Daily Comment

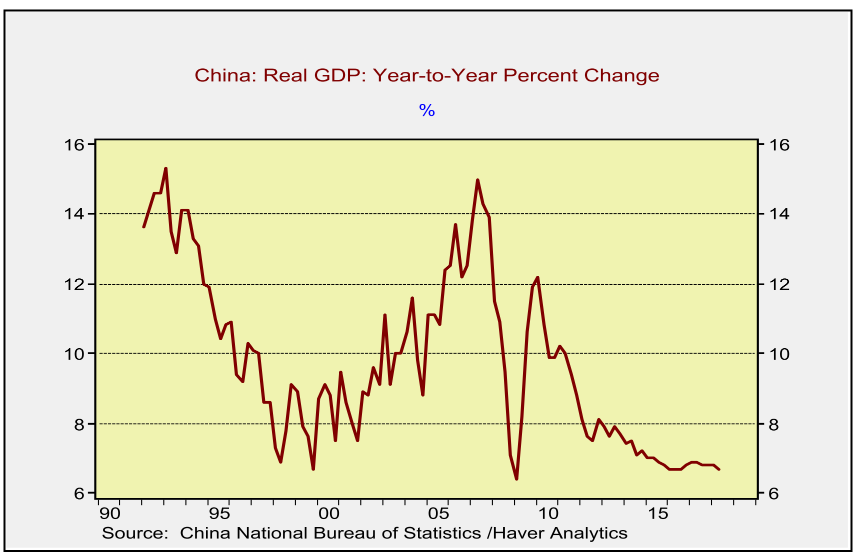
By Bill O'Grady and Thomas Wash

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: July 16, 2018—9:30 AM EDT] Global equity markets are down this morning. The EuroStoxx 50 is down 0.2% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.2% from the prior close. Chinese markets were down, with the Shanghai composite down 0.6% and the Shenzhen index down 0.1%. U.S. equity index futures are signaling a lower open. With 27 companies having reported, the S&P 500 Q2 earnings are below expectations at $39.18 compared to the $39.20 forecast for the quarter. The forecast reflects a 19.9% increase from Q2 2017 earnings. Thus far this quarter, 88.9% of the companies reported earnings above forecast, while 7.4% reported earnings below forecast.

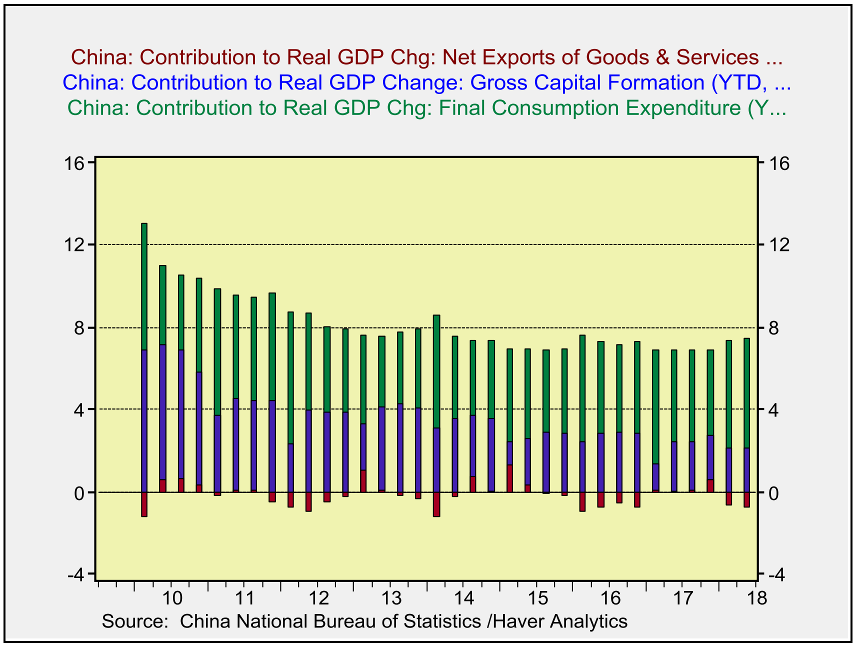
Happy Monday! The media is focused on the Trump/Putin meetings in Helsinki but financial markets are mostly ignoring the spectacle. The biggest major market move is in oil, which we discuss below. Here is what we are watching this morning:

China GDP: China's Q2 GDP[1] rose 6.7% from last year, down from 6.8% in Q1. In related news, industrial production rose 6.0% from last year compared to expectations of 6.5%. Although China's economy remains healthy, there is some slowing which has weighed on emerging markets.



[1] https://www.ft.com/content/f17e67e4-8646-11e8-96dd-fa565ec55929?emailId=5b4c1d124cf1530004fccd78&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

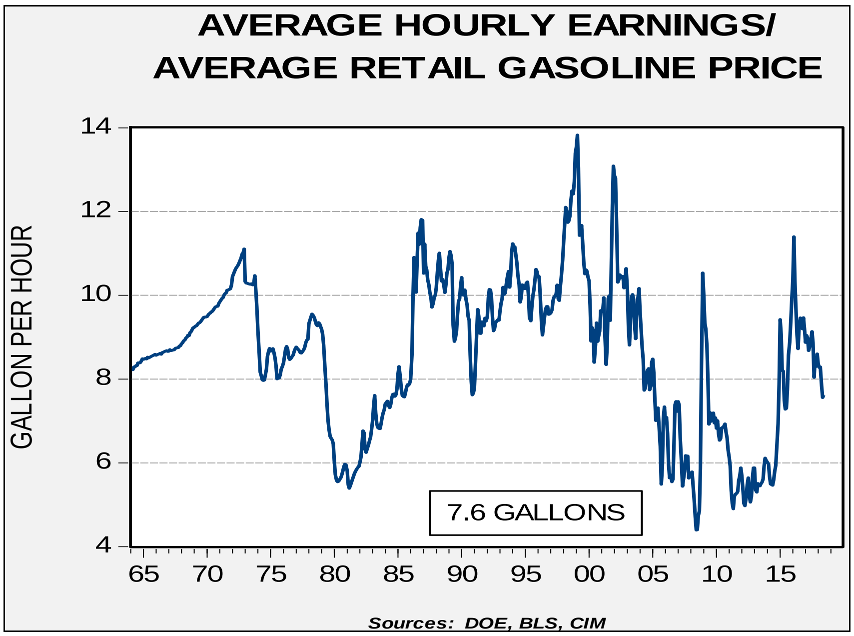
Here's the contribution to growth:



Although China continues to run a large trade surplus with the U.S., it is actually seeing negative net exports in the GDP data. This would suggest that China has a bilateral issue with the U.S. but, unlike Germany, China's overall dependence on exports has lessened over the years.

This chart shows China's net exports as a percentage of GDP. The data is only available on an annual basis but it would not be surprising to see this number in "the red" for 2018 given the current net exports. China, like most successful developing nations in the postwar world, has used export promotion for development. That explains why China's net exports jumped above 2.5% after 1995 and reached nearly 8% in 2007. Recent data would suggest that China is attempting to restructure its economy but the country is still dependent on the U.S. to absorb its excess output. That's why the trade war is a major threat to its economy.

Oil weakness: Last week's U.S. inventory data showed a massive decline in stockpiles, putting us on a path toward high $80s for WTI by Labor Day. But, prices are slumping this morning. There are two reasons cited for the decline. First, Saudi Arabia is offering additional supplies to Asia.[2] Second, the U.S. and other Western nations are considering SPR releases if oil prices continue to rise.[3] We suspect President Trump is worried that high gasoline prices will hurt his party's chances in the November midterms. Currently, gasoline prices are elevated but not yet at a level that would be considered critical.



This chart shows the average hourly wage for non-supervisory workers compared to the national average for retail gasoline prices. Currently, the average worker needs to work an hour to buy 7.6 gallons of gasoline. The long-term average is 8.5 gallons per hour, so the price is "hurting" but it's not at a level where it would be considered a serious problem. As a general rule, we pay attention when this ratio dips under 7.0 gallons for each working hour.

This news offsets two potentially bullish items. First, there was significant unrest in the Basra region of Iraq over the weekend. The protests appear local; anger over the lack of jobs and poor public services appear to be the driving force behind the anger. But, this region accounts for 80% of Iraq's oil reserves and 3.2 mbpd of exports. Despite being local in nature, we would not be surprised to see Iranian operatives try to fan the unrest in a bid to restrict Iraqi exports and lift oil prices. Second, the U.S. refused to grant any waivers to European firms doing business in

[2] https://www.bloomberg.com/news/articles/2018-07-16/saudis-said-to-offer-extra-oil-in-asia-as-opec-leader-pumps-more
[3] https://www.wsj.com/articles/u-s-and-allies-consider-possible-oil-reserve-release-1531509351

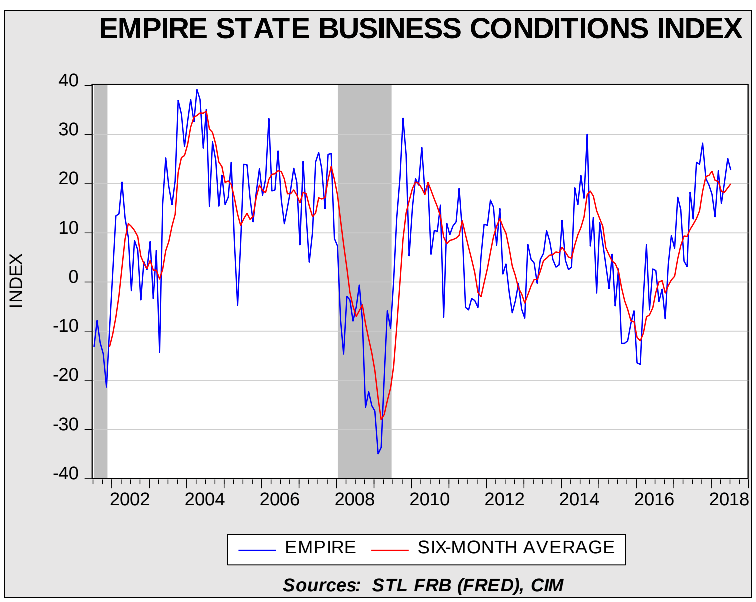
Iran.[4] This means that sanctions will weaken Iranian oil sales. Iran is trying to send its oil to Asia[5] but, as we noted above, Saudi Arabia is doing the same thing.

The production shortfalls in Libya and Venezuela, the sanctions on Iran and the unrest in Iraq are all bullish factors for oil prices. Even if Saudi Arabia responds by lifting output, the risk is that OPEC is rapidly depleting its excess reserves. This means the world is approaching the "vertical" part of the global supply curve, which can result in large price spikes. The SPR is designed to offset such events. However, it's been years since the SPR was "fired in anger"; one would have to go back to the First Gulf War and, even then, the drawdown was small (and was eventually unnecessary). The risk to using the SPR is that it doesn't work as planned and the oil can't be tapped as quickly as the "specs" suggest. If that becomes evident, there is no backstop and prices could move higher. In reality, the SPR is probably a better threat than it is a real protector against supply disruption.

Bitcoin worries: Last week, the Mueller investigation indicted a number of Russians involved in an attempt to sway the U.S. presidential election. One little detail caught our attention. Apparently, some of the conspirators used bitcoin to pay for their nefarious actions. Given the anonymous nature of cryptocurrencies, we would expect a crackdown to emerge from nation states as they discover the usefulness of cryptocurrencies for illegal activities.

U.S. Economic Releases

Empire manufacturing came in above expectations at 22.6 compared to the forecast of 21.0.

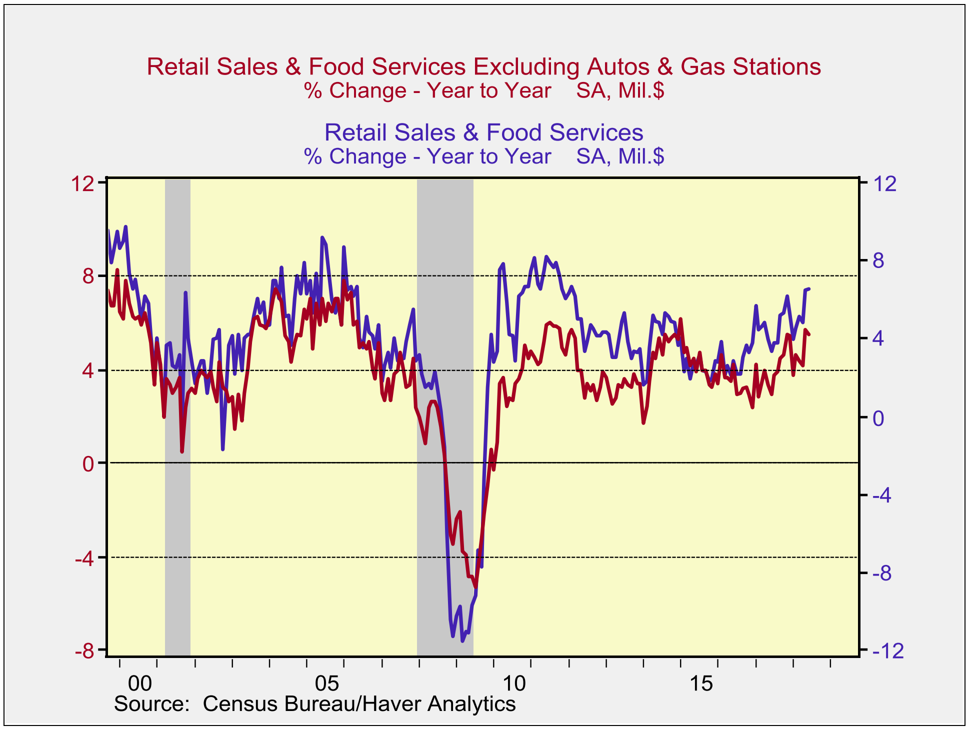


The chart above shows the six-month moving average of the Empire State Business Conditions Index. Currently, the six-month moving average is 19.85.

---

4 https://www.ft.com/content/6a16440a-8837-11e8-bf9e-8771d5404543
5 https://www.ft.com/content/e54129b4-85cc-11e8-96dd-fa565ec55929?emailId=5b4c1d124cf1530004fccd78&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

Advance retail sales came in line with expectations, rising 0.5% from the prior month. The prior month's report was revised upward from 0.8% to 1.3%. Retail sales ex-auto came in above expectations, rising 0.4% from the prior month compared to the forecast of 0.3%. The prior report's gain was revised upward from 0.9% to 1.4%. Retail sales ex-auto and gas came in below expectations, rising 0.3% from the prior month compared to the forecast of 0.4. The prior report was revised upward from 0.8% to 1.3%. The retail sales control group came in below expectations, remaining unchanged from the prior month compared to the forecast of 0.4%. The prior month's report was revised upward from 0.5% to 0.8%.



The chart above shows the year-over-year change in retail sales and core retail sales. Retail sales and core retail sales rose 6.6% and 5.5%, respectively.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Business Inventories	m/m	may	0.4%	0.3%	**
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	Survey Jobless Rate	m/m	jun	4.8%	4.8%		***	Equity and bond neutral
	GDP	m/m	2q	6.7%	6.8%	6.7%	***	Equity and bond neutral
	Retail Sales	m/m	jun	9.0%	8.5%	8.8%	**	Equity bullish, bond bearish
	Industrial Production	m/m	jun	6.0%	6.8%	6.5%	***	Equity bearish, bond bullish
	Fixed Asset Investment ex Rural	m/m	jun	6.0%	6.1%	6.0%	**	Equity and bond neutral
India	Wholesale Prices	m/m	jun	5.8%	4.4%	5.2%	**	Equity and bond neutral
New Zealand	Performance Services	m/m	jun	52.8	57.3		**	Equity and bond neutral
EUROPE								
Eurozone	Trade Balance	m/m	may	16.9 bn	18.1bn	18.5bn	**	Equity bearish, bond bullish
Italy	Trade Balance	m/m	may	3.378 bn	2.938 bn		**	Equity bullish, bond bearish
Switzerland	Total Sight Deposits	m/m	may	576.1 bn	576.0 bn		**	Equity and bond neutral
	Domestic Sight Deposits	m/m	may	473.0 bn	468.6 bn		**	Equity and bond neutral
AMERICAS								
Brazil	Economic Activity	m/m	may	-3.3%	0.5%	-3.5%	***	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)	193	194	-1	Neutral
TED spread (bps)	41	40	1	Neutral
U.S. Libor/OIS spread (bps)	197	197	0	Up
10-yr T-note (%)	2.83	2.83	0.00	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	3	2	1	Down
Currencies	**Direction**			
dollar	down			Down
euro	up			Up
yen	up			Up
pound	up			Up
franc	up			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	$73.79	$75.33	-2.04%	Supply Speculation
WTI	$69.83	$71.01	-1.66%	
Natural Gas	$2.77	$2.75	0.51%	
Crack Spread	$17.56	$17.90	-1.87%	
12-mo strip crack	$18.80	$19.15	-1.81%	
Ethanol rack	$1.57	$1.57	0.07%	
Metals				
Gold	$1,244.49	$1,244.32	0.01%	
Silver	$15.82	$15.82	0.06%	
Copper contract	$275.90	$277.55	-0.59%	
Grains				
Corn contract	$ 353.25	$ 354.75	-0.42%	
Wheat contract	$ 492.75	$ 497.00	-0.86%	
Soybeans contract	$ 830.75	$ 834.25	-0.42%	
Shipping				
Baltic Dry Freight	1666	1632	34	

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. Precipitation is expected in the eastern region. There are no tropical disturbances expected over the next 48 hours.

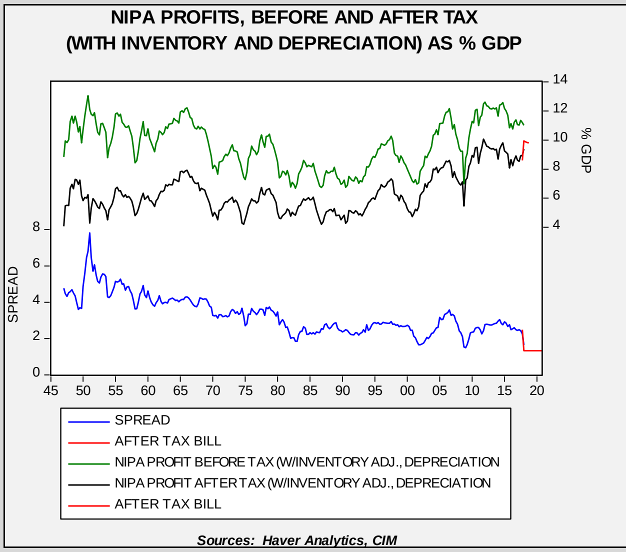
Asset Allocation Weekly Comment

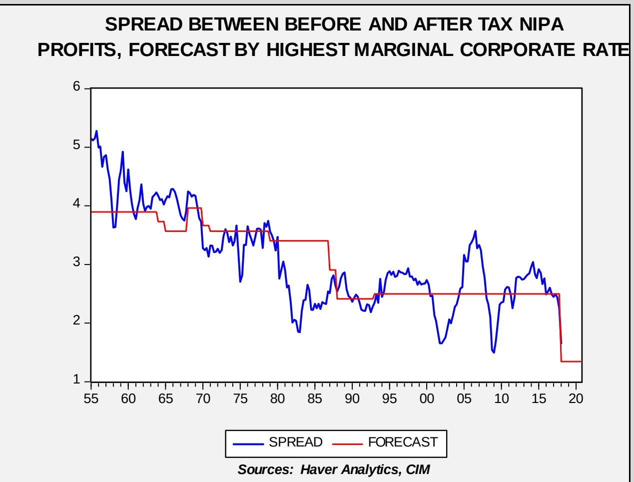
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

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.

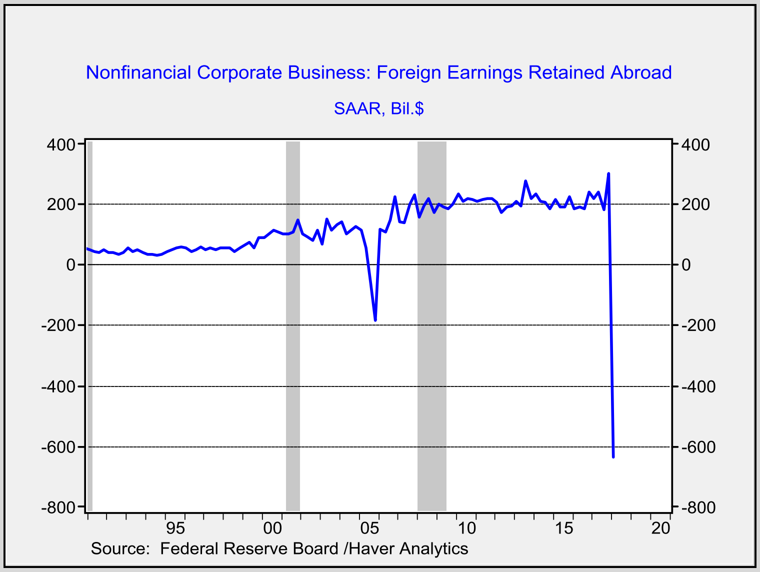




The chart on the left shows corporate profits from the National Product and Income Accounts, the profits data calculated as part of GDP. This chart shows the pre- and post-tax profits as a percentage of GDP and the lower line shows the spread between the two. A narrower spread indicates fewer profits 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.

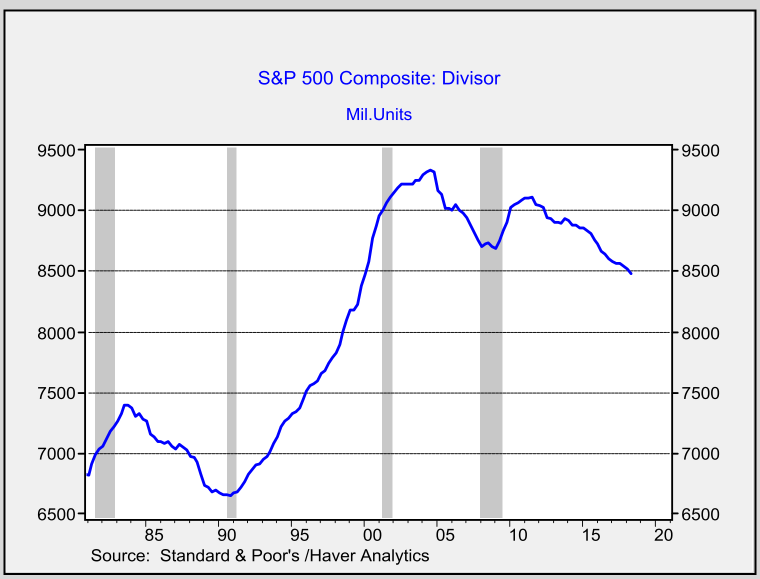
The consensus forecast for Q2 is $39.20 per share,[6] which is up 19.9% over last year. In addition, companies are repatriating money from their overseas accounts.

[6] 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.[7] 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.[8] 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.



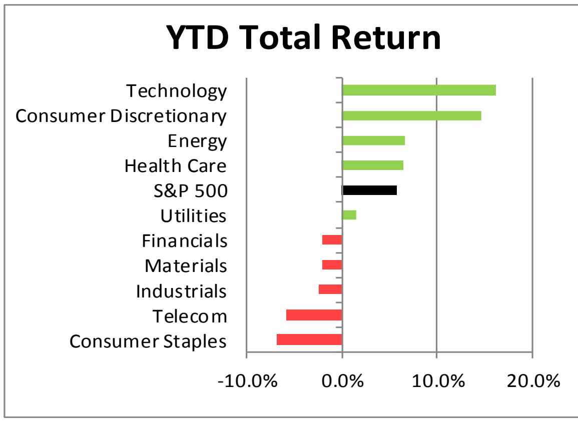
[7] In reality, most of it was already in U.S. banks but were in foreign accounts denominated in dollars.
[8] https://www.wsj.com/articles/stock-buybacks-are-booming-but-share-prices-arent-budging-1531054801

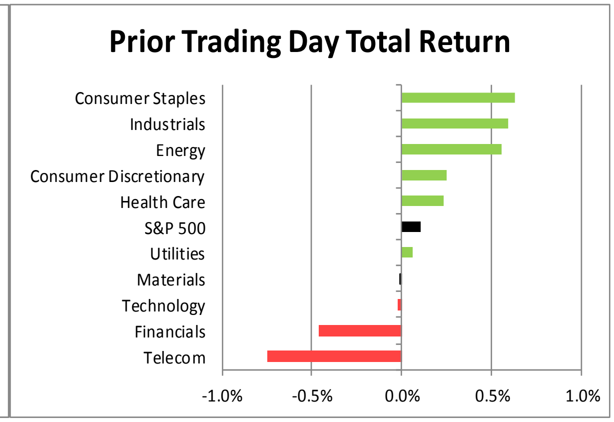
This chart shows the S&P 500 Index divisor; it takes mergers, share buybacks and new issuance into account. Since 2011, the divisor has been steadily declining due to mergers and share buybacks overwhelming new issuance. Note the difference from the 1990s bull market which was characterized by a rising 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 7/13/2018 close)

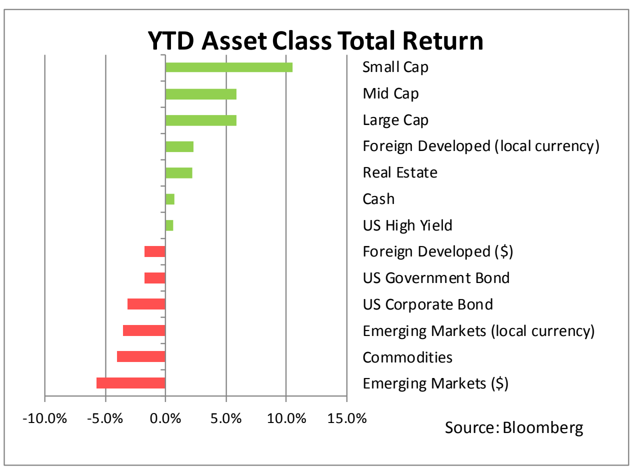




(Source: Bloomberg)

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 7/13/2018 close)

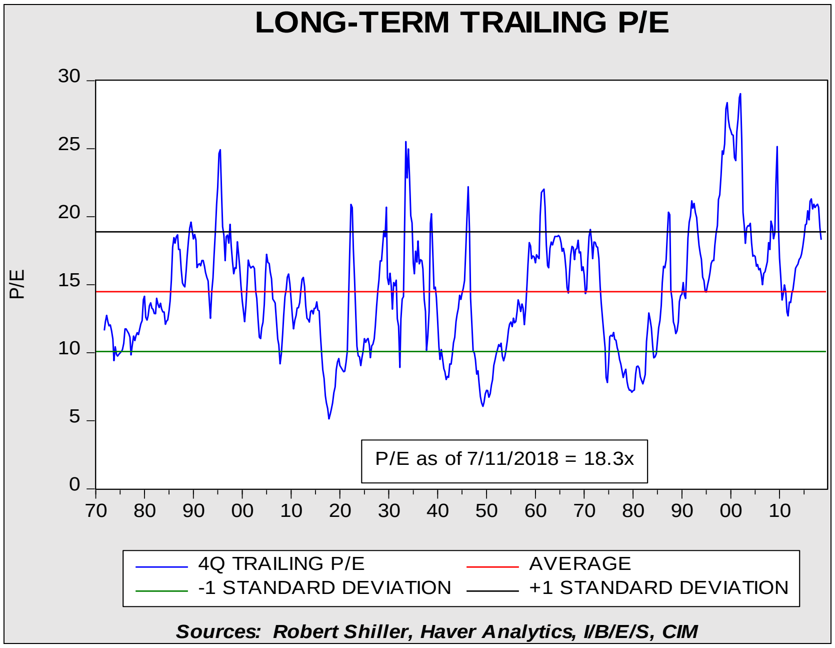


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[9] 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.

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.

[9] 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.