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 24, 2019—9:30 AM EDT] Global equity markets are generally steady to lower this morning. The EuroStoxx 50 is down 0.3% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.1% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.2% and the Shenzhen index down 0.1% from prior close. U.S. equity index futures are signaling a higher 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 Monday! Erdogan loses big in the Istanbul "do over," protests emerge in the Czech Republic and the markets are digesting the Iran situation. Here is what we are watching today:

Istanbul: After his party suffered a narrow loss three months ago in mayoral elections, President Erdogan claimed there were irregularities and this led to a second vote, which was held over the weekend. In a rather stunning development, the opposition candidate, Ekrem Immoglu, won in a landslide, taking 54% of the vote compared to 45% for the AK Party's candidate. This loss is a blow to the Turkish president. He was once the mayor of the city and considers it a base of operations. In an equally interesting development, financial markets cheered the outcome, with Turkish equities and the lira rallying on the news. We suspect financial markets would like to see Erdogan's power lessened so as to achieve less erratic policy.

Trouble in Prague: An estimated 250k protestors flooded Prague in Wenceslas Square, the same place where the Velvet Revolution started which led to the overthrow of communism. The protests were calling for PM Andrej Babis to resign on corruption issues. He appointed a crony to justice minister, which has raised fears that she won't prosecute the PM for his alleged criminal activity.

Iran: In the aftermath of the president's decision to scrub a bombing mission, here is what we are seeing:

1. The U.S. is opting for new sanctions and cyberattacks in lieu of limited airstrikes. The president also indicated he is open to talks with Iran on its nuclear program and sanctions. It is clear that President Trump wants to avoid escalation with Iran.

2. The decision to scrub the mission appeared to be due to a couple of factors. First, the president was concerned that the action was "disproportionate." Although shooting down the drone was clearly a hostile act, no Americans died in the incident; that would not have been the case with U.S. action. Second, there are reports, not fully confirmed, that the missile strike on the drone may have been ordered by a lower ranking military officer in Iran and the Mullahs were not happy about the result.
3. The unknown factor is how Iran views U.S. behavior. If the Iranian leadership views this event as evidence that President Trump has no interest in a war but intends to keep sanctions in place, they may simply keep "upping the ante" until a military strike occurs. We would expect the U.S. to signal, through backchannels, that such a response would be a mistake. Nevertheless, it would not be unreasonable for Iran to take this position.
4. Iran has a myriad of ways to respond to sanctions. The two we are most concerned about would be a cyberattack on the U.S. and its allies, and/or actions in the Persian Gulf that would cause a rapid rise in oil prices. The first option is problematic because it may be very difficult to determine the source which would make it hard to retaliate. The second option can be managed through SPR releases, but the world economy is already fragile and a spike in oil prices might be enough to put the world economy into recession.
5. Another interesting facet of the Iran issue is that much of the rest of the world is looking at the 2020 elections and making the decision to stall and hope for a new resident in the White House. The EU appears to be doing just that with trade policy. However, in Iran's case, it isn't obvious if a new administration would make much of a difference. The Iran nuclear deal wasn't a treaty because there was no way Congress would approve it. Going back to the old agreement will be a trick because why would Iran trust any American government?
6. Our market take is that recent events are bullish for crude oil and risk-on assets. The opportunity cost of aborting the bombing mission is that it may simply embolden Iran to act rashly and get away with it. We think this is a misread of Trump's Jacksonian nature but, as noted in point #3, it would not be an unreasonable position to take.

Trade talks: There isn't too much new on the trade front, although there is activity in front of the G-20 meeting this weekend. Our expectation is that we will see a promise to continue talking but a full deal probably isn't possible.

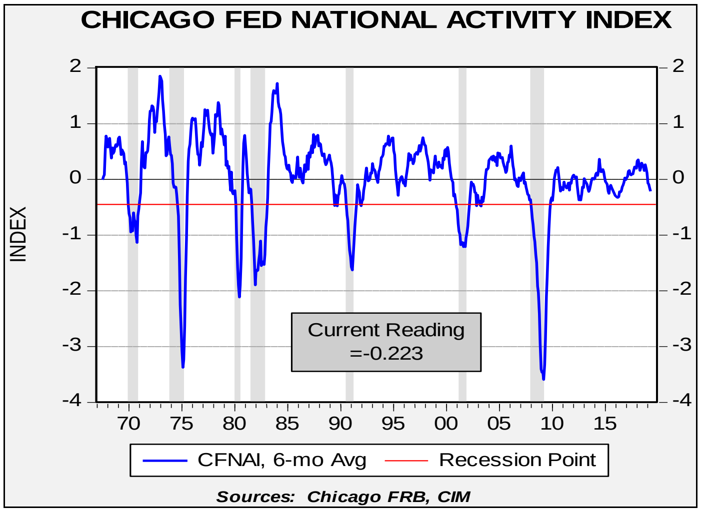
Brexit: Boris Johnson had a tough weekend. There were reports of a domestic disturbance and Steve Bannon has apparently been consulting with the PM hopeful. Although we still expect Johnson to win, he isn't really running on policy but on personality, so these reports are a problem for him. The vote of the Tory party members will occur on July 22. It appears the next PM will get to choose the new BOE Governor.

Italy gets a reprieve (of sorts): The EU has decided to delay any disciplinary actions against Italy to give more time for the Italian government to address its fiscal budget issues.

Odds and ends: Congress is looking at making social media firms show how valuable your information is to them. Global financial markets continue to deal with falling bond yields. Truckers are noting growth deceleration. FedEx (FDX, 165.35) has been accused of diverting another package destined for the Huawei (002502, CNY 3.62) headquarters.

U.S. Economic Releases

The Chicago FRB National Activity Index came in better than expected at -0.05 compared to estimates of -0.20. Improved consumption offset weakness in the rest of the report. The six-month average of the index continues to deteriorate.



The index remains above the recession line at -0.45 but is clearly weakening. The data bolsters the case for at least a pause in monetary policy, if not an outright ease.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:30	Dallas FRB Manufacturing Activity	m/m	jun	-2.0	-5.3	**
Fed speakers or events						
	Speaker or event	District or position				
	NO SPEAKERS OR EVENTS TODAY					

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								
Japan	Leading indicators	m/m	apr	95.9	95.5		*	Equity and bond neutral
EUROPE								
Germany	IFO business climate	m/m	jun	97.4	97.9	97.4	***	Equity and bond neutral
	IFO expectations	m/m	jun	94.2	95.3	94.6	***	Equity bearish, bond bullish
	IFO current assessment	m/m	jun	100.8	100.6	100.3	***	Equity bullish, bond bearish
AMERICAS								
Mexico	Economic Activity index	y/y	apr		1.3%	-0.4%	**	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)	235	234	1	Down
3-mo T-bill yield (bps)	205	206	-1	Neutral
TED spread (bps)	30	28	2	Neutral
U.S. Libor/OIS spread (bps)	215	217	-2	Up
10-yr T-note (%)	2.03	2.06	-0.03	down
Euribor/OIS spread (bps)	-34	-34	0	Neutral
EUR/USD 3-mo swap (bps)	12	12	0	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Up
yen	up			Up
pound	up			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	$65.10	$65.20	-0.15%	
WTI	$57.76	$57.43	0.57%	
Natural Gas	$2.22	$2.19	1.51%	
Crack Spread	$20.42	$20.40	0.12%	
12-mo strip crack	$17.40	$17.56	-0.87%	
Ethanol rack	$1.69	$1.69	-0.06%	
Metals				
Gold	$1,409.99	$1,399.63	0.74%	Market Uncertainty
Silver	$15.38	$15.35	0.24%	
Copper contract	$269.05	$270.40	-0.50%	
Grains				
Corn contract	$ 457.00	$ 453.50	0.77%	Continued rain in Midwest
Wheat contract	$ 532.50	$ 530.75	0.33%	
Soybeans contract	$ 933.00	$ 927.50	0.59%	
Shipping				
Baltic Dry Freight	1239	1194	45	

Weather

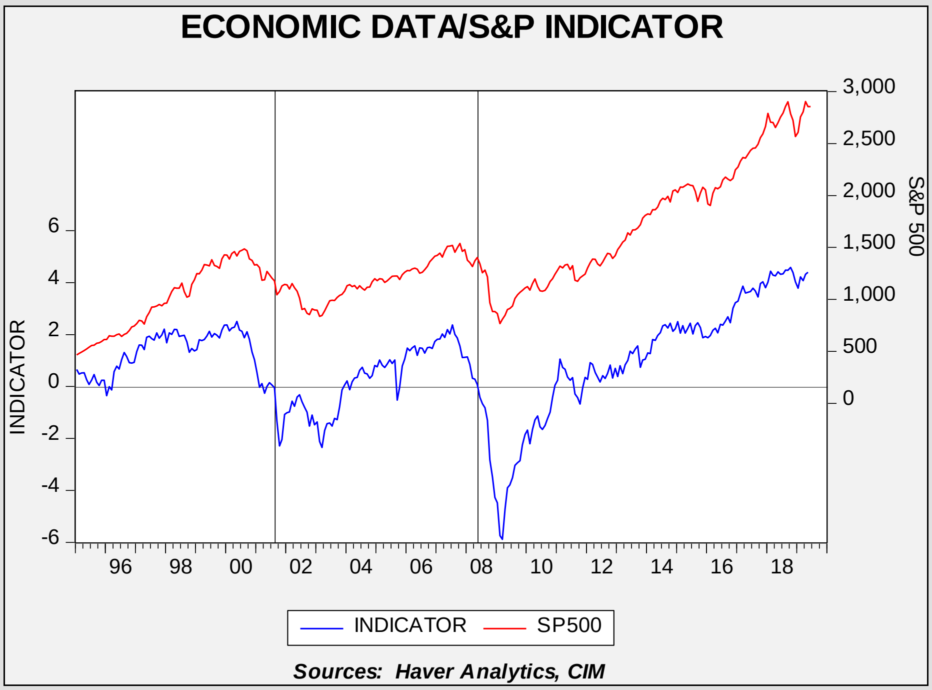
The 6-10 forecast shows a warming trend for most of the country with cooler temps in Texas. The 8-14 day forecast shows a cooling pattern for most of the country but, unfortunately, the wet pattern remains. There is no tropical activity expected over the next 48 hours.

Asset Allocation Weekly

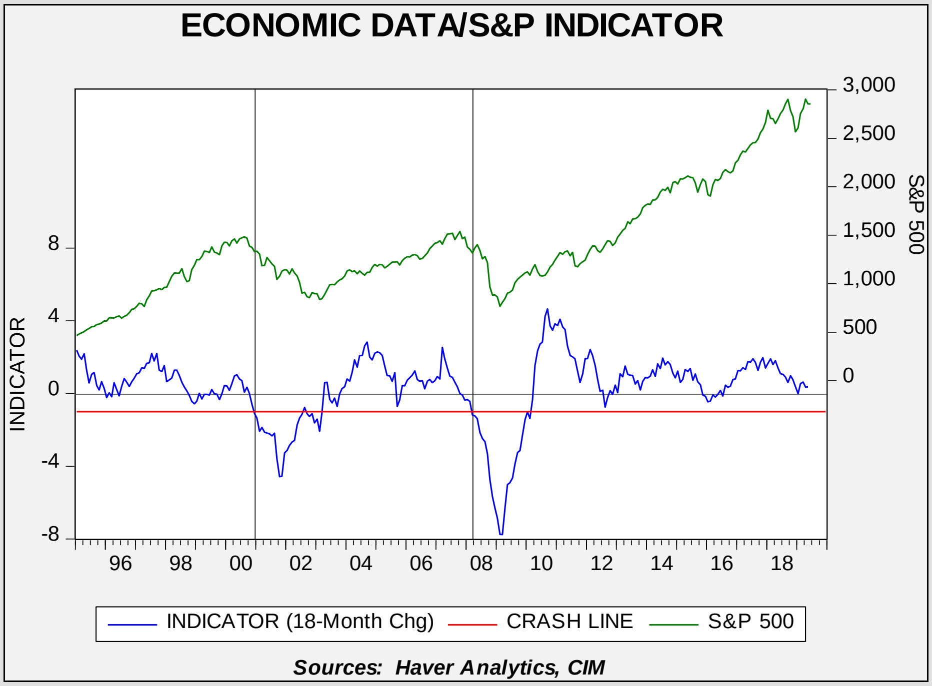
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

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.

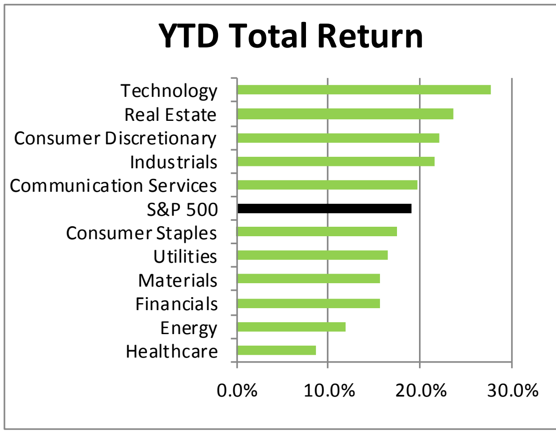


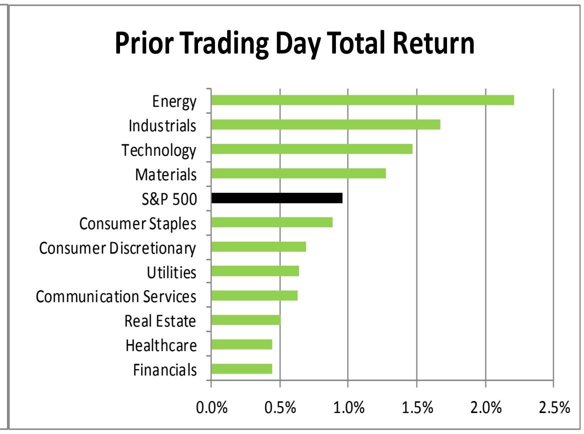
To make the indicator more sensitive, we took the 18-month change and put the signal threshold at -1.0. This provides an earlier bearish signal and also eliminates the false positives that the zero threshold generates. Notwithstanding, we will pay close attention when the 18-month change approaches zero 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 6/21/2019 close)

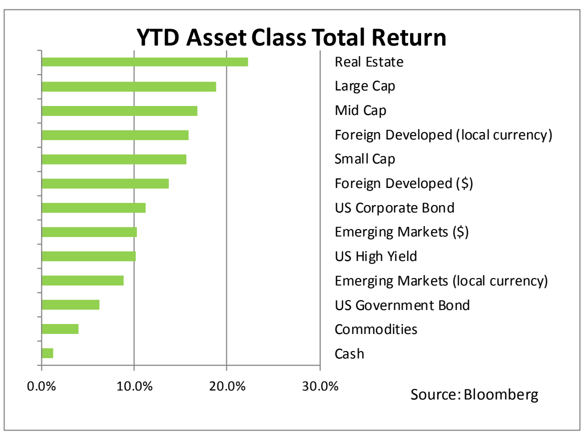




(Source: Bloomberg)

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 6/21/2019 close)

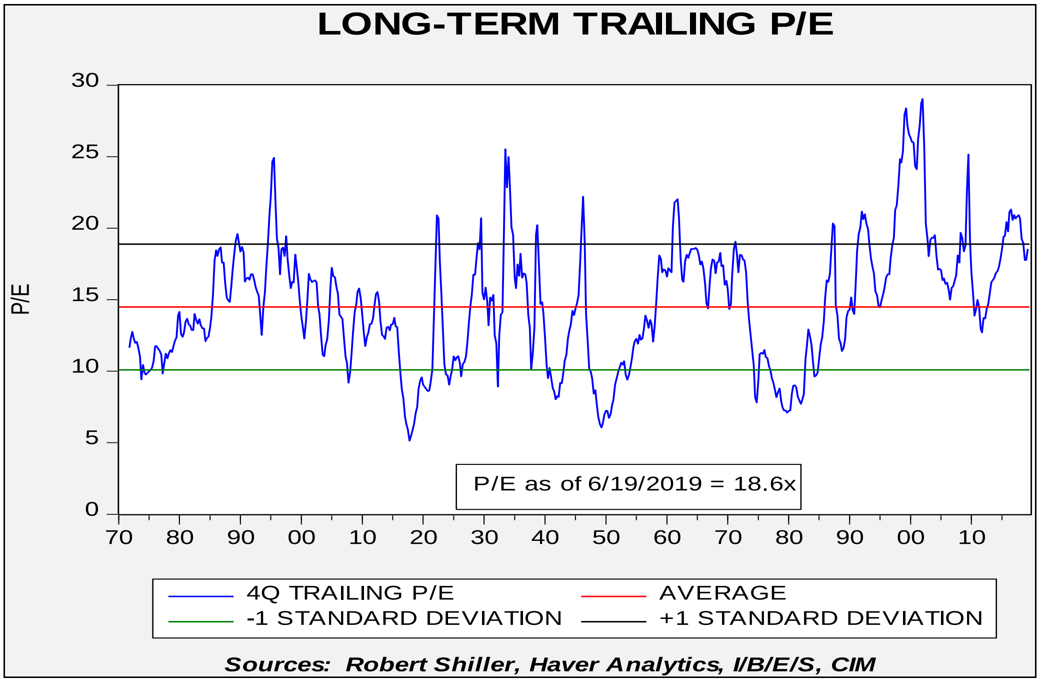


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.