Daily Comment

By Bill O'Grady, Thomas Wash, and
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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 5, 2019—9:30 AM EST] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.5% from its last close. In Asia, the MSCI Asia Apex 50 closed up 0.5%. Chinese markets were higher, with the Shanghai composite up 0.7% and the Shenzhen index up 1.2% from the prior close. U.S. equity index futures are signaling a higher open.

It's a "Seinfeld" equity market this morning—equity futures are advancing on nothing in particular. Tory optimism is rising. There's a general strike in France. U.S. is worried about Iran. Here are the details:

Brexit: The GBP has been steadily rising in the past few days on increasing optimism that the Tories will win a majority of seats in Parliament. The opposition to the Tories remains hopelessly divided, with the Lib-Dems reiterating they won't join a coalition led by Corbyn. PM Johnson, is laying out an aggressive legislative agenda on his assumed victory. Although a Tory victory is bullish for the GBP, the rally may be tempered by the next step in the process; once Parliament passes Johnson's exit bill, the U.K. will need to start negotiations on a free trade agreement with the EU. That won't be pretty. The general consensus is that a $1.35 GBP/USD is likely the target after a Tory win. It's quite possible we could get there before next week's vote.

France: The Macron government is proposing pension reforms; unfortunately, no one seems pleased with the plan. So, in response, a massive general strike, the largest since 1995, is occurring today. Transportation will be paralyzed, and large protest marches are planned. We don't expect the unrest to extend in time, but the strike will clearly grab the attention of the government.

OPEC and Saudi Aramco: The Kingdom of Saudi Arabia (KSA) is expected to price its IPO on Saudi Aramco today. Reports suggest $8.50 per share will be the going price. The IPO is a scaled-down version of what was originally proposed but still large. Meanwhile, the KSA needs a high price for oil for a successful IPO and support from OPEC+Russia is key to that effort. However, perhaps a reflection of the youth of the Crown Prince, the Saudis are threatening a historic tool of punishing quota violators by flooding the market with oil and depressing the price of oil. We don't expect anything rash to occur in the near term; but, once the IPO is priced, it would not be out of character for the KSA to try to recapture market share.

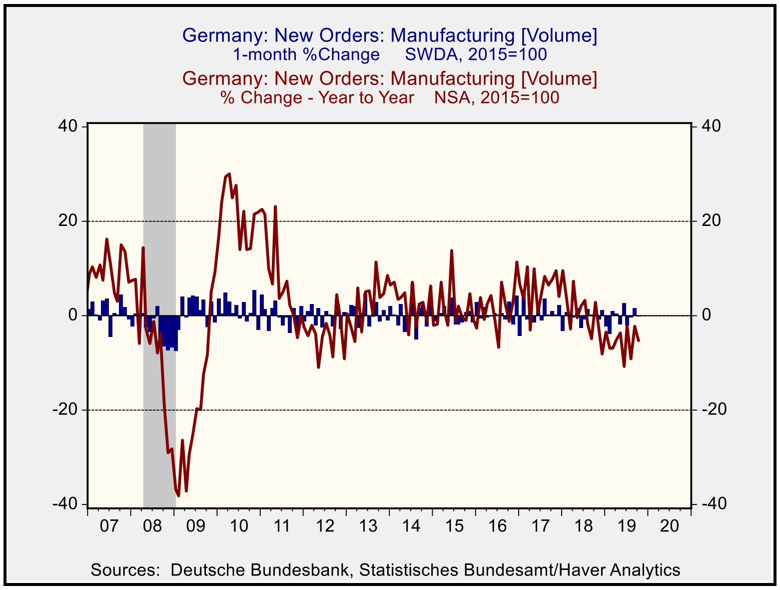
Iran: The U.S. has announced it is considering a significant boost in troop strength in the Middle East. The administration is thinking about a 14k increase in soldiers along with more military hardware. It is not clear what has prompted this consideration. Israel has been expressing concern about Iran's actions. There are reports Iran has moved short-range missiles into Iraq; it is not exactly clear who is being targeted by these missiles. Not to get overly "John Nash" but one cannot help but notice the proposed increase in troop strength and the threat by the KSA to flood the market with oil. A sharp drop in oil prices would likely lift consumer sentiment in the U.S. in an election year. However, it should also be noted that a lower oil price isn't an unalloyed positive for the U.S. economy compared to a decade ago. Iran may be escalating tensions in response to sanctions in an attempt to increase the risk premium in oil prices; the KSA could thwart that goal by raising output after the IPO.

Trade update: China has reiterated that any Phase 1 deal will require tariff rollbacks. The Senate is expected to approve a bill punishing China for its repression of the Uighurs, mirroring a similar bill recently passed in the House. So far, these bills affecting Hong Kong and Xinxiang have not derailed trade talks, but they probably haven't helped the process, either. Treasury Secretary Mnuchin has expressed worries about an OECD effort to create a harmonized digital tax. The U.S. dominates this space and thus the tax will probably have the most adverse impact on American firms. Speaker Pelosi is pushing to remove legal protections for online content which is currently part of USMCA. If she is successful, the tech firms will likely oppose the new NAFTA.

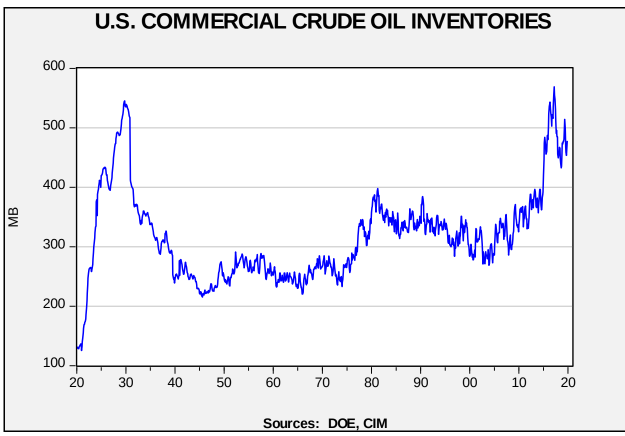
United States-North Korea: The Chief of the General Staff of North Korea responded to President Trump's threat of military force earlier in the week, saying the United States would face "horrible" consequences if it took any action against his country. Although the dustup hasn't been getting much coverage in the press, there probably is an increased chance of provocative North Korean military action as we approach the end of the year – Kim Jong Un's deadline for making new progress in the U.S.-North Korea denuclearization talks.

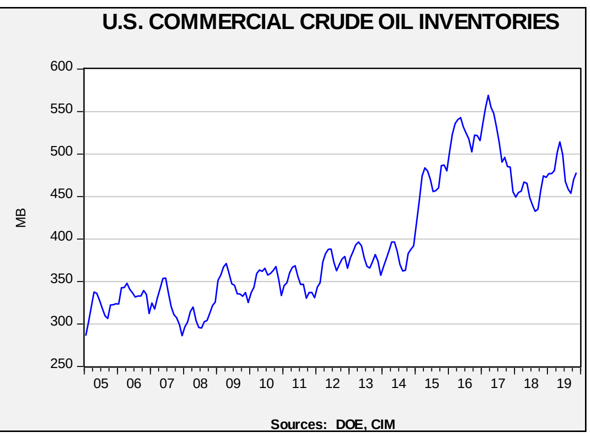
U.S. Economy: In a new *Financial Times*/Peterson Foundation poll, 61% of likely voters said this year's stock market gains had little or no impact on their financial wellbeing. Only 40% of respondents were even aware the market has risen this year. The report is being presented as a sign that the market's gains may not help President Trump's reelection prospects as much as he thinks.

Germany: Preliminary data shows German factory orders unexpectedly fell at the start of the fourth quarter. After stripping out price changes and seasonal impacts, October manufacturing orders declined 0.4%, coming up far short of expectations for a small gain, and erasing much of September's revised increase of 1.5%. Compared with October 2018, orders were down a sharp 5.4%. The figures call into question the recent sense that Europe's economy might be bottoming out, so they're likely to put negative pressure on European stocks today.

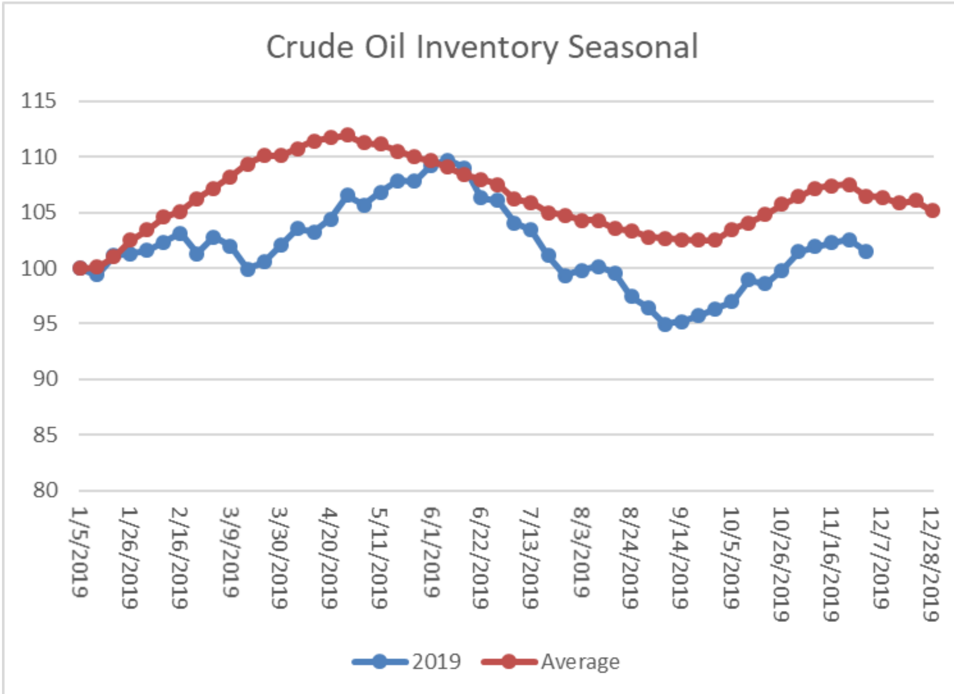


Energy update: Crude oil inventories fell 4.9 mb compared to an expected draw of 1.5 mb.



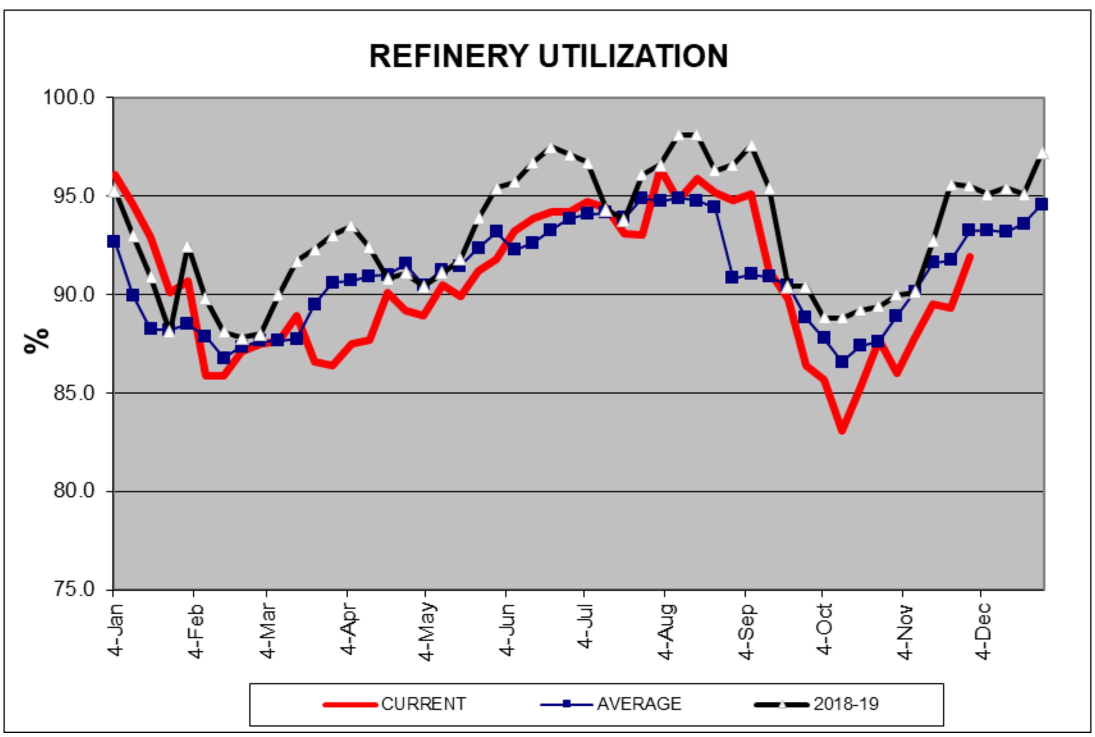


In the details, U.S. crude oil production was unchanged at 12.9 mbpd. Exports fell 0.3 mbpd while imports declined 0.2 mbpd. The rise in stockpiles was greater than expected mostly due to rising refinery operations.



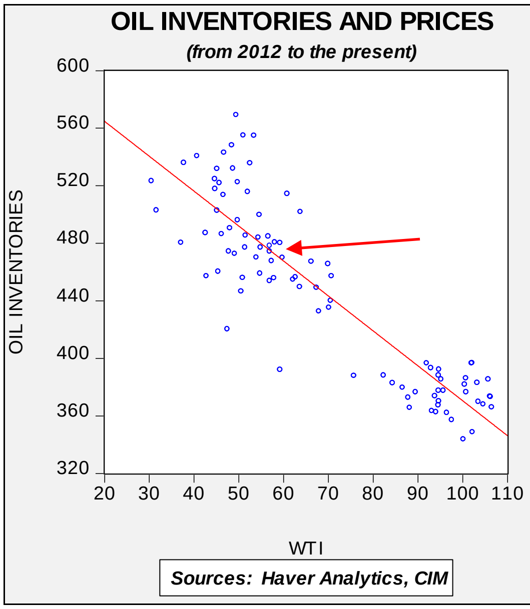
(Sources: DOE, CIM)

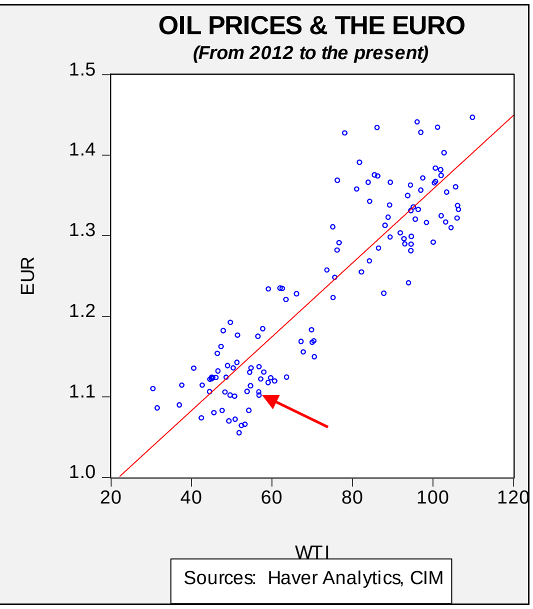
This chart shows the annual seasonal pattern for crude oil inventories. The autumn build season has come to a close and we would expect modest declines in inventory into year's end. We continue to monitor the autumn refinery maintenance season.



(Sources: DOE, CIM)

This week's rise is seasonally consistent, but utilization still remains below average. Run rates should mostly stabilize into the new year.



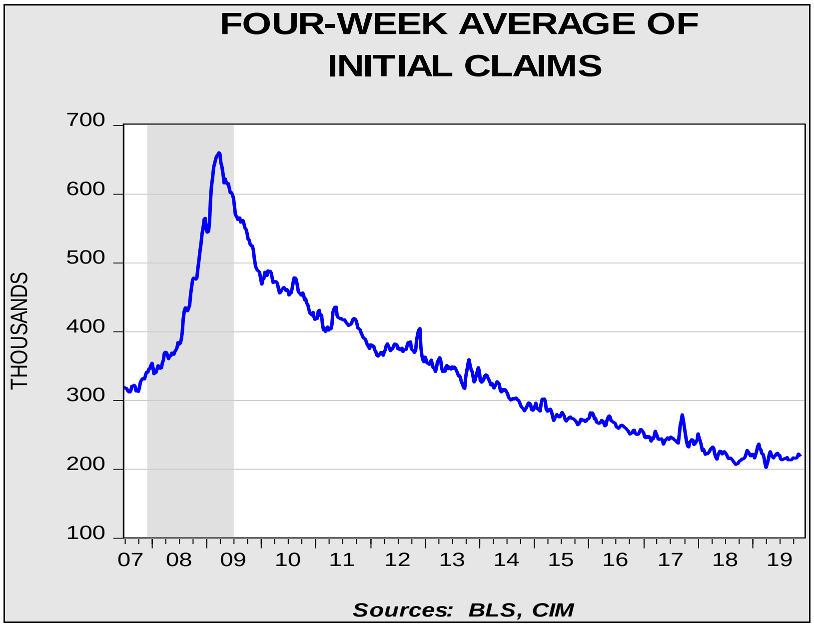


Based on our oil inventory/price model, fair value is $58.43; using the euro/price model, fair value is $48.95. The combined model, a broader analysis of the oil price, generates a fair value of $51.40.   We are seeing the divergence between the dollar and oil inventories narrow as the dollar weakens and oil stocks rise. We have oil market information in the above commentary.

U.S. Economic Releases

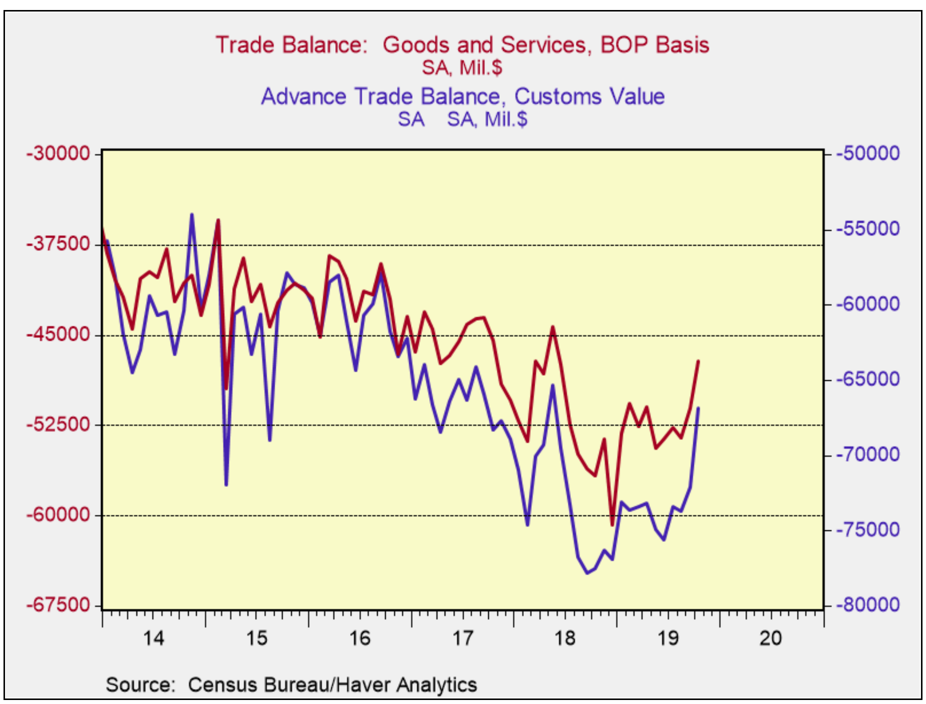
The November Challenger job cuts report fell by 16.0% from the prior year. The index measures the number of announced job cuts by employers, which is a proxy for future layoffs but does not necessarily indicate the state of current layoffs.

Initial jobless claims came in below expectations at 203k compared to the forecast of 215k. Although claims came in near historic lows, we suspect that it may be more of a reflection of severe weather conditions and the holiday break deterring workers from filing new claims as opposed to the actual strength of the labor market. Therefore, we wouldn't be surprised if there was a sudden spike in claims in the next week.



The chart above shows the four-week moving average for initial claims. The four-week moving average fell from 219.75 to 217.75.

The October trade deficit came in below expectations at $47.2 bn compared to the forecast of $48.5 bn. The prior report's deficit was revised from $52.5 bn to $51.1 bn.



The chart above shows the trade balance of goods and the advance trade balance. Even though exports and imports fell in October, the drop in imports was larger than the drop in exports, which is why the trade deficit narrowed. As a result, it is possible that net exports, which is usually a drag, could add to the GDP figures for Q4.

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	Bloomberg Consumer Comfort	m/m	1-Dec		60.5	**
10:00	Factory Orders	m/m	oct	0.3%	-0.6%	***
10:00	Factory Orders ex Trans	m/m	oct		-0.1%	***
10:00	Durable Goods Orders	m/m	oct	0.6%	0.6%	***
10:00	Durable Goods Orders ex Transportation	m/m	oct	0.6%	0.6%	**
10:00	Cap Goods Orders Nondef Ex Air	m/m	oct		1.2%	**
10:00	Cap Goods Ship Nondef Ex Air	m/m	oct		0.8%	**
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								
Australia	Trade Balance	m/m	oct	A$4.502 Bil	A$7.180 Bil	A$6.500 Bil	**	Equity bearish, bond bullish
	Retail Sales	m/m	oct	0.0%	0.2%	0.3%	**	Equity bearish, bond bullish
New Zealand	Volume of All Buildings	q/q	3q	0.4%	-1.5%	1.0%	*	Equity bearish, bond bullish
EUROPE								
Eurozone	Retail Sales	m/m	oct	-0.6%	0.1%	-0.5%	**	Equity and bond bearish
	Employment	q/q	3q	0.1%	0.1%		***	Equity and bond neutral
	Gross Fix Capital	m/m	3q	0.3%	0.5%	0.3%	**	Equity and bond neutral
	Government Expenditure	m/m	3q	0.4%	0.3%	0.4%	**	Equity and bond neutral
	Household Consumption	m/m	3q	0.5%	0.2%	0.3%	***	Equity bullish, bond bearish
UK	New car registrations	y/y	nov	-1.3%	-6.7%		*	Equity and bond neutral
Russia	Light Vehicle Car Sales	m/m	nov	-6.4%	-5.2%	-5.8%	*	Equity and bond bearish
AMERICAS								
Mexico	Consumer Confidence	m/m	nov	43.5	43.9	43.2	***	Equity and bond neutral
Brazil	Industrial Production	y/y	oct	1.0%	1.1%	1.4%	***	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)	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	Down			Up
euro	Up			Down
yen	Flat			Neutral
pound	Up			Up
franc	Flat			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Canada Benchmark Rate	1.75%	1.75%	1.75%	On forecast
RBI Repurchase Rate	5.15%	5.15%	4.90%	Above Forecast
RBI Reverse Repo Rate	4.90%	4.90%	4.65%	Above Forecast
RBI Cash Reserve Ratio	4.00%	4.00%	4.00%	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	$63.59	$63.00	0.94%	Possible Saudi Production Cuts
WTI	$58.69	$58.43	0.44%	
Natural Gas	$2.43	$2.40	1.17%	
Crack Spread	$13.78	$13.52	1.92%	
12-mo strip crack	$17.00	$16.88	0.68%	
Ethanol rack	$1.66	$1.67	-0.41%	
Metals				
Gold	$1,476.14	$1,474.59	0.11%	
Silver	$16.90	$16.86	0.27%	
Copper contract	$266.65	$265.90	0.28%	
Grains				
Corn contract	$ 377.75	$ 378.50	-0.20%	
Wheat contract	$ 528.75	$ 527.50	0.24%	
Soybeans contract	$ 880.25	$ 878.00	0.26%	
Shipping				
Baltic Dry Freight	1599	1606	-7	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-4.9	-1.5	-3.4	
Gasoline (mb)	3.4	2.0	1.4	
Distillates (mb)	3.1	-0.5	3.6	
Refinery run rates (%)	2.60%	0.70%	1.90%	
Natural gas (bcf)		-27.0		

Weather

The 6-10 and 8-14 day forecast is calling for colder-than-normal temperatures throughout most of the country, with warmer-than-normal temperatures only along the West and East Coast. Precipitation is expected for most of the country, with dry conditions expected in California and parts of Nevada.

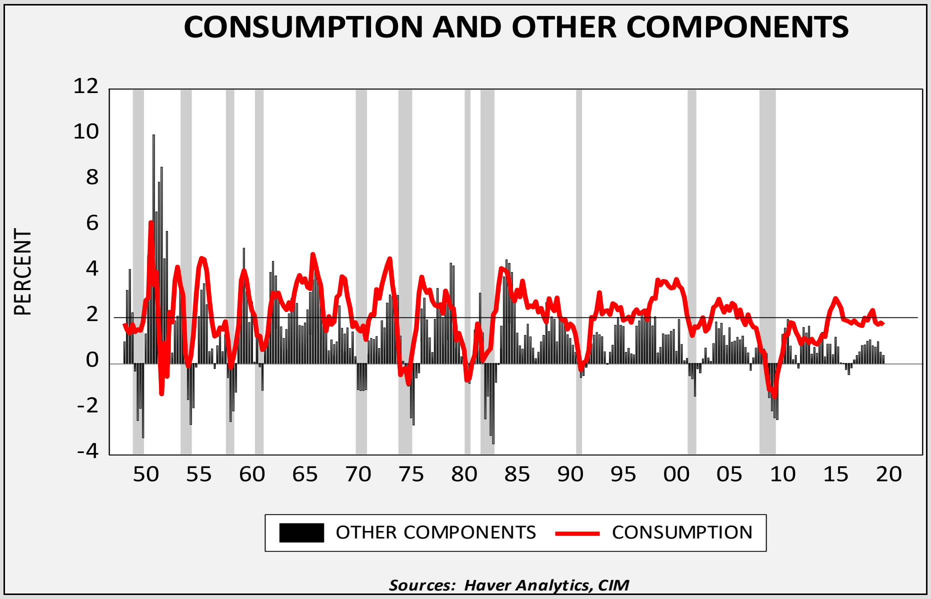
<u>Asset Allocation Weekly</u>

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

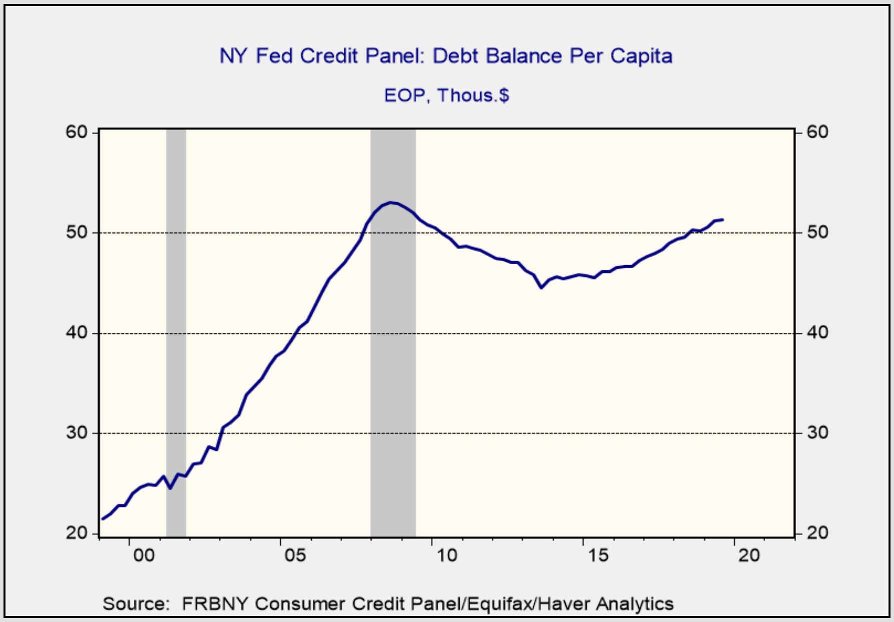
(NB: Due to the Thanksgiving holiday, the next report will be published on December 6.)

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.



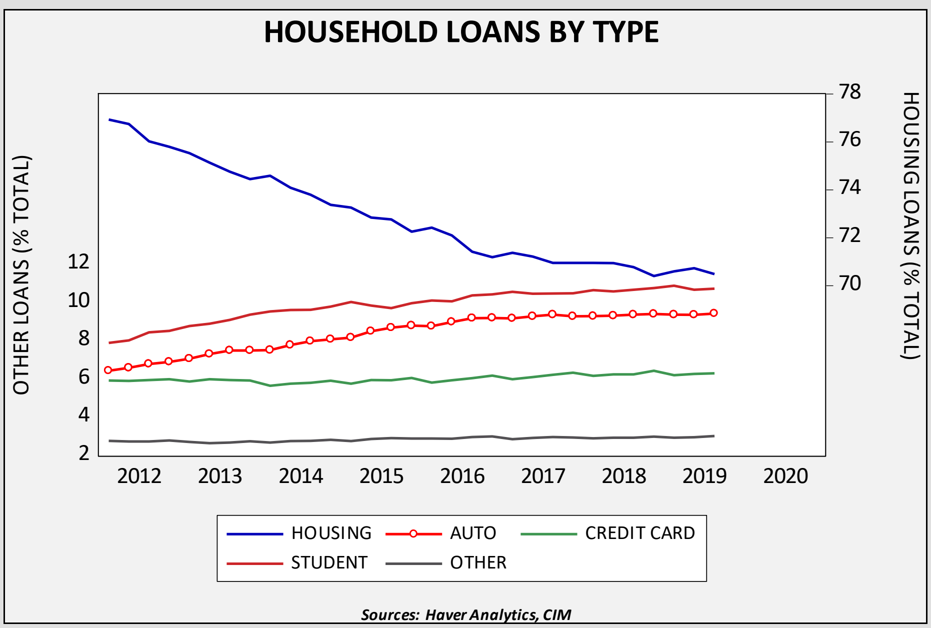
This chart shows the four-quarter average of the contribution to real GDP from consumption compared to the net of the contribution from government, investment and net exports. Over recent business cycles, the contribution outside of consumption has diminished. The other sign from the data is that the 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.

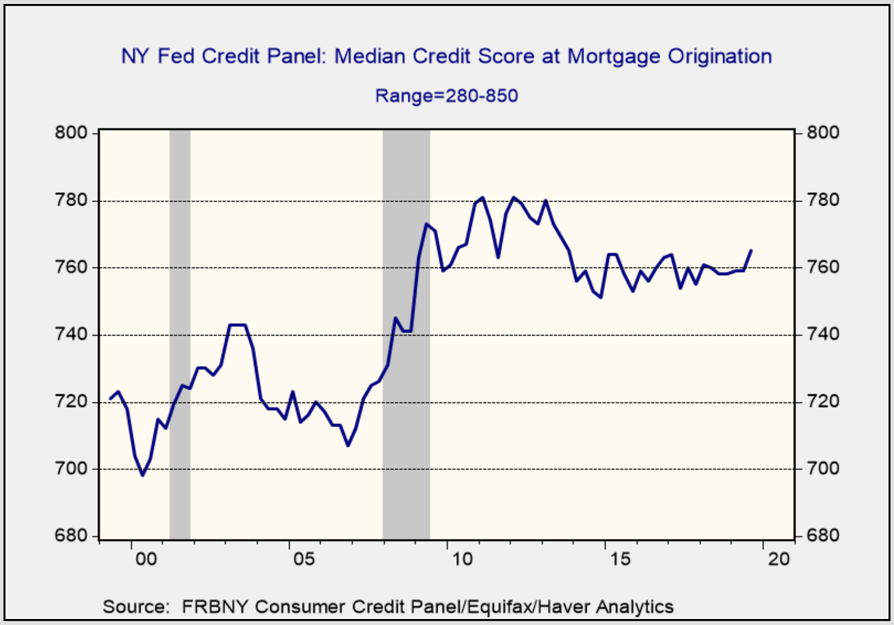


From its peak of $53.0k in Q3 2008, this measure of debt declined to $44.5k in Q3 2013. Since then, it has gradually increased. However, it has not reached levels that would trigger significant concern. In the last expansion, per capita debt growth was 10.9%; in this expansion the average growth is -0.4%.

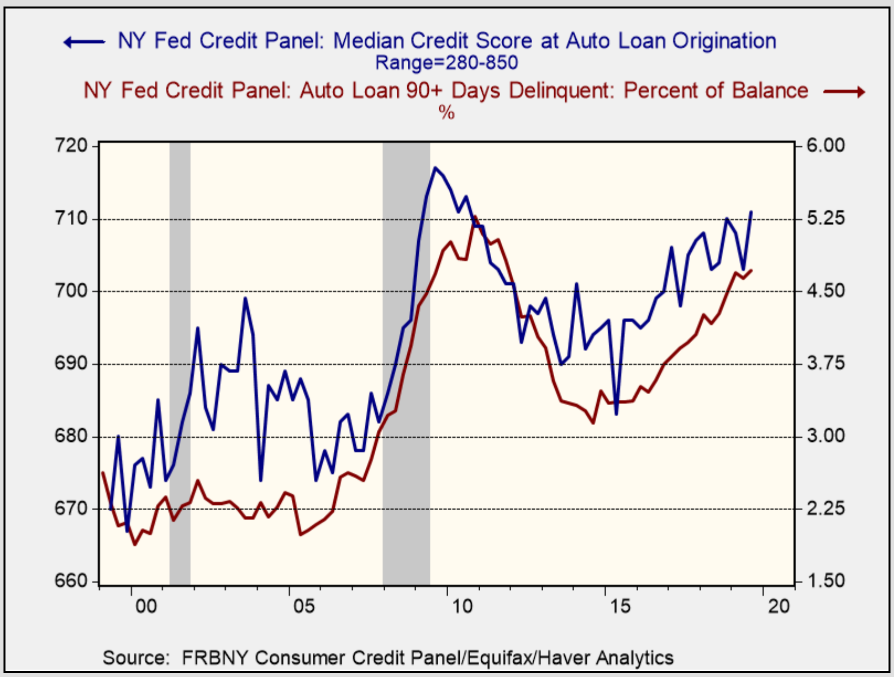
As a percentage of the total, housing debt has been declining relative to auto and student loans.



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.

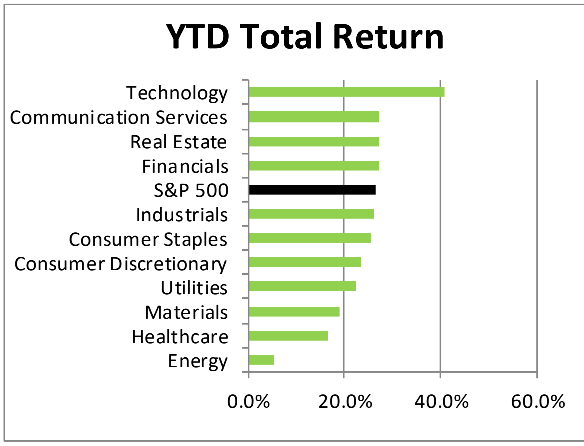


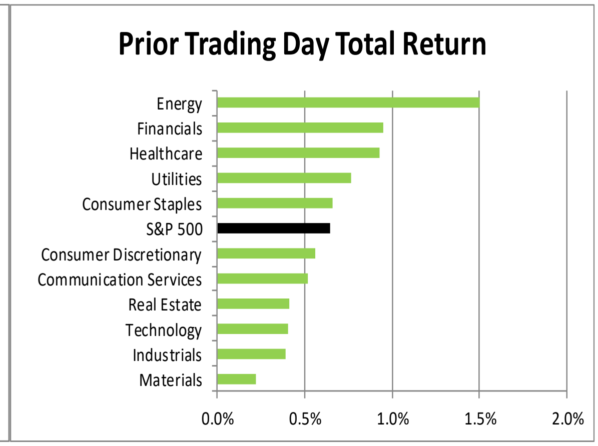
Overall, the data suggests that the areas of greatest concern are auto and student loans; lenders do appear to be addressing the auto loan issue by becoming more selective in granting credit. Student loans, which have a 90+-day delinquency rate of around 10% since 2012, are ultimately a public policy 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 12/4/2019 close)

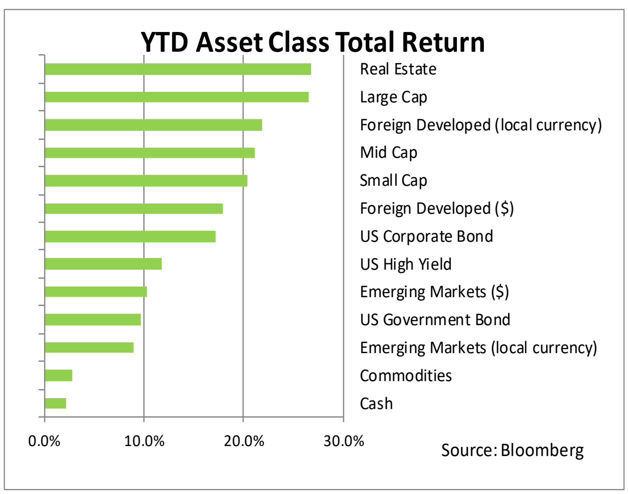




(Source: Bloomberg)

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 12/4/2019 close)

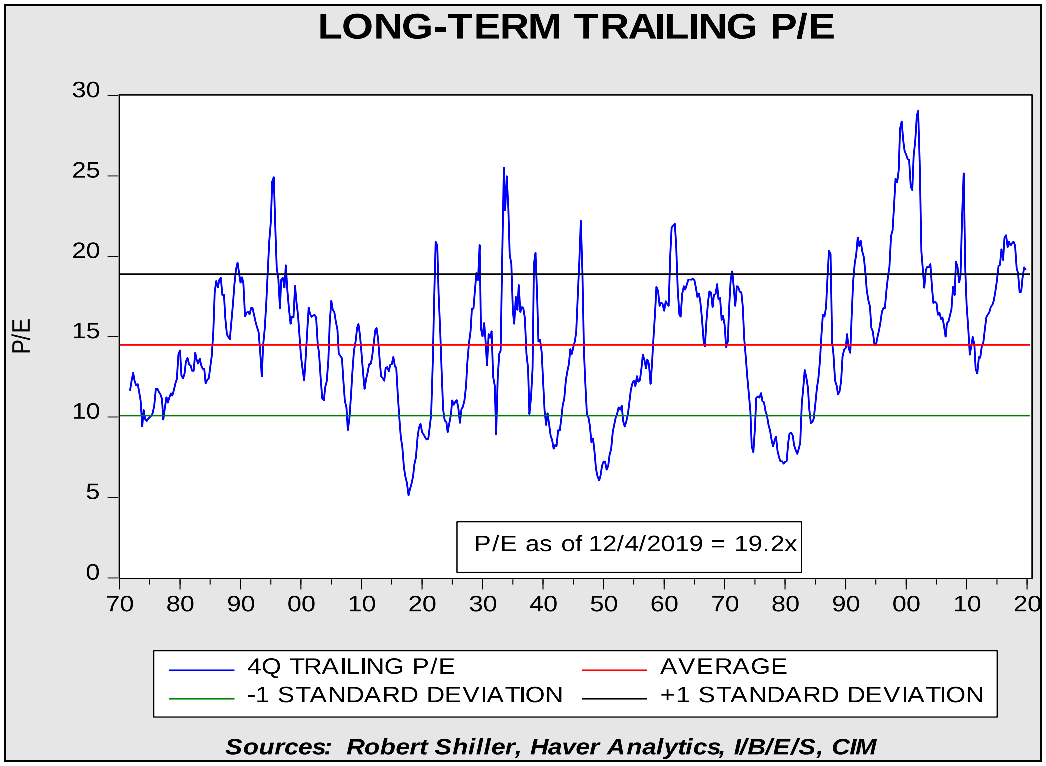


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

December 5, 2019



Based on our methodology,[1] the current P/E is 19.2x, up 0.1x from last week.

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 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.