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 20, 2018—9:30 AM EST] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.9% from the last close. In Asia, the MSCI Asia Apex 50 was down 1.7% from the prior close. Chinese markets were lower, with the Shanghai composite down 2.3% and the Shenzhen index down 2.1%. U.S. equity index futures are signaling a lower open.

(NB: The Daily Comment will go on hiatus beginning Wednesday, November 21st, returning on Monday, November 26th. From all of us at Confluence Investment Management, have a Happy Thanksgiving!)

Another down day for equities—stocks continue their slide. News flow was surprisingly light overnight. Here is what we are watching:

Equity markets: Stock markets around the world continue to struggle. Although there are some earnings issues, for the most part, weakness is coming from multiple contraction, suggesting investor sentiment is waning. The current weakness is specific to two factors—fears based on Fed policy and Trump administration trade policy. The first problem is not unusual. The FOMC has been steadily raising rates and we are now seeing the policy rate reach a level that, by itself, isn't necessarily restrictive but could become so in short order if comments from Fed officials are accurate on the future path of tightening. A related concern is that policymakers appear to be abandoning, or at least questioning, the Phillip's Curve construct without offering another framework for setting policy. One trend that does appear to be in place, however, is that investors, for the first time in years, appear to be considering cash and near cash instruments as an asset class. In simpler terms, "cash is no longer trash."

The trade issue is much more confounding. Since the end of WWII, U.S. trade policy has been set on open and free trade. In practice, this meant the U.S. acted as importer of last resort and ran persistent trade deficits to provide the world with the dollar, the global reserve currency. Although this policy was key to winning the Cold War and boosting globalization, it has detrimental effects on equality in the U.S. It has become clear that political support for free trade is waning; in the last presidential campaign, for example, both candidates promised to jettison TTP, a trade arrangement with the Pacific Rim. Restricting trade will tend to undermine efficiency and eventually lead to higher inflation. However, in the short run, the more likely impact will be a reduction in margins.

What is generally unappreciated about the administration's trade policy is that it appears to be a reversal of over seven decades of U.S. policy. In fact, we would argue that the last time the U.S.

took broad actions to restrict imports was during the 1920s. Thus, no economist today has a working economic model that incorporates deglobalization. This creates uncertainty which the equity markets are struggling to discount.

Currently, there is hope of some sort of trade truce at the G-20. The continued weakness in equities may be enough to lead the president to "call off the dogs" for a period of time. However, our view is that the president's core belief is anti-trade, at least in the form the U.S. has pursued since WWII.[1] We believe the person in the administration that most closely mirrors the president's trade policy is Robert Lighthizer. His view essentially favors the deglobalization of supply chains—in other words, he wants to bring production back to the U.S.[2] The policy is also treating China as a strategic competitor,[3] in a fashion not like we treated the Soviet Union, but more like how Britain viewed Germany before WWI. Thus, any easing of trade tensions that come from the G-20 probably won't last. Instead, the goal will be to stabilize markets. So, we would not be surprised to see the president attempt to temporarily ease market concerns but one should be cautious about expecting a retreat from trade policy.

After the holiday, we are launching a three-part series on the evolving superpower policy of the U.S.; it is titled "The Malevolent Hegemon." Our thesis is that the narrative that the U.S. is abandoning its hegemonic role is probably not true. Instead, the U.S. is changing how it exercises that role and doing it in a manner that is much less friendly to the rest of the world, thus shifting from the previous model we dub "The Benevolent Hegemon" to the Malevolent Hegemon. On trade, a key component is to shift trade negotiations from multilateral, which tends to restrict American power in trade, to bilateral, which enhances it. In the end, it isn't clear to us if it will work. But, we don't think the evolution of U.S. policy should be seen as isolationist.

Overall, the economy is still doing well and earnings, while probably peaking in terms of growth, will likely remain elevated. And, seasonally, we are in what is usually a bullish environment. Thus, we would not be surprised to see a recovery in the near term. But, a lift will likely need a catalyst, either in the form of a trade truce or some indication from the Fed that a pause in tightening policy is being considered.

Rising tensions in the royal family: The Khashoggi affair adds to previous evidence that the crown prince, Mohammad bin Salman, is mercurial and his policies could contribute to regional instability. As we argued in the last WGR, we would expect other potential claimants to the throne (the grandsons of Ibn Saud) to try and unseat MbS.[4] Reuters is reporting that the royal family is considering putting off the decision of which grandson will become king by putting the last "king-eligible" son of Ibn Saud, Prince Ahmed bin Abdulaziz, into the king's role after the

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[1] https://www.wsj.com/articles/trump-forged-his-ideas-on-trade-in-the-1980sand-never-deviated-1542304508
[2] https://www.ft.com/content/0cf1948c-ebba-11e8-89c8-d36339d835c0 and https://www.wsj.com/articles/a-silicon-valley-tech-leader-walks-a-high-wire-between-the-u-s-and-china-1542650707?tesla=y
[3] https://www.ft.com/content/6ffc7756-ec58-11e8-89c8-d36339d835c0?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56 and https://www.washingtonpost.com/technology/2018/11/19/trump-administration-proposal-could-target-exports-tech-behind-siri-self-driving-cars-supercomputers/?utm_term=.efba287538c0
[4] https://www.reuters.com/article/us-saudi-khashoggi-royals-exclusive/exclusive-after-khashoggi-murder-some-saudi-royals-turn-against-kings-favorite-son-idUSKCN1NO2KP

death of King Salman. Our fear is that the transition will not be smooth; MbS has become quite powerful and would likely move quickly after his father's death to secure power. We believe financial and commodity markets are underestimating the potential disruption to regional stability and the oil markets from succession.

EU sours on Iran: Although the EU clearly didn't care for the Trump administration's decision to exit the Iran nuclear deal, support for helping Iran break sanctions has taken a blow after Tehran was implicated in plots to assassinate Iranian dissidents in Denmark and France.[5] If Europe turns on Iran over these issues, it would be a diplomatic "own goal" for the mullahs. It would also be bullish for crude oil.

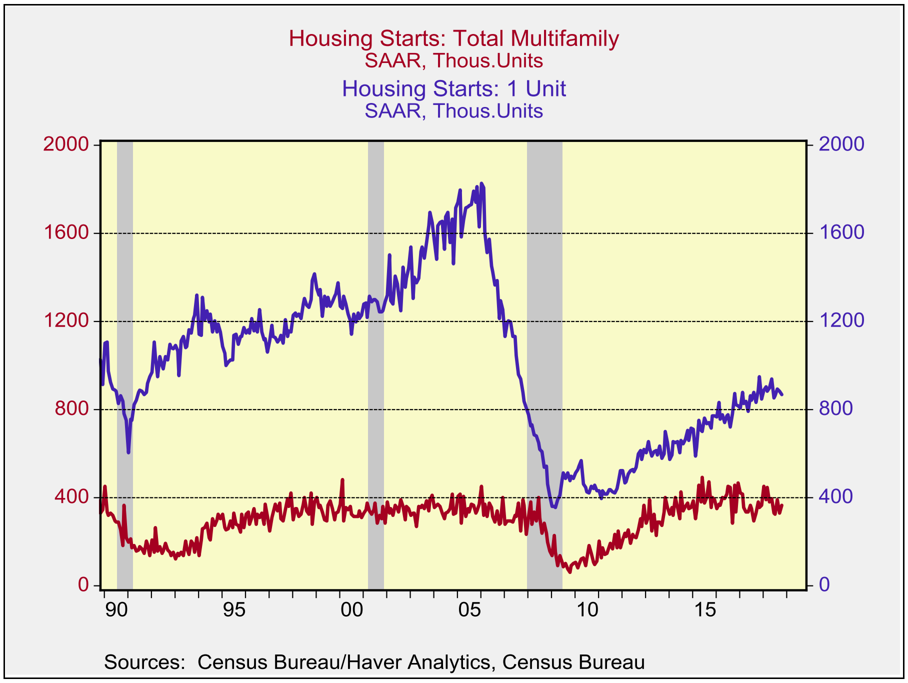
Brexit update: Not a whole lot more to report. The Tory rebels still don't have enough letters to bring a leadership vote. There is widespread discontent with the deal May negotiated with the EU but no one has come up with a better offer. The three outcomes—the current deal, a hard Brexit with no deal or a new referendum—all remain on the table. Given that neither the current deal nor a hard Brexit appears attractive, we would not be surprised to see a new referendum. It is not out of the question that the U.K. decides that being in the EU isn't all that bad (especially if one isn't in the Eurozone) and if the U.K. can negotiate some degree of border control on immigration (which, by the way, is happening all over Europe), we may see a reversal of Brexit.

The Swiss consider nationalism: This Sunday, Switzerland is holding a referendum on "self-determination" which would make the Swiss constitution supreme over any international treaties the country joins. Thus, if the Swiss pass a referendum at a future date that conflicted with an international treaty, the agreement would have to be either renegotiated or cancelled.[6] If this measure passes, it will make it very difficult for any future Swiss government to negotiate treaties because the other parties will never know if the pact will be rejected at some point by a future referendum. We view this vote as another example of rising opposition to globalization.

U.S. Economic Releases

October housing starts were in line with expectations at 1.228 mm units. The prior report was revised upward from 1.201 mm to 1.210 mm. Permits were above forecast at an annual rate of 1.263 mm units compared to the forecast of 1.260 mm units. The prior report was revised upward from 1.241 mm to 1.270 mm.

[5] https://www.reuters.com/article/us-iran-nuclear-eu/eu-open-to-iran-sanctions-after-foiled-france-denmark-plots-diplomats-idUSKCN1NO1OQ?il=0
[6] https://www.ft.com/content/67c3950a-e826-11e8-8a85-04b8afea6ea3



The chart above shows the level of starts for both multi-family and single-family starts. Single-family housing starts fell 2.6% from the prior year, while multi-family homes fell 3.7%. Housing starts rose 10.6% in the West and 5.0% in the Midwest, while housing starts fell 40.0% in the Northeast, and 3.4% in the South.

There were no economic release or Fed events scheduled for the rest of the day.

Foreign Economic News

We monitor numerous global economic indicators on a continuous basis. The most significant international news that was released overnight is outlined below. Not all releases are equally significant, thus we have created a star rating to convey to our readers the importance of the various indicators. The rating column below is a three-star scale of importance, with one star being the least important and three stars being the most important. We note that these ratings do change over time as economic circumstances change. Additionally, for ease of reading, we have also color-coded the market impact section, which indicates the effect on the foreign market. Red indicates a concerning development, yellow indicates an emerging trend that we are following closely for possible complications and green indicates neutral conditions. We will add a paragraph below if any development merits further explanation.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
Japan	Convenience Store Sales	y/y	oct	-1.5%	3.5%		**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	m/m	nov	117.8	119.8		**	Equity and bond neutral
EUROPE								
France	ILO Unemployment Rate	y/y	3q	9.1%	9.1%	9.2%	***	Equity and bond neutral
	Mainland Unemployment Change	y/y	3q	22k	-48k		***	Equity and bond neutral
Germany	PPI	y/y	oct	3.3%	3.2%	3.3%	**	Equity and bond neutral
U.K.	CBI Trends Total Orders	m/m	nov	10	-6	-5	**	Equity bullish, bond bearish
	CBI Trends Selling Prices	m/m	nov	9	10		**	Equity and bond neutral
Switzerland	Exports Real	m/m	oct	6.3%	-0.8%		**	Equity bullish, bond bearish
	Imports Real	m/m	oct	-3.6%	-0.4%		**	Equity and bond neutral
	Swiss Watch Exports	y/y	oct	7.2%	-6.9%		**	Equity and bond neutral
AMERICAS								
Canada	Bloomberg Nanos Confidence	m/m	nov	56.6	57.6		**	Equity and bond neutral
Brazil	Trade Balance Weekly	w/w	nov	$1.802 bn	$1.633 bn		**	Equity bullish, bond bearish

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)	264	264	0	Up
3-mo T-bill yield (bps)	233	233	0	Neutral
TED spread (bps)	32	31	1	Neutral
U.S. Libor/OIS spread (bps)	234	233	1	Up
10-yr T-note (%)	3.05	3.06	-0.01	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	31	31	0	Down
Currencies	Direction			
dollar	up			Neutral
euro	down			Neutral
yen	up			Neutral
pound	flat			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	$66.40	$66.79	-0.58%	
WTI	$57.12	$57.20	-0.14%	
Natural Gas	$4.49	$4.70	-4.43%	
Crack Spread	$15.31	$15.90	-3.71%	
12-mo strip crack	$18.33	$18.67	-1.81%	
Ethanol rack	$1.41	$1.41	0.10%	
Metals				
Gold	$1,226.25	$1,224.17	0.17%	
Silver	$14.46	$14.43	0.24%	
Copper contract	$280.60	$280.65	-0.02%	
Grains				
Corn contract	$ 373.50	$ 373.25	0.07%	
Wheat contract	$ 507.75	$ 506.50	0.25%	
Soybeans contract	$ 874.50	$ 873.75	0.09%	
Shipping				
Baltic Dry Freight	1023	1031	-8	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.5		
Gasoline (mb)		-0.5		
Distillates (mb)		-2.5		
Refinery run rates (%)		1.00%		

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temps for the western region and cooler temps for the rest of the country. Precipitation is expected for most of the country outside of the Midwest.

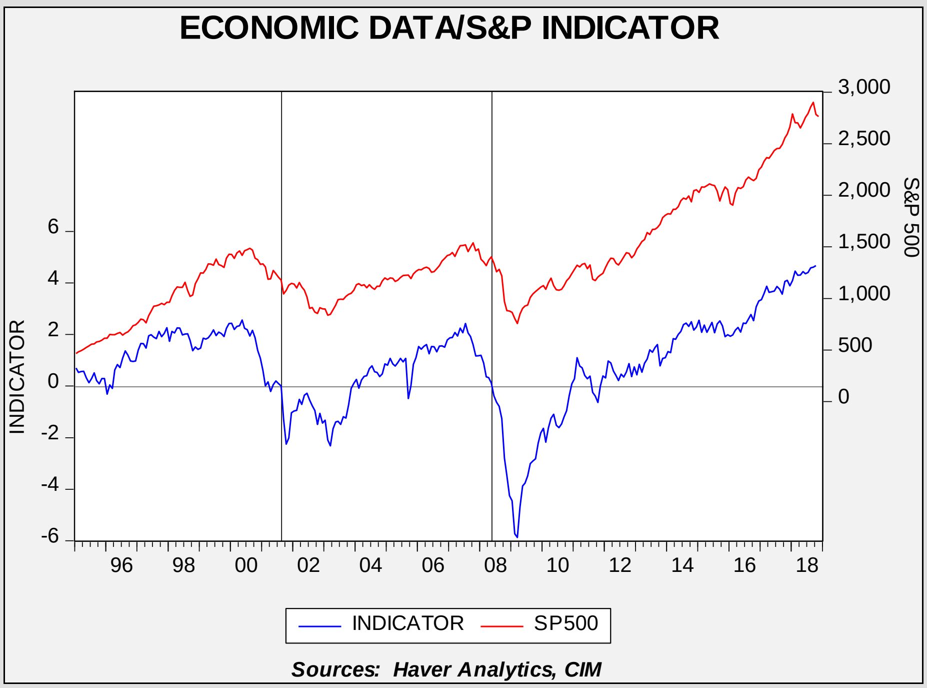
Asset Allocation Weekly Comment

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.

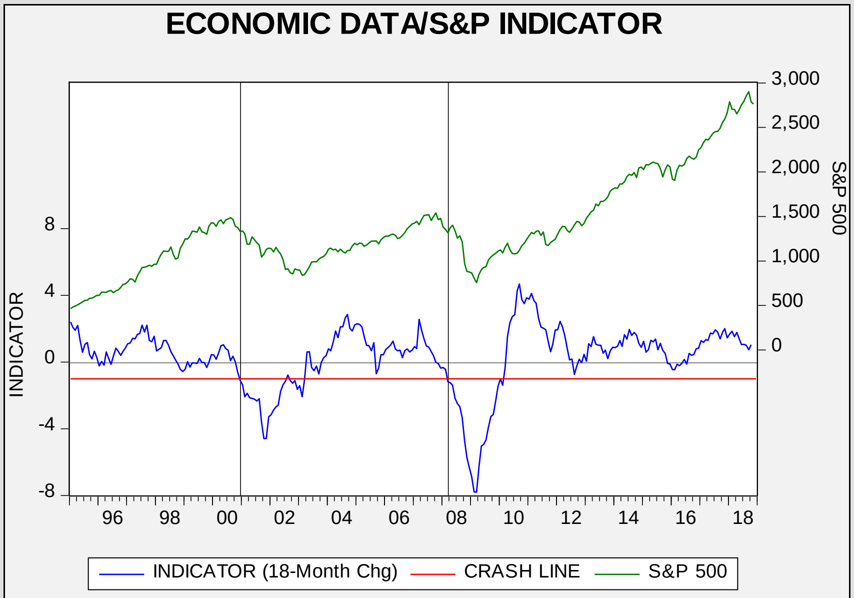
November 16, 2018

(NB: Due to the Thanksgiving holiday, the next report will be published on November 30.)

Last year, we introduced an indicator of the basic health of the economy and added it to the many charts we monitor to gauge market conditions. The indicator is constructed with commodity prices, initial claims and consumer confidence. The thesis behind this indicator is that these three components should offer a simple and clear picture of the economy; in other words, rising initial claims coupled with falling commodity prices and consumer confidence is a warning that a downturn may be imminent. The opposite condition should support further economic recovery. In this report, we will update the indicator with October data.



This chart shows the results of the indicator and the S&P 500 since 1995. The updated chart shows that the economy is doing quite well. We have placed vertical lines at certain points when the indicator falls below zero. Although it works fairly well as a signal that equities are turning lower, there is a lag. In other words, by the time this indicator suggests the economy is in trouble, the recession is likely near or underway and the equity markets have already begun their decline.



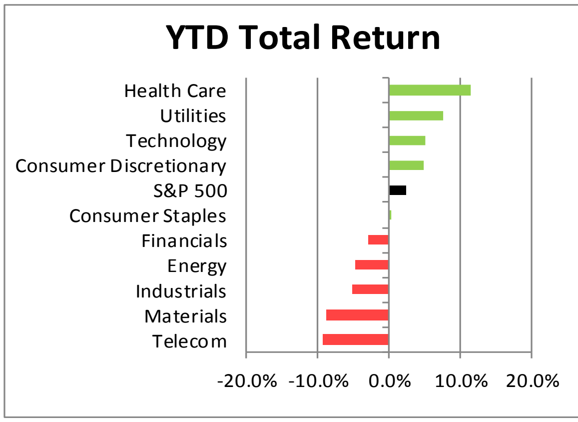
Sources: Haver Analytics, CIM

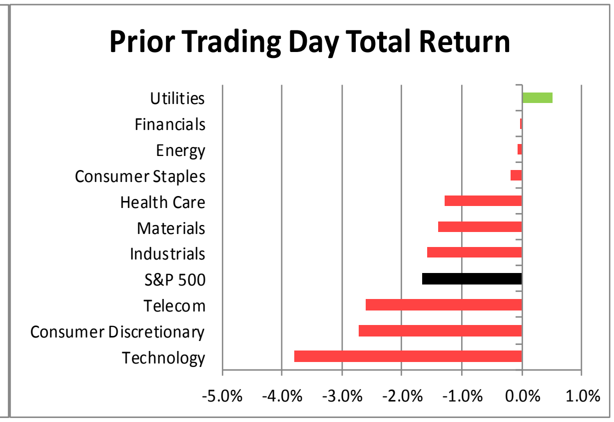
To make the indicator more sensitive, we took the 18-month change and put the signal threshold at -1.0. This provides an earlier bearish signal and also eliminates the false positives that the zero threshold generates. Notwithstanding, we will pay close attention when the 18-month change approaches zero.

What does the indicator say now? The economy is healthy and currently supportive for equity markets. Thus, the recent weakness in equities is not due to the economy but other factors, including monetary and trade policy. The good news is that if there is any reduction in concern over these issues then the economic data would likely support stronger equity prices. The negative news is that there isn't much evidence yet to expect a pause in Fed tightening or a systemic easing of trade tensions. Thus, for the time being, equities will struggle to challenge recent highs.

Data Section

U.S. Equity Markets – (as of 11/19/2018 close)

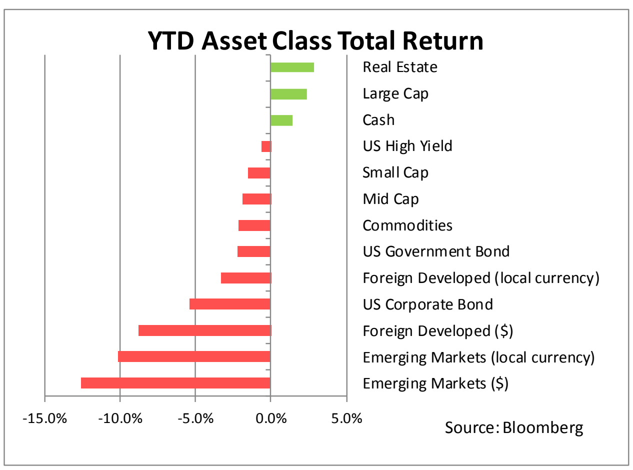




(Source: Bloomberg)

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 11/19/2018 close)

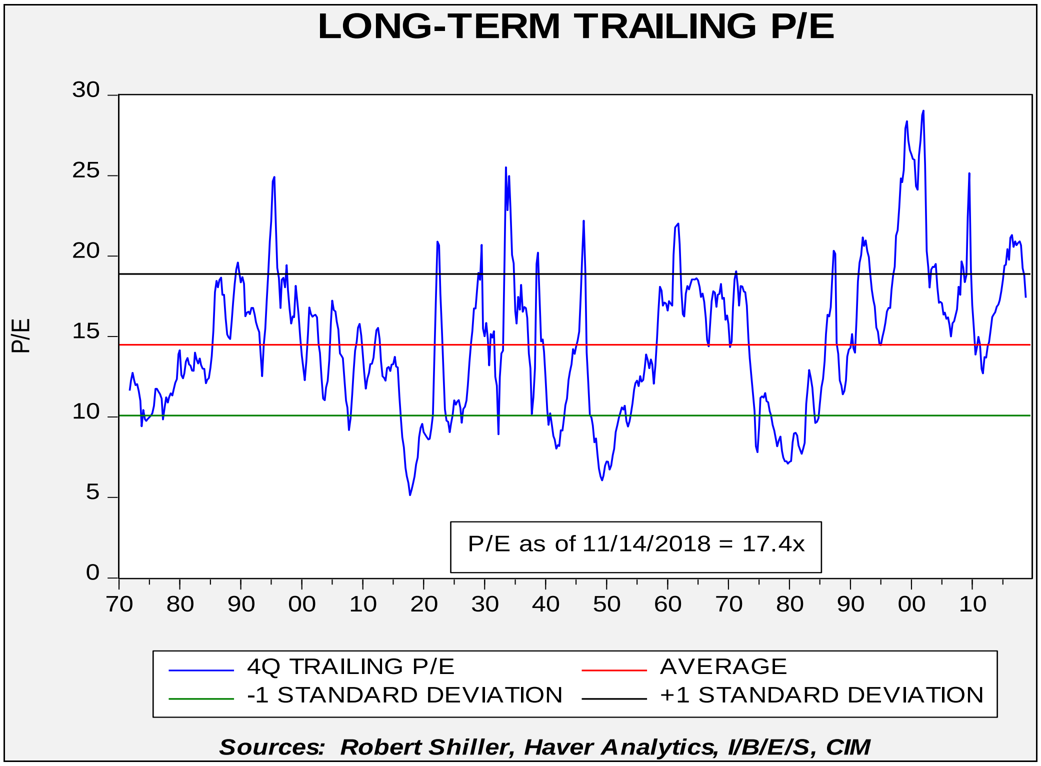


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 15, 2018



Based on our methodology,[7] the current P/E is 17.4x, down 0.1x from last week's reading of 17.5x. The primary reason for the drop in the P/E is the continued correction in the S&P 500.

[7] 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.