Daily Comment

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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 20, 2019—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.2%. Chinese markets were mixed, with the Shanghai composite down 0.1% and the Shenzhen index up 0.1% from the prior close. U.S. equity index futures are signaling a lower open.

Markets are mostly quiet this morning, more typical of late August. Here is what we are watching:

G-7 Summit: Japanese government sources say the Group of Seven (G-7) summit this weekend in France will probably not adopt a joint communiqué because of the deep disagreements between the various countries regarding free trade and climate change.

Italian no-confidence vote: Italy's legislature will vote today as to whether it will continue with its current government or force new elections. Although we think the odds that the government falls are not that high (members seem cool to the idea), anytime a vote is held unexpected outcomes can emerge. If Deputy PM Salvini had his way, he would bring down the government and become the new prime minister. While this outcome is likely at some point in the future, it probably won't happen today. A Salvini-led government would be a problem for the EU; he has been pressing to violate EU fiscal rules and would likely foster a governance crisis for the union.

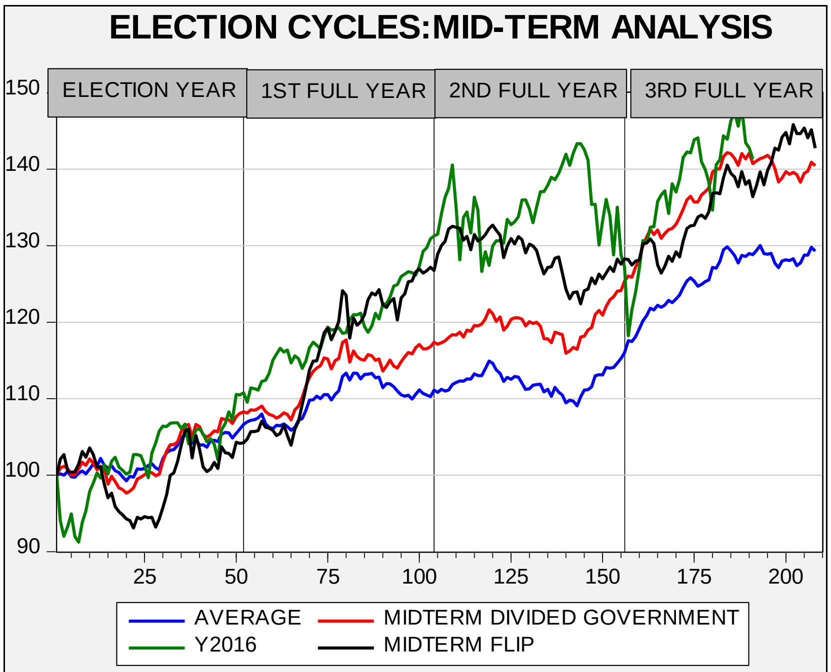
Brexit letters: PM Johnson is trying to prod the EU into reopening negotiations; he sent a note to Donald Tusk, the president of the European Council,[1] indicating that the Irish backstop should be removed and in its place, well…that part's not clear. Mr. Tusk rejected the proposal. The Irish backstop is a real problem for Brexit; the EU won't allow a free trade border to exist with a nation that isn't in the EU, which is what Johnson seems to want. That's why Theresa May accepted the backstop which effectively keeps Britain in the trading union without the ability to influence it. Essentially, if Britain wants to leave, a hard border on the Northern Ireland/Ireland frontier will return. Additionally, that will seriously complicate Britain's ability to negotiate a free trade deal with the U.S. It looks to us like the odds of a hard Brexit are rising. A looming constitutional crisis could emerge as Johnson tries to overcome opposition in Parliament to a hard Brexit. In addition, dissention in Parliament could trigger new elections.

[1] The European Council is a body whose members comprise the heads of state of the EU governments, along with the presidents of the European Council and the European Commission. Although it has little formal power, it's informal power is significant as it is the "talking shop" for the leadership of the EU.

United Kingdom-China: The British consulate in Hong Kong has announced that one of its employees [has been detained in mainland China] since making a business trip there in early August. The detention could be Chinese retaliation for a telephone call that British Foreign Secretary Raab made to Hong Kong Chief Executive Carrie Lam earlier this month. In the call, Raab lobbied for an investigation into the issues surrounding the anti-Chinese political protests that have been plaguing Hong Kong, which Beijing sees as its own internal affair.

Social media firms accused China of spreading disinformation about Hong Kong protestors, and the firms have [removed accounts with suspected ties to Beijing] that have been involved in disseminating such disinformation. These firms will likely face retaliation from Beijing.

More stimulus: The year before the election year tends to be a good year for equities.



Sources: Bloomberg, CIM

To create the data for this chart, we index the Friday close for the S&P 500 going back to the first week of January 1928 for a four-year period. We repeat the process for every four-year period to the present; this gives us a consistent presidential cycle. Note that in the second year, after the November midterms, equities tend to rally strongly until around mid-year of the last year before the election. Part of that rally is the removal of uncertainty surrounding the midterm elections, but often presidents act to stimulate the economy to either improve the odds of reelection or support the party in power. This year generally fits that pattern.

And, right on cue, the White House is pressing for economic support. First, [the president has subjected the Federal Reserve to strong criticism, pressing for aggressive rate cuts]. Second, [the White House is apparently considering a payroll tax cut]. A payroll tax cut would be a significant move for the economy. It would affect almost all workers and, unlike the earlier tax cuts, the benefit would mostly go to the bottom 80% of households in terms of income share. We have seen such reductions in the past; the Obama administration cut the rate by 200 bps in 2011 and 2012, but the rate returned to its earlier level after the two-year break. The administration has denied the report, but we doubt that a measure such as this isn't at least being considered.

Syria-Russia-Turkey: Syrian forces and their Russian allies have bombed a Turkish military convoy making its way toward an observation post set up to help diffuse tensions in northwestern Syria. Ankara claims the convoy was merely trying to resupply the post, but the Syrians and Russians say it was bringing supplies to anti-government rebels in the area.

Russia-Ukraine: French President Macron and Russian President Putin agreed at a summit yesterday that there may be a new chance to resolve the military conflict in eastern Ukraine, based on the election of the new Ukrainian president, Volodymyr Zelensky. Earlier this month, Zelensky called for fresh peace talks between his government and Russian-backed separatists in the region.

Russia: Two more radiation-monitoring stations in Russia have gone dark, adding to evidence that the government is trying to hide what happened in the apparent test failure of a new nuclear-powered cruise missile last week. A total of four monitoring stations connected with the Comprehensive Nuclear Test Ban Treaty have now gone silent.

Iran: State-run media are casting the release of the Iranian oil tanker seized in Gibraltar last month as a sign that Iran can stand up to the economic sanctions imposed on it by the United States. Iranian politicians reportedly believe the tanker was released only because the country's Revolutionary Guards retaliated by seizing a British tanker. That could encourage further such actions by Iran, which will keep tensions high in the Persian Gulf and maintain some measure of a risk bid for oil. Meanwhile, as the released tanker steams toward Greece, the U.S. government has issued a warning that any entity that provides support to the ship or her crew would be subject to U.S. "immigration and potential criminal consequences."

Mexico: In another worrying sign for the viability of contracts under leftist President Andrés Manuel López Obrador, the Mexican government has demanded $900 million from the builders of a major natural gas pipeline that is supposed to deliver natural gas from Texas to Mexico. The government is demanding the money as compensation for construction delays, and it has already forced the builders to enter into arbitration. Separately, the government is trying to reduce the capacity and usage charges it faces under the contract for the project.

Colombia: Agricultural officials in Bogotá have confirmed that a soil fungus that has devastated banana plantations throughout Southeast Asia has been detected in Colombia, the top global exporter of the fruit. While the fungus isn't dangerous to humans, it prevents trees from producing and is considered so dangerous that it could eventually eliminate all Cavendish bananas, which make up 95% of world exports.

Odds and ends: Yesterday, we reported that the Business Roundtable moved to change the focus of business from promoting shareholder value to a broader goal of stakeholder value. Shareholders have responded unfavorably. The Reserve Bank of Australia discussed unconventional policy at its August meeting. Japan allowed more exports of high-tech materials to South Korea, easing recent tensions. Another reason for the recent U.S. attraction to Greenland—rare earths. And, ISIS isn't completely eliminated yet.

U.S. Economic Releases

The table below shows the Fed events scheduled for the rest of the day.

Economic Releases		
	No economic releases today	
Fed speakers or events		
	Speaker or event	**District or position**
16:30	Mary Daly Takes Part Quora session online	President of the Federal Reserve Bank of San Francisco
18:00	Randal Quarles Discusses Community Development	Federal Reserve Vice Chairman of Supervision

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	Convenience Store Sales	y/y	jul	-2.5%	0.0%		**	Equity bearish, bond bullish
Australia	ANZ Roy Morgan Weekly Consumption	w/w	18-Aug	112.8	115.5		**	Equity and bond neutral
EUROPE								
Eurozone	Construction Output	m/m	jun	1.0%	2.0%		**	Equity bearish, bond bullish
Germany	PPI	y/y	jul	1.1%	1.2%	1.0%	**	Equity bearish, bond bullish
UK	CBI Trends Total Orders	m/m	aug	-13	-34	-25	**	Equity and bond neutral
	CBI Trends Selling Prices	m/m	aug	-2	12		**	Equity and bond neutral
Switzerland	Exports Real	m/m	jul	-1.8%	-0.1%		**	Equity and bond bearish
	Imports Real	m/m	jul	-0.5%	1.4%		**	Equity and bond bearish
	Swiss Watch Exports	y/y	jul	4.3%	-10.7%		*	Equity and bond neutral
Russia	Real Wages	m/m	jul	3.5%	2.3%	2.6%	**	Equity bullish, bond bearish
	Retail Sales Real	m/m	jul	1.0%	1.4%	1.5%	**	Equity and bond neutral
	Unemployment Rate	m/m	jul	4.5%	4.4%	4.5%	***	Equity and bond neutral
AMERICAS								
Canada	Bloomberg Nanos Confidence	w/w	16-Aug	57.3	57.8		**	Equity and bond neutral
Brazil	Trade Balance Weekly	m/m	19-Aug	$0.701 Bil.	$1.319 Bil.		*	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)	214	212	2	Down
3-mo T-bill yield (bps)	186	185	1	Neutral
TED spread (bps)	28	27	1	Neutral
U.S. Libor/OIS spread (bps)	188	189	-1	Up
10-yr T-note (%)	1.56	1.61	-0.05	Down
Euribor/OIS spread (bps)	-42	-42	0	Neutral
EUR/USD 3-mo swap (bps)	8	9	-1	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	flat			Up
yen	up			Up
pound	down			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	$59.56	$59.74	-0.30%	
WTI	$55.97	$56.21	-0.43%	
Natural Gas	$2.20	$2.21	-0.45%	
Crack Spread	$16.07	$16.10	-0.20%	
12-mo strip crack	$15.22	$15.28	-0.40%	
Ethanol rack	$1.55	$1.55	-0.34%	
Metals				
Gold	$1,507.65	$1,495.92	0.78%	
Silver	$17.04	$16.88	0.99%	
Copper contract	$258.65	$260.80	-0.82%	
Grains				
Corn contract	$ 378.75	$ 374.50	1.13%	
Wheat contract	$ 473.50	$ 472.50	0.21%	
Soybeans contract	$ 873.75	$ 866.50	0.84%	
Shipping				
Baltic Dry Freight	2067	2088	-21	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.4		
Gasoline (mb)		0.2		
Distillates (mb)		-0.3		
Refinery run rates (%)		0.00%		

Weather

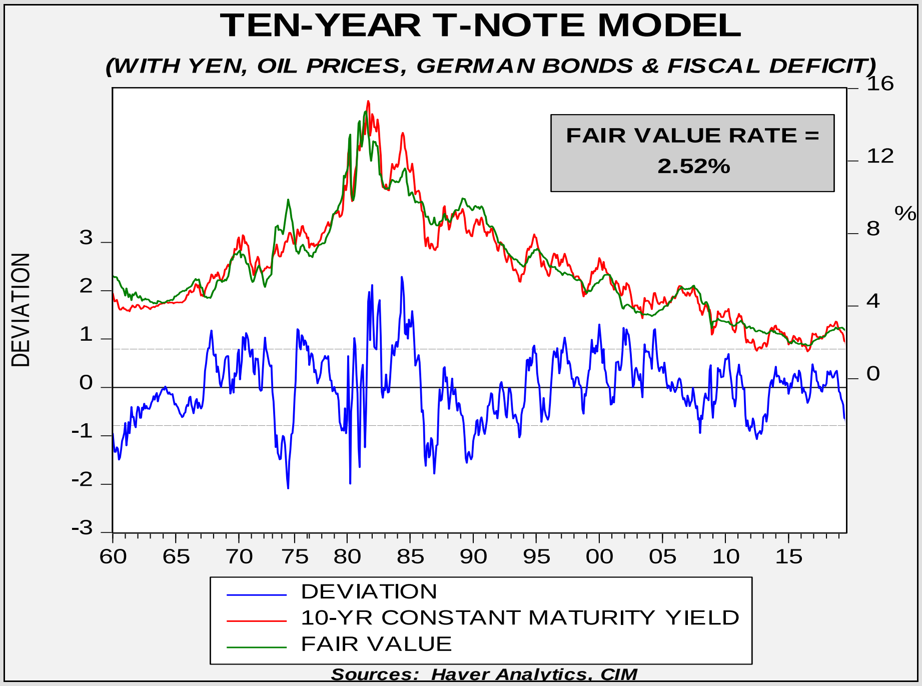
The 6-10 and 8-14 day forecasts show warmer temperatures for the western and southeastern regions, with cooler temperatures for the rest of the country. Precipitation is expected for most of the country. There is some cyclone formation along the East Coast, but it appears to be moving away from shore.

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 16, 2019

As the 10-year T-note yield tumbles, we are reaching a point where the market looks overvalued based on current fundamentals.



Our yield model uses fed funds and the 15-year average of the yearly change in CPI[2] along with the JPY/USD exchange rate, oil prices, the yield on 10-year German bunds and the fiscal deficit as a percentage of GDP. The current yield on the 10-year T-note, dipping below 1.70%, puts the deviation from fair value at nearly a standard error below fair value. Not every deviation from fair value is resolved through higher interest rates; sometimes the fair value yield declines. The last time we saw this sort of event occur was in 2012 during the Euro crisis and the U.S. Treasury downgrade. That proved to be an unsustainable low in yields. We also saw a dip in early 2008; that issue was resolved by falling T-note yields due to the financial crisis.

Isolating fed funds and assuming the rest of the variables remain steady shows that the bond market has factored in a fed funds of 10 bps, or essentially a return to ZIRP. To be fair, it is also possible that the financial markets are lowering estimates of inflation. The 5-year/5-year TIPS calculation[3] puts the forward inflation rate at 1.80%; our long-term average calculation is around 2.08%. Applying that inflation rate expectation into the model means the current T-bond yield has discounted a 50 bps fed funds rate.

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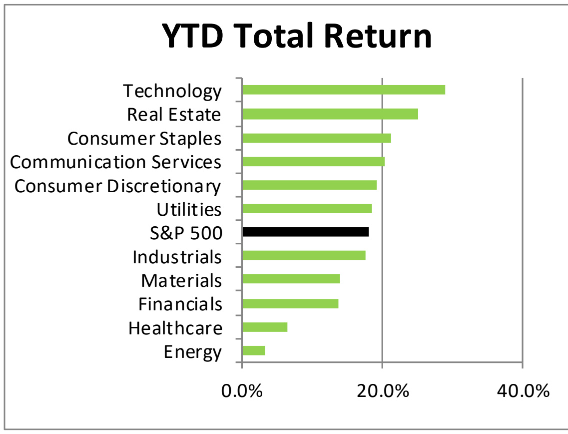
[2] This variable acts as a proxy for inflation expectations.

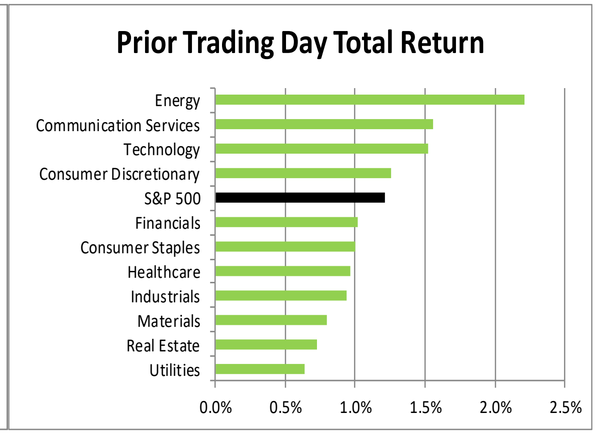
[3] This series is a measure of expected inflation (on average) over the five-year period that begins five years from today.

In any case the bond market is essentially making the case that a recession is likely. If a recession is avoided, we would expect to see a significant rise in long-duration yields. For now, the uncertainty surrounding trade and weakening global growth will probably continue to support a long-duration position. But, given the mercurial nature of the trade discussions, a rapid reversal is not out of the question and thus requires close monitoring.

Data Section

U.S. Equity Markets – (as of 8/19/2019 close)

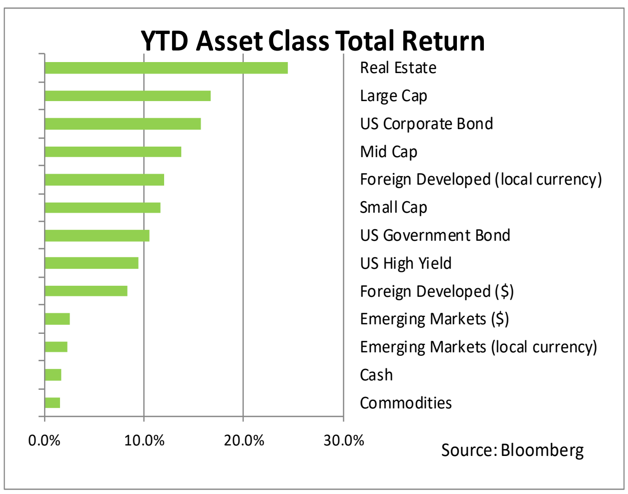




(Source: Bloomberg)

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 8/19/2019 close)

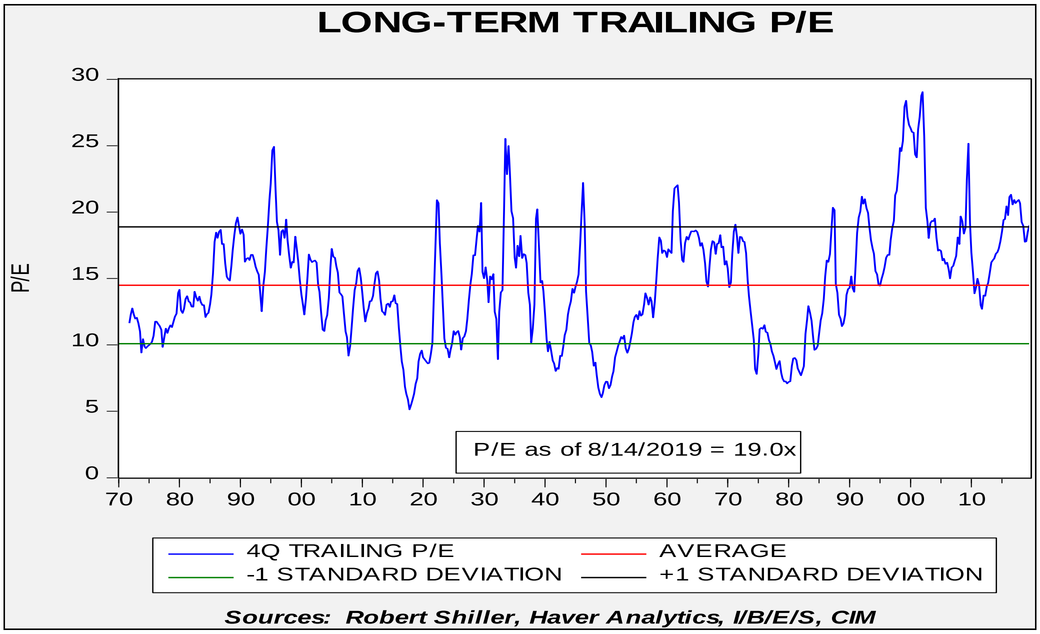


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 15, 2019



Based on our methodology,[4] the current P/E is 19.0x, unchanged 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.

[4] 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.