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 12, 2018—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is up 0.2% from the last close. In Asia, the MSCI Asia Apex 50 was down 0.2% from the prior close. Chinese markets were down, with the Shanghai composite down 0.3% and the Shenzhen index down 0.4%. U.S. equity index futures are signaling a lower open.

Financial markets are mostly quiet this morning. PPI (discussed below) came in lower than expected. Here are the other items we are watching today:

EU pushes back against Hungary: With populists gaining political leverage in the EU, the establishment is fighting back and targeting Viktor Orban, the PM of Hungary. Orban has been aggressively promoting populism. He has erected barriers to African and Middle Eastern refugees, curtailed the domestic press and has described his government as "illiberal democracy." The European Parliament will vote today[1] on whether to suspend Hungary's voting rights within the EU. Sanctioning Hungary will require a "yes" vote from 28 leaders of nations in the EU, which might not be possible; it is not certain that Italy[2] will vote to sanction Hungary. The sanction vote, called "Article 7," is described in this reference.[3]

Trade: There does appear to be some progress on NAFTA. According to reports, Canada is willing to offer at least some degree of access to its dairy market.[4] The American business sector is beginning to ramp up objections to tariffs.[5] As we noted earlier, U.S. trade actions against China have led Beijing to improve relations with Japan, which is also facing threats from the U.S.[6] The United Steelworkers are pressing steel companies to boost wages in light of tariff-

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[1] https://www.nytimes.com/2018/09/11/world/europe/viktor-orban-european-peoples-party.html?emc=edit_mbe_20180912&nl=morning-briefing-europe&nlid=567726720180912&te=1
[2] https://www.lapresse.it/politica/ue_berlusconi_sente_orban_fi_vota_contro_sanzioni-571360/news/2018-09-11/?utm_source=POLITICO.EU&utm_campaign=6c7501ff37-EMAIL_CAMPAIGN_2018_09_12_04_34&utm_medium=email&utm_term=0_10959edeb5-6c7501ff37-190334489
[3] https://www.politico.eu/article/graphic-what-is-article-7-the-eus-nuclear-option/?utm_source=POLITICO.EU&utm_campaign=6c7501ff37-EMAIL_CAMPAIGN_2018_09_12_04_34&utm_medium=email&utm_term=0_10959edeb5-6c7501ff37-190334489
[4] https://www.cnbc.com/2018/09/11/reuters-america-update-1-canada-ready-to-allow-u-s-dairy-access-in-nafta-talks-sources.html
[5] https://www.wsj.com/articles/u-s-businesses-ramp-up-lobbying-against-trumps-tariffs-1536724811
[6] https://www.wsj.com/articles/japan-and-china-find-common-ground-in-trumps-tariffs-as-leaders-meet-1536732536

driven price increases on domestic steel. We believe this outcome is what the Trump administration wanted but will be unwelcome for financial markets.[7]

Tech under the gun: Although anti-trust theoreticians are debating the underlying principles of enforcement, any change in policy could be years in the making. A more immediate threat could come from the Federal Trade Commission. The FTC will hold public hearings tomorrow which could set the stage for regulation surrounding data, privacy and other corporate behaviors.[8]

Rupee recovery? The Indian rupee (INR) has come under pressure along with other emerging market currencies, recently falling to new all-time lows against the dollar.

(Source: Bloomberg)

This weekend, PM Modi is holding an economic review meeting[9] to come up with measures to bolster the exchange rate. Indian equities and the INR bounced on the news.

Tropical situation: Hurricane Florence remains a significant threat, although we have seen a change in the path forecast over the past 24 hours. Yesterday, we were expecting a more northerly path. The current forecast has the storm turning south, making landfall near the border of South and North Carolina and heading toward Georgia. Most of the Eastern Seaboard, excluding Florida, will be affected by the storm. We have seen a jump in oil prices due to expectations of rising gasoline demand for evacuation. The other event we are tracking, a

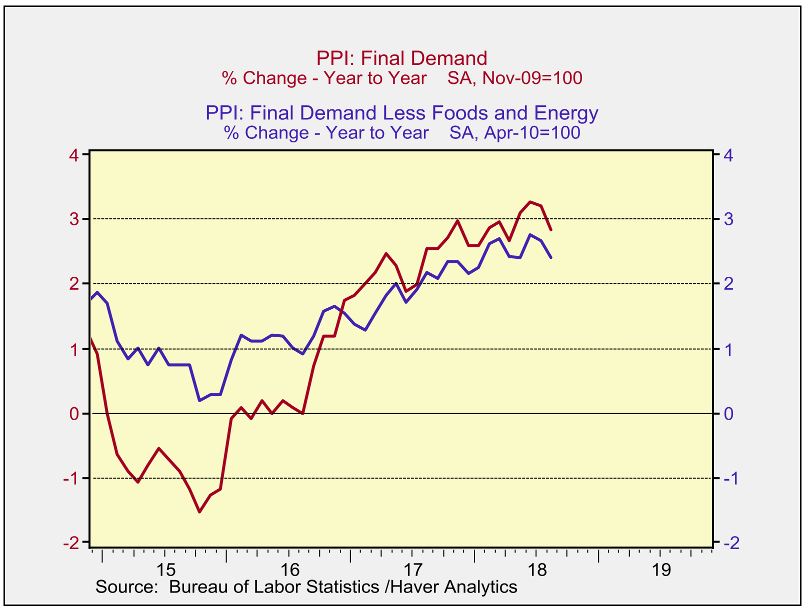
[7] https://www.wsj.com/articles/steel-workers-demand-higher-pay-raises-as-tariffs-lift-profits-1536668815
[8] https://www.axios.com/ftc-hearings-competition-tech-industry-innovation-58c116fa-5e93-485f-9a30-4c0163fdf857.html
[9] https://economictimes.indiatimes.com/news/economy/policy/pm-modi-may-call-review-meet-to-check-fall-in-rupee/articleshow/65781598.cms

disturbance now over the Yucatan, probably won't develop into anything more than a tropical depression. It is expected to reach the Texas coast later this week but probably won't disrupt energy flows.

U.S. Economic Releases

MBA mortgage applications fell 1.8% from the prior week. Purchases rose 0.9%, while refinancing fell 5.9% from the prior week. The average 30-year fixed rate rose 4 bps from 4.80% to 4.84%.

PPI final demand came in below expectations, falling 0.1% from the prior month compared to the forecast rise of 0.2%. Core PPI came in below expectations, rising 0.1% from the prior month compared to the forecast of 0.2%.



The chart above shows the year-over-year change in PPI and core PPI. Annually, PPI and core PPI rose 2.8% and 2.3%, respectively. Although there isn't a strong correlation between PPI and CPI, the PPI report is considered to be a precursor to the CPI report.

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**
14:00	US Federal Reserve Releases Beige Book	Members 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	Money Supply M2	y/y	aug	8.2%	8.5%	8.6%	**	Equity bearish, bond bullish
	New Yuan Loans	m/m	aug	1.280 tn	1.450 tn	1.400 tn	**	Equity bearish, bond bullish
Japan	BSI Large All Industry	q/q	aug	3.8	-2.0		**	Equity bullish, bond bearish
	BSI Large Manufacturing	q/q	aug	6.5	-3.2		**	Equity and bond neutral
Australia	Westpac Consumer Confidence Index	m/m	sep	100.5	103.6		**	Equity and bond neutral
EUROPE								
Eurozone	Industrial Production	m/m	jul	-0.8%	-0.7%	-0.5%	***	Equity bearish, bond bullish
Italy	Industrial Production	m/m	jul	-1.3%	1.7%	1.6%	***	Equity bearish, bond bullish
	Unemployment Rate	m/m	2q	10.7%	11.1%	10.8%	***	Equity and bond neutral
Russia	Trade Balance	m/m	jul	13.4 bn	15.6 bn	14.5 bn	**	Equity bearish, bond bullish
AMERICAS								
Mexico	Industrial Production	m/m	aug	1.3%	0.2%	1.0%	***	Equity bullish, bond bearish
	International Reserves Weekly	m/m	sep	$173.516 bn	$173.606 bn		**	Equity and bond neutral
	ANTAD Same-Store Sales	y/y	aug	5.0%	4.8%		**	Equity and bond neutral
Canada	Housing Starts	m/m	jul	201.0k	206.3k	216.3k	**	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)	211	210	1	Neutral
TED spread (bps)	23	23	0	Neutral
U.S. Libor/OIS spread (bps)	213	213	0	Up
10-yr T-note (%)	2.96	2.98	-0.02	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	12	11	1	Down
Currencies	**Direction**			
dollar	flat			Neutral
euro	flat			Neutral
yen	up			Neutral
pound	up			Neutral
franc	down			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	$79.21	$79.06	0.19%	
WTI	$69.86	$69.25	0.88%	
Natural Gas	$2.84	$2.83	0.32%	
Crack Spread	$18.33	$18.68	-1.87%	
12-mo strip crack	$21.05	$21.17	-0.53%	
Ethanol rack	$1.43	$1.43	-0.12%	
Metals				
Gold	$1,194.23	$1,198.59	-0.36%	
Silver	$14.13	$14.14	-0.11%	
Copper contract	$263.90	$262.15	0.67%	
Grains				
Corn contract	$ 365.75	$ 366.75	-0.27%	
Wheat contract	$ 524.00	$ 518.75	1.01%	
Soybeans contract	$ 827.50	$ 831.75	-0.51%	
Shipping				
Baltic Dry Freight	1439	1482	-43	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.3		
Gasoline (mb)		0.8		
Distillates (mb)		2.0		
Refinery run rates (%)		-0.55%		
Natural gas (bcf)		66.0		

Weather

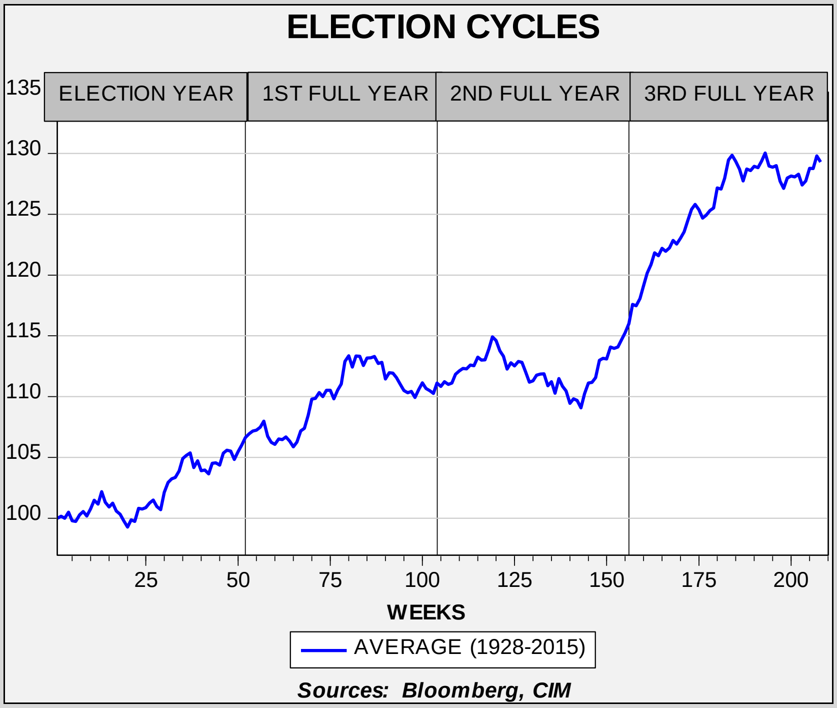
The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country, with cooler temps in the northwestern region. Precipitation is expected for the eastern region of the country. Hurricane Florence continues to gain strength and is expected to make landfall on the Carolina coast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

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.

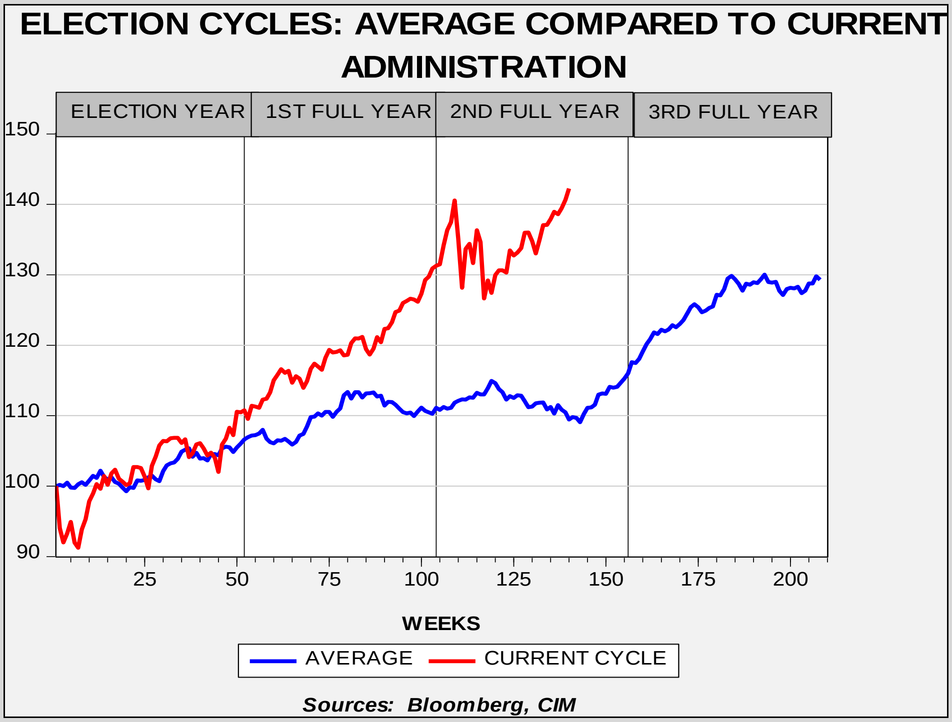
September 7, 2018

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.

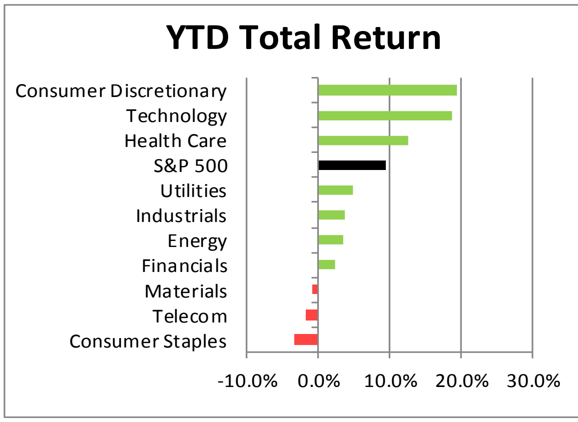


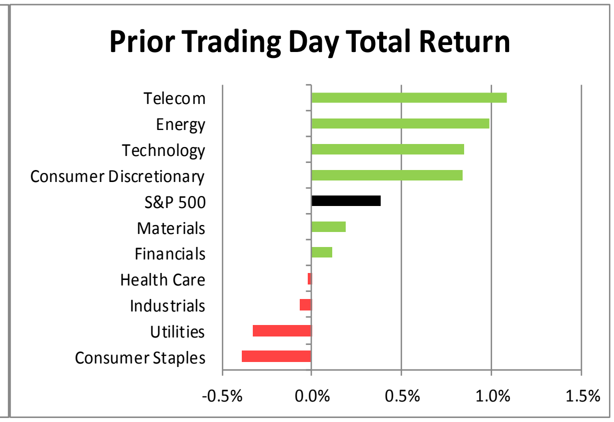
Clearly, the Trump administration has been popular with investors, especially during the first full year after the election. The tax cuts boosted equity prices into Q1 of this year. However, concerns about trade, tightening monetary policy and worries about the midterms have all likely conspired to bring 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 9/11/2018 close)

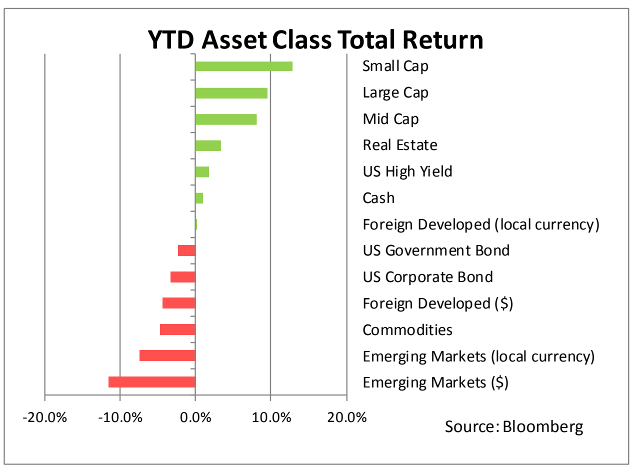




(Source: Bloomberg)

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 9/11/2018 close)

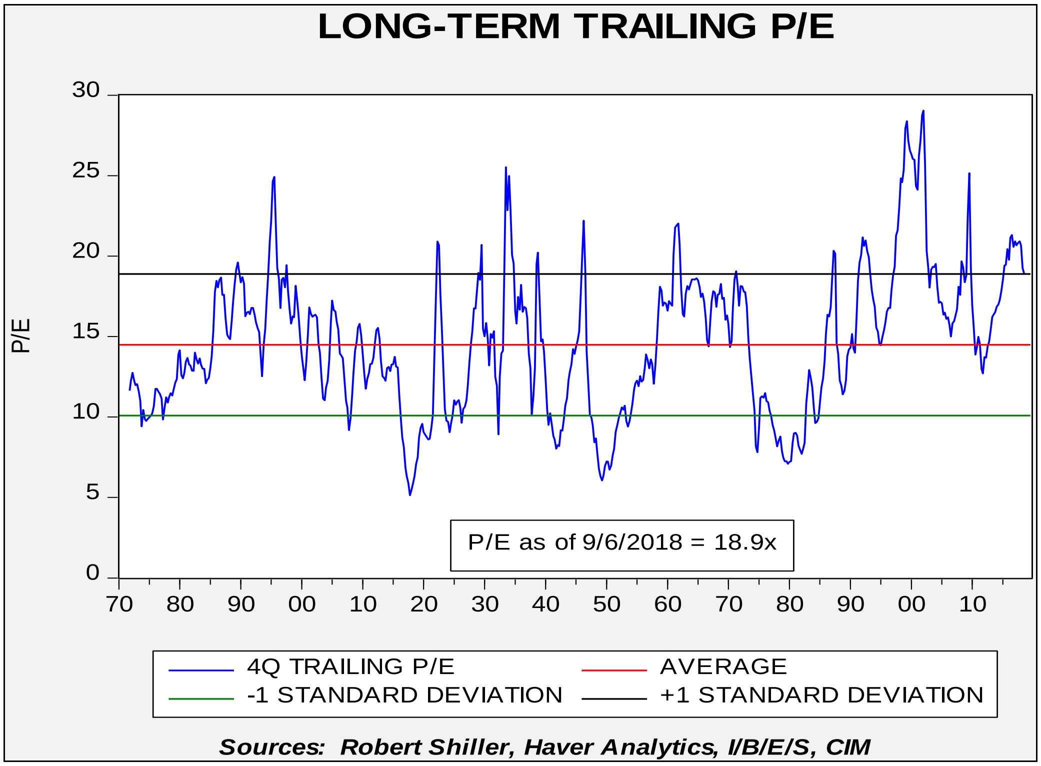


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

[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.