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 27, 2018—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is up 0.4% 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 0.3% and the Shenzhen index down 0.7%. U.S. equity index futures are signaling a lower open. With 217 companies having reported, the S&P 500 Q2 earnings are above expectations at $39.90 compared to the $39.20 forecast for the quarter. The forecast reflects a 19.9% increase from Q2 2017 earnings. Thus far this quarter, 86.6% of the companies reported earnings above forecast, while 8.8% reported earnings below forecast.

It's GDP day! We detail the data below but the quick take is that it was a very solid number, up 4.1%. Unfortunately, hyperbolic comments from the White House in front of the report increased the odds of disappointment. The initial market reaction is showing disappointment. However, it should not be lost that this was a really strong report. Other than that, it was a fairly quiet overnight session. Here is what we are watching:

Trade: The recent truce between the EU and the U.S. has sparked all kinds of speculation of a process behind the rhetoric. Some see the potential for an EU/U.S. united front against China; this idea is being pushed by Larry Kudlow.[1] If the U.S. makes a trade deal with the EU, the two could isolate China. This is a very worthwhile geopolitical tactic. However, that process was already underway—it was called the Transatlantic Trade and Investment Partnership, or TTIP. The president killed that deal but it was already on the rocks before his election. The combination of TPP and TTIP[2] would have completely isolated China and Russia and forced them to deal with the lynchpin state, the U.S., to remain relevant to trade. It should be noted that both were dead letters before the last election. And so, the real issue isn't Trump, it's that the American people are no longer on board to support American hegemony. Is it possible that Kudlow is correct? Sure, but the risk is that there isn't sufficient support for any such program.

We are working from the position that the president's primary goal is to reduce imports and boost domestic manufacturing activity by forcing firms to shorten supply chains. If we are correct, the "Juncker truce" is a tactical retreat. The pushback the White House is getting from sectors of the economy adversely affected by trade impediments is leading the president to

[1] https://www.reuters.com/article/us-usa-trade-eu-kudlow/white-houses-kudlow-says-eu-will-help-trump-confront-china-idUSKBN1KG2FF and Weekly Geopolitical Report, The TTIP and the TPP: An Update (10/17/16)
[2] See Weekly Geopolitical Report, The TTIP and the TPP (1/27/14)

moderate his trade position in front of the mid-term elections. But, we see no evidence that his central policy goal is changing.

A take on Russia: There are reports that former SoS Henry Kissinger suggested to Trump administration officials that they should consider a reversal of the policy that became "Nixon to China" in the 1970s.[3] Kissinger offered the idea that the incoming administration should improve relations with Russia and use that to isolate China. This isn't a bad idea. Russia naturally fears China; the former is facing a demographic catastrophe and fears that China will eventually take the far eastern reaches of Russia.[4] The problem with this policy is that it isn't clear whether the friendliness the president shows to Vladimir Putin is to isolate China or if he just likes the Russian leader. At this point, we don't know, but if it is the latter the improvement in relations may not lead to isolating China at all. It may simply isolate our post-WWII allies, Japan and the EU.

Bitcoin strikes out again: The SEC rejected an application by the Winklevoss twins to launch a Bitcoin ETF. This is the second time in two years that the SEC has rejected the application. Bitcoin fell on the news.

Turkey threats: Andrew Brunson is a Christian pastor who has been in a Turkish prison for 21 months; he is one of 20 other Americans who were arrested after the failed coup against President Erdogan. It seems highly unlikely that Brunson participated in any action to support the coup.[5] He has been working in Turkey for 23 years. Instead, Erdogan is using Brunson as a bargaining chip to swap Fethullah Gulen, an Islamist figure who was once allied with Erdogan to oppose Turkey's then secularist government. However, as Erdogan rose to power, the two had a falling out and the current Turkish president has feared that Gulen's followers will try to oust him. Gulen currently lives in a rural Pennsylvania compound. The U.S. has, so far, refused to extradite Gulen. On this issue, instead of swapping Gulen for Brunson, the Trump administration worked out an agreement where Israel would trade Ebru Ozkan, a 27-year-old Turkish woman currently imprisoned on smuggling charges, for Brunson. From the perspective of Turkey, this wasn't much of a trade. The case against Ozkan isn't very strong; in fact, it's weak enough that an Israeli court released her to house arrest. That agreement apparently fell apart when a Turkish court kept Brunson under house arrest, although they did release him from prison. Both President Trump and Vice President Pence reacted with great anger to this development and both promised new sanctions against Turkey.[6] The embattled Turkish lira took another leg down on the U.S. reaction. From our perspective, Turkey overplayed its hand. The U.S. does not appear compelled to extradite Gulen. He may be useful to American interests

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[3] https://www.thedailybeast.com/henry-kissinger-pushed-trump-to-work-with-russia-to-box-in-china?ref=home

[4] https://www.nytimes.com/2016/08/01/world/asia/russia-china-farmers.html and https://www.scmp.com/week-asia/geopolitics/article/2100228/chinese-russian-far-east-geopolitical-time-bomb

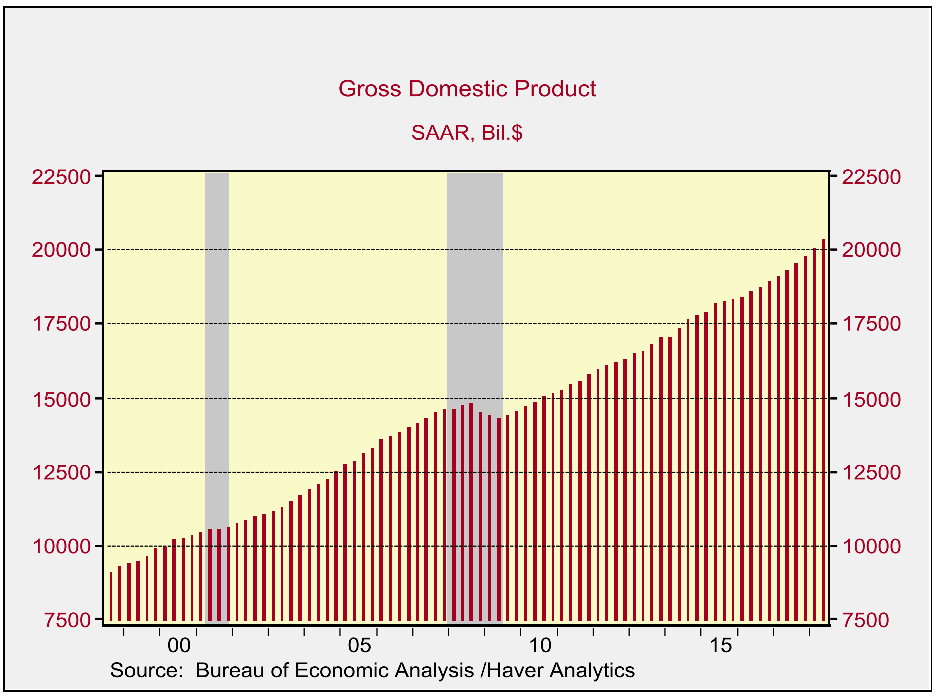
[5] For background, see Weekly Geopolitical Reports, The Turkish Coup, Part 1 (7/25/16); Part II (8/1/16); and Part III (8/8/16).

[6] https://www.washingtonpost.com/politics/trump-says-us-will-impose-large-sanctions-on-turkey-for-detaining-american-pastor-for-nearly-two-years/2018/07/26/75dcde32-90e5-11e8-bcd5-9d911c784c38_story.html?utm_term=.e6b299282fd1 ; https://www.nytimes.com/2018/07/26/world/europe/turkey-sanctions-trump.html?emc=edit_mbe_20180727&nl=morning-briefing-europe&nlid=567726720180727&te=1

because he does seem to threaten Erdogan and thus can be used to control Erdogan's behavior. After all, Turkish and American interests don't completely align; Turkey systematically oppresses the Kurds who are a reliable U.S. ally in the region. Erdogan has also flirted with Russia and has allowed Middle Eastern refugees to surge into Europe. As a result, the U.S. views Turkey as rather unreliable. The idea that this pastor would be important enough to swap Gulen is fairly farfetched. The U.S. could inflict rather severe pain on Turkey; the drop in the lira is causing problems for the economy[7] and the administration could sanction the country for dealing in Iranian oil. We would expect Turkey will realize at some point that it isn't going to get Gulen and conclude that continuing to hold Brunson isn't worth the trouble.

U.S. Economic Releases

The first reading of Q2 GDP came in below expectations at 4.1% compared to the forecast of 4.2%. Personal consumption came in above expectations, rising 4.0% from the prior quarter compared to the forecast of 3.0%. Core PCE rose 2.0% from the prior quarter. The overall GDP price index came in higher than expected, rising 2.0% from the prior quarter compared to the forecast of 1.9%.

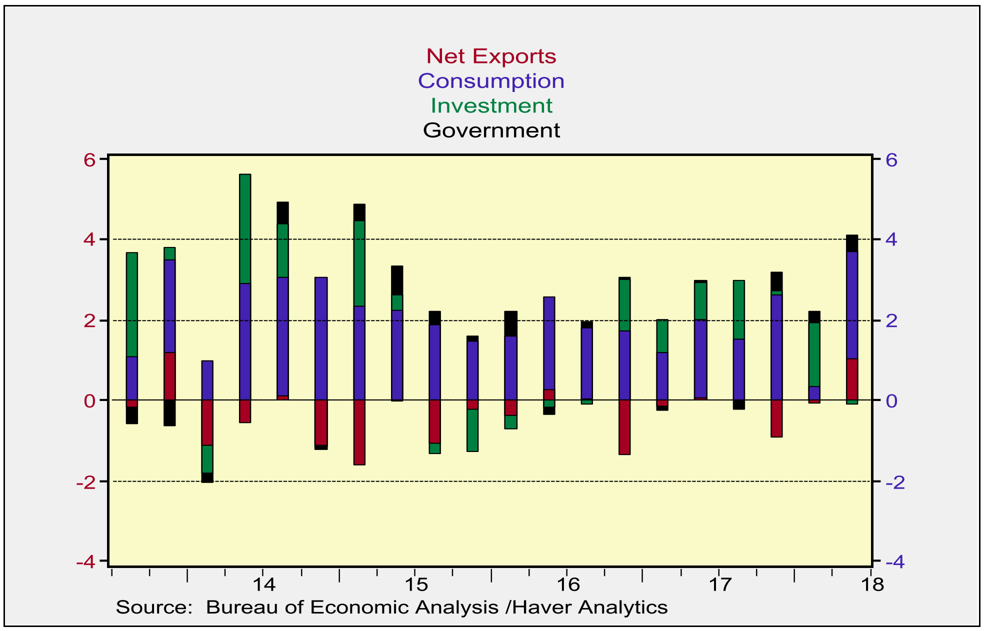


The chart above shows historical GDP. As of right now, GDP continues to grow at a solid pace.

[7] https://www.ft.com/content/c114d1ca-90d6-11e8-b639-7680cedcc421

	Q2 2018 Prelim Reading	Q1 2018 Final Reading	Difference
GDP	4.1%	2.2%	1.9%
Consumption	2.7%	0.4%	2.3%
Investment	-0.1%	1.6%	-1.7%
Inventories	-1.0%	0.3%	-1.3%
Net Exports	1.1%	0.0%	1.1%
Government	0.4%	0.3%	0.1%

The table above shows the contributions to GDP. There was a sharp rise in consumption in Q2 as well as a boost in exports. This rise in consumption could be a result of growing consumer confidence, whereas the rise in exports is likely the result of foreign companies loading up on inventories before tariffs were put in place. As a result, it is unlikely the momentum from this quarter will continue.



This chart shows the contributions graphically. Investment was the only negative component in Q2 GDP and that was due to the drawdown of inventories. This would argue that Q3 should benefit from inventory rebuilding.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	U. of Michigan Sentiment	m/m	jul	97.1	97.1	**
10:00	U. of Michigan Current Conditions	m/m	jul		113.9	**
10:00	U. of Michigan Expectations	m/m	jul		86.4	**
10:00	U. of Michigan 1 yr Inflation	m/m	jul		2.9%	**
10:00	U. of Michigan 5-10 Yr Inflation	m/m	jul		2.4%	**
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	Industrial Profits	y/y	jun	20.0%	21.1%		**	Equity and bond neutral
Japan	Tokyo CPI	y/y	jul	0.9%	0.6%	0.7%	***	Equity bullish, bond bearish
Australia	PPI	y/y	2q	1.5%	1.7%		**	Equity and bond neutral
New Zealand	ANZ Consumer Confidence	m/m	jul	-1.3%	-0.8%		**	Equity bearish, bond bullish
EUROPE								
Germany	Import Price Index	m/m	jul	4.8%	3.2%	4.5%	***	Equity bullish, bond bearish
France	GDP	y/y	2q	1.7%	2.2%	1.9%	***	Equity and bond neutral
	Consumer Spending	m/m	jun	0.3%	-0.2%	0.7%	**	Equity bearish, bond bullish
Italy	PPI	y/y	jun	3.2%	2.7%		**	Equity bullish, bond bearish
Russia	Gold and Forex Reserve	m/m	jul	457.9 bn	460.3 bn		*	Equity and bond neutral
AMERICAS								
Mexico	Unemployment Rate	m/m	jun	3.4%	3.2%	3.3%	***	Equity bullish, bond bearish
Canada	CFIB Business Barometer	m/m	jul	56.8	62.2		**	Equity and bond neutral
Brazil	Current Account Balance	m/m	jun	$0.435 bn	$0.729 bn	$0.250 bn	**	Equity and bond neutral
	Foreign Direct Investment	m/m	jun	$6.533 bn	$2.978 bn	$6.000 bn	**	Equity bullish, bond bearish
	FGV Construction Cost	m/m	jun	0.7%	0.8%	0.7%	**	Equity and bond neutral

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)	195	195	0	Neutral
TED spread (bps)	39	39	0	Neutral
U.S. Libor/OIS spread (bps)	201	201	0	Up
10-yr T-note (%)	2.98	2.98	0.00	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	5	5	0	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	down			Neutral
yen	up			Neutral
pound	flat			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Russia Key Rate	7.250%	7.250%	7.250%	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	$74.55	$74.54	0.01%	
WTI	$69.53	$69.61	-0.11%	
Natural Gas	$2.79	$2.78	0.22%	
Crack Spread	$20.38	$20.19	0.95%	
12-mo strip crack	$20.46	$20.48	-0.10%	
Ethanol rack	$1.58	$1.57	0.16%	
Metals				
Gold	$1,219.16	$1,222.69	-0.29%	
Silver	$15.37	$15.38	-0.09%	
Copper contract	$281.65	$281.80	-0.05%	
Grains				
Corn contract	$ 375.50	$ 375.75	-0.07%	
Wheat contract	$ 533.50	$ 536.50	-0.56%	
Soybeans contract	$ 881.25	$ 876.00	0.60%	
Shipping				
Baltic Dry Freight	1708	1772	-64	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-6.1	-3.1	-3.0	
Gasoline (mb)	-2.3	-1.2	-1.1	
Distillates (mb)	-0.1	0.6	-0.7	
Refinery run rates (%)	-0.50%	1.00%	-1.5%	
Natural gas (bcf)	24.0	46.0	-22.0	

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 for the eastern half of the country. 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 27, 2018

Last week, in a wide-ranging interview on CNBC,[8] President Trump ended a 25-year détente with the Federal Reserve, openly criticizing the current path of monetary policy. The president followed up the interview with numerous social media tweets, further criticizing policy tightening.

Although it's been a long time since a president weighed in directly on the Federal Reserve's monetary policy, such criticism is not at all unusual. In fact, the détente is perhaps the outlier. There is a natural tension between a government in power and a central bank. Political leadership, regardless of whether a country is a democracy or not, generally prefers lower interest rates. In the U.S., the Federal Reserve became untethered from the Treasury in 1951 when the White House, Congress and the Federal Reserve agreed to give the central bank independence in setting monetary policy. Up until that point, the Federal Reserve was required to assist the Treasury in facilitating the management of Treasury debt. However, it should be noted that President Truman was not comfortable with this change.

As inflation rose in the late 1960s, chairs of the Federal Reserve faced increasing pressure from various administrations. President Johnson criticized William Martin for not supporting his stimulus policies with monetary accommodation.[9] Nixon tried to replace Martin after his election in 1968, offering to nominate him for treasury secretary. There is speculation that Nixon blamed Martin for his loss to Kennedy in 1960[10] and wanted a more compliant Fed chair. When Martin refused to leave, Nixon eventually replaced him with Arthur Burns. Nixon persistently browbeat Burns and, in order to ensure he would provide easy monetary policy, started a rumor that Burns was pressing for a raise when the Fed chair was publicly opposing wage increases. Nixon then recruited Alan Greenspan to tell Burns that if he promised to keep policy accommodative, the White House would deny the rumors.[11]

Reagan was not above criticizing the Fed; in 1980 his government issued a statement warning that the Fed's independence "should not mean lack of accountability" and that Congress should "monitor the Fed's performance."[12] Reagan strongly considered not reappointing Paul

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[8] https://www.cnbc.com/video/2018/07/20/watch-cnbcs-full-exclusive-interview-with-president-donald-trump.html

[9] https://www.nytimes.com/2017/06/13/business/economy/a-president-at-war-with-his-fed-chief-5-decades-before-trump.html

[10] https://www.minneapolisfed.org/publications/the-region/remembering-william-mcchesney-martin-jr ; also, Mallaby, Sebastian. (2016). *The Man Who Knew: The Life and Times of Alan Greenspan*. New York, NY: Penguin Books, p. 134.

[11] Ibid., pp. 141-144

[12] https://books.google.com/books?id=hclu1_TJ9K8C&pg=PA1976&lpg=PA1976&dq=coordinating+committee+on+economic+policy+economic+strategy+of+the+Reagan+administration+november+16+1980&source=bl&ots=URIX4HAra8&sig=iBKs1W1J94qfuMmq5l8k-F-

Volcker.[13] Volcker left the Fed in 1987, surrounded by governors appointed by President Reagan who were in the habit of dissenting with his decisions.

Even Alan Greenspan, who for a period took on a persona of "the maestro,[14]" faced heavy criticism from the Bush administration as he refused to cut interest rates; he was even called "creepy."[15] George H.W. Bush blamed Greenspan for his defeat by Bill Clinton.[16] The current détente between the Federal Reserve and the White House came when Robert Rubin, the director of the National Economic Council, convinced the president that the Fed's policy decisions should not be questioned.[17] Rubin argued that if the Fed could establish inflation-fighting credibility and reduce inflation expectations, then long-term interest rates would fall and the economy would prosper.

President Trump has clearly ended that detente. Does that mean anything in the very short run? Probably not. We still expect four more rate hikes; the Eurodollar futures market hasn't changed its assessment of the current policy path. But, the criticism will likely increase with each rate hike and it will begin to affect policy at some point. In fact, Chair Powell faces a difficult future. Every rate hike will prompt unfriendly comments from the White House. Once easing starts, Powell could face charges of acquiescence to Trump.

For markets, concern about the Fed eventually manifests itself in rising inflation expectations. Actual inflation is based on the intersection of aggregate supply and aggregate demand. Since 1978, deregulation and globalization have shifted the supply curve away from its origin and likely flattened this slope as well. These factors have led to persistently low inflation. The role of the central bank is more about managing inflation expectations. Since Volcker, the Federal Reserve has made it clear that it won't tolerate or accommodate sharply rising price levels. The combination of credible monetary policy and rising productive capacity has led to disinflation and a steady decline in long-term interest rates.

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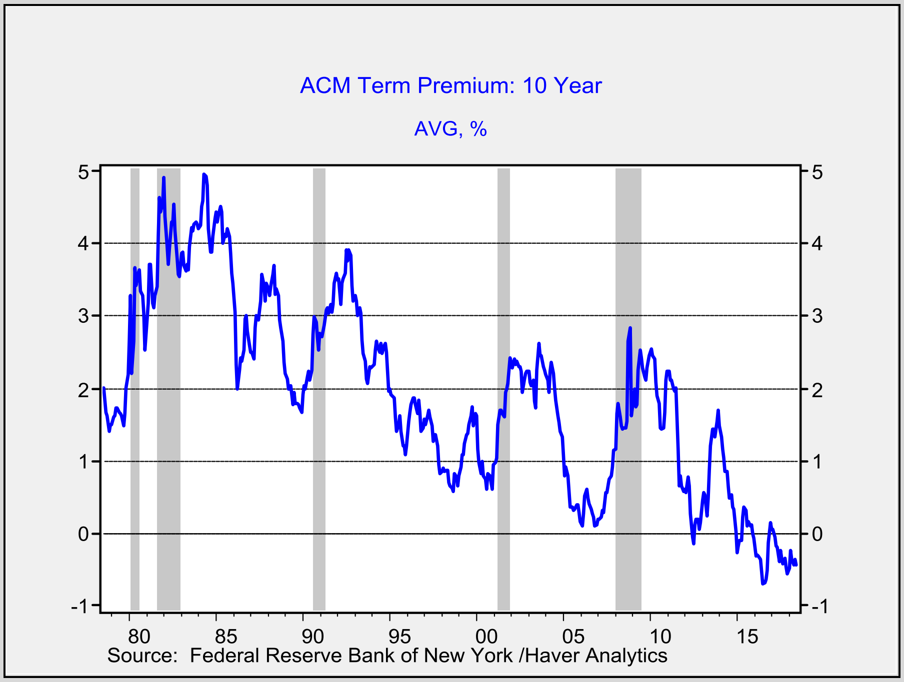
[13] Op. cit., Mallaby, p. 286

[14] Woodward, Bob. (2000). *Maestro: Greenspan's Fed and the American Boom*. New York, NY: Simon and Schuster.

[15] Op. cit., Mallaby, p. 415

[16] Ibid., p. 416

[17] https://www.wsj.com/articles/a-brief-history-of-the-federal-reserves-independence-1497346201

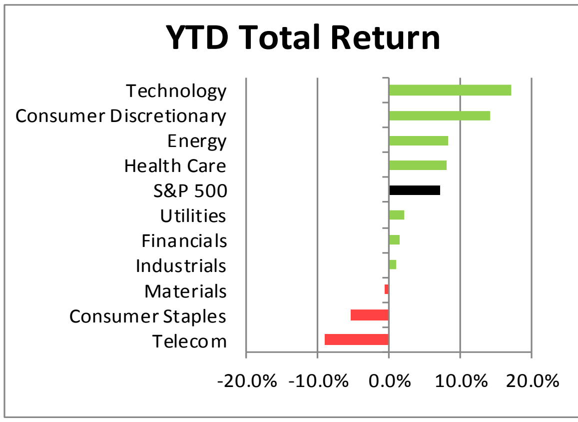


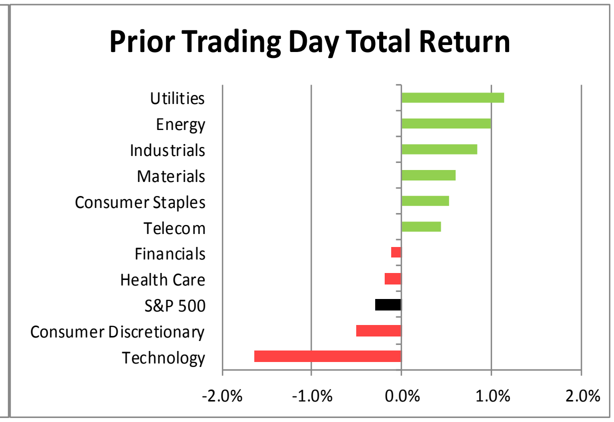
This chart shows a calculation of the term premium on 10-year T-notes. The term premium measures how much more yield investors demand for holding longer term notes. In other words, an investor could simply buy a one-year T-bill each year for 10 years or a 10-year T-note. Usually, the longer duration instrument carries a higher yield because there are risks that rates could rise in the future, lowering the price of the T-note. Simply put, the term premium is an attempt to measure the market's estimate of the riskiness of owning long-duration debt. As the above chart shows, the current term premium is negative, suggesting investors would much rather own the long-duration instrument and are willing to accept a "discounted" rate.

Undermining the Fed runs the risk of reversing this term premium, which would lead to a steeper yield curve and higher interest rates. So far, that has not occurred. There are a couple reasons for this lack of movement. First, the deregulatory policies of the Trump administration are disinflationary. Thus, the inflationary impact from trade impediments may not be as large if the economy can still enjoy the unfettered introduction of new technology. Second, the term premium is mostly a function of inflation expectations, which take a long time to evolve. Milton Friedman argued that inflation expectations are set over decades. Thus, for now, we don't expect a major increase in long-term rates. But, the potential risks are rising. Investors should be wary of long-duration positions and consider bond laddering.

<u>Data Section</u>

U.S. Equity Markets – (as of 7/26/2018 close)

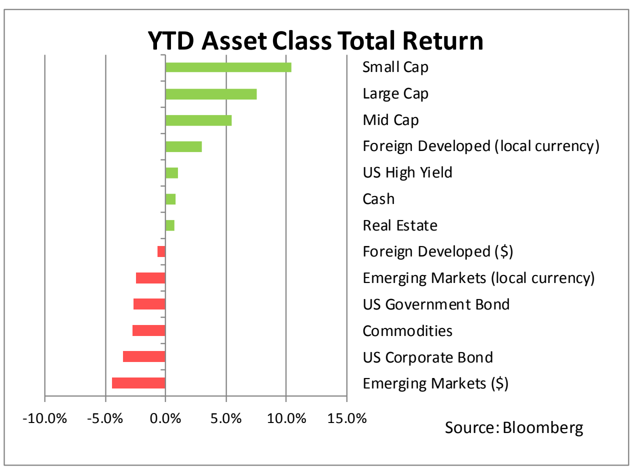




(Source: Bloomberg)

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 7/26/2018 close)

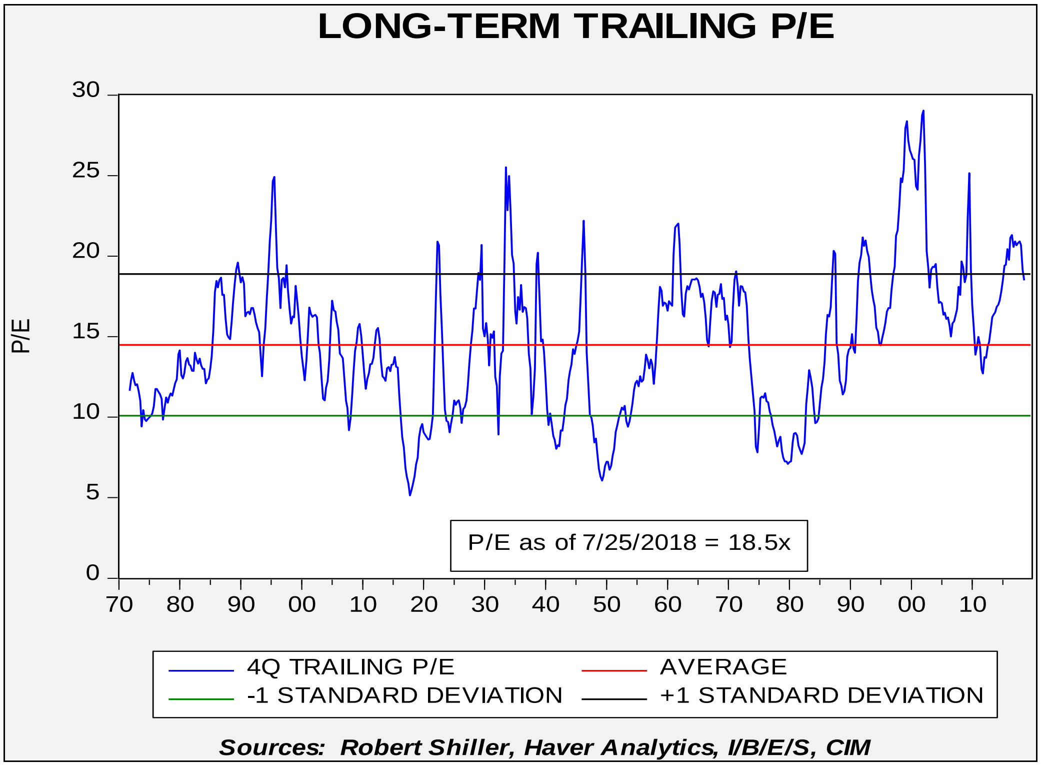


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 26, 2018



Based on our methodology,[18] the current P/E is 18.5, 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.

[18] 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.