

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 11, 2018—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 0.5% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.7% from the prior close. Chinese markets were mixed, with the Shanghai composite down 0.2% and the Shenzhen index up 0.2%. U.S. equity index futures are signaling a lower open.

It's a solemn day, the 17th anniversary of the 9/11 attacks. Here is what we are watching today:

Trade: Talks continue with Canada but reports suggest that dairy remains a major sticking point. China has asked the WTO for authorization to impose trade sanctions against the U.S., while the U.S. is considering sanctions on Chinese officials involved with the suppression of Uighurs.¹ The U.S. is offering a partial trade deal with the EU.² For the most part, the pattern emerging appears to be the creation of a united front of sorts against China. However, such a front would depend on Canada agreeing to a new NAFTA deal and trade reforms with the EU.³ Neither of these outcomes is guaranteed.

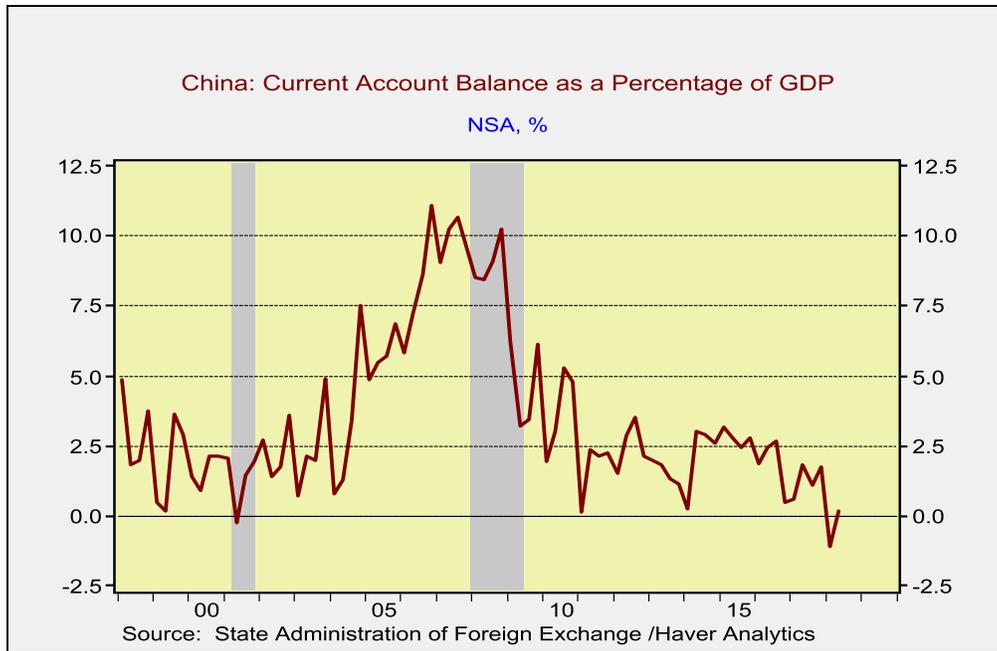
One trend we are seeing is that China is extending its reach by increased use of the CNY in international transactions.⁴ However, what we haven't seen yet is China opening its capital account for foreign investment in a manner consistent with a reserve currency. And, to become a real reserve currency, China would need to start running consistent current account deficits, which seems unlikely.

¹ <https://www.nytimes.com/2018/09/10/world/asia/us-china-sanctions-muslim-camps.html?action=click&module=Top%20Stories&pgtype=Homepage>

² <https://www.ft.com/content/c0b6bb52-b508-11e8-bbc3-ccd7de085ffe?emailId=5b97422fbb7cb7000439634a&segmentId=22011ee7-896a-8c4c-22a0-7603348b7f22>

³ https://www.nytimes.com/2018/09/10/business/europe-us-trade-lighthizer-malmstrom.html?emc=edit_mbe_20180911&nl=morning-briefing-europe&nid=567726720180911&te=1

⁴ <https://www.scmp.com/economy/article/2163421/us-china-trade-war-helping-boost-use-yuan-international-transactions>



A more likely outcome is the use of CNY in the “one belt, one road” zone, similar to Britain’s Commonwealth area that used the GBP for trade and investment.

Another North Korean summit? Reuters⁵ is reporting that Kim Jong-un has sent a “warm...positive” letter to President Trump asking for a second meeting. The White House is apparently looking for dates. Although meetings between SoS Pompeo and North Korean officials have been less than fruitful, there are hopes the leaders can forge an agreement. Our read is that Pyongyang is trying to free itself from China’s grip and thus the potential for a deal is probably higher than it looks.

Attacks in Syria: Our most recent WGR⁶ discusses those involved in the last major rebel stronghold in Syria. Although we expect the U.S. to remain mostly uninvolved in this likely attack, the Trump administration has held a strict line on chemical weapons use. Apparently, the U.S. is holding talks with the U.K. and France on coordinating attacks against Syrian forces if they deploy such weapons.⁷ Russia, consistent with its emerging doctrine on warfare, has already introduced reports that the U.S. and its allies plan to deploy chemical weapons in the region to provide an excuse for attacking Syrian troops.⁸

Brazil elections: In what remains one of the strangest election seasons we have seen, another twist emerged today. Luiz Inácio Lula da Silva has finally admitted he cannot run for president

⁵ <https://www.reuters.com/article/us-northkorea-usa/north-koreas-kim-asks-trump-for-another-meeting-in-very-warm-letter-idUSKCN1LQ2E3>

⁶ See WGR, [The Battle for Idlib](#) (9/10/18)

⁷ <https://www.wsj.com/articles/u-s-holds-talks-with-u-k-france-on-possible-syria-strikes-1536618235>

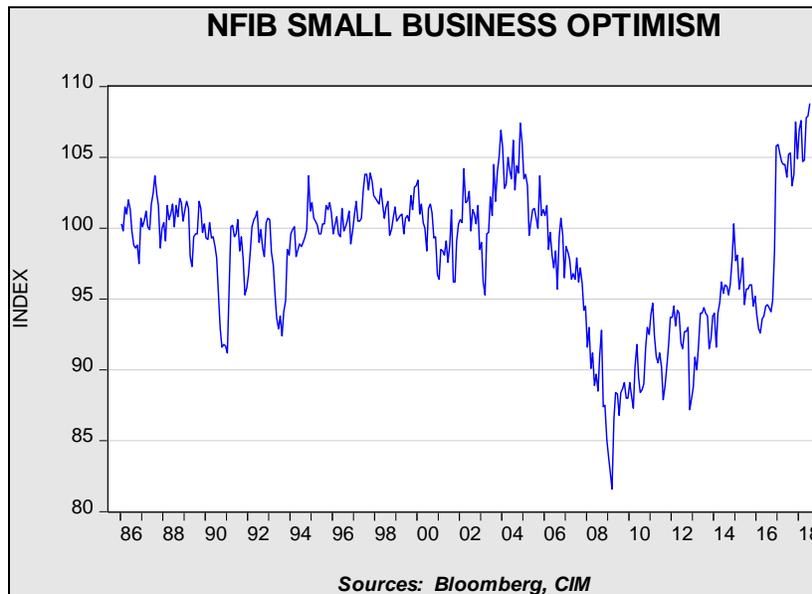
⁸ <https://www.telegraph.co.uk/news/2018/08/27/british-general-accuses-russia-ridiculous-propaganda-claims/>

from prison and has formally withdrawn from the race for president.⁹ Last week, we reported that the front-runner in the race, Jair Bolsonaro, had been assaulted and stabbed. Bolsonaro was seriously wounded in the attack and will likely require additional surgery. Interestingly enough, his poll numbers jumped after the incident.¹⁰

Florence, et al.: As we note below, Hurricane Florence¹¹ is bearing toward the Carolinas and is developing into a massive storm, likely reaching Category 4 by landfall on Friday (the storm has slowed from yesterday’s forecasts). This storm is looking like an extreme event, perhaps another Harvey. TS Isaac could make its way into the Gulf of Mexico (GOM), although its most likely path is into Central America. We are also monitoring a “blob”¹² between the Yucatan and Cuba that might develop into a tropical event. If this one does develop, it will likely disrupt oil and gas production in the GOM and could make it to the Texas coast.

U.S. Economic Releases

NFIB Small Business Optimism came in above expectations at 108.8 compared to the forecast of 108.0.



The chart above shows the NFIB Small Business Optimism level. The current reading sets a new record which suggests that small businesses are not worried about increased trade tensions.

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

⁹ <https://www.reuters.com/article/us-brazil-election/jailed-lula-to-bow-out-of-brazils-presidential-race-sources-idUSKCN1LR08N>

¹⁰ <https://www.ft.com/content/99d45bea-b547-11e8-bbc3-ccd7de085ffe>

¹¹ https://www.washingtonpost.com/amphtml/news/capital-weather-gang/wp/2018/09/09/florence-strengthens-to-hurricane-and-poses-extreme-threat-to-southeast-and-mid-atlantic/?_twitter_impression=true

¹² <https://www.wunderground.com/wundermap?lat=19.6&lon=-86.1&wxstn=0&satellite=1&hur=1>

Economic Releases							
EDT	Indicator			Expected	Prior	Rating	
10:00	JOLTS Job Openings	m/m	jul	6675	6662	**	
10:00	Wholesale Inventories	m/m	jul	0.7%	0.7%	**	
10:00	Wholesale Trade Sales	m/m	jul	0.1%	-0.1%	**	
Fed speakers or events							
EST	Speaker or event	District or position					
12:45	Lael Brainard Speaks in Cambridge, Massachusetts	Member of the Board of Governors					

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	Manpower Survey	q/q	4q	7.0%	10.0%		**	Equity and bond neutral
Japan	Money Stock M3	y/y	aug	2.5%	2.6%	2.6%	**	Equity and bond neutral
	Money Stock M2	y/y	aug	2.9%	3.0%	3.0%	**	Equity and bond neutral
	Manpower Survey	q/q	4q	26.0	26.0		**	Equity and bond neutral
	Tertiary Industry Index	m/m	jul	0.1%	-0.5%	0.1%	**	Equity and bond neutral
India	Manpower Survey	q/q	4q	13.0%	16.0%		**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	m/m	sep	116.2	117.7		**	Equity and bond neutral
	Manpower Survey	q/q	4q	15.0%	8.0%		**	Equity and bond neutral
	NAB Business Conditions	m/m	aug	15	12		**	Equity bullish, bond bearish
	NAB Business Confidence	m/m	aug	4	7		**	Equity and bond neutral
New Zealand	ANZ Truckometer Heavy	m/m	aug	1.1%	-0.4%		**	Equity and bond neutral
	Card Spending Retail	m/m	aug	1.0%	0.7%	0.5%	**	Equity bullish, bond bearish
	Card Spending Total	m/m	aug	1.1%	0.5%		**	Equity bullish, bond bearish
	Manpower Survey	q/q	4q	16.0%	7.0%		**	Equity bullish, bond bearish
EUROPE								
Eurozone	Employment	y/y	2q	1.5%	1.4%		**	Equity and bond neutral
Germany	ZEW Survey Current Situation	m/m	sep	76.0	72.6	72.0	**	Equity bullish, bond bearish
	ZEW Survey Expectations	m/m	sep	-10.6	-13.7	-13.0	**	Equity and bond neutral
France	Total Payrolls	m/m	jul	0.0%	0.2%	0.2%	***	Equity bearish, bond bullish
	Private Sector Payrolls	m/m	jul	0.1%	0.2%	0.2%	***	Equity bearish, bond bullish
U.K.	Claimant Count Rate	m/m	jul	2.6%	2.5%		***	Equity and bond neutral
	Jobless Claims Change	m/m	jul	8.7k	6.2k		***	Equity and bond neutral
	ILO Unemployment Rate	m/m	jul	4.0%	4.0%	4.0%	***	Equity and bond neutral
Russia	GDP	y/y	2q	1.9%	1.8%	1.8%	***	Equity bullish, bond bearish
AMERICAS								
Mexico	Nominal Wages	m/m	aug	5.5%	5.7%		**	Equity and bond neutral
Canada	Bloomberg Nanos Confidence	m/m	sep	55.9	56.5		**	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)	233	233	0	Up
3-mo T-bill yield (bps)	210	210	0	Neutral
TED spread (bps)	24	22	2	Neutral
U.S. Libor/OIS spread (bps)	213	213	0	Up
10-yr T-note (%)	2.95	2.93	0.02	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	13	12	1	Down
Currencies	Direction			
dollar	up			Neutral
euro	flat			Neutral
yen	down			Neutral
pound	flat			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	\$78.00	\$77.37	0.81%	Weather Conditions
WTI	\$67.84	\$67.54	0.44%	
Natural Gas	\$2.80	\$2.80	0.00%	
Crack Spread	\$18.90	\$18.37	2.90%	
12-mo strip crack	\$21.40	\$21.02	1.79%	
Ethanol rack	\$1.43	\$1.43	-0.07%	
Metals				
Gold	\$1,194.47	\$1,195.88	-0.12%	
Silver	\$14.13	\$14.18	-0.32%	
Copper contract	\$262.90	\$262.80	0.04%	
Grains				
Corn contract	\$ 367.00	\$ 367.25	-0.07%	
Wheat contract	\$ 524.00	\$ 528.25	-0.80%	
Soybeans contract	\$ 847.75	\$ 845.25	0.30%	
Shipping				
Baltic Dry Freight	1482	1490	-8	
DOE inventory report				
	Actual	Expected	Difference	
Crude (mb)		-2.3		
Gasoline (mb)		0.8		
Distillates (mb)		2.0		
Refinery run rates (%)		-0.55%		

Weather

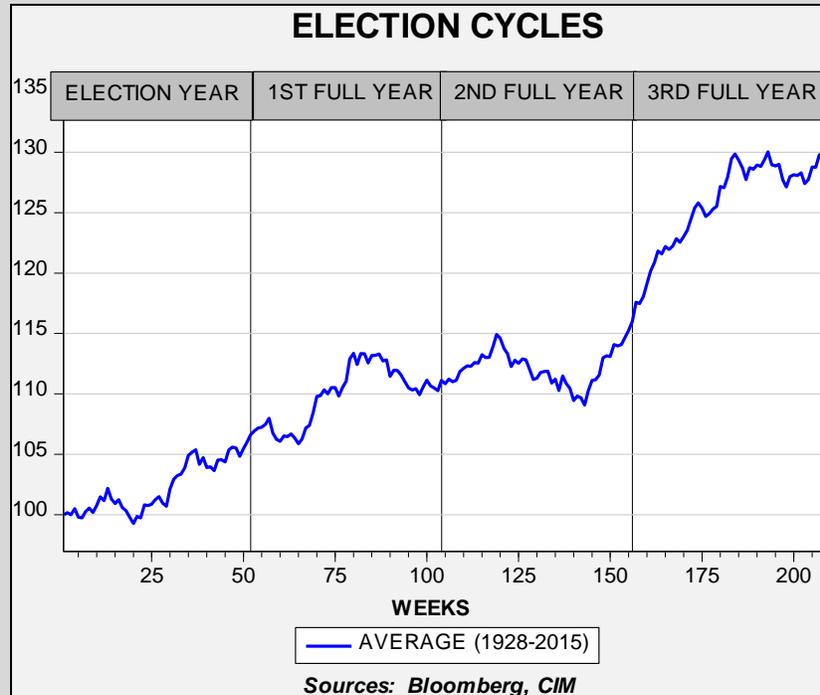
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps in the northwestern region. Precipitation is expected for the eastern region of the country. Hurricane Florence continues to gain strength and is expected to make landfall on the Carolina coast on Friday. Hurricane Isaac has been downgraded to a tropical storm and is expected to make landfall on Sunday. Hurricane Helene is still in the Atlantic, but is not a threat to touch down on land 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.

September 7, 2018

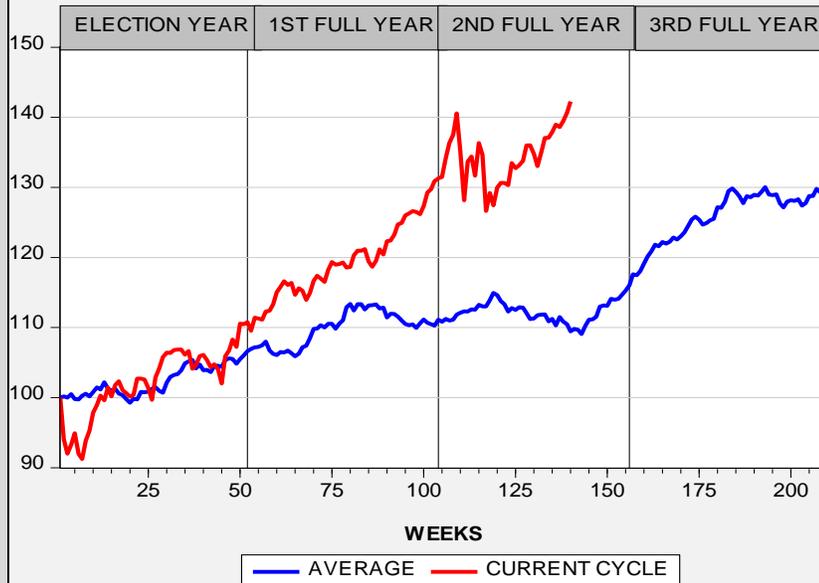
Traditionally, the election season kicks off with Labor Day so, with last Monday’s holiday, the election cycle is upon us. The midterm election year tends to be lackluster for equities until Q4, when a strong rally usually develops.



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.

ELECTION CYCLES: AVERAGE COMPARED TO CURRENT ADMINISTRATION



Sources: Bloomberg, CIM

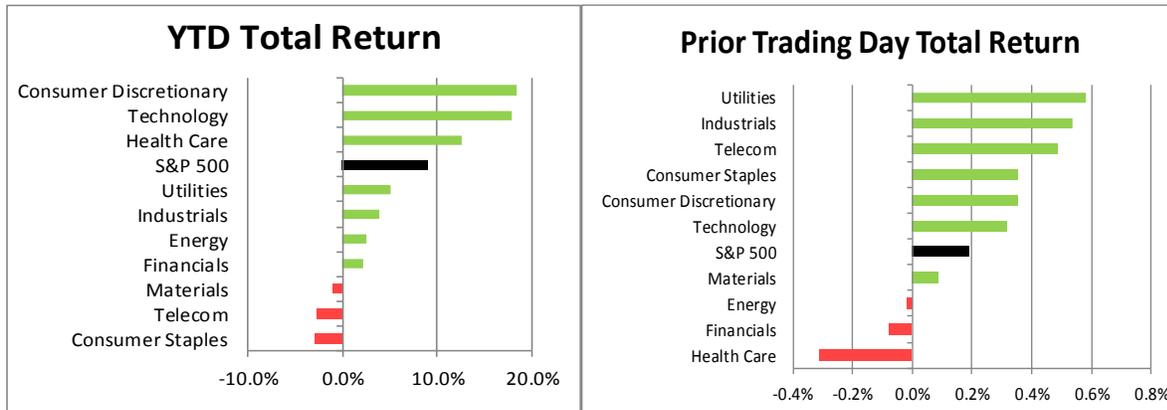
Clearly, the Trump administration has been popular with investors, especially during the first full year after the election. The tax cuts boosted equity prices into Q1 of this year. However, concerns about trade, tightening monetary policy and worries about the midterms have all likely conspired to bring 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.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

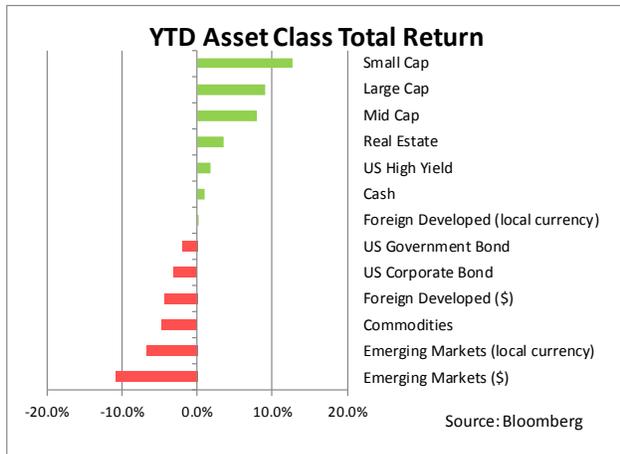
U.S. Equity Markets – (as of 9/10/2018 close)



(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 9/10/2018 close)



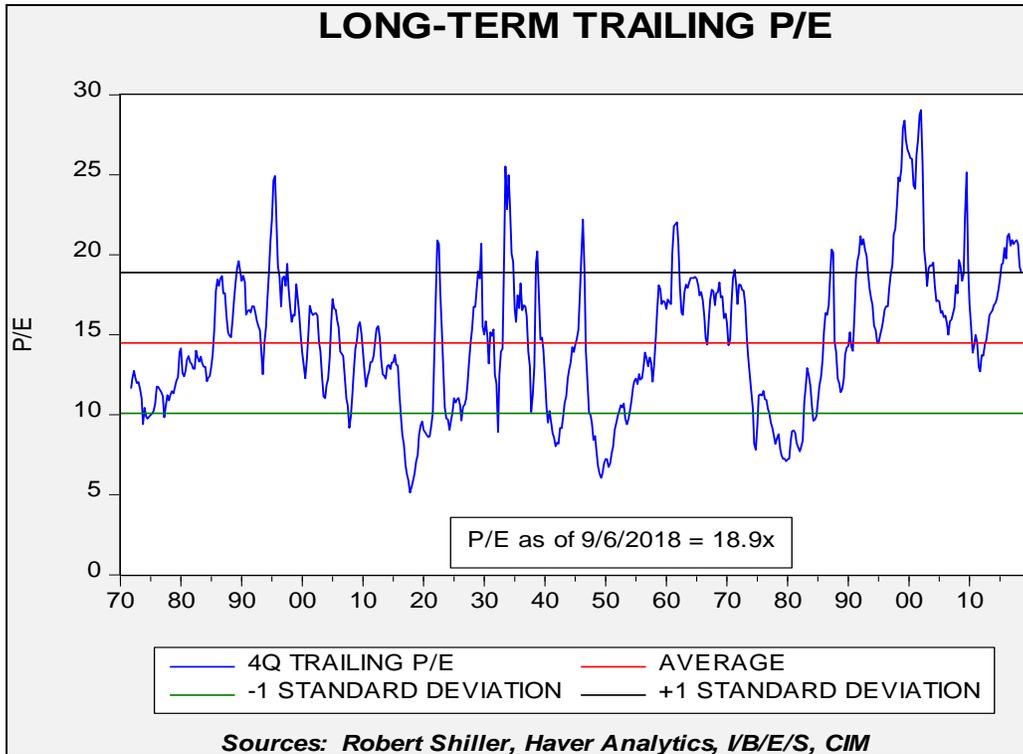
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,¹³ the current P/E is 18.9, unchanged from last week.

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.

¹³ 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.