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 20, 2019—9:30 AM EST] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.2% from the last close. In Asia, the MSCI Asia Apex 50 was up 1.2% from the prior close. Chinese markets were higher, with the Shanghai composite up 0.2% and the Shenzhen index up 0.3%. U.S. equity index futures are signaling a lower open. With 409 companies having reported, the S&P 500 Q4 earnings stand at $41.39, higher than the $40.86 forecast for the quarter. The forecast reflects a 13.4% increase from Q4 2017 earnings. Thus far this quarter, 67.0% of the companies reported earnings above forecast, while 23.2% reported earnings below forecast.

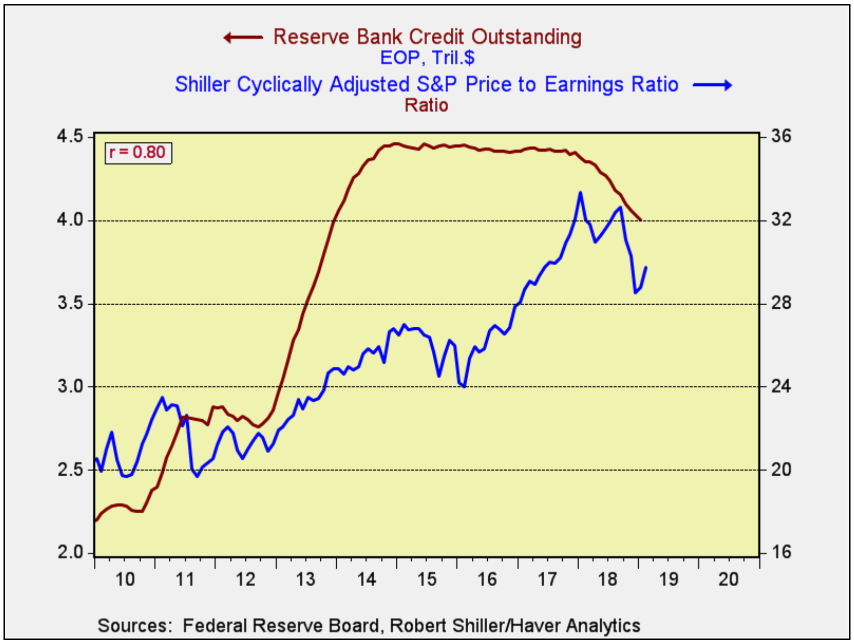
It's mid-week (already!). Global equities are stronger this morning and U.S. equity futures are flat. Here is what we are watching this morning:

More U.K. defections: Yesterday, we reported that seven Labour MPs left their party to form a new centrist party, called the Independent Group. Today, three Tory MPs left their party to join them.[1] May's coalition of Tories and the DUP gives her a narrow majority of two seats; her party holds 317 seats and the DUP 10. The loss of three MPs actually puts her now in the minority and thus makes her vulnerable to a no-confidence vote. However, given that she has survived one no-confidence vote already,[2] we doubt another one will come anytime soon. But, for now, it does appear she is operating a minority government.

Brexit: May is on her way to Brussels for more negotiations.[3] This looks to us as a "going through the motions" exercise but May is probably hoping for language on the Irish backstop that might mollify her coalition. It isn't likely. On the backstop issue, May officially scotched a rather odd plan from Brexit Conservatives to create a high tech border control mechanism on the Ireland frontier that would act as an invisible customs monitor.[4] Since the technology doesn't currently exist, it was rather easy to put it to rest. Brexit is steadily progressing toward next month's deadline. May's tactics appear to be to run out the clock and leave MPs with one of two options, either her plan or a catastrophic hard Brexit. The MPs are trying hard to avoid that difficult choice but they don't have an alternative plan. However, there is one increasingly obvious downside—businesses are quitting the U.K. on fears of a hard Brexit.[5]

[1] https://www.ft.com/content/4bd129da-3500-11e9-bd3a-8b2a211d90d5
[2] https://www.nytimes.com/2019/01/16/world/europe/brexit-theresa-may-no-confidence-vote.html
[3] https://www.bloomberg.com/news/articles/2019-02-19/britain-targets-brexit-deal-within-days-as-may-heads-to-brussels
[4] https://www.ft.com/content/93745dd2-3476-11e9-bb0c-42459962a812
[5] https://www.politico.eu/article/the-day-project-fear-got-real/?utm_source=POLITICO.EU&utm_campaign=9cb3b43de9-

Fed: The FOMC releases the minutes of its most recent meeting today. We will pore over the report for any clues about policy but we don't expect too much new information. Although we expect some caution that the markets may have become too sanguine on rate expectations,[6] what we are hearing from Fed officials suggests the committee is rather comfortable with leaving rates about where they are now.[7] In fact, most of the focus has now, for better or worse, shifted to the balance sheet. Our position is that the balance sheet's effect has mostly been psychological.



This chart overlays the CAPE with the Fed's balance sheet. Since the last recession, the two tended to track each other, although expectations of tax reform did lead to a large rise in the multiple in late 2016 through 2017. Note that the P/E has declined as the balance sheet has contracted. There are obviously other factors that contributed to the multiple contraction. Fears of a trade war are part of the contraction and the CAPE, which uses the 10-year average of earnings, is rolling off the 2008 earnings drop, thus lifting the "E." But, we would argue that the balance sheet did contribute to weakening investor sentiment. Thus, if the FOMC signals an end to QT, it would be reasonable to expect a rise in P/E.

Trade: According to reports, China's lead negotiator, Vice Premier Liu He, is planning to discuss a memorandum of understanding (MOU) with U.S. negotiators. Such a document would be a clear signal that an agreement was reached. The fact that Liu was given the authority to make a MOU would suggest that China is serious about a deal.[8] President Trump has signaled

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[6] https://www.wsj.com/articles/investors-sound-warning-about-markets-complacency-on-interest-rates-11550588400

[7] https://www.reuters.com/article/us-usa-fed-williams-exclusive/exclusive-feds-williams-says-new-economic-outlook-necessary-for-rate-hikes-idUSKCN1Q82KL

[8] https://www.scmp.com/news/china/diplomacy/article/2186735/chinese-vice-premier-liu-he-set-washington-talks-week-latest?li_source=LI&li_medium=home-top-picks-for-you

some flexibility by making the March 1 deadline somewhat optional.[9] The U.S. is pressing China to promise to not use its exchange rate as a tool to manage its trade issues.[10] However, former Fed Chair Yellen cautions that such promises may not be possible to keep.[11]

Huawei (002502, CNY 4.09) and the Europeans: The U.S. is working to prevent Huawei from selling its products to allies. However, Europe is cool to cooperating with Washington. The U.K. has indicated that it views the risks to using the Chinese company's products for 5G as "manageable"[12] and Germany has indicated it may buy the company's products.[13] We expect this issue to become increasingly complicated. The U.S. will likely threaten not to do a free trade deal with the U.K. after Brexit if London goes down this path and may use the car tariff threat against Germany to accomplish its goal with Huawei.

A curious report out of China: A Chinese blogger reports that local governments in China are banning price cuts on housing. Price cuts on unsold inventory have been a source of unrest in China; households that bought at a higher price face an immediate decline in wealth if the prices on new homes fall. Thus, local governments appear to be signaling to developers that they cannot engage in price cuts to clear inventory.[14]

Purges in the Hermit Kingdom: Reports indicate that Kim Jong-un has purged between 50 and 70 wealthy and high-ranking officials. Some of this action appears to be a simple shakedown. North Korea has been gradually and quietly using markets to boost the economy but the regime likely fears that if some people get too wealthy they may opt to gain political power. In addition, the regime may need money and therefore the crackdown is a rather harsh form of taxation. Some of the crackdown does appear to be aimed at critics who oppose talks with the U.S. To some extent, the purges probably indicate that the regime does want to improve relations with the U.S. and Kim wants to ensure that he can make changes without opposition.[15]

And, finally: There are some pundits who don't really offer any penetrating insights but are important for their signaling. We tend to view Tom Friedman at the *NYT* in this light. His insights are rarely penetrating but he says them well and we use them as signals of elite consensus. In other words, he is almost never in front of anything, but when he says something it officially becomes common knowledge. In today's *NYT*, he has an op-ed suggesting that the U.S. now has four political parties.[16] Friedman, a spokesman for the center-left elite, hammers the populist left in his article. Of course, he hits at the populist right and the center-right as well. The analysis in the article doesn't break any new ground, but the fact that he wrote it is

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[9] https://www.reuters.com/article/us-usa-trade-china-deadline/trump-says-march-1-deadline-for-china-trade-talks-not-magical-date-idUSKCN1Q82HD

[10] https://www.bloomberg.com/news/articles/2019-02-19/u-s-said-to-press-china-for-stable-yuan-as-trade-talks-progress

[11] https://www.bloomberg.com/news/articles/2019-02-19/yellen-offers-caution-as-u-s-pushes-china-to-keep-yuan-stable?srnd=markets-vp

[12] https://www.ft.com/content/619f9df4-32c2-11e9-bd3a-8b2a211d90d5

[13] https://www.wsj.com/articles/in-rebuke-to-u-s-germany-considers-letting-huawei-in-11550577810

[14] http://investinginchinesestocks.blogspot.com/2019/02/big-trouble-in-china-housing-govt-bans.html

[15] https://www.wsj.com/articles/kim-jong-un-purges-north-korean-elite-in-violent-crackdown-11550593810

[16] We discussed the issues of identity and class in the WGR series, Reflections on Politics and Populism: Part I (7/16/2018) and Part II (7/23/2018).

important—it is now common knowledge that the political system is split and the fragile populist/elite coalitions of the past four decades are no longer holding (and, for what it's worth, in our opinion the divide began in 2008).

U.S. Economic Releases

MBA mortgage applications rose 3.6% from the prior week. Purchases and refinancing are up 1.7% and 6.4%, respectively, from the previous week. The average 30-year fixed rate rose by 1 bp from 4.65% to 4.66%.

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**
13:10	Robert Kaplan to Speak in Q&A in Houston, Texas	President of the Federal Reserve Bank of Dallas
14:00	FOMC Meeting Minutes	Members of the Board of Governors

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	Trade Balance	m/m	jan	-¥1.415 tn	-¥0.055 tn	-¥1.029 tn	**	Equity bearish, bond bullish
Australia	Westpac Leading Index	m/m	jan	0.0%	-0.2%		**	Equity and bond neutral
	Skilled Vacancies	m/m	jan	0.5%	0.6%	0.6%	**	Equity and bond neutral
	Wage Price Index	y/y	4q	2.3%	2.3%	2.3%	*	Equity and bond neutral
New Zealand	PPI Output	q/q	4q	0.8%	1.5%		**	Equity and bond neutral
	PPI Input	q/q	4q	1.6%	1.4%		*	Equity and bond neutral
EUROPE								
Germany	PPI	y/y	jan	2.6%	2.7%	2.2%	**	Equity bearish, bond bullish
UK	CBI Trends Total Orders	m/m	feb	6	-1	-5	**	Equity bullish, bond bearish
	CBI Trends Selling Prices	m/m	feb	22	18	16	**	Equity bullish, bond bearish
Russia	Real Wages	m/m	jan	0.2%	2.5%	1.0%	**	Equity bearish, bond bullish
	Retail Sales Real	m/m	jan	1.6%	2.3%	1.0%	**	Equity and bond neutral
	Real Disposable Income	w/w	jan	-1.3%	0.1%	-0.9%	**	Equity and bond bearish
	Unemployment Rate	m/m	jan	4.9%	4.8%	4.9%	**	Equity and bond neutral
AMERICAS								
Canada	Bloomberg Nanos Confidence	m/m	feb	54.8	54.3		**	Equity and bond neutral
Mexico	International Reserves Weekly	w/w	feb	$175.501 bn	$175.511 bn		**	Equity and bond neutral
Brazil	Tax Collections	m/m	jan	160.426 bn	141.529 bn	157.550 bn	*	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)	264	268	-4	Up
3-mo T-bill yield (bps)	238	238	0	Neutral
TED spread (bps)	26	31	-5	Neutral
U.S. Libor/OIS spread (bps)	240	240	0	Up
10-yr T-note (%)	2.64	2.63	0.01	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	10	11	-1	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	flat			Up
yen	down			Neutral
pound	down			Neutral
franc	flat			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	$65.93	$66.45	-0.78%	
WTI	$55.66	$56.09	-0.77%	
Natural Gas	$2.68	$2.66	0.56%	
Crack Spread	$15.58	$15.73	-0.99%	
12-mo strip crack	$16.81	$16.97	-0.94%	
Ethanol rack	$1.44	$1.45	-0.17%	
Metals				
Gold	$1,342.89	$1,340.94	0.15%	
Silver	$16.02	$15.99	0.19%	
Copper contract	$288.45	$287.80	0.23%	
Grains				
Corn contract	$ 381.00	$ 378.00	0.79%	
Wheat contract	$ 492.25	$ 492.25	0.00%	
Soybeans contract	$ 913.25	$ 914.50	-0.14%	
Shipping				
Baltic Dry Freight	635	643	-8	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.1		
Gasoline (mb)		-0.9		
Distillates (mb)		-1.5		
Refinery run rates (%)		0.00%		

Weather

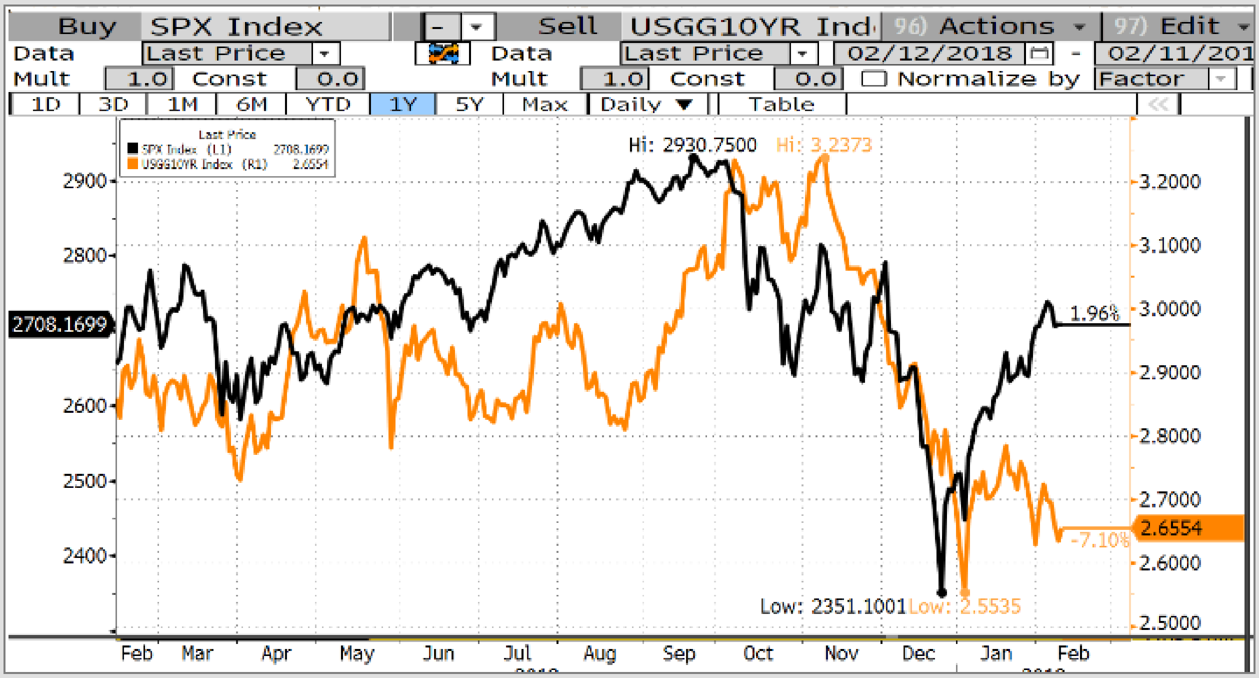
The 6-10 and 8-14 day forecasts show cooler temperatures for most of the country, with warmer temps in the southeastern region.

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

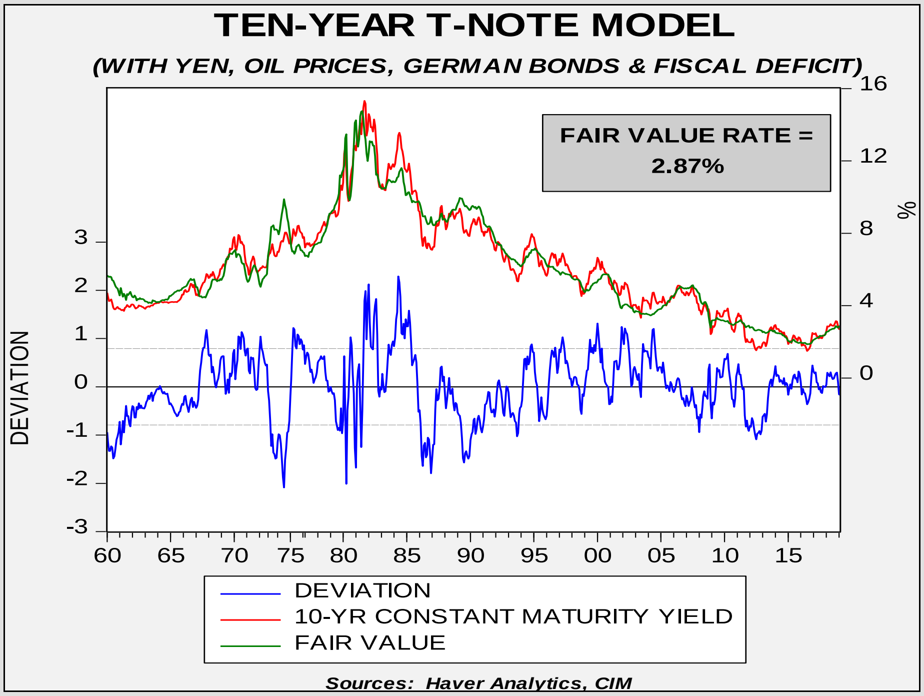
The pullback in equities in Q4 coincided with a sharp drop in long-duration Treasury yields. However, the recovery seen in early 2019 has not led to a rise in yields.



(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.



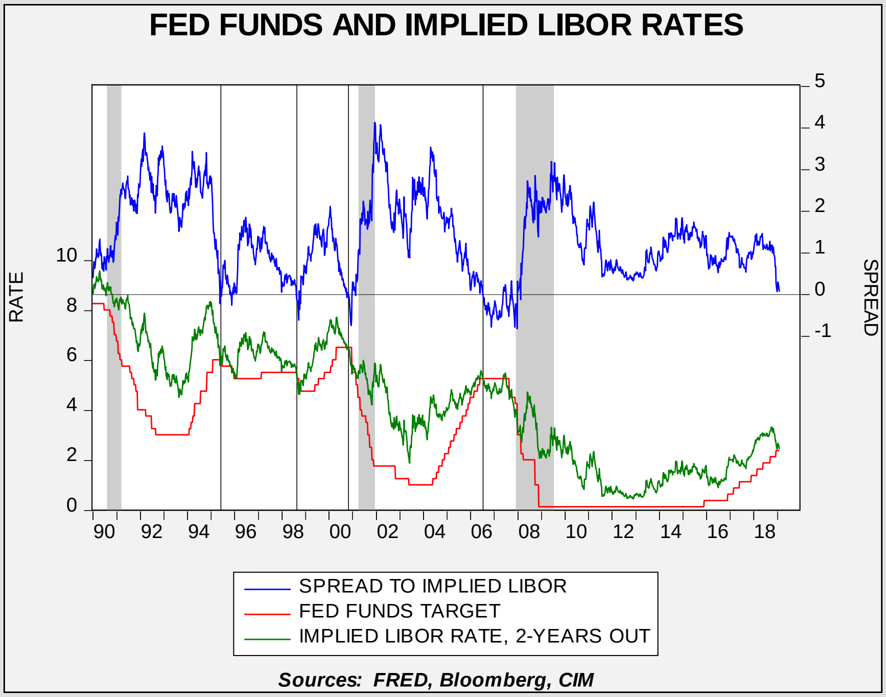
This chart shows our bond model; the core variables are fed funds and the 15-year average of CPI.[17] In addition to these variables, we add the JPY/USD exchange rate, crude oil prices, German 10-year sovereign yields and the Federal deficit/GDP ratio. The market would not be "rich" in this model until 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.

[17] Which is a proxy for inflation expectations.

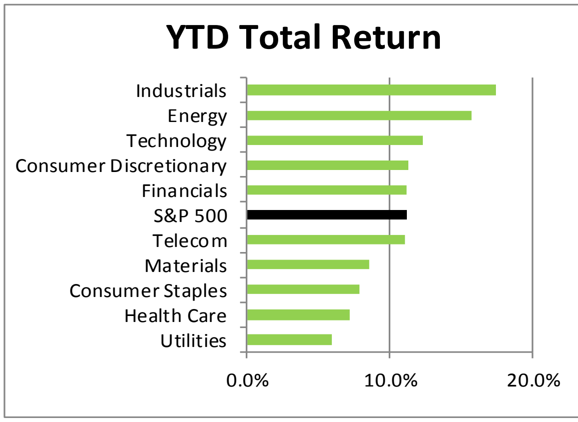


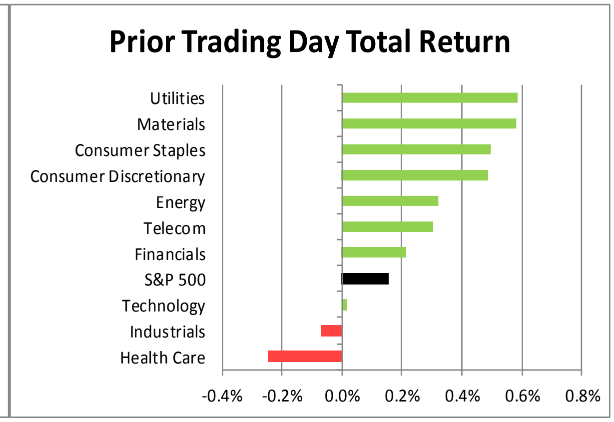
This chart compares the fed funds target to the implied three-month LIBOR rate from the two-year deferred Eurodollar futures contract. History shows that policymakers tend to stop raising rates when the spread between these two rates invert. As the spread line shows, the spread is near inversion which 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.

Data Section

U.S. Equity Markets – (as of 2/19/2019 close)

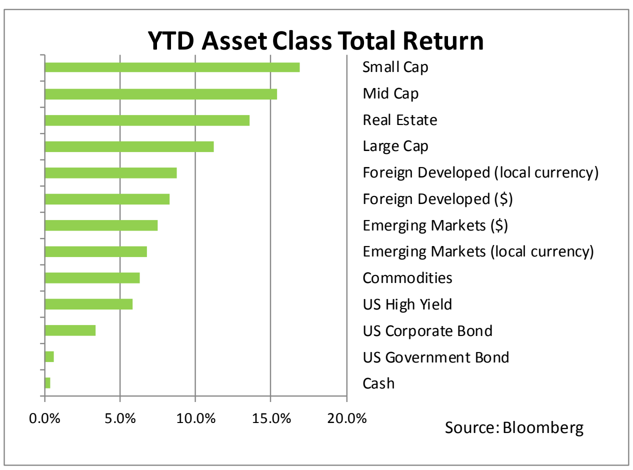




(Source: Bloomberg)

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 2/19/2019 close)

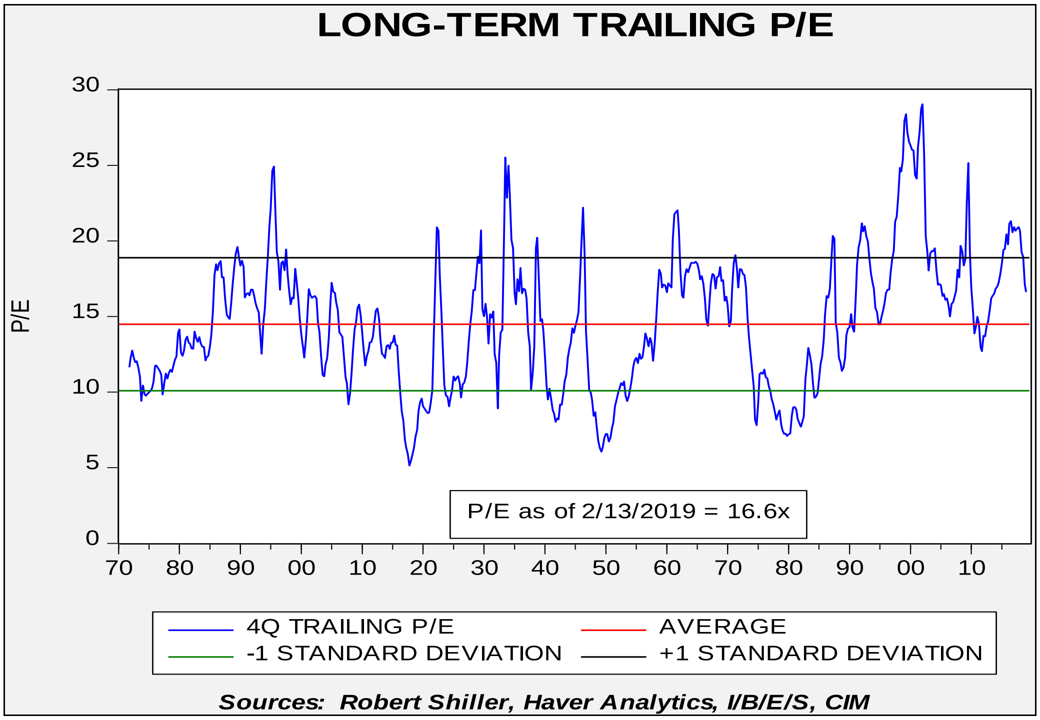


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[18] 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.

[18] 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.