Daily Comment

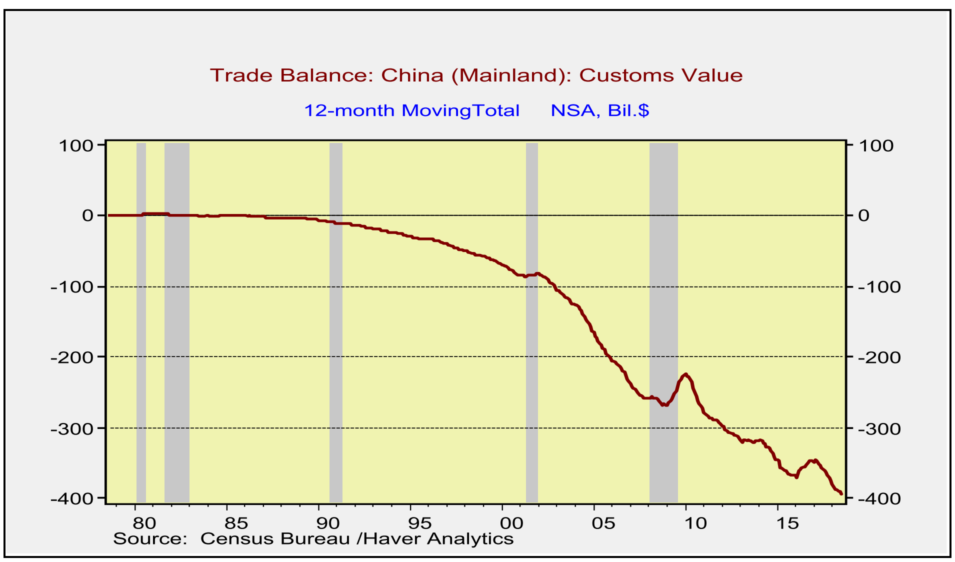
By Bill O'Grady and Thomas Wash

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: September 6, 2018—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is unchanged from the last close. In Asia, the MSCI Asia Apex 50 was down 0.9% from the prior close. Chinese markets were down, with the Shanghai composite down 0.5% and the Shenzhen index down 0.7%. U.S. equity index futures are signaling a lower open.

For financial markets, it's fairly quiet (especially compared to the political turmoil in Washington) with EM still coming under pressure. Here is what we are watching today:

New Chinese tariffs? One of the effects of the Woodward book and yesterday's anonymous editorial is that there appears to be some distraction on trade. Today is the deadline for deciding on new Chinese tariffs; these would be an additional $200 bn in size.[1] There doesn't appear to be any talks of substance underway and we do expect some kind of announcement today. Anything less than $200 bn at 25% would likely be taken as bullish by equities. If a tariff announcement is made, we would expect China to retaliate, although China is starting to approach limits to what it can do because of the trade disparity. And, as yesterday's data showed, the goods deficit with China continues to widen. On a rolling-12 month basis, the deficit is $393.5 bn.



[1] https://www.reuters.com/article/us-usa-trade-china-analysis/as-next-round-of-u-s-tariffs-on-china-looms-both-sides-dig-in-idUSKCN1LM0YN

NAFTA: According to reports, U.S. and Canadian negotiators made progress in NAFTA discussions.[2] If an agreement is reached, it would be bullish for equities.

Government shutdown? Although Congressional Republicans appear cool to the idea, President Trump seems open to shutting down the government to force funding for a border wall.[3] Government funding is set to lapse on September 30. A government shutdown could further undermine the GOP's chances to retain the House. For financial markets, we would not expect too much of a reaction. Shutdowns in the past have been bullish for Treasuries and bearish for equities but, given that we have seen a few of these now, the financial markets will likely look beyond the initial event and assume a timely resolution.

Another North Korean thaw? Kim Jong-un was quoted as saying he wants to achieve Korean peninsula denuclearization by the end of President Trump's first term.[4] President Trump responded positively. Our take on the overall negotiations is that Kim would like to improve relations with the U.S. in order to be less dependent on China. We note that China has openly flouted sanctions[5] in the aftermath of SoS Pompeo's recent difficult talks with North Korean officials. Beijing does not want a thaw between the U.S. and North Korea; a potentially hostile power on its border would be an unwelcome development. At the same time, Pyongyang does not want to denuclearize without getting something substantial in return. Normalization of relations and the chance to see better economic growth are probably minimum requirements.

Italian populists blink: The leadership in Italy has indicated it will adhere to EU fiscal constraints.[6] Until these comments, Italy appeared ready to challenge the EU and expand beyond the 3% deficit/GDP limit. However, rising Italian yields appear to have sent a message to the government and this climb down is likely designed to reduce Italy's borrowing costs.

India and Iranian oil: U.S. and Indian officials are in talks regarding Iranian oil imports.[7] The U.S. is implementing sanctions on Iran and is pressing all of Iran's export customers to cease buying Iran's oil. India has indicated it will likely continue to purchase Iran's oil but is probably willing to make concessions to the U.S. and at least reduce imports from Iran. If the U.S. is successful in that effort, it will put further pressure on the Iranian regime.

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[2] https://www.reuters.com/article/us-trade-nafta/nafta-talks-make-progress-u-s-canadian-officials-to-work-into-night-idUSKCN1LL0CM

[3] https://www.politico.com/story/2018/09/05/government-shutdown-conservatives-border-wall-807989

[4] https://www.reuters.com/article/us-northkorea-southkorea/north-koreas-kim-says-wants-to-denuclearize-in-trumps-first-term-seoul-idUSKCN1LM07M

[5] https://www.nbcnews.com/news/north-korea/china-eases-economic-pressure-north-korea-undercutting-trump-admin-n906166

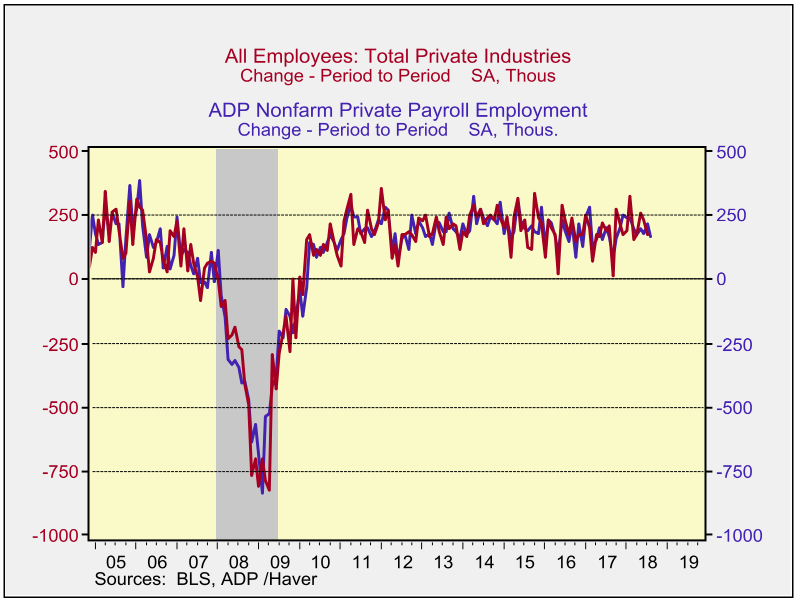
[6] https://www.politico.eu/article/matteo-salvini-italy-eurozone-softens-tone-pledges-to-respect-eu-deficit-rule/?utm_source=POLITICO.EU&utm_campaign=5eb385e814-EMAIL_CAMPAIGN_2018_09_06_04_40&utm_medium=email&utm_term=0_10959edeb5-5eb385e814-190334489

[7] https://www.reuters.com/article/us-india-usa-iran/u-s-india-in-very-detailed-talks-about-halting-iran-oil-imports-state-department-official-idUSKCN1LM0FW

U.S. Economic Releases

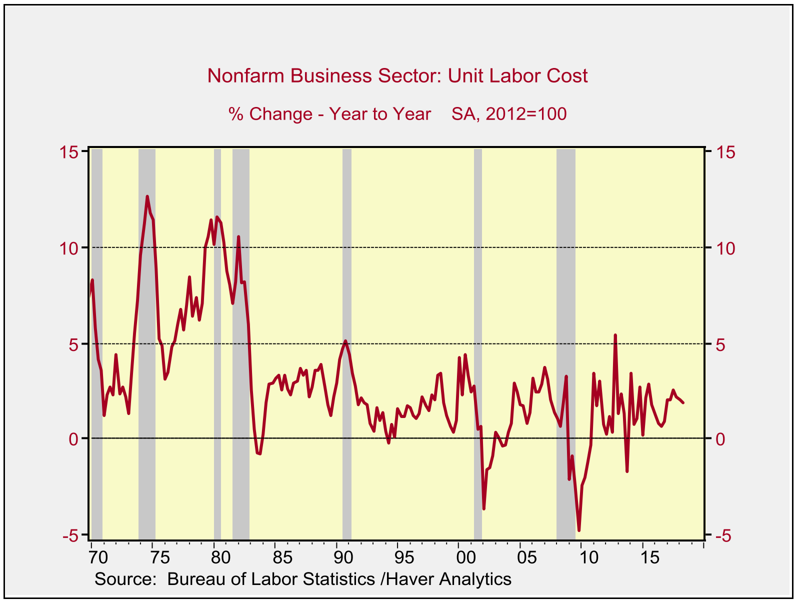
The May Challenger job cuts report rose by 13.7% from the prior year. The index measures the number of announced job cuts by employers, which is a proxy for future layoffs but does not necessarily indicate the state of current layoffs.

ADP employment change came in below expectations at 163k compared to the forecast of 200k. The prior report was revised downward from 219k to 217k.



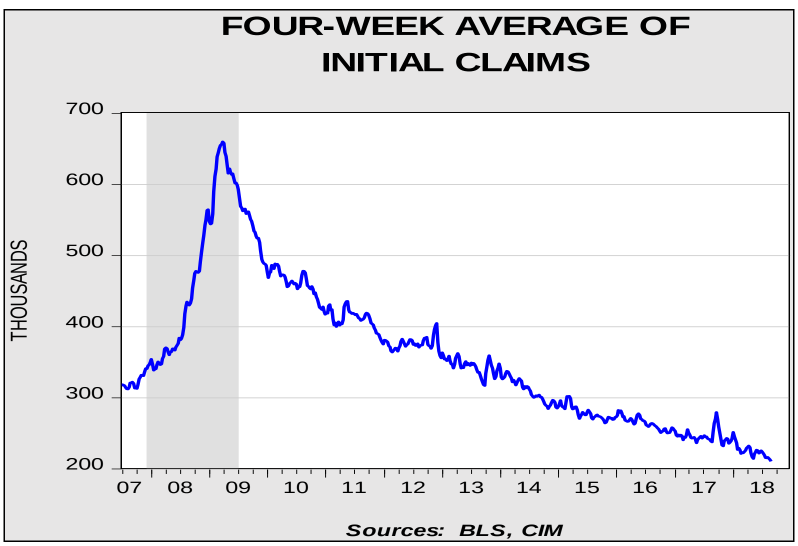
The chart above shows the change in ADP employment and private payrolls. A high ADP employment change number signals a strong BLS non-farm payroll report for Friday.

Non-farm productivity came in below expectations, rising 2.9% from the prior quarter compared to the forecast gain of 3.0%. Unit labor costs came in below expectations, falling 1.0% from the prior quarter compared to the forecast drop of 0.9%.



The chart above shows yearly changes in unit labor costs.

Initial jobless claims in below expectations at 203k compared to the forecast of 213k. Claims are at their lowest level since 1969.



The chart above shows the four-week moving average for initial claims. The four-week moving average fell from 212.25k to 209.5k.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Consumer Comfort	m/m	sep		58.3	**
9:45	Markit US Services PMI	m/m	aug	55.2	55.2	**
9:45	Markit US Composite PMI	m/m	aug		55.0	**
10:00	ISM Non-Manf. Composite	m/m	aug	56.8	55.7	**
10:00	Factory Orders	m/m	jul	-0.6%	0.7%	**
10:00	Factory Orders ex Trans	m/m	jul		0.4%	**
10:00	Durable Goods Orders	m/m	jul	-1.7%	-1.7%	**
10:00	Durable Goods Orders ex Transportation	m/m	jul		0.2%	**
10:00	Cap Goods Orders Nondef Ex Air	m/m	jul		1.4%	**
10:00	Cap Goods Ship Nondef Ex Air	m/m	jul		0.9%	**
Fed speakers or events						
EST	Speaker or event	District or position				
10:00	John Williams Speaks at University of Buffalo	President of the Federal Reserve Bank of San Francisco				

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	Japan buying foreign bonds	m/m	aug	¥543.4 bn	¥235.5 bn		*	Equity and bond neutral
	Japan buying foreign stocks	m/m	aug	¥186.1 bn	-¥60.9 bn		*	Equity and bond neutral
	Foreign buying Japan bonds	m/m	aug	-¥9.2 bn	-¥14.5 bn		*	Equity and bond neutral
	Foreign buying Japan stocks	m/m	aug	-¥4.6 bn	-¥334.9 bn		*	Equity and bond neutral
Australia	Trade Balance	m/m	jul	A$1.551 bn	A$1.873 bn	A$1.450 bn	**	Equity bullish, bond bearish
New Zealand	QV House Prices	y/y	aug	4.8%	5.1%		**	Equity and bond neutral
EUROPE								
Germany	Factory Orders	m/m	jul	-0.9%	-4.0%	1.8%	**	Equity bearish, bond bullish
	Markit Germany Construction	m/m	aug	51.5	50.0		**	Equity bullish, bond bearish
Switzerland	GDP	y/y	2q	3.4%	2.2%	2.4%	***	Equity bullish, bond bearish
Russia	CPI	y/y	aug	3.1%	2.5%	3.1%	***	Equity and bond neutral
	CPI Core	y/y	aug	2.6%	2.4%	2.6%	***	Equity and bond neutral
AMERICAS								
Mexico	Consumer Confidence	m/m	aug	103.9	105.0	102.6	***	Equity bullish, bond bearish
Canada	Markit Brazil PMI Composite	m/m	2q	47.8	50.4		**	Equity bearish, bond bullish
	Markit Brazil PMI Services	m/m	jul	46.8	50.4		**	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)	232	232	0	Up
3-mo T-bill yield (bps)	209	209	0	Neutral
TED spread (bps)	24	22	2	Neutral
U.S. Libor/OIS spread (bps)	212	211	1	Up
10-yr T-note (%)	2.90	2.90	0.00	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	13	14	-1	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	flat			Neutral
yen	up			Neutral
pound	up			Neutral
franc	up			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Canada Rate Decision	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	$77.52	$77.27	0.32%	
WTI	$68.83	$68.72	0.16%	
Natural Gas	$2.79	$2.80	-0.21%	
Crack Spread	$17.85	$17.58	1.56%	
12-mo strip crack	$20.76	$20.69	0.34%	
Ethanol rack	$1.45	$1.46	-0.31%	
Metals				
Gold	$1,205.08	$1,196.73	0.70%	Uncertainty in Emerging Markets
Silver	$14.26	$14.19	0.50%	
Copper contract	$265.80	$261.00	1.84%	
Grains				
Corn contract	$ 364.75	$ 365.25	-0.14%	
Wheat contract	$ 520.00	$ 521.75	-0.34%	
Soybeans contract	$ 838.75	$ 838.00	0.09%	
Shipping				
Baltic Dry Freight	1477	1513	-36	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.8		
Gasoline (mb)		-1.8		
Distillates (mb)		0.5		
Refinery run rates (%)		-0.35%		
Natural gas (bcf)		61.0		

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 weakened into a depression and is currently moving toward Arkansas. In addition, Hurricane Florence continues to gain strength and is expected to make landfall in Bermuda on Tuesday.

__**Asset Allocation Weekly Comment**__

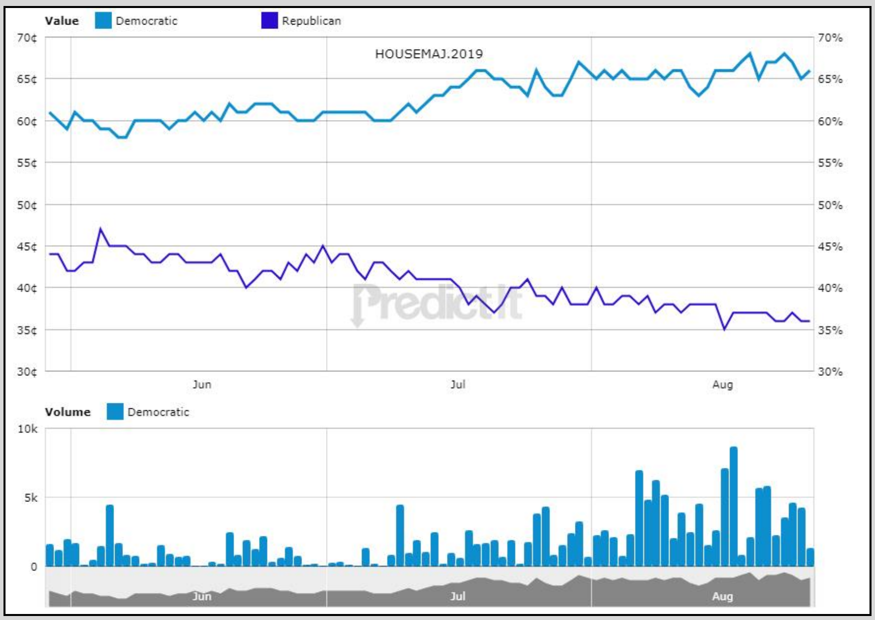
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

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%.[8]

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,[9] there will be a plethora of potential areas to examine. Because of this distraction, we

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[8] https://www.predictit.org/Market/2703/Which-party-will-control-the-Senate-after-2018-midterms

[9] 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.

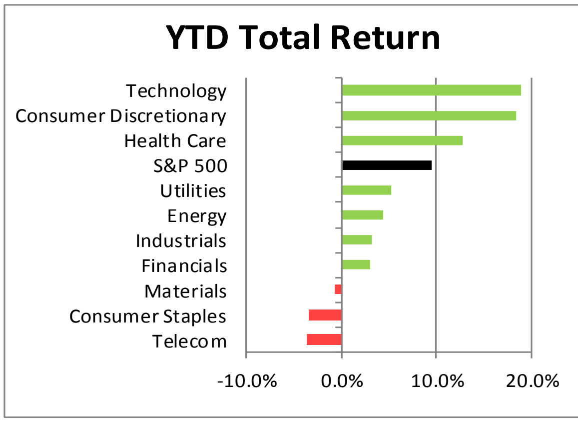
Debt markets: If trade impediments don't increase and the Fed continues to raise rates, the odds of higher interest rates will increase. Political turmoil may lead to some flight-to-safety buying for Treasuries, but credit spreads could widen as a result. Overall, we could see the 10-year Treasury yield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

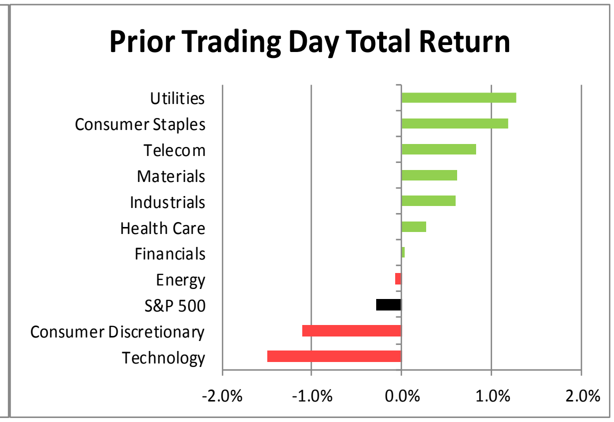
Currencies: The dollar is probably the most vulnerable of all the asset classes. On a parity basis, the dollar is overvalued (our parity against the EUR is approximately $1.3050) and has been rallying mostly on trade worries. If the U.S. puts up broad trade barriers, we would expect foreign nations to 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 9/5/2018 close)

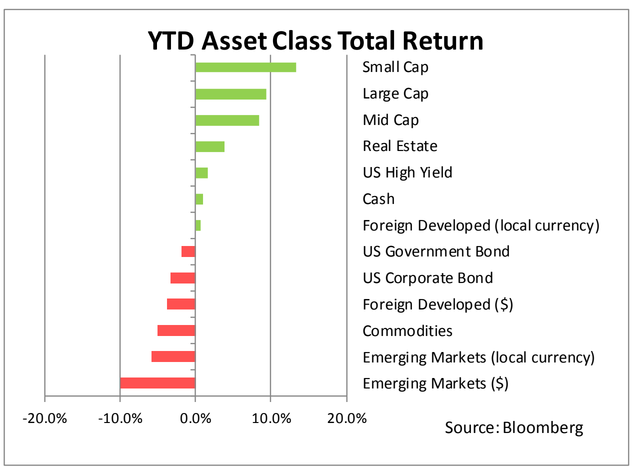




(Source: Bloomberg)

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 9/5/2018 close)

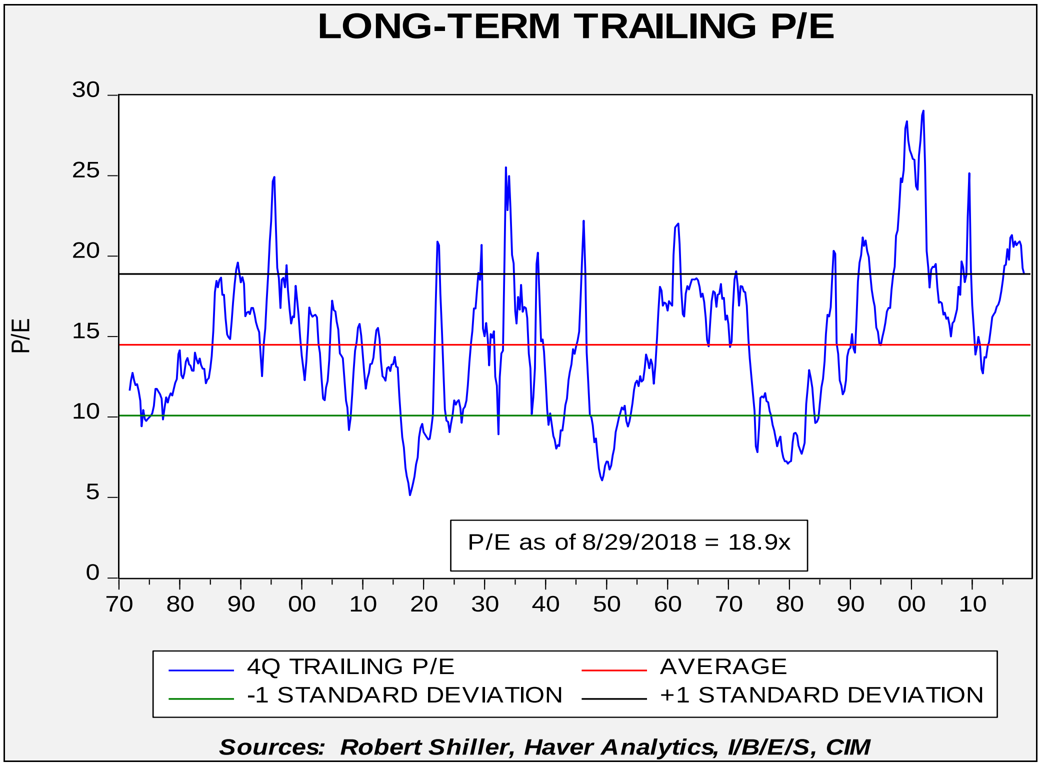


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[10] the current P/E is 18.9, unchanged from last week.

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[10] 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.