Daily Comment

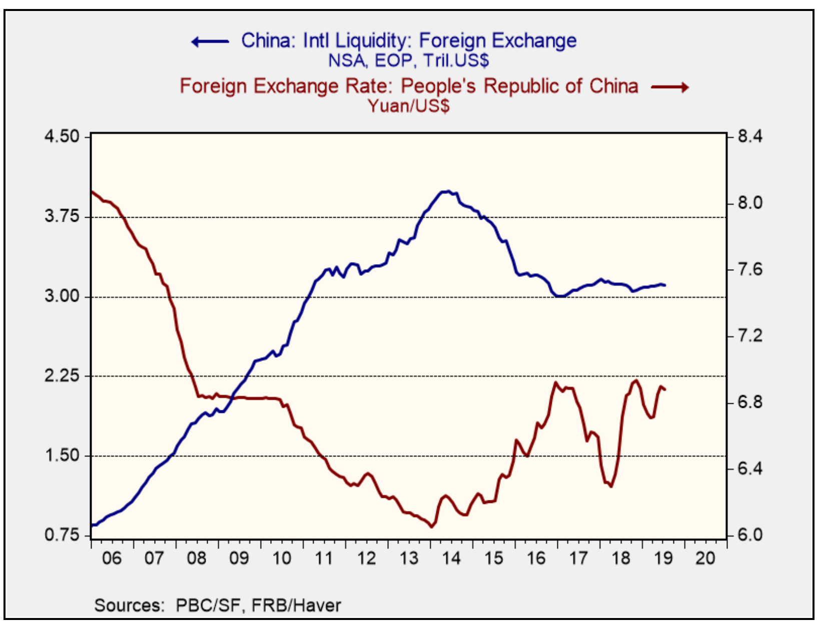
By Bill O'Grady, Thomas Wash, and Patrick Fearon-Hernandez, CFA

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: August 12, 2019—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.2%. Chinese markets were higher, with the Shanghai composite up 1.5% and the Shenzhen index up 2.0% from the prior close. U.S. equity index futures are signaling a lower open. With 450 companies having reported, the S&P 500 Q2 earnings stand at $42.10, higher than the $40.70 forecast for the quarter. The forecast reflects a 2.7% decrease from Q2 2018 earnings. Thus far this quarter, 74.2% of the companies reported earnings above forecast, while 18.4% reported earnings below forecast.

It's an August Monday. Equities are under pressure again this morning and risk assets, in general, are weaker. Here is what we are watching:

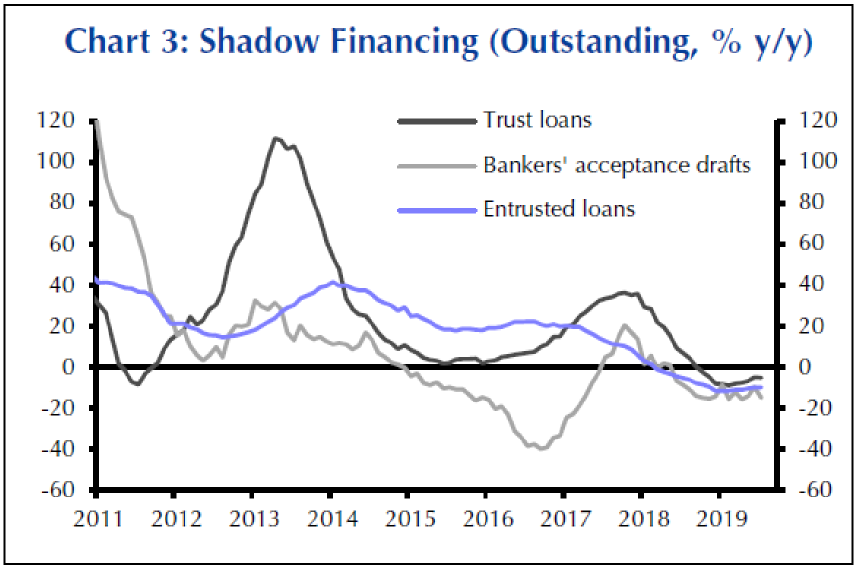
China and the dollar: For the third consecutive day, the PBOC fixed the CNY/USD exchange rate above 7. Although this reference rate was a bit stronger than Friday's level, it suggests PBOC policy is more about stabilizing the exchange rate at a point weaker than 7 (the higher the rate, the weaker the CNY). There are two reasons why the PBOC probably isn't letting the CNY sink lower. First, there is the constant problem of capital flight. During previous periods of CNY weakness, foreign reserves fell as Chinese investors moved money out of the country to protect themselves from a depreciation.



This chart shows foreign reserves and the CNY/USD exchange rate. The CNY began to weaken in early 2014. From 2014 to late 2016, the currency weakened nearly a full CNY and foreign reserves fell by nearly a trillion dollars. Some of the decline in reserves was due to valuation changes but there were notable levels of capital flight. China has measures to prevent capital flight but, as the data shows, regulators' ability to prevent it is limited. The second issue, as we noted last week, was the high level of dollar-denominated debt in the private sector. There are reports that private Chinese companies are being forced to sell off foreign assets because they face a shortage of dollars. There is some debate among analysts as to what this dollar shortage means. One possibility is that the above chart's $3.1 trillion of dollar assets is not liquid or is already committed. In other words, these companies may be facing a real dollar shortage and China may be in bigger trouble than it appears. The second explanation is that China has ample dollar reserves but doesn't want to spend them on the private sector. Allowing (forcing?) private companies who splurged on foreign buying (which may have been related to capital flight) may be in Beijing's best interest. The leadership may want to discourage Chinese companies from buying assets overseas and warn foreign lenders that lending to private Chinese companies, even big ones, is riskier than it looks. We tend to think the second explanation is more likely. There has been a clear bias toward the state-owned enterprises (SOE) under Chairman Xi, and "starving" the private sector's demand for dollars while allowing access for the SOEs would fit that partiality. Still, the reason there is a debate at all is due to the opaque nature of China's reserve management; it is possible that the first explanation is correct and, if it is, China could be quite vulnerable to market volatility.

China's lending slows: Chinese lending in July came in weaker than expected. Total loan growth slowed under 13% as the PBOC tries to rein in lending.

The slowdown highlights the problem Chinese authorities are facing, something similar to what the U.S. saw in 2011-13. Although monetary policy itself suggests easing, regulatory constraints are hampering the transmission process. Essentially, the entities that China wants borrowing from aren't doing so and the firms that need the liquidity are being restricted. For example, components of private financing, or "shadow banking," are down for the year.



(Source: Capital Economics)

In other words, China wants to see more borrowing but only by certain borrowers. If this bias continues, monetary stimulus will likely disappoint.

Authoritarians under pressure: Hong Kong remains a tinderbox as protests continue. Air traffic was halted due to unrest as thousands of demonstrators flooded terminals. Protests continue in the city as well. Beijing is escalating its rhetoric, calling it "terrorism," which may be laying the groundwork for a military crackdown to restore order. Meanwhile, there were massive protests in Moscow, dwarfing those of previous weeks. Although the bulk of the unrest remains in Moscow, there is evidence of smaller actions elsewhere. One source of trouble for Putin is a disappointing economy. With Hong Kong, the protests there could trigger a Tiananmen-style response. If that occurs, capital flight would soar and relations with Taiwan would harden. In terms of Russia, we expect Putin to remain in control but the fact that protests are happening at all suggests his power is under pressure. In another interesting sidelight, a massive munitions explosion last week apparently caused a radiation leak, raising speculation that the blast involved a nuclear cruise missile project. If so, this is yet another setback in Russia's military technology.

Italy: It is still unclear whether the government will fall, but the uncertainty isn't helping Italy's perilous financial situation as it faces credit downgrades. Salvini had to deny that his party wants to exit the Eurozone; such talk would lead to further capital flight and more downward rate pressure on German Bunds.

Brexit: There is growing talk that MPs may not be able to stop PM Johnson from a hard Brexit if he is determined to go that path. It is starting to look like the available measures of no-confidence will probably backfire and may deny MPs any role in halting a sudden exit.

Argentina: In a sign that populism may be returning to Argentina, Alberto Fernández of the Peronist party won the nationwide primary election over the weekend by a far larger margin than expected. Fernández, whose wife is former president Cristina Fernández de Kirchner, received 47.0% of the vote, while the current pro-business president, Mauricio Macri, won just 32.7%. Investors probably fear the return of the Peronists' radical, unorthodox economic policies under Fernández and Kirchner, so Argentine assets will likely come under pressure in the coming days.

Deep thoughts: With fond memories of Jack Handey, here are some broader items that caught our attention over the weekend:

1. *The waning superpower problem*: The *FT* ran a long thought piece about what happens to the world if the U.S. becomes less involved. We have been discussing this issue for some time; our take is that Americans were sold the policy of containing communism to foster participation in the hard work of hegemony. But, in reality, containing communism was only a small part of freezing other global conflicts worldwide. When communism fell, most Americans believed we could end the hegemonic role without realizing that a world without a hegemon is a world at risk of WWIII. We found the comment section from the aforementioned *FT* article to confirm that position.
2. *Other kinds of inflation*: Although price inflation remains sticky, firms will try to maintain margins in other ways. Showrooms may have fewer sales staff; dining rooms may be less clean. Sizes may shrink. If tariffs bite, we would expect more tactics like this to maintain margins and price levels.
3. *The long expansion*: One characteristic of this expansion is that most of the benefits have accrued to a few major metropolitan areas. Much of the rise in growth has not found its way into the rest of the country. That may be starting to change. As the cost of living in the supercities becomes onerous, there are reports that some areas of the country are seeing a secondary boom as people leave the "hot" areas for parts of the country that are more affordable. If this is the beginning of a trend, policymakers will likely try to support it by keeping policy more accommodative.

U.S. Economic Releases

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
14:00	Monthly Budget Statement	m/m	jul	-$120.0 Bil	-$76.9 Bil	***
	Mortgage Delinquencies	q/q	2q		4.42%	*
	MBA Mortgage Foreclosures	q/q	2q		0.92%	*
Fed speakers or events						
No speakers or events scheduled						

Foreign Economic News

We monitor numerous global economic indicators on a continuous basis. The most significant international news that was released overnight is outlined below. Not all releases are equally significant, thus we have created a star rating to convey to our readers the importance of the various indicators. The rating column below is a three-star scale of importance, with one star being the least important and three stars being the most important. We note that these ratings do change over time as economic circumstances change. Additionally, for ease of reading, we have also color-coded the market impact section, which indicates the effect on the foreign market. Red indicates a concerning development, yellow indicates an emerging trend that we are following closely for possible complications and green indicates neutral conditions. We will add a paragraph below if any development merits further explanation.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
China	Aggregate Financing CNY	y/y	jul	1.010 tn	2.260 tn	1.625 tn	**	Equity and bond neutral
	Money Supply M0	y/y	jul	4.5%	4.3%	4.4%	**	Equity and bond neutral
	Money Supply M1	y/y	jul	3.1%	4.4%	4.7%	**	Equity and bond neutral
	Money Supply M2	y/y	jul	8.1%	8.5%	8.4%	**	Equity and bond neutral
India	Industrial Production	y/y	jun	2.0%	3.1%	1.4%	***	Equity bullish, bond bearish
New Zealand	Card Spending Total	m/m	jul	-0.3%	0.1%		**	Equity and bond neutral
	Card Spending Retail	m/m	jul	-0.1%	0.0%	0.5%	**	Equity and bond neutral
EUROPE								
Switzerland	Total Sight Deposits	m/m	9-Aug	585.0 Bil	582.7 Bil		*	Equity and bond neutral
	Domestic Sight Deposits	m/m	9-Aug	469.0 Bil	473.9 Bil		*	Equity and bond neutral
AMERICAS								
Mexico	Nominal Wages	y/y	jul	5.9%	6.1%		***	Equity and bond neutral
Canada	Housing Starts	y/y	jun	222.0k	245.7k	202.0k	***	Equity bullish, bond bearish
	Building Permits	m/m	jul	-3.7%	-13.0%	1.0%	***	Equity and bond bearish
	Net Change in Employment	m/m	jul	-24.2k	-2.2k	15.0k	**	Equity and bond bearish
	Unemployment Rate	m/m	jun	5.7%	5.5%	5.5%	***	Equity and bond bearish

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)	218	218	0	Down
3-mo T-bill yield (bps)	195	195	0	Neutral
TED spread (bps)	23	23	0	Neutral
U.S. Libor/OIS spread (bps)	190	193	-3	Up
10-yr T-note (%)	1.69	1.75	-0.06	down
Euribor/OIS spread (bps)	-40	-40	0	Neutral
EUR/USD 3-mo swap (bps)	15	13	2	Down
Currencies	Direction			
dollar	flat			Neutral
euro	flat			Up
yen	up			Up
pound	up			Down
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	$58.17	$58.53	-0.62%	
WTI	$53.90	$54.50	-1.10%	
Natural Gas	$2.13	$2.12	0.61%	
Crack Spread	$17.76	$17.52	1.41%	
12-mo strip crack	$15.91	$15.74	1.09%	
Ethanol rack	$1.63	$1.63	0.21%	
Metals				
Gold	$1,506.43	$1,496.95	0.63%	
Silver	$16.97	$16.98	-0.06%	
Copper contract	$259.10	$258.90	0.08%	
Grains				
Corn contract	$ 415.00	$ 417.75	-0.66%	
Wheat contract	$ 497.75	$ 501.50	-0.75%	
Soybeans contract	$ 887.75	$ 891.75	-0.45%	
Shipping				
Baltic Dry Freight	1748	1720	28	

Weather

The 6-10 and 8-14 day forecasts show warmer temperatures for most of the country, with cooler temps around Washington state and surrounding areas. There is no cyclone activity expected over the next 48 hours.

Asset Allocation Weekly

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.

August 9, 2019

Since the end of WWII, there have generally been three factors that have caused recessions. The first, and most important, is policy error. Although fiscal tightening can cause recessions, major tax increases have become less common. The usual source of policy error comes from the monetary side, where the central bank either raises rates too high or doesn't move quickly enough to lower rates when business conditions weaken. The second cause comes from geopolitical events. The 1973-75 recession was triggered by the Arab Oil Embargo, a direct result of U.S. aid to Israel during the Yom Kippur War. The 1990-91 recession was due to the Persian Gulf War. The third cause is due to inventory mismanagement. The third reason has become rare due to improved logistics technology. Although inventory issues can affect sectors of the economy, it hasn't led to a national downturn since the 1950s.

As a result, currently, there are two factors we watch most closely to predict recessions, monetary policy and geopolitical issues. Although predicting recessions is difficult, at least with monetary policy, there are consistent indicators, such as yield curves, financial stress indexes, volatility indexes, Phillips Curve measures, etc. Obviously, timing is difficult, even when the indicators flash warning signs, but at least there are fairly consistent indicators one can monitor.

Geopolitical indicators are far more idiosyncratic. Global tensions are constant. There are always geopolitical tensions so it is hard to parse the signal from the noise. To some extent, this is always a problem with geopolitics. It's not that there is a lack of situations that could develop into a threat to the business cycle; it's just that most don't.

Perhaps a better way to think about geopolitics and theory impact comes from the book, *Ubiquity: Why Catastrophes Happen.*[1] In this book, Mark Buchanan makes the case that geopolitical events are much like sandpiles where grains rise steadily, making the structure increasingly unstable. A final grain triggers a collapse and, due to the *post hoc, egro propter hoc* fallacy, that last "grain" becomes the "cause" of the collapse. In reality, the structure had been losing stability for some time and the triggering event may not have led to the catastrophe under conditions of stability.

For example, the Persian Gulf War occurred mostly because Saddam Hussein miscalculated the reaction of the world to his invasion of Kuwait. He probably would not have invaded Kuwait if the Kuwaitis had been willing to reduce production to allow Iraq to have a greater market share of world oil markets, something that Iraq felt it was owed from the Persian Gulf states due to its prosecution of the war against Iran. In addition, if the Soviet Union hadn't collapsed, Moscow would have probably not supported the invasion by its client state. The trigger to the war, the reports that Kuwait was using horizontal drilling to tap Iraq's oil fields, was the proximate cause of the war. But, the mere act of taking the oil may not, by itself, have triggered the invasion without the other factors in play.

[1] Buchanan, Mark. (2000). *Ubiquity: Why Catastrophes Happen*. New York, NY: Three Rivers Press.

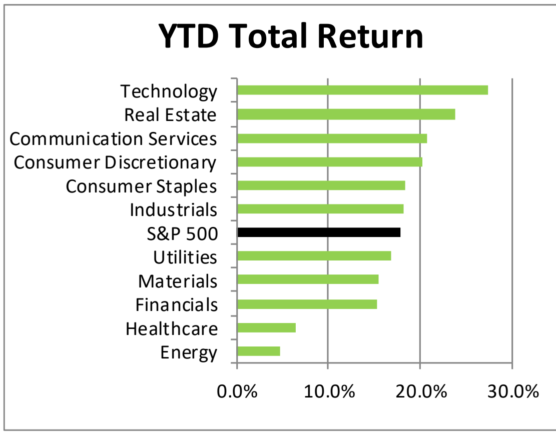
The current trade conflict with China has similar complicated characteristics. The U.S. has been struggling to develop a consistent foreign policy since the end of the Cold War. Policy toward China has mostly been to support its economic development on the idea that the richer it becomes, the more likely that it will democratize, following the path of other Asian nations. Unlike Japan, South Korea and Taiwan, however, China was not as reliant on American security. Those nations were directly protected by the U.S., whereas China only relied on America's sea lane security. In addition, China viewed its commitment to communism as something to be maintained. The construct of the Trans-Pacific Partnership, which was designed to isolate China, showed that the U.S. was rethinking its relationship with China by 2008.

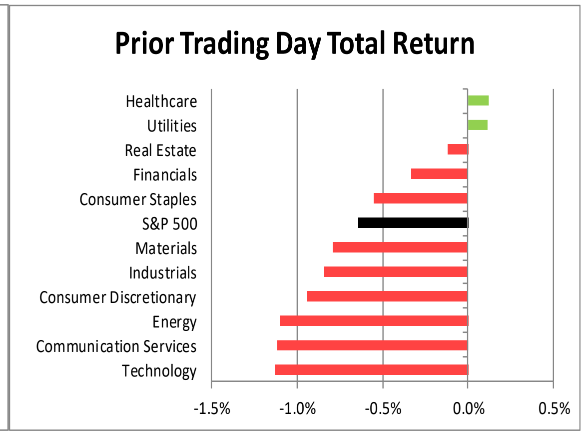
Under President Trump, the relationship with China has become increasingly contentious. The application of tariffs and continued negotiations have caused increasing equity market turmoil. Nevertheless, so far, the impact on the economy has been less dramatic. However, we may be reaching the point where the trade conflict will begin to affect the economy. The most recent decision by the Trump administration to apply 10% tariffs on $300 bn of imports, by itself, is probably not enough to trigger a downturn. But, the culmination of earlier tariffs and the impact to technology restrictions may be creating conditions that lead to recession.

History suggests that recessions induced by geopolitical events are difficult to avoid even with stimulative economic policies. The unknown is whether we are near a point where geopolitical risks are great enough to trigger a downturn. At this point, we are probably not at that level, but risks are escalating and the odds of a geopolitical mistake are rising. Although it is probably too soon to position portfolios in a defensive manner, tactical planning is in order.

Data Section

U.S. Equity Markets – (as of 8/9/2019 close)

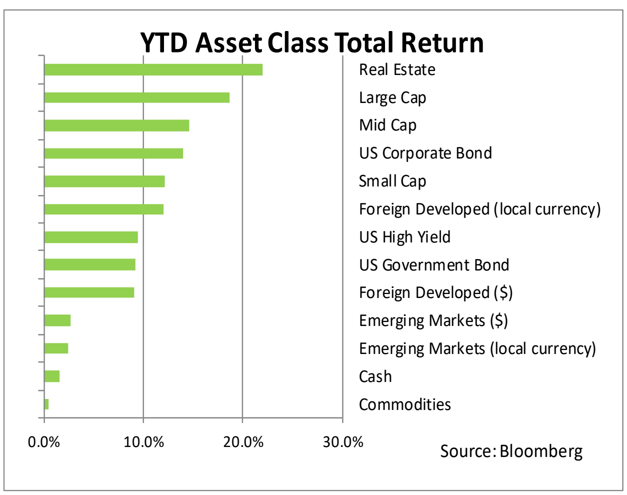




(Source: Bloomberg)

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. These charts represent the new sectors following the 2018 sector reconfiguration.

Asset Class Performance – (as of 8/9/2019 close)

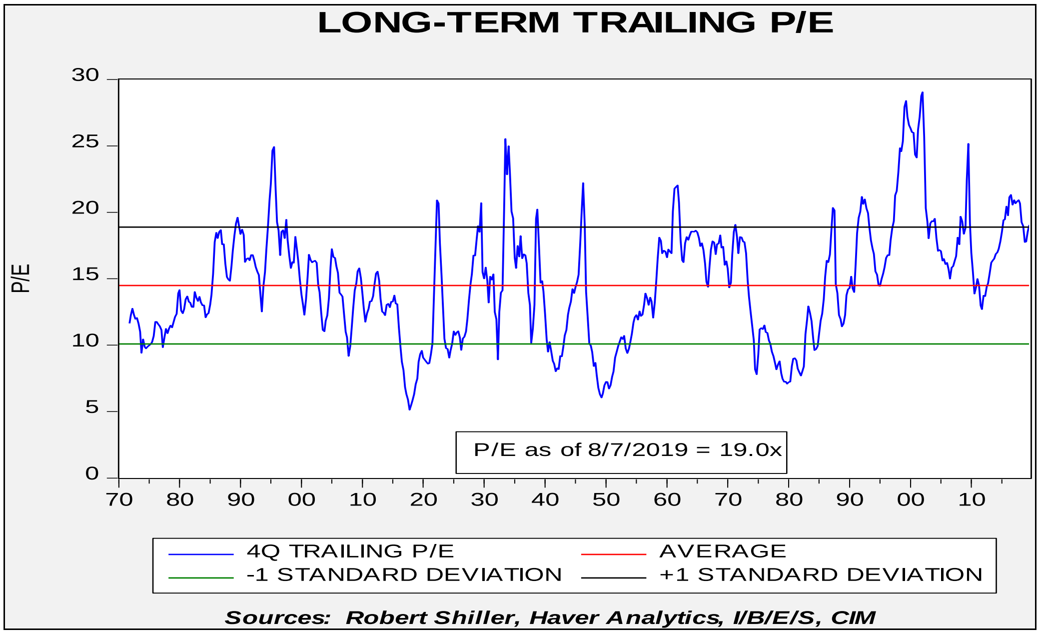


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

August 8, 2019



Based on our methodology,[2] the current P/E is 19.0x, down 0.1x from last week.

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[2] 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 two actual quarters (Q4 and Q1) and two estimates (Q2 and Q3). 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.