Confluence INVESTMENT MANAGEMENT

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 4, 2018—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.5% from the last close. In Asia, the MSCI Asia Apex 50 was unchanged from the prior close. Chinese markets were higher, with the Shanghai composite up 0.4% and the Shenzhen index up 0.4%. U.S. equity index futures are signaling a higher open.

(NB: Due to tomorrow's National Day of Mourning and the closure of financial markets and the government, we will not publish the Daily Comment tomorrow. We will return to our regular schedule on Thursday.)

Good morning! The euphoria of yesterday has dissipated to some degree. Here is what we are watching today:

Trade skepticism: As we noted yesterday, the lack of a unified communique after the Trump-Xi meeting led to both sides reporting different results. President Trump has added to uncertainty with a tweet indicating that China has agreed to eliminate tariffs on U.S. autos.[1] There isn't any evidence (at least, not yet) that such a deal was made. In addition, the White House has appointed Robert Lighthizer to lead upcoming talks with China.[2] He is a hardliner on trade and his appointment to lead the talks, instead of Kudlow or Mnuchin, is a sign that the president intends to keep pressure on China.

As mentioned yesterday, the clock is working against President Trump, assuming he does want to be reelected. If a recession is triggered next year, it will deeply weaken his chances of winning reelection in 2020. It is obvious that trade worries are dampening the financial markets; the effects on the economy are still at the anecdotal level, but even this evidence suggests that the sluggish level of investment may be tied to trade uncertainty.[3] The political calculation that the president might be making is whether the value of being hard on China is enough to offset a much weaker economy. History suggests that a recession would be a death knell for reelection, but the situation with China is somewhat unique. Our position is that the president should avoid recession at all costs, thus tamping down the trade issue for the next year or so would be prudent. Appointing Lighthizer suggests that probably isn't the president's thinking.[4]

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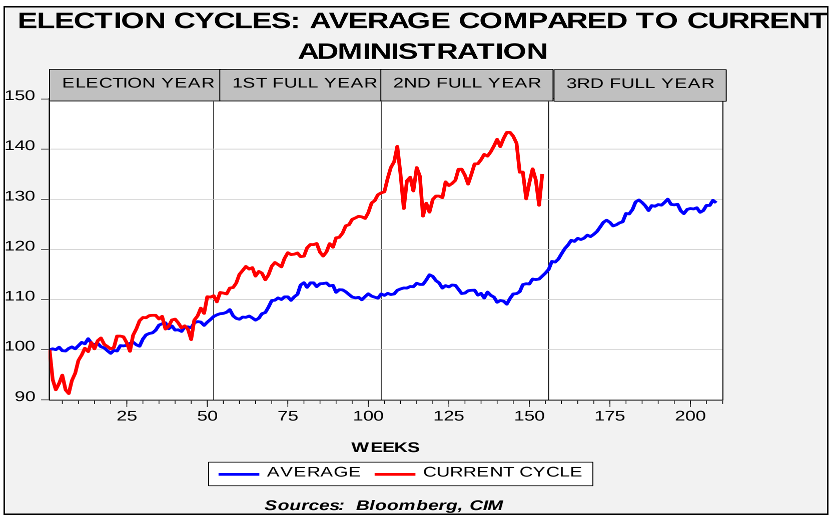
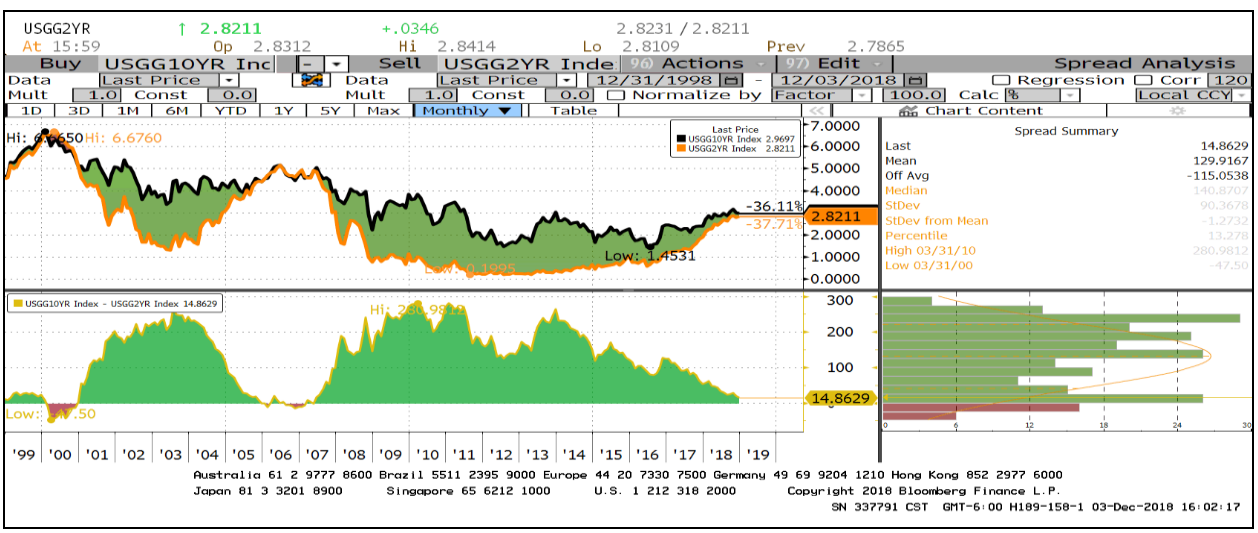
[1] https://www.bloomberg.com/news/articles/2018-12-03/trump-s-advisers-struggle-to-explain-deal-he-says-he-cut-with-xi
[2] https://www.politico.com/story/2018/12/03/trump-china-relations-trade-pact-1037425
[3] https://www.nytimes.com/2018/11/28/magazine/trade-war-tariffs-small-business.html
[4] https://www.wsj.com/articles/lighthizerhas-long-seen-chinese-trade-policy-as-unfair-to-u-s-1543860249

The chart below shows the election cycle with the current government. To build this data, we take weekly data for the S&P 500 beginning in 1928 and index each four-year period to 100. The blue line shows the average market performance. The midterms occur near the end of the second full year. Note that, on average, the market rises nearly 20% from late October of the midterm year into summer of the year before the election year. This pattern isn't an accident; presidents tend to "pump prime" the economy going into that year to help the reelection process. President Trump has actually done the pump priming early, but that doesn't mean he won't continue the process. We would not be at all surprised to see an infrastructure deal made to boost growth. However, if the trade situation becomes a depressant on the economy, it could hurt his election chances. That's why it would be logical to ease up on trade, but just because it's logical doesn't mean it will happen.

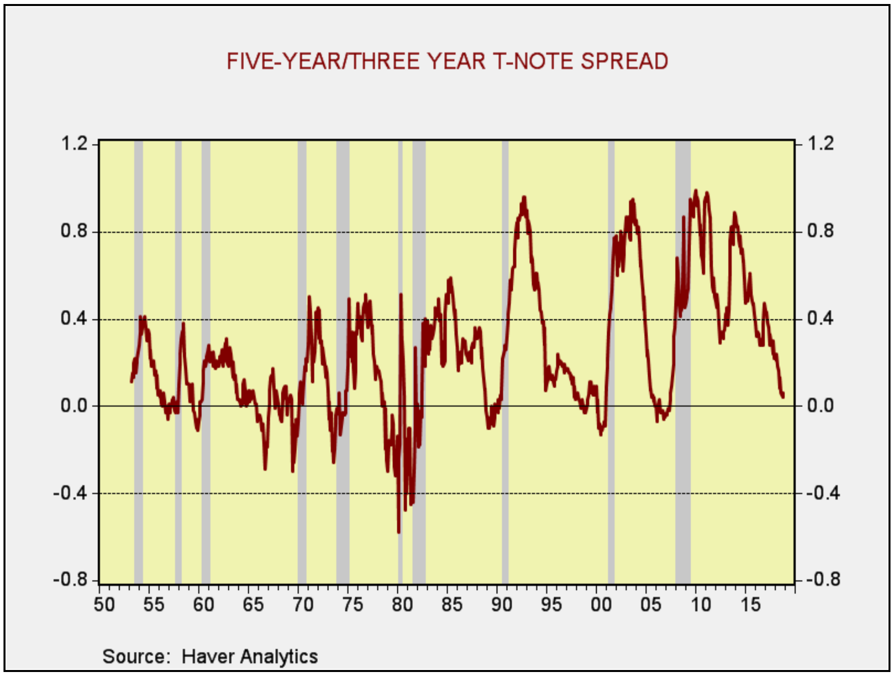


The yield curve: There have been some ominous developments in the interest rate markets in the past 72 hours. First, the two-year/10-year T-note spread has dipped under 15 bps, nearing inversion.



(Source: Bloomberg)

Note that the two-year yield has been rising much faster than the 10-year yield. This is consistent with policy tightening. Second, the three-year/five-year T-note spread, which is much less monitored, has actually inverted. The chart below shows a history of that data.



Although this spread gave a couple of false positives (e.g., 1965, 1998), it is generally reliable. The FOMC is treading into difficult waters.

Given the reliability of the yield curve in predicting the business cycle, the financial media will enter a "hair on fire" moment with every pundit suggesting trouble ahead. That isn't to say that we won't be concerned as well. But, we offer a couple of caveats. First, as we discussed in the June 29th Asset Allocation Weekly,[5] yield curve inversion doesn't mean the equity markets immediately go negative. In fact, using the 2/10 spread from the late 1960s, equities rise for about nine months on average after inversion and, in some cases, equities remain above the level at inversion for at least two years. Thus, inversion is a real concern but may not be immediately negative. Second, the general public's increased focus on the yield curve may lead policymakers afoul of Goodhart's Law, which states, ***"Any observed statistical regularity will tend to collapse once pressure is placed on it for control purposes."***[6] We could very easily see the FOMC use the yield curve to guide policy and thus take the necessary steps to avoid inversion, upending the predictive value of the relationship.

Still, the near inversion is a worry. The FOMC should pay attention to this and tread carefully.[7]

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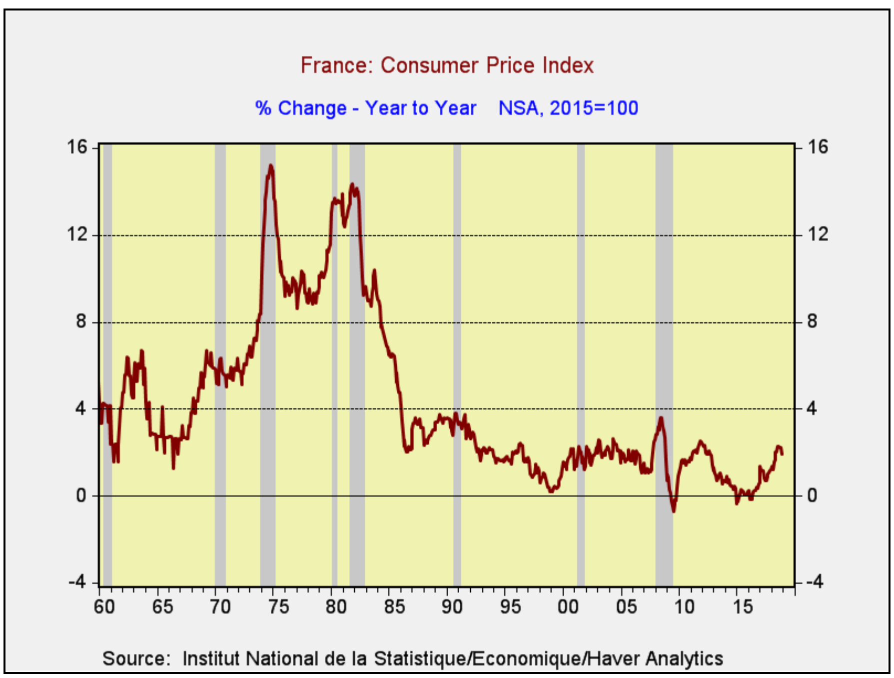
[5] See Asset Allocation Weekly (6/29/18)
[6] https://en.wikipedia.org/wiki/Goodhart's_law
[7] https://www.reuters.com/article/us-usa-fed/as-fed-says-on-track-narrowing-yield-curve-could-complicate-debate-idUSKBN1O22MK

Brexit: In exactly one week, Parliament will vote on PM May's Brexit deal. The odds of passage appear slim; in fact, most observers now say the key is the level of defeat. If the loss is close (< 30 votes), she may be able to go to the EU for adjustments to her deal to improve its odds in a second vote. On the other hand, if the loss is overwhelming (>50 votes), then her plan is doomed as is her government. We then enter a world of binary outcomes—we either get a hard Brexit with catastrophic losses for the GBP and British financial assets or a second referendum that may lead to no Brexit at all, which would trigger a large rally in the aforementioned assets. Interestingly, the European Court of Justice ruled yesterday that the U.K. could unilaterally end Brexit, which increased the attractiveness of another referendum.[8] We are leaning toward another vote; between a hard Brexit and a new vote the odds are probably leaning a bit toward the latter.

Macron backs down: The French government has suspended its fuel tax increase in the face of rising unrest.[9] The *FT* has an interesting report on the incidence of Macron's taxes.[10] The report shows that the bulk of Macron's tax benefits has gone to the richest segment of the income distribution, while the poorest have suffered significantly. This outcome should not have been a shock; this is the essence of neoliberalism, the policies of Thatcher and Reagan. The goal of such policies is to expand the supply side of the economy by rewarding entrepreneurship; it is implemented to contain inflation, not necessarily to spur growth. Why Macron would seek to implement such changes now, nearly four decades after the inflation crisis has passed, is inexplicable.



At the same time, it should come as no surprise that unrest has developed.

[8] https://www.ft.com/content/a17f134a-f79f-11e8-af46-2022a0b02a6c
[9] https://www.ft.com/content/b7ee911c-f79c-11e8-8b7c-6fa24bd5409c
[10] https://www.ft.com/content/b6297b3a-f4bd-11e8-9623-d7f9881e729f

OPEC: The Saudi oil minister indicated this morning that a deal is not in place yet.[11] That news has taken oil off its highs. We still expect a deal to be made but talks continue.

U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below lists the economic releases and Fed events scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Markit US manufacturing PMI	m/m	nov	55.4	55.4	**
10:00	Construction Spending	m/m	oct	0.3%	0.0%	**
10:00	ISM Manufacturing	m/m	nov	57.5	57.7	**
10:00	ISM Prices Paid	m/m	nov		56.8	**
10:00	ISM New Orders	m/m	nov	70.0	71.6	**
10:00	ISM Employment	m/m	nov		57.4	**
	Wards Total Vehicle Sales	m/m	may	17.15 mn	17.50 mn	**

Fed speakers or events		
EST	Speaker or event	District or position
10:30	Lael Brainard Gives Keynote at NY Fed Treasury Market	Member of the Board of Governors
15:00	Robert Kaplan Speaks at Community Forum in Laredo, Texas	President of the Federal Reserve Bank of Dallas

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.

[11] https://uk.reuters.com/article/us-oil-opec/opec-works-on-deal-to-cut-output-still-needs-russia-on-board-idUKKBN1O30Y6

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
Australia	ANZ Roy Morgan Weekly Consumption	m/m	dec	119.5	118.6		**	Equity bullish, bond bearish
	BoP Current Account Balance	m/m	3q	-A$10.7 bn	-A$13.5 bn	-$A10.2 bn	**	Equity bearish, bond bullish
	Net Exports of GDP	q/q	3q	0.4	0.1	0.3	**	Equity and bond neutral
EUROPE								
Eurozone	PPI	m/m	nov	0.8%	0.5%	0.5%	**	Equity bearish, bond bullish
France	Budget Balance	ytd	oct	-87.0 bn	-87.1 bn		**	Equity and bond neutral
Germany	Markit/BME Germany Manufacturing	m/m	nov	51.8	51.6	51.6	**	Equity and bond neutral
U.K.	Markit/CIPS UK Construction	m/m	nov	53.4	53.2	52.5	**	Equity bullish, bond bearish
Switzerland	CPI	y/y	nov	0.9%	1.1%	1.0%	***	Equity bullish, bond bearish
	CPI Core	y/y	nov	0.2%	0.4%	0.4%	***	Equity bullish, bond bearish
AMERICAS								
Mexico	Markit Mexico PMI Mfg	m/m	nov	49.7	50.7		**	Equity bearish, bond bearish
Canada	MLI Leading Indicator	ytd	oct	-0.1%	0.1%		**	Equity and bond neutral
	Markit Canada Manufacturing	y/y	nov	54.9	53.9		**	Equity and bond neutral
Brazil	Industrial Production	y/y	oct	1.1%	-2.0%	2.1%	***	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)	274	274	0	Up
3-mo T-bill yield (bps)	235	233	2	Neutral
TED spread (bps)	38	40	-2	Neutral
U.S. Libor/OIS spread (bps)	238	238	0	Up
10-yr T-note (%)	2.96	2.97	-0.01	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	23	25	-2	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	down			Neutral
pound	up			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBA Official Cash Rate	1.500%	1.500%	1.500%	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	$62.94	$61.69	2.03%	Prospective Production Cuts
WTI	$53.89	$52.95	1.78%	
Natural Gas	$4.43	$4.34	2.03%	
Crack Spread	$14.29	$13.55	5.46%	
12-mo strip crack	$17.16	$16.62	3.24%	
Ethanol rack	$1.42	$1.41	0.43%	
Metals				
Gold	$1,239.29	$1,230.67	0.70%	
Silver	$14.56	$14.39	1.22%	
Copper contract	$281.35	$280.95	0.14%	
Grains				
Corn contract	$ 380.50	$ 382.00	-0.39%	
Wheat contract	$ 517.75	$ 521.25	-0.67%	
Soybeans contract	$ 904.75	$ 905.75	-0.11%	
Shipping				
Baltic Dry Freight	1203	1231	-28	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.3		
Gasoline (mb)		2.0		
Distillates (mb)		2.3		
Refinery run rates (%)		2.90%		

Weather

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

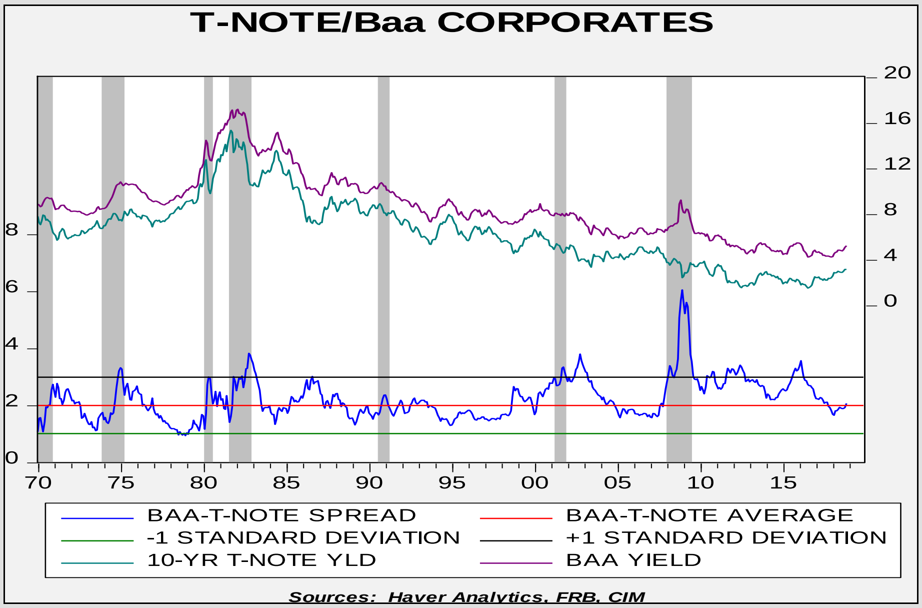
Asset Allocation Weekly Comment

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.

November 30, 2018

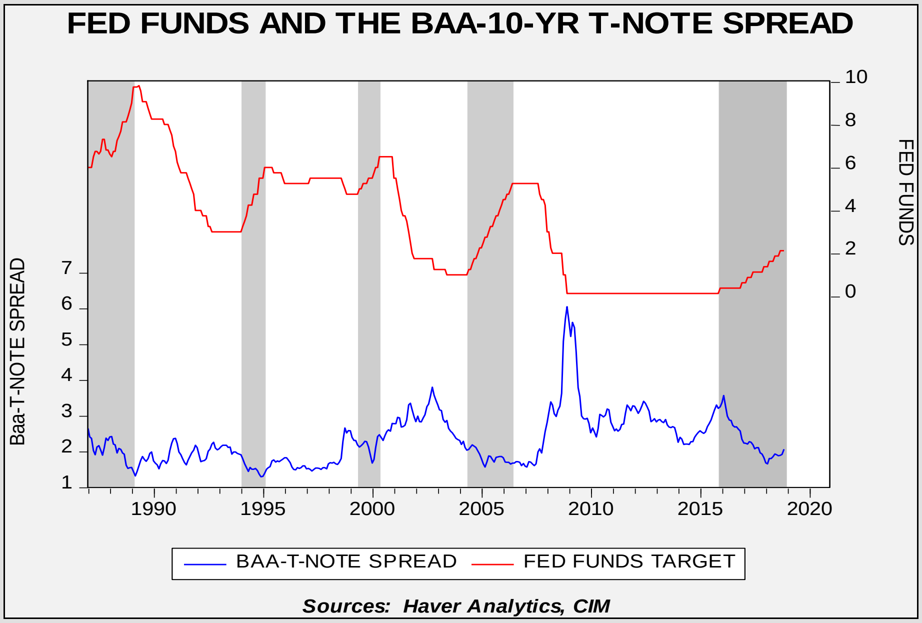
As the FOMC raises rates, there are increasing concerns about the credit markets. After a long period of low rates, credit spreads are starting to widen, raising fears of financial stress. In this report, we will look at these concerns.

First, here is what we are seeing with credit spreads:



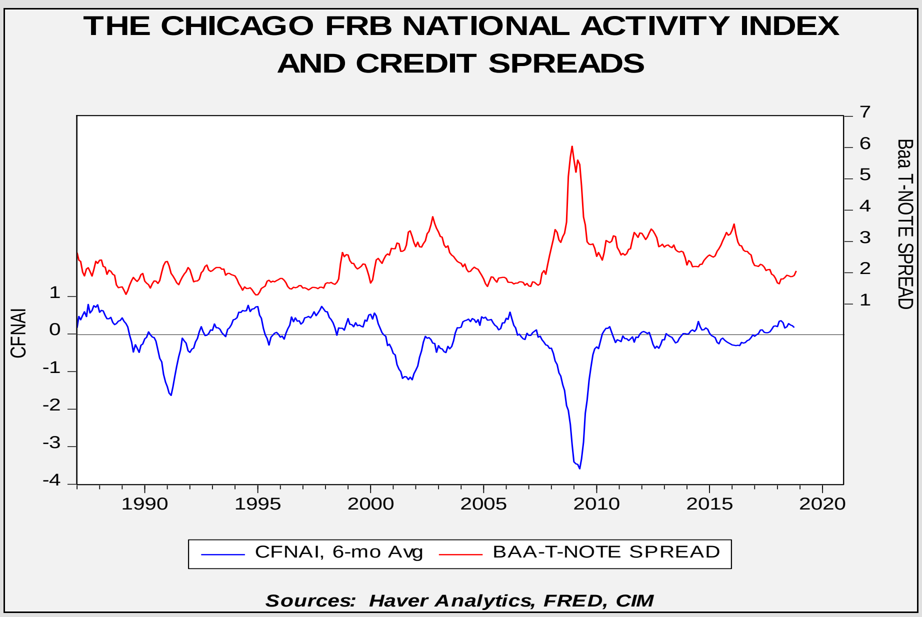
This chart looks at the spread between 10-year T-notes and similar term Baa corporates. The average and standard deviation lines are calculated from 1921. Currently, the spread is about average but it has been widening recently.

Second, here is the impact of monetary policy on credit spreads:

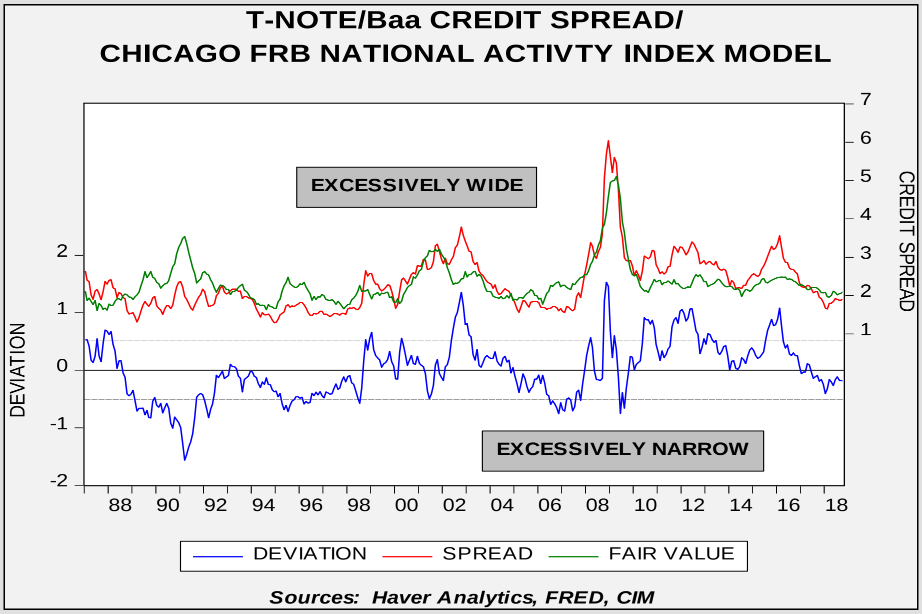


This chart examines credit spreads with periods of policy tightening. Although policy tightening may bring conditions that trigger a widening of credit spreads, in reality, periods of tightening usually coincide with narrowing credit spreads. This is because the FOMC usually raises rates in response to positive economic conditions, which, coincidentally, are also consistent with conditions that support firms' ability to service debt. ***Credit spreads tend to widen when the Fed is easing rates.***

Third, the key trigger to widening credit spreads is economic conditions.



This chart shows the Chicago Federal Reserve Bank's National Activity Index along with the T-note/Baa credit spread. The national activity index uses 85 variables to track the economy; we smooth the raw data with a six-month moving average. A reading of zero indicates an economy growing at trend. Thus, a reading below zero suggests a weakening economy. Note how credit spreads widen when the index dips below zero. The two series are correlated at -71.9%. A regression based on this relationship suggests that the recent widening of the T-note/Baa spread is mostly a rise toward fair value.

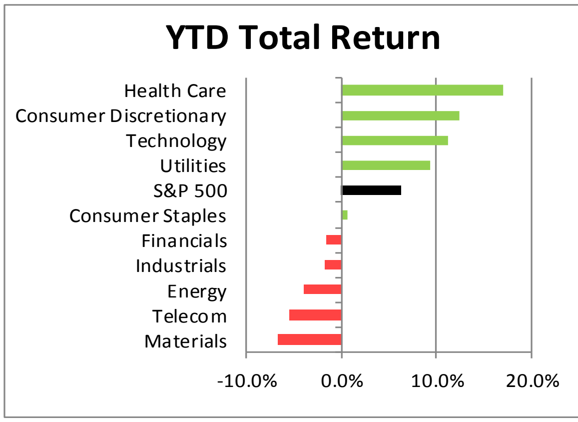


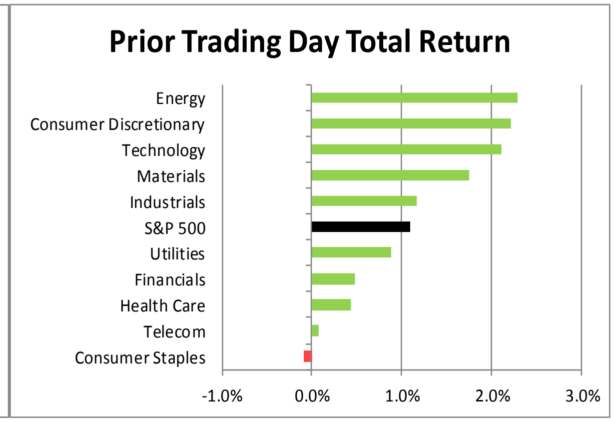
The regression suggests the spread had become too narrow given the performance of the economy. The recent widening has mostly moved the spread back to fair value. Although it is possible the spread could widen further, it would not be justified based on the performance of the economy. For this reason, we still view credit risk as manageable.

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.

Data Section

U.S. Equity Markets – (as of 12/3/2018 close)

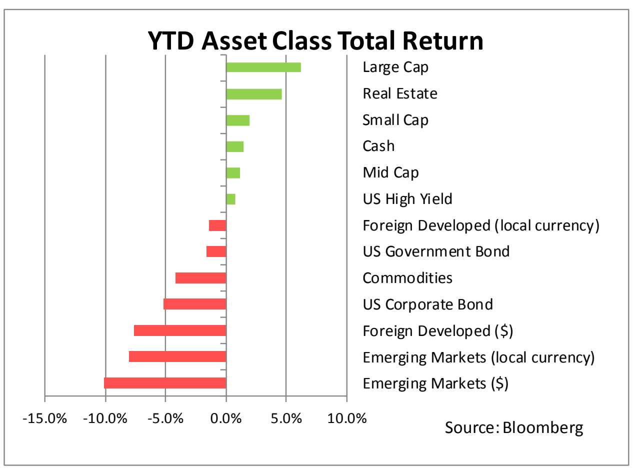




(Source: Bloomberg)

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 12/3/2018 close)

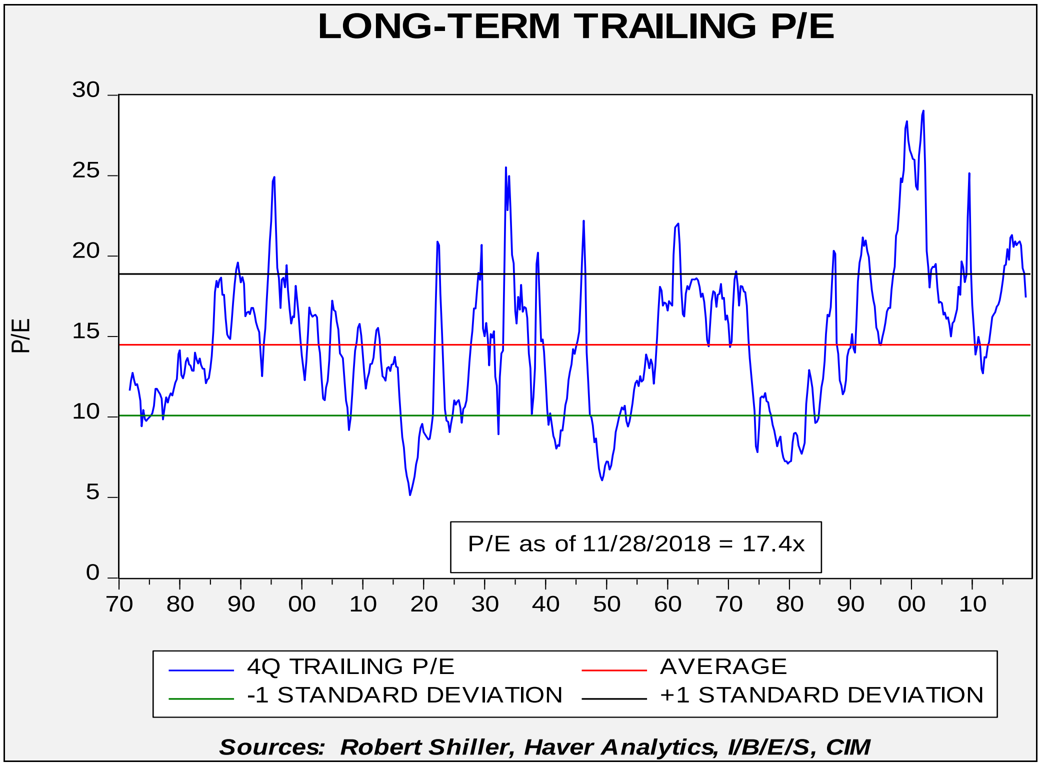


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

November 29, 2018



Based on our methodology,[12] 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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[12] 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.