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 30, 2019—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.1% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.5% from the prior close. Chinese markets were lower, with the Shanghai composite down 0.7% and the Shenzhen index down 1.3%. U.S. equity index futures are signaling a higher open. With 115 companies having reported, the S&P 500 Q4 earnings stand at $40.54, lower than the $40.86 forecast for the quarter. The forecast reflects a 13.4% increase from Q4 2017 earnings. Thus far this quarter, 68.7% of the companies reported earnings above forecast, while 22.6% reported earnings below forecast.

Happy Fed Day! U.S. equity futures are higher this morning in light of some solid earnings reports. Here is what we are watching this morning:

Fed meeting: The FOMC ends its two-day meeting today. Although we won't get new dots or forecasts, Chair Powell begins his new policy of press conferences after each meeting. No action on rates is expected, but we will be watching for any hints on future policy (are risks "balanced" and will rate hikes be removed from the statement or contain the usual "gradual" language?). In addition, the markets will be looking for any flexibility on the balance sheet. We expect a mostly neutral statement; it would be a surprise to see them turn hawkish but it would also be a surprise to see them move toward a clear dovish stance.

Trade talks: Talks with China begin today and, so far, trade is being kept separate from the Huawei (002502, Shenzhen, CNY 3.32) issue. China is offering protection for foreign investors[1] and is also preparing a timeline of reforms to address structural trade concerns.[2] Although we doubt this will satisfy USTR Lighthizer, it will likely be enough for the president. While we think U.S./China relations are on a deteriorating path, as we noted yesterday, both Chairman Xi and President Trump need peace this year.[3] Thus, we remain optimistic that some sort of deal will be negotiated.

Venezuela: Conditions are deteriorating further in Venezuela. The courts, firmly under the control of Maduro, have frozen opposition leader Guaido's banks accounts and have prevented

[1] https://www.scmp.com/economy/china-economy/article/2184138/china-rushing-through-overseas-investment-reform-unprecedented
[2] https://asia.nikkei.com/Economy/Trade-War/China-to-kick-off-trade-talks-with-timeline-for-structural-reforms
[3] https://www.wsj.com/articles/as-china-trade-talks-begin-trump-faces-pressure-to-make-a-deal-11548808477

him from leaving the country.[4] Maduro did indicate he was willing to "negotiate" but it is unclear who would mediate. In response to the freezing of Guaido's assets, the U.S. is giving Guaido control of some Venezuelan government accounts held by the U.S. at the NY FRB.[5] The situation is a mess and oil prices are rising on fears that oil production from Venezuela will fall further. Saudi Arabia has indicated it has no plans to offset any decline in output from Venezuela; in fact, the Saudi oil minister indicated the U.S. should use the SPR if shortfalls develop.[6] The Saudis believe they were wrong-footed on the Iran sanctions issue and are making it clear it won't happen again.[7]

Brexit: Things got rather weird yesterday. Parliament rejected a series of proposals but did approve a non-binding measure to avoid a hard Brexit. And, they approved an amendment that sends PM May back to Brussels to negotiate a different border agreement in Ireland.[8] However, May was not given any specific instructions as to what the border agreement should look like. It isn't that there was no direction; May was told that Parliament doesn't want a hard Brexit and the Euroskeptics don't want an Irish border solution that effectively keeps the U.K. in the EU with few of the benefits. This outcome isn't really possible.[9] The EU has made it clear that it won't renegotiate the current agreement.[10] With such uncertainty, it would seem the most logical outcome would be to delay Article 50; however, that solution is a problem for the EU because it holds EU Parliamentary elections in May. If the U.K. is still in the EU, Britain would seemingly participate in these elections even though it wants to leave. Although there is universal desire to avoid a hard Brexit, the chances of stumbling into one remain elevated and not fully discounted by the market.

Our parity model suggests fair value for the GBP/USD exchange rate is 1.65, which means we would have a much stronger pound in the absence of Brexit. We assume a hard Brexit would lead to a rapid drop in economic output and yield an exchange rate of 1.10. Thus, if a deal ends up with the U.K. leaving but maintaining most of the benefits of the EU (or not leaving at all), then we get 1.65. The current exchange rate should indicate the market's estimate of the odds of either outcome. So, if P = good Brexit and 1-P = bad Brexit, then (P*1.65) + ((1-P)*1.10) = current exchange rate. Solving for P at current exchange rates would indicate the market thinks there is about a 40% chance of a good Brexit and a 60% chance of a hard Brexit.

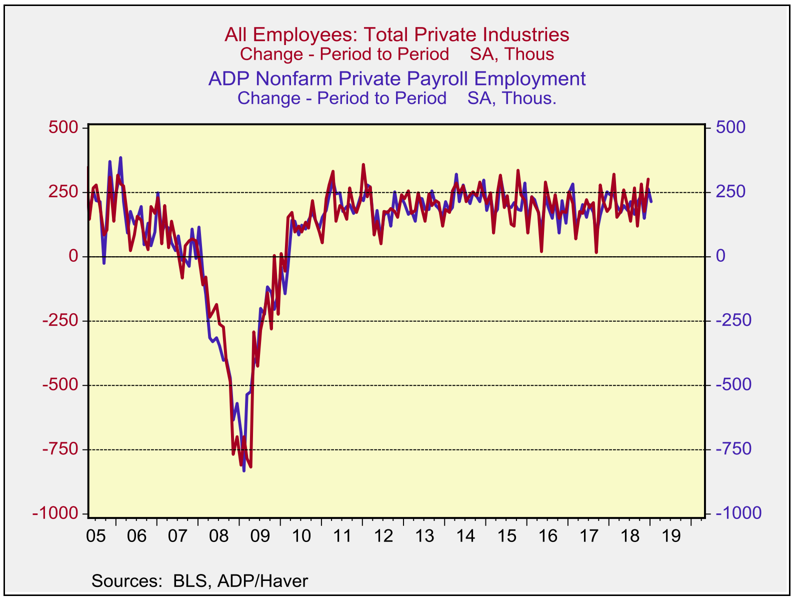
---

[4] https://www.washingtonpost.com/world/the_americas/venezuelan-officials-seek-to-block-us-supported-opposition-leader-juan-guaido-from-leaving-the-country-freeze-his-assets/2019/01/29/1a4791a0-232c-11e9-b5b4-1d18dfb7b084_story.html?utm_term=.453c43ca259c&wpisrc=nl_todayworld&wpmm=1
[5] https://www.nytimes.com/2019/01/29/us/politics/venezuela-bank-accounts-guaido-pompeo.html?emc=edit_mbe_20190130&nl=morning-briefing-europe&nlid=567726720190130&te=1
[6] https://www.wsj.com/articles/saudis-not-rushing-to-respond-to-venezuela-oil-ban-11548794233
[7] https://www.youtube.com/watch?v=gqzA1VOiC-M
[8] https://www.washingtonpost.com/world/europe/brexit-theresa-may-tells-a-divided-parliament-she-wants-to-reopen-talks-with-eu/2019/01/29/66ebca3a-1fe9-11e9-a759-2b8541bbbe20_story.html?utm_term=.4dc5921db939&wpisrc=nl_todayworld&wpmm=1
[9] https://www.ft.com/content/8ecf0b4c-2328-11e9-8ce6-5db4543da632?emailId=5c512e3432bcbc000472fcc1&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22
[10] https://www.nytimes.com/2019/01/29/world/europe/brexit-theresa-may-eu-irish-border.html?emc=edit_mbe_20190130&nl=morning-briefing-europe&nlid=567726720190130&te=1 ; https://www.ft.com/content/75f24764-23c9-11e9-8ce6-5db4543da632 ; and https://www.ft.com/content/390709e2-23de-11e9-8ce6-5db4543da632

U.S. Economic Releases

MBA mortgage applications fell 3.0% from the prior week. Purchases and refinancing fell 2.3% and 5.5%, respectively. The average 30-year fixed rate mortgage rose by 1 bp to 4.76%.

The ADP employment change came in above expectations at 213k compared to the forecast of 181k. The prior report was revised downward from 271k to 263k.



The chart above shows the change in total private employment, which suggests the economic expansion continues.

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	Pending Homes Sales	m/m	dec	0.5%	-0.7%	**
10:00	Pending Homes Sales	m/m	dec	-7.0%	-7.7%	**
Fed speakers or events						
EST	Speaker or event	District or position				
14:00	FOMC Meeting Minutes	Federal Reserve Board				
14:00	Interest Rate on Excess Reserves	Federal Reserve Board				

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	Retail Trade	m/m	dec	1.3%	1.0%	1.4%	**	Equity and bond neutral
	Retail Sales	m/m	dec	0.9%	-1.0%	0.4%	**	Equity bullish, bond bearish
	Dept. Store, Supermarket Sales	m/m	dec	-1.0%	-2.2%	-1.1%	**	Equity and bond neutral
	Consumer Confidence	m/m	jan	41.9	42.7	42.4	***	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	m/m	jan	116.5	115.7		**	Equity and bond neutral
	CPI	y/y	4q	1.8%	1.9%	1.7%	***	Equity and bond neutral
EUROPE								
Eurozone	Economic Confidence	m/m	jan	106.2	107.3	102.1	**	Equity bullish, bond bearish
	Business Climate Indicator	m/m	jan	0.69	0.82	0.77	**	Equity bearish, bond bullish
	Industrial Confidence	m/m	jan	0.5	1.1	0.5	**	Equity and bond neutral
	Services Confidence	m/m	jan	11.0	12.0	11.5	**	Equity bearish, bond bullish
	Consumer Confidence	m/m	jan	-7.9	-7.9	-7.9	***	Equity and bond neutral
Germany	Import Price Index	m/m	dec	1.6%	3.1%	2.1%	**	Equity bearish, bond bullish
	GfK Consumer Confidence	y/y	dec	10.8	10.4	10.3	***	Equity and bond neutral
France	GDP	y/y	4q	0.9%	1.4%	0.9%	***	Equity and bond neutral
	Consumer Spending	y/y	dec	-2.3%	-2.0%	-0.7%	***	Equity and bond bearish
	PPI	y/y	dec	1.2%	2.6%		**	Equity and bond neutral
Italy	Consumer Confidence Index	y/y	dec	114.0	113.1	112.8	***	Equity bullish, bond bearish
	Manufacturing Confidence	m/m	dec	102.1	103.6	103.0	**	Equity and bond neutral
	Economic Sentiment	y/y	dec	99.2	99.8		***	Equity and bond neutral
UK	Mortgage Approvals	y/y	dec	63.8k	63.7k	63.1k	**	Equity bullish, bond bearish
AMERICAS								
Mexico	International Reserves Weekly	w/w	jan	$175.156 bn	$175.029 bn		**	Equity and bond neutral
Brazil	Total Outstanding Loans	m/m	dec	3.260 tn	3.202 tn		**	Equity and bond neutral
	FGV Inflation IGPM	y/y	jan	6.7%	7.5%	6.7%	**	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)	275	275	0	Up
3-mo T-bill yield (bps)	236	236	0	Neutral
TED spread (bps)	39	39	0	Neutral
U.S. Libor/OIS spread (bps)	241	241	0	Up
10-yr T-note (%)	2.72	2.71	0.01	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	5	5	0	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	flat			Up
yen	down			Neutral
pound	up			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
FOMC Rate Decision(Upper Limit)		2.500%	2.500%	On forecast
FOMC Rate Decision(Lower Limit)		2.250%	2.250%	On forecast
Interest Rate on Excess Reserves		2.400%	2.400%	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	$61.87	$61.32	0.90%	Bullish API Report
WTI	$53.83	$53.31	0.98%	
Natural Gas	$2.87	$2.90	-1.14%	
Crack Spread	$11.62	$11.59	0.21%	
12-mo strip crack	$14.98	$14.96	0.13%	
Ethanol rack	$1.38	$1.38	0.04%	
Metals				
Gold	$1,312.90	$1,311.79	0.08%	
Silver	$15.91	$15.84	0.45%	
Copper contract	$273.95	$272.50	0.53%	
Grains				
Corn contract	$ 379.00	$ 377.25	0.46%	
Wheat contract	$ 515.00	$ 513.25	0.34%	
Soybeans contract	$ 922.75	$ 919.00	0.41%	
Shipping				
Baltic Dry Freight	797	852	-55	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.0		
Gasoline (mb)		2.4		
Distillates (mb)		-2.0		
Refinery run rates (%)		-0.65%		
Natural gas (bcf)		-200.0		

Weather

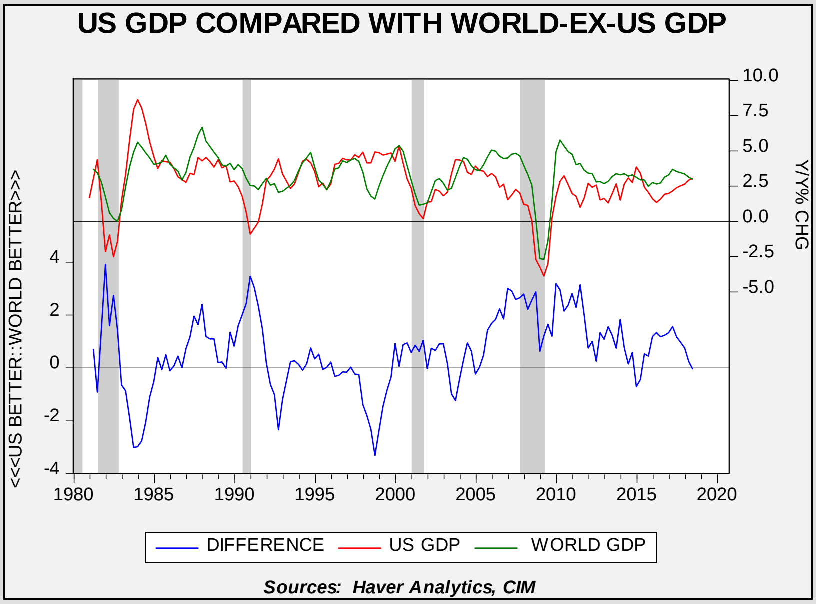
The 6-10 and 8-14 day forecasts show cooler temperatures for most of the country, with warmer temps in the southeastern region.

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 25, 2019

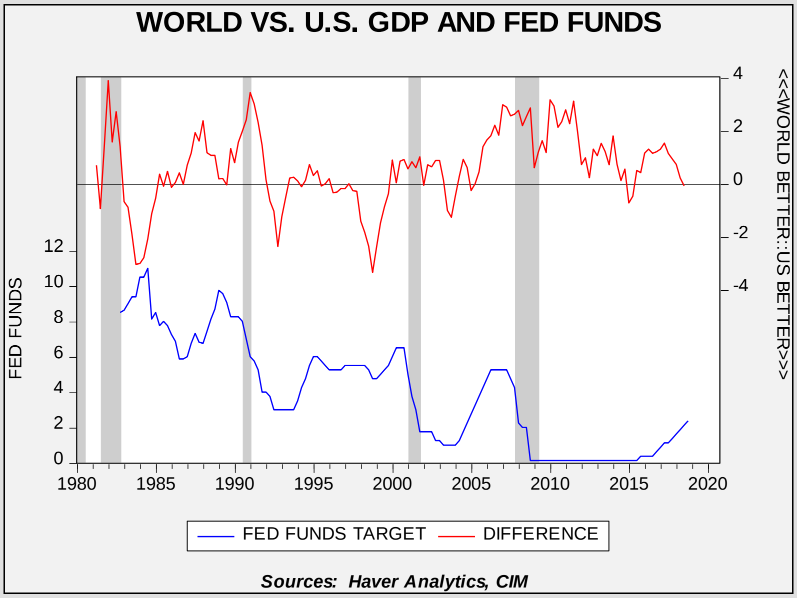
One of the important unknown factors for 2019 is whether slowing global growth will have a negative impact on the U.S. economy. Or, put another way, can the world lead the U.S. into recession? For the most part, history suggests the answer is no—the U.S. can bring down the world but the world can't bring down the U.S.



The upper two lines show the yearly change in U.S. GDP and World ex-U.S. GDP. The lower line shows the difference. World and U.S. GDP are positively correlated at the 70% level, suggesting they are sensitive to each other. Since the U.S. provides the reserve currency it would make sense that a stronger U.S. economy would also support imports from abroad which would foster foreign economic growth. However, the U.S. doesn't export as much relative to its size as other nations do, so it follows that stronger U.S. growth would support higher world growth but better growth in the rest of the world wouldn't necessarily lead to better American growth.

A couple of examples show this pattern. In the late 1990s, world GDP growth fell sharply while the U.S. was unaffected. The Asian Economic Crisis and the Russian debt default did not derail the U.S. economy. In 2005, the U.S. economy began to slump due to the deflating housing bubble. World growth did hold up into 2008 but eventually succumbed to follow the U.S. into recession.

At the same time, this analysis doesn't mean policymakers should ignore the world. In theory, the Federal Reserve's mandate is full employment and low inflation. Since these goals can be mutually exclusive at times, the Fed has tended to leave both specifically undefined. That has changed; the Fed now has a semiformal[11] 2% core PCE goal, which means the full employment goal is even more amorphous. When asked about the world, Fed officials are usually circumspect but do say they will address the issue if overseas events affect the U.S. economy. The above research suggests this comment is something of a "fudge"; the world rarely affects the U.S. directly. But, there are times when the Fed does appear to move policy in light of world events.



A couple of events are notable, where the Fed appeared to have adjusted policy due to global events. In the early 1980s, the Fed was still managing interest rates by focusing on the money supply. However, the high level of interest rates led Mexico to default and caused cascading debt crises throughout the region. The Volcker and Greenspan Feds reacted by cutting interest rates from 11% to 6% and the spread between U.S. and global growth narrowed. The Greenspan Fed eventually cut rates during the Asian Economic Crisis and the Russian debt default in the late 1990s, although the Long-Term Capital Management debacle contributed to that move. We also note that the Fed continued to reduce rates into 2004 even though the recession had ended; while weak global growth may have contributed, as we discussed two weeks ago, high equity market volatility probably contributed as well.

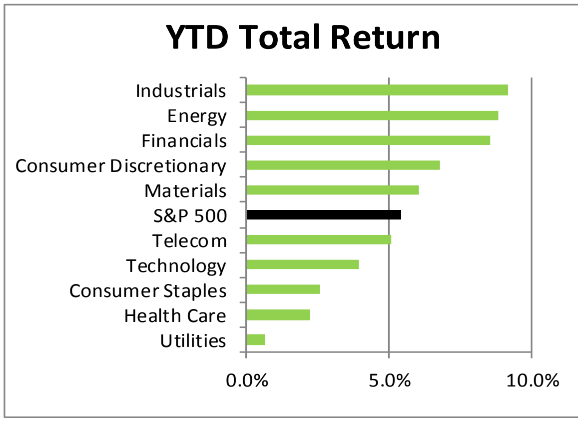
If the FOMC is looking for an excuse to ease policy, it could certainly use concerns about global growth affecting the U.S. economy as a reason. Although we doubt that the weak global economy will bring down American growth, concerns about it could allow the Fed to lower rates and maintain credibility. So far, we have not seen any indication that this factor is affecting policy, but it would not be a stretch to see the reason pop up in comments and statements from the U.S. central bank to at least justify a sustained pause in rate hikes.

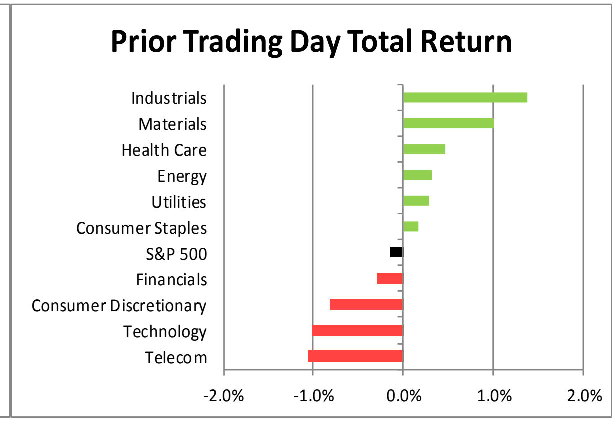
---

[11] It's semiformal because Congress hasn't given the Fed an exact mandate.

Data Section

U.S. Equity Markets – (as of 1/29/2019 close)

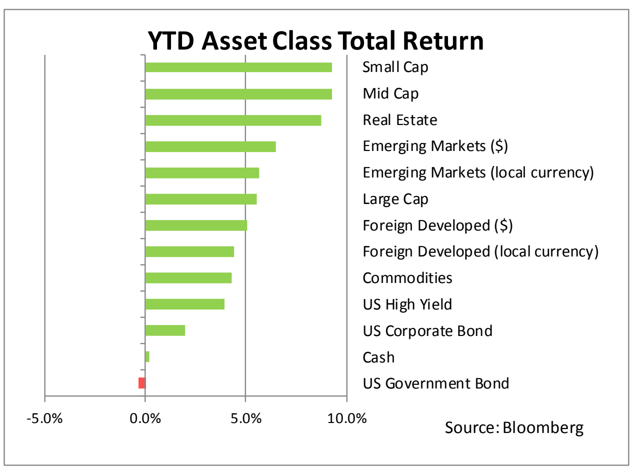




(Source: Bloomberg)

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 1/29/2019 close)

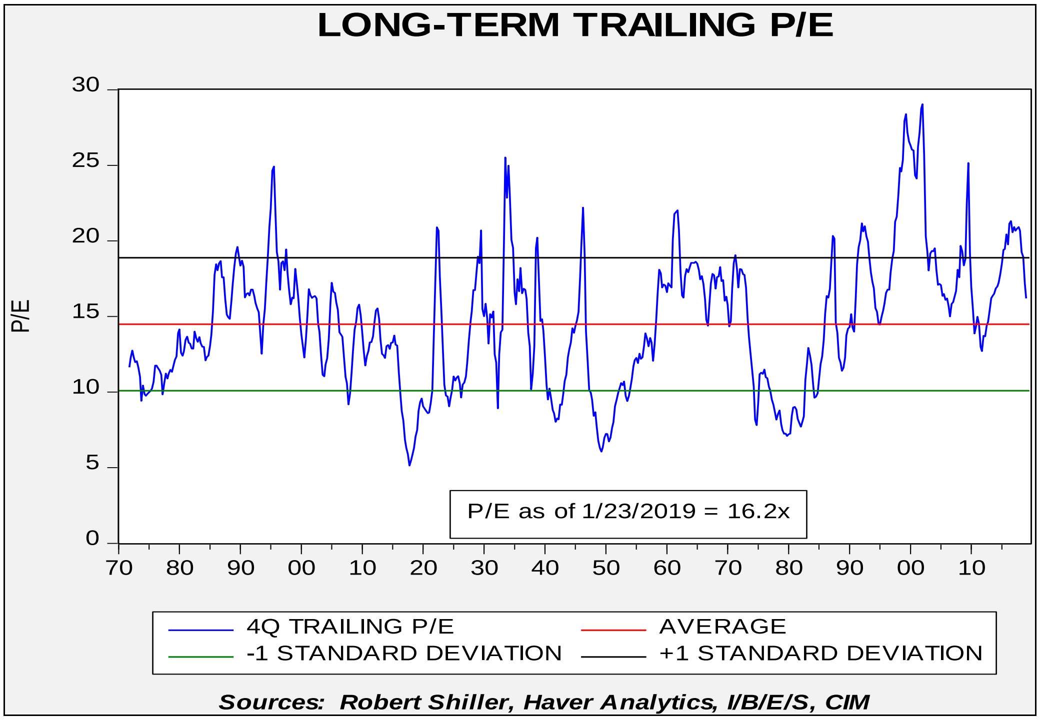


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 24, 2019



Based on our methodology,[12] the current P/E is 16.0x, up 0.2x from last week. The rebound in equities and a decline in earnings estimates led to the rise in the multiple.

[12] 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.