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 27, 2018—9:30 AM EST] 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 up 0.3% from the prior close. Chinese markets were mixed, with the Shanghai composite unchanged and the Shenzhen index up 0.4%. U.S. equity index futures are signaling a lower open.

Good morning! Risk markets are under pressure this morning after the president maintained a hard line on Chinese tariffs. Here is what we are watching today:

Chinese tariffs: In an interview with the *WSJ*,[1] President Trump indicated that he expects to lift existing tariffs on $200 bn of Chinese imports to 25% from 10%, suggesting it is "highly unlikely" he would delay their implementation. He also said that if talks with Chairman Xi don't bear fruit, he would likely apply tariffs to the rest of China's imports. That would be another $267 bn in goods; it is not clear if the rate on the proposed new tariffs would be 10% or 25%. One of the key points the president made offers an insight into his thinking—he had a message to companies wondering how to cope with tariffs.

> **"What I'd advise is for them to build factories in the United States and to make the product here," Mr. Trump said in the interview. "And they have a lot of other alternatives."[2]**

President Trump's vision for America is a pre-1978 version where the economy is deglobalized and most production is performed in the U.S. by highly paid American workers. Although this would be better for U.S. labor it will (a) almost certainly contract profit margins, and (b) lead to higher inflation. We have been warning our readers for some time that we are likely moving into an equality cycle and leaving an efficiency cycle. That quote adds to evidence that this shift is underway. The eventual outcome will likely be less inequality but higher inflation.

GM (36.75, +1.72): As a reminder, we don't discuss individual companies in this report unless the news surrounding them have macro implications. Yesterday, Mary Barra, the CEO of General Motors, announced sweeping plant closures and layoffs.[3] In total, seven production

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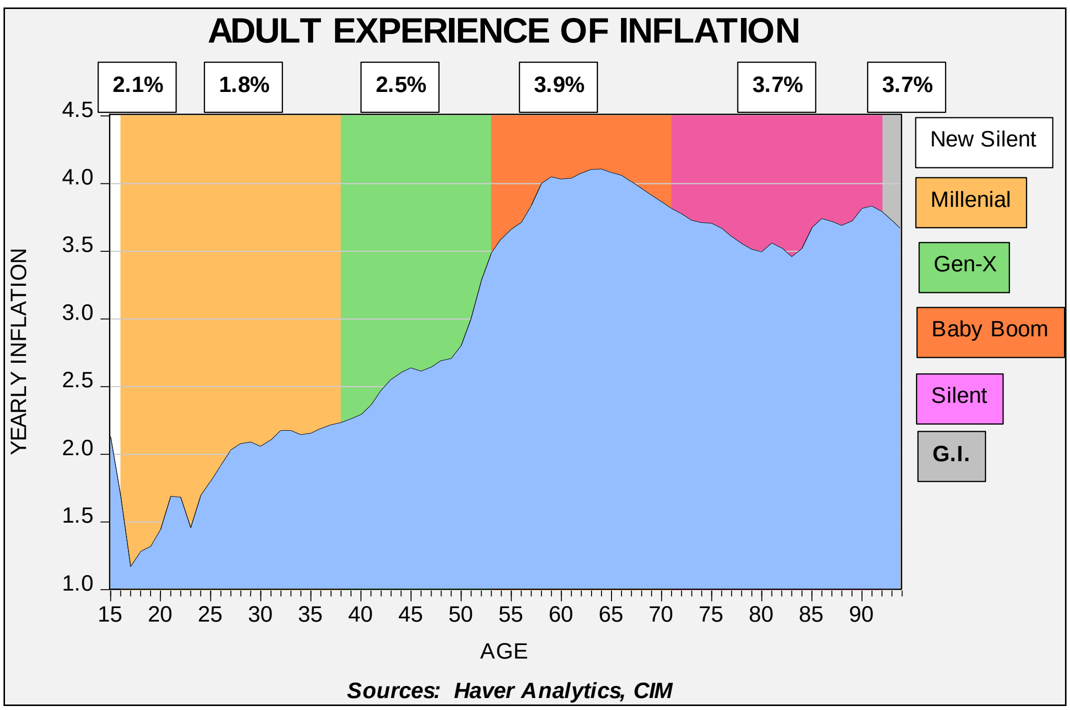
[1] https://www.wsj.com/articles/trump-expects-to-move-ahead-with-boost-on-china-tariffs-1543266545
[2] Ibid.
[3] https://www.ft.com/content/0ef6a0bc-f1ad-11e8-ae55-df4bf40f9d0d?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top

plants will close and 14,000 workers will lose their jobs. The layoffs represent 4.8% of the firm's North American workforce. The company is reacting to a weakening global auto sales market (China rescinded a tax break in January; the cut in 2016 led to a jump in car sales in that year but since then sales have been weak[4]) and excess capacity. GM, much like Ford (F, 9.40, 0.27), is abandoning the sedan market to foreign nameplates and focusing on trucks and SUVs. GM is also trying to divert revenue to future auto technology.

Extending the equality and efficiency theme, we note that both President Trump[5] and Senator Sherrod Brown (D-OH)[6] have criticized the move. The juxtaposition of a GOP president and a hard-left Democrat senator holding the same position is notable. To be fair, Ohio was a key state in the president's capture of the Electoral College and plant closures in the state would likely trigger a response from its senators. But, the real key is that we may be entering a world in which firms will be less able to freely allocate capital where costs are most favorable. Again, we are not saying that company pursuit of profit is the highest value. ***But, we think it does show that worries have diminished about triggering inflation by restricting supply.*** We describe this process as "intergenerational forgetfulness." Simply put, it means that the memory of the 1970s inflation is steadily aging out and this memory is being replaced by low inflation and increasing concern about inequality.



[4] https://www.reuters.com/article/us-china-autos-dealers-exclusive/exclusive-reverse-gear-china-car-dealers-push-for-tax-cut-as-auto-growth-stalls-idUSKCN1ML100
[5] https://www.wsj.com/articles/gm-says-it-will-cut-15-of-salaried-workforce-in-north-america-1543246232
[6] https://thehill.com/homenews/senate/418240-sherrod-brown-ohio-taxpayers-rescued-gm-yet-company-doesnt-respect-workers

This chart shows the adult experience of inflation for Americans by age. We start adulthood at 16 years old. Although the thought of such an early start to adulthood is somewhat humorous in the present day, for the population at the right end of the chart adult responsibilities were taken on at a much earlier age. Note that the baby boom has the highest lifetime experience of inflation, an average of 3.9%. The aggressive anti-inflation policies that began in 1978 successfully lowered inflation, so successfully, in fact, that now a large contingent of Americans see no issue with inflation. For adult Americans under the age of 50, the average inflation rate is 2.1%; older than 50, it is 3.7%. Thus, it makes sense that there is less fear of causing inflation by undermining supply-favoring policies as there are simply fewer Americans that have experience of high inflation.

While we think we are early in this process, the direction appears rather clear. However, that doesn't mean that inflation is necessarily imminent. A new study from the San Francisco FRB makes a strong case that the recent lift in core PCE was due to factors unrelated to the cyclical trends in the economy. Instead, the article indicates that the recent rise was due to one-off events and core inflation is likely to fall below target as these factors wane. This report would argue for a cautious approach to policy tightening.[7]

Trouble on the farm: Two items of note here. The Minneapolis FRB reports[8] a rise in Chapter 12 bankruptcy filings. This part of the bankruptcy code is mostly constructed for farmers and combines the corporate features of Chapter 11 with the filing simplicity of the household Chapter 13 structure. The weakness in the farm belt is mostly due to weak commodity prices which is forcing consolidation. Thus, smaller farms are facing trouble and being forced to either restructure or sell out. The report notes an increase in non-performing agriculture loans in the Ninth Fed District. The second item relates to soybeans. It is no secret that China has retaliated against U.S. tariffs by applying tariffs to U.S. soybeans. China is buying its supplies from other sources, mostly South America. Although the logistics are not seamless, U.S. farmers have been picking up sales from former customers of South America who are now focusing on China. At the same time, China has been experimenting with feed mixes for its hogs to use less protein, which would reduce demand altogether. However, a new fear has emerged—African swine fever is apparently spreading through China's hog herds. The disease is usually fatal for hogs and the spread of the fever is starting to affect overall Chinese soybean imports.[9] This news will add increased pressure on grain prices and add to farmer woes.

Update on the Kerch Strait: As we reported yesterday, 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. Three Ukrainian naval vessels were attacked and taken by the Russians. The Ukraine parliament declared a month of martial law.[10] Although there is some concern that conditions could

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[7] https://www.frbsf.org/economic-research/publications/economic-letter/2018/november/has-inflation-sustainably-reached-target/

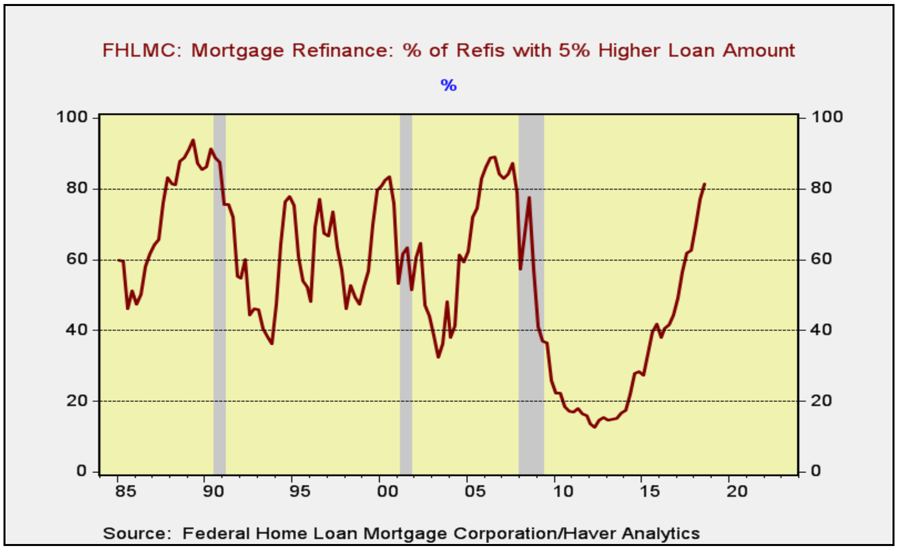
[8] https://www.minneapolisfed.org/publications/fedgazette/chapter-12-bankruptcies-on-the-rise-in-the-ninth-district

[9] https://www.reuters.com/article/us-china-soybean-demand/crop-drop-china-swine-fever-outbreak-to-curb-its-soybean-imports-idUSKCN1NW0PH

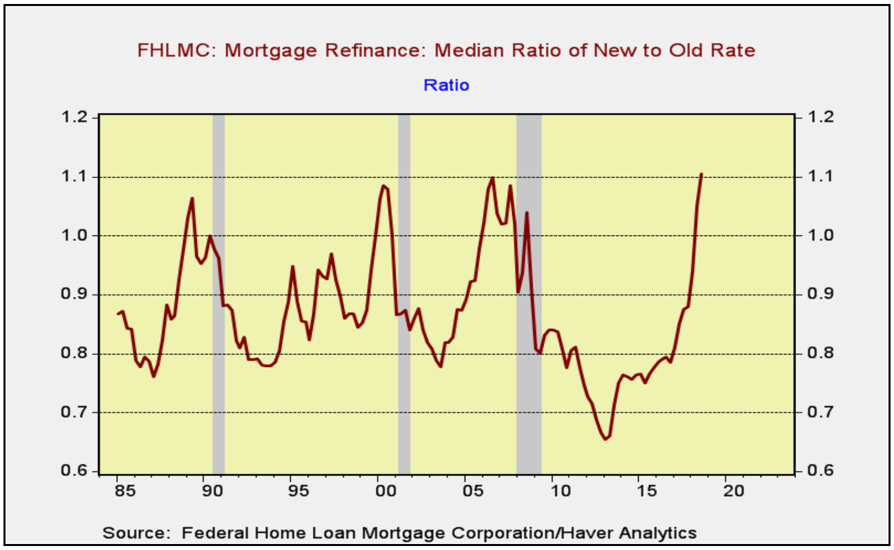
[10] https://www.politico.eu/article/ukraine-martial-law-imposed-by-parliament-kiev/?utm_source=POLITICO.EU&utm_campaign=d75247bdb7-

deteriorate, neither side likely wants an escalation. The fact that this occurred just before the G-20 meeting may be an indication that both sides want to remind the world that the Ukraine situation has not been resolved. But, we would not expect a hot war to emerge from this event.

A couple of housing charts: We are seeing a rise in household refinancing, with the majority of borrowers taking cash out of the transaction.[11]



The above chart shows that 80% of new loans are for more than 5% of the previous loan amount; since the data began in 1985, a reading over 80% occurs about 18.5% of the time. However, what is surprising is that these refinancing loans are clearly occurring with the express purpose of equity withdrawal as these borrowers are giving up lower mortgage rates.



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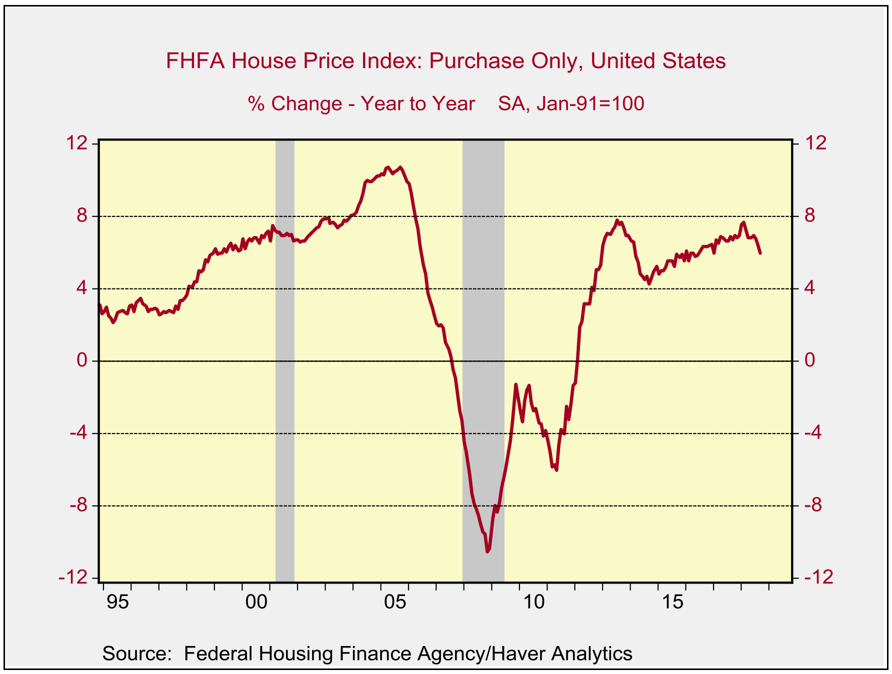
[11] https://www.wsj.com/articles/borrowers-are-tapping-their-homes-for-cash-even-as-rates-rise-1543159864

A ratio of one would indicate a swap at the same rate. The current ratio is now the highest on record. As the referenced *WSJ* article suggests, homeowners are returning to cash-out refinancing because they have not been able to generate enough income to pay down other debt or make other purchases. As these charts show, however, activity at these levels has become problematic in the past. This is an area we will continue to watch closely.

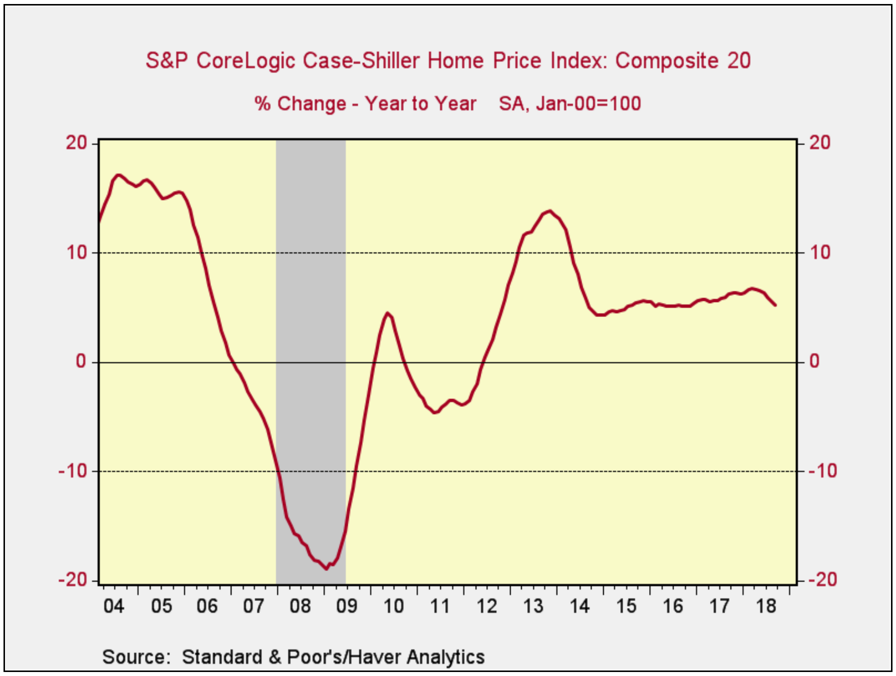
U.S. Economic Releases

The FHFA House Price Index came in below expectations, rising 0.2% from the prior month compared to the forecast of 0.4%. The prior report was revised upward from 0.3% to 0.4%. The housing price index rose 1.3% in the third quarter. The previous report was revised upward from 1.1% to 1.3%.



The chart above shows the year-over-year change in the FHFA House Price Index. Housing prices have risen 6.0% from the prior year. Although still rising, the price momentum is starting to show signs of weakness.

The S&P CoreLogic CS 20-City Home Price Index came in below expectations at 5.15% compared to the forecast rise of 5.20% from the prior year. The prior report was revised from 5.49% to 5.53%. The S&P CoreLogic CS U.S. Home Price Index rose by 5.51% from the prior year. The prior report was revised downward from 5.77% to 5.69%.



The chart above shows the year-over-year change in the S&P CoreLogic CS 20-City Home Price Index. The HPI continues to lose steam, likely as a result of higher interest rates weighing on demand for homes.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Conference Board Consumer Confidence	m/m	nov	135.9	137.9	**
10:00	Conference Board Present Situation	m/m	nov		172.8	**
10:00	Conference Board Expectations	m/m	nov		114.8	**
Fed speakers or events						
EST	Speaker or event	District or position				
12:00	Raphael Bostic speaks on Panel	President of the Federal Reserve Bank of Atlanta				
12:00	Esther George Speaks on Panel	President of the Federal Reserve Bank of Kansas City				
12:00	Charles Evans Speaks on Panel	President of the Federal Reserve Bank of Chicago				

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 Profits	y/y	oct	3.6%	4.1%		**	Equity and bond neutral
Japan	PPI Services	y/y	oct	1.3%	1.2%	1.2%	**	Equity bearish, bond bullish
Australia	ANZ Roy Morgan Weekly Consumption	w/w	nov	118.6	117.8		**	Equity bullish, bond bearish
New Zealand	Trade Balance NZD	m/m	oct	-1.295 bn	-1.560 bn	-0.850 bn	**	Equity bearish, bond bullish
EUROPE								
France	Consumer Confidence	y/y	nov	92	95	94	***	Equity and bond neutral
Italy	Manufacturing Confidence	m/m	nov	104.4	104.9	104.0	**	Equity and bond neutral
	Consumer Confidence	m/m	nov	114.8	116.6	116.0	***	Equity bearish, bond bullish
U.K.	CBI Retailing Reported Sales	m/m	nov	19	5	10	**	Equity bullish, bond bearish
	CBI Total Dist. Reported Sales	m/m	nov	18	17		*	Equity bullish, bond bearish
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)	237	236	1	Up
10-yr T-note (%)	3.06	3.05	0.01	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	26	28	-2	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	flat			Neutral
yen	down			Neutral
pound	down			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	$60.48	$60.48	0.00%	
WTI	$51.49	$51.63	-0.27%	
Natural Gas	$4.19	$4.25	-1.44%	
Crack Spread	$14.62	$14.64	-0.15%	
12-mo strip crack	$17.59	$17.55	0.20%	
Ethanol rack	$1.42	$1.42	0.04%	
Metals				
Gold	$1,223.52	$1,222.40	0.09%	
Silver	$14.29	$14.23	0.44%	
Copper contract	$274.80	$277.30	-0.90%	
Grains				
Corn contract	$ 369.00	$ 368.00	0.27%	
Wheat contract	$ 512.00	$ 514.00	-0.39%	
Soybeans contract	$ 866.25	$ 862.25	0.46%	
Shipping				
Baltic Dry Freight	1217	1093	124	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.0		
Gasoline (mb)		1.0		
Distillates (mb)		0.5		
Refinery run rates (%)		1.00%		

Weather

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

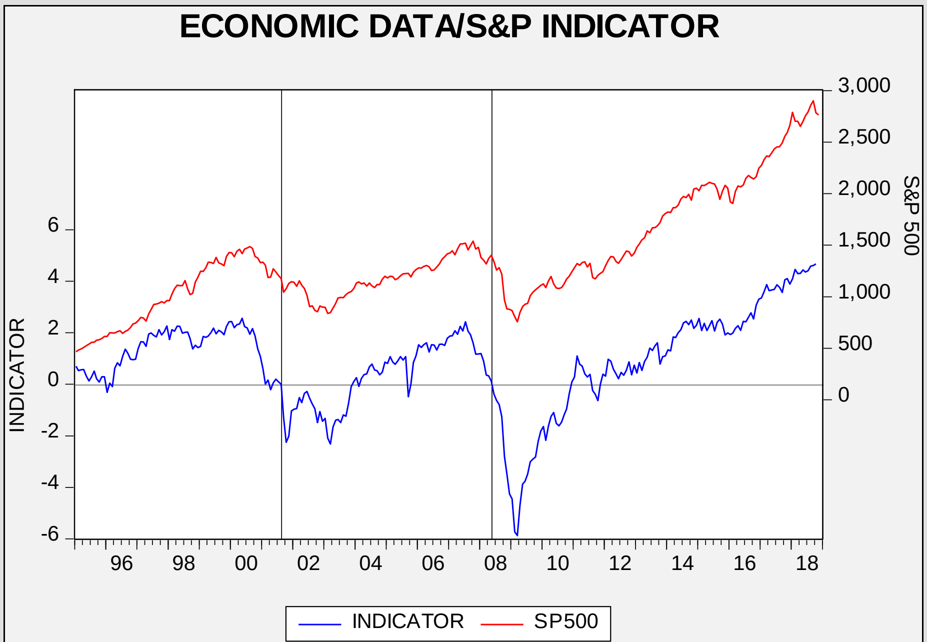
Asset Allocation Weekly Comment

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

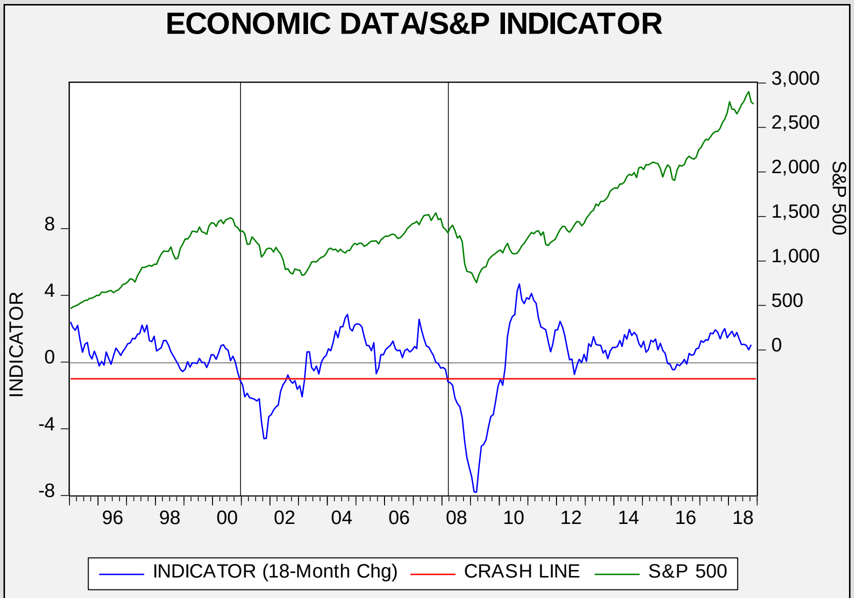
(NB: Due to the Thanksgiving holiday, the next report will be published on November 30.)

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.



Sources: Haver Analytics, CIM

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

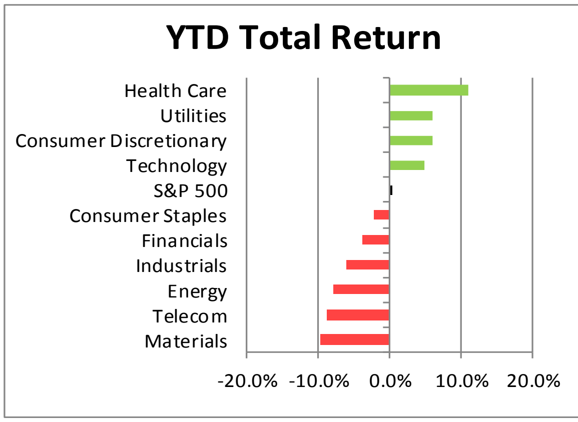
To make the indicator more sensitive, we took the 18-month change and put the signal threshold at -1.0. This provides an earlier bearish signal and also eliminates the false positives that the zero threshold generates. Notwithstanding, we will pay close attention when the 18-month change approaches zero.

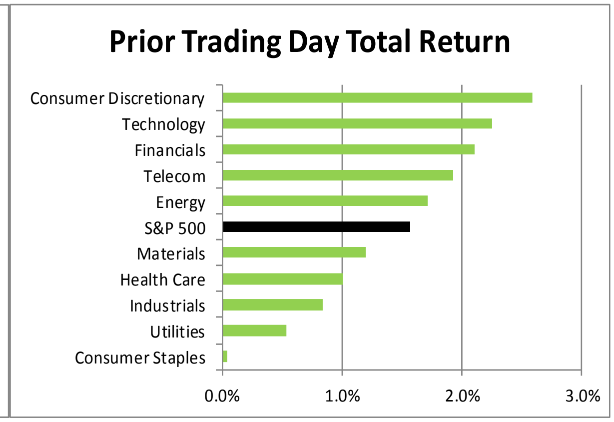
What does the indicator say now? The economy is healthy and currently supportive for equity markets. Thus, the recent weakness in equities is not due to the economy but other factors, including monetary and trade policy. The good news is that if there is any reduction in concern over these issues then 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.

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 11/26/2018 close)

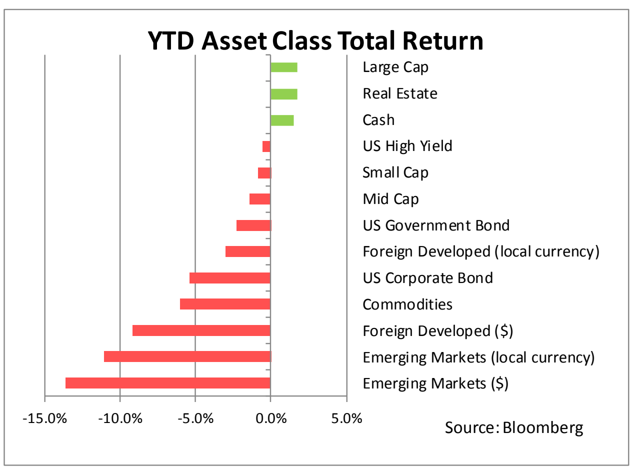




(Source: Bloomberg)

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 11/26/2018 close)

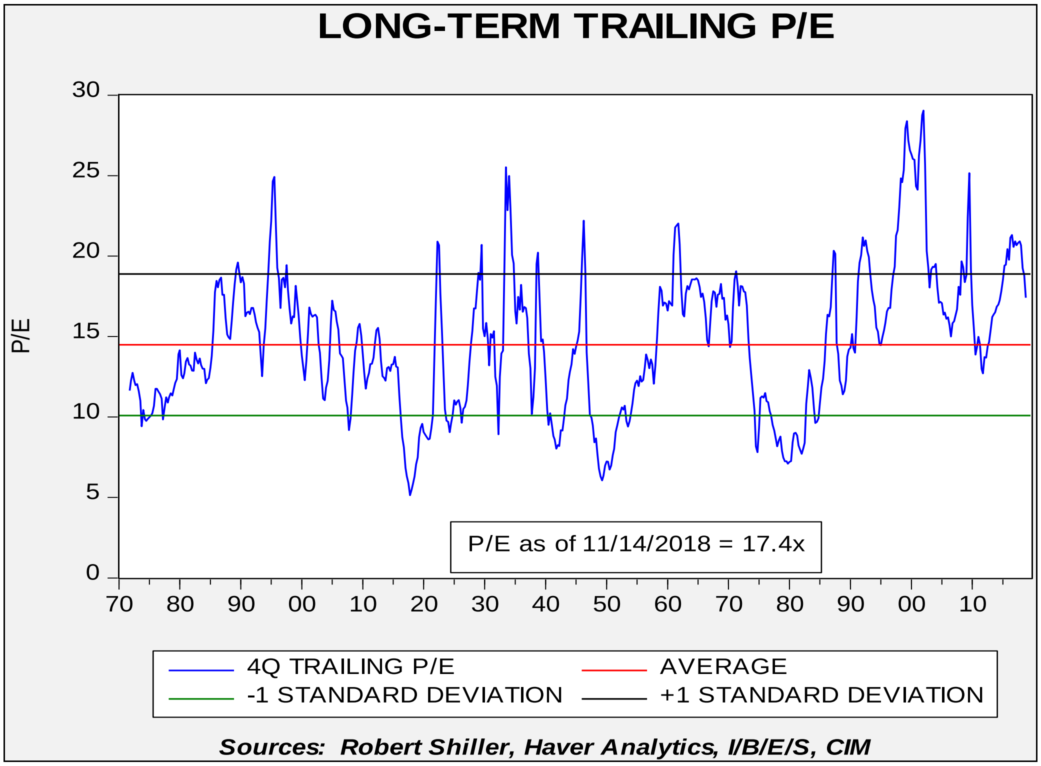


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[12] 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.

[12] 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.