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 31, 2019—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.4% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.5% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.4% and the Shenzhen index down 0.7%. U.S. equity index futures are signaling a higher open. With 180 companies having reported, the S&P 500 Q4 earnings stand at $40.74, lower than the $40.86 forecast for the quarter. The forecast reflects a 13.4% increase from Q4 2017 earnings. Thus far this quarter, 70.6% of the companies reported earnings above forecast, while 21.1% reported earnings below forecast.

Yesterday brought a strong rally in U.S. equities. Here is what we are watching this morning:

Fed meeting: The Fed meeting delivered more than what was expected.[1] First, the FOMC removed language from previous statements suggesting the path for the policy rate was on a gradual path higher. Second, the statement suggested the balance sheet could be adjusted in either direction, although it did reiterate that the fed funds target remains the primary policy vehicle. Essentially, policymakers moved from a path of steady tightening to signaling that further tightening may well be on hold.

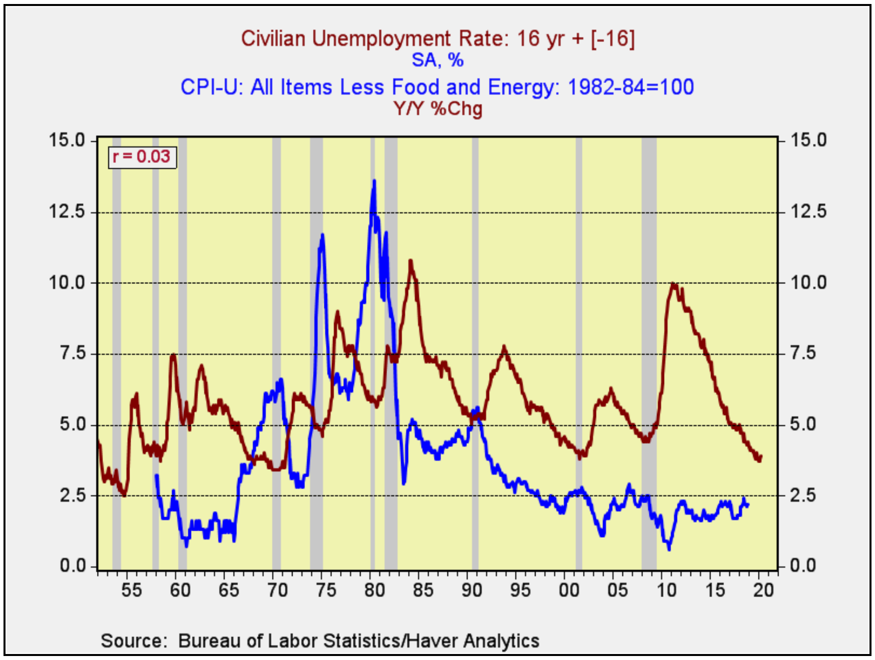
What led to the change? Chair Powell noted the events that led to what appears to be an end to the current tightening cycle. First, slower global growth apparently entered the discussion. Although the Fed's mandate precludes acting as the global central bank (even though it is), the Fed will, on occasion, pay attention to world events. However, this usually occurs when the world economy encroaches on the U.S. economy. We are seeing a clear slowing of U.S. growth so the Fed may be thinking the slowdown is coming from abroad. Second, trade tensions were mentioned, and third, so was the government shutdown. We do note that the Treasury will hit the debt ceiling in March, although the real funding crunch won't occur until summer. Perhaps the Fed is trying to get in front of all that.

We note the financial media is carrying stories from economists and analysts with words such as "perplexed" and "puzzled," meaning, of course, that they had forecast multiple hikes this year

[1] https://www.ft.com/content/2565e154-24b7-11e9-b329-c7e6ceb5ffdf?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56 and https://www.nytimes.com/2019/01/30/us/politics/fed-interest-rate.html?emc=edit_mbe_20190131&nl=morning-briefing-europe&nlid=567726720190131&te=1

and now appear wrong.[2] The doves who have been crying for the Fed to stop are now celebrating their influence.[3]

So, what do we think happened here? It appears to us that two things may be unfolding. First, Chair Powell may be finally killing the Philips Curve. The theory, which has guided Fed policy for decades, states that inflation is caused by the degree of slack in the economy. When slack is removed, the chances for inflation increase. One of the best measures of slack is the labor market. Essentially, the Phillips Curve argues there is a trade-off between unemployment and inflation; if you want less of the latter, you have to accept more of the former. Fed policymakers have clung to the theory even when evidence supporting it has become increasingly thin.



This chart shows the relationship between core CPI and the unemployment rate. Visually, the unemployment rate tends to lead inflation by a bit more than five quarters. During the 1960s into the early 1980s, one can observe a pattern that supports the Phillips Curve. However, in the 1990s, inflation and the unemployment rate fell simultaneously and the level of unemployment seen around the turn of the century supported a peak in core CPI of 2.5%. During the 1970s, the same level of unemployment triggered inflation near 12%. So, something clearly changed. We believe globalization and deregulation flattened the aggregate supply curve, meaning there is lower inflation at each intersection of aggregate demand.

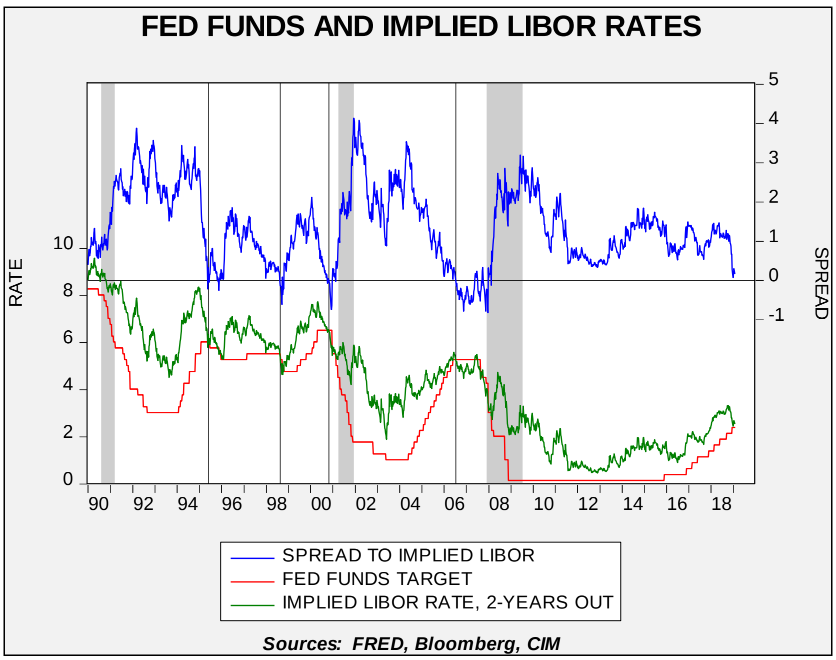
Although FOMC members were aware of these changes, a theory one was raised on is hard to shake. Accordingly, members of the FOMC continued to use the language of the Phillips Curve even though they tended to ignore it in terms of policy. Thus, we would often see deviations from the Taylor Rule or the Mankiw Rule, both of which are tied to the Phillips Curve. Over

[2] https://www.ft.com/content/36cb58ba-24ef-11e9-8ce6-5db4543da632?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56 and https://www.wsj.com/articles/the-feds-mysterious-pause-11548893175
[3] https://www.wsj.com/articles/the-fed-apologizes-11548894046

time, policy seemed to pay an increasing amount of attention to financial markets (hence the idea of the "Fed put").

Powell appears to be finally ditching the Phillips Curve once and for all. Why now? Age probably plays a role. The idea that scientific progress occurs "one funeral at a time" is part of it. The economists who came of age in the 1970s are aging out and the newer economists live in a world of lower inflation. Of course, if policy shifts to deglobalization and reregulation, both very likely given the rise of populism, then the Fed may by ending its use of the Phillips Curve just when it becomes useful again. But, for now, it appears the Phillips Curve is dead.

This leads us to the second change; if the Phillips Curve is out, what has replaced it? For now, nothing is official. But, we suspect the Fed is focusing on inflation and the financial markets. In a recent Asset Allocation Weekly, we discussed the relationship of policy to the VIX.[4] The recent jump in the VIX would have been enough to signal a pause to the FOMC. Another item the FOMC seems to track is the implied LIBOR rate from the Eurodollar futures contract, two-years deferred.



This chart shows the fed funds target and the implied LIBOR rate, with the spread on the upper line of the graph. We have placed vertical lines at points of inversion. In general, the Fed tends to stop raising rates at the point of inversion. The rapid drop in the implied LIBOR rate is a clear signal that the Fed should stop raising rates and, right on cue, that's what Powell indicated yesterday.

We should note one of the dangers the FOMC has now created for itself with this reversal is that financial markets will struggle to cope if conditions improve and it decides it needs to tighten

[4] See Asset Allocation Weekly (1/11/2019).

further. At the same time, the slowing we are seeing in the U.S. economy and abroad, along with controlled inflation, will likely allow the Fed to stop raising rates here without serious problems.

In terms of market impact, the most obvious was yesterday's rally in the front end of the yield curve and in equities. However, we also saw the dollar fall sharply. As we noted in the 2019 Outlook and elsewhere, we have been expecting the dollar to weaken this year. The reaction to the FOMC statement supports that idea.

Gold: Dollar weakness supported a strong rally in gold yesterday. Another factor helping gold is that nations that have run afoul of the U.S. and face financial sanctions are turning to gold in their foreign reserves. Although gold doesn't offer a yield, it is transferable and is mostly protected from the U.S. Treasury. Last year, gold-buying by central banks reached its highest level in nearly 50 years. The highest year was when President Nixon ended Bretton Woods by closing the gold window.[5] A weaker dollar combined with central bank buying should support further strength in gold.

China: In this week's WGR, we opened a two-part report on U.S. relations with China.[6] Overall, it looks like relations will become more hostile over time. That doesn't mean we won't get a trade deal, but it likely won't be anything more than a "can-kicking" exercise to help the U.S. and Chinese economies for the next 18 months. There are reports that Foxconn (TPE: 2354, TWD, 59.20) is considering a significant reduction in its announced direct investment into the U.S.[7] Although the company is based in Taiwan, it has large facilities in China and may be signaling that it is going to side with China if relations cool between the two countries.

Venezuela: There's not much new to report as the standoff continues. However, the *WSJ* reports that the effort to oust Maduro is part of a broader policy to extend U.S. influence in South and Central America and curb Russia's and China's forays into the region.[8] Succeeding in that goal would also undermine Cuba. In a historical sense, the policy is consistent with the Monroe Doctrine. The U.S. has historically worked to thwart leftist regimes in the region that could have, or did, offer alliances with the communist bloc. Undermining Chinese influence would also make sense. However, we do wonder how much of this policy change is coming from the president himself and how much is coming from John Bolton. Given Trump's Jacksonian leanings, it would make sense for him to push back against Maduro, especially when he was going to oust U.S. diplomats. At the same time, Jacksonians tend to avoid such open-ended foreign entanglements that intervening directly in Venezuela would entail. In other Venezuelan news, Maduro is cracking down hard in the poor neighborhoods that used to be the backbone of regime support.[9] Chavez built his coalition on the military and the poor, isolating the merchant and middle classes. He paid for this policy by raiding PDVSA's oil coffers. The drop in oil

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[5] https://www.ft.com/content/8148a8f0-2479-11e9-8ce6-5db4543da632?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

[6] See WGR, What to do with China: Part I (1/28/2019).

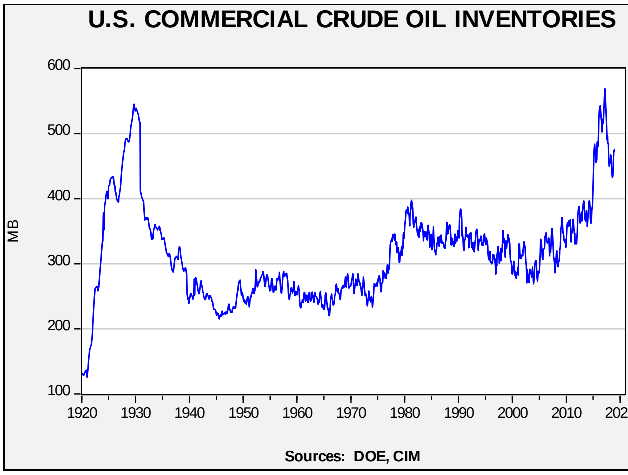
[7] https://www.politico.com/story/2019/01/30/foxconn-manufacturing-jobs-1136919

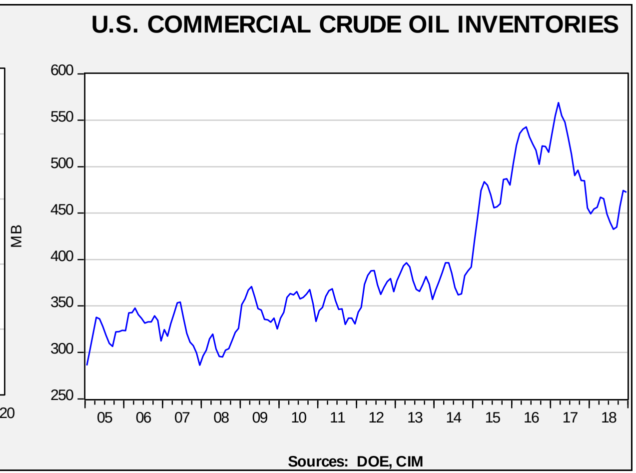
[8] https://www.wsj.com/articles/u-s-push-to-oust-venezuelas-maduro-marks-first-shot-in-plan-to-reshape-latin-america-11548888252

[9] https://www.nytimes.com/2019/01/30/world/americas/venezuela-maduro-protests-faes.html?emc=edit_mbe_20190131&nl=morning-briefing-europe&nlid=567726720190131&te=1

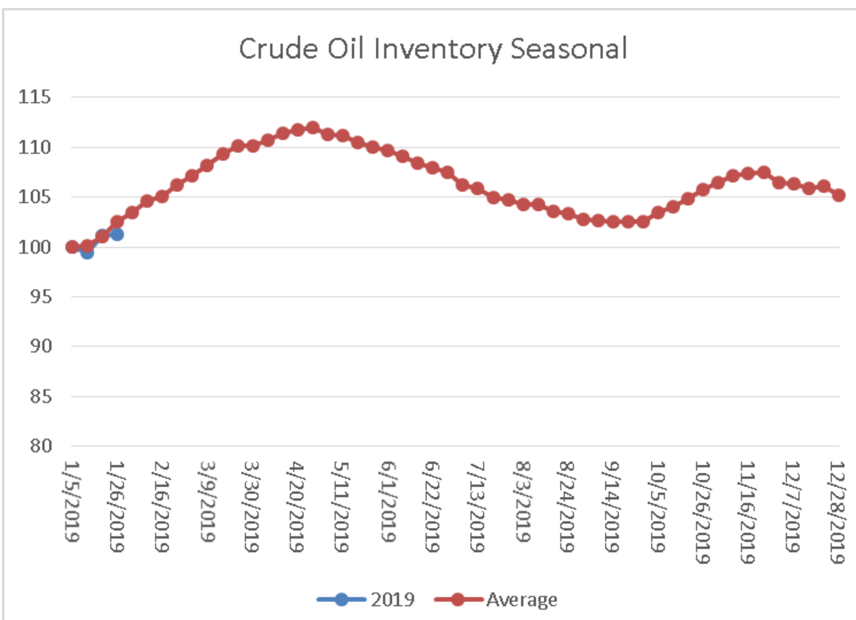
output, due in part to the lack of investment, has forced Maduro to choose between the brass and the poor. The latter have lost out.

Energy update: Crude oil inventories rose 0.9 mb last week compared to the forecast rise of 3.0 mb.



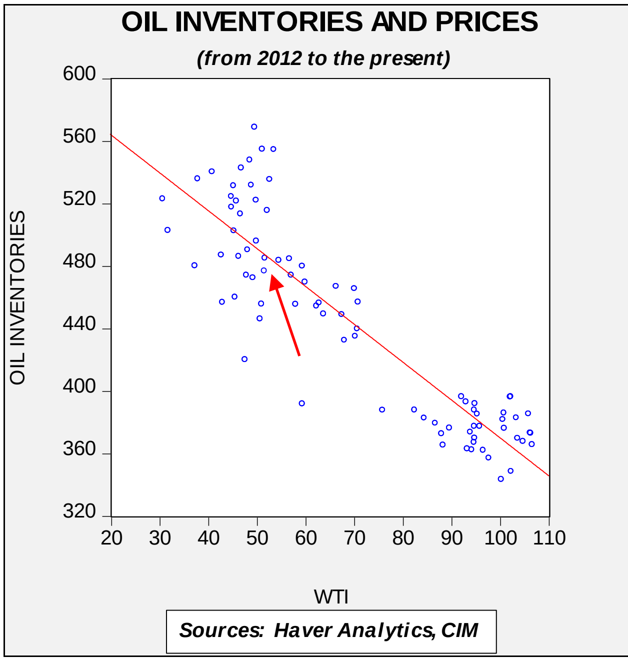


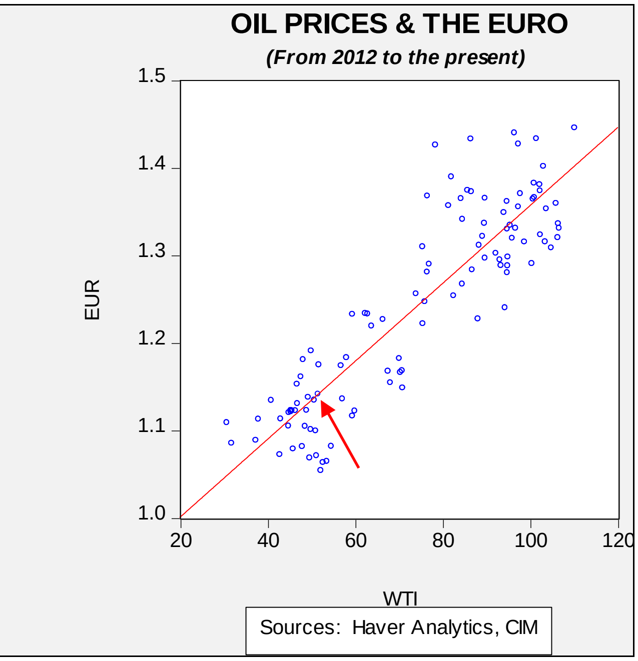
In the details, estimated U.S. production was unchanged at 11.9 mbpd. Crude oil imports dropped 1.1 mbpd, while exports were unchanged. The drop in imports may reflect the impact of Venezuelan sanctions. Refinery runs declined 2.8% and should continue to fall in Q1. Product stocks fell.



(Source: DOE, CIM)

This is the seasonal pattern chart for commercial crude oil inventories. We would expect to see a steady increase in inventory levels that will peak in early May. This week's increase was well below expectations and a bit below seasonal norms.



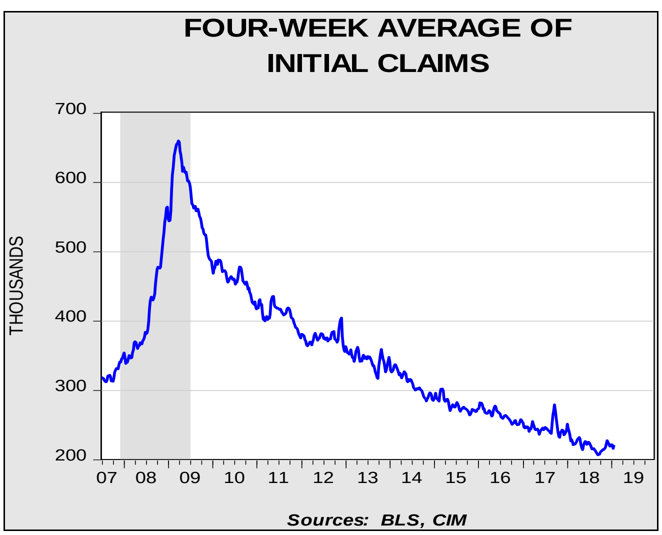


Based on oil inventories alone, fair value for crude oil is $58.76. Based on the EUR, fair value is $55.61. Using both independent variables, a more complete way of looking at the data, fair value is $55.99. By all these measures, current oil prices are generally in the neighborhood of fair value. We still expect prices to move toward $60 in the coming weeks, although rising oil inventories will tend to be a bearish factor for the market.

U.S. Economic Releases

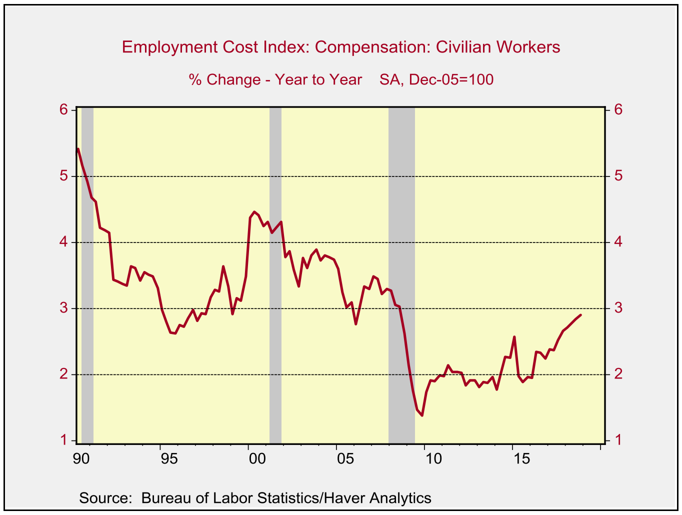
The January Challenger job cuts report rose by 18.7% from the prior year. The index measures the number of announced job cuts by employers, which is a proxy for future layoffs but does not necessarily indicate the state of current layoffs.

Initial claims came in well above expectations at 253k compared to the forecast of 215k.



The chart above shows the four-week moving average of initial claims, which rose from 215.25k to 220.25k.

The employment cost index for Q4 came in below expectations, rising 0.7% from the prior quarter compared to the forecast of 0.8%.



The chart above shows the year-over-year change of the employment cost index, which rose 2.9% from the prior year. Since the financial crisis, the ECI has been relatively weak, remaining below its historical average of 3.0% for over a decade. An ECI approaching its historical average would confirm that the labor market is tightening.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Chicago Purchasing Manager	m/m	jan	61.5	65.4	**
9:45	Bloomberg Consumer Comfort	m/m	jan		57.4	**
10:00	New Home Sales	m/m	nov	570k	544k	**
10:00	New Home Sales	m/m	nov	4.8%	-8.9%	**
16:00	Total Net TIC Flows	m/m	nov		$42.0 bn	*
16:00	Net Long-term TIC Flows	m/m	nov		$31.3 bn	*
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	Non-manufacturing PMI	m/m	jan	54.7	53.8	53.8	**	Equity bullish, bond bearish
	Manufacturing PMI	m/m	jan	49.5	49.4	49.3	**	Equity and bond bearish
	Composite PMI	m/m	jan	53.2	52.6		**	Equity and bond neutral
	Swift Global Payments	m/m	dec	2.1%	2.1%		**	Equity and bond neutral
Japan	Industrial Production	m/m	dec	-1.9%	1.5%	-2.3%	**	Equity bearish, bond bullish
	Housing Starts	y/y	dec	2.1%	-0.6%	2.0%	***	Equity bullish, bond bearish
	Annualized Housing Starts	m/m	dec	0.961 mn	0.957 mn	0.954 mn	***	Equity bullish, bond bearish
India	GDP Annual Estimate	y/y	2018	7.2%	7.2%		***	Equity and bond neutral
	Eight Infrastucture Industries	m/m	dec	2.6%	3.5%		**	Equity and bond neutral
Australia	Import Price Index	q/q	4q	0.5%	1.9%	0.3%	**	Equity bullish, bond bearish
	Export Price Index	q/q	4q	4.4%	3.7%	2.7%	**	Equity bullish, bond bearish
	Private Sector Credit	y/y	dec	4.3%	4.4%	4.4%	**	Equity and bond neutral
EUROPE								
Eurozone	Unemployment Rate	m/m	dec	7.9%	7.9%	7.9%	***	Equity and bond neutral
	GDP	y/y	4q	1.2%	1.2%	1.2%	***	Equity and bond neutral
Germany	Retail Sales	m/m	dec	-2.1%	1.1%	1.5%	**	Equity and bond bearish
	Unemploynent Change	m/m	jan	-2k	-14k	-10k	**	Equity and bond neutral
	Unemployment Claims Rate	m/m	jan	5.0%	5.0%	5.0%	***	Equity and bond neutral
France	CPI	y/y	jan	1.2%	1.6%	1.2%	***	Equity and bond neutral
Italy	Unemployment Rate	y/y	dec	10.3%	10.5%	10.6%	***	Equity and bond neutral
	GDP	y/y	4q	-0.2%	-0.1%	-0.1%	***	Equity and bond bearish
	Hourly Wages	y/y	dec	1.7%	1.9%		***	Equity and bond neutral
UK	Nationwide House Px	y/y	jan	0.3%	-0.7%	0.2%	**	Equity bullish, bond bearish
AMERICAS								
Mexico	GDP	y/y	4q	1.8%	2.5%	2.0%	***	Equity bearish, bond bullish
	Budget Balance	ytd	dec	-495.0 bn	-316.1 bn		**	Equity bearish, bond bullish
Canada	CFIB Business Barometer	y/y	jan	56.1	53.6		***	Equity and bond neutral
Brazil	National Unemployment Rate	y/y	dec	11.6%	11.6%	11.4%	***	Equity bearish, bond bullish
	Net Debt % GDP	m/m	dec	53.8%	53.3%	53.7%	***	Equity and bond neutral
	Primary Budget Balance	m/m	dec	-41.1 bn	-15.6 bn	-37.7 bn	**	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)	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%	2.500%	On forecast
FOMC Rate Decision(Lower Limit)	2.250%	2.250%	2.250%	On forecast
Interest Rate on Excess Reserves	2.400%	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	$61.95	$61.65	0.49%	
WTI	$54.26	$54.23	0.06%	
Natural Gas	$2.89	$2.85	1.40%	
Crack Spread	$12.08	$11.83	2.16%	
12-mo strip crack	$15.11	$15.02	0.55%	
Ethanol rack	$1.39	$1.39	0.19%	
Metals				
Gold	$1,323.27	$1,319.91	0.25%	
Silver	$16.09	$16.07	0.16%	
Copper contract	$278.05	$276.75	0.47%	
Grains				
Corn contract	$ 380.75	$ 381.25	-0.13%	
Wheat contract	$ 515.75	$ 516.75	-0.19%	
Soybeans contract	$ 924.25	$ 921.00	0.35%	
Shipping				
Baltic Dry Freight	721	797	-76	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	0.9	3.0	-2.1	
Gasoline (mb)	-2.2	2.4	-4.7	
Distillates (mb)	-1.1	-2.0	0.9	
Refinery run rates (%)	-2.80%	-0.65%	-2.15%	
Natural gas (bcf)		-200.0		

Weather

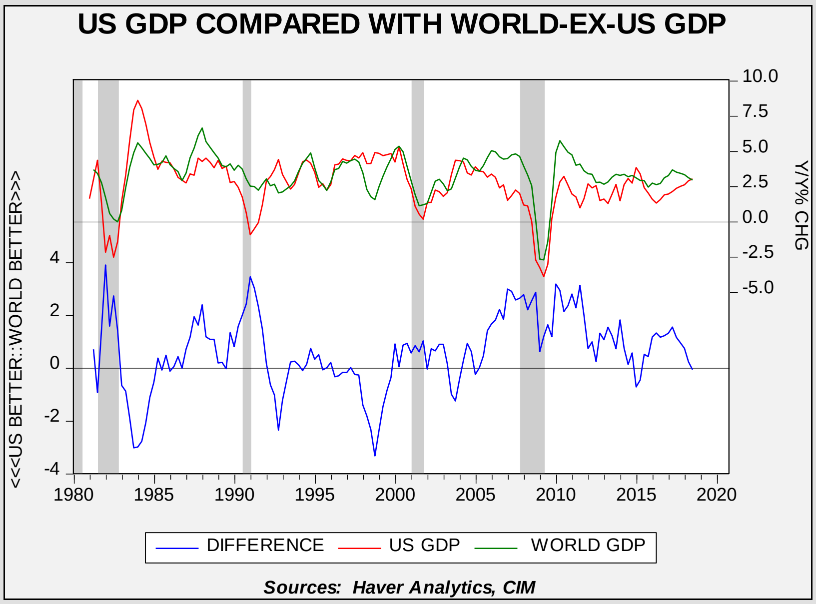
The 6-10 and 8-14 day forecasts show cooler temperatures for most of the country, with warmer temps in the southeastern region.

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

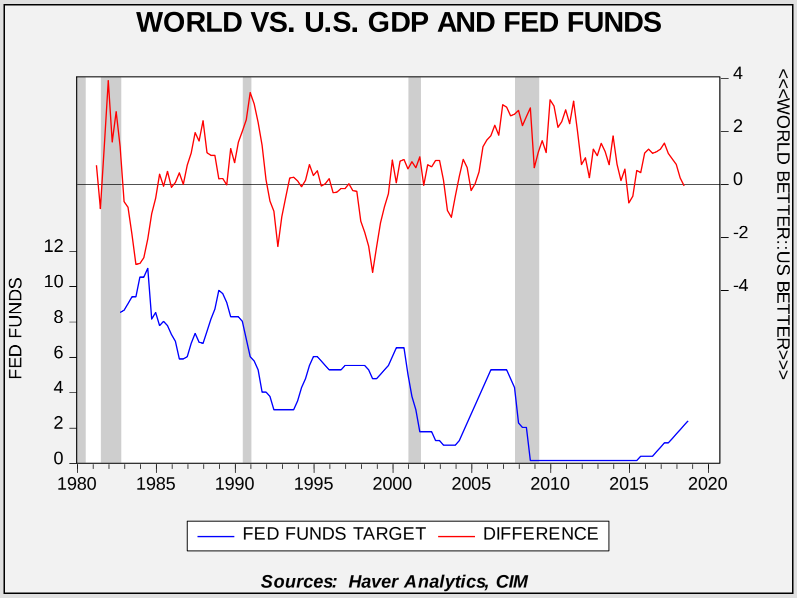
One of the important unknown factors for 2019 is whether slowing global growth will have a negative impact on the U.S. economy. Or, put another way, can the world lead the U.S. into recession? For the most part, history suggests the answer is no—the U.S. can bring down the world but the world can't bring 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[10] 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.



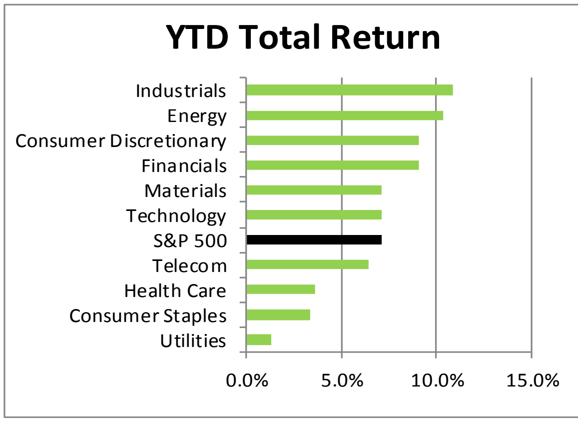
A couple of events are notable, where the Fed appeared to have adjusted policy due to global events. In the early 1980s, the Fed was still managing interest rates by focusing on the money supply. However, the high level of interest rates led Mexico to default and caused cascading debt crises throughout 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.

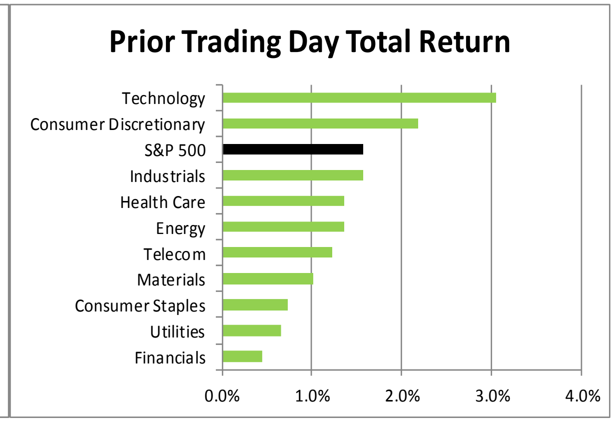
If the FOMC is looking for an excuse to ease policy, it could certainly use concerns about global growth affecting the U.S. economy as a reason. Although we doubt that the weak global economy will bring down American growth, concerns about it could allow the Fed to lower rates and maintain credibility. 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.

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

Data Section

U.S. Equity Markets – (as of 1/30/2019 close)

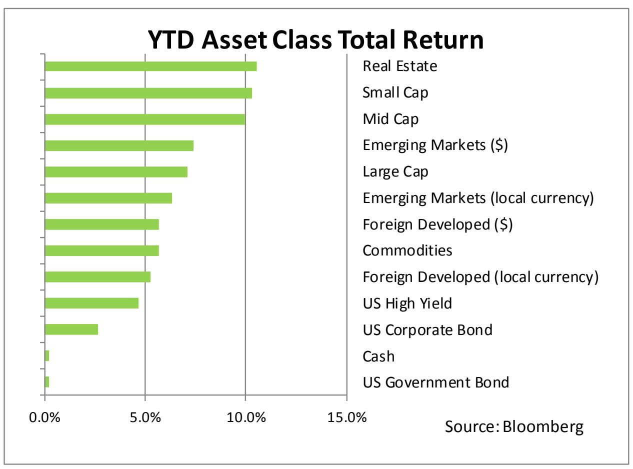




(Source: Bloomberg)

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 1/30/2019 close)

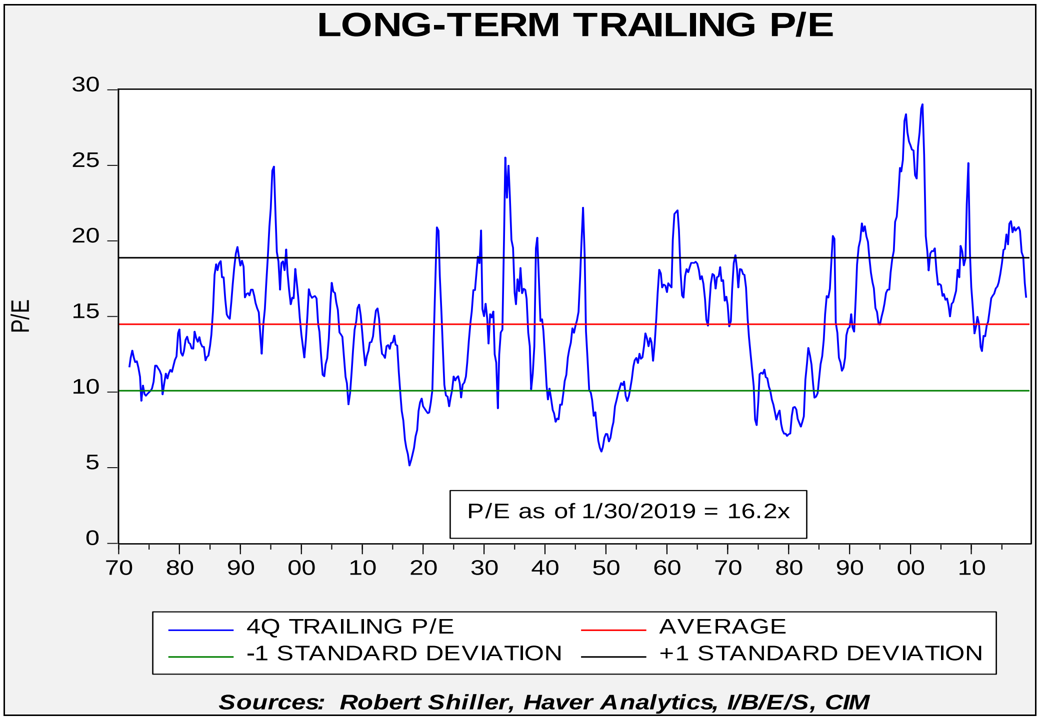


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 31, 2019



Based on our methodology,[11] the current P/E is 16.2x, up 0.2x from last week. The rebound in equities led to the rise in the multiple.

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[11] 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.