Confluence INVESTMENT MANAGEMENT

Daily Comment

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 14, 2019—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 0.7% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.5% from the prior close. Chinese markets were lower, with the Shanghai composite down 1.0% and the Shenzhen index down 1.8% from prior close. U.S. equity index futures are signaling a lower open.

Happy Flag Day! Tensions remain high with Iran and protests continue in Hong Kong. Here is what we are watching today:

Pompeo blames Iran: Yesterday, we reported that two tankers were attacked in the Gulf of Oman. SoS Pompeo has assigned blame to Iran. Pompeo suggested the attack was delivered by divers attaching limpet mines to the tankers. The U.S. Navy provided video giving strong evidence that Islamic Revolutionary Guard Corps (IRGC) commandos were removing previously attached limpet mines. This action by Iran is a significant escalation; the U.S. is taking the matter to the UNSC but, given that Russia and China have veto power, we doubt the U.N. will do anything. We note that Iran continues to dispute the U.S. claim that Tehran is responsible for the attack.

The attack does seem oddly timed. Japan's PM Abe was in Iran trying to ease tensions; to attack two vessels with cargoes en route to Japan seems to send a belligerent message. One possibility is that rogue elements within the IRGC, wanting to prompt escalation, moved without authorization. If this is the case, we could see reports in the coming weeks of officials in the Corps being demoted or retired. The IRGC's power has been increasing in recent years and it could be that elements of the group want to challenge the leadership of the clerics. We will be watching for evidence of this theory in the coming weeks.

So, with conditions escalating, why aren't oil prices soaring? We suspect the next step will be for the U.S. and allies to send military escort vessels to the region as was done in the "tanker war" during the Iran-Iraq War. Although the escorting process is expensive and will slow shipping out of the Gulf, it will prevent escalation (it would be foolhardy for Iran to directly attack U.S. Naval vessels) and keep the waterways open for shipping.

Worries about global demand are also pressuring prices. The IEA cut its forecast for 2019 crude oil demand by 0.1 mbpd to 1.2 mbpd, blaming worsening trade conditions. We note that China's May industrial production came in weaker than forecast (5.0% vs. 5.4%), and fixed investment eased to 4.3% in May from 5.7% in April on a year-to-date basis. Weakening economic growth in China will obviously dent oil demand and may lead the IEA to make further cuts in demand estimates.

Next week's WGR looks at the issue of war with Iran.

Hong Kong: Another mass rally is planned for this weekend. We note that Chairman Xi has been touring central Asia during the recent uprising. As he returns to Beijing, we continue to watch to see if China's calm response to the protests continues. The Chinese leader has a hardline reputation and we can't see him tolerating this insolence much longer. At the same time, a highly visible crackdown will almost force the Trump administration to react with trade sanctions and could scuttle any chances of a deal at the G-20. Other actions are being considered as well. Therefore, this weekend could be key to the upcoming talks.

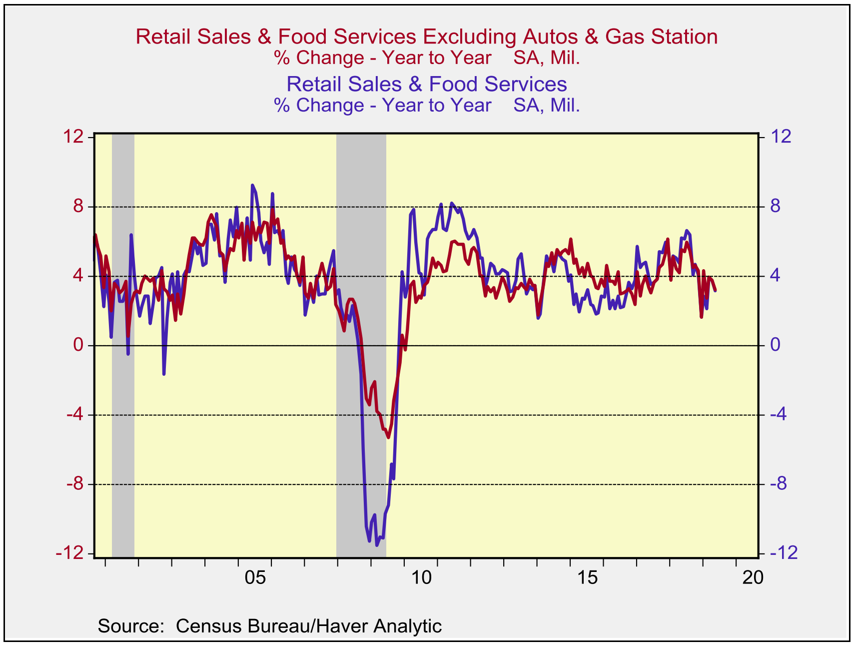
China trade news: China announced new anti-dumping measures against U.S. and European steel pipes and tubes. Although China has indicated it wants to move up the tech value chain, it apparently has a serious gap in semiconductors that will severely hamper its desire for tech independence. Six-hundred companies have issued a public letter to the White House asking for the president to resolve the trade dispute with China.

Brexit: Boris Johnson is the front-runner to replace PM May. Although a no-deal Brexit is still being considered, the risks of such an event for the U.K. economy are significant.

Odds and ends: Social media firms have been granted relief from legal liability stemming from posts on their sites. Congress is apparently revisiting this relief and considering if the legal protections should be reduced or removed. If the law is changed, it could open up these firms to legal liability for the content on their platforms. A recent survey suggests that 23% of households believe they are still worse off than they were before the financial crisis. With the expansion nearing record levels, the high number of those still feeling left behind could trigger a strong social reaction in the next downturn if conditions don't improve further.

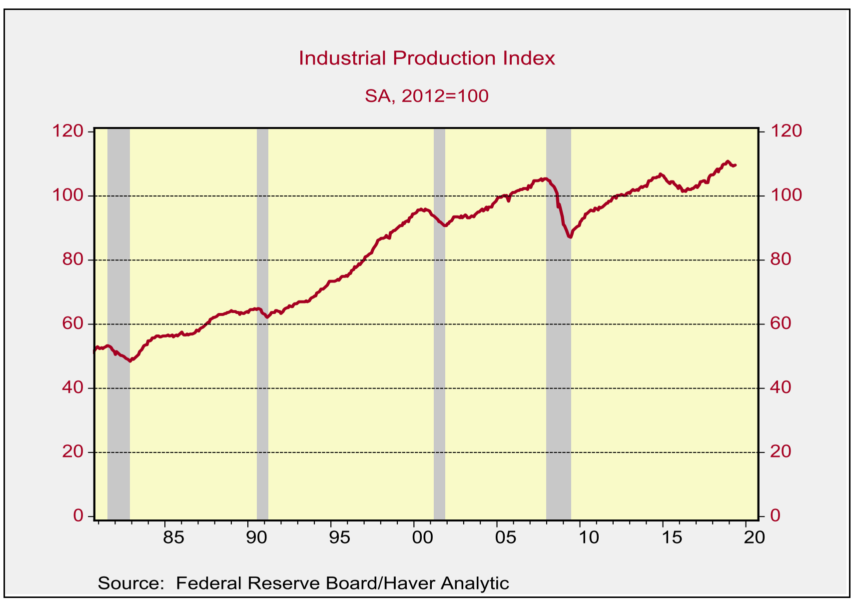
U.S. Economic Releases

Advance retail sales for May came in below expectations, rising 0.5% from the prior month compared to the forecast rise of 0.6%. The prior month's loss was revised upward from 0.1% to a gain of 0.5%. Retail sales ex-auto came in above expectations, rising 0.5% from the prior month compared to the forecast gain of 0.4%. The prior month's gain was revised upward from 0.1% to 0.5%. Retail sales ex-auto and gasoline came in above expectations, rising 0.5% from the prior month compared to the forecast rise of 0.4%. The prior month's loss was revised upward from 0.2% to a gain of 0.5%. The retail sales control group came in above expectations, rising 0.5% from the prior month compared to the forecast gain of 0.4%. The prior month's gain was revised from 0.0% to 0.4%.



The chart above shows the year-over-year change in retail sales and core retail sales. Annually, retail sales and core retail sales each rose 3.2%.

Industrial production for May came in stronger than forecast, rising 0.4% from the prior month compared to the forecast rise of 0.2%. Capacity utilization was 78.1%, above the 78.0% expected.



The chart above shows the Industrial Production Index. The current reading is 109.6, just above last month's 109.2.

The table below shows the economic releases scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	U. of Michigan Sentiment	m/m	jun	98.0	100.0	***
10:00	U. of Michigan Current Conditions	m/m	jun	109.0	110.0	**
10:00	U. of Michigan Expectations	m/m	jun	92.0	93.5	**
10:00	U. of Michigan 1 yr Inflation	m/m	jun		2.9%	**
10:00	U. of Michigan 5-10 Yr Inflation	m/m	jun		0.0	**
10:00	Business Inventories	m/m	apr	0.5%	0.0%	**
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	Fixed Assets Ex Rural	y/y	may	5.6%	6.1%	6.1%	**	Equity bearish, bond bullish
	Industrial Production	y/y	may	5.0%	5.4%	5.4%	***	Equity bearish, bond bullish
	Retail Sales	y/y	may	8.6%	7.2%	8.1%	**	Equity bullish, bond bearish
	Surveyed Jobless Rate	m/m	may	5.0%	5.0%		***	Equity and bond neutral
Japan	Industrial Production	m/m	may	-1.1%	-1.1%		***	Equity and bond neutral
	Capacity Utilization	m/m	may	1.6%	-0.4%		***	Equity bullish, bond bearish
India	Wholesale Price Index	m/m	may	2.5%	3.1%	3.0%	**	Equity bearish, bond bullish
New Zealand	REINZ House Sales	m/m	may	-7.8%	-11.5%		**	Equity and bond neutral
	BusinessNZ Manufacturing PMI	m/m	may	50.2	53.0		**	Equity and bond neutral
	Food Prices	m/m	may	0.7%	-0.1%		***	Equity and bond neutral
EUROPE								
Germany	Wholesale Price Index	m/m	may	1.6%	2.1%		***	Equity and bond neutral
France	CPI EU Harmonized	m/m	may	1.1%	1.1%	1.1%	***	Equity and bond neutral
	CPI	m/m	may	0.9%	1.0%	1.0%	***	Equity and bond neutral
Italy	Industrial Sales	m/m	apr	-0.7%	1.3%		**	Equity bearish, bond bullish
	Industrial Orders	m/m	apr	-0.2%	-3.6%		**	Equity and bond neutral
	CPI EU Harmonized	m/m	may	0.9%	0.9%	0.9%	***	Equity and bond neutral
Russia	Money Supply Narrow Def	m/m	jun	10.34 tn	10.24 tn		*	Equity and bond neutral
AMERICAS								
Brazil	Economic Activity	y/y	apr	-0.6%	-2.5%	-0.5%	***	Equity bearish, bond bullish

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)	243	245	-2	Up
3-mo T-bill yield (bps)	213	214	-1	Neutral
TED spread (bps)	30	31	-1	Neutral
U.S. Libor/OIS spread (bps)	221	222	-1	Up
10-yr T-note (%)	2.07	2.10	-0.03	Neutral
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	15	13	2	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Up
yen	up			Neutral
pound	down			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Key Rate	7.500%	7.750%	7.500%	On forecast

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	$61.33	$61.31	0.03%	
WTI	$52.09	$52.28	-0.36%	
Natural Gas	$2.34	$2.33	0.47%	
Crack Spread	$21.66	$21.39	1.27%	
12-mo strip crack	$17.67	$17.53	0.82%	
Ethanol rack	$1.64	$1.63	0.54%	
Metals				
Gold	$1,353.86	$1,342.31	0.86%	
Silver	$15.04	$14.91	0.89%	
Copper contract	$264.15	$265.65	-0.56%	
Grains				
Corn contract	$ 458.25	$ 455.75	0.55%	
Wheat contract	$ 539.75	$ 539.00	0.14%	
Soybeans contract	$ 891.00	$ 888.00	0.34%	
Shipping				
Baltic Dry Freight	1062	1080	-18	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	2.2	-1.0	3.2	
Gasoline (mb)	0.8	1.0	-0.2	
Distillates (mb)	-1.0	1.1	-2.1	
Refinery run rates (%)	1.40%	0.55%	0.85%	
Natural gas (bcf)	102.0	119.0	-17.0	

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.

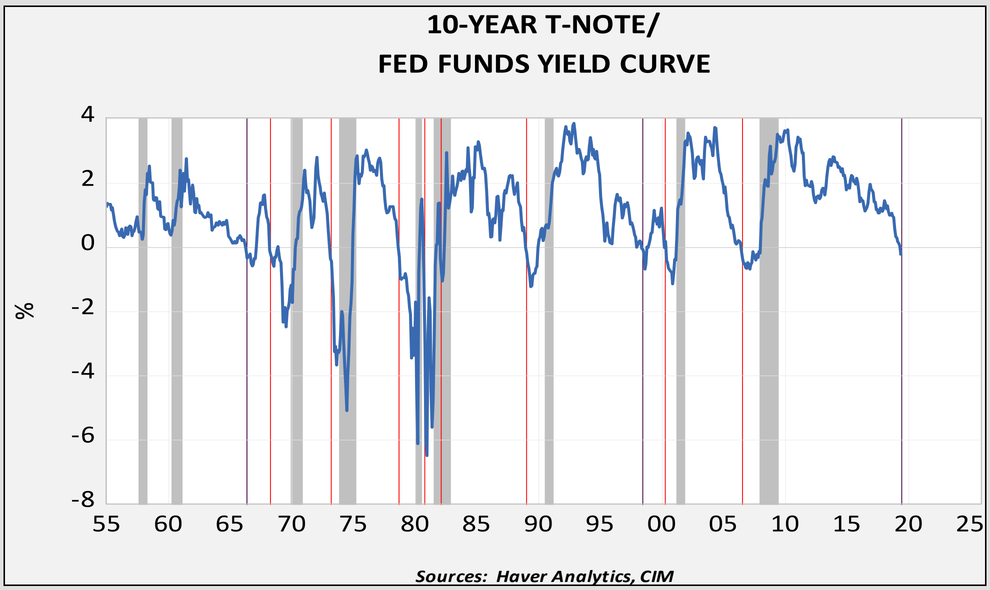
<u>Asset Allocation Weekly</u>

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 14, 2019

Establishing when "the" yield curve inverts is a bit of guesswork as there are a plethora of permutations one can use to calculate the spread. One yield curve we like is the same one the Conference Board uses in its index of Leading Economic Indicators, namely, the 10-year T-note less fed funds yield. As we show below, this particular spread has inverted this month. Because of the time it takes to fully accumulate all the data points in the leading indicators, the inverted yield curve won't be in the index until August. But, the inversion will start to act as a drag on the leading indicators and likely start signaling a slowdown in the economy.

Here is a chart of the 10-year/fed funds yield curve.

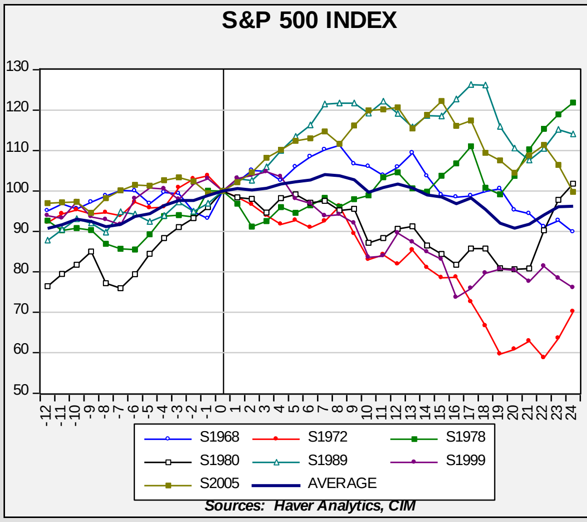


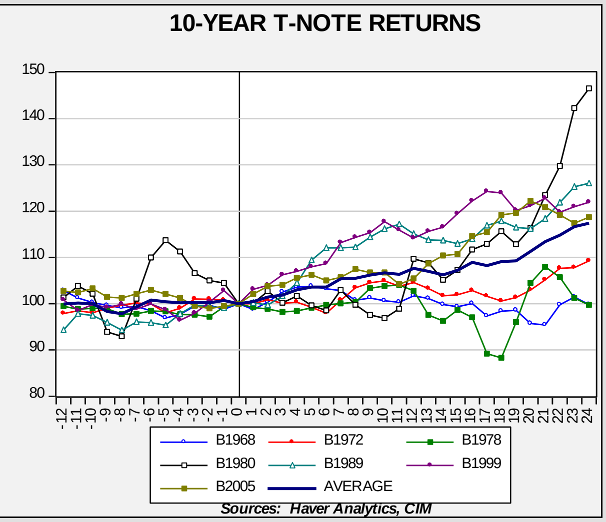
This spread didn't become a reliable indicator of the economy until the 1960s. It isn't perfect; it has had two false positives (shown as a black lines on the above chart). In the 1981-82 recession, the curve didn't invert until the recession was underway. We have shown the current inversion as a black line, but we will change this if, or when, the recession develops.

INVERT	RECESSION	MONTHS
Apr-68	Dec-69	20
Mar-73	Nov-73	8
Sep-78	Jan-80	16
Feb-82	Jul-81	-7
Oct-80	Jul-81	9
Jan-89	Jul-90	18
May-00	Mar-01	10
Jul-06	Dec-07	17
Average		12

This table shows the time period from the inversion to recession. Although there is variation, the average is 12 months. Using the range, a recession would be due at the earliest in February 2020 or the latest at February 2021.

So, with inversion, what should investors do?



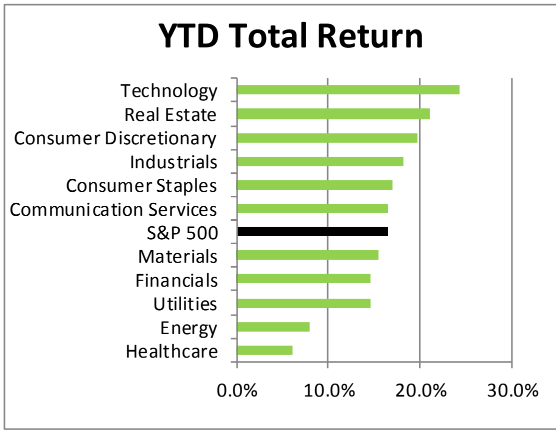


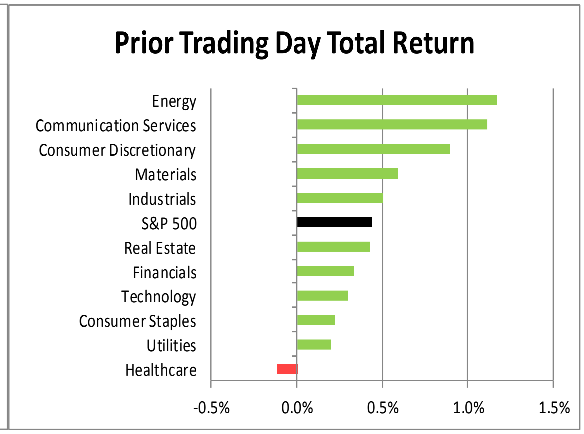
These two charts show equities (the S&P 500) and long-duration bonds (10-year T-notes total return index), indexed to the yield curve inversion (shown as a vertical line on the chart). We looked at the data 12 months before the inversion and 24 months after the inversion, excluding the 1982 inversion since the recession was already underway. We also calculated the average for the seven events. These calculations show that the financial markets don't always treat inversions as bearish. Under low inflation conditions, long-duration interest rates tend to perform well. Equities decline about 10% or less after inversion the majority of the time; however, in three cases, they actually continued to rise. Furthermore, during the 2005 inversion, the real bear market didn't start until two years after the yield curve turned negative.

There are two key issues for investors. First, it is possible that the current inversion is a false positive. If the FOMC moves quickly to cut the fed funds rate, the slope of the curve could return to positive so remaining fully invested is recommended. Second, even if this inversion is a harbinger of recession, there were several events where equities performed quite well for some time after the inversion. This is especially true when the inversion predated the recession by more than a year. At the same time, investors are now on notice that if the Fed doesn't react soon to unwind this inversion then the odds of recession are rising, thus it would be prudent to build a plan to become defensive.

Data Section

U.S. Equity Markets – (as of 6/13/2019 close)

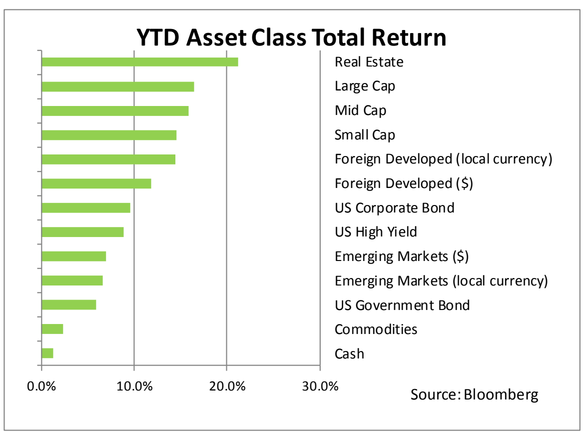




(Source: Bloomberg)

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 6/13/2019 close)

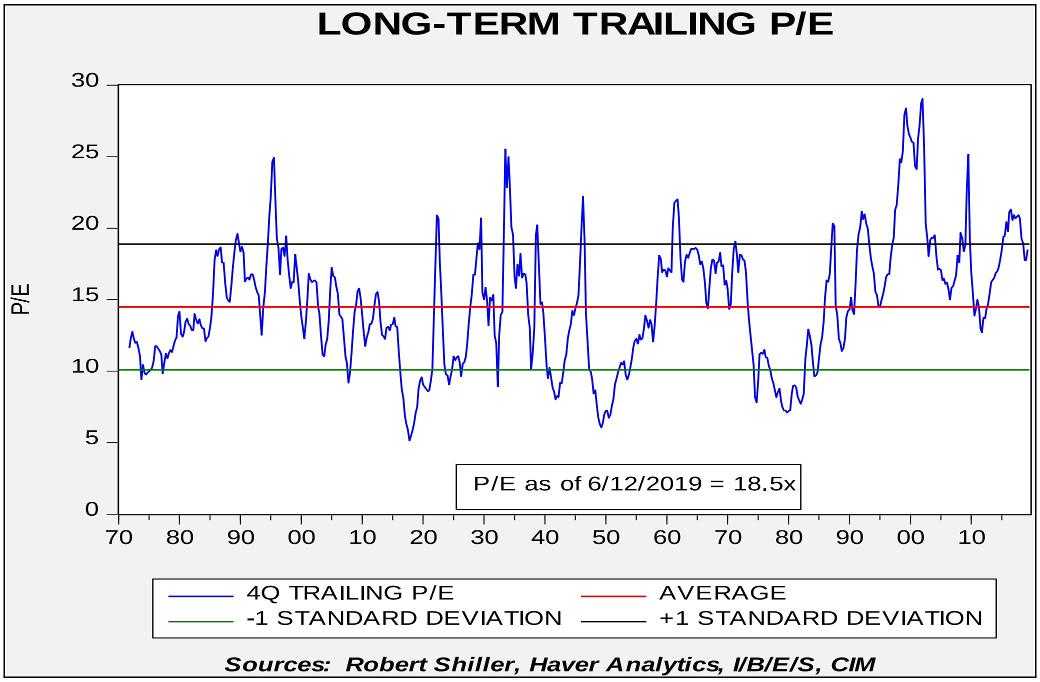


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 13, 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.

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 (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.