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.

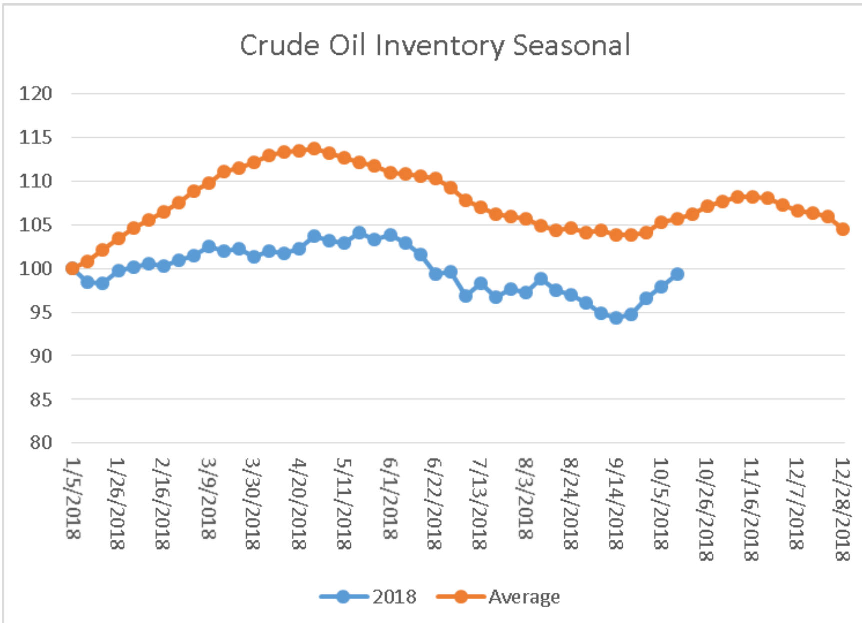
[Posted: October 18, 2018—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 0.1% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.4% from the prior close. Chinese markets were lower, with the Shanghai composite down 2.9% and the Shenzhen index down 2.7%. U.S. equity index futures are signaling a lower open. With 56 companies having reported, the S&P 500 Q3 earnings stand at $40.71, higher than the $40.50 forecast for the quarter. The forecast reflects a 21.0% increase from Q3 2017 earnings. Thus far this quarter, 78.6% of the companies reported earnings above forecast, while 14.3% reported earnings below forecast.

Good morning! Equities fell and Treasury yields rose due to the hawkish tone of the Fed minutes. There was not a lot of overnight news but below are the stories we are following today:

EU trade truce on the rocks: The truce between the U.S. and the EU appears to be in jeopardy as negotiators trade barbs in the press, accusing each other of stalling the negotiation process. At the heart of the dispute is the trade truce, also known as the Trump- Junker deal, which lacks any concrete parameters. The EU appears unwilling to begin negotiations without assurances that there will be no retaliation in the event of a stalemate. The U.S. seems reluctant to grant those assurances, likely due to fears that it could undermine its leverage. It appears that the Trump administration has been using a series of bilateral agreements with its allies to apply more pressure on China in trade negotiations, in much the same way TPP was intended. That being said, President Trump's harsh criticism of allied nations, specifically, has created an environment of mistrust, which could explain why countries are hesitant to engage in trade negotiations. Nevertheless, we expect the impasse between the U.S. and Europe to end somewhat soon given that recent trade agreements with Korea, Canada and Mexico were relatively non-controversial; hence, the EU agreement will likely follow suit. We continue to monitor this situation.

FOMC minutes: The Fed minutes, released on Wednesday, support the case for future rate hikes. Although there were some concerns regarding rising trade tensions and strain in emerging market economies, the FOMC believes the U.S. economy is moving in the right direction. At the same time, members of the FOMC have expressed willingness to raise rates past the neutral rate, which is a rate that is neither accommodate nor constrains the economy, in order to address financial imbalances and to contain future inflation. This point of view runs counter to the views of the president, who believes the Fed should consider the impact that higher rates will have on the economy. The president responded to the minutes by calling Fed Chairman Jerome Powell a weak link. At this point, it is unclear how high the Fed is willing to raise rates but current projections suggest a neutral rate around 3.0%. The president's pugnacious response could be a concern as it seems he is starting to view the Fed as an adversary. Although Powell seems unbothered by the criticism, that position could change if the president releases the bully pulpit.

Energy recap: U.S. crude oil inventories rose 6.5 mb compared to market expectations of a 1.6 mb build. Refinery utilization was unchanged at 88.8% and oil production fell by 0.3 mbpd to 10.9 mbpd. Exports rose 0.1 mbpd, while imports fell by 0.2 mbpd. The rise in stockpiles was mostly due to 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.

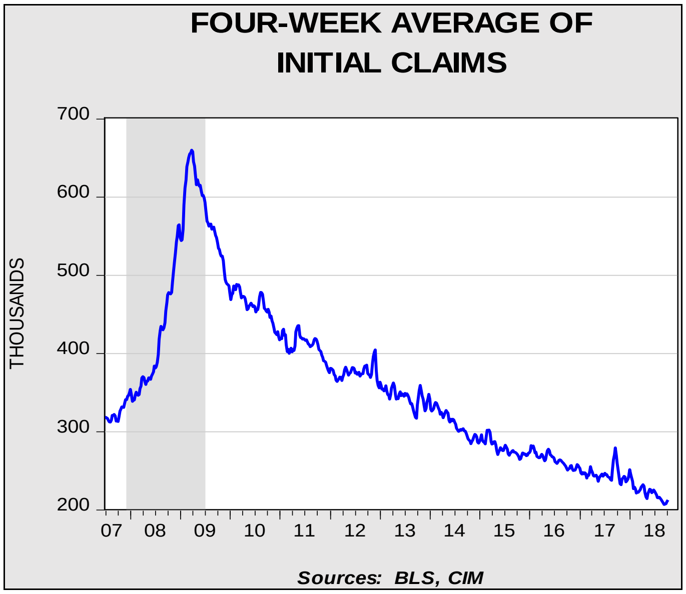


(Source: DOE, CIM)

The build up in inventories led to a drop in the price of Brent and WTI crude oil. Rising tensions between the U.S. and Saudi Arabia, as well as the impending U.S. sanctions on Iran, have led to supply pessimism. As a result, rising shale production is becoming important in maintaining oil price stability.

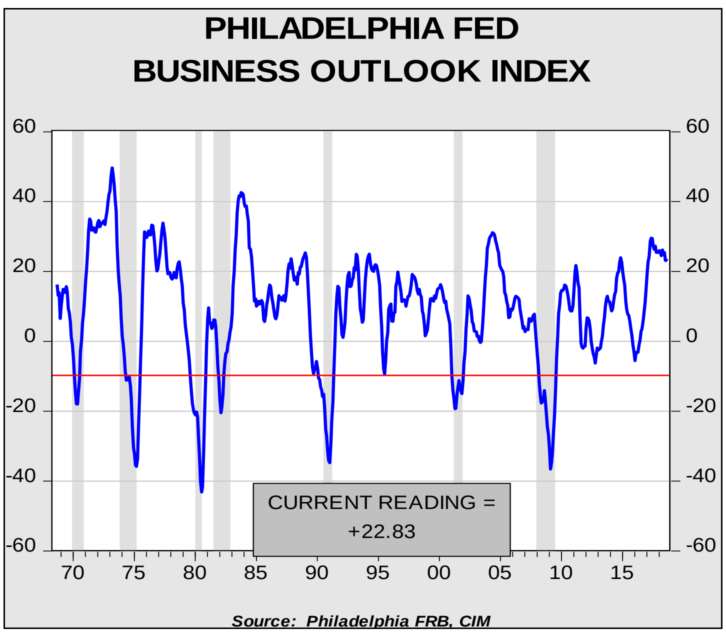
U.S. Economic Releases

Initial jobless claims came in below expectations at 210k compared to the forecast of 211k. The previous report was revised upward from 214k to 215k.



The chart above shows the four-week moving average of initial claims. The four-week moving average increased from 209.75k to 211.75k.

The October Philadelphia FRB Business Outlook Index came in stronger than forecast at 22.2 compared to estimates of 20.0.



We smooth the data on the above chart with a six-month moving average. The current reading is near cycle highs and is well above the recession signal of -10. What makes this index important is that it is measuring business sentiment for the Mid-Atlantic region, where the Fed governors work and mostly live, at least part of the time. No matter how data-sensitive one is, the economic activity that one directly observes will tend to affect one's outlook. Thus, a robust local economy in the Mid-Atlantic region could lead Fed governors to lean hawkish even if the rest of the nation's economy is less robust.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Existing Home Sales	m/m	sep	5.29 mn	5.34 mn	**
10:00	Existing Home Sales	m/m	sep	-0.9%	0.0%	**
Fed speakers or events						
EST	Speaker or event	District or position				
12:15	Randal Quarles Speaks in New York on the Economic Outlook	U.S. Federal Reserve Vice Chairman for Supervision				

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								
China	Foreign Direct Investment	y/y	sep	8.0%	1.9%		*	Equity and bond neutral
Japan	Trade Balance	y/y	sep	-¥238.9 bn	-¥190.4 bn	-¥333.4 bn	**	Equity bullish, bond bearish
Australia	Employment Change	y/y	sep	5.6k	44.0k	15.0k	**	Equity and bond neutral
	Unemployment Rate	m/m	sep	5.0%	5.3%	5.3%	***	Equity bullish, bond bearish
	Participation Rate	m/m	sep	65.4%	65.7%	65.7%	**	Equity and bond neutral
	NAB Business Confidence	y/y	3q	3	7		**	Equity and bond neutral
EUROPE								
Germany	Wholesale Price Index	y/y	sep	3.5%	3.8%		**	Equity and bond neutral
U.K.	Retail Sales ex Auto Fuel	y/y	sep	3.2%	3.5%	3.8%	**	Equity bearish, bond bullish
	Retail Sales inc Auto Fuel	y/y	sep	3.0%	3.3%	3.6%	**	Equity bearish, bond bullish
Switzerland	Exports Real	m/m	sep	-0.8%	0.6%		**	Equity and bond neutral
	Imports Real	m/m	sep	-0.4%	-2.8%		**	Equity and bond neutral
Russia	PPI	y/y	sep	14.4%	15.3%	14.3%	**	Equity and bond neutral
	Unemployment Rate	y/y	sep	4.5%	4.6%	4.7%	***	Equity bullish, bond bearish
	Real Wages	y/y	sep	7.2%	7.0%	6.5%	***	Equity bullish, bond bearish
AMERICAS								
Canada	Manufacturing Sales	y/y	aug	-0.4%	0.9%	-0.6%	**	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	245	-1	Up
3-mo T-bill yield (bps)	227	226	1	Neutral
TED spread (bps)	18	19	-1	Neutral
U.S. Libor/OIS spread (bps)	227	226	1	Up
10-yr T-note (%)	3.21	3.21	0.00	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	48	46	2	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	up			Neutral
pound	flat			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	$79.14	$80.05	-1.14%	Bearish EIA Report
WTI	$69.11	$69.75	-0.92%	
Natural Gas	$3.29	$3.32	-0.96%	
Crack Spread	$16.02	$16.33	-1.87%	
12-mo strip crack	$19.36	$19.65	-1.44%	
Ethanol rack	$1.40	$1.40	-0.01%	
Metals				
Gold	$1,223.80	$1,222.29	0.12%	
Silver	$14.52	$14.61	-0.61%	
Copper contract	$273.40	$277.80	-1.58%	
Grains				
Corn contract	$ 373.00	$ 374.25	-0.33%	
Wheat contract	$ 519.00	$ 517.50	0.29%	
Soybeans contract	$ 878.75	$ 885.75	-0.79%	
Shipping				
Baltic Dry Freight	1554	1578	-24	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	6.5	1.3	5.2	
Gasoline (mb)	-2.0	1.0	-3.0	
Distillates (mb)	-0.8	-1.0	0.2	
Refinery run rates (%)	0.00%	-0.50%	0.5%	
Natural gas (bcf)		84.0		

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for the western half of the country, with cooler temps for the rest of the country. Precipitation is expected for most of the country. There are no tropical cyclones forecast over the next 48 hours.

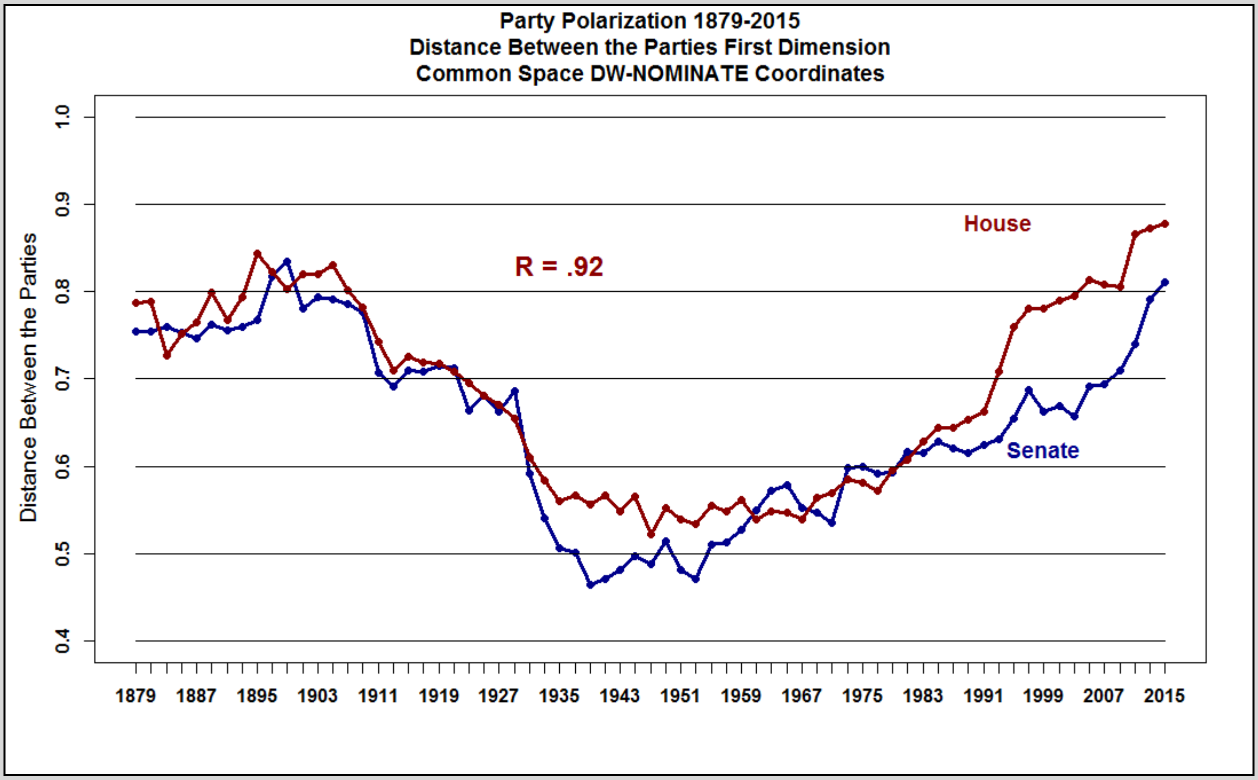
Asset Allocation Weekly Comment

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.



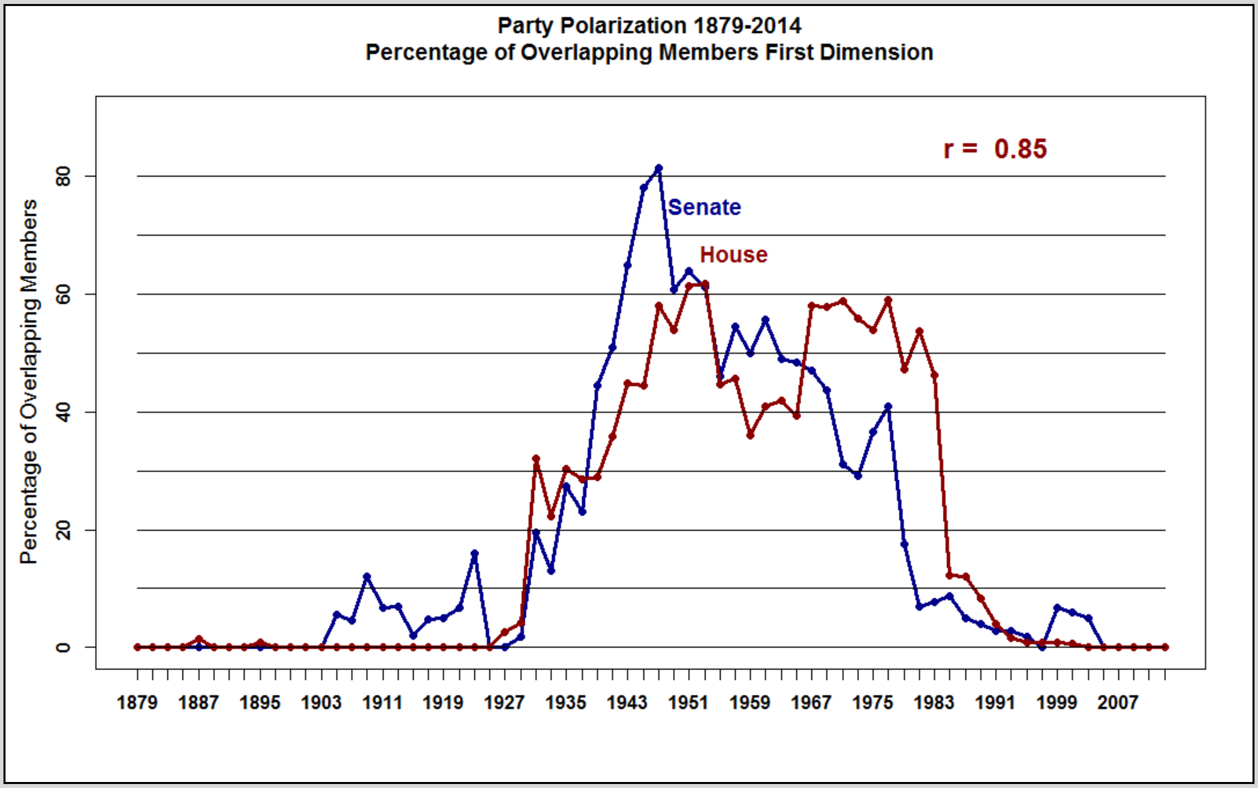
(Source: Rosenthal and Poole)

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:

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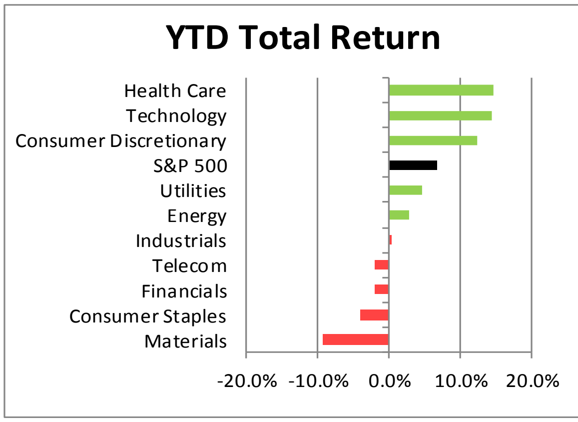
[3] https://thehill.com/homenews/administration/348014-threats-of-political-violence-rise-in-polarized-trump-era

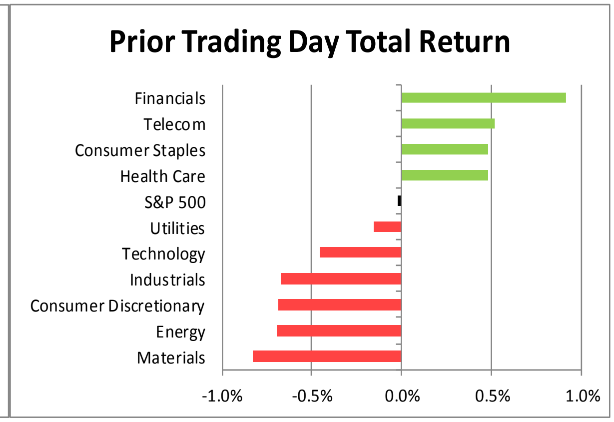
1. Long-duration interest rates will rise. These rates are sensitive to inflation expectations. Undermining Federal Reserve independence will tend to raise fears that policymakers won't increase rates for fear of criticism, leading the central bank to tolerate higher inflation.
2. The dollar will weaken. 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 10/17/2018 close)

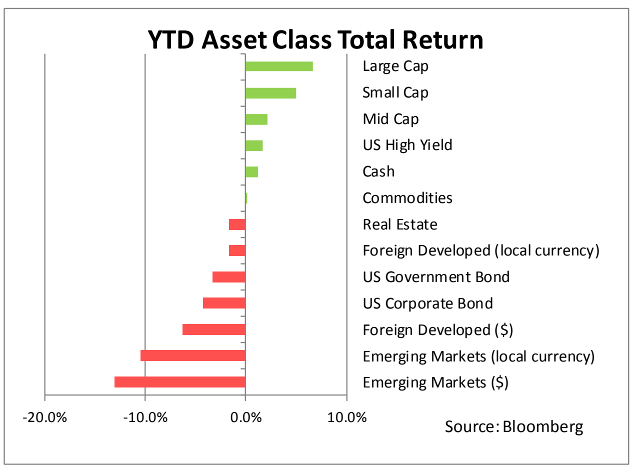




(Source: Bloomberg)

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 10/17/2018 close)

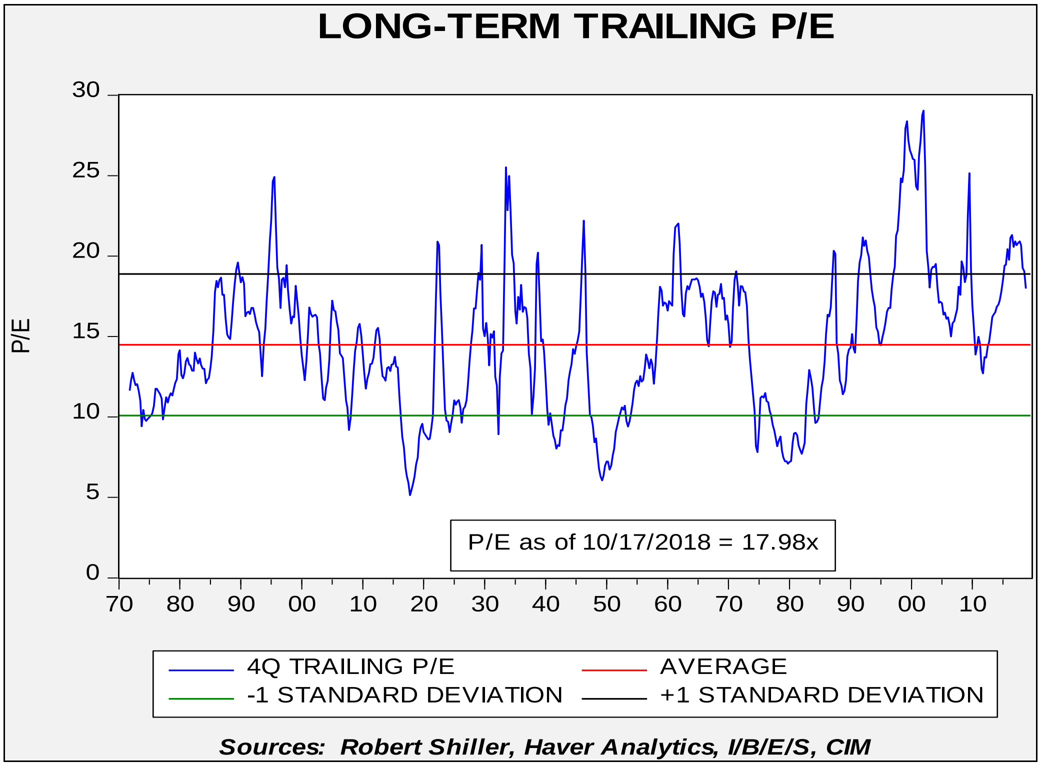


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 18, 2018



Based on our methodology,[4] the current P/E is 17.98, down 0.27x from last week's reading of 18.25. The primary reason for the drop in the P/E is primarily due to a sharp drop in 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.