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 19, 2018—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 0.3% 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 0.5% and the Shenzhen index down 0.8%. U.S. equity index futures are signaling a lower open. With 55 companies having reported, the S&P 500 Q2 earnings are above expectations at $39.31 compared to the $39.20 forecast for the quarter. The forecast reflects a 19.9% increase from Q2 2017 earnings. Thus far this quarter, 92.7% of the companies reported earnings above forecast, while 3.6% reported earnings below forecast.

We are in the back half of the week! Everything is down this morning except the dollar. Here is what we are watching:

Brexit thoughts: Yesterday's vote in the House of Commons actually suggests a rather interesting informal coalition may be evolving. As we noted yesterday, PM May avoided a no-confidence vote by gathering enough Remain supporters among the Tories and by finding a few Labor MPs to support her as well; the Labor defectors also support either a soft Brexit or staying in the EU. The Labor MPs could have easily forced a no-confidence vote and new elections where the Labor Party would have a good chance of winning control of Parliament. However, that is not necessarily a favored outcome if one is a "Blairite" Labor MP, which is essentially an establishment center-left politician. In other words, pushing for elections that lead to Jeremy Corbyn becoming prime minister is probably not an attractive outcome. Thus, we may be seeing an informal grouping of Blairite Labor MPs joining Tory Remainers to keep Theresa May in office. If our theory is correct, May will remain as PM and there will be a soft Brexit. That would be a bullish outcome for the GBP.

Trade talk: The G-20 Finance Ministers meet this weekend. Discussions are expected to focus on trade. The Commerce Department is holding a day-long hearing today on auto tariffs. There are 45 witnesses scheduled; only one, Jennifer Kelly of the UAW, is expected to be supportive of auto tariffs. Companies are uniformly opposed to tariffs as automobile production has become increasingly globalized. Later this month, EU President Jean-Claude Juncker is expected to visit Washington, and there are hopes he will bring some tariff concessions on European tariffs.[1] Even trade hawks in the Trump administration see the auto tariffs as misguided and would like to

[1] Actually, the history of light-truck tariffs, where the U.S. imposes a 25% tariff on imported light trucks, is fascinating. Here is a like to the background: https://en.wikipedia.org/wiki/Chicken_tax

see some modest concessions offered that would allow the president to declare victory[2]. The administration is apparently investigating the uranium market to see if U.S. miners are being unfairly affected; if so, we could see tariffs implemented on that commodity[3]. Meanwhile, NEC's Larry Kudlow blamed Chairman Xi for the lack of movement on Chinese/U.S. trade negotiations.[4] The Chinese suggest otherwise.[5] The bottom line is that there are no talks occurring between the two nations. As we note in the next segment, China appears to be using the currency as a weapon.

The weaker CNY: It does appear that China is retaliating against the Trump administration's trade policy by a deliberate depreciation of the CNY.

(Source: Bloomberg)

The PBOC is deliberately allowing the CNY to weaken rather rapidly. Although this move will tend to weaken the impact of tariffs, China runs the risk that the weaker currency could spur capital flight. Our readers on the West Coast will likely have a front row seat to the show if capital flight accelerates; residential real estate in that region is one of the favored spots for Chinese flight capital. Xi may be bargaining that he has enough controls in place to prevent outflows. When the foreign reserve data is released, we will see how effective the controls are.

Energy Recap: U.S. crude oil inventories rose 5.8 mb compared to market expectations which called for a 4.1 mb draw.

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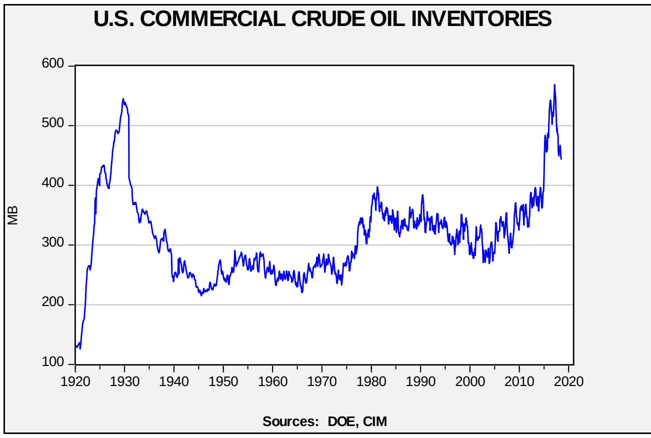
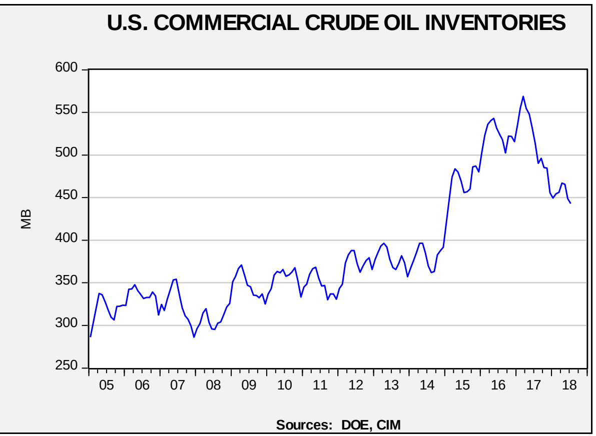
[2] https://www.politico.com/newsletters/morning-money

[3] https://www.ft.com/content/f23cc632-8ac2-11e8-b18d-0181731a0340?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

[4] https://www.bloomberg.com/news/articles/2018-07-18/trump-economic-aide-blames-china-s-xi-for-stalling-trade-deal

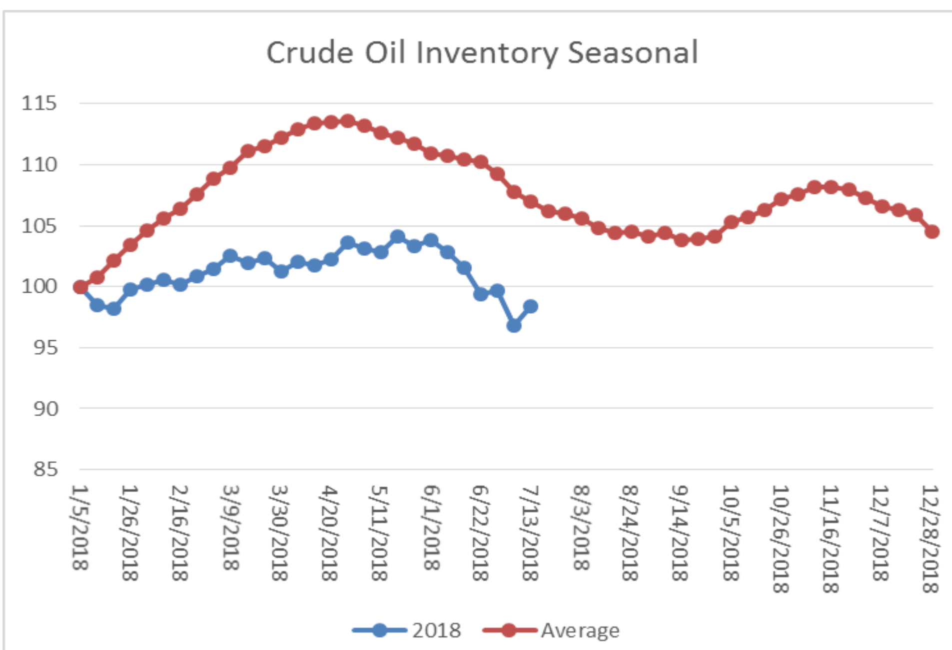
[5] https://www.reuters.com/article/us-usa-trade-china/china-says-u-s-blaming-xi-for-blocking-trade-deal-is-bogus-idUSKBN1K90UF



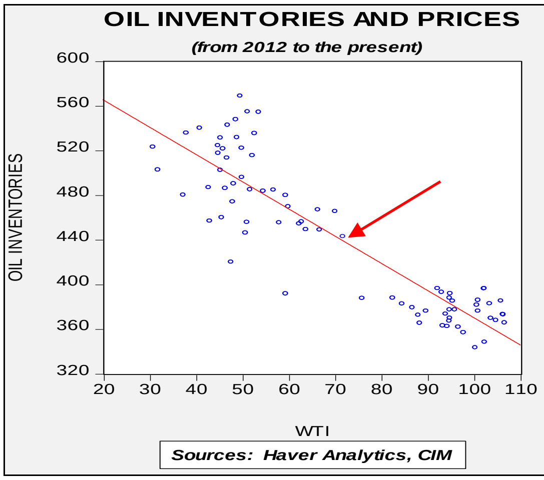


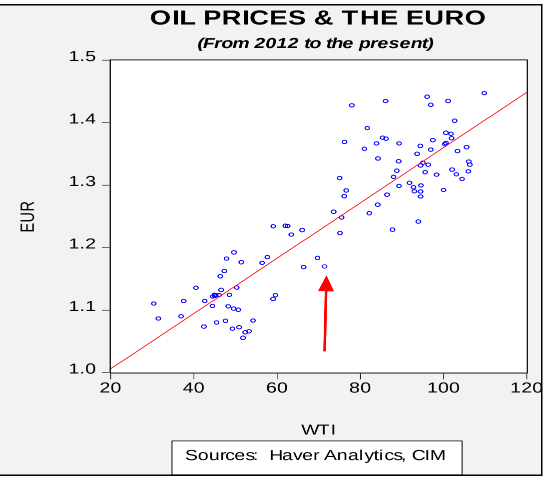
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventory remains historically high but inventories have declined significantly since March 2017. We would consider the overhang closer if stocks fell under 400 mb. This week's unexpected increase in oil inventories occurred because of a rise in imports and a drop in refinery operations. The drop in refining activity led to a 3.2 mb draw in gasoline stocks when a rise of 1.0 mb was expected. We would expect a rebound in refining activity next week which will probably bring a drop in oil inventories.

As the seasonal chart below shows, inventories are well into the seasonal withdrawal period. This week's increase in stocks was unusual, but given last week's rather large decline, some adjustment was not a huge shock. If the usual seasonal pattern plays out, mid-September inventories will be 405 mb.



(Source: DOE, CIM)

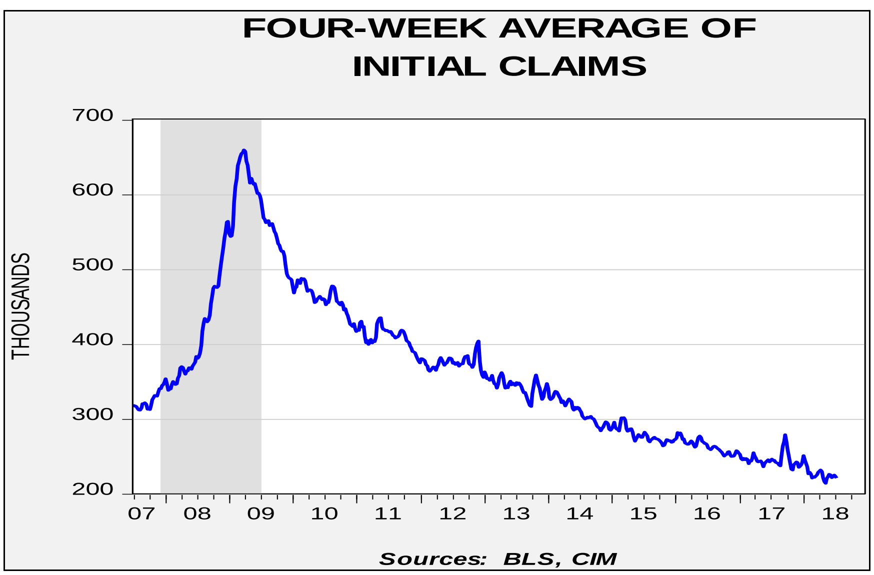




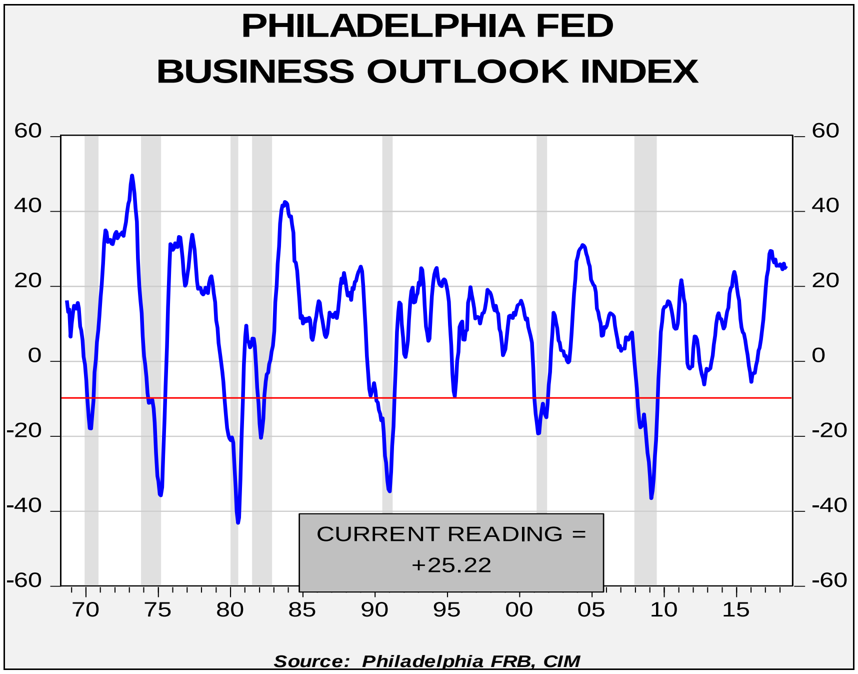
Based on inventories alone, oil prices are near the fair value price of $70.23. Meanwhile, the EUR/WTI model generates a fair value of $61.09. Together (which is a more sound methodology) fair value is $63.80, meaning that current prices are above fair value. Currently, the oil market is dealing with divergent fundamental factors. Falling oil inventories are fundamentally bullish but the stronger dollar is a bearish factor. The action to suppress Iranian oil exports has boosted oil prices but the rapid decline in oil inventories over the past week is very supportive for prices. It should be noted that a 405 mb number by September would put the oil inventory/WTI model in the mid $80s per barrel. Although dollar strength could dampen that price action, oil prices should remain elevated.

U.S. Economic Releases

Initial claims fell 8k to 207k, below the 220k forecast. The four-week average of claims fell 3.25k to 220.5k. As the chart below shows, the level of claims remains very low.



The July Philadelphia FRB Business Outlook index came in stronger than forecast, at 25.7 compared to estimates of 21.5.



We smooth the data on the above chart with a six-month moving average. The current reading is near cycle highs and is well above the recession signal which is -10. What makes this index important is that it is measuring business sentiment for the Mid-Atlantic region where the Fed governors work and mostly live, at least part of the time. No matter how data-sensitive one is, the economic activity that one observes directly will tend to affect one's outlook. Thus, a robust local economy in the Mid-Atlantic region could lead Fed governors to lean hawkish even if the rest of the nation's economy is less robust.

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	Leading economic indicators			0.4%	0.2%	***
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
9:00	Quarles	Governor				

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								
Australia	NAB Business Confidence	q/q	Q2	7.0	0.0	7.0	**	Equity and bond neutral
	Unemployment Rate	m/m	jun	5.4%	5.4%	5.4%	***	Equity and bond neutral
	Participation rate	m/m	jun	65.7%	65.5%	65.5%	**	Equity and bond neutral
Japan	Trade Balance	m/m	jun	¥721.4	¥296.8 bn	¥ 155.0 bn	**	Equity and bond neutral
	export growth	y/y	jun	6.7%	8.1%	7.0%	*	Equity and bond neutral
	import growth	y/y	jun	2.5%	14.0%	5.3%	*	Equity and bond neutral
EUROPE								
Switzerland	real export growth	m/m	jun	0.5%	0.0%		*	Equity and bond neutral
	real import growth	m/m	jun	-0.4%	3.1%		*	Equity and bond neutral
U.K.	Retail sales	y/y	Jun	3.0%	3.9%	3.5%	**	Equity bearish, bond bullish
	Retail sales, ex-fuel	y/y	Jun	2.9%	4.4%	3.7%	***	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	233	1	Up
3-mo T-bill yield (bps)	196	196	0	Neutral
TED spread (bps)	38	37	1	Neutral
U.S. Libor/OIS spread (bps)	199	199	0	Up
10-yr T-note (%)	2.89	2.87	0.02	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	4	4	0	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	$72.07	$72.90	-1.14%	strong dollar
WTI	$68.19	$68.76	-0.83%	
Natural Gas	$2.73	$2.72	0.40%	
Crack Spread	$17.48	$17.75	-1.49%	
12-mo strip crack	$18.64	$18.74	-0.52%	
Ethanol rack	$1.57	$1.57	-0.02%	
Metals				
Gold	$1,215.34	$1,227.51	-0.99%	strong dollar
Silver	$15.24	$15.56	-2.01%	
Copper contract	$268.45	$276.00	-2.74%	
Grains				
Corn contract	$ 360.25	$ 361.00	-0.21%	strong dollar
Wheat contract	$ 493.25	$ 494.50	-0.25%	
Soybeans contract	$ 853.25	$ 857.75	-0.52%	
Shipping				
Baltic Dry Freight	1688	1721	-33	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	5.8	-4.1	9.9	
Gasoline (mb)	-3.2	-0.7	-2.5	
Distillates (mb)	-0.4	1.1	-1.5	
Refinery run rates (%)	-2.40%	0.30%	-2.7%	
Natural gas (bcf)		56.0	-56.0	

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for the West Coast and Southwest, with the rest of the country 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.

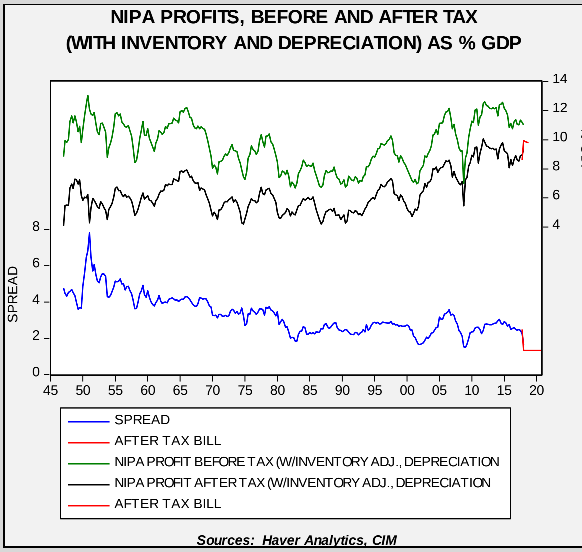
Asset Allocation Weekly Comment

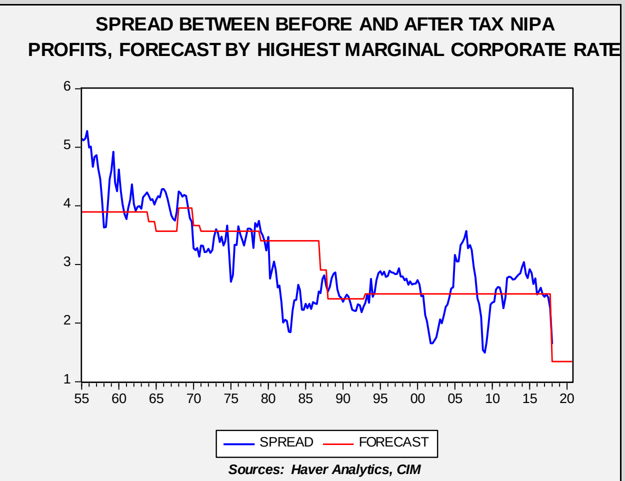
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

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.

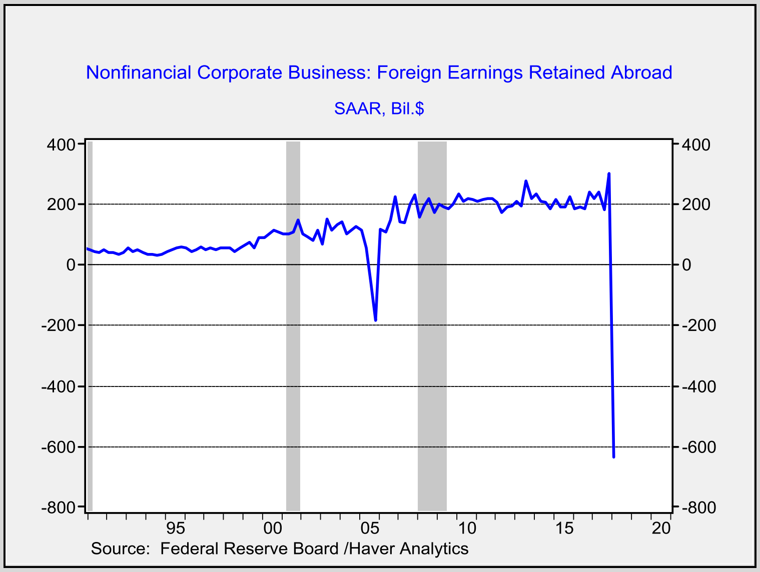




The chart on the left shows corporate profits from the National Product and Income Accounts, the profits data calculated as part of GDP. This chart shows the pre- and post-tax profits as a percentage of GDP and the lower line shows the spread between the two. A narrower spread indicates fewer profits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

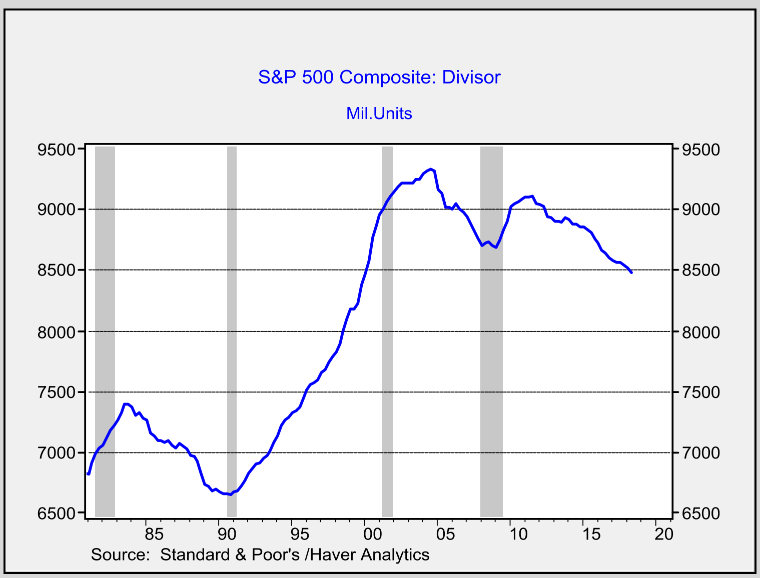
The consensus forecast for Q2 is $39.20 per share,[6] which is up 19.9% over last year. In addition, companies are repatriating money from their overseas accounts.

[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.



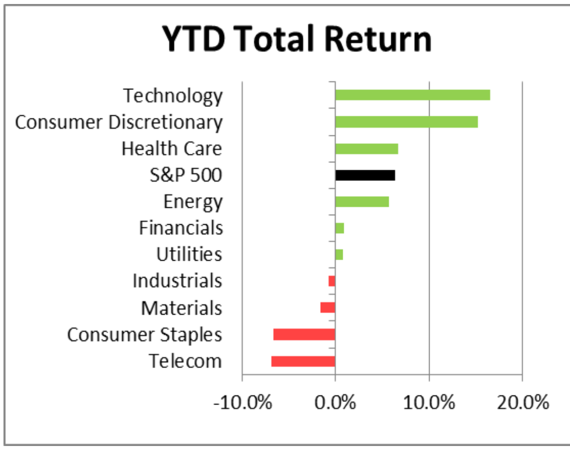
[7] In reality, most of it was already in U.S. banks but were in foreign accounts denominated in dollars.
[8] https://www.wsj.com/articles/stock-buybacks-are-booming-but-share-prices-arent-budging-1531054801

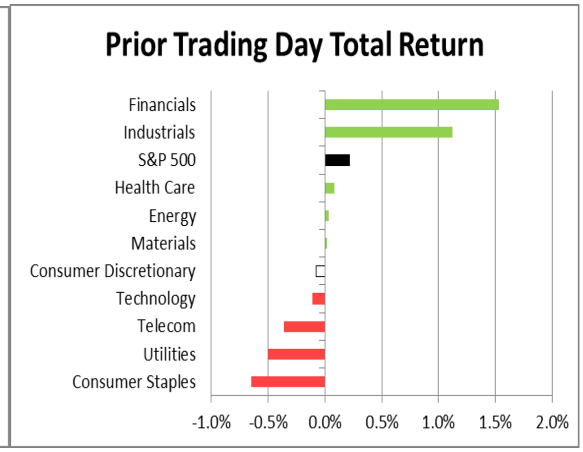
This chart shows the S&P 500 Index divisor; it takes mergers, share buybacks and new issuance into account. Since 2011, the divisor has been steadily declining due to mergers and share buybacks overwhelming new issuance. Note the difference from the 1990s bull market which was characterized by a rising 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 7/17/2018 close)

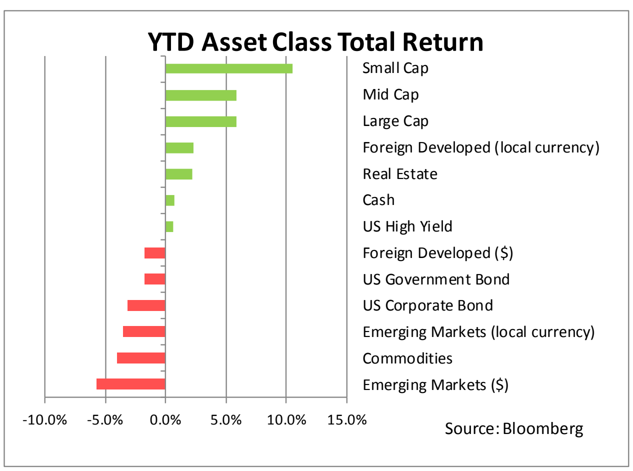




(Source: Bloomberg)

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 7/17/2018 close)

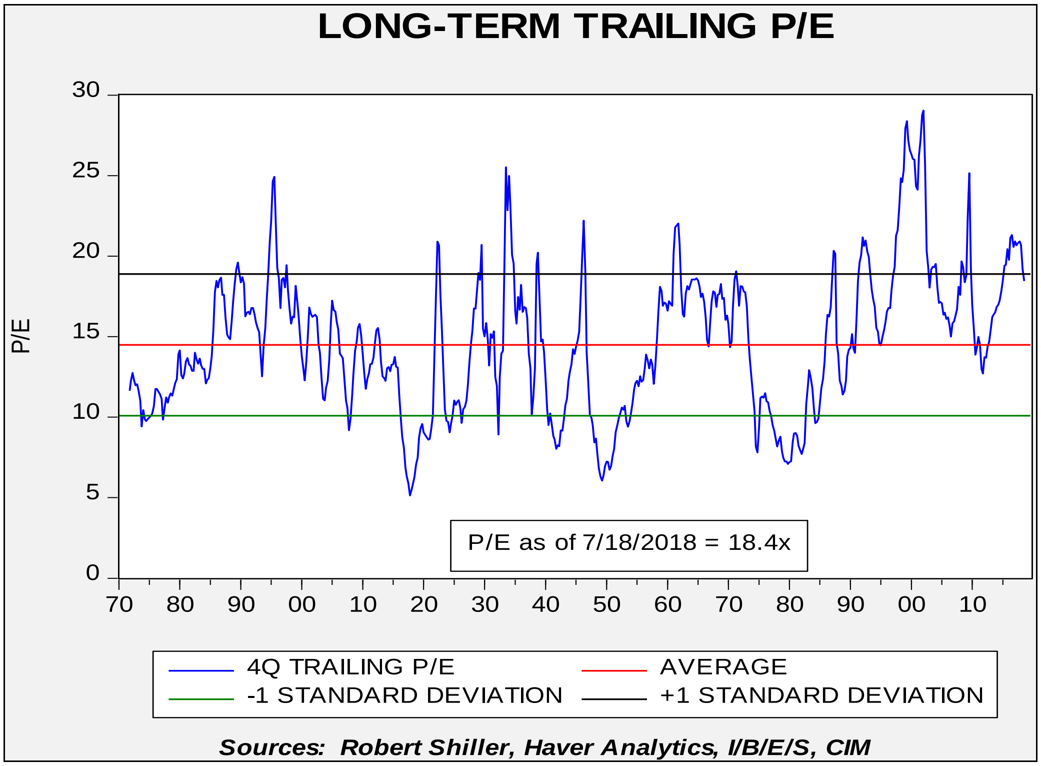


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 19, 2018



Based on our methodology,[9] the current P/E is 18.4, up 0.1x 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.

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[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.