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.

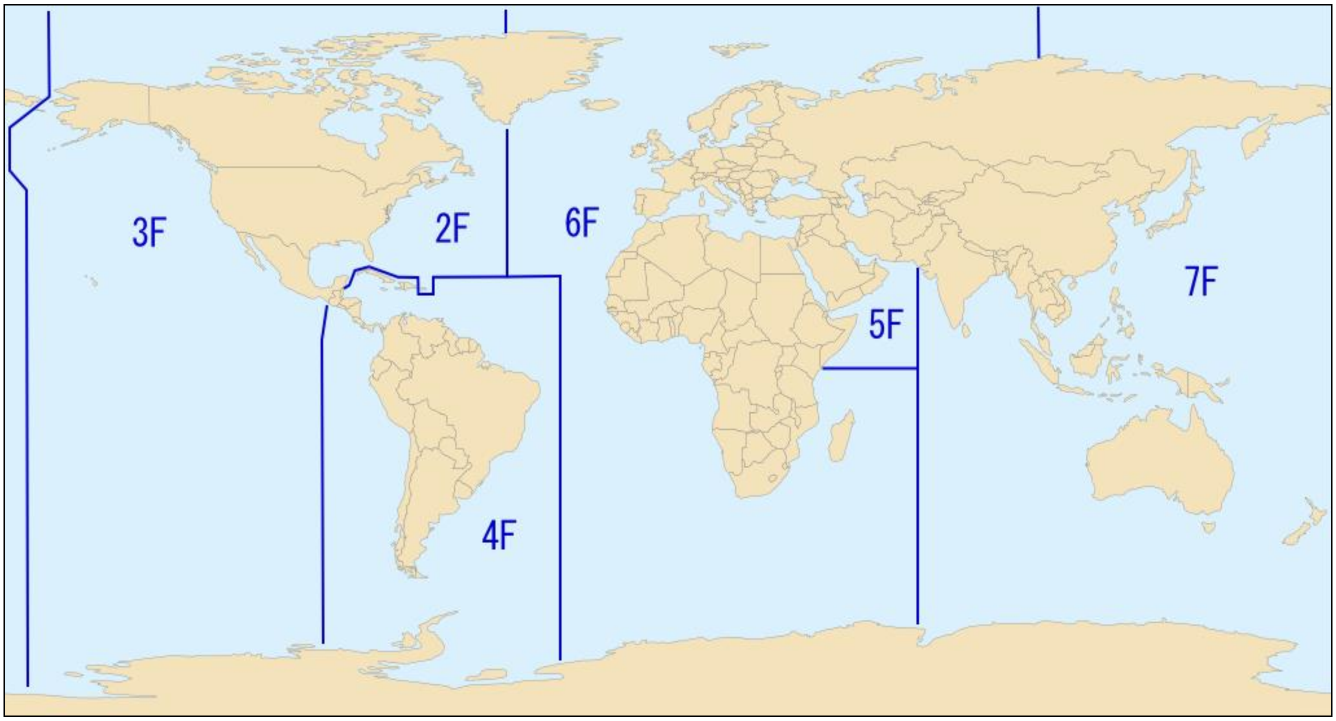
[Posted: May 8, 2018—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.5% from the last close. In Asia, the MSCI Asia Apex 50 closed up 1.0% from the prior close. Chinese markets were up, with the Shanghai composite up 0.8% and the Shenzhen index up 0.8%. U.S. equity index futures are signaling a lower open. With 421 companies having reported, the S&P 500 Q1 earnings stand at $38.80, higher than the $36.49 forecast for the quarter. The forecast reflects an 18.4% increase from Q1 2017 earnings. Thus far this quarter, 79.6% of the companies reported earnings above forecast, while 14.5% reported earnings below forecast.

It's a quiet morning in a very busy week. Here is what we are monitoring this morning:

The Iran deal: The president will announce his Iran decision at 2:00 (EDT). Although we expect him to end U.S. participation in the pact, it is unclear what he will actually do with the withdrawal. Will he delay resuming U.S. sanctions? Will Europe go along? Given the mercurial behavior of President Trump, even after the announcement it is possible it won't be completely clear what has occurred. The White House seems to believe that ending the Obama agreement will prompt Iran to renegotiate with the Trump administration. We think a more likely outcome is that Iran threatens to "race for a bomb." However, Iran knows that actually having a bomb might trigger a nuclear response from Israel.[1] Thus, it may refrain from racing to the bomb, making it clear the nuclear program was a bargaining position all along. Simply put, after the announcement, things could get complicated quickly and a "drop dead" position isn't likely. That explains why oil prices have declined this morning. Ending the deal is bullish for oil but maybe not as immediately bullish as recent market action has signaled.

The 2nd Fleet returns: The 2nd Fleet was deactivated in 2011. It was part of the Atlantic Fleet, covering the U.S. East Coast (see map below). Its primary mission was to defend the eastern U.S. from Soviet naval incursions; for example, it was heavily involved in the Cuban Embargo in 1962. It was also responsible for training at the Naval Station Norfolk. It was decommissioned in 2011 in an effort to husband resources.

[1] There are two reasons behind this thought. First, Israel has stated on numerous occasions that a nuclear-armed Iran is an existential threat. If that statement is more than rhetoric, Israel should react strongly before Iran actually has a deliverable weapon. Second, Israel's air force cannot conduct a long conventional air campaign by itself that can guarantee the elimination of the nuclear threat. Thus, if the threat is really existential, it should use its poorly kept secret nuclear capacity to attack Iran. We believe Israel's real goal is to quietly threaten to use nuclear weapons as a way to draw the U.S. into a conventional air campaign against Iran, and the U.S. does have the capacity to conduct a massive air war that could dramatically reduce Iran's nuclear program.



(Source: File:World map with nations.svg & myown, Public Domain, https://commons.wikimedia.org/w/index.php?curid=7789761)

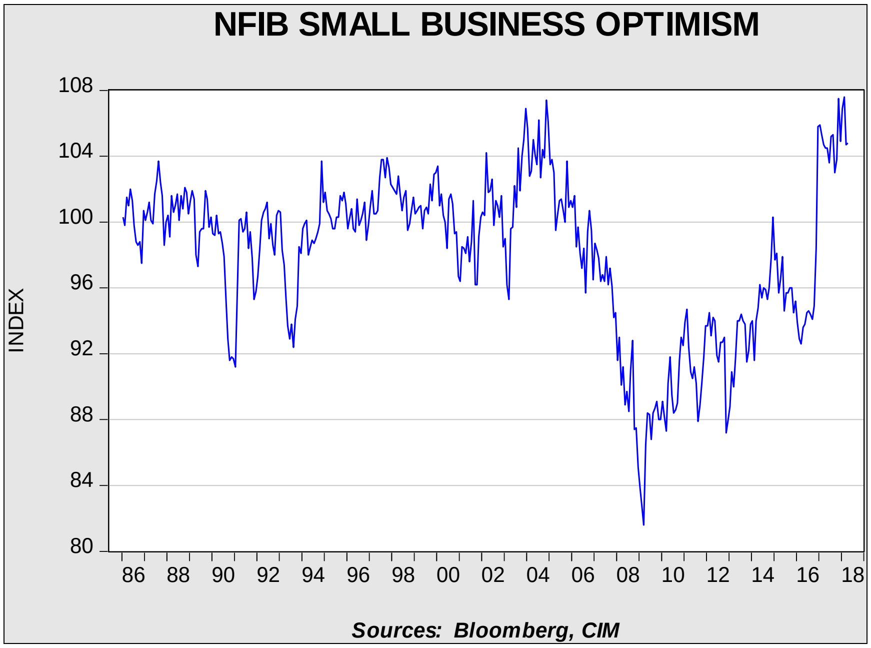
The resurgent Russia has led the administration to recommission the fleet, a recognition of the growing threat from Putin.

A hawkish turn: As we have noted, San Francisco FRB President Williams is going to take over for NY FRB President Dudley on June 17. Thus, Williams's position will be vacant after that date. Until the San Francisco FRB selects a new president, Mark Gould, the first VP at the bank, will be acting president. According to Federal Reserve rules, Gould can participate in the discussion but cannot vote on policy. Instead, rules require that an alternative from one of the non-voting regional banks vote in San Francisco's place and it just so happens that Esther George, the KC FRB president, will fill that role. George is perhaps the most hawkish member of the FOMC. Although this won't change the June vote (fed funds futures put the odds of a rate hike at 100%), she might push for increases in the meetings without a press conference. Although we suspect she would be outvoted, she could dissent which would give the meetings a more hawkish tone. She will continue to vote until the San Francisco FRB appoints a new president.

Italy: President Mattarella has asked the political parties in Italy to allow him to form a non-partisan caretaker government after negotiations following recent elections have led to a stalemate. The caretaker government would rule Italy until (a) new elections are held, or (b) the parties form a new government. The announcement has raised fears that choice (a) will be selected, meaning that another round of elections may lead to another chance for a populist government to gain a majority. Fears of another vote have pressured the EUR and sent Italian bond yields higher this morning.

U.S. Economic Releases

NFIB Small Business Optimism came in above expectations at 104.8 compared to the forecast of 104.5.



The chart above shows the level of small business optimism. Small business optimism rose slightly from the previous month and remains relatively elevated.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	JOLTS Job Openings	m/m	mar	6100	6052	**
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	Trade Balance	m/m	apr	$28.75 bn	-$4.98 bn	$27.75 bn	**	Equity bullish, bond bearish
Japan	Household Spending	y/y	mar	-0.7%	0.1%	1.0%	**	Equity bearish, bond bullish
Australia	ANZ Roy Morgan Weekly Consumption	m/m	apr	119.6	119.2		**	Equity and bond neutral
	Retail Sales ex Inflation	q/q	1q	0.2%	0.9%	0.6%	**	Equity bearish, bond bullish
	Retail Sales	m/m	apr	0.0%	0.6%	0.2%	**	Equity bearish, bond bullish
New Zealand	ANZ Truckometer Heavy	m/m	apr	1.4%	-0.3%		*	Equity and bond neutral
	2yr Inflation Expectation	q/q	2q	2.0%	2.1%		**	Equity and bond neutral
EUROPE								
Germany	Trade Balance	m/m	mar	25.2 bn	18.4 bn	22.5 bn	**	Equity bullish, bond bearish
	Current Account Balance	m/m	mar	29.1 bn	20.7 bn	27.0 bn	**	Equity bullish, bond bearish
	Industrial Production	m/m	mar	3.2%	2.6%	3.0%	***	Equity bullish, bond bearish
U.K.	Halifax House Prices	m/m	apr	-3.1%	1.5%	-0.2%	**	Equity bearish, bond bullish
Switzerland	Unemployment Rate	m/m	apr	2.7%	2.9%	2.9%	***	Equity and bond neutral
	UBS Real Estate Bubble Index	m/m	apr	1.10	1.32		**	Equity and bond neutral
AMERICAS								
Mexico	Consumer Confidence Index	m/m	apr	85.8	82.5	84.0	***	Equity and bond neutral
	Gross Fixed Investment	m/m	apr	4.8%	4.1%	5.2%	**	Equity and bond neutral
Canada	Bloomberg Nanos Confidence	m/m	may	58.0	57.9		**	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)	237	236	1	Up
3-mo T-bill yield (bps)	183	182	1	Neutral
TED spread (bps)	54	54	0	Neutral
U.S. Libor/OIS spread (bps)	186	185	1	Up
10-yr T-note (%)	2.95	2.95	0.00	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	down			Up
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	$75.34	$76.17	-1.09%	Stronger Dollar
WTI	$69.80	$70.73	-1.31%	
Natural Gas	$2.76	$2.74	0.77%	
Crack Spread	$19.68	$19.61	0.37%	
12-mo strip crack	$18.73	$18.82	-0.45%	
Ethanol rack	$1.59	$1.58	0.06%	
Metals				
Gold	$1,309.55	$1,314.21	-0.35%	
Silver	$16.43	$16.47	-0.26%	
Copper contract	$303.85	$307.90	-1.32%	
Grains				
Corn contract	$ 401.50	$ 400.75	0.19%	
Wheat contract	$ 511.00	$ 511.50	-0.10%	
Soybeans contract	$ 1,016.50	$ 1,011.50	0.49%	
Shipping				
Baltic Dry Freight	1384	1376	8	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.3		
Gasoline (mb)		0.0		
Distillates (mb)		-1.6		
Refinery run rates (%)		0.50%		

Weather

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

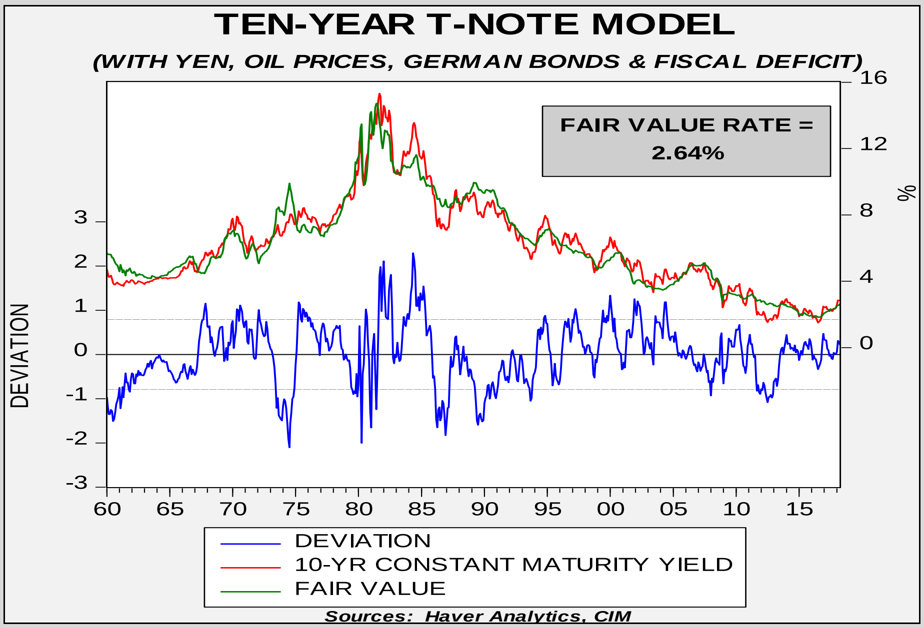
Asset Allocation Weekly Comment

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.

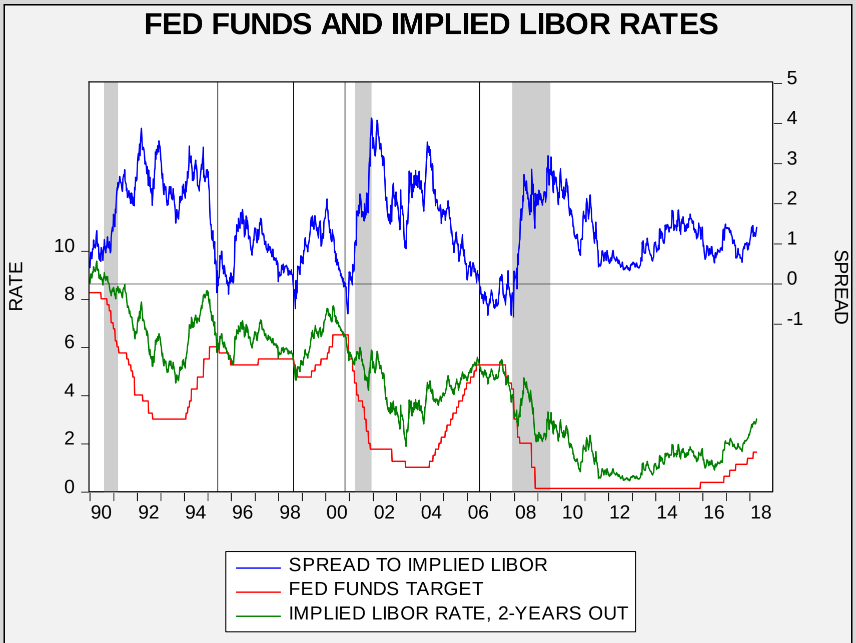
Here is our updated 10-year T-note model.



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%.



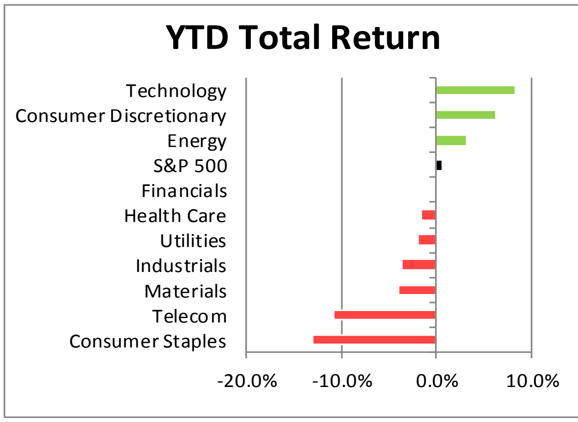
Sources: FRED, Bloomberg, CIM

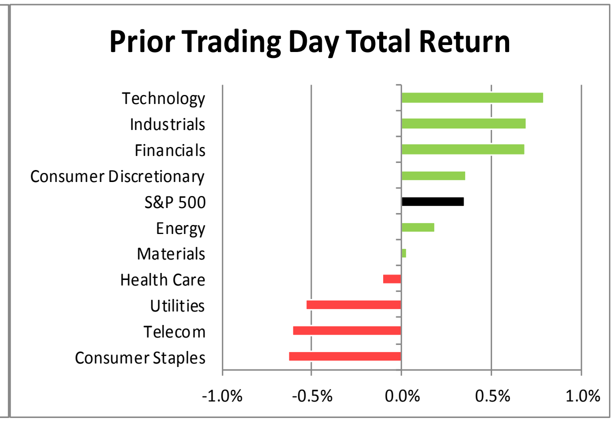
Assuming 3.00% fed funds over the next two years, our T-note model yields a fair value of 3.17%. Essentially, it appears the Treasury market has discounted a terminal fed funds rate of 2.75%; as the above chart shows, the FOMC tends to lift the fed funds rate until the implied Eurodollar rate falls below 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 5/7/2018 close)

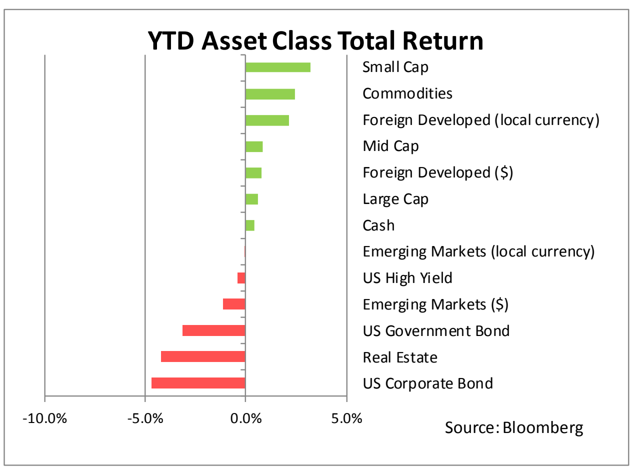




(Source: Bloomberg)

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 5/7/2018 close)

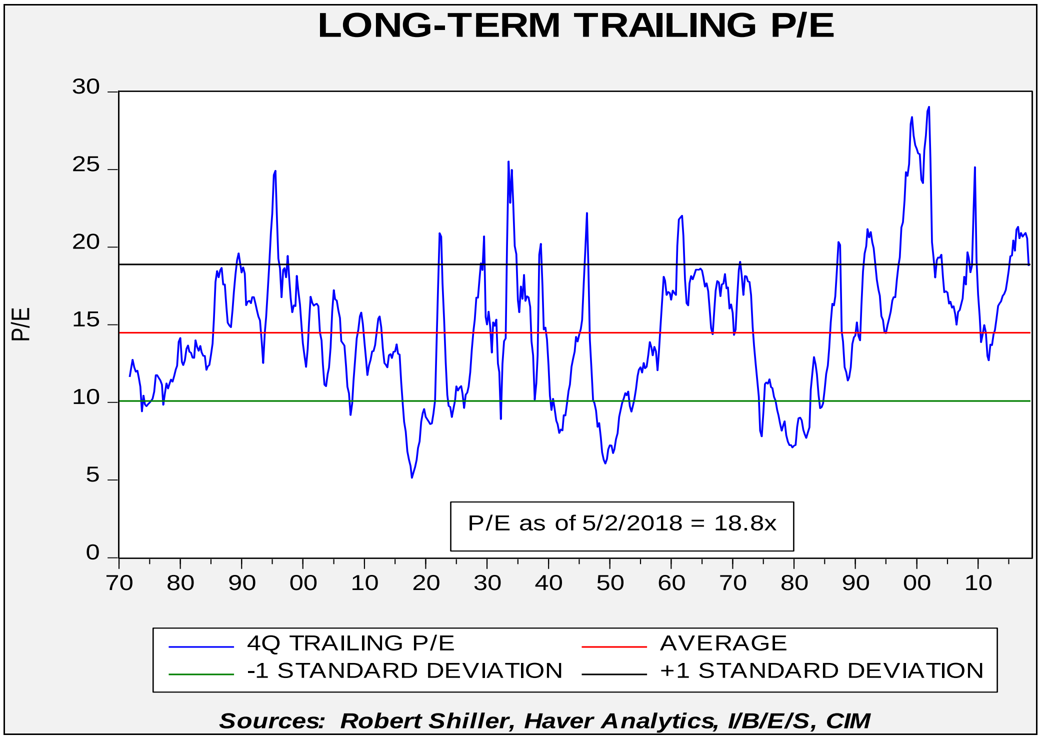


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

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.

[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.