Daily Comment

By Bill O'Grady, Thomas Wash, and Patrick Fearon-Hernandez, CFA

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 26, 2019—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.6% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.3%. Chinese markets were lower, with the Shanghai composite down 0.8% and the Shenzhen index down 0.9% from the prior close. U.S. equity index futures are signaling a higher open.

Markets are rather quiet this morning. The IMF has a new leader. The head of the DNI testifies today before the House and Senate Intelligence Committees. The House testimony will be public, while the Senate will be closed. We expect the media to remain focused on the impeachment issue. Here is what we are watching this morning:

Impeachment update: Before we start, we want to correct something we said yesterday. We implied that we didn't think the president would be impeached. That's not exactly what we meant. We would not be surprised if the House impeaches the president but think the odds of a conviction in the Senate are near zero.

After another 24 hours, here are some additional thoughts on the impeachment issue:

1. Although we suspect this event will look more like the Clinton impeachment rather than the Nixon one, history doesn't necessarily tell us very much. The fact that there are only two events in recent history means we simply don't have enough of these circumstances to draw clear conclusions. Our expectation is that these proceedings will probably help the president more than hurt him. However, our confidence in that expectation isn't all that solid. To frame just how current conditions affect these events, imagine the Clinton impeachment in the #MeToo era. Democratic Party senators would have been torn between trying to protect their party's president and allowing him to get away with what was clearly an inappropriate relationship. In other words, in the late 1990s, what President Clinton did was framed as an unfortunate dalliance. In the current world, such actions, especially by older, powerful men against younger women, are not tolerated. In today's world, Clinton may have been removed from office. So, we will have to play this one by ear because each one of these is unique.
2. Americans have little knowledge of the degree of corruption in Ukrainian politics. There have been chemical attacks on candidates. Former leaders have been jailed. The country elected a young comedian hoping he might be able to clean things up. If we see Ukrainian officials testify before Congress, it will be quite a show.

3. Ukrainian President Zelenskiy will likely be making some apology calls to EU leaders over the coming week.

The German resigns: Sabine Lautenschläger, the German representative and only woman on the ECB's executive board, has resigned over recent easing actions by the ECB. She was in her sixth year of an eight-year term. Germany, along with other northern European nations, has become increasingly unhappy with the easy money policies of the ECB. Draghi was able to force his will on the ECB, in part, because he has the intellectual "chops" to argue for his position. It will be interesting to see how Legarde handles this growing hawkish opposition to easy policy. It is possible that she will not be able to stand against it. We will also be closely watching to see who Germany appoints to replace Lautenschläger.

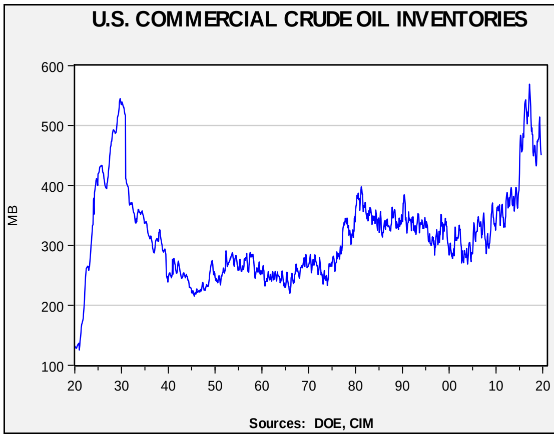
More repo: Like the cowbell, the financial system can't get enough Fed repurchase operations. The NY FRB will increase the size of the repo operations to $100 bn from $75 bn. It appears that the Fed is focusing on the largest banks' reserve hoarding as the reason for why there appears to be a scarcity of liquidity in the repo market. If the large banks are, in fact, hoarding reserves, the key question then becomes, "why?" We suspect it is regulation uncertainty causing this behavior, but will be watching to see if other reasons emerge.

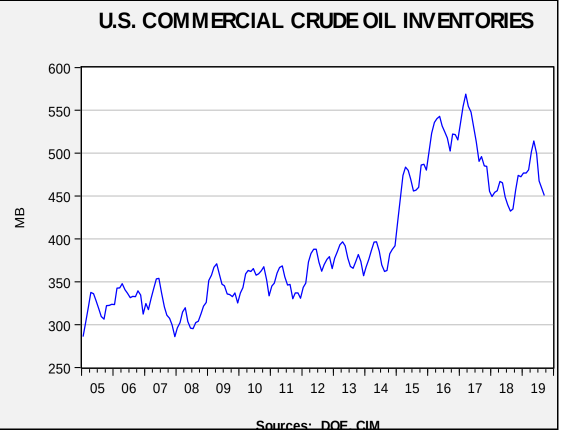
United States-Japan: At the UN yesterday, President Trump and Japanese Prime Minister Abe signed a trade deal that will cut Japanese agriculture tariffs and U.S. industrial duties. However, the agreement is seen as limited. It doesn't appear to open up major new markets, nor does it produce major new momentum for the U.S.-China trade negotiations.

North Korea-South Korea: Recent reporting suggests North Korea secretly annexed and occupied a small South Korean island near the countries' maritime border, sparking a scandal for the South Korean government. The government denies the islets are really South Korean territory, but reporters have found evidence that they were considered so in the past.

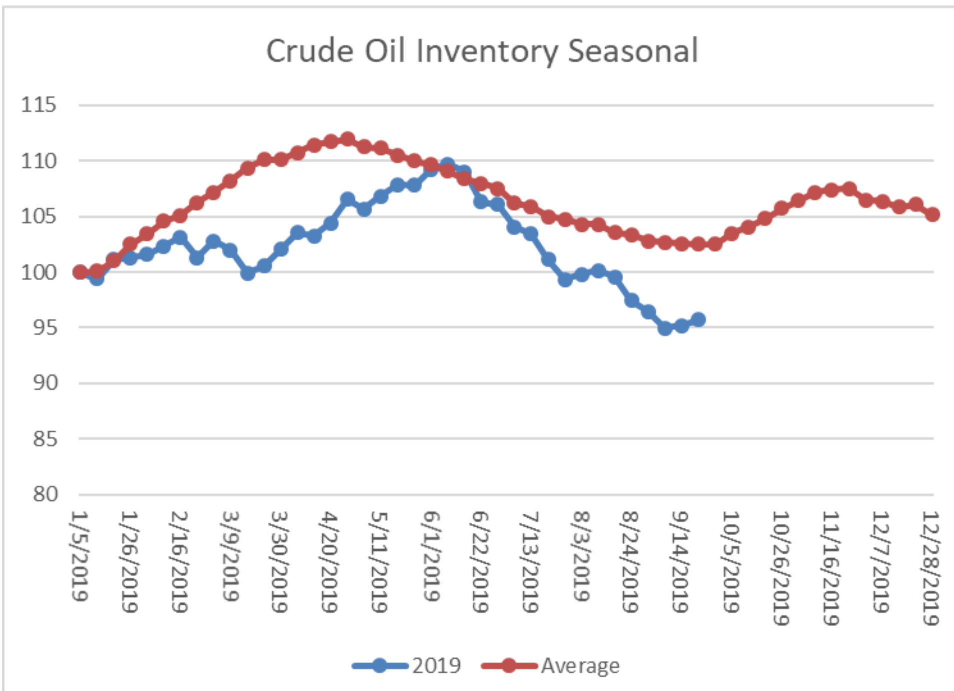
China: Chinese buyers continue to lap up U.S. agricultural products. At the same time, U.S. hardwood lumber exports to China have fallen 40% this year, after China's imposition of 25% retaliatory tariffs on the product. This helps explain why major timber REITs have fallen in price over the last year, while REITs as a whole have surged. On another topic, the PBOC auctioned 10 billion yuan of six-month bills in Hong Kong to shore up the yuan exchange rate. The trade war has also affected global trade. The Netherlands Bureau for Economic Policy Analysis has a World Trade monitor; for the first seven months of 2019, world trade contracted.

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





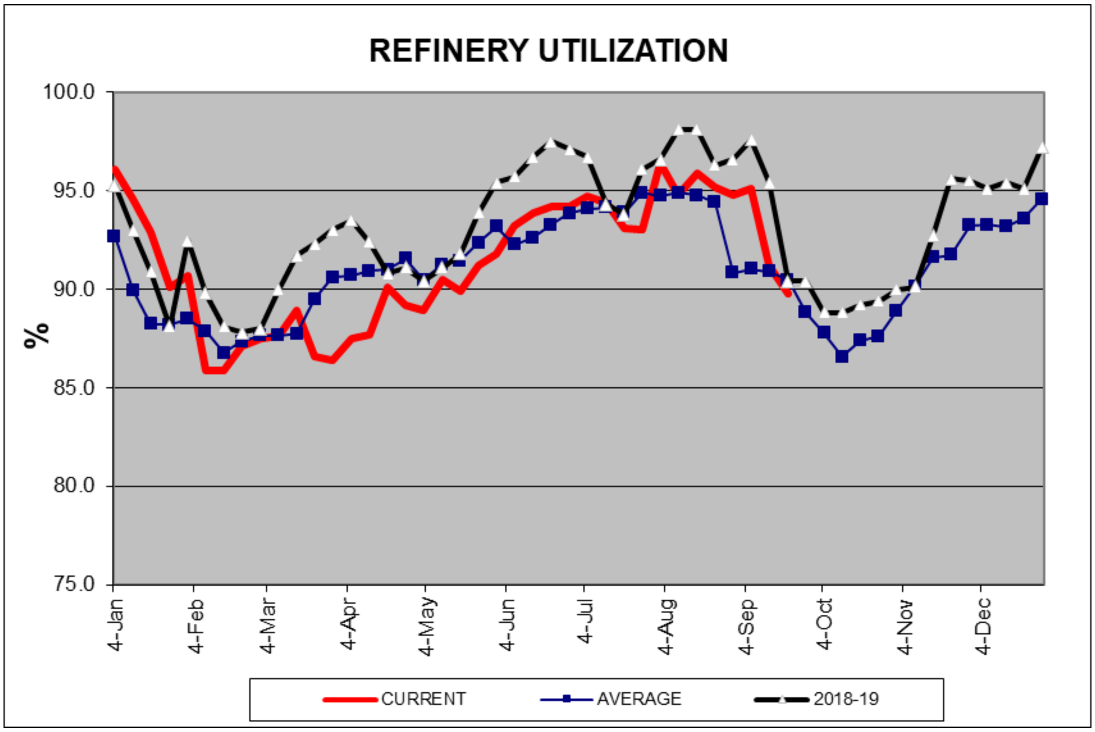
In the details, U.S. crude oil production rose 0.1 mbpd to 12.5 mbpd, a new record. Exports fell 0.2 mbpd, while imports fell 0.7 mbpd. The rise in stockpiles was mostly due to falling refinery demand (see below).



(Sources: DOE, CIM)

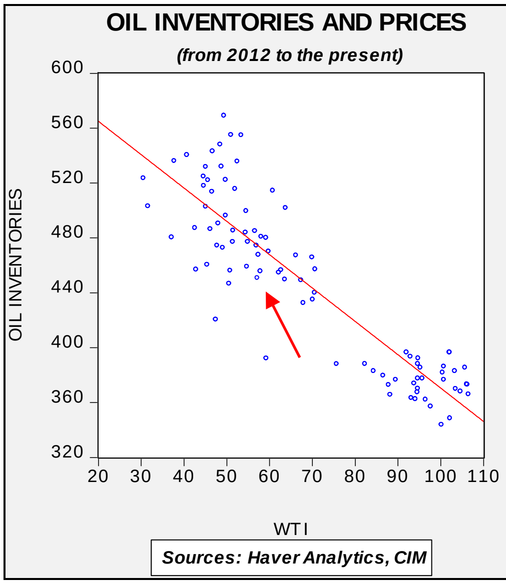
This chart shows the annual seasonal pattern for crude oil inventories. As we approach the end of the spring/summer inventory withdrawal, we are starting the autumn rebuild period at a sizeable deficit. For the past two weeks, we have seen small builds but, as the chart shows, the seasonal gap is still significant. Without aggressive increases in stockpiles, we will likely continue to lag seasonal patterns which, on its own, is bullish.

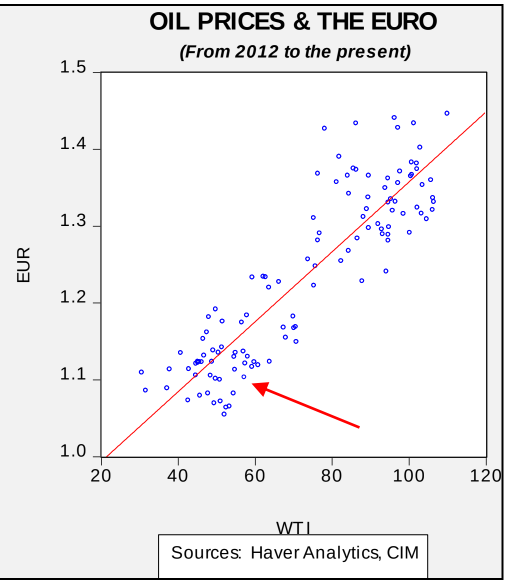
The most important information from this week's data is that we appear to be well into the autumn refinery maintenance season.



(Sources: DOE, CIM)

The drop in refinery utilization will likely continue for the next three weeks; utilization should begin to rise by mid-October. During this period, inventories usually rise. However, the usual seasonal rise will depend on Saudi production.





Based our oil inventory/price model, fair value is $67.53; using the euro/price model, fair value is $48.17. The combined model, a broader analysis of the oil price, generates a fair value of $54.23. We are seeing a clear divergence between the impact of the dollar and oil inventories.

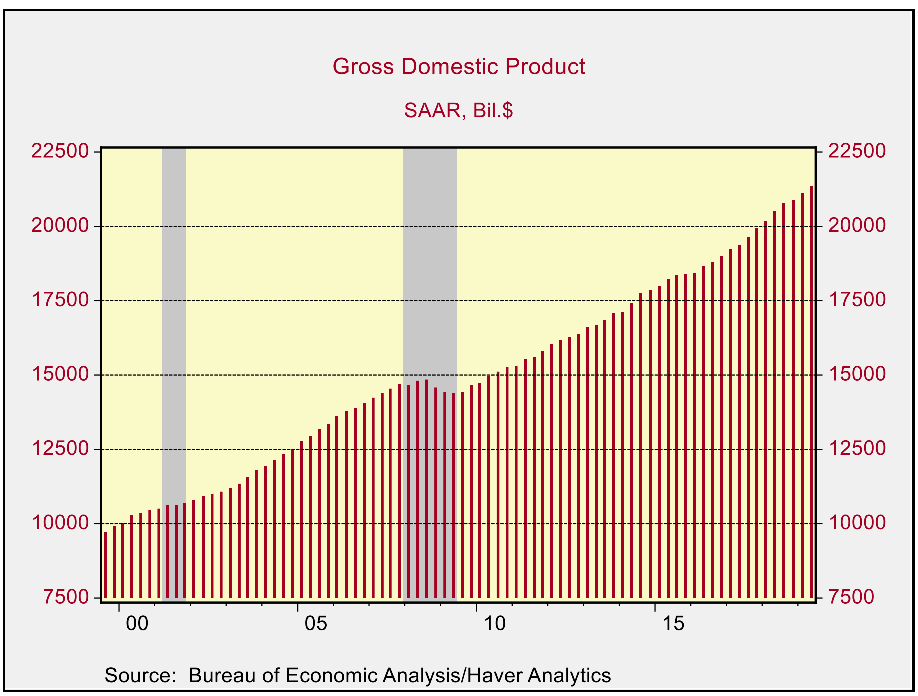
Given that we are in the maintenance season, we would normally expect inventories to rise. Prices will remain sensitive to Saudi output and tensions in the Middle East.

On the Middle East, conflicting trends are emerging. The Kingdom of Saudi Arabia (KSA) is arguing that its oil production is recovering quickly, claiming it is producing around 8.0 mbpd, mostly from other fields and facilities that were not affected by the recent attacks. However, it is not clear if the production has any use; if the oil can't be processed to rid it of impurities and imbedded gasses, it can't go anywhere. So far, the KSA has been fulfilling its export requirements by using storage, but it is unclear how much longer it can maintain exports by draining stockpiles. So far, markets are obviously giving the KSA the benefit of the doubt and pushing prices lower.

As the KSA supplies the oil market, calming supply fears, the U.S. continues to "turn the screws" on Iran. The White House has barred senior Iranian officials from entering the U.S. In addition, in the midst of trade talks with China, the U.S. has sanctioned Chinese firms that have conducted oil trade with Iran. Tightening conditions probably increase the likelihood of a lashing out by Iran; even if there is another attack on the KSA, U.S. support for the kingdom may be tepid at best. We view the geopolitics as bullish.

U.S. Economic Releases

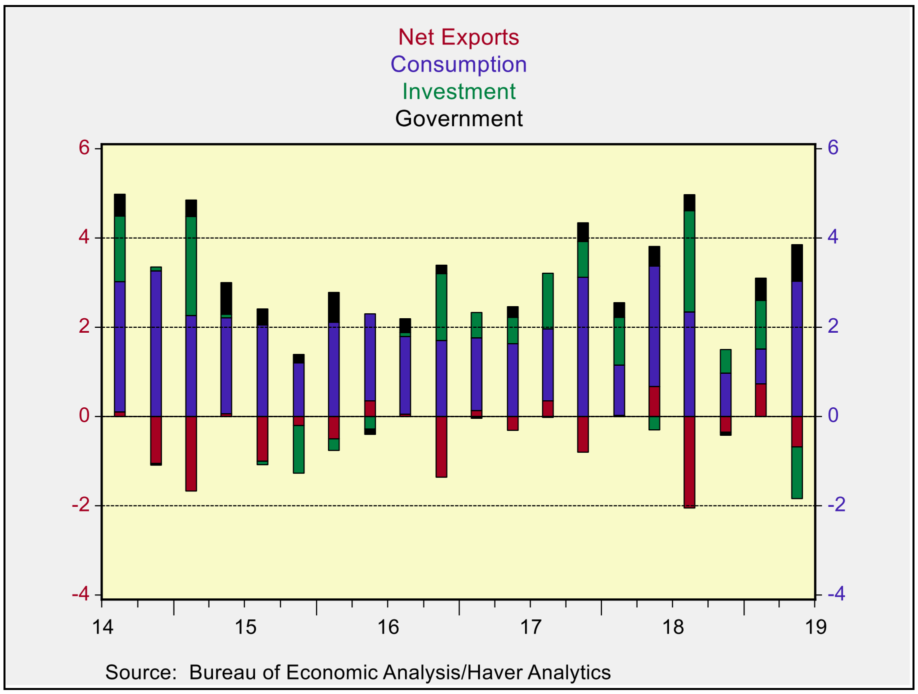
The third reading of Q2 GDP came in line with expectations, at an annualized pace of 2.0%. Personal consumption came in at 4.6%, compared to the forecast of 4.7%. Core PCE rose 1.9% from the prior quarter. The overall GDP price index rose in line with expectations at 2.4%.



The chart above shows historical GDP. Currently, GDP continues to grow at a solid pace.

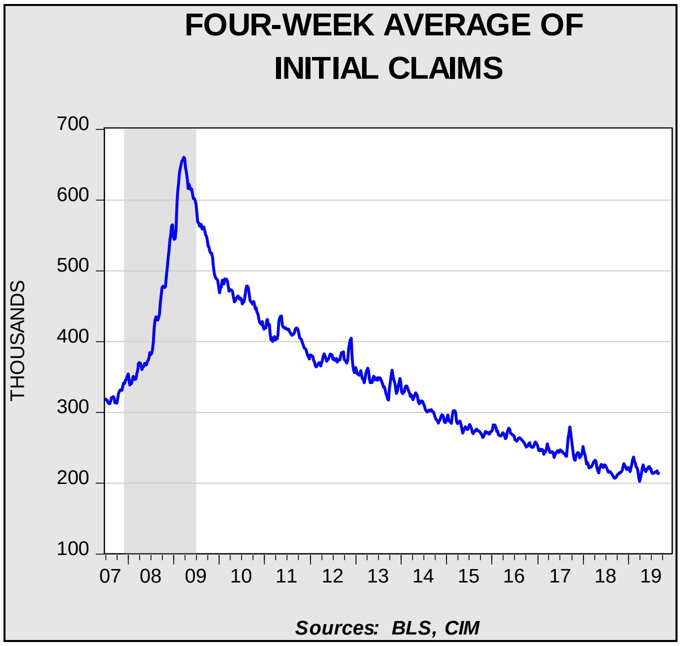
	Q2 2019 Third Reading	Q2 2019 Second Reading	Difference
GDP	2.0%	2.0%	0.0%
Consumption	3.0%	3.1%	-0.1%
Investment	-1.2%	-1.1%	0.0%
Inventories	-0.9%	-0.9%	0.0%
Net Exports	-0.7%	-0.7%	0.0%
Government	0.8%	0.8%	0.1%

The table above shows the contributions to GDP. Consumption was revised downward, while government spending was revised upward.



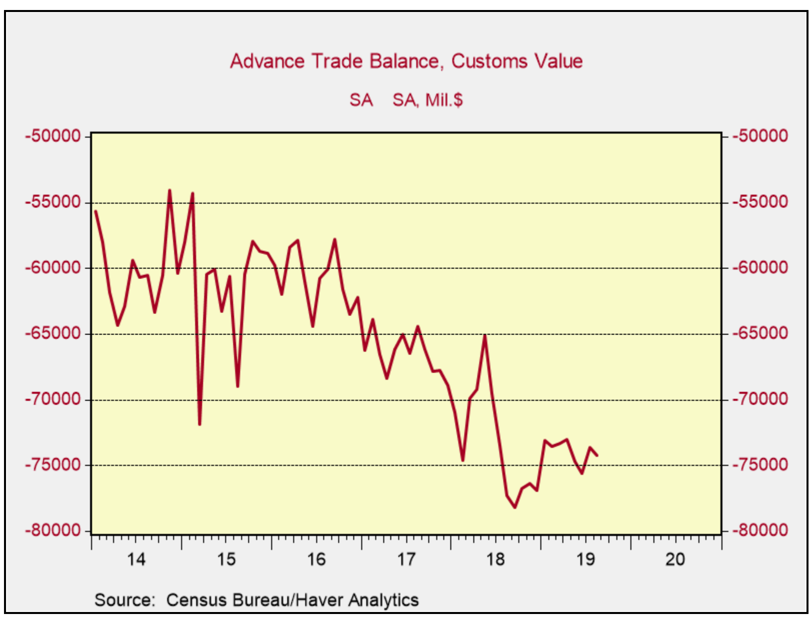
This chart shows the contributions graphically. As the table above shows, there were only slight changes to the GDP contribution.

Initial jobless claims came in above expectationsdown at 213k, compared to the forecast of 212k. The prior report was revised upward from 208k to 210k.



The chart above shows the four-week moving average for initial claims. The four-week moving average fell from 212.50k to 212.00k.

The advanced August goods trade deficit came in narrower than expected at $72.8 bn compared to the forecast of $73.4 bn.



The chart above shows the trade balance of goods and the advance trade balance.

Wholesale inventories came in above expectations, rising 0.4% from the prior month compared to the forecast of 0.1%, while retail inventories remained unchanged from the prior month.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Consumer Comfort	m/m	15-Sep		62.7	***
10:00	Pending Home Sales	m/m	aug	1.0%	-2.5%	***
10:00	Pending Home Sales	m/m	aug	1.3%	1.7%	**
11:00	Kansas City Fed Manufacturing Index	m/m	sep	-4	-6	**
Fed Speakers or Events						
	Speaker or event	**District or position**				
9:30	Robert Kaplan Opening Remarks at Dallas Fed Conference	President of the Federal Reserve Bank of Dallas				
10:00	James Bullard Welcoming Remarks at Minorities Banking Forum	President of the Federal Reserve Bank of St. Louis				
10:45	Mary Daly Speaks at Fed Listen's Event in San Francisco	President of the Federal Reserve Bank of San Francisco				
10:45	Richard Clarida Speaks at Fed Listen's Event in San Francisco	Vice Chairman of Board of Governors of Federal Reserve				
14:00	Neel Kashkari Speaks at Townhall Event in Montana	President of Federal Reserve Bank of Minneapolis				
16:30	Thomas Barkin Speaks at Financial Markets Event in Richmond	President of the Federal Reserve Bank of Richmond				

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	Machine Tool Orders	y/y	aug	-37.0%	-37.1%		*	Equity and bond neutral
Australia	Job Vacancies	m/m	aug	-1.9%	-1.1%		**	Equity and bond neutral
EUROPE								
Eurozone	M3 Money Supply	m/m	aug	5.7%	5.2%	5.1%	**	Equity bullish, bond bearish
Germany	Gfk Consumer Confidence	m/m	oct	9.9	9.7	9.6	***	Equity bullish, bond bearish
Russia	CPI	w/w	23-Sep	0.0%	-0.1%		***	Equity and bond neutral
AMERICAS								
Mexico	Economic Activity IGAE	y/y	jul	0.3%	-0.9%	0.6%	**	Equity and bond neutral
Canada	CFIB Business Barometer	y/y	sep	59.3	60.6		**	Equity and bond neutral
Brazil	Outstanding Loans	m/m	aug	1.1%	-0.2%	1.1%	**	Equity and bond neutral
	Total Outstanding Loans	m/m	aug	3.326 Tril	3.290 Tril	3.324 Tril	**	Equity and bond neutral
	Formal Job Creation Total	m/m	aug	121387	43820	100000	**	Equity bullish, 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)	211	211	0	Down
3-mo T-bill yield (bps)	184	185	-1	Neutral
TED spread (bps)	28	26	2	Neutral
U.S. Libor/OIS spread (bps)	178	179	-1	Up
10-yr T-note (%)	1.72	1.74	-0.02	Down
Euribor/OIS spread (bps)	-41	-40	-1	Neutral
EUR/USD 3-mo swap (bps)	14	13	1	Down
Currencies	**Direction**			
dollar	Up			Up
euro	Flat			Down
yen	Flat			Down
pound	Flat			Up
franc	Flat			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
Overnight Rate		8.000%	7.750%	On forecast

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	$62.24	$62.39	-0.24%	
WTI	$56.41	$56.49	-0.14%	
Natural Gas	$2.54	$2.50	1.44%	
Crack Spread	$15.79	$15.57	1.36%	
12-mo strip crack	$17.71	$17.64	0.39%	
Ethanol rack	$1.59	$1.58	1.03%	
Metals				
Gold	$1,507.66	$1,504.05	0.24%	
Silver	$17.92	$17.91	0.03%	
Copper contract	$261.25	$261.20	0.02%	
Grains				
Corn contract	$ 375.00	$ 374.25	0.20%	
Wheat contract	$ 485.00	$ 477.25	1.62%	
Soybeans contract	$ 893.00	$ 889.25	0.42%	
Shipping				
Baltic Dry Freight	2053	2116	-63	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	2.4	-0.6	3.0	
Gasoline (mb)	0.5	-0.6	1.1	
Distillates (mb)	-3.0	-0.5	-2.5	
Refinery run rates (%)	-1.40%	-0.50%	-0.90%	
Natural gas (bcf)		84.0		

Weather

The 6-10 and 8-14 day forecasts call for higher-than-normal temperatures for the eastern half of the country, with lower-than-normal temperatures for the western half. Precipitation is expected throughout the High Plains, and the area around the Permian Basin in New Mexico and Texas. Tropical Storm Karen has moved further into the Atlantic and does not appear to be a threat of making landfall anywhere.

Asset Allocation Weekly

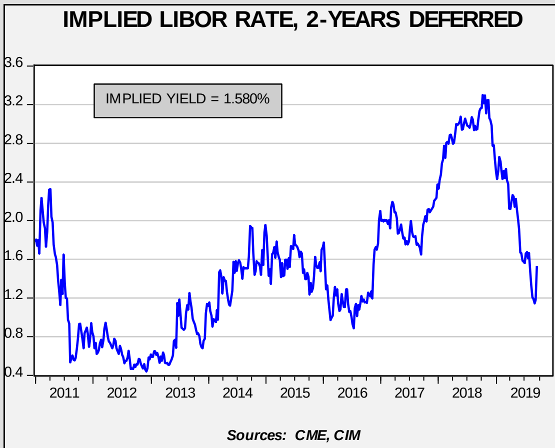
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

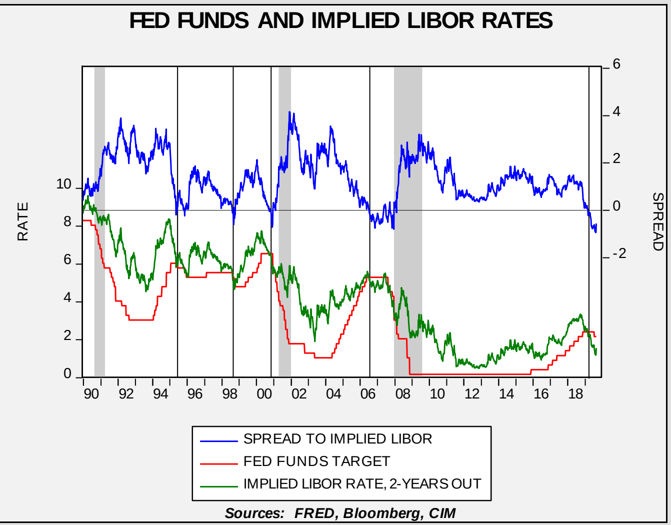
September 20, 2019

Interest rates have increased since early September.

(Source: Bloomberg)

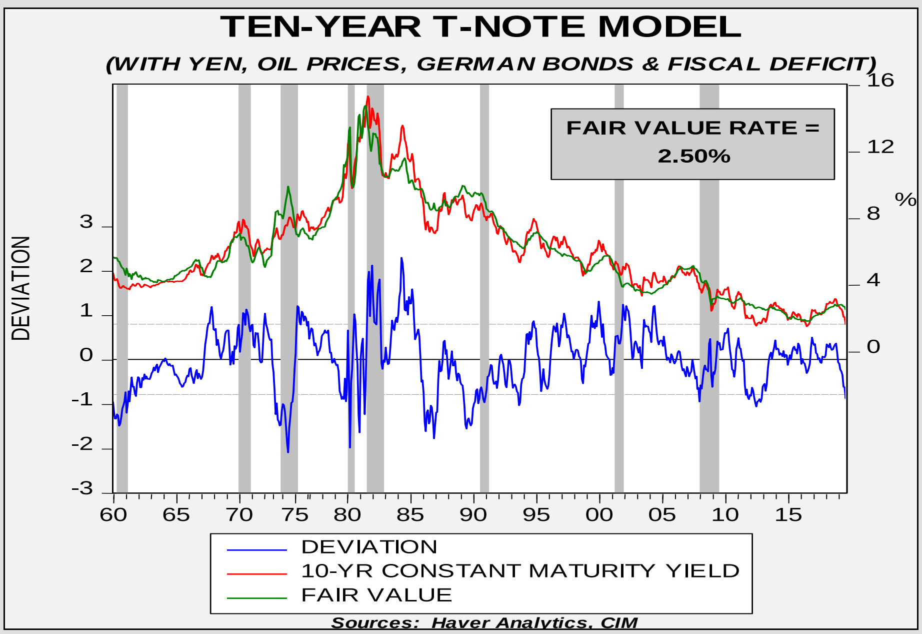
The 10-year T-note yield dipped to 1.45% in early September but has risen strongly since then. What has prompted this rise? Some of the rise appears to be caused by a revaluation of the path of monetary policy.





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.

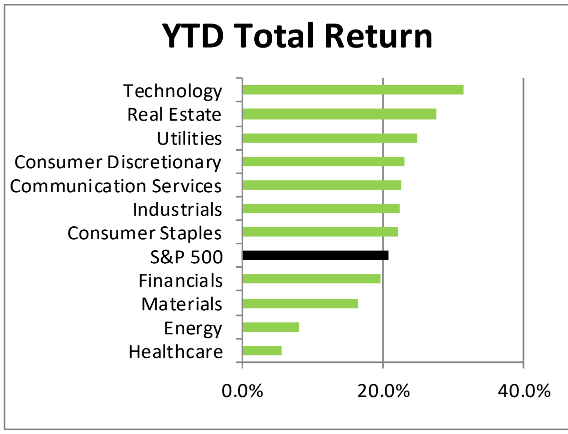
Our 10-year T-note model suggests that long-duration yields are too low, or prices on these instruments are too high.

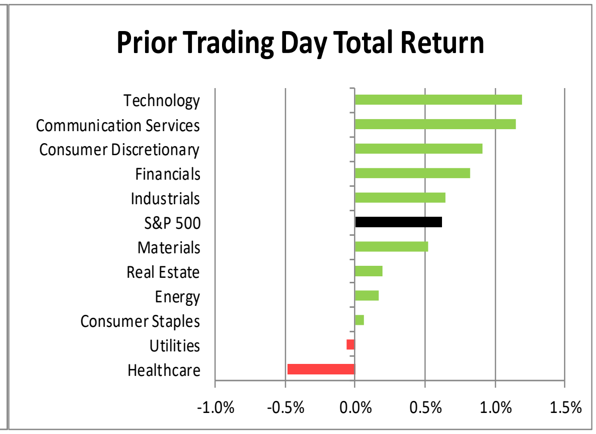


This chart shows our 10-year T-note yield model. The deviation line is at the one-standard error level. Essentially, the bond market yield is consistent with recession. If the bond market is right and a recession is coming, the chart above suggests that if that recession is a "garden-variety" type, like 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 9/25/2019 close)

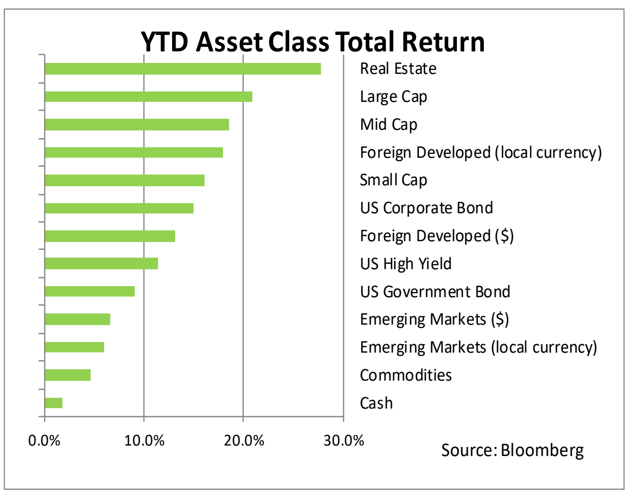




(Source: Bloomberg)

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 9/25/2019 close)

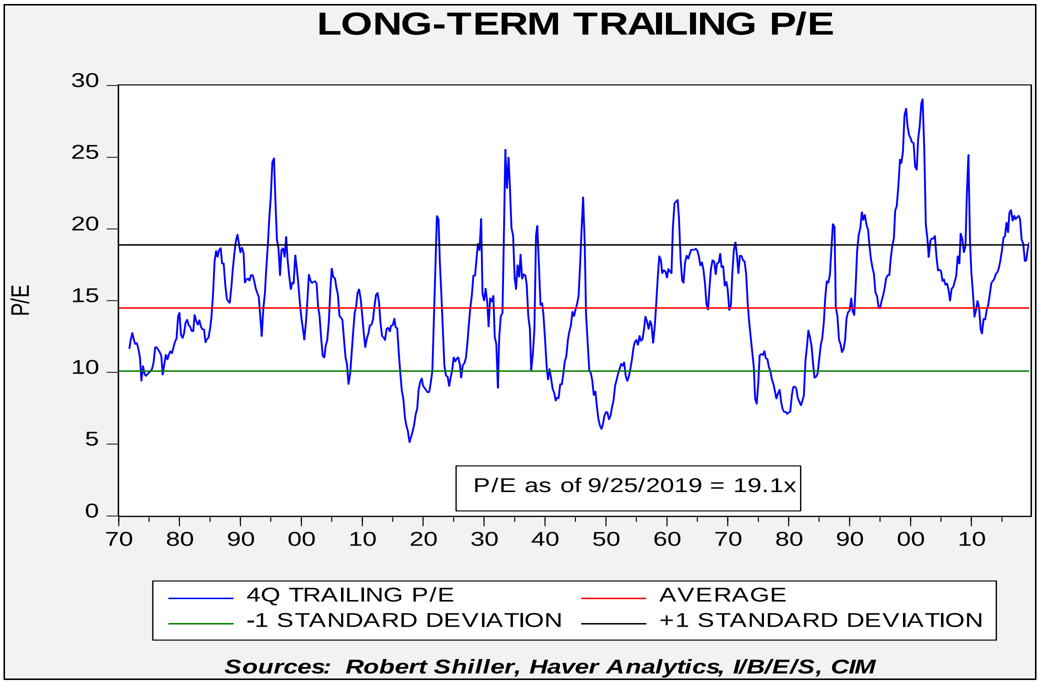


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 26, 2019



Based on our methodology,[1] the current P/E is 19.1x, 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.