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 7, 2018—9:30 AM EDT] Global equity markets are generally mixed this morning. The EuroStoxx 50 is up 1.3% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.2% from the prior close. Chinese markets were lower, with the Shanghai composite down 0.7% and the Shenzhen index down 0.4%. U.S. equity index futures are signaling a higher open. With 408 companies having reported, the S&P 500 Q3 earnings stand at $42.60, higher than the $40.50 forecast for the quarter. The forecast reflects a 21.0% increase from Q3 2017 earnings. Thus far this quarter, 77.0% of the companies reported earnings above forecast, while 15.2% reported earnings below forecast.

Happy Wednesday! No more political ads on TV! Here is what we are watching this morning:

Election takeaways: The midterms came out about as expected, with the House going to the Democrats and the GOP expanding its hold on the Senate. Although, in the end, things turned out roughly as forecast, there was a lot of drama throughout the night. Some of the closely watched political pollsters and pundits caused all sorts of swings in the overnight markets. Here is what we are seeing:

Hardening bases—The president's plan of creating voter interest by focusing on immigration worked with voters that are his key constituency, which would be rural and suburban older white voters, especially men, with less than a college degree. The GOP dominated the less populated areas of the country. The Democratic Party plan of focusing on women in the suburbs worked. Democrats not only did well in cities but also in more affluent suburbs. Democrats continue to make gains with those holding college degrees.[1] Progressive candidates in red states didn't fare well. Moderate Democratic candidates for Midwestern governors did quite well. One of the hardest issues of leadership is understanding the correct lessons to learn from victory or defeat. GOP leaders will note that moderate Republican candidates lost in suburban districts. They could decide that moderates can't win. Democrats may decide that the countryside is lost for good. It is highly likely that the lesson both parties will take from this election is to keep pounding on the same themes to the same voters. Although this may lead to narrow victories, it won't create any sort of national unity. In summary, the likely lesson learned by both parties will increase national divisions.

The race for the White House begins today—Although we expect the president to take a breather after a punishing campaigning schedule, the rallies he held recently will likely continue,

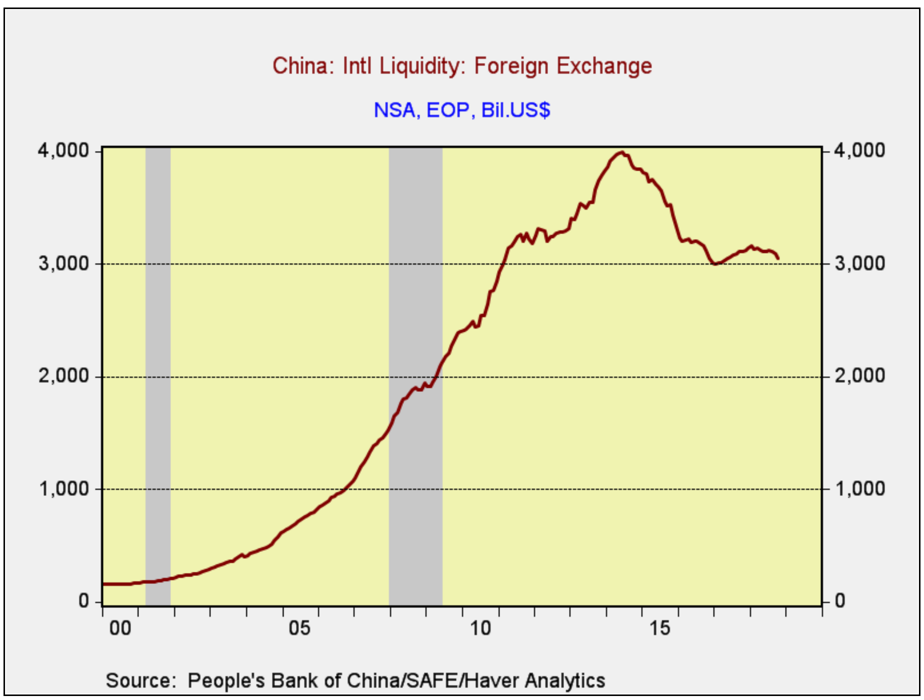
[1] https://www.politico.eu/article/7-takeaways-from-a-wild-us-midterm-election-house-senate-donald-trump/

although the pace probably won't be as frenetic. But, expect Democratic presidential hopefuls to emerge. Who are we watching? Sherrod Brown (D-OH) was easily re-elected to his Senate seat even as the GOP won the governor's race. Brown is a true blue collar populist; he was anti-trade before it was cool. The national media is focused on a lot of other candidates but Brown would pose a real alternative for the Trump constituency.

Markets are good with gridlock—Perhaps the most interesting market response to the election has been a drop in the dollar. It is possible traders are thinking that the House will now run a parade of investigations against Trump and distract him from his trade agenda. Although possible, we haven't seen much evidence to suggest the Democrats have become ardent free trade supporters. In addition, gridlock likely reduces the chances of further fiscal spending, which is supportive for Treasuries. Equities have bounced this morning and Treasuries are rallying.

Overall—The results were as expected. We would look for equities to follow their usual pattern after midterm elections and rally. If dollar weakness holds, it will be bullish for commodities.

Chinese foreign reserves: China's foreign reserves fell $34.0 bn, a bit more than forecast. We suspect the decline was due to the PBOC's support for the CNY, although the pace of declines would suggest that Chinese authorities are trying to guide the currency lower, not prevent it from falling.



Oil supply cuts? Now that the elections are out of the way, OPEC appears to be shifting gears and returning to price supports. OPEC ministers are meeting in Abu Dhabi this weekend and are planning to discuss production cuts for next year.[2] Oil prices are up today despite a large jump in oil inventories reported by the API. We get the DOE data later this morning.

BOJ again: Another member of Japan's central bank board, Yukitoshi Funo, said today that the BOJ may need to raise rates soon to support the banking system.[3] This is the second time in a week that members of the BOJ have hinted at reversing accommodative policy.

U.S. Economic Releases

Mortgage applications fell by 4.0% from the prior week. In addition, purchases and refinancing fell 5.0% and 2.5%, respectively. The average 30-year fixed rate rose by 4 bps from 5.11% to 5.15%. Mortgage applications have fallen to their lowest level since 2004 as rising borrowing costs weigh on demand.

The table below lists the economic releases scheduled for today.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
15:00	Consumer Credit	m/m	sep	$15.00 bn	$20.08 bn	***
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.

[2] https://www.bnnbloomberg.ca/opec-said-to-consider-2019-oil-output-cuts-in-yet-another-u-turn-1.1164366
[3] https://in.reuters.com/article/japan-economy-boj/boj-policymaker-signals-chance-of-future-rate-hike-to-ease-bank-strains-idINKCN1NC0NP

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
China	Foreign Reserves	m/m	oct	$3.053 bn	$3.087 bn	$3.059 bn	**	Equity and bond neutral
Japan	Official Reserve Assets	m/m	oct	$1.253 tn	$1.260 tn		**	Equity and bond neutral
	Labor Cash Earnings	y/y	sep	1.1%	0.9%	1.1%	**	Equity and bond neutral
	Real Cash Earnings	y/y	sep	-0.4%	-0.6%	-0.3%	**	Equity bearish, bond bullish
	Leading Index CI	m/m	sep	103.9	104.5	103.9	**	Equity and bond neutral
	Coincident Index	m/m	sep	114.6	116.7	114.6	**	Equity and bond neutral
Australia	AiG Perf of Construction Index	m/m	oct	46.4	49.3		**	Equity bearish, bond bearish
	Foreign Reserves	m/m	oct	A$64.0 bn	A$73.7 bn		**	Equity and bond neutral
New Zealand	Unemployment Rate	m/m	3q	3.9%	4.5%	4.4%	***	Equity bullish, bond bearish
	Employment Change	m/m	3q	2.8%	3.7%	2.0%	**	Equity bullish, bond bearish
	2Yr Inflation Expectation	m/m	4q	2.0%	2.0%		**	Equity and bond neutral
EUROPE								
Eurozone	Retail Sales	y/y	sep	0.8%	1.8%	0.9%	**	Equity bearish, bond bullish
Germany	Industrial Production	m/m	sep	0.8%	-0.1%	0.5%	***	Equity bullish, bond bearish
	Markit Germany Construction	m/m	oct	49.8	50.2		**	Equity bearish, bond bearish
Italy	Retail Sales	m/m	sep	-2.5%	2.2%	2.1%	**	Equity bearish, bond bearish
U.K.	Halifax House Prices	m/m	oct	0.7%	-1.4%	0.8%	**	Equity and bond neutral
Switzerland	Foreign Currency Reserves	m/m	oct	753.3 bn	739.7 bn		**	Equity and bond neutral
Russia	CPI	m/m	oct	3.5%	3.4%	3.6%	***	Equity and bond neutral
	CPI Core	m/m	oct	3.1%	2.8%	3.1%	***	Equity and bond neutral
AMERICAS								
Mexico	Consumer Confidence Index	m/m	oct	103.0	101.7	101.1	***	Equity bullish, bond bearish
	Gross Fixed Investment	m/m	aug	-2.4%	5.0%	0.0%	**	Equity bearish, bond bearish
Canada	Building Permits	m/m	sep	0.4%	0.4%	0.3%	**	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)	259	258	1	Up
3-mo T-bill yield (bps)	230	229	1	Neutral
TED spread (bps)	29	29	0	Neutral
U.S. Libor/OIS spread (bps)	231	230	1	Up
10-yr T-note (%)	3.19	3.20	-0.01	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	41	39	2	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	up			Neutral
pound	down			Neutral
franc	flat			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	$73.22	$72.13	1.51%	Supply Pessimism
WTI	$62.89	$62.21	1.09%	
Natural Gas	$3.54	$3.56	-0.48%	
Crack Spread	$15.84	$15.86	-0.12%	
12-mo strip crack	$18.39	$18.40	-0.06%	
Ethanol rack	$1.42	$1.42	0.08%	
Metals				
Gold	$1,232.01	$1,227.19	0.39%	
Silver	$14.68	$14.54	0.98%	
Copper contract	$276.10	$273.25	1.04%	
Grains				
Corn contract	$ 372.75	$ 373.25	-0.13%	
Wheat contract	$ 513.00	$ 512.00	0.20%	
Soybeans contract	$ 885.25	$ 884.25	0.11%	
Shipping				
Baltic Dry Freight	1395	1428	-33	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.0		
Gasoline (mb)		-1.8		
Distillates (mb)		-2.0		
Refinery run rates (%)		0.90%		
Natural gas (bcf)		48.0		

Weather

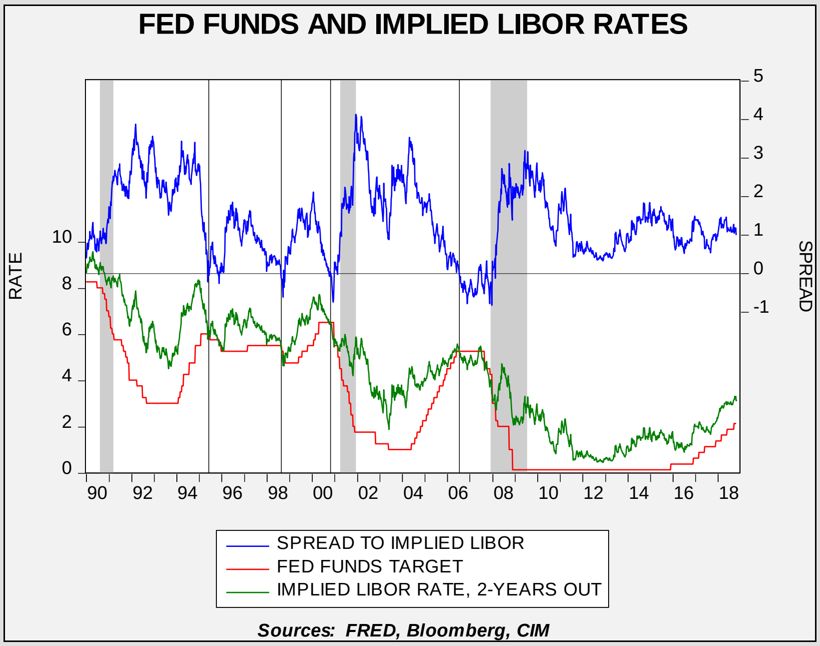
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for the West Coast and cooler temps for the rest of the country. Precipitation is expected for the eastern region. There are no tropical cyclones expected over the next 48 hours.

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.

November 2, 2018

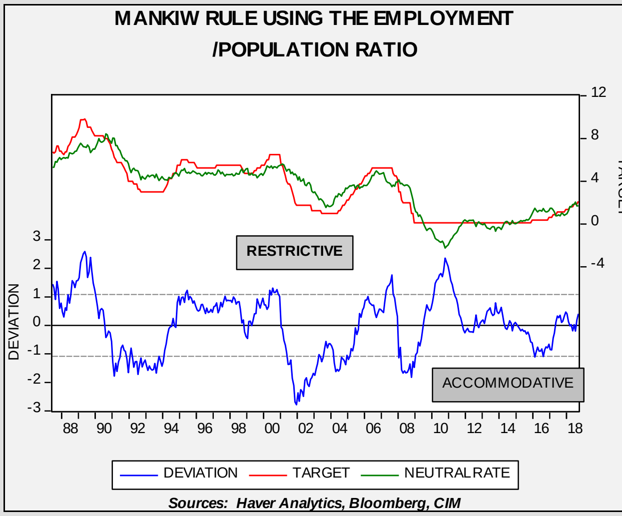
In light of the recent pullback in equities, there has been rising speculation that the FOMC might not increase rates as much as projected. Although possible, we are not seeing much evidence to support this position.

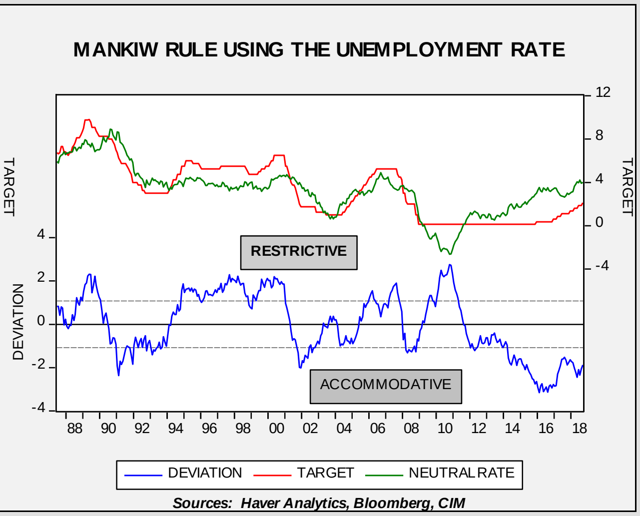


This chart shows the fed funds target along with the implied three-month LIBOR rate, two years deferred, from the Eurodollar futures market. The upper line shows the spread between the two rates. We have placed vertical lines where the spread inverts. The spread inversion has tended to signal the end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

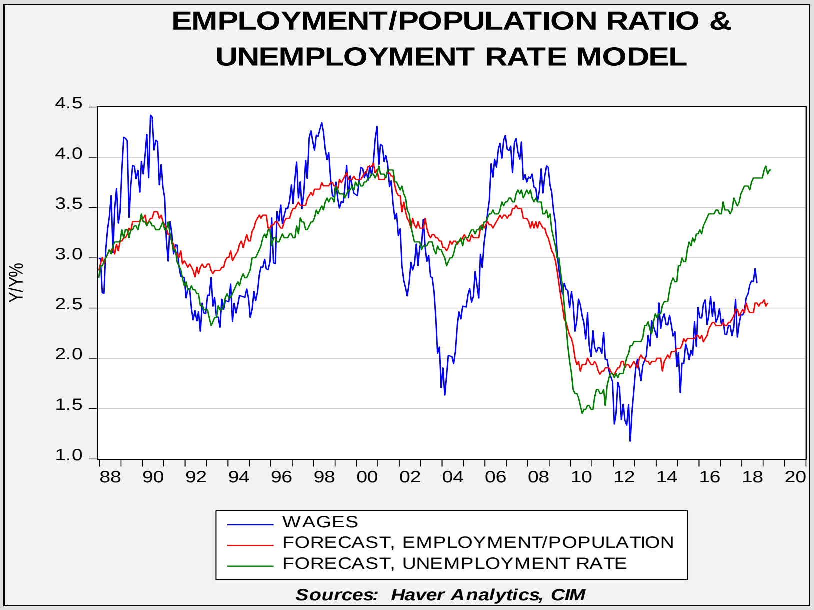
The answer to that question is whether a 3.25% policy rate would be considered "tight"? And, the answer to the second question is all about the degree of slack in the economy. If the FOMC is raising rates into an economy without much excess capacity, it is unlikely that it will take rates to a level 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.



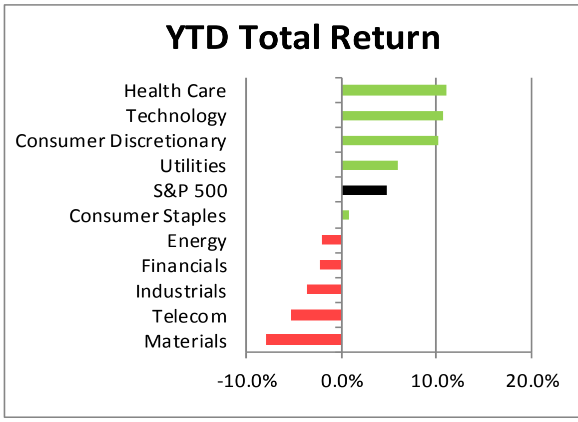
So, what is the FOMC actually doing? It appears they are trying to pick a point between the extremes of the Mankiw variations. However, if the employment/population ratio is the right model, barring a strong improvement in this number, the FOMC is moving into dangerous territory. Given the caution shown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

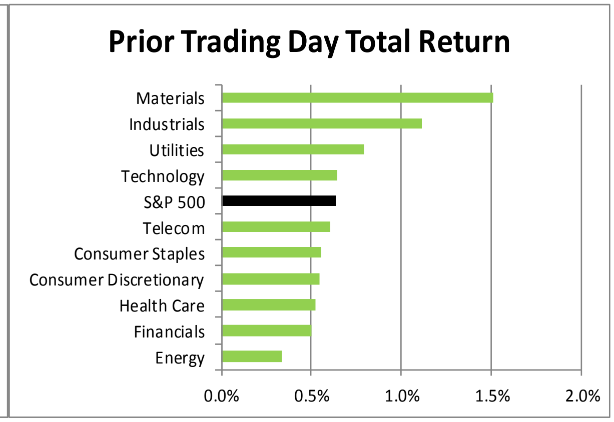
It is important to remember that all FOMC meetings next year will have a press conference, making each meeting a chance to raise rates…or not! If the Fed begins to show signs that it is approaching neutral, we would expect equities and debt to rally. We would not expect to see such indications in December 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.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

U.S. Equity Markets – (as of 11/6/2018 close)

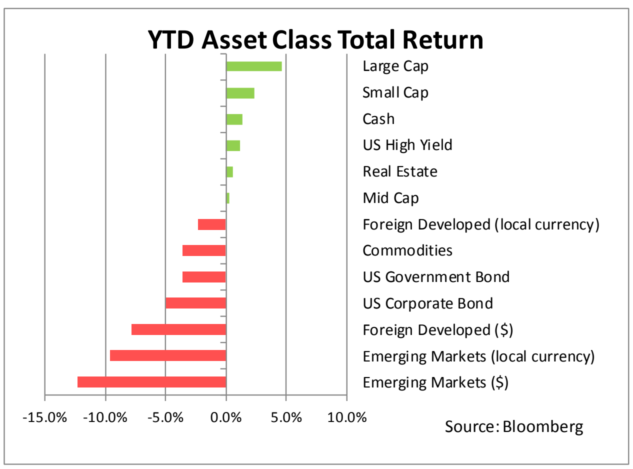




(Source: Bloomberg)

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 11/6/2018 close)

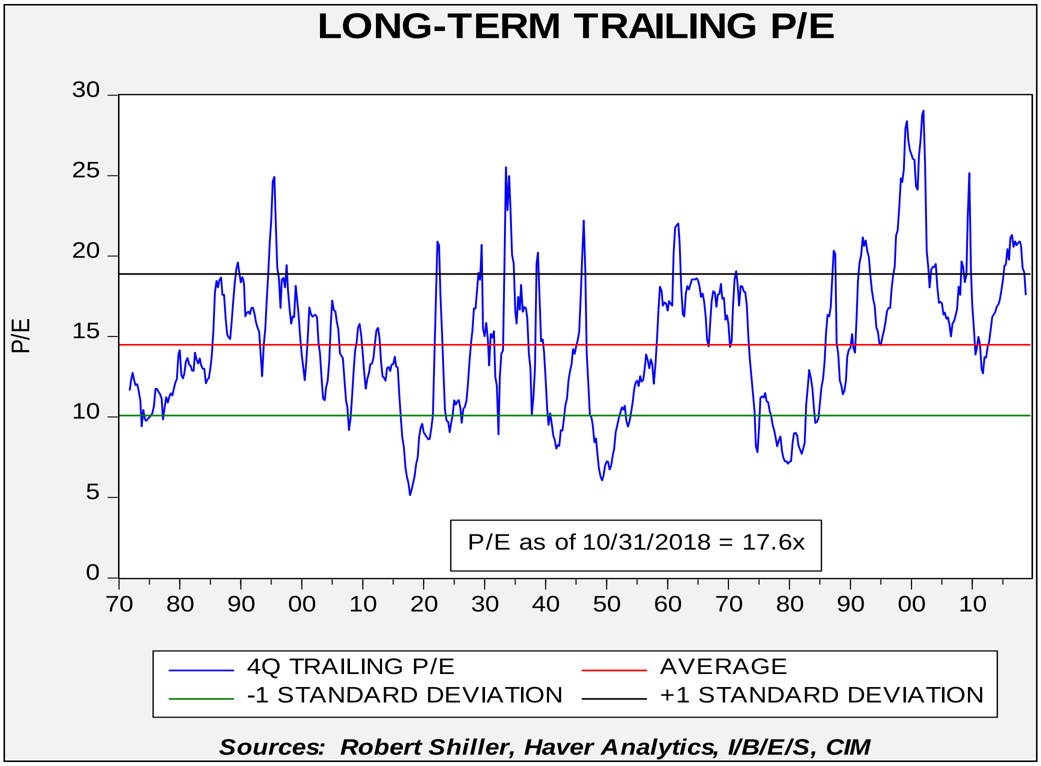


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[4] 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.

[4] 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.