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 28, 2019—9:30 AM EDT] Global equity markets are flat-to-lower this morning. The EuroStoxx 50 is down 0.9% from the last close. In Asia, the MSCI Asia Apex 50 closed basically unchanged. Chinese markets were lower, with the Shanghai composite down 0.3% and the Shenzhen index down 0.1% from the prior close. U.S. equity index futures are signaling a lower open.

It's midweek; halfway to Labor Day weekend! Boris moves against Parliament, Parliament moves against Boris and we are reacting to the Bill Dudley op-ed. Here are the details and other items we are watching:

Brexit: For the first time since 1948, PM Johnson has asked Queen Elizabeth to suspend Parliament on September 10, only a week after it returns from summer break, until October 14, which would severely limit the ability of the MPs to block a no-deal Brexit. There are currently court challenges against the move in Scotland and former PM John Major has promised similar action in English courts. By convention, the sovereign accepts the PM's request for proroguing Parliament, although it is possible she might reject the suggestion. The move increases the odds of a no-deal Brexit. The GBP tumbled on the news. The opposition in Parliament is trying to cobble together a response, which seems similar to what was used to delay Brexit at the end of March. Meanwhile, the Johnson government is pushing for additional fiscal spending, which is normal if one is preparing for elections.

We note the move comes a day after Boris Johnson told German Chancellor Angela Merkel and European Commission President Jean-Claude Junker that he was willing to accept minor changes to the Brexit agreement if they agreed to changes to the Irish backstop. This proposal was likely to assuage fears of a broader rewriting of the bill. That said, by suspending Parliament, Boris Johnson's Brexit agreement would likely force MPs to accept his agreement as-is or nothing at all. As a result, the likelihood of a no-confidence vote and a no-deal Brexit is extremely elevated. Following the news, the pound weakened significantly against the dollar due to growing uncertainty of Brexit.

The Dudley op-ed: Bill Dudley, the former president of the NY FRB, penned an essay for Bloomberg where he suggested that the Fed should not accommodate the president's trade policy, essentially acting as a governor against the trade war. His concern is that by reducing rates to offset the negative effects of tariffs, the Fed is enabling the president's trade policy.

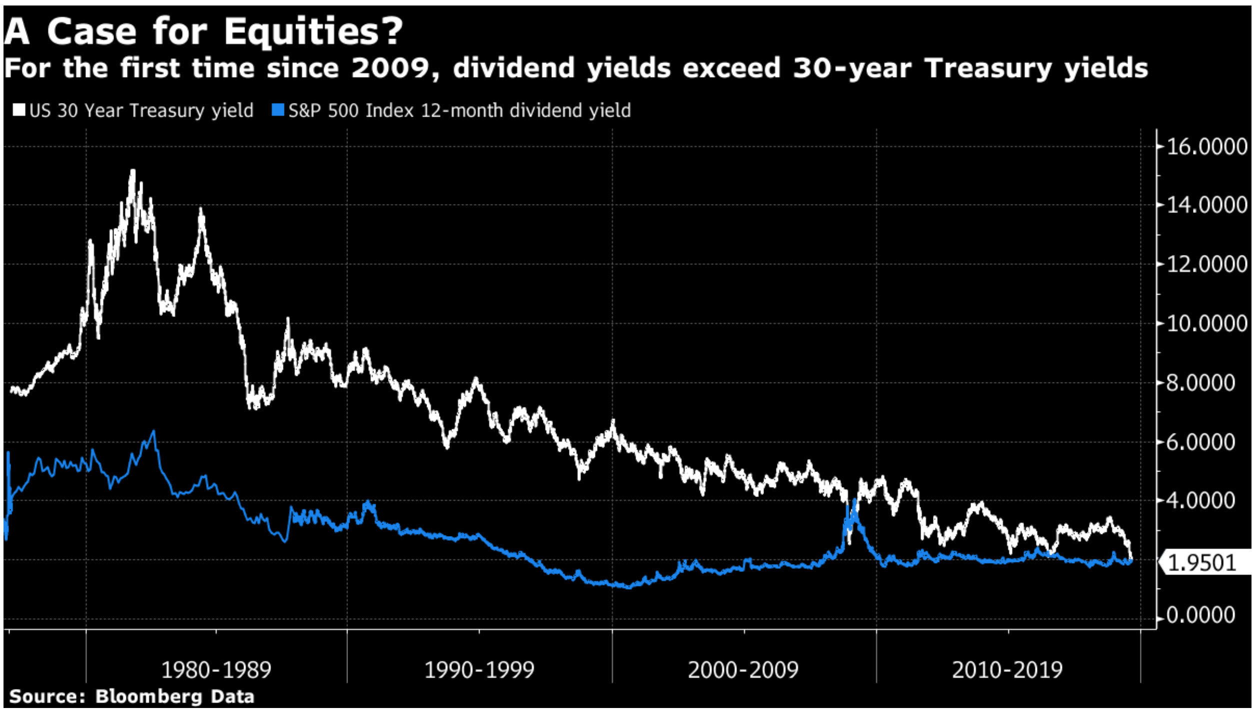
As a private citizen, he has every right to express his opinion. Additionally, he isn't the first person to make such observations. However, as a former member of the FOMC and permanent voter on monetary policy, the expression of his views is dangerous, even if he firmly believes them.

1. The Federal Reserve is an unelected body. Although the Fed governors are approved by the Senate, the regional bank presidents are not so there is limited democratic oversight of monetary policy. The U.S. government does give power to unelected organs of government but limits their scope by giving them specific mandates. The Fed has a relatively simple mandate, full employment and low inflation with fairly limited tools to meet these goals. After 2008, the Fed veered closely into fiscal policy, but we do note that instead of simply recapitalizing the banks itself, which it had the wherewithal to do, Chair Bernanke insisted on the passage of TARP to ensure recapitalization had democratic legitimacy. We let the Fed do a lot with its powerful tools, but with limited scope. Tensions between the legislature, the executive and the Fed are nothing new, but Dudley's recommendations would suggest that the Fed should take steps to thwart the desires of elected officials. ***This may only be done within the strict limits of its mandate, not to simply stop a policy it may not favor***.
2. Dudley's comments as a former official are inappropriate because they will apply a political taint on the central bank. A theme that runs through populism is that the elites are a cabal that use the tools of government to support the goals and aspirations of the elite. Populists of all stripes are, at best, jaded over free trade or, at worst, support autarky. For a former central banker to suggest that the Fed should engage in behaviors that undermine an administration's trade policy simply confirms to populists that the "game is rigged."
3. A political taint for the Fed raises worries that yet another non-elected part of government is becoming politicized. For those in the political sphere, manipulating bodies like the Fed or the Supreme Court is fair game because their goal is to further their political aims. That is what power is all about. We create these apolitical bodies to limit the scope of political power, to make groups in government that can make decisions based on considerations other than simply political concerns. When these apolitical bodies shift into policy advocacy, problems develop. ***In general, one can either change the world or understand it, but you can't do both***. If one decides to change the world, everything becomes a tool to meeting that goal. If one decides to understand the world, they must avoid crossing over into altering the world, because at that point bias sets in. Some have argued that we are political at heart and no one is unbiased. We disagree, but the costs of being unbiased is that one cannot cross the line into advocacy. History has shown periods when the Supreme Court appeared to venture into advocacy; once that occurs, faith in the court diminishes and its decisions can be seen as merely political. Justice Roberts appears to be disappointing some in the political sphere for not moving toward their goals, but we suspect the chief justice is trying to uphold the integrity of the institution. The concern now, in the wake of Dudley's comment, is that decisions made

by the Fed will be subject to political analysis. In other words, Dudley may have inadvertently undermined the integrity of the Federal Reserve.

The Fed has officially rejected Dudley's comments, as it should, but the damage has been done. Chair Powell was already facing a difficult task of conducting monetary policy under a constant barrage of criticism. Now, Dudley's comments can be used to frame unpopular monetary policy decisions as having a political agenda.

A rare occurrence: Yesterday, the dividend yield on the S&P 500 rose above the yield on the 30-year T-bond.



(Source: Bloomberg)

The 30-year T-bond has a relatively short history; the first issuance occurred in 1977. The only other time this occurred was in 2009 and was due to the collapse in equity prices. This time, it was due to the drop in Treasury yields.

Conte returns? The Five-Star Movement and the Democratic Party are close to coming to an agreement that would avoid new elections. Under the new government, Guiseppe Conte would return as prime minister, with Five-Star's Luigi Di Maio returning as his deputy, and co-deputy Matteo Salvini would likely be replaced by a member of the Democratic Party.

Last week, the parliament dissolved after the League Party decided that it no longer wanted to form a coalition government with the Five-Star Movement. To say that the relationship between the two sides was rocky from the start would be putting it lightly as the two parties represent populist wings of opposite sides of the political spectrum. Following the dissolvement of the coalition, Italian President Sergio Mattarella gave the parties the opportunity to form a government in order to avoid snap elections; within that time, the Five-Star Movement held talks with the Democratic Party. In the event of an election, the co-deputy and League leader Matteo Salvini, who helped initiate the procedure, is favored to take over as prime minister. Optimism about a possible coalition between the Democratic Party and the Five-Star Movement has resulted in a rally in Italians bonds.

Big Tech project on hold: A plan to build an undersea cable that would link the U.S. and mainland China has been put on hold due to national security concerns. The Justice Department has concerns over one of the Chinese backers, Dr. Peng Telecom & Media Group Co. (600804, CNY 6.81). U.S. official involvement is another example of the growing distrust between the U.S. and China.

Russia-Turkey: At the opening of a major airshow in Moscow yesterday, President Putin personally gave Turkish President Recep Tayyip Erdogan a tour of Russia's newest stealth fighter jet, the Su-57. Putin continues to take advantage of Turkey's growing estrangement from the West (see our Weekly Geopolitical Report from August 5). Ankara's purchase of a Russian air defense system this summer prompted President Trump to prohibit any sales of the U.S. F-35 stealth fighter to Turkey, so Putin is now dangling the Su-57 and other aircraft in front of Turkey with the hope of pulling Ankara further onto Russia's side.

U.S. Economic Releases

MBA mortgage applications in the week ended August 23 were down 6.2% from the prior week. Applications for home-purchase mortgages fell 4.0%, while applications for refinancing mortgages dropped 7.6%. The average interest rate on a 30-year, fixed-rate mortgage edged up to 3.94%.

The table below lists the Federal Reserve speakers scheduled for the rest of the day.

Economic Releases		
	No economic releases today	
Fed speakers or events		
	Speaker or event	**District or position**
12:20	Thomas Barkin Speaks to WV Chamber of Commerce	President of the Federal Reserve Bank of Richmond
17:30	Mary Daly Speaks at RBNZ/IMF Conference in New Zealand	President of the Federal Reserve Bank of San Francisco

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								
Australia	Construction Work Done	q/q	2Q	-3.8%	-2.2%	-1.0%	*	Equity bearish, bond bullish
EUROPE								
Eurozone	M3 Money Supply	y/y	jul	5.2%	4.5%	4.7%	**	Equity and bond neutral
Germany	GfK Consumer Confidence	m/m	sep	9.7	9.7	9.6	**	Equity and bond neutral
Italy	Consumer Confidence	m/m	aug	111.9	113.3	112.7	**	Equity and bond neutral
	Manufacturing Confidence	m/m	aug	99.7	100.1	99.6	**	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	213	1	Down
3-mo T-bill yield (bps)	194	194	0	Neutral
TED spread (bps)	20	20	0	Neutral
U.S. Libor/OIS spread (bps)	186	187	-1	Up
10-yr T-note (%)	1.45	1.47	-0.02	Down
Euribor/OIS spread (bps)	-42	-42	0	Neutral
EUR/USD 3-mo swap (bps)	15	15	0	Down
Currencies	**Direction**			
dollar	Up			Up
euro	Down			Down
yen	Up			Up
pound	Down			Down
franc	Flat			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	$60.20	$59.51	1.16%	
WTI	$55.73	$54.93	1.46%	
Natural Gas	$2.23	$2.20	1.18%	
Crack Spread	$13.55	$13.55	-0.03%	
12-mo strip crack	$15.82	$15.79	0.21%	
Ethanol rack	$1.55	$1.55	-0.17%	
Metals				
Gold	$1,545.86	$1,542.81	0.20%	
Silver	$18.47	$18.20	1.45%	
Copper contract	$255.25	$255.30	-0.02%	
Grains				
Corn contract	$ 365.75	$ 366.25	-0.14%	
Wheat contract	$ 472.25	$ 476.75	-0.94%	
Soybeans contract	$ 861.50	$ 859.25	0.26%	
Shipping				
Baltic Dry Freight	2213	2168	45	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.3		
Gasoline (mb)		0.4		
Distillates (mb)		1.3		
Refinery run rates (%)		-0.40%		
Natural gas (bcf)		59.0		

Weather

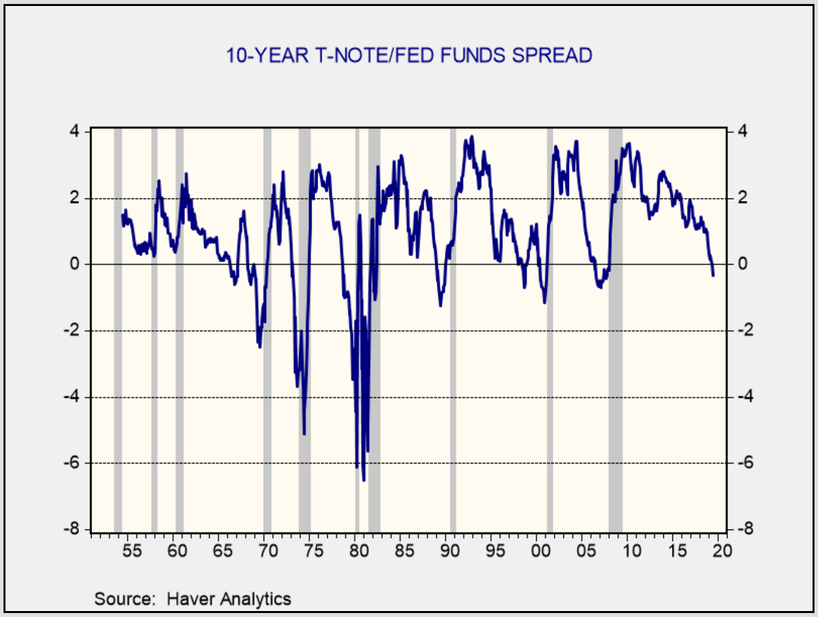
The 6-10 and 8-14 day forecasts show below-normal temperatures in the Midwest, with above-normal temperatures for the rest of the country. Precipitation is expected in all states bordering Canada, in the Midwest and in the Deep South. There are currently two tropical storms we are watching. Tropical Storm Erin is in the Atlantic off the coast of North Carolina, but it is not expected to make landfall in the United States. Tropical Storm Dorian is making its way through the Caribbean and is expected to hit the Virgin Islands and Puerto Rico today. It will likely make its way to Florida over the weekend.

Asset Allocation Weekly

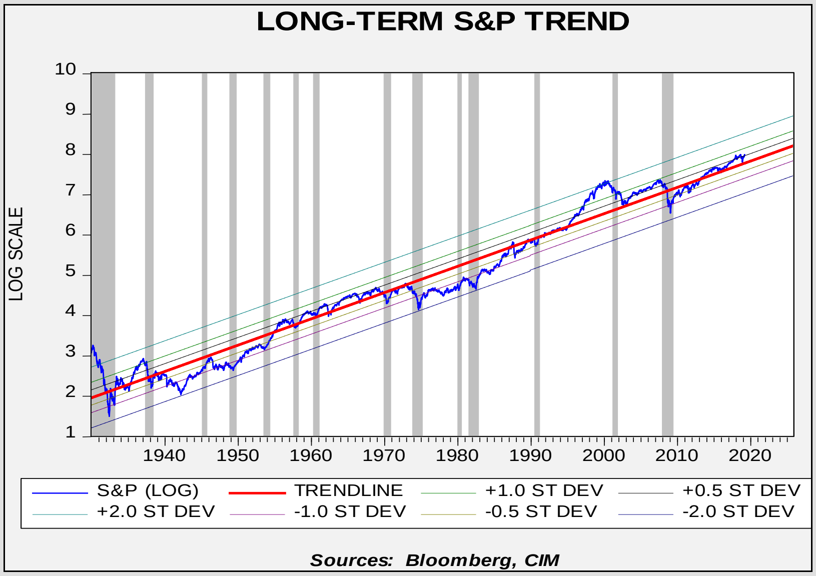
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

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.

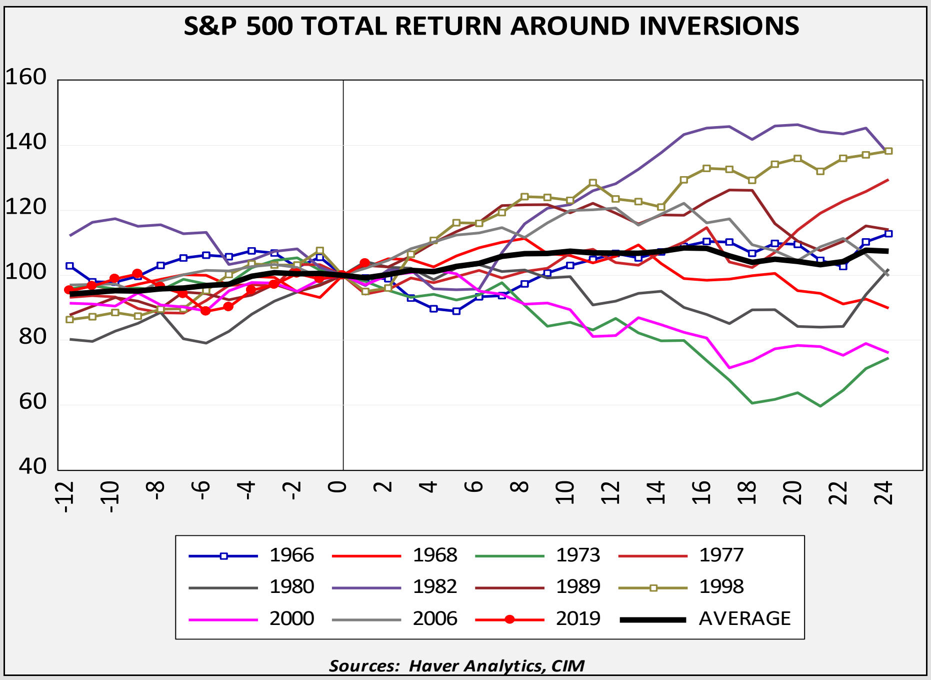


This chart shows the aforementioned spread. Since the 1970 recession, the spread has inverted before every recession. It did have two false positives, one in 1966 and another in 1998. The recent inversion could be a false positive as well, but it makes sense that investors should be concerned about a 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.

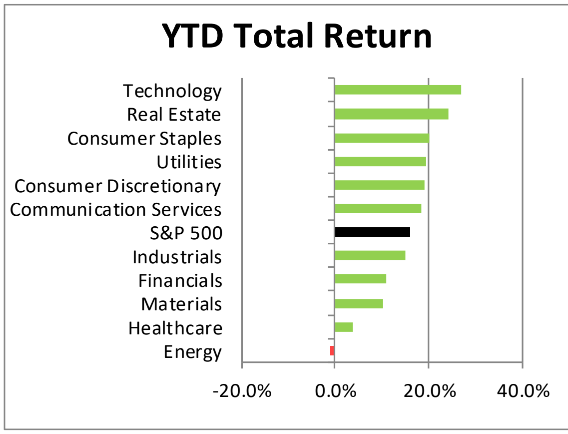
This chart shows the performance of the S&P 500 around inversions of the 10-year T-Note/fed funds spread. We took every inversion from 1966 forward, indexing the S&P to 100 at the month of inversion.

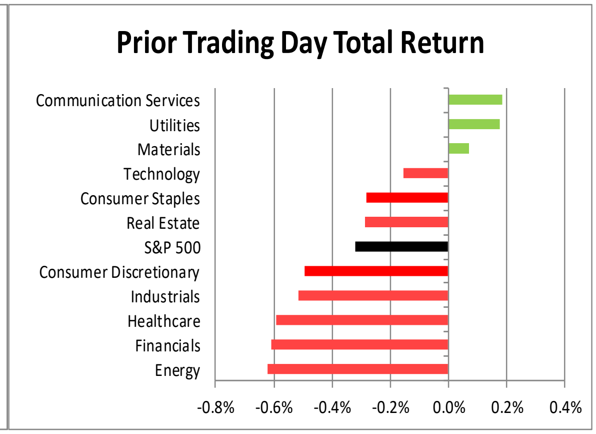


We added symbols to the 1966 and 1998 inversions as both were false positives for recession. In the former case, equities fell in the first 10 months of inversion but rallied. In 1998, there was a brief drop followed by a strong rally in stocks. Generally speaking, false positives are buying opportunities. 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 8/27/2019 close)

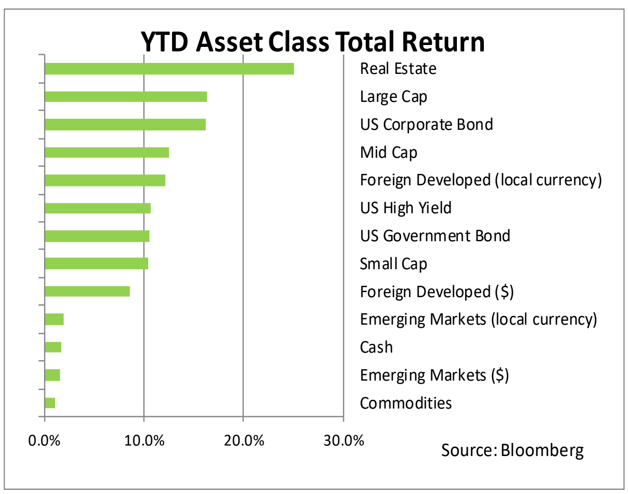




(Source: Bloomberg)

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 8/27/2019 close)

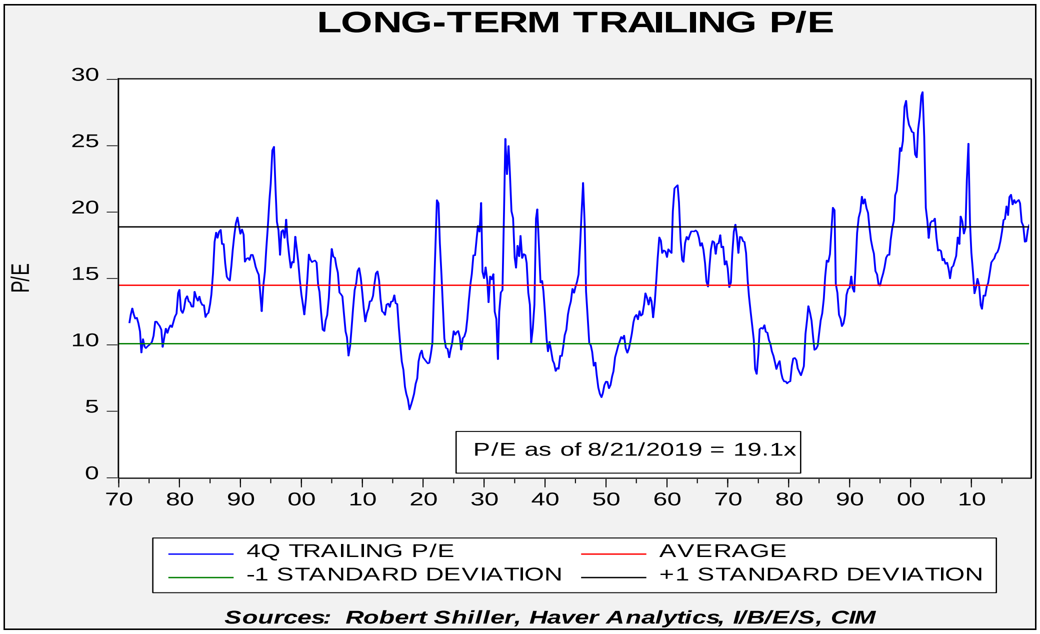


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[1] 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.

[1] 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.