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 15, 2018—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is up 0.5% 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 1.5% and the Shenzhen index down 1.2%. U.S. equity index futures are signaling a lower open. With 28 companies having reported, the S&P 500 Q3 earnings stand at $40.56, slightly higher than the $40.50 forecast for the quarter. The forecast reflects a 21.0% increase from Q3 2017 earnings. Thus far this quarter, 82.1% of the companies reported earnings above forecast, while 14.3% reported earnings below forecast.

The equity sell-off has returned as U.S. tensions with Saudi Arabia and China escalated over the weekend. Growing concerns of market uncertainty have led to a rise in oil prices, gold and Treasuries, as well as a drop in the dollar. Below are the stories we will be following throughout the day:

Saudi Arabia hits back: Saudi Arabia responded to threats from President Trump by vowing to strike back if any actions are taken against the kingdom. Over the weekend, the president suggested there will be consequences for Saudi Arabia if it was responsible for the suspected killing of *Washington Post* journalist Jamal Khashoggi. In response to the allegations, businesses have begun to distance themselves from the kingdom by withdrawing from the Saudi conference nicknamed "Davos in the Desert," with the most notable withdrawals being Ford Motor (F, $8.64) Chairman Bill Ford and JP Morgan (JPM, $106.95) Chief Executive Jamie Dimon. Equity markets in Saudi Arabia also took a hit. As mentioned last week, in the event of escalating tensions between the U.S. and Saudi Arabia we expect the kingdom to reduce oil production in an attempt to raise oil prices. Although the U.S. could use some of its strategic supplies to offset some of the reduction in production, it will likely do little to change the world price of oil. Therefore, we expect global equities to suffer as a result of tit-for-tat responses between the U.S. and Saudi Arabia.

Pastor Brunson's return: On Friday, Turkey released Pastor Andrew Brunson who was detained on terrorism charges following the failed coup in 2016. Pastor Brunson's release will likely lead to a de-escalation of tensions between Turkey and the U.S. Earlier this year, the Trump administration imposed sanctions on Turkey to pressure the country to release Pastor Brunson with no conditions attached. Although there have been rumors of Pastor Brunson's release being linked to President Trump's decision to take a tougher stance against Saudi Arabia, the Trump administration has denied any such deal. As a result of Pastor Brunson's release the Turkish lira strengthened against the dollar due to the possibility of a lift in U.S. sanctions.

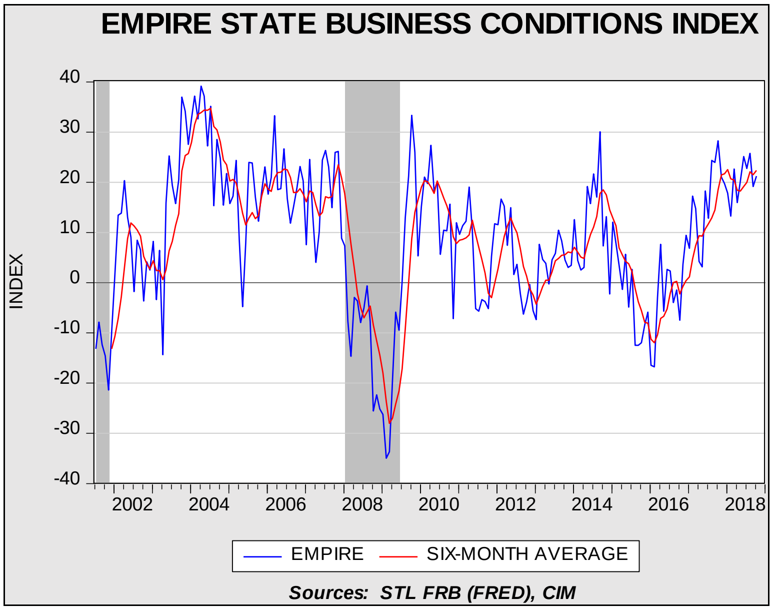
(Source: Bloomberg)

Another round of tariffs: On Sunday, President Trump threatened to impose another round of tariffs on Chinese goods on the grounds that it has interfered with American elections. The president appears to be alluding to a newspaper ad in Iowa designed to sway voters in the midterm elections. Although this does seem like an unorthodox reason for implementing new tariffs, the president may have broad protections under the "Trading with the Enemy Act of 1917" if he decides to follow through on this threat. This law is meant to be enacted during times of war, but the U.S. involvement in Syria may be enough justification. China's decision to aid Iran in avoiding U.S. sanctions could be interpreted as an act to aid an enemy of the state. While there isn't direct conflict between the U.S. and Iran within Syria, the two are strategic foes in the region. That being said, if the president were to proceed down this route he will likely meet stiff opposition from Congress, especially from congressmen whose states will be impacted in the event of retaliation. We do not expect there to be much criticism from members of the Republican Party until after the midterm elections as tariffs appear to be popular with their base.

Brexit deal in trouble: The prospect of an imminent Brexit deal seems to have hit a snag after UK Prime Minister Theresa May stated she is not ready to agree to the deal in its currents state. This shift comes two days after a report suggesting PM May told her inner cabinet that a potential deal was close. It appears that backlash from members of the Tory party and coalition partners DUP could have swayed her position over the weekend. On Friday, the DUP categorically ruled out supporting the deal in its current state after reports suggested Northern Ireland would be treated differently from other members of the United Kingdom. It is becoming increasingly clear that the UK parliament in its current form will not be able to agree to a Brexit deal prior to the March deadline. The possibility of a UK exit from the EU without a deal will spark more uncertainty throughout the region; therefore, we wouldn't be surprised if there is a push for snap elections before the end of the year. Following the report, the pound weakened against the dollar. We will continue to monitor this situation.

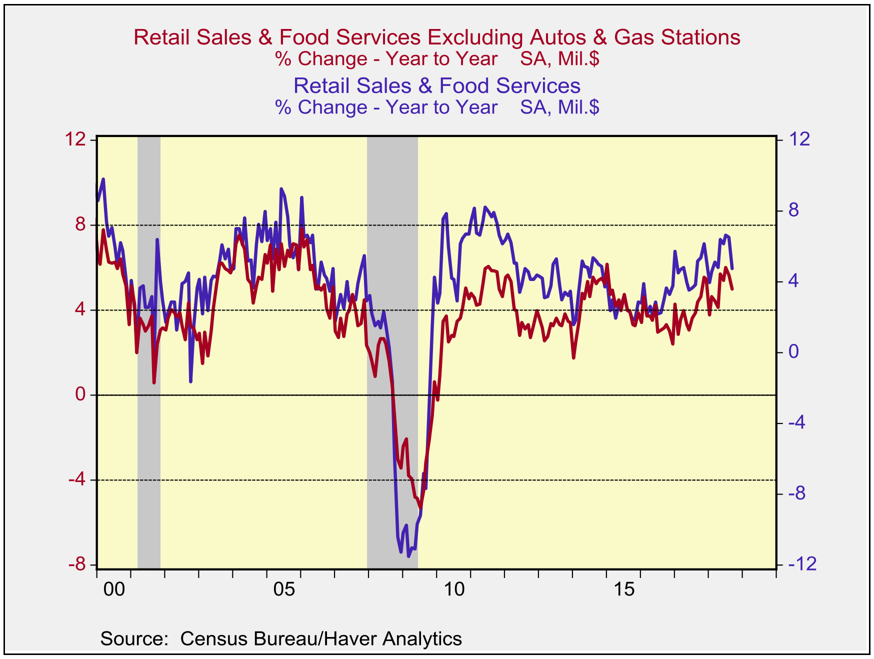
U.S. Economic Releases

Empire manufacturing came in above expectations at 21.1 compared to the forecast of 20.0.



The chart above shows the six-month moving average of the Empire State Business Conditions Index. Currently, the six-month moving average is 22.2.

Advance retail sales came in below expectations, rising 0.1% from the prior month compared to the forecast of 0.6%. Retail sales ex-auto came in below expectations, falling 0.1% from the prior month compared to the forecast rise of 0.6%. The prior report's gain was revised downward from 0.3% to 0.2%. Retail sales ex-auto and gasoline came in below expectations, remaining unchanged from the prior month compared to the forecast rise of 0.3%. The prior report was revised downward from 0.2% to 0.1%. The retail sales control group came in above expectations, rising 0.5% from the prior month compared to the forecast of 0.4%. The prior month's report was revised downward from 0.1% to 0.0%.



The chart above shows the year-over-year change in retail sales and core retail sales. Annually, retail sales and core retail sales rose 4.7% and 5.0%, respectively. The weaker than expected data suggests the stimulus from the tax cuts appears to be waning, although the impact of Hurricane Florence may have also played a role. This is the second report in a row to come in softer than expected; if this continues we would expect the Fed to reconsider its pace of monetary tightening.

The table below lists the economic releases scheduled for the rest of the day.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Business Inventories	m/m	oct	0.5%	0.6%	***
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								
Japan	Captacity Utilization	y/y	aug	2.2%	-0.6%		***	Equity bullish, bond bearish
	Industrial Production	y/y	aug	0.2%	0.7%		***	Equity and bond neutral
India	CPI	y/y	sep	3.8%	3.7%	4.0%	***	Equity bullish, bond bearish
	Industrial Production	m/m	aug	4.3%	6.6%	3.8%	***	Equity bullish, bond bearish
New Zealand	Perfomance Services Index	m/m	sep	53.9	53.2		**	Equity and bond neutral
EUROPE								
Italy	General Government Debt	y/y	aug	2.327 tn	2.342 tn		***	Equity and bond neutral
Switzerland	Producer and import prices	w/w	sep	2.6%	3.4%	3.1%	**	Equity bullish, bond bearish
Russia	Trade Balance	m/m	aug	15.8 bn	13.4 bn	15.0 bn	**	Equity bullish, bond bearish
AMERICAS								
Mexico	Industrial Production	m/m	aug	0.2%	1.3%	0.9%	***	Equity bearish, bond bullish
Canada	Teranet/ National HPI	y/y	sep	2.1%	1.4%		**	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)	244	244	0	Up
3-mo T-bill yield (bps)	222	222	0	Neutral
TED spread (bps)	22	21	1	Neutral
U.S. Libor/OIS spread (bps)	225	225	0	Up
10-yr T-note (%)	3.15	3.16	-0.01	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	46	48	-2	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	up			Neutral
pound	up			Neutral
franc	up			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	$81.25	$80.43	1.02%	Supply Pessimism
WTI	$71.88	$71.34	0.76%	
Natural Gas	$3.23	$3.16	2.18%	
Crack Spread	$15.51	$15.59	-0.50%	
12-mo strip crack	$19.27	$19.32	-0.28%	
Ethanol rack	$1.41	$1.41	-0.10%	
Metals				
Gold	$1,203.80	$1,194.79	0.75%	Global Uncertainty
Silver	$14.40	$14.30	0.69%	
Copper contract	$273.85	$278.05	-1.51%	
Grains				
Corn contract	$ 361.25	$ 362.75	-0.41%	
Wheat contract	$ 509.25	$ 510.50	-0.24%	
Soybeans contract	$ 848.00	$ 852.25	-0.50%	
Shipping				
Baltic Dry Freight	1493	1503	-10	

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for the western region, with cooler temps for the rest of the country. Precipitation is expected for the southern half of the country. There are no tropical cyclones forecast over the next 48 hours, but there is a tropical formation in the Caribbean Sea.

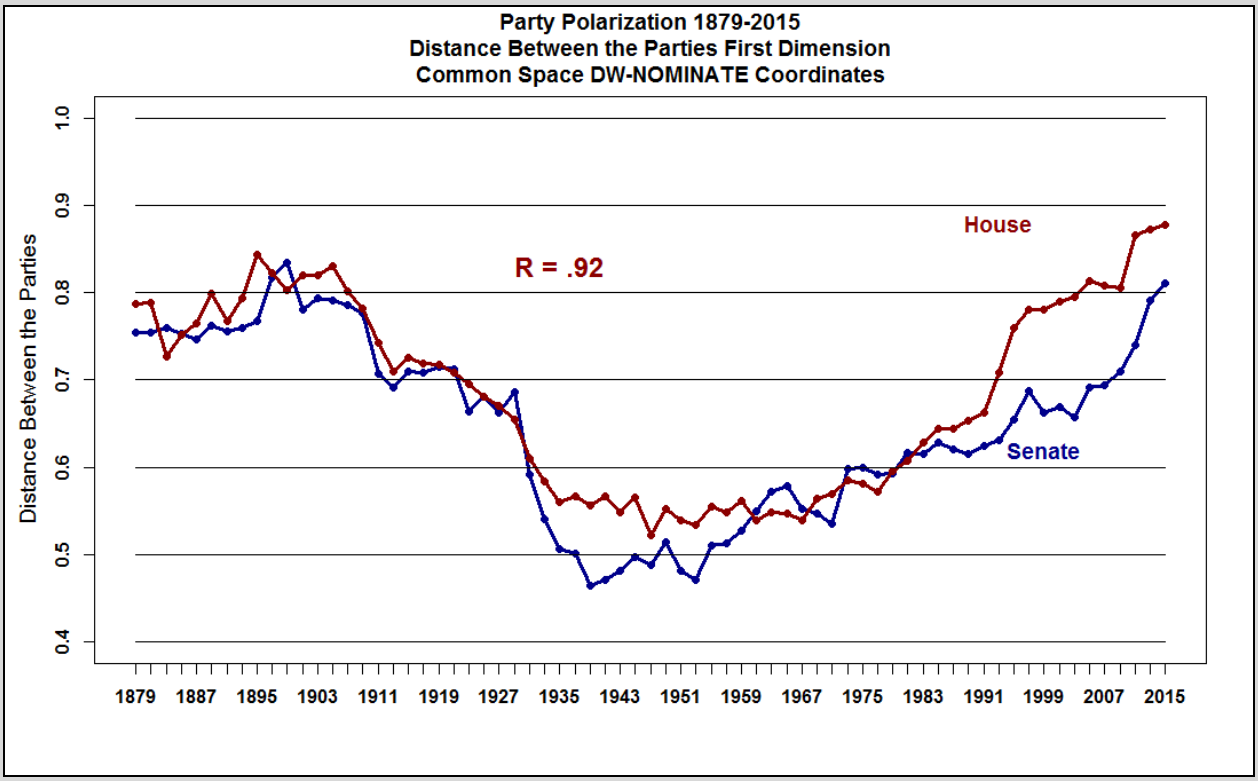
Asset Allocation Weekly Comment

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 12, 2018

Politics is usually an uncomfortable topic for financial market analysts. The subject is fraught with high emotion, and being overly concerned about a specific political outcome can sometimes cloud judgement. At the same time, political trends offer insight into future policy changes that can affect financial market performance. For example, we have documented the growing trend of populism and its potential impact on economic and market performance.[1]

One of the more disturbing trends we have noted in recent years is the growing division among Americans that is being reflected in our political system. Race and gender concerns in marriage have become less of a concern, but marrying across political lines has become increasingly frowned upon.[2] The level of partisanship has increased steadily over the past two decades.



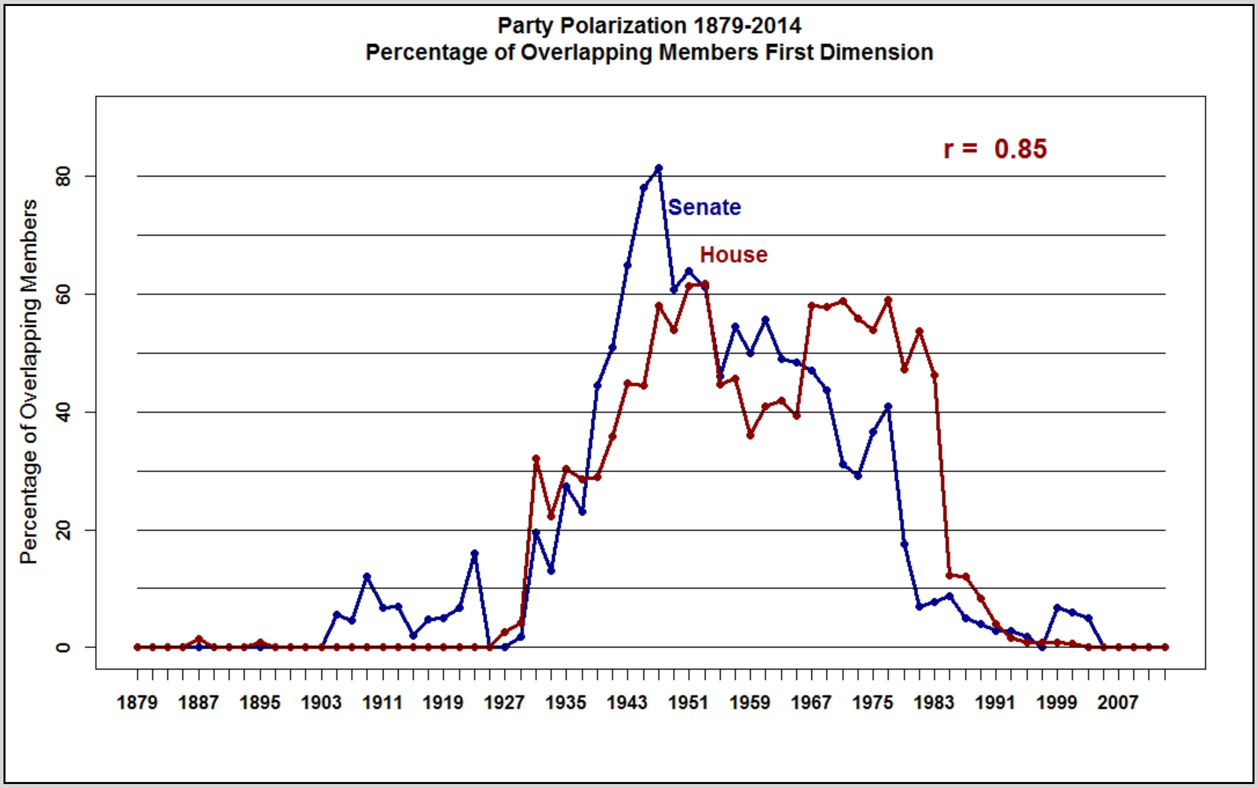
(Source: Rosenthal and Poole)

This data measures the difference between the party voting patterns in Congress. The higher the number, the greater the degree of difference, meaning a higher level of partisanship. A similar

[1] See Weekly Geopolitical Reports, Reflections on Politics and Populism: Part I (7/16/18) and Part II (7/23/18); and European Populism (1/12/15).

[2] https://www.voanews.com/a/mixed-political-marriages-an-issue-on-rise/3705468.html

measure that estimates the percentage of overlapping members (likelihood of voting across party lines) has diminished as well.



(Source: Rosenthal and Poole)

This deepening polarization, coupled with the widespread use of social media, is leading to increasingly aggressive behavior and threats.[3] More American institutions are progressively being viewed under the lens of partisanship; the courts, regulatory agencies and law enforcement are all facing scrutiny for their decisions. Reaching an agreement on the impact of seemingly objective facts is becoming increasingly difficult.

The reasons for polarization are beyond the scope of this report. Our concern is the impact of polarization and partisanship on financial markets. So far, the Federal Reserve has mostly avoided the worst of this trend. However, it would seem naïve to believe that the U.S. central bank can remain above the partisan fray indefinitely. Already, President Trump has undermined protocol with regard to monetary policy established by Robert Rubin in the mid-1990s. That protocol meant the White House would refrain from commenting on monetary policy, with the concept being that the less political pressure the Federal Reserve faced, the more confidence investors would have in the central bank maintaining anchored inflation expectations. President Trump has been openly critical of monetary tightening. So far, we have not seen political pundits frame monetary policy in a partisan fashion. But, the risks of such events are rising. If monetary policy actions are increasingly viewed through the parameters of partisan politics, we would expect the following market effects:

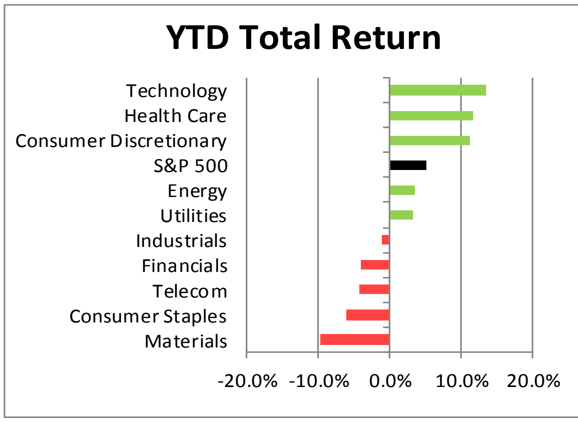
[3] https://thehill.com/homenews/administration/348014-threats-of-political-violence-rise-in-polarized-trump-era

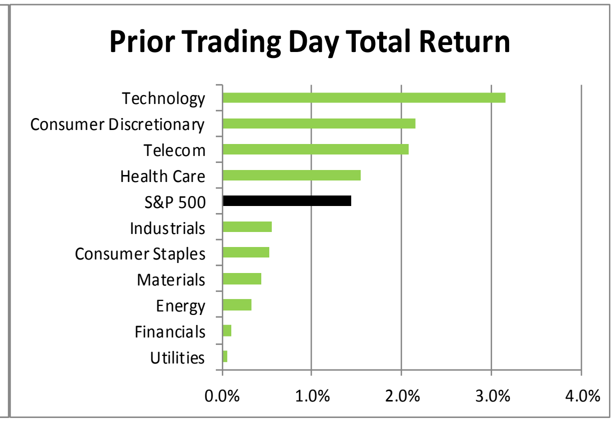
1. Long-duration interest rates will rise. These rates are sensitive to inflation expectations. Undermining Federal Reserve independence will tend to raise fears that policymakers won't increase rates for fear of criticism, leading the central bank to tolerate higher inflation.
2. The dollar will weaken. If the central bank won't act against inflation impulses, then the attractiveness of the dollar will be diminished.
3. Gold prices will rise. Gold will be seen as a store of value instrument, which will become more appealing in a rising inflation environment.
4. Equity markets will suffer through falling multiples. Price/earnings multiples are partly a function of inflation expectations. If prices are rising, earnings become suspect and investors lower the price at which they will purchase those earnings.

To date, there is no evidence that monetary policy has been affected by White House criticism. However, that condition may not endure. We continue to closely monitor developments but we will take appropriate action if the Federal Reserve finds its independence compromised.

Data Section

U.S. Equity Markets – (as of 10/12/2018 close)

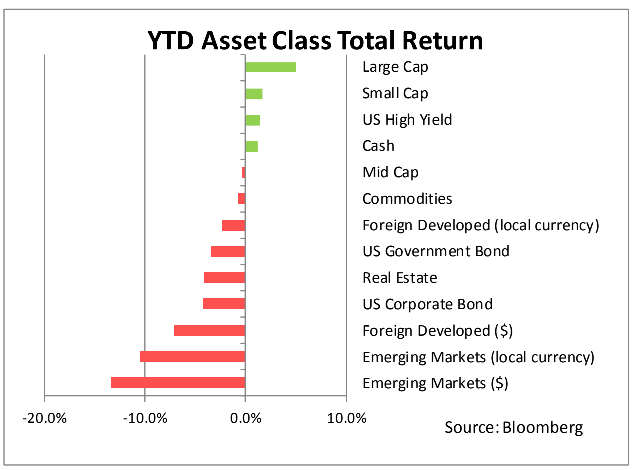




(Source: Bloomberg)

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 10/12/2018 close)

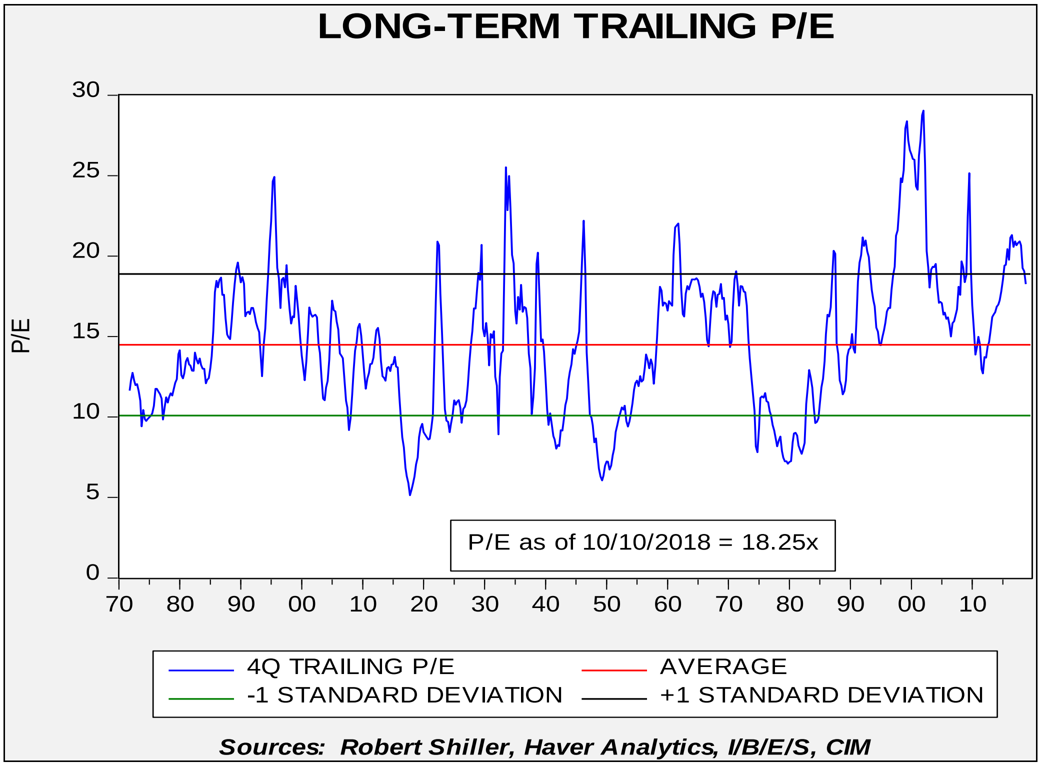


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 11, 2018



Based on our methodology,[4] the current P/E is 18.25, down 0.25x from last week's reading of 18.5. The primary reason for the drop in the P/E is due to a sharp rise in earnings relative to the S&P 500.

[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.