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 9, 2019—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed up 0.3%. Chinese markets were higher, with the Shanghai composite up 0.8% and the Shenzhen index up 1.9% from the prior close. U.S. equity index futures are signaling a higher open.

Happy Monday! Global equity markets are edging higher this morning. China's economic data was a bit soft. Russian local elections were a rebuke of Putin. The Brexit saga continues in Ireland. Here is what we are watching this morning:

Russia: In Moscow's city council elections over the weekend, the ruling United Russia Party of President Putin lost more than one-third of its seats in spite of its aggressive efforts to keep opposition candidates out of the competition over the last several months (as we discussed in our Weekly Geopolitical Report on July 15). United Russia will still have a majority on the council, with 24 of the 45 seats, but opposition legislators will gain a significant soapbox to stand on with 20 seats.

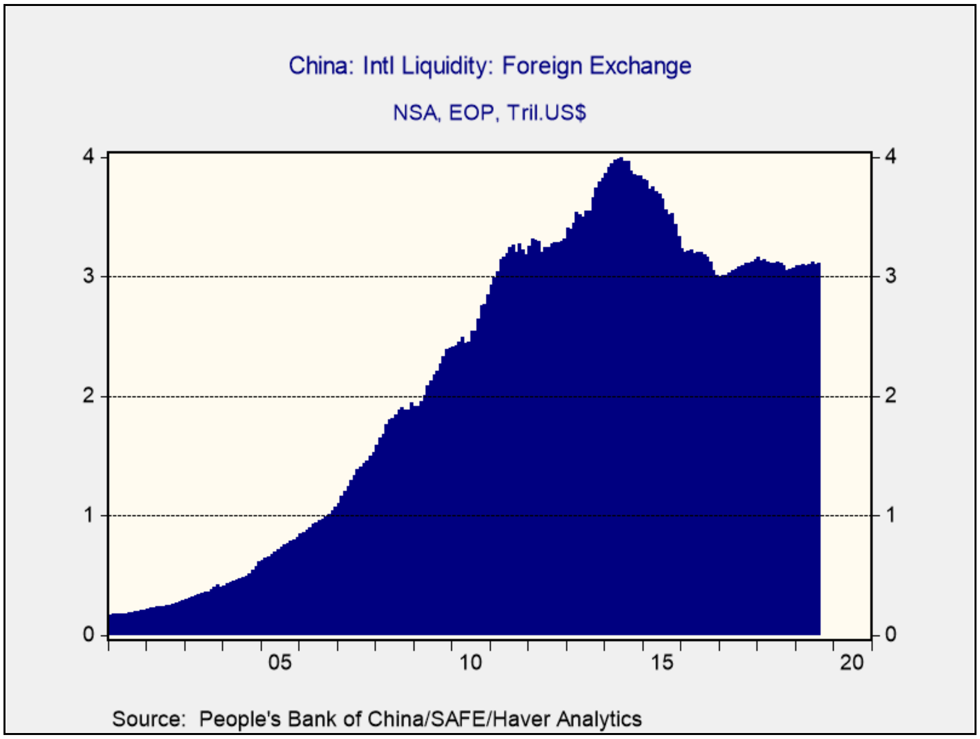
Russia-Ukraine: As part of a Russia-Ukraine prisoner swap, two dozen Ukrainian sailors detained by Russia last November have been released. Ukraine also secured the release of 11 other Ukrainians held by Russia, while Russia got dozens of Russians and other citizens that Moscow wanted. The swap suggests Ukraine's new president, Volodymyr Zelenskiy, is continuing to make progress on diffusing tensions with Russia. Although we doubt Zelenskiy can reverse major Russian moves such as the annexation of Crimea, he could potentially ease or end Moscow's support for Russian separatists in Eastern Ukraine. That, in turn, could take some wind out of Russian sanctions sentiment in the West.

Iran: An Iranian foreign ministry spokesman said the crude oil tanker previously seized and released from Gibraltar has unloaded its cargo, apparently in Syria. That would seem to violate Iran's promise to Gibraltar authorities that the oil would not go to Syria, which is under European Union sanctions. The apparent breaking of the promise will likely keep tensions high between Iran and the West, helping keep oil prices higher than they otherwise would be.

China data: Exports fell 6.0% in August compared to July, while imports fell a more modest 2.7% (CNY terms; media headline data is using USD terms). It does appear that the combination of tariffs and slowing global growth is putting pressure on China's export sector. Exports to the U.S. plunged 16% from last year but some of that decline is likely due to transshipments, where Chinese exports go to other nations and eventually end up in the U.S. Overall, exports from

China are declining and the Xi government is going to have to either find other sources of demand or begin to more aggressively stimulate. There are growing worries among investors that China's economy is weaker than the official data suggests.

One factor that will help is that foreign reserves remain ample.



Reserves were mostly steady in August. The fact that reserves are holding up suggests that the recent CNY volatility hasn't triggered significant capital flight and signals to the PBOC that steady, modest depreciation can be implemented without triggering investor unrest.

A China trade thaw? There are reports of a "mini-deal" where the U.S. would delay the October 1 tariffs and ease the pressure on Huawei (002502, CNY 3.24) in return for agriculture purchases. At first glance, this seem like an uneven offer. The tariffs cover $250 bn of imports and giving in on Huawei would look bad. To make this work, China's purchases would have to be huge. If the administration takes this deal, it would suggest they are worried about the impact of the trade deal on the economy and markets. The "whiff" of an agreement is helping to lift stocks.

Hong Kong: Protests continued in Hong Kong; protestors waved American flags in an attempt to gain sympathy from U.S. lawmakers. We don't expect much movement on Hong Kong until after the party meetings in early October. Although we are not seeing anything overt, there is talk of "grumbling" about Xi's leadership; after all, he now faces unrest in Hong Kong that doesn't appear to be abating and he has "lost" China's relationship with the country's most important trading partner, the U.S. Xi has solidified power with the purges he held in his first term. Thus, he will probably remain in power, but his grip may be weakening and we might see new leadership emerge if conditions don't improve.

Brexit: PM Johnson suffered yet another political blow when his work and pensions secretary, Amber Rudd, resigned over the weekend. She left because she doesn't believe Johnson really wants a deal with the EU. Johnson is in Dublin today to try to heal frayed relations with Ireland; the Irish have already indicated that they don't expect much from the meeting. Meanwhile, France has suggested that if the U.K. doesn't have anything new to offer, it might not agree to an extension. Although we think this is a bluff, Macron is rather tired of Brexit and would rather see Britain off and regroup with the remaining EU members.

Meanwhile, there is swirling speculation about what Johnson's next moves might bring. We do not expect him to ask for snap elections for a second time; odds of passage are very small. From there, things could get weird. There is speculation that Johnson might offer a vote of no-confidence on his own government, which would only need a mere majority. This action would bring down the government, resulting in a caretaker government and new elections. Another possibility would be him quitting and petitioning the Queen to appoint opposition leader Corbyn to take power, only to immediately make a no-confidence motion, which he might win, bringing new elections. There is also speculation that Johnson might reject the will of Parliament and not ask for an extension of Article 50. That would trigger a constitutional crisis. Thus, there is the potential for significant turmoil in the next six weeks; the fact that the GBP (that's Great Britain pound, not peso) is holding steady does suggest we may be reaching a price level where most of the bad news is discounted.

A Saudi shakeup: Crown Prince Salman fired Energy Minister Khalid al-Falih, replacing him with his older half-brother, Prince Abdulaziz bin Salman. This breaks a longstanding tradition where the Royal Family leaves the oil industry in the hands of the technocrats. Although this does put a family member in charge of the oil industry, the new energy head has extensive experience in the Saudi oil industry. Why the shift? We suspect there are two reasons. First, the former energy minister was "slow walking" the Saudi Aramco IPO; the crown prince wants to use funds from the sale of the state oil company to fund his plans to develop the kingdom's economy away from its dependence on energy. Second, oil prices have languished under al-Falih; the crown prince wants oil prices in the high $60s to low $70s to boost revenue in the short run and to lift the IPO price. If our analysis is correct, we will (a) see rapid movement on the IPO, and (b) see further output restrictions and higher oil prices. Oil prices are modestly higher this morning on the news.

Mexico: The government of left-wing President Andrés Manuel López Obrador has released a proposed budget for 2020 that aggressively assumes the economy will grow 2% next year, versus just 1% this year. The budget also assumes Mexican oil production will grow 15% next year, despite years of declines. Based on those assumptions, the document claims the government can boost spending on an array of social programs, while still keeping the overall budget deficit at just 2.1% of gross domestic product (GDP).

The Taliban talks: We won't spend a lot of time on this issue because it had little immediate impact on the financial markets. But, in a bid to accelerate a deal, President Trump tried to broker a meeting between the Taliban and the Afghan government. However, a Taliban bombing that killed a U.S. soldier led the president to call off the meeting. The meeting underscores the problem for superpowers, which is the issue of extricating from these sort of conflicts. On the one hand, Afghanistan isn't critical to U.S. security. This is the problem seen during U.S. hegemony; how does the hegemon maintain credibility and avoid entanglements? This problem bedeviled Truman, Johnson, Clinton, Obama and, now, Trump. Trump campaigned on getting out of these types of conflicts, but leaving usually means exiting without "finishing the job" because it may be nearly impossible to do so. However, staying and maintaining credibility leaves one fighting an endless war.

U.S. Economic Releases

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
15:00	Consumer Credit	m/m	jul	$16.000 Bil	$14.596 Bil	**
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	Trade Balance	m/m	aug	$34.84 Bil	$45.06 Bil	$44.30 Bil	**	Equity bearish, bond bullish
Japan	BoP Current Account Balance	m/m	jul	¥2.000 Tril	¥1.211 Tril	¥1.701 Tril	**	Equity bullish, bond bearish
	Trade Balance BoP Basis	m/m	jul	-¥74.5 Bil	¥759.3 Bil	-¥24.0 Bil	**	Equity and bond neutral
	GDP Annualized	q/q	2q	1.3%	1.8%	1.3%	***	Equity and bond neutral
Australia	Home Loans	m/m	jul	4.2%	0.4%	1.5%	**	Equity bullish, bond bearish
	Investment Lending	m/m	jul	4.7%	0.5%	1.5%	**	Equity bullish, bond bearish
	Owner-Occupier Loan Value	m/m	jul	5.3%	2.4%	1.0%	**	Equity bullish, bond bearish
New Zealand	Manufacturing Activity SA	q/q	2q	-0.7%	1.0%		**	Equity and bond neutral
	Manufacturing Activity Volume	q/q	2q	-2.7%	2.0%		**	Equity and bond neutral
EUROPE								
Eurozone	Sentix Investor Confidence	m/m	sep	-11.1	-13.7	-13.4	**	Equity and bond neutral
Germany	Trade Balance	m/m	jul	21.400 Bil	16.800 Bil	17.400 Bil	**	Equity bullish, bond bearish
	Current Account Balance	m/m	jul	22.100 Bil	20.600 Bil	16.400 Bil	**	Equity bullish, bond bearish
France	CPI	m/m	aug	2.6%	2.7%		***	Equity and bond neutral
UK	Industrial Production	y/y	jul	-0.9%	-0.6%	-1.1%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	jul	-0.6%	-1.4%	-1.2%	***	Equity and bond neutral
	Monthly GDP	m/m	jul	0.3%	0.0%	0.1%	**	Equity bullish, bond bearish
	Index of Services	m/m	jul	0.3%	0.0%	0.1%	**	Equity bullish, bond bearish
	Visible Trade Balance	m/m	aug	-9.144 Bil	-7.009 Bil	-9.500 Bil	**	Equity and bond neutral
Switzerland	Unemployment Rate	m/m	aug	2.1%	2.1%	2.1%	**	Equity and bond neutral
AMERICAS								
Mexico	Vehicle Production	m/m	jun	337462	292641		**	Equity bullish, bond bearish
	Vehicle Exports	m/m	aug	281811	270904		**	Equity bullish, bond bearish
	CPI	y/y	aug	3.2%	3.8%	3.2%	***	Equity and bond neutral
Brazil	FGV CPI IPC-S	w/w	7-Sep	0.15%	0.17%	0.12%	**	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)	213	210	3	Down
3-mo T-bill yield (bps)	192	192	0	Neutral
TED spread (bps)	21	18	3	Neutral
U.S. Libor/OIS spread (bps)	183	183	0	Up
10-yr T-note (%)	1.60	1.56	0.04	Down
Euribor/OIS spread (bps)	-44	-44	0	Neutral
EUR/USD 3-mo swap (bps)	15	14	1	Down
Currencies	**Direction**			
dollar	Down			Up
euro	Flat			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	$61.79	$61.54	0.41%	
WTI	$56.82	$56.52	0.53%	
Natural Gas	$2.52	$2.50	1.12%	
Crack Spread	$13.97	$14.11	-1.03%	
12-mo strip crack	$16.56	$16.66	-0.62%	
Ethanol rack	$1.52	$1.53	-0.29%	
Metals				
Gold	$1,511.27	$1,506.82	0.30%	
Silver	$18.22	$18.18	0.20%	
Copper contract	$262.10	$263.40	-0.49%	
Grains				
Corn contract	$ 355.25	$ 355.50	-0.07%	
Wheat contract	$ 461.00	$ 463.75	-0.59%	
Soybeans contract	$ 856.00	$ 857.75	-0.20%	
Shipping				
Baltic Dry Freight	2462	2499	-37	

Weather

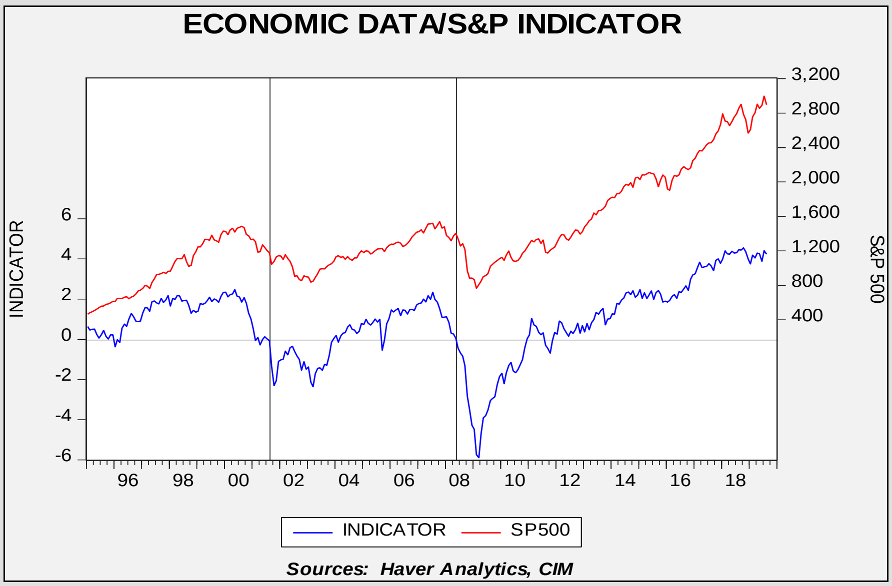
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. Hurricane Dorian continues to move along the Carolina coasts. There is some cyclone formation further out in the Atlantic Ocean, but it is unclear whether it will make it to the U.S. On average, hurricane season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

Asset Allocation Weekly

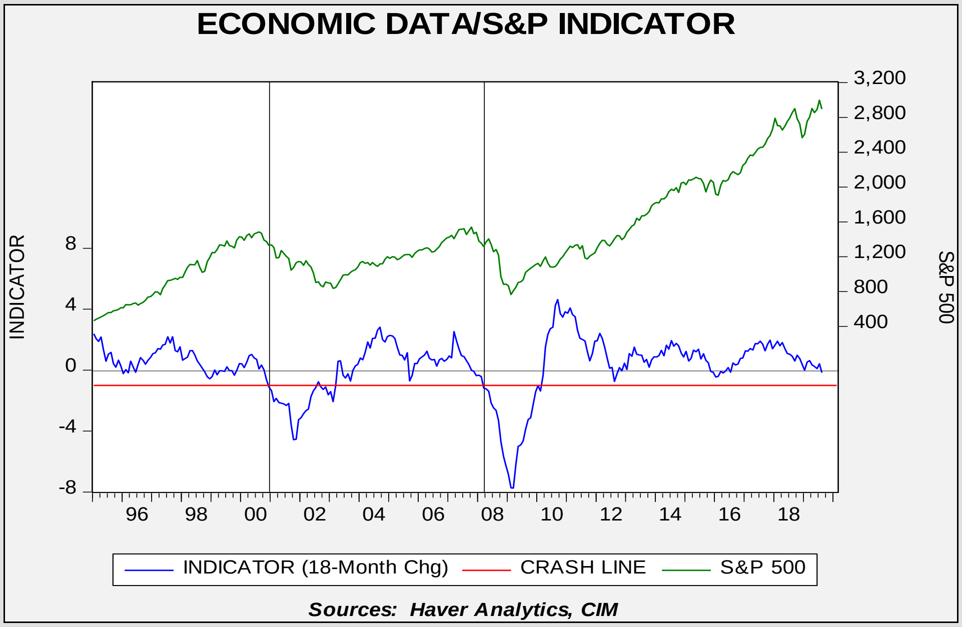
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

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.

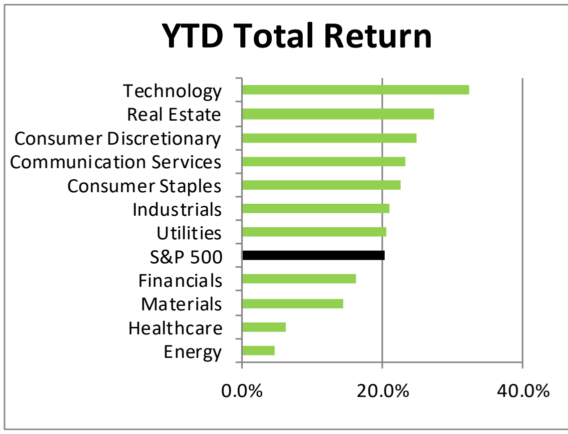


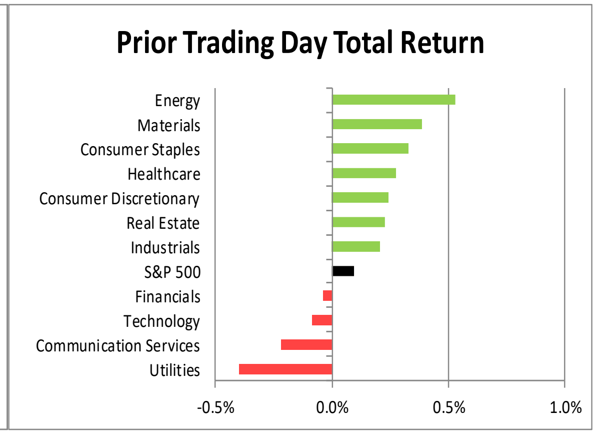
To make the indicator more sensitive, we took the 18-month change and put the signal threshold at minus 1.0. This provides an earlier bearish signal and also eliminates the false positives that the zero threshold generates. At the same time, the fact that this variation of the indicator is just below 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 9/6/2019 close)

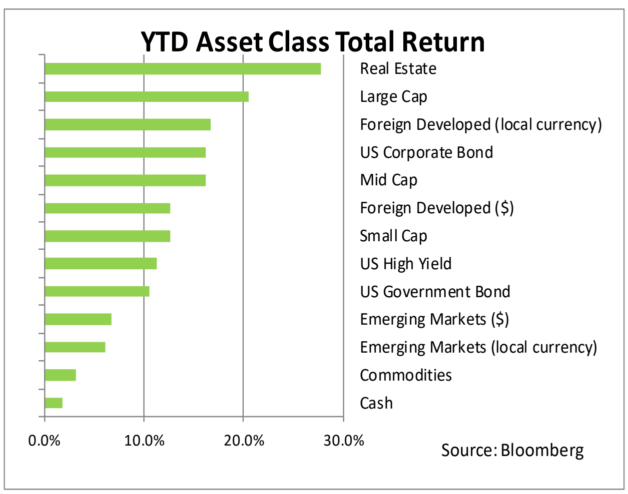




(Source: Bloomberg)

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 9/6/2019 close)

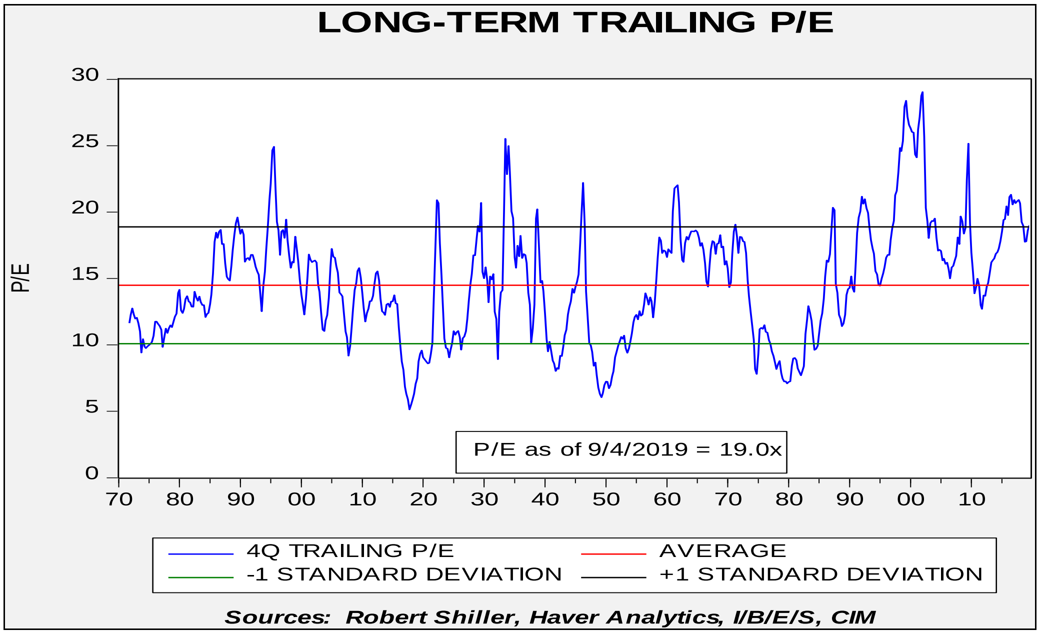


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[1] 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.

[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.