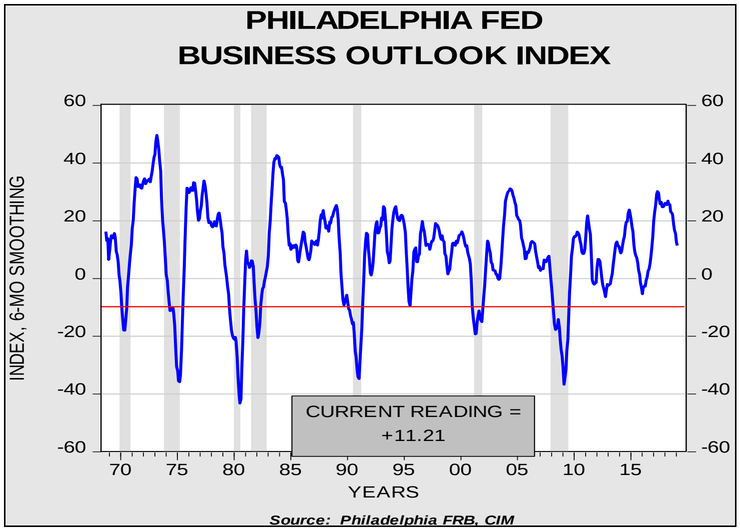
U.S. Economic Releases

Initial claims came in below expectations at 221k compared to the forecast of 225k. The prior report was revised from 229k to 230k.



The chart above shows the four-week moving average of initial claims, which fell from 227.75k to 223.25k.

The March Philadelphia FRB Business Outlook Index came in above expectations at 13.7 compared to estimates of 4.8. The survey shows a jump in shipments from the prior month.



We smooth the data on the above chart with a six-month moving average. The current reading is well above the recession signal of -10. What makes this index important is that it measures business sentiment for the Mid-Atlantic region, where most of the Fed governors work and live, at least part of the time. No matter how data-sensitive one is, the economic activity that one directly observes will tend to affect one's outlook. Thus, a robust local economy in the Mid-Atlantic region could lead Fed governors to lean hawkish even if the rest of the nation's economy is less robust, and vice versa.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Bloomberg Consumer Comfort	m/m	mar		60.8	**
9:45	Bloomberg Economic Expectations	m/m	mar		54.5	**
10:00	Leading Index	m/m	feb	0.1%	-0.1%	**
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								
Australia	Employment Change	y/y	feb	4.6k	39.1k	15.0k	**	Equity and bond neutral
	Unemployment Rate	y/y	feb	4.9%	5.0%	5.0%	**	Equity and bond neutral
	Participation Rate	m/m	feb	65.6%	65.7%	65.7%	**	Equity and bond neutral
New Zealand	GDP	y/y	4q	2.3%	2.6%	2.5%	**	Equity and bond neutral
	Credit Card Spending	y/y	feb	6.4%	6.9%		**	Equity and bond neutral
EUROPE								
UK	Public Finaces	m/m	feb	0.6 bn	-25.4 bn		**	Equity and bond neutral
	Central Government NCR	m/m	feb	-1.7 bn	-25.8 bn		**	Equity and bond neutral
	Public Sector Net Borrowing	m/m	feb	-0.7	-15.8 bn	-0.8 bn	**	Equity and bond neutral
	PSNB ex Banking Groups	m/m	feb	0.2 bn	-14.9 bn	0.7 bn	**	Equity and bond neutral
	Retail Sales ex Auto Fuel	y/y	feb	3.8%	4.1%	3.5%	**	Equity bullish, bond bearish
	Retail Sales inc Auto Fuel	y/y	jan	4.0%	4.2%	3.3%	**	Equity bullish, bond bearish
AMERICAS								
Mexico	International Reserves Weekly	m/m	mar	$176.045 bn	$175.767 bn		**	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	263	-2	Up
3-mo T-bill yield (bps)	241	241	0	Neutral
TED spread (bps)	21	22	-1	Neutral
U.S. Libor/OIS spread (bps)	241	241	0	Up
10-yr T-note (%)	2.51	2.53	-0.02	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	14	12	2	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	flat			Up
yen	up			Neutral
pound	down			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of England Bank Rate	0.750%	0.750%	0.750%	On forecast
BOE Asset Purchase Target	10 bn	10 bn	10 bn	On forecast
BOE Corporate Bond Target	435 bn	435 bn	435 bn	On forecast
FOMC Rate Decision (Upper Bound)	2.500%	2.500%	2.500%	On forecast
FOMC Rate Decision (Lower Bound)	2.250%	2.250%	2.250%	On forecast
Interest Rate on Excess Reserves	2.400%	2.400%	2.400%	On forecast
SNB Sight Deposit Interest Rates	-0.750%	-0.750%	-0.750%	On forecast
SNB 3-month Libor Lower Target Range	-1.250%	-1.250%	-1.250%	On forecast
SNB 3-month Libor Upper Target Range	-0.250%	-0.250%	-0.250%	On forecast
Selic Rate	6.500%	6.500%	6.500%	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	$68.08	$68.50	-0.61%	
WTI	$59.74	$60.23	-0.81%	
Natural Gas	$2.82	$2.82	0.00%	
Crack Spread	$21.02	$21.04	-0.08%	
12-mo strip crack	$17.44	$17.46	-0.09%	
Ethanol rack	$1.49	$1.49	-0.06%	
Metals				
Gold	$1,315.65	$1,312.53	0.24%	
Silver	$15.57	$15.48	0.62%	
Copper contract	$295.80	$292.10	1.27%	
Grains				
Corn contract	$ 373.00	$ 371.50	0.40%	
Wheat contract	$ 463.25	$ 464.75	-0.32%	
Soybeans contract	$ 907.00	$ 906.00	0.11%	
Shipping				
Baltic Dry Freight	709	712	-3	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-9.6	2.0	-11.6	
Gasoline (mb)	-4.6	-2.5	-2.1	
Distillates (mb)	-4.1	-1.2	-2.9	
Refinery run rates (%)	1.30%	0.40%	0.90%	
Natural gas (bcf)		-54.0		

Weather

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

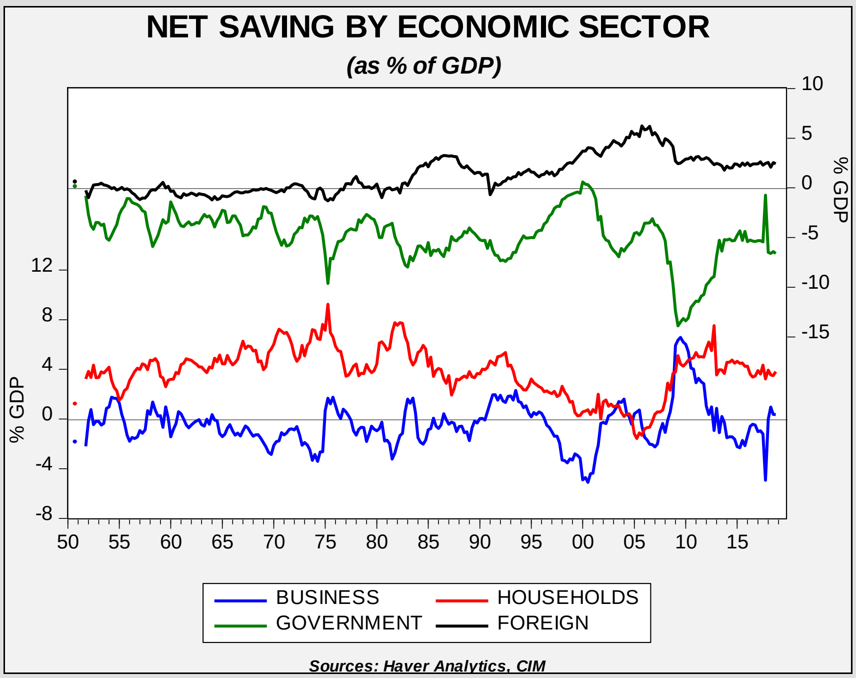
<u>Asset Allocation Weekly Comment</u>

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

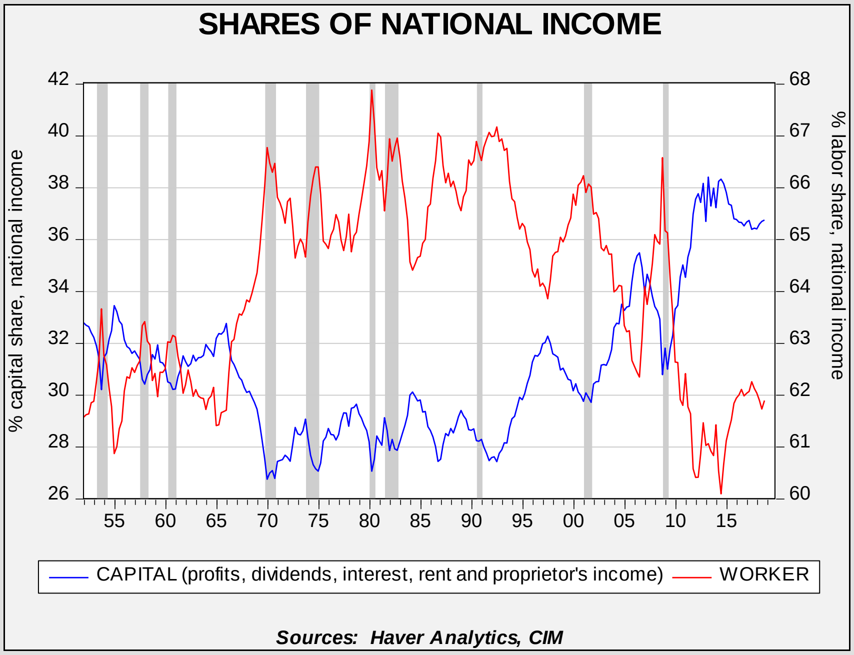
The Financial Accounts of the United States, formerly known as the Flow of Funds Report, was released last week. It is a plethora of information about the state of the economy. Below we discuss the charts we find most noteworthy.

First, here is the saving balance by sector.



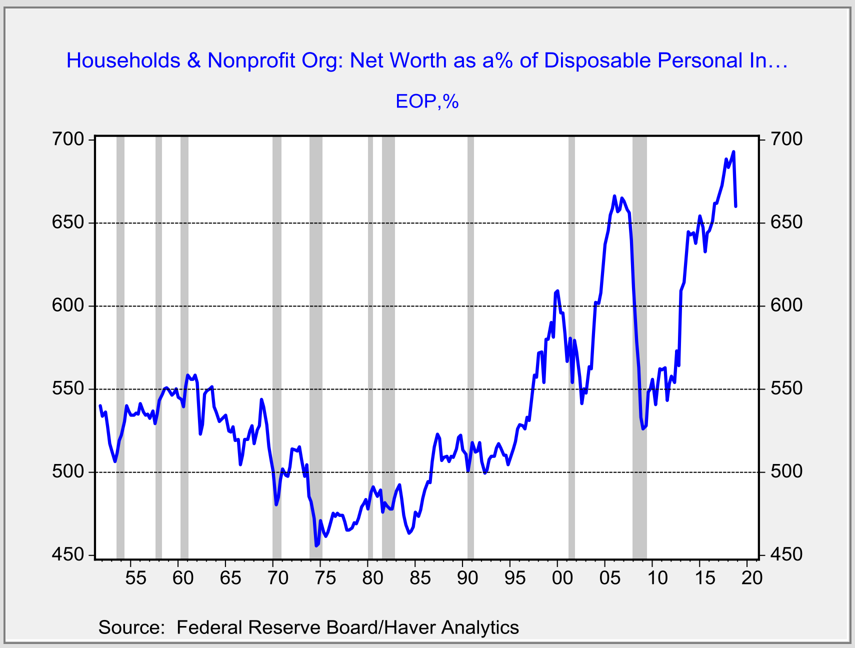
The tax cut has led to an increase in business saving and a wider fiscal deficit. Household and foreign saving was essentially unchanged. We are watching to see if the administration's trade policy reduces the trade deficit; if it does, then foreign saving, the inverse of the trade deficit, will decline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



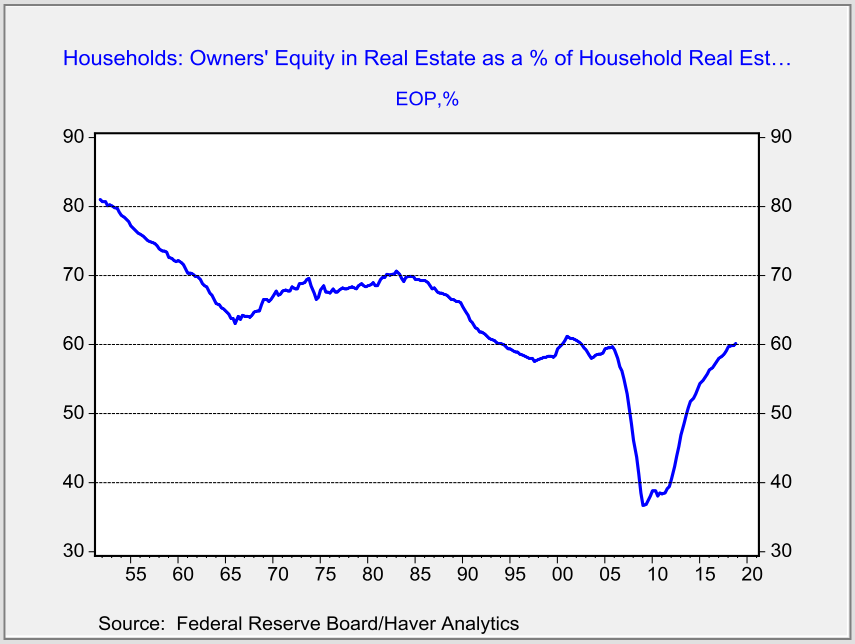
Since the end of communism in the early 1990s, capital has been taking a steadily larger share of national income. In each expansion, the capital share has made a higher peak.

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

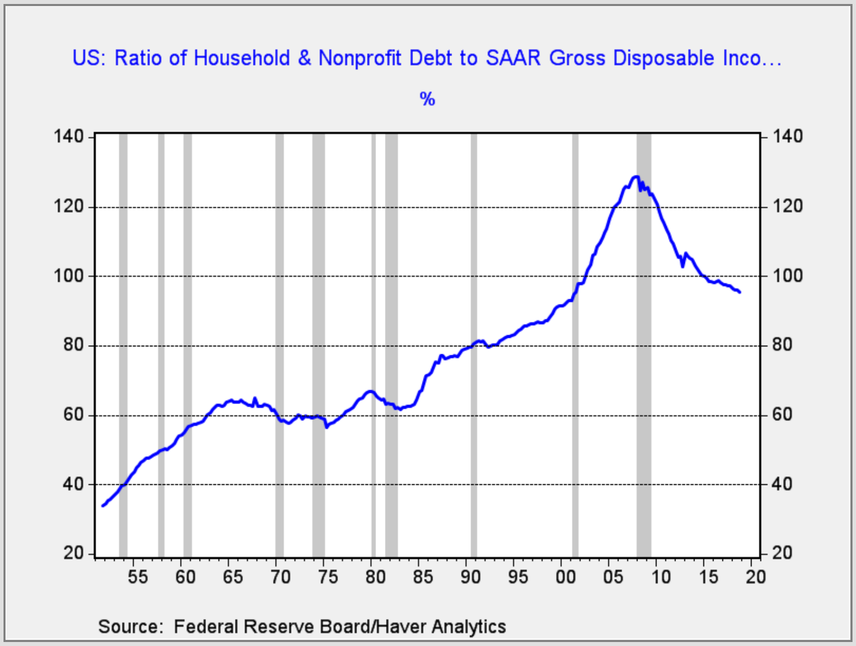


Net worth relative to after-tax income took a dive in Q4; the recent recovery in equity markets should reverse this dip, but we do note that in previous cycles such declines tended to signal that the business cycle was coming to a close.

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.[7]



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



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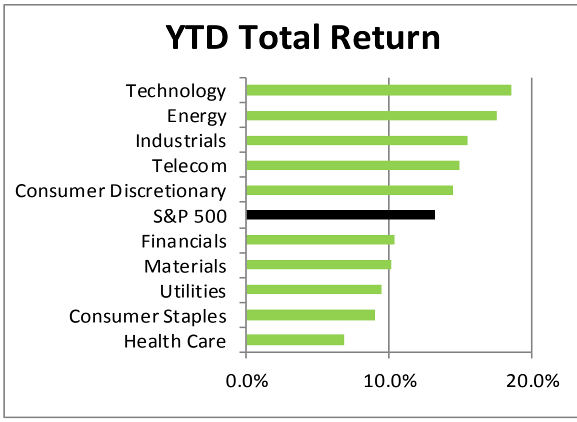
[7] This is only true for the financial system. Many communities are still struggling with the aftermath of the crisis.

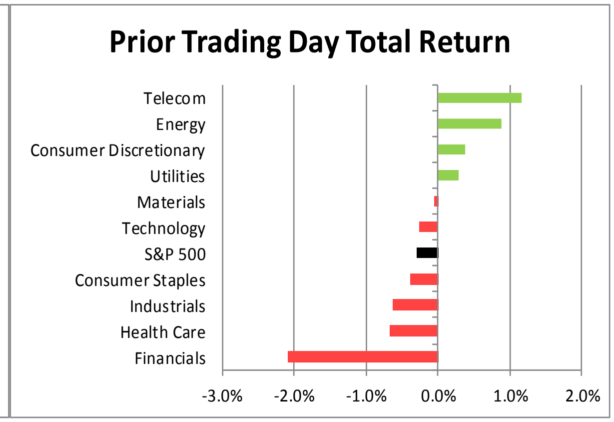
This chart shows household debt as a percentage of after-tax income. From the early 1980s into 2005, household debt rose steadily. The Great Financial Crisis led households to lower their debt levels relative to income. Although there is no generally accepted level that signals when deleveraging has 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 3/20/2019 close)

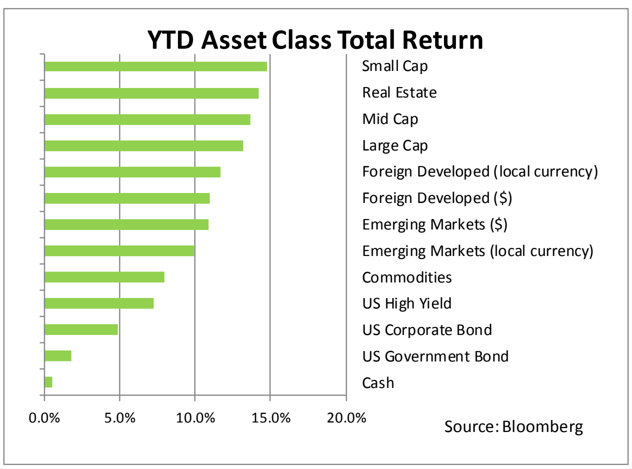




(Source: Bloomberg)

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 3/20/2019 close)

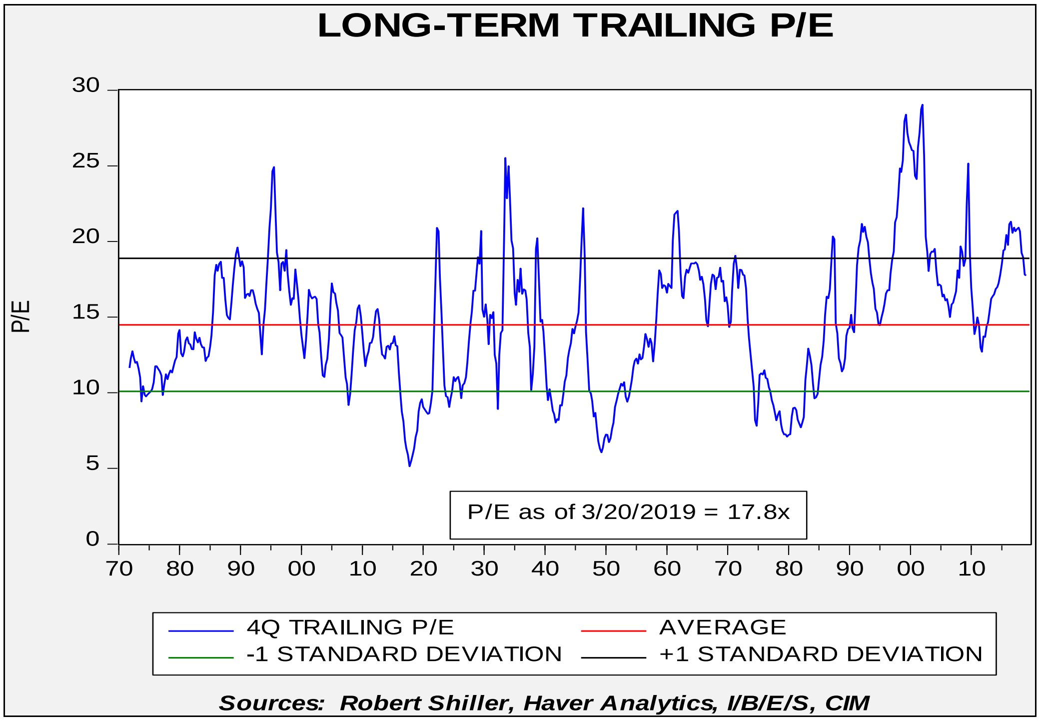


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 21, 2019



Based on our methodology,[8] the current P/E is 17.8x, up 0.1x from last week. The rise in the P/E was due to declining earnings estimates and rising index values.

[8] 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.