Daily Comment

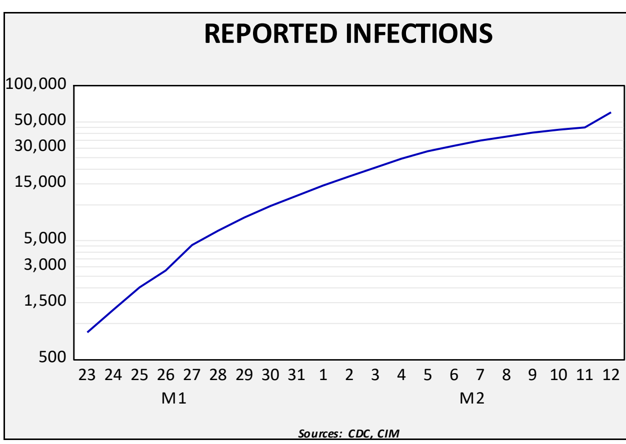
By Bill O'Grady, Thomas Wash, and Patrick Fearon-Hernandez, CFA

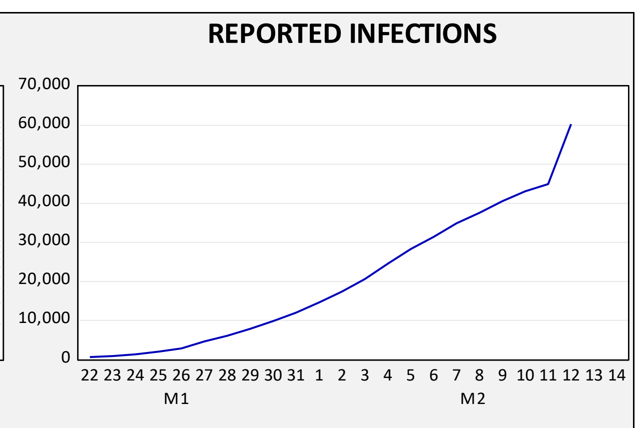
Looking for something to read? See our Reading List; these books, separated by category, are ones we find interesting and insightful. We will be adding to the list over time.

[Posted: February 13, 2020—9:30 AM EST] Global equity markets are lower this morning. The EuroStoxx 50 is currently down 1.0% from its last close. In Asia, the MSCI Asia Apex 50 closed down 0.1%. Chinese markets were lower, with the Shanghai Composite down 0.7% and the Shenzhen Composite down 0.8%. U.S. equity index futures are signaling a higher open. With 337 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, 71.8% of the companies have reported earnings above forecast, while 19.6% have reported earnings below forecast.

After a steady rise, equities are lower this morning following a jump in reported infections; we update news on COVID-19. The nominating process for the remaining two vacant governor positions begins today. PM Johnson shakes up his cabinet. The CDU/CSU begins the process of selecting a new party leader. We update the energy data; the IEA warns of weakening oil demand. French unemployment falls (see foreign economic data below). Here are the details:

COVID-19: Due to new reporting standards, there was a massive jump in reported infections in China. The new count is 60,407 with 1,370 fatalities. Health authorities in Hubei province started counting clinically diagnosed cases as infections. Previously, only a positive laboratory test would trigger a diagnosis. There have been serious concerns about undercounting; testing kits were seen to be inaccurate, or worse, because they had a tendency to produce false negatives. The new reporting does show a noticeable bump in the data.





Both charts show the same data but the chart on the left uses a logarithmic scale, which shows the rate of change in the data; the chart on the right uses a linear scale and has been used by some media outlets to highlight the "hockey stick" nature of the increase. Although the jump in the data is clearly noticeable, even using the more legitimate log scale, it should be treated as a one-off event. In a sense, the new reporting should be treated as a data revision. The good news is that the increase in the number of cases highlights that most of those infected are suffering a mild case of the disease. So, today's equity weakness is probably not a proper reaction to this news; on the other hand, the rally we have seen over the past several days was ignoring the likelihood of under-reporting so today's drop could also be seen as a correction to previous overconfidence.

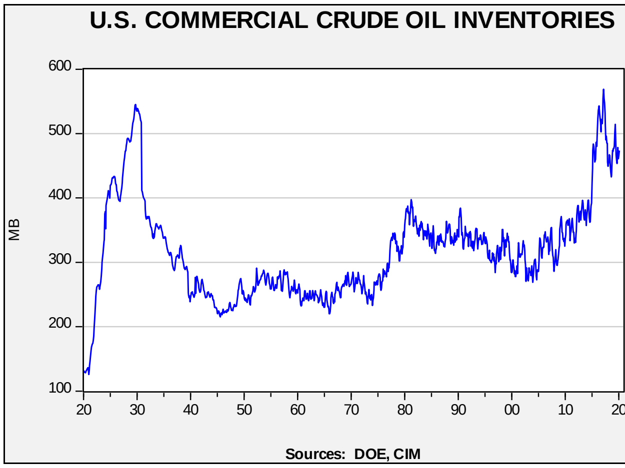
In related news, China continues to fire province-level officials over the handling of this crisis. And, proving the universality of Rahm Emmanuel's dictum that a political leader should never let a crisis go to waste, Chairman Xi has installed his close ally, Xia Baolong, as leader of the Hong Kong and Macau Affairs Office. Xi is clearly working to extend his control over the restive Hong Kong. The banking system is showing some signs of stress as the virus weakens the economy. Global tourism is weakening as well. China's car sales plunged 22% in January.

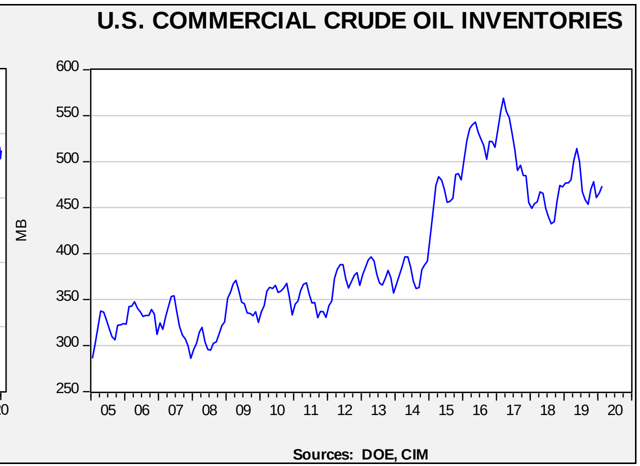
PM Johnson's shakeup: The most notable firing is Sajid Javid, who was Chancellor of the Exchequer. However, there were numerous other sackings. The government is expected to announce replacements throughout the day. It is still uncertain what these replacements will bring. The GBP did move higher on the news.

The Fed nominating process: At long last, Christopher Waller and Judy Shelton go before the Senate Banking Committee at 9:00 EST today. To some extent, Waller may be the most fortunate candidate in recent memory; he is a conventional candidate and, most likely, Shelton will take a grilling. She is a very unconventional candidate. She has supported the gold standard and has expressed doubts about the very wisdom of having a central bank. For GOP senators, this nomination may prove to be yet another loyalty test to the White House. Our view? We have been expecting doves to be nominated to the vacant seats and both these candidates will be reliable advocates for rate cuts. It will make the composition of the Fed more dovish. At the same time, as we move from an efficiency to an equality cycle, central bank independence will be undermined. What we are concerned about with Shelton is that she may not be a dove or hawk in the traditional sense but may instead represent a "new bird." She may be a political bird who will support easier policy when a Republican controls the White House but call for tight policy when a Democrat is in the Oval Office.

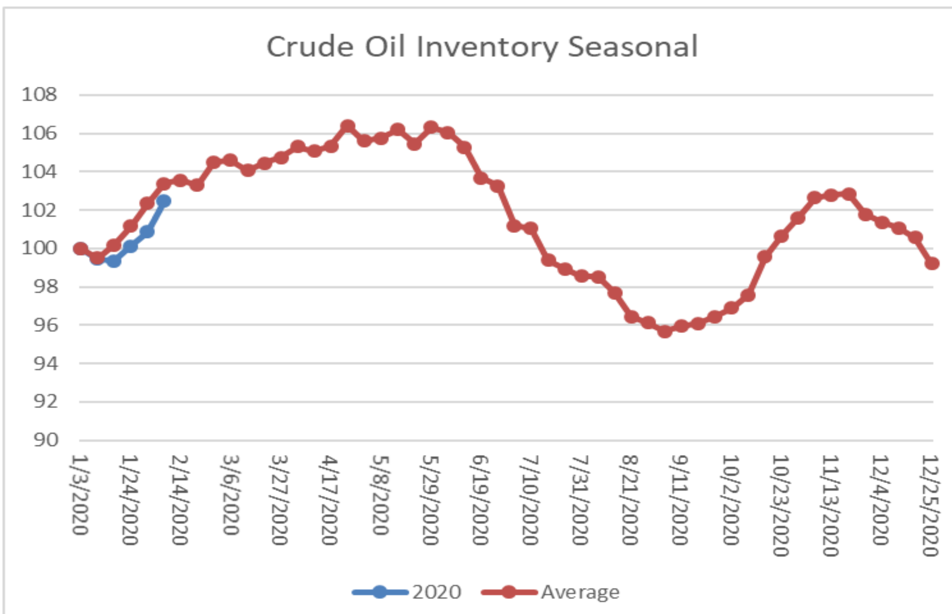
Odds and ends: As AKK leaves the leadership of the CDU/CSU, new candidates for the job are circling. The vetting process is beginning with familiar names emerging for a second chance at the position. And, here's one to ponder—Greek 10-year bond yields have fallen below 1% to 0.98%.

Energy update: Crude oil inventories rose 7.5 mb compared to a forecast rise to 3.2 mb.



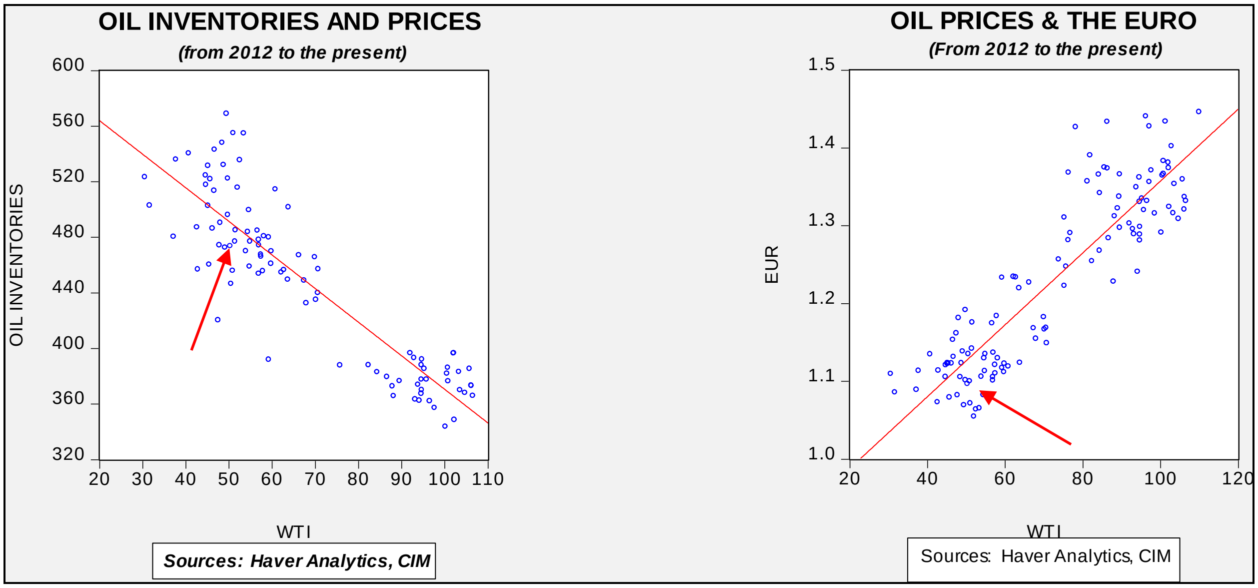


In the details, U.S. crude oil production rose 0.1 mbpd to 13.0 mbpd. Exports fell 0.4 mbpd, while imports rose 0.4 mbpd. The rise in stockpiles was more than 2x what was forecast. The rise in imports coupled with the decline in exports prompted the large rise.



(Sources: DOE, CIM)

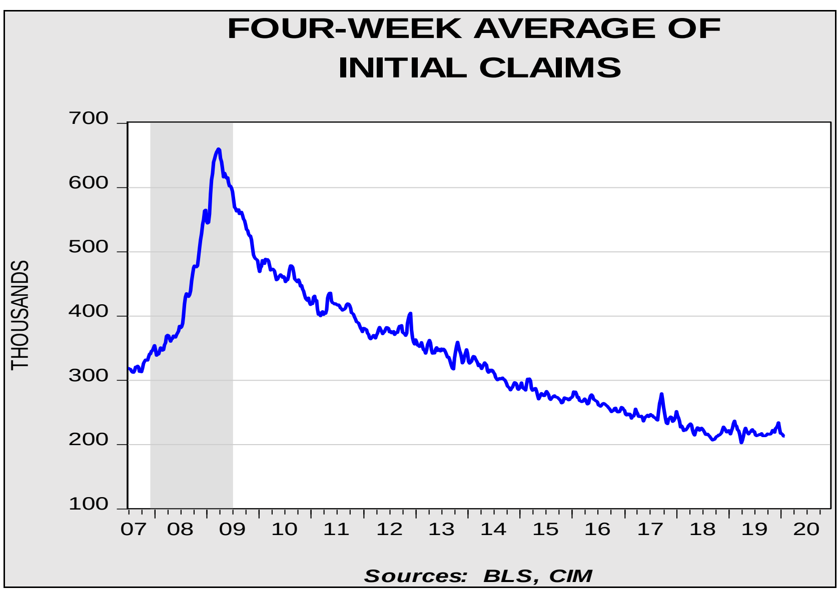
This chart shows the annual seasonal pattern for crude oil inventories. This week's rise was consistent with seasonal patterns, and the gap between the normal pace of inventory accumulation and the actual has narrowed significantly. The next two weeks are usually steady so continued accumulation will put the current year above normal.



Based on our oil inventory/price model, fair value is $59.72; using the euro/price model, fair value is $47.58. The combined model, a broader analysis of the oil price, generates a fair value of $51.04. We are seeing a steady decline in all of the fair value calculations as the dollar strengthens and oil inventories rise. However, the combined model is within range of fair value so we may see some consolidation in the coming weeks. [The IEA, citing the impact of the COVID-19 virus, has cut its global oil demand forecast by 365 kbpd].

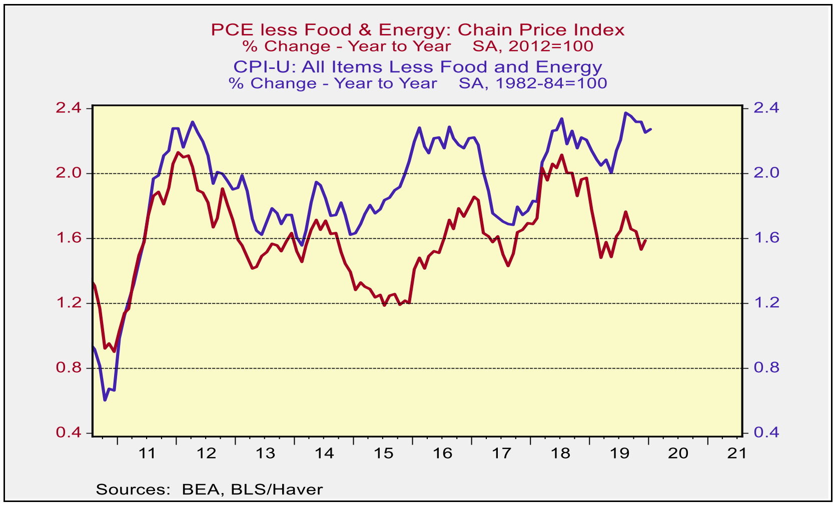
U.S. Economic Releases

Initial jobless claims came in at 205k compared to expectations of 210k. The prior report was revised from 202k to 203k.



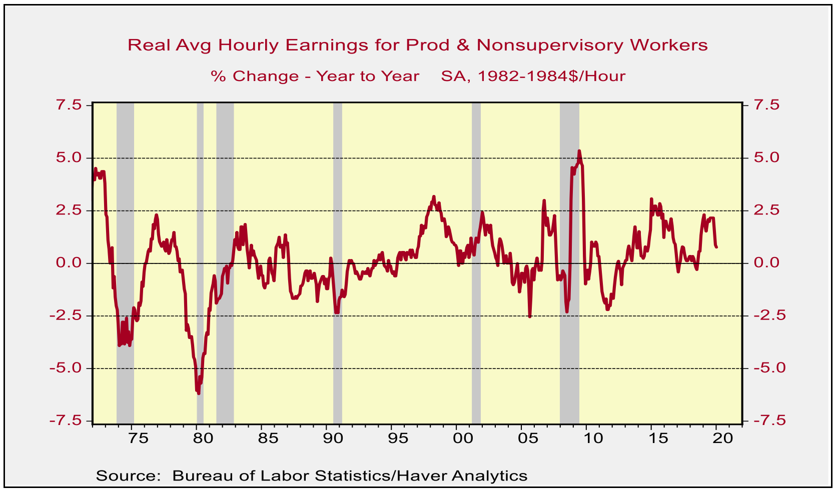
The chart above shows the four-week moving average of initial claims. The four-week average remained unchanged from the previous week at 212k.

CPI rose 0.1% from the prior month compared to expectations of a rise of 0.2%. Additionally, core CPI rose 0.2% from the prior month, in line with expectations.



The chart above shows the annual change in core CPI and core PCE. Although both variables are used to gauge inflation, the latter is preferred by the Fed. In other words, CPI being above the Fed's 2.0% target will likely not have an impact on monetary policy.

Real average hourly earnings rose 0.6% from the prior year, in line with expectations. Meanwhile, real average weekly earnings remained unchanged from the prior year.



The chart above shows the annual change in real wages for production and nonsupervisory workers. Real average hourly earnings rose 0.8% from the prior year.

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

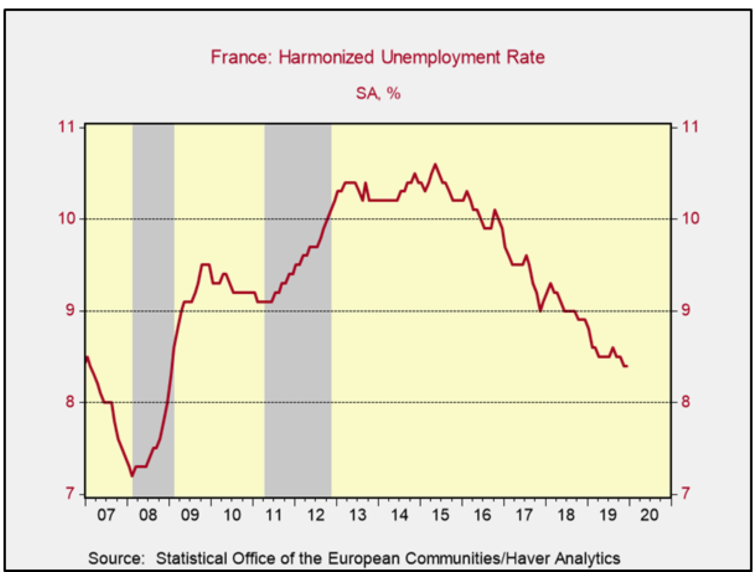
Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Consumer Comfort	m/m	9-Feb		66.5	**
Fed Speakers or Events						
	Speaker or event	District or position				
12:45	Robert Kaplan Speaks in Texas	President of the Federal Reserve Bank of Dallas				
17:30	John Williams Speaks at BoE in London	President of the Federal Reserve Bank of New York				

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	PPI	y/y	Jan	1.7%	0.9%	1.5%	**	Equity bearish, bond bearish
Australia	Consumer Inflation Expectations	y/y	Feb	4.0%	4.7%		**	Equity and bond neutral
EUROPE								
Germany	CPI EU Harmonized	y/y	jan	1.6%	1.6%	1.6%	***	Equity and bond neutral
	CPI	y/y	jan	1.7%	1.7%	1.7%	***	Equity and bond neutral
France	ILO Unemployment Rate	y/y	jan	8.1%	8.6%	8.5%	***	Equity bullish, bond bearish
	ILO Mainland Unemployment Rate	m/m	jan	7.9%	8.3%	8.2%	***	Equity bullish, bond bearish
AMERICAS								
Brazil	IBGE Services Sector Volume	y/y	Dec	1.6%	1.8%	1.5%	***	Equity and bond neutral

France: The fourth quarter unemployment rate fell to a seasonally adjusted 8.1%, beating expectations that it would stay at the revised third quarter rate of 8.5%. Joblessness in the fourth quarter was at its lowest in eleven years, reflecting at least in part the moderate labor reforms implemented by President Macron.



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	171	0	Up
3-mo T-bill yield (bps)	153	154	-1	Neutral
TED spread (bps)	17	17	0	Neutral
U.S. Libor/OIS spread (bps)	156	157	-1	Up
10-yr T-note (%)	1.59	1.63	-0.04	Neutral
Euribor/OIS spread (bps)	-41	-41	0	Neutral
EUR/USD 3-mo swap (bps)	8	7	1	Down
Currencies	**Direction**			
dollar	Flat			Neutral
euro	Down			Down
yen	Up			Down
pound	Up			Down
franc	Flat			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
Mexican Overnight Rate		7.250%	7.000%	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	$55.39	$55.79	-0.72%	
WTI	$51.02	$51.17	-0.29%	
Natural Gas	$1.85	$1.84	0.27%	
Crack Spread	$16.17	$16.55	-2.30%	
12-mo strip crack	$15.89	$16.25	-2.25%	
Ethanol rack	$1.45	$1.45	0.20%	
Metals				
Gold	$1,573.39	$1,566.06	0.47%	
Silver	$17.63	$17.49	0.84%	
Copper contract	$259.45	$260.00	-0.21%	
Grains				
Corn contract	$ 380.25	$ 383.00	-0.72%	
Wheat contract	$ 546.50	$ 548.50	-0.36%	
Soybeans contract	$ 889.50	$ 892.50	-0.34%	
Shipping				
Baltic Dry Freight	421	418	3	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	7.5	3.2	4.3	
Gasoline (mb)	-0.1	0.7	-0.7	
Distillates (mb)	-2.0	-0.8	-1.3	
Refinery run rates (%)	0.60%	-0.40%	1.00%	

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.

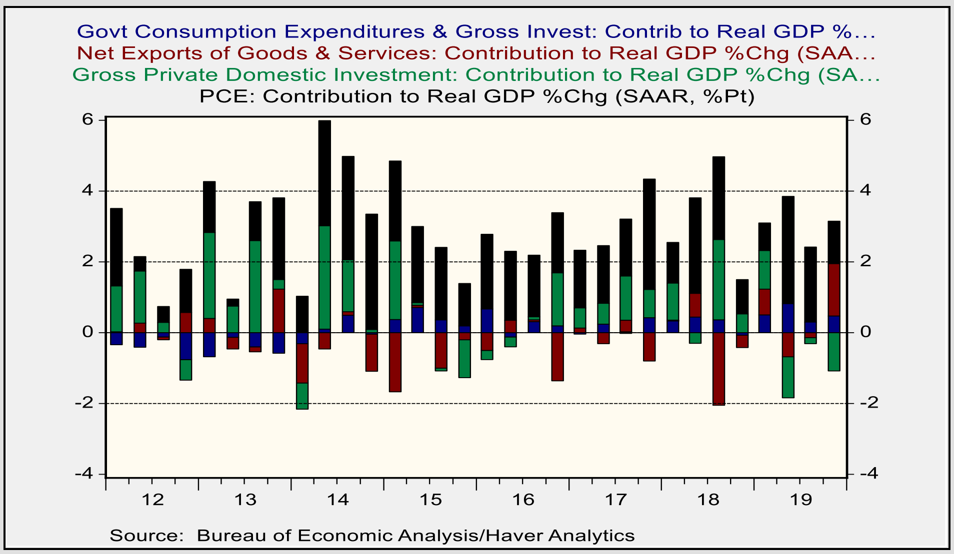
Asset Allocation Weekly

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

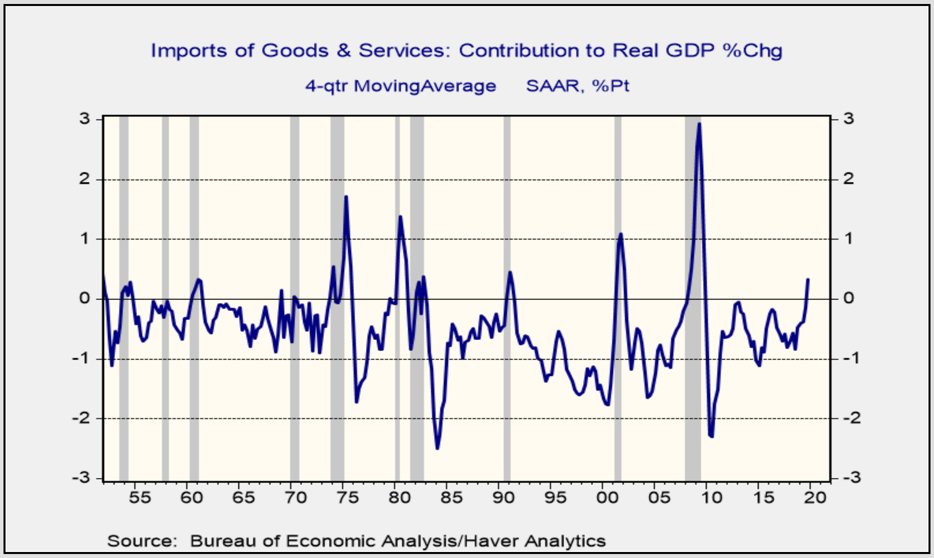
The Commerce Department recently released its first iteration of Q4 GDP. The overall growth rate, at 2.1%, was mostly on forecast but the composition of the growth showed some unexpected developments. In this week's report, we will examine the most interesting changes and what it may be telling us about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



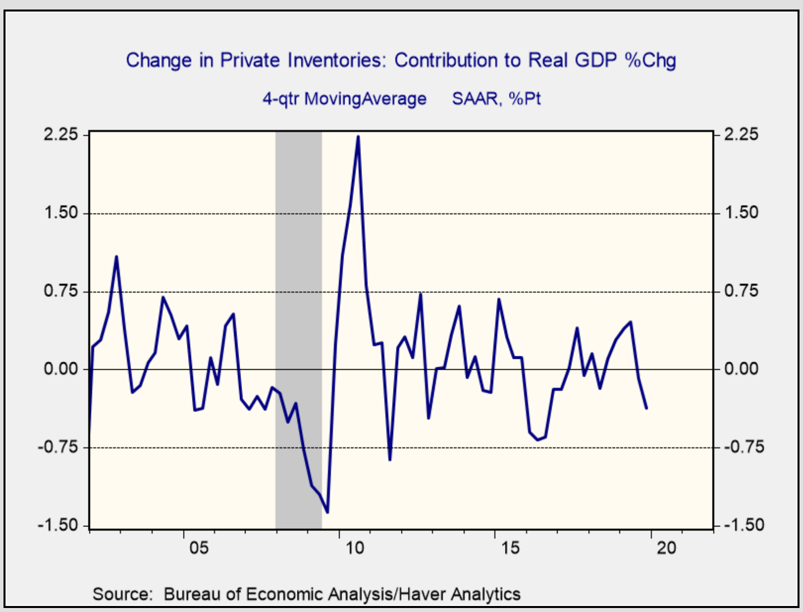
The largest positive contributor to growth was net exports; although it is not unprecedented, outside of recessions, net exports are usually a drag on growth. It is important to note that this data is looking at the rate of change of the change, so a smaller deficit will contribute positively to growth.

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?

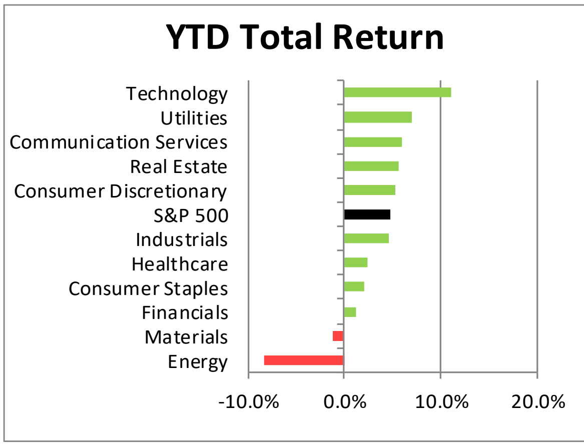
It might be, but there are two reasons why this event might be a false positive. First, the trade wars have probably had some impact on reducing imports. Since WWII, the general trend in tariffs has been downward. The recent reversal in this trend is a new factor that may be shifting consumption to domestic 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.

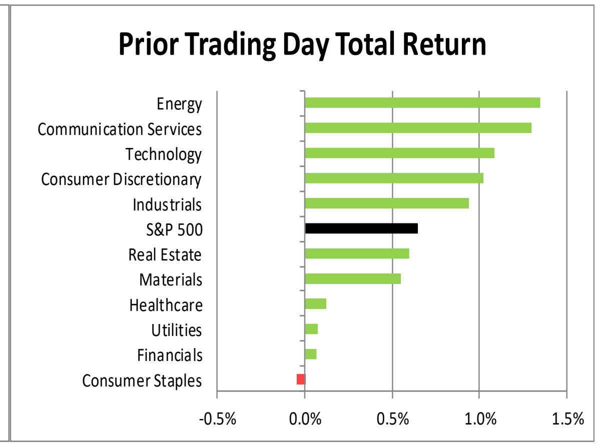


We will be watching the gross import data with great interest this year to see if (a) we are seeing a structural change in the economy where imports decline, or (b) we are on the cusp of a recession. For now, the most likely explanation is that the swing in gross imports was affected by trade policy 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 2/12/2020 close)

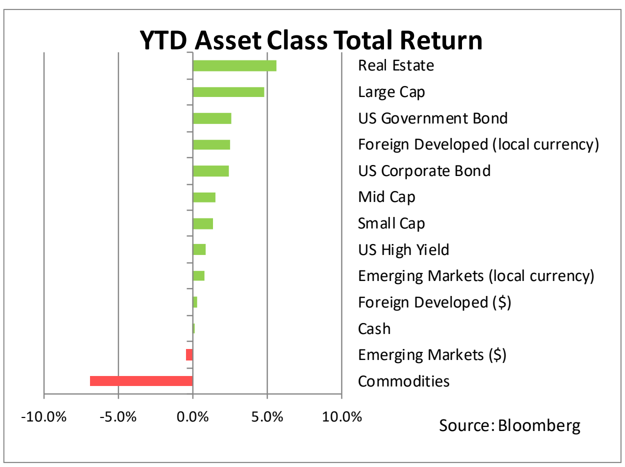




(Source: Bloomberg)

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 2/12/2020 close)

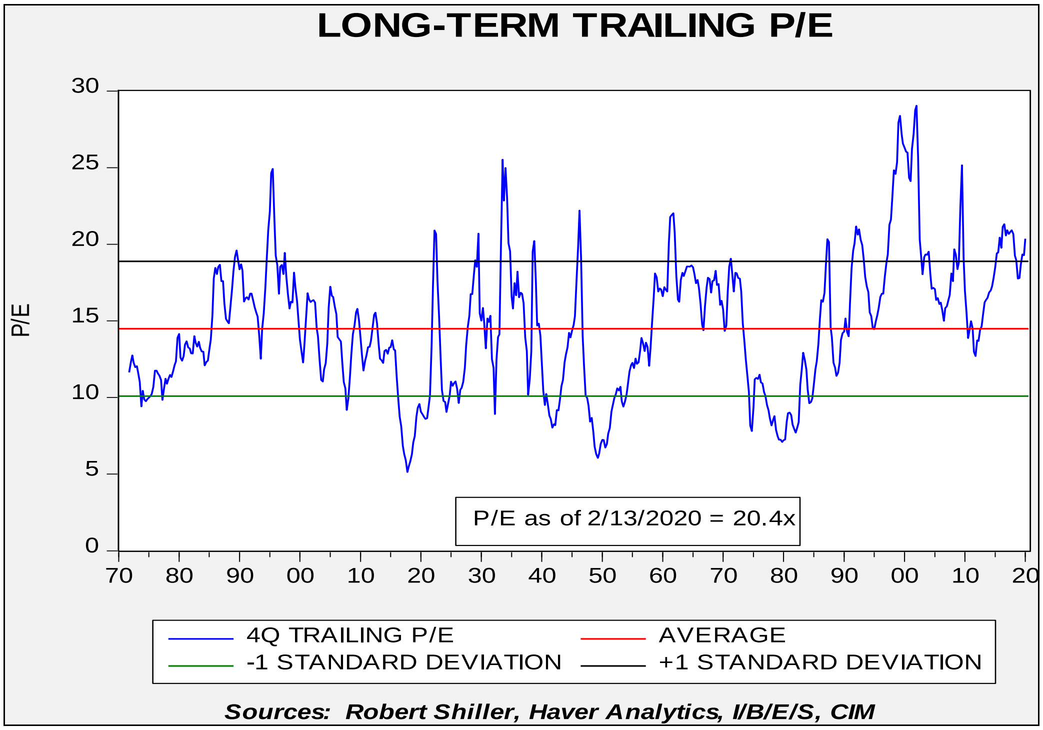


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 13, 2020



Based on our methodology,[1] the current P/E is 20.4x, up 0.1x, as the recovery in equity prices outpaced the improvement in earnings.

---

[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.