# 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: February 26, 2021—9:30 AM EST]** Global equity markets are mostly lower this morning. The EuroStoxx 50 is down 0.9% from its last close. In Asia, the MSCI Asia Apex 50 is down 3.6% from the prior close. Chinese markets were also lower, with the Shanghai Composite down 2.1% from the prior close and the Shenzhen Composite down 1.8%. In contrast, U.S. equity index futures are signaling a modestly higher open. With 476 companies having reported, the S&P 500 Q4 earnings stand at $43.20, higher than the $37.94 forecast for the quarter. The forecast reflects a 9.7% decrease from Q4 2019 earnings. Thus far this quarter, 79.4% of the companies have reported earnings above forecast, while 17.0% have reported earnings below forecast.

The fifth and final part in our recent *Weekly Geopolitical Report* series, "The U.S.-China Balance of Power," is now published. We also have several other recent multimedia offerings. There is a new chart book recapping the recent changes we made to our Asset Allocation portfolios. Here is the latest *Confluence of Ideas* podcast. Being Friday, a new *Asset Allocation Weekly*, chart book, and podcast are also available. The *Weekly Energy Update* is available. You can find all this research and more on our website.

Good morning and happy Friday! Although U.S. equity futures are stabilizing this morning, the overall market action looks like a flight to safety. Treasury yields are dropping, but the dollar is up sharply, emerging markets are lower, and commodity prices are off hard. We begin today with market comments. Policy and economics come next; the minimum wage hike looks to be in danger. International news is next. We close with the pandemic roundup.

**Financial Markets:** This looks like a market tantrum, and rising interest rates, coming mostly from Treasuries, are the primary culprit. In our analysis, the 10-year T-note yield is about in line with fair value. Given market conditions, yields have been unusually low. At least some of the rise in yields is probably a function of improving growth prospects. That appears to be how the Fed is viewing it. Two concerns are surrounding this rise. First, the lift in yields will adversely affect interest-rate-sensitive parts of the economy and markets. Residential real estate will likely be the first to suffer, but other areas will eventually cool due to the rise. Second, and perhaps the most worrisome, is that we live in a shadow banking world where leverage is a key characteristic. Since the 1990s, every rate increase has eventually led to a financial hiccup. By itself, this shouldn't be a big deal; it's called "risk" for a reason. But, the pattern since the late 1990s is that these hiccups tend to go systemic quickly. From LTCM to the mortgage crisis, to the repo meltdown from August 2019 through March 2020, even modest rate hikes tend to expose not only excessive leverage but conditions that threaten market stability. Unfortunately, it is tough to tell in advance where the problem lies and when it becomes critical. Our current situation is no different, but the pattern of the past 25 years suggests that there is the potential for another systemic problem lurking, and that will likely also raise fears in the market.

So, what will policymakers do? We already saw the Reserve Bank of Australia make a surprise bond purchase today. ECB President Lagarde noted that the bank was "closely monitoring" bond yields. We haven't seen anything similar from the Fed, at least nothing in addition to what is already being done. We do anticipate that, at some point, the Fed will opt for yield curve control. If it decides against that action, economic growth will be crimped by rising interest rates. There is nothing wrong with that decision; in fact, that's allowing the markets to work. However, that outcome flies in the face of Fed promises to allow the economy to "run hot" to improve the labor markets. Perhaps the most pertinent question isn't if the Fed will engage in yield curve control, but what is the path to reach that point. History would suggest a crisis may be necessary to trigger that action. For now, we think the FOMC would prefer to let Treasury yields stabilize on their own and allow the financial markets to adjust to a new equilibrium. It remains to be seen whether that option is available to the FOMC.

**Economics and policy:** The parliamentarian rules, the Texas energy crisis evolves, farmers react to high crop prices.

- Congressional Democrats wanted to put the minimum wage hike in the budget resolution bill. That would allow it to pass outside of filibuster rules. This tactic was a bit of a stretch. It is hard to see how exactly a rise in the minimum wage is part of the budget process. The parliamentarian apparently concluded that the minimum wage isn't a budget item and must be passed separately. Although there is some talk about overruling her decision, or firing her, we suspect that the Biden administration, preferring to get its stimulus passed, will move on. This setback doesn't mean the action is dead. As we noted yesterday, Sen. Hawley offered a different proposal that could become the basis for a compromise measure.
- In the aftermath of the Texas energy crisis, the situation is evolving from an energy problem to a financial one. One of the theories underlying Texas energy markets was that if conditions deteriorated and generators were allowed to increase prices, more electricity would be produced. Instead, the market failed; prices rose, but no appreciable supply emerged, meaning customers simply got stuck with high bills. Ranchers and farmers are steadily calculating their losses. Chickens died in the cold, citrus was frozen, and milk cows were hurt. This is what we don't know yet—winter wheat germinates in the fall and then goes dormant in winter. Although wheat (which is grass, after all) is a tough plant, the deep cold may have harmed the crop, and we won't know the extent of the damage until dormancy ends in the spring.
- Farmers, looking to take advantage of high prices, are planning to increase acreage under cultivation this year.
- Global trade is recovering rapidly, but most of the recovery is occurring in Asia.
- Nigeria has seen a rapid increase in cryptocurrency trading.
- Yes, 'there gr-r-reat' but apparently scarce!

**International news:** Syria, Armenia, northeastern Africa, and the EU are in the news.

- U.S. forces carried out airstrikes against Iran-affiliated militias in eastern Syria who attacked coalition forces stationed in Iraq. This is the Biden administration's first military action.
- There was an apparent coup attempt in Armenia. PM Pashinyan has seen his popularity plummet after he agreed to harsh terms in last year's ceasefire that ended the conflict between Armenia and Azerbaijan. It doesn't appear that the coup was successful, and several military leaders were fired.
- One of the issues we monitor is the Grand Ethiopian Renaissance Dam project, which is designed to bring electricity to the country but will have the potential to reduce water flow on the Nile, depriving downstream nations of water. Egypt is calling on international help to ensure it receives flows; Ethiopia is reluctant to accept any such intervention.
- Iran will hold elections in June. Sanctions have crippled the Iranian economy and will be an important issue in the campaign. Unrest, tied to the depressed economy, erupted in the southeastern city of Saravan.
- The Biden administration is expected to release a declassified report on the Khashoggi assassination today. President Biden did talk to King Salman yesterday; we suspect the report was delayed until after the call.
- The EU is expected to use a new human rights mechanism to sanction Russia over the Navalny situation.

**China:** The U.S. is engaging in talks with Taiwan to secure semiconductors. This action will likely upset China. China is allowing the CNY to appreciate, despite the impact on exporters. We suspect some of the tolerance is an attempt to control commodity prices (since commodities are priced in dollars, a stronger CNY lowers the relative cost) and to show the currency should be internationalized.

**COVID-19:** The number of reported cases is 113,111,157 with 2,509,729 fatalities. In the U.S., there are 28,413,949 confirmed cases with 508,314 deaths. 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. The CDC reports that 91,673,010 doses of the vaccine have been distributed with 68,274,117 doses injected. The number receiving a first dose is 46,074,392, while the number of second doses, which would grant the highest level of immunity, is 21,555,117. The FT has a page on global vaccine distribution.

*Virology*

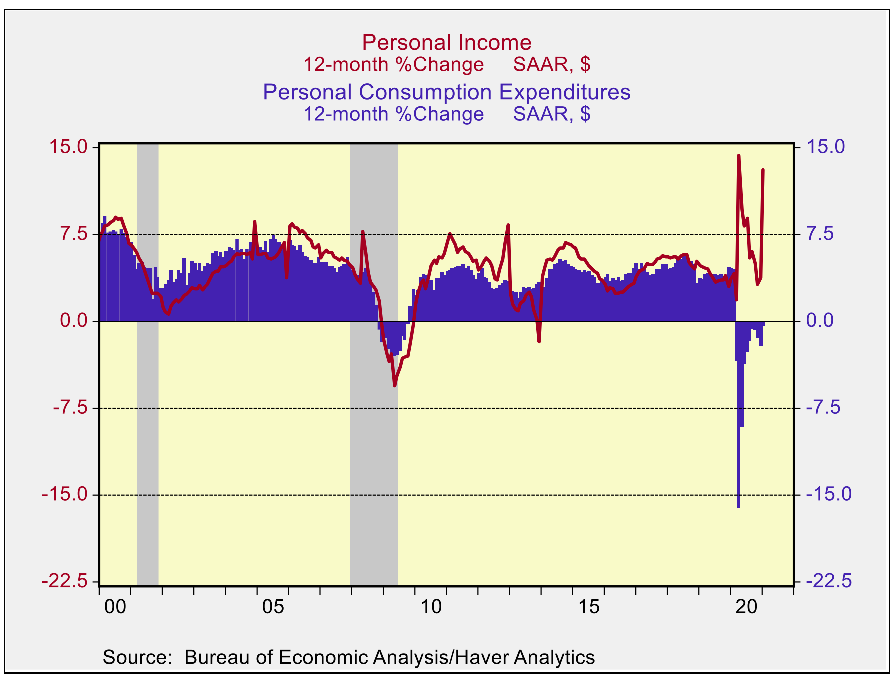
- The EU continues to stumble with vaccine distribution, and leaders are getting nervous. One issue is that some Europeans are being picky about which vaccine they prefer.
- The single does Johnson and Johnson (JNN, USD, 162.76) vaccine is being reviewed by the FDA advisory panel, the last step before approval.

- Although the overall infection data has been positive, [we are seeing an uptick in cases](). This bears watching because it coincides with an easing of lockdown restrictions.
- One item being considered is a "[vaccine passport]()." Although this document could foster the recovery of travel and tourism, there are concerns regarding who would issue such a document, and the security could become difficult to manage.

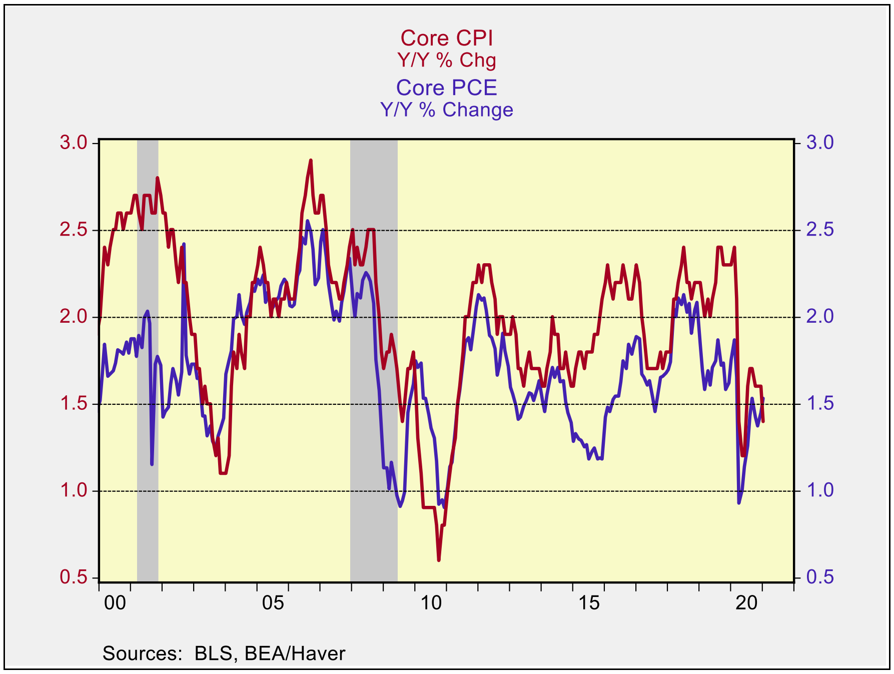
**U.S. Economic Releases**

According to the Commerce Department, January's personal income jumped by a seasonally adjusted 10.0%, beating the expected rise of 9.5% and smashing the December increase of 0.6%. The rise reflected the latest coronavirus stimulus bill passed into law late last year. Meanwhile, the January personal consumption expenditures (PCE) increased 2.4%, coming in slightly weaker than the anticipated rise of 2.5%. It was still more than enough to erase the revised 0.4% decline in the prior month. This report also includes the Fed's preferred gauge of consumer inflation. Excluding the volatile food and energy components, the January "core PCE deflator" was up 1.5% from the same month one year earlier. That was a slight acceleration from the annual gain of 1.4% in December, but it remained significantly lower than the Fed's target of 2.0%.

The chart below shows the annual growth in the volume of personal income versus the annual growth in PCE over time.

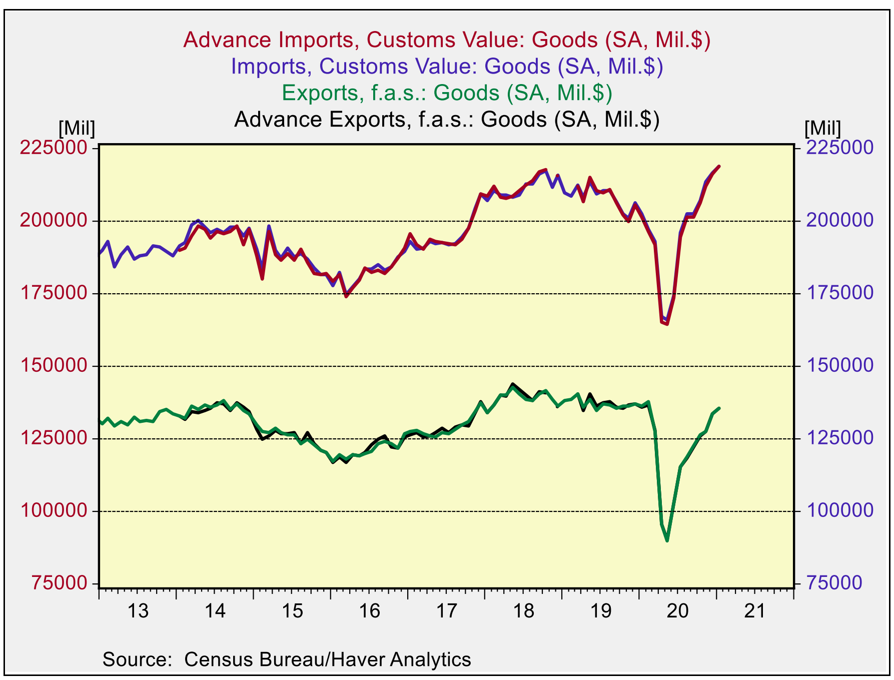



The chart below shows how inflation has been progressing over time, as measured by both the Core Consumer Price Index (CPI) and the Core PCE index. Either way you measure it, U.S. inflation remains below the Fed's target of 2.0%.




Separately, the Census Bureau reported that the advance merchandise trade balance for January showed a deficit of $83.7B. That was somewhat worse than both the expected shortfall of $83.0B and the revised December deficit of $83.2B.

The chart below shows the recent trends in U.S. merchandise exports and imports. The difference between the two is the merchandise trade deficit.




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

| Economic Releases | | | | | | |
|---|---|---|---|---|---|---|
| **EDT** | **Indicator** | | | **Expected** | **Prior** | **Rating** |
| **9:45** | Chicago PMI | m/m | Feb | 61.0 | 63.8 | *** |
| **10:00** | U. of Michigan Consumer Sentiment | m/m | Feb F | 76.5 | 76.2 | ** |
| **10:00** | U. of Michigan Current Conditions | m/m | Feb F | | 86.2 | ** |
| **10:00** | U. of Michigan Expectations | m/m | Feb F | | 69.8 | ** |
| **10:00** | U. of Michigan 1-Year Inflation Expectation | m/m | Feb F | | 3.3% | * |
| **10:00** | U. of Michigan 5-10 Year Inflation Expectation | m/m | Feb F | | 2.7% | * |
| **Fed Speakers or Events** | | | | | | |
| No speakers or events scheduled | | | | | | |

## 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** | Tokyo CPI | y/y | Feb | -0.3% | -0.5% | -0.4% | ** | Equity and bond neutral |
| | Tokyo CPI Ex Fresh Food and Energy | y/y | Feb | 0.2% | 0.2% | 0.2% | *** | Equity and bond neutral |
| | Industrial Production | y/y | Jan P | -5.3% | -2.6% | -5.4% | ** | Equity and bond neutral |
| | Retail Sales | y/y | Jan | -2.4% | -0.2% | -2.6% | ** | Equity and bond neutral |
| | Housing starts | y/y | Jan | -3.1% | -9.0% | -1.9% | ** | Equity bearish, bond bullish |
| **Australia** | Private Sector Credit | y/y | Jan | 1.7% | 1.8% | 1.8% | ** | Equity and bond neutral |
| **India** | GDP SA | y/y | 4Q | 0.4% | -7.3% | 0.6% | ** | Equity bearish, bond bullish |
| **Europe** | | | | | | | | |
| **France** | GDP | y/y | 4Q F | -4.9% | -5.0% | -5.0% | * | Equity and bond neutral |
| | Consumer Spending | y/y | Jan | 0.0% | 3.6% | 0.3% | *** | Equity bearish, bond bullish |
| | CPI | y/y | Feb P | 0.4% | 0.6% | 0.3% | ** | Equity and bond neutral |
| | CPI EU Harmonized | y/y | Feb P | 0.7% | 0.8% | 0.5% | ** | Equity and bond neutral |
| | PPI | y/y | Jan | 0.4% | -1.0% | | ** | Equity and bond neutral |
| **Switzerland** | GDP | y/y | 4Q | -1.6% | -1.4% | -2.0% | *** | Equity bullish, bond bearish |
| | KOF Leading Indicator | m/m | Feb | 102.7 | 96.5 | 96.6 | ** | Equity bullish, bond bearish |
| **AMERICAS** | | | | | | | | |
| **Canada** | Industrial Production | m/m | Jan | 2.0% | 1.5% | 1.9% | ** | Equity and bond neutral |
| | Raw Materials Price Index | m/m | Jan | 5.7 | 3.5% | | ** | Equity and bond neutral |
| **Mexico** | Trade Balance | m/m | Jan | -1236.4m | 6262.0m | -600.0m | ** | Equity bearish, bond bullish |
| **Brazil** | Unemployment Rate | m/m | Dec | 13.9% | 14.1% | 14.0% | *** | Equity and bond neutral |
| | Primary Budget Balance | m/m | Jan | 58.4b | -51.8b | 46.8b | ** | Equity and bond neutral |
| | Nominal Budget Balance | m/m | Jan | 17.9b | -75.8b | 5.4b | ** | Equity and bond neutral |
| | Net Debt / GDP | m/m | Jan | 61.6% | 63.0% | 62.9% | * | Equity and bond neutral |

## 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 | 19 | 0 | Down |
| **3-mo T-bill yield (bps)** | 3 | 4 | -1 | Neutral |
| **TED spread (bps)** | 16 | 15 | 1 | Up |
| **U.S. Libor/OIS spread (bps)** | 8 | 8 | 0 | Up |
| **10-yr T-note (%)** | 1.48 | 1.52 | -0.04 | Neutral |
| **Euribor/OIS spread (bps)** | -54 | -54 | 0 | Neutral |
| **EUR/USD 3-mo swap (bps)** | 8 | 5 | 3 | Down |
| **Currencies** | **Direction** | | | |
| dollar | Up | | | Down |
| euro | Flat | | | Up |
| yen | Down | | | Up |
| pound | Down | | | Up |
| franc | Down | | | 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.

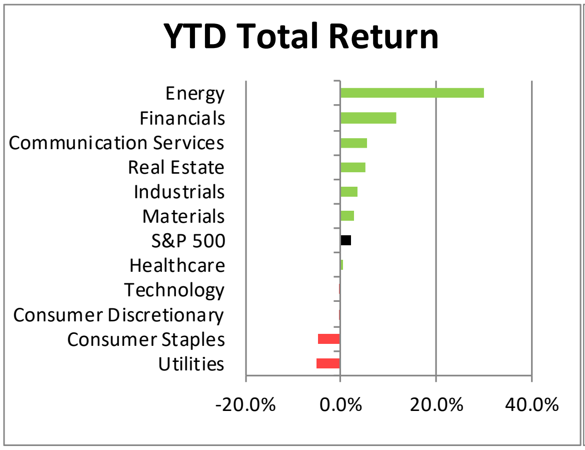
| | Price | Prior | Change | Explanation |
|---|---|---|---|---|
| **Energy Markets** | | | | |
| Brent | $66.01 | $66.88 | -1.30% | |
| WTI | $62.34 | $63.53 | -1.87% | |
| Natural Gas | $2.74 | $2.78 | -1.44% | |
| Crack Spread | $18.61 | $18.55 | 0.29% | |
| 12-mo strip crack | $16.60 | $16.70 | -0.61% | |
| Ethanol rack | $1.88 | $1.88 | -0.01% | |
| **Metals** | | | | |
| Gold | $1,758.32 | $1,770.56 | -0.69% | |
| Silver | $26.66 | $27.43 | -2.79% | |
| Copper contract | $414.60 | $426.35 | -2.76% | |
| **Grains** | | | | |
| Corn contract | $541.00 | $549.75 | -1.59% | |
| Wheat contract | $665.00 | $675.75 | -1.59% | |
| Soybeans contract | $1,385.75 | $1,407.50 | -1.55% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 1700 | 1709 | -9 | |
| **DOE inventory report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | 1.3 | -6.5 | 7.8 | |
| Gasoline (mb) | 0.1 | -3.5 | 3.6 | |
| Distillates (mb) | -5.0 | -4.2 | -0.8 | |
| Refinery run rates (%) | -14.50% | -7.00% | -7.50% | |
| Natural gas (bcf) | -338.0 | -335.0 | -3.0 | |

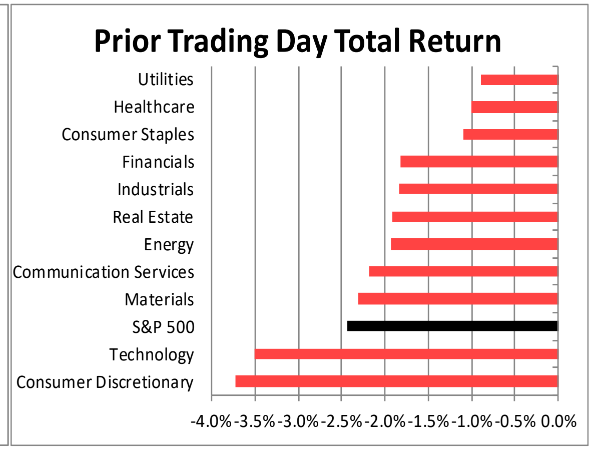
## Weather

The 6-10 and 8-14 day forecasts currently call for warmer than normal temperatures over the entire eastern two-thirds of the country, but especially in the Upper Midwest. Temperatures are expected to be lower than normal only along the West Coast. The forecast calls for wetter than normal conditions from the Northern Rockies to the Upper Midwest, and on the West Coast, with dry conditions throughout the Southeast.

## Data Section

**U.S. Equity Markets** – (as of 2/25/2021 close)

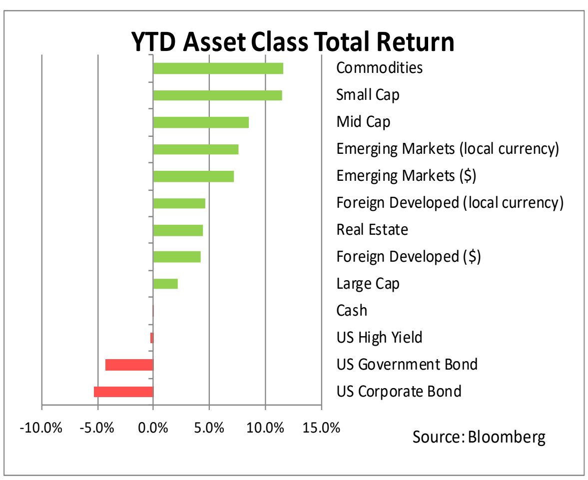



(Source: Bloomberg)

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 2/25/2021 close)

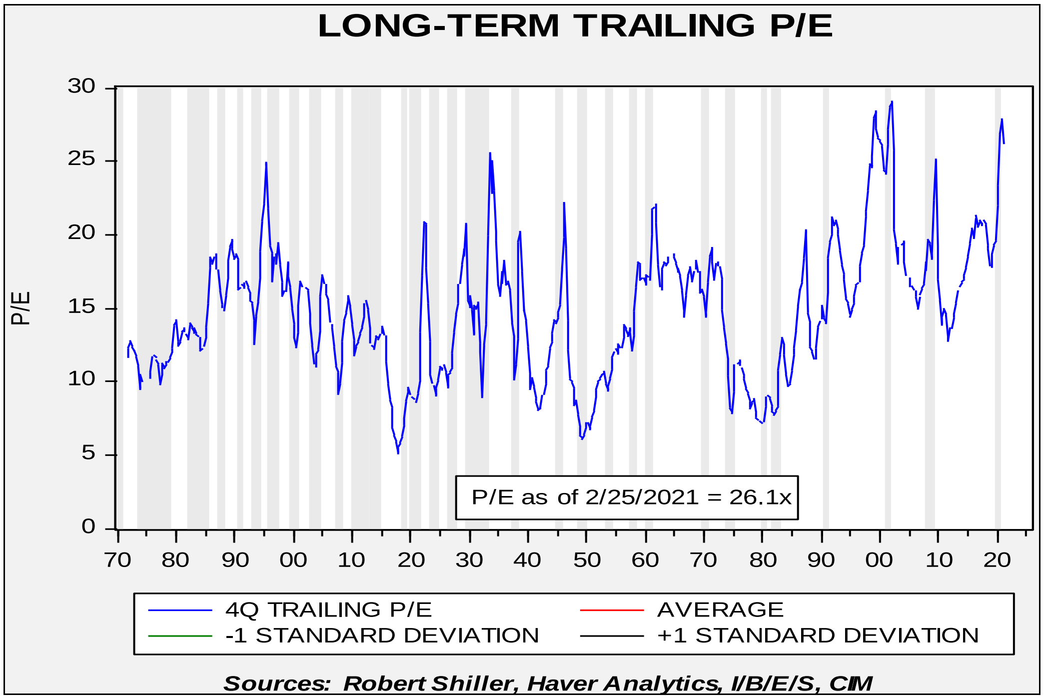



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 26, 2021




Based on our methodology,[1] the current P/E is 26.1x, 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 (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.