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.

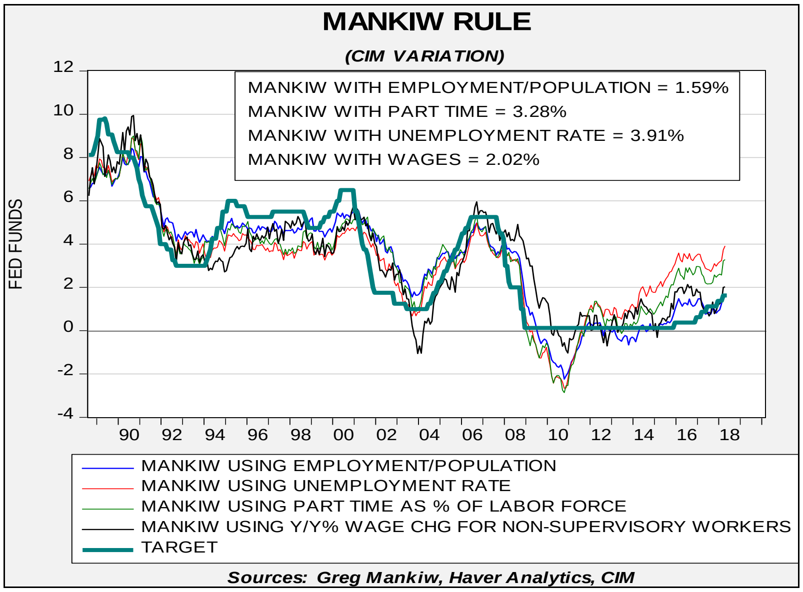
[Posted: May 10, 2018—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is down 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed up 1.1% from the prior close. Chinese markets were up, with the Shanghai composite up 0.5% and the Shenzhen index up 0.5%. U.S. equity index futures are signaling a higher open. With 448 companies having reported, the S&P 500 Q1 earnings stand at $38.86, higher than the $36.49 forecast for the quarter. The forecast reflects an 18.4% increase from Q1 2017 earnings. Thus far this quarter, 79.2% of the companies reported earnings above forecast, while 14.7% reported earnings below forecast.

BOE meeting: The BOE results were neutral to hawkish. Rates were left unchanged, as expected, but the vote was 7-2 with the dissenters voting for a hike. The press conference and the statement were rather dovish, belying the vote. Markets took the results as moderately dovish.

Israel v. Iran: Although we don't think either side wants a full-blown conflict, Israel has launched a series of missile strikes against Iranian targets in Syria. These targets appear to be command and control centers for Iranian operatives and proxies in Syria. Iran has retaliated with similar strikes against military targets in the Golan Heights. The tempo of attacks has clearly escalated since the president withdrew from the Iran nuclear deal. Escalating tensions continue to support oil prices. At this point, we would characterize conditions as tense but not necessarily a prelude to an open conflict. However, the potential for escalation is rising.

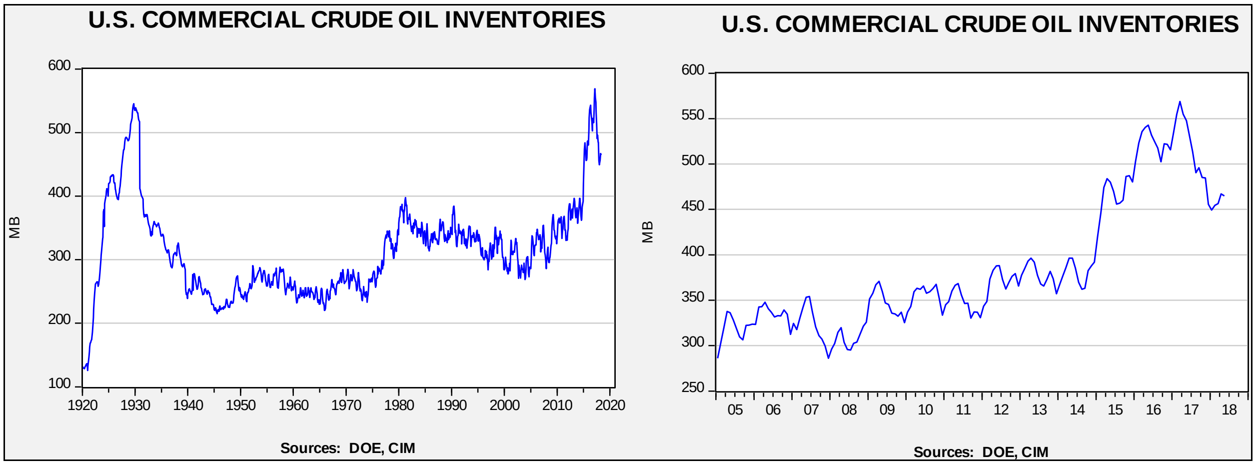
Italian government: The Five-Star Movement and the Northern League are trying to form a government. It's sort of a "damned if you do, damned if you don't" issue for the markets. A government based on this coalition would be decidedly populist. Although all parties have moderated their stance on the Eurozone, the populists will push for fiscal stimulus and threaten the German-enforced order in the Eurozone. At the same time, if the move to form a government fails, summer elections are possible and the odds of an even stronger showing by the populist parties would be elevated. We have seen a modest rise in Italian sovereign yields; if conditions deteriorate, look for the spread between Italian sovereigns and Bunds to widen.

Fed policy: With the release of the CPI data we can update the Mankiw models. The Mankiw rule models attempt to determine the neutral rate for fed funds, which is a rate that is neither accommodative nor stimulative. Mankiw's model is a variation of the Taylor Rule. The latter measures the neutral rate using core CPI and the difference between GDP and potential GDP, which is an estimate of slack in the economy. Potential GDP cannot be directly observed, only estimated. To overcome this problem with potential GDP, Mankiw used the unemployment rate as a proxy for economic slack. We have created four versions of the rule, one that follows the original construction by using the unemployment rate as a measure of slack, a second that uses the employment/population ratio, a third using involuntary part-time workers as a percentage of the total labor force and a fourth using yearly wage growth for non-supervisory workers.



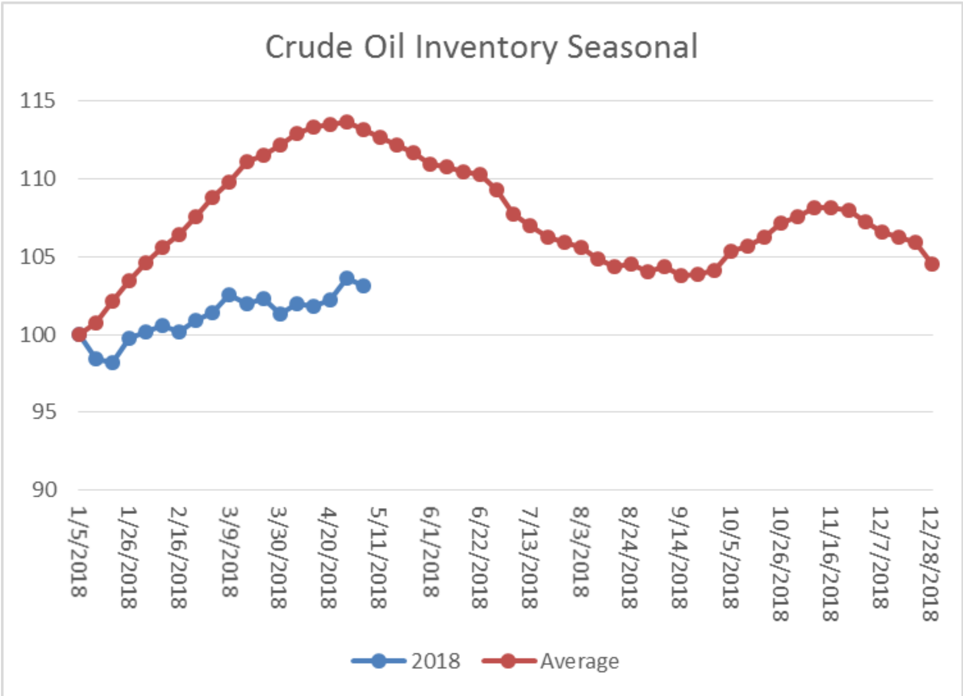
Using the unemployment rate, the neutral rate is now 3.91%, up from 3.75%. The rise reflects the decline in the unemployment rate. Using the employment/population ratio, the neutral rate is 1.59%, down from 1.68%. Using involuntary part-time employment, the neutral rate is 3.28%, up from 3.22%. Using wage growth for non-supervisory workers, the neutral rate is 2.02%, up from 1.67%. The modest rise in core inflation (which was less than forecast) has lifted the forecast estimates for the neutral rate for all models. Although the divergence is wide between the models, three of the four do signal that the FOMC is still accommodative, with the target rate running below estimated neutral rates. Only the employment/population ratio version shows the neutral rate roughly equal to the current policy mid-point. In other words, if the FOMC is basing policy on the employment/population ratio, they would have already achieved policy neutrality and should refrain from further rate hikes. If anything, we suspect they lean toward the unemployment rate but, due to the high degree of uncertainty surrounding slack, the committee prefers to raise rates slowly in order to avoid a policy error.

Energy recap: U.S. crude oil inventories fell 2.2 mb compared to market expectations of a 1.3 mb build.

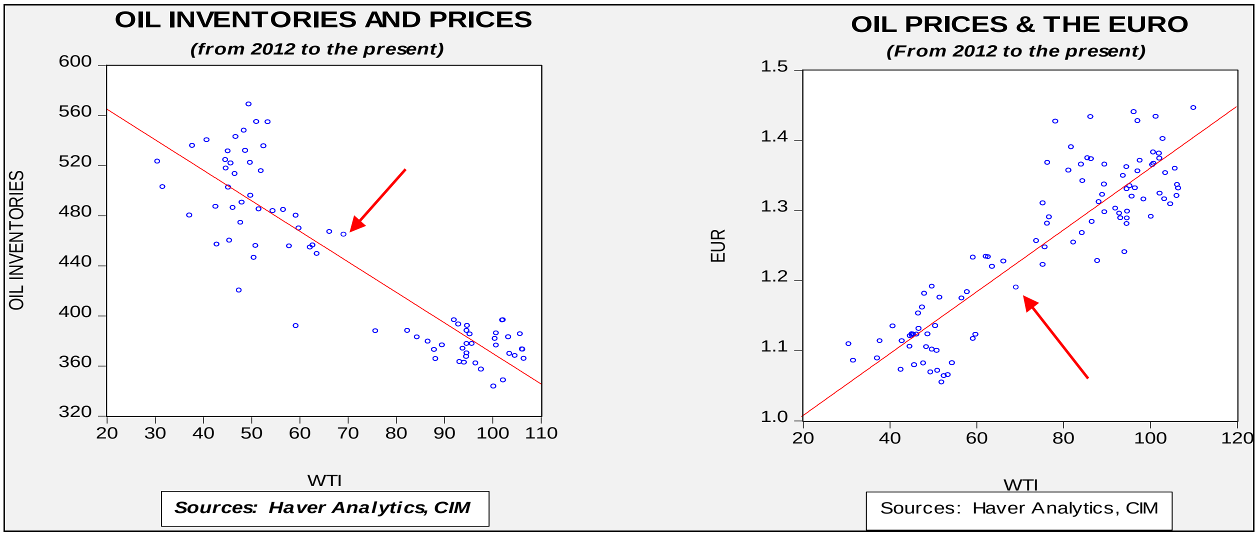


This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but have declined significantly since last March. We would consider the overhang closed if stocks fall under 400 mb.

As the seasonal chart below shows, inventories are usually rising this time of year. This week's decline is consistent with the onset of seasonal patterns. We expect steady stock withdrawals from now until mid-September. If we follow the normal seasonal draw in stockpiles, crude oil inventories will decline to approximately 425 mb by September.



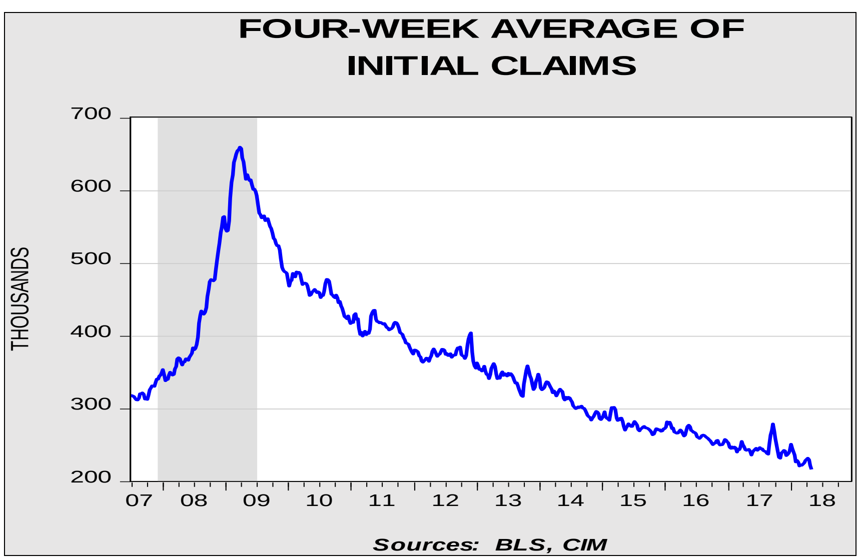
(Source: DOE, CIM)



Based on inventories alone, oil prices are overvalued with the fair value price of $64.09. Meanwhile, the EUR/WTI model generates a fair value of $65.38. Together (which is a more sound methodology), fair value is $64.31, meaning that current prices are above fair value. The combination of a stronger dollar and the peak of seasonal inventories has weakened our fair value calculations. However, we do expect the dollar to weaken in the coming months and oil inventories to decline based on seasonal factors. Using the oil inventory scatterplot, a reading of 425 on oil inventories would generate oil prices in the high $70s to low $80s range. At present, we have no reason to believe that inventories won't follow their usual path, so barring a seasonal divergence that increases supply or a sharp rise in the dollar the case for higher oil prices remains. We should note that worries over the Iran nuclear deal are supporting oil prices and this factor will likely remain in place for the foreseeable future.

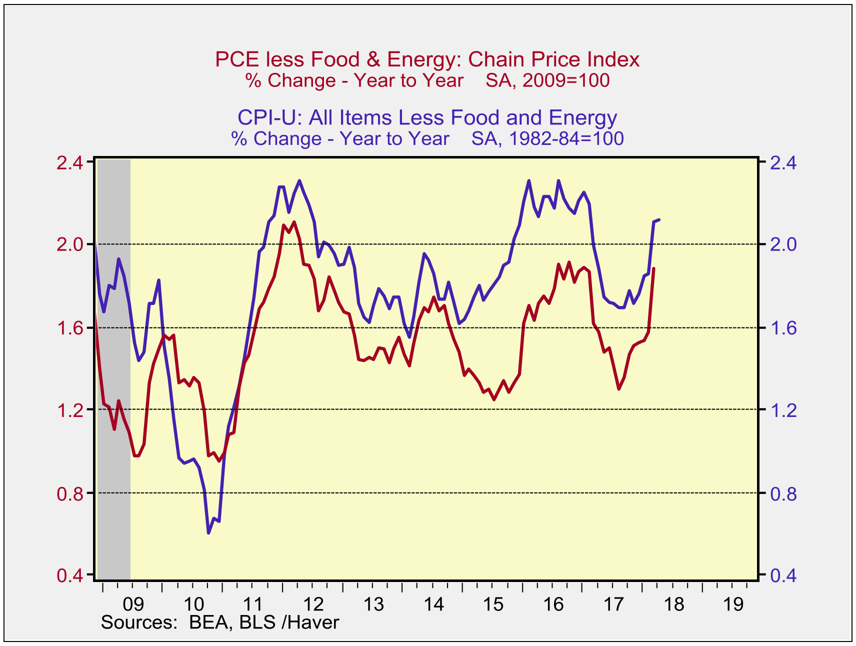
U.S. Economic Releases

Initial jobless claims came in below expectations at 211k compared to the forecast of 219k.



The chart above shows the four-week moving average for initial jobless claims. The four-week moving average fell from 221.5k to 216.5k.

CPI came in below expectations, rising 0.2% from the prior month compared to the forecast of 0.3%. Core CPI also came in below expectations, rising 0.1% from the prior month compared to the forecast of 0.2%.



The chart above shows the year-over-year change in core CPI and core PCE. Core CPI rose 2.1% from the prior year. Despite concerns over inflation, price levels remain fairly steady. It is worth noting that although CPI is the most commonly used inflation gauge, the Fed's preferred measure is the PCE.

Real average weekly earnings rose by 0.4% from the prior year, while real average hourly earnings rose by 0.2% from the prior year.

The chart above shows real average hourly earnings. Real wage pressures remain mostly steady.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Consumer Comfort	m/m	may		56.6	**
14:00	Monthly Budget Statement	m/m	apr	$212.0 bn	-$208.7 bn	**
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								
China	PPI	y/y	apr	3.4%	3.1%	3.4%	**	Equity and bond neutral
	CPI	y/y	apr	1.8%	2.1%	1.9%	***	Equity bearish, bond bullish
Japan	BoP Current Account Balance	m/m	mar	¥3.122 tn	¥2.076 tn	¥2.899 tn	**	Equity bullish, bond bearish
	Trade Balance BoP Basis	m/m	mar	¥1.191 tn	¥0.189 tn	¥1.023 tn	**	Equity bullish, bond bearish
	Bank Lending Incl Trusts	m/m	apr	2.1%	2.0%	1.9%	*	Equity bullish, bond bearish
	Bank Lending Ex-Trusts	m/m	apr	2.0%	1.9%	1.9%	**	Equity bullish, bond bearish
	Tokyo Average Office Vacancies	m/m	apr	2.65	2.80		**	Equity and bond neutral
	Bankruptcies	y/y	apr	-4.4%	0.4%		**	Equity and bond neutral
	Eco Watchers Current Situation	m/m	mar	49.0	48.9	49.0	**	Equity bearish, bond bullish
	Eco Watchers Outlook	m/m	mar	50.1	49.6	49.9	**	Equity bullish, bond bearish
EUROPE								
Italy	Industrial Production	m/m	mar	3.6%	2.5%	2.3%	***	Equity bullish, bond bearish
U.K.	Trade Balance	m/m	mar	-3091	-2000	-965	**	Equity bullish, bond bearish
	Industrial Production	m/m	mar	2.9%	2.2%	3.1%	***	Equity and bond neutral
	Manufacturing Production	m/m	apr	-0.1%	-0.2%	-0.2%	**	Equity and bond neutral
	Constructin Output	m/m	apr	-2.3%	-1.6%	-2.3%	**	Equity and bond neutral
	NIESR GDP Estimate	m/m	apr	0.1%	0.2%		**	Equity and bond neutral
AMERICAS								
Mexico	CPI Core	m/m	apr	0.2%	0.3%	0.2%	***	Equity and bond neutral
	CPI	m/m	apr	-0.3%	0.3%	-0.3%	***	Equity and bond neutral
Canada	Building Permits	m/m	may	3.1%	-2.6%	2.0%	**	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)	235	237	-2	Up
3-mo T-bill yield (bps)	184	185	-1	Neutral
TED spread (bps)	51	52	-1	Neutral
U.S. Libor/OIS spread (bps)	187	186	1	Up
10-yr T-note (%)	2.97	3.00	-0.03	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	3	2	1	Down
Currencies	**Direction**			
dollar	down			Down
euro	up			Up
yen	up			Up
pound	up			Up
franc	up			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBNZ Official Cash Rate	1.750%	1.750%	1.750%	On forecast
Bank of England Bank Rate	0.500%	0.500%	0.500%	On forecast
BOE Asset Purchase Target	435 bn	435 bn	435 bn	On forecast
BOE Corporate Bond Target	10 bn	10 bn	10 bn	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	$77.38	$77.21	0.22%	
WTI	$71.54	$71.14	0.56%	
Natural Gas	$2.73	$2.74	-0.44%	
Crack Spread	$20.36	$20.60	-1.13%	
12-mo strip crack	$19.13	$19.34	-1.10%	
Ethanol rack	$1.58	$1.58	-0.14%	
Metals				
Gold	$1,317.89	$1,312.72	0.39%	
Silver	$16.64	$16.49	0.87%	
Copper contract	$309.90	$305.75	1.36%	
Grains				
Corn contract	$ 404.00	$ 402.75	0.31%	
Wheat contract	$ 512.00	$ 510.50	0.29%	
Soybeans contract	$ 1,020.50	$ 1,015.75	0.47%	
Shipping				
Baltic Dry Freight	1465	1432	33	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.2	1.3	-3.4	
Gasoline (mb)	-2.2	0.0	-2.2	
Distillates (mb)	-3.8	-1.6	-2.2	
Refinery run rates (%)	-0.70%	0.50%	-1.20%	
Natural gas (bcf)		90.0		

Weather

The 6-10 and 8-14 day forecasts continue to signal warmer to normal temperatures for most of the country. Precipitation is expected for most of the country.

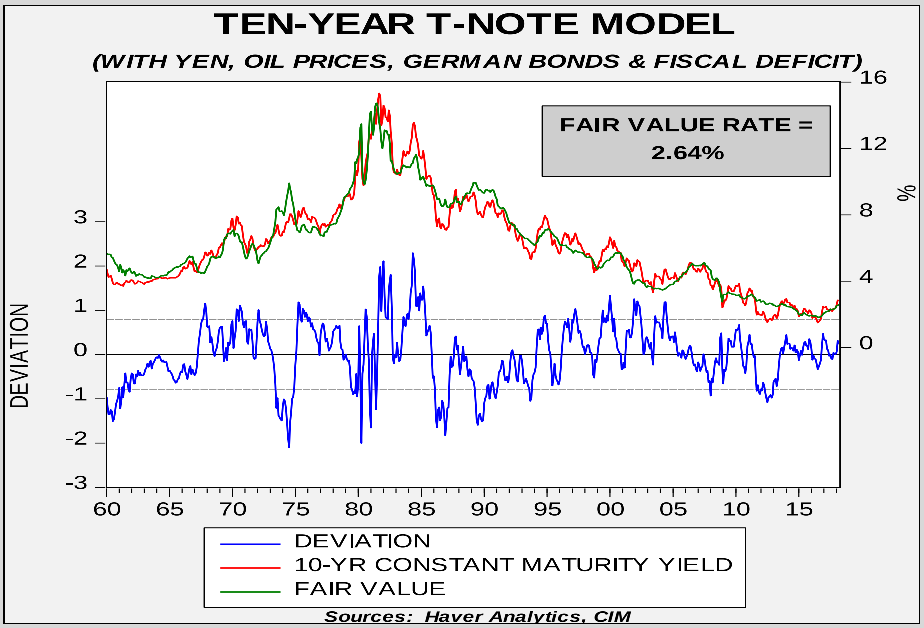
Asset Allocation Weekly Comment

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.

May 4, 2018

The continued rise in long-term interest rates, with the 10-year T-note breaking above a 3.00% yield, is becoming the focus of financial markets.

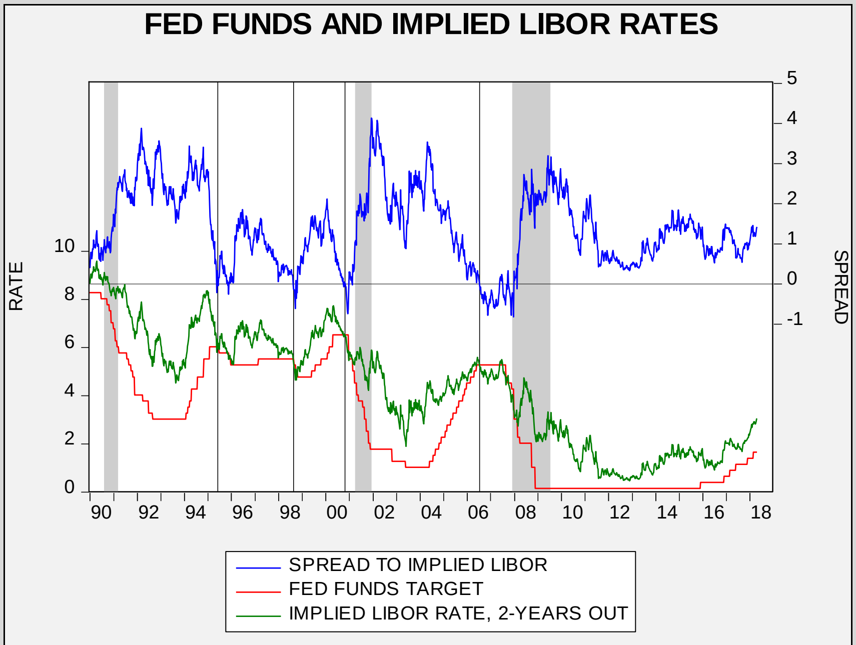
Here is our updated 10-year T-note model.



The model's core variables are fed funds and the 15-year moving average of inflation, which we use as a proxy for inflation expectations. The other four variables are the yen, oil prices, German long-duration sovereign yields and the U.S. fiscal deficit as a percentage of GDP. The current yield on the 10-year T-note, which has recently moved above 3.00%, is running above fair value. The standard error for this model, shown on the lower part of the graph as the lines running parallel to the midpoint, is ±70 bps. Thus, a level that would signal excessively high yields is 3.35%.

Looking at the components of the model, fed funds are usually responsible for cyclical shifts in long-duration assets while changes in inflation expectations drive secular trends. The lift in yields would be significant if we were seeing a sustained rise in inflation. For example, assuming no change in any of the current variables, moving up inflation expectations by 100 bps would raise the fair value to 3.3%. Assuming fed funds at 3.00% with this level of inflation expectations would generate a fair value yield of 3.81%.

Instead, it appears that expectations of tighter monetary policy are the key factor in lifting 10-year Treasury yields. We estimate the terminal policy rate from the Eurodollar futures market, using the implied yield from the two-year deferred contract. Based off that measure, the FOMC will raise rates to around 3.00%.



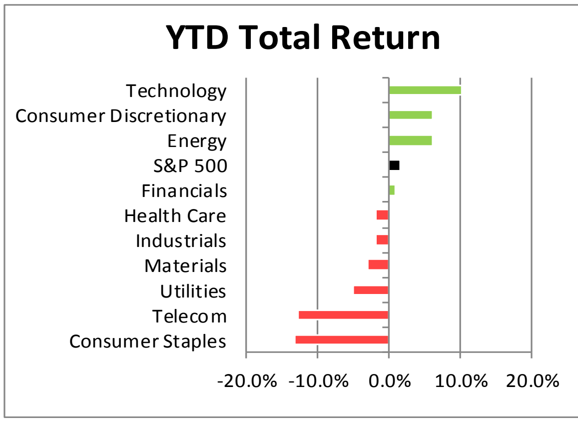
Sources: FRED, Bloomberg, CIM

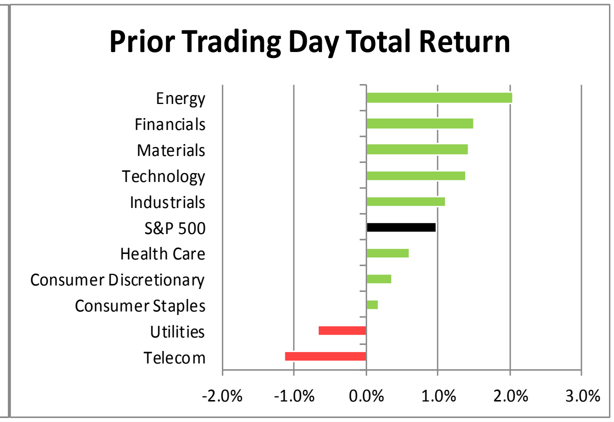
Assuming 3.00% fed funds over the next two years, our T-note model yields a fair value of 3.17%. Essentially, it appears the Treasury market has discounted a terminal fed funds rate of 2.75%; as the above chart shows, the FOMC tends to lift the fed funds rate until the implied Eurodollar rate falls below the current fed funds rate. The bottom line is that there is a high probability of increased long-duration rates but we are rapidly approaching a level that should discount policy tightening. If inflation expectations become unanchored, even higher rates are possible but we don't think this scenario is likely.

As the first chart shows, it isn't uncommon for the 10-year yield to overshoot fair value to reach one-standard error above the forecast; that would imply a 3.87% peak. Any yield around that level would lead us to become aggressively bullish on long-duration assets. We don't expect that development to occur; it has been nearly 13 years since the T-note model signaled that degree of undervaluation. Assuming economic growth remains relatively modest and inflation mostly steady, the current level of undervaluation probably signals a period of consolidation.

Data Section

U.S. Equity Markets – (as of 5/9/2018 close)

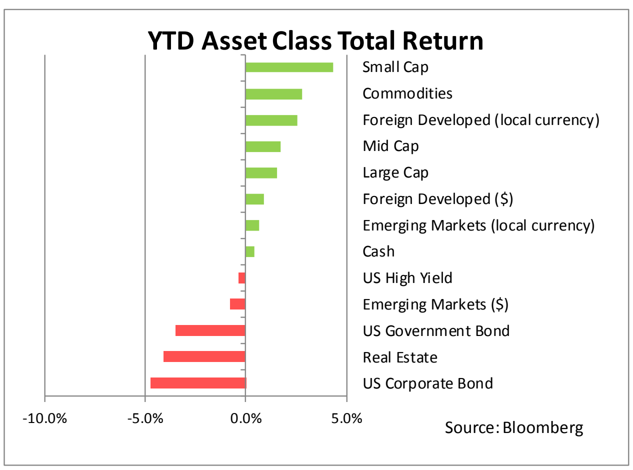




(Source: Bloomberg)

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 5/9/2018 close)

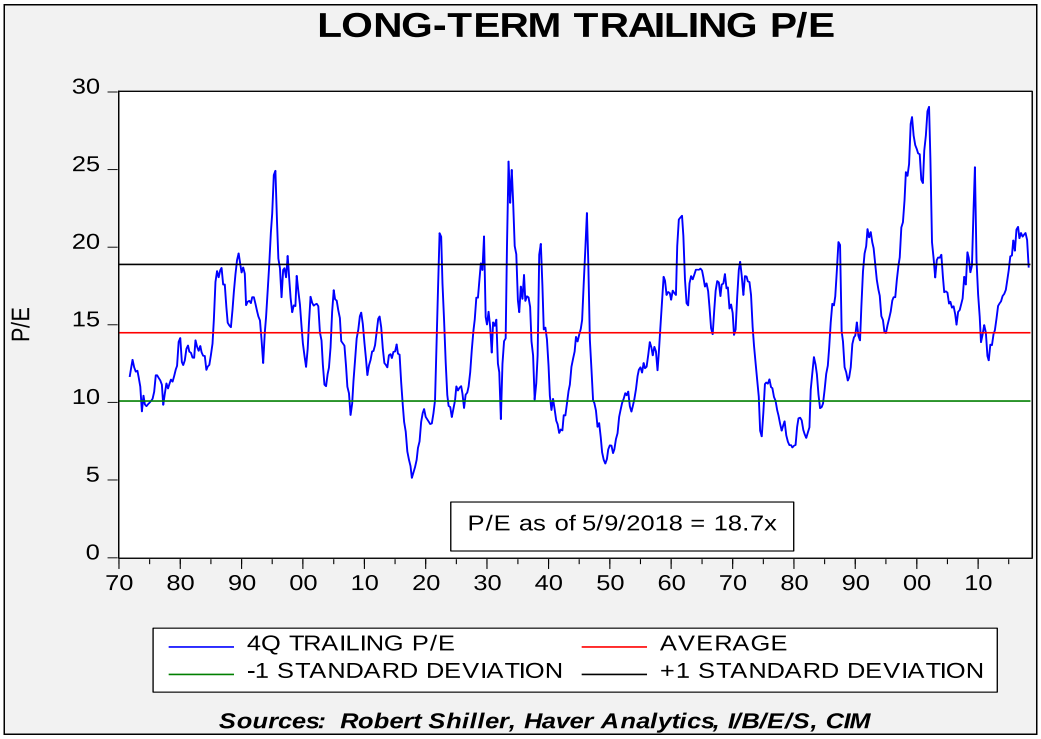


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

May 10, 2018



Based on our methodology,[1] the current P/E is 18.7x, down 0.1x from last week. The decline was due to rising earnings.

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 two actual quarters (Q3 and Q4) and two estimates (Q1 and Q2). 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.