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 11, 2018—9:30 AM EST] Global equity markets are higher this morning. The EuroStoxx 50 is up 1.8% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.2% from the prior close. Chinese markets were higher, with the Shanghai composite up 0.4% and the Shenzhen index up 0.9%. U.S. equity index futures are signaling a higher open.

On the second day of the week, risk markets are rising. Trade hopes seem to be part of the reason for the increase as U.S. and Chinese negotiators are planning meetings and setting timelines.¹ It looks like the Meng arrest won’t derail trade talks. There is a lot of news this morning. Here is what we are watching:

**Meng doesn’t get bail:** The Canadians denied Meng Wanzhou bail despite offers to wear a location bracelet.² The Canadian judge has not decided on extradition yet, although we expect that she will eventually end up in the U.S. Meanwhile, we are seeing some ramifications on the trade front, mostly with technology.³

**Brexit vote postponed:** The fallout from the likely defeat of PM May’s Brexit plan continues to accumulate. Since her plan was doomed to defeat, she was forced to pull the vote and is now petitioning the EU for new terms.⁴ So far, her requests are facing a “non” response.⁵ While the EU would face some losses from a hard Brexit, it’s nothing compared to the difficulties the U.K. would likely suffer, although there is wide disparity in the forecasts.⁶ However, there is no doubt that the initial impact of a hard border between the EU and Britain would lead to serious disruptions that will take weeks, if not months, to adjust.⁷ It’s important to realize that the EU

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² [https://www.ft.com/content/585c0506-fcdb-11e8-aebf-99e208d3e521](https://www.ft.com/content/585c0506-fcdb-11e8-aebf-99e208d3e521)
³ [https://www.ft.com/content/4d9f48a4-fc85-11e8-ac00-57a2a826423e?emailid=5c0f40831a95f60004f1fc7a&segmentid=22011ee7-896a-8c4c-22a0-7603348b7f22](https://www.ft.com/content/4d9f48a4-fc85-11e8-ac00-57a2a826423e?emailid=5c0f40831a95f60004f1fc7a&segmentid=22011ee7-896a-8c4c-22a0-7603348b7f22)
⁴ [https://www.ft.com/content/9c59a204-fc6d-11e8-aebf-99e208d3e521?emailid=5c0f40831a95f60004f1fc7a&segmentid=22011ee7-896a-8c4c-22a0-7603348b7f22](https://www.ft.com/content/9c59a204-fc6d-11e8-aebf-99e208d3e521)
⁵ [https://www.ft.com/content/32849728-fd1a-11e8-aebf-99e208d3e521](https://www.ft.com/content/32849728-fd1a-11e8-aebf-99e208d3e521)
⁶ [https://www.ft.com/video/88be2a8e-8ff8-4d03-8e11-805676432825?emailid=5c0f40831a95f60004f1fc7a&segmentid=22011ee7-896a-8c4c-22a0-7603348b7f22&playlist-name=editors-picks&playlist-offset=0](https://www.ft.com/video/88be2a8e-8ff8-4d03-8e11-805676432825?emailid=5c0f40831a95f60004f1fc7a&segmentid=22011ee7-896a-8c4c-22a0-7603348b7f22&playlist-name=editors-picks&playlist-offset=0)
has an interest in a hard Brexit being a disaster. That would curb the enthusiasm of other nations thinking of leaving the EU (e.g., Italy). If it weren’t for the return of a hard border in Ireland, the EU may not have negotiated at all. But, a hard Brexit will almost certainly bring a return of the troubles in Northern Ireland, something the British government really doesn’t want due to the costs of maintaining security and Ireland clearly doesn’t want that outcome, either.

Notably, the most likely driver of Brexit was immigration. Polls show that at the time of the Brexit vote the EU wasn’t an issue but immigration was. By framing Brexit as a way to gain control of the borders, the Leave campaign won a victory. Recent behavior in the EU has shown that the free movement of peoples has become mostly aspirational as even Merkel has softened her pro-refugee stance. Like everywhere in the West, immigration is becoming a critical issue, even though there is strong evidence to suggest that immigration is a net benefit to developed economies. However, it should be noted that there are distributional effects to immigration; in general, the wealthy tend to benefit the most from immigration while the poorest bear the costs. If PM Cameron had simply put up restrictions to immigration before the Brexit vote, it may have failed. But, that would have undermined his personal class interests. What about a second referendum? Although there is support for a new vote, it begs the question…will the elites continue to hold referendums until they get the outcome they want? What if the majority vote to leave again? Or, if the vote reverses, have you created a permanent “opposition class” that will be an indefinite problem?

The path forward is becoming increasingly difficult. Labour is pushing for a no-confidence measure that would likely lead to new elections and quite likely a Corbyn-led Labour government. The Tories don’t want that outcome but to move forward they may need to settle on a new party leader and PM and there is no clear leader. Meanwhile, financial markets remain under pressure and the GBP has been weak. At the same time, based on purchasing power parity, the GBP is remarkably cheap.

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8 https://ftalphaville.ft.com/2018/12/11/1544504400000/The-only-Brexit-chart-you-need-to-see/
9 https://www.ft.com/content/18b9b194-fb98-11e8-aebf-99e208d3e521
10 https://www.ft.com/content/797f7b42-bb44-11e8-94b2-17176fbf93f5
This chart shows the GBP parity model with standard error bands. The only time the GBP has been cheaper was at the peak of the dollar strength in 1985. If a hard Brexit is avoided, the potential for a rally in the currency is significant.

**Macron blinks:** In a bid to placate protestors, French President Macron gave an address yesterday and promised various fiscal measures to help the middle class and working poor, including a minimum wage hike. It remains to be seen if these actions will quell unrest. However, there is one serious side effect from Macron’s spending—it could boost the French deficit/GDP ratio next year to 3.5%, well above the 3% limit established by EU treaty. France has repeatedly had deficits that exceed the limit but it has never faced scrutiny due to its influence in the EU.

It remains to be seen if these actions will quell unrest. However, there is one serious side effect from Macron’s spending—it could boost the French deficit/GDP ratio next year to 3.5%, well above the 3% limit established by EU treaty. France has repeatedly had deficits that exceed the limit but it has never faced scrutiny due to its influence in the EU.

\[
\text{France: Central Governm: Gen Budget Surplus[+]/Deficit[-] as a % of GDP}
\]

Source: Min. de l'Economie, des Fin et de l'Industrie/Haver

Italy’s deficit is only 2.4% but the EU has issues with the structural nature of the deficit, which means the deficit could reach higher levels in recessions. However, that distinction will be lost on the average Italian voter; this issue will look like the famous phrase, “all animals are equal but some are more equal than others.”

**New leader of the CDU:** Chancellor Merkel won a significant victory, with her favored candidate, Annegret Kramp-Karrenbauer (henceforth to be known as AKK), winning party

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leadership.\textsuperscript{14} Although the margin was narrow (51.8/48.5), AKK’s win means Merkel will remain chancellor for the time being. AKK is considered a “mini-Merkel” by the media and promised to continue the policies of her predecessor. Still, this is a victory for EU stability and is modestly bullish for the EUR.

**U.S. Economic Releases**

NFIB small business optimism came in below expectations at 104.8 compared to the forecast of 107.0.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{NFIB_Small_Business_Optimism.png}
\caption{NFIB SMALL BUSINESS OPTIMISM}
\end{figure}

It appears that recent market weakness along with trade concerns may have dampened the outlook of small business owners. On the other hand, even with this recent decline, the index remains elevated. The net share of companies that expect the economy to improve in six months fell to a two-year low.

PPI final demand came in above expectations, rising 0.1\% from the prior month compared to the forecast of 0.0\%. PPI excluding food and energy also came in above expectations, rising 0.3\% from the prior month compared to the forecast of 0.1\%. Core PPI, which excludes food, energy and trade services, came in above expectations, rising 0.3\% from the prior month compared to the forecast of 0.2\%.

\textsuperscript{14} \url{http://www.spiegel.de/international/germany/kramp-karrenbauer-succeeds-merkel-as-cdu-leader-a-1242904.html}
The chart above shows the year-over-year change in headline PPI and core PPI, which rose 2.5% and 2.7%, respectively.

There are no economic releases or Fed events scheduled for the rest of the day.

**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.
### 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.

<table>
<thead>
<tr>
<th>Country</th>
<th>Indicator</th>
<th>Country</th>
<th>Indicator</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASIA-PACIFIC</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>Money stock M3 y/y nov 2.1% 2.3% 2.3% **</td>
<td>Japan</td>
<td>Money stock M2 y/y nov 2.3% 2.7% 2.6% **</td>
</tr>
<tr>
<td></td>
<td>Machine tool orders y/y nov -16.8% -0.7%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>India</td>
<td>Manpower Survey q/q 1q 12.0% 13.0% **</td>
<td>Australia</td>
<td>NAB Business Conditions m/m nov 11 12</td>
</tr>
<tr>
<td></td>
<td>House Price Index y/y 3q -1.9% -0.6% -2.0% ***</td>
<td></td>
<td>NAB Business Confidence m/m nov 3 4 **</td>
</tr>
<tr>
<td>New Zealand</td>
<td>ANZ Truckometer Heavy m/m nov -1.9% 4.6% **</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Card Spending Retail m/m nov -0.4% 0.1% 0.3% **</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Card Spending Total m/m nov -0.2% -0.1% **</td>
<td></td>
<td></td>
</tr>
<tr>
<td>EUROPE</td>
<td>ZEW Survey Expectations m/m dec -21.0 22.0 -22.0 **</td>
<td></td>
<td>ZEW Survey Expectations m/m dec -17.5 24.1 -25.0 **</td>
</tr>
<tr>
<td></td>
<td>ZEW Survey Current Situation m/m dec 45.3 58.2 55.0 **</td>
<td></td>
<td>Private Sector Payrolls m/m 3q 0.1% 0.2% 0.2% **</td>
</tr>
<tr>
<td></td>
<td>Wages m/m 3q 0.3% 0.3% 0.3% **</td>
<td></td>
<td>Jobless Claims Change m/m nov 21.9k 20.2k **</td>
</tr>
<tr>
<td></td>
<td>Claimant Count Rate m/m nov 2.8% 2.7% **</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Unemployment Rate m/m nov 2.8% 2.7% **</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Jobless Claims Change m/m nov 21.9k 20.2k **</td>
<td></td>
<td></td>
</tr>
<tr>
<td>AMERICAS</td>
<td>Nominal Wages y/y nov 5.3% 3.8% ***</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>Housing Starts m/m nov 215.9k 205.9k 198.0k ***</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canada</td>
<td>Building Permits m/m oct -0.2% 0.4% -0.3% **</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Daylight Saving Time m/m nov 2hr 3hr 2hr **</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### 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.

<table>
<thead>
<tr>
<th>Commodity</th>
<th>Today</th>
<th>Prior</th>
<th>Change</th>
<th>Trend</th>
</tr>
</thead>
<tbody>
<tr>
<td>3-mo Libor yield (bps)</td>
<td>277</td>
<td>277</td>
<td>0</td>
<td>Up</td>
</tr>
<tr>
<td>3-mo T-bill yield (bps)</td>
<td>233</td>
<td>233</td>
<td>0</td>
<td>Neutral</td>
</tr>
<tr>
<td>TED spread (bps)</td>
<td>44</td>
<td>44</td>
<td>0</td>
<td>Neutral</td>
</tr>
<tr>
<td>U.S. Libor/OIS spread (bps)</td>
<td>239</td>
<td>237</td>
<td>2</td>
<td>Up</td>
</tr>
<tr>
<td>10-yr T-note (%)</td>
<td>2.89</td>
<td>2.86</td>
<td>0.03</td>
<td>Neutral</td>
</tr>
<tr>
<td>Euribor/OIS spread (bps)</td>
<td>-31</td>
<td>-32</td>
<td>1</td>
<td>Neutral</td>
</tr>
<tr>
<td>EUR/USD 3-mo swap (bps)</td>
<td>17</td>
<td>19</td>
<td>-2</td>
<td>Down</td>
</tr>
<tr>
<td>Currencies</td>
<td>Direction</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>dollar</td>
<td>down</td>
<td>Neutral</td>
<td></td>
<td></td>
</tr>
<tr>
<td>euro</td>
<td>up</td>
<td>Up</td>
<td></td>
<td></td>
</tr>
<tr>
<td>yen</td>
<td>up</td>
<td>Neutral</td>
<td></td>
<td></td>
</tr>
<tr>
<td>pound</td>
<td>up</td>
<td>Neutral</td>
<td></td>
<td></td>
</tr>
<tr>
<td>franc</td>
<td>up</td>
<td>Neutral</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Price</td>
<td>Prior</td>
<td>Change</td>
<td>Explanation</td>
</tr>
<tr>
<td>--------------------------------</td>
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<td>-------</td>
<td>--------</td>
<td>------------------------------</td>
</tr>
<tr>
<td><strong>Energy Markets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brent</td>
<td>$60.49</td>
<td>$59.97</td>
<td>0.87%</td>
<td>Prospective Production Cuts</td>
</tr>
<tr>
<td>WTI</td>
<td>$51.61</td>
<td>$51.00</td>
<td>1.20%</td>
<td></td>
</tr>
<tr>
<td>Natural Gas</td>
<td>$4.48</td>
<td>$4.55</td>
<td>-1.47%</td>
<td></td>
</tr>
<tr>
<td>Crack Spread</td>
<td>$14.59</td>
<td>$14.55</td>
<td>0.26%</td>
<td></td>
</tr>
<tr>
<td>12-mo strip crack</td>
<td>$17.09</td>
<td>$16.99</td>
<td>0.55%</td>
<td></td>
</tr>
<tr>
<td>Ethanol rack</td>
<td>$1.41</td>
<td>$1.41</td>
<td>-0.01%</td>
<td></td>
</tr>
<tr>
<td><strong>Metals</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gold</td>
<td>$1,247.80</td>
<td>$1,244.46</td>
<td>0.27%</td>
<td></td>
</tr>
<tr>
<td>Silver</td>
<td>$14.67</td>
<td>$14.53</td>
<td>0.96%</td>
<td></td>
</tr>
<tr>
<td>Copper contract</td>
<td>$275.70</td>
<td>$272.00</td>
<td>1.36%</td>
<td></td>
</tr>
<tr>
<td><strong>Grains</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corn contract</td>
<td>$384.00</td>
<td>$384.00</td>
<td>0.00%</td>
<td></td>
</tr>
<tr>
<td>Wheat contract</td>
<td>$526.00</td>
<td>$525.25</td>
<td>0.14%</td>
<td></td>
</tr>
<tr>
<td>Soybeans contract</td>
<td>$914.25</td>
<td>$909.75</td>
<td>0.49%</td>
<td></td>
</tr>
<tr>
<td><strong>Shipping</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Baltic Dry Freight</td>
<td>1385</td>
<td>1372</td>
<td>13</td>
<td></td>
</tr>
<tr>
<td><strong>DOE inventory report</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Actual</td>
<td>Expected</td>
<td>Difference</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Crude (mb)</td>
<td>-3.5</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gasoline (mb)</td>
<td>2.0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Distillates (mb)</td>
<td>1.6</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Refinery run rates (%)</td>
<td>0.30%</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

**Weather**

The 6-10 and 8-14 day forecasts show warmer temps for most of the country. Precipitation is expected 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.

December 7, 2018

The election of Donald Trump has been characterized as part of a populist uprising. In the president’s inaugural address, he talked about the “forgotten” that would have a voice in his administration. At the same time, we work under John Mitchell’s dictum of “watch what we do, not what we say.”

In a recent Bloomberg podcast, Edward Alden, a journalist and fellow at the Council on Foreign Relations, was asked if the Trump administration favored business or labor. He replied that they are trying to help both. We think Alden is correct in his assessment which is one of the reasons why analyzing the direction of policy with this administration is so difficult. It appears that one of the goals of the president’s trade policy is to bring production back to the United States which would benefit labor. At the same time, tax policy has generally favored capital. But, the most underestimated benefit to capital may be deregulation.

George Washington University measures the pages of the Federal Register, which is the official journal of the federal government. It publishes agency rules, proposed rules and public notices. So, the number of pages in the register says something about the number of regulations. The idea is that the more pages added to the register signals an increase in regulation.

The decline seen in the first full year of the Trump administration is remarkable.

![PAGES IN THE FEDERAL REGISTER](image-url)

Sources: George Washington University, CIM

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15 [http://www.arlingtoncemetery.net/mitchell.htm](http://www.arlingtoncemetery.net/mitchell.htm)
The drop from 2016 to 2017 was 35.4%, which exceeds the 21.2% decline in 1981, Ronald Reagan’s first full year in office. The only year that was larger was 1947, which saw a 39.6% slide. That drop was likely due to postwar changes.

Another measure is called the “significant rule changes,” a policy measure created during President Clinton’s first term. The decline in 2017 was unprecedented.

![Significant Rules Added](image1)

Only 55 new rules were added in 2017. That is clearly the fewest on record by multiples.

The drop in regulatory activity is partly why small business sentiment has been so strong.

![NFIB Small Business Optimism](image2)

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The jump in small business sentiment mostly tracks the drop in regulation. A persistent complaint from small business leaders during the Obama administration was the regulatory burden. Not only did President Trump promise to reduce regulation, he actually accomplished it.

Tax changes and deregulation have been supportive factors for equities since the November 2016 presidential election. However, as Edward Alden noted, the Trump administration has tried to placate both capital and labor. Recent market action, with equities selling off despite a civil meeting between Presidents Trump and Xi and the yield curve flirting with inversion, suggests that the financial markets are pressing President Trump to choose. Will it be capital or labor that wins out in the end? If capital is going to win, a lasting trade ceasefire needs to be declared. If President Trump sticks with tariffs, and there are ample indications that he intends to for now, then the financial markets appear to be preparing for recession. A recession in 2019 will jeopardize the president’s chances at reelection in 2020. Our expectation is that, at some point, President Trump will “blink” and tone down the trade rhetoric. But, that is an open question for now.

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.

18 For an analysis of the impact of inversion, see our Asset Allocation Weekly (6/29/18).
Data Section

U.S. Equity Markets – (as of 12/10/2018 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 12/10/2018 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

December 6, 2018

Based on our methodology, the current P/E is 17.4x, unchanged from our last reading.

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.

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19 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 onestimates (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.