Daily Comment

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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 7, 2019—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.1%. Chinese markets were closed for National Day. U.S. equity index futures are signaling a lower open.

Happy Monday (is it just me? Or are weekends getting shorter?)! It's a big week—the Fed releases its minutes on Wednesday, we get CPI on Thursday and Chinese officials are in town for trade talks. Here are some of the details:

China talks: It appears that Chinese officials are not open to making a broad trade deal with the U.S. Current thinking is that China will push for a narrow agreement, wanting a removal of sanctions in return for some grain purchases. The most important development is that China will not agree to changes to its industrial policy, a key demand of the U.S. We suspect China is betting that the president needs a win as we are a mere 13 months from the next election. In addition, with political turmoil in the U.S. rising, China likely believes it has the upper hand. Unspoken in this stance is perhaps the idea that Beijing thinks there may be a new president in 2020, and that might lead to a different negotiating position. President Trump has consistently stated that he won't accept a small deal; although the president is mercurial, his position on trade does appear to be a core belief. There seems to be a general belief in the financial markets that Trump will accept a small deal to declare victory; we remain unconvinced and would not be surprised to see the trade talks end without an agreement, which would be bearish for risk assets.

Strike continues: According to reports, contract negotiations between the UAW and General Motors (GM, 34.91) are not going very well. The union has rejected the latest offer from the car company. It appears the two sides, though still talking, remain far apart. The UAW wants new workers to reach full pay quicker, something GM is reluctant to accept. However, looming over these talks are worker fears that as the transportation system moves to electric, the number of workers required to build cars will fall as electric cars have fewer parts and are easier to assemble. GM likely sees the move to electrification as a way to reduce its assembly force and thus will likely fight hard to prevent job guarantees. As the strike heads into its third week, we will start to see the outage affect the macro data; claims should start to rise, and layoffs could begin to spread into the dealer network and independent parts suppliers.

Pity the Kurds: The U.S. has begun moving troops out of northern Syria, as Turkey is preparing military operations against the Kurds. Turkey fears Kurdish autonomy on its southern border in Iraq and Syria because it could build into separatist movements among Turkish Kurds.

The Kurds have been allied with the U.S. since the no-fly zones were established after the Gulf War and have been steadfast allies. Although the Kurds are a fine fighting force, they will likely struggle to resist the Turkish military. We will be watching to see how Assad and the Russians react to this incursion, as it could mean Turkey intends to expand its territory into what was once Syrian territory on the pretense that it is combating Kurdish separatists.

There are three items will we be watching. First, the Kurdish forces, which were instrumental in destroying most of Islamic State's power in Syria, will now be distracted and weakened which could potentially set the stage for a revival of the Islamic State. Second, this could mark the beginning of a rapprochement between the U.S. and Turkey, after a long period of worsening relations (see our *Weekly Geopolitical Report* from August 5, 2019). Third, the troop withdrawal will likely be seen as confirmation that President Trump has abandoned the Carter Doctrine and has no stomach for being involved in Middle Eastern military operations. The third point is especially important, as it suggests Iran will be emboldened by the move.

Germany: August industrial new orders came in worse than expected, with a seasonally-adjusted decline of 0.6% instead of the expected rise. In a sign that the world's manufacturing recession may be spreading beyond trade-oriented sectors, the decline was driven by a sharp 2.6% fall in domestic orders. Overall orders in August were down 8.9% year-over-year.

Unrest update: Despite a ban against face masks, masked protests were widespread in Hong Kong over the weekend. Now that the National Day holiday is behind us, we will be watching to see how much longer Beijing will tolerate the unrest. Meanwhile, in Iraq protests continue despite harsh retaliation by the government and paramilitary groups. So far, the protests have not affected oil flows, but we are watching closely for that development.

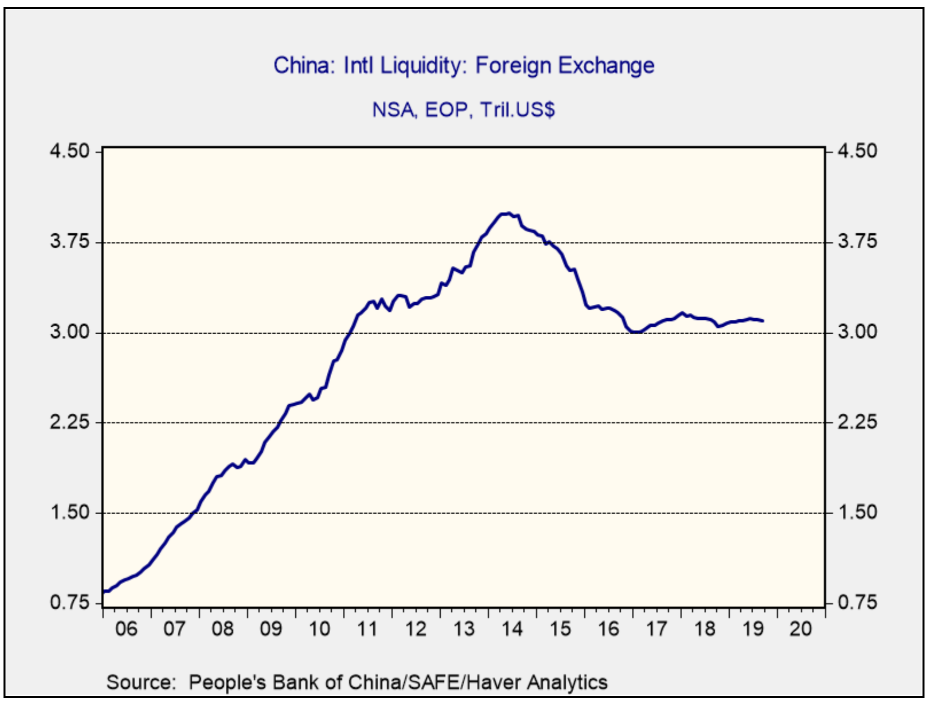
Brexit news: A Scottish court refused a petition by Remain supporters that would have forced the PM to ask for an extension if an agreement isn't reached with the EU. The judge argued that the Benn Act prevents a hard Brexit, so the court order was unnecessary. Remainers fear that

Johnson will violate the act and may exit on Halloween despite the legislation. Meanwhile, the EU is signaling to the U.K. that a new proposal on the Irish border will be necessary by Friday.

Iran news: China's state oil company has pulled out of a plan to develop part of Iran's offshore natural gas field. Although China does conduct business with Iran despite sanctions, apparently the Chinese company decided not to run afoul of the U.S. In another interesting development, Iran has detained a Russian journalist. Although there is a tendency to view Iran and Russia as allies, both are trying to dominate the Middle East and could very well end up at loggerheads.

Portugal: Prime Minister Costa and his center-left Socialist Party won Sunday's elections, boosting their seat total to 106 in the 230-seat parliament. Although Costa still needs to find allies to gain a majority, the results suggest Europe's center-left parties are regaining their appeal after the rise of right-wing, populist parties in recent years.

China reserves: China's foreign reserves fell more than expected to $3.092 bn compared to forecasts of $3.106 bn. For the most part, reserves remain steady and the larger than expected decline may reflect less dollar exposure; if so, as the dollar appreciates the non-dollar portion of reserves would decline in value.



Odds and ends: Talks with North Korea appear to have broken down, although the State Department has put a positive spin on discussions. The National Association of Business economists are projecting sub-2% growth for 2020. A heads-up—you will likely see the linked chart show up often today.

U.S. Economic Releases

The table below lists the Fed events and Economic Releases scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
15:00	Consumer Credit	m/m	aug	$15.000 Bil	$23.394 Bil	**
	Monthly Budget Statement	m/m	sep	$93.000 Bil	$119.100 Bil	**
Fed Speakers or Events						
	Speaker or event	District or position				
10:20	Neel Kashkari Discusses Fed's Work on Native American Reservations	President of Federal Reserve Bank of Minneapolis				

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	Foreign Reserves	m/m	sep	$3.092 Tril	$3.107 Tril	$3.106 Tril	**	Equity and bond neutral
Japan	Official Reserves Assets	m/m	sep	$1.323 Tril	$1.331 Tril		**	Equity and bond neutral
	Leading Index CI	m/m	aug	91.7	93.7	91.8	**	Equity and bond bearish
	Coincident Index	m/m	aug	99.3	99.7	99.4	**	Equity and bond neutral
Australia	AiG Performance of Construction Index	m/m	sep	42.6	44.6		**	Equity and bond neutral
EUROPE								
Eurozone	Sentix Investor Confidence	m/m	oct	-16.8	-11.1	-13.0	**	Equity and bond bearish
Germany	Factory Orders	m/m	aug	-0.6%	-2.7%	-0.3%	**	Equity and bond bearish
UK	BRC Sales Like-for-Like	y/y	sep	-1.7%	-0.5%	-0.9%	*	Equity and bond bearish
Switzerland	Foreign Currency Reserves	m/m	sep	776.9 Bil	767.1 Bil		*	Equity and bond neutral
AMERICAS								
Mexico	Gross Fixed Investment	y/y	jul	-7.6%	-8.8%	-7.8%	**	Equity and bond neutral
Canada	International Merchandise Trade	m/m	aug	-0.960 Bil	-1.120 Bil	-1.200 Bil	**	Equity bullish, bond bearish
	Ivey Purchasing Managers Index	w/w	4-Oct	48.7	60.6		**	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)	203	204	-1	Down
3-mo T-bill yield (bps)	166	166	0	Neutral
TED spread (bps)	37	38	-1	Neutral
U.S. Libor/OIS spread (bps)	166	167	-1	Up
10-yr T-note (%)	1.53	1.53	0.00	Down
Euribor/OIS spread (bps)	-42	-43	1	Neutral
EUR/USD 3-mo swap (bps)	24	27	-3	Down
Currencies	**Direction**			
dollar	Up			Up
euro	Flat			Down
yen	Flat			Down
pound	Flat			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	$58.85	$58.37	0.82%	
WTI	$53.37	$52.81	1.06%	
Natural Gas	$2.31	$2.35	-1.70%	
Crack Spread	$17.50	$17.67	-0.95%	
12-mo strip crack	$18.10	$18.21	-0.59%	
Ethanol rack	$1.70	$1.72	-0.79%	
Metals				
Gold	$1,499.95	$1,504.66	-0.31%	
Silver	$17.46	$17.55	-0.53%	
Copper contract	$255.90	$256.25	-0.14%	
Grains				
Corn contract	$ 385.50	$ 384.75	0.19%	
Wheat contract	$ 489.50	$ 490.50	-0.20%	
Soybeans contract	$ 915.00	$ 916.25	-0.14%	
Shipping				
Baltic Dry Freight	1767	1757	10	

Weather

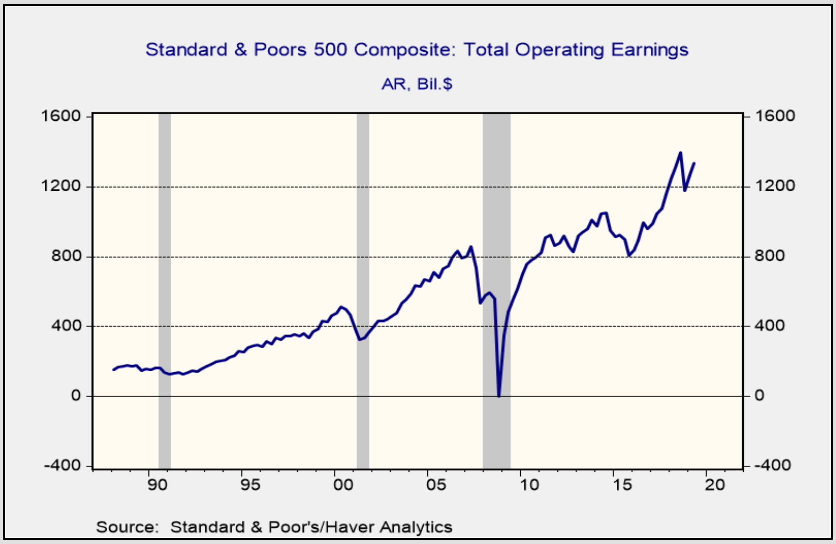
The 6-10 and 8-14 day forecasts call for cooler-than-normal temperatures for most of the country, with normal or higher-than-normal temperatures along the East Coast. There is a disturbance in the Caribbean, but it is not expected to develop into a tropical storm. There is no cyclone formation expected in the next 48 hours.

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.

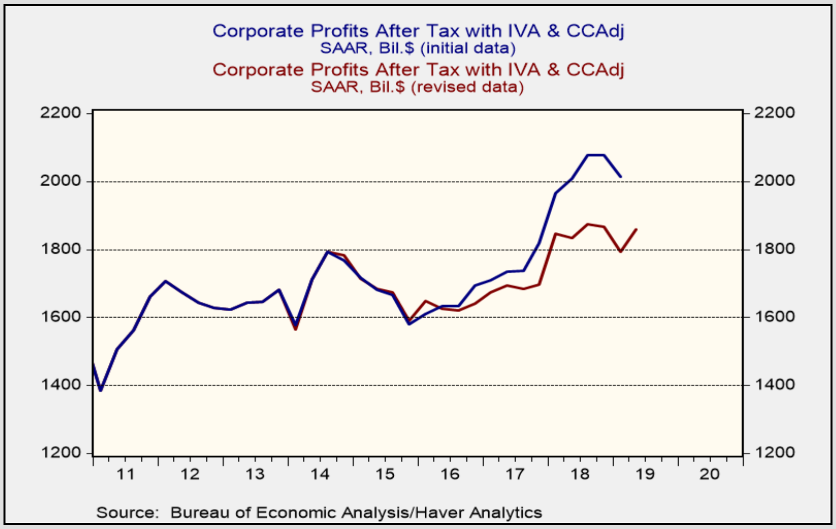
October 4, 2019

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.



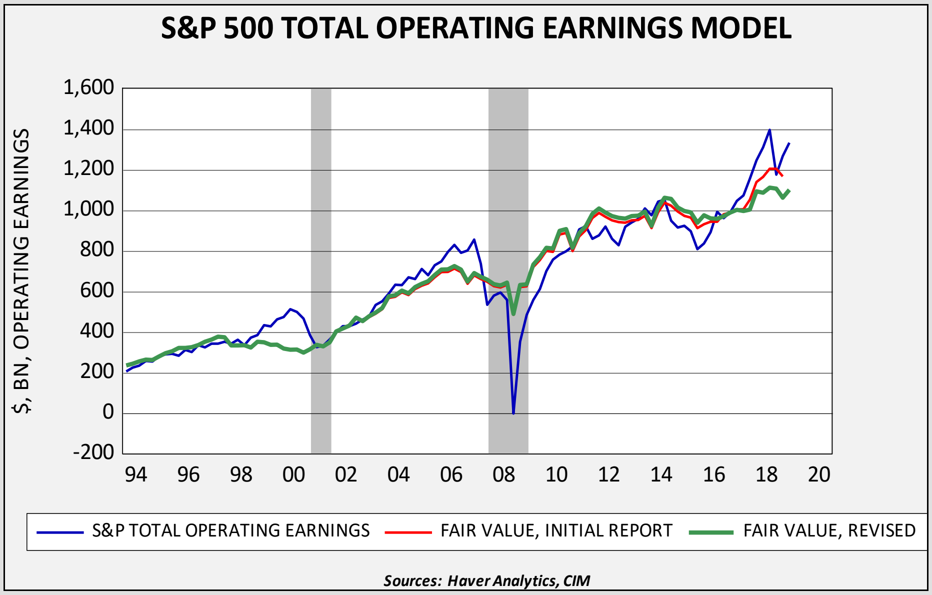
The per-share value is calculated by dividing this number by the S&P divisor. The advantage of this number versus the per-share data is that it is easier to compare total operating earnings of the S&P to the profits data compiled by the Bureau of Economic Analysis (BEA) as part of the National Product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



[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.



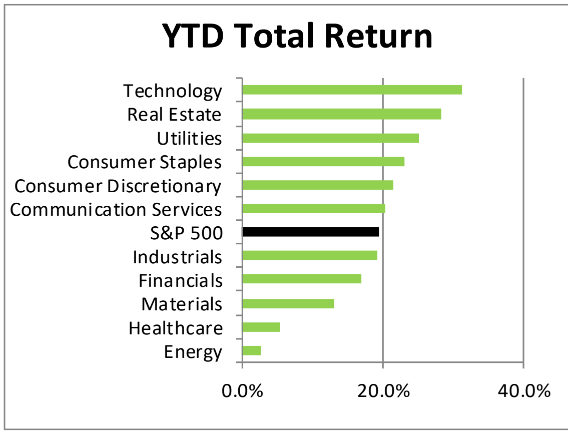
This chart is a model that estimates S&P operating earnings using the BEA profits data. The value of comparing the BEA profits data to S&P operating earnings is that it does give us a warning when earnings for the index are "frothy" and probably due to decline. In 2000 and 2006, S&P total operating earnings 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.

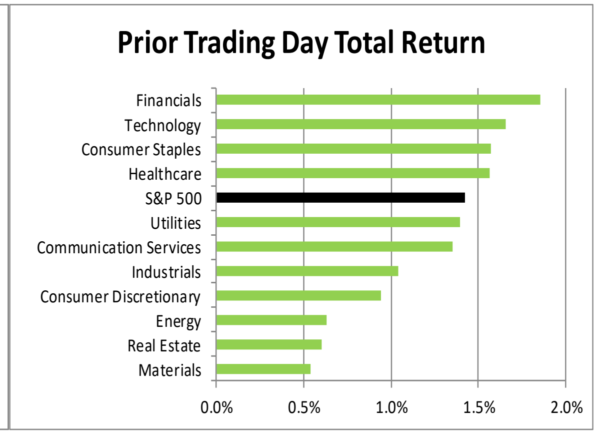
Until the revisions, the S&P total operating earnings data was a bit high but not outside model ranges. The revisions now suggest that current operating earnings are high and will likely decline in the coming quarters. We still have other factors to take into account (the path of the divisor and the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

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

Data Section

U.S. Equity Markets – (as of 10/4/2019 close)

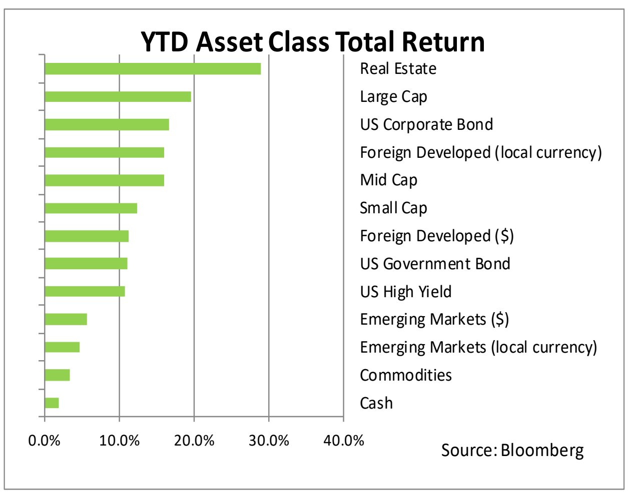




(Source: Bloomberg)

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 10/4/2019 close)

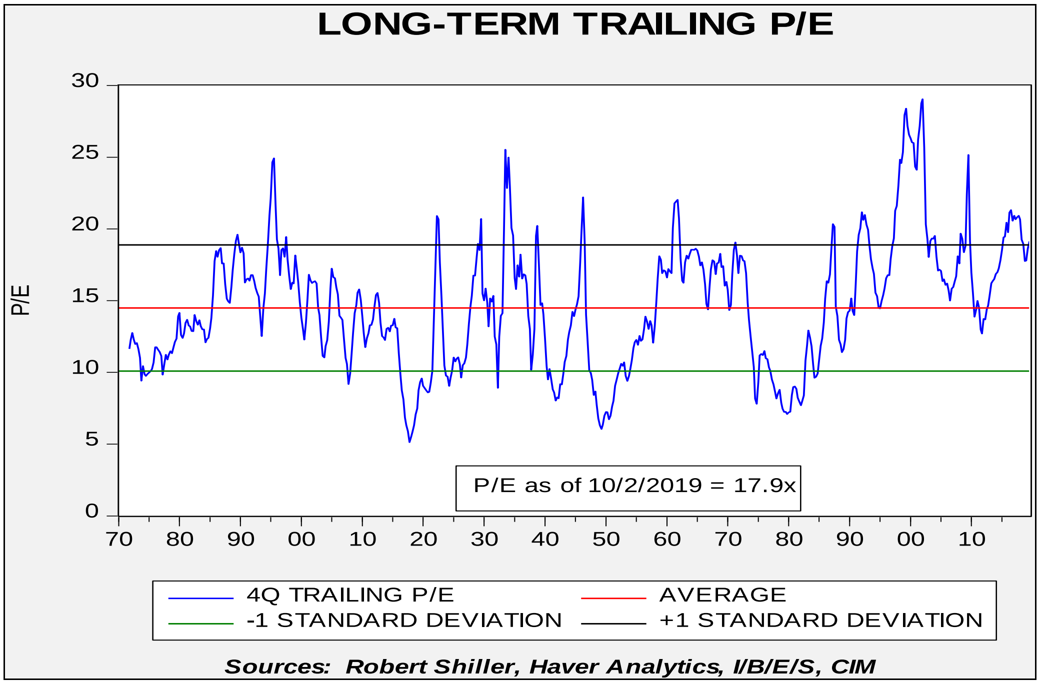


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[3] 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.

[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.