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: October 1, 2018—9:30 AM EDT] Global equity markets were mixed this morning. The EuroStoxx 50 is up 0.5% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.1% from the prior close. Chinese markets were closed for the National Holiday, which will run until October 7. U.S. equity index futures are signaling a much higher open, supported by the NAFTA news.

It's Monday! It's a risk-on day and the U.S, Canada and Mexico have struck a deal on NAFTA. U.S. equity futures are higher, while precious metals and Treasury prices are lower. Here is what we are watching:

A NAFTA deal: Although the deadline wasn't as "dead" as it looked, Canadian and U.S. negotiators reached a deal late yesterday.[1] Mexico's president-elect had indicated he would sign whatever deal was made, meaning the deadline wasn't as crucial. There had been fears that AMLO would not go along with the arrangement and thus a deal had to be reached before September 30 for the current Mexican president to approve it. Still, a deal was reached. Although details are still sketchy, it does appear that U.S. dairy farmers will get access to the Canadian market while the dispute mechanism that Canada wanted to keep was retained. In fact, the new arrangement appears to have a new name—the United States, Mexico and Canada Agreement (USMCA).[2]

It should be noted that Congress will have to approve USMCA and the composition of the House will almost certainly change. It is unclear if congressional approval will occur because the White House has lost "fast-track" authority. Still, the president is making some progress on revamping U.S. trade patterns. His administration has a free trade arrangement with South Korea and is negotiating with Japan and the EU. So, for the most part, we are seeing some positive movement. Of course, the real issue remains with China, and trade policy with Beijing appears to be going beyond mere trade.

Conservatives meet: The Tories in Britain are meeting this week and tensions are elevated between the hardline Brexiters and the rest.[3] It is possible that Boris Johnson could make a leadership challenge; if he does, it raises the chances that the government will face a no-

[1] https://www.ft.com/content/8a43c9f4-c51e-11e8-8670-c5353379f7c2?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

[2] Contact the Village People—I see music video potential. https://www.youtube.com/watch?v=Vc0gYbTNctU

[3] https://www.ft.com/content/60f62f1a-c49c-11e8-8670-c5353379f7c2?emailId=5bb1a5ff2c91a600040730ff&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

confidence vote and broader elections. We expect lots of strong headlines but little new movement from these meetings.

China news: There were some interesting articles regarding China in the weekend media. First, the *NYT* reported that Chinese authorities are directing journalists to refrain from making negative comments about the economy.[4] Specifically, they are to avoid discussing worse than expected economic data, local government debt risks, the trade war with the U.S., any signs of weakening consumer confidence, stagflation and personal interest stories showing economic hardship. It is not clear exactly what is going on here. One possibility is that the economy is worse than it looks and the Xi regime wants to avoid a crisis of confidence. Another is a trend we have seen for some time, which is that the CPC derives its legitimacy from delivering strong growth and if growth slows it fears that the result won't be just a downturn but will undermine the legitimacy of the communist party.

A second interesting development is that the Trump administration actively considered cutting aid to El Salvador for ending diplomatic relations with Taiwan in favor of China.[5] The idea of punishing nations that end relations with Taiwan in favor of China gets into a very touchy issue. The U.S. and China have employed strategic ambiguity regarding Taiwan. This diplomatic term means that two parties use exactly the same words but the words have different meaning to each party. For the U.S., Taiwan should, maybe someday, in a time far, far, away, formally become part of China. For China, Taiwan should be absorbed into China soon. Hardliners within the Trump administration (Bolton, mostly) are agitating to support a more independent Taiwan. As relations between China and the U.S. deteriorate, using Taiwan as "the point of the spear" is looking increasingly attractive. However, from China's perspective, this would be like Beijing encouraging Florida to separate from the U.S. Simply put, the harder the U.S. pushes for Taiwan independence, the greater the chances are of a Chinese overreaction. These odds may be higher than we think, considering the above analysis. If the Chinese economy is undermining CPC legitimacy, a war would do wonders to boost it.

Oil: The EU and Iran are said to be close to an agreement, which would allow the latter to continue its oil sales to the Europeans.[6] We really don't see how this will work but, for now, we will continue to monitor this development. Our expectation is that the largest European oil companies, which need access to the U.S. financial system, will likely decline to participate. If we are correct, European governments will be forced to buy the oil and the Trump administration will have to sanction governments directly. The U.S. will need to decide if the escalation is worth it. There are reports that President Trump called King Salman,[7] most likely to press for higher oil supplies. We doubt the Saudis will make significant changes because the kingdom is running out of excess capacity.

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[4] https://www.nytimes.com/2018/09/28/business/china-censor-economic-news.html
[5] https://www.nytimes.com/2018/09/29/world/americas/trump-china-taiwan-el-salvador.html
[6] https://www.nytimes.com/2018/09/29/us/politics/iran-trump-zarif.html?action=click&module=In%20Other%20News&pgtype=Homepage&action=click&module=News&pgtype=Homepage
[7] https://www.reuters.com/article/us-saudi-us-oil/trump-calls-saudis-king-to-discuss-oil-supplies-idUSKCN1M90SE

U.S. Economic Releases

There were no economic releases before publication this morning.

The table below lists the economic releases and Fed events scheduled for today.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Markit Manufacturing PMI	m/m	sep	55.6	55.6	**
10:00	ISM Manfacturing PMI	m/m	aug	60.0	61.3	***
10:00	Construction spending	m/m	aug	0.4%	0.1%	**
	Wards Total Vehicle Sales	m/m	jun	16.8mm	16.60 mn	**
Fed speakers or events						
EST	Speaker or event	District or position				
9:00	Raphael Bostic to Meet on econ develop panel in Atlanta	President of the Federal Reserve Bank of Atlanta				
11:00	Neel Kashkari Speaks at Townhall in Minnetonka, MN	President of the Federal Reserve Bank of Minneapolis				
12:15	Eric Rosengren to speak on U.S. Economy in Boston	President of the Federal Reserve Bank of Boston				

Foreign Economic News

We monitor numerous global economic indicators on a continuous basis. The most significant international news that was released overnight is outlined below. Not all releases are equally significant, thus we have created a star rating to convey to our readers the importance of the various indicators. The rating column below is a three-star scale of importance, with one star being the least important and three stars being the most important. We note that these ratings do change over time as economic circumstances change. Additionally, for ease of reading, we have also color-coded the market impact section, which indicates the effect on the foreign market. Red indicates a concerning development, yellow indicates an emerging trend that we are following closely for possible complications and green indicates neutral conditions. We will add a paragraph below if any development merits further explanation.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
Australia	AiG Manufacturing index	m/m	sep	59.00	56.7		**	Equity and bond neutral
China	National manufacturing PMI	m/m	sep	50.8	54.2	54.0	***	Equity bearish, bond bullish
	National non-manufacturing PMI	m/m	sep	54.9	51.3	51.2	**	Equity bullish, bond bearish
	National Composite PMI	m/m	sep	54.1	53.8	0.0	*	Equity bullish, bond bearish
	Caixin manufacturing PMI	m/m	sep	50.0	50.6	50.5	***	Equity bearish, bond bullish
India	Nikkei manufacturing PMI	m/m	sep	52.2	51.7	0.0	**	Equity bullish, bond bearish
Japan	Vehicle sales	y/y	sep	-3.1%	-0.2%		**	Equity bearish, bond bullish
	Tankan manufacturing index	m/m	sep	19.0	21.0	22.0	***	Equity bullish, bond bearish
	Tankan manufacturing index outlook	m/m	sep	19.0	21.0	20.0	***	Equity bullish, bond bearish
	Tankan non-manufacturing index	m/m	sep	22.0	24.0	23.0	***	Equity bullish, bond bearish
	Tankan non-manufacturing outlook	m/m	sep	22.0	21.0	21.0	***	Equity bullish, bond bearish
	Nikkei manufacturing PMI	m/m	sep	52.5	52.9		***	Equity and bond neutral
EUROPE								
Eurozone	Markit manufacturing PMI	m/m	sep	53.2	53.3	53.3	***	Equity and bond neutral
	Unemployment rate	m/m	aug	8.1%	8.2%	8.2%	**	Equity and bond neutral
France	Markit manufacturing PMI	m/m	sep	52.5	52.5	52.5	*	Equity and bond neutral
Germany	Retail sales	y/y	aug	1.6%	0.8%	1.6%	**	Equity and bond neutral
	Markit manufacturing PMI	m/m	sep	53.7	53.7	53.7	**	Equity and bond neutral
Italy	Markit manufacturing PMI	m/m	sep	50.0	50.1	50.2	***	Equity bearish, bond bullish
	Unemployment rate	m/m	aug	9.7%	10.4%	10.5%	**	Equity bullish, bond bearish
Switzerland	Real retail sales	y/y	aug	0.4%	-0.3%	1.7%	*	Equity bullish, bond bearish
	PMI manufacturing	m/m	sep	59.7	64.8	62.1	***	Equity and bond neutral
U.K.	Mortgage approvals	m/m	aug	66.4	64.8	64.5	***	Equity bullish, bond bearish
	Markit manufacturing PMI	m/m	sep	53.8	52.8	52.5	***	Equity bullish, bond bearish

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)	240	240	0	Up
3-mo T-bill yield (bps)	216	216	0	Neutral
TED spread (bps)	24	24	0	Neutral
U.S. Libor/OIS spread (bps)	222	221	1	Up
10-yr T-note (%)	3.08	3.06	0.02	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	41	42	-1	Down
Currencies	**Direction**			
dollar	steady			Neutral
euro	down			Neutral
yen	down			Neutral
pound	steady			Neutral
franc	down			Neutral

Commodity Markets

The commodity section below shows some of the commodity prices and their change from the prior trading day, with commentary on the cause of the change highlighted in the last column.

	Price	Prior	Change	Explanation
Energy Markets				
Brent	$82.88	$82.73	0.18%	
WTI	$73.38	$73.25	0.18%	
Natural Gas	$3.07	$3.01	2.16%	
Crack Spread	$18.06	$17.93	0.73%	
12-mo strip crack	$21.14	$21.02	0.61%	
Ethanol rack	$1.40	$1.40	-0.17%	
Metals				
Gold	$1,185.49	$1,190.88	-0.45%	NAFTA settlement
Silver	$14.51	$14.66	-1.00%	NAFTA settlement
Copper contract	$276.15	$280.50	-1.55%	NAFTA settlement
Grains				
Corn contract	$ 358.50	$ 356.25	0.63%	
Wheat contract	$ 507.75	$ 509.00	-0.25%	
Soybeans contract	$ 844.25	$ 845.50	-0.15%	
Shipping				
Baltic Dry Freight	1540	1524	16	

Weather

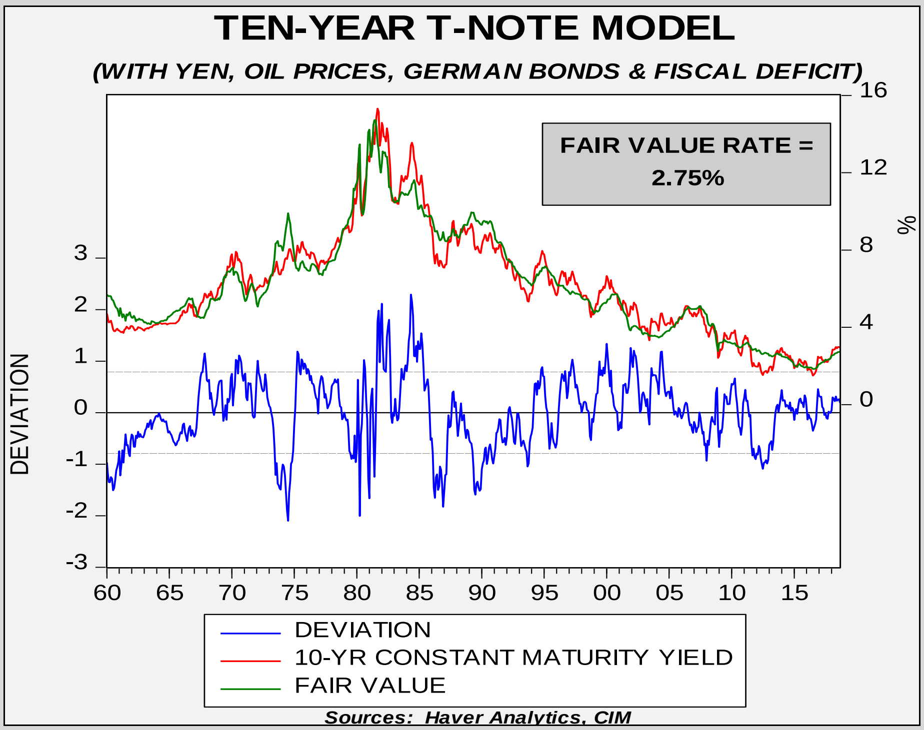
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for the eastern third of the nation, with a developing cold snap for the rest of the country. Above-average precipitation is expected for most of the country. Tropical Storm Leslie remains in the central Atlantic and is not expected to make landfall. There are no other tropical developments of note. The hurricane season officially ends on November 30. On average, the risk of tropical storm activity remains elevated into the third week of October but then declines rapidly into the end of the season.

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.

September 28, 2018

Since late August, interest rates have been steadily rising. The 10-year T-note yield made its recent low at 2.82%[8] on August 4th. Since then, yields have moved above 3.00%. Our 10-year T-note model suggests rates are a bit elevated.

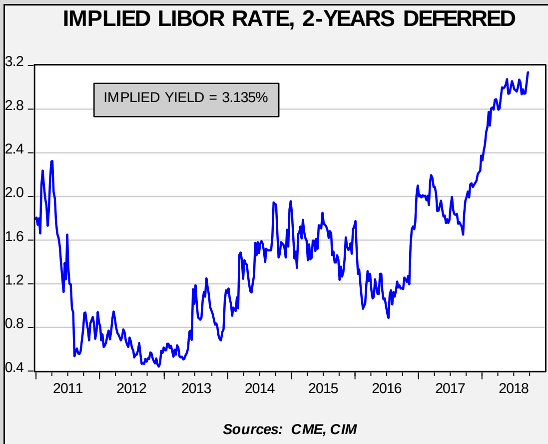


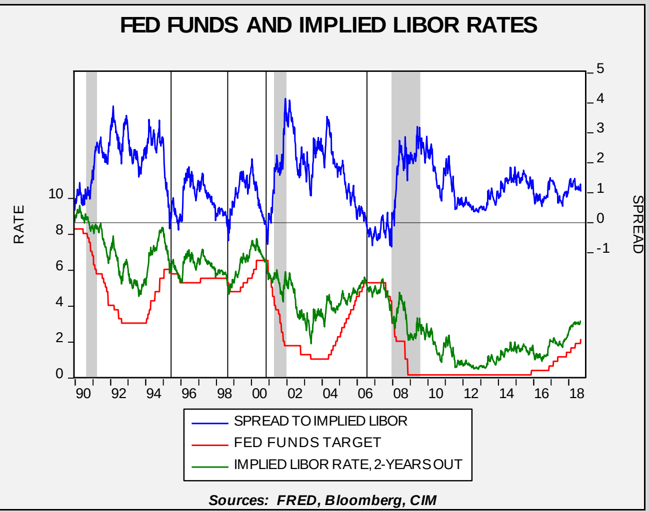
This model includes fed funds and the 15-year moving average of inflation (a proxy for inflation expectations) as the core variables. These two variables explain more than 90% of the variation in the interest rate on this T-note. The additional variables, the yen, oil prices, German bund yields and the fiscal deficit, are all statistically significant but have much less explanatory power than the core variables. Based on the core variables alone, the fair value yield is 3.45%. The weak yen and low German rates (currently around 42 bps) are mostly responsible for the lower fair value reading in the full model.

In the short to intermediate term,[9] the two variables we are watching most closely are fed funds and German yields. Fed funds expectations have been increasing due to robust economic growth and expectations that the FOMC will contain any potential inflation threat.

[8] Using the constant maturity T-note yield. See: https://fred.stlouisfed.org/series/DGS10

[9] Three months to two years





The chart on the left shows the implied three-month LIBOR rate two years into the future. It has recently ticked higher to 3.135%. The chart on the right shows that FOMC policymakers tend to use this rate as a policy target.[10] In a tightening cycle, the FOMC tends to raise rates until fed funds reach the aforementioned implied LIBOR rate. The vertical lines on the right chart show when inversion occurs. Policy tightening usually stops at that point. Given the current implied rate, this would lead to a terminal fed funds target of 3.25%.

If we assume a 3.25% rate and no other changes, the fair value for the 10-year yield rises to 3.28%. Thus, it is reasonable to assume that much of the rise in yields over the past month has been due to the market preparing for future rate hikes. The low level of German yields is also a concern but even taking bunds to 1.00% only raises the fair value yield to 3.40% (assuming a fed funds rate of 3.25%).

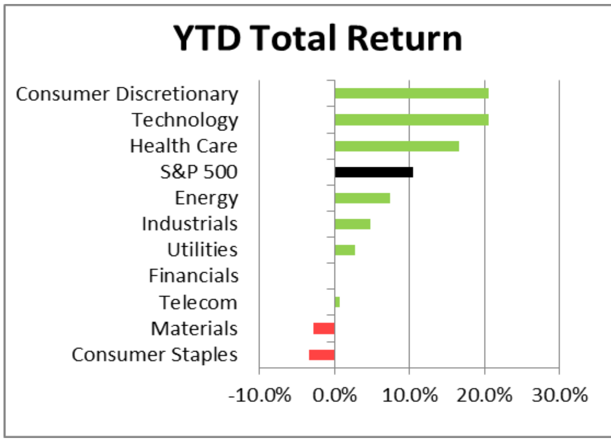
The long-run concern is inflation expectations. A modest rise to 3.00% (from the current 2.10%) and a 3.25% fed funds rate would take the fair value yield to 3.86%. Major bear markets in long-duration assets are mostly a function of unanchored inflation expectations. Although the Federal Reserve has limited capabilities to restrain actual inflation (inflation control is mostly a function of the supply side of the economy), central banks are critical to managing inflation expectations. If investors, households and firms conclude that the central bank won't raise rates in the face of rising inflation, their behavior will likely change to adapt to steadily rising prices. Alan Greenspan's definition of inflation control is when economic actors no longer take inflation into account when making consumption and investment decisions. If inflation fears emerge, these actors will tend to increase inventories, rush to purchase before prices rise and set the stage for a price spiral. The control of inflation expectations is one of the reasons modern central banks are given policy independence. Anything that infringes on this independence runs the risk of un-anchoring inflation expectations. To date that hasn't occurred but the rise of populism increases the odds that central banks will lose their independence, which increases the risk of higher long-duration yields.

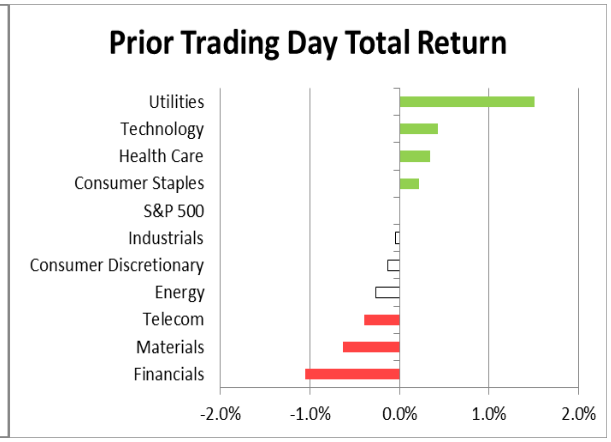
[10] We don't know for sure if this is overt or coincidental, although we suspect the latter.

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 9/28/2018 close)

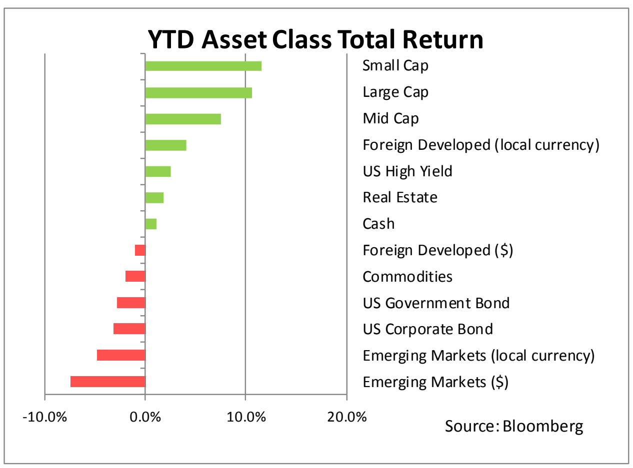




(Source: Bloomberg)

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 9/28/2018 close)

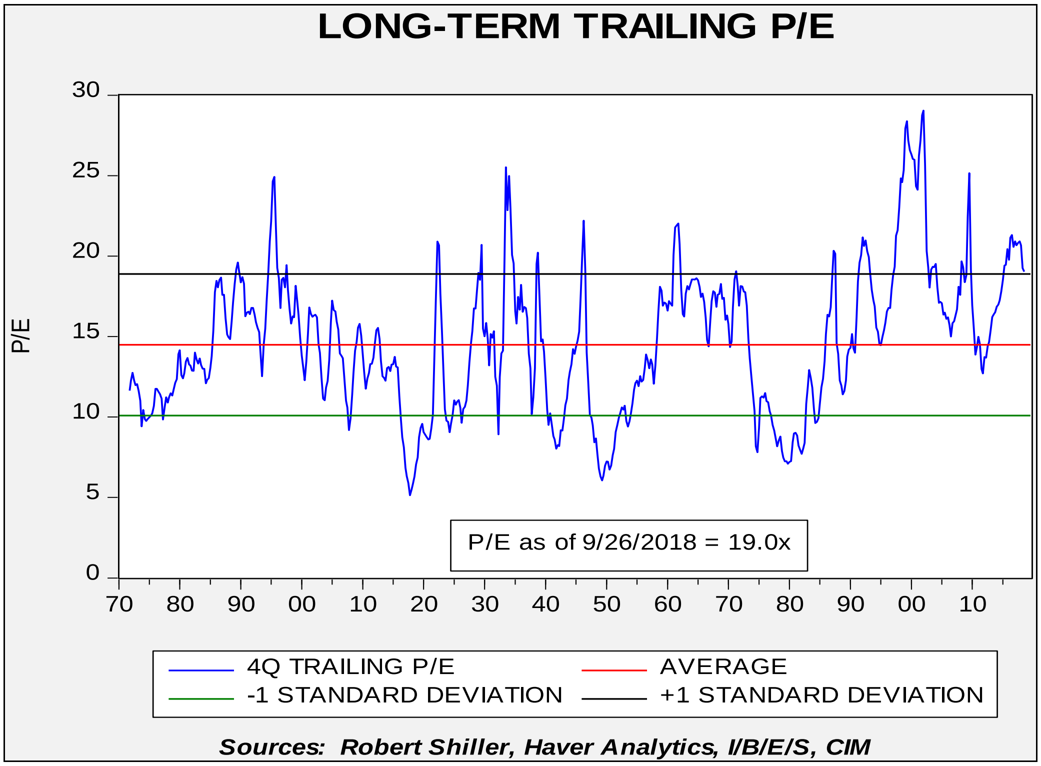


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

September 27, 2018



Based on our methodology,[11] the current P/E is 19.0, up 0.1x from last week.

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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[11] 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, Q1 and Q2) and one estimate (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.