By Bill O'Grady and Thomas Wash

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: June 10, 2019—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.2% from the last close. In Asia, the MSCI Asia Apex 50 was up 1.8% from the prior close. Chinese markets were higher, with the Shanghai composite up 0.9% and the Shenzhen index up 1.3% from prior close. U.S. equity index futures are signaling a higher open.

Happy Monday! It's a risk-on day, with equities higher, and gold and Treasury prices lower. The U.S. and Mexico have a trade deal. The G-20 Finance Ministers' meeting (the pre-meeting for the leaders' meeting) didn't resolve much. Here is what we are watching today:

The Mexico deal: The U.S. and Mexico arrived at a deal, avoiding tariffs. Financial markets were leaning toward this outcome so we are higher this morning, but the rally actually began last week. Here are the key takeaways:

1. It isn't completely clear that the U.S. got anything it didn't already have. According to reports, Mexico had already agreed to increase border security on its southern border. The president has indicated there is more to the agreement but hasn't detailed what additional concessions he received. There have been reports that Mexico agreed to buy more U.S. agricultural goods. However, that assertion has been denied by Mexico. So, on its face, it doesn't look like too much changed.
2. Mexico is clearly relieved that the tariffs were averted. The MXP rose on the news. However, the tariff threat, now introduced, could return if the White House determines Mexico isn't delivering.
3. It still isn't clear why the president reversed himself. He may believe he did get something new from Mexico. He may have concluded the economic damage from the tariffs would be too costly, thus retreated and declared a win. If the first answer is right, then a return of the tariff threat is likely. If it's the second, we probably won't hear of it again. Unfortunately, we have no good insights as to which option is the correct one.
4. One of the important policy items to note is that this administration, unlike its predecessors, is aggressively mixing trade and security policy. This is a major departure from previous administrations and has created some divisions within the current administration. For example, USTR Lighthizer has tried to keep technology policy and trade separate in his negotiations. Although the president has been criticized for this mixing of policy, and Senate GOP leaders seemed to join this opposition, there is some logic to putting the two together. American hegemony is partly built on trade policy. The U.S. deliberately accepted the reserve currency role; once that role was in place, the

need from foreign nations to acquire dollars allowed the U.S. to weaponize trade. Whether or not this policy continues post-Trump is not clear. However, we note that Sen. Warren has argued the U.S. should "actively manage" the dollar's exchange rate to promote domestic manufacturing. In many respects, exchange rate manipulation would be much more effective than tariffs but would end up at the same endpoint—weaponizing trade. Thus, by design, trade and national security policy could become linked. How? Because the reserve currency nation can use trade as a foreign policy tool. Both Trump's and Warren's policies would cause economic volatility.

5. Even after this outcome, the problem of Central American migration remains. If anything, we expect it to become exponentially worse because, at some point, some of the four million Venezuelans that have fled their country will start heading north. Interestingly enough, as Mexico and the U.S. become more hostile to these refugees, Europe is becoming a destination.
6. For now, this agreement is good news for financial markets and should provide a lift to Mexican assets.

The G-20: The finance ministers from the G-20 nations met in Japan over the weekend to prepare the agenda for the leaders' meeting at the end of June. There didn't appear to be much progress in easing tensions. The group was critical of U.S. trade policy. Treasury Secretary Mnuchin suggested that the U.S. and China would probably create a similar outcome to the Buenos Aires summit. If so, it would imply that a deal won't be finalized but a ceasefire might emerge. It is interesting to note that Mnuchin suggested an advancement in trade talks could lead the U.S. to ease up on Huawei (002502, CNY 3.36); if so, it would confirm Chinese suspicions that the tech issue is merely being used for leverage and has less to do with national security. However, as we note above, with this administration the two are more closely linked than in previous governments. There was an agreement to create uniform tax rules; if put in place, it would be especially onerous for tech companies.

China and trade: We note that China's May trade surplus widened due to an unexpected jump in exports, which rose 1.1% from last year. Most likely, foreign buyers are stockpiling on worries about future trade impediments. If so, the gains will not be sustained. China has summoned U.S. tech firms to meet with officials and indicated that they should not cooperate with the U.S. restrictions on technology trade. This action puts tech firms in a dilemma; either cooperate with the U.S. and lose business in China or break U.S. law. China is planning export controls on "sensitive technology," a retaliatory act against U.S. proposals. Meanwhile, Vietnam is cracking down on firms re-exporting Chinese goods to avoid tariffs. And, the U.S. is moving to undermine the ability of Chinese companies to list on American exchanges. Finally, more Western newspapers are being blocked by the "great firewall."

The Hong Kong protests: There were widespread protests against a new extradition law that would allow China to extradite people in Hong Kong to the mainland. Fights broke out in the Hong Kong legislature over the measure. Steadily, Beijing is expanding its control over Hong Kong despite treaty arrangements that were designed to protect the area from encroachment. As this encroachment continues, Hong Kong will be seen as less independent from the mainland and therefore less attractive for investors and free thinkers alike. As is its custom, Beijing blamed foreign influences for the unrest.

Middle East: The Pentagon is considering a request for a major troop buildup in the region. This request will tend to run counter to the president's desire to avoid being tied down to conflicts in the region. The U.S. has given Turkey a deadline on the S-400 missile purchase from Russia. If Turkey makes the purchase, the U.S. will cancel sales of the F-35 and end pilot training. Saudi Arabia claims that OPEC is fully on board to maintain output cuts but Russia is still considering whether it will cooperate. PM Abe of Japan is going to Iran to act as an intermediary between the U.S. and Iran.

Odds and ends: The leadership race begins in Britain today. Speculation is rising that PM Abe will implement the consumption tax hike.

U.S. Economic Releases

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
11:00	JOLTS Job Openings	m/m	apr	7496	7488	**
Fed speakers or events						
No speakers or events scheduled						

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	Foreign Rerserves	m/m	may	$3.101 bn	$3.094 bn	$3.090 bn	*	Equity and bond neutral
	Trade Balance	m/m	may	$41.65 bn	$13.84 bn	$22.30 bn	**	Equity and bond neutral
Japan	BoP Current Account Balance	m/m	apr	¥1.707 bn	¥2.848 bn	¥1.515 bn	**	Equity and bond neutral
	Trade Balance	m/m	apr	-¥98.2 bn	¥700.1 bn	¥5.0 bn	**	Equity bearish, bond bullish
	GDP	q/q	1q	2.2%	2.1%	2.2%	***	Equity and bond neutral
	Banktuptcies	y/y	may	-9.4%	-0.8%		**	Equity bearish, bond bullish
	Eco Watchers Outlook	m/m	may	45.6	48.4	48.0	**	Equity and bond bearish
	Eco Watchers Current Situation	m/m	may	44.1	45.3	45.4	**	Equity and bond bearish
EUROPE								
Italy	Industrial Production	y/y	apr	-1.5%	-1.4%	-0.5%	***	Equity and bond bearish
UK	GDP	m/m	apr	-0.4%	-0.1%	-0.4%	***	Equity and bond neutral
	Industrial Production	y/y	apr	-1.0%	1.3%	0.9%	***	Equity and bond bearish
	Manufacturing Production	y/y	apr	-0.8%	2.6%	2.0%	**	Equity and bond bearish
	Construction Output	y/y	apr	2.4%	3.2%	3.3%	**	Equity and bond neutral
	Trade Balance	m/m	apr	-£2.740 bn	-£5.408 bn	-£4.700 bn	**	Equity and bond neutral
AMERICAS								
Canada	Net Change in Employment	m/m	may	27.7k	106.5k	5.0k	***	Equity bullish, bond bearish
	Unemployment Rate	m/m	may	5.4%	5.7%	5.7%	***	Equity bullish, bond bearish
Brazil	IBGE Inflation	m/m	may	4.7%	4.9%	4.7%	***	Equity and bond neutral
Mexico	CPI	y/y	may	4.3%	4.4%	4.4%	***	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)	245	245	0	Up
3-mo T-bill yield (bps)	222	222	0	Neutral
TED spread (bps)	23	23	0	Neutral
U.S. Libor/OIS spread (bps)	226	224	2	Up
10-yr T-note (%)	2.14	2.08	0.06	Neutral
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	14	11	3	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Up
yen	down			Neutral
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	$63.39	$63.29	0.16%	
WTI	$54.26	$53.99	0.50%	
Natural Gas	$2.33	$2.34	-0.21%	
Crack Spread	$19.98	$20.15	-0.85%	
12-mo strip crack	$16.62	$16.79	-1.04%	
Ethanol rack	$1.60	$1.60	-0.21%	
Metals				
Gold	$1,326.50	$1,340.86	-1.07%	Ease in trade tensions
Silver	$14.74	$15.02	-1.90%	
Copper contract	$263.20	$262.75	0.17%	
Grains				
Corn contract	$ 412.00	$ 415.75	-0.90%	
Wheat contract	$ 496.50	$ 504.50	-1.59%	
Soybeans contract	$ 851.00	$ 856.25	-0.61%	
Shipping				
Baltic Dry Freight	1138	1138	0	

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temps for most of the country, with cooler temps in the Midwest. Precipitation is expected for most of the country. There is no tropical activity expected over the next 48 hours.

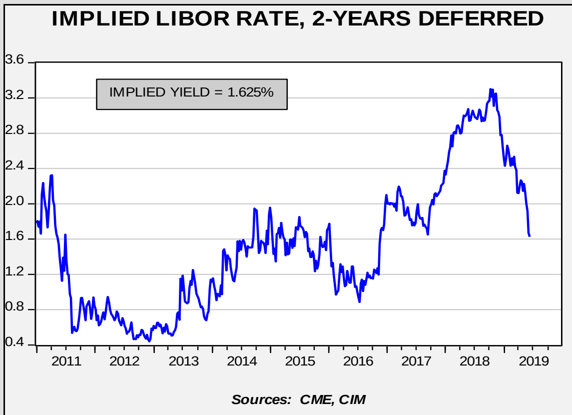
Asset Allocation Weekly

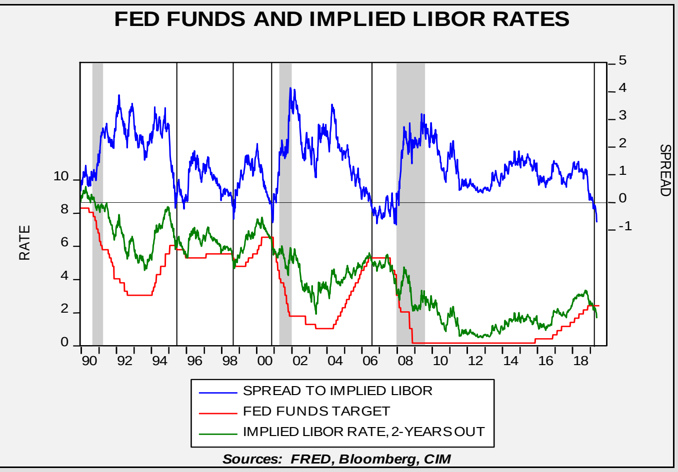
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

June 7, 2019

Monetary policymakers are facing divergent trends that complicate future policy actions.

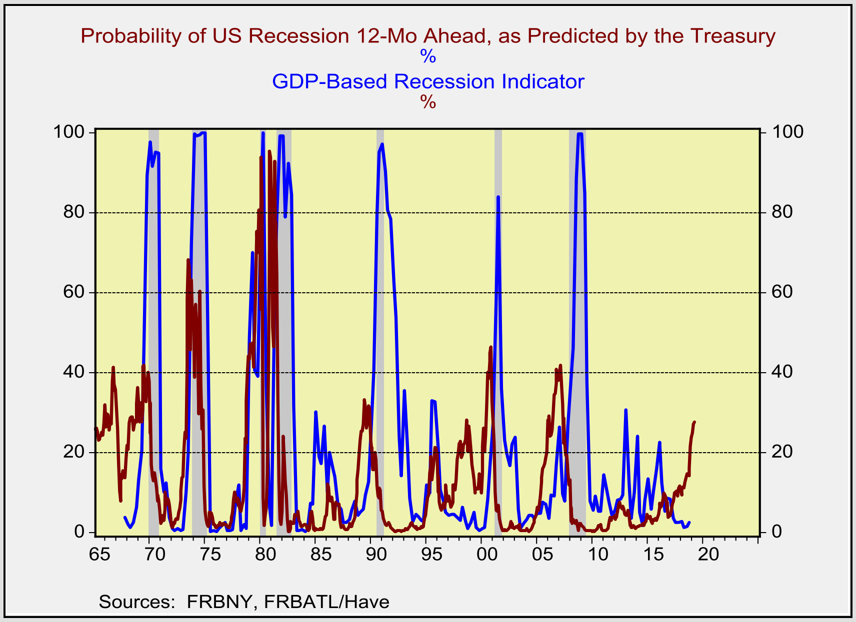
Financial markets are signaling that the policy rate needs to be cut immediately.





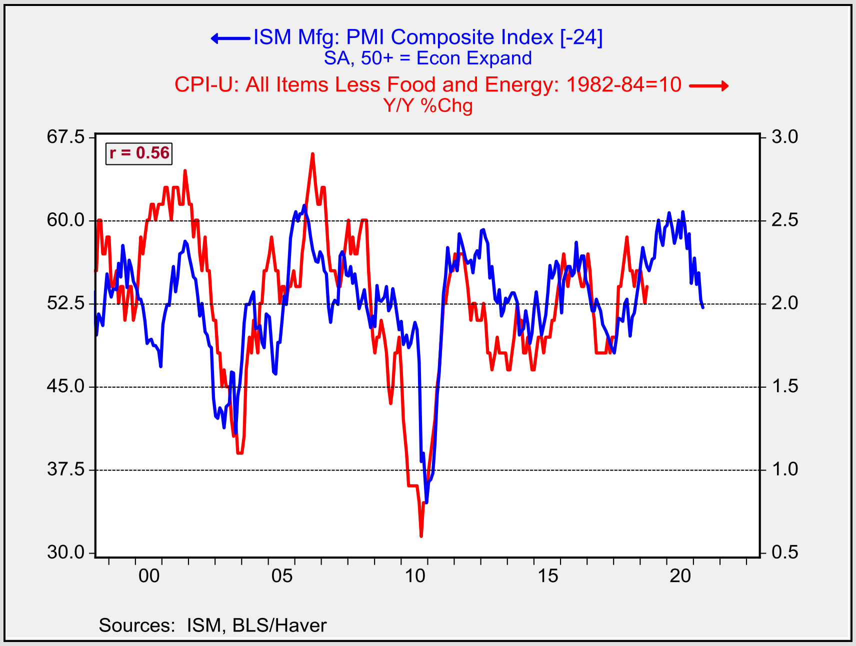
The chart on the left shows the implied three-month LIBOR rate, two-years deferred, from the Eurodollar futures market. Last October, the implied rate was around 3.30%; it has fallen sharply to 1.625%, a decline of nearly 70 bps. The chart on the right compares that implied rate to the fed funds target. History shows the Fed has tended to cut the target rate when the implied rate inverts relative to the policy rate (shown on the upper line). The spread has widened considerably, meaning the Fed should be moving to cut rates soon. This data would suggest the longer policymakers wait, the higher the probability of a recession.

Current economic conditions probably don't warrant a rate reduction.



This chart shows the NY FRB recession indicator, which projects the odds of recession 12 months out and the Atlanta FRB GDP-based recession indicator. In general, combining the two indicators reduces the chance of a false positive, namely, predicting a recession that doesn't occur. We use the 20% threshold as a warning sign; if both indicators are above 20% then a recession warning is warranted. The only false positive that was triggered with the 20% threshold was in 1995 and that event was considered a rare "soft landing." As the first chart shows, in 1995, the Greenspan Fed did cut rates and this action probably extended the expansion. The current reading of these two indicators suggests caution, but the economic data is not signaling that a downturn is imminent. And, as a cautionary tale, we had a similar configuration in the data in 1997-98. The Fed did ease in that event, in part driven by the LTCM Crisis, and that easing is often blamed for stoking the tech bubble in 1999.

Inflation remains controlled, but tariffs could affect prices.

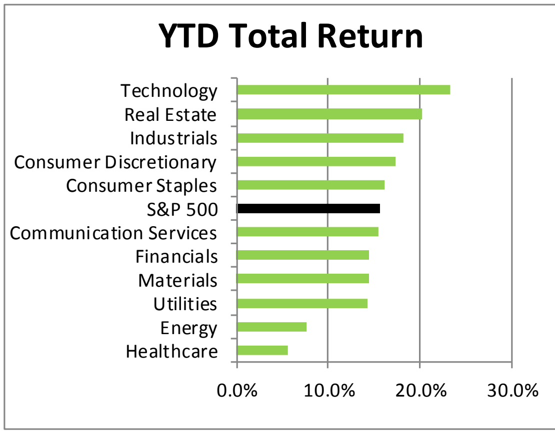


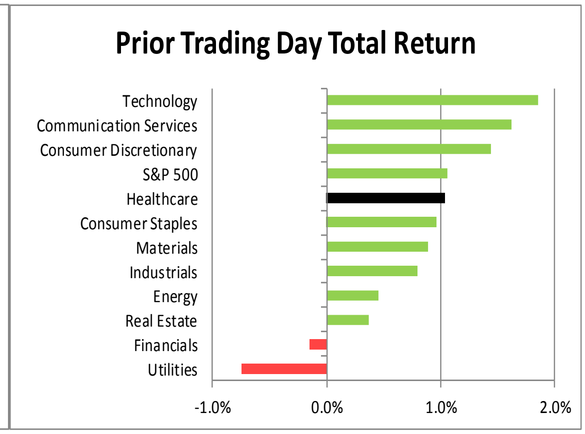
This chart compares the ISM Manufacturing Index to core CPI. The ISM index tends to lead inflation by two years. Comparing core CPI to the ISM Manufacturing Index suggests that inflation might lift in the coming months but should not overshoot by a wide margin. However, it is important to note that tariffs are a form of consumption tax. While the incidence of the tax does not automatically fall to the consumer (the producer or importer could absorb the cost, cutting profit margins, or the dollar could appreciate and offset the tariff), there is the possibility of an unexpected rise in inflation.

These three issues will likely keep the FOMC on hold in the near term. If that analysis is correct, the chances of recession will tend to rise in the coming months.

Data Section

U.S. Equity Markets – (as of 6/7/2019 close)

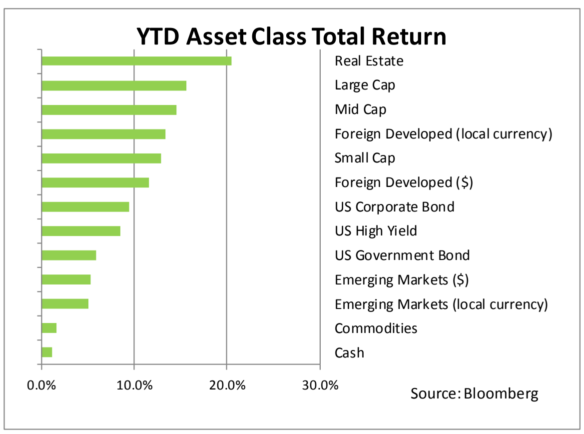




(Source: Bloomberg)

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 6/7/2019 close)

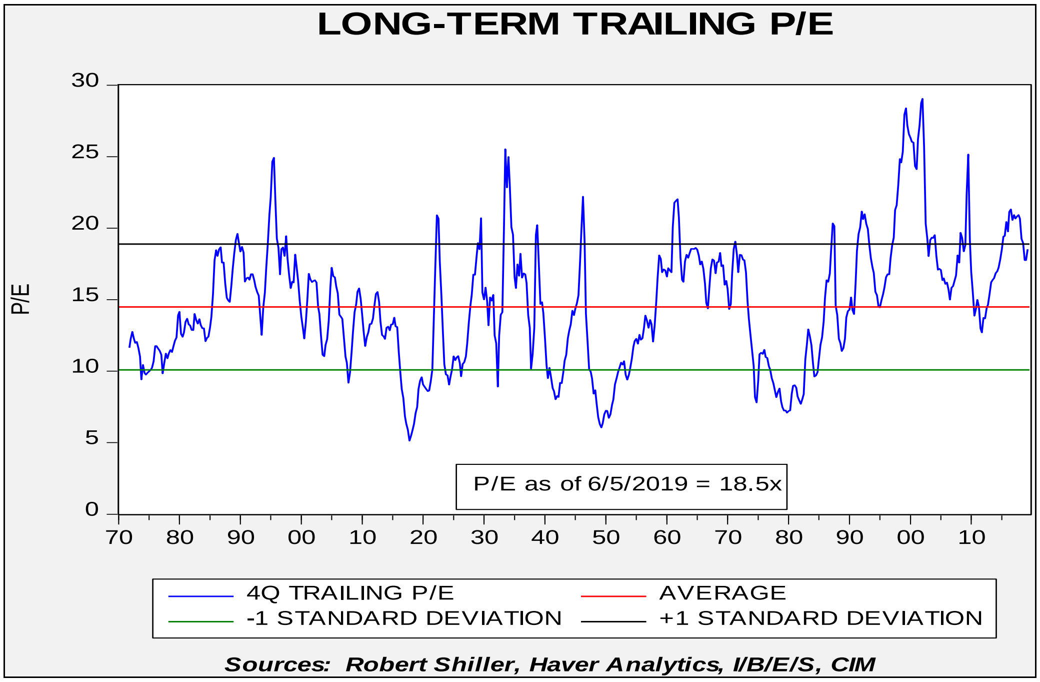


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

June 6, 2019



Based on our methodology,[1] the current P/E is 18.5x, down 0.1x from last week. The decline in the S&P index led to the modest multiple contraction.

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[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 (Q3, Q4 and Q1) and one estimate (Q2). 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.