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 13, 2018—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.6% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.1% from the prior close. Chinese markets were higher, with the Shanghai composite up 0.9% and the Shenzhen index up 1.6%. U.S. equity index futures are signaling a higher 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.

Good morning! We are seeing a recovery in equities this morning after a rough day yesterday. The dollar's a bit weaker this morning. Energy is mixed—oil prices are continuing their slump but natural gas is on a tear due to early winter weather east of the Rockies. Here is what we are watching today:

Italian deadline day: It appears Italy is only making cosmetic changes to its recent budget, daring the EU[1] to sanction the country. Italian yields are ticking higher, with the 10-year sovereign hitting a yield of 3.45%. Although we are sympathetic to Italy's plight, this budget will do nothing more than give the economy a short-term boost. What Italy really needs is debt restructuring, something the creditor nations in the EU are loath to offer. Thus, we are getting a short-term confrontation over something that won't really fix the problem. The other solution is for Italy to exit the Eurozone and service its debt in a new local currency (another form of debt restructuring) but that process would likely trigger a crisis. We will be watching to see if the EU rejects the budget but offers Italy an "out" by requiring modest changes.[2]

Brexit: David Lidington, an official in the May government, suggests that a Brexit deal is "almost within touching distance" and a final agreement could emerge in the next 48 hours.[3] Although negotiators may reach an agreement (the biggest sticking point remains the Irish frontier), getting any agreement through Parliament will be the most difficult part. First, it isn't evident that May has enough support in her narrow coalition to win a majority on any agreement. There are enough hard leavers among the Tories that anything less than a total abandonment of

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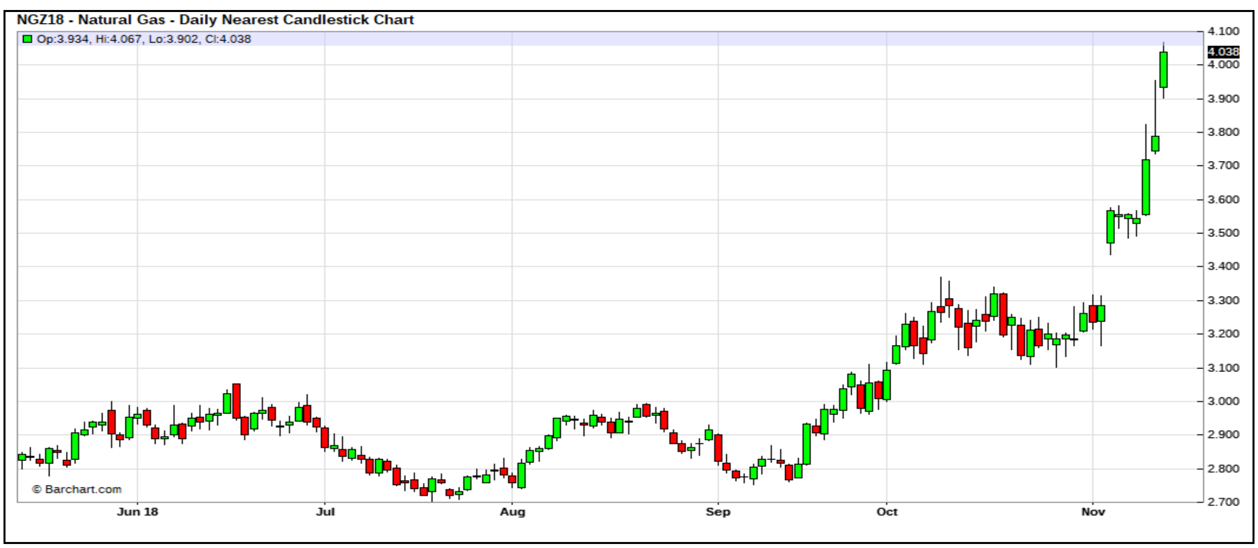
[1] https://www.politico.eu/article/commission-sees-italy-surpassing-budget-deficit-limit-in-2020/?utm_source=POLITICO.EU&utm_campaign=a6acca9c80-EMAIL_CAMPAIGN_2018_11_13_05_42&utm_medium=email&utm_term=0_10959edeb5-a6acca9c80-190334489
[2] https://www.nytimes.com/2018/11/12/world/europe/italy-budget-european-union.html?emc=edit_mbe_20181113&nl=morning-briefing-europe&nlid=567726720181113&te=1
[3] https://www.ft.com/content/f7e26d32-e71d-11e8-8a85-04b8afea6ea3

the EU is unacceptable. Second, the government coalition partner, the DUP, will reject anything that sniffs of a plan that makes Northern Ireland not quite the same as the rest of the U.K. It appears that some basic vote counting leaves May 37 votes short of approval, assuming any deal that emerges isn't egregiously biased against the U.K.[4] Thus, May will need that many Labour MPs to support the plan. Labour's Corbyn has ordered his party to reject any deal,[5] which means any Labour MP voting for the plan will have to reject the orders of the party leadership, always risky for the future career of an elected official. On the other hand, there is the risk of something similar to what we saw in the TARP situation in the U.S. in 2008. Congress initially rejected the arrangement only to trigger a financial crisis, which led Congress to reconvene, make a few cosmetic changes to the bill and pass it. Corbyn's goal is to bring down the government and force elections, which could bring a Labour government into power. The question is, "will Corbyn be willing to create financial calamity to become PM?"

Merkel speaks: In what may likely be her last major speech, Chancellor Merkel will address the European MPs today in Strasbourg about the "future of Europe." Although there is hope among Europhiles that Merkel will offer a striking vision to further the cause of European integration, such an outcome would be quite out of character. We expect a speech without much substance.

Oil woes: After staging an early morning rally yesterday, oil prices failed to hold gains and are lower this morning. President Trump tweeted against the cartel this morning, calling for lower prices.[6] Meanwhile, OPEC feels it was "duped" by Trump into raising output only to see the U.S. grant waivers to eight nations on Iranian crude exports.[7] Oil prices won't bottom until oil inventories stop rising. Meanwhile, an early cold snap has led to sharply higher natural gas prices.



(Source: Barchart.com)

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[4] https://www.ft.com/content/6dfaf06e-e685-11e8-8a85-04b8afea6ea3
[5] https://www.ft.com/content/22dfd306-e667-11e8-8a85-04b8afea6ea3
[6] https://www.ft.com/content/1e3639a6-e5e7-11e8-8a85-04b8afea6ea3
[7] https://www.investors.com/news/oil-prices-jump-saudi-arabia-signals-opec-production-cuts/

Early winter cold weather tends to be very bullish for natural gas prices because utilities prefer to hold inventory in November to avoid an inventory shortage in February. This practice will tend to cause price spikes if winter arrives early. At the same time, once temperatures moderate, prices will tend to reverse rather quickly.

Trade: The White House is returning to trade policy now that the midterms are over. According to reports, President Trump really wants tariffs against foreign automakers.[8] Frankly, if President Carter would have rolled out such trade impediments the U.S. automakers would have cheered. However, it is worth noting that U.S. nameplates haven't been all that supportive of such measures today. This is because the industry is thoroughly globalized. If the president does push in this direction, we would expect a sharp increase in U.S. car prices but it could be years before jobs shift to the U.S. – assuming that these jobs aren't automated away. Some of today's lift comes from headlines that Treasury Secretary Mnuchin and Vice Premier Liu have resumed discussions, raising hopes that some cooling of trade tensions between the U.S. and China are in the offing.[9] However, we doubt that much will come of these talks; American companies were something of a no-show at China's recent import expo[10] and the administration is rolling out a new strategy to prevent China from obtaining American technological secrets.[11] Meanwhile, negotiations between the EU and the U.S. have restarted; the EU was stalling talks before the midterms, perhaps hoping the GOP would take a drubbing and give European negotiators an edge. Instead, the vote was more of a draw and so talks are accelerating[12] in an atmosphere where President Trump continues to criticize NATO members for running trade surpluses with the U.S.[13] Finally, we note the *WSJ* opinion writers have taken notice of Peter Navarro's recent accusation of American business leaders being "unregistered foreign agents" for China. The editorial board clearly sees that Navarro's policies are deglobalizing and a threat to profit margins. It is trying to separate Navarro from the president, perhaps hoping that Trump, at heart, supports trade. However, it is quite possible that Navarro is in government because Trump is more in the anti-trade camp than the *WSJ* would care to admit.[14]

Tax threat: For now, the tax cuts enacted late last year are safe. However, there is growing evidence that the Democrats are considering enacting bills in the House that would raise the marginal rate.[15] Again, these would have no chance getting through the Senate or surviving a veto. However, the mere threat of changing the rate will affect corporate behavior. After all, the Democrats might return to power at some point and make a play to raise the marginal rate. If businesses begin to fear this outcome, they will be inclined to use the tax code for short-term benefits rather than for long-term investment.

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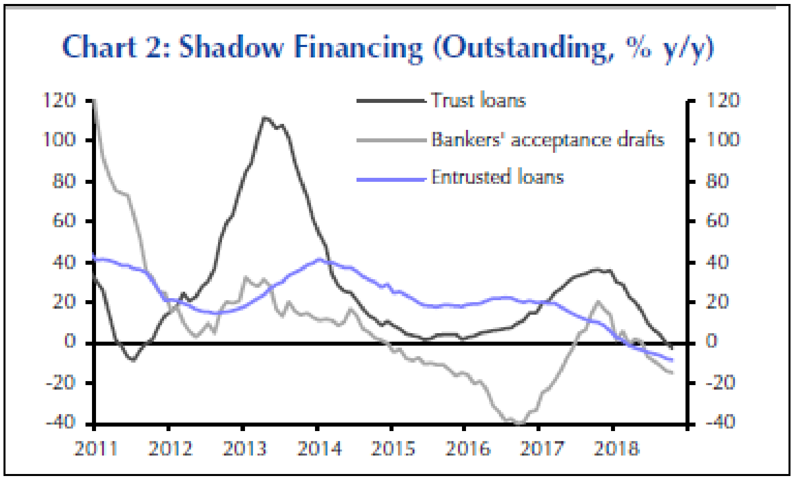
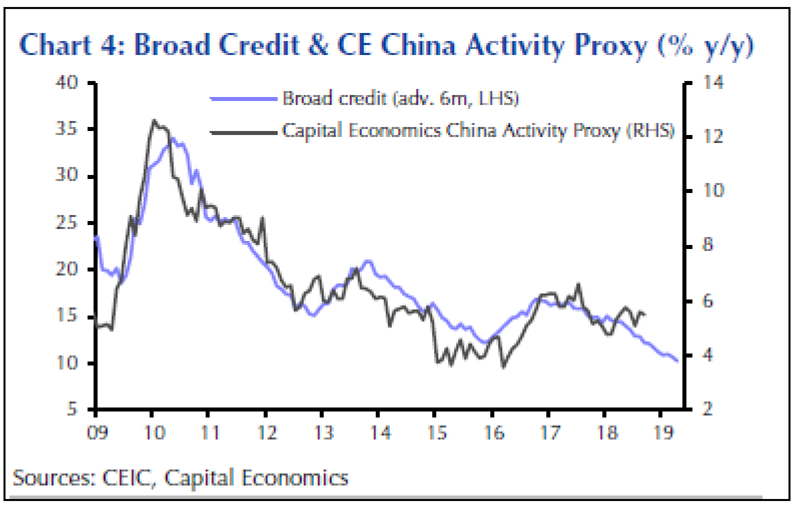
8 https://www.axios.com/donald-trump-automobile-tariffs-trade-war-b4f472c8-7e52-4748-b216-fd1c49794c3c.html
9 https://www.wsj.com/articles/u-s-china-resume-talks-to-cool-trade-tensions-1542064355
10 https://www.wsj.com/articles/u-s-china-trade-tensions-on-display-at-shanghai-expo-1541590039
11 https://www.wsj.com/articles/u-s-deploys-new-tactics-to-curb-chinas-intellectual-property-theft-1542027624
12 https://www.nytimes.com/2018/11/12/business/europe-trade-usa.html
13 https://www.nytimes.com/2018/11/12/us/politics/trump-nato-trade.html?emc=edit_mbe_20181113&nl=morning-briefing-europe&nlid=567726720181113&te=1
14 https://www.wsj.com/articles/peter-navarros-politburo-playbook-1542068623
15 https://www.bloombergquint.com/uselections/tax-overhaul-might-be-imperiled-as-democrats-eye-corporate-hike#gs.R3==Gno

China data: China released data on its credit markets and the bottom line is that the pace of borrowing is slowing. Bank loans increased in October by CNY 697 billion, down from CNY 1.38 trillion in September. Some of that decline is seasonal as the first week of October is a holiday week, but growth was +13.1% from last year, down from +13.2% a year ago. Shadow bank financing is falling rapidly, too.



(Source: Capital Economics)

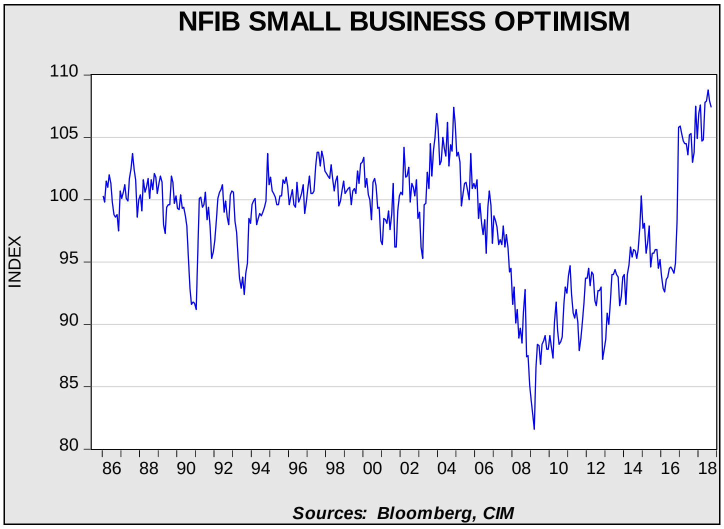
According to Capital Economics, Chinese economic growth continues to slow.



So far, the Xi government's push to boost the economy doesn't seem to be working.

U.S. Economic Releases

NFIB small business optimism came in below expectations at 107.4 compared to the forecast of 108.0.



The chart above shows the level of small business optimism. In spite of the unexpected decline, small business optimism is still near all-time highs.

The table below lists the economic releases and Fed events scheduled for today.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Monthly Budget Statement	m/m	oct	-$100.0 bn	-$63.2 bn	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
10:00	Neel Kashkari Speaks at Conference on Immigration	President of the Federal Reserve Bank of Minneapolis				
10:00	Lael Brainard Speaks on AI and New Financial Landscape	Member of the Board of Governors				
14:20	Patrick Harker Speaks at Fintech Conference	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	Money Supply M1	y/y	oct	2.7%	4.0%	4.2%	**	Equity bearish, bond bullish
	New Yuan Loans CNY	m/m	oct	697.0 bn	1380.0 bn	904.5 bn	**	Equity bearish, bond bullish
	Aggregate Financing CNY	m/m	oct	728.8 bn	2205.4 bn	1300.0 bn	**	Equity bearish, bond bullish
India	CPI	m/m	oct	3.3%	3.8%	3.6%	***	Equity bullish, bond bearish
	Industrial Production	m/m	sep	4.5%	4.3%	4.3%	***	Equity bullish, bond bearish
Australia	ANZ Roy Morgan Weekly Consumption	m/m	nov	119.8	116.8		**	Equity bullish, bond bearish
	NAB Business Conditions	m/m	oct	12	15		**	Equity and bond neutral
	NAB Business Confidence	m/m	oct	4	6		**	Equity and bond neutral
New Zealand	Food Prices	m/m	oct	-0.6%	-0.1%		**	Equity and bond neutral
EUROPE								
Germany	CPI	y/y	oct	2.5%	2.5%	2.5%	***	Equity and bond neutral
	CPI EU Harmonized	m/m	oct	2.4%	2.4%	2.4%	***	Equity and bond neutral
	ZEW Survey Current Situations	m/m	nov	58.2	70.1	65.0	**	Equity bearish, bond bearish
	ZEW Survey Expectations	m/m	nov	-24.1	-24.7	-26.0	**	Equity and bond neutral
France	Wages	q/q	3q	0.3%	0.4%	0.4%	**	Equity and bond neutral
U.K.	Claimant Count Rate	m/m	oct	2.7%	2.6%		***	Equity and bond neutral
	Jobless Claims Change	m/m	oct	20.2k	18.5k		**	Equity and bond neutral
	Average Weekly Earnings	m/m	sep	3.0%	2.7%	3.0%	***	Equity and bond neutral
Switzerland	Producer and import prices	m/m	oct	2.3%	2.6%	2.2%	***	Equity and bond neutral
AMERICAS								
Canada	Bloomberg Nanos Confidence	m/m	nov	57.6	57.6		***	Equity and bond neutral
Brazil	Retail Sales	y/y	sep	0.1%	4.1%	1.5%	***	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)	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)	234	234	0	Up
10-yr T-note (%)	3.17	3.18	-0.01	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	50	48	2	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
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	$68.86	$70.12	-1.80%	Supply Optimism
WTI	$58.75	$59.93	-1.97%	
Natural Gas	$3.98	$3.79	5.04%	
Crack Spread	$16.10	$16.08	0.12%	
12-mo strip crack	$18.10	$18.10	0.01%	
Ethanol rack	$1.41	$1.41	-0.04%	
Metals				
Gold	$1,199.20	$1,200.37	-0.10%	
Silver	$14.06	$14.00	0.41%	
Copper contract	$271.35	$267.65	1.38%	
Grains				
Corn contract	$ 369.75	$ 371.25	-0.40%	
Wheat contract	$ 516.25	$ 519.75	-0.67%	
Soybeans contract	$ 888.50	$ 883.25	0.59%	
Shipping				
Baltic Dry Freight	1125	1147	-22	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.1		
Gasoline (mb)		0.5		
Distillates (mb)		-2.2		
Refinery run rates (%)		1.00%		

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.

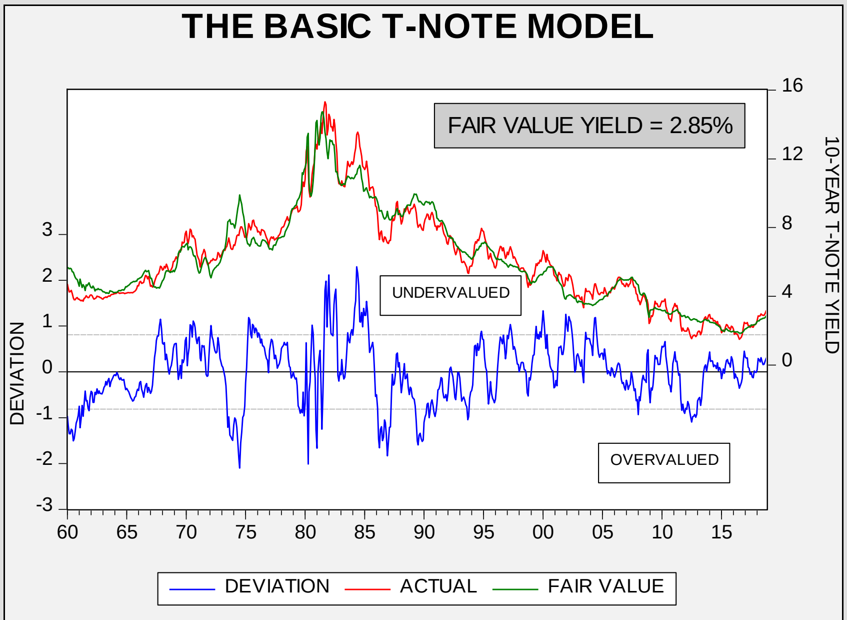
Asset Allocation Weekly Comment

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.

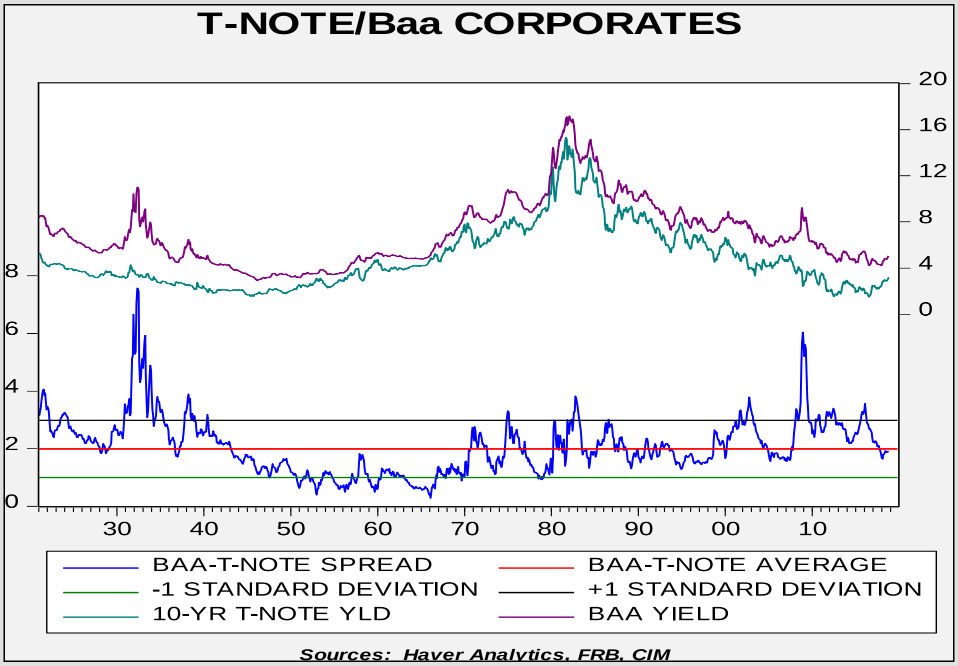
This chart is our 10-year T-note model. It incorporates fed funds, the Japanese yen exchange rate, German sovereign 10-year yields, oil prices, the fiscal deficit as a percentage of GDP and an inflation proxy.[16]



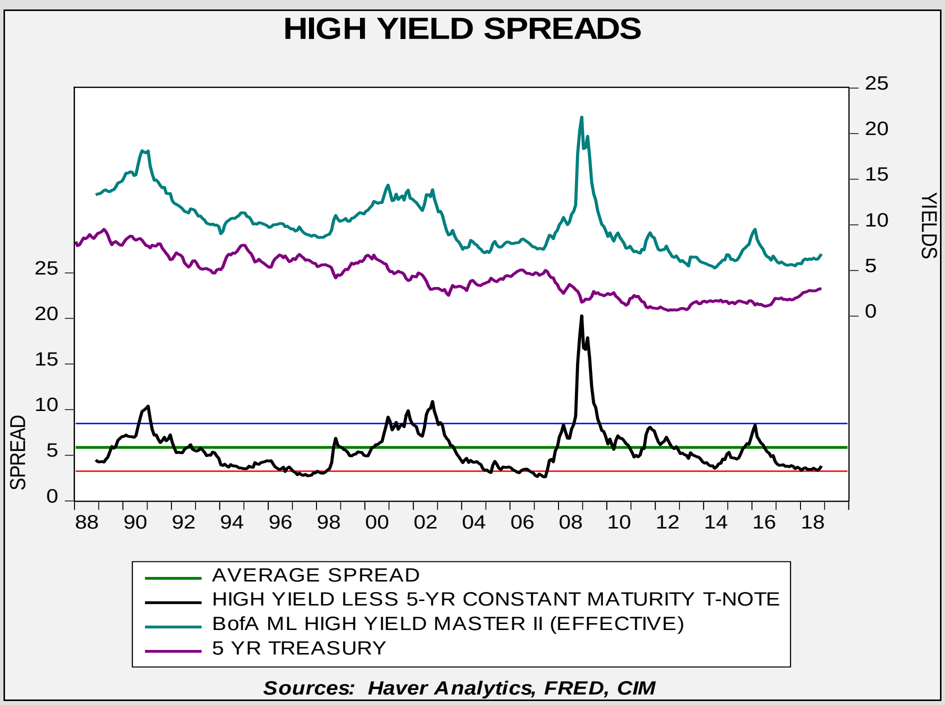
This model does suggest current 10-year yields are elevated, but not at extreme levels. However, if we assume a terminal fed funds rate of 3.25%, assuming no change in the rest of the variables in the model, fair value for the 10-year rises to 3.27%, which is near current levels. Thus, we can postulate 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.

[16] 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.

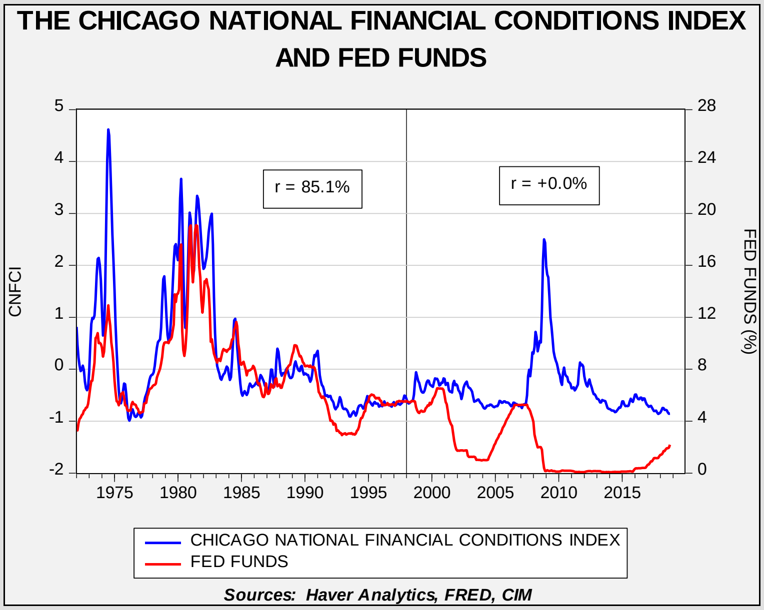
Thus far, the impact on credit spreads from rising Treasury yields has been minor. The chart below shows investment grade spreads. Current investment grade spreads are holding near their long-term average.



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



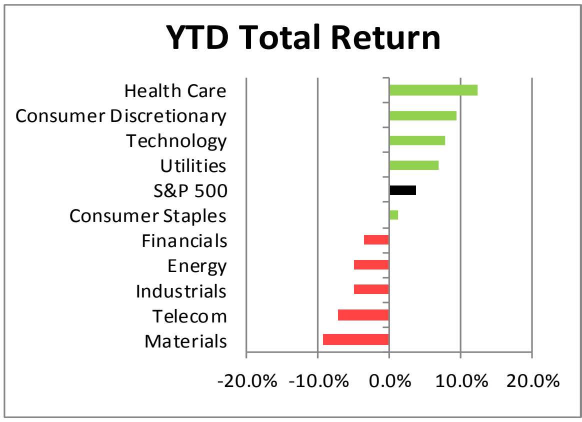
The lack of spread widening is consistent with the continued low level of stress in the financial system.

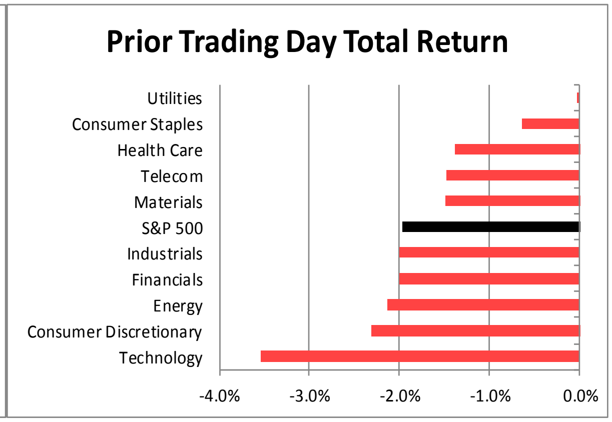


This chart shows fed funds with the Chicago FRB National Financial Conditions Index; the index rises when stress increases (or, put another way, when financial conditions deteriorate). From 1973 (when the index data begins) until 1997, the two series were tightly correlated; if the FOMC raised rates, 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 11/12/2018 close)

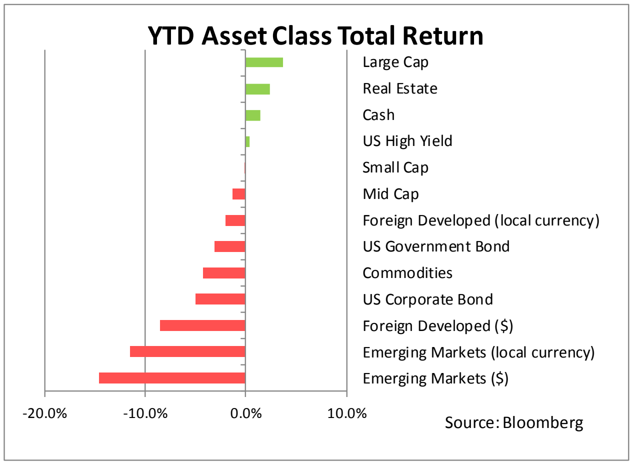




(Source: Bloomberg)

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 11/12/2018 close)

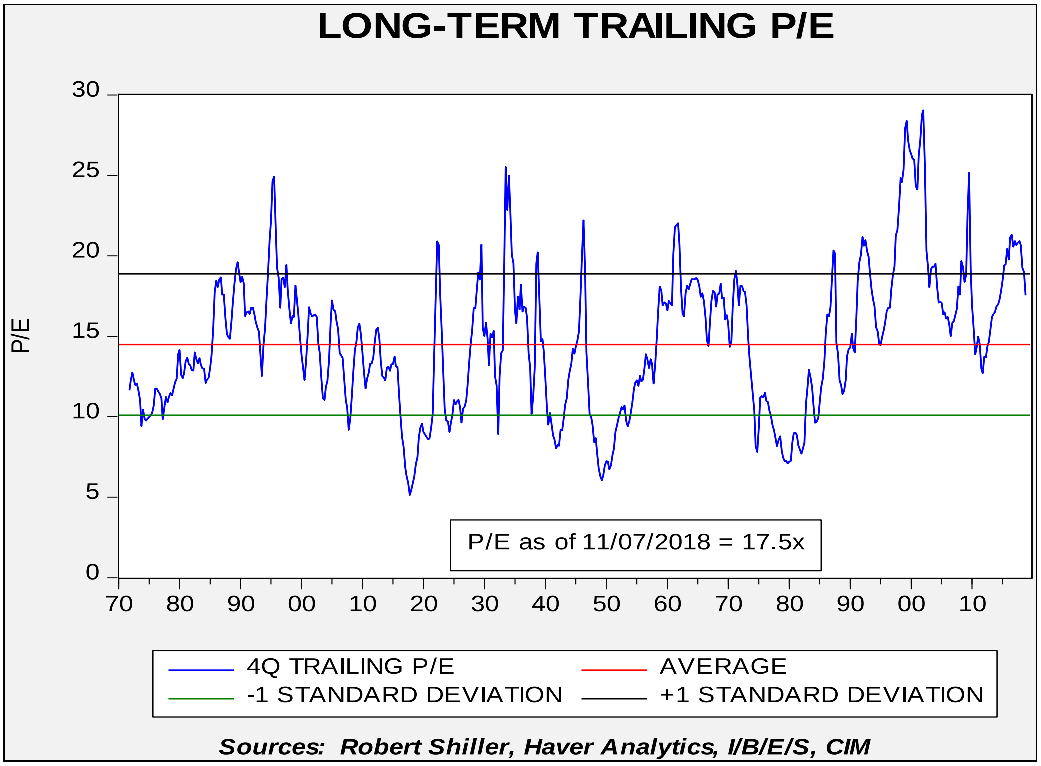


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[17] 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.

[17] 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.