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 26, 2018—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 1.2% from the last close. In Asia, the MSCI Asia Apex 50 was down 1.1% from the prior close. Chinese markets were down, with the Shanghai composite down 0.2% and the Shenzhen index down 0.2%. U.S. equity index futures are signaling a lower open. With 227 companies having reported, the S&P 500 Q3 earnings stand at $41.73, higher than the $40.50 forecast for the quarter. The forecast reflects a 21.0% increase from Q3 2017 earnings. Thus far this quarter, 77.5% of the companies reported earnings above forecast, while 15.0% reported earnings below forecast.

It's Friday and equities are taking on water again this morning. Today's weakness is due to disappointing earnings from two tech giants, Amazon[1] (AMZN, 1782.17), which is down 7.7% in pre-market trading, and Alphabet[2] (GOOGL, 1103.59), down 4.2% in the pre-market. We cover Q3 GDP in detail below but it did come in a bit better than forecast. Here is the news we are watching today:

Establishment versus populist redux: After the election, we offered extensive comments about the differences within the parties, noting that the policies favored by the establishment (low taxes, deregulation, free trade, immigration) are not the policy goals of the populists (regulation to protect jobs, trade impediments, reduced immigration). For much of the first year of President Trump's term, he talked like a populist but governed like an establishment member. Taxes were cut and regulation was reduced. Equity markets clearly favored his policies. Like his GOP predecessors, he seemed to give lip service to populist goals; he didn't aggressively condemn alt-right groups, for example. But, if one ignored the commentary, Trump governed mostly as an establishment GOP president.

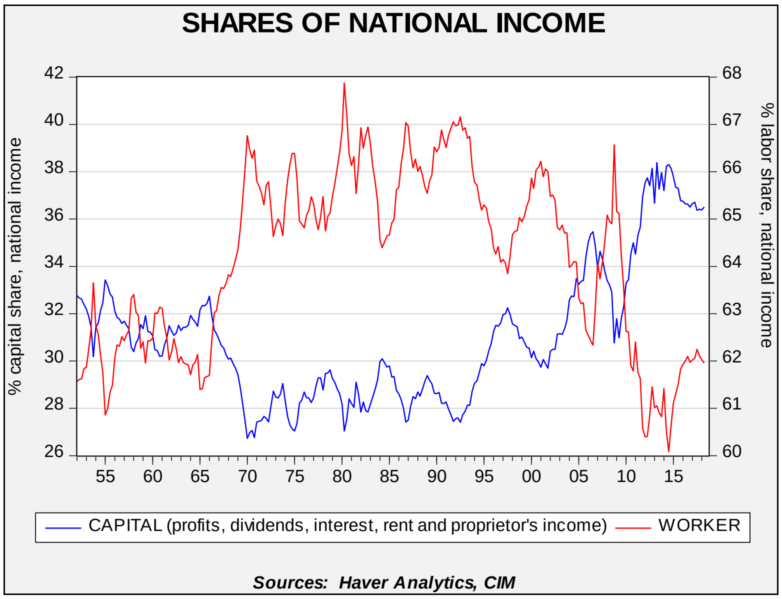
That scenario began to change this year. The administration became increasingly aggressive against immigration. This has led to scattered complaints from some agriculture sectors.[3] In late January, it became clear that the president was serious about implementing sanctions and changing trade. Attacks on the Federal Reserve have become more frequent and pointed. As

[1] https://www.wsj.com/articles/amazon-reports-another-profit-but-sales-underwhelm-1540498816
[2] https://www.wsj.com/articles/google-parent-alphabet-delivers-surging-profit-but-slowing-sales-growth-1540498892
[3] http://www.latimes.com/projects/la-fi-farm-labor-guestworkers/

policy turned populist, the president's approval ratings have improved.[4] The establishment may be starting to push back. We note this morning the *WSJ* editorial board[5] has criticized the president's handling of the Fed. GOP lawmakers have been quietly unhappy with the president's trade policy.[6] For Republican politicians, openly opposing the president appears, at this point, to be a political suicide mission. And so, as long as the president maintains his popularity with the base, the rest of the GOP will be forced to go along, occasionally implementing establishment goals when the president is not paying attention (e.g., the establishment FOMC appointments).

What investors need to consider is that a GOP president might not be good for equities.[7] Although earnings are still strong, we have been seeing a steady drop in the multiple; rising interest rates do affect the P/E but ultimately it's a measure of market sentiment. Investors are becoming worried and thus stocks are under pressure even with good earnings.

We have worried for some time that a policy shift toward equality and populism was inevitable regardless of who is in power. After all, capital has been gaining on labor since 1990 and is one of the reasons populism has been surging. Although it's still too early to tell, the policy mix of globalization and deregulation, supported by both the left- and right-wing establishment, is under threat. It would be reasonable to expect that this pressure is expressed in the P/E.



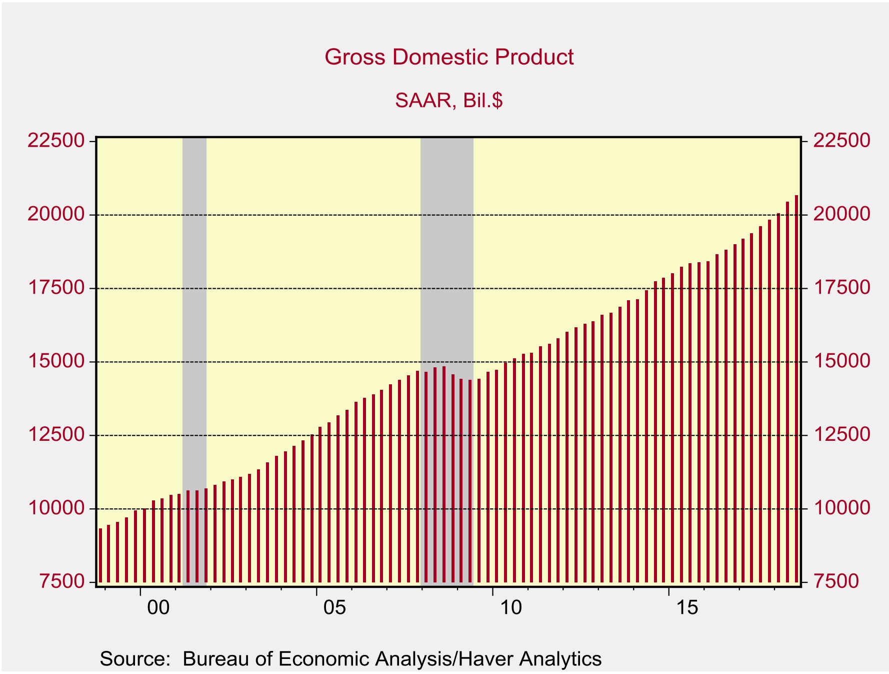
CNY under pressure: The CNY fell to nearly 7.0 this morning, the weakest in 10 years.[8] China has vowed to prevent a move above 7.0 by spending its foreign reserves.[9] Chinese

[4] https://www.realclearpolitics.com/epolls/other/president_trump_job_approval-6179.html NB: the president's approval rating bottomed in January, just after the tax cut. After turning populist, his approval ratings have improved.
[5] https://www.wsj.com/articles/trump-flunks-fed-politics-1540423551
[6] https://www.cnbc.com/2018/07/06/republicans-criticize-trump-tariff-trade-war-with-china.html
[7] https://www.bloomberg.com/opinion/articles/2018-10-26/trump-is-bad-for-the-stock-market
[8] https://www.ft.com/content/4fa1fbc0-d8d5-11e8-a854-33d6f82e62f8

officials could use a weaker CNY to offset tariffs but fears of currency weakness will lead to capital flight.

U.S. Economic Releases

The preliminary reading of Q3 GDP came in above expectations at 3.5% compared to the forecast of 3.3%. Personal consumption came in above expectations at 4.0% compared to the forecast of 3.3%. Core PCE rose 1.6% from the prior quarter. The overall GDP price index came in below expectations at 1.7% compared to the forecast of 2.1%.



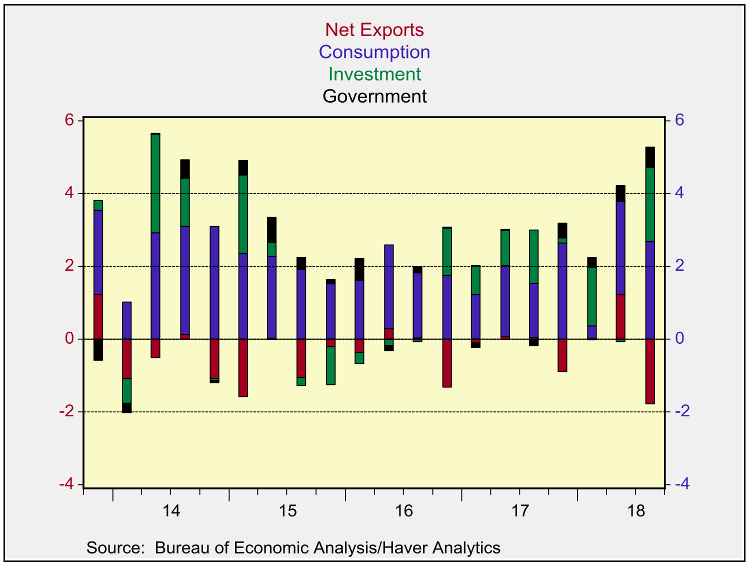
The chart above shows historical GDP. As of right now, GDP continues to grow at a solid pace.

	Q3 2018 Prelim Reading	Q2 2018 Third Reading	Difference
GDP	3.5%	4.2%	-0.7%
Consumption	2.7%	2.6%	0.1%
Investment	2.0%	-0.7%	2.7%
Inventories	2.1%	-1.2%	3.2%
Net Exports	-1.8%	1.2%	-3.0%
Government	0.6%	0.4%	0.1%

The table above shows the contributions to GDP. There was a sharp rise in inventories, which boosted investment. In addition, consumption remains strong which suggests consumer

[9] https://www.cnbc.com/2018/10/26/reuters-america-exclusive-guarding-stability-china-likely-to-slow-yuans-slide-to-7-per-dlr-sources.html

confidence remains high in light of tariffs. As we mentioned last week, the rise in exports in Q2 was likely due to firms front-running tariffs; as a result, there was a sharp drop in exports in Q3.



This chart above shows the contributions graphically. Net exports was the only negative component in Q3 GDP. Investment was boosted by a sharp rise in inventories.

The table below lists the economic releases scheduled for today.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	U. of Michigan Sentiment	m/m	oct	99.0	99.0	***
10:00	U. of Michigan Current Conditions	m/m	oct		115.2	**
10:00	U. of Michigan Expectations	m/m	oct		90.5	**
10:00	U. of Michigan 1 yr Inflation	m/m	oct		2.7%	**
10:00	U. of Michigan 5-10 Yr Inflation	m/m	oct		2.5%	**
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	Tokyo CPI	m/m	oct	1.5%	1.3%	1.5%	***	Equity and bond neutral
	Tokyo CPI ex-Fresh Food	m/m	oct	1.0%	1.0%	1.0%	***	Equity and bond neutral
	Tokyo CPI ex-Fresh Food, Energy	m/m	oct	0.6%	0.7%	0.7%	***	Equity and bond neutral
China	FX Net Settlement	y/y	sep	-110.3 bn	-63.3 bn		**	Equity and bond neutral
EUROPE								
Germany	Gfk consumer confidence	m/m	nov	10.6	10.6	10.5	***	Equity and bond neutral
France	Consumer Confidence	m/m	oct	95	94	95	***	Equity and bond neutral
	PPI	y/y	sep	3.6%	3.7%		**	Equity and bond neutral
Italy	Hourly Wages	y/y	sep	1.9%	2.0%		***	Equity and bond neutral
Russia	Gold and Forex Reserve	m/m	oct	461.4 bn	460.4 bn		*	Equity and bond neutral
	Money Supply Narrow Def	m/m	oct	10.41 tn	10.42 tn		*	Equity and bond neutral
AMERICAS								
Mexico	Retail Sales	y/y	aug	3.9%	4.2%	3.8%	**	Equity and bond neutral
Canada	CFIB Business Barometer	m/m	oct	60.5	61.4		**	Equity and bond neutral
Brazil	Current Account Balance	m/m	sep	$32 mn	-$717 mn	$430 mn	**	Equity bearish, bond bullish
	Foreign Direct Investment	m/m	oct	$7.829 bn	$10.607 bn	$7.118 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)	251	249	2	Up
3-mo T-bill yield (bps)	228	228	0	Neutral
TED spread (bps)	23	21	2	Neutral
U.S. Libor/OIS spread (bps)	228	228	0	Up
10-yr T-note (%)	3.09	3.12	-0.03	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	45	44	1	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	up			Neutral
pound	down			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Russia Key Rate	7.500%	7.500%	7.500%	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	$76.24	$76.89	-0.85%	
WTI	$66.55	$67.33	-1.16%	
Natural Gas	$3.14	$3.20	-1.97%	
Crack Spread	$15.26	$15.26	0.03%	
12-mo strip crack	$18.47	$18.62	-0.82%	
Ethanol rack	$1.40	$1.40	-0.03%	
Metals				
Gold	$1,235.43	$1,232.17	0.26%	
Silver	$14.66	$14.64	0.12%	
Copper contract	$272.15	$275.45	-1.20%	
Grains				
Corn contract	$ 362.75	$ 361.00	0.48%	
Wheat contract	$ 494.00	$ 487.25	1.39%	
Soybeans contract	$ 856.25	$ 854.50	0.20%	
Shipping				
Baltic Dry Freight	1516	1546	-30	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	6.3	3.0	3.3	
Gasoline (mb)	-4.8	-1.5	-3.3	
Distillates (mb)	-2.3	-2.0	-0.3	
Refinery run rates (%)	0.40%	0.50%	-0.10%	
Natural gas (bcf)	58.0	81.0	-23.0	

Weather

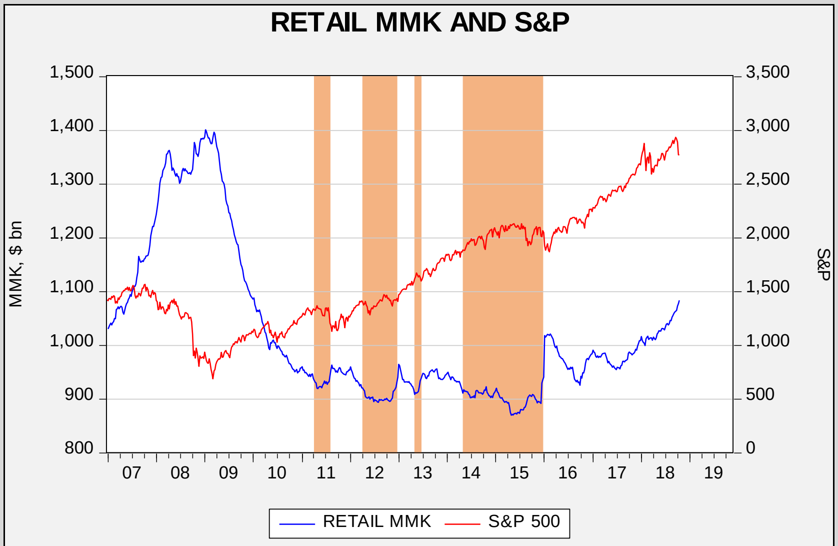
The 6-10 and 8-14 day forecasts show warmer to normal temperatures along the coastline, with cooler temps for the rest of the country. Precipitation is expected for most of the country. There is a cyclone formation in the Atlantic, but at this moment it is unclear whether it will make landfall anywhere.

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 26, 2018

One of the earliest lessons taught in statistics is that "correlation does not equal causality." Any relationship that exists between two variables usually rests on a myriad of conditions; if any of these conditions change, correlations can break down rapidly. This doesn't mean that correlation isn't a useful tool but it show that one must be aware of the conditions that support the relationship. If those conditions prove to be unstable, the resulting correlation can be unreliable. In addition, when a correlation breaks down, it's important to figure out why. Sometimes the change in correlation is understandable; in other circumstances, it can signal more ominous problems.

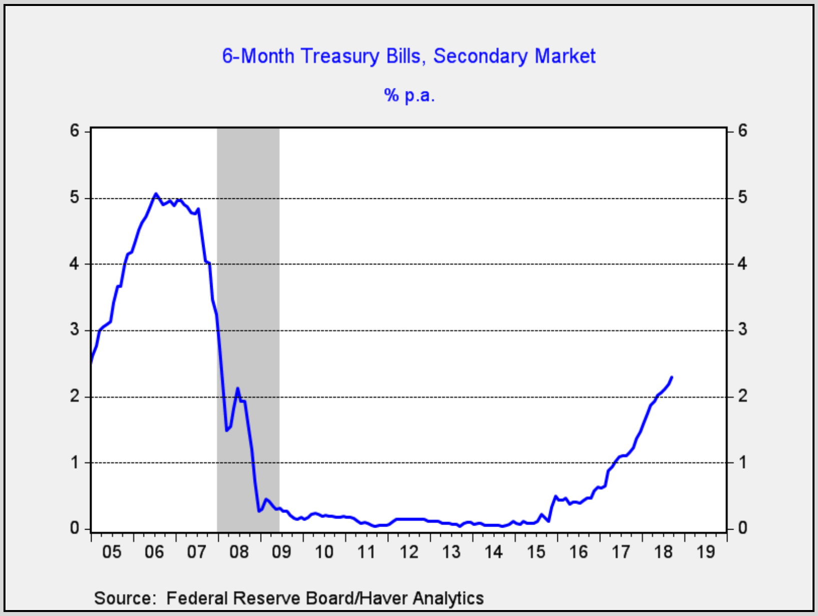


Sources: Haver Analytics, CIM

This chart shows the level of retail money market funds along with the S&P 500 on a weekly basis. We have highlighted four periods. These periods show that equity performance stalls when the level of retail money market funds falls below $920 bn. It would seem that households had a minimum level of desired liquidity and if that level falls below that minimum then households would liquidate financial assets to rebuild cash. After money market funds were rebuilt, equities tended to recover.

It appears that this relationship is breaking down. We have seen choppy equity performance this year with money market funds continuing to rise; in other words, households have levels of cash available that, in recent years, would have led to equity purchases. So, why did this relationship break down? Although there could be a myriad of reasons, here are the two we think are most likely.

Current interest rates are attractive to investors. After years of near-zero interest rates on cash and near-cash instruments, current yields look remarkably high.



This chart shows the six-month T-bill rate; in the middle of 2015, the yield was a mere 9 bps. The current yield is 2.29%. Although this is still a low rate historically,[10] the perceived penalty for holding cash is much less onerous than three years ago.

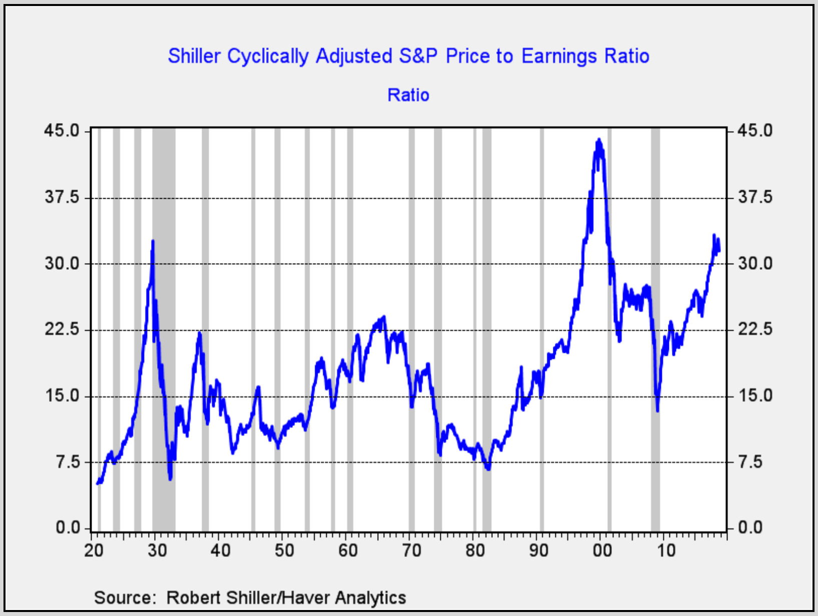
There are rising levels of fear among investors. Fear is hard to define but here are three potential concerns that are probably reducing enthusiasm for equities.

1. *Monetary policy tightening is raising the risk of recession.* Business expansions don't end "naturally." The usual causes are excessive monetary policy tightening or a geopolitical event. Although the FOMC is raising rates, we are not yet at a level that would be considered tight by any measure. Real fed funds remain below zero; the past three recessions occurred with real fed funds in excess of 2.5%. That would imply a fed funds of nearly 5% based on the current overall CPI of 2.3%. However, the 2008 Financial Crisis may have changed how the economy works and thus there may be greater sensitivity to policy tightening. The FOMC does appear cognizant of this risk and is moving rates up slowly.
2. *Fears of a change in the inflation regime.* After peaking at 14.8% in March 1980, overall CPI has averaged a mere 2.6% since 1985. The Federal Reserve is given much of the credit for this development, although we believe globalization and deregulation played a much larger role in keeping price increases contained. Unfortunately, these two factors also tend to cause inequality and there is growing political backlash against both. President Trump's changes to trade policy and the rising criticism against technology

[10] The average rate since 1970 is 5.04%.

companies are, perhaps, a signal of a regime change. The fact that we have seen weak equities and rising long-duration yields simultaneously may be signaling that concerns about the inflation regime are rising. However, our analysis suggests that most of the recent rise in long-dated yields can be explained by monetary policy tightening. If the inflation regime changes (inflation expectations become unanchored, using "Fedspeak") we would expect further price weakness for equities and long-duration debt.

3. *Lingering fears of 2008.* The 2008 Financial Crisis was a generational event, undermining investor faith in markets and policy. After the Great Depression, it took investors years before confidence returned.

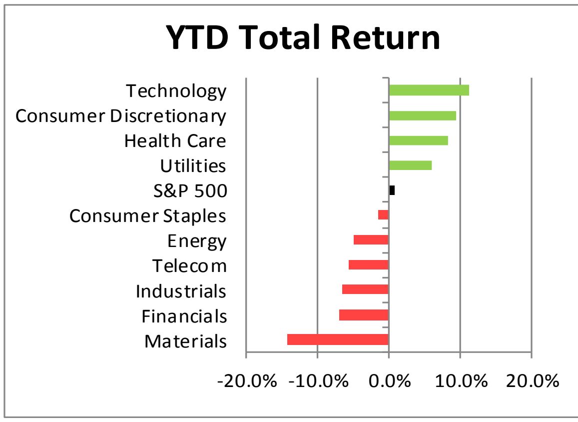


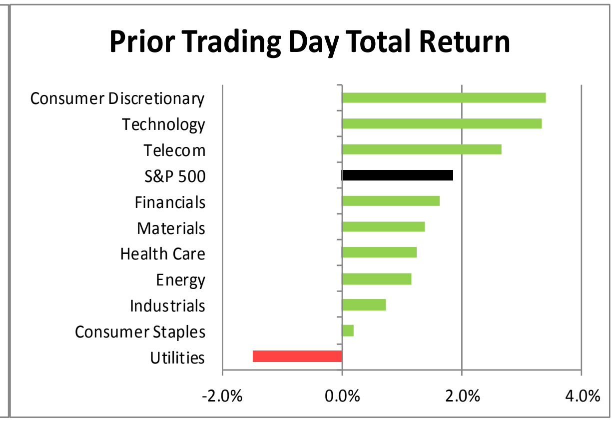
This chart shows the Schiller CAPE. Although there were occasional bounces when the P/E rose above 15x after the Great Depression, it wasn't until the late 1950s that we saw a sustained rise in multiples. That has not been the experience of the equity market thus far but the market has also been supported by extraordinary policy support. Although anecdotal, in our travels talking to investors, we hear a nearly universal comment that, "I can't suffer through another event like 2008 again." Thus, it would not be unreasonable to see investors move to cash if they see even faint signs of recession.

So, what do we glean from this analysis? Rising rates are looking attractive to some investors, especially those with high levels of risk aversion. At the same time, even 3.0% on T-bills isn't much of a return and probably has had a limited impact on equities. The fear section is more telling. If the primary fear is overly tight monetary policy, then any hint of a pause should be bullish for equities. That's especially true given high cash levels. A regime change in inflation is perhaps the greatest threat; there are clearly changes occurring that are worrisome but the general realization that the regime has changed takes time. We are watching this issue carefully but, so far, we are not ready to declare a change. If regime change were the primary factor, long-term interest rates would be rising much faster. The fear of another 2008 will be with investors for a generation. That fear may lead to more frequent corrections, especially under conditions where monetary policy isn't overtly accommodative. In some respects, that is a healthier situation for equity markets as it reduces the odds of bubbles. Our take is that the primary factor behind the rise in cash is monetary policy tightening.

Data Section

U.S. Equity Markets – (as of 10/25/2018 close)

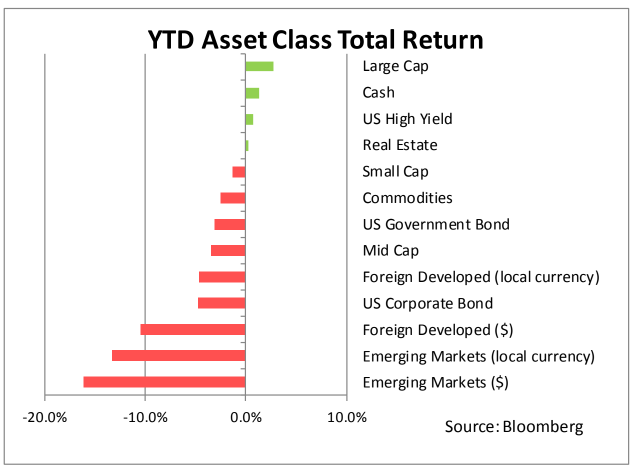




(Source: Bloomberg)

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 10/25/2018 close)

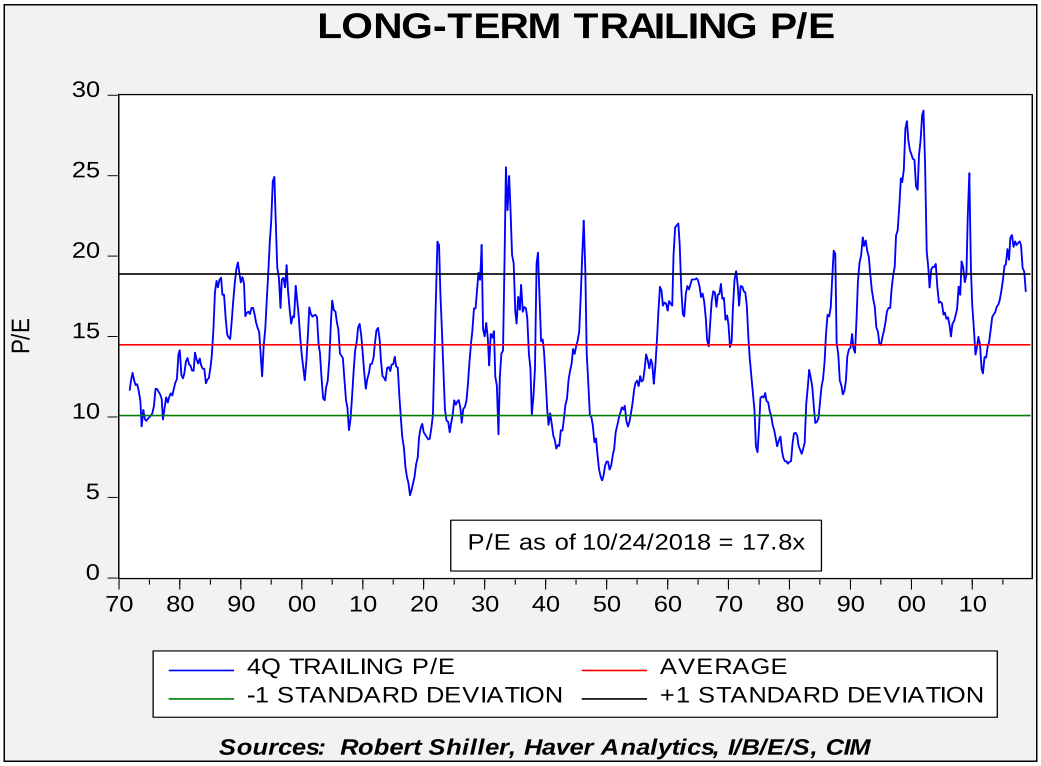


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 25, 2018



Based on our methodology,[11] the current P/E is 17.8x, down 0.1x from last week's reading of 17.9x. The primary reason for the drop in the P/E is 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.

[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.