Confluence Investment Management

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 9, 2018—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is down 0.4% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.5% from the prior close. Chinese markets were up, with the Shanghai composite up 1.8% and the Shenzhen index up 2.7%. U.S. equity index futures are signaling a higher open. With 440 companies having reported, the S&P 500 Q2 earnings are above expectations at $41.31 compared to the $39.20 forecast for the quarter. The forecast reflects a 19.9% increase from Q2 2017 earnings. Thus far this quarter, 80.7% of the companies reported earnings above forecast, while 13.9% reported earnings below forecast.

Markets are quiet this morning. Here is what we are watching:

Trade update: Russia is facing another round of sanctions,[1] these tied to the chemical weapons poisoning in April of British citizen and former Russian spy Sergei Skripal and his daughter. The sanctions are part of a specific U.S. law, the Chemical and Biological Weapons Control and Warfare Elimination Act. The act is designed to punish nations that use chemical and biological weapons; it essentially denies export licenses for dual-use technologies.[2] An interesting aspect of this law is that a second set of "draconian" sanctions will follow if Russia does not supply evidence that it is no longer using such weapons ***and does not allow on-site UN chemical weapons inspections within 90 days***.[3]

Needless to say, Russia is furious about these new sanctions, although some of their effectiveness will be reduced if the EU doesn't go along. Attaining unity among the EU nations for sanctions will be hard as the new Italian government has been quite friendly to Moscow and may not support action. Russian financial assets, especially the RUB, weakened on the news.

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[1] https://www.ft.com/content/0bfcff0c-9bb6-11e8-9702-5946bae86e6d and https://www.nytimes.com/2018/08/08/world/europe/sanctions-russia-poisoning-spy-trump-putin.html
[2] https://www.ft.com/content/0d1d64dc-9b41-11e8-ab77-f854c65a4465
[3] Ibid.

(Source: Bloomberg)

China announced it is retaliating[4] against the recent tariffs from the Trump administration on $16 bn of Chinese goods. Yesterday, we noted that Chinese officials were meeting for their annual meetings at the Beidaihe resort. We have been hearing increased rumblings of discontent with Chairman Xi. Although we don't think his position is in doubt, it does appear the chairman is getting some criticism, with the focus being that he may have overplayed his hand with the U.S.[5]

Last month's acclaimed meeting between President Trump and EC President Juncker did avert a trade war but the Europeans have indicated the promised trade talks won't happen anytime soon. According to reports, EU negotiators need another six weeks to prepare. We suspect this is a stall tactic. The Europeans are likely hoping that the GOP will lose legislative power in the mid-term elections which will distract the president and lead to a reduction in trade pressure.

A comment on Tuesday's election: Missouri voters overwhelming rejected a "right-to-work" proposal that was on the ballot. Right-to-work laws make "closed shops" illegal; in a closed shop, a worker doesn't have to join the union but he must pay dues to the union as a condition of employment. In an open shop, a worker can choose to accept or reject union representation and he is not required to pay dues if he rejects joining. Unions argue that open shops encourage workers to "free ride" the union, getting the negotiated benefits without paying dues for representation. Open shop advocates argue that no one should be forced to join a group they may not agree with.

Initially, the Missouri legislature, dominated by the GOP, passed a right-to-work measure but labor groups were able to gather enough petition signatures to bring the issue to the voters. This lopsided win for labor in a deep red state is something of a surprise. But, to use our "identity and

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4 https://www.wsj.com/articles/china-hunkers-down-for-a-long-trade-fight-1533731889
5 https://www.reuters.com/article/us-usa-trade-china-politics-analysis/handling-of-u-s-trade-dispute-causes-rift-in-chinese-leadership-sources-idUSKBN1KU0TU?il=0

class" paradigm we discussed in a recent WGR,[6] it is quite likely that voters who would usually support Republicans were able to vote for their class interests on this specific issue, separate from their identity interests. It is likely these union GOP voters would probably still support a Republican candidate, even if that candidate espoused a right-to-work position, because they would perceive their identity interests are being met even if their class interests are not. Although this vote has raised some speculation that the labor rank and file might be moving back to the Democrats,[7] we doubt this is the case. Identity interests are very strong. What will be interesting to watch in the coming years is if the GOP begins to support labor-friendly policies to adapt to this part of the electorate and reject the business-friendly element of its constituency (the recent blow-up with the Kochs comes to mind).

Turkey and China: Turkey's energy minister announced that China will build a nuclear power plant northwest of Istanbul.[8] This news comes on the heels of comments from China's ambassador to Syria, along with its military attaché, that China is open to the possibility of Chinese military operations in Syria to support the government.[9] It appears that China's interest is in preventing the Turkistan Islamic Party from training Uighur militants that operate in China's far west Uighur province. Although there has been no confirmation of China sending any military personnel, the comment itself is striking and further evidence that other nations are looking to fill the power vacuum created by the slow withdrawal of American influence.

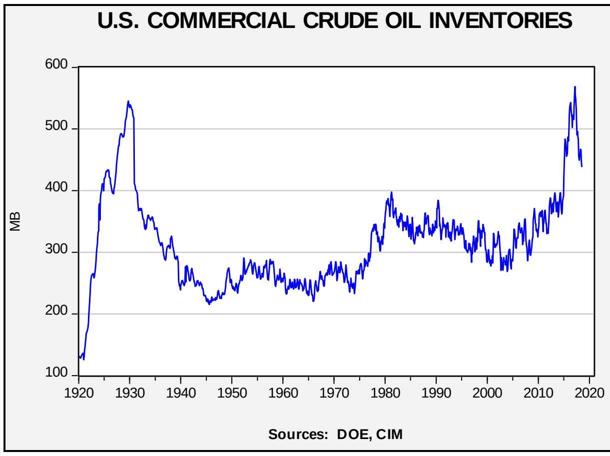
Meanwhile, the U.S. and Turkey have been unable to resolve their differences on U.S. citizens being held in detention. The TRY continues to probe new lows on the lack of progress.

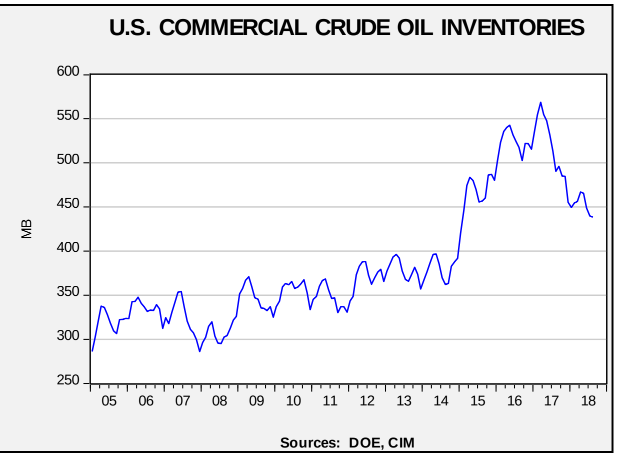
(Source: Bloomberg)

[6] See WGRs, Reflections on Politics and Populism: Part I (7/16/18) and Part II (7/23/18)
[7] https://www.politico.com/story/2018/08/08/unions-missouri-election-trump-728260
[8] https://en.trend.az/world/turkey/2938307.html
[9] https://www.stratfor.com/article/china-military-officials-help-syrian-army-retake-idlib (paywall)

Is a key support for Treasuries on the way out? As part of the recent tax law, corporations have been granted a temporary tax break. Companies can deduct their payments to pensions but the cut in the highest marginal rate, from 35% to 21%, reduces the value of those payments on a post-tax basis. However, the tax law allows payments to pensions to be deducted at the old 35% rate until September 15. Reports suggest firms have been aggressively taking advantage of this measure and buying long-dated Treasuries for their pension funds. That may be part of the reason why longer dated Treasuries have performed well in recent months and could rally further as firms rush to take advantage of this loophole. However, there is the potential for a rate back-up after mid-September when the measure expires.[10] We would argue that the impact of this measure may be overstated, that continued low inflation and low inflation expectations are still more important to yields, but a back-up in yields next month might occur simply based on sentiment.

Energy recap: U.S. crude oil inventories fell 1.4 mb compared to market expectations of a 3.0 mb draw.

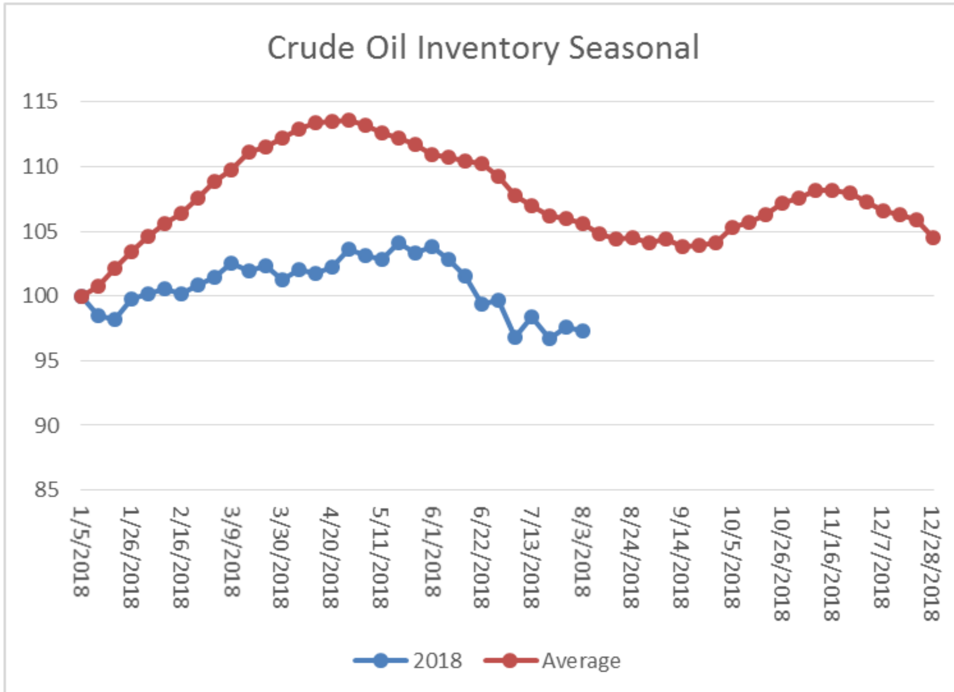




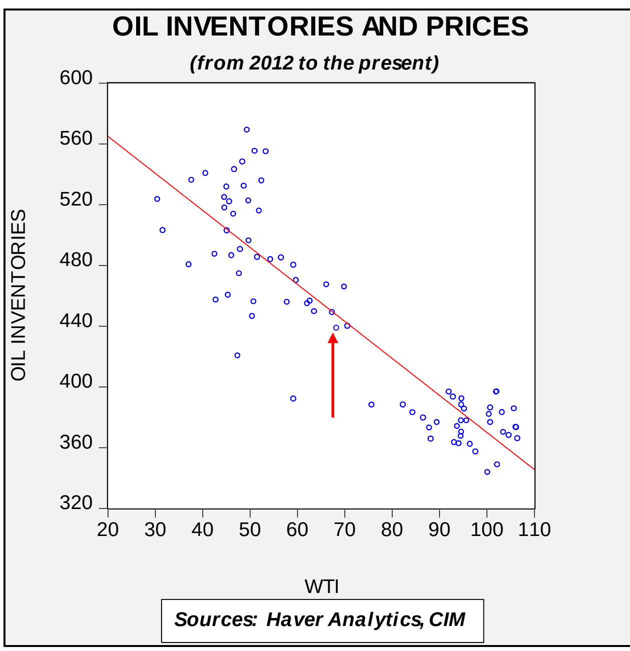
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but have declined significantly since March 2017. We would consider the overhang closed if stocks fall under 400 mb. This week's decrease in inventories was a bit less than expected as oil exports did not rise as much as anticipated. We do note that U.S. production declined 0.1 mbpd to 10.5 mbpd.

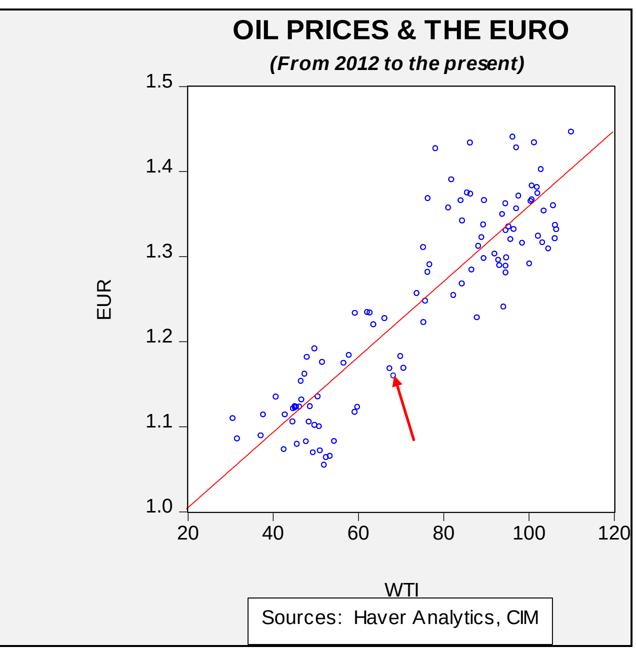
As the seasonal chart below shows, inventories are well into the seasonal withdrawal period. This week's decline in stocks was consistent with seasonal patterns. If the usual seasonal pattern plays out, mid-September inventories will be 401 mb.

[10] https://www.ft.com/content/2042117e-975a-11e8-b747-fb1e803ee64e?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56



(Source: DOE, CIM)

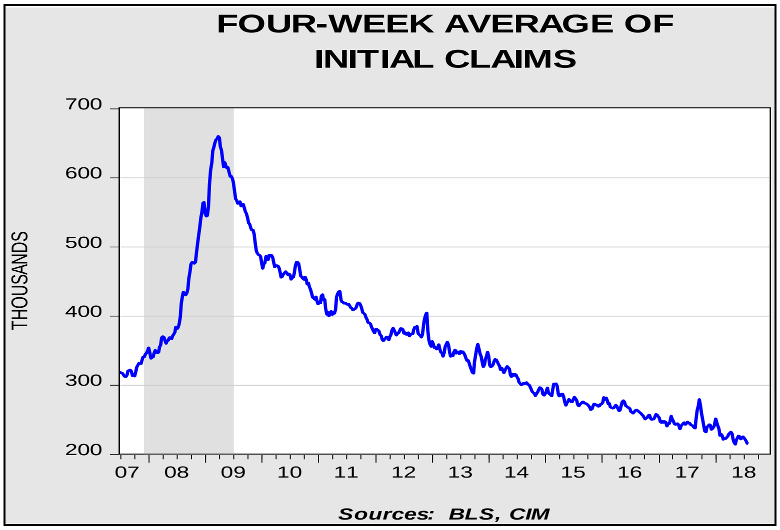




Based on inventories alone, oil prices are near the fair value price of $71.14. Meanwhile, the EUR/WTI model generates a fair value of $59.18. Together (which is a more sound methodology), fair value is $63.14, meaning that current prices are above fair value. Currently, the oil market is dealing with divergent fundamental factors. Falling oil inventories are fundamentally bullish but the stronger dollar is a bearish factor. It should be noted that a 401 mb number by September would put the oil inventory/WTI model in the low $80s per barrel. Although dollar strength could dampen that price action, oil prices should remain elevated.

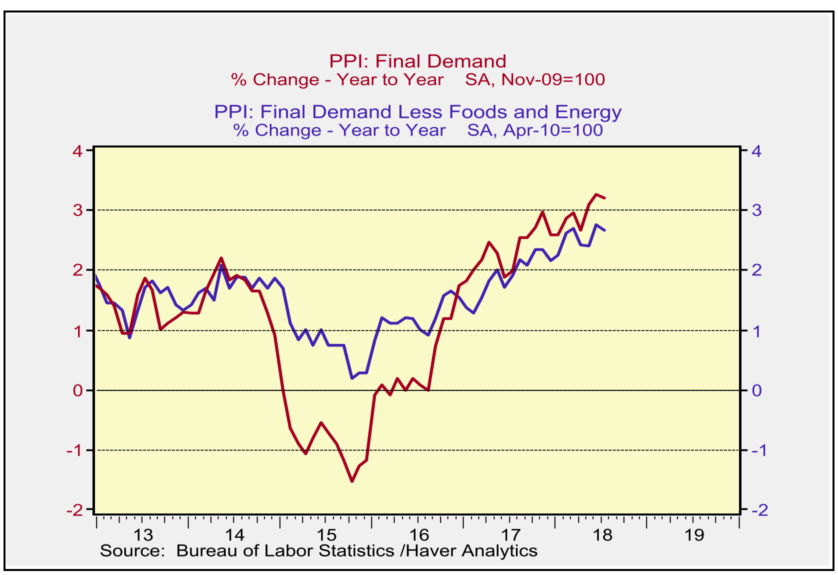
U.S. Economic Releases

Initial jobless claims came in below expectations at 213k compared to the forecast of 220k. The prior report was revised from 218k to 219k.



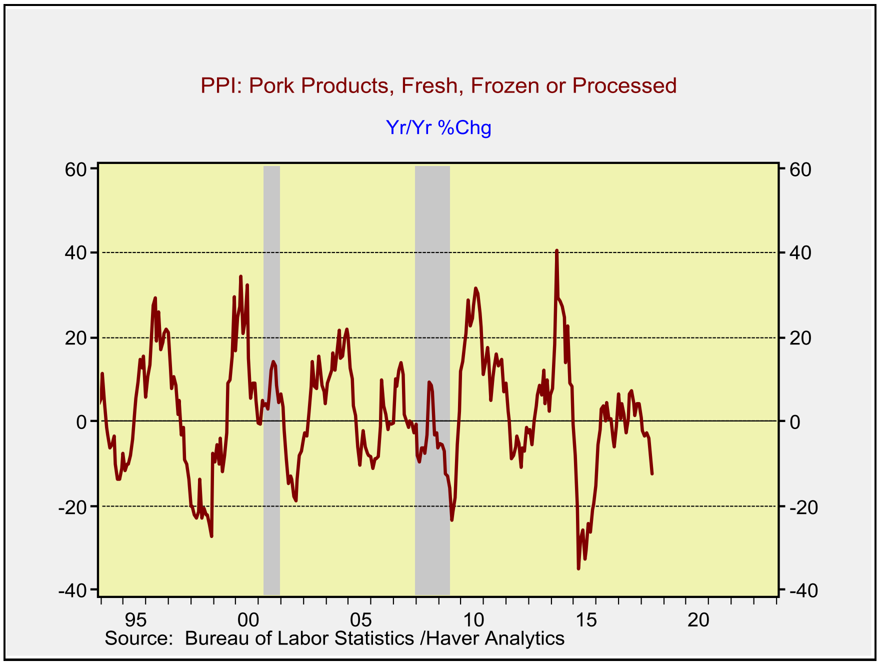
The chart above shows the four-week moving average for initial claims. The four-week moving average decreased from 214.75k to 214.25k.

PPI final demand came in below expectations, remaining unchanged from the prior month compared to the forecast rise of 0.2%. PPI excluding food and energy came in below expectations, rising 0.1% from the prior month compared to the forecast of 0.2%. Core PPI came in above expectations, rising 0.3% from the prior month compared to the forecast of 0.2%.

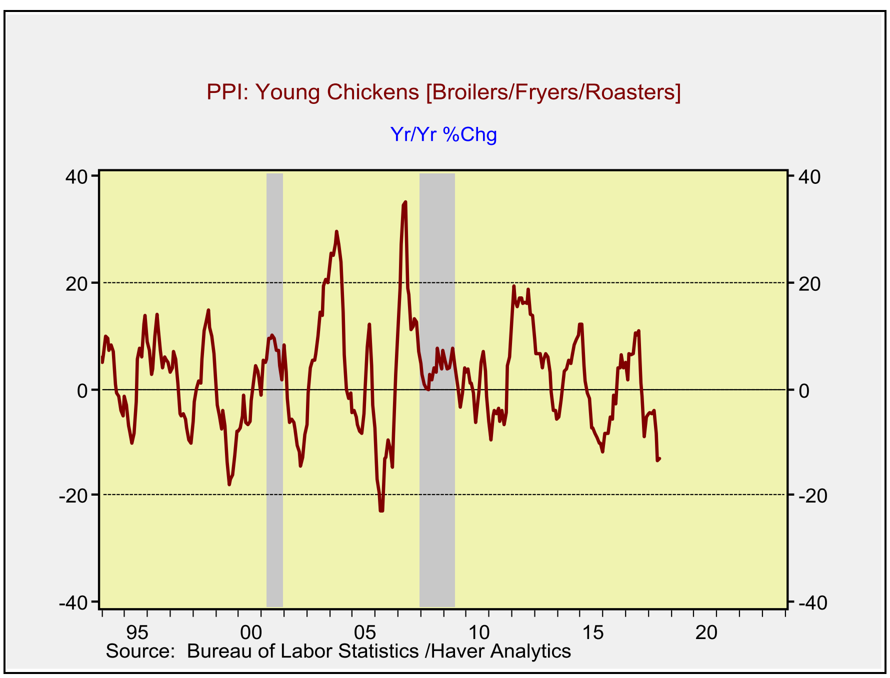


The chart above shows the year-over-year change in PPI and core PPI. Annually, PPI and core PPI rose 3.3% and 2.8, respectively. Although there isn't a strong correlation between PPI and CPI, the PPI report is considered to be a precursor to the CPI report.

Here are a couple other items of interest. Pork and poultry prices have dipped, likely due to retaliatory tariffs. First, pork:



And chicken:



The drop in these prices will offset some of the higher prices brought by tariffs on other goods. However, this "price holiday" won't last as ranchers will adjust by cutting their herds and flocks to adapt to the loss of foreign demand. Simply put, fill the freezer…

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Consumer Comfort	m/m	aug		58.6	**
10:00	Wholesale Inventories	m/m	jul	0.0%	0.0%	**
10:00	Wholesale Trade Sales	m/m	jul	0.2%	2.5%	**
Fed speakers or events						
EST	Speaker or event	District or position				
13:00	Charles Evans Speaks to Reporters	President of the Federal Reserve Bank of Chicago				

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	PPI	m/m	jul	4.6%	4.7%	4.5%	**	Equity and bond neutral
	CPI	m/m	jul	2.1%	1.9%	2.0%	**	Equity and bond neutral
Japan	Housing Loans	y/y	2q	2.7%	2.7%		**	Equity and bond neutral
	Money stock M3	y/y	jul	2.6%	2.7%	2.7%	**	Equity and bond neutral
	Money Stock M2	y/y	jul	3.0%	3.2%	3.1%	**	Equity and bond neutral
	Core Machine Orders	y/y	jun	0.3%	16.5%	10.5%	**	Equity bearish, bond bullish
	Tokyo Average Office Vacancies	m/m	jul	2.58	2.57		**	Equity and bond neutral
EUROPE								
Switzerland	Unemployment Rate	m/m	jul	2.4%	2.4%	2.4%	**	Equity and bond neutral
AMERICAS								
Canada	Building Permits	m/m	jun	-2.3%	4.7%	-0.1%	***	Equity bearish, bond bullish

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)	201	201	0	Neutral
TED spread (bps)	33	33	0	Neutral
U.S. Libor/OIS spread (bps)	204	203	1	Up
10-yr T-note (%)	2.96	2.95	0.01	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	7	7	0	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	down			Neutral
pound	flat			Neutral
franc	flat			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBNZ Official Cash Rate	1.750%	1.750%	1.750%	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
Energy Markets				
Brent	$72.42	$72.28	0.19%	
WTI	$66.98	$66.94	0.06%	
Natural Gas	$2.95	$2.95	0.00%	
Crack Spread	$19.27	$19.23	0.23%	
12-mo strip crack	$19.48	$19.46	0.09%	
Ethanol rack	$1.55	$1.55	-0.30%	
Metals				
Gold	$1,214.51	$1,213.88	0.05%	
Silver	$15.48	$15.43	0.36%	
Copper contract	$280.90	$275.10	2.11%	
Grains				
Corn contract	$ 385.75	$ 385.00	0.19%	
Wheat contract	$ 585.25	$ 591.25	-1.01%	
Soybeans contract	$ 907.50	$ 910.50	-0.33%	
Shipping				
Baltic Dry Freight	1704	1732	-28	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-1.4	-3.0	1.6	
Gasoline (mb)	2.9	-2.0	4.9	
Distillates (mb)	1.2	1.0	0.2	
Refinery run rates (%)	0.50%	0.30%	0.20%	
Natural gas (bcf)		49.0		

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps in the South. Precipitation is expected for most of the country. Tropical Storm Debby has developed in the Atlantic and is currently moving away from the U.S. eastern coastline.

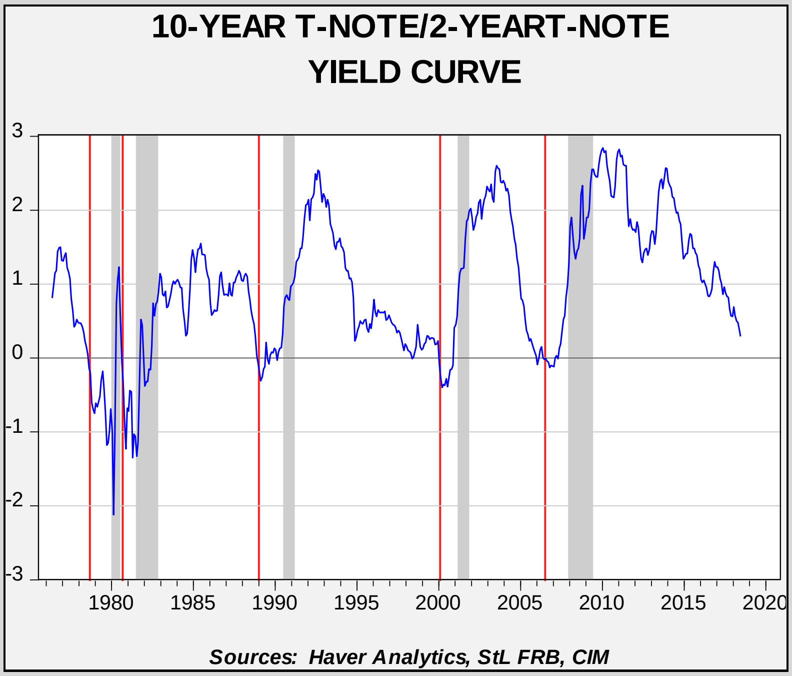
Asset Allocation Weekly Comment

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.[11] 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.

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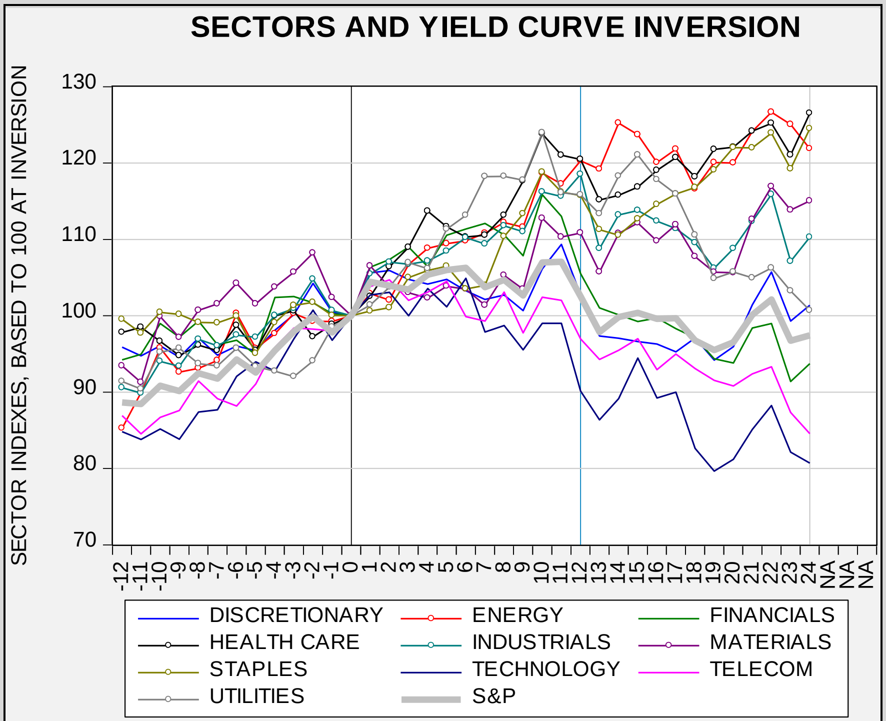
[11] We exclude REITS from this study.



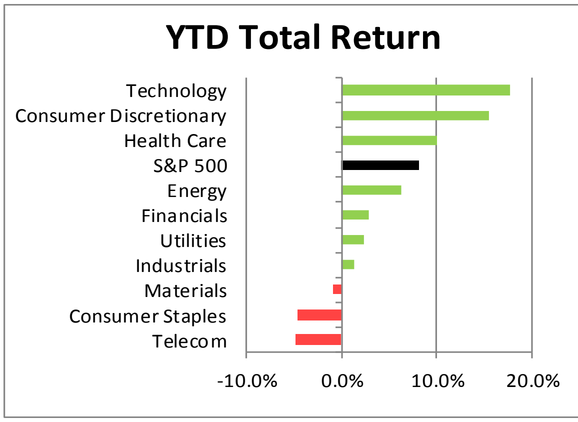
Sources: Bloomberg, Haver Economics, CIM

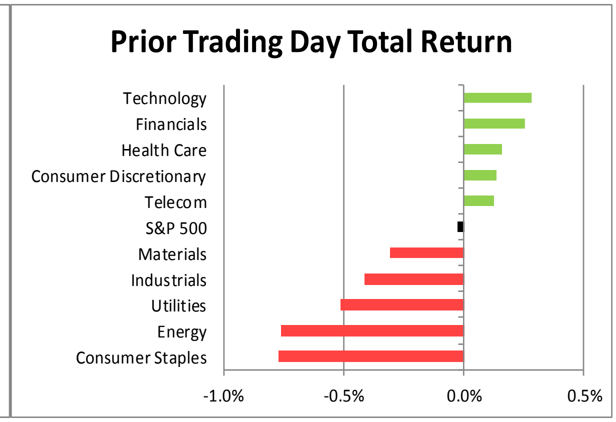
We have placed vertical lines at the point of inversion at one year and two years from inversion. As we noted earlier, the overall S&P 500 tends to avoid an outright decline until the recession starts. The best sectors are Health Care, Consumer Staples and Energy. Materials and Industrials tend to hold 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.

Data Section

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

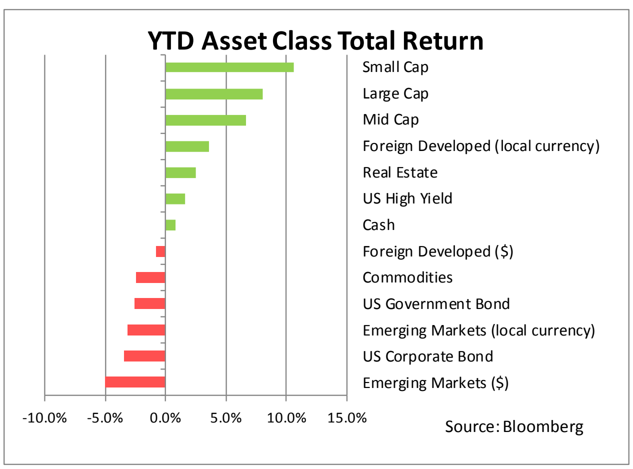




(Source: Bloomberg)

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 8/8/2018 close)

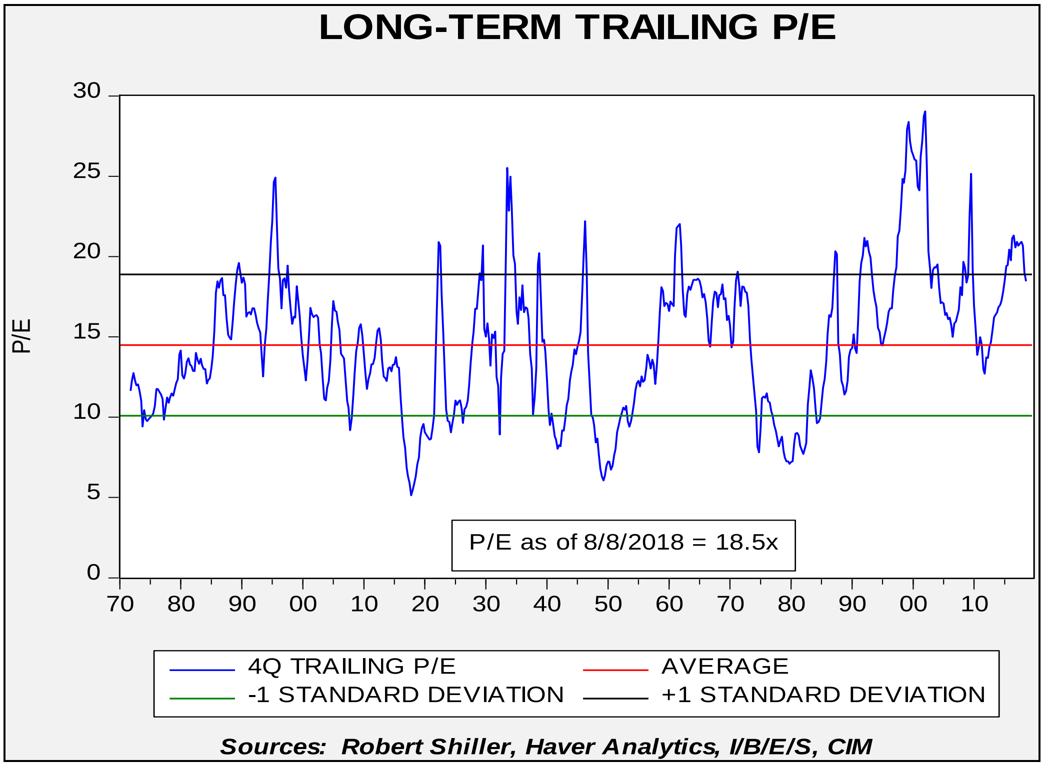


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 9, 2018



Based on our methodology,[12] 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.

[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 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.