Daily Comment

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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 10, 2019—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is down 1.0% from its last close. In Asia, the MSCI Asia Apex 50 closed down 0.1%. Chinese markets were higher, with the Shanghai composite up 0.1% and the Shenzhen index up 0.4% from the prior close. U.S. equity index futures are signaling a lower open.

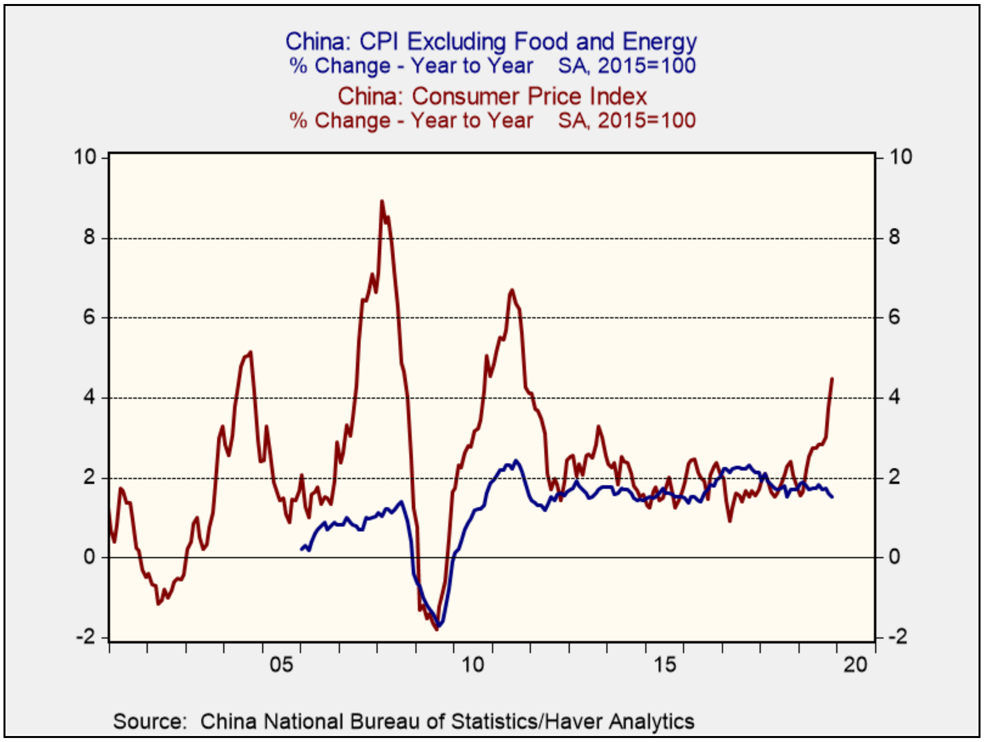
Equities were trending lower this morning; worries about new tariffs scheduled for Dec. 15th were blamed. However, prices have flipped into positive territory on reports from China that the scheduled tariffs will be delayed. Broader trade news is improving. Russia and Ukraine are in a standoff. China data was mixed; German data was improved. Here are the details:

Looking for something to listen to while shopping? Episode #4 of the *Confluence of Ideas Podcast* has been released. It's all about the Equality/Efficiency Cycle. Enjoy!

Trade: It appears the USMCA is near completion in the House with a vote likely before year's end. If passed (and we think it is likely) it will be a major win for the Trump administration. Although there are worries that the U.S. will add new tariffs on Monday, we doubt that the tariffs will be applied this month which should give equities a lift into year's end.

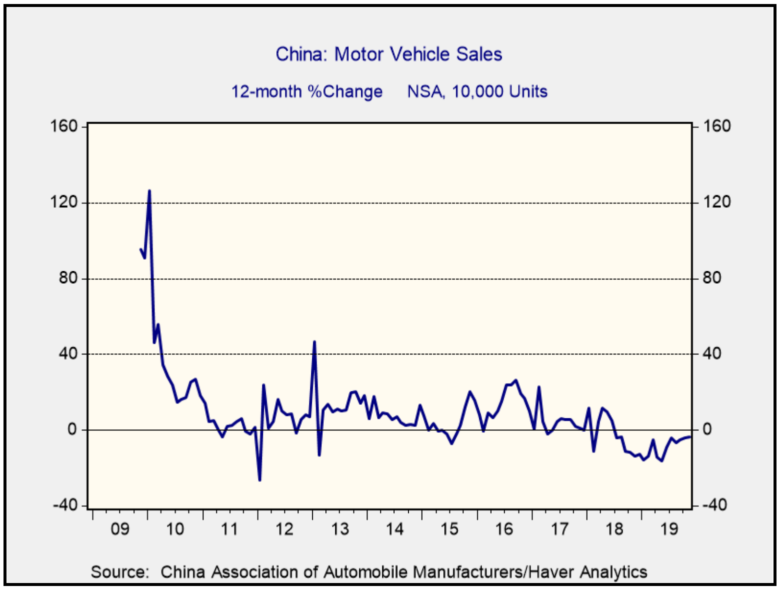
Russia-Ukraine: Russian President Putin and Ukrainian President Zelenskiy have reportedly agreed to another ceasefire, troop pullback, mine removal and prisoner exchange in the eastern Ukrainian territory currently held by pro-Russian separatists. However, there have been many such ceasefires in the five years since Russia annexed the Crimean Peninsula and the separatists rose up in the areas near Donetsk and Luhansk. The new agreement seems little more than a reiteration of the moribund Minsk agreement of 2014, as we described in this week's WGR. Indeed, President Zelenskiy reiterated that the conflict can't be solved until the Ukrainian government gets full control over its border again.

Foreign data: China's November CPI soared to 4.5%, led by a 110.0% rise in pork prices. Food prices overall were up 19.2%. However, core inflation fell to 1.5% from 1.6%, suggesting that the food price spike isn't leading to higher prices in other sectors.



Meanwhile, deflation continues at the producer level, with PPI coming in at -1.7%. China's total loan growth was 12.4%, roughly steady with October. The lack of growth suggests the PBOC will be inclined to ease policy further.

Reflecting the domestic challenges to China's growth, November auto sales were down 3.6% year-over-year, marking their 17th straight annual decline.



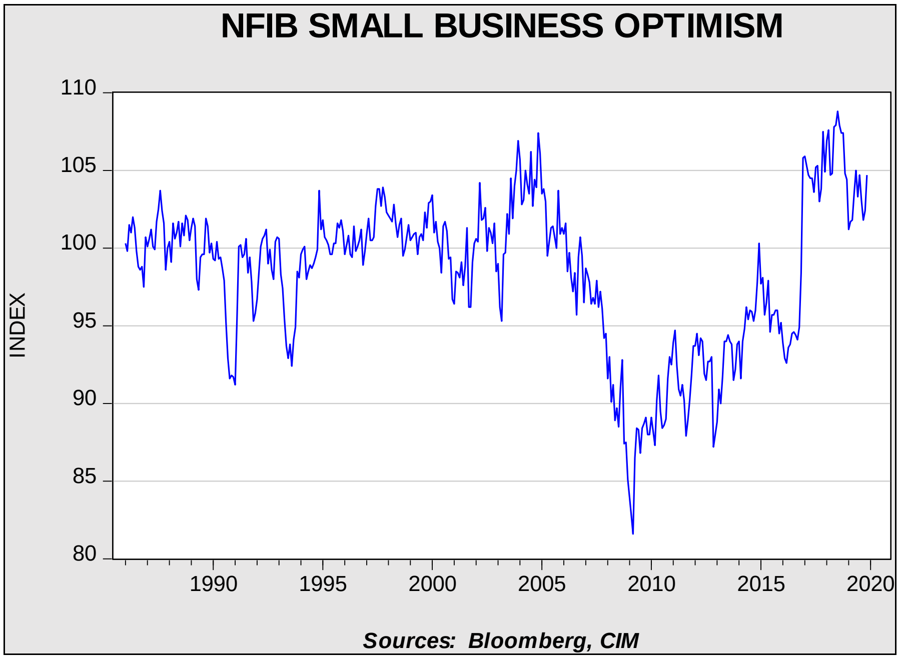
German investor sentiment improved in December.

North Korea: After a tweet from President Trump that "Kim Jong Un is too smart" to not denuclearize North Korea as promised, North Korean state media quoted the chairman of its Asia-Pacific Peace Committee as denouncing Trump as a "heedless and erratic old man." Increasingly provocative rhetoric and military activities suggest North Korea may be reverting to its risky, confrontational stance of previous years. Despite recent friction, the U.S. has protected North Korea from U.N. human rights scrutiny.

Odds and ends: Chinese companies are finding that shifting production to Southeast Asia to avoid tariffs has limits. The Washington Post reports that internal documents indicate the lack of strategy in the Afghanistan conflict. There are reports of an ANC plot to push President Ramaphosa out of office. Protests continue in Malta. Congress is considering a ban on Chinese rail and bus products. Blue collar jobs are requiring higher education levels, reducing the ability of manufacturing to create high paying unskilled jobs.

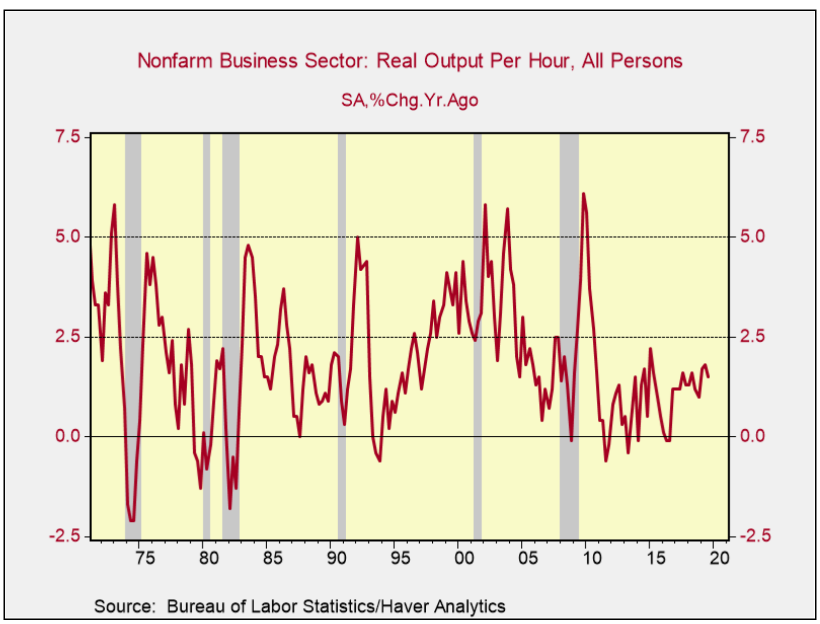
U.S. Economic Releases

NFIB Small business optimism survey came in higher than expected at 104.7, compared to estimates of 103.0. The biggest news coming out of this report was that the number of small business owners planning higher pay reached its highest share since 1989. Pressure on small business owners to raise wages suggests that the labor market may be finally showing signs of tightness. If higher wages lead to a rise inflation, it will be interesting to see how the Federal Reserve responds. There has been growing discussions that the Fed will consider allowing inflation, as measured by personal consumption expenditure, to remain above its 2% target for some time before intervening.



The chart above shows the NFIB small business.

Nonfarm productivity for the third quarter fell 0.2% from the prior quarter compared to estimates of a fall of 0.1%. The fall in productivity appears to be the result of rising employee hours outpacing the rise in output. In addition, unit labor costs came in well below expectations rising only 2.5% from the prior quarter, compared to expectations of a 3.4% rise.



The chart above shows the annual change in nonfarm productivity. As the chart shows, although there was a drop from quarter-to-quarter, productivity has increased from a year ago.

There are no economic releases or Fed events scheduled for today.

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	CPI	y/y	nov	4.5%	3.8%	4.8%	***	Equity bullish, bond bearish
	PPI	y/y	nov	-1.4%	-1.6%	-1.5%	**	Equity and bond neutral
	Money Supply M2	y/y	nov	8.2%	8.4%	8.4%	**	Equity and bond neutral
Japan	Money Stock M2	y/y	nov	2.8%	2.5%	2.5%	**	Equity bullish, bond bearish
	Money Stock M3	y/y	nov	2.3%	2.1%	2.1%	**	Equity bullish, bond bearish
	Manpower	q/q	1q	25.0	26.0		**	Equity and bond neutral
India	Manpower	q/q	1q	10.0%	20.0%		**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	w/w	8-Dec	109.0	108.1		*	Equity and bond neutral
	House Price Index	q/q	3q	2.4%	-0.7%	1.5%	**	Equity bullish, bond bearish
	NAB Business Conditions	m/m	nov	4	3		**	Equity and bond neutral
	NAB Business Confidence	m/m	nov	0	2		**	Equity and bond bearish
	Manpower Survey	q/q	1q	12.0%	12.0%		***	Equity and bond neutral
EUROPE								
Eurozone	Zew Survey Expectations	m/m	dec	11.2	-1.0		**	Equity and bond neutral
Germany	ZEW Survey Current Situation	m/m	dec	-19.9	-24.7	-22.0	**	Equity and bond neutral
	ZEW Survey Expectations	m/m	dec	10.7	-2.1	0.3	**	Equity bullish, bond bearish
France	Industrial Production	m/m	oct	-0.2%	0.1%	-0.4%	***	Equity and bond neutral
	Manufacturing Production	m/m	oct	0.5%	0.6%	0.4%	***	Equity bullish, bond bearish
	Private Sector Payrolls	q/q	3q	0.2%	0.3%	0.3%	**	Equity and bond neutral
Italy	Industrial Production	m/m	oct	-0.3%	-0.4%	-0.2%	***	Equity and bond bearish
UK	Industrial Production	m/m	oct	0.1%	-0.3%	0.2%	***	Equity and bond neutral
	Manufacturing Production	m/m	oct	0.2%	0.0%	-0.4%	***	Equity and bond neutral
	Visble Trade Balance GBP/Mn	m/m	nov	-£14.486 Bil	-£12.541 Bil	-£11.673 Bil	**	Equity and bond neutral
AMERICAS								
Canada	Housing Starts	m/m	nov	201.3k	202.0k	215.0k	**	Equity and bond bearish
	Building Permits	m/m	oct	-1.5%	-6.5%	2.8%	**	Equity and bond bearish
	Bloomberg Nanos Confidence	w/w	6-Dec	55.1	54.8		**	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)	189	189	0	Down
3-mo T-bill yield (bps)	150	150	0	Neutral
TED spread (bps)	39	38	1	Neutral
U.S. Libor/OIS spread (bps)	155	155	0	Up
10-yr T-note (%)	1.80	1.82	-0.02	Down
Euribor/OIS spread (bps)	-39	-39	0	Down
EUR/USD 3-mo swap (bps)	18	16	2	Down
Currencies	**Direction**			
dollar	Down			Up
euro	Up			Down
yen	Flat			Neutral
pound	Up			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	$63.84	$64.25	-0.64%	
WTI	$58.65	$59.02	-0.63%	
Natural Gas	$2.23	$2.23	0.00%	
Crack Spread	$14.42	$14.49	-0.50%	
12-mo strip crack	$17.47	$17.60	-0.73%	
Ethanol rack	$1.62	$1.64	-0.87%	
Metals				
Gold	$1,467.39	$1,461.68	0.39%	
Silver	$16.68	$16.61	0.42%	
Copper contract	$276.40	$275.85	0.20%	
Grains				
Corn contract	$ 375.75	$ 375.75	0.00%	
Wheat contract	$ 521.00	$ 522.75	-0.33%	
Soybeans contract	$ 898.50	$ 897.25	0.14%	
Shipping				
Baltic Dry Freight	1551	1558	-7	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.5		
Gasoline (mb)		2.2		
Distillates (mb)		1.5		
Refinery run rates (%)		0.50%		

Weather

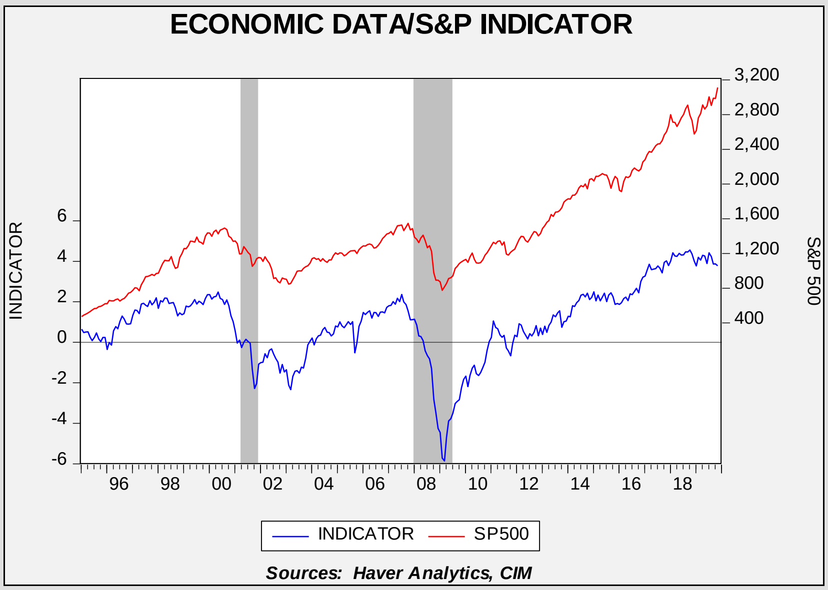
The 6-10 forecast is calling for warmer-than-normal temperatures throughout most of the southwestern and eastern regions, with cooler-than-normal temperatures for the rest of the country. Precipitation is expected for the eastern and central states. Meanwhile the 8-14 forecast is calling for warmer-than-normal temperatures for most of the country, with cooler temperatures in the central pacific region. Precipitation is expected for most of the country, with dry conditions expected in Nebraska and South Dakota.

Asset Allocation Weekly

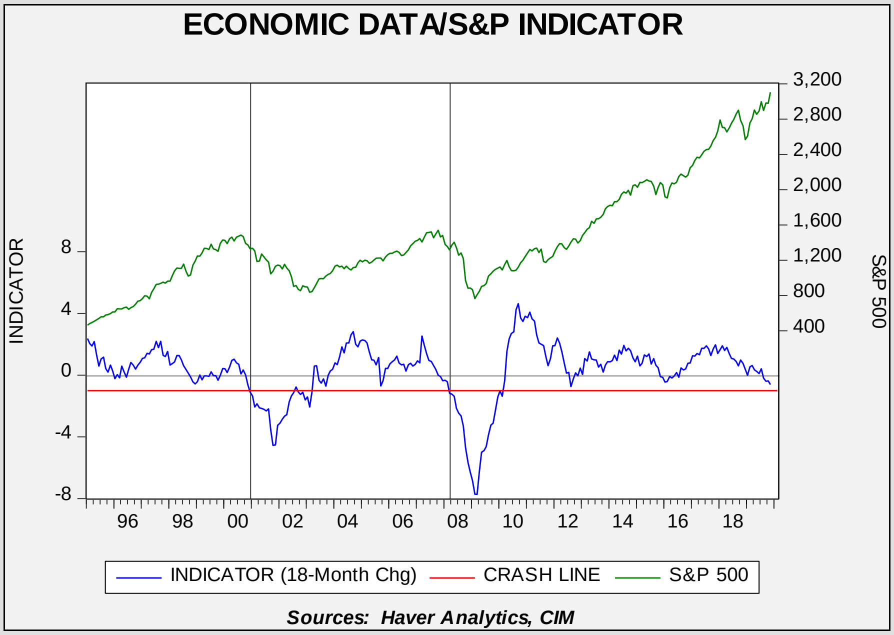
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

December 6, 2019

In 2017, we introduced an indicator of the basic health of the economy and added it to the many charts we monitor to gauge market conditions. The indicator is constructed using commodity prices, initial claims and consumer confidence. The thesis behind this indicator is that these three components should offer a simple and clear picture of the economy; in other words, rising initial claims coupled with falling commodity prices and consumer confidence is a warning that a downturn may be imminent. The opposite condition should support further economic recovery. In this report, we will update the indicator with November data.



This chart shows the results of the indicator and the S&P 500 since 1995. The updated chart shows that the upward momentum in the economy slowed last year but it does remain well above zero. We have placed vertical lines at certain points when the indicator fell below zero. It works fairly well as a signal that equities are turning lower, but there is a lag. In other words, by the time this indicator suggests the economy is in trouble, either the recession is imminent, or we are already in a downturn and the equity markets have started their decline.

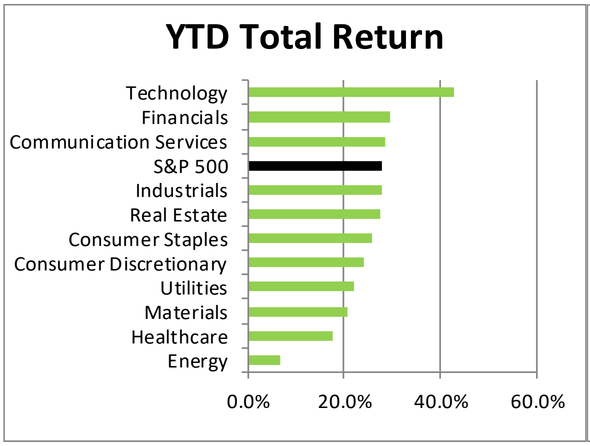


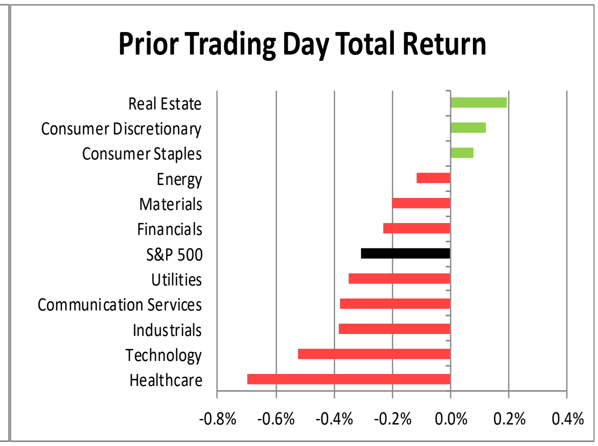
To make the indicator more sensitive, we took the 18-month change and put the signal threshold at minus 1.0. This provides an earlier bearish signal and also eliminates the false positives that the zero threshold generates. Nevertheless, the fact that this variation of the indicator is below zero raises caution.

What does the indicator say now? The economy has decelerated but is not yet at a point where investors should become overly defensive. At the same time, the 18-month change in the indicator has fallen below zero; in 2016, this situation led to several months of sideways market activity. If we continue to see the lower chart hover around zero, then the likelihood is greater that equities will flatten. Thus, reducing equity risk by rebalancing for a more defensive equity sector exposure would be prudent.

Data Section

U.S. Equity Markets – (as of 12/9/2019 close)

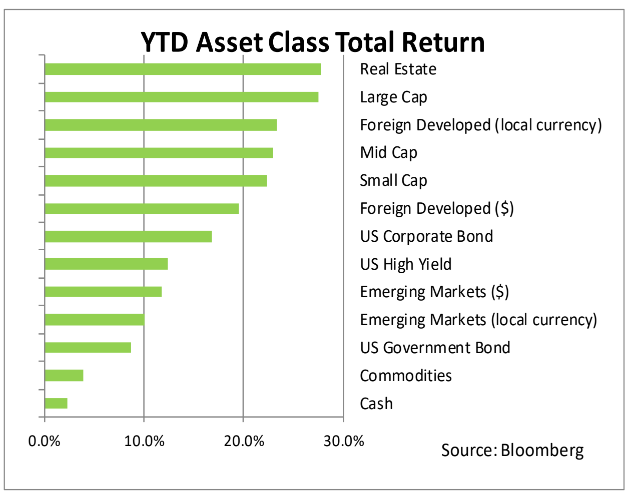




(Source: Bloomberg)

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 12/9/2019 close)

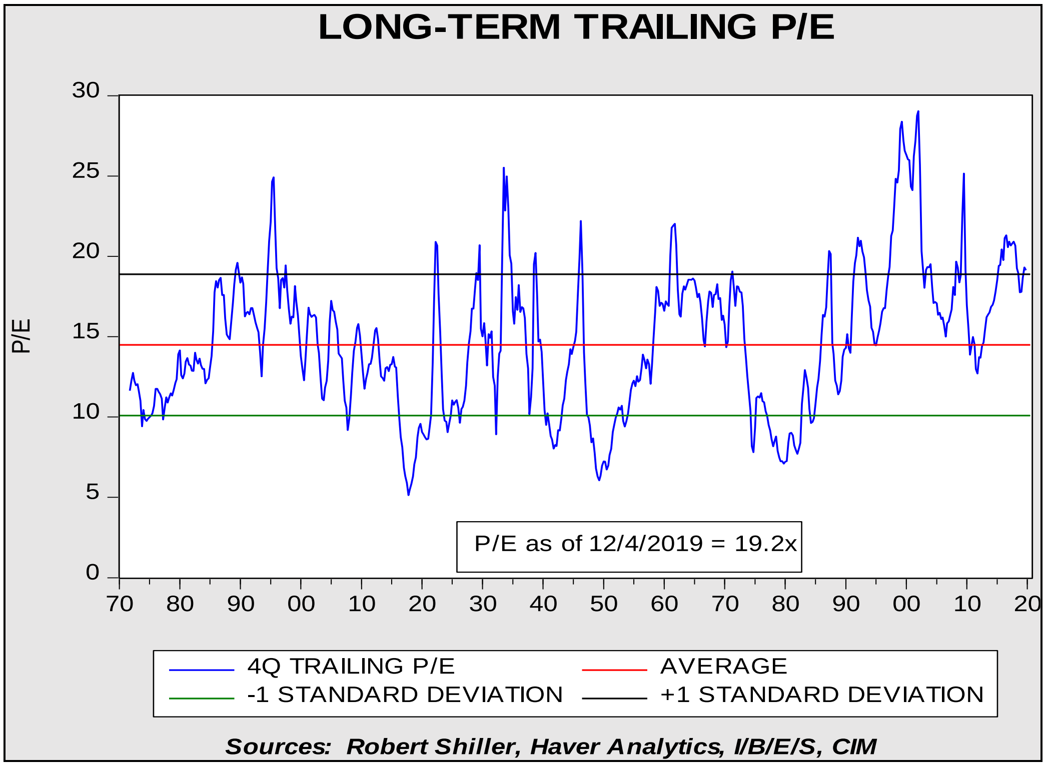


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.