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 8, 2018—9:30 AM EST]** Global equity markets are higher this morning. The EuroStoxx 50 is up 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed up 1.2% from the prior close. Chinese markets were higher, with the Shanghai composite up 0.5% and the Shenzhen index up 1.0%. U.S. equity index futures are signaling a higher open.

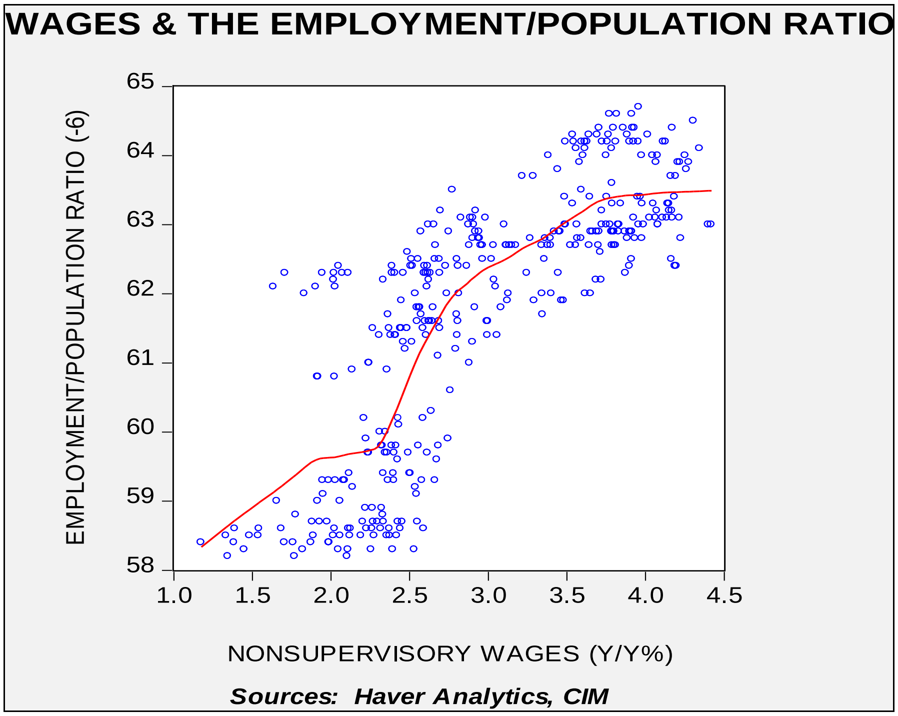
After a torrent of news this week, it's comparatively quiet this morning. Here is what we are watching:

**ECB:** The ECB meets today and the statement contained a surprise—the central bank has dropped its pledge to expand QE if needed. This announcement signals the beginning of tapering. On the news, the EUR jumped, Eurozone interest rates rose and European equities weakened. To some extent, this decision shouldn't have been a surprise. The bank has been saying for some time that QE would eventually be coming to a close. The market's reaction does suggest that even the most modest change in ECB policy accommodation is seen as hostile. But, the reality is that dropping this pledge isn't a big deal. Policy remains easy and this decision merely affects forward guidance and not current policy.

During the press conference, ECB President Draghi announced the bank increased its GDP forecast for this year to 2.4% from 2.3%, and lowered CPI forecast for next year to 1.4% from 1.5%. In the Q&A, Draghi indicated that the decision to remove the QE expansion language was unanimous. But, the rest of the commentary was not hawkish and the EUR fell from pre-press conference highs. The currency is off its highs but remains above the intraday lows. Overall, as we noted above, the ECB is preparing to taper but does remain very accommodative.

**Trade:** According to numerous reports, the GOP establishment is working furiously to reduce the impact of the steel and aluminum tariffs. It appears that Canada and Mexico will not be penalized due to their cooperation with the U.S. on security, and the EU is lobbying for similar carve-outs for NATO. The situation with trade remains fluid. We will continue to monitor how the administration deals with trade but the worst case outcome is stagflation—trade impediments that lift inflation and slow growth. To put it in terms related to this week's AAW (see gray section below), trade interference shifts the aggregate supply curve higher and toward the "y" axis. In other words, inflation is higher at each intersection of supply and demand.

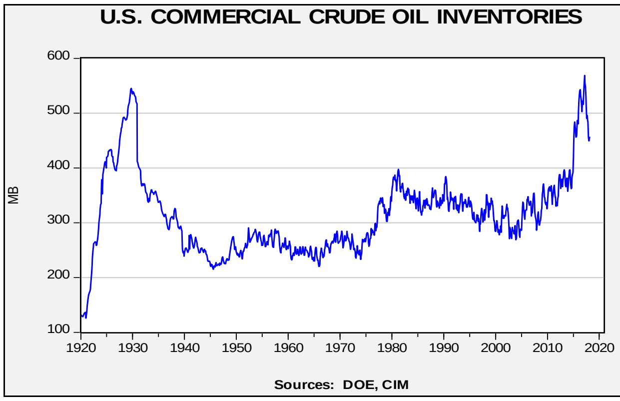
**Beige book:** The FOMC recently released its economic report by region. The anecdotal evidence suggests that wage pressures are rising. We have no doubt that wage pressures are rising but, so far, we have not yet seen widespread acceleration of wages. We suspect that much of this talk is from businesses complaining about not being able to find workers at prevailing wages. However, wage growth itself remains around 2.4% (for production and non-supervisory workers, the majority of employment). The chart below details the issue.

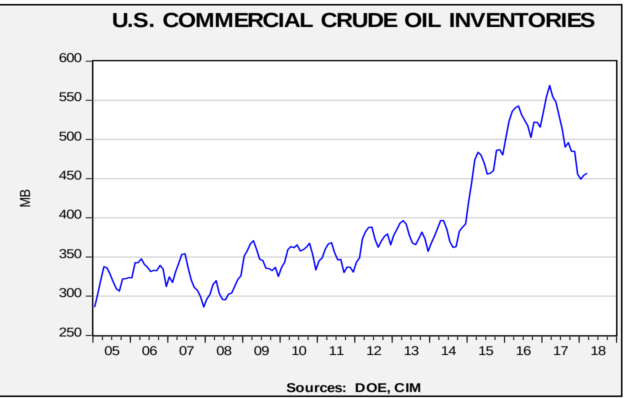



This is a scatter chart with the employment/population ratio, advanced six months, and wage growth for non-supervisory workers. We have placed a nearest neighbor fit line. Note that wages tend to rise quickly when the employment/population ratio moves from 58% to 60%; the slope then changes to nearly vertical, meaning that the ratio can rise from roughly 60% to nearly 62% without significant wage increases. Labor markets don't tighten significantly until around 62%, when wage growth accelerates significantly. With the current ratio around 60%, this analysis would suggest there are still workers available and the threat of accelerating wages is not imminent.

**Russians in Britain:** Former Russian spy (and double agent) Sergei Skripal and his daughter remain hospitalized in the U.K. after an apparent attack by some sort of nerve agent. Skripal had become an agent for MI-6 and is said to have provided the names of Russian agents working in Europe. He was detained and jailed in Russia until 2010, when he was part of a spy swap. Skripal was pardoned a year later. He and his daughter were found unresponsive on a park bench, and the policeman who responded first showed signs of nerve poisoning and was also treated. Both Skripals remain in critical condition. The British continue to investigate; although we suspect Russian involvement, the May government will need undeniable evidence before it will respond. This isn't the first time Russian security services have executed Russians in the U.K. Former FSB officer Alexander Litvinenko was poisoned with polonium-210 in 2006. If it is determined that Russian security services attacked the Skripals, it remains to be seen how Her Majesty's government will respond—we would expect an expulsion of diplomats.

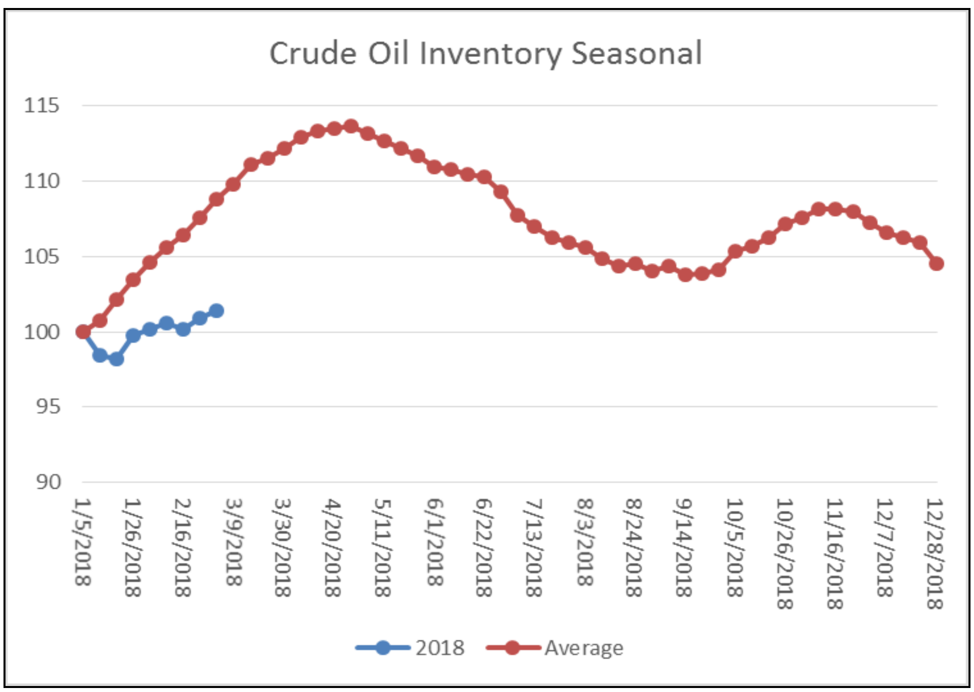
**Energy recap:** U.S. crude oil inventories rose 2.4 mb compared to market expectations of a 2.5 mb build.



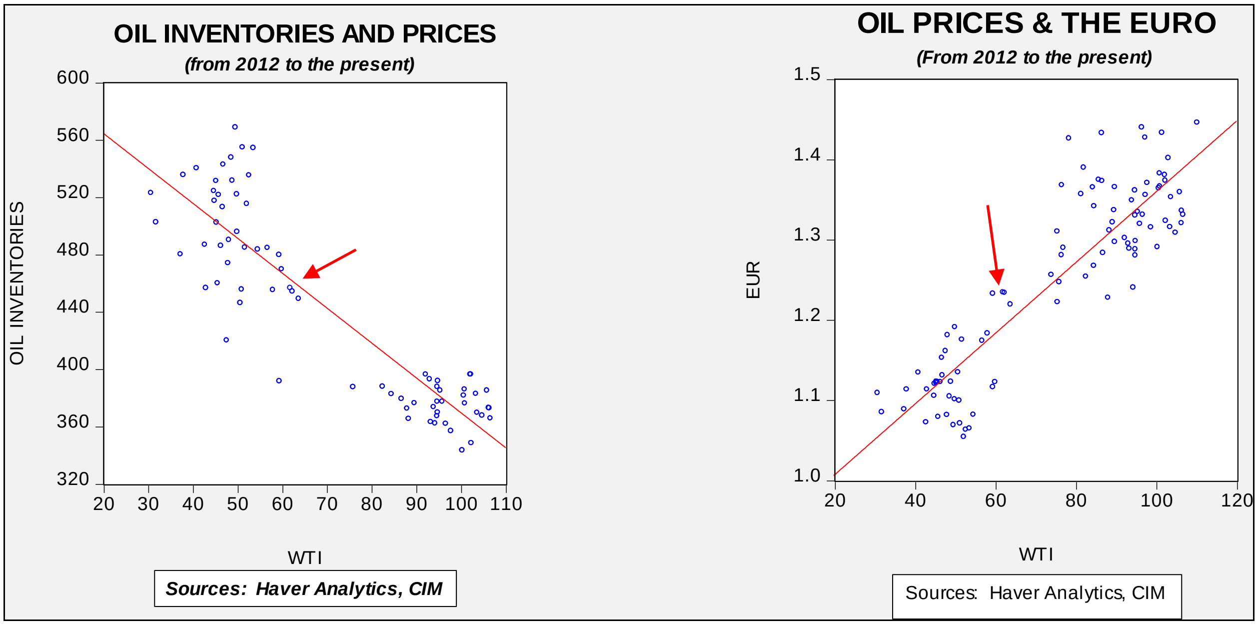




This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but have declined significantly since last March. We would consider 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 it becomes; thus, even with the higher than expected build this week, it is important to realize that stockpiles are well below where they should be.




(Source: DOE, CIM)

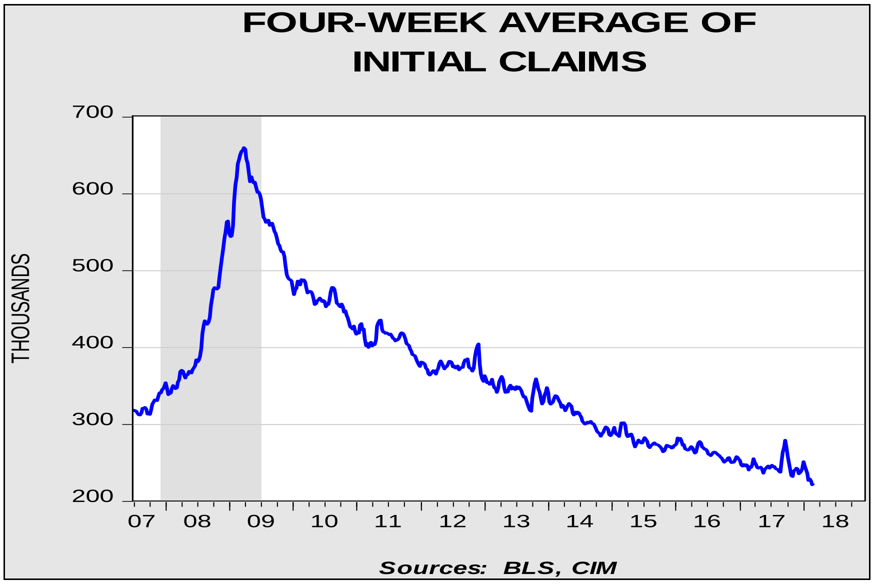



Based on inventories alone, oil prices are undervalued with the fair value price of $65.53. Meanwhile, the EUR/WTI model generates a fair value of $75.20. Together (which is a more sound methodology), fair value is $72.08, meaning that current prices are below fair value. Oil prices sold off yesterday despite the modest rise in stockpiles due to rising domestic production. The DOE's weekly report indicated that production rose to 10.369 mbpd, a new record. Still, the strong level of output isn't going to inventory and we have doubts that this production can be maintained without an increase in rigs in the near future. Thus, we look for tightening supplies and higher prices in the coming months.

**U.S. Economic Releases**

The February Challenger job cuts report fell by 4.3% from the prior year. The index measures the number of announced job cuts by employers, which is a proxy for future layoffs but does not necessarily indicate the state of current layoffs.

Initial jobless claims came in below expectations at 231k compared to the forecast of 220k.




The chart above shows the four-week moving average of initial jobless claims. The four-week moving average rose from 220.5k to 222.5k.

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

| Economic Releases | | | | | | |
|---|---|---|---|---|---|---|
| EDT | Indicator | | | Expected | Prior | Rating |
| 9:45 | Bloomber Consumer Comfort | m/m | Mar | | 56.2 | ** |
| 12:00 | Household Change in Net Worth | m/m | 4q | | $1.742 tn | ** |
| 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 | BoP Current Account Balance | m/m | jan | ¥607.4 bn | ¥797.2 bn | ¥437.4 bn | ** | Equity bullish, bond bearish |
| | Trade Balance | m/m | jan | -¥666.6 bn | -¥538.9 bn | -¥695.5 bn | ** | Equity and bond neutral |
| | GDP | q/q | 4q | 0.4% | 0.1% | 0.2% | *** | Equity bullish, bond bearish |
| | GDP Deflator | y/y | 4q | 0.1% | 0.0% | 0.0% | *** | Equity bullish, bond bearish |
| | Bankruptcies | y/y | feb | -10.3% | 5.0% | | ** | Equity and bond neutral |
| Australia | Trade Balance | m/m | jan | A$1.055 bn | A$1.358 bn | A$0.160 bn | ** | Equity bullish, bond bearish |
| EUROPE | | | | | | | | |
| Germany | Factory Orders | m/m | jan | -3.9% | 3.8% | -1.8% | ** | Equity bearish, bond bullish |
| France | Bank of France Industry Sentiment | m/m | feb | 105 | 105 | 104 | ** | Equity and bond neutral |
| Switzerland | Unemployment Rate | m/m | feb | 3.2% | 3.3% | 3.2% | *** | Equity and bond neutral |
| AMERICAS | | | | | | | | |
| Canada | Labor Productivity | q/q | 4q | 0.2% | -0.6% | 0.1% | ** | Equity and bond neutral |
| | International Merchandise Trade | m/m | jan | -1.91 bn | -3.19 bn | -2.50 bn | ** | Equity and bond neutral |
| Mexico | Formal Job Creation Total | m/m | feb | 164.3k | 113.7k | 157.8k | ** | 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)** | 205 | 203 | 2 | Up |
| **3-mo T-bill yield (bps)** | 165 | 165 | 0 | Neutral |
| **TED spread (bps)** | 40 | 39 | 1 | Neutral |
| **U.S. Libor/OIS spread (bps)** | 164 | 163 | 1 | Up |
| **10-yr T-note (%)** | 2.88 | 2.88 | 0.00 | 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 | down | | | Up |
| yen | down | | | Up |
| pound | down | | | Up |
| franc | down | | | Neutral |
| **Central Bank Action** | **Current** | **Prior** | **Expected** | |
| ECB Main Refinancing Rate | 0.000% | 0.000% | 0.000% | On forecast |
| ECB Marginal Lending Facility Rate | 0.250% | 0.250% | 0.250% | On forecast |
| ECB Deposit Facility Rate | -0.400% | -0.400% | -0.400% | On forecast |
| Bank of Canada Rate Decision | 1.250% | 1.250% | 1.250% | 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 | $64.08 | $64.34 | -0.40% | Bearish EIA Report |
| WTI | $61.04 | $61.15 | -0.18% | |
| Natural Gas | $2.77 | $2.78 | -0.18% | |
| Crack Spread | $18.41 | $18.58 | -0.95% | |
| 12-mo strip crack | $17.12 | $17.32 | -1.15% | |
| Ethanol rack | $1.55 | $1.55 | 0.15% | |
| **Metals** | | | | |
| Gold | $1,324.97 | $1,325.57 | -0.05% | |
| Silver | $16.49 | $16.50 | -0.09% | |
| Copper contract | $308.90 | $313.60 | -1.50% | |
| **Grains** | | | | |
| Corn contract | $ 386.50 | $ 387.25 | -0.19% | |
| Wheat contract | $ 495.50 | $ 497.25 | -0.35% | |
| Soybeans contract | $ 1,059.75 | $ 1,065.25 | -0.52% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 1191 | 1212 | -21 | |
| **DOE inventory report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | 2.4 | 2.5 | -0.1 | |
| Gasoline (mb) | -0.8 | 1.8 | -2.5 | |
| Distillates (mb) | -0.6 | -0.8 | 0.2 | |
| Refinery run rates (%) | 0.20% | -0.30% | 0.5% | |
| 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.

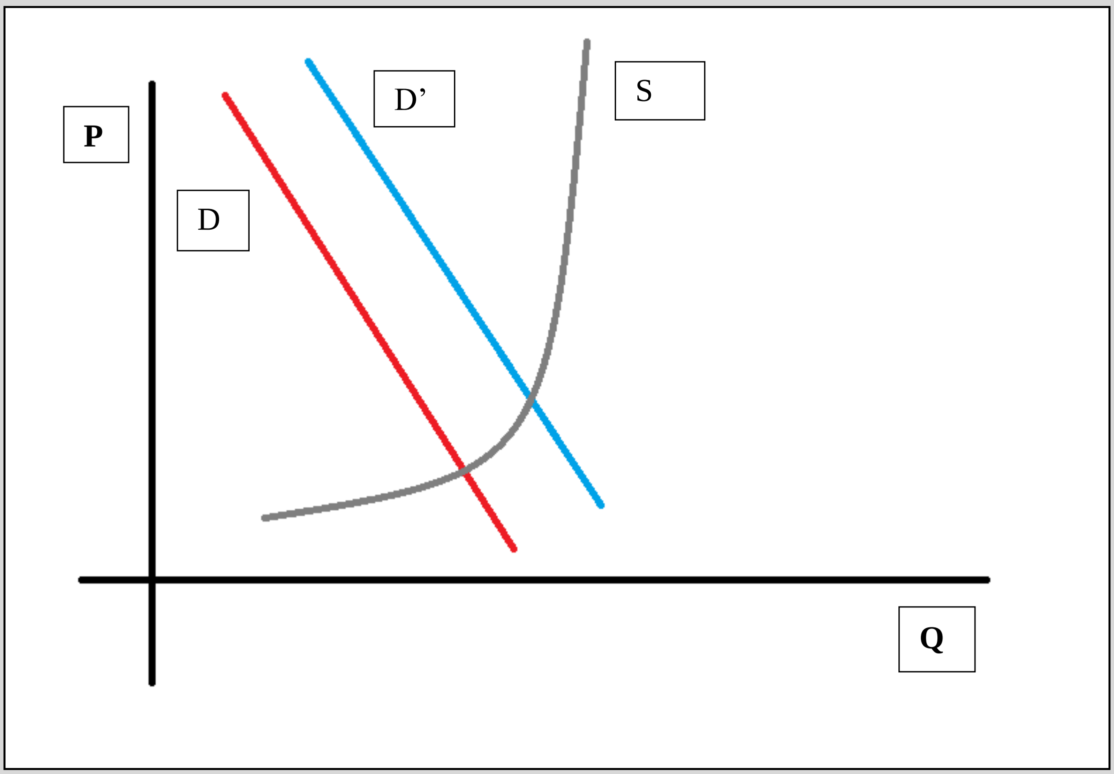
**Asset Allocation Weekly Comment**

*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.*

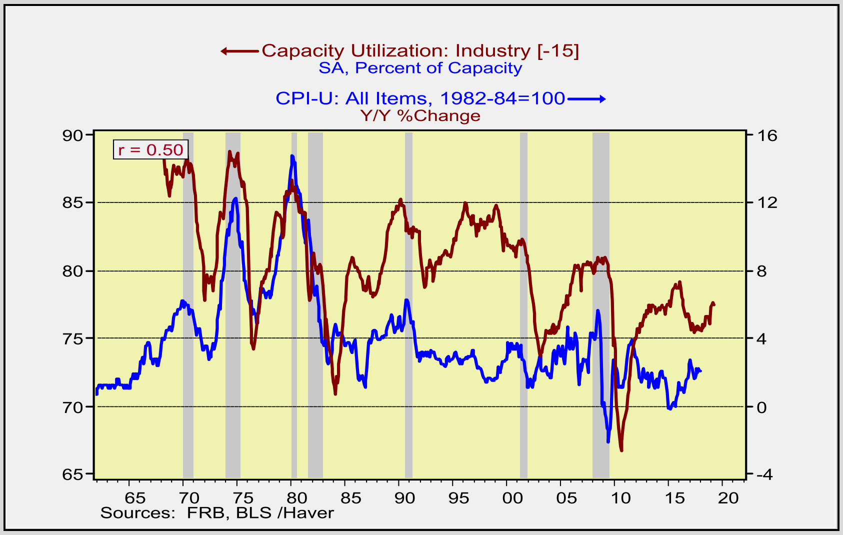
March 2, 2018

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.

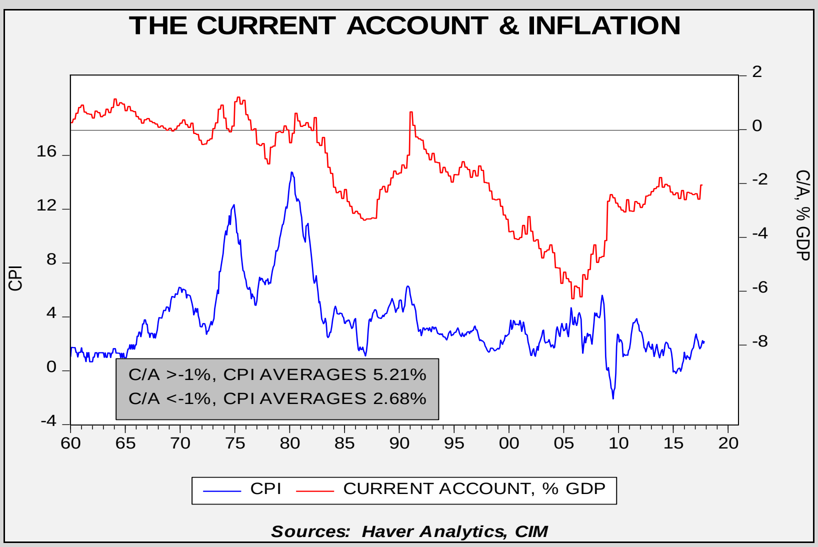



This stylized drawing shows that as demand rises from D to D', the quantity supplied rises but so do price levels. Obviously, the slope of the supply curve is critical. Policies designed to increase the supply side of the market will tend to bring more output with less inflation. Cyclical inflation is 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.



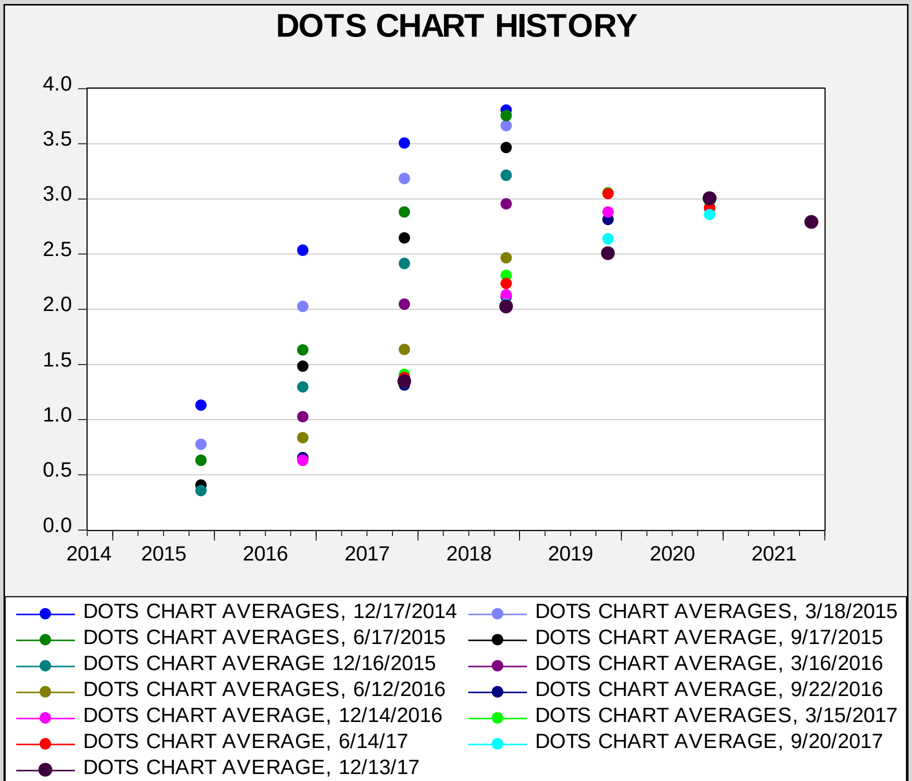

This chart shows the relationship between the yearly change in inflation and capacity utilization; the latter leads inflation by five quarters. Note that in the 1970s into the early 1980s, high levels of capacity utilization were consistent with very high levels of inflation. If the relationship between 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.



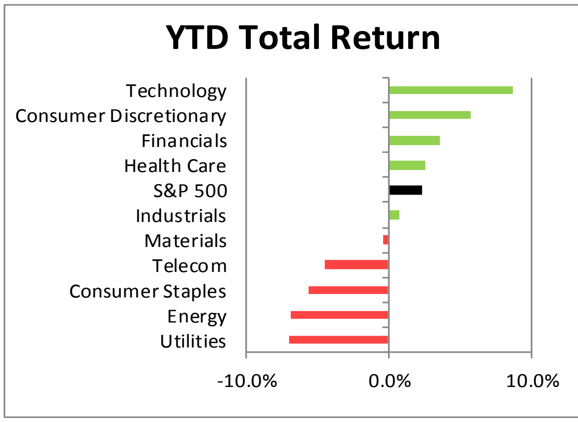

***Sources: Federal Reserve, CIM***

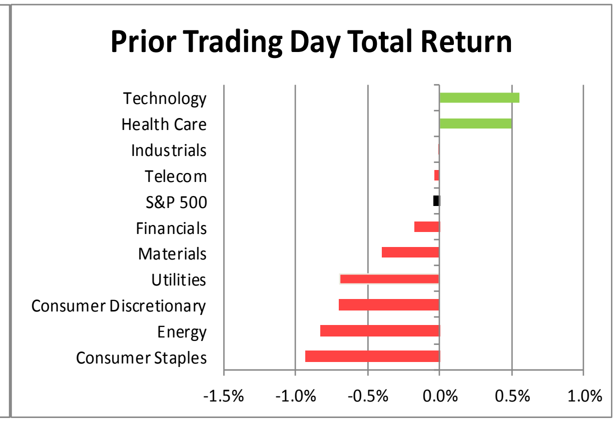
Although our base case is that secular inflation factors remain unchanged, we are watching trade policy very closely. If the president makes good on his promises to restrict imports, the potential is there for at least a significant secular inflation scare. So far, there has been more rhetoric than action 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


*Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.*

## Data Section

**U.S. Equity Markets** – (as of 3/7/2018 close)

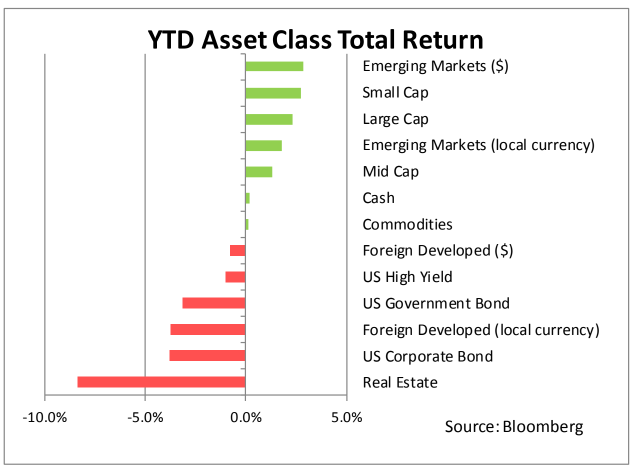



(Source: Bloomberg)

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 3/7/2018 close)

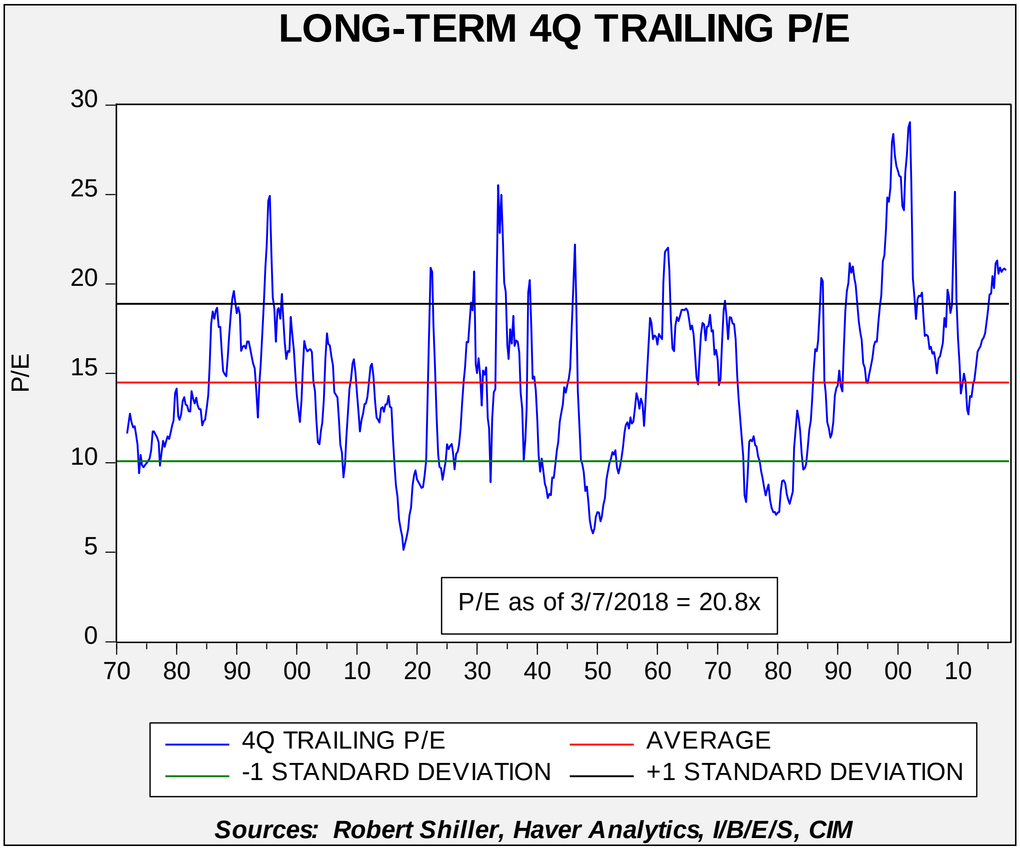



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 8, 2018




Based on our methodology,[1] the current P/E is 20.8, unchanged from last week. Earnings remain strong but the S&P remains elevated for the quarter, even with the recent correction.

*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.*

---

[1] 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.