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 23, 2019—9:30 AM EDT] Global equity markets are generally higher this morning, but Europe and the U.S. have reversed on the China news. The EuroStoxx 50 is up 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.3%. Chinese markets were mixed, with the Shanghai composite up 0.5% and the Shenzhen index unchanged from the prior close. U.S. equity index futures are signaling a higher open.

Happy Friday! It's quiet this morning in front of Chair Powell's presentation. Here is what we are watching:

BREAKING: China to levy tariffs on another $75 bn of U.S. exports. Bonds and gold rally, while equities, oil and copper decline. Oil, soybeans and auto exports were specifically targeted.

Powell: Between the minutes and a series of interviews suggesting a wide disparity of views, there is growing sentiment, which we tend to share, that Chair Powell will struggle to bring the committee to make aggressive rate cuts. We suspect his speech today will try to create a narrative that will support future action. A set of variables could be established as guideposts; three possibilities might include persistently low inflation, global economic weakness or the dampening of investment from the trade war. Another key idea to remember is that Powell doesn't necessarily have to make the members of the committee happy, he merely needs their votes. The members know that if Powell can't sway the committee and he resigns, then the White House may press for a new chair who is an ideologue. Thus, the committee members may grudgingly accept rate cuts to avoid turmoil.

Recession worries: Although the media coverage of any White House often sensationalizes divisions and concerns within the executive branch, recent reports of concerns about the economy probably have an element of truth. Worries about the economy, especially in the year before the election, have been evident in most administrations. We have seen earlier governments attempt to tag the Fed with blame if the economy slumps; again, nothing unusual here. Presidents Johnson, Nixon, Reagan and Bush (H.W.) all engaged in attempts to sway monetary policy. We lived through an unusual détente since Clinton where the White House and the Fed left each other alone. That informal peace accord has clearly ended and we have returned to the earlier tensions.

Therefore, in light of these worries, we have seen a number of trial balloons floated, including indexing capital gains taxes to inflation, a payroll tax holiday and other unspecified tax cuts. To some extent, the problem is that the trade conflict with China was bound to have adverse economic repercussions. It's possible the president didn't believe that, but his advisors should have been aware. At the same time, presidents sometimes have a policy goal so important to them that they engage in that policy even though it adversely affects other goals. It looks to us that President Trump deeply believes the trade regime established after WWII isn't working for the majority of Americans and a strong case can be made that this is true. Both sides of the populist wings have turned against trade and only the elites still believe in it (mostly because they benefit greatly from overall globalization, of which free trade is an element). The problem for the president is timing. He spent his "golden period"[1] deregulating and cutting taxes. If these were the president's most deeply held goals, then he did the right thing. However, it appears to us that changing the postwar trade regime may be his most deeply felt goal; if so, he should have done that first. If he had moved on trade immediately after winning the election, then we would likely be past the worst effects by now and the disruption of supply chains would not be threatening the business cycle.

Given today's news out of China on tariffs, it seems unlikely that tensions can ease without one side caving. China seems to be banking on the idea that the U.S. needs a deal more than it does because of looming elections. The U.S. doesn't appear open to backing down and the recent move to tie conditions in Hong Kong to a trade deal likely reduces the odds of a deal. ***It is quite possible that the most effective policy to lift the economy in the short run would be a reduction in trade tensions.*** The problem is that neither side appears open to a way out of this conflict.

G-7: The G-7 meets this weekend, with the members deeply divided. As we noted yesterday, the host nation, France, has already indicated that it won't deliver a communiqué. Macron wants to talk about the fires in Brazil, while President Trump wants to talk about France's recent tech company tax. The EU would like to ease trade tensions with the U.S. Although we don't expect this meeting to have a major market impact, the divisions among the leading democracies are problematic and an indication of the deglobalization that is underway.

Italy: Parties were given until next Tuesday to form a government. The center-left and populist-left parties are continuing to negotiate. Although these parties have been at odds for a long time, the prospect of a government dominated by the populist-right is concentrating their efforts. If the negotiations fail, it doesn't necessarily mean immediate elections. Instead, we could see the president of Italy install a caretaker government until the budget process is completed.

Brexit: PM Johnson continues to hear the same message from EU leaders: the backstop is necessary and negotiations are futile. It is becoming difficult to see how a hard Brexit is avoided unless Parliament stops it from happening.

Champions: The EU is floating a plan to create a €100 bn sovereign wealth fund to create "European champions" in the technology space to compete with the U.S. and Chinese tech giants. Although the sentiment makes sense, we have doubts that money is the problem. After

[1] We consider the first 18 months of a president's first term as the most important. This is the period when a president can get the most accomplished and therefore one should try to move their highest priority goals through before the summer of the year before the election year.

all, rates in Europe are below zero in many markets. The key is allowing companies to "move fast and break things," something Europe doesn't seem too comfortable with allowing.

U.S. Economic Releases

There were no economic releases scheduled prior to the release of this report. The table below lists the economic releases and Fed events scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	New Home Sales	m/m	jul	647k	646k	***
10:00	New Home Sales	m/m	jul	0.2%	7.0%	**
Fed speakers or events						
	Speaker or event	District or position				
10:00	Annual Federal Reserve Policy Symposium in Jackson Hole	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								
Japan	National CPI	y/y	jul	0.5%	0.7%	0.6%	***	Equity bullish, bond bearish
	National CPI ex Fresh Food	y/y	jul	0.6%	0.6%	0.5%	***	Equity and bond neutral
	National CPI EX Fresh Food, Energy	y/y	jul	0.6%	0.5%	0.5%	***	Equity and bond neutral
New Zealand	Retail Sales ex Inflation	q/q	2q	0.2%	0.7%	0.3%	**	Equity bullish, bond bearish
EUROPE								
Eurozone	Consumer Confidence	m/m	aug	-7.1	-6.6	-7.0	***	Equity and bond neutral
Russia	Gold and Forex Reserve	m/m	16-Aug	528.4 Bil	527.1 Bil		*	Equity and bond neutral
	Money Supply Narrow Def	m/m	16-Aug	10.6 Tril	10.5 Tril		*	Equity and bond neutral
AMERICAS								
Mexico	GDP Nominal	q/q	2q	3.0%	6.3%	3.4%	***	Equity and bond neutral
	Economic Activity IGAE	y/y	jun	-0.9%	-0.4%	-0.6%	***	Equity and bond bearish
Canada	Wholesale Trade Sales	m/m	jun	0.6%	-1.8%	-0.2%	**	Equity bullish, bond bearish
Brazil	IBGE Inflation IPCA-15	y/y	aug	3.2%	3.3%	3.3%	***	Equity and bond neutral
	Tax Collections	m/m	jul	137.735 Bil	119.946 Bil	136.950 Bil	*	Equity bullish, 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)	215	215	0	Down
3-mo T-bill yield (bps)	194	194	0	Neutral
TED spread (bps)	21	21	0	Neutral
U.S. Libor/OIS spread (bps)	190	190	0	Up
10-yr T-note (%)	1.64	1.61	0.03	Down
Euribor/OIS spread (bps)	-42	-42	0	Neutral
EUR/USD 3-mo swap (bps)	17	14	3	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Down
yen	down			Up
pound	down			Down
franc	down			Up

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	$59.88	$60.30	-0.70%	
WTI	$55.28	$55.68	-0.72%	
Natural Gas	$2.15	$2.17	-0.74%	
Crack Spread	$13.73	$14.00	-1.92%	
12-mo strip crack	$16.06	$16.20	-0.86%	
Ethanol rack	$1.57	$1.56	0.63%	
Metals				
Gold	$1,498.76	$1,502.65	-0.26%	
Silver	$17.06	$17.12	-0.35%	
Copper contract	$256.75	$259.20	-0.95%	
Grains				
Corn contract	$ 371.00	$ 370.25	0.20%	
Wheat contract	$ 471.75	$ 468.00	0.80%	
Soybeans contract	$ 868.75	$ 873.00	-0.49%	
Shipping				
Baltic Dry Freight	2061	2059	2	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.7	-1.4	-1.3	
Gasoline (mb)	0.3	0.2	0.2	
Distillates (mb)	2.6	-0.3	3.0	
Refinery run rates (%)	1.10%	0.00%	1.10%	
Natural gas (bcf)	59.0	49.0	10.0	

Weather

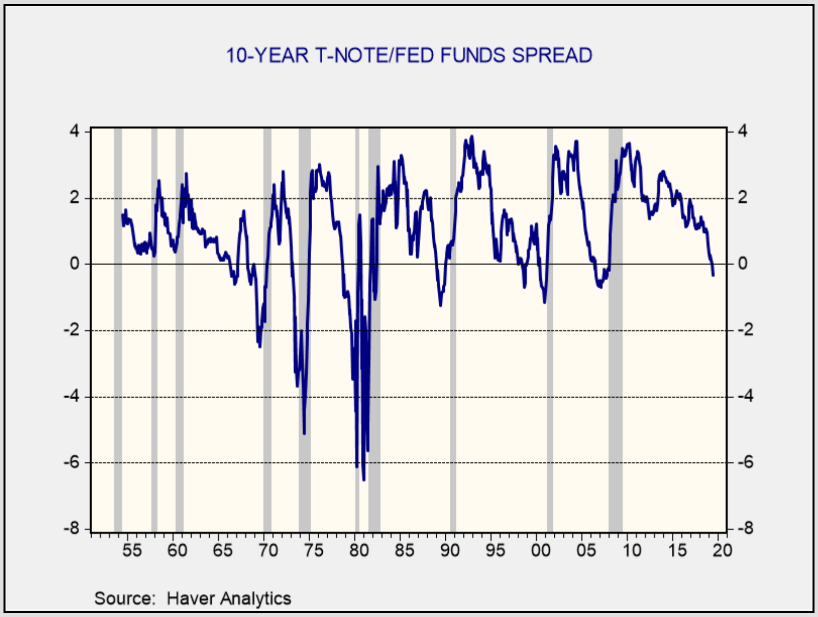
The 6-10 and 8-14 day forecasts show above-normal temperatures on the East Coast and the far western region, with below-normal temperatures for the rest of the country. Precipitation is expected for most of the country. There is currently a cyclone disturbance over the Bahamas that has been gaining momentum but, at this time, it is not expected to develop into a tropical storm.

Asset Allocation Weekly

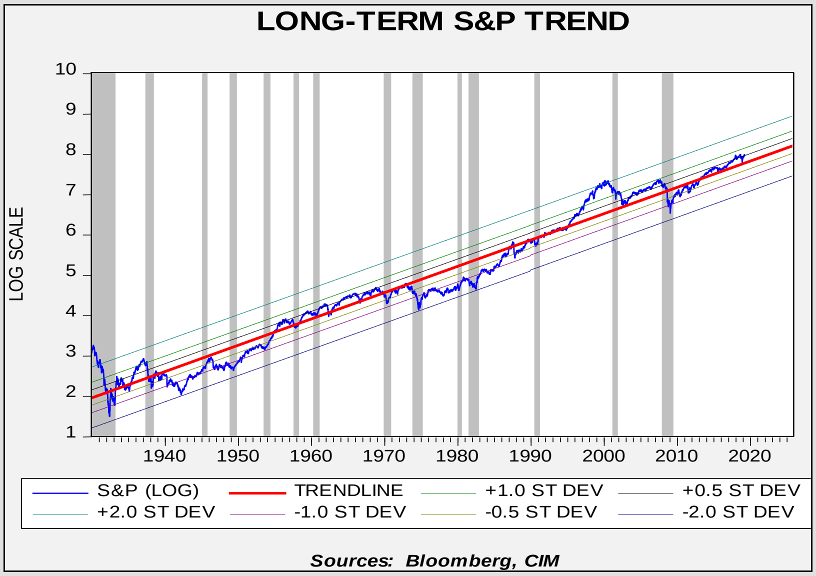
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

August 23, 2019

Recession worries have increased due to falling long-duration interest rates and the short-lived inversion of the two-year/10-year T-note spread. Although this spread is important, it is merely one in a whole series of permutations of the yield curve. Our preferred measure is the 10-year/fed funds spread because it measures the long end of the yield curve to the policy rate and thus should provide a clearer picture of whether or not the central bank policy is too tight. It is also the same spread the Conference Board uses in its leading economic indicators.

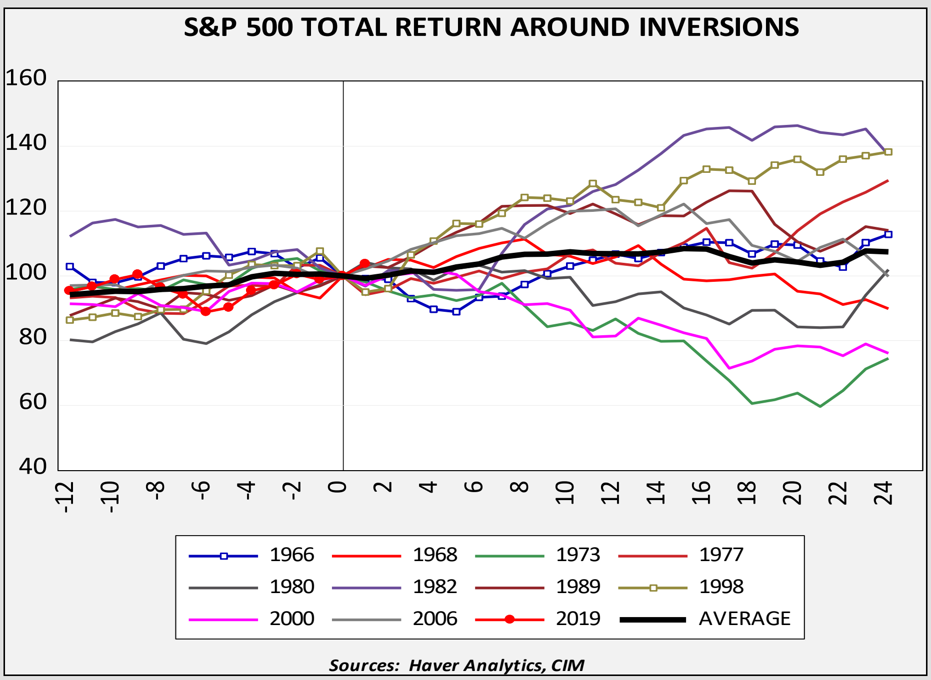


This chart shows the aforementioned spread. Since the 1970 recession, the spread has inverted before every recession. It did have two false positives, one in 1966 and another in 1998. The recent inversion could be a false positive as well, but it makes sense that investors should be concerned about a recession. This is because equities often decline during recessions; in some cases, the drop is significant.



This chart shows the weekly Friday close for the S&P 500 on a log scale. We have regressed a time trend through the data. In nearly all recessions, some weakness in equities is observed, although often the decline in stocks predates the recession to some degree.

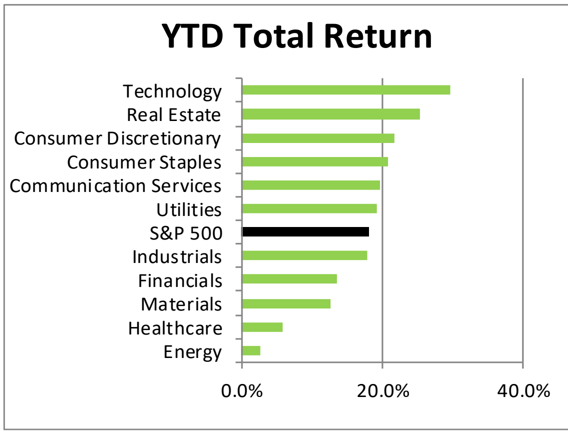
This chart shows the performance of the S&P 500 around inversions of the 10-year T-Note/fed funds spread. We took every inversion from 1966 forward, indexing the S&P to 100 at the month of inversion.

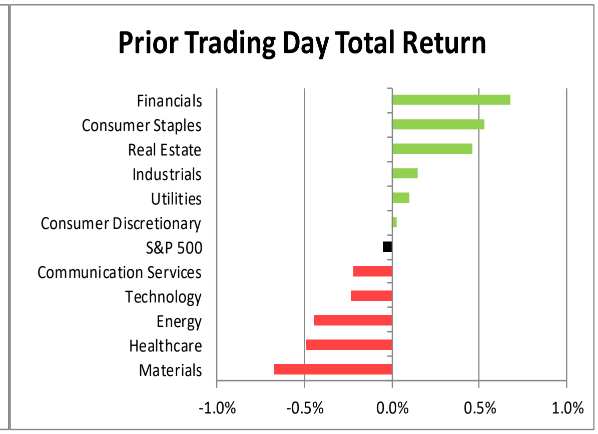


We added symbols to the 1966 and 1998 inversions as both were false positives for recession. In the former case, equities fell in the first 10 months of inversion but rallied. In 1998, there was a brief drop followed by a strong rally in stocks. Generally speaking, false positives are buying opportunities. All the other events were eventually followed by recessions. However, as the data shows, the dispersion is remarkably wide. It's hard to ascertain a clear message with this much noise, but, in general, a case can be made that a delayed recession after inversion tends to support equity values. The other message is that valuations and inflation issues do matter around inversions. The worst performing markets in the two years after an inversion was 1973, a bear market that suffered from falling margins and multiples, and 2000, which was a highly overvalued equity market. Other than these lessons, the data tends to support the idea that panic around an inversion is probably unwise, which is what the average of all the events tends to suggest. Each inversion has specific characteristics that affect equity market performance. In the current environment, we would be most concerned about profit margins; if a recession occurs, we would expect margins to contract which would likely trigger a notable bear market. So far, margins have declined but remain historically elevated. Margins will likely be the key to equity performance in the coming quarters.

Data Section

U.S. Equity Markets – (as of 8/22/2019 close)

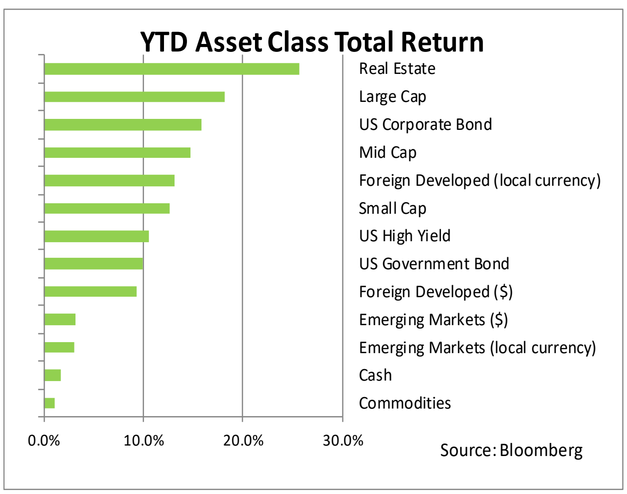




(Source: Bloomberg)

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 8/22/2019 close)

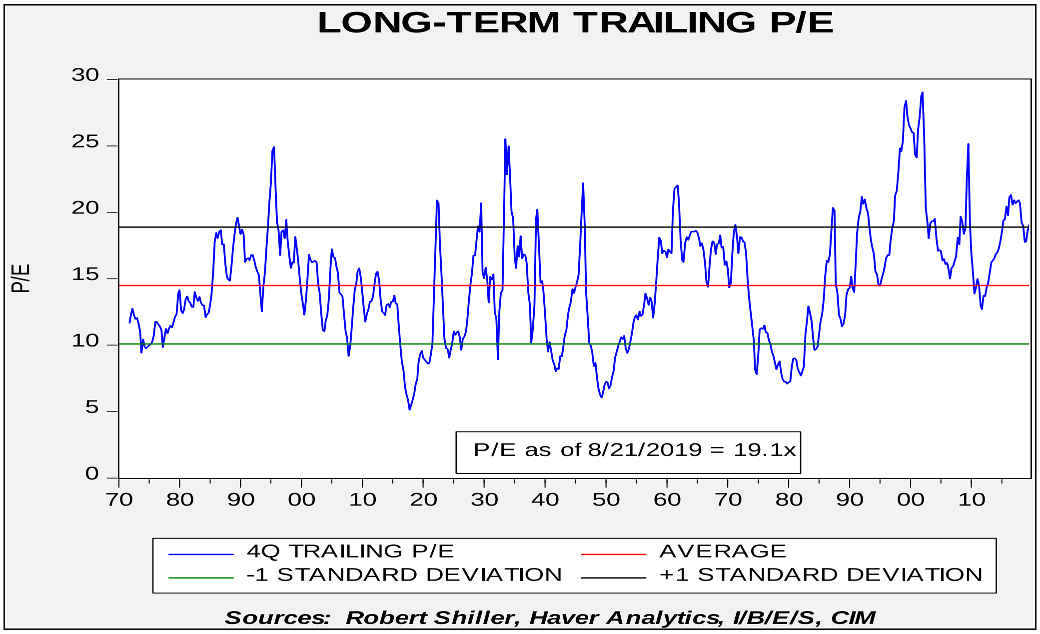


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 22, 2019



Based on our methodology,[2] the current P/E is 19.1x, up 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 three actual quarters (Q4, Q1 and Q2) and one estimate (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.