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 21, 2018—9:30 AM EST] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.5% from the last close. In Asia, the MSCI Asia Apex 50 was up 1.0% from the prior close. Chinese markets were lower, with the Shanghai composite down 0.8% and the Shenzhen index down 1.0%. U.S. equity index futures are signaling a lower 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.

Happy Winter Solstice! It's another risk-off day—Washington unrest is the catalyst. Here is what we are watching this morning:

Washington unrest: Although spending any time watching cable news could lead one to think that Washington is always in crisis, what is going on now is actually chaotic. Here is the rundown:

***Shutdown*:** It appeared the White House and Congress had a deal. In fact, a large number of senators headed home after voting for a spending bill, thinking the issue was resolved. The president, however, changed his mind and demanded border wall funding. The House did vote for the measure but it has no chance in the Senate. And so, we are heading into a partial shutdown. Usually, financial markets pay little mind when we have a shutdown outside of a debt ceiling issue. However, the sudden shift from an agreement to no deal has undermined investor confidence, which is already fragile. The president indicated that the shutdown could last a long time; that outcome could eventually start delaying data releases, which would further unsettle conditions (imagine no employment data for a month, or relying on the API for energy data).

***Mattis*:** General Mattis was the last constituent of the "committee to save America,"[1] members of the administration representing the establishment who saw themselves as the primary barrier preventing the president's populist instincts from running rampant. Since the president's

[1] https://www.axios.com/the-committee-to-save-america-1513304754-2e4002e8-5720-422a-a668-8db4210785fb.html

election, we have noted the continued battle between the establishment and the populists within his administration. The establishment pushes for business and market-friendly policies, such as tax cuts and deregulation. It opposes the populist goal of deglobalization, which includes trade impediments and immigration restrictions. The president has tended to straddle these divisions; the establishment has clearly benefited from tax cuts and deregulation, but the populists cheer the tariffs, tough talk on the border and anti-immigration stance of the White House.

In terms of foreign policy, populists want to reduce the American superpower role while the establishment supports continued American hegemony. That means continuing to freeze the three conflict zones,[2] which include the Middle East. This policy goal has been coming under pressure well before Trump took office. The Middle East became unstable after Bush removed Saddam Hussein from power and led Iraq into civil war. President Obama's support for the Arab Spring led to civil conflict in Syria. The decision not to enforce the "red line" against Assad for using chemical weapons further weakened the U.S. position in the region. The power vacuum led to the rise of IS and prompted the U.S. to insert troops in the region to weaken this group. Russia has reasserted itself in the region. Iran is attempting to expand its influence. Saudi Arabia has been courting the U.S. to undermine the Obama-era policy of normalizing relations with Iran.

So, it's not like President Trump inherited a well-functioning policy. However, removing U.S. troops from Syria ensures the U.S. will have even less influence in the region.[3] Secretary Mattis opposed removing the troops, but the president exercised his prerogative and ordered the withdrawal of the 2,000 American troops in the area. Mattis apparently saw this as his red line and resigned. And, he didn't just resign—his exit letter lacked any of the usual expressions of gratitude to the president and instead offered a stinging rebuke.[4] In the letter, Mattis defended the Liberal World Order of free trade and support for allies—in other words, the policy the U.S. has followed since the end of WWII. Essentially, Mattis is indicating that, in his view, the president doesn't support that policy, while Mattis does, and it is probably better for the president to have a defense secretary who has views consistent with his own.[5] Already, U.S. allies are viewing the resignation with trepidation.[6]

This exit isn't just the normal flow in and out of an administration. Mattis is signaling to the GOP establishment that Trump is turning populist and the members of the establishment have to start considering their options. And, we are seeing some pushback. Sen. Ben Sasse, who has been critical of the president, was critical on this issue, too.[7] Sen. Lindsey Graham, who has had

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[2] For a more in-depth discussion, see our WGR, The Mid-Year Geopolitical Outlook (6/25/18).

[3] https://www.nytimes.com/2018/12/20/world/middleeast/syria-us-withdrawal-iran.html?emc=edit_mbe_20181221&nl=morning-briefing-europe&nlid=567726720181221&te=1

[4] https://www.politico.com/story/2018/12/20/mattis-to-retire-in-february-trump-says-1072150

[5] https://www.bloomberg.com/opinion/articles/2018-12-21/mattis-resigns-and-puts-trump-s-presidency-in-peril?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top

[6] https://www.nytimes.com/2018/12/20/world/asia/mattis-resign-afghanistan-withdrawal-trump.html?emc=edit_mbe_20181221&nl=morning-briefing-europe&nlid=567726720181221&te=1

[7] https://www.sasse.senate.gov/public/index.cfm/press-releases?ID=A6A8DA56-49E5-44B3-8E76-25CD20A2D182&utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top

an on and off relationship with the president, is in a full-on Twitter feud with the White House.[8] However, perhaps the most unexpected response came from Sen. Mitch McConnell, who has generally been supportive of the president; he was actually rather critical of the decision that led Mattis to resign.[9] Mattis represented, to some degree, a member of the administration that the establishment could look to for comfort. That is now gone.

We will be watching how far this establishment rebellion goes. Already we are seeing Sen. Grassley push back on steel and aluminum tariffs as part of USMCA.[10] The shutdown will likely anger Senate Republicans. At the same time, the president seems to be moving into an increasingly populist stance this year. The trade conflict began in earnest in February. The removal of troops is classic Jacksonian policy, who like to fight wars with overwhelming force and clear endings. The president is planning on drawing down troops in Afghanistan,[11] likely opening up the country for the return of the Taliban.

Our view is that President Trump has been attempting to placate both the populists and the establishment but he is steadily being forced to choose. If he decides to go populist, he will lose support in the Senate which may hurt him if impeachment occurs. At the same time, his victory was mostly due to populist support. The president has a difficult political path to hew. It may be difficult to pull off. But, the more he leans populist the greater the risk to equity markets. It would make sense to delay this conflict as long as possible but it appears that option may not be available. Thus, we will continue to closely watch how this situation evolves.

China: The U.S. has accused two Chinese nationals of a series of cyberattacks on the U.S.[12] Other nations have made similar accusations. So far, the U.S. and China have kept trade talks separate from security issues. But, that condition may not last. China has announced further measures to boost the economy, which has slowed due to earlier deleveraging and trade issues.[13] Although China has been buying more American soybeans, thus far it has not purchased U.S. crude oil.[14] That fact has likely added to recent crude oil weakness.

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[8] https://www.postandcourier.com/politics/lindsey-graham-and-president-trump-are-feuding-on-twitter-and/article_a1e66484-0490-11e9-baee-df7f0ecc2475.html

[9] https://twitter.com/senatemajldr?ref_src=twsrc%5Egoogle%7Ctwcamp%5Eserp%7Ctwgr%5Eauthor&utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top

[10] https://www.axios.com/chuck-grassley-trump-tariffs-section-232-national-security-613bb759-acac-4a36-9703-9a2ee1958f28.html

[11] https://www.nytimes.com/2018/12/20/us/politics/afghanistan-troop-withdrawal.html?emc=edit_mbe_20181221&nl=morning-briefing-europe&nlid=567726720181221&te=1

[12] https://www.nytimes.com/2018/12/20/us/politics/us-and-other-nations-to-announce-china-crackdown.html?emc=edit_mbe_20181221&nl=morning-briefing-europe&nlid=567726720181221&te=1 and https://www.ft.com/content/f5f0b42c-046c-11e9-99df-6183d3002ee1?emailId=5c1c6e9b0e56a1000466bc18&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

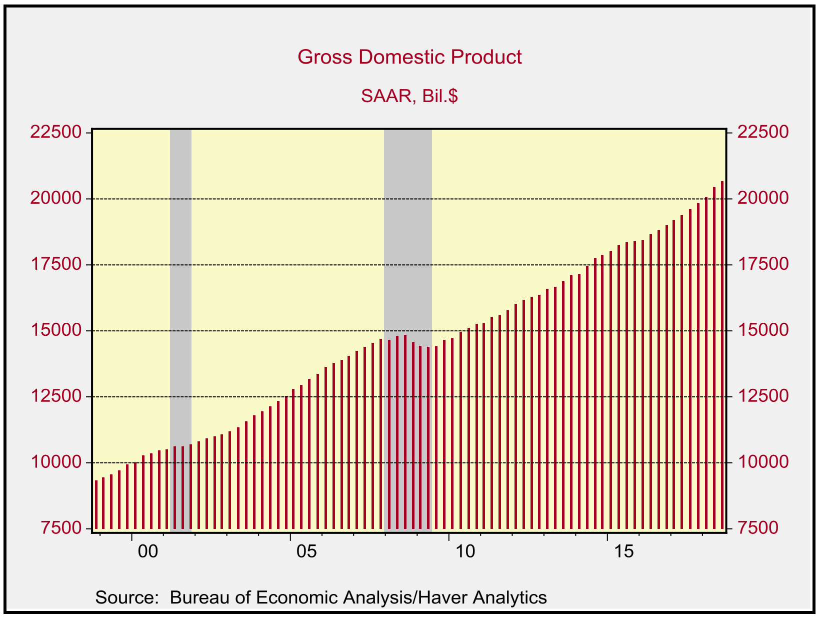
[13] https://www.bloomberg.com/news/articles/2018-12-21/china-says-more-tax-cuts-coming-signals-easier-monetary-policy?utm_source=google&utm_medium=bd&cmpId=google

[14] https://www.reuters.com/article/us-usa-trade-china-oil/crude-refusal-china-shuns-u-s-oil-despite-trade-war-truce-idUSKCN1OK0FG

Brexit: According to reports, PM May is building options in case her Brexit proposal fails. This may include delaying the exit,[15] a new referendum or new elections.[16] Given that deadlines didn't improve the chances of her plan, it probably makes sense to consider other options. We still expect another referendum with the increased chance that Brexit may be rescinded.

U.S. Economic Releases

The third reading of Q3 GDP came in below expectations at 3.4% compared to the forecast of 3.5%. Personal consumption came in below expectations at 3.5% compared to the forecast of 3.6%. Core PCE rose 1.6% from the prior quarter. The overall GDP price index rose 1.8% compared to the forecast of 1.7%.



The chart above shows historical GDP. As of right now, GDP continues to grow at a solid pace.

	Q3 2018 Third Reading	Q3 2018 Second Reading	Difference
GDP	3.4%	3.5%	-0.1%
Consumption	2.4%	2.5%	-0.1%
Investment	2.5%	2.5%	0.0%
Inventories	2.3%	2.3%	0.1%
Net Exports	-2.0%	-1.9%	-0.1%
Government	0.4%	0.4%	0.0%

The table above shows the contributions to GDP. There was a downward revision in consumption and net exports.

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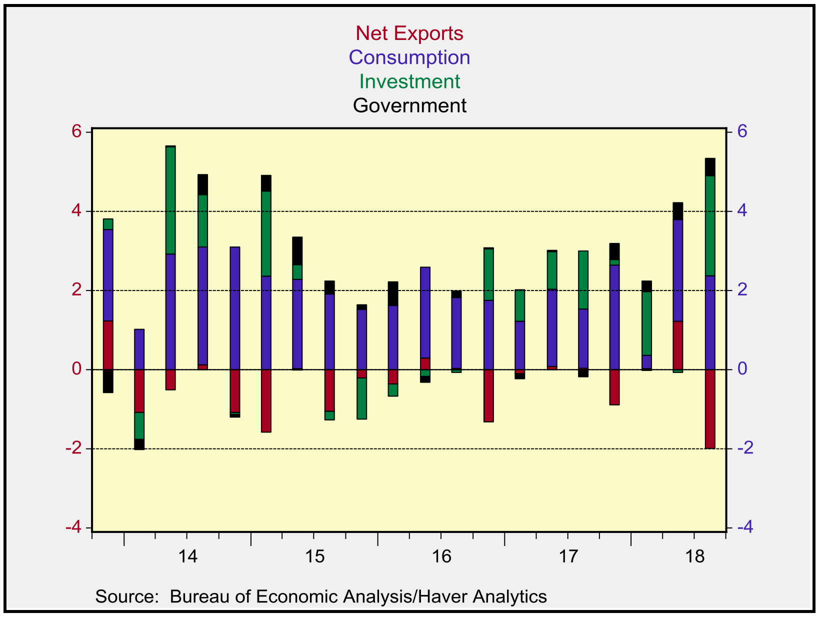
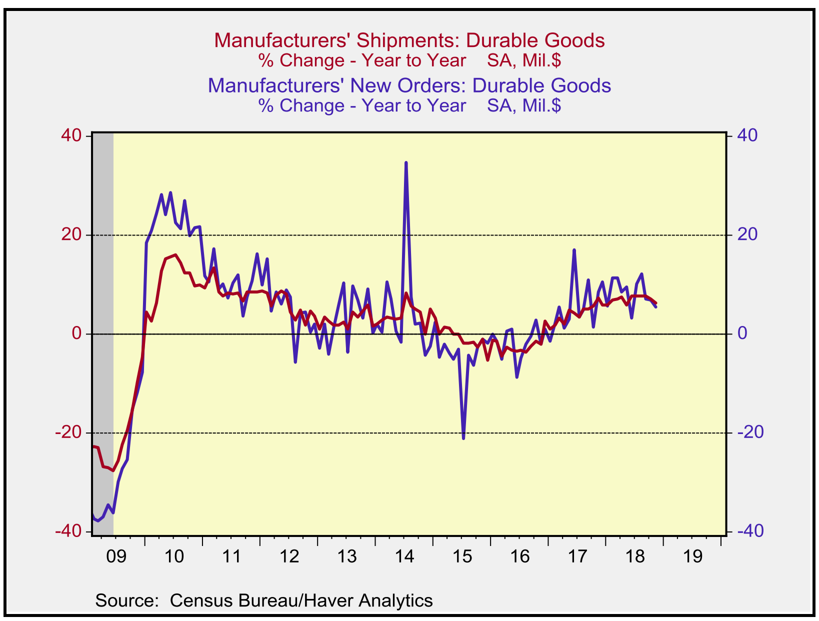
15 https://www.ft.com/content/e8d70ba8-03a7-11e9-99df-6183d3002ee1?emailId=5c1c6e9b0e56a1000466bc18&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

16 https://www.bloomberg.com/news/articles/2018-12-20/u-k-s-may-is-hatching-secret-brexit-plan-b-to-avoid-armageddon



This chart above shows the contributions graphically. Net exports was the only negative component in Q3 GDP. Investment was boosted by a sharp rise in inventories.

November durable goods orders came in below expectations, rising 0.8% from the prior month compared to the forecast gain of 1.6%. Durables ex-transportation came in below expectations, falling 0.3% from the prior month compared to the forecast gain of 0.3%. The prior report was revised upward from 0.2% to 0.4%. Capital goods orders non-defense ex-air came in below expectations, falling 0.6% from the prior month compared to the forecast gain of 0.2%. The prior report was revised from 0.0% to 0.5%. Capital goods shipments non-defense ex-air came in below expectations, falling 0.1% from the prior month compared to the forecast rise of 0.2%.



The chart above shows the annual change in new durable goods orders and shipments. Annually, new orders rose by 5.3%, shipments rose by 6.2%, unfilled orders rose by 4.6% and inventories rose by 4.7%.

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

Economic Releases							
EDT	Indicator			Expected	Prior	Rating
10:00	Personal Income	m/m	nov	0.3%	0.5%	***
10:00	Personal Spending	m/m	nov	0.3%	0.6%	***
10:00	Real Personal Spending	m/m	dec	0.3%	0.4%	***
10:00	PCE Deflator	m/m	nov	0.0%	0.2%	***
10:00	PCE Core	m/m	nov	0.2%	0.1%	***
10:00	U. of Michigan Sentiment	m/m	dec	97.4	97.5	***
10:00	U. of Michigan Current Conditions	m/m	dec		115.2	**
10:00	U. of Michigan Expectations	m/m	dec		86.1	**
10:00	U. of Michigan 1 yr Inflation	m/m	dec		2.7%	**
10:00	U. of Michigan 5-10 Yr Inflation	m/m	dec		2.4%	**
10:00	Kansas City Fed Manufacturing Activity	m/m	dec	13	15	**
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	National CPI	y/y	nov	0.8%	1.4%	0.8%	***	Equity and bond neutral
	National CPI ex Fresh Food	y/y	nov	0.9%	1.0%	1.0%	***	Equity and bond neutral
	Supermarket Sales	m/m	nov	-2.5%	-0.7%		**	Equity bearish, bond bullish
	National Department Sales	m/m	nov	-0.6%	1.6%		**	Equity bearish, bond bullish
	Tokyo Department Store Sales	m/m	nov	0.2%	2.6%		**	Equity bearish, bond bullish
New Zealand	ANZ Consumer Confidence	m/m	dec	121.9	118.6		***	Equity bullish, bond bearish
EUROPE								
Germany	Import Price Index	m/m	nov	3.1%	4.8%		**	Equity and bond neutral
	GfK Consumer Confidence	m/m	jan	10.4	10.4	10.5	***	Equity and bond neutral
France	Business Confidence	y/y	nov	102	104	102	**	Equity and bond neutral
	Manufacturing Confidence	y/y	nov	104	105	103	**	Equity and bond neutral
	Production Outlook Indicator	y/y	nov	-10	4	2	**	Equity bearish, bond bullish
	Own-Company Production	y/y	nov	11	14		**	Equity and bond neutral
	PPI	y/y	nov	2.6%	3.9%		**	Equity and bond neutral
	Consumer Spending	y/y	nov	-2.0%	0.9%	-1.6%	***	Equity bearish, bond bullish
	GDP	m/m	3q	1.4%	1.4%	1.4%	***	Equity and bond neutral
Italy	Manufacturing Confidence	m/m	dec	103.6	104.4	103.8	**	Equity and bond neutral
	Economic Sentiment	m/m	dec	113.1	114.8	114.0	***	Equity and bond neutral
AMERICAS								
Mexico	Retail Sales	y/y	oct	3.0%	4.1%	3.9%	**	Equity bearish, bond bullish
Canada	Wholesale Trade Sales	m/m	oct	1.0%	-0.5%	0.4%	**	Equity bullish, bond bearish
Brazil	Formal Job Creation Total	m/m	nov	58664	57733	30704	***	Equity bullish, bond bearish
	IBGE Inflation	m/m	dec	3.9%	4.4%	3.9%	***	Equity and bond neutral
	Current Account Balance	m/m	nov		$0.329 bn	-$1.846 bn	**	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)	279	279	0	Up
3-mo T-bill yield (bps)	233	234	-1	Neutral
TED spread (bps)	46	45	1	Neutral
U.S. Libor/OIS spread (bps)	242	242	0	Up
10-yr T-note (%)	2.79	2.81	-0.02	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	5	3	2	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Up
yen	up			Neutral
pound	up			Neutral
franc	down			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	$53.10	$54.35	-2.30%	Possible Glut
WTI	$45.41	$45.88	-1.02%	
Natural Gas	$3.64	$3.58	1.48%	
Crack Spread	$14.50	$15.06	-3.70%	
12-mo strip crack	$16.34	$16.94	-3.57%	
Ethanol rack	$1.41	$1.42	-0.21%	
Metals				
Gold	$1,259.43	$1,259.86	-0.03%	
Silver	$14.68	$14.77	-0.58%	
Copper contract	$268.90	$269.65	-0.28%	
Grains				
Corn contract	$ 376.50	$ 375.25	0.33%	
Wheat contract	$ 519.50	$ 523.50	-0.76%	
Soybeans contract	$ 904.75	$ 906.25	-0.17%	
Shipping				
Baltic Dry Freight	1318	1378	-60	
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)	-141.0	-144.0	3.0	

Weather

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

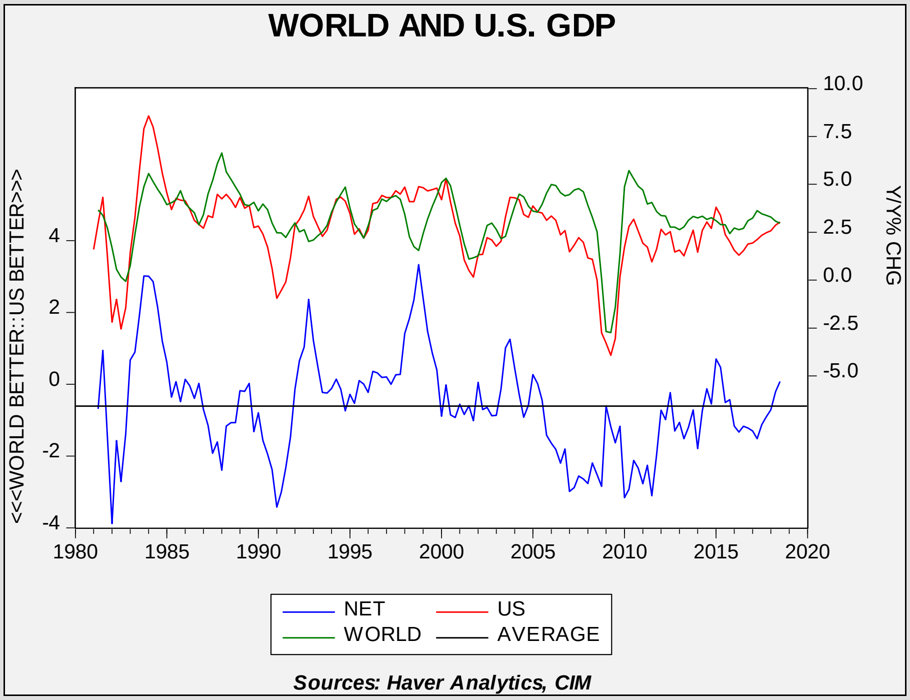
Asset Allocation Weekly Comment

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 21, 2018

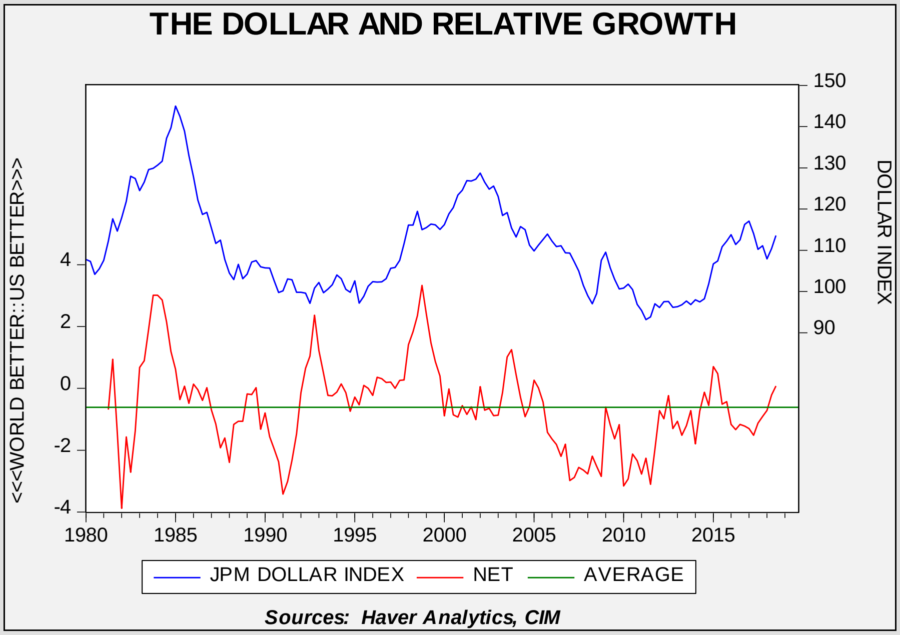
(N.B. This is the last Asset Allocation Weekly for 2018. Have a Merry Christmas and Happy New Year. The next report will be published January 4, 2019.)

The U.S. economy is performing in line with the rest of the world.



This chart shows the yearly change in U.S. and world ex-U.S. GDP. The lower line on the chart shows the difference. On average, U.S. growth is usually 0.61% lower than world growth and the world exceeds U.S. growth 70% of the time (with data since 1981). This situation isn't a huge surprise; the U.S. is the world's largest economy and smaller economies can grow faster more easily. The lower line shows that U.S. growth has been gaining on world growth for the past two years.

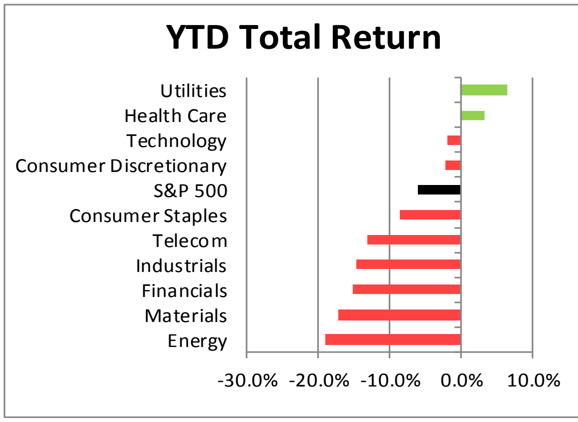
The net number does coincide with dollar cycles.

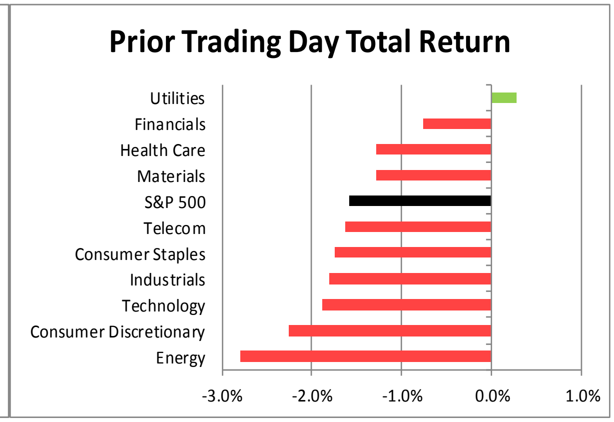


When the growth differential is below average (implying stronger world growth relative to the U.S.), the JPM dollar index averages 107.21. When growth exceeds average, the index averages 113.14. We are projecting slower growth in the U.S. next year, around 2.7%, which is essentially average growth. If world growth also holds near average, around 3.3%, it would be reasonable to expect the dollar to weaken from current levels. The U.S. growth surge in 2015 led to a strengthening dollar and this year's rally was partly due to the lift in U.S. growth due to fiscal stimulus. As that wanes, relative growth should favor the world, which will support a softer greenback. In general, a weaker dollar will tend to support commodities and foreign equities, especially emerging markets. We expect those assets to perform better in 2019.

Data Section

U.S. Equity Markets – (as of 12/20/2018 close)

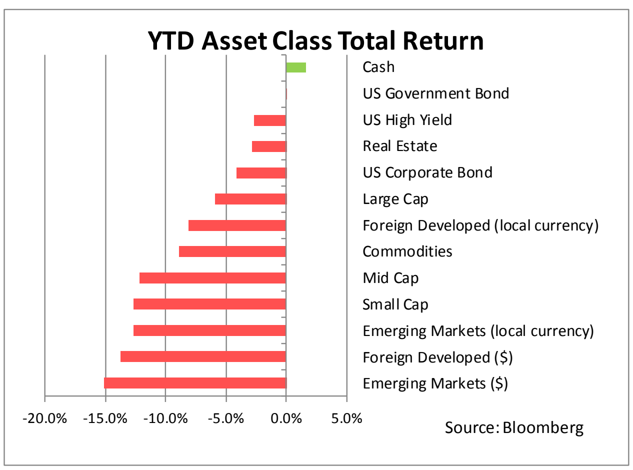




(Source: Bloomberg)

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 12/20/2018 close)

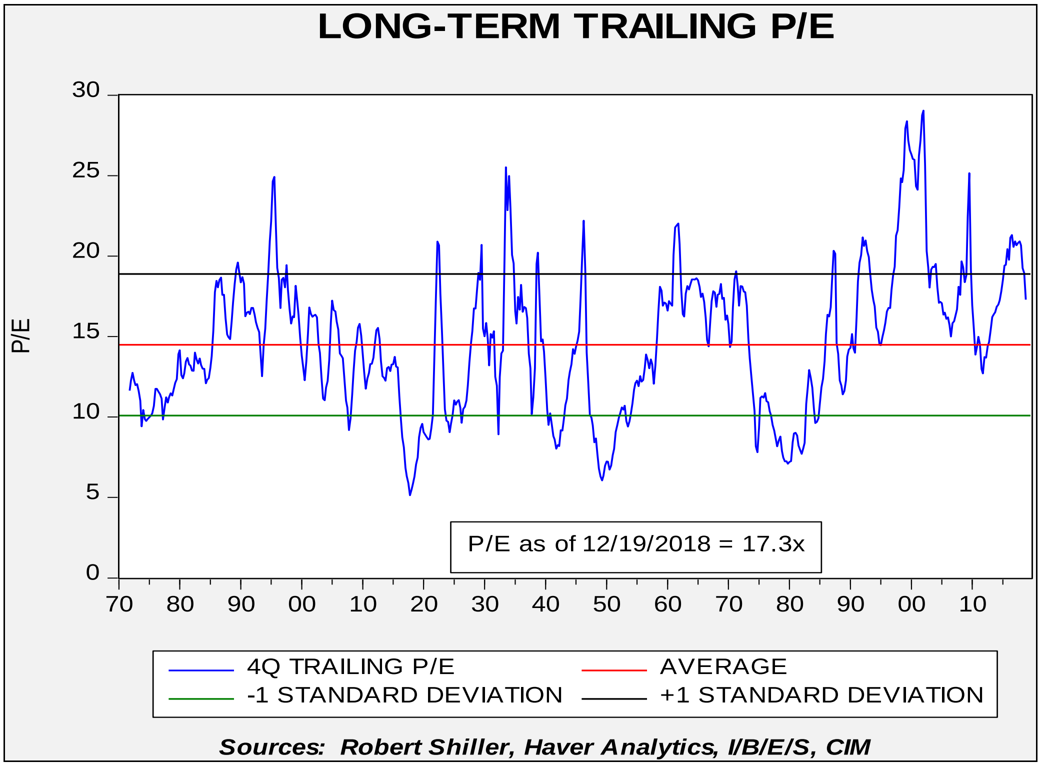


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

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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[17] 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.