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.

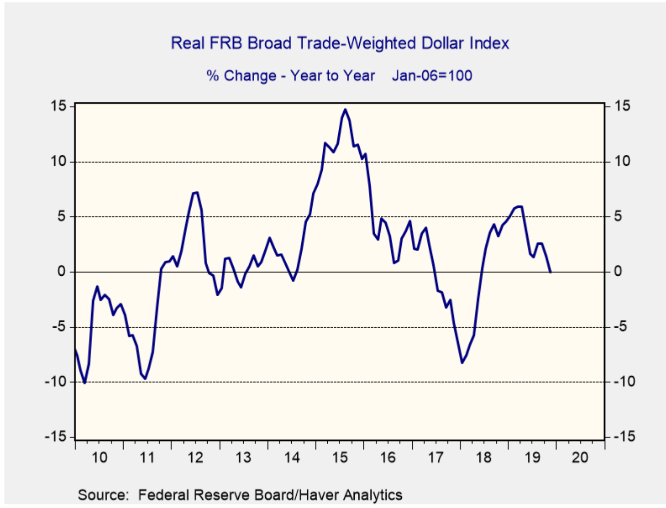
[Posted: December 18, 2019—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is basically flat compared with its last close. In Asia, the MSCI Asia Apex 50 closed up 0.2%. Chinese markets were mixed, with the Shanghai composite down 0.2% and the Shenzhen index unchanged from the prior close. U.S. equity index futures are signaling a higher open.

Good morning, all. So far, the overnight news has been relatively mum as fears of an ongoing trade war appear to be dissipating. Meanwhile, rising concerns of a "hard" Brexit have weighed on the pound. Below are the stories we will be following today:

Weaker dollar in 2020: Following the agreement of the "phase one" trade deal, there has been a growing consensus that the U.S. dollar will likely weaken in the coming year. As we have written in previous reports, one of the setbacks of imposing tariffs is that it generally leads to currency strengthening. There are a few possible explanations for this:

1) Targeted countries may decide to weaken their currency through easy monetary policy, which would therefore soften the impact of the tariffs.
2) If tariffs are successful at getting countries to purchase more U.S. goods, it will lead to a boost in demand of the U.S. dollar and result in U.S. dollar appreciation.
3) When tariffs adversely hurt a country's economy, it can lead to capital flight in which foreign investors seek refuge by purchasing assets in another country, thereby leading to currency depreciation in the host country.

That being said, a rollback of some tariffs should lead to a weakening of the dollar as investors attempt to move away from U.S. assets, which are generally considered havens. Furthermore, if this trend persists it will likely be bullish for foreign equities.



The chart above shows the year-over-year change in the Real FRB Broad Trade-Weighted Dollar Index. The index measures the strength of the U.S. dollar relative to the currencies from 26 of the country's most important trading partners. The trend spiked in the beginning of the year but has been slowing down since April.

China agriculture purchases: There are growing concerns that the partial trade pact may not live up to expectations. In the trade pact, China has agreed to purchase at least $40 billion worth of agricultural products annually over the next two years; this would almost double its largest purchase order of nearly $25 billion in 2013 and 2014. The biggest concern about the deal is that it has not been formally put on paper; therefore, it is difficult to discern where China will make purchases. Despite the need for pork and soybeans, skeptics wonder whether China has a need for $40 billion worth of agricultural goods and may try to make up for it by purchasing non-agricultural products such as crude oil and natural gas. At this time, the formal written agreement is under review, so the commitment has yet to be finalized. Nevertheless, unless there is something in the agreement that leads investors to believe this deal will not hold, we expect the agreement to have little effect on equities.

Fears of manufacturing slowdown: Despite the reduction in global trade tensions, there are growing fears that manufacturing production will not pick up as fast as many would hope. On Tuesday, Boeing (BA, 327) announced that it will be halting its production in January of one of its flagship products, the Boeing 737 Max, as it undergoes regulatory reviews following crashes of two of its planes. Arguably the biggest U.S. manufacturing exporter, the company's decision to halt production is expected to have an impact on the economy. Earlier this year, the company reduced its production of the plane from 52 per month to 42, resulting in a slowdown of durable goods orders. Accordingly, the halt is expected to result in a slowdown in inventory accumulation for Q1 2020 but will likely spike whenever the company decides to restore production.

Odds and ends: The U.S. has given up its efforts to stop the Nord Stream 2 gas pipeline. Brazilian equities have been hit due to concerns about the country's economy. Data released by the BLS showed that many of the counties the president carried in the 2016 election were arguably in recession at the time.

U.S. Economic Releases

MBA mortgage applications declined 5.0% in the week ended December 13, erasing their 3.8% gain in the previous week. Applications for home-purchase mortgages fell 2.1%, while applications for refinancing mortgages dropped 6.5%. The average interest rate on a 30-year, fixed-rate mortgage was unchanged at 3.98%.

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

Economic Releases		
	No economic releases today	
Fed Speakers or Events		
	Speaker or event	**District or position**
12:40	Charles Evans speaks at an event in Indianapolis	President of the Federal Reserve Bank of Chicago

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	Trade Balance	m/m	nov	-82.1 Bil.	15.7 Bil.	-355.5 Bil.	***	Equity bullish, bond bearish
	Trade Balance Adjusted	m/m	nov	-60.8 Bil.	-48.2 Bil.	-56.4 Bil.	**	Equity and bond neutral
	Exports	y/y	nov	-7.9%	-9.2%	-8.9%	**	Equity bullish, bond bearish
	Imports	y/y	nov	-15.7%	-14.8%	-12.8%	*	Equity and bond neutral
Australia	Westpac Leading Index	m/m	nov	-0.1%	-0.1%		**	Equity and bond neutral
New Zealand	BoP Current Account Balance	q/q	3q	-6.351 Bil.	-1.037 Bil.	-6.300 Bil.	*	Equity and bond neutral
	Current Account/GDP Ratio	q/q	3q	-3.3%	-3.4%	-3.4%	*	Equity and bond neutral
EUROPE								
Eurozone	CPI	y/y	nov	1.0%	0.7%	1.0%	***	Equity and bond neutral
	Core CPI	y/y	nov	1.3%	1.3%	1.3%	***	Equity and bond neutral
Germany	PPI	y/y	nov	-0.7%	-0.6%	-0.6%	*	Equity and bond neutral
	IFO Business Climate	m/m	oct	96.3	95.0	95.5	***	Equity bullish, bond bearish
	IFO Expectations	m/m	nov	93.8	92.1	93.0	***	Equity bullish, bond bearish
	IFO Current Assessment	m/m	nov	98.8	97.9	98.1	**	Equity bullish, bond bearish
UK	CPI	y/y	nov	1.5%	1.5%	1.4%	***	Equity and bond neutral
	Core CPI	y/y	nov	1.7%	1.7%	1.7%	***	Equity and bond neutral
	Output PPI	y/y	nov	0.5%	0.8%	0.8%	***	Equity and bond neutral
	Core Output PPI	y/y	nov	1.1%	1.3%	1.2%	***	Equity and bond neutral
Russia	Unemployment Rate	m/m	nov	4.6%	4.6%	4.7%	***	Equity and bond neutral
	Real Wages	y/y	nov	3.8%	3.1%	3.3%	*	Equity bullish, bond bearish
	Real Retail Sales	y/y	nov	2.3%	1.6%	1.4%	***	Equity bullish, bond bearish
AMERICAS								
Canada	CPI	y/y	nov	2.2%	1.9%	2.2%	***	Equity and bond neutral
	Core CPI - Median	y/y	nov	2.4%	2.2%	2.2%	*	Equity and bond neutral
	Core CPI - Common	y/y	nov	1.9%	1.9%	1.9%	*	Equity and bond neutral
	Core CPI - Trim	y/y	nov	2.2%	2.1%	2.2%	*	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	190	0	Down
3-mo T-bill yield (bps)	152	152	0	Neutral
TED spread (bps)	38	38	0	Neutral
U.S. Libor/OIS spread (bps)	156	156	0	Up
10-yr T-note (%)	1.88	1.88	0.00	Down
Euribor/OIS spread (bps)	-40	-40	0	Down
EUR/USD 3-mo swap (bps)	16	17	-1	Down
Currencies	**Direction**			
dollar	Up			Down
euro	Down			Up
yen	Flat			Down
pound	Down			Up
franc	Flat			Up

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	$65.95	$66.10	-0.23%	
WTI	$60.61	$60.94	-0.54%	
Natural Gas	$2.29	$2.32	-1.38%	
Crack Spread	$14.27	$14.56	-2.02%	
12-mo strip crack	$17.49	$17.68	-1.07%	
Ethanol rack	$1.53	$1.54	-0.84%	
Metals				
Gold	$1,475.90	$1,476.22	-0.02%	
Silver	$17.00	$17.01	-0.07%	
Copper contract	$279.90	$281.35	-0.52%	
Grains				
Corn contract	$ 388.50	$ 390.00	-0.38%	
Wheat contract	$ 550.00	$ 556.25	-1.12%	
Soybeans contract	$ 939.25	$ 940.75	-0.16%	
Shipping				
Baltic Dry Freight	1281	1315	-34	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.8		
Gasoline (mb)		2.0		
Distillates (mb)		-0.5		
Refinery run rates (%)		0.78%		
Natural gas (bcf)		-88.0		

Weather

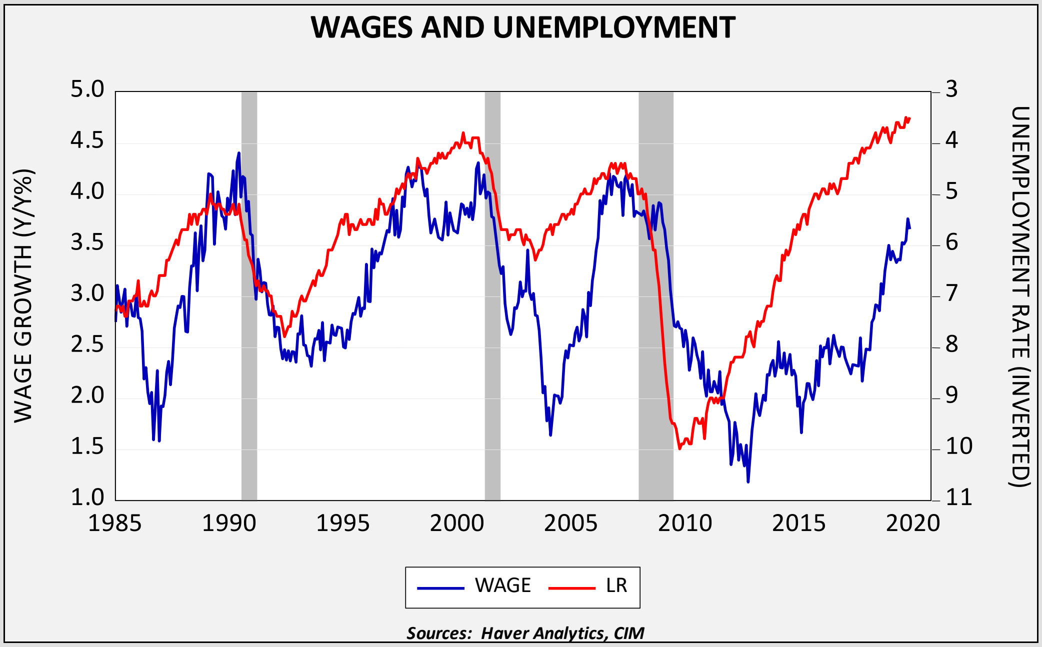
The 6-10 and 8-14 day forecasts show warmer-than-normal temperatures throughout the lower Midwest and the South, with colder-than-normal temperatures in the far West. Wet conditions are expected to prevail in the Southwest.

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.

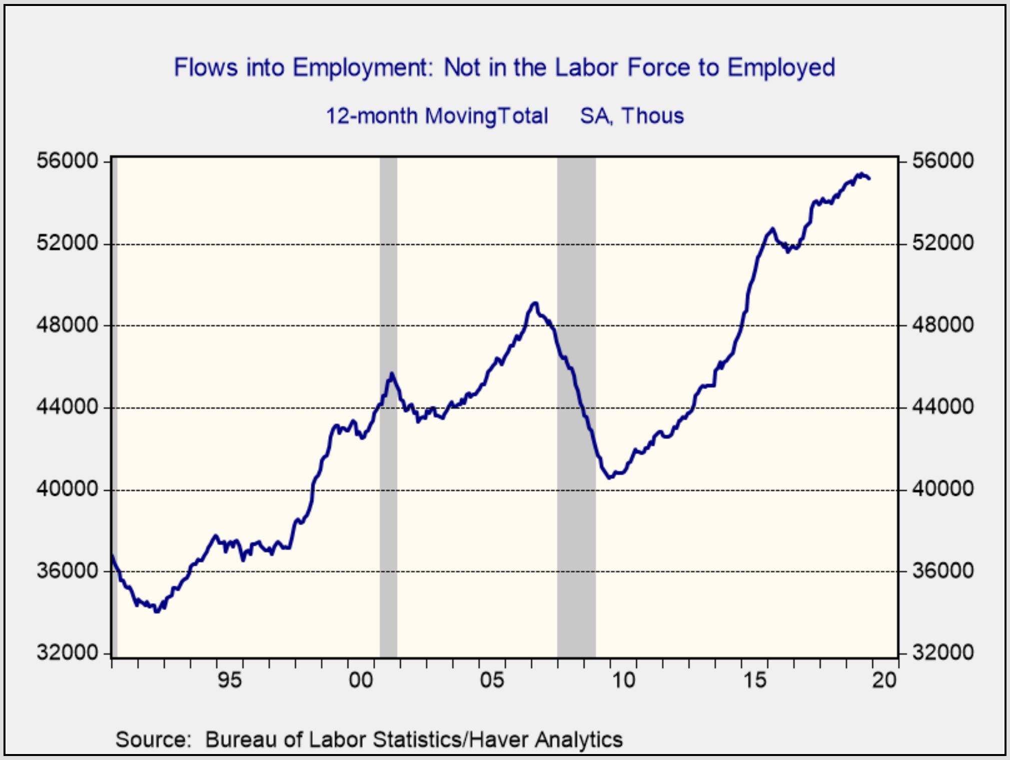
December 13, 2019

The recent employment report was very strong, with payroll growth rising more than forecast and the unemployment rate declining more than expected. One uncertainty that develops when labor markets tighten is the point at which wage growth begins to lift inflation.



This chart shows yearly wage growth and the unemployment rate (inverted scale). In the past three cycles, an unemployment rate at this level would have been consistent with wage growth in excess of 4.0%. Although wages have been increasing, the growth rate remains below the 4.0% level.

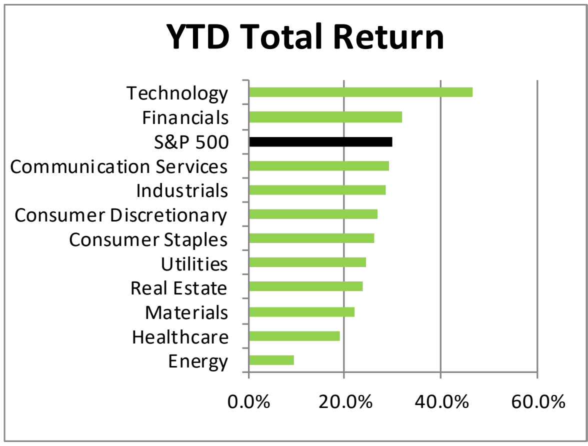
The reason wage growth remains modest is complicated, but a contributing factor is that the labor force continues to increase. A key function in that process has been that citizens who were not part of the labor force have been steadily finding jobs. The chart below shows the 12-month rolling total of those who have been out of the labor force and found employment. This number has been increasing in this expansion.

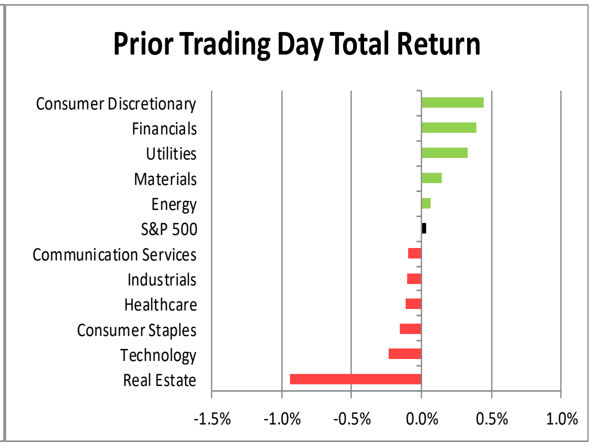


At the same time, the pace of these flows is beginning to slow. If this source of new employees declines, in theory, it would tend to lift wages at an increasing pace until employment growth slows. Nevertheless, for now, the labor market appears to be strong enough to attract new entrants into the labor force and employment, without excessive wage growth, which is a positive development for the economy.

Data Section

U.S. Equity Markets – (as of 12/17/2019 close)

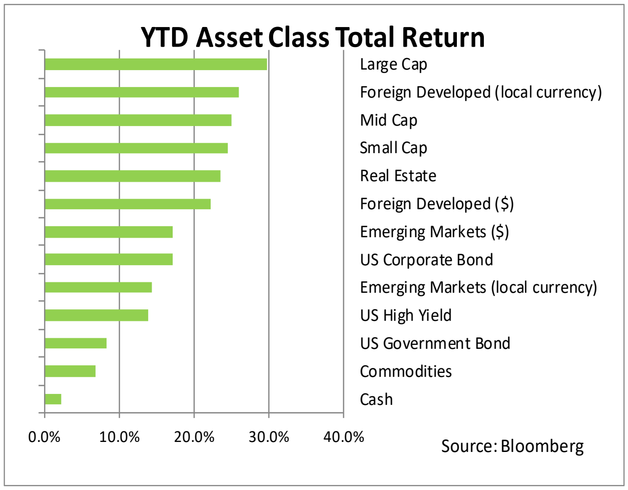




(Source: Bloomberg)

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 12/17/2019 close)

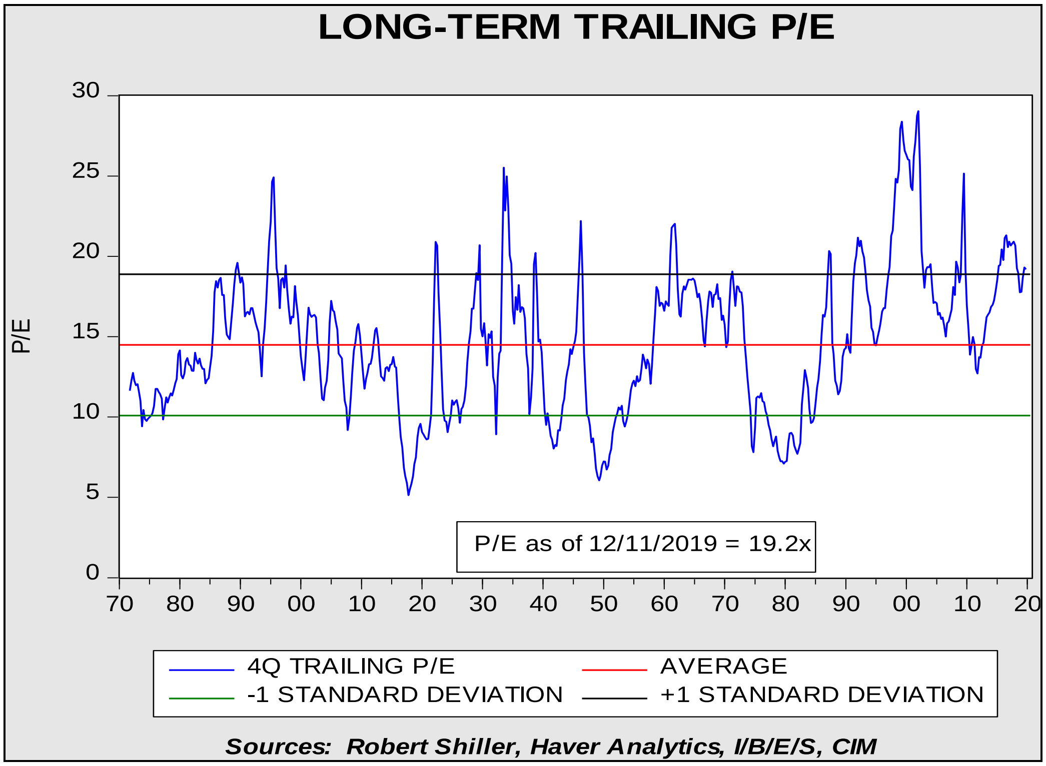


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 12, 2019



Based on our methodology,[1] the current P/E is 19.2x, unchanged 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.