By Bill O'Grady, Thomas Wash, and Patrick Fearon-Hernandez, CFA

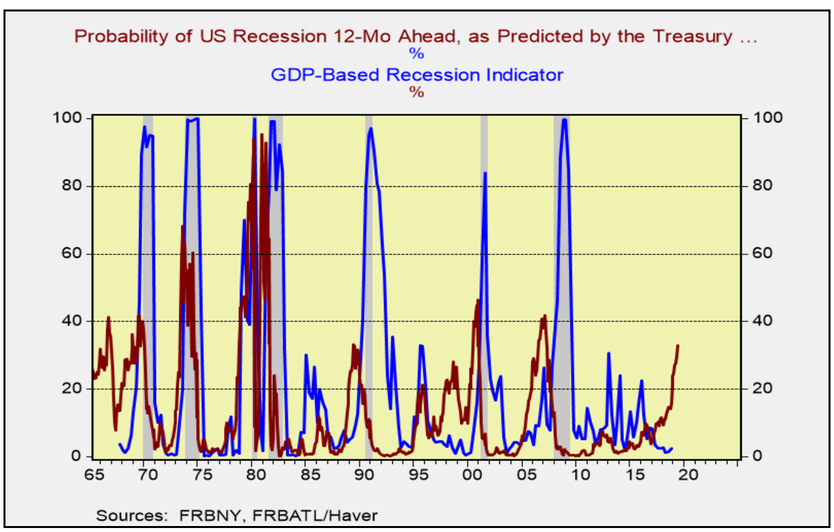
Looking for something to read? See our Reading List; these books, separated by category, are ones we find interesting and insightful. We will be adding to the list over time.

[Posted: July 10, 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 0.6%. Chinese markets were lower, with the Shanghai composite down 0.2% and the Shenzhen index down 0.5% from the prior close. U.S. equity index futures are signaling a higher open.

Good morning! Other than oil, most markets were lower this morning in front of Powell's testimony. However, in the wake of his prepared remarks, U.S. equity futures have rallied. Precious metals are up, the dollar is down and Treasuries are flat. Here is what we are watching today:

Powell: The Fed has released the chair's prepared remarks. There were no major surprises; it looks like the FOMC will likely cut rates at the end of July. The path of policy from that point is still uncertain but we can safely say this tightening cycle is probably about done. Financial and commodity markets are taking the tone as dovish.

The only new twist we have to the testimony today is an ominous signal coming from the New York FRB. It has a recession indicator based on the yield curve and its most recent number is signaling recession.



In the past, a reading above 30 has correctly signaled recession. We like to pair this indicator with another recession indicator from the Atlanta FRB based on GDP. The latter acts to confirm the signal from the New York index. We have not gotten confirmation yet, but the New York indicator on its own should give the FOMC enough evidence to at least make an "insurance cut."

Although the administration continues to be critical of Powell's conduct of monetary policy, he has rather firm support on Capitol Hill, likely because of Powell's good relations with members. Thus, the White House may face strong opposition to any moves to fire the Fed chair.

Mexico's finance minister resigns: Finance Minister Carlos Urzúa resigned unexpectedly yesterday, citing "many disagreements over economic policy" between himself and President López Obrador and accusing the left-wing, nationalist president of making economic decisions based on extremist ideology. In a press conference this morning, President López Obrador said he can't rule out further resignations from his cabinet, but that his government would continue to work toward its goals. Although Mexican equities and the peso fell on the news, the damage was limited by the president's decision to replace him with Deputy Finance Minister Arturo Herrera, a respected NYU economist with experience in both the government and the World Bank. All the same, the episode has rekindled investor concerns that Mexican economic policy could become more radical in the coming years.

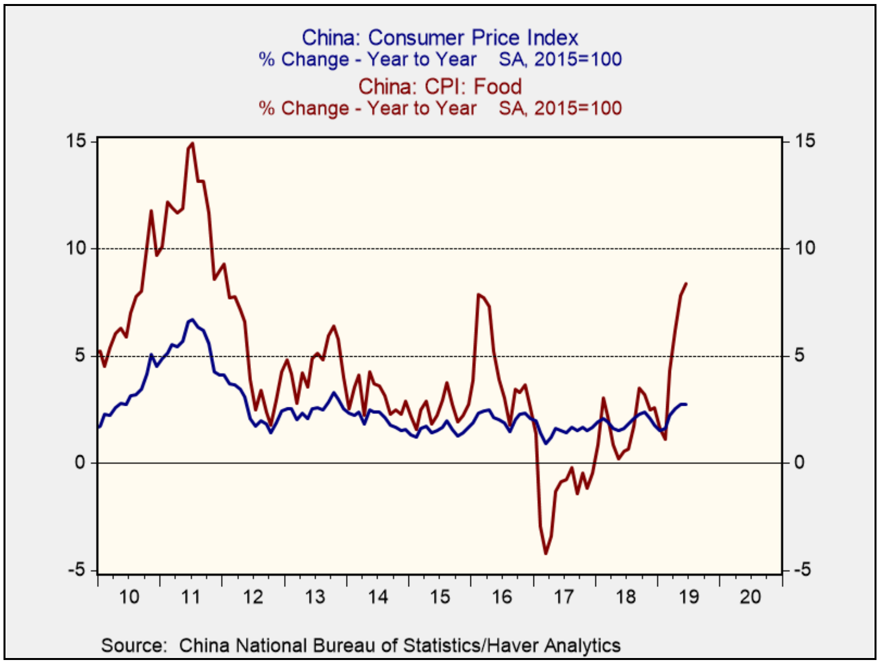
U.K. news: The two leading Tory candidates held a debate last night. Jeremy Hunt needed a "knockout" to seriously threaten Johnson's candidacy, but it doesn't look like he landed any major blows to the front-runner. Worries about a no-deal Brexit continue to rise, leading to a steady decline in the GBP. Acting Deputy PM Lidington warns that a no-deal Brexit could lead to a breakup of the United Kingdom.

Meanwhile, Britain's ambassador to the United States, Kim Darroch, submitted his resignation today amidst a dustup surrounding leaked diplomatic cables in which he referred to the Trump administration as "inept." Sources say Darroch's decision came after he watched a televised debate between the Conservative Party's two remaining candidates for prime minister, Jeremy Hunt and Boris Johnson. In that debate, Hunt offered a robust defense of Darroch, promised to keep him in place if he became prime minister and demanded that President Trump treat the U.K. with respect. In contrast, front-runner Boris Johnson equivocated on Darroch's future. While the incident may seem like largely an internal issue for the British government, it offers strong evidence that Johnson would prioritize good relations with the Trump administration if he wins the prime minister's job as expected.

U.S.-China trade talks: There are reports that President Trump has toned down his support for Hong Kong protestors in order to support trade talks. That move is consistent with a report this week that the departing U.S. consul general in Hong Kong was told to tone down several critical comments about China in his final speech in the city. Coupled with the fact that Hong Kong's government still refuses to definitively withdraw an unpopular bill that would allow extradition from Hong Kong to China, and that protestors continue to agitate for Hong Kong Chief Executive Lam to resign, we suspect a U.S. promise to look the other way will help encourage President Xi and the Chinese leadership to keep a Hong Kong crackdown on the table for now.

Meanwhile, the Chinese are claiming that General Secretary Xi did not make a firm pledge to buy U.S. agricultural products. In a concession to China arising from the Trump-Xi meeting at the G-20 summit, U.S. Commerce Secretary Wilbur Ross announced yesterday that licenses would be issued to U.S. firms seeking to sell any products to Chinese telecom firm Huawei (002502.SZ, $4.41) that do not present a "threat to national security." Both sides are trying to suggest the other has a greater need to capitulate. Although China is putting on a brave face, there is growing evidence that China is starting to show signs of trouble from the trade conflict.

Other China news: Despite continued increases in food prices (up 8.3% from last year), overall CPI rose 2.7%.



Due to the African Swine Fever crisis, we do expect the trajectory of food prices to continue higher but the PBOC will likely view these price hikes as transitory and maintain easy policy.

Iran: In yet another sore point between Iran and the West, Iranian President Rouhani warned that the U.K. will face unspecified consequences for its seizure last week of an Iranian oil tanker that was purportedly carrying crude to Syria in violation of European Union sanctions. Hardliners in Iranian media have called for the government to retaliate by stopping British tankers from operating in the Strait of Hormuz. In a sign that at least some shipping officials are taking that threat seriously, reports yesterday said at least one British tanker sought shelter in a Saudi port yesterday in order to avoid transiting the passage.

European Union: In updated economic projections, the European Commission maintained its forecast that Eurozone gross domestic product (GDP) would grow a tepid 1.2% in 2019 as the stronger than expected growth in the first half would be offset by weakening momentum in the second half. The forecast for 2020 was unchanged at 1.4%.

The European refugee crisis: As Italy and Greece harden their borders against refugee flows from North Africa, vessels bearing these souls are finding their way to other European island nations in the Mediterranean. Cyprus and Malta have become new waystations. However, both are small nations with limited resources so they are trying to manage the crisis in an ad hoc manner. Malta usually only accepts seaborne refugees if other EU nations agree to take them in. Cyprus's handling of the situation is even more convoluted given the divided status of the country. The northern part of the island, controlled by Turkey, mostly allows refugees easy access from Turkey. Turkey does have an agreement with the EU to control the flow of refugees from the Turkish mainland but doesn't enforce it in Northern Cyprus. Once in Northern Cyprus, the refugees cross into the southern part of the island which is part of the EU. Because Cyprus doesn't have the resources to manage the influx, it is also trying to get other EU nations to voluntarily accept new refugees.

U.S. Economic Releases

MBA mortgage applications fell 2.4% from the prior week. Purchases rose 2.3% from the prior week, while refinancing fell 6.5%. The average 30-year fixed rate mortgage fell 3 bps from 4.07% to 4.04%.

The table below lists the economic releases and Fed events scheduled for today.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Wholesale Trade Sales	m/m	may	0.4%	0.4%	**
10:00	Wholesale Inventories	m/m	may	0.3%	-0.4%	**
Fed speakers or events						
10:00	Jerome Powell Testifies to the House Financial Services Panel	Chairman of Board of Governors of Federal Reserve				
13:30	James Bullard Speaks in Washington Univesity of St. Louis	President of the Federal Reserve Bank of St. Louis				
14:00	FOMC Meeting Minutes	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								
China	CPI	m/m	jun	2.7%	2.7%	2.7%	***	Equity and bond neutral
	PPI	m/m	jun	0.0	0.6%	0.2%	**	Equity bearish, bond bullish
Japan	PPI	y/y	jun	-0.1%	0.7%	0.4%	**	Equity bullish, bond bearish
Australia	Westpac Consumer Confidence	m/m	jul	-4.1%	-0.6%		***	Equity and bond bearish
New Zealand	Food Prices	m/m	jun	-0.7%	0.7%		**	Equity and bond neutral
EUROPE								
Italy	Industrial Production	m/m	may	-0.7%	-1.5%	-1.5%	***	Equity bearish, bond bullish
France	Industrial Production	m/m	may	4.0%	1.1%	1.6%	***	Equity bullish, bond bearish
	Manufacturing Production	m/m	jun	3.4%	0.5%		**	Equity bullish, bond bearish
UK	Monthly GDP	m/m	may	0.3%	-0.4%	0.3%	*	Equity and bond neutral
	Industrial Production	y/y	may	0.9%	-1.0%	1.2%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	june	0.0%	-0.8%	1.1%	**	Equity bearish, bond bullish
	Construction Output	y/y	1q	1.7%	2.4%	0.9%	**	Equity bullish, bond bearish
	Index of Services	y/y	jun	0.3%	0.2%	0.1%	*	Equity and bond neutral
	Visible Trade Balance	m/m	jun	-£11.524 bn	-£12.113 bn	-£12.550 bn	**	Equity bullish, bond bearish
AMERICAS								
Mexico	CPI	y/y	jun	3.95%	4.28%	3.94%	***	Equity and bond neutral
Canada	Housing Starts	m/m	jun	245.7k	202.3k	208.6k	***	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)	234	231	3	Down
3-mo T-bill yield (bps)	221	220	1	Neutral
TED spread (bps)	13	11	2	Neutral
U.S. Libor/OIS spread (bps)	217	217	0	Up
10-yr T-note (%)	2.10	2.07	0.03	down
Euribor/OIS spread (bps)	-36	-36	0	Neutral
EUR/USD 3-mo swap (bps)	17	16	1	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	flat			Up
yen	down			Up
pound	down			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	$65.62	$64.16	2.28%	Bullish API and Rising Tensions in the Middle East
WTI	$59.22	$57.83	2.40%	
Natural Gas	$2.43	$2.43	0.25%	
Crack Spread	$22.87	$22.47	1.78%	
12-mo strip crack	$18.45	$18.15	1.65%	
Ethanol rack	$1.66	$1.67	-0.40%	
Metals				
Gold	$1,395.48	$1,397.61	-0.15%	
Silver	$15.10	$15.11	-0.03%	
Copper contract	$265.80	$262.50	1.26%	
Grains				
Corn contract	$ 433.50	$ 437.25	-0.86%	
Wheat contract	$ 500.25	$ 502.75	-0.50%	
Soybeans contract	$ 903.50	$ 904.25	-0.08%	
Shipping				
Baltic Dry Freight	1759	1725	34	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.9		
Gasoline (mb)		-2.0		
Distillates (mb)		0.8		
Refinery run rates (%)		0.10%		
Natural gas (bcf)		69.0		

Weather

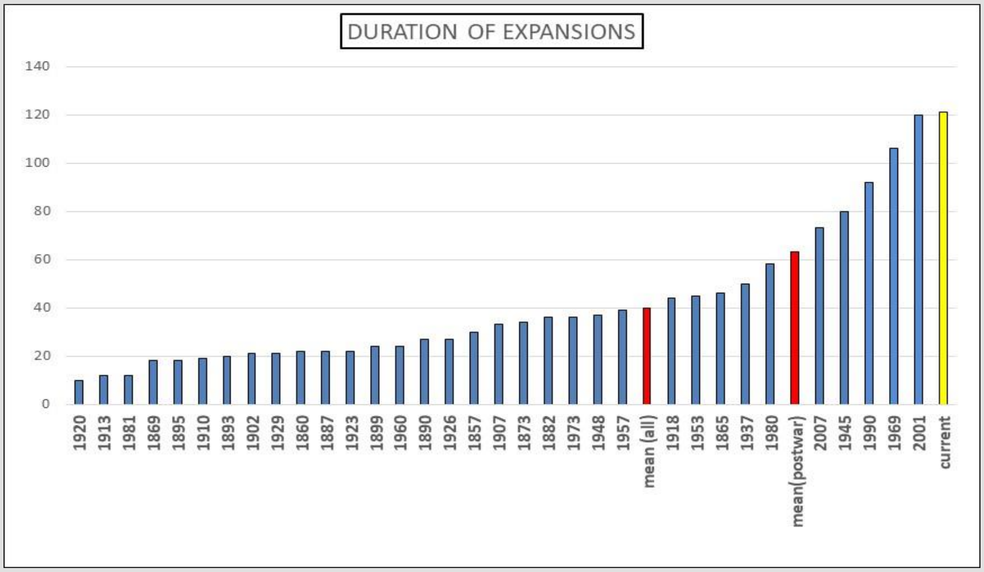
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps around Washington. Precipitation is expected for most of the country. There is a cyclone formation in the Gulf of Mexico and is expected to form into a tropical storm this week and move across portions of Louisiana, Texas and Mississippi. It is unclear whether the tropical disturbance will disrupt the shipment or production of refineries located along the Gulf. In general, the energy infrastructure can usually manage a hurricane up to a Category 3 without significant disruption.

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.

July 5, 2019

Although it's not official,[1] it appears the current expansion has reached a new record.



(Source: NBER)

This chart shows expansions by months since 1850. The current expansion just reached 121 months, exceeding the 1991-2001 expansion, which was previously the longest.

Part of the reason this expansion has lasted so long is because economic growth has been rather slow.

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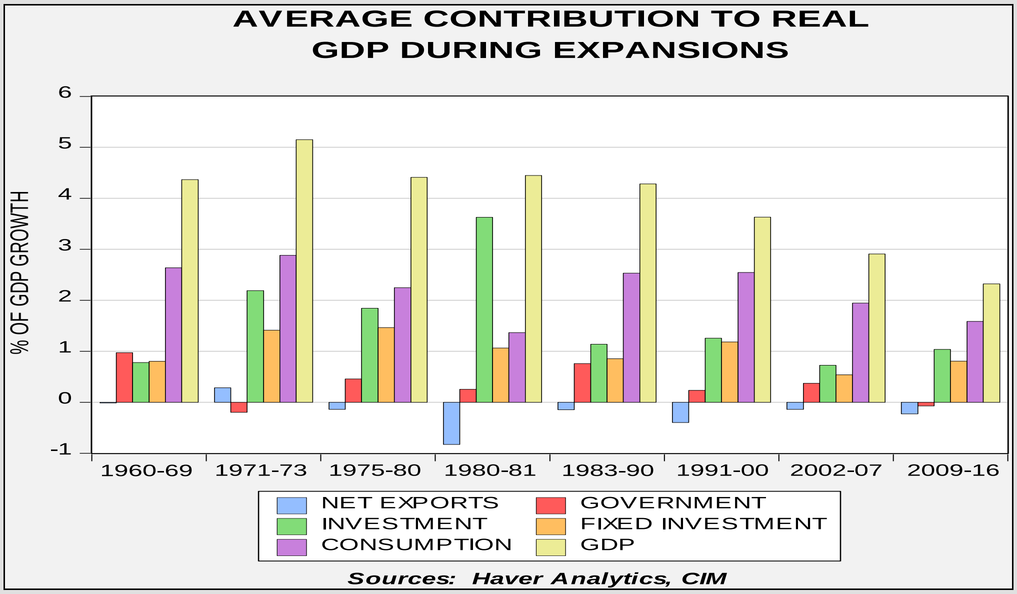
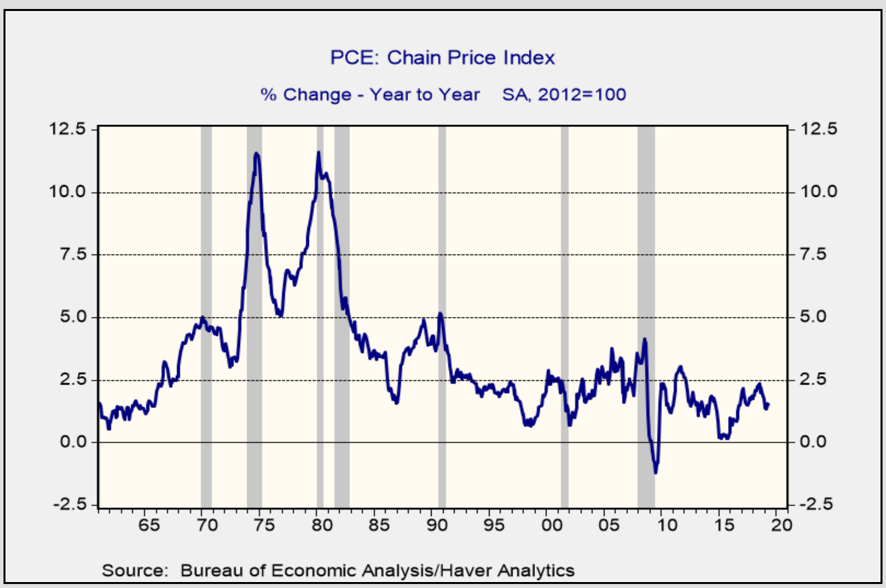
[1] The National Bureau of Economic Research, a private body, is the official arbiter of business cycles. When it dates the onset of recession, it is usually months after the downturn has occurred. Thus, it is possible (but not likely) that the group could determine that a recession began before July. We won't know for certain that the current expansion is the longest until the next recession starts.



This chart shows the average GDP for expansions since 1960; we have also isolated the average contribution from the components of GDP.[2] Not only has this expansion had the slowest average GDP growth, but two of the components, net exports and government, were negative contributors. That had never happened over this time frame before.

Because the expansion was slow, the bottlenecks that often develop in a long expansion have not become evident in this cycle. Inflation remains tame, with the overall PCE deflator below 2.5%. In previous recessions this measure of inflation had exceeded 2.5%, which would tend to trigger policy tightening.



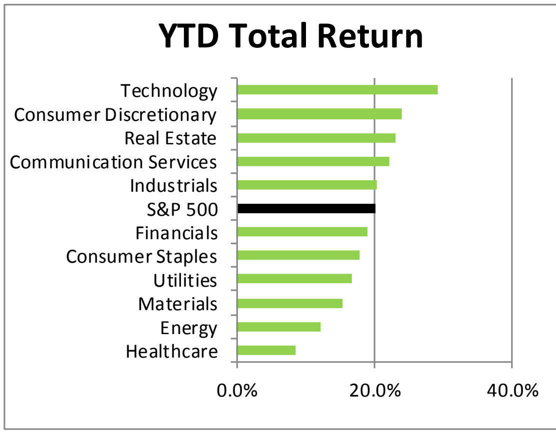
[2] We break out fixed investment to eliminate the impact of inventories. The actual calculation is GDP = Consumption + Investment + Government + Net Exports.

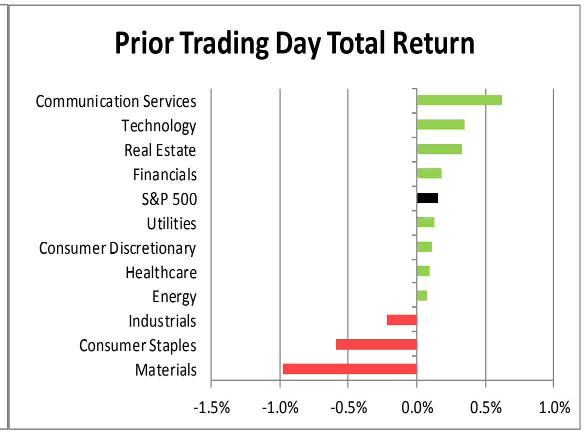
Recessions are usually triggered by either policy tightening or a geopolitical event. The former tends to occur when policymakers are facing rising inflation. With current inflation tame, excessive tightening would be a major mistake. The potential for a geopolitical risk is elevated at this time but not high enough to suggest a significant defensive position.

So, until inflation rises or a geopolitical event occurs, there is no reason that the current expansion can't last longer. And, as long as the expansion continues, equities should continue to perform relatively well.

Data Section

U.S. Equity Markets – (as of 7/9/2019 close)

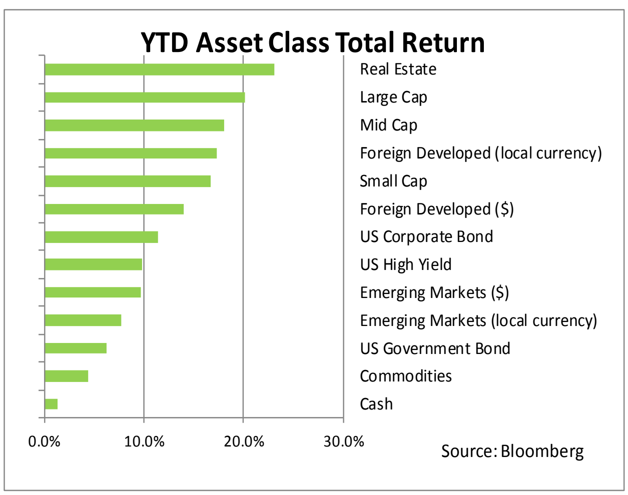




(Source: Bloomberg)

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 7/9/2019 close)

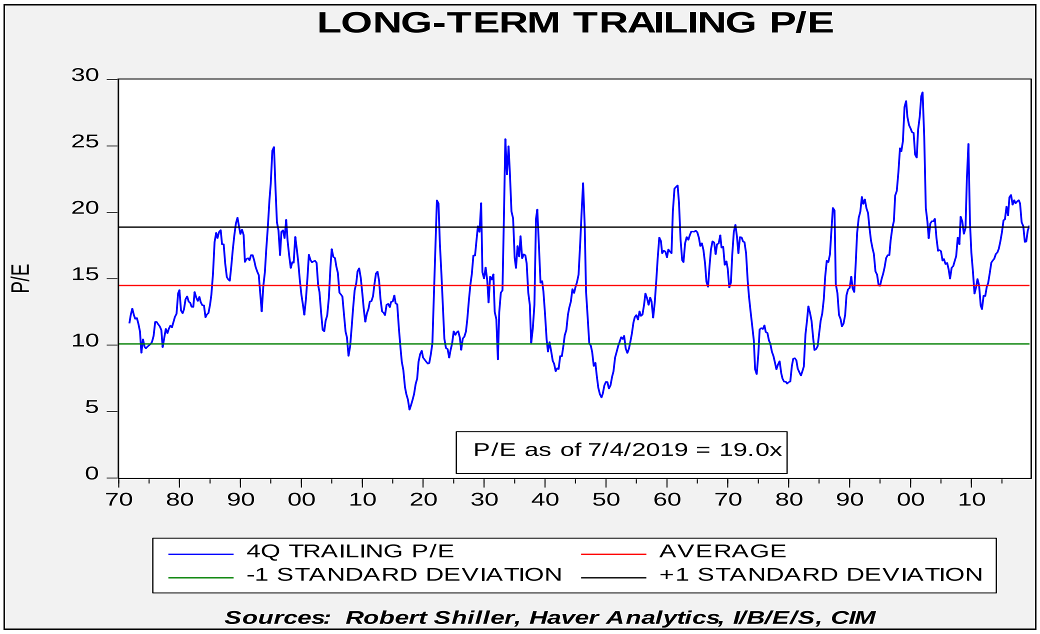


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

July 5, 2019



Based on our methodology,[3] the current P/E is 19.0x, up 0.4x from last week. We are now rotating Q3, meaning we have dropped Q3 earnings (see footnote). There was a drop in Q4 earnings compared to Q3 and that fact, coupled with a rising market, led to the multiple expansion.

[3] 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.