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 26, 2019—9:30 AM EST] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.3% from the last close. In Asia, the MSCI Asia Apex 50 was also down 0.3% from the prior close. Chinese markets were lower, with the Shanghai composite down 0.7% and the Shenzhen index down 0.5%. U.S. equity index futures are signaling a lower open. With 447 companies having reported, the S&P 500 Q4 earnings stand at $41.42, higher than the $40.86 forecast for the quarter. The forecast reflects a 13.4% increase from Q4 2017 earnings. Thus far this quarter, 67.1% of the companies reported earnings above forecast, while 23.0% reported earnings below forecast.

Equities are taking a breather this morning in a news heavy environment. Here is what we are watching this morning:

Brexit: The drama continues. PM May met with her cabinet this morning and will support a vote on delaying Brexit past the March 29 deadline[1] and another vote that would not allow a hard (no deal) Brexit.[2] Meanwhile, opposition leader Corbyn has reversed his earlier positon and will back a second referendum.[3] In fact, a number of Labour leaders have indicated they will support a Remain position (Labour, like the Tories, are divided on Brexit). May opposes extending the deadline; we suspect her support for these measures is designed to push Brexit supporters into adopting her plan as the best alternative to no Brexit. The votes are seen by the market as lessening the odds of a hard Brexit; the GBP rallied on the news. We will likely have votes on these issues in the next day or so.

Powell to Capitol Hill: Chair Powell will visit the capitol for his semi-annual congressional testimony.[4] We doubt new ground on monetary policy will be established; the FOMC is on pause and will likely remain so as the economy goes through a soft patch. We would expect regulation to be a topic of interest, with left-wing political figures pressing the chair on macro prudential issues. Expect lots of coverage but nothing market moving.

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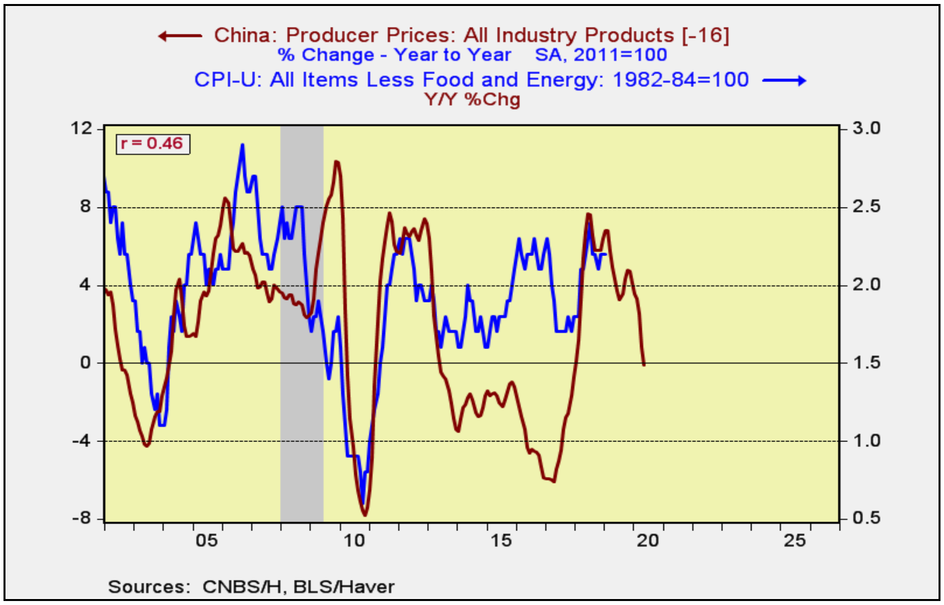
[1] https://www.ft.com/content/3875b900-3901-11e9-b72b-2c7f526ca5d0
[2] https://www.reuters.com/article/us-britain-eu/theresa-may-buckles-british-pm-to-rule-out-no-deal-brexit-the-sun-idUSKCN1QF0LZ
[3] https://www.ft.com/content/028b90ca-3925-11e9-b856-5404d3811663 and https://www.nytimes.com/2019/02/25/world/europe/Jeremy-Corbyn-brexit-referendum.html
[4] https://finance.yahoo.com/news/fed-chair-powell-senate-testimony-184449926.html

Here is an interesting chart that might help explain why the FOMC decided to pause:



This chart shows U.S. core CPI along with China's PPI, both on a yearly change basis, starting with China's entrance into the WTO. Although not a perfect correlation, it does suggest that, with a bit more than a five-quarter lead, China's producer prices affect U.S. core CPI. The recent drop in China's PPI would signal that price pressure in the U.S. should dissipate in the coming months and give the FOMC room to keep policy steady.

The administration's decision to delay additional tariffs on China may have also affected monetary policy.[5] A paper by the San Francisco FRB suggests that the second round of tariffs could have boosted personal consumption prices by 0.4% and business investment costs by 1.4%.[6] So, the delay gives Powell additional reasons to be patient.

Zarif turns in his resignation: Iran's foreign minister, Javad Zarif, has offered to resign from his position.[7] It isn't clear why he resigned or if President Rouhani will accept the resignation. Zarif was the lead negotiator of the Iran nuclear deal and has come under pressure from Iranian hardliners for negotiating the deal in the first place. At the same time, he is schooled in Western diplomacy and if Iran's plan is to hope President Trump is defeated in 2020 (and assuming a Democratic president would want to revive the nuclear agreement) then keeping Zarif in government would make more sense. If Rouhani accepts the resignation it would be a signal that

[5] https://www.wsj.com/articles/trumps-retreat-on-tariffs-may-help-keep-inflation-pressure-at-bay-report-says-11551130832

[6] https://www.frbsf.org/economic-research/publications/economic-letter/2019/february/inflationary-effects-of-trade-disputes-with-china/?mod=article_inline

[7] https://www.nytimes.com/2019/02/25/world/middleeast/javid-zarif-resigns.html?emc=edit_mbe_20190226&nl=morning-briefing-europe&nlid=567726720190226&te=1 ; https://www.apnews.com/08cb7394544947f5aa0459a2fb99fcd7?utm_source=POLITICO.EU&utm_campaign=6c8db1e66d-EMAIL_CAMPAIGN_2019_02_26_05_51&utm_medium=email&utm_term=0_10959edeb5-6c8db1e66d-190334489 ; https://www.wsj.com/articles/irans-foreign-minister-resigns-in-an-instagram-post-11551128482

Iran has given up hope that the nuclear deal will return even with a change in government in Washington. We expect Rouhani to turn down the offer; by resigning and having his offer refused, one would expect the pressure from hardliners to dissipate. In other words, Zarif may be bluffing.

Trade: We have been expecting the administration to accept a lesser trade deal with China to avoid the economic dislocation that broader trade conflict might bring. After all, the 2020 elections are not all that far away. We have noted that hardliners in the administration, Navarro and Lighthizer, might balk at a lesser deal and could resign. However, this isn't the only area of political pressure. Democrats are also pressing the administration to push back on China. It isn't clear if this is an ideological position or simply supporting the "right" policy that would also harm the president's reelection chances.[8]

Venezuela: VP Pence met with South American leaders yesterday to shore up support to isolate the Maduro regime.[9] Pence also announced additional sanctions on Venezuela and promised additional measures would be coming soon from the Treasury Department.[10] So far, the military remains aligned with Maduro; we suspect U.S. sanctions will be designed to reduce cash flows to the military in hopes that fears of pauperism might lead the brass to change sides.

Trump on oil: Yesterday, we noted that the president called for OPEC to increase production and reduce oil prices; futures prices dropped on the news. OPEC has responded by saying it will maintain and likely extend current production cuts.[11]

League wins: We are watching Italian politics closely because its current coalition is the rare mix of both left- and right-wing populists, a "Nader coalition." We have noted recently that the alliance is fraying as the Five-Star Movement, the left-wing of the coalition, has been losing favor. Regional elections held yesterday are continuing that trend. In the election in Abruzzo, the League doubled its share compared to the region's vote in the last general election, while the Five-Star Movement saw its share drop in half.[12] If current trends continue, we expect the League, the right-wing side of the current arrangement, to eventually end its pairing with the Five-Star Movement and join with the center-right to form a new coalition. Although the Nader coalition remains theoretically possible, in nature it is difficult to manage given the wide divisions between left- and right-wing populists on social issues. What remains to be seen is whether the center-right would control policy in a right-wing coalition or if the League would gain the upper hand.

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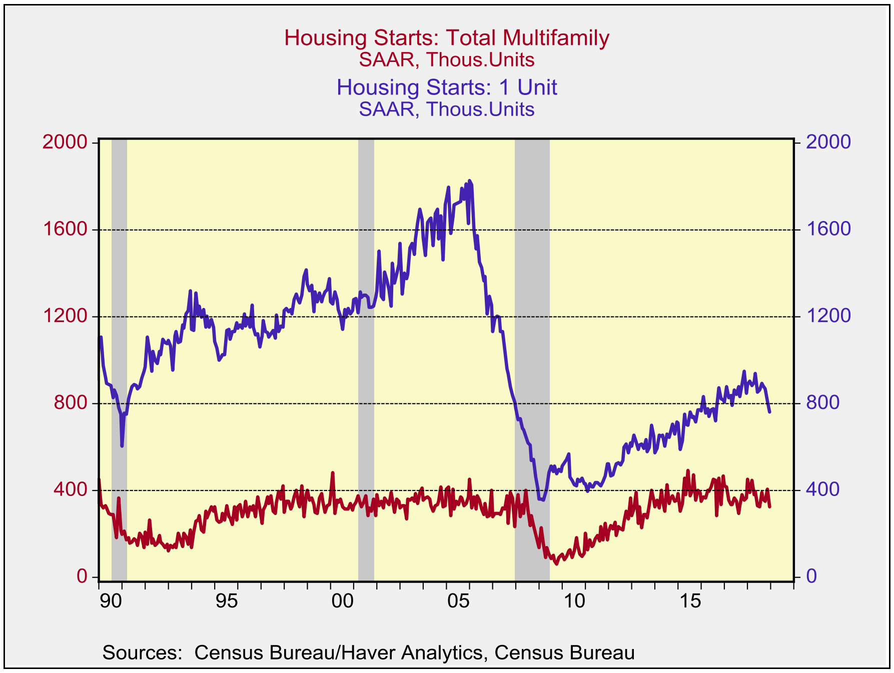
[8] https://www.nytimes.com/2019/02/25/us/politics/china-trump-trade-deal-democrats.html
[9] https://www.ft.com/content/3722d028-393e-11e9-b72b-2c7f526ca5d0?emailId=5c74b26254742a0004f1e257&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22
[10] https://www.nytimes.com/2019/02/25/world/americas/pence-guaido-venezuela-colombia.html?emc=edit_mbe_20190226&nl=morning-briefing-europe&nlid=567726720190226&te=1
[11] https://www.wsj.com/articles/saudis-likely-to-push-to-maintain-opec-output-cuts-despite-u-s-pressure-11551117577
[12] https://www.politico.eu/article/right-wing-parties-set-to-win-regional-italian-election-projections/?utm_source=POLITICO.EU&utm_campaign=6c8db1e66d-EMAIL_CAMPAIGN_2019_02_26_05_51&utm_medium=email&utm_term=0_10959edeb5-6c8db1e66d-190334489

U.S. Economic Releases

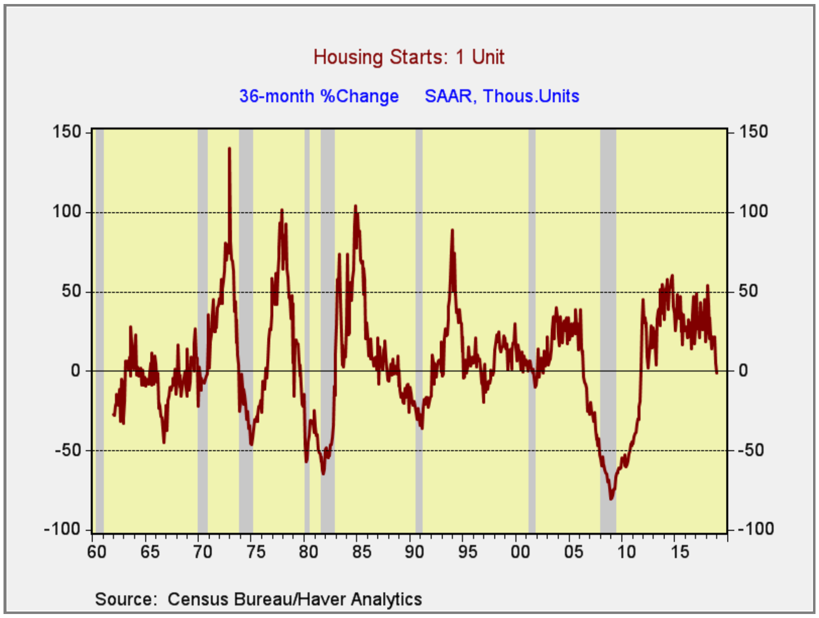
December housing starts came in well below expectations at 1.078 mm units compared to the forecast of 1.256 mm units. The prior report was revised downward from 1.256 mm to 1.214 mm. Permits were above forecast at an annual rate of 1.326 mm units compared to the forecast of 1.290 mm units. The prior report was revised downward from 1.328 mm to 1.322 mm.



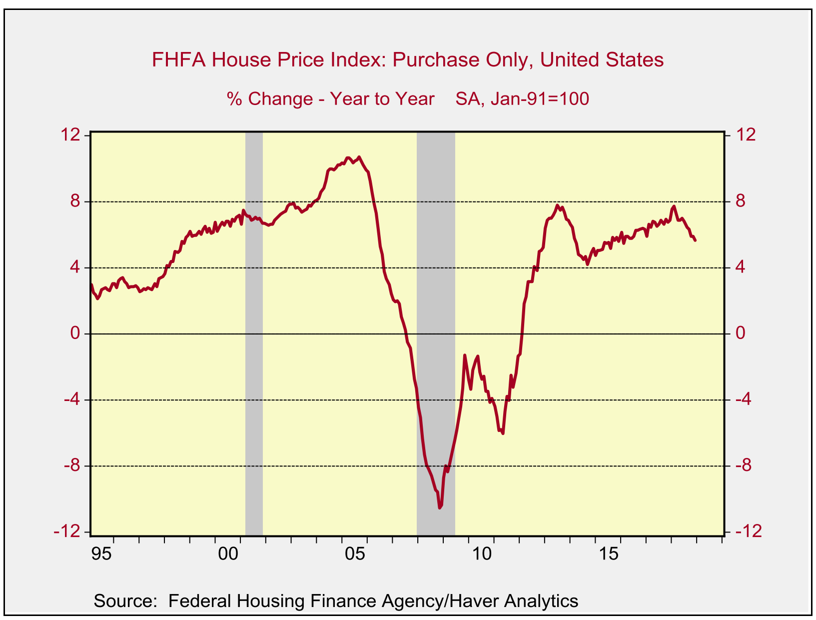
The chart above shows the level of starts for both multi-family and single-family. Single-family housing starts fell 10.5% from the prior year, while multi-family homes fell 11.9%. Housing starts rose 21.6% in the Northeast and 6.1% in the South, while housing starts fell 26.5% in the Midwest and 39.7% in the West.

The housing starts data is clearly worrisome. Although some of the weakness could be attributed to weather, the data is seasonally adjusted which should account for at least some of the effects of winter. And, this decline occurred before the government shutdown, which may have affected the ability to process mortgages.

The three-year rate of change in single-family housing starts does have some usefulness in signaling the business cycle. The chart below shows this measure of housing starts. In general, a decline below zero has tended to indicate problems in housing and can act as an early warning for a recession. If starts remain depressed, it adds to evidence of an economic slowdown but the lead times on this measure and recession can be rather lengthy; thus, the current negative reading isn't a sign of immediate distress.

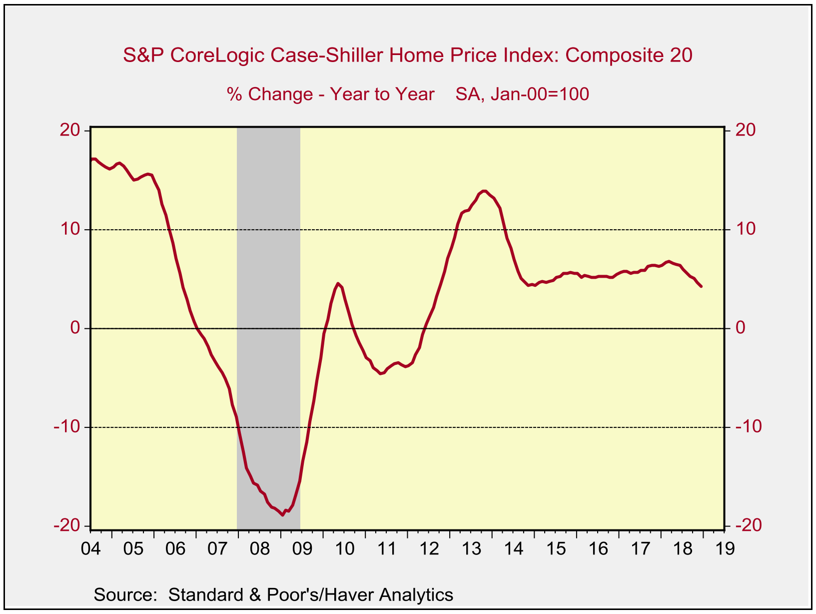


The FHFA House Price Index came in below expectations, rising 0.3% from the prior month compared to the forecast of 0.4%. The housing price index rose 1.1% in the fourth quarter.



The chart above shows the year-over-year change in the FHFA House Price Index. Housing prices have risen 6.0% from the prior year. Although still rising, the price momentum is starting to show signs of weakness.

The S&P CoreLogic CS 20-City Home Price Index came in below expectations at 4.2% compared to the forecast rise of 4.5% from the prior year. The prior report was revised from 4.68% to 4.58%. The S&P CoreLogic CS U.S. Home Price Index rose by 4.72% from the prior year. The prior report was revised downward from 5.19% to 5.09%.



The chart above shows the year-over-year change in the S&P CoreLogic CS 20-City Home Price Index. The HPI continues to lose steam, likely as a result of higher interest rates weighing on demand for homes.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Richmond Fed Manufacturing Index	m/m	feb	5	-2	**
10:00	Conference Board Consumer Confidence	m/m	feb	124.9	120.2	**
10:00	Conference Board Present Situation	m/m	feb		169.6	**
10:00	Conference Board Expectations	m/m	feb		87.3	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
9:45	Jerome Powell testifies before Senate Banking Panel	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								
India	Fiscal Deficit INR Crore	m/m	jan	69388	-15168		**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	w/w	feb	114.1	115.2		**	Equity and bond neutral
EUROPE								
Germany	GfK Consumer Confidence	y/y	mar	10.8	10.8	10.8	***	Equity and bond neutral
France	Consumer Confidence	y/y	feb	95	91	92	***	Equity bullish, bond bearish
AMERICAS								
Canada	Bloomberg Nanos Confidence	m/m	feb	54.4	54.8		**	Equity and bond neutral
Brazil	Current Account Balance	m/m	jan	-$6.548 bn	-$0.815 bn	-$6.424	**	Equity bearish, bond bullish
	Foreign Direct Investment	m/m	jan	$5.866 bn	$8.950 bn	$4.500 bn	**	Equity and bond neutral
Mexico	GDP	q/q	4q	0.2%	0.3%	0.3%	***	Equity bearish, bond bullish
	Economic Activity	y/y	dec	0.0%	1.8%	0.4%	**	Equity bearish, bond bullish
	Current Account Balance	m/m	4q	-$3.424 bn	-$5.082 bn	-$4.080 bn	**	Equity bullish, bond bearish

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)	265	265	0	Up
3-mo T-bill yield (bps)	240	239	1	Neutral
TED spread (bps)	25	26	-1	Neutral
U.S. Libor/OIS spread (bps)	241	241	0	Up
10-yr T-note (%)	2.65	2.66	-0.01	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	9	7	2	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	flat			Up
yen	up			Neutral
pound	up			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	$65.18	$64.76	0.65%	
WTI	$55.47	$55.48	-0.02%	
Natural Gas	$2.86	$2.84	0.92%	
Crack Spread	$20.35	$19.99	1.80%	
12-mo strip crack	$17.06	$16.83	1.40%	
Ethanol rack	$1.45	$1.45	-0.14%	
Metals				
Gold	$1,325.26	$1,327.58	-0.17%	
Silver	$15.81	$15.90	-0.55%	
Copper contract	$294.55	$294.90	-0.12%	
Grains				
Corn contract	$ 378.75	$ 380.00	-0.33%	
Wheat contract	$ 468.25	$ 472.75	-0.95%	
Soybeans contract	$ 919.00	$ 925.00	-0.65%	
Shipping				
Baltic Dry Freight	637	634	3	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.0		
Gasoline (mb)		-1.5		
Distillates (mb)		-2.0		
Refinery run rates (%)		0.00%		

Weather

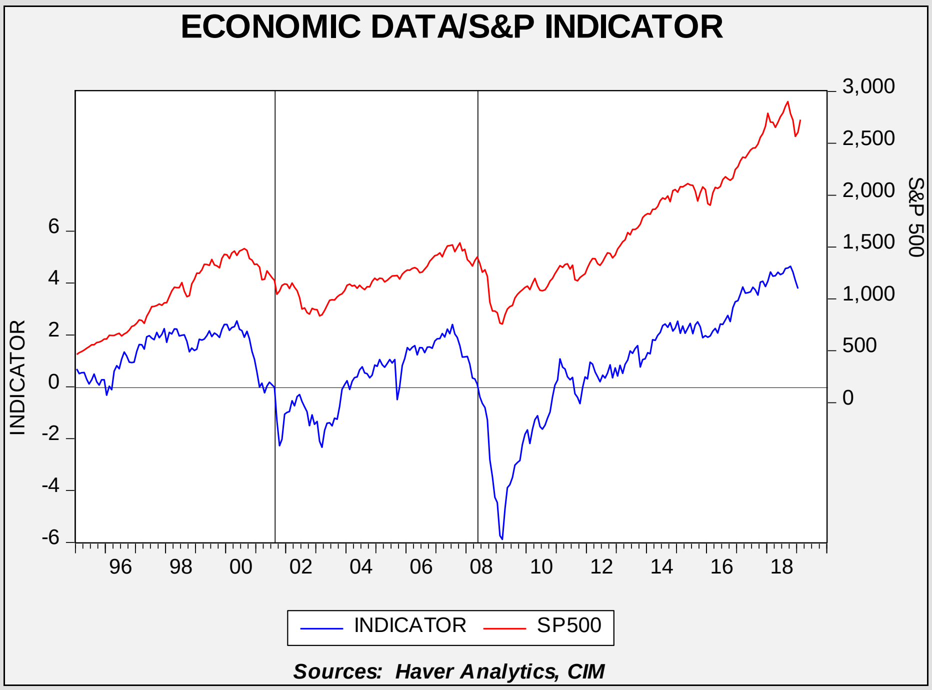
The 6-10 and 8-14 day forecasts show cooler temperatures for most of the country, with warmer temps in Florida and its surrounding areas.

Asset Allocation Weekly Comment

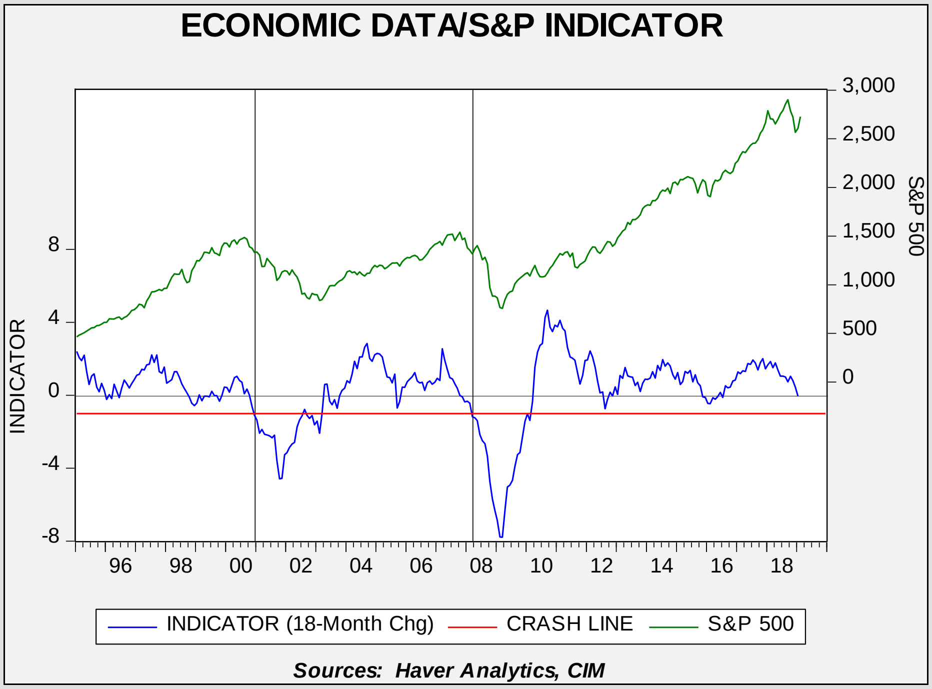
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

February 22, 2019

In 2017, we introduced an indicator of the basic health of the economy and added it to the many charts we monitor to gauge market conditions. The indicator is constructed with commodity prices, initial claims and consumer confidence. The thesis behind this indicator is that these three components should offer a simple and clear picture of the economy; in other words, rising initial claims coupled with falling commodity prices and consumer confidence is a warning that a downturn may be imminent. The opposite condition should support further economic recovery. In this report, we will update the indicator with January data.



This chart shows the results of the indicator and the S&P 500 since 1995. The updated chart shows that the economy did slip late last year. We have placed vertical lines at certain points when the indicator fell below zero. Although it works fairly well as a signal that equities are turning lower, there is a lag. In other words, by the time this indicator suggests the economy is in trouble, the recession is likely near or underway and the equity markets have already begun their decline.

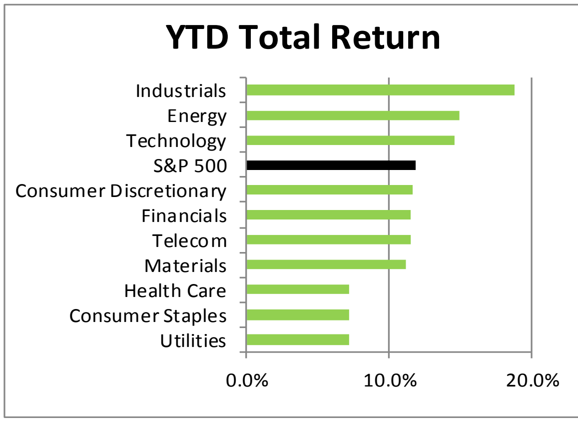


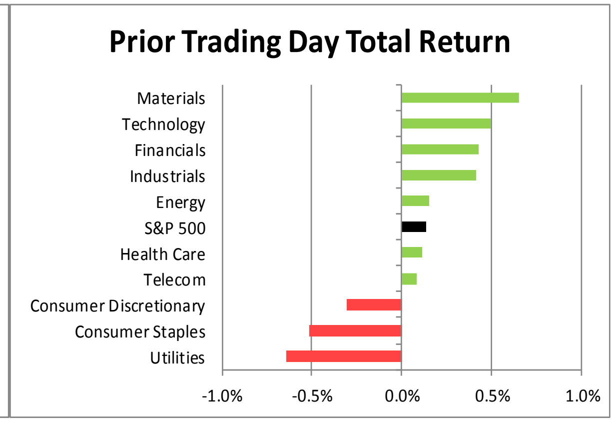
To make the indicator more sensitive, we took the 18-month change and put the signal threshold at -1.0. This provides an earlier bearish signal and also eliminates the false positives that the zero threshold generates. Notwithstanding, we will pay close attention when the 18-month change approaches zero as it did in January.

What does the indicator say now? The economy has weakened but is not yet at a point where an investor should become defensive. Breaking below the red line would be our signal to expect a broader downturn. Most likely, we are going through a period similar to what we experienced in 2016. If so, and the economic data begins to improve, then we should see equities turn higher in the coming months.

Data Section

U.S. Equity Markets – (as of 2/25/2019 close)

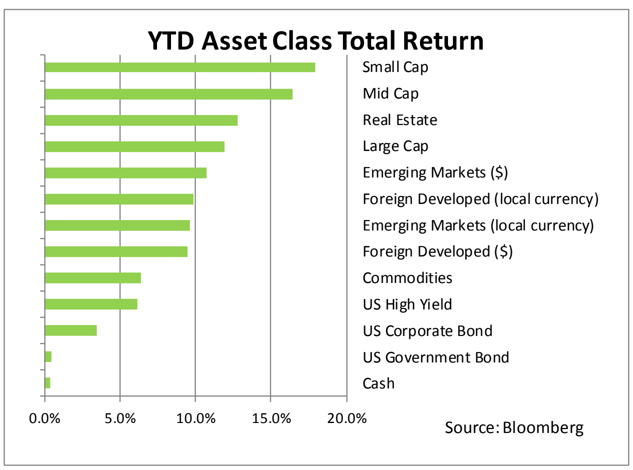




(Source: Bloomberg)

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 2/25/2019 close)

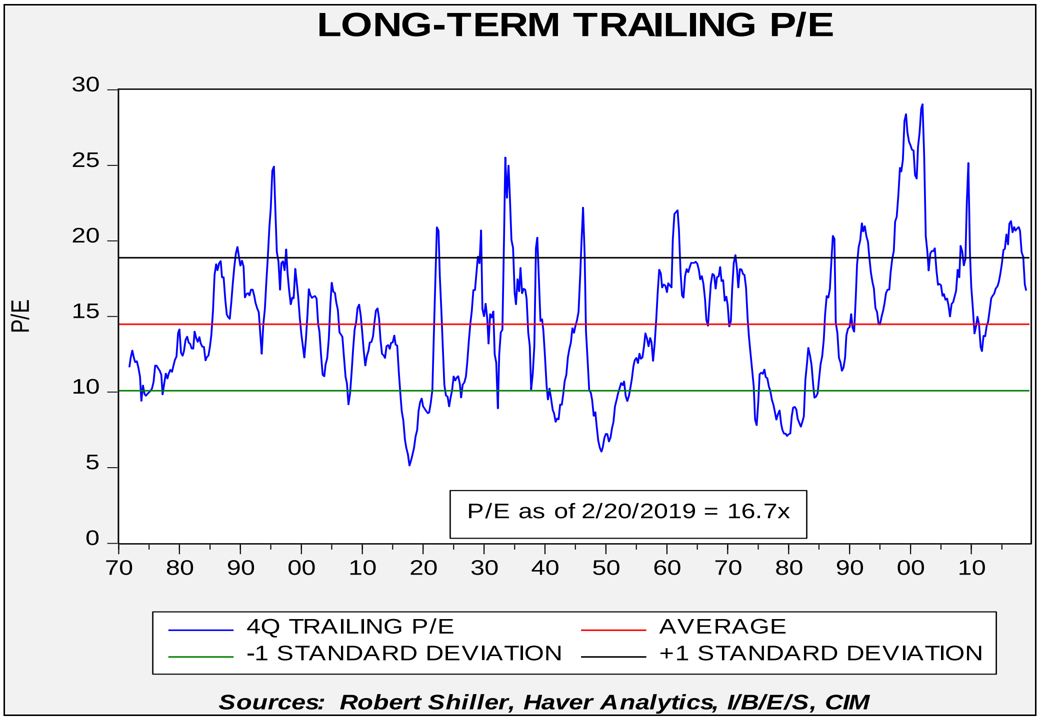


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 21, 2019



Based on our methodology,[13] the current P/E is 16.7x, up 0.1x from last week. Rising index values 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.

[13] 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.