Daily Comment

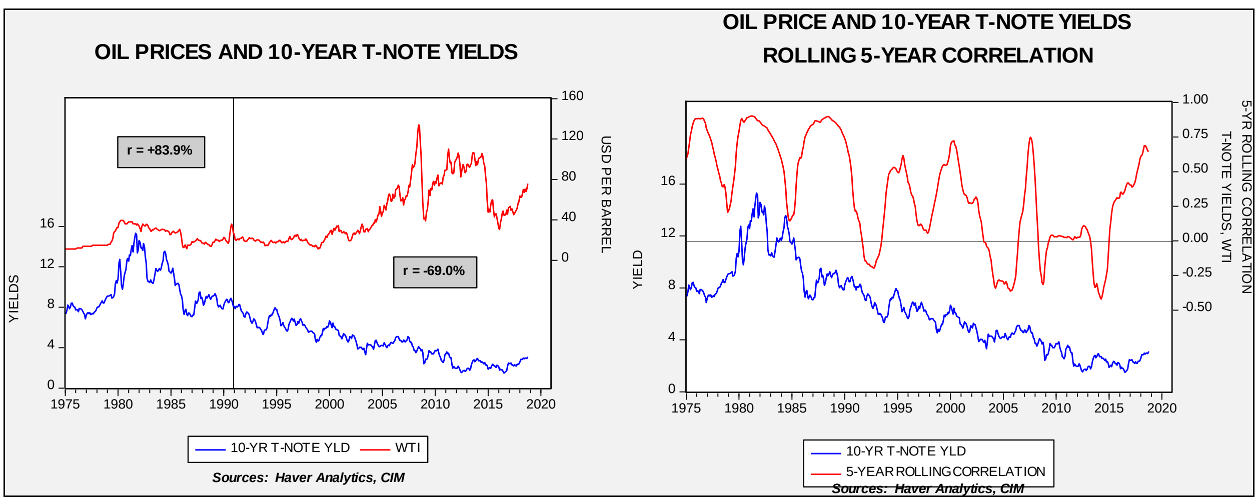
By Bill O'Grady and Thomas Wash

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 4, 2018—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 0.4% from the last close. In Asia, the MSCI Asia Apex 50 was down 1.9% 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 lower open.

It's a global down day for equities. Rising long-duration interest rates are the most cited culprit. Here is what we are watching today:

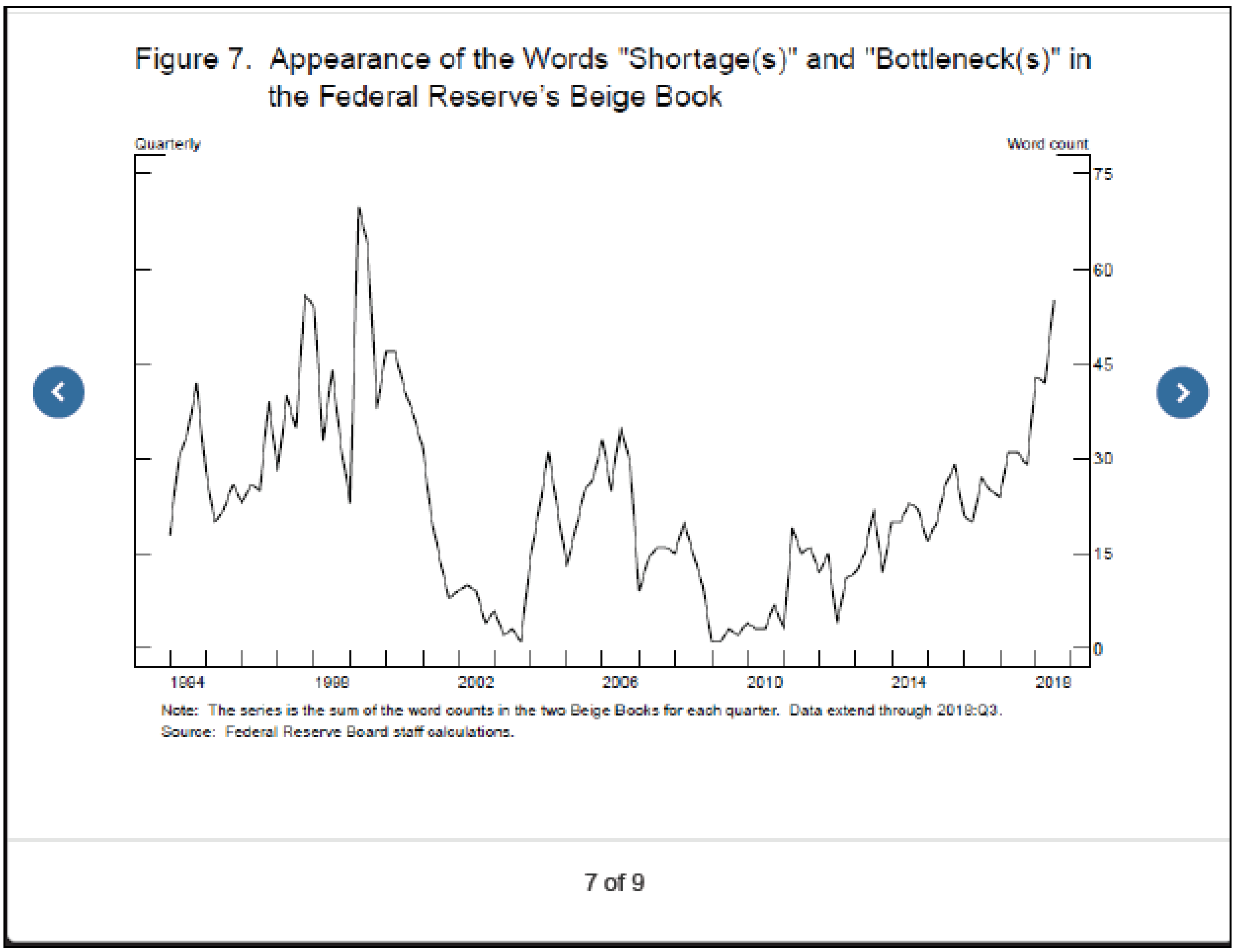
Rising long-duration yields: Long-duration yields are mostly a function of the policy rate and inflation expectations. Determining the policy rate is a snap. Determining inflation expectations is another matter. History tends to show that inflation expectations change slowly, although some factors, like oil, can cause short-term shifts in anticipated inflation.



The chart on the left shows oil prices and 10-year yields. From the mid-1970s into 1990, the two series were positively correlated at the level of +83.9%. Since then, the two series are *negatively* correlated at the level of -69.0%. During the 1980s into the 1990s, anyone building a yield model incorporated oil prices because yields were very sensitive to oil prices. However, as investors began to believe that the central banks would prevent oil prices from triggering wider inflation, the correlation flipped. Simply put, until the early 1990s, investors believed that high oil prices lifted inflation. After the early 1990s, investors believed that high oil prices depressed economic activity and thus was bullish for Treasury prices (leading to lower yields).

However, the chart on the right shows that there are short periods when there is a positive correlation between oil prices and yields. We use a five-year rolling correlation which shows that even in the post-1990 period, when the general correlation was lower, there are episodes when the correlation turns positive for short periods of time. It would seem that these phases tend to occur when economic growth is strong, such as the one we are in now. Thus, part of the rout we are seeing in the long end is due to high oil prices, which, as we note below, are mostly due to fears of Iranian sanctions.

At the same time, there are growing worries about the policy rate. Recent speeches by Chair Powell and other FOMC members mostly lean hawkish.[1] Although the Phillips Curve seems to be rapidly falling out of favor (as it probably should), we are entering a period where there is no dominant model for inflation and its effect on policy. Instead, we are increasingly left with anecdotes. For example, here is one from Chair Powell's recent speech which measures reported bottlenecks or shortages in the Beige Book.



(Source: https://www.federalreserve.gov/newsevents/speech/powell20181002a.htm)

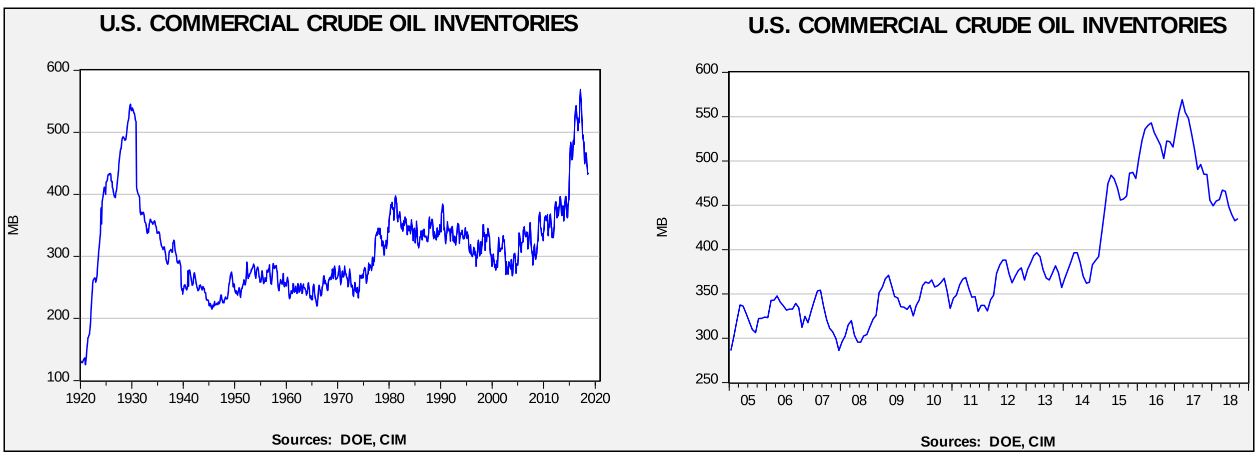
[1] https://apnews.com/cf5305d356fd49309543d711ea5ef6e9/Fed-chairman-defends-gradual-pace-of-rate-hikes

Pretty scary, huh kids?[2] Well, in the 1998 period, when bottlenecks were being widely reported, core CPI topped out at 2.5%. In 2001, when reported bottlenecks nearly disappeared, core CPI peaked at 2.8%. Simply put, reported bottlenecks seem to have little relationship to actual inflation.

So, what's driving bond yields higher? Fears of continued policy tightening and oil prices. The two-year deferred Eurodollar futures have ticked up to an implied yield of 3.27%, suggesting a terminal fed funds target of at least 3.25%. And, oil prices are raising short-term inflation worries. But, the recent move is excessive and smacks of short-covering and we suspect it won't be maintained.

China: The news flow on China overnight was quite negative. First. Bloomberg broke an important story alleging that Chinese spies used a hardware hack to essentially use our smart phones to monitor our behavior.[3] The U.S. Navy is proposing a major show of force in the South China Sea.[4] VP Pence is said to be preparing a speech outlining Chinese aggression.[5] Overall, relations are looking increasingly strained. The breakdown in relations will tend to pressure Chinese financial assets with residual effects on other EM markets.

Energy recap: U.S. crude oil inventories rose 8.0 mb compared to market expectations of a 1.5 mb draw.



This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but have declined significantly since March

[2] https://www.youtube.com/watch?v=t9iIf4tFoyE

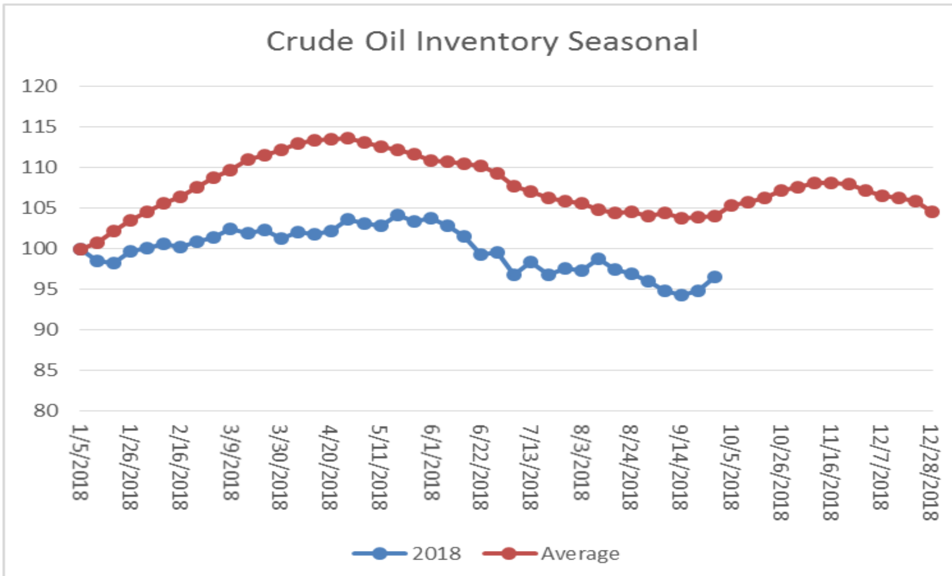
[3] https://www.bloomberg.com/news/features/2018-10-04/the-big-hack-how-china-used-a-tiny-chip-to-infiltrate-america-s-top-companies?srnd=businessweek-v2&utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top

[4] https://www.cnn.com/2018/10/03/politics/us-navy-show-of-force-china/index.html?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top

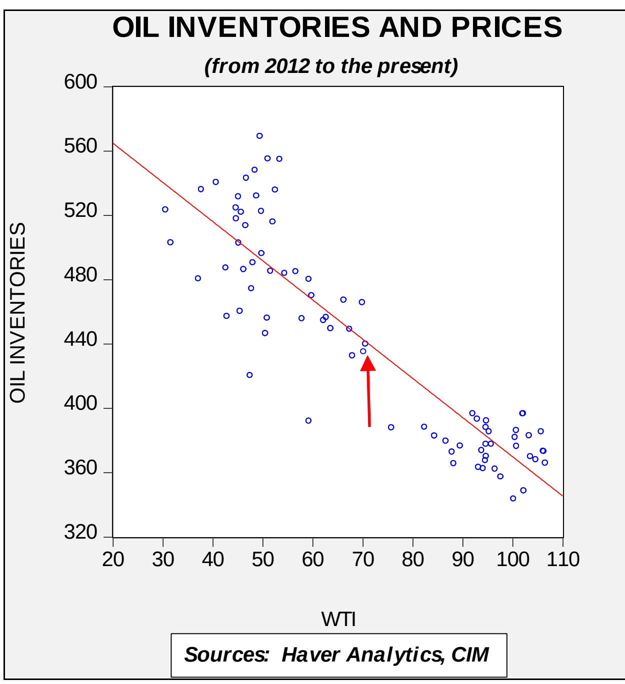
[5] https://www.nytimes.com/2018/10/03/us/politics/china-pence-trade-military-elections.html?action=click&module=Top%20Stories&pgtype=Homepage

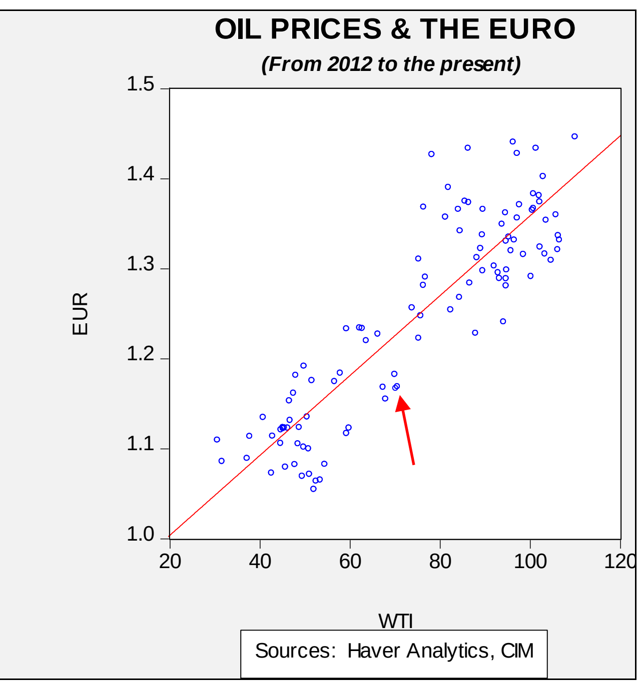
2017. We would consider the overhang closed if stocks fall under 400 mb. Refinery utilization was unchanged at 90.4% as was oil production at 11.1 mbpd. Exports declined 0.4 mbpd, while imports rose 0.2 mbpd. The rise in stockpiles was mostly due to falling exports and slower refining activity.

As the seasonal chart below shows, inventories have begun their seasonal build period. We should see inventories continue to rise in the coming weeks as refinery operations decline for autumn maintenance.



(Source: DOE, CIM)



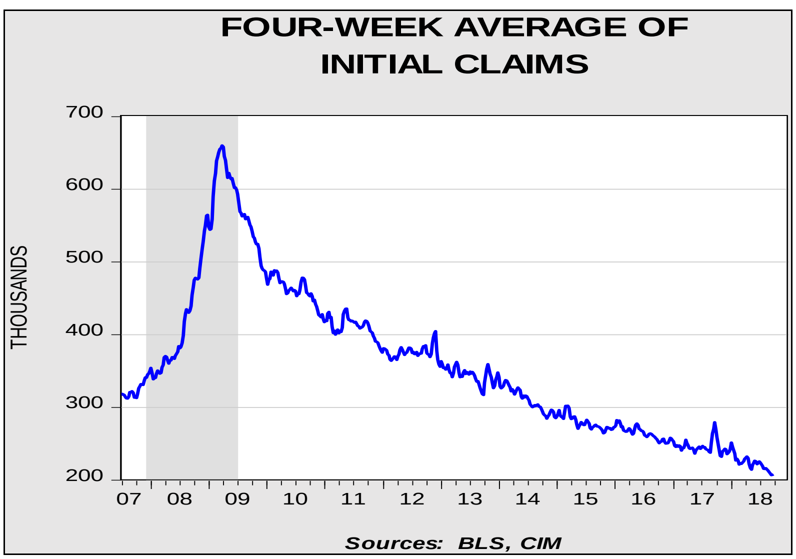


Based on inventories alone, oil prices are below fair value price at $70.20. Meanwhile, the EUR/WTI model generates a fair value of $60.88. Together (which is a more sound methodology), fair value is $64.77, meaning that current prices are well above fair value. Oil prices have been in a strong bull market for the past several weeks, mostly on fears of supply constraints from sanctions on Iranian oil exports. In fact, Russian President Putin suggested to President Trump today that he should stop blaming OPEC and foreign oil suppliers for high oil prices and instead "look in the mirror."[6] Although this week's data is bearish for oil prices, news that the U.S. was pulling out of a 63-year oil treaty with Iran after the Iranians won a verdict at the International Court of Justice boosted prices.[7] Relations with Iran continue to deteriorate and the increase in tensions is supporting higher prices in the face of rising stockpiles.[8] It is possible that, at least in the short run, oil prices are getting a bit ahead of themselves. But, fear of supply losses in the coming weeks is keeping a bid under the price of oil.

U.S. Economic Releases

The May Challenger job cuts report rose by 70.9% from the prior year. The index measures the number of announced job cuts by employers, which is a proxy for future layoffs but does not necessarily indicate the state of current layoffs.

Initial jobless claims came in below expectations at 207k compared to the forecast of 215k. The previous report was revised upward from 214k to 215k.



The chart above shows the four-week moving average for initial claims. The four-week moving average increased from 206.50k to 207.00k.

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6 https://www.bloomberg.com/news/articles/2018-10-03/putin-tells-trump-to-blame-guy-in-the-mirror-for-high-oil-prices
7 https://www.cnn.com/2018/10/03/politics/pompeo-icj-iran-ruling/index.html
8 https://www.bloomberg.com/news/articles/2018-10-03/iran-oil-buyers-craving-obama-s-waivers-get-trump-shock-instead

The table below lists the economic releases scheduled for today.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Bloomberg Consumer Comfort	m/m	sep		61.2	***
10:00	Factory Orders	m/m	aug	2.1%	-0.8%	***
10:00	Factory Orders ex Trans	m/m	aug		0.2%	**
10:00	Durable Goods Orders	m/m	aug	4.5%	4.5%	***
10:00	Durable Goods Orders ex Transportation	m/m	aug		0.1%	**
10:00	Cap Goods Orders Nondef Ex Air	m/m	aug		-0.5%	**
10:00	Cap Goods Ship Nondef Ex Air	m/m	aug		0.1%	**
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								
India	Nikkei India PMI Services	m/m	sep	50.9	51.5		**	Equity bearish, bond bullish
	Nikkei India PMI Composite	m/m	sep	51.6	51.9		**	Equity and bond neutral
Australia	CBA Australia PMI Services	m/m	sep	52.2	51.8		**	Equity bullish, bond bearish
	CBA Australia PMI Composite	m/m	sep	52.5	52.0		**	Equity bullish, bond bearish
	Trade Balance	m/m	aug	A$1.604 bn	A$1.551 bn	A$1.450 bn	**	Equity bullish, bond bearish
EUROPE								
Germany	Markit Germany Construction	m/m	sep	50.2	51.5		**	Equity bearish, bond bullish
U.K.	New Car Registraion	m/m	sep	-20.5%	23.1%		**	Equity bearish, bond bullish
Russia	Light Vehicle Car Sales	y/y	sep	6.0%	11.0%	11.0%	**	Equity bearish, bond bullish
AMERICAS								
Mexico	Vehicle Domestic Sales AMIA	m/m	sep	114653	118715		**	Equity and bond neutral
Brazil	Markit Brazil PMI Composite	m/m	sep	47.3	47.8		**	Equity bearish, bond bearish
	Markit Brazil PMI Services	m/m	sep	46.4	46.8		**	Equity bearish, 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)	241	240	1	Up
3-mo T-bill yield (bps)	218	218	0	Neutral
TED spread (bps)	23	22	1	Neutral
U.S. Libor/OIS spread (bps)	224	224	0	Up
10-yr T-note (%)	3.21	3.18	0.03	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	40	39	1	Down
Currencies	**Direction**			
dollar	steady			Neutral
euro	up			Neutral
yen	up			Neutral
pound	up			Neutral
franc	steady			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	$86.17	$86.29	-0.14%	
WTI	$76.33	$76.41	-0.10%	
Natural Gas	$3.23	$3.23	0.03%	
Crack Spread	$17.23	$17.57	-1.92%	
12-mo strip crack	$20.64	$20.95	-1.48%	
Ethanol rack	$1.40	$1.40	-0.10%	
Metals				
Gold	$1,200.17	$1,197.35	0.24%	
Silver	$14.67	$14.64	0.26%	
Copper contract	$283.05	$283.40	-0.12%	
Grains				
Corn contract	$ 366.00	$ 364.75	0.34%	
Wheat contract	$ 518.25	$ 515.25	0.58%	
Soybeans contract	$ 862.00	$ 861.50	0.06%	
Shipping				
Baltic Dry Freight	1574	1570	4	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	8.0	1.5	6.5	
Gasoline (mb)	-0.5	1.0	-1.5	
Distillates (mb)	-1.8	-1.5	-0.3	
Refinery run rates (%)	0.00%	-1.00%	1.00%	
Natural gas (bcf)		46.0		

Weather

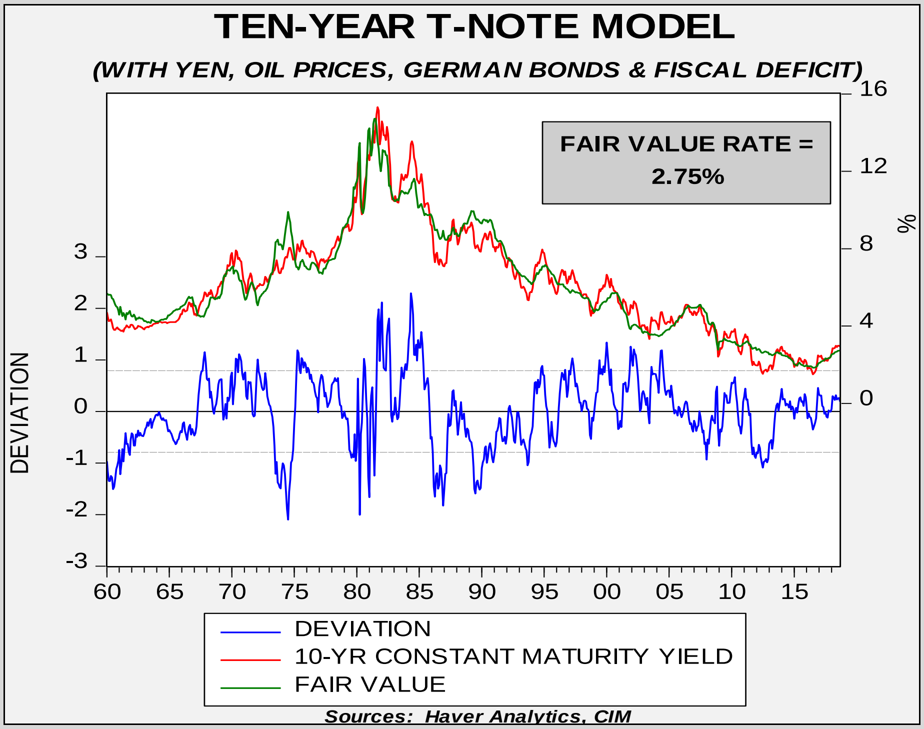
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for the eastern third of the nation, with a developing cold snap for the rest of the country. Above-average precipitation is expected for most of the country. Tropical Storm Leslie remains in the central Atlantic and is not expected to 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%[9] on August 4th. Since then, yields have moved above 3.00%. Our 10-year T-note model suggests rates are a bit elevated.

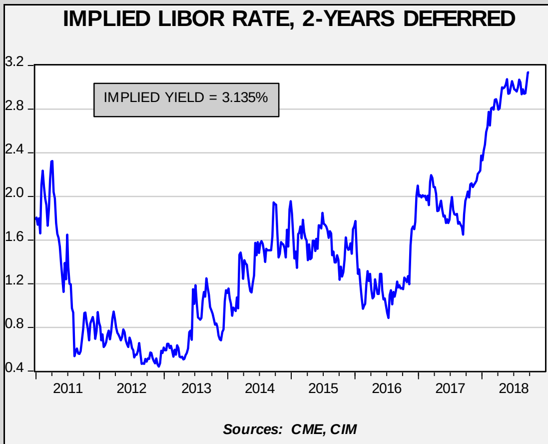


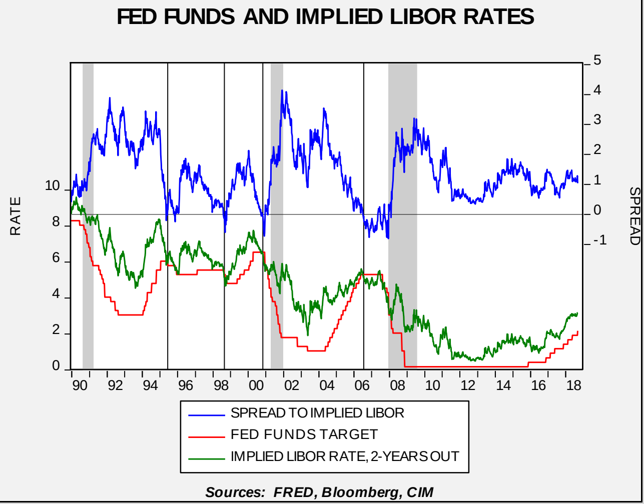
This model includes fed funds and the 15-year moving average of inflation (a proxy for inflation expectations) as the core variables. These two variables explain more than 90% of the variation in the interest rate on this T-note. The additional variables, the yen, oil prices, German bund yields and the 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,[10] 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.

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

[10] 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.[11] 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.

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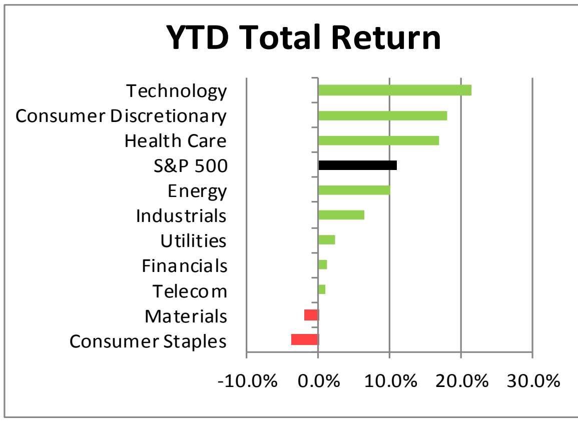
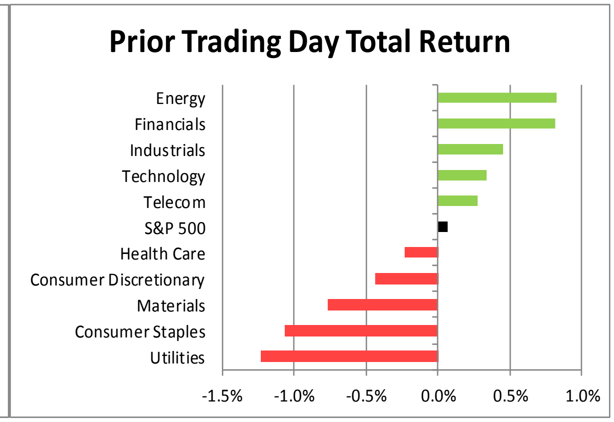
[11] We don't know for sure if this is overt or coincidental, although we suspect the latter.

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 10/3/2018 close)

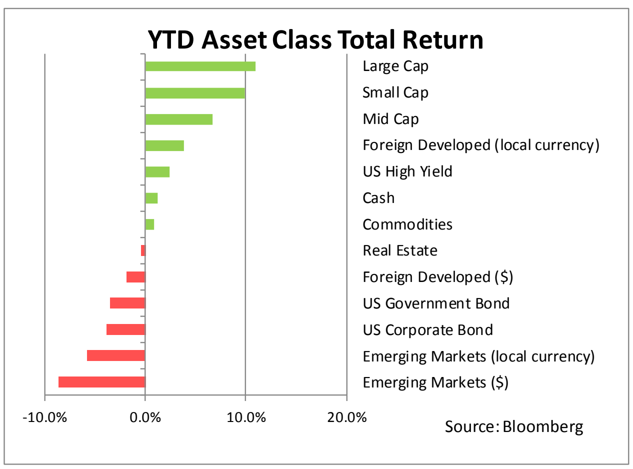




(Source: Bloomberg)

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 10/3/2018 close)

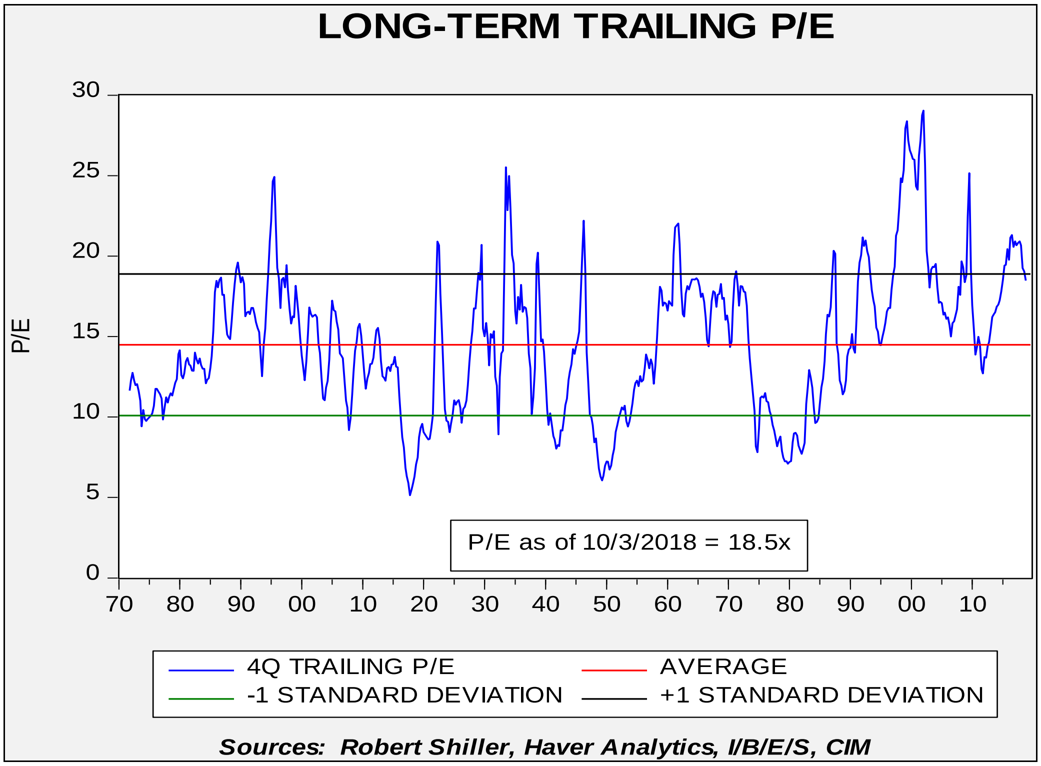


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

October 4, 2018



Based on our methodology,[12] the current P/E is 18.5, down 0.5x from last week's reading of 19.0. The primary reason for the drop in the P/E is the calendar; we have moved into Q4, which means earnings are being calculated on two actual quarters and two forecast quarters and the latter two are generally higher than the actuals.

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[12] 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.