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: November 12, 2018—9:30 AM EDT] 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 down 0.3% from the prior close. Chinese markets were higher, with the Shanghai composite up 1.2% and the Shenzhen index up 2.5%. U.S. equity index futures are signaling a lower open. With 450 companies having reported, the S&P 500 Q3 earnings stand at $42.66, higher than the $40.50 forecast for the quarter. The forecast reflects a 21.0% increase from Q3 2017 earnings. Thus far this quarter, 76.9% of the companies reported earnings above forecast, while 15.3% reported earnings below forecast.

It's Monday and a bank holiday. Since Veteran's Day fell on a weekend, the banking system is partially closed today, which means the cash Treasury market is closed. This is what we are watching this morning:

OPEC and oil: President Trump has been critical of OPEC and high oil prices, and the Saudis have been sensitive to his complaints. However, now that the midterms are over, it appears the kingdom is pressing for higher prices. The Saudi energy minister, Khalid al-Falih, suggested yesterday that the oil markets have overcorrected and prices should move higher.[1] In addition, the kingdom is officially pushing for a 1.0 mbpd cut by December.[2] Although Russia isn't necessarily warm to the idea, it hasn't shot it down either.[3] Oil prices have suffered a significant decline recently, mostly due to seasonal factors and rising U.S. output. The OPEC news may arrest the decline, but a reversal will need inventory reduction; a bit of dollar weakness would be helpful, too.

MbS: This week's Weekly Geopolitical Report concludes our two-part series on the Saudi crown prince. We note a couple of articles today. First, the *NYT* reports that the crown prince was considering an assassination campaign against his and the kingdom's enemies.[4] Second, as we note in our report, it is likely the other princes will try to rein in MbS.[5] His unstable decision-making is becoming a problem and could bring instability to a nation that strives for stability.

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[1] https://www.cnbc.com/2018/11/11/oil-prices-saudi-arabia-says-markets-are-getting-it-wrong-again.html
[2] https://www.ft.com/content/1e3639a6-e5e7-11e8-8a85-04b8afea6ea3?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56
[3] https://www.wsj.com/articles/opec-edges-closer-to-production-cut-as-saudis-russia-signal-intent-1541956957
[4] https://www.nytimes.com/2018/11/11/world/middleeast/saudi-iran-assassinations-mohammed-bin-salman.html?emc=edit_mbe_20181112&nl=morning-briefing-europe&nlid=56772672020181112&te=1
[5] https://www.ft.com/content/2f853996-e5d3-11e8-8a85-04b8afea6ea3?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

Brexit: Earlier this month, there was optimism that PM May would be able to strike a deal with the EU on Brexit. Although the substance of an agreement appeared to be lacking, hopes were high. It appears these hopes are fading rapidly. The EU has rejected a key compromise point[6] on the Ireland/Northern Ireland border. Negotiations have been intense but both sides can't seem to come up with an agreement that will work for both parties.[7] The British prime minister is facing political broadsides from both Remainers and Leavers; May has been trying to weave a path that would give each side enough to accept a Brexit deal that would not leave the U.K. economy completely outside the EU. However, she has not been able to craft a compromise; in fact, such an arrangement may not be possible. The GBP has declined on the lack of progress. It should be noted that most EU deals don't occur until the deadlines, mostly because there are so many parties involved that getting to an early answer is impossible. Thus, one should not conclude that a deal isn't coming. However, if a plan isn't in place by the end of November, it will be virtually impossible for the remaining members of the EU to agree in time for the March 29th deadline. A "hard" Brexit, which simply pushes the U.K. out of the EU and forces trade to WTO rules, would be a hard shock to the U.K. economy. Already, there are calls for government bailouts if such an event occurs.[8]

Chinese tensions rise: Chinese authorities have been cracking down against labor protests that have been springing up recently. These follow student activism at Peking University, where students, acting as good Marxists, supported a unionization movement for workers at the school.[9] Another issue facing the leadership is growing financial problems. China has been using financial repression against households for years; it is how it creates saving for investment. Households were generally only allowed to put their savings in banks that offered low interest rates, usually below the rate of inflation. Financial firms have sprung up over the years offering higher interest rates; however, these firms are loosely regulated and, occasionally, default, causing localized unrest. Peer-to-peer lending has been one of these industries. Now, it appears a major one, Ezubao, has failed and depositors are demanding the government bail them out.[10] We saw similar issues with wealth management products. There is a solution—allow banks to raise interest rates to market levels which would undermine these unregulated financial products. But, that would undermine the development model China has used since the late 1970s and, more importantly, reduce the wealth of powerful figures in the CPC. Finally, the PBOC is signaling that it will act to prevent the CNY from depreciating significantly.[11] Although the central bank may be successful in its goals, it should be noted that if the Trump administration does follow through on additional tariffs then CNY weakness is a nearly inevitable response.

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6 https://www.thetimes.co.uk/edition/news/may-s-brexit-deal-crashes-as-eu-turns-off-life-support-fg02wktsp

7 https://www.theguardian.com/politics/2018/nov/12/may-has-little-room-for-manoeuvre-brexit-german-minister-warns

8 https://www.politico.eu/article/business-will-need-state-bail-outs-in-no-deal-brexit/?utm_source=POLITICO.EU&utm_campaign=f80619b654-EMAIL_CAMPAIGN_2018_11_12_05_40&utm_medium=email&utm_term=0_10959edeb5-f80619b654-190334489

9 https://www.ft.com/content/cbecd5d8-e627-11e8-8a85-04b8afea6ea3?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

10 https://www.ft.com/content/c71eea4a-c198-11e8-84cd-9e601db069b8?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

11 https://www.bloomberg.com/news/articles/2018-11-12/china-signals-tougher-yuan-management-at-expense-of-market-role

Navarro reacts: Senior trade advisor Peter Navarro accused major Wall Street firms of being "unpaid foreign agents"[12] for meeting with Chinese officials earlier this month. These strong words should be seen in the context of the divisions within not only the administration but the political system as well. Populist wings have emerged on both the left and the right and Navarro, along with Robert Lighthizer, represent the right-wing version, at least on trade. Populists of both stripes oppose globalization. However, it is a bit jarring for a GOP administration to label Wall Street as unpaid foreign agents.

North Korea lurks: Although the Hermit Kingdom has been off the front pages for a while, we note that the Kim government has been continuing to work on its weapons of mass destruction. According to the *Washington Post*,[13] the regime is working on its ballistic missile program at new "secret" bases. Kim Jong-un, like his father and grandfather, won't be ignored indefinitely and the lack of progress on improving relations could mean new tensions in 2019.

U.S. Economic Releases

There were no economic news releases prior to the publication of this report. The table below lists the Fed events scheduled for today.

Economic Releases		
No economic releases today		
Fed speakers or events		
EST	**Speaker or event**	**District or position**
14:30	Mary Daly speaks on Economic Outlook	President of the Federal Reserve Bank of San Francisco

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.

[12] https://www.wsj.com/articles/peter-navarro-blasts-china-and-wall-street-globalists-1541787254
[13] https://www.nytimes.com/2018/11/12/us/politics/north-korea-missile-bases.html

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
Japan	PPI	y/y	oct	2.9%	3.0%	2.8%	**	Equity and bond neutral
	Loans & Discounts Corp	y/y	sep	3.5%	3.4%		**	Equity and bond neutral
New Zealand	Card Spending Retail	m/m	oct	0.1%	1.1%	0.6%	**	Equity bearish, bond bullish
	Card Spending Total	m/m	oct	-0.1%	1.3%		**	Equity and bond neutral
EUROPE								
Italy	Industrial Production	m/m	sep	1.3%	-0.8%	0.5%	***	Equity bullish, bond bearish
France	Bank of France Ind. Sentiment	m/m	oct	103	105	104	**	Equity and bond neutral
Switzerland	Total Sight Deposits CHF	m/m	sep	577.2 bn	577.5 bn		**	Equity and bond neutral
	Domestic Sight Deposits CHF	m/m	sep	475.6 bn	469.9 bn		**	Equity and bond neutral
AMERICAS								
Mexico	Industrial Production	y/y	sep	1.8%	0.2%	1.8%	***	Equity and bond neutral
	Manufacturing Production	m/m	sep	2.4%	2.1%	2.0%	***	Equity bullish, bond bearish
	Nominal Wages	m/m	oct	3.8%	5.8%		**	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)	262	261	1	Up
3-mo T-bill yield (bps)	230	230	0	Neutral
TED spread (bps)	32	31	1	Neutral
U.S. Libor/OIS spread (bps)	233	234	-1	Up
10-yr T-note (%)	3.18	3.18	0.00	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	47	45	2	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	down			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	$71.01	$70.18	1.18%	Prospective Supply Cuts
WTI	$60.58	$60.19	0.65%	
Natural Gas	$3.85	$3.72	3.39%	
Crack Spread	$15.71	$15.55	1.00%	
12-mo strip crack	$17.92	$17.78	0.76%	
Ethanol rack	$1.41	$1.41	-0.51%	
Metals				
Gold	$1,206.88	$1,209.65	-0.23%	
Silver	$14.15	$14.16	-0.03%	
Copper contract	$269.35	$268.45	0.34%	
Grains				
Corn contract	$ 370.75	$ 369.75	0.27%	
Wheat contract	$ 505.25	$ 502.00	0.65%	
Soybeans contract	$ 884.00	$ 886.75	-0.31%	
Shipping				
Baltic Dry Freight	1147	1231	-84	

Weather

The 6-10 and 8-14 day forecasts show cooler to normal temps for the eastern region and warmer temps for the rest of the country. There is some cyclone formation near the Leeward Islands but at this time it is unclear whether it will develop into a storm; we will continue to monitor this situation.

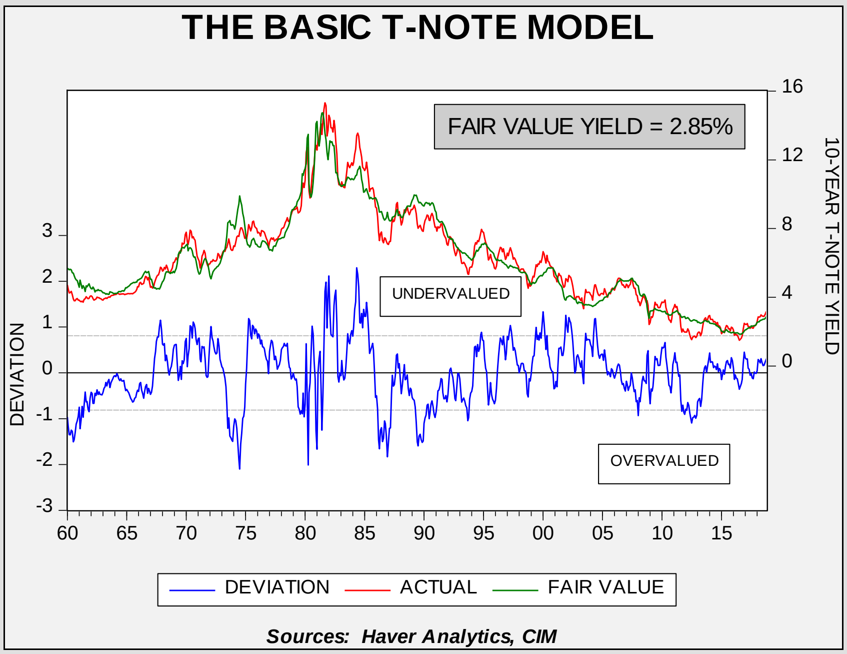
Asset Allocation Weekly Comment

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.

November 9, 2018

In light of rising interest rates, this week we will take a look at credit spreads. But, before doing that, it makes sense to examine overall Treasury valuation.

This chart is our 10-year T-note model. It incorporates fed funds, the Japanese yen exchange rate, German sovereign 10-year yields, oil prices, the fiscal deficit as a percentage of GDP and an inflation proxy.[14]



This model does suggest current 10-year yields are elevated, but not at extreme levels. However, if we assume a terminal fed funds rate of 3.25%, assuming no change in the rest of the variables in the model, fair value for the 10-year rises to 3.27%, which is near current levels. Thus, we can postulate that current yields have discounted about 100 bps of further tightening. Another interesting note is that the most significant variables in the model are fed funds and the inflation proxy. Just using these two variables in the model yields a fair value of 3.60%; if we assume another 100 bps of tightening, the terminal 10-year yield ends up at 4.10%. Compared to the broader model, it is clear that overseas factors, especially German yields, are keeping U.S. yields from rising faster. Overall, we don't expect these foreign factors or oil prices to change in such a way as to support higher yields, so we don't expect a rise in the 10-year yield to exceed 3.50% unless (a) inflation expectations become unanchored, or (b) the FOMC signals it will raise rates much more than expected.

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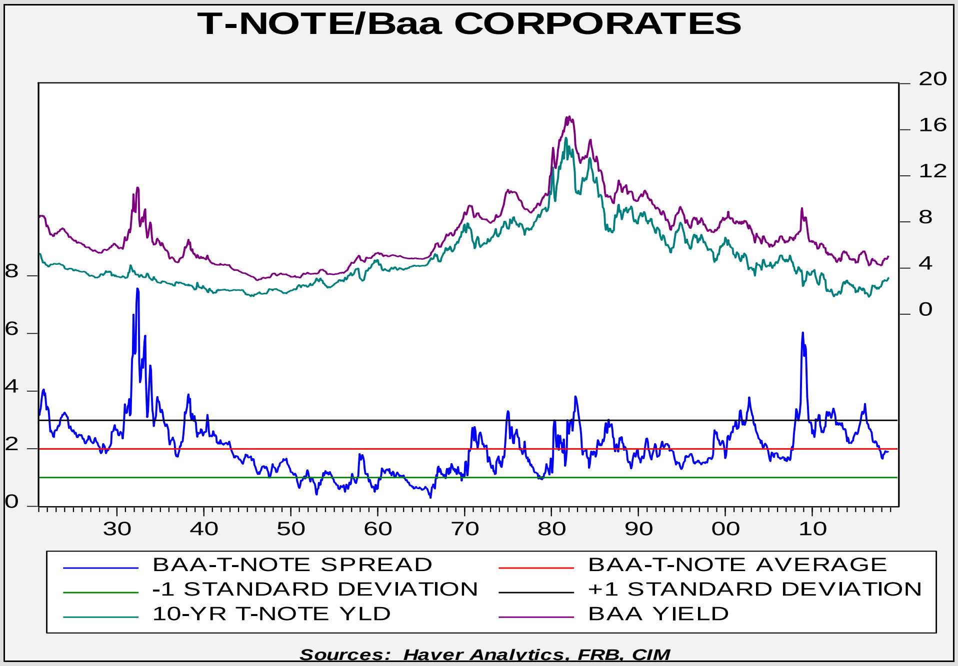
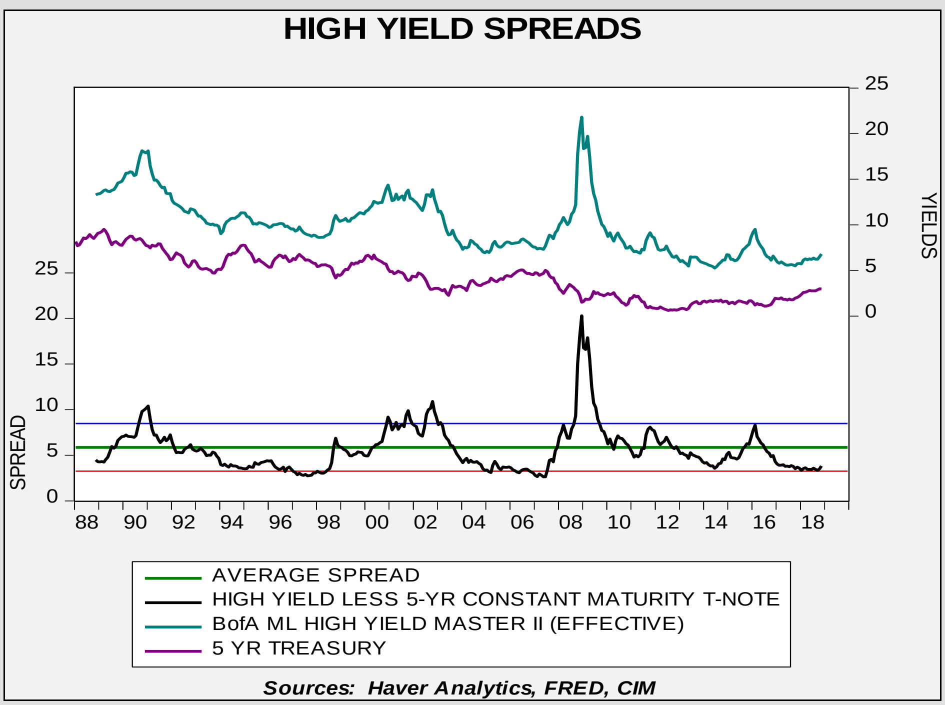
[14] For an inflation proxy, we use the 15-year moving average of the yearly change in CPI. This is based off research by Milton Friedman, who postulated that investors build their inflation expectations over a long time frame.

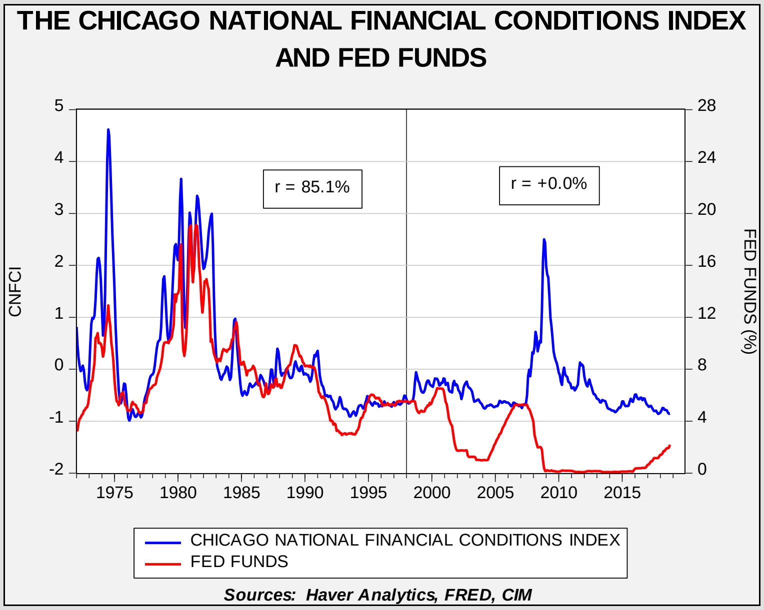
Thus far, the impact on credit spreads from rising Treasury yields has been minor. The chart below shows investment grade spreads. Current investment grade spreads are holding near their long-term average.



High-yield spreads have nudged higher but remain tight, with spreads holding near the bottom of their historical ranges.



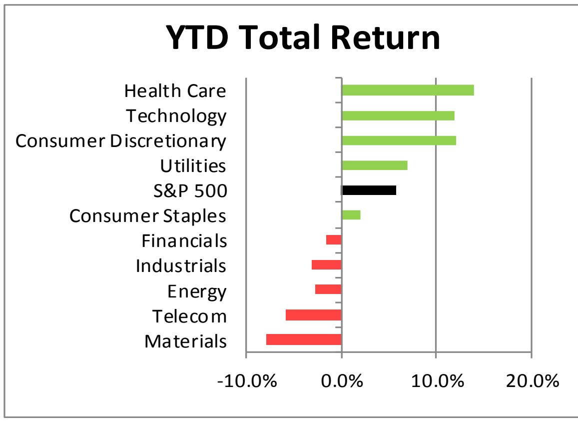
The lack of spread widening is consistent with the continued low level of stress in the financial system.

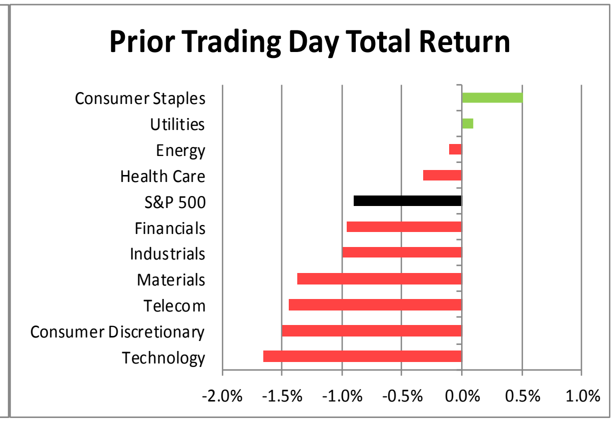


This chart shows fed funds with the Chicago FRB National Financial Conditions Index; the index rises when stress increases (or, put another way, when financial conditions deteriorate). From 1973 (when the index data begins) until 1997, the two series were tightly correlated; if the FOMC raised rates, stress rose. Stress was a "force multiplier" for monetary policy. We believe increasing transparency has removed this "tool" from the Fed; now, financial participants can so easily project the path of policy that they don't necessarily fear the rising rates. And so, instead of seeing participants react to stress as policy tightens, we now have a situation where stress remains low only to soar. Credit spreads are a key component of the aforementioned conditions index. If spreads begin to widen, they could do so rapidly, leading to significant market disruptions. For now, all is calm, but we continue to closely watch market conditions because when they begin to deteriorate they tend to so rapidly. In asset allocation, we have tended to favor investment grade spread products but are less favorable toward high yield. If conditions start to deteriorate, we will shift allocations toward Treasuries.

Data Section

U.S. Equity Markets – (as of 11/9/2018 close)

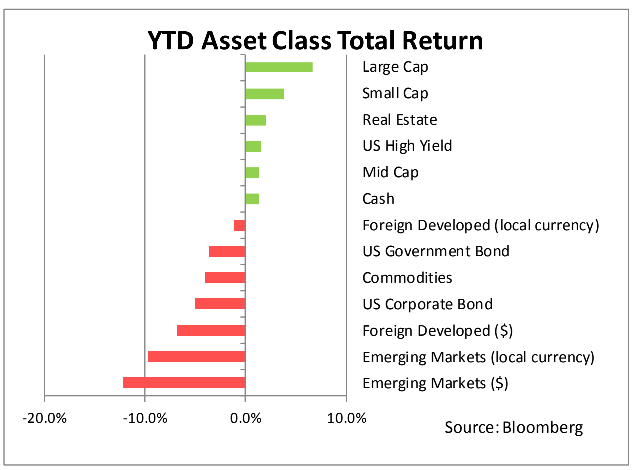




(Source: Bloomberg)

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 11/9/2018 close)

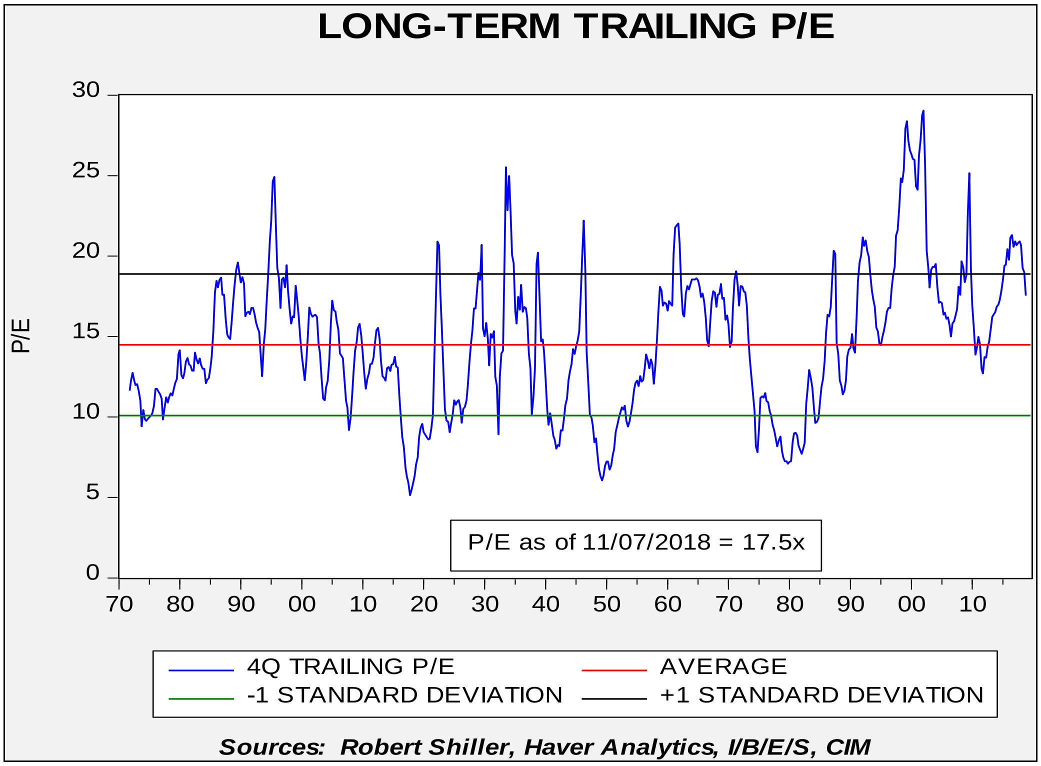


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

November 8, 2018



Based on our methodology,[15] the current P/E is 17.5x, down 0.1x from last week's reading of 17.6x. The primary reason for the drop in the P/E is recent correction in the S&P 500.

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 twi actual quarters (Q1 and Q2) and two estimates (Q3 and 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.