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 11, 2019—9:30 AM EST] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.2% from its last close. In Asia, the MSCI Asia Apex 50 closed down 1.7%. Chinese markets were down, with the Shanghai composite down 1.8% and the Shenzhen index down 2.3% from the prior close. U.S. equity index futures are signaling a lower open. With 445 companies having reported, the S&P 500 Q3 earnings stand at $42.50, higher than the $41.08 forecast for the quarter. The forecast reflects a 4.0% decrease from Q3 2018 earnings. Thus far this quarter, 75.5% of the companies reported earnings above forecast, while 17.5% reported earnings below forecast.

It's Veterans' Day; Treasury markets are closed but equities trade today. Risk assets are lower this morning. A lot of global political news. Update on trade. Here is what we are watching this morning:

Global political news: There was a plethora of political news over the weekend. Here is a recap:

1. Spain—The country held elections and the outcome, as expected, was muddled. PM Sanchez's Socialists won the majority of seats but actually ceded three seats compared to the last election. His party won 28% of the vote, down from 29% in the last election. The populist right wing Vox party was the big winner, gathering 15% of the vote, up from 10% last election. Given the distribution of seats, there is no natural path to a coalition. Sanchez may either govern with a minority, or try a grand coalition with the center right. However, all outcomes point to another election.
2. Bolivia—Eva Morales, the current president who claimed to have won recent elections, was "encouraged" to step down by the nation's police and military. Recent elections were marred with fraud and unrest was rising. In addition, Morales's re-election appeared to violate the constitution he implemented. It is not clear who will govern Bolivia; Carlos Mesa came in second in the disputed election last month; new elections may be necessary. Mexico has offered Morales exile.
3. Brazil—Former Brazilian President Luiz Inácio Lula da Silva, commonly referred to as "Lula," was released from prison over the weekend. The Supreme Court of Brazil ruled that he was imprisoned before all of his defenses had been exhausted. There is evidence to suggest prosecutors engaged in unscrupulous behavior to imprison Lula before the last elections. The return of Lula is a significant political threat to the Bolsonaro government.

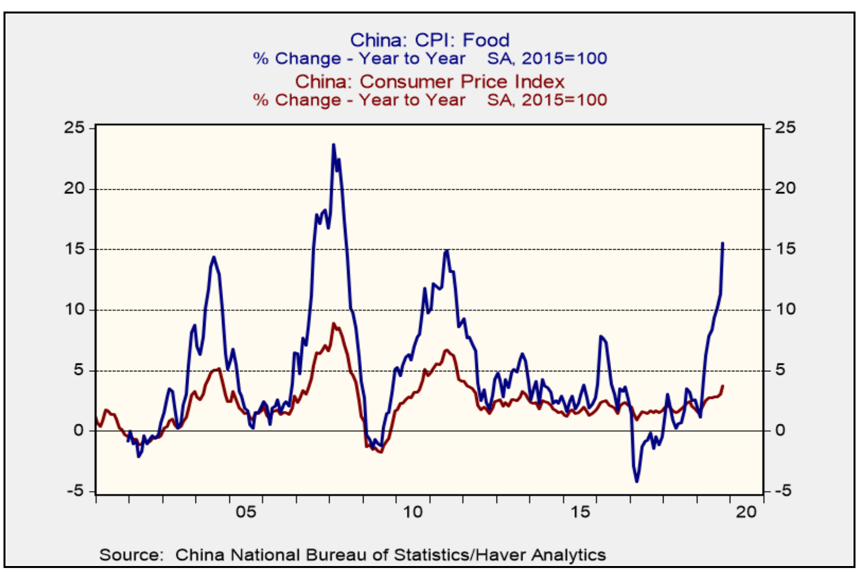
Lula was implicated in corruption and may still return to prison at some point. But he is popular and offers a left-wing alternative to the current regime.

4. U.K.—In an unexpected retreat, Nigel Farage announced this morning that his Brexit party won't run party candidates against Tories in next month's election. That decision greatly reduces the threat form the right flank for Johnson and increases the odds he will win the upcoming election. The Tories continue to lead in the polls. Meanwhile, the Scottish National Party has informed Labour that if it wants its support in building a government, it will have to agree to a new independence referendum. Moody's has lowered its outlook on the U.K. due to Brexit. The GBP rallied on the news.
5. Chile—After weeks of political protests primarily against inequality, the government acceded to a key demand of the demonstrators by agreeing to draft a new constitution to replace the current one, which dates back to the dictatorship of Augusto Pinochet. It is still unclear how effective the move will be in ending the tensions and restoring calm to Chile's markets

Trade news: President Trump cooled recent market ardor by indicating he wasn't planning on rolling back any tariffs. We may get further clarification this week from the president himself, who speaks to the Economic Club of New York tomorrow. Meanwhile, Peter Navarro continues to indicate that there will be no rollback in tariffs. Meanwhile, on Wednesday, the U.S. will decide on auto tariffs; the auto industry is lobbying for a postponement.

Hong Kong: A protestor was apparently shot with live ammunition from close range, and reportedly is in critical condition. Six pro-democracy lawmakers were also arrested. Protestors apparently set a man on fire. Although tensions remain high, Beijing has been careful not to crack down with excessive force because Hong Kong remains a key conduit for Western finance.

China data: China's inflation remains elevated due to pork supply issues.



Overall CPI rose 3.8% from last year led by a 15.5% jump in food prices. Pork inflation is up 100%, a doubling of prices, over the past year. The African Swine Fever is the culprit for reducing supply. Core CPI, on the other hand, remains well contained, at +1.6%. Loan growth in October was weaker than forecast, rising CNY 661 billion, down from CNY 1.69 trillion in September. Despite easing by the PBOC, loan growth is stagnant and will likely need further stimulus to lift growth.

Macron speaks: This weekend's Economist reported on a long interview with French President Macron. He discussed, at length, the withdrawal of the U.S. from European security, calling NATO "brain dead." The interview was widely discussed across Europe; Polish Prime Minister Morawiecki strongly criticized French President Macron's suggestion last week that Europe could no longer rely on the United States fulfilling its mutual defense commitments under NATO. Turning the tables, Morawiecki questioned whether France would fulfill its obligation to spend more on defense. Although Macron's position is unpopular, we tend to think Macron is right. Europe's key problem is that it hasn't been able to integrate Germany into the continent since its founding in 1870. The only system that kept the peace for an extended period involved the U.S. providing a security guarantee. Without it, Germany will need to rearm; how it does so without triggering fear is the question.

Saudi Aramco: The company has released a prospectus for its December 5th pricing. It does not indicate the total amount to be floated or the valuation. The company has pledged a $75 bn dividend through 2024 to increase investor interest. Another item of interest was the slide in profits caused by the attack on its oil gathering facilities.

European Central Bank: As further evidence that ultraloose monetary policy has probably hit its economic and political limits, members of the ECB's top policymaking council are preparing to tell newly inaugurated ECB President Lagarde that they want greater control over interest-rate decisions. That sets up a potential disappointment in the Eurozone's bond market, since investors are currently pricing in another rate cut next spring.

Oil market news: Iran claims it has found a 53-billion-barrel reserve. This news has not been confirmed. Venezuela is selling oil cheaply in a bid to evade U.S. sanctions. There are reports that shale-focused petroleum companies are preparing to pump less oil and gas, calculating that it's better to spend and produce less today while hoping for higher commodity prices in the future. The article quotes an estimate that shale producers expect to spend 17% less in 2020 than in 2019. While the article suggests this renewed discipline will be financially beneficial for drillers, it doesn't mention that there would also likely be economic costs. As in 2014 to 2016, when plunging crude prices discouraged new drilling, the impact would probably range from decreased demand and pricing for steel to slower employment growth in the oil patch. Coupled with the headwinds from the trade war and the lingering impact of the previously tight monetary policy, reduced oil and gas investment will mean a continuing risk of economic slowing and weaker equity markets going forward.

Odds and ends: Farmers are turning to other lenders as banks shun the sector. As a result, borrowing costs are rising. The practice of auto lenders to wrap "underwater" trade-ins into new, higher interest loans examined here. The unemployment rate for recent college graduates has increased.

U.S. Economic Releases

There were no new economic releases scheduled prior to the publication of this report.

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								
China	Aggregate Financing	m/m	oct	618.9 Bil	2270 Bil	950.0 Bil	*	Equity and bond neutral
	New Yuan Loans	m/m	oct	661.3 Bil	1690.0 Bil	800.0 Bil	**	Equity and bond neutral
	Money Supply M2	m/m	oct	8.4%	8.4%	8.4%	**	Equity and bond neutral
India	Industrial Production	y/y	sep	-4.3%	-1.1%	-2.5%	***	Equity and bond bearish
EUROPE								
Germany	Wholesale Price Index	y/y	oct	-2.3%	-1.9%		**	Equity and bond bearish
Italy	Industrial Production	y/y	sep	-2.1%	-1.8%	-2.1%	***	Equity and bond bearish
U.K.	Industrial Production	m/m	sep	-1.4%	-1.8%	-1.2%	***	Equity and bond bearish
	Manufacturing Production	m/m	sep	-1.8%	-1.7%	-1.6%	***	Equity and bond bearish
	GDP	y/y	3q	1.0%	1.3%	1.1%	***	Equity and bond neutral
	Visible Trade Balance	m/m	sep	-12.541 Bil	-9.806 Bil	-10.100 Bil	**	Equity bearish, bond bullish
	Construction Output	m/m	sep	0.5%	2.4%	0.8%	**	Equity and bond neutral
AMERICAS								
Mexico	Nominal Wages	m/m	oct	6.2%	4.0%		***	Equity and bond neutral
	Industrial Production	m/m	sep	-1.8%	-1.3%	-1.7%	***	Equity and bond neutral
Canada	Housing Starts	y/y	oct	202.0k	221.1k	220.0k	**	Equity and bond neutral
	Net Change in Employment	m/m	oct	-1.8k	53.7k	15.0k	***	Equity bearish, bond bullish
	Unemployment Rate	m/m	oct	5.5%	5.5%	5.5%	***	Equity and bond neutral
	Building Permits	m/m	sep	-6.5%	6.1%	-2.0%	***	Equity and 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)	190	190	0	Down
3-mo T-bill yield (bps)	151	152	-1	Neutral
TED spread (bps)	39	38	1	Neutral
U.S. Libor/OIS spread (bps)	155	156	-1	Up
10-yr T-note (%)	1.94	1.94	0.00	Down
Euribor/OIS spread (bps)	-40	-40	0	Neutral
EUR/USD 3-mo swap (bps)	16	16	0	Down
Currencies	**Direction**			
dollar	Down			Up
euro	Up			Up
yen	Down			Down
pound	Up			Up
franc	Down			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	$61.89	$62.51	-0.99%	Trade Uncertainty
WTI	$56.53	$57.24	-1.24%	
Natural Gas	$2.68	$2.79	-3.98%	
Crack Spread	$15.48	$15.30	1.19%	
12-mo strip crack	$17.64	$17.68	-0.23%	
Ethanol rack	$1.67	$1.66	0.31%	
Metals				
Gold	$1,464.35	$1,459.00	0.37%	
Silver	$16.89	$16.81	0.43%	
Copper contract	$266.10	$268.20	-0.78%	
Grains				
Corn contract	$ 375.00	$ 377.25	-0.60%	
Wheat contract	$ 506.25	$ 510.25	-0.78%	
Soybeans contract	$ 926.75	$ 931.00	-0.46%	
Shipping				
Baltic Dry Freight	1378	1428	-50	

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 the western half of the country. Wet conditions are expected on the East Coast, while unusually dry conditions are anticipated throughout the western region.

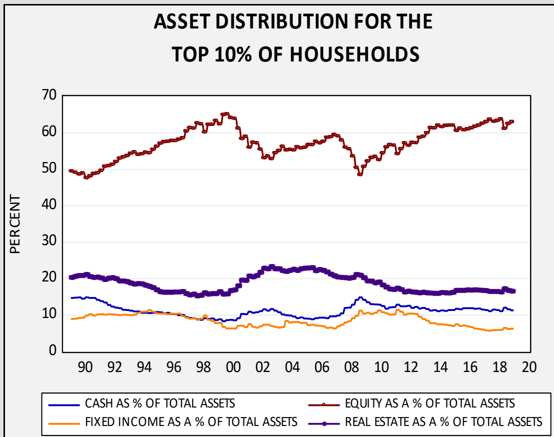
Asset Allocation Weekly

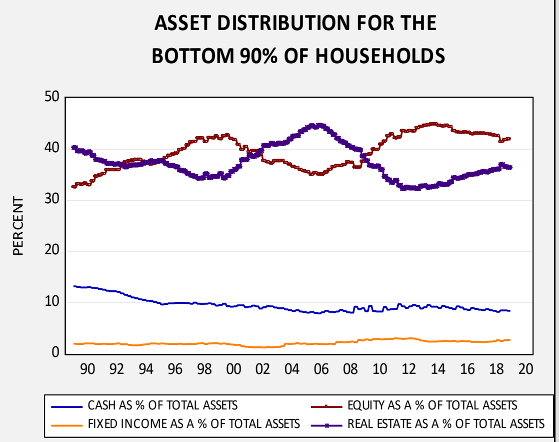
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

November 8, 2019

The Federal Reserve, in its Financial Accounts of the United States database,[1] has created a Distributional Financial Accounts sub-database that measures household wealth by percentile groups. The data is only reported in four broad categories (Top 1%, 90% to 99%, 50% to 89%, and bottom 50%) and has a fairly short history, starting in Q3 1989. However, even with these limitations, it offers some interesting insights into which different segments of society hold wealth.

For starters, we group the data by the top 10% compared to the bottom 90%.



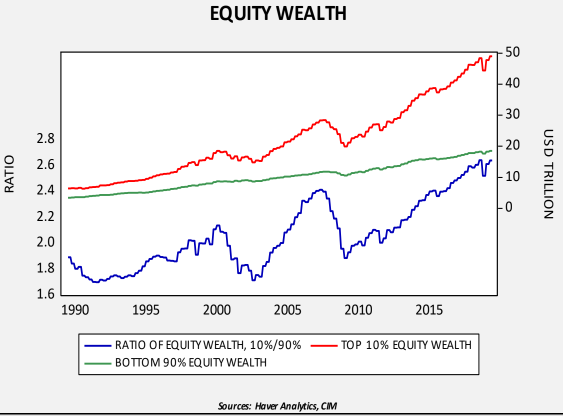


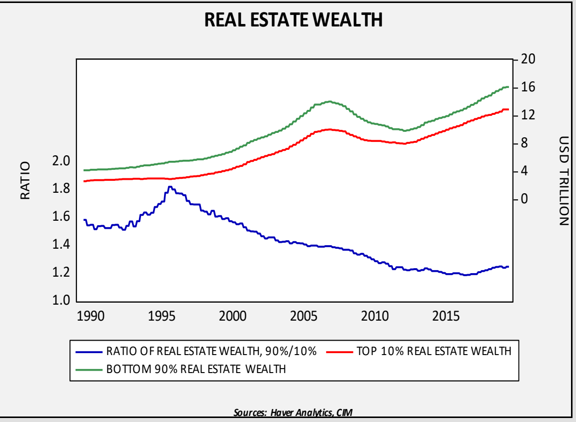
Sources: Haver Analytics, CIM

Both charts compare four categories of wealth—cash, equities, fixed income and residential real estate, including vacant land—relative to total assets. A clear distinction between the two groups is that the top 10% hold most of their wealth in equities. Real estate represents less than 20% for the top 10% but it's around 40% of assets for the bottom 90% of households. Equities represent around 40% of assets for the bottom 90% as well. This tells us that booms and busts affect households differently relative to their wealth; a housing boom tends to make the bottom 90% wealthier, while a bull market in stocks is a bigger deal to the top 10%.

The ratio of equity and real estate wealth for the top 10% to the bottom 90% highlights this factor.

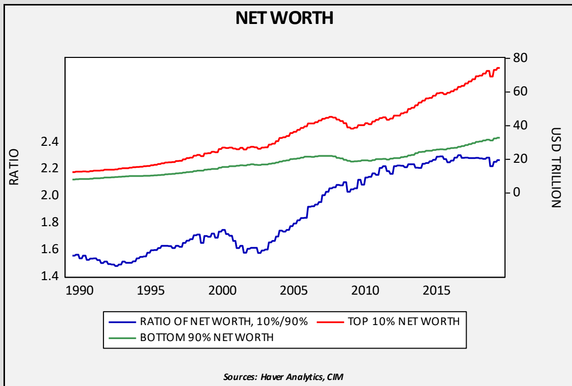
[1] This database was previously called the "Flow of Funds."

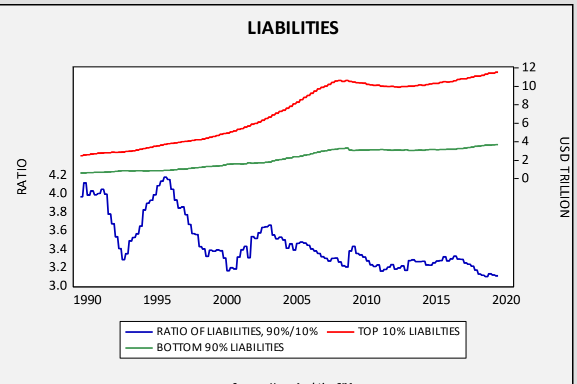




Currently, the equity wealth of the top 10% exceeds the bottom 90% by 2.6x. In terms of real estate, the bottom 90% hold more in total terms, but the two segments tend to mirror each other.

Finally, the ratios of net worth and liabilities show a similar pattern.



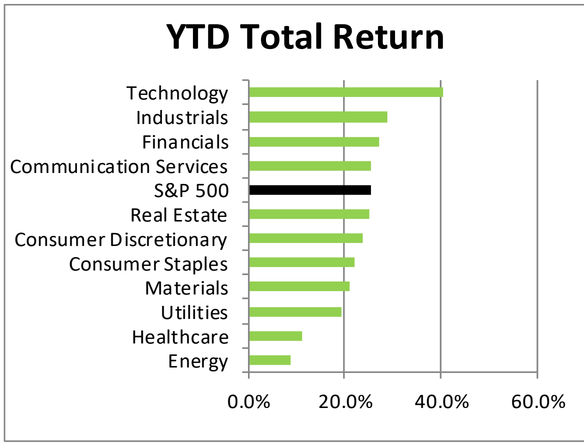


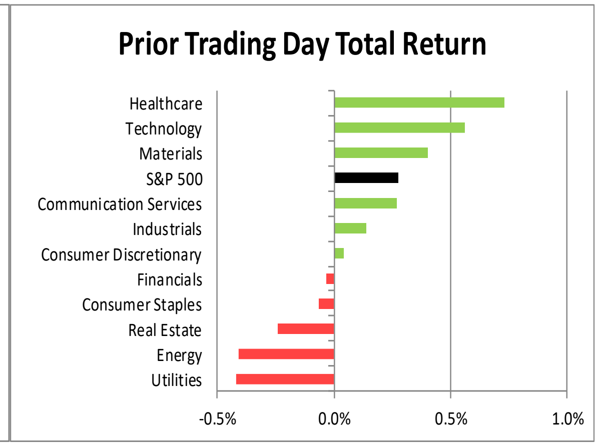
The top 10% net worth exceeds the net worth of the bottom 90% by 2.2x. Liabilities of the bottom 90% exceed those of the top 10% by 3.1x.

These charts show the relative risk to the economy from various market events. A bear market in equities will have much less of an impact on the economy than would declining home prices. Higher borrowing costs will hurt the bottom 90% more than the top 10%. And, in terms of net worth, the difference between the top 10% and the bottom 90% highlights the precarious nature of the latter.

Data Section

U.S. Equity Markets – (as of 11/8/2019 close)

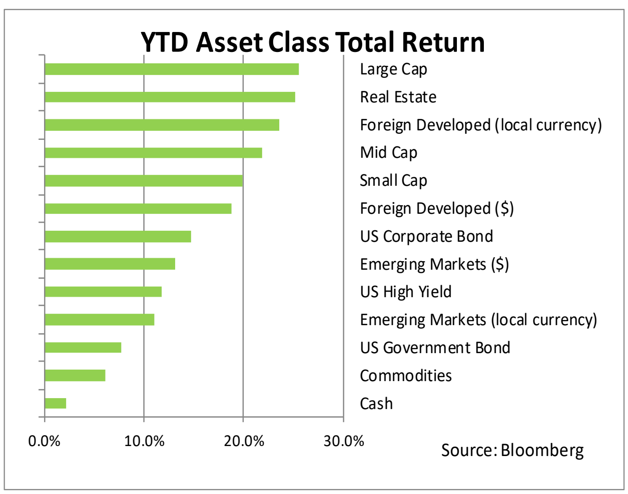




(Source: Bloomberg)

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 11/8/2019 close)

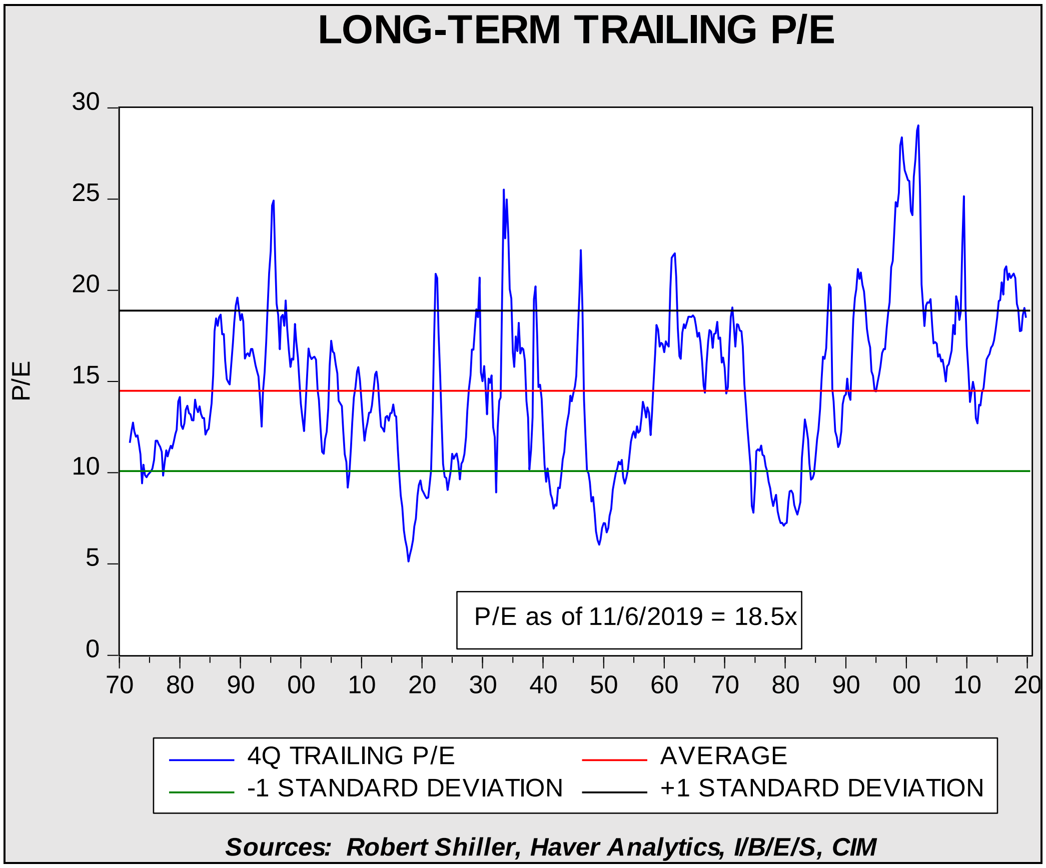


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

November 7, 2019



Based on our methodology,[2] the current P/E is 18.5x, up 0.1x 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.

[2] 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.