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 7, 2018—9:30 AM EST] Global equity markets are generally lower this morning. The EuroStoxx 50 is up 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.5% from the prior close. Chinese markets were lower, with the Shanghai composite down 0.6% and the Shenzhen index down 0.8%. U.S. equity index futures are signaling a lower open.

There is much to discuss this morning. Let's get to it:

Cohn out: Gary Cohn, Director of the National Economic Council, resigned yesterday evening. Although reports suggest he has been considering the move for a couple of months, the proximate cause was the inability to turn the president on tariffs. The financial market reaction was swift—equity futures plunged after the announcement, although they have regained some of their initial decline.

At this point, the broader market reaction has been rather scattered. A turn to protectionism is, over time, inflationary (using the structural/cyclical model discussed in the AAW below, this is a structural component), but Treasuries have rallied and gold has declined. This would suggest more worries about an economic downturn and less about inflation. Some of this reaction may be based on expectations that the Fed will maintain inflation expectations by lifting rates. Supporting that notion were comments late yesterday from Governor Brainard who suggested that growth "tailwinds" may speed policy tightening.[1] What makes this remarkable is that Brainard is one of the most dovish members of the FOMC, a consistent voter for accommodation. For her to turn even modestly hawkish does indicate tighter policy is likely.

How important is Cohn's departure? From day one we framed the administration as made up of factions, populists and establishment. The former support policies that harm capital and support inflation, while the latter want policies that boost capital and contain inflation. The backdrop of the Trump presidency has been a consistent battle between these two sides. At first, the populists were winning, with Bannon and Miller seemingly driving policy. The ouster of Preibus and the installation of Kelly as Chief of Staff brought order and the rise of the establishment. The tax cuts were the clearest evidence of establishment power. Cohn's departure suggests a populist counterinsurgency. But, it is clear that Trump doesn't consistently favor one side over the other. Instead, he seems to foster an "ebb and flow" between the two sides. This is partly a function of

[1] https://www.bloomberg.com/amp/news/articles/2018-03-07/brainard-suggests-growth-tailwinds-may-speed-fed-rate-hike-pace?__twitter_impression=true

his management style. He seems to like to watch conflict and use it to make decisions. So, now that it appears that the populists are winning, it wouldn't be a shock to see him do something that flips the script. One signal of that would be replacing Cohn with Larry Kudlow, an avowed supply side economist who would also strongly oppose trade barriers. And, Cohn might not be completely gone. There have been rumors that he could replace Kelly as Chief of Staff.

So, there are two core ideas that we are using to analyze policy. First, pundits are turning themselves inside-out trying to divine the "real" Trump and watch him develop a consistent set of policies only to see constant vacillation. This isn't a bug in Trump's management, it's a feature. No faction ever gets complete control because that would mean Trump loses the ability to change course. Trump does believe, at a visceral level, that trade deficits are "losses." That is a common belief, but the reality is much more complicated. As a clear example, there is only one autarky in the world, which is North Korea. No other nation is trying to emulate the Hermit Kingdom's economy. In other words, trade is good for an economy. In fact, if the president really wants to affect trade, he should have signed on to the border adjustment tax idea that was floated as part of the corporate tax reform. That would have raised import costs, likely reduced the trade deficit and made tax reform revenue neutral. But, that would have also taken away the president's ability to bargain by offering and taking away benefits. In other words, the border adjustment tax would have affected trade in his favored direction efficiently at the cost of negotiating flexibility. The president seems to prize the latter over everything.

Second, although we watch the administration, we firmly believe in trends, not people. The rise of populism and a revolt against the establishment and capital is underway. Election results in Italy last weekend are just another example of this phenomenon. Trump's election was part of this wave. However, he isn't a perfect "vessel" of the trend because he does want the support of the establishment at times. So, we have tax cuts, which populists don't necessarily favor. But, trade impediments are clearly part of the populist package. Although the Cohn news dominated, we also note Bloomberg is reporting that the U.S. is considering broader action against China for violating intellectual property rules.[2] That's a much bigger deal. Thus, there is likely more protectionism to come. One of our paradigms is that economies go through 30- to 50-year cycles of efficiency versus equality. During the former, deregulation and globalization are supported, while it's just the opposite during the latter. We have been in an efficiency cycle since 1978. We are moving into an equality cycle, although it may take another decade for it to become completely obvious. But, the tipping point is being reached. Trade impediments and reregulation are a likely outcome.

So, where does this leave us? The economy is still doing very well. Earnings are robust. The path of equities really comes down to the multiple. Based on consumer confidence, the multiple should be fine but what we saw yesterday can upend confidence and eventually lead to a falling P/E. For now, we still think the risk for equities is to the upside. If Cohn's replacement is an establishment figure, equities will likely recover. We are much more worried about 2019; a tighter Fed and a lessening of the fiscal boost have the potential to weaken the economy and earnings. But, for now, we still think odds favor rising equity prices.

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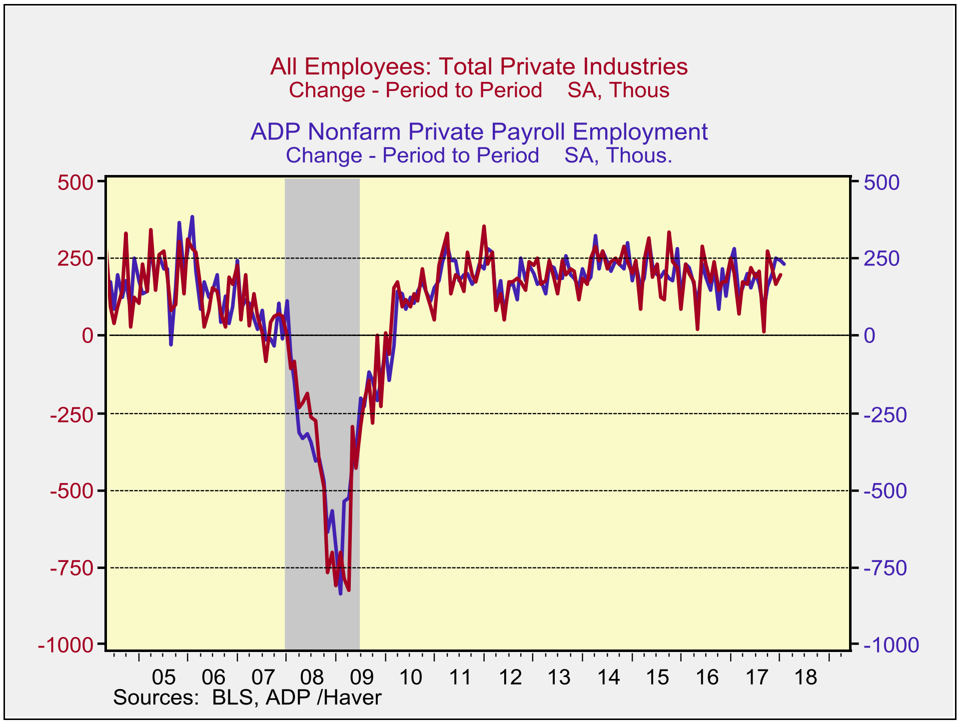
[2] https://www.bloomberg.com/amp/news/articles/2018-03-06/u-s-said-to-consider-broad-curbs-on-chinese-imports-takeovers?__twitter_impression=true

U.S. Economic Releases

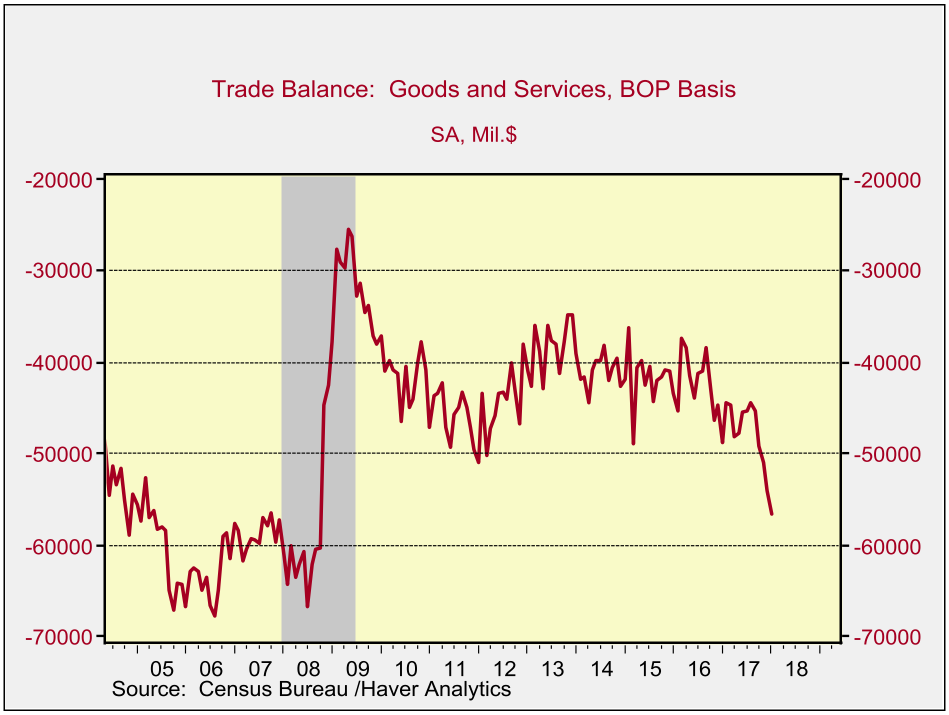
MBA mortgage applications rose 0.3% from the prior week. Purchases fell by 0.5%, while refinancing rose 1.5% from the prior week. The average 30-year fixed rate rose by 1 bp from 4.64% to 4.65%.

ADP employment change came in above expectations at 235k compared to the forecast of 200k. The prior report was revised upward from 234k to 244k.



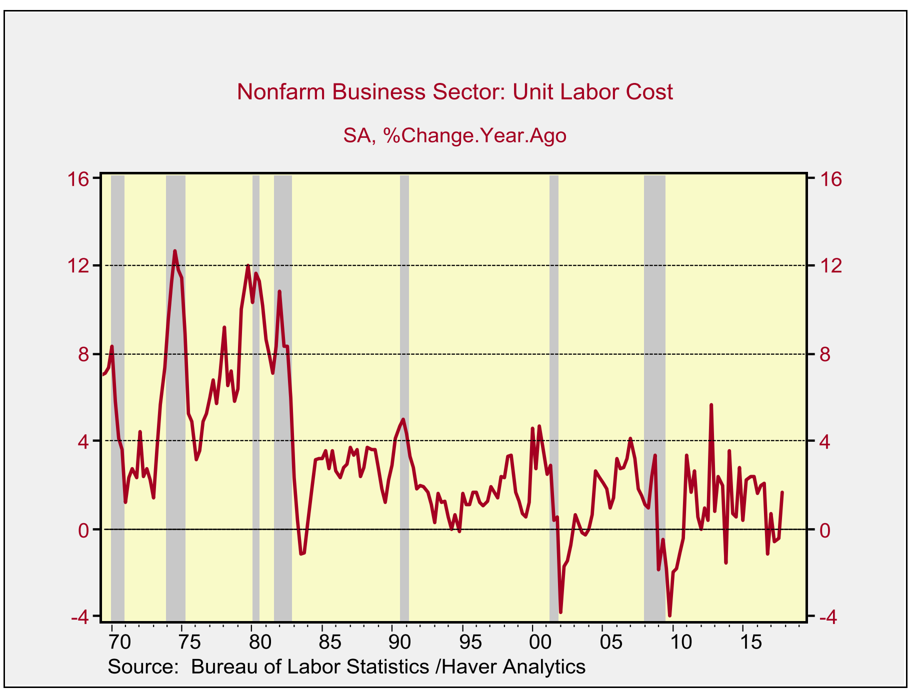
The chart above shows the change in ADP employment and private payrolls. A high ADP employment change number signals a strong BLS non-farm payroll report for Friday.

The trade deficit came in wider than expected at $56.6 bn compared to the forecast of $55.0 bn. The prior report's deficit was revised wider from $53.1 bn to 53.9 bn.



The chart above shows the level of the trade balance for goods and services.

Nonfarm productivity came in above expectations, remaining unchanged from the prior quarter compared to the forecast loss of 0.1%. Unit labor costs came in above expectations, rising 2.5% from the prior quarter compared to the forecast gain of 2.1%. The chart below shows yearly changes in unit labor costs.



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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
15:00	Consumer Credit	m/m	jan	$17.650 bn	$18.447 bn	**
Fed speakers or events						
EST	Speaker or event	District or position				
14:00	US Federal Reserve Releases Beige Book	Members of the Board of Governors				

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	Official Reserve Assets	m/m	feb	$1.262 tn	$1.267 tn		**	Equity and bond neutral
	Leading Index CI	m/m	jan	104.8	107.4	106.5	**	Equity and bond neutral
	Coincident Index	m/m	jan	114.0	120.2	115.3	**	Equity and bond neutral
Australia	AiG Perf of Construction Index	m/m	feb	56.0	54.3		**	Equity and bond neutral
	GDP	y/y	feb	2.4%	2.8%	2.5%	***	Equity and bond neutral
	Foreign Reserves	m/m	feb	A$70.8 bn	A$65.3 bn		**	Equity and bond neutral
New Zealand	QV House Prices	y/y	feb	6.5%	6.4%		**	Equity and bond neutral
EUROPE								
Eurozone	GDP	m/m	4q	0.6%	0.6%	0.6%	***	Equity and bond neutral
France	Trade Balance	m/m	jan	-5.560 bn	-3.468 bn	-4.450 bn	**	Equity bearish, bond bullish
	Current Account Balance	m/m	jan	-1.600 bn	0.900 bn		**	Equity bearish, bond bullish
U.K.	Halifax House Prices	m/m	feb	0.4%	-0.6%	0.4%	**	Equity and bond neutral
Switzerland	CPI	y/y	feb	0.6%	0.7%	0.6%	***	Equity and bond neutral
Russia	CPI	y/y	feb	0.2%	0.3%	0.3%	***	Equity and bond neutral
	CPI Core	y/y	feb	0.1%	0.2%	0.2%	***	Equity and bond neutral
AMERICAS								
Canada	Ivey Purchasing Managers Index	m/m	feb	59.6	55.2		**	Equity bullish, bond bearish
Brazil	Industrial Production	m/m	jan	5.7%	4.3%	5.2%	***	Equity bullish, bond bearish
Mexico	Consumer Confidence Index	m/m	feb	82.0	84.2	84.1	***	Equity and bond neutral
	Gross Fixed Investment	m/m	dec	-0.4%	-4.5%	-0.6%	**	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)	203	203	0	Up
3-mo T-bill yield (bps)	164	164	0	Neutral
TED spread (bps)	39	39	0	Neutral
U.S. Libor/OIS spread (bps)	163	163	0	Up
10-yr T-note (%)	2.85	2.89	-0.04	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	31	30	1	Down
Currencies	**Direction**			
dollar	up			Down
euro	flat			Up
yen	up			Up
pound	down			Up
franc	flar			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBA Cash Rate Target	1.500%	1.500%	1.500%	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	$65.17	$65.79	-0.94%	Bearish API Report
WTI	$62.04	$62.60	-0.89%	
Natural Gas	$2.78	$2.75	1.13%	
Crack Spread	$18.44	$18.17	1.46%	
12-mo strip crack	$17.22	$17.11	0.63%	
Ethanol rack	$1.55	$1.54	0.09%	
Metals				
Gold	$1,330.03	$1,334.56	-0.34%	Stronger Dollar
Silver	$16.64	$16.76	-0.74%	
Copper contract	$312.65	$315.90	-1.03%	
Grains				
Corn contract	$ 387.75	$ 388.25	-0.13%	
Wheat contract	$ 504.25	$ 507.00	-0.54%	
Soybeans contract	$ 1,068.25	$ 1,074.75	-0.60%	
Shipping				
Baltic Dry Freight	1212	1210	2	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.5		
Gasoline (mb)		1.8		
Distillates (mb)		-0.8		
Refinery run rates (%)		-0.30%		
Natural gas (bcf)		-56.0		

Weather

The 6-10 and 8-14 day forecasts continue to signal colder than normal temperatures for most of the country, with warmer temperatures in the central region of the country.

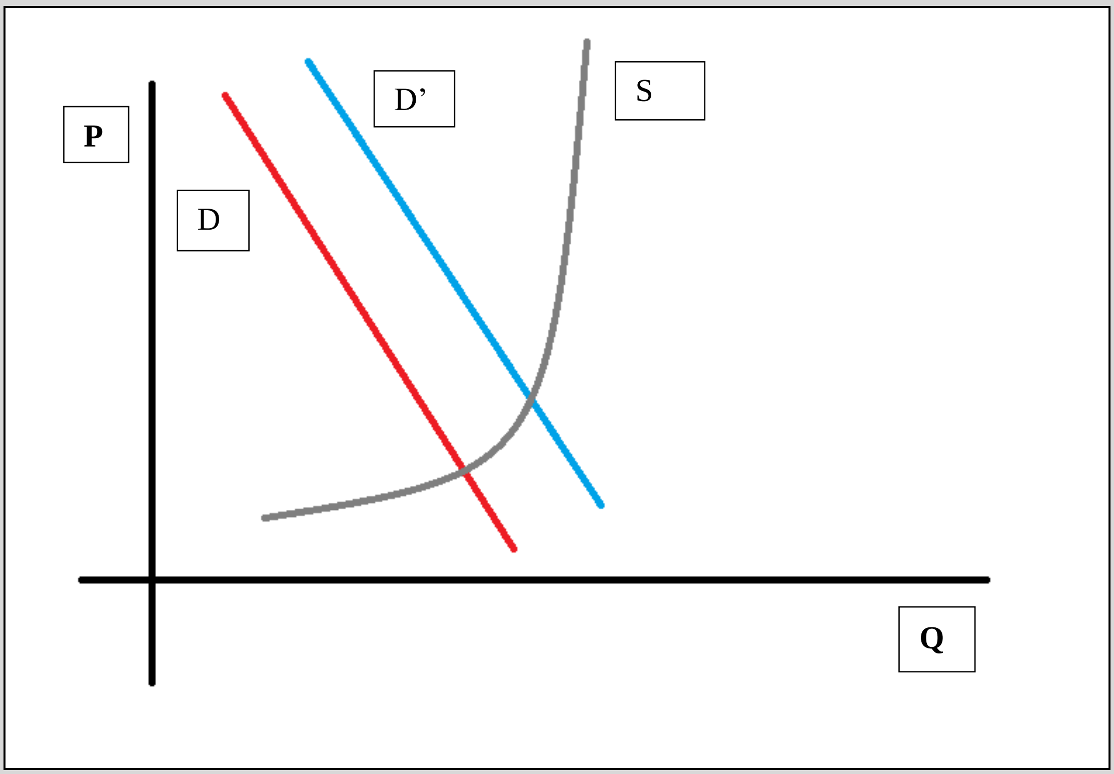
Asset Allocation Weekly Comment

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.

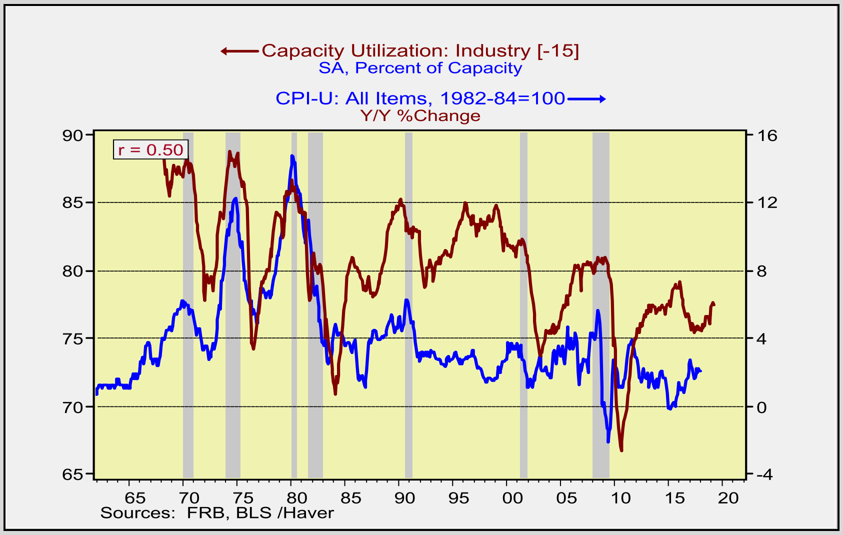
March 2, 2018

The recent rise in long-duration yields has been partially blamed on rising inflation expectations. Although this reason is a possible explanation, the reality is that it's more likely the fixed income markets are simply adjusting to a faster pace of policy tightening. In this report, we examine the differences between cyclical and secular trends in inflation.

Cyclical trends in inflation are driven by available slack in the economy. In purely theoretical terms, it's based on the slope of the aggregate supply curve. As available capacity is depleted, additional demand intersects supply when the slope of the supply curve is becoming increasingly vertical.

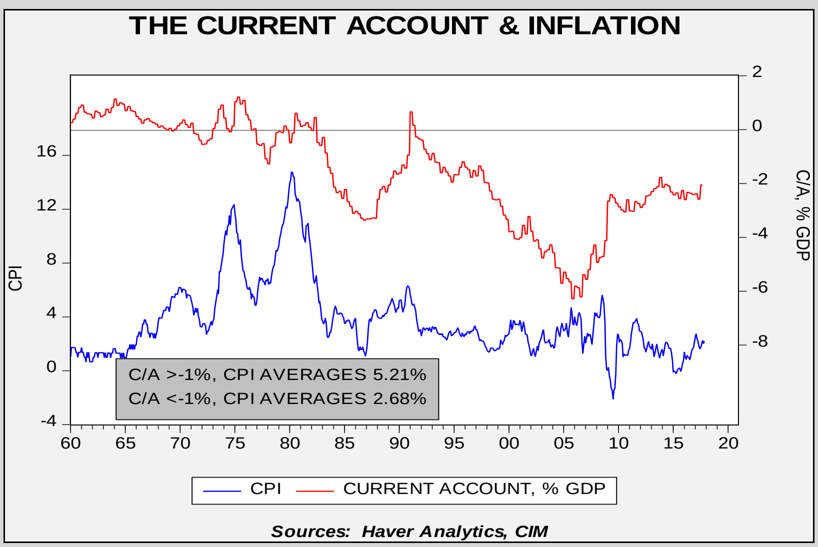


This stylized drawing shows that as demand rises from D to D', the quantity supplied rises but so do price levels. Obviously, the slope of the supply curve is critical. Policies designed to increase the supply side of the market will tend to bring more output with less inflation. Cyclical inflation is a function of movements along an existing aggregate supply curve, which is fixed in the short run. In the long run, the supply curve can expand or contract; the former leads to lower inflation at all levels of demand and the latter leads to higher levels of inflation at all levels.



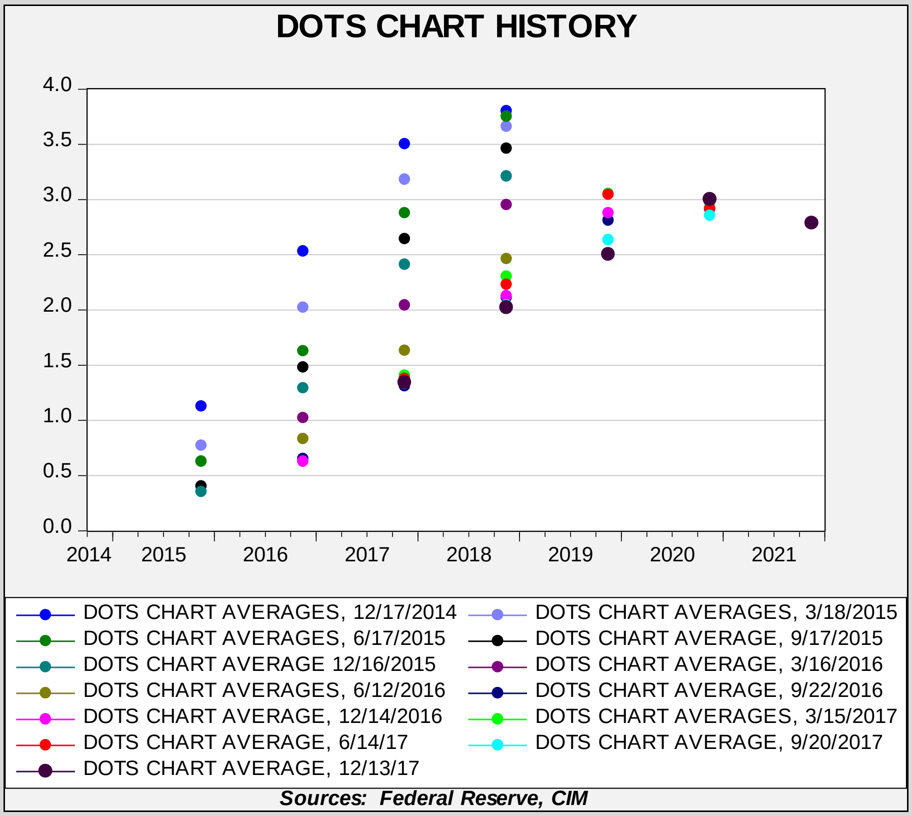
This chart shows the relationship between the yearly change in inflation and capacity utilization; the latter leads inflation by five quarters. Note that in the 1970s into the early 1980s, high levels of capacity utilization were consistent with very high levels of inflation. If the relationship between inflation and capacity utilization that existed in 1972-82 had been maintained, the current level of utilization would have generated inflation of 4.5%, reaching 5.3% by early 2019. But, clearly, the relationship has changed.

We believe the key elements of structural inflation are trade and regulation. An economy open to trade can tap excess capacity globally, and one that is deregulated can rapidly introduce new techniques and technology to improve productivity. The upside to this these policies is lower inflation at each level of aggregate demand; the downside is usually higher levels of inequality.



This chart shows the current account with inflation. Inflation fell dramatically as the current account deficit rose from the early 1980s forward.

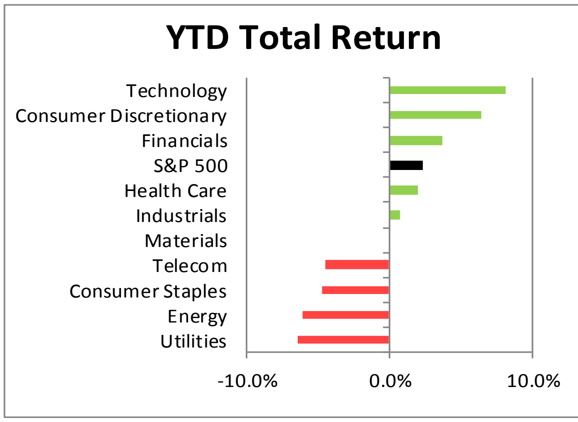
The recent lift in long-term interest rates appears to be due to a re-evaluation of monetary policy expectations. The FOMC's dots chart has consistently expected normalization in three to four years' time. However, slow growth and low inflation have persistently pushed off that actual tightening into the ever distant future. The chart below shows the average of the FOMC members' dots for future year-end fed funds rates. For example, in December 2014, the committee expected the terminal rate in 2018 to be 3.75%. Note how that rate for the end of 2018 steadily declined until last December's average of just over 2%, or two hikes this year. We expect three increases are more likely.

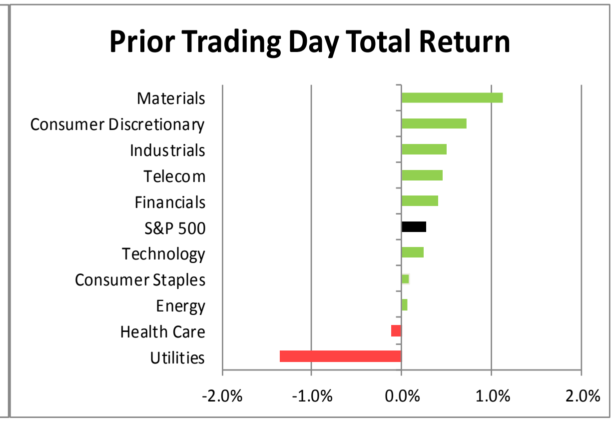


Although our base case is that secular inflation factors remain unchanged, we are watching trade policy very closely. If the president makes good on his promises to restrict imports, the potential is there for at least a significant secular inflation scare. So far, there has been more rhetoric than action but that may change in the coming year. The FOMC would face a dilemma if inflation expectations were to become "unanchored." Do they move up the fed funds target with enough vigor to offset the rise in inflation caused by the leftward shift of the aggregate supply curve and likely face a "tweet storm" from the White House, or do they acquiesce to the negative change in aggregate supply and allow inflation fears to return in earnest? Hopefully, Chair Powell won't face that difficult choice but, if he does, the potential for market disruption would be high

Data Section

U.S. Equity Markets – (as of 3/6/2018 close)

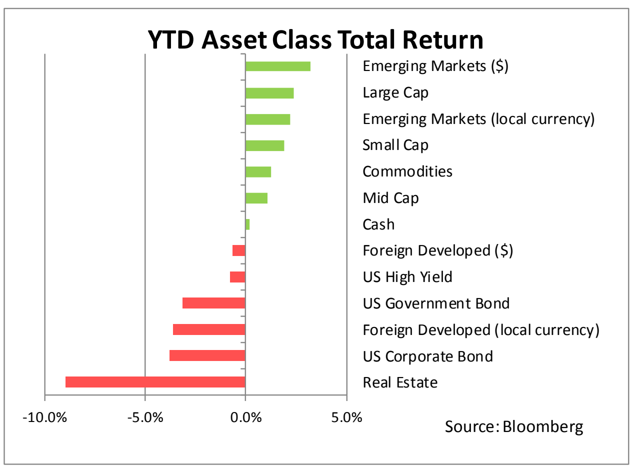




(Source: Bloomberg)

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 3/6/2018 close)

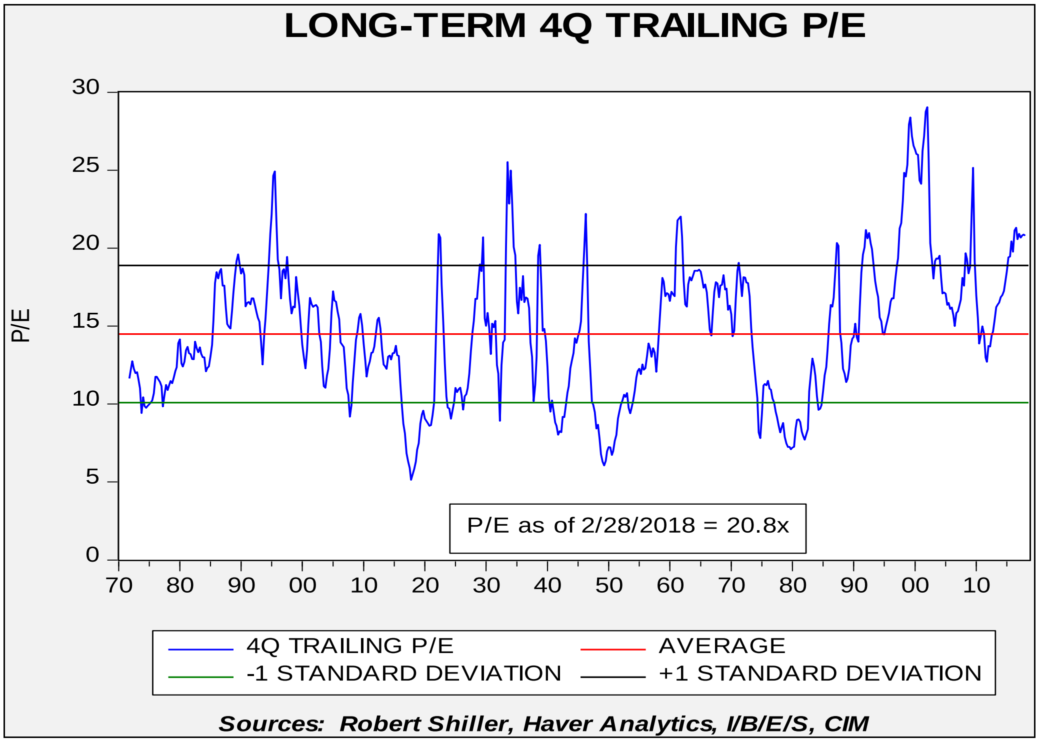


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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).

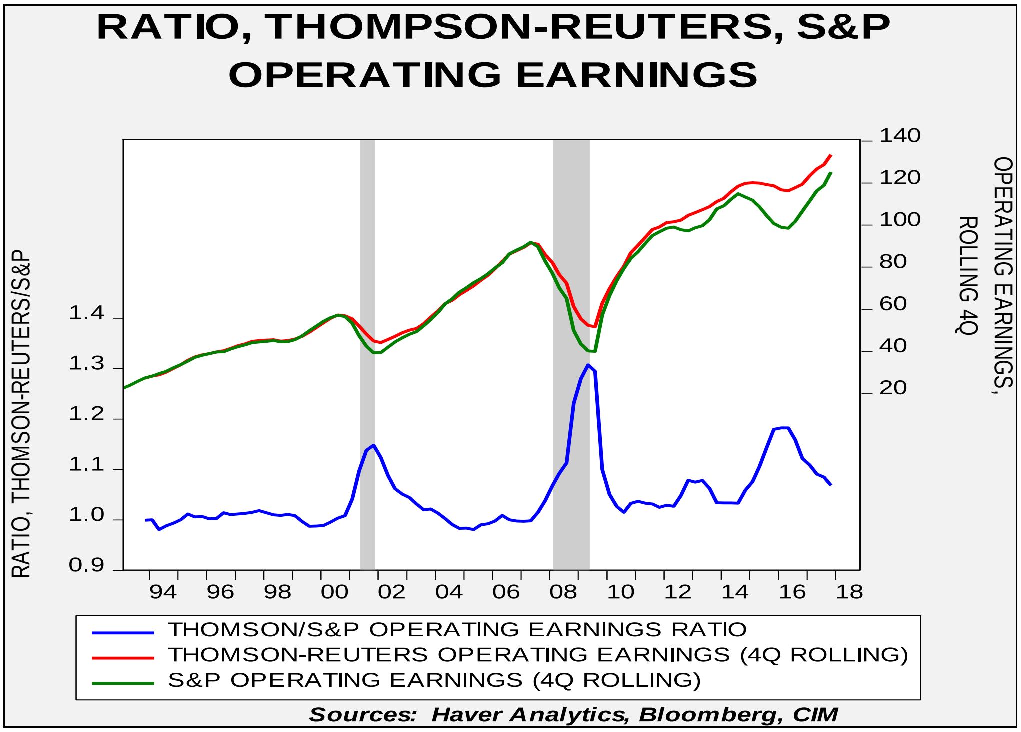
P/E Update

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.



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