

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: February 16, 2021—9:30 AM EST] Global equity markets are flat-to-higher as we move into the U.S. trading day. The EuroStoxx 50 is essentially unchanged from its last close. In Asia, the MSCI Asia Apex 50 is up 0.1% from the prior close. Chinese markets are closed for the Lunar New Year. U.S. equity index futures are signaling a higher open. With 370 companies having reported, the S&P 500 Q4 earnings stand at \$42.80, higher than the \$37.94 forecast for the quarter. The forecast reflects a 9.7% decrease from Q4 2019 earnings. Thus far this quarter, 81.1% of the companies have reported earnings above forecast, while 15.7% have reported earnings below forecast.

We want to point our readers toward our recent multimedia offerings. First, we have a new [chart book](#) recapping the recent changes we made to our Asset Allocation portfolios. As we noted last week, we've also posted a new [Confluence of Ideas podcast](#). We also have a new [Asset Allocation Weekly](#), [chart book](#), and [podcast](#). You can find all this research and more on our [website](#).

Turning to today's *Comment*, we open with a report over the long weekend that Japanese economic growth at the end of 2020 was much better than expected. That news helped give a boost to international markets while the U.S. was closed for its holiday yesterday. In another positive development, Mario Draghi officially became Italy's new prime minister. We review key international news, the latest U.S. developments, and recent trends with the coronavirus pandemic.

Japan: Following reports that Japan's GDP [grew by a much faster-than-expected 3.0%](#) in the fourth quarter, the Nikkei 225 index Monday [closed above 30,000 for the first time since 1990](#). Even though Japan had to reimpose some coronavirus restrictions to deal with a renewed outbreak in certain areas in January, the economic impact is anticipated to be relatively mild. Investors remain optimistic that Japan will benefit from the rollout of vaccines and a global economic rebound as the pandemic comes under control.

China-United States: The Chinese government [is reportedly exploring limits on the export of "rare earth" minerals that are crucial for the manufacture of advanced U.S. weaponry](#) such as the F-35 fighter. According to the reports, the Ministry of Industry and Information Technology last month proposed draft controls on the production and export of 17 such minerals from China, which controls about 80% of the global supply. Industry executives said government officials asked how badly companies in the U.S. and Europe, including defense contractors, would be affected if China restricted rare earth exports during a bilateral dispute. As we've noted in our

recent *WGR* series on the U.S.-China balance of power (see [Part I](#), [Part II](#), [Part III](#), and [Part IV](#)), China's growing military, economic, and diplomatic power and aggressiveness under President Xi will likely keep it on a course toward more friction with the U.S., especially given that the Biden administration's traditionalist, establishment foreign policy team is signaling it will push back against China more strongly than many people anticipated. In other words, U.S.-China frictions will likely remain a risk for financial markets going forward, although it is difficult to say when or if they might cause broad market disruptions.

Italy: Over the weekend, former ECB Chief Mario Draghi succeeded in forming a government and [was sworn in as Italy's new prime minister](#). Importantly, Draghi [named a very broad-based cabinet that includes both career politicians from a wide range of parties and technocrats](#) with practical policymaking expertise. In fact, Draghi's broad-based approach points to one potential political advantage to be gained from large pandemic relief programs like the EU's new program. Italy's previous government fell in large part due to disagreements over how to use the EU money for Italy, expected to total at least €200 billion. Once asked to form the government, Draghi apparently used that funding as an incentive for most major Italian parties to support him. Essentially, the pot is big enough that Draghi could offer "something for everyone," so all the major parties wanted a seat at the table with him. There's still a long way to go before Italy has a workable plan and implements it, but the political signs so far are encouraging, which helps explain why Italian equities and bonds continue to perform so strongly.

Spain: In elections on Sunday, pro-independence parties [cumulatively received more than 50% of the vote in Catalonia and strengthened their majority in the regional parliament](#). As a result, key separatist politicians are already calling for a renewed effort to negotiate with Madrid over an independence referendum, even though the central government has taken tough measures against such a move in the past and points to the Spanish constitution's provision stating that the country is "indivisible."

Energy Markets: The frigid weather enveloping much of the country [has led to rolling electricity blackouts across Texas, which will likely disrupt at least some energy production](#) in the coming week. Coupled with the high demand for fuel to heat homes and power the ongoing economic recovery from the coronavirus pandemic, that's pushing energy prices even higher. So far this morning, WTI crude oil is trading at approximately \$59.84. Natural gas prices stand at approximately \$3.07.

COVID-19: Official data show confirmed cases [have risen to 109,246,204 worldwide, with 2,410,455 deaths](#). In the United States, confirmed cases rose to 27,695,365, with 486,334 deaths. [Vaccine doses delivered in the U.S. now total 70,057,800, while the number of people who have received at least their first shot totals 38,292,270](#). Finally, 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 [totaled only about 52,000 yesterday](#), far less than the seven-day moving average of 90,416 and the 14-day moving average of 103,822. Of course, the figure may reflect the impact of yesterday's holiday, but even so, recent

trends point to a stunningly rapid drop in new infections. Hospitalizations related to the virus fell to 65,455, while new deaths came in at a two-and-a-half-month low of 985.

- Although U.S. vaccinations have ramped up in recent weeks, the winter storm stretching across the country [is disrupting vaccine distribution and closed vaccination sites](#), especially in the hard-hit South.
- Israel's rapid vaccination [program has now inoculated approximately 42% of the country's population](#). The success of the program to date suggests countries can benefit from simple steps like sending relatively smaller shipments to vaccination centers, setting up dedicated vaccination sites at large venues like stadiums, actively encouraging high-risk people to get the shot, and taking special care to encourage minorities to get vaccinated.
- Data from Israel [show a 94% drop in symptomatic COVID-19 infections](#) among 600,000 people who received two doses of the vaccine developed by Pfizer (PFE, 34.72) and BioNTech (BNTX, 117.56). The news confirms that the vaccine's high efficacy in clinical trials is likely to be replicated in real-life vaccination programs.
- Cypriot President Anastasiades announced Sunday that starting in April, Israeli citizens who have had coronavirus vaccination [will be able to travel to Cyprus without being required to quarantine or take a test](#). The announcement indicates the positive economic impacts that are likely in store as more countries roll out their massive inoculation programs.
- European Health Commissioner Kyriakides said any EU-approved coronavirus vaccine upgraded by the manufacturer based on the previous vaccine to combat new mutations [would not have to go through the whole approval process again](#). Rather, the EU will shorten the approval process for vaccines that are simply altered to better protect against new mutations, which should help speed the fight against those new mutations.
- The UK [is considering rapid virus testing for the entertainment industry to allow mass gatherings to resume later this year](#) in situations where social distancing is impractical or uneconomical. Government officials confirmed that plans were being drawn up for rapid testing to roll out once most of the economy had reopened.
- Around the world, [militaries are seeing upticks in enlistment](#) as younger adults seek refuge from a pandemic that has curbed job opportunities, social life, and traditional education. Some younger adults are also lured by the fact that life in the military often brings healthcare perks such as free virus tests, treatment, and vaccines, while social distancing has made some facets of early military life less strenuous.

U.S. Policy Response

- This week, President Biden [will try to go over the heads of Congress and make his case directly to the people for his \\$1.9 trillion pandemic relief plan](#). In his first official trip as president today, Biden will travel to Wisconsin for a town hall meeting. On Thursday, he'll be visiting a Pfizer plant in Michigan. Since expectations for more fiscal stimulus have helped buoy risk markets so far this year, the markets could get an added boost if the trips seem to generate additional support for the plan.

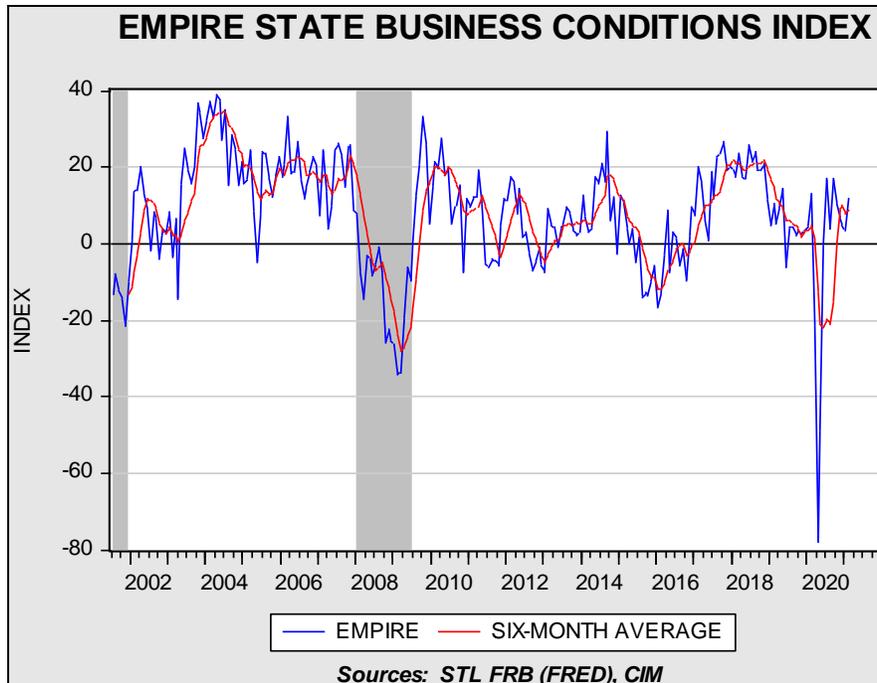
- Despite the promise that vaccinations could soon bring the pandemic under control, [government reluctance to lift restrictions on travel is sparking fears in the airline industry.](#)

Economic and Market Impacts

- Loose monetary policy and ultralow bond yields continue to push investors into riskier debt, [leading to record issuance of \\$139 billion in below-investment-grade obligations for the year through February 10.](#)
 - In recent weeks, at least three companies have financed dividends to private shareholders by issuing PIK toggle notes—bonds that give the issuer flexibility to pay interest in additional bonds rather than cash. Such deals are hallmarks of hot credit markets, rising to prominence in the years leading up to the 2008-2009 financial crisis.
 - According to a new study by Refinitiv, [more than 15% of all debt raised in the U.S. high-yield bond market this year has been sold by groups with ratings of CCC or below.](#) That's the highest share for such debt since 2007.
 - Easy financing at low rates will probably help many firms weather the pandemic, even if it exposes many investors to more risk than they would normally want.
- At the same time, and despite the growing risk that China will face a wave of defaults, Chinese high-yield bonds [are luring investors with their massive spread over U.S. rates.](#) As of Monday, yields on an ICE BofA index of Chinese offshore high-yield corporate bonds stood at 9.18%, a roughly 4.5-percentage-point premium over U.S. yields. More broadly, the increasing lure of Chinese assets is [boosting Chinese economic power.](#)
- In Europe, one potentially positive result of the pandemic is that it [seems to be forcing banks to slash payrolls, close expensive branches, and push customers toward online systems.](#) Cost-cutting has long been a key demand from investors. If banks continue to streamline and become more efficient, it will likely make an even stronger case for European bank stocks.

U.S. Economic Releases

Manufacturing in New York expanded at a faster-than-expected pace in February, according to the Fed Empire Manufacturing Index. The index came in at 12.1 compared to expectations of 6.0.



The chart above shows the six-month moving average of the index, rising from 7.6 to 9.0.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
16:00	Total Net TIC Flows	m/m	Dec		\$214.1b	***
16:00	Net Long-term TIC Flows	m/m	Dec		\$149.2b	**
Fed Speakers or Events						
EST	Speaker or event	District or position				
11:10	Michelle Bowman Speaks on Community Banking	Member of the Board of Governors				
12:30	Esther George Discusses Economic Outlook	President of the Federal Reserve Bank of Kansas City				
13:00	Robert Kaplan Discusses the Economy	President of the Federal Reserve Bank of Dallas				
15:00	Mary Daly Discusses Economy and Inequality	President of the Federal Reserve Bank of San Francisco				

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								
Japan	Tertiary Industry Index	m/m	Dec	-0.4%	-0.7%	-0.6%	**	Equity bullish, bond bearish
India	Trade Balance	m/m	Jan	-\$14540.0m	-\$15440.0m	-\$14750.0m	**	Equity and bond neutral
	Wholesale Prices	y/y	Jan	2.0%	1.2%	1.1%	**	Equity bullish, bond bearish
Australia	ANZ Roy Morgan Consumer Confidence	w/w	14-Feb	109.9	111.4		**	Equity and bond neutral
New Zealand	REINZ House Sales	y/y	Jan	3.2%	36.6%		**	Equity and bond neutral
	Net Migration SA	m/m	Dec	451	672		**	Equity and bond neutral
Europe								
Eurozone	Employment	y/y	4Q	-2.0%	-2.3%		***	Equity and bond neutral
	GDP SA	q/q	4Q	-0.6%	-0.7%	-0.7%	***	Equity and bond neutral
	ZEW Survey Expectations	m/m	Feb	69.60	58.30		**	Equity and bond neutral
France	ILO Unemployment Rate	m/m	4Q	8.0%	9.0%	9.1%	***	Equity bullish, bond bearish
	ILO Mainland Unemployment Rate	m/m	4Q	7.7%	8.8%	8.9%	***	Equity bullish, bond bearish
Germany	ZEW Survey Expectations	m/m	Feb	71.2	61.8	59.5	**	Equity bullish, bond bearish
	ZEW Survey Current Situation	m/m	Feb	-67.2	-66.4	-66.5	**	Equity and bond neutral
Italy	Trade Balance Total	m/m	Dec	6844m	6766m		**	Equity and bond neutral
	Trade Balance EU	m/m	Dec	-1197m	88m		**	Equity and bond neutral
Russia	Industrial Production	y/y	Jan	-2.5%	-0.2%	0.0%	**	Equity bearish, bond bullish
AMERICAS								
Canada	Housing Starts	m/m	Jan	282.4k	228.3k	228.3k	**	Equity and bond neutral
	Manufacturing Sales	m/m	Dec	0.9%	-0.6%	0.6%	**	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)	19	20	-1	Down
3-mo T-bill yield (bps)	4	4	0	Neutral
TED spread (bps)	16	16	0	Up
U.S. Libor/OIS spread (bps)	7	7	0	Up
10-yr T-note (%)	1.25	1.21	0.04	Neutral
Euribor/OIS spread (bps)	-55	-55	0	Neutral
EUR/USD 3-mo swap (bps)	2	1	1	Down
Currencies	Direction			
dollar	Down			Down
euro	Up			Up
yen	Flat			Up
pound	Up			Up
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.

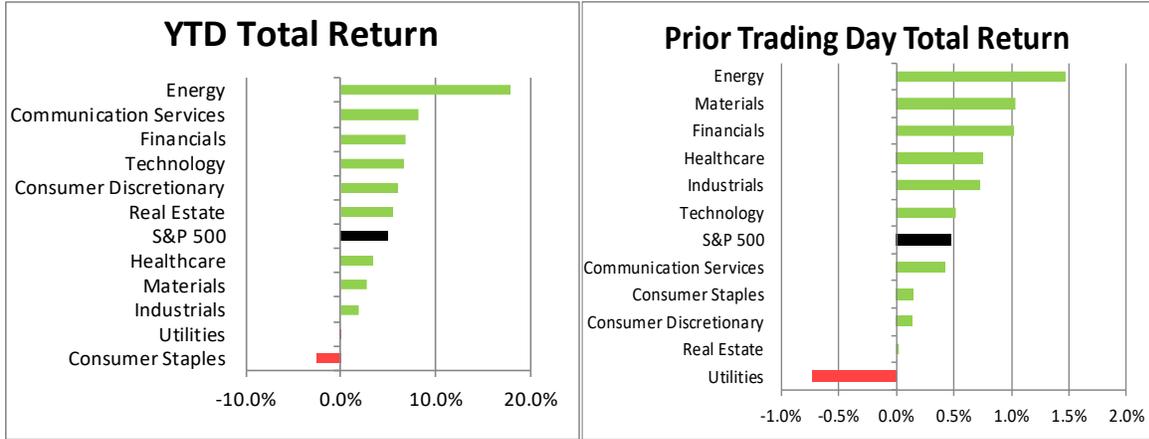
	Price	Prior	Change	Explanation
Energy Markets				
Brent	\$63.18	\$63.30	-0.19%	
WTI	\$59.84	\$59.47	0.62%	
Natural Gas	\$3.07	\$2.91	5.49%	
Crack Spread	\$15.07	\$14.56	3.52%	
12-mo strip crack	\$16.04	\$15.98	0.42%	
Ethanol rack	\$1.80	\$1.79	0.20%	
Metals				
Gold	\$1,824.48	\$1,818.86	0.31%	
Silver	\$27.81	\$27.62	0.71%	
Copper contract	\$383.65	\$378.80	1.28%	
Grains				
Corn contract	\$543.25	\$536.50	1.26%	
Wheat contract	\$653.75	\$641.25	1.95%	
Soybeans contract	\$1,385.25	\$1,371.25	1.02%	
Shipping				
Baltic Dry Freight	1364	1339	25	

Weather

The 6-10 and 8-14 day forecasts currently call for colder than normal temperatures to recede westward over the next few days. In addition, the forecast calls for wetter than normal conditions in the New England and the Northwest regions, with dry conditions in the Southwest and Florida.

Data Section

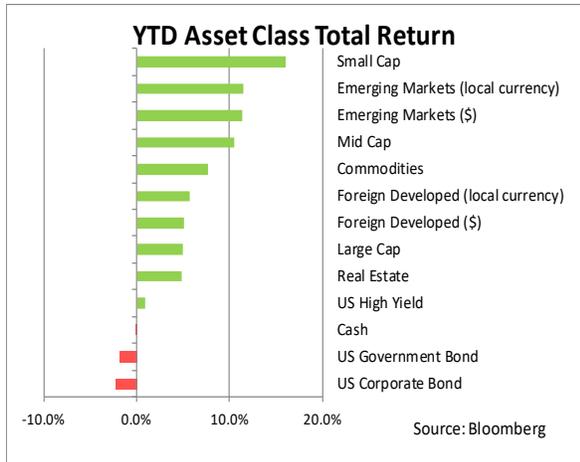
U.S. Equity Markets – (as of 2/12/2021 close)



(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 2/12/2021 close)

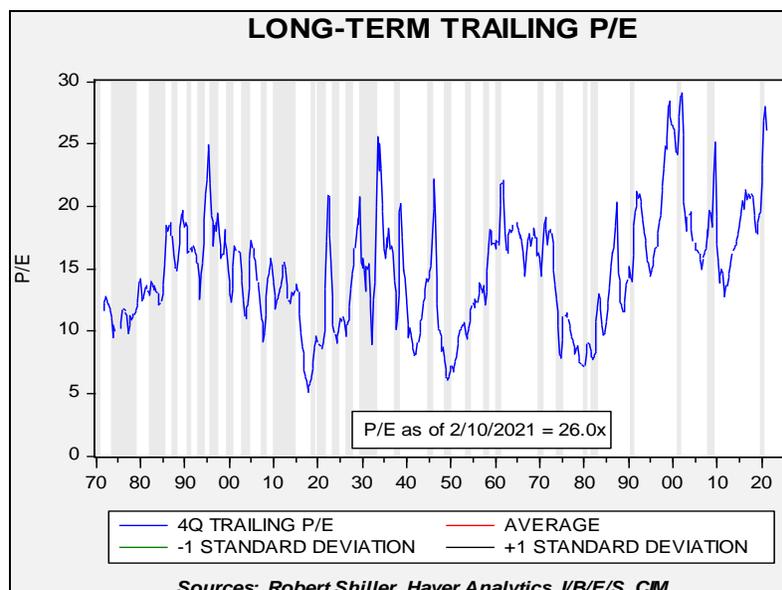


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

February 12, 2021



Based on our methodology,¹ the current P/E is 26.0x, down 0.1x from last week. Improving earnings contracted the multiple.

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