Daily Comment

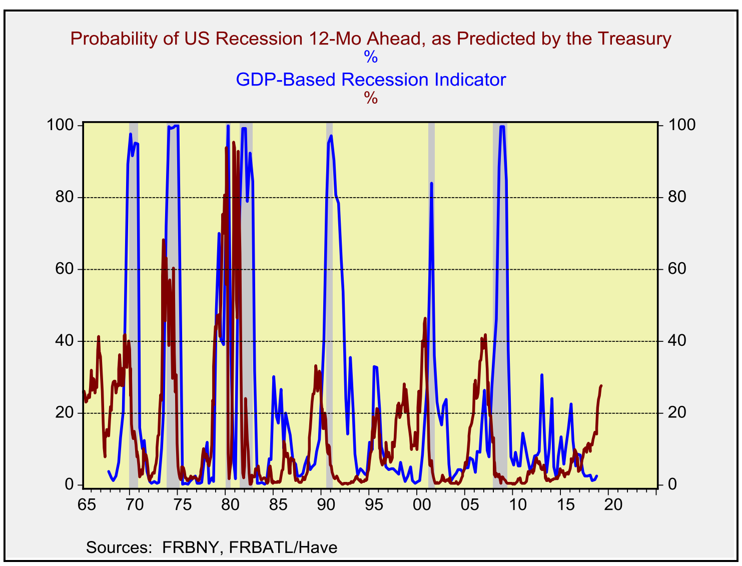
By Bill O'Grady and Thomas Wash

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 29, 2019—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 1.3% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.8% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.2% and the Shenzhen index remained unchanged. U.S. equity index futures are signaling a lower open. With 483 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, 75.6% of the companies reported earnings above forecast, while 18.4% reported earnings below forecast.

Good morning! Risk-off is dominating the financial markets this morning. Here is what we are watching:

Global bonds: U.S. 10-year Treasury yields are falling toward the 2.20% level and yields around the developed world continue to spin lower. Although most economic indicators continue to signal slowing but positive growth, the behavior of the interest rate markets are sending warning signs of potential recession.



This chart shows two recession indicators, one from the NY FRB, which forecasts recession based on the yield curve, and the second from the Atlanta FRB, which estimates the odds of recession from GDP. When the NY indicator breaks above 20% it is a warning signal of a downturn, but we like using the two indicators in concert to reduce the odds of a false positive reading. For example, in the late 1990s, the NY indicator was signaling recession as it is now but it wasn't confirmed by the Atlanta indicator and the recession didn't occur. The opposite condition existed in the mid-1980s. For now, the NY indicator is clearly signaling recession concerns but the likelihood of recession is still low until we also get confirmation from the Atlanta indicator. However, our "antenna" is up.

The European Commission presidency: The process now turns to selecting a president for the European Commission (EC), the position currently held by Jean-Claude Juncker, who is leaving office. The appointment of the president of this body is a complicated process; essentially, this person must be (a) considered a leader of the EU Parliament, thus an important, known figure, officially called a *Spitzenkandidat*, and (b) acceptable to the leaders of the EU countries. In terms of condition (b), not all nations are equal so, in practice, the EC president must be acceptable to Germany and France. Going into the election, Manfred Weber, Merkel's favorite, was considered the front runner. Given that Weber's EPP won the largest share of the vote, he has a claim to the job. However, while he may have passed requirement (a), requirement (b) is becoming a problem because French President Macron is objecting to Weber's appointment. Instead, Macron, along with other leaders in the EU, are pushing other candidates. Complicating matters for Merkel is an apparent political rupture within her CDU Party; she is now defending her hand-selected successor, AKK, after reports surfaced yesterday that Merkel believed she was incapable of leading the German center-right coalition. Merkel has indicated she wants the president named next month, but it is possible the appointment could become protracted. An important side note is that if Merkel loses on Weber, look for Germany to press hard for the ECB presidency. Jens Weidmann, the current president of the Bundesbank, is considered hawkish and his appointment could give a boost to the EUR but would be bearish for Eurozone bonds, especially the periphery.

Hardening on Brexit: The EU is making it abundantly clear that it is in no mood to renegotiate Brexit. In fact, the current president of the EU Council (the body of EU heads of state), Poland's Donald Tusk, indicated that he views the Pro-EU win in the elections as partly due to the hardline take on Brexit, calling the position a "vaccine" to populism. The candidates for Tory leadership are all arguing they will renegotiate a better deal, but it is more likely that we either get a new vote or a hard Brexit before the EU changes its position.

The Populist Right and the EU: Although Tusk noted that the Pro-EU position "won," in reality, the election showed the strength of the populist right. Although these parties didn't win power, they are a significant enough majority that they will have increasing influence. It is interesting to note that these parties are no longer pushing to break up the EU but instead are trying to change the EU to implement policies more to their liking, including deglobalization (against immigration and trade) and anti-environmental regulation.

Currency manipulators: The Treasury has a process whereby it can name a country a "currency manipulator," indicating that it is using its exchange rate unfairly. If a nation is found to have achieved currency manipulator status, the Treasury then opens an investigation which can lead to trade retaliation. The tool has been rarely used, in part, because nearly all nations outside of a few major industrialized nations allow a full float. But, over time, policymakers have tightened the definition of what manipulation looks like. Although the Treasury didn't name a particular [nation](#) as being a manipulator, [it has tightened the rules and expanded the number of countries being monitored](#), setting up a structure to allow this process to become more important in trade policy. Exchange rates have been an item of interest for Treasury Secretary Mnuchin (part of his department's mandate) as he seems concerned that countries hit with tariffs will use exchange rates to mitigate the impact.

Rare earths: In recent days, China has sent clear signals that it is considering using its dominance in rare earth minerals as [a weapon](#) against U.S. trade and technology restrictions. There is precedent for such actions; China cut off Japan from these minerals in 2010 over disputed islands in the South China Sea. This issue will be the topic of next week's WGR.

The tragedy in the farm belt: It has been a cold, wet spring for the nation's midsection, with persistent flooding and otherwise lousy weather. As a result, farmers have been unable to get into the fields to plant. As of May 26, 58% of the nation's corn crop has been planted compared to the past 10-year average of 90% by this reporting week. The southern states, which have been spared from the deluge, are nearly all planted (but are now getting too dry), while Indiana and Ohio are only 22% planted. Illinois, another key corn state, is only 35% planted. We are rapidly reaching the point where the potential loss of yield by planting this late will force farmers into other crops. The most likely alterative is soybeans but planting is well behind normal there as well. Only 29% of the soybean crop is planted compared to the decade average of 62%. There is still time for soybeans to get in the ground if the rain stops soon, but forecasts show rain continuing into the weekend. Complicating matters is the recent tariff relief program announced by the administration which pays farmers only if they put a crop in place. The program incentivizes farmers to plant something and the "something" is most likely soybeans. Of course, the point is moot if the rain doesn't let up. Corn (shown below) and soybean prices, which have been under pressure due to Chinese retaliatory tariffs, are rising sharply on supply fears. But, if the rain stops, there is potential for a sharp drop in soybean prices in the coming weeks.

(Source: Barchart)

More on Baoshang: Yesterday, we reported that Chinese financial regulators had taken over Baoshang Bank due to worries about its solvency. There were two additional news items on this issue. First, China appears to be forcing a [30% "haircut" on bank bondholders](#). Second, the

PBOC made a massive injection of liquidity into the Chinese financial system, an indicator that regulators are concerned about the stability of the banking system in the wake of the takeover.

U.S. Economic Releases

MBA mortgage applications fell 3.3% from the prior week. Purchases and refinancing fell 1.4% and 6.0%, respectively. The average 30-year fixed rate remained unchanged at 4.33%.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Richmond Fed Manufacturing Index	m/m	may	3	7	**
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								
New Zealand	ANZ Activity Outlook	m/m	may	8.5	7.1		**	Equity bullish, bond bearish
	ANZ Business Confidence	m/m	may	-32.0	-37.5		**	Equity and bond neutral
EUROPE								
Italy	Economic Sentiment	m/m	may	100.2	98.7		***	Equity and bond neutral
	Manufacturing Confidence	m/m	may	102.0	100.6	100.4	**	Equity bullish, bond bearish
	Consumer Confidence	m/m	may	111.8	110.5	110.0	***	Equity bullish, bond bearish
Germany	Unemployment Claims Rate	m/m	may	5.0%	4.9%	4.9%	***	Equity bearish, bond bullish
	Unemployment Change	m/m	may	60.0k	-12.0k	-7.5k	**	Equity bullish, bond bearish
France	PPI	y/y	apr	2.2%	1.9%		**	Equity bearish, bond bullish
	Consumer Spending	y/y	apr	1.2%	-1.9%	0.6%	***	Equity bullish, bond bearish
	CPI EU Harmonized	y/y	may	1.1%	1.5%	1.2%	***	Equity and bond neutral
	CPI	m/m	may	1.0%	1.3%	1.1%	***	Equity and bond neutral
	GDP	m/m	1q	1.2%	1.1%	1.1%	***	Equity and bond neutral
Switzerland	KOF Leading Indicator	m/m	may	94.4	96.2	96.0	**	Equity bearish, bond bullish
	Credit Suisse Survey Expectations	m/m	may	-14.3	-7.7		**	Equity and bond bearish
AMERICAS								
Mexico	Unemployment Rate	m/m	apr	3.5%	3.6%	3.6%	***	Equity and bond neutral
Brazil	Federal Debt Total	m/m	apr	3.879 tn	3.918 tn		**	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)	252	252	0	Up
3-mo T-bill yield (bps)	230	230	0	Neutral
TED spread (bps)	23	22	1	Neutral
U.S. Libor/OIS spread (bps)	237	237	0	Up
10-yr T-note (%)	2.24	2.27	-0.03	Neutral
Euribor/OIS spread (bps)	-32	-31	-1	Neutral
EUR/USD 3-mo swap (bps)	18	19	-1	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	flat			Up
yen	flat			Neutral
pound	flat			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	$68.80	$70.11	-1.87%	Rising Trade Tensions
WTI	$57.95	$59.14	-2.01%	
Natural Gas	$2.61	$2.58	1.24%	
Crack Spread	$22.84	$22.98	-0.59%	
12-mo strip crack	$18.58	$18.71	-0.72%	
Ethanol rack	$1.58	$1.54	2.10%	
Metals				
Gold	$1,283.18	$1,279.33	0.30%	
Silver	$14.38	$14.35	0.22%	
Copper contract	$266.60	$269.60	-1.11%	
Grains				
Corn contract	$ 437.00	$ 420.25	3.99%	Poor Weather Conditions
Wheat contract	$ 519.75	$ 504.75	2.97%	
Soybeans contract	$ 886.75	$ 856.00	3.59%	
Shipping				
Baltic Dry Freight	1082	1066	16	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-0.5		
Gasoline (mb)		-0.8		
Distillates (mb)		0.9		
Refinery run rates (%)		1.00%		
Natural gas (bcf)				

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temps for most of the country. Precipitation is expected for most of the country.

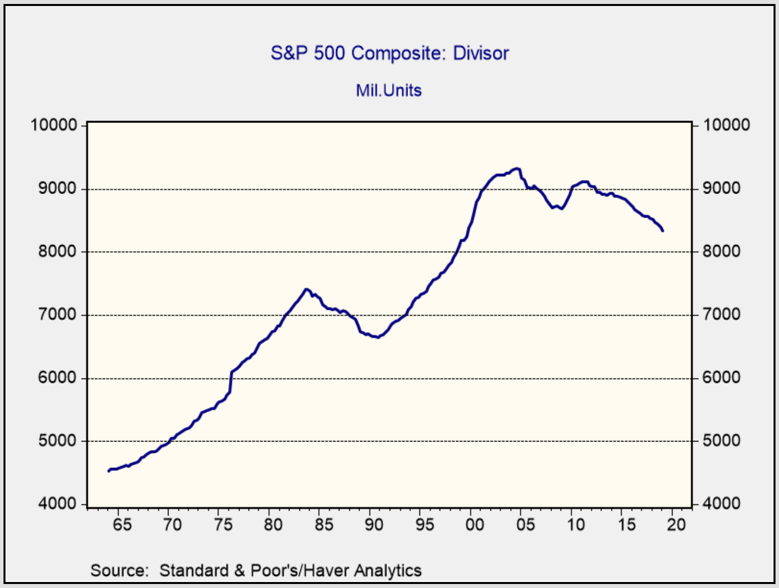
<u>**Asset Allocation Weekly**</u>

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.

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.

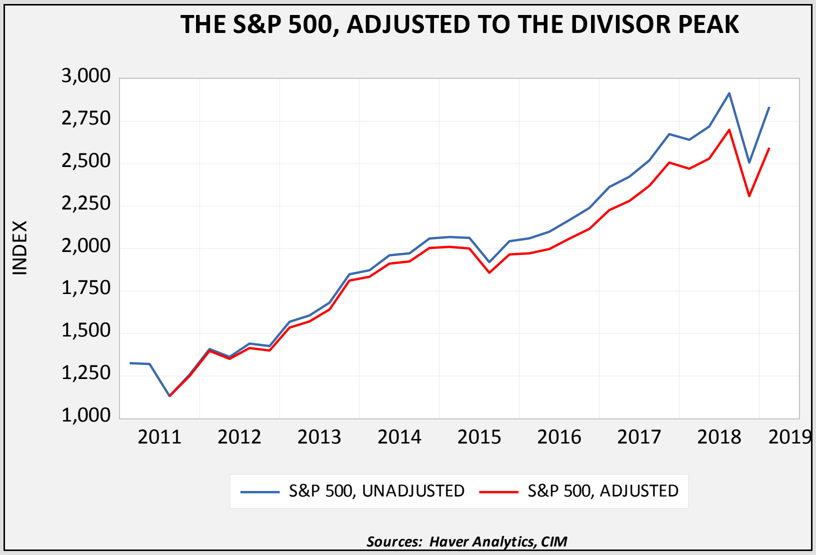
To calculate the impact of the divisor, we would use the following formula:

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

Rearranging terms leads to this formula:

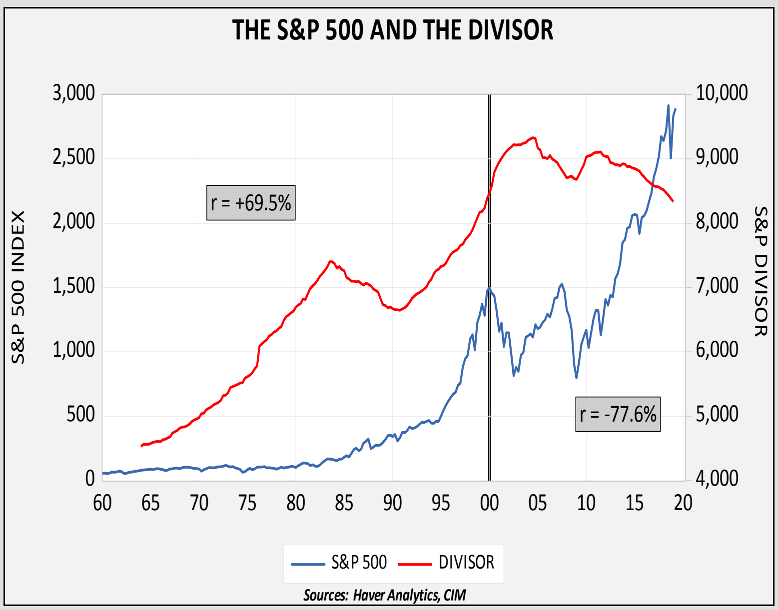
S&P Index = S&P Market Capitalization/Divisor

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.

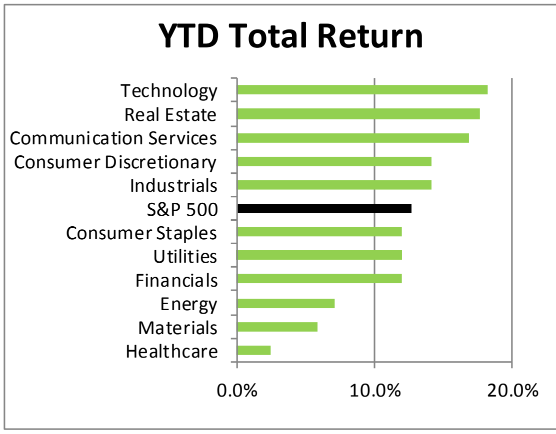
The more important question is if or when the trend in the divisor might reverse. In general, history suggests that elevated equity market values tend to trigger equity issuance. However, that has not been the case since 2000.

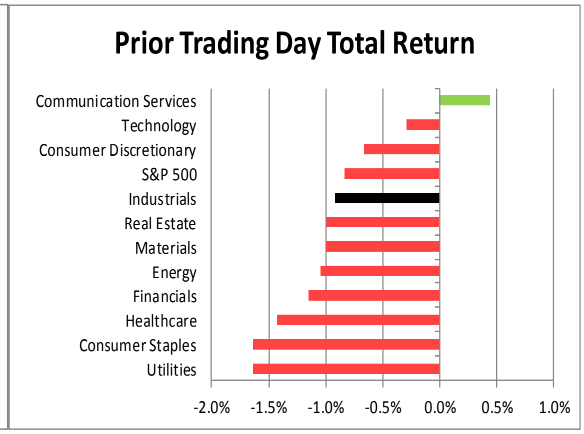


This chart shows the divisor and the S&P 500 Index since 1964. From that year to Q1 2000, the two series were positively correlated at the 69.5% level. However, since then, the correlation between the two series has not only flipped to inverse but strengthened. During this century, for the most part, 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.

Data Section

U.S. Equity Markets – (as of 5/28/2019 close)

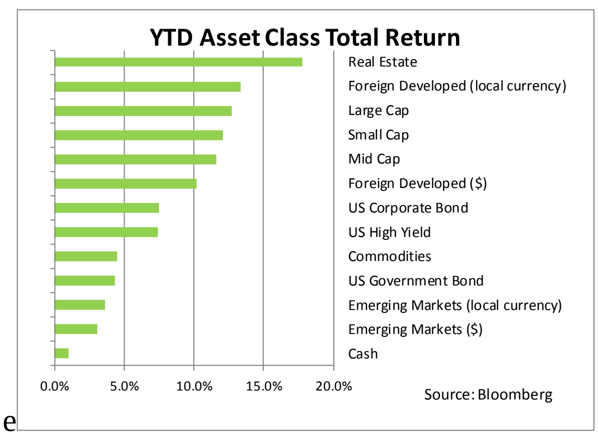




(Source: Bloomberg)

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 5/28/2019 close)



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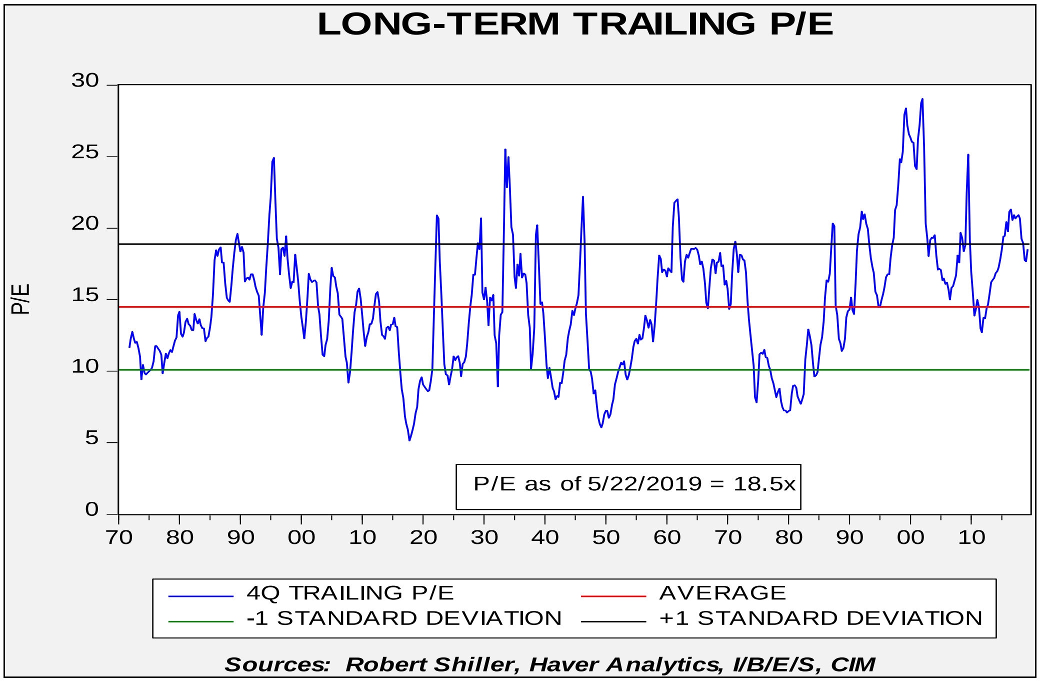
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.