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 5, 2019—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.8% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.9%. Chinese markets were higher, with the Shanghai composite up 0.9% and the Shenzhen index up 0.9% from the prior close. U.S. equity index futures are signaling a higher open.

Trade optimism is lifting risk assets; equities are up, while gold, the dollar and Treasuries are down. Here are the details and other items we are watching:

An observation: One of the most difficult tasks humans face is trying to deal with low probability/high impact events. If something can happen that is highly unlikely but extremely positive or negative, our minds tend to become a muddle. This situation explains why lotteries flourish; anyone with a modest understanding of basic statistics realizes that a lottery is a voluntary tax paid by those who fail to understand how the numbers work. And yet, money is wagered 24/7 in these long-shot bets. Anyone who has raised teenagers can see this problem work out first hand. Teens will take completely unnecessary risks for inconsequential benefits and then be shocked when the unlikely outcome occurs and causes an expensive consequence.[1]

Financial markets struggle with this issue constantly. In fact, we have options markets available to give us tools to deal with these circumstances. Nicholas Taleb has made a career out of making small wagers on unlikely but very consequential events that occasionally pay off enormously. Still, most of the time, the unlikely event doesn't occur and we, like the teenagers we once were, go our merry way.

Today is an interesting example of this situation. Equities are up sharply on hopes of a trade deal with China due to the news that the two parties will meet in October. Although there is hope that something might come of these meetings, positions have hardened and anything beyond a truce would be surprising. This isn't the only situation that may be improving. A hard, Halloween Brexit appears unlikely as PM Johnson has suffered a series of electoral defeats. Like a cat playing with a mouse, Jeremy Corbyn continues to delay the inevitable general election, keeping Johnson in Downing #10 with little power. In Hong Kong, the fear was an invasion of the island by the PLA; instead, we are seeing grudging concessions that probably won't stop the protests completely but will likely reduce the intensity over time. And, in Italy, fears that the League would gain control and trigger a Eurozone crisis have been eased by a new leftist government.

[1] Yes, this did happen to us. It involved an unnecessary decision to drive at night and a deer. Enough said…

Market strategy, in part, requires one to look out for what can go terribly wrong. At the same time, there is a realization that, most of the time, things work out ok. Unfortunately, the longer things work out ok, the more complacent we become. Hyman Minsky noticed this issue, dubbing it the "financial instability hypothesis." In effect, the longer conditions remain stable, the more investors are inclined to take more risk, eventually creating conditions where a financial crisis cannot be avoided. It's a bit like forestry management that never allows a fire to develop. Over time, the underbrush that would normally be reduced by small fires becomes so thick that a small fire becomes a big one. Our industry is characterized by Cassandras who are always projecting the end is near, along with permabulls who assume everything will always be ok. What we try to do, as is likely true with most strategists, is hew a path between these extremes. Most of the time, the worst is avoided; but, when the worst occurs, "it leaves a mark." In some respects, holding to either extreme is intellectually easy. Cassandras are wrong most of the time, but when they are right their calls appear to be spectacular. Permabulls are right most of the time, but it can feel like they are "gathering nickels in front of freight trains."

So, where does all this leave us? Although trade talks with China may bring us to a truce, we don't think that China is going to fundamentally change its approach to trade and there isn't much evidence to suggest that President Trump sees much risk from his trade policy. To the president's credit, he has concluded that China is a strategic competitor and so, regardless of the outcome of the current round of talks or who wins the White House in 2020, our relations with China are changed for good. The U.K. is going off on its own; even if a new referendum rescinds Article 50, its relations with the EU will be forever fraught because of Brexit. In addition, the Brexit debate has exposed societal divisions that plague not only the U.K. but the West, in general. Hong Kong is eventually going to come under control of Beijing and its current freedoms are likely to be lost; capital and human flight are likely. This outcome not only affects Hong Kong but Taiwan as well; if anything, the protests in Hong Kong may have increased the odds that Taiwan won't rejoin the mainland peacefully. Italy has suffered during its tenure in the Eurozone; either Germany changes its export-driven economy or Italy will need to leave the Eurozone at some point. Today, it looks like these potential crises have been averted, and if this optimistic sentiment continues, we will likely challenge the recent highs in the equity indices. However, the structure beneath has not changed.

In the PBS drama *Doc Martin*, Luisa, the nurturing, lovely wife of the curmudgeonly Doc Martin, purrs to a frightened young girl:

> "No one's going to die." Martin, as affectless and socially clueless as always, counters, **"Yes you are. Everyone's going to die." Before adding, "But not today."**

This line is a decent reflection of what investors face; there are a myriad of low probability/high impact events that can occur that would have either a very positive or negative impact on one's portfolio. This is the business we have chosen. Our take on events? As we have been saying, it's too early to take an overly defensive stance in portfolios but the time to do so is probably on the foreseeable horizon. Stay tuned…

U.S.-China Trade: The United States and China have both confirmed that their top-level trade negotiators – Chinese Vice Premier Liu He, U.S. Trade Representative Robert Lighthizer and

U.S. Treasury Secretary Steven Mnuchin – will meet again in early October to try to resolve the countries' trade dispute. Lower-level officials will meet in September to prepare for the meeting. The prospect of further meetings offers a glimmer of hope that the trade war can be reversed, so risk markets across the globe are rallying today. However, it's important to remember that the countries remain fundamentally at odds on their trade goals, so there is limited hope for meaningful progress at the talks, even as the dispute continues to weigh on global investment and trade.

Hong Kong: Municipal Chief Executive Carrie Lam said today that she alone made the decision this week to formally withdraw her controversial China extradition bill, which sparked the massive political protests of recent weeks. While that decision has been taken as a positive, prompting a surge in Hong Kong assets yesterday, it's important to remember that she also insisted that to "withdraw" the bill was substantively no different than her decision to "suspend" it earlier in the summer. The withdrawal announcement was already being taken as too little, too late by many protest leaders. If Lam's statement is now taken as confirmation that nothing has really changed, there's an even greater chance that the protests will continue, which would probably weigh on Hong Kong stocks again. That's especially true if it looks like the government and police continue to clamp down on demonstrators, sometimes apparently working with organized crime groups to harass them. Today, masked assailants threw Molotov cocktails at the home of media mogul and democracy activist Jimmy Lai Chee-ying.

United Kingdom: You know things are going badly when even your family abandons you, and that's what has happened to Prime Minister Johnson today. The prime minister's brother, Jo Johnson, announced he would leave his position as universities minister and give up his seat in parliament to protest the government's headlong drive toward a no-deal Brexit. The bill requiring the prime minister to ask the European Union for a delay in Brexit completed its passage through the House of Commons last night and is expected to get through the House of Lords by the end of Friday, allowing it to return to Commons on Monday. However, a spokesman for Prime Minister Johnson said he will not make the request to the EU even if the bill becomes law. Having lost any hope of blocking that bill, the Johnson government is pushing for a new election in order to secure a mandate for its Brexit policy, but yesterday parliament also voted against snap elections. In a final blow, influential Conservatives are pressuring Johnson to reinstate 21 legislators that he purged from the party yesterday for voting against him on the measures.

Eurozone: In testimony related to her nomination as the chief of the European Central Bank, yesterday Christine Lagarde said Eurozone governments should adopt stimulative fiscal policies to accelerate economic growth. Lagarde insisted that "central banks are not the only game in town" and she is not a "fairy" who can magically prompt greater growth through monetary policy alone. We still don't see a lot of movement toward greater use of fiscal policy to promote economic growth around the world, but if the trends toward economic sovereignty and populism play out as we expect, we do think greater fiscal stimulus will be more widely adopted down the road.

Italy: Yesterday, the new Democrat-Five Star coalition government announced its lineup of ministers, and the appointments suggest there will be fewer disputes between Italy and the EU over the country's budget deficit, debt and migration policy. Importantly, the new finance minister, Roberto Gualtieri, is a member of the center-left Democratic Party who previously served as the chairman of the economic and monetary affairs committee in the European Parliament. Even if Gualtieri pushes for new spending or tax cuts to boost the economy, as the Five Star Movement will demand, we think EU leaders will be more flexible with him than they were with the more combative previous coalition composed of the Five Star Movement and the far-right League. In sum, the developments in Italy are now looking more supportive of European risk assets.

Sweden: Although yesterday the Riksbank held its benchmark short-term interest rate unchanged at -0.25%, its policy statement reiterated that policymakers soon plan to start hiking rates again. The projected rate hikes would be milder than previously planned, but the policy stance is at odds with most major central banks. That's at least partially explained by the recent weakness of the krona and the general outperformance of Scandinavian economies in recent years.

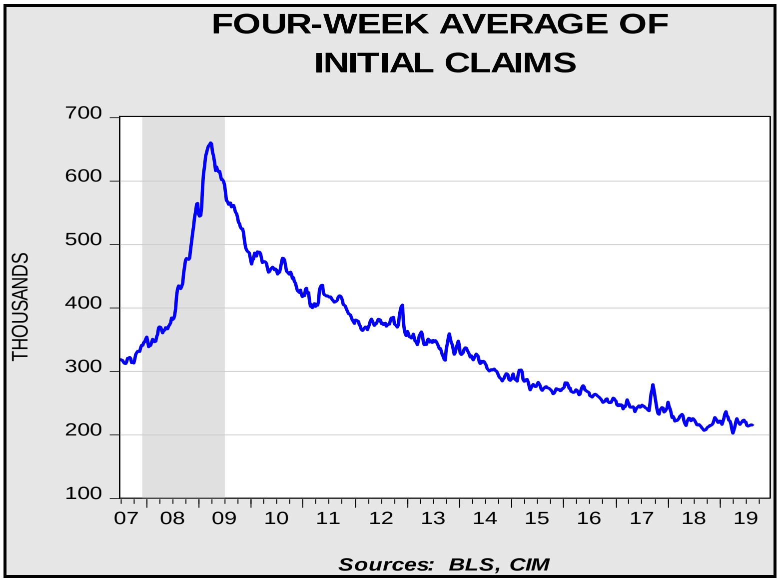
Argentina: Some of the country's largest international creditors held informal discussions this week on President Macri's proposal that they "voluntarily" accept delayed repayment on some $100 billion of government debt. Most importantly, the participants agreed that any debt deal would require a commitment from Alberto Fernández, the populist leader of the opposition Peronist party who is currently the frontrunner in the upcoming presidential elections.

Central bank issues: Although financial markets in Europe and the U.S. continue to project aggressive easing by the Fed and the ECB, internally, there is growing opposition to taking strong actions. Yesterday, we noted the differences between Jim Bullard and Eric Rosengren. Today, we see there are elements within the ECB opposing Draghi's plan for stimulus. A divided Fed will likely lead to a modest rate cut later this month, not the more aggressive action discounted by the financial markets.

U.S. Economic Releases

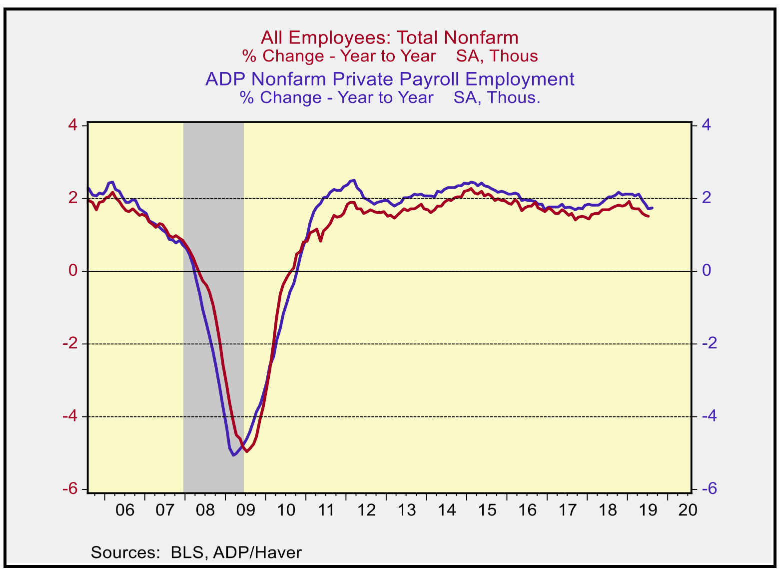
The August Challenger job cuts report rose by 39.0% from the prior year. The index measures the number of announced job cuts by employers, which is a proxy for future layoffs but does not necessarily indicate the state of current layoffs.

Initial jobless claims came in above expectations at 217k compared to the forecast of 215k. The prior report was revised upward from 215k to 216k.



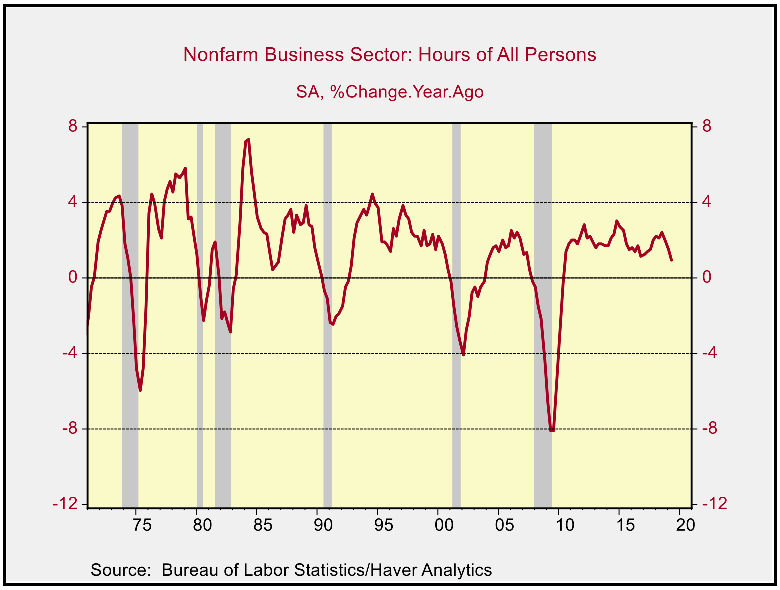
The chart above shows the four-week moving average for initial claims. The four-week moving average rose from 214.5k to 216.0k. We expect initial claims to rise in the coming weeks as a result of Hurricane Dorian.

ADP employment change came in at 195,000 compared with the forecast of 148,000. The prior report was revised upward to 156,000 from 142,000.



This chart shows the level of ADP payrolls relative to nonfarm payrolls as collected by the Department of Labor.

Non-farm productivity came in above expectations, rising 2.3% from the prior quarter compared to the forecast of 2.2%. Unit labor costs also came in above expectations, rising 2.6% from the prior quarter compared to the forecast rise of 2.4%.



The chart above shows the yearly change of hours of all persons and real output. The rise in productivity was the result of hours of all persons decelerating at a faster rate than real output.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Consumer Comfort	m/m	aug		62.5	***
9:45	Markit US Services PMI	m/m	aug	50.9	50.9	**
9:45	Markit US Composite PMI	m/m	aug		50.9	**
10:00	Factory Orders	m/m	jul	1.0%	0.6%	**
10:00	Factory Orders ex Transportation	m/m	jul		0.1%	**
10:00	Durable Good Orders	m/m	jul	2.1%	2.1%	**
10:00	Durables ex Transportation	m/m	jul	-0.4%	-0.4%	**
10:00	Capital Good Orders Nondef ex Air	m/m	jul		0.4%	**
10:00	Capital Good Ship Nondef ex Air	m/m	jul		-0.7%	**
10:00	ISM Non-manufacturing Index	m/m	aug	54.0	53.7	**
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								
Australia	Trade Balance	m/m	jul	A$7.268 Bil	A$8.036 Bil	A$7.000 Bil	**	Equity bullish, bond bearish
New Zealand	Volume of All Buildings	q/q	2q	-1.5%	6.2%	1.3%	*	Equity and bond bearish
South Korea	BoP Current Account Balance	m/m	jul	$6.949 Bil	$6.377 Bil		**	Equity and bond neutral
	BoP Goods Balance	m/m	jul	$6.187 Bil	$6.270 Bil		**	Equity and bond neutral
EUROPE								
Germany	Factory Orders	m/m	jul	-2.7%	2.5%	-1.4%	**	Equity and bond bearish
	Markit Germany Construction Orders PMI	m/m	aug	46.3	49.5		**	Equity and bond bearish
	Retail Sales	y/y	jul	2.2%	2.8%	2.0%	**	Equity bullish, bond bearish
UK	New Car Registrations	y/y	aug	-1.6%	-4.1%		*	Equity and bond neutral
Switzerland	GDP	q/q	2q	0.3%	0.6%	0.2%	***	Equity and bond neutral
Russia	CPI Weekly	ytd	w/w	2.4%	2.5%		***	Equity and bond neutral
AMERICAS								
Mexico	Vehicle Domestic Sales	m/m	aug	107651	105699		*	Equity and bond neutral
Brazil	Markit Brazil PMI Services	m/m	aug	51.4	52.2		**	Equity and bond neutral
	Markit Brazil PMI Composite	m/m	aug	51.9	51.6		**	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)	213	213	0	Down
3-mo T-bill yield (bps)	191	191	0	Neutral
TED spread (bps)	21	22	-1	Neutral
U.S. Libor/OIS spread (bps)	180	180	0	Up
10-yr T-note (%)	1.52	1.47	0.05	Down
Euribor/OIS spread (bps)	-44	-45	1	Neutral
EUR/USD 3-mo swap (bps)	16	16	0	Down
Currencies	**Direction**			
dollar	Down			Up
euro	Up			Down
yen	Down			Down
pound	Up			Up
franc	Down			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Canada Rate Decision	1.750%	1.750%	1.750%	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	$60.71	$60.70	0.02%	
WTI	$56.07	$56.26	-0.34%	
Natural Gas	$2.46	$2.45	0.45%	
Crack Spread	$13.14	$13.03	0.83%	
12-mo strip crack	$15.85	$15.86	-0.07%	
Ethanol rack	$1.53	$1.53	-0.12%	
Metals				
Gold	$1,541.87	$1,552.55	-0.69%	
Silver	$19.23	$19.60	-1.86%	
Copper contract	$262.05	$259.50	0.98%	
Grains				
Corn contract	$ 361.00	$ 358.50	0.70%	
Wheat contract	$ 466.50	$ 460.75	1.25%	
Soybeans contract	$ 877.00	$ 875.50	0.17%	
Shipping				
Baltic Dry Freight	2518	2501	17	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.5		
Gasoline (mb)		-2.0		
Distillates (mb)		0.5		
Refinery run rates (%)		-0.35%		
Natural gas (bcf)		60.0		

Weather

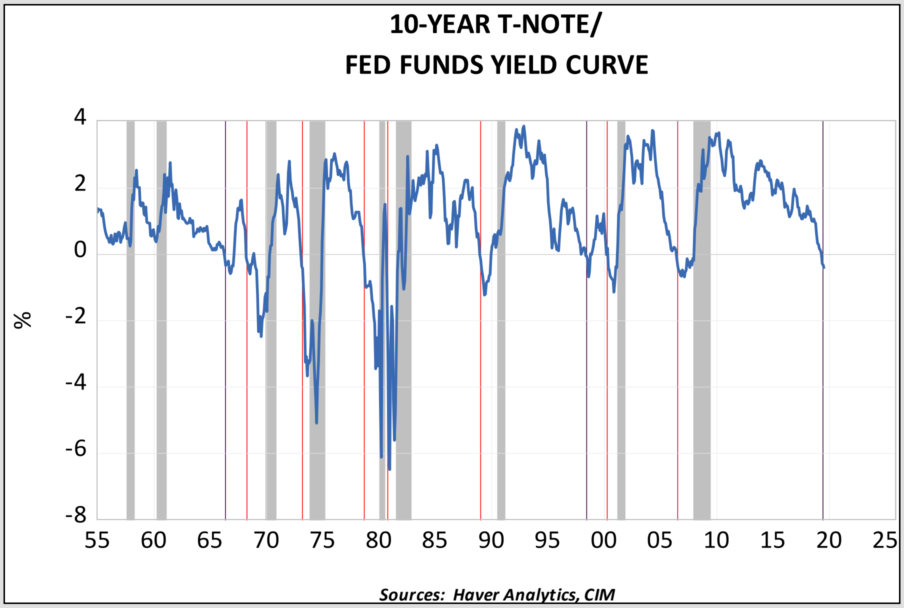
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. There continues to be a lot of cyclone activity in both the Gulf of Mexico and the Atlantic Ocean. In the Atlantic, Hurricane Dorian is expected to trace a path up the Carolinas. There is some cyclone formation further out in the Atlantic Ocean, but it is unclear whether it will make it to the U.S. On average, hurricane season peaks on September 10.

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.

August 30, 2019

As various permutations of the yield curve invert, projections of recession are increasing. One of our favorites, the 10-year T-note/fed funds yield curve, has been inverted for three months.



This chart shows the history of this yield curve; since 1960, every recession was preceded by an inversion of this indicator. However, that isn't to say that every inversion led to a recession. There were two false positives in the series, one in 1965 and another in 1998. The former we consider a true false positive as the inversion lasted several months but a recession didn't follow. The latter event only lasted one month and was tied to the financial turmoil of the Asian Economic Crisis, the collapse of Long-Term Capital Management and the Russian debt default. The fact that the inversion was short-lived weakens the case that it was a true inversion.

If this signal of recession holds, when does it arrive? Here is a look at the timing:

RECESSION YEARS	INVERSION	RECESSION	MONTHS
1969-70	Apr-68	Dec-69	20
1973-75	Mar-73	Nov-73	8
1980	Sep-78	Jan-80	16
1981-82	Aug-80	Jul-81	11
1990-91	Jan-89	Jul-90	18
2001	Apr-00	Mar-01	11
2007-09	Jul-06	Dec-07	17
AVERAGE			15

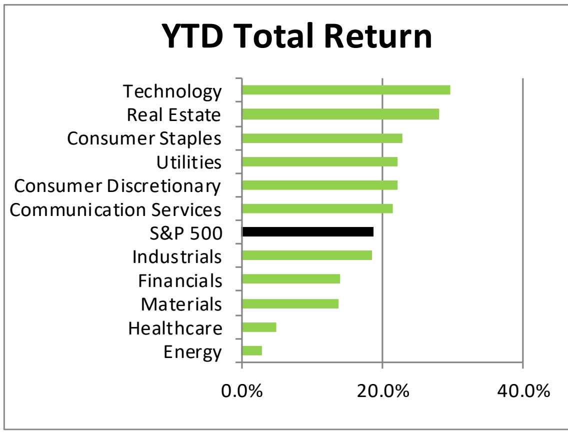
On average, recessions occur 15 months after inversion; that would put the onset around next September. The range is eight months to 18 months. Using that range, the recession could begin as early as February 2020 or as late as February 2021. Although this history offers some insight into timing, the reality is that the number of events is rather limited. Thus, investors should treat the data as a guide. The economic data remains mixed, but the preponderance of the evidence suggests that the U.S. economy is weakening but not in recession.

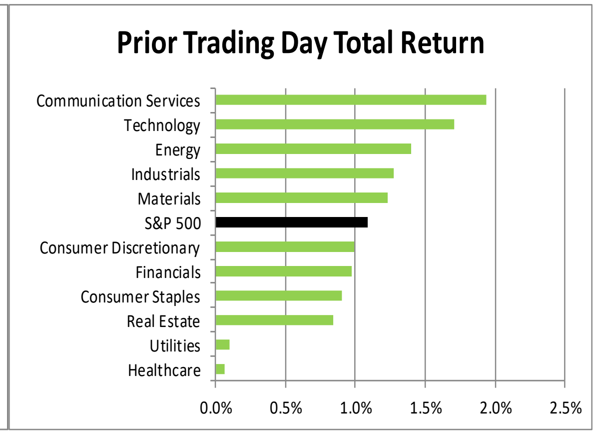
As we have noted before, recessions tend to have two causal factors, policy error and geopolitical events. The 1973-75 and 1990-91 recessions are considered to be partly due to geopolitical factors; the former was affected by the Arab Oil Embargo and the latter by the Persian Gulf War. However, both also had yield curve inversions. It is quite possible that the geopolitical events caused the recessions to occur faster than they might have otherwise in the absence of these events.

We are watching the trade conflict with great interest because it might affect the timing of a downturn. If the trade conflict worsens, lifting import prices and forcing the Fed to slow its path of lowering rates, the recession might occur sooner than it otherwise would. A recession would certainly affect the 2020 elections; no incumbent has survived a recession since Calvin Coolidge. We will likely begin to prepare for a downturn next year. If the trade conflict worsens, the timing may be accelerated.

Data Section

U.S. Equity Markets – (as of 9/4/2019 close)

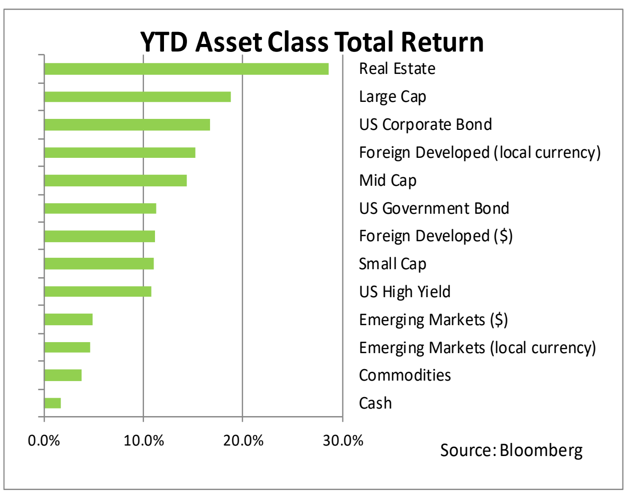




(Source: Bloomberg)

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 9/4/2019 close)

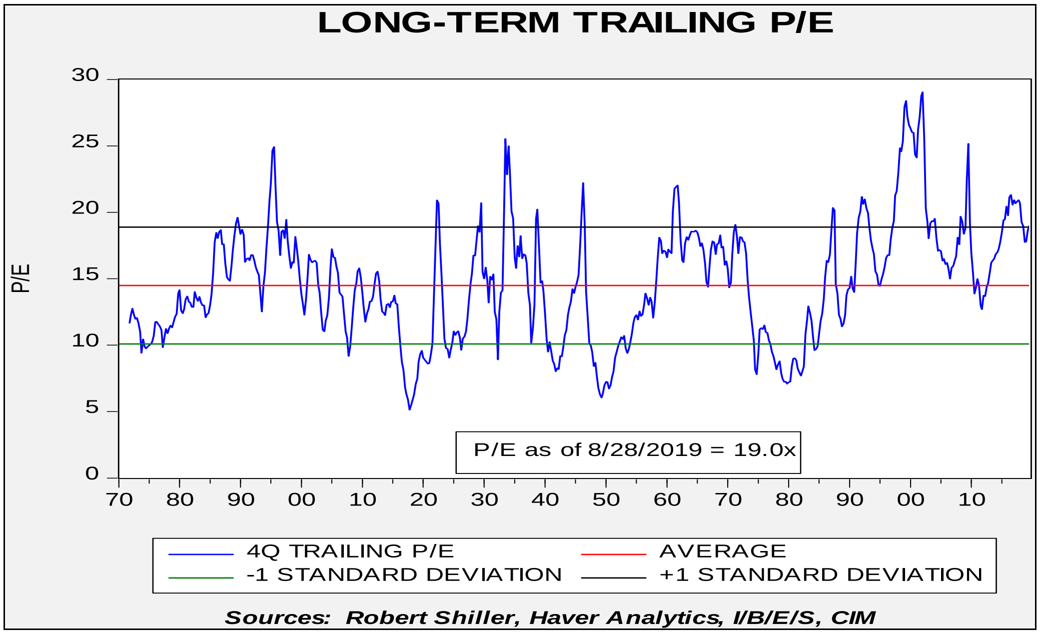


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

August 29, 2019 (due to the holiday, we will update this chart tomorrow)



Based on our methodology,[2] the current P/E is 19.0x, down 0.1x from last week.

[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.