Daily Comment

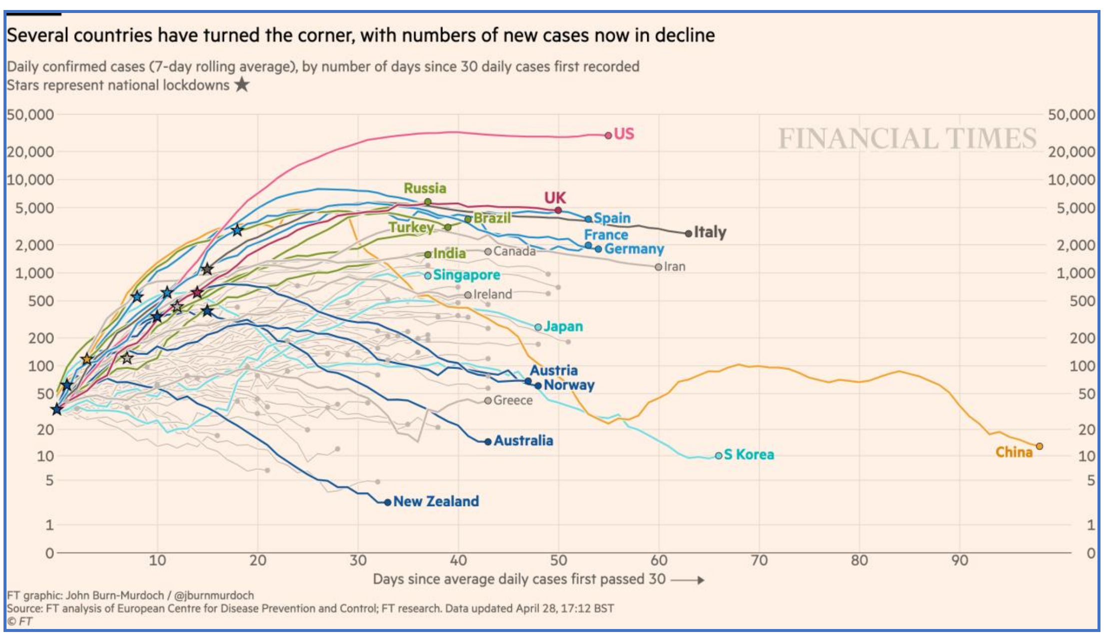
By Bill O'Grady, Thomas Wash, and Patrick Fearon-Hernandez, CFA

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: April 29, 2020—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.1% from its last close. In Asia, the MSCI Asia Apex 50 closed up 0.5% from the prior close. Chinese markets were mixed, with the Shanghai Composite up 0.4% and the Shenzhen Composite down 0.1%. U.S. equity index futures are signaling a higher open. With 170 companies having reported, the S&P 500 Q1 earnings stand at $32.60, lower than the $35.51 forecast for the quarter. The forecast reflects a 10.0% decrease from Q1 2019 earnings. Thus far this quarter, 65.3% of the companies have reported earnings above forecast, while 32.4% have reported earnings below forecast.

The uptick in the markets today comes as coronavirus lockdowns continue to be softened around the world and several drug groups say they could have a COVID-19 vaccine within months. The Fed ends its latest policy meeting today. Overseas, it's still a mystery where Kim Jong Un is, while Russia has apparently sent yet another hit squad to kill an enemy overseas.

COVID-19: Official data show confirmed cases have risen to 3,132,363 worldwide, with 217,947 deaths and 938,037 recoveries. In the United States, confirmed cases rose to 1,012,583, with 58,355 deaths and 115,936 recoveries. Here is the chart of infections now being published by the *Financial Times*:



Virology

- Multiple U.S. and foreign pharmaceutical companies working on a COVID-19 vaccine say they have moved up their timetable for testing and could have a product available for emergency use as early as this fall. Several organizations have already started safety and efficacy tests on human subjects. The news should be a significant positive for a wide range of risk assets.
- On a less positive note, many commercial and academic laboratories in the U.S. say a lack of high-level coordination has left them processing far fewer coronavirus tests than they could. Lab executives and public health officials blame barriers including fragmented supply chains, relatively strict test guidelines, incompatible electronic systems and a lack of centralized data on where capacity exists.

Real Economy

- President Trump invoked the Defense Production Act to declare meatpacking plants as critical infrastructure that must keep operating, in spite of some local governments and unions preferring to close them to slow the spread of the virus. The move will require new measures to protect workers from infection, but it will not compel employees to return to work if they don't want to. Nevertheless, the news should be positive for major meat company stocks.
    - As much as 25% of U.S. pork production capacity is currently idle as is about 10% of beef production. Administration officials said they feared 80% of all U.S. meat production capacity could be shut down without any action.
    - Large packing plants have become a target for virus shutdowns because they often represent a large, concentrated share of the total workforce in the small or rural communities where they are typically located.
- The American Petroleum Institute released data showing U.S. oil inventories expanded less than anticipated last week. The news is boosting oil prices sharply higher so far today, although it will be important to see whether the more benign picture is confirmed by the Energy Information Agency's data later this morning.
- As European countries gradually ease their coronavirus restrictions, high-frequency alternative data on economic activity, such as electricity use and travel, are already starting to show a revival.
- Unfortunately, new analysis shows that emerging market countries trying to support their plunging currencies last month depleted their foreign exchange reserves at the fastest pace since the global financial crisis of 2008-2009. The drawdown of reserves leaves some nations vulnerable to further shocks, so the news is likely to be negative for emerging market bonds and stocks.

Financial Markets

- As a reminder that Italy's economy has been left in tatters even as it gets control of the pandemic, Fitch has cut its rating of Italian sovereign bonds to BBB-.
    - With the downgrade, Fitch joins Moody in assessing Italy's debt at just one notch above junk. S&P last week rated it two notches above.

- In its announcement, Fitch suggested it had been prepared to cut the rating even further, but the Italian government provided additional information that allowed for the investment-grade assessment.

U.S. Policy Responses

- Treasury Secretary Mnuchin said Payment Protection Program loans of $2 million or more would face an audit before being forgiven, with spot checks for smaller loans. The audits will check whether the funds were really used to keep or rehire workers or meet other allowed expenses.
  - Some observers question whether the SBA will really be able to conduct effective audits, which it normally entrusts to banks.
  - All the same, the announcement reflects concern about the political ramifications if the emergency lending leads to widespread fraud.
- In another setback for the PPP, many restaurant owners are expected to forego or return the loans on concerns that they can't meet the requirement to spend the funds within eight weeks, especially when lockdown orders are still in place and many of their employees have more income from unemployment benefits than they get from working.
- Senate Majority Leader Mitch McConnell told Republican lawmakers he doesn't want to include infrastructure funding in the next coronavirus relief bill, but he does want a provision shielding companies from liability in pandemic-related lawsuits.

International Policy Responses

- Expectations are building that the ECB, as early as this week, could significantly expand its relatively modest €750 billion coronavirus bond-buying program toward something more similar to the Fed's aggressive programs.
- The leftist economist Thomas Piketty, who is famous for his recent books linking capitalism to inequality, said in an interview that the EU's need for a strong fiscal response to the coronavirus crisis was being undermined by the policy of making unanimous decisions. To solve the crisis, he called for "a small group of countries" to start making decisions on their own based on majority voting. The idea is yet another reflection of the growing potential for a breakup of the bloc.

Political Fallout

- Australian Prime Minister Morrison has called for an independent international inquiry into the origins of the COVID-19 crisis. The call has drawn a furious response from Chinese officials, who have accused Morrison of being a U.S. pawn and threatened a boycott of Australian goods.

United States: The FOMC will wrap up its latest policy meeting today. While no change is expected in the Fed's basic policy stance, the policymakers will release updated economic forecasts and Chairman Powell could provide additional color on policy going forward during his post-meeting news conference.

North Korea: There is still no solid news on Kim Jong Un's whereabouts, but media reports say North Korean consumers have been panic-buying staples. If even domestic residents of the Hermit Kingdom are sensing a potential crisis, it provides further evidence that an important development may be happening.

Russia-Czech Republic: A Prague district mayor says he is under police protection after authorities informed him that he and two other Prague officials, including the city's mayor, were the targets of a Russian intelligence agent sent to the Czech capital to "liquidate" them. The officials were apparently targeted for their role in removing a statue of a Soviet war hero from a public square in Prague.

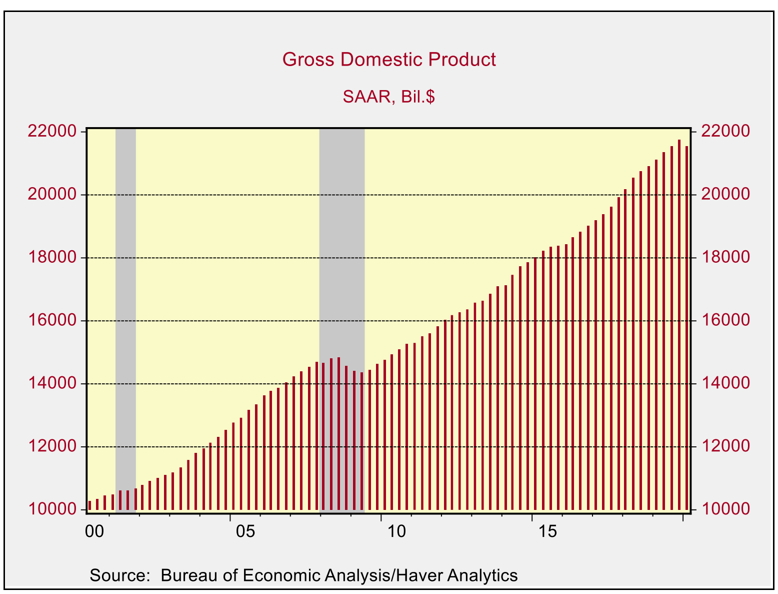
Brazil: The supreme court has authorized a police investigation into President Bolsonaro, days after Justice Minister Celso de Mello resigned and accused the president of crimes ranging from influence-peddling to obstruction of justice for trying to replace police officials investigating his family members. The threat of a massive new political scandal and potential impeachment will likely be negative for Brazilian assets.

Lebanon: As Lebanon's government begins lifting its coronavirus lockdown, protesters demanding economic and political reforms are already back in the streets staging violent demonstrations.

U.S. Economic Releases

MBA mortgage applications fell 3.3% from the prior week. Applications for purchases rose 11.6% from the prior week, while refinancing applications fell 7.3% during that period. The average 30-year fixed rate fell 2 bps from 3.45% to 3.43%.

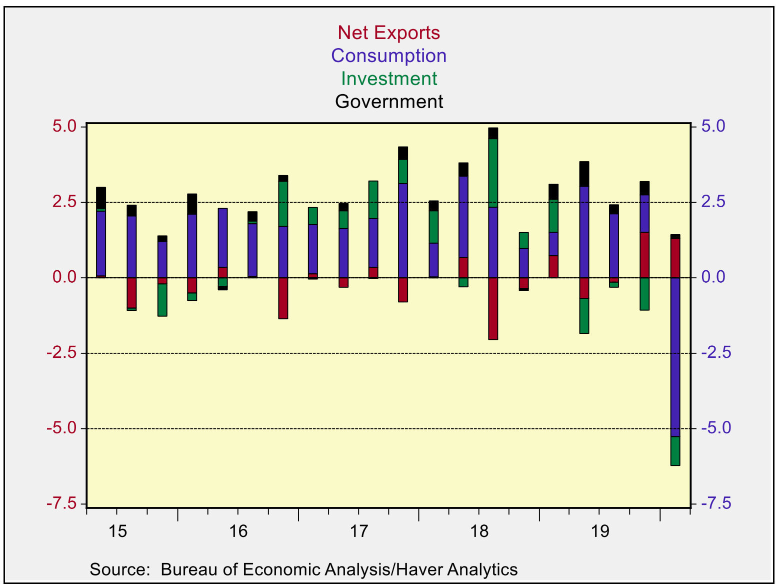
Annualized GDP for Q1 came in at -4.8% compared to forecasts of -4.0%. Meanwhile, the annualized quarterly change in personal consumption came in at -7.6% compared to the forecast of -3.6%. The GDP Price Index and core PCE rose by 1.3% and 1.8%, respectively.



The chart above shows the GDP. Q1 officially marks the end of the longest expansion period in this country's history. GDP currently stands at 21.537 billion, down from 21.729 billion in the previous quarter

	Q1 2020 First Reading	Q4 2019 Third Reading	Difference
GDP	-4.8%	2.1%	-6.9%
Consumption	-5.3%	1.2%	-6.5%
Investment	-1.0%	-1.1%	0.1%
Inventories	-0.5%	-1.0%	0.5%
Net Exports	1.3%	1.5%	-0.2%
Government	0.1%	0.4%	-0.3%

The table above shows the contribution to GDP. Consumption and investment subtracted from GDP 5.3% and 1.0%, respectively. Meanwhile, net exports and government contributed to GDP by 1.3% and 0.1%, respectively.



The chart shows the contribution charts graphically. The rise in exports is likely due to a weakening dollar, making U.S. goods relatively more expensive. The drop in consumption is likely due to economic uncertainty, reducing spending on non-essential goods. At this time, we are optimistic that economic contraction will probably end sometime this year.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Pending Home Sales	m/m	Apr	-13.6%	2.4%	**
10:00	Pending Home Sales	y/y	Apr	-7.6%	11.5%	**
Fed Speakers or Events						
	Speaker or event	**District or position**				
14:00	FOMC Rate Decision	Federal Reserve Board				

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								
Australia	CPI	y/y	2q	2.2%	1.8%	1.9%	***	Equity bearish, bond bullish
New Zealand	Trade Balance NZD	m/m	Mar	0.672 Bil	0.594 Bil	0.686 Bil	**	Equity bullish, bond bearish
Europe								
Eurozone	M3 Money Supply	y/y	Mar	7.5%	5.5%	5.5%	**	Equity bullish, bond bearish
	Economic Confidence	m/m	Apr	67	94.5	73.1	***	Equity bearish, bond bullish
	Industrial Confidence	m/m	Apr	-30.4	-10.8	-25	**	Equity bearish, bond bullish
	Services Confidence	m/m	Apr	-35	-2.2	-27	**	Equity bearish, bond bullish
	Consumer Confidence	m/m	Apr	-22.7	-22.7		***	Equity bearish, bond bullish
Germany	Import Price Index	m/m	Mar	-3.5%	-0.9%	-2.5%	**	Equity bearish, bond bullish
Italy	PPI	m/m	Mar	-1.3%	-0.6%		**	Equity bullish, bond bearish
	Hourly Wages	m/m	Mar	0.1%	0.0%		***	Equity and bond neutral
Switzerland	Credit Suisse Survey Expectations	m/m	Apr	12.7	-45.8		**	Equity and bond neutral
AMERICAS								
Mexico	International Reserves Weekly	w/w	24-Apr	$186.128 Bil	$185.943 Bil		**	Equity bullish, bond bearish
Brazil	IBGE Inflation IPCA-15	m/m	Apr	-0.01%	0.02%	0.01%	***	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)	84	89	-5	Down
3-mo T-bill yield (bps)	8	10	-2	Neutral
TED spread (bps)	76	79	-3	Up
U.S. Libor/OIS spread (bps)	7	7	0	Up
10-yr T-note (%)	0.59	0.61	-0.02	Neutral
Euribor/OIS spread (bps)	-23	-22	-1	Neutral
EUR/USD 3-mo swap (bps)	-17	-18	1	Down
Currencies	**Direction**			
dollar	Down			Neutral
euro	Up			Up
yen	Up			Up
pound	Flat			Down
franc	Flat			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
FOMC Rate Decision (Upper Bound)		0.250%	0.250%	On forecast
FOMC Rate Decision (Lower Bound)		0.000%	0.000%	On forecast
Interest Rate on Excess Reserves		0.100%	0.100%	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	$21.38	$20.46	4.50%	Bullish API Report
WTI	$14.20	$12.34	15.07%	
Natural Gas	$1.96	$1.95	0.46%	
Crack Spread	$16.62	$17.15	-3.06%	
12-mo strip crack	$9.98	$10.01	-0.24%	
Ethanol rack	$1.16	$1.16	0.06%	
Metals				
Gold	$1,706.60	$1,707.79	-0.07%	
Silver	$15.23	$15.17	0.42%	
Copper contract	$235.10	$234.55	0.23%	
Grains				
Corn contract	$ 312.50	$ 312.00	0.16%	
Wheat contract	$ 521.00	$ 526.00	-0.95%	
Soybeans contract	$ 832.25	$ 832.00	0.03%	
Shipping				
Baltic Dry Freight	655	661	-6	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		12.7		
Gasoline (mb)		2.2		
Distillates (mb)		4.8		
Refinery run rates (%)		1.20%		
Natural gas (bcf)		71.0		

Weather

The 6-10 and 8-14 day forecasts currently call for cooler temps for most of the country, with warmer conditions in the Pacific and southwestern regions. Precipitation is expected to move eastward, with dry conditions expected for most of the country toward the end of the forecast period.

Asset Allocation Weekly

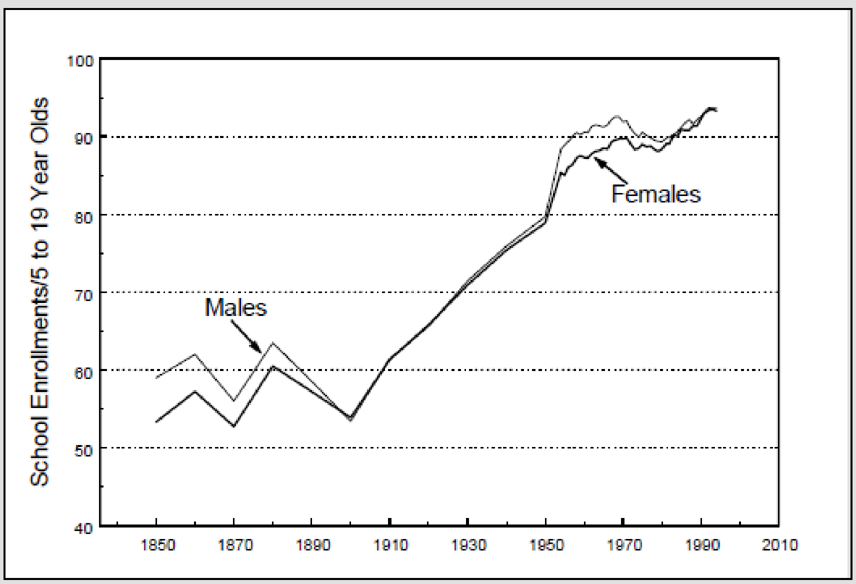
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday. Note that this report is also offered as a separate document on our website.

April 24, 2020

As the COVID-19 pandemic continues to evolve, we are watching to see how the disease will affect the economy longer term. Of course, projections of this sort are highly probabilistic; factors could and will likely emerge that could render these projections irrelevant. At the same, ignoring potential long-term consequences of the virus could lead to improper decisions, failing to fully appreciate the changes the disease has caused.

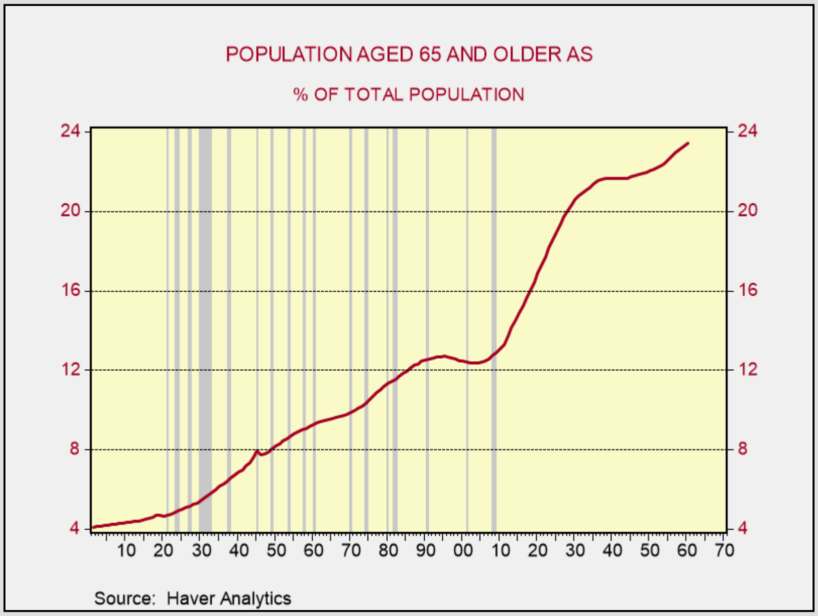
In this week's report, we will look at demographics. Demographic analysis is important because it is a "deep background" of what affects markets. Demographic change tends to occur slowly but can be rather easily forecast far into the future. Thus, if a variable is sensitive to changes in the population, it can be rather simple to forecast trends well into the future.

The baby boom, encompassing Americans born during 1946-64, has always been the "pig in the snake" for demographers. When this generation reached school age, the number of elementary enrollments jumped. Later, in the mid-1970s, enrollment fell and led to empty school buildings.

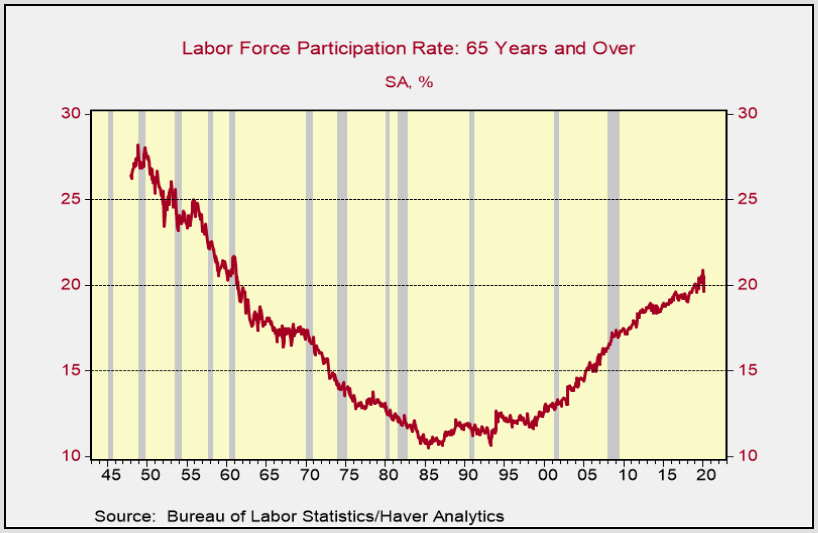


(Source: Goldin, Claudia. "A Brief History of Education in the United States," NBER, Aug. 1999.)

The current age range for the baby boom is 56 to 74. In another seven years, this entire generation will reach retirement age. The chart below shows that the population share 65 years and older is set to rise rapidly for the next two decades. Demographers for years have been warning that the mass retirement of this generation would cause problems in the labor market, predicting that employers would be scrambling to fill positions.



That hasn't happened yet for a number of reasons—globalization has allowed firms to tap labor resources abroad, immigration has offset some of the retirement numbers, and baby boomers have continued to work longer.



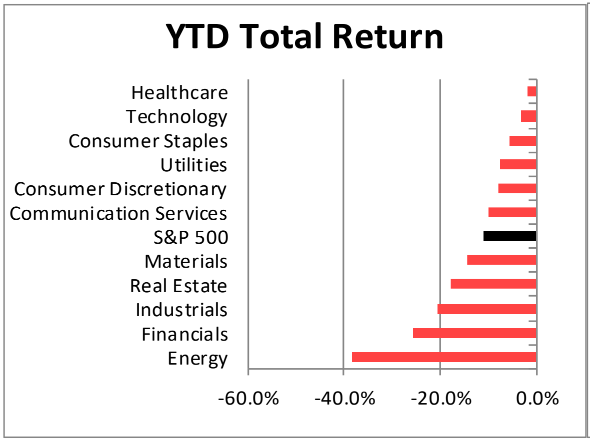
At the turn of the century, the participation rate[1] was around 12.5%. It has steadily increased to over 20%, although it has recently declined. Essentially, baby boomers, which include nine years of this group, appear to have remained in the labor force. We suspect there are two reasons. First, as life expectancies have increased, wealthier boomers, who are probably healthy, likely wanted to remain working. Second, less affluent boomers probably needed to keep working as long as possible due to the lack of retirement saving.

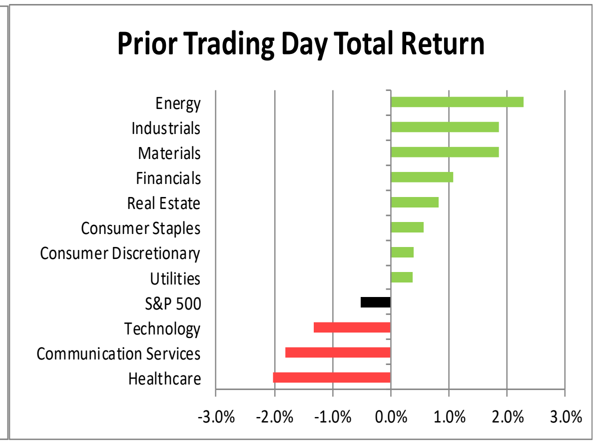
[1] The participation rate is the labor force (employed + unemployed seeking employment)/population eligible to be in the labor force.

COVID-19 could reverse this participation trend. The fatality rate of the virus tends to rise with age. Older workers who have stayed in the labor force may decide that the threat of infection is too high and thus opt to retire. If a broad-spectrum vaccine is developed, this potential trend could be thwarted, but if COVID-19 mutates like influenza and requires an annual vaccination of varying effectiveness, a vaccine might not be enough to prevent older workers from exiting the workforce. A decline in older worker participation would reduce the labor force; if that action occurs along with restrictions on immigration and trade impediments, all tenets of deglobalization, we would expect the labor share of national income to rise.

Data Section

U.S. Equity Markets – (as of 4/28/2020 close)

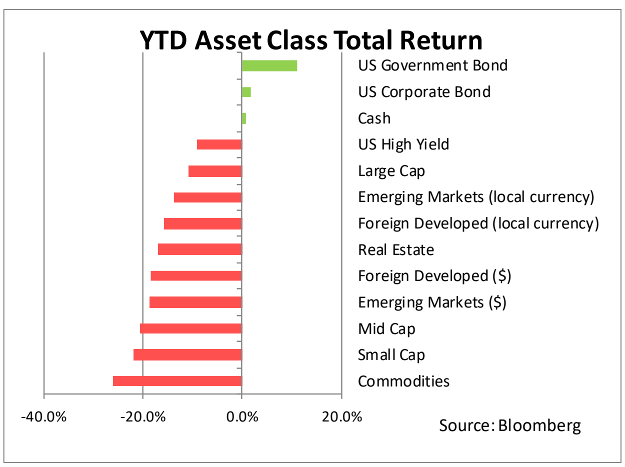




(Source: Bloomberg)

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. These charts represent the new sectors following the 2018 sector reconfiguration.

Asset Class Performance – (as of 4/28/2020 close)

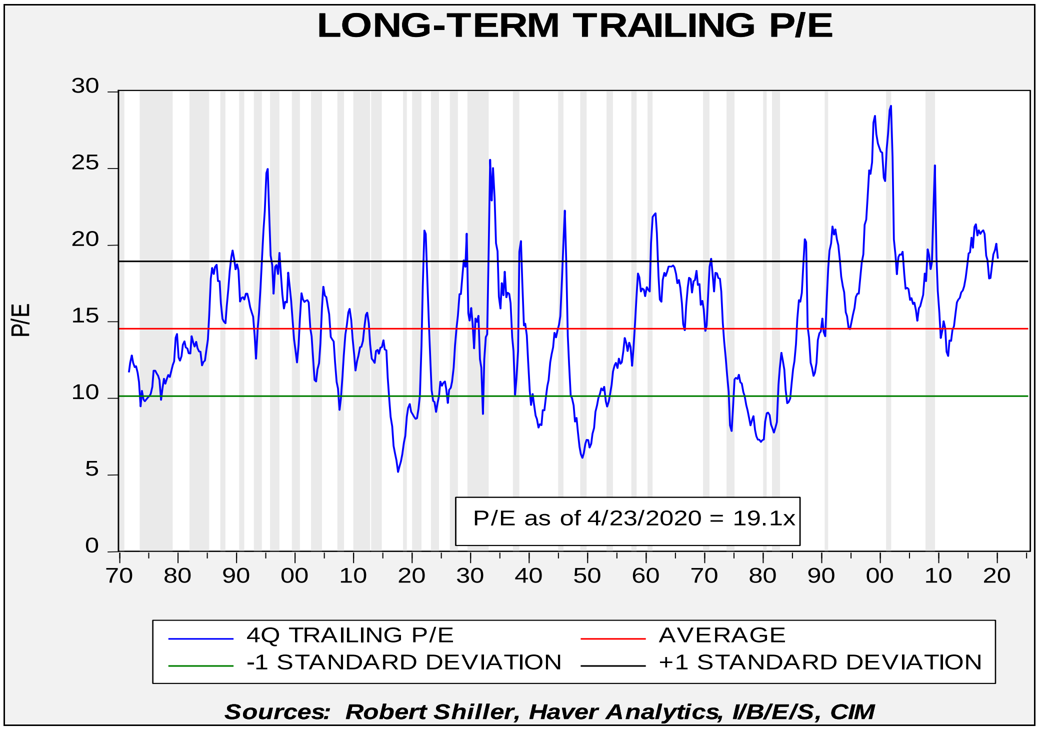


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

April 23, 2020



Based on our methodology,[2] the current P/E is 19.1x, up 0.9x from last week. The rise in the P/E was caused by the recovery in the S&P and falling earnings estimates.

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.

[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 two actual quarters (Q3 and Q4) and two estimates (Q1). 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.