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 3, 2019—9:30 AM EDT] Global equity markets are flat this morning. The EuroStoxx 50 is up 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.1%. Chinese markets were closed for National Day. U.S. equity index futures are signaling a flat open.

Equity markets are mostly flat this morning after two sharp down days. Johnson has a new Brexit plan. The WTO approves U.S. retaliatory tariffs against the EU. Here is what we are watching this morning:

Equity worries: Equity markets have taken a bruising in the first two days of the quarter. Worries about global growth are front and center, but other issues are important as well. First, with Chinese negotiators coming to Washington next week, there is hope that at least a truce will emerge. In fact, a narrative is developing that suggests President Trump will make a deal with China because he needs equities to rally and he needs a "win" amidst impeachment investigations and slowing growth. Perhaps. However, the president has suggested on numerous occasions that he views the trade conflict with China as politically supportive; in addition, there is growing support for confronting China in Congress. Thus, if the administration takes a partial deal it might backfire. Another point to consider is what China wants. There is no doubt a trade war hurts both sides. The issue isn't who suffers the most but who has the greater ability to absorb pain. China probably can win on this one; Xi runs a surveillance state and has much more control over his media. China probably won't accept anything other than a full removal of tariffs, something we doubt the U.S. will accept. If the meetings next week don't offer something to the markets, and tariffs are applied as scheduled, further weakness is likely.

Second, there is a worry that the Fed may react too slowly to problems in the economy, as it did in 2007. We note recent speakers have struck an optimistic tone on the economy, which may make it more difficult to cut rates quickly. It is hard for an institution that has relied on the Phillips Curve for decades to cut rates when unemployment is this low. History shows, unfortunately, that policymakers tend to wait until the evidence is abundant to support easier policy. Usually by that point, it's too late.

EU tariffs: The WTO has confirmed that Airbus (EADSY, 31.34) received illegal subsidies and gave the U.S. permission to apply $7.5 bn of retaliatory tariffs against EU products. The USTR has drawn up a list of products he recommends to be taxed.[1] In addition to these tariffs,

[1] Front and center are single-malt Irish and Scotch whiskies.

President Trump will decide by November 13 if he will place tariffs on autos and parts that could be worth up to $100 bn. EU leaders are quietly begging Congress to prevent this from happening. Even though talks with China loom large, the potential that the trade conflict could shift to Europe doesn't appear to have been discounted by the market; otherwise, we would likely see a much weaker EUR.

On the other hand: All isn't lost on trade. Despite the impeachment proceedings, Congress does appear to be making progress on USMCA. Getting that deal done would likely be positive for Canada and Mexico.

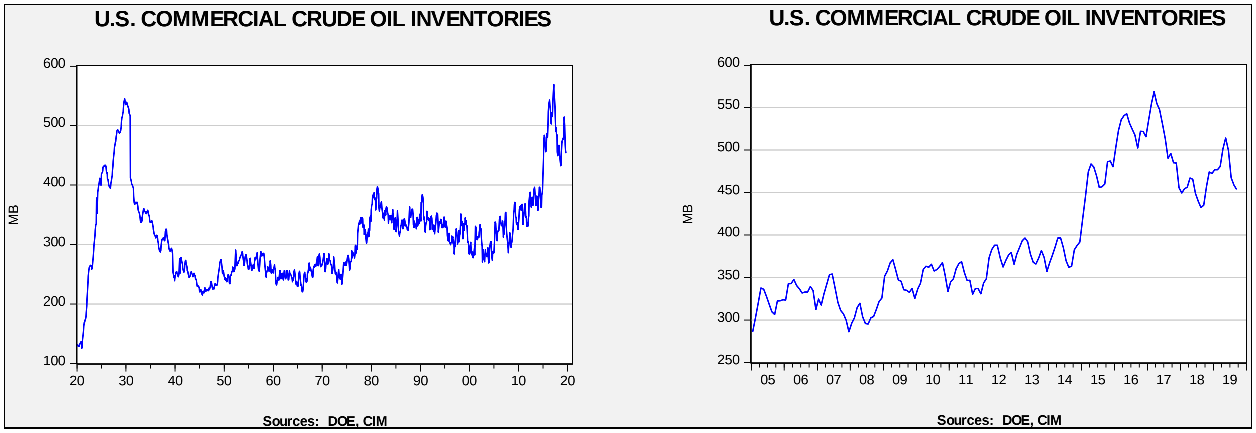
Johnson's plan: PM Johnson released his Brexit plan. It's rather convoluted, involving a customs border and a separate regulatory border. So far, the EU has reacted cautiously, not because it thinks the plan has merit but because it fears Johnson will use rejection to argue that the EU will never agree to an acceptable plan and a hard Brexit is the real goal. In our opinion, Johnson's goal is to get new elections. He would prefer not to have a hard Brexit but feels that is a better outcome than constantly extending the deadline. What Johnson seems to want is Brexit followed by elections; if the U.K. is out of the EU, then the Brexit Party has no reason for existence and the Liberal-Democrats have no issue to run on. Labour is hopelessly split and the Tories will likely romp to victory. There is only one problem with this plan—if a hard Brexit proves to be the economic disaster that many have warned against, it's hard to see how Johnson can win an election. Whether or not these dire forecasts are correct is an empirical question, but therein lies the risk of where Johnson seems to be heading. Of course, if everything breaks his way, an even better outcome is that the EU caves and accepts his plan, he pulls the U.K. out of the EU on time and is the conquering hero. But, the aforementioned "Plan B" of leaving without a deal is also acceptable.

Hong Kong: The city's cabinet will meet Friday to approve using a colonial-era emergency powers law to get control over the ongoing anti-China protests. One measure being considered would be a ban on publicly wearing the masks that protestors use to protect themselves from tear gas. We suspect the government's further clampdown will likely spawn more, not less, protests.

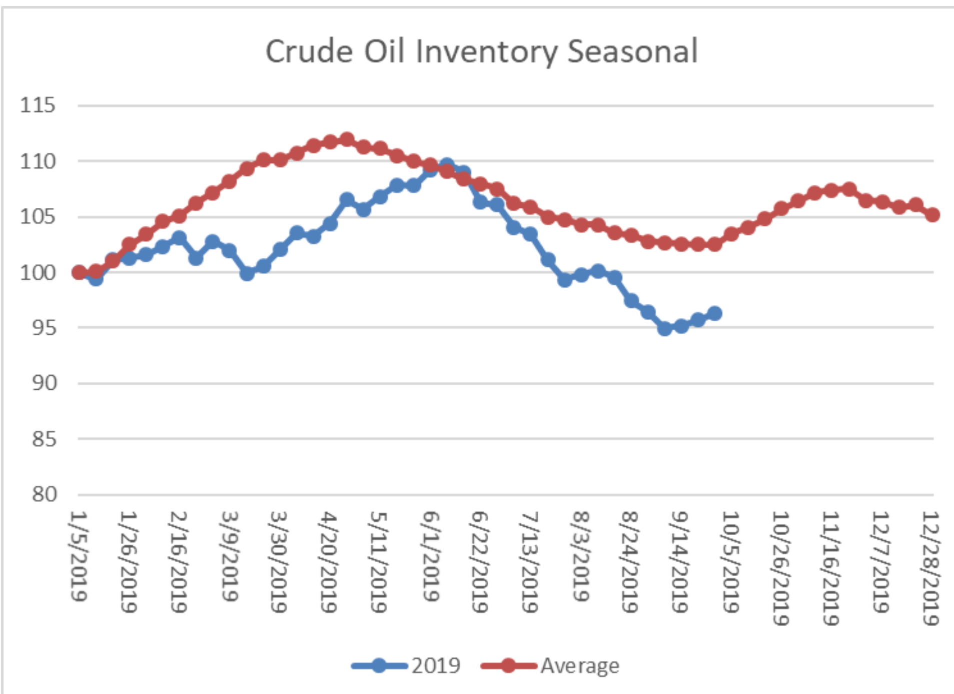
Turkey: U.S. national security officials say Turkey seems to be preparing to send troops into northeastern Syria to attack the U.S.-allied Kurdish forces battling ISIS there. If a large attack transpires, the officials say the U.S. may have to pull its remaining 1,000 or so troops out of Syria, potentially allowing ISIS to regroup.

Ukraine: While President Zelensky may be in hot water over the U.S. impeachment inquiry, that shouldn't detract from his success in easing tensions with the pro-Russia separatists in eastern Ukraine. This week, his government signed a deal with the separatists, Russia and EU monitors for a limited troop withdrawal and local elections in separatist-controlled areas as soon as Kiev gets control over its border with Russia.

Energy update: Crude oil inventories rose 2.4 mb compared to an expected draw of 0.6 mb.



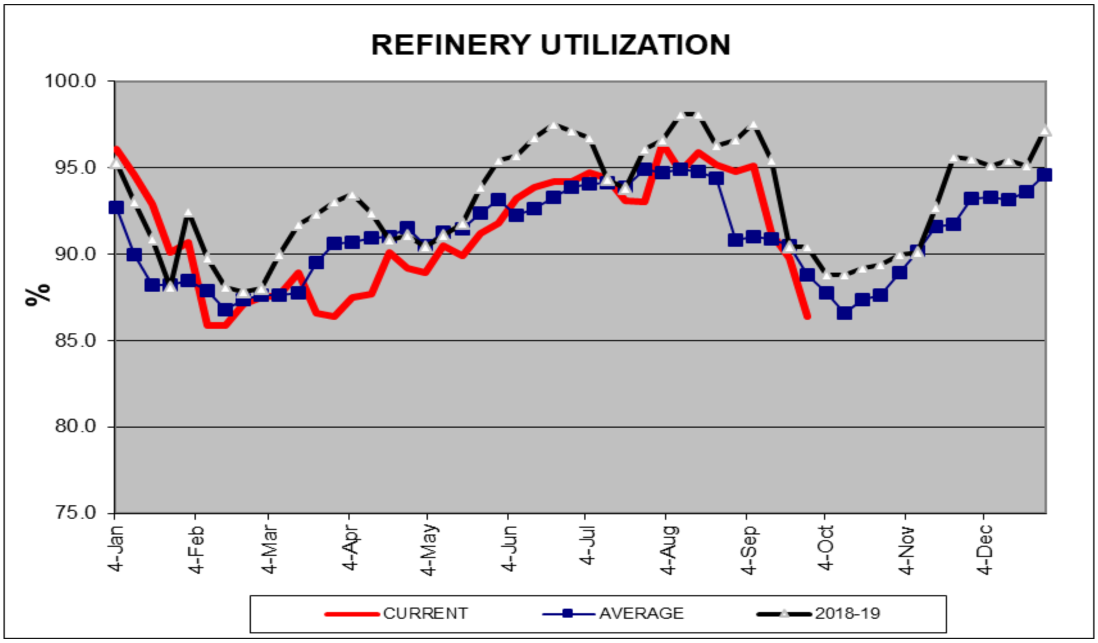
In the details, U.S. crude oil production fell 0.1 mbpd to 12.4 mbpd. Exports and imports both fell 0.1 mbpd. The rise in stockpiles was mostly due to falling refinery demand (see below).



(Sources: DOE, CIM)

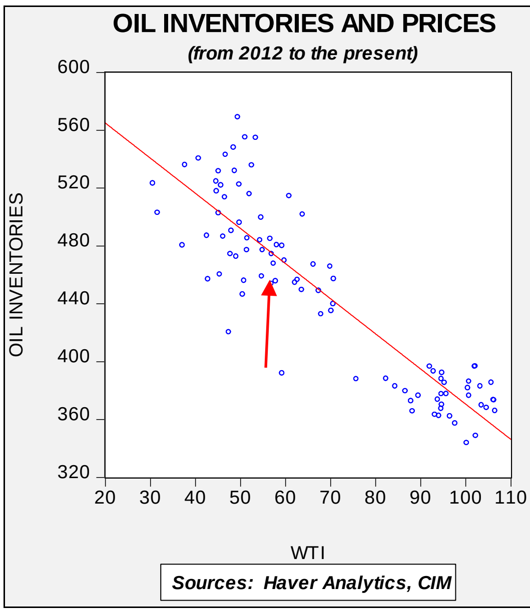
This chart shows the annual seasonal pattern for crude oil inventories. This week usually signals the beginning of the autumn build season. We have already troughed stocks but expect them to rise into early December.

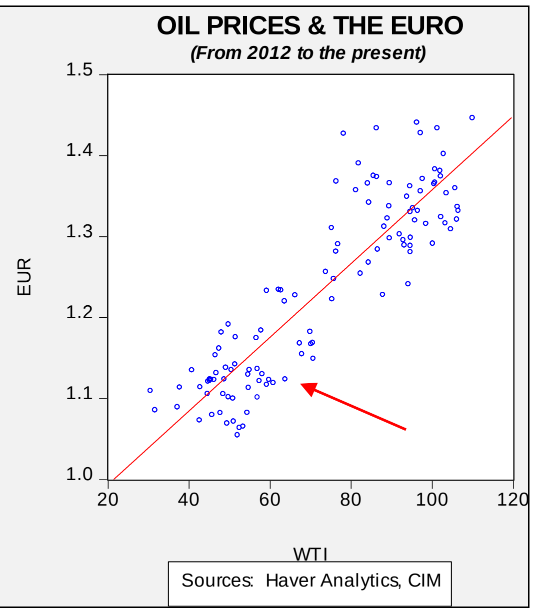
The most important information from this week's data is that we are now well into the autumn refinery maintenance season.



(Sources: DOE, CIM)

The decline in refinery utilization will likely continue for the next two weeks and should begin to rise by mid-October. During this period, inventories usually rise. However, the extent of the rise will depend on Saudi production.



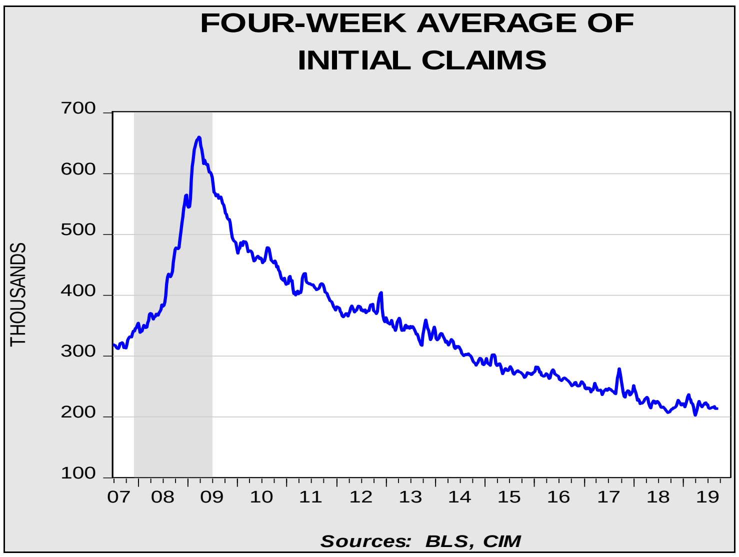


Based on our oil inventory/price model, fair value is $66.51; using the euro/price model, fair value is $47.84. The combined model, a broader analysis of oil prices, generates a fair value of $53.63. We are seeing a clear divergence between the impact of the dollar and oil inventories. Given that we are into the maintenance season, we would normally expect inventories to rise. Reports that the [KSA has lifted output to pre-attack levels] has put further pressure on oil prices. We also note that Iraqi PM Mahdi has imposed a 24-hour curfew in response to two days of large [demonstrations against government corruption and high unemployment](#) that have killed 18 people.

U.S. Economic Releases

The September Challenger job cuts report fell by 24.8% from the prior year. The index measures the number of announced job cuts by employers, which is a proxy for future layoffs but does not necessarily indicate the state of current layoffs.

Initial jobless claims came in above expectations at 219k compared to the forecast of 215k. The prior report was revised upward from 213k to 215k.



The chart above shows the four-week moving average for initial claims. The four-week moving average remains unchanged at 212.5k.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Bloomberg Consumer Comfort	m/m	29-Sep		61.7	**
9:45	Markit US Services PMI	m/m	aug	50.9	50.9	**
9:45	Markit US Composite PMI	m/m	aug		51.0	**
10:00	ISM Non-manufacturing Index	m/m	sep	55.0	56.4	**
10:00	Factory Orders	m/m	aug	-0.2%	1.4%	***
10:00	Factory Orders ex Trans	m/m	aug		0.3%	*
10:00	Durable Goods Orders	m/m	aug		0.2%	***
10:00	Durables ex Transportation	m/m	aug		0.5%	**
10:00	Cap Goods Orders Nondefense Expenditure	m/m	aug		-0.2%	*
10:00	Cap Goods Shipt Nondef ex Air	m/m	aug		0.4%	*
Fed Speakers or Events						
	Speaker or event	**District or position**				
12:10	Loretta Mester takes Part in a Panel Discussion on Inflation	President of the Federal Reserve Bank of Cleveland				
13:00	Robert Kaplan Speaking at Community Forum in Houston	President of the Federal Reserve Bank of Dallas				
18:35	Richard Clarida Discusses Economy, Monetary Policy in New York	Vice Chairman of Board of Governors of Federal Reserve				

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 Bank Japan PMI Services	m/m	sep	52.8	52.8		**	Equity and bond neutral
	Jibun Bank Japan PMI Composite	m/m	sep	51.5	51.5		**	Equity and bond neutral
Australia	AiG Performance of Services Index	m/m	sep	51.5	51.4		**	Equity and bond neutral
	CBA Australia PMI Services	m/m	sep	52.4	49.1		**	Equity bullish, bond bearish
	CBA Australia PMI Composite	m/m	sep	52.0	51.9		**	Equity and bond neutral
	Trade Balance	m/m	sep	A$5.926 Bil	A$7.268 Bil	A$6.100 Bil	**	Equity and bond neutral
New Zealand	ANZ Commodity Price	m/m	sep	0.0%	0.3%		***	Equity and bond neutral
EUROPE								
Eurozone	PPI	m/m	aug	-0.8%	0.2%	-0.4%	**	Equity bullish, bond bearish
	Retail Sales	m/m	aug	0.3%	-0.6%	0.3%	**	Equity and bond neutral
	Markit Eurozone Services	m/m	sep	51.6	52.0	52.0	**	Equity and bond neutral
	Markit Eurozone Composite	m/m	sep	50.1	50.4	50.4	**	Equity and bond neutral
Germany	Markit Germany Services	m/m	sep	51.4	52.5	52.5	**	Equity and bond neutral
	Markit/BME Germany Composte	m/m	sep	48.5	49.1	49.1	**	Equity and bond bearish
Italy	Markit Italy Services PMI	m/m	sep	51.4	50.6	50.5	**	Equity bullish, bond bearish
	Markit Italy Composite PMI	m/m	sep	50.6	50.3	50.0	**	Equity bullish, bond bearish
France	Markit France Services PMI	m/m	sep	51.1	51.6	51.6	**	Equity and bond neutral
	Markit France Composite PMI	m/m	sep	50.8	51.3	51.3	**	Equity and bond neutral
UK	Markit/CIPS UK Services PMI	m/m	sep	49.5	50.6	50.3	**	Equity and bond bearish
	Markit/CIPS UK Composite PMI	m/m	sep	49.3	50.2	50.0	**	Equity and bond bearish
	Official Reserves Changes	m/m	sep	$0.475 Bil	$1.918 Bil		*	Equity and bond neutral
Russia	GDP	y/y	2q	0.9%	0.9%	0.9%	***	Equity and bond neutral
AMERICAS								
Mexico	Consumer Confidence	m/m	aug	44.7	43.4	43.6	***	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)	209	209	0	Down
3-mo T-bill yield (bps)	170	171	-1	Neutral
TED spread (bps)	39	37	2	Neutral
U.S. Libor/OIS spread (bps)	168	168	0	Up
10-yr T-note (%)	1.58	1.60	-0.02	Down
Euribor/OIS spread (bps)	-43	-43	0	Neutral
EUR/USD 3-mo swap (bps)	29	29	0	Down
Currencies	**Direction**			
dollar	Down			Up
euro	Flat			Down
yen	Up			Down
pound	Up			Up
franc	Down			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	$57.71	$57.69	0.03%	
WTI	$52.66	$52.64	0.04%	
Natural Gas	$2.28	$2.25	1.56%	
Crack Spread	$16.93	$16.83	0.55%	
12-mo strip crack	$17.96	$17.84	0.67%	
Ethanol rack	$1.75	$1.74	0.62%	
Metals				
Gold	$1,502.30	$1,499.45	0.19%	
Silver	$17.58	$17.56	0.11%	
Copper contract	$255.00	$257.05	-0.80%	
Grains				
Corn contract	$ 387.00	$ 387.75	-0.19%	
Wheat contract	$ 487.50	$ 489.00	-0.31%	
Soybeans contract	$ 912.75	$ 913.75	-0.11%	
Shipping				
Baltic Dry Freight	1803	1809	-6	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	3.1	2.3	0.9	
Gasoline (mb)	-0.2	0.6	-0.8	
Distillates (mb)	-2.4	-2.0	-0.4	
Refinery run rates (%)	3.40%	-0.50%	3.90%	

Weather

The 6-10 and 8-14 day forecasts call for higher-than-normal temperatures for most of the country, with normal or lower-than-normal temperatures only in the Pacific Northwest. Precipitation is expected in New England, the Southeast and the Pacific Northwest. There is a disturbance in the Caribbean, but it is not expected to develop into a tropical storm.

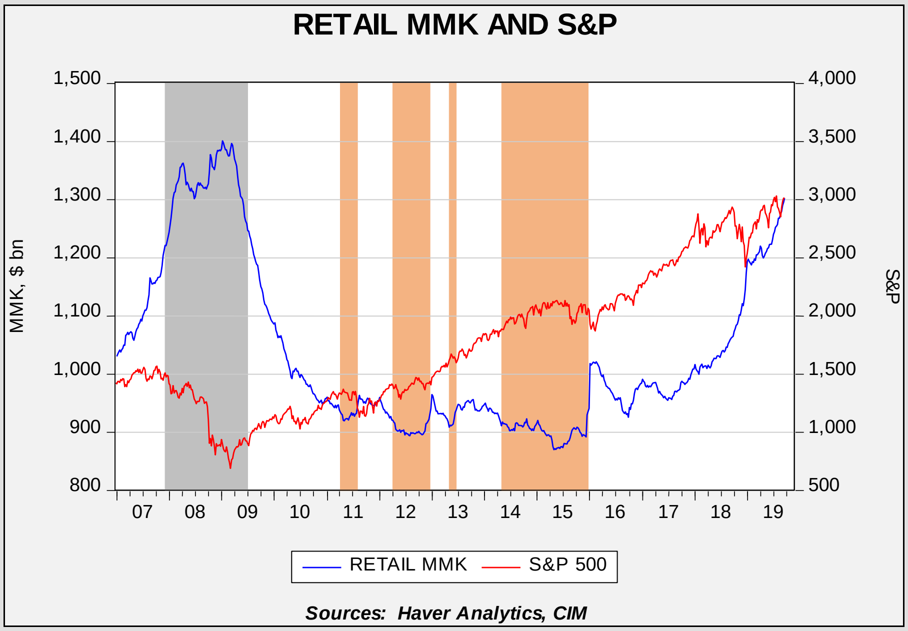
Asset Allocation Weekly

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.

September 27, 2019

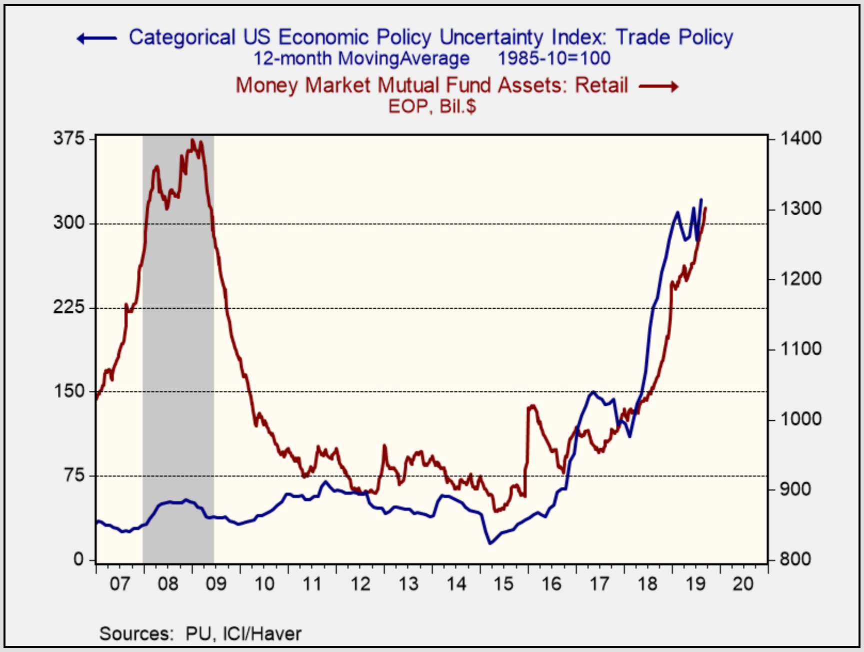
Over the past few months, we have been on "recession watch." Our position is that the odds of a downturn are elevated but it is too soon to fully position for a downturn. The inversion of yield curves is a reliable recession warning. On the other hand, the economic data continues to signal a slow U.S. economy but not one seeing negative growth. As long as the economy continues to expand, it does not make sense to underweight equities.

However, there is another possibility to consider. Investors appear to have become overly cautious recently.



This chart shows retail money market levels on a weekly basis along with the Friday closes of the S&P 500. The gray bars show recessions, whereas the orange bars show periods when retail money markets (RMMK) fall below $920 bn. In general, when RMMK fall to $920 bn or below, the uptrend in equities tends to stall. It would seem there is a certain level of desired cash, and when that level falls below $920 bn, households try to rebuild cash by either slowing their purchases of equities or selling stocks to build liquidity.

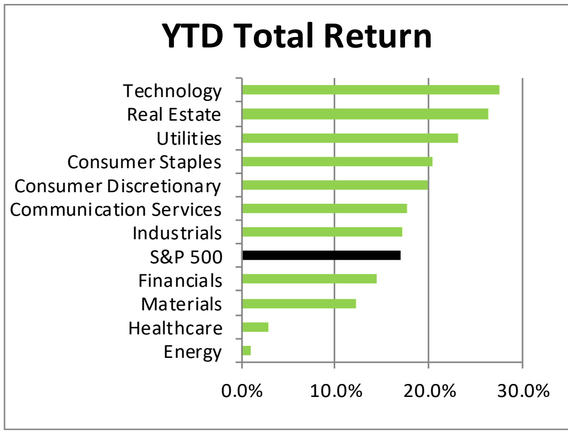
The chart shows that, in early 2018, households began to aggressively build RMMK, which would coincide with rising trade tensions.

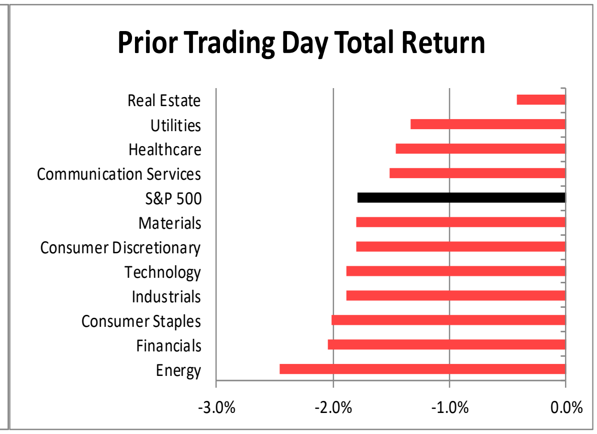


This chart shows RMMK with the 12-month average of the Policy Uncertainty Index for trade policy. The fit is rather obvious. If the U.S. and China come to a short-term agreement that reduces trade worries, it might free up significant liquidity that would find its way into equities. The potential for such flows, coupled with the usual positive seasonal trend in Q4, could lead to a strong close in equities for 2019. This doesn't mean that investors should not continue to watch for recession signals, but de-risking portfolios too quickly may very well be counterproductive.

Data Section

U.S. Equity Markets – (as of 10/2/2019 close)

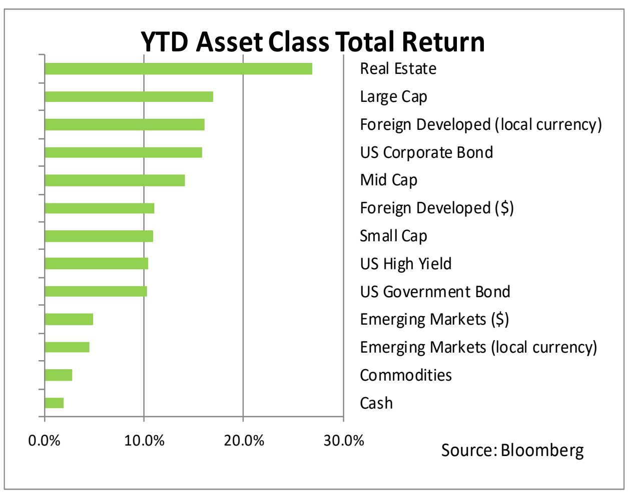




(Source: Bloomberg)

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 10/2/2019 close)

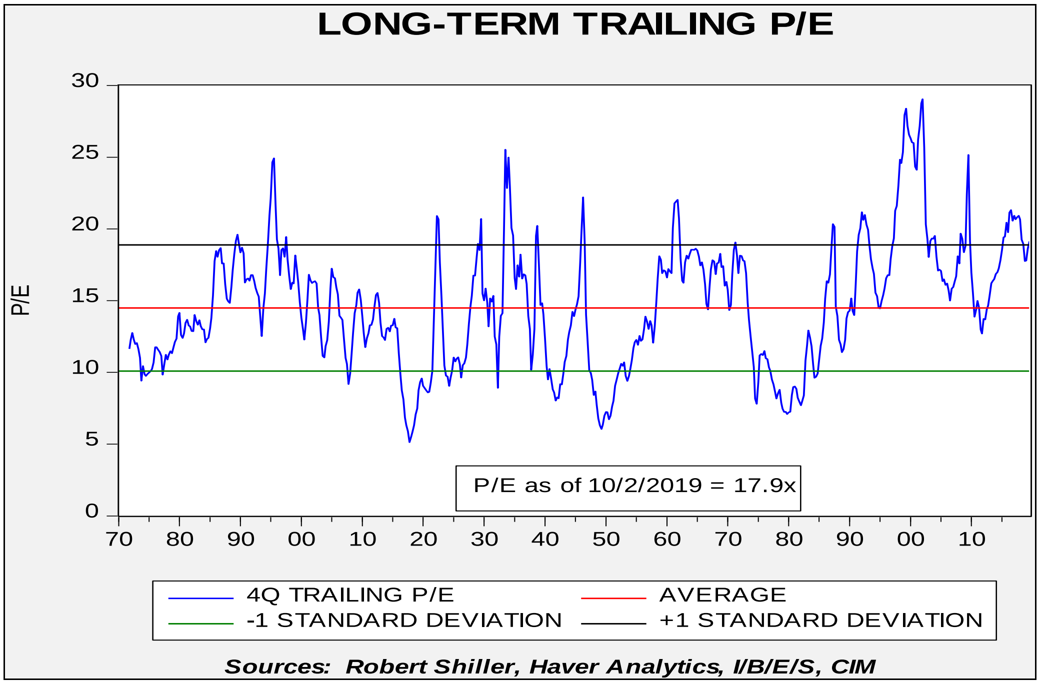


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 3, 2019



Based on our methodology,[2] the current P/E is 17.9x, down 1.1x from last week. With the onset of Q4, we add this quarter's estimates for earnings and drop Q4 2018. This change lifted the "E" in the ratio and accounts for the lower multiple.

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[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.