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: June 21, 2019—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is unchanged from the last close. In Asia, the MSCI Asia Apex 50 was up 0.2% from the prior close. Chinese markets were higher, with the Shanghai composite up 0.5% and the Shenzhen index up 1.3% from prior close. U.S. equity index futures are signaling a lower open.

NB: Our strategy team is expanding! Patrick Fearon-Hernandez has joined our firm as Market Strategist. He comes to us from a broad and interesting career, including a stint at A.G. Edwards and the Central Intelligence Agency. You will be seeing his work in the coming weeks and we are excited to have him aboard.

Happy Friday! It's the summer solstice today. In the news, an operation against Iran was about to start but was called off by the president. There are elections in Istanbul over the weekend and the G-20 meets. Additionally, the global ISM data was mostly steady to better than expected. Here is what we are watching today:

Iran: As we noted yesterday, Iran has downed a U.S. drone. President Trump warned Iran against such actions. According to reports, the U.S. was about to conduct an air operation against Iranian targets but President Trump called off the action. According to reports, the action was designed to target radar facilities that use missile or artillery against Persian Gulf shipping or aircraft (hence a response to the aforementioned drone attack). It isn't clear as to why the action was rescinded. However, we do note that there is a key divergence within the administration, between hawks, such as Bolton and Pompeo, and the president himself, on such matters. President Trump was to avoid deep involvements in the Middle East—and other areas too. That isn't how a superpower usually acts and is certainly not how the U.S. has behaved since the end of communism. However, populists in the GOP oppose foreign interventions, while the establishment tends to support them.

So, where does this leave us? Clearly, the potential for escalation is still in place. Although, it also shows great reluctance to dive into a conflict. We now await to see what sort of response we get from Tehran. At the same time, we don't know why the action was halted. Was it due to something as simple as "cold feet?" Did President Trump get information, perhaps from a foreign source, that led him to rethink the action? We may never know but for now, the mere threat of a conflict will tend to support risk assets, such as oil, gold and the yen.

Trade talks: There isn't too much new on the trade front. China appears to be framing the discussion between Presidents Trump and Xi as occurring because the U.S. is asking for talks. The trade teams have resumed negotiations. The best outcome is the two leaders not only restart talks but make progress in a compromise deal. The worst outcome is both leaders walk away from discussions and end trade talks. The most likely outcome? A freeze on new tariffs and a promise to return to negotiations in earnest. The problem for both the U.S. and China is the easy parts have been discussed and fleshed out, while the remainder gets to core issues that will determine the direction of relations going forward. Those issues are very difficult. The other issued we are concerned with is both leaders may be overestimating the strength of their positions and thus feel no need to compromise. We are assuming a neutral outcome, but the chances of a hard break are not insignificant.

Brexit: It's now down to two candidates, Boris Johnson and Jeremy Hunt. This outcome, in a sense, is already a win for Johnson, who likely didn't want to face the formidable Michael Gove in the final vote. There were rumors of "tactical voting" where Johnson supporters voted for Hunt to prevent Gove from winning second place; the outcome for second was close, with Hunt besting Gove by a mere two votes. From here, the Tory party members will vote for a new PM. We expect Johnson to win this vote on July 22.

EU woes: The EU is in turmoil after being unable to agree on a new leader to replace Juncker. In some respects, the leadership vote in the EU is in flux because the establishment is losing its grip on the union. At the same time, the viciousness of the vote reminds us of an old line from Henry Kissinger, who once noted that "academic politics are so vicious precisely because the stakes are so small."

Italy: Deputy PM Salvini is threatening to resign if he doesn't get his way for budget conflicts with the EU. Salvini is trying to push through a tax cut that will lift the deficit and threaten to break EU budget rules.

Hong Kong: Although the extradition bill has been postponed the city is preparing for another weekend of protests. Apparently, protests are already underway. With President Xi focusing on the G-20 and North Korea, the protestors likely have another weekend to act. However, when Xi gets back to normal business, we will be watching to see how long he tolerates this behavior. Investors will be taking notice as well.

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
9:45	Markit US Manufacturing PMI	m/m	jun	50.5	50.5	***
9:45	Markit US Services PMI	m/m	jun	51.0	50.9	**
9:45	Markit US Composite PMI	m/m	jun		50.9	**
10:00	Existing Home Sales	m/m	may	2.1%	-0.4%	**
Fed speakers or events						
	Speaker or event	District or position				
12:00	Lael Brainard Fed Listens conference	Member of the Board of Governors				
12:00	Loretta Mester Listens conference	President of the Federal Reserve Bank of Cleveland				
15:00	Mary Daly hosts podcast	President of the Federal Reserve Bank of San Francisco				

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								
Australia	CBA Australia PMI Mfg	m/m	jun	51.7	51.0		**	Equity bullish, bond bearish
	CBA Australia PMI Services	m/m	jun	53.3	51.5		**	Equity bullish, bond bearish
	CBA Australia PMI Composite	m/m	jun	53.1	51.5		**	Equity bullish, bond bearish
Japan	National CPI	y/y	jun	0.7%	0.7%	0.9%	***	Equity bearish, bond bullish
	Markit manufacturing PMI	m/m	jun	49.5	49.8		**	Equity and bond neutral
	Department store sales	y/y	mayh	-0.8%	-1.1%		*	Equity and bond neutral
EUROPE								
Eurozone	Markit manufacturing PMI	m/m	jun	47.8	47.7	48.0	**	Equity bearish, bond bullish
	Markit Services PMI	m/m	jun	53.4	53.0	52.9	**	Equity bullish, bond bearish
	Markit Composite PMI	m/m	jun	52.1	52.0	51.8	**	Equity bullish, bond bearish
France	Markit manufacturing PMI	m/m	jun	52.0	50.6	50.8	**	Equity bullish, bond bearish
	Markit Services PMI	m/m	jun	53.1	51.5	51.6	**	Equity bullish, bond bearish
	Markit Composite PMI	m/m	jun	52.9	51.2	51.3	**	Equity bullish, bond bearish
	Wages	q/q	1q	0.8%	0.7%	0.7%	***	Equity bullish, bond bearish
Germany	Markit manufacturing PMI	m/m	jun	45.4	44.3	44.6	**	Equity and bond neutral
	Markit Services PMI	m/m	jun	55.6	55.4	55.2	**	Equity and bond neutral
	Markit Composite PMI	m/m	jun	52.6	52.6	52.5	**	Equity and bond neutral
Switzerland	M3 Money stock	y/y	may	3.4%	3.5%		**	Equity and bond neutral
UK	Public Finance	m/m	may	£10.7 bn	£ -7.1 bn		*	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)	239	239	0	Up
3-mo T-bill yield (bps)	208	209	-1	Neutral
TED spread (bps)	31	30	1	Neutral
U.S. Libor/OIS spread (bps)	217	218	-1	Up
10-yr T-note (%)	2.03	2.03	0.00	Neutral
Euribor/OIS spread (bps)	-34	-34	0	Neutral
EUR/USD 3-mo swap (bps)	13	12	1	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Up
yen	down			Neutral
pound	down			Neutral
franc	flat			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	$65.47	$64.45	1.58%	Rising tensions in the Middleeast
WTI	$57.69	$57.07	1.09%	
Natural Gas	$2.20	$2.19	0.59%	
Crack Spread	$19.94	$18.75	6.32%	
12-mo strip crack	$17.40	$16.74	3.96%	
Ethanol rack	$1.69	$1.69	0.11%	
Metals				
Gold	$1,399.65	$1,388.44	0.81%	Market Uncertainty
Silver	$15.36	$15.42	-0.40%	
Copper contract	$270.45	$271.20	-0.28%	
Grains				
Corn contract	$ 461.50	$ 461.00	0.11%	
Wheat contract	$ 532.25	$ 531.75	0.09%	
Soybeans contract	$ 937.75	$ 941.00	-0.35%	
Shipping				
Baltic Dry Freight	1194	1179	15	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-3.1	-1.8	-1.4	
Gasoline (mb)	-1.7	1.0	-2.7	
Distillates (mb)	-0.6	0.7	-1.2	
Refinery run rates (%)	0.70%	0.00%	0.70%	
Natural gas (bcf)	115.0	104.0	11.0	

Weather

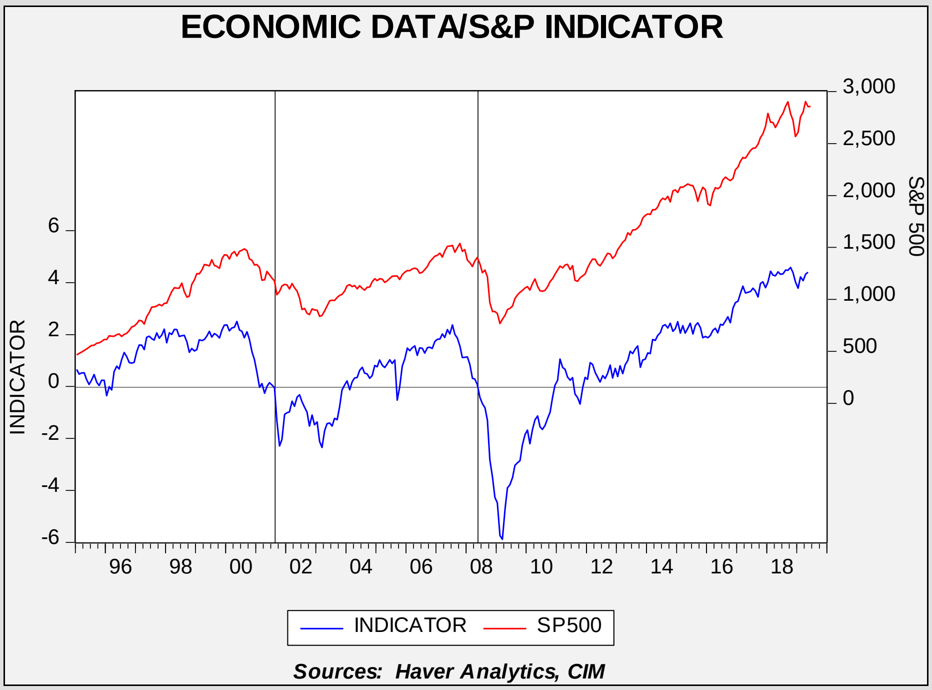
The 6-10 and 8-14 day forecasts show warmer to normal temps for most of the country, with cooler temps in the in Texas and Nevada. Precipitation is expected for most of the country. There is no tropical activity expected over the next 48 hours.

Asset Allocation Weekly

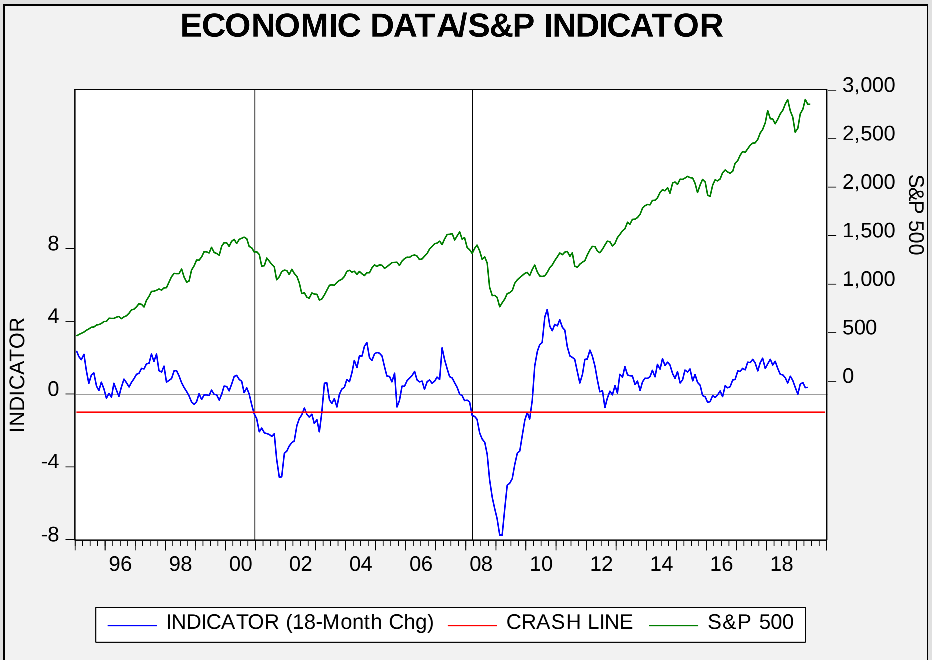
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

June 21, 2019

In 2017, we introduced an indicator of the basic health of the economy and added it to the many charts we monitor to gauge market conditions. The indicator is constructed using commodity prices, initial claims and consumer confidence. The thesis behind this indicator is that these three components should offer a simple and clear picture of the economy; in other words, rising initial claims coupled with falling commodity prices and consumer confidence is a warning that a downturn may be imminent. The opposite condition should support further economic recovery. In this report, we will update the indicator with May data.



This chart shows the results of the indicator and the S&P 500 since 1995. The updated chart shows that the economy did slip late last year but has recovered in 2019. We have placed vertical lines at certain points when the indicator fell below zero. It works fairly well as a signal that equities are turning lower, but there is a lag. In other words, by the time this indicator suggests the economy is in trouble, the recession is likely near or already underway and the equity markets have already begun their decline.



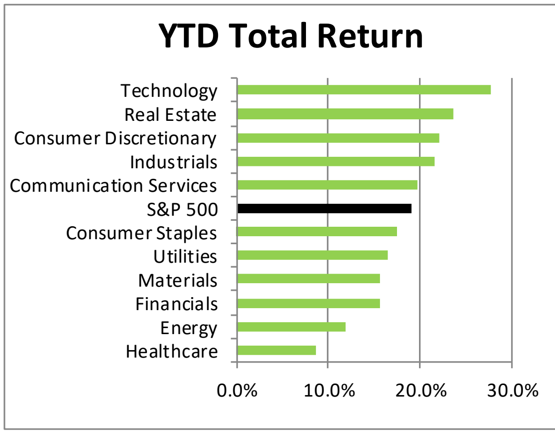
Sources: Haver Analytics, CIM

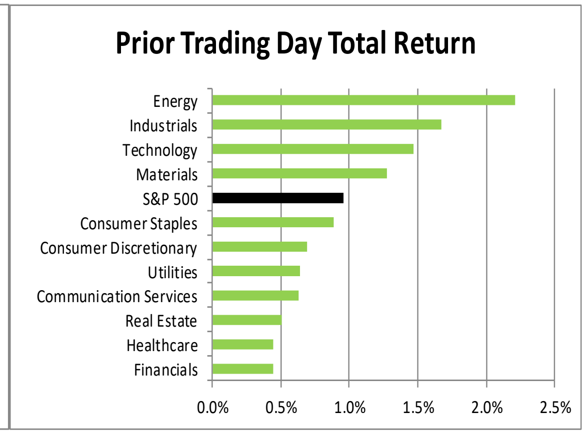
To make the indicator more sensitive, we took the 18-month change and put the signal threshold at -1.0. This provides an earlier bearish signal and also eliminates the false positives that the zero threshold generates. Notwithstanding, we will pay close attention when the 18-month change approaches zero as it did in January.

What does the indicator say now? The economy has decelerated but is not yet at a point where investors should become defensive. Breaking below the red line would be our signal to expect a broader downturn. Most likely, we are going through a period similar to what we experienced in 2016. If this is the case, and the economic data begins to improve, then equities should remain supported into H2.

Data Section

U.S. Equity Markets – (as of 6/19/2019 close)

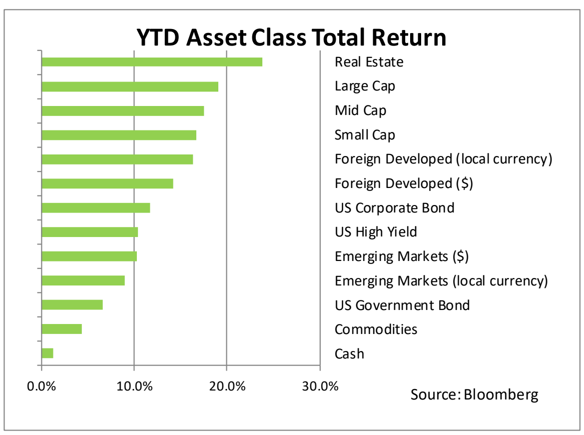




(Source: Bloomberg)

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 6/19/2019 close)

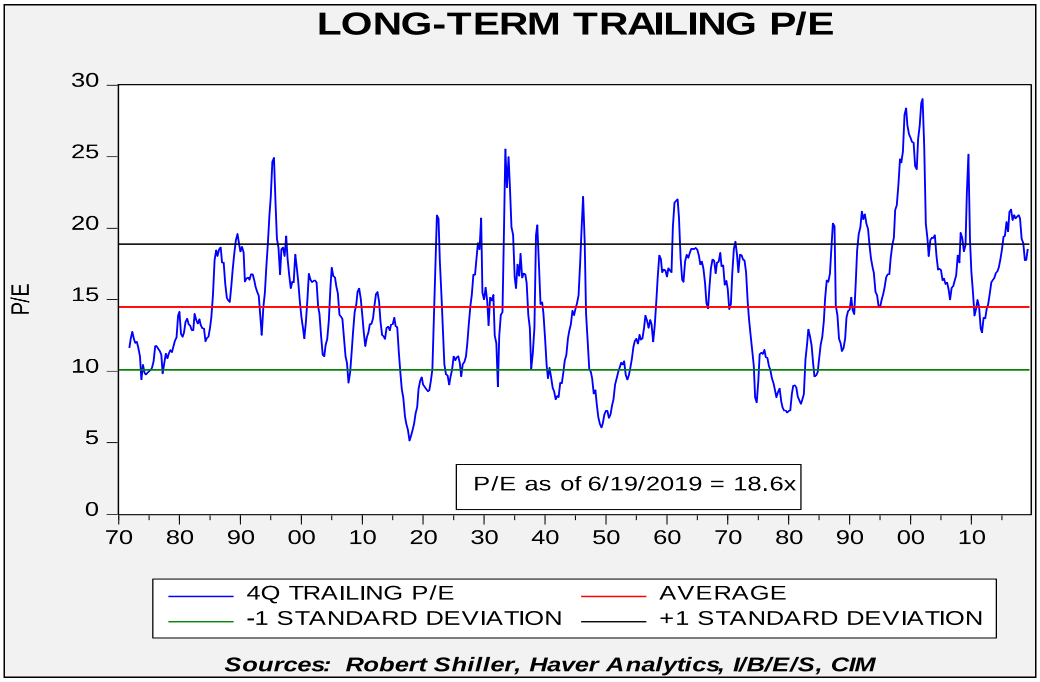


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 20, 2019



Based on our methodology,[1] the current P/E is 18.6x, up 0.1x from last week. The rise in the S&P index led to the modest multiple expansion.

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.