Confluence INVESTMENT MANAGEMENT

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 14, 2019—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 1.5% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.7%. Chinese markets were higher, with the Shanghai composite up 0.4% and the Shenzhen index up 0.7% 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 mid-week in what has been a busy week. President Trump blinks (sort of) on trade. Equity markets don't follow through, mostly due to lingering trade uncertainty and mounting evidence of global economic weakness. Hong Kong remains a flashpoint. Here is what we are watching:

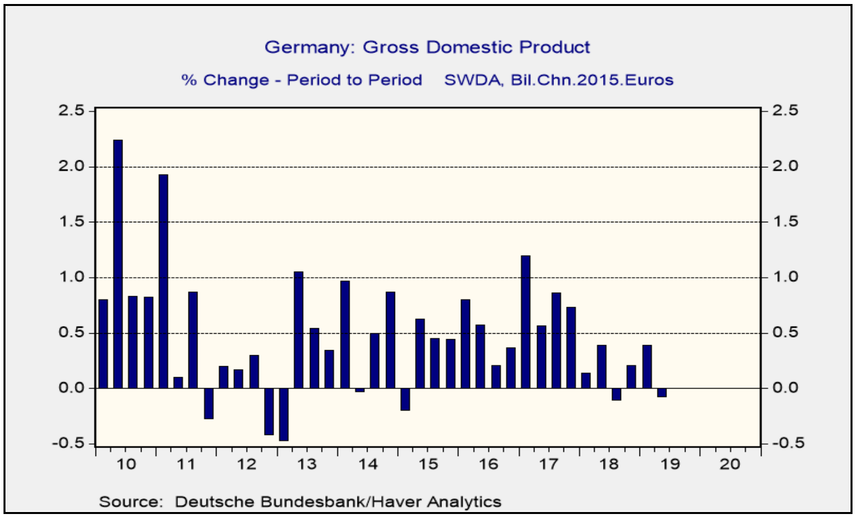
Trade: In a surprise move, President Trump announced delays in the majority of announced tariffs until December 15. Looking at the goods affected, there was a clear decision to avoid tariffs on consumer goods before Christmas. Risk assets were emboldened by the announcement. All in all, more than $150 billion of goods were affected by the delay. Both sides agreed to resume negotiations.

This action appears tactical in nature. Delaying the implementation doesn't mean they have gone away. It is interesting that the president framed the action as a way to avoid issues for the holidays, perhaps a tacit acknowledgement that consumers may pay at least some of the tariffs. If that is true, then delaying the tariffs into the year before elections is a risky ploy. It also signals to China that the White House may be less tolerant of inflicting pain on the U.S. economy and therefore may make Beijing less open to concessions.

If the goal was to lift confidence and financial markets, the effect was short-lived. Risk markets did rally strongly but are giving back everything today. Equities, from a technical perspective, are starting to look soft; fading rallies is not a good sign.

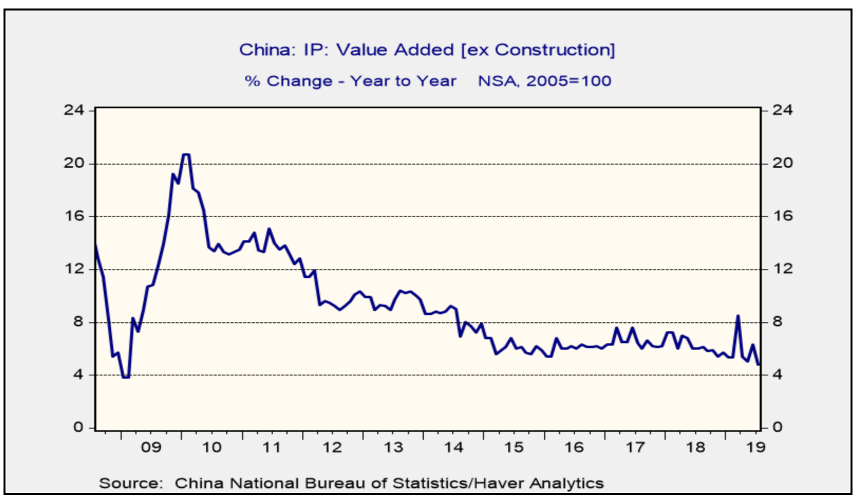
What happens as we approach December 15? We suspect it will all depend on how the economy looks. If the economy is struggling, the tariffs may remain in place. At the same time, there will be a political calculus at work as well. If the president believes the tariffs improve his chances of reelection, they will probably go forward. But, overall, we think the economy will be the key variable and we would envision further delays if deceleration continues.

Weakening global growth: A key factor for today's equity weakness is a batch of soft economic data abroad. German GDP fell into negative territory.

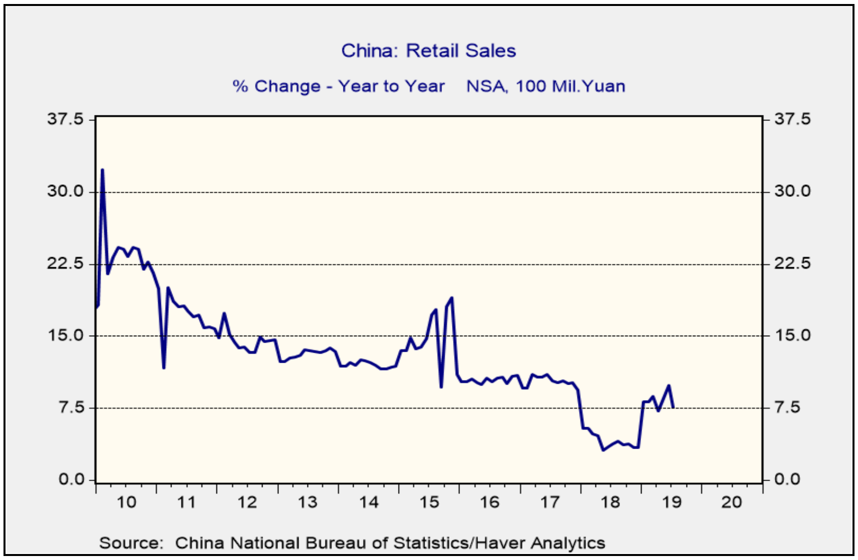


Although the data was near expectations, a negative reading isn't welcome and the odds of two consecutive negative quarters, the "working" definition of recession, is highly likely. This data highlights the fact that the major European nations are likely in a downturn. German economic sentiment fell to its lowest level since 2011.

China released a series of weak numbers as well. Industrial production came in weaker than forecast, at 4.8% (Y/Y%), well below the 6.0% expected. As the chart below shows, this is the weakest showing since 2008.



Retail sales also slumped.

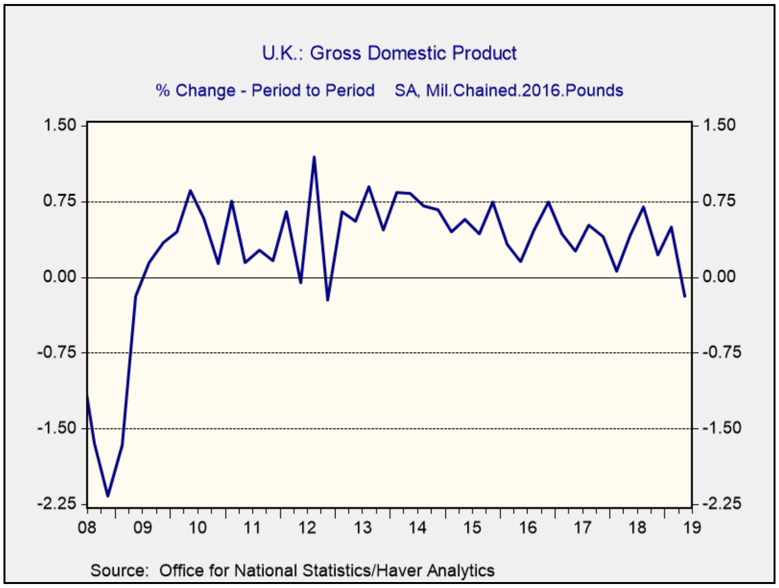


This data raises questions about the effectiveness of Chinese stimulus measures. Given China's history (and the continued problems in Hong Kong), we would expect the Xi administration to return to more aggressive stimulus measures if the economic slowdown continues.

Slumping global growth will almost certainly bring easier policy from the FOMC. As various permutations of the yield curve either invert further or approach inversion, the signal from the financial markets is clear that the Fed needs to cut rates. Unfortunately, given the fact that we had two dissents last meeting, it may be hard not only to lower rates but to move more than 25 bps. The other worry, of course, is that a rate cut might not matter all that much.

Finally, it's worth noting that the Eurozone and China are both export-dependent. Germany has essentially turned the Eurozone into a broader version of itself, making it heavily dependent on foreign sales, and China's development model was based on exports. Thus, the trade conflict is affecting China and Europe much more than the U.S., which is less dependent on exports for growth.

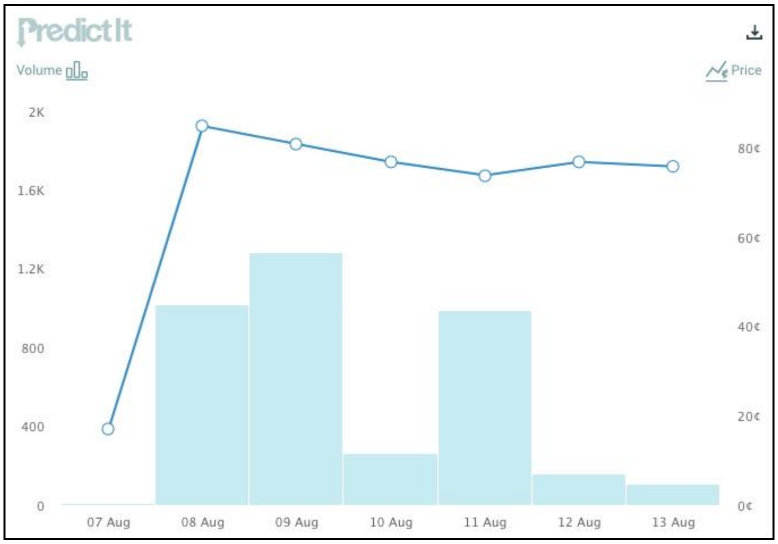
Yield curve inversion: Today, U.K. and U.S. bonds inverted after a stream of bad economic data from Germany and China triggered a flight to safety into 10-year bonds. Because yield curve inversions have a strong track record of predicting recessions, they are often followed closely by investors. That being said, the yield curve inversion in the U.K. is probably the bigger concern as its economy had contracted in Q2 and there are still growing concerns about the impact Brexit will have on the economy. Meanwhile, the U.S. yield inversion has grown; the yield on the 10-year Treasury was already lower than the three-month Treasury bill. At this time, we do not expect a recession to take place in the U.S. in the immediate future as consumption still appears strong, but we are becoming more vigilant as financial markets appear to be sending a strong signal that the economy may be more vulnerable than we realize.



Hong Kong: The scene at the Hong Kong airport was tense yesterday as violence erupted. Apparently, protestors attacked two men thought to be undercover agents for Beijing. Police attacked protestors in response; there was a moment when it appeared police were about to open fire on the demonstrators. There were social media pictures suggesting the PLA is mobilizing, although this wasn't confirmed by the Pentagon. There is now a court order barring the protestors from the airport and officials are taking steps to prevent anyone other than passengers to enter the airport terminal. Hong Kong police have brought a hardline former deputy commissioner out of retirement and actions by police have become more hostile since his return. Chinese media is actively spreading disinformation about the protests, trying to frame the protestors as "terrorists," perhaps to give them an excuse to use heavy force. A British MP has indicated he thinks the U.K. should issue passports to Hong Kong citizens, an action that would infuriate Chinese leaders who often refer to the colonial period of British domination to stir nationalist sentiment. Finally, companies operating in Hong Kong have been activating contingency plans as unrest continues.

Italy—populist coalition collapse? On Tuesday, Matteo Salvini failed in his plans to call early elections, which will be needed for him to shore up support for his reforms. Last month, Salvini's party, the Northern League, was unable to get reforms that included tax cuts through parliament after members of its coalition in the Five-Star party failed to support the reforms. Following the defeat, Salvini has been angling to call snap elections, a move that might see him become the new prime minister of Italy. Salvini's popularity appears to be on the rise, while support for the Five-Star movement has fallen in recent months.

Despite his failed attempt to call a vote on Tuesday, a no-confidence vote is expected to take place on August 20. If the vote succeeds, Prime Minister Giuseppe Conte will have to submit his letter of resignation and new elections will be held. In the event of new elections, the Northern League would be expected to win a plurality of the seats, but there are rumors that the Five-Star Movement could align with the Democratic Party to block Salvini from becoming prime minister. Nevertheless, if Salvini does become prime minister it will likely raise the possibility of Italy's exit from the Eurozone, which should weigh on the euro and possibly European equities.



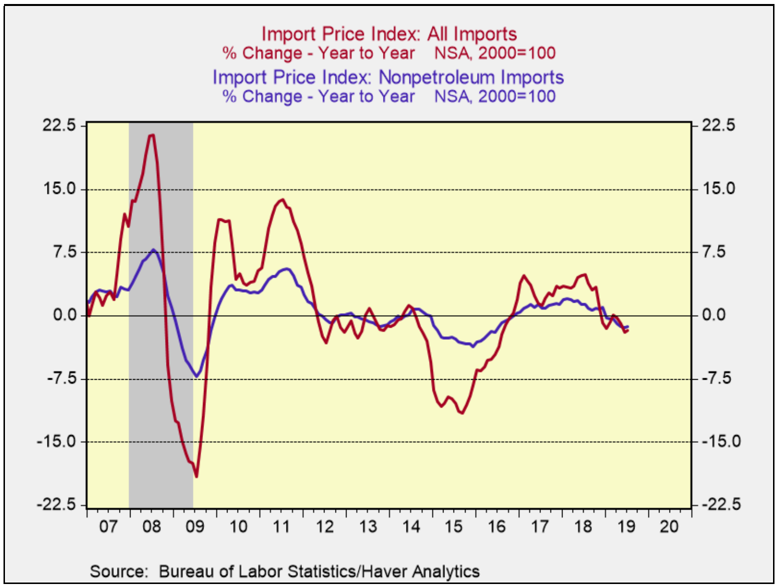
(Source: PredictIt)

The chart above shows how the prediction markets view the likelihood of the dissolution of the Italian government before the end of the year, with each cent representing a percentage point. As of yesterday, the prediction markets value the possibility at about $0.76, which suggests there is about a 76% chance of the Italian parliament dissolving. At the same time, even though there will be a no-confidence vote on August 20, it isn't likely that snap elections will follow anytime soon. Instead, the coalition leaders have decided to keep the government in place until a government restructuring law is passed. This action could take up to a year.

U.S. Economic Releases

MBA mortgage applications in the week ended August 9 jumped 21.7%. Applications for home purchase mortgages were up a modest 1.9%, but applications for refinancing mortgages surged 36.9% to reach their highest level since July 2016. The average interest rate on a 30-year mortgage fell to 3.9%.

Separately, overall July import prices were up 0.2% month-over-month, but prices excluding petroleum were unchanged. Those numbers beat expectations, which had called for both to fall slightly. Nevertheless, total import prices in July were still down 1.8% year-over-year, and import prices excluding petroleum were down 0.9%. Meanwhile, export prices were also up 0.2% on the month, beating expectations.



The chart above shows the year-over-year change in overall import prices and import prices excluding petroleum since 2007.

There are no other economic releases or Fed events scheduled for the rest of the day.

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								
Japan	Core Machinery Orders	y/y	jun	12.5%	-3.7%	-1.1%	**	Equity bullish, bond bearish
South Korea	Unemployment Rate	m/m	jul	4.0%	4.0%	4.0%	**	Equity and bond neutral
Australia	Westpac Consumer Confidence Index	m/m	aug	3.6%	-4.1%		**	Equity bullish, bond bearish
China	Fixed Asset Invest. Ex-Rural YTD	y/y	jul	5.7%	5.8%	5.8%	**	Equity bearish, bond bullish
	Property Investment YTD	y/y	jul	10.6%	10.9%		**	Equity bearish, bond bullish
	Industrial Production	y/y	jul	4.8%	6.3%	6.0%	**	Equity bearish, bond bullish
	Retail Sales	y/y	jul	7.6%	9.8%	8.6%	**	Equity bearish, bond bullish
	Surveyed Jobless Rate	m/m	jul	5.3%	5.1%		*	Equity bearish, bond bullish
EUROPE								
Eurozone	Industrial Production	m/m	jun	-1.6%	0.9%	-1.5%	**	Equity and bond neutral
	Employment Change	y/y	2Q	1.1%	1.3%		**	Equity and bond neutral
	GDP	y/y	2Q	1.1%	1.1%	1.1%	***	Equity and bond neutral
Germany	GDP	y/y	2Q	0.0%	0.6%	-0.3%	**	Equity bearish, bond bullish
France	CPI	y/y	jul	1.1%	1.1%	1.1%	***	Equity and bond neutral
	Harmonized CPI	y/y	jul	1.3%	1.3%	1.3%	***	Equity and bond neutral
UK	CPI	y/y	jul	2.1%	2.0%	1.9%	**	Equity and bond neutral
	Core CPI	y/y	jul	1.9%	1.8%	1.8%	**	Equity and bond neutral
	House Price Index	y/y	jun	0.9%	1.2%	1.0%	**	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)	218	218	0	Down
3-mo T-bill yield (bps)	194	195	-1	Neutral
TED spread (bps)	24	23	1	Neutral
U.S. Libor/OIS spread (bps)	191	194	-3	Up
10-yr T-note (%)	1.61	1.71	-0.10	down
Euribor/OIS spread (bps)	-40	-40	0	Neutral
EUR/USD 3-mo swap (bps)	18	20	-2	Down
Currencies	**Direction**			
dollar	flat			Neutral
euro	up			Up
yen	up			Up
pound	flat			Down
franc	up			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	$60.32	$61.30	-1.60%	
WTI	$55.98	$57.10	-1.96%	
Natural Gas	$2.18	$2.15	1.44%	
Crack Spread	$18.17	$17.76	2.30%	
12-mo strip crack	$16.07	$15.87	1.26%	
Ethanol rack	$1.57	$1.59	-0.90%	
Metals				
Gold	$1,510.20	$1,501.51	0.58%	
Silver	$17.12	$16.97	0.93%	
Copper contract	$259.50	$263.00	-1.33%	
Grains				
Corn contract	$ 380.00	$ 376.50	0.93%	
Wheat contract	$ 483.25	$ 475.75	1.58%	
Soybeans contract	$ 887.00	$ 889.00	-0.22%	
Shipping				
Baltic Dry Freight	1864	1774	90	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.3		
Gasoline (mb)		0.6		
Distillates (mb)		1.0		
Refinery run rates (%)		0.00%		
Natural gas (bcf)		55.0		

Weather

The 6-10 and 8-14 day forecasts show warmer temperatures for most of the country, except for the northern Rockies and the Deep South. Precipitation is expected primarily in the eastern region and in the Deep South. No cyclonic activity is 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.

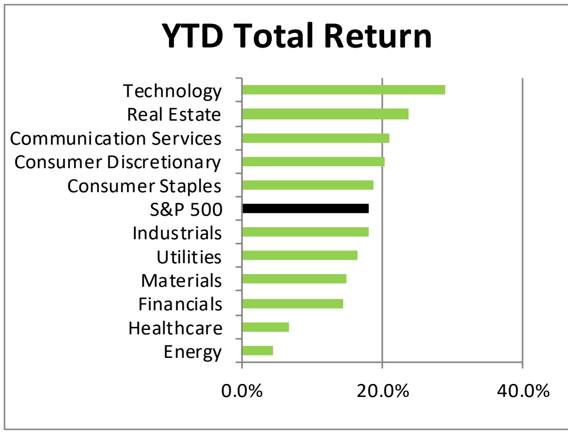
The current trade conflict with China has similar complicated characteristics. The U.S. has been struggling to develop a consistent foreign policy since the end of the Cold War. Policy toward China has mostly been to support its economic development on the idea that the richer it becomes, the more likely 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.

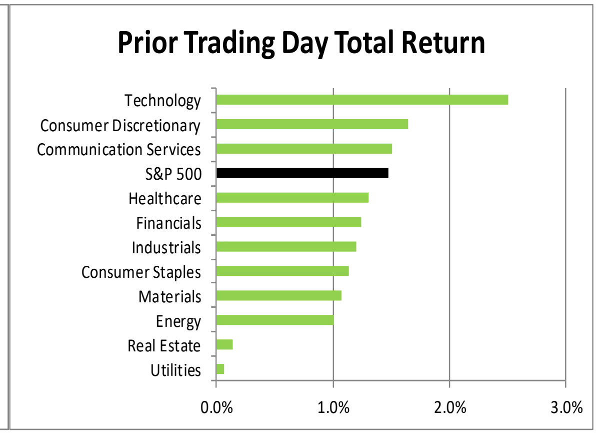
Under President Trump, the relationship with China has become increasingly contentious. The application of tariffs and continued negotiations have caused increasing equity market turmoil. Nevertheless, so far, the impact on the economy has been less dramatic. However, we may be reaching the point where 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 8/13/2019 close)

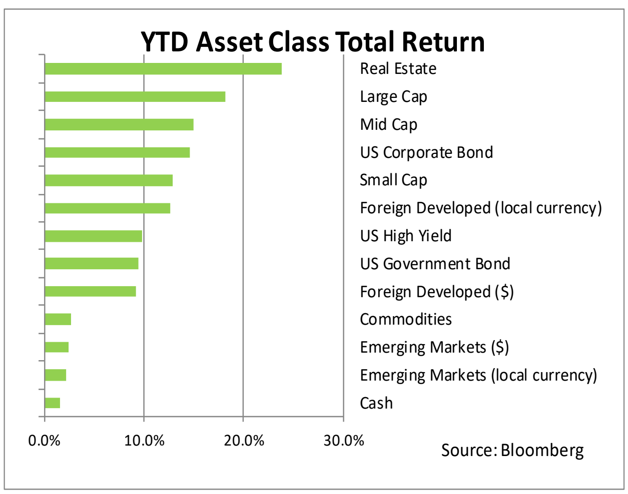




(Source: Bloomberg)

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 8/13/2019 close)

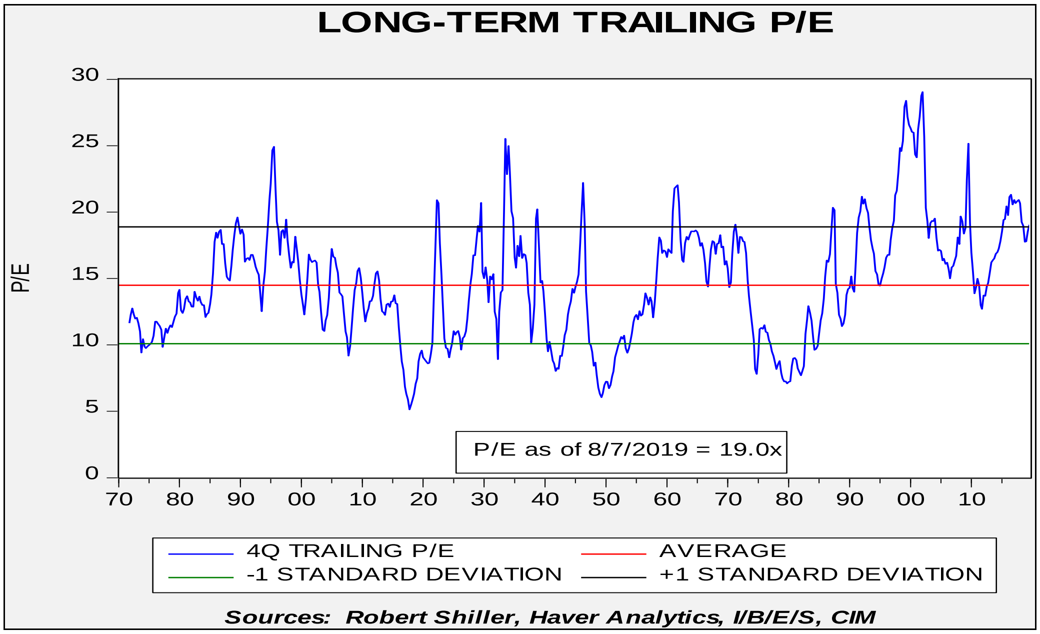


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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.

[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.