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 31, 2020—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.3% from its last close. In Asia, the MSCI Asia Apex 50 closed down 1.2% from the prior close. Chinese markets were lower, with the Shanghai Composite down 0.2%, and the Shenzhen Composite down 0.4%. U.S. equity index futures are signaling a higher open.

Happy Monday on this last day of August. Risk markets are quietly higher this morning. We begin with Japan, as leaders of the LDP jockey to replace Abe. We update the situation in Belarus and then discuss other foreign news. China's update comes next. We close with the pandemic update. Here are the details:

Abe: After PM Abe's sudden decision to resign, candidates are emerging to replace him. The LDP is planning on filling the position by as early as mid-September, meaning if a MP is interested in taking the role, he (and it appears all the leading candidates are men) needs to make his intentions known. Whoever gets the job will have a long list of tasks to address. Although Japan has managed COVID-19 remarkably well, given the advanced age of Japan, dealing with Japan will remain a serious challenge. In addition, the postponed Olympics are expected next summer, and there is also the issue of the U.S elections.

Belarus: For the fourth consecutive weekend, large protests were held in Minsk. The action didn't ease even on Lukashenko's birthday. Lukashenko is exercising increasing control of the foreign media; if he is considering a major crackdown, having foreign "eyes" out of the way would make sense. The Baltic states announced new sanctions on the country and various officials. Although Lukashenko continues to hold power, we are starting to hear names emerge as a potential replacement. Oleg Gaidukevich, Elivra Mirsalimova, and Viktor Babariko are seen as pro-Russia. If Putin does need to intervene to end the protests, he probably realizes that Lukashenko's time has passed. Sending in security forces but ousting Lukashenko would make sense. There are other potential replacements; however, they are not seen as all that supportive of Moscow. So far, Russia is signaling it could intervene, but it clearly is in no great hurry to do so. Lukashenko has been less than helpful to Moscow for some time; we suspect Putin will allow things to get bad enough that removing Lukashenko will be welcomed, giving Russia the opportunity to replace the current president with someone more compliant.

Other foreign news:

- We should know today if Argentina has enough support from creditors to restructure $65 billion of existing foreign debt. The country has been in default since May. The debt under negotiation is only part of the $323 billion of foreign debt Argentina has on the books. The country is a serial defaulter. The current event is the ninth.

- The EU is considering sanctions on Turkey over the current tensions in the Eastern Mediterranean. We doubt these will be meaningful because Ankara could release thousands of Syrian refugees into the EU, causing another crisis. Adding to this threat is the potential for a wave of new refugees from Lebanon.
- In Lebanon, French President Macron is on his way to Lebanon for the second time since the port tragedy.
- India is accusing China of "provocative military movements" on its northern border. This region has seen rising tensions this year. The two sides did try to improve relations after a flare-up this spring and, until today, there appeared to be at least a cold peace. But it does appear that China is prepared to escalate the situation.
- Brexit talks are stalling. This outcome may not be all that bad for the U.K. Financial markets have had plenty of time to digest this outcome and should have discounted a "hard Brexit." In the end, a U.K. compliant with EU rules but not in the EU is probably worse for Britain. Increasingly, it looks like we will probably get a modest agreement and spend the next decade working out a more permanent solution.
- Montenegro held elections over the weekend. The pro-Western Democratic Party of Socialists appears to have a narrow lead over the pro-Russian parties. Neither bloc has enough seats to form a majority in the legislature, meaning that coalition talks will commence after the vote.

China news:

- TikTok's plan to sell its U.S. operations may run afoul of new Chinese laws that govern technology exports. Under the new regulations, TikTok's product may be considered subject to export controls, thus requiring Beijing's approval before a sale can occur. If this is the case, it may make it impossible to break up the company and the popular app may be shut down for U.S. users.
- China has offered some form of debt relief to 10 nations, half of the 20 asking for help from Beijing. The G-20 has a "standstill program" that defers debt service for 76 low-income countries. China is using the G-20 framework. Angola was not part of the first group. The African nation owes $49 billion of foreign debt, with China's share being 45% of that total. We will be watching to see what sort of aid China will offer Angola, looking for a signal of just how helpful Beijing will be over this issue.
- The leader of the Senate of the Czech Republic has led a 90-person delegation to Taiwan. Milos Vystrcil is the second-highest ranking person in the Czech government. China is furious with the visit. Czech President Zeman has seen his support decline over his policy of building close ties to China; it appears Vystrcil may be signaling a distancing from Zeman by this unofficial visit.
- As tensions rise in the South China Sea, Taiwan is moving to boost its defenses against potential military action by China.

- When Thomas Piketty wrote his tome on capital, it was welcomed in Beijing as a criticism of capitalism and a confirmation of socialism. Piketty followed *Capital in the 21st Century* with *Capital and Ideology*, a book that focuses on inequality. The second book will probably not be published in China because Piketty noted the high level of inequality in China despite its socialist economy. Beijing made censorship of those passages a requirement for Chinese distribution; Piketty refused and so the book is apparently banned.

Unemployment insurance: It appears that only five states are planning to deploy the $300 per week boost to unemployment benefits at this time. Forty-one have applied but implementing the benefits requires tweaks to aging state unemployment systems, and the majority of states simply aren't ready to distribute them.

COVID-19: The number of reported cases is 25,248,595 with 846,871 deaths and 16,634,346 recoveries. In the U.S., there are 5,997,622 confirmed cases with 183,068 deaths and 2,153,939 recoveries. For illustration purposes, the *FT* has created an 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.

Virology:

- The FDA has indicated that it would consider "fast-tracking" a vaccine for COVID-19, although Stephen Hahn has indicated he would not make the decision under political duress. This means the FDA may approve a vaccine before Phase Three clinical trials are complete. Both China and Russia have made similar decisions. There is already a high level of vaccine skepticism in the U.S. Any vaccine will probably have a slow path of adoption, but one that has a rushed approval could be problematic.
- As nations live with COVID-19, we are seeing researchers rethink how to navigate the virus. Broad lockdowns are increasingly being shunned. It does appear outdoor activities are much less risky than indoor meetings. Mask wearing seems to help curb infections. Ensuring the highest risk population take precautions, while allowing younger people to circulate appears to allow the economy to recover without overburdening the medical system. More sophisticated guidance, based on behaviors and locations, are starting to emerge.
  - One trend that has developed is that men appear more susceptible to the negative effects of COVID-19. It appears women have a stronger immune response. This factor may also account for a greater incidence of autoimmune diseases from the virus.
  - As we await a vaccine, one of the unknowns is what sort of immunity a shot will provide. This report offers a primer on the four types of immunities.

COVID-19 and the economy: Two items of note—first, soon after the pandemic shutdowns, companies furloughed thousands of workers. The idea was that the workers were facing temporary layoffs and would soon return to work after the pandemic was corralled. Sadly, it appears that more of these layoffs are turning into permanent separations. Second, real estate finance has a history of fragility. Building lending is rarely self-liquidating, the very definition of Hyman Minsky's speculative finance. Under such conditions, real estate financing is fine until there is a disruption and it suddenly becomes scarce. We are seeing rising stress in the financing for this sector.

U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below lists the economic releases and Fed events scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:30	Dallas Fed Manf. Activity	m/m	Aug	0.0	-3.0	***
Fed Speakers or Events						
	Speaker or event	District or position				
10:30	Raphael Bostic Discusses Inclusive Innovation	President of the Federal Reserve Bank of Atlanta				

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	Composite PMI	m/m	Aug	54.5	54.1		***	Equity bullish, bond bearish
	Manufacturing PMI	m/m	Aug	51.0	51.1	51.2	***	Equity bullish, bond bearish
	Non-manufacturing PMI	m/m	Aug	55.2	54.2	54.2	**	Equity bullish, bond bearish
Japan	Industrial Production	m/m	Jul	8.0%	1.9%	5.0%	***	Equity bullish, bond bearish
	Retail Sales	y/y	Jul	-2.8%	-1.2%	-1.7%	*	Equity and bond neutral
	Vehicle Production	y/y	Jun	-36.6%	-61.1%		**	Equity bearish, bond bullish
	Housing Starts	y/y	Jul	-11.4%	-12.8%	-12.5%	**	Equity and bond neutral
Australia	Melbourne Institute Inflation	m/m	Aug	0.1%	0.9%		**	Equity and bond neutral
	Private Sector Credit	m/m	Jul	-0.1%	-0.2%	-0.1%	**	Equity and bond neutral
	Company Operating Profit	q/q	2Q	15%	1.1%	-6.0%	**	Equity bullish, bond bearish
	Inventories SA	q/q	2Q	-3.0%	-1.2%	-1.0%	**	Equity bearish, bond bullish
	CBA Australia PMI Composite	m/m	Aug	48.8	57.8		**	Equity bearish, bond bullish
New Zealand	ANZ Business Confidence	m/m	Aug	-41.8	-42.4		**	Equity bearish, bond bullish
	ANZ Activity Outlook	m/m	Aug	-17.5	-17		**	Equity bearish, bond bullish
Europe								
Italy	GDP WDA	q/q	2Q	-12.8%	-12.4%	-12.4%	***	Equity bullish, bond bearish
	CPI NIC incl. tobacco	y/y	Aug	-0.5%	-0.5%	-0.3%	***	Equity bullish, bond bearish
	CPI EU Harmonized	y/y	Aug	-0.5%	-0.3%	0.8%	***	Equity bullish, bond bearish
Switzerland	Real Retail Sales	m/m	Aug	4.1%	1.1%		**	Equity and bond neutral
AMERICAS								
Canada	Quarterly GDP Annualized	q/q	2q	-38.7%	-8.2%	-39.6%	***	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)	24	25	-1	Down
3-mo T-bill yield (bps)	10	10	0	Neutral
TED spread (bps)	15	15	0	Up
U.S. Libor/OIS spread (bps)	7	7	0	Up
10-yr T-note (%)	0.74	0.72	0.02	Neutral
Euribor/OIS spread (bps)	-48	-48	0	Neutral
EUR/USD 3-mo swap (bps)	5	5	0	Down
Currencies	**Direction**			
dollar	Down			Down
euro	Up			Up
yen	Up			Up
pound	Up			Down
franc	Up			Up

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	$46.45	$45.81	1.40%	Global Growth Optimism
WTI	$43.52	$42.97	1.28%	
Natural Gas	$2.64	$2.66	-0.56%	
Crack Spread	$9.21	$9.34	-1.39%	
12-mo strip crack	$10.79	$10.81	-0.15%	
Ethanol rack	$1.53	$1.53	-0.04%	
Metals				
Gold	$1,966.72	$1,964.83	0.10%	
Silver	$27.91	$27.50	1.49%	
Copper contract	$305.10	$301.95	1.04%	
Grains				
Corn contract	$ 363.75	$ 359.25	1.25%	
Wheat contract	$ 558.25	$ 548.75	1.73%	
Soybeans contract	$ 964.50	$ 950.50	1.47%	
Shipping				
Baltic Dry Freight	1488	1504	-16	

Weather

The 6-10 and 8-14 day forecasts currently call for cooler temperatures for most of the country, with warmer temperatures throughout the East and West Coasts. Dry conditions are expected throughout most of the country, with wet conditions expected in the eastern third. There is some cyclone formation off the Carolina coast.

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 28, 2020

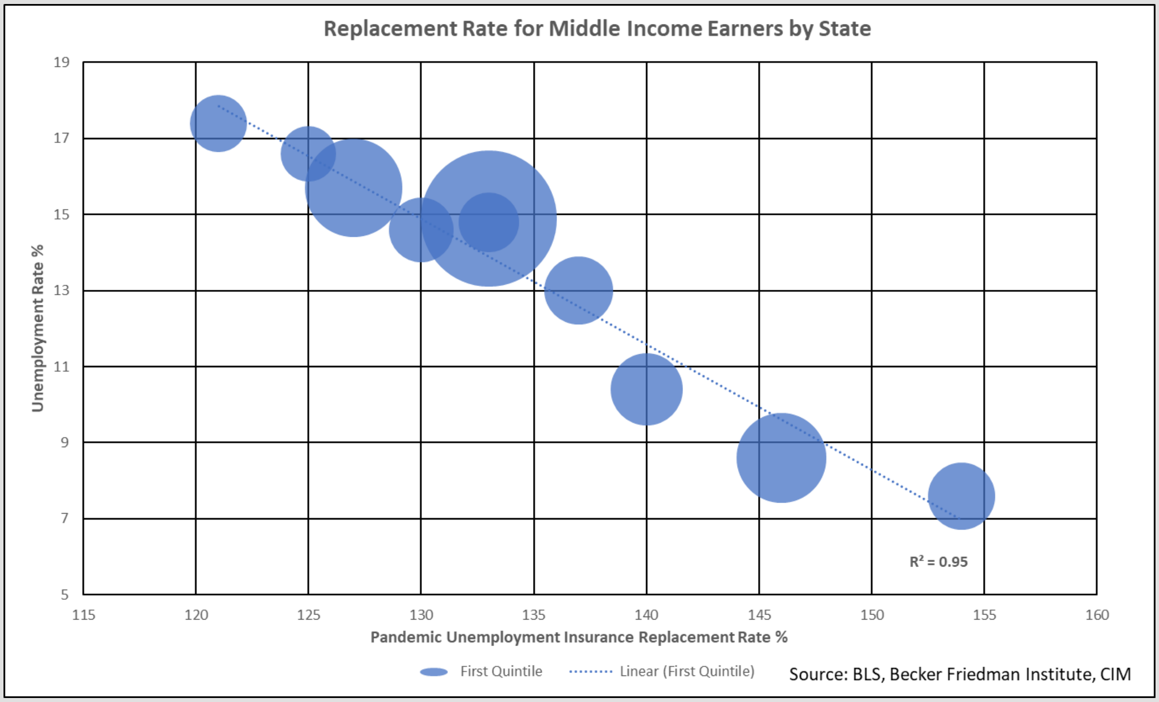
As people think about the supplemental federal unemployment benefit of $600 per week that was in place through July, most would assume that if the total benefits exceed a person's actual wages, they will choose to be unemployed instead of accepting employment. Anecdotal reports suggest that companies are running into this problem. In fact, Dallas FRB President Robert Kaplan, in an interview with Bloomberg's Mike McKee, noted that he was hearing of this problem from his business contacts in the 11th Federal Reserve District. However, he also noted that there was little evidence in the data of this phenomena. So, why isn't this seen in the data? The answer may have something to do with a person's economic outlook.

Accepting unemployment benefits, even with the added booster, may be a costlier choice than most people realize. Because employment benefits are temporary, people must weigh whether it is in their best interest to accept benefits with the opportunity cost of giving up work tenure and experience, even at lower compensation compared to not working. During an expansion, it might make sense to accept benefits, especially if it comes with a booster, as people would have an easier time finding work once the entitlements run out. However, the same is not true when an economy is in recession.

In a recession, having a job provides workers a relatively reliable and potentially long-lasting source of income during a time of uncertainty. Unemployment benefits, particularly with the added booster, are not only temporary but are also subject to change. Hence, workers may be less receptive to generous benefits if they suspect that a job won't be available when they need it. This dilemma may partially explain why many economists failed to find conclusive evidence in the data to suggest that getting rid of the added benefits would lead to lower unemployment.[1, 2]

Our own research found evidence to suggest that the opposite may be true. Looking at the top 10 states by the number of continuing claims, we found that unemployment benefits and the unemployment rate were inversely correlated. Thus, the more generous the benefits, the lower the unemployment rate. One possible explanation for this inverse relationship may be due to the fact that people who live in or near a megalopolis are more confident in finding new opportunities than people who don't, hence people living in those areas are more likely to accept the benefit.

[1] https://tobin.yale.edu/sites/default/files/files/C-19%20Articles/CARES-UI_identification_vF(1).pdf
[2] https://www.wsj.com/articles/economists-vs-common-sense-11596398926



The chart above shows the unemployment rate and the pandemic unemployment insurance replacement rate by state.[3] The bubble size represents the amount of people receiving unemployment benefits. Eight of these 10 states, listed on the above graph, are the highest in population and the two that are not, New Jersey and Massachusetts, are near major population centers. It is possible that employment opportunities are better in these larger states.

In no way are we arguing that higher unemployment benefits will lead to lower unemployment. In fact, the full chart,[4] which includes all 50 states, clearly shows that the unemployment rate and the replacement rate are uncorrelated. However, this chart may be a reflection of workers' unwillingness to turn down a job today when there is no guarantee that there will be a job in the future.

This thesis is further supported by the jobs report. From May through July, the industries offering the lowest average weekly wage saw the biggest expansion in their respective payrolls. In fact, the two lowest-paying industries, "leisure and hospitality" and "retail trade," accounted for nearly 60% of the jobs created in that time frame. Therefore, wages clearly aren't being prioritized for those choosing to return to work.

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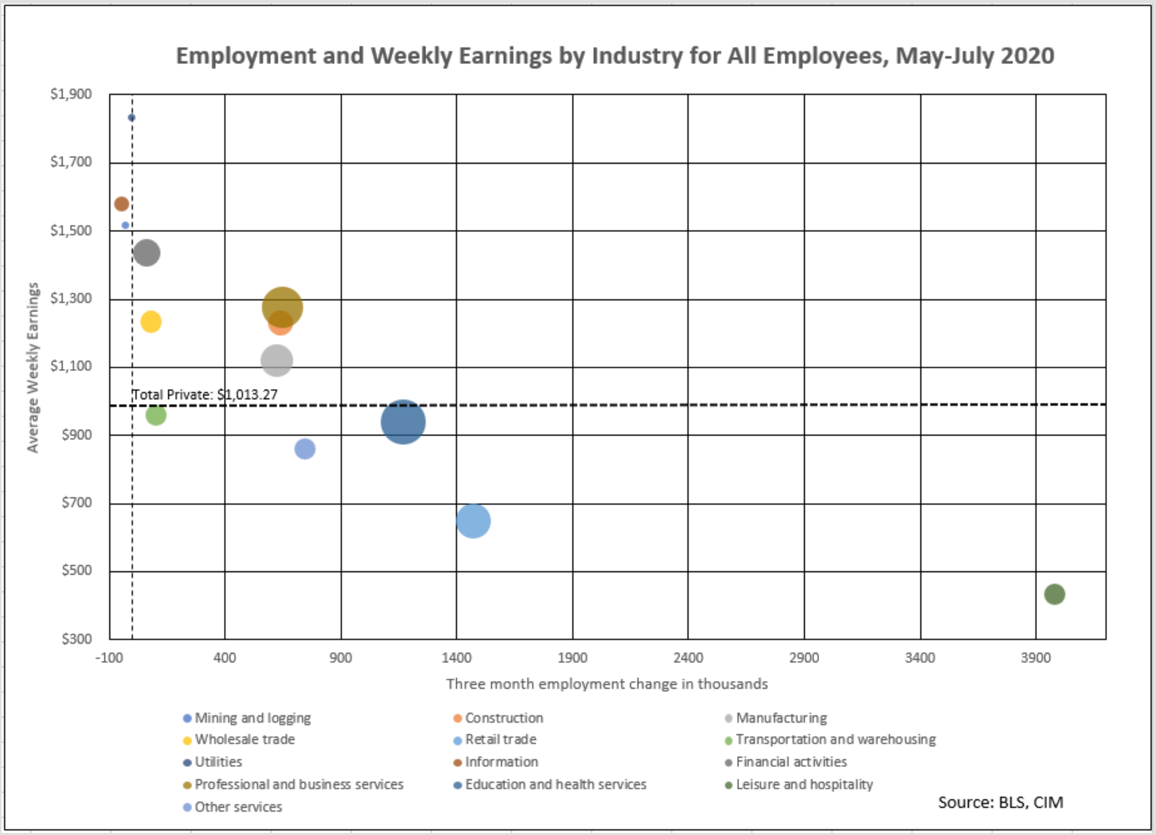
[3] The pandemic unemployment insurance replacement rate is calculated by dividing the amount of insurance employment benefits plus the booster divided by the average weekly rate by state.
[4] Included in this week's [AAW chart book](#).



The chart above shows the average weekly earnings and the three-month change in employment by industry. The size of the bubble represents the employment level. With the exception of transportation and warehousing, every industry in which average weekly earnings were below the national average added more jobs than the industries in which average weekly earnings were above the national average.

We are clearly in the midst of an anomalous event. As a result, things may not always be as they appear. If we were to push both charts to their logical conclusions, it would suggest that the key to bringing down the unemployment rate would be for the government to raise unemployment benefits to infinity and for employers to reduce wages to zero. That conclusion would clearly be absurd. That being said, it does suggest that lawmakers and policymakers alike should be cautious when deciding whether to scale back stimulus as it will likely have unknown and unintended consequences. Under normal circumstances, when jobs are easy to get, taking a break to collect outsized unemployment benefits might be an attractive option. But, if jobs are scarce, there is a risk to not returning to a job. Anecdotal evidence is true as far as it goes, but may not be generalizable, so policymakers should exercise care in shaping policy based on "what they are hearing." The consensus among economists is that the supplemental benefit likely does more good than harm as it contributes to consumption spending.[5] In summary, the costs of the higher supplement to unemployment insurance may be lower than generally believed in terms of discouraging employment, and it may have an outsized impact on consumption if it is reduced.

[5] https://www.wsj.com/articles/wsj-survey-benefits-of-extra-unemployment-aid-outweigh-work-disincentive-11597327200?st=y030ojqt1zyug3h

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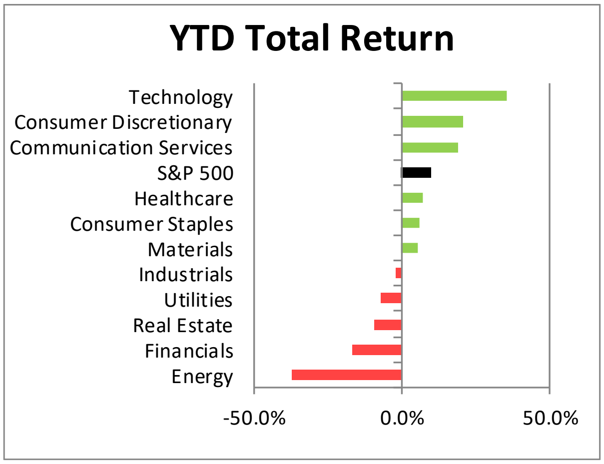
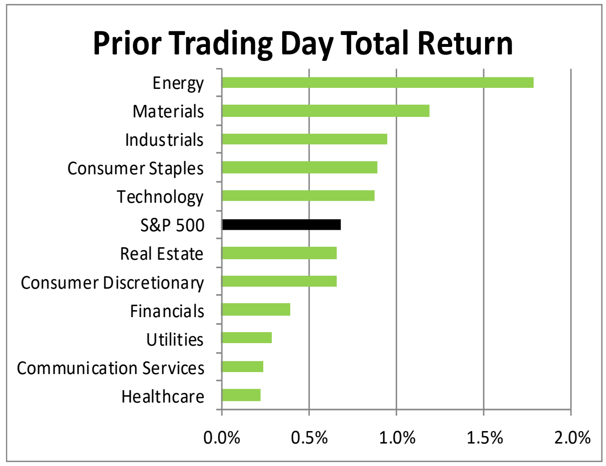
Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

U.S. Equity Markets – (as of 8/28/2020 close)

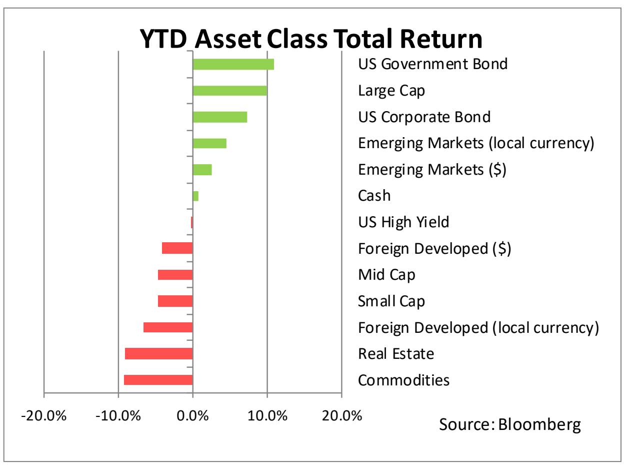




(Source: Bloomberg)

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 8/28/2020 close)

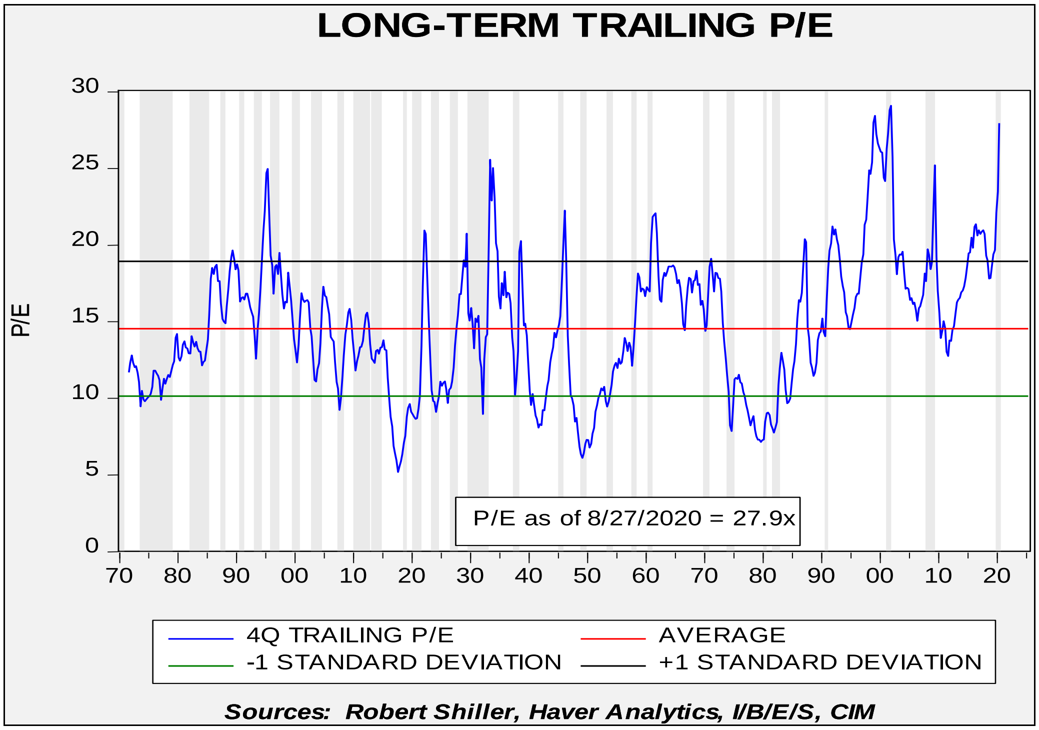


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

August 27, 2020



Based on our methodology,[6] the current P/E is 27.9x, up 0.2x from last week. The rise in the multiple is due to the continued rise in the index and the inclusion of S&P's operating earnings for Q2. During the accumulation of earnings reports, we use Thomson/Reuters data from I/B/E/S, which tends to run higher than the data from S&P.

[6] 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.