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 28, 2019—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 0.2% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.2% from the prior close. Chinese markets were lower, with the Shanghai composite down 0.9% and the Shenzhen index also down 0.9%. U.S. equity index futures are signaling a lower open.

Happy Opening Day! Even as cool temperatures linger in much of the country, major league baseball opens in the U.S. today, one of the official signs of summer. Here's something to make you feel older: for the first time in the 21st century, there are no players on team rosters that have major league playing time in the 20th century.[1] Equities are modestly higher in a quiet news environment. There have been a number of Fed speakers in the past few days. The message remains consistent—the central bank is on pause, but not moving to ease. Here is what we are watching this morning:

Brexit: If ever there was a day that showed there is no consensus on a path forward, it was yesterday. All the indicative votes failed to reach a majority.[2] PM May offered to resign if her plan was accepted. Although that did sway some hardline Brexit supporters, the Northern Irish DUP rejected the offer.[3] This outcome probably means we will get a long extension of Article 50 and a new PM to guide the effort. The GBP is down a bit today but a long extension probably means the exchange rate will remain mired at roughly current levels.

Turkey: As we noted yesterday, in the run-up to elections Turkey has sent overnight interest rates to astounding levels, in excess of 1,000%, to punish currency shorts. Turkey has been struggling for the past year with rising inflation and recession. We would expect rates to fall after this weekend's local elections.[4] While Erdogan is clearly safe in his position, this election has evolved into a referendum of sorts on the regime, so he is trying all kinds of actions to lift

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[1] https://www.apnews.com/c171fd38f1d0498390b4e7f0e5b092ee?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top

[2] https://ig.ft.com/brexit-indicative-votes/?emailId=5c9c3e08c597400004352bc8&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

[3] https://www.ft.com/content/27ac0b14-50d1-11e9-9c76-bf4a0ce37d49?emailId=5c9c3e08c597400004352bc8&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22 and https://www.ft.com/content/c80604c4-50b4-11e9-9c76-bf4a0ce37d49?emailId=5c9c3e08c597400004352bc8&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

[4] https://www.politico.eu/article/tayyip-erdogan-turkey-election-the-invincible-faces-tough-election-test/?utm_source=POLITICO.EU&utm_campaign=6ce3f2f806-EMAIL_CAMPAIGN_2019_03_28_05_45&utm_medium=email&utm_term=0_10959edeb5-6ce3f2f806-190334489

sentiment. Although conditions in Turkey remain difficult, we note that the exchange rate has fallen significantly, supporting a strong improvement in the current account. In other words, conditions are not good, but most of the bad news is already discounted.

Chinese trade: USTR Lighthizer is back in Beijing for talks; Chinese officials are expected in Washington next week. There are reports of progress[5] but nothing concrete ever emerges. This looks like a "stall" game. China is probably hoping that it can extend negotiations into early next year and expect election issues to dominate, allowing China to avoid making excessive concessions.[6] From a financial markets perspective, discussions won't end suddenly, leading to tariffs and a drop in equity values.

A side note on China: Former colleagues of mine at Doane, an agricultural research service, inform me that the African Swine Fever[7] (ASF) is becoming a serious problem. The disease, so far, has affected Europe, Asia and South America. It poses no risk to humans but it is nearly 100% fatal to pigs. Thus, once a herd is affected, it essentially wipes out the group. The USDA and Customs continue to work hard to prevent the disease from entering the U.S.[8] ASF can be spread by pork products, so strict enforcement is vital. This event will almost certainly lead to higher pork prices in the U.S. as summer grilling season approaches; we would also expect China to "offer" to buy lots of U.S. pork as their supplies dwindle due to the epidemic in China.

Another side note on China: Taiwan's President Tsai Ing-wen said today that the U.S. is open to the island's request for new arms sales.[9] If the Trump administration does increase arms sales to Taipei, it will increase tensions with Beijing.

India joins another club: India has successfully shot down a satellite with a ground-based missile, becoming the fourth nation in the world to show it has this capacity.[10] Although there is speculation that this news is part of a pre-election plan to boost Modi's reelection, the fact that India could "blind" its primary adversary, Pakistan, in a conflict raises the potential for escalation in a crisis.

Energy update: Crude oil inventories rose 2.8 mb last week compared to the forecast decline of 3.0 mb.

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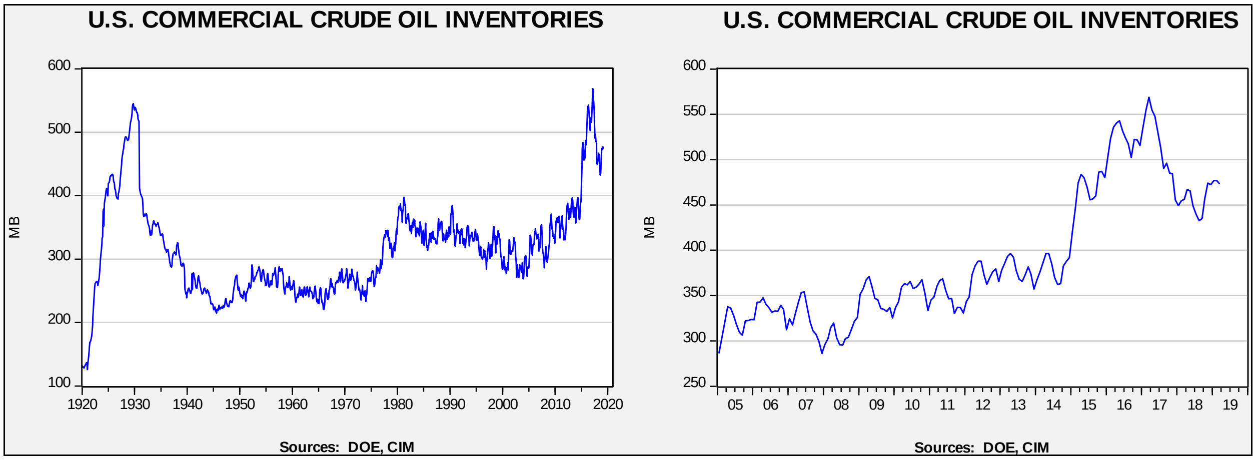
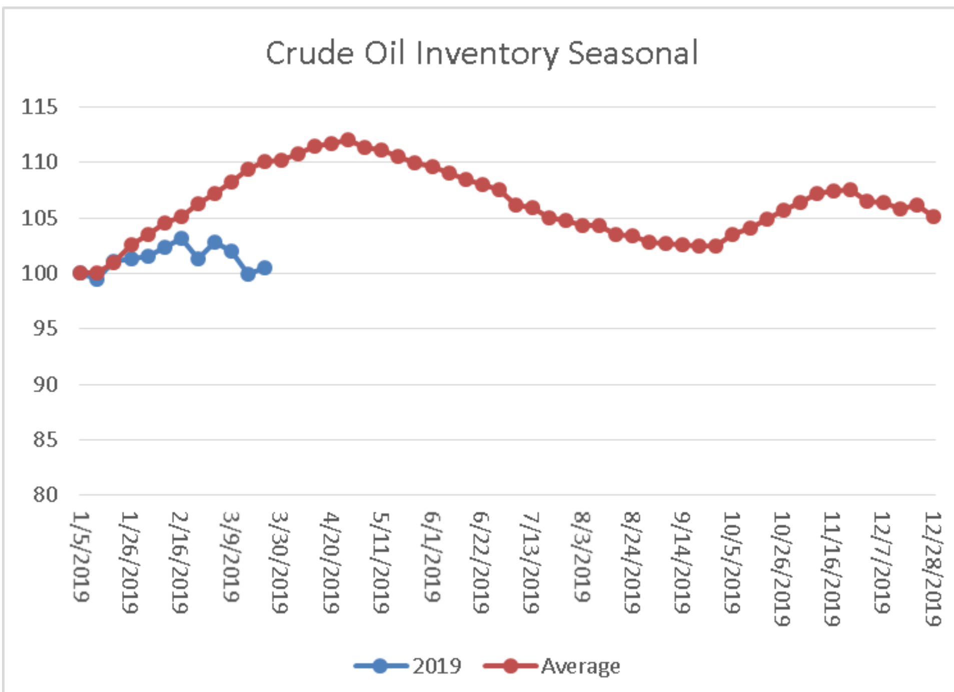
[5] https://www.reuters.com/article/us-usa-china-trade-exclusive/exclusive-china-makes-unprecedented-proposals-on-tech-trade-talks-progress-u-s-officials-idUSKCN1R905P
[6] https://www.ft.com/content/3c84214a-507f-11e9-b401-8d9ef1626294?emailId=5c9c3e08c597400004352bc8&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22
[7] http://www.oie.int/en/animal-health-in-the-world/animal-diseases/african-swine-fever/
[8] https://www.agdaily.com/news/illegal-chinese-pork-products-seized/
[9] https://www.reuters.com/article/us-taiwan-usa/taiwan-president-seeking-tanks-and-fighters-says-us-responding-positively-idUSKCN1R82OA
[10] https://www.washingtonpost.com/world/asia_pacific/india-shoots-down-satellite-announces-itself-to-be-a-space-power/2019/03/27/a1e73426-5068-11e9-af35-1fb9615010d7_story.html?utm_term=.1f898d630442&wpisrc=nl_todayworld&wpmm=1

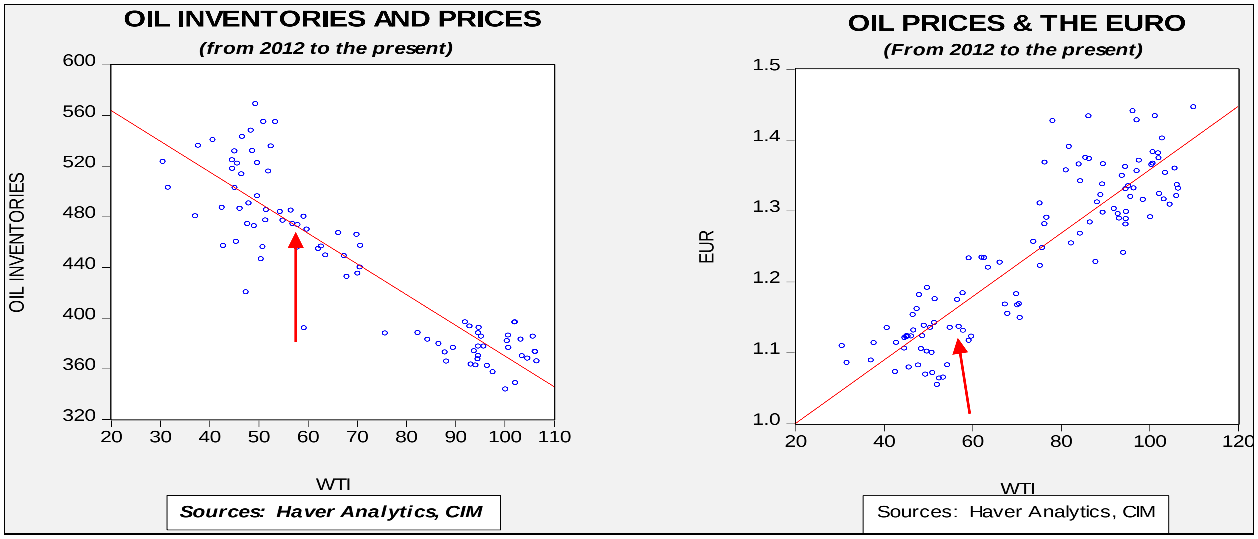


In the details, refining activity fell 2.3%, which was a surprise. Estimated U.S. production was unchanged at 12.1 mbpd. Crude oil imports and exports both fell 0.4 mbpd.



(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. Even with the build this week, the market is well behind normal which is supportive for prices.

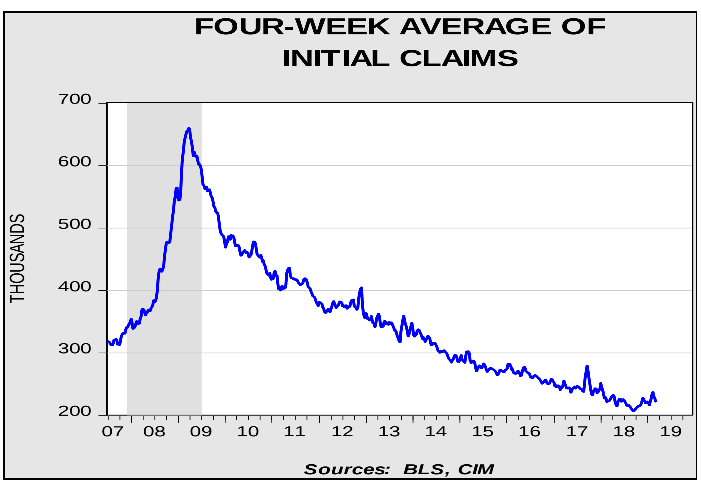


Based on oil inventories alone, fair value for crude oil is $59.87. Based on the EUR, fair value is $53.30. Using both independent variables, a more complete way of looking at the data, fair value is $54.86. We are seeing the two fair value levels widen, with oil stocks very supportive, while the dollar isn't all that supportive for prices.

In other oil news, President Trump tweeted for lower oil prices this morning, sending markets lower. OPEC has consistently ignored the president on his calls for greater output. Saudi Aramco is coming to market with a $10 bn bond to partially fund its purchase of a Saudi petrochemical company.[11]

U.S. Economic Releases

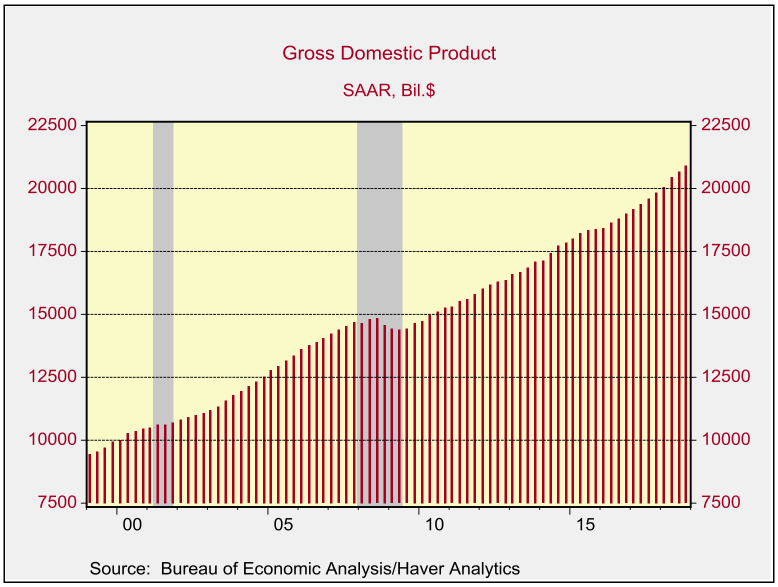
Initial claims came in below expectations at 211k compared to the forecast of 220k. The previous report was revised downward from 221k to 216k.



[11] https://www.wsj.com/articles/aramco-plans-10-billion-bond-next-week-opening-books-for-first-time-11553761555?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosmarkets&stream=business

The chart above shows the four-week moving average of initial claims, which fell from 222k to 220.5k.

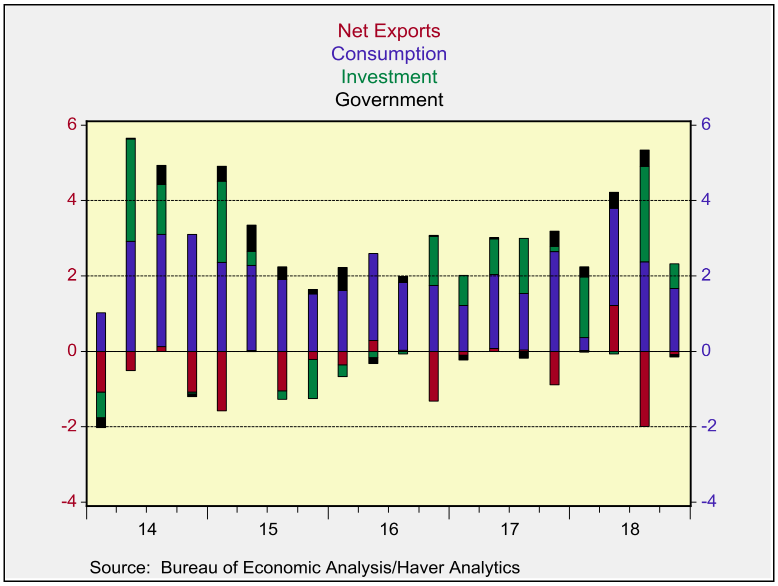
The third reading of Q4 GDP came in below expectations at 2.2% compared to the forecast of 2.3%. Personal consumption came in below expectations at 2.5% compared to the forecast of 2.6%. Core PCE rose 1.8% from the prior quarter. The overall GDP price index rose 1.7% compared to the forecast of 1.8%.



The chart above shows historical GDP. Currently, GDP continues to grow at a solid pace. GDP grew 2.9% in 2018, the highest rate since 2015.

	Q4 2018 Third Reading	Q4 2018 Second Reading	Difference
GDP	2.2%	2.6%	-0.4%
Consumption	1.7%	1.9%	-0.2%
Investment	0.7%	0.8%	-0.1%
Inventories	0.1%	0.1%	0.0%
Net Exports	-0.1%	-0.2%	0.1%
Government	-0.1%	0.1%	-0.2%

The table above shows the contributions to GDP. Downward revisions in consumption and government led to a drop in overall GDP.



This chart shows the contributions graphically. Net exports was the only negative component in Q4 GDP.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Bloomberg Consumer Comfort	m/m	mar		61.5	**
10:00	Pending Homes Sales	m/m	mar	-0.5%	4.6%	**
10:00	Pending Homes Sales	y/y	mar	-3.0%	-3.2%	**
11:00	Kansas City Manufacturing Activity	m/m	mar	0	1	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
10:00	Michelle Bowman Discusses Agriculture and Community	Member of the Board of Governors				
11:30	Raphael Bostic Speaks on Economic Outlook	President of the Federal Reserve Bank of Atlanta				
13:15	John Williams speaks at Economic Forecast in Luncheon	President of the Federal Reserve Bank of San Francisco				
16:20	James Bullard Speaks in Washington	President of the Federal Reserve Bank of St. Louis				

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	Swift Global Payments	m/m	feb	1.9%	2.2%		**	Equity and bond neutral
Japan	Japan buying foreign bonds	y/y	mar	¥1773 bn	-¥571.6 bn		*	Equity and bond neutral
	Japan buying foreign stocks	y/y	mar	-¥74.2 bn	¥450.9 bn		*	Equity and bond neutral
	Foreign buying Japan bonds	ytd	mar	-¥1490.0 bn	¥401.6 bn		*	Equity and bond neutral
	Foreign buying Japan stocks	m/m	mar	-¥1.090 tn	-¥1.589 tn		*	Equity and bond neutral
Australia	Job Vacancies	m/m	mar	1.4%	1.3%		**	Equity and bond neutral
New Zealand	ANZ Activity Outlook	m/m	mar	6.3	10.5		**	Equity and bond neutral
	ANZ Business Confidence	m/m	mar	-38.0	-30.9		**	Equity and bond neutral
EUROPE								
Eurozone	Economic Confidence	m/m	mar	105.5	106.1	105.9	**	Equity and bond neutral
	Business Climate Indicator	m/m	mar	0.53	0.69	0.68	**	Equity and bond neutral
	Consumer Confidence	m/m	mar	-7.2	-7.2	-7.2	**	Equity and bond neutral
	Services Confidence	m/m	mar	11.3	12.1	12.0	**	Equity and bond neutral
	M3 Money Supply	m/m	mar	4.3%	3.8%	3.9%	**	Equity bullish, bond bearish
AMERICAS								
Mexico	Trade Balance	y/y	feb	1.222 bn	-4.810 bn	0.304 bn	**	Equity bullish, bond bearish
	Unemployment Rate	m/m	feb	3.4%	3.5%	3.5%	**	Equity bullish, bond bearish
Canada	International Merchandise Trade	m/m	jan	-4.25 bn	-4.59 bn	-3.55 bn	**	Equity bearish, bond bullish
	CFIB Business Barometer	m/m	mar	55.9	59.0		**	Equity and bond neutral
Brazil	Total Outstanding Loans	m/m	feb	3.241 tn	3.232 tn		**	Equity and bond neutral
	Personal Default Rate	m/m	feb	4.7%	4.8%		**	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)	260	261	-1	Up
3-mo T-bill yield (bps)	237	238	-1	Neutral
TED spread (bps)	22	23	-1	Neutral
U.S. Libor/OIS spread (bps)	239	239	0	Up
10-yr T-note (%)	2.36	2.37	-0.01	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	11	11	0	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Up
yen	up			Neutral
pound	down			Neutral
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	$67.10	$67.83	-1.08%	Bearish IEA Report
WTI	$58.63	$59.41	-1.31%	
Natural Gas	$2.74	$2.72	0.88%	
Crack Spread	$20.04	$20.66	-2.97%	
12-mo strip crack	$16.60	$17.07	-2.75%	
Ethanol rack	$1.51	$1.52	-0.53%	
Metals				
Gold	$1,305.09	$1,309.55	-0.34%	
Silver	$15.21	$15.29	-0.57%	
Copper contract	$287.50	$286.30	0.42%	
Grains				
Corn contract	$ 373.75	$ 373.75	0.00%	
Wheat contract	$ 463.00	$ 469.50	-1.38%	
Soybeans contract	$ 890.00	$ 887.50	0.28%	
Shipping				
Baltic Dry Freight	690	683	7	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	2.8	-3.0	5.8	
Gasoline (mb)	-2.8	-3.0	0.2	
Distillates (mb)	-2.1	-0.5	-1.6	
Refinery run rates (%)	-2.30%	0.50%	-2.80%	
Natural gas (bcf)		-44.0		

Weather

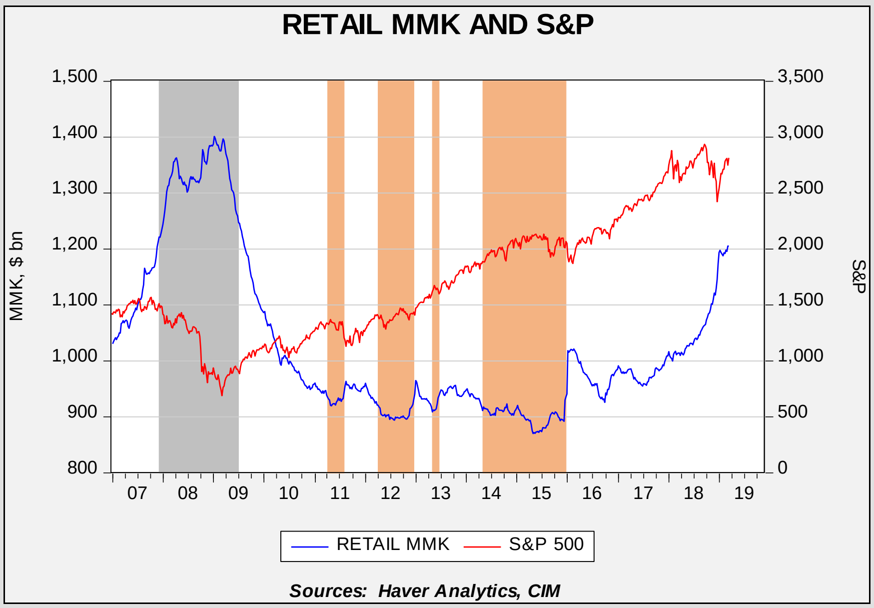
The 6-10 and 8-14 day forecasts show warmer temperatures for the West Coast and cooler temps for the rest of the country. Precipitation is expected for most of the country.

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 22, 2019

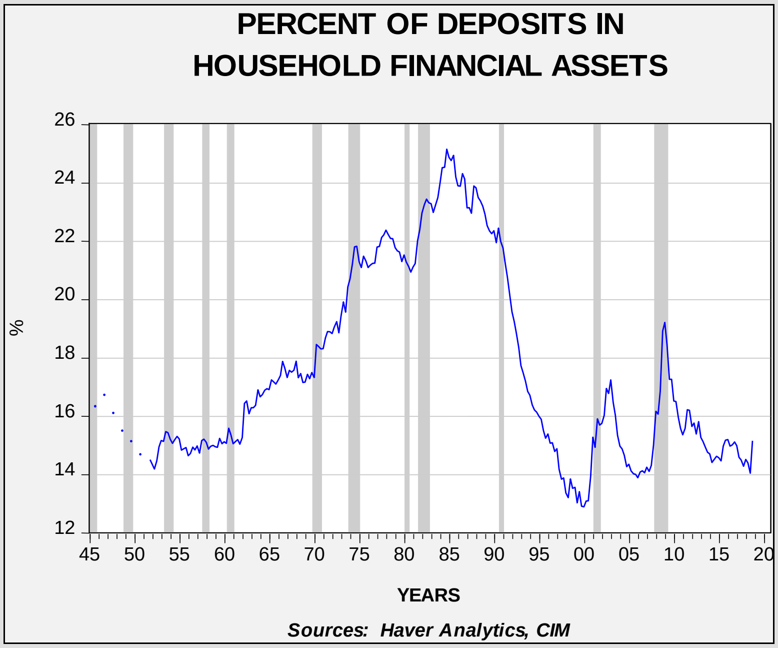
One factor we have been tracking is the recent behavior of retail money market funds. We have noted that households began building money market funds about the time that the equity market peaked and U.S. trade policy began to turn toward protectionism. In the coming months, money market funds continued to rise even as the S&P 500 made new highs. However, as equity markets fell in Q4, money market funds rose rapidly, with the pace of the increase rivaling what we saw in 2007-08.



This chart shows retail money market funds and the S&P 500. The gray shaded area shows the 2007-09 recession. The orange shaded areas show periods when money market funds fell below $920 bn. When money market funds fell to those levels, equities tended to stall. In recent weeks, the pace of increases in retail money market funds has slowed but still continues to rise, even with the market's recovery. It may be difficult for equities to move much higher without retail participation.

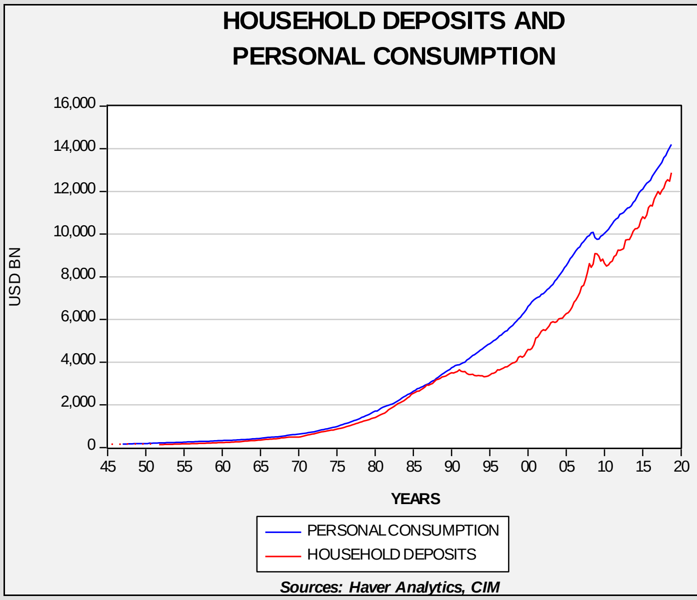
In light of this analysis, which we have been discussing on a regular basis, another thought emerged—what is the role of cash in a portfolio? To examine this issue, we decided to look at cash instruments in the holdings of households.

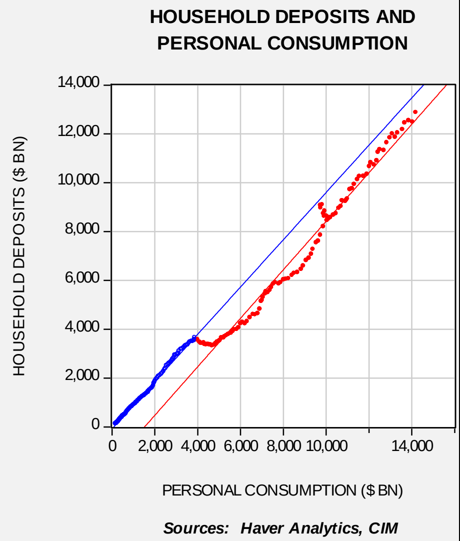
It turns out that cash has a complicated history.



This chart shows the percentage of deposits in household financial assets. From the early 1950s into the early 1980s, the level of deposits generally rose. This rise was probably due to a number of factors. During this period, there was a steady rise in household income; at the same time, the financial system was heavily regulated. Regulations limited households' flexibility in investing. However, by the mid-1980s, Regulation Q, which put caps on deposit rates, was removed. And, the financial services industry greatly expanded the products available and improved the logistics of investing. Financial deregulation increased the access to borrowing for households; thus, the need to save for purchases diminished. Income inequality also rose after 1979, which likely concentrated saving into fewer households. With more liquidity, these high income households were more likely to look for other investment opportunities. Essentially, the bull market in stocks that began in the early 1980s and ended in 2000 was supported by a more than 10% point decline in the share of deposits in household accounts.

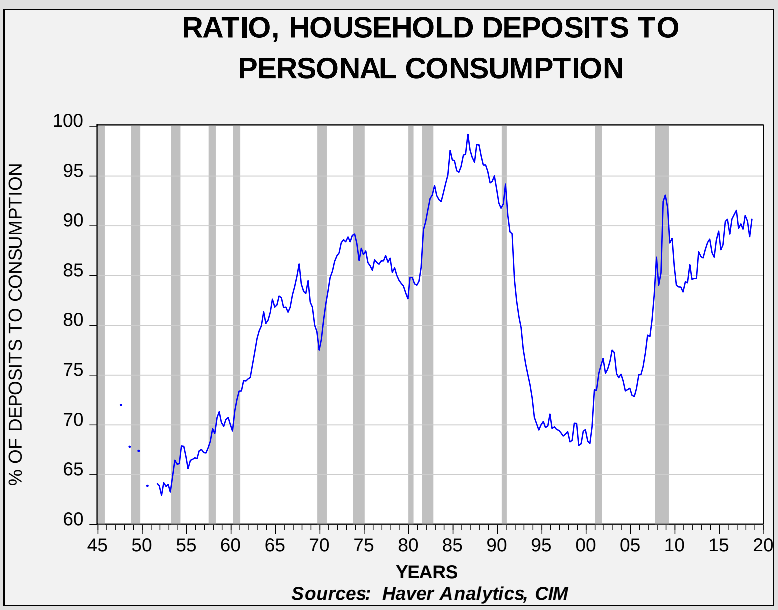
Household deposits function as an investment, a way to smooth out spending and a flight to safety instrument. Thus, one would expect there to be a close relationship between consumption and deposits and a rise in deposits relative to consumption during periods of crisis. In fact, these features do exist, but there was a significant break in the relationship starting in 1990.





The chart on the left shows the time series of personal consumption and household deposits; the one on the right shows a scatterplot with regression lines. Note that after 1990, the relationship curve shifted to the right, meaning that fewer deposits were required to support consumption. Deposits rose sharply in 2005, even faster than consumption. That was when the housing crisis began and there was clearly a flight to safety.

Since 2005, there has been a steady increase in deposits relative to consumption, which would suggest a generalized increase in fear relative to the period from 1995 to 2005.



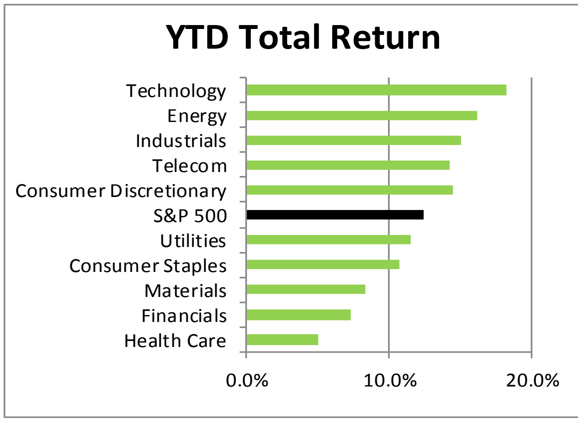
This chart shows the ratio of deposits to consumption. In 2000, deposits fell below 70% of consumption. The ratio rose after that and has currently reached 90%. Note how fast the ratio rose after housing peaked in 2005—there was a clear flight to cash that culminated in the Great

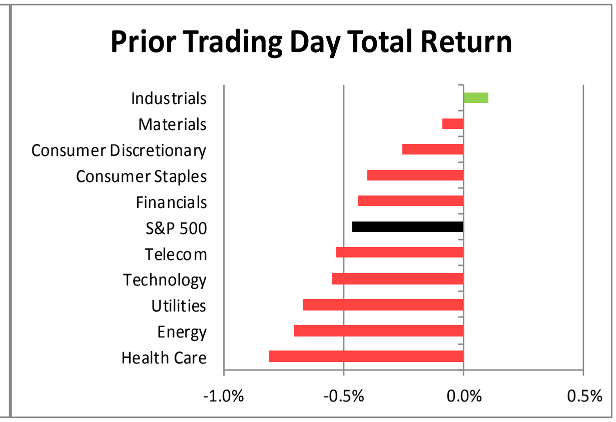
Financial Crisis. That level of fear has persisted, shown by the high level of deposits relative to consumption.

In conclusion, as the first chart shows, we have seen a lift in money market funds. This does suggest an elevated level of fear in financial markets. However, the recent rise should be viewed within the context of overall cash holdings in households.   Essentially, households are holding high levels of deposits relative to consumption, suggesting rather high levels of caution already. We still believe that retail money market funds need to decline in order to see equities rise this year; however, it also seems that households are not as complacent as they were in 2005 and therefore the likelihood of a financial crisis is probably not very high.

Data Section

U.S. Equity Markets – (as of 3/27/2019 close)

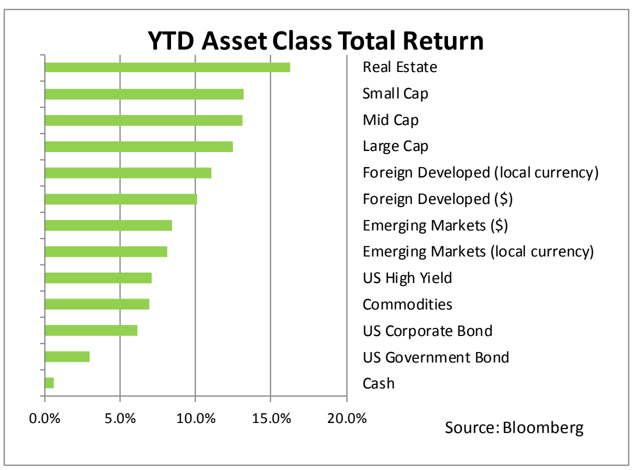




(Source: Bloomberg)

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 3/27/2019 close)

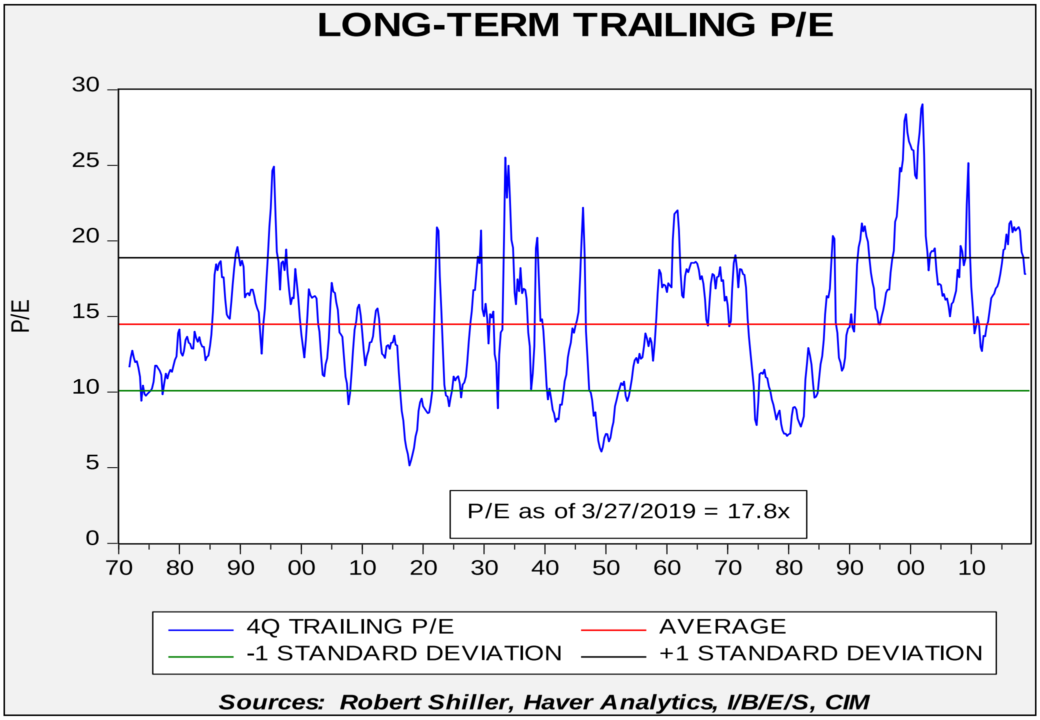


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 28, 2019



Based on our methodology,[12] the current P/E is 17.8x, unchanged from last week.

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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[12] 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.