Daily Comment

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 27, 2018—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.3% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.2% from the prior close. Chinese markets were up, with the Shanghai composite up 1.9% and the Shenzhen index up 2.4%. U.S. equity index futures are signaling a higher open.

It's a solemn Monday as the nation mourns the passing of Sen. John McCain. It is dominating the media's focus. It is also the last week of summer and it is clear that trading desks are thin and quiet. Here is what we are watching today:

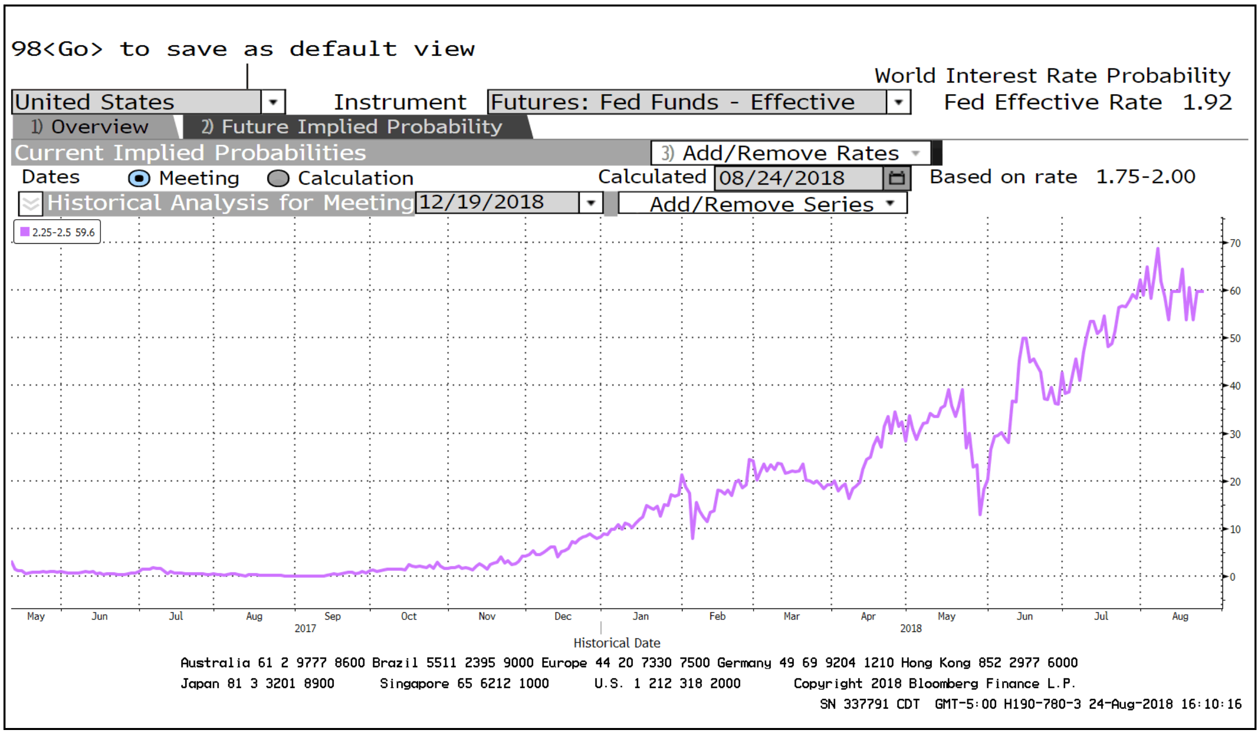
Steadying the CNY: The PBOC took steps today to stabilize the CNY in the face of a stronger dollar. In January, the PBOC stopped using an adjustment factor that took the stronger dollar into account. Thus, as it priced the CNY against a currency basket, overall dollar strength was leading to a weaker CNY. By reintroducing this adjustment factor, the CNY should be less prone to weakness when the dollar rallies. The CNY's stabilization boosted emerging market equities this morning, offsetting continued worries in Turkey.

Turkey: As Turkey returns from a weak off of vacation, the TRY has resumed its downtrend.

(Source: Bloomberg)

Over the past several sessions, the TRY had stabilized. However, we are seeing weakness return this morning. President Erdogan announced a visit to Tehran on September 7.[1] We note that Iran's finance minister was fired by the legislature over the weekend due to the poor performance of the economy.

Is Powell a dove? The Jackson Hole speech was taken as more dovish than expected. His comment that "there does not seem to be an elevated risk of overheating" is being seen as evidence that he does not see a reason to accelerate the path of tightening, even though there will be a press conference after each meeting next year. We caution that, as is often the case, this dovishness was offset by expressed worries about inflation and overheating financial markets. In our view, nothing has really changed. We note that the fed funds futures market is still expecting a 60% chance of a 25 bps rate hike after an almost certain rate hike in September.



(Source: Bloomberg)

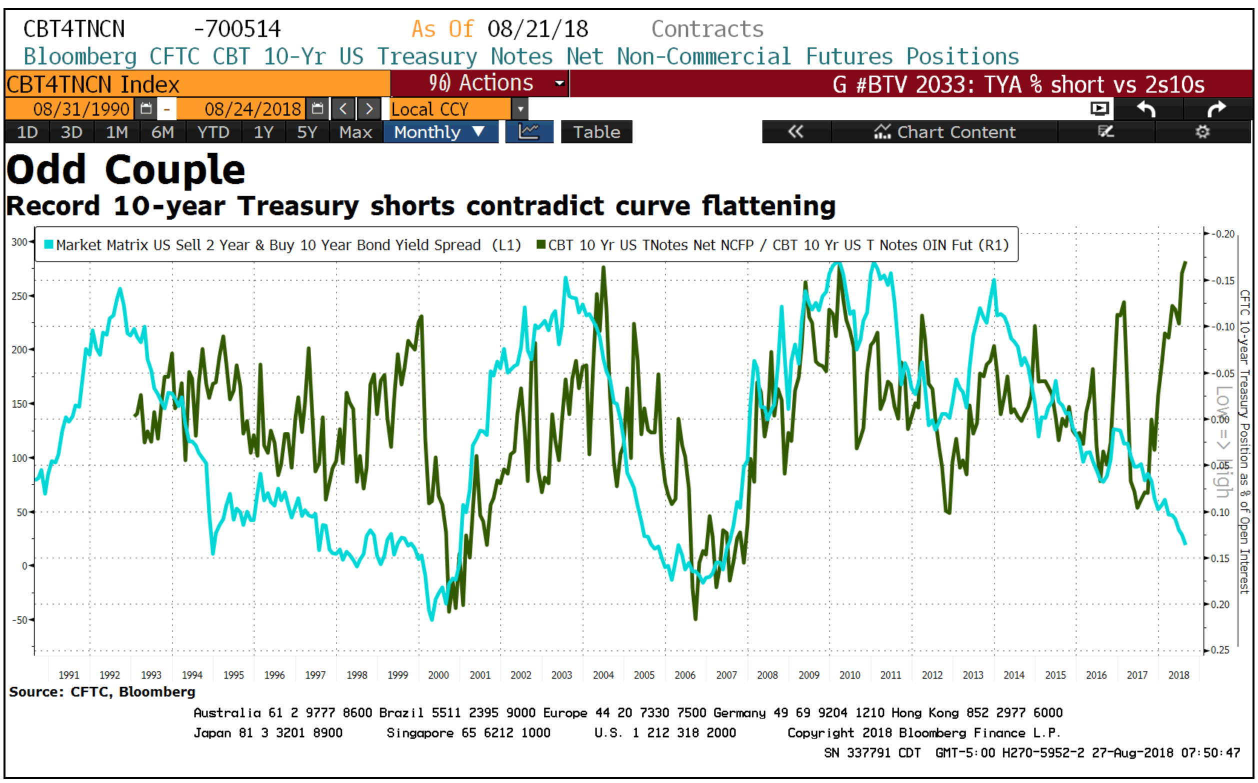
We also note that the two-year deferred Eurodollar futures market is still projecting a terminal rate of 3.00% for fed funds. The market reaction, which was bullish for gold and equities and bearish for the dollar, suggests that the financial markets were somewhat fearful of a more hawkish speech, perhaps in response to recent comments from the White House. In other words, financial markets may have been worried that Powell would overreact to Trump's criticism by signaling that he was going to push rates higher to prove Fed independence. Instead, we got a fairly straightforward reiteration of the current approach that suggests policy will continue to gradually tighten; in other words, White House criticism against the Fed is being ignored. The

[1] https://www.reuters.com/article/us-iran-syria-defence-minister/iran-and-syria-sign-deal-for-military-cooperation-idUSKCN1LC0GL

lack of reaction to criticism appears to have led the financial markets to give Powell's speech a dovish take. We don't see it as dovish as none of the internal factors we monitor have changed. Instead, the financial markets were discounting a hawkish speech and didn't get one.

Trade: It appears that we did not get a NAFTA deal on Friday because AMLO, the president-elect of Mexico, opposes restrictions on Mexico's ability to control foreign sector involvement in its energy sector.[2] AMLO is an economic nationalist who has consistently opposed opening up the energy sector to foreigners. Although he has softened this view recently, it appears he is not comfortable with the current structure of the agreement. Talks continue but there is a real push to get the deal done before September 1. NAFTA rules say that any new deal must have a 90-day waiting period before it can be approved. If discussions extend past the end of August, the new Mexican administration will be the signatory, which might lead to an entirely new set of negotiations.

A big short: Speculators have built a massive short position in 10-year Treasury futures, likely anticipating mid-September rule changes for pensions that will reduce the attractiveness of these instruments. However, the level of short positions is contrary to the narrowing of the yield curve.



(Source: Bloomberg)

[2] https://www.bloomberg.com/news/articles/2018-08-24/amlo-s-oil-stand-said-to-keep-u-s-mexico-from-nafta-agreement

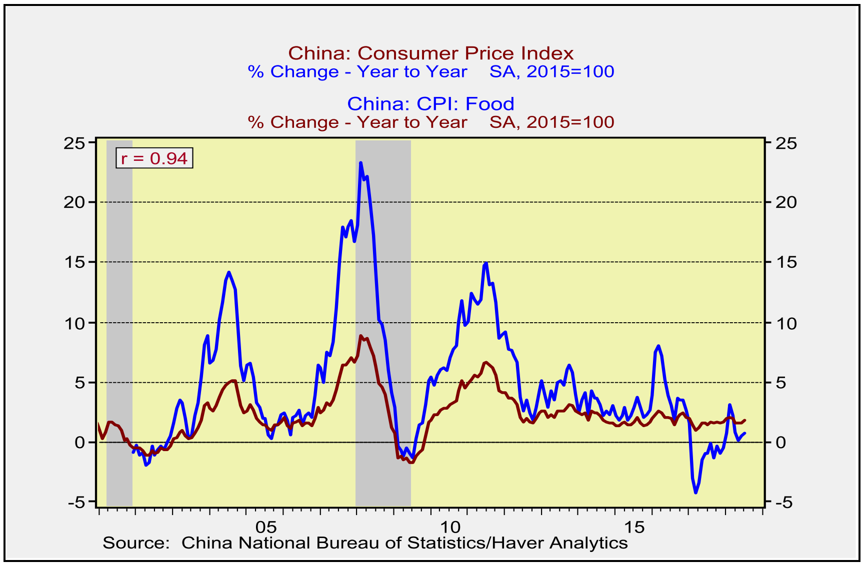
This chart shows the yield curve (teal) and the level of non-commercial short positions relative to open interest (which is the number of non-offset futures contracts), shown in green. Note that the green line is unusually high, indicating a large speculative short position. Speculative short positions are almost always resolved by an offsetting purchase; in futures markets, rarely do speculators take delivery. If bond yields don't rise soon (and the narrowness of the yield curve argues against that in the near term), we could see a large short-covering rally in the next couple of weeks.

Italy's anger: Italy is planning on vetoing the EU budget to express its displeasure with the lack of progress on immigration. Italy, due to its proximity to North Africa, is a popular landing point for migrants seeking to enter Europe. Due to EU rules, when migrants disembark on Italian soil, that becomes their new EU nation. Italy feels it is being unfairly burdened by this rule and wants it changed. However, the rest of the EU is apparently fine with the current arrangement and has been slow to acknowledge Italy's predicament. Unlike many EU rules, budgets do not require unanimity, but Italy has also threatened to withhold its payments to the EU, which would set a dangerous precedent. We are still early in this process but it is a risk to the EU and the Eurozone.

Broken arrow? Russia is apparently missing a nuclear powered missile. Russia claims to have a new nuclear powered hypersonic missile[3] that could reach speeds of up to Mach 20, so fast as to be able to evade U.S. missile defense systems. However, the technology has had four failures and one of the missiles is apparently lost somewhere in the Barents Sea.[4] Although there has been no indication that the missile is an environmental threat, the Russians are attempting to recover it. A missile traveling at those reported speeds is difficult to control because small changes in trajectory can cause large variations in flight. So far, Russia has not worked out the kinks.

A pig problem: African swine fever has appeared in China;[5] the disease, which is highly contagious and often fatal, affects domestic swine and wild boars. It is carried by ticks and can be spread by bodily fluids. The incidence of this disease is the first time it has appeared in Asia. In previous events, large preventative slaughters have been reported. The Chinese pork industry is decentralized; unlike the U.S., large operations in enclosures exist alongside small farm herds. Thus, controlling the spread of the disease is difficult. Food prices make up about 30% of China's CPI and meat makes up about 3% of the overall index.[6] China consumes more than half of the world's pork, although the government is taking steps to reduce meat consumption, in general.[7] The U.S. provides 13.6% of Chinese pork imports, the fourth largest supplier.[8]

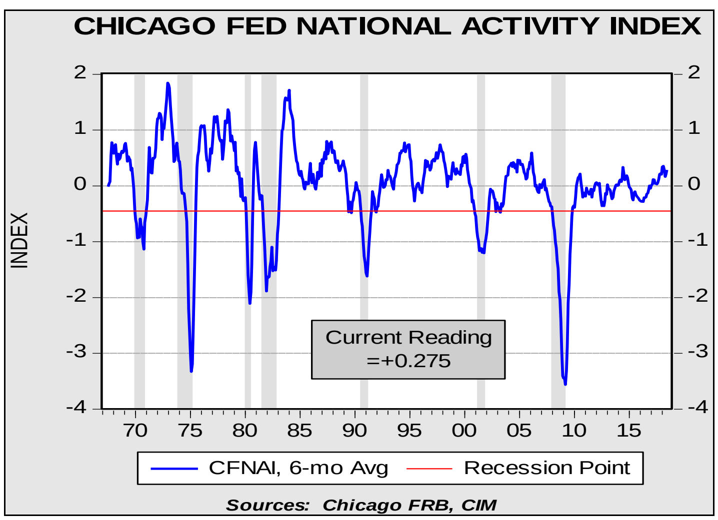
[3] https://www.livescience.com/62653-russia-hypersonic-weapon.html
[4] https://www.cnbc.com/2018/08/21/russias-nuclear-powered-missile-that-putin-claimed-had-infinite-range-is-currently-lost-at-sea.html?wpisrc=nl_daily202&wpmm=1
[5] http://www.sciencemag.org/news/2018/08/can-china-world-s-biggest-pork-producer-contain-fatal-pig-virus-scientists-fear-worst
[6] https://www.rba.gov.au/publications/bulletin/2017/dec/pdf/bu-1217-4-underlying-consumer-price-inflation-in-china.pdf
[7] https://www.weforum.org/agenda/2016/06/china-consumes-more-than-a-quarter-of-the-worlds-meat-the-government-wants-to-change-that/
[8] http://www.thepigsite.com/articles/5421/an-overview-of-chinas-pork-import-market-2017-forecast-of-2018/



China is very sensitive to inflation and the strong impact of food prices means the leadership will need to take steps to contain a jump in pork prices if culling is necessary. Pork is so important to China that it has a strategic reserve.[9] We will be watching to see if China relaxes its recent tariff increases on U.S. pork imports in light of this crisis.[10]

U.S. Economic Releases

The Chicago Fed National Activity Index came in below expectations at +0.13 compared to the forecast of +0.45. The prior month's report was revised upward from +0.43 to +0.48.



[9] https://www.cnbc.com/id/100795405?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axioschina&stream=top-stories

[10] https://www.cnbc.com/2018/07/04/us-pork-producers-brace-for-new-pork-tariffs-from-china-mexico.html

The current smoothed reading is +0.275. The index is constructed to show trend growth at zero, thus a reading above zero shows above-trend growth. Casual observation would suggest this expansion has seen very modest growth, with much of the time spent below zero.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:30	Dallas Fed Manufacturing Activity	m/m	aug	30.0	32.3	**
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	Industrial Profits	y/y	jul	16.2%	20.0%		**	Equity bearish, bond bullish
EUROPE								
Germany	IFO Business Climate	m/m	aug	103.8	101.7	101.8	**	Equity bullish, bond bearish
	IFO Expectations	m/m	aug	101.2	98.2	98.4	**	Equity bullish, bond bearish
	IFO Current Assessment	m/m	aug	106.4	105.3	105.3	**	Equity bullish, bond bearish
Switzerland	Total Sight Deposits CHF	m/m	aug	576.8 bn	576.2 bn		*	Equity and bond neutral
	Domestic Sight Deposits CHF	m/m	aug	477.0 bn	472.6 bn		*	Equity and bond neutral
AMERICAS								
Mexico	GDP Nominal	y/y	aug	8.3%	6.4%	7.5%	***	Equity bullish, bond bearish
	Economic Activity	y/y	2q	1.2%	2.2%	1.7%	**	Equity and bond neutral
	Current Account Balance	y/y	2q	-$3.882 bn	-$6.941 bn	-$4.133 bn	***	Equity bullish, bond bearish
Brazil	FGV Consumer Confidence	y/y	aug	83.8	84.2		***	Equity and bond neutral

Financial Markets

The table below highlights some of the indicators that we follow on a daily basis. Again, the color coding is similar to the foreign news description above. We will add a paragraph below if a certain move merits further explanation.

	Today	Prior	Change	Trend
3-mo Libor yield (bps)	232	231	1	Up
3-mo T-bill yield (bps)	204	205	-1	Neutral
TED spread (bps)	27	26	1	Neutral
U.S. Libor/OIS spread (bps)	209	208	1	Up
10-yr T-note (%)	2.82	2.81	0.01	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	10	10	0	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	flat			Neutral
yen	up			Neutral
pound	flat			Neutral
franc	flat			Neutral

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	$75.59	$75.82	-0.30%	
WTI	$68.47	$68.72	-0.36%	
Natural Gas	$2.91	$2.92	-0.27%	
Crack Spread	$17.62	$17.59	0.16%	
12-mo strip crack	$20.45	$20.50	-0.27%	
Ethanol rack	$1.48	$1.48	-0.22%	
Metals				
Gold	$1,204.24	$1,205.35	-0.09%	
Silver	$14.78	$14.82	-0.29%	
Copper contract	$272.30	$272.30	0.00%	
Grains				
Corn contract	$ 359.75	$ 362.75	-0.83%	
Wheat contract	$ 529.00	$ 536.50	-1.40%	
Soybeans contract	$ 841.00	$ 855.25	-1.67%	
Shipping				
Baltic Dry Freight	1697	1709	-12	

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps in the western region. There is no tropical cyclone activity expected over the next 48 hours in the Atlantic basin.

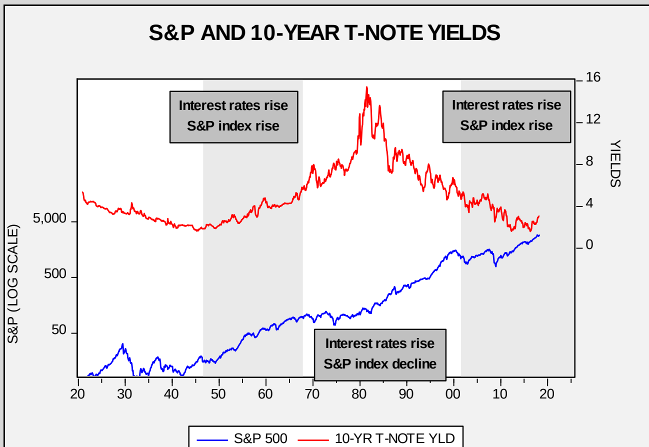
Asset Allocation Weekly Comment

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.

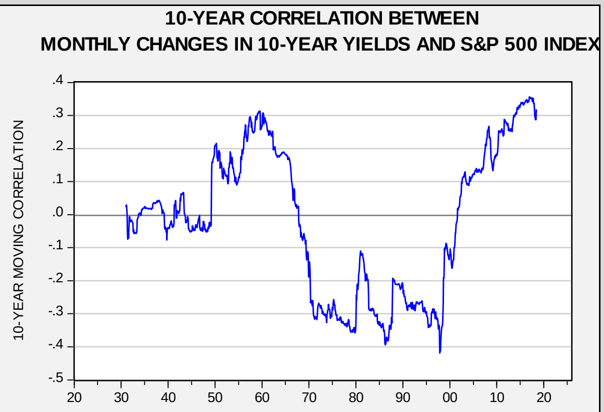
August 24, 2018

What is price stability? The working definition for the Federal Reserve was crafted by Alan Greenspan in 1994, when he suggested that price stability has been achieved when "…households and businesses need not factor expectations of changes in the average level of prices into their decisions."[11] In other words, a central bank has achieved its price objective not necessarily when it has reached 0% inflation but when households and firms no longer take inflation (or deflation) into account when making purchase or investment decisions. This is probably the best answer to those who complain that 2% inflation is still inflation; although true, we have observed that no one seems to care about inflation around this level. Once the perception of price stability has been achieved, firms and households react to price increases by assuming the rise is due to particular factors in a specific market, not because of overall inflation. If prices rise in one market but economic actors don't believe it's due to an overall increase in the price level, then they are less likely to react to that specific price change by assuming they should buy other goods before prices increase there as well.

Assumptions surrounding price stability change how financial markets operate. If investors fear inflation, or, more accurately, when expectations of price stability are absent, then anything that increases the fear of inflation, such as currency weakness, will force the central bank to raise rates to offset that concern. The increase in interest rates will slow economic activity and weaken financial asset prices. Fiscal expansion can cause similar fears. On the other hand, when investors expect price stability, fiscal or monetary expansion is welcomed because it will support the economy and lift asset prices.



Sources: Haver Analytics, CIM



Sources: Haver Analytics, CIM

The chart on the left shows the 10-year T-note yield and the S&P 500 Index; the latter is on a log scale. The chart on the right is the focus of this analysis. Here we examine the 10-year moving

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[11] https://www.dallasfed.org/~/media/documents/institute/wpapers/2008/0008.pdf

correlation between the monthly change in the S&P 500 and the 10-year yield. Note that the change in the two series was positively correlated from 1946 into 1967; in other words, when the S&P rose, so did long-duration interest rates. From an investor's perspective, the 10-year Treasury could act as a partial hedge to an equity portfolio. Because bond prices fell when rates rose, a portfolio holding bonds and stocks would tend to have lower risk. Under conditions of rising equity values, an investor would expect his bonds to fall in value ***and vice versa***, meaning the same investor could expect his bond values to rise when equity values fell.

From 1967 into 2001, this correlation reversed its sign. When rates rose, the S&P fell. Thus, a portfolio of bonds and stocks, in terms of price, moved in the same direction. Now, as the chart on the right shows, in terms of overall direction, there was a bull market in both bonds and stocks from roughly 1985 to 1990. But, since we are examining this on a monthly change basis, there was still a tendency for rising interest rates to trigger equity weakness. The 1987 crash is an example.

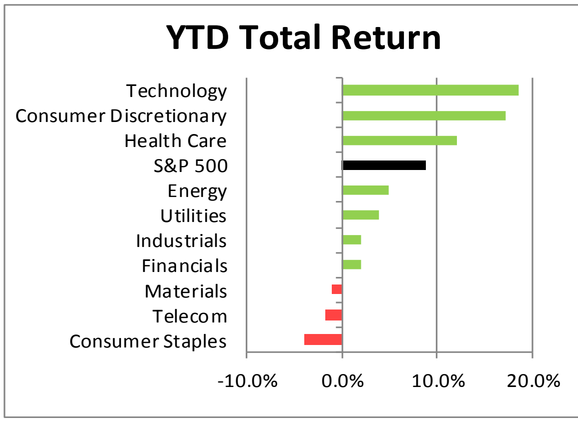
Since 2002 into the present, the correlation sign has reverted back to the 1946-67 condition. This means that holding long-duration bonds in a portfolio will act as an effective hedge to an equity portfolio. In other words, when equity prices fall, the prices within the fixed income portion of the portfolio will tend to rise.

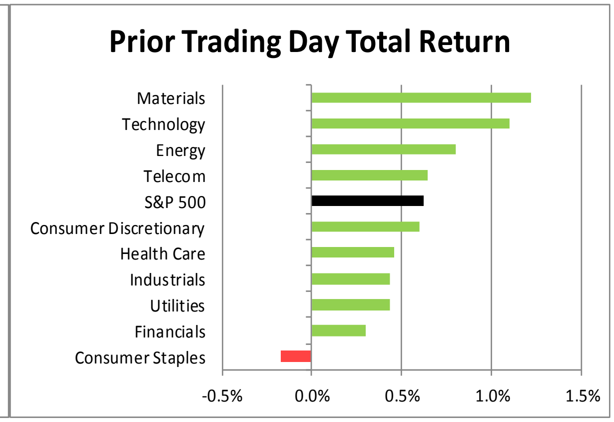
Modern portfolio theory postulates that holding two less than perfectly correlated assets will offer some degree of risk-adjusted outperformance. And, it is worth noting that the rolling correlation shown above isn't ever all that strong, maxing out at around 0.4. So, even during the late 1960s into the early aughts, holding bonds did offer some diversification effect. However, when the correlation between bond prices and equities is inverse, it allows an investor to "hide" in fixed income during bear markets in equities. That tactic wasn't available to investors from the late 1960s through the mid-1980s.

The key to the relationship between bonds and stocks involves expectations surrounding price stability.   Price stability, in our opinion, rests on three legs. The first is globalization. By allowing firms and consumers to scour the globe for the best places to build productive capacity and source goods, price pressures are contained. The second is deregulation. Allowing firms to introduce new technologies and techniques into the economy without government interference supports efficiency and productivity. And, central bank independence is the third pillar. Allowing central banks to peruse the most appropriate monetary policy without political interference gives investors, consumers and firms confidence that inflation will not be allowed to erupt regularly for short-term political gain. We monitor the viability of these three legs constantly. Currently, the first is under fire and the third is facing threats as well. If these components continue to face pressure, expectations of price stability could erode and proper asset allocation will change, too. For now, we still expect price stability to be maintained but the threats are growing. If the threats rise to a level that undermines price stability, we will act accordingly.

Data Section

U.S. Equity Markets – (as of 8/24/2018 close)

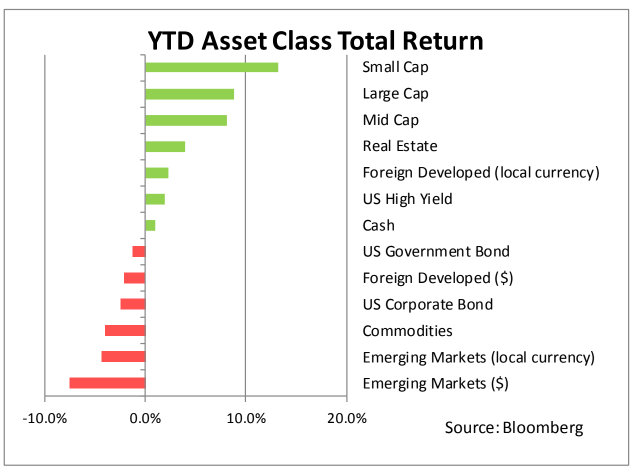




(Source: Bloomberg)

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 8/24/2018 close)

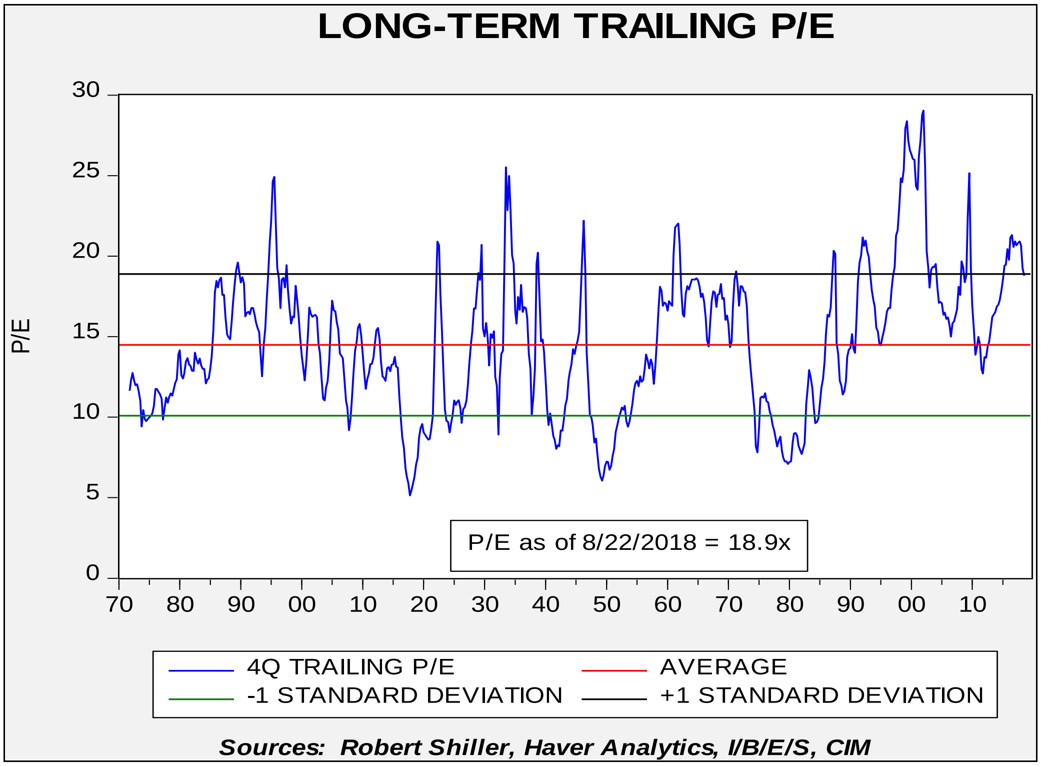


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

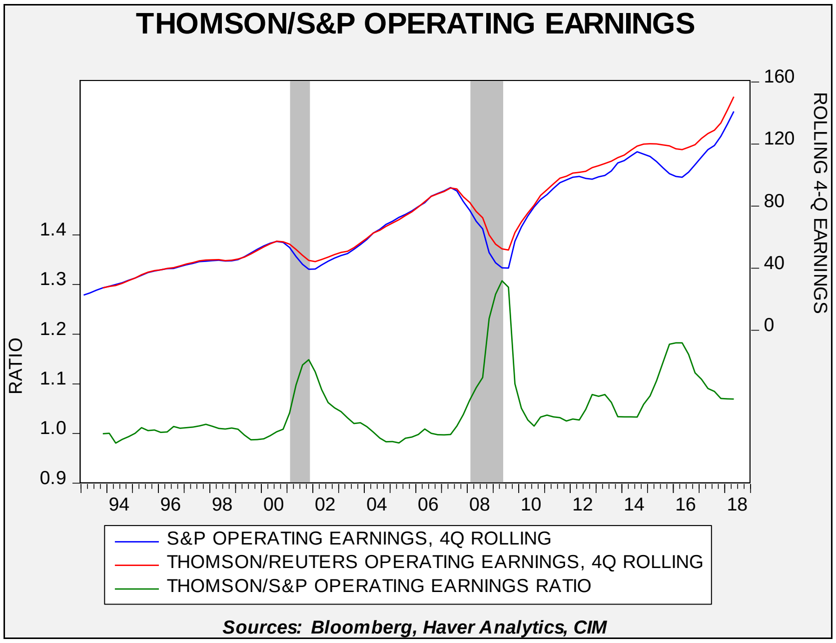
August 23, 2018



Based on our methodology,[12] the current P/E is 18.9, up 0.4x from last week.

This is the time in the quarter when we adjust our earnings series to account for the difference between Thomson/Reuters and S&P's calculation of operating earnings. As the chart below shows, there is typically a spread between the two, with the former running a bit higher than the latter (specifically, it's about 6.7%). Our long-term history is based on S&P but we use Thomson/Reuters for estimates. Thus, when earnings season nears a close and Haver Analytics estimates the S&P numbers (they do this when more than 90% of companies have reported), we adjust to the lower S&P number, which causes a rise in the P/E multiple above.

[12] 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.



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