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.

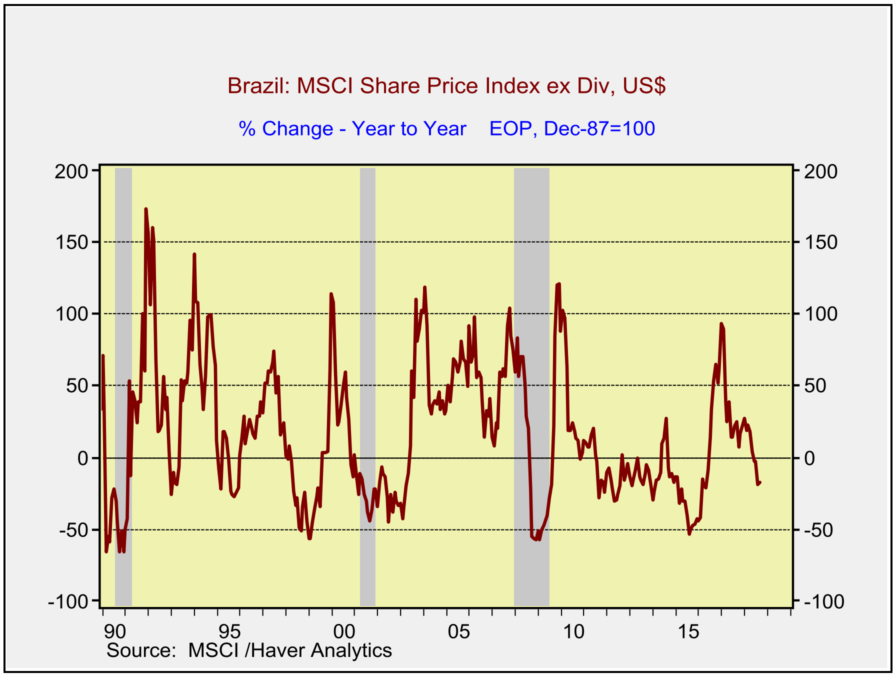
[Posted: October 5, 2018—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.3% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.5% from the prior close. Chinese markets were closed for the National Holiday, which will run until October 7. U.S. equity index futures are signaling a higher open.

It's employment Friday! We cover the data in detail below, but the short recap is that the payroll data came in well below forecast at 134k vs. estimates of 185k. However, revisions added 87k, so the overall increase in payrolls did exceed estimates. The unemployment rate dipped to 3.7%, below the 3.8% expected. Wages were on forecast at 2.8%. Overall, it's a solid report and should support further increases in the policy rate. We are seeing further weakness in bond prices and a stronger dollar. Equities are mostly steady. Here are other items we are watching today:

Brazil to the polls: Brazilian voters go to the polls Sunday in what has been a rather wild pre-election season. For much of the run-up to the election, former president Luiz Inacio Lula da Silva was the front-runner, although he had been convicted of corruption. The courts barred him from running. With Lula out of the way, Jair Bolsonaro is leading in the polls.[1] Bolsonaro, a former member of the military, is a controversial figure[2] running on a right-wing populist platform. He was recently stabbed during a campaign rally, but has recovered.[3] The electorate's shift from favoring Lula, a hard-left candidate, to Bolsonaro, a hard-right candidate, is a pattern we have seen across the democracies of the world. The center-left and center-right are losing support, seen as the vanguard of globalization and deregulation. Voters want something different even if that "difference" is not ideologically consistent. We would not expect a final result from Sunday's election; Brazil requires a majority to take the presidency and if no candidate exceeds 50% (polls don't suggest any candidate will) then a runoff between the two largest vote winners will be held on October 28. Brazilian equities (in dollar terms) have been under pressure this year.

---

[1] https://en.wikipedia.org/wiki/Opinion_polling_for_the_Brazilian_general_election,_2018
[2] https://www.voanews.com/a/brazil-presidential-candidate-let-police-kill-criminals/4550275.html?utm_source=newsletter&utm_medium=email&utm_campaign=newsletter_axiosam&stream=top
[3] https://www.theguardian.com/world/2018/sep/06/brazil-jair-bolsonaro-far-right-presidential-candidate-stabbed



A Bolsonaro victory may be a catalyst for an equity rally as he would be seen, at least initially, as friendly to capital.

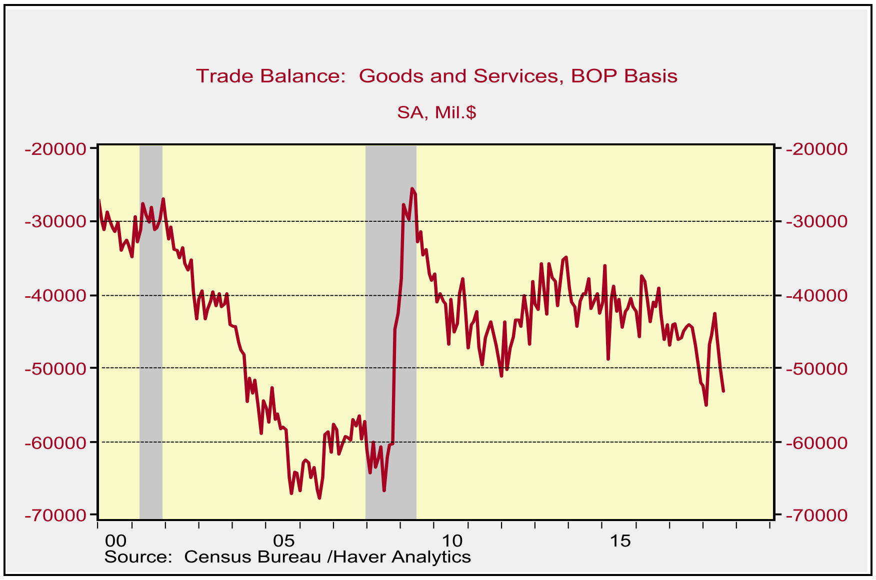
The disappearing journalist: Jamal Khashoggi is a Saudi journalist who has been living outside the kingdom recently on apparent fears of arrest. Earlier in the week, he entered the Saudi consulate in Istanbul.[4] He hasn't been seen since. The Saudis say they don't have him but it is generally believed that the kingdom has detained him. Khashoggi has been critical of Saudi Crown Prince Salman,[5] a leader who has shown he will not tolerate dissent. We would not look for the U.S. to get deeply involved in this issue, but Khashoggi is well known and if he has been arrested it could be a public relations issue for Saudi Arabia.

U.S. Economic Releases

The trade deficit came in narrower than expected at $53.2 bn compared to the forecast of $53.6 bn. The prior report's deficit was revised narrower from $50.1 bn to $50.0 bn.

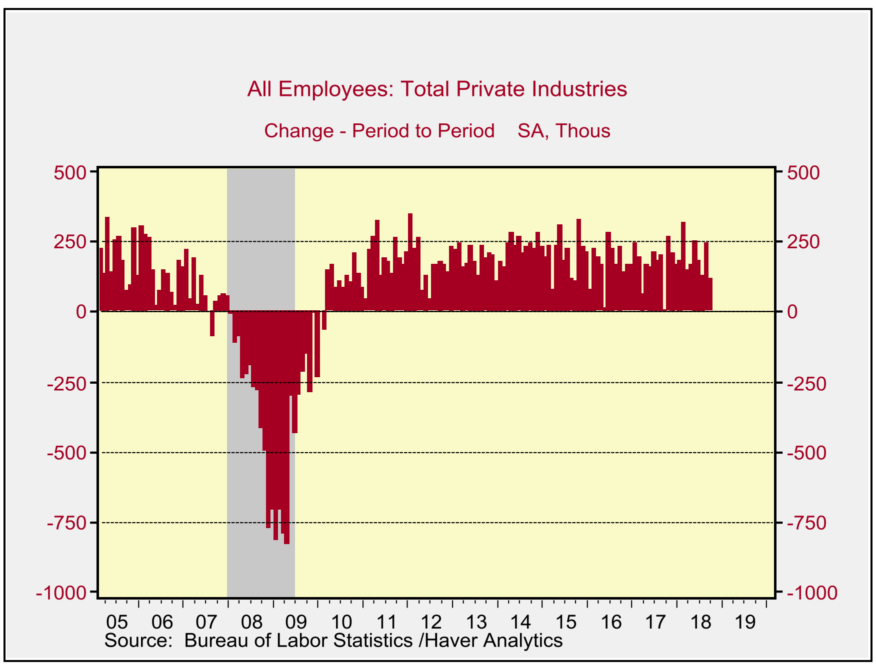
---

[4] https://www.washingtonpost.com/news/global-opinions/wp/2018/10/02/post-contributor-and-prominent-saudi-critic-jamal-khashoggi-feared-missing-in-turkey/?noredirect=on&utm_term=.f2897ec3a42a
[5] https://www.washingtonpost.com/news/global-opinions/wp/2018/09/11/saudi-arabias-crown-prince-must-restore-dignity-to-his-country-by-ending-yemens-cruel-war/?noredirect=on&utm_term=.a2d2b3321ca5



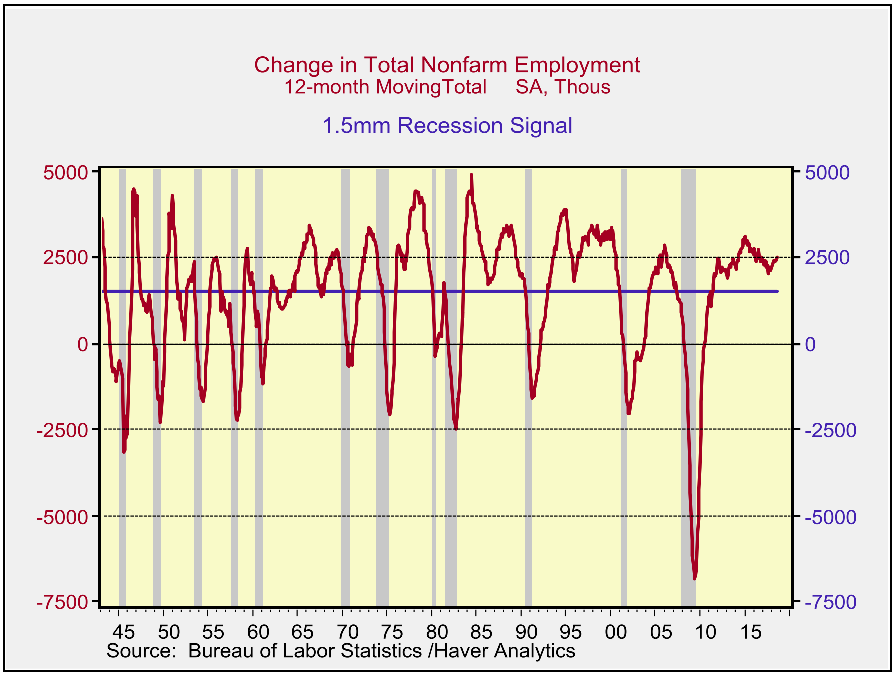
The chart above shows the level of the trade balance for goods and services.

The change in non-farm payrolls for September came in below expectations at 134k compared to the forecast of 185k. The prior report was revised upward from 201k to 270k. The two-month payroll net revision rose 87k. The change in private payrolls came in below expectations at 121k compared to the forecast of 180k. The prior report was revised upward from 204k to 254k. The change in manufacturing payrolls was above expectations, rising by 18k compared to the forecast of a 15k gain. The prior month's report was revised from a loss of 3k to a gain of 5k.

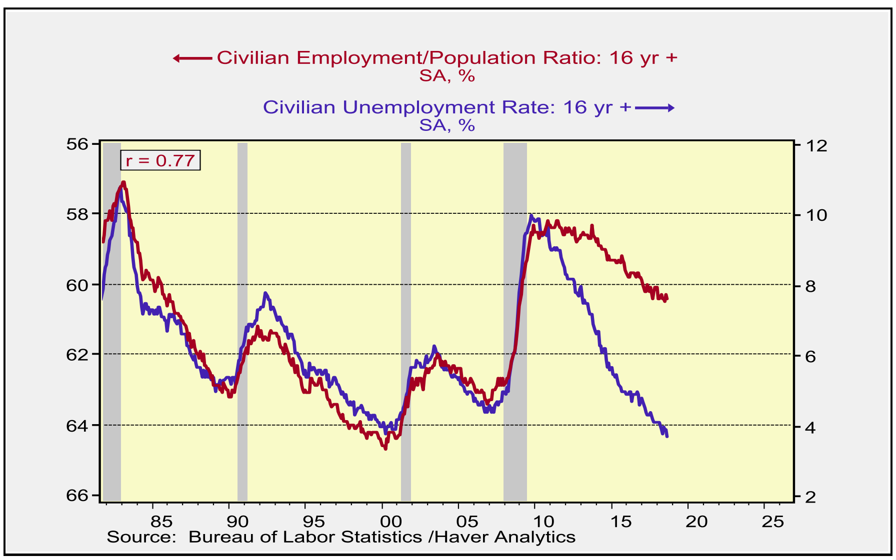


The chart above shows the change in total private employment. This chart suggests the economic expansion continues.

The chart below shows the 12-month moving total of the change in non-farm payrolls; a dip under 1.5 mm signals recession.

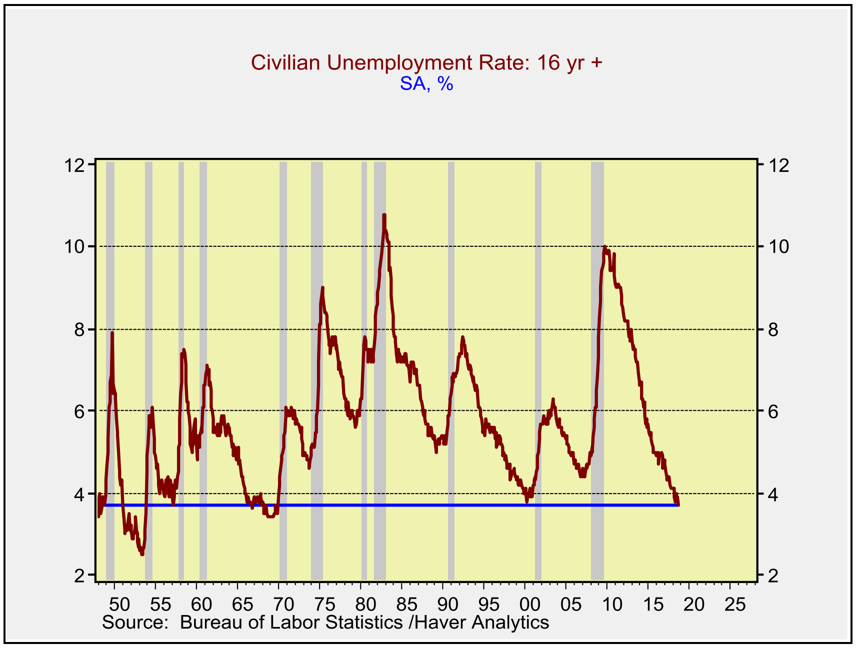


The unemployment rate came in better than expected at 3.7% compared to the forecast of 3.8%. The labor force participation rate was 62.7%, while the U-6 unemployment rate rose 10 bps from 7.4% to 7.5%.

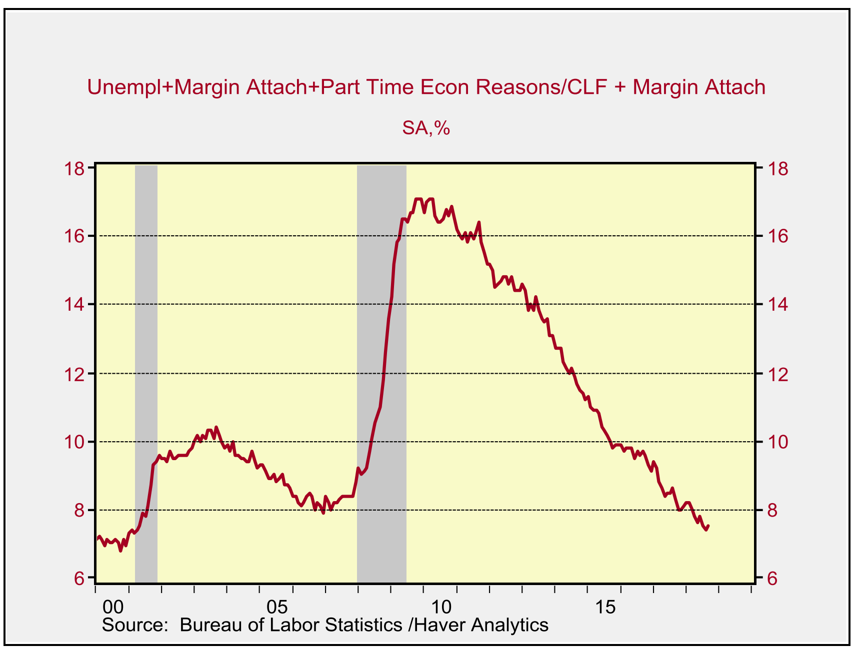


The chart above shows the relationship between the unemployment rate and the employment/ population ratio. The divergence of the two variables has been one of the defining factors of this recovery and argues that labor market slack still remains.

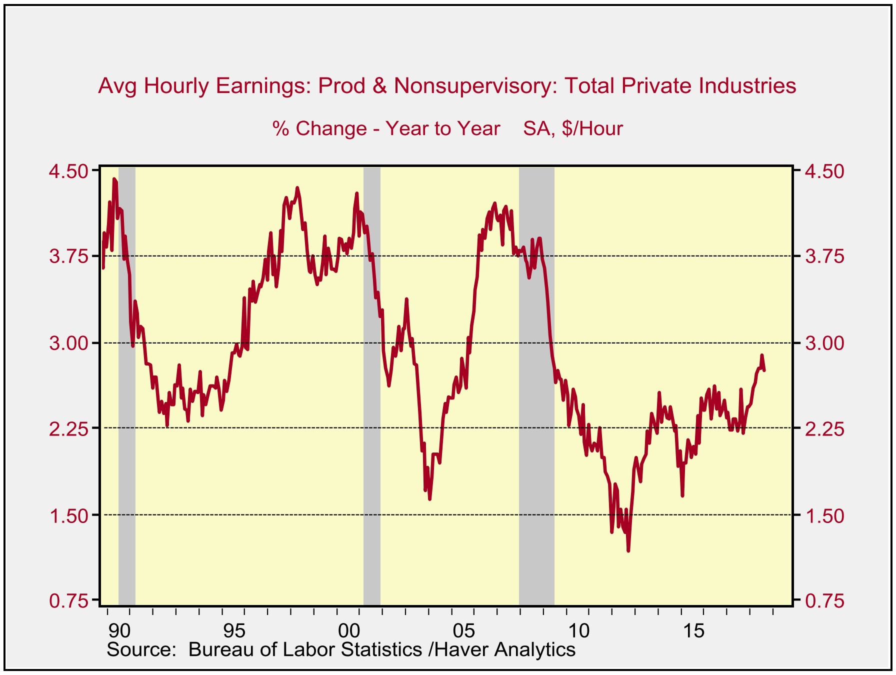
The unemployment rate (U-3) has declined to its lowest rate since 1969.



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.



Average hourly earnings for all workers came in line with expectations, rising 0.3% from the prior month. The chart below shows the yearly change in overall wages for non-supervisory and production workers.



As mentioned, this chart shows the yearly growth in hourly earnings for production and non-supervisory workers. On an annual basis, wage growth for production and non-supervisory employees rose 2.8%, slightly higher than last month. Although wage growth remains modest relative to unemployment, the trend is unmistakable—wages are starting to rise. At the same time, this month's dip is mostly due to the fact that we had a large rise in wages last October.

The data is somewhat skewed by the recent hurricane. For example, the drop in the unemployment rate was aided by a modest increase in the labor force of 150k relative to an increase in employment of 420k. It will take a couple of months for the data to sort itself out from the hurricane to give a clearer picture of the details. But, we can say with high certainty that the labor markets are doing well.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
15:00	Consuner Credit	m/m	aug	$15.000 bn	$16.640 bn	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
12:30	Robert Kaplan Speaks in El Paso	President of the Federal Reserve Bank of Dallas				
12:40	Raphael Bostic to Meet with Fed Up Coalition in Atlanta	President of the Federal Reserve Bank of Atlanta				

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	Household Spending	y/y	aug	2.8%	0.1%	0.1%	**	Equity bullish, bond bearish
	Official Reserve Assets	m/m	sep	$1.260 tn	$1.259 tn		**	Equity and bond neutral
	Labor Cash Earnings	m/m	aug	0.9%	1.5%	1.3%	**	Equity bearish, bond bullish
	Real Cash Earnings	m/m	aug	-0.6%	0.4%	0.0%	**	Equity bearish, bond bullish
	Leading Index CI	m/m	aug	104.4	103.9	104.2	**	Equity and bond neutral
	Coincident Index	m/m	aug	117.5	116.1	117.4	**	Equity and bond neutral
Australia	AiG Performance of Construction Index	m/m	sep	49.3	51.3		**	Equity bearish, bond bullish
EUROPE								
Germany	Factory Orders	m/m	aug	2.0%	-0.9%	0.8%	**	Equity bullish, bond bearish
	PPI	y/y	aug	3.1%	3.0%	2.9%	**	Equity bullish, bond bearish
France	Trade Balance	y/y	aug	-5.632 bn	-3.490 bn	-4.848 bn	**	Equity bearish, bond bullish
	Current Account Balance	m/m	aug	-1.6 bn	0.5 bn		**	Equity bearish, bond bullish
	Budget Balance YTD	m/m	aug	-97.3 bn	-82.8 bn		**	Equity bearish, bond bullish
Italy	Retail Sales	m/m	aug	0.7%	-0.1%	0.1%	**	Equity bullish, bond bearish
U.K.	Halifax House Prices	m/m	sep	-1.4%	0.1%	0.2%	***	Equity bearish, bond bullish
	Unit Labor Costs	y/y	2q	2.0%	3.1%		**	Equity bullish, bond bearish
Switzerland	Foreign Currency Reserves	m/m	sep	739.7 bn	730.9 bn		**	Equity and bond neutral
	CPI	m/m	sep	1.0%	1.2%	1.1%	***	Equity bullish, bond bearish
	CPI core	y/y	sep	0.4%	0.5%	0.6%	***	Equity bullish, bond bearish
AMERICAS								
Mexico	Consumer Confidence Index	m/m	sep	101.7	103.9	102.9	***	Equity and bond neutral
Canada	Ivey Purchasing Manager	m/m	sep	50.4	61.9		**	Equity and bond neutral
Brazil	Vehicle Production Anfavea	m/m	sep	223115	291425		*	Equity and bond neutral
	Vehicle Sales Anfavea	y/y	sep	213339	248623		*	Equity and bond neutral
	Vehicle Exports Anfavea	m/m	sep	39449	56104		*	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)	241	241	0	Up
3-mo T-bill yield (bps)	217	218	-1	Neutral
TED spread (bps)	24	23	1	Neutral
U.S. Libor/OIS spread (bps)	224	224	0	Up
10-yr T-note (%)	3.20	3.19	0.01	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	40	40	0	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	steady			Neutral
yen	down			Neutral
pound	up			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBI Repurchase Rate	6.500%	6.500%	6.750%	On forecast
RBI Reverse Repo Rate	6.250%	6.250%	6.500%	On forecast
RBI Cash Reserve Ratio	4.000%	4.000%	4.000%	On forecast
Mexican Overnight Rate	7.750%	7.750%	7.750%	On forecast

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	$84.32	$84.58	-0.31%	
WTI	$74.50	$74.33	0.23%	
Natural Gas	$3.19	$3.17	0.82%	
Crack Spread	$17.80	$18.08	-1.56%	
12-mo strip crack	$20.94	$21.20	-1.24%	
Ethanol rack	$1.40	$1.40	0.06%	
Metals				
Gold	$1,202.89	$1,199.92	0.25%	
Silver	$14.64	$14.60	0.31%	
Copper contract	$277.15	$277.75	-0.22%	
Grains				
Corn contract	$ 367.75	$ 367.50	0.07%	
Wheat contract	$ 521.75	$ 518.00	0.72%	
Soybeans contract	$ 859.50	$ 859.25	0.03%	
Shipping				
Baltic Dry Freight	1554	1574	-20	
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)	98.0	46.0	52.0	

Weather

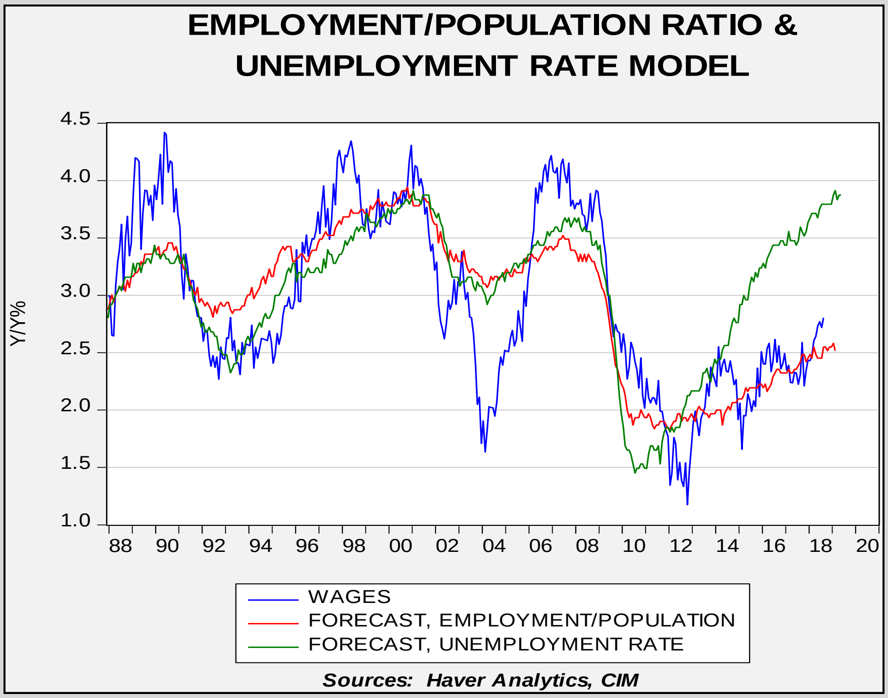
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for the eastern third of the nation, with a developing cold snap for the rest of the country. Above-average precipitation is expected for most of the country. Tropical Storm Leslie remains in the central Atlantic and is not expected to 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.

October 5, 2018

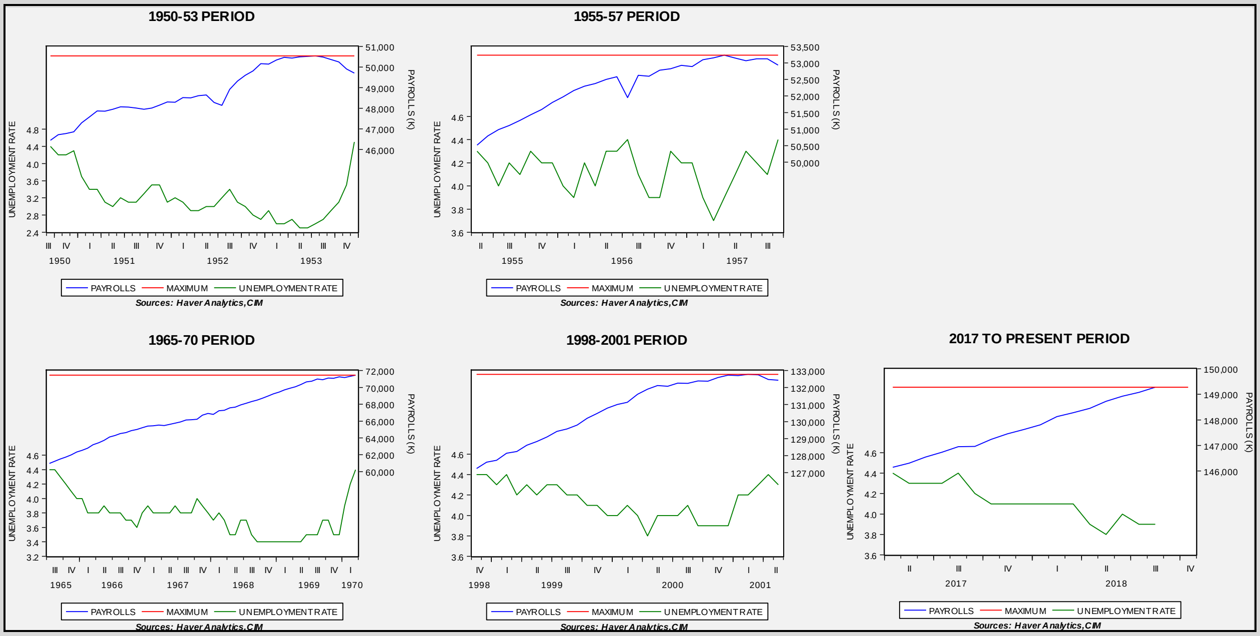
As the unemployment rate declines, there is a worry that wage growth may accelerate and lead to a wage-price spiral, forcing the FOMC to raise rates rapidly. Although possible, the key issue is slack in the labor market. Based on the unemployment rate, there would appear to be little; based on the employment/population ratio, employers should still be able to find workers without having to raise wages to attract them.



This chart shows yearly wage growth for non-supervisory workers. We forecast the results from two models of wages, one using the unemployment rate and the other using the employment/population ratio. Until the latest recovery, both models worked reasonably well; however, in the current recovery, there is a significant divergence. The model using the unemployment rate suggests wage growth should be closer to 4%. Using the employment/population ratio, wages should be growing around 2.5%, which is about in line with actual wage growth. This analysis would suggest there is probably more slack in the economy than the unemployment rate would indicate.

However, just because this pattern has been in place for several years doesn't mean it will continue. One potential signal that the labor market is "running short of workers" would be if the unemployment rate remains low while non-farm payroll growth slows. To see if slowing payrolls occurs when the unemployment rate is low, we compared five periods since the 1950s when the unemployment rate was under 4.5% for an extended period. We compared payrolls to their maximum to see if payrolls turn down while unemployment is low.

There were four periods in the past that met this criteria.

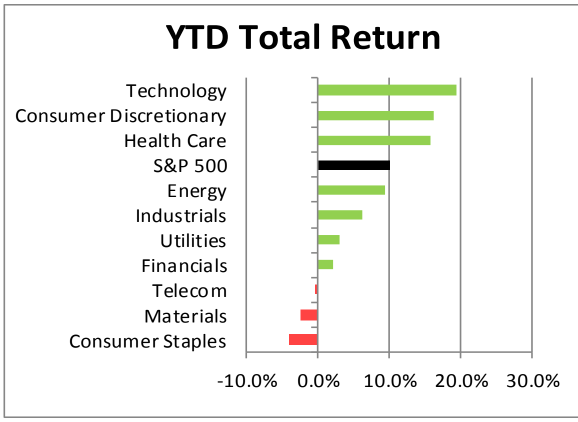


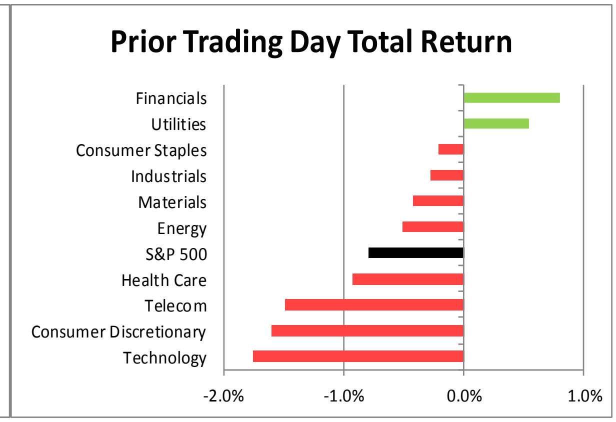
The 1950-53, the 1955-57 and the 1998-2001 periods all had payrolls decline from their maximum even with low unemployment. However, it should also be noted that in all cases the unemployment rate began to rise as well. In other words, a decline in payrolls doesn't necessarily offer any better signal than simply watching the unemployment rate. In the 1966-70 period, payrolls continued to rise even though the unemployment rate began to rise. Of course, we have the current event, which still shows rising payrolls.

So, what does this mean for markets? This analysis shows that slowing payrolls won't necessarily offer a better signal for weakening labor markets than rising unemployment. And, for now, the employment/population ratio is a superior measure of slack. Based on this analysis, there is probably more room for additional increases in the labor force before wage growth accelerates.

Data Section

U.S. Equity Markets – (as of 10/4/2018 close)

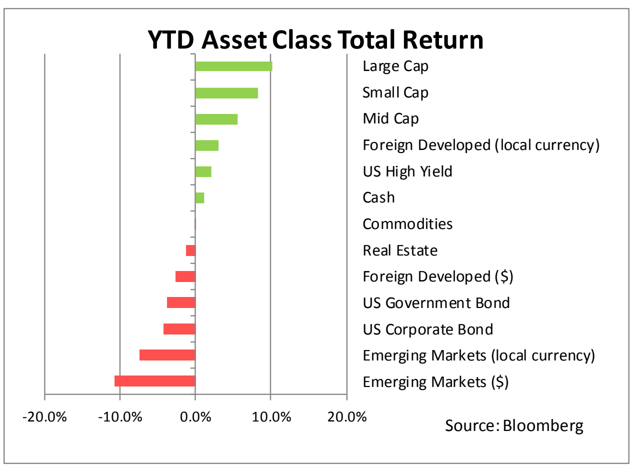




(Source: Bloomberg)

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 10/4/2018 close)

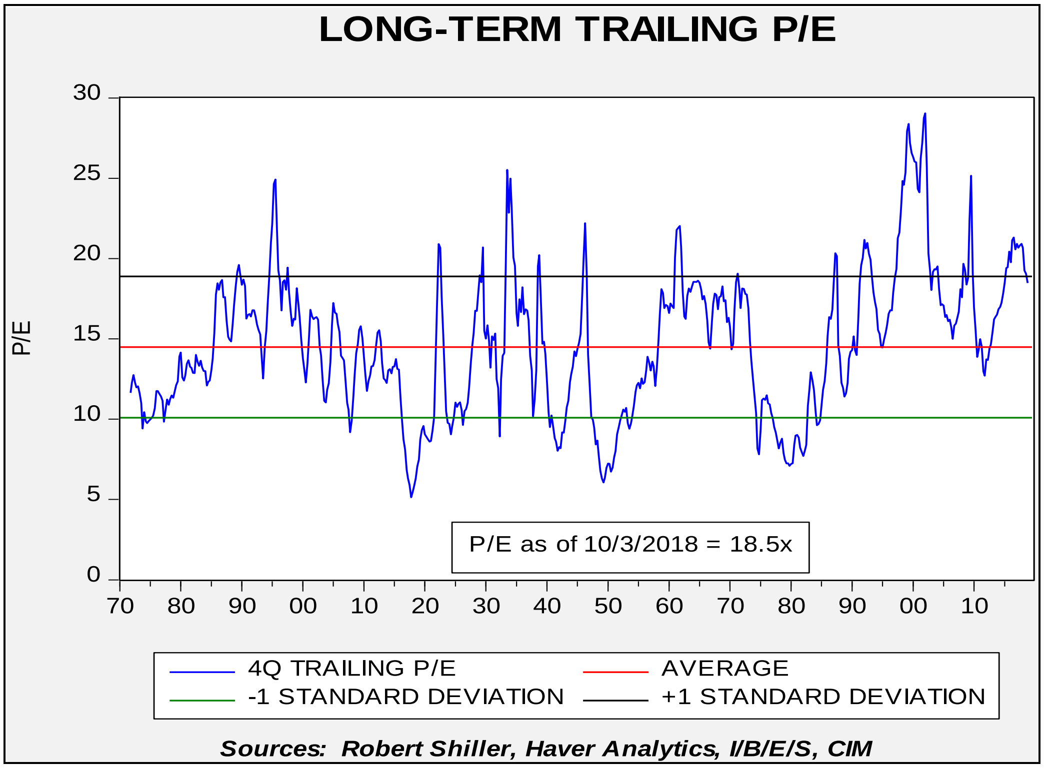


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[6] 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.

[6] 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.