Daily Comment

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

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

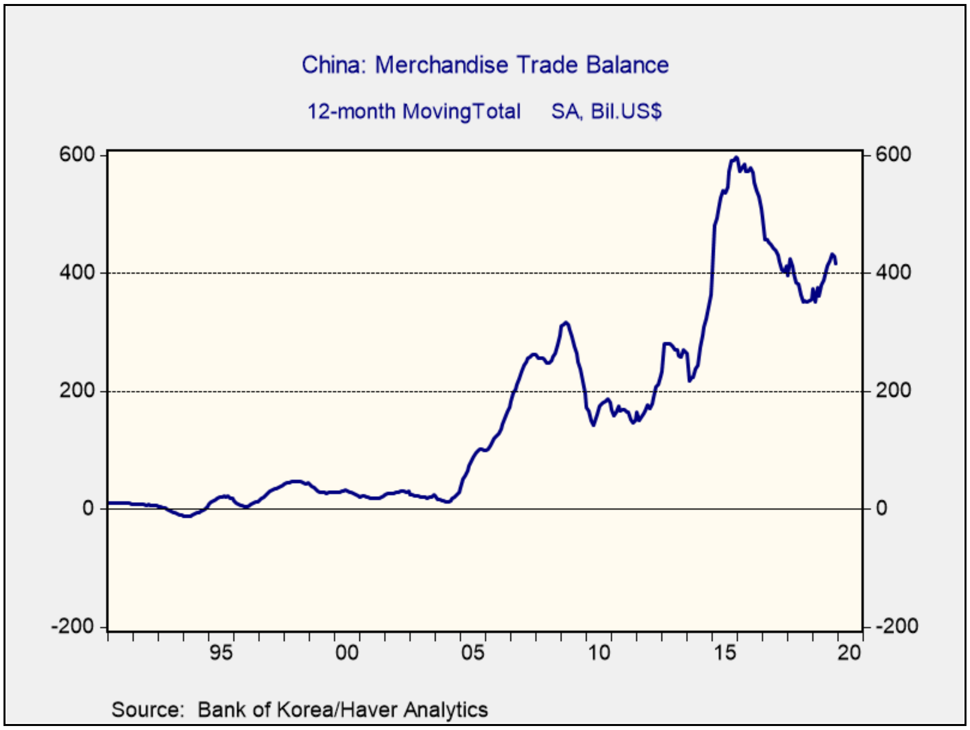
[Posted: January 14, 2020—9:30 AM EST] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.3% compared with its last close. In Asia, the MSCI Asia Apex 50 closed unchanged. Chinese markets were lower, with the Shanghai composite down 0.3% and the Shenzhen index down 0.2% from the prior close. U.S. equity index futures are signaling a flat open.

The sixth episode of the *Confluence of Ideas* podcast is now available. Featuring Confluence CEO/CIO Mark Keller, "Process is King" takes the decision-making discussion from our previous episode and shows how the process works at Confluence.

Markets are quiet this morning as earnings season begins. Trade is the biggest headline, as the U.S. and China are expected to sign a deal tomorrow. Here is what we are watching this morning:

Trade: First, the U.S. and China are expected to sign a deal tomorrow. The PRC will pledge $200 bn in new U.S. purchases; although the full details may not be released, it is generally expected that China promised to buy around $75 bn of manufactured goods, $50 bn of energy, $32 bn of agriculture and around $35 bn in services. These numbers represent purchases over two years. The U.S. won't implement new tariffs that were signaled in September and has removed the currency manipulator label on China. Casual observation would suggest the U.S. won this round handily. It appears Beijing is sensitive to this idea; a well-connected blogger in China has taken great pains to suggest that we are early in the evolution of the trade relationship. The deal should reduce the bilateral trade deficit the U.S. has with China; however, since trade is ultimately the difference between public and private sector net saving, the deficit in these accounts invariably will lead to trade deficits with other nations. Austerity is the most effective way to reduce trade deficits; it is also the least popular.

Second, China's trade data improved in December, with exports up 7.6% and imports up 16.3% from the prior year. However, these eye-popping numbers are mostly due to base effects. Last year, trade was hurt by the early stages of the trade conflict. The overall balance was mostly flat.



Third, as the U.S./China trade situation stabilizes, the administration is likely to shift its focus to the EU. In anticipation, the new EU trade negotiator, Phil Hogan is coming to Washington this week to attempt to get ahead of any conflict. He will have his work cut out for him. The U.S. is at odds with France's new digital tax and President Trump has targeted Europe's car industry as a problem.

Iran: Iranian leaders are trying to cope with protests and have announced arrests of those responsible for downing the Ukrainian airliner. EU leaders have put Tehran on notice that it will reimpose international sanctions on Iran if it doesn't return to compliance with the JCPOA. Iran has been trying to create daylight between the U.S. and Europe, with the hope of cracking the sanctions bind that the Iranian economy faces. However, those hopes appear dashed as Europe is demanding a return to the nuclear deal and Iran will still face U.S. sanctions, which have effectively cratered the Iranian economy. We expect Iran to try and limp along and hope a new U.S. president in November might offer a way out of their current crisis. However, if President Trump is re-elected, they may have no choice but to renegotiate the nuclear deal.

Canada-Iran-United States: Responding to Iran's airliner shootdown that killed dozens of Canadians last week, Canadian Prime Minister has laid the blame mostly on the Iranian government. However, in an interview yesterday, he obliquely blamed the U.S. as well, noting that "those Canadians would be, right now, home with their families" if not for the escalation of tensions in the region. There are some signs that other high-profile Canadians are also making that connection. Only time will tell how much the incident might damage U.S.-Canadian relations, but in any case, it does show how the administration's "America First" strategy has the potential to isolate the U.S. even from its strongest historical allies.

Germany: A group of auto-industry executives has warned that Germany could lose as many as 400,000 jobs by 2030 if the country's carmakers have to rely on imports to meet sales targets for electric vehicles. Reflecting Germany's loss of competitiveness in key technologies, the biggest danger is that Germany may not be competitive enough in manufacturing batteries for the cars.

United Kingdom: Prime Minister Johnson has finally admitted that there is little chance Britain will be able to conclude a trade deal with the EU before it leaves the bloc at the end of 2020. That matches what we've been saying all along. It also serves as a reminder that Brexit-related uncertainty has not gone away, but will remain an issue for the markets for some time to come.

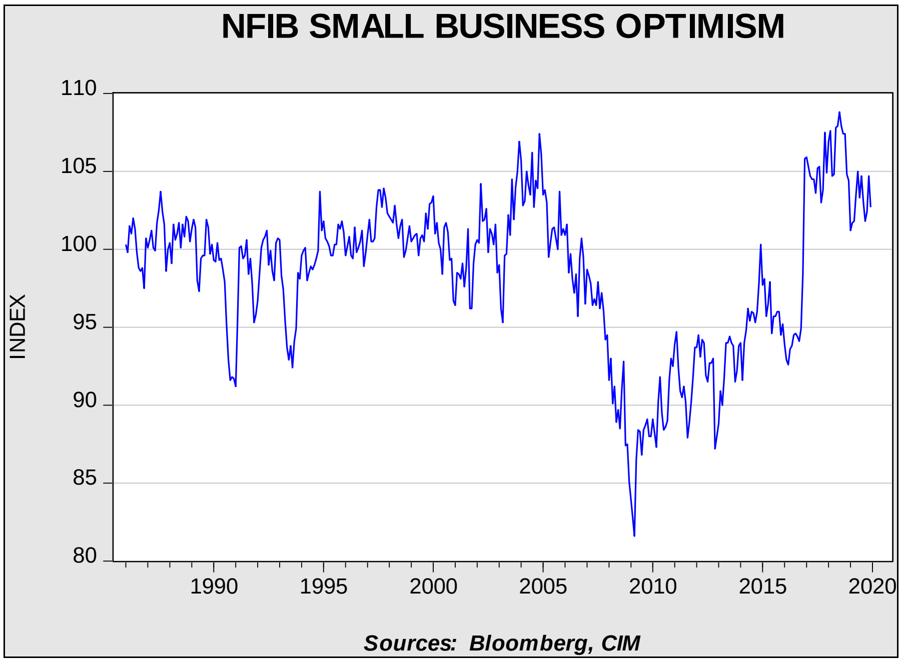
Ireland: Confirming reports we noted yesterday, PM Varadkar has called a snap general election for February 8. The call scuttles a 2016 parliamentary voting deal under which the opposition Fianna Fáil Party propped up Varadkar's center-right government to ensure political stability during the Brexit negotiations.

China economic news: A couple of Chinese economic anecdotes caught our eye. First, it is no secret that China's corporate sector is generating a rising level of defaults. Anytime a loan is made, there is a certain chance that the borrower will default. Additionally, given that China only outlawed defaults in 2014, and restricted the use of defaults until 2018, the potential for a significant level of dodgy loans from non-financial corporations in China is very high. So, the real focus should be on workouts. If there are lots of bad loans, some sort of resolution is required. In other words, who gets "stuck" with the costs of resolution? Here is one item that got our attention. Dandong Port Group, a port operator on the border with North Korea, had its business adversely affected by sanctions on the Hermit Kingdom. However, it does appear that aggressive overexpansion is mostly to blame for its debt problems. In 2017, it defaulted on $150 mm in bonds. It continued to default on other issues, eventually stopping payment on $1.2 bn in debt. In April, the firm began formal bankruptcy proceedings. The bankruptcy court has rendered its verdict. The company will be divided into two firms, one controlled by the state and the other private. The best assets will go to the state firm, which will be controlled by a state-run company. The other firm will be controlled by the private creditors. Bondholders will get CNY 300k maximum compensation (roughly, $44k) and shares in the new company. Needless to say, private creditors are not happy. What is of concern is that if this settlement becomes the norm in China, it will become very difficult for non-state firms to borrow money and given the level of corporate debt in China, rollovers will likely be necessary to avoid bankruptcies. Of course, if the goal is to increase state control, the Dandong Port settlement might be a desirable model. Second, Chinese automakers are laying off workers as car sales continue to slump.

An economic puzzle: In theory, the world trade balance should be zero. Short of trading with Mars or the Moon, a trade deficit in one part of the world is a trade surplus in another part, and taken as a whole, there should not be a global trade surplus or deficit. In reality, due to reporting errors and other factors, the world does run a trade surplus with itself. However, a recent paper uncovered that nearly 80% of that global surplus comes from the EU. The paper makes the case that fraud related to the EU's value added taxes (VAT) is the culprit. Exports are treated differently in the EU VAT calculations, so it appears there is a systemic fraud going on were domestic sales are being treated as exports to evade taxes. Public finance experts have suggested the U.S. could adopt a VAT to increase government revenues to improve confidence in public deficit financing. However, this paper does highlight that such a move isn't without risks.

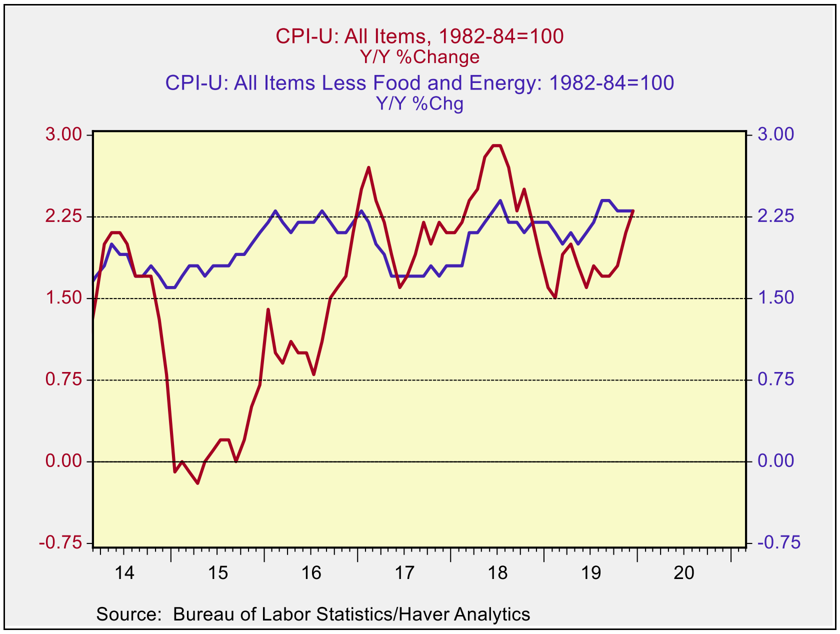
U.S. Economic Releases

NFIB small business optimism came in below expectations at 102.7, compared to the forecast of 104.6. The drop in optimism appears to be due to less business owners wanting to increase capital spending, or create new jobs.



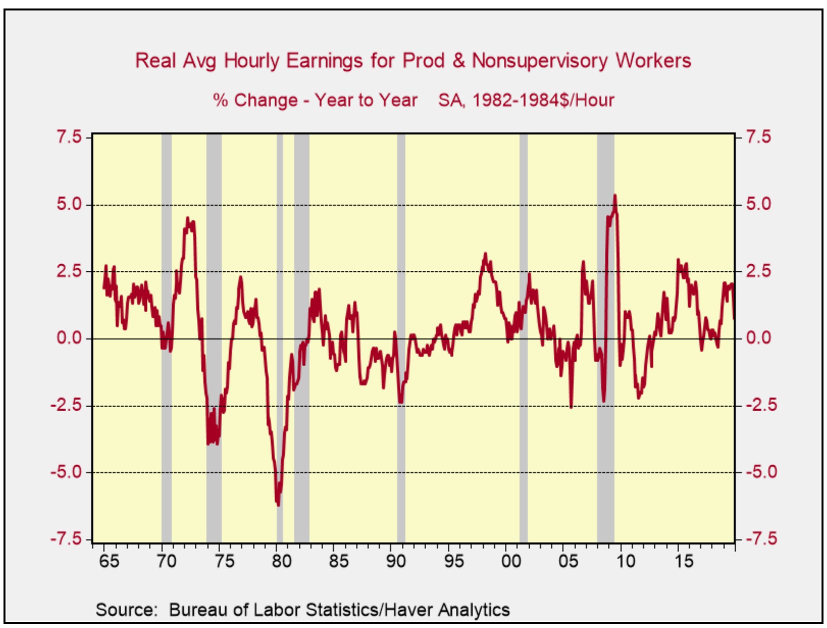
The chart above shows the level of small business optimism. It appears that progress made in securing the "phase one" trade deal has not altered perceptions of most business owners. One of the issues may be due to rising minimum wages. In 2019, 20 states raised the minimum wage for workers, while 24 states plan on doing so this year. As a result, business owners may be reluctant to spend more without first understanding how their budgets will change.

CPI rose less than expected rising 0.2% from the prior month, compared to a forecast of 0.3%. Additionally, core CPI also came in below expectations rising 0.1% from the prior month, compared to the forecast rise of 0.2%.



The chart above shows the year-over-year change in headline CPI and core CPI. Headline CPI and core CPI both came in at 2.3%.

Real average weekly earnings remained unchanged from the prior year, while average hourly earnings rose 0.6% from the prior year.



The chart above shows real hourly earnings for the production and supervisory workers. Hourly earnings rose 0.75% from the prior year.

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

Economic Releases		
No economic releases today		
Fed Speakers or Events		
	Speaker or event	District or position
13:00	Esther George Speaks in Kansas City	President of the Federal Reserve Bank of Kansas City

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	Bank Lending Incl Trusts	y/y	dec	1.8%	2.1%		**	Equity and bond neutral
	Bank Lending Ex- Trusts	y/y	dec	1.9%	2.3%		**	Equity and bond neutral
	BoP Current Account Balance	m/m	nov	¥1.437 Tril	¥1.817 Tril	¥1.423 Tril	**	Equity and bond neutral
	Trade Balance BoP Basis	m/m	nov	-¥2.5 Bil	¥254.0 Bil	¥101.5 Bil	**	Equity and bond bearish
	Bankruptcies	y/y	dec	13.2%	1.4%		**	Equity and bond neutral
	Eco Watchers Survey Current Situation	m/m	dec	39.8	39.4	41.0	**	Equity bearish, bond bullish
	Eco Watchers Survey Outlook	m/m	dec	45.4	45.7	46.8	**	Equity bearish, bond bullish
New Zealand	Building Permits	m/m	nov	-8.5%	-1.1%		**	Equity and bond bearish
AMERICAS								
Canada	Bloomberg Nanos Confidence	w/w	10-Jan	57.1	56.5		**	Equity and bond neutral
	BoC Overall Business Outlook	q/q	4q	0.7	0.4		**	Equity and bond neutral
	BoC Business Outlook Future	q/q	4q	11.00	23.00		**	Equity and bond neutral
Brazil	Trade Balance Weekly	w/w	12-Jan	$14 Mil	$1.764 Mil		**	Equity and bond neutral
	IBGE Services Sector Volume	y/y	nov	1.8%	2.0%	2.7%	**	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)	184	185	-1	Up
3-mo T-bill yield (bps)	151	152	-1	Neutral
TED spread (bps)	33	33	0	Neutral
U.S. Libor/OIS spread (bps)	158	158	0	Up
10-yr T-note (%)	1.84	1.85	-0.01	Neutral
Euribor/OIS spread (bps)	-39	-40	1	Neutral
EUR/USD 3-mo swap (bps)	4	4	0	Down
Currencies	**Direction**			
dollar	flat			Neutral
euro	flat			Up
yen	flat			Neutral
pound	flat			Neutral
franc	up			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	$64.71	$64.20	0.79%	
WTI	$58.47	$58.08	0.67%	
Natural Gas	$2.21	$2.18	1.15%	
Crack Spread	$14.92	$15.05	-0.87%	
12-mo strip crack	$17.24	$17.36	-0.67%	
Ethanol rack	$1.42	$1.43	-0.04%	
Metals				
Gold	$1,543.18	$1,547.88	-0.30%	
Silver	$17.75	$17.96	-1.19%	
Copper contract	$285.40	$286.10	-0.24%	
Grains				
Corn contract	$ 389.50	$ 389.50	0.00%	
Wheat contract	$ 566.50	$ 562.25	0.76%	
Soybeans contract	$ 942.00	$ 942.25	-0.03%	
Shipping				
Baltic Dry Freight	765	774	-9	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		0.0		
Gasoline (mb)		3.5		
Distillates (mb)		5.3		
Refinery run rates (%)		-1.50%		

Weather

The 6-10 and 8-14 day forecasts currently call for colder-than-normal temperatures throughout most of the country, with higher-than-normal temperatures expected for the Southwest. Wet conditions in Texas and surrounding areas are expected to move north. In addition, Florida and surrounding areas also expected to receive some precipitation.

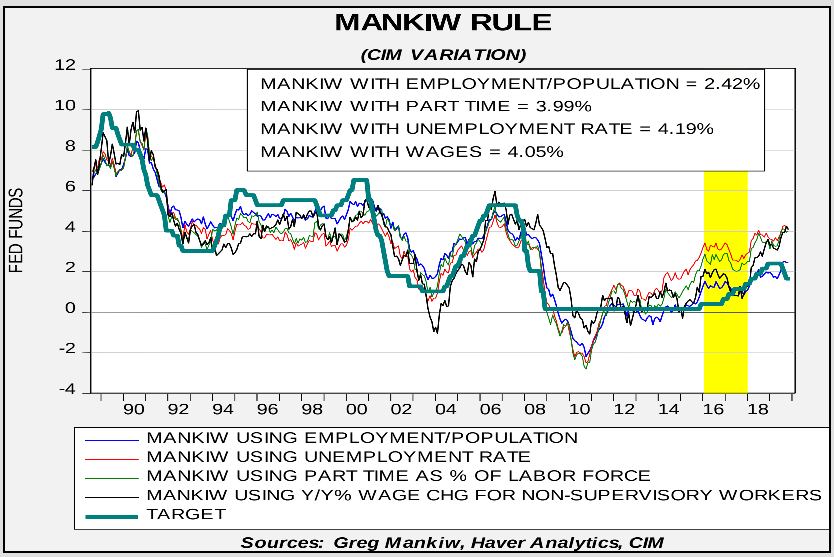
Asset Allocation Weekly

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

January 10, 2020

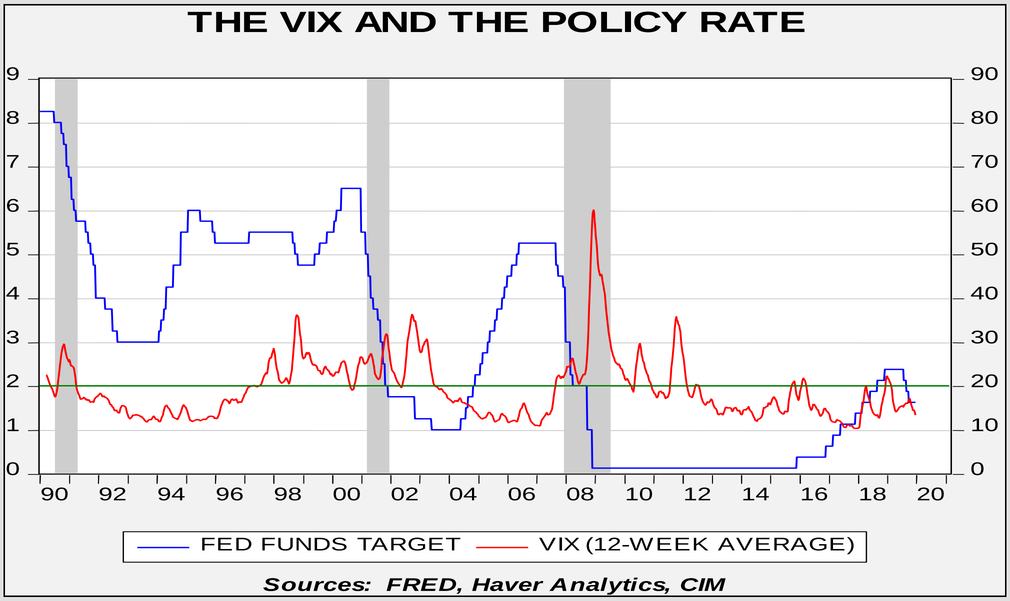
In our 2020 Outlook, we discussed three risks to the forecast, with one of them being a "melt-up" or a dramatic rise in stock prices. One of the key factors that could bolster higher prices for risk assets would be the idea that the FOMC has engineered a soft landing, which is best defined as a tightening cycle that doesn't result in a recession.

In December 2015, the Fed raised the policy rate by 25 bps, lifting the rate from 0.125% to 0.375%. The conventional policy models, mostly based on the Taylor Rule, suggested that a series of rate hikes was likely.



This chart shows four variations of the Mankiw Rule, which is different from the Taylor Rule in how it measures slack in the economy. The former used the unemployment rate, while the latter uses the difference between actual and potential GDP. We prefer the Mankiw Rule because labor market measures are easily observable, whereas potential GDP is not. We have created four variations of the Mankiw Rule using various measures of the labor market. In the chart above, the area highlighted in yellow shows that all the Mankiw variations were suggesting the policy rate was too low and the Fed needed to raise rates aggressively. The financial markets feared tighter monetary policy but, as the chart shows, after an initial hike the Yellen Fed paused for a year before raising rates again.

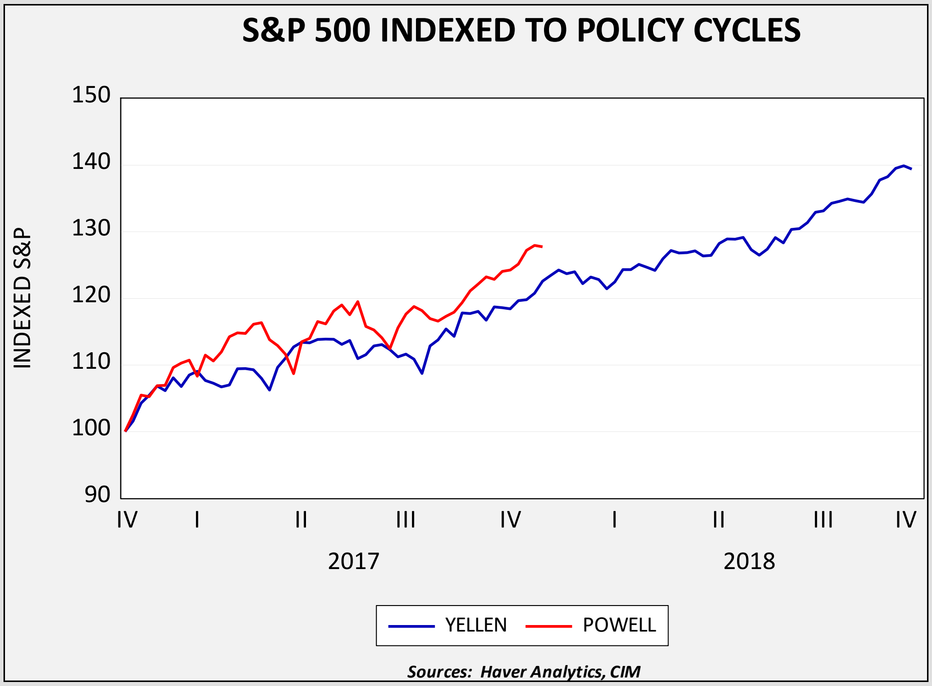
Why did this pause occur? A contributing factor appears to be fragility in the financial markets.



This chart shows the 12-week average of the VIX index of S&P 500 volatility and the fed funds target. Note that the VIX rose above 20 with the rate hike in December 2015. It is possible the FOMC worried about triggering broader financial problems by raising rates and thus paused to allow financial markets to "calm down" before raising rates further.

In the recent tightening cycle, the Powell Fed raised rates until the VIX broke 20; soon after, the Fed lowered rates even though the Mankiw Rules would suggest further tightening was in order. The Fed would be loath for the financial markets to conclude there is a "Fed put," but, given how sensitive consumption has become to asset values, avoiding a recession may require guiding policy to prevent volatility from rising.

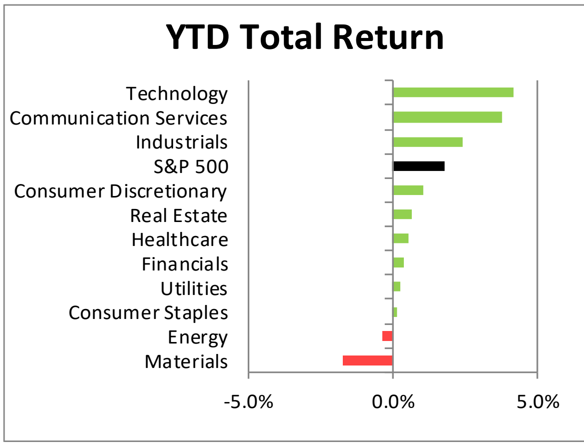
So, if this is what the Fed is doing, what does it mean for equities? We indexed the S&P 500 to early February 2016, when it became clear that Yellen would keep policy on hold, and January 2019, when Powell signaled at least a pause in tightening. The idea is that equities should benefit if the Fed avoids a "hard landing."

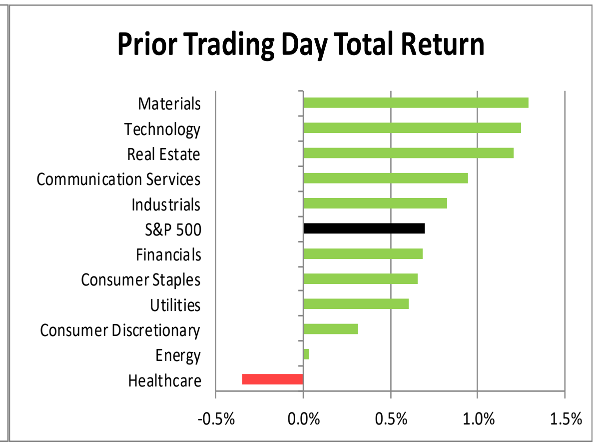


The two periods are generally tracking each other; if this pattern continues, the current S&P 500 would end up at 3532.56 by late November. This analysis is clearly not foolproof as one episode of a soft landing won't necessarily generate a repeat performance. Nevertheless, we are tracking relatively closely so further gains in stocks are possible if a recession is avoided. The trick is avoiding recession; accommodative monetary policy is probably a necessary, but not completely sufficient, condition for avoiding a downturn.

Data Section

U.S. Equity Markets – (as of 1/10/2019 close)

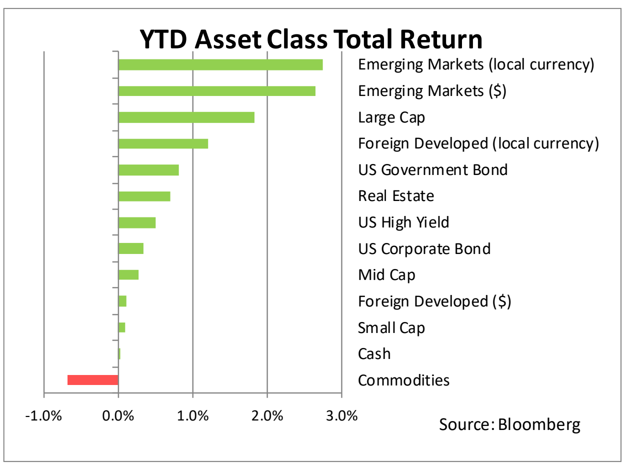




(Source: Bloomberg)

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. These charts represent the new sectors following the 2018 sector reconfiguration.

Asset Class Performance – (as of 1/10/2019 close)

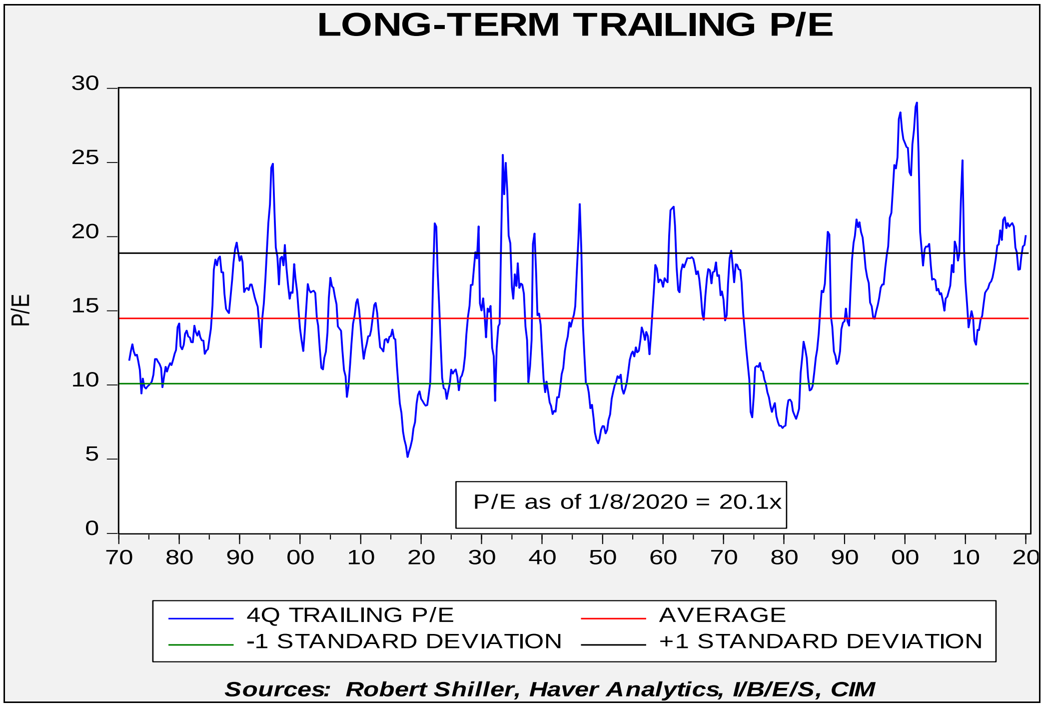


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 9, 2020



Based on our methodology,[1] the current P/E is 20.1x up 0.8x from report. Rising index values led to the increase.

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.

[1] This chart offers a running snapshot of the S&P 500 P/E in a long-term historical context. We are using a specific measurement process, similar to *Value Line*, which combines earnings estimates and actual data. We use an adjusted operating earnings number going back to 1870 (we adjust as-reported earnings to operating earnings through a regression process until 1988), and actual operating earnings after 1988. For the current quarter, we use the I/B/E/S estimates which are updated regularly throughout the quarter; currently, the four-quarter earnings sum includes two actual quarters (Q2 and Q3) and two estimates (Q4 and Q1, 2020). We take the S&P average for the quarter and divide by the rolling four-quarter sum of earnings to calculate the P/E. This methodology isn't perfect (it will tend to inflate the P/E on a trailing basis and deflate it on a forward basis), but it will also smooth the data and avoid P/E volatility caused by unusual market activity (through the average price process). Why this process? Given the constraints of the long-term data series, this is the best way to create a long-term dataset for P/E ratios.