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 27, 2018—9:30 AM EDT] Global equity markets were generally lower this morning. The EuroStoxx 50 is down 0.1% from the last close. In Asia, the MSCI Asia Apex 50 was unchanged from the prior close. Chinese markets were lower, with the Shanghai composite down 0.5% and the Shenzhen index down 1.3%. U.S. equity index futures are signaling a higher open.

Financial markets are mostly steady this morning (although the dollar is stronger) after a rather large number of economic releases this morning. The FOMC meeting ended as expected, with no major surprises. Economics will take a back seat to politics on this Thursday. Here is what we are watching today:

Politics: There are two major events in Washington today. Deputy AG Rosenstein is scheduled to go to the White House today (although we would not be surprised to see the meeting postponed); we are assuming Rosenstein has decided he would rather be fired than resign and we don't expect Trump to do that until after the midterms. The second event, of course, is the Kavanaugh hearing. We haven't said a lot about this because it hasn't had much of a market impact. However, that doesn't mean we aren't paying attention. There is a lot going on here. From our perspective, one of the key elements that has been overlooked is that our constitution was written for a decentralized republic that was not in the business of hegemony. But, as our country took to the role, we quickly found that Congress, designed as a deliberative body, moved too slowly for a superpower. Thus, power has steadily shifted from the legislative to the executive branch. As a result, presidents have much more power than the founders envisioned.

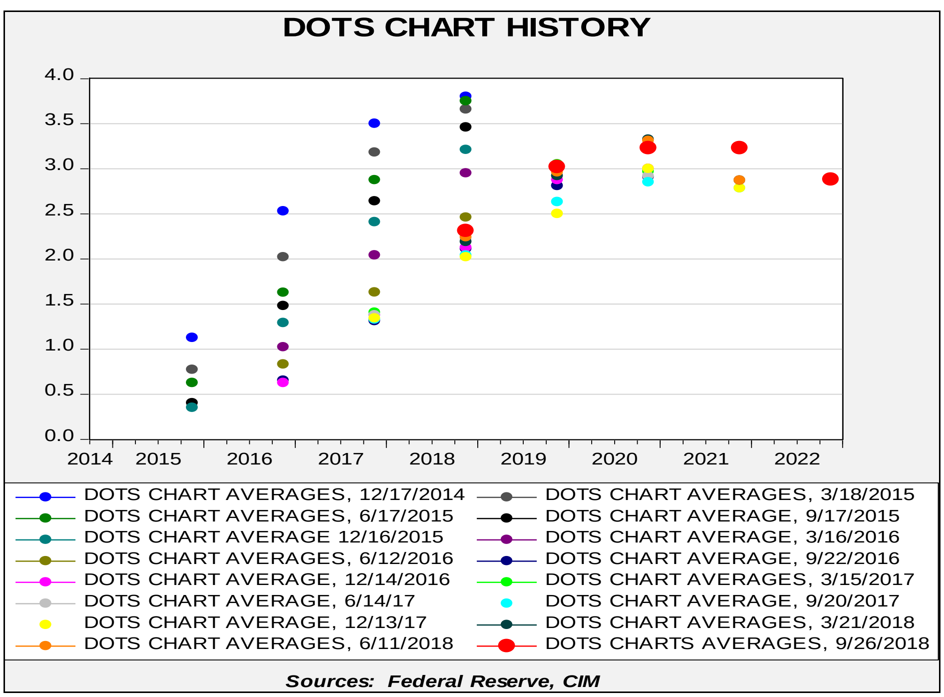
The strain of providing global public goods to the world has distorted our economy and left us with a dilemma—we can have low inflation, but only at the cost of rising inequality. Or, we can reduce inequality at the risk of rising price levels. It may be possible to eliminate this dilemma but, to date, no one has come up with a feasible economic ***and*** political solution that works. Therefore, widespread disaffection with how "the system" works has led to a very fluid political situation that is currently leading to adjusting coalitions. As the legislature struggles, agents looking to create change have turned to the courts to make policy. And so, the Supreme Court, created to adjudicate constitutional matters, has become embroiled in policy issues that should have been decided in Congress. When the founders created a system of lifetime appointments, the goal was to create a body that would rationally decide if a law was in line with the constitution; now, we have created a body that resembles lifetime legislators.

With this development, court appointments have moved from a cool analysis of the legal competence of the nominee to a full-contact political fight. Conditions could become much worse. Watching the arguments from partisan pundits begins to take on the tone of two brothers arguing their case before parents ("he started it…did not!"). In our opinion, the beginning of this current predicament was the Bork nomination, but now we have reached a point where the opposition party may decide that changing the court is their best option. We would not be surprised to see term limits introduced and increases in the number of justices.

For the markets, this is important because policy is likely to change more rapidly than it has in the past. The country and financial markets have been fortunate to have enjoyed a series of long business cycles. After suffering four recessions from 1970 through 1982, we have seen only three since (although, admittedly, the last one was a doozy). Rapidly changing policy, including on regulation and taxes, will make investing decisions difficult and likely lead to shorter business cycles and shorter equity cycles, too.

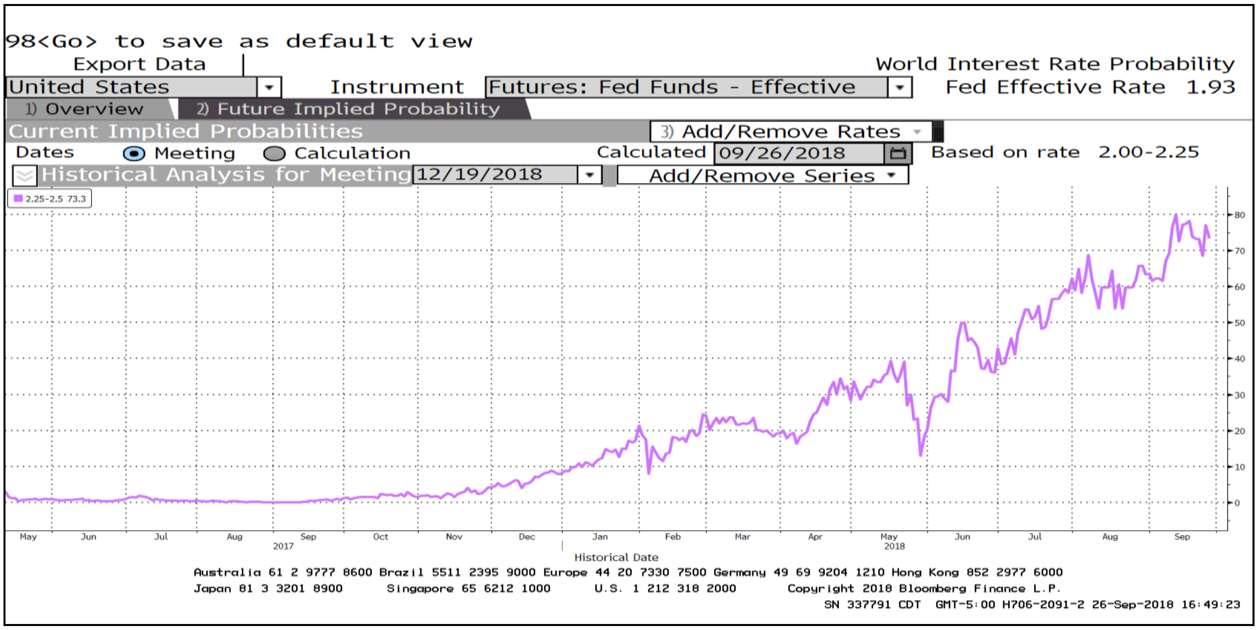
FOMC meeting recap: The statement did what we expected—the word "accommodative" was removed but in the press conference Chair Powell quickly indicated that we shouldn't read too much into the change. In other words, as we noted yesterday, this change likely has more to do with reducing forward guidance and is less about achieving neutrality. The press conference itself was a meandering affair, flipping between suggesting more hikes to come and then reversing to when cuts will commence. This uncertainty is to be expected. We are approaching the point where policy has become less easy and thus we are closer to shifts in policy than we were before.

Here are some charts that detail what we know. Here are the "dots."



The red dots represent yesterday's meeting. The changes from June are not significant and probably reflect the votes of the new vice chair Clarida. The dots signal at least two hikes in 2019, to 3.00% to a potential of 3.25%. The terminal rate is forecast at around 3.25%, and rates are expected to come down in 2020.

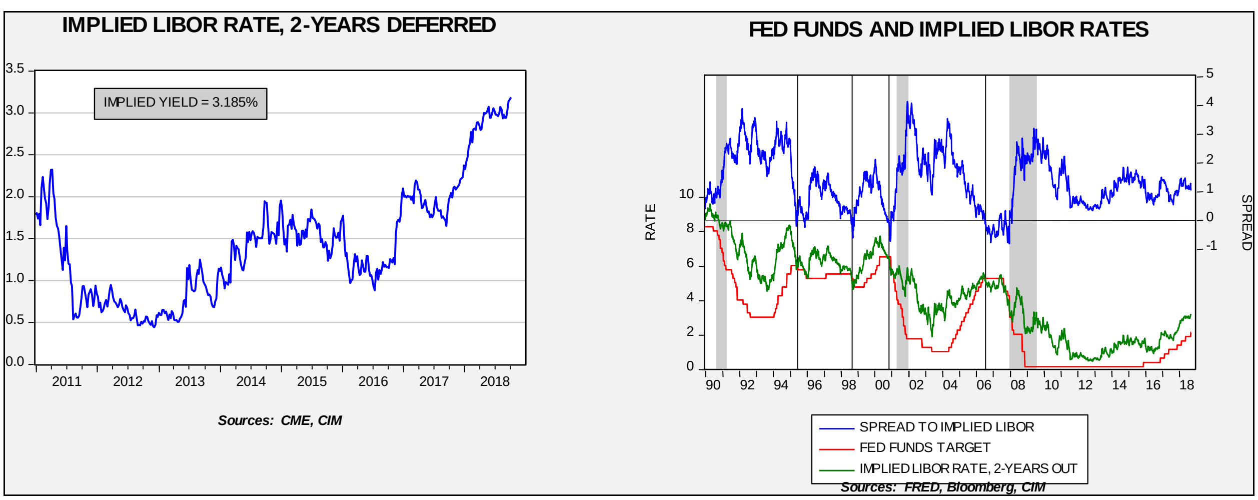
Market projections for rates continue to suggest the path is moving higher. Fed funds futures are putting a high probability on a December rate hike.



(Source: Bloomberg)

The odds for a December hike are around 75%.

The three-month implied LIBOR rate from the two-year deferred Eurodollar futures suggests more hikes to come.



The implied LIBOR rate is up to 3.185%, and the spread between this rate and the Fed's target is suggesting a terminal rate of 3.25% to 3.50%. Of course, the difficult question is when does the rate increase enough to hurt the economy? The chart on the right offers the best clue; when the implied LIBOR rate intersects with the fed funds target, further rate hikes risk recession. Thus, we are about 100 bps from "trouble."

Although the removal of the word accommodative was initially taken as dovish, we really don't see it that way. In yesterday's report, we noted that some of the governors and regional bank presidents are adjusting positions. The hawkish shift from Governor Brainard is of particular interest. The fear, of course, is that the FOMC overtightens. We are not there yet but we are also now entering a rate level where each increase could begin to adversely affect the economy. Today's market action suggests a more hawkish concern.

And, finally, the president did object to the latest rate hike. Although his comments didn't create much of a stir, we are still watching closely to see if he begins to increase pressure on the Fed to adjust policy. We really haven't seen anything like this since Nixon, but if the U.S. government's goal is reflation then a compliant Fed is a necessary component.

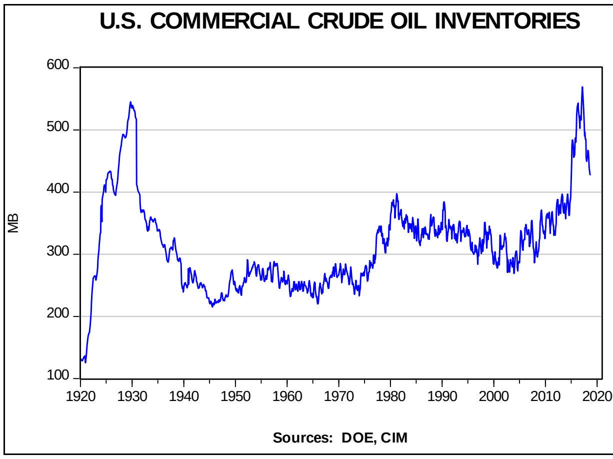
Italian job: Italy is facing a deadline for its budget today; the official word is that the deficit is likely to come in around 2.4% of GDP or less. However, elements within the populist coalition are making noise about increased spending and thus we could see Italian debt pressure develop if the final budget comes in anywhere north of 2.4%.

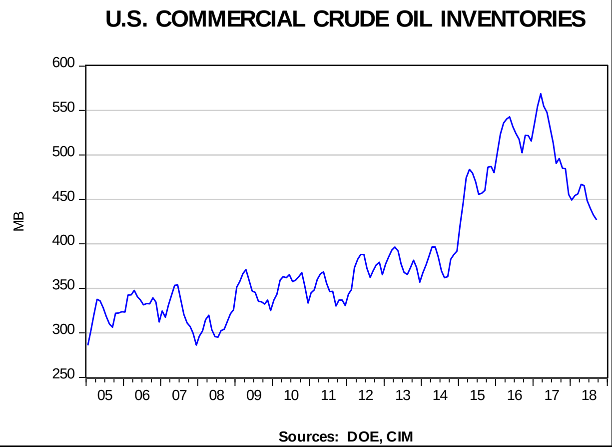
China: There were a couple of news items on China that caught our attention. First, President Trump accused China of meddling in U.S. elections.[1] There was no evidence offered to substantiate the claim, and China has indicated it is not true.[2] It is possible there is classified information that shows Chinese interference. Or, he could be referencing ads taken out recently in the *Des Moines Register* indicating that China was planning on buying South American soybeans due to the administration's trade policy.[3] Tensions with China are clearly increasing; we would not be shocked by evidence of Chinese interference but the CPC should realize that Trump represents a trend in U.S./Chinese relations, not a one-off. The second issue is a growing row between Beijing and Stockholm. According to reports, Chinese tourists arrived a day early at a Swedish hotel and decided to decamp in the lobby. When the proprietors objected to this plan, a shouting match ensued and security forces became involved. A Swedish media outlet made a satirical video skit that has been taken offensively by Chinese officials.[4] China has had tense relations with Sweden due to the Nobel organization giving awards to ostracized Chinese

[1] https://www.washingtonpost.com/politics/without-evidence-trump-accuses-china-of-interfering-in-us-midterm-elections/2018/09/26/c0069910-c19d-11e8-b338-a3289f6cb742_story.html?utm_term=.034d32e938fc&wpisrc=nl_todayworld&wpmm=1
[2] https://www.reuters.com/article/us-usa-china-un/trump-accuses-china-of-2018-election-meddling-beijing-rejects-charge-idUSKCN1M623Y
[3] https://twitter.com/JenniferJJacobs/status/1043916756522283008
[4] https://www.washingtonpost.com/world/2018/09/26/chinas-row-with-sweden-over-racist-tv-skit-has-citizens-urging-boycott-ikea-hm/?utm_term=.3d36b27c928f&wpisrc=nl_todayworld&wpmm=1

artists. We don't know if anything more will come from this,[5] but the level of anger is surprisingly high.

Energy recap: U.S. crude oil inventories rose 1.9 mb compared to market expectations of a 1.5 mb draw.

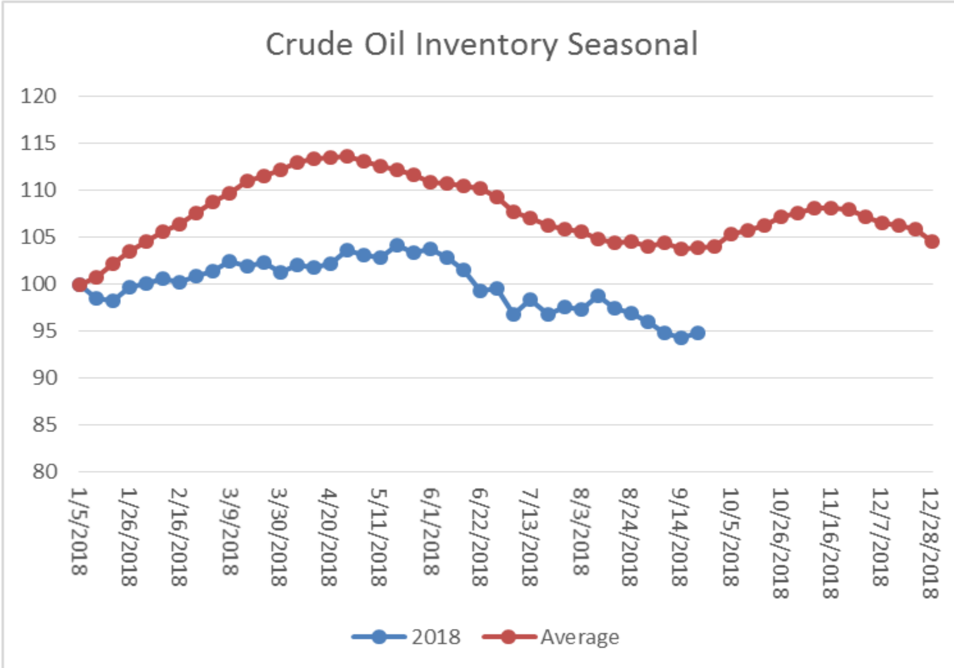




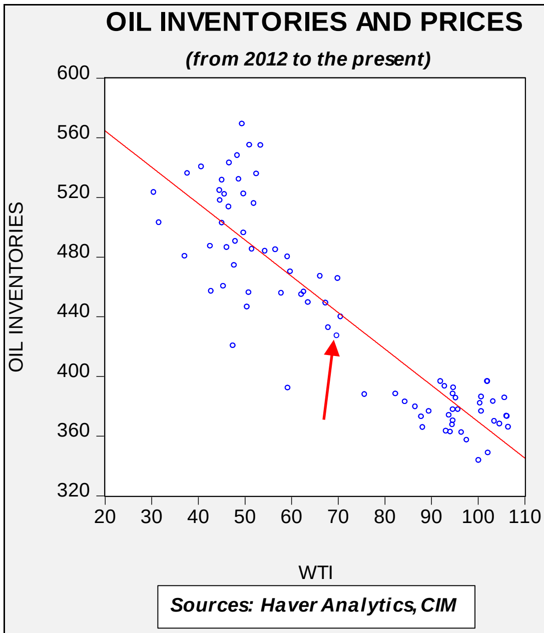
This chart shows current crude oil inventories, both over the long term and the last decade. We have added the estimated level of lease stocks to maintain the consistency of the data. As the chart shows, inventories remain historically high but have declined significantly since March 2017. We would consider the overhang closed if stocks fall under 400 mb. Refinery utilization fell 5.0% to 90.4% last week. Oil production rose 0.1 mbpd to 11.1 mbpd. Exports increased, rising 0.2 mbpd, while imports fell 0.2 mbpd. The rise in stockpiles was a function of falling refining demand.

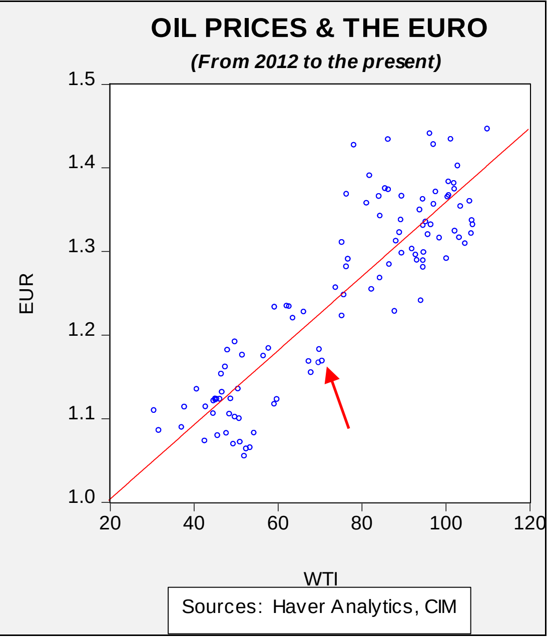
As the seasonal chart below shows, inventories have reached the end of the seasonal withdrawal period. We should begin to see inventories rise in the coming weeks as refinery operations decline for autumn maintenance.

[5] https://www.scmp.com/comment/insight-opinion/united-states/article/2164981/what-chinese-tourist-row-sweden-says-about?wpisrc=nl_todayworld&wpmm=1



(Source: DOE, CIM)



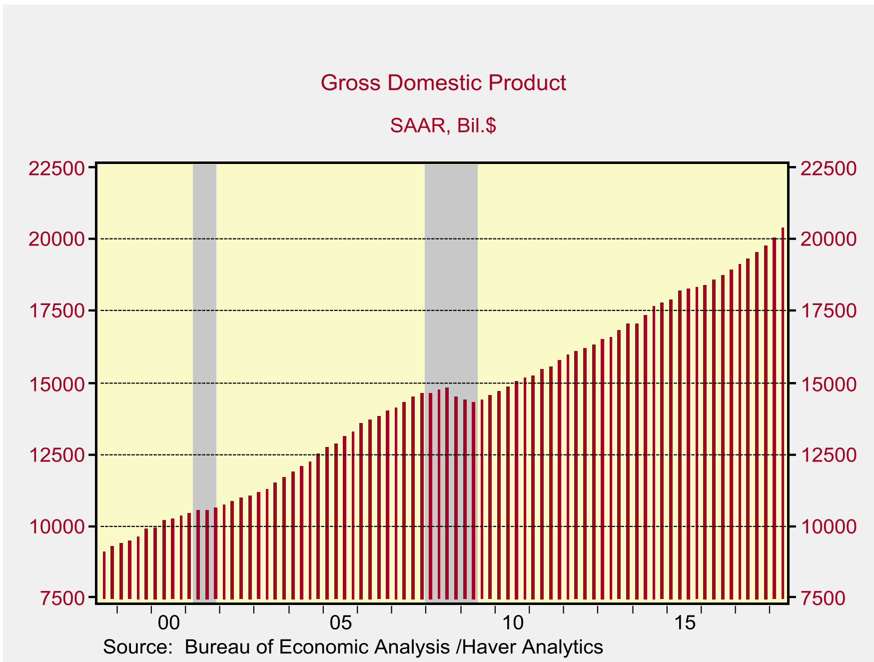


Based on inventories alone, oil prices are below fair value price at $75.35. Meanwhile, the EUR/WTI model generates a fair value of $60.81. Together (which is a more sound methodology), fair value is $65.78, meaning that current prices are well above fair value. The most bearish factor for oil is dollar strength, while the decline in inventories this driving season has been a significant supportive factor.

We note that oil prices lifted this morning on reports that DOE Secretary Perry indicated the U.S. would not release oil from the SPR to lower oil prices. Although this news is bullish if true, the chance that the president could shift quickly on this policy isn't trivial.

U.S. Economic Releases

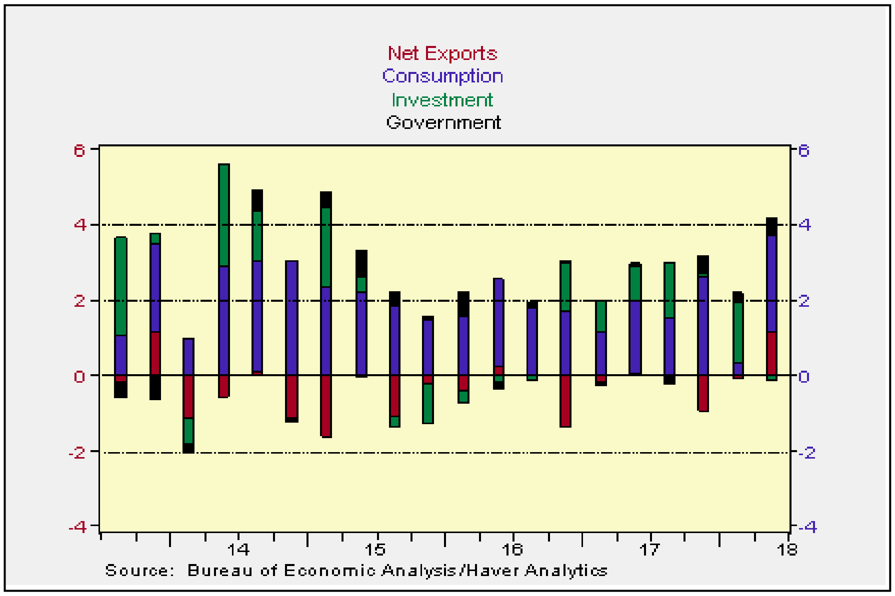
The third reading of Q2 GDP came in line with expectations at 4.2%. Personal consumption was also in line with expectations at 3.8%. Core PCE rose 2.1% from the prior quarter. The overall GDP price index was in line with expectations at 3.0%.



The chart above shows historical GDP. As of right now, GDP continues to grow at a solid pace.

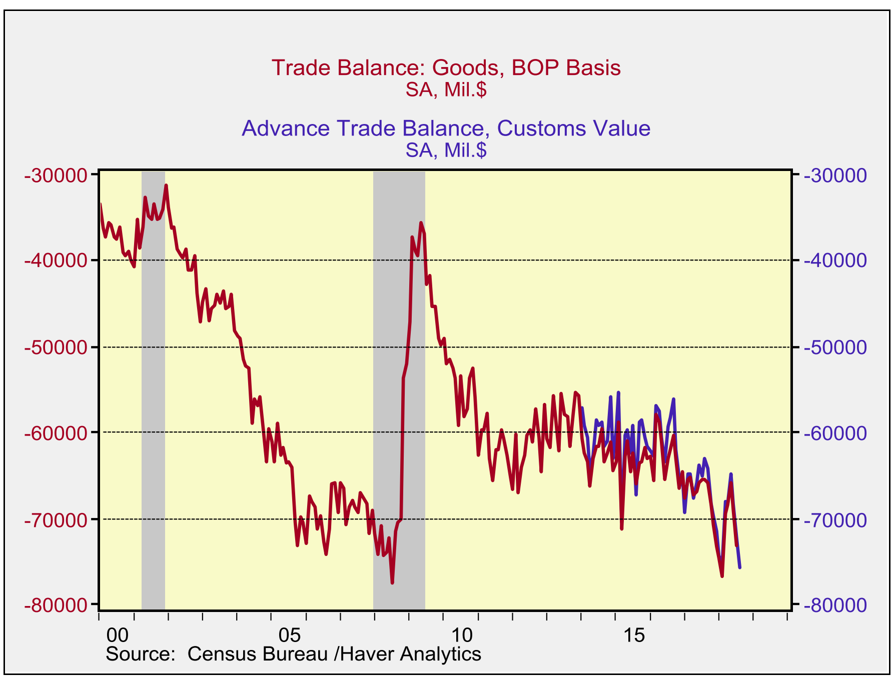
	Q2 2018 Third Reading	Q2 2018 Second Reading	Difference
GDP	4.2%	4.2%	0.0%
Consumption	2.6%	2.6%	0.0%
Investment	-0.7%	0.1%	-0.8%
Inventories	-1.2%	-1.0%	-0.2%
Net Exports	1.2%	1.2%	0.1%
Government	0.4%	0.4%	0.0%

The table above shows the contributions to GDP. There was a sharp rise in consumption in Q2 as well as a boost in exports. This rise in consumption could be a result of growing consumer confidence, whereas the rise in exports is likely the result of foreign companies loading up on inventories before tariffs were put in place. As a result, it is unlikely the momentum from this quarter will continue. At the same time, inventory rebuilding will likely boost Q3 GDP and keep it around 4%.



This chart above shows the contributions graphically. Investment was the only negative component in Q2 GDP and that was due to the drawdown of inventories. As noted above, this would argue that Q3 should benefit from inventory rebuilding.

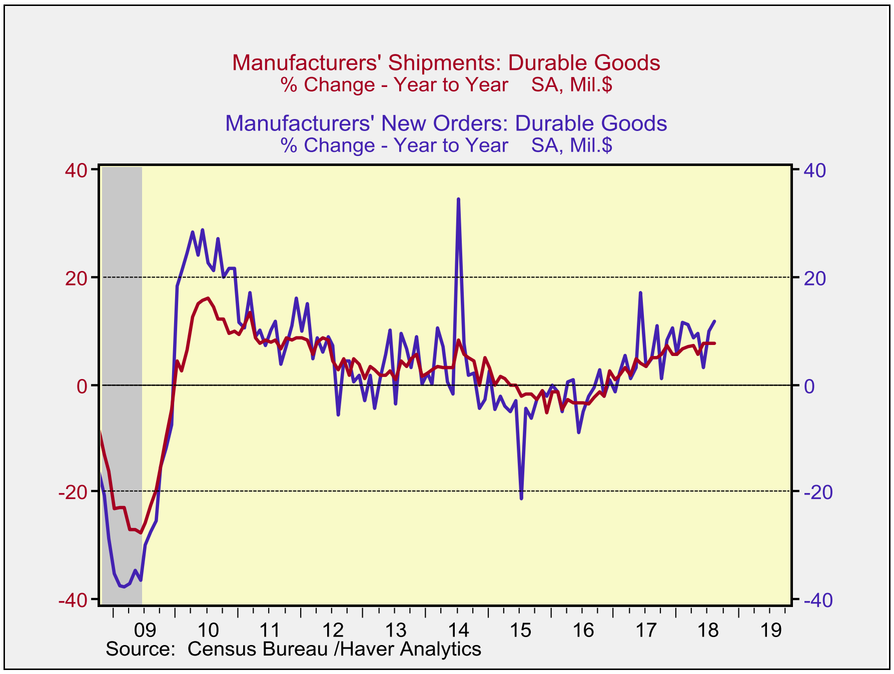
The goods trade deficit came in wider than expected at $75.8 bn compared to the forecast of $70.6 bn. The deficit in the prior report was revised downward from $72.2 bn to $72.0 bn.



The chart above shows the trade balance of goods and the advance trade balance.

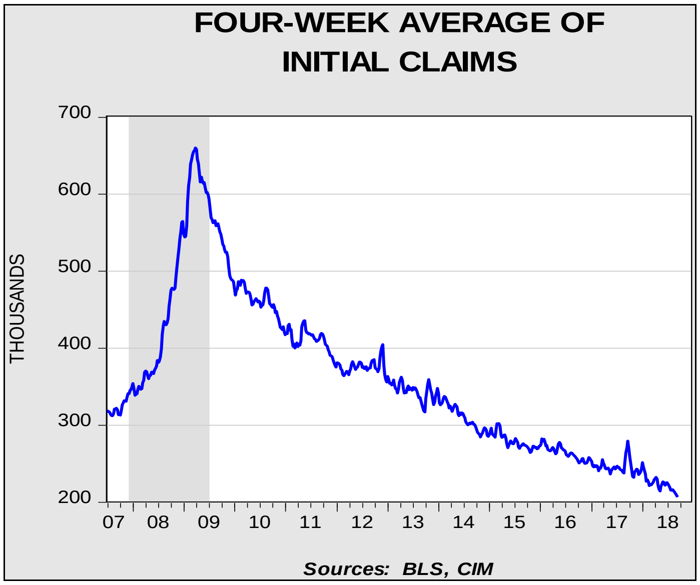
Wholesale inventories came in above expectations, rising 0.8% from the prior month compared to the forecast gain of 0.3%. Retail inventories rose 0.7% from the prior month. The prior month's report was revised upward from 0.4% to 0.6%.

August durable goods orders came in above expectations, rising 4.5% from the prior month compared to the forecast gain of 2.0%. The prior report's loss was revised from 1.7% to 1.2%. Durables ex-transportation came in below expectations, rising 0.1% from the prior month compared to the forecast gain of 0.4%. The prior report was revised upward from 0.1% to a 0.2% gain. Capital goods orders non-defense ex-air came in below expectations, falling 0.5% from the prior month compared to the forecast gain of 0.4%. The prior report was revised from a gain of 1.6% to 1.5%. Capital goods shipments non-defense ex-air came in below expectations, rising 0.1% from the prior month compared to the forecast rise of 0.5%. The prior report was revised upward from 1.0% to 1.1%.



The chart above shows the annual change in new durable goods orders and shipments. Annually, new orders rose by 11.8%, shipments rose by 7.6%, unfilled orders rose by 4.9% and inventories rose by 4.7%.

Initial jobless claims came in above expectations at 214k compared to the forecast of 210k. The previous report was revised upward from 201k to 202k. The rise in claims is likely hurricane-related.



The chart above shows the four-week moving average for initial claims. The four-week moving average increased from 206.00k to 206.25k.

The table below lists the economic releases and Fed events scheduled for today.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Bloomberg Consumer Comfort	m/m	sep		60.2	**
10:00	Pending Home Sales	m/m	aug	-0.5%	-0.7%	**
10:00	Pending Home Sales	m/m	aug	-1.0%	-0.5%	**
11:00	Kansas City Fed Manufacturing Activity	m/m	sep	17	14	**
Fed speakers or events						
EST	**Speaker or event**	**District or position**				
14:00	Robert Kaplan Speaks at Forum for Minority Banking	President of the Federal Reserve Bank of Dallas				
16:30	Jerome Powell Makes Brief Remarks on U.S. Economy	Chairman of Board of Governors of Federal Reserve				

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	Swift Global Payments	y/y	aug	2.1%	2.0%		**	Equity and bond neutral
	Industrial Profits	y/y	aug	9.2%	16.2%		**	Equity bearish, bond bullish
Australia	Job Vacancies	y/y	aug	0.6%	5.7%		**	Equity bearish, bond bullish
EUROPE								
Eurozone	Economic Confidence	m/m	aug	110.9	111.6	111.2	**	Equity and bond neutral
	Business Climate Indicator	m/m	sep	1.21	1.22	1.19	**	Equity bullish, bond bearish
	Industrial Confidence	m/m	sep	4.7	5.5	5.1	**	Equity bearish, bond bullish
	Services Confidence	m/m	sep	14.6	14.7	14.8	**	Equity and bond neutral
	Consumer Confidence	m/m	sep	-2.9	-2.9	-2.9	***	Equity and bond neutral
	M3 Money Supply	y/y	aug	3.5%	4.0%	3.9%	**	Equity bearish, bond bullish
Germany	Gfk Consumer Confidence	m/m	oct	10.6	10.5	10.5	***	Equity and bond neutral
Italy	Manufacturing Confidence	m/m	sep	105.7	104.8	104.5	**	Equity bullish, bond bearish
	Consumer Confidence Index	m/m	sep	116.0	115.2	115.0	***	Equity bullish, bond bearish
	Economic Sentiment	m/m	sep	103.7	103.8		**	Equity and bond neutral
	PPI	m/m	aug	5.1%	3.6%		**	Equity bearish, bond bullish
AMERICAS								
Mexico	Unemployment Rate	y/y	aug	3.5%	3.5%	3.5%	***	Equity bullish, bond bearish
Canada	CFIB Business Barometer	m/m	sep	61.4	61.6		**	Equity and bond neutral
Brazil	Total Sight Deposits Loans	m/m	aug	3155 bn	3125 bn		**	Equity and bond neutral
	Personal Loan Default Rate	m/m	aug	5.0%	5.0%		**	Equity and bond neutral
	FGV Inflation IGPM	y/y	sep	1.5%	0.7%	1.5%	**	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)	238	237	1	Up
3-mo T-bill yield (bps)	214	215	-1	Neutral
TED spread (bps)	24	22	2	Neutral
U.S. Libor/OIS spread (bps)	221	221	0	Up
10-yr T-note (%)	3.05	3.05	0.00	Up
Euribor/OIS spread (bps)	-32	-32	0	Neutral
EUR/USD 3-mo swap (bps)	40	16	24	Down
Currencies	**Direction**			
dollar	up			Neutral
euro	down			Neutral
yen	down			Neutral
pound	down			Neutral
franc	down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
RBNZ Official Cash Rate	1.750%	1.750%	1.750%	On forecast

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	$81.74	$81.34	0.49%	
WTI	$72.25	$71.57	0.95%	
Natural Gas	$2.97	$2.98	-0.30%	
Crack Spread	$17.89	$17.98	-0.47%	
12-mo strip crack	$20.78	$20.87	-0.42%	
Ethanol rack	$1.40	$1.40	0.06%	
Metals				
Gold	$1,194.35	$1,194.44	-0.01%	
Silver	$14.39	$14.33	0.42%	
Copper contract	$279.60	$282.80	-1.13%	
Grains				
Corn contract	$ 361.75	$ 363.00	-0.34%	
Wheat contract	$ 513.50	$ 517.50	-0.77%	
Soybeans contract	$ 848.50	$ 850.00	-0.18%	
Shipping				
Baltic Dry Freight	1503	1450	53	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	1.9	-1.5	3.4	
Gasoline (mb)	1.5	0.7	0.8	
Distillates (mb)	-2.2	0.3	-2.5	
Refinery run rates (%)	-5.00%	-1.00%	-4.00%	

Weather

The 6-10 and 8-14 day forecasts show warmer to normal temperatures for most of the country. Precipitation is expected for most of the country. Tropical Storm Kirk has developed in the Atlantic Ocean and appears to be heading toward the Caribbean Sea; it is forecast to weaken to a depression north of Colombia by the weekend and should not have a significant impact on energy flows. There is a tropical cyclone formation in the middle of the Atlantic that is expected to develop into a tropical storm by Friday, but it is undetermined whether it will make landfall anywhere.

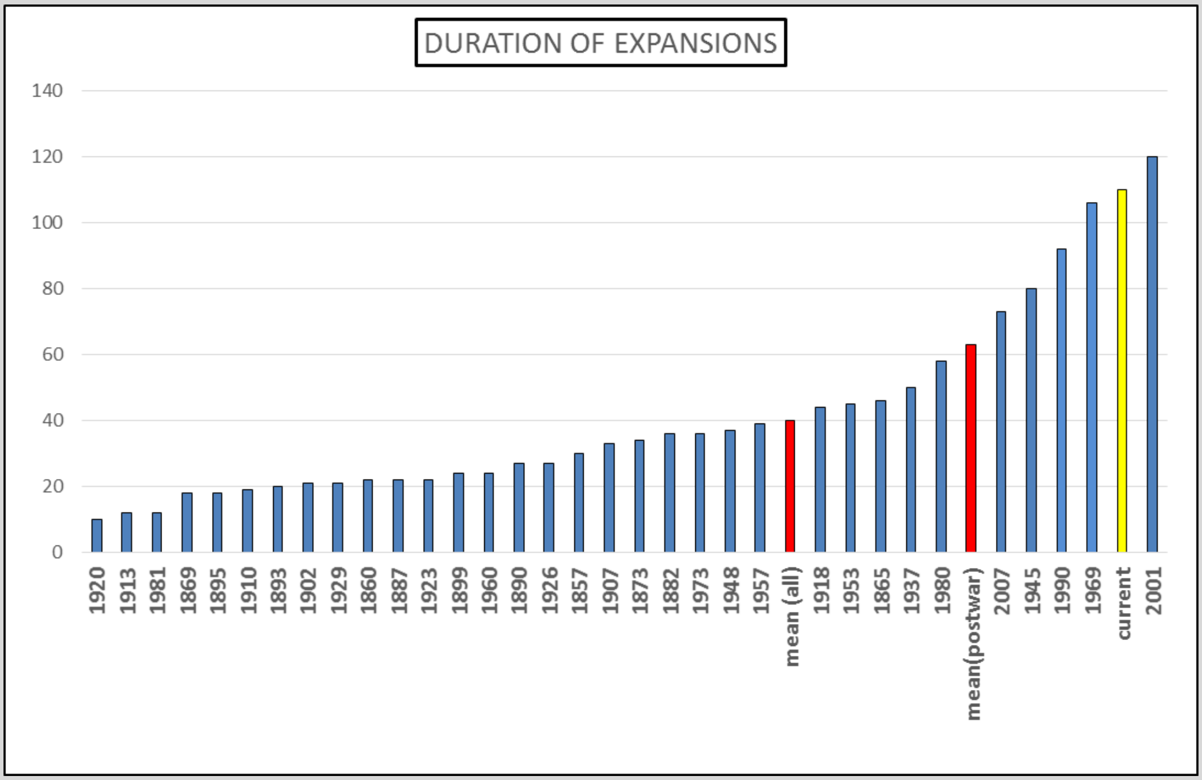
Asset Allocation Weekly Comment

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 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.[6]



(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.

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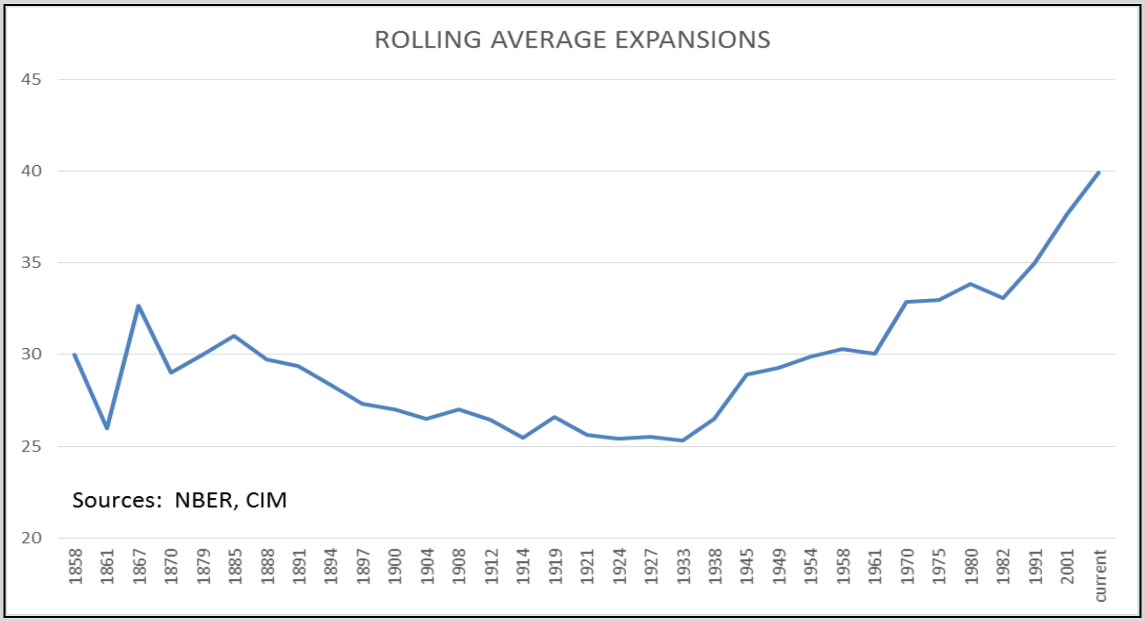
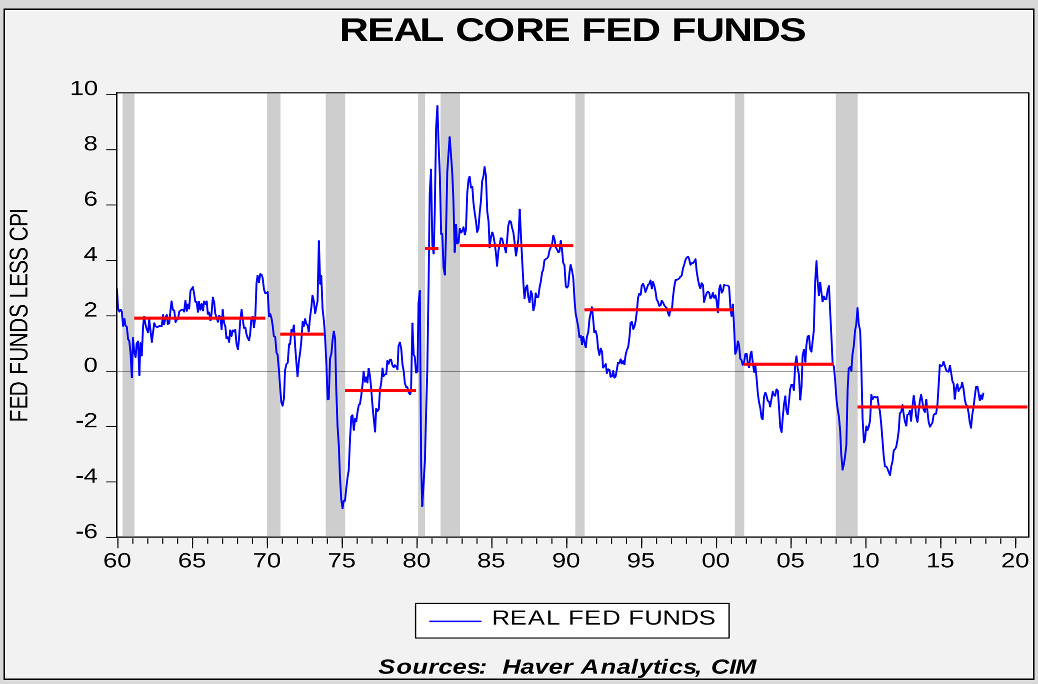
[6] The National Bureau of Economic Research is the arbiter of business cycles. It began tracking business cycles in 1854.

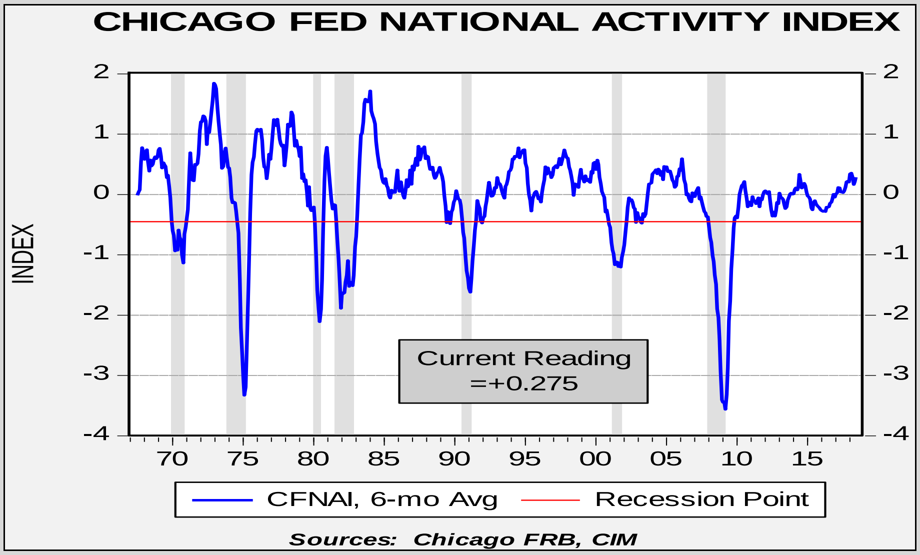


Since the Great Depression, expansions have been lengthening. Moving off the gold standard has allowed for discretionary monetary policy which has tended to support longer expansions. However, the most important factor that has supported longer business cycles in the past forty years has been falling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



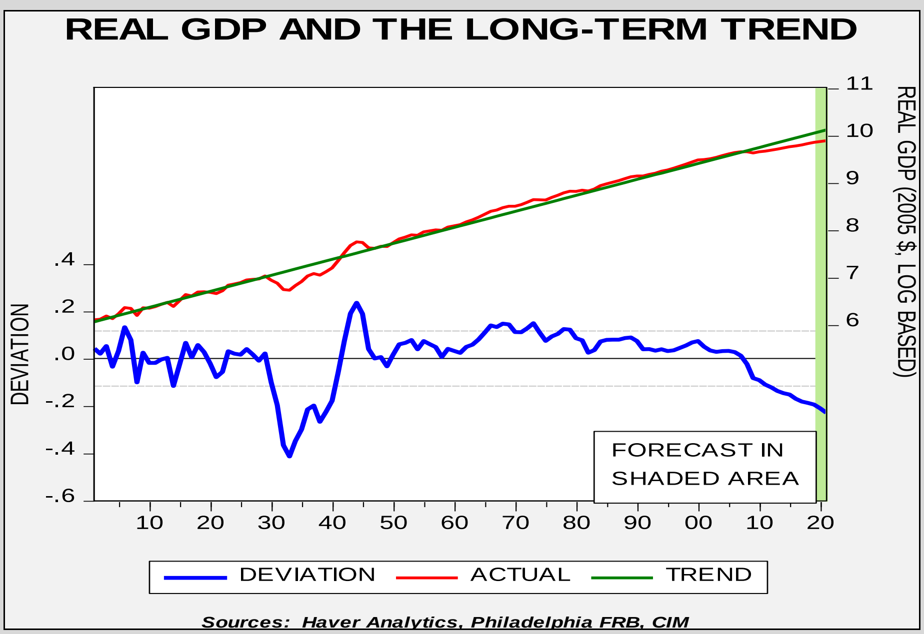
This chart measures real fed funds (effective fed funds less yearly CPI). Note that since the early 1980s, each cycle has had a lower average real rate over the term of the recovery. Much of this is because the Federal Reserve has successfully lowered inflation expectations. With lowered expectations 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.

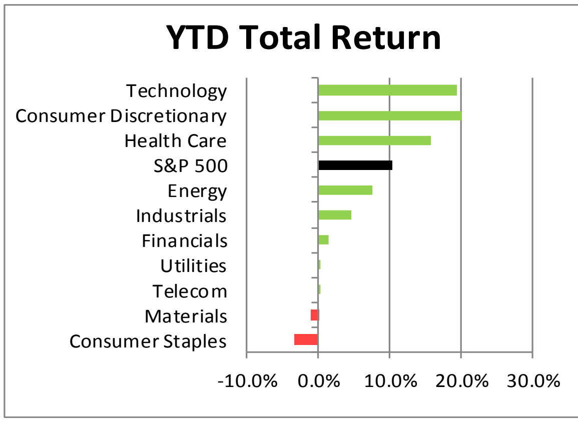
The most interesting issue with the economy is potential growth.

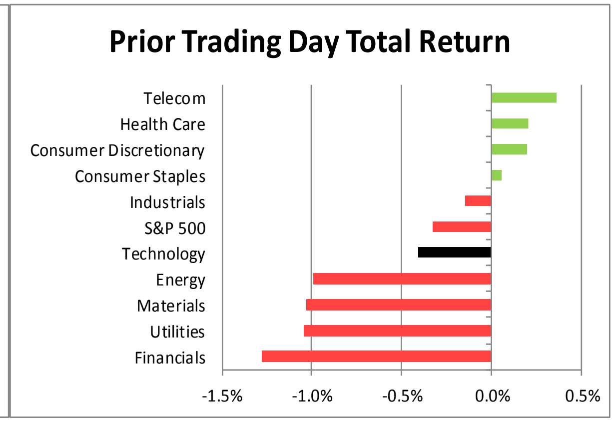


This chart looks at the long-term pattern of real GDP; we have put the data on a log scale and regressed it against a time trend. The deviation line on the lower part of the graph shows the deviation from the long-term trend. We have only seen two periods of well below-trend growth, during the Great 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 9/26/2018 close)

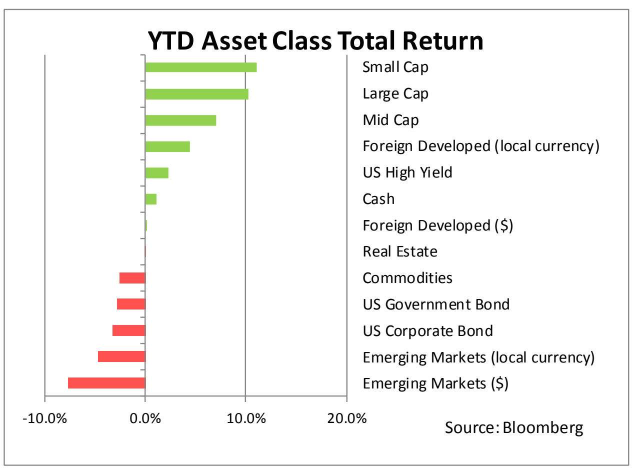




(Source: Bloomberg)

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 9/26/2018 close)

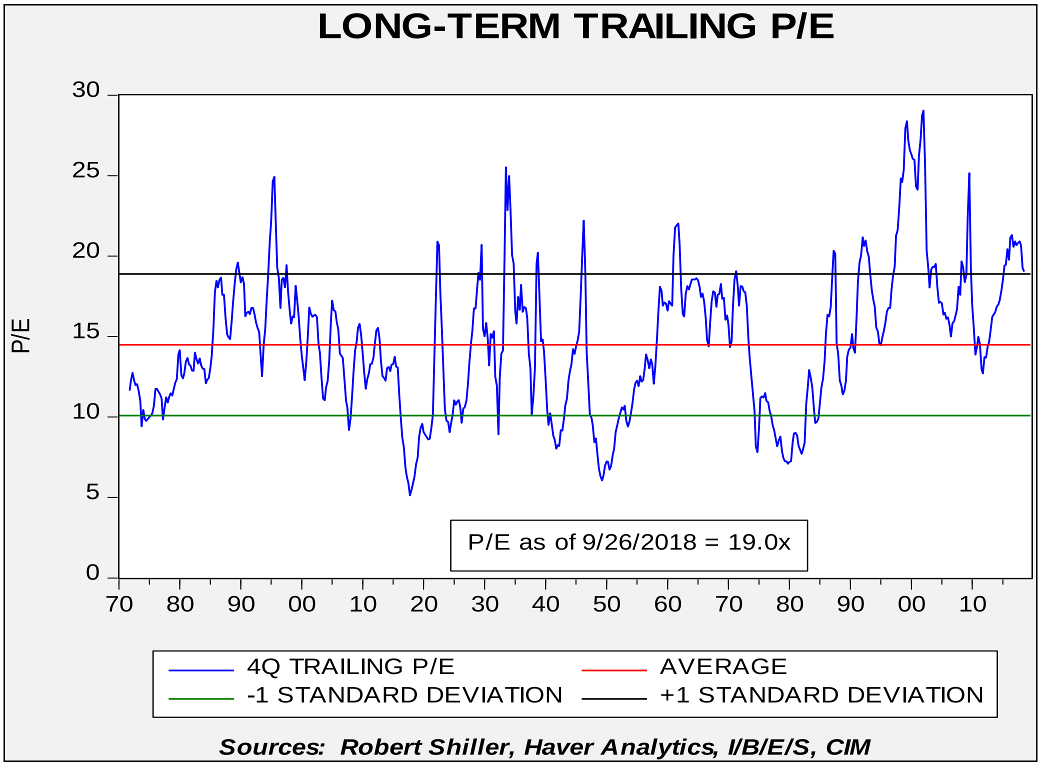


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 27, 2018



Based on our methodology,[7] the current P/E is 19.0, up 0.1x 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.

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[7] 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.