Daily Comment

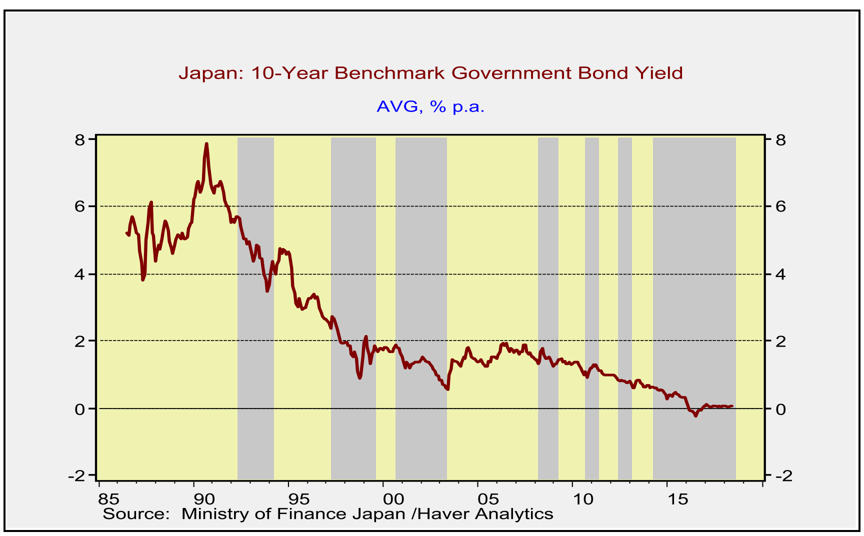
By Bill O'Grady and Thomas Wash

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 30, 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 0.3% from the prior close. Chinese markets were down, with the Shanghai composite down 0.2% and the Shenzhen index down 1.4%. U.S. equity index futures are signaling a lower open. With 265 companies having reported, the S&P 500 Q2 earnings are above expectations at $40.27 compared to the $39.20 forecast for the quarter. The forecast reflects a 19.9% increase from Q2 2017 earnings. Thus far this quarter, 85.3% of the companies reported earnings above forecast, while 10.2% reported earnings below forecast.

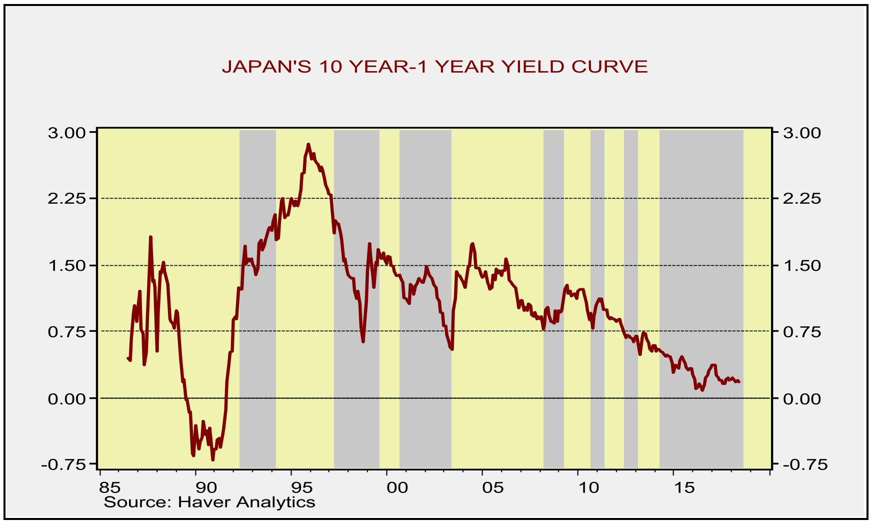
Today we kick off central bank week. The BOE, BOJ and Fed all meet this week. The last meeting is probably of least consequence. Here is what we are watching:

BOJ: The BOJ has clearly spooked the market; the Japanese central bank's current policy is to fix the 10-year JGB interest rate at 0% and buy all the bonds required to fix the rate. This practice has generally put the rate around 5 bps. Now, the BOJ is considering adjusting that policy and fears of policy tightening have lifted yields and forced the BOJ to increase market intervention to prevent yields from rising.[1]

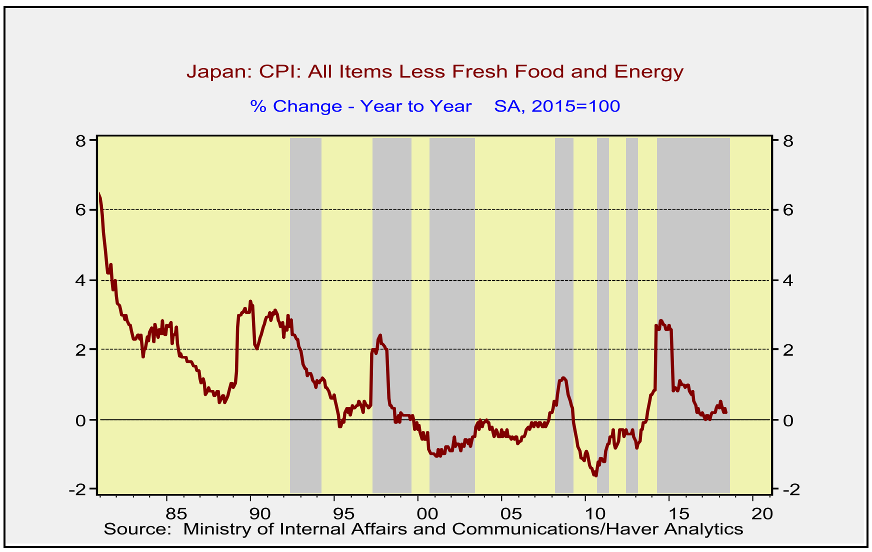


[1] https://www.ft.com/content/d1606352-9309-11e8-b747-fb1e803ee64e?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

This has also led to a very flat yield curve.



Despite all this stimulus, Japan appears no closer to reaching any sort of rising price levels.



So, if forcing the long-term rate to zero isn't generating any inflation, why is the BOJ thinking about allowing the 10-year yield to rise? It's probably about the yield curve. Banking is a spread business; one borrows at the short end of the curve and lends at the long end. The usual spread between long- and short-term rates generally represents bank margins. Thus, the flat yield curve is hurting the banking system and the BOJ probably wants to help that sector. The problem is that if the BOJ signals that the long rate may be allowed to rise, which will likely be seen as tightening, the JPY could appreciate. A stronger currency will undermine Abenomics and thus the BOJ will try very hard to avoid that outcome. We expect the BOJ to offer a tepid promise to allow some rise in the long-term interest rate but prevent too much of a rise. Consequently, the fear may overshadow what actually happens.

The Fed: No rate hike is forecast. The only item of interest will be the statement which probably won't tell us anything. Nevertheless, in light of Q2 GDP, we would not be surprised to see a statement that focuses on strong growth which will bolster the argument for raising rates. However, that is mostly to confirm the current expected policy path, nothing more.

BOE: We expect the BOE to raise rates 25 bps. That move is well discounted but still could be modestly bullish for the GBP.

China in South America: China has been making investments in South America for some time. Since 2000, China has been the world's largest consumer of numerous commodity products and friendly ties would make sense since the region is a major producer. However, a report in Sunday's *NYT*[2] caught our attention; China has built a space station in Argentina that could be for dual use. In other words, the facility could have military applications. This facility is a troubling development, a clear violation of the Monroe Doctrine. The article notes that U.S. interest in the region has been waning for some time, and China is moving to fill the void in what is essentially America's backyard.

Russia dumps Treasuries: Despite the controversial meeting between President Trump and President Putin, which has raised fears in some quarters of a risky thaw in relations, Russia isn't acting as if it believes conditions will improve. Reports over the weekend indicate that Russia has sold nearly all of its Treasuries held in its official foreign reserves.[3] This is an unusual move and would normally only be made if a nation wanted to diversify into some other reserve currency, e.g., euros. However, there isn't much evidence that any such action occurred. It has been noted that Cayman Island holdings rose by over $20 bn in the past two months, which may suggest some Russians are trying to hide the assets. Clearly, the move didn't move yields.

A government shutdown? President Trump indicated he would be willing to shut down the government if Congress fails to fund his border wall.[4] So far, the financial markets are not taking the threat seriously. It would be politically risky to shut down the government just before mid-terms; if the GOP were blamed, it could cost them votes. In addition, the distraction could prevent Brett Kavanaugh from being confirmed in this term. The market take, so far, is that this is bluster but if the president is serious the usual market pattern would be risk-off.

Iranian sanctions loom: Iran will face new sanctions on August 7, with the final phase being implemented in early November. The Iranian rial plunged,[5] falling to 111,500 rials/USD on the open market, a new record low. The Iranian currency has lost over half its value since April. There have been reports of scattered unrest as the economy stumbles. This week's WGR will kick off a three-part report on Iran's potential responses to sanctions. The first part will be published later today.

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[2] https://www.nytimes.com/2018/07/28/world/americas/china-latin-america.html

[3] http://www.dailymail.co.uk/news/article-6003457/amp/Mystery-Russia-LIQUIDATES-holdings-Treasury-securities.html?__twitter_impression=true

[4] https://twitter.com/realDonaldTrump/status/1023557246628900864

[5] https://www.aljazeera.com/news/2018/07/iran-currency-plunges-record-sanctions-loom-180729135733789.html?utm_source=Sailthru&utm_medium=email&utm_campaign=ebb%2030.07.18&utm_term=Editorial%20-%20Early%20Bird%20Brief

An interesting political development: The Koch brothers have been important funders of the GOP in recent years. They are demonized on the left in a similar fashion to George Soros being lambasted from the right. However, we believe it is naïve to view the Kochs or Soros purely through the perspective of party. The Kochs are mostly right-wing establishment with some libertarian leanings; Soros is left-wing establishment with similar market-friendly positions. Over the weekend, Charles Koch shocked the political world by suggesting he would work with Democrats who share some of his policy goals.[6] The reaction was swift; Steve Bannon essentially told the Kochs to pipe down and fund the president's favored candidates.[7] We believe the proper way to view this "spat" is through the lens of our recent WGRs on class and identity in politics.[8] Soros and the Kochs are establishment in terms of class. The Kochs apparent defection likely stems from their perception that the GOP is being taken over by right-wing populists who will support policies that eventually harm capital (e.g., trade impediments, restrictions on foreign investment, immigration restrictions). That doesn't mean the Democrats will now become the party of the establishment class; after all, the Democrats are facing their own internal revolt between the left-wing establishment and left-wing populists. What this does show is that the party affiliations are becoming increasingly fluid as we are going through a significant restructuring of the U.S. political system. The Kochs opening up to the idea that Democrats may be friendlier to their interests is an element of this restructuring.

U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below lists the economic releases scheduled for the rest of the day.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Pending Home Sales	m/m	jul	0.2%	-0.5%	**
10:00	Pending Homes	m/m	jul		-2.8%	**
10:30	Dallas Fed Manf, Activity	m/m	jul	31.0	36.5	**
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.

[6] https://www.politico.com/story/2018/07/29/koch-democrats-funding-747501
[7] https://www.politico.com/story/2018/07/29/bannon-koch-brothers-midterms-trump-747650
[8] See Weekly Geopolitical Reports, Reflections on Politics and Populism: Part I (7/16/18) and Part II (7/23/18).

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
Japan	Retail Sales	m/m	jun	1.5%	-1.7%	1.5%	**	Equity and bond neutral
	Retail Trade	y/y	jun	1.8%	0.6%	1.7%	**	Equity bullish, bond bearish
	Dept. Store, Supermarket Sales	y/y	jun	1.6%	-2.0%	1.6%	**	Equity and bond neutral
EUROPE								
Eurozone	Economic Confidence	m/m	jul	112.1	112.3	112.0	***	Equity and bond neutral
	Business Climate Indicator	m/m	jul	1.29	1.39	1.35	**	Equity bearish, bond bullish
	Industrial Confidence	m/m	jul	5.8	6.9	6.7	**	Equity bearish, bond bullish
	Services Confidence	m/m	jul	15.3	14.4	14.2	**	Equity bullish, bond bearish
	Consumer Confidence	m/m	jul	-0.6	-0.6	-0.6	***	Equity and bond neutral
Germany	CPI	y/y	jul	2.0%	2.1%	2.1%	***	Equity and bond neutral
U.K.	Net Consumer Credit	m/m	jul	1.6 bn	1.4 bn	1.4 bn	**	Equity bullish, bond bearish
	Net Lending Sec. on Dwellings	m/m	jul	3.9 bn	4.0 bn	4.0 bn	**	Equity and bond neutral
	Mortgage Approvals	m/m	jul	65.6k	64.5k	65.5k	**	Equity and bond neutral
	Money Supply M4	m/m	jul	-0.3%	0.4%		**	Equity and bond neutral
Switzerland	KOF Leading Indicator	m/m	jul	101.1	101.7	101.5	**	Equity and bond neutral
AMERICAS								
Mexico	Budget Balance	m/m	jun	-0.897 bn	-1.587 bn	-0.275 bn	**	Equity bearish, bond bullish
Brazil	Personal Loan Default Rate	m/m	jun	5.0%	5.0%		**	Equity and bond neutral
	Central Government Budget Balance	m/m	jun	-$16.4 bn	-$11.0 bn	-$13.4 bn	**	Equity bearish, bond bullish
	FGV Inflation IGPM	m/m	jun	0.5%	1.9%	0.5%	**	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	234	0	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	2.96	0.02	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	up			Neutral
yen	down			Neutral
pound	up			Neutral
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	$74.95	$74.29	0.89%	Short Covering
WTI	$70.12	$68.69	2.08%	
Natural Gas	$2.78	$2.78	-0.22%	
Crack Spread	$19.65	$20.43	-3.85%	
12-mo strip crack	$20.02	$20.45	-2.10%	
Ethanol rack	$1.57	$1.57	0.04%	
Metals				
Gold	$1,223.28	$1,224.22	-0.08%	
Silver	$15.53	$15.51	0.14%	
Copper contract	$278.35	$280.20	-0.66%	
Grains				
Corn contract	$ 379.50	$ 376.25	0.86%	
Wheat contract	$ 539.75	$ 530.50	1.74%	
Soybeans contract	$ 891.25	$ 885.25	0.68%	
Shipping				
Baltic Dry Freight	1676	1708	-32	

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temperatures in the southeastern region. 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,[9] 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.[10] 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[11] 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.[12]

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."[13] Reagan strongly considered not reappointing Paul

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

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

[11] 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.

[12] Ibid., pp. 141-144

[13] 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.[14] 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,[15]" faced heavy criticism from the Bush administration as he refused to cut interest rates; he was even called "creepy."[16] George H.W. Bush blamed Greenspan for his defeat by Bill Clinton.[17] 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.[18] 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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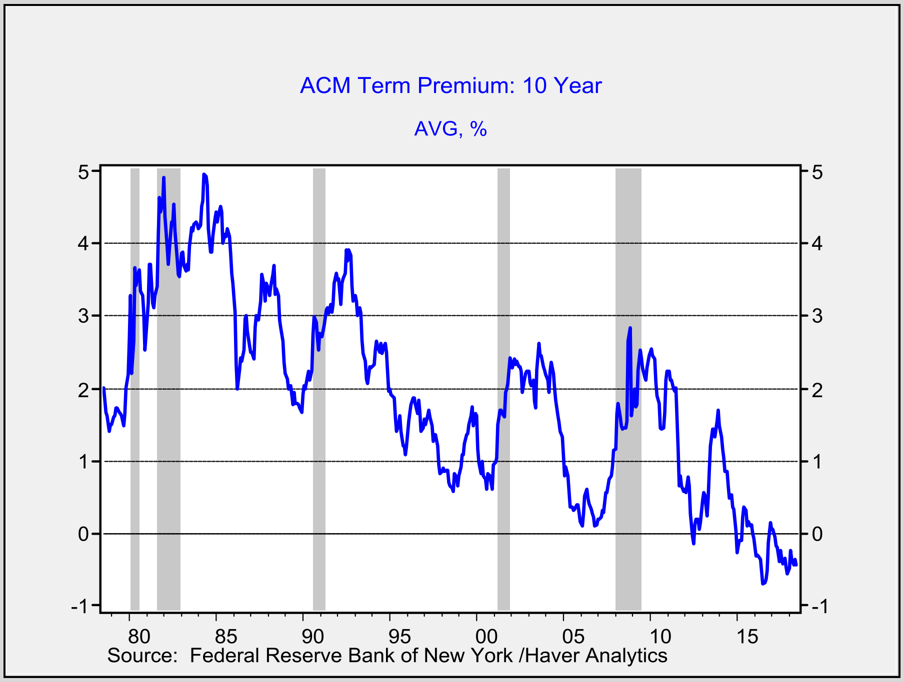
14 Op. cit., Mallaby, p. 286

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

16 Op. cit., Mallaby, p. 415

17 Ibid., p. 416

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

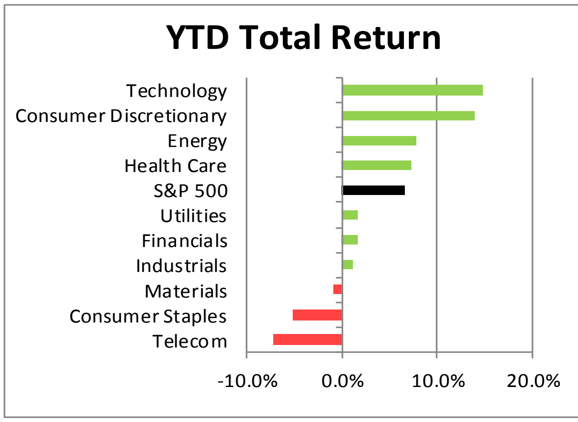


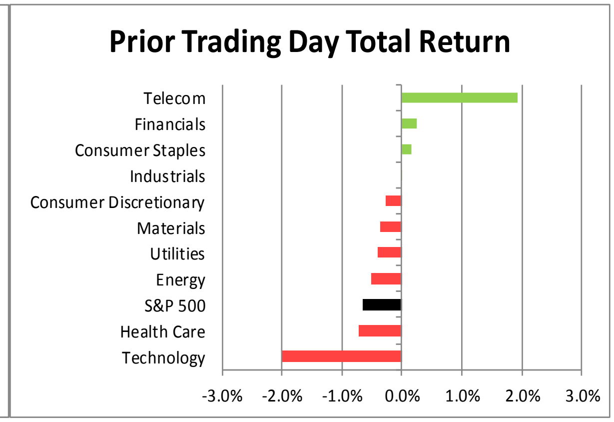
This chart shows a calculation of the term premium on 10-year T-notes. The term premium measures how much more yield investors demand for holding longer term notes. In other words, an investor could simply buy a one-year T-bill each year for 10 years or a 10-year T-note. Usually, the longer duration 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.

Data Section

U.S. Equity Markets – (as of 7/27/2018 close)

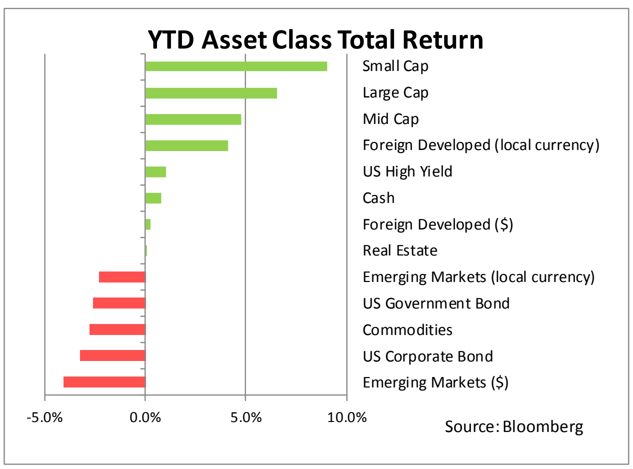




(Source: Bloomberg)

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 7/27/2018 close)

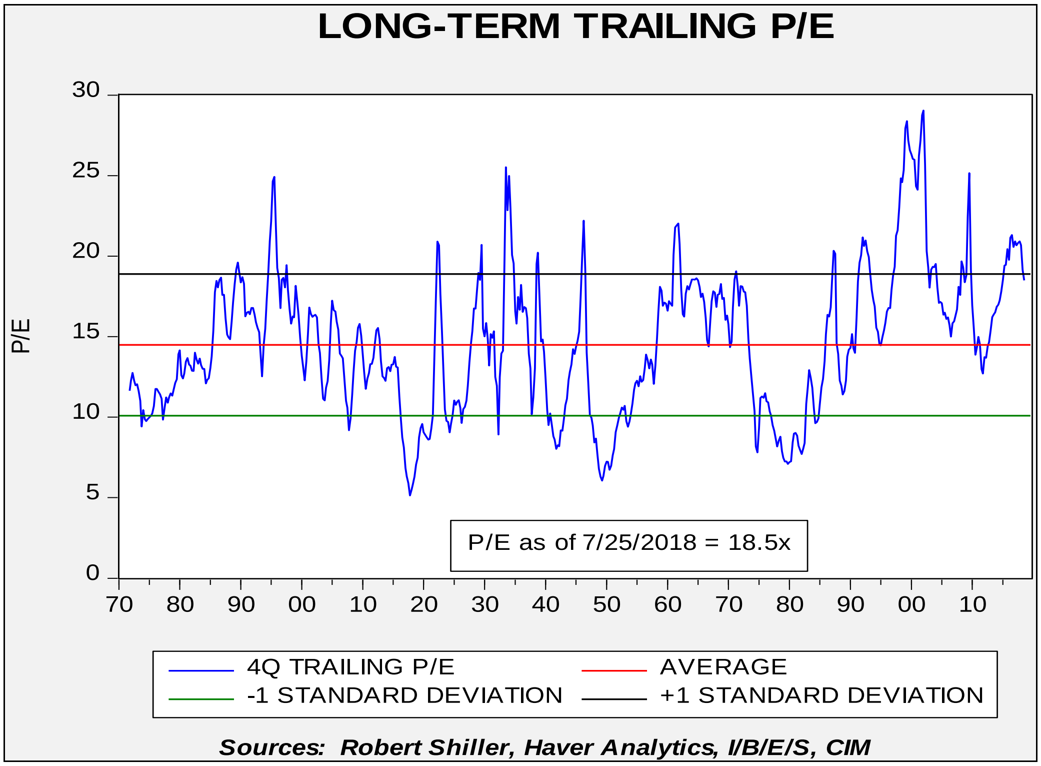


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[19] 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.

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[19] 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.