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.

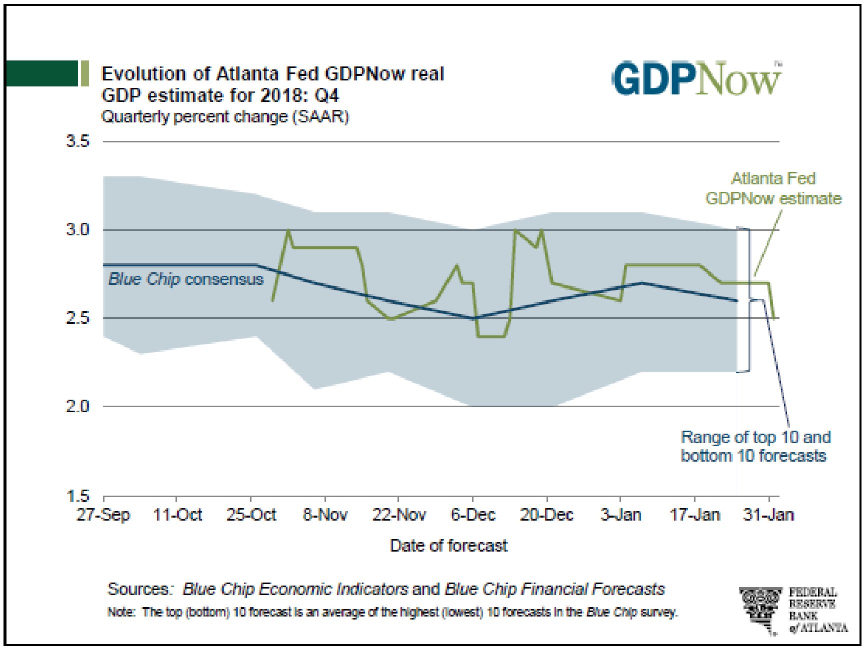
[Posted: February 5, 2019—9:30 AM EST] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.9% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.1% from the prior close. Chinese markets were closed for the Lunar New Year. U.S. equity index futures are signaling a higher open. With 234 companies having reported, the S&P 500 Q4 earnings stand at $41.09, higher than the $40.86 forecast for the quarter. The forecast reflects a 13.4% increase from Q4 2017 earnings. Thus far this quarter, 70.5% of the companies reported earnings above forecast, while 20.1% reported earnings below forecast.

U.S. equity futures are modestly higher this morning in a very quiet trade. Much of Asia remains closed for the New Year. Here is what we are watching this morning:

The President and the Chair: President Trump, Treasury Secretary Mnuchin, Chair Powell and Vice Chair Clarida met for an informal dinner yesterday.[1] It doesn't appear that much new emerged. Monetary policy has become less of a threat to the economy so the White House had little incentive to create a hostile environment. The inclusion of Mnuchin and Clarida reduced the odds of confrontation. If this meeting had been held in November, it could have been tense but the recent change in monetary policy defused the situation.

A warning sign for the economy: Car dealers are reporting high levels of inventory; cars on deal lots are up 3% from last year (January), with nearly 4.0 mm vehicles available. If inventory levels remain high, automakers will begin slowing production which will tend to depress economic growth.[2] We also note that the Atlanta FRB's GDPNow forecast shows growth falling to 2.5%.

[1] https://www.ft.com/content/ef1bc0fe-28e5-11e9-88a4-c32129756dd8
[2] https://www.wsj.com/articles/car-dealer-lots-are-flush-with-unsold-cars-as-sales-are-expected-to-drop-11549319709



The contributions table shows that falling commercial building and declining inventories weighed on growth.

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
14-Dec	Retail trade, Industrial production	3.0	2.79	0.41	0.30	-0.03	-0.09	0.41	-0.50	-0.30
18-Dec	Housing starts	2.9	2.79	0.41	0.30	-0.03	-0.17	0.41	-0.50	-0.30
19-Dec	Existing-home sales	3.0	2.79	0.41	0.30	-0.03	-0.12	0.41	-0.50	-0.30
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
3-Jan	ISM Manufacturing Index	2.6	2.45	0.29	0.31	-0.04	-0.14	0.42	-0.49	-0.21
4-Jan	Employment situation	2.8	2.54	0.32	0.31	-0.03	-0.11	0.44	-0.50	-0.19
7-Jan	ISM Nonmanufacturing Index	2.8	2.55	0.32	0.31	-0.03	-0.11	0.44	-0.50	-0.19
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
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										
7-Dec	Employment sit., Wholesale trade	2.4	2.27	0.43	0.30	-0.03	-0.09	0.30	-0.47	-0.33

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

The data flow to calculate this number has been affected by the government shutdown but the overall trend does suggest that GDP is falling back toward the 2.0% to 2.5% growth level.

Thinking about the next recession: Over the past 11 years since the financial crisis, central banks have deployed unconventional policy tools; the two primary ones were balance sheet expansion and negative interest rates. Both are controversial. The impact of quantitative easing (QE) on the economy remains in dispute. In Europe, negative interest rates were used; although there wasn't a lot of evidence of disintermediation,[3] it wasn't obvious there was much economic stimulus from the action either. A new study[4] from the San Francisco FRB suggests the Federal Reserve should have used a negative fed funds target instead of QE. The report suggests that inflation would have increased faster and growth would have been stronger with negative rates. Although we doubt this will be the final word on the issue, we would expect the FOMC to consider negative interest rates in the next downturn.

Will the China hawks lose? Our most recent WGRs[5] discuss the trend of U.S. policy toward China. The conclusion of the report is that the U.S. and China are likely moving toward an antagonistic geopolitical stance. Current trade talks reflect this issue. On the one hand, using trade to change China's behavior should be the long-term policy of the U.S. However, in the short run, such a policy might lead to financial market turmoil and undermine the president's reelection campaign. Reports suggest that trade hawks are worried the president might be inclined to take a short-term deal to boost financial market sentiment at the cost of delaying the inevitable shift to a more hostile policy stance.[6]

The Bundesbank returns? ECB President Draghi's term ends in October. The race to replace him has been underway for months. The EU has been developing some informal rules for key positions. The ECB has had a southerner with Draghi, so a northern European nation should get a "turn." The leading candidate is Erkki Liikanen, a Finn and former member of the ECB. Recently, though, Jens Weidmann's star has been ascending.[7] Merkel has been using Weidmann for leverage on other EU issues; most of the southern nations are leery of Weidmann, fearful he will implement Bundesbank-era hard money policies. We still view Weidmann as a long-shot candidate. But, if he does get the job, we would expect the EUR to appreciate on the news.

Populism on the rise: Yesterday, we commented on the growing war on capital. We note the establishment is pushing back against the Jacksonian thrust of the White House.[8] The president's instincts are to pull troops out of the Middle East, for example, concluding there is no end to these conflicts. He isn't wrong on this assessment; however, enduring never-ending conflicts is part of the hegemonic role. At the same time, what the establishment doesn't seem to understand is that the bulk of the nation's voters are at a loss as to why the U.S. must play the

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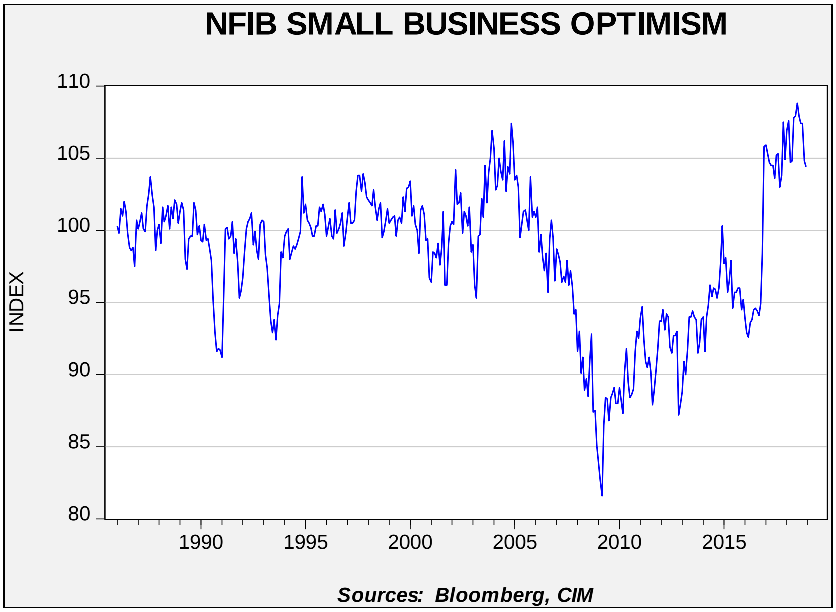
[3] Disintermediation is when households and firms withdraw money from the banking system for alternatives. The Eurodollar market in the 1960s and 1970s occurred because economic actors could not get a positive real interest rate from the U.S. banking system due to regulation and moved money into the unregulated Eurodollar market. In theory, if a bank offers negative nominal rates, households and firms will simply remove money from the banking system to earn a real yield on the cash.
[4] https://www.frbsf.org/economic-research/publications/economic-letter/2019/february/how-much-could-negative-rates-have-helped-recovery/
[5] See WGRs, What to do with China: Part I (1/28/2019) and Part II (2/4/2019).
[6] https://www.bloomberg.com/news/articles/2019-02-04/trade-hawks-quietly-bristle-as-trump-guns-for-deal-with-china
[7] https://www.bloomberg.com/news/articles/2019-02-05/weidmann-comeback-could-yet-jolt-ecb-race-for-draghi-succession
[8] https://www.washingtonpost.com/opinions/global-opinions/congress-is-beginning-to-check-trumps-worst-foreign-policy-impulses/2019/02/04/9d16f970-28a1-11e9-984d-9b8fba003e81_story.html?utm_term=.f3999a15da02

superpower role. In our opinion, the Truman administration sold hegemony to the American public as necessary to contain communism. Although it was certainly true, it was only partially true. To avoid WWIII, the U.S. also needed to contain long-standing geopolitical confrontation zones in Europe, the Middle East and Asia. The partial truth worked—Americans did get behind the role, but only as long as communism was a threat. The fall of the Soviet Union signaled to most Americans that the U.S no longer needed to expend the resources to police the world (remember the "peace dividend?"). From that point forward, Truman's ruse was exposed. The establishment knew a withdrawal from the world was fraught with risk but it has been unable to create a new narrative to sell to the American people. Bush tried to do it with Islamic terrorism, but it didn't really take. The establishment runs the risk of further losing the support of the American people unless it can show why the U.S. needs to maintain the role. From the perspective of most Americans, the superpower role goes hand in hand with globalization. And that's because it does! Unless the establishment can convince the average American that globalization is more than trading a good-paying manufacturing job for cheap imports then the cause will be lost. So, for now, the establishment is taking advantage of Trump's missteps to push back against troop withdrawals. But, it may be losing the broader policy goal.[9] In a related op-ed, Gideon Rachman of the *FT* notes that one of the unknowns is whether the current populist uprising is a permanent change or merely a blip on the screen of a Davos-led globalized world. He concludes that the change is permanent, that Brexit, the yellow vests and Trump represent a multi-decade change in trend.[10] This reflects our analysis of equality/efficiency cycles.[11]

U.S. Economic Releases

The December NFIB small business sentiment index came in better than forecast at 104.4, above the 103.0 expected. The December reading was down from 104.8 in November. Overall, the index remains elevated despite recent market turmoil. However, as the chart below shows, the index is well off its earlier highs.

[9] https://www.wsj.com/articles/trumps-foreign-policy-critics-are-losing-11549325062
[10] https://www.ft.com/content/debb6f2c-285c-11e9-a5ab-ff8ef2b976c7?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top
[11] See WGR, Reflections on Trade: Part IV (5/22/2017)



There were no other economic releases prior to the publication of this report. The table below shows the economic releases scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Markit Services PMI	m/m	jan	54.2	54.2	**
9:45	Markit Composite PMI	m/m	jan		54.5	**
9:45	ISM Non-Manufacturing Index	m/m	jan	57.1	57.6	**
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								
Japan	Nikkei Japan PMI Composite	m/m	jan	50.9	52.0		**	Equity and bond neutral
	Nikkei Japan PMI Services	m/m	jan	51.6	51.0		**	Equity and bond neutral
India	Nikkei India PMI Services	m/m	jan	53.6	53.6		**	Equity and bond neutral
	Nikkei India PMI Composite	m/m	jan	52.2	53.2		**	Equity and bond neutral
Australia	AiG Perf of Services Index	m/m	jan	44.3	52.1		**	Equity and bond bearish
	CBA Australia PMI Services	m/m	jan	51.0	51.0		**	Equity and bond neutral
	CBA Australia PMI Composite	m/m	jan	51.3	51.3		**	Equity and bond neutral
	Trade Balance	m/m	dec	A$3.681 bn	A$1.925 bn	A$2.225 bn	**	Equity bullish, bond bearish
	Retail Sales	m/m	dec	-0.4%	0.4%	0.0%	**	Equity and bond bearish
	Retail Sale ex Inflation	q/q	4q	0.1%	0.2%	0.5%	**	Equity and bond bearish
New Zealand	ANZ Commodity Price	m/m	jan	2.1%	-0.2%		**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Services	m/m	jan	51.2	50.8	50.8	**	Equity bullish, bond bearish
	Markit Eurozone Composite	m/m	jan	51.0	50.7	50.7	**	Equity bullish, bond bearish
	Retail Sales	y/y	dec	0.8%	1.1%	0.5%	**	Equity and bond neutral
Italy	Markit/ADACI Italy Services	m/m	jan	49.7	50.5	50.0	**	Equity and bond bearish
	MarkiT/ADACI Italy Composite	m/m	jan	48.8	50.0	49.4	**	Equity and bond bearish
France	Markit France Services PMI	m/m	jan	47.8	47.5	47.5	**	Equity and bond bearish
	Markit France Composite PMI	m/m	jan	48.2	47.9	47.9	**	Equity and bond bearish
UK	New Car Registrations	y/y	jan	-1.6%	-5.5%		**	Equity and bond neutral
	Markit/CIPS UK Services PMI	m/m	jan	50.1	51.2	51.0	***	Equity and bond neutral
	Markit/CIPS UK Composite PMI	m/m	jan	50.3	51.4	51.4	**	Equity and bond neutral
	Official Reserves Changes	m/m	jan	$1.535 bn	$1.387 bn		**	Equity and bond neutral
Russia	Annual GDP	y/y	2018	2.3%	1.5%	1.9%	***	Equity bullish, bond bearish
	Markit Russia PMI Services	m/m	jan	54.9	54.4	54.1	**	Equity bullish, bond bearish
	Markit Russia PMI Composite	m/m	jan	53.6	53.9		**	Equity and bond neutral
AMERICAS								
Mexico	Bloomberg Nanos Confidence	m/m	feb	54.2	54.4		**	Equity and bond neutral
Brazil	Markit Brazil PMI Services	m/m	jan	52.0	51.9		**	Equity and bond neutral
	Markit Brazil PMI Composite	m/m	jan	52.3	52.4		**	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)	273	274	-1	Up
3-mo T-bill yield (bps)	236	236	0	Neutral
TED spread (bps)	37	38	-1	Neutral
U.S. Libor/OIS spread (bps)	241	241	0	Up
10-yr T-note (%)	2.73	2.72	0.01	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	5	6	-1	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Up
yen	down			Neutral
pound	down			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBA Cash Rate Target	1.500%	1.500%	1.500%	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	$62.25	$62.51	-0.42%	
WTI	$54.35	$54.56	-0.38%	
Natural Gas	$2.67	$2.66	0.30%	
Crack Spread	$12.18	$12.24	-0.43%	
12-mo strip crack	$14.51	$14.53	-0.12%	
Ethanol rack	$1.41	$1.41	0.41%	
Metals				
Gold	$1,314.02	$1,312.25	0.13%	
Silver	$15.84	$15.87	-0.18%	
Copper contract	$280.45	$279.45	0.36%	
Grains				
Corn contract	$ 379.50	$ 379.25	0.07%	
Wheat contract	$ 525.25	$ 525.75	-0.10%	
Soybeans contract	$ 919.00	$ 918.50	0.05%	
Shipping				
Baltic Dry Freight	634	645	-11	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.5		
Gasoline (mb)		1.5		
Distillates (mb)		-2.3		
Refinery run rates (%)		-0.55%		

Weather

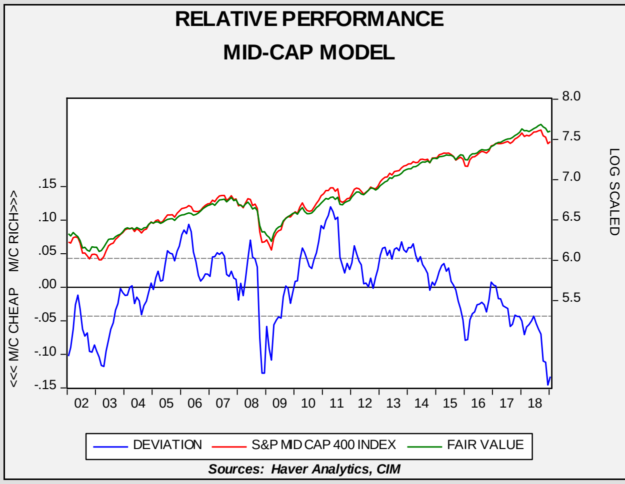
The 6-10 and 8-14 day forecasts show cooler temperatures for most of the country, with warmer temps in the southeastern region. Precipitation is expected for most of the country.

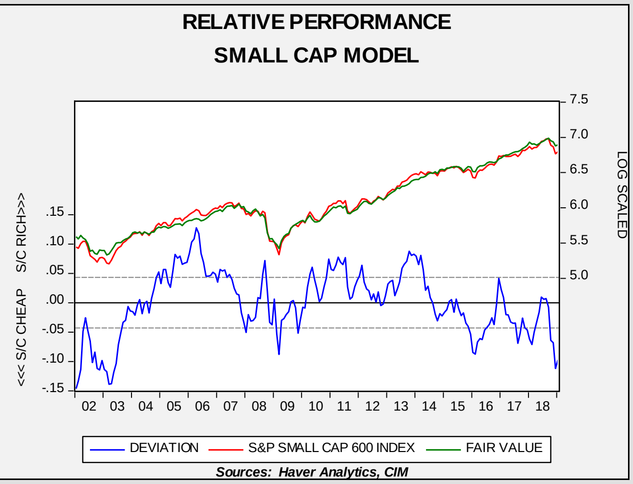
Asset Allocation Weekly Comment

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 1, 2019

In our analysis, both small caps and mid-caps are undervalued relative to their large cap cousins.





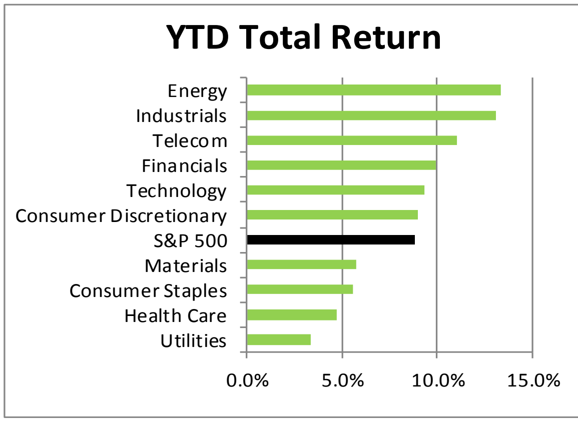
These charts compare mid-caps and small caps to large cap stocks. We log-transform the data and use a time trend to scale the transformed indices as well. The lower line on both charts indicate that small caps and especially mid-caps are deeply underperforming large caps.

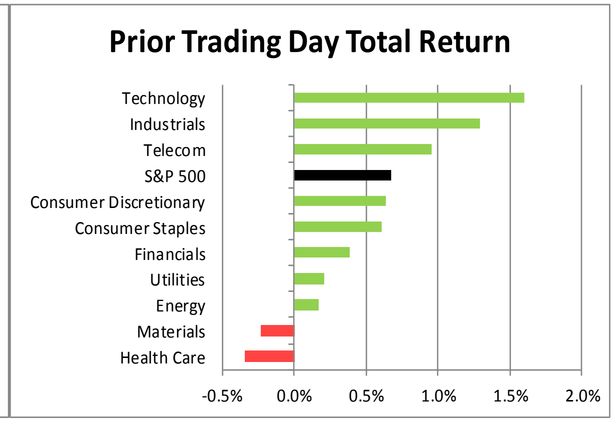
Why is this occurring? One clue is the relative underperformance in the last recession. Smaller capitalization stocks tend to be more sensitive to the economic cycle. Thus, monetary policy tightening can raise fears of recession and encourage investors to move to larger companies that would better withstand economic weakness. Note that both of the smaller capitalization indices underperformed large caps during the slowdown in late 2015 into 2016. However, when recession was avoided, both recovered strongly. In addition, both the smaller capitalization groups are mildly inversely correlated to the broad P/E multiple; using the CAPE, a rising multiple tends to benefit large cap stocks more than the smaller caps, although the impact is rather modest. Since the CAPE has been contracting, this factor should contribute to our expected smaller capitalization rebound.

Thus, given the deep level of undervaluation relative to large caps, we tend to favor both small and mid-caps. This position assumes that a recession will be avoided over the next year to 18 months. However, if the economy stumbles into recession, large caps will likely continue to outperform their smaller capitalization brethren.

Data Section

U.S. Equity Markets – (as of 2/4/2019 close)

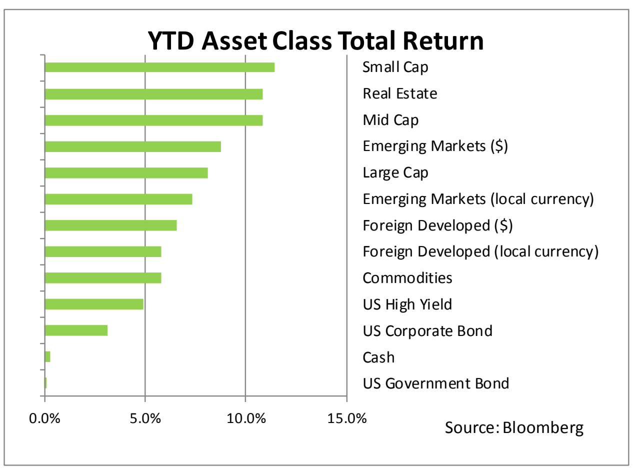




(Source: Bloomberg)

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 2/4/2019 close)

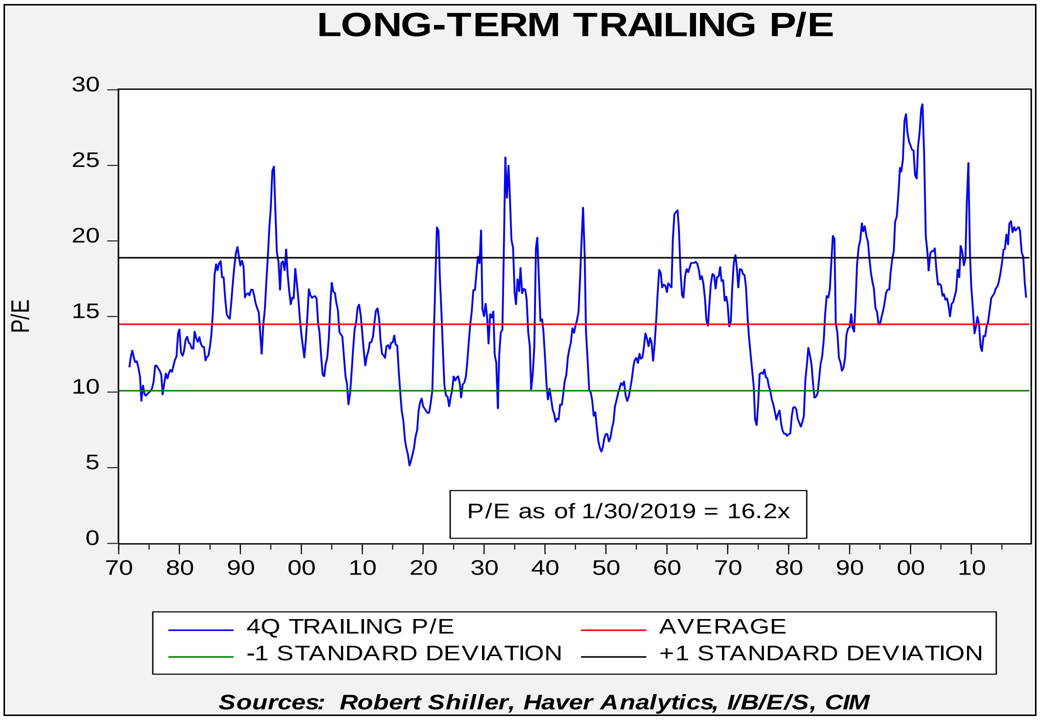


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

January 31, 2019



Based on our methodology,[12] the current P/E is 16.2x, up 0.2x from last week. The rebound in equities 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.

[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.