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 7, 2018—9:30 AM EDT] Global equity markets are generally mixed this morning. The EuroStoxx 50 is down 0.4% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.2% from the prior close. Chinese markets were up, with the Shanghai composite up 0.4% and the Shenzhen index up 0.1%. U.S. equity index futures are signaling a lower open.

It's employment Friday. We cover the data in detail below, but the quick take is that labor markets are tightening. Although the unemployment rate rose, both the labor force and underemployment fell. August can have seasonal adjustment issues (it can be difficult to capture school/employment flows) and thus we will likely see revisions. The financial markets are taking the data as evidence of overheating, likely due to the faster than expected rise in wages. Interest rates are higher, the dollar is stronger and equity values have declined. Here are the other items we are watching today:

Brexit optimism: Comments suggesting some degree of thaw between the EU and the U.K. sent the GBP higher this morning. EU negotiators indicated that a modified border in Northern Ireland could be workable. Earlier in the week, Chancellor Merkel called for compromise and relaxing the border issue would be an important step in that direction. If there were a hard Brexit with no deal, border checks on the Ireland/Northern Ireland frontier would return and potentially increase tensions between Protestants and Catholics that have rocked the region for decades.

Brazilian elections: Brazil will hold its first round of presidential elections on October 7. On October 28, there will be a run-off to determine a majority for president. This election season has been quite unusual. For example, the leading candidate, former president Lula da Silva, cannot run...because he is incarcerated. Polls suggest he would capture around 35% of the first round's vote. His replacement, Fernando Haddad, is only polling at around 6%. And, he has come under investigation on corruption charges.[1] In another twist, the current official front-runner, Jair Bolsonaro, a hard-right-wing candidate, was stabbed at a campaign rally yesterday.[2] Initial reports suggested that Bolsonaro, currently polling at around 22%, was not seriously injured. However, these reports turned out to be inaccurate. According to his family,[3] Bolsonaro was in critical condition and is now listed as "stable" but in serious condition[4] after

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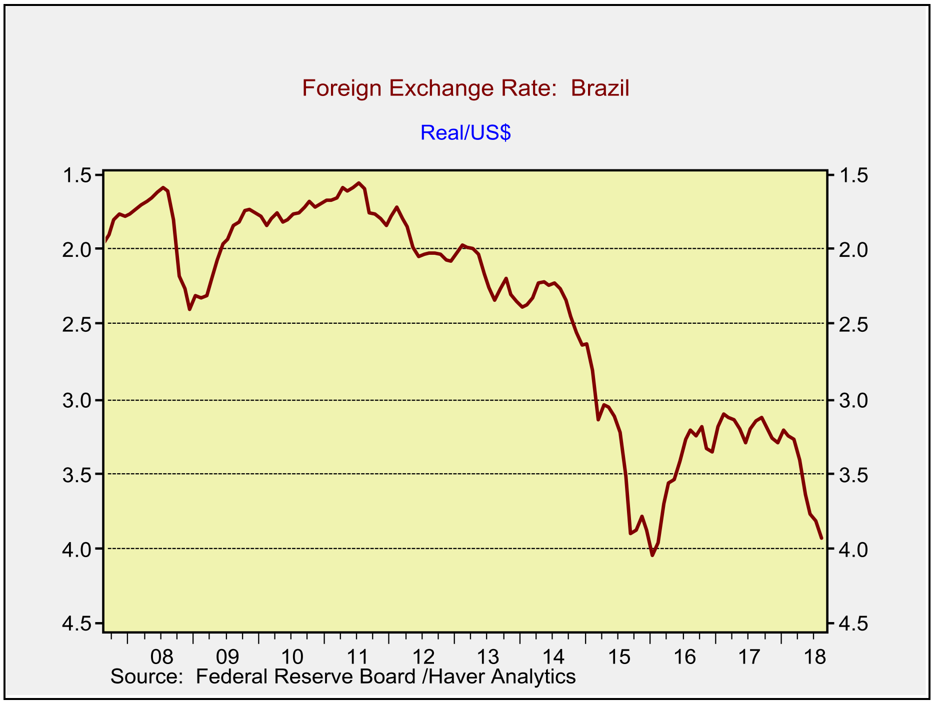
[1] https://www.ft.com/content/18918e34-b062-11e8-99ca-68cf89602132?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56
[2] https://mobile.reuters.com/article/amp/idUSKCN1LM2YJ?__twitter_impression=true
[3] https://twitter.com/FlavioBolsonaro?wpisrc=nl_todayworld&wpmm=1
[4] https://www.reuters.com/article/us-brazil-election-bolsonaro/brazil-far-right-candidate-bolsonaro-in-serious-condition-after-stabbing-idUSKCN1LM2YJ

treatment.[5] The Brazilian real has been under pressure recently, in part due to the disarray surrounding the upcoming election.



Trade: It doesn't look like we will get a NAFTA deal before the weekend but talks continue. Optimism remains that the U.S., the EU, Canada and Japan will reconcile differences. However, there is no sign of peace with China. We are past the deadline for implementing another round of tariffs with China, this tranche reportedly on $200 bn of imports with a 25% rate. We do expect an announcement at any time, although no timetable is in place. Once announced, we expect China to retaliate in kind. We may be seeing an evolving trade policy that is designed to focus on China. Reports from China suggest that is Beijing's take.

Social media under the gun: High-ranking executives from some of the most prominent social media firms have been testifying in the Senate over competition and free speech issues. Now, the DoJ is considering an investigation into the free speech and competition issues with these companies. Public scrutiny has been building against these tech giants for some time.[6] However, the momentum against them does appear to be increasing.

Threats to U.S. troops in Syria? Russia has warned U.S. military officials that Russian forces, combined with Syrian troops, are preparing an attack in an area where U.S. military personnel

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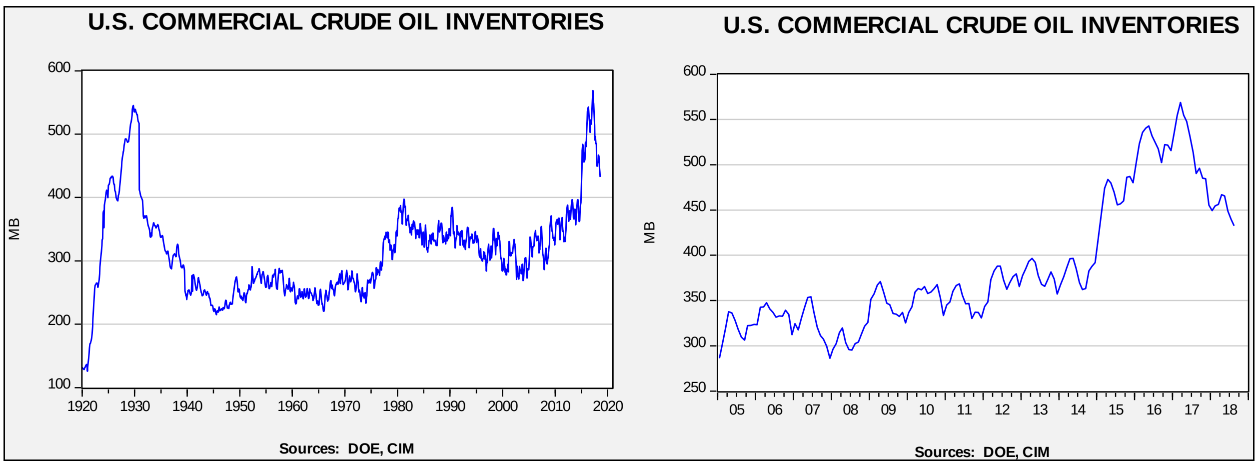
5 https://www.washingtonpost.com/world/the_americas/right-wing-brazilian-presidential-candidate-jair-bolsonaro-stabbed-while-campaigning/2018/09/06/62381332-b20b-11e8-8b53-50116768e499_story.html?utm_term=.9164938c7e22&wpisrc=nl_todayworld&wpmm=1
6 See our review of *The Four*. https://www.confluenceinvestment.com/research-news/reading-list/

are in place.[7] The region of concern is in southeastern Syria in an area called At Tanf. This is one of the two remaining strongholds of rebel troops in Syria, the other being Idlib (which will be the topic of next week's WGR). Although we doubt Russian troops would directly attack American soldiers, it could create a major international crisis if they do.

Swedish elections:[8] The Swedes go to the polls on Sunday in what has been a very divisive election season. For most of the postwar era, Sweden has been dominated by a center-left coalition led by the Social Democrats. This party and its coalition partners are currently polling at 40.2%. Center-right parties, the traditional opposition, are polling at 37.7%. The major change has come from the Sweden Democrats, a populist, anti-immigration party, which is polling at 19% and was seeing support above 22% just a couple of weeks ago. The key issue appears to be immigration, which has been a critical issue in the West in recent years. Neither the center-right nor center-left has indicated it would allow the Sweden Democrats to join in a coalition but a strong showing by this populist party will make it difficult to put a majority coalition in place. If polls are accurate, Sweden will represent another example of the problem Western nations are facing in dealing with immigration.

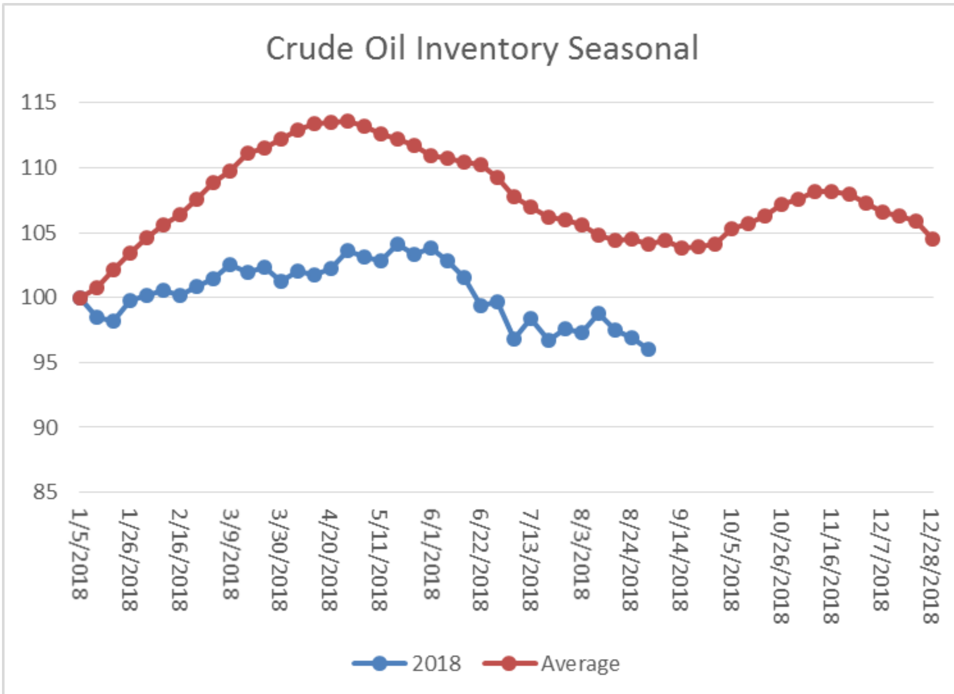
Energy recap: U.S. crude oil inventories fell 4.3 mb compared to market expectations of a 2.8 mb draw.



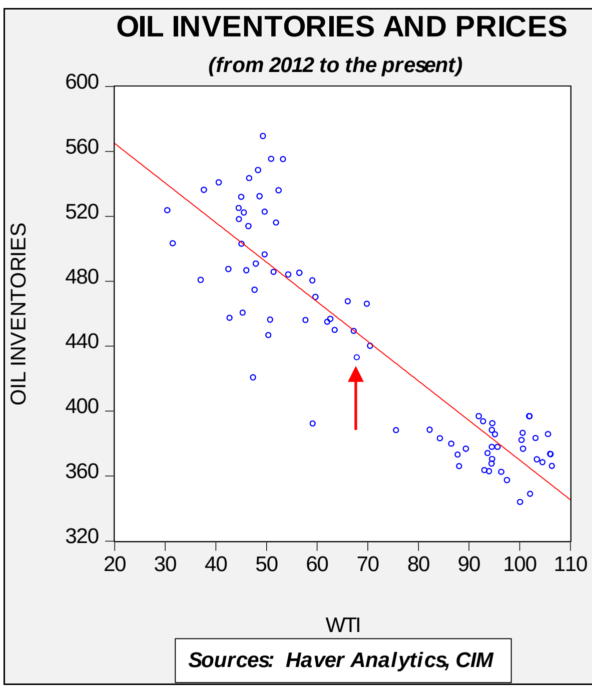
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but have declined significantly since March 2017. We would consider the overhang closed if stocks fall under 400 mb. This week's decline in inventories is in line with seasonal trends. Refinery utilization rose modestly to 96.6%, up 0.3% from last week. Oil production reached 11.0 mbpd.

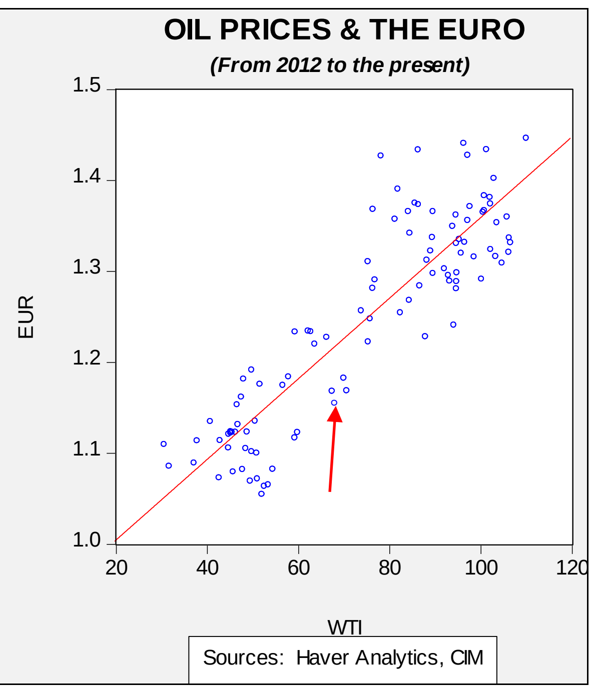
[7] https://amp.cnn.com/cnn/2018/09/06/politics/syria-russia-attack-warning-pentagon/index.html?__twitter_impression=true
[8] https://www.ft.com/content/63d25936-b199-11e8-8d14-6f049d06439c?emailId=5b91d7f20f6a6e000401f543&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22

As the seasonal chart below shows, inventories are late in the seasonal withdrawal period. This week's decline is normal but the size of the withdrawal was higher than usual. Over the next few weeks, we look for inventories to approach 400 mb, which would signal the end of the storage overhang that has developed over the past few years.



(Source: DOE, CIM)



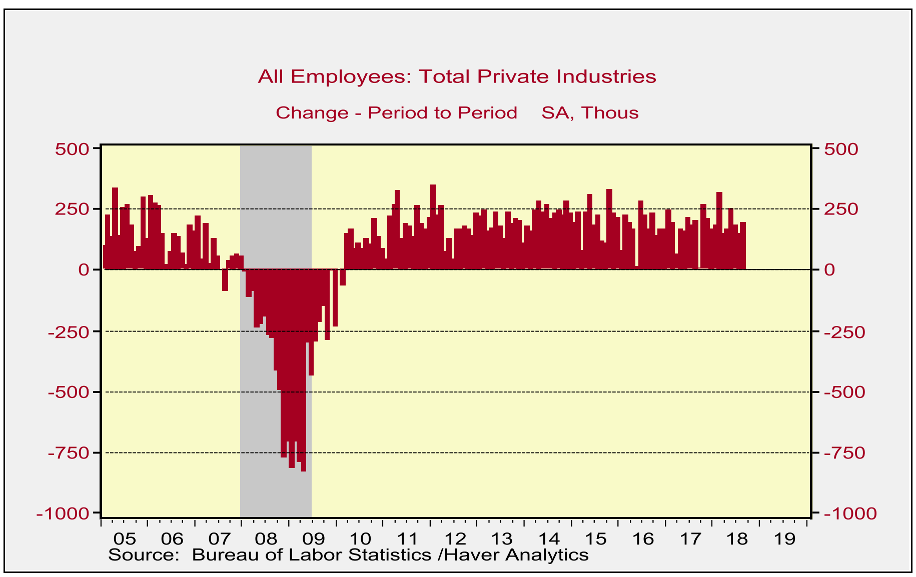


Based on inventories alone, oil prices are below fair value price at $73.62. Meanwhile, the EUR/WTI model generates a fair value of $58.13. Together (which is a more sound methodology), fair value is $63.12, meaning that current prices are well above fair value. However, the most bearish factor for oil is dollar strength. It will be difficult for oil prices to move higher without some reversal in the greenback.

A couple of items on the oil markets—first, Saudi Arabia is boosting its oil exports[9] to the U.S. in response to President Trump's pressure to reduce oil prices. This decision could lead to an interesting situation. If the Saudis sell more oil to the U.S., it could widen the spread between WTI and Brent, encouraging U.S. producers to export more U.S. oil. If the U.S. had adequate infrastructure in place, the Saudis' actions would certainly lead to a "merry-go-round" of oil flows. However, the U.S. doesn't yet have the infrastructure in place to make U.S. exports seamless, so the likely outcome is weaker WTI but stronger Brent. Second, the U.S is warning[10] European firms not to break sanctions with Iran. Washington threatens that the U.S. will retaliate against Europeans, perhaps denying them access to the U.S. financial system, if sanctions are not honored.

U.S. Economic Releases

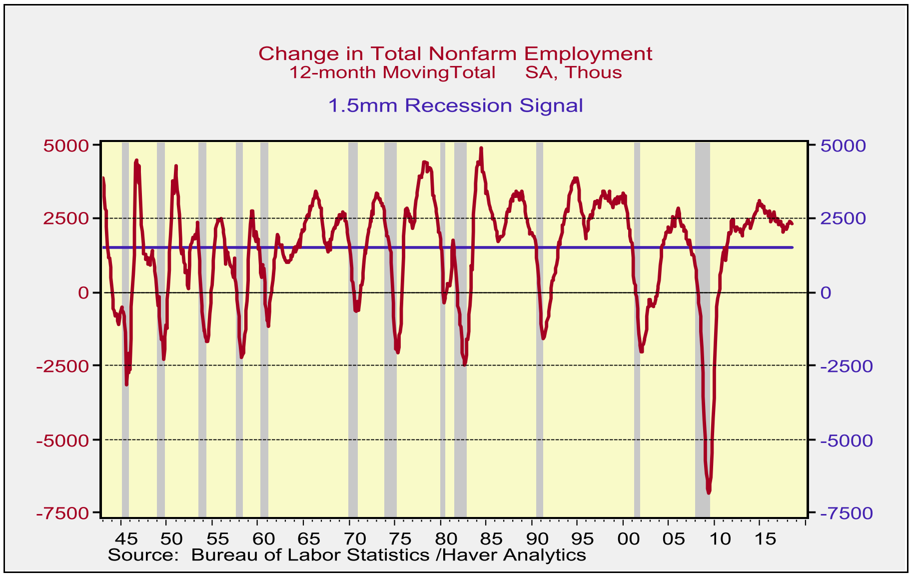
The change in non-farm payrolls for August came in above expectations at 201k compared to the forecast of 190k. The prior report was revised downward from 157k to 147k. The change in private payrolls came in above expectations at 204k compared to the forecast of 194k. The prior report was revised downward from 170k to 153k. The change in manufacturing payrolls was below expectations, falling by 3k compared to the forecast of a 23k gain.



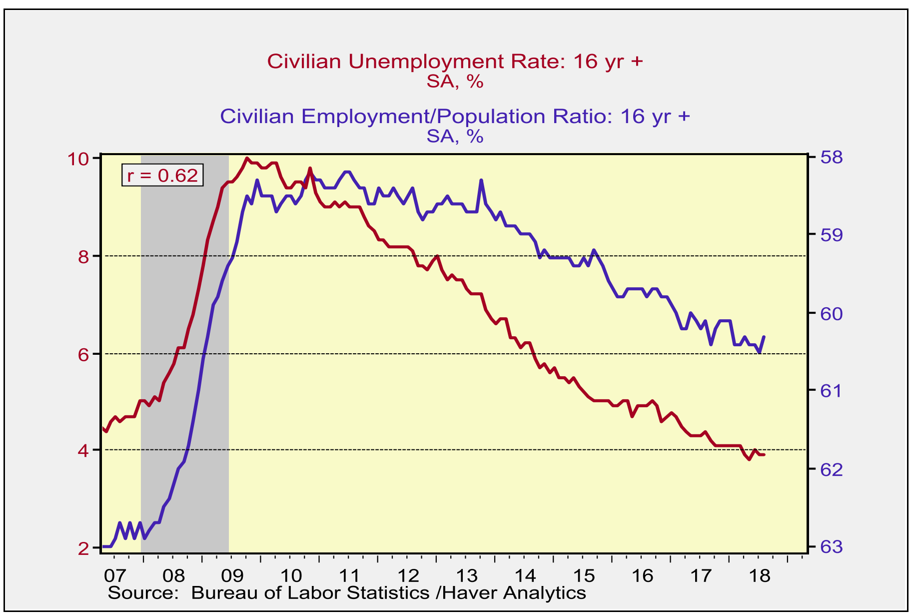
The chart above shows the change in total private employment. This chart suggests the economic expansion continues.

[9] https://www.worldoil.com/news/2018/9/7/saudis-ramp-up-oil-exports-to-the-us
[10] https://www.ft.com/content/f6edbfc8-b1ec-11e8-8d14-6f049d06439c?segmentId=a7371401-027d-d8bf-8a7f-2a746e767d56

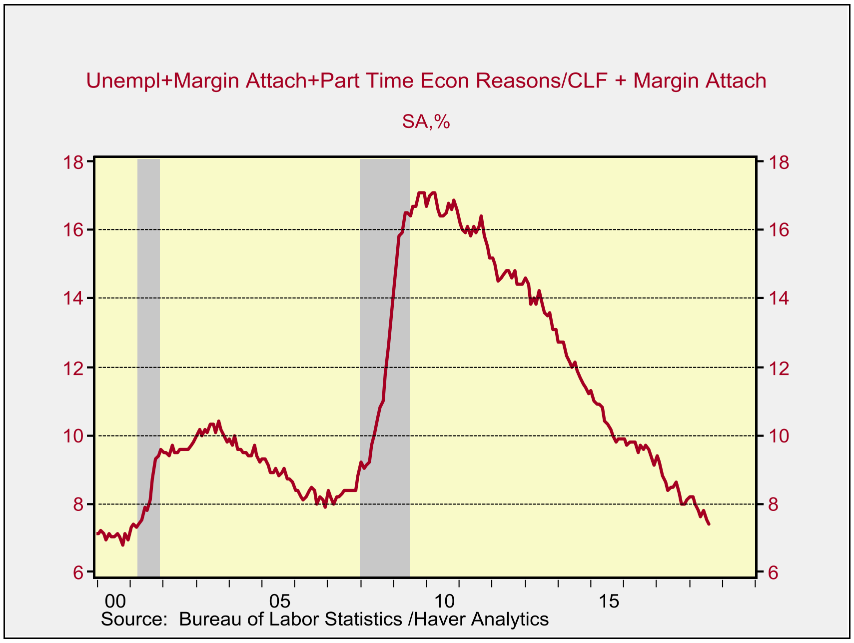
The chart below shows the 12-month moving total of the change in non-farm payrolls; a dip under 1.5 mm signals recession.



The unemployment rate came in worse than expectations at 3.9% compared to the forecast of 3.8%. The labor force participation rate was 62.7%, while the U-6 unemployment rate fell 10 bps from 7.5% to 7.4%.

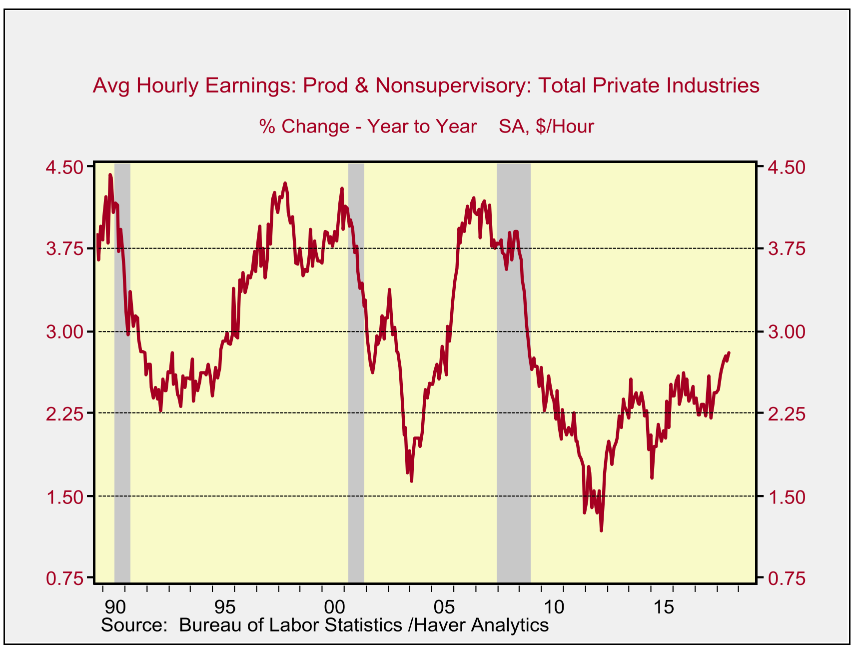


The chart above shows the relationship between the unemployment rate and the employment/population ratio. The divergence of the two variables has been one of the defining factors of this recovery and argues that labor market slack still remains.

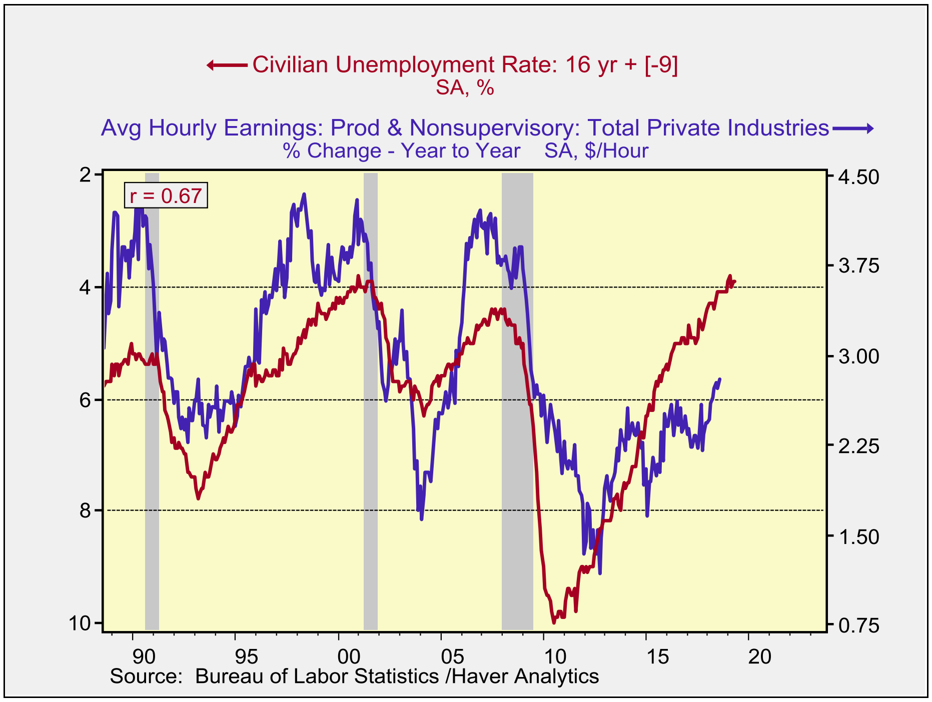


The chart above shows the underemployment rate, also referred to as the U-6 rate. This is a broader measure of unemployment and it's showing a tightening labor situation.

Average hourly earnings for all workers came in above expectations, rising 0.4% from the prior month compared to the forecast of 0.2%. The chart below shows the yearly change in overall wages for non-supervisory and production workers.



As mentioned, this chart shows the yearly growth in hourly earnings for production and non-supervisory workers. On an annual basis, wage growth for production and non-supervisory employees rose 2.8%, slightly higher than last month. Although wage growth remains modest relative to unemployment, the trend is unmistakable—wages are starting to rise.



This chart shows the unemployment rate and the yearly rise in wages. In the past, an unemployment rate below 4% would coincide with wage growth in excess of 3.75%. That hasn't happened yet, but it is worth noting that the unemployment rate tends to lead wage growth by about three quarters. Thus, the uptick in wages is notable because the relationship between these two variables suggests that wage growth should continue to rise.

As noted above, the market reaction is clear; there is fear of overheating. Treasury yields have jumped, equities are lower and the dollar is up. However, we do note that fed funds futures are not increasing the odds of rate hikes for the rest of the year and the two-year deferred Eurodollar futures are continuing to put the terminal fed funds rate at 3.00%. Thus, the data hasn't yet triggered expectations of tighter policy.

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

Economic Releases		
	No economic releases today	
Fed speakers or events		
EST	**Speaker or event**	**District or position**
12:45	Robert Kaplan Speaks at Energy Conference in Dallas	President of the Federal Reserve Bank of Dallas

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	Household Spending	m/m	jul	0.1%	-1.2%	-0.9%	**	Equity bullish, bond bearish
	Official Reserve Assets	m/m	aug	$1.259 tn	$1.256 tn		**	Equity and bond neutral
	Labor Cash Earnings	m/m	jul	1.5%	3.6%	2.4%	**	Equity bearish, bond bullish
	Real Cash Earnings	m/m	jul	0.4%	2.8%	1.1%	**	Equity bearish, bond bullish
	Leading index CI	m/m	jul	103.5	104.7	103.5	**	Equity and bond neutral
	Coincident Index	m/m	jul	116.3	116.4	115.7	**	Equity bullish, bond bearish
Australia	AiG Performance of Construction Index	m/m	aug	51.8	52.0		**	Equity and bond neutral
	Home Loans	m/m	jul	0.4%	-1.1%	-0.1%	**	Equity bullish, bond bearish
	Investment Lending	m/m	jul	-1.3%	-2.7%		**	Equity and bond neutral
	Owner-Occupier Loan Value	m/m	jul	1.3%	-1.0%		**	Equity bullish, bond bearish
EUROPE								
Eurozone	GDP	m/m	2q	2.1%	2.2%	2.2%	***	Equity and bond neutral
	Gross Fix Cap	m/m	2q	1.2%	0.5%	1.0%	**	Equity bullish, bond bearish
	Government Expenditure	y/y	2q	0.4%	0.0%	0.4%	**	Equity and bond neutral
	Household Consumption	y/y	2q	0.2%	0.5%	0.3%	**	Equity bearish, bond bullish
Italy	Retail Sales	y/y	jul	-0.6%	1.5%		**	Equity and bond neutral
Germany	Trade Balance	m/m	jul	16.5 bn	21.8 bn	19.5 bn	**	Equity bearish, bond bullish
	Current Account Balance	m/m	jul	15.3 bn	26.2 bn	20.0 bn	**	Equity bearish, bond bullish
	Industrial Production	m/m	jul	1.1%	2.5%	2.6%	***	Equity bearish, bond bullish
	Labor Costs	q/q	jul	2.0%	2.3%		**	Equity bearish, bond bullish
France	Trade Balance	m/m	jul	-3.490 bn	-6.248 bn	-5.739 bn	**	Equity bullish, bond bearish
	Current Account Balance	m/m	jul	0.500 bn	-2.300 bn		**	Equity bullish, bond bearish
	Budget Balance	m/m	jul	-82.8 bn	-58.9 bn		**	Equity and bond neutral
	Industrial Production	y/y	jul	1.8%	1.7%	1.0%	***	Equity bullish, bond bearish
	Manufacturing Production	m/m	jul	1.9%	1.6%	1.5%	***	Equity bullish, bond bearish
Switzerland	Unemployment Rate	m/m	aug	2.4%	2.4%	2.4%	***	Equity and bond neutral
Russia	Money Supply Narrow Def	y/y	aug	10.29 tn	10.36 tn		*	Equity and bond neutral
AMERICAS								
Mexico	Gross Fixed Investment	m/m	jun	1.4%	0.9%	2.2%	***	Equity bearish, bond bullish
Canada	Building Permits	m/m	jul	-0.1%	-2.3%	1.0%	**	Equity bearish, bond bullish
Brazil	IBGE Inflation IPCA	m/m	aug	-0.1%	0.3%	0.0%	***	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)	23	24	-1	Neutral
U.S. Libor/OIS spread (bps)	212	212	0	Up
10-yr T-note (%)	2.88	2.87	0.01	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	12	12	0	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	down			Neutral
pound	up			Neutral
franc	flat			Neutral

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	$76.61	$76.50	0.14%	
WTI	$67.87	$67.77	0.15%	
Natural Gas	$2.77	$2.77	-0.14%	
Crack Spread	$17.96	$17.79	0.97%	
12-mo strip crack	$20.65	$20.73	-0.41%	
Ethanol rack	$1.44	$1.45	-0.15%	
Metals				
Gold	$1,201.50	$1,199.98	0.13%	
Silver	$14.19	$14.15	0.24%	
Copper contract	$263.15	$263.65	-0.19%	
Grains				
Corn contract	$ 364.00	$ 366.25	-0.61%	
Wheat contract	$ 509.50	$ 513.75	-0.83%	
Soybeans contract	$ 837.00	$ 839.25	-0.27%	
Shipping				
Baltic Dry Freight	1484	1477	7	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-4.3	-2.8	-1.6	
Gasoline (mb)	1.8	-1.8	3.6	
Distillates (mb)	3.1	0.5	2.6	
Refinery run rates (%)	0.30%	-0.35%	0.65%	
Natural gas (bcf)	63.0	61.0	2.0	

Weather

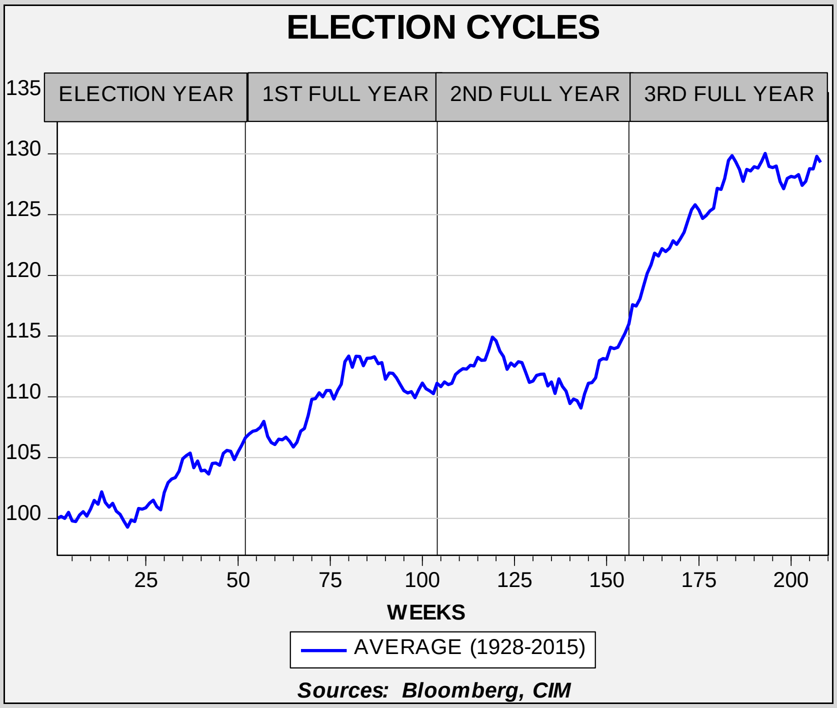
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps in the northwestern region. Precipitation is expected for the eastern region of the country. Tropical Storm Gordon has weakened into a depression and is currently moving across Arkansas. In addition, Hurricane Florence has weakened into a depression and is no longer expected to make landfall in Bermuda.

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.

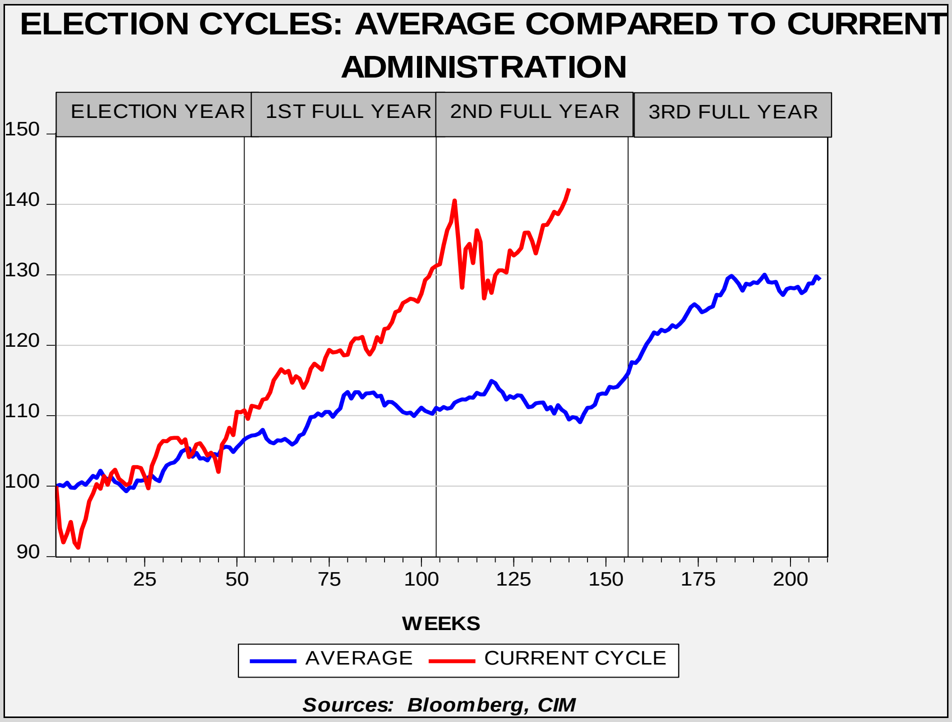
September 7, 2018

Traditionally, the election season kicks off with Labor Day so, with last Monday's holiday, the election cycle is upon us. The midterm election year tends to be lackluster for equities until Q4, when a strong rally usually develops.



The data for this chart is developed by taking the weekly closes for the S&P 500, beginning with the first Friday close in 1928. We index the data over the next four years and then average each week across each four-year cycle. Thus, this graph represents 22 cycles. The election occurs around week 48 in the election year. On average, the euphoria surrounding the election lasts until week 80 (into the summer of the year after the election) when equities become range-bound. Some of this pattern is probably due to the inevitable disappointment that a new administration can't implement all the changes it promised. By the midterm year (third full year), equities test the low end of the range into October then begin a multi-month rally that persists into the middle of the year after the midterms. Another range-bound pattern develops into the election year.

The following chart shows how the current administration compares to the average.

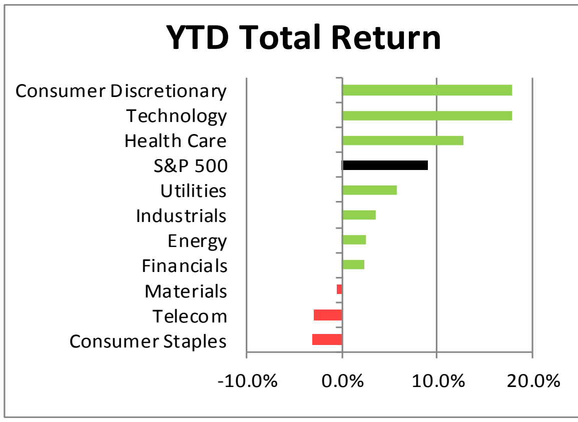


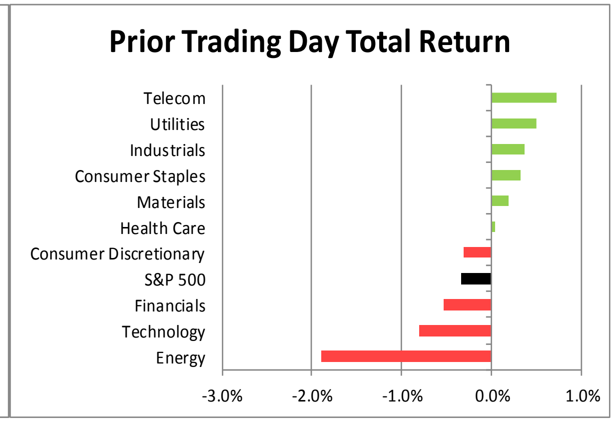
Clearly, the Trump administration has been popular with investors, especially during the first full year after the election. The tax cuts boosted equity prices into Q1 of this year. However, concerns about trade, tightening monetary policy and worries about the midterms have all likely conspired to bring a period of consolidation. Equities have improved recently, making new highs. The range-bound pattern that has emerged this year is consistent with the average election cycle pattern, albeit from a higher level.

The key question is whether we will see the typical midterm rally in Q4 through next summer. As we discussed last week, although there are worries about political turmoil in the wake of a potential change in power in Congress, the political situation, by itself, probably won't derail the bull market. The primary threat to the bull market is recession and the most likely culprit would be overly tight monetary policy. Given the current pattern of tightening, we don't expect that to be a problem until H2 2019. Thus, the pattern will probably hold but, given the recent strength in equities, we would not necessarily expect the usual 20% rise seen after the midterms. However, a more pedestrian rally of 5% to 10% would not be a surprise. To conclude, we do expect a post-midterm rally, perhaps less vigorous than average but a stronger equity market nonetheless.

Data Section

U.S. Equity Markets – (as of 9/6/2018 close)

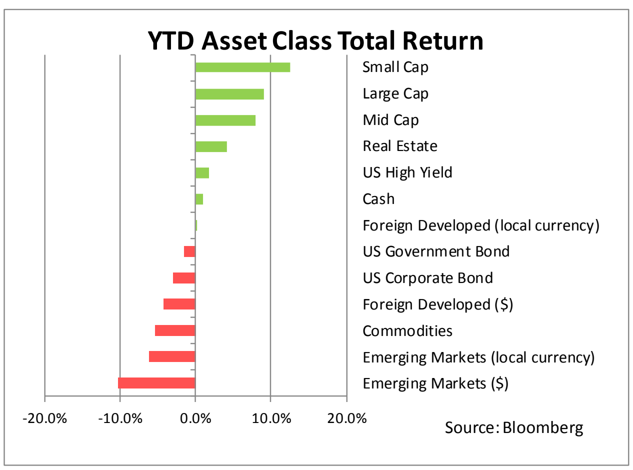




(Source: Bloomberg)

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 9/6/2018 close)

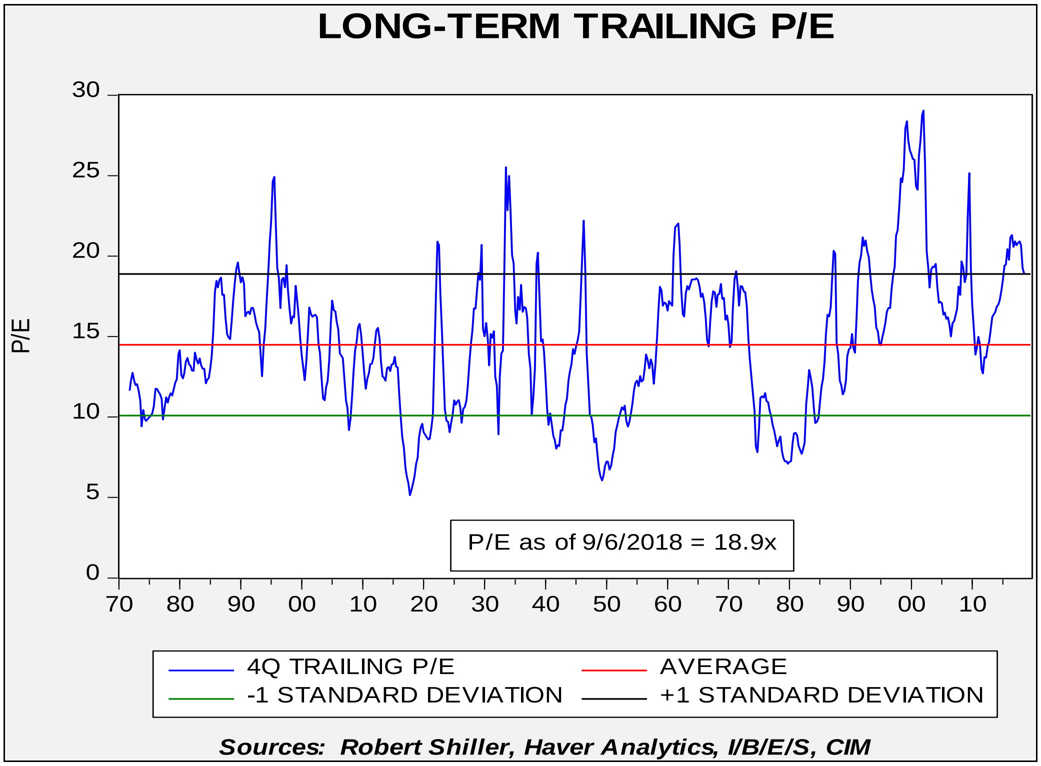


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

September 7, 2018



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

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[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.