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 30, 2019—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.2% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.4%. Chinese markets were lower, with the Shanghai composite down 1.0% and the Shenzhen index down 1.1% from the prior close. U.S. equity index futures are signaling a higher open.

Happy Monday! It's the last day of the quarter and there is a lot going on. Let's dig in. Here is what we are watching this morning:

Happy Anniversary! The Communist Party of China (CPC) will hold major celebrations this week for the 70th anniversary of the CPC's takeover of the mainland. Tomorrow, a large parade will be held. Meanwhile, it was another weekend of protests in Hong Kong. Chairman Xi has been trying to bring Hong Kong under Beijing's control since coming to office. Xi's policy has been to homogenize China culturally; he has cracked down on Islam and Christianity, and clearly does not want any other social narrative but that of the CPC. The actions in Hong Kong are affecting Taiwan's view of the mainland and may make the island even more determined to remain separate from Beijing. In other China news, PMIs came in better than forecast.

Capital issues: Equity markets took a tumble on Friday on reports that the U.S. is considering delisting Chinese equities from U.S. financial markets. The administration has denied the reports, but we note these ideas have been floating around Congress for some time. As our recent WGRs[1] note, attacking the trade deficit from the current account doesn't really work in a floating exchange rate environment. But, attacking it from the capital account can be very effective. Similar to the Baldwin/Hawley bill, which would force the Fed to ease policy to achieve a weaker dollar and allow the Fed to levy taxes on foreign Treasury buyers, delisting measures would affect China through the capital account. China has a serious debt overhang and is likely considering something akin to debt/equity swaps to eventually resolve the problem. Getting foreigners to "participate" would be a reasonable desire. Delisting would dramatically reduce China's ability to tap global financial markets and thus force the debt adjustment onto China.

Financial markets were affected by the reports.

[1] See WGRS, Weaponizing the Dollar: The Nuclear Option, Part I (9/16/19) and Part II (9/23/19).

(Sources: Bloomberg, H/T, John Authers)

It makes sense that the administration would downplay the delisting news in front of this week's anniversary (see below) and trade talks in mid-October. However, we doubt this will be the last word on the issue. As the aforementioned WGRs noted, the capital account would be an effective avenue to address deglobalization. Restricting foreign access to U.S. financial markets is part of that process. On a related note, China has been reducing its foreign direct investment, in part, due to worries over the trade deal and also due to some rather questionable investments.

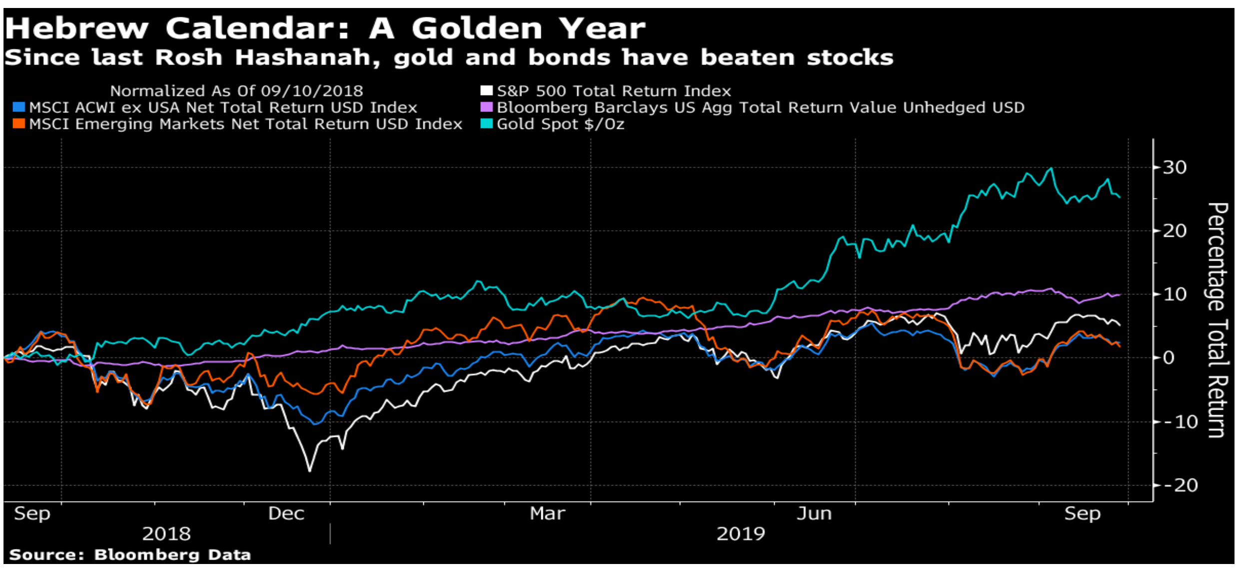
European Union: The European Parliament will hold confirmation hearings this week for incoming European Commission President von der Leyen's slate of commissioners. Several of her nominees are already in trouble because of financial conflicts of interest, and observers worry political bickering will push the process well beyond November 1.

Trouble for Johnson: PM Johnson isn't just struggling to deal with a difficult Parliament. His wayward past is also bubbling up to hurt his ability to lead. And, the DUP is cooling to the possibility of a trade deal that keeps Northern Ireland in the EU trading zone.

Repos continue: The Fed carried out repos again this morning among increasing fears that the Federal Reserve may have given the NY FRB presidency to the wrong guy. John Williams was appointed to the position in April 2018. Williams had an illustrious turn as president of the San Francisco FRB and is a well-respected monetary and financial market economist. His work on "R*" has shaped monetary policy for the past decade. However, he is not a "market guy." Historically, the president of the NY FRB has had experience in the "plumbing" of the financial system. Ed Corrigan and Bill McDonough had long experience on "the desk." Tim Geithner had broad international experience. However, there was some departure from the streetwise presidents with Bill Dudley, and Williams had little financial market experience. Complicating matters, last May, Williams fired two long-term veterans, Simon Potter, who had been at the NY FRB since 1998 and ran the markets desk since 2012, and Richard Dzina, who had been with the bank since 1991. Reports suggest that Williams wanted to change the management structure of the markets desk and apparently decided these leaders were not helping that effort. It is also important to note that the Fed hasn't really had to conduct repo operations since 2009 when QE flooded the banking system with reserves. There may be a lack of experience on the trading desk in the execution of these actions. Although Williams's academic work shows clear expertise in theoretical monetary policy, he may have a gap in understanding the actual operations of the financial system. We suspect Williams will acquire this knowledge in due time, but the actions of the NY FRB have done little to inspire confidence.

Austria elections: Sebastian Kurz's party had a strong showing in this weekend's elections, with the center-left and the populist-right losing support. The Greens showed a dramatic improvement. Kurz now has his pick of coalition partners. He could return to the chastened populist-right to form a government, or break tradition and bring the Greens into government. We will be watching to see how Kurz chooses because it could indicate how the political situations of other European nations may evolve.

Happy New Year! Rosh Hashanah began yesterday evening and will end tomorrow evening. We usually mark market performance on the Gregorian calendar, but here is a chart showing how we have done over the past year using the Hebrew calendar.



(Sources: Bloomberg, H/T, John Authers)

It's been a good year for gold and bonds, but rather "meh" for stocks.

Saudi Arabia: Fitch's Ratings cut Saudi Arabia's long-term, foreign-currency debt rating to A from A+, citing the increased geopolitical and military risks that became evident in the recent attacks on the country's oil infrastructure. Importantly, the agency said it saw a risk of further attacks that could hurt the country's economy.

Odds and ends: Protests continue in Moscow. The Houthis are claiming a major victory against Saudi forces in Yemen. Crown Prince Salman warns of "skyrocketing" oil prices if the world does not bring Iran to heel. As one would expect given the turmoil, voter turnout in Afghanistan was light.

U.S. Economic Releases

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	MNI Chicago PMI	m/m	sep	50.0	50.4	**
10:00	Dallas Fed Manufacturing Index	m/m	sep	1.0	2.7	**
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	Composite PMI	m/m	aug	53.1	53.0		**	Equity and bond neutral
	Manufacturing PMI	m/m	aug	49.8	49.5	49.6	**	Equity and bond neutral
	Non-manufacturing PMI	y/y	aug	53.7	53.8	53.9	**	Equity and bond neutral
	Caixin China PMI Mfg	m/m	aug	51.4	50.4	50.2	**	Equity bullish, bond bearish
Japan	Retail Sales	m/m	aug	4.8%	-2.3%	2.4%	**	Equity bullish, bond bearish
	Department Store, Supermarket Sales	m/m	aug	0.4%	-4.8%	-4.8%	**	Equity bullish, bond bearish
	Industrial Production	m/m	aug	-1.2%	1.3%	-3.9%	***	Equity and bond neutral
	Vehicle Production	m/m	jul	11.8%	-1.5%		**	Equity and bond neutral
	Housing Starts	y/y	aug	-7.1%	-4.1%	-5.9%	***	Equity and bond neutral
	Construction Orders	y/y	aug	-25.9%	26.9%		**	Equity and bond bearish
South Korea	Industrial Production	m/m	aug	-2.9%	0.6%	-0.2%	***	Equity and bond bearish
	Cyclical Leading Index Changes	m/m	aug	-0.1	-0.3		**	Equity and bond neutral
Australia	Melbourne Institute Inflation	m/m	aug	1.5%	1.7%		*	Equity and bond neutral
	Private Sector Consumption	m/m	aug	0.2%	0.2%	0.3%	**	Equity and bond neutral
	CBA Australia PMI Mfg	m/m	aug	49.4	49.4		**	Equity and bond neutral
New Zealand	Building Permits	m/m	aug	0.8%	-1.3%		**	Equity bullish, bond bearish
	ANZ Activity Outlook	m/m	sep	-1.8	-0.5		**	Equity and bond bearish
	ANZ Business Confidence	m/m	sep	-53.5	-52.3		**	Equity and bond bearish
EUROPE								
Eurozone	Unemployment Rate	m/m	aug	7.4%	7.5%	7.5%	***	Equity bullish, bond bearish
Italy	CPI NIC incl. tobacco	m/m	sep	-0.5%	0.5%	-0.3%	***	Equity bullish, bond bearish
	CPI EU Harmonized	m/m	sep	0.3%	0.5%	0.5%	***	Equity and bond neutral
	Unemployment Rate	m/m	sep	9.5%	9.9%	9.9%	***	Equity and bond neutral
Germany	Retail Sales	m/m	aug	0.5%	-2.2%	0.5%	**	Equity and bond neutral
	Unemployment Changes	m/m	sep	-10.0k	4.0k	5.0k	***	Equity and bond bearish
	Unemployment Claims Rate	m/m	sep	5.0%	5.0%	5.0%	***	Equity and bond neutral
UK	GDP	y/y	2q	1.3%	1.2%	1.2%	***	Equity and bond neutral
	Total Business Investment	y/y	2q	-1.4%	-1.6%	-1.6%	*	Equity and bond bearish
	Current Account Balance	q/q	2q	-25.2 Bil	-30.0 Bil	-19.0 Bil	**	Equity and bond bearish
	Mortgage Approvals	m/m	aug	65.5k	67.3k	66.5k	*	Equity and bond neutral
Switzerland	KOF LEI	m/m	sep	93.2	97.0	96.2	**	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)	210	210	0	Down
3-mo T-bill yield (bps)	173	175	-2	Neutral
TED spread (bps)	37	35	2	Neutral
U.S. Libor/OIS spread (bps)	176	176	0	Up
10-yr T-note (%)	1.69	1.68	0.01	Down
Euribor/OIS spread (bps)	-41	-41	0	Neutral
EUR/USD 3-mo swap (bps)	34	32	2	Down
Currencies	**Direction**			
dollar	Up			Up
euro	Down			Down
yen	Down			Down
pound	Up			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	$61.12	$61.91	-1.28%	Demand Pessimism
WTI	$55.30	$55.91	-1.09%	
Natural Gas	$2.37	$2.40	-1.50%	
Crack Spread	$16.34	$16.05	1.78%	
12-mo strip crack	$17.73	$17.67	0.33%	
Ethanol rack	$1.64	$1.62	1.04%	
Metals				
Gold	$1,487.68	$1,497.01	-0.62%	
Silver	$17.24	$17.54	-1.69%	
Copper contract	$260.05	$259.75	0.12%	
Grains				
Corn contract	$ 372.50	$ 371.50	0.27%	
Wheat contract	$ 489.75	$ 487.25	0.51%	
Soybeans contract	$ 891.00	$ 883.00	0.91%	
Shipping				
Baltic Dry Freight	1857	1963	-106	

Weather

The 6-10 and 8-14 day forecasts call for higher-than-normal temperatures for most of the country, with lower-than-normal temperatures in the northern Pacific region. Precipitation is expected for most of the country. Hurricane Lorenzo is in the middle of the Atlantic Ocean, but it is not expected to make landfall.

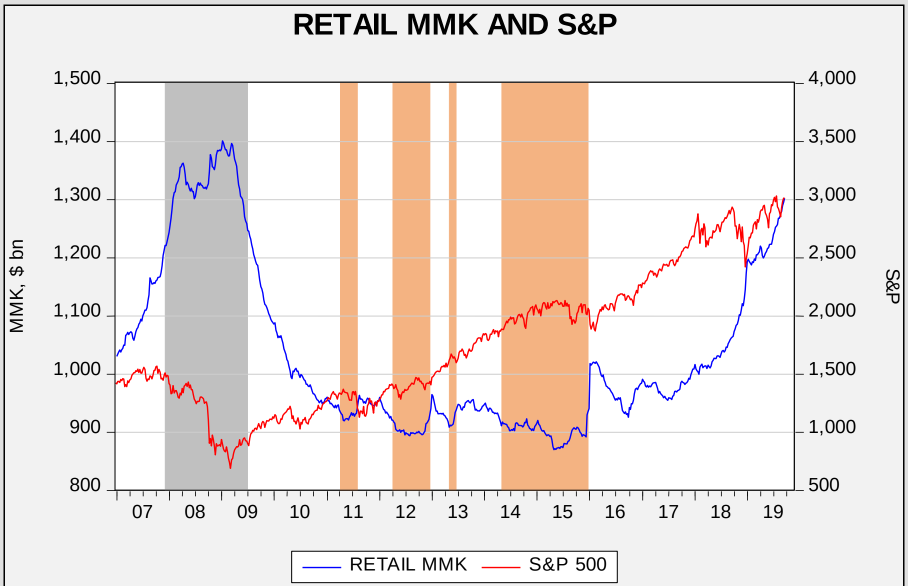
Asset Allocation Weekly

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 27, 2019

Over the past few months, we have been on "recession watch." Our position is that the odds of a downturn are elevated but it is too soon to fully position for a downturn. The inversion of yield curves is a reliable recession warning. On the other hand, the economic data continues to signal a slow U.S. economy but not one seeing negative growth. As long as the economy continues to expand, it does not make sense to underweight equities.

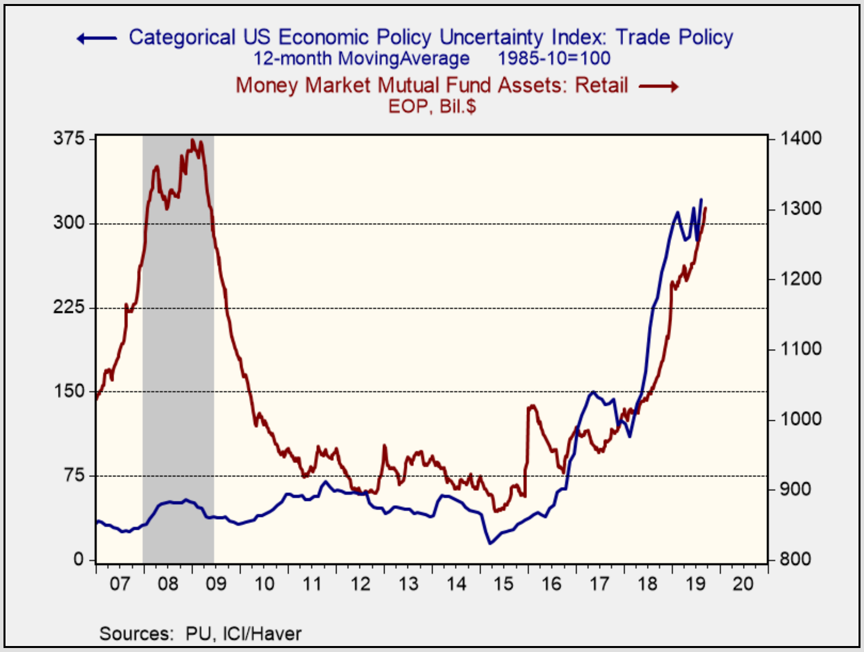
However, there is another possibility to consider. Investors appear to have become overly cautious recently.



Sources: Haver Analytics, CIM

This chart shows retail money market levels on a weekly basis along with the Friday closes of the S&P 500. The gray bars show recessions, whereas the orange bars show periods when retail money markets (RMMK) fall below \$920 bn. In general, when RMMK fall to \$920 bn or below, the uptrend in equities tends to stall. It would seem there is a certain level of desired cash, and when that level falls below \$920 bn, households try to rebuild cash by either slowing their purchases of equities or selling stocks to build liquidity.

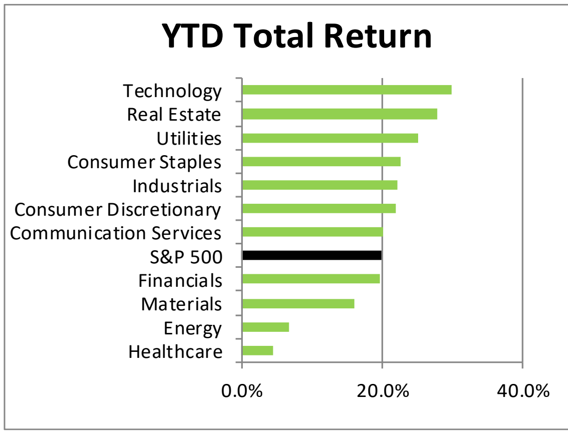
The chart shows that, in early 2018, households began to aggressively build RMMK, which would coincide with rising trade tensions.

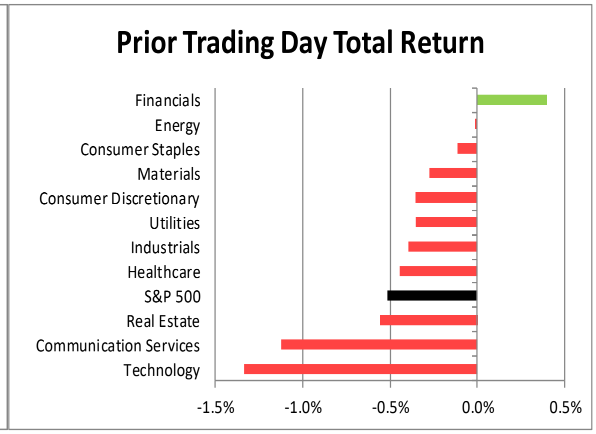


This chart shows RMMK with the 12-month average of the Policy Uncertainty Index for trade policy. The fit is rather obvious. If the U.S. and China come to a short-term agreement that reduces trade worries, it might free up significant liquidity that would find its way into equities. The potential for such flows, coupled with the usual positive seasonal trend in Q4, could lead to a strong close in equities for 2019. This doesn't mean that investors should not continue to watch for recession signals, but de-risking portfolios too quickly may very well be counterproductive.

Data Section

U.S. Equity Markets – (as of 9/27/2019 close)

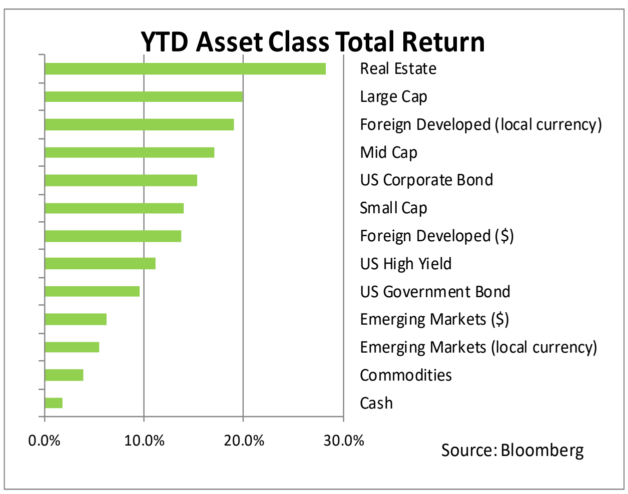




(Source: Bloomberg)

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 9/27/2019 close)

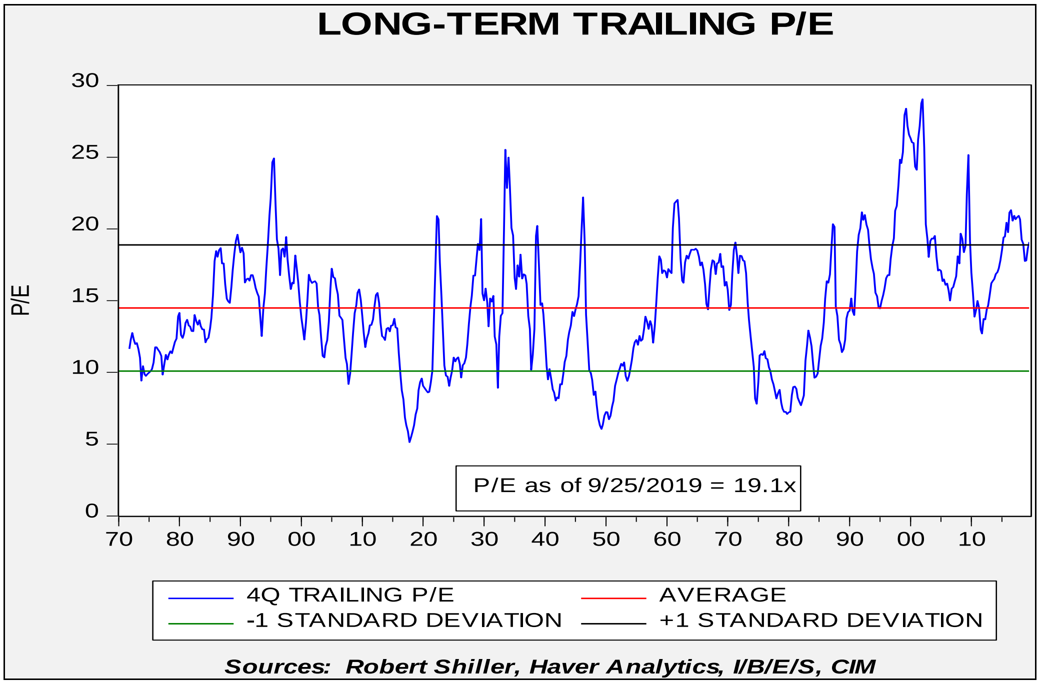


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[2] 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.

[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.