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: July 13, 2018—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.3% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.5% from the prior close. Chinese markets were mixed, with the Shanghai composite down 0.2% and the Shenzhen index up 0.5%. U.S. equity index futures are signaling a lower open. With 23 companies having reported, the S&P 500 Q2 earnings stand at $39.20, which is level with the $39.20 forecast for the quarter. The forecast reflects a 19.9% increase from Q2 2017 earnings. Thus far this quarter, 91.3% of the companies reported earnings above forecast, while 4.3% reported earnings below forecast.

Equity markets are mixed this morning as investors balance expectations of stronger earnings and rising trade tensions. The British pound fell due to political uncertainty and the dollar has strengthened against global currencies. Below are the news stories we are following today:

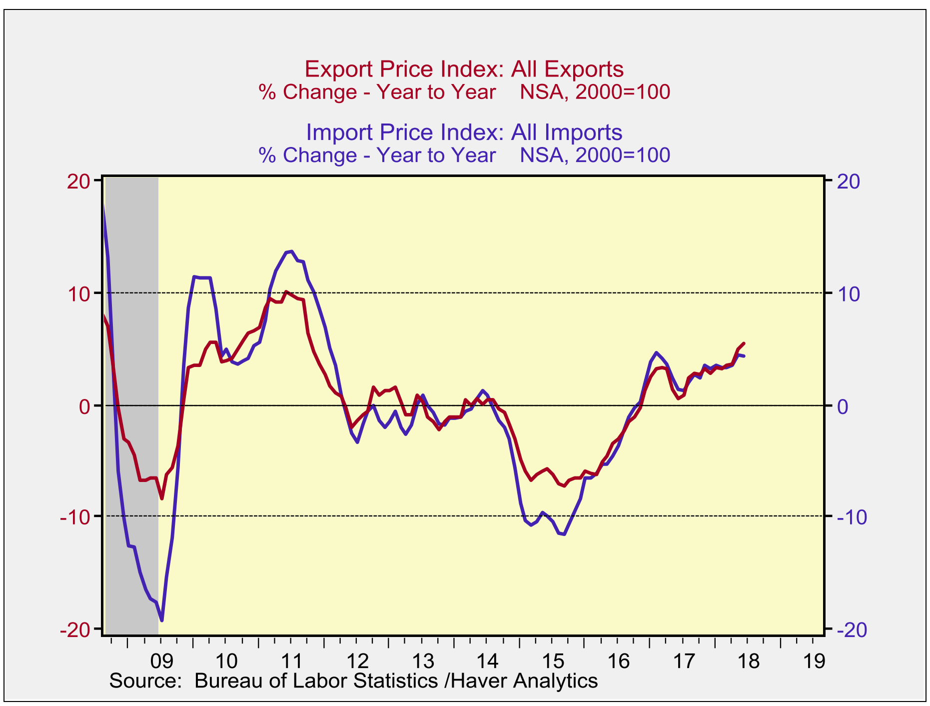
No U.K.-U.S. trade deal? Yesterday, in an interview with the British tabloid *The Sun*, President Trump scolded PM Theresa May for attempting to negotiate a "soft" Brexit. In the interview, he stated that the current deal being negotiated with the EU would likely undermine U.K. efforts to secure a bilateral deal with the U.S. He went on to say that her possible challenger for the premiership, Boris Johnson, would be a great choice for prime minister. President Trump's criticism is likely to add to the political turmoil surrounding PM May as she struggles to maintain her government. Although we still do not expect a leadership challenge in the immediate future, the chances of one happening are slightly elevated, which is the reason for the drop in the pound. As we have mentioned, Tory Eurosceptics can launch a leadership challenge once every twelve months, therefore if they were to challenge and lose they would have less clout in Brexit negotiations as the deadline to secure a Brexit deal expires in eight months. Currently, Tory Eurosceptics have enough support to start the process but still lack the support needed to oust PM May. That being said, President Trump's ultimatum to PM May on Brexit further supports the belief that he favors bilateral agreements over multilateral agreements, which is a break from prior administrations. Prior to the publication of this report, President Trump in a joint press conference with PM May walked back the idea that the U.S. would not be willing to trade with the U.K. if it pushes for a "soft" Brexit.

Bipartisan tariff backlash: Yesterday, Treasury Secretary Steve Mnuchin testified before the House Financial Services Committee. During his testimony, he was hit with a barrage of questions from Republicans and Democrats alike about the effects trade tariffs will have on the U.S. economy. To date, the U.S. has imposed tariffs on steel and aluminum imports from Mexico, Canada, the European Union and China. In addition, the president has hinted at imposing more tariffs in the future, possibly targeting cars. The various countries have responded to the tariffs in kind. There are growing concerns that trade tariffs are likely to hurt individual states. In response to questions on this issue, Mnuchin stated that the U.S. is not in a trade war but rather in a trade dispute, and the administration is currently monitoring the effects that tariffs are having on the economy.

A letter from North Korea: Yesterday, President Trump sought to counter reports suggesting that little progress is being made on North Korean denuclearization by releasing a letter he received from North Korean Leader Kim Jong-un. In the letter, Kim Jong-un expressed his appreciation for Trump's efforts to improve relations between the two sides. Despite this letter, recent negotiation have been a bit rocky. Last week, North Korea accused the U.S. of acting "gangster-like" during negotiations and on Monday failed to show up to an agreed upon meeting site in the demilitarized zone. The U.S. has accused China of being responsible for North Korea's behavior as of late, while China has denied its involvement. We continue to monitor this situation.

U.S. Economic Releases

The import price index came in below expectations, falling 0.4% from the prior month compared to the forecast gain of 0.1%. The prior month's gain was revised upward from 0.6% to 0.9%. The import price index excluding petroleum came in below expectations, falling 0.3% from the prior month compared to the forecast rise of 0.2%. The export price index came in above expectations, rising 0.3% from the prior month compared to the forecast rise of 0.2%.



The chart above shows the year-over-year changes in the import price and export price indexes. The import price and export price indexes rose 4.3% and 5.3%, respectively.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	U. of Michigan Sentiment	m/m	jul	98.0	98.2	**
10:00	U. of Michigan Current Conditions	m/m	jul		116.5	**
10:00	U. of Michigan Expectations	m/m	jul		86.3	**
10:00	U. of Michigan 1 yr Inflation	m/m	jul		3.0%	**
10:00	U. of Michigan 5-10 Yr Inflation	m/m	jul		2.6%	**
Fed speakers or events						
EST	Speaker or event	District or position				
12:30	Raphael Bostic to Meet with Fed Up Coalition in Atlanta	President of the Federal Reserve Bank of Atlanta				

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	Industrial Production	m/m	may	4.2%	4.2%		***	Equity and bond neutral
	Capacity Utilization	m/m	may	-2.1%	1.8%		**	Equity bearish, bond bullish
New Zealand	BusinessNZ Manufacturing PMI	m/m	jun	52.8	54.5		**	Equity and bond neutral
EUROPE								
Germany	Wholesale Price Index	y/y	jun	3.4%	2.9%		**	Equity and bond neutral
Italy	General Government Debt	y/y	may	2.327 tn	2.312 tn		**	Equity and bond neutral
Russia	Gold and Forex Reserve	w/w	may	459.6 bn	455.5 bn		*	Equity and bond neutral
	Trade Balance	m/m	may	15.2 bn	15.3 bn	13.8 bn	**	Equity bullish, bond bearish
AMERICAS								
Mexico	Industrial Production	m/m	may	0.1%	-0.4%	0.6%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	may	2.8%	5.6%	2.8%	**	Equity and bond neutral
Canada	Teranet/ National Bank HPI	m/m	jun	2.9%	4.5%		**	Equity and bond neutral
	New Housing Price Index	m/m	may	0.9%	1.6%	1.0%	**	Equity bearish, bond bullish
Brazil	Retail Sales	y/y	may	2.7%	2.6%	0.6%	**	Equity bullish, bond bearish

Financial Markets

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

	Today	Prior	Change	Trend
3-mo Libor yield (bps)	234	234	0	Up
3-mo T-bill yield (bps)	192	193	-1	Neutral
TED spread (bps)	41	41	0	Neutral
U.S. Libor/OIS spread (bps)	197	196	1	Up
10-yr T-note (%)	2.83	2.85	-0.02	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	4	2	2	Down
Currencies	**Direction**			
dollar	up			Down
euro	down			Up
yen	down			Up
pound	down			Up
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	$74.19	$74.45	-0.35%	
WTI	$70.21	$70.33	-0.17%	
Natural Gas	$2.80	$2.80	0.07%	
Crack Spread	$17.36	$17.40	-0.22%	
12-mo strip crack	$18.97	$18.90	0.40%	
Ethanol rack	$1.57	$1.57	0.14%	
Metals				
Gold	$1,240.78	$1,247.39	-0.53%	
Silver	$15.81	$15.95	-0.88%	
Copper contract	$276.45	$277.70	-0.45%	
Grains				
Corn contract	$ 355.75	$ 359.25	-0.97%	
Wheat contract	$ 488.50	$ 484.50	0.83%	
Soybeans contract	$ 842.00	$ 849.25	-0.85%	
Shipping				
Baltic Dry Freight	1632	1586	46	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-12.6	-3.9	-8.8	
Gasoline (mb)	-0.7	-1.0	0.3	
Distillates (mb)	4.1	1.0	3.1	
Refinery run rates (%)	-0.40%	0.10%	-0.5%	
Natural gas (bcf)	51.0	56.0	-5.0	

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps expected in the northern regions. There are no tropical disturbances expected over the next 48 hours.

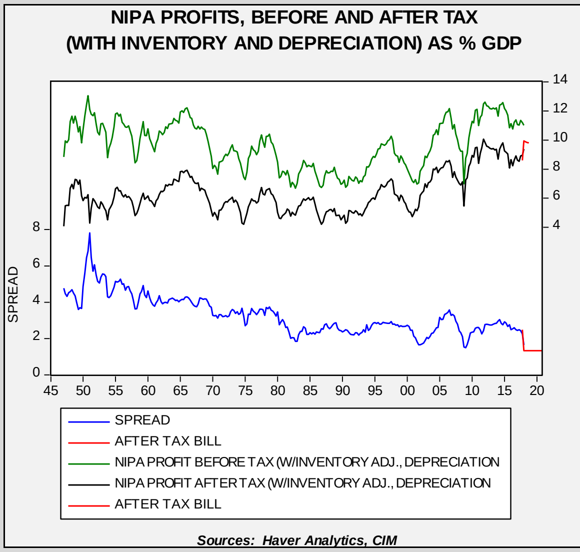
<u>Asset Allocation Weekly Comment</u>

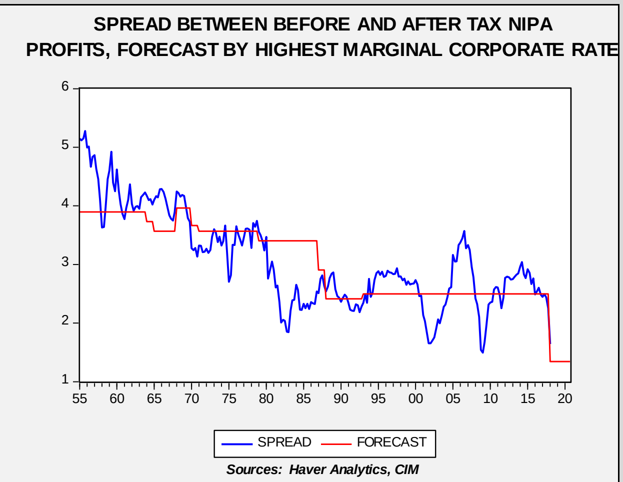
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

July 13, 2018

Earnings season is upon us. We normally don't report on earnings season since we discuss it every day and update the P/E chart weekly, but we are seeing significant growth in earnings which warrants some reflection.

The primary reason for the jump in earnings has been the decline in corporate tax rates.

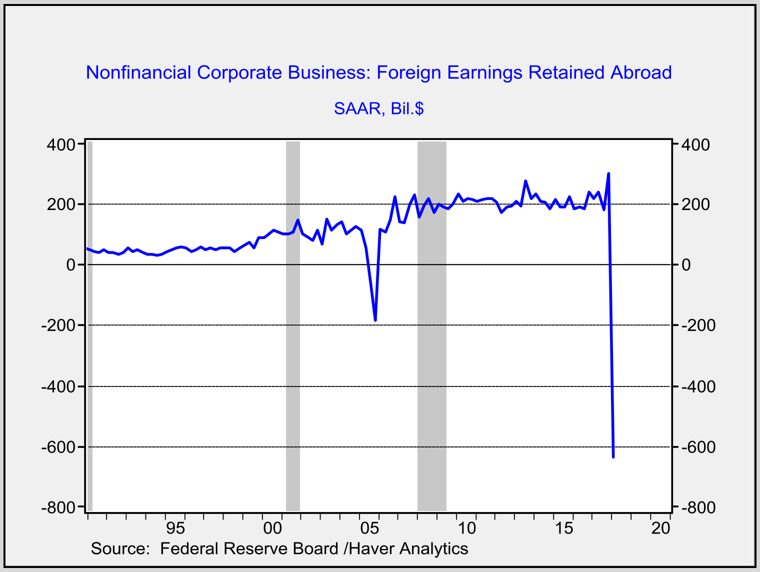




The chart on the left shows corporate profits from the National Product and Income Accounts, the profits data calculated as part of GDP. This chart shows the pre- and post-tax profits as a percentage of GDP and the lower line shows the spread between the two. A narrower spread indicates fewer profits lost to taxes. The chart on the right shows the spread with a forecast derived from the highest marginal corporate tax rate. There are two important factors to note. First, we are seeing the spread narrow as the forecast would have suggested, shown by the narrowing of the Q1 spread. Second, the forecast signals that post-tax corporate profits over the rest of the year should approach 10% of GDP.

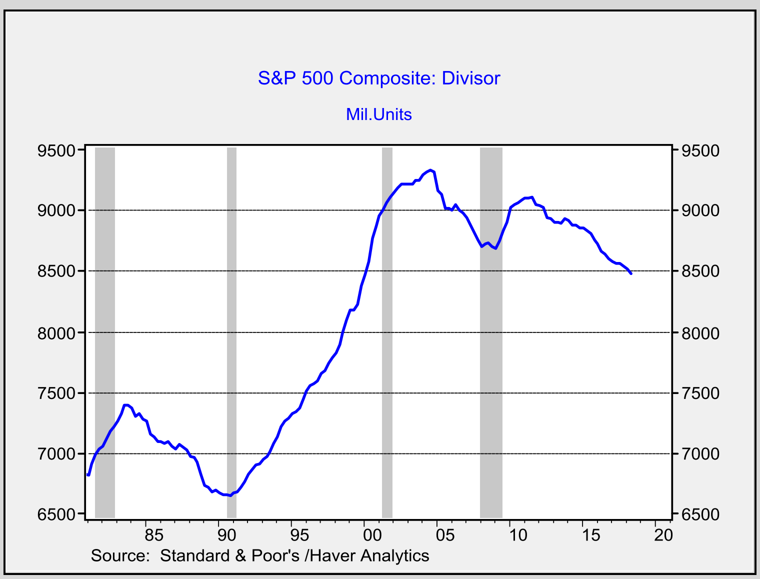
The consensus forecast for Q2 is $39.20 per share,[1] which is up 19.9% over last year. In addition, companies are repatriating money from their overseas accounts.

[1] This is a Thomson-Reuters calculated number.



This chart shows foreign earnings retained abroad on a flow basis. In Q1, nonfinancial corporate businesses moved $632.7 bn back to the U.S.[2] Note the last time this occurred was in 2005 when a tax holiday on foreign earnings was relaxed. The hope of policymakers was that these inflows would be used for investment to boost growth and, eventually, employment. However, at least one-third has been used by S&P companies to buy back stock.[3] The hopes of policymakers were always questionable; a decade of low interest rates meant that the investing environment was already favorable. It would be odd for a project to need the implementation of a tax cut with historically low interest rates already in place.

If buybacks remain elevated, the number of shares outstanding will contract which will tend to support multiple expansion.



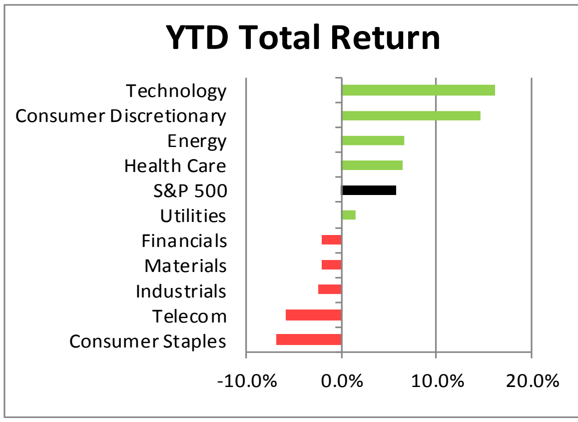
[2] In reality, most of it was already in U.S. banks but were in foreign accounts denominated in dollars.
[3] https://www.wsj.com/articles/stock-buybacks-are-booming-but-share-prices-arent-budging-1531054801

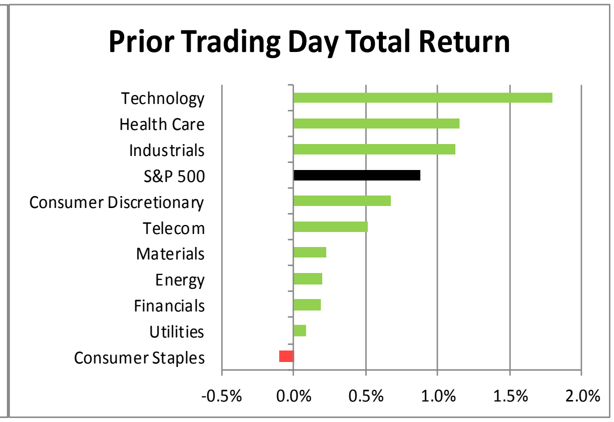
This chart shows the S&P 500 Index divisor; it takes mergers, share buybacks and new issuance into account. Since 2011, the divisor has been steadily declining due to mergers and share buybacks overwhelming new issuance. Note the difference from the 1990s bull market which was characterized by a rising divisor. During this period, rising equity prices led to an increase in stock issuance. That has not been the case in this bull market. It is also interesting that the divisor fell from 9000 to 8700 after the 2005 tax holiday, suggesting that the last episode likely led to share buybacks as well.

The combination of rising earnings and a falling divisor will lead to a contraction of the P/E multiple without higher equity prices. Although trade issues are a serious concern, we remain bullish on equities due to earnings and falling share levels. If the trade situation stabilizes, we should see equity values rise into autumn.

Data Section

U.S. Equity Markets – (as of 7/12/2018 close)

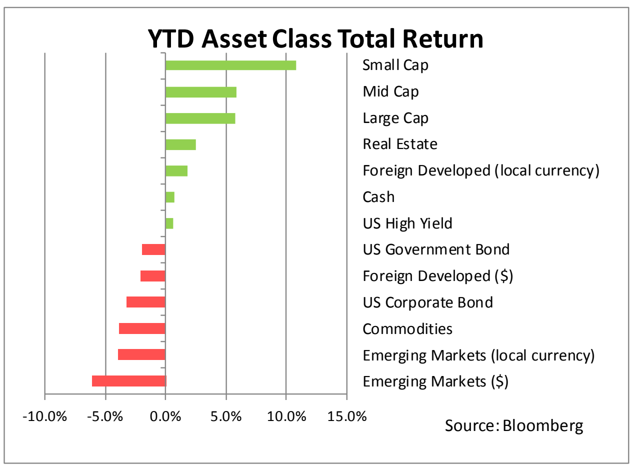




(Source: Bloomberg)

These S&P 500 and sector return charts are designed to provide the reader with an easy overview of the year-to-date and prior trading day total return. Sectors are ranked by total return; green indicating positive and red indicating negative return, along with the overall S&P 500 in black.

Asset Class Performance – (as of 7/12/2018 close)

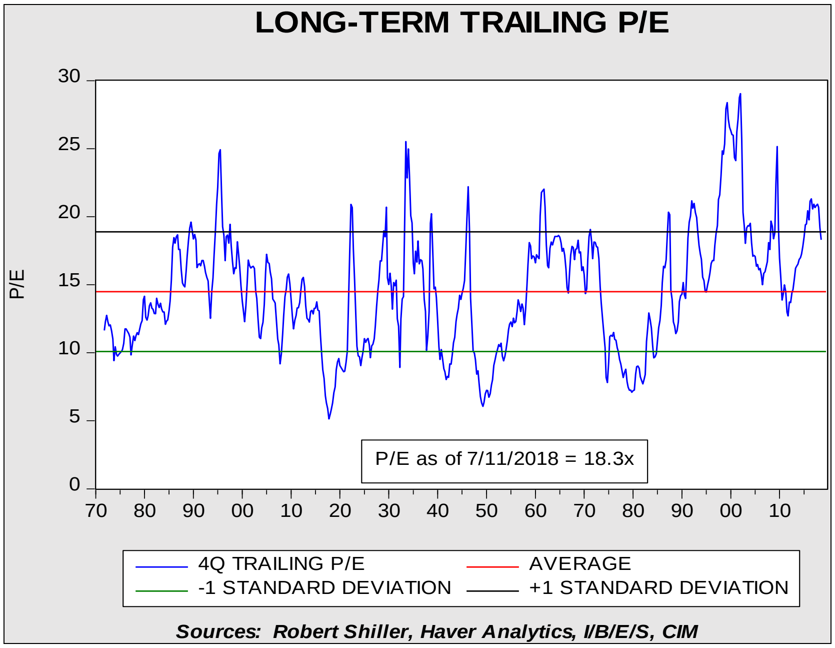


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

Asset classes are defined as follows: Large Cap (S&P 500 Index), Mid Cap (S&P 400 Index), Small Cap (Russell 2000 Index), Foreign Developed (MSCI EAFE (USD and local currency) Index), Real Estate (FTSE NAREIT Index), Emerging Markets (MSCI Emerging Markets (USD and local currency) Index), Cash (iShares Short Treasury Bond ETF), U.S. Corporate Bond (iShares iBoxx $ Investment Grade Corporate Bond ETF), U.S. Government Bond (iShares 7-10 Year Treasury Bond ETF), U.S. High Yield (iShares iBoxx $ High Yield Corporate Bond ETF), Commodities (Bloomberg total return Commodity Index).

P/E Update

July 12, 2018



Based on our methodology,[4] the current P/E is 18.3, up 0.2x from last week. The rise in the S&P 500 outweighed the rise in earnings, which led to a higher P/E.

[4] 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.