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: May 24, 2019—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 1.1% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.1% from the prior close. Chinese markets were mixed, with the Shanghai composite unchanged and the Shenzhen index down 0.5%. U.S. equity index futures are signaling a lower open. With 482 companies having reported, the S&P 500 Q4 earnings stand at $39.42, higher than the $37.29 forecast for the quarter. The forecast reflects a 2.0% decrease from Q1 2018 earnings. Thus far this quarter, 75.7% of the companies reported earnings above forecast, while 18.3% reported earnings below forecast.

Good morning! U.S. equity futures are recovering after a hard break yesterday. PM May is on her way out. There is hope of a break on the China/U.S. trade dispute. Here is what we are watching:

Trade: There was mixed news on the trade front. Late afternoon yesterday, President Trump suggested that the technology restrictions the U.S. was putting in place against China could be part of trade negotiations. However, at the same time, the Commerce Department is changing regulations on tech exports to China, making such trade more difficult. Meanwhile, China is considering measures to block American firms from buying Chinese technology. Although the president suggested that U.S. policy toward the Chinese tech sector could be part of trade negotiations, increasingly, it appears that trade and technology are on two separate tracks and the latter may be far more important. Today's rally in risk assets has been attributed to the president's comments yesterday about resolving both trade and tech together but those comments appear to be contradicting what we are seeing in practice.

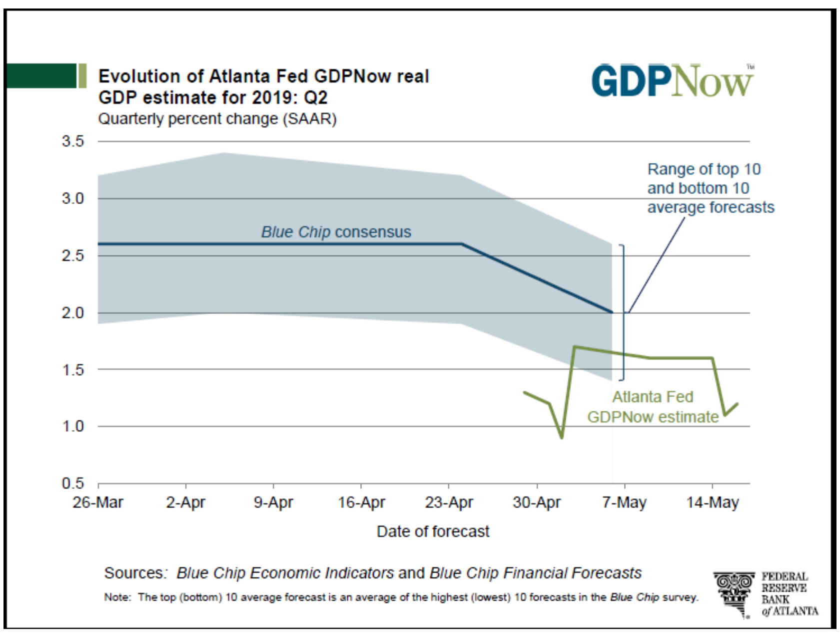
In other Chinese trade news, pork imports jumped 24% in April, mostly due to the loss of supply in China caused by the African Swine Virus. Even the U.S., which faced tariffs in China, has seen exports increase.

May leaving: For the past few weeks, it has been more a question of when, rather than if, PM May would step down. She plans to leave office officially on June 6, although there is some speculation she could be around until the end of June if the Tories struggle to name a new PM. The focus now shifts to her replacement. The leading candidate is Boris Johnson, who has, in the past, advocated for a hard break. Although there are concerns that Johnson will simply move to exit without a trade arrangement, it's important to remember that it's easy to be radical when you have no power. At least in the short run, a hard break will have a detrimental impact on the U.K. economy and could lead to the loss of Northern Ireland. In other words, if Johnson gets the reins of power, he will likely find himself in the same spot May was in; a painless Brexit is impossible to deliver. We note that Johnson made comments today suggesting the U.K. should leave on Halloween, deal or no deal. The GBP has weakened in the wake of his comments.

Dollar politics: The Treasury Department announced that it's considering a new rule that will allow it to implement duties on nations that it deems have undervalued their currencies. The U.S. already has a review process in place on exchange rates but, in practice, it has been mostly irrelevant. The current regulations appear to give the U.S. the ability to prevent currency policies designed to lift exports to the U.S. but, in reality, the reserve currency nation will always encourage other nations to undervalue their currencies to acquire the reserve currency. The Treasury has not indicated what the new regulations would entail but we do expect policy to change and the U.S. to use exchange rates as a reason for increasing tariffs. On a related note, there is growing speculation that the PBOC is trying to dampen expectations that it will defend 7.0 CNY/USD. The PBOC, a bit like the Bundesbank of old, seems to enjoy baiting traders into overweight positions only to hit them with intervention. Thus, this seeming signal of weak defense could be a ploy to lure traders into being overly short the CNY, only to hit them with intervention.

Saturday in Japan: President Trump is heading to Japan for the weekend for talks with PM Abe. Abe usually goes out of his way to personalize visits with Trump; he seems to have the idea that it helps to have a close personal relationship with the U.S. president. Thus, expect lots of photo opportunities. However, the U.S. is pressing Japan hard on trade and we doubt the personal relationship between Abe and Trump will give Japan much slack. One potential market fallout—referencing the aforementioned Treasury policy change, we could see the U.S. press for a stronger JPY. At the same time, the Abe government downgraded its assessment for economic growth but is still signaling it will continue to support the proposed consumption tax increase.

Weaker economy: Yesterday, we noted the Atlanta FRB GDPNow forecast is signaling GDP for Q2 at 1.2%, a significant slowdown from the Q1 3.2% growth. Here is the forecast chart.



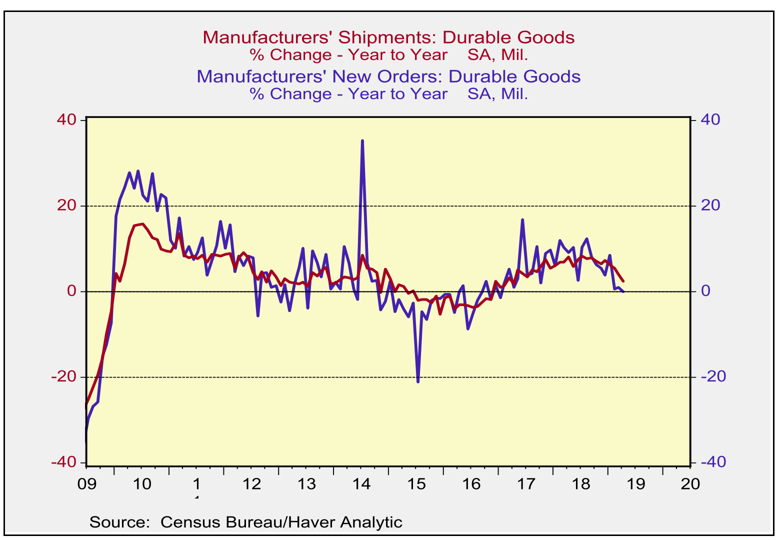
Although we tend to take a jaundiced eye toward using weather as an excuse, this time around there may be [something to the claim](). Spring weather in the Midwest has delayed planting and caused severe flooding. If weather has played a role, we could see a bounce later in the summer.

In another related issue, although the economy has bounced in recent years, the problem of inequality remains. A map by the [Economic Innovation Group]() shows the economic problems of rural America, especially in the South. [A Fed survey]() noted that 40% of Americans would struggle to cover an unexpected $400 expense. The tensions caused by inequality are part of the political shift to populism.

Sunlight: Anyone who has dealt with the U.S. healthcare system is usually baffled by the inability to determine exactly what they are paying for drugs or services and why. The administration is preparing an [executive order]() to force healthcare providers to be transparent about their billing practices. The industry, not surprisingly, is fighting the measure but the recent dive seen in the healthcare sector is partly due to such rules designed to force transparency.

U.S. Economic Releases

April durable goods orders came in lower than expectations, falling 2.1% from the prior month compared to the forecast drop of 2.0%. The prior week's gain was revised downward from 2.6% to 1.7%. Durables ex-transportation came in below expectations, remaining unchanged from the prior month compared to the forecast rise of 0.1%. The prior report's gain of 0.3% was revised to a loss of 0.5%. Capital goods orders non-defense ex-air were below expectations, falling 0.9% from the prior month compared to the forecast loss of 0.3%. The prior report's gain was revised downward from 1.4% to 0.3%. Capital goods shipments non-defense ex-air came in above expectations, remaining unchanged from the prior month compared to the forecast loss of 0.1%. The prior report was revised downward from unchanged to -0.6%.



The above chart shows the annual change in new durable goods orders and shipments. Annually, new orders fell by 0.1%, shipments rose by 2.4%, unfilled orders rose by 2.1% and inventories rose by 5.0%.

There are no other economic releases or Fed events scheduled for the rest of the day.

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	National CPI	m/m	apr	0.9%	0.5%	0.9%	***	Equity and bond neutral
	National CPI ex Fresh Food	m/m	apr	0.9%	0.8%	0.9%	***	Equity and bond neutral
	National CPI ex Fresh Food, Energy	m/m	apr	0.6%	0.4%	0.6%	***	Equity and bond neutral
	All Industry Activity Index	m/m	may	-0.4%	-0.2%	-0.2%	**	Equity and bond bearish
New Zealand	Trade Balance	m/m	apr	433 mn	922 mn	450 mn	**	Equity and bond neutral
EUROPE								
UK	Retail Sales Ex Auto Fuel	y/y	apr	4.9%	6.2%	4.2%	**	Equity bullish, bond bearish
	Retail Sales Inc Auto Fuel	y/y	apr	5.2%	6.7%	4.5%	**	Equity bullish, bond bearish
	CBI Retailing Reported Sales	m/m	may	-27	13	6	**	Equity and bond bearish
	CBI Total Dist. Reported Sales	m/m	may	-20	9		**	Equity and bond bearish
Russia	Money Supply Narrow Def	w/w	may	10.40 tn	10.35 tn		**	Equity and bond neutral
AMERICAS								
Mexico	Bi-Weekly CPI	m/m	may	4.4%	4.4%	4.5%	***	Equity and bond neutral
Canada	Wholesale Trade Sales	m/m	mar	1.4%	0.3%	0.9%	**	Equity bullish, bond bearish
Brazil	Tax Collections	m/m	apr	139.090 bn	109.854 bn	138.000 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)	252	252	0	Up
3-mo T-bill yield (bps)	231	231	0	Neutral
TED spread (bps)	22	21	1	Neutral
U.S. Libor/OIS spread (bps)	237	237	0	Up
10-yr T-note (%)	2.33	2.32	0.01	Neutral
Euribor/OIS spread (bps)	-31	-31	0	Neutral
EUR/USD 3-mo swap (bps)	18	18	0	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	flat			Up
yen	down			Neutral
pound	up			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	$68.63	$67.76	1.28%	Middle East Uncertainty
WTI	$58.62	$57.91	1.23%	
Natural Gas	$2.58	$2.58	-0.12%	
Crack Spread	$22.48	$22.35	0.55%	
12-mo strip crack	$18.48	$18.38	0.53%	
Ethanol rack	$1.48	$1.49	-0.28%	
Metals				
Gold	$1,281.54	$1,283.45	-0.15%	
Silver	$14.56	$14.59	-0.23%	
Copper contract	$269.60	$268.05	0.58%	
Grains				
Corn contract	$ 395.00	$ 389.75	1.35%	
Wheat contract	$ 478.00	$ 470.25	1.65%	
Soybeans contract	$ 825.50	$ 821.50	0.49%	
Shipping				
Baltic Dry Freight	1068	1059	9	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	4.7	-1.9	6.6	
Gasoline (mb)	3.7	-1.0	4.7	
Distillates (mb)	0.8	-0.6	1.4	
Refinery run rates (%)	-0.60%	0.50%	-1.10%	
Natural gas (bcf)	100.0	103.0	-3.0	

Weather

The 6-10 and 8-14 day forecasts show cooler temps for most of the country, with warmer temps in the southeastern and northwestern regions. Precipitation is expected for most of the country.

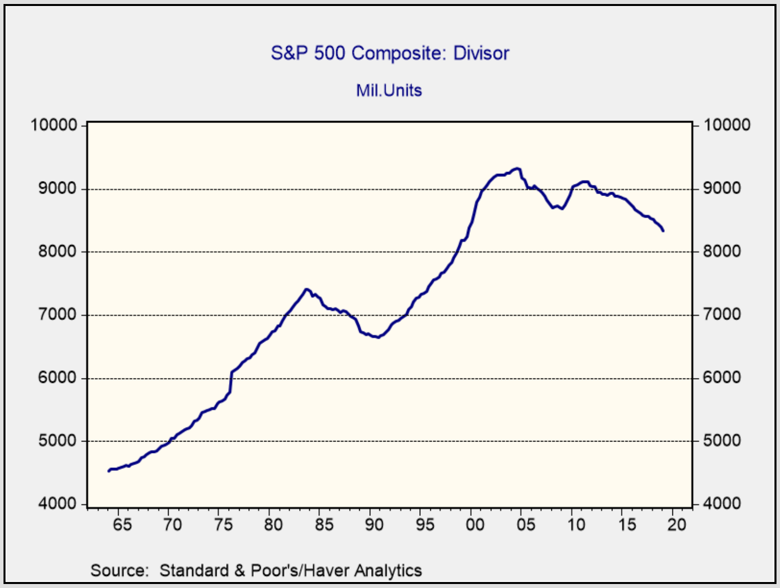
Asset Allocation Weekly

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.

May 24, 2019

How important have mergers, buybacks, etc. been to equity market performance? Several analysts have attempted to answer this question by focusing on buybacks alone. However, there is a more straightforward method of looking at this question and including all the factors that affect the number of shares available—the index divisor.

This chart shows the divisor for the S&P 500.



The divisor adjusts the S&P for membership changes (either by mergers or index adjustment), new share issuance or repurchases, or special stock-related transactions. So, it isn't a pure look at buybacks but isolating buybacks alone may overstate the impact of the activity if new shares are being issued or it may ignore the impact of membership adjustments. In general, a rising divisor tends to depress the index and vice versa. In the most recent data, the divisor peaked in Q3 2011; the decline in the divisor is partly due to buybacks, but merger activity has affected it as well.

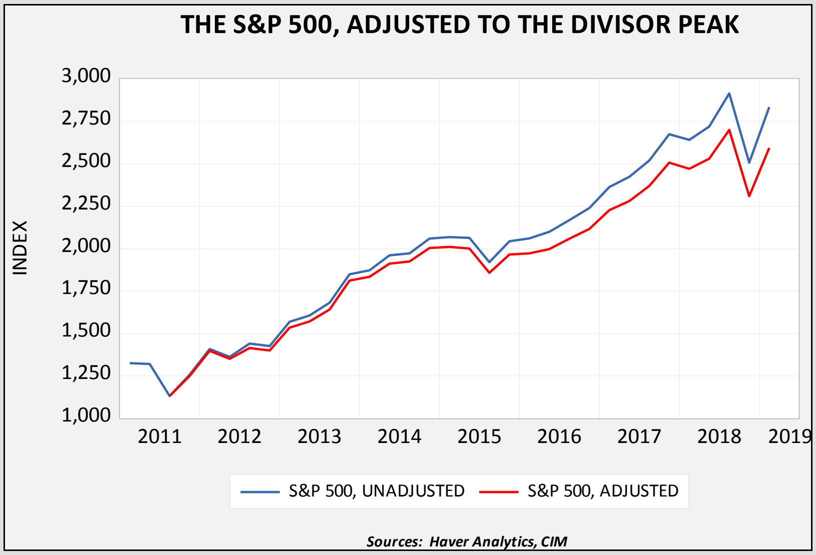
To calculate the impact of the divisor, we would use the following formula:

Divisor * S&P Index = S&P Market Capitalization

Rearranging terms leads to this formula:

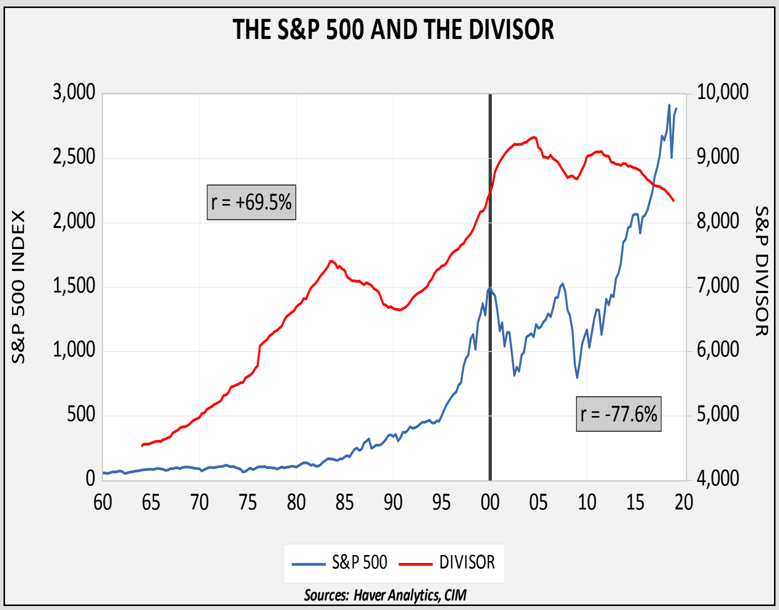
S&P Index = S&P Market Capitalization/Divisor

And so, if we take the market capitalization and hold the divisor fixed at this peak in Q3 2011, we can estimate what the S&P 500 would have been without the decline in the divisor.



At the end of Q1, the S&P 500 was at 2824.44; if the divisor had held at its previous peak, it would have been 2593.63, or 8.2% lower.

The more important question is if or when the trend in the divisor might reverse. In general, history suggests that elevated equity market values tend to trigger equity issuance. However, that has not been the case since 2000.

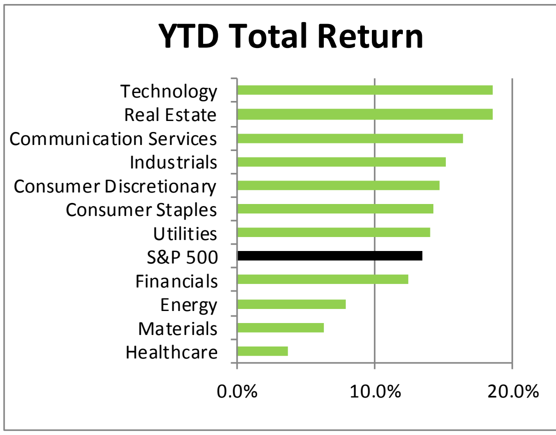


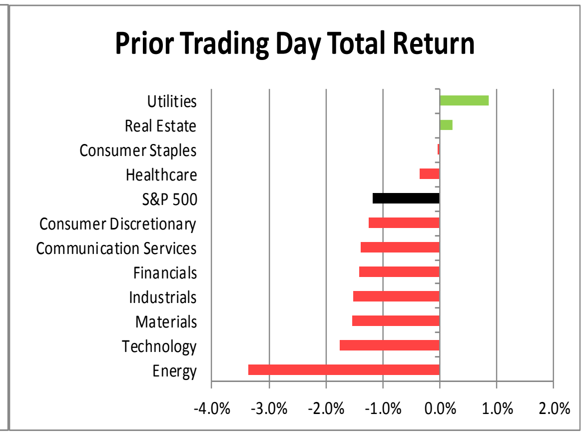
This chart shows the divisor and the S&P 500 Index since 1964. From that year to Q1 2000, the two series were positively correlated at the 69.5% level. However, since then, the correlation between the two series has not only flipped to inverse but strengthened. During this century, for the most part, the equity markets appear less critical to raising capital. Overall, we expect the divisor to continue to decline as firms continue to shrink the number of shares available; if we are correct, the equity markets have a modest tailwind going forward.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

U.S. Equity Markets – (as of 5/23/2019 close)

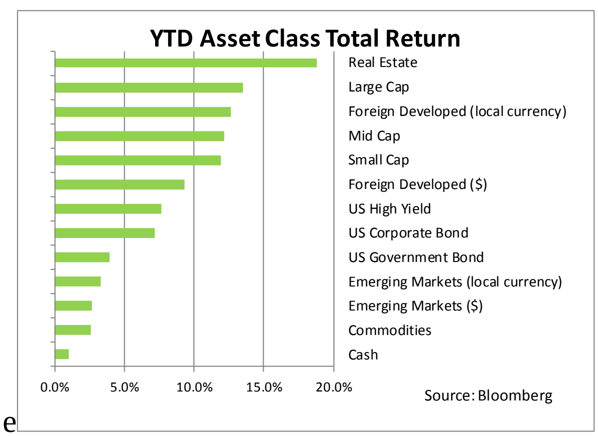




(Source: Bloomberg)

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 5/23/2019 close)



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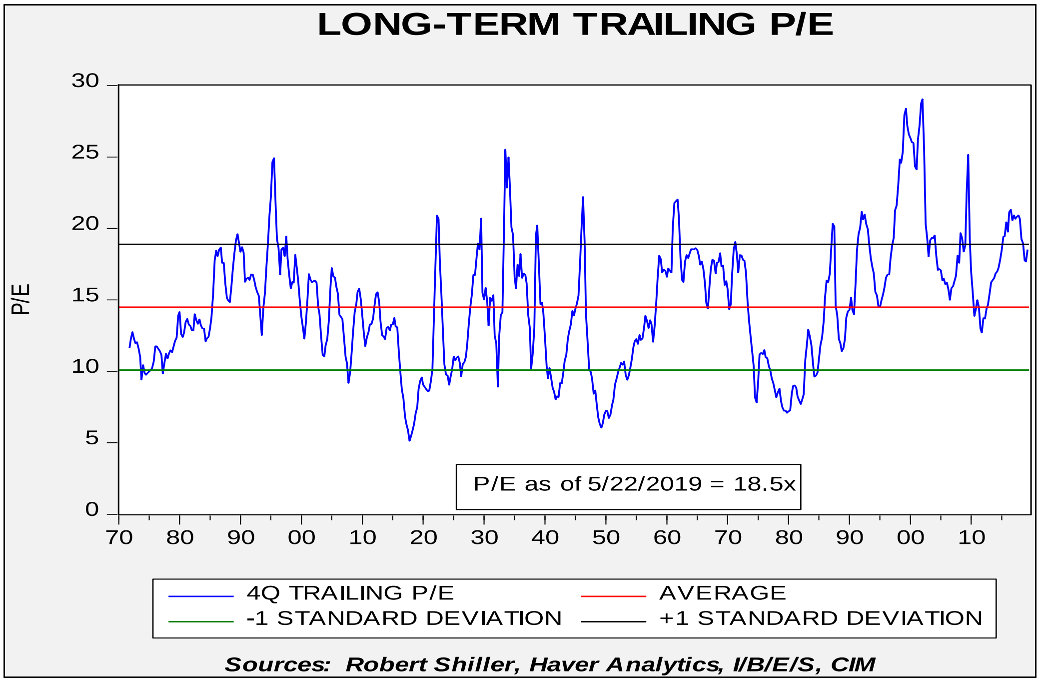
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

May 23, 2019



Based on our methodology,[1] the current P/E is 18.5x, down 0.1x from last week. Improved earnings and lower index values caused the contraction.

[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 and Q4) and two estimates (Q1 and 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.