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 29, 2018—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.3% from the last close. In Asia, the MSCI Asia Apex 50 was unchanged from the prior close. Chinese markets were lower, with the Shanghai composite down 1.3% and the Shenzhen index down 2.2%. U.S. equity index futures are signaling a lower open.

Good morning! Equities are consolidating this morning after a strong rally yesterday. Here is what we are watching today:

Powell: After spooking the financial markets in October, Fed Chair Powell gave a much more dovish speech yesterday. There were two elements of this talk that boosted market sentiment. First, he suggested that the current fed funds target was close to neutral[1], implying that the FOMC may be close to ending its tightening cycle or at least considering a pause. In fact, a pause would be consistent with the notion of data dependence. One element that Powell has brought to the Fed is the idea that even the best economic models are approximations and thus it's wise not to be overly reliant on such models in making policy. It is likely that only a non-economist, or perhaps a non-academic economist, could come to such a conclusion. One could argue that Alan Greenspan conducted policy in a similar fashion. Although Greenspan was a trained economist, he worked in the private sector and was never a professor. His decision in the late 1990s to not raise rates when unemployment was low turned out to be correct. However, we would argue he was right for the wrong reasons. His argument for not raising rates was expectations of a productivity boom. Although productivity did rise, it was probably due more to fully utilizing capacity and not any "miracle." Instead, inflation stayed low because of long-running trends in globalization and deregulation. However, it is interesting that the primary proponent of raising rates was Janet Yellen, who was likely working off of Phillips Curve models. So, having Powell in this position means the risk of policy overtightening due to adhering to an academic model has lessened. The risk has been replaced with data dependence. Operating policy on data dependence means, by definition, that policy will be reactive. That's not necessarily a bad thing but it's important to know what risks one is taking.

The second supportive comment from Powell was that he didn't see evidence of financial excess in the financial markets at this time. We would agree with this perspective in most markets. High yield is the one major sector where we would disagree. Spreads remain very narrow;

[1] https://www.ft.com/content/221b509e-f32d-11e8-ae55-df4bf40f9d0d?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

although they can remain at such levels for a long time, the risk/reward isn't all that attractive. Other areas, such as private equity, are frothy as well. But, the major broad markets, stocks and bonds, are, if anything, a bit cheap.

Where do we go from here? Although the financial markets appear to be holding that the Fed is now less of an issue, we do note that the official range of the potential neutral rate is between 2.50% to 3.50%. That information is simply useless, because it implies one to five more hikes. Our Mankiw Rule estimates of neutral range from 1.85% to 3.93%. These model ranges are worthless by themselves. Instead, these models all have independent variables that reflect potential measures of slack. If you think the economy is running at full employment, fed funds should be closer to 4.00%. If you think slack exists, the policy rate is probably already at neutral. Our belief is that there is slack in the economy, which accounts for the continued low level of inflation. Thus, we see little danger in at least pausing the pace of rate hikes. ***The key point here, however, is that the Fed is making decisions under conditions of uncertainty. When making such decisions, one must be aware that the potential for making mistakes is high and thus caution is warranted. Powell seems to understand this better than the last two Chairs, which is probably a plus.***

Further gains in equities in the short run will be dependent on this weekend's G-20 meeting. We do note that there will be a number of Fed speakers in the coming days and some dissent might be expressed. But, for the most part, the focus will now shift to trade.

The G-20 and China talks: We expect some sort of short-term accommodation at this weekend's meeting. We look for the U.S. to delay implementing the tariff hike on China and postpone expanding tariffs on the rest of Chinese imports. China will offer to buy some American goods—look for soybeans, oil and LNG purchases to resume. But, this outcome is merely a reprieve. It has become evident that the president (a) holds that trade is a mercantilist exercise, meaning that trade surpluses are good, deficits bad, and (b) China is a strategic competitor. Simply put, the president views tariffs as a core position.[2]

Apparently, the president is returning to auto tariffs[3], specifically targeting Chinese vehicles.[4] The U.S. is warning European nations to be wary of using Chinese 5G technology for security reasons.[5] The strategic goals of the U.S. and China have diverged and are probably not reconcilable.[6] We note that elite opinion is turning on China, meaning it isn't just the White House that is viewing China as a strategic threat.[7] ***We will likely see a deal this weekend, but it***

[2] https://www.wsj.com/articles/bring-me-tariffshow-trump-and-xi-drove-their-countries-to-the-brink-of-a-trade-war-1543420440

[3] https://www.cnbc.com/2018/11/28/trump-says-auto-tariffs-being-studied-after-gm-restructuring-announcement.html and https://www.ft.com/content/571cd042-f32d-11e8-ae55-df4bf40f9d0d?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

[4] https://www.reuters.com/article/us-usa-trade-china-autos/trump-administration-to-study-tools-to-raise-u-s-tariffs-on-chinese-autos-idUSKCN1NX2XL Note China only exported 53k of cars to the U.S. last year.

[5] https://www.ft.com/content/6719b6b2-f33d-11e8-9623-d7f9881e729f

[6] https://www.ft.com/content/be50582a-f2e6-11e8-ae55-df4bf40f9d0d

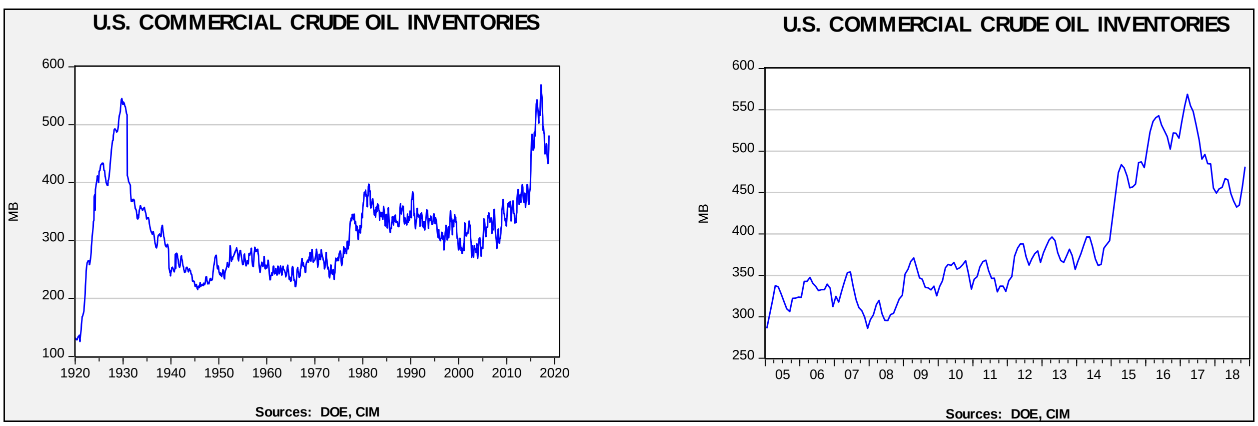
[7] https://www.washingtonpost.com/opinions/chinas-ominous-plan-to-penetrate-and-sway-the-united-states/2018/11/28/bc245ece-f34b-11e8-aeea-b85fd44449f5_story.html?utm_term=.493f55b33445

should only be seen as a truce; U.S. and China policy is likely to become increasingly hostile going forward.

Brexit update: Both the government and the BOE gave their economic assessments of Brexit yesterday. In all cases, leaving the EU is expected to harm the British economy, with a "hard Brexit" causing serious economic damage.[8] Market reaction to these studies was barely noticeable, suggesting the financial markets expect policymakers to avoid the worst outcomes. We tend to agree with this assessment, but worry that policymakers, seeing the lack of market turmoil, may misinterpret the reaction and think they don't have to worry about a hard Brexit. We do expect the May Brexit plan to fail in Parliament; it may pass with a second vote after May resigns, or we could have another referendum. Hard Brexit, exiting without a deal, is still the least likely outcome, but that isn't to say that outcome is impossible.

A sober note: U.S. life expectancy from birth fell a tenth of a year; it peaked at 78.9 years in 2014 and is now down to 78.6 years.[9] Rapidly rising suicide rates[10] and drug overdoses are the primary culprits for the stalling of life expectancy.[11] It is highly unusual for life expectancy to decline in an industrialized nation and what we are seeing in the U.S. may also reflect the economic fallout from the Great Financial Crisis.

Energy Recap: U.S. crude oil inventories rose 3.6 mb compared to market expectations for a 1.0 mb draw.



This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. Refinery utilization rose last week 2.9%, but crude oil imports also increased 0.6 mbpd. Oil production

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[8] https://www.politico.eu/article/best-case-brexit-scenario-means-2-5-percent-hit-to-uk-growth-over-15-years/?utm_source=POLITICO.EU&utm_campaign=d371e174d1-EMAIL_CAMPAIGN_2018_11_29_05_34&utm_medium=email&utm_term=0_10959edeb5-d371e174d1-190334489 and https://www.nytimes.com/2018/11/28/world/europe/uk-brexit-economy.html?emc=edit_mbe_20181129&nl=morning-briefing-europe&nlid=567726720181129&te=1

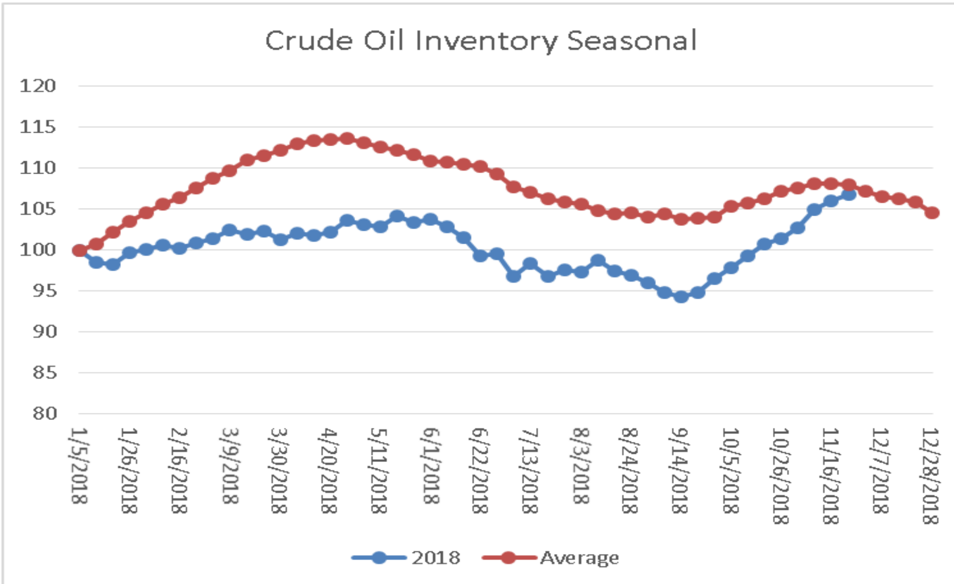
[9] https://www.wsj.com/articles/u-s-life-expectancy-falls-further-1543467660

[10] https://www.wsj.com/articles/cdc-finds-rise-in-suicide-rates-across-the-u-s-1528417378

[11] https://www.wsj.com/articles/cocaine-meth-opioids-all-fuel-rise-in-drug-overdose-deaths-1537466455

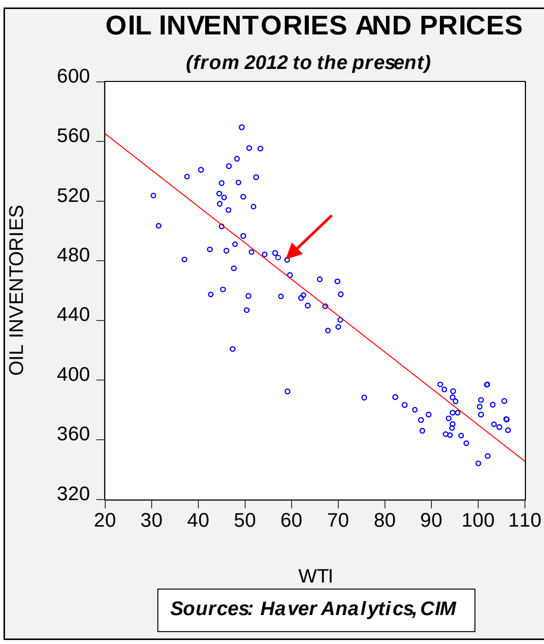
remains elevated at 11.7 mbpd. The rise in stockpiles was due mostly to high production and rising imports offsetting the recovery in refining operations.

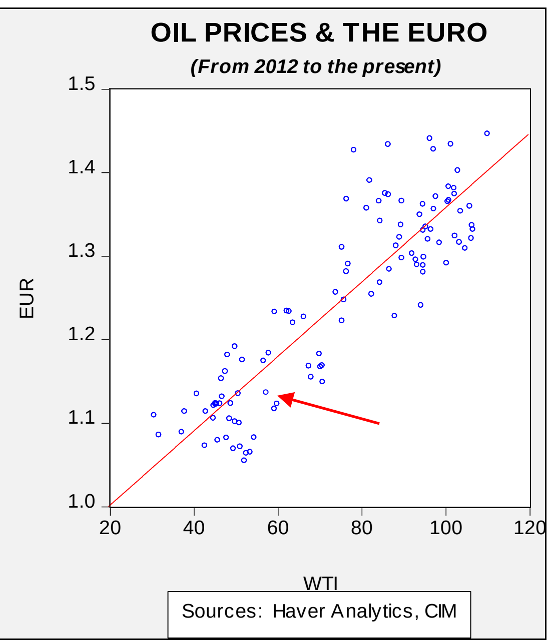
As the seasonal chart below shows, inventories have recovered strongly this autumn.



(Sources: DOE, CIM)

Although the seasonal pattern would suggest inventory declines into year's end, the decline won't be significant and in early January, another seasonal build should commence. If OPEC doesn't act to curtail supply by Q1, prices could come under further pressure.



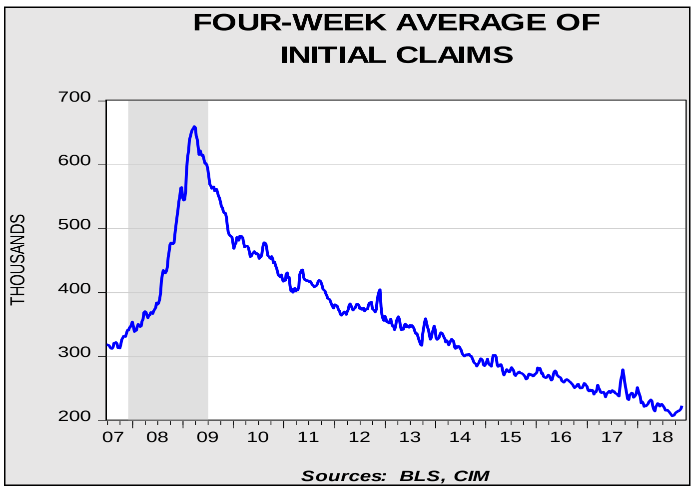


Based on inventories alone, oil prices are below fair value price at $57.58. Meanwhile, the EUR/WTI model generates a fair value of $54.56. Together (which is a more sound methodology), fair value is $54.81, meaning that current prices are below fair value. It is worth noting the dollar has weakened modestly following Powell's speech yesterday. If this continues, it would be supportive for oil prices.

We are seeing higher oil prices this morning after Russia indicated it is considering production cuts[12]; this is a change from comments yesterday, which sent prices lower. If Russia agrees to join OPEC in reducing supply, we should see oil prices recover.

U.S. Economic Releases

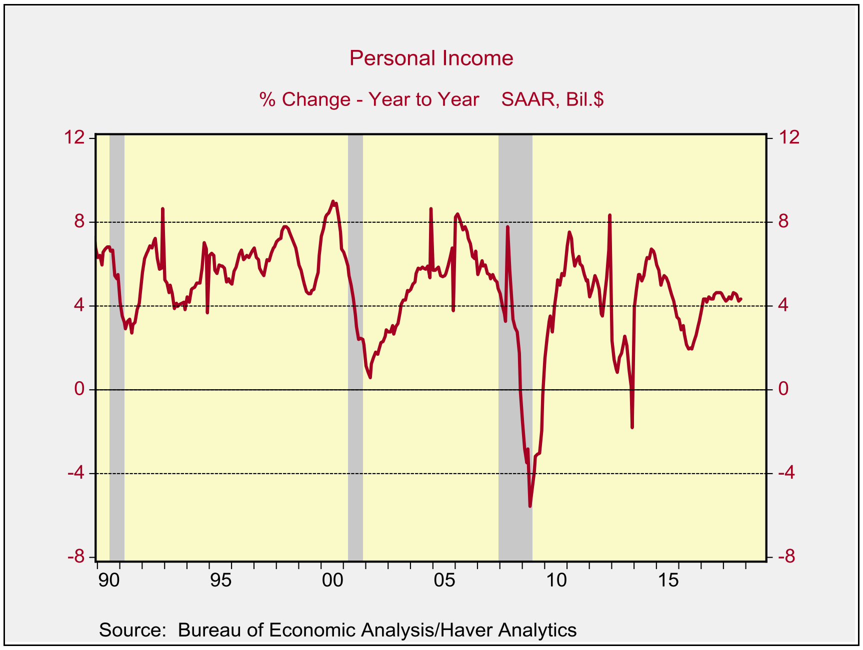
Initial jobless claims came in above expectations at 234k compared to the forecast of 220k.



The chart above shows the four-week moving average of initial claims. The four-week moving average increased from 217.25k to 222.00k. This may be due to wildfires that took place in California.

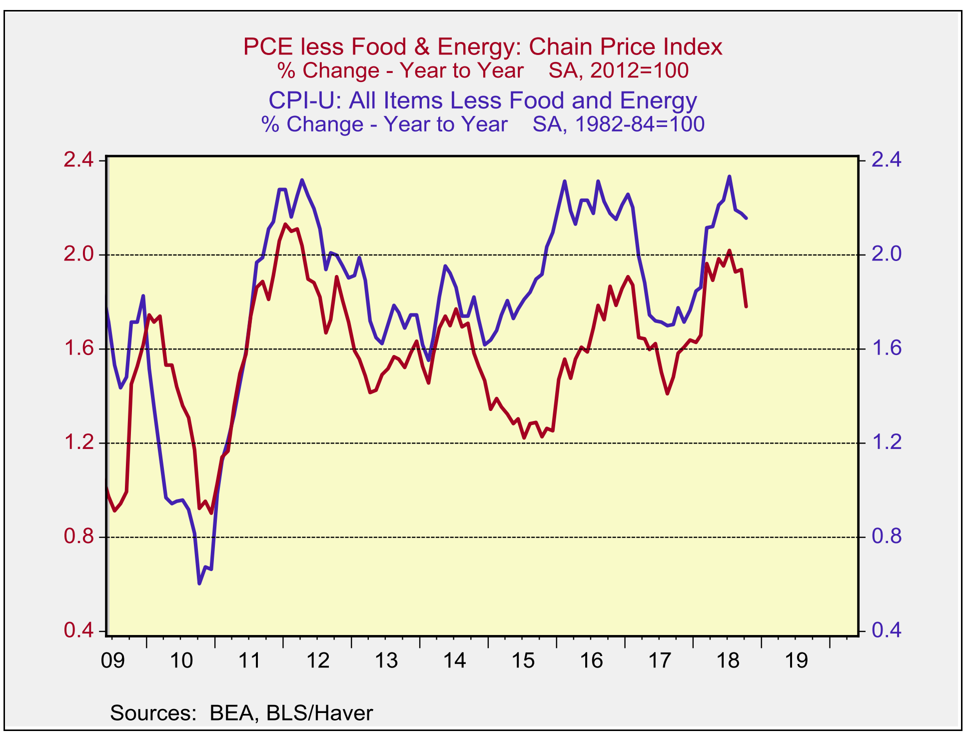
Personal income came in above expectations, rising 0.5% from the prior month compared to the forecast of 0.4%. Personal spending came in above expectations, rising 0.6% from the prior month compared to a forecast of 0.4%. The prior month was revised downward from 0.4% to 0.2%. Real personal spending also came in above expectations rising 0.4% from the prior month compared to the forecast of 0.2%. The prior month was revised downward from 0.3% to 0.1%.

[12] https://www.reuters.com/article/us-oil-opec-russia-exclusive/exclusive-russia-accepts-need-for-oil-cuts-bargains-with-saudi-on-details-sources-idUSKCN1NY1GX



The chart above shows the year-over-year change in personal income. Personal income rose 4.3% from the prior year.

The PCE deflator was in line with expectations, rising 0.2% from the prior month. Core PCE was below expectations, rising 0.1% from the prior month compared to the forecast of 0.2%.



The chart above shows the year-over-year change in core PCE and core CPI. The yearly change in core PCE and core CPI rose 1.8% and 2.2%, respectively. The FOMC has a target of 2.0% for core PCE inflation. By this measure, the Fed has achieved its policy goal on both full employment and inflation.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Bloomberg Consumer Comfort	m/m	nov		61.3	**
10:00	Pending Home Sales	m/m	oct	0.5%	0.5%	**
10:00	Pending Home Sales	m/m	oct	-2.8%	-3.4%	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
14:00	FOMC Meeting Minutes	Members of the Board of Governors				

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	Swift Global Payments CNY	y/y	oct	1.7%	1.9%		**	Equity and bond neutral
Japan	Japan Buying Foreign Bonds	y/y	nov	-¥736.40 bn	-¥145.2 bn		*	Equity and bond neutral
	Japan Buying Foreign Stocks	y/y	nov	¥80.8 bn	¥245.3 bn		*	Equity and bond neutral
	Foreign Buying Japan Bonds	y/y	nov	¥392.0 bn	-¥16.1 bn		*	Equity and bond neutral
	Foreign Buying Japan Stocks	y/y	nov	-¥195.0 bn	-¥179.2 bn		*	Equity and bond neutral
	Retail Trade	y/y	oct	1.3%	1.2%	1.2%	**	Equity bullish, bond bearish
	Retail Sales	m/m	oct	1.2%	-0.2%	0.4%	**	Equity and bond neutral
Australia	Private Capital Expenditure	q/q	3q	-0.5%	-2.5%	1.0%	**	Equity bearish, bond bullish
EUROPE								
Eurozone	Economic Confidence	m/m	nov	109.5	109.8	109.1	**	Equity bullish, bond bearish
	Business Climate Indicator	m/m	nov	1.09	1.01	0.96	**	Equity bullish, bond bearish
	Industrial Confidence	m/m	nov	3.4	3.0	2.5	**	Equity bullish, bond bearish
	Service Confidence	m/m	nov	13.3	13.6	13.1	**	Equity bullish, bond bearish
	Consumer Confidence	m/m	nov	-3.9	-3.9	-3.9	**	Equity and bond neutral
France	Consumer Spending	m/m	oct	0.9%	-1.5%	0.9%	**	Equity and bond neutral
	GDP	y/y	3q	1.4%	1.5%	1.5%	**	Equity and bond neutral
U.K.	Net Consumer Credit	m/m	oct	0.9 bn	0.8 bn	1.0 bn	**	Equity and bond neutral
	Net Lending Sec. on Dwellings	m/m	oct	4.1 bn	3.9 bn	3.5 bn	**	Equity bullish, bond bearish
	Mortgage Approvals	m/m	oct	67.1k	65.3k	64.6k	**	Equity bullish, bond bearish
Switzerland	GDP	y/y	3q	2.4%	3.4%	2.9%	**	Equity bearish, bond bullish
AMERICAS								
Brazil	Total Outstanding Loans	m/m	oct	3.165 bn	3.169 bn		**	Equity and bond neutral
	National Unemployment Rate	m/m	oct	11.7%	11.9%	11.7%	**	Equity and bond neutral
Canada	CFIB Business Barometer	m/m	nov	61.2	60.5		**	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	271	0	Up
3-mo T-bill yield (bps)	233	234	-1	Neutral
TED spread (bps)	38	37	1	Neutral
U.S. Libor/OIS spread (bps)	238	237	1	Up
10-yr T-note (%)	3.02	3.06	-0.04	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	17	21	-4	Down
Currencies	**Direction**			
dollar	flat			Neutral
euro	up			Neutral
yen	up			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	$59.48	$58.76	1.23%	Russia willing to Join OPEC cut
WTI	$51.06	$50.29	1.53%	
Natural Gas	$4.58	$4.70	-2.62%	
Crack Spread	$13.97	$14.00	-0.19%	
12-mo strip crack	$17.11	$17.07	0.28%	
Ethanol rack	$1.41	$1.41	-0.17%	
Metals				
Gold	$1,227.14	$1,221.23	0.48%	
Silver	$14.32	$14.33	-0.06%	
Copper contract	$280.80	$281.35	-0.20%	
Grains				
Corn contract	$ 372.75	$ 373.25	-0.13%	
Wheat contract	$ 508.25	$ 511.50	-0.64%	
Soybeans contract	$ 886.00	$ 890.50	-0.51%	
Shipping				
Baltic Dry Freight	1330	1339	-9	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	3.6	-1.0	4.6	
Gasoline (mb)	-0.8	1.0	-1.8	
Distillates (mb)	2.6	0.5	2.1	
Refinery run rates (%)	2.90%	1.00%	1.9%	
Natural gas (bcf)		-85.0		

Weather

The 6-10 and 8-14 day forecasts show cooler temps for the country. Precipitation is expected for most of the country.

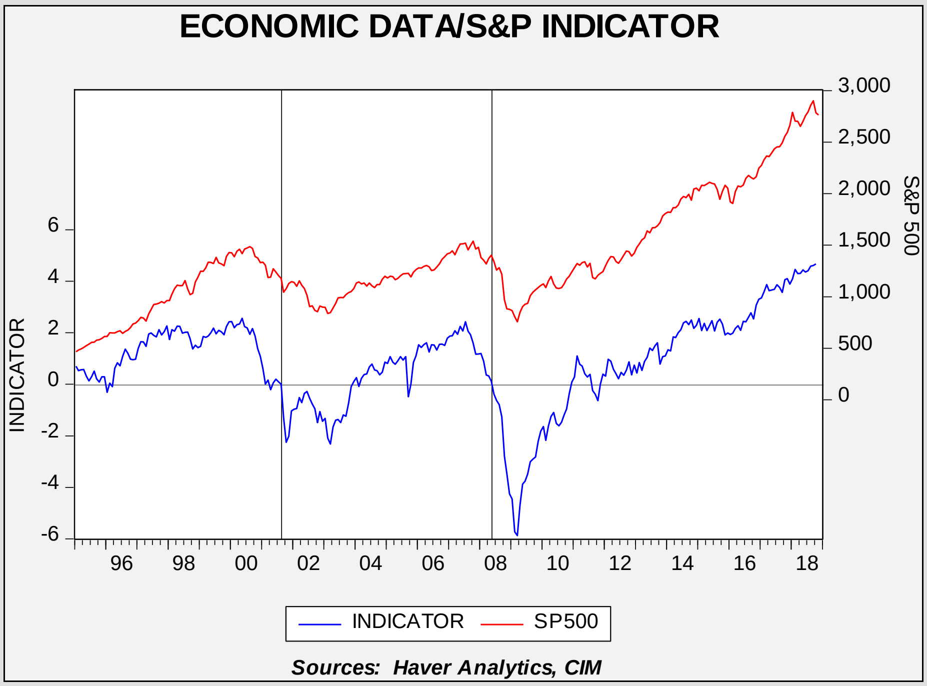
Asset Allocation Weekly Comment

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.

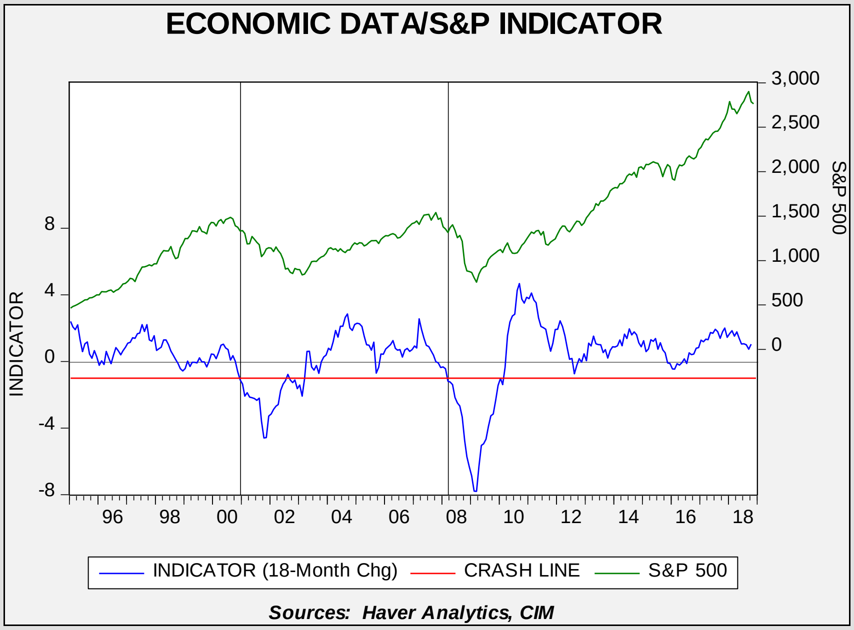
November 16, 2018

(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.

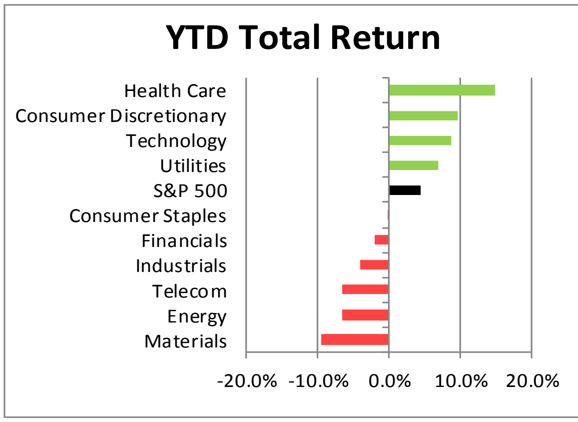


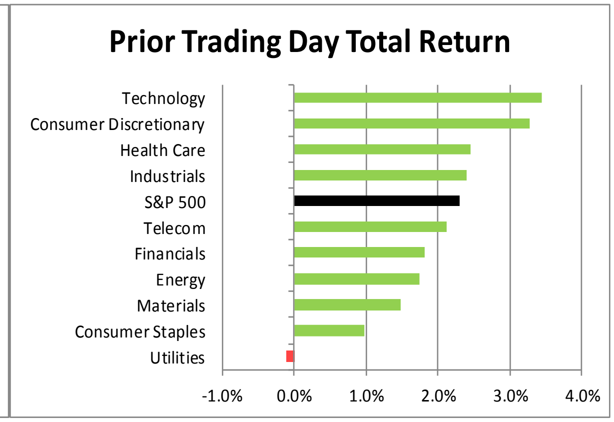
To make the indicator more sensitive, we took the 18-month change and put the signal threshold at -1.0. This provides an earlier bearish signal and also eliminates the false positives that the zero threshold generates. Notwithstanding, we will pay close attention when the 18-month change approaches zero.

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 11/28/2018 close)

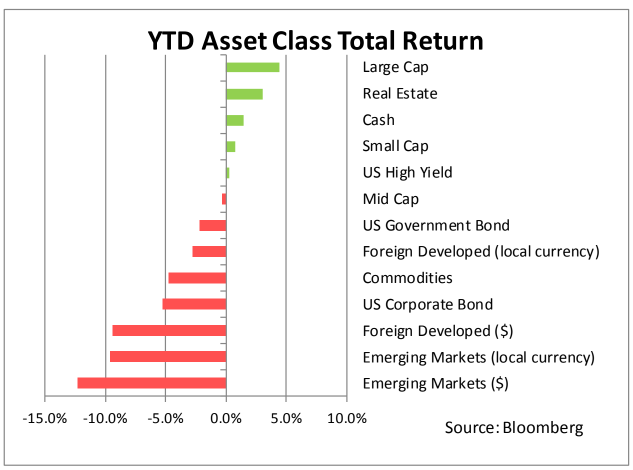




(Source: Bloomberg)

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 11/28/2018 close)

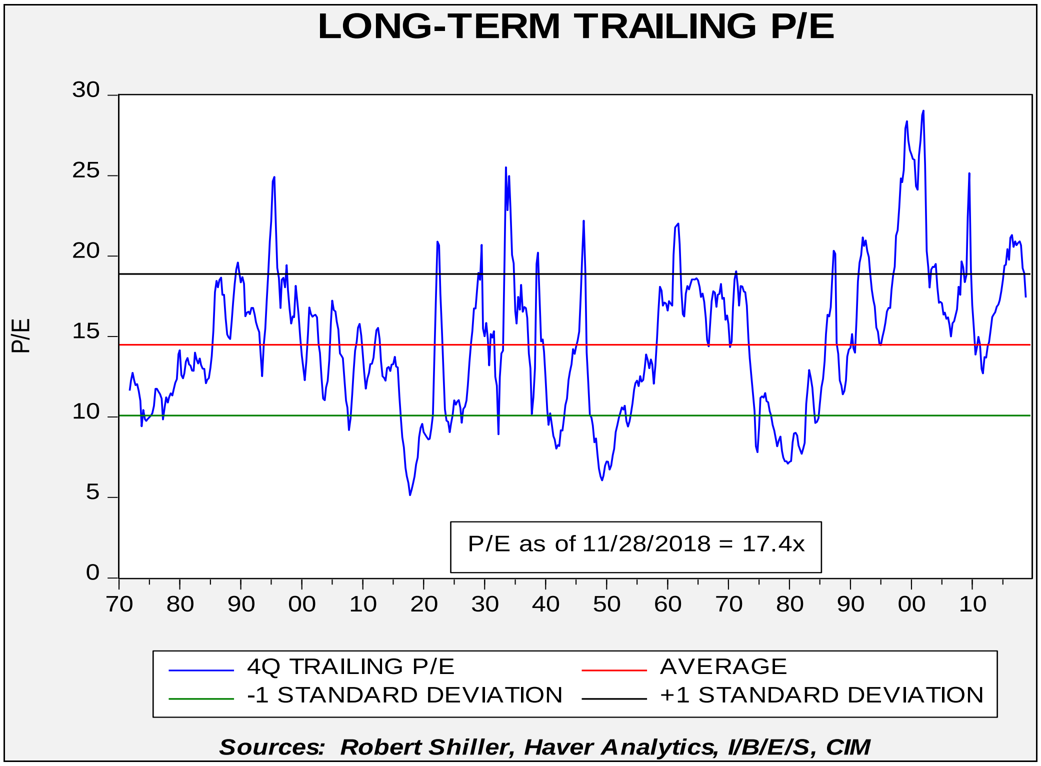


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 29, 2018



Based on our methodology,[13] the current P/E is 17.4x, unchanged from our last reading.

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.

[13] 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 three actual quarters (Q1, Q2 and Q3) and onestimates (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.