Daily Comment

By Bill O'Grady, Thomas Wash, and
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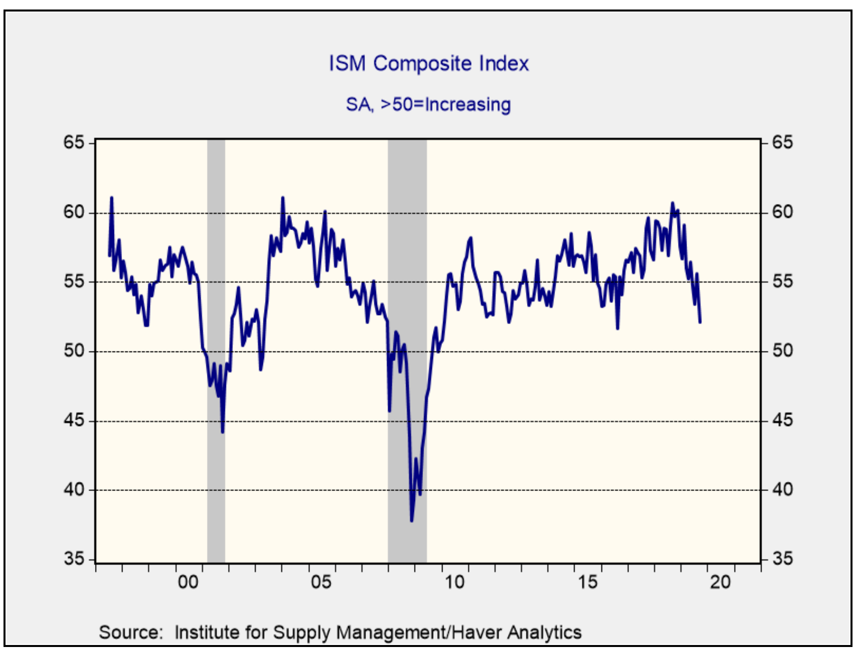
Looking for something to read? See our Reading List; these books, separated by category, are ones we find interesting and insightful. We will be adding to the list over time.

[Posted: October 4, 2019—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is up 0.1% from the last close. In Asia, the MSCI Asia Apex 50 closed down 0.3%. Chinese markets were closed for National Day. U.S. equity index futures are signaling a lower open.

Happy employment Friday! We cover the data below, but the quick take is that the report is mixed. The drop in the unemployment rate to 3.5%, a new cycle low, is impressive. However, wage growth for non-supervisory workers fell to 3.5% from 3.6%, and the growth rate for all workers fell rather markedly to 2.9% from 3.2%. The headline payroll number came in at 136k, a bit below expectations. The data has triggered a risk-on trade, with interest rates rising amid stronger equity prices. Here is what else we are watching this morning:

The economy and the Fed: Yesterday's ISM services data came in soft and added to concerns that the economy was coming under pressure.



This index is generally a coincident indicator and doesn't signal recession until it crosses 50. It also doesn't have a long history, but the data is clearly in a downtrend. Unlike the manufacturing index, the exports portion was a bit weak but most purchasing managers were reporting steady export orders. Unfortunately, the subsector that showed the most profound weakness was employment, which has fallen from 56.2 in July to 50.4 in September.

Weaker economic data is raising expectations that the FOMC will accelerate rate cuts. Vice Chair Clarida seemed to support this notion. Hopes of easing likely led to yesterday's equity market recovery. However, the drop in the unemployment rate (see below) will make it hard for the Phillips Curve faction of the FOMC to agree to a rate decline.

Brexit: PM Johnson's plan for the Irish border fell with a thud in Brussels. Although there hasn't been an outright rejection yet, it is unlikely that the plan as it is currently constructed would get all 27 nations to agree. Johnson has suggested he is open to other concessions but it isn't obvious if they would be material. Meanwhile, Johnson is working on Parliament to see if they will approve his exit proposal. He might be closer than one would think. To pass, there are three groups he needs to win over. First, there is the matter of the 21 former Tories who he kicked out. He needs all of them. He needs all 9 DUP members. To get over the line, he needs some defections from Labour. There are a number of Labour MPs who come from Leave boroughs that might vote for Johnson's plan. In fact, this is the primary reason why Labour has not actually taken a position on Brexit; the party is divided, and Corbyn would lose MPs if he elects to support Remain. If Johnson can get his deal passed and the EU rejects it, it appears to us that the U.K. will leave on Halloween.

Next week's trade talks: In light of market weakness, there is some speculation that the administration will at least agree to a truce. That would entail a postponement of tariffs and at least a jump in Chinese agricultural imports. However, a postponement without anything on intellectual property would look weak and it would be hard for the Trump administration to accept. Additionally, China views the U.S. as an unreliable negotiating partner because, from their perspective, the administration changes its position after a deal has been made. This charge is not exactly fair; instead, we suspect there is a high level of "strategic ambiguity," where both parties say the same thing but mean something quite different. In reality, we don't think either side is willing to make the concessions necessary to make an arrangement but neither wants a "blow up" either. There is also a narrative that Xi may simply wait out Trump and hope for a more compliant administration in 2020. Beijing may want to rethink that position.

Masks off: Carrie Lam will make it illegal to wear masks at protests. We doubt these measures will have an immediate effect, but it will make it easier for the government to arrest protestors who otherwise will be vulnerable to tear gas.

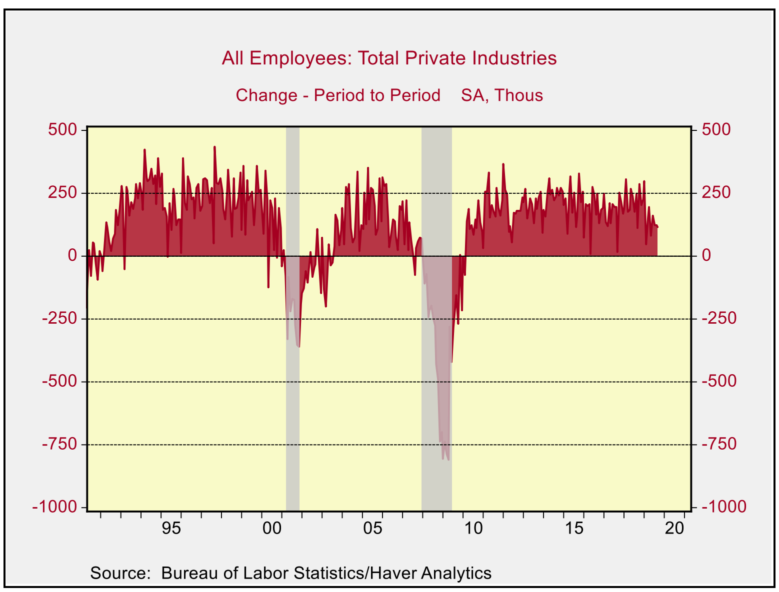
Israel: Prime Minister Netanyahu has agreed that if he is able to form a unity government with opposition leader Gantz, and if he is then indicted for bribery, fraud and breach of trust, as is widely expected, he will retain his title but give up his powers to an "interim premier." The coalition negotiations are currently deadlocked, but the deal could help move things forward.

India: The Reserve Bank of India slashed its benchmark short-term interest rate to a nine-year low of 5.15%, from 5.40% previously. That marked the fifth rate cut in a row as the economy has slowed due to heavy corporate debt on weak consumer confidence. In fact, the RBI also cut its forecast of economic growth in the year ending in March 2020 to 6.1% from 6.9%.

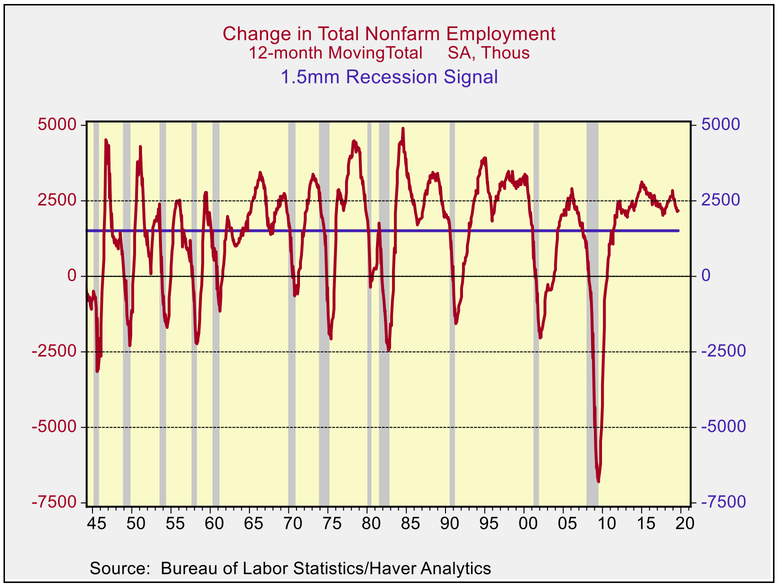
Odds and ends: Civil disorder has developed in Iraq. Although it appears to be driven by opposition to widespread government corruption, such unrest can be co-opted by outside actors (read: Iran) to disrupt oil flows or to mask attacks in the region. Although the situation in Kashmir has not been in the news lately, warnings that the conflict could escalate have been issued, cautioning that the problem could go nuclear. EU migration commissioner Avramopoulos warned that "irregular" crossings from Turkey into Greece are on the rise again. That raises fears of a new immigration crisis that could give nativist, populist parties renewed energy despite recent signs they may be on the wane. The risk of renewed political instability would likely weigh on Eurozone stocks and the EUR. Finally, we are monitoring the impeachment inquiry, but until it has a direct effect on the financial markets our commentary on the issue will be limited.

U.S. Economic Releases

The change in non-farm payrolls for September came in below expectations at 136k compared to the forecast of 145k. The prior report was revised upward from 130k to 168k. Therefore, the two-month payroll net revision rose by 45k. The change in private payrolls came in below expectations at 114k compared to the forecast of 130k. The prior report was revised upward from 96k to 122k. The change in manufacturing payrolls was below expectations, falling by 2k compared to the forecast of a 3k gain. The prior report was revised downward from 3k to 2k.

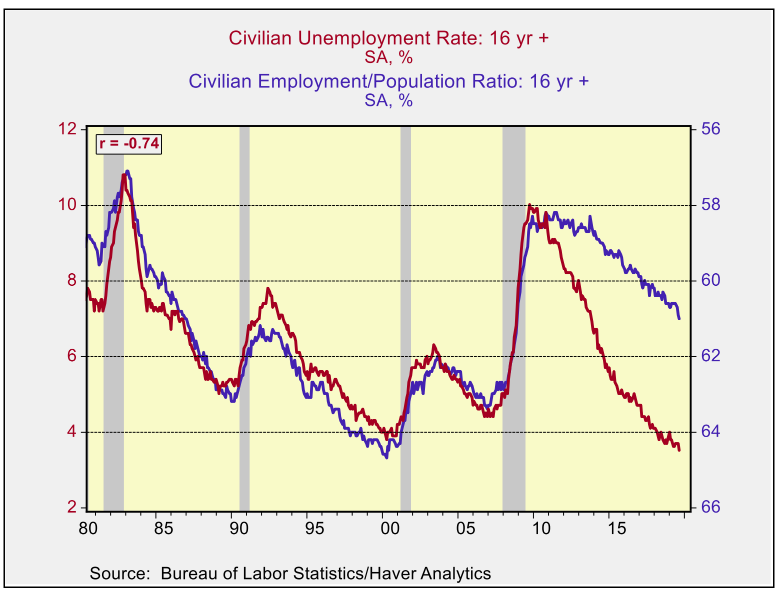


The chart above shows the change in total private employment, which suggests the economic expansion continues.



The chart above shows the 12-month moving total of the change in non-farm payrolls; a dip under 1.5mm signals recession. Despite the payrolls numbers coming in below expectations, revisions in last month's report showed a slight reversal in trend, with the 12-month moving sum rising from 2.119mm to 2.147mm.

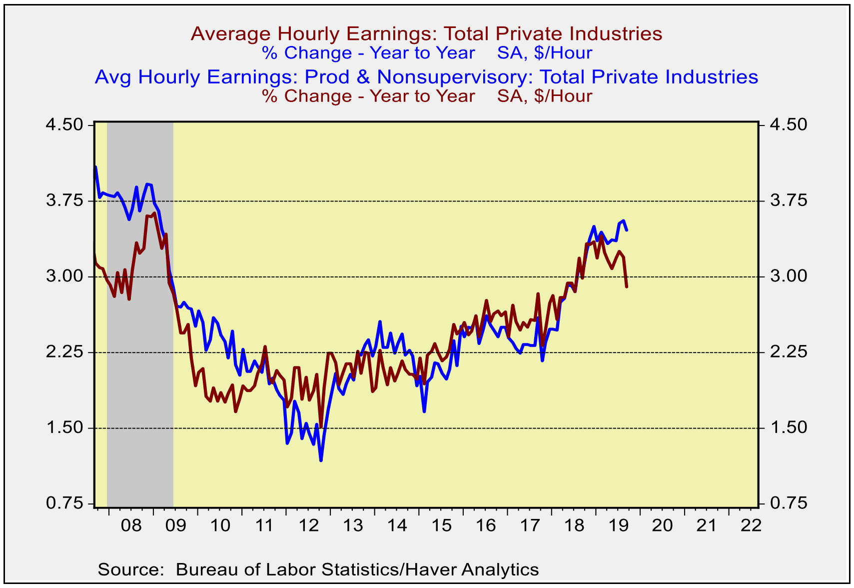
The unemployment rate came in below expectations at 3.5% compared to the forecast of 3.7%. The labor force participation rate remained steady at 63.2%, while the U-6 unemployment rate fell from 7.2% to 6.9%.



The chart above shows the relationship between the unemployment rate and the employment/population ratio. The divergence of the two variables has been one of the defining factors of this recovery and argues that labor market slack still remains.

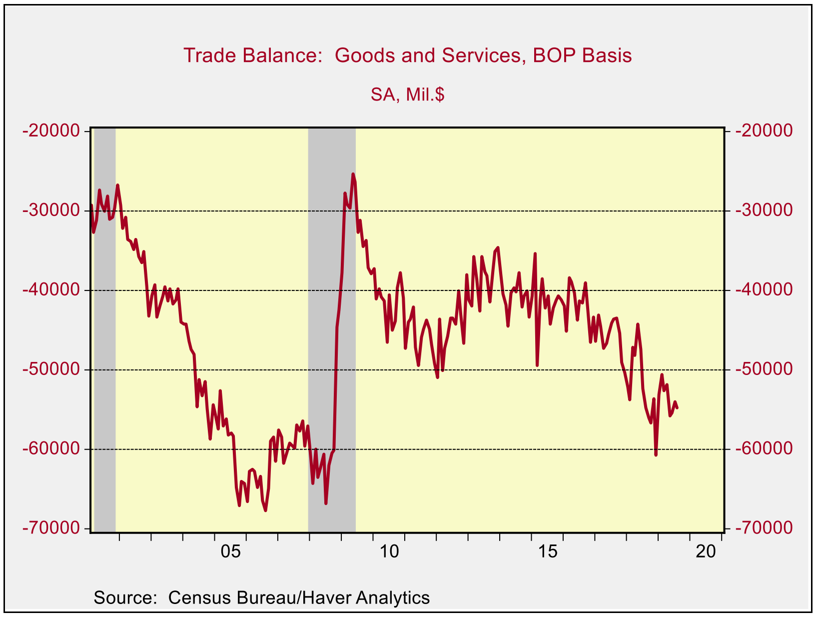
The unemployment rate fell to a new cycle low of 3.5%. Employment in the household survey rose 391k, while the labor force rose by only 117k. As the above chart shows, that lifted the employment/population ratio to 61.0%, also a new cycle high.

Average hourly earnings for all workers came in below expectations, remaining unchanged from the prior month compared to the forecast rise of 0.2%.



The chart above shows the yearly change in overall wages for all workers along with production and non-supervisory workers. Average hourly earnings for all workers rose 2.9% from the prior month, with wage growth for non-supervisory workers at 3.5%. The divergence likely reflects the fact that tighter labor markets and widespread increases in minimum wages rules have boosted wage growth for lower income workers, while the upper levels of income are showing slower wage growth.

The August trade deficit came in wider than expected at $54.9 bn compared to the forecast of $54.5 bn.



The chart above shows the trade balance of goods and the advance trade balance.

In total, the jobs report was mixed; the financial markets are taking the data as bullish for equities and bearish for debt. Although the unemployment rate fell to a new cycle low, the payroll and wage numbers suggest that the economy is losing momentum but not nearly as fast as investors feared. It is likely that the Fed may lower rates this month, but the decision will be contentious.

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

Economic Releases		
No economic releases today		
Fed Speakers or Events		
	Speaker or event	**District or position**
10:25	Raphael Bostic Speaks at Tulane University	President of the Federal Reserve Bank of Atlanta
14:00	Jerome Powell Makes Opening Remarks at Fed Listens Event	Chairman of Board of Governors of Federal Reserve

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								
India	Markit India PMI Services	m/m	sep	48.7	52.4		**	Equity and bond bearish
	Markit India PMI Composite	m/m	sep	49.8	52.6		**	Equity and bond bearish
Australia	Retail Sales	m/m	aug	0.4%	-0.1%	0.5%	**	Equity and bond neutral
EUROPE								
Germany	Markit Germany Construction	m/m	sep	50.1	46.3		**	Equity bullish, bond bearish
France	Budget Balance	ytd	aug	-123.1 Bil	-109.7 Bil		**	Equity and bond neutral
Italy	Deficit to GDP	ytd	2q	4.0%	4.1%		***	Equity and bond neutral
UK	New car registrations	y/y	sep	1.3%	-1.6%		*	Equity and bond neutral
Russia	Gold and Forex Reserves	w/w	27-Sep	531.8 Bil	532.6 Bil		**	Equity and bond neutral
AMERICAS								
Mexico	Vehicle Production	m/m	sep	318906	337462		*	Equity and bond neutral
	Vehicle Exports	m/m	sep	284243	281811		*	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)	206	209	-3	Down
3-mo T-bill yield (bps)	166	167	-1	Neutral
TED spread (bps)	40	42	-2	Neutral
U.S. Libor/OIS spread (bps)	165	166	-1	Up
10-yr T-note (%)	1.52	1.54	-0.02	Down
Euribor/OIS spread (bps)	-43	-43	0	Neutral
EUR/USD 3-mo swap (bps)	29	28	1	Down
Currencies	**Direction**			
dollar	Down			Up
euro	Flat			Down
yen	Up			Down
pound	Flat			Up
franc	Up			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
RBI Repurchase Rate	5.400%	5.400%	5.150%	On forecast
RBI Reverse Repo Rate	5.150%	5.150%	4.900%	On forecast
RBI Cash Reserve Ratio	4.000%	4.000%	4.000%	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	$58.07	$57.71	0.62%	
WTI	$52.50	$52.45	0.10%	
Natural Gas	$2.32	$2.33	-0.26%	
Crack Spread	$17.76	$17.40	2.06%	
12-mo strip crack	$18.24	$18.01	1.26%	
Ethanol rack	$1.73	$1.74	-0.33%	
Metals				
Gold	$1,508.80	$1,505.19	0.24%	
Silver	$17.59	$17.56	0.18%	
Copper contract	$254.40	$255.35	-0.37%	
Grains				
Corn contract	$ 386.75	$ 388.75	-0.51%	
Wheat contract	$ 487.25	$ 488.75	-0.31%	
Soybeans contract	$ 910.00	$ 911.75	-0.19%	
Shipping				
Baltic Dry Freight	1757	1803	-46	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	3.1	2.3	0.9	
Gasoline (mb)	-0.2	0.6	-0.8	
Distillates (mb)	-2.4	-2.0	-0.4	
Refinery run rates (%)	3.40%	-0.50%	3.90%	
Natural gas (bcf)	112.0	102.0	10.0	

Weather

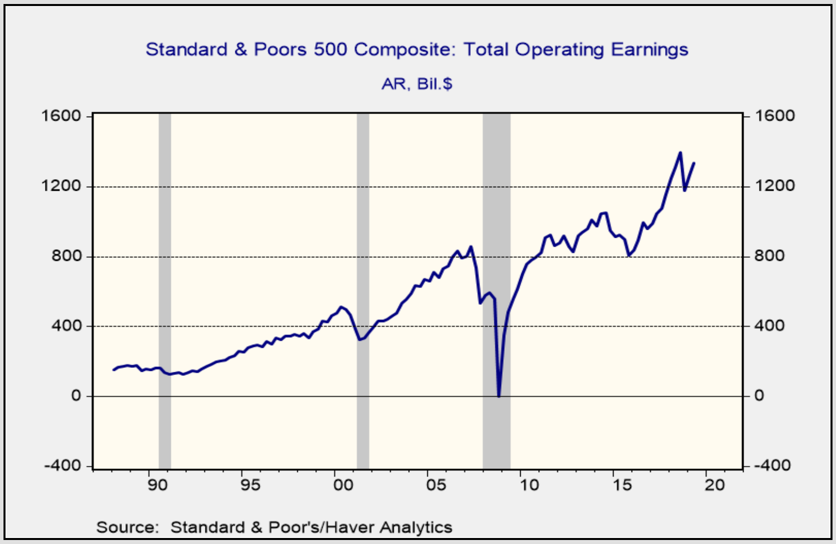
The 6-10 and 8-14 day forecasts call for cooler-than-normal temperatures for most of the country, with normal or higher-than-normal temperatures along the coasts. There is a disturbance in the Caribbean, but it is not expected to develop into a tropical storm.

Asset Allocation Weekly

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.

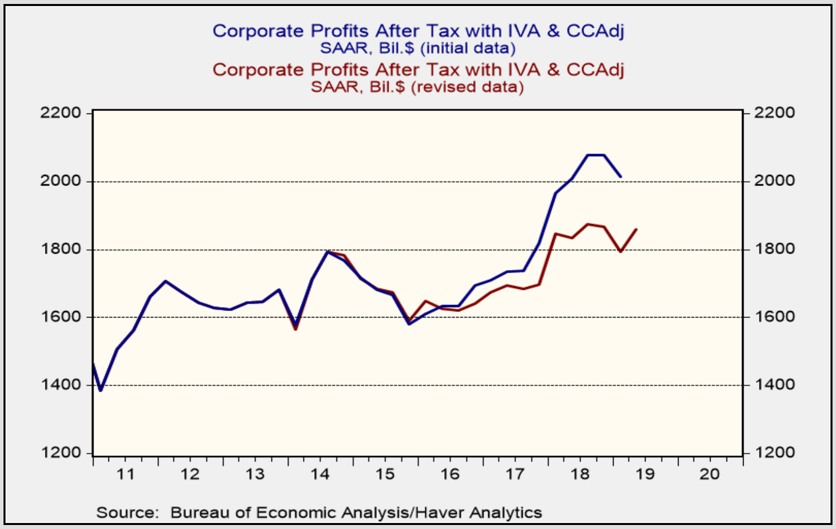
October 4, 2019

Although the convention for measuring earnings is compared to shares, Standard and Poor's also calculates the level of operating earnings for all the stocks in the S&P 500.



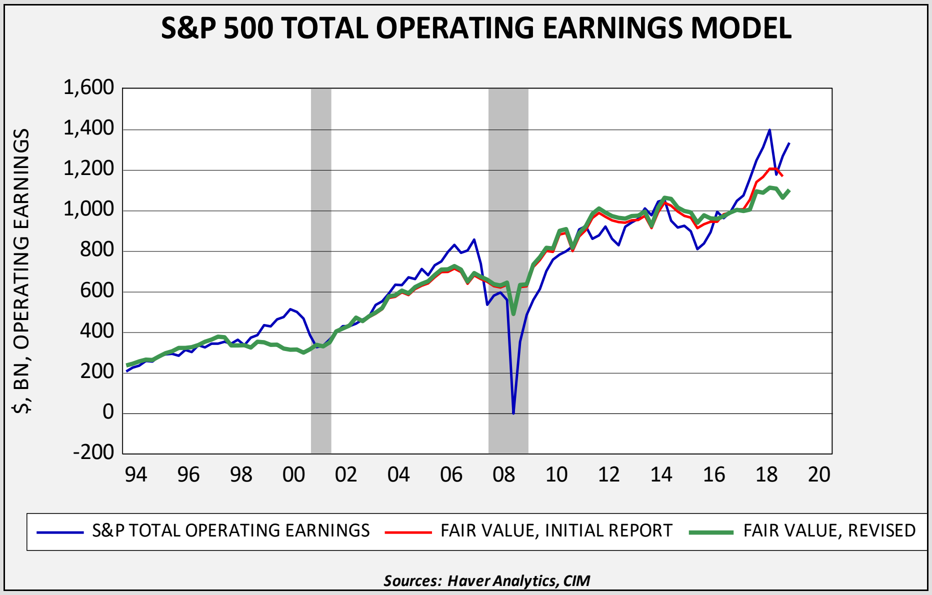
The per-share value is calculated by dividing this number by the S&P divisor. The advantage of this number versus the per-share data is that it is easier to compare total operating earnings of the S&P to the profits data compiled by the Bureau of Economic Analysis (BEA) as part of the National Product Accounts data.[1] The BEA data measures total corporate profitability.

The BEA makes occasional revisions to the GDP and related reports, and recently we had a significant revision to the profits calculation.



[1] The GDP data comes from this effort.

The BEA made a meaningful revision to its profit calculation.[2] We use this data and forecasts from the Survey of Economists conducted by the Philadelphia FRB in calculating our earnings forecast.



This chart is a model that estimates S&P operating earnings using the BEA profits data. The value of comparing the BEA profits data to S&P operating earnings is that it does give us a warning when earnings for the index are "frothy" and probably due to decline. In 2000 and 2006, S&P total operating earnings far exceeded the model's fair value forecast and, as the recession approached, the index's earnings fell to or exceeded the BEA-based model forecast.

Until the revisions, the S&P total operating earnings data was a bit high but not outside model ranges. The revisions now suggest that current operating earnings are high and will likely decline in the coming quarters. We still have other factors to take into account (the path of the divisor and the business cycle are two important ones) but, overall, earnings are likely to decline in the coming quarters.

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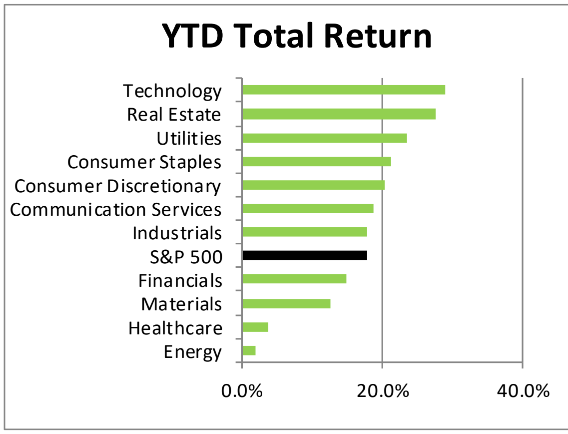
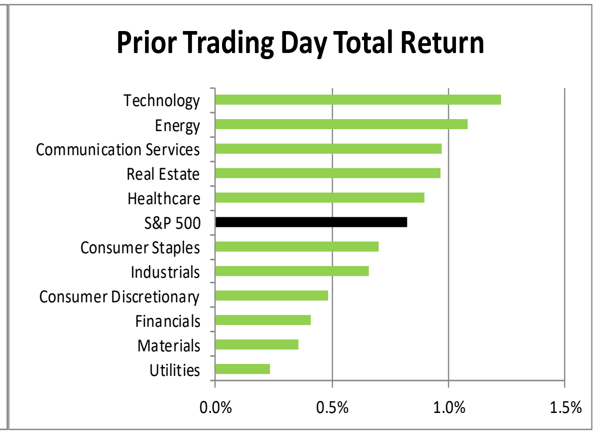
[2] For reference, we use after-tax profits with inventory and depreciation adjustment.

Data Section

U.S. Equity Markets – (as of 10/3/2019 close)

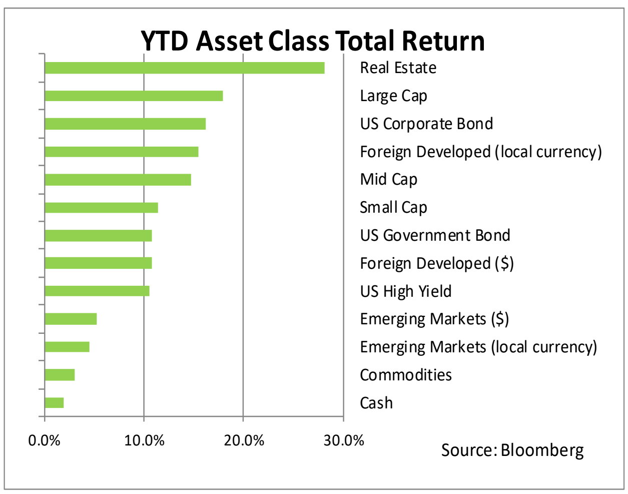




(Source: Bloomberg)

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. These charts represent the new sectors following the 2018 sector reconfiguration.

Asset Class Performance – (as of 10/3/2019 close)

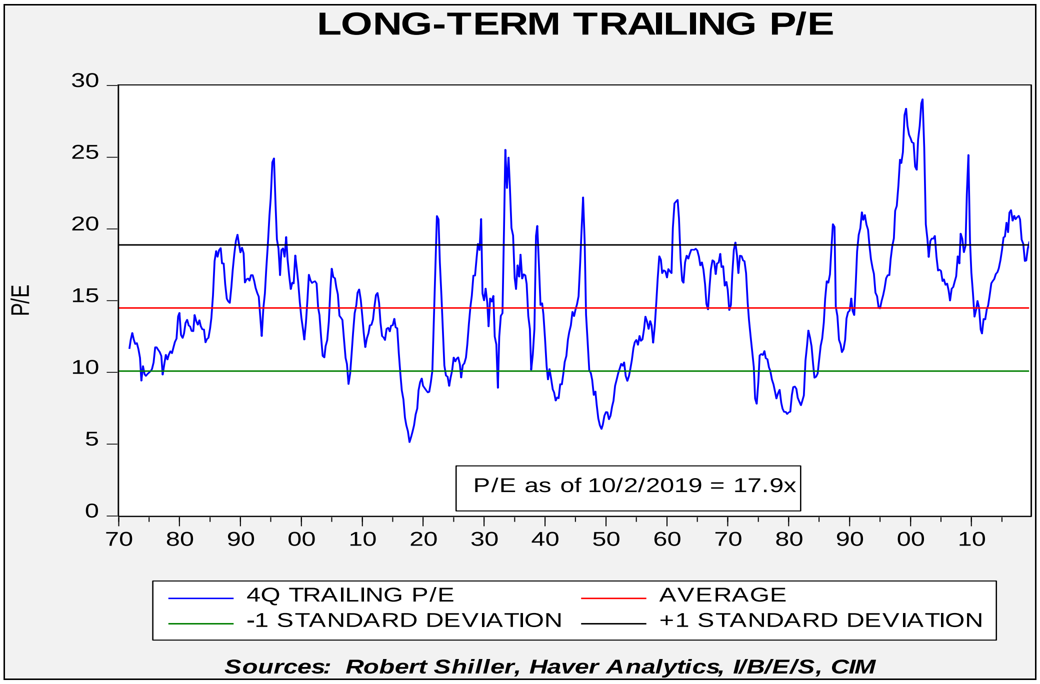


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 3, 2019



Based on our methodology,[3] the current P/E is 17.9x, down 1.1x from last week. With the onset of Q4, we add this quarter's estimates for earnings and drop Q4 2018. This change lifted the "E" in the ratio and accounts for the lower multiple.

[3] 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.