# Daily Comment

By Bill O'Grady, Thomas Wash, and
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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.*

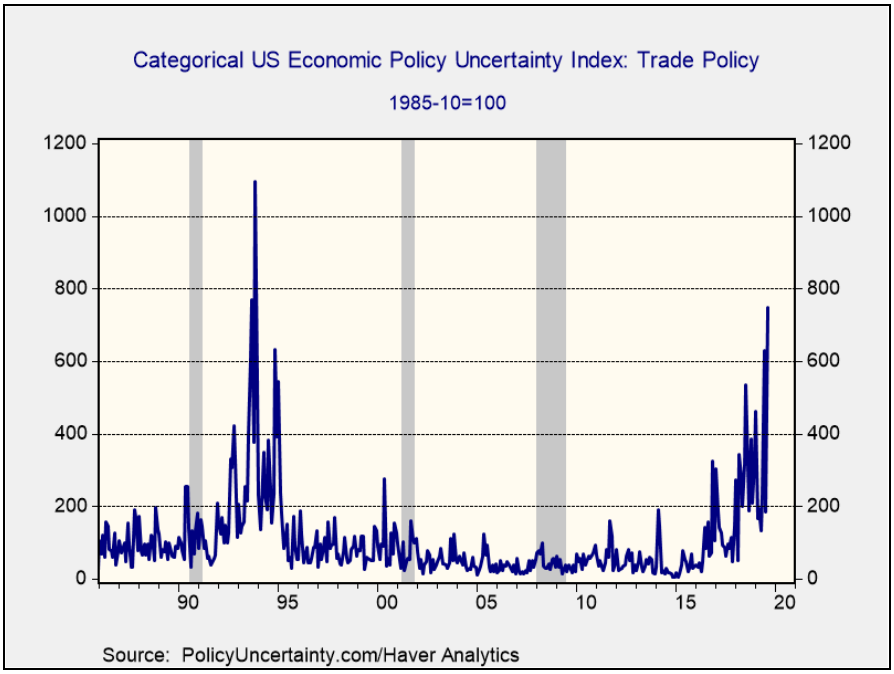
**[Posted: September 6, 2019—9:30 AM EDT]** Global equity markets are mostly higher this morning. The EuroStoxx 50 is up 0.3% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.7%. Chinese markets were higher, with the Shanghai composite up 0.5% and the Shenzhen index up 0.4% from the prior close. U.S. equity index futures are signaling a higher open.

Happy employment data Friday! We cover the data in detail below but here is the snapshot—it was mixed. The payroll report was soft, but wage growth and the household survey were rather strong. Financial markets are taking the report as weak, focusing on the payroll data. In other news, Powell speaks today, the PBOC reduced reserve requirements and Robert Mugabe has crossed over the earthly veil. Gold is lower on the rebound in interest rates. Here are the details and other items we are watching:

**China:** As widely anticipated, the People's Bank of China reduced the amount of reserves that commercial banks are required to hold at the central bank. The reserve requirement ratio will be cut by 50 basis points for most banks, and by 100 basis points for certain medium and small institutions. The cut is expected to increase the amount of funds available for lending by approximately $126 billion. The move is part of a modest package of stimulus measures that the government has been rolling out over recent months to cushion the economy from the U.S.-China trade war. Investors are likely to cheer the move, but it's still not clear how much the measures will really help. Excessive debt throughout the economy will probably continue to limit borrowing, while uncertainty over the trade situation will likely keep weighing on investment and hiring.

**Hong Kong:** Fitch Ratings has downgraded its credit rating for Hong Kong to AA from AA+, with a negative outlook, based on increased political instability. The company suggested Beijing's reaction to the city's continued anti-China protests pointed to less policy flexibility for Hong Kong's government and greater integration with the mainland, which would imply that the city's rating should be closer to the A+ rating assigned to China. The downgrade is another reason to think Hong Kong assets will remain under pressure in spite of Chief Executive Lam's withdrawal of her controversial extradition bill this week.

**Trade uncertainty:** Although there is no doubt that the administration's trade policy is having an impact on the economy, getting a precise gauge on the effect is difficult. A research group, PolicyUncertainty.com, has created a series of uncertainty measures based on the level of news reporting on a category, the number of tax code provisions due to expire and the dispersion of forecasts among economists on a certain category. With regard to trade, we are at the highest level of uncertainty since the initial NAFTA negotiations.




A research paper by economists at the Federal Reserve suggests the trade situation will probably reduce U.S. GDP growth by about 1%.

Recessions tend to come from two causes—policy errors and geopolitical events. The former is measurable by looking at the economic data.[1] The latter is trickier. Although we pay close attention to geopolitical issues, each event is unique and the impact of such events tends to be cumulative, therefore assessing causality to a particular incident is difficult. The trade conflict falls into this category; we view the administration's trade policy as part of America's rejection of the hegemonic role that we have shouldered since 1945 and so the anti-trade policy, in one form or another, will outlast President Trump.[2] Our worry is that the trade war could either (a) accelerate the onset of recession, or (b) deepen a recession when one occurs. If the Fed researchers are right, a 1% decline in GDP next year, due to the trade conflict, will reduce growth to the point where a recession will be difficult to avoid.

**United Kingdom:** Labour Party shadow chancellor John McDonnell warned today that if he had control of the Treasury, he would impose severe constraints on British financial firms. McDonnell said he would work especially hard to ban large bonuses, which he said are offensive to people and a large source of inequality. Increased regulation of financial services would be consistent with the radical left-wing program laid out by Labour Party leader Jeremy Corbyn, which includes the nationalization of multiple industries and huge increases in the minimum wage. McDonnell's statement therefore illustrates the kinds of policy risks that would arise in

[1] We have a report on this. See our Business Cycle Report.
[2] Interestingly enough, Chairman Xi seems to agree with our assessment that what we are seeing is a fundamental change in the world order.

Britain if Prime Minister Johnson loses power to Corbyn. More broadly, we think it also reflects the left-wing direction that today's populism might be headed toward after transitional figures like President Trump and Prime Minister Johnson pass from power.

**Brexit:** Even if Prime Minister Johnson can extricate Britain from the EU as he wants, many observers have noted that he would probably have only limited bargaining power in any post-Brexit trade negotiations with the United States. Now, it appears he's also undermining his position for any post-Brexit negotiations with the EU. Johnson's team this week warned the EU that they wanted to abandon prior commitments made by Theresa May to keep British environmental and social standards similar to the EU's in order to secure a bilateral trade deal. Various EU officials say that would make it very difficult to gain approval for a deal.

There is another facet of Brexit that is worth exploring. The Brexiteers may be underestimating the role of Ireland in Brexit. We, like others, are guilty of focusing on the major powers in the EU—thus, we pay close attention to what is happening in Germany, France, the U.K. and Italy. However, an important element to joining the EU is the power it gives the smaller nations in Europe. A small nation in Europe that isn't part of the EU has little power; it will never have a significant enough military to protect itself from larger powers and its economy is subject to the influence of the larger states in the EU and the world. By joining the EU, the small states get the protection of NATO and have a vote on economic policy. Thus, the EU may be seen, at times, as a constraint on the larger nations but it is a force multiplier for the small states.

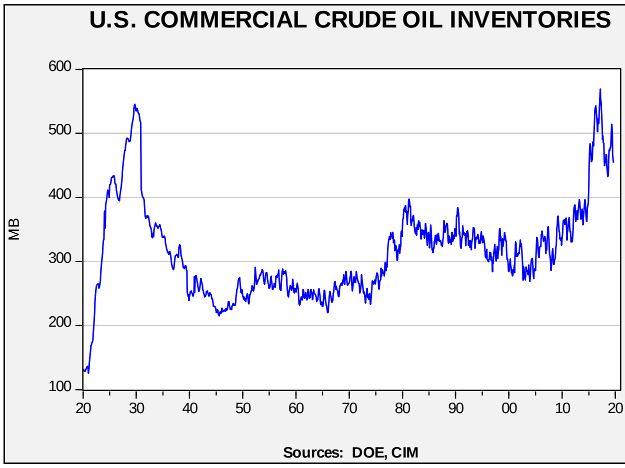
This factor is playing a role in the Irish backstop issue. The smaller EU states are viewing the Brexit supporters' position on the backstop as a big nation attempting to push around a smaller one. This dynamic could make it very difficult for the EU to give any ground on the backstop issue; it isn't just that it is hard to come to a unanimous agreement among the EU nations, but it's also that the smaller states see this as a test of how the EU will support a smaller state against a "bully." In the end, if the U.K. follows through on Brexit, the eventual deal may require that Northern Ireland remains in the EU trading area to ensure the trade zone integrity of the EU. One proposal made by the negotiators was to put the trade border at the Irish Sea, effectively keeping Northern Ireland within the EU trade zone. When former PM May lost her party's majority in snap elections, she was forced to form a coalition with the DUP, a unionist party in Northern Ireland. The DUP strongly opposed the prospect of Northern Ireland remaining in the trade union, rightly fearing that this will be the first step in unifying Ireland. If PM Johnson were to win the upcoming election and continue to press for leaving, the eventual cost of Brexit might be Northern Ireland.

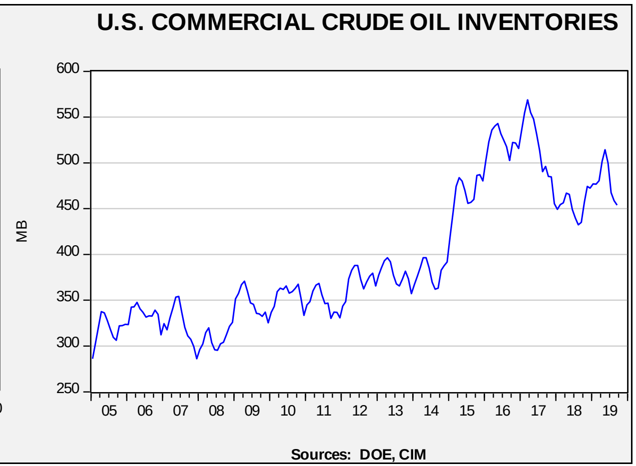
**Japan-South Korea:** Even though the dispute over Japan's behavior in Korea before and during World War II has cooled a bit recently, new ordinances in two South Korean cities show it still isn't completely over. The city councils of both Seoul and Busan have passed nonbinding ordinances designating 284 Japanese firms as "war crimes companies" and discouraging purchases from them.

**Iran:** The Iranian government announced that it would cease following restrictions on its nuclear research contained in its 2015 nuclear deal with the West. That follows earlier moves to violate the deal's limits on how much nuclear material it could stockpile and how highly it could enrich uranium. The violations aim to put more pressure on European governments to come up with compensation for U.S. sanctions imposed after the U.S. pulled out of the agreement. The violations are likely to keep tensions high in the Middle East, which should continue to keep oil prices higher than they would be otherwise.

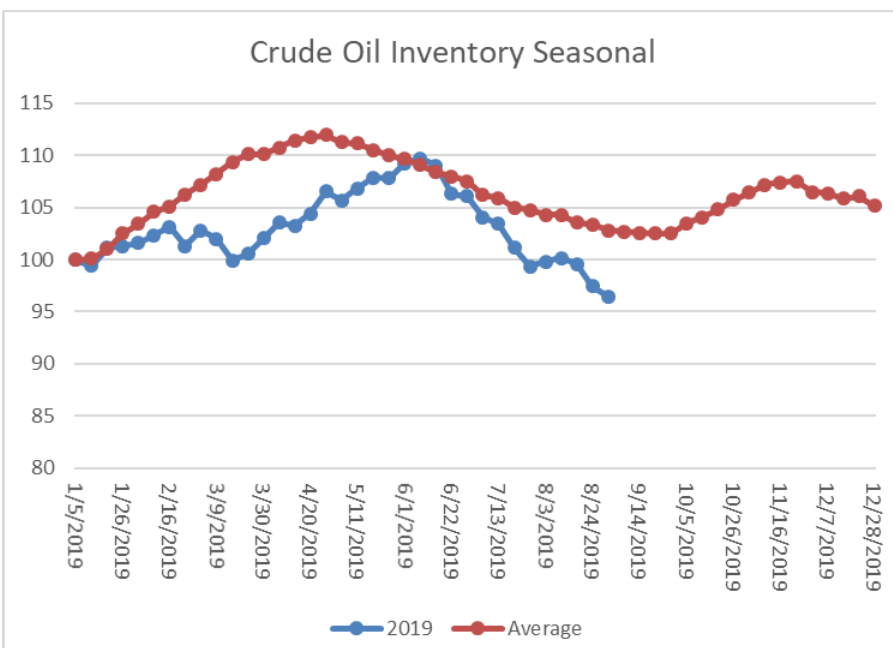
**Mexico:** The chairman of the Chamber of Deputies budget committee, who is a key member of left-wing President Andrés Manuel López Obrador's party, has [introduced a bill to apply Mexico's value-added tax (VAT) to digital services](). Currently, internet services and the like aren't subject to the tax in Mexico.

**Energy update:** Crude oil inventories fell 4.8 mb compared to an expected draw of 3.5 mb.



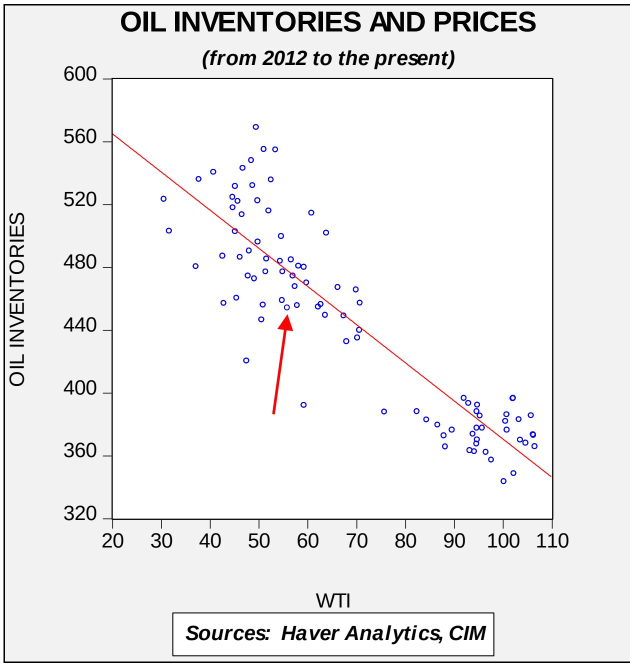



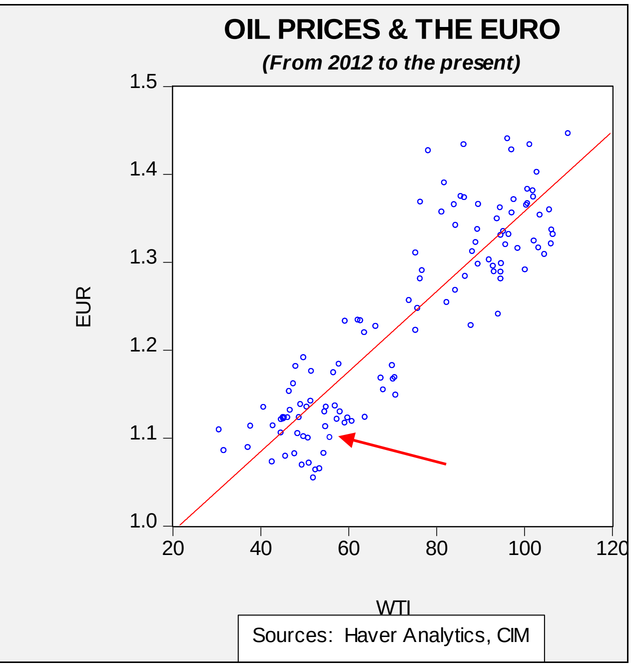

In the details, U.S. crude oil production fell 0.1 mbpd to 12.4 mbpd. Exports were unchanged, while imports rose 1.0 mbpd. Refinery operations fell 0.4%. The drop in stockpiles was mostly due to reduced production.




(Sources: DOE, CIM)

The above chart shows the annual seasonal pattern for crude oil inventories. As we approach the end of spring/summer inventory withdrawal, we are starting the autumn rebuild period at a sizeable deficit. Without aggressive increases in stockpiles, we will likely continue to lag seasonal patterns.

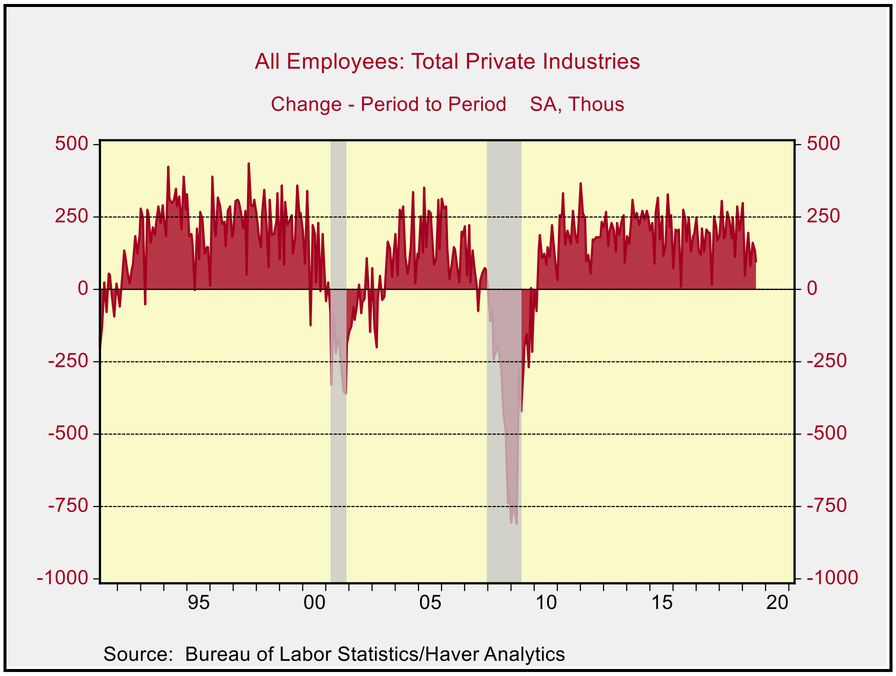


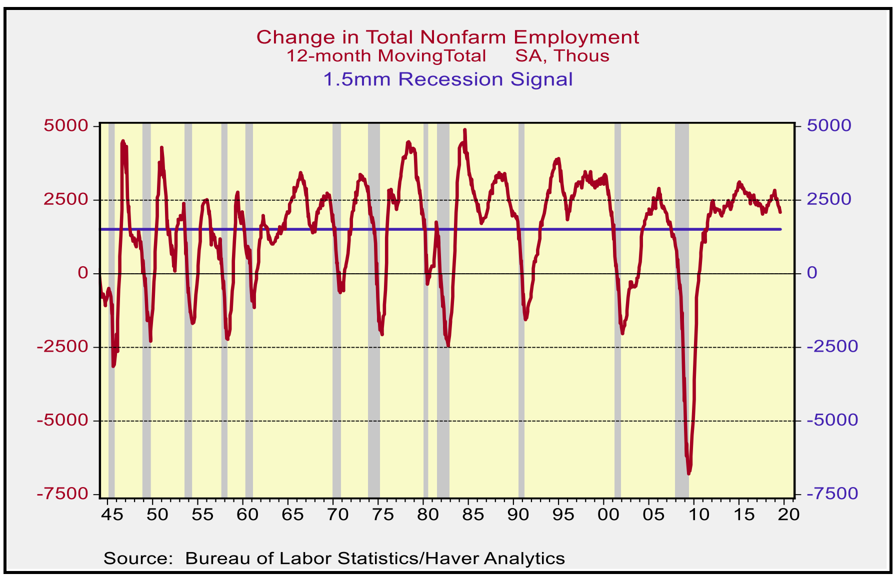

Based on our oil inventory/price model, fair value is $66.39; using the euro/price model, fair value is $53.44. The combined model, a broader analysis of the oil price, generates a fair value of $57.68. We are seeing a clear divergence between the impact of the dollar and oil inventories. Given that we are nearing the end of the summer driving season, the bullish impact of inventories will likely diminish in the coming weeks; a sideways to lower price path is the most likely outcome.

## U.S. Economic Releases

The change in non-farm payrolls for August came in below expectations at 130k compared to the forecast of 160k. The prior report was revised downward from 164k to 159k. Therefore, the two-month payroll net revision fell by 20k. The change in private payrolls came in below expectations at 96k compared to the forecast of 150k. The prior report was revised downward from 148k to 131k. The change in manufacturing payrolls was below expectations, rising by 3k compared to the forecast of a 5k gain. The prior report was revised downward from 16k to 4k.

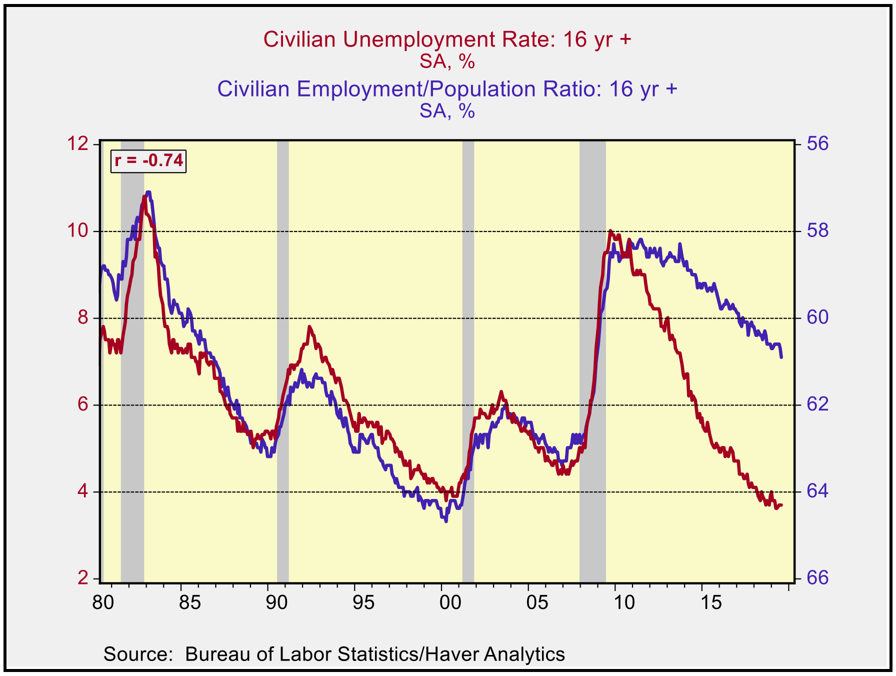



The chart above shows the change in total private employment, which suggests the economic expansion continues.



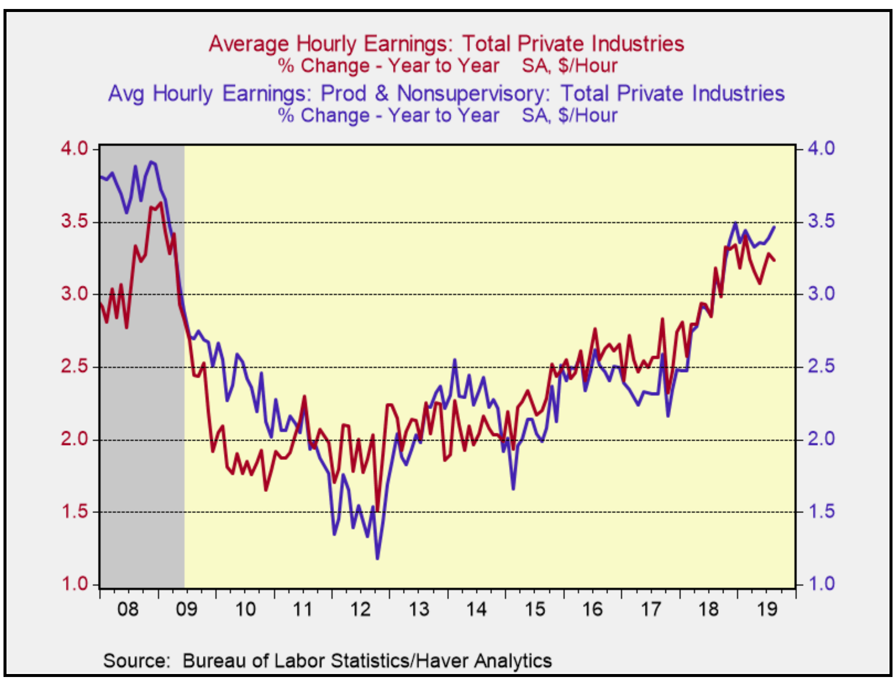

The chart above shows the 12-month moving total of the change in non-farm payrolls; a dip under 1.5mm signals recession. The pace of hiring has clearly slowed, but we expect a slight pick-up in the coming months due to the recovery needed for Hurricane Dorian.

The unemployment rate was in line with expectations at 3.7%. The labor force participation rate rose to 63.2%, while the U-6 unemployment rate rose to 7.2%.




The chart above shows the relationship between the unemployment rate and the employment/population ratio. The divergence of the two variables has been one of the defining factors of this recovery and argues that labor market slack still remains.

Average hourly earnings for all workers came in above expectations, rising 0.4% from the prior month compared to the forecast of 0.3%.



The chart above shows the yearly change in overall wages for all workers along with production and non-supervisory workers. Average hourly earnings for all workers rose 3.2% from the prior month, with wage growth for non-supervisory workers at 3.5%.

In total, the jobs report was relatively mixed. A tightening labor market likely resulted in a boost to wages, but weak payroll numbers suggest hiring is slowing. That being said, the report is somewhat inconclusive as to what should be done with monetary policy. The slowing of payrolls suggests the Fed should be cutting rates, whereas increasing wages would support maintaining rates to prevent inflation from rising. The Fed chairman will be in Zurich today and it will be interesting to hear his take on the jobs report.

The table below lists the Fed events scheduled for the rest of the day.

| **Economic Releases** | | |
|---|---|---|
| | No economic releases today | |
| **Fed speakers or events** | | |
| | **Speaker or event** | **District or position** |
| **12:30** | Jerome Powell Speaks in Zurich on Economic Outlook | Chairman of Board of Governors of Federal Reserve |

## 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 | Leading Index CI | m/m | jul | 93.6 | 93.3 | 93.2 | ** | Equity and bond neutral |
| | Coincident Index | m/m | jul | 99.8 | 100.4 | 100.7 | ** | Equity bearish, bond bullish |
| Australia | Foreign Reserves | m/m | aug | A$72.2 Bil | A$65.3 Bil | | ** | Equity and bond neutral |
| | AiG Performance of Construction Index | m/m | aug | 44.6 | 39.1 | | ** | Equity and bond neutral |
| EUROPE | | | | | | | | |
| Eurozone | Employment Change | q/q | 2q | 1.2% | 1.1% | | *** | Equity and bond neutral |
| | GDP | y/y | 2q | 1.2% | 1.1% | 1.1% | *** | Equity bullish, bond bearish |
| Italy | Retail Sales | m/m | jul | 2.6% | 1.3% | | ** | Equity bullish, bond bearish |
| Germany | Industrial Production | y/y | jul | -4.2% | -5.2% | -3.9% | *** | Equity and bond bearish |
| | Labor Costs | y/y | 2q | 3.2% | 2.5% | | *** | Equity and bond neutral |
| France | Trade Balance | m/m | jul | -4.607 Bil | -5.187 Bil | -4.454 Bil | ** | Equity bearish, bond bullish |
| | Current Account Balance | m/m | jul | 0.200 Bil | -0.800 Bil | | ** | Equity and bond neutral |
| Italy | Retail Sales | y/y | aug | 2.6% | 1.3% | | *** | Equity bullish, bond bearish |
| UK | BoE/TNS Inflation Next 12 months | m/m | aug | 3.3% | 3.1% | | ** | Equity and bond neutral |
| Switzerland | Foreign Currency Reserves | m/m | aug | 767.1 Bil | 767.9 Bil | | * | Equity and bond neutral |
| Russia | Light Vehicle Car Sales | y/y | aug | -1.3% | -2.4% | -2.4% | * | Equity bearish, bond bullish |
| | Money Supply Narrow Def | m/m | aug | 10.51 Tril | 10.58 Tril | | * | Equity and bond neutral |
| AMERICAS | | | | | | | | |
| Mexico | Gross Fixed Investment | m/m | jun | -8.8% | -7.4% | -9.2% | ** | Equity bearish, bond bullish |
| Brazil | Vehicle Sales Anfavea | m/m | aug | 242985 | 243614 | | ** | Equity and bond neutral |
| | Vehicle Production Anfavea | m/m | aug | 269809 | 266371 | | ** | Equity and bond neutral |
| | Vehicle Exports Anfavea | m/m | aug | 36717 | 42115 | | ** | 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)** | 211 | 213 | -2 | Down |
| **3-mo T-bill yield (bps)** | 192 | 192 | 0 | Neutral |
| **TED spread (bps)** | 19 | 21 | -2 | Neutral |
| **U.S. Libor/OIS spread (bps)** | 184 | 183 | 1 | Up |
| **10-yr T-note (%)** | 1.59 | 1.56 | 0.03 | Down |
| **Euribor/OIS spread (bps)** | -44 | -44 | 0 | Neutral |
| **EUR/USD 3-mo swap (bps)** | 15 | 16 | -1 | Down |
| **Currencies** | **Direction** | | | |
| dollar | Up | | | Up |
| euro | Down | | | Down |
| yen | Down | | | Down |
| pound | Down | | | Up |
| franc | Down | | | Down |
| **Central Bank Action** | **Current** | **Prior** | **Expected** | |
| Russia Key Rate | 7.000% | 7.250% | 7.000% | Above Forecast |
| China Reserve Requirement | 13.000% | 13.500% | | 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 | $59.72 | $60.95 | -2.02% | Global trade tensions |
| WTI | $55.21 | $56.30 | -1.94% | |
| Natural Gas | $2.41 | $2.44 | -0.99% | |
| Crack Spread | $13.19 | $13.42 | -1.74% | |
| 12-mo strip crack | $15.95 | $16.16 | -1.27% | |
| Ethanol rack | $1.53 | $1.53 | 0.01% | |
| **Metals** | | | | |
| Gold | $1,505.14 | $1,519.05 | -0.92% | |
| Silver | $18.14 | $18.65 | -2.72% | |
| Copper contract | $262.65 | $264.20 | -0.59% | |
| **Grains** | | | | |
| Corn contract | $ 360.00 | $ 358.75 | 0.35% | |
| Wheat contract | $ 464.50 | $ 466.25 | -0.38% | |
| Soybeans contract | $ 865.75 | $ 861.50 | 0.49% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 2499 | 2518 | -19 | |
| **DOE inventory report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | -4.8 | -3.5 | -1.3 | |
| Gasoline (mb) | -2.4 | -2.0 | -0.4 | |
| Distillates (mb) | -2.5 | 0.5 | -3.0 | |
| Refinery run rates (%) | -0.40% | -0.35% | -0.05% | |
| Natural gas (bcf) | 84.0 | 60.0 | 24.0 | |

## Weather

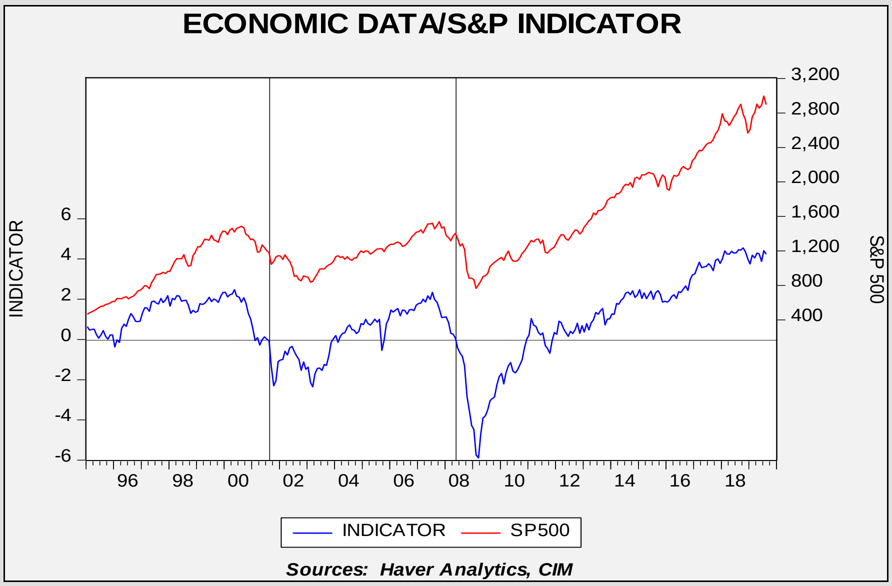
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. Hurricane Dorian continues to move along the Carolina coasts. There is some cyclone formation further out in the Atlantic Ocean, but it is unclear whether it will make it to the U.S. On average, hurricane season peaks on September 10.

## Asset Allocation Weekly

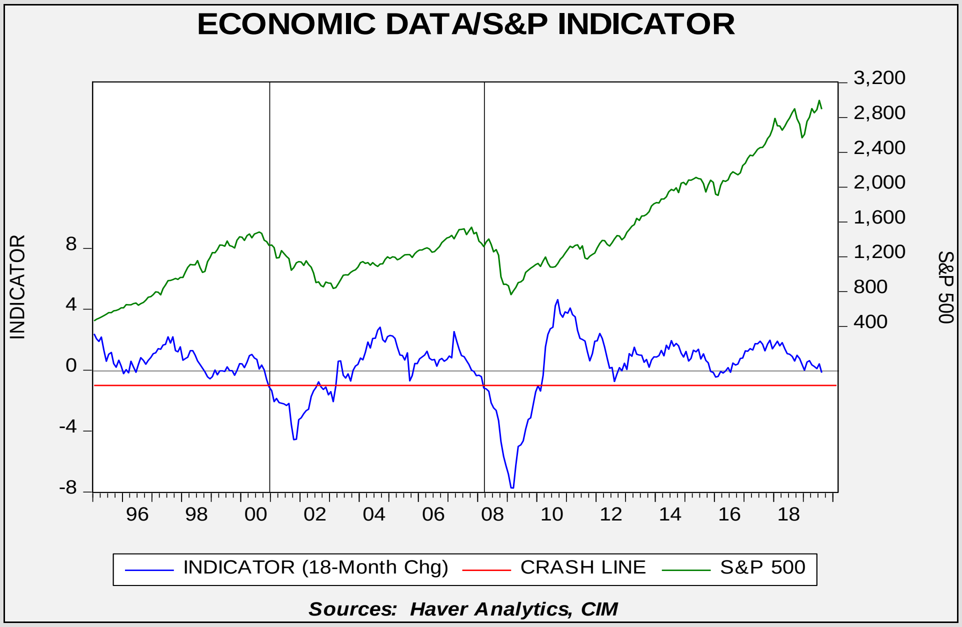
*Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.*

September 6, 2019

In 2017, we introduced an indicator of the basic health of the economy and added it to the many charts we monitor to gauge market conditions. The indicator is constructed using commodity prices, initial claims and consumer confidence. The thesis behind this indicator is that these three components should offer a simple and clear picture of the economy; in other words, rising initial claims coupled with falling commodity prices and consumer confidence is a warning that a downturn may be imminent. The opposite condition should support further economic recovery. In this report, we will update the indicator with August data.




This chart shows the results of the indicator and the S&P 500 since 1995. The updated chart shows that the economy did slip late last year but has stabilized in 2019. We have placed vertical lines at certain points when the indicator fell below zero. It works fairly well as a signal that equities are turning lower, but there is a lag. In other words, by the time this indicator suggests the economy is in trouble, the recession is likely near or already underway and the equity markets have already begun their decline.

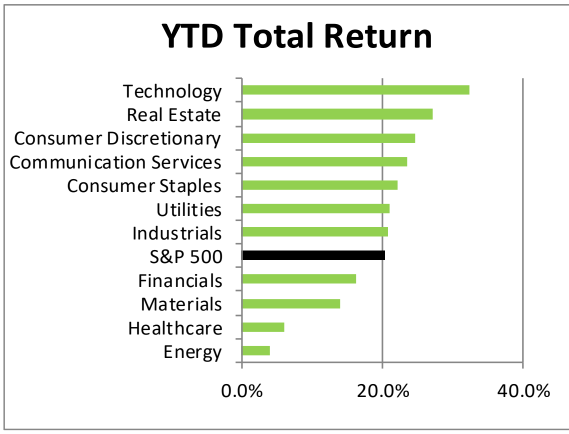


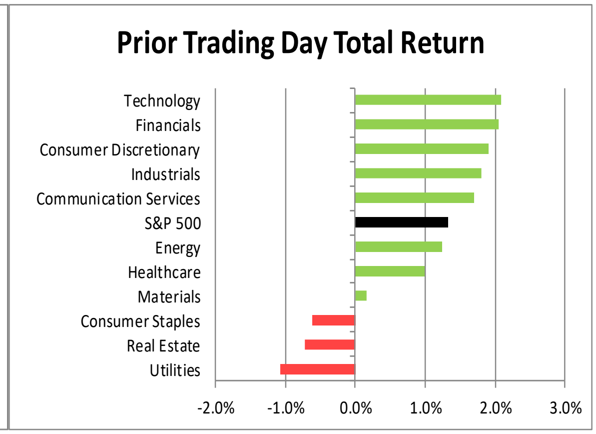

To make the indicator more sensitive, we took the 18-month change and put the signal threshold at minus 1.0. This provides an earlier bearish signal and also eliminates the false positives that the zero threshold generates. At the same time, the fact that this variation of the indicator is just below zero raises caution.

What does the indicator say now? The economy has decelerated but is not yet at a point where investors should become defensive. Breaking below the red line would be our signal to expect a broader downturn. As we have noted over the past two weeks, other indicators have signaled rising odds of recession. We continue to monitor conditions closely but, as noted above, it is still too early to shift portfolios into a fully defensive stance.

## Data Section

**U.S. Equity Markets** – (as of 9/5/2019 close)

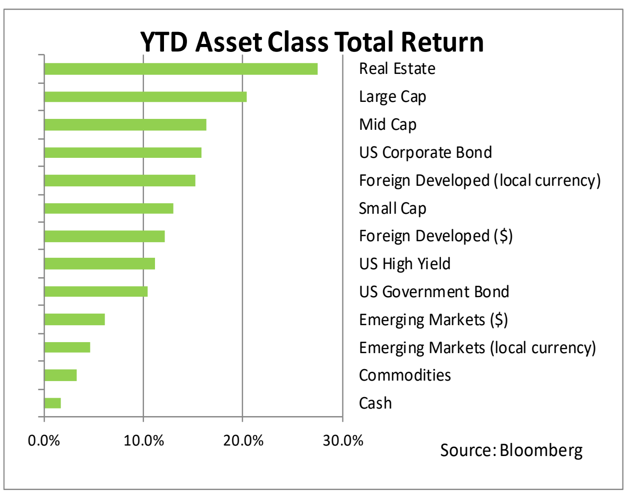



(Source: Bloomberg)

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 9/5/2019 close)

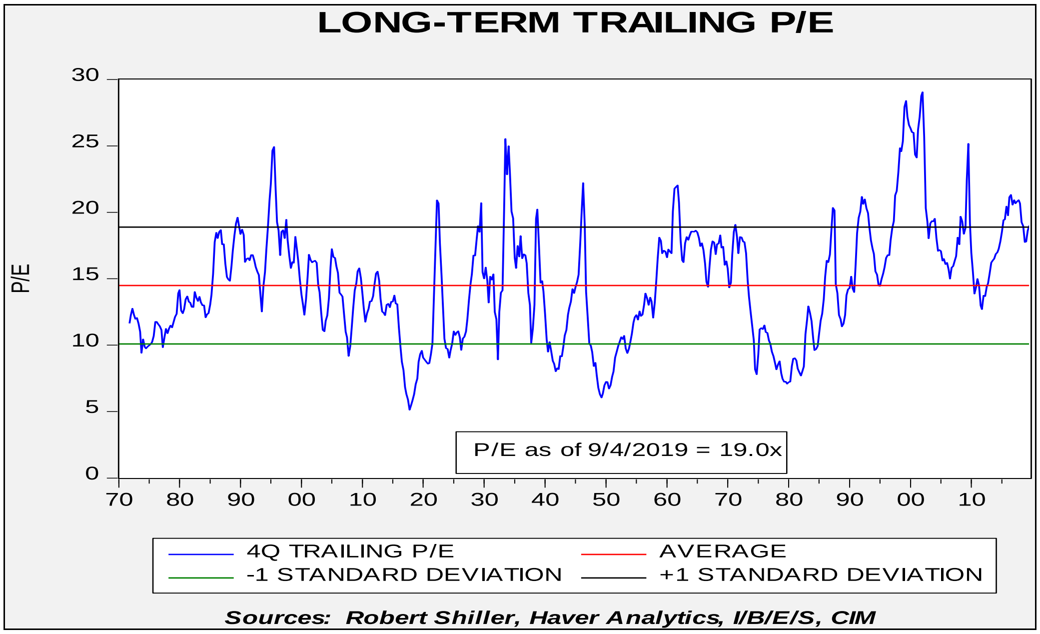



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 6, 2019




Based on our methodology,[3] 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.*

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[3] 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.