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 8, 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 1.1% from the prior close. Chinese markets were lower, with the Shanghai composite down 3.7% and the Shenzhen index down 3.8%. U.S. equity index futures are signaling a lower open.

It's Monday—financial markets are in clear risk-off mode amid lots of news. It is Columbus Day, a bank holiday, so commercial banks and the Treasury market are closed today. Here is what we are following:

China: Chinese markets reopened after a week-long holiday to a significant drop in equity values and a drop in the CNY.

(Source: Bloomberg)

The exchange rate is testing recent lows as trade tensions rise with the U.S. There was an exchange between Chinese Foreign Minister Wang Yi and Secretary of State Mike Pompeo that has been described as "frosty"[1] during a five-hour visit by Pompeo to Beijing. China indicated that U.S. policy was "misguided."[2] Tensions between the two countries are clearly rising. There was a near collision between Chinese and U.S. destroyers recently and the U.S. is considering increasing the number of Freedom of Navigation operations near outcroppings that China has been fortifying in recent years. Meanwhile, on trade, the U.S. doesn't seem to be anywhere close to easing pressure on China; in fact, the long-term goal of the Trump administration appears to be shortening the supply chains,[3] with a focus on pulling productive capacity out of China. Part of China's retaliation will be a weaker currency; we note that China lowered its reserve requirements in a bid to boost the economy.[4] We believe the CPC will do all it can to maintain high levels of economic growth as it views growth as legitimizing the rule of the party. Although the Chinese government tends to keep a lid on dissent, we do note there were riots over the holiday when a real estate developer cut prices in a bid to sell remaining units. The current property owners were furious and attacked the sales office, smashing windows.[5] Falling real estate values may be a more significant threat to the CPC than trade.

Brazilian elections: As expected, Jair Bolsonaro won a plurality on Sunday,[6] taking 46% of the vote, nearly winning a majority. There will be a runoff on the 28th which will likely make Bolsonaro the new president of Brazil. Bolsonaro is a right-wing populist whose platform is law and order and has shown an affinity for the military dictatorships of the early 1980s. Equity markets in Brazil have welcomed the outcome.

Italy: After agreeing on a budget last week, the EU criticized Italy's rising deficits. This criticism prompted a strong reaction from the League's deputy PM, Matteo Salvini, who suggested that "the enemies of Europe are those sealed in the bunker in Brussels."[7] The exchange triggered another sell-off in Italian bonds and a drop in the EUR. As the chart below shows, the spread between German bunds and Italian 10-year sovereigns widened out over 300 bps, with Italian paper hitting a yield of 3.60% and German yields easing lower. Italy is a mortal threat to the Eurozone; if Italy leaves, it will severely damage the single currency to the point where it would probably not survive in its current form. We would expect other southern tier nations to exit the single currency if Italy leaves. If Germany wants to keep the Eurozone in place, it will be forced to ease its restrictions on fiscal spending and probably accept a Eurobond, a sovereign backed by the full faith and credit of all members in the Eurozone. Germany will see this as giving the Italians a credit card, leaving Germans to service the debt. Simply put, it is unlikely that Germany will accept this change. Thus, tensions will likely remain elevated.

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[1] https://www.ft.com/content/bb666e06-cad2-11e8-b276-b9069bde0956

[2] https://www.washingtonpost.com/world/china-tells-trump-administration-to-stop-its-misguided-actions-and-allegations/2018/10/08/cd17c926-cac1-11e8-a85c-0bbe30c19e8f_story.html?utm_term=.946be1214f51

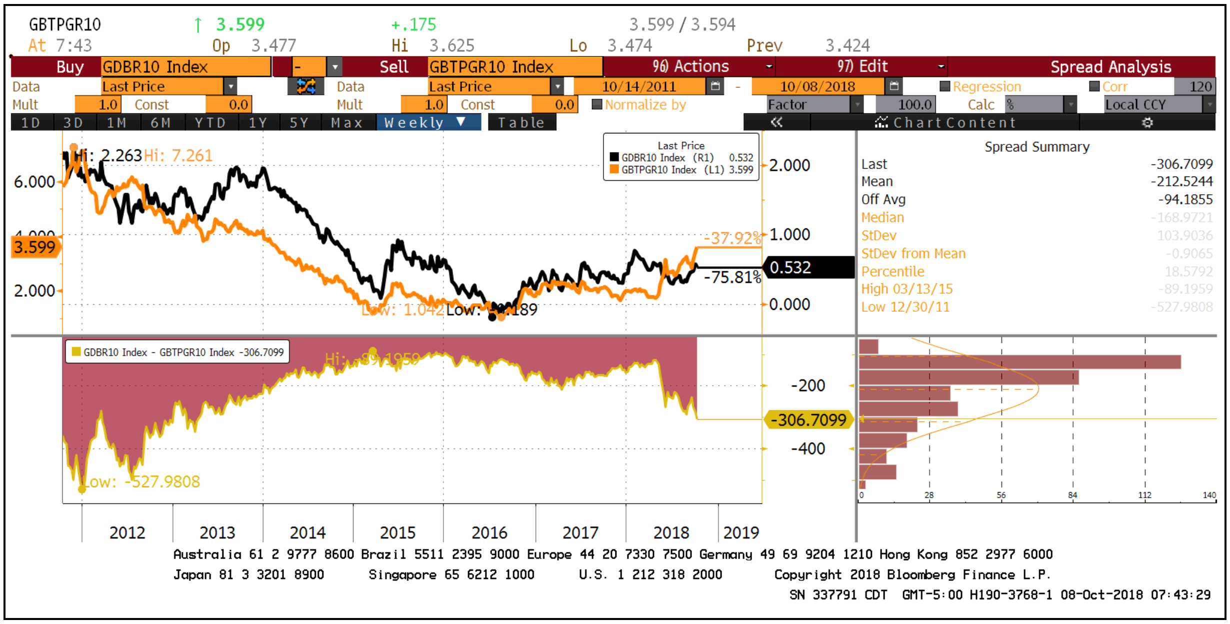
[3] https://www.wsj.com/articles/u-s-tariffs-on-china-arent-a-short-term-strategy-1538841600

[4] https://www.marketwatch.com/discover?url=https%3A%2F%2Fwww.marketwatch.com%2Famp%2Fstory%2Fguid%2F8187f748-ca70-11e8-9cdc-8834b4cd15bb&link=sfmw_tw#https://www.marketwatch.com/amp/story/guid/8187f748-ca70-11e8-9cdc-8834b4cd15bb?mod=dist_amp_social

[5] https://twitter.com/polarmcbear/status/1048473629015465984?s=11

[6] https://www.ft.com/content/86a29826-cad1-11e8-9fe5-24ad351828ab

[7] https://www.ft.com/content/36abf528-cac3-11e8-b276-b9069bde0956



(Source: Bloomberg)

The long arm of the authoritarians: Last week, we noted that Jamal Khashoggi, a Saudi journalist who had been critical of the Salman reign in Saudi Arabia, had gone missing after entering the Saudi embassy in Istanbul. He was recently living outside the kingdom on apparent fears of arrest and writing for the *Washington Post*.[8] Turkey claims that a Saudi unit tortured and killed Khashoggi last week.[9] The Saudis have denied the report. Separately, the head of Interpol, a Chinese national named Meng Hongwei, has resigned after he was arrested while visiting China last week.[10] Although two unrelated events, both indicate that authoritarian regimes, which generally won't tolerate dissent, are signaling to their citizens that (a) you can't run away, and (b) the West won't protect you. If this message is true, it may stem capital flight which has boosted coastal real estate markets in the U.S. and Britain.

Oil prices: Oil prices have dipped on reports that the Trump administration is considering granting some waivers to nations wanting to import Iranian oil. That action may be necessary to contain the recent jump in oil prices. We will be watching to see if these waivers are permanent or if they need to be renewed after the midterm elections. If it's the latter, we view this as a bid to lower oil prices in front of the midterms.

U.S. Economic Releases

There are no economic releases or Fed events scheduled for the day.

[8] https://www.washingtonpost.com/news/global-opinions/wp/2018/10/06/read-jamal-khashoggis-columns-for-the-washington-post/?utm_term=.ba113d6a41ef
[9] https://www.ft.com/content/d62a06ec-c9b7-11e8-b276-b9069bde0956?emailId=5bbae01f8faec70004dff956&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22
[10] https://www.ft.com/content/52edca9e-ca56-11e8-b276-b9069bde0956

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	ANZ Job Advertisements	m/m	sep	-0.8%	-0.6%		**	Equity bearish, bond bullish
China	Foreign Reserve	m/m	sep	$3.087 tn	$3.110 tn	$3.105 bn	**	Equity bearish, bond bullish
	Caixin China PMI Composite	m/m	aug	52.1	52.0		**	Equity bullish, bond bearish
	Caixin China PMI Services	m/m	aug	53.1	51.5	51.4	**	Equity bullish, bond bearish
EUROPE								
Eurozone	Sentix Investor Confidence	m/m	aug	11.4	12.0	11.6	**	Equity and bond neutral
Germany	Industrial Production	y/y	aug	-0.3%	1.1%	-0.1%	***	Equity bearish, bond bullish
France	Bank of France Industry Sentiment	y/y	sep	105	103	102	**	Equity bullish, bond bearish
Switzerland	Unemployment Rate	m/m	sep	2.5%	2.6%	2.5%	**	Equity and bond neutral
	Total Sight Deposits CHF	m/m	sep	577.5 bn	577.9 bn		**	Equity and bond neutral
	Domestic Sight Deposits CHF	m/m	sep	469.4 bn	474.8 bn		**	Equity and bond neutral
AMERICAS								
Mexico	Gross Fixed Investment	m/m	jul	5.0%	1.4%	6.7%	***	Equity bearish, bond bullish
Canada	International Merchandise Trade	m/m	aug	0.53 bn	-0.11 bn	-0.52 bn	**	Equity bullish, bond bearish
	Unemployment Rate	m/m	sep	5.9%	6.0%	5.9%	***	Equity and bond neutral
	Hourly Earnings Permanent Employment	y/y	sep	2.2%	2.6%	2.6%	*	Equity bearish, bond bullish
	Participation Rate	m/m	sep	65.4	65.3	65.4	*	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	217	0	Neutral
TED spread (bps)	24	24	0	Neutral
U.S. Libor/OIS spread (bps)	224	224	0	Up
10-yr T-note (%)	3.23	3.23	0.00	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	40	39	1	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	up			Neutral
pound	down			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	$82.89	$84.16	-1.51%	Iran Sanction Waivers
WTI	$73.40	$74.34	-1.26%	
Natural Gas	$3.20	$3.14	1.78%	
Crack Spread	$17.26	$17.50	-1.37%	
12-mo strip crack	$20.63	$20.85	-1.07%	
Ethanol rack	$1.40	$1.40	-0.18%	
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	

Weather

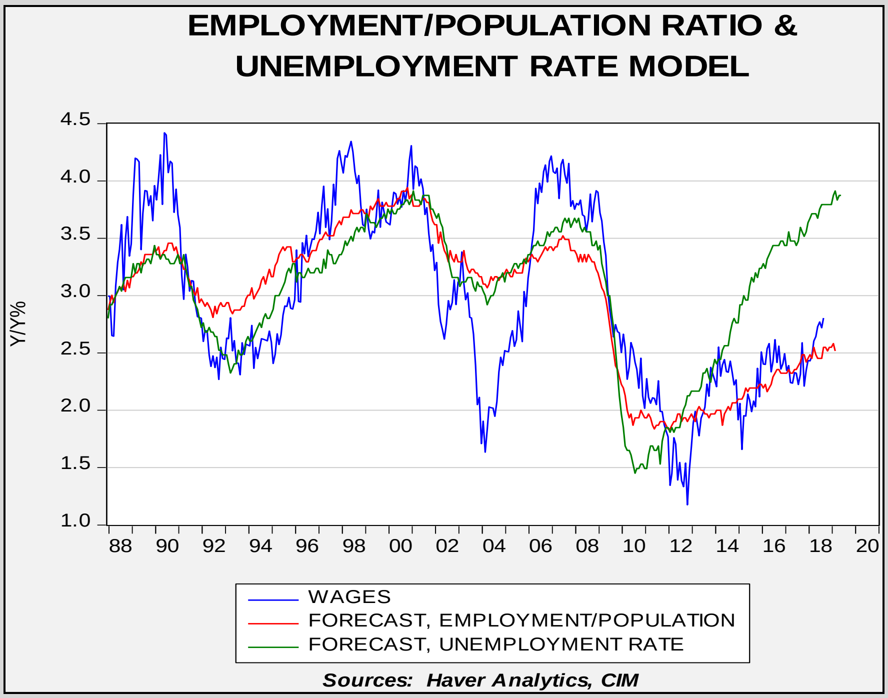
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for the West Coast, with a developing cold snap for the rest of the country. Tropical Storm Leslie remains in the central Atlantic and is not expected to make landfall. Tropical Storm Michael has developed in the Caribbean Sea and is forecast to move into the Gulf of Mexico by Wednesday; it is expected to develop into a hurricane, touching down in Cuba and making its way to the Florida coast. We will continue to monitor this situation.

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

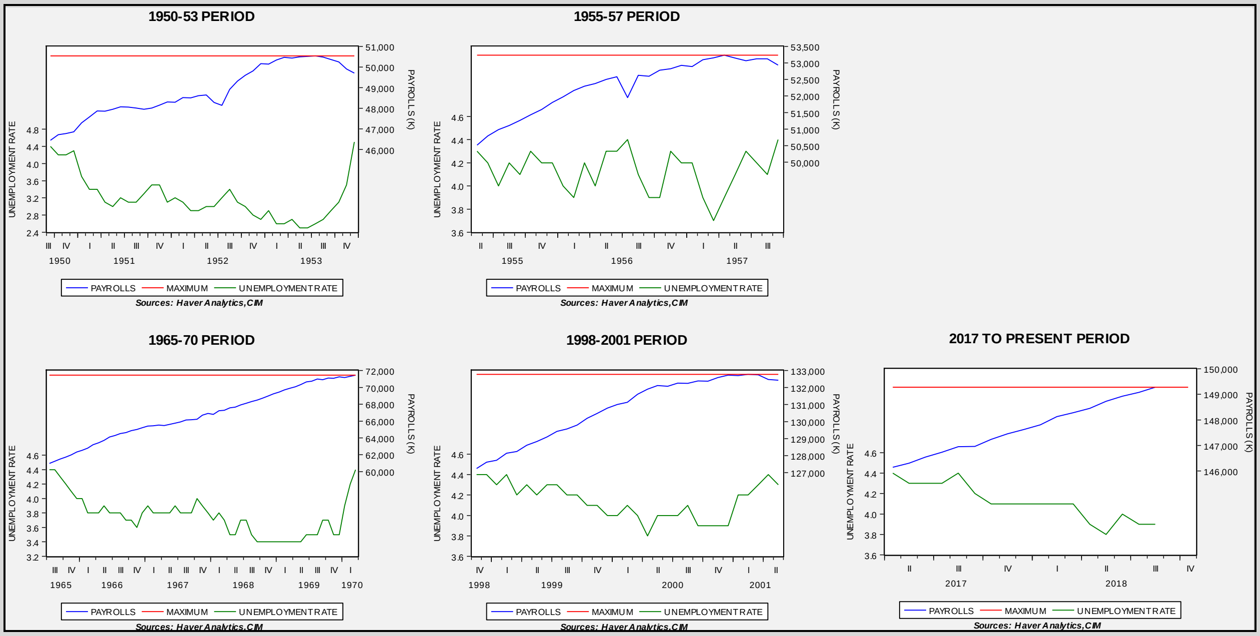
As the unemployment rate declines, there is a worry that wage growth may accelerate and lead to a wage-price spiral, forcing the FOMC to raise rates rapidly. Although possible, the key issue is slack in the labor market. Based on the unemployment rate, there would appear to be little; based on the employment/population 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.

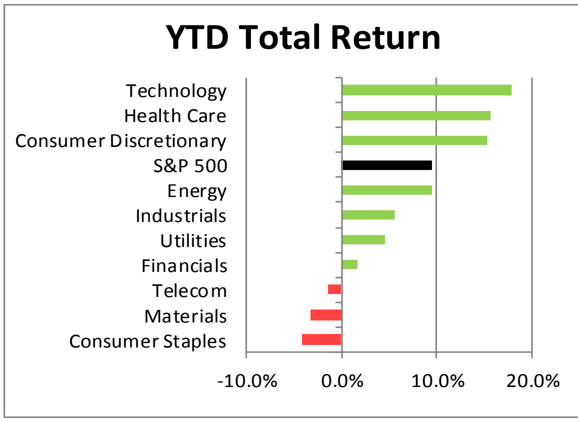


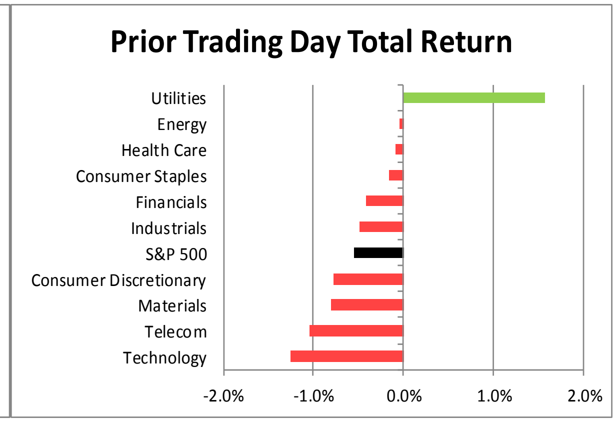
The 1950-53, the 1955-57 and the 1998-2001 periods all had payrolls decline from their maximum even with low unemployment. However, it should also be noted that in all cases the unemployment rate began to rise as well. In other words, a decline in payrolls doesn't necessarily offer any better signal 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 10/5/2018 close)

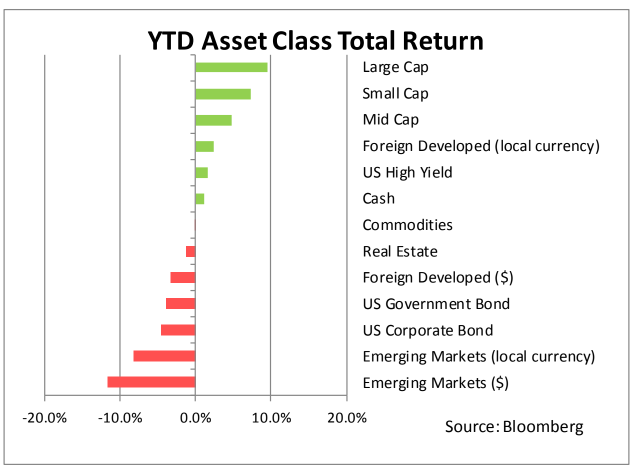




(Source: Bloomberg)

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 10/5/2018 close)

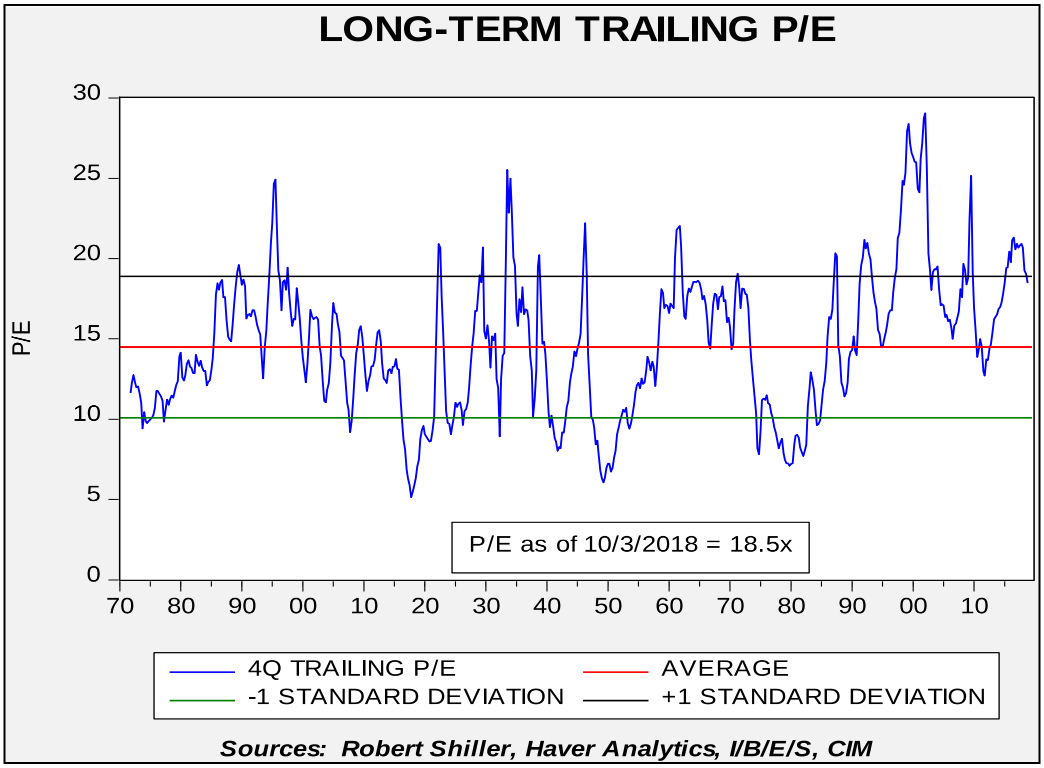


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[11] 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.

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 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.