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: September 10, 2019—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is unchanged from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.2%. Chinese markets were down slightly, with the Shanghai composite up 0.1% and the Shenzhen index down 0.1% from the prior close. U.S. equity index futures are signaling a lower open.

Good morning! Equity markets are a bit lower this morning, although there is a huge amount of rotation in the sectors. Chinese inflation data was mixed. Parliament is prorogued. Here is what we are watching this morning:

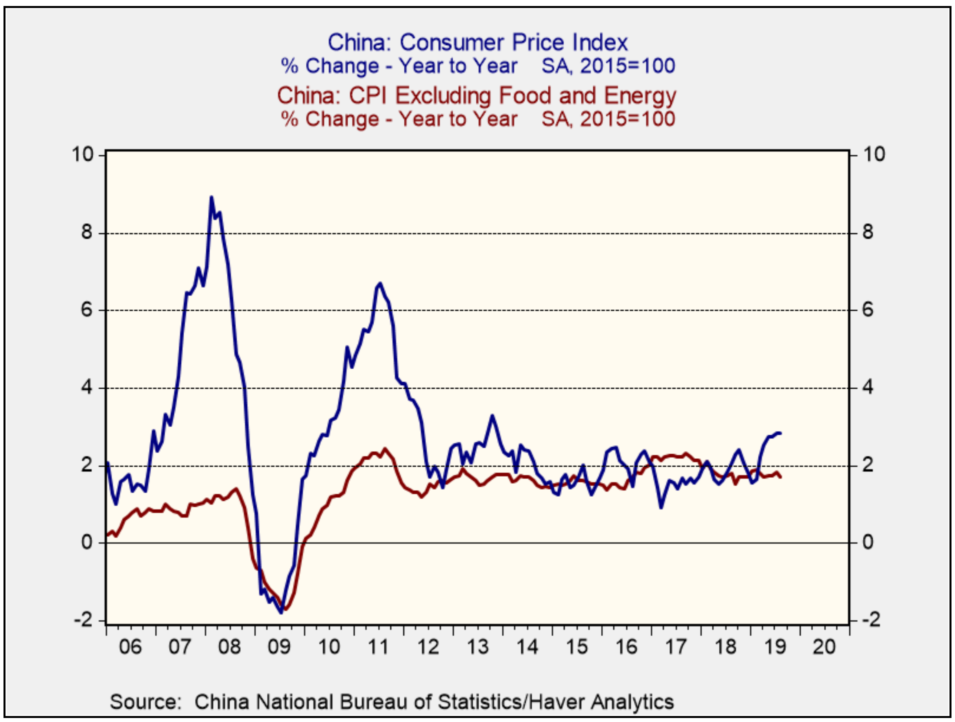
Is the ECB set to disappoint? Mario Draghi leaves the ECB on Halloween and he is trying to deliver one last burst of stimulus. Talk of new rate cuts, tiered negative rates and new QE have been offered but there is growing concern that Draghi, a lame duck, won't be able to deliver. Growing opposition among the members of the ECB centers on the idea that things aren't all that bad, at least not bad enough to warrant such aggressive actions. This situation is important, because if Draghi can't implement these measures, it's unlikely his successor, Christine Legarde, will be able to push measures through, at least immediately. Legarde is not considered an economic heavyweight and thus probably won't be able to sway the members on the strength of her arguments. Instead, she will likely need time to build a consensus on the committee to bring any changes into place. If the ECB falls short, look for a further rise in long-term rates, weaker gold prices and a stronger EUR. We don't view these market reactions as the beginning of a long-term trend. The European economy is still struggling and will need additional stimulus. Although there is a glimmer of hope for fiscal loosening (see below) if economic conditions don't improve, we will likely see the ECB eventually adopt what Draghi is proposing. But, in the short run, we think the odds of disappointment are elevated with the aforementioned results.

A fiscal expansion in Germany? German officials are starting to make noise about a fiscal expansion and there is growing speculation that policymakers are working on ways to get around the balanced budget rules. To some extent, this is a "no duh" moment; Germany has ample fiscal capacity (negative yielding sovereign debt is a clear indication of its existence). Europe, and, for that matter, the world, needs Germany to shrink its current account surplus and fiscal expansion could do the trick. However, despite the obvious need, Germany has a deep-seated aversion to fiscal expansion and inflation. Actual deficit spending probably doesn't occur without a full-blown recession in place. Nevertheless, if the policy mechanisms are in place, fiscal expansion could be implemented quickly.

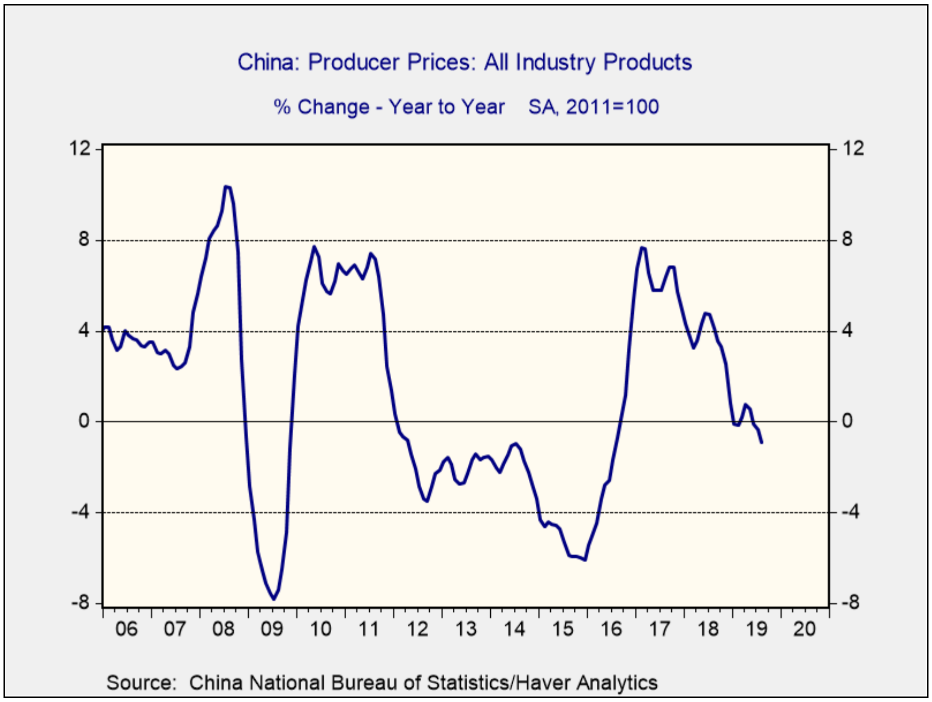
Brexit: Prime Minister Johnson has lost a second vote on having a snap election, as the Labour Party and other opposition groups refused to allow the ballot in order to ensure that Johnson asks the EU for a delay with Brexit, as now required by law. Since parliament is now on leave for the next five weeks, the earliest an election can take place is November. Recent polling shows Johnson is still the most popular British politician, with much higher support than Labour Party leader Jeremy Corbyn. However, he doesn't necessarily have a majority, and he continues to lose support from traditional Conservative Party stalwarts who reject his drive toward a no-deal Brexit. In the House of Lords, the Duke of Wellington announced he would quit the party to protest Johnson's program. As Johnson becomes increasingly hemmed in, there are some signs that he may be shifting his position. In talks yesterday with Prime Minister Varadkar of Ireland, Johnson said Northern Ireland and the Republic of Ireland could trade agricultural and food products under EU rules, although that idea would be strongly resisted by British nationalists on grounds that it would weaken the status of Northern Ireland in the United Kingdom.

We may see the GBP drift higher as positions are squared in front of the return of Parliament in mid-October.

Chinese inflation: China released PPI and CPI for August. The data told two stories. On the CPI data, it's all about pork.



Overall, CPI rose 2.8%, while core CPI rose by only 1.7%. Food prices jumped 10.2%, led by a 47% rise in pork prices caused by the African Swine Fever pandemic. There are rising concerns about the political impact of the pork issue. However, despite the spike in prices, there has been no movement by China to increase its buying from the U.S. This may occur if conditions continue to deteriorate, but probably not before the CPC meetings in early October. Meanwhile, the PPI data shows evidence of renewed deflation.



Tech troubles: Tech firms are facing two threats. First, more than 40 state attorney generals have joined a bipartisan probe into large tech firms, including Facebook (FB, 188.76) and Alphabet (GOOG, 1204.41), in a broad anti-competitive probe. Perhaps the greatest threat to the large tech platforms is regulation and the fact that this is state-level, broad and bipartisan will make fending off this action through lobbying very difficult. Second, California is about to pass new labor laws that will force companies that rely on "gig workers" to reclassify them as employees. Many of these platforms struggle to attain profitability even with the 1099 structure; the regulatory burden of making their workers W-2 employees will either (a) destroy the model, or (b) require much higher prices.

European Commission: Incoming European Commission President Ursula von der Leyen is naming her top lieutenants today, and perhaps the most important news is that current Competition Chief Margrethe Vestager will continue in her role. Vestager has aggressively pursued anti-trust actions against a number of major U.S. and foreign technology firms, including assessing huge fines. This aggressive approach to enforcing market competition rules will now likely continue, which will add some measure of risk to international firms doing business in Europe. In a nomination that has implications for Brexit, the EU's trade chief will be Phil Hogan of Ireland. The new economic policy leader will be Paolo Gentiloni of Italy, and the responsibility for defense, the single market and industrial policy will be in the hands of Sylvie Gouland of France. The nominees will face questioning by the European Parliament later this month, after which the legislators could reject them as a team or pressure von der Leyen to give them different jobs.

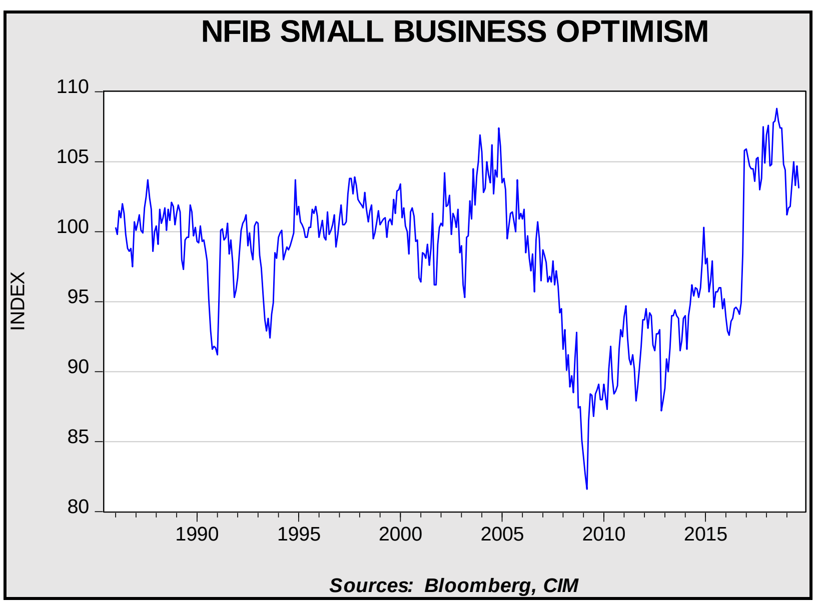
Iran: Although it isn't catching the attention of the media, tensions in the Middle East surrounding Iran and its proxies are heating up again. First, Iran is trying to pressure Europe into breaking U.S. sanctions by steadily violating the nuclear deal through increased uranium enrichment. With the U.S. exit from the agreement and the reimplementation of sanctions, Iran is arguing that it is no longer bound to the deal. However, it had initially complied (sort of) to try to encourage Europe to violate American sanctions. Nonetheless, despite efforts to create a method of evading the U.S. financial system, in practice, the Europeans are not buying enough Iranian goods to support the Iranian economy. In addition, it does appear that one of the fears of opponents of the nuclear deal, the fear that Iran might cheat, may have been realized. Israel has been arguing that Iran violated the arrangement by illegally stockpiling fissile material. The IAEA reports that it has found traces of nuclear material in a warehouse. Finally, Hezbollah has downed an Israeli drone as tensions rise in the region. All of this is bullish for oil prices, which have been bolstered by the change of leadership in the Saudi oil industry.

Spain: An advisor to the European Court of Justice warned today that Spanish banks may have violated consumer protection laws by the way they explained a widely used mortgage price index to borrowers. As might be expected, the potential for lawsuits and fines is weighing on Spanish bank stocks today.

North Korea: First Vice Minister Choe Son Hui was quoted in state-run media today as saying Pyongyang is ready to restart denuclearization talks with the United States later this month. At the same time, however, the country launched two more short-range missiles, likely as a warning that Washington needs to get back to the bargaining table.

U.S. Economic Releases

NFIB Small Business Optimism came in below expectations at 103.1 compared to the forecast of 103.5.



The chart above shows the historical trend of the NFIB Small Business Optimism. In the month of August, rising trade tensions and recessions have weighed on small business optimism. As a result, small business owners' outlook on the economy and future sales have fallen.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	JOLTS Job Openings	m/m	jul	7331	7348	**
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								
China	Manpower Survey	m/m	aug	4.0%	8.0%		**	Equity bearish, bond bullish
	CPI	m/m	jul	2.8%	2.8%	2.7%	***	Equity and bond neutral
	PPI	m/m	jul	-0.8%	-0.3%	-0.9%	**	Equity and bond neutral
Japan	Money Stock M2	y/y	aug	2.4%	2.4%	2.4%	***	Equity and bond neutral
	Money Stock M3	y/y	aug	2.0%	2.0%	2.0%	**	Equity and bond neutral
	Manpower Survey	m/m	4q	26.0	25.0		**	Equity and bond neutral
	Machine Tool Orders	y/y	aug	-37.1%	-33.0%		*	Equity and bond neutral
India	Manpower Survey	q/q	4q	20.0%	13.0%		**	Equity bullish, bond bearish
Australia	ANZ Roy Morgan Weekly Consumption	q/q	2q	-2.7%	2.0%		**	Equity and bond bearish
	Manpower Survey	q/q	4q	12%	13%		**	Equity and bond neutral
	NAB Business Conditions	m/m	aug	1	2		**	Equity bearish, bond bullish
	NAB Business Confidence	m/m	aug	1	4		**	Equity bearish, bond bullish
New Zealand	ANZ Truckometer Heavy	m/m	aug	-4.2%	4.1%		**	Equity bearish, bond bullish
	Card Spending Total	m/m	aug	1.3%	-0.3%		*	Equity and bond neutral
	Card Spending Retail	m/m	aug	1.1%	-0.1%	0.5%	*	Equity bullish, bond bearish
	Manpower Survey	q/q	4q	16.0%	10.0%		**	Equity and bond neutral
EUROPE								
France	Industrial Production	m/m	jul	0.3%	-2.3%	0.5%	***	Equity and bond neutral
	Manufacturing Production	m/m	jul	0.3%	-2.2%	0.8%	***	Equity and bond neutral
	Private Sector Payrolls	q/q	2q	0.2%	0.3%	0.3%	***	Equity and bond neutral
	Total Payrolls	q/q	2q	0.2%	0.4%	0.3%	***	Equity and bond neutral
Italy	Industrial Production	y/y	jul	-0.7%	-0.2%	-0.1%	***	Equity and bond bearish
UK	Claimant Count Rate	m/m	aug	3.3%	3.2%		***	Equity and bond neutral
	Jobless Claims Change	m/m	aug	28.2k	28.0k		**	Equity and bond neutral
	ILO Unemployment Rate	m/m	aug	3.8%	3.9%	3.9%	***	Equity and bond neutral
AMERICAS								
Canada	Bloomberg Nanos Confidence	w/w	6-Sep	56.5	56.4		**	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)	213	210	3	Down
3-mo T-bill yield (bps)	190	188	2	Neutral
TED spread (bps)	23	22	1	Neutral
U.S. Libor/OIS spread (bps)	183	183	0	Up
10-yr T-note (%)	1.64	1.64	0.00	Down
Euribor/OIS spread (bps)	-43	-44	1	Neutral
EUR/USD 3-mo swap (bps)	15	15	0	Down
Currencies	**Direction**			
dollar	Up			Up
euro	Flat			Down
yen	Down			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	$63.04	$62.59	0.72%	
WTI	$58.30	$57.85	0.78%	
Natural Gas	$2.62	$2.59	1.51%	
Crack Spread	$13.72	$13.50	1.57%	
12-mo strip crack	$16.57	$16.47	0.59%	
Ethanol rack	$1.52	$1.52	-0.19%	
Metals				
Gold	$1,494.07	$1,499.13	-0.34%	
Silver	$17.97	$18.01	-0.24%	
Copper contract	$260.90	$262.75	-0.70%	
Grains				
Corn contract	$ 358.25	$ 354.25	1.13%	
Wheat contract	$ 479.25	$ 474.50	1.00%	
Soybeans contract	$ 863.00	$ 857.75	0.61%	
Shipping				
Baltic Dry Freight	2422	2462	-40	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.8		
Gasoline (mb)		-1.0		
Distillates (mb)		-1.0		
Refinery run rates (%)		-0.50%		

Weather

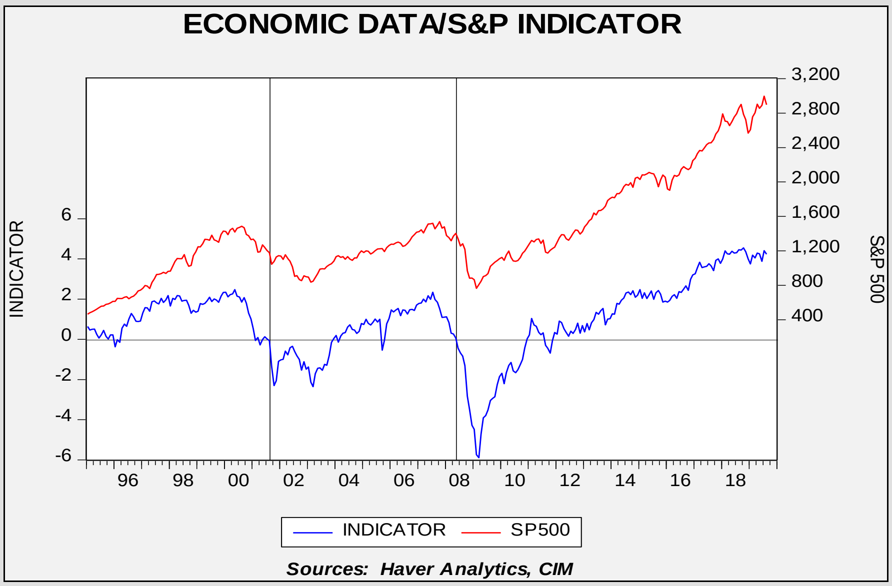
The 6-10 and 8-14 day forecasts show normal to warmer temperatures for most of the country. Hurricane Dorian continues to move along the Carolina coasts. There is some cyclone formation further out in the Atlantic Ocean, but it is unclear whether it will make it to the U.S. On average, hurricane season peaks today.

Asset Allocation Weekly

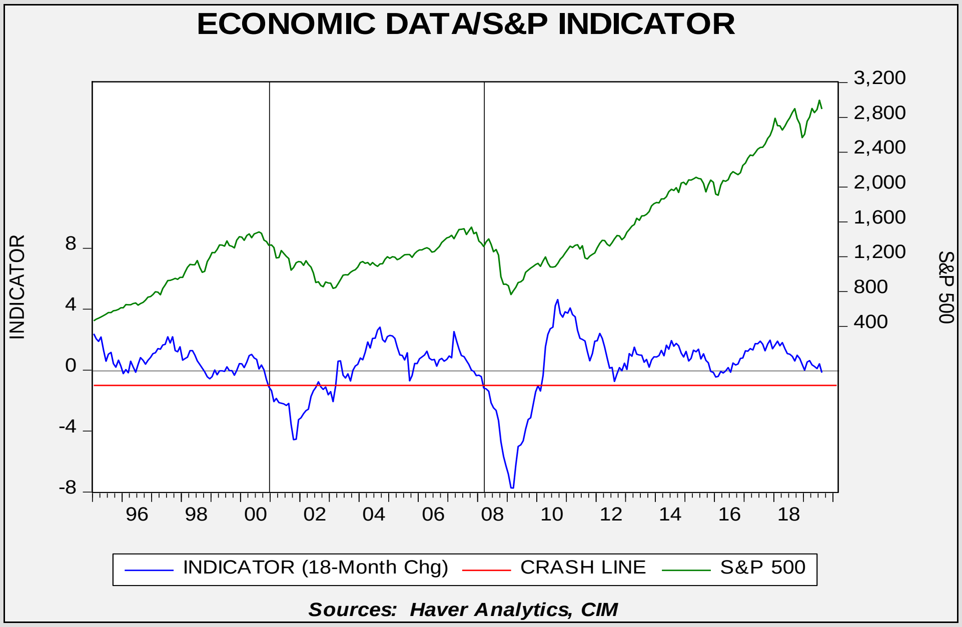
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

September 6, 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 August data.



This chart shows the results of the indicator and the S&P 500 since 1995. The updated chart shows that the economy did slip late last year but has stabilized in 2019. 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 likely near or already underway and the equity markets have already begun their decline.



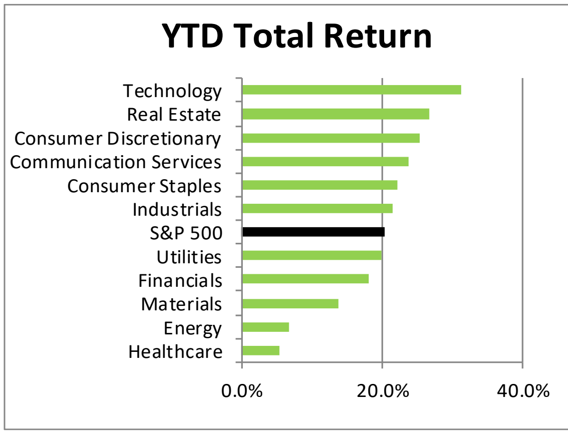
To make the indicator more sensitive, we took the 18-month change and put the signal threshold at minus 1.0. This provides an earlier bearish signal and also eliminates the false positives that the zero threshold generates. At the same time, the fact that this variation of the indicator is just below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

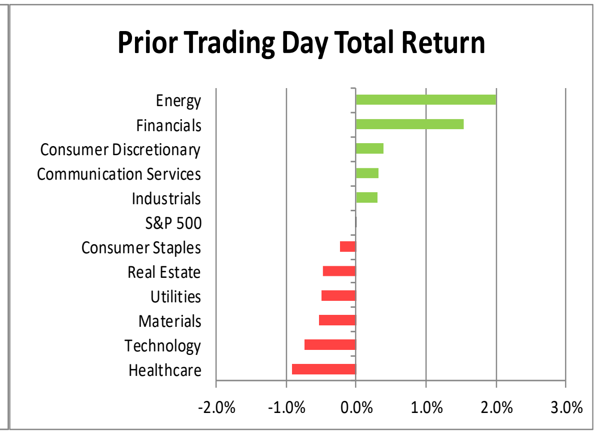
What does the indicator say now? The economy has decelerated but is not yet at a point where investors should become defensive. Breaking below the red line would be our signal to expect a broader downturn. As we have noted over the past two weeks, other indicators have signaled rising odds of recession. We continue to monitor conditions closely but, as noted above, it is still too early to shift portfolios into a fully defensive stance.

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 9/9/2019 close)

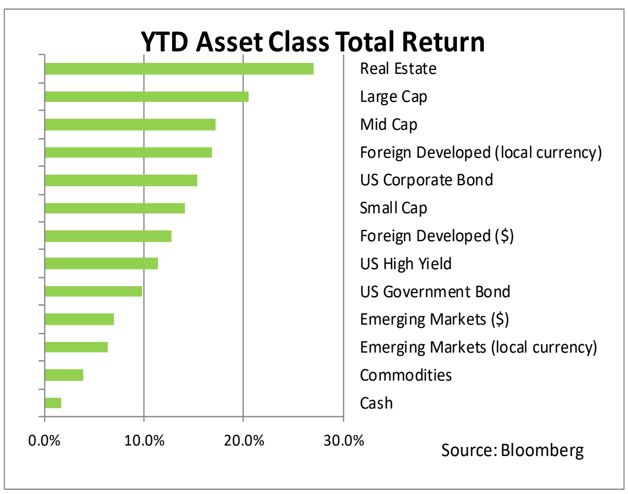




(Source: Bloomberg)

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 9/9/2019 close)

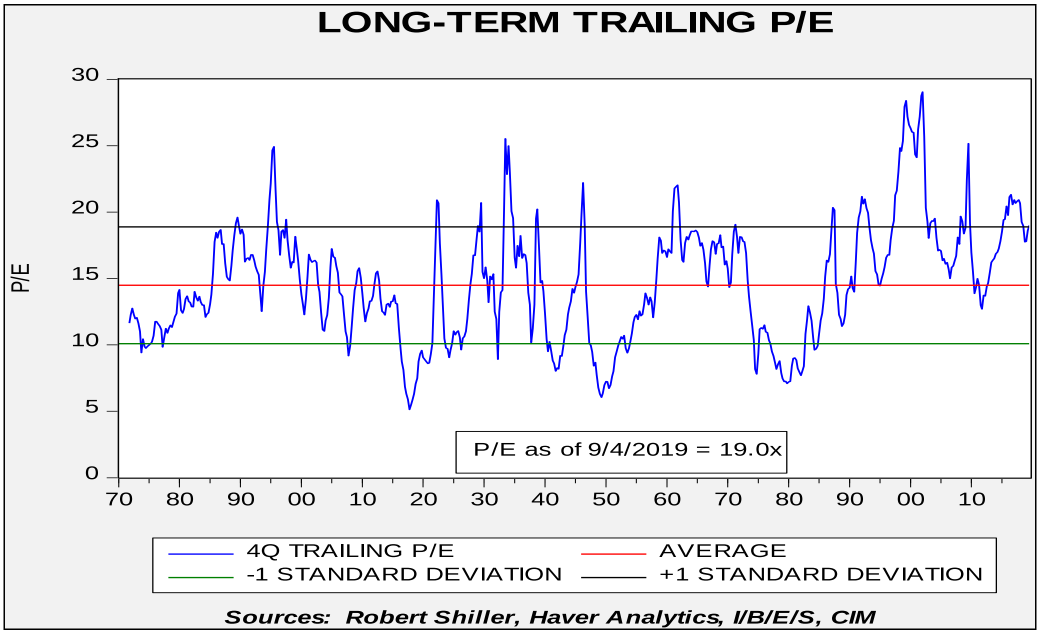


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

September 6, 2019



Based on our methodology,[1] the current P/E is 19.0x, unchanged 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 three actual quarters (Q4, Q1 and Q2) and one estimate (Q3). 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.