Daily Comment

By Bill O'Grady, Thomas Wash, and Patrick Fearon-Hernandez, CFA

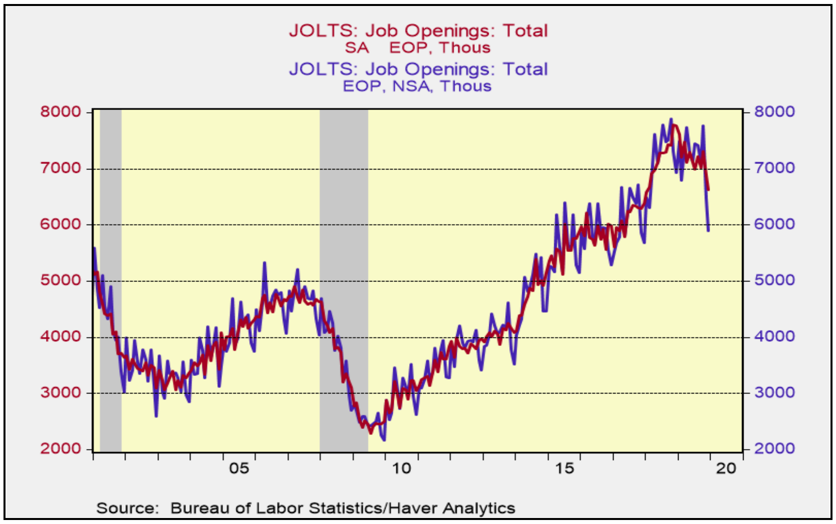
Looking for something to read? See our Reading List; these books, separated by category, are ones we find interesting and insightful. We will be adding to the list over time.

[Posted: February 12, 2020—9:30 AM EST] Global equity markets are higher this morning. The EuroStoxx 50 is currently up 0.5% from its last close. In Asia, the MSCI Asia Apex 50 closed up 0.7%. Chinese markets also continued to recover, with the Shanghai Composite up 0.9% and the Shenzhen Composite up 1.6%. U.S. equity index futures are signaling a higher open. With 322 companies having reported, the S&P 500 Q4 earnings stand at $41.90, higher than the $40.59 forecast for the quarter. The forecast reflects a 2.0% decrease from Q4 2018 earnings. Thus far this quarter, 71.7% of the companies have reported earnings above forecast, while 19.9% have reported earnings below forecast.

It's a rather quiet Wednesday as global equity markets continue their steady rise. We have an update on the COVID-19 virus (it now has an official name), along with some disquieting data from JOLTS and headlines about consumer debt. The EU fires back at the U.K. The NZD rallies. Here are the details:

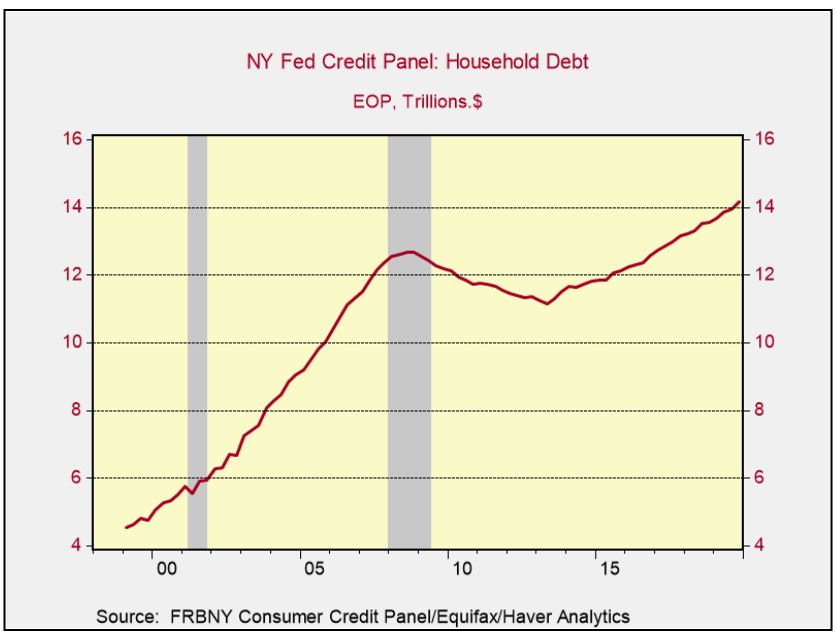
COVID-19: The Wuhan virus now has an official name; this was done by the WHO to reduce the stigma applied to China. However, changing the name doesn't change the general perception. Documented infections are now 45,171 with fatalities at 1,115. There are worries that the diagnostic process is missing a lot of cases. Beijing continues to take aggressive actions to contain the virus, seizing hotels, hospitals and autos to manage the situation. CPC leadership is following a time-worn tactic of blaming local officials for the crisis; this practice was common during the emperor periods. At the same time, General Secretary Xi is expressing concern about the economic damage from the virus, cautioning against an overreaction. Leaders walk a fine line in these situations. President Ford's aggressive reaction to the swine flu in the mid-1970s turned out to be an overreaction as the vaccine proved more dangerous than the illness itself. At the same time, if COVID-19 turns out to be the "big one," warning of overreaction will look incredibly foolish. There is growing worry about supply disruptions; commodities have obviously been adversely affected but drug makers are also worried. Still, overall, financial markets are continuing to look through this issue. In a world with accommodative policy, it is hard to contain risk assets.

JOLTS: The Bureau of Labor Statistics releases a dataset that covers job openings, hires, quits and labor flows. Although the report gets less attention than the payroll and household surveys, it does offer some granular information about the labor market. The number that has caught everyone's attention is a sharp drop in job openings. However, as we show in the chart below, the decline probably had more to do with January than weakness.

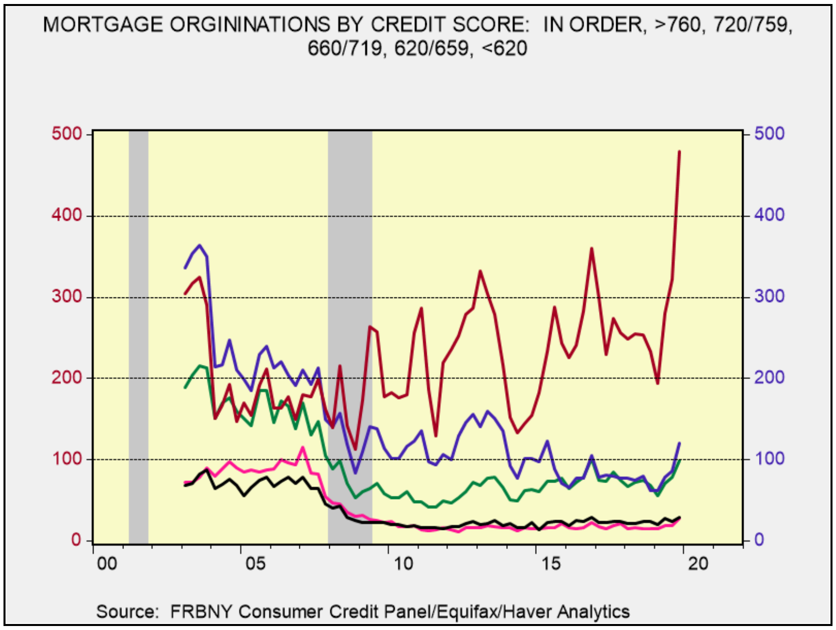


The blue line on the chart shows the non-seasonally adjusted report. The decline in January is remarkable as job openings fell by nearly 600k. However, when we seasonally adjust the data, the decline is significant, around 250k, but much less than the headline data would suggest. The number bears watching; if it continues to decline it would suggest an early warning that the labor market is starting to soften. We would not be surprised to see a recovery in the coming months as the drop appears to be exacerbated by seasonal factors.

Another chart violation: The NY FRB publishes data on consumer lending and there are headlines this morning talking about how household debt is at a new record level. Well, that is true, but the pace of debt accumulation appears rather manageable.



From 1999 into 2008, annual growth rates averaged between 10% to 20%. Last year's growth rate was 4.4%. On a per capita basis, the average person is carrying $51,740 of debt; although that number has been rising, it is below the $53,040 peak set in Q3 2008. In other words, on a per capita basis, the growth rate is a mere 3.1%. Overall, households remain cautious about debt and lenders are being careful, too.



By far, the most mortgage originations are for the highest credit score. Note that before the Financial Crisis, low credit scores acquired nearly twice as many mortgages as they do now.

EU/U.K.: Yesterday we noted that the U.K. indicated it wants "permanent equivalence" for its financial services industry; today, the EU signaled this isn't going to happen. Instead, access will always be temporary and subject to removal with 30 days' notice. If a deal cannot be worked out, London's financial services industry will be in big trouble.

German trouble: We have been documenting the turmoil within the CDU/CSU and the rising threat to Chancellor Merkel's tenure. Foreign policy experts are starting to see the void developing as a leaderless Germany essentially becomes a leaderless Europe.

Odds and ends: The Reserve Bank of New Zealand indicated it was leaving policy rates at 1.0% and did not intend to cut further. The NZD rallied on the news. The USTR has issued a report critical of the WTO's appellate mechanism. The U.S. wants the WTO to become less of an adjudicator and more of a facilitator of talks. This is more about advancing national sovereignty over supranational power. The FTC is expanding its anti-trust investigation of big tech. The U.S. is accusing Huawei (002502, CNY 2.72) of having the ability to access telecom networks in a bid to discourage allies from using the company's equipment for 5G. President Trump is planning a trip to Africa. In order to bolster a coalition against Iran, the U.S. is expected to recruit the help of Sudan and Morocco.

U.S. Economic Releases

MBA mortgage applications rose 1.1% in the week ended February 7, building on their 5.0% gain in the previous week. Applications for home-purchase mortgages declined 5.8%, but that was offset by a 5.0% increase in applications for refinancing mortgages. The average interest rate on a 30-year, fixed-rate mortgage edged up to 3.72%.

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

Economic Releases							
EDT	Indicator			Expected	Prior	Rating	
13:00	Monthly Budget Statement	m/m	Jan	-$10.0 Bil.	$8.7 Bil.	**	
Fed Speakers or Events							
	Speaker or event	District or position					
10:00	Jerome Powell Testifies Before Senate Banking Committee	Chairman of Board of Governors of Federal Reserve					

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	Money Stock M2	y/y	Jan	2.8%	2.7%	2.7%	**	Equity and bond neutral
	Money Stock M3	y/y	Jan	2.3%	2.3%	2.3%	**	Equity and bond neutral
	Machine Tool Orders	y/y	Jan	-35.6%	-33.5%		**	Equity bearish, bond bullish
Australia	Westpac Consumer Confidence	m/m	Feb	95.5	93.4		*	Equity bullish, bond bearish
	Westpac Consumer Confidence	m/m	Feb	2.3%	-1.8%		***	Equity bullish, bond bearish
South Korea	Unemployment Rate	m/m	Jan	4.0%	3.7%	3.8%	***	Equity bearish, bond bullish
India	CPI	y/y	Jan	7.6%	7.4%	7.4%	**	Equity and bond neutral
	Industrial Production	y/y	Dec	-0.3%	1.8%	1.7%	***	Equity bearish, bond bearish
EUROPE								
Eurozone	Industrial Production	y/y	Dec	-4.1%	-1.7%	-2.5%	**	Equity bearish, bond bearish
AMERICAS								
Brazil	Retail Sales	y/y	Dec	2.6%	3.1%	3.3%	***	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)	171	173	-2	Up
3-mo T-bill yield (bps)	153	153	0	Neutral
TED spread (bps)	18	20	-2	Neutral
U.S. Libor/OIS spread (bps)	157	157	0	Up
10-yr T-note (%)	1.62	1.60	0.02	Neutral
Euribor/OIS spread (bps)	-41	-40	-1	Neutral
EUR/USD 3-mo swap (bps)	7	7	0	Down
Currencies	**Direction**			
dollar	Flat			Neutral
euro	Flat			Down
yen	Down			Down
pound	Up			Down
franc	Flat			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
RBNZ Official Cash Rate	1.000%	1.000%	1.000%	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	$55.14	$54.01	2.09%	Reduced concern about Wuhan coronavirus.
WTI	$50.71	$49.94	1.54%	Reduced concern about Wuhan coronavirus.
Natural Gas	$1.82	$1.79	1.79%	
Crack Spread	$16.08	$15.32	4.97%	
12-mo strip crack	$15.74	$15.28	2.97%	
Ethanol rack	$1.45	$1.45	-0.05%	
Metals				
Gold	$1,565.75	$1,567.89	-0.14%	
Silver	$17.56	$17.65	-0.51%	
Copper contract	$260.55	$258.30	0.87%	
Grains				
Corn contract	$ 379.00	$ 379.75	-0.20%	
Wheat contract	$ 541.75	$ 542.00	-0.05%	
Soybeans contract	$ 884.25	$ 884.75	-0.06%	
Shipping				
Baltic Dry Freight	418	411	7	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.2		
Gasoline (mb)		0.7		
Distillates (mb)		-0.8		
Refinery run rates (%)		-0.40%		
Natural gas (bcf)		-108.0		

Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal conditions for the entire eastern half of the country, with cooler-than-normal temperatures only in the Rocky Mountains. Wet conditions are expected in virtually all regions except the Southwest and Southern Florida.

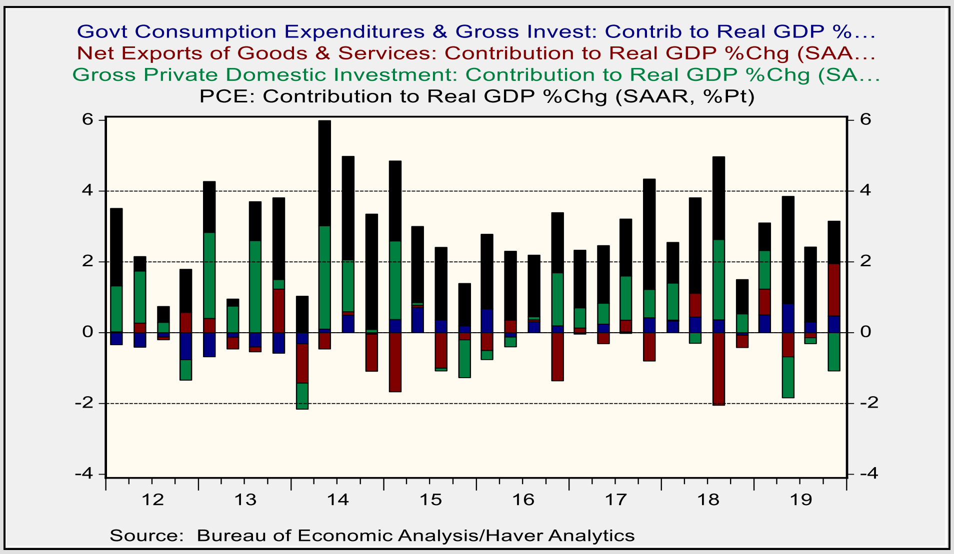
Asset Allocation Weekly

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.

February 7, 2020

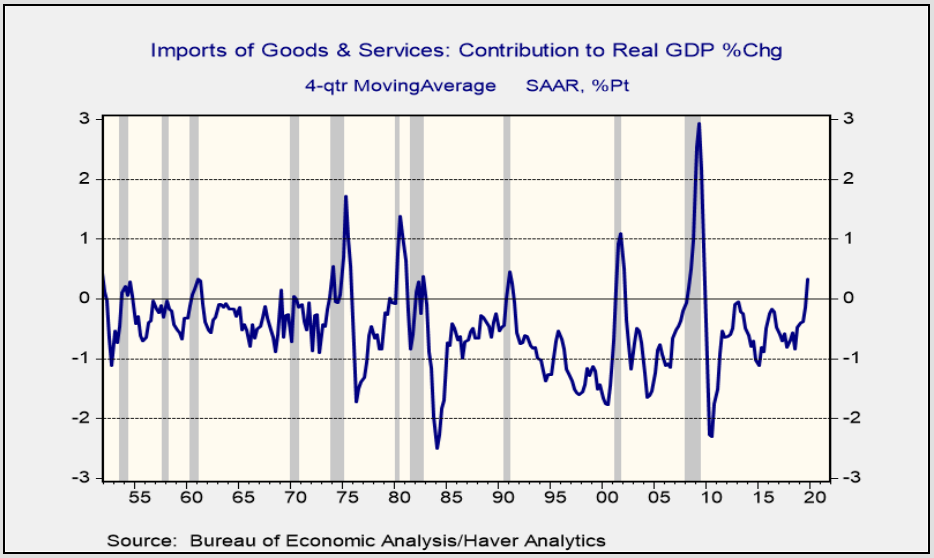
The Commerce Department recently released its first iteration of Q4 GDP. The overall growth rate, at 2.1%, was mostly on forecast but the composition of the growth showed some unexpected developments. In this week's report, we will examine the most interesting changes and what it may be telling us about future economic activity.

To analyze the data, we focus on a set of statistics called "contributions to GDP growth." These datapoints show how much various parts of GDP contributed to overall growth. Here is a chart of the data.



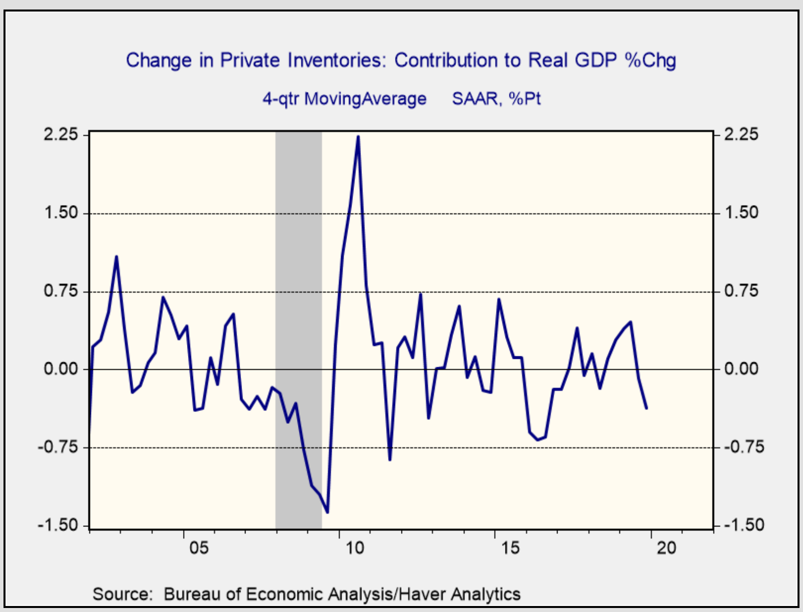
The largest positive contributor to growth was net exports; although it is not unprecedented, outside of recessions, net exports are usually a drag on growth. It is important to note that this data is looking at the rate of change of the change, so a smaller deficit will contribute positively to growth.

Net exports are the sum contribution of gross imports and exports. Usually, during expansions, the contribution from gross imports is negative. But, during recessions or when growth falters, imports fall and contribute positively to growth.



This chart shows the four-quarter moving average of the contribution of gross imports to GDP. A positive contribution tends to be consistent with recession. So, is that the case this time?

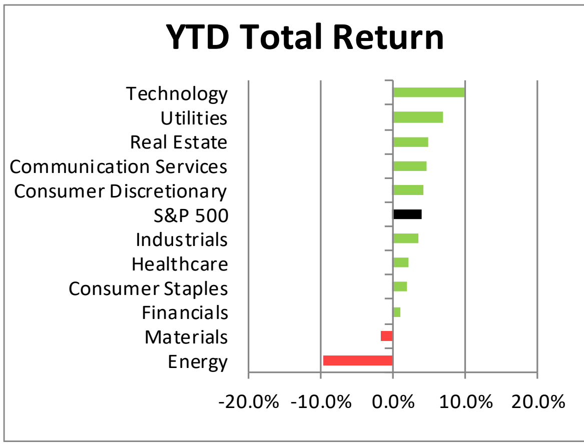
It might be, but there are two reasons why this event might be a false positive. First, the trade wars have probably had some impact on reducing imports. Since WWII, the general trend in tariffs has been downward. The recent reversal in this trend is a new factor that may be shifting consumption to domestic goods and away from imports. In some respects, this is the goal of the administration's trade policy. Second, there is evidence that U.S. firms accumulated inventories in the months prior to the Phase One trade deal with China. This was likely done to buy goods that might be the target of future tariffs. As a deal was made, it would make sense for firms to reduce inventories. The act of selling down inventories would reduce imports.

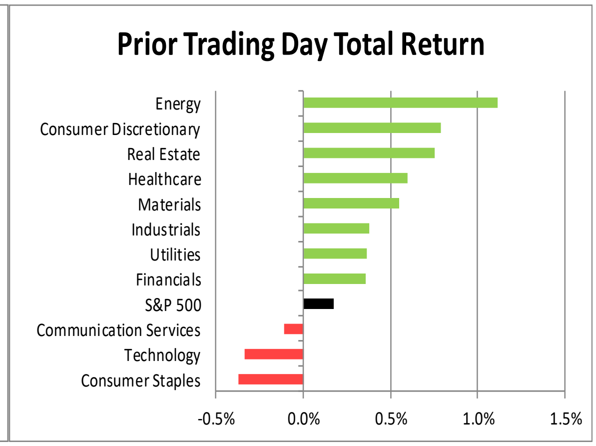


We will be watching the gross import data with great interest this year to see if (a) we are seeing a structural change in the economy where imports decline, or (b) we are on the cusp of a recession. For now, the most likely explanation is that the swing in gross imports was affected by trade policy uncertainty. But, if other economic data begins to corroborate the recession signal from gross imports, we would recommend that investors reduce portfolio risk.

Data Section

U.S. Equity Markets – (as of 2/11/2020 close)

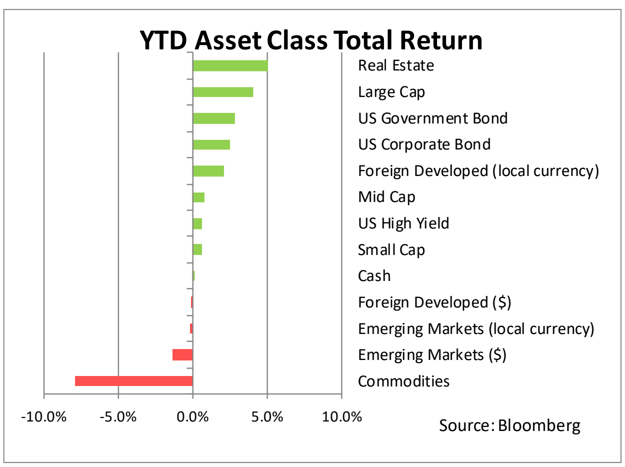




(Source: Bloomberg)

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 2/11/2020 close)

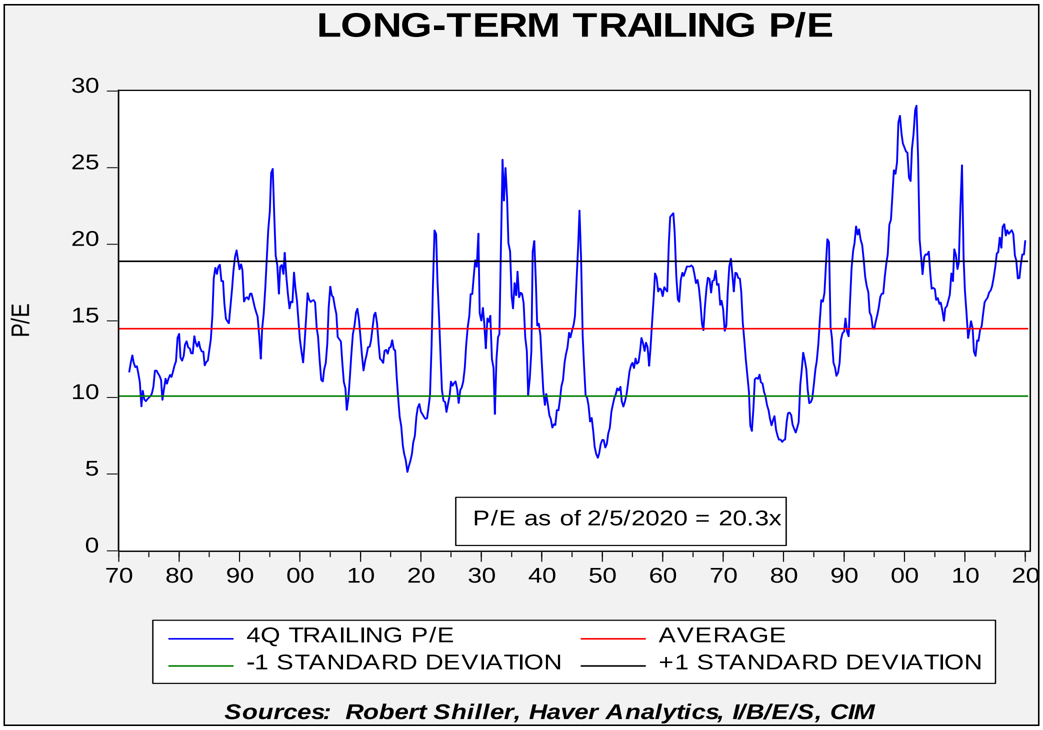


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 6, 2020



Based on our methodology,[1] the current P/E is 20.3x, down 0.1x, as equity values fell due to the Wuhan virus and earnings rose in Q4.

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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[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 two actual quarters (Q2 and Q3) and two estimates (Q4 and Q1, 2020). 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.