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 20, 2019—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.4% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.1%. Chinese markets were higher, with the Shanghai composite up 0.2% and the Shenzhen index also up 0.2% from the prior close. U.S. equity index futures are signaling a higher open.

After a busy week, it's been a quiet Friday so far. We wonder how history will deal with the end of Mayor de Blasio's campaign. Here is what we are watching this morning:

Misjudging Trump: We have been getting questions from readers about U.S. Iran policy. So, here is our response. It is starting to look like Iran has concluded that President Trump is a bully who will back down when his bluff gets called. Yesterday, Iran's foreign minister, Javad Zarif, suggested that a military attack on Iran would trigger "all-out war." This is a clear and strong threat. Throughout its history since the Iranian Revolution, Iran has generally been cautious in foreign affairs. Although it underwrites audacious acts (e.g., bombing of U.S. troops in Beirut, Khobar Towers bombing in Saudi Arabia), these are usually carried out by proxies or in ways that provide plausible deniability. In the attack on the Saudi oil infrastructure, Iran tried to follow the same script, with the Houthis immediately taking responsibility. However, unless the Houthis are hanging out in southeastern Iran or southern Iraq, it probably wasn't their doing and Iran had to know that it would be hard to maintain that ruse.

After the U.S. failed to respond militarily to the downing of a U.S. drone, the leadership of Iran appears to have concluded that the White House is reluctant to engage Iran militarily. The U.S. response to the attacks last weekend has done nothing to suggest this assumption is wrong. So far, the U.S. has responded to what is probably the most significant act against the Carter Doctrine since Iraq annexed Kuwait with sanctions and threats of a military buildup. This isn't to say that sanctions haven't been effective; they have had a major impact on the Iranian economy. However, between the harsh sanctions and the lack of a diplomatic path, Iran has decided to up the ante.

One of our "go-to" tools in analyzing foreign relations and the reactions of presidents is to use Mead's Archetypes. Regular readers are familiar with the four major ones. We note that these are merely archetypes as no president is a pure reflection of any of the four, but all lean toward one. So, here is how we think each archetype would react to last weekend's events:

1. **Jeffersonian:** A Jeffersonian president would be angry that the U.S. was still even in this part of the world, but since we are there we should talk to allies and formulate a response. Military action would be a reluctant and last resort. This president would not have responded to the drone downing.
2. **Wilsonian:** The drone downing would have triggered a strong military response. This recent escalation would have led to an ordinance being already in the air. Although this type would try to avoid escalation, its actions usually end up leading to a broader conflict.
3. **Hamiltonian:** Always a realist, a Hamiltonian president would be trying to pull out of the Middle East, concluding that China was the real issue and shale oil has made the extensive U.S. commitment to the region unnecessary. However, this president, faced with the problem at hand would likely attempt to escalate carefully, bombing highly visible but mostly symbolic areas in Iran, e.g., old oil fields that are in decline, secondary industrial sites, etc. In other words, it would send a signal that the U.S. wasn't happy, but also trying to avoid hitting anything that would lead to an escalation. This archetype would have attacked after the drone downing.
4. **Jacksonian:** This response would have been identical to the Jeffersonian response. These two types are the most isolationist of the four. However, if honor is violated, this response is the most aggressive. So, what would this president react to? The spilling of American blood, or the harming of innocents. The response to such events would likely be swift and disproportionate.

We characterize President Trump as Jacksonian. In WWII, Jacksonians were America First supporters…until Pearl Harbor. Then, they wanted to annihilate Japan and Germany. If Iran escalates further and an American is killed, or if Iran's actions kill children, Trump will likely shift to aggression that is stronger than Tehran expects. However, as long as the escalation avoids these two outcomes, we expect Iran to increase its belligerence, and probably get away with it. As a result, oil markets are likely underestimating the level of risk.

Brexit: A thaw is developing. Although a deal is still a ways off, the two sides are clearly trying to come up with a way to reach an accommodation on the Irish border issue. We have seen the GBP rally on hopes of a deal. If an agreement is forged, we could see a much larger rally in the currency.

A deal of sorts with China: Our base position on China is that the U.S. has concluded Beijing is a strategic competitor, that will not fold itself into the U.S.-led order. Because of this, a slow decoupling and increased competition is in our future. However, that doesn't mean an intermediate deal cannot be struck. We note the Trump administration has exempted a large number of Chinese goods from tariffs. U.S. agricultural interests are talking to China as well. These actions might lead to a limited deal that would improve market sentiment. At the same time, Michael Pillsbury, a Hudson Institute analyst and key informal advisor to President Trump, has warned the U.S. will dramatically ramp up pressure on China if a trade deal isn't struck soon. Pillsbury characterized the current U.S. tariffs against China as "low" and warned they could go as high as 100%.

Monetary policy: The Fed has conducted open market operations for the fourth consecutive day. The PBOC cut its benchmark lending rate for the second straight month, but only by 5 bps to 4.20%. The BOJ, on the other hand, cut its purchases across the yield curve in an attempt to steepen it. We doubt the BOJ can continue this action for long without triggering a strengthening JPY.

India: Prime Minister Modi announced a surprise tax cut that will slash the effective corporate rate to 25.17% from the current 34.94%, putting it on par with many other fast-growing Asian countries. New manufacturing firms will face an even lower rate. Indian stocks are surging on the news, but Indian bonds are down on concerns about the fiscal deficit.

Russia: President Putin has again been forced to back down a bit with his political repression, as he faces strong public outcry over the police beating and jailing of aspiring actor Pavel Ustinov during a protest last month. The actor was released on bail today. Putin still has a strong grip on power, but popular discontent is rising and has the potential to destabilize the country.

Saudi Arabia: There are reports that the crown prince is "bullying" wealthy Saudi families into large purchases of the Aramco IPO to bolster the price. Such action is further evidence that the Salman family effectively is "taxing the rich."

U.S. Economic Releases

There were no domestic releases prior to the publication of this report. The table below shows the economic releases and Fed events scheduled for the rest of the day.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
12:00	Household Change in Net Worth	m/m	2q		$4.691 Tril	**
Fed speakers or events						
	Speaker or event	**District or position**				
11:20	Eric Rosengren Speaks in New York	President of the Federal Reserve Bank of Boston				
13:00	Robert Kaplan to Speak in Moderate Q&A	President of the Federal Reserve Bank of Dallas				

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	1-Year Loan Prime Rate	m/m	aug	4.20	4.25	4.20	**	Equity and bond neutral
	5-Year Loan Prime Rate	m/m	aug	4.85	4.85	4.80	**	Equity bearish, bond bullish
Japan	National CPI	m/m	aug	0.3%	0.5%	0.3%	***	Equity and bond neutral
	National CPI Fresh Food	m/m	aug	0.5%	0.6%	0.5%	***	Equity and bond neutral
	National CPI Fresh Food, Energy	m/m	aug	0.6%	0.5%	0.6%	***	Equity and bond neutral
New Zealand	Credit Card Spending	y/y	aug	5.0%	6.0%		**	Equity and bond neutral
EUROPE								
Germany	PPI	y/y	aug	0.3%	1.1%	0.6%	**	Equity bullish, bond bearish
France	Wages	q/q	2q	0.5%	0.5%	0.5%	**	Equity and bond neutral
Russia	Gold and Forex Reserve	w/w	13-Sep	531.2 Bil	532.7 Bil		**	Equity and bond neutral
	Money Supply Narrow Def	w/w	13-Sep	10.66 Tril	10.56 Tril		**	Equity and bond neutral
AMERICAS								
Mexico	Aggregate Supply and Demand	m/m	2q	-1.0%	1.4%	-1.0%	**	Equity and bond neutral
Canada	Teranet/National Bank HPI	y/y	aug	0.6%	0.4%		**	Equity and bond neutral
Brazil	CNI Industrial Confidence	m/m	sep	59.4	59.4		**	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)	216	216	0	Down
3-mo T-bill yield (bps)	187	188	-1	Neutral
TED spread (bps)	29	28	1	Neutral
U.S. Libor/OIS spread (bps)	181	181	0	Up
10-yr T-note (%)	1.78	1.79	-0.01	Down
Euribor/OIS spread (bps)	-40	-40	0	Neutral
EUR/USD 3-mo swap (bps)	8	8	0	Down
Currencies	**Direction**			
dollar	Up			Up
euro	Flat			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	$64.83	$64.40	0.67%	
WTI	$58.72	$58.13	1.01%	
Natural Gas	$2.55	$2.54	0.63%	
Crack Spread	$17.35	$17.08	1.61%	
12-mo strip crack	$18.27	$18.19	0.43%	
Ethanol rack	$1.56	$1.56	-0.23%	
Metals				
Gold	$1,503.38	$1,499.03	0.29%	
Silver	$17.87	$17.79	0.47%	
Copper contract	$261.05	$260.85	0.08%	
Grains				
Corn contract	$ 372.50	$ 372.75	-0.07%	
Wheat contract	$ 490.00	$ 488.00	0.41%	
Soybeans contract	$ 891.50	$ 893.00	-0.17%	
Shipping				
Baltic Dry Freight	2192	2266	-74	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	1.1	-2.0	3.1	
Gasoline (mb)	0.8	-1.0	1.8	
Distillates (mb)	0.4	0.2	0.2	
Refinery run rates (%)	-3.90%	-0.50%	-3.40%	
Natural gas (bcf)	84.0	78.0	6.0	

Weather

The 6-10 and 8-14 day forecasts call for higher-than-normal temperatures for most of the country, with cooler temperatures in the Pacific region. Precipitation is expected for most of the country with the exception of the East Coast. Hurricane Humberto has fully dissipated, while Tropical Storm Jerry has developed into a hurricane. Lastly, there are two cyclone formations in the Caribbean Sea and in the Atlantic, but neither is expected to develop into a tropical storm.

Asset Allocation Weekly

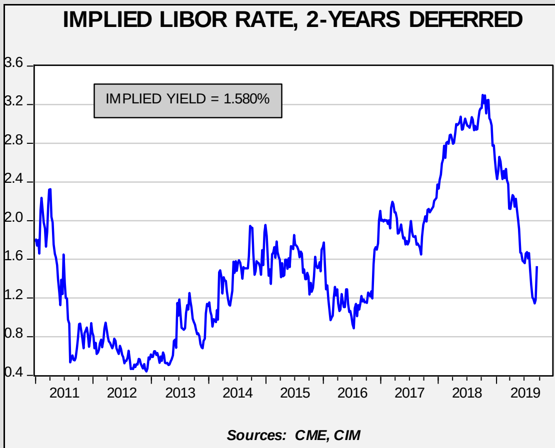
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

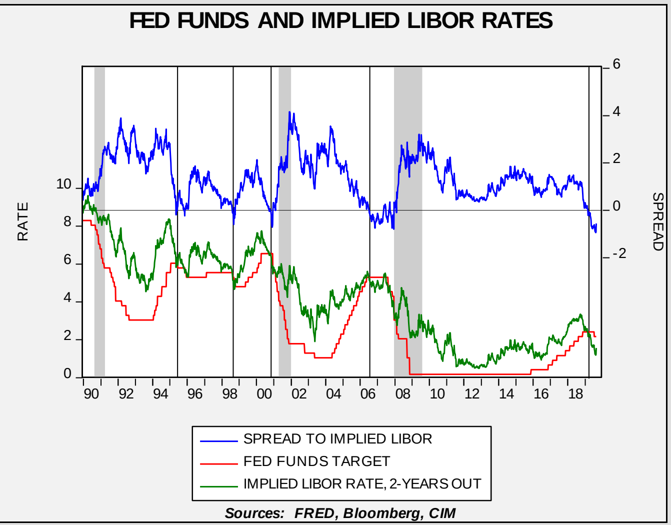
September 20, 2019

Interest rates have increased since early September.

(Source: Bloomberg)

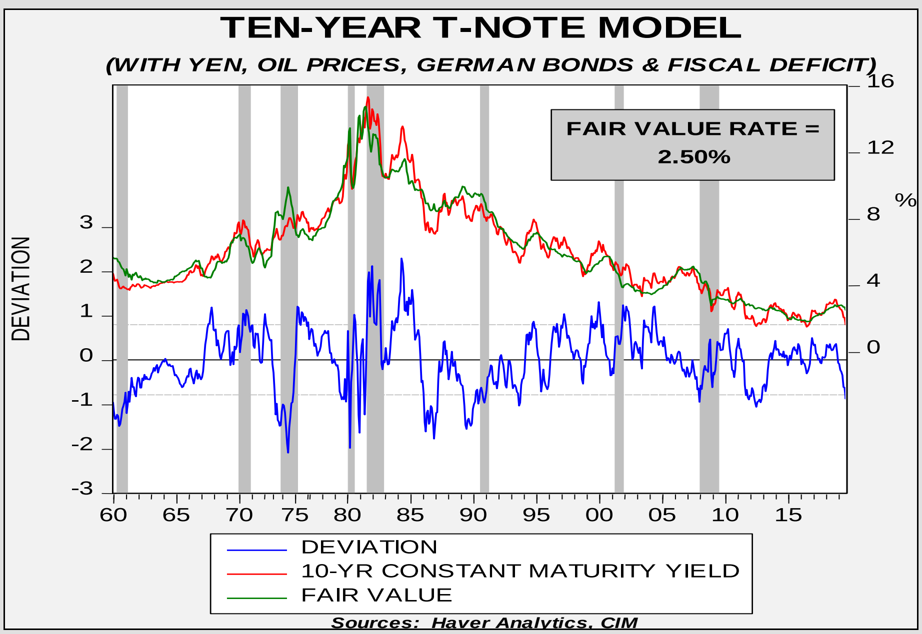
The 10-year T-note yield dipped to 1.45% in early September but has risen strongly since then. What has prompted this rise? Some of the rise appears to be caused by a revaluation of the path of monetary policy.





The chart on the left shows the implied three-month LIBOR rate, two-years deferred, from the Eurodollar futures market. After falling to a low near 1.15%, the yield has jumped to 1.58%. The chart on the right shows this implied rate compared to the fed funds target. Although the backup in the implied rate has reduced the expected decline in fed funds from nearly 100 bps to around 60 bps, the spread remains inverted, meaning the market still expects the Federal Reserve to cut rates somewhere between 50 bps and 75 bps over the next two years.

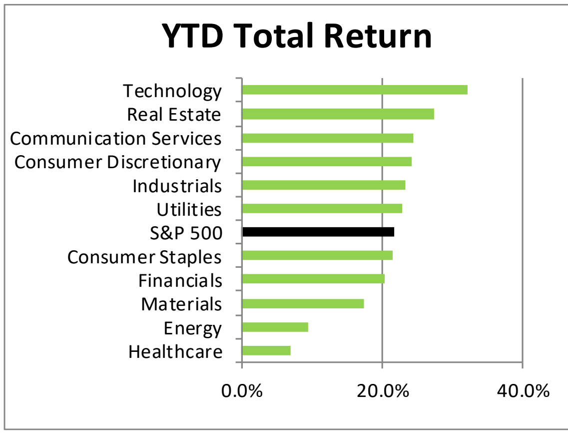
Our 10-year T-note model suggests that long-duration yields are too low, or prices on these instruments are too high.

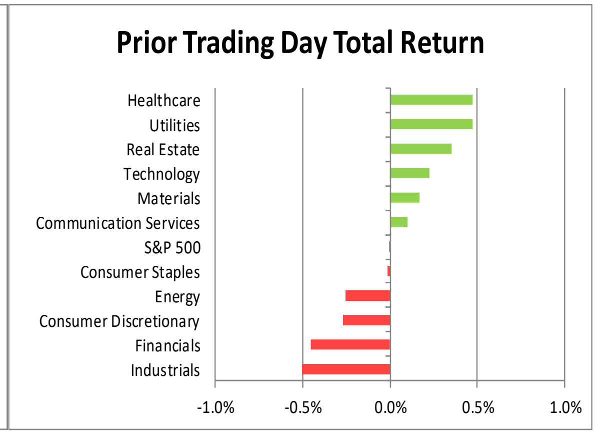


This chart shows our 10-year T-note yield model. The deviation line is at the one-standard error level. Essentially, the bond market yield is consistent with recession. If the bond market is right and a recession is coming, the chart above suggests that if that recession is a "garden-variety" type, like those seen in the 1990-91 and 2001 downturns, then it would be unlikely that we will see further yield declines. On the other hand, when the model suggests long-dated Treasuries are overvalued and a recession doesn't follow, the backup in yields is notable. It's still too early to tell if a recession is coming, but the evidence that one could develop is increasing. ***Our analysis suggests, however, that the protection that long-duration Treasuries usually offer in a recession and bear market may not be all that significant at current yields.*** If the above LIBOR analysis is correct, the recent backup in those yields would suggest a fed funds rate of around 1.50% and a fair value 10-year Treasury yield of 2.27%. Thus, the recent backup in yields likely has further to run.

Data Section

U.S. Equity Markets – (as of 9/19/2019 close)

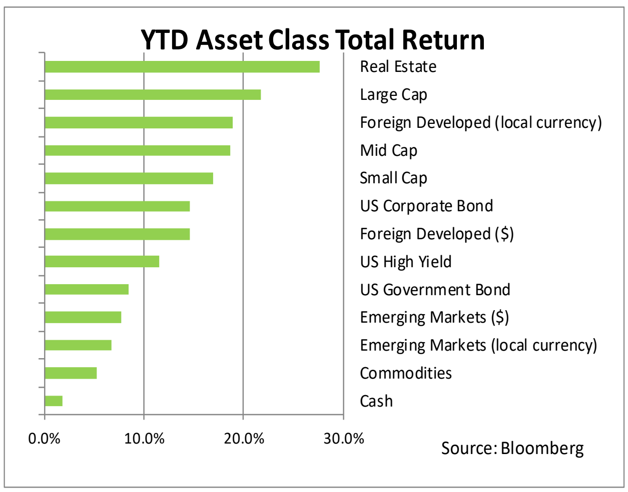




(Source: Bloomberg)

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 9/19/2019 close)

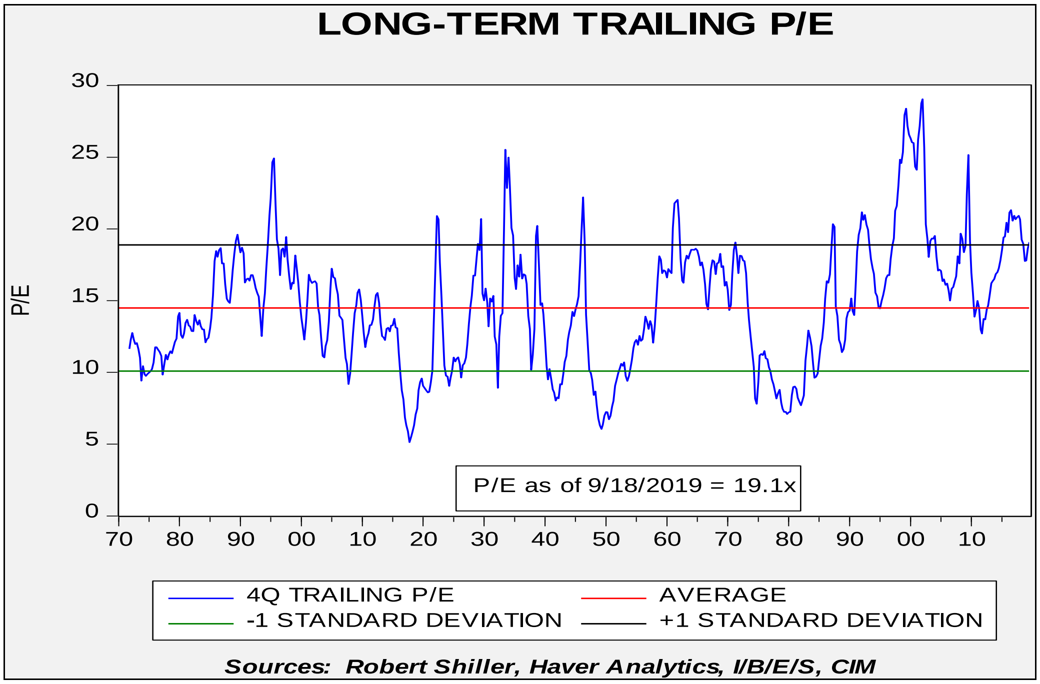


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 19, 2019



Based on our methodology,[1] the current P/E is 19.1x, up 0.1x from last week.

[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.