

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: February 11, 2019—9:30 AM EST] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.9% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.7% from the prior close. Chinese markets were higher, with the Shanghai composite up 1.4% and the Shenzhen index up 2.9%. U.S. equity index futures are signaling a higher open. With 332 companies having reported, the S&P 500 Q4 earnings stand at \$41.50, higher than the \$40.86 forecast for the quarter. The forecast reflects a 13.4% increase from Q4 2017 earnings. Thus far this quarter, 70.1% of the companies reported earnings above forecast, while 21.5% reported earnings below forecast.

U.S. equity futures are trending higher this morning after a later rally on Friday. It's the 40th anniversary of the Iranian Revolution.¹ Here is what we are watching today:

Trade: Talks between China and the U.S. will restart next week; the focus on this round will be intellectual property.² Although last week's dip in equities was tied to reports that Chairman Xi and President Trump wouldn't meet until after the March 1st deadline, that fear has been eased as market participants realize the deadline is artificial and can be extended by the U.S. Reports suggest China is "upbeat" about the talks,³ although there was another U.S. freedom of navigation exercise in the South China Sea that did upset the Chinese. There were reports that the two leaders may meet next month at Mar-a-Lago; the report itself is a good sign of progress.⁴ As we have noted before, the president needs a good economic and market year in 2019 to support his re-election chances.

Chinese economy: Spending during the Chinese New Year was the slowest since 2005 as consumers held back due to rising uncertainty.⁵ Foreign reserves were mostly unchanged in January, with little evidence that the PBOC intervened in the forex markets.

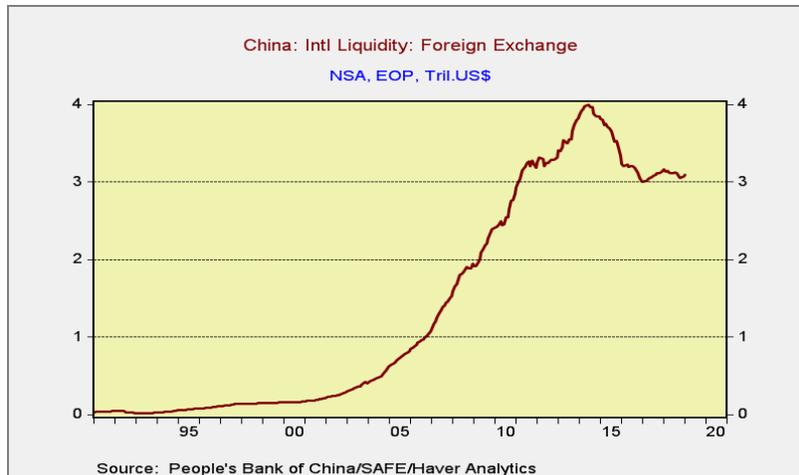
¹ https://www.washingtonpost.com/opinions/2019/02/10/irans-decaying-islamic-republic-is-showing-its-age/?utm_term=.79648e883e6a

² <https://www.reuters.com/article/us-usa-trade-china/u-s-china-trade-talks-resume-next-week-focus-on-intellectual-property-idUSKCN1PX1WI>

³ <https://www.reuters.com/article/us-usa-trade-china/china-upbeat-on-u-s-trade-talks-but-south-china-sea-tensions-weigh-idUSKCN1Q00KQ>

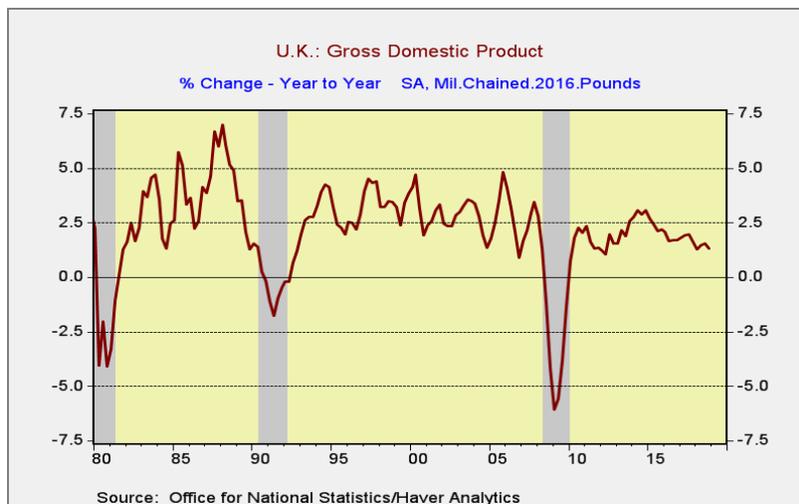
⁴ <https://www.axios.com/newsletters/axios-sneak-peek-c1216ffb-5529-46db-94ac-f3017e693b8c.html?chunk=0#story0>

⁵ <https://www.ft.com/content/67b9203c-2dd3-11e9-8744-e7016697f225>



Another shutdown? Negotiations on the budget have broken down mostly over border security issues.⁶ Although there are fears of another government shutdown, we suspect it will be averted. The president doesn't have the votes to get a border wall through the House; we think odds favor a declaration of a national emergency followed by months of legal maneuvering. This action would allow government funding to go forward. It should be remembered that the U.S. will be facing the debt limit issue by early summer, so the potential for another shutdown looms later this year.

Brexit: The U.K. economy weakened in Q4, with annualized GDP falling to 0.8%, down from 2.4% in Q3. This is the slowest growth since 2012.



This chart shows yearly GDP growth. Worries about Brexit are likely behind the slowing.⁷ Meanwhile, PM May is reaching out to Labour MPs,⁸ offering concessions on workers' rights in

⁶ https://www.nytimes.com/2019/02/10/us/politics/trump-border-wall.html?emc=edit_mbe_20190211&nl=morning-briefing-europe&nid=567726720190211&te=1

⁷ <https://uk.finance.yahoo.com/news/brexit-black-friday-helped-punch-hole-uk-economic-growth-093155177.html>

a bid to build support for her plan. We suspect there is a working majority for May's proposal, just not within her coalition. The best outcome for May would be that Euroskeptic MPs within the Tories, fearful of an even softer Brexit, would then support her plan. A less favorable outcome would be that she gets enough Labour votes to pass her bill but splits the Conservatives. The EU showed a bit of easing as the EU chief negotiator Barnier offered to rework the political declarations. In an *FT* op-ed, Wolfgang Münchau warns that negotiations are likely to go down to the wire and both sides will probably make concessions. He reminds readers that this is normal for negotiations within the EU.⁹

Sanchez in trouble? Spain's PM is facing a crisis over Catalan, the province that has made moves to separate from Spain. Sanchez indicated he would appoint a mediator between the central government and separatists. This has triggered a firestorm¹⁰ that threatens to bring down Sanchez's minority government.¹¹ For background on this issue, we have footnoted two Weekly Geopolitical Reports.¹²

Are right-wing populists taking control of Italy? We have been watching Italy closely as its government is made up of populists from both wings. History suggests that such alignments are difficult to manage, although it remains a goal among notable populist thinkers.¹³ In weekend regional elections, right-wing parties of both the populist variety and center-right overwhelmingly won, taking 48% of the vote, with right-wing populist party The League gaining 28% of the vote.¹⁴ Although one must be cautious about reading too much into one election, the results may be signaling that Italian voters are more inclined toward right-wing populism compared to its leftist variant.

A Thai crisis: In practice, Thailand is governed by three groups—the monarchy, the military and the legislature. The three maintain an uneasy relationship. The military regularly intervenes via coups when the legislature takes a direction it opposes. The monarchy has traditionally remained above the fray, intervening only to reduce tensions between the military and the legislature. That

⁸ <https://www.ft.com/content/2c088e3e-2d19-11e9-ba00-0251022932c8?emailId=5c60e8dce4cb920004977dea&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22>

⁹ <https://www.ft.com/content/2128565a-2ba9-11e9-88a4-c32129756dd8?emailId=5c60e8dce4cb920004977dea&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22>

¹⁰ https://www.politico.eu/article/spains-right-wing-parties-protest-government-talks-with-catalan-nationalists-pedro-sanchez/?utm_source=POLITICO.EU&utm_campaign=31b984c7e7-EMAIL_CAMPAIGN_2019_02_11_05_48&utm_medium=email&utm_term=0_10959edeb5-31b984c7e7-190334489 and https://www.nytimes.com/2019/02/10/world/europe/madrid-protest-spain-catalonia.html?emc=edit_mbe_20190211&nl=morning-briefing-europe&nid=567726720190211&te=1

¹¹ https://www.politico.eu/article/spain-pedro-sanchez-faces-backlash-over-catalan-secessionists-concession/?utm_source=POLITICO.EU&utm_campaign=31b984c7e7-EMAIL_CAMPAIGN_2019_02_11_05_48&utm_medium=email&utm_term=0_10959edeb5-31b984c7e7-190334489

¹² See WGRs, The Situation in Catalonia: [Part I](#) (11/6/2017) and [Part II](#) (11/13/2017).

¹³ A union of right- and left-wing populists is the goal of Ralph Nader. We refer to such alignments as a Nader Coalition. Nader, R. (2014). *Unstoppable: The Emerging Left-Right Alliance to Dismantle the Corporate State*. New York, NY: Nation Books.

¹⁴ https://www.politico.eu/article/right-wing-parties-set-to-win-regional-italian-election-projections/?utm_source=POLITICO.EU&utm_campaign=31b984c7e7-EMAIL_CAMPAIGN_2019_02_11_05_48&utm_medium=email&utm_term=0_10959edeb5-31b984c7e7-190334489

delicate balance was disrupted when King Bhumibol Adulyadej died in October 2016. His son, Vajiralongkorn Bodindradebayavarangkun, succeeded him. Unlike his father, who lived a modest and dignified life, the new king is considered less dignified. After a coup in 2014 put the military in charge, the generals are trying to shift back toward a democracy, but only if they can prevent populists led by the Pheu Thai Party (PTP) from gaining control. In fact, the last two leaders of the PTP have been deposed by coup and live in exile. In a bombshell, Princess Ubolratana Rajakanya, the eldest child of the late king, aligned with the PTP and agreed to run for prime minister.¹⁵ This was a shocking development. There is clearly an uneasy relationship between the military and the PTP; for the royal family to directly support the PTP threatens to undermine the balance in Thai politics. The king has decided to step in to postpone a crisis by forbidding his sister from running for office.¹⁶ Although the princess gave up her royal status by marrying a commoner (an American, BTW), the daughter of the late king is still considered a royal in practical terms. The new king clearly wants to avoid a political crisis. If the PTP wins upcoming elections, tensions will likely rise further.

Another ECB support package? German bond yields continue to spiral lower, with the 10-year falling to 11 bps this morning. The German sovereign yield curve has a negative nominal yield out to nine years as the German and Eurozone economy slows. There are reports that the ECB is considering another round of long-term refinancing operations,¹⁷ a form of QE. This news is lifting European stocks this morning.

In other news: The U.S. is reportedly in direct contact with members of the Venezuelan military, trying to weaken the brass's support for Maduro.¹⁸ There are reports that Russian oligarchs are pressing Putin to end cooperation with OPEC.¹⁹

U.S. Economic Releases

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

Economic Releases		
No economic releases today		
Fed speakers or events		
EST	Speaker or event	District or position
11:15	Michelle Bowman Speaks on Community Banking	Member of the Board of Governors

¹⁵ <https://www.ft.com/content/013f5b92-2d00-11e9-8744-e7016697f225?emailId=5c60e8dce4cb920004977dea&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22> and <https://www.ft.com/content/b7219798-2b4a-11e9-a5ab-ff8ef2b976c7?emailId=5c5d05bdd83b3f00042c1d53&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22>

¹⁶ <https://asia.nikkei.com/Politics/Turbulent-Thailand/Thai-party-accepts-king-s-edict-barring-princess-as-PM-candidate>

¹⁷ <https://www.reuters.com/article/us-eurozone-bonds-tltros-analysis/time-to-tltro-markets-home-in-on-details-of-ecbs-potential-new-booster-idUSKCN1Q00FR?il=0>

¹⁸ <https://www.reuters.com/article/us-venezuela-politics-military-exclusive/exclusive-u-s-in-direct-contact-with-venezuelan-military-urging-defections-source-idUSKCN1PX22L>

¹⁹ <https://www.reuters.com/article/us-oil-opec-russia-rosneft-exclusive/exclusive-russias-sechin-raises-pressure-on-putin-to-end-opec-deal-idUSKCN1PX1R7?feedType=RSS&feedName=businessNews>

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
EUROPE								
France	Bank of France Industry Sentiment	m/m	jan	99	103	103	**	Equity and bond bearish
UK	GDP	y/y	4q	1.3%	1.5%	1.4%	***	Equity and bond bearish
	Private Consumption	q/q	4q	0.4%	0.5%	0.3%	***	Equity and bond neutral
	Government Spending	q/q	4q	1.4%	0.6%	0.5%	***	Equity bullish, bond bearish
	Gross Fixed Capital Formation	q/q	4q	-0.5%	0.8%	-0.1%	***	Equity and bond bearish
	Industrial Production	m/m	dec	-0.9%	-1.5%	-0.5%	***	Equity and bond bearish
	Manufacturing Production	m/m	dec	-2.1%	-1.1%	-1.1%	***	Equity and bond bearish
	Trade Balance	m/m	dec	-3.229 bn	-2.904 bn	-3.000 bn	**	Equity bearish, bond bullish
Switzerland	CPI	y/y	jan	0.6%	0.7%	0.6%	***	Equity and bond neutral
	CPI Core	y/y	jan	0.5%	0.3%	0.3%	***	Equity and bond neutral
AMERICAS								
Mexico	Gross Fixed Investment	y/y	jan	-3.2%	3.4%	-2.4%	***	Equity and bond bearish
	Vehicle Production	m/m	jan	333677	237677		**	Equity and bond neutral
	Vehicle Exports Anfeava	m/m	jan	242299	275045		**	Equity and bond neutral
	Nominal Wages	m/m	jan	5.2%	4.7%		***	Equity bearish, bond bullish
Canada	Housing Starts	m/m	jan	208.0k	213.4k	205.0k	**	Equity and bond neutral
	Net Change in Employment	m/m	jan	66.8k	9.3k	5.0k	**	Equity and bond neutral
	Unemployment Rate	m/m	jan	5.8%	5.6%	5.7%	***	Equity and bond neutral
Brazil	IBGE Inflation	y/y	jan	3.8%	3.8%	3.8%	***	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)	270	270	0	Up
3-mo T-bill yield (bps)	237	237	0	Neutral
TED spread (bps)	33	33	0	Neutral
U.S. Libor/OIS spread (bps)	240	240	0	Up
10-yr T-note (%)	2.65	2.64	0.01	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	9	8	1	Down
Currencies	Direction			
dollar	up			Neutral
euro	down			Up
yen	down			Neutral
pound	down			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	\$62.08	\$62.10	-0.03%	
WTI	\$52.37	\$52.72	-0.66%	
Natural Gas	\$2.68	\$2.58	3.87%	
Crack Spread	\$14.98	\$14.44	3.76%	
12-mo strip crack	\$16.11	\$15.89	1.35%	
Ethanol rack	\$1.42	\$1.41	0.34%	
Metals				
Gold	\$1,306.17	\$1,314.29	-0.62%	
Silver	\$15.71	\$15.82	-0.75%	
Copper contract	\$279.30	\$281.05	-0.62%	
Grains				
Corn contract	\$ 373.50	\$ 374.25	-0.20%	
Wheat contract	\$ 513.75	\$ 517.25	-0.68%	
Soybeans contract	\$ 913.25	\$ 914.50	-0.14%	
Shipping				
Baltic Dry Freight	601	610	-9	

Weather

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

Asset Allocation Weekly Comment

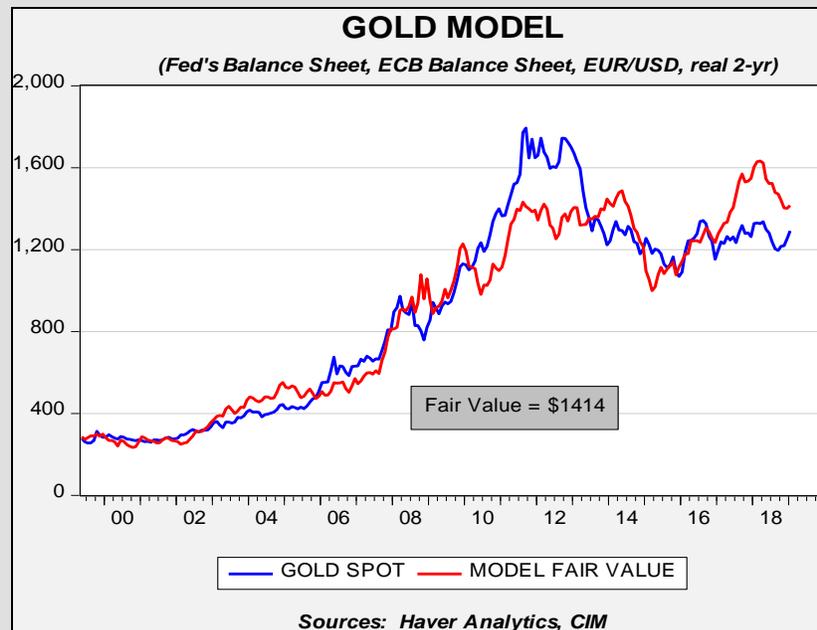
Confluence Investment Management offers various asset allocation products which are managed using “top down,” or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

February 8, 2019

Gold is considered by some to be a commodity, but we treat it as a non-liability-backed currency. In other words, gold isn't created because someone makes a loan. Instead, it is created by mining. In addition, most commodities are consumed but much of the gold refined through the ages still exists. In other words, gold may be “lost” but it is rarely consumed. Even in jewelry, it can return to its bullion state with modest effort.

Instead, gold provides one of the three functions of money. It is rarely used as a medium of exchange and we don't price things in ounces of gold, so it isn't a numeraire. But, it does act as a store of value. Thus, gold demand tends to rise during periods of monetary instability. Monetary instability is partially described as rapid increases in the money supply, currency depreciation and negative real interest rates. When any of these three events occur, they tend to be supportive for gold prices. In other words, gold prices tend to react to excessive money growth, dollar weakness and falling real short-term interest rates.

Our gold model uses the central bank balance sheets of the Federal Reserve and the European Central Bank, the two most frequently used currencies for foreign reserves. We also add the EUR/USD exchange rate as a proxy for the dollar and the real two-year T-note yield.



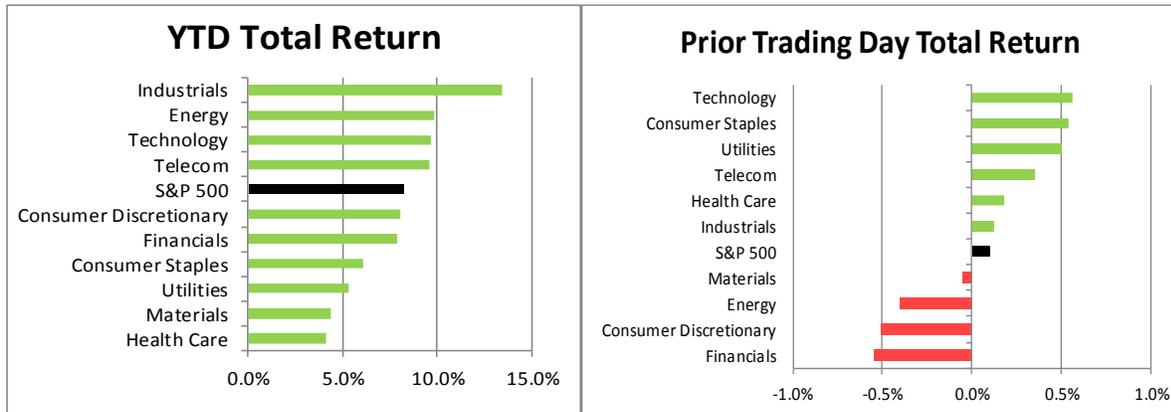
The model's current fair value is \$1,414, suggesting the current price is undervalued. We have seen the fair value decline recently. This is due to the explanatory variables adjusting in a bearish fashion; the Fed's balance sheet is contracting, short-term real interest rates have increased and the dollar has strengthened. However, even taking these issues into account, gold

prices still appear cheap. If our expectations of dollar weakness this year come to pass, the fair value for gold will likely rise. However, given the level of undervaluation, gold should have further upside potential in the coming months.

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

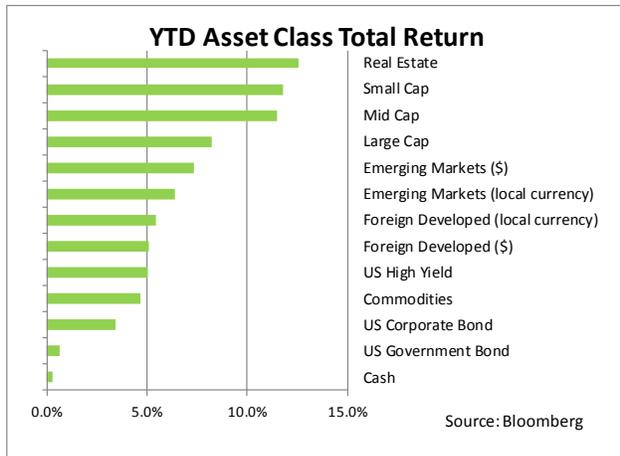
U.S. Equity Markets – (as of 2/8/2019 close)



(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.

Asset Class Performance – (as of 2/8/2019 close)



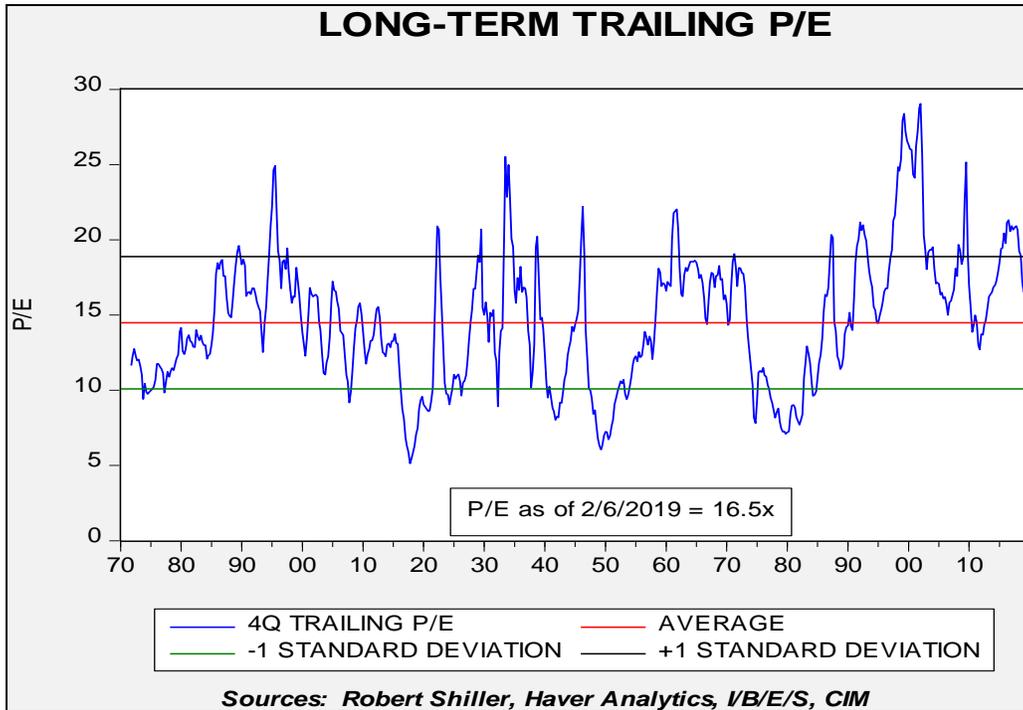
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

February 7, 2019



Based on our methodology,²⁰ the current P/E is 16.5x, up 0.3x from last week. Rising index values and a decline in Q1 earnings expectations led to the rise in 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.

²⁰ 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 two actual quarters (Q2 and Q3) and two estimates (Q4 and Q1). 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.