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: September 17, 2019—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is up 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.8%. Chinese markets were lower, with the Shanghai composite down 1.7% and the Shenzhen index down 2.0% from the prior close. U.S. equity index futures are signaling a lower open.

After a wild day yesterday, markets are rather quiet. The FOMC meeting starts today, the new Saudi energy minister is conducting his first press conference at 1:15, and Israel is holding elections. Here is what we are watching this morning:

The aftermath of the Saudi strikes: Here are three items we are following in the wake of the missile and drone attack on Saudi oil facilities:

1. The retaliation issue—although President Trump suggested the U.S. was "locked and loaded," it appears he is not in a hurry to escalate the situation. Although the president says it "appears" Iran was behind the attack, he also indicates he does not want war. In addition, the White House seems to be suggesting the U.S. is going to be led by Saudi Arabia's decision on Iran. Part of the reluctance is probably due to the lack of attractive alternatives. It is hard to see how the U.S. could find additional economic sanctions (Iran is heavily sanctioned already), and mere sanctions would look like a weak response to a historic attack. A blockade against Iran is an option, but how one determines when "victory" is achieved is difficult. In other words, what would have to occur to lift the blockade? Additionally, a blockade could put U.S. Navy vessels in harm's way. Limited airstrikes against the Iranian defense industry (to weaken its capacity to build missiles and drones) is probably the most likely response, but that action could escalate. The president doesn't want a war this close to an election that could spike oil prices and undermine his reelection chances. Also, like his predecessors, he would really prefer less involvement in the Middle East. However, as we noted yesterday, doing nothing or something less than a proportional retaliation runs the risk of ending the Carter Doctrine.
2. The negotiations issue—the Ayatollah Khamenei has announced that there will be no talks on any level with the U.S. This decision effectively ends any chance of a diplomatic solution.
3. The "how did this happen" issue—one of the unanswered questions is how did the Saudis not have adequate defense against this attack? The KSA's defense spending ranks third in the world with total defense spending and first relative to the GDP, at 8.8%. We haven't seen much written on this issue, other than Russia's offer to sell the KSA the S-

400 system. In our estimation, there are two potential reasons why the kingdom was unable to protect these key facilities from a combined drone and missile strike. First, pure incompetence. The leadership was more concerned with a terrorist or ground attack and simply didn't consider this sort of strike. Thus, the defense that was purchased was inadequate. Second, the defense system was adequate but was disarmed by a cyber-attack. If the answer is the first reason, it's inexcusable. If it's the second, it's terrifying because it means that missile defense systems are vulnerable. We don't know the answer to this issue but will continue to watch for information.

What now? OPEC and Russia appear to be using this event to drain global inventories. OPEC and Russia's output policy has been designed to slowly reduce global stockpiles; with the KSA partially offline, the cartel appears to be using this situation to accelerate the process. If so, this should keep a bid to oil prices. We note that the KSA has already signaled to customers that October oil loadings will be delayed. The risk of much higher prices is tied to the U.S. response to this attack. At this juncture, the White House is exhibiting caution, which reduces the odds of a spike.

Venezuela heats up: The situation in Venezuela has become a stalemate in recent weeks. The U.S. has mostly exhausted economic sanctions and the Venezuelan economy is moribund, so additional measures probably won't have much of an impact. The U.S. has no interest in a military response. However, we are seeing tensions rise between Colombia and Venezuela. The former is accusing the Maduro regime of harboring guerrillas, and of planning bombings against Colombia's capital, Bogota. Leaders in the region are calling for the activation of the 1947 Rio Treaty, a mutual defense treaty among Latin American countries. We will be watching to see if a group of nations in the region will build a military force to remove the Maduro regime. Although Venezuela's oil production has declined precipitously, Colombia does produce 0.9 mbpd and a conflict could reduce supplies in an already tight world.

Islamic State: Secretive ISIL leader Abu Bakr al-Baghdadi issued an audio message urging his followers to redouble their fight against nonbelievers, and their efforts to build an Islamic caliphate, in spite of the group's severe weakening and loss of territory. The message is a reminder that ISIL hasn't been completely destroyed, and that it will probably continue to pose a terrorism threat in the near term.

Trade: Liao Min, China's vice-minister of finance, is in route to Washington to begin preliminary trade talks. USTR Lighthizer remains committed to a comprehensive trade agreement with China, something that China does not appear to want. Again, this issue underscores the differences within the Trump administration on trade; the Lighthizer/Navarro wing want a broad agreement that will encompass not only trade but intellectual property and security, while the Mnuchin/Kudlow wing want a narrow agreement that only affects trade. The president vacillates between the two camps. In general, we watch Lighthizer; if he does not get his way, we would expect him to resign and if he does, we will get a narrow deal. If he stays, we doubt China will agree to anything before the elections. Meanwhile, the U.S. and Japan appear to be near a trade agreement.

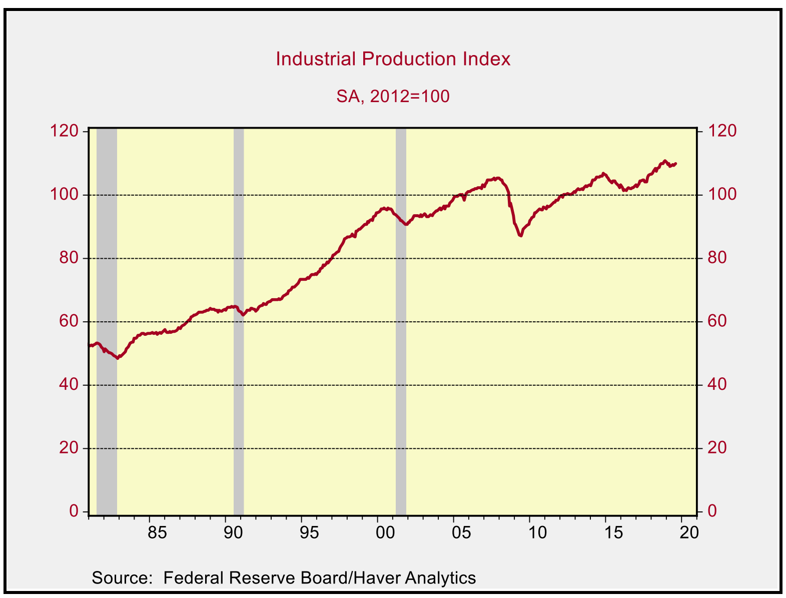
Hong Kong: Illustrating the negative impact of the continued anti-Chinese political protests, and the threat of a violent Chinese crackdown, private investors are reportedly pulling millions of dollars of gold out of Hong Kong. The pullout not only reflects concerns that China could restrict capital outflow from the city, but also that protests at the municipal airport and other facilities could impede shipments.

Italian politics: Just after the center-left and populist-left formed a government, former Italian PM Matteo Renzi announced he is leaving the center-left Democratic Party to create a new centrist group similar to what Macron has created in France. His decision will weaken the current coalition, and could end up bringing down the government. We are seeing a backup in Italian sovereign yields this morning.

Russia: Another powerful Russian has floated the idea of amending the country's constitution to allow President Putin to stay in power after his current term ends in 2024. Sources close to the Russian leadership say Putin currently thinks he and his United Russia Party are strong enough that they don't need to worry about the future yet. However, the Russian oligarchs and others who have profited from the Putin regime are worried about losing their favored positions, so they're laying the groundwork for legal changes that could keep Putin in power.

U.S. Economic Releases

Industrial production came in stronger than expected, rising 0.6% from the prior month compared to the forecast rise of 0.2%. The prior month's loss was revised downward from 0.2% to 0.1%. Capacity utilization was 77.9%, above the 77.6% expected.



The chart above shows the Industrial Production Index. The current reading is 109.2. Although the broader economy may be okay, one could argue we are seeing a recession in the industrial economy. The unexpected rise in industrial production was due to a boost in energy and construction supply, which was likely the result of a broad recovery in areas hit by Hurricane Barry.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	NAHB Housing Market Index	m/m	sep	66	66	***
16:00	Net Long-Term TIC Flows	m/m	jul		$99.1 Bil	**
16:00	Total Net TIC Flows	m/m	jul		$1.7 Bil	**
Fed speakers or events						
No speakers or events scheduled						

Foreign Economic New

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	New Home Prices	m/m	aug	0.6%	0.6%		***	Equity and bond neutral
Japan	Tokyo Condominiums for Sales	m/m	aug	21.1%	-35.3%		**	Equity bullish, bond bearish
Australia	ANZ Roy Morgan Weekly Consumption	w/w	15-Sep	109.3	113.3		*	Equity and bond neutral
	House Price Index	q/q	aug	-7.4%	-7.4%	-7.7%	***	Equity and bond neutral
New Zealand	Westpac Consumer Confidence	m/m	aug	103.1	103.5		**	Equity and bond neutral
	Non Resident Bond Holdings	m/m	aug	53.3%	53.6%		**	Equity and bond neutral
EUROPE								
Eurozone	ZEW Survey Expectations	m/m	sep	-22.4	-43.6		**	Equity and bond neutral
Germany	ZEW Current Situations	m/m	jul	-19.9	-13.5	-15.0	**	Equity and bond bearish
	ZEW Survey Expectations	y/y	sep	-22.5	-44.1	-38.0	**	Equity bearish, bond bullish
Russia	Industrial Production	y/y	aug	2.9%	2.8%	2.2%	***	Equity bullish, bond bearish
AMERICAS								
Canada	International Securities Transactions	m/m	jul	-1.17 Bil	-3.98 Bil		**	Equity and bond neutral
	Existing Home Sales	m/m	aug	1.4%	3.5%	1.3%	*	Equity and bond neutral
	Bloomberg Nanos Confidence	w/w	jul	56.7	56.5		**	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)	214	212	2	Down
3-mo T-bill yield (bps)	194	193	1	Neutral
TED spread (bps)	20	19	1	Neutral
U.S. Libor/OIS spread (bps)	184	185	-1	Up
10-yr T-note (%)	1.81	1.85	-0.04	Down
Euribor/OIS spread (bps)	-39	-40	1	Neutral
EUR/USD 3-mo swap (bps)	18	15	3	Down
Currencies	**Direction**			
dollar	Flat			Up
euro	Up			Down
yen	Flat			Down
pound	Down			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	$67.95	$69.02	-1.55%	Position squaring
WTI	$61.83	$62.90	-1.70%	
Natural Gas	$2.68	$2.68	0.00%	
Crack Spread	$16.02	$15.45	3.66%	
12-mo strip crack	$18.55	$18.52	0.16%	
Ethanol rack	$1.56	$1.55	0.54%	
Metals				
Gold	$1,504.64	$1,488.53	1.08%	
Silver	$17.87	$17.44	2.46%	
Copper contract	$267.20	$269.95	-1.02%	
Grains				
Corn contract	$ 368.00	$ 368.75	-0.20%	
Wheat contract	$ 482.75	$ 483.50	-0.16%	
Soybeans contract	$ 894.50	$ 898.75	-0.47%	
Shipping				
Baltic Dry Freight	2312	2331	-19	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.0		
Gasoline (mb)		-1.0		
Distillates (mb)		0.2		
Refinery run rates (%)		-0.50%		

Weather

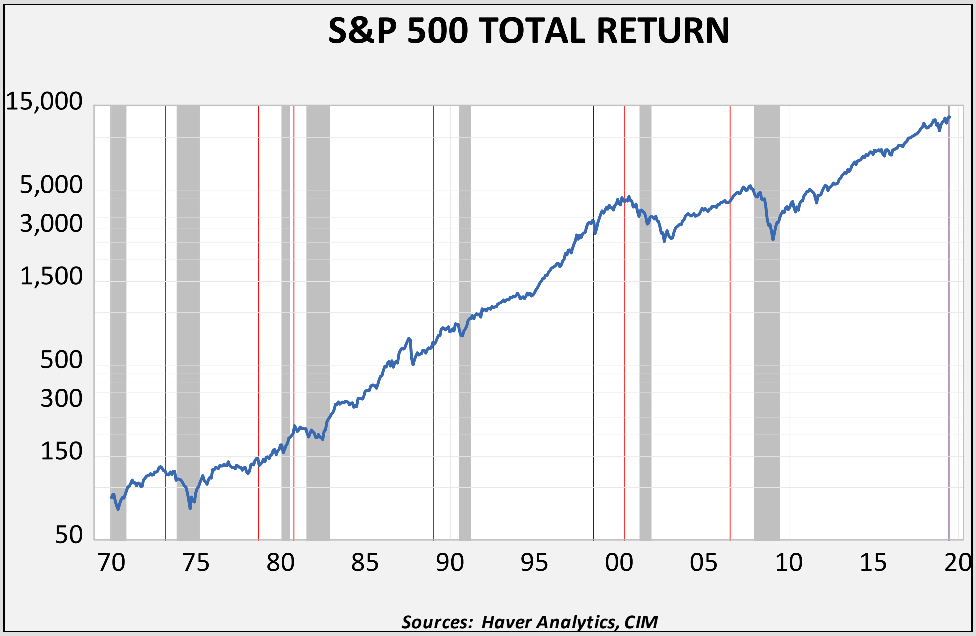
The 6-10 and 8-14 day forecasts call for higher-than-normal temperatures for most of the country. Precipitation is expected for the Midwest and parts of Texas and Louisiana. Hurricane Humberto has developed near the Georgia and South Carolina coastline, but is not expected to make landfall. There is some cyclone formation in the Gulf of Mexico near the Texas coastline; at this time, it is not expected to develop into a tropical cyclone.

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 13, 2019

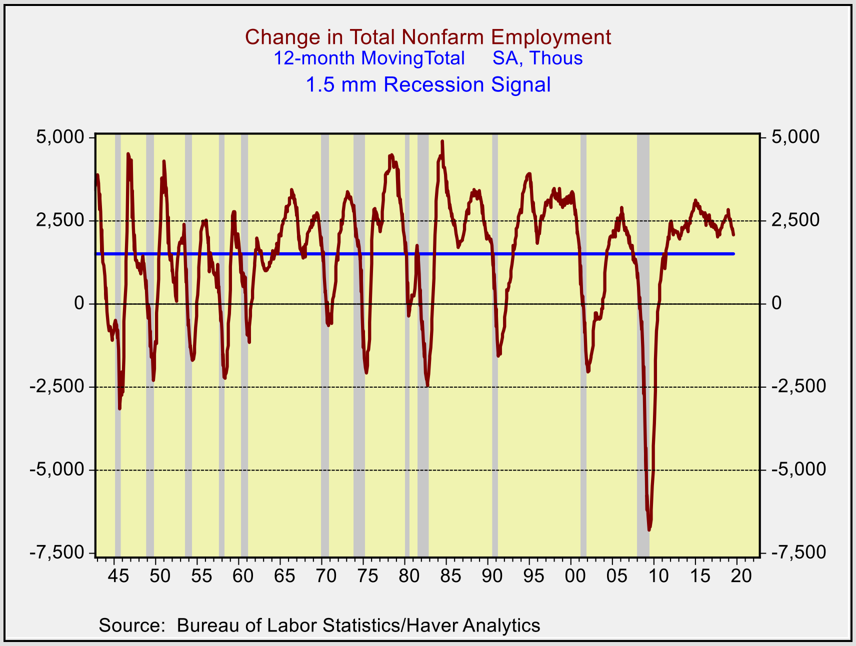
In recent reports, we have discussed the yield curve and its value in signaling the business cycle. One of the problems for investors with using the various permutations of the yield curve as a signaling device is that it gives such early warnings that it may not be all that useful.



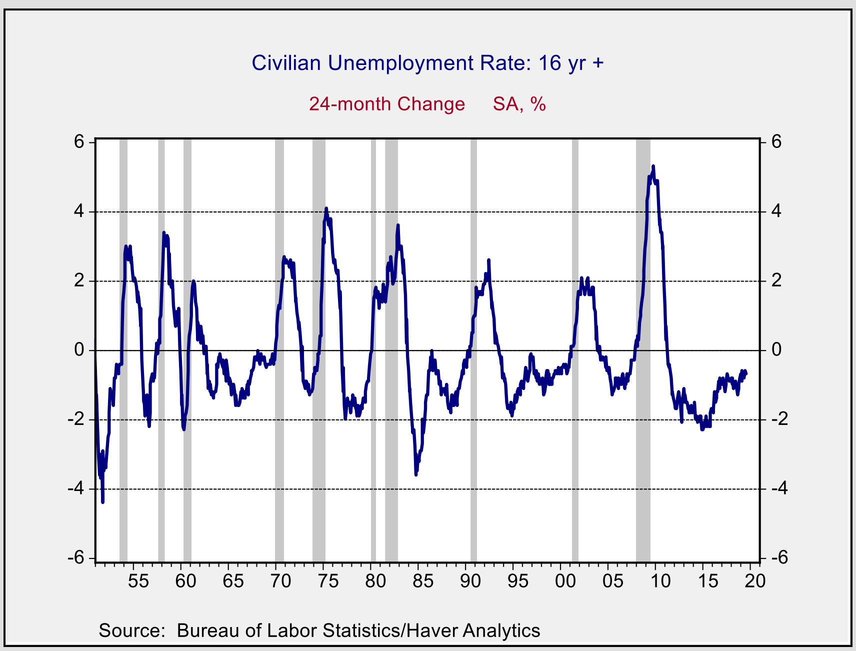
This chart shows the total return for the S&P 500; the vertical lines denote the inversions of the yield curve. The red lines represent when the inversion preceded a recession. The black lines are inversions that resulted in false positives.[1] The data shows that exiting equities at the point of inversion would, in several cases, be premature. It might make sense to reduce equity exposure, but a complete retreat would not be warranted.

Labor market signals of recession tend to occur at or just before a downturn, but they also give us insight into when a recession may be imminent. There are two indicators we like. The first is the rolling 12-month sum of the monthly change in non-farm payrolls. A reading of 1.5 million jobs is the indicator; falling below that level means a recession is near or underway.

[1] We are treating the current inversion as a false positive until proven otherwise.



The current reading is 2.074 mm, meaning payrolls remain in expansion mode. The second indicator is the two-year change in the unemployment rate.

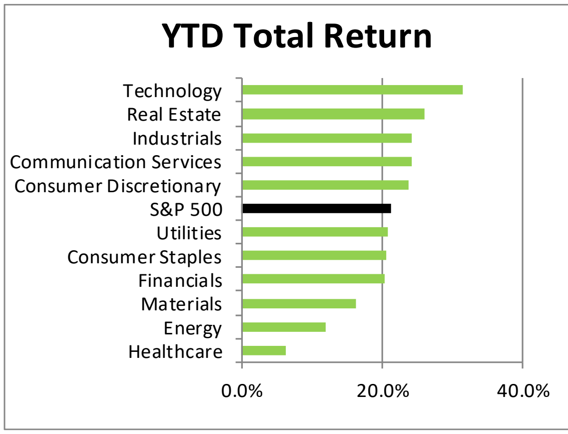


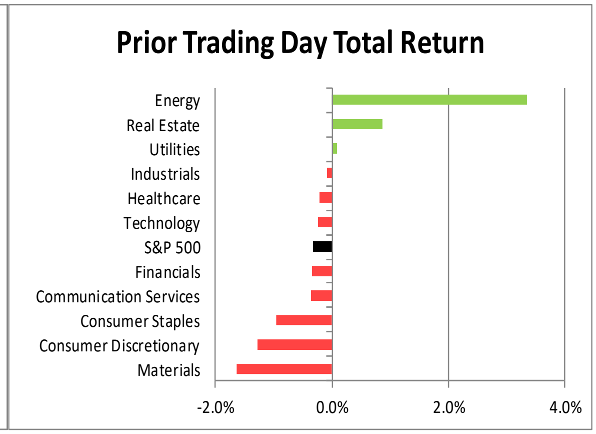
The current unemployment rate is 3.7%; in August 2017, it was 4.4%, meaning we still haven't triggered a recession signal. If the unemployment rate remains stable, we could be close to a recession signal in September 2020.

The labor market data suggests a recession isn't imminent, meaning investors should avoid becoming overly defensive at this juncture. That doesn't mean one should not be watchful, but overreacting to the yield curve would be imprudent for most investors.

Data Section

U.S. Equity Markets – (as of 9/16/2019 close)

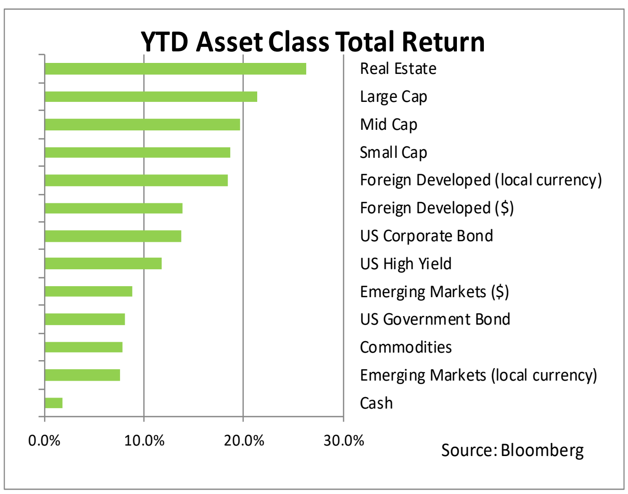




(Source: Bloomberg)

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 9/16/2019 close)

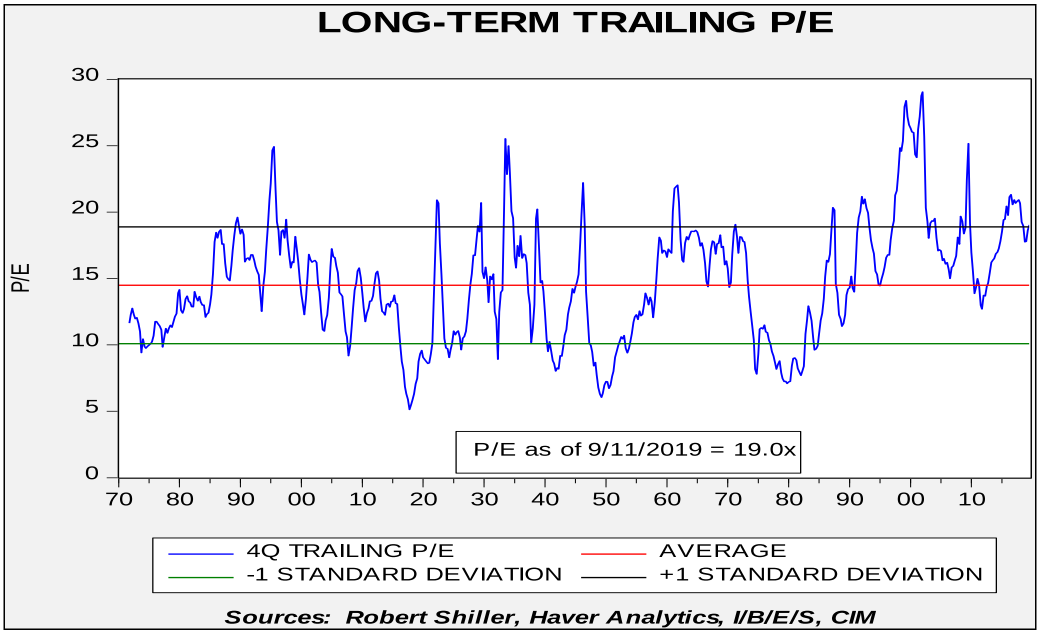


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 12, 2019



Based on our methodology,[2] 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.

[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 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.