Confluence Investment Management

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: January 15, 2019—9:30 AM EST] Global equity markets are generally higher this morning. The EuroStoxx 50 is down 0.3% from the last close. In Asia, the MSCI Asia Apex 50 was up 1.8% from the prior close. Chinese markets were higher, with the Shanghai composite up 1.4% and the Shenzhen index up 1.5%. U.S. equity index futures are signaling a higher open. With 20 companies having reported, the S&P 500 Q4 earnings stand at $45.38, higher than the $40.86 forecast for the quarter. The forecast reflects a 13.4% increase from Q4 2017 earnings. Thus far this quarter, 90.0% of the companies reported earnings above forecast, while 10.0% reported earnings below forecast.

U.S. equity futures are roughly flat, giving up most of their overnight gains. Asia was higher on hopes of Chinese stimulus, but the big news is that today is Brexit Day. Here is what we are watching this morning:

Brexit: So, it all comes down to this.[1] A vote on PM May's Brexit plan is scheduled for 7:00 GMT, (which is 2:00 EST). The only real question is how badly will the measure fail? We note that MP Gareth Johnson, an assistant whip,[2] resigned from government, the 13th member of May's government to resign over Brexit. The loss could be colossal, perhaps by more than 200 votes. After the loss, we expect two things to occur. First, May will have three days to come up with a "Plan B." Second, Labour leader Corbyn is expected to call for a no-confidence vote. We have no idea what a Plan B will look like; we expect the MPs to offer tons of new amendments to the plan that May proposed but, since there is no consensus on what Brexit should look like, it seems unlikely that the House of Commons will draft a plan. Thus, in three days, look for the government to ask for an extension of the March 29 deadline. Corbyn's bid to bring down the government will be interesting to watch. Although May isn't popular, the Tories loathe Corbyn and we suspect they will coalesce around May to prevent her loss.

Financial markets continue to lean toward some sort of resolution that avoids a hard Brexit. Although that is the desired outcome by nearly everyone involved, there is no obvious plan to achieve this goal. The fear is that, in the absence of a plan to go forward, Britain and the EU will stumble into a hard break that would be expected to crush the U.K. economy and the GBP. Since neither side wants this outcome, the most likely result of all this is a delay. That's why the currency is holding up. But, the risks of an unwanted hard Brexit are rising.

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[1] https://www.ft.com/content/efb7088a-17eb-11e9-9e64-d150b3105d21?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

[2] A whip is a legislative role held by a member who counts and steers voters in the legislature.

China: Bank lending for December came in a bit better than expected, rising CNY 1.08 trillion ($198 bn). However, given the drop in reserve requirements, this level of loan growth won't keep growth at the 6% level. The Chinese government announced plans for tax cuts and other stimulus measures.[3] Hopes surrounding those measures sent Asian equities higher overnight. However, for growth to be sustainable, more of it needs to come from the household sector and less from investment. We believe the most effective measures China could implement in support of consumption growth would be to extend the social safety net, including health care and pensions. Both actions would reduce households' incentives to save. However, it would also deprive the powerful members of the Chinese Communist Party cheap money for investment. Thus, aggressive action that would be effective in restructuring the economy isn't likely.

China and Canada: China has issued a death sentence for Robert Schellenberg,[4] a Canadian citizen living in China. He was arrested on a drug trafficking charge. Ottawa strongly suspects that China is arresting Canadians in response to Canada's arrest of Meng Wanzhou of Huawei. Tensions between the two countries remain elevated with no obvious path to easing short of releasing Meng, who awaits extradition to the U.S. on sanctions-busting charges.

Shutdown issues: TSA absences are increasing rapidly, now representing 7.6% of the workforce, more than double normal levels.[5] So far, the system is dealing with the security issues but if the absences increase, which appears likely, it will eventually affect the air transportation system. There is no sign of budging from either side.

Iran oil: The State Department indicated yesterday that the Trump administration is not planning to issue further oil export waivers.[6] If they stick to that position, Iranian oil exports will be further curtailed by the end of May. Although we would not expect Iranian oil exports to fall to zero, they will decline from current levels.

Iranian populism? U.S. sanctions have hurt the Iranian economy. Interestingly enough, we are hearing reports of a backlash against the well-connected wealthy in Iran. The ones catching most of the flack are the young of those connected to the government who have a habit of flaunting their lifestyles on social media (sound familiar?).[7] What makes this trend dangerous for the ruling class is that they are pushing policies that have led to American sanctions and are calling for shared sacrifice in response. If it isn't seen as shared, they could face civil unrest.

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[3] https://www.reuters.com/article/us-china-economy/china-signals-more-stimulus-as-economic-slowdown-deepens-idUSKCN1P9090

[4] https://www.washingtonpost.com/world/asia_pacific/china-sentences-canadian-man-to-death-in-drug-case-linked-to-huawei-row/2019/01/14/058306a0-17fb-11e9-a804-c35766b9f234_story.html?utm_term=.188f1c9e417d&wpisrc=nl_todayworld&wpmm=1

[5] https://www.apnews.com/a50e00cb683b4b9697c1c957bae39cd2?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top

[6] http://www.arabnews.com/node/1434591/business-economy

[7] https://www.washingtonpost.com/world/middle_east/crazy-rich-iranians-face-blowback-at-a-time-of-sanctions-and-economic-stress/2019/01/13/f45bc594-ffb6-11e8-a17e-162b712e8fc2_story.html?wpisrc=nl_todayworld&wpmm=1

Oil sales to China: The U.S. is exporting oil to China, likely part of the trade talks currently underway.[8] Three cargos departed from the Gulf of Mexico on their way to China, the first oil sale in three months between the two countries. We suspect this news lifted oil futures this morning.

Trump versus the Wilsonians: As we noted yesterday, Trump tends to be best characterized by the Jacksonian archetype.[9] However, most members of his foreign policy staff have tended to be either Hamiltonians (the early "generals") or Wilsonians. His current staff, Pompeo and Bolton, are clearly in the Wilsonian camp. Wilsonians tend to have a moralistic view of foreign policy, seeing the world in terms of "good and evil," unlike the Hamiltonians, who tend to view the world through the veil of "interests." Both groups have been attempting to prevent Trump from exercising his Jacksonian tendencies; Jacksonians are essentially isolationists who are driven to intervene globally on issues of "honor." Thus, President Trump sees no disconnect between firing cruise missiles against Assad and pulling troops from Syria. Assad besmirched America's honor by using chemical weapons after being told not to, but Trump has no interest in being tied up in the Middle East indefinitely. Today, we are seeing reports that Trump was considering pulling out of NATO.[10] Both the "generals" and the "Wilsonians" have been trying to corral the president from this action. The paper of record, the *NYT*, frames the news as a "gift to Russia," putting it in the narrative that Trump is favoring Putin. Perhaps. Our view is that the biggest risk to pulling out of NATO isn't the risk of Russian influence on Europe, it's that the "German Problem" will return, a conflict zone that was frozen by the U.S. In other words, the real risk is the remilitarization of Germany and a return to the world of 1870-1945.

It's worth noting that SOS Pompeo made pointed criticisms of President Obama's policies in the Middle East during a speech in Egypt. In our opinion, Obama was a Jeffersonian, the most isolationist of the four archetypes. However, the primary difference between the Jacksonians and the Jeffersonians is the concept of honor. In practice, both want to retreat from the world and avoid involvement. Pompeo's criticism of Obama could easily be said of Trump as well. As time passes, we will be watching to see how long the president tolerates both his national security director and secretary of state working to prevent the execution of the president's worldview.

And, one more thing to worry about: The world's magnetic pole isn't static; it moves around over time. Usually, the movements aren't enough to make compass readings unreliable; however, over geologic time, the North and South magnetic poles have actually flipped (the last time was estimated to have been 780,000 years ago). The map below shows how the pole has moved over time. The last maps adjusting to the movement of the magnetic pole were completed in 2015. Although they weren't scheduled to be updated until next year, the movement was enough to accelerate the process. The new maps would have been published

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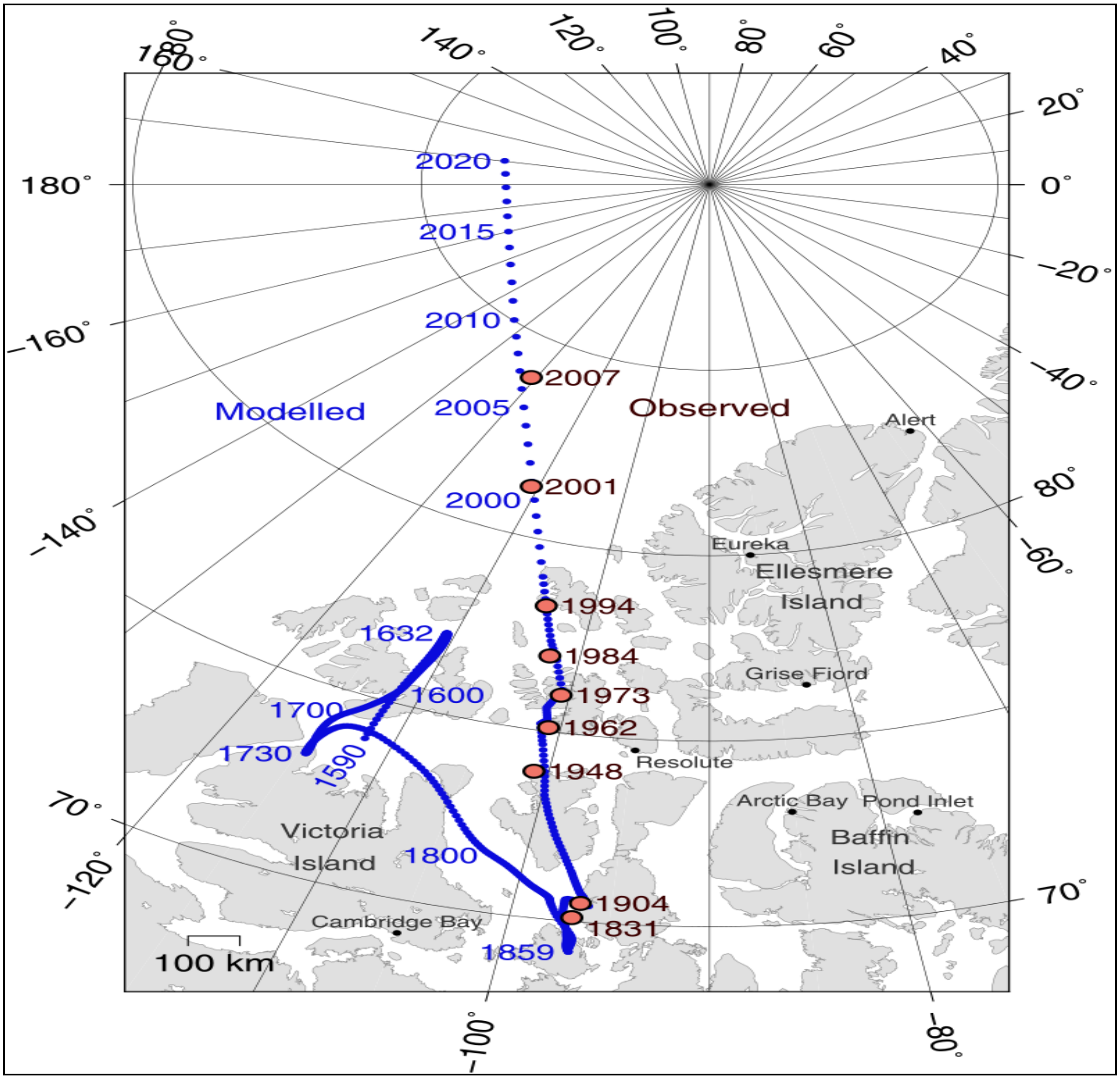
[8] https://www.reuters.com/article/us-usa-crude-exports/first-u-s-crude-cargoes-head-to-china-since-trade-breakthrough-sources-idUSKCN1P82LN
[9] See WGR, The Archetypes of American Foreign Policy: A Reprise (4/4/2016).
[10] https://www.nytimes.com/2019/01/14/us/politics/nato-president-trump.html?emc=edit_mbe_20190115&nl=morning-briefing-europe&nlid=567726720190115&te=1

today, but have been delayed until January 30 due to the government shutdown.[11] These maps are needed for navigation; not only do ships at sea and aircraft use them, but they are also now part of our everyday lives as they assist in smartphone navigation.

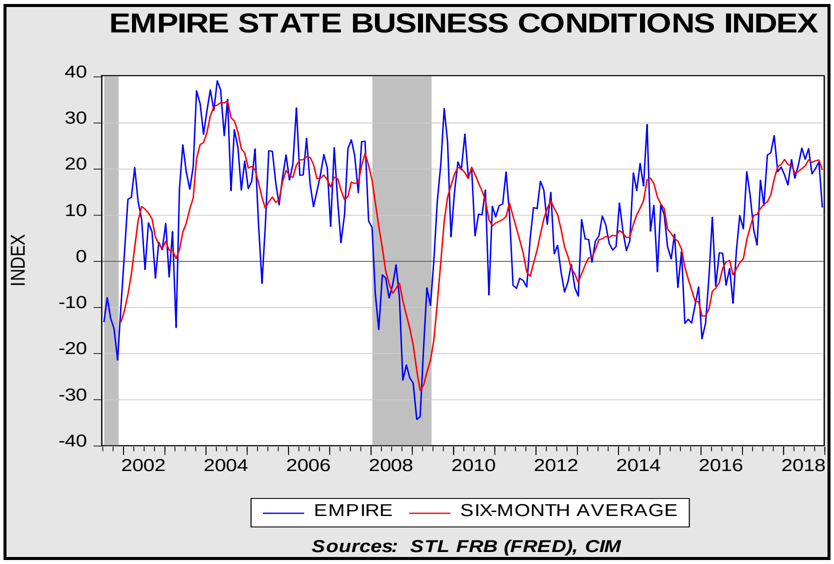


(Source: commons.wikimedia.org/)

U.S. Economic Releases

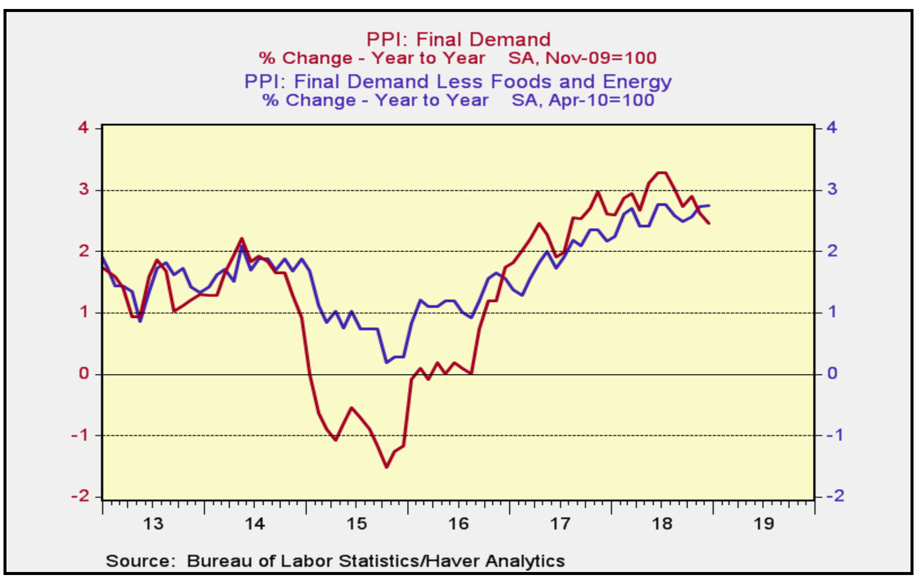
Empire manufacturing came in below expectations at 3.9 compared to the forecast of 10.0. The prior report was revised upward from 10.9 to 11.5. The survey showed there was a drop in inventory and a lower-than-expected rise in the number of employees.

[11] https://www.livescience.com/64486-earth-magnetic-pole-moving.html



The chart above shows the six-month moving average of the Empire State Business Conditions Index. Currently, the six-month moving average is 16.7.

PPI final demand came in below expectations, falling 0.2% from the prior month compared to the forecast loss of 0.1%. PPI excluding food and energy also came in below expectations, falling 0.1% from the prior month compared to the forecast of 0.2%. Core PPI, which excludes food, energy and trade services, came in below expectations, remaining unchanged from the prior month compared to the forecast of 0.2%.



The chart above shows the year-over-year change in headline PPI and core PPI, which rose 2.5% and 2.7%, respectively.

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
11:30	Neel Kashkari Speaks on Regional Economy in Minnesota	President of the Federal Reserve Bank of Minneapolis
13:00	Esther George Speaks on Economy and Monetary Policy	President of the Federal Reserve Bank of Kansas City
13:00	Robert Kaplan Speaks in Plano, Texas	President of the Federal Reserve Bank of Dallas

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	Money Supply M2	y/y	dec	8.1%	8.0%	8.1%	*	Equity and bond neutral
	New Yuan Loans CNY	y/y	dec	1.080 tn	1.250 tn	0.825 tn	*	Equity bullish, bond bearish
Japan	Machine Tool Orders	y/y	dec	-18.3%	-17.0%		**	Equity and bond neutral
	Money Stock M2	y/y	dec	2.4%	2.3%	2.4%	**	Equity and bond neutral
	Bankruptcies	y/y	dec	-10.6%	6.1%		***	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	w/w	jan	116.8	115.2		**	Equity and bond neutral
New Zealand	Food Prices	m/m	dec	-0.2%	-0.6%		***	Equity and bond neutral
EUROPE								
Eurozone	Trade Balance	m/m	nov	15.1 bn	12.5 bn	12.6 bn	**	Equity bullish, bond bearish
Germany	GDP	y/y	2018	1.5%	2.2%	1.5%	***	Equity and bond neutral
	Budget Maastricht % GDP	y/y	2018	1.7%	1.0%		***	Equity and bond neutral
France	CPI	y/y	dec	1.6%	1.6%	1.6%	***	Equity and bond neutral
	CPI EU Harmonized	y/y	dec	1.9%	1.9%	1.9%	***	Equity and bond neutral
AMERICAS								
Mexico	Gross Fixed Investment	y/y	oct	3.4%	-0.9%	3.4%	***	Equity and bond neutral
Brazil	Retail Sales	y/y	nov	4.4%	1.9%	2.2%	**	Equity bullish, bond bearish
	Retail Sales Broad	y/y	nov	5.8%	6.2%	4.3%	**	Equity bullish, bond bearish
Canada	Bloomberg Nanos Confidence	m/m	jan	54.5	55.5		***	Equity and bond neutral
	Teranet/National Bank HPI	y/y	dec	2.5%	3.1%		**	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)	279	280	-1	Up
3-mo T-bill yield (bps)	239	238	1	Neutral
TED spread (bps)	39	42	-3	Neutral
U.S. Libor/OIS spread (bps)	241	241	0	Up
10-yr T-note (%)	2.69	2.70	-0.01	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	2	2	0	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Up
yen	down			Neutral
pound	down			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	$59.70	$58.99	1.20%	Bullish API Report
WTI	$51.09	$50.51	1.15%	
Natural Gas	$3.57	$3.59	-0.70%	
Crack Spread	$13.78	$13.61	1.20%	
12-mo strip crack	$16.02	$15.92	0.62%	
Ethanol rack	$1.41	$1.41	-0.12%	
Metals				
Gold	$1,291.11	$1,291.72	-0.05%	
Silver	$15.60	$15.65	-0.34%	
Copper contract	$263.95	$263.50	0.17%	
Grains				
Corn contract	$ 380.00	$ 378.50	0.40%	
Wheat contract	$ 515.25	$ 514.25	0.19%	
Soybeans contract	$ 905.00	$ 903.50	0.17%	
Shipping				
Baltic Dry Freight	1147	1169	-22	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.5		
Gasoline (mb)		3.0		
Distillates (mb)		1.5		
Refinery run rates (%)		-0.80%		

Weather

The 6-10 and 8-14 day forecasts show cooler temperatures for most of the country, with warmer to normal temperatures 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.

January 11, 2019

Does the Federal Reserve adjust policy for asset prices? This is perhaps one of the most controversial topics in U.S. monetary policy. Alan Greenspan faced this issue in the early 1990s. Both Volcker and Greenspan wanted to focus monetary policy on containing inflation. But, Larry Lindsey, a Fed governor at the time, noted that if outside forces, such as technology and trade, were keeping inflation down then the Fed could engage in easy monetary policy without the risk of rising price levels. He warned this could cause asset bubbles.[12] Greenspan, an adept corporate infighter, prevented Lindsey's position from gathering any momentum. But, as the "irrational exuberance" speech showed on December 20, 1996, he became concerned about overheating financial markets.[13] However, the reaction to the speech led the powerful Greenspan to realize there wasn't much upside in conducting monetary policy to quell asset bubbles. Instead, policy evolved to address the aftermath of bubbles.

Still, the idea of low interest rates triggering asset inflation never really went away. The Great Financial Crisis proved that the costs of cleaning up after a bubble could be considerable. It was one thing to have a bubble in technology stocks; in general, technology becomes obsolete so quickly that excess capacity in that sector doesn't have a lasting effect. On the other hand, a bubble in housing can depress economic activity for years. Jeremy Stein, a Fed governor from 2012 to 2014, raised concerns about financial excesses.[14]

In the current configuration of the FOMC, shown below, we rate them according to their policy bias (on a 1 to 5 scale, with 1 being the most hawkish and 5 most dovish) and by theoretical inclination. The latter reflects traditional hawks, characterized by a restrictive view of the Phillips Curve, traditional doves, who have an expansive view of the Phillips Curve, moderates, who make policy based on a variety of factors but tend to be "data-dependent" (in practice, atheoritical and not tied to the Phillips Curve) and financial asset-sensitive. The table below shows the breakdown. The number shows policy bias based on our analysis of comments and voting patterns. The colors show what we view as their theoretical background. Among the voters this year, the average is nearly 3, suggesting a moderate voting bloc. This year, there is only one dove and one hawk, five moderates and three financial market-sensitive voters. The doves tend to raise rates reluctantly; hawks tend to cut rates with the same distaste. Moderates are mostly a diverse group from a theoretical perspective. For our purposes, the important difference of this group compared to the traditional hawks and doves is skepticism about the Phillips Curve. These voters tend to watch trends in the overall economy and make policy decisions. Interestingly enough, three of the governors appointed by President Trump have been moderates and he also promoted Jerome Powell to chair of the FOMC. For a president who

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[12] Mallaby, Sebastian. (2016). *The Man Who Knew: The Life and Times of Alan Greenspan*. New York, NY: Penguin Books. (pp. 435-36.)

[13] Ibid, pp. 504-506.

[14] https://fraser.stlouisfed.org/title/1163/item/2372 and https://fraser.stlouisfed.org/title/1163/item/476707

seems to prefer doves, he has been steered into appointing moderates. Finally, there are three members who, in the comments, seem much attuned to the behavior of financial markets. Governor Brainard has voted as a dove but has expressed concern about market overheating and has used that position to support recent rate hikes.

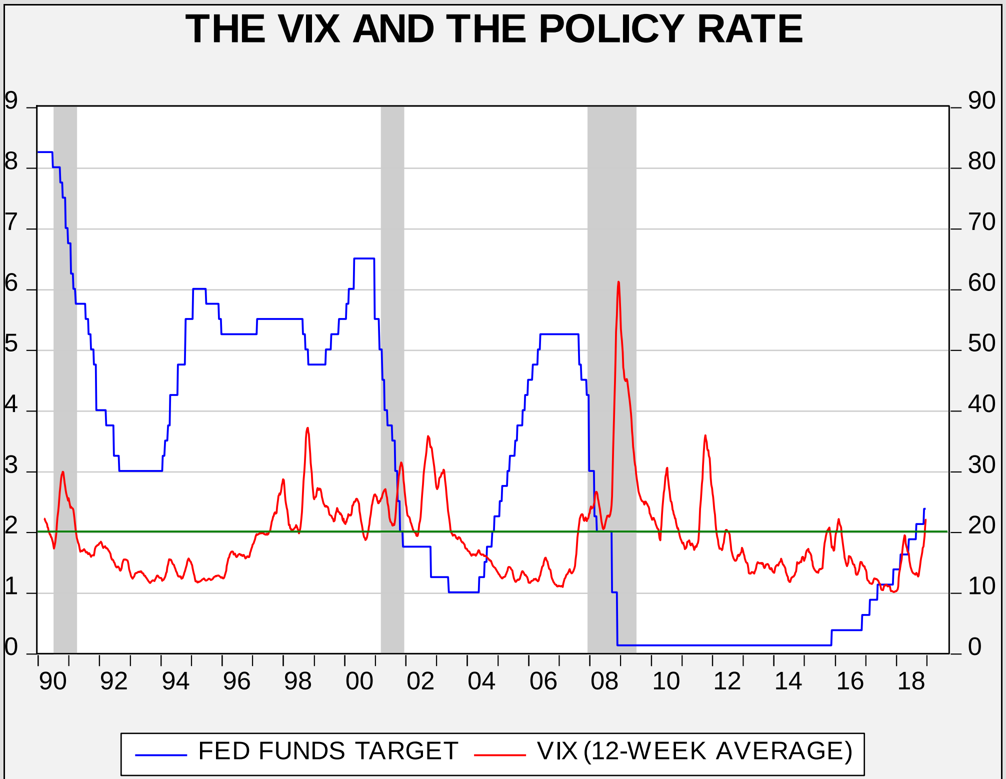
		all	2019	2020
Powell		3	3	3
Clarida		3	3	3
Brainard		4	4	4
Bowman		3	3	3
Quarles		2	2	2
Goodfriend				
Vacant				
Williams NY		2	2	2
Evans CHI		4	4	
Bullard STL		5	5	
George KC		1	1	
Barkin RICH		2		
Bostic ATL		3		
Daly SF		4		
Mester CLEV		2		2
Rosengren BOS		2	2	
Kashkari MINN		5		5
Kaplan DAL		3		3
Harker PHI		3		3
		3.00	2.90	3.00
DOVE				
MODERATE				
TRADITIONAL HAWK				
FINANCAL SENSITIVE				

This year, we have three voters we dub as "financial-sensitive." Thus, financial market behavior may be important to the path of policy this year.

However, as Greenspan noted, it's hard in real time to determine whether an asset market is in a bubble. And, it can be equally difficult to determine whether the cost of raising rates to prevent the bubble is less expensive than addressing the aftermath. The key problem with asset bubbles is that they leads to malinvestment. In a long-lasting asset, that can mean years of technical inefficiency because capacity can't be fully utilized. Thus, a housing bubble can lead to too much real estate that can take years to absorb; cutting interest rates can help slow the inevitable decline in prices but may actually expend the period necessary to balance the market. On the other hand, a bubble in wheat lasts one growing season and policymakers shouldn't bother to address the problem.

In addition, it would be politically explosive for policymakers to raise rates solely because equity or home prices have risen "excessively." The backlash would threaten central bank independence. Thus, if the Fed is worried about an asset bubble, it would need some measure other than valuation to raise rates.

One possibility we have examined recently is volatility. Does the FOMC adjust rates based on the equity market VIX? There appears to be some evidence that policymakers may be sensitive to market volatility.



Sources: FRED, Haver Analytics, CIM

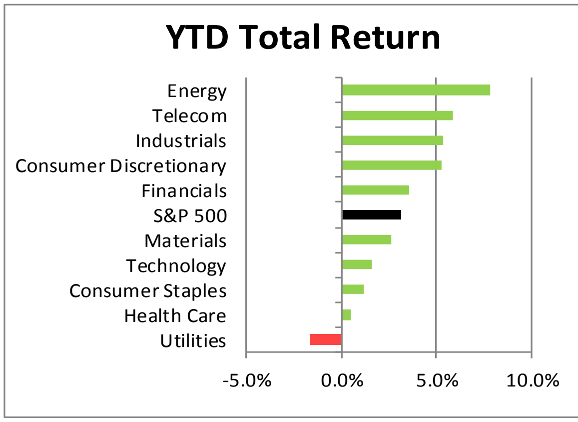
This chart shows the weekly fed funds target with the 12-week average of the CBOE VIX index. We have placed a bold line at 20 for the VIX. Since the late 1990s, we note that the FOMC was inclined to keep lowering rates with a VIX above 20; a reading under 20 would tend to support policy tightening. So, in 2002, Chair Greenspan kept cutting rates even though the economy was in clear recovery. It may have been due to perceptions that investor sentiment was overly negative. The 2004-06 tightening cycle occurred with a VIX persistently below 20. In fact, rate cuts seemed to occur as the VIX rose. We also note that the 2016 pause occurred after the VIX rose back above 20, and tapering was announced in 2016 after a prolonged period of a low VIX. The current pause coincides with the recent lift in volatility.

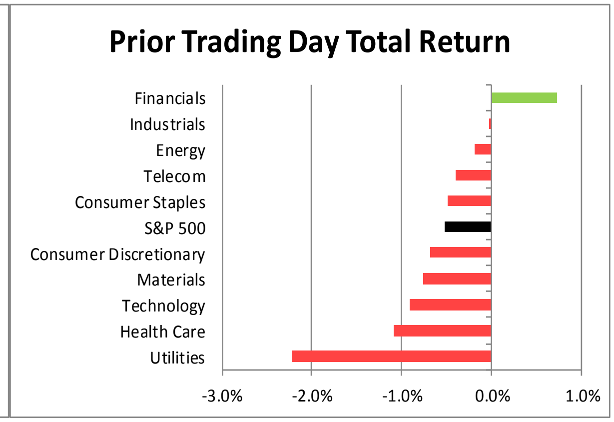
We also examined adding the VIX to the Mankiw Rule model variations. What we found is that the index is statistically significant in three of the variations and the correct sign in two. However, in the variations it did correctly affect, it didn't necessarily improve the forecasting accuracy by more than 10 bps. This performance suggests that the VIX may have an impact on policy but the Phillips Curve variables, labor market data and inflation, are still more important. However, the hard part to divine is the impact of the VIX on the moderate voters. Even if all of the market-sensitive members pay attention to the VIX, the moderates may only pay attention at extremes.

Therefore, in conclusion, we can probably say the following—when the VIX is below 20, the Fed is probably more likely to consider tightening policy. A reading above 20 may lead to a pause or could encourage further easing. However, the relationship isn't precise, which suggests the traditional hawks and doves don't pay much attention to market volatility. The VIX may be the way that market-sensitive FOMC members can incorporate financial markets into their policy decisions without overtly targeting valuations or returns.

<u>Data Section</u>

U.S. Equity Markets – (as of 1/14/2019 close)

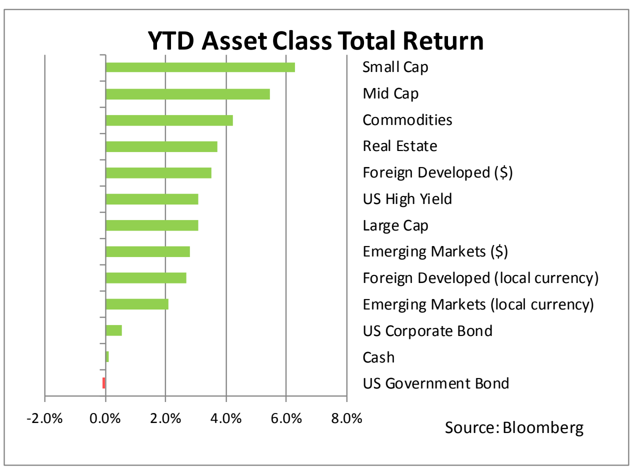




(Source: Bloomberg)

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 1/14/2019 close)

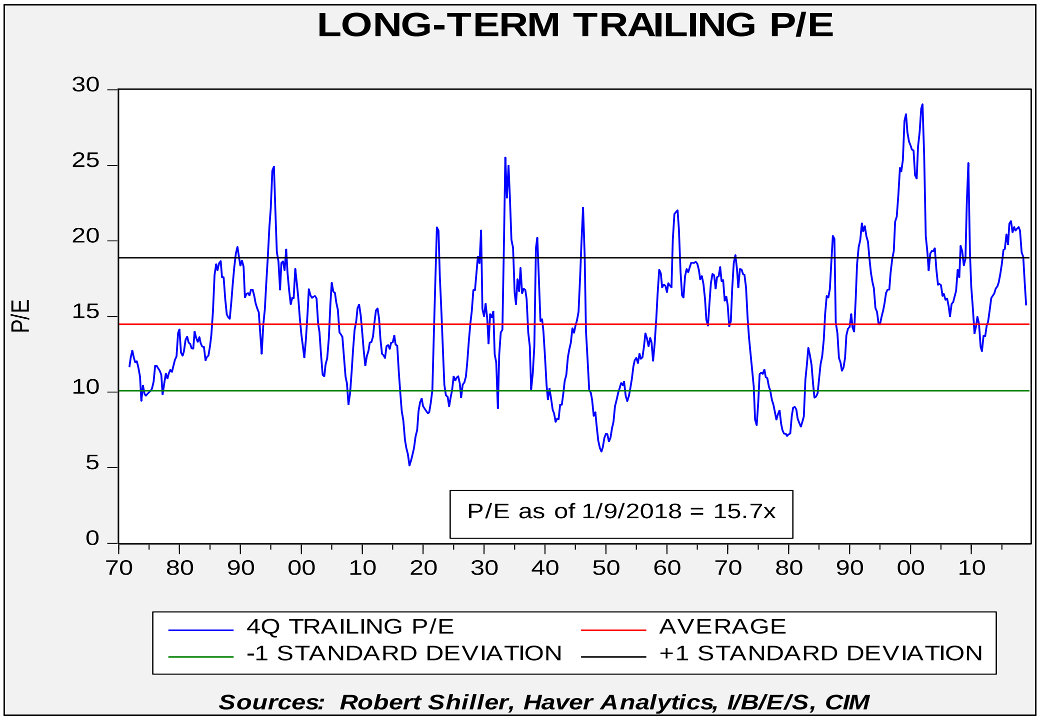


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

January 10, 2019



Based on our methodology,[15] the current P/E is 15.7x, up 0.1x from last week. The rebound in equities and a modest decline in earnings estimates led to the decline.

[15] 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.