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: September 4, 2018—9:30 AM EDT] Global equity markets are generally mixed this morning. The EuroStoxx 50 is down 0.9% from the last close. In Asia, the MSCI Asia Apex 50 was up 0.5% from the prior close. Chinese markets were up, with the Shanghai composite up 1.1% and the Shenzhen index up 1.2%. U.S. equity index futures are signaling a flat open.

Back in session! Summer's over. Today is all about the dollar, EM and oil. Here is what we are watching:

Emerging markets: Emerging equities were mixed overnight, with China doing well but others not so much. It's looking like concerns are breaking into two broad categories. The first is the fragile group. These are nations that have borrowed in dollars and are vulnerable to dollar strength and rising U.S. interest rates. Argentina and Turkey are the prime examples of countries that will struggle to avoid default or restructuring. The second category includes those nations that are dependent on the U.S.-supported global trade structure; China and India are two examples of this group. The first group is most vulnerable to tightening monetary conditions in the U.S. The second group is being influenced by the Trump administration's trade policies. If this analysis is correct, the first group will remain under pressure until we see signs that the FOMC is nearly finished with tightening. The second group may benefit if there is a change of control in Congress in November. For the time being, there doesn't appear to be immediate relief on the horizon. The administration is poised to implement $200 bn of sanctions on Chinese goods by Thursday. Recent trade actions are already affecting global supply chains.[1] Argentina has released an austerity program.[2] We view it as a first step in stabilizing the currency. Turkey is also hinting at raising rates.[3]

The dollar: Continued trade friction and Fed tightening are boosting the dollar this morning.[4] The U.S. and Canada were unable to agree on a renegotiation of NAFTA last week but talks do

[1] https://www.ft.com/content/03e4f016-aa9a-11e8-94bd-cba20d67390c?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56
[2] https://www.ft.com/content/402a9d1a-af80-11e8-8d14-6f049d06439c?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56
[3] https://www.ft.com/content/50dbd284-af47-11e8-8d14-6f049d06439c
[4] https://www.reuters.com/article/us-global-forex/trade-and-emerging-market-worries-keep-dollar-near-one-week-high-idUSKCN1LJ02Z

continue.[5] President Trump, in an interview with Bloomberg, made off-the-record comments that made their way into Canadian media. Essentially, the president indicated that Canada would have no choice but to accept the agreement made with Mexico. As we noted last week, this puts PM Trudeau in an impossible position and, predictably, the Canadians balked. The problem for the White House is that NAFTA is a treaty and Congress has input. Already, we are hearing that Congress may force negotiators to keep Canada in the agreement. U.S. labor leaders are pushing to maintain the pact in its current form.[6] Simply put, Congress may trim the degree of changes the White House can make to the treaty and get it passed. Dollar strength is weighing on most commodities this morning, including gold. Oil, as noted below, has bucked the trend.

Oil and Gordon: As noted below, TS Gordon has formed and is moving into the Gulf of Mexico. Oil rigs have been evacuated,[7] although some production will be maintained as many of the facilities have automated systems that will keep oil flowing until wind speeds reach certain levels. Such storms will disrupt imports and thus could lead to a reduction in inventory levels over the next couple of weeks. In addition to Gordon, expectations of tightening sanctions are already affecting Iranian oil flows. Concerns over Iran have been supportive for oil prices and the tropical storm has simply added to supply concerns.

Pound down: Worries about a hard Brexit are hitting the GBP. PM May has tried to weave a policy that will meet the goals of the "leavers" but keep enough ties to the EU so as not to harm the economy. Unfortunately, this policy has managed to please neither side and is raising worries that the May government won't be able to recommend a coherent policy for leaving.[8] If no plan emerges, we will likely see further weakness in the U.K. currency.

U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below lists the economic releases scheduled for the rest of the day.

[5] https://www.nytimes.com/2018/08/31/business/us-canada-nafta.html?rref=collection/sectioncollection/business&action=click&contentCollection=business&region=rank&module=package&version=highlights&contentPlacement=5&pgtype=sectionfront

[6] https://www.politico.com/story/2018/09/03/trump-nafta-labor-unions-806291 and https://www.politico.com/story/2018/09/02/trumka-trump-union-labor-day-806115 and https://www.wsj.com/articles/union-leader-says-a-new-nafta-wont-work-without-canada-1535903570

[7] https://www.reuters.com/article/us-global-oil/u-s-oil-prices-rise-as-gulf-platforms-shut-ahead-of-hurricane-idUSKCN1LK028

[8] https://www.ft.com/content/1f3a606c-af6d-11e8-8d14-6f049d06439c?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Markit US Manufacturing PMI	m/m	aug	54.5	54.5	**
10:00	Construction Spending	m/m	jul	0.4%	-1.1%	**
10:00	ISM Manufacturing	m/m	aug	57.6	58.1	**
10:00	ISM Employment	m/m	aug		56.5	**
10:00	ISM Prices Paid	m/m	aug	69.5	73.2	**
10:00	ISM New Orders	m/m	aug		60.2	**
	Wards Total Vehicle Sales	q/q	aug	16.80 mn	16.68 mn	**
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								
China	Caixin China PMI Manufacturing	m/m	aug	50.6	50.8	50.7	**	Equity and bond neutral
Japan	Capital Spending	y/y	2q	12.8%	3.4%	6.5%	**	Equity bullish, bond bearish
	Company Profits	m/m	2q	17.9%	0.2%		**	Equity bullish, bond bearish
	Company Sales	m/m	2q	5.1%	3.2%		**	Equity and bond neutral
	Nikkei Japan PMI Mfg	y/y	aug	52.5	52.5		**	Equity and bond neutral
India	Nikkei India PMI Mfg	m/m	aug	51.7	52.3		**	Equity and bond neutral
Australia	AiG Perf of Mfg Index	m/m	aug	56.7	52.0		**	Equity bullish, bond bearish
	Melbourne Institute Inflation	m/m	jul	0.1%	0.1%		*	Equity and bond neutral
	Retail Sales	m/m	jul	0.0%	0.4%	0.3%	**	Equity bearish, bond bullish
New Zealand	Terms of Trade Index	q/q	2q	0.6%	-1.9%	1.0%	**	Equity bearish, bond bullish
EUROPE								
Eurozone	Markit Eurozone Manufacturing	m/m	aug	54.6	54.6	54.6	**	Equity and bond neutral
	PPI	m/m	jul	4.0%	3.6%	3.9%	**	Equity and bond neutral
Germany	Markit/BM Germany Manufacturing	m/m	aug	55.9	56.1	56.1	**	Equity bearish, bond bullish
Italy	Markit/ADACI Italy Manufacturing	m/m	aug	50.1	51.5	51.2	**	Equity bearish, bond bullish
France	Markit France Manufacturing	m/m	aug	53.5	53.7	53.7	**	Equity and bond neutral
U.K.	Markit UK PMI Manufacturing	m/m	aug	52.8	54.0	53.9	**	Equity and bond neutral
Switzerland	Retail Sales	m/m	jul	-0.3%	0.3%		**	Equity and bond neutral
	PMI Manufacturing	m/m	aug	64.8	61.9	61.0	**	Equity and bond neutral
Russia	Markit Russia PMI Mfg	m/m	aug	48.9	48.1	49.3	**	Equity bearish, bond bullish
AMERICAS								
Brazil	GDP	y/y	jun	1.0%	1.2%	1.1%	***	Equity and bond neutral
Mexico	Net Outstanding Loans	y/y	jul	4257 bn	4272 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)	232	232	0	Up
3-mo T-bill yield (bps)	206	206	0	Neutral
TED spread (bps)	27	26	1	Neutral
U.S. Libor/OIS spread (bps)	211	211	0	Up
10-yr T-note (%)	2.87	2.86	0.01	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	13	13	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**	
RBA Cash Rate	1.500%	1.500%	1.500%	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	$79.54	$78.15	1.78%	Weather Conditions
WTI	$71.31	$69.80	2.16%	
Natural Gas	$2.86	$2.92	-1.92%	
Crack Spread	$18.65	$18.55	0.54%	
12-mo strip crack	$21.30	$21.07	1.12%	
Ethanol rack	$1.46	$1.46	0.00%	
Metals				
Gold	$1,194.16	$1,201.27	-0.59%	
Silver	$14.25	$14.52	-1.85%	
Copper contract	$260.45	$267.10	-2.49%	
Grains				
Corn contract	$ 365.50	$ 365.00	0.14%	
Wheat contract	$ 529.00	$ 545.50	-3.02%	
Soybeans contract	$ 842.75	$ 843.50	-0.09%	
Shipping				
Baltic Dry Freight	1557	1579	-22	

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps in the northwestern region. Precipitation is expected for the eastern region of the country. Tropical Storm Gordon has developed in the Gulf of Mexico and is expected to develop into a hurricane and make landfall in Louisiana and Mississippi on Wednesday. The tropical storm has already impacted oil production as platforms that operate along the gulf were forced to evacuate. In addition, Tropical Storm Florence has developed in the Atlantic Ocean and could possibly hit Bermuda but is unlikely to make landfall elsewhere.

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.

August 31, 2018

In light of the recent conviction of Paul Manafort and the guilty pleas by Michael Cohen, along with the upcoming midterm elections, we have been receiving questions about the political landscape going into winter. In this report, we will discuss our baseline expectations for political trends and their potential effect on financial markets.

Our expectations:

We expect the Democrats to win the House in November but the GOP will hold the Senate. Current prediction market wagers are the primary basis for this expectation.

(Source: PredictIt.com)

For the House, the prediction market has been consistently indicating a 65% likelihood that House control changes parties. At the same time, the same group shows the likelihood that the GOP retains control of the Senate is above 70%.[9]

A divided legislature will lead to gridlock. We expect a Democrat-controlled House to use its subpoena power to investigate any potential corruption in the Trump White House. According to Axios,[10] there will be a plethora of potential areas to examine. Because of this distraction, we

[9] https://www.predictit.org/Market/2703/Which-party-will-control-the-Senate-after-2018-midterms
[10] https://www.axios.com/2018-midterm-elections-republicans-preparation-investigations-180abf7b-0de8-4670-ae8a-2e6da123c584.html

doubt the White House will be able to muster any significant legislative achievements. This outcome isn't all that unusual. Normally, the peak of a president's power is in the first 18 months of his first term. Any political capital that isn't spent in this period is lost. By summer of the second year in office, midterm elections are looming and Congress is distracted by the upcoming vote. Often, the president's party loses seats in Congress after the midterms and legislative progress grinds to a halt. This usual pattern, coupled with the likelihood of perpetual investigations, probably means not much will get done.

Will the Democrats impeach President Trump? Much of this will depend on what the House investigations unearth. Although articles of impeachment might be approved, there is very little chance that two-thirds of the Senate would vote to remove Trump from office.

How will financial markets react to these baseline forecasts?

Equity markets: There have only been two impeachment events during modern market conditions, in the early 1970s under Nixon and the late 1990s under Clinton. In the former event, equities declined but the Watergate scandal was probably nothing more than a minor contributing factor. The economy was in a deep recession in 1973-74, and the world economy was reeling from the end of Bretton Woods and the Arab Oil Embargo. Simply put, there was a lot going wrong and the Nixon resignation was only part of the overall turmoil. In the latter case, equity markets were in the midst of the great tech bubble and mostly ignored the political news.

In general, equity markets will be sensitive to the business cycle and policy. We don't expect a recession over the next three to four quarters. If the Fed overtightens, which will be an increasing risk next year, a recession is possible. For now, we expect the FOMC to move slowly on rates and avoid a policy error. In terms of fiscal and regulatory policy, the equity markets have already received support in the form of corporate tax cuts, additional spending and deregulation. At the same time, we have seen some weakness develop on fears of a wider trade war. If congressional investigations slow the trade conflict, we could see the bull market in equities not only continue but gain strength.

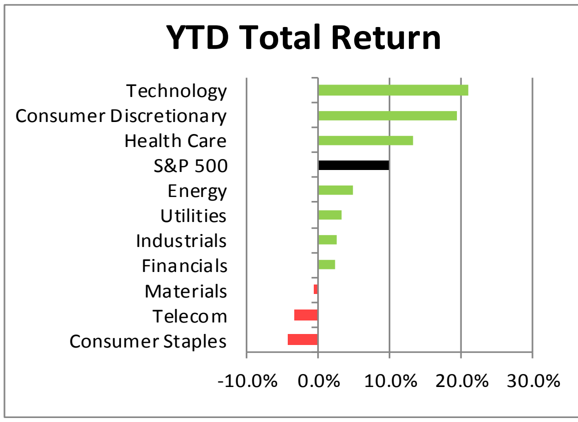
Debt markets: If trade impediments don't increase and the Fed continues to raise rates, the odds of higher interest rates will increase. Political turmoil may lead to some flight-to-safety buying for Treasuries, but credit spreads could widen as a result. Overall, we could see the 10-year Treasury yield move toward 3.15% but would not expect it to move much above that level.

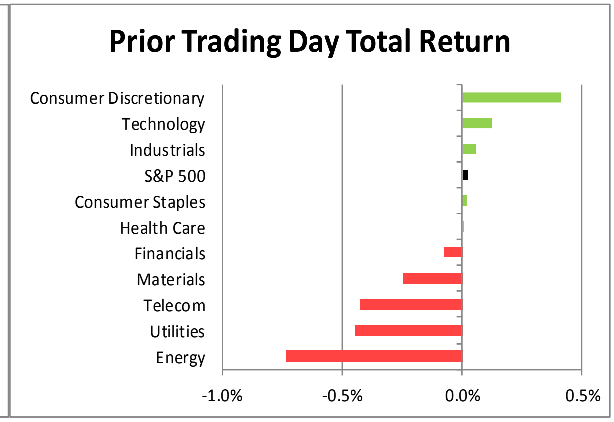
Currencies: The dollar is probably the most vulnerable of all the asset classes. On a parity basis, the dollar is overvalued (our parity against the EUR is approximately $1.3050) and has been rallying mostly on trade worries. If the U.S. puts up broad trade barriers, we would expect foreign nations to depreciate their currencies in order to offset the price increases triggered by the tariffs. When President Trump appeared ready to apply trade restrictions globally, the dollar rallied. However, the recent deal on NAFTA and the détente with the EU suggests that the administration's real goal may be to contain China. If so, the dollar could weaken; political turmoil might accelerate that trend. A weaker dollar would tend to benefit international investments, U.S. large caps and commodities.

The political situation will not be the only factor affecting market behavior. For equities, earnings and the overall economy will still be significant. Political peace coupled with a recession would still be bearish for stocks. The above discussion addresses the likely impact of the unfolding political situation. The bottom line is that our position, for now, is that the current political situation, by itself, probably won't be a major market-moving event.

Data Section

U.S. Equity Markets – (as of 8/31/2018 close)

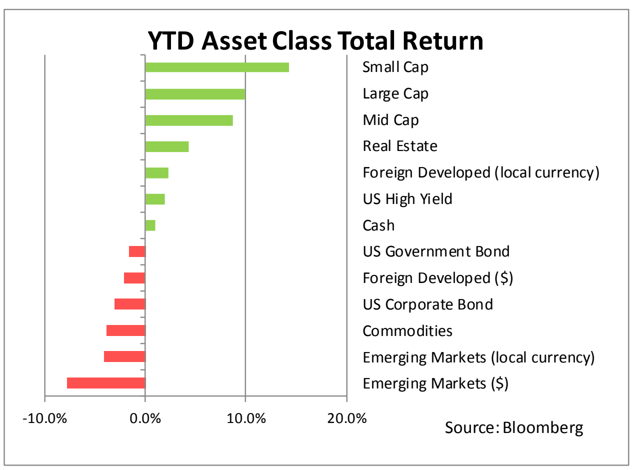




(Source: Bloomberg)

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 8/31/2018 close)

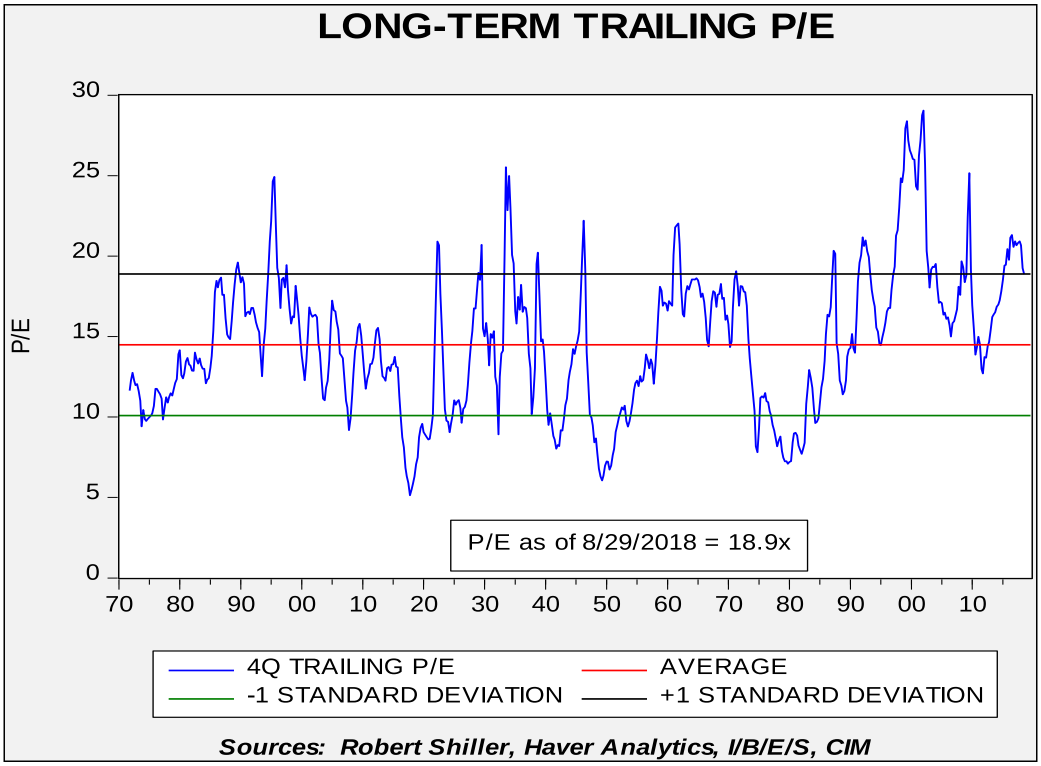


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

August 30, 2018



Based on our methodology,[11] the current P/E is 18.9, unchanged from last week.

[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 three actual quarters (Q4, Q1 and Q2) and one estimate (Q3). 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.