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: October 14, 2019—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.7% from the last close. In Asia, the MSCI Asia Apex 50 closed up 1.6%. Chinese markets were higher, with the Shanghai composite up 1.2% and the Shenzhen index up 1.4% from the prior close. U.S. equity index futures are signaling a lower open.

It's Columbus Day! Treasury markets are closed but equity exchanges are open. Today looks like a "upon further review day" as markets reverse Friday's optimism. Here are some of the details:

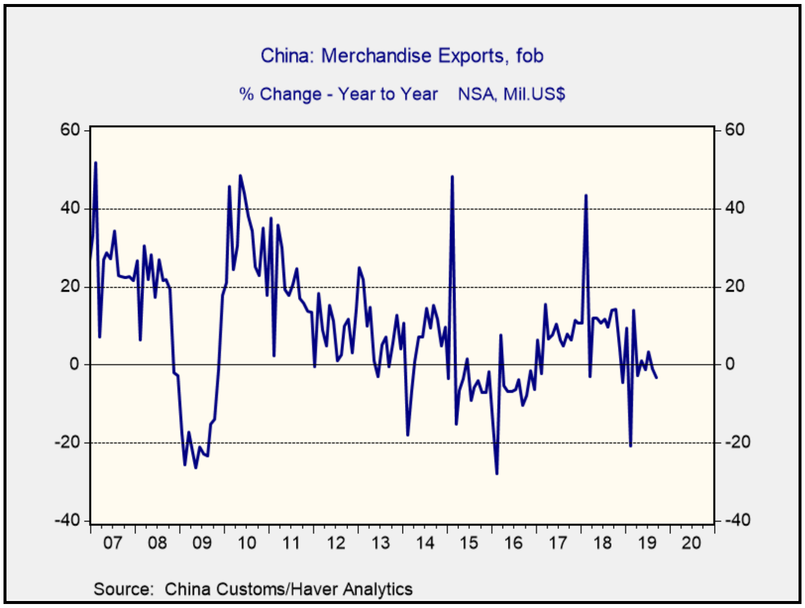
Trade: After touting the progress made on Friday, the mood has shifted this morning. China has announced it wants more talks before signing anything at the APEC summit. Additionally, all that grain China said it would buy? Apparently, Beijing hasn't committed to making those purchases. Meanwhile, the U.S. has delayed the tariffs that were due to start tomorrow; The December tariffs, however, are still on schedule. Overall, the Phase One agreement doesn't seem to have much to it.

The general takeaway is that Xi got a win last week. Perhaps the most insightful comment came from an unnamed Chinese official, who noted China was fortunate that the Trump administration waited for more than a year before tackling the trade issue. By the time the trade policy change began, it was too close to the next election. Now the president can't easily risk the economic disruption that comes from trade tensions. This is a classic mistake presidents often make; they don't realize their power is at a peak at the inauguration, and is mostly spent about 18 months later. This White House focused on tax cuts and reversing the ACA; if the most important goal was changing the trade relationship with China, that is where the focus should have been from day one.

So, what now? This situation has an air of May; recall that in May, we thought we were close to a deal only to have Beijing reverse its position. China has even more incentive now to drag out negotiations, confident that election pressures will reduce Washington's room to maneuver. Overall, the trade issue with China will continue to hang over the financial markets; we are seeing weaker equities on these reports this morning.

As a side note, the EU is preparing new trade weapons against the U.S. that expand beyond the retaliation allowed by the WTO. It appears that the WTO is rapidly becoming obsolete, no longer offering a framework to deal with trade disputes.

China: According to the General Administration of Customs, September merchandise exports were down 3.2% year-over-year, driven by a 22.0% fall in shipments to the United States. That helps explain why China has been so focused on resolving the trade dispute. A trade deal now may help, but the damage from the slowdown in trade to date is probably already baked into the Chinese economy. Euphoria on a trade deal could still give a boost to Chinese assets, but if the actual economic data remains in the doldrums, that boost may be limited or short-lived.



Brexit: On Friday it also looked like progress was being made. Those hopes are being dimmed in the early light of Monday. Although nothing official has been released, there is enough in the press to suggest that Johnson would leave Northern Ireland in the U.K. customs union, but treat the tariffs on goods differently based on their final destination. The EU, which wants Northern Ireland in the EU customs union, has called the plan "devilishly difficult." The good news is that both sides are still talking. The bad news is that both sides remain divided, with little time to complete a deal. The GBP fell on the news.

Turkey: This week's WGR explores the breakdown of the Carter Doctrine, the explicit commitment of the U.S. to stabilize the Middle East. It's breaking down at a rather furious pace. Turkey is aggressively invading Kurdish controlled areas of Syria, even "bracketing" U.S. forces in artillery attacks. The U.S. is removing our troops from the region. The Kurds are turning to Russia and Syria for aid. The U.S. is prepared to apply additional sanctions to Turkey; Germany has warned Erdogan to halt the offensive, and has cut off some arms exports to Turkey.

We have been forecasting for some time that the U.S. was allowing the world's three prime conflict zones, the Far East, Europe and the Middle East to "thaw" after freezing them during the Cold War. The Middle East is especially problematic because many of the nations in the region that currently exist did not evolve naturally, but were artificial constructs of the colonial era. The U.S. studiously maintained these borders to maintain stability. As the U.S. withdraws from the region, the evolution of statehood is developing which will be messy. The U.S. withdrawal is creating massive power vacuums that others are rushing to fill. Although oil prices are lower this morning, the overall geopolitical conditions suggest increasing instability, which should put a risk premium in the price at some point.

QE, not QE: The Fed has announced it will buy $60 bn worth of Treasuries per month over the next six months to relieve funding pressure in the repo market. Chair Powell has made it clear this isn't QE, and focused on the fact that the Fed will only be buying T-bills. This expansion of the balance sheet should allow the Fed to ease what has been daily open market operations to inject liquidity into the banking system. Despite this balance sheet announcement, these open market operations will continue into Nov. 4th. What caught our attention about this action is the timing. The Fed could have simply kept up with the daily funding operations until the next meeting. We don't know if this means that Powell is concerned he can't get enough votes to cut rates later this month and was worried that if no cut emerges, that news would have swamped the balance sheet expansion news. We have noted rising opposition to further cuts and would not be surprised to see the next cut delayed into December.

Odds and ends: Spain's Supreme Court has sentenced a group of Catalan leaders to as much as 13 years in prison for their role in organizing the region's illegal 2017 referendum on independence and subsequent declaration of independence. Madrid has reportedly sent hundreds of extra law enforcement personnel to Catalonia in anticipation of widespread protests against the sentence. In Poland, the conservative-nationalist Law and Justice Party handily won Sunday's parliamentary elections with 44.4% of the vote. That should give the party an outright majority in the legislature, albeit a slim one. In Ecuador, after 11 days of protests against a decree eliminating a longstanding system of fuel subsidies, President Moreno has struck a deal with indigenous activists to withdraw and replace it with a milder version. Since scrapping the subsidies would have saved $1.3 billion per year, the problem now will be how to meet the fiscal targets of Ecuador's IMF debt program. Japan is starting the recovery process from a Super Typhoon. The UAW has increased its strike pay, suggesting the union does not expect a resolution soon. The strike will bring lower job growth in the employment data for October.

U.S. Economic Releases

There are no domestic 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								
China	Trade Balance	m/m	sep	$39.650 Bil	$34.840 Bil	$34.750 Bil	**	Equity bullish, bond bearish
India	Wholesale Prices	y/y	sep	0.3%	1.1%	0.8%	**	Equity and bond neutral
New Zealand	Performances Services Index	m/m	sep	54.4	54.6		**	Equity and bond neutral
EUROPE								
Eurozone	Industrial Production	m/m	aug	-2.8%	-2.0%	-2.5%	***	Equity and bond bearish
Germany	Wholesale Price Index	m/m	sep	-1.9%	-1.1%		**	Equity bullish, bond bearish
Switzerland	Total Sight Deposits CHF	w/w	11-Oct	592.2 Bil	592.2 Bil		*	Equity and bond neutral
	Domestic Sight Deposits CHF	w/w	11-Oct	484.1 Bil	480.1 Bil		*	Equity and bond neutral
AMERICAS								
Brazil	IBGE Services Sector Volume	m/m	aug	-1.4%	1.8%	-0.9%	*	Equity and bond bearish
Canada	Net Change in Employment	m/m	aug	53.7k	81.1k	7.5k	***	Equity bullish, bond bearish
	Unemployment Rate	m/m	aug	5.5%	5.7%	5.7%	***	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)	200	199	1	Down
3-mo T-bill yield (bps)	163	165	-2	Neutral
TED spread (bps)	37	34	3	Neutral
U.S. Libor/OIS spread (bps)	164	165	-1	Up
10-yr T-note (%)	1.73	1.73	0.00	Down
Euribor/OIS spread (bps)	-42	-42	0	Neutral
EUR/USD 3-mo swap (bps)	13	17	-4	Down
Currencies	**Direction**			
dollar	Up			Up
euro	Flat			Down
yen	Up			Down
pound	Down			Up
franc	Flat			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	$59.28	$60.51	-2.03%	Concerns about trade agreement
WTI	$53.54	$54.70	-2.12%	
Natural Gas	$2.29	$2.21	3.43%	
Crack Spread	$18.54	$18.56	-0.12%	
12-mo strip crack	$18.58	$18.72	-0.79%	
Ethanol rack	$1.75	$1.74	0.98%	
Metals				
Gold	$1,495.57	$1,489.01	0.44%	
Silver	$17.60	$17.54	0.32%	
Copper contract	$260.10	$262.80	-1.03%	
Grains				
Corn contract	$ 395.50	$ 397.75	-0.57%	
Wheat contract	$ 508.50	$ 508.00	0.10%	
Soybeans contract	$ 936.00	$ 936.00	0.00%	
Shipping				
Baltic Dry Freight	1924	1929	-5	

Weather

The 6-10 and 8-14 day forecasts call for cooler-than-normal temperatures throughout the western region, with normal or higher-than-normal temperatures for the rest of the country. 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 is a tropical disturbance off the East Coast, but it isn't expected to develop into a tropical storm. Hurricane season usually ends November 1.

Asset Allocation Weekly

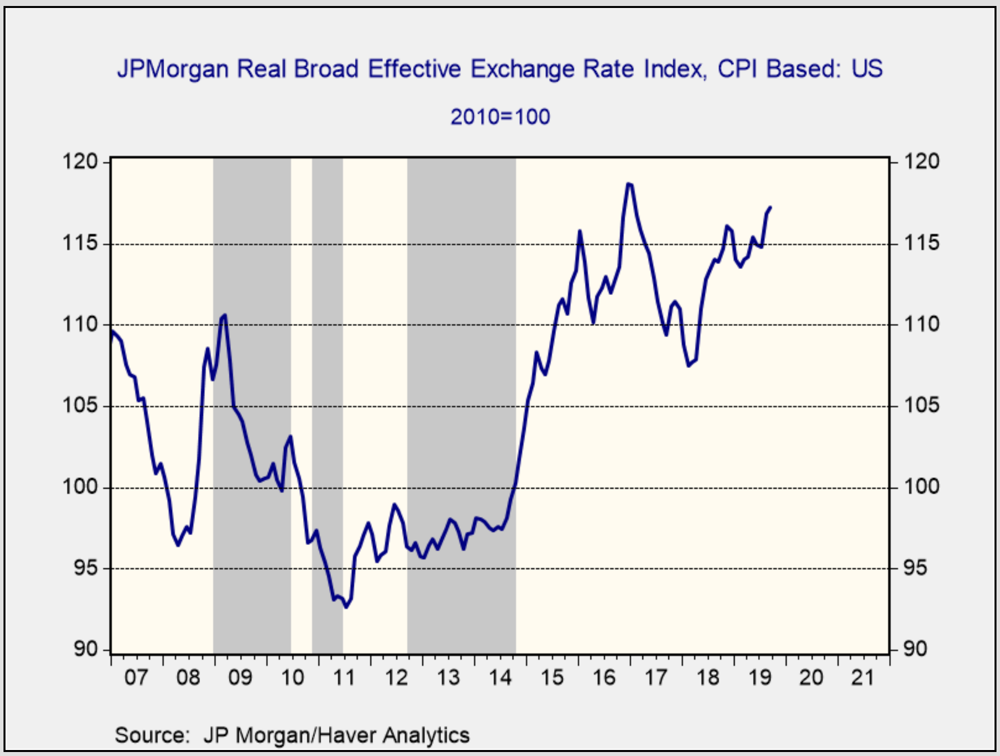
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

October 11, 2019

The financial markets have been roiled recently by the apparent shortage of liquidity in the repo markets. Our take is that the problem is twofold—there are regulatory problems that mean the banking system requires more in reserves than it did prior to the Great Financial Crisis, and there are likely industry concentration issues that are exacerbating the issue. Although we don't expect the repo situation to become a systemic problem, there are potential second order effects that could affect financial markets.

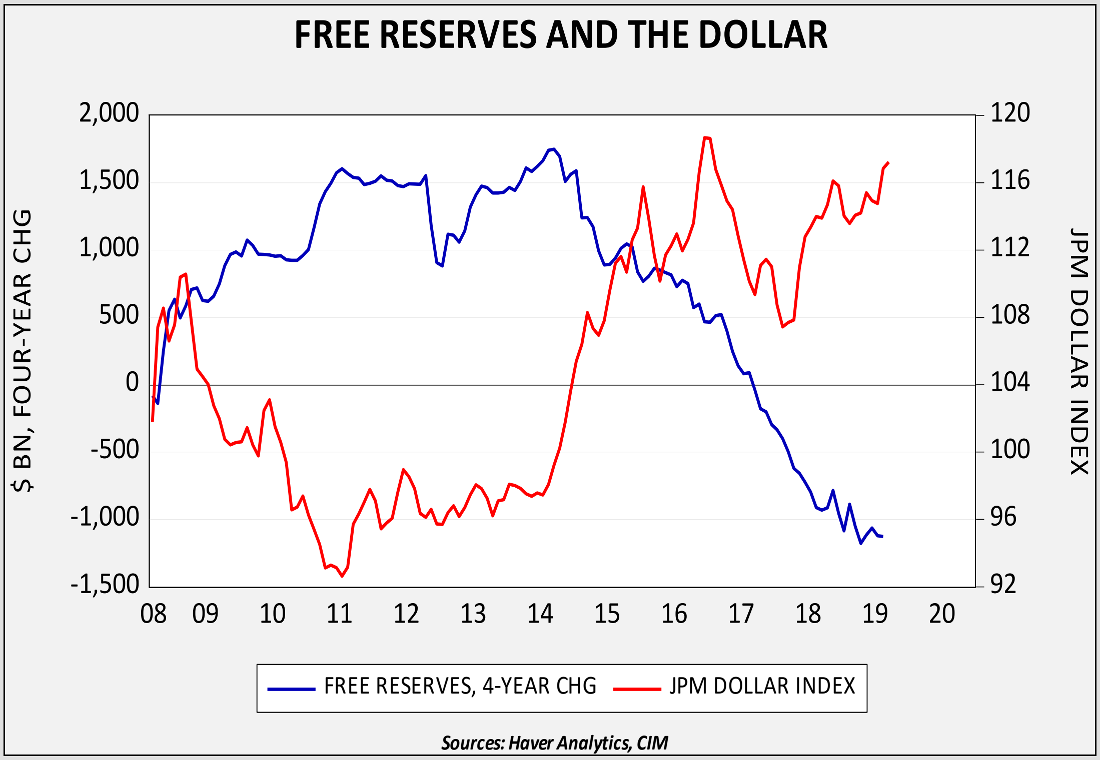
Ultimately, the repo situation makes it clear that the Fed has reduced its balance sheet more than it should have. Therefore, the fix will require expanding the balance sheet again. As a result, other than to calm the short-term money markets, we have been searching to figure out what other markets might be affected by a new expansion of the balance sheet.

When the Bernanke Fed implemented the three phases of quantitative easing (QE), one of the overlooked areas of impact was the dollar.



The areas in gray show periods of QE; in the first two events, the dollar clearly weakened. In the third episode, the dollar did weaken going into the event but mainly was steady at low levels. However, the dollar soared as the Fed signaled the end of QE.

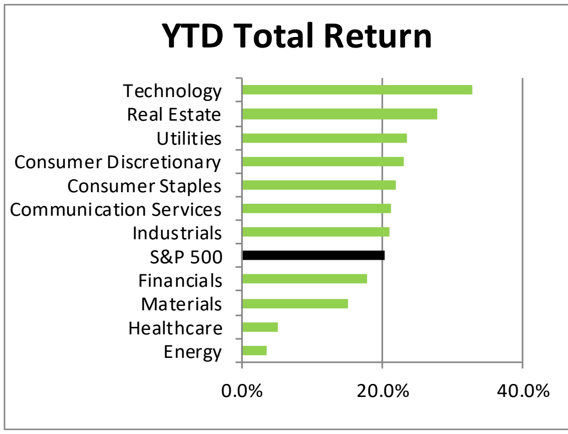
One way to examine the effect of the balance sheet on the banking system is to monitor free reserves. These are banking reserves that are above the level of required reserves.

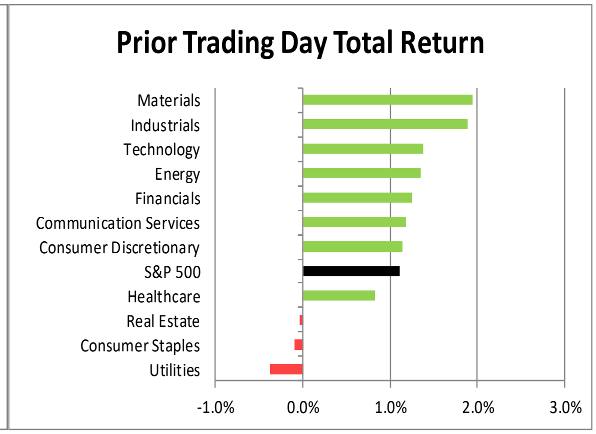


This chart examines the relationship between the four-year change in free reserves and the JPM dollar index. The key point is that the level of reserves matters less to the dollar than the direction of change. If the Fed begins to reflate its balance sheet, it will likely cause free reserves to rise. That action will likely be dollar bearish. Although monetary aggregates are not the sole driver of the path of the dollar, given that other measures have suggested the dollar is overvalued, a return to some sort of QE should be considered a bearish event for the greenback. In general, a weaker dollar is bullish for gold and commodities, along with foreign equities, especially emerging markets.

Data Section

U.S. Equity Markets – (as of 10/11/2019 close)

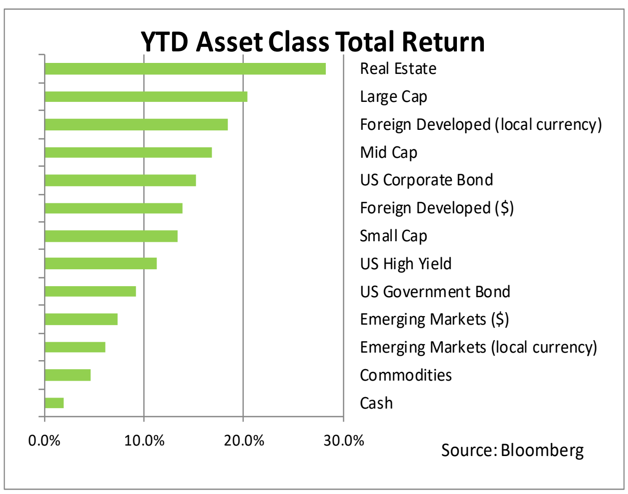




(Source: Bloomberg)

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 10/11/2019 close)

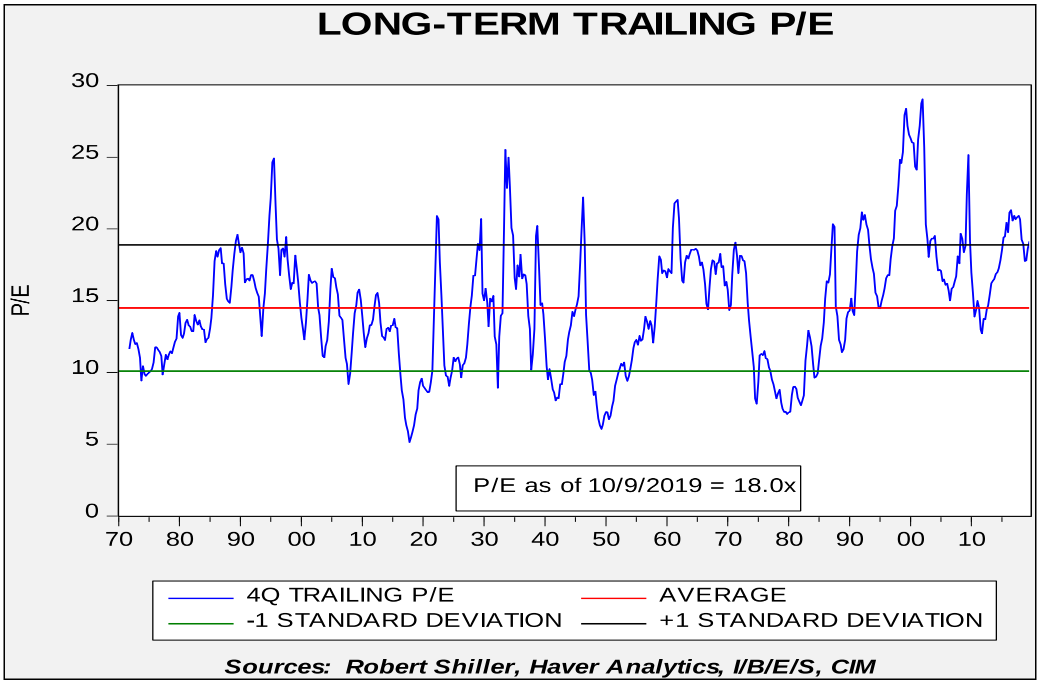


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[1] the current P/E is 18.0x, up 0.1x from last week.

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.

[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.