Confluence INVESTMENT MANAGEMENT

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 26, 2018—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is up 1.1% from the last close. In Asia, the MSCI Asia Apex 50 was up 1.6% from the prior close. Chinese markets were lower, with the Shanghai composite down 0.1% and the Shenzhen index down 0.3%. U.S. equity index futures are signaling a higher open.

Happy Monday! Risk markets are higher this morning on hopes of a détente between China and the U.S. on trade and on hopes that the FOMC will signal some dovishness. Thanksgiving has passed and the West is gearing up for Christmas. Here is what we are watching today:

Tensions at the Kerch Strait: Russia used a tanker to block a bridge arch on the Kerch Strait, a narrow waterway that links the Black Sea to the Sea of Azov. Although both Ukraine and Russia technically share jurisdiction over the area, Russia, with control of Crimea, effectively holds power over the strait. Both nations have disputes over territorial waters, making the region a potential hotbed for conflict. According to reports, three Ukrainian naval vessels approached the bridge but were blocked by the tanker. Later, Russian warplanes and coast guard vessels fired on the Ukrainian vessels and seized the three Ukrainian ships.[1] Russia claims the Ukrainian ships illegally entered Russian waters after Russia had told the Ukrainian vessels that the strait was temporarily closed[2]; Ukraine obviously disputes this narrative. NATO is backing Ukraine on this issue and the latter has asked for an emergency U.N.S.C. meeting. Ukrainian President Poroshenko is asking parliament to impose martial law which would make it easier to mobilize.

The below map shows the strait.

[1] https://www.ft.com/content/a3a3bc10-f14c-11e8-ae55-df4bf40f9d0d and https://www.ft.com/content/fffa63c4-f0c5-11e8-ae55-df4bf40f9d0d
[2] https://www.nytimes.com/2018/11/25/world/europe/ukraine-russia-kerch-strait.html?emc=edit_mbe_20181126&nl=morning-briefing-europe&nlid=567726720181126&te=1

(Source: BBC)

Will tensions escalate from here? Only if NATO (which means the U.S.) decides to make a strong response. We don't expect that to occur. The White House is not likely to directly defend Ukraine over this skirmish and the Europeans don't have enough power to do so. What is worrisome about this incident is that it could be a probing tactic by Putin to gauge the West's resolve. If he can get away with this, he may try a similar tactic with the Baltics at some point. For now, financial markets, with the exception of Russian financial assets, are mostly ignoring this event. But, it could make the G-20 meeting later this week a bit more interesting.[3]

Italy relents? Italy's governing coalition is hinting it may reduce its deficit target to avoid a confrontation with the EU commission.[4] Although we have our doubts that the deficit will actually be reduced, there is the potential for enough "window dressing" to allow the official numbers to improve and, at least for now, ease tensions between the EU and Italy. Financial markets rallied on the news.

Macron's woes: French President Macron is facing continued widespread protests over his government's decision to raise fuel taxes. The policy was designed for environmental reasons but car owners in France are not happy with the decision. Although the numbers are down from last week, the persistence of the protests are somewhat unusual. This weekend's action was mostly in Paris, which is also a departure from last week, when they were more widespread.[5] Our take on the protests is that the participants are mostly working class and the concern is primarily financial. The West is facing widespread populism, a revolt of the bottom 90% against

[3] https://www.reuters.com/article/us-g20-argentina/g20-forged-in-crisis-faces-major-test-next-week-donald-trump-idUSKCN1NS1LH
[4] https://www.reuters.com/article/us-italy-budget/italy-discussing-reducing-2019-deficit-target-idUSKCN1NV0LQ
[5] https://www.nytimes.com/2018/11/24/world/europe/france-yellow-vest-protest.html?emc=edit_mbe_20181126&nl=morning-briefing-europe&nlid=567726720181126&te=1

globalization and deregulation. Macron's political movement was, in some regards, part of this reaction. He built a party from scratch, defeated the established center-left and center-right and prevented a populist surge from either the left or right. However, winning elections is one thing, governing is another. He is trying to govern as a center-right supporter of free markets when the bottom 90% want to be protected from the forces of globalization and deregulation. The administration's response to the protests has been to mostly berate or ignore them. That may prove to be a mistake.

Brexit update: The EU approved the Brexit deal.[6] Now, PM May faces the difficult task of moving a reluctant parliament to accept the arrangement.[7] She has a couple of weeks to cobble together a coalition of Conservatives and Labour to pass the measure. Although there is little enthusiasm for the deal, it isn't obvious that a better deal can be arranged. We would not be shocked to see the first vote fail, which could lead to another try—an outcome we refer to as the "TARP method." The first TARP vote failed but market reaction concentrated the minds of legislators to pass the measure. If this deal fails, the next step would be May's resignation followed by either hard Brexit (leaving without a deal, likely causing significant economic disruption) or another referendum. We are leaning toward the second referendum outcome, but we do think the odds that the current form passes may be higher than most think. Although a hard Brexit is still a possibility, it is probably the least likely outcome.

Taiwan swings toward China: In local elections over the weekend, the China-leaning KMT party won going away, rejecting the separatist Democratic Progressive Party (DPP).[8] Taiwan President Tsai Ing-wen resigned from DPP party leadership following the drubbing. Presidential elections are coming in a year and these local elections raise the possibility that the island will return to KMT rule. In general, the DPP tends to find support among local Taiwanese who would prefer independence, whereas the KMT finds support among the Chinese Nationalists whose ancestors fled the mainland after Mao won the civil war in 1949. Power tends to swing between the two parties. Neither has been able to maintain power but the KMT's recent performance does ease some of the potential tensions that have been rising under President Tsai.

Trump and the Fed: Financial markets have been hinting that the FOMC should be considering at least a pause to prevent further weakness in the financial markets. Chair Powell will be giving a speech Wednesday evening on Fed policy and emerging markets and there is hope of a dovish tone. Meanwhile, the *WSJ*[9] reports that the president is unhappy with Powell and is blaming Treasury Secretary Mnuchin. As we stated numerous times after the election, there was a battle going on between the GOP establishment and the populists. That battle is still underway; Mnuchin, along with Kudlow, represent the former. To some extent, the president has been balancing these two forces. His stump speeches are pure populist but his governing is mixed. The tax cuts and deregulation generally favor the establishment, whereas the immigration and

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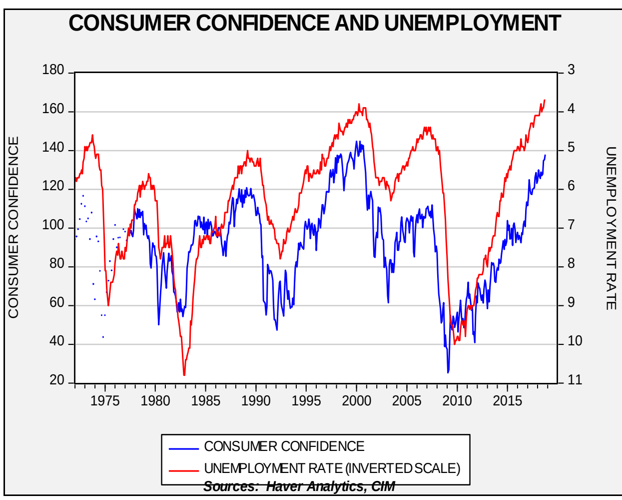
[6] https://www.nytimes.com/2018/11/25/world/europe/brexit-uk-eu-agreement.html?emc=edit_mbe_20181126&nl=morning-briefing-europe&nlid=567726720181126&te=1
[7] https://www.ft.com/content/053915fc-f156-11e8-ae55-df4bf40f9d0d
[8] https://www.reuters.com/article/us-taiwan-politics/taiwan-rebukes-ruling-party-emboldens-china-friendly-opposition-idUSKCN1NU01L
[9] https://www.wsj.com/articles/trump-expresses-dissatisfaction-with-treasury-secretary-1543006250

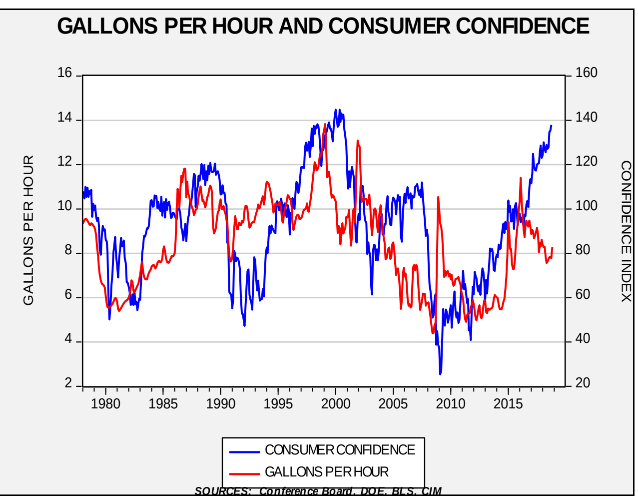
trade policy are populist. One issue we have been watching since Trump's election is relations with the Fed. Presidents since Truman have, at times, been at odds with the central bank. It is powerful, independent and can wreck a president's political position by bring a recession. Trump is not unique but appears so because since the early 1990s there has been a détente between the two forces—presidents leave the Fed alone and the Fed promises to be careful.

Our concern has been that President Trump might take a page out of President Nixon's playbook and force the Fed to deliver easy policy. He has already undermined the truce via tweet. Nixon got his way with the Fed by creating a crisis for Chair Arthur Burns (his administration leaked that Burns wanted a doubling of his pay) and then offered to support Burns in return for easy policy. We thought we would get something similar with Trump picking easy money governors but instead the president, mostly under Mnuchin's guidance, delivered center-right establishment picks for governors. It appears the president has finally figured out he didn't get what he wanted and is turning on his treasury secretary. If the president can browbeat the Fed into delivering easy policy and this causes financial markets to worry that the Fed won't stand up to inflation threats, then it could unanchor inflation expectations and lead to a much weaker dollar and higher bond yields.

Oil: Oil prices have taken a beating over the past few weeks; rising inventories are the primary culprit, although a steady series of presidential tweets are playing a role as well. There seems to be a notion floating around that the Saudi crown prince, now indebted to the White House for not pressing the Khashoggi incident, will be beholden to Washington. Recent production numbers from the kingdom support this idea.[10] Perhaps…but, at the same time, there isn't anything coming out of the Kingdom of Saudi Arabia (KSA) to suggest it wants prices to continue to fall. At the same time, continued declines in oil prices do appear to be President Trump's goal.

Does this make sense? There is evidence to suggest that lower gasoline prices lift consumer confidence. But, it isn't the most important factor.

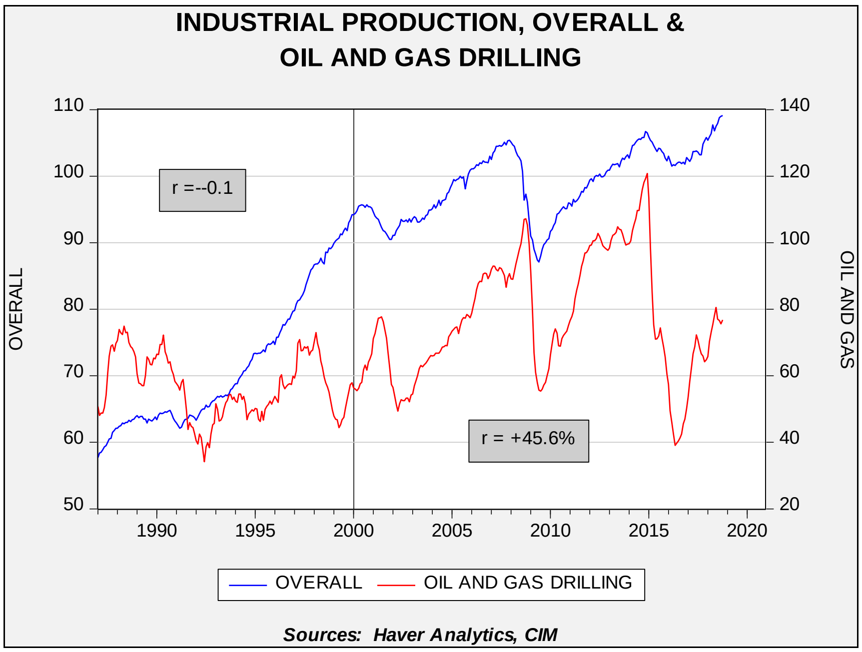




[10] https://www.wsj.com/articles/to-placate-trump-saudis-mull-clandestine-cuts-to-opec-production-1542994694

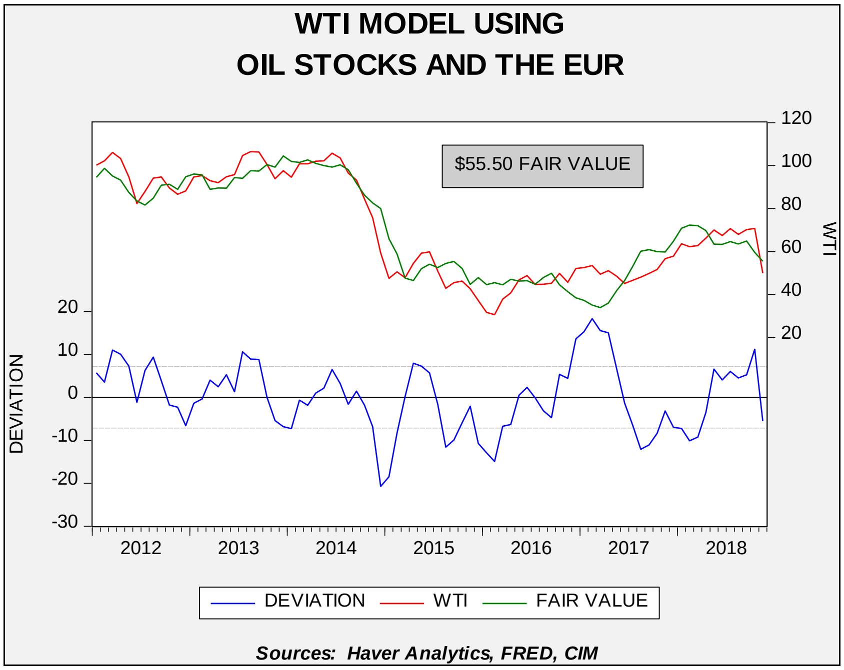
The above chart on the left shows consumer confidence and the unemployment rate (the latter with an inverted scale). The two series track each other closely and correlate at the -75% level. To measure the impact of gasoline prices, we scale gasoline prices by the hourly wages of nonsupervisory workers. This gives us a measure of how many gallons of gasoline a worker can purchase for an hour's worth of work. The recent decline in gasoline prices has lifted the number to 8.3 gallons; however, this measure has been falling since 2016 and has not prevented consumer confidence from continuing to rise. The evidence suggests falling unemployment plays a bigger role.

At the same time, oil and gas drilling has become more important to the U.S. economy.



This chart shows the relationship between overall industrial production compared with industrial production from oil and gas drilling. From 1987 to 2000, the correlation was nil, suggesting that the impact of oil and gas drilling was minimal for overall output. However, since 2000, the correlation has risen to +45.6%. This suggests that if oil prices remain low, oil and gas production will likely decline and weaken the overall economy. In general, the impact on the U.S. economy from lower oil prices is probably still positive, on balance, but the positive benefits are less than they used to be.

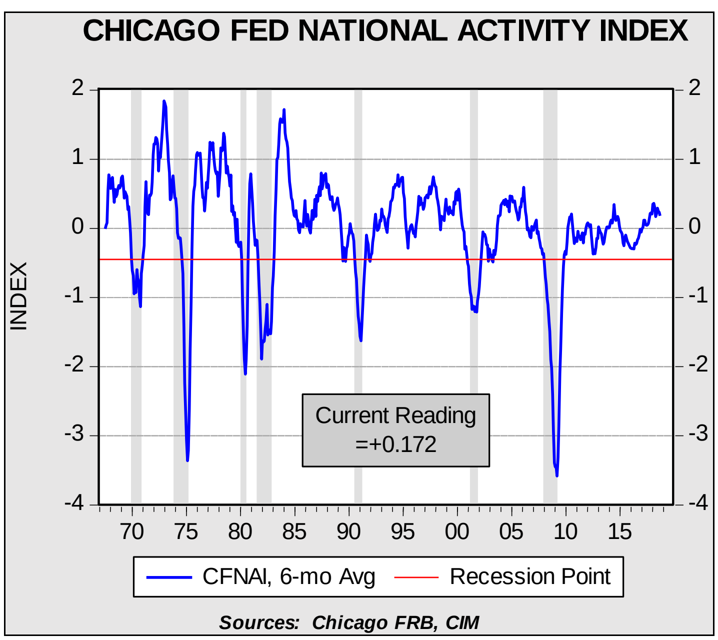
Finally, oil prices have fallen to a level where they are undervalued.



Our EUR and oil inventory model suggests fair value of $55.50 and is nearly a standard error below fair value. In the past, such valuation usually leads to at least consolidation. Seasonally, we should see inventories decline into year's end and these fundamental factors, coupled with a deeply oversold market, should lead to a bounce in crude oil in the near term.

U.S. Economic Releases

The Chicago Fed National Activity Index came in above expectations at +0.24 compared to the forecast of +0.18. The prior month's report was revised downward from +0.17 to +0.14.



The current smoothed reading is +0.17. The index is constructed to show trend growth at zero, thus a reading above zero shows above-trend growth. Casual observation would suggest this expansion has seen very modest growth, with much of the time spent below zero.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:30	Dallas Fed Manufacturing Index	m/m	nov	0.18	0.17	***
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								
Japan	Nikkei Japan PMI	m/m	nov	51.8	52.9		**	Equity and bond neutral
	Leading Index CI	m/m	sep	104.3	103.9		**	Equity bullish, bond bearish
	Coincident Index	m/m	sep	114.4	114.6		**	Equity and bond neutral
	Tokyo Condominium Sales	m/m	oct	2.8%	13.2%		**	Equity and bond neutral
New Zealand	Retail Sales Ex Inflation	m/m	3q	0.0%	1.1%	1.0%	**	Equity bearish, bond bullish
EUROPE								
Germany	IFO Business Climate	y/y	nov	102.0	102.8	102.3	**	Equity and bond neutral
	IFO expectations	y/y	nov	98.7	99.8	99.2	**	Equity bearish, bond bullish
	IFO Current Assessment	y/y	nov	105.4	105.9	105.3	**	Equity and bond neutral
U.K.	UK Finance Loan for Housing	m/m	oct	39697	38505	38150	**	Equity and bond neutral
Switzerland	Total Sight Deposits CHF	m/m	nov	577.3 bn	577.3 bn		*	Equity and bond neutral
	Domestic Sight Deposits CHF	m/m	nov	472.7 bn	474.5 bn		*	Equity and bond neutral
AMERICAS								
Brazil	FGV Consumer Confidence	m/m	nov	93.2	86.1		**	Equity bullish, bond bearish
	Federal Debt Total	w/w	oct	3.763 tn	3.779 tn		**	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)	269	269	0	Up
3-mo T-bill yield (bps)	235	235	0	Neutral
TED spread (bps)	34	34	0	Neutral
U.S. Libor/OIS spread (bps)	236	235	1	Up
10-yr T-note (%)	3.07	3.04	0.03	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	32	32	0	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	$60.33	$58.80	2.60%	Short Covering
WTI	$51.28	$50.42	1.71%	
Natural Gas	$4.03	$4.31	-6.41%	
Crack Spread	$14.48	$14.22	1.83%	
12-mo strip crack	$17.50	$17.25	1.46%	
Ethanol rack	$1.42	$1.42	0.00%	
Metals				
Gold	$1,224.89	$1,223.05	0.15%	
Silver	$14.35	$14.29	0.42%	
Copper contract	$278.85	$278.55	0.11%	
Grains				
Corn contract	$ 370.25	$ 370.50	-0.07%	
Wheat contract	$ 512.75	$ 507.25	1.08%	
Soybeans contract	$ 873.00	$ 881.00	-0.91%	
Shipping				
Baltic Dry Freight	1093	1018	75	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	4.9	3.5	1.4	
Gasoline (mb)	-1.3	-0.5	-0.8	
Distillates (mb)	-0.8	-2.5	1.7	
Refinery run rates (%)	2.60%	1.00%	1.60%	
Natural gas (bcf)	-134.0	-109.0	-25.0	

Weather

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

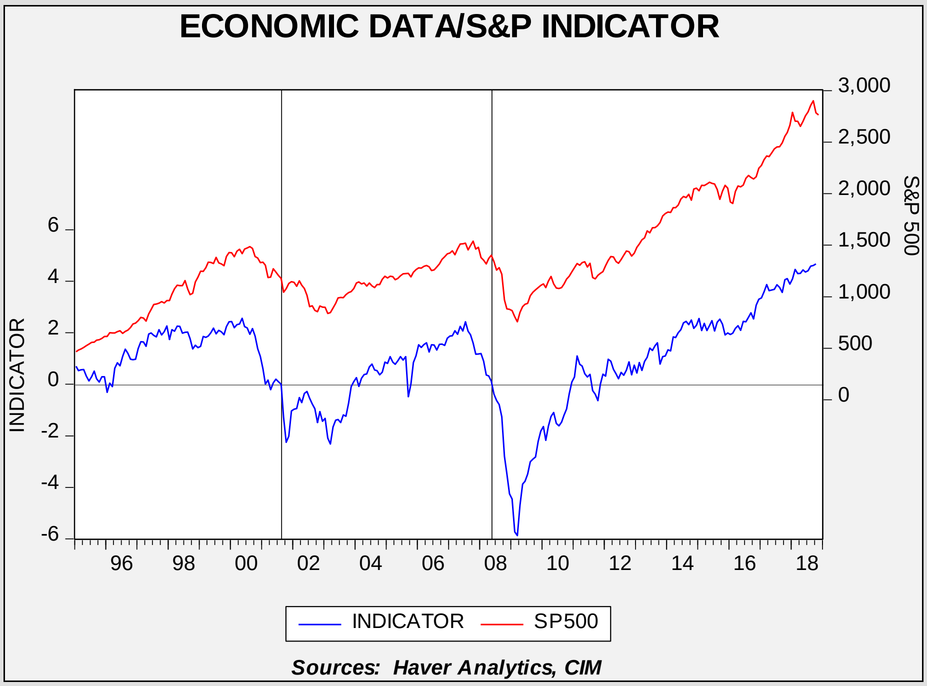
Asset Allocation Weekly Comment

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.

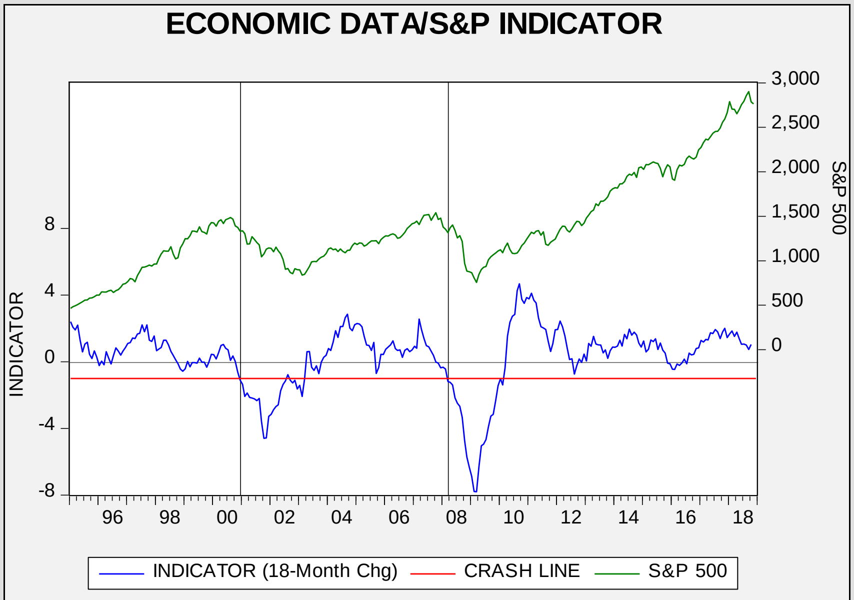
November 16, 2018

(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.



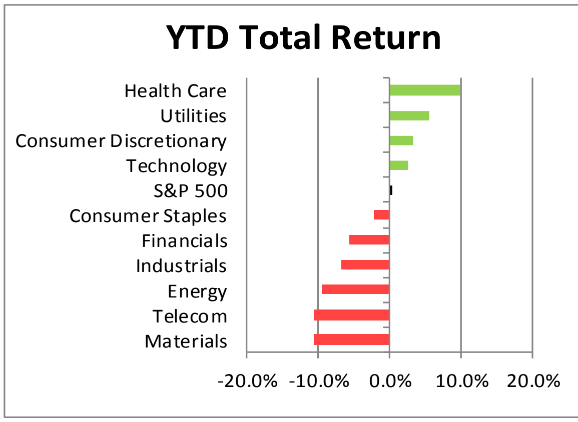
Sources: Haver Analytics, CIM

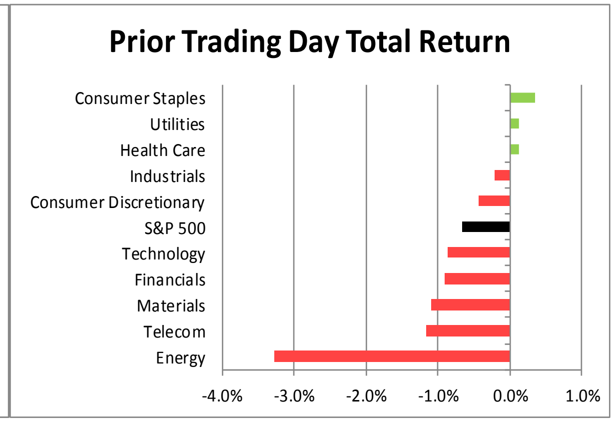
To make the indicator more sensitive, we took the 18-month change and put the signal threshold at -1.0. This provides an earlier bearish signal and also eliminates the false positives that the zero threshold generates. Notwithstanding, we will pay close attention when the 18-month change approaches zero.

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.

<u>Data Section</u>

U.S. Equity Markets – (as of 11/23/2018 close)

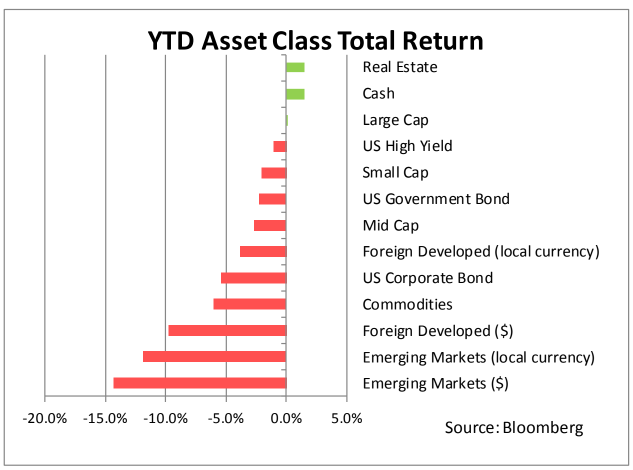




(Source: Bloomberg)

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 11/23/2018 close)

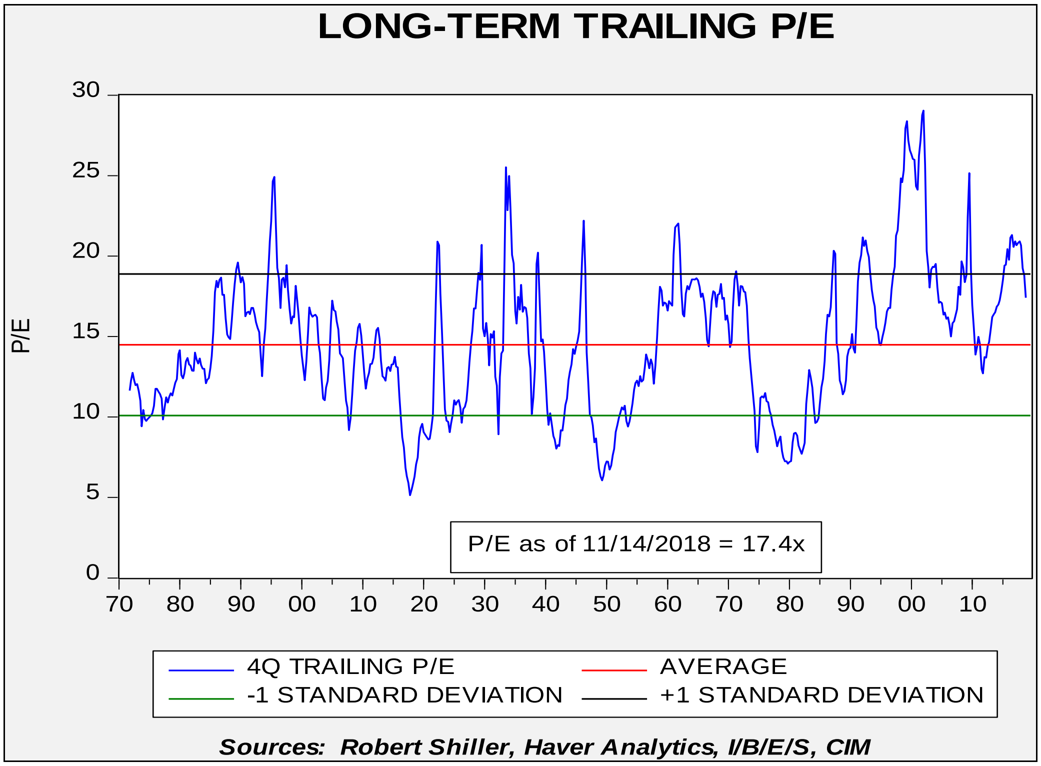


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[11] 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.

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.

[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 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.