

*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 3, 2018—9:30 AM EDT]** Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.6% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.5% from the prior close. Chinese markets were down, with the Shanghai composite down 1.0% and the Shenzhen index down 1.7%. U.S. equity index futures are signaling a higher open. With 381 companies having reported, the S&P 500 Q2 earnings are above expectations at \$40.69 compared to the \$39.20 forecast for the quarter. The forecast reflects a 19.9% increase from Q2 2017 earnings. Thus far this quarter, 82.7% of the companies reported earnings above forecast, while 12.3% reported earnings below forecast.

**Happy Beer Day!**<sup>1</sup> Also, it's employment data day. We detail the data below but the quick take is that the data is a bit better than expected but not so strong as to change policy. Financial markets are treating the report with some caution, mostly due to the weaker headline data on payrolls; initially, equities fell modestly on the news, the dollar retreated and bonds held mostly steady. Here is what we are watching today.

**Trade update:** China has announced a series of retaliation acts against the U.S., a \$60 bn list of goods for tariffs. We have seen some pullback in equity markets on the news, although the impact was rather modest. Meanwhile, talks with Mexico are showing signs of improvement and Canada appears poised to join the negotiations. For now, trade hostilities are focused on China.<sup>2</sup>

**Mileage standards:** The Trump administration took action yesterday to roll back Obama-era mileage standards for autos.<sup>3</sup> The new standard will be held at 2020 levels, which is around 37 mpg for fleets. Obama's original plan was for fleet standards to reach 54.5 mpg by 2025. Perhaps even more important is the goal of ending California's dominance in setting environmental rules by ending the state's authority to establish its own auto emissions standards. That will allow the auto industry to focus on a 50-state regulatory environment and no longer be forced to adjust to the actions of a single, but very important, state in terms of auto demand.

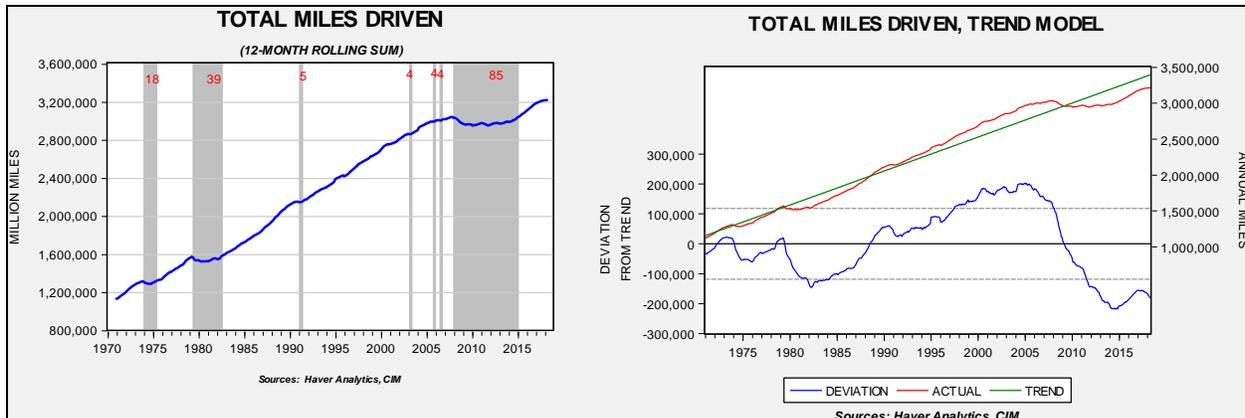
On its face, this is a major win for the automakers and oil companies. For automakers, it will free them from difficult to achieve standards and allow them to sell cars Americans seem to

<sup>1</sup> <http://ec.europa.eu/eurostat/web/products-eurostat-news/-/EDN-20180803-1?inheritRedirect=true&redirect=%2Feurostat%2F> and <https://www.youtube.com/watch?v=e3WkVUe8xRI>

<sup>2</sup> <https://www.ft.com/content/425448b8-9674-11e8-b747-fb1e803ee64e?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56>

<sup>3</sup> <https://www.nbcnews.com/business/autos/trump-administration-revokes-obama-era-fuel-economy-standards-n896846>

prefer, which are larger SUVs and light trucks. For the oil industry, the Obama mileage standards were part of a two-part nightmare. Not only did the standards mean that gasoline consumption per vehicle was poised to decline but, in addition, the industry is dealing with a major trend change in miles driven.



The chart on the left shows total annual miles driven by autos and light trucks. We have put gray bars during periods when that month is below the previous peak. As the chart shows, most of the time, until 2008, we made new highs each month. The chart on the right shows the level of miles driven per year relative to trend. As the lower line shows, we fell below trend during the financial crisis and have not returned to trend.

The reason for the continued stagnation in miles driven is complicated. The slow development of household formation among the 19-35 age cohort likely plays a role. The advent of social media likely affects the trend as well (one no longer has to “cruise” the local burger joint or go to the mall to meet up with friends). We may have reached “peak sprawl,” ending the ever-expanding commutes that bolstered the upward trend. There is little evidence that we are returning to trend anytime soon, so the oil industry is being forced to cope with a loss of demand that will be hard to offset. Consequently, the change in mileage standards has to be welcome news for the oil industry because the miles driven trend coupled with increased efficiency is a clear path to weaker consumption.

Losers with this news are the electric car sector, copper and lithium and public transportation projects. There will be a tendency for households to lean toward gasoline powered vehicles, which are usually less expensive.

However, there is an important underlying issue that this event highlights. Put oneself into the position of a vehicle manufacturer. If the Obama-era rules were to remain in place, about the only way to reach those standards would be through increased hybridization. Building hybrid cars and introducing new generations of larger, battery powered electric motors, along with a plug-in capability, was the likely path forward. And, doing research to expand and improve hybridization would be reasonable as well. Now that the standards have changed, does the industry now stop that process?

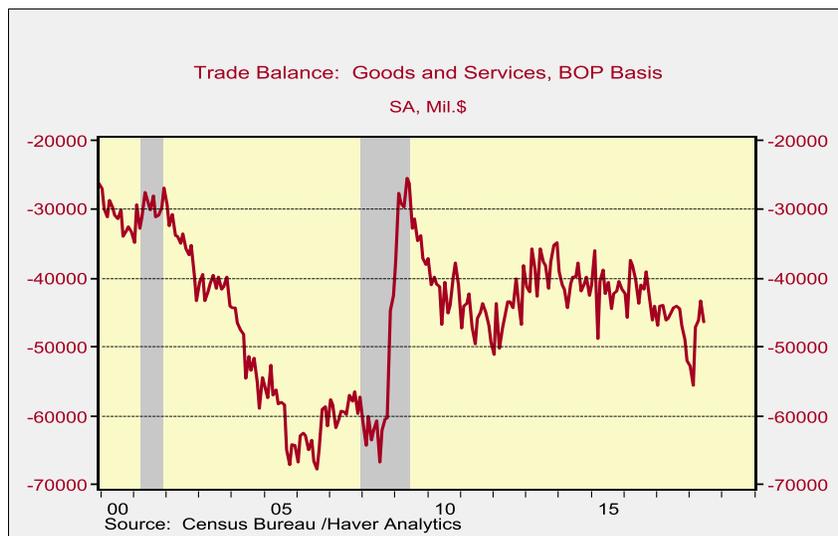
There is a risk to doing so and it has to do with how government works now. The Cold War consensus led to mostly steady policies in regulation. That isn't to say policies never changed, but change was usually legislated, making it "sticky," and was maintained by the subsequent administrations with modest tweaks. But, in our current age of discord, policy is often made by executive order. Even when legislation passes, much of the actual rule-making is still done by regulatory bodies. Thus, the next executive can simply reverse the previous policy by either changing it or not enforcing earlier rules. If a populist left-wing government takes power in 2020 or 2024, these mileage rules could revert back to the Obama-era rules or perhaps become even stricter. If an auto company abandons hybridization research, it could find itself at a horrible disadvantage of not being able to meet the new standards.

This age of discord means that the potential for policy "whipsaw" increases and forces companies to gamble on where future regulation will go. In addition, it increases the stakes in elections, making them more "life and death," and thus encourages not only more lobbying efforts but also election interference.

Although the media will focus on what just passed, investors and companies have to look beyond the present and estimate how likely it is that policy will change in the future. That means forecasting political outcomes as well as the path of development and future consumer demand. It will be interesting to see how automakers react to this change.

### U.S. Economic Releases

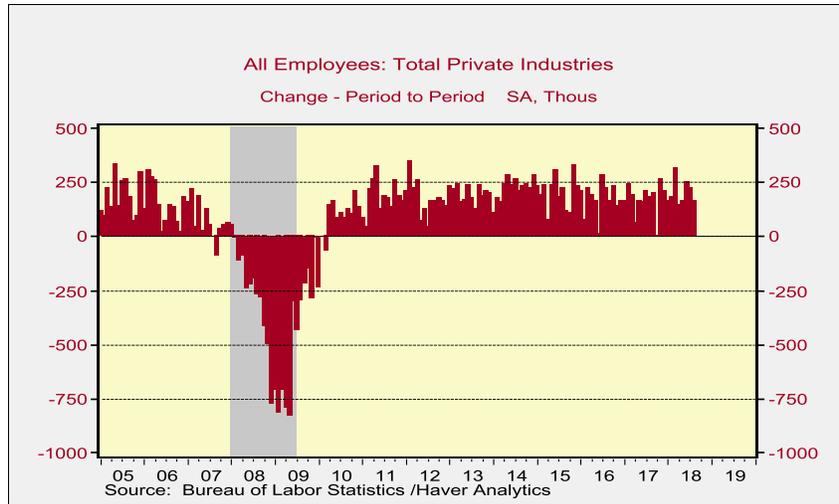
The trade deficit came in narrower than expected at \$46.3 bn compared to the forecast of \$46.5 bn. The prior report's deficit was revised wider from \$43.1 bn to \$43.2 bn.



The chart above shows the level of the trade balance for goods and services.

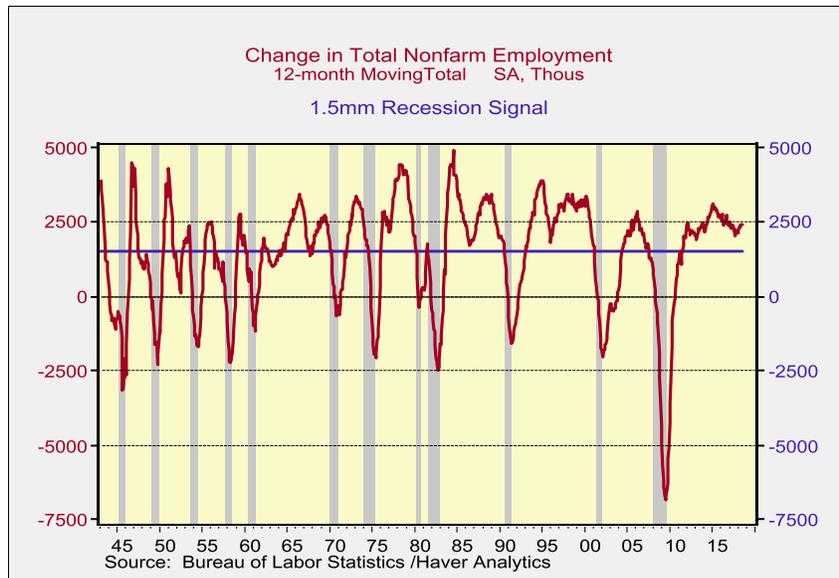
The change in non-farm payrolls for July came in below expectations at 157k compared to the forecast of 193k. The prior report was revised upward from 213k to 248k. The change in private

payrolls came in below expectations at 170k compared to the forecast of 190k. The prior report was revised upward from 202k to 234k. The change in manufacturing payrolls was above expectations at 37k compared to the forecast of 25k.

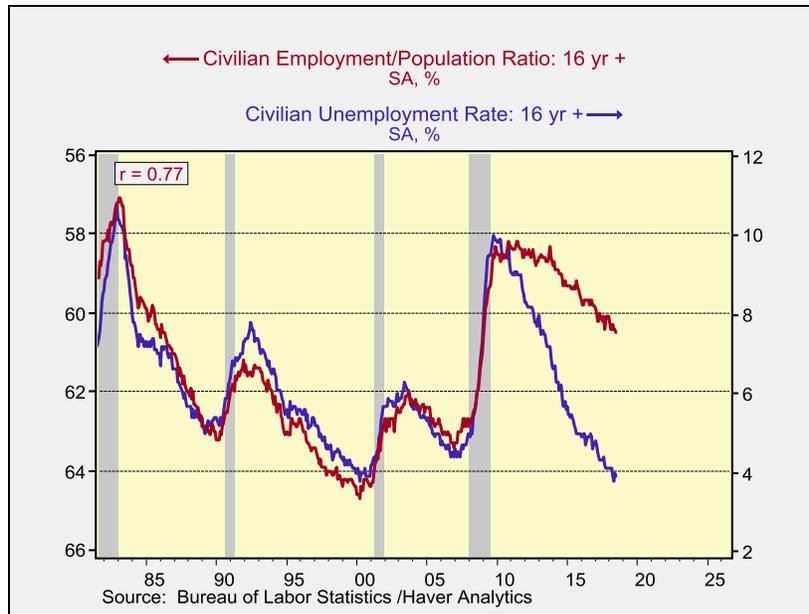


The chart above shows the change in total private employment. This chart suggests the economic expansion continues.

The chart below shows the 12-month moving total of the change in non-farm payrolls; a dip under 1.5 mm signals recession.



The unemployment rate came in better than expectations at 3.9% compared to the forecast of 4.0%. The labor force participation rate was 62.9%, while the U-6 unemployment rate fell 30 bps from 7.8% to 7.5%.



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.

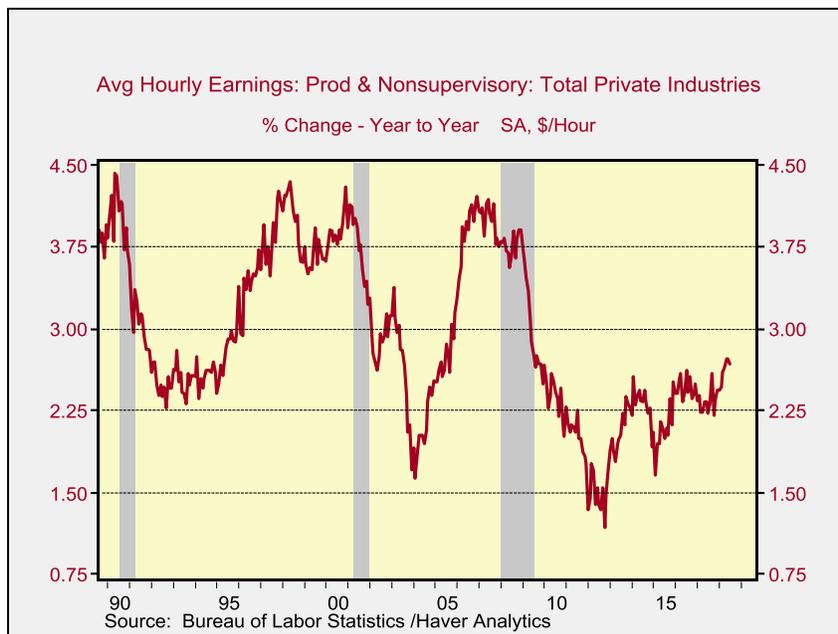


The chart above shows the underemployment rate, also referred to as the U-6 rate. This is a broader measure of unemployment and it's showing a tightening labor situation.

A similar measure is the level of involuntary part-time employment. That measure fell to 2.8% of the labor force, a new cycle low.



Average hourly earnings for all workers came in line with expectations, rising 0.3% from the prior month. The chart below shows the yearly change in overall wages for non-supervisory and production workers.



As mentioned, this chart shows the yearly growth in hourly earnings for production and non-supervisory workers. On an annual basis, wage growth for production and non-supervisory employees rose 2.7%, in line with the prior month. Wage growth remains subdued even with the historically low unemployment rate.

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

Economic Releases							
EDT	Indicator				Expected	Prior	Rating
9:45	Markit US Services PMI	m/m	jul		56.2	56.2	**
9:45	Markit US Composite PMI	m/m	jul			55.9	**
10:00	ISM Non-Manf. Composite	m/m	jun		58.6	59.1	**
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
<b>ASIA-PACIFIC</b>								
China	Caixin China PMI Composite	m/m	jul	52.3	53.0		**	Equity and bond neutral
	Caixin China PMI Services	m/m	jul	52.8	53.9	53.5	**	Equity bearish, bond bullish
Japan	Nikkei Japan PMI Services	m/m	jul	51.3	51.4		**	Equity and bond neutral
	Nikkei Japan PMI Composite	m/m	jul	51.8	52.1		**	Equity and bond neutral
India	Nikkei India PMI Services	m/m	jul	54.2	52.6		**	Equity and bond neutral
	Nikkei India PMI Composite	m/m	jul	54.1	53.3		**	Equity and bond neutral
Australia	AIG Performance of Services Index	m/m	jul	53.6	63.0		**	Equity bearish, bond bullish
	CBA Australia PMI Services	m/m	jul	52.3	52.7		***	Equity and bond neutral
	CBA Australia PMI Composite	m/m	jul	52.3	52.9		**	Equity and bond neutral
	Retail Sales	m/m	jun	0.4%	0.4%	0.3%	**	Equity bullish, bond bearish
New Zealand	ANZ Job Advertisements	m/m	jul	3.1%	-1.6%		**	Equity and bond neutral
<b>EUROPE</b>								
Eurozone	Markit Eurozone Services	y/y	jul	54.2	54.4	54.4	**	Equity and bond neutral
	Markit Eurozone Composite	m/m	jul	54.3	54.3	54.3	**	Equity and bond neutral
	Retail Sales	m/m	jul	1.2%	1.4%	1.4%	**	Equity and bond neutral
Germany	Markit Germany Services	m/m	jul	54.1	54.4	54.4	**	Equity and bond neutral
	Markit Germany Composite	m/m	jul	55.0	55.2	55.2	**	Equity and bond neutral
Italy	Industrial Production	y/y	jul	1.7%	2.1%	1.5%	**	Equity bullish, bond bearish
	Retail Sales	m/m	jun	1.5%	0.4%		**	Equity and bond neutral
	Markit Italy Services	m/m	jul	54.0	54.3	53.7	**	Equity and bond neutral
	Markit Italy Composite	m/m	jul	53.0	53.9	53.4	**	Equity bearish, bond bullish
U.K.	Markit/CIPS UK Services PMI	m/m	jul	53.5	55.1	54.7	**	Equity bearish, bond bullish
	Markit/CIPS UK Composite PMI	m/m	jul	53.6	55.2	54.9	**	Equity bearish, bond bullish
Switzerland	CPI	y/y	jul	1.2%	1.1%	1.2%	***	Equity and bond neutral
	CPI EU Harmonized	y/y	jul	1.2%	0.9%	1.0%	***	Equity and bond neutral
Russia	Markit Russia Services	m/m	jul	52.8	52.3	53.0	**	Equity and bond neutral
	Markit Russia Composite	m/m	jul	51.7	52.0		**	Equity and bond neutral
<b>AMERICAS</b>								
Mexico	Leading Indicators	m/m	jun	-0.07	-0.12		**	Equity and bond neutral
Brazil	Industrial Production	m/m	jun	13.1%	-10.9%	14.0%	***	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
<b>3-mo Libor yield (bps)</b>	235	235	0	Up
<b>3-mo T-bill yield (bps)</b>	196	197	-1	Neutral
<b>TED spread (bps)</b>	39	38	1	Neutral
<b>U.S. Libor/OIS spread (bps)</b>	202	202	0	Up
<b>10-yr T-note (%)</b>	2.98	2.99	-0.01	Up
<b>Euribor/OIS spread (bps)</b>	-32	-32	0	Neutral
<b>EUR/USD 3-mo swap (bps)</b>	7	7	0	Down
<b>Currencies</b>	<b>Direction</b>			
dollar	down			Neutral
euro	up			Neutral
yen	up			Neutral
pound	up			Neutral
franc	up			Neutral
<b>Central Bank Action</b>	<b>Current</b>	<b>Prior</b>	<b>Expected</b>	
Overnight Rate	7.750%	7.750%	7.750%	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
<b>Energy Markets</b>				
Brent	\$73.55	\$73.45	0.14%	
WTI	\$68.99	\$68.96	0.04%	
Natural Gas	\$2.83	\$2.82	0.46%	
Crack Spread	\$18.85	\$18.79	0.32%	
12-mo strip crack	\$19.51	\$19.52	-0.07%	
Ethanol rack	\$1.57	\$1.57	-0.09%	
<b>Metals</b>				
Gold	\$1,212.32	\$1,207.83	0.37%	
Silver	\$15.45	\$15.31	0.88%	
Copper contract	\$276.25	\$273.75	0.91%	
<b>Grains</b>				
Corn contract	\$ 382.75	\$ 381.25	0.39%	
Wheat contract	\$ 583.50	\$ 582.75	0.13%	
Soybeans contract	\$ 895.50	\$ 897.50	-0.22%	
<b>Shipping</b>				
Baltic Dry Freight	1756	1760	-4	
<b>DOE inventory report</b>				
	<b>Actual</b>	<b>Expected</b>	<b>Difference</b>	
Crude (mb)	3.8	-3.0	6.8	
Gasoline (mb)	-2.5	-2.1	-0.4	
Distillates (mb)	3.0	-0.1	3.1	
Refinery run rates (%)	2.30%	0.60%	1.7%	
Natural gas (bcf)	35.0	42.0	-7.0	

## Weather

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

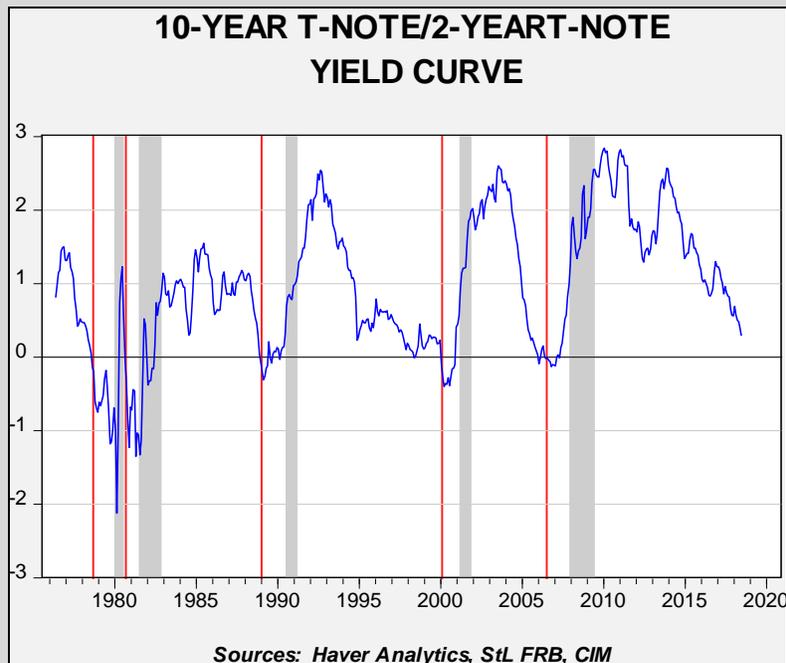
## **Asset Allocation Weekly Comment**

*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.*

August 3, 2018

At the end of June, we published a study of how the equity and bond markets reacted to the inversion of the yield curve. This week’s report takes that inversion data and compares it to how the 10 sectors of the S&P 500 perform.<sup>4</sup> For this report, we will use the two-year/10-year Treasury spread as our yield curve variation; although this alternative has a shorter history than the fed funds/10-year Treasury spread, data on the 10 sectors we will analyze begins in 1988. Thus, the two-year/10-year Treasury spread will offer enough history to analyze the behavior of the sectors.

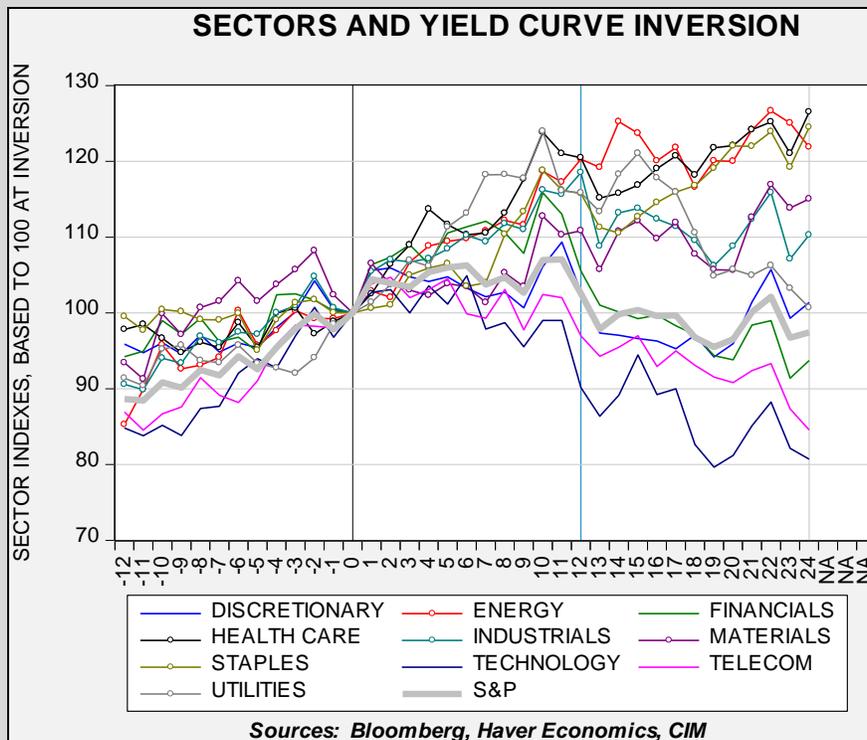
For reference, this is the two-year/10-year Treasury spread.



The gray bars show recession and the red vertical lines are placed where the yield curve inverts. On average, it takes 15-months from inversion to recession, with the range being 10 to 18 months.

The sector data only covers the last three recessions. We have taken each inversion and index the 10 sectors to the inversion, tracking the data one year before the inversion and two years after. The chart below averages the three events.

<sup>4</sup> We exclude REITS from this study.



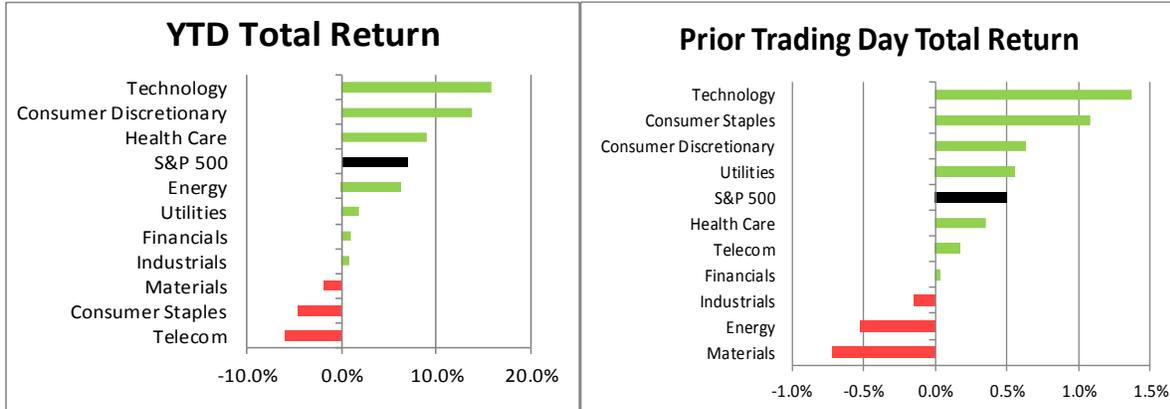
We have placed vertical lines at the point of inversion at one year and two years from inversion. As we noted earlier, the overall S&P 500 tends to avoid an outright decline until the recession starts. The best sectors are Health Care, Consumer Staples and Energy. Materials and Industrials tend to hold up. The worst performing sectors are Technology, Telecom and Financials, although Financials performed rather well in the 2000 inversion. Thus, there are no huge surprises here. Health Care and Consumer Staples are defensive sectors. In all three cases, oil prices were rising into the inversions and thus supported energy equities. The 2000 inversion and subsequent recession also ushered in a major decline in Technology and Telecom and these sectors were generally weak during the other two events. Finance fell hard in the 1989 and 2006 inversions.

This tells us that when the next inversion occurs, investors should consider positions in Health Care, Consumer Staples and Energy, with underweights in Technology and Telecom. Obviously, each cycle has its own unique characteristics, but history does offer some insight into potential market behavior.

*Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.*

**Data Section**

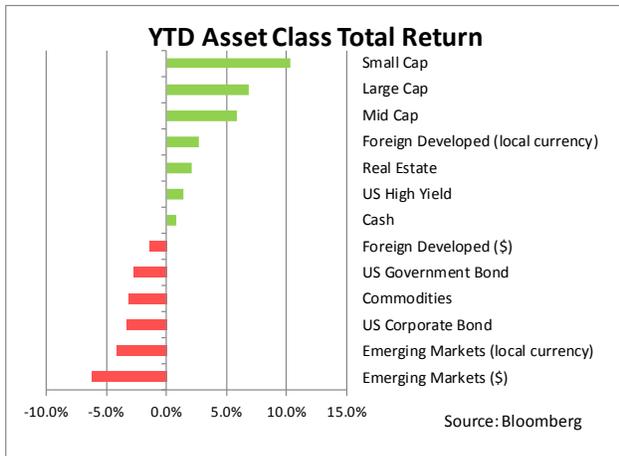
**U.S. Equity Markets – (as of 8/2/2018 close)**



(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 8/2/2018 close)**



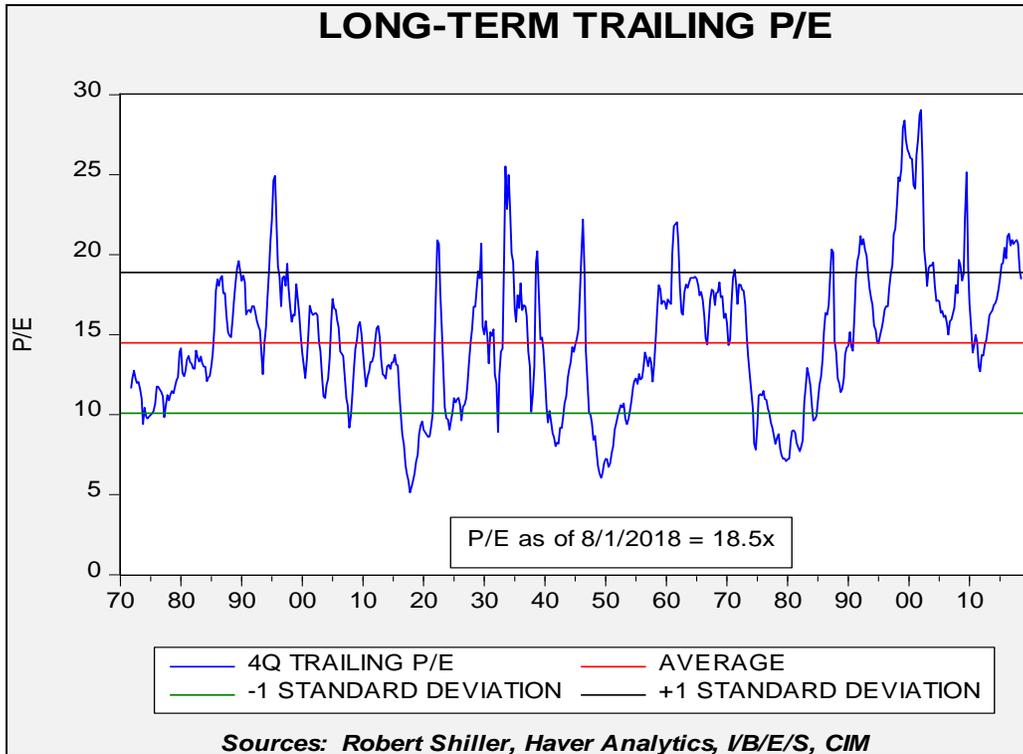
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 2, 2018



Based on our methodology,<sup>5</sup> the current P/E is 18.5, 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.*

<sup>5</sup> 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.