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 28, 2018—9:30 AM EST] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.4% from the last close. In Asia, the MSCI Asia Apex 50 was up 1.1% from the prior close. Chinese markets were higher, with the Shanghai composite up 1.1% and the Shenzhen index up 1.4%. U.S. equity index futures are signaling a higher open.

Good morning! Equities are ticking higher in front of Chair Powell's speech this morning. Here is what we are watching today:

The Fed: Chair Powell speaks in NY at 12:00 EST. We don't expect anything groundbreaking but we will be watching to see if he follows the path laid out by Vice Chair Clarida yesterday. Clarida didn't give up much on the direction of policy (he stuck to "data dependent") but there is one change he did signal, which is that forward guidance is dead, at least in terms of FOMC comments.[1] Forward guidance became a policy tool under ZIRP; once the Fed reached 0% fed funds, Chair Bernanke shifted his comments to say, in effect, that "rates are low and going to stay that way." That was done to enhance whatever benefit the economy would get from low rates by indicating borrowers and investors could rely on rates staying low for a long time. The policy was always controversial; Stanley Fischer didn't care for it at all because he feared it locked the bank into a policy that it may need to adjust in case of a sudden change in conditions. We view the discontinuation of forward guidance as evidence of policy normalization. Once rates lifted off zero, the value of forward guidance as a way to enhance the value of zero rates was removed. However, policymakers did keep guidance policy as rates rose, using the informal policy of only raising rates at meetings with a press conference, for example. However, as the Fed approaches neutrality, forward guidance becomes a problem because it could lead market participants to overestimate how much tightening is in the pipeline, leading policy to be tighter than the Fed intends. Instead, the FOMC does appear to be trying to create as much flexibility as possible so it can act appropriately if the economy slumps or accelerates and not be "straightjacketed" into a policy path.

The other Fed news of note is the president's continued bashing of the central bank.[2] The persistence of the criticism, in some sense, reduces its effectiveness. The lambasting has become so frequent that it has become part of the background and, so far, has had no obvious impact on

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[1] We expect the dots, a form of forward guidance, to remain for now.

[2] https://www.washingtonpost.com/politics/trump-slams-fed-chair-questions-climate-change-and-threatens-to-cancel-putin-meeting-in-wide-ranging-interview-with-the-post/2018/11/27/4362fae8-f26c-11e8-aeea-b85fd44449f5_story.html?utm_term=.6c200bd81c76&wpisrc=nl_politics&wpmm=1

changing FOMC behavior. However, it may someday; if policy is designed to reflate the economy, and we think that is the underlying policy trend, then curtailing central bank independence is part of that goal. When you want low inflation, you implement central bank independence. We would not expect a formal return to the pre-1951 era Fed which was forced, by regulation, to facilitate Treasury borrowing. But, the White House can accomplish the same thing by emasculating the Fed chair, as Nixon did with Arthur Burns. The undermining of Fed independence hasn't happened yet, but we do expect that to occur at some point and President Trump has started the process by breaking the Clinton-era "Rubin truce."

The G-20 and China talks: It is getting increasingly difficult to figure out how much of the administration's rhetoric is posturing for negotiations and how much is the indication of actual positions. For example, Larry Kudlow suggested yesterday that a deal might occur but his tone was not as optimistic as he usually projects.[3] Kudlow did admit that pre-meeting talks have apparently stalled.[4] At the same time, the *NYT*[5] suggests that, despite Kudlow's attempt to reduce expectations, the president really wants a deal. Since we view the *NYT* as more of a signaling channel for elite opinion and less of a news organization, this could either be an attempt from elements within the administration to nudge the president or it really does reflect the position of the White House. The financial markets have generally discounted a truce of sorts. Although the sides appear too far apart to make a significant agreement, the promises of substantial talks in return for a delay of additional tariffs might be doable. If discussions end badly, look for global equities to sell off.

Macron's woes continue: The French president gave a speech yesterday[6] offering his long-term vision for France. The talk was widely panned with the primary criticism being that Macron seems far too focused on long-term goals and is ignoring the plight of the bottom 90%. The recent hike in gasoline taxes appears to be the trigger; middle and lower class citizens found themselves priced out of the cities due to rising rents and were forced to move to the distant suburbs. Now, with the hike in taxes, they can't afford to drive to work in the cities. Macron appears tone deaf to the concerns of the "yellow jackets" (protestors are wearing the yellow vests that road crews wear), and the longer these protests go on the greater the odds are that a left- or right-wing populist will see increasing popularity.

Brexit update: PM May's plan continues to take harsh criticism; there is growing support for the U.K. to instead join the European Free Trade Association (EFTA),[7] which is what Norway operates under. This alternative does take the U.K. out from under the jurisdiction of the EU courts but still requires it to allow for the free movement of peoples. EFTA is a solution for the elites; the Euroskeptics won't like it but such a program might be able to garner enough support from all the parties to pass. However, PM May is likely a goner if this option becomes "Plan B."

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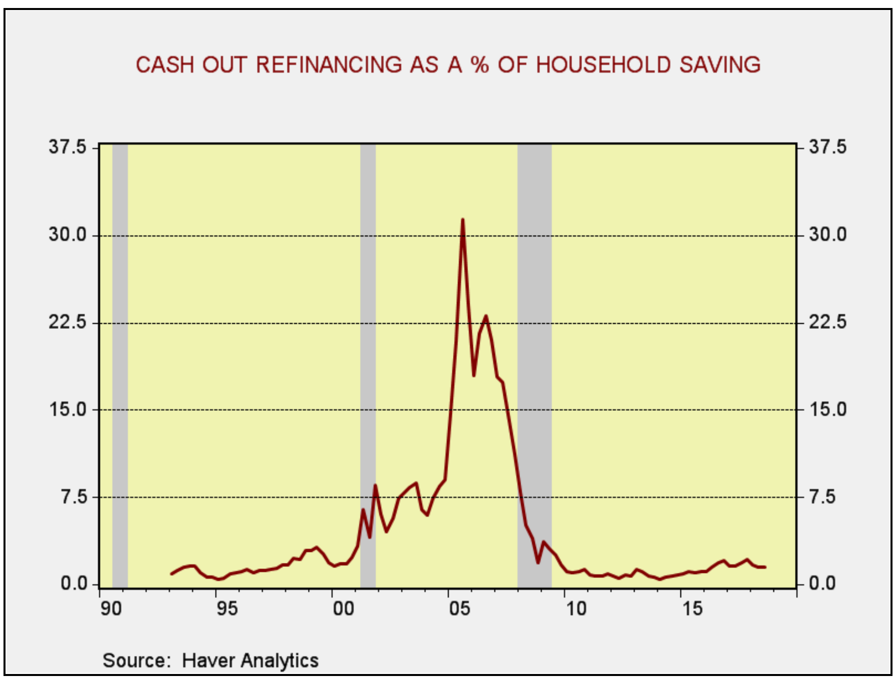
[3] https://www.politico.com/story/2018/11/27/trump-trade-china-xi-meeting-1018195
[4] https://www.ft.com/content/27d7948c-f26c-11e8-ae55-df4bf40f9d0d?emailId=5bfe1af9fe2cdd0004198877&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22
[5] https://www.nytimes.com/2018/11/27/us/politics/trump-xi-trade-g-20.html?emc=edit_mbe_20181128&nl=morning-briefing-europe&nlid=5677267201811 28&te=1
[6] https://www.nytimes.com/2018/11/27/world/europe/macron-france-nuclear-yellow-vests.html?emc=edit_mbe_20181128&nl=morning-briefing-europe&nlid=567726720181128&te=1
[7] https://www.ft.com/content/833dd0b6-f168-11e8-938a-543765795f99

PM May has been something of a political Houdini; her political obituary has been written often. However, this issue might bring her down. On the other hand, the Tories don't want new elections and so we would not expect her resignation to trigger a successful no-confidence vote. Instead, we would expect another compromise PM that will finally bring Brexit to a close.

OPEC: Although we may not get an official cut in quotas, we do expect the cartel to informally reduce output.[8] Russia has indicated it would support Brent at $60, which implies policies to at least stabilize prices, but we expect the Saudis to try to boost prices by at least $10 per barrel.

Don't sleep on a government shutdown: It appears the president is hardening his position on the border wall[9] and lawmakers are struggling to develop a compromise.[10] Given the relative frequency with which such events occur, under normal circumstances we would expect the market to mostly ignore a shutdown, assuming it will be resolved soon. But, with market sentiment fragile, a shutdown could be seen as a "last straw" and trigger a selloff.

One more housing chart: We received a number of comments about our charts in yesterday's report, most expressing surprise that cash-out refinancing has returned. We want to add one more chart which highlights that, even with the surge, current conditions are different than 2005.



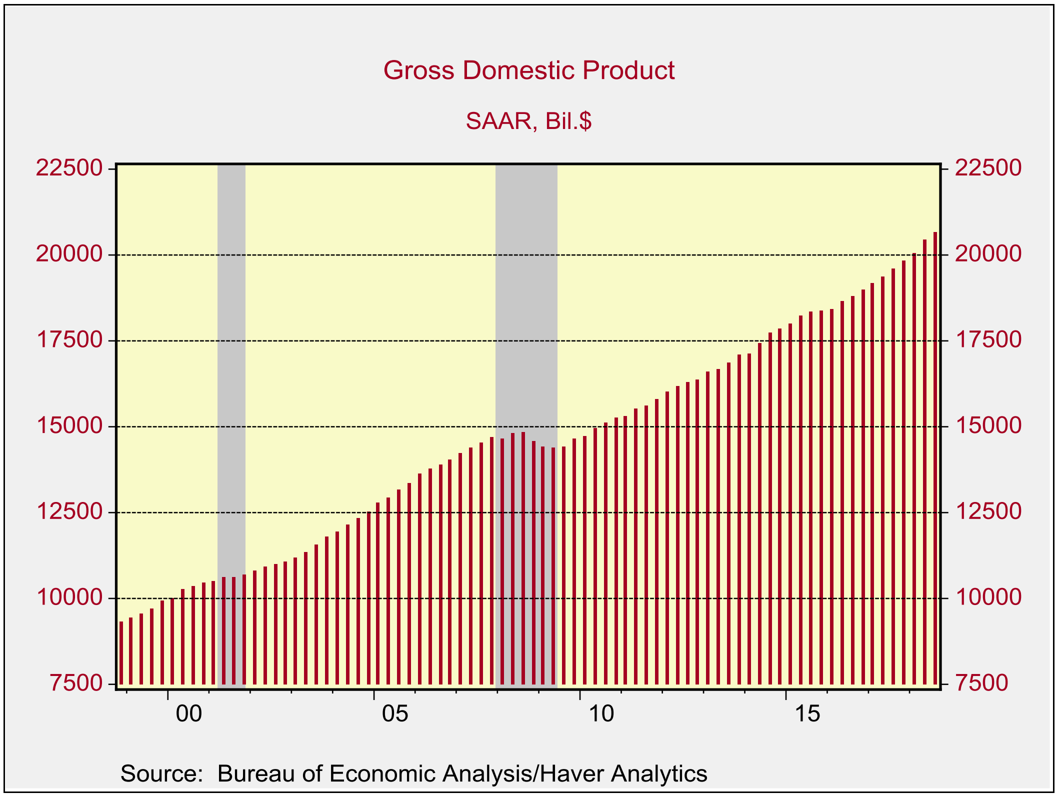
This chart uses the level of cash taken from cash-out refinancing and compares it to overall household saving. At the peak of the housing bubble, cash-out refinancing represented over 30% of total household saving; simply put, households were truly using their homes as a source of saving. Currently, the percentage is 1.5%. Although cash-out refinancing is rising, it is dwarfed

[8] https://www.wsj.com/articles/opec-open-to-risking-trumps-ire-prompted-by-budgets-and-shale-1543333651
[9] https://www.politico.com/story/2018/11/28/trump-politico-interview-1023306
[10] https://www.wsj.com/articles/lawmakers-gridlocked-over-wall-funding-as-deadline-nears-1543361830

by the overall increase in household saving. Thus, in this regard, the reliance on refinancing for cash is probably a localized issue, a factor in housing markets that have seen sharp appreciation.

U.S. Economic Releases

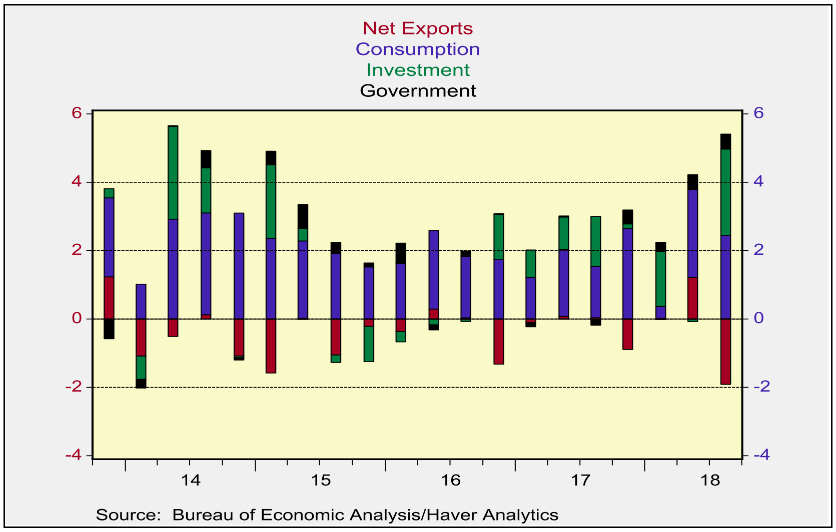
The second reading of Q3 GDP came in line with expectations at 3.5%. Personal consumption came in below expectations at 3.6% compared to the forecast of 3.9%. Core PCE rose 1.5% from the prior quarter. The overall GDP price index was in line with expectations at 1.7%.



The chart above shows historical GDP. As of right now, GDP continues to grow at a solid pace.

	Q3 2018 Second Reading	Q3 2018 Prelim Reading	Difference
GDP	3.5%	3.5%	0.0%
Consumption	2.5%	2.7%	-0.2%
Investment	2.5%	2.0%	0.5%
Inventories	2.3%	2.1%	0.2%
Net Exports	-1.9%	-1.8%	-0.1%
Government	0.4%	0.6%	-0.1%

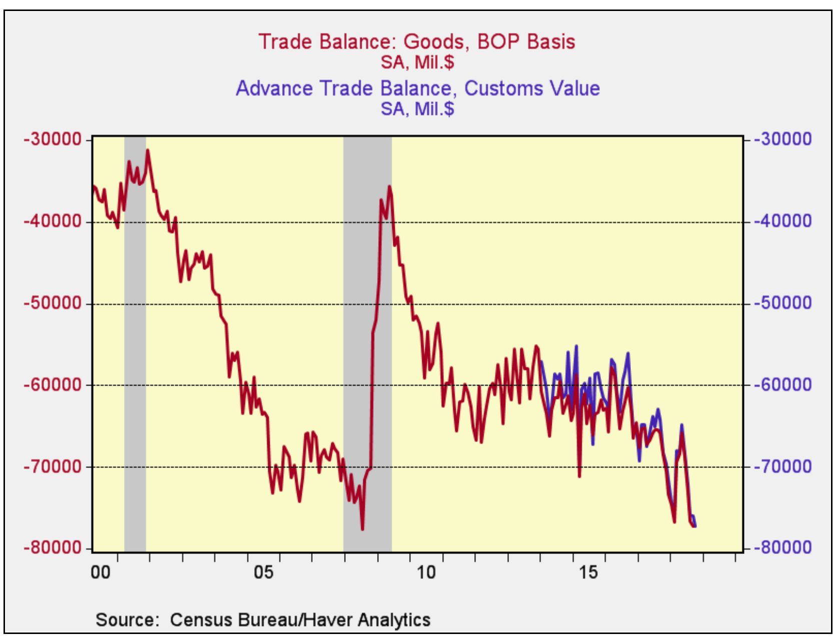
The table above shows the contributions to GDP. There was an upward revision in investment due to a boost in inventories. Consumption and net exports were both revised downward.



This chart above shows the contributions graphically. Net exports was the only negative component in Q3 GDP. Investment was boosted by a sharp rise in inventories.

MBA mortgage applications are down 5.5% from the prior week. Purchases and refinancing are up 8.8% and 0.5%, respectively. The average 30-year fixed rate fell by 4 bps from 5.16% to 5.12%.

The goods trade deficit came in wider than expected at $77.2 bn compared to the forecast of $77.0 bn. The deficit in the prior report was revised upward from $76.0 bn to $76.3 bn. Wholesale inventories came in above expectations, rising 0.7% from the prior month compared to the forecast gain of 0.4%. Retail inventories rose 0.9% from the prior month.



The chart above shows the trade balance of goods and the advance trade balance.

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	New Home Sales	m/m	nov	135.9	137.9	**
10:00	New Home Sales	m/m	nov	4.0%	-5.5%	**
10:00	Richmond Fed Manufacturing Index	m/m	nov	15	15	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
12:00	Jerome Powell speaks to Economic Club of New York	Chairman of Board of Governors of Federal Reserve				

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)	271	269	2	Up
3-mo T-bill yield (bps)	235	235	0	Neutral
TED spread (bps)	36	34	2	Neutral
U.S. Libor/OIS spread (bps)	237	237	0	Up
10-yr T-note (%)	3.06	3.06	0.00	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	22	25	-3	Down
Currencies	**Direction**			
dollar	flat			Neutral
euro	flat			Neutral
yen	flat			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	$59.34	$60.21	-1.44%	Supply Optimism
WTI	$50.97	$51.56	-1.14%	
Natural Gas	$4.43	$4.26	3.85%	
Crack Spread	$14.05	$14.11	-0.39%	
12-mo strip crack	$17.10	$17.26	-0.90%	
Ethanol rack	$1.41	$1.41	-0.11%	
Metals				
Gold	$1,214.34	$1,215.05	-0.06%	
Silver	$14.20	$14.15	0.34%	
Copper contract	$275.85	$272.60	1.19%	
Grains				
Corn contract	$ 370.75	$ 368.50	0.61%	
Wheat contract	$ 507.75	$ 506.50	0.25%	
Soybeans contract	$ 880.50	$ 875.50	0.57%	
Shipping				
Baltic Dry Freight	1339	1217	122	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.0		
Gasoline (mb)		1.0		
Distillates (mb)		0.5		
Refinery run rates (%)		1.00%		
Natural gas (bcf)		-85.0		

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.

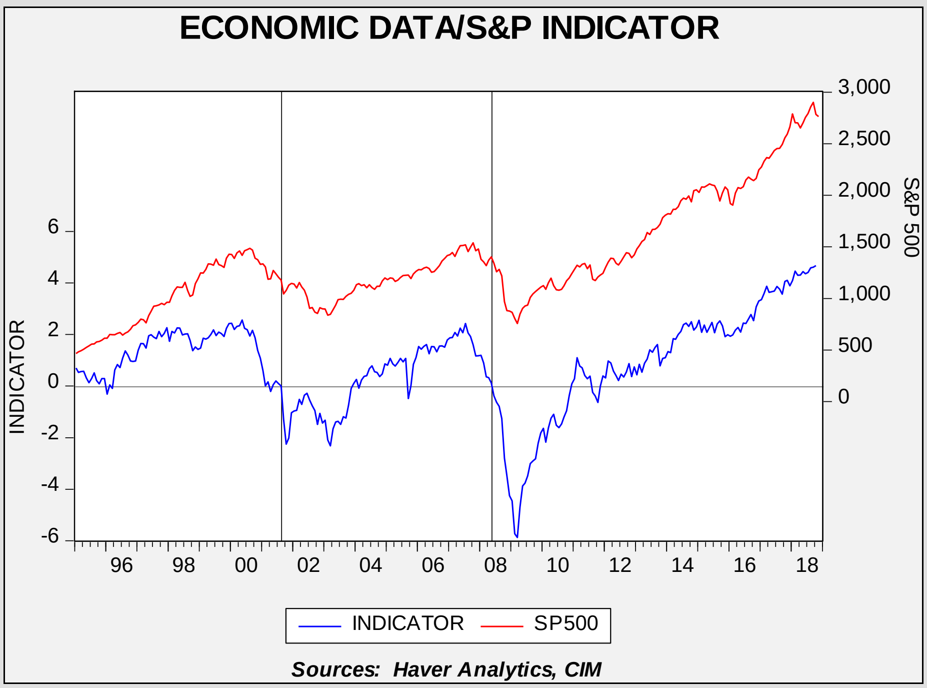
Asset Allocation Weekly Comment

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.

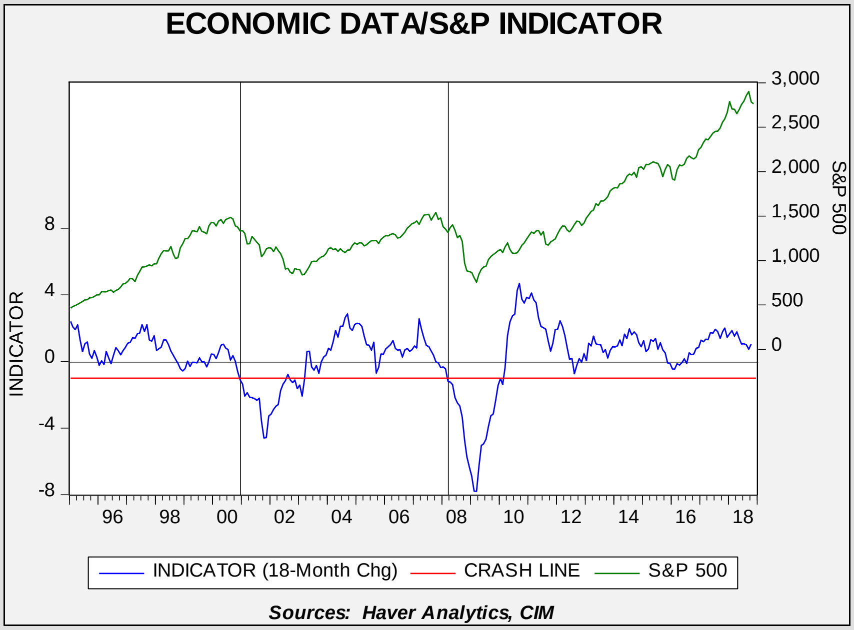
November 16, 2018

(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.



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.

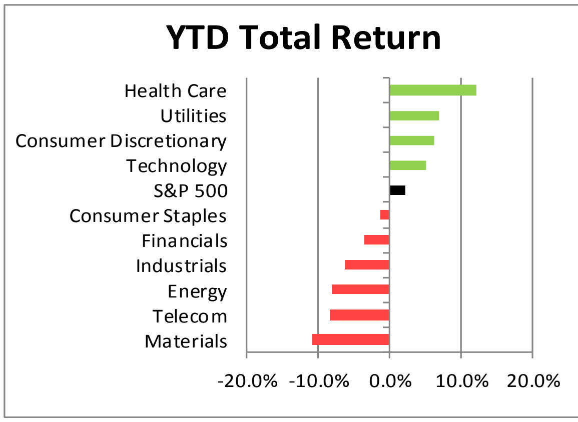


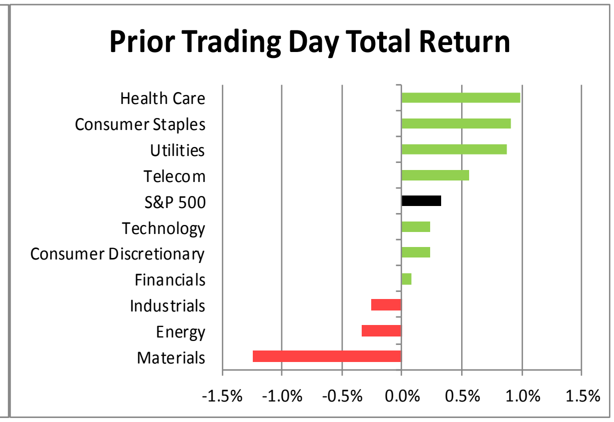
To make the indicator more sensitive, we took the 18-month change and put the signal threshold at -1.0. This provides an earlier bearish signal and also eliminates the false positives that the zero threshold generates. Notwithstanding, we will pay close attention when the 18-month change approaches zero.

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 11/27/2018 close)

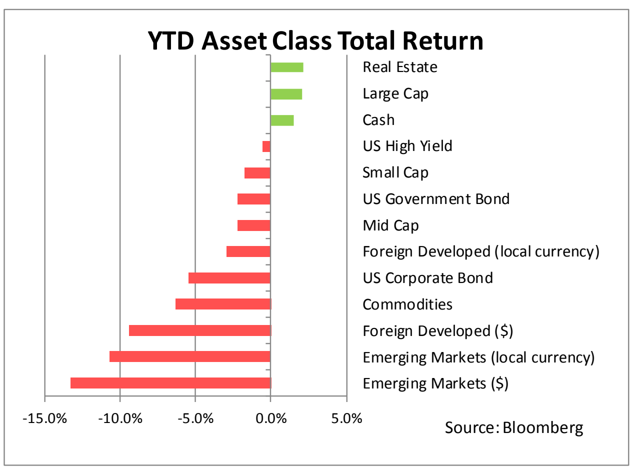




(Source: Bloomberg)

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 11/27/2018 close)

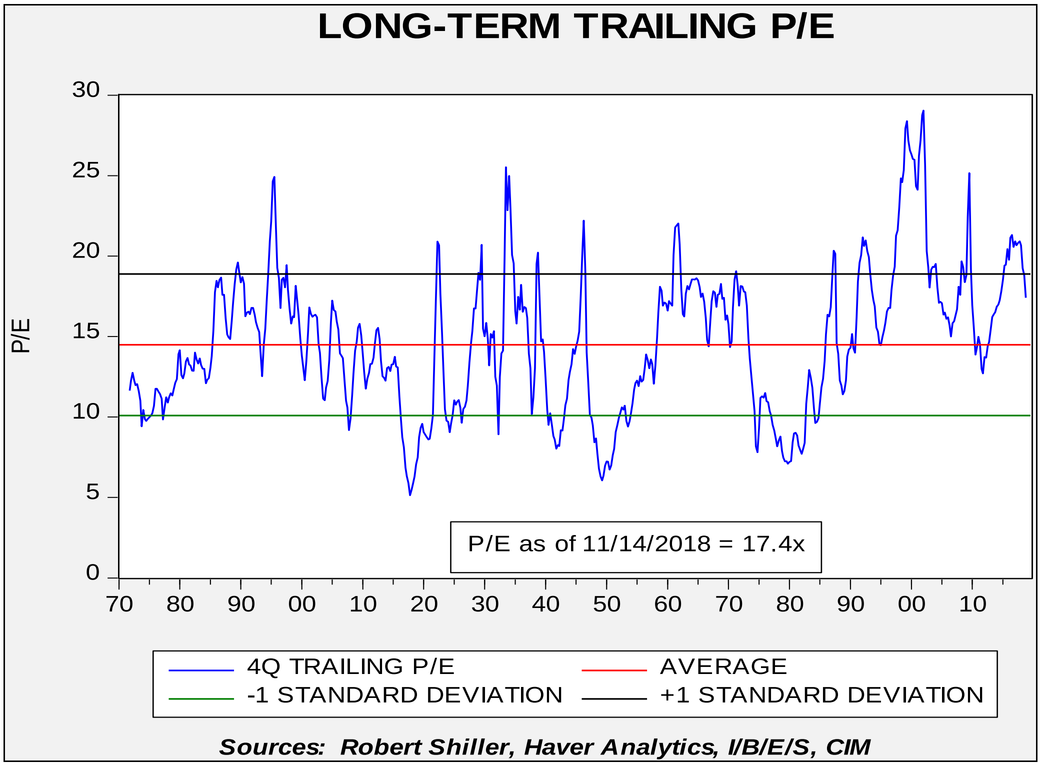


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.