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 16, 2020—9:30 AM EST] Global equity markets are generally mixed this morning. The EuroStoxx 50 is down 0.2% compared with its last close. In Asia, the MSCI Asia Apex 50 closed up 0.3%. Chinese markets were lower, with the Shanghai composite down 0.4% and the Shenzhen index down 0.5% from the prior close. U.S. equity index futures are signaling a higher 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! Equity markets continue to grind steadily higher; in fact, it's the third longest streak since 1995 of the major indices not moving more than 1% in either direction. Why? Our quick take is that we are seeing the combination of monetary accommodation coupled with uncommon caution by retail investors. We look at the aftermath of the China/U.S. trade deal. Putin moves to extend his rule. Here is what we are watching this morning:

U.S./China deal: Although the press has focused simply on the signing of the U.S.-China Phase One trade deal yesterday and the big import commitments China made in the agreement, our read of the text itself suggests the bigger story may be that the U.S. got the Chinese to make significant concessions in a number of important areas. The draft deal that China walked away from last May was apparently quite intrusive, with detailed changes to multiple areas of Chinese law. The text of the deal signed yesterday also includes many requirements that China change its legal and regulatory system to match U.S. standards, but without specifically enumerating each article, chapter and clause of Chinese law that has to be changed. Most of those changes relate to the protection of intellectual property, so there are many more issues in the U.S.-China relationship that still need to be addressed.

The agreement is being widely panned in the media. Although we always take the position of political neutrality, the tone is probably more negative than justified. There are two primary criticisms of the agreement. First, China's practice of subsidizing firms that supports their export efforts wasn't addressed. This charge is accurate. However, as we noted yesterday, USTR Lighthizer is working to use the WTO and team up with Japan and the EU to address this issue. In our view, Lighthizer is a grandmaster of trade negotiations; he appears to have decided that the subsidy issue is better dealt with in a broader context. Second, there is legitimate concern that China will not live up to its promises as it has in previous agreements. What is different this time is that the U.S. has shown it will implement tariffs if China doesn't do what it says it will.

We find it notable that the U.S. has kept the vast majority of tariffs in place even after this deal. That suggests the U.S. feels it won't get compliance from Beijing without the persistent threat of a "stick."

At least in our initial look, we have some worries too. There doesn't appear to be a well-designed dispute mechanism; thus, the ultimate enforcement may come down to "I quit." We are also concerned that China may not be able to fully meet the import targets; we note soybean prices fell yesterday on these worries.

However, overall, the trade war with China has clearly caught the attention of Chairman Xi. We suspect the USTR's primary goal is to change the way the Chinese economy works, similar to what he helped engineer against Japan in the late 1980s. Simply put, he wants to change China's economy from being investment and export driven, to consumption and import driven. Japan was never able to make the transition and thus has suffered 30+ years of economic stagnation. If China wants to avoid the same fate, it will need to make changes. Of course, history never repeats exactly the same way; China is big enough that it may try to create its own sphere of influence, something that Japan, who was dependent on the U.S. for its security, could never execute.

So, where do we go from here? There are two trends we are following. The Trump administration will likely conclude that, given what they were able to accomplish with China, tariffs are effective. Thus, tariffs can be used to force trade concessions and to change behavior. We suspect the EU is the next area that will come under scrutiny. We also note reports that the U.S. threatened the EU with tariffs on autos if they didn't warn Iran about violating the nuclear deal.

Putin: We once worked with a strategist who pretty much always had the same forecast, but the "show" was seeing how he would manage to create a path to that outcome. Vladimir Putin is similar in that respect. We know the outcome is always that Putin will remain in power. However, how he does it is interesting to watch. In his annual State of the Union address yesterday, President Putin launched a surprise constitutional revamp that could keep him in power past the end of his term in 2024. Under the proposal, which Putin said would be put to a referendum, the power to name the prime minister and his or her cabinet would be transferred from the president to the lower house of parliament (although the president would still be able to dismiss the prime minister and cabinet ministers). Parliament would also get greater power over the judiciary and the security services. Eligibility to become president would be tightened up so that anyone taking the post would need to first live 25 years in Russia and have no foreign citizenship or residency. Future presidents would also be limited to two terms in total. Meanwhile, the State Council, which Putin already heads, would be given increased power. To put the changes in motion, Putin replaced incumbent Prime Minister Medvedev with Mikhail Mishustin, the head of Russia's tax office who is relatively unknown and has no appreciable political base. The move reflects a number of important principles: 1) Putin takes great pain to prolong the illusion of constitutional legitimacy, just as he did a decade and a half ago when he temporarily took the role of prime minister after reaching the term limit on his first presidency; 2) By neutering the presidency and installing a weak figure as prime minister, Putin is ensuring that he will maintain overwhelming control over the government from his position at the top of the State Council; and 3) Although the timing of the change seems early compared with the 2024 end of Putin's current term, moving now may make sense given that Russia will hold parliamentary elections in 2021, and Putin could package the move to the advantage of his party in that balloting.

Germany: The federal government has struck a deal with the country's coal-producing regions to phase out the use of coal for power by 2038 in return for €40 billion worth of compensation and benefits. That suggests Germany will try to stop using both nuclear and coal power at the same time, replacing them with renewables and natural gas.

South Korea: The U.S. ambassador to South Korea said the Trump administration has softened its demand that Seoul quintuple its contribution to supporting the U.S. troops stationed on the Korean peninsula. The ambassador gave no details on the new demand, but if the softening is significant, it could help diffuse tensions between the U.S. and South Korean governments, and allow them to focus on issues like the renewed threats from North Korea.

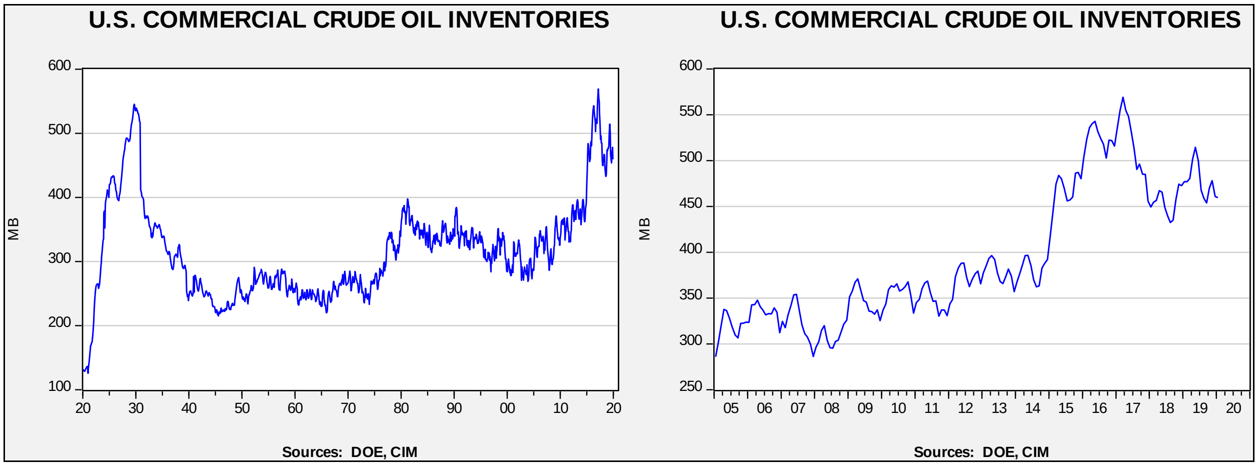
Turkey: Despite a recent rebound in inflation, the Turkish central bank today cut its benchmark short-term interest rate more sharply than expected, to 11.25% from 12.00% previously. The recent rate cuts, which have been driven largely by President Erdogan, appear to be spurring better economic activity even if they are spurring stronger price hikes. That may explain why the lira actually strengthened slightly after the rate cut was announced.

Iraq: Caretaker Prime Minister Adel Abdul-Mahdi suggested in a cabinet meeting that he would leave the decision of whether to expel U.S. forces from the country to his successor. In spite of parliament's recent call for such an expulsion and the Trump administration's threat to impose sanctions if it does so, that means the issue may not come to a head in the near term. Any U.S. sanctions could very well be targeted against Iraqi oil exports, boosting oil prices, so pushing the issue off into the future could help keep the oil markets calmer than would otherwise be the case.

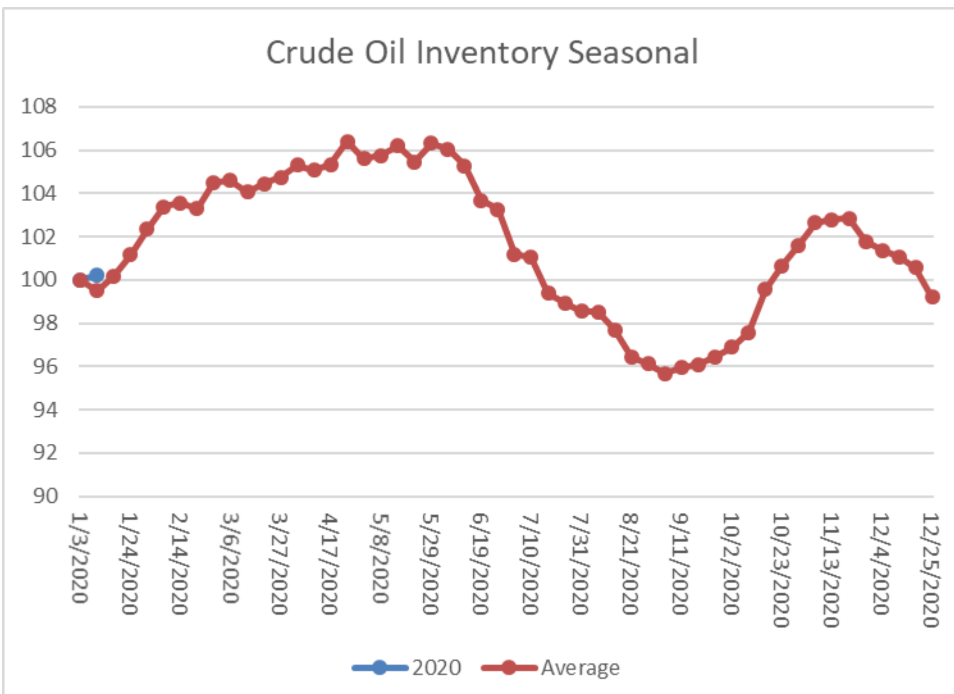
European news: The German media is reporting that an unnamed EU diplomat and two others are being investigated by German officials on suspicions of spying for China. British MEPs are preparing to leave the European Parliament after the Brexit. The U.S. has added Switzerland to its currency manipulator watch list (it's about time!).

Odds and ends: Amid unrelenting drought, Australian mining firms are struggling to find enough water for their mining operations. The Wuhan coronavirus may be capable of human-to-human transmission; if so, this would make the disease much more dangerous. We also note that the Japanese health ministry has confirmed that the new coronavirus that has sickened dozens in China has now spread to Japan.

Energy update: Crude oil inventories fell 2.5 mb compared to expected no change in stockpiles.

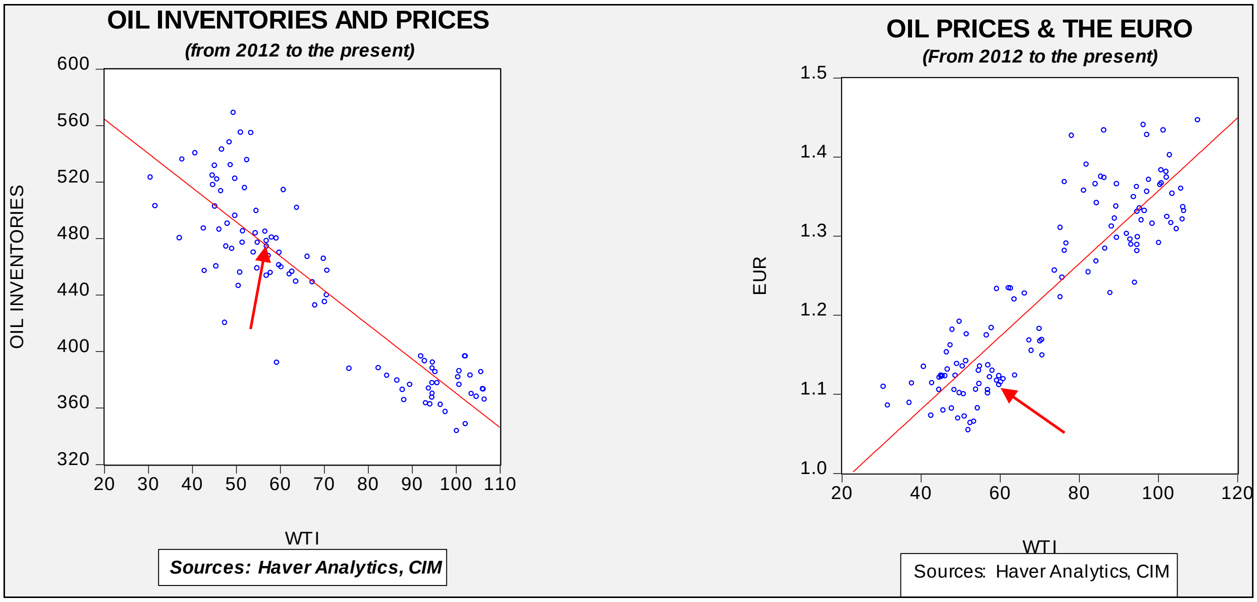


In the details, U.S. crude oil production rose 0.1 mbpd to a new record of 13.0 mbpd. Exports fell 0.4 mbpd while imports fell 0.3 mbpd. The decline in stockpiles was unexpected but offset by large increases in product.



(Sources: DOE, CIM)

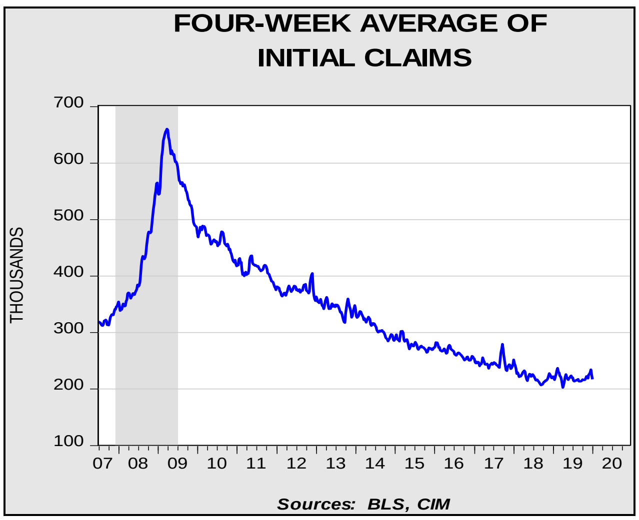
This chart shows the annual seasonal pattern for crude oil inventories. This week's decline was a bit below normal. As the chart shows, oil inventories usually rise into late spring and then decline significantly into late summer. Last year, this pattern was disrupted to some extent because of exports.



Based on our oil inventory/price model, fair value is $64.41; using the euro/price model, fair value is $51.35. The combined model, a broader analysis of the oil price, generates a fair value of $55.43. We are seeing the divergence between dollar and oil inventories narrow as dollar weakness persists. Given the level of geopolitical risk, prices have not moved significantly above the inventory fair value price, although the combined model would suggest a richly valued market. With inventories poised to rise seasonally and tensions seemingly easing, softer prices are more likely in the coming weeks.

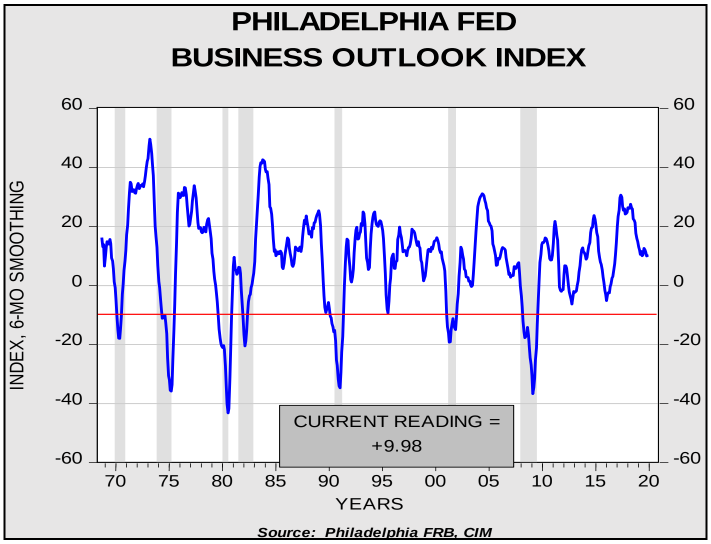
U.S. Economic Releases

Initial jobless claims came in below expectations at 204k compared to expectations of 218k.



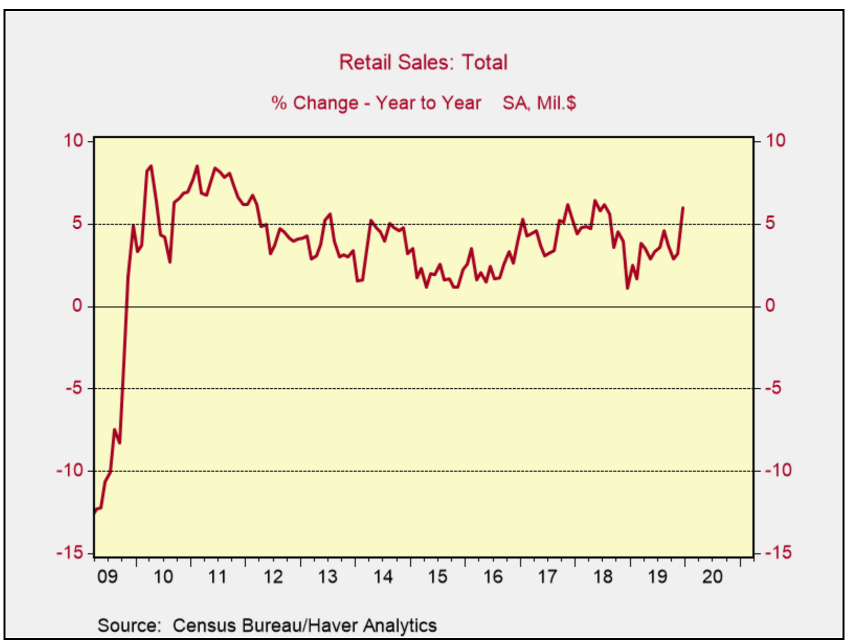
The chart above shows the four-week moving average of initial jobless claims. The four-week average fell from 223.75k to 216.25k.

Philadelphia Fed Business Outlook came in well above forecast at 17.0 compared to expectations of 3.8. The prior report was revised upward from 0.3 to 2.4.



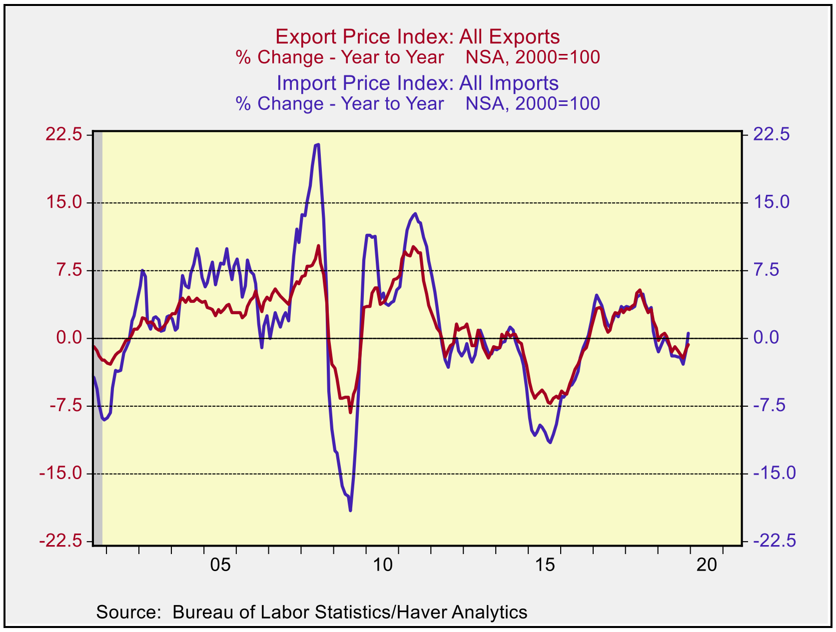
The chart above shows the six-month moving average of the Philadelphia Fed Business Outlook index.

Retail sale rose 0.3% from the prior month, in line with expectations. The prior month report was revised upward from 0.2% to 0.3%. Retail sale ex auto rose 0.7% from the prior month, compared to expectations of 0.5%. Meanwhile, retail sale ex auto and gas rose 0.5% from the prior month, compared to expectations of 0.4%. The prior report revised downward from 0.0% to -0.2%. Lastly, the retail sale control group rose 0.5% from prior month, compared to expectations of 0.4%. The prior month's report was revised downward from 0.1% to -0.1%.



The chart above shows the year-over-year change in retail sales. Retail sale rose 6.0% from the prior year. The strong growth in retail sales bodes well for U.S. consumption, which is the biggest contributor to GDP.

The import price index rose 0.3% from the prior month, in line with expectations. The prior report was revised downward from 0.2% to 0.1%. The import price index ex petroleum rose 0.2% from the prior month, compared to expectations at 0.1%. The export price index fell 0.2% from the prior month, which was in line with expectations of 0.2%



The chart above shows the year-over-year change in the import and export price index.

The table below shows the Economic releases scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Consumer Comfort	w/w	12-Jan		65.1	**
10:00	Business Inventories	m/m	nov	-0.2%	0.2%	**
10:00	NAHB Housing Market Index	m/m	jan	74	76	**
16:00	Net Long-Term TIC Flows	m/m	nov		$32.5 Bil	**
16:00	Total Net TIC Flows	m/m	nov		-$48.3 Bil	**
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								
China	New Home Prices	y/y	dec	0.4%	0.3%		**	Equity and bond neutral
	Money Supply M2	y/y	dec	8.7%	8.2%	8.3%	**	Equity bullish, bond bearish
	Aggregate Financing CNY	m/m	dec	2.100 Tril	1.750 Tril	1.650 Tril	**	Equity bullish, bond bearish
	New Yuan Loans	y/y	dec	1.140 Tril	1.390 Tril	1.200 Tril	**	Equity and bond neutral
Japan	Core Machine Orders	y/y	nov	5.3%	-6.1%	-5.3%	**	Equity and bond neutral
	PPI	y/y	dec	0.9%	0.1%	0.9%	**	Equity and bond neutral
Australia	Investor Loan Value	m/m	nov	2.2%	1.4%	1.0%	**	Equity bullish, bond bearish
	Home Loan Value	m/m	nov	1.8%	2.0%	1.4%	**	Equity bullish, bond bearish
	Owner-Occupier Loan Value	m/m	nov	1.6%	2.2%	1.8%	**	Equity and bond neutral
New Zealand	REINZ House Sales	y/y	dec	12.3%	-1.9%		**	Equity bullish, bond bearish
	Card Spending Retail	y/y	dec	-0.8%	2.6%	1.0%	*	Equity and bond bearish
	Card Spending Total	m/m	dec	-0.6%	1.0%		*	Equity and bond bearish
EUROPE								
Eurozone	EU27 New Car Registration	y/y	dec	21.7%	4.9%		*	Equity bullish, bond bearish
Germany	CPI	y/y	dec	1.5%	1.5%	1.5%	***	Equity and bond neutral
	CPI - EU Harmonized	y/y	dec	1.5%	1.5%	1.5%	***	Equity and bond neutral
UK	RICS House Price Balance	m/m	dec	-2.0%	-12.0%	-8.0%	*	Equity bullish, bond bearish
AMERICAS								
Canada	Existing Home Sales	m/m	dec	-0.9%	0.6%		**	Equity and bond bearish
Brazil	Retail Sales	y/y	nov	2.9%	4.2%	3.9%	**	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	183	1	Up
3-mo T-bill yield (bps)	152	153	-1	Neutral
TED spread (bps)	32	30	2	Neutral
U.S. Libor/OIS spread (bps)	158	158	0	Up
10-yr T-note (%)	1.78	1.78	0.00	Neutral
Euribor/OIS spread (bps)	-39	-39	0	Neutral
EUR/USD 3-mo swap (bps)	2	1	1	Down
Currencies	**Direction**			
dollar	Flat			Neutral
euro	Up			Flat
yen	Down			Down
pound	Down			Down
franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
RBA FX Transactions Market	A$1.776 Bil	A$0.665 Bil		On forecast
RBA FX Transactions Other	A$3.403 Bil	A$0.239 Bil		On forecast
RBA FX Transactions Government	-A$2.062 Bil	-A$0.756 Bil		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	$64.01	$64.00	0.02%	
WTI	$57.61	$57.81	-0.35%	
Natural Gas	$2.13	$2.12	0.33%	
Crack Spread	$14.33	$14.48	-1.02%	
12-mo strip crack	$16.94	$17.08	-0.78%	
Ethanol rack	$1.41	$1.41	-0.19%	
Metals				
Gold	$1,555.97	$1,556.25	-0.02%	
Silver	$17.99	$18.00	-0.05%	
Copper contract	$287.60	$286.60	0.35%	
Grains				
Corn contract	$ 383.00	$ 387.50	-1.16%	
Wheat contract	$ 564.75	$ 573.25	-1.48%	
Soybeans contract	$ 926.50	$ 928.75	-0.24%	
Shipping				
Baltic Dry Freight	768	763	5	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.5	0.0	-2.5	
Gasoline (mb)	6.7	3.5	3.2	
Distillates (mb)	8.2	5.3	2.9	
Refinery run rates (%)	-0.80%	-1.50%	0.70%	

Weather

The 6-10 and 8-14 day forecasts currently call for a cold front moving from the east into most of the country, the western and New England states are expected to remain warmer-than-normal. Wet conditions are expected throughout the country, with dry conditions expected for the north eastern states and California.

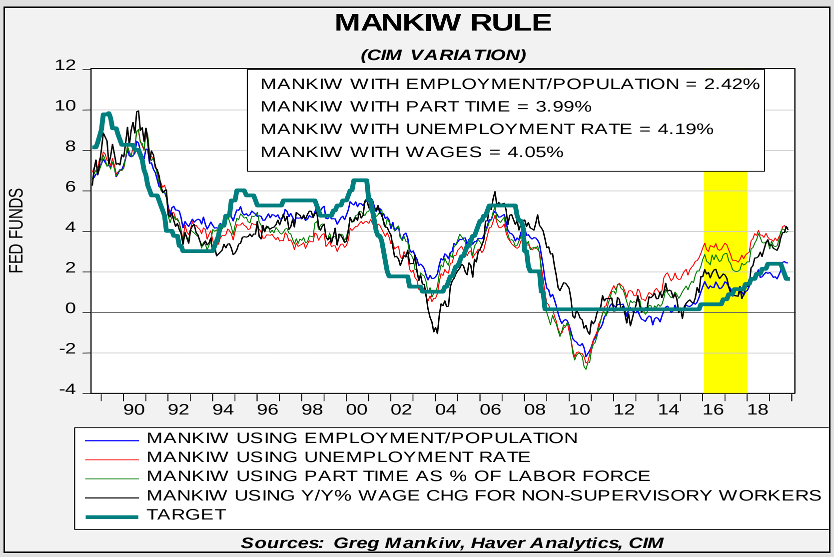
Asset Allocation Weekly

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

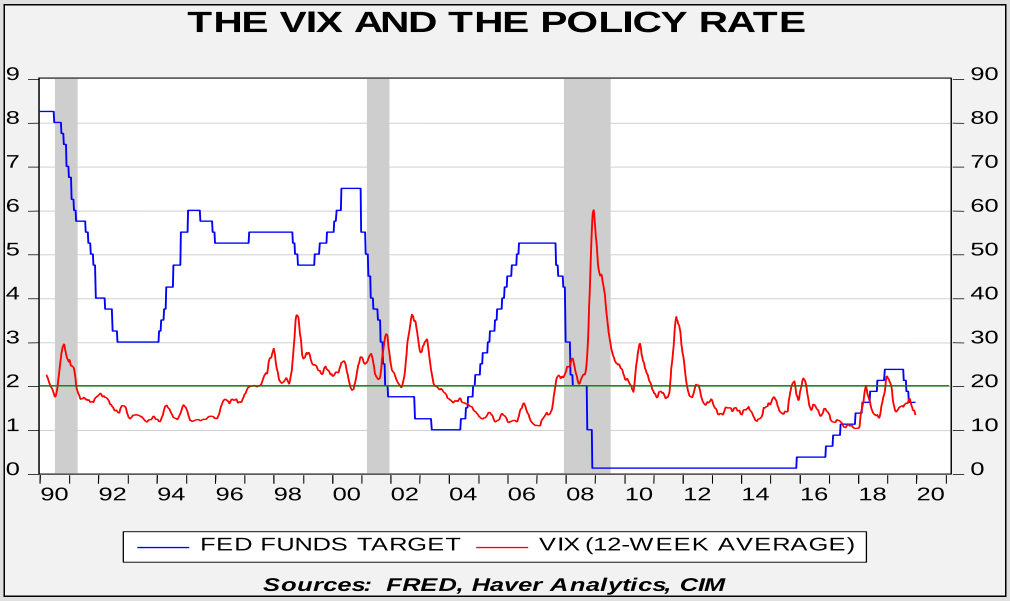
In our 2020 Outlook, we discussed three risks to the forecast, with one of them being a "melt-up" or a dramatic rise in stock prices. One of the key factors that could bolster higher prices for risk assets would be the idea that the FOMC has engineered a soft landing, which is best defined as a tightening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

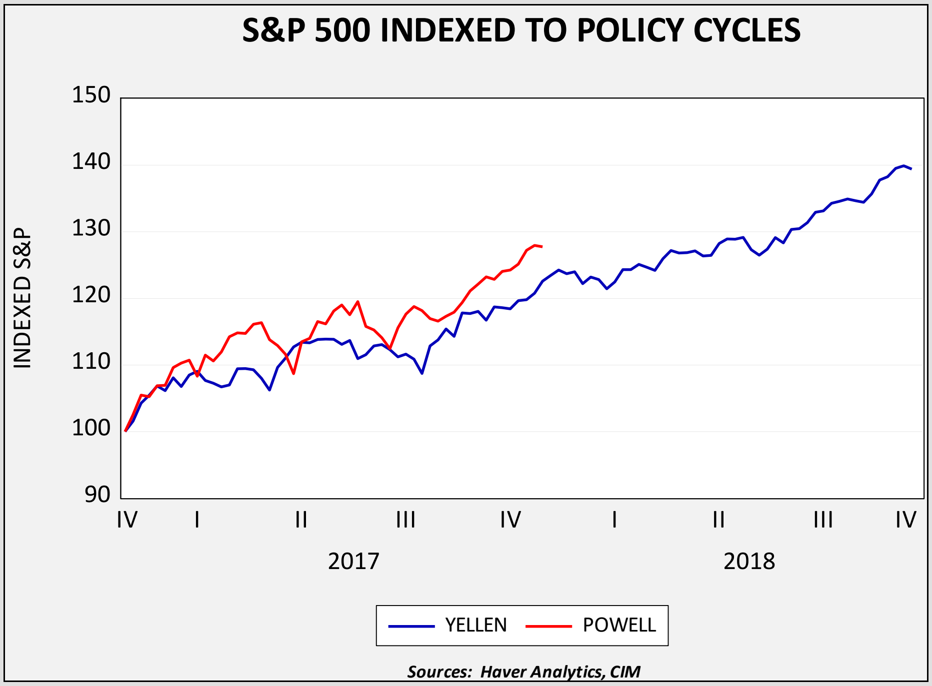
Why did this pause occur? A contributing factor appears to be fragility in the financial markets.



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.

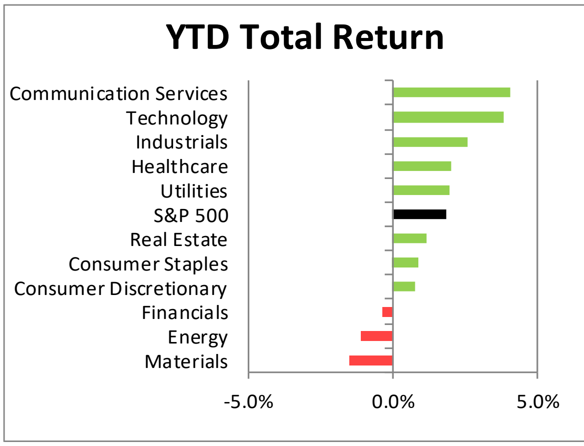
So, if this is what the Fed is doing, what does it mean for equities? We indexed the S&P 500 to early February 2016, when it became clear that Yellen would keep policy on hold, and January 2019, when Powell signaled at least a pause in tightening. The idea is that equities should benefit if the Fed avoids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

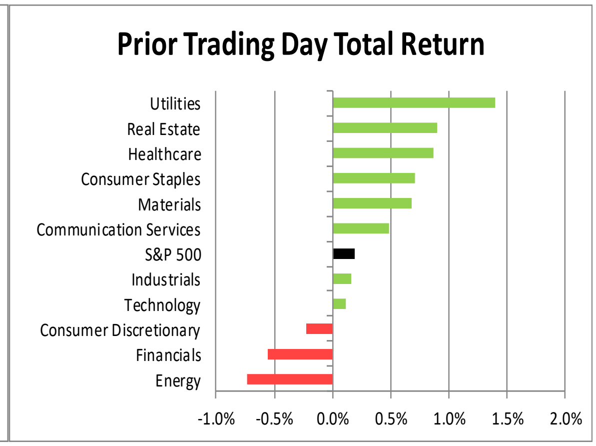


The two periods are generally tracking each other; if this pattern continues, the current S&P 500 would end up at 3532.56 by late November. This analysis is clearly not foolproof as one episode of a soft landing won't necessarily generate a repeat performance. Nevertheless, we are tracking relatively 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 1/15/2019 close)

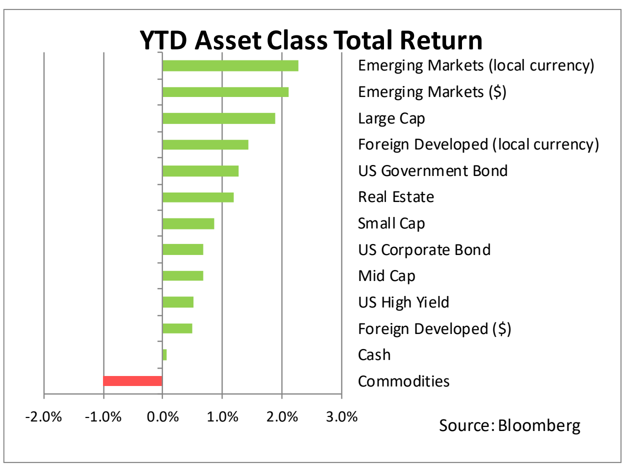




(Source: Bloomberg)

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 1/15/2019 close)

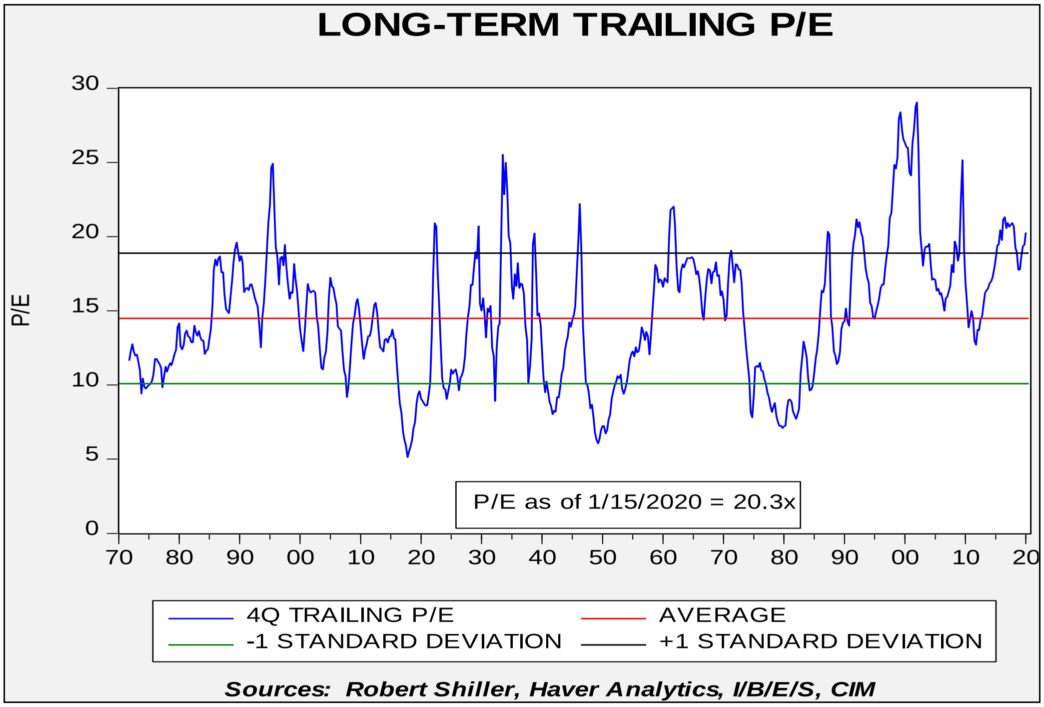


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 16, 2020



Based on our methodology,[1] the current P/E is 20.3x, up 0.2x from last week. 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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[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.