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 5, 2019—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 1.6% from the last close. In Asia, the MSCI Asia Apex 50 closed down 2.7%. Chinese markets were lower, with the Shanghai composite down 1.6% and the Shenzhen index down 1.5% from the prior close. U.S. equity index futures are signaling a lower open. With 387 companies having reported, the S&P 500 Q2 earnings stand at $42.13, higher than the $40.70 forecast for the quarter. The forecast reflects a 2.7% decrease from Q2 2018 earnings. Thus far this quarter, 73.9% of the companies reported earnings above forecast, while 18.6% reported earnings below forecast.

It's Monday, but far from a happy one. Global equity markets are taking a beating while interest rates continue to decline. Geopolitical tensions are rising in several theaters. The U.S. is dealing with two mass shootings. And, the Haj begins today. Here are the details:

Trade wars: Media reports indicate that nearly all the president's advisors (Peter Navarro was the exception) did not want to see tariffs implemented on China. As we have noted in the past, the president believes that the incidence of the tariffs falls on Chinese exporters and thus it is a "free tax" for the U.S. Although this point is often disputed with great certainty by the media, in reality, it can work as the president suggests. Without question, a tariff raises the price to a U.S. importer. If the transaction were that simple, the president's critics are correct. However, the Chinese exporter, in order to maintain market share, may reduce his price to the level of the tariff. In that case, the incidence falls on the exporter. Or, the foreign nation may depreciate its currency by the amount of the tariff, offsetting the levy. In that case, the incidence of the tax falls on U.S. exporters (the price of their goods increased due to a weaker currency) and on consumers in China (the cost of imports rises for those buyers). In other words, it's complicated.

However, China followed the textbook and this morning allowed the CNY to fall, as the currency broke seven CNY to the USD. This was a level that markets assumed the PBOC would defend. Instead, monetary officials simply allowed the currency to decline. Although this action is consistent with international economic theory, Chinese officials tended to hold the line on this level due to worries about capital flight. Although there have been conflicting reports, it appears China may be halting agricultural purchases. In addition, China has disputed Trump's claim over fentanyl exports. Fears of a currency war are clearly undermining investor confidence. At the same time, investors should be aware that the president could flip on this position at any time, as we saw with Mexico. The hurdle for making a switch isn't all that high. All China would probably have to do is announce soybean purchases and make some show about seizing narcotics. Although, doing so and not appearing to cave to the U.S. is tricky, especially in front of party meetings. In addition, China is blaming the U.S. for not just the tariffs, but for unrest in Hong Kong; giving in to U.S. demands in this atmosphere looks unlikely.

India: India appears to be moving to remove autonomy from Kashmir. In the past few days, New Delhi has warned tourists to evacuate and has put the region on lockdown. Communication links have been broken and local officials have been placed under house arrest. The region has been a flashpoint in tensions between Pakistan and India, both who claim control over the districts. The area, mostly Muslim, wants autonomy from both nations but neither are inclined to cede it to the other. If India moves to absorb its area of control into greater India, local unrest will almost certainly escalate, and Pakistan could become involved.

Hong Kong: There a no signs of cooling in Hong Kong. A general strike, the first in 50 years, has been called for today and widespread protests occurred over the weekend. Public transportation was disrupted over the weekend, and civil servants held protests against their government.

Iran: Iran has seized another petroleum tanker although it appears it may be a smuggler's vessel. Iran subsidizes its petroleum products and there is an active business in buying product at lower prices in Iran and selling elsewhere in the region. A broader problem for the U.S. is that China is actively defying U.S. sanctions on Iran by smuggling oil from Iran. Smuggling adds complications not only with Iran but with China as well. Iran is indicating it is reducing its commitment to JCOPA; the more Iran goes down this path, the greater the odds Europe will be forced to shift to the U.S. position on Iran.

Brexit: Boris Johnson appears to be preparing for a snap election due to the narrow nature of this coalition. Polls in Scotland show a rise in separatist sentiment due to Brexit.

International Monetary Fund: Leaders from the European Union over the weekend settled on Bulgarian economist Kristalina Georgieva as their candidate to replace Christine Lagarde as head of the IMF. The Europeans have traditionally been afforded the right to name the IMF chief, while U.S. government names the World Bank head. Perhaps the more interesting element of the decision is that it marks the second time in the last few weeks that French President Macron got his way with a major EU personnel decision. At least for the moment, the French president seems to be in the ascendency, even as German Chancellor Merkel sees her power on the wane.

Russia: For a second straight weekend, demonstrations against unfair municipal elections led to more than 1,000 arrests in Moscow alone. Perhaps more important, authorities have reportedly started to investigate whether the anti-corruption group run by opposition leader Alexei Navalny has been using illegal financing. Such investigations are often used to muzzle government critics in Russia. Now that President Putin's approval rating has fallen to a six-year low of 64%, the government may be getting desperate to nip any further political protests at the bud. Although we doubt Putin's regime is in any danger, conditions are not good in Russia. Consumer debt is becoming an issue, massive, uncontrolled wildfires are occurring in Siberia, and in the Ukraine, the new leader there is making life difficult for Putin.

Japan-South Korea: The South Korean government's free-trade commission has fined four Japanese companies for rigging bids to supply South Korean automakers. Although this could be just a run-of-the-mill action, it could also be retaliation for Japan's decision last week to tighten its control over exports to South Korea. South Korea is taking steps to reduce its reliance on Japan's technology. That move was retaliation over Seoul's continuing demands related to Japan's colonization of the Korean peninsula before and during World War II. There are deep tensions between China, Japan and the Koreas going back centuries. One of the keys to post WWII peace has been America's ability to freeze these hostilities and force cooperation on the parties. However, as the U.S. retreats from the world stage, these ancient disputes are becoming a problem again. The tensions threaten the U.S. security arc in the region. Interestingly enough, China is meeting with both Japan and South Korea in December to hold a security summit. China may be trying to fill the security gap by calming tensions between Japan and South Korea.

The U.S. and South Korea are set to start military exercises today.

The NY FRB: The New York Fed is the most important of the regional Fed banks. It is the only one whose president is a permanent voting member and it executes the Fed's activities in financial markets. The president of this bank has often come from the financial services industry, but its current president is more of a policy wonk out of the San Francisco FRB. John Williams has apparently fired two long-time high-ranking officials in a dispute over management priorities. Although this may be nothing more than a leader wanting his own people in place, firing officials with front line experience over the past two decades appears a bit rash.

Middle East: Congressional officials are trying to convince President Trump to keep American soldiers in Afghanistan. The U.S. is trying to stop Turkey from invading northeast Syria, the home of Kurdish fighters who have been allied with the U.S.

U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below shows the economic releases scheduled for the rest of the day.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Markit Services PMI	m/m	jul	52.2	52.2	***
9:45	Markit Composite PMI	m/m	jul		51.6	***
10:00	ISM Non-Manufacturing	m/m	jul	55.5	55.1	***
Fed speakers or events						
13:30	Lael Brainard Speaks on the Payment System	Member of the Board of Governors				

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	Caixin China PMI Composite	m/m	jul	50.9	50.6		**	Equity and bond neutral
	Caixin China PMI Services	m/m	jul	51.6	52.0	52.0	**	Equity bearish, bond bullish
Japan	Jibun Bank Japan PMI Composite	m/m	jul	51.2	51.2		**	Equity and bond neutral
	Jibun Bank Japan PMI Services	m/m	jul	51.8	52.3		**	Equity bearish, bond bullish
India	Markit India PMI Services	m/m	jul	53.8	49.6		**	Equity bullish, bond bearish
	Markit India PMI Composte	m/m	jul	53.9	50.8		**	Equity bullish, bond bearish
Australia	AiG Performance of Services Index	m/m	jul	43.9	52.2		**	Equity and bond bearish
	CBA Australia PMI Services	m/m	jul	52.3	51.9		**	Equity bullish, bond bearish
	CBA Australia PMI Composite	m/m	jul	52.1	51.8		**	Equity bullish, bond bearish
	Melbourne Institute Inflation	y/y	jul	1.8%	1.6%		**	Equity and bond neutral
New Zealand	ANZ Commodity Price	m/m	jul	-1.4%	-3.9%		**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Services	m/m	jul	53.2	53.3	53.3	**	Equity and bond neutral
	Markit Eurozone Composite	m/m	jul	51.5	51.5	51.5	**	Equity and bond neutral
	Sentix Investor Confidence	m/m	aug	-13.7	-5.8	-7.0	**	Equity and bond bearish
France	Markit France Services	m/m	jul	52.6	52.2	52.2	**	Equity bullish, bond bearish
	Markit France Composite	m/m	jul	51.9	51.7	51.7	**	Equity bullish, bond bearish
Germany	Markit Germany Services	m/m	jul	54.5	55.4	55.4	**	Equity bearish, bond bullish
	Markit Germany Composite	m/m	jul	50.9	51.4	51.4	**	Equity bearish, bond bullish
UK	New Car Registrations	y/y	jul	-4.1%	-4.9%		*	Equity and bond neutral
	Markit/ CIPS UK Services PMI	m/m	jul	51.4	50.2	50.3	**	Equity bullish, bond bearish
	Markit/ CIPS UK Composite PMI	m/m	jul	50.7	49.8	49.7	**	Equity bullish, bond bearish
	Official Reserve Changes	m/m	jul	$1.749 bn	$3.650 bn		*	Equity and bond neutral
Switzerland	SECO Consumer Confidence	m/m	jul	-8	-6	-8	***	Equity and bond neutral
	Retail Sales Real	y/y	jun	0.7%	-1.7%		***	Equity and bond neutral
Russia	Markit Russia PMI Services	m/m	jul	50.4	49.7	50.7	**	Equity bearish, bond bullish
	Markit Russia PMI Composite	m/m	jun	50.2	49.2		**	Equity bullish, bond bearish
AMERICAS								
Mexico	Consumer Confidence Index	m/m	jul	105.1	106.1	107.8	***	Equity and bond neutral
Canada	International Merchandise Trade	m/m	jun	-0.14 bn	0.76 bn	-0.30 bn	**	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)	224	229	-5	Down
3-mo T-bill yield (bps)	198	201	-3	Neutral
TED spread (bps)	26	27	-1	Neutral
U.S. Libor/OIS spread (bps)	196	200	-4	Up
10-yr T-note (%)	1.77	1.85	-0.08	down
Euribor/OIS spread (bps)	-38	-38	0	Neutral
EUR/USD 3-mo swap (bps)	16	17	-1	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Up
yen	up			Up
pound	flat			Neutral
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	$61.16	$61.89	-1.18%	Long liquidation
WTI	$55.07	$55.66	-1.06%	
Natural Gas	$2.08	$2.12	-2.17%	
Crack Spread	$20.34	$20.60	-1.25%	
12-mo strip crack	$17.32	$17.56	-1.37%	
Ethanol rack	$1.64	$1.64	0.23%	
Metals				
Gold	$1,459.46	$1,440.83	1.29%	Market Uncertainty
Silver	$16.46	$16.20	1.56%	
Copper contract	$255.30	$257.15	-0.72%	
Grains				
Corn contract	$ 403.25	$ 409.50	-1.53%	
Wheat contract	$ 481.00	$ 490.75	-1.99%	
Soybeans contract	$ 861.50	$ 868.50	-0.81%	
Shipping				
Baltic Dry Freight	1788	1812	-24	

Weather

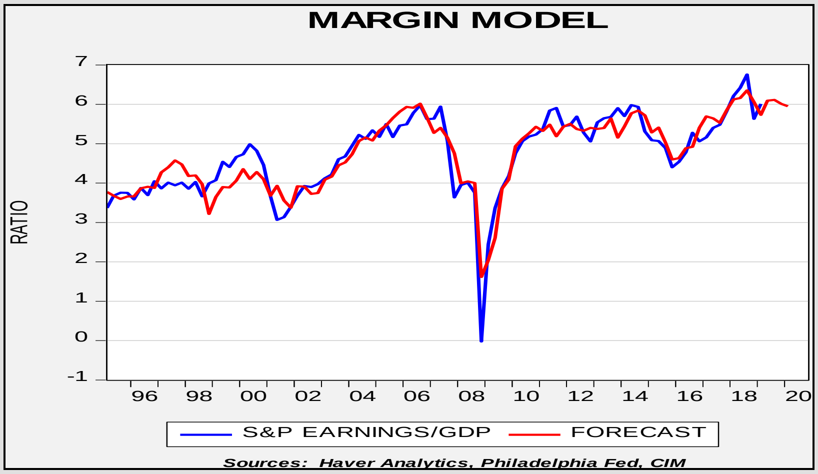
The 6-10 and 8-14 day forecasts show warmer temperatures for most of the country, with cooler temperatures in the northern region and across the Midwest. The forecast calls for precipitation over most of the country other than the coasts. There is no cyclone activity expected over the next 48 hours.

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 2, 2019

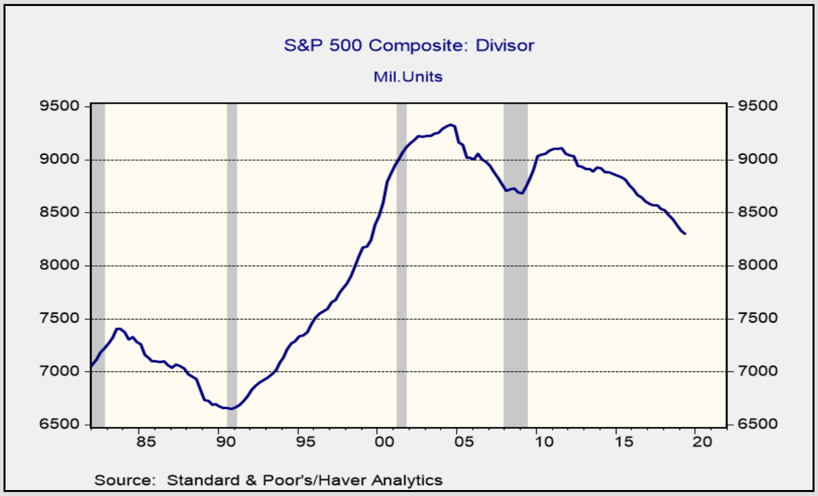
As wages and other costs rise and pricing power appears constrained, there are reasonable worries about the path of corporate earnings. We use purely top-down analysis to forecast earnings. Essentially, we forecast the percentage of total S&P company earnings relative to GDP. We use the nominal GDP forecast from the Philadelphia FRB's Survey of Economists along with our earnings as a percentage of GDP forecast to arrive at our estimate; we do note that this estimate is for total earnings for all members of the S&P 500 and not the per share estimate.



We are currently expecting S&P earnings to equal around 6% of GDP.

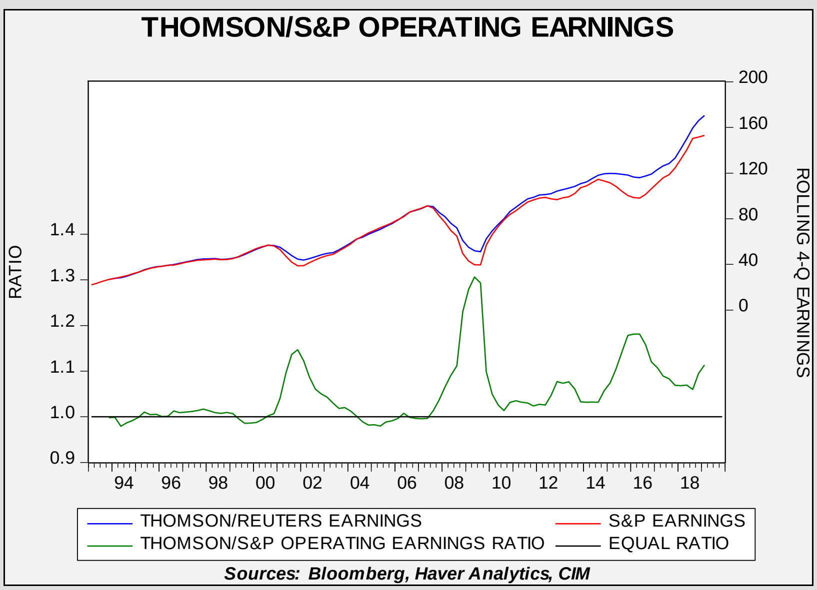
There are a large number of components in the model but the most statistically significant are net exports as a percentage of GDP, credit spreads, the dollar and oil prices. The components suggest that margins will likely contract if the U.S. does move to reduce the trade deficit. A weaker dollar will help lift margins, and higher oil prices will tend to lift margins as well. Narrow credit spreads tend to support margins.

The process of getting to earnings per share is tied to the divisor of the index. And, that has been steadily falling, which is lifting earnings per share.



The divisor adjusts the index by accounting for mergers, the exchange of new companies into the index, and share issuance and buybacks. The persistence of share buybacks is clearly reducing the divisor which acts to boost earnings per share.

Adjusting for all these factors, our current forecast for earnings this year is $157.20, which is down from $160.93 at the beginning of the year. We do use Standard and Poor's earnings data, which tends to be less than the more widely reported data from Thomson-Reuters; we use the former because we have a much longer history of that data. The current difference is significant. Thomson-Reuters data is about 11% higher than what is reported by Standard and Poor's.

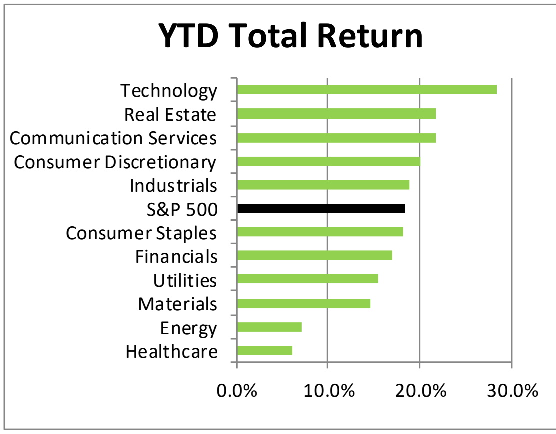


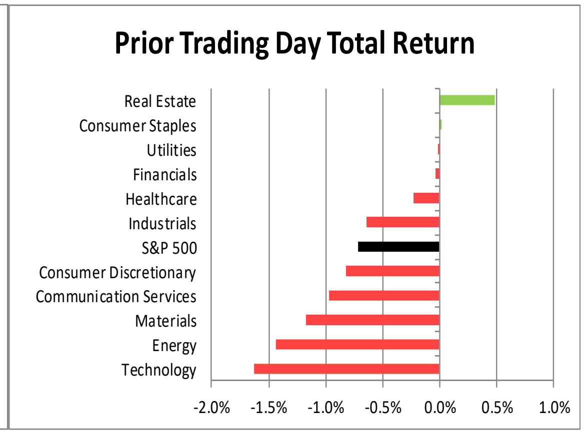
Our conversion model suggests a Thomson-Reuters earnings number of $168.92, which is well above the current consensus of $165.21. Given that we are working off a 3.8% nominal GDP growth rate (and so, 2% inflation would lead to a 1.8% GDP growth number), which seems achievable, the financial markets are probably too pessimistic on earnings for the rest of the year. If we are wrong, it's probably due to margin contraction. Although there are worries about future policy causing margins to fall, the policy effect probably occurs next year, not in 2019.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

U.S. Equity Markets – (as of 8/2/2019 close)

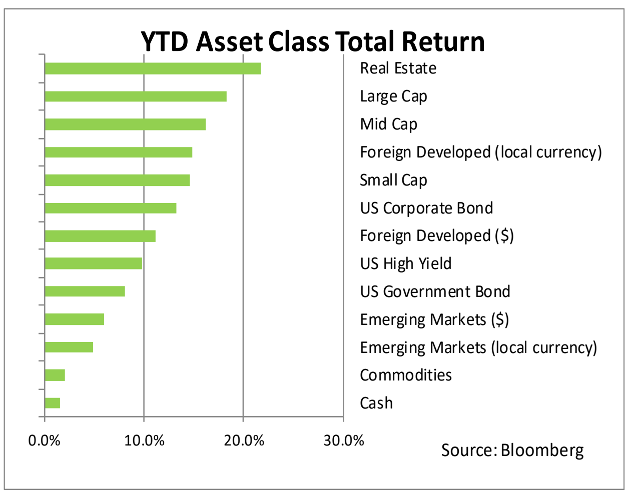




(Source: Bloomberg)

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 8/2/2019 close)

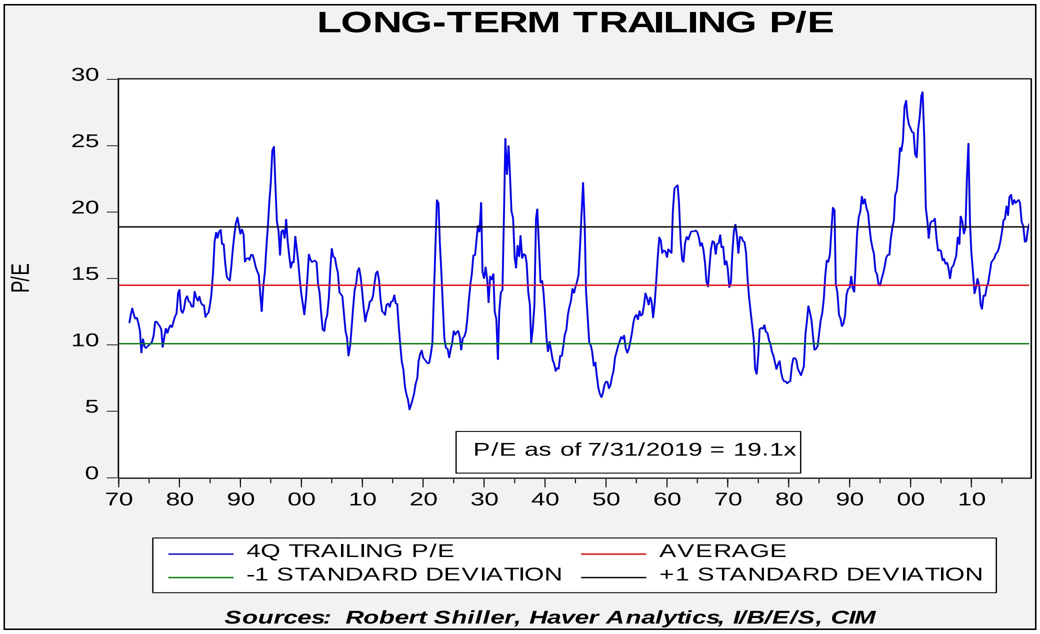


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 1, 2019



Based on our methodology,[1] the current P/E is 19.1x, 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.

[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 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.