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: August 13, 2020—9:30 AM EDT] Global equity markets are relatively muted this morning. The EuroStoxx 50 is down 0.2% from its last close. In Asia, the MSCI Asia Apex 50 closed unchanged. Chinese markets were unchanged, with the Shanghai Composite relatively unchanged from the prior close and the Shenzhen Composite up 0.1%. U.S. equity index futures are signaling a lower open. With 455 companies having reported, the S&P 500 Q2 earnings stand at $27.50, higher than the $23.72 forecast for the quarter. The forecast reflects a 43.8% decrease from Q2 2019 earnings. Thus far this quarter, 82.4% of the companies have reported earnings above forecast, while 14.1% have reported earnings below forecast.

A new *Confluence of Ideas* podcast episode is available. "The Q3 2020 Asset Allocation Update" joins Greg Ellston, CIO of Asset Allocation, for a discussion of this quarter's outlook and changes to the Asset Allocation portfolios.

The summer doldrums are upon us. Equity markets are mostly steady, with the dollar weakening. We detail the claims data below, but they are showing improvement. We lead with market and economic news this morning, followed by China. Foreign news is next, with updates on the situation in Belarus. We close out today's report with an update on the pandemic. And, being Thursday, we have a new Weekly Energy Update. Here are the details.

Market and Economic news:

- In this week's Asset Allocation Weekly, we discuss the risk to the economy from cuts in state and local government spending (with further analysis in our podcast and chartbook). Library systems, including St. Louis County, have announced layoffs. Cities, strapped for revenue, are reporting job cuts. Reports suggest that cities are suffering more in this downturn than in 2008. Although talks on fiscal stimulus are stuck, the Fed is lowering the rates it charges to state and local government borrowers who use its emergency lending program. We risk seeing a repeat of 2010-11, when falling state and local spending more than offset federal spending, slowing the recovery. In the current situation, it raises the potential for either a stalled recovery or an extended recession. Fed officials are raising concerns that the lack of stimulus is threatening the recovery.
- If working from home is now the future and perhaps remote learning is too, then the location of where you live is less important than the functionality of one's quarters. Being in a tiny neighborhood or big city with exorbitant veterinarian costs doesn't make sense when one can't go outside much anyway. And thus, we are seeing a rising flight to

the suburbs for lower per square foot costs of housing and backyards. Even proximity to shopping isn't a feature now that home delivery is available.

- Remember "liar loans"? These were infamous during the 2007-09 recession as dodgy, no-documentation mortgages were found to be classic examples of Hyman Minsky's third class of financing, "ponzi financing." At the residential level, they don't appear to have returned. But, interestingly enough, we are seeing reports that commercial property borrowers may have overstated their property's income and lenders may have encouraged the practice. If so, this could raise risks in commercial mortgage-backed security markets.
- Mortgage refinancing activity has been elevated in recent months as mortgage rates have declined. The primary guarantors of these mortgages, Fannie Mae (FNMA, 2.11) and Freddie Mac (FMCC, 2.09), are applying a new fee to newly refinanced mortgages of 50 bps. The fee is ostensibly to protect the firms from loan losses, although mortgage lenders are viewing it in less sanguine terms. The fee will tend to dampen refinancing activity, all else held equal.
- One of the problems with using executive orders to legislate is that Congress controls funding. Thus, if the White House wants to fund something via executive orders, it has to find the funding from some other source. To fund the $300 per week additional boost to unemployment insurance, the government is using $44 billion from FEMA funding. Unfortunately, that funding may only last six weeks.
- One of the key components in solar panels, polysilicon, is in short supply after a series of explosions at processing plants in China. Since the industrial mishaps in July, prices are up 50%. China supplies two-thirds of the world's polysilicon and nine of the top 10 solar panel manufacturers are Chinese. This news highlights the problem of deglobalization. When the world is perceived to be at peace, extending and concentrating supply chains is rational. It looks less so in a fractured world.
- The gig economy firms are facing an increasingly adverse legal environment. The district attorney of San Francisco has been filing injunctions against the gig firms forcing them to treat their workers as employees. The business model of these firms borders on regulatory arbitrage; treating their workers as independent contractors allows them to avoid much of the regulatory cost of employees. The firms are threatening to quit California over the dispute.

China news:

- The U.S. is considering a free trade arrangement with Taiwan and Beijing is furious. After the CPC took control of mainland China in 1945, the Nationalist Chinese moved to Taiwan and established the Republic of China. For years, both sides claimed to be the legitimate government of China. Interestingly enough, this led to a period of stasis; the threat to this tacit agreement was if Taiwan ever decided it was a country independent of China. The U.S. action would be similar to China making a free trade deal with California, independent of the federal government. Polls suggest that the majority of Taiwan residents view themselves as singularly Taiwanese. Taiwan independence would be a flashpoint for conflict.

- Despite looming restrictions on Chinese companies listing in the U.S., Chinese firms continue to flock to U.S. exchanges and Wall Street continues to collect fees for their service.
- According to reports, the Xi regime has warned its military not to fire first in standoffs with the U.S. military.
- We have been watching the fate of Taiwan Semiconductor (TSM, 79.39) for some time. The firm is a critical supplier of semiconductors; it also straddles the superpowers, providing products to both China and the U.S. Both nations want to influence the company. Earlier this year, it announced it was building a production facility in the U.S. Today, we note reports that Chinese firms are poaching talent from the company.
- In our WGR series on the elections, we noted that various foreign nations were poised to try to affect the outcome of our election. China was mentioned; we commented that its methods were probably not as sophisticated as Russia's (which are world class, IOHO). However, that isn't to say China's methods are crude. Reports indicate that China has created a network of fake social media accounts to promulgate polished videos against President Trump. We expect more of this sort of activity as November approaches from a variety of nations.

Foreign news:

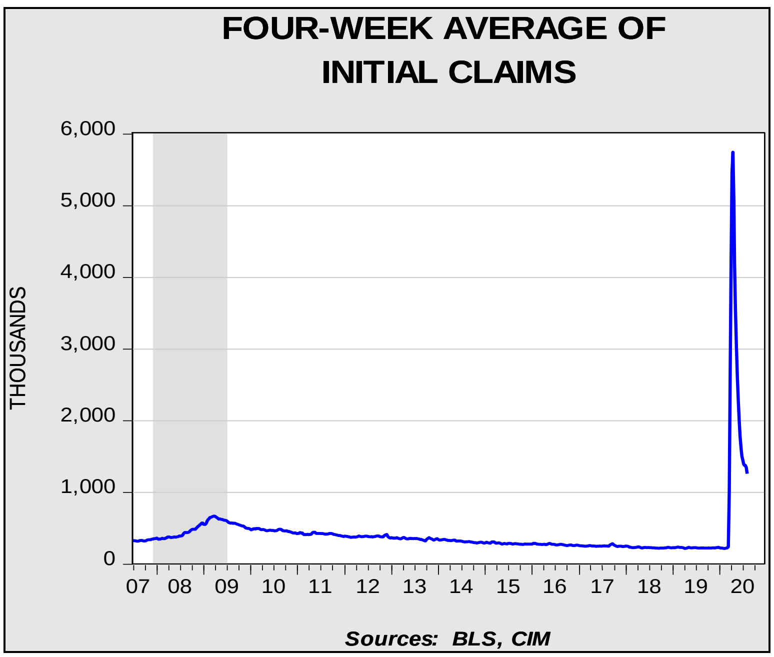
- Despite an aggressive crackdown, protests continue in Belarus. Thousands have been arrested. Security forces have resorted to live ammunition against protestors. At this point, we don't think Lukashenko will be forced from power. Unlike in Ukraine, Belarus doesn't have a natural division. Ukraine has been divided between a Russia-sympathizing east and a Europe-sympathizing west. In Belarus, there is no obvious alternative to Lukashenko. He has greater control over the security apparatus. However, even if he survives this threat, it is unlikely the country will thrive. The election will likely spur the young and talented to emigrate, causing a brain drain. It is likely Lukashenko will be forced to improve ties with Russia as Western nations will be less inclined to deal with him. This means less flexibility in dealing with Putin. Thus, he will survive, but in a weakened state.
- There are reports that Iran seized an oil tanker in the Persian Gulf. The vessel was held for five hours, then released. It is not clear why it was boarded or why it was allowed to leave. Oil markets ignored the news. The event is one in a series of provocative acts by both the U.S. and Iran over the past year. They have raised tensions but not enough to trigger a war.
- Israel claims that North Korean hackers attempted to breach one of its defense firms.

COVID-19: The number of reported cases is 20,648,298 with 750,030 deaths and 12,849,485 recoveries. In the U.S., there are 5,197,749 confirmed cases with 166,038 deaths and 1,755,225 recoveries. For illustration purposes, the *FT* has created a nifty interactive chart that allows one to compare cases across nations using similar scaling metrics. The *FT* has also issued an economic tracker that looks across countries with high frequency data on various factors. The weekly Axios map shows a clear improvement in cases in the U.S.

- We have been reporting a large backlog of testing results that has rendered testing useless. If the results of a test take more than 10 days, by that time, the patient has probably recovered. As a result of this backlog, we are seeing a drop in testing; the good news is that the backlog will likely ease, meaning those getting tested will get their results sooner.
- The most helpful testing is one that generates a rapid result. Although such tests exist, the machines that read the tests are in short supply.
- Although testing and reporting protocols in the developing world are considered weaker than in the developed world, it does appear that the rate of change is slowing in the former. However, the caseloads seem to be plateauing at a high level, which will tend to dampen growth in the emerging world.

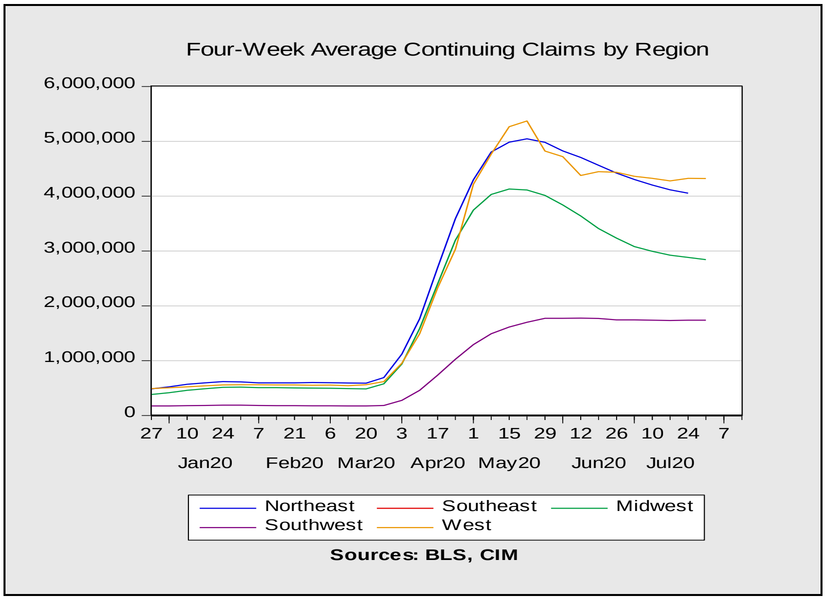
U.S. Economic Releases

For the week ending August 8, initial claims came in at 0.963MM, below expectations of 1.100MM. The prior report was revised from 1.186MM to 1.191MM



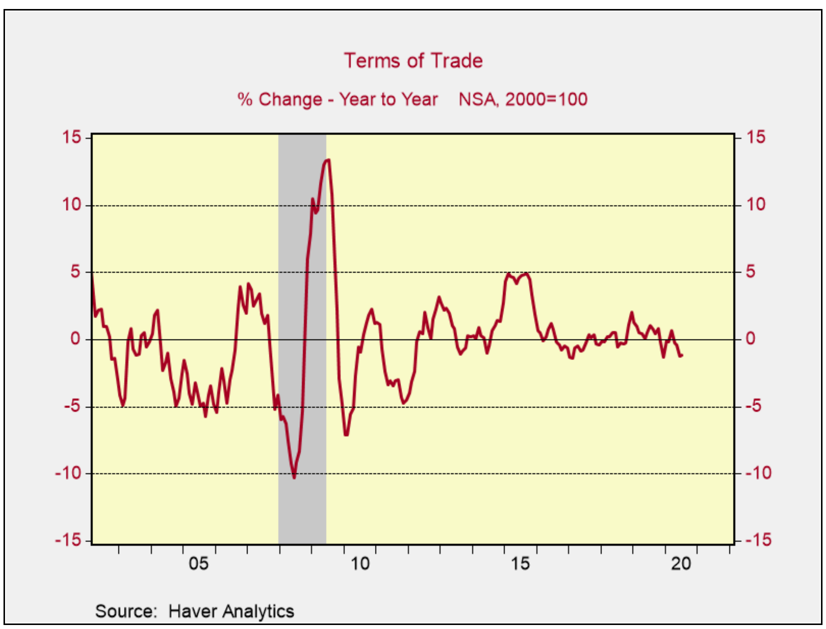
The chart above shows the four-week moving average for initial claims. Last week, the moving average fell from 1.339MM to 1.253MM.

For the week ending August 1, continuing claims came in at 15.486MM compared to expectations of 15.800MM. The prior report was revised from 16.107MM to 16.090MM.



The chart above shows the four-week moving average of continuing claims by region.

Rising commodity prices lifted export and import prices above expectations in July, suggesting that the global economy is starting to recover. The import price index rose 0.7% from the prior month, above expectations of 0.6%. Excluding petroleum, the index rose 0.2% from the prior month, also higher than expectations of a 0.1% rise. The export price index rose 0.8% from the prior month, above expectations of 0.4%.



The chart above shows the annual change in terms of trade. Terms of trade looks at the country export prices relative to its import prices. An improving terms of trade number suggests the living conditions within a country are improving as it is likely the result of either rising export revenue or cheaper input costs. In July, the terms of trade fell 1.21% from the prior year, suggesting a small deterioration in the terms of trade.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomber Consumer Comfort	w/w	9-Aug		44.9	**
Fed Speakers or Events						
	Speaker or event	District or position				
11:00	Raphael Bostic Discusses Equitable Solutions for Future Cities	President of the Federal Reserve Bank of Atlanta				
15:00	Lael Brainard Speaks at Fintech Event	Member 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								
Japan	PPI	y/y	Jul	-0.9%	-1.6%	-1.1%	**	Equity and bond neutral
	Housing Loans	y/y	2Q	2.5%	2.6%		**	Equity and bond neutral
Australia	Consumer Inflation Expectation	y/y	Aug	3.3%	3.2%		**	Equity and bond neutral
	Employment Change	m/m	Jul	114.7k	210.8k	30.0k	***	Equity bullish, bond bearish
	Unemployment Rate	m/m	Jul	7.5%	7.4%	7.8%	***	Equity bullish, bond bearish
	Participation Rate	m/m	Jul	64.7%	64.0%	64.4%	**	Equity bullish, bond bearish
New Zealand	Food Prices	m/m	Jul	1.20%	0.50%		**	Equity and bond neutral
Europe								
France	ILO Unemployment Rate	m/m	2Q	7.1%	7.8%	8.3%	***	Equity bullish, bond bearish
	ILO Mainland Unemployment Rate	m/m	2Q	7.0%	7.6%	8.3%	***	Equity bullish, bond bearish
Germany	Wholesale Price Index	y/y	Jul	-2.6%	-3.3%		**	Equity bullish, bond bearish
	CPI EU Harmonized	y/y	Jul	0.0%	0.0%	0.0%	***	Equity and bond neutral
	CPI	y/y	Jul	-0.1%	-0.1%	-0.1%	***	Equity and bond neutral
UK	RICS House Price Balance	m/m	Jul	-5.0%	12.0%	-15.0%	**	Equity and bond neutral
Russia	Budget Balance YTD	m/m	Jul	-1522.4b	-955.9b		**	Equity and bond neutral
	CPI WoW	w/w	10-Aug	-0.1%	0.0%		**	Equity and bond neutral
AMERICAS								
Mexico	Formal Job Creation	m/m	Jul	-3.9k	-83.3k		***	Equity and bond neutral
Brazil	Retail Sales	y/y	Jun	0.5%	-7.2%	-2.8%	***	Equity bullish, bond bearish
Canada	Housing Starts	m/m	Jul	245.6k	211.7k	205.0k	***	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)	25	26	-1	Down
3-mo T-bill yield (bps)	9	10	-1	Neutral
TED spread (bps)	16	16	0	Up
U.S. Libor/OIS spread (bps)	8	8	0	Up
10-yr T-note (%)	0.67	0.69	-0.02	Neutral
Euribor/OIS spread (bps)	-49	-48	-1	Neutral
EUR/USD 3-mo swap (bps)	1	0	1	Down
Currencies	**Direction**			
dollar	Down			Down
euro	Up			Up
yen	Up			Up
pound	Up			Down
franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Mexico Overnight Rate		5.000%	4.500%	Above 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	$45.27	$45.43	-0.35%	
WTI	$42.56	$42.67	-0.26%	
Natural Gas	$2.17	$2.15	0.60%	
Crack Spread	$9.67	$9.74	-0.75%	
12-mo strip crack	$10.11	$10.18	-0.70%	
Ethanol rack	$1.44	$1.43	0.52%	
Metals				
Gold	$1,929.05	$1,915.83	0.69%	
Silver	$26.01	$25.51	1.96%	
Copper contract	$288.75	$291.20	-0.84%	
Grains				
Corn contract	$ 331.75	$ 327.25	1.38%	
Wheat contract	$ 501.25	$ 500.00	0.25%	
Soybeans contract	$ 890.50	$ 883.00	0.85%	
Shipping				
Baltic Dry Freight	1540	1510	30	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-4.5	-3.7	-0.8	
Gasoline (mb)	-0.7	-1.0	0.3	
Distillates (mb)	-2.3	0.3	-2.6	
Refinery run rates (%)	1.40%	-0.20%	1.60%	
Natural gas (bcf)		33.0		

Weather

The 6-10 and 8-14 day forecasts currently call for warmer temperatures for most of the country, with cooler temps in the eastern half of the country. Wet conditions are expected throughout the southeastern region of the country. There is some cyclone formation south of the Cabo Verde Islands, but it is not expected to make its way to the U.S.

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.

August 7, 2020

Investors often fall into the habit of sloppy thinking about government spending and its relation to the economy. For example, it's easy to focus only on total government-sector expenditures. According to the White House Office for Management and Budget, total government outlays in the U.S. averaged 32.3% of nominal gross domestic product (GDP) over the two decades ended in 2019 (one of the lowest ratios among advanced countries). However, that figure overstates the government's contribution to GDP because it includes a lot of "transfer payments," i.e., funds that are simply redistributed from one set of economic actors to another. Social Security retirement checks, Medicare payments, and unemployment benefits are all examples of such transfers. Counting transfers as a component of GDP would result in double-counting because the funds would also be captured in the calculation when they are spent. Instead, economists strip out transfers from total government outlays and focus only on government consumption and investment expenditures. Over the last two decades, government consumption and investment averaged just 18.8% of GDP.

Government consumption expenditures (on items like wages, fuel, and office supplies) averaged about 15.0% of GDP over the last two decades. Government investment (spending on long-lasting goods like vehicles, buildings, and roads) was much less important for the economy, averaging 3.8% of GDP. The public sector data can also be broken down into the federal government's share and the portion spent by state and local agencies. Over the last two decades, total federal consumption and investment (both defense and nondefense) averaged 7.2% of GDP, while state and local spending accounted for a full 11.6%. Showing all these subcomponents together, the heat table below makes clear that consumption spending by state and local agencies is by far the public sector's most important contributor to national economic activity, at 9.5% of GDP.

U.S. Government Spending / GDP

Average, 2000 - 2019

Source: Haver Analytics

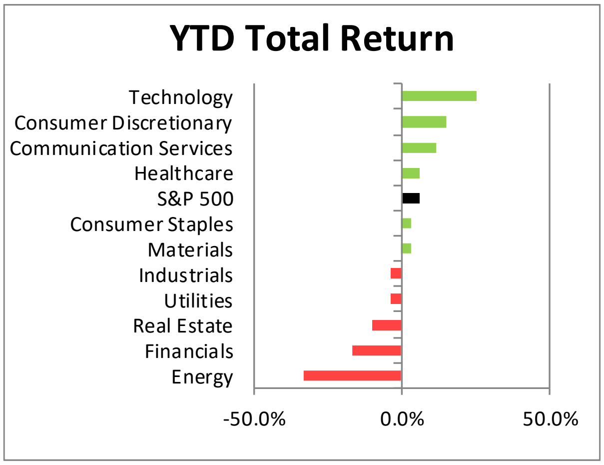
	Consumption	Investment	Total
Federal Defense	3.5%	0.9%	4.5%
Federal Nondefense	2.0%	0.7%	2.7%
State & Local	9.5%	2.2%	11.6%
Total	15.0%	3.8%	18.8%

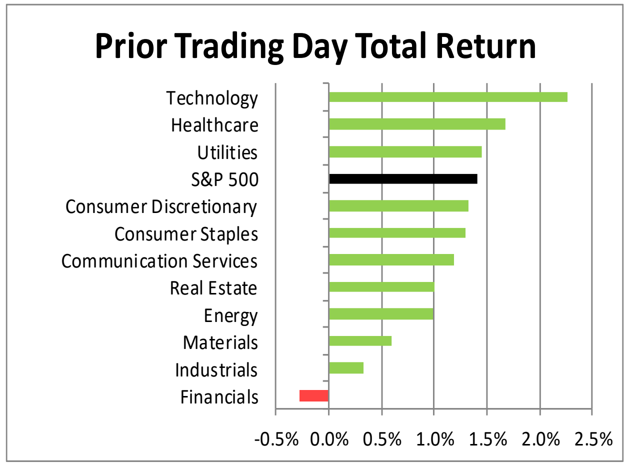
These figures help explain why a key risk for the economy going forward is whether state and local governments, facing a sharp decline in revenues because of the coronavirus crisis, will be forced to cut their spending so much that they offset the stimulatory effect of loose fiscal and monetary policy at the federal level. That's exactly what happened after the Great Financial Crisis of 2008-2009. Corporate and personal income taxes, sales taxes, property taxes, and fees all plunged with the collapse in the housing market and the deep recession that followed, but the impact was especially severe on state and local governments since they are usually bound by law to balance their budgets. Their consumption and investment spending fell far more sharply than the federal government's spending from 2008 to 2013. State and local spending declines in those years initially offset the federal government's increased stimulus spending and later exacerbated the federal spending cuts associated with the "sequester" law. That can be seen most clearly in the chart below, which shows the contribution to GDP from each level of government and the particularly negative contribution from state and local spending in 2010 through 2012.

Going forward, we remain optimistic that the economy will eventually recover from the disruptions of the coronavirus pandemic. With the plethora of potential virus vaccines and treatments in development and the extraordinary amount of monetary and fiscal stimulus being provided, we think many sectors and businesses are likely to regain their footing and start growing again, which would be positive for corporate profits and stocks. However, as the administration and Congress continue to negotiate over the latest coronavirus relief bill, we see a significant risk. If insufficient aid is provided to state and local governments to make up for the pandemic's hit to their revenues, spending in that big chunk of the economy could be cut enough to drag down overall economic activity and weigh on the equity market.

Data Section

U.S. Equity Markets – (as of 8/12/2020 close)

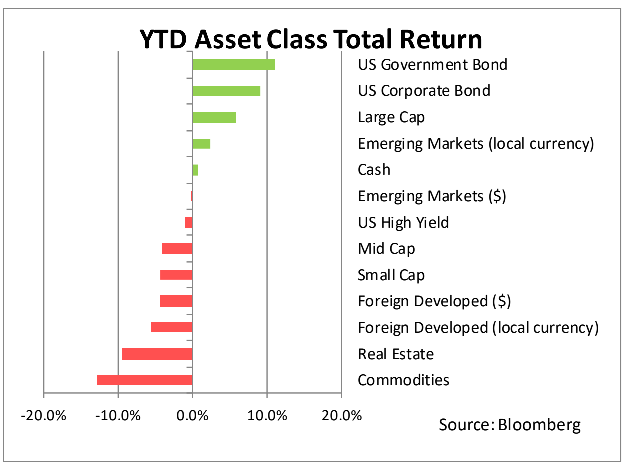




(Source: Bloomberg)

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 8/12/2020 close)

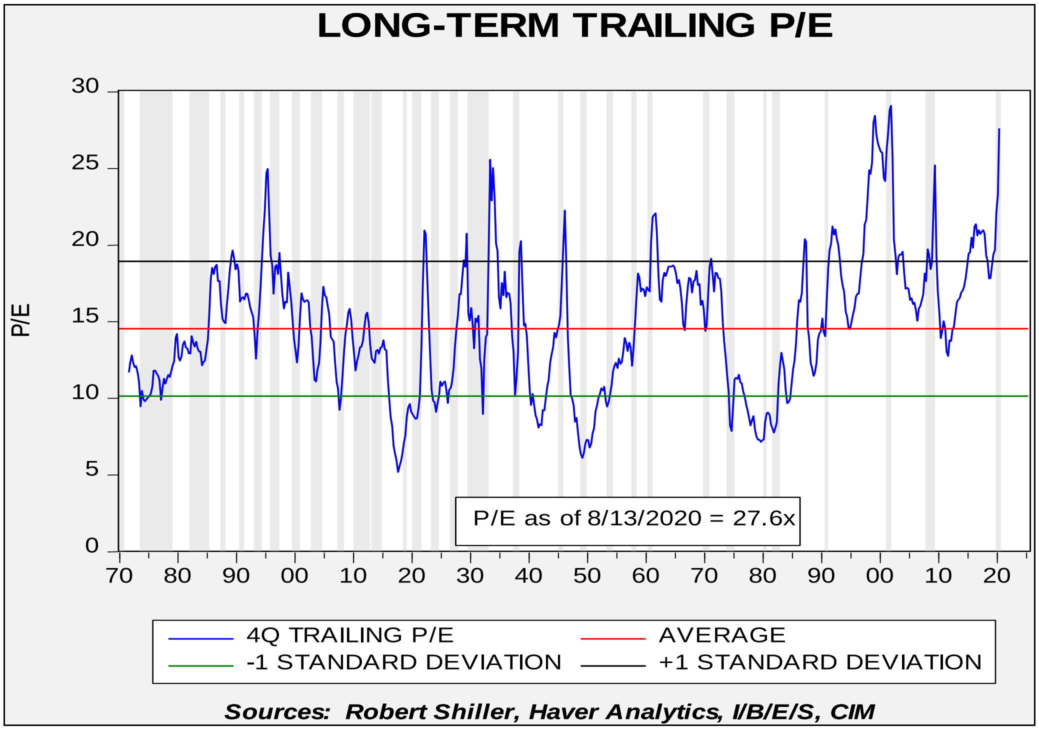


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

August 13, 2020



Based on our methodology,[1] the current P/E is 27.6x, up 0.2x from last week. The rise in the multiple is due to the continued rise in the index. Next week, we expect S&P to update its earnings numbers which tend to be lower than I/B/E/S, which is where we get our forecasts. We expect to see a notable rise in the P/E.

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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[1] 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 (Q4 and Q1) and two estimates (Q2 and 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.