Confluence Investment Management

Daily Comment

By Bill O'Grady, Thomas Wash, and
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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: October 10, 2019—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed unchanged. Chinese markets were higher, with the Shanghai composite up 0.8% and the Shenzhen index up 1.4% from the prior close. U.S. equity index futures are signaling a lower open.

As the Nationals staged a remarkable comeback to earn the right to play the Cardinals for the National League pennant, the financial markets were roiled over conflicting stories of the trade talks. Turkey threatens the EU. The EU issues an ultimatum to Johnson. The ECB and the FOMC are divided. Here are the details:

A night of whipsaws: Equity futures had a wild night.

(Source: Barchart.com)

This chart shows December S&P futures intraday trade. Last night as the Cardinals were finishing off the Braves, futures plunged on reports the trade talks were not going well. The China negotiation team was considering leaving early. Then, around 8:00, there were reports that China might agree to a currency pact similar to the one considered last May. As the chart above shows, equities rebounded on the news. The dollar is weaker this morning on talk of the currency pact, although in reality, the agreement would really do nothing more than ask China to fix the CNY/USD rate. We doubt China would maintain that rate if the U.S. expanded tariffs. The Trump administration then moved to increase the number of licenses for Huawei (002502, CNY, 3.25) which is viewed as a minor concession.

All these actions and counter actions make it difficult to tell what is really going on. We suspect the U.S. side would prefer to avoid the market downdraft that will likely occur if the talks lead nowhere. At the same time, trade has been an area of strength for the administration; despite differences on the negotiating team, they have mostly held a united front. We suspect a "mini-deal" might break that unity and is something to be avoided. The focus today will be on the talks; we think the likelihood of a mini-deal is less than the market expects (hence the sharp decline last night), and thus if the negotiations end with nothing of substance, look for short-term equity weakness.

Turkey: The media is covering the dissention between the president and numerous advisors and senators in great detail. We won't go over them here. There are three items that we think are important about this event.

1. This action is part of a path we have been discussing for more than a decade. The U.S. is backing away from its hegemonic role, and slowly ending its "freezing" of three conflict zones, Europe, the Far East and the Middle East. This didn't start with Trump but with Obama. Elements of the U.S. policy apparatus have concluded the U.S. doesn't have the will to maintain security in all these areas. The first to go was the Middle East. President Obama wanted to "lead from behind" in Libya, and withdrew U.S. forces from Iraq without much of a fuss. He also put a timeline on the surge of troops in Afghanistan, signaling to the Taliban that all they needed to do was wait. He set "red lines" in Syria and then refused to enforce them. President Trump's policies are similar. He wants out of the Middle East too. The primary difference between the two administrations is that Obama was prepared to leave Iran in charge of the Middle East; Trump didn't like that idea but has likely found no one else really is able to dominate the region, and thus the Middle East is turning into a "jump ball". Russia, Turkey and Iran are all trying to position themselves as dominators of the region. This is a recipe for unrest. Look for IS to return to the stage in this political vacuum.
2. The political establishment on both the left and right want to maintain U.S. hegemony, but don't want to pay for it. In other words, higher income households want to enjoy the benefits of hegemony (continued globalization), but are unwilling to pay higher taxes to fund those who fail to benefit from hegemony. They will fight a rearguard action against America's withdrawal, but we believe the tide of history is turning against them. What the establishment is doing is a bit like the counterreformation. It didn't put Protestantism into retreat, but it did slow down its gains.
3. Perhaps the most important element of Turkey's invasion to the financial markets is that the EU condemned the invasion. Erdogan has unveiled his most potent tool to force the Europeans to heel; he is threatening to release Syrian refugees to Europe. We suspect EU officials will become quiet on this issue.

Divided central banks: The Fed minutes showed the FOMC divided on policy. There was clear concern about the trade war. We think the worry is correctly placed, but monetary policy might not be very effective in countering it. There was one surprise in the minutes. There wasn't as much discussion about the repo issue and the balance sheet as we expected. This fact is a bit unsettling, as it suggests the leadership may not fully appreciate the gravity of the situation. At the same time, there was a focus on the inflation mandate with some indications the FOMC might lean toward an average inflation target. This would mean easier policy going forward.

Meanwhile, it is looking a bit like Mario Draghi "went rogue" at the last policy meeting. The decision to restart QE came over the objections of bank officials, the technocrats that provide research and support for the members. Given the divisions on the ECB, we will be watching to see if Legarde can maintain this policy direction, or if the staff and the northern Europeans will curb the policy ease.

Brexit: As we have noted, our path going forward is that no deal will emerge before Halloween, the U.K. will ask for an extension of Article 50 into late January, and new elections will be held in the U.K. to establish a mandate for moving forward. In every forecast, there is a risk of error. Such a risk is emerging. As PMs Johnson and Varadkar plan to meet today, the EU has issued an ultimatum—either the U.K. accepts that Northern Ireland will remain in the customs union, or there is no withdrawal agreement. We don't think Johnson will accept the customs union idea, so the next outcome is that the EU would see no point in giving an extension causing a hard Brexit to occur on Halloween. We doubt the EU really wants an unmanaged departure but that might occur. At the same time, we want to reiterate that we still believe the path we have outlined is the most probable outcome.

Bank rules: The Fed began easing rules for smaller banks, which will reduce the regulatory burden and capital rules, about a year ago. It is now extending these rule changes to foreign banks with operations in the U.S.

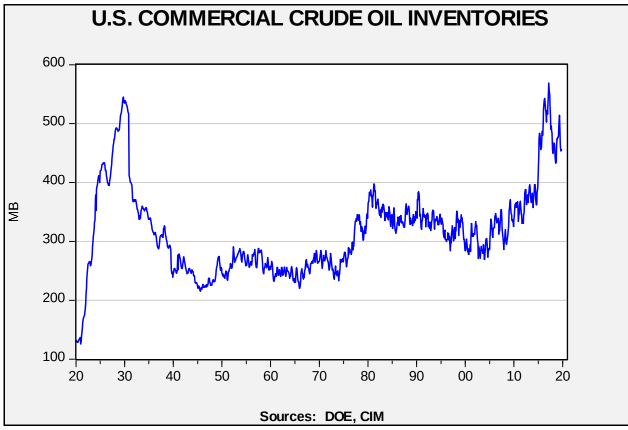
Taiwan: In light of the turmoil in Hong Kong, Taiwan President Tsai Ing-wen gave a speech defending the island's independence. This talk will likely get the attention of Beijing, and it won't be well received. We will be watching to see how the PRC retaliates against Tsai for the comments.

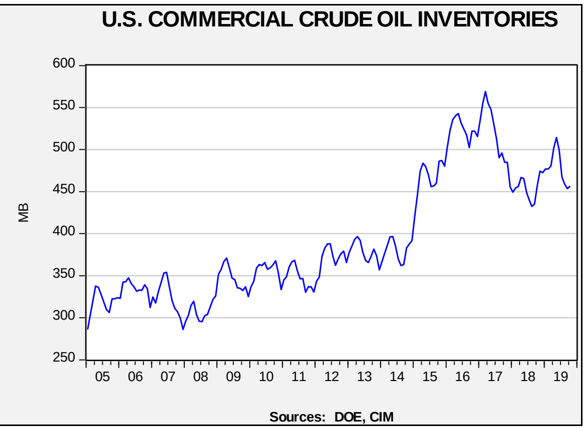
China: Highlighting the hard choices Western governments and companies have to make now that the political and economic ambitions of China have become more clear, Apple (AAPL, 227.03) has removed an app criticized by Chinese state media for being a tool of anti-China protestors in Hong Kong. In this example, at least, it appears the company has decided that staying in the good graces of the Chinese government, and preserving commercial opportunities in China is more important than defending traditional Western values, like the free flow of information.

With trends suggesting the world's economy, financial markets, and technological system will bifurcate into a Chinese-dominated bloc and a U.S-dominated bloc by 2030, Swiss private bank

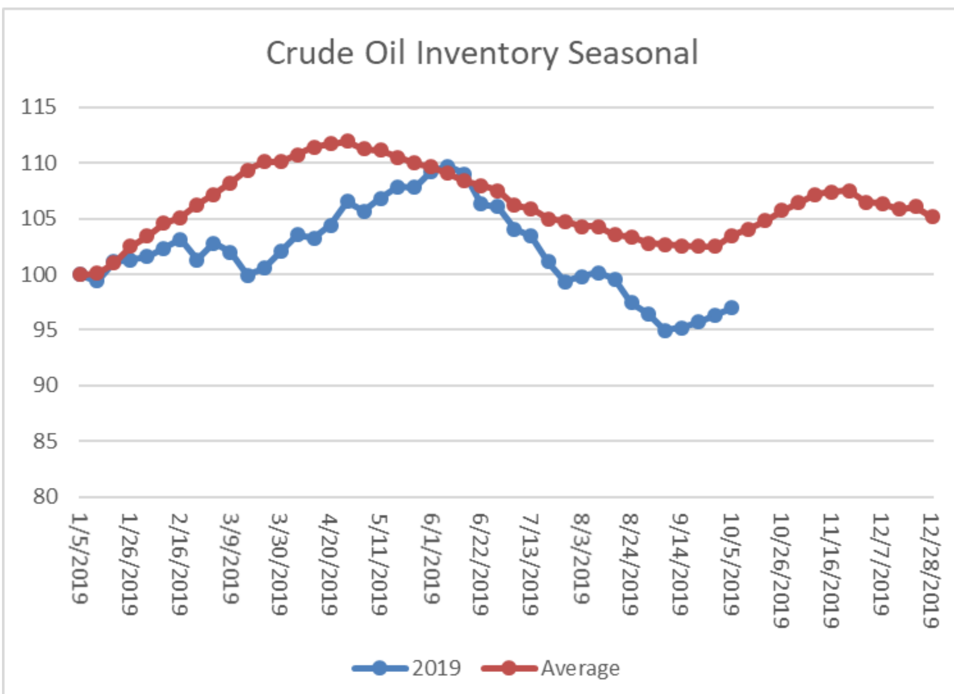
Julius Baer has issued [a report arguing a robust portfolio will require diversifying](#) across both blocs.

Energy update: Crude oil inventories rose 2.9 mb compared to an expected build of 2.0 mb.





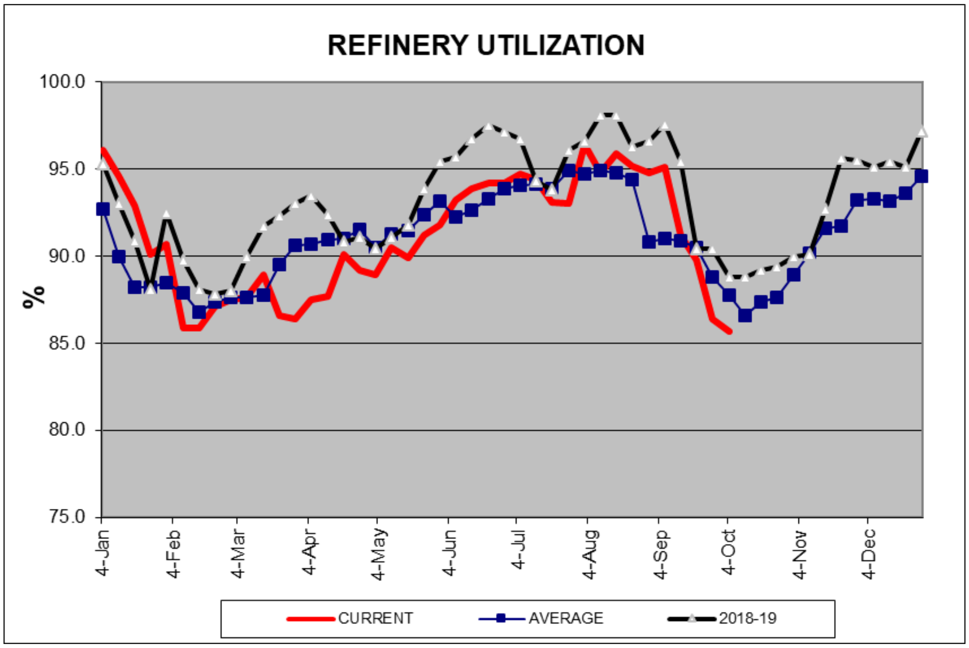
In the details, U.S. crude oil production rose 0.2 mbpd to 12.6 mbpd, a new record. Exports rose 0.5 mbpd while imports fell 0.1 mbpd. The rise in stockpiles was mostly due to rising output and continued declines in refinery demand (see below).



(Sources: DOE, CIM)

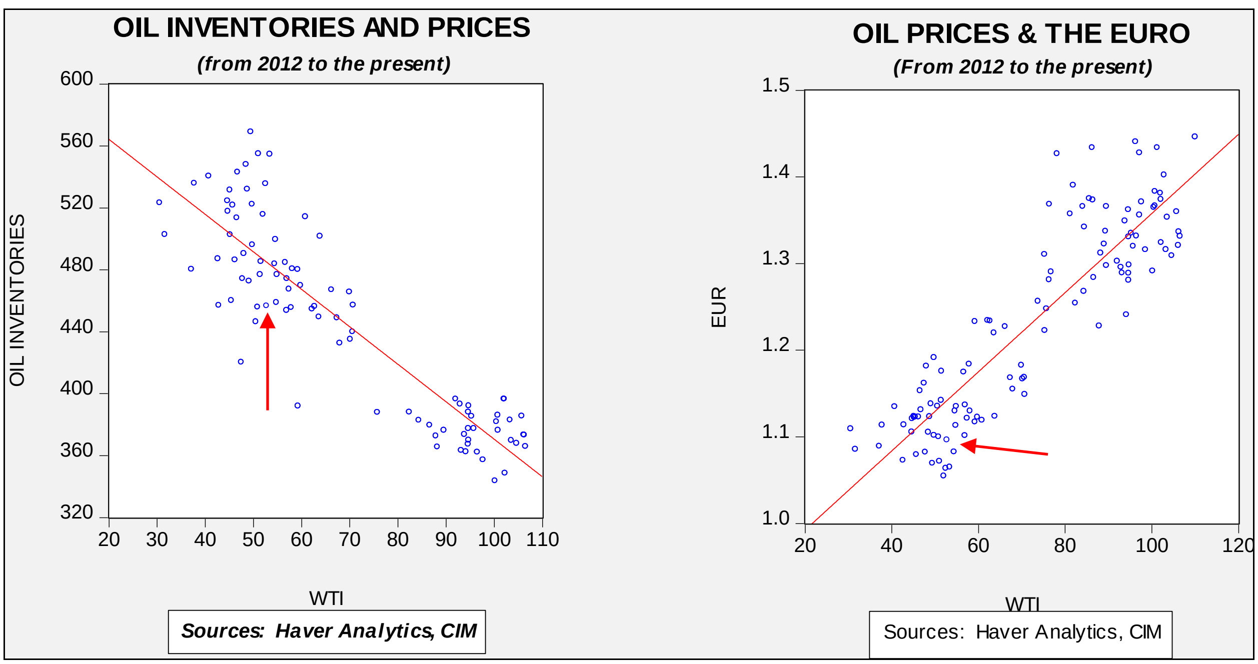
This chart shows the annual seasonal pattern for crude oil inventories. We are now into the autumn build season which usually lasts into early December.

The most important information from this week's data is that we are now well into the autumn refinery maintenance season.



(Sources: DOE, CIM)

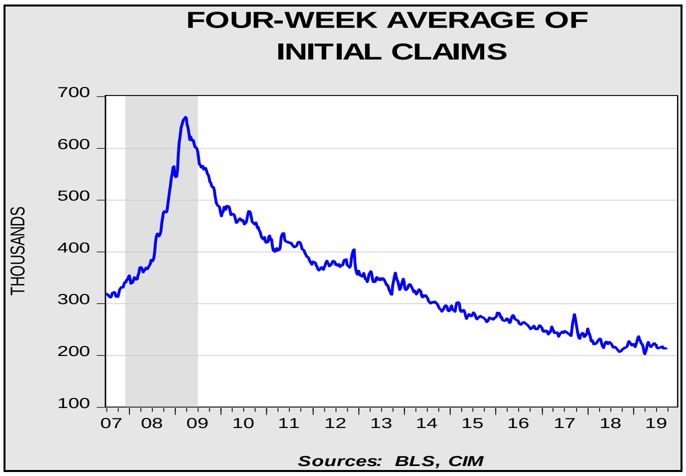
The drop in refinery utilization should end next week and rise soon after.



Based on our oil inventory/price model, fair value is $65.41; using the euro/price model, fair value is $46.93. The combined model, a broader analysis of the oil price, generates a fair value of $52.79. We are seeing a clear divergence between the impact of the dollar and oil inventories. Given that we are into the maintenance season, we normally would expect inventories to continue to rise. Prices will remain sensitive to Saudi output and tensions in the Middle East.

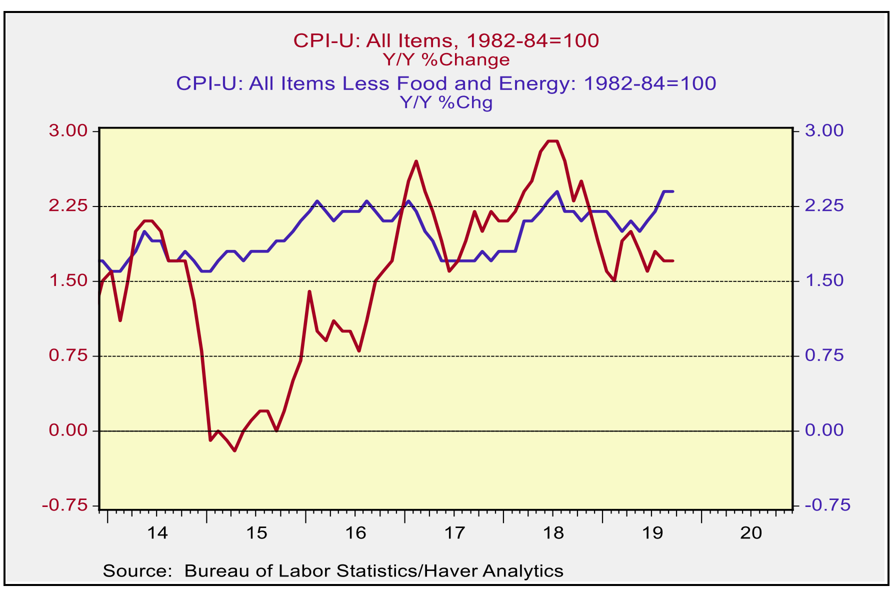
U.S. Economic Releases

Initial jobless claims came in below expectations at 210k compared to the forecast of 220k. The prior report was revised upward from 219k to 220k.



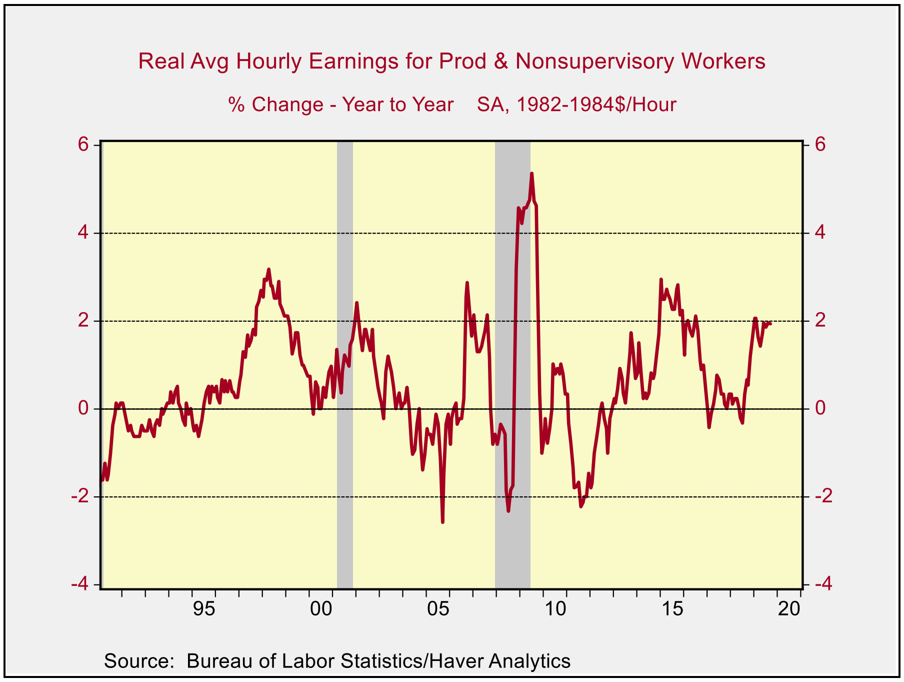
The chart above shows the four-week moving average for initial claims. The four-week moving average rose from 212.75k to 213.75k.

CPI came in below expectations remaining unchanged from the prior month, compared to a forecast of 0.1%. Core CPI came in below expectations, rising 0.1% from the prior month compared to the forecast of 0.2%.



Although core CPI is above the Fed 2.0% target, it is important to note that the Fed uses PCE as its preferred gauge for inflation. The chart above shows the year-over-year change in core PCE and core CPI. Headline CPI and core CPI rose 2.4%, while core PCE rose 1.8%.

Real average weekly earnings rose by 0.9% from the prior year, while real average hourly earnings rose 1.2% from the prior year for all workers, and 1.9% for non-supervisory workers.



The chart above shows real average hourly earnings for production and non-supervisory workers.

The table below lists the economic releases and Fed events scheduled for the rest of the day.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	JOLTS Job Openings	m/m	aug	7250	7217	*
10:00	Wholesale Trade Sales	m/m	aug	0.3%		*
10:00	Wholesale Inventories	m/m	aug	0.4%	0.4%	**
	Monthly Budget Statement	m/m	sep	$93.000 Bil	$119.100 Bil	**
Fed Speakers or Events						
	Speaker or event	**District or position**				
10:30	Jerome Powell Participates in "Fed Listens" Event	Chairman of Board of Governors of Federal Reserve				
14:00	FOMC Meeting Minutes	Federal Reserve Board				

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	PPI	y/y	sep	-1.1%	-0.9%	-1.1%	**	Equity and bond neutral
	Core Machine Orders	y/y	aug	-14.5%	0.3%	-8.4%	**	Equity and bond bearish
	Bank Lending Including Trusts	y/y	sep	2.0%	2.1%		**	Equity and bond neutral
	Bank Lending Excluding Trusts	y/y	sep	2.2%	2.2%		**	Equity and bond neutral
	Tokyo Average Office Vacancies	m/m	sep	1.64	1.71		**	Equity and bond neutral
Australia	Home Loans	y/y	sep	0.7%	4.2%	2.3%	**	Equity bearish, bond bullish
	Investment Lending	m/m	sep	5.7%	4.7%	3.0%	**	Equity bullish, bond bearish
	Owner-Occupier Loan Value	m/m	sep	1.9%	5.3%	3.0%	**	Equity bearish, bond bullish
	Consumer Inflation Expectations	m/m	sep	3.6%	3.1%		**	Equity bearish, bond bullish
New Zealand	Food Prices	m/m	sep	0.0%	0.7%		**	Equity bullish, bond bearish
EUROPE								
France	Industrial Production	y/y	aug	-1.4%	-0.2%	0.1%	***	Equity and bond bearish
	Manufacturing Production	y/y	aug	-0.8%	0.3%	0.3%	***	Equity and bond bearish
Germany	Current Account Balance	m/m	aug	16.900 Bil	22.100 Bil	17.900 Bil	**	Equity bearish, bond bullish
	Trade Balance	m/m	aug	16.200 Bil	21.400 Bil	18.800 Bil	**	Equity bearish, bond bullish
Italy	Industrial Production	y/y	aug	-1.8%	-0.7%	-1.8%	***	Equity and bond neutral
UK	Monthly GDP	m/m	aug	-0.1%	0.3%	0.0%	**	Equity and bond bearish
	Industrial Production	y/y	aug	-1.8%	-0.9%	-0.8%	***	Equity and bond bearish
	Manufacturing Production	m/m	aug	-1.7%	-0.6%	-0.4%	***	Equity and bond bearish
	Construction Output	y/y	aug	2.4%	0.3%	-0.1%	**	Equity bullish, bond bearish
	Index of Services	m/m	aug	0.0%	0.3%	-0.1%	**	Equity bullish, bond bearish
	Trade Balance	m/m	aug	-£1.546 Bil	-£0.219 Bil	-£1.050 Bil	**	Equity and bond bearish
Russia	Current Account Balance	q/q	3q	12.900 Bil	10.552 Bil	12.925 Bil	**	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)	201	201	0	Down
3-mo T-bill yield (bps)	163	165	-2	Neutral
TED spread (bps)	38	36	2	Neutral
U.S. Libor/OIS spread (bps)	162	163	-1	Up
10-yr T-note (%)	1.59	1.58	0.01	Down
Euribor/OIS spread (bps)	-42	-42	0	Neutral
EUR/USD 3-mo swap (bps)	28	25	3	Down
Currencies	**Direction**			
dollar	Down			Up
euro	Up			Down
yen	Up			Down
pound	Up			Up
franc	Up			Down

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	$58.40	$58.32	0.14%	
WTI	$52.69	$52.59	0.19%	
Natural Gas	$2.25	$2.23	0.81%	
Crack Spread	$18.68	$18.51	0.91%	
12-mo strip crack	$18.47	$18.50	-0.16%	
Ethanol rack	$1.74	$1.71	1.41%	
Metals				
Gold	$1,507.54	$1,505.57	0.13%	
Silver	$17.77	$17.73	0.22%	
Copper contract	$259.20	$256.80	0.93%	
Grains				
Corn contract	$ 394.25	$ 394.25	0.00%	
Wheat contract	$ 503.25	$ 500.25	0.60%	
Soybeans contract	$ 925.25	$ 923.75	0.16%	
Shipping				
Baltic Dry Freight	1873	1801	72	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	2.9	2.0	1.0	
Gasoline (mb)	-1.2	-1.0	-0.2	
Distillates (mb)	-3.9	-2.0	-1.9	
Refinery run rates (%)	-0.70%	0.15%	-0.85%	

Weather

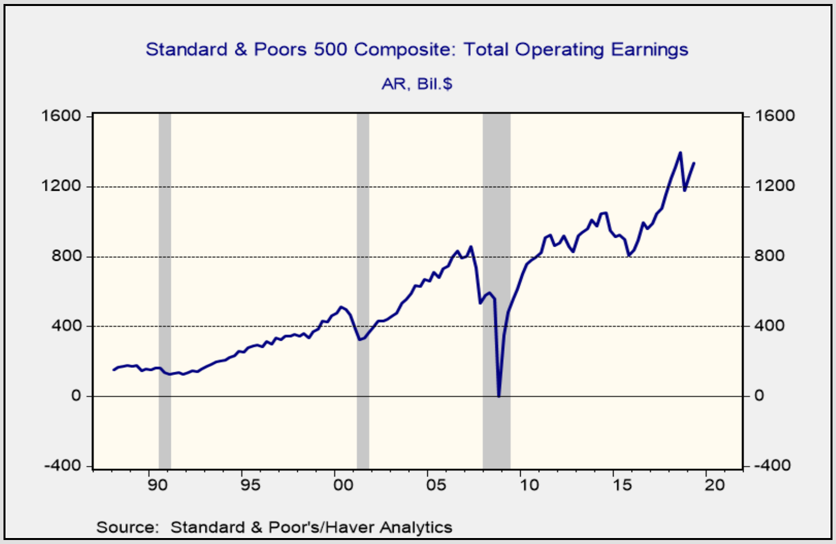
The 6-10 and 8-14 day forecasts call for cooler-than-normal temperatures throughout the Northern Tier and into the Midwest, with normal or higher-than-normal temperatures along the East Coast and in the South. The dry spell in the center of the country is expected to gradually dissipate by late into the forecast period, while precipitation is expected in the Pacific Northwest and in the South. There are two tropical disturbances off the East Coast, but neither is expected to develop into a tropical storm.

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.

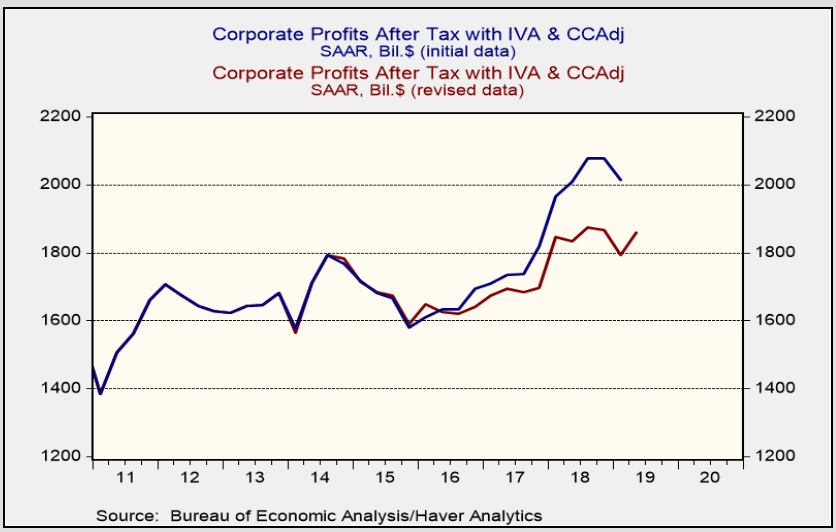
October 4, 2019

Although the convention for measuring earnings is compared to shares, Standard and Poor's also calculates the level of operating earnings for all the stocks in the S&P 500.



The per-share value is calculated by dividing this number by the S&P divisor. The advantage of this number versus the per-share data is that it is easier to compare total operating earnings of the S&P to the profits data compiled by the Bureau of Economic Analysis (BEA) as part of the National Product Accounts data.[1] The BEA data measures total corporate profitability.

The BEA makes occasional revisions to the GDP and related reports, and recently we had a significant revision to the profits calculation.



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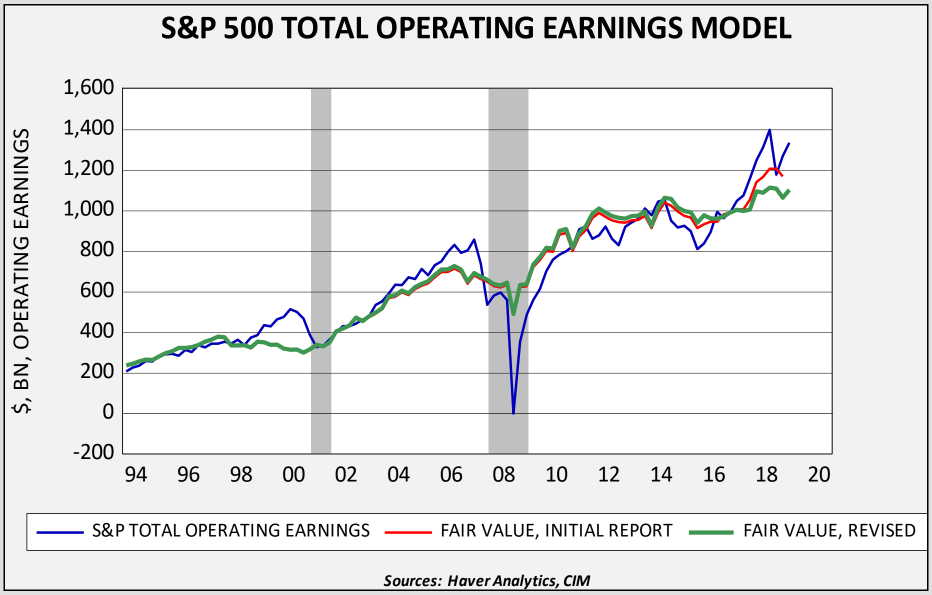
[1] The GDP data comes from this effort.

The BEA made a meaningful revision to its profit calculation.[2] We use this data and forecasts from the Survey of Economists conducted by the Philadelphia FRB in calculating our earnings forecast.



This chart is a model that estimates S&P operating earnings using the BEA profits data. The value of comparing the BEA profits data to S&P operating earnings is that it does give us a warning when earnings for the index are "frothy" and probably due to decline. In 2000 and 2006, S&P total operating earnings far exceeded the model's fair value forecast and, as the recession approached, the index's earnings fell to or exceeded the BEA-based model forecast.

Until the revisions, the S&P total operating earnings data was a bit high but not outside model ranges. The revisions now suggest that current operating earnings are high and will likely decline in the coming quarters. We still have other factors to take into account (the path of the divisor and the business cycle are two important ones) but, overall, earnings are likely to decline in the coming quarters.

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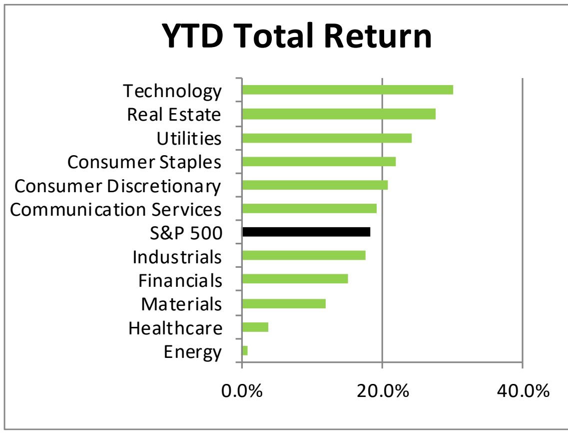
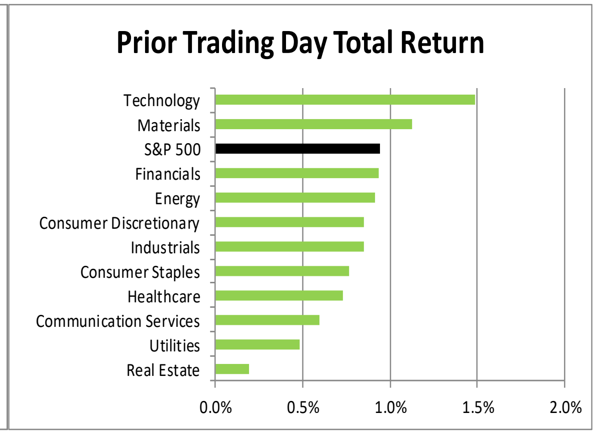
[2] For reference, we use after-tax profits with inventory and depreciation adjustment.

Data Section

U.S. Equity Markets – (as of 10/9/2019 close)

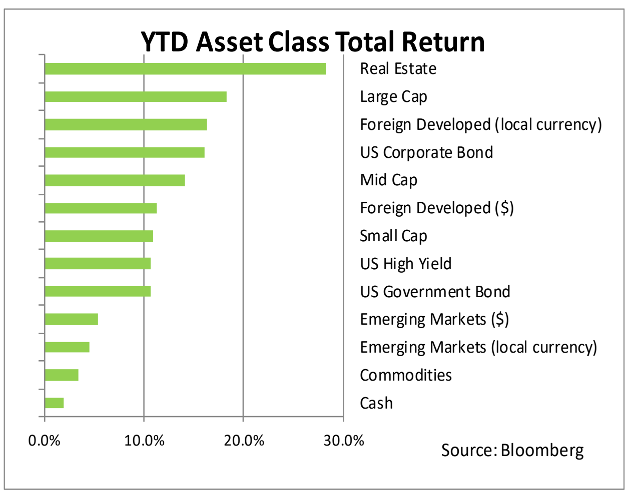




(Source: Bloomberg)

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 10/9/2019 close)

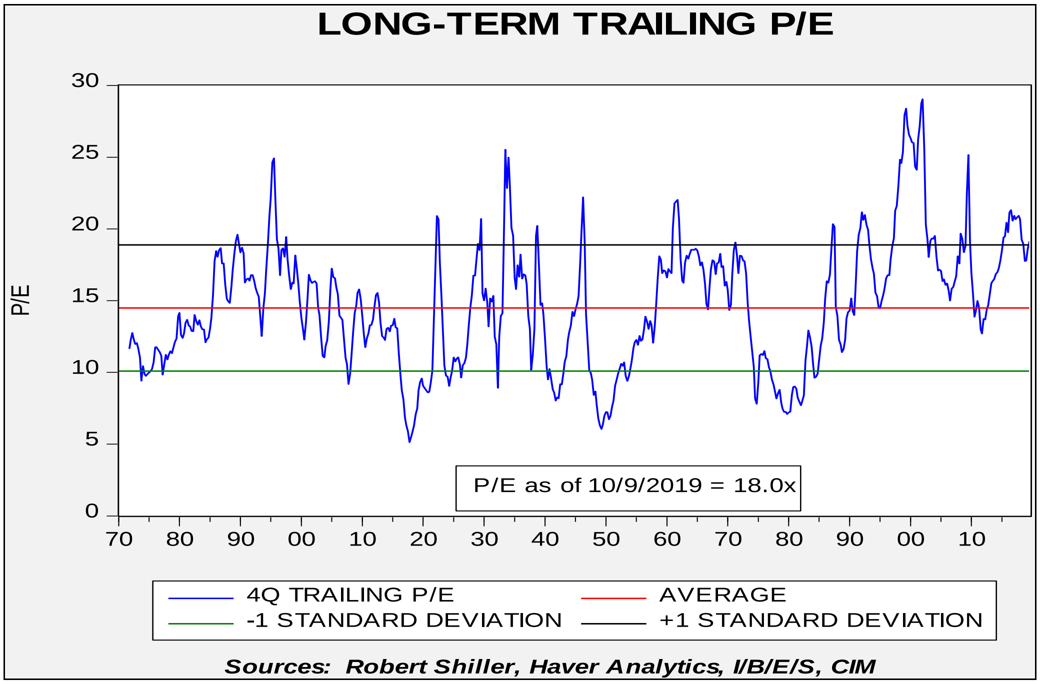


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 10, 2019



Based on our methodology,[3] the current P/E is 18.0x, up 0.1x from last week.

[3] 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.