

*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 23, 2018—9:30 AM EDT]** Global equity markets are lower this morning. The EuroStoxx 50 is down 1.0% from the last close. In Asia, the MSCI Asia Apex 50 was down 2.6% from the prior close. Chinese markets were lower, with the Shanghai composite down 2.3% and the Shenzhen index down 1.9%. U.S. equity index futures are signaling a lower open. With 91 companies having reported, the S&P 500 Q3 earnings stand at \$40.82, higher than the \$40.50 forecast for the quarter. The forecast reflects a 21.0% increase from Q3 2017 earnings. Thus far this quarter, 75.8% of the companies reported earnings above forecast, while 14.3% reported earnings below forecast.

Global equities are under pressure this morning. Note that China's big rally yesterday was unable to hold. Earnings disappointments are being cited as the reason. However, as our figures above show, earnings are coming in a bit higher than expected. What is starting to affect equities is the idea that sequential earnings growth is clearly slowing. That notion, coupled with a declining multiple, is putting pressure on stocks. Here are the items we are watching this morning:

**Day of decision:** The EC has rejected Italy's budget. We now begin a three-week negotiation period during which Italy will be required to submit an amended budget. If an agreement isn't reached, the EC could implement the "Excessive Deficit Procedure." This process would probably continue until the end of November. Ultimately, fines could be imposed.<sup>1</sup> Although EC rules create lots of temporary deadlines that help facilitate agreements, Italy appears ready to defy the Eurozone. In the end, we expect the EC to blink which will undermine Germany's hold on the Eurozone and pressure the EUR lower.

**Brexit grinds on:** PM May has offered a four-point plan to address the Brexit issue.<sup>2</sup> The most important element is that she proposes to extend the transition period to the end of 2021. In addition, the troublesome Northern Ireland issue would be addressed by a temporary joint border control body that would prevent a hard border. During this period of "limbo" negotiations would continue on a free trade deal. May's political position within the Tories remains dicey; however, she continues to survive against all odds,<sup>3</sup> mostly because there is no good alternative within the

<sup>1</sup> <https://www.cnbc.com/2018/10/22/european-commission-on-italys-2019-budget--what-could-happen-next.html>

<sup>2</sup> <https://www.ft.com/content/de915670-d60d-11e8-a854-33d6f82e62f8?emailId=5bcea6664ab701000494c62b&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22>

<sup>3</sup> [https://www.politico.eu/article/theresa-may-only-four-steps-left-to-reach-irish-backstop-brexit-deal/?utm\\_source=POLITICO.EU&utm\\_campaign=378803a464-](https://www.politico.eu/article/theresa-may-only-four-steps-left-to-reach-irish-backstop-brexit-deal/?utm_source=POLITICO.EU&utm_campaign=378803a464-)

party.<sup>4</sup> At the same time, if the government falls and elections are necessary, the Tories may find themselves out of office. That fear has been enough to keep May in power.

**Khashoggi:** Turkish President Erdogan continues to pressure the Saudis, indicating today that the Saudi journalist was killed in a “savage” manner, laying out a case that comes just short of accusing the KSA of a pre-meditated murder.<sup>5</sup> Although we and others have speculated that Erdogan wants financial support for his beleaguered economy and a withdrawal of funding and support for the Kurds, there is nothing in the Turkish president’s tone to suggest that he has achieved satisfactory compensation for this act that occurred within the Turkish state. If Erdogan changes his tone, we will take it as evidence that an agreement has been reached.

**Other items:** Oil prices fell today after the Saudis promised to offset any loss of Iranian oil.<sup>6</sup> Although we are not surprised by the announcement, “saying is one thing, but doing is another.” Chancellor Merkel has agreed to open up Germany to U.S. LNG imports.<sup>7</sup> This is an important concession by Germany, which has mostly supported piped natural gas from Russia, even supporting projects that would avoid land pipes through Ukraine. Finally, Canada has allowed China to install underwater monitoring devices near a U.S. nuclear submarine base.<sup>8</sup> We view this as a stunning and disturbing development, perhaps done by the Trudeau government in retaliation over trade tensions. The Canadians seem to miss that their defense relies deeply on U.S. power projection. Participating in a Chinese project that could undermine U.S. power projection is dangerous for them as well.

## U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below lists the economic releases and Fed events scheduled for today.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Richmond Fed Manufacturing Index	m/m	oct	24	29	**
Fed speakers or events						
EST	Speaker or event	District or position				
13:00	Raphael Bostic speaks on Economic and Monetary Policy	President of the Federal Reserve Bank of Atlanta				
14:15	Robert Kaplan Speaks at Economic Development Event	President of the Federal Reserve Bank of Dallas				
20:00	Esther George Takes Part in Payment Conference in Sydney	President of the Federal Reserve Bank of Kansas City				

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<sup>4</sup> <https://www.ft.com/content/c4f357dc-d5fd-11e8-a854-33d6f82e62f8?emailId=5bcea6664ab701000494c62b&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22>

<sup>5</sup> <https://www.ft.com/content/76a34b70-d6a5-11e8-ab8e-6be0dcf18713>

<sup>6</sup> <https://www.bloomberg.com/news/articles/2018-10-23/saudi-oil-chief-says-opec-s-in-produce-as-much-as-you-can-mode> and <https://www.reuters.com/article/us-global-oil/oil-falls-as-saudi-arabia-says-it-will-play-responsible-role-idUSKCN1MX046>

<sup>7</sup> <https://www.wsj.com/articles/in-win-for-trump-merkel-changes-course-on-u-s-gas-imports-1540209647>

<sup>8</sup> <https://www.scmp.com/news/china/society/article/2169474/canada-installs-chinese-underwater-monitoring-devices-next-us>

## 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
<b>ASIA-PACIFIC</b>								
China	Swift Global Payments CNY	m/m	sep	1.9%	2.1%		**	Equity and bond neutral
Japan	Supermarket Sales	m/m	sep	1.9%	0.1%		**	Equity and bond neutral
	Nationwide Department Sales	m/m	sep	-3.0%	-0.2%		**	Equity bearish, bond bearish
	Tokyo Department Store Sales	m/m	sep	0.3%	1.6%		**	Equity and bond neutral
	Machine Tool Orders	m/m	sep	2.9%	2.8%		**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	w/w	oct	112.3	119.5		**	Equity and bond neutral
<b>EUROPE</b>								
Germany	PPI	y/y	sep	3.2%	3.1%	3.0%	**	Equity bearish, bond bearish
U.K.	CBI Trends Total Orders	y/y	sep	-6	-1	2	**	Equity bearish, bond bearish
	CBI Trends Selling Prices	m/m	sep	10	13	15	**	Equity bearish, bond bearish
	CBI Business Optimism	m/m	sep	-16	-3	-4	**	Equity bearish, bond bearish
<b>AMERICAS</b>								
Canada	Wholesale Trade Sales	m/m	aug	-0.1%	1.5%	-0.2%	**	Equity and bond neutral
	Bloomberg Nanos Confidence	w/w	oct	57.4	56.3		**	Equity and bond neutral
Brazil	Trade Balance Weekly	w/w	oct	\$1.408 bn	\$1.746 bn		**	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)	248	247	1	Up
3-mo T-bill yield (bps)	225	226	-1	Neutral
TED spread (bps)	23	21	2	Neutral
U.S. Libor/OIS spread (bps)	228	228	0	Up
10-yr T-note (%)	3.15	3.20	-0.05	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	42	43	-1	Down
<b>Currencies</b>	<b>Direction</b>			
dollar	down			Neutral
euro	flat			Neutral
yen	up			Neutral
pound	up			Neutral
franc	flat			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
<b>Energy Markets</b>				
Brent	\$78.18	\$79.83	-2.07%	Supply Optimism
WTI	\$68.18	\$69.36	-1.70%	
Natural Gas	\$3.15	\$3.14	0.22%	
Crack Spread	\$15.92	\$16.45	-3.22%	
12-mo strip crack	\$19.11	\$19.59	-2.46%	
Ethanol rack	\$1.40	\$1.40	0.01%	
<b>Metals</b>				
Gold	\$1,234.81	\$1,222.10	1.04%	Global tensions
Silver	\$14.72	\$14.56	1.05%	
Copper contract	\$276.20	\$278.55	-0.84%	
<b>Grains</b>				
Corn contract	\$ 370.50	\$ 369.50	0.27%	
Wheat contract	\$ 509.75	\$ 508.00	0.34%	
Soybeans contract	\$ 868.25	\$ 872.50	-0.49%	
<b>Shipping</b>				
Baltic Dry Freight	1579	1576	3	
<b>DOE inventory report</b>				
	<b>Actual</b>	<b>Expected</b>	<b>Difference</b>	
Crude (mb)		3.0		
Gasoline (mb)		-1.5		
Distillates (mb)		-2.0		
Refinery run rates (%)		0.50%		

## Weather

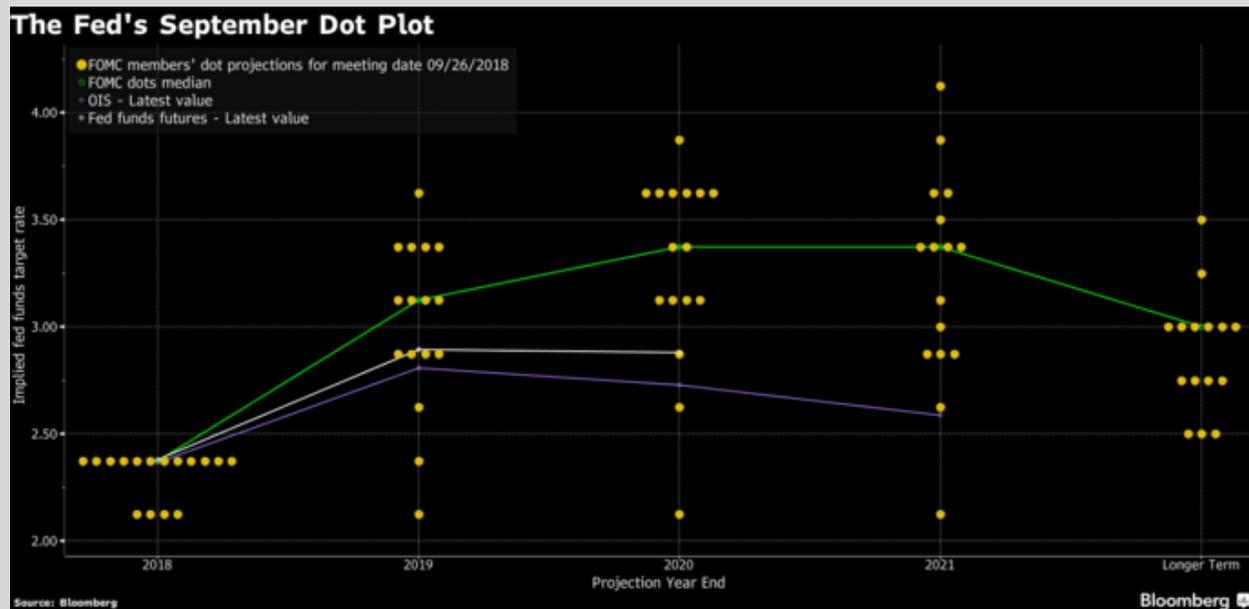
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for the western region, with cooler temps in the rest of the country. Precipitation is expected for most of the country. There are no tropical cyclones forecast over the next 48 hours.

## 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 19, 2018

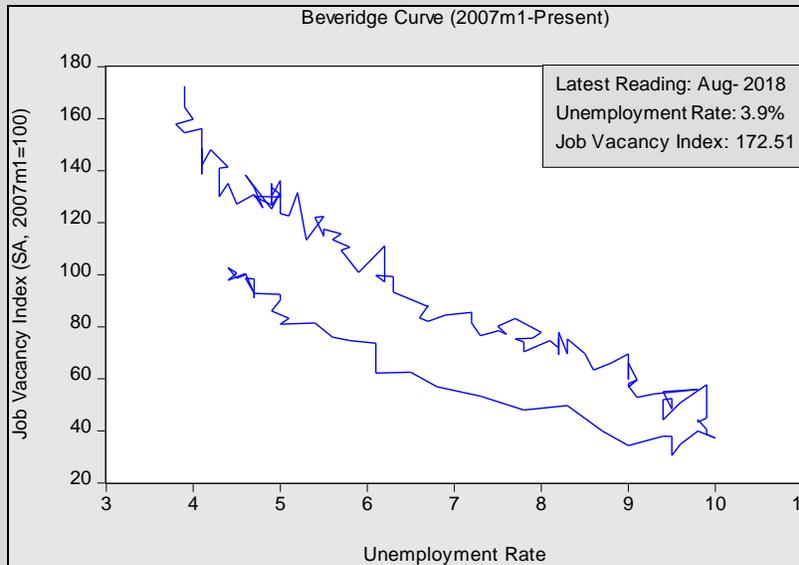
The accompanying notes to the release of the FOMC minutes on October 17<sup>th</sup> indicated expectations from a majority of members to eventually push fed fund rates above the level that they would otherwise view as neutral. In the most recent projections, the average of members’ estimates for the neutral level by 2021 is 3.0%.



(Source: Bloomberg)

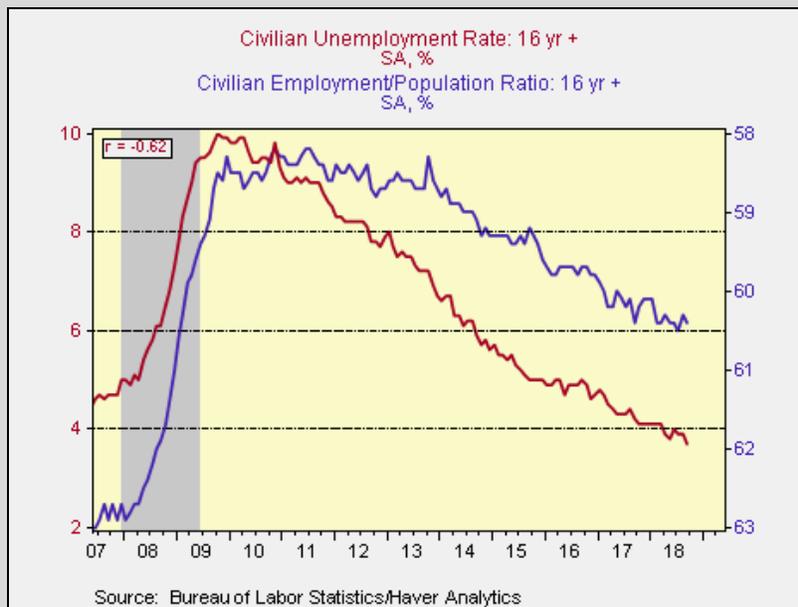
We understand the hawkish tone these notes carry within the context of the mention of the Beveridge Curve. According to this data, the labor markets appear to be tight. The chart below shows a modified Beveridge Curve, which is a graphical representation of the relationship of the number of openings represented as an index and the unemployment rate. The chart starts toward the end of the previous cycle in 2007 and tracks the relationship through the end of August. The lower end of the curve represents the slowing momentum in the previous cycle and the higher end of the curve represents the current cycle. A reversal of the curve would typically signal an inflection point within the cycle; a reversal downward toward the right signals deceleration, whereas a reversal upward toward the left signals acceleration. According to the chart below, the Beveridge curve continues its upward trend as job vacancies hit a cycle record at 172.51 in August, while the unemployment rate remained steady at 3.9%<sup>[1]</sup>.

<sup>[1]</sup> Due to JOLTS being published on a one-month delay, August is the latest reading. The current unemployment rate is 3.7%.



(Source: BLS, CIM)

Although the Beveridge Curve suggests there is tightness in the labor market, the chart below indicates a degree of slack still remains. Wage growth is widely perceived as being insufficient to encourage longer term unemployed individuals to re-enter the labor market; hence the concerns of some market participants that Fed tightening could lead to an economic downturn.

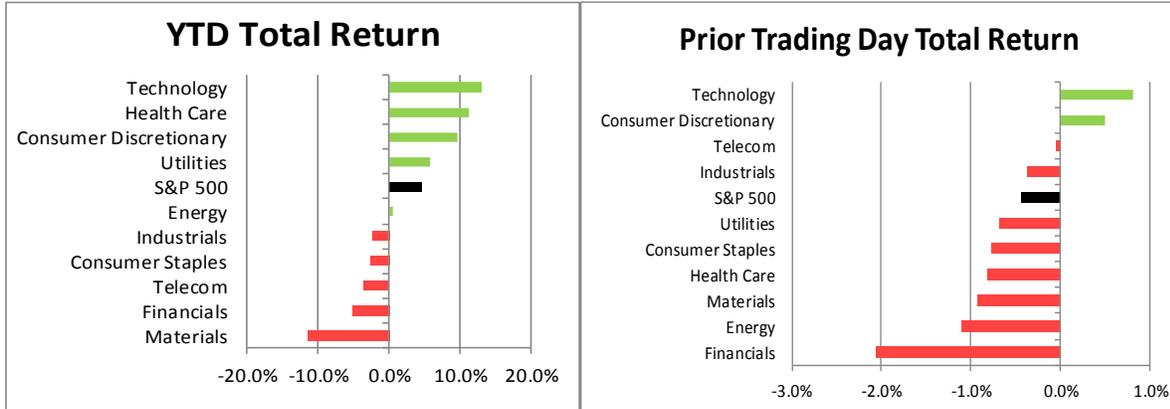


Though we acknowledge overly tight labor conditions can lead to inflation surprises, at this juncture we view the inflationary data to be productive and not hostile. Moreover, the Fed actions appear to be geared toward asset inflation as opposed to inflation in the real economy. In light of Fed tightening, we don't expect an acceleration of the pace of rate hikes; thus, financial markets should be able to adjust without significant disruption.

*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**

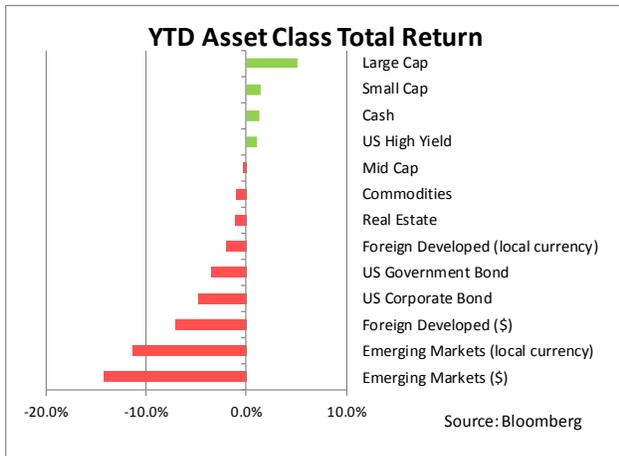
**U.S. Equity Markets – (as of 10/22/2018 close)**



(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 10/22/2018 close)**



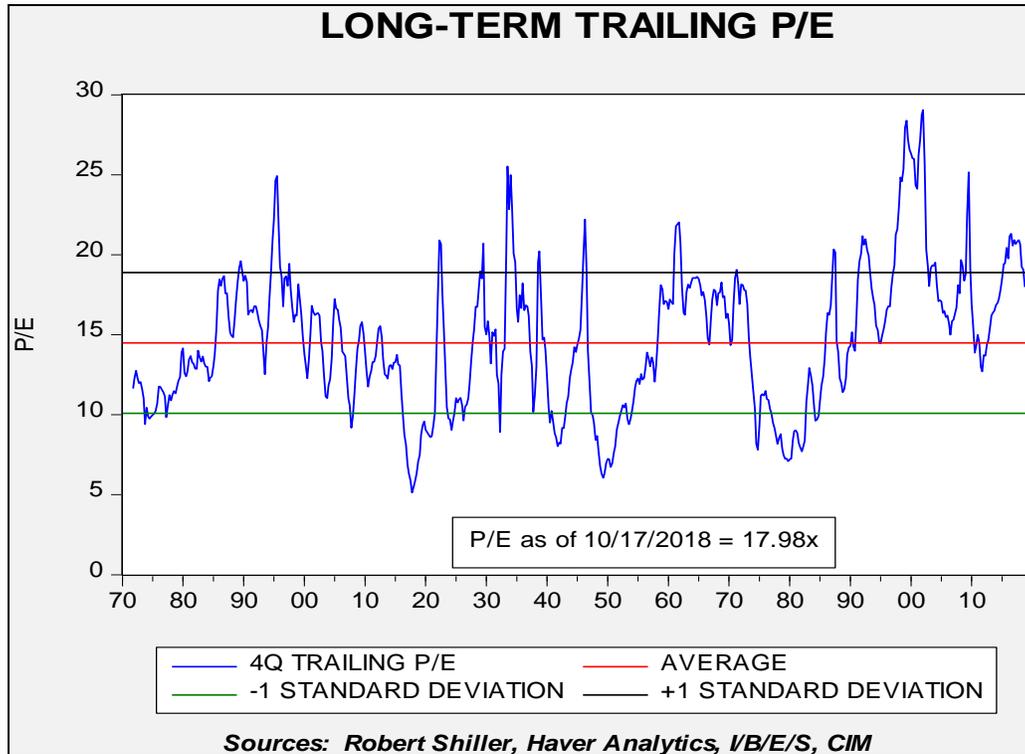
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,<sup>9</sup> 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.

*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.*

<sup>9</sup> 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 two 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.