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 17, 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 1.2% from the prior close. Chinese markets were lower, with the Shanghai composite down 1.1% and the Shenzhen index down 1.5%. U.S. equity index futures are signaling a lower open.

The weekend news was dominated by tropical events in the U.S. and the Far East, and the travails of SCOTUS candidate Kavanaugh. In addition, there were a plethora of retrospectives across the media focusing on "10 years after the crisis." Here are the other items we are watching today:

Trade: It appears that President Trump will announce sometime this week that China will be hit with tariffs on another $200 bn in goods.[1] Instead of a 25% rate, it appears the U.S. will start with a 10% rate. We would expect China to retaliate in equal measure.[2] From there, we will be watching to see if conditions escalate. Last week, there was a glimmer of hope for a reopening of talks between Washington and Beijing. However, China is indicating that it will not join talks if the U.S. signals new tariffs.[3] Emerging equities fell on this news. Industrial metals,[4] a likely target of tariffs, are under pressure this morning as well.

India disappoints:[5] Last week, the Modi government indicated it was developing a strategy to arrest the decline in the rupee. The market has found the measures wanting; essentially, the government plans to put import barriers in place on "non-essential imports" but hasn't detailed the exact list.[6] This plan is a high-risk strategy. Not only will it upset trading partners in a period when the U.S. isn't going to give India a pass on trade impediments, but the likely outcome is higher inflation. It does appear the Modi government is trying hard to avoid the most effective response, higher interest rates, with elections looming next year.

A new Fed president: The San Francisco FRB announced that Mary Daly has been appointed as the new president of the San Francisco FRB, effective October 1. Daly has been director of

[1] https://www.wsj.com/articles/trump-to-announce-new-tariffs-on-200-billion-in-china-goods-1537040325
[2] https://www.wsj.com/articles/china-weighs-skipping-trade-talks-after-u-s-tariff-threat-1537115334
[3] https://www.axios.com/trump-tweets-mnuchins-credibility-china-trade-talks-4c450538-b6c7-4c5c-94df-fdd98643a15b.html
[4] https://www.ft.com/content/70917a9a-ba67-11e8-94b2-17176fbf93f5
[5] https://www.ft.com/content/54ece0f8-ba2c-11e8-94b2-17176fbf93f5
[6] https://www.ft.com/content/1ce01368-b83f-11e8-b3ef-799c8613f4a1

research at the bank since 2017 and succeeds John Williams, who became the president of the New York FRB. Her focus area is labor economics. However, the most interesting part of her appointment, at least to us, is her academic background, most notably at the undergraduate level. Her MA is from the University of Illinois (Champaign-Urbana) and Ph.D. is from Syracuse. However, her undergraduate degree is from the University of Missouri—Kansas City in economics, philosophy and psychology. UMKC along with the Levy Institute at Bard College are, by our estimation, the leading schools for heterodox economics. This is where neo-Marxists, Modern Monetary Theorists (MMT) and neo-Keynesians dwell. We have been paying very close attention to MMT and think it may become the intellectual construct for the next major development in economic policy. In other words, in the next equality cycle, MMT will be how large fiscal deficits are justified. Daly will be a voter the rest of this year but not at the next meeting. In her place, KC FRB President George has been acting as the alternate voter and, given that George is perhaps the most hawkish member of the board, she will surely vote to raise rates at the upcoming meeting. The December vote might be more contentious. However, Daly would need an excess of ego strength to dissent against a rate hike in her first vote. Fed fund futures are indicating a near 80% chance of a 2.50% upper target for the policy rate at the December meeting, suggesting another rate hike is highly probable.

A couple of weekend thoughts: First, Adam Tooze is a historian who currently teaches at Columbia University. He has published a number of well-regarded histories and his most recent is on the Great Financial Crisis.[7] We spent part of the weekend listening to numerous podcasts where he discussed his book. Although we haven't read it yet, it will go on the list. But, one of the thoughts we had as we listened to the podcasts and read various "where were you" retrospectives on the crisis was how the impact of this event may not be past us. Think of it this way…there could have been discussions and analyses 10 years after the 1929 Crash but they would not have captured the crisis that WWII brought. We should be careful about thinking that the last decade may be the final story of how the world financial system recovered; simply put, the story may not be over yet.

Second, we have been thinking a lot about the amplitude shifts coming out of the political system. Our founding fathers created a system that was designed to prevent sudden shifts in policy. Checks and balances and the requirement of a supermajority in the Senate were all put in place to temper changes, make them more gradual and reduce the odds of a sudden shift in policy. Since WWII, we have been steadily eroding these measures. The superpower role created the need for a stronger executive; the presidency is now described as "imperial."[8] We have recently weakened the power of the filibuster; although this measure has slowed progress it also forces lawmakers to make changes that are palatable to opponents. Without the filibuster, we now have two legislative houses that are almost identical.

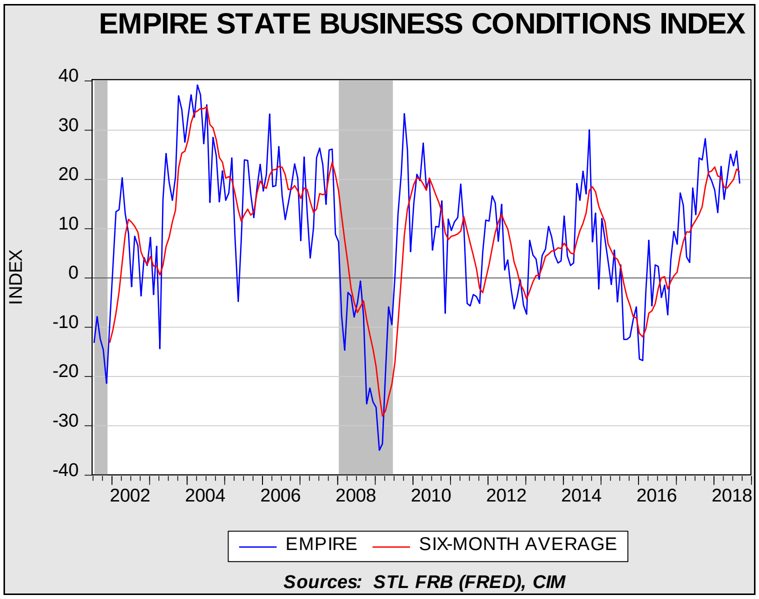
What this could mean is that we will be facing a future where changes in government mean massive changes in policy. One party passes infrastructure spending only to have a change in government halt the projects. One party passes tax changes only to see them reversed by the next administration. It could become even more radical; a party could try to expand or reduce

[7] https://www.amazon.com/Crashed-Decade-Financial-Crises-Changed/dp/0670024937
[8] https://www.amazon.com/Imperial-Presidency-Jr-Arthur-Schlesinger/dp/0618420010

the number of judges on the Supreme Court to undermine changes brought by the previous administration. If this becomes the norm, not only will American democracy become dysfunctional, but it seems hard to imagine how businesses could make rational investment decisions. Although neither of these factors affect the markets today, it is something we are watching.[9]

U.S. Economic Releases

Empire manufacturing came in below expectations at 19.0 compared to the forecast of 25.6.



The chart above shows the six-month moving average of the Empire State Business Conditions Index. Currently, the six-month moving average is 21.4.

There were no economic releases or Fed events scheduled for the rest of the day.

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.

---

[9] https://www.axios.com/2020-democrats-rebels-restorationists-080c9e81-c961-4b20-8c96-103c45ed0905.html

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
China	New Home Prices	y/y	aug	1.5%	1.2%		**	Equity and bond neutral
India	Trade Balance	y/y	aug	-$17.394 bn	-$18.020 bn	-$17.307 bn	**	Equity and bond neutral
New Zealand	Perfomance Services Index	y/y	aug	53.2	55.1		**	Equity and bond neutral
EUROPE								
Eurozone	CPI	y/y	aug	2.0%	2.1%	2.0%	***	Equity and bond neutral
	CPI Core	y/y	aug	1.0%	1.0%	1.0%	***	Equity and bond neutral
Italy	Trade Balance Total	m/m	jul	5.676 bn	5.071 bn		**	Equity and bond neutral
	Trade Balance EU	m/m	jul	2.677 bn	1.520 bn		**	Equity bullish, bond bearish

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)	234	233	1	Up
3-mo T-bill yield (bps)	211	211	0	Neutral
TED spread (bps)	23	23	0	Neutral
U.S. Libor/OIS spread (bps)	215	215	0	Up
10-yr T-note (%)	3.01	3.00	0.01	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	12	14	-2	Down
Currencies	**Direction**			
dollar	down			Neutral
euro	up			Neutral
yen	up			Neutral
pound	down			Neutral
franc	up			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	$78.10	$78.18	-0.10%	
WTI	$69.00	$68.59	0.60%	
Natural Gas	$2.77	$2.82	-1.74%	
Crack Spread	$17.22	$18.34	-6.13%	
12-mo strip crack	$20.13	$20.90	-3.66%	
Ethanol rack	$1.42	$1.42	-0.22%	
Metals				
Gold	$1,193.94	$1,201.47	-0.63%	Trade Tensions
Silver	$14.08	$14.17	-0.62%	
Copper contract	$261.75	$268.30	-2.44%	
Grains				
Corn contract	$ 351.75	$ 350.50	0.36%	
Wheat contract	$ 511.50	$ 497.00	2.92%	
Soybeans contract	$ 830.50	$ 833.25	-0.33%	
Shipping				
Baltic Dry Freight	1382	1411	-29	

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 most of the country. Hurricane Florence has been downgraded to a tropical depression and is currently moving along the border of North and South Carolina. Tropical Storm Joyce has been downgraded to a tropical depression.

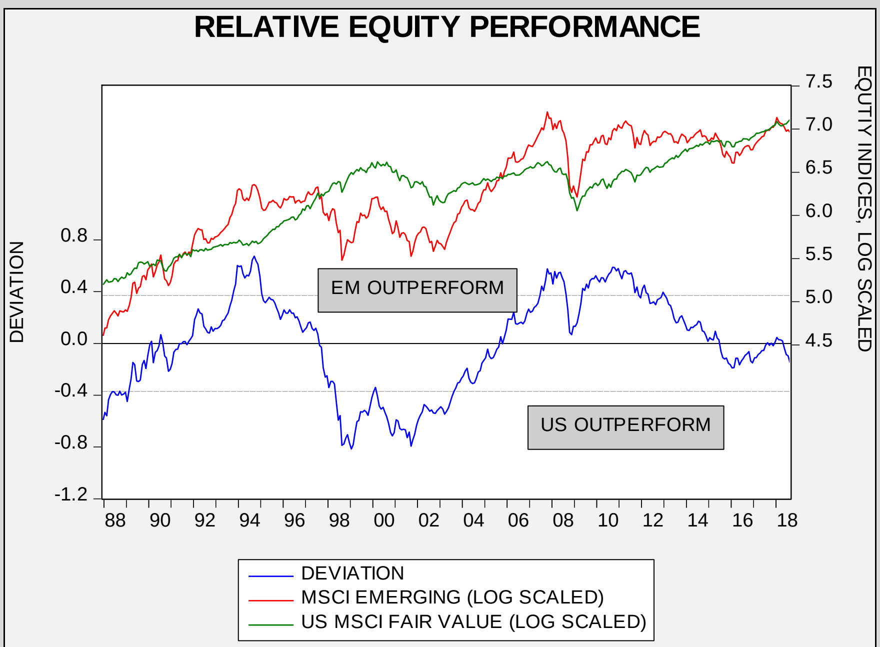
Asset Allocation Weekly Comment

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 14, 2018

Emerging markets have fallen in recent weeks. The decline is being driven by a couple of factors. First, the dollar has appreciated due to concerns that tariffs will restrict foreign country access to the U.S. consumer and the dollars they spend. In other words, if the U.S. restricts trade, countries will struggle to acquire dollars for reserve and trade purposes. As we will show below, there is a clear inverse correlation between the dollar and relative emerging market equity performance. Second, and related to the first point, restricting access to dollars coupled with tightening monetary policy has led to crises in nations with high levels of foreign debt; namely, this has been the case in Argentina and Turkey, although we are seeing weakness spread to other nations as well, including South Africa.

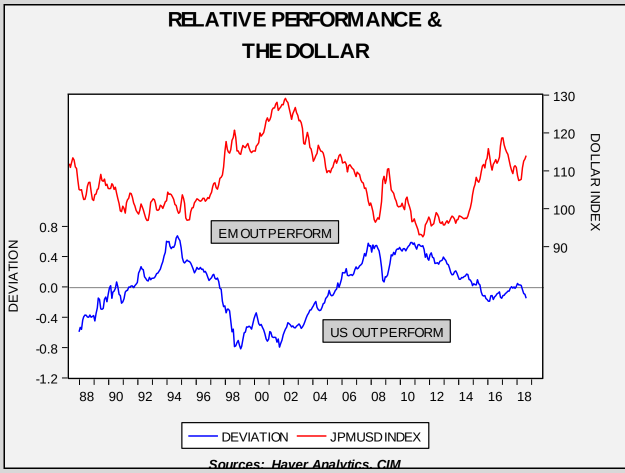
The arguments for owning emerging markets from a macro perspective are based on expectations of dollar weakness and a Fed that doesn't overtighten monetary policy. First, a look at relative performance.

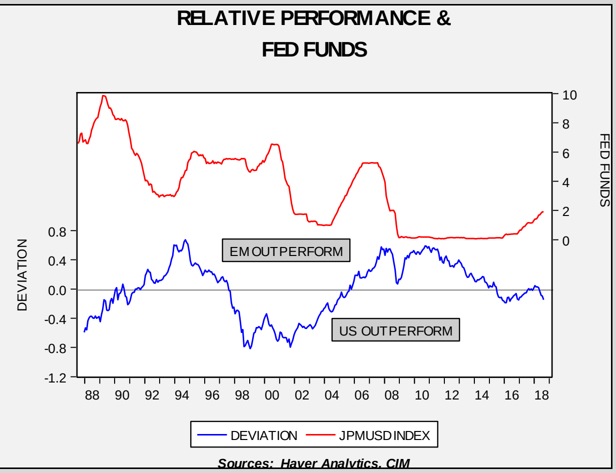


Sources: Haver Analytics, CIM

This chart regresses the emerging market index against the U.S. index, log scaled. When the deviation line is above zero, emerging markets are outperforming. Below zero, the U.S. is outperforming. There is an obvious broad cycle in the deviation line.

There are two variables that generally explain the divergence, the dollar and fed funds.





The chart on the left shows the dollar and relative performance. In general, a weaker dollar tends to support emerging market performance. A stronger dollar increases the risk for emerging markets that borrow in dollars as it increases debt service costs. And, many emerging market economies are commodity producers and a stronger dollar tends to pressure commodity prices. The dollar peaked in early 2017 and appeared to be rolling over. As we have discussed before,[10] on a relative inflation basis, the dollar is overvalued. However, in late Q1, President Trump began discussing tariffs and trade barriers. The potential for trade restrictions is bullish for the dollar; the problem is that there is nothing in the historical record since WWII that would suggest how bullish barriers might become. In addition, it isn't completely clear what the end point of tariffs will be. However, if the president is successful in narrowing the trade deficit, it would be dollar supportive.

The second chart shows the impact of monetary policy on relative performance. Although the fit isn't as strong as the dollar, there have been policy cycles where rate cuts boosted emerging market outperformance. Thus, Fed tightening would tend to favor the U.S. over emerging markets. Our analysis suggests the FOMC will raise rates to around 3%, which would not be unusually tight based on historical ranges. Thus, we believe this level is already discounted in the market.

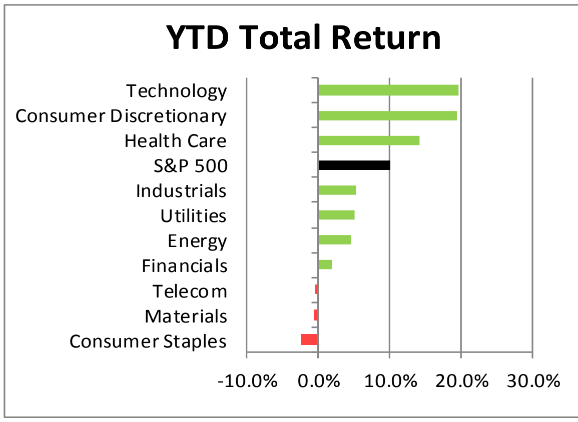
So, do emerging markets look attractive? If the dollar rolls over, emerging markets should do better. What would make the dollar weaken? Anything that suggests the drive for trade protection is being mitigated, either by political turmoil or Congressional action, would likely pressure an already extended greenback. We tend to rely on parity extremes to forecast our dollar outlook and, as noted, we are at levels that should support dollar-bearish positions. At the same time, we will have to assess our view on the government's trade policy going forward. Trade protection will tend to support a stronger dollar and lead to further weakness in emerging markets.

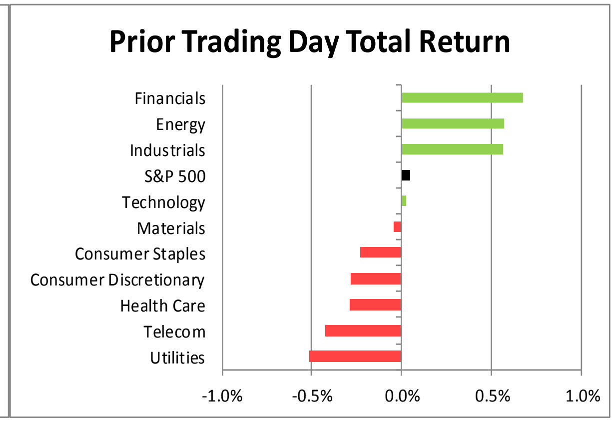
---

[10] https://www.confluenceinvestment.com/wp-content/uploads/AAW_Feb_2_2018.pdf

Data Section

U.S. Equity Markets – (as of 9/14/2018 close)

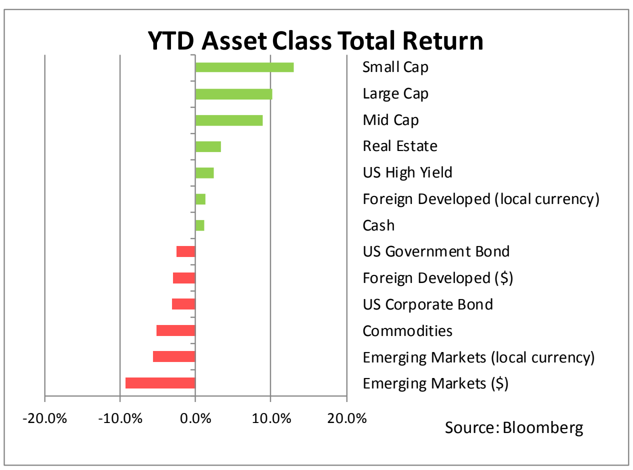




(Source: Bloomberg)

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 9/14/2018 close)

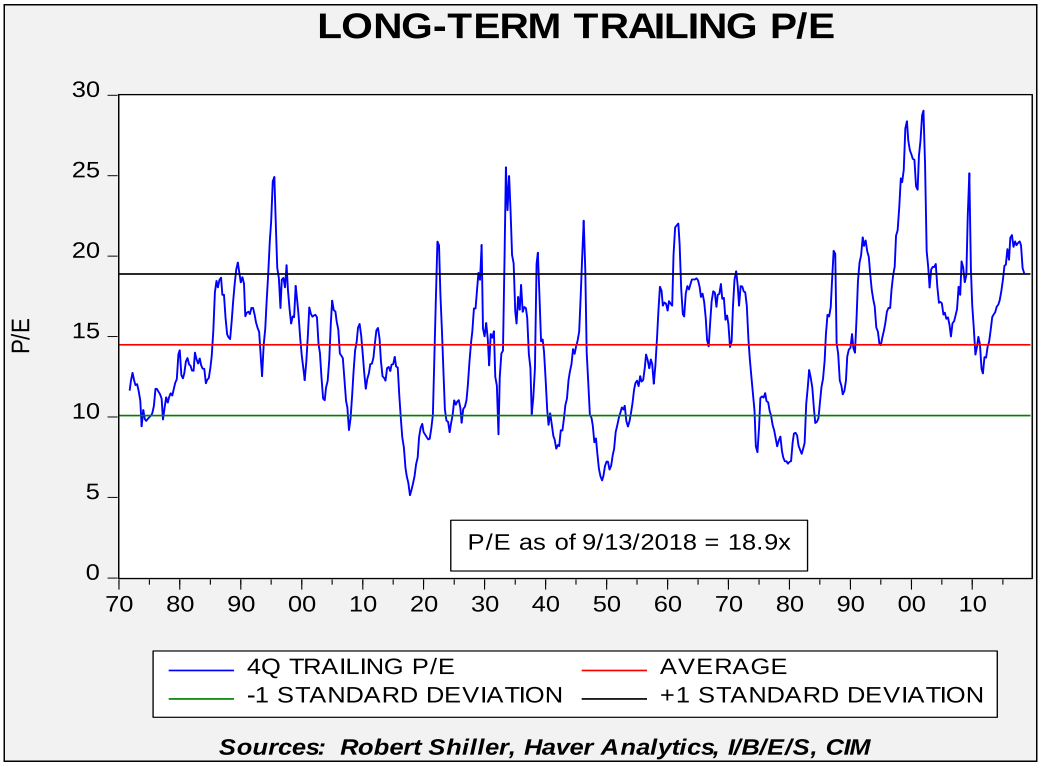


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 13, 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.