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 15, 2019—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.4% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.3% from the prior close. Chinese markets were up, with the Shanghai composite up 1.9% and the Shenzhen index up 2.3%. U.S. equity index futures are signaling a higher open. With 451 companies having reported, the S&P 500 Q4 earnings stand at $39.39, higher than the $37.29 forecast for the quarter. The forecast reflects a 2.0% decrease from Q1 2018 earnings. Thus far this quarter, 75.4% of the companies reported earnings above forecast, while 18.2% reported earnings below forecast.

Good morning! Markets are mixed this morning as Chinese equities lifted on speculation that Beijing will provide stimulus following weak economic data, while concerns that U.S. tariffs could dampen economic growth have weighed on U.S. futures. Here are the stories we are following today:

War with Iran? Increased posturing by Iran has led the White House to call for an evacuation of all but essential staff at the embassy and consulate in Iraq. Tensions continue to simmer between the U.S. and Iran following the president's decision to ban countries from purchasing oil from Iran, effective May 1. Currently, the two countries appear to be in somewhat of a standoff. It is believed that Iran has mobilized forces in Iran and Syria, while the White House is reportedly discussing sending military forces to the region. The president has downplayed discussions about possible military plans, but rumors persist.[1] It was reported this morning that the U.S. has already reached out to some of its allies for possible support, but they have declined.[2] That being said, we believe President Trump, similar to his predecessor Barack Obama, favors holding off on military action against Iran until he has the support of allies. However, this could change if the president is perceived as being weak. If conflict does break out it will likely be supportive of oil prices.

Possible Huawei ban? Today, President Trump is expected to issue an executive order that would effectively ban all companies from using Huawei (CNY 3.78, +0.08) technology. The executive order will likely escalate trade tensions as China might view the move as a blatant attempt to undermine its tech ambitions. Huawei is crucial to Beijing's "Made in China 2025" plan, which is designed to move China up the supply chain in order to avoid Japanese-style

[1] https://www.reuters.com/article/us-usa-iran-military/trump-denies-us-plan-to-send-120000-troops-to-counter-iran-threat-idUSKCN1SK1YM
[2] https://www.nytimes.com/2019/05/14/world/middleeast/trump-iran-threats.html?action=click&module=Top%20Stories&pgtype=Homepage

deflation. The U.S. has never liked the plan as it fears the initiative could make China a more formidable military opponent. Thus, the U.S. has used trade negotiations to impede its progress. Additionally, the U.S. has accused Huawei technology of having spy capabilities and as a result has encouraged allies to steer clear of using it. The dispute surrounding Huawei is the latest example that the trade dispute could extend longer than the market has anticipated as neither side appears ready back down.

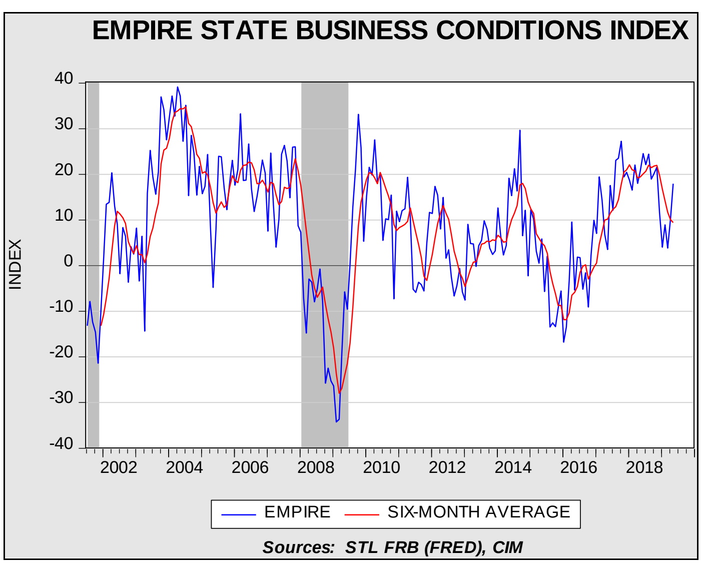
Fed taking on China: President Trump has called on the Fed to ease monetary policy in order to offset the side effects that tariffs may have on the economy. This represents another attempt by the president to force the Fed to stimulate the economy as he prepares to run for reelection. The Fed has consistently stated that it sees no reason to lower rates as the economy appears to be growing and unemployment remains at a 49-year low. We believe the president could use his campaign rallies to stir up his base against the Fed.

European joint military project: In another sign of a growing rift between the U.S. and its allies, the Pentagon sent an angry letter to the EU warning against any European military partnership that does not include the U.S. This comes in response to a plan by the EU to develop and manufacture its own weapons as well as restrict the amount of weapons it purchases from non-EU companies. The Pentagon has vowed to retaliate if the EU were to follow through on the proposal. In all fairness, it appears the EU may be responding to the president's suggestion that cars from the EU could represent a national security threat to the U.S. The president is due to make a decision on Friday as to whether or not car imports represent a national security threat and therefore could be subjected to tariffs under section 232 of the Trade Expansion Act.

U.S. Economic Releases

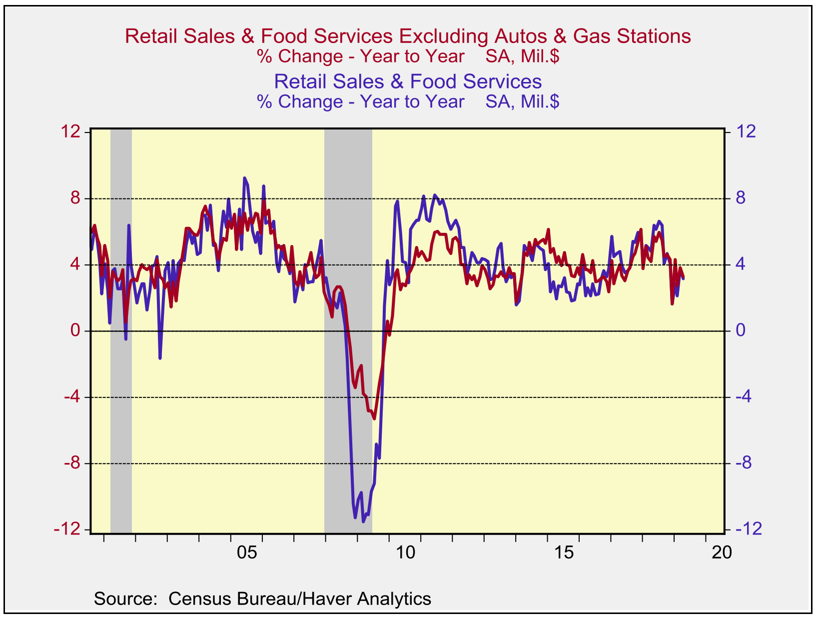
MBA mortgage applications fell by 0.6% from prior week. Purchases and refinancing fell 0.6% and 0.5%, respectively. The average 30-year fixed rate mortgage fell by 1 bp from 4.41% to 4.40%.

Empire manufacturing came in above expectations at 17.8 compared to the forecast of 8.0.



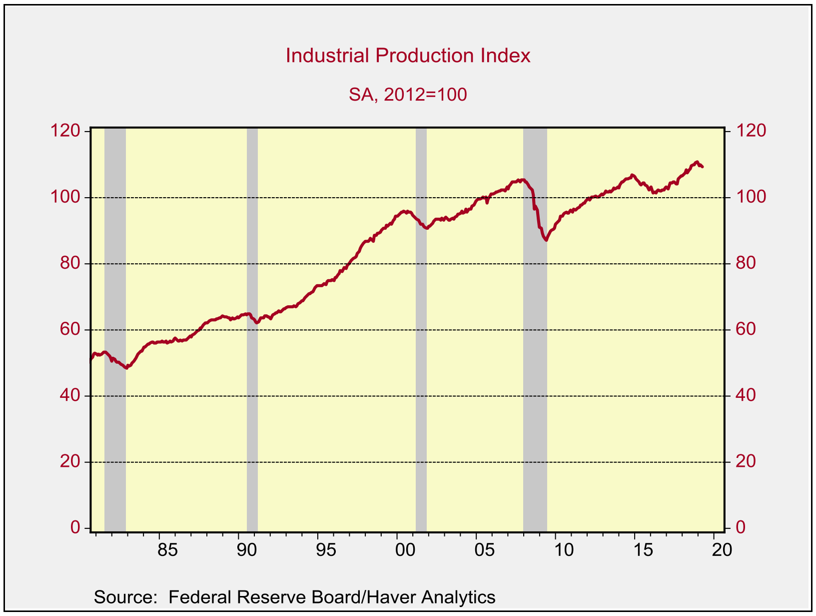
The chart above shows the six-month moving average of the Empire State Business Conditions Index. Currently, the six-month moving average is 9.3.

Advance retail sales for April came in below expectations, falling 0.2% from the prior month compared to the forecast rise of 0.2%. The prior month's gain was revised upward from 1.6% to 1.7%. Retail sales ex-auto came in below expectations, rising 0.1% from the prior month compared to the forecast gain of 0.7%. The prior month's gain was revised upward from 1.2% to 1.3%. Retail sales ex-auto and gasoline came in below expectations, falling 0.2% from the prior month compared to the forecast rise of 0.3%. The prior month's gain was revised upward from 0.9% to 1.0%. The retail sales control group came in below expectations, remaining unchanged from the prior month compared to the forecast gain of 0.3%. The prior month's gain was revised from 1.0% to 1.1%.



The chart above shows the year-over-year change in retail sales and core retail sales. Annually, retail sales and core retail sales rose 3.2% and 3.1%, respectively.

Industrial production for March came in weaker than forecast, falling 0.5% from the prior month compared to the forecast of remaining unchanged. Capacity utilization was 77.9%, below the 78.7% expected.



The chart above shows the Industrial Production Index. The current reading is 109.2, just below last month's 109.7.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	NAHB Housing Market Index	m/m	may	64	63	***
10:00	Business Inventories	m/m	mar	0.0%	0.3%	**
16:00	Net Long-Term TIC Flows	m/m	mar		$51.9 bn	**
16:00	Total Net TIC Flows	m/m	mar		-$21.6 bn	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
12:00	Thomas Barkin Speaks to Economists in New York	President of the Federal Reserve Bank of Richmond				

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	Fixed Assets Ex Rural YTD	y/y	mar	6.1%	6.3%	6.4%	**	Equity bearish, bond bullish
	Industrial Production	y/y	mar	5.4%	8.5%	6.5%	***	Equity bearish, bond bullish
	Retail Sales	y/y	mar	7.2%	8.7%	8.6%	**	Equity bearish, bond bullish
	Surveyed Jobless Rate	m/m	apr	5.0%	5.2%		***	Equity bullish, bond bearish
Japan	Money Stock M2	y/y	apr	2.6%	2.4%	2.3%	**	Equity bullish, bond bearish
	Money Stock M3	y/y	apr	2.2%	2.1%	2.1%	**	Equity bullish, bond bearish
	Construction Orders	y/y	mat	66.1%	-3.4%		**	Equity bullish, bond bearish
	Machine tool orders	y/y	apr	-33.4%	-28.5%		*	Equity and bond bearish
Australia	Westpac Consumer Confidence	m/m	may	0.6%	1.9%		***	Equity and bond neutral
	Wage Price Index	m/m	1q	2.3%	2.3%	2.3%	***	Equity and bond neutral
EUROPE								
Eurozone	Employment	y/y	may	1.3%	1.3%		***	Equity and bond neutral
	GDP	m/m	may	1.2%	1.2%	1.2%	***	Equity and bond neutral
Germany	GDP	y/y	apr	0.7%	0.6%	0.7%	***	Equity and bond neutral
France	CPI	y/y	apr	1.3%	1.2%	1.2%	***	Equity bearish, bond bullish
	CPI EU Harmonized	y/y	apr	1.5%	1.4%	1.4%	***	Equity bearish, bond bullish
Italy	Industrial Sales	m/m	mar	1.3%	1.3%		**	Equity and bond neutral
	Industrial Orders	m/m	mar	-3.6%	-2.7%		**	Equity bearish, bond bullish
Russia	Official Reserve Assets	m/m	apr	491.1 bn	487.8 bn	493.0 bn	*	Equity and bond neutral
AMERICAS								
Mexico	Teranet/National Bank HPI	m/m	apr	1.2%	1.5%		**	Equity and bond neutral
Brazil	IBGE Services Sector Volume	y/y	mar	-2.3%	3.8%	-0.7%	**	Equity and 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)	252	253	-1	Up
3-mo T-bill yield (bps)	235	235	0	Neutral
TED spread (bps)	17	18	-1	Neutral
U.S. Libor/OIS spread (bps)	235	236	-1	Up
10-yr T-note (%)	2.38	2.41	-0.03	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	17	18	-1	Down
Currencies	**Direction**			
dollar	flat			Neutral
euro	down			Up
yen	up			Neutral
pound	flat			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	$70.85	$71.24	-0.55%	
WTI	$61.23	$61.78	-0.89%	
Natural Gas	$2.66	$2.66	-0.08%	
Crack Spread	$22.69	$22.43	1.14%	
12-mo strip crack	$18.54	$18.34	1.07%	
Ethanol rack	$1.45	$1.45	0.31%	
Metals				
Gold	$1,298.20	$1,296.92	0.10%	
Silver	$14.83	$14.79	0.29%	
Copper contract	$272.55	$272.50	0.02%	
Grains				
Corn contract	$ 376.00	$ 368.75	1.97%	
Wheat contract	$ 453.25	$ 448.50	1.06%	
Soybeans contract	$ 838.50	$ 831.50	0.84%	
Shipping				
Baltic Dry Freight	1043	1026	17	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.4		
Gasoline (mb)		0.5		
Distillates (mb)		-0.8		
Refinery run rates (%)		-0.30%		
Natural gas (bcf)		103.0		

Weather

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

Asset Allocation Weekly

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 10, 2019

While the financial industry is rife with performance comparisons to selected benchmarks, the most important investing goal for the majority of clients is a return above inflation that avoids catastrophic losses. Although beating the S&P 500 is a nice goal, solely focusing on that outcome may lead an investor to accept more risk than appropriate. This is an age-old issue where one confuses ends with means. Benchmarking is a means to an end. A benchmark gives investors some insight into how their investments are doing but should never be considered an end in itself. Sadly, measurement of performance seems to have eclipsed, and even replaced, the principal goals for clients. In other words, the benchmark has become the goal.

A good example of the problem with benchmarking is found in academia. Students have been told that the "4.0" is the clear marker of academic success. Now, getting all "As" is a good thing. But, anyone who has been to college knows that the GPA can be gamed. Students can fill their electives with easy courses. They can select the easiest professors in their major's hardest courses. And, they can cheat. Or, perhaps equally as perverse, they can "know it for the test." In other words, they can memorize the necessary information but fail to really understand it. Resolving this issue is part of hiring new graduates. There are ways to ferret out who knows their stuff and who gamed. Checking transcripts is a good way to look for clues—what were the electives and how did the candidate do in the hard classes? Another is to ask questions about the most basic components of a discipline but in a way that is rarely presented in class. An example for economists is, "Assume all drug users are addicts; what is the best way to reduce illicit drug consumption?"[3] However, how many positions are filled by candidates who are screened by GPA? In other words, how many good candidates never get an interview because their GPA fell below 3.5 because they took more challenging course work?

Let's suppose that instead of attempting to help clients accumulate wealth within their acceptable risk tolerance, the goal was to outperform the S&P 500 Index and the criteria was what outperformed the index over the past seven calendar years. Out of the 34,468 U.S. dollar-based indices in Morningstar's database, the sole index that met this criteria was the S&P HealthCare Equipment Select Industry Index. Naturally, exposure exclusively to this single index would be a poor investment strategy for the vast majority of clients, as it would expose them to very specific risks, yet it underscores the notion that simply striving to outperform the return of a particular index is fraught with the potential risk of a permanent impairment of capital.

	Annual Return 2018	Annual Return 2017	Annual Return 2016	Annual Return 2015	Annual Return 2014	Annual Return 2013	Annual Return 2012
S&P 500	-4.38	21.83	11.96	1.38	13.69	32.39	16.00
S&P HealthCare Equip Sel Industry	9.57	30.44	12.89	9.23	16.36	36.85	16.98

(Source: Morningstar)

[3] If all users are addicts, then the demand curve is highly inelastic. Reducing supply merely drives up the price, but reducing demand (drug rehab, substitution) could reduce demand and have the biggest effect on reducing consumption.

Another problem that arises in making relative performance the principal objective is the potential for miscreants to juggle benchmarks in order to appear successful. As an example, the table below illustrates the divergence that is associated with popular small cap growth benchmarks. While all four of the benchmarks in the table are from highly reputable providers with well-documented methodologies for the U.S. small cap growth stocks included in their indices, the variance among these four in any given year can be profound. Note that even with indices from the same vendor the differences can be significant as evidenced by the MSCI U.S. Small Cap Growth Index varying from the MSCI U.S.A. Small Growth by 244 basis points in 2018.

	Total Return 2019 YTD	Annual Return 2018	Annual Return 2017	Annual Return 2016	Annual Return 2015	Annual Return 2014
MSCI US Small Cap Growth	21.29	-9.18	21.22	13.13	-3.24	4.51
MSCI USA Small Growth	22.17	-6.74	23.13	13.70	-2.43	5.35
Russell 2000 Growth	20.71	-9.31	22.17	11.32	-1.38	5.60
S&P SmallCap 600 Growth	14.65	-4.05	14.79	22.16	2.78	3.87

(Source: Morningstar)

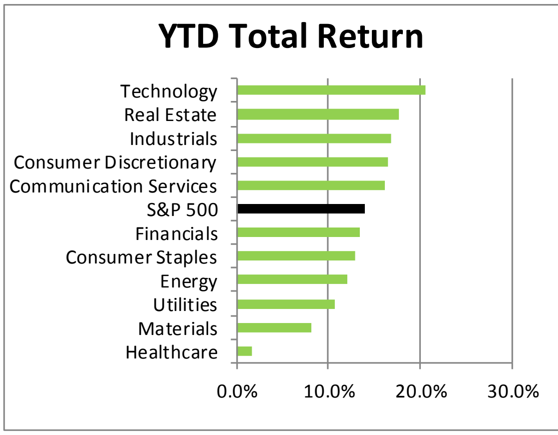
A further complication that may be encountered is the utilization of benchmarks that incorporate significant complexity in the myriad sub-asset classes that roll up to major asset classes. The resulting information will be a hash of statistics that are of little use to either investors or advisor supervision.

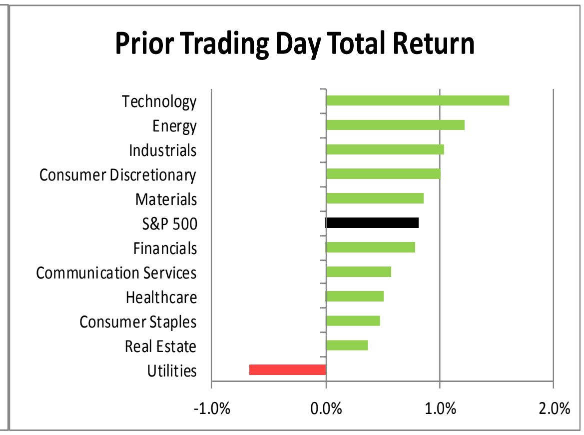
These potential pitfalls do not obviate the necessity of monitoring and evaluating relative performance as part of proper due diligence. The evaluation of a manager's portfolio or asset allocation strategy against an appropriate benchmark is an essential tool for validation of an investment thesis, which can lead to the achievement of the client's goals. However, this can be taken to extremes. Our industry's all-consuming fascination with performance measurement has the potential to cause actions that are perpendicular to the goal of inflation-adjusted wealth creation, such as performance chasing.

What, then, is the correct approach to ensure a manager is properly positioned in a client's portfolio or an asset allocation strategy is appropriate to help attain the client's goal? The most straightforward means is to evaluate a manager or asset allocation strategy against a benchmark that is objective, possesses a sound methodology, recognizable, germane to the asset class represented and free of unnecessary complexity. For this last facet, the notion of Occam's razor applies. This approach will naturally yield significant tracking error; however, tracking error should not only be expected, but embraced, for an active manager. While on a quarter-to-quarter basis investors may observe divergent returns relative to the benchmark, during discrete, representative periods and especially through a full market cycle, an uncomplicated and recognizable benchmark will represent a solid barometer against which to measure the risk-adjusted return of a manager or investment strategy. This will serve to evaluate whether the manager or strategy is contributing to the overarching client goal. But, ultimately, the key point to remember is that a benchmark is a means to an end, not an end in itself.

Data Section

U.S. Equity Markets – (as of 5/14/2019 close)

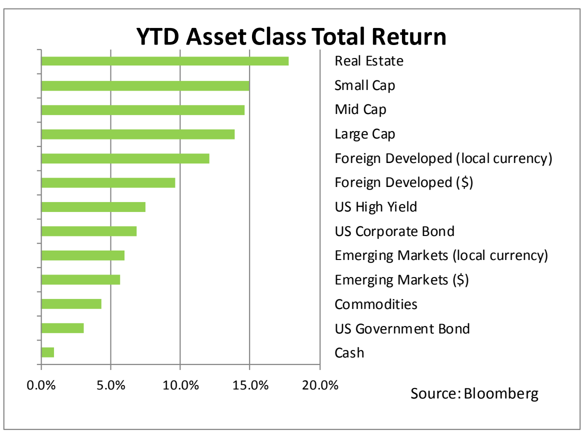




(Source: Bloomberg)

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. These charts represent the new sectors following the 2018 sector reconfiguration.

Asset Class Performance – (as of 5/14/2019 close)

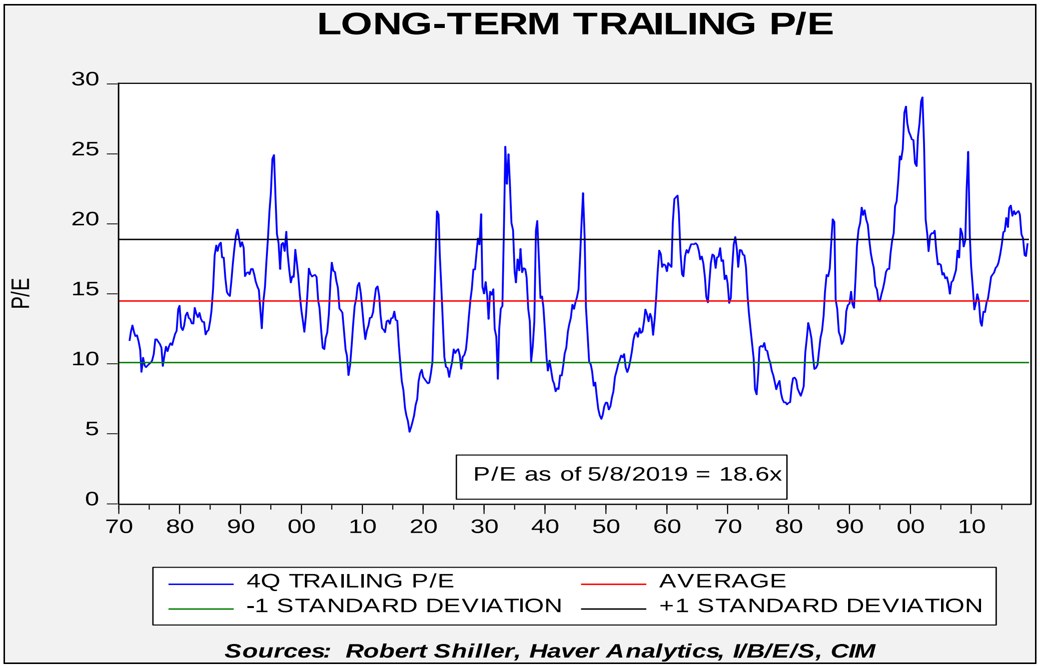


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

May 9, 2019



Based on our methodology,[4] the current P/E is 18.6x, down 0.1x from last week. Rising earnings accounted for the decline 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.

[4] 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 (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.