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 17, 2018—9:30 AM EDT] Global equity markets are down this morning. The EuroStoxx 50 is down 0.4% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.7% from the prior close. Chinese markets were down, with the Shanghai composite down 0.6% and the Shenzhen index down 0.2%. U.S. equity index futures are signaling a lower open. With 31 companies having reported, the S&P 500 Q2 earnings are above expectations at $39.26 compared to the $39.20 forecast for the quarter. The forecast reflects a 19.9% increase from Q2 2017 earnings. Thus far this quarter, 90.3% of the companies reported earnings above forecast, while 6.5% reported earnings below forecast.

Tonight's midsummer classic, the All-Star Game, is really the official midpoint of summer. Markets are quiet this morning. Here is what we are watching:

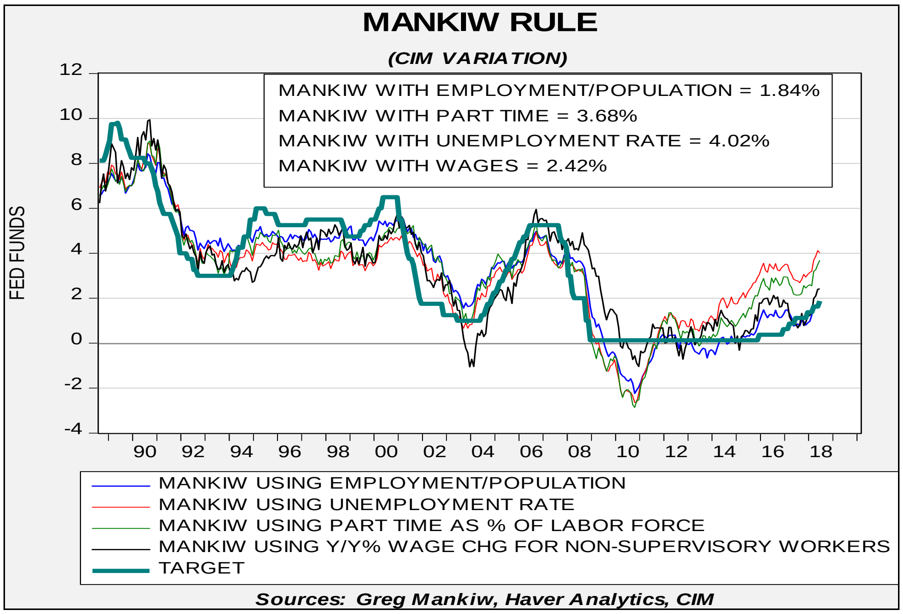
Did the president go too far? Criticism of President Trump's performance at the press conference with Russian President Vladimir Putin was widespread. Even Fox News, which is generally supportive of the White House, was remarkably critical.[1] Our primary concern is always the impact of actions on the financial markets. It's too early for any reliable polling to tell us much and there was no significant movement in the prediction markets, either. The history of populism does show that sometimes populist leaders, mostly due to inexperience, can overshoot their support. If Trump's approval wanes, it might not necessarily be bearish for financial markets because it may slow the trade conflict. For now, we are treating yesterday's Russia event as an item to watch. However, we must say that the breadth of condemnation was rare.

Powell to the Hill: Chair Powell goes to the Senate this morning for his semiannual testimony on monetary policy. Below we discuss a couple of charts worth noting.

First, we have updated our Mankiw model with four variations. The Mankiw rule models attempt to determine the neutral rate for fed funds, which is a rate that is neither accommodative nor stimulative. Mankiw's model is a variation of the Taylor Rule. The latter measures the

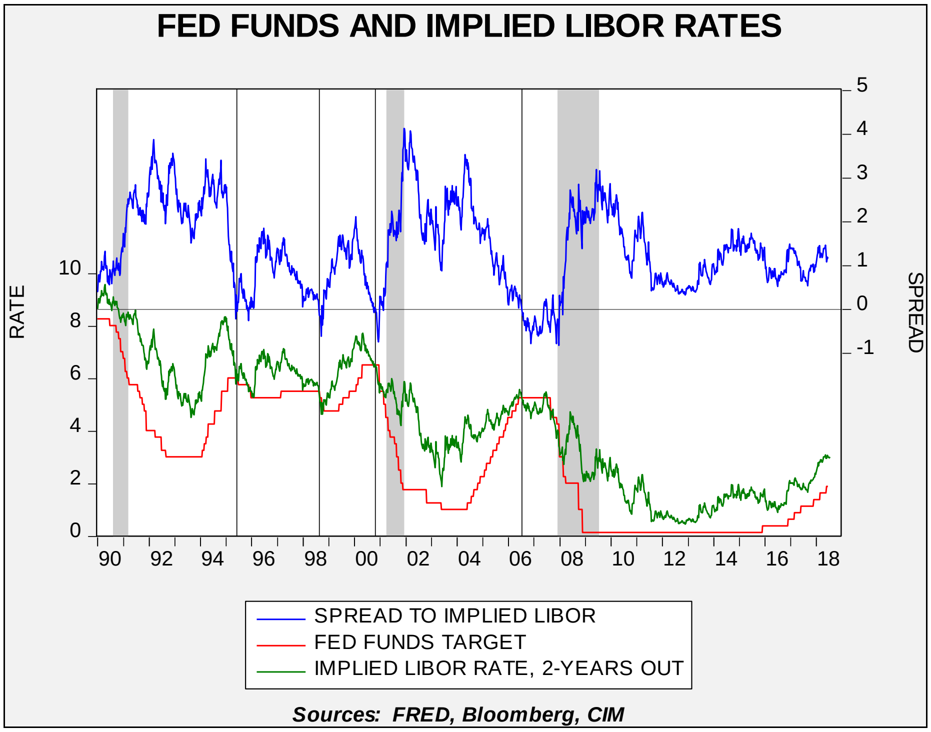
[1] https://talkingpointsmemo.com/livewire/fox-news-host-calls-trump-presser-performance-disgusting-wrong?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top and https://www.thedailybeast.com/several-fox-news-hosts-bash-trumps-disgusting-putin-presser/?via=twitter_page&utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top and https://twitter.com/IngrahamAngle/status/1018996752064634880?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top

neutral rate using core CPI and the difference between GDP and potential GDP, which is an estimate of slack in the economy. Potential GDP cannot be directly observed, only estimated. To overcome this problem, Mankiw used the unemployment rate as a proxy for economic slack. We have created four versions of the rule, one that follows the original construction by using the unemployment rate as a measure of slack, a second using the employment/population ratio, a third using involuntary part-time workers as a percentage of the total labor force and a fourth using yearly wage growth for non-supervisory workers.



Using the unemployment rate, the neutral rate is now 4.02%, down from 4.14%, reflecting the rise in the unemployment rate. Using the employment/population ratio, the neutral rate is 1.84%, up modestly from May's 1.81%. Using involuntary part-time employment, the neutral rate is 3.68%, up from the last calculation of 3.50%. Using wage growth for non-supervisory workers, the neutral rate is 2.42%, roughly unchanged from the last report of 2.48%. June's employment data was mostly in line with May's so the neutral rate calculations didn't change a lot. The only variation that is policy neutral is the one using the employment/population ratio. Thus, given that the majority of the FOMC still holds to some sort of Phillips Curve model for monetary policy, the bias should be for additional rate hikes.

The second chart is our estimate of what the financial markets have discounted in terms of tightening. The chart below compares the fed funds target to the implied three-month LIBOR rate, two-years deferred, which comes from the Eurodollar futures market. Historically, the FOMC tends to tighten until the implied LIBOR rate equals the fed funds target. In fact, when the target overshoots the implied rate, the odds of recession increase. Currently, the implied LIBOR rate is near 3.00%, suggesting the Fed has four more hikes to go. Clearly, the financial market's estimate of the terminal rate is well below what the dots plot or the majority of the Mankiw rule estimates suggest for the terminal rates. If the FOMC continues on its expected path, meaning two more hikes this year and perhaps more in 2019, the odds of recession will begin to rise.



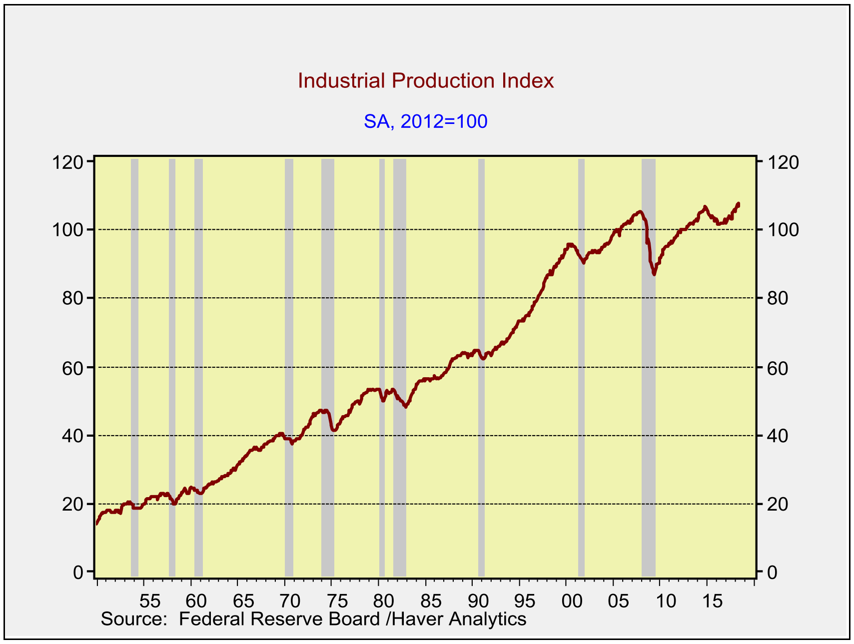
We are already hearing discordant voices from the FOMC. Minneapolis FRB President Kashkari[2] (not a current voter) is calling for a pause, citing the rapid narrowing of the yield curve. We don't expect anything from Powell other than "steady as she goes," but concerns about monetary policy will likely rise by year's end.

U.S. Economic Releases

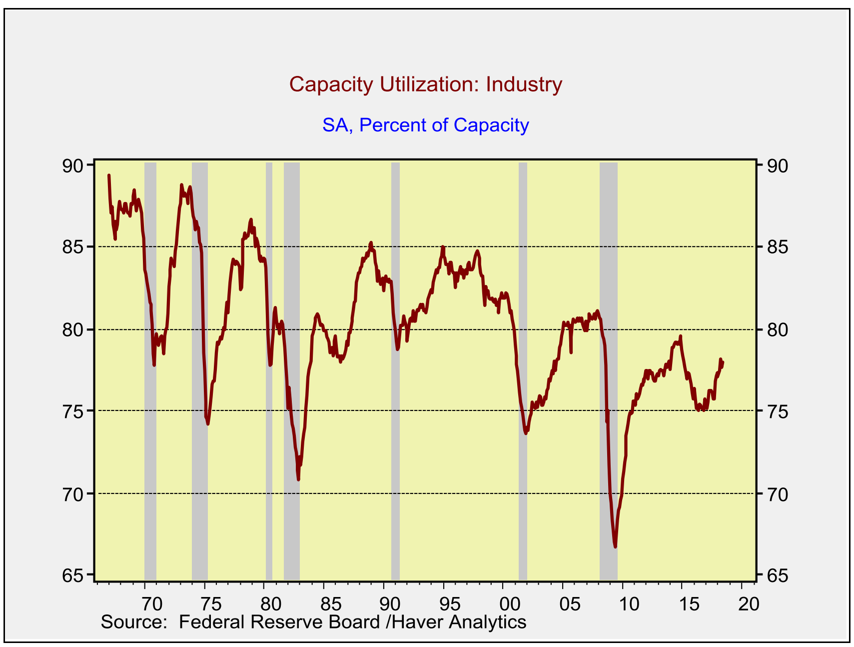
Industrial production from June came in stronger than forecast, rising 0.6% compared to the forecast rise of 0.5%. However, May was revised to -0.5% from the initial report of -0.1%. Manufacturing showed a similar pattern, with the data rising 0.8% compared to estimates calling for a 0.7% rise, but May was revised lower to -1.0% from the initial report of -0.7%. Capacity utilization was 78.0%, a bit below the 78.3% expected. There was a downward revision to the previous report, with the update showing utilization at 77.7% compared to the 77.9% initially reported.

---

[2] https://www.reuters.com/article/us-usa-fed-kashkari/feds-kashkari-citing-yield-curve-wants-rate-hike-pause-idUSKBN1K62EE



This data represents a new cycle high. Capacity utilization is elevated but remains below the cycle high made in 2014.



The data is being taken as bearish by the financial markets, likely on fears that economic growth will lead the FOMC to raise rates and perhaps bring a more hawkish tone from Powell in his testimony today.

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	NAHB Housing Market Index	m/m	jul	68	68	**
16:00	Total Net TIC Flows	m/m	may		$138.7 bn	**
16:00	Net Long-Term TIC Flows	m/m	may		$93.9 bn	**
Fed speakers or events						
EST	Speaker or event	District or position				
10:00	Jerome Powell to Deliver Semi-Annual Testimony	Chairman of Board of Governors of Federal Reserve				

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	New Home Prices	m/m	jun	1.1%	0.8%		**	Equity and bond neutral
Japan	Tokyo Condominium Sales	m/m	jun	16.4%	-5.4%		*	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	m/m	jul	121.5	120.1		*	Equity and bond neutral
New Zealand	REINZ House Sales	m/m	jun	-1.6%	1.3%		**	Equity bearish, bond bullish
	CPI	y/y	2q	1.1%	1.1%	1.6%	***	Equity and bond bullish
	Non Resident Bond Holdings	m/m	jun	58.1%	58.9%		**	Equity and bond neutral
India	Wholesale Price Index	y/y	jun	5.8%	4.4%	5.2%	**	Equity bearish, bond bearish
EUROPE								
Eurozone	EU27 New Car Registration	m/m	jun	5.2%	0.8%		*	Equity bullish, bond bearish
Italy	Industrial Sales	m/m	may	5.0%	4.0%		**	Equity bullish, bond bearish
	Industrial Orders	m/m	may	4.9%	6.4%		**	Equity and bond neutral
	CPI EU Harmonizesd	y/y	jun	1.4%	1.5%	1.5%	***	Equity and bond neutral
U.K.	Claimant Count Rate	m/m	jun	2.5%	2.5%		**	Equity and bond neutral
	Jobless Claims Change	m/m	jun	7.8k	-7.7k		**	Equity bearish, bond bullish
	Weekly Earnings ex Bonus	m/m	may	2.7%	2.8%	2.7%	**	Equity and bond neutral
	ILO Unemployment Rate	m/m	may	4.2%	4.2%	4.2%	***	Equity and bond neutral
Russia	Industrial Production	y/y	jun	2.2%	3.7%	3.2%	***	Equity and bond neutral
AMERICAS								
Mexico	Formal Job Creation Total	m/m	jun	-13.5k	34.0k		***	Equity and bond neutral
Canada	manufacturing sales	m/m	may	1.4%	-1.3%	0.4%	**	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)	196	196	0	Neutral
TED spread (bps)	37	38	-1	Neutral
U.S. Libor/OIS spread (bps)	198	197	1	Up
10-yr T-note (%)	2.85	2.86	-0.01	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	5	4	1	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	down			Neutral
pound	down			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	$71.78	$71.84	-0.08%	
WTI	$67.99	$68.06	-0.10%	
Natural Gas	$2.78	$2.76	0.69%	
Crack Spread	$16.94	$16.76	1.04%	
12-mo strip crack	$18.16	$18.08	0.42%	
Ethanol rack	$1.57	$1.57	0.03%	
Metals				
Gold	$1,240.19	$1,240.93	-0.06%	
Silver	$15.74	$15.79	-0.31%	
Copper contract	$275.60	$276.45	-0.31%	
Grains				
Corn contract	$ 359.00	$ 355.25	1.06%	deteriorating crop conditions
Wheat contract	$ 493.50	$ 488.50	1.02%	
Soybeans contract	$ 852.00	$ 845.75	0.74%	deteriorating crop conditions
Shipping				
Baltic Dry Freight	1695	1666	29	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.1		
Gasoline (mb)		-0.9		
Distillates (mb)		1.1		
Refinery run rates (%)		0.50%		
Natural gas (bcf)		56.0		

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for the coasts and the southern tier of states, with the northern central states getting a break from the summer heat. Precipitation is expected in the eastern region. There are no tropical disturbances expected over the next 48 hours.

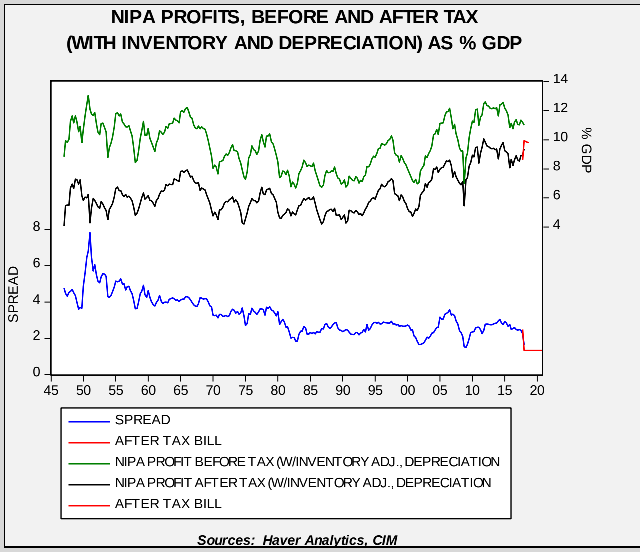
Asset Allocation Weekly Comment

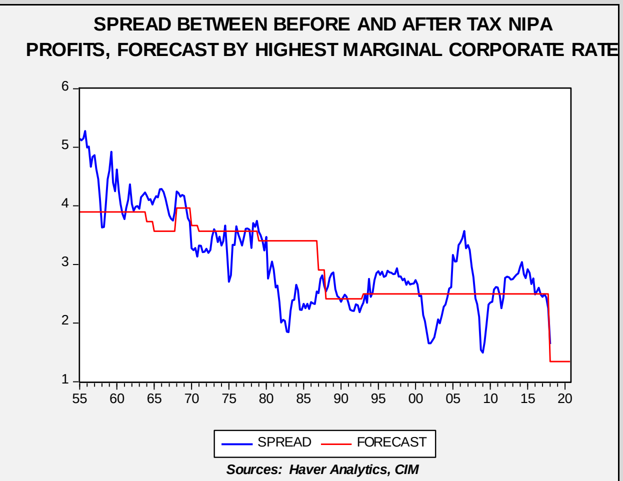
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

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.

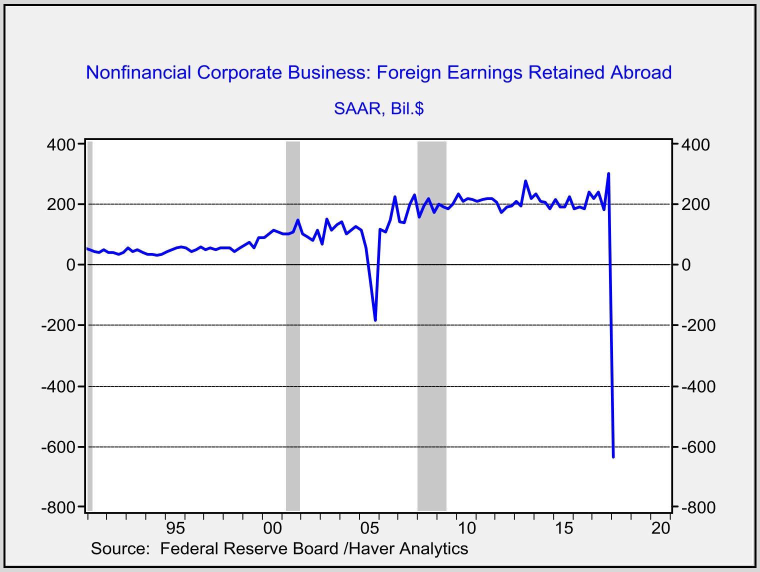




The chart on the left shows corporate profits from the National Product and Income Accounts, the profits data calculated as part of GDP. This chart shows the pre- and post-tax profits as a percentage of GDP and the lower line shows the spread between the two. A narrower spread indicates fewer profits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

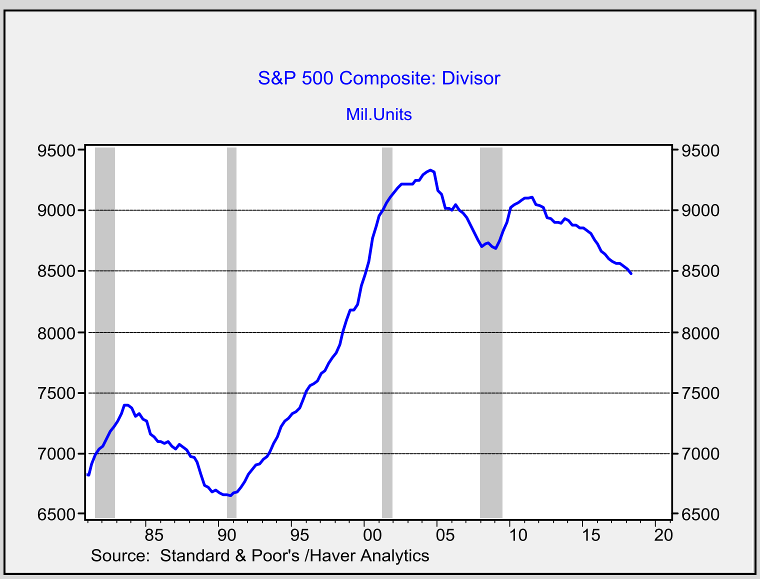
The consensus forecast for Q2 is $39.20 per share,[3] which is up 19.9% over last year. In addition, companies are repatriating money from their overseas accounts.

[3] 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.[4] 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.[5] 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.



---

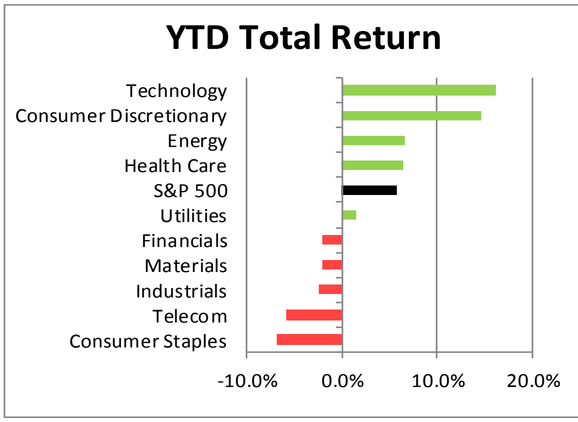
[4] In reality, most of it was already in U.S. banks but were in foreign accounts denominated in dollars.
[5] https://www.wsj.com/articles/stock-buybacks-are-booming-but-share-prices-arent-budging-1531054801

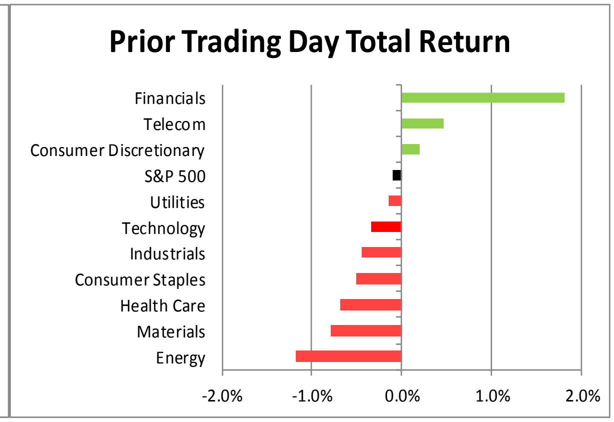
This chart shows the S&P 500 Index divisor; it takes mergers, share buybacks and new issuance into account. Since 2011, the divisor has been steadily declining due to mergers and share buybacks overwhelming new issuance. Note the difference from the 1990s bull market which was characterized by a rising 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 7/16/2018 close)

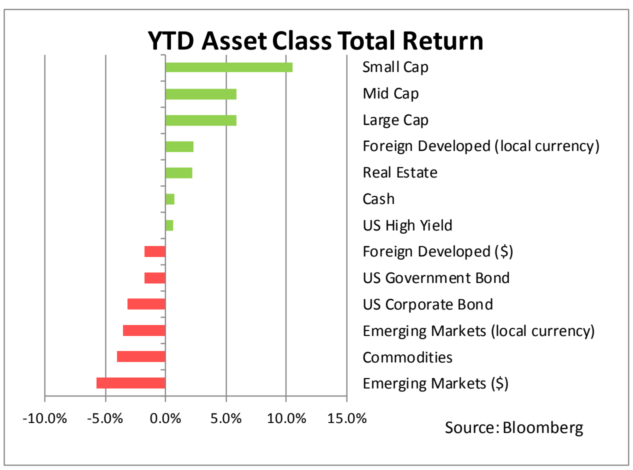




(Source: Bloomberg)

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 7/16/2018 close)

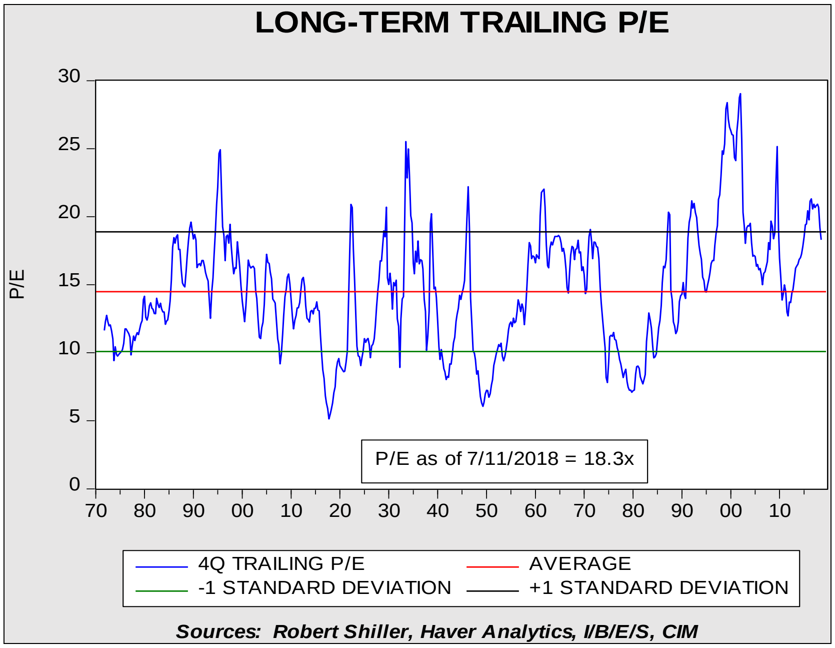


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[6] 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.

[6] 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.