By Bill O'Grady and Thomas Wash

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: August 1, 2018—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.5% from the last close. In Asia, the MSCI Asia Apex 50 was down 1.2% from the prior close. Chinese markets were down, with the Shanghai composite down 1.7% and the Shenzhen index down 1.8%. U.S. equity index futures are signaling a higher open. With 301 companies having reported, the S&P 500 Q2 earnings are above expectations at $40.42 compared to the $39.20 forecast for the quarter. The forecast reflects a 19.9% increase from Q2 2017 earnings. Thus far this quarter, 84.4% of the companies reported earnings above forecast, while 10.6% reported earnings below forecast.

Happy August! Summer is winding down—it seems like it just started. Here is what we are watching:

The Fed: The meeting ends this afternoon. No rate hike is forecast.[1] The only item of interest will be the statement, which probably won't tell us anything. Even so, in light of Q2 GDP, we would not be surprised to see a statement that focuses on strong growth, which would bolster the argument for raising rates. However, that would mostly confirm the current expected policy path, nothing more.

Trade update: There is a trade truce with Europe. Talks with Mexico are said to be doing well,[2] although in terms of NAFTA Canada seems to be sidelined at the moment. However, talks with China, which are currently backchannel, don't appear to be going well. The Trump administration has indicated it will put 10% tariffs on $200 bn of Chinese goods later this month; according to reports the administration has boosted the threat to 25%.[3] Beijing has been increasing fiscal and monetary stimulus to offset the tariff threat to exports.[4] The country has also threatened retaliation if the Trump administration goes the route of increasing trade protection.[5] Financial markets are hopeful that reports of informal talks with Chinese officials will lead to some sort of trade deal. After all, there is a truce now with the EU and it looks like an agreement with Mexico is coming. Nevertheless, it is important to remember that Navarro

[1] https://www.reuters.com/article/us-usa-fed/fed-set-to-hold-rates-steady-remain-on-track-for-more-hikes-idUSKBN1KL0LF
[2] https://www.reuters.com/article/us-usa-trade-coordination/mexican-officials-optimistic-about-nafta-news-in-coming-days-idUSKBN1KM3LI
[3] https://www.wsj.com/articles/u-s-talks-with-china-over-trade-dispute-show-little-progress-1533066018
[4] https://www.wsj.com/articles/chinese-economy-starts-to-feel-tariff-impact-1533015872
[5] https://www.reuters.com/article/us-usa-trade-china/trump-to-propose-25-percent-tariff-on-200-billion-of-chinese-imports-source-idUSKBN1KM3B3

and Lighthizer are mostly focused on China. Thus, the potential for a rupture and trade war with China is probably more likely than with other parts of the world.

BOE: We expect the BOE to raise rates 25 bps on Thursday. That move is well discounted but still may be modestly bullish for the GBP.

Iran: The situation in Iran appears to be deteriorating. The rial remains under pressure.[6] President Rouhani has replaced the head of the central bank.[7] Unrest is rising as inflation increases. Although it is possible the regime could fall, we doubt that will happen. A much more likely outcome is that Rouhani will be forced to throw his lot in with the IRGC and adopt hardline policies. Of course, the secondary effect could be that unrest worsens and does become a threat to the regime. In 2009, the IRGC proved to be very effective in containing the political threat. However, that event was really an elite protest; in other words, the more liberal elite was in a fight with the conservative elite and the latter won. This case could be different in that the masses may rise up against the state. History shows that mass uprisings tend to fail without a leader and Iran's security services have done a good job in decapitating any such leader from emerging. If Iran devolves and the regime runs into trouble, a short-term disruption of oil production is possible.

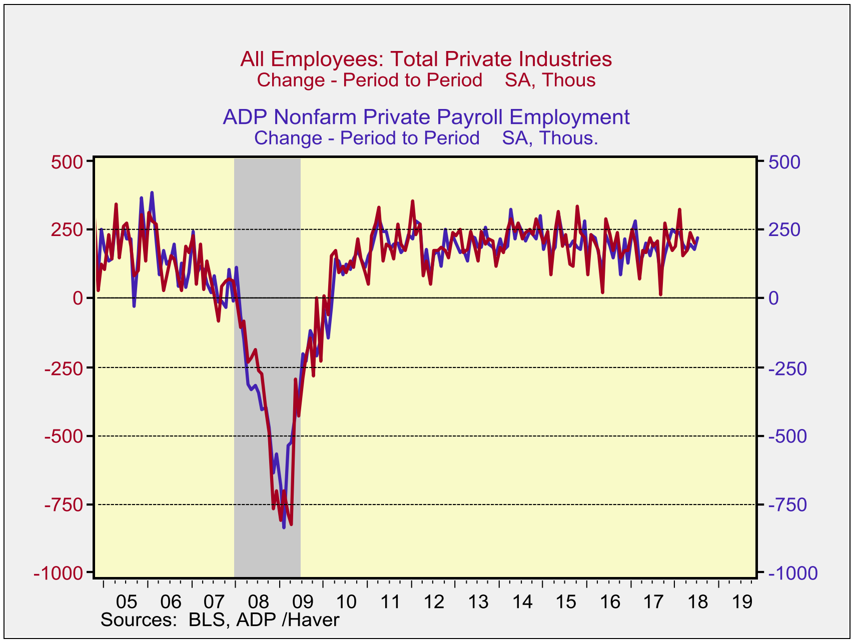
Foreign buying of U.S. real estate[8]: One of the factors we follow is foreign buying of U.S. residential real estate. Not only does it affect our markets, it is a measure of capital flight. The latest data shows there was a 21% decline in inflows for the year ending March 2018, with $121 bn purchased. Chinese buyers accounted for 25% of that total. Compared to the previous year, Chinese buying fell about 4%, at $30.4 bn. Chinese buyers purchased homes about 50% higher than the median price of $292,400, mostly because they tend to purchase in higher cost urban areas in states such as California, New York and Washington. The largest state with foreign home buying is Florida, which tends to attract both European and South American buyers. California is the second largest foreign market.

U.S. Economic Releases

MBA mortgage applications fell 2.6% from the prior week. Purchases and refinancing fell 3.1% and 1.7%, respectively. The average 30-year fixed rate rose by 7 bps from 4.77% to 4.84%.

ADP employment change came in above expectations at 219k compared to the forecast of 186k. The prior report was revised upward to 181k from 177k.

[6] https://www.wsj.com/articles/irans-rial-at-historic-low-as-u-s-sanctions-loom-1532957022
[7] https://www.rferl.org/a/iran-names-new-central-bank-head-hemati-currency-collapse/29389655.html
[8] https://www.yicaiglobal.com/news/chinese-housing-buyers-splurge-most-us-amid-market-cooling



The chart above shows the change in ADP employment and private payrolls. A high ADP employment change number signals a strong BLS non-farm payroll report for Friday.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Markit US Manufacturing PMI	m/m	jul	55.5	55.5	**
10:00	Construction Orders	m/m	jun	0.3%	0.4%	**
10:00	ISM Employment	m/m	jun	59.4	60.2	**
10:00	ISM Manufacturing	m/m	jun		56.0	**
10:00	ISM Prices Paid	m/m	jun	75.3	76.8	**
10:00	ISM New Orders	m/m	apr		63.5	**
	Wards Total Vehicle Sales	m/m	jun	17.00 mn	17.38 mn	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
14:00	FOMC Rate Decision	Federal Reserve Board				

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	Caixin China PMI Mfg	y/y	jul	50.8	51.0	50.9	**	Equity and bond neutral
Japan	Nikkei Japan PMI Mfg	y/y	jul	52.3	51.6		**	Equity bullish, bond bearish
India	Nikkei India PMI Mfg	y/y	jul	52.3	53.1		**	Equity and bond neutral
Australia	AiG Performance of Mfg Index	y/y	jul	52.0	57.4		**	Equity and bond neutral
	CBA Australia PMI Mfg	y/y	jun	52.4	55.0		**	Equity and bond neutral
	CoreLogic House Px	m/m	jun	-0.6%	-0.3%		**	Equity bearish, bond bullish
New Zealand	QV House Prices	m/m	2q	5.1%	5.7%		**	Equity and bond neutral
	Unemployment Rate	m/m	2q	4.5%	4.4%	4.4%	***	Equity bearish, bond bullish
	Employment Change	m/m	2q	0.5%	0.6%	0.4%	**	Equity and bond neutral
	Participation Rate	m/m	2q	70.9%	70.8%	70.8%	**	Equity and bond neutral
	Private Sector Credit	m/m	jun	0.6%	0.3%	0.6%	**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Manufacturing	m/m	jul	55.1	55.1	55.1	**	Equity and bond neutral
Germany	Markit/ BME Germany Manufacturing	m/m	jul	56.9	57.3	57.3	**	Equity and bond neutral
Italy	Markit Italy Manufacturing	m/m	jul	51.5	53.3	53.0	**	Equity and bond neutral
U.K.	Nationwide House Px	m/m	jul	2.5%	2.0%	1.8%	**	Equity bullish, bond bearish
	Markit UK PMI Manufacturing	y/y	jul	54.0	54.4	54.2	**	Equity and bond neutral
Russia	Markit Russia PMI Manufacturing	y/y	jul	48.1	49.5	50.2	**	Equity bearish, bond bullish
AMERICAS								
Mexico	GDP	m/m	2q	2.7%	1.3%	2.8%	***	Equity and bond neutral
Brazil	National Unemployment Rate	m/m	jun	12.4%	12.7%	12.6%	***	Equity bullish, bond bearish
Canada	GDP	y/y	may	2.6%	2.5%	2.3%	***	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)	234	234	0	Up
3-mo T-bill yield (bps)	198	199	-1	Neutral
TED spread (bps)	36	36	0	Neutral
U.S. Libor/OIS spread (bps)	202	201	1	Up
10-yr T-note (%)	2.98	2.96	0.02	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	5	6	-1	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	flat			Neutral
yen	down			Neutral
pound	up			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBI Repurchase Rate	6.500%	6.250%	6.500%	On forecast
RBI Reverse Repo Rate	6.250%	6.000%	6.250%	On forecast
RBI Cash Reserve Ratio	4.000%	4.000%	4.000%	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	$73.28	$74.21	-1.25%	Bearish API report
WTI	$67.98	$68.76	-1.13%	
Natural Gas	$2.76	$2.78	-0.72%	
Crack Spread	$19.36	$19.42	-0.29%	
12-mo strip crack	$19.56	$19.88	-1.57%	
Ethanol rack	$1.58	$1.58	0.08%	
Metals				
Gold	$1,223.18	$1,224.15	-0.08%	
Silver	$15.47	$15.52	-0.36%	
Copper contract	$275.75	$283.15	-2.61%	
Grains				
Corn contract	$ 386.00	$ 386.50	-0.13%	
Wheat contract	$ 557.75	$ 553.75	0.72%	
Soybeans contract	$ 908.00	$ 919.00	-1.20%	
Shipping				
Baltic Dry Freight	1747	1703	44	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.0		
Gasoline (mb)		-2.1		
Distillates (mb)		-0.1		
Refinery run rates (%)		0.60%		
Natural gas (bcf)		42.0		

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temperatures in the Pacific region. Precipitation is expected for the eastern half of the country. There are no tropical disturbances expected over the next 48 hours.

Asset Allocation Weekly Comment

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.

July 27, 2018

Last week, in a wide-ranging interview on CNBC,[9] President Trump ended a 25-year détente with the Federal Reserve, openly criticizing the current path of monetary policy. The president followed up the interview with numerous social media tweets, further criticizing policy tightening.

Although it's been a long time since a president weighed in directly on the Federal Reserve's monetary policy, such criticism is not at all unusual. In fact, the détente is perhaps the outlier. There is a natural tension between a government in power and a central bank. Political leadership, regardless of whether a country is a democracy or not, generally prefers lower interest rates. In the U.S., the Federal Reserve became untethered from the Treasury in 1951 when the White House, Congress and the Federal Reserve agreed to give the central bank independence in setting monetary policy. Up until that point, the Federal Reserve was required to assist the Treasury in facilitating the management of Treasury debt. However, it should be noted that President Truman was not comfortable with this change.

As inflation rose in the late 1960s, chairs of the Federal Reserve faced increasing pressure from various administrations. President Johnson criticized William Martin for not supporting his stimulus policies with monetary accommodation.[10] Nixon tried to replace Martin after his election in 1968, offering to nominate him for treasury secretary. There is speculation that Nixon blamed Martin for his loss to Kennedy in 1960[11] and wanted a more compliant Fed chair. When Martin refused to leave, Nixon eventually replaced him with Arthur Burns. Nixon persistently browbeat Burns and, in order to ensure he would provide easy monetary policy, started a rumor that Burns was pressing for a raise when the Fed chair was publicly opposing wage increases. Nixon then recruited Alan Greenspan to tell Burns that if he promised to keep policy accommodative, the White House would deny the rumors.[12]

Reagan was not above criticizing the Fed; in 1980 his government issued a statement warning that the Fed's independence "should not mean lack of accountability" and that Congress should "monitor the Fed's performance."[13] Reagan strongly considered not reappointing Paul

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[9] https://www.cnbc.com/video/2018/07/20/watch-cnbcs-full-exclusive-interview-with-president-donald-trump.html

[10] https://www.nytimes.com/2017/06/13/business/economy/a-president-at-war-with-his-fed-chief-5-decades-before-trump.html

[11] https://www.minneapolisfed.org/publications/the-region/remembering-william-mcchesney-martin-jr ; also, Mallaby, Sebastian. (2016). *The Man Who Knew: The Life and Times of Alan Greenspan*. New York, NY: Penguin Books, p. 134.

[12] Ibid., pp. 141-144

[13] https://books.google.com/books?id=hclu1_TJ9K8C&pg=PA1976&lpg=PA1976&dq=coordinating+committee+on+economic+policy+economic+strategy+of+the+Reagan+administration+november+16+1980&source=bl&ots=URIX4HAra8&sig=iBKs1W1J94qfuMmq5l8k-F-

Volcker.[14] Volcker left the Fed in 1987, surrounded by governors appointed by President Reagan who were in the habit of dissenting with his decisions.

Even Alan Greenspan, who for a period took on a persona of "the maestro,[15]" faced heavy criticism from the Bush administration as he refused to cut interest rates; he was even called "creepy."[16] George H.W. Bush blamed Greenspan for his defeat by Bill Clinton.[17] The current détente between the Federal Reserve and the White House came when Robert Rubin, the director of the National Economic Council, convinced the president that the Fed's policy decisions should not be questioned.[18] Rubin argued that if the Fed could establish inflation-fighting credibility and reduce inflation expectations, then long-term interest rates would fall and the economy would prosper.

President Trump has clearly ended that detente. Does that mean anything in the very short run? Probably not. We still expect four more rate hikes; the Eurodollar futures market hasn't changed its assessment of the current policy path. But, the criticism will likely increase with each rate hike and it will begin to affect policy at some point. In fact, Chair Powell faces a difficult future. Every rate hike will prompt unfriendly comments from the White House. Once easing starts, Powell could face charges of acquiescence to Trump.

For markets, concern about the Fed eventually manifests itself in rising inflation expectations. Actual inflation is based on the intersection of aggregate supply and aggregate demand. Since 1978, deregulation and globalization have shifted the supply curve away from its origin and likely flattened this slope as well. These factors have led to persistently low inflation. The role of the central bank is more about managing inflation expectations. Since Volcker, the Federal Reserve has made it clear that it won't tolerate or accommodate sharply rising price levels. The combination of credible monetary policy and rising productive capacity has led to disinflation and a steady decline in long-term interest rates.

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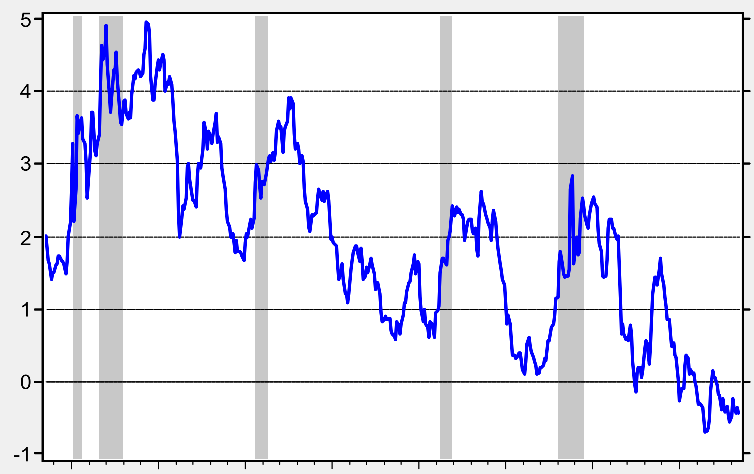
[14] Op. cit., Mallaby, p. 286

[15] Woodward, Bob. (2000). *Maestro: Greenspan's Fed and the American Boom*. New York, NY: Simon and Schuster.

[16] Op. cit., Mallaby, p. 415

[17] Ibid., p. 416

[18] https://www.wsj.com/articles/a-brief-history-of-the-federal-reserves-independence-1497346201

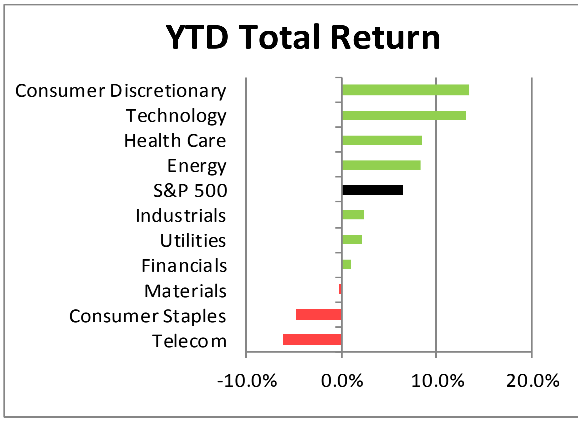


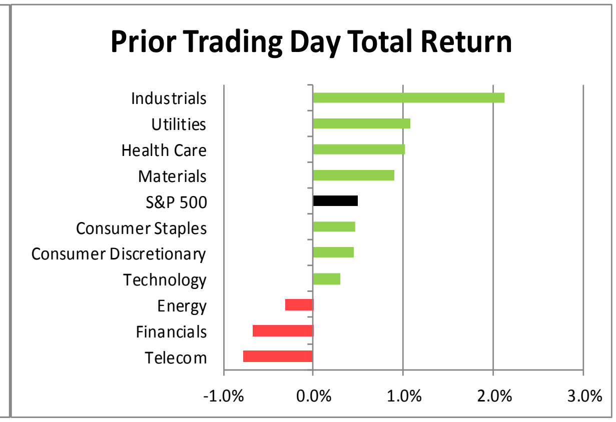
This chart shows a calculation of the term premium on 10-year T-notes. The term premium measures how much more yield investors demand for holding longer term notes. In other words, an investor could simply buy a one-year T-bill each year for 10 years or a 10-year T-note. Usually, the longer duration instrument carries a higher yield because there are risks that rates could rise in the future, lowering the price of the T-note. Simply put, the term premium is an attempt to measure the market's estimate of the riskiness of owning long-duration debt. As the above chart shows, the current term premium is negative, suggesting investors would much rather own the long-duration instrument and are willing to accept a "discounted" rate.

Undermining the Fed runs the risk of reversing this term premium, which would lead to a steeper yield curve and higher interest rates. So far, that has not occurred. There are a couple reasons for this lack of movement. First, the deregulatory policies of the Trump administration are disinflationary. Thus, the inflationary impact from trade impediments may not be as large if the economy can still enjoy the unfettered introduction of new technology. Second, the term premium is mostly a function of inflation expectations, which take a long time to evolve. Milton Friedman argued that inflation expectations are set over decades. Thus, for now, we don't expect a major increase in long-term rates. But, the potential risks are rising. Investors should be wary of long-duration positions and consider bond laddering.

Data Section

U.S. Equity Markets – (as of 7/31/2018 close)

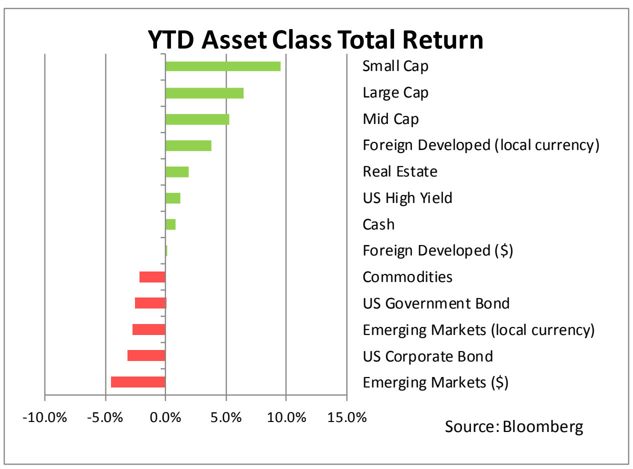




(Source: Bloomberg)

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.

Asset Class Performance – (as of 7/31/2018 close)

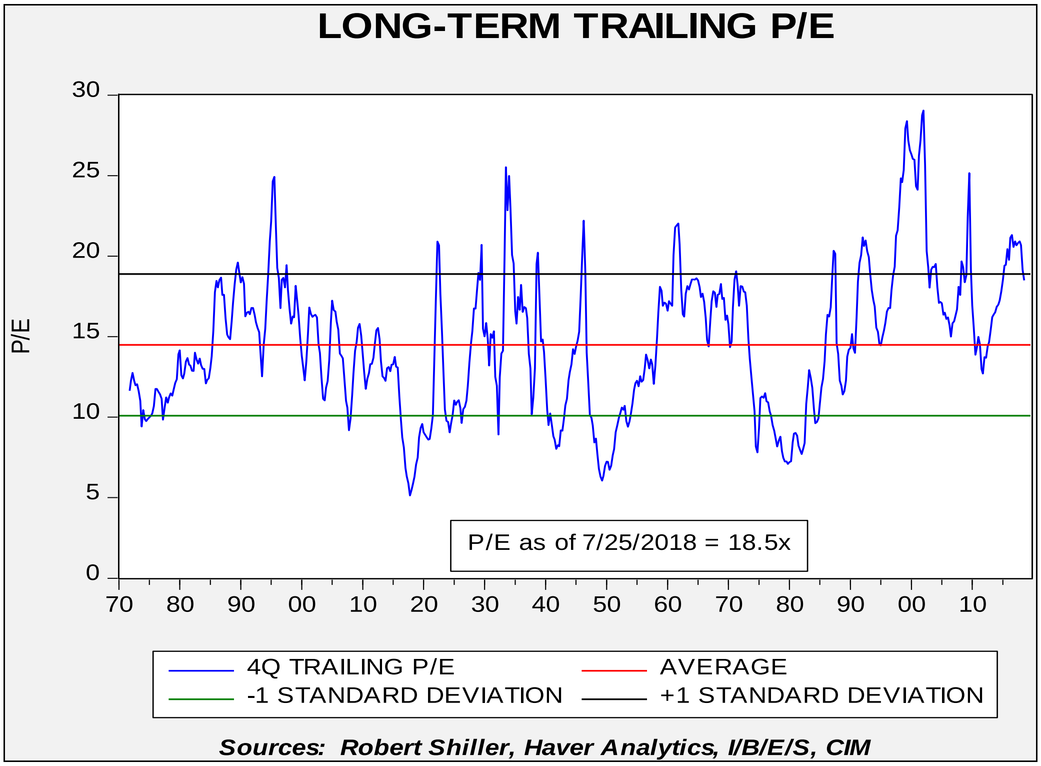


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

July 26, 2018



Based on our methodology,[19] the current P/E is 18.5, up 0.1x from last week. The rise in the S&P 500 outweighed the rise in earnings, which led to a higher P/E.

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.

[19] 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 and Q1) and two estimates (Q2 and 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.