Daily Comment

By Bill O'Grady, Thomas Wash, and Patrick Fearon-Hernandez, CFA

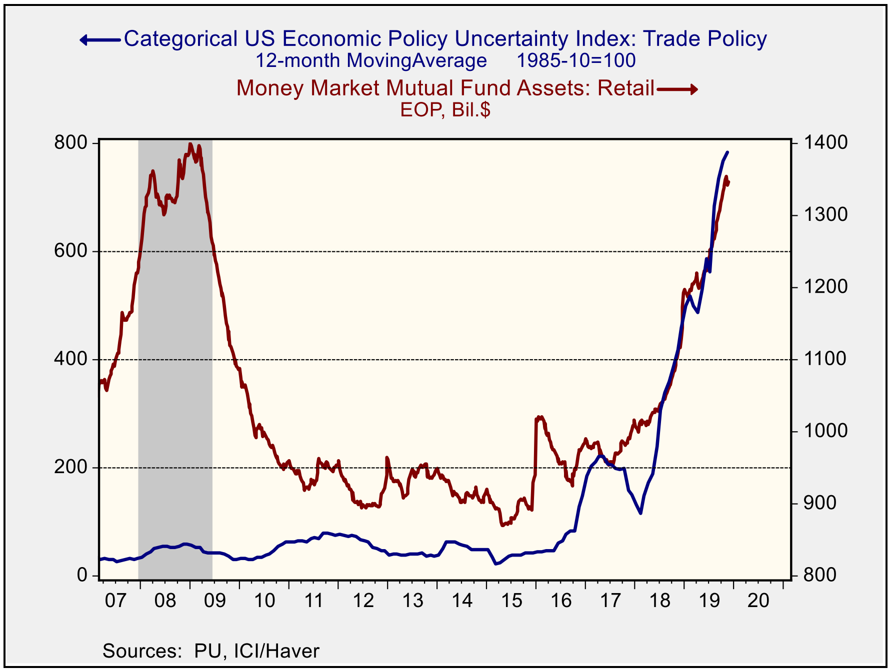
Looking for something to read? See our Reading List; these books, separated by category, are ones we find interesting and insightful. We will be adding to the list over time.

[Posted: December 4, 2019—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is up 1.2% from its last close. In Asia, the MSCI Asia Apex 50 closed down 0.7%. Chinese markets were mixed, with the Shanghai composite down 0.2% and the Shenzhen index up 0.2% from the prior close. U.S. equity index futures are signaling a higher open. With 487 companies having reported, the S&P 500 Q3 earnings stand at $42.60, higher than the $41.08 forecast for the quarter. The forecast reflects a 4.0% decrease from Q3 2018 earnings. Thus far this quarter, 76.0% of the companies reported earnings above forecast, while 16.8% reported earnings below forecast.

Yesterday, trade worries with China led to a selloff. This morning, optimism has returned and equities are higher. Protests in Iran turn increasingly deadly. Thoughts on the U.K. elections. Here is what we are watching this morning:

Trade: Yesterday, equity markets tumbled on comments from President Trump who indicated that a trade deal might not happen this year, and on reports from the commerce secretary that additional tariffs on China could be implemented on Dec. 15th. Well, that was yesterday. Today is today and optimism has returned. First, media reports suggested that the president's comments yesterday may have been nothing more than a bargaining tactic. Negotiators for the U.S. and China indicate that talks are continuing and nearing an agreement. Complicating matters is that the House passed the Uighur Act of 2019, which would call on the White House to attach sanctions on members of the CPC Politburo. Although China has warned that if this bill becomes law, it will retaliate, if the Hong Kong bill is any indication, it won't affect trade.

What do we make of all this? We have noted that if the president really wanted to address the trade imbalance, which is really about saving and capital flows, he has had a couple of opportunities to address this issue systemically. The first was during the tax reform discussions; there was a border adjustment tax that would have applied tariffs in such a way to equalize prices. That idea never gained traction. The second remains the Hawley-Ballwin bill, which we discussed in detail here and here. The Competitive Dollar for Jobs and Prosperity Act would get at the heart of the problem by applying sanctions and capital flows, not trade. However, it would indirectly, but effectively, take trade policy away from the White House and give it to the Federal Reserve in the form of setting the exchange rate. The reality is that the president seems more intent on making headlines and swaying policy by swinging market sentiment by how he talks about trade. In other words, as Bloomberg's Tracy Alloway noted, the lasting legacy of the Trump presidency may be the use of tariffs as a flexible policy tool. Trump doesn't really want to solve the trade issue directly; he wants to shape the behavior of foreign nations on an *ad hoc* basis with the use of tariffs. Of course, what that means for markets is continued uncertainty. Although this does keep the president's name in the news, it does have a cost; investors have been building cash positions based on fears surrounding trade.



This chart shows the 12-month average of the trade policy uncertainty index[1] and retail MMK funds. We started to see a strong accumulation of liquidity as trade concerns increased. There are a couple of takeaways from this chart; first, despite rising cash levels, equity markets have moved higher but would likely be even higher in the absence of the trade tensions[2] and second, if the trade issue is resolved, or at least temporarily eased, a FOMO rally in stocks could be significant.

A few other trade items of note. First, Japan has officially approved the U.S. free trade agreement. Second, the Johnson government is apparently considering its own digital sales tax that appears similar to the controversial one passed by France. We would not expect President Trump to bring up this issue with elections just over a week away, but if the U.K. proceeds with this plan, look for trade friction to rise with Britain. Third, Mexico is balking at a demand from House Democrats to give U.S. inspectors the right to unilaterally investigate Mexican firms for labor law violations. It is unclear if the USMCA can pass without this provision. It is also unlikely that Mexico will approve such intrusive inspections.

Iran: The gasoline protests have become increasingly deadly. Reports now suggest that somewhere between 208 to 450 Iranians have died at the hands of state security. Hard liners of the regime are trying to pin the unpopular price hikes on the Rohini government. There are

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[1] This index measures mentions of trade issues in the news media; it was created by Economic Policy Uncertainty.
[2] At the same time, one should treat that last statement with some caution; the Fed might have raised rates faster and higher in the absence of the trade issue.

reports the Trump administration, viewing the unrest as a sign their sanctions policy is working, is [considering additional sanctions]. The more desperate the Iranian government becomes, the more likely it is to at least consider attacking a neighbor to distract its unhappy Iranians.

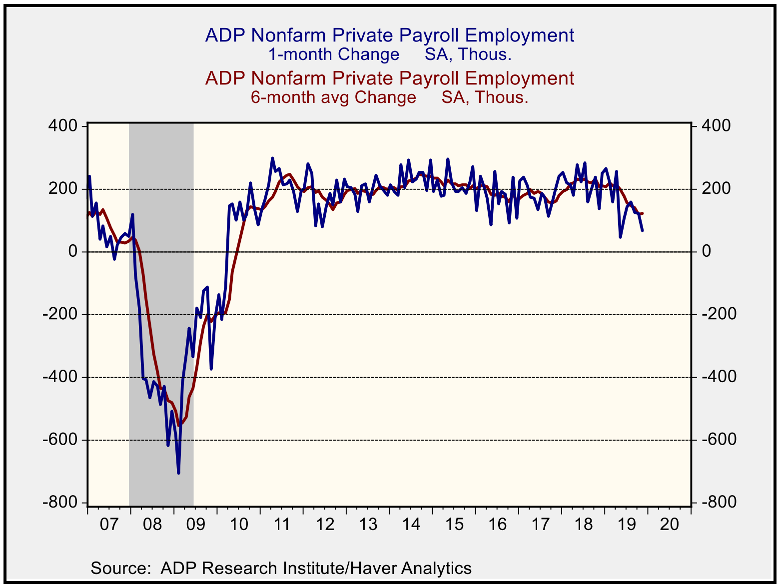
U.K. elections: As the poll looms on Dec. 12, we are seeing a few interesting developments. There has been increasing discussion of "[tactical voting]" by the Remain camp. The Remain parties are divided between the SNP, the Lib-Dems and Labour. The idea is that voters who want to support Remain should vote for one of these parties in their districts with the best chance of beating the Tory MP candidate. However, there are two problems with this concept. First, it requires accurate polling. In a vote for a Lib-Dem, a Labour and a Tory MP candidate, the Remain voter has to be confident that a vote for the Lib-Dem or the Labour candidate can overcome the Tory candidate. If the polling isn't definitive, the likely outcome would be to split the Remain vote and swing the seat to the Tory candidate. The second problem is that even if the Tories are denied a majority, it isn't obvious who would lead a SNP/Lib-Dem/Labour government. The SNP is really only concerned with Scotland and thus would not provide the PM. The Lib-Dem and Labour party agree on little, even on the Brexit issue. The former wants to revoke Article 50 outright, while Labour wants another referendum. Our base case is that tactical voting will fail, and the Tories will carry the election.

The second issue is that Labour has touted a document indicating that the Tories would allow the U.S. to dictate changes to trade laws that would undermine the National Health Service. Reports have emerged that suggest this report may be [nothing more than Russian disinformation]. This situation highlights something we may see next year in the U.S. presidential election; damming reports circulate that have no basis in fact but lead voters unsure what to believe.

U.S. Economic Releases

MBA mortgage applications dropped 9.2% in the week ended November 29, easily erasing their 1.5% rise in the previous week. Applications for home-purchase mortgages actually rose 0.9% last week, but applications for refinancing mortgages plunged 15.6%. The average interest rate on a 30-year, fixed-rate mortgage was unchanged at 3.97%.

Separately, the ADP National Employment Report showed private nonfarm payrolls grew only tepidly in November, posting a seasonally-adjusted increase of just 67,000. That was less than half the expected rise of 135,000, and it was far short of the revised October increase of 121,000. In fact, it was the second-weakest gain of the decade. Much of the problem in November stemmed from a drop of 18,000 jobs in the goods-producing sector, but there was also only modest job growth of 85,000 in the services sector.



The figure above shows the monthly change in private nonfarm payrolls as estimated by ADP, compared with its rolling six-month average.

The table below shows the Economic Releases and Fed events scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Markit Services PMI	m/m	nov	51.6	51.6	**
9:45	Markit Composite PMI	m/m	nov		51.9	**
10:00	ISM Nonmanufacturing	m/m	nov	54.5	54.7	**
Fed Speakers or Events						
	Speaker or event	**District or position**				
10:00	Randal Quarles Speaks to Congress on Supervision and Regulation	Federal Reserve Vice Chairman of Supervision				

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	Jibun Bank Japan PMI Services	m/m	nov	50.3	50.4		**	Equity and bond neutral
	Jibun Bank Japan PMI Composite	m/m	nov	49.8	49.9		**	Equity and bond neutral
Australia	AiG Performance of Services Index	m/m	nov	53.7	54.2		*	Equity and bond neutral
	CBA Australia PMI Services	m/m	nov	49.7	49.5		*	Equity and bond neutral
	CBA Australia PMI Composite	m/m	nov	49.7	49.5		*	Equity and bond neutral
	GDP	y/y	3q	1.7%	1.6%	1.7%	***	Equity and bond neutral
New Zealand	QV House Price Index	y/y	nov	3.3%	2.8%		**	Equity and bond neutral
	ANZ Commodity Price Index	m/m	nov	4.3%	1.2%		**	Equity and bond neutral
South Korea	Foreign Reserves	m/m	nov	$407.5 Bil.	$406.3 Bil.		*	Equity and bond neutral
China	Caixin China PMI Composite	m/m	nov	53.2	52.0		**	Equity bullish, bond bearish
	Caixin China PMI Services	m/m	nov	53.5	51.1	51.2	**	Equity bullish, bond bearish
India	Markit PMI Services	m/m	nov	52.7	49.2		**	Equity bullish, bond bearish
	Markit PMI Composite	m/m	nov	52.7	49.6		**	Equity bullish, bond bearish
EUROPE								
Eurozone	Markit PMI Services	m/m	nov	51.9	51.5	51.5	**	Equity bullish, bond bearish
	Markit PMI Composite	m/m	nov	50.6	50.3	50.3	**	Equity bullish, bond bearish
Germany	Markit PMI Services	m/m	nov	51.7	51.3	51.3	**	Equity bullish, bond bearish
	Markit/BME PMI Composite	m/m	nov	49.4	49.2	49.2	**	Equity and bond neutral
France	Markit PMI Services	m/m	nov	52.2	52.9	52.9	**	Equity bearish, bond bullish
	Markit PMI Composite	m/m	nov	52.1	52.7	52.7	**	Equity bearish, bond bullish
Italy	Markit PMI Services	m/m	nov	50.4	52.2	52.2	**	Equity bearish, bond bullish
	Markit PMI Composite	m/m	nov	49.6	50.8	50.8	**	Equity bearish, bond bullish
UK	Markit/CIPS PMI Services	m/m	nov	49.3	48.6	48.6	**	Equity bullish, bond bearish
	Markit/CIPS PMI Composite	m/m	nov	49.3	48.5	48.5	**	Equity bullish, bond bearish
Russia	Markit PMI Services	m/m	nov	55.6	55.8	55.8	**	Equity and bond neutral
	Markit PMI Composite	m/m	nov	52.9	53.3	53.3	**	Equity and bond neutral
AMERICAS								
Canada	Labor Productivity	q/q	3q	0.2%	0.2%	0.2%	*	Equity and bond neutral
Brazil	Industrial Production	y/y	oct	1.0%	1.1%	1.4%	***	Equity and bond neutral
	Markit PMI Services	m/m	nov	50.9	51.2		**	Equity and bond neutral
	Markit PMI Composite	m/m	nov	51.8	51.8		**	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)	190	191	-1	Down
3-mo T-bill yield (bps)	153	153	0	Neutral
TED spread (bps)	37	37	0	Neutral
U.S. Libor/OIS spread (bps)	155	155	0	Up
10-yr T-note (%)	1.75	1.72	0.03	Down
Euribor/OIS spread (bps)	-40	-40	0	Down
EUR/USD 3-mo swap (bps)	12	16	-4	Down
Currencies	**Direction**			
dollar	Flat			Up
euro	Flat			Down
yen	Flat			Flat
pound	Up			Up
franc	Down			Flat

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	$61.98	$60.82	1.91%	
WTI	$57.02	$56.10	1.64%	
Natural Gas	$2.39	$2.44	-2.17%	
Crack Spread	$14.31	$13.93	2.76%	
12-mo strip crack	$17.12	$16.86	1.55%	
Ethanol rack	$1.67	$1.68	-0.56%	
Metals				
Gold	$1,477.25	$1,477.61	-0.02%	
Silver	$17.16	$17.17	-0.09%	
Copper contract	$264.40	$262.30	0.80%	
Grains				
Corn contract	$ 381.00	$ 381.25	-0.07%	
Wheat contract	$ 526.75	$ 525.25	0.29%	
Soybeans contract	$ 876.00	$ 871.00	0.57%	
Shipping				
Baltic Dry Freight	1606	1568	38	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.5		
Gasoline (mb)		2.0		
Distillates (mb)		-0.5		
Refinery run rates (%)		0.70%		
Natural gas (bcf)		-27.0		

Weather

The 6-10 and 8-14 day forecast is calling for colder-than-normal temperatures throughout the Midwest, with warmer-than-normal temperatures only along the West Coast and the Southeast Coast. Precipitation is expected throughout the eastern two-thirds of the country, concentrating in the Appalachians, the Dakotas, and New Mexico. Dry conditions are expected along the West Coast.

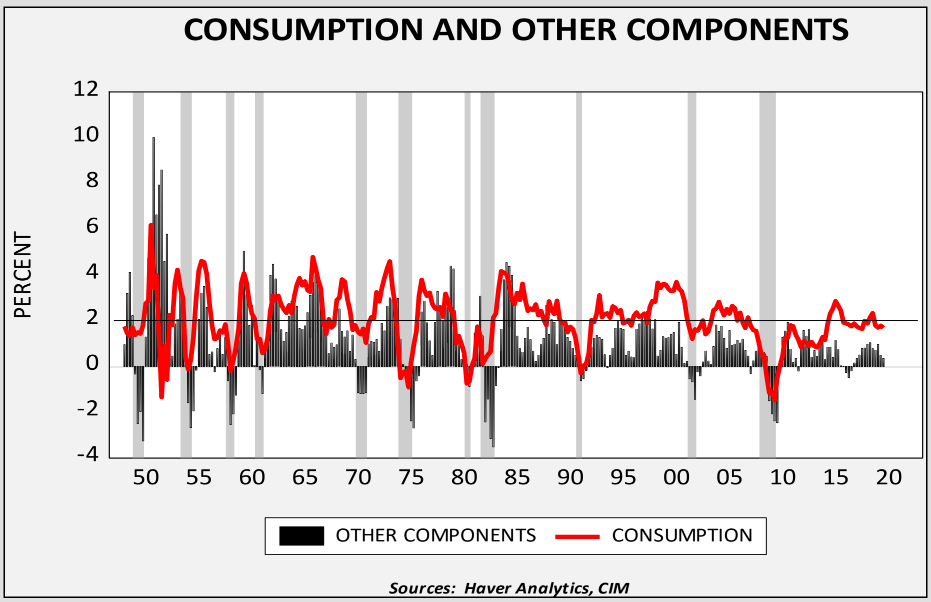
Asset Allocation Weekly

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.

November 22, 2019

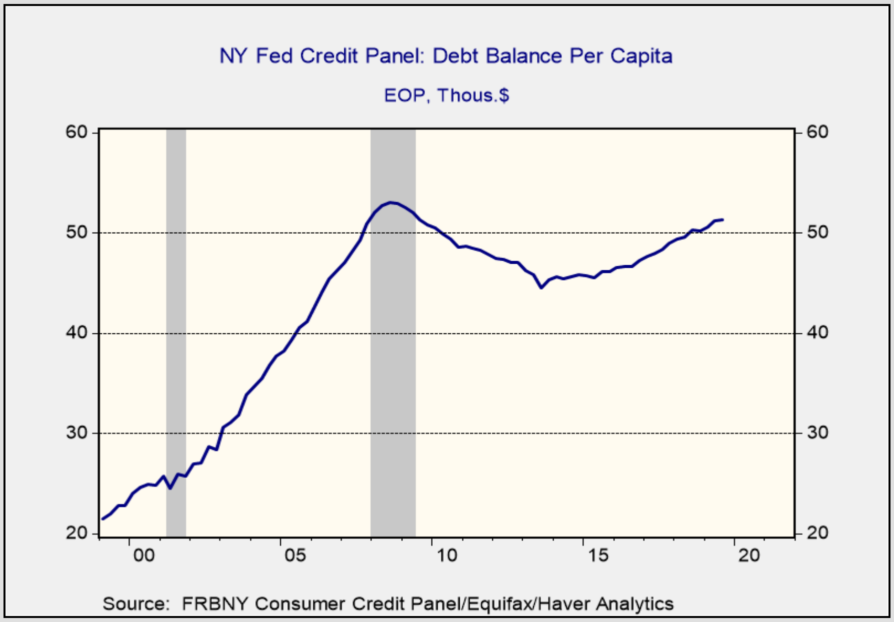
(NB: Due to the Thanksgiving holiday, the next report will be published on December 6.)

The health of the consumer is critical to the future path of economic growth. For the most part, consumption is accounting for most of the growth in the economy.



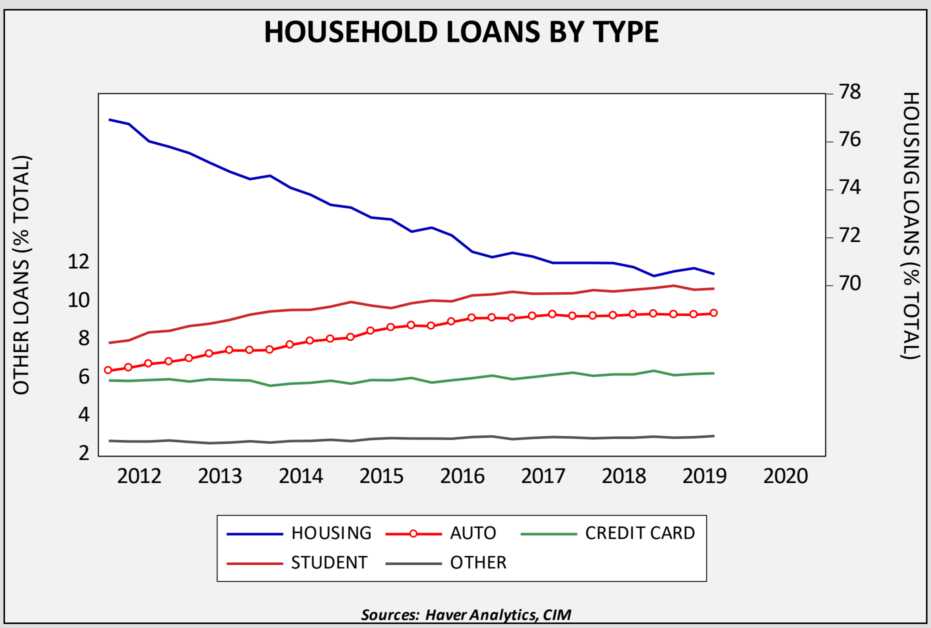
This chart shows the four-quarter average of the contribution to real GDP from consumption compared to the net of the contribution from government, investment and net exports. Over recent business cycles, the contribution outside of consumption has diminished. The other sign from the data is that the risk of recession rises when consumption's contribution declines below 2%.

Household debt plays a role in consumption. The New York FRB has a data series on consumer debt that has just been recently updated. The balance of household debt is now $13.95 trillion, a new record high. However, on a per capita basis, we remain below the previous record.

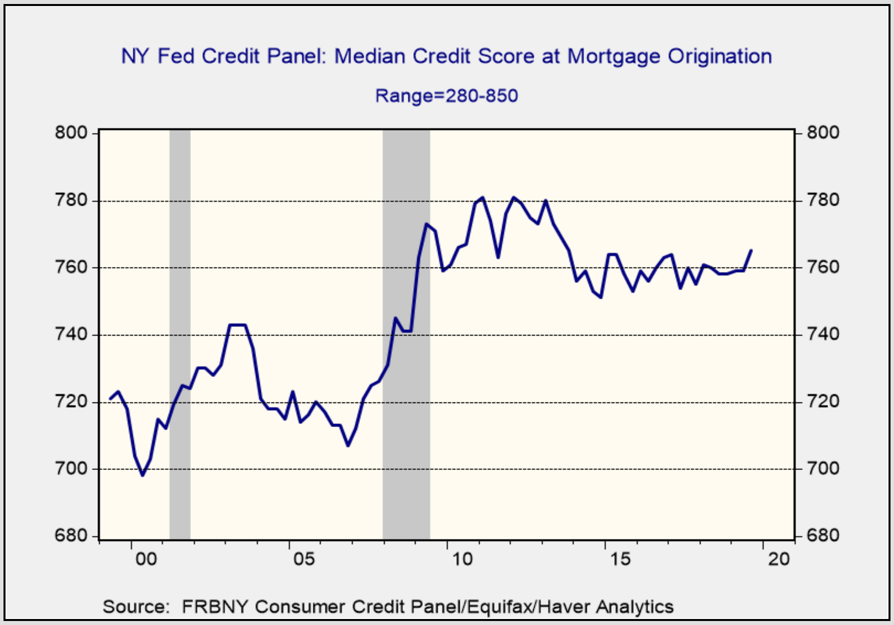


From its peak of $53.0k in Q3 2008, this measure of debt declined to $44.5k in Q3 2013. Since then, it has gradually increased. However, it has not reached levels that would trigger significant concern. In the last expansion, per capita debt growth was 10.9%; in this expansion the average growth is -0.4%.

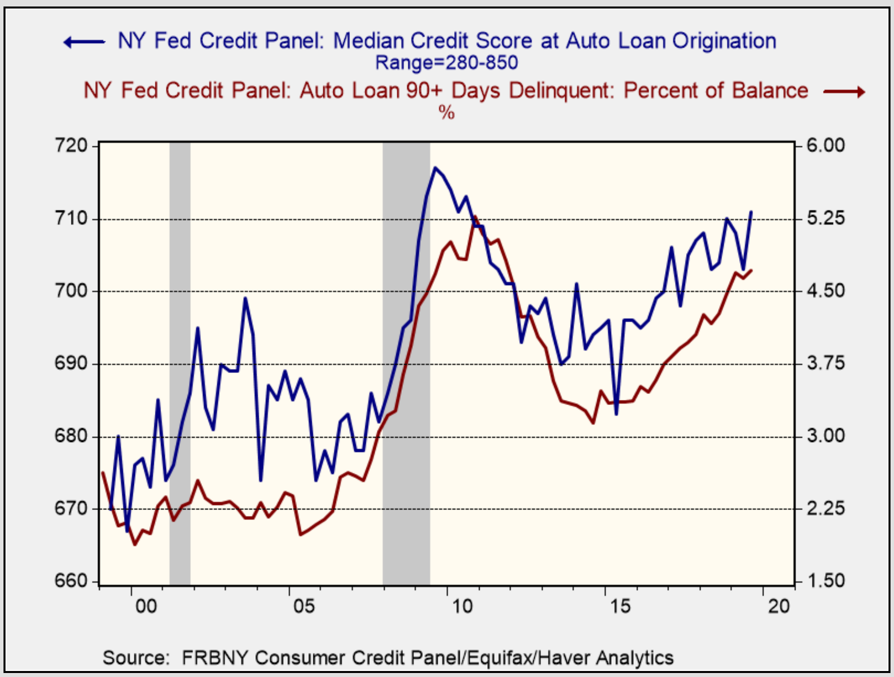
As a percentage of the total, housing debt has been declining relative to auto and student loans.



In 2012, housing represented about 76.9% of outstanding household loans; it now stands at 70.5%. Both student and auto loans have increased. The median credit score for mortgages is a rather strong 763.



Auto loans is a bit lower, at 710, but credit quality has been improving, mostly a reflection of higher delinquencies. Lenders appear to be increasing their caution.

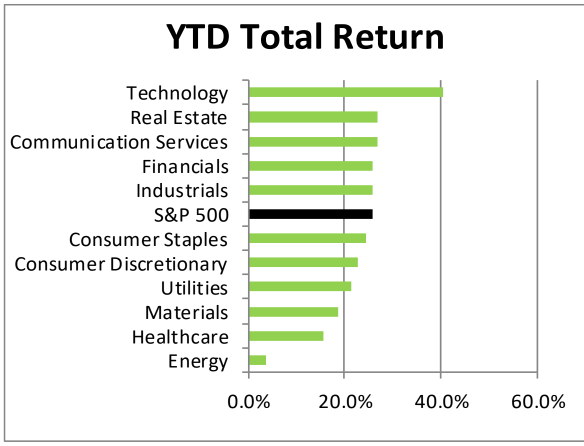


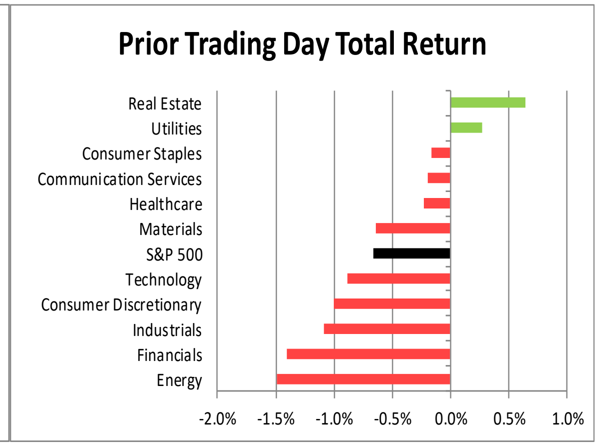
Overall, the data suggests that the areas of greatest concern are auto and student loans; lenders do appear to be addressing the auto loan issue by becoming more selective in granting credit. Student loans, which have a 90+-day delinquency rate of around 10% since 2012, are ultimately a public policy issue, but until this issue is resolved these loans will have an adverse impact on spending. If there is going to be a financial crisis, this data would suggest it probably won't come from the household sector.

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 12/3/2019 close)

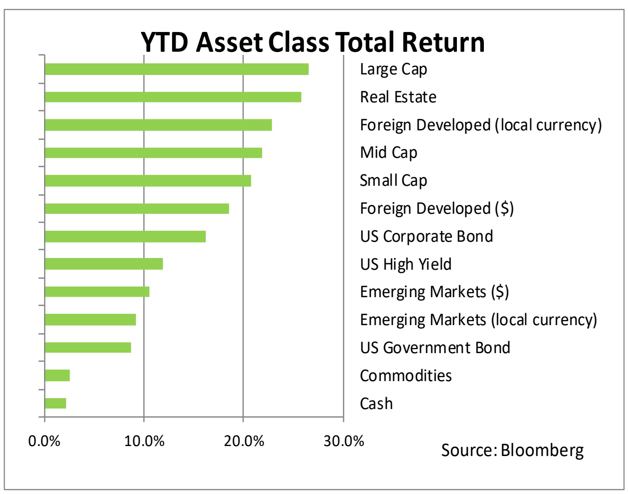




(Source: Bloomberg)

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 12/3/2019 close)

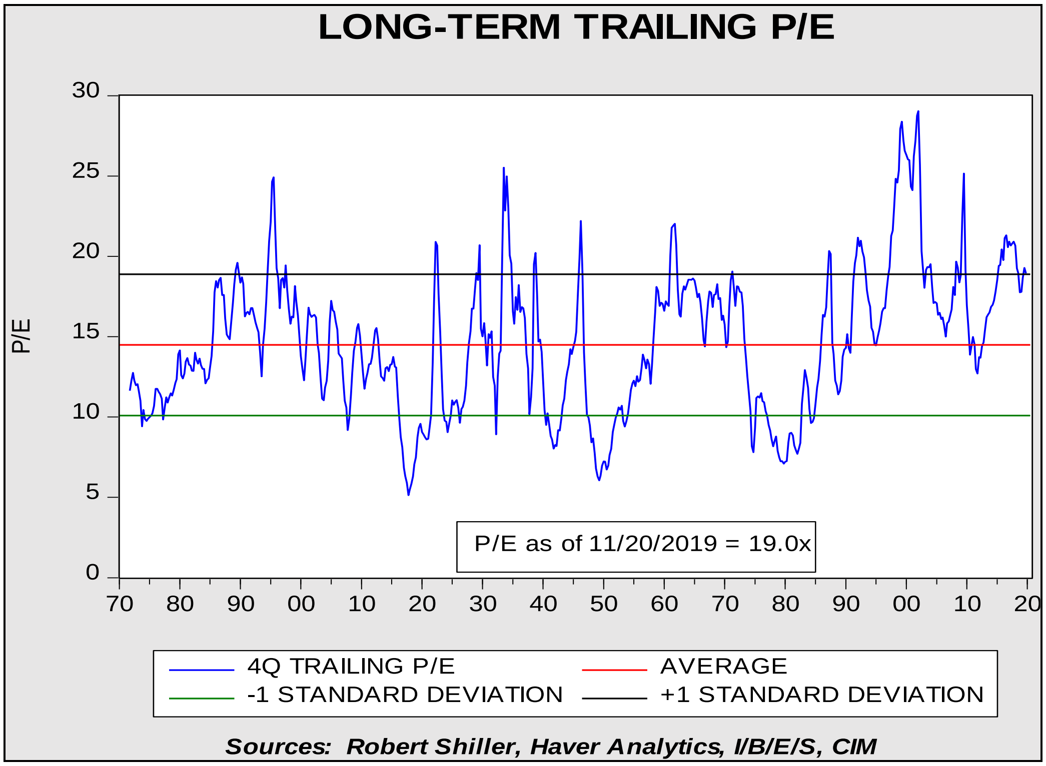


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

November 21, 2019



Based on our methodology,[3] the current P/E is 19.0x, up 0.5x from last week. The rise in the P/E is due to the adjustment to Q3 earnings by shifting to Standard and Poor's calculation of operating earnings from Thomson/Reuters, whose I/B/E/S provides earnings estimates. This event happens each quarter due to the divergence between the two series.

[3] 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 (Q1, Q2 and Q3) and one estimate (Q4). 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.