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 15, 2020—9:30 AM EST] Global equity markets are lower this morning. The EuroStoxx 50 is down 0.3% compared with its last close. In Asia, the MSCI Asia Apex 50 closed down 0.7%. Chinese markets were lower, with the Shanghai composite down 0.5% and the Shenzhen index down 0.2% from the prior close. U.S. equity index futures are signaling a lower 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.

Good morning! It was a very quiet overnight session as markets await the signing of the Phase One deal with China. Here is what we are watching this morning:

BREAKING: Russian PM Medvedev resigned this morning along with the entire Russian government. This follows a speech from Putin in which he called on increasing the power of the PM and cabinet ministers. It is suspected that Putin, facing term limits in 2024, may opt to repeat his earlier job swap, where he accepts a newly empowered PM position and makes the presidency a ceremonial post.

Trade: Phase One will be signed this morning. The White House indicated that current tariffs will remain in place until after the November vote. That put a bit of a damper on equities yesterday; however, it also leaves open the possibility that the president could unilaterally reduce tariffs as the year progresses to reward compliance from China or to boost equities if we see weakness in the coming months.

However, it should be noted that trade relations are hardening outside this agreement. In what could be an important long-term move, USTR Lighthizer is pushing Japan and the EU to target China on corporate subsidies. This is a change in tenor; up until now, the U.S. has mostly engaged in bilateral actions. Lighthizer seems to recognize that "teaming up" with the rest of the industrialized world will probably have a stronger impact on the problematic issue of subsidies. This action won't bear fruit for a long time; WTO actions are notoriously slow, which is part of the reason the Trump administration has mostly ignored the body. Nevertheless, it does create a framework for cooperation, and if this group can eventually include India it could force China to reduce or eliminate market-distorting subsidies.

Another issue is that the U.S. is taking steps to further block sales of items from Huawei (002502, CNY 3.16). These moves are pushing China to become more self-sufficient in technology. Without Huawei, moving to 5G will be difficult; the Senate, recognizing this problem, has legislation under consideration that would offer $1.0 billion to U.S. firms to develop American 5G.

Finally, the Senate will move to pass USMCA before the impeachment trial begins. We expect the bill to pass easily.

Britain: A number of news items emerged overnight. First, PM Johnson admitted that a comprehensive trade deal with the EU might not happen before year-end. Although we do expect some progress to be made this year, it will almost certainly take more than a year for a full arrangement. The EU is also indicating that goods entering Northern Ireland from the U.K. will be subject to customs, contradicting comments from Johnson. This shows the degree of trade isolation that Northern Ireland faces in the wake of Brexit. Scotland wants to hold a new separation referendum; Johnson rejected that request. Although separation remains a threat, momentum for such a move is unlikely until after Scottish elections next year.

Iran: We reported yesterday that Germany, France and the U.K. were planning to start the process of protesting Iran's recent violations of the JCPOA. The three nations made it official. Iran warned that European soldiers in the region "could be in danger" after the move.

German slowdown: Germany expanded at its slowest pace in six years in 2019, expanding only 0.6%. As an export-promoter, Germany struggled to grow its economy as rising protectionism throughout the world led to a decrease in demand for exports. Additionally, auto-manufacturing, which represents a large part of the country's exports, has also been hurt by changing regulations and a declining market. A reduction in the trade war may contribute to a more favorable environment for Germany, but it is worth noting that the president has the European Union in his sights as well.

Africa: The U.S. has stationed troops in various regions of Africa as part of the war against insurgencies. Europe, especially France, also has forces in its colonial areas. The Pentagon has decided to reduce the force levels to redeploy soldiers to the great power confrontations with China and Russia. Europe isn't happy about this development.

Data: For years, the government's data-releasing agencies (BLS, Commerce, USDA, etc.) would release its sensitive data to news organizations up to an hour before the official release. This allowed these news feeds to prepare stories and make the data available at the release time. There has always been a problem with this system; the government had to put elaborate security systems in place to prevent a journalist from leaking the reports.[1] The USDA even took to guarding the Venetian blinds in the reporter room to prevent signaling.

The Obama administration, in a bid to reduce costs, tried to end the embargo practice and make the news organizations wait like everyone else to get the data. However, the news bodies

[1] Of course, the most famous movie about such things is *Trading Places*.

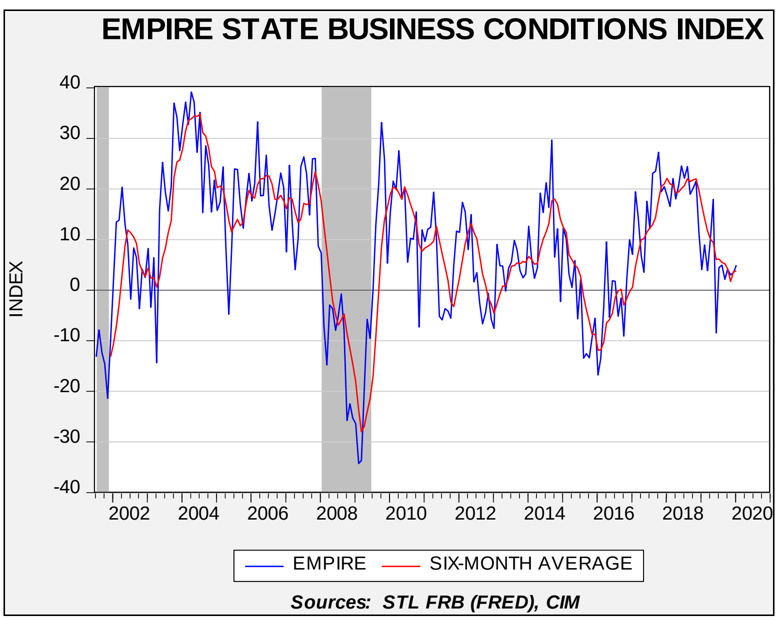
petitioned the administration and they retracted the decision. Now the Trump administration is apparently taking another swing at this action. If they follow through with this decision, government websites will be hammered with data requests as the release point nears. It isn't hard to imagine their sites freezing up due to the demand. The bottom line is that if this path is taken there will invariably be some reports that won't be disseminated in an orderly fashion. The pressure on government employees will also rise; traders who would benefit from an early look at the data (cue the Dukes) would likely be willing to bribe such employees. We will continue to monitor developments.

Odds and ends: Tensions in Lebanon increase as the economy deteriorates. President Trump is considering a trip to India. Repo demand remains robust; after adding $60.7 billion on Monday, the Fed sold another $82.0 billion yesterday.

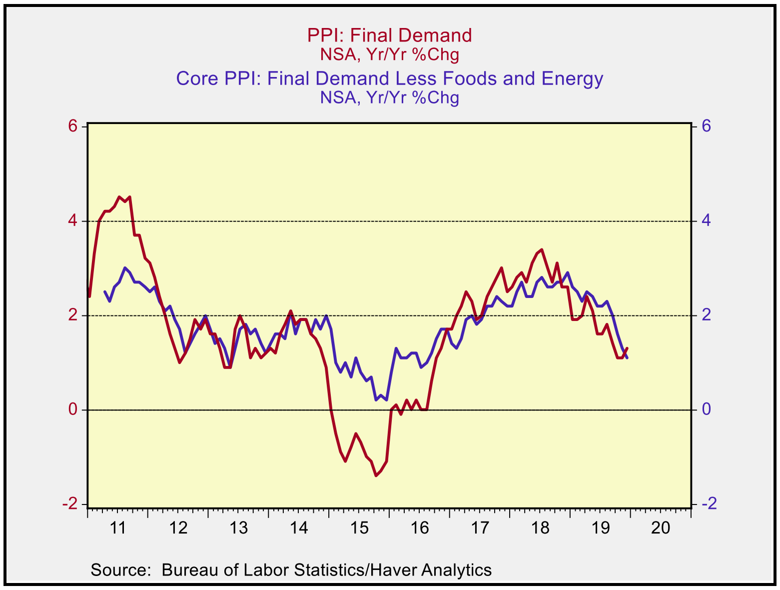
U.S. Economic Releases

MBA mortgage applications jumped 30.2% in the week ended January 10, building on their 13.5% rise in the previous week. Applications for home-purchase mortgages rose 15.5%, while applications for refinancing mortgages surged 42.7%. The average interest rate on a 30-year, fixed-rate mortgage fell to 3.87%.

Separately, the Federal Reserve Bank of New York said its January Empire State Manufacturing Index rose to a seasonally adjusted 4.8, beating both the expected reading of 3.6 and the revised December reading of 3.3. The reading suggests factory activity in New York State is continuing to grow modestly.



Finally, the December producer price index (PPI) rose weakly by a seasonally adjusted 0.1% compared with the expected increase of 0.2%. Even after excluding the volatile food and energy components, December "core" PPI was only up 0.1%. Overall PPI in December was up a modest 1.3% from December 2018, while core PPI was up just 1.1%.



The chart above shows the year-over-year change in PPI and core PPI over the last decade.

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**
11:00	Patrick Harker Speaks in New York	President of the Federal Reserve Bank of Philadelphia
11:00	Mary Daly Speaks in San Ramon, California	President of the Federal Reserve Bank of San Francisco
12:00	Robert Kaplan Speaks to the Economic Club of New York	President of the Federal Reserve Bank of Dallas
14:00	US Federal Reserve Releases Beige Book	Members of the Board of Governors

Foreign Economic News

We monitor numerous global economic indicators on a continuous basis. The most significant international news that was released overnight is outlined below. Not all releases are equally significant, thus we have created a star rating to convey to our readers the importance of the various indicators. The rating column below is a three-star scale of importance, with one star being the least important and three stars being the most important. We note that these ratings do change over time as economic circumstances change. Additionally, for ease of reading, we have also color-coded the market impact section, which indicates the effect on the foreign market. Red indicates a concerning development, yellow indicates an emerging trend that we are following closely for possible complications and green indicates neutral conditions. We will add a paragraph below if any development merits further explanation.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
Japan	Money Stock M2	y/y	dec	2.8%	2.7%	2.8%	**	Equity and bond neutral
	Money Stock M3	y/y	dec	2.3%	2.2%	2.3%	**	Equity and bond neutral
	Machine Tool Orders	y/y	dec	-33.6%	-37.9%		**	Equity bullish, bond bearish
New Zealand	Food Prices	m/m	dec	-0.2%	-0.7%		***	Equity and bond neutral
South Korea	Export Prices	y/y	dec	-3.1%	-6.5%		*	Equity and bond neutral
	Import Prices	y/y	dec	3.4%	-2.1%		*	Equity and bond neutral
	Unemployment Rate	m/m	dec	3.8%	3.6%	3.6%	***	Equity and bond neutral
India	Exports	y/y	dec	-1.8%	-0.3%		**	Equity and bond neutral
	Imports	y/y	dec	-8.8%	-12.7%		**	Equity and bond neutral
	Trade Balance	m/m	dec	-$11250 Mil.	-$12120 Mil.	-$11550 Mil.	**	Equity and bond neutral
EUROPE								
Eurozone	Industrial Production WDA	y/y	nov	-1.5%	-2.6%	-1.0%	*	Equity bearish, bond bullish
	Trade Balance	m/m	nov	19.2 Bil.	24.0 Bil.	22.0 Bil.	*	Equity bearish, bond bullish
France	CPI	y/y	dec	1.5%	1.4%	1.4%	***	Equity and bond neutral
	CPI - EU Harmonized	y/y	dec	1.6%	1.6%	1.6%	**	Equity and bond neutral
UK	CPI	y/y	dec	1.3%	1.5%	1.5%	***	Equity bearish, bond bullish
	Core CPI	y/y	dec	1.4%	1.7%	1.7%	***	Equity bearish, bond bullish
	Retail Price Index	y/y	dec	2.2%	2.2%	2.3%	**	Equity and bond neutral
	PPI - Output	y/y	dec	0.9%	0.5%	1.0%	***	Equity bearish, bond bullish
	Core PPI - Output	y/y	dec	0.9%	1.1%	1.0%	**	Equity bearish, bond bullish
AMERICAS								
Brazil	Retail Sales	y/y	nov	2.9%	4.2%	3.8%	***	Equity bearish, bond bullish
	Retail Sales - Broad	y/y	nov	3.8%	5.6%	5.2%	*	Equity bearish, bond bullish

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)	183	184	-1	Up
3-mo T-bill yield (bps)	153	153	0	Neutral
TED spread (bps)	31	31	0	Neutral
U.S. Libor/OIS spread (bps)	158	158	0	Up
10-yr T-note (%)	1.79	1.81	-0.02	Neutral
Euribor/OIS spread (bps)	-39	-39	0	Neutral
EUR/USD 3-mo swap (bps)	1	2	-1	Down
Currencies	**Direction**			
dollar	Flat			Neutral
euro	Up			Flat
yen	Up			Down
pound	Down			Down
franc	Up			Up

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	$64.50	$64.49	0.02%	
WTI	$58.29	$58.23	0.10%	
Natural Gas	$2.16	$2.19	-1.46%	
Crack Spread	$14.89	$14.96	-0.45%	
12-mo strip crack	$17.24	$17.27	-0.18%	
Ethanol rack	$1.42	$1.42	-0.15%	
Metals				
Gold	$1,552.02	$1,546.39	0.36%	
Silver	$17.83	$17.80	0.18%	
Copper contract	$284.75	$287.35	-0.90%	
Grains				
Corn contract	$ 389.00	$ 389.00	0.00%	
Wheat contract	$ 572.50	$ 568.50	0.70%	
Soybeans contract	$ 941.75	$ 942.25	-0.05%	
Shipping				
Baltic Dry Freight	763	765	-2	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		0.0		
Gasoline (mb)		3.5		
Distillates (mb)		5.3		
Refinery run rates (%)		-1.50%		
Natural gas (bcf)		-94.0		

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 only in the Southwest. The only consolation is that most areas are expected to be dry. Wet conditions are anticipated only in Texas and Florida.

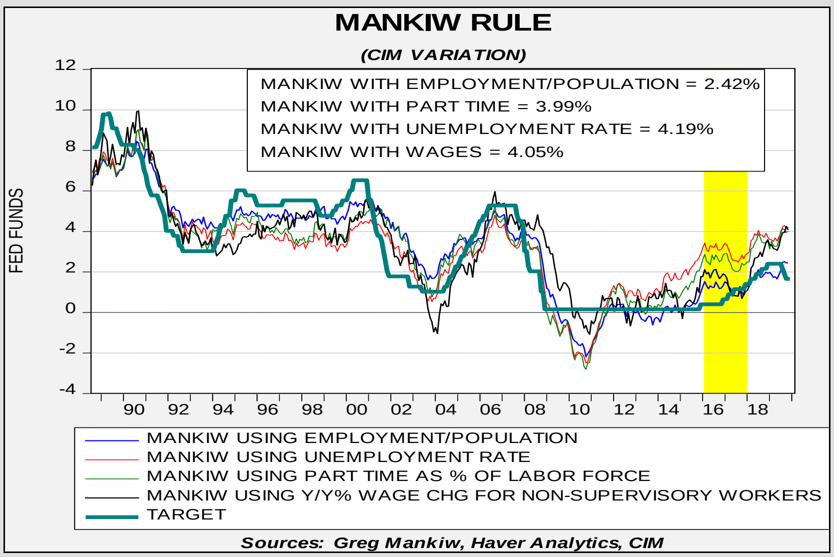
Asset Allocation Weekly

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

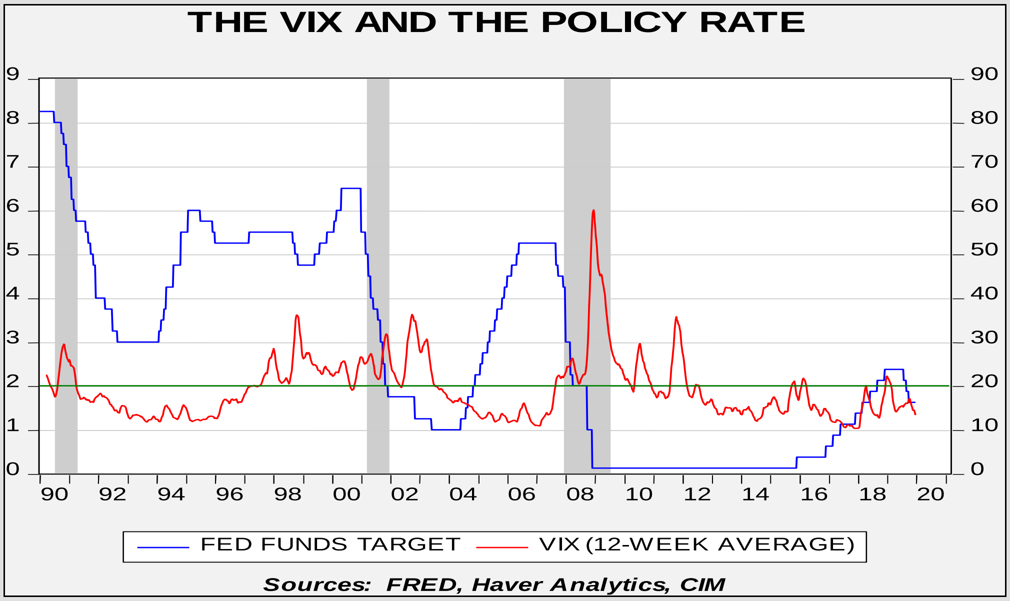
In our 2020 Outlook, we discussed three risks to the forecast, with one of them being a "melt-up" or a dramatic rise in stock prices. One of the key factors that could bolster higher prices for risk assets would be the idea that the FOMC has engineered a soft landing, which is best defined as a tightening 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.

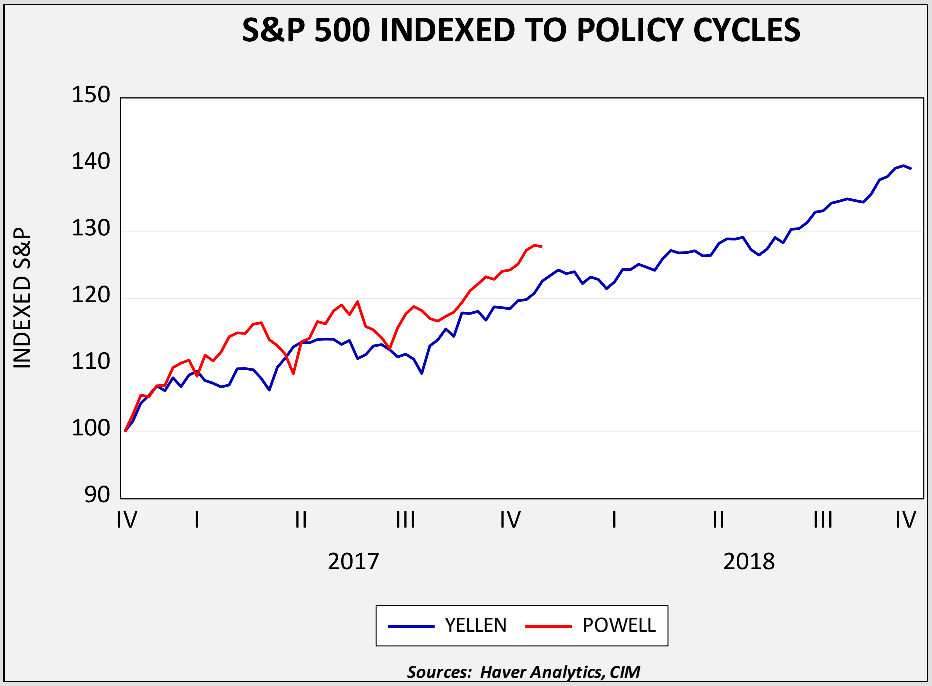
Why did this pause occur? A contributing factor appears to be fragility in the financial markets.



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.

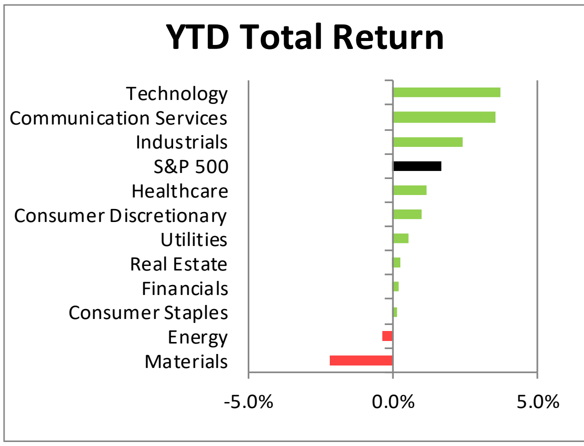
So, if this is what the Fed is doing, what does it mean for equities? We indexed the S&P 500 to early February 2016, when it became clear that Yellen would keep policy on hold, and January 2019, when Powell signaled at least a pause in tightening. The idea is that equities should benefit if the Fed avoids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

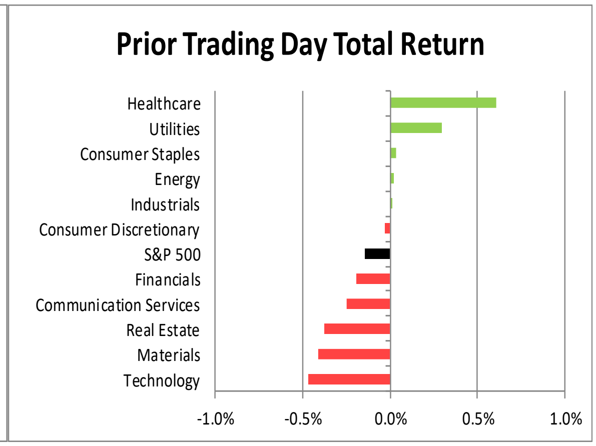


The two periods are generally tracking each other; if this pattern continues, the current S&P 500 would end up at 3532.56 by late November. This analysis is clearly not foolproof as one episode of a soft landing won't necessarily generate a repeat performance. Nevertheless, we are tracking relatively 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 1/14/2019 close)

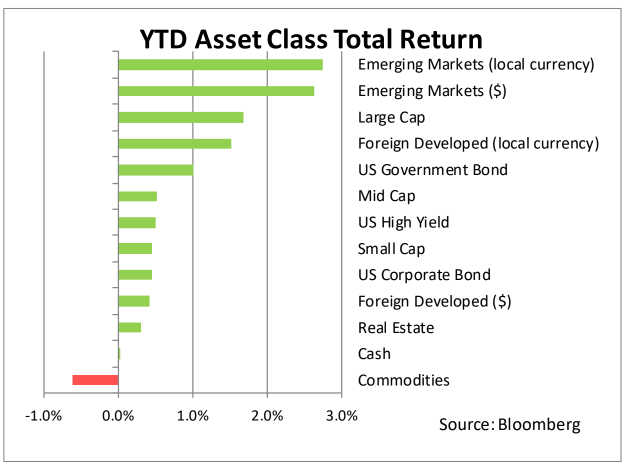




(Source: Bloomberg)

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

Asset Class Performance – (as of 1/14/2019 close)

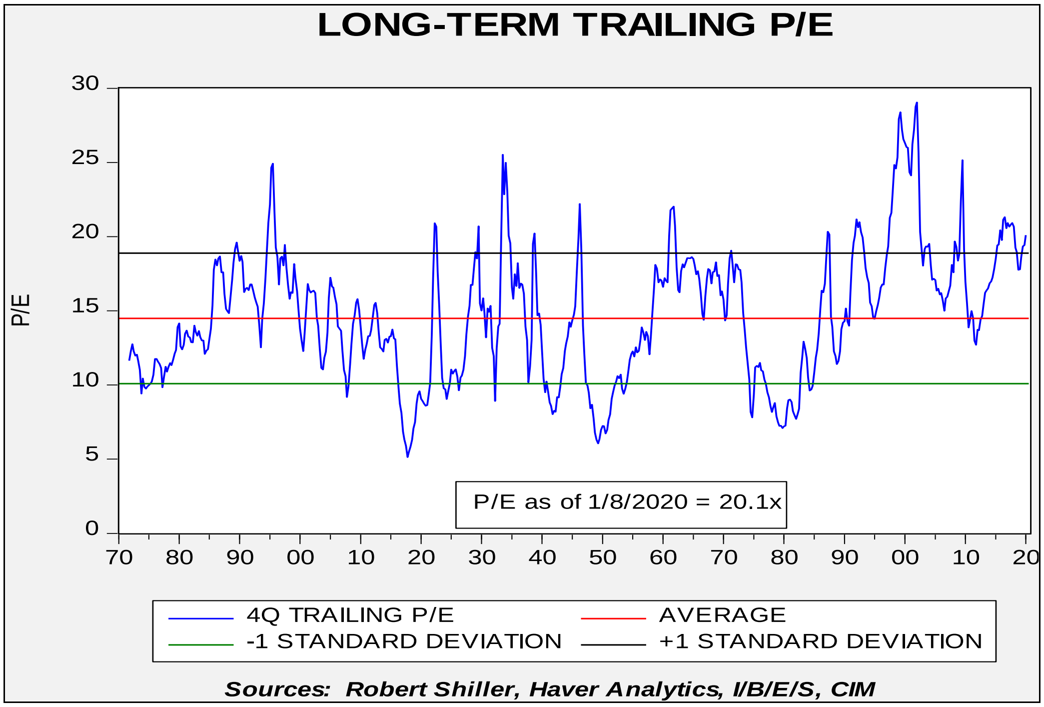


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 9, 2020



Based on our methodology,[2] the current P/E is 20.1x, up 0.8x from the previous 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.

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[2] 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.