Daily Comment

By Bill O'Grady and Thomas Wash

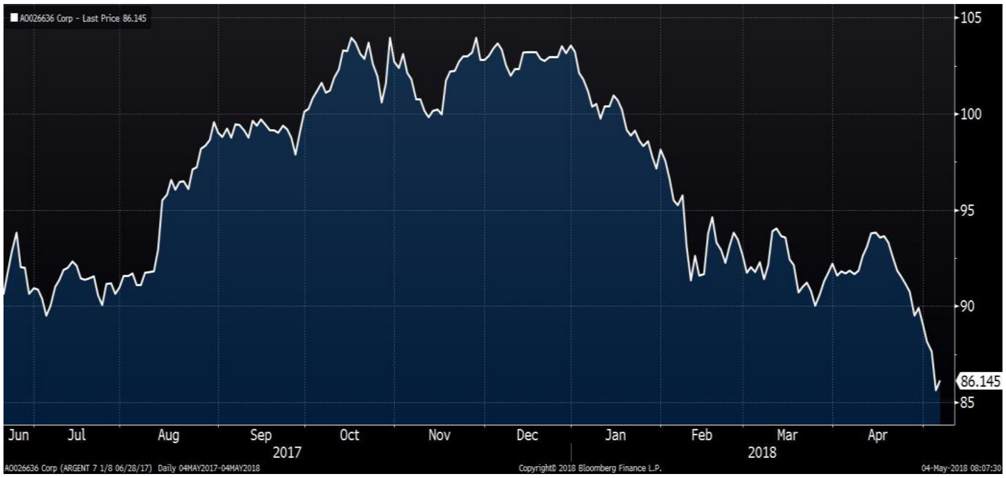
Looking for something to read? See our Reading List; these books, separated by category, are ones we find interesting and insightful. We will be adding to the list over time.

[Posted: May 4, 2018—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is up 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed lower 1.0% from the prior close. Chinese markets were down, with the Shanghai composite down 0.3% and the Shenzhen index down 0.2%. U.S. equity index futures are signaling a lower open. With 390 companies having reported, the S&P 500 Q1 earnings stand at $38.40, higher than the $36.49 forecast for the quarter. The forecast reflects an 18.4% increase from Q1 2017 earnings. Thus far this quarter, 79.5% of the companies reported earnings above forecast, while 14.4% reported earnings below forecast.

Happy Employment Day! We cover the data in detail below but the quick take is that it was weaker than expected. Although the unemployment rate fell to a new cycle low, it appears to be due to people leaving the workforce. The other major issue is that wage growth still remains subdued. Here is what we are watching this morning:

Changes to Iran deal? In an attempt to salvage the Iran deal, the EU settled on a supplementary agreement that would allow the U.S. to impose sanctions on Iran if it attempts to develop an ICBM. The arrangement was made in response to criticism from President Trump that the Iran deal is too lax. There has been growing speculation that President Trump may not renew the sanction waivers on May 12 unless there are drastic changes to the deal. Global powers seemed to be on edge regarding his decision because if this deal were to fail a second one will be much harder to secure. Hawks in both Iran and the U.S. have expressed an unwillingness to compromise in the event of new negotiations. We will continue to monitor this situation.

Argentina default? A combination of rising inflation and weakness of the Argentine peso has called into question Argentina's debt quality. Argentina's central bank has struggled to meet its annual inflation target of 15%, with the latest annualized CPI reading at 25.4%. The central bank has responded by raising rates aggressively, hiking rates by 300 bps two times this week and again this morning by 675 bps; currently its benchmark interest rate is 40.0%. Meanwhile, the Argentine peso has weakened against the dollar as markets prepare for the FOMC to raise rates in June. As a result, Argentine Century Bond, which are U.S.-dollar denominated, have tumbled. The chart below shows the historical price—at the time of this publication, Argentine Century Bonds were trading at a discount of $86.15.



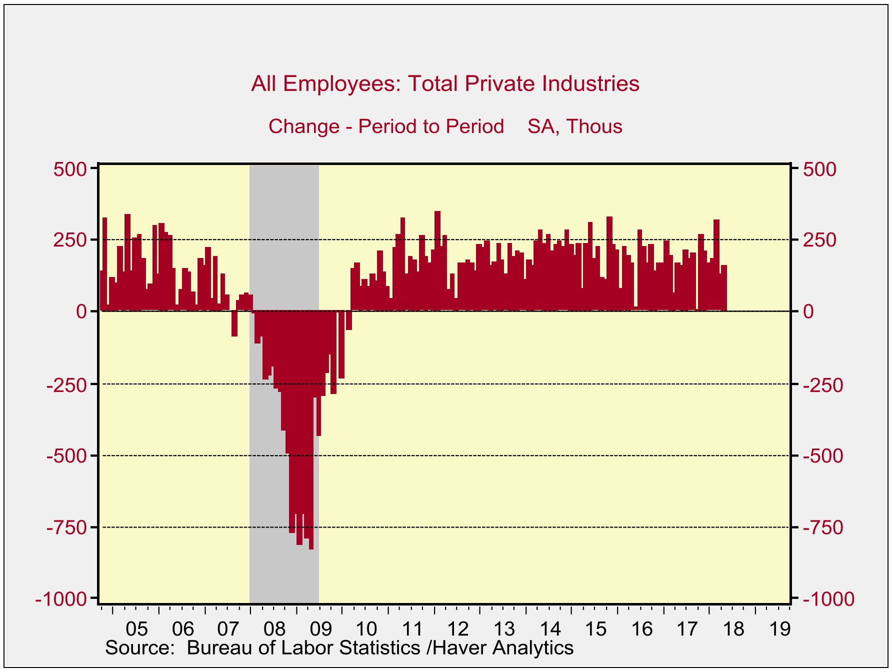
(Source: Bloomberg)

China negotiations: Earlier this morning, the U.S. trade delegation demanded that China lower its trade deficit with the U.S. by $200 bn by 2020. Last year, the U.S. trade deficit with China was $337 bn. In addition, the U.S. asked China to eliminate all subsidies linked with its "Made in China 2025" initiative and lower import tariffs to levels similar to the U.S. This appears to be the opening offer from the U.S. and therefore probably will not resemble the final deal. That said, China has expressed a willingness to lower its trade deficit with the U.S. — as it tries to make a switch from an export-based economy to a consumption-based economy — but wants to do so on its own terms. China will be reluctant to accept any deal that will make it look weak to its public and will likely keep its hand close to its chest. Yesterday, it was announced that China's largest news outlets were banned from reporting on the negotiations.[1] We will continue to monitor this situation.

U.S. Economic Releases

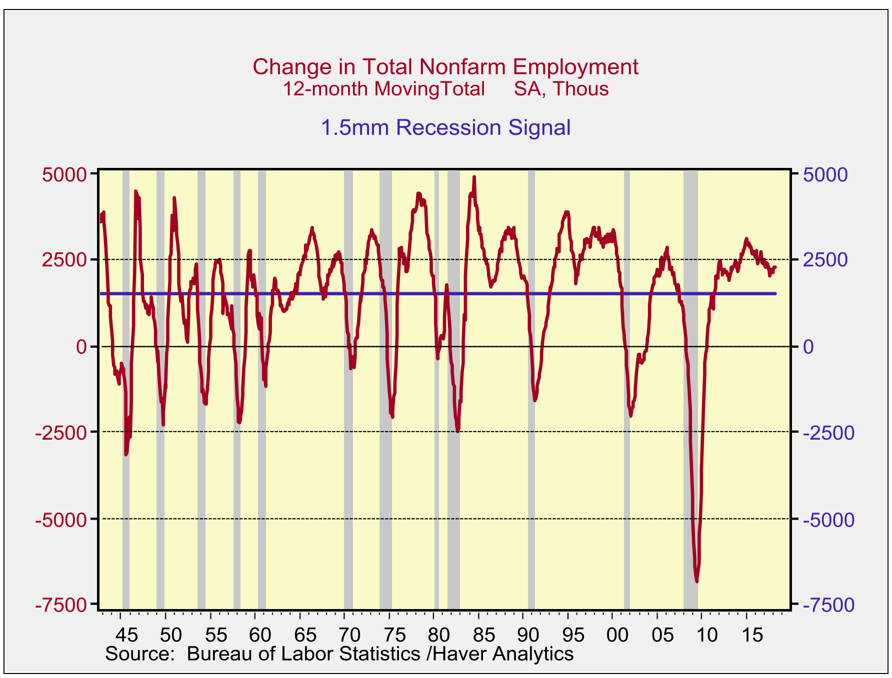
The change in non-farm payrolls for March came in below expectations at 164k compared to the forecast of 193k. The prior report was revised upward from 103k to 135k. The change in private payrolls came in below expectations at 168k compared to the forecast of 190k. The prior report was revised upward from 102k to 135k. The change in manufacturing payrolls was above expectations at 22k compared to the forecast of 24k.

[1] https://www.bloomberg.com/news/articles/2018-05-03/china-is-said-to-order-reporting-ban-on-mnuchin-led-trade-talks

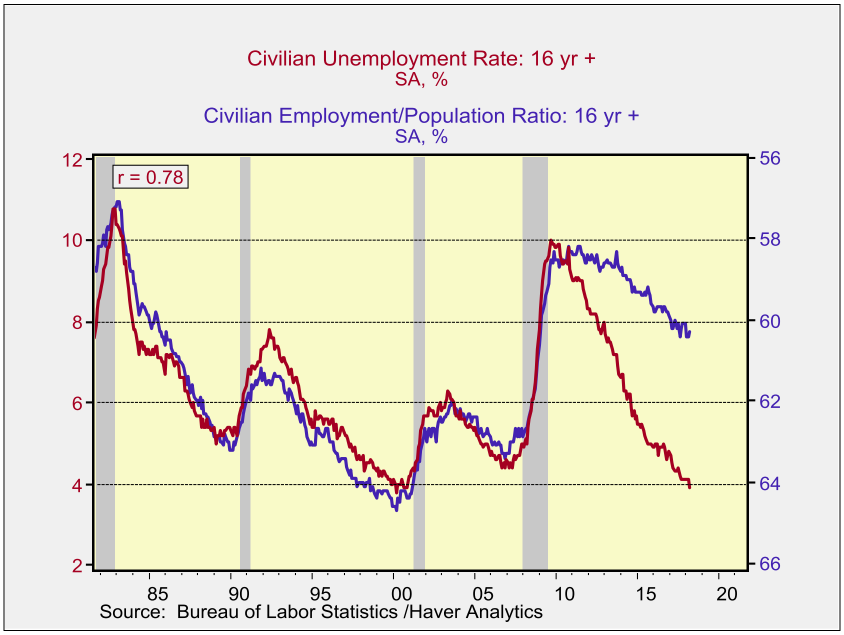


The chart above shows the change in total private employment. This chart suggests the economic expansion continues.

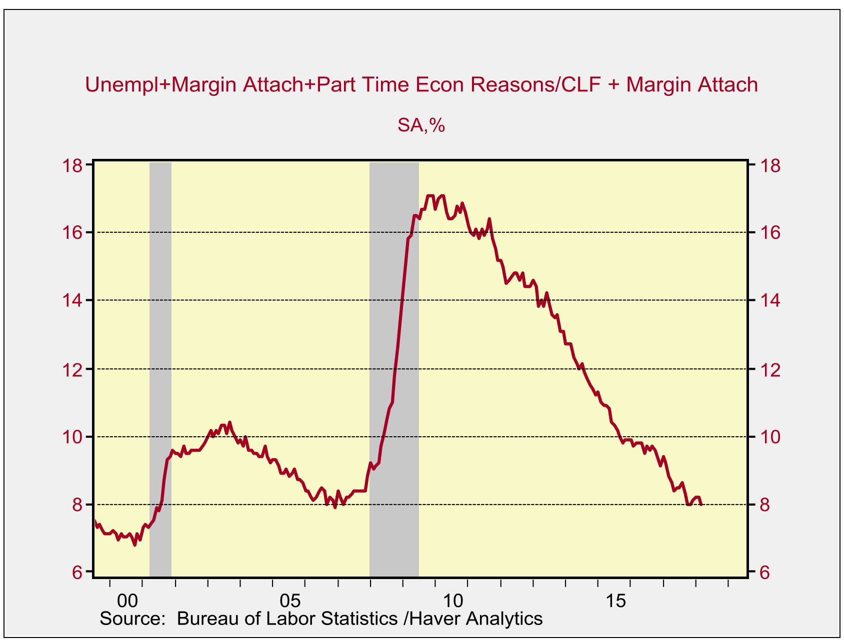
The chart below shows the 12-month moving total of the change in non-farm payrolls; a dip under 1.5 mm signals recession.



The unemployment rate came in below expectations at 3.9% compared to the forecast of 4.0%. The labor force participation rate was 62.8%, a small dip from the previous month, while the U-6 unemployment rate fell 20 bps from 8.0% to 7.8%.

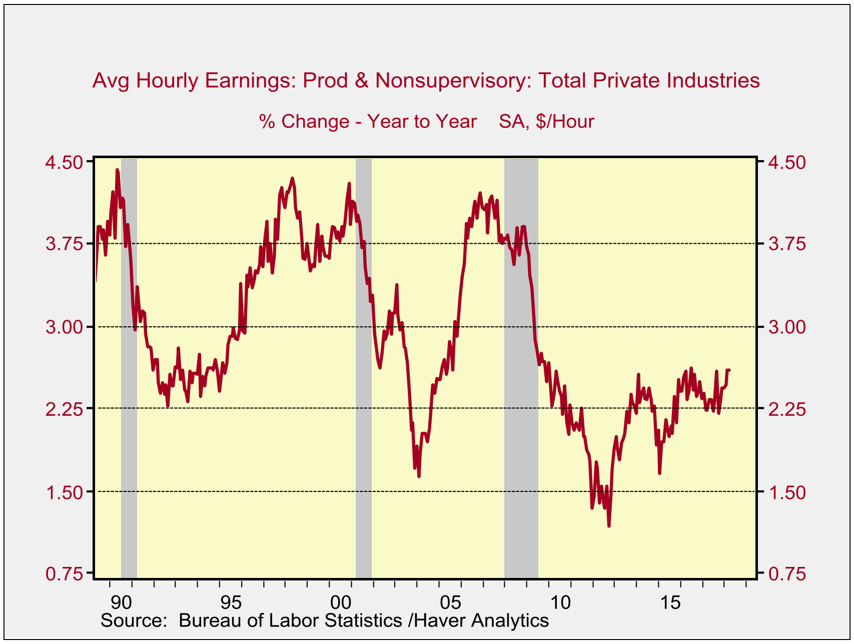


The chart above shows the relationship between the unemployment rate and the employment/population ratio. The divergence of the two variables has been one of the defining factors of this recovery and argues that labor market slack still remains.



The chart above shows the underemployment rate, also referred to as the U-6 rate. This is a broader measure of unemployment and it's showing a tightening labor situation.

Average hourly earnings for all workers came in below expectations, rising 0.1% from the prior month. The chart below shows the yearly change in overall wages for non-supervisory and production workers.



As mentioned, this chart shows the yearly growth in hourly earnings for production and non-supervisory workers. On an annual basis, wage growth for production and non-supervisory employees rose 2.6%, in line with the prior month. Wage growth remains subdued even with the historically low unemployment rate.

Overall, the jobs report does provide evidence that the economy is not overheating. That said, we do not believe this report will have an impact on whether the FOMC decides to raise rates in June.

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**
12:45	William Dudley Speaks with Bloomberg's Matthew Winkler	President of the Federal Reserve Bank of New York
15:00	John Williams Speaks at Hoover Institution	President of the Federal Reserve Bank of San Francisco
17:30	Randal Quarles Speaks on Liquidity Regulation at Hoover	U.S. Federal Reserve Vice Chairman for Supervision
20:00	Robert Kaplan Speaks at Hoover Institution	President of the Federal Reserve Bank of Dallas
20:00	Esther George Speaks at Hoover Institution	President of the Federal Reserve Bank of Kansas City
20:00	Raphael Bostic Speaks at Hoover Institution	President of the Federal Reserve Bank of Atlanta

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	Caixin China PMI Composite	m/m	apr	52.3	51.8		**	Equity and bond neutral
	Caixin China PMI Composite	m/m	apr	52.9	52.3	52.3	**	Equity bullish, bond bearish
	BoP Current Account Balance	q/q	1q	-$28.2 bn	$63.2 bn		**	Equity bearish, bond bullish
India	Nikkei India PMI Services	m/m	apr	51.4	50.3		**	Equity and bond neutral
	Nikkei India PMI Composite	m/m	apr	51.9	50.8		**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Composite	m/m	apr	54.7	55.0	55.0	**	Equity and bond neutral
	Markit Eurozone Services	m/m	apr	55.1	55.2	55.2	**	Equity and bond neutral
	Retail Sales	m/m	mar	0.8%	1.8%	1.9%	**	Equity bearish, bond bullish
France	Trade Balance	m/m	mar	-5.258 bn	-5.186 bn	-5.000 bn	**	Equity bearish, bond bullish
	Current Account Balance	y/y	mar	-1.300 bn	-2.000 bn		**	Equity and bond neutral
	Budget Balance	y/y	mar	-33.100 bn	-28.500		**	Equity bearish, bond bullish
	Markit France Services	m/m	apr	57.4	57.4	57.4	**	Equity and bond neutral
	Markit France Composite	m/m	apr	56.9	56.9	56.9	**	Equity and bond neutral
Italy	Markit/ADACI Italy Services	m/m	apr	52.6	52.6	53.0	**	Equity and bond neutral
	Markit/ADACI Italy Composite	y/y	apr	52.9	53.7	53.5	**	Equity and bond neutral
U.K.	New Car Registrations	y/y	apr	10.4%	-15.7%		*	Equity and bond neutral
Russia	Money Supply Narrow Def	y/y	apr	9.91 tn	9.87 tn		*	Equity and bond neutral
AMERICAS								
Mexico	Leading Indicator	y/y	mar	-0.02	0.0%		**	Equity bearish, bond bullish
Brazil	Industrial Production	y/y	mar	1.3%	2.8%	3.0%	***	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)	236	235	1	Up
3-mo T-bill yield (bps)	179	179	0	Neutral
TED spread (bps)	57	56	1	Neutral
U.S. Libor/OIS spread (bps)	184	184	0	Up
10-yr T-note (%)	2.93	2.95	-0.02	Up
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	3	3	0	Down
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	up			Up
pound	flat			Up
franc	down			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	$73.87	$73.62	0.34%	
WTI	$68.65	$68.43	0.32%	
Natural Gas	$2.73	$2.73	0.00%	
Crack Spread	$19.85	$19.60	1.28%	
12-mo strip crack	$18.74	$18.68	0.36%	
Ethanol rack	$1.57	$1.57	0.18%	
Metals				
Gold	$1,310.57	$1,312.06	-0.11%	
Silver	$16.42	$16.43	-0.08%	
Copper contract	$307.40	$308.05	-0.21%	
Grains				
Corn contract	$ 406.50	$ 408.00	-0.37%	
Wheat contract	$ 533.00	$ 538.00	-0.93%	
Soybeans contract	$ 1,038.25	$ 1,053.25	-1.42%	
Shipping				
Baltic Dry Freight	1376	1346	30	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	6.2	1.0	5.2	
Gasoline (mb)	1.2	-0.5	1.7	
Distillates (mb)	-3.9	-1.5	-2.4	
Refinery run rates (%)	0.30%	0.45%	-0.15%	
Natural gas (bcf)	62.0	-18.0	80.0	

Weather

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

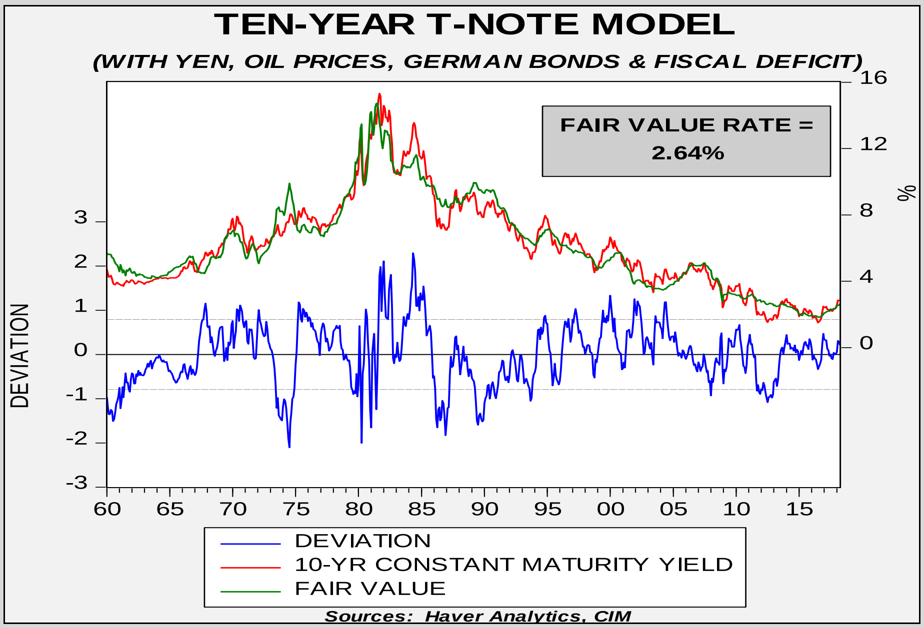
Asset Allocation Weekly Comment

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.

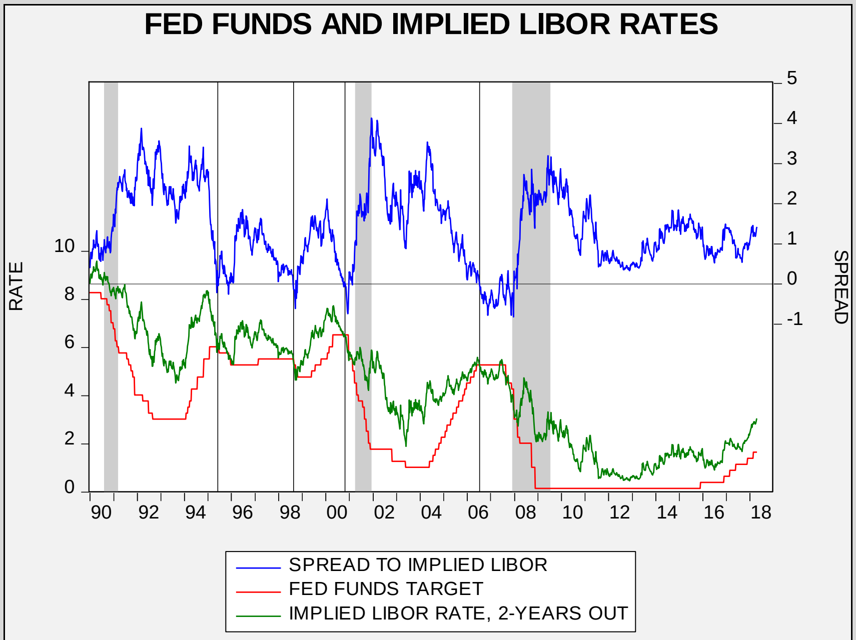
Here is our updated 10-year T-note model.



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%.



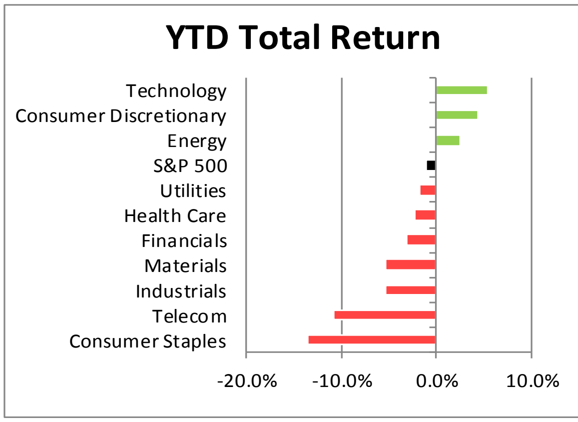
Sources: FRED, Bloomberg, CIM

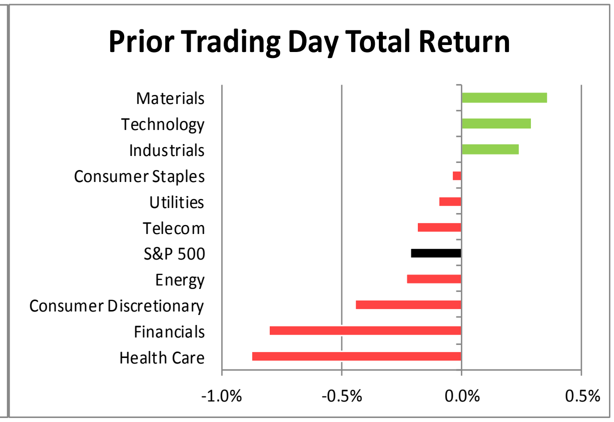
Assuming 3.00% fed funds over the next two years, our T-note model yields a fair value of 3.17%. Essentially, it appears the Treasury market has discounted a terminal fed funds rate of 2.75%; as the above chart shows, the FOMC tends to lift the fed funds rate until the implied Eurodollar rate falls below 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 5/3/2018 close)

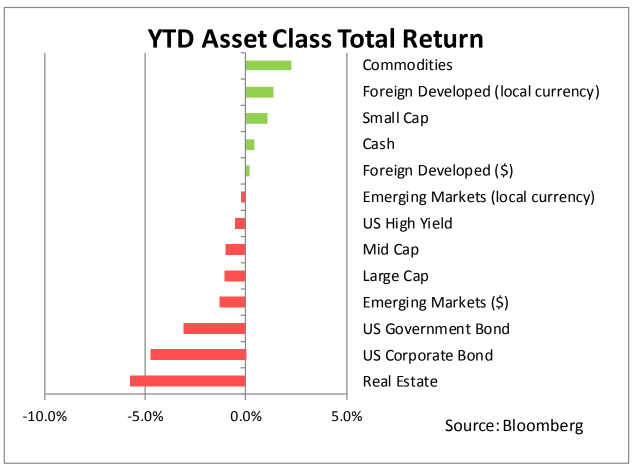




(Source: Bloomberg)

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 5/3/2018 close)

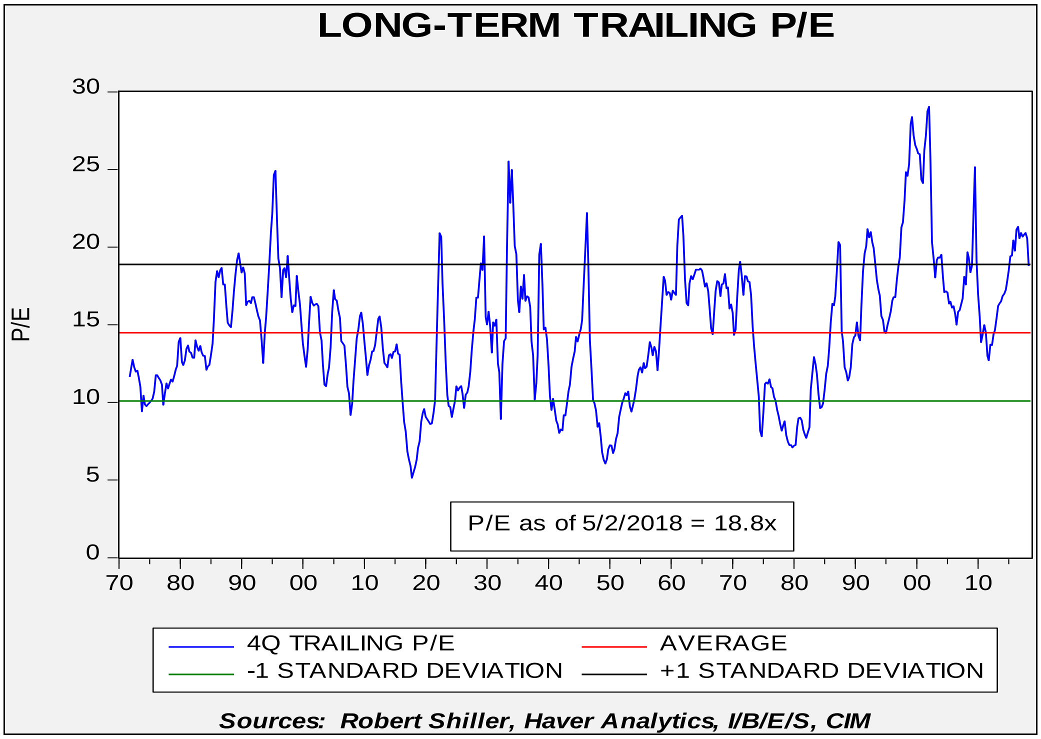


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 3, 2018



Based on our methodology,[2] the current P/E is 18.8x, down 0.1x from last week. The decline was mostly due to rising earnings.

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[2] 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.