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: November 6, 2019—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.3% from its last close. In Asia, the MSCI Asia Apex 50 closed up 0.2%. Chinese markets were lower, with the Shanghai composite down 0.4% and the Shenzhen index down 0.9% from the prior close. U.S. equity index futures are signaling a higher open. With 383 companies having reported, the S&P 500 Q3 earnings stand at $42.40, higher than the $41.08 forecast for the quarter. The forecast reflects a 4.0% decrease from Q3 2018 earnings. Thus far this quarter, 76.0% of the companies reported earnings above forecast, while 16.7% reported earnings below forecast.

The second episode of the *Confluence of Ideas* podcast is available!

A German breakthrough? Since unification, Germany has supported the EU with certain qualifications. The primary goal, at least from the German point of view, is to prevent giving the rest of the profligate Europeans free access to German saving. As part of that fear, Germany has resisted the creation of a Eurozone bond, a bond that would have the full faith and credit of all the nations of the Eurozone. Although such a bond would be a significant competitor to the U.S. Treasury and raise the likelihood that the EUR would become a viable reserve currency, Germany has feared that its free-spending neighbors would borrow using this bond and force Germany to make good on the paper. So far, a single bond hasn't developed and that means a foreign nation holding EUR as reserves must choose a national bond to hold. Given the divergence in yield and credit quality, this can be a difficult choice. Another area of disagreement has been over deposit insurance. It would be better for the Eurozone, since everyone has the same central bank, to have a unified regulatory structure. This would include unified deposit insurance. However, for reasons similar to its opposition to a Eurobond, Germany fears that a bad failure in another Eurozone nation could force German savers to spend money to bail out foreign depositors. That opposition may be cracking. Germany's finance minister, Olaf Scholz, indicated he might support a unified deposit insurance program. If such a program does develop, it would reduce the risk for Eurozone banks and likely give their equities a lift.

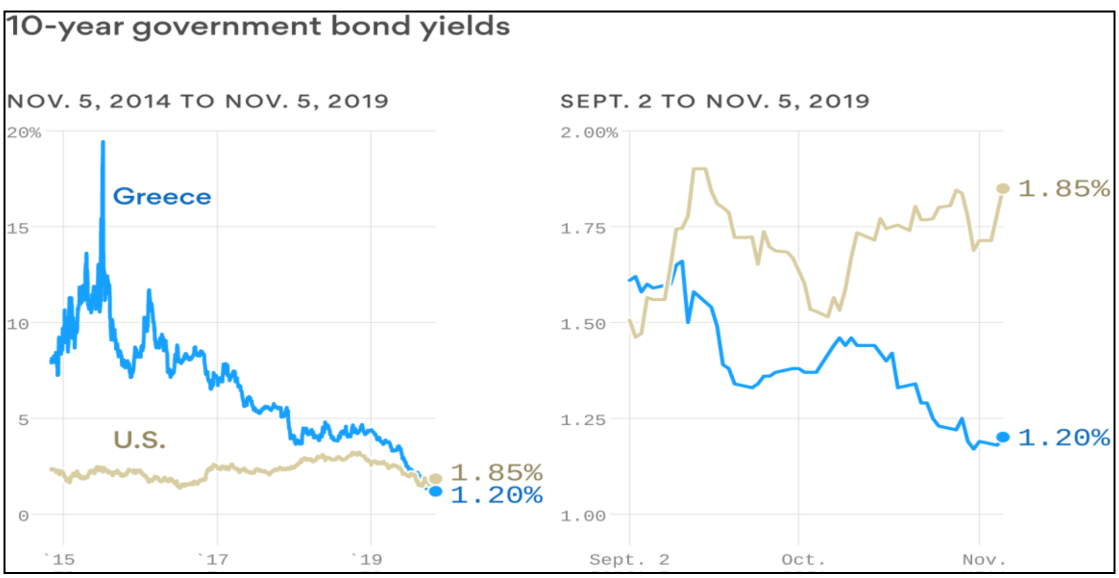
China's Eurobond: Although the Eurozone doesn't issue a Eurobond, apparently China does. China has just issued a Euro-denominated bond, the first in 15 years. The Chinese financial authorities sold €4 bn of bonds with seven-, 12- and 20-year maturities. Half of the proceeds were issued in the seven-year at a 0.197% yield, with the remainder split equally between the other two maturities. The 12-year carried a yield of 0.618% and the 20-year has a yield of 1.078%. Demand was quite strong, with a bid/cover of 4.87x. Part of the reason demand was strong is that China is considered a safe credit (even though it can't print euros) and the seven-year yield compares favorably to a -0.5% German yield. We suspect China has issued this paper to diversify its funding base; foreign-issued EUR paper is only about 5% of the world's foreign denominated bonds, with USD dominating nearly all the rest.

China trade: Optimism on a trade deal is high. Both sides seem to want a deal, and there is evidence that the Chinese leadership is preparing its citizens for a partial, not complete, removal of tariffs. The Chinese position seems to be a measured and proportional removal of tariffs on both sides. There is a problem with this plan, unfortunately, which is that the U.S. has a much larger target of Chinese imports to apply tariffs. A pure one-for-one removal will leave China at a disadvantage. This issue may be leading Chinese negotiators to overplay their hand. In effect, China seems to want a near full removal of tariffs for opening up agricultural trade and promising to guard intellectual property. This would seem to take away President Trump's favorite trade tool—the tariff. If China is really insisting that the U.S. forgo future tariffs for what it has offered, this will look like a cave by the U.S., something the White House probably won't accept. This all means that risk markets have been rising on expectations of a trade agreement; if that deal fails, as small as it will likely be, the reaction will be negative for equities.

On a side note, Europe is becoming worried that the focus on U.S. and China trade is leaving Europe out of the discussion. The Chinese vice premier recently canceled a trip to Brussels.

Saudi Aramco IPO: Our suspicions that the Saudis would want to push up oil prices into the IPO have been confirmed. The kingdom may need all the help it can get; foreign buyers will likely remain cautious about the geopolitical risk of the Saudi state oil company.

A weird world we live in: Greek sovereign bonds are on a tear. Its 10-year yields, which hit 34.8% in December 2011, are currently yielding 1.20%. That's right…that's significantly less than the current U.S. 10-year at 1.85%.



(Source: Axios)

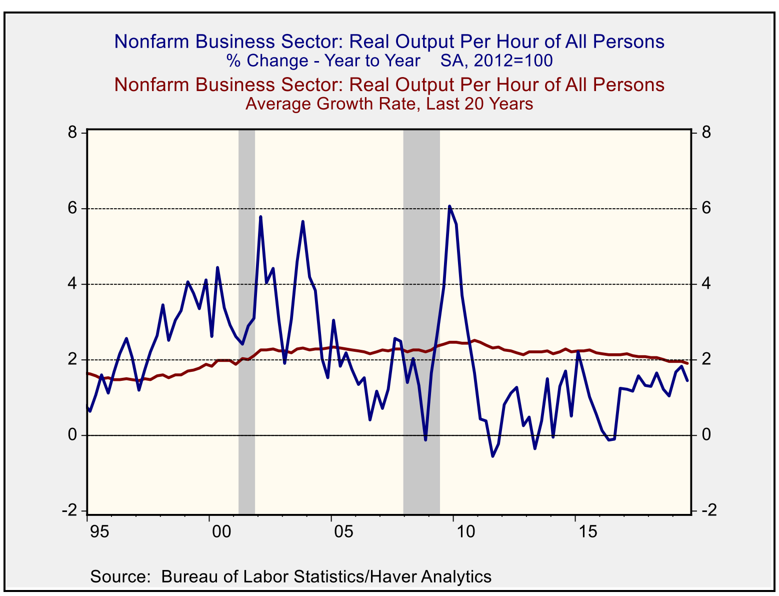
The reason? European inflation remains low and Greece has cleaned up its act after the near debacle earlier this decade. However, we agree it makes little sense to believe that the risk of Greece is less than the U.S. After all, Greece still is issuing bonds in a currency it can't print. Perhaps this is the clearest evidence yet of the distortions caused by low and negative policy rates.

Odds and ends: [Russia has moved a small number of troops into Libya] to support [Khalifa Hifter]. This action is further evidence of Russia expanding its influence in the Middle East. The U.S. is [expanding the military mission in Syria solely to control the oil fields]. [China is signaling that it will back stronger action] to stabilize Hong Kong.

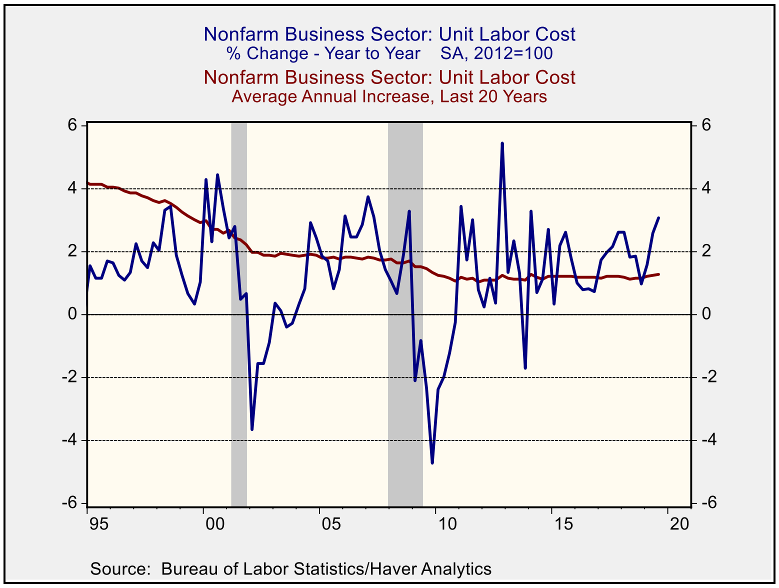
U.S. Economic Releases

MBA mortgage applications edged down 0.1% in the week ended November 1. Applications for home-purchase mortgages fell 2.5%, but applications for refinancing mortgages rose 1.8%. The average interest rate on a 30-year, fixed-rate mortgage fell back to 3.98%.

Separately, new data showed a drop in U.S. workers' productivity, defined as the average value of output per hour worked. After stripping out seasonal impacts and price changes, preliminary third quarter nonfarm productivity fell at an annualized rate of 0.3%. That was far short of both the expected increase of 0.9% and the revised second quarter growth rate of 2.5%. The data suggests that as the unemployment rate remains low and companies are forced to scrounge for new workers, their newest hires may not be particularly productive. While hours worked jumped in the period, output accelerated only modestly. On top of that, hourly compensation continued to rise briskly. Preliminary third quarter unit labor costs therefore rose strongly at a rate of 3.6%, way ahead of both the expected growth rate of 2.9% and the revised second quarter growth rate of 2.4%.



Compared with the same period one year earlier, productivity in the third quarter was up a modest 1.4%, substantially weaker than the average increase of 1.9% over the last 20 years. The chart above compares the year-over-year growth in productivity to its long-run average since the mid-1990s.



With productivity growth weak, unit labor costs have also been rising relatively fast. As shown in the chart above, unit labor costs in the third quarter were up 3.1% from one year earlier, far above their average annual rise of just 1.3% over the last two decades. Rising unit labor costs will increase pressure on profit margins.

The table below lists the Federal Reserve events scheduled for the rest of the day.

Economic Releases		
	No economic releases today	
Fed Speakers or Events		
	Speaker or event	**District or position**
8:00	Charles Evans speaks at an event in New York	President of the Federal Reserve Bank of Chicago
9:30	John Williams participates in Q&A in New York	President of the Federal Reserve Bank of New York
15:15	Patrick Harker discusses Innovation and the Future of Work	President of the Federal Reserve Bank of Philadelphia

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	Jibun PMI Composite	m/m	oct	49.1	49.8		**	Equity bearish, bond bullish
	Jibun PMI Services	m/m	oct	49.7	50.3		**	Equity bearish, bond bullish
New Zealand	Unemployment Rate	m/m	oct	4.2%	3.9%	4.1%	**	Equity bearish, bond bullish
	Employment Change	y/y	oct	0.9%	1.4%	0.9%	*	Equity bearish, bond bullish
South Korea	Current Account Balance	m/m	sep	$7477.2 Mil.	$5265.6 Mil.		**	Equity bullish, bond bearish
	Merchandise Trade Balance	m/m	sep	$8836.5 Mil.	$4768.3 Mil.		*	Equity bullish, bond bearish
EUROPE								
Eurozone	Markit Services PMI	m/m	oct	52.2	51.8	51.8	**	Equity bullish, bond bearish
	Markit Composite PMI	m/m	oct	50.6	50.2	50.2	**	Equity bullish, bond bearish
	Retail Sales	y/y	sep	3.1%	2.1%	2.4%	*	Equity bullish, bond bearish
Germany	Markit Services PMI	m/m	oct	51.6	51.2	51.2	**	Equity and bond neutral
	Markit Composite PMI	m/m	oct	48.9	48.6	48.6	**	Equity and bond neutral
	Factory Orders	y/y	sep	-5.4%	-6.7%	-6.3%	**	Equity bullish, bond bearish
France	Markit Services PMI	m/m	oct	52.9	52.9	52.9	**	Equity and bond neutral
	Markit Composite PMI	m/m	oct	52.6	52.6	52.6	**	Equity and bond neutral
Italy	Markit Services PMI	m/m	oct	52.2	51.4	51.4	**	Equity bullish, bond bearish
	Markit Composite PMI	m/m	oct	50.8	50.6	50.6	**	Equity and bond neutral
Russia	Markit Services PMI	m/m	oct	55.8	53.6	52.8	**	Equity bullish, bond bearish
	Markit Composite PMI	m/m	oct	53.3	51.4		**	Equity bullish, bond bearish
	CPI	y/y	oct	3.8%	4.0%	3.8%	***	Equity and bond neutral
	Core CPI	y/y	oct	3.7%	4.0%	3.9%	*	Equity and bond neutral
AMERICAS								
Mexico	Gross Fixed Investment	m/m	aug	-4.3%	-7.6%	-6.0%	**	Equity and bond neutral
	Consumer confidence	m/m	oct	43.9	44.7	45.0	*	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)	191	189	2	Down
3-mo T-bill yield (bps)	152	152	0	Neutral
TED spread (bps)	39	37	2	Neutral
U.S. Libor/OIS spread (bps)	156	156	0	Up
10-yr T-note (%)	1.85	1.86	-0.01	Down
Euribor/OIS spread (bps)	-40	-40	0	Neutral
EUR/USD 3-mo swap (bps)	12	13	-1	Down
Currencies	**Direction**			
dollar	Down			Up
euro	Up			Up
yen	Up			Down
pound	Flat			Up
franc	Flat			Up

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	$62.61	$62.96	-0.56%	
WTI	$57.10	$57.23	-0.23%	
Natural Gas	$2.87	$2.86	0.42%	
Crack Spread	$16.85	$17.07	-1.32%	
12-mo strip crack	$18.43	$18.57	-0.80%	
Ethanol rack	$1.67	$1.67	-0.15%	
Metals				
Gold	$1,484.24	$1,483.61	0.04%	
Silver	$17.44	$17.58	-0.81%	
Copper contract	$269.30	$270.05	-0.28%	
Grains				
Corn contract	$ 384.00	$ 381.75	0.59%	
Wheat contract	$ 517.50	$ 515.25	0.44%	
Soybeans contract	$ 934.50	$ 934.25	0.03%	
Shipping				
Baltic Dry Freight	1656	1675	-19	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.0		
Gasoline (mb)		-2.0		
Distillates (mb)		-1.3		
Refinery run rates (%)		0.75%		
Natural gas (bcf)		89.0		

Weather

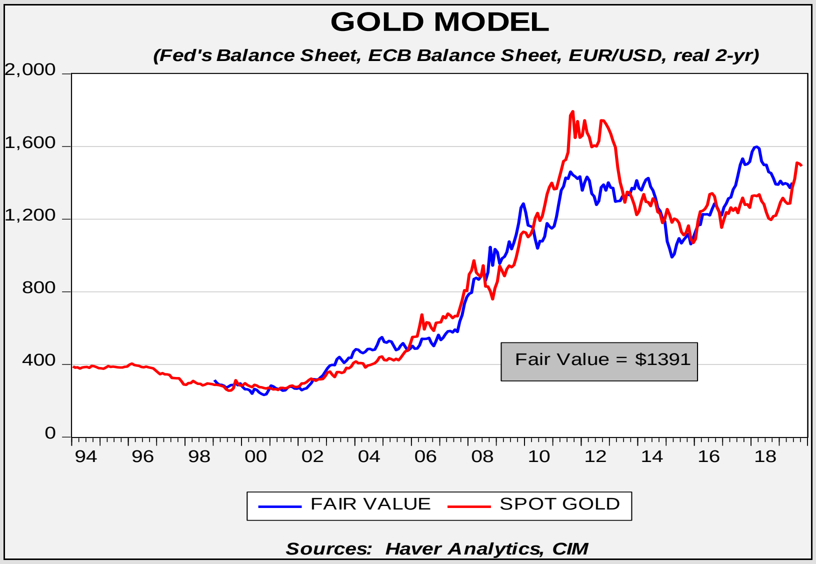
The 6-10 and 8-14 day forecasts call for much colder-than-normal temperatures for the Midwest and East Coast, with warmer-than-normal temperatures in California and the Southwest. Wet conditions are expected in the south, while unusually dry conditions are anticipated throughout the West.

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.

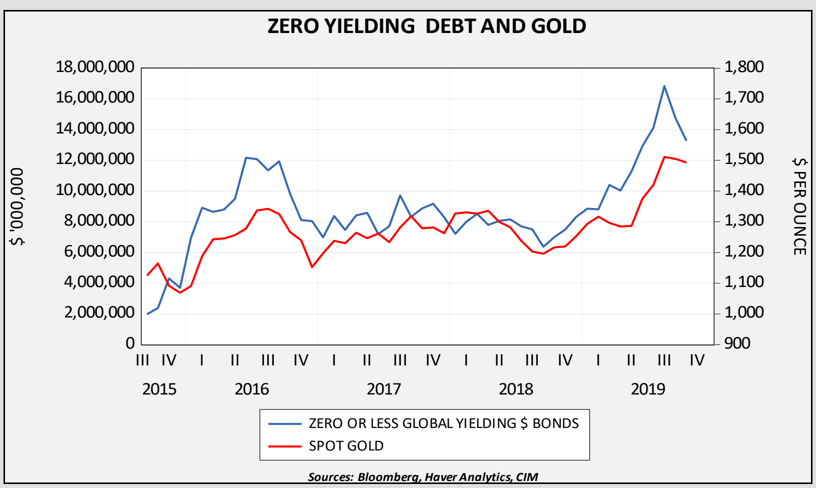
November 1, 2019

We continue to hold a favorable outlook toward gold despite evidence that current prices may be getting a bit ahead of themselves. Our gold model puts fair value at 1391.



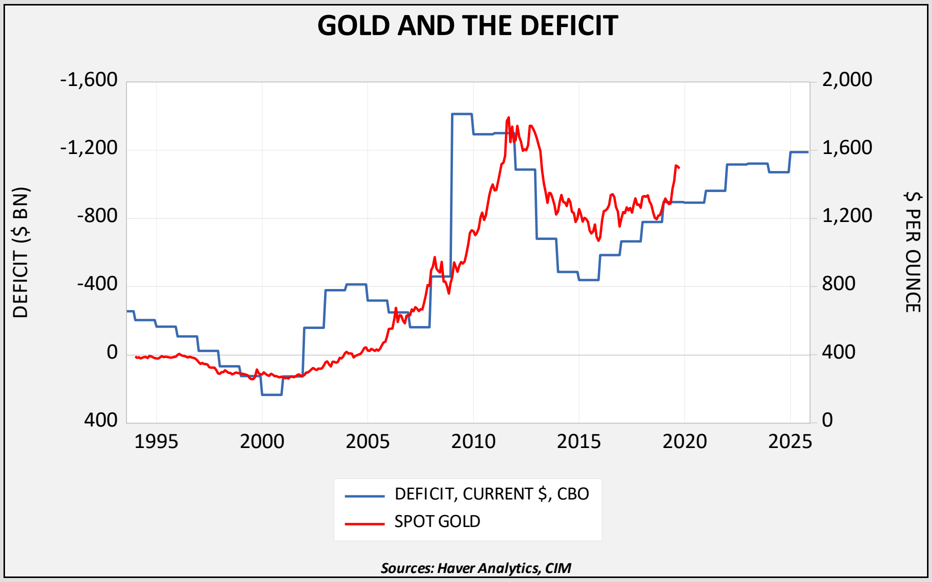
In the coming months, we expect the fair value to rise; both the ECB and the Federal Reserve have resumed expanding their balance sheets. And, the Fed will likely continue to cut rates, which would be expected to reduce the real interest rate on two-year T-notes. The dollar remains overvalued but will likely need a catalyst to trigger depreciation. Still, over time, we do expect gold prices to find support from improving fundamentals.

In addition, the high level of zero-yielding debt should be supportive.



We have seen a drop in zero-yielding debt recently, but with slowing global economic growth, a renewed expansion is likely.

Finally, there is a long-term relationship between gold prices and the level of the fiscal deficit. Although the level of the current deficit does suggest, again, that gold prices might be a bit overvalued currently, the likelihood of expanding deficits should offer underlying support for gold prices.

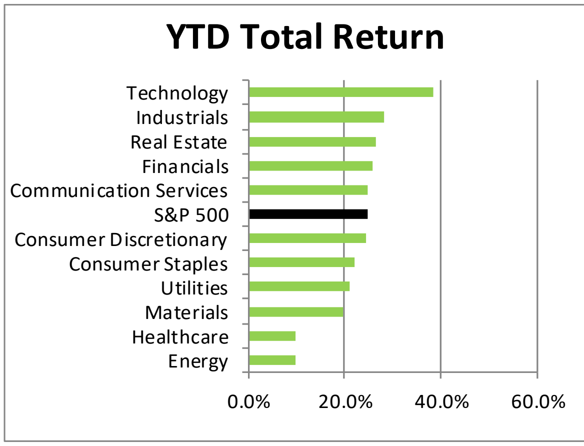


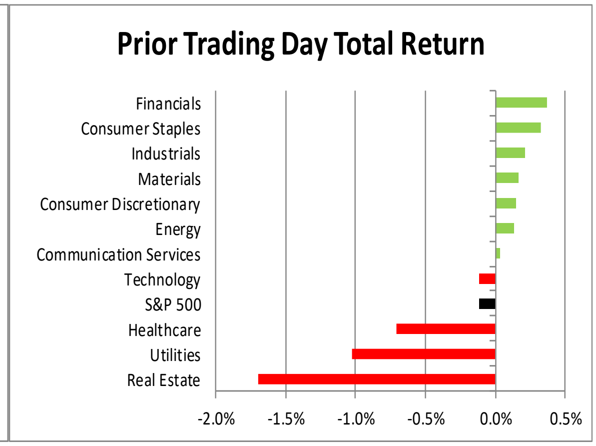
In the immediate term, we may see steady to lower gold prices but there are ample fundamental factors that should support future prices.

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 11/5/2019 close)

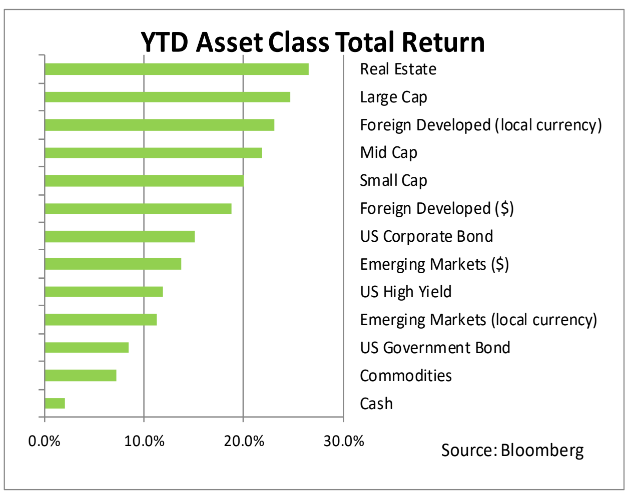




(Source: Bloomberg)

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 11/5/2019 close)

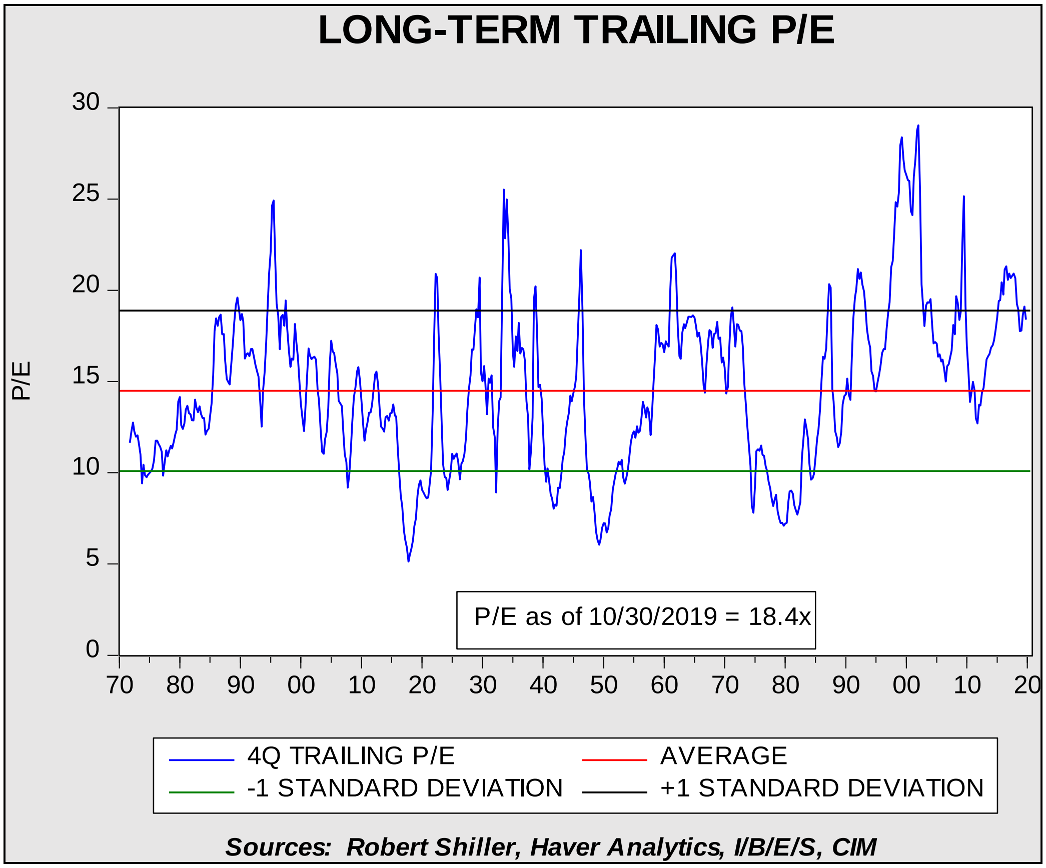


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

October 31, 2019



Based on our methodology,[1] the current P/E is 18.4x, up 0.21x from last week. The rise in the P/E is due to higher equity prices.

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.

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[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 two actual quarters (Q1 and Q2) and two estimates (Q3 and Q4). 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.