Confluence INVESTMENT MANAGEMENT

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 6, 2019—9:30 AM EST] Global equity markets are generally mixed this morning. The EuroStoxx 50 is down 0.2% from the last close. In Asia, the MSCI Asia Apex 50 was unchanged from the prior close. Chinese markets were higher, with the Shanghai composite up 1.6% and the Shenzhen index up 1.5%. U.S. equity index futures are signaling a lower open.

It's another very quiet news morning. Equity futures continue to struggle. Here is what we are watching this morning:

BREAKING: The ECB is reportedly cutting its inflation forecasts through 2021. The reductions are said to be enough to allow the ECB to extend easy policy into the next decade. The EUR fell on the news.

Slower global growth: International agencies tend to confirm what we already know; the OECD[1] today cut its world growth forecast to 3.3% this year, a drop of 0.2%, and reduced the 2020 forecast to 3.4%, a decline of 0.1%. The agency cited Brexit, trade tensions and weaker European growth for the downgrade. Falling world growth has been a factor in the FOMC's pause. Although the Fed officially shuns its global role, tied to the dollar's reserve status, the committee is concerned that weaker global growth is affecting the U.S. economy.

Market confirmation: Bloomberg[2] is reporting that the president is pressuring trade negotiators to cut a deal with China to boost equity markets. The president's fixation with market performance has been well documented.[3] The problem for the president? Financial markets have already discounted a deal with China so the odds of a lift on official news of an agreement will be modest, at best, and could actually suffer from "buy rumor, sell fact" market action. As we noted yesterday, trade negotiations are shifting from China to Europe, so new worries may emerge on that front. Simply put, trade impediments are not capital friendly.

Italy and China: To the chagrin of the U.S. and EU,[4] Italy has formally endorsed China's "one belt, one road" project.[5] In doing so, it becomes the first G-7 nation to endorse the program.

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[1] https://www.wsj.com/articles/u-s-china-trade-deal-expected-to-give-limited-boost-to-growth-11551867256
[2] https://www.bloomberg.com/news/articles/2019-03-06/trump-is-said-to-push-for-china-deal-with-market-gains-in-mind
[3] https://www.nytimes.com/interactive/2019/01/21/business/trump-stock-market.html
[4] https://www.ft.com/content/4ba18efa-377b-11e9-b72b-2c7f526ca5d0?emailId=5c7f2fea2d8a680004667b0d&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

Italy's economy has stagnated this century after joining the Eurozone, so it is likely looking for some sort of foreign investment boost. We view China's program as a form of imperialism; China has reached a stage of development where it has built more productive capacity than it can consume. To deal with this problem, which left unattended leads to deflation and potentially a depression (the U.S. Great Depression occurred, in part, due to this issue), China is trying a myriad of tactics, including moving up the value chain (China 2025) and lifting exports. The belt and road project is designed to use China's capacity to build projects abroad and create dependent governments that will absorb China's imports. Imperialism was the way European nations dealt with this issue in the 19th and 20th centuries. The other way to address the issue, mass mobilization war, hasn't been tried yet (thankfully).

Brexit: U.K. negotiators are in Brussels trying to adjust the Irish backstop.[6] Although we don't see the EU making major changes to the current proposal,[7] we could see some assurances from Brussels that the backstop won't be permanent and may allow the U.K. to negotiate its own trade pacts. With the odds of a hard Brexit diminishing, votes next week will either lead to a grudging acceptance of May's proposal or a delay.

North Korea: In the aftermath of the Hanoi summit, it appears North Korea is back in the missile business. Pyongyang has started to rebuild its Sohae Satellite Launching station, which it had been dismantling before the summit.[8] The missile issue is important because North Korea had stopped testing missiles and the Trump administration seemed to be moving along a path that might have offered Pyongyang aid if it gave up its ability to strike the U.S. mainland. Returning to rocket building is likely an attempt to push the U.S. back into negotiations.[9] However, we note that President Trump's initial stance toward North Korea was openly hostile so if he feels like he was "played" by Kim Jong-un then he may very well return to that position.

U.S. Economic Releases

MBA mortgage applications fell 2.5% from the prior week. Purchases and refinancing fell by 2.6% and 2.0%, respectively. The average 30-year fixed rate rose by 2 bps from 4.65% to 4.67%.

The ADP employment change came in below expectations at 183k compared to the forecast of 190k.

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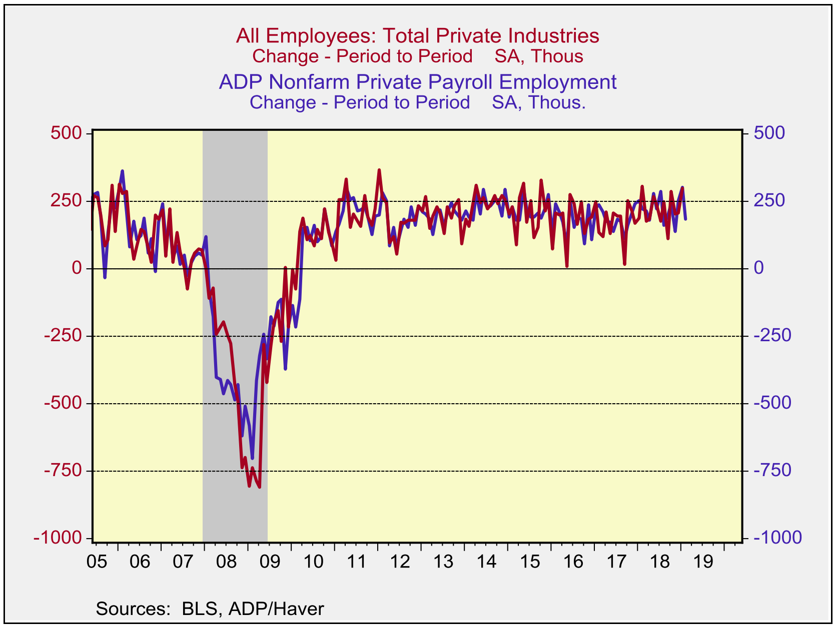
[5] https://www.ft.com/content/17f91d24-3f60-11e9-b896-fe36ec32aece?emailId=5c7f2fea2d8a680004667b0d&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22 ; for background: https://www.ft.com/reports/china-belt-and-road-initiative?emailId=5c7f2fea2d8a680004667b0d&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

[6] https://www.nytimes.com/2019/03/05/world/europe/brexit-irish-backstop-uk-brussels.html?emc=edit_mbe_20190306&nl=morning-briefing-europe&nlid=567726720190306&te=1

[7] https://www.reuters.com/article/us-britain-eu-weekend/eu-sees-no-brexit-breakthrough-before-the-weekend-sources-idUSKCN1QN10Y?feedType=RSS&feedName=worldNews

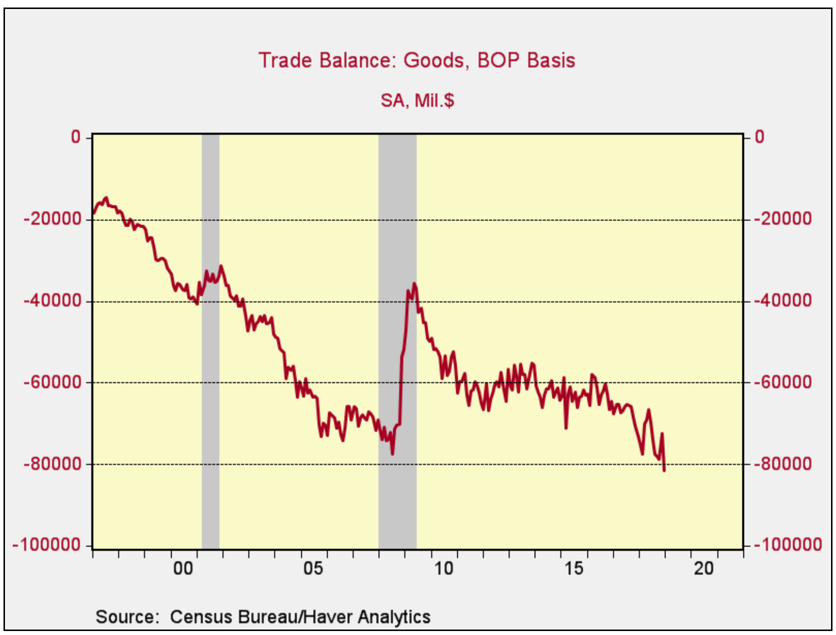
[8] https://www.38north.org/2019/03/sohae030519/

[9] https://www.washingtonpost.com/world/north-korea-rebuilds-rocket-engine-test-site-in-ominous-signal-about-attitude-to-talks/2019/03/05/de9c7e54-3faf-11e9-a44b-42f4df262a4c_story.html?utm_term=.ee7ab7aa113a&wpisrc=nl_todayworld&wpmm=1



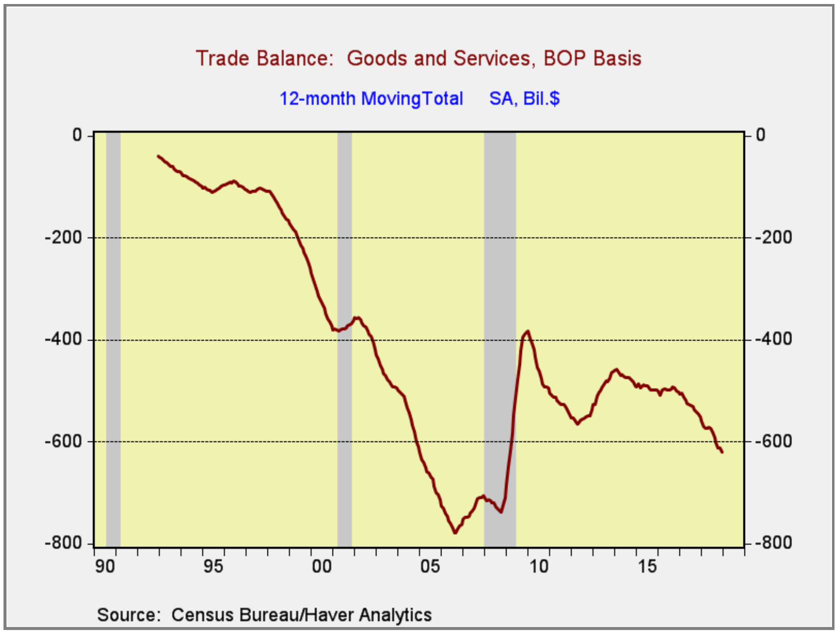
The chart above shows the change in total private employment, which suggests the economic expansion continues.

The December trade deficit came in wider than expected at $59.8 bn compared to the forecast of $57.9 bn. The prior report's deficit was revised to $50.3 bn from $49.3 bn.

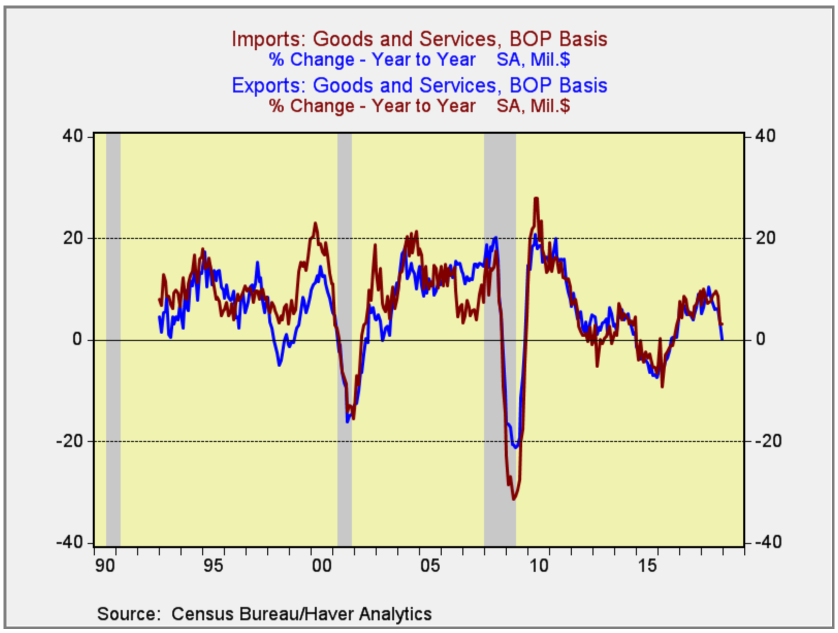


The chart above shows the trade balance. The U.S. trade deficit in goods grew to the widest margin in its history.

For all of 2018, the goods and services deficit reached $621.0 bn.



The deficit widened mostly because of weaker export growth. Exports reflect foreign demand and thus the slowdown in global growth reduced U.S. export activity.



The table below shows the Fed events scheduled for the rest of the day.

Economic Releases		
No economic releases today		
Fed speakers or events		
EST	**Speaker or event**	**District or position**
12:00	John Williams Speaks to Economic Club of New York	President of the Federal Reserve Bank of New York
12:00	Loretta Mester Participated in Moderated Discussion	President of the Federal Reserve Bank of Cleveland
14:00	IS Federal Reserve Releases Beige Book	Federal Reserve Board

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	GDP	y/y	4q	2.3%	2.8%	2.3%	***	Equity and bond neutral
New Zealand	QV House Prices	y/y	feb	3.0%	2.9%		**	Equity and bond neutral
EUROPE								
Germany	Markit Germany Construction	m/m	feb	54.7	50.7		**	Equity bullish, bond bearish
Russia	Light Vehicle Car Sales	m/m	feb	-0.4%	1.0%	0.0%	**	Equity and bond bearish
AMERICAS								
Mexico	Consumer Confidence Index	m/m	feb	116.8	111.9	111.8	***	Equity bullish, bond bearish
	Internation Reserves Weekly	m/m	mar	$175.646 bn	$175.694 bn		**	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)	261	260	1	Up
3-mo T-bill yield (bps)	240	239	1	Neutral
TED spread (bps)	21	21	0	Neutral
U.S. Libor/OIS spread (bps)	241	241	0	Up
10-yr T-note (%)	2.70	2.72	-0.02	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	8	9	-1	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	flat			Up
yen	up			Neutral
pound	down			Neutral
franc	flat			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	$65.83	$65.86	-0.05%	
WTI	$56.15	$56.56	-0.72%	
Natural Gas	$2.88	$2.88	-0.14%	
Crack Spread	$21.60	$21.23	1.74%	
12-mo strip crack	$17.82	$17.50	1.86%	
Ethanol rack	$1.45	$1.45	-0.01%	
Metals				
Gold	$1,286.44	$1,288.01	-0.12%	
Silver	$15.09	$15.14	-0.29%	
Copper contract	$293.55	$293.35	0.07%	
Grains				
Corn contract	$ 375.25	$ 375.75	-0.13%	
Wheat contract	$ 459.25	$ 462.75	-0.76%	
Soybeans contract	$ 913.25	$ 913.75	-0.05%	
Shipping				
Baltic Dry Freight	663	669	-6	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.1		
Gasoline (mb)		-1.5		
Distillates (mb)		-9.1		
Refinery run rates (%)		-0.05%		
Natural gas (bcf)		-144.0		

Weather

The 6-10 and 8-14 day forecasts show cooler temperatures for most of the country, with warmer temps in the eastern region of the country. Precipitation is expected for most of the country.

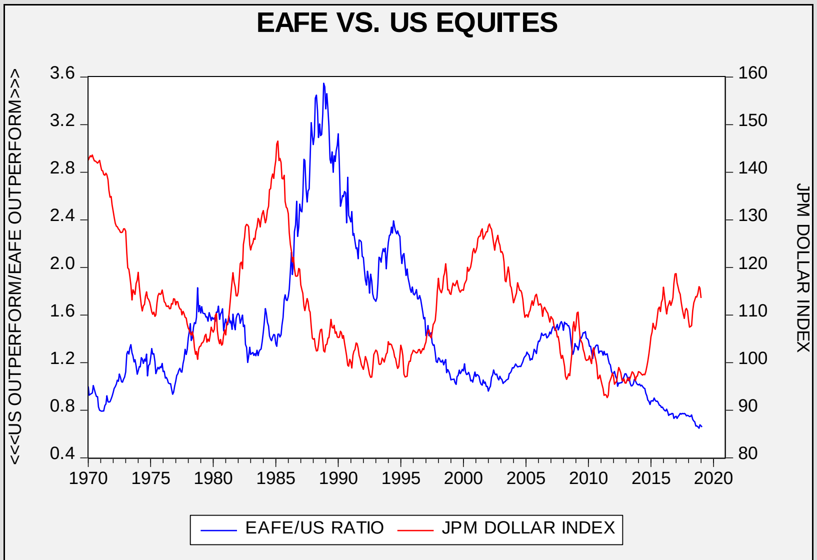
Asset Allocation Weekly Comment

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 1, 2019

Our cyclical position on foreign investing remains with a zero allocation; although the committee has not been negative on foreign, our work suggested that the risk/reward compared to small and mid-cap stocks warranted putting more assets in those areas. However, we are continuing to pay close attention to foreign as an area that may be attractive in the future.

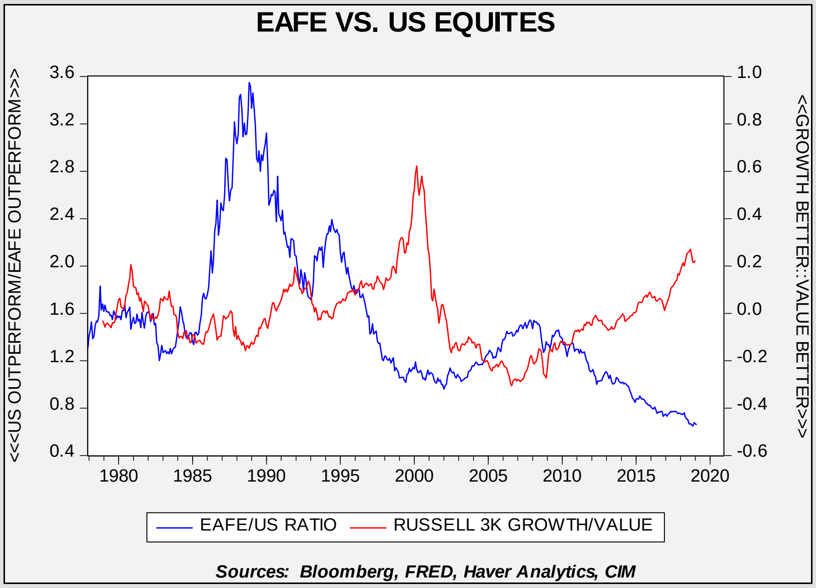
In the past, we have noted that relative performance between foreign developed and U.S. equities is sensitive to the dollar. In general, during periods of dollar strength, U.S. equities tend to outperform (assuming both are denominated in dollars, which is the case for a U.S. investor).



Sources: Bloomberg, Haver Analytics, CIM

The blue line on the chart shows the ratio of performance between EAFE and the U.S., rebased to 1970. When this line is rising, foreign stocks are outperforming. The red line shows the JPM Dollar Index. Note that a rising dollar tends to favor U.S. outperformance, while dollar weakness helps foreign market performance. Although the dollar has remained strong, both on a purchasing power parity basis and a cycle basis, the dollar is extended and should begin to depreciate later this year.

However, in this business cycle, U.S. stocks have generally outperformed even during periods of dollar weakness. This has led us to look for other factors that might account for this discrepancy. It appears that the growth/value variation explains at least part of this divergence.



As in the first chart, the blue line shows the relative equity performance. The red line shows the Russell 3000 Growth/Value divergence; a rising line suggests growth outperformance. Growth stocks have outperformed in this bull market but are showing signs they may finally be starting to give way to value. The primary driver of growth/value is the P/E ratio. Significant multiple expansion isn't all that likely, although a return to the 18x+ area would not be surprising.

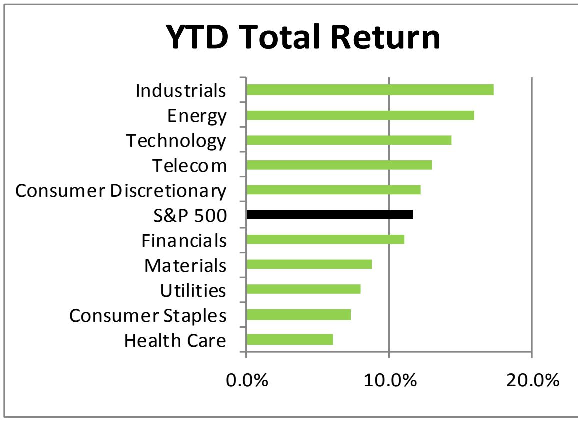
Why would the growth/value divergence affect foreign stocks? The most likely reason is index construction. U.S. indices will tend to have a greater weighting toward technology due to the size of that industry in the U.S. economy. Foreign nations, for the most part, have less dominant tech industries. With technology being considered a growth sector, a period of strong technology performance would tend to lead to outperformance by growth. If foreign equity indices have less technology, they would likely underperform. Consequently, when the growth/value balance shifts to the latter, we would anticipate foreign outperformance. The table below provides a comparison of sector exposures.

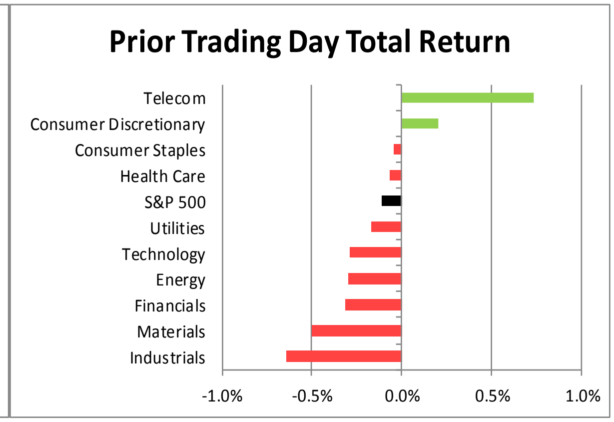
	MSCI EAFE	**S&P 500**	**Difference**
Energy	5.9%	5.4%	0.5%
Materials	7.4%	2.7%	4.7%
Industrials	14.1%	9.7%	4.3%
Consumer Discretionary	11.2%	10.0%	1.3%
Consumer Staples	11.8%	7.1%	4.6%
Healthcare	11.4%	14.9%	-3.5%
Financials	19.2%	13.3%	5.9%
Information Technology	6.2%	20.5%	-14.3%
Communication Services	5.6%	10.1%	-4.4%
Utilities	3.5%	3.2%	0.2%
Real Estate	3.7%	3.0%	0.7%
Source: Morningstar Direct, Data as of 2/22/19			

Overall, we continue to monitor the relative performance of foreign compared to other asset classes. If our risk/reward estimates change later this year, we could consider a return to international.

Data Section

U.S. Equity Markets – (as of 3/5/2019 close)

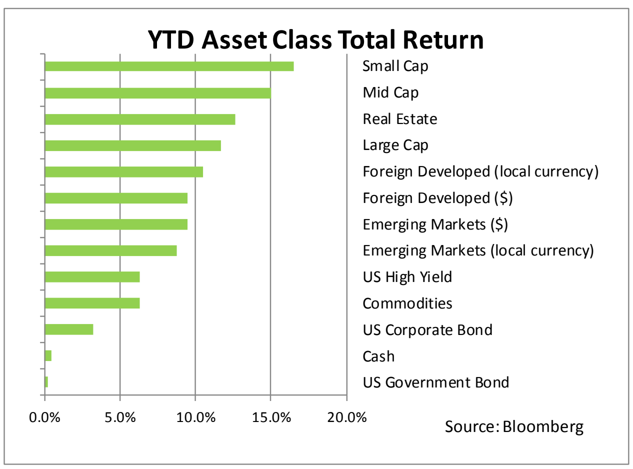




(Source: Bloomberg)

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 3/5/2019 close)

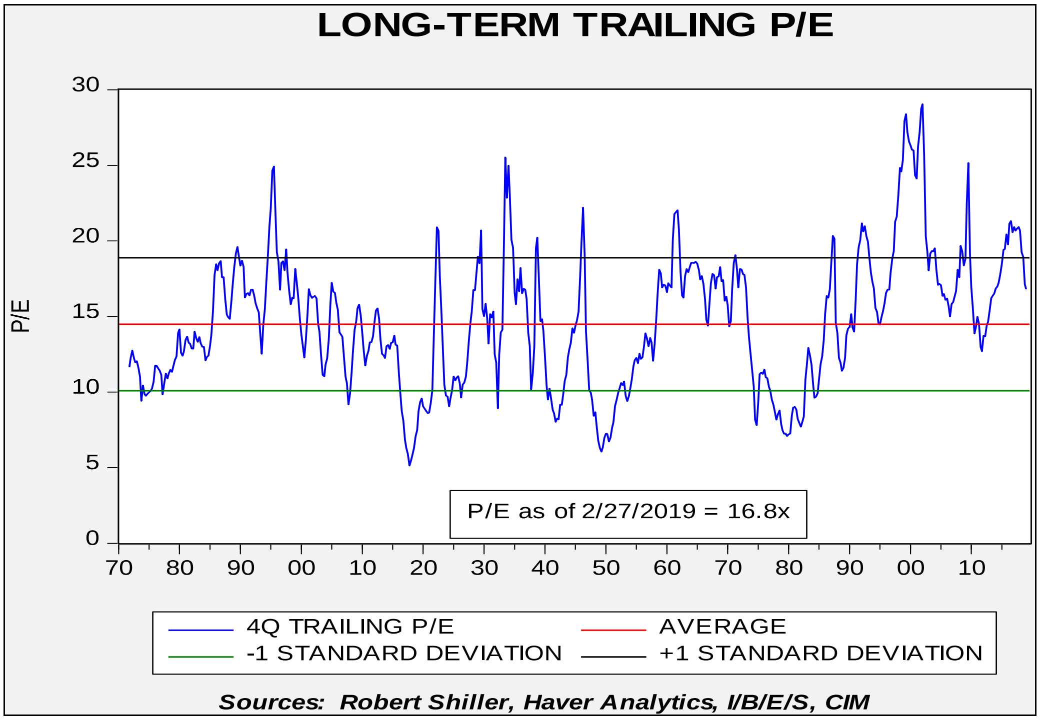


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

February 28, 2019



Based on our methodology,[10] the current P/E is 16.8x, up 0.1x from last week. Rising index values led to the rise in the multiple.

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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[10] 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 two actual quarters (Q2 and Q3) and two estimates (Q4 and 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.