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 29, 2018—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is unchanged from the last close. In Asia, the MSCI Asia Apex 50 was up 0.3% from the prior close. Chinese markets were down, with the Shanghai composite down 0.3% and the Shenzhen index down 0.6%. U.S. equity index futures are signaling a higher open.

It's a quiet Wednesday, very typical of late summer. Here is what we are watching today:

Ottawa to Washington: The U.S. has given Canadian negotiators a deadline of Friday to accept the deal negotiated by the U.S. and Mexico. In response, Canada's foreign minister, Chrystia Freeland,[1] is in Washington to conduct talks. It seems almost impossible that Canada would accept terms on such short notice. If the Canadians join, it would suggest the changes agreed to by Mexico and the U.S. are not different enough to matter. At the same time, not signing off on the pact could be very damaging to the Canadian economy. Politically, it will be hard for the Trudeau government to spin that it didn't cave to the Trump administration if they accept the deal on such a short deadline. There is also increased grumbling about the deal among U.S. senators.[2] It isn't completely clear that this agreement could pass Congress. So, yesterday's declaration of victory may be premature. If the deal fails, it will raise fears surrounding trade and would be bearish for equities and bullish for the dollar.

About last night: A number of primaries were held last night as the primary season winds down for November's main event. The key takeaway is that the current political coalition continues to fray and the populist insurgency is still growing. We are especially taking notice of the choice Florida voters will be facing, which is between a left- and right-wing populist.[3] The other interesting item of note was the heavy GOP turnout in Florida, which does suggest a higher degree of enthusiasm[4] than would be indicated if a "blue wave" is coming in November.

China and influenza: A new strain of the influenza virus has emerged in China. This is nothing unusual; nearly every year, a new strain mutates and often originates in China, which has a

---

[1] https://www.nytimes.com/2018/08/28/business/canada-and-us-meet-as-trump-moves-ahead-with-mexico-trade-deal.html?emc=edit_mbe_20180829&nl=morning-briefing-europe&nlid=567726720180829&te=1
[2] https://www.ft.com/content/0923fd48-aa8a-11e8-94bd-cba20d67390c?emailId=5b861cc11fdcec0004aca586&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22
[3] https://apnews.com/4046fb95237e43cbb450e02c8e61484d/Primary-takeaways:-Establishment-fails-and-diversity-grows?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top-stories
[4] Ibid.

natural reservoir of swine and fowl that propagate new strains. The new virus, called H7N9, has been circulating for over a year. The U.S. would like to get a sample of it to start creating new vaccines for the upcoming flu season. However, China is refusing to share samples of the virus. According to reports,[5] some U.S. laboratories have received samples from Hong Kong and Taiwan, but it is unclear if enough material is available to build ample vaccine reserves. Although neither government is saying much officially, this lack of cooperation appears to be due, in part, to deteriorating relations between China and the U.S.

Russian war games: Russia is conducting the Vostok-2018 war games[6] next month. Beginning on September 11, the games will be the largest conducted since the fall of the Soviet Union. China has agreed to participate. The exercises, held in eastern Russia, used to be designed to prepare for a conflict with China. Thus, the participation of Chinese military units is unprecedented. This show of force coincides with a flotilla of Russian Navy vessels that have moved into the Mediterranean. These ships may be part of a build-up to support Syria in operations against rebel positions in Idlib, Syria.

U.S. war games return: As part of the agreement at the recent U.S./North Korean summit, the U.S. agreed to suspend military exercises with South Korea. Secretary of Defense Mattis[7] announced yesterday that this suspension would be lifted going forward, most likely due to the lack of denuclearization from Pyongyang. It is interesting to note that South Korea has been reluctant to say it would also resume war games.

India boosts defense spending: India has approved the acquisition of $6.5 bn of military hardware, including 111 naval helicopters. There has been an arms race escalation across Asia; current spending is $450 bn, with 44% coming from China alone.[8] This spending is due, in part, to fears that the U.S. is withdrawing from its postwar role of protecting the region. This spending is really not a surprise, but the mounting increase in spending and the arms build-up could lead regional powers to use this military hardware to either project power or resist incursions. What we are seeing in Asia will likely be seen in Europe over time.

A German bailout of Turkey? There are reports that the Merkel government is considering providing emergency economic aid to Turkey, fearful that an economic collapse could destabilize the Middle East and Europe.[9] In our most recent WGR,[10] we speculated that Ankara might use the threat of a migrant overflow into Europe to encourage support from EU leaders. These recent reports may indicate that Turkey is using backchannels to warn Germany and the EU that it might make good on this negative outcome. If so, the odds that Turkey stabilizes would improve, to some degree.

---

[5] https://www.nytimes.com/2018/08/27/health/china-flu-virus-samples.html

[6] https://www.nytimes.com/2018/08/28/world/europe/russia-military-drills.html?emc=edit_mbe_20180829&nl=morning-briefing-europe&nlid=567726720180829&te=1

[7] https://www.ft.com/content/373e31e6-aae2-11e8-89a1-e5de165fa619?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

[8] https://www.ft.com/content/4492a134-9687-11e8-b67b-b8205561c3fe

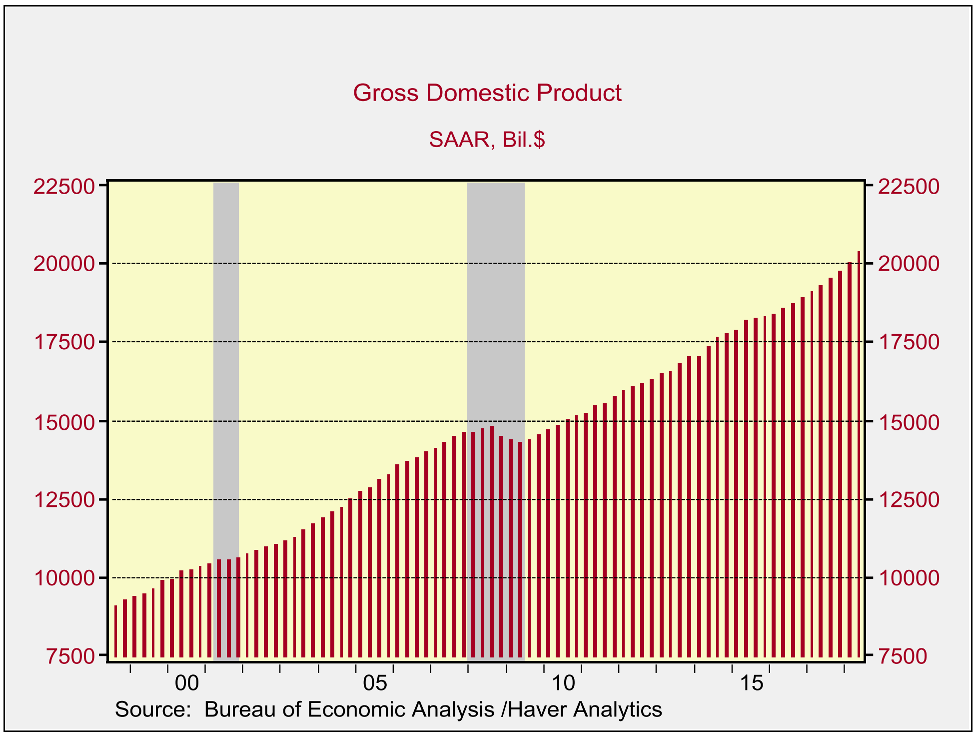
[9] https://www.wsj.com/articles/as-turkey-teeters-germany-considers-offering-a-financial-lifeline-1535459427

[10] See WGRs, The Turkey Crisis: Part I (8/20/18) and Part II (8/27/18).

Richard Clarida to the FOMC: At long last, Richard Clarida made it over the final hurdle and will join the FOMC for the September meeting. We expect Clarida to vote as a moderate governor.

U.S. Economic Releases

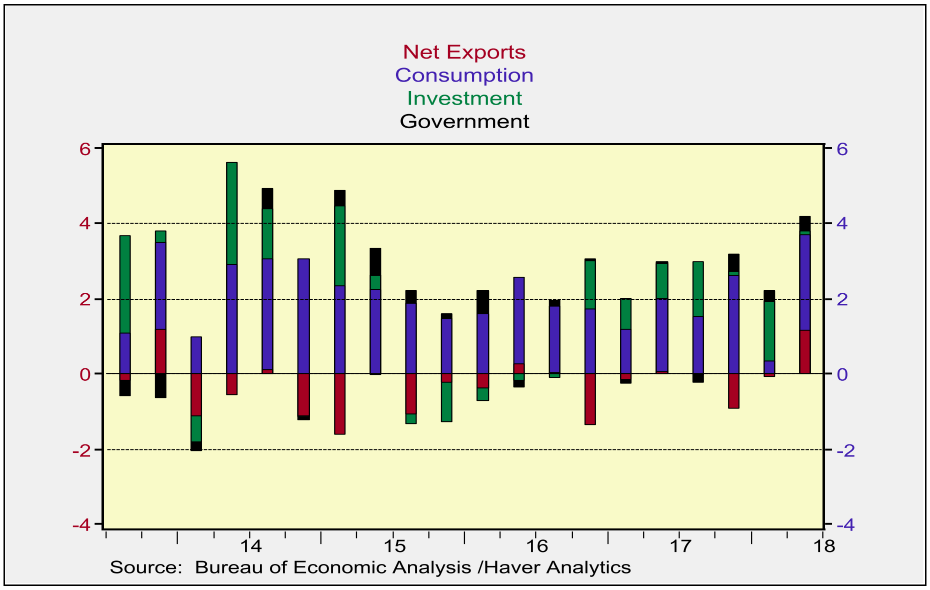
The second reading of Q2 GDP came in above expectations at 4.2% compared to the forecast of 4.0%. Personal consumption came in below expectations, rising 3.8% from the prior quarter compared to the forecast of 3.9%. Core PCE rose 2.0% from the prior quarter. The overall GDP price index came in line with expectations, rising 3.0%.



The chart above shows historical GDP. As of right now, GDP continues to grow at a solid pace.

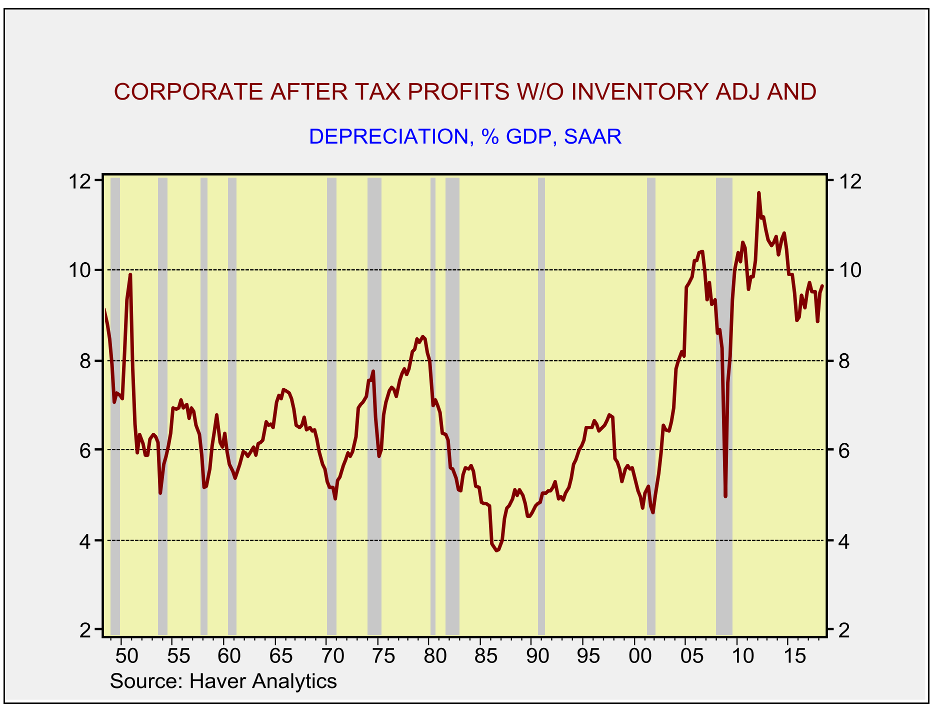
	Q2 2018 Second Reading	Q2 2018 Prelim Reading	Difference
GDP	4.2%	4.0%	0.2%
Consumption	2.6%	2.7%	-0.1%
Investment	0.1%	-0.1%	0.2%
Inventories	-1.0%	-1.0%	0.0%
Net Exports	1.2%	1.1%	0.1%
Government	0.4%	0.4%	0.0%

The table above lists the contributions to GDP. There was a modest drop in consumption in Q2 as well as an upward revision in exports.



This chart shows the contributions graphically. The downward revision in consumption was offset by an upward revision in investment and exports. We expect investment to rise in the next quarter as a result of inventory rebuilding.

We get the NIPA profits data in the first revision. Corporate profits edged higher in Q2.



MBA mortgage applications fell 1.7% from the prior week. Purchases and refinancing fell 0.9% and 3.0%, respectively. The average 30-year fixed rate mortgage fell 3 bps from 4.81% to 4.78%.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Pending Home Sales	m/m	aug	0.3%	0.9%	**
10:00	Pending Home Sales	m/m	aug	-2.5%	-4.0%	**
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								
Japan	Consumer Confidence	m/m	aug	43.3	43.5	43.3	***	Equity and bond neutral
EUROPE								
Germany	GfK Consumer Confidence	y/y	sep	10.5	10.6	10.6	***	Equity and bond neutral
France	Consumer Spending	m/m	aug	0.2%	0.3%	0.2%	***	Equity and bond neutral
	GDP	y/y	2q	1.7%	1.7%	1.7%	***	Equity and bond neutral
Switzerland	Credit Suisse Survey Expectations	m/m	aug	-14.3	-4.0		**	Equity bearish, bond bullish
AMERICAS								
Mexico	Unemployment Rate	m/m	jul	3.4%	3.4%	3.4%	***	Equity and bond neutral
	International Reserves Weekly	w/w	aug	$173.569 bn	$173.329 bn		**	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)	208	208	0	Neutral
TED spread (bps)	24	24	0	Neutral
U.S. Libor/OIS spread (bps)	209	209	0	Up
10-yr T-note (%)	2.87	2.88	-0.01	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	11	11	0	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	flat			Neutral
pound	up			Neutral
franc	down			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	$76.13	$75.95	0.24%	
WTI	$68.82	$68.53	0.42%	
Natural Gas	$2.85	$2.85	-0.11%	
Crack Spread	$17.55	$17.81	-1.44%	
12-mo strip crack	$20.36	$20.60	-1.16%	
Ethanol rack	$1.47	$1.47	-0.18%	
Metals				
Gold	$1,202.95	$1,201.00	0.16%	
Silver	$14.70	$14.71	-0.06%	
Copper contract	$272.85	$275.85	-1.09%	
Grains				
Corn contract	$ 356.50	$ 356.25	0.07%	
Wheat contract	$ 530.00	$ 523.25	1.29%	
Soybeans contract	$ 833.50	$ 833.25	0.03%	
Shipping				
Baltic Dry Freight	1684	1697	-13	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.5		
Gasoline (mb)		0.0		
Distillates (mb)		1.5		
Refinery run rates (%)		-0.60%		
Natural gas (bcf)		58.0		

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. Precipitation is expected for most of the country. There is no tropical cyclone activity expected over the next 48 hours in the Atlantic basin.

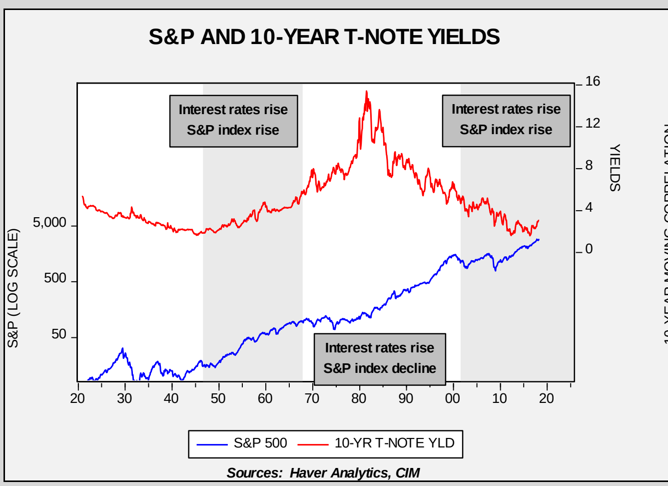
Asset Allocation Weekly Comment

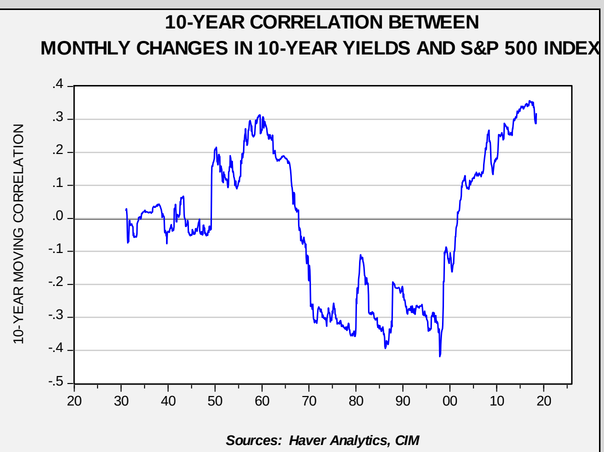
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

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.





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

---

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.

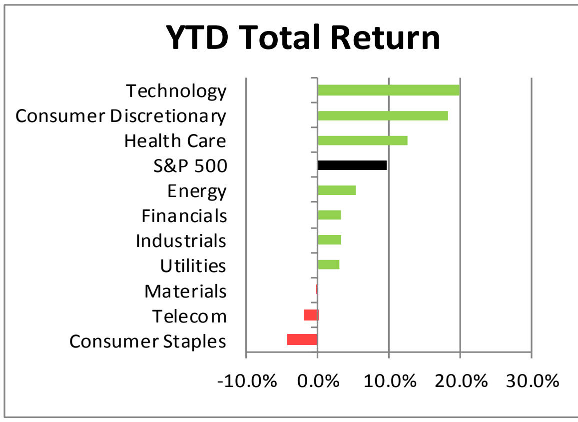
Since 2002 into the present, the correlation sign has reverted back to the 1946-67 condition. This means that holding long-duration bonds in a portfolio will act as an effective hedge to an equity portfolio. In other words, when equity prices fall, the prices within the fixed income portion of the portfolio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

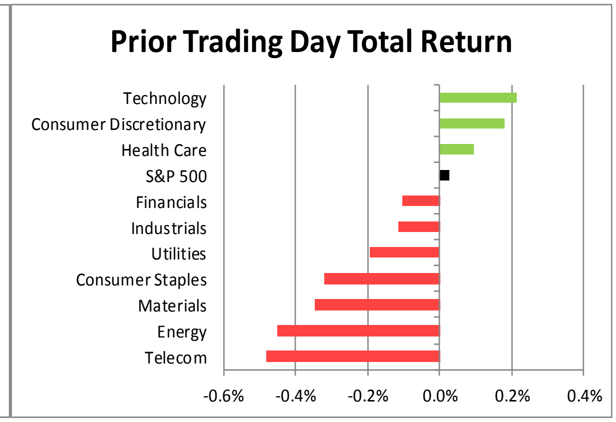
Modern portfolio theory postulates that holding two less than perfectly correlated assets will offer some degree of risk-adjusted outperformance. And, it is worth noting that the rolling correlation shown above isn't ever all that strong, maxing out at around 0.4. So, even during the late 1960s into 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 8/28/2018 close)

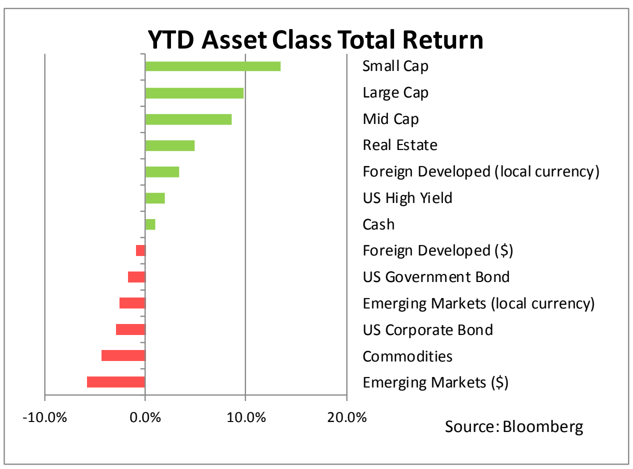




(Source: Bloomberg)

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 8/28/2018 close)

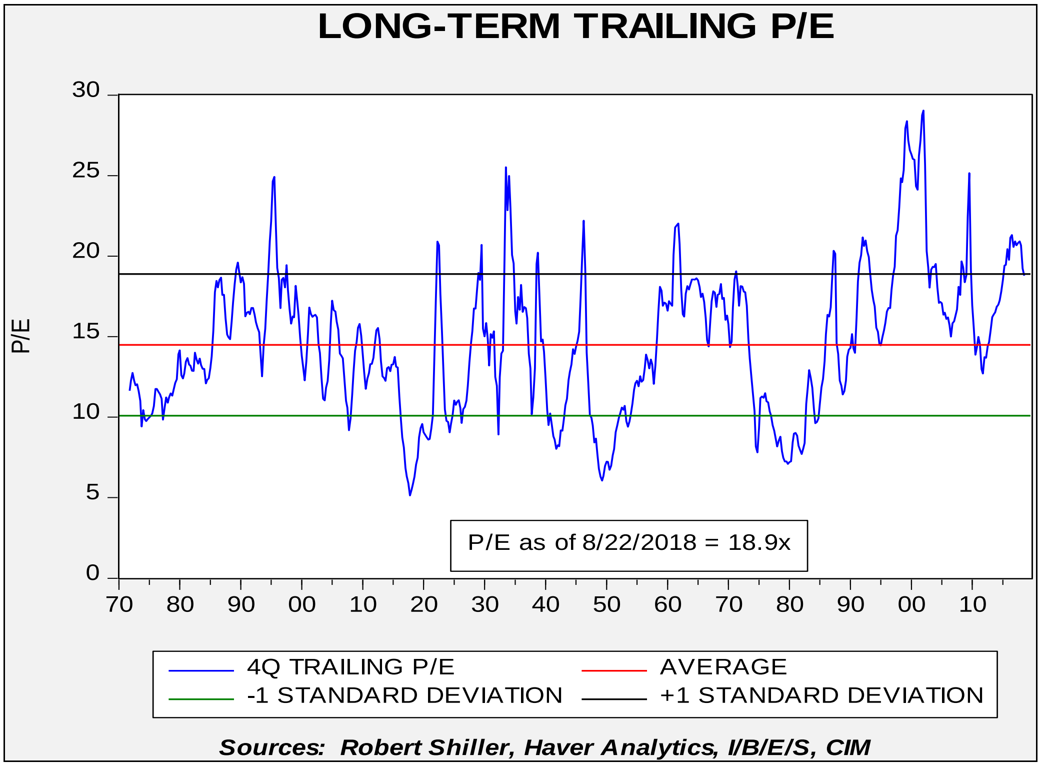


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

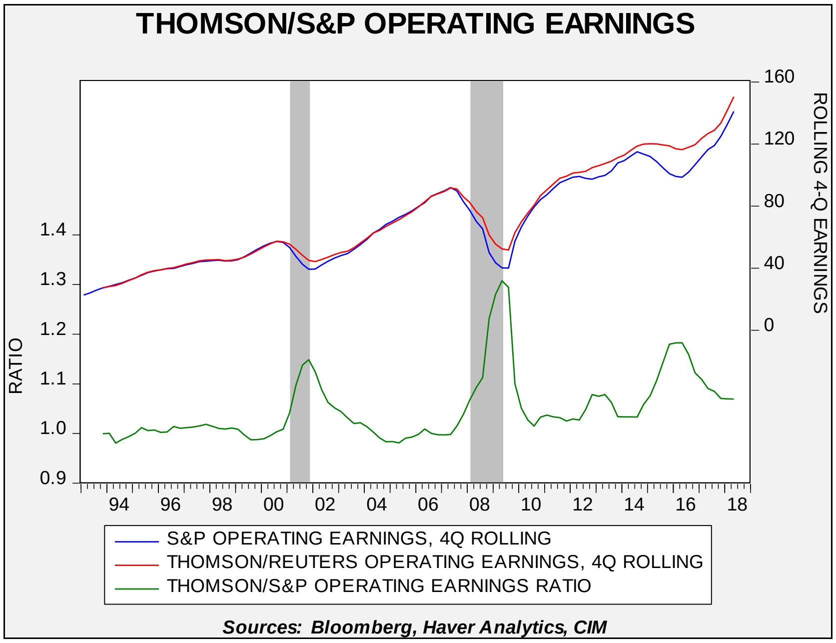


Based on our methodology,[12] the current P/E is 18.9, up 0.4x from last week.

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.



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.