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: November 2, 2018—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 1.3% from the last close. In Asia, the MSCI Asia Apex 50 was up 4.1% from the prior close. Chinese markets were up, with the Shanghai composite up 2.7% and the Shenzhen index up 3.4%. U.S. equity index futures are signaling a higher open. With 348 companies having reported, the S&P 500 Q3 earnings stand at $42.13, higher than the $40.50 forecast for the quarter. The forecast reflects a 21.0% increase from Q3 2017 earnings. Thus far this quarter, 75.9% of the companies reported earnings above forecast, while 17.0% reported earnings below forecast.

Happy Employment Friday! We cover the data in detail below, but the snapshot is that the data was very strong. Payrolls and wages rose well above forecast. Global equities are higher this morning on optimism that the U.S. and China can come to a trade agreement.[1] Here is what we are following this morning:

A China trade deal? President Trump raised hopes of a thaw in U.S./Chinese trade relations after noting he had a "long conversation" with Chairman Xi. Trump indicated he plans to meet with the Chinese leader at the G-20 summit later this month. This positive tone was one of the bullish catalysts that lifted equities. However, it is always difficult to determine how much substance any of these announcements have. We note that Trump and EU Commission President Juncker met this summer to great fanfare on trade; so far, nothing has been resolved. On the other hand, a Bloomberg report this morning indicating the president has asked his cabinet to draft a possible trade deal with China might mean that the upcoming meeting could be real.[2] Our position is that the Trump administration is changing U.S. policy toward China, treating the latter as a long-term strategic threat. If our position is correct, any trade agreement made later this month will likely be superficial. But, in the short run, it's having the desired effect. Not only have equity prices jumped, but soybean prices have rallied strongly and the CNY has appreciated. The positive talk has offered markets some relief, which is helpful in the short run.

Oil waivers: As we head toward Iran sanctions coming into effect, the U.S. has granted waivers to eight nations.[3] Although American policy is designed to hurt Iran and force new talks on its

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[1] https://www.reuters.com/article/us-global-markets/asian-shares-rise-as-trump-xi-lift-hopes-on-resolving-trade-row-idUSKCN1N7033
[2] https://www.bloomberg.com/news/articles/2018-11-02/trump-said-to-ask-cabinet-to-draft-possible-trade-deal-with-xi-jnzjeqx4?srnd=premium
[3] https://www.bloomberg.com/news/articles/2018-11-02/u-s-said-to-give-eight-nations-oil-waivers-under-iran-sanctions?srnd=markets-vp

nuclear program and regional power projection, the U.S. fears a big jump in oil prices will hurt global growth. The waivers should ease some of these concerns. In addition, the U.S. is working to clear some political bottlenecks in the Middle East. For example, disputes between the Kurds in northern Iraq and the Iraqi government have reduced oil flows out of Iraq. The U.S. is working to bring the parties to an agreement to lift supply. The Trump administration is also working with Saudi Arabia and Kuwait to lift output in the so-called "neutral zone," a disputed region claimed by both nations. If both issues are resolved, it could boost global output by up to 1.3 mbpd.[4] It would be quite optimistic to expect all these barrels to return to market but any additional supply, combined with waivers, will likely keep oil prices mostly stable in the near term.

Brexit update: There has been a surge of optimism on Brexit mostly coming from London, but there are reports that the EU is softening its position on the Northern Ireland frontier, which would avoid a hard border.[5] If this were to occur, the odds would increase for a workable Brexit strategy that would have minimum disruption. It's still not clear if May can gather enough Tory votes to pass a Brexit plan as she envisions it. We believe it would get enough moderate Labour votes to pass Parliament, which would mean a deal was made but May's position as PM could be threatened. Although Tory backbenchers would want her ousted, given the narrow coalition that is holding the government in place, any action to remove May could lead to a no-confidence vote and elections. And, given current conditions, new elections would almost certainly lead to a Labour government. Any Brexit deal would be very bullish for the GBP.

A Friday oddity: Yesterday, at 8 am Eastern European Standard Time, the Finnish government released taxable income data on every Finnish citizen. Dubbed "National Jealousy Day,"[6] the data dump lets every Finnish citizen see "who makes what." Although the government has released the data for years, now it can put it out electronically which makes searching much easier. This transparency appears unique to any Western nation but the Finns seem to take it in stride.

U.S. Economic Releases

The September trade deficit came in a bit wider than expected at $54.0 bn compared to the forecast of $53.6 bn. The prior report's deficit was revised to $53.3 from $53.2 bn.

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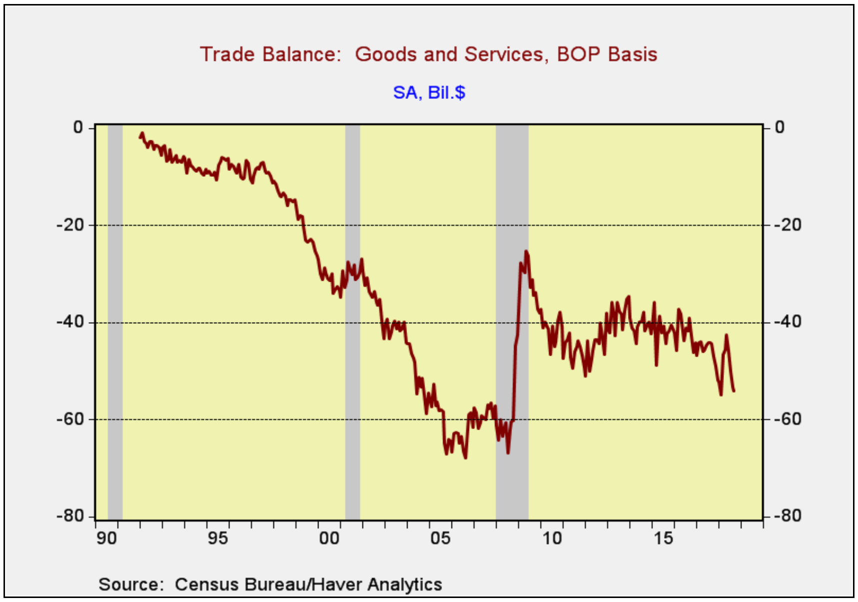
[4] https://www.wsj.com/articles/u-s-redoubles-efforts-to-resolve-oil-field-disputes-to-boost-global-supply-1541112738

[5] https://www.ft.com/content/ee75a230-dde7-11e8-9f04-38d397e6661c?emailId=5bdbdd938c7cba0004e3a767&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

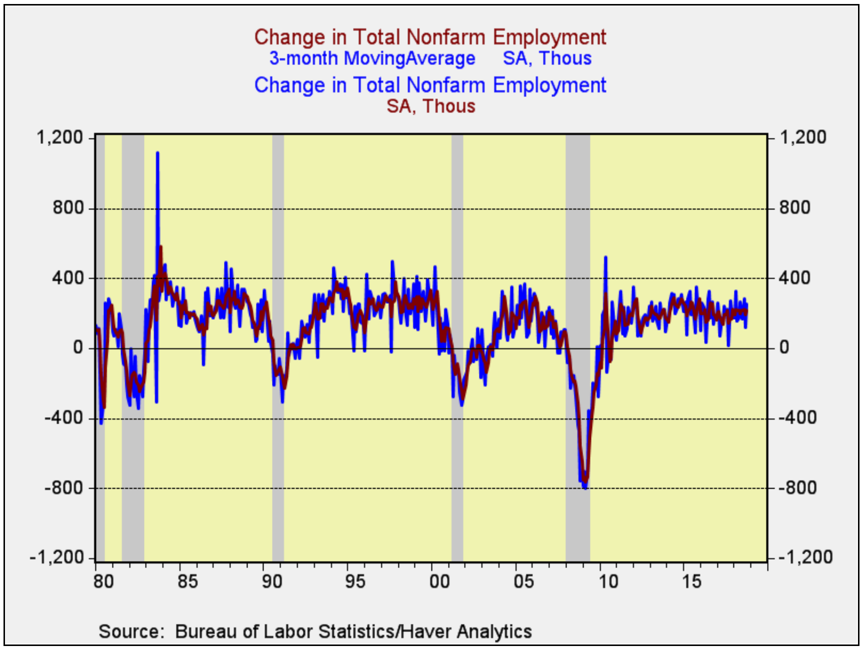
[6] https://www.nytimes.com/2018/11/01/world/europe/finland-national-jealousy-day.html?emc=edit_mbe_20181102&nl=morning-briefing-europe&nlid=567726720181102&te=1



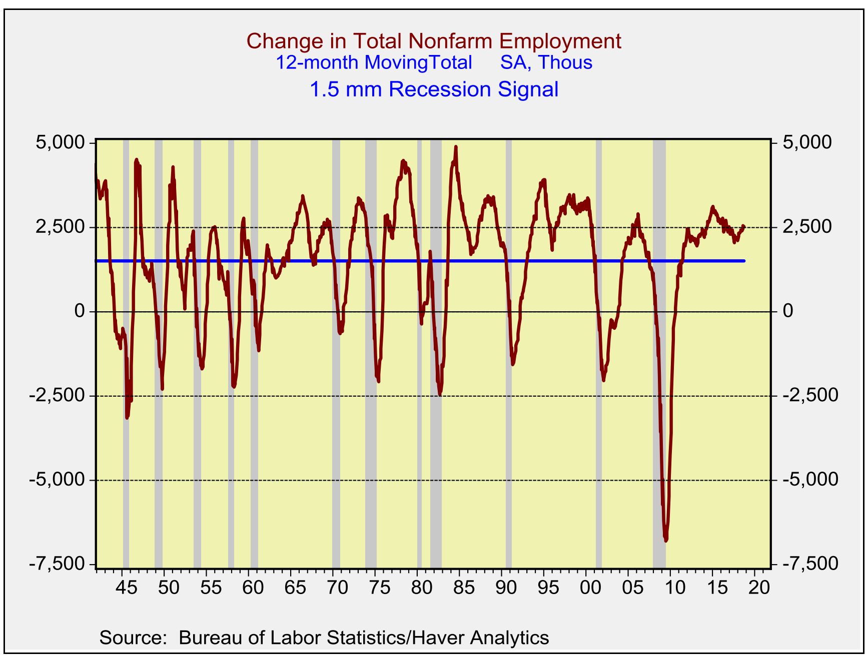
For the month, both exports and imports rose 1.5%. Note on the above chart that the narrowing seen last summer was likely due to stockpiling in front of anticipated tariffs. That effect has clearly dimished.

The October employment data showed significant economic strength. Non-farm payrolls rose 250k, exceeding forecasts of 200k+. September payrolls were revised lower by 16k but August was revised higher by the same amount, meaning the net impact of revisions was zero. In the household survey, the unemployment rate was unchanged at 3.7% as forecast. The labor force jumped 711k but was mostly offset by a 600k rise in employment. The participation rate (employed/labor force) rose to 62.9%, above the forecast of 62.7%. The employment/ population ratio showed a similar increase, to 60.6% from last month's 60.4%. Overall wage growth was +3.1%, on forecast. Wage growth for non-supervisory workers rose sharply, +3.2% compared to last month's 2.8%.

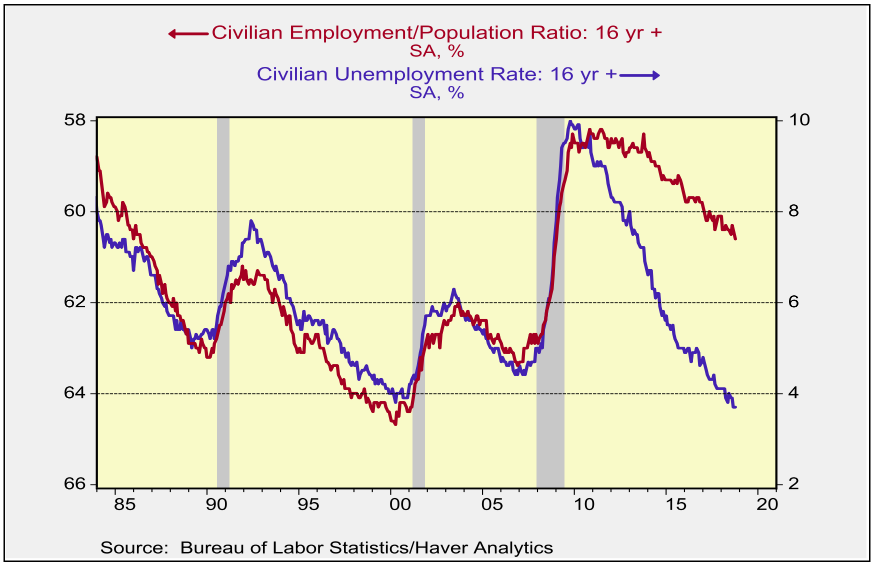
The chart below shows the change in total private employment. The three-month average of the change in payrolls is 218k, up from 190k last month. This chart suggests the economic expansion continues.



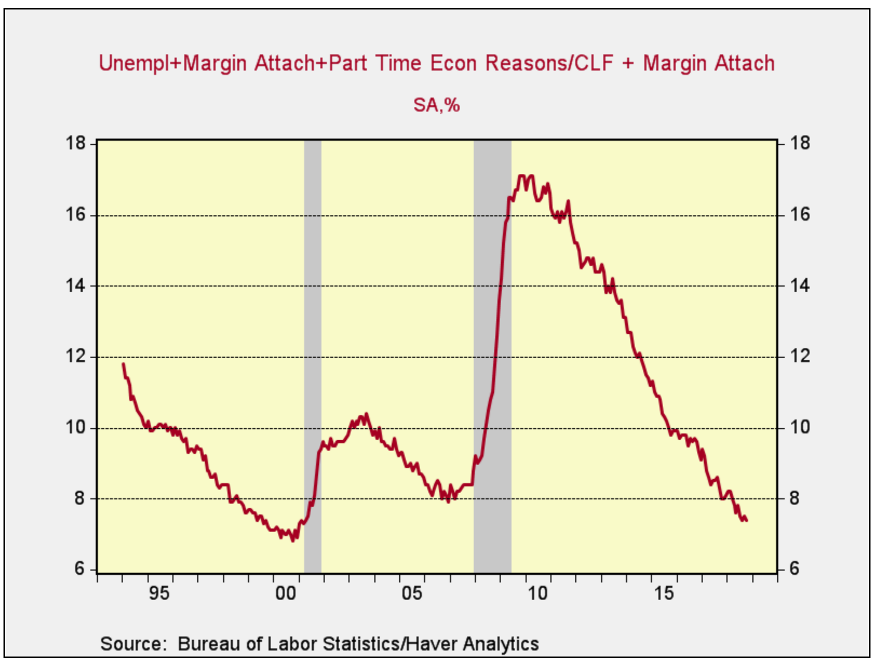
The chart below shows the 12-month moving total of the change in non-farm payrolls; a dip under 1.5 mm signals recession. For most of this year, the 12-month moving total has been increasing, a sign of strength that belies any recession concerns.



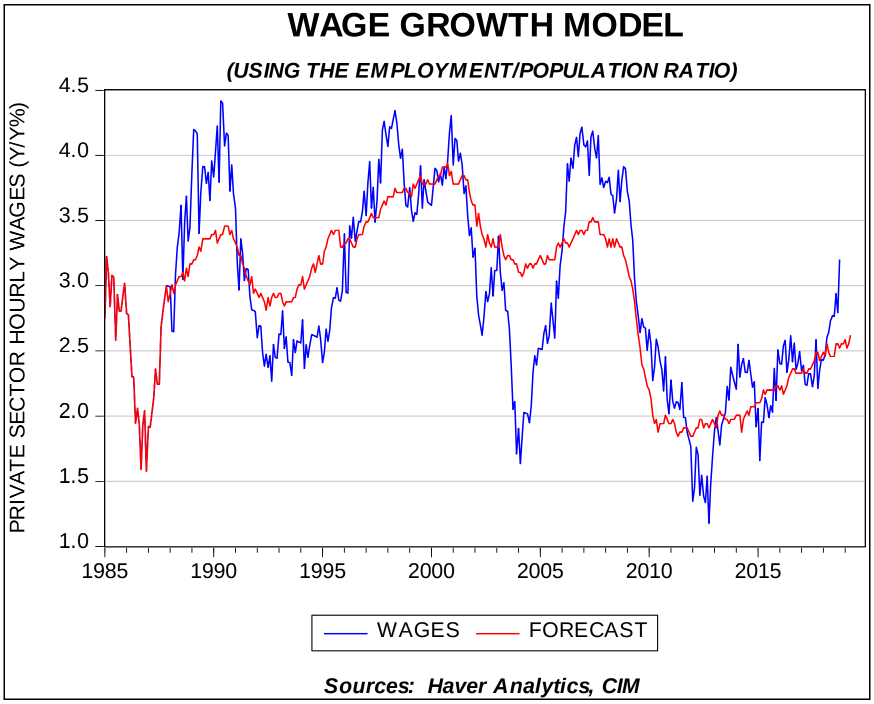
The unemployment rate came in on forecast at 3.7% and the employment/population ratio improved to 60.6%. As the chart below shows, we are seeing some modest narrowing in the gap between these two series. The labor force participation rate was 62.7%, while the U-6 unemployment rate fell to 7.4% from 7.5%.



The chart below shows the underemployment rate, also referred to as the U-6 rate. This is a broader measure of unemployment and it's showing a tightening labor situation.



The rise in wage growth is outpacing the employment/population ratio. Although the data is noisy and subject to revision, we are starting to see an acceleration in wages that will certainly get the attention of the FOMC.



This chart shows wage growth for non-supervisory workers compared to a forecast derived from the employment/population ratio. For the bulk of this recovery and expansion, this independent variable has been a superior forecasting tool compared to other measures, such as the unemployment rate. However, the recent acceleration in wage growth suggests that although the employment/population ratio remains low, it is taking higher wages to attract workers into the labor force. This data will concern monetary policymakers and likely support calls for tighter policy.

Overall, the data show a very robust U.S. labor market. The labor force is continuing to expand, people are finding work and wages are rising. The only concern arising from the report is the acceleration of wages. However, as yesterday's unit labor cost data showed, we are still not seeing major wage pressure once productivity is taken into account. The data is neutral for equities, bearish for debt and bullish for the dollar.

The table below lists the economic releases scheduled for today.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Factory Orders	m/m	sep	0.5%	2.3%	***
10:00	Factory Orders ex Trans	m/m	sep		0.1%	**
10:00	Durable Goods Orders	m/m	sep		0.8%	***
10:00	Durable Goods Orders ex Transportation	m/m	sep		0.1%	**
10:00	Cap Goods Orders Nondef Ex Air	m/m	sep		-0.1%	**
10:00	Cap Goods Ship Nondef Ex Air	m/m	sep		0.0%	**
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								
Japan	Monetary Base	y/y	oct	5.9%	5.9%		**	Equity and bond neutral
EUROPE								
Eurozone	Markit Eurozone Manufacturing	m/m	oct	52.0	52.1	52.1	**	Equity and bond neutral
Germany	Import Price Index	m/m	sep	4.4%	4.8%	4.5%	**	Equity and bond neutral
	Markit/BME Germany Composite	m/m	oct	52.2	52.3	52.3	**	Equity and bond neutral
France	Budget Balance YTD	m/m	sep	-87.1 bn	-97.3 bn		**	Equity and bond neutral
	Markit France Manufacturing	m/m	oct	51.2	51.2	51.2	**	Equity and bond neutral
Italy	Markit/ADACI Italy Manufacturing	m/m	oct	49.2	50.0	49.7	**	Equity bearish, bond bearish
U.K.	Markit/CIPS UK Construction	m/m	oct	53.2	52.1	52.0	**	Equity bullish, bond bearish
Switzerland	UBS Real Estate Bubble Index	q/q	3q	0.87	1.00		**	Equity and bond neutral
	Retail Sales Real	y/y	sep	-2.7%	0.4%	-0.1%	**	Equity bearish, bond bullish
AMERICAS								
Mexico	Markit Mexico PMI Mfg	m/m	sep	50.7	51.7		**	Equity and bond neutral
	Remittances Total	m/m	sep	$2.709.3 bn	$2.856 bn	$2.784.9 bn	**	Equity and bond neutral
	IMEF Non-manufacturing Index	m/m	oct	50.2	51.6	51.2	**	Equity bearish, bond bullish
	IMEF Manufacturing Index	m/m	oct	49.7	51.5	51.7	**	Equity bearish, bond bearish
Canada	Markit Canada Manufacturing PMI	m/m	3q	53.9	54.8		**	Equity and bond neutral
	MLI Leading Indicator	m/m	sep	0.1%	0.1%		**	Equity and bond neutral
Brazil	Industrial Production	m/m	sep	-2.0%	2.0%	-0.8%	***	Equity bearish, bond bearish
	Markit Brazil PMI Manufacturing	m/m	oct	51.1	50.9		**	Equity bullish, bond bearish
	Trade Balance Monthly	m/m	oct	$6.121 bn	$4.971 bn	$6.700 bn	**	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)	256	254	2	Up
3-mo T-bill yield (bps)	227	228	-1	Neutral
TED spread (bps)	29	27	2	Neutral
U.S. Libor/OIS spread (bps)	230	230	0	Up
10-yr T-note (%)	3.16	3.13	0.03	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	37	41	-4	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	$73.23	$72.89	0.47%	
WTI	$63.67	$63.69	-0.03%	
Natural Gas	$3.19	$3.24	-1.45%	
Crack Spread	$15.36	$15.18	1.13%	
12-mo strip crack	$18.22	$18.04	0.98%	
Ethanol rack	$1.41	$1.41	0.18%	
Metals				
Gold	$1,235.68	$1,233.43	0.18%	
Silver	$14.80	$14.75	0.37%	
Copper contract	$277.15	$272.15	1.84%	
Grains				
Corn contract	$ 369.25	$ 366.75	0.68%	
Wheat contract	$ 509.00	$ 508.00	0.20%	
Soybeans contract	$ 899.00	$ 882.00	1.93%	
Shipping				
Baltic Dry Freight	1470	1490	-20	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	3.2	6.3	-3.1	
Gasoline (mb)	-3.2	-4.8	1.7	
Distillates (mb)	-4.1	-2.3	-1.8	
Refinery run rates (%)	0.20%	0.40%	-0.20%	
Natural gas (bcf)	48.0	52.0	-4.0	

Weather

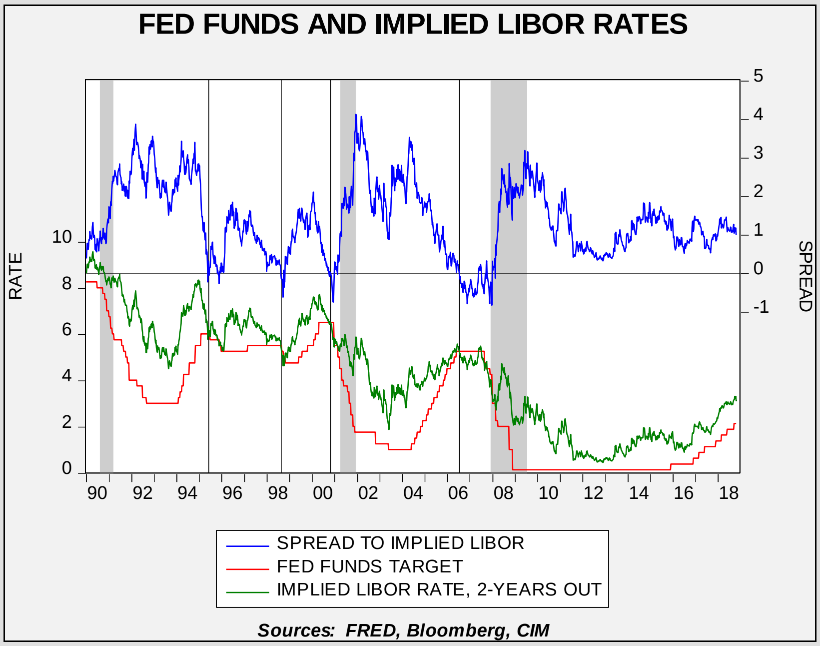
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for the coasts, and cooler temps for the rest of the country. There are no tropical cyclones expected for the next 48 hours.

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.

November 2, 2018

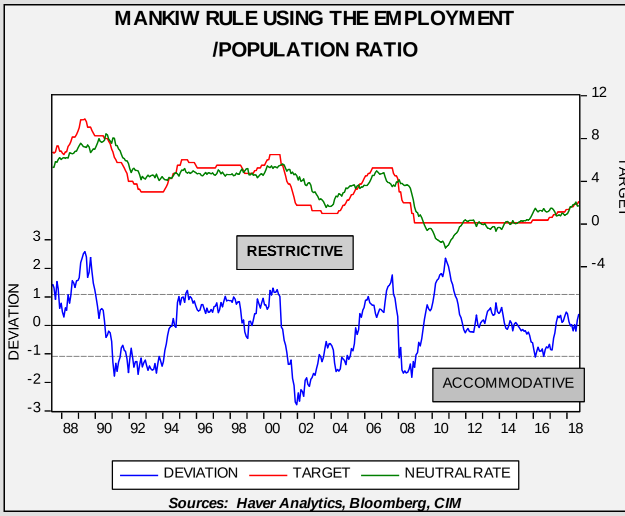
In light of the recent pullback in equities, there has been rising speculation that the FOMC might not increase rates as much as projected. Although possible, we are not seeing much evidence to support this position.

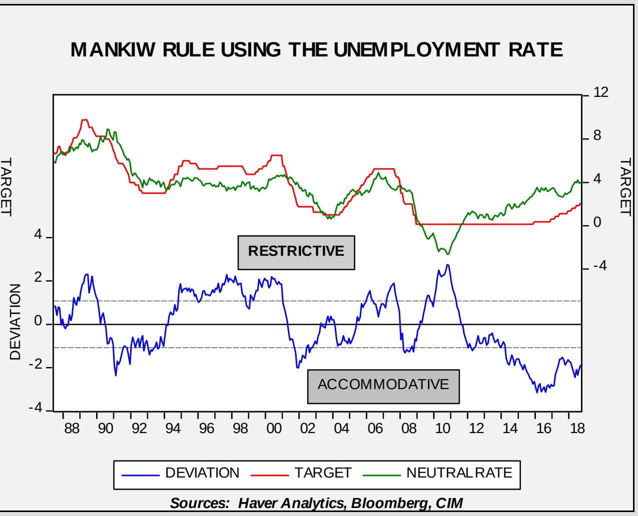


This chart shows the fed funds target along with the implied three-month LIBOR rate, two years deferred, from the Eurodollar futures market. The upper line shows the spread between the two rates. We have placed vertical lines where the spread inverts. The spread inversion has tended to signal the end of the tightening cycle.

Although the implied rate has eased from a peak of 3.30% in early October to 3.15% in the most recent reading, the overall target remains the same. The Fed, based on this analysis, will raise rates another 100 bps. The key question is if such a rate hike were implemented, would it lead to recession?

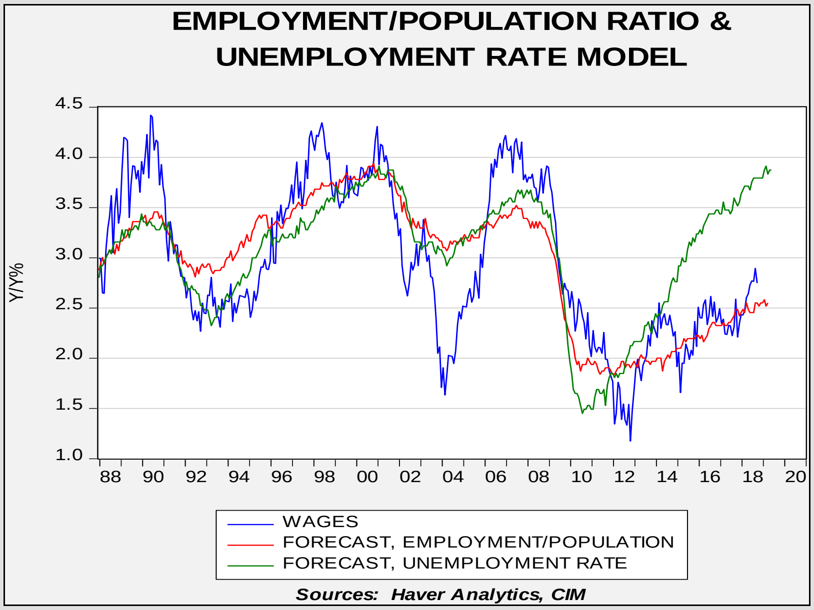
The answer to that question is whether a 3.25% policy rate would be considered "tight"? And, the answer to the second question is all about the degree of slack in the economy. If the FOMC is raising rates into an economy without much excess capacity, it is unlikely that it will take rates to a level of restrictive policy. On the other hand, if there is still slack in the economy then raising rates to the level implied by deferred Eurodollar futures could, indeed, be too tight.





These charts show the results of the Mankiw rule, a simplified version of the Taylor rule. These charts show two different variations for measuring slack. Mankiw's original model used core CPI and the unemployment rate. That model is shown on the right. We have created a different variation on the left, which uses the employment/population ratio. The unemployment model suggests that policymakers are woefully behind the curve; the neutral rate is 4.00% with restrictive policy not achieved until fed funds reach 5.50%. The employment/population model suggests the Fed has already achieved a neutral policy and should stop raising rates now. The neutral rate, according to this variation, is 1.75% with restrictive policy achieved at 2.75%.

Which model is correct? We believe the employment/population model is likely the most accurate. The chart below shows a model that projects the yearly growth in wages for non-supervisory workers based either on the unemployment rate or the employment/population ratio. Both variations did about the same during the cycles since 1988, but, in the current cycle, the employment/population ratio has done a superior job of estimating wage growth. Based on the unemployment rate, wage growth should be approaching 4.0%, while the employment/population ratio estimates a growth rate of 2.5%, a much closer estimate during this recovery and expansion. We are seeing some upward "creep" in wage growth but that may be tied to recent increases in the minimum wage. If so, the growth rate should slow because such changes tend to be infrequent.

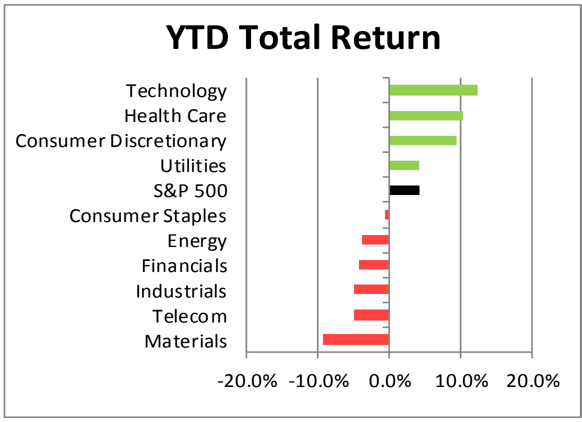


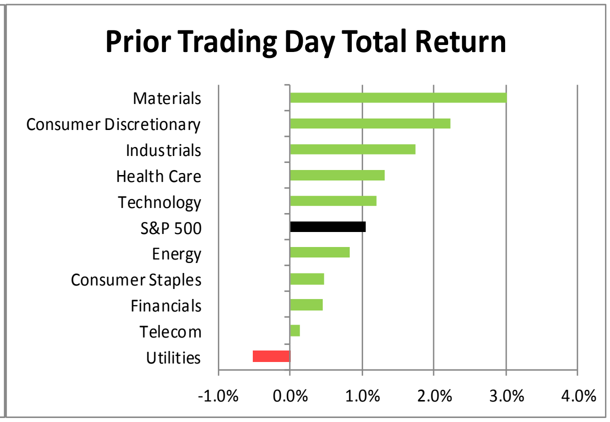
So, what is the FOMC actually doing? It appears they are trying to pick a point between the extremes of the Mankiw variations. However, if the employment/population ratio is the right model, barring a strong improvement in this number, the FOMC is moving into dangerous territory. Given the caution shown by the Fed, we would expect to see greater concern about moving too quickly and increased talk of a "pause."

It is important to remember that all FOMC meetings next year will have a press conference, making each meeting a chance to raise rates…or not! If the Fed begins to show signs that it is approaching neutral, we would expect equities and debt to rally. We would not expect to see such indications in December but could in early 2019. Therefore, we will continue to closely monitor the behavior of deferred Eurodollar futures. If the two-year implied rate begins to decline, we may be close to ending this tightening cycle.

Data Section

U.S. Equity Markets – (as of 11/1/2018 close)

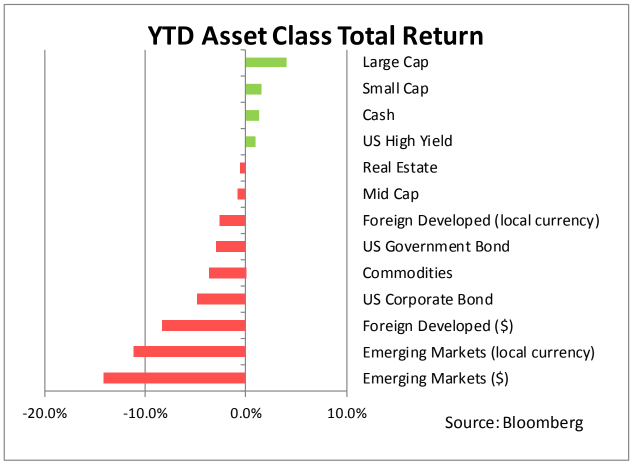




(Source: Bloomberg)

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 11/1/2018 close)

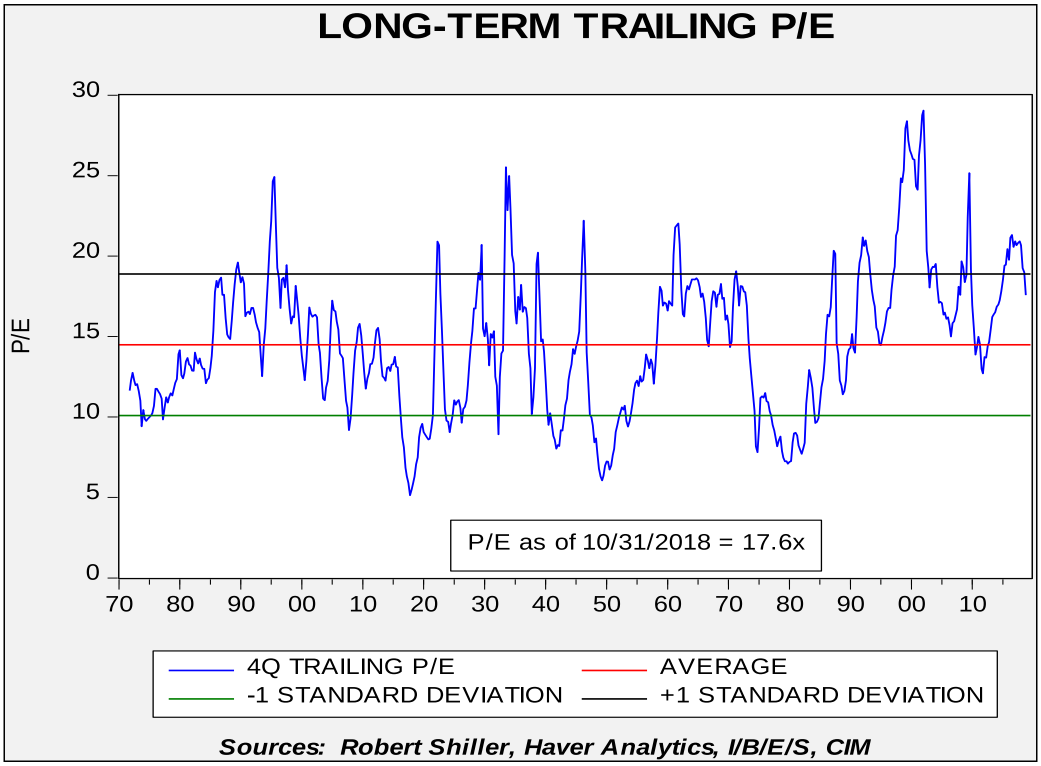


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

November 1, 2018



Based on our methodology,[7] the current P/E is 17.6x, down 0.2x from last week's reading of 17.9x. The primary reason for the drop in the P/E is a sharp drop in the S&P 500.

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.

[7] 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 twi actual quarters (Q1 and Q2) and two estimates (Q3 and Q4). 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.