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.

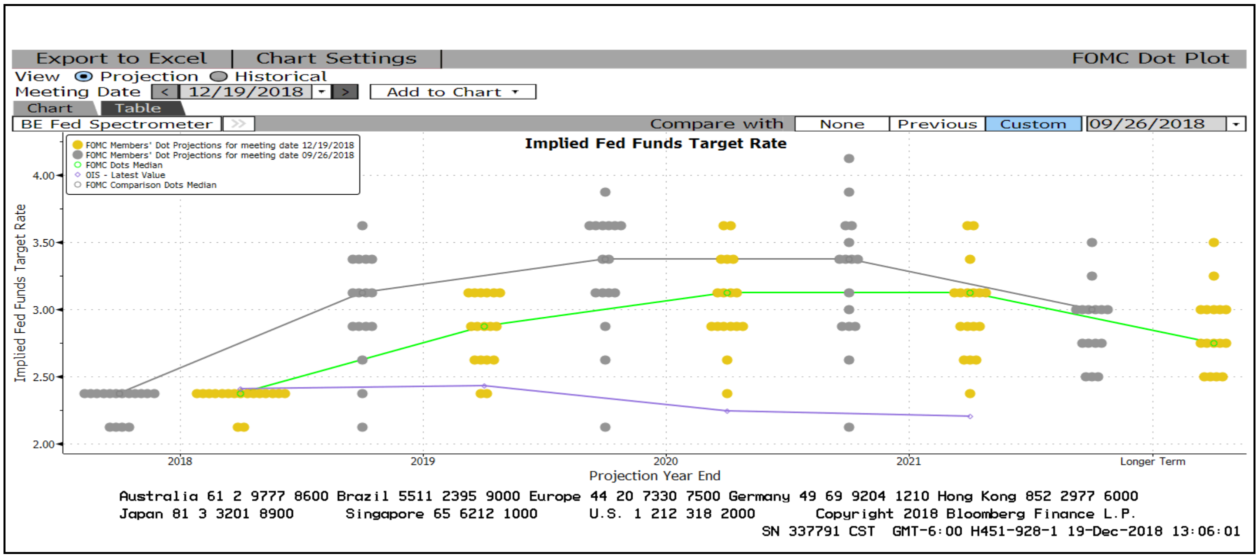
[Posted: December 20, 2018—9:30 AM EST] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 1.3% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.8% from the prior close. Chinese markets were mixed, with the Shanghai composite down 0.5% and the Shenzhen index up 0.2%. U.S. equity index futures are signaling a higher open.

[N.B. The Daily Comment will go on holiday from December 24 to January 2. From all of us at Confluence, but especially Thomas and me, thanks for reading and have a Merry Christmas and Happy New Year!]

On Friday, December 14, we published our 2019 Outlook: Red Sky at Morning report. If you missed it, you can find the report linked here or on our website.

There isn't a whole lot going on this morning; most of the market commentary is a post mortem on the Fed. We offer our views on the U.S. central bank below. Equity markets are trying to rally this morning but oil prices are testing recent lows. Here are the updates:

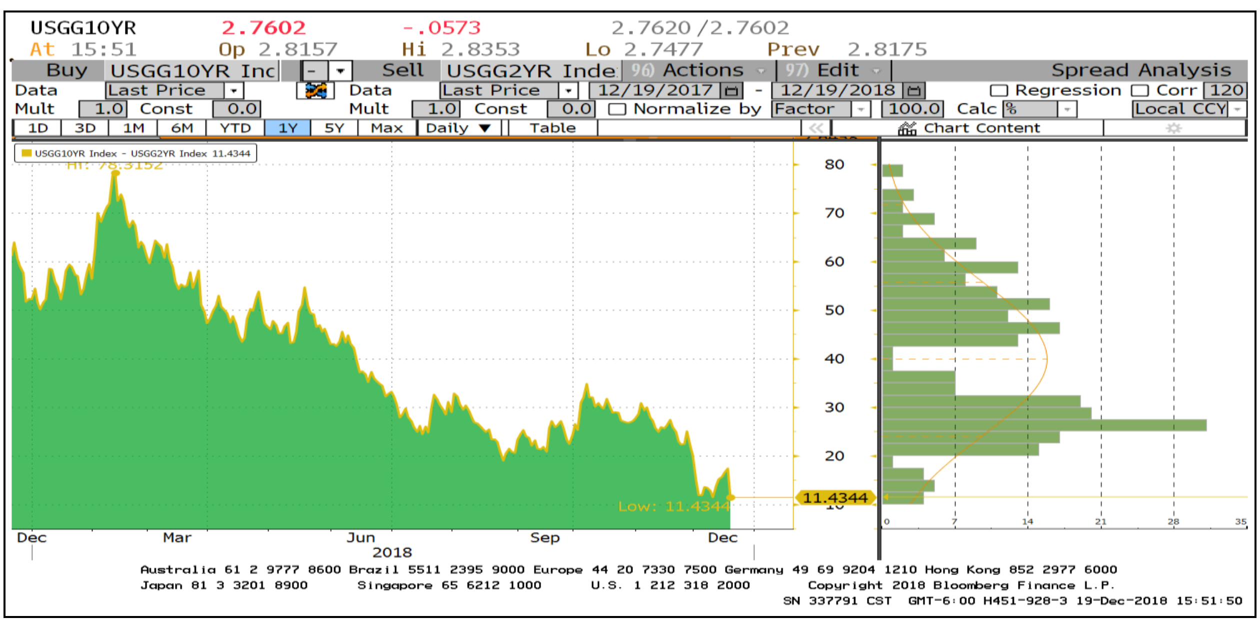
The Fed: Yesterday, we offered four outcomes from the Fed meeting. Essentially, the FOMC split the difference between outcomes #3 and #4. To recap, #3 was a hike with a clear signal of no further increases, while #4 was no change in the previous policy path. What we actually got was a hike with a reduction in the path forward.



(Source: Bloomberg)

The yellow dots show yesterday's meeting, while the gray dots show the meeting from September, the last time we had a dots plot. The lines show the median rate path. Note that there has been a cut of about 25 bps in the path for next year and 2020. The statement had few changes, with the most significant being an acknowledgement of monitoring global and financial market conditions. The economic projections were mostly unchanged; there was a modest increase in forecast GDP growth for next year to 2.5% from September's 2.3%, while core PCE is expected at 2.0%, down from 2.1% in September.

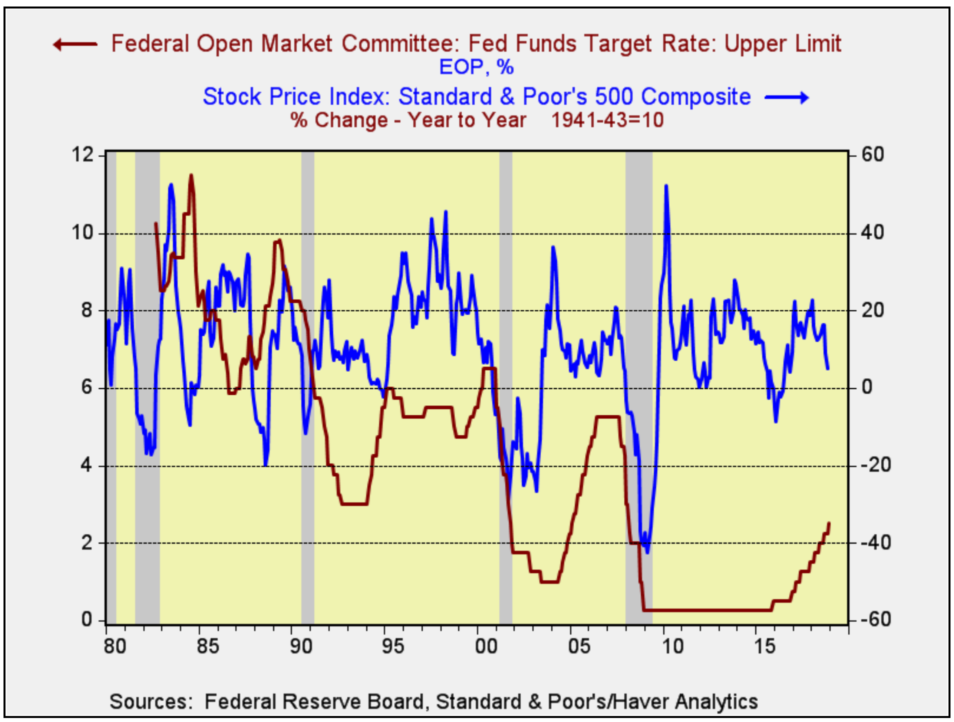
Clearly, financial markets were disappointed. The yield curve (2yr/10yr Treasury) flattened further.



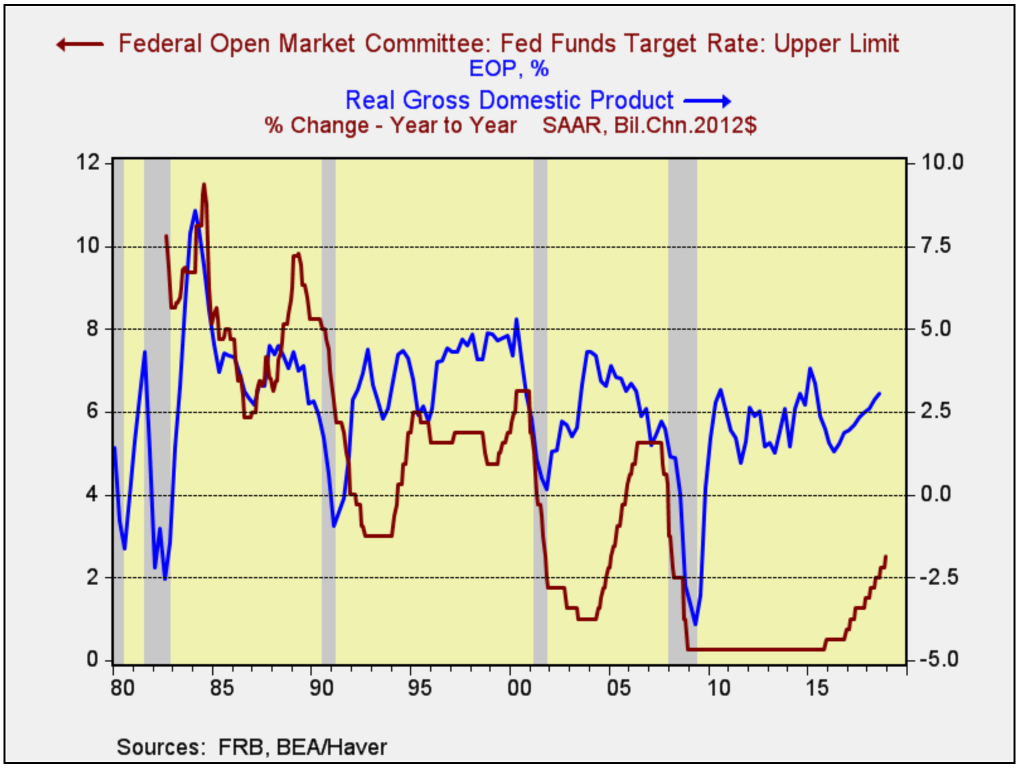
(Source: Bloomberg)

The spread narrowed to just over 11 bps. Equity markets fell; the decline from peak to yesterday's low has now reached about 15.4%. In general, a correction is 10% and a bear market occurs at 20%. The latter is usually associated with recession. Sentiment indicators are reaching levels that usually signal a washout. If recession is avoided, the chances are elevated for a rally in equities.

At the same time, financial markets were clearly disappointed. The Fed is dealing with what has been called the "Tinbergen dilemma," named for the economist Jan Tinbergen, who first described it. The dilemma describes when a policymaker faces two policy problems but only has one policy tool. It is sometimes described as "trying to shoot two bad guys with one bullet." The Tinbergen dilemma can only be resolved if the two policy problems can be fixed by the same solution. The Fed is facing an economy that is still rather strong (though momentum is clearly weakening), which supports tighter policy, and financial markets that are signaling increasing stress, which begs for easing. What has the financial markets so upset is that there is evidence that, in the past, the Fed has tended to placate the financial markets when facing a similar Tinbergen dilemma.



This chart shows the fed funds target with the yearly change in the S&P 500. When the yearly growth in the S&P becomes negative, the Fed has tended to take notice. Perhaps the clearest evidence of the Fed favoring financial markets was in 2000-04 when the Greenspan Fed kept cutting rates to what were historic lows at the time, even though the economy was recovering.



This chart shows the yearly change in real GDP. Greenspan didn't start raising rates even with GDP growth exceeding 4% in 2003, most likely due to continued weakness in equities. In 2016, Yellen paused on rates as equities fell, but the economy has softened, too.

Essentially, financial markets have become accustomed to being favored when the aforementioned Tinbergen dilemma exists. Powell is trying to weave a path that addresses both but, in reality, it looks like the Fed is more concerned about the economy overheating than it is about a weak stock market or a flattening yield curve. This position increases the likelihood of a policy mistake, one of our four potential threats to the expansion we discussed in our 2019 Outlook.

So, what happens now? Equity market valuations are improving and sentiment is becoming increasingly negative. Both tend to favor a bounce at some point. The proverbial "Santa Claus Rally" probably won't happen this year, but we would expect a January bounce.

U.S. out of Syria: President Trump announced that the 2,000 U.S. troops in Syria will be leaving very soon. The foreign policy and military establishment[1] is horrified at the prospect of having no influence in this part of the world. The winners in this decision are Iran, Russia, Turkey and Assad. The losers are Israel (due to the improvement in Iran's position), Europe (will likely see a rise in refugees) and the Kurds. The Kurds are especially harmed; they have supported U.S. efforts in this part of the world since the early 1990s when the U.S. began protecting northern

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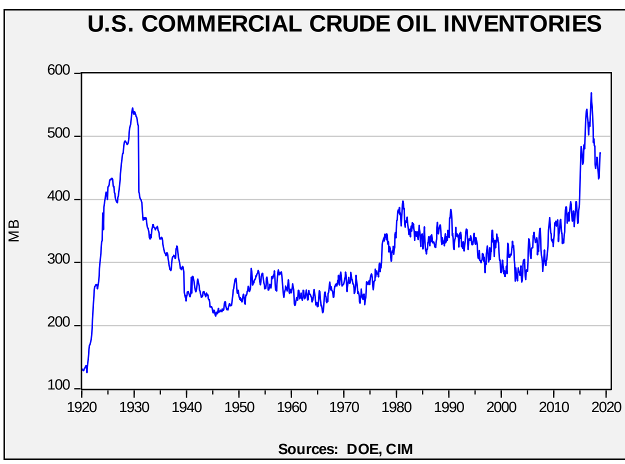
[1] https://www.washingtonpost.com/opinions/2018/12/19/trump-undermines-his-entire-national-security-team-syria/?noredirect=on&utm_term=.9cf4f85a3cda&wpisrc=nl_todayworld&wpmm=1

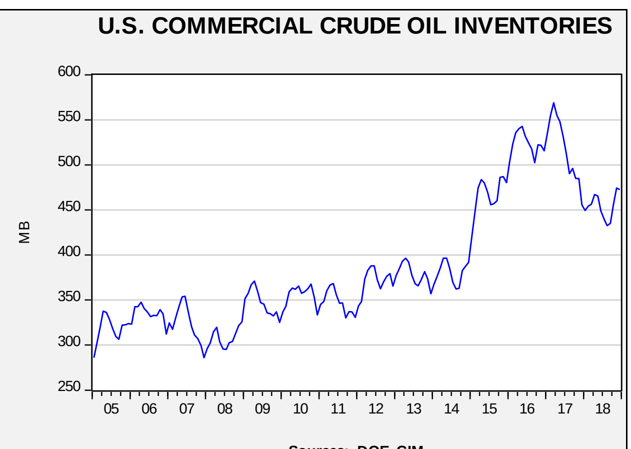
Iraq with a no-fly zone. However, now they will be subject to the tender mercies of President Erdogan. The reaction from Washington is actually rather interesting; populists are applauding the president. Even some former Obama officials are supporting Trump. Meanwhile, establishment figures on both sides of the aisle oppose the move.[2]

What are the ramifications? We will likely see the powers in the region turn on each other. Iran will try to maintain its "Shiite arc" from Tehran to Beirut, while Turkey will attempt to contain the Kurds. There will be conflict points between these two. Israel will try to prevent Iran from projecting power. Russia will likely try to manage the parties but we would not be surprised to see Moscow caught in a trap of maintaining peace. Meanwhile, the likely chaos will help Islamic State revive. Iraq will also be threatened by the ensuing conflict. The problem for the U.S. is that the commitment is never-ending. Trump, like a true Jacksonian, sees no reason why the U.S. should concern itself with the region. The consequence is that the region will likely descend into chaos.

At the same time, it is important to remember that the last three presidents have struggled to craft a working policy for the Middle East. President Bush made a critical error by removing Saddam Hussein from power without being able to replace him, creating a power vacuum in the region that still hasn't been filled. President Obama tried to extricate the U.S. from the region by putting Iran in charge; although a defensible policy, it was far from ideal. President Trump reversed the Obama-era Iran policy but found that none of the other parties in the region can stabilize it. It appears that U.S. policy is now to allow the chips to fall where they may. This policy will allow one of the three frozen conflict zones to thaw; how this works out is anyone's guess but we doubt it will be smooth. The primary market beneficiary will likely be oil.

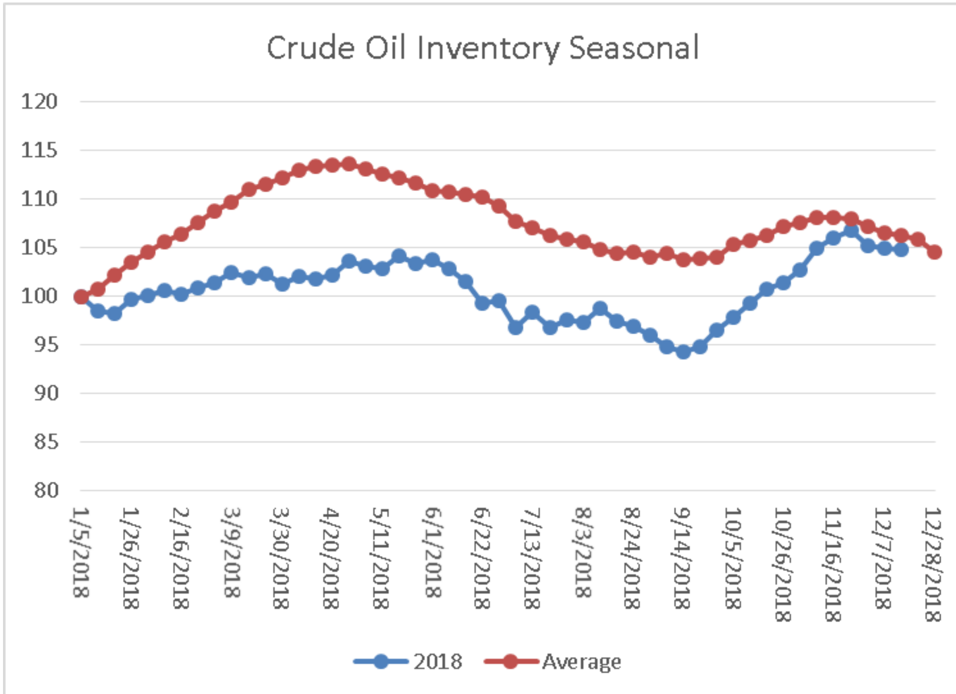
Energy update: Crude oil inventories fell 0.5 mb last week compared to the forecast decline of 3.3 mb.





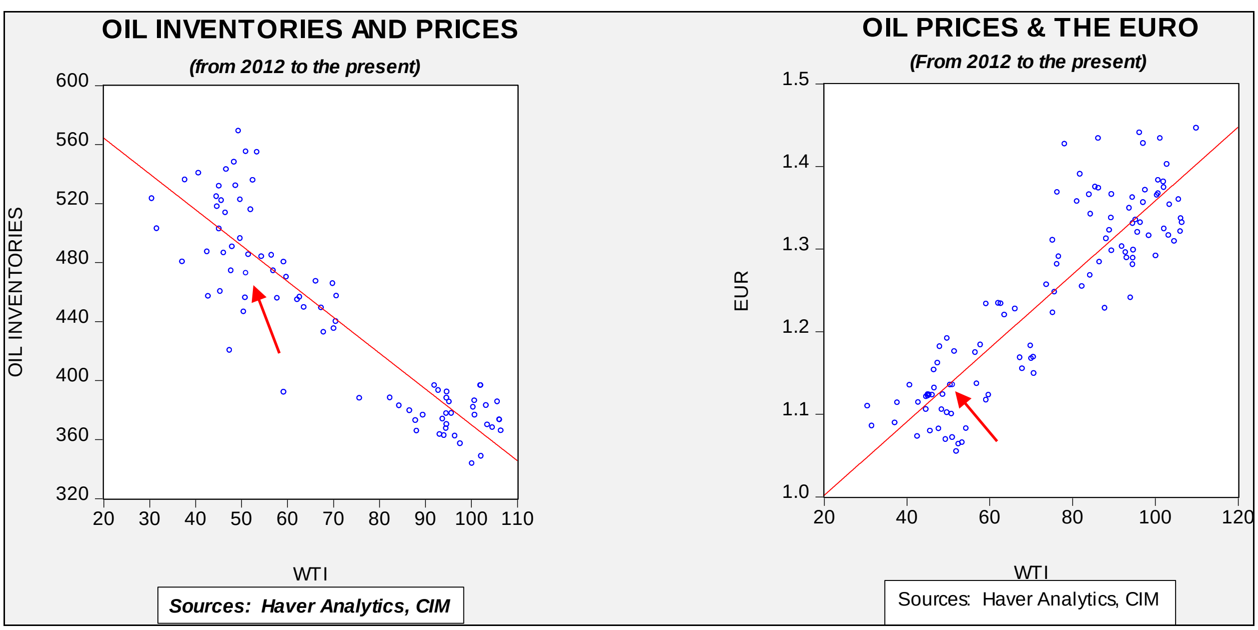
In the details, estimated U.S. production was unchanged at 11.6 mbpd. Crude oil imports and exports were essentially unchanged, while refinery runs rose a modest 0.4 mbpd.

[2] https://www.axios.com/trump-syria-troops-withdrawal-isis-6ccb1c80-b702-4ae0-8087-546830c02158.html



(Source: DOE, CIM)

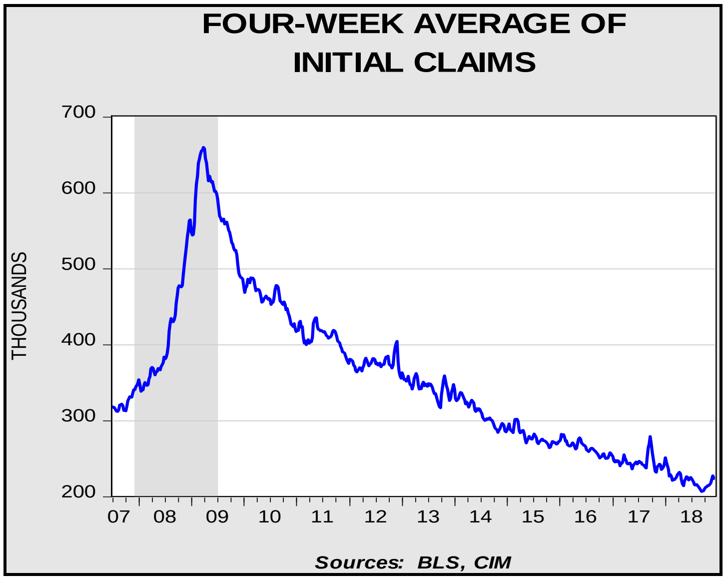
The seasonal chart suggests the usual easing of inventory accumulation into year's end is underway. Inventories usually decline into the new year.



Based on oil inventories alone, fair value for crude oil is $60.35. Based on the EUR, fair value is $54.30. Using both independent variables, a more complete way of looking at the data, fair value is $55.70. By all measures, current oil prices are undervalued. Although fears of a weaker global economy do play a role in price weakness, it appears that even modest action by OPEC to restrict output should lift prices to the mid-$50s in the coming weeks.

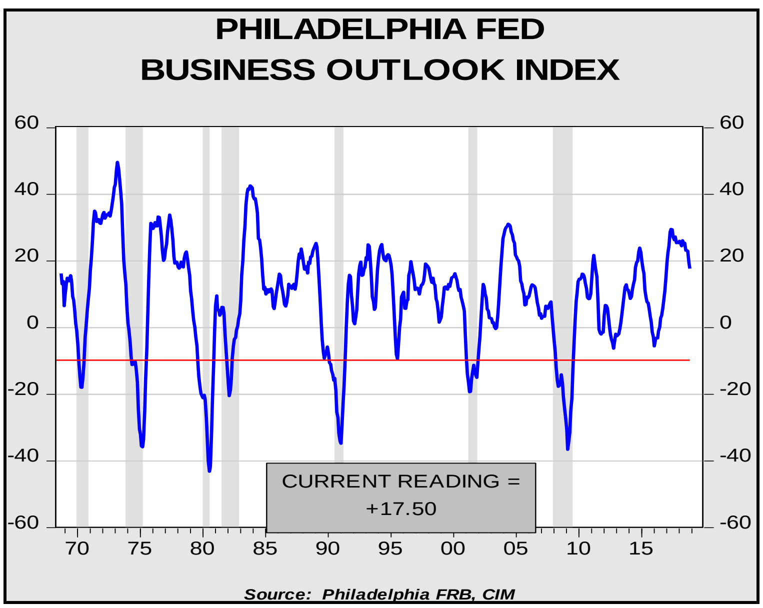
U.S. Economic Releases

Initial jobless claims came in below expectations at 214k compared to the forecast of 215k.



The chart above shows the four-week moving average of initial claims. The four-week moving average decreased from 224.25k to 221.75k.

The December Philadelphia FRB Business Outlook Index came in below expectations at 9.4 compared to estimates of 15.0.



We smooth the data on the above chart with a six-month moving average. The current reading is near cycle highs and is well above the recession signal of -10. What makes this index important is that it is measuring business sentiment for the Mid-Atlantic region, where most of the Fed governors work and live, at least part of the time. No matter how data-sensitive one is, the economic activity that one directly observes will tend to affect one's outlook. Thus, a robust local economy in the Mid-Atlantic region could lead Fed governors to lean hawkish even if the rest of the nation's economy is less robust, and vice versa.

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	nov		59.4	**
9:45	Bloomberg Economic Expectations	m/m	nov		56.0	**
10:00	Leading Index	m/m	nov	0.0%	0.1%	**
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	¥0.063 tn	¥1.241 tn		**	Equity and bond neutral
	Japan buying foreign stocks	m/m	dec	-¥0.063 tn	-¥0.112 tn		**	Equity and bond neutral
	Foreign buying Japan bonds	m/m	dec	¥1.607 tn	¥1.718 tn		**	Equity and bond neutral
	Foreign buying Japan stocks	m/m	dec	-¥0.167 tn	-¥0.447 tn		***	Equity and bond neutral
	All Industry Activity Index	m/m	oct	1.9%	-0.9%	2.0%	**	Equity and bond neutral
	Machine Tool Orders	m/m	nov	-17.0%	-16.8%		**	Equity and bond neutral
	Convenience Store Sales	m/m	nov	0.6%	-1.5%		**	Equity and bond neutral
Australia	Employment Change	m/m	nov	37.0k	32.8k	20.0k	***	Equity bullish, bond bearish
	Unemployment Rate	m/m	nov	5.1%	5.0%	5.0%	***	Equity and bond neutral
	Participation Rate	m/m	nov	65.7%	65.6%	65.6%	***	Equity and bond neutral
New Zealand	GDP	y/y	3q	2.6%	2.8%	2.8%	***	Equity and bond neutral
	Credit Spending	y/y	nov	6.1%	6.3%		**	Equity and bond neutral
EUROPE								
Eurozone	ECB Current Account Balance	m/m	oct	23.000 bn	16.900 bn		**	Equity bullish, bond bearish
Italy	PPI	m/m	dec	5.7%	7.1%		**	Equity bullish, bond bearish
	Current Account Balance	m/m	oct	6.081 bn	3.154 bn		**	Equity bullish, bond bearish
UK	Retail Sales Ex Auto Fuel	y/y	nov	3.8%	2.7%	2.3%	**	Equity bullish, bond bearish
	Retail Sales Inc Auto Fuel	y/y	nov	3.6%	2.2%	2.0%	**	Equity bullish, bond bearish
	CBI Retailing Reported Sales	y/y	nov	-13	19	15	**	Equity bearish, bond bullish
	CBI Total Dist. Reported Sales	y/y	nov	10	18		**	Equity and bond neutral
	PPI Output Core	y/y	nov	2.4%	2.4%	2.3%	**	Equity and bond neutral
Russia	PPI	y/y	nov	16.8%	16.9%	16.9%	**	Equity and bond neutral
AMERICAS								
Mexico	International Reserves Weekly	m/m	dec	$174.081 bn	$174.118 bn		**	Equity and bond neutral
Canada	Manufacturing Sales	m/m	oct	-0.1%	0.2%	0.4%	**	Equity bearish, bond bullish
Brazil	CNI Consumer Confidence	m/m	dec	114.3	113.6		***	Equity bullish, bond bearish

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)	279	280	-1	Up
3-mo T-bill yield (bps)	234	235	-1	Neutral
TED spread (bps)	45	45	0	Neutral
U.S. Libor/OIS spread (bps)	242	241	1	Up
10-yr T-note (%)	2.77	2.76	0.01	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	10	15	-5	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Up
yen	up			Neutral
pound	up			Neutral
franc	up			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
BOJ Policy Balance Rate	-0.100%	-0.100%	-0.100%	On forecast
BOJ 10-yr Yield Target	0.00%	0.00%	0.00%	On forecast
Bank of England Bank Rate	0.750%	0.750%	0.750%	On forecast
BOE Asset Purchase Target	435 bn	435 bn	435 bn	On forecast
BOE Corporate Bond Target	10 bn	10 bn	10 bn	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	$55.75	$57.24	-2.60%	Bearish EIA report
WTI	$46.88	$48.17	-2.68%	
Natural Gas	$3.83	$3.73	2.82%	
Crack Spread	$15.46	$15.43	0.16%	
12-mo strip crack	$17.14	$17.21	-0.38%	
Ethanol rack	$1.42	$1.42	-0.18%	
Metals				
Gold	$1,255.49	$1,243.08	1.00%	Weaker Dollar
Silver	$14.74	$14.60	1.01%	
Copper contract	$269.65	$271.60	-0.72%	
Grains				
Corn contract	$ 382.50	$ 381.75	0.20%	
Wheat contract	$ 527.50	$ 522.50	0.96%	
Soybeans contract	$ 915.50	$ 913.00	0.27%	
Shipping				
Baltic Dry Freight	1378	1395	-17	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-0.5	-3.3	2.8	
Gasoline (mb)	1.8	1.5	0.3	
Distillates (mb)	-4.2	0.3	-4.5	
Refinery run rates (%)	0.30%	-0.10%	0.0	
Natural gas (bcf)		-144.0		

Weather

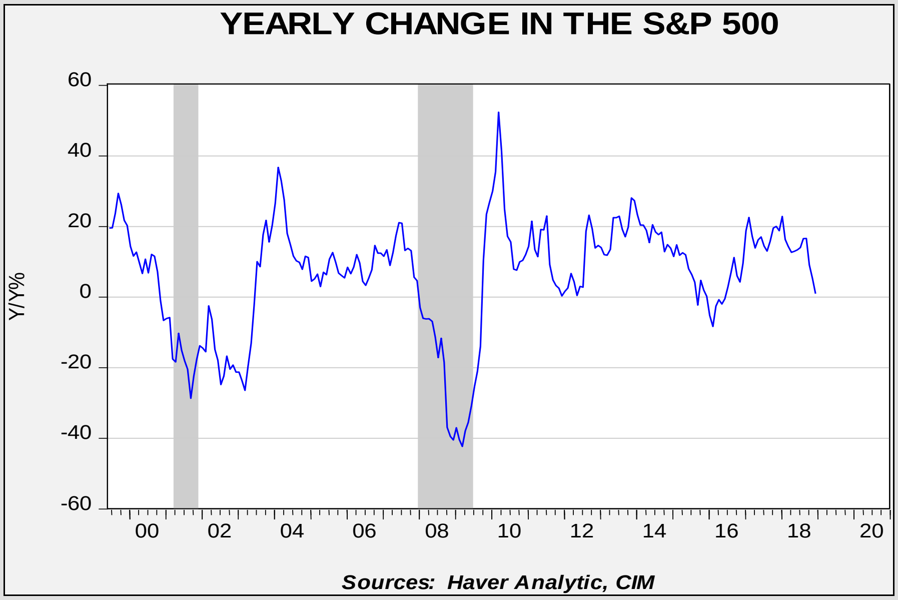
The 6-10 and 8-14 day forecasts show cooler temps for the western region and warmer temps for most of the country. Precipitation is expected for most of the country.

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.

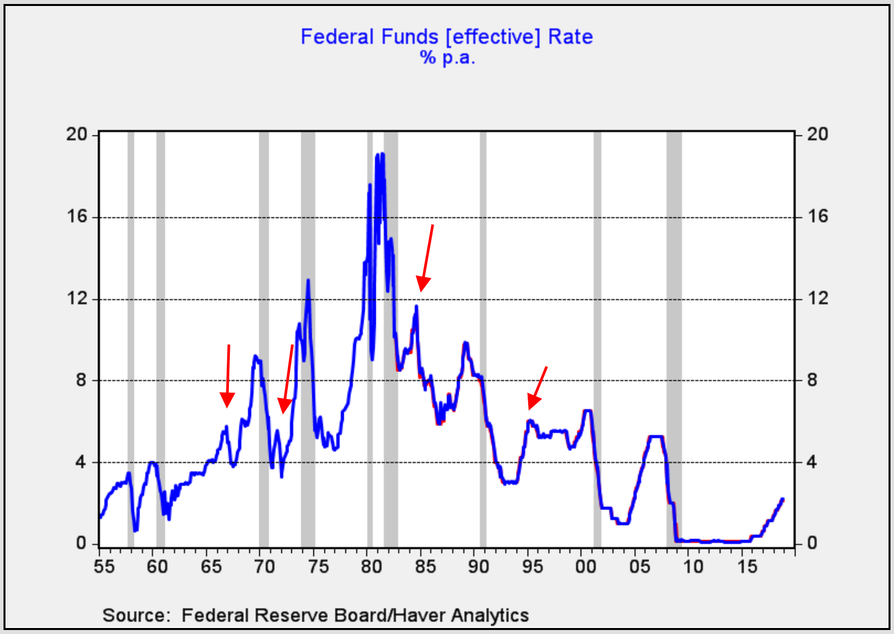
December 14, 2018

Equity markets have come under pressure this autumn. The weakness has gained momentum in recent weeks.



This chart shows the yearly change in the S&P 500 Index on a monthly average basis. We have added recession shading; in general, recessions tend to trigger bear market declines of 20% or more. In fact, every decline of this magnitude has been associated with a downturn in the business cycle since the 1987 Crash.

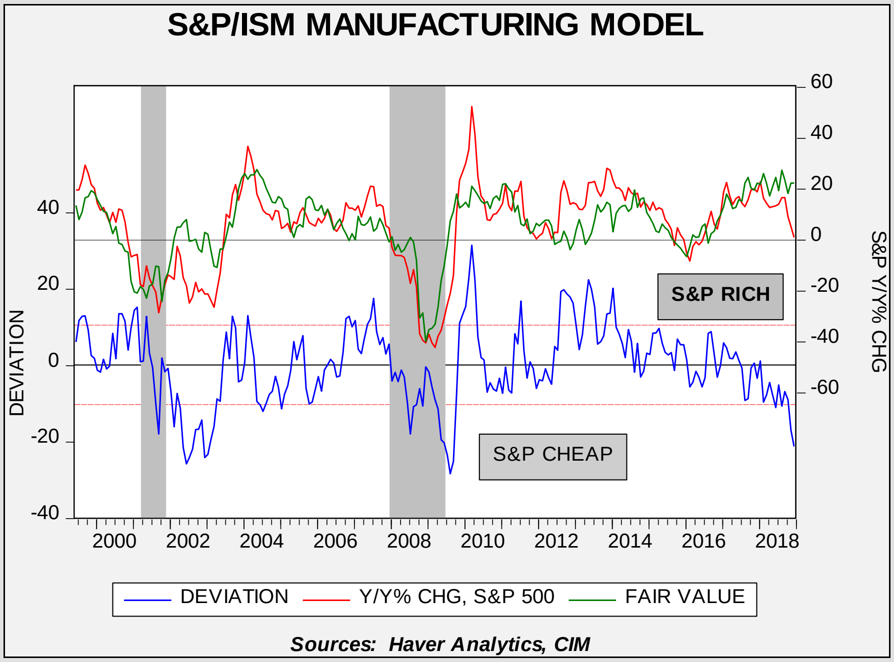
There have been two sources of recent weakness. The first is fear that the Federal Reserve will make a policy error and trigger a recession. These fears are not unfounded. Since the mid-1950s there have been 13 tightening cycles; only four have resulted in a "soft landing," a cycle that didn't trigger a recession.



This chart shows the path of fed funds since 1955, shortly after the central bank became independent of the Treasury. We have placed arrows where tightening cycles didn't bring a downturn. As the chart shows, it's rare for the Fed to avoid a downturn. It should be noted that the second arrow coincided with the Nixon price and wage freeze; Chair Burns likely lowered fed funds in response to the price freeze. Thus, we can make the case that there were only three soft landings that were independently engineered by the Fed.

The second concern is over trade policy. The administration's trade policy threatens to disrupt supply chains tied to China which could lead to shortage and higher prices for various goods. The impact of this outcome is very difficult to estimate; we haven't had an aggressive policy of trade impediments since the 1920s. At the same time, it should be noted that trade frictions are partly a negotiating stance. These issues can be adjusted given the economic and political climate. Since next year is the last full year before elections, we would not be surprised to see some moderation of the Trump administration's stance on trade policy.

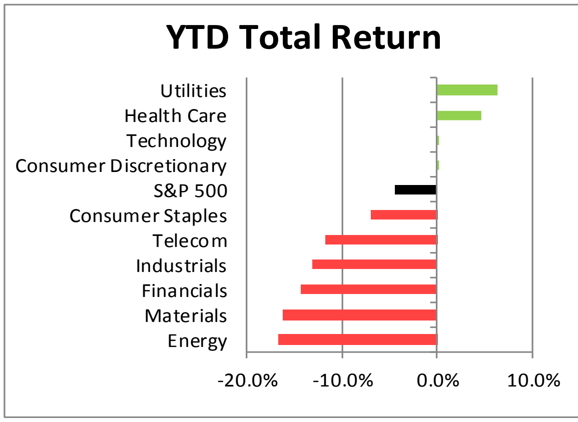
If the FOMC does manage to bring a fifth soft landing and we see some moderation of trade policy, the equity market may be poised for a recovery. Since the late 1990s, the ISM manufacturing index has been a reasonably good indicator of the S&P 500.

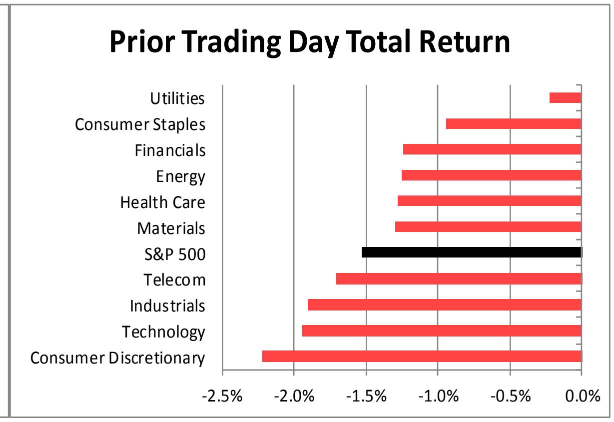


This chart compares the yearly change in the S&P 500 Index monthly average against the ISM Manufacturing Index. The equity index, relative to the perspective of U.S. manufacturing purchasing managers, should be up 22.1% from last year; that would put the index at 3259.27. Not only that, but the current reading is at levels consistent with recession. This analysis suggests that if recession is avoided in 2019 then the equity market could be poised for a strong recovery. Essentially, this model is saying there is a disconnect between the economy and equities. These disconnects occur occasionally but the current one stands out as extreme. Therefore, there may be more risk to reducing equity exposure in the current turmoil.

Data Section

U.S. Equity Markets – (as of 12/19/2018 close)

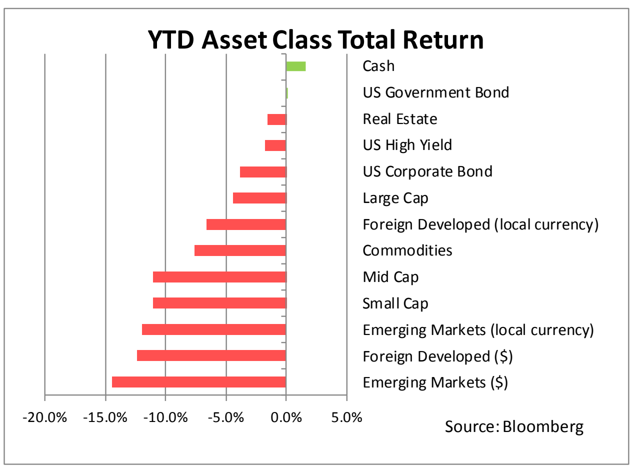




(Source: Bloomberg)

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 12/19/2018 close)

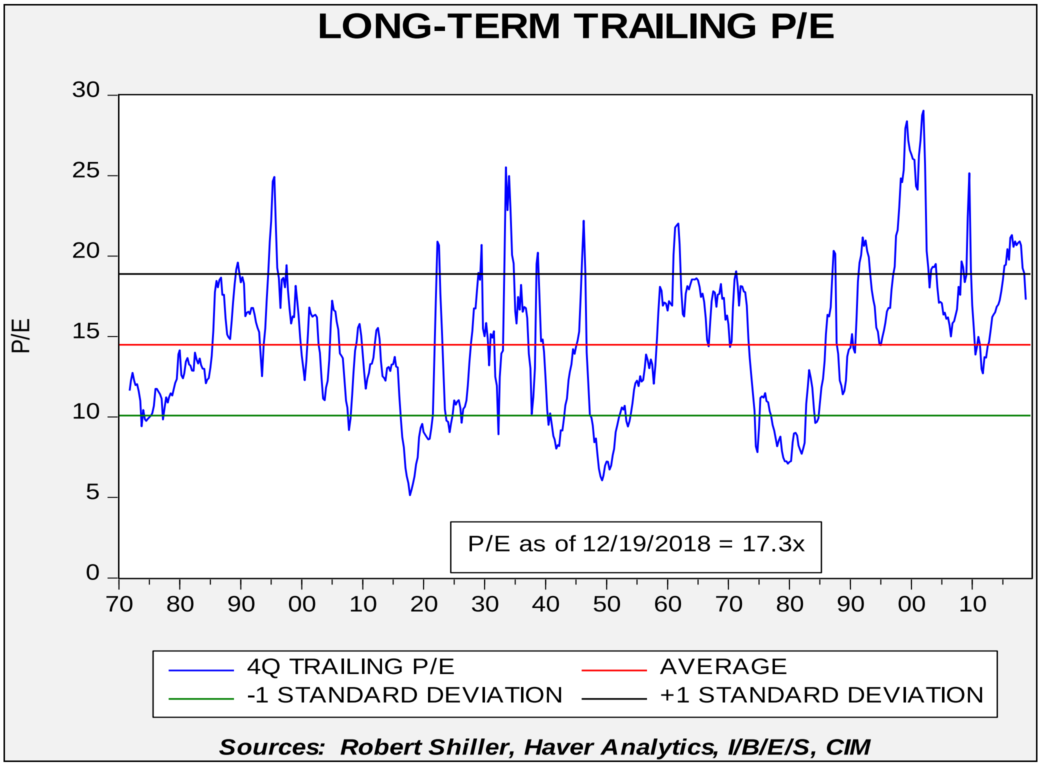


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 20, 2018



Based on our methodology,[3] the current P/E is 17.3x, down 0.1x from our last reading. Weaker prices led to the contraction of the multiple.

[3] 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.