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: December 13, 2018—9:30 AM EST] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.4% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.5% from the prior close. Chinese markets were higher, with the Shanghai composite up 1.3% and the Shenzhen index up 1.1%. U.S. equity index futures are signaling a higher open.

Risk markets are mixed this morning with the pattern of fading overnight equity futures rallies continuing. Here is what we are watching:

ECB: The ECB is meeting today and has released a statement indicating that QE is ending[1] but the balance sheet will be maintained for the foreseeable future. That means the ECB will continue to invest in new bonds as old bonds expire. Interest rates were not changed. Overall, this outcome was mostly expected. The European economy has been weakening this year despite currency weakness and policy accommodation. Thus, we don't expect the central bank to begin raising rates anytime soon. In the press conference, ECB President Draghi noted the weakness of recent data, which suggests policy won't really tighten anytime soon.

May wins—now what? As expected, PM May won her leadership challenge and, based on Tory party rules, cannot face another internal party leadership challenge for a year. The vote was closer than expected, 200/117, which is disappointing. May had to promise not to run for PM in the next election, which is a bit of a humiliation. [2] On the other hand, she probably has no chance anyway. So, for now, May will lead the government into Brexit.

This is what we see going forward. First, there is little chance the EU will make material changes to the current agreement. Although there is nearly universal dislike for what May has negotiated, she was in a really weak position and was mostly forced to take whatever mercies the EU was willing to grant. Second, there is no stomach for a hard Brexit. It is now common knowledge that a hard Brexit will lead to serious economic disruption. Imagine the U.S. making a sudden stop to trade with Canada and Mexico. Grocery stores would quickly run out of some products (no guacamole!) and car production would halt as parts flow hit a sudden stop. Over time, the supply chains would adjust but the change would be painful and almost certainly inflationary. Although the BOE has made brave talk about raising rates to fight stagflation, in

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[1] https://www.ft.com/content/bc0a5184-fd44-11e8-ac00-57a2a826423e?emailId=5c11f0b0859321000480fa79&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

[2] https://www.nytimes.com/2018/12/12/world/europe/theresa-may-no-confidence-brexit.html?emc=edit_mbe_20181213&nl=morning-briefing-europe&nlid=567726720181213&te=1

reality, a central bank facing inflation and recession will tend to fight the latter. Only under unique circumstances, like we saw in the late 1970s, will the first be the primary policy focus. Third, if our analysis is correct, the next likely step is a second referendum. Although this outcome is fraught with risk, there is no real middle ground between impossible new negotiations and a hard Brexit. Thus, a referendum to at least delay implementation might make sense and it's possible a second referendum could reverse the outcome of first. Although there is grumbling about the elites re-running the vote until they get the outcome they want, one could argue that a second vote would be more informed because now the parameters are clearer. It should also be noted that holding multiple votes isn't unprecedented; separation referendums have been held on multiple occasions in Quebec and Scotland. In the end, at a minimum, we think a hard Brexit will be avoided and the deadlines will be extended. And, "calling the whole thing off" is a clear possibility.

China trade: Negotiations continue and, actually, the situation appears to be improving. The Meng issue remains; in fact, a second Canadian was arrested in China yesterday.[3] On this issue, the Xi government is pressing Canada hard but is studiously avoiding taking actions against Americans…so far. If Meng is extradited, that could change. But, for now, China appears willing to restrict aggressive steps against Canada alone.

Meanwhile, trade talks continue and China is taking steps to improve the optics for the situation,[4] making high profile announcements. For example, China announced large purchases of U.S. soybeans.[5] The timing is important, as farmers are struggling to find storage space for the recent harvest, especially with steel tariffs driving up the price of silos.[6] China is moving to cut tariffs on U.S. autos from 40% to 15%.[7] It has asked for high level trade talks.[8] It is even offering to change its "China 2025" program to increase foreign participation.[9] We suspect that Xi is betting that Trump will accept a trade truce to improve sentiment going into 2019 to raise the odds of re-election. We doubt China has any intention to actually meet U.S. demands. From China's perspective, the Plaza Accord of 1985 (which drove up the value of the JPY) and Reagan-era "voluntary" car export restrictions on Japanese car exports (interestingly enough, negotiated by none other than Robert Lighthizer), paved the road for Japan's 30 years of economic stagnation. That isn't exactly true, because Japan could have taken policy measures to adjust more quickly, but U.S. policy undermined Japan's ability to export to the U.S. and made

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[3] https://www.reuters.com/article/us-china-icg/china-says-second-canadian-being-probed-for-harming-state-security-idUSKBN1OC0A4

[4] https://www.nytimes.com/2018/12/12/business/china-trade-war.html?emc=edit_mbe_20181213&nl=morning-briefing-europe&nlid=567726720181213&te=1

[5] https://www.reuters.com/article/us-usa-trade-china-soybeans/exclusive-china-makes-first-major-buy-of-u-s-soybeans-since-trump-xi-meet-idUSKBN1OB29S

[6] https://www.ft.com/content/2387f97c-fd7e-11e8-aebf-99e208d3e521?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

[7] https://www.scmp.com/news/china/diplomacy/article/2177536/trade-talk-movement-china-agrees-slash-tariffs-us-auto-imports

[8] https://www.scmp.com/news/china/diplomacy/article/2177358/trade-war-chinas-liu-he-and-us-steven-mnuchin-and-robert and https://www.reuters.com/article/us-usa-trade-china/china-commerce-ministry-would-welcome-u-s-trade-delegation-visit-idUSKBN1OC0R7

[9] https://www.wsj.com/articles/china-is-preparing-to-increase-access-for-foreign-companies-11544622331

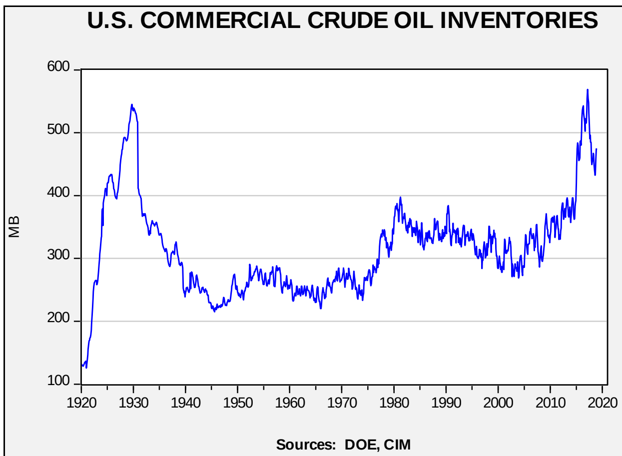
the adjustment process more difficult. Beijing fears the U.S. has similar plans for China. At the same time, offering concessions can buy China time, especially when the Chinese economy is slowing.

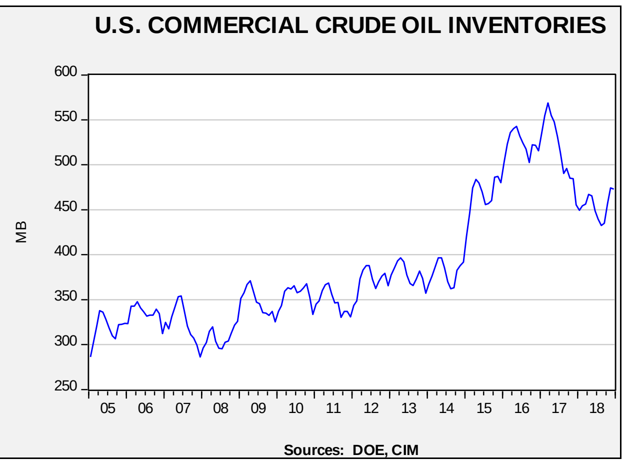
The unknown is the reaction of the Trump administration. If it is taking a long-term view, it should continue to press its advantage and force China to make significant concessions. However, that path would keep financial markets under pressure. Holding the line might be the best long-term policy but will reduce the president's chances of re-election. We suspect the administration will soften to improve market sentiment.

Italian budget news: Yesterday, there were reports the Italian government was giving in to EU demands, offering an adjusted budget with a mere 2% deficit/GDP.[10] Although the reports were initially downplayed, in fact, it appears the reports were accurate.[11] Italian bonds have rallied strongly on the news. We suspect the bond market forced the Italian government to offer concessions.

More on tech: Apple (APPL, 169.10) has announced a significant investment plan in the U.S., boosting American employment by 20k by 2023. It is unclear if any of this $1.0 bn on new investment will bring production back to the U.S. (that seems unlikely for now). The high profile investment spending will improve its political profile.[12]

Energy update: Crude oil inventories fell 1.2 mb last week compared to a forecast decline of 3.5 mb.





In the details, estimated U.S. production declined 0.1 mbpd to 11.6 mbpd as the lower 48 states reported a decline. Crude oil imports rose a modest 0.2 mbpd but exports dropped 0.9 mbpd.

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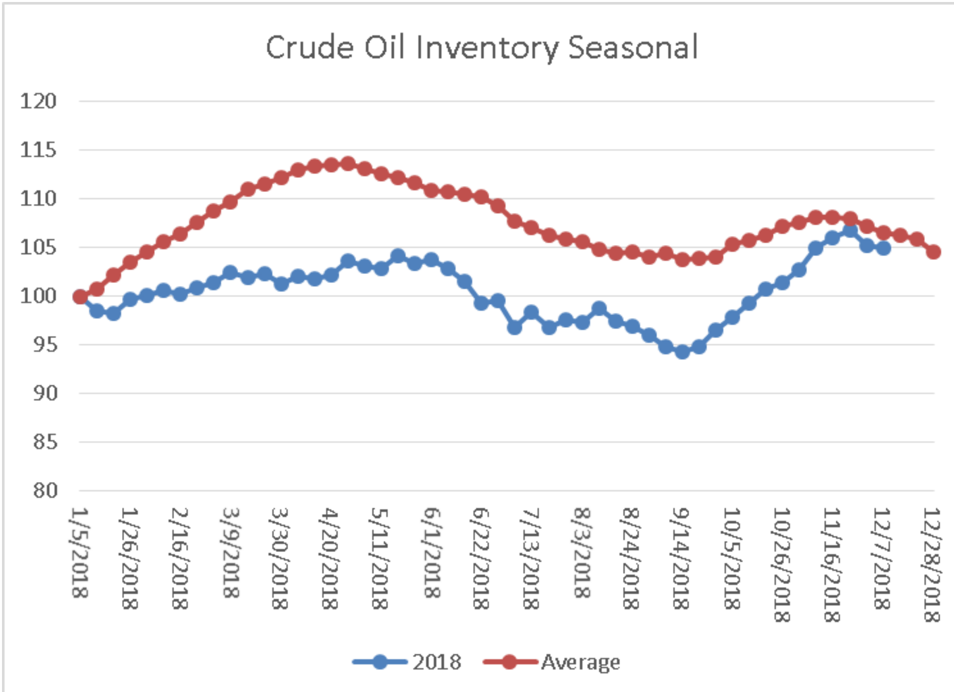
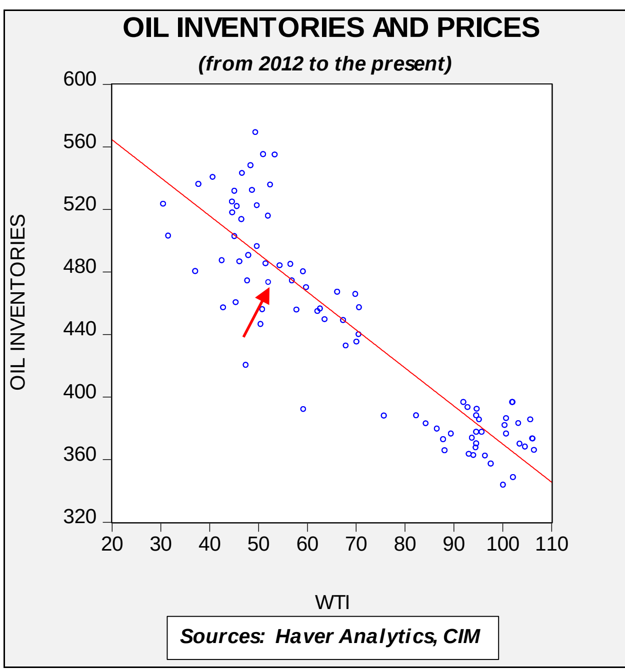
[10] https://www.bloombergquint.com/onweb/italy-to-propose-new-fiscal-targets-to-european-union-wednesday#gs.YKz3mng
[11] https://www.ft.com/content/18d29fbe-fe19-11e8-ac00-57a2a826423e?emailId=5c11f0b0859321000480fa79&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22
[12] https://www.axios.com/apple-to-expand-in-austin-00c6c2a5-2e5d-4444-a5a7-4d117879cfe3.html

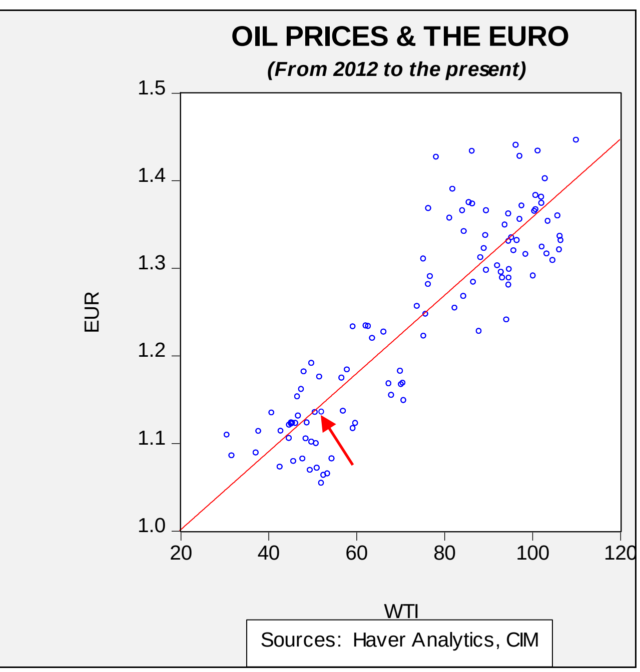
The fall in imports, coupled with a small decline in refinery runs, led to the lower than expected drop in inventories.



(Source: DOE, CIM)

The seasonal chart suggests that the usual easing of inventory accumulation into year's end has likely started.

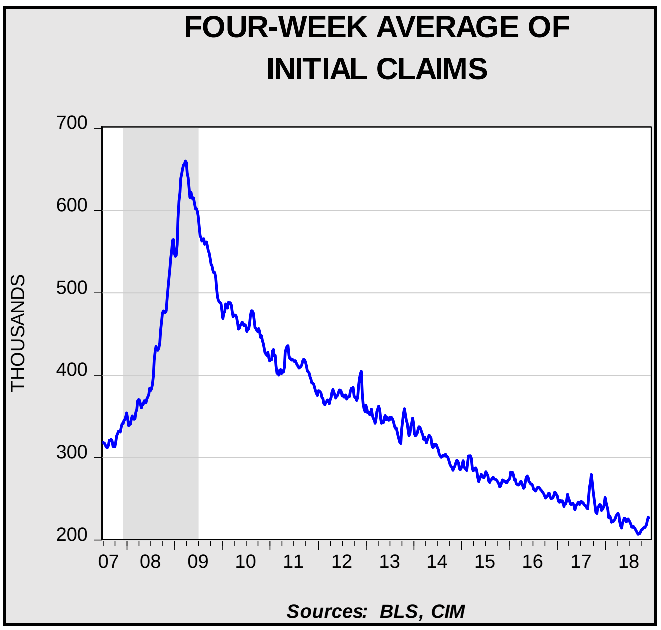




Based on oil inventories alone, fair value for crude oil is $60.20. Based on the EUR, fair value is $54.37. Using both independent variables, a more complete way of looking at the data, fair value is $55.69. By all these measures, current oil prices are undervalued. Although fears of a weaker global economy do play a role in price weakness, it does appear that even modest action by OPEC to restrict output should lift prices to the mid-$50s in the coming weeks. We note the IEA is adjusting its expectations due to the recent OPEC decision to reduce output and is expecting the oil market to tighten next year.[13]

U.S. Economic Releases

Initial jobless claims came in below expectations at 206k compared to the forecast of 226k. The prior report was revised upward from 231k to 233k.



The chart above shows the four-week moving average of initial claims. The four-week moving average decreased from 226.75k to 224.25k.

The import price index came in below expectations, falling 1.6% from the prior month compared to the forecast drop of 1.0%. The import price index excluding petroleum was below expectations, falling 0.3% from the prior month compared to the forecast drop 0.1%. The export price index came in below expectations, falling 0.9% from the prior month compared to the forecast drop of 0.13%.

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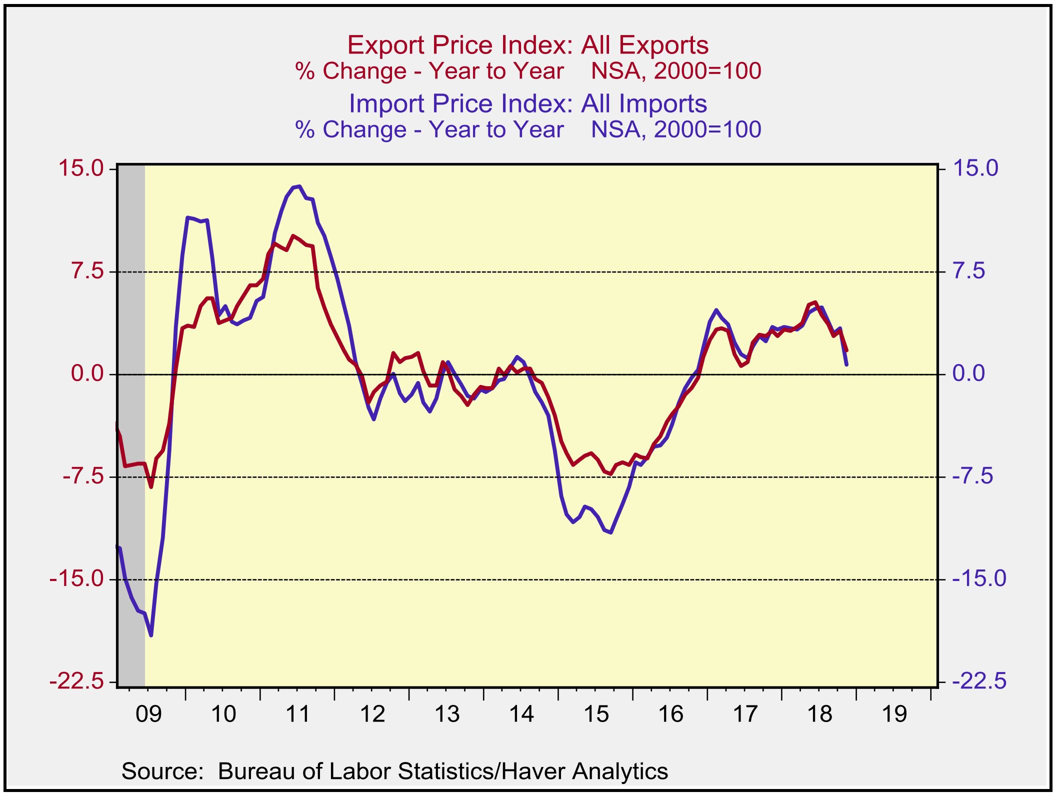
[13] https://www.reuters.com/article/us-oil-iea/iea-sees-global-oil-supply-tightening-more-quickly-in-2019-idUSKBN1OC0Y4?il=0



The chart above shows the year-over-year changes in the import price and export price indexes. The import price and export price indexes rose 0.7% and 1.8%, respectively.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Bloomberg Consumer Comfort	m/m	dec		60.3	**
14:00	Monthly Budget Statement	m/m	nov	-$199.0 bn	-$100.5 bn	**
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								
Japan	Japan Buying Foreign Bonds	m/m	dec	¥1.241 tn	¥1.054 tn		*	Equity and bond neutral
	Japan Buying Foreign Stocks	m/m	dec	-¥0.112 tn	-¥0.075 tn		*	Equity and bond neutral
	Foreign Buying Japan Bonds	m/m	dec	¥1.718 tn	¥0.733 tn		*	Equity and bond neutral
	Foreign Buying Japan Stocks	m/m	dec	-¥0.447 tn	-¥0.138 bn		*	Equity and bond neutral
	Tokyo Average Office Vacancies	m/m	nov	1.98	2.20		**	Equity and bond neutral
New Zealand	Food Prices	m/m	nov	-0.6%	-0.6%		**	Equity and bond neutral
Australia	Consumer Inflation Expectations	y/y	dec	4.0%	3.6%		**	Equity and bond neutral
EUROPE								
Germany	CPI	y/y	nov	2.3%	2.3%	2.3%	***	Equity and bond neutral
France	CPI	y/y	nov	1.9%	1.9%	1.9%	***	Equity and bond neutral
Switzerland	Producer and import prices	m/m	nov	-0.3%	0.2%	0.1%	**	Equity bullish, bond bearish
	Private Sector Payrolls	m/m	3q	0.1%	0.2%	0.2%	**	Equity bearish, bond bullish
	Wages	m/m	3q	0.3%	0.3%	0.3%	***	Equity and bond neutral
U.K.	Claimant Count Rate	m/m	nov	2.8%	2.7%		**	Equity and bond neutral
	Jobless Claims Change	m/m	nov	21.9k	20.2k		**	Equity and bond neutral
AMERICAS								
Mexico	Industrial Production	y/y	oct	1.0%	1.8%	1.8%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	oct	2.5%	2.4%	2.5%	***	Equity and bond neutral
Brazil	Retail Sales	y/y	oct	1.9%	0.1%	2.5%	**	Equity bearish, bond bullish
Canada	Teranet/National Bank HPI	y/y	y/y	3.1%	2.8%		**	Equity and bond neutral
	Capacity utilization	q/q	3q	82.6%	85.5%	86.0%	**	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)	278	278	0	Up
3-mo T-bill yield (bps)	237	238	-1	Neutral
TED spread (bps)	41	40	1	Neutral
U.S. Libor/OIS spread (bps)	240	239	1	Up
10-yr T-note (%)	2.90	2.91	-0.01	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	9	12	-3	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Up
yen	down			Neutral
pound	up			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
ECB Main Refinancing Rate	0.000%	0.000%	0.000%	On forecast
ECB Marginal Lending Facility Rate	0.250%	0.250%	0.250%	On forecast
ECB Deposit Facility Rate	-0.400%	-0.400%	-0.400%	On forecast
SNB Sight Deposit Interest	-0.750%	-0.750%	-0.750%	On forecast
SNB 3-Month Libor Lower Target Rate	-1.250%	-1.250%	-1.250%	On forecast
SNB 3-Month Libor Higher Target Rate	-2.500%	-2.500%	-2.500%	On forecast
Brazil Selic Rate	6.500%	6.500%	6.500%	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	$59.53	$60.15	-1.03%	Bearish IEA Report
WTI	$50.53	$51.15	-1.21%	
Natural Gas	$4.18	$4.14	1.02%	
Crack Spread	$14.63	$14.53	0.65%	
12-mo strip crack	$16.90	$16.95	-0.32%	
Ethanol rack	$1.42	$1.42	0.47%	
Metals				
Gold	$1,243.14	$1,245.66	-0.20%	
Silver	$14.72	$14.74	-0.09%	
Copper contract	$278.25	$277.00	0.45%	
Grains				
Corn contract	$ 385.75	$ 385.25	0.13%	
Wheat contract	$ 531.25	$ 526.50	0.90%	
Soybeans contract	$ 931.50	$ 933.25	-0.19%	
Shipping				
Baltic Dry Freight	1353	1364	-11	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-1.2	-3.5	2.3	
Gasoline (mb)	2.1	2.0	0.1	
Distillates (mb)	-1.5	1.6	-3.1	
Refinery run rates (%)	-0.40%	0.30%	-0.7%	
Natural gas (bcf)		-81.0		

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.

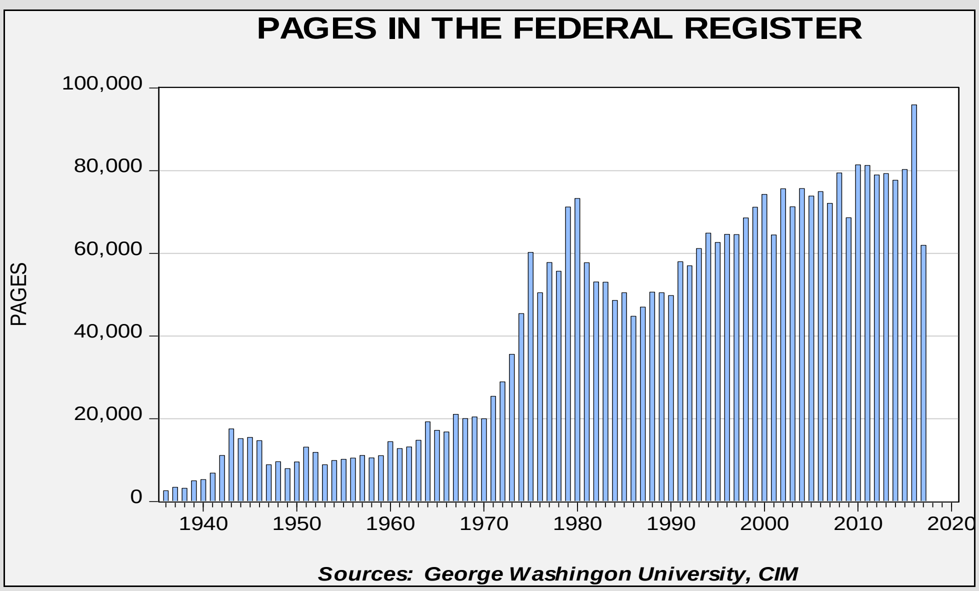
December 7, 2018

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."[14]

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.[15] 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.

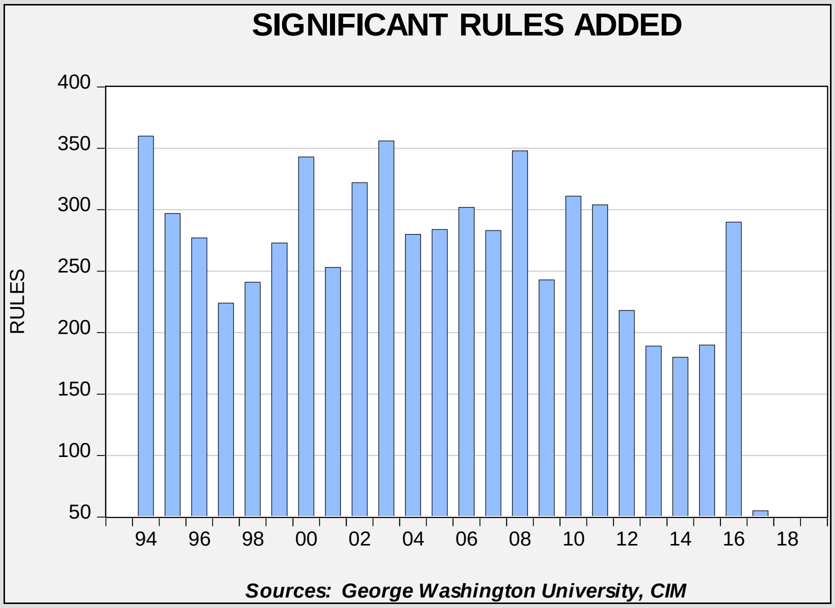


[14] http://www.arlingtoncemetery.net/mitchell.htm

[15] https://www.bloomberg.com/news/audio/2018-11-27/surveillance-china-general-motors-with-cfr-s-alden-podcast Alden's segment begins at 16:00 minutes and the response in question is at 18:40.

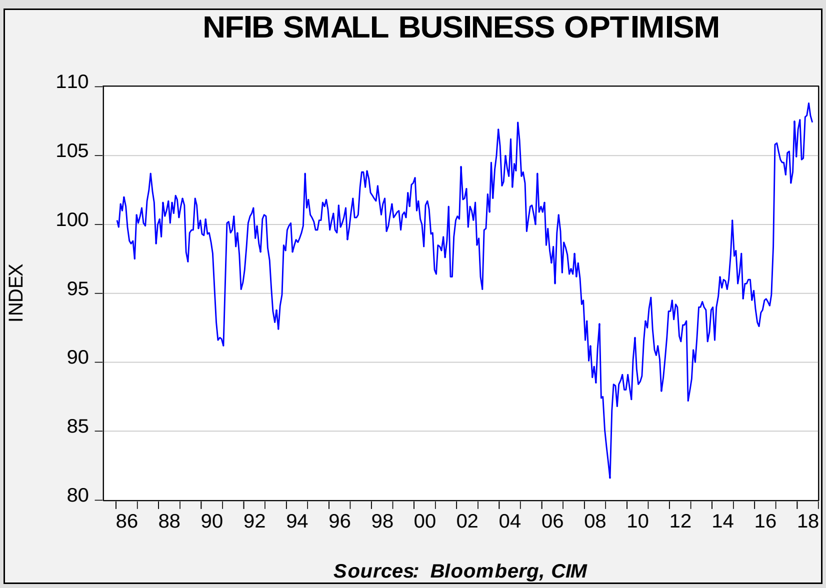
The drop from 2016 to 2017 was 35.4%, which exceeds the 21.2% decline in 1981, Ronald Reagan's first full year in office. The only year that was larger was 1947, which saw a 39.6% slide. That drop was likely due to postwar changes.

Another measure is called the "significant rule changes,"[16] a policy measure created during President Clinton's first term. The decline in 2017 was unprecedented.



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.



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[16] https://www.reginfo.gov/public/jsp/Utilities/EO_12866.pdf and summarized https://www.epa.gov/laws-regulations/summary-executive-order-12866-regulatory-planning-and-review

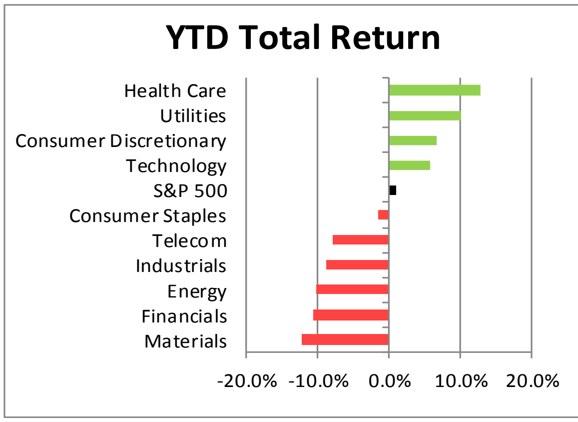
The jump in small business sentiment mostly tracks the drop in regulation. A persistent complaint from small business leaders during the Obama administration was the regulatory burden. Not only did President Trump promise to reduce regulation, he actually accomplished it.

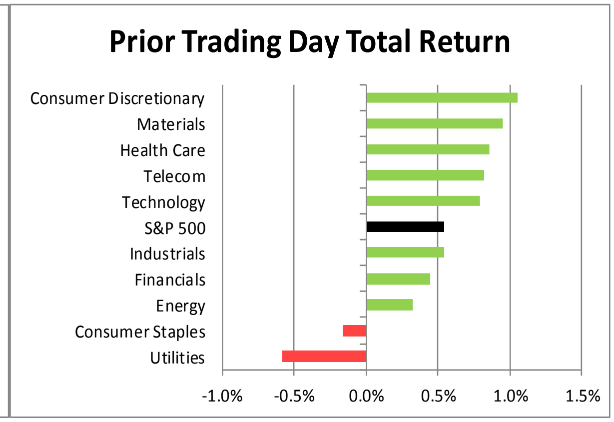
Tax changes and deregulation have been supportive factors for equities since the November 2016 presidential election. However, as Edward Alden noted, the Trump administration has tried to placate both capital and labor. Recent market action, with equities selling off despite a civil meeting between Presidents Trump and Xi and the yield curve flirting with inversion,[17] 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.

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

Data Section

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

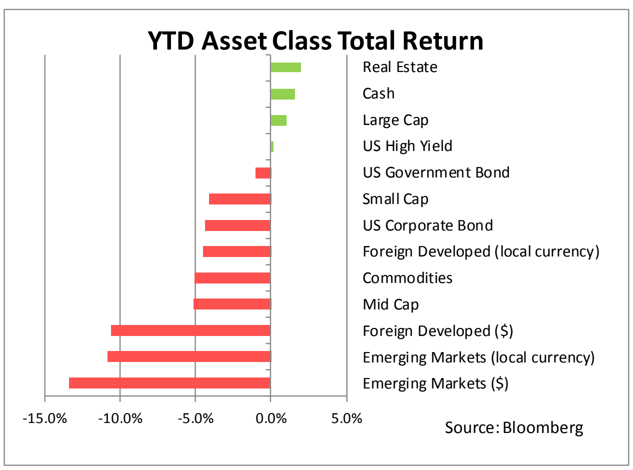




(Source: Bloomberg)

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 12/12/2018 close)

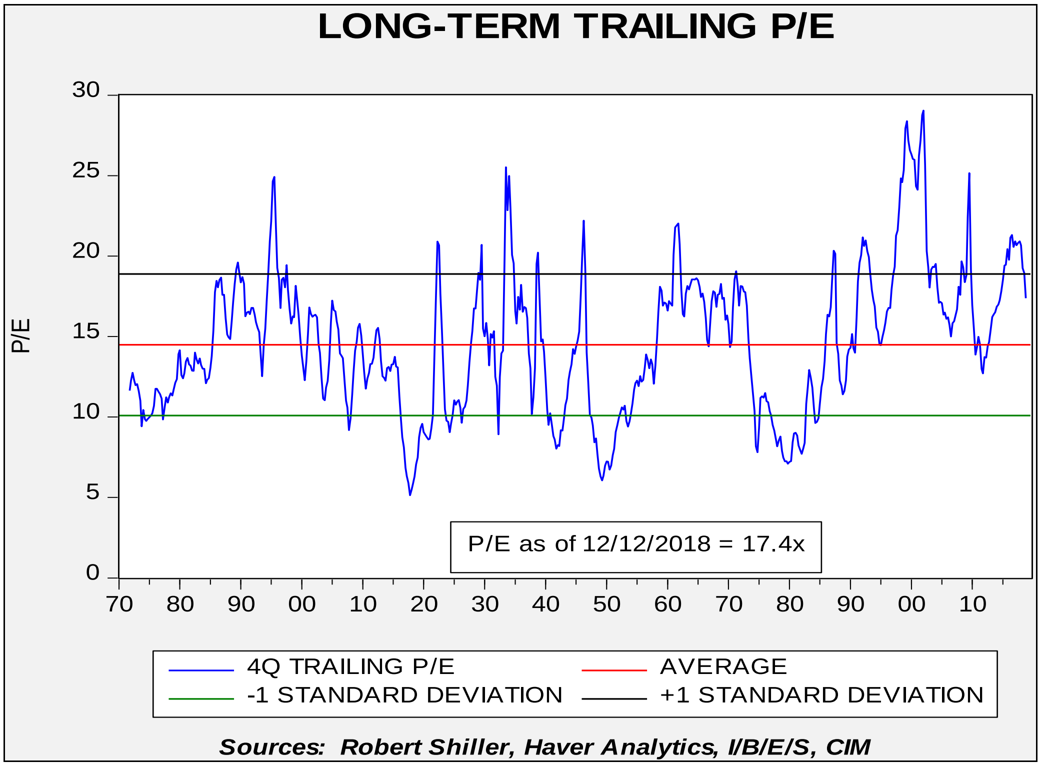


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 13, 2018



Based on our methodology,[18] 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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[18] 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.