Daily Comment

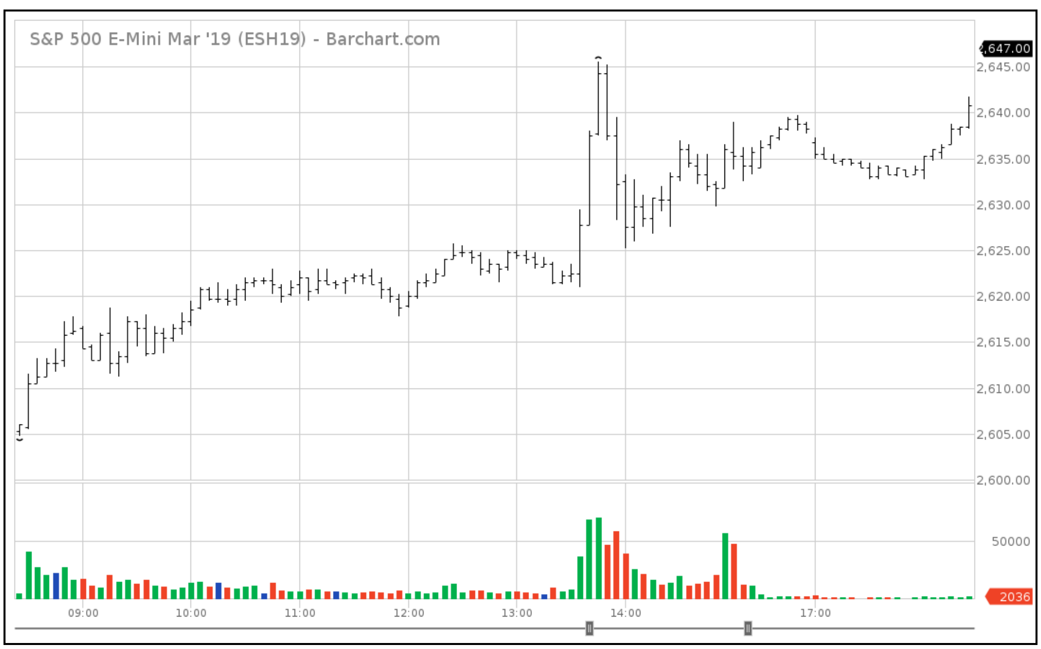
By Bill O'Grady and Thomas Wash

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 18, 2019—9:30 AM EST] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 1.6% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.8% from the prior close. Chinese markets were higher, with the Shanghai composite up 1.4% and the Shenzhen index up 1.0%. U.S. equity index futures are signaling a higher open. With 44 companies having reported, the S&P 500 Q4 earnings stand at $40.31, lower than the $40.86 forecast for the quarter. The forecast reflects a 13.4% increase from Q4 2017 earnings. Thus far this quarter, 72.7% of the companies reported earnings above forecast, while 17.6% reported earnings below forecast.

Happy Friday! Equities are moving higher this morning. Here is what we are watching today:

About those tariffs: Yesterday, equity prices were jolted higher on reports that the Trump administration was considering rolling back tariffs on China.



(Source: Barchart)

This chart shows March S&P futures; note the jump around 1:30, where the index rose 25 full points. The report came from the *WSJ*[1] and indicated that Treasury Secretary Mnuchin is

[1] https://www.wsj.com/articles/u-s-weighs-lifting-china-tariffs-to-hasten-trade-deal-calm-markets-11547754006

spearheading a negotiating tactic to remove some or all of the Chinese tariffs to show good faith to Beijing and use this action to make a longer term deal. Needless to say, the Lighthizer/ Navarro wing of the party will reject this tactic out of hand. Instead, this report suggests that this story was a Mnuchin-led leak to show the president how positive equities would react to a significant reduction in trade tensions with China. If our take is correct, the real audience for the report was President Trump. The report was denied soon after and equities fell about as fast as they rose, which bolsters the case that the equity markets would look quite favorably on an easing of the trade front. At the same time, equities have been drifting higher, most likely on hopes of a trade thaw.

As we noted yesterday, there is a strong incentive on both sides for a short-term cessation of trade hostilities. China and the U.S. are dealing with slowing economic growth and President Trump is dealing with the run-up to elections in 2020. At the same time, the long-term outlook for relations between China and the U.S. is becoming a serious risk factor. Therefore, any short-term peace must be viewed in the context of problematic long-term relations.

Brexit and the EU: There really isn't much more to say on this topic from the U.K. perspective. PM May and opposition leader Corbyn are at an impasse as the latter wants May to guarantee there won't be a sudden exit on March 29, which she has no interesting in doing because it would remove most of her bargaining leverage.[2] Thus, British politics is in deadlock with no clear way forward.

Meanwhile, the EU is discovering Wilde's observation.[3] The EU did not want to make the U.K. exit easy. Its leaders feared that a smooth exit would encourage others to leave the EU as well. The EU especially didn't want to give the impression that a departing country could deal with the EU on an "a la carte" basis, picking the parts it wants and rejecting the rest. In the case of Britain, the EU has made it clear that the only way to have access to the free trade area is to accept the free movement of peoples within the EU. Given that goal, the EU plan has worked splendidly. The U.K. is in political chaos and the potential for a hard Brexit, which is only wanted by a minority, is rising.

However, the EU is discovering there are costs to it as well. The economic disruption from a hard break will hurt the U.K. significantly as 40% of its trade is with the EU, but that also means it will be disruptive to the EU. In addition, a U.K. out of the EU changes the balance of power within the union; France has been moving quickly to fill the void created by London's exit. France has always viewed the EU as a force multiplier for its policy goals but the rise of Germany and the U.K.'s inclusion, along with the massive increase in the union with the addition of Eastern European nations, has diluted France's impact. In addition, the U.K. is important to continental security as most of Europe has weak militaries. A U.K. separate from the EU makes Europe less safe.[4] Unfortunately for the EU, there really isn't anyone to negotiate with in the

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[2] https://www.ft.com/content/c0138c7c-1a4b-11e9-9e64-d150b3105d21?emailId=5c41582afd5a4e000407e783&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

[3] "When the gods wish to punish us, they answer our prayers."

[4] https://www.nytimes.com/2019/01/17/world/europe/brexit-eu-brussels.html?emc=edit_mbe_20190118&nl=morning-briefing-europe&nlid=567726720190118&te=1

U.K. PM May was politically damaged by the historic loss of her Brexit plan; if anyone else wanted to be PM, they surely should be able to win after that drubbing. However, Parliament also showed that Corbyn isn't a popular replacement. Now, if the EU wants to avoid a U.K. exit, it isn't clear who they would tell.

Financial markets are mostly convinced that both sides will agree to extend the March 29 deadline. For now, we agree that such an extension makes sense. However, it is important to note that EU Parliamentary elections will be held in May. It would be rather awkward for the U.K. to participate given that it wants to leave but, if the deadline is extended, it may be hard to prevent British voters from casting ballots for representatives who, at some point, will no longer be in the EU. In addition, the EU is facing its own demons. The European Parliament has backed a plan to make EU fund access conditional to nations that "back the rule of law."[5] That is a direct swipe against Hungary but also other Eastern European nations, such as Poland. The EU is finding it difficult to integrate both Western and Eastern Europe; funding support is one lever the West can use against the East.

Goodfriend out? In November 2017, President Trump nominated Professor Marvin Goodfriend to the Federal Reserve Board of Governors. The choice always seemed odd to us. President Trump has made it abundantly clear he wants a dovish FOMC and Goodfriend is a hawk. Goodfriend's positions were always controversial, but one policy he supported was a codified 2% inflation target; since there is no codified unemployment rate, a congressional mandate for 2% (or less) inflation would turn the Fed into the Bundesbank or its successor, the ECB. Again, one can make a perfectly reasonable argument for ending the dual mandate because it can put the Fed into a position where meeting one target necessarily requires violating the other. But, if one wants a perpetually dovish Fed, a codified 2% inflation mandate isn't the way to accomplish this goal. So, we have been expecting the president to nominate someone else.[6]

One factor in the choice of filling open governor seats has been the evolution of the Trump presidency. All presidents tend to lean on experienced advisors early in their terms. Thus, the first cabinets and advisor groups tend to be "all-stars" from the major political parties. However, these all-stars also have their own policy agendas and use their White House positions to achieve these agendas.[7] Over time, presidents realize the goals of the all-stars can differ from those of the president. For example, President Obama's foreign policy was spearheaded by Hillary Clinton in his first term; in his second term, Ben Rhodes was the leader. The Fed governor selections, thus far, appear to be centrists out of central casting, likely recommended by Treasury Secretary Mnuchin. Trump has two remaining vacancies; we expect the president to take control

[5] https://www.politico.eu/article/budget-hungary-poland-rule-of-law-european-parliament-backs-plan-to-link-eu-funds/?utm_source=POLITICO.EU&utm_campaign=6fcd43d665-EMAIL_CAMPAIGN_2019_01_18_05_37&utm_medium=email&utm_term=0_10959edeb5-6fcd43d665-190334489

[6] https://www.cnbc.com/2019/01/17/goodfriends-nomination-to-the-fed-appears-in-doubt.html

[7] We note reports that SOS Pompeo is being wooed for the open seat in the Kansas Senate. Pompeo's neoconservative (Wilsonian) views on foreign policy are clearly in opposition to President Trump's Jacksonian policy stance. The Senate seat would give Pompeo a graceful exit now and prevent a fight in the future. https://www.washingtonpost.com/powerpost/mcconnell-courting-pompeo-to-run-for-open-senate-seat-in-kansas/2019/01/17/aa29f4aa-1aaf-11e9-9ebf-c5fed1b7a081_story.html?utm_term=.a0bc3c5762a7&wpisrc=nl_todayworld&wpmm=1

of these open positions and pick two doves. Although we have seen no indications, we would offer Minneapolis FRB President Kashkari and St. Louis FRB President Bullard as dovish candidates who would likely make it through the nomination process. Two doves would seriously undermine Chair Powell's attempts to raise rates as two governor dissentions would make the chair look weak and likely lead to his resignation.

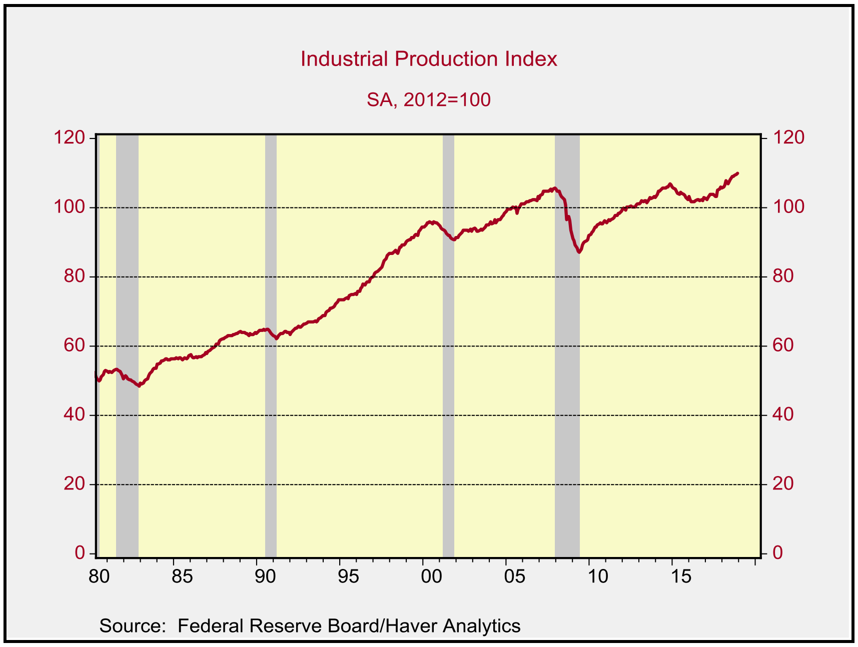
Oil talk: The potential for additional sanctions on Venezuela is leading some Gulf Coast refiners to scramble for heavy crude. Crude oil comes in grades based mostly on viscosity (heavy/light) and sulfur content (sour/sweet). Gulf Coast refineries invested heavily in equipment that would allow them to efficiently process heavy/sour crude oil, which is usually cheaper than light/sweet. However, fracked oil tends to be light/sweet, so the bulk of the new U.S. output isn't ideal for these refiners. The two primary sources for heavy/sour have been Mexico and Venezuela. The former has seen production steadily decline, while the latter is not only facing falling output but sanctions could further reduce supplies.[8] This has led several oil companies to quietly inform the White House that further sanctions on Venezuela may be counterproductive. Meanwhile, the State Department is clarifying its positon on Iranian sanctions waivers. It looks like five nations will get further waivers, three will be cut off and Iranian oil exports will be capped at 1.1 mbpd.[9] If true, that would reduce the odds of a major supply disruption.

U.S. Economic Releases

Industrial production from December came in stronger than forecast, rising 0.3% compared to the forecast rise of 0.2%. The prior report was revised downward from 0.6% to 0.4%. Capacity utilization was 78.7%, which is above the 78.5% expected.

[8] https://www.reuters.com/article/us-usa-refineries-venezuela/u-s-refiners-scramble-as-white-house-eyes-venezuela-sanctions-idUSKCN1PB2ZX?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosmarkets&stream=business

[9] https://af.reuters.com/article/energyOilNews/idAFL3N1ZI1ID



The chart above shows the Industrial Production Index. The current reading is 109.9, the highest on record.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	U. of Michigan Sentiment	m/m	jan	96.8	98.3	***
10:00	U. of Michigan Current Conditions	m/m	jan	116.0	116.1	**
10:00	U. of Michigan Expectations	m/m	jan	86.5	87.0	**
10:00	U. of Michigan 1 yr Inflation	m/m	jan		2.7%	**
10:00	U. of Michigan 5-10 Yr Inflation	m/m	jan		2.5%	**
Fed speakers or events						
EST	Speaker or event	District or position				
9:05	John Williams Speaks on Economic Outlook and Policy	President of the Federal Reserve Bank of New York				
11:00	Patrick Harker Speaks at Symposium on Prosperity	President of the Federal Reserve Bank of Philadelphia				

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	FX Net Settlement- Clients CNY	m/m	dec	-56.0 bn	-139.4 bn		*	Equity and bond neutral
Japan	National CPI	y/y	dec	0.3%	0.8%	0.3%	***	Equity and bond neutral
	National CPI ex Fresh Food	y/y	dec	0.7%	0.9%	0.8%	***	Equity bullish, bond bearish
	Japan buying foreign bonds	m/m	jan	¥2.210 tn	-¥1.004 tn		*	Equity and bond neutral
	Japan buying foreign stocks	m/m	jan	-¥0.173 tn	¥0.024 tn		*	Equity and bond neutral
	Foreign buying Japan bonds	m/m	jan	¥0.712 bn	¥0.072 tn		*	Equity and bond neutral
	Foreign buying Japan stocks	m/m	jam	-¥0.428 tn	-¥248.5 bn		*	Equity and bond neutral
	Capacity utilization	m/m	dec	1.0%	4.0%		**	Equity bearish, bond bullish
	Industrial Production	m/m	dec	1.5%	1.4%		***	Equity and bond neutral
New Zealand	BusinessNZ Manufacturing PMI	m/m	dec	55.1	53.5		**	Equity and bond neutral
	Non Resident Bond Holdings	m/m	dec	54.6%	56.2%		**	Equity and bond neutral
EUROPE								
Eurozone	ECB Current Account Balance	m/m	nov	23.0 bn	20.3 bn		**	Equity and bond neutral
Italy	Current Account Balance	m/m	nov	4.806 bn	6.081 bn		**	Equity and bond neutral
U.K.	Retail Sales ex Auto Fuel	y/y	dec	2.6%	3.8%	3.8%	***	Equity bearish, bond bullish
	Retail Sales inc Auto Fuel	y/y	dec	3.0%	3.6%	3.6%	**	Equity bearish, bond bullish
Switaerland	Real Estate Index Family Homes	y/y	4q	468.5	472.3		*	Equity and bond neutral
	Producer and import prices	y/y	dec	0.6%	1.4%	1.0%	***	Equity bearish, bond bullish
Russia	Current Account Balance	m/m	nov	38.800 bn	27.664 bn	35.700 bn	**	Equity bullish, bond bearish
	Consumer Confidence Index	q/q	4q	-17	-14		**	Equity bearish, bond bullish
AMERICAS								
Brazil	Economic Activity	y/y	nov	1.9%	3.0%	1.8%	***	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)	278	277	1	Up
3-mo T-bill yield (bps)	235	236	-1	Neutral
TED spread (bps)	43	42	1	Neutral
U.S. Libor/OIS spread (bps)	241	241	0	Up
10-yr T-note (%)	2.76	2.75	0.01	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	0	0	0	Down
Currencies	**Direction**			
dollar	flat			Neutral
euro	up			Up
yen	down			Neutral
pound	up			Neutral
franc	flat			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	$61.75	$61.18	0.93%	Ease in global trade tensions
WTI	$52.66	$52.07	1.13%	
Natural Gas	$3.31	$3.41	-2.90%	
Crack Spread	$14.10	$14.35	-1.77%	
12-mo strip crack	$16.16	$16.29	-0.80%	
Ethanol rack	$1.40	$1.40	0.03%	
Metals				
Gold	$1,286.17	$1,292.05	-0.46%	
Silver	$15.48	$15.53	-0.31%	
Copper contract	$271.55	$268.00	1.32%	
Grains				
Corn contract	$ 381.00	$ 380.00	0.26%	
Wheat contract	$ 519.75	$ 517.75	0.39%	
Soybeans contract	$ 912.25	$ 907.75	0.50%	
Shipping				
Baltic Dry Freight	1077	1055	22	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.7	-2.5	-0.2	
Gasoline (mb)	7.5	3.0	4.5	
Distillates (mb)	3.0	1.5	1.5	
Refinery run rates (%)	-1.50%	-0.80%	-0.70%	
Natural gas (bcf)	-81.0	-71.0	-10.0	

Weather

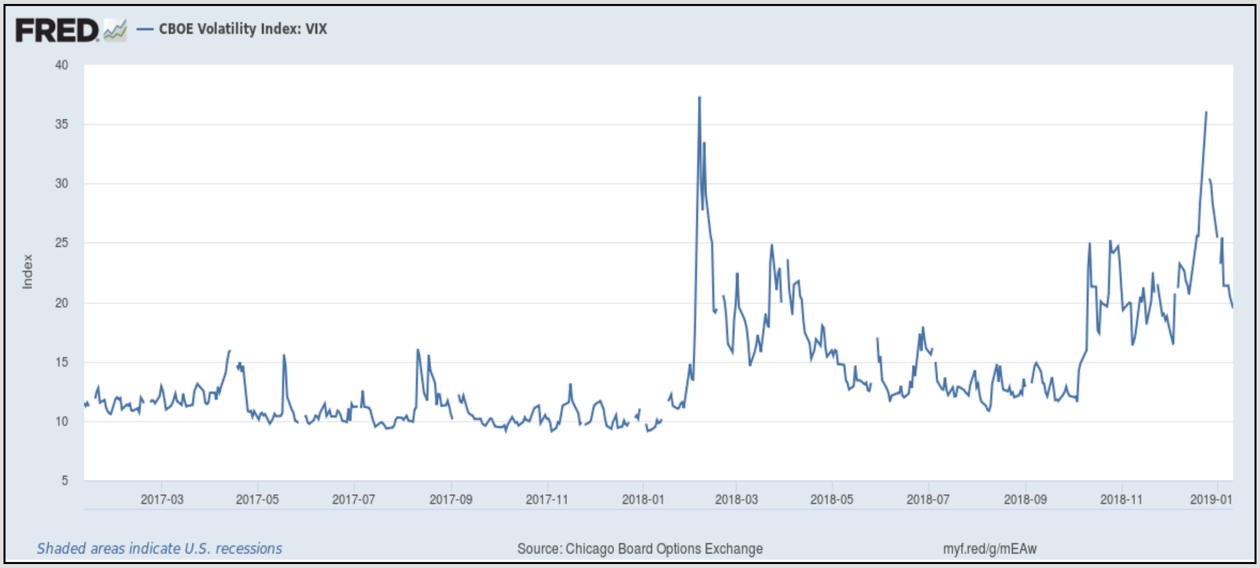
The 6-10 and 8-14 day forecasts show cooler temperatures for most of the country, with warmer temps on the West Coast. Precipitation is expected for most of the eastern half of the country.

Asset Allocation Weekly Comment

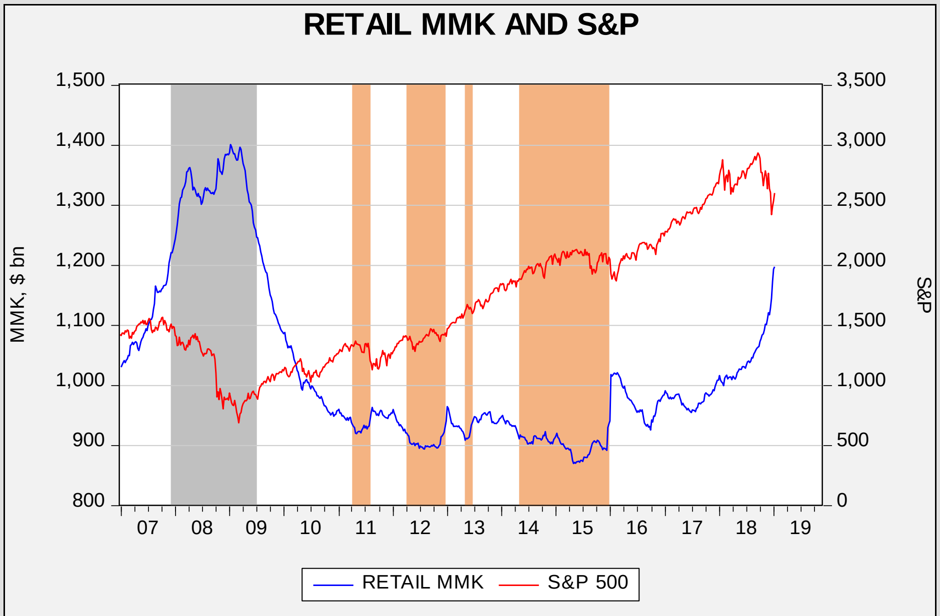
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

January 18, 2019

Equity markets struggled in 2018; although new highs were achieved twice during the year, volatility was elevated compared to 2017.



This is a chart of the CBOE VIX index, a measure of implied volatility from the equity options market. An elevated VIX means implied volatility is high, which implies a wider dispersion of expected outcomes for future equity index outcomes. As fear rises, it would make sense for investors to react. As the chart shows, for most of 2017, the VIX ranged between 10 and 15. Last year, the range was significantly wider. As fear rose, investors reacted by accumulating higher levels of cash.



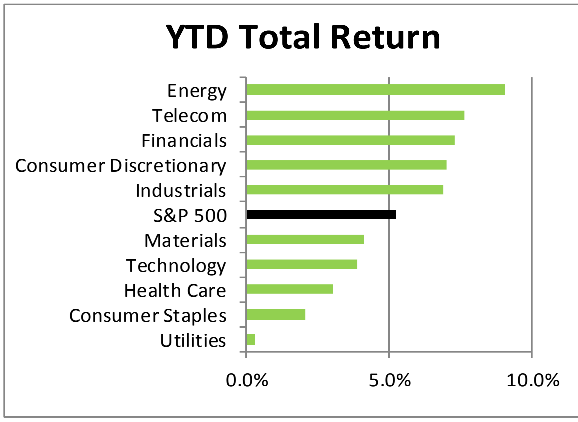
Sources: Haver Analytics, CIM

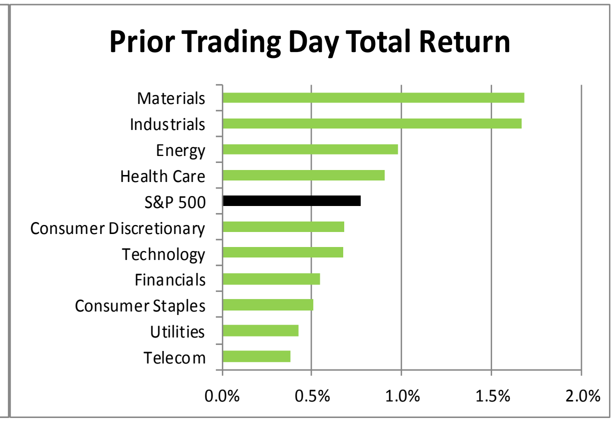
This chart shows the weekly close for the S&P 500 along with the level of retail money market funds. We have highlighted the 2007-09 recession in gray. The tan areas show periods when the level of money market funds fell below $920 bn. In this bull market, we have tended to see the upside momentum wane once money market funds fell below the aforementioned level. In other words, the market ran out of "dry powder."

What is occurring now is completely different. Money market levels are nearly $1.2 trillion. They are rising in a manner closely resembling what we observed before the Great Recession. It appears that the level and rise of money market funds is consistent with the financial markets' expectations of a recession. If a recession is avoided—if the trade conflict with China cools and the FOMC avoids overtightening—then odds likely favor a recovery in equities. The retail money market data suggests there is ample liquidity to support a significant rally. Of course, not all those money market funds will necessarily move back to equities. Given higher interest rates, some of it could stay in money markets. But, the key point is that financial markets appear to be in recession mode now. If recession is avoided in 2019, as we expect, the odds of a significant rally in equities is likely.

Data Section

U.S. Equity Markets – (as of 1/18/2019 close)

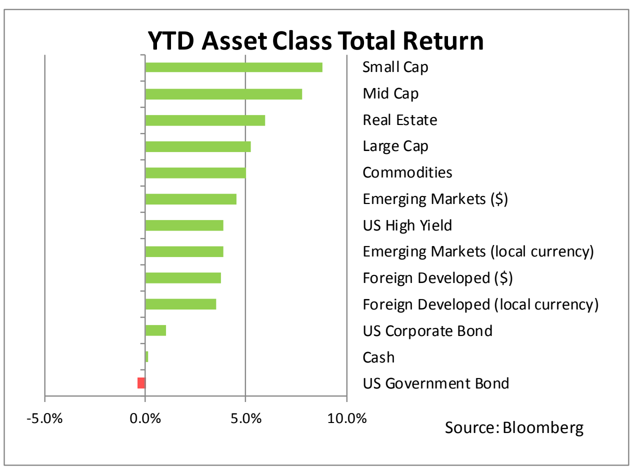




(Source: Bloomberg)

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 1/18/2019 close)

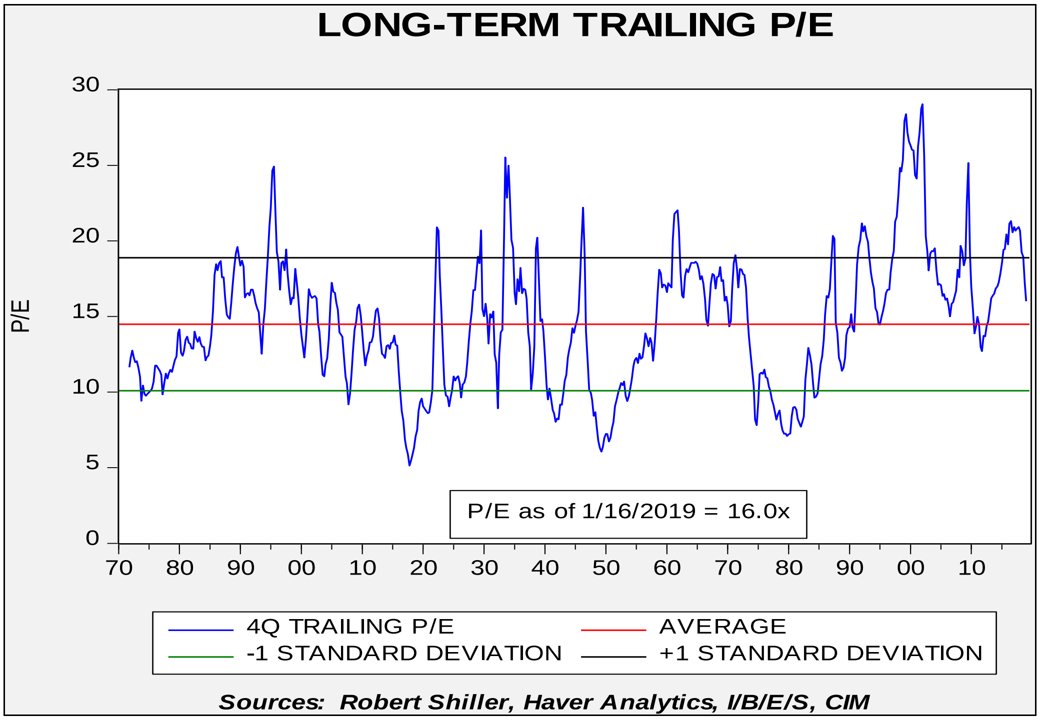


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 17, 2019



Based on our methodology,[10] the current P/E is 16.0x, up 0.3x from last week. The rebound in equities and a decline in earnings estimates led to the rise in the multiple.

This report was prepared by Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change. This is not a solicitation or an offer to buy or sell any security.

[10] 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.