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 9, 2018—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 0.8% from the last close. In Asia, the MSCI Asia Apex 50 was down 2.0% from the prior close. Chinese markets were lower, with the Shanghai composite down 1.4% and the Shenzhen index down 0.4%. U.S. equity index futures are signaling a lower open. With 449 companies having reported, the S&P 500 Q3 earnings stand at $42.62, higher than the $40.50 forecast for the quarter. The forecast reflects a 21.0% increase from Q3 2017 earnings. Thus far this quarter, 77.1% of the companies reported earnings above forecast, while 15.1% reported earnings below forecast.

It's Friday, just not a very happy one. The market tone is definitely risk-off. Today's weakness is mostly made in China but there are other concerns as well. Here is what we are watching:

China: The inflation data (see below) was mostly in line with expectations. There was some welcome easing of inflation at the producer level. We may see a pickup in import prices in the coming months due to recent CNY weakness. Easing price pressures could give the PBOC room for further stimulus. However, other media reports are raising concerns. For example, over the past year, companies were trying to maintain borrowing when the PBOC was cracking down on shadow banking. The response was to circumvent these restrictions by borrowing from banks using shares that were pledged as collateral. As any financial advisor in the U.S. knows, this is a form of margin lending and the risk of such borrowing is that the value of the collateral declines, leading to the dreaded margin call. In China, the pledged shares were not used for additional share-buying but for business needs. The bear market in Chinese stocks has now raised concerns about the collateral of these loans, which are said to be about $620 bn, or about 10% of market capitalization.[1] So far, lenders have not forced borrowers to sell shares and pay back the loans; we suspect financial regulators are pressing banks not to take this action.[2] However, by not forcing the sale of shares, banks are now reserving against these loans, which will further crimp lending.

This isn't the only area of concern in China. For the fourth straight month, car sales have shown negative yearly growth, falling 12% in October. For the year through October, sales are down

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[1] https://www.reuters.com/article/us-china-markets-pledgedshares-insight/in-china-response-to-pledged-share-meltdown-stirs-concern-idUSKCN1NE0PD?feedType=RSS&feedName=businessNews&utm_source=Twitter&utm_medium=Social&utm_campaign=Feed%3A+reuters%2FbusinessNews+%28Business+News%29

[2] https://www.apnews.com/c14fed9f16594f1d9df6baf9b656de66

0.1% compared to the same period last year. It appears a confluence[3] of events, including worries over trade, falling equity values and tightening credit standards, is undermining car sales.[4] Sentiment weakness has also led to falling Chinese tourism.[5]

The geopolitical situation is deteriorating as well. The Trump administration is accusing China of violating an Obama-era cyber-theft agreement.[6] In fact, it appears cyber-theft jumped after Obama left office. The U.S. has already responded with the DOJ starting a "Chinese initiative" to counter China's activity.[7] In the meantime, the U.S. Navy and the People's Liberation Army Navy continue their dangerous encounters in the South China Sea.[8] Defense Secretary Mattis has been working hard to maintain open lines of communication to reduce the chances of a spiraling conflict.[9] Although President Trump has made no secret of his dislike for his SoD,[10] for now, his position appears safe.[11]

In summary, China's financial situation is becoming increasingly perilous. Although a sudden debt crisis is possible, we don't think it is the most likely outcome. Instead, we suspect China is going the route of Japan, post-1990, where growth slows to a level where additional debt isn't necessary to support growth. The key unknown is whether the CPC can change its political legitimacy from delivering high growth to something else. Chairman Xi has amassed enough power to make changes that will address this issue; what we don't know is whether he can come up with a new form of legitimacy that allows China to remain a single-party state. The most likely outcome is a long period of slowing growth. But, that doesn't mean that a sudden stop isn't possible—it's just not as likely.

The Fed: There were no surprises in the FOMC action or statement.[12] The Fed did acknowledge that unemployment is really low but also noted that business investment has been disappointing. There is no doubt the Fed will raise rates in December.[13] It should also be noted that every meeting going forward will have a press conference. In theory, this could make every meeting live but we note that forecasts and dots will still only occur quarterly. We will be watching to see if the FOMC will take action on rates when there are no new dots.

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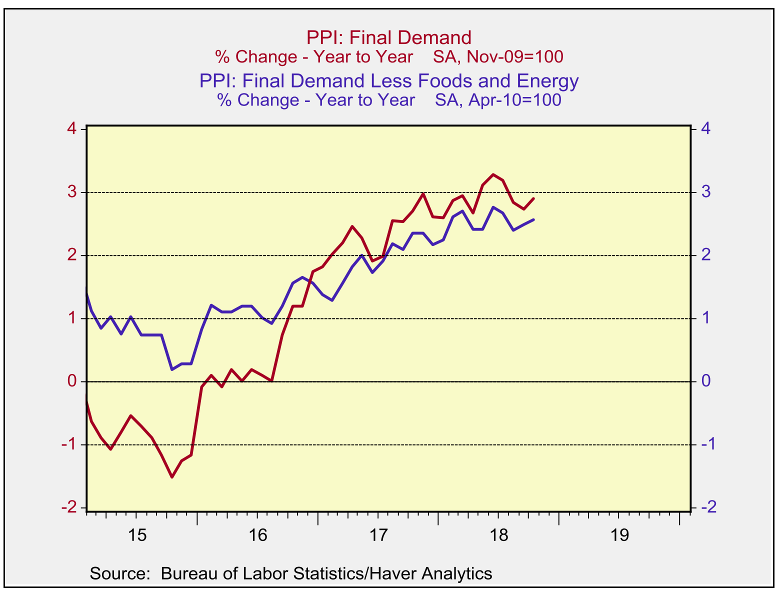
[3] See what we did there?
[4] https://www.wsj.com/articles/china-auto-sales-on-track-for-a-down-year-1541750936
[5] https://www.wsj.com/articles/chinese-travel-giant-trips-up-investors-1541743516
[6] https://www.wsj.com/articles/china-violated-obama-era-cybertheft-pact-u-s-official-says-1541716952
[7] https://www.wsj.com/articles/u-s-accuses-two-firms-of-stealing-trade-secrets-from-micron-technology-1541093537
[8] https://www.nytimes.com/2018/11/08/world/asia/south-china-sea-risks.html
[9] https://www.reuters.com/article/us-usa-china-mattis-insight/how-mattis-is-trying-to-keep-u-s-china-tensions-from-boiling-over-idUSKCN1NE0FF
[10] https://www.nytimes.com/2018/10/14/us/politics/trump-mattis-democrat.html
[11] https://www.bloomberg.com/news/articles/2018-11-05/trump-says-he-plans-to-keep-mattis-as-defense-chief-after-vote
[12] https://www.wsj.com/articles/fed-doesnt-budge-1541710988
[13] https://www.ft.com/content/8989b08c-e387-11e8-8e70-5e22a430c1ad?emailId=5be51a6f4c00e900045a33a8&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22&kbc=undefined

Oil prices continue to decline: Oil prices remain under pressure this morning, with WTI dropping below $60 per barrel. The catalyst today was a report that the Keystone Pipeline project was halted by a federal judge, arguing that the administration didn't take environmental concerns into account.[14] To some extent, the market reaction doesn't make a lot of sense. If the Keystone project was functioning, it would be bringing Canadian tar sands oil to the Gulf Coast, adding to supplies there. The bigger reason for the weakness is rising domestic inventories that are partly due to seasonal factors and partly due to rising U.S. production. In addition, Iraq may be close to a deal with the Kurds that would restart exports from Kirkuk.[15] Oil remains oversold but clearly hasn't found a bottom yet.

Cabinet changes: Although the Sessions resignation has been the focus of the media, there are rumors that Wilbur Ross may be out at Commerce.[16] A potential replacement could be Linda McMahon; she is considered a free trader and may signal a shift toward trade deals and away from punitive tariffs. Although we doubt China will get much relief, a McMahon Commerce Department may be more open to deals with the EU and Japan.

U.S. Economic Releases

PPI final demand came in above expectations, rising 0.6% from the prior month compared to the forecast of 0.2%. PPI excluding food and energy also came in above expectations, rising 0.5% from the prior month compared to the forecast of 0.2%. Core PPI, which excludes food, energy and trade services, came in line with expectations, rising 0.2% from the prior month.



The chart above shows the year-over-year change in headline PPI and core PPI, which rose 2.9% and 2.6%, respectively.

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[14] https://www.washingtonpost.com/nation/2018/11/09/keystone-xl-pipeline-blocked-by-federal-judge-major-blow-trump-administration/?utm_term=.9e32c5ce427a
[15] https://www.ft.com/content/4c7d6e66-e370-11e8-a6e5-792428919cee
[16] https://www.politico.com/story/2018/11/08/russia-probe-trumps-attorney-general-hunt-978771

The table below lists the economic releases and Fed events scheduled for today.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Wholesale Inventories	m/m	sep	0.3%	0.3%	***
10:00	Wholesale Trade Sales	m/m	sep	0.4%	0.8%	**
10:00	U. of Michigan Sentiment	m/m	nov	98.0	98.6	***
10:00	U. of Michigan Current Conditions	m/m	nov	87.2	89.3	**
10:00	U. of Michigan Expectations	m/m	nov	114.9	113.1	**
10:00	U. of Michigan 1 yr Inflation	m/m	nov		2.9%	**
10:00	U. of Michigan 5-10 Yr Inflation	m/m	nov		2.4%	**
Fed speakers or events						
EST	Speaker or event	District or position				
12:00	Inaugural Supervision and Regulation Report	Federal Reserve Board				

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	PPI	y/y	oct	3.3%	3.6%	3.3%	**	Equity and bond neutral
	CPI	y/y	oct	2.5%	2.5%	2.5%	***	Equity and bond neutral
Japan	Money stock M3	y/y	sep	2.3%	2.5%	2.4%	**	Equity and bond neutral
	Money stock M2	y/y	sep	2.7%	2.8%	2.8%	**	Equity and bond neutral
Australia	Home Loans	m/m	sep	-1.0%	-2.1%	-1.0%	**	Equity and bond neutral
New Zealand	ANZ Truckometer Heavy	m/m	sep	4.6%	-2.6%		**	Equity and bond neutral
EUROPE								
France	Industrial Production	y/y	sep	-1.1%	1.6%	1.1%	***	Equity bearish, bond bearish
	Manufacturing Production	y/y	sep	-1.0%	1.9%	1.8%	**	Equity bearish, bond bearish
AMERICAS								
Mexico	CPI	y/y	oct	4.9%	5.0%	4.9%	***	Equity and bond neutral
	CPI core	m/m	oct	0.3%	0.3%	0.3%	***	Equity and bond neutral
Canada	Housing Starts	m/m	oct	205.9k	188.7k	198.0k	**	Equity bullish, bond bearish
	New Housing Price Index	y/y	sep	0.2%	0.4%	0.2%	**	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)	260	259	1	Up
3-mo T-bill yield (bps)	230	231	-1	Neutral
TED spread (bps)	30	29	1	Neutral
U.S. Libor/OIS spread (bps)	233	233	0	Up
10-yr T-note (%)	3.21	3.24	-0.03	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	44	44	0	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	up			Neutral
pound	down			Neutral
franc	flat			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
FOMC Rate Decision (Upper Bound)	2.250%	2.250%	2.250%	On forecast
FOMC Rate Decision (Lower Bound)	2.000%	2.000%	2.000%	On forecast
Interest Rate on Excess Reserves	2.200%	2.200%	2.200%	On forecast

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	$69.73	$70.65	-1.30%	Fears of Oversupply
WTI	$59.82	$60.67	-1.40%	
Natural Gas	$3.61	$3.54	1.78%	
Crack Spread	$15.32	$15.73	-2.60%	
12-mo strip crack	$17.57	$17.80	-1.28%	
Ethanol rack	$1.42	$1.42	0.00%	
Metals				
Gold	$1,218.82	$1,224.00	-0.42%	
Silver	$14.33	$14.44	-0.76%	
Copper contract	$269.70	$273.60	-1.43%	
Grains				
Corn contract	$ 371.00	$ 373.50	-0.67%	
Wheat contract	$ 501.75	$ 507.75	-1.18%	
Soybeans contract	$ 875.75	$ 879.00	-0.37%	
Shipping				
Baltic Dry Freight	1231	1304	-73	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	5.8	2.0	3.8	
Gasoline (mb)	1.9	-1.8	3.6	
Distillates (mb)	-3.5	-2.0	-1.5	
Refinery run rates (%)	0.60%	0.90%	-0.30%	
Natural gas (bcf)	65.0	48.0	17.0	

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temps for the West Coast and cooler temps for the rest of the country. There are no tropical cyclones expected over the next 48 hours.

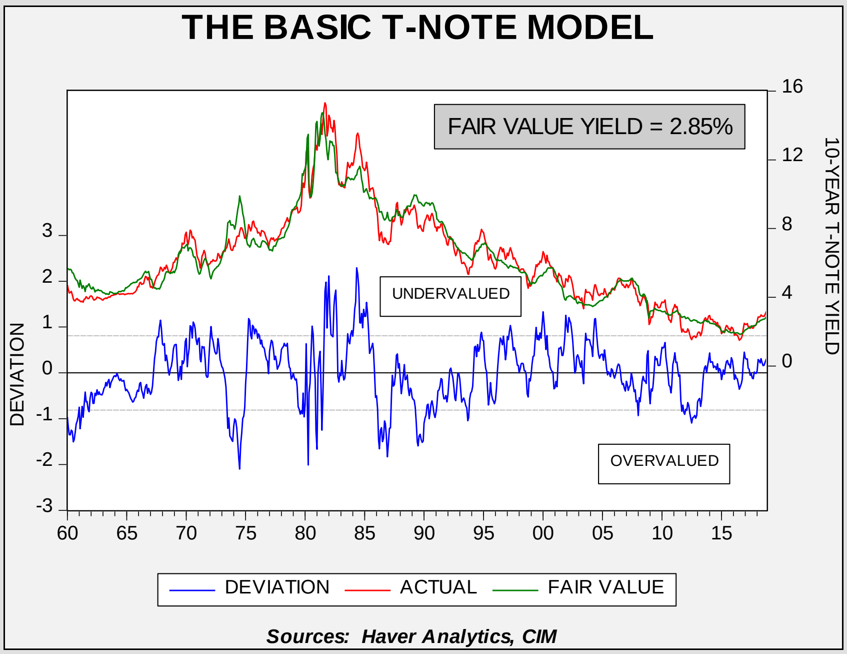
Asset Allocation Weekly Comment

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 9, 2018

In light of rising interest rates, this week we will take a look at credit spreads. But, before doing that, it makes sense to examine overall Treasury valuation.

This chart is our 10-year T-note model. It incorporates fed funds, the Japanese yen exchange rate, German sovereign 10-year yields, oil prices, the fiscal deficit as a percentage of GDP and an inflation proxy.[17]



This model does suggest current 10-year yields are elevated, but not at extreme levels. However, if we assume a terminal fed funds rate of 3.25%, assuming no change in the rest of the variables in the model, fair value for the 10-year rises to 3.27%, which is near current levels. Thus, we can postulate that current yields have discounted about 100 bps of further tightening. Another interesting note is that the most significant variables in the model are fed funds and the inflation proxy. Just using these two variables in the model yields a fair value of 3.60%; if we assume another 100 bps of tightening, the terminal 10-year yield ends up at 4.10%. Compared to the broader model, it is clear that overseas factors, especially German yields, are keeping U.S. yields from rising faster. Overall, we don't expect these foreign factors or oil prices to change in such a way as to support higher yields, so we don't expect a rise in the 10-year yield to exceed 3.50% unless (a) inflation expectations become unanchored, or (b) the FOMC signals it will raise rates much more than expected.

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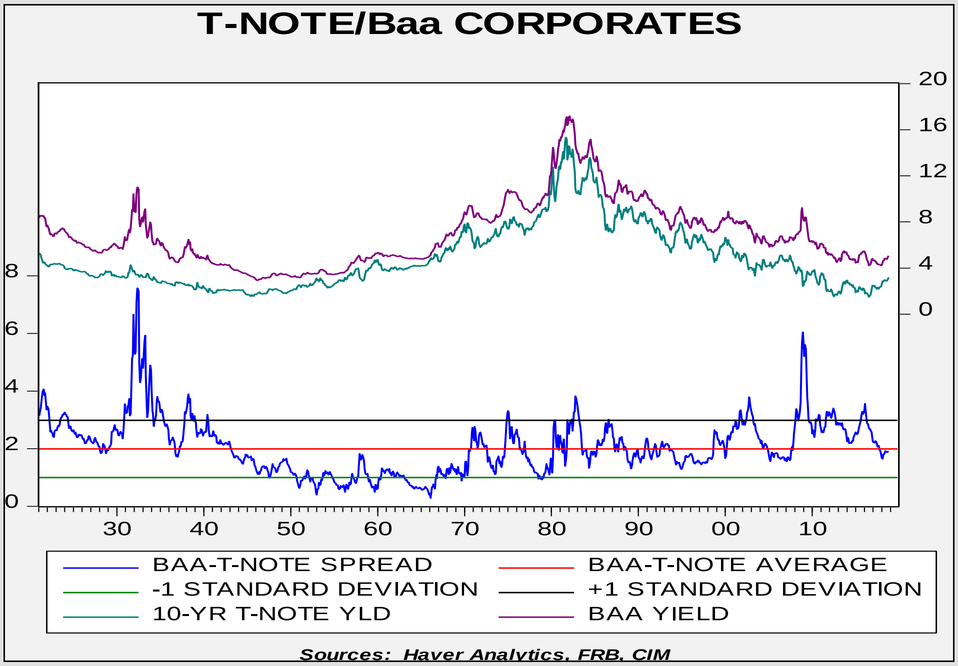
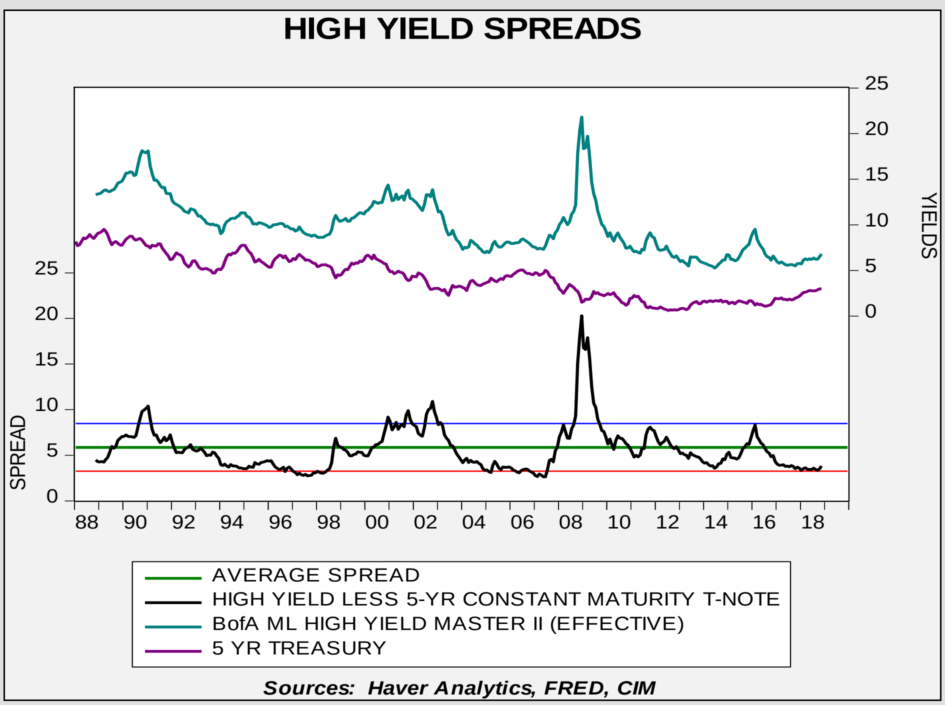
[17] For an inflation proxy, we use the 15-year moving average of the yearly change in CPI. This is based off research by Milton Friedman, who postulated that investors build their inflation expectations over a long time frame.

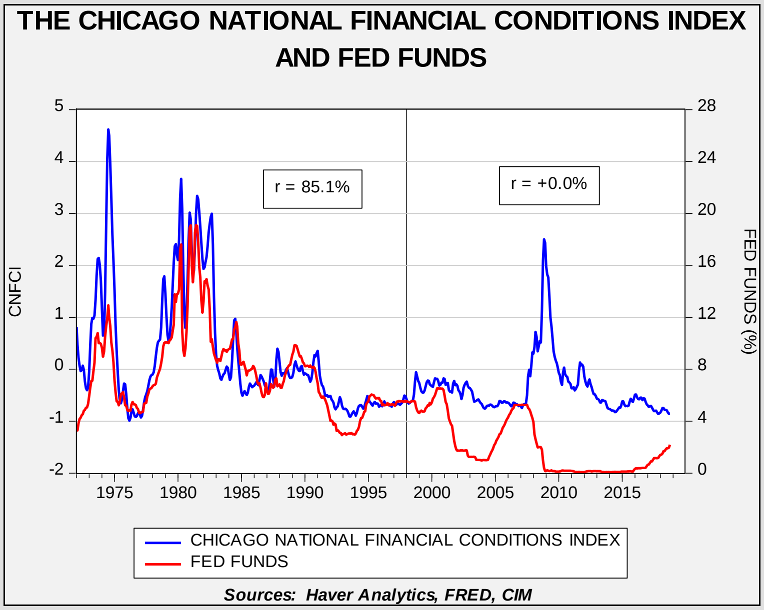
Thus far, the impact on credit spreads from rising Treasury yields has been minor. The chart below shows investment grade spreads. Current investment grade spreads are holding near their long-term average.



High-yield spreads have nudged higher but remain tight, with spreads holding near the bottom of their historical ranges.



The lack of spread widening is consistent with the continued low level of stress in the financial system.

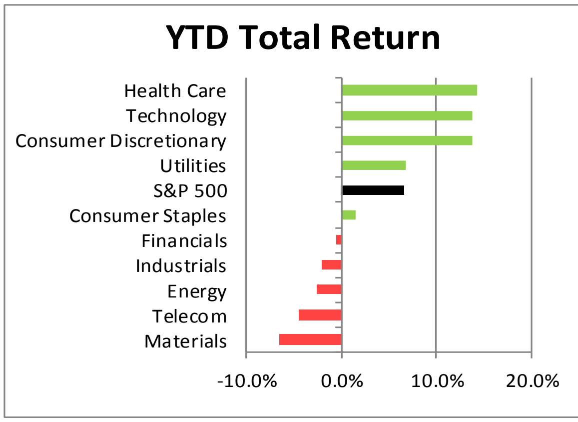


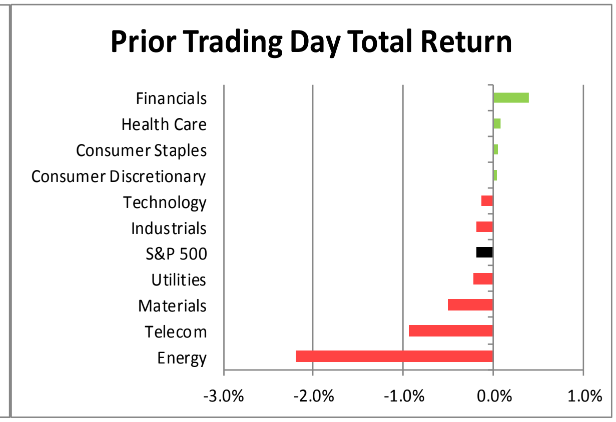
This chart shows fed funds with the Chicago FRB National Financial Conditions Index; the index rises when stress increases (or, put another way, when financial conditions deteriorate). From 1973 (when the index data begins) until 1997, the two series were tightly correlated; if the FOMC raised rates, stress rose. Stress was a "force multiplier" for monetary policy. We believe increasing transparency has removed this "tool" from the Fed; now, financial participants can so easily project the path of policy that they don't necessarily fear the rising rates. And so, instead of seeing participants react to stress as policy tightens, we now have a situation where stress remains low only to soar. Credit spreads are a key component of the aforementioned conditions index. If spreads begin to widen, they could do so rapidly, leading to significant market disruptions. For now, all is calm, but we continue to closely watch market conditions because when they begin to deteriorate they tend to so rapidly. In asset allocation, we have tended to favor investment grade spread products but are less favorable toward high yield. If conditions start to deteriorate, we will shift allocations toward Treasuries.

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 11/8/2018 close)

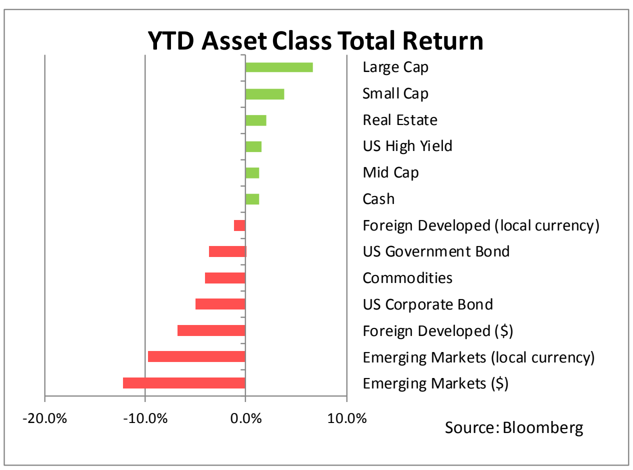




(Source: Bloomberg)

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 11/8/2018 close)

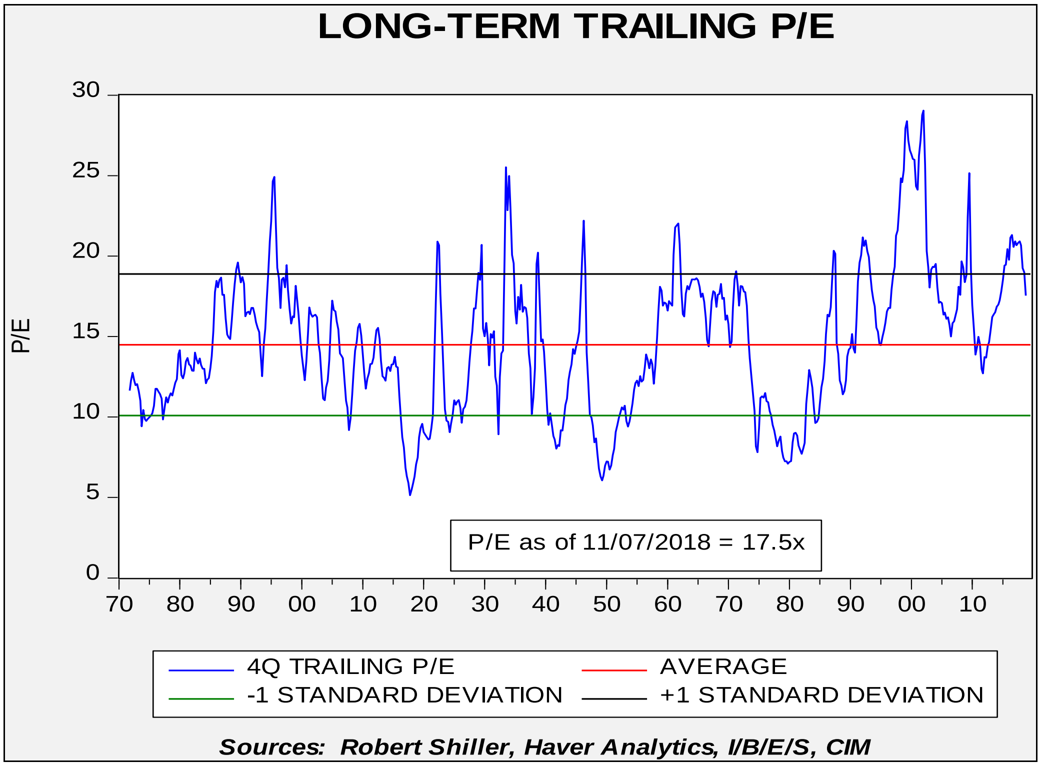


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 8, 2018



Based on our methodology,[18] the current P/E is 17.5x, down 0.1x from last week's reading of 17.6x. The primary reason for the drop in the P/E is recent 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.

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[18] 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.