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 24, 2018—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 1.0% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.3% from the prior close. Chinese markets were mixed, with the Shanghai composite up 0.3% and the Shenzhen index down 0.2%. U.S. equity index futures are signaling a lower open. With 112 companies having reported, the S&P 500 Q3 earnings stand at $40.90, higher than the $40.50 forecast for the quarter. The forecast reflects a 21.0% increase from Q3 2017 earnings. Thus far this quarter, 75.9% of the companies reported earnings above forecast, while 15.2% reported earnings below forecast.

It's mid-week and equity markets are trying to find their footing. Yesterday's action almost qualified for what a former boss of mine would call a "Hollywood finish." That's one where the market takes a beating in the early part of the day only to recover to positive territory by the close. We didn't get out of the red yesterday but we did see a solid recovery. Here is what we are watching this morning:

Earnings: Although there is much hand-wringing about earnings, the fact is that, overall, S&P 500 earnings appear to be coming in about as forecast. This is positive; however, the usual pattern is to somewhat understate earnings in the estimates and then celebrate beating the forecast. That may not happen this quarter. At the same time, S&P 500 earnings are running above 6% of GDP, which is a record. Earnings themselves look fine but sequential momentum is clearly fading.

Given where we are in the business cycle, this development shouldn't be a shock. Wage pressures are rising. Interest costs are increasing, too. Although it's difficult to see the impact of trade restrictions in the macro data, individual companies are reporting adverse effects.[1] Our margin model suggests that margins will remain elevated but growth will be flat; that would mean earnings growth may be limited to the growth of nominal GDP next year. That's not bad, but significant market appreciation will require multiple expansion. Given how elevated confidence readings are now, it would take a major decline in interest rates to boost P/Es.

Fed bashing: In an interview with the *WSJ*,[2] President Trump lambasted the FOMC and Chair Powell. In a telling quote from the article, the president said, "He was supposed to be a low-

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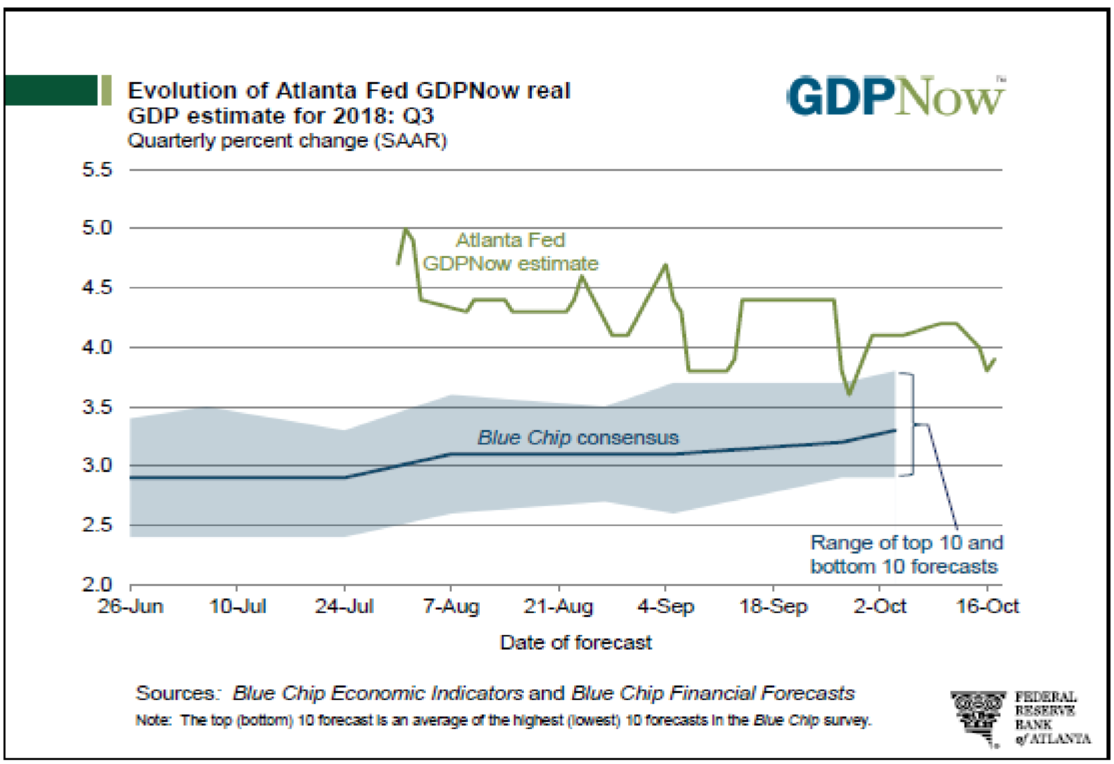
[1] https://www.reuters.com/article/us-usa-stocks-earnings-analysis/tariffs-begin-to-take-bite-out-of-us-corporate-earnings-growth-idUSKCN1MX2W0

[2] https://www.wsj.com/articles/trump-steps-up-attacks-on-fed-chairman-jerome-powell-1540338090

interest-rate buy. It's turned out he's not." We wondered at the time Powell was selected (to replace Chair Yellen, who was perceived as dovish) whether Powell got the job because he was seen as an easy money person. It should be noted that Treasury Secretary Mnuchin supported Powell's nomination; Mnuchin is an establishment figure in the administration. In fact, all the appointees for Fed governor so far have been remarkably mainstream. It's becoming obvious that Powell will be blamed for equity market volatility and any economic weakness. Interestingly enough, criticism from the White House will tend to make it more difficult for FOMC policymakers to pause the pace of hikes. There may be legitimate reasons for the Fed to pause—equity market turmoil is one.[3] However, FOMC members may feel the need to maintain hikes simply to enforce Fed independence.

Our position is that we are on a slow pace to reflate the economy as part of reversing four decades of rising inequality. Central bank independence was a key policy tool to bring down inflation. Although the actual impact of monetary policy on inflation isn't all that strong, policy does clearly affect inflation expectations. But, when policymakers want to reflate, they can't have the central bank undermining their policy actions. President Trump's statements to undermine Fed independence, though a reversal of the early 1990s détente, does fit a reflation narrative.

GDP: We get Q3 GDP tomorrow. Here is the most recent GDPNow estimate from the Atlanta FRB.



[3] https://www.reuters.com/article/us-usa-fed-selloff-analysis/for-fed-sell-off-could-point-to-fading-trump-stimulus-idUSKCN1MX32L

The current forecast is 3.9%. Here is the contribution table:

Atlanta Fed GDPNow estimates for 2018: Q3, contributions to growth

Date	Major Releases	GDP	PCE	Equip-ment	Intell. prop. prod.	Nonres. struct.	Resid. inves.	Govt.	Net exports	CIPI
31-Jul	Initial nowcast	4.7	2.12	0.58	0.33	0.08	-0.07	0.04	-0.23	1.83
30-Aug	GDP (8/29), Pers. income & outlays	4.1	2.06	0.28	0.34	-0.05	-0.04	0.08	-0.64	2.06
20-Sep	Existing-home sales	4.4	2.54	0.24	0.33	-0.09	-0.04	0.18	-0.72	1.96
26-Sep	New-home sales/prices/costs	4.4	2.54	0.24	0.33	-0.08	-0.02	0.18	-0.72	1.96
27-Sep	GDP, Advance Economic Indicators, Advance durable manufacturing	3.8	2.54	0.22	0.33	-0.08	-0.02	0.18	-1.20	1.87
28-Sep	Personal income and outlays, Most NIPA underlying detail tables	3.6	2.41	0.14	0.33	-0.08	-0.02	0.18	-1.20	1.88
1-Oct	ISM Manuf., Construction spending, NIPA underlying invent. detail (9/28)	4.1	2.50	0.17	0.34	-0.10	-0.05	0.29	-1.21	2.14
3-Oct	Auto sales, ISM Nonmanufacturing	4.1	2.55	0.19	0.34	-0.10	-0.04	0.29	-1.21	2.11
4-Oct	M3 Manufacturing	4.1	2.55	0.18	0.34	-0.10	-0.04	0.29	-1.21	2.07
5-Oct	Foreign trade, Employment situation	4.1	2.45	0.17	0.33	-0.11	-0.08	0.36	-1.13	2.09
10-Oct	PPI, Wholesale trade	4.2	2.45	0.17	0.33	-0.11	-0.08	0.36	-1.14	2.20
11-Oct	Consumer Price Index	4.2	2.45	0.17	0.33	-0.11	-0.08	0.36	-1.14	2.20
12-Oct	Import/Export prices	4.2	2.45	0.17	0.33	-0.11	-0.08	0.36	-1.11	2.20
15-Oct	Retail trade	4.0	2.23	0.17	0.33	-0.11	-0.07	0.36	-1.11	2.20
16-Oct	Monthly Treasury Statement (10/15), Industrial production	3.8	2.22	0.17	0.33	-0.12	-0.07	0.22	-1.11	2.20
17-Oct	Housing starts	3.9	2.22	0.17	0.33	-0.12	-0.06	0.22	-1.11	2.20
Maximum forecast of real GDP growth										
1-Aug	ISM Manuf., Construction spending	5.0	2.31	0.61	0.33	0.11	-0.03	0.02	-0.25	1.85
Minimum forecast of real GDP growth										
28-Sep	Personal income and outlays, NIPA underlying detail tables	3.6	2.41	0.14	0.33	-0.08	-0.02	0.18	-1.20	1.88

Note: CIPI is "change in private inventories." All numbers are percentage-point contributions to GDP growth (SAAR). The table does not necessarily include all estimates for the quarter; see tab "ContribHistory" in the online excel file for the entire history.

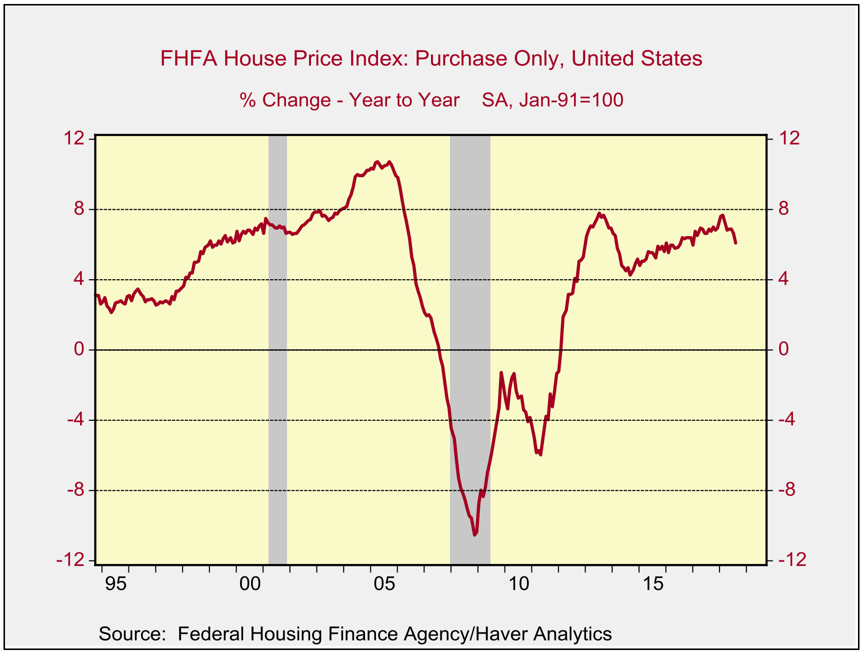
FEDERAL RESERVE BANK of ATLANTA

The two largest positive contributors to growth are consumption and inventory rebuilding. The largest offset is net exports. We would not expect as strong of a contribution from inventory in Q4, so there is a chance we will see GDP closer to 3% in Q4.

U.S. Economic Releases

Mortgage applications rose 4.9% from the prior week, while purchases and refinancing rose 2.0% and 9.7%, respectively. The average 30-year fixed rate rose 1 bp from 5.10% to 5.11%.

The FHFA House Price Index came in line with expectations, rising 0.3% from the prior month. The prior report was revised upward from 0.2% to 0.4%.



The chart above shows the year-over-year change in the FHFA House Price Index. Housing prices have risen 6.1% from the prior year.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Markit US Manufacturing PMI	m/m	oct	0.2%	0.3%	**
9:45	Markit US Services PMI	m/m	oct	55.3	55.6	**
9:45	Markit US Composite	m/m	oct		53.9	**
10:00	New Home Sales	m/m	sep	625k	629k	***
10:00	New Home Sales	m/m	sep	-0.6%	3.5%	***
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
11:30	James Bullard Speaks on US Economy and Monetary Policy	President of the Federal Reserve Bank of St. Louis				
13:00	Raphael Bostic speaks at Energy Summit in Baton Rouge	President of the Federal Reserve Bank of Atlanta				
13:10	Loretta Mester speaks at Forecasters Club in New York	President of the Federal Reserve Bank of Cleveland				
14:00	Federal Reserve Beige Book	Members of the Board of Governors				
19:00	Lael Brainard Speaks on Economic/ Financial Literacy	Member of the Board of Governors				

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	Nikkei Japan PMI	m/m	oct	53.1	52.5		**	Equity bullish, bond bearish
	Leading Index CI	m/m	aug	104.5	104.4		**	Equity and bond neutral
	Coincident Index	m/m	aug	116.7	117.5		**	Equity and bond neutral
Australia	CBA Australia PMI Mfg	m/m	oct	54.3	54.0		**	Equity and bond neutral
	CBA Australia PMI Services	m/m	oct	50.8	52.2		**	Equity and bond neutral
	CBA Australia PMI Composite	w/w	oct	51.2	52.5		**	Equity and bond neutral
	Skilled Vacancies	m/m	sep	-0.6%	0.6%		**	Equity bearish, bond bearish
EUROPE								
Eurozone	Markit Eurozone Services	m/m	sep	53.3	54.7	54.5	**	Equity bearish, bond bullish
	Markit Eurozone Manufacturing	m/m	sep	52.1	53.2	53.0	**	Equity bearish, bond bullish
	Markit Eurozone Composite	m/m	sep	52.7	54.1	53.9	**	Equity bearish, bond bullish
	M3 Money Supply	m/m	sep	3.5%	3.5%	3.5%	**	Equity and bond neutral
Germany	Markit/BME Germany Manufacturing	m/m	sep	52.3	53.7	53.4	**	Equity bearish, bond bullish
	Markit Germany Services	m/m	sep	53.6	55.9	55.5	**	Equity bearish, bond bullish
	Markit/BME Germany Composite	m/m	sep	52.7	53.2	53.0	**	Equity bearish, bond bullish
France	Business Confidence	m/m	oct	104	106	106	**	Equity and bond neutral
	Manufacturing Confidence	m/m	oct	104	107	107	**	Equity and bond neutral
	Production Outlook Indicator	m/m	oct	7	9	9	**	Equity and bond neutral
	Own-Company Production	m/m	oct	10	9		**	Equity and bond neutral
	Business Survey Overall	m/m	oct	2	6		**	Equity bearish, bond bullish
	Markit France Manufacturing	m/m	oct	51.2	52.5	52.4	**	Equity bearish, bond bullish
	Markit France Services	m/m	oct	55.6	54.8	54.7	**	Equity bullish, bond bearish
	Markit France Composite	m/m	oct	54.3	54.0	53.9	**	Equity bullish, bond bearish
U.K.	UK Finance Loan for Housing	m/m	sep	38505	39402	39000	**	Equity and bond neutral
AMERICAS								
Mexico	Economic Activity	m/m	aug	1.7%	3.3%	1.9%	**	Equity bearish, bond bullish

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)	249	248	1	Up
3-mo T-bill yield (bps)	228	228	0	Neutral
TED spread (bps)	20	19	1	Neutral
U.S. Libor/OIS spread (bps)	228	228	0	Up
10-yr T-note (%)	3.15	3.17	-0.02	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	42	42	0	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	down			Neutral
pound	down			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Canada Rate Decision		1.500%	1.750%	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	$76.36	$76.44	-0.10%	Supply Optimism
WTI	$66.70	$66.43	0.41%	
Natural Gas	$3.18	$3.21	-0.90%	
Crack Spread	$16.04	$16.43	-2.38%	
12-mo strip crack	$19.05	$19.35	-1.55%	
Ethanol rack	$1.40	$1.40	-0.04%	
Metals				
Gold	$1,230.31	$1,230.30	0.00%	Global tensions
Silver	$14.76	$14.73	0.17%	
Copper contract	$277.20	$275.80	0.51%	
Grains				
Corn contract	$ 368.75	$ 370.25	-0.41%	
Wheat contract	$ 503.25	$ 509.00	-1.13%	
Soybeans contract	$ 867.75	$ 871.00	-0.37%	
Shipping				
Baltic Dry Freight	1577	1579	-2	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.0		
Gasoline (mb)		-1.5		
Distillates (mb)		-2.0		
Refinery run rates (%)		0.50%		
Natural gas (bcf)		81.0		

Weather

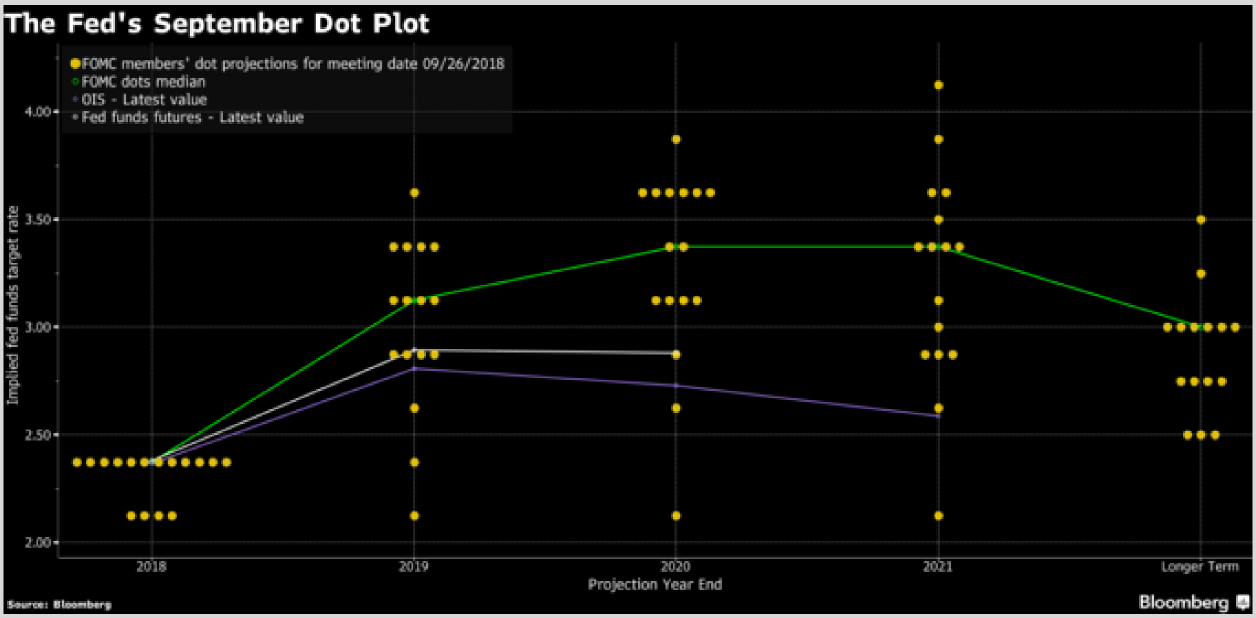
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for the western region, with cooler temps in the rest of the country. Precipitation is expected for most of the country. There are no tropical cyclones forecast over the next 48 hours.

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 17th 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%[1].

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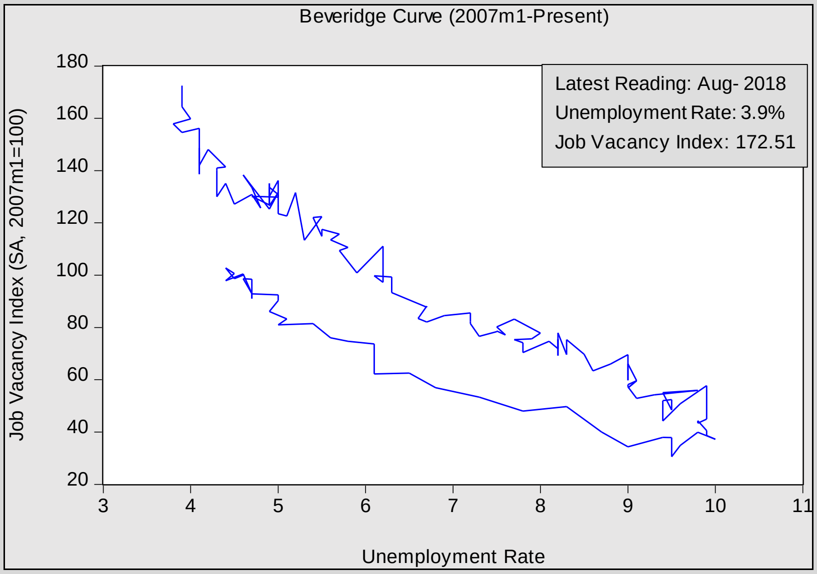
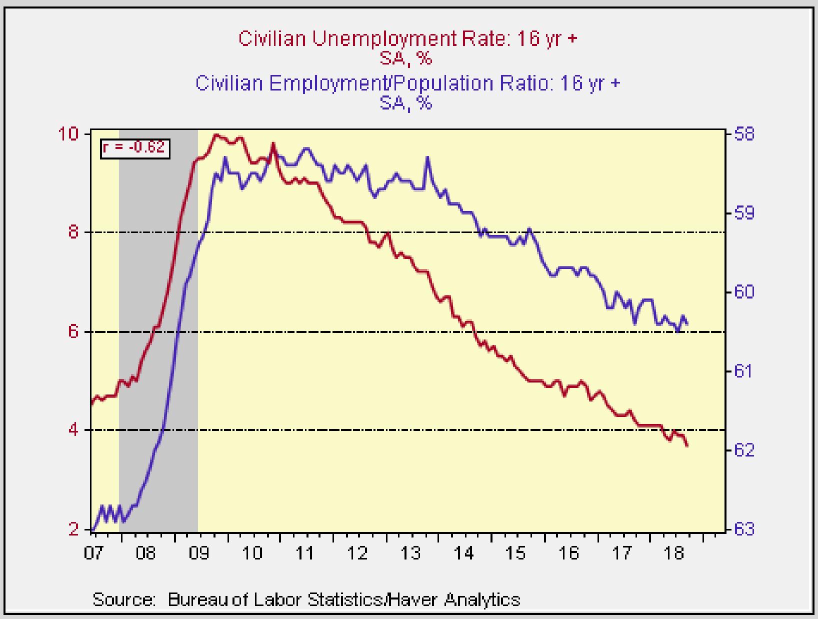
[1] Due to JOLTS being published on a one-month delay, August is the latest reading. The current unemployment rate is 3.7%.



(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.

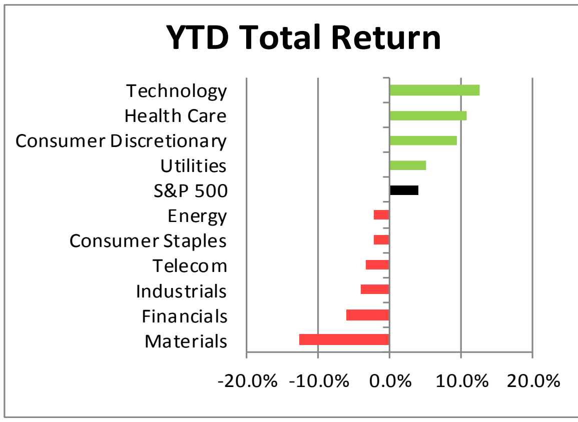


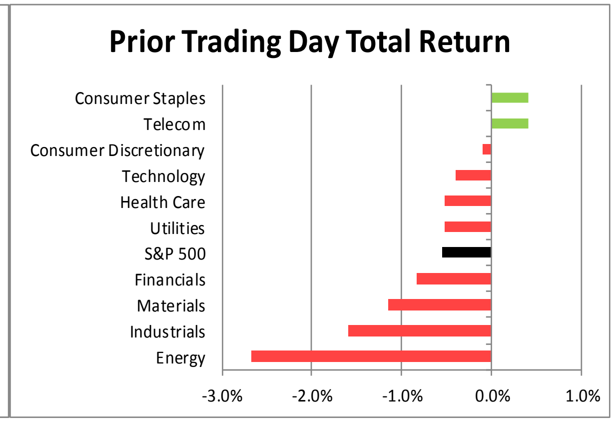
Though we acknowledge overly tight labor conditions can lead to inflation surprises, at this juncture we view the inflationary data to be productive and not hostile. Moreover, the Fed actions appear to be geared toward asset inflation as opposed to inflation in the real economy. In light of Fed tightening, 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 10/23/2018 close)

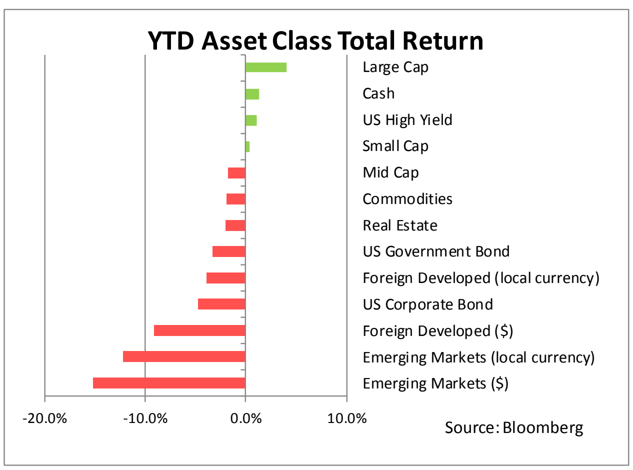




(Source: Bloomberg)

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 10/23/2018 close)

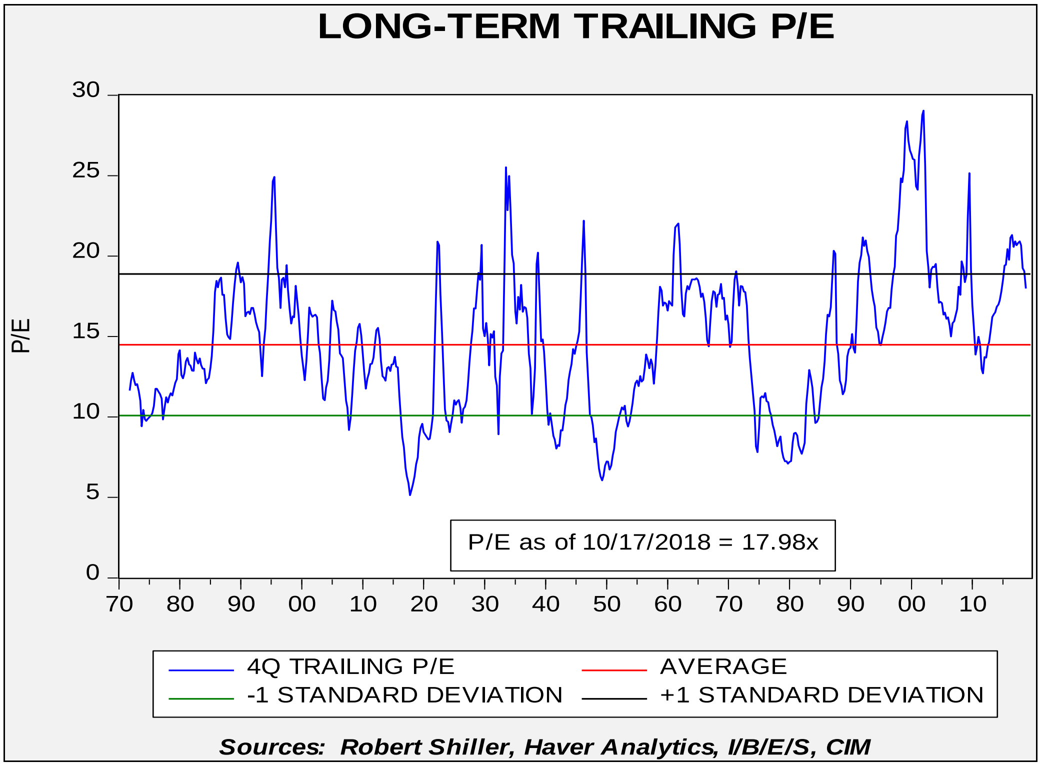


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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[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.