Daily Comment

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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: December 2, 2020—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.2% from its last close. In Asia, the MSCI Asia Apex 50 up 0.4%. Chinese markets were mixed, with the Shanghai Composite down 0.7% from the prior close and the Shenzhen Composite up 0.2%. U.S. equity index futures are signaling a lower open.

Our *Daily Comment* today opens with a discussion of President-elect Biden's economic team, which was formally introduced yesterday. We then cover developments related to Brexit, the EU's proposed coronavirus recovery fund, mutualized debt, and other international issues. We end with our usual review of the latest pandemic developments, including the important news that the U.K. has granted the first approval for a vaccine in Western industrialized countries, and lawmakers in the U.S. have resumed their discussions about a new pandemic relief bill.

U.S. Presidential Transition: President-elect Biden formally introduced his picks for key economic positions yesterday, emphasizing their experience and diverse backgrounds. He announced that the team was working on a plan to revitalize the U.S. economy and help the nation recover from the coronavirus crisis. This article provides a useful overview of the general mindset of the new economic team. Importantly, interviews and a review of their recent statements suggest the team members have no predisposition to go back to the full-bodied embrace of globalism that was so prevalent among Democrats and Republicans in the 1990s and early 2000s. The team, which is heavily populated by labor economists, appears to have fully internalized the damage globalization inflicted on U.S. manufacturing and factory workers, even as it brought benefits like lower inflation. It therefore appears that the thrust of Biden's international economic policy, especially given the likely constraints imposed by Congress, will be to adjust and soften some of the harder edges of Trumpian deglobalization but not to go back to full globalization. In addition, the Biden team will likely focus its protectionist measures against Chinese economic cheating, while easing tariffs and other measures aimed at traditional U.S. allies, in order to present a united front against Beijing.

- Biden also called on Congress to pass a robust coronavirus relief bill as soon as possible.
- However, he said a larger stimulus effort would be necessary during his administration to address the long-term impact of the pandemic.

Brexit: The EU's top Brexit negotiator, Michel Barnier, said he is working on "creative" compromises with the U.K. in order to strike a trade deal before the year-end deadline. According to Barnier, the next 36 hours will be critical to deciding whether or not there will be a hard Brexit. In fact, he stressed that by the end of the week Brussels and London need to assess whether an agreement is possible.

- In a closed-door briefing for EU lawmakers, Barnier said key sticking points remain in the areas of "level playing field" conditions for businesses, EU fishing rights in British waters, and how any trade deal might be implemented.
- Barnier said the compromises being considered include a transitional period for fishing rights and a broader review clause for the trade deal.

European Union: As Poland and Hungary continue to block the EU's long-term budget, pandemic recovery fund, and mutual EU debt proposal, an official at the European Commission said EU leaders are considering ways to push ahead without them. One idea being considered is to set up the recovery fund as a temporary "bridge" until Poland and Hungary come around to supporting it. By demonstrating the determination of EU leaders to get the fund and mutual debt program in place, and by increasing the pressure on Poland and Hungary to back down, the move is probably a modest positive for European equities and the Euro.

China-Hong Kong: In Hong Kong, pro-democracy activist Joshua Wong was sentenced to 13 and a half months in prison after pleading guilty to charges of organizing, participating in, and inciting others to take part in an unauthorized assembly when protesters surrounded police headquarters last summer. Several other anti-China activists were also sentenced in connection with the protest. Although China's clampdown on Hong Kong's freedoms was not a major focus of the Trump administration, it's likely to get much more attention from the incoming Biden team and will likely keep U.S.-China tensions high. In turn, that will keep alive political risks related to Chinese assets trading in the U.S.

COVID-19: Official data show confirmed cases have risen to 64,015,351 worldwide, with 1,483,676 deaths. In the United States, confirmed cases rose to 13,728,154 with 270,691 deaths. Here is the interactive chart from the *Financial Times* that allows you to compare cases and deaths among countries, scaled by population.

Virology

- Newly confirmed U.S infections topped 180,000 yesterday, and coronavirus-related hospitalizations rose to yet another record of 98,691. Of those hospitalized, 19,035 were in intensive care, setting another record. California and Texas continue to see extremely high infection rates, but in reality, the resurgence of the disease is widely spread throughout the country.
- In the first approval of a coronavirus vaccine among the Western developed countries, the U.K. has authorized use of the compound developed by Pfizer (PFE, 39.41) and BioNTech (BNTX, 114.01). According to the British government, initial doses of the shot will be available in the U.K. within days. Under provisional plans released by the government last month, the vaccine will first be made available to nursing home residents and staff. It will then be administered to those over the age of 80 and to frontline healthcare workers.

- As expected, a panel of experts advising the Centers for Disease Control and Prevention yesterday voted 13-1 in favor of reserving the first available coronavirus vaccine doses for healthcare workers and residents of long-term care facilities. Other high-risk populations – including essential workers such as teachers, police, adults with underlying health conditions, and people ages 65 and over who aren't in communal settings – are expected to be next in line, although the panel didn't set recommendations for them yet.
    - The CDC usually follows the recommendation of its advisory panel. If they are accepted by the agency's director and Secretary of Health and Human Services Alex Azar, they will become official CDC policy. A spokeswoman said CDC Director Robert Redfield will likely make his decision on Wednesday.
    - States wouldn't have to follow the CDC recommendations, but state and local authorities are expected to rely on them as guideposts for deciding who gets the vaccine first. States have until Friday to indicate to the federal government where they want their initial doses sent.

Economic Impacts

- According to a survey by the National Retail Federation and Prosper Insights & Analytics, U.S shoppers spent an average of just under $312 on holiday-related purchases from Thanksgiving to Cyber Monday, down 14% from 2019. The decline reflected a huge drop in in-store purchases because of the pandemic, which was only partially offset by online purchases.
- In a sign that inflation expectations are rising with the prospects for safe and effective vaccines and a likely economic recovery, the break-even rate on 10-year TIPS hit 1.83% yesterday, reaching its highest point since May of last year. A swap rate that measures expectations for the average level of inflation over five years, five years from now, has jumped to 2.25%, exceeding the 2.0% inflation target that the Fed has for years persistently failed to achieve.
- In another sign that vaccine progress and an impending economic recovery are impacting the markets, investors have backed off from bets on sub-zero interest rates in the U.K. According to derivative contracts linked to the key British bank rate, the Bank of England's main interest rate is now expected to trough at roughly zero percent in late 2022.

U.S. Policy Response

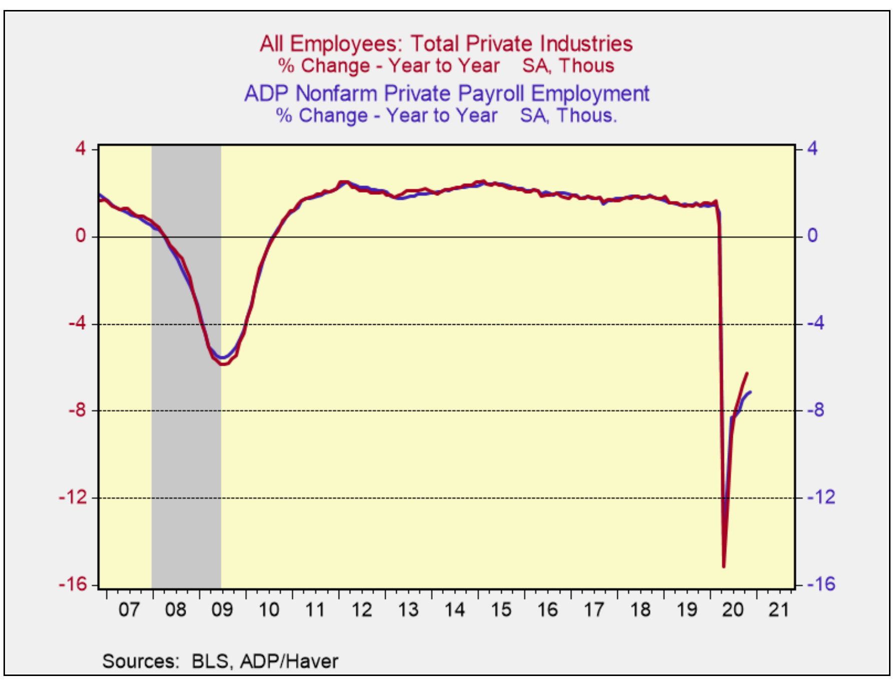
- At a Senate Banking Committee hearing yesterday, Treasury Secretary Mnuchin defended his decision last month not to renew a suite of emergency Federal Reserve lending programs propping up various financial markets, while Fed Chair Powell called the move "premature." As might be expected, Republicans on the panel generally supported Mnuchin, while Democrats supported Powell's position. Although we suspect the economy and markets can get by when the programs expire at the end of December, they will be operating with significantly less insurance than they would have otherwise, raising risks if the pandemic or other crisis intensifies again.

- Meanwhile, lawmakers refocusing after the drama of the elections have launched a number of new initiatives aimed at another pandemic relief bill. House Speaker Pelosi and Treasury Secretary Mnuchin spoke by telephone about a new coronavirus relief bill yesterday, and a bipartisan group of House and Senate lawmakers unveiled a $908 billion aid proposal seeking a middle ground between Democratic and Republican leaders' stances. Republican and Democratic leaders also traded new offers, as the looming expiration of some relief measures intensified the pace of year-end negotiations.
- Janet Yellen warned of "more devastation" if the country fails to address the economic fallout from the coronavirus pandemic and its disproportionate toll on low-income families, as she was introduced yesterday by Joe Biden as the next Treasury secretary.
- In monetary policy, some investors are betting the Fed could start buying more long-term U.S. Treasury securities as soon as its next policy meeting, a trend that has helped temper some recent selling and kept yields from rising higher.

U.S. Economic Releases

For the week ending November 27, mortgage applications fell 0.6% from the prior week. Applications for purchases rose 9.0% from the prior week, while applications for refinances fell 3.6%. The average 30-year fixed mortgage rate remained unchanged at 2.92%.

Hiring in the private sector decelerated more than forecast in November, according to the ADP Employment report, signaling a relatively weak BLS report. Private payrolls came in at 307K compared to expectations of 440K.



The chart above shows the annual change in private payrolls in the ADP and BLS reports.

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

	No economic releases today	
Fed Speakers or Events		
	Speaker or event	**District or position**
14:00	US Federal Reserve Releases Beige Book	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.

	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
China	Caixin China PMI Mfg	m/m	Nov	54.9	53.5	53.6	**	Equity bullish, bond bearish
Japan	Jobless Rate	m/m	Oct	3.1%	3.0%	3.1%	**	Equity and bond neutral
	Job-To-Applicant Ratio	m/m	Oct	1.04	1.03	1.03	**	Equity bullish, bond bearish
	Jibun Bank Japan PMI Mfg	m/m	Nov F	49.0	48.3		**	Equity and bond neutral
	Vehicle Sales	y/y	Nov	6.0%	31.6%		**	Equity and bond neutral
India	Markit India PMI Mfg	m/m	Nov	56.3	58.9		**	Equity and bond neutral
Australia	AiG Perf of Mfg Index	m/m	Nov	52.1	56.3		**	Equity and bond neutral
	Markit Australia PMI Mfg	m/m	Nov	55.8	56.1		**	Equity and bond neutral
	CoreLogic House Px	m/m	Nov	0.7%	0.2%		**	Equity bullish, bond bearish
	BoP Current Account Balance	q/q	3Q	A$10.0b	A$17.7b	A$7.1b	**	Equity bullish, bond bearish
	Building Approval	m/m	Oct	3.8%	15.4%	-3.0%	**	Equity bullish, bond bearish
	Commodity Index SDR	y/y	Nov	2.2%	-0.3%		**	Equity bullish, bond bearish
New Zealand	CoreLogic House Prices	y/y	Nov	9.2%	8.0%		**	Equity bullish, bond bearish
Europe								
Eurozone	Markit Eurozone Manufacturing PMI	m/m	Nov	53.8	53.6	53.6	***	Equity and bond neutral
	CPI Estimate	y/y	Nov	-0.3%	-0.3%	-0.2%	***	Equity bullish, bond bearish
	CPI Core	y/y	Nov	0.2%	0.2%	0.2%	***	Equity and bond neutral
France	Markit France Manufacturing PMI	m/m	Nov	49.6	49.1	49.1	**	Equity and bond neutral
Germany	Markit/BME Germany Manufacturing PMI	m/m	Nov	57.8	57.9	57.9	**	Equity and bond neutral
	Unemployment Change (000's)	m/m	Nov	-39.0k	-35.0k	8.0k	***	Equity bullish, bond bearish
	Unemployment Claims Rate SA	m/m	Nov	6.1%	6.2%	6.3%	***	Equity bullish, bond bearish
Italy	Markit Italy Manufacturing PMI	m/m	Nov	51.5	53.8	52.0	**	Equity and bond neutral
	GDP WDA	q/q	3Q	15.9%	16.1%	16.1%	**	Equity and bond neutral
UK	Nationwide House PX	m/m	Nov	0.9%	0.8%	0.2%	**	Equity bullish, bond bearish
	Markit UK PMI Manufacturing SA	m/m	Nov	55.6	55.2	55.2	**	Equity and bond neutral
Switzerland	GDP	q/q	3Q	7.2%	-8.2%	6.0%	***	Equity and bond neutral
	PMI Manufacturing	m/m	Nov	55.2	52.3	51.6	***	Equity and bond neutral
Russia	Markit Russia PMI Mfg	m/m	Nov	46.3	46.9	47.7	**	Equity bearish, bond bullish
AMERICAS								
Mexico	Net Outstanding Loans	m/m	Oct	4711b	4772b		**	Equity bullish, bond bearish
	Budget Balance YTD	m/m	Oct	-327.4b	-308.5b		**	Equity and bond neutral
Canada	Current Account Balance	q/q	3Q	-$7.53b	-$8.63b	-$9.00b	**	Equity and bond neutral
	Building Permits	m/m	Oct	-14.60%	17.00%	-3.90%	**	Equity and bond neutral
	Industrial Product Price	m/m	Oct	-0.4%	-0.1%	0.0%	**	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

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	Today	Prior	Change	Trend
3-mo Libor yield (bps)	23	23	0	Down
3-mo T-bill yield (bps)	8	8	0	Neutral
TED spread (bps)	15	14	1	Up
U.S. Libor/OIS spread (bps)	8	8	0	Up
10-yr T-note (%)	0.92	0.93	-0.01	Neutral
Euribor/OIS spread (bps)	-53	-53	0	Neutral
EUR/USD 3-mo swap (bps)	20	21	-1	Down
Currencies	**Direction**			
dollar	Up			Down
euro	Down			Up
yen	Up			Up
pound	Down			Down
franc	Flat			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	$47.18	$47.42	-0.51%	
WTI	$44.20	$44.55	-0.79%	
Natural Gas	$2.89	$2.88	0.35%	
Crack Spread	$8.56	$8.40	1.92%	
12-mo strip crack	$11.41	$11.33	0.72%	
Ethanol rack	$1.45	$1.46	-0.75%	
Metals				
Gold	$1,827.21	$1,815.24	0.66%	
Silver	$24.15	$24.00	0.61%	
Copper contract	$347.60	$348.50	-0.26%	
Grains				
Corn contract	$ 418.75	$ 420.75	-0.48%	
Wheat contract	$ 578.25	$ 577.25	0.17%	
Soybeans contract	$ 1,147.50	$ 1,162.00	-1.25%	
Shipping				
Baltic Dry Freight	1211	1227	-16	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.7		
Gasoline (mb)		2.0		
Distillates (mb)		-1.5		
Refinery run rates (%)		0.55%		
Natural gas (bcf)		-19.0		

Weather

The 6-10 and 8-14 day forecasts currently call for warmer temperatures for most of the country, with cooler temperatures in the Southeast. Dry conditions are expected throughout most of the country, with wet conditions expected in the Rockies.

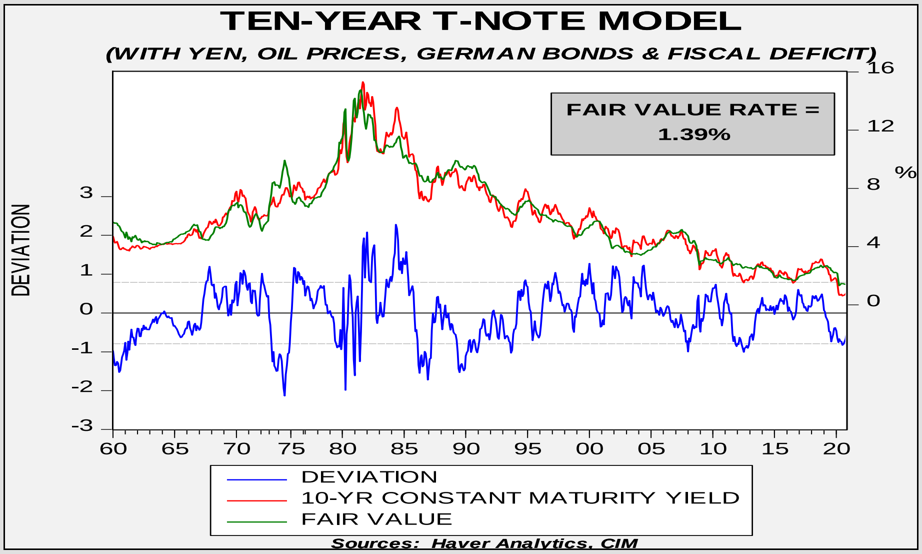
Asset Allocation Weekly

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.

November 20, 2020

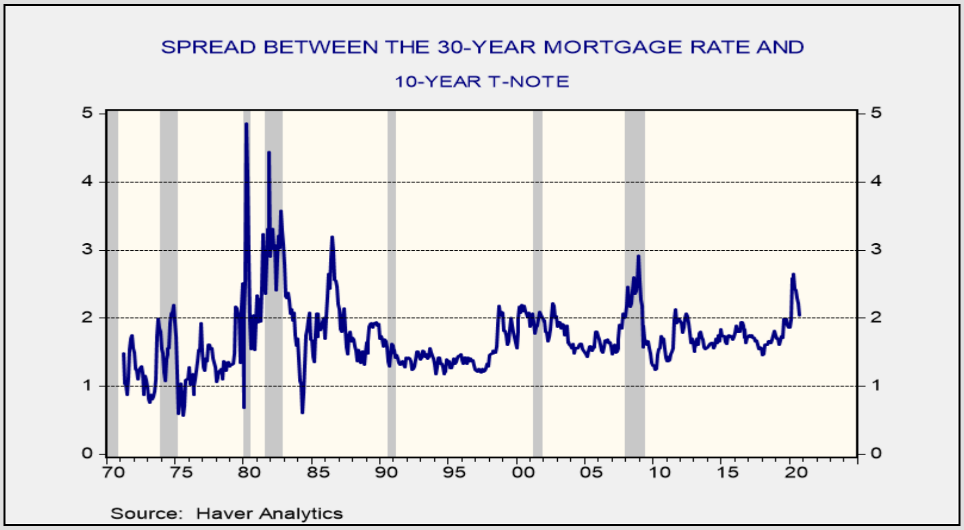
In the aftermath of the election and favorable news on vaccine progress, we have seen a notable backup in interest rates. The 10-year T-note yield is flirting with 1%. In this report, we will examine the future path of long-duration interest rates.

We start with our 10-year T-note yield model.



The model, which uses fed funds, the 15-year average of CPI (an inflation expectations proxy), the JPY/USD exchange rate, oil prices, German 10-year bond yields, and the fiscal deficit, suggests the fair value yield is near 140 bps. Although this fair value is historically low, it is well above the current rate of around 90 bps. In the absence of outside interference, it would not be unreasonable to expect yields to continue to drift higher. However, we do expect weaker economic growth in Q4 2020 and Q1 2021, so the pace of increases may slow.

However, the potential for outside intervention is high. The issue comes down to Federal Reserve policy. The U.S. central bank has hinted at the possibility of yield curve control. So far, the Fed has not taken concrete steps to implement fixing long-duration interest rates. But a rapid rise in such rates would not be welcome because it would have an adverse effect on the mortgage and housing markets.

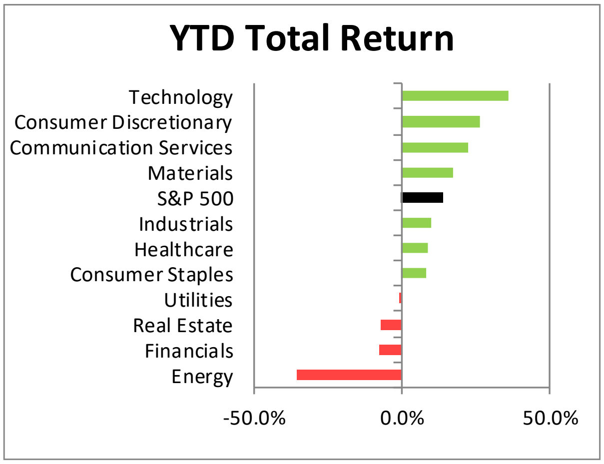


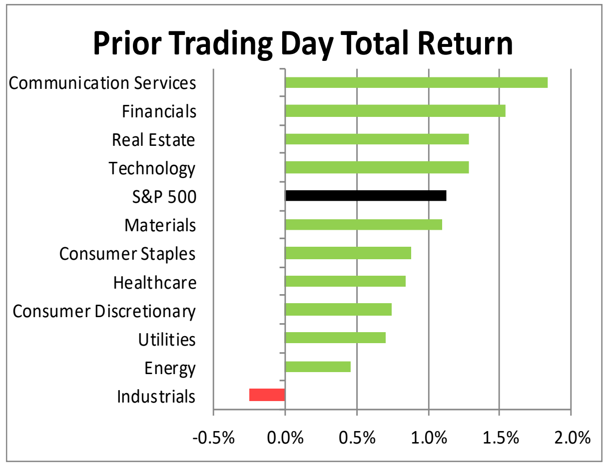
Mortgage rates, relative to the 10-year Treasury, spiked in April. The spread has narrowed since then but remains above 2%, which is elevated. If rising T-note rates lead to higher mortgage rates, it will tend to stifle part of the economy that is showing promise. This may lead the Fed to try to slow the rise in long-duration interest rates.

At the same time, a low interest rate regime tends to act as a headwind for banks. This factor may encourage the Fed to allow long-term rates to rise modestly. But we doubt that policymakers would be comfortable with a 10-year T-note yield in excess of 1.25%. If rates approach that level soon, we would not be surprised to see the Fed signal it isn't pleased with the development. And so, we may see a further rise in long-term interest rates, but a move to revert to the rate levels seen before 2008 is improbable.

Data Section

U.S. Equity Markets – (as of 12/1/2020 close)

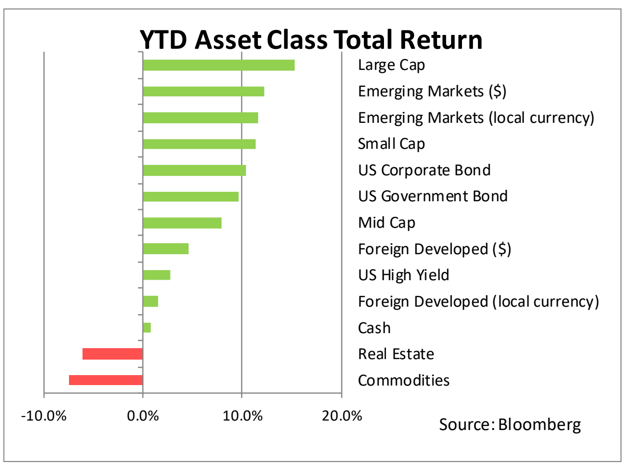




(Source: Bloomberg)

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 12/1/2020 close)

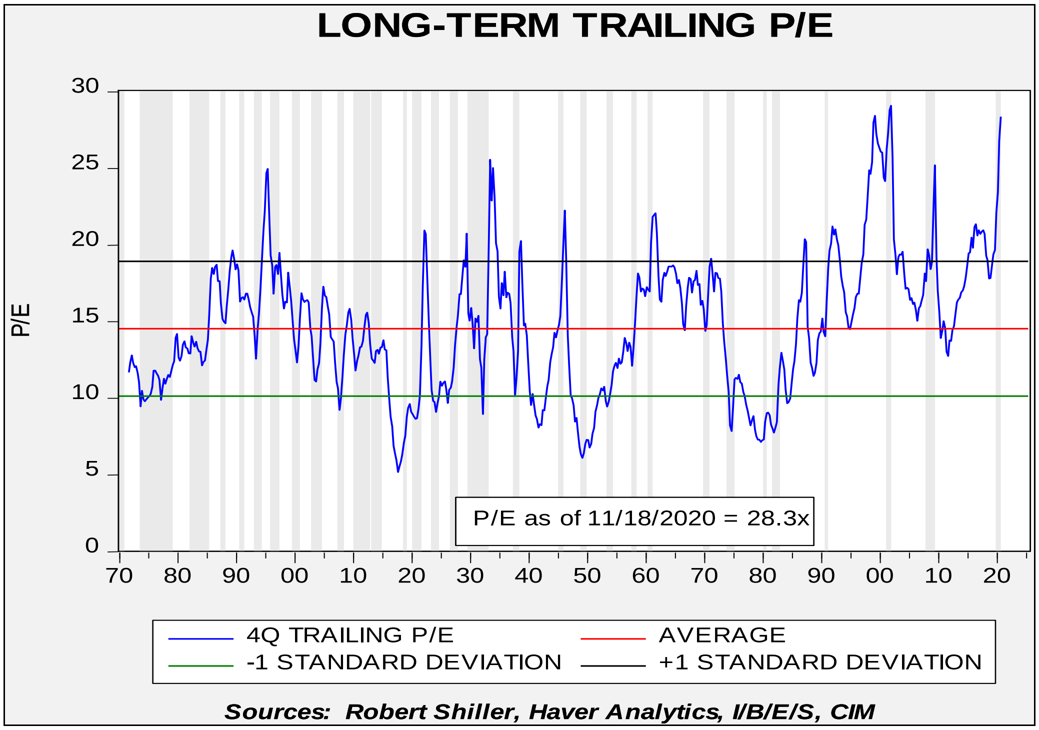


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

November 19, 2020



Based on our methodology,[1] the current P/E is 28.3x, unchanged 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.

[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 (Q1 and Q2) and two estimates (Q3 and Q4). 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.