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 24, 2019—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.4%%. Chinese markets were flat, with the Shanghai composite unchanged and the Shenzhen index down 0.1% from the prior close. U.S. equity index futures are signaling a higher open. With 124 companies having reported, the S&P 500 Q3 earnings stand at $41.30, higher than the $41.08 forecast for the quarter. The forecast reflects a 4.0% decrease from Q3 2018 earnings. Thus far this quarter, 79.8% of the companies reported earnings above forecast, while 15.3% reported earnings below forecast.

Good morning! It's a rather quiet day in earnings season. Mario Draghi holds his last meeting as president of the ECB, Boris Johnson waits for the EU and we have an update on Syria. Here are the details:

ECB: The statement held no surprises. The ECB left rates unchanged and QE of €20 bn per month will begin on November 1. In the press conference, the tone was defiantly dovish. However, market reaction has been very modest, probably because Draghi will be out in just over a week.

In related news, Germany has nominated Isabel Schnabel to the ECB. She appears to be more moderate than her predecessors which may reflect an "olive branch" from the Merkel government.

Brexit update: The EU will decide tomorrow on how long it will give the U.K. to leave the bloc. All indications suggest the decision will be an extension until the end of January. Meanwhile, the Conservatives are trying to figure out if they should press for an election or wait until after Brexit. The argument for an election is that a big win would give Johnson a mandate to push through his legislation without amendments. However, there are three caveats to this decision. First, Theresa May thought she, too, would win a large mandate; instead, she lost her majority and could only govern with an alliance with the DUP. Simply put, the polls could be wrong. Second, the polls could be wrong because the Brexit Party could siphon off Tory votes. If Brexit is completed, there is no reason for the Brexit Party to exist. Third, Johnson can't call an election unilaterally; he either needs Jeremy Corbyn to agree to a no-confidence vote or convince a two-thirds majority to call an election. Neither option is likely. The downside of waiting for an election is that Parliament will start debating the withdrawal bill in detail, which will require compromises and amendments that will make Johnson look weak. The good news on Brexit is that the odds of a sudden exit have diminished considerably. The bad news is that it will go on longer.

Germany: Christian Kastrop, a former finance ministry official who helped author Germany's constitutional "debt brake," said in a *Financial Times* interview that it's now time to change the law to allow increased borrowing and greater investment in infrastructure, digital technology and climate mitigation. It's one more sign that global sentiment is shifting, slowly but surely, toward looser fiscal policy as the impact of loose monetary policy peters out.

Syria: President Trump, satisfied with the ceasefire and the new buffer zone, has removed sanctions on Turkey. Kurds are evacuating the buffer zone. The president couched the quick revocation as a reward for Turkey's adherence to the five-day ceasefire brokered by the United States, but his statements suggest it was actually a doubling down against the bipartisan criticism he has taken for abandoning the long-time U.S. ally.

China in its place: In a recent speech, SoS Pompeo made the following comment:

> *We've reconvened "the Quad" – the security talks between Japan, Australia, India and the Untied (sic) States that had been dormant for nine years. This will prove very important in the efforts ahead, ensuring that China retains only its proper place in the world.*

He did not elaborate on what he means by China's "proper place." It's hard to see how that could be anything other than containment. Needless to say, we are sure that Beijing has read this statement and have no doubts it was not welcomed. Although some sort of trade deal next month is likely, the fundamental relationship between China and the U.S. has changed and won't return to the *status quo ante*.

In another interesting comment, an unnamed U.S. military officer told reporters that the Japanese government should do more to explain to its citizens the threat China means for the region, suggesting Japan should consider an offensive-defensive stance. This report is additional evidence that the U.S. is steadily removing itself from the stabilization role that it has performed since the end of WWII.

Other China news: In response to slower housing demand, Chinese developers have been cutting prices to spur sales. It should also be noted that about a fourth of real estate developer debt is dollar-denominated, so any weakness in the CNY could make debt service more difficult. In the absence of pork, rural communities are returning to eating other proteins. U.S. senators are pressing Federal worker retirement funds to cease the use of index funds that hold large components of Chinese equities. In general, economists don't think that the upcoming "phase one" of the trade deal will reduce recession odds. We also note that M&A activity between the U.S. and China has plummeted.

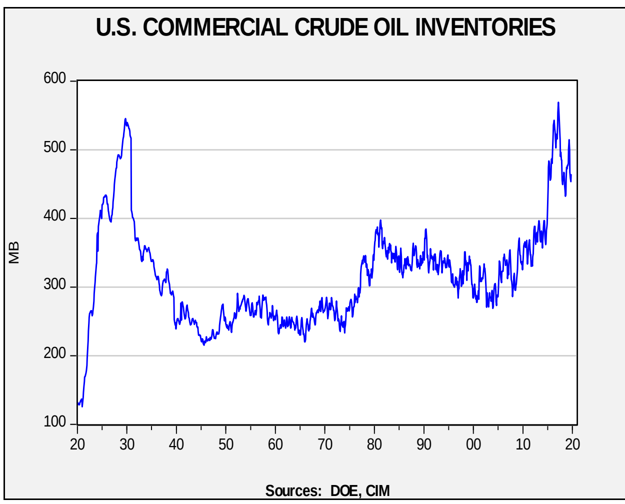
Global unrest: Although it hasn't had much of an impact on markets, we are paying attention to widespread unrest and protests. One common theme we are noticing is that seemingly modest changes in charges for public services are not being accepted; in fact, the reaction seems far out of proportion. In general, our observation is that disproportional reactions are usually not due to only the apparent catalyst but have longer roots in the past. Mass dissatisfaction has lots of factors behind it but underlying them all is a belief that societal elites are not looking out for the interest of the general public.[1]

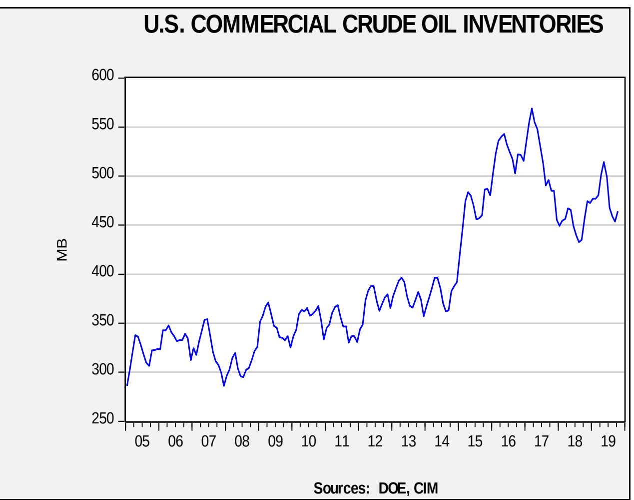
Japan-South Korea: Japanese Prime Minister Abe held a short meeting with South Korean Prime Minister Lee, who was in Tokyo this week for the enthronement of Japan's new emperor. Unfortunately, however, the talks yielded no progress on the dispute over Japan's behavior in Korea before and during World War II, which we wrote about in a two-part WGR series on Sept. 30 and Oct. 7.

Canada: Even though his Liberal Party lost its parliamentary majority in Monday's elections, Prime Minister Trudeau said he will not enter into either a formal or informal coalition with rival parties. That suggests Trudeau will have more freedom to form the government he wants, but it also points to potential stalemates or instability as Trudeau will have to pass legislation – and survive any no-confidence motions – by forming ad hoc coalitions. On balance, Trudeau's approach is probably negative for Canadian risk assets going forward.

Odds and ends: We have a new emperor in Japan. The Riksbank warned in its latest monetary policy report that it would probably hike its benchmark interest rate to zero in December, compared with -0.25% currently. This action by the Swedish central bank could signal the limits of negative interest rates. The Turkish central bank yesterday slashed its benchmark interest rate to 14.0% from 16.5% previously, citing decreased inflation pressure and a stabilizing lira.

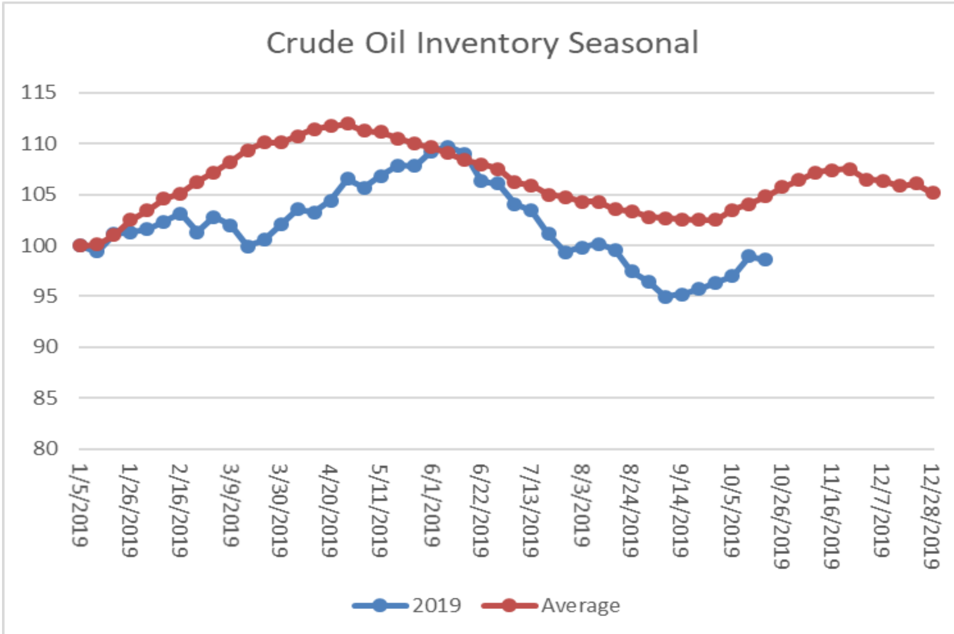
Energy update: Crude oil inventories fell 1.7 mb compared to an expected build of 3.0 mb.





In the details, U.S. crude oil production was unchanged at 12.6 mbpd. Exports rose 0.4 mbpd, while imports fell 0.5 mbpd. The decline in stockpiles was mostly due to rising exports but a rise in refinery demand contributed to the draw.

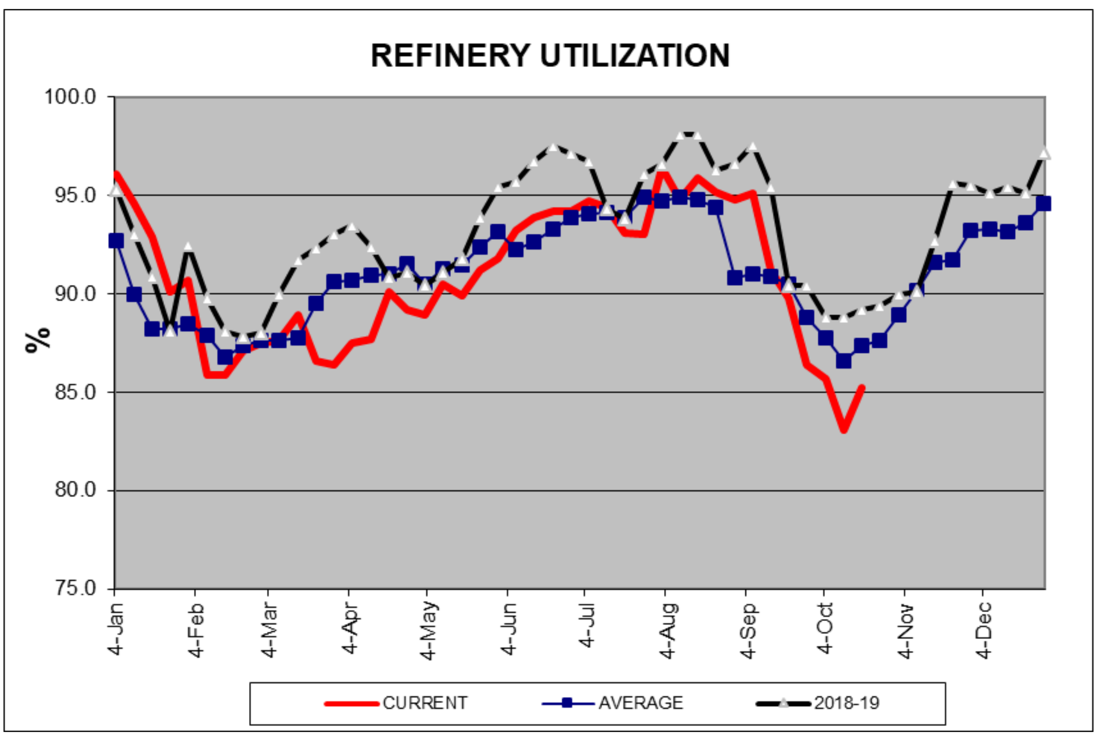
[1] A good book on this topic is *Ages of Discord* by Peter Turchin.



(Sources: DOE, CIM)

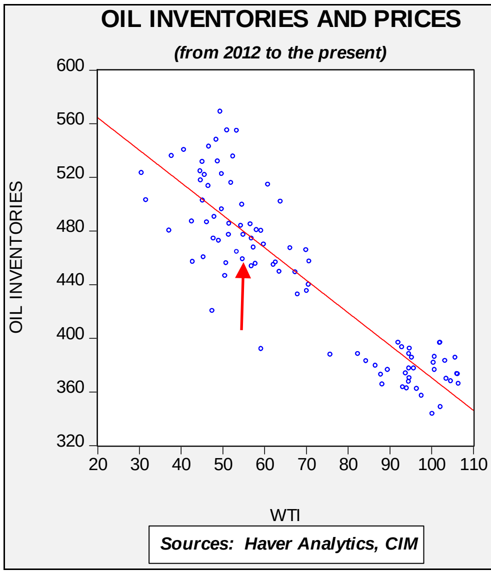
This chart shows the annual seasonal pattern for crude oil inventories. We are now in the autumn build season, which usually lasts into early December. This week's drop, though modest, is contraseasonal and bullish for crude oil.

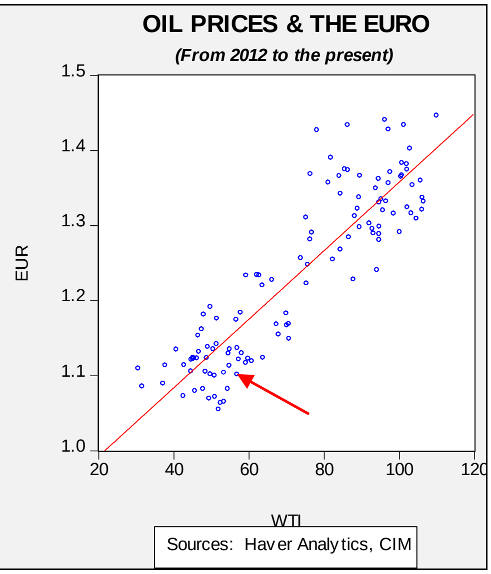
We continue to monitor the autumn refinery maintenance season.



(Sources: DOE, CIM)

This week's recovery in utilization turned "on schedule." We would expect refinery operations to rise steadily into year's end.

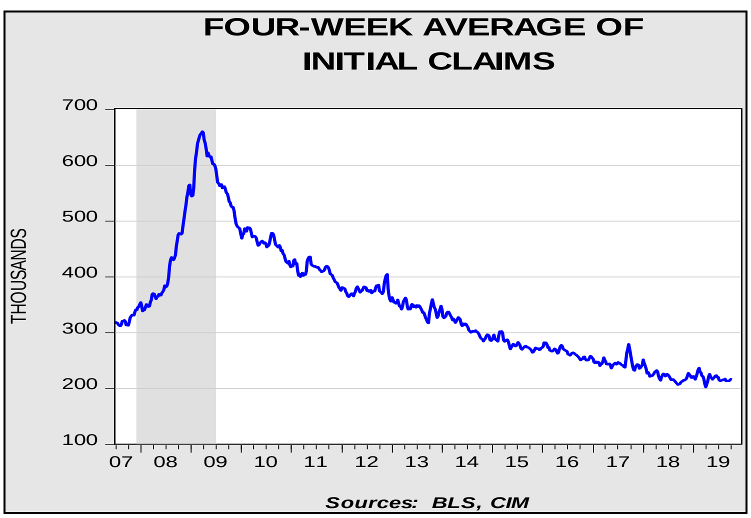




Based our oil inventory/price model, fair value is $62.96; using the euro/price model, fair value is $48.47. The combined model, a broader analysis of oil prices, generates a fair value of $52.73. We are seeing a clear divergence between the impact of the dollar and oil inventories. Given that we are in the maintenance season, we would normally expect inventories to continue to rise. We have been seeing stabilization of oil prices and would expect that to continue for the next few weeks.

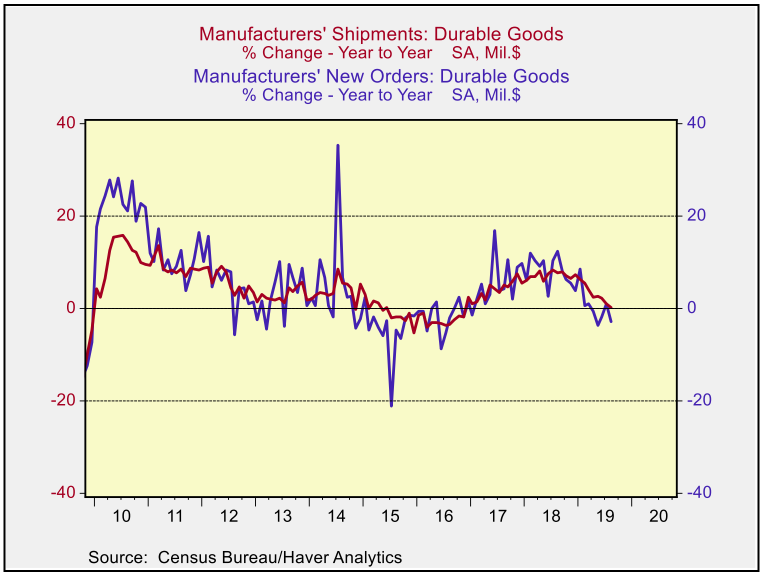
U.S. Economic Releases

Initial jobless claims came in below expectations at 212k compared to the forecast of 215k.



The chart above shows the four-week moving average for initial claims. The four-week moving average fell from 215.75k to 215.00k.

September durable goods orders came in below expectations, falling 1.1% from the prior month compared to the forecast fall of 0.7%. Durables ex-transportation came in below expectations, falling 0.3% from the prior month compared to the forecast drop of 0.2%. The prior report's gain of 0.5% was revised downward to 0.3%. Capital goods orders non-defense ex-air came in below expectations, falling 0.5% from the prior month compared to the forecast drop of 0.1%. The prior report's loss was revised downward from 0.4% to 0.6%. Capital goods shipments non-defense ex-air came in below expectations, falling 0.7% from the prior month compared to the forecast drop of 0.2%. The prior report's gain was revised downward from 0.3% to 0.0%.



The above chart shows the annual change in new durable goods orders and shipments. Annually, new orders fell by 4.0%, shipments fall by 0.2%, unfilled orders fell by 1.8% and inventories rose by 4.8%.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Consumer Comfort	m/m	oct		63.5	**
9:45	Markit Manufacturing PMI	m/m	oct	50.9	51.1	**
9:45	Markit Services PMI	m/m	oct	51.0	50.9	***
9:45	Markit Composite PMI	m/m	oct		51.0	*
10:00	New Home Sales	m/m	sep	702k	713k	***
10:00	New Home Sales	m/m	sep	-1.6%	7.1%	**
10:00	Kansas City Manufacturing Activity	m/m	oct	-3	-2	*
	Monthly Budget Statement	m/m	sep	$83.000 Bil	$119.100 Bil	**
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								
Japan	Swift Global Payments CNY	y/y	sep	2.0%	2.2%		*	Equity and bond neutral
	Jibun Bank Japan PMI Mfg	m/m	oct	48.5	48.9		**	Equity and bond bearish
	Jibun Bank Japan PMI Services	m/m	oct	50.3	52.8		**	Equity and bond neutral
	Jibun Bank Japan PMI Composite	m/m	oct	49.8	51.5		**	Equity and bond neutral
Australia	CBA Australia PMI Mfg	m/m	oct	50.1	50.3		**	Equity and bond neutral
	CBA Australia PMI Services	m/m	oct	50.8	52.4		**	Equity and bond neutral
	CBA Australia PMI Composite	m/m	oct	50.7	52.0		**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Manufacturing PMI	m/m	oct	45.7	45.7	46.0	**	Equity and bond bearish
	Markit Eurozone Services PMI	m/m	oct	51.8	51.6	51.9	**	Equity and bond neutral
	Markit Eurozone Composite PMI	m/m	oct	50.2	50.3	50.1	**	Equity and bond neutral
France	Markit France Manufacturing PMI	m/m	oct	50.5	50.1	50.2	**	Equity and bond neutral
	Markit France Services PMI	m/m	oct	52.9	51.1	51.6	**	Equity and bond neutral
	Markit France Composite PMI	m/m	oct	52.6	50.8	51.0	**	Equity and bond neutral
Germany	Markit/BME Germany Manufacturing PMI	m/m	oct	41.9	41.7	42.0	**	Equity and bond bearish
	Markit/BME Germany Services PMI	m/m	oct	51.2	51.4	52.0	**	Equity and bond neutral
	Markit/BME Germany Composite PMI	m/m	oct	48.6	48.5	48.8	**	Equity and bond neutral
UK	UK Finance Loans for Housing	m/m	sep	42310	42576	42350	*	Equity and bond neutral
AMERICAS								
Mexico	Economic Activity	m/m	aug	-0.9%	0.3%	0.5%	***	Equity and bond bearish
	Bi-Weekly CPI	m/m	15-Oct	0.4%	0.1%	0.4%	**	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)	194	193	1	Down
3-mo T-bill yield (bps)	161	162	-1	Neutral
TED spread (bps)	32	31	1	Neutral
U.S. Libor/OIS spread (bps)	158	159	-1	Up
10-yr T-note (%)	1.76	1.77	-0.01	Down
Euribor/OIS spread (bps)	-40	-40	0	Neutral
EUR/USD 3-mo swap (bps)	23	23	0	Down
Currencies	**Direction**			
dollar	Flat			Up
euro	Flat			Up
yen	Up			Down
pound	down			Up
franc	Flat			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
ECB Main Refinancing Rate	0.000%	0.000%	0.000%	On forecast
ECB Marginal Lending Facility	0.250%	0.250%	0.250%	On forecast
ECB Deposit Facility Rate	-0.500%	-0.400%	-0.500%	On forecast

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	$60.98	$61.17	-0.31%	
WTI	$55.64	$55.97	-0.59%	
Natural Gas	$2.30	$2.28	0.96%	
Crack Spread	$16.50	$16.58	-0.47%	
12-mo strip crack	$18.20	$18.28	-0.42%	
Ethanol rack	$1.66	$1.66	-0.01%	
Metals				
Gold	$1,490.10	$1,492.12	-0.14%	
Silver	$17.53	$17.55	-0.13%	
Copper contract	$267.45	$267.15	0.11%	
Grains				
Corn contract	$ 388.75	$ 387.75	0.26%	
Wheat contract	$ 519.75	$ 520.75	-0.19%	
Soybeans contract	$ 950.25	$ 948.25	0.21%	
Shipping				
Baltic Dry Freight	1779	1806	-27	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-1.7	3.0	-4.7	
Gasoline (mb)	-3.1	-2.0	-1.1	
Distillates (mb)	-2.7	-2.5	-0.2	
Refinery run rates (%)	2.10%	1.00%	1.10%	
Natural gas (bcf)		104.0		

Weather

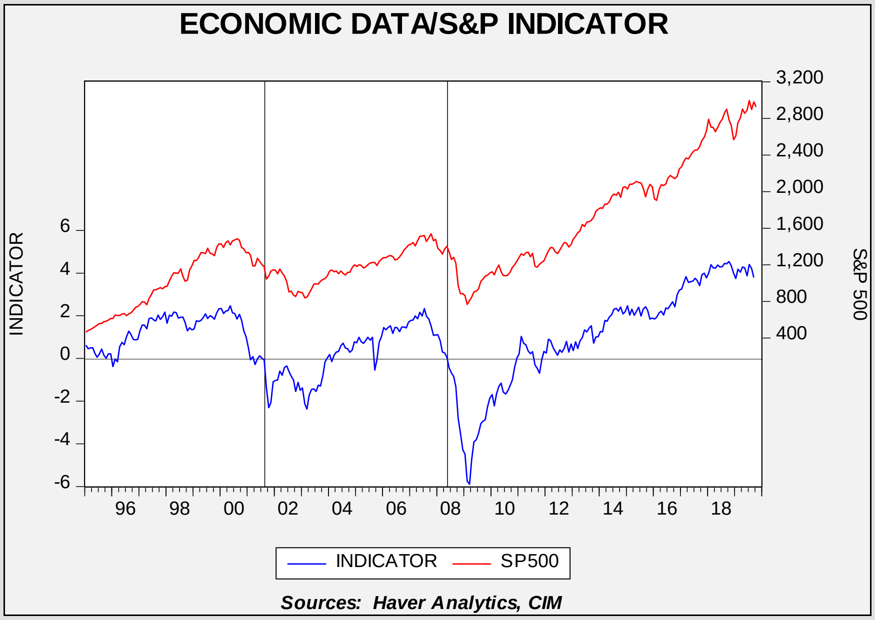
The 6-10 and 8-14 day forecasts call for much cooler-than-normal temperatures for most of the country from the Rockies to the Appalachians, with warmer temperatures on the East Coast and the northern California coast. Wet conditions are expected for the eastern half of the country. There is some cyclone formation in the Gulf of Mexico, but it is not expected to develop into a tropical storm within the next 48 hours. Hurricane season usually ends on November 1.

Asset Allocation Weekly

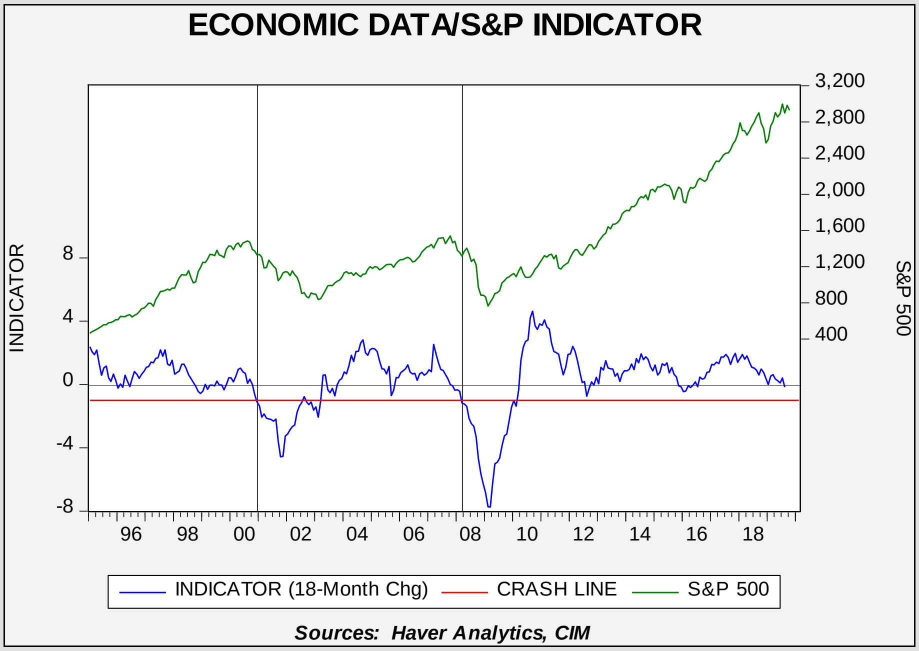
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

October 18, 2019

In 2017, we introduced an indicator of the basic health of the economy and added it to the many charts we monitor to gauge market conditions. The indicator is constructed using commodity prices, initial claims and consumer confidence. The thesis behind this indicator is that these three components should offer a simple and clear picture of the economy; in other words, rising initial claims coupled with falling commodity prices and consumer confidence is a warning that a downturn may be imminent. The opposite condition should support further economic recovery. In this report, we will update the indicator with September data.



This chart shows the results of the indicator and the S&P 500 since 1995. The updated chart shows that the upward momentum in the economy slowed last year but it does remain well above zero. We have placed vertical lines at certain points when the indicator fell below zero. It works fairly well as a signal that equities are turning lower, but there is a lag. In other words, by the time this indicator suggests the economy is in trouble, the recession is very near and the equity markets have already begun their decline.



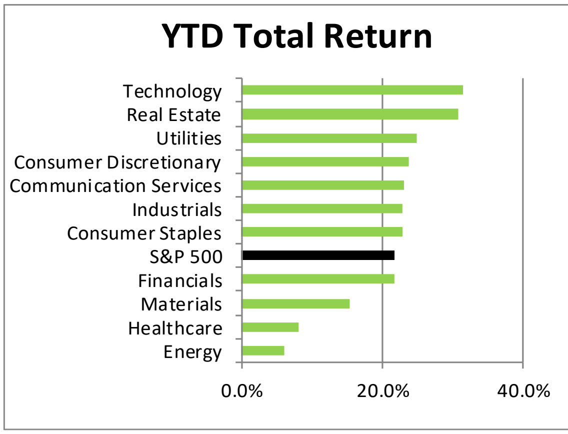
To make the indicator more sensitive, we took the 18-month change and put the signal threshold at minus 1.0. This provides an earlier bearish signal and also eliminates the false positives that the zero threshold generates. Nevertheless, the fact that this variation of the indicator is just below zero raises caution.

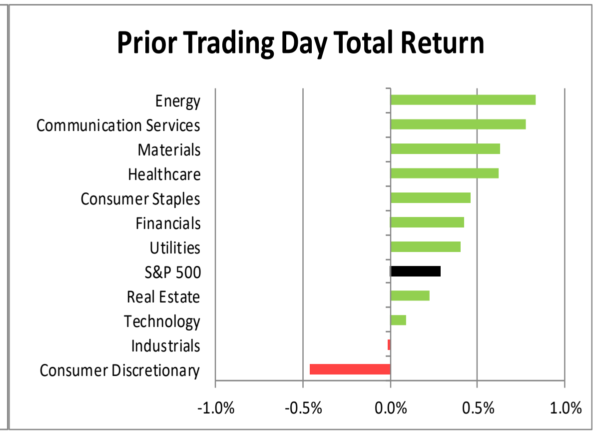
What does the indicator say now? The economy has decelerated but is not yet at a point where investors should become overly defensive. At the same time, the 18-month change in the indicator has fallen below zero; in 2016, this situation led to several months of sideways market activity. If we continue to see the lower chart hover around zero, the greater the likelihood that equities will flatten. Thus, reducing equity risk by rebalancing for a more defensive equity sector exposure would be prudent.

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 10/23/2019 close)

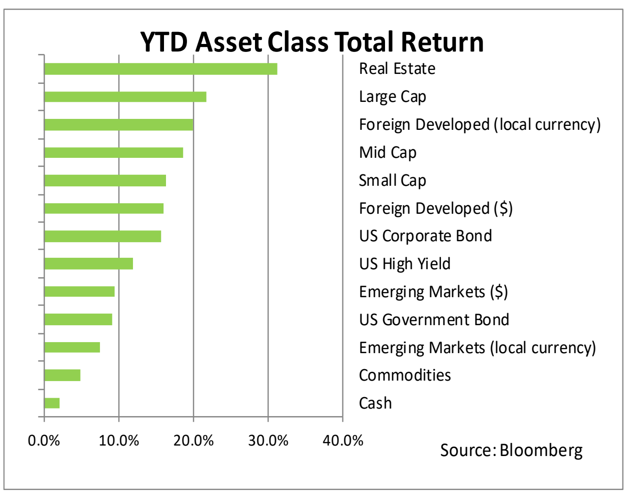




(Source: Bloomberg)

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 10/23/2019 close)

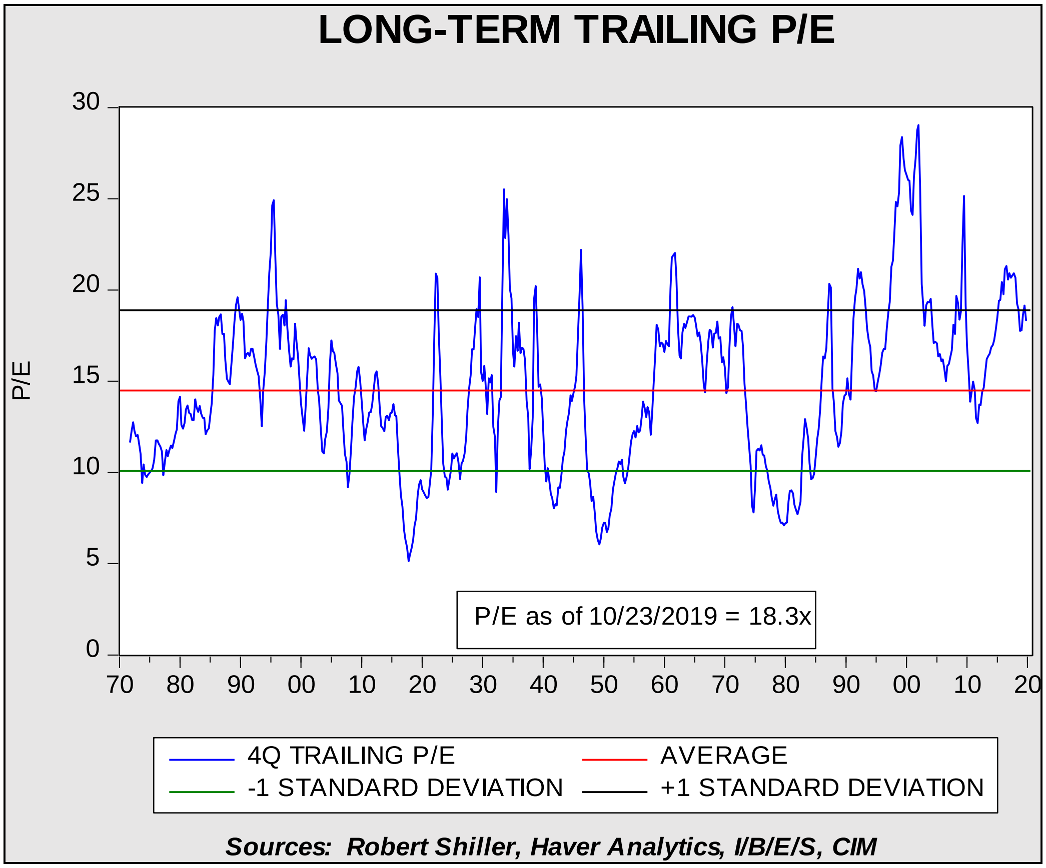


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 24, 2019



Based on our methodology,[2] the current P/E is 18.3x, up 0.21x from last week. The rise in the P/E is due to a combination of falling earnings forecasts and 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.