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 9, 2019—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 1.1% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.2%. Chinese markets were lower, with the Shanghai composite down 0.7% and the Shenzhen index down 1.3% 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.

Happy Friday! Equities are giving back some of yesterday's stronger gains. The Italian government is near a collapse. U.K. economy disappoints. U.S. holds off on tech decisions. And, five decades ago today, the famous album cover photo of *Abbey Road* was snapped. Here is what we are watching today:

Italian troubles: Making good on earlier threats, Deputy Prime Minister and League leader Matteo Salvini withdrew his party from government, and called for new elections. Despite Salvini's actions, new elections are not inevitable. Italy's president, Sergio Matarella, actually decides if the government will fall, and he might decide to give other parties the opportunity to form a new government. The legislature is in recess for the summer (after all, it is Europe) and the president probably won't want to take this action while lawmakers are away. In addition, the body is working on budgets and bringing new elections at this time could delay that process.

We see two important takeaways from Salvini's move. First, as we noted yesterday, this action probably spells the end of the world's only "Nader coalition," one described by Ralph Nader in his book *Unstoppable*,[1] which is a coalition of right-wing and left-wing populists. Although Nader's idea of this coalition seems reasonable, the reality is that the differences between the two sides may simply be unworkable. If so, a coalition between an elite group with a populist group is more likely; perhaps the most enduring one in U.S. politics was engineered by Franklin Roosevelt, who tied left-wing elites to right-wing populists. This coalition dominated U.S. politics from 1940-65. Since then, both elite groups have had looser ties with populists, but in reality, the right-wing and left-wing elites have governed as a minority coalition (at least in terms of economic policy) with ties of convenience to populist groups. This is why we have seen the

[1] Nader, Ralph. (2014). *Unstoppable: The Emerging Left-Right Alliance to Dismantle the Corporate State*. New York, NY: Nation Books.

White House consistently shift between parties. Second, the move by Salvini is roiling Italian financial markets. The spread between German bunds and Italian bonds blew out this morning with German yields declining on flight-to-safety buying. Salvini has been confrontational with the EU and if the government falls and he leads the next one, the odds of the conflict escalating increases.

Commerce delays: The Commerce Department has decided to delay its decision on granting exemptions for companies wanting to buy equipment from Huawei (002502, CNY 2.83). What seems to be occurring is that the U.S. wants China to buy U.S. agricultural goods, and China wants the U.S. to ease restrictions on Huawei. However, both want the other side to make the first move, perhaps in order to show the other side "caved". In the 7th grade, similar disputes are either resolved by each party having a hand on what the other wants and releasing each good on the count of "3," or by bringing in a third party to hold both goods in "escrow" and releasing each after both sides hold up their end of the bargain. Apparently, the U.S. and China haven't experienced these resolution measures. The decision's delay is probably behind today's equity market pullback.

CNY fixing: For the second straight day, the PBOC has fixed the CNY above seven CNY/USD. Although Chinese officials are preventing the currency from weakening further, they are also clearly giving up on the previous ceiling at seven.[2] Meanwhile, the White House jawboning for a weaker dollar continues; next week's WGR will discuss the potential for a shift in the global forex regime.

Hong Kong: Tensions remain very high. China has singled out Julie Eadeh, a U.S. consulate official, for meeting with protest leaders. Chinese official media is suggesting that the meeting is clear evidence the U.S. is influencing the protesters. Protests are planned for this weekend; the U.S. has issued a travel warning. Although the Trump administration has been mostly quiet about the protests, it is clear Chinese officials feel they need to paint the protesters as being influenced by foreigners to frame the protests are unpatriotic.

Global Economic Growth: Japan and the United Kingdom, which typically represent the two biggest non-U.S. stock markets in the broad international indexes, today both reported their second-quarter economic growth. Japan's gross domestic product beat expectations with an increase of 0.4%, as trade headwinds were offset by rising corporate investment. In contrast, the United Kingdom's GDP unexpectedly declined 0.2%, marking its first contraction since late 2012. The U.K. decline, which is driving sterling downward today, came in large part because pre-Brexit stockpiles built up in previous quarters have started to be consumed.

Global Oil Market: The International Energy Agency cut its forecast for this year's global oil demand for the third time in the last four months. After demand in January through May increased at its weakest rate since 2008, the IEA now expects demand in all of 2019 to be up just 1.2 million barrels per day. The cut in the forecast mostly reflected slowing economic growth around the world and the worsening U.S.-China trade war. Separately, officials in Tokyo are hinting that Japanese naval forces may be sent to the waters off Yemen in order to help protect

[2] Readers should note that the higher the exchange rate, the weaker the CNY.

oil shipments through the Persian Gulf without unduly antagonizing Iran. In another interesting development, Iranian oil traders have found themselves being wooed by Western intelligence agencies and surveilled by Iranian officials as the former tries to figure out how Iran is smuggling oil, and the latter tries to prevent the information from getting out. Additionally, British private guards are being pulled from Persian Gulf shipping on fears they could be captured by Iran and used as potential bargaining chips.

Japan-South Korea: As a sign that the Japan-South Korea dispute over World War II reparations is still not resolved, the South Korean Environment Ministry said yesterday it would tighten radiation checks on coal ash imports from Japan. That comes after some positive news yesterday, when Japan approved the export of a key chemical to South Korea. Although the dispute is likely to remain relatively contained, perhaps the worst aspect of it is that it shows how countries are now using protectionist trade measures as their weapon of choice in international disputes.

Turkey: Sources say several high-level officials at the central bank have been removed from their posts, just weeks after President Erdogan sacked the previous governor because he "wouldn't follow orders." The move is a sign that Erdogan's effort to take control over monetary policy goes deeper than originally thought. It also points to the kinds of developments that might become more common as other leaders – including U.S. President Trump – work to dismantle the independence of their central banks. Attacks on central-bank independence raises the risk of politically motivated interest-rate cuts, higher inflation and a depreciating currency. However, the lira has responded little to today's news so far.

Not only is President Erdogan trying to shore up his political fortunes with looser monetary policy, but he is also responding to popular anger over Syrian refugees, by pushing them out of the country. The problem is that the plan would relocate some 700,000 of the refugees to Syrian territory that Ankara aims to seize from a U.S.-allied Kurdish group. U.S. and Turkish military forces have in the past almost come to blows over Turkey's desire to attack the Kurds, so the new plan again raises the risk of a confrontation.

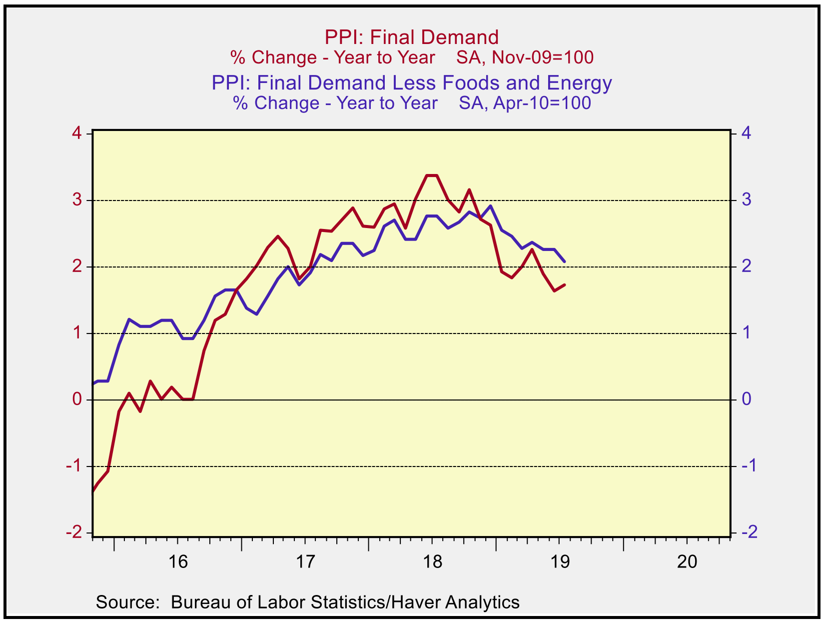
Finally, in late breaking news on Turkey, China apparently negotiated a $1.0 bn swap arrangement with the Central Bank of Turkey, likely a move to shore up Ankara's foreign exchange reserves. This action is further evidence that Turkey is being pulled out of the West's orbit. Our latest WGR has analysis of the situation in Turkey.

Australia: As more evidence that cybersecurity is now perhaps the key skillset for Western defense leaders, the new chief of the Australian Security Intelligence Organization will be Mike Burgess, the former head of the military's top cyber defense agency, who had advised the government to bar Chinese telecom firm Huawei (002502, CNY 2.83) from the country's new 5G communications network. As a reminder, the U.S. government announced last month that Michael Gilday, the three-star head of the Navy's Cyber Command, will be promoted over several four-star colleagues to be the new Chief of Naval Operations.

Russia: Today marks 20 years since President Boris Yeltsin picked Vladimir Putin to be Russia's prime minister, launching two decades of Putin's effort to stabilize the Russian economy, rebuild its military and eventually make it a more assertive global power again. Radio Free Europe today has a useful review of Putin's years in power.

U.S. Economic Releases

PPI final demand came in line with expectations, rising 0.2% from the prior month. PPI excluding food and energy also came in below expectations, falling 0.1% from the prior month compared to a forecast rise of 0.1%. Core PPI, which excludes food, energy and trade services, came in below expectations, falling 0.1% from the prior month compared to the forecast rise of 0.2%.



The chart above shows the year-over-year change in headline PPI and core PPI, which rose 1.7% and 2.1%, respectively.

There are no 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								
China	CPI	y/y	jul	2.8%	2.7%	2.7%	***	Equity bearish, bond bullish
	PPI	y/y	jul	-0.3%	0.0%	-0.1%	**	Equity bullish, bond bearish
Japan	Money Stock M2	y/y	jul	2.4%	2.3%	2.3%	**	Equity and bond neutral
	Money Stock M3	y/y	jul	2.0%	2.0%	2.0%	**	Equity and bond neutral
	GDP Annualized	q/q	2q	1.8%	2.2%	0.5%	***	Equity bullish, bond bearish
	GDP Deflator	q/q	2q	0.4%	0.1%	0.3%	***	Equity and bond neutral
New Zealand	ANZ Truckometer Heavy	m/m	jul	4.1%	-4.5%		*	Equity and bond neutral
	Net Migration	m/m	jun	3100	4240		**	Equity and bond neutral
EUROPE								
Germany	Trade Balance	m/m	jun	16.800 Bil	20.600 Bil	19.500 Bil	**	Equity bearish, bond bullish
	Current Account Balance	y/y	jun	20.600 Bil	16.500 Bil	21.700 Bil	**	Equity bearish, bond bullish
France	Wages	q/q	2q	0.5%	0.8%	0.5%	***	Equity and bond neutral
	Private Sector Payrolls	q/q	2q	0.3%	0.5%	0.3%	**	Equity and bond neutral
	Industrial Production	y/y	jun	0.0%	4.0%	1.0%	***	Equity and bond bearish
	Manufacturing Production	y/y	jun	-0.6%	3.4%	0.7%	***	Equity and bond bearish
Italy	Trade Balance Total	m/m	jul	5.728 Bil	5.347 Bil		**	Equity and bond neutral
	Trade Balance EU	m/m	jul	1.876 Bil	2.246 Bil		**	Equity and bond neutral
	CPI EU Harmonized	y/y	jul	0.3%	0.4%	0.4%	***	Equity and bond neutral
UK	GDP	q/q	2q	1.2%	1.8%	1.4%	***	Equity and bond bearish
	Industrial Production	m/m	jul	-0.1%	1.4%	-0.2%	***	Equity and bond neutral
	Manufacturing Production	m/m	jul	-1.4%	0.0%	-1.1%	***	Equity and bond bearish
	Index of Services	y/y	jun	0.1%	0.3%	0.2%	**	Equity and bond neutral
	Visible Trade Balance GBP	m/m	jun	-£7.009 Bil	-£11.524 Bil	-£11.800 Bil	**	Equity and bond neutral
Russia	Money Supply Narrow Def	w/w	2-Aug	10.42 Tril	10.44 Tril		*	Equity and bond neutral
AMERICAS								
Mexico	Industrial Production	y/y	jun	-2.9%	-3.3%	-2.6%	***	Equity and bond bearish
	Manufacturing Production	y/y	jun	-0.8%	0.7%	-0.4%	***	Equity and bond bearish
Brazil	IBGE Inflation IPCA	y/y	jul	3.2%	3.4%	3.3%	***	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	219	-1	Down
3-mo T-bill yield (bps)	197	197	0	Neutral
TED spread (bps)	22	21	1	Neutral
U.S. Libor/OIS spread (bps)	192	193	-1	Up
10-yr T-note (%)	1.70	1.72	-0.02	down
Euribor/OIS spread (bps)	-40	-39	-1	Neutral
EUR/USD 3-mo swap (bps)	12	12	0	Down
Currencies	Direction			
dollar	down			Neutral
euro	up			Up
yen	up			Up
pound	down			Down
franc	down			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	$58.21	$57.38	1.45%	Possible Saudi Production Cut
WTI	$53.22	$52.54	1.29%	
Natural Gas	$2.09	$2.13	-1.60%	
Crack Spread	$18.72	$18.40	1.77%	
12-mo strip crack	$16.41	$16.17	1.52%	
Ethanol rack	$1.63	$1.63	0.18%	
Metals				
Gold	$1,503.77	$1,500.95	0.19%	
Silver	$17.03	$16.93	0.54%	
Copper contract	$259.85	$260.75	-0.35%	
Grains				
Corn contract	$ 419.50	$ 418.25	0.30%	
Wheat contract	$ 500.25	$ 498.50	0.35%	
Soybeans contract	$ 888.50	$ 883.00	0.62%	
Shipping				
Baltic Dry Freight	1720	1712	8	
DOE inventory report				
	Actual	Expected	Difference	
Crude (mb)	2.4	-3.0	5.4	
Gasoline (mb)	4.4	-1.5	5.9	
Distillates (mb)	1.5	-0.4	1.9	
Refinery run rates (%)	3.40%	0.50%	2.90%	
Natural gas (bcf)	55.0	59.0	-4.0	

Weather

The 6-10 and 8-14 day forecasts show warmer temperatures for most of the country, with cooler temps around Washington state and surrounding areas. The forecast calls for precipitation over most of the country other than the Southwest. 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 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 theor impact comes from the book, *Ubiquity: Why Catastrophes Happen.*[3] 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.

[3] Buchanan, Mark. (2000). *Ubiquity: Why Catastrophes Happen*. New York, NY: Three Rivers Press.

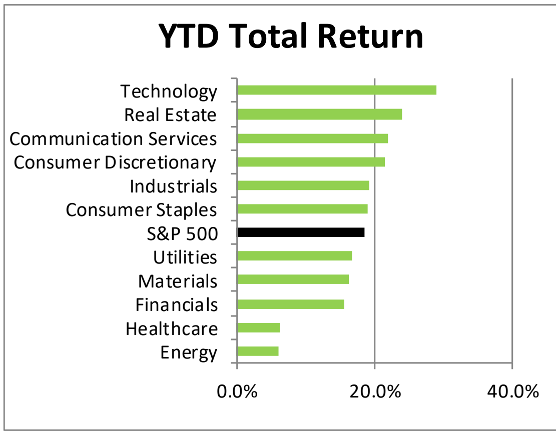
The current trade conflict with China has similar complicated characteristics. The U.S. has been struggling to develop a consistent foreign policy since the end of the Cold War. Policy toward China has mostly been to support its economic development on the idea that the richer it becomes, the more likely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

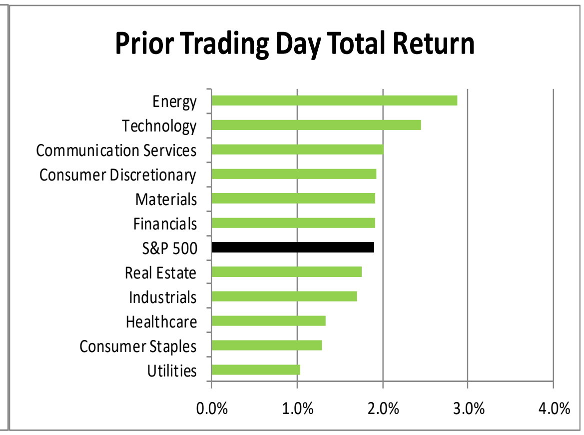
Under President Trump, the relationship with China has become increasingly contentious. The application of tariffs and continued negotiations have caused increasing equity market turmoil. Nevertheless, so far, the impact on the economy has been less dramatic. However, we may be reaching the point where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

<u>Data Section</u>

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

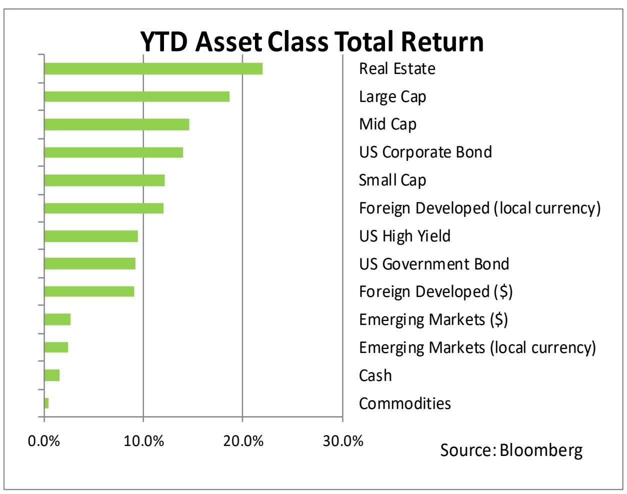




(Source: Bloomberg)

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 8/8/2019 close)

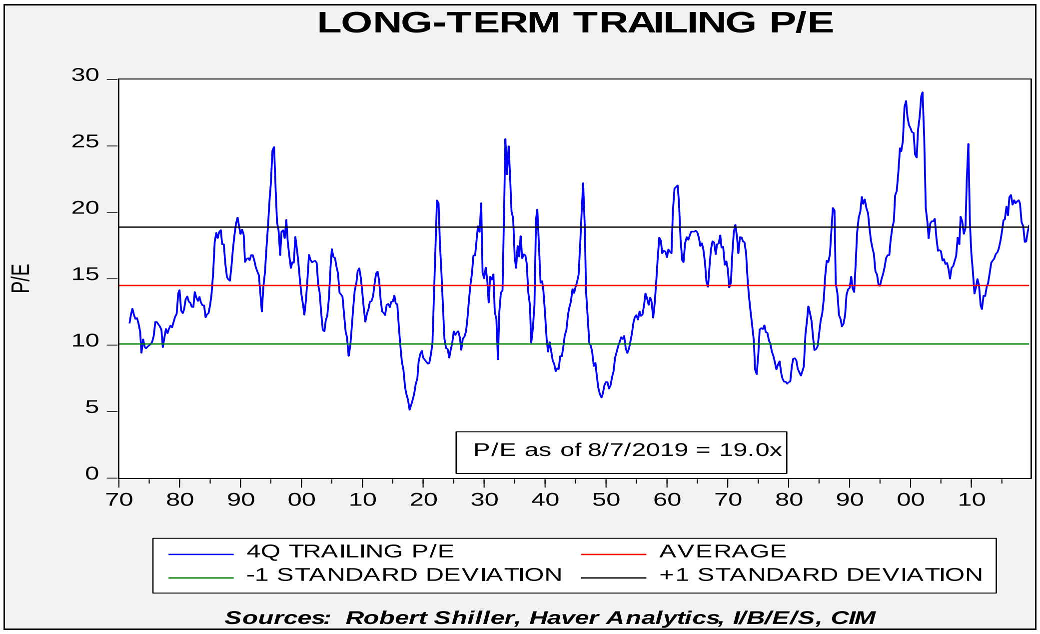


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[4] 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.

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[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.