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 25, 2018—9:30 AM EDT] Global equity markets were mixed this morning. The EuroStoxx 50 is up 0.4% from the last close. In Asia, the MSCI Asia Apex 50 was relatively unchanged from the prior close. Chinese markets were down, with the Shanghai composite down 0.6% and the Shenzhen index down 0.5%. U.S. equity index futures are signaling a higher open.

Good morning, all! There was a lot of overnight news; below are the stories we are paying the most attention to:

Labour to reject Brexit deal? Earlier this morning, Labour's Brexit spokesman Keir Starmer fueled speculation of a second Brexit referendum by suggesting the Labour party will likely reject the Brexit deal as it currently stands. In addition, he stated that remaining in the EU has not been ruled out. Starmer's remarks will likely harden the stance of EU negotiators who would welcome a second vote. PM May is in a precarious situation as she is currently fighting a multiple-front war in order to secure a deal. In addition to battling EU officials, she is taking on Tory rebels who want a clean break from the EU and Labour Party members who are pushing for more cooperation with the EU following Brexit. At this time, it is unclear whether there will be a second referendum but the possibility is becoming increasingly likely. We will continue to monitor this situation.

New Swedish government: Last night, Swedish PM Stefan Lofven was voted out in a confidence vote, which has led to the end of the Social Democrats' four-year reign in parliament. At the moment, the two establishment blocs, the Social Democrats and Sweden Democrats, are vying to take control of parliament with neither side holding a clear advantage. The confidence vote came only two weeks after Swedish elections saw the rise of far-right populist groups at the expense of the Social Democrats. Rising concerns over immigration appear to be the driving force behind the Social Democrats' loss of support. Although expectations are relatively low for new elections, we are uncertain what the new government will look like. Currently, the speaker of parliament is expected to meet with members of the coalition to discuss the formation of a new government, with many speculating that Ulf Kristersson, the leader of the Swedish Moderate Party, will be chosen as the next PM.

Iran blinks first? Last night, Iranian President Hassan Rouhani stated that he would consider reopening nuclear talks if President Trump reverses his decision to exit the 2015 Iran nuclear accord. Iran-U.S. tensions have been high since President Trump decided to exit the nuclear accord in 2017, and will likely be on display during the UN Summit, where both Rouhani and

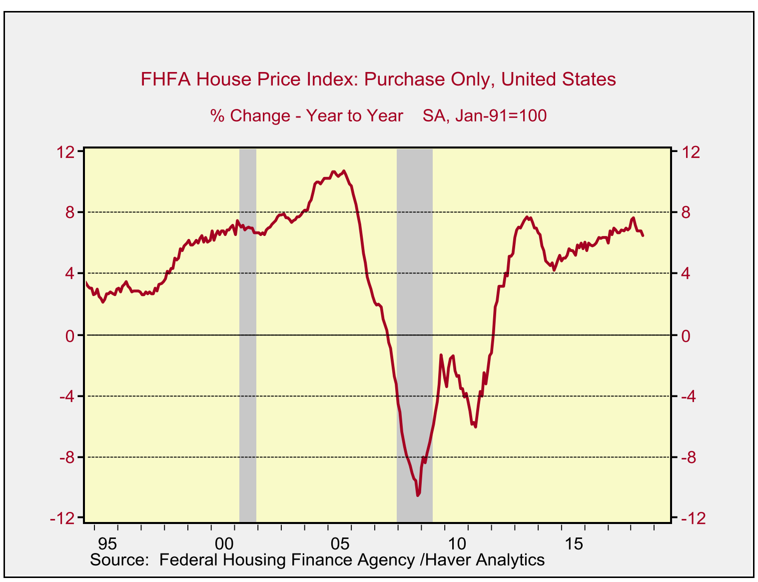
Trump are expected to take aim at each other. Despite rumors, both leaders have stated they will not meet with the other during the summit.

Trade talks: As trade talks with China begin to cool and NAFTA negotiations near an end, the Trump administration has focused its attention on establishing bilateral trade deals with Japan and Europe. While the president is in New York for the UN Summit he is expected to try to persuade Japan to enter into bilateral trade talks. The negotiations will likely revolve around opening up Japan's markets to more U.S. agricultural goods and setting new terms for trade in the automotive sector. Currently, Japan is resisting trade negotiations as it fears the ultimate U.S. aim is to lower its trade surplus. Meanwhile, discussions with Europe will likely focus on regulatory standards. It is too early to conclude whether these negotiations have made any meaningful changes to the current trade arrangement, but the recent trade deal with South Korea suggests it may not be on par with the president's rhetoric. That said, we believe the president's most prominent shift in U.S. trade will most likely be with NAFTA members and China.

Rosenstein lives: Although Rod Rosenstein verbally resigned from his position as deputy attorney general, he was convinced to take a meeting with President Trump on Thursday to determine whether or not he should remain in his position. Rosenstein has been under increased pressure due to a *New York Times* article stating he was willing to wear a wire in order to build a case for invoking the 25th Amendment, which would start impeachment proceedings if the president is declared mentally unfit to be president. It is worth noting that Rosenstein was believed to have said it sarcastically, but the remark will still not go over well with the White House. It is unclear what the president will do as he has often questioned Rosenstein's position as the overseer of the Mueller investigation. It is widely expected he will be fired following the Thursday meeting, but the actual outcome is uncertain at this time.

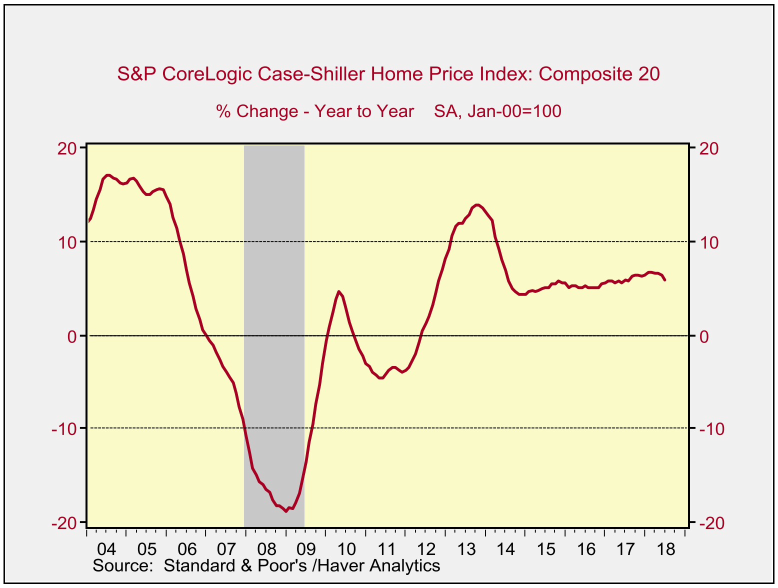
U.S. Economic Releases

The FHFA House Price Index came in below expectations, rising 0.2% from the prior month compared to the forecast rise of 0.3%. The prior report was revised upward from 0.2% to 0.3%.



The chart above shows the year-over-year change in the FHFA House Price Index. Housing prices have risen 6.5% from the prior year.

The S&P CoreLogic CS 20-City Home Price Index came in below expectations at 5.92% compared to the forecast rise of 6.20% from the prior year. The prior report was revised from 6.31% to 6.36%. The S&P CoreLogic CS U.S. Home Price Index rose by 6.00% from the prior year. The prior report was revised downward from 6.24% to 6.22%.



The chart above shows the year-over-year change in the S&P CoreLogic CS 20-City Home Price Index. The HPI continues to remain steady near 6.0%. The rise in prices is likely due to a lack of supply as housing starts continue to remain below the long-term average.

The table below lists the economic releases scheduled for today.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Richmond Fed Manufacturing Index	m/m	sep	20	24	**
10:00	Conference Board Consumer Confidence	m/m	sep	132.0	133.4	**
10:00	Conference Board Present Situation	m/m	aug		172.2	**
10:00	Conference Board Expectations	m/m	aug		107.6	**
Fed speakers or events						
No speakers or events scheduled						

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	PPI Services	y/y	aug	1.3%	1.1%	1.1%	**	Equity bullish, bond bearish
	Supermarket Sales	y/y	aug	0.1%	1.5%		**	Equity bearish, bond bullish
	Leading Index CI	m/m	jul	103.9	103.5		**	Equity bearish, bond bullish
	Coincident Index	m/m	jul	116.1	116.3		**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	w/w	sep	117.2	118.0		**	Equity bearish, bond bullish
EUROPE								
Germany	Wholesale Price Index	m/m	aug	0.3%	0.0%		**	Equity bullish, bond bearish
France	Business Confidence	m/m	sep	106	105	105	**	Equity bullish, bond bearish
	Manufacturing Confidence	m/m	sep	107	110	109	**	Equity and bond neutral
	Production Outlook Indicator	m/m	sep	9	11		**	Equity and bond neutral
	Own-Company Production	m/m	sep	9	18	17	**	Equity and bond neutral
AMERICAS								
Mexico	Bi-weekly CPI	y/y	sep	4.9%	5.0%	5.0%	***	Equity and bond neutral
Brazil	FGV Consumer Confidence	m/m	sep	82.1	83.8		***	Equity and bond neutral
	Federal Debt Total	m/m	aug	3.786 bn	3.749 bn		**	Equity bullish, bond bearish
	Current Account Balance	m/m	aug	-$0.717 bn	-$4.433 bn	-$1.300 bn	**	Equity bullish, bond bearish
	Foreign Direct Investment	m/m	aug	$10.607 bn	$3.897 bn	$9.500 bn	**	Equity bullish, bond bearish
Canada	Blomberg Nanos Confidence	m/m	sep	55.7	55.2		**	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)	237	237	0	Up
3-mo T-bill yield (bps)	216	216	0	Neutral
TED spread (bps)	21	20	1	Neutral
U.S. Libor/OIS spread (bps)	219	219	0	Up
10-yr T-note (%)	3.11	3.09	0.02	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	up			Neutral
yen	down			Neutral
pound	up			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	$82.01	$81.20	1.00%	Supply Pessimism
WTI	$72.50	$72.08	0.58%	
Natural Gas	$3.05	$3.04	0.43%	
Crack Spread	$17.33	$17.16	0.95%	
12-mo strip crack	$20.60	$20.49	0.57%	
Ethanol rack	$1.39	$1.39	-0.08%	
Metals				
Gold	$1,200.74	$1,199.03	0.14%	
Silver	$14.30	$14.26	0.33%	
Copper contract	$282.15	$283.60	-0.51%	
Grains				
Corn contract	$ 359.50	$ 360.50	-0.28%	
Wheat contract	$ 521.25	$ 527.00	-1.09%	
Soybeans contract	$ 845.75	$ 841.00	0.56%	
Shipping				
Baltic Dry Freight	1434	1413	21	

Weather

The 6-10 and 8-14 day forecasts show cooler to normal temperatures for the northern half of the country. Precipitation is expected for most of the country. Hurricane Leslie has been downgraded to a tropical depression. There is a cyclone formation just south of Cape Hatteras, North Carolina, but it is currently undetermined whether it will develop into an actual storm.

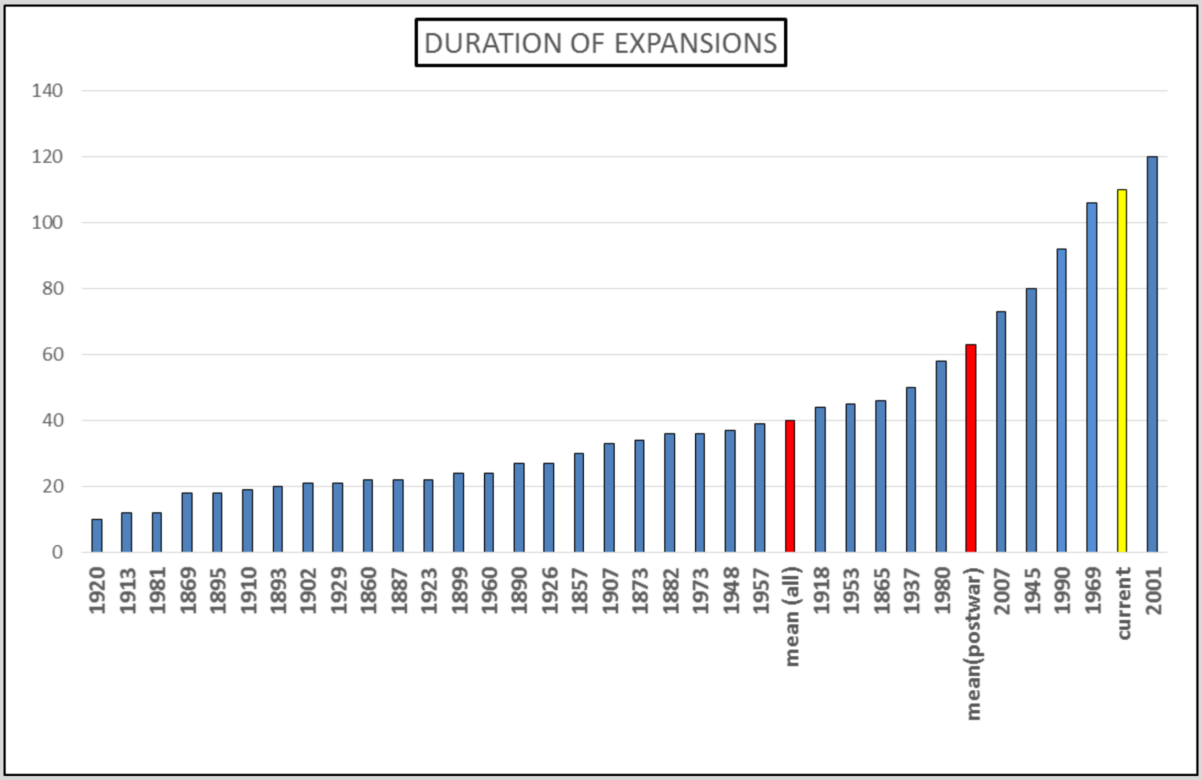
Asset Allocation Weekly Comment

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 21, 2018

In this week's report, we will focus on the U.S. economy. Since the 1987 crash every major equity market decline has coincided with a recession. Thus, we pay close attention to the economy with the goal of projecting the next recession.

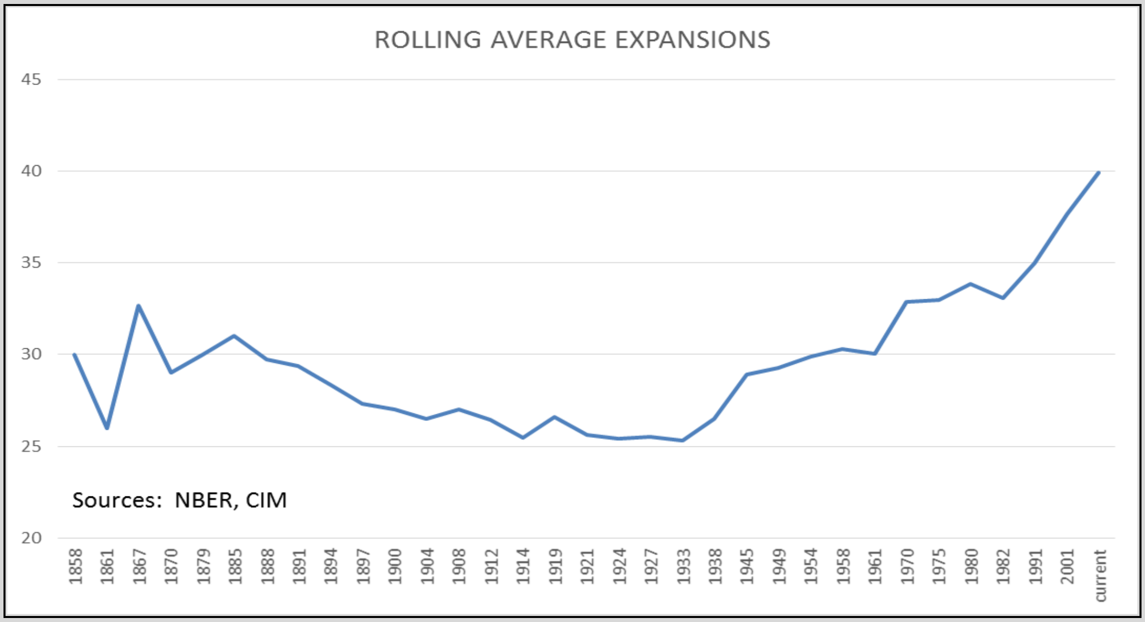
This expansion, which began in June 2009, is now the second longest in U.S. history.[1]



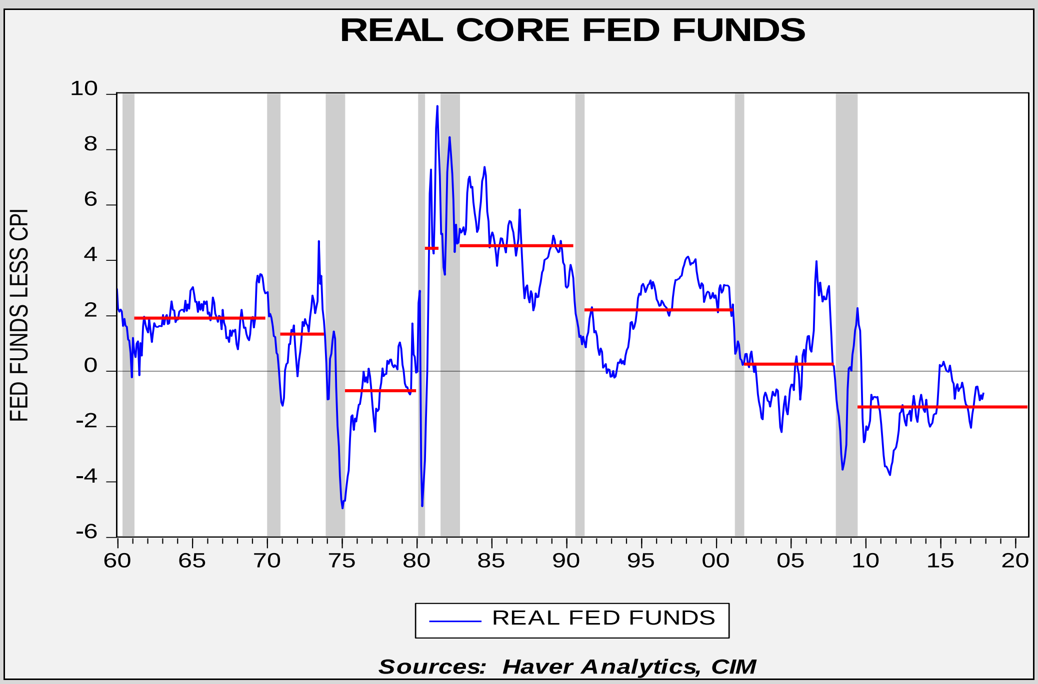
(Source: NBER, CIM)

If the expansion makes it another eight months, it will tie the longest expansion, which ended with the 2001 recession. Business cycles have been lengthening in recent years.

[1] The National Bureau of Economic Research is the arbiter of business cycles. It began tracking business cycles in 1854.

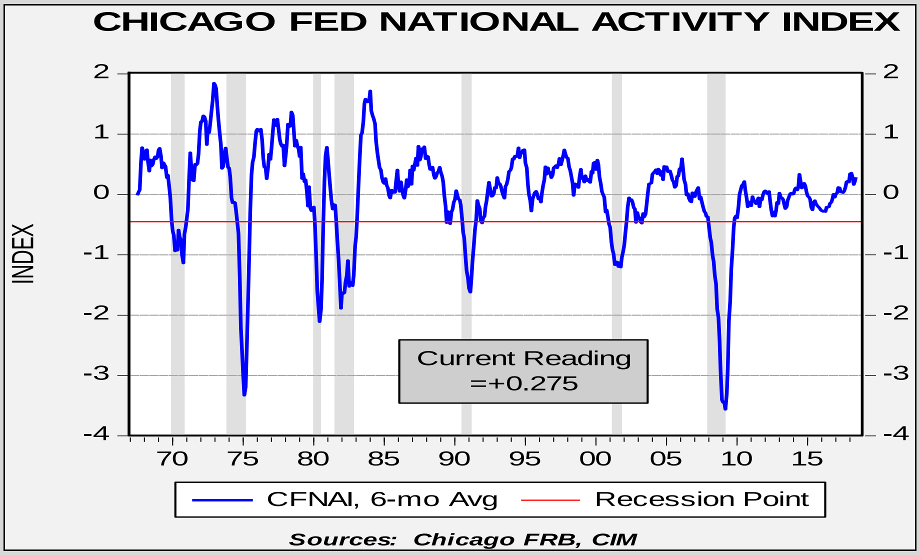


Since the Great Depression, expansions have been lengthening. Moving off the gold standard has allowed for discretionary monetary policy which has tended to support longer expansions. However, the most important factor that has supported longer business cycles in the past forty years has been falling inflation. As inflation declines, the Federal Reserve has less need to aggressively tighten credit which supports economic expansion.



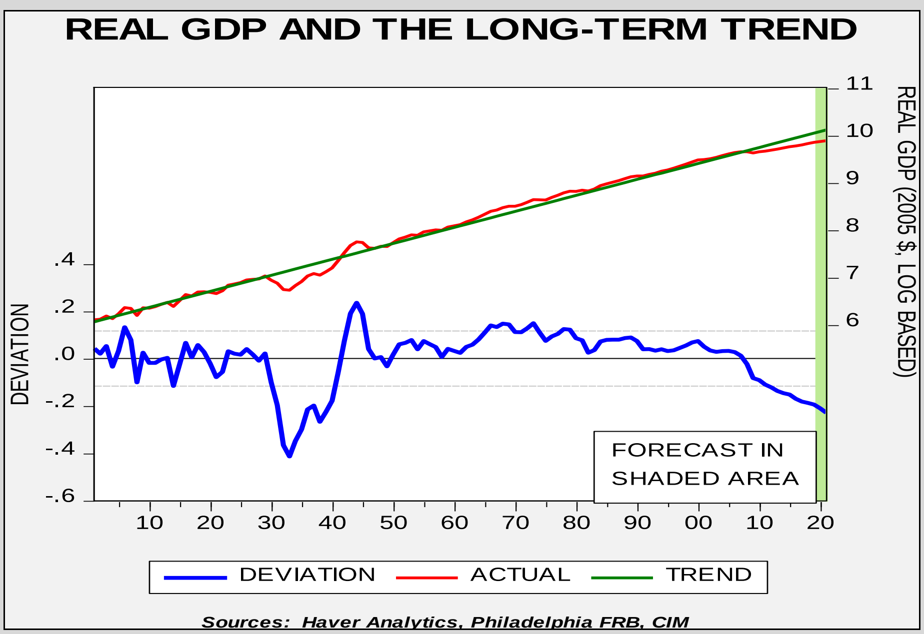
This chart measures real fed funds (effective fed funds less yearly CPI). Note that since the early 1980s, each cycle has had a lower average real rate over the term of the recovery. Much of this is because the Federal Reserve has successfully lowered inflation expectations. With lowered expectations of inflation, the U.S. central bank can keep rates lower for longer without triggering overheating. The ability to keep rates low has allowed for longer business expansions.

The current economy is doing quite well.



This chart shows the Chicago FRB National Activity Index, a broad-based index of economic indicators which are structured against trend. When the reading is above zero, the economy is growing above trend and vice versa. We smooth the data with a six-month moving average. Overall, the economy is running well above trend.

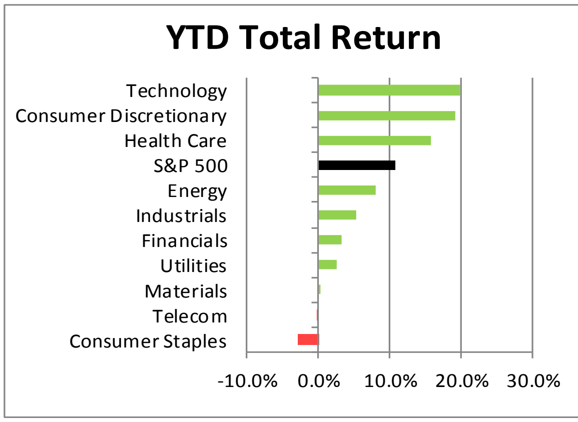
The most interesting issue with the economy is potential growth.

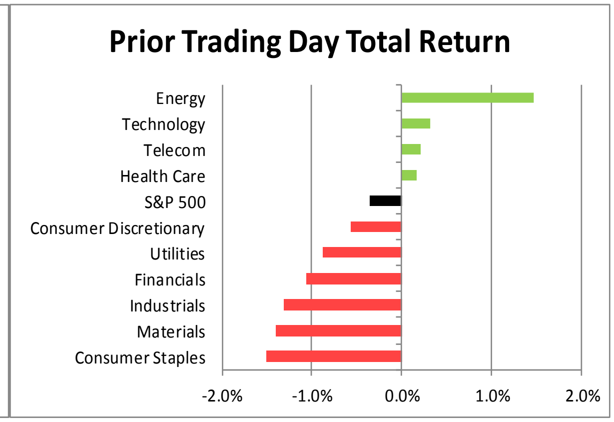


This chart looks at the long-term pattern of real GDP; we have put the data on a log scale and regressed it against a time trend. The deviation line on the lower part of the graph shows the deviation from the long-term trend. We have only seen two periods of well below-trend growth, during the Great Depression and the current environment. It is unknown whether or not the long-term trend still represents potential output. If it does, not only will the economy easily absorb the stimulus without triggering inflation but the FOMC should be very careful about tightening monetary policy. Note the dip in the deviation chart in 1937; that was due to premature fiscal and monetary tightening that led to a short but deep recession. We tend to think there is more slack in the economy than generally thought. Although the odds are rising that the FOMC will overtighten monetary policy, given the current path of policy, we probably won't reach the point of concern until the middle of next year.

Data Section

U.S. Equity Markets – (as of 9/24/2018 close)

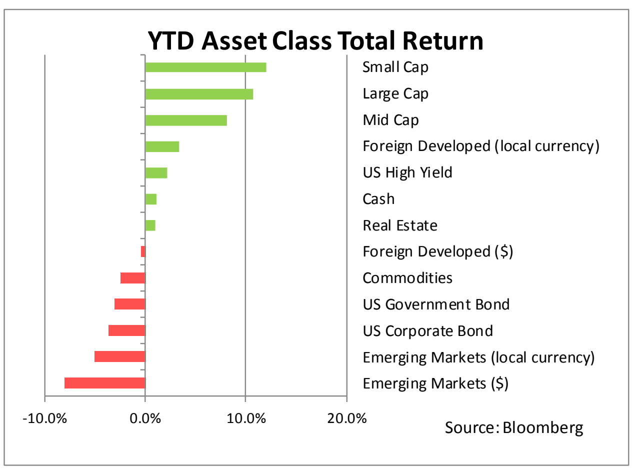




(Source: Bloomberg)

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 9/24/2018 close)

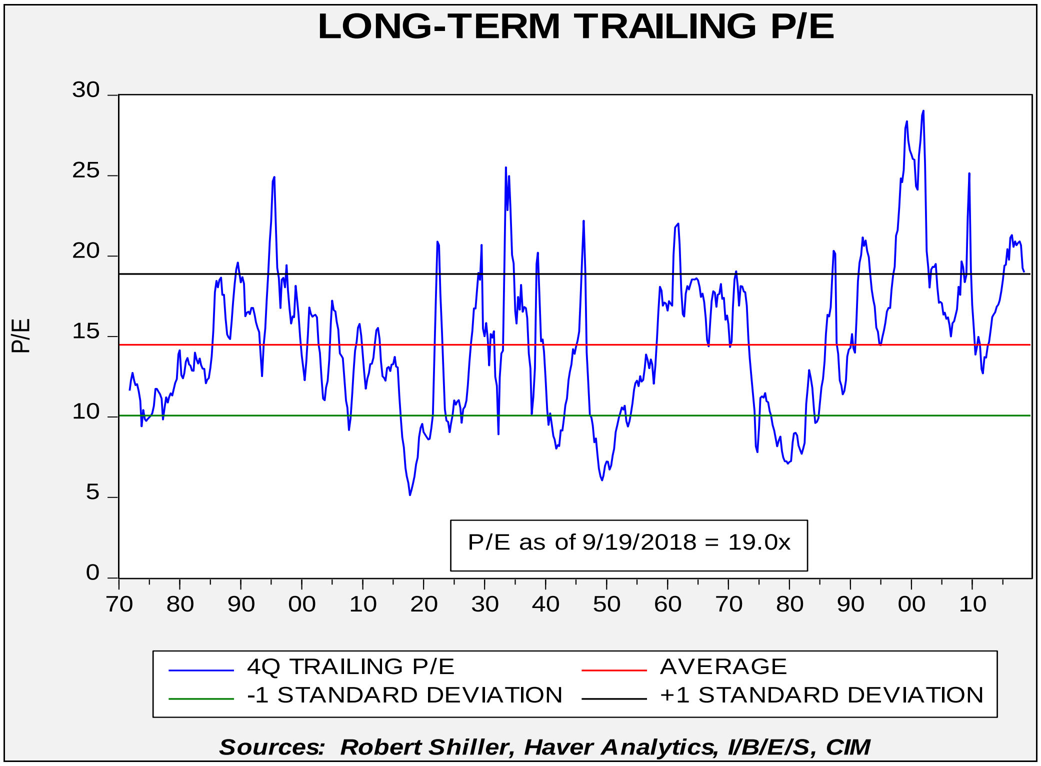


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 20, 2018



Based on our methodology,[2] the current P/E is 19.0, up 0.1x from last week.

[2] 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.