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.

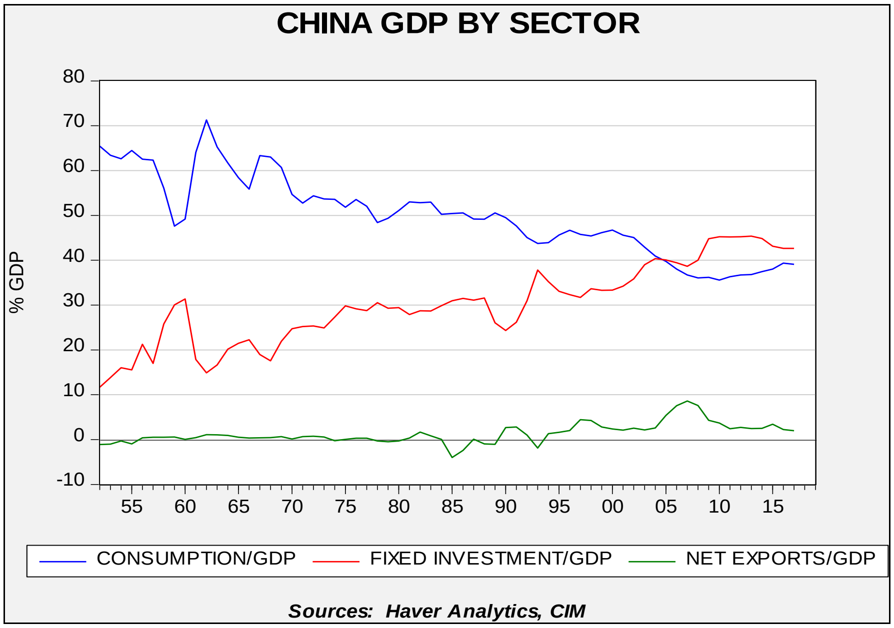
[Posted: January 2, 2019—9:30 AM EST] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.9% from the last close. In Asia, the MSCI Asia Apex 50 was down 2.0% from the prior close. Chinese markets were lower, with the Shanghai composite down 1.2% and the Shenzhen index down 0.9%. U.S. equity index futures are signaling a lower open.

Back to the salt mines! The New Year, 2019 (hard to believe, isn't it?), is starting out with a thud as weak Chinese data has sent equities into the red. Here is what we are watching this morning:

The Chinese data: The PMI data[1] from China came in soft, with the Caixin PMI dipping under the expansion line of 50 with a reading of 49.7 in December. This is the first time since May 2017 that the number has fallen below 50. The official PMI report, which came out on New Year's Eve, was also under 50 at 49.4. Although the equity market mostly shrugged off the earlier report, the combination of both numbers under the expansion line has clearly raised fears that the Chinese economy is slumping. And, the usual response from policymakers, which would be strong stimulus, seems to be lacking this time. For example, the central government is warning local governments to avoid pushing property and real estate development to boost output.[2] Although the position of the central government makes sense (boosting apartment building would likely only bring further overcapacity and bad debt), China may be moving into the phase where it can no longer rely on investment for growth. In other words, China may now need to get serious about boosting consumption as its engine of growth. The problem is that (a) consumption would have to grow very fast to absorb the excess capacity, and (b) this path will have significant political consequences as it will upend the business model that has made important members of the CPC billionaires.

---

[1] https://www.ft.com/content/6880779c-0e46-11e9-a3aa-118c761d2745
[2] https://www.reuters.com/article/us-china-property/china-warns-cities-to-cut-reliance-on-property-developers-shares-fall-idUSKCN1OW031



This chart shows China's GDP by sector in percentage terms. A developed economy generally has consumption around 60% to 70% of GDP. China's development model was based on investment and net exports, which were funded by household saving, mostly through suppression consumption. Although this model delivers strong growth, eventually excess capacity develops as investment becomes excessive and the "safety valve" of exports becomes stretched as foreign nations rebel against the loss of market share and unemployment. One way China could address this issue would be to shift ownership of state owned enterprises to households; the increased wealth would likely boost consumption (wealth effect) but it would deny ranking members of the CPC the avenue to power. This is why Beijing's decision to signal to local governments that real estate development won't be supported is important because it indicates that investment, at least for now, won't be the path to support growth. Unfortunately, the Xi government hasn't signaled how growth will be lifted.[3]

Washington unrest: There are two items of concern, the shutdown and the Right-Wing Establishment (RWE) rebellion.

***Shutdown*:** The partial government closure has moved into 2019. Congressional leaders are meeting with the president today. The Democratic House leadership is preparing legislation to end the shutdown that will not include the $5.0 billion for border wall funding. It's hard to see how the president won't veto the bill and McConnell has already indicated he won't approve a House bill that the president won't sign. For now, the shutdown isn't having much impact on the economy or, for that matter, the financial markets. But, it is causing individual hardship and we would not be surprised to see national park managers begin to close their facilities because they don't have enough personnel to secure them. That outcome is bad publicity and will increase pressure for an agreement.

---

[3] https://www.scmp.com/tech/article/2180362/baidu-ceo-warns-winter-coming-amid-slowing-growth-economic-restructuring

***Rebellion*:** Before the break, we noted there was growing pushback against the president from the RWE. The situation with General Mattis was a key element in the criticism of the White House. The latest censure comes from the newly elected senator from Utah, Mitt Romney.[4] The op-ed, printed in the *Washington Post*, is a textbook response from the RWE. Romney applauds the president's policy successes of cutting corporate taxes, reducing regulation, appointing conservative judges and attacking China's unfair trade practices. What he slams the president on is character. As we have noted before, until January 2018, the president's policy mix was establishment-supportive by cutting taxes and regulations. And, the financial markets rewarded the president with a strong rally. But, once the president moved to a serious attack on global trade, the equity markets began to stumble and are now in bear market territory. Although the RWE would like relief on technology transfers to China, it does not support tariffs or wants to see the loss of globalization, something the president favors. Trump has responded to Romney's comments via Twitter[5]; as these responses usually go, this one was actually rather tame (no new nicknames for Mitt, for example). Romney is in a position to be critical of Trump; he is a senator, meaning he doesn't face election for another six years, and he is nearly unassailable in his home state.

There are other new critics as well. Retired Gen. Stanley McChrystal sent a broadside against the president, calling him "dishonest, immoral."[6] Trump's response was more typical.[7] Retired Gen. David Petraeus indicated he wouldn't serve in a Trump administration.[8] Probably the key issue that has led to the attacks from former generals is the sudden withdrawal from Syria. In response, the White House is slowing the withdrawal to about four months instead of weeks.[9]

The key question politically is whether Trump can win the 2020 presidential election with only the support of Right-Wing Populists (RWP). Much of that will be determined by who the Democrats nominate. Sen. Warren put her name on the list over the holiday. We would expect at least 19 more to participate in the nomination process. The conventional wisdom will be to run a Left-Wing Establishment (LWE) figure (e.g., Mayor Bloomberg, VP Biden) that would act as a "unifier." This temptation will be strong; the GOP faced a similar situation in 2012 and lost by nominating Mitt Romney who failed to generate enthusiasm among the RWP. A similar move by the Democrats is possible, which would improve the odds of another term for President Trump. On the other hand, a Left-Wing Populist (LWP) would very well leave the financial markets with no favored candidate. That outcome would justify the current weakness in equities.

---

[4] https://www.washingtonpost.com/opinions/mitt-romney-the-president-shapes-the-public-character-of-the-nation-trumps-character-falls-short/2019/01/01/37a3c8c2-0d1a-11e9-8938-5898adc28fa2_story.html?utm_term=.1d57684ca1f7

[5] https://www.cnn.com/2019/01/02/politics/donald-trump-mitt-romney-oped/index.html

[6] https://www.nbcnews.com/politics/donald-trump/retired-four-star-gen-stanley-mcchrystal-says-trump-dishonest-immoral-n953076

[7] https://deadline.com/2019/01/donald-trump-tweetstorm-new-years-nancy-pelosi-stanley-mccrystal-jair-bolsonaro-1202527771/

[8] https://thehill.com/homenews/administration/423311-david-petraeus-suggests-he-wouldnt-serve-in-trump-administration

[9] https://www.nytimes.com/2018/12/31/us/politics/trump-troop-withdrawal-syria-months.html

Trade with China: We think the odds favor a short-term deal with China that would offer relief to the equity markets. Trade Representative Lighthizer appears to oppose this outcome.[10] The problem for Trump is that if he orders Lighthizer to make a temporary agreement, the latter might walk. Although Lighthizer's exit would be welcomed by the equity markets, it would seriously undermine the president's efforts to change China's trade behavior.

Taiwan: General Secretary Xi threatened to unify the island with the PRC.[11] Although we still view such comments as rhetoric and not a call to arms, if China decides it needs a "splendid little war" to assert its power in the region then a forcible unification of Taiwan with the mainland would be attractive. This issue did not reach a level to make our 2019 Geopolitical Outlook[12] list; however, it may reach this status by mid-year.

Italian banks: The ECB has appointed temporary administrators[13] to Banca Carige (CRG-IT, EUR .0015).[14] Although the Italian government mostly caved to EU demands on its budget, the problems with Italian banking have not been resolved and could still trigger a problem in the Eurozone.

U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below shows the economic releases scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Markit US Manufacturing PMI	m/m	dec	53.9	53.9	**
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.

---

[10] https://www.nytimes.com/2019/01/01/us/politics/robert-lighthizer-president-trump.html?action=click&module=Top%20Stories&pgtype=Homepage
[11] https://www.reuters.com/article/us-china-taiwan/chinas-xi-threatens-taiwan-with-force-but-also-seeks-peaceful-reunification-idUSKCN1OW04K
[12] See WGR, The 2019 Geopolitical Outlook (12/17/18).
[13] https://www.cnbc.com/2019/01/02/italys-watchdog-reportedly-suspends-trading-in-carige-shares.html
[14] https://www.cnbc.com/quotes/?symbol=CRG-IT

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
China	Caixin China PMI Mfg	m/m	dec	49.7	50.2	50.2	**	Equity bearish, bond bullish
India	Nikkei India PMI Mfg	m/m	dec	53.2	54.0		**	Equity and bond neutral
Australia	CBA Australia PMI Mfg	m/m	dec	54.0	53.7		**	Equity and bond neutral
	CoreLogic House Px	m/m	dec	-1.3%	-0.9%		**	Equity bearish, bond bullish
	Commodity Index AUD	m/m	dec	121.2	122.1		**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Manufacturing	m/m	dec	51.4	51.4	51.4	**	Equity and bond neutral
Germany	Markit/BME Germany Manufacturing	m/m	dec	51.5	51.5	51.5	**	Equity and bond neutral
Italy	Markit/ADACI Italy Manufacturing	m/m	dec	49.7	49.7	49.7	**	Equity and bond neutral
U.K.	Markit UK PMI Manufacturing	y/y	dec	54.2	53.1	53.1	**	Equity bullish, bond bearish

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)	281	280	1	Up
3-mo T-bill yield (bps)	240	240	0	Neutral
TED spread (bps)	41	40	1	Neutral
U.S. Libor/OIS spread (bps)	241	241	0	Up
10-yr T-note (%)	2.65	2.69	-0.04	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	-4	-4	0	Down
Currencies	Direction			
dollar	up			Neutral
euro	down			Up
yen	up			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	$53.29	$53.80	-0.95%	Demand Pessimism
WTI	$44.94	$45.41	-1.04%	
Natural Gas	$3.00	$2.94	1.97%	
Crack Spread	$14.54	$14.16	2.68%	
12-mo strip crack	$16.13	$15.65	3.09%	
Ethanol rack	$1.43	$1.43	0.00%	
Metals				
Gold	$1,286.78	$1,282.60	0.33%	
Silver	$15.45	$15.51	-0.41%	
Copper contract	$261.65	$263.10	-0.55%	
Grains				
Corn contract	$ 375.00	$ 375.50	-0.13%	
Wheat contract	$ 503.25	$ 511.50	-1.61%	
Soybeans contract	$ 895.00	$ 895.50	-0.06%	
Shipping				
Baltic Dry Freight	1271	1279	-8	

Weather

The 6-10 and 8-14 day forecasts show warmer temperatures for most of the country. Precipitation is expected for most of the country.

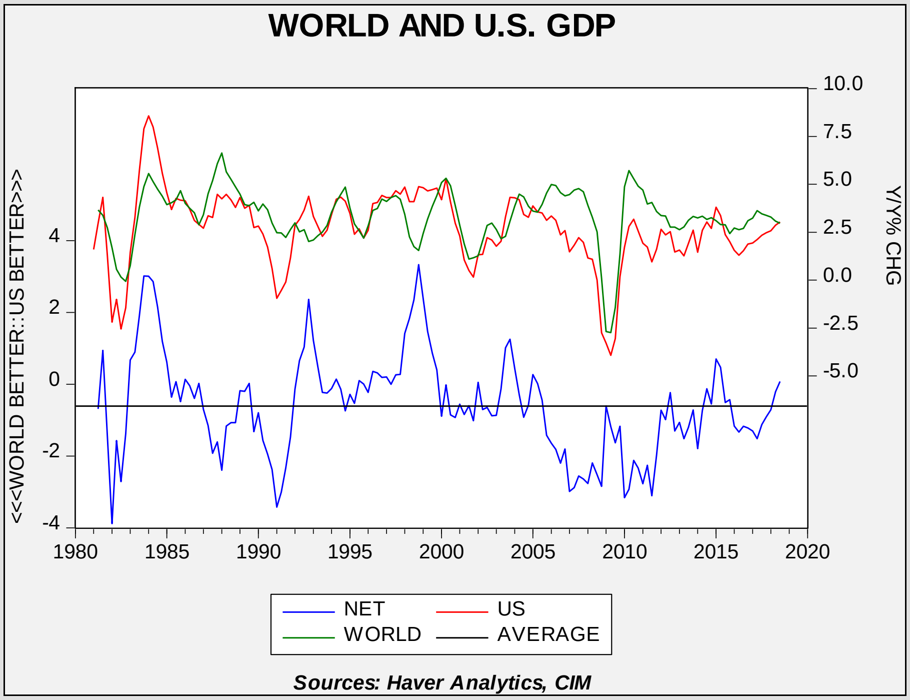
Asset Allocation Weekly Comment

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.

December 21, 2018

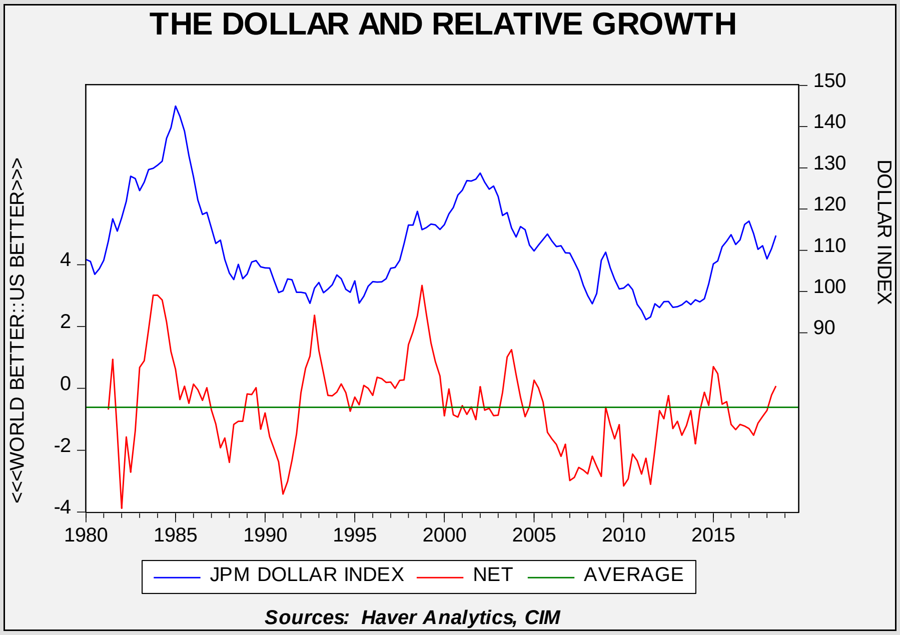
(N.B. This is the last Asset Allocation Weekly for 2018. Have a Merry Christmas and Happy New Year. The next report will be published January 4, 2019.)

The U.S. economy is performing in line with the rest of the world.



This chart shows the yearly change in U.S. and world ex-U.S. GDP. The lower line on the chart shows the difference. On average, U.S. growth is usually 0.61% lower than world growth and the world exceeds U.S. growth 70% of the time (with data since 1981). This situation isn't a huge surprise; the U.S. is the world's largest economy and smaller economies can grow faster more easily. The lower line shows that U.S. growth has been gaining on world growth for the past two years.

The net number does coincide with dollar cycles.

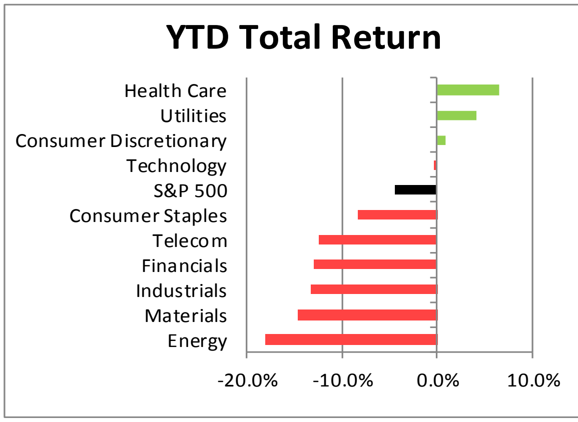


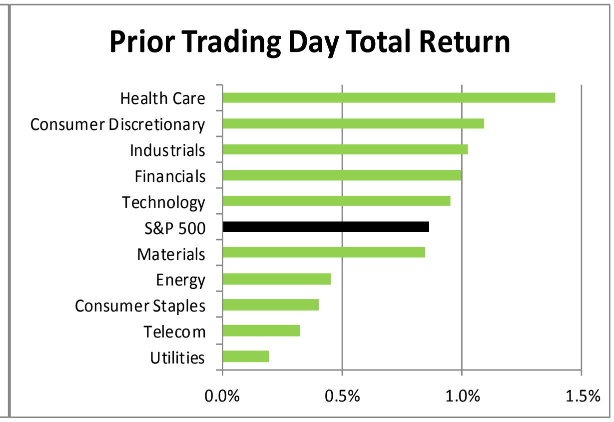
When the growth differential is below average (implying stronger world growth relative to the U.S.), the JPM dollar index averages 107.21. When growth exceeds average, the index averages 113.14. We are projecting slower growth in the U.S. next year, around 2.7%, which is essentially average growth. If world growth also holds near average, around 3.3%, it would be reasonable to expect the dollar to weaken from current levels. The U.S. growth surge in 2015 led to a strengthening dollar and this year's rally was partly due to the lift in U.S. growth due to fiscal stimulus. As that wanes, relative growth should favor the world, which will support a softer greenback. In general, a weaker dollar will tend to support commodities and foreign equities, especially emerging markets. We expect those assets to perform better in 2019.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

U.S. Equity Markets – (as of 12/31/2018 close)

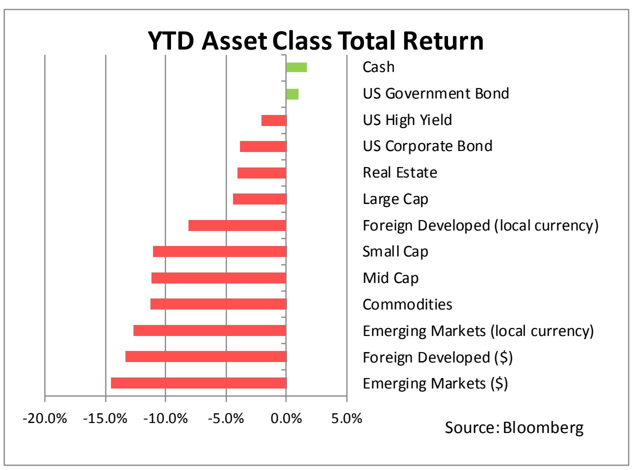




(Source: Bloomberg)

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 12/31/2018 close)

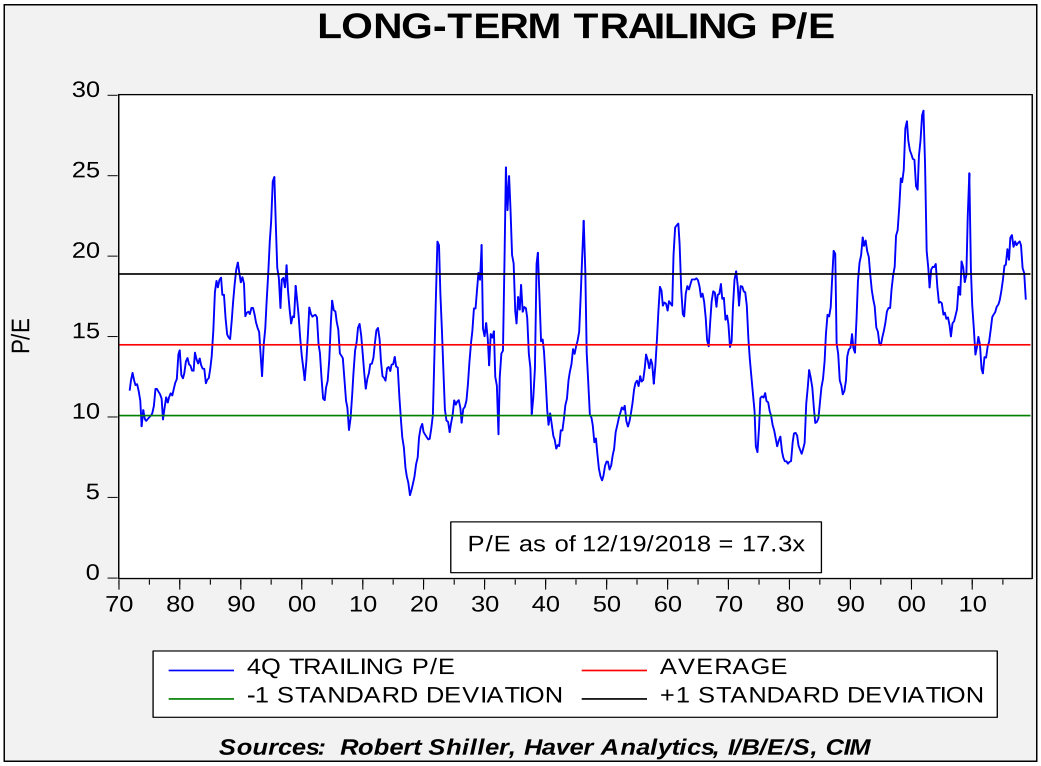


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

December 20, 2018



Based on our methodology,[15] the current P/E is 17.3x, down 0.1x from our last reading. Weaker prices led to the contraction of 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.

---

[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 three actual quarters (Q1, Q2 and Q3) and onestimates (Q4). 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.