Daily Comment

By Bill O'Grady, Thomas Wash, and
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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 14, 2019—9:30 AM EST] Global equity markets are generally mixed this morning. The EuroStoxx 50 is down 0.2% from its last close. In Asia, the MSCI Asia Apex 50 closed down 0.4%. Chinese markets were mixed, with the Shanghai composite up 0.2% and the Shenzhen index up 0.6% from the prior close. U.S. equity index futures are signaling a lower open. With 452 companies having reported, the S&P 500 Q3 earnings stand at $42.50, higher than the $41.08 forecast for the quarter. The forecast reflects a 4.0% decrease from Q3 2018 earnings. Thus far this quarter, 75.4% of the companies reported earnings above forecast, while 17.7% reported earnings below forecast.

Episode #3 of our *Confluence of Ideas* podcast is now available.

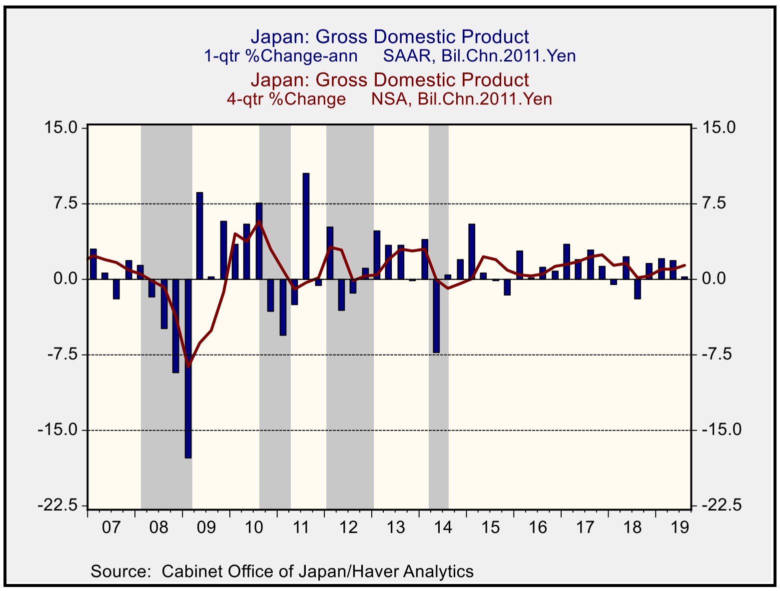
Hong Kong is deteriorating rapidly. Trade talks continue, but friction is emerging. Global economic data was 'meh.' Powell follows up his Congressional testimony today. Worries about disease. Here are all the details and more:

Hong Kong: Conditions in Hong Kong continue to deteriorate. As we noted yesterday, the protests have moved from being a merely weekend event to daily. Protestors are increasingly destroying public property, such as tollbooths and vandalizing train stations. They are also aggressively disrupting auto traffic by lighting up barricades. Today, the area closed schools due to the civil disruption. Mainlander students have been threatened and attacked by Hong Kong students; groups are arranging to rescue these students. Civil order is breaking down in a profound manner; violence by both sides is elevated, and Hong Kong citizens have been remarkably tolerant of the disorder. So far, Beijing has not cracked down but the increasing violence is reaching a point where a harsh reaction is increasingly likely. Our take is that a full-blown crackdown will likely make any conciliatory moves on trade by the administration impossible. The violence, if not quelled soon, is becoming a risk to financial markets.

Trade: According to reports, trade talks are stalling over agricultural purchases. On the surface, this doesn't make any sense. Chinese food prices are soaring, and a clear remedy is to import agricultural products in massive quantities. Additionally, U.S. farmers and ranchers have that supply. The problem comes down to process. USTR Lighthizer has a long history in forming trade agreements with clear targets and responses if the targets are not met. The U.S. is demanding that China "provide monthly, quarterly and annual targets for purchases." It is likely that if these numbers are not met, the U.S. would be able to retaliate with additional tariffs. China has good reason to avoid hard numbers; by forcing Chinese buyers to purchase American goods, they could find themselves unable to arbitrage lower prices from other sources.[1] China is making concessions in other areas, e.g., opening its markets to U.S. poultry.

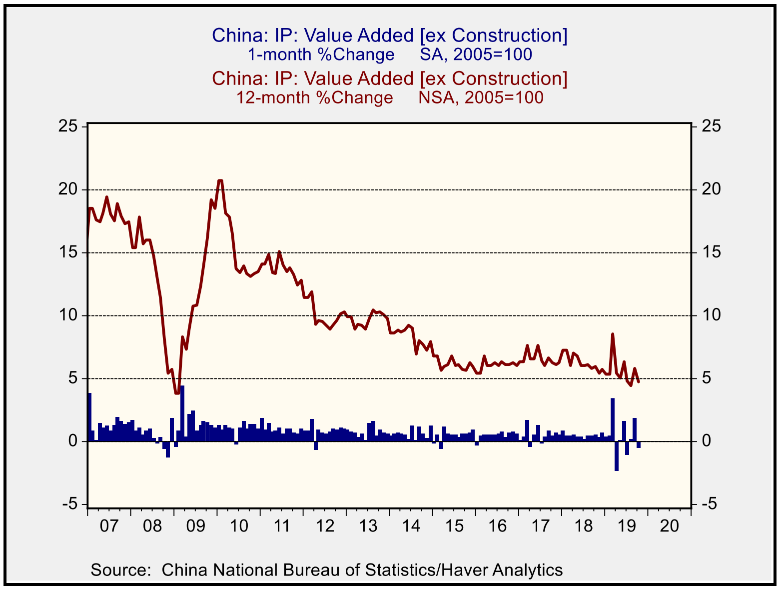
In addition to farm product issues, China is apparently balking at strong enforcement mechanisms for technology transfers. At the same time, the U.S. is reluctant to remove any tariffs without clear concessions from China. China, of course, wants to see the U.S. remove tariffs to begin talks. It is possible that both sides believe they need a narrative that shows the other side capitulated. If so, the odds of a deal are much longer than the market currently thinks.

Global economic data: Japan's GDP rose an annualized 0.2%, the weakest growth this year. The data was adversely affected by some one-off events, such as Typhoon Hagibis, but trade friction with South Korea and a slowing Chinese economy are also causing problems.



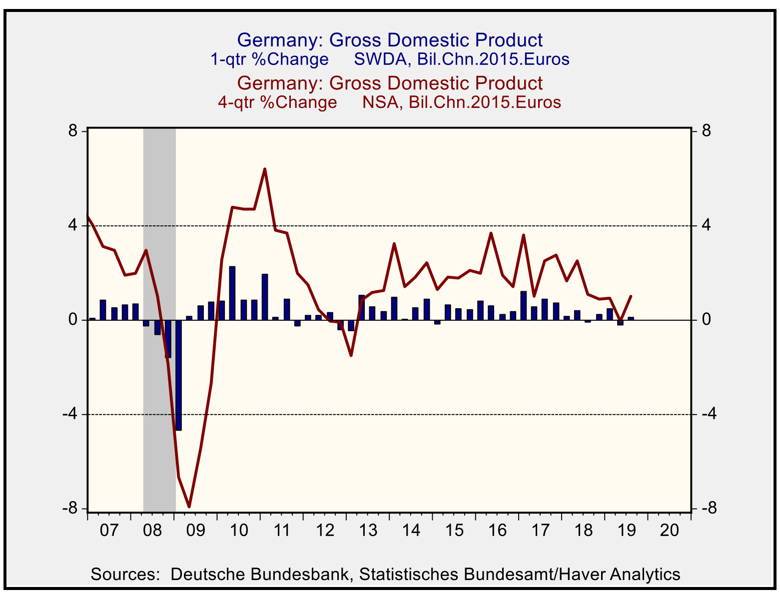
China's data mostly disappointed investors. China's industrial production came in weaker than forecast, up 4.7% from last year, less than the 5.4% expected. Private firms showed the most weakness, as state-owned firms' production was steady.

[1] This is a short-run problem. Agriculture commodities tend to close arbitrage windows fairly quickly; it would not even be unheard of for U.S. supplies to buy Brazilian grain to meet China's quotas. But, such arrangements mean that China will likely pay higher prices.



[Investment was also weak](), rising 5.2% through the first nine months of the year compared to the same period last year. Capital spending dipped to 3.7% in October, down from 4.8% in September. Retail sales disappointed as well, rising 7.2% compared to forecasts of +7.8%.

About the only bright spot was Germany, who saw its GDP rise 0.1%, avoiding the layman's definition of recession (two consecutive negative quarters of GDP growth) but still very sluggish growth.



Powell: The testimony was modestly dovish. In this press conference after the last meeting, Powell seemed to suggest the risks to the economy were balanced. At the testimony, he seemed to signal that there was perhaps more risk to the downside, suggesting that the odds of the next move being a cut is higher.

Germany-Russia: The German parliament has passed one of the final legal changes needed for Russia to complete its Nord Stream 2 gas pipeline to Germany. The law exempts the project from EU rules forbidding one entity to be both the producer and the supplier of natural gas. If the pipeline is soon completed as expected, the U.S. administration has threatened to impose sanctions on it, which would likely be a source of tension and headwinds for European stocks.

United States-North Korea: After signaling its frustration at stalled denuclearization talks over the last several months, North Korea yesterday threatened to take a "new path" if the United States and South Korea resume the joint military exercises next month as planned. Any resumption of North Korea's provocative acts would likely hurt Asian stocks.

Brexit: The Liberal Democrats have indicated they would not join a coalition with Labour if Corbyn is the PM. The Brexit party will still run candidates in key Labour seats, a disappointment to the Tories.

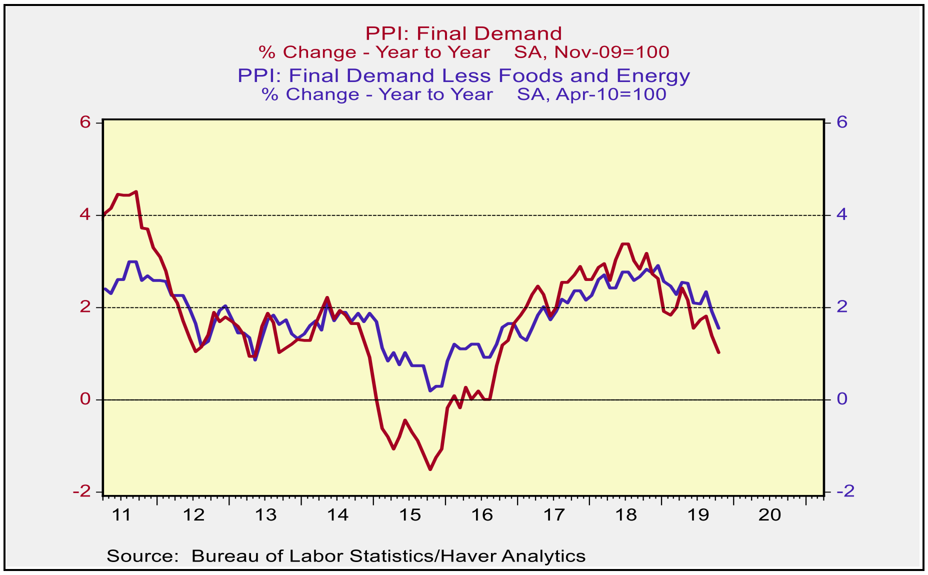
Turkey: Turkish President Erdogan received a warm welcome from President Trump yesterday. However, his meetings with Senate leaders did not go well. The Senate is rather unified on defying Turkey, and could force the president to veto sanctions at some point.

Bugs: If there isn't enough to worry about, the CDC warns that new viruses, bacteria and fungi that are resistant to antibiotics are resulting in 35k deaths per year. China has confirmed at least two cases of pneumonic plague. This version is a less known type of plague (bubonic caused the Black Death) but is actually more of a problem. The pneumonic version can be transmitted human to human via the lungs; bubonic requires a flea bite. So far, the Chinese situation appears under control but if it were to spread, it could be difficult to control. It is curable with antibiotics.

Odds and ends. Gang activity, originating in Sweden, has prompted Denmark to reinstitute border checks on ground traffic coming from northern countries. Supporters of Juan Guaido seized the Venezuelan embassy in Brasilia, creating a standoff with security officials from both Venezuela and Brazil.

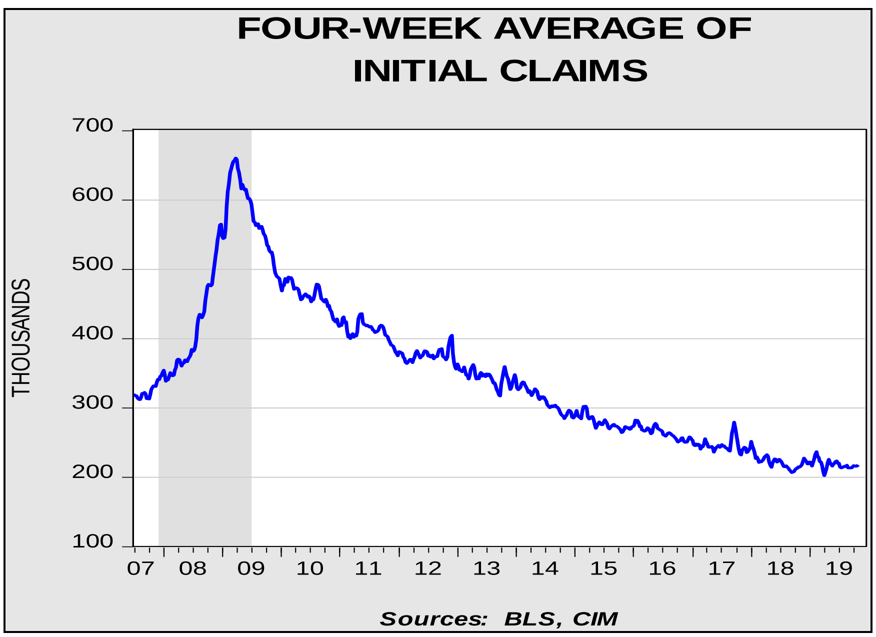
U.S. Economic Releases

PPI final demand came in above expectations, rising 0.4% from the prior month, compared to a forecast of 0.3%. PPI excluding food and energy also came in above expectations, rising 0.4% from the prior month compared to a forecast rise of 0.2%. Core PPI, which excludes food, energy and trade services, came in below expectations, rising 0.1% from the prior month compared to the forecast rise of 0.2%.



The chart above shows the year-over-year change in headline PPI and core PPI, which rose 1.1% and 1.6%, respectively.

Initial jobless claims came in above expectations at 225k compared to the forecast of 215k.



The chart above shows the four-week moving average for initial claims. The four-week moving average rose from 215.25k to 217.00k.

The table below shows the Economic Releases and the Fed events scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Consumer Comfort	m/m	nov		59.1	**
	Mortgage Delinquencies	q/q	3q		4.5%	**
	MBA Mortgage Foreclosures	q/q	3q		0.9%	**
Fed Speakers or Events						
	Speaker or event	District or position				
10:00	Jerome Powell Addresses House Budget Committee	Chairman of Board of Governors of Federal Reserve				
11:45	Mary Daly Makes Opening Remarks at Economic Policy Conference	President of the Federal Reserve Bank of San Francisco				
12:00	John Williams speaks at Economic Policy Conference	President of the Federal Reserve Bank of New York				
12:20	James Bullard Speaks in Louisville	President of the Federal Reserve Bank of St. Louis				
13:00	Robert Kaplan Speaks at Community Forum Texas	President of the Federal Reserve Bank of Dallas				

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	Industrial Production	y/y	oct	5.6%	5.6%	5.6%	***	Equity and bond neutral
	Retail Sales	y/y	oct	7.2%	7.8%	7.8%	**	Equity bearish, bond bullish
	Surveyed Jobless	m/m	oct	5.1%	5.2%		***	Equity and bond neutral
Japan	GDP Annualized	q/q	3q	0.2%	1.3%	0.9%	***	Equity bearish, bond bullish
	Tertiary Industry Index	m/m	sep	1.8%	0.4%	1.1%	**	Equity bullish, bond bearish
India	Wholesale Prices	y/y	oct	0.2%	0.3%	-0.2%	**	Equity bullish, bond bearish
Australia	Employment Change	m/m	oct	-19.0k	14.7k	15.0k	**	Equity and bond bearish
	Unemployment Rate	m/m	oct	5.3%	5.2%	5.3%	***	Equity and bond neutral
New Zealand	REINZ House Sales	m/m	oct	-4.0%	3.3%		**	Equity and bond bearish
EUROPE								
Eurozone	Employment Change	y/y	oct	1.0%	1.2%		**	Equity and bond neutral
	GDP	y/y	oct	1.2%	1.1%	1.1%	***	Equity and bond neutral
France	ILO Unemployment Change	y/y	3q	8.6%	8.5%	8.6%	**	Equity and bond neutral
	ILO Mainland Unemployment	y/y	3q	10k	-66k		***	Equity bullish, bond bearish
	CPI	y/y	oct	0.8%	0.7%	0.7%	***	Equity bearish, bond bullish
Russia	Retail Sales ex Auto Fuel	y/y	oct	2.7%	3.0%	3.4%	**	Equity bearish, bond bullish
	Retail Sales inc Auto Fuel	y/y	oct	3.1%	3.1%	3.7%	**	Equity bearish, bond bullish
Switzerland	Producer and import prices	y/y	oct	-2.4%	-2.0%	-2.2%	**	Equity bullish, bond bearish
Russia	GDP	y/y	3q	1.7%	0.9%	1.7%	***	Equity and bond neutral
AMERICAS								
Brazil	Retail Sales	y/y	sep	2.1%	1.3%	2.1%	***	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)	191	190	1	Down
3-mo T-bill yield (bps)	153	154	-1	Neutral
TED spread (bps)	38	37	1	Neutral
U.S. Libor/OIS spread (bps)	154	154	0	Up
10-yr T-note (%)	1.84	1.89	-0.05	Down
Euribor/OIS spread (bps)	-40	-40	0	Neutral
EUR/USD 3-mo swap (bps)	16	16	0	Down
Currencies	**Direction**			
dollar	Flat			Up
euro	Flat			Down
yen	Up			Down
pound	Flat			Up
franc	Up			Up

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	$63.11	$62.37	1.19%	Supply Pessimism
WTI	$57.70	$57.12	1.02%	
Natural Gas	$2.66	$2.60	2.31%	Warmer weather expected in USA.
Crack Spread	$15.51	$15.34	1.11%	
12-mo strip crack	$17.91	$17.70	1.20%	
Ethanol rack	$1.68	$1.68	-0.18%	
Metals				
Gold	$1,468.47	$1,463.58	0.33%	
Silver	$17.04	$16.97	0.41%	
Copper contract	$264.90	$263.95	0.36%	
Grains				
Corn contract	$ 376.75	$ 375.25	0.40%	
Wheat contract	$ 514.75	$ 513.75	0.19%	
Soybeans contract	$ 914.00	$ 915.25	-0.14%	
Shipping				
Baltic Dry Freight	1365	1354	11	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.5		
Gasoline (mb)		-1.3		
Distillates (mb)		-1.0		
Refinery run rates (%)		1.00%		
Natural gas (bcf)		-2.0		

Weather

The 6-10 day forecast is calling for colder temperatures for the Midwest and East Coast, with warmer-than-normal temperatures in the western half of the country. Wet conditions are expected for most of the country, excluding northern California. The 8-14 day forecast is signaling a broad warming trend for both coasts with normal temps in the nation's midsection. Colder-than-normal temps will dominate the southwest.

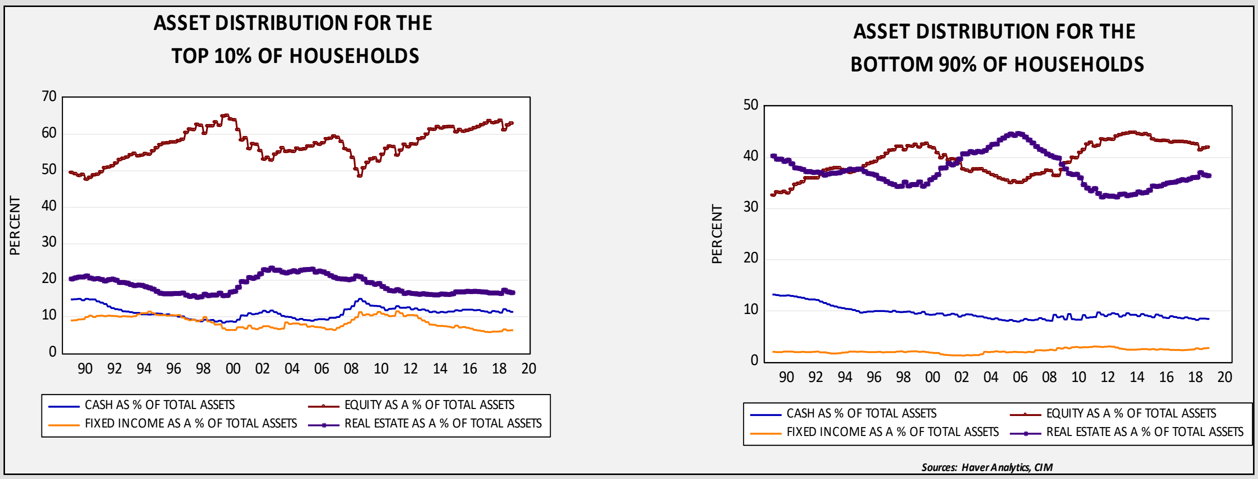
Asset Allocation Weekly

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 8, 2019

The Federal Reserve, in its Financial Accounts of the United States database,[2] has created a Distributional Financial Accounts sub-database that measures household wealth by percentile groups. The data is only reported in four broad categories (Top 1%, 90% to 99%, 50% to 89%, and bottom 50%) and has a fairly short history, starting in Q3 1989. However, even with these limitations, it offers some interesting insights into which different segments of society hold wealth.

For starters, we group the data by the top 10% compared to the bottom 90%.



Both charts compare four categories of wealth—cash, equities, fixed income and residential real estate, including vacant land—relative to total assets. A clear distinction between the two groups is that the top 10% hold most of their wealth in equities. Real estate represents less than 20% for the top 10% but it's around 40% of assets for the bottom 90% of households. Equities represent around 40% of assets for the bottom 90% as well. This tells us that booms and busts affect households differently relative to their wealth; a housing boom tends to make the bottom 90% wealthier, while a bull market in stocks is a bigger deal to the top 10%.

The ratio of equity and real estate wealth for the top 10% to the bottom 90% highlights this factor.

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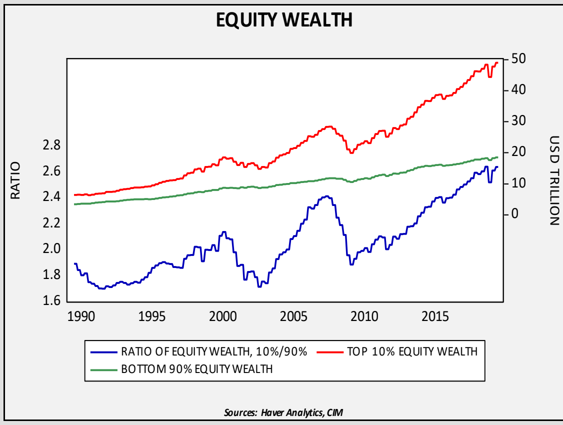
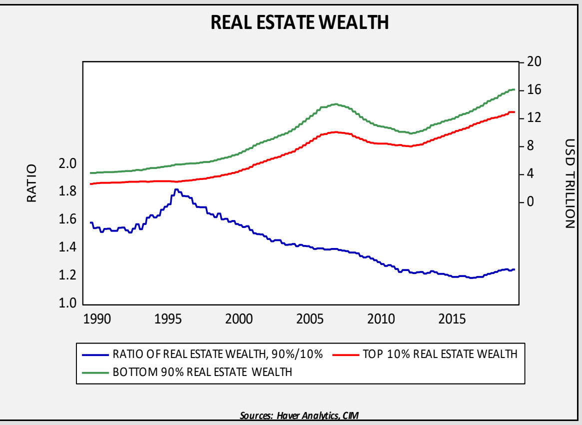
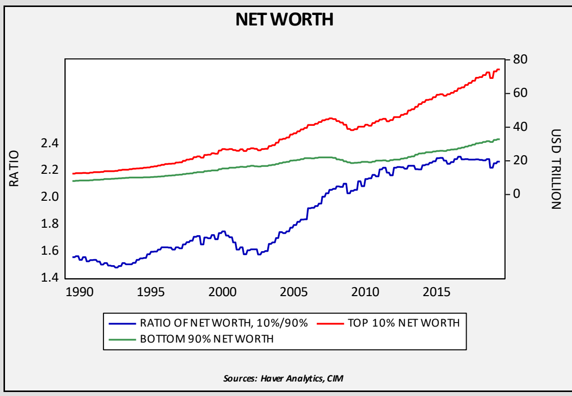
[2] This database was previously called the "Flow of Funds."

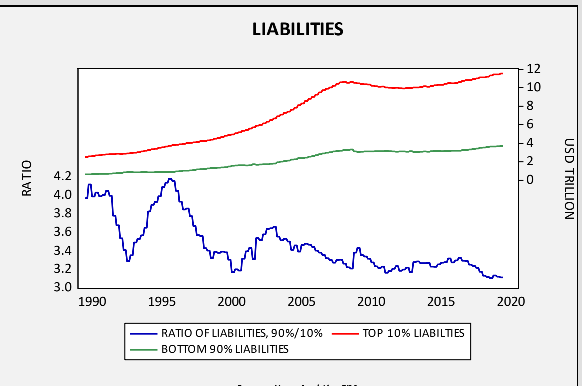




Currently, the equity wealth of the top 10% exceeds the bottom 90% by 2.6x. In terms of real estate, the bottom 90% hold more in total terms, but the two segments tend to mirror each other.

Finally, the ratios of net worth and liabilities show a similar pattern.





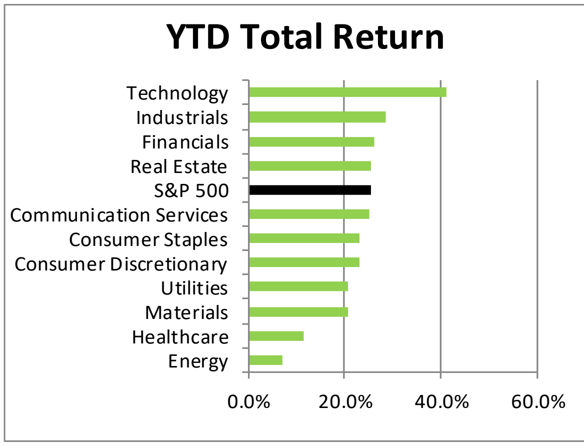
The top 10% net worth exceeds the net worth of the bottom 90% by 2.2x. Liabilities of the bottom 90% exceed those of the top 10% by 3.1x.

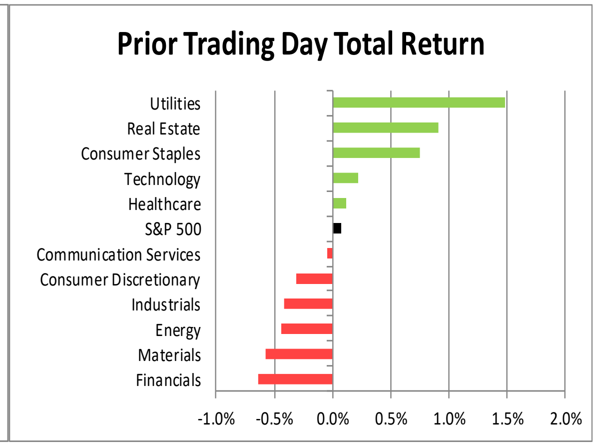
These charts show the relative risk to the economy from various market events. A bear market in equities will have much less of an impact on the economy than would declining home prices. Higher borrowing costs will hurt the bottom 90% more than the top 10%. And, in terms of net worth, the difference between the top 10% and the bottom 90% highlights the precarious nature of the latter.

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

Data Section

U.S. Equity Markets – (as of 11/13/2019 close)

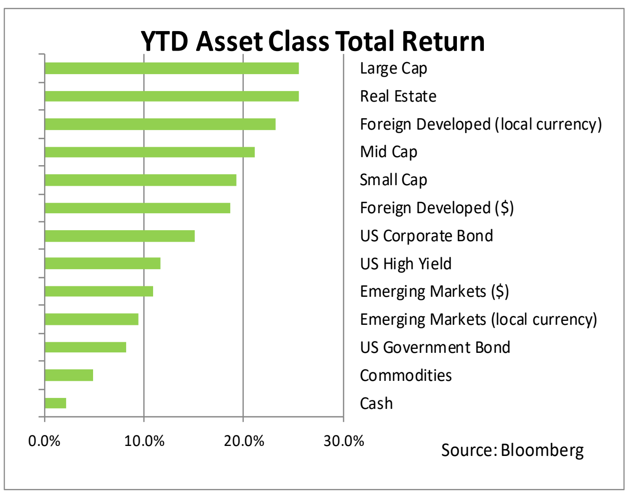




(Source: Bloomberg)

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. These charts represent the new sectors following the 2018 sector reconfiguration.

Asset Class Performance – (as of 11/13/2019 close)

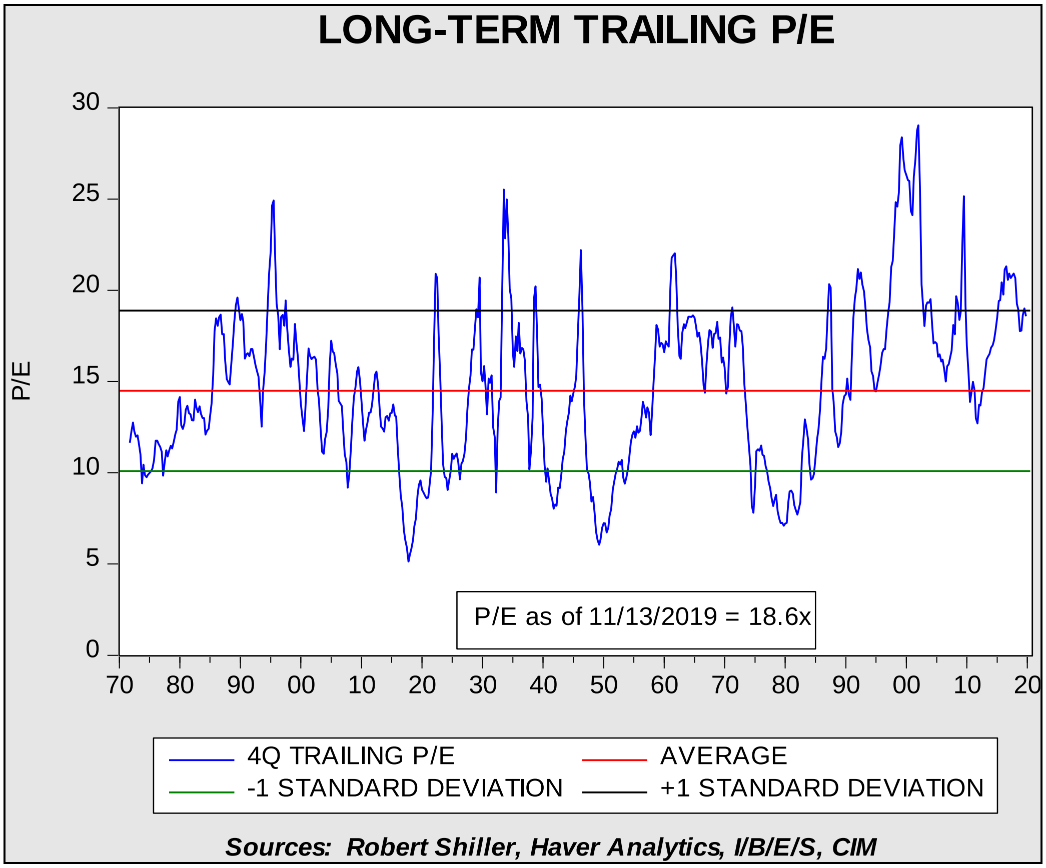


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

November 14, 2019



Based on our methodology,[3] the current P/E is 18.5x, up 0.1x from last week. The rise in the P/E is due to higher equity prices.

[3] 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 (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.