# 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: February 15, 2019—9:30 AM EST]** Global equity markets are mixed this morning. The EuroStoxx 50 is up 1.0% from the last close. In Asia, the MSCI Asia Apex 50 was down 1.5% from the prior close. Chinese markets were lower, with the Shanghai composite down 1.4% and the Shenzhen index down 0.7%. U.S. equity index futures are signaling a higher open. With 372 companies having reported, the S&P 500 Q4 earnings stand at $41.36, higher than the $40.86 forecast for the quarter. The forecast reflects a 13.4% increase from Q4 2017 earnings. Thus far this quarter, 68.2% of the companies reported earnings above forecast, while 22.4% reported earnings below forecast.

U.S. equity futures are steady to higher this morning in quiet trading. There is some optimism on the China/U.S. trade talks and on the Fed's balance sheet. Here is what we are watching this morning:

**Trade talks:** Although there isn't much evidence of real progress (e.g., no memorandum of understanding emerged),[1] the two sides are continuing to talk[2] and President Trump has indicated that he is willing to extend the deadline. Treasury Secretary Mnuchin described the talks as "positive," which was seconded by Larry Kudlow.[3] Both have been dovish on Chinese trade; no such characterization came from USTR Lighthizer, a trade hawk. Chairman Xi also lauded progress on talks.[4] There are reports that China will offer to end subsidies to Chinese exporters but, so far, such plans lack details.[5] Other reports suggest China really hasn't moved on exporter subsidies or forced technology transfers but is making the usual offer of large purchases in a bid to end trade pressure.[6] Our expectation hasn't changed. President Trump needs to avoid a trade war with China because it will weaken the U.S. economy going into the critical election year in 2020. Thus, we expect *a* deal but not *the* deal that would really change China's behavior.

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[1] https://www.ft.com/content/c2783d84-30ce-11e9-8744-e7016697f225?emailId=5c6643dc26450200045b796d&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

[2] https://www.wsj.com/articles/chinese-u-s-negotiators-expected-to-show-progress-on-trade-deal-framework-11550212318 and https://www.scmp.com/economy/china-economy/article/2186338/china-and-united-states-make-progress-beijing-trade-war-talks

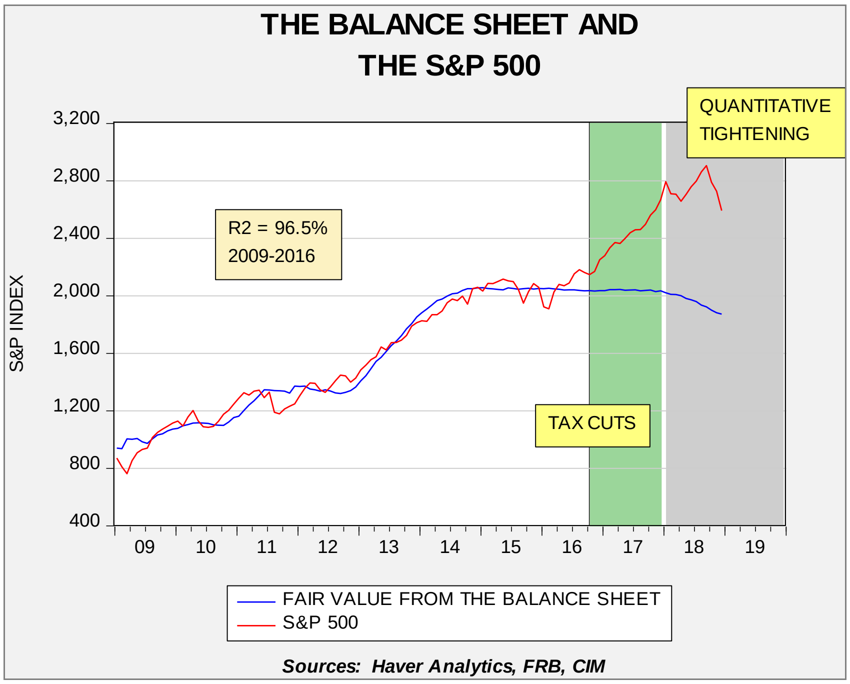
[3] https://www.scmp.com/news/china/diplomacy/article/2186292/us-china-trade-talks-good-vibes-and-laughter-venue-rivals-work

[4] https://www.reuters.com/article/us-usa-trade-china/mnuchin-says-u-s-had-productive-trade-meetings-with-china-idUSKCN1Q40S0

[5] https://www.reuters.com/article/us-usa-trade-china-subsidies-exclusive/exclusive-china-offers-to-end-market-distorting-subsidies-but-wont-say-how-idUSKCN1Q32X6

[6] https://www.wsj.com/articles/china-seeks-to-lure-u-s-with-pledges-to-boost-chip-and-other-purchases-11550151263

**The balance sheet:** The Fed's balance sheet is a controversial topic. There has been a good bit of market consternation about the reduction of the balance sheet, or quantitative tightening (QT). Our research has suggested that the impact of quantitative easing (QE), or the expansion of the Fed's balance sheet, was mostly psychological; if the FOMC was seen as out of tools after fed funds reached zero percent, the perception likely would have led to market panic. However, the impact on the real economy (impact on interest rates, lending behavior) from QE was nil. Still, it clearly did affect investor sentiment.[7] This chart shows why QT has become such a hot topic.




This chart shows the S&P 500 along with the fair value from a regression where the S&P is the dependent variable and the balance sheet is the independent variable. The match between the two series is very tight from 2009 to 2016, with an R2 of 96.5%. Equities departed from the model during the discussion of tax cuts after President Trump's election but now that the tax cuts have passed, the focus appears to have returned to the balance sheet just in time for QT. Again, if the impact of the balance sheet is psychological, it makes sense that its reduction would have an impact on investor sentiment.

Governor Brainard indicated yesterday that the FOMC may be winding down QT much sooner than the markets expected.[8] That news would be supportive for equities if true.

**Q4 looking soft:** The Atlanta FRB GDPNow forecast for Q4 has plunged to 1.5%, being hit by the soft retail sales data released yesterday.

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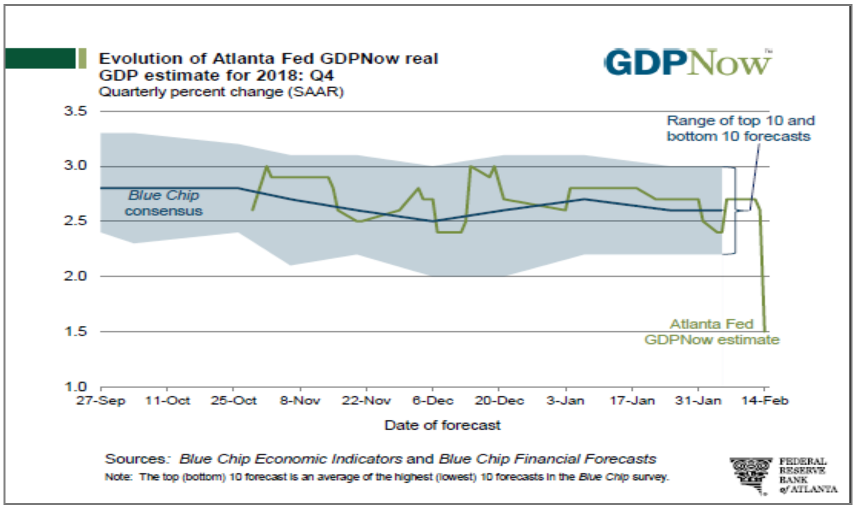
[7] For a more in depth view, see Asset Allocation Weekly (1/4/2019).
[8] https://www.cnbc.com/2019/02/14/fed-gov-brainard-downside-risks-have-definitely-increased-on-the-economy.html and https://www.wsj.com/articles/fed-officials-near-plan-to-finish-portfolio-wind-down-11550180143




The contribution to growth table shows that the slide in consumption was the primary culprit for the forecast downgrade.

**Atlanta Fed GDPNow estimates for 2018: Q4, contributions to growth**

| Date | Major Releases | GDP | PCE | Equip-ment | Intell. prop. prod. | Nonres. struct. | Resid. inves. | Govt. | Net exports | CIPI |
|---|---|---|---|---|---|---|---|---|---|---|
| 29-Oct | Initial nowcast | 2.6 | 1.88 | 0.60 | 0.33 | -0.02 | -0.22 | 0.41 | -0.30 | -0.03 |
| 29-Nov | GDP+Foreign trade+New-home sales (11/28), Pers. inc. and outlays | 2.6 | 2.19 | 0.47 | 0.30 | 0.07 | -0.12 | 0.37 | -0.39 | -0.27 |
| 21-Dec | GDP, Personal income and outlays, Advance durable manufacturing | 2.7 | 2.53 | 0.32 | 0.31 | -0.03 | -0.12 | 0.42 | -0.49 | -0.22 |
| 11-Jan | Consumer Price Index | 2.8 | 2.55 | 0.32 | 0.31 | -0.03 | -0.11 | 0.44 | -0.50 | -0.18 |
| 15-Jan | Producer Price Index | 2.8 | 2.55 | 0.33 | 0.31 | -0.03 | -0.10 | 0.44 | -0.50 | -0.18 |
| 16-Jan | Import/Export prices | 2.8 | 2.55 | 0.33 | 0.31 | -0.03 | -0.10 | 0.44 | -0.52 | -0.18 |
| 18-Jan | Industrial production | 2.8 | 2.49 | 0.34 | 0.31 | -0.03 | -0.10 | 0.44 | -0.53 | -0.12 |
| 22-Jan | Existing-home sales | 2.7 | 2.48 | 0.34 | 0.31 | -0.03 | -0.17 | 0.44 | -0.53 | -0.12 |
| 31-Jan | New-home sales/prices/costs | 2.7 | 2.49 | 0.34 | 0.31 | -0.04 | -0.20 | 0.43 | -0.53 | -0.12 |
| 1-Feb | Employ. report, ISM Manuf. Index, Constr. spending, Wholesale trade | 2.5 | 2.46 | 0.33 | 0.31 | -0.17 | -0.13 | 0.39 | -0.52 | -0.17 |
| 4-Feb | M3 Manufacturing, Auto sales | 2.4 | 2.45 | 0.34 | 0.31 | -0.18 | -0.13 | 0.39 | -0.52 | -0.26 |
| 5-Feb | ISM Nonmanufacturing Index | 2.4 | 2.45 | 0.34 | 0.31 | -0.18 | -0.13 | 0.39 | -0.52 | -0.26 |
| 6-Feb | International trade | 2.7 | 2.49 | 0.34 | 0.31 | -0.18 | -0.13 | 0.39 | -0.23 | -0.27 |
| 12-Feb | Revised PPI seasonal factors | 2.7 | 2.49 | 0.27 | 0.31 | -0.18 | -0.13 | 0.39 | -0.23 | -0.27 |
| 13-Feb | Monthly Treasury Statement | 2.6 | 2.49 | 0.27 | 0.31 | -0.18 | -0.13 | 0.31 | -0.23 | -0.27 |
| 14-Feb | Retail trade, Producer Price Index | 1.5 | 1.73 | 0.26 | 0.31 | -0.17 | -0.15 | 0.31 | -0.23 | -0.55 |
| Maximum forecast of real GDP growth | | | | | | | | | | |
| 14-Dec | Retail trade, Industrial production | 3.0 | 2.79 | 0.41 | 0.30 | -0.03 | -0.09 | 0.41 | -0.50 | -0.30 |
| Minimum forecast of real GDP growth | | | | | | | | | | |
| 14-Feb | Retail trade, Producer Price Index | 1.5 | 1.73 | 0.26 | 0.31 | -0.17 | -0.15 | 0.31 | -0.23 | -0.55 |

Note: CIPI is "change in private inventories." All numbers are percentage-point contributions to GDP growth (SAAR). The table does not necessarily include all estimates for the quarter; see tab "ContribHistory" in the online excel file for the entire history.

FEDERAL RESERVE BANK of ATLANTA

If this forecast holds, the odds of the Fed moving rates higher will likely be off the table until H2, if it occurs at all. Today's IP data (see below) will likely depress the forecast further.

**Brexit:** In what appears to be a classic "own goal," PM May suffered yet another Parliamentary defeat on a bill that was non-binding. The bill was an endorsement of the government's ability to negotiate with the EU and show EU negotiators that May had the support of the legislature. May wanted the vote to show the EU that she could bring a deal to fruition if they were more flexible. It failed 303-258.[9] Financial markets still believe that a hard Brexit will be avoided. If it is, it looks increasingly like it will take a MP revolt of lawmakers in both the Conservative and

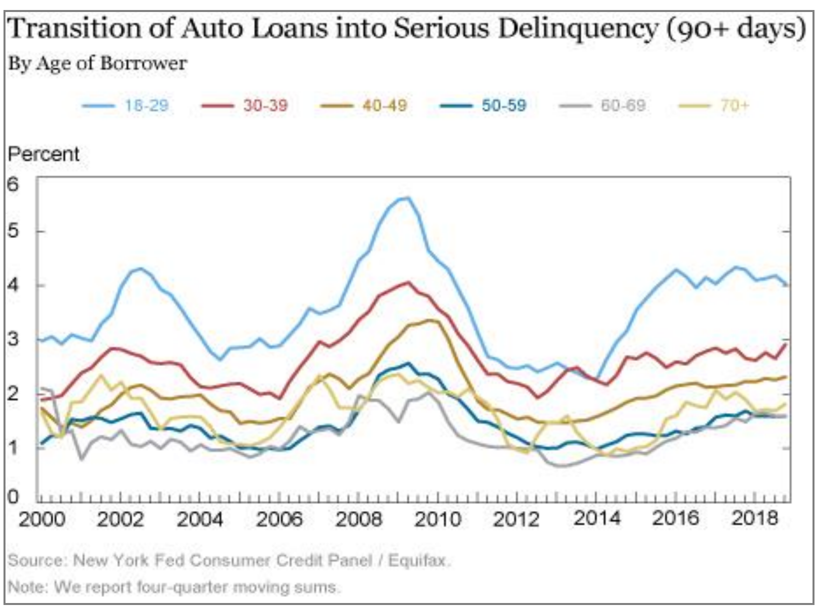
[9] https://www.nytimes.com/2019/02/14/world/europe/brexit-parliament-vote-theresa-may.html?emc=edit_mbe_20190215&nl=morning-briefing-europe&nlid=567726720190215&te=1

Labour parties to defy their leaders and force an extension or a second referendum. Such a revolt may require new parties to emerge or destroy the existing ones.

**Chinese inflation data:** CPI eased modestly from 1.8% to 1.7% on a yearly basis. However, producer prices (which tend to reflect company profitability) fell into negative territory at -0.1%.


Weakening PPI will likely prompt the PBOC to consider further credit easing, which would be supportive for Chinese equities.

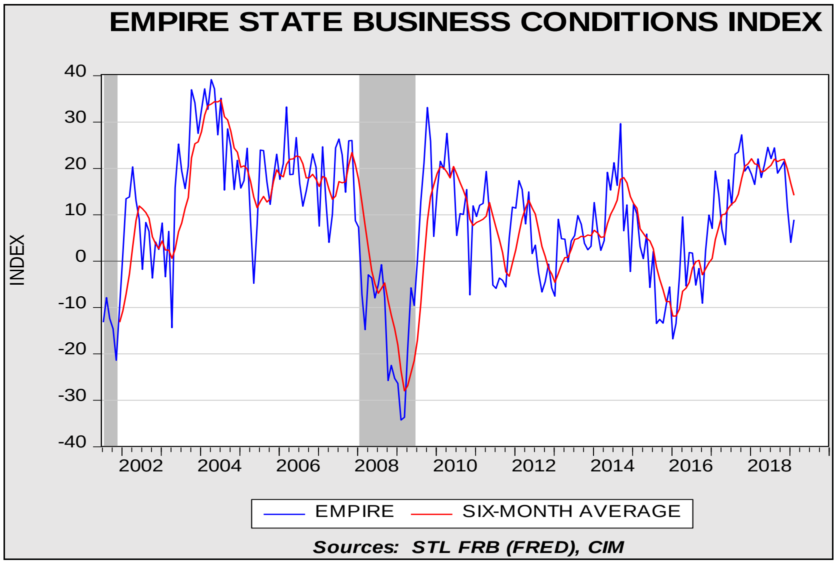
**Correction:** In Wednesday's comment, we noted that car loan delinquencies were up for older Americans. That isn't really true. A sharp-eyed reader noted that we were a bit colorblind on this chart.



We mistakenly thought the blue line showing the highest level of delinquencies represented the 50-59 age bracket. To quote John McLaughin, "WRONG!"[10] Our apologies. The highest delinquency age bracket is actually 18-29.

## U.S. Economic Releases

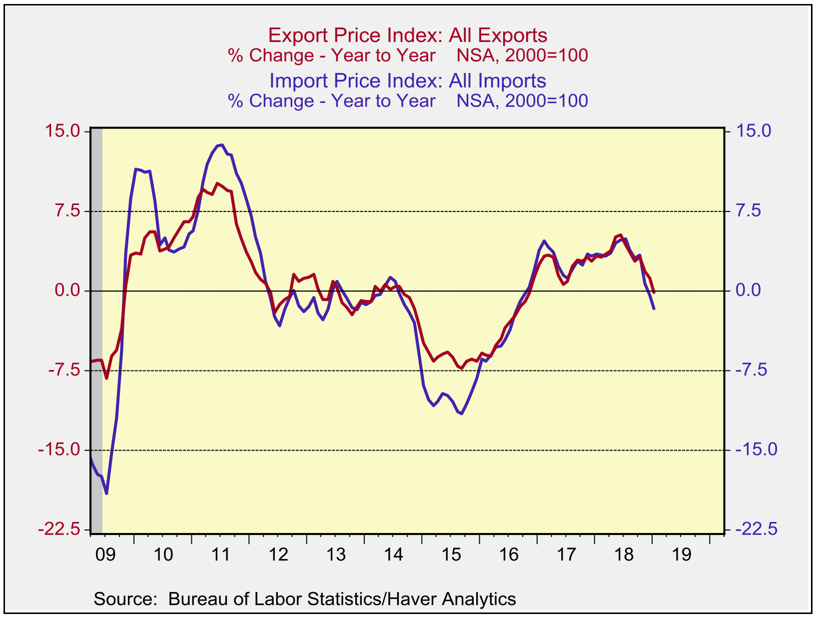
Empire manufacturing came in above expectations at 8.8 compared to the forecast of 7.0.




The chart above shows the six-month moving average of the Empire State Business Conditions Index. Currently, the six-month moving average is 14.1.

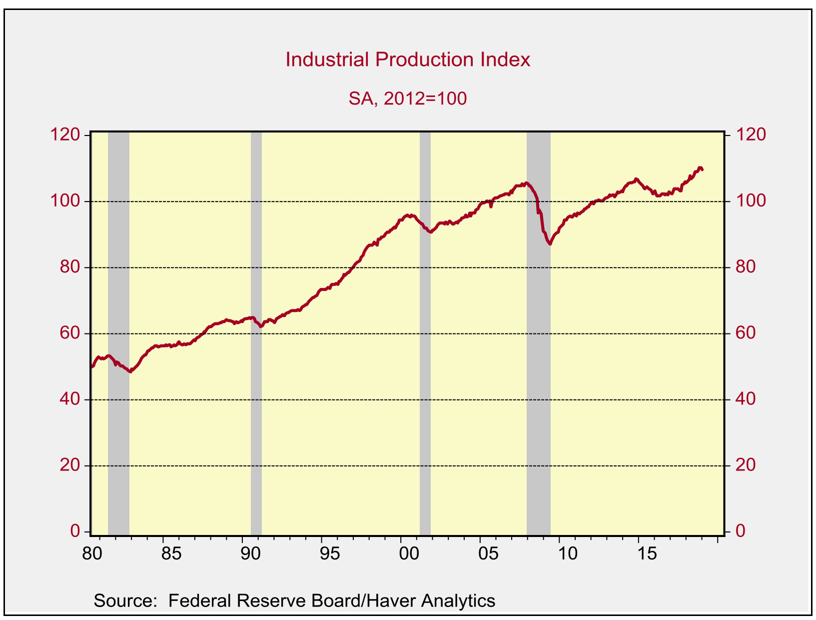
The January import price index came in below expectations, falling 0.5% from the prior month compared to the forecast loss of 0.2%. The import price index excluding petroleum was below expectations, falling 0.7% from the prior month compared to the forecast loss of 0.1%. The export price index was also below expectations, falling 0.6% from the prior month compared to the forecast drop of 0.1%.

[10]https://www.nbc.com/saturday-night-live/video/mclaughlin-group/n9987




The chart above shows the year-over-year changes in the import price and export price indexes. The import price index fell 1.7% from the prior year, while the export price index fell 0.2%. Weakening global demand for goods and lower oil prices likely led to weaker import and export price growth.

Industrial production for January came in weaker than forecast, falling 0.6% from the prior month compared to the forecast loss of 0.1%. The prior report's gain was revised downward from 0.3% to 0.1%. Capacity utilization was 78.2%, below the 78.7% expected.




The chart above shows the Industrial Production Index. The current reading is 109.4, the highest on record.

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

| Economic Releases | | | | | | |
|---|---|---|---|---|---|---|
| EDT | Indicator | | | Expected | Prior | Rating |
| 10:00 | U. of Michigan Sentiment | m/m | feb | 93.7 | 91.2 | ** |
| 10:00 | U. of Michigan Current Conditions | m/m | feb | 111.6 | 108.8 | ** |
| 10:00 | U. of Michigan Expectations | m/m | feb | 85.5 | 79.9 | ** |
| 10:00 | U. of Michigan 1 yr Inflation | m/m | feb | | 2.7% | ** |
| 10:00 | U. of Michigan 5-10 Yr Inflation | m/m | feb | | 2.6% | ** |
| 10:00 | Mortgage Delinquencies | q/q | 4q | | 4.5% | ** |
| 10:00 | MBA Mortgage Foreclosures | q/q | 4q | | 1.0% | ** |
| 16:00 | Total Net TIC Flows | m/m | dec | | $37.6 bn | ** |
| 16:00 | Net Long-Term TIC Flows | m/m | dec | | $31.0 bn | ** |
| 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 | | | | | | | | |
| China | Aggregate Financing CNY | m/m | jan | 4.640 tn | 1.590 tn | 3.307 tn | ** | Equity bullish, bond bearish |
| | New Yuan Loans CNY | m/m | jan | 3.230 tn | 1.080 tn | 3.000 tn | ** | Equity bullish, bond bearish |
| | BoP Current Account Balance | q/q | 4q | $54.6 bn | $23.3 bn | | ** | Equity bullish, bond bearish |
| Japan | Industrial Production | m/m | dec | -0.1% | -0.1% | | *** | Equity and bond neutral |
| | Capacity Utilization | m/m | dec | -1.9% | -1.0% | | ** | Equity and bond neutral |
| New Zealand | BusinessNZ Manufacturing PMI | m/m | jan | 53.1 | 55.1 | | ** | Equity and bond neutral |
| | Net Migration | m/m | dec | 5080 | 2480 | | ** | Equity and bond neutral |
| EUROPE | | | | | | | | |
| Eurozone | EU27 New Car Registration | m/m | jan | -4.6% | -8.4% | | * | Equity and bond neutral |
| | Trade Balance | m/m | dec | 15.6 bn | 15.1 bn | 15.7 bn | ** | Equity and bond neutral |
| Italy | Trade Balance Total | m/m | dec | 3.658 bn | 3.843 bn | | ** | Equity and bond neutral |
| UK | Retail Sales Ex Auto Fuel | m/m | jan | 4.1% | 2.6% | 3.2% | ** | Equity bullish, bond bearish |
| | Retail Sales Inc Auto Fuel | m/m | jan | 4.2% | 3.0% | 3.4% | ** | Equity bullish, bond bearish |
| Russia | Gold and Forex Reserve | w/w | feb | 475.0 bn | 477.7 bn | | ** | Equity and bond neutral |
| | Money Supply Narrow Def | w/w | feb | 10.20 tn | 10.13 tn | | ** | Equity and bond neutral |
| AMERICAS | | | | | | | | |
| Canada | Manufacturing Sales | m/m | dec | -1.3% | -1.4% | 0.4% | ** | Equity and bond bearish |
| | New Housing Price Index | y/y | dec | 0.0% | 0.0% | 0.0% | ** | Equity and bond neutral |
| Brazil | Economic Activity | y/y | dec | 0.2% | 1.9% | 0.0% | *** | 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)** | 268 | 269 | -1 | Up |
| **3-mo T-bill yield (bps)** | 237 | 238 | -1 | Neutral |
| **TED spread (bps)** | 31 | 32 | -1 | Neutral |
| **U.S. Libor/OIS spread (bps)** | 240 | 240 | 0 | Up |
| **10-yr T-note (%)** | 2.66 | 2.65 | 0.01 | Neutral |
| **Euribor/OIS spread (bps)** | -31 | -31 | 0 | Neutral |
| **EUR/USD 3-mo swap (bps)** | 7 | 7 | 0 | Down |
| **Currencies** | **Direction** | | | |
| dollar | up | | | Neutral |
| euro | down | | | Up |
| yen | down | | | Neutral |
| pound | flat | | | 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 | $64.95 | $64.57 | 0.59% | |
| WTI | $54.70 | $54.41 | 0.53% | |
| Natural Gas | $2.60 | $2.57 | 0.97% | |
| Crack Spread | $15.57 | $15.47 | 0.66% | |
| 12-mo strip crack | $16.66 | $16.59 | 0.42% | |
| Ethanol rack | $1.45 | $1.45 | -0.07% | |
| **Metals** | | | | |
| Gold | $1,317.59 | $1,312.57 | 0.38% | |
| Silver | $15.67 | $15.62 | 0.32% | |
| Copper contract | $280.10 | $277.40 | 0.97% | |
| **Grains** | | | | |
| Corn contract | $ 384.25 | $ 383.00 | 0.33% | |
| Wheat contract | $ 509.75 | $ 510.50 | -0.15% | |
| Soybeans contract | $ 922.00 | $ 917.75 | 0.46% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 628 | 608 | 20 | |
| **DOE inventory report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | 3.6 | 2.4 | 1.2 | |
| Gasoline (mb) | 0.4 | 1.2 | -0.8 | |
| Distillates (mb) | 1.2 | -1.7 | 2.9 | |
| Refinery run rates (%) | -4.80% | -0.85% | -3.95% | |
| Natural gas (bcf) | -78.0 | -82.0 | 4.0 | |

## Weather

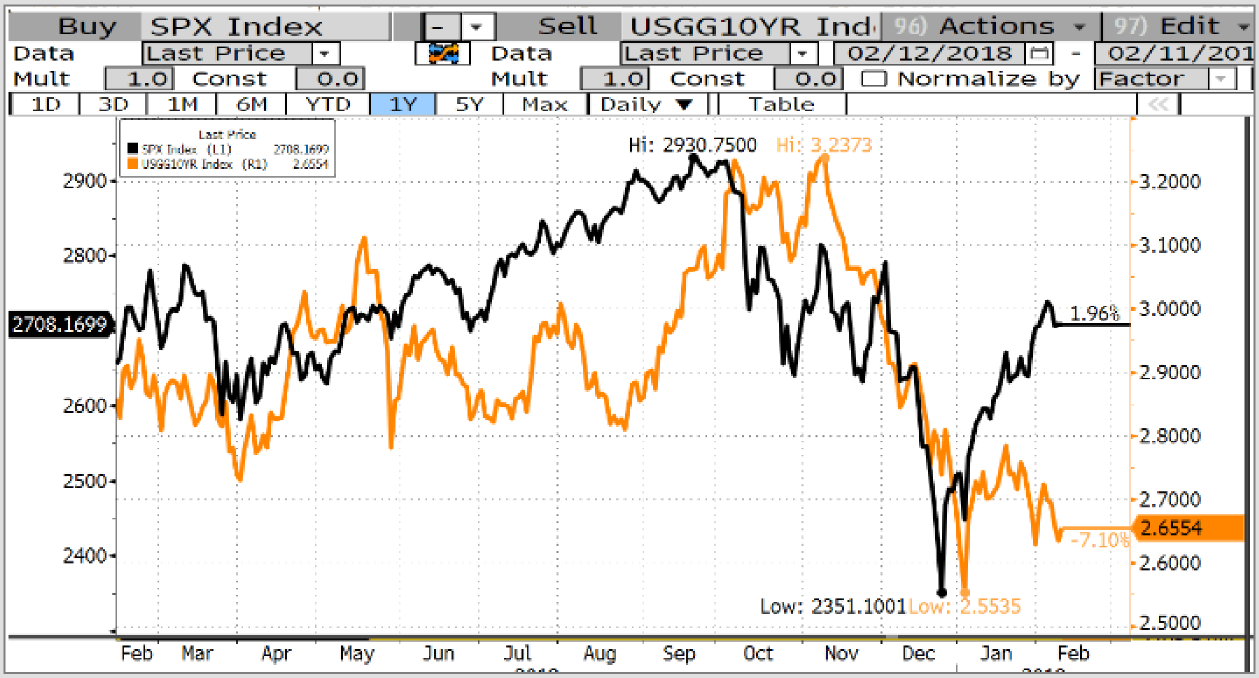
The 6-10 and 8-14 day forecasts show cooler temperatures for most of the country, with warmer temps on the East Coast. Precipitation is expected for most of the country.

**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 15, 2019

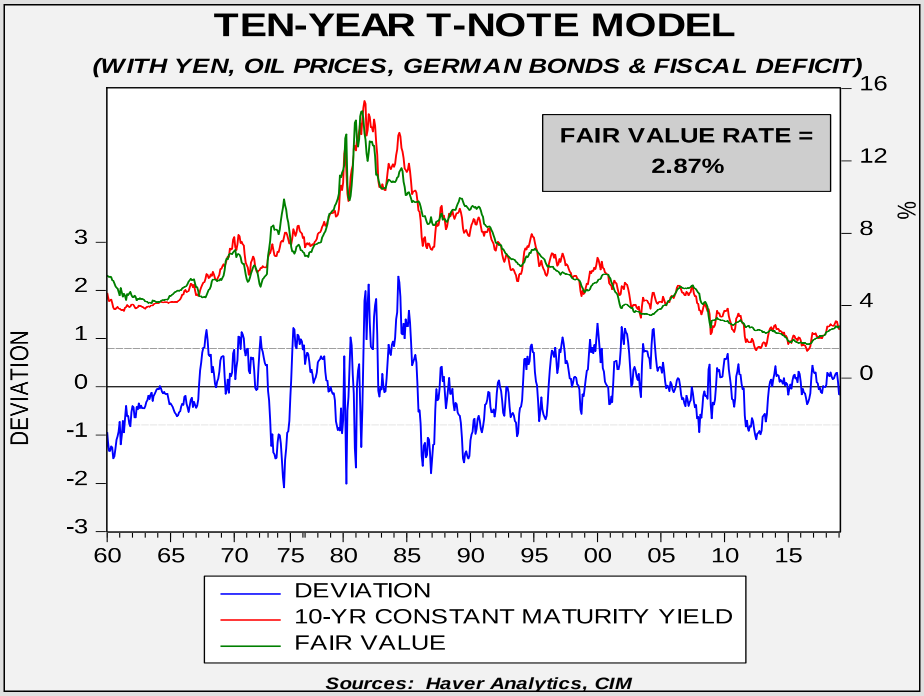
The pullback in equities in Q4 coincided with a sharp drop in long-duration Treasury yields. However, the recovery seen in early 2019 has not led to a rise in yields.




(Source: Bloomberg)

This chart shows the S&P 500 (left axis) and the 10-year T-note yield (right axis). Note that yields and the equity markets tended to rise together in the first three quarters of 2018. More importantly, they tracked each other in the fourth quarter; as equity values fell, yields also declined. However, as equities have recovered since late December, yields have not rebounded into the range where they were when the S&P was around 2700.

In part, yields are currently running below fair value.



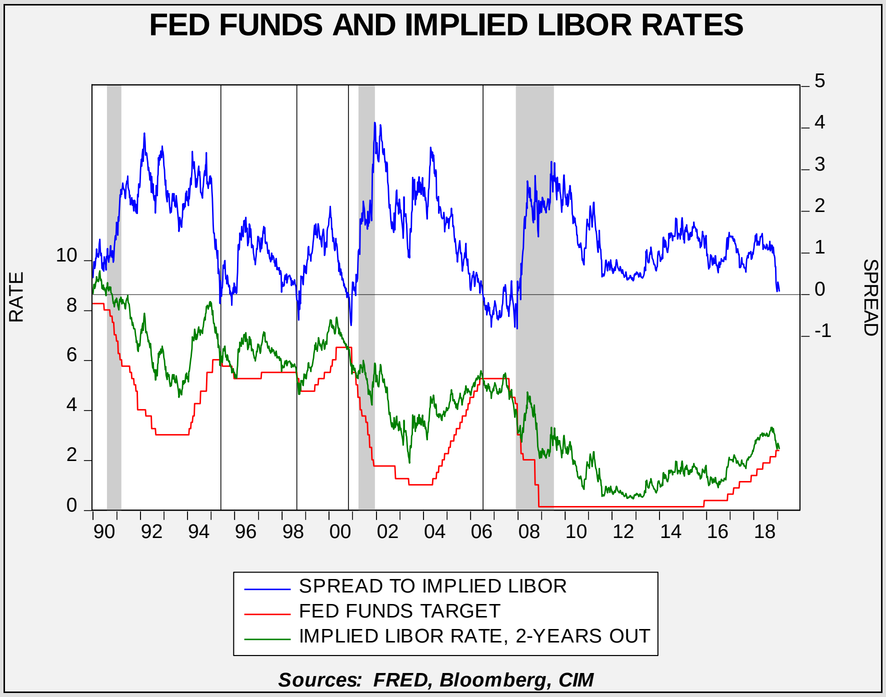

This chart shows our bond model; the core variables are fed funds and the 15-year average of CPI.[11] In addition to these variables, we add the JPY/USD exchange rate, crude oil prices, German 10-year sovereign yields and the Federal deficit/GDP ratio. The market would not be "rich" in this model until yields approach 2.17% but they are modestly below fair value after being above fair value for most of last year.

There are thee variables that account for the decline in the 10-year T-note yield, fed funds, German sovereign 10-year yields and oil prices. In October, the 10-year T-note yield was running around 3.15%. That level had discounted oil prices at $60 per barrel, German yields at 20 bps and a terminal fed funds rate of 3.25%. The decline in the fed funds estimate to 2.50% accounted for 30 bps in the decline in yield, while the remaining 3 bps to fair value came from the decline in oil prices to $55 per barrel and German 10-year sovereign yield declines to 14 bps.

The "undershoot" to 2.70, below the fair value of 2.87%, could be achieved with a fed funds of 2.12%. Given that the actual target is the mid-point between the upper and lower bound of the fed funds target (the announced rate is actually the upper bound), this would imply a rate cut. Or, a decline in inflation expectations to 1.8% from 2.1% could also account for the undershoot, assuming no change in fed funds.

We suspect the primary reason for the slide is that inflation expectations have probably fallen. This is because there isn't much in the data to support the FOMC cutting rates.

[11] Which is a proxy for inflation expectations.



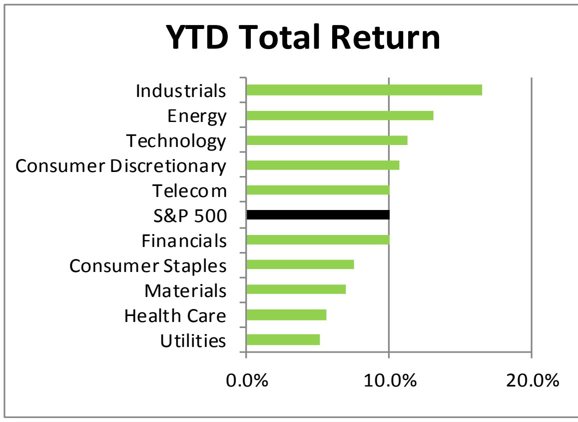

This chart compares the fed funds target to the implied three-month LIBOR rate from the two-year deferred Eurodollar futures contract. History shows that policymakers tend to stop raising rates when the spread between these two rates invert. As the spread line shows, the spread is near inversion which is consistent with a policy pause but would not be consistent with rate declines. Policy cuts would be in order if the implied yield were to fall further, but that evidence doesn't exist for now.

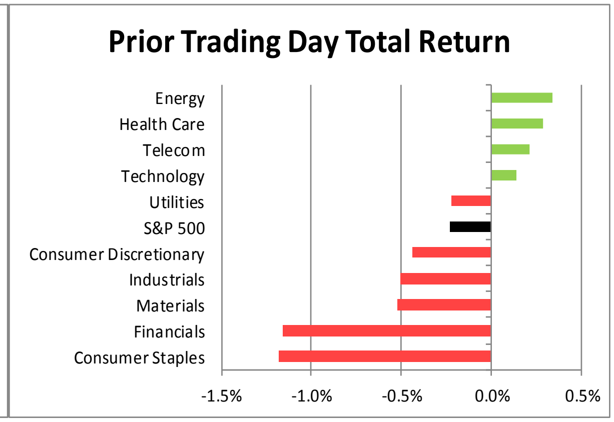
If inflation expectations are leading to the undershoot, then stronger economic growth could trigger a rise in inflation fears. We would not be surprised to see a modest rise in yields in the coming weeks, but a rise beyond 3.00% on the 10-year T-note yield would likely require a return to policy tightening by the FOMC. We would not expect such a shift until later this year, if then.

*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 2/14/2019 close)

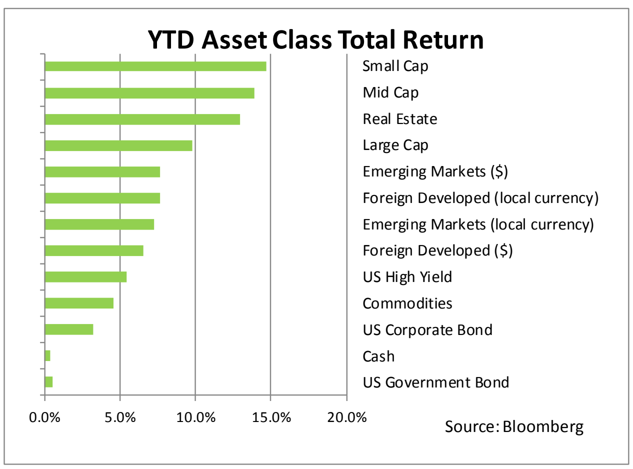



(Source: Bloomberg)

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 2/14/2019 close)

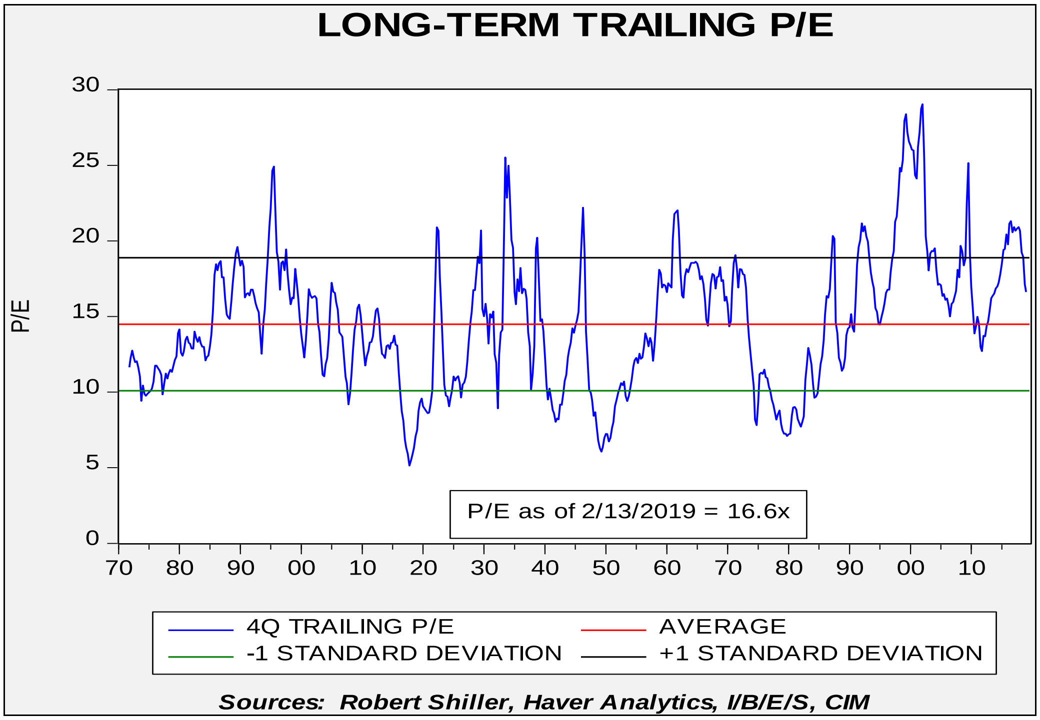



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 14, 2019




Based on our methodology,[12] the current P/E is 16.5x, up 0.1x from last week. Rising index values and a decline in Q1 earnings expectations led to the rise in the multiple.



[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 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.