# 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 27, 2020—9:30 AM EST]** Global equity markets are generally mixed this morning. The EuroStoxx 50 is currently down 3.3% from its last close. In Asia, the MSCI Asia Apex 50 closed relatively unchanged. Chinese markets were modestly higher, with the Shanghai Composite up 0.1% and the Shenzhen Composite up 0.2%. U.S. equity index futures are signaling a lower open. With 452 companies having reported, the S&P 500 Q4 earnings stand at $41.90, higher than the $40.59 forecast for the quarter. The forecast reflects a 2.0% decrease from Q4 2018 earnings. Thus far this quarter, 72.1% of the companies have reported earnings above forecast, while 20.1% have reported earnings below forecast.

**The newest episode of our *Confluence of Ideas* podcast series is now available.** This episode discusses Confluence's 2020 Geopolitical Outlook. We examine the U.S. 2020 elections, the situation in Iran, China's debt, the impact of demographics and North Korea. We also provide an update on emerging issues since we published the report in mid-December.

Global equity markets are down again due to the continued spread of COVID-19. U.S. futures are down this morning. We update the latest on the virus, including some thoughts about the Fed's reaction function. Despite everything, U.S. housing data is looking remarkably robust. There is our usual recap of the weekly energy report. Here are the details:

**COVID-19:** The number of reported cases worldwide is 82,446 with 2,808 fatalities. The number of new cases is now higher outside of China. The decline in risk assets today appears to be driven by reports of endogenous infections—a case in California does not appear to have any ties to China. This raises the potential that asymptomatic carriers could be spreading the disease. The reports of new cases in the U.S. and Europe are making it clear that attempts to contain the virus have failed. Now the focus is shifting to dealing with the onset of COVID-19 in the U.S. and Europe.

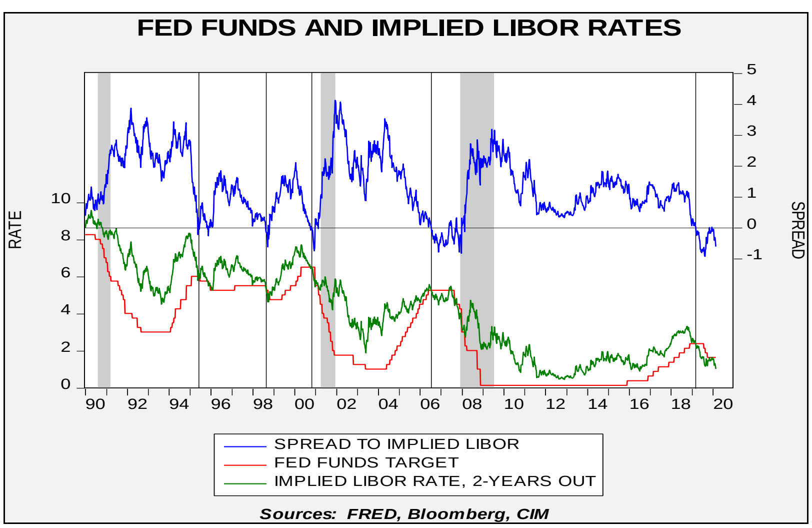
Meanwhile, there have been rising reports of aggressive actions overseas. Japan has announced it is closing schools for an extended spring holiday. The U.S. and South Korea have called off military exercises. As the virus spreads across Europe, nations are taking steps to try to slow the expansion. Brazil confirmed its first case. Holy sites in the Middle East are being closed. There are reports that 600 patients are being monitored for the disease in Massachusetts.

President Trump held a news conference on COVID-19 yesterday evening. He tried to strike an upbeat tone but acknowledged the virus is going to be with us. He appointed VP Pence to coordinate the response. These [sorts of events are risky for elected officials](). Many a mayor has been ousted for failing to respond to weather events; the unpredictable is risky. So, the president was trying to thread the needle between showing enough caution to be seen as taking the event seriously, but not act so concerned as to prompt a panic. That is a hard line to weave. We could see some officials ousted in this process. As we saw in China, the usual political response is to underreact and underreport on hopes the event doesn't worsen. At the same time, overdoing it is risky too. President Ford's reaction to the 1976 Swine Flu outbreak was so strong that the action to counter the outbreak (that really never happened) caused more problems than the flu itself.

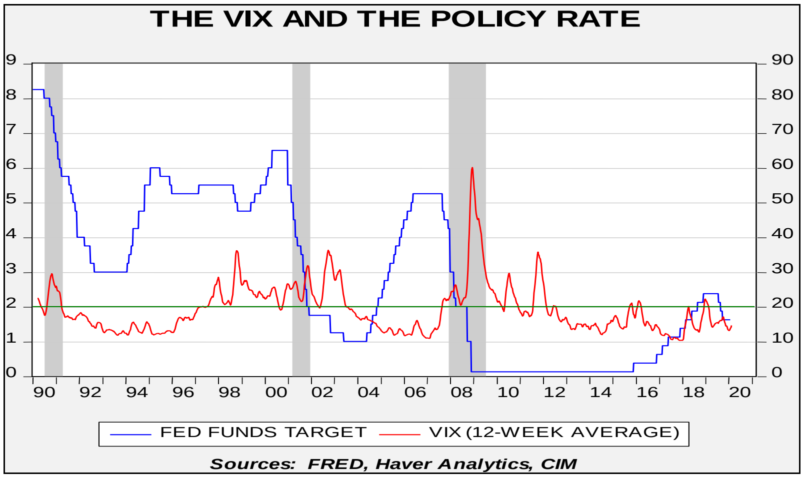
As we have been saying *ad nauseam*, our central case is that this will be a three- to four-month event that will pull some nations into recession. We doubt the U.S. will go into recession, but the event will leave a mark, especially around the world. We would expect a negative impact on earnings. The key issue to watch is whether the supply crunch that will come from COVID-19 becomes a demand event. In other words, as the virus spreads in the U.S., watch household consumption and consumer confidence. If stores empty out and Opening Day has few attendees, the follow-on effects on demand could bring the economy into a downturn. At the same time, our view on equities is that this decline, which is into correction areas in the U.S., is probably short-lived. That doesn't mean we are out of the woods yet in the near term. As the bull market has extended, all sorts of schemes to enhance performance using option strategies have become imbedded into equities. How these tactics are affected by the recent weakness is anyone's guess, but our expectation is that they will increase volatility.

At the same time, watching China is instructive. It appears that China may be through the worst of it and is now trying to recover. Emergency measures are starting to come down in some areas and there are calls to ease restrictions further. Getting workers back on the job is proving to be complicated. Some companies are resorting to bonuses to get workers to return. If China is any guide, the wave of infection takes about six weeks to peak and then it dissipates.

The Fed is under pressure to cut rates. Partly that is coming from public pressure. The financial markets are another area of pressure. The implied LIBOR rate from the two-year deferred Eurodollar futures is down to 100 bps, signaling that the Fed needs to cut rates by at least 50 bps.

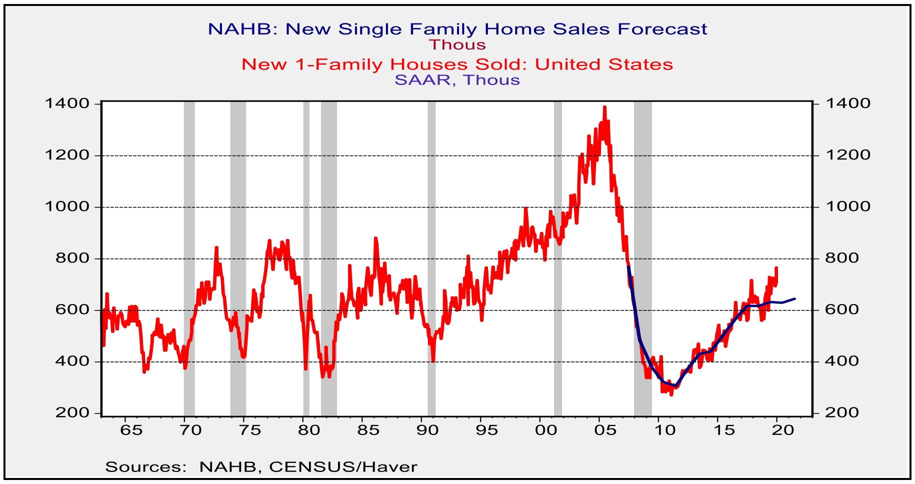


So, what about timing?  Since 2000, the FOMC has tended to lower rates when the 12-week average of the VIX rises above 20.  Since the VIX has just started rising, we may need to see more equity weakness before the Fed decides to move.  It might move before then, but the combination of a falling implied LIBOR rate and higher equity market volatility would make a strong case for the central bank to act.




We do expect the Fed to cut rates, probably in the summer.  FOMC members are still signaling "wait and see."  But, the bank's reaction function to financial signals is making a clear case that further rate reductions are warranted.

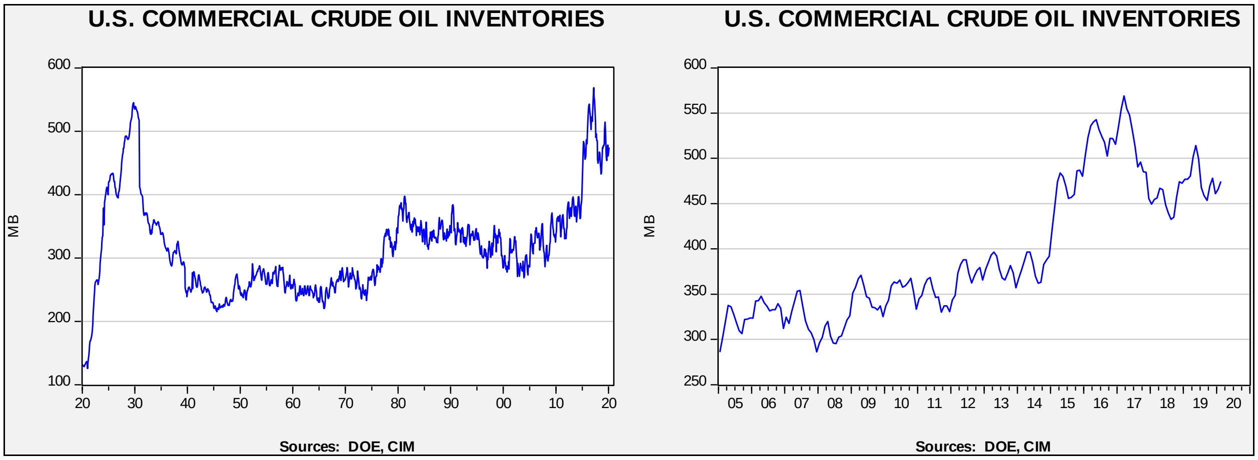
**Housing:** Recent housing data has been remarkably robust.  Yesterday, new home sales data was very strong.



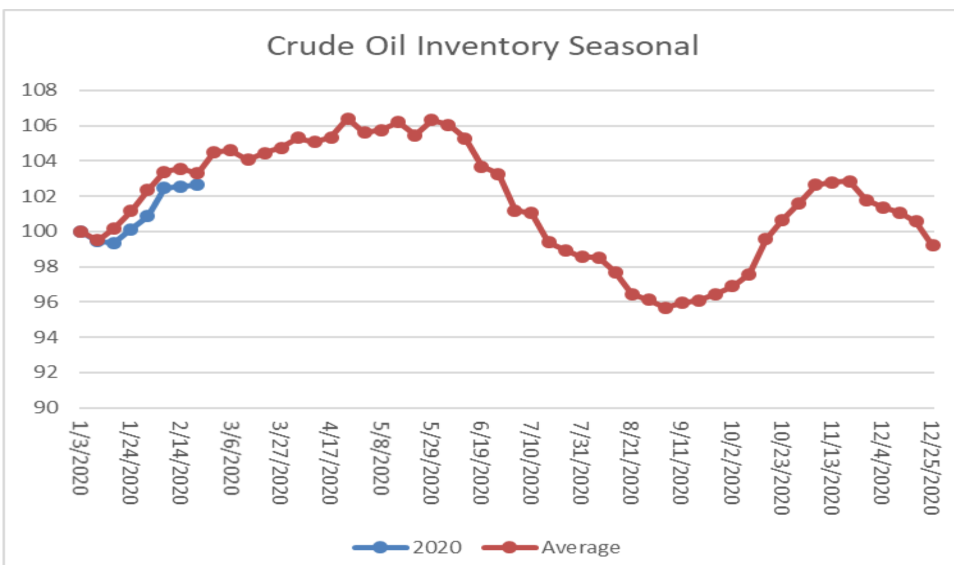

This chart shows new single-family home sales compared to the National Association of Home Builders' forecast for sales.  As the chart shows, current sales are very strong.  Before 1995, sales tended to range between 400k to 800k.  We are approaching the high end of that range, and with current low rates there is no reason not to expect that we will move above 800.  And, it is perhaps not a moment too soon as we have been observing reports of homelessness and substandard housing.

**Odds and ends:** The EU and U.K. remain at odds, with the U.K. signaling it will not abide by EU environmental and labor laws. The EU is viewing this as a breach of the agreements made before Brexit. Russia is planning a nationwide poll on constitutional reforms. Germany is hinting it will ease the "debt brake" and fiscally stimulate. South Korea's central bank kept rates steady, thwarting expectations of a rate cut.

**Energy update:** Crude oil inventories rose 0.5 mb compared to the forecast rise of 1.8 mb.

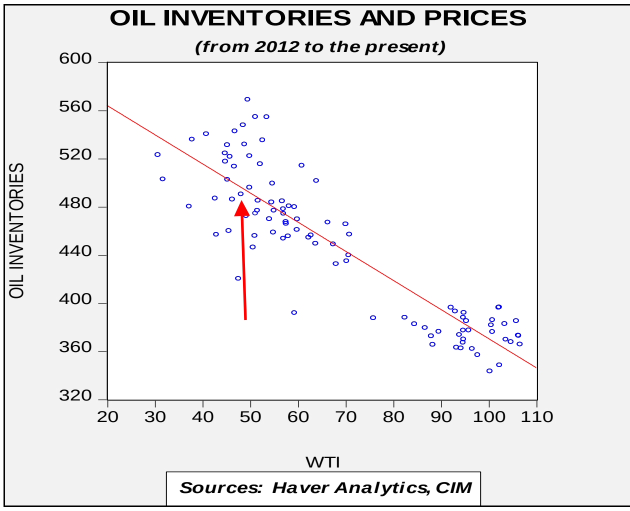


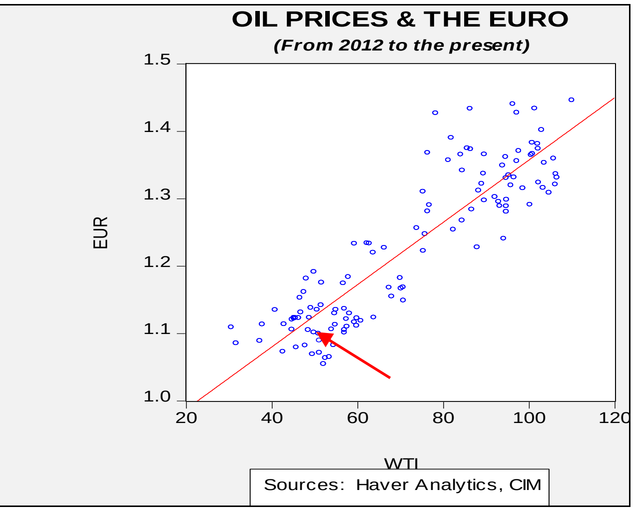

In the details, U.S. crude oil production was unchanged at 13.0 mbpd. Exports rose 0.1 mbpd, while imports fell 0.3 mbpd. The inventory build was less than forecast due to rising exports and falling imports.




(Sources: DOE, CIM)

This chart shows the annual seasonal pattern for crude oil inventories. This week's report was consistent with seasonal patterns and the gap between the normal pace of inventory accumulation and the actual remains narrow. Seasonally, next week should see a notable rise; if stocks fail to rise around 3.0 mb next week, it would be considered somewhat bullish.

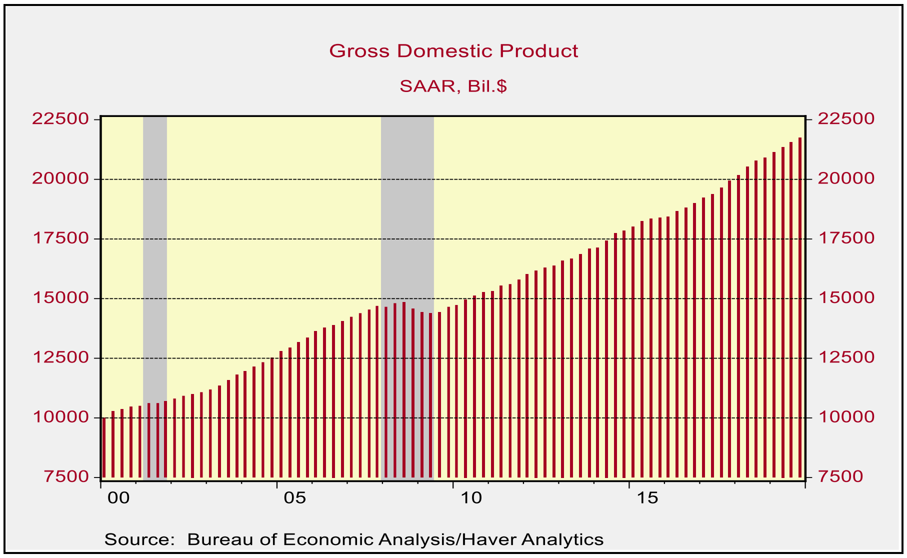



Based on our oil inventory/price model, fair value is $59.43; using the euro/price model, fair value is $46.12. The combined model, a broader analysis of the oil price, generates a fair value of $49.96. The COVID-19 continues to play havoc on the oil markets, but the strong dollar and seasonal pressures are not helping either.

## U.S. Economic Releases

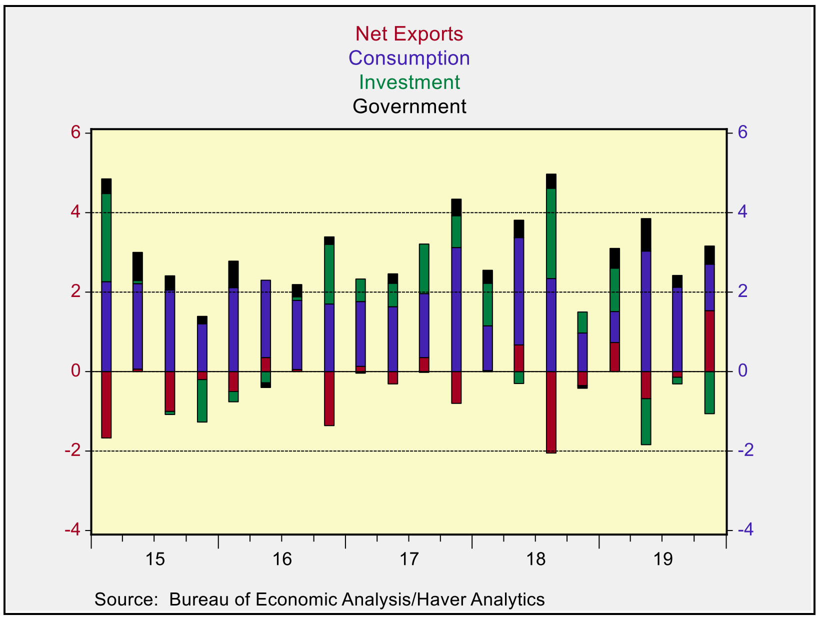
The second reading for Q4 GDP came in line with expectations, rising at an annualized pace of 2.1%. Personal consumption was also in line with expectations at 1.7%, while core PCE and the GDP price index came in at 1.2% and 1.3%, respectively.




The chart above shows the current level of nominal GDP. The chart shows the economy is still in expansion territory.

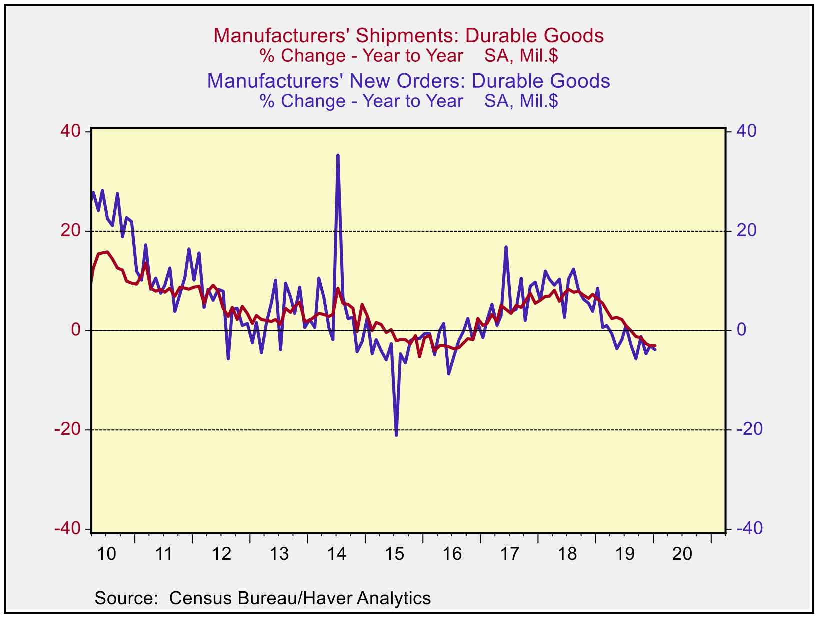
| | Q4 2019 First Reading | Q4 2019 First Reading | Difference |
|---|---|---|---|
| ***GDP*** | 2.1% | 2.1% | 0.0% |
| ***Consumption*** | 1.2% | 1.2% | 0.0% |
| ***Investment*** | -1.1% | -1.1% | 0.0% |
| ***Inventories*** | -1.0% | -1.1% | 0.1% |
| ***Net Exports*** | 1.5% | 1.5% | 0.0% |
| ***Government*** | 0.5% | 0.5% | 0.0% |

The table above shows the GDP contribution table. The contributions were relatively unchanged from the first reading numbers.  Inventories were revised slightly higher.



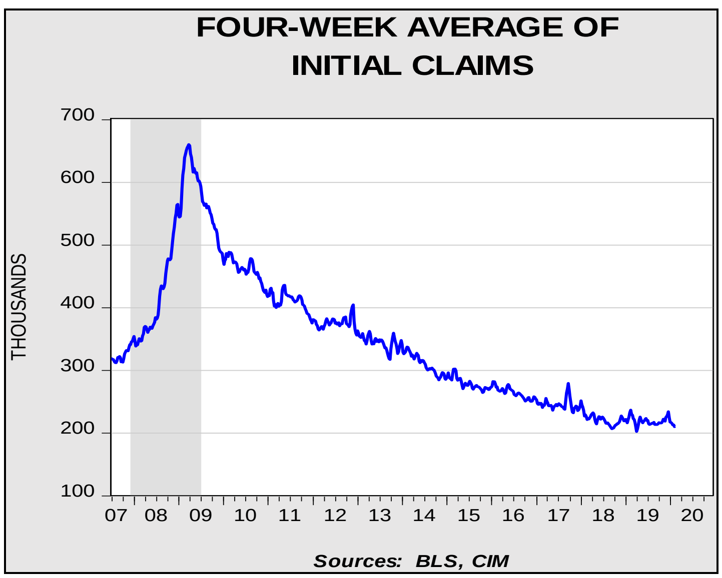

The chart above shows the contribution chart visually.

For January, durable goods orders were generally strong.  Durable goods orders came in better than expected, falling 0.2% from the prior month compared to the forecast drop of 1.4%. Additionally, durable goods excluding transportation rose higher than expected at 0.9% from the prior month compared with a forecast rise of 0.2%.  Meanwhile, capital goods orders nondefense ex-air came in above expectations, rising 1.1% from the prior month compared to the forecast rise of 0.1%.  Lastly, capital goods shipment nondefense excluding air came in above expectations, rising 1.1% from the prior month compared to the forecast of remaining flat.




The chart above shows the annual change in durable goods orders and shipments, which fell 3.3% and 3.9%, respectively.

Intial jobless claims came in above expectations at 219k compared to the forecast of 212k.




The chart above shows the four-week moving average of initial claims. The moving average rose from 209.25k to 209.75k.

The table below shows the economic releases and Federal Reserve events scheduled for the rest of the day.

| Economic Releases | | | | | | | |
|---|---|---|---|---|---|---|---|
| EDT | Indicator | | | Expected | Prior | Rating |
| 9:45 | Bloomberg Consumer Comfort | m/m | 23-Feb | | 65.6 | ** |
| 10:00 | Pending Home Sales | m/m | Jan | 3.0% | -4.9% | ** |
| 10:00 | Pending Home Sales | m/m | Jan | 2.1% | 6.8% | ** |
| 10:00 | Kansas City Fed Manufacturing Activity | m/m | Feb | -1 | -1 | ** |

| Fed Speakers or Events | | |
|---|---|---|
| | Speaker or event | District or position |
| 11:30 | Charles Evans Speaks in Mexico City | President of the Federal Reserve Bank of Chicago |
| 15:30 | Loretta Mester Takes Part in Women in Economic Symposium | President of the Federal Reserve Bank of Cleveland |

## 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 | | | | | | | | |
| Australia | Private Capital Expenditure | q/q | 4Q | -2.8% | -0.2% | 0.5% | ** | Equity and bond neutral |
| New Zealand | Trade Balance NZD | m/m | Jan | -0.340 Bil | 0.547 Bil | -0.549 Bil | ** | Equity bullish, bond bearish |
| | ANZ Business Confidence | m/m | Feb | -19.4 | -13.2 | | ** | Equity bearish, bond bearish |
| | ANZ Activity Outlook | m/m | Feb | 12.0 | 17.2 | | ** | Equity and bond neutral |
| EUROPE | | | | | | | | |
| Eurozone | Economic Confidence | m/m | Feb | 103.5 | 102.8 | 102.8 | ** | Equity bullish, bond bearish |
| | Industrial Confidence | m/m | Feb | -6.1 | -7.3 | -7.2 | ** | Equity and bond neutral |
| | Services Confidence | m/m | Feb | 11.2 | 11.0 | 11.0 | ** | Equity bullish, bond bearish |
| | Consumer Confidence | m/m | Feb | -6.6 | -6.6 | | *** | Equity and bond neutral |
| | M3 Money Supply | y/y | Jan | 5.2% | 5.0% | 5.3% | * | Equity and bond neutral |
| Italy | Consumer Confidence | m/m | Feb | 111.4 | 111.8 | 111.4 | *** | Equity and bond neutral |
| | Manufacturing Confidence | m/m | Feb | 100.6 | 99.9 | 99.4 | ** | Equity bullish, bond bearish |
| | Economic Sentiment | m/m | Feb | 99.8 | 99.2 | | ** | Equity bullish, bond bearish |
| AMERICAS | | | | | | | | |
| Canada | CFIB Business Barometer | m/m | Feb | 60.5 | 55.3 | | ** | Equity bullish, bond bearish |
| Brazil | FGV Inflation IGPM | y/y | Feb | 6.8% | 7.8% | 6.8% | *** | Equity and bond neutral |
| Mexico | Unemployment Rate | m/m | Jan | 3.8% | 2.9% | 3.3% | *** | Equity bearish, 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)** | 164 | 165 | -1 | Up |
| **3-mo T-bill yield (bps)** | 146 | 148 | -2 | Neutral |
| **TED spread (bps)** | 18 | 16 | 2 | Neutral |
| **U.S. Libor/OIS spread (bps)** | 143 | 148 | -5 | Up |
| **10-yr T-note (%)** | 1.28 | 1.34 | -0.06 | Neutral |
| **Euribor/OIS spread (bps)** | -42 | -42 | 0 | Neutral |
| **EUR/USD 3-mo swap (bps)** | 11 | 10 | 1 | Down |
| **Currencies** | **Direction** | | | |
| dollar | Down | | | Neutral |
| euro | Up | | | Down |
| yen | Up | | | Down |
| pound | Down | | | Down |
| franc | Up | | | Down |

## 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 | $52.13 | $53.43 | -2.43% | Global growth pessimism |
| WTI | $47.55 | $48.73 | -2.42% | |
| Natural Gas | $1.78 | $1.84 | -3.32% | |
| Crack Spread | $15.04 | $16.11 | -6.65% | |
| 12-mo strip crack | $12.90 | $13.35 | -3.36% | |
| Ethanol rack | $1.43 | $1.43 | -0.39% | |
| **Metals** | | | | |
| Gold | $1,650.76 | $1,640.96 | 0.60% | |
| Silver | $18.06 | $17.92 | 0.75% | |
| Copper contract | $255.85 | $257.35 | -0.58% | |
| **Grains** | | | | |
| Corn contract | $ 372.25 | $ 374.50 | -0.60% | |
| Wheat contract | $ 531.50 | $ 535.75 | -0.79% | |
| Soybeans contract | $ 887.75 | $ 892.00 | -0.48% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 517 | 508 | 9 | |
| **DOE inventory report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | 0.5 | 1.8 | -1.3 | |
| Gasoline (mb) | -2.7 | -2.0 | -0.7 | |
| Distillates (mb) | -2.1 | -1.5 | -0.6 | |
| Refinery run rates (%) | -1.50% | -0.65% | -0.85% | |
| Natural gas (bcf) | | -164.0 | | |

## Weather

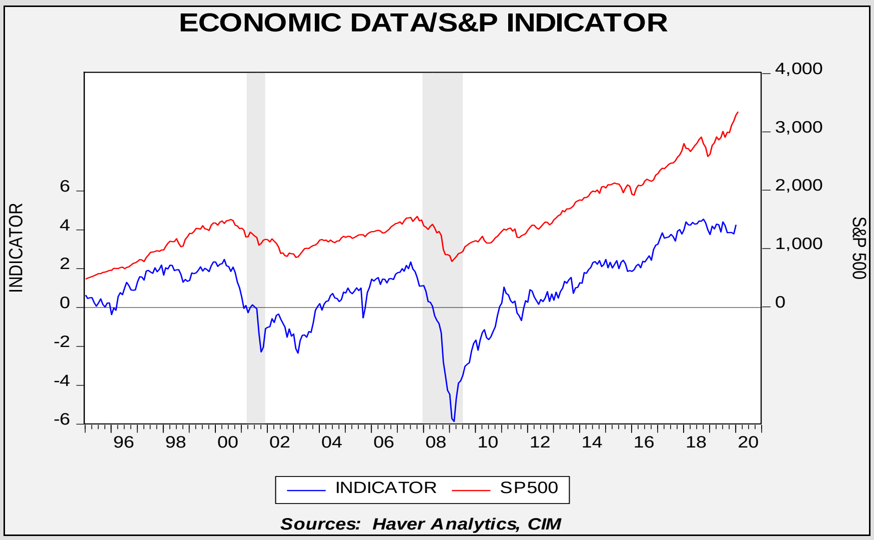
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in the central states and the Northeast, with colder-than-normal temperatures in Florida and the Rockies. Wet conditions are expected for virtually all of the country except for the Pacific Northwest and Florida.

## Asset Allocation Weekly

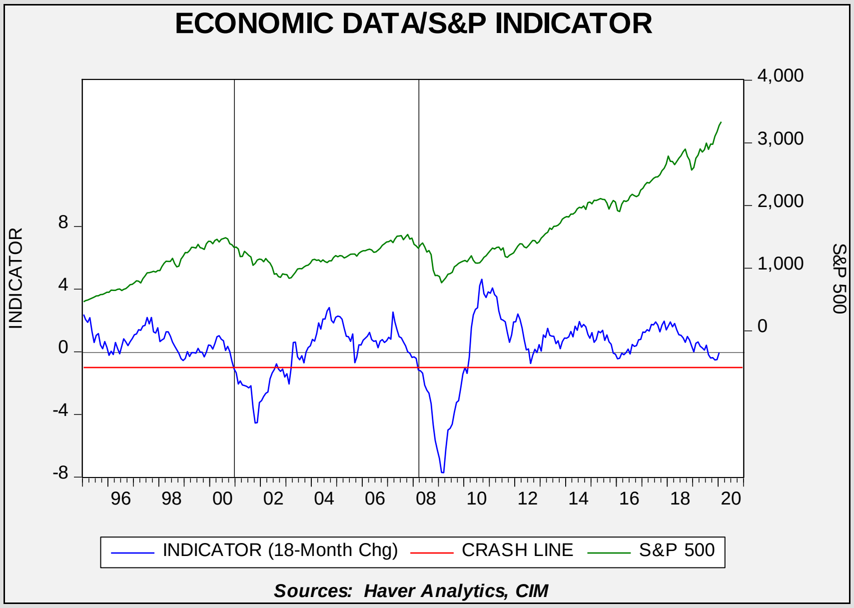
*Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.*

February 21, 2020

In 2017, we introduced an indicator of the basic health of the economy and added it to the many charts we monitor to gauge market conditions. The indicator is constructed using commodity prices, initial claims and consumer confidence. The thesis behind this indicator is that these three components should offer a simple and clear picture of the economy; in other words, rising initial claims coupled with falling commodity prices and consumer confidence is a warning that a downturn may be imminent. The opposite condition should support further economic recovery. In this report, we will update the indicator with January data.




This chart shows the results of the indicator and the S&P 500 since 1995. The updated chart shows that the upward momentum in the economy has slowed but remains well above zero. We have placed gray bars to indicate recessions. The indicator was coincident with the 2001 recession but didn't turn negative until June 2008, when the recession was well underway. Unfortunately, in its raw form, it signals trouble when the equity markets are already well into their decline.



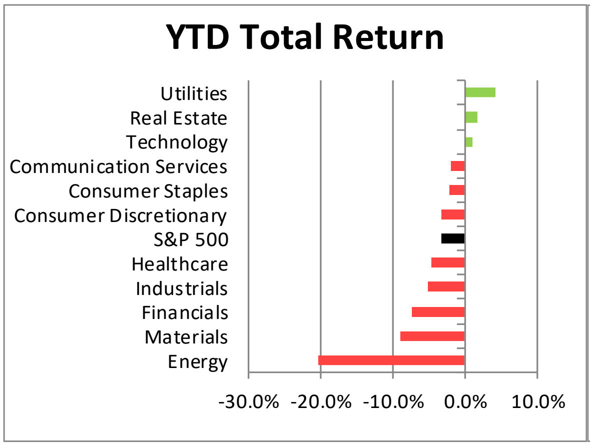

To make the indicator more sensitive, we took the 18-month change and put the signal threshold at minus 1.0. This provides an earlier bearish signal and also eliminates the false positives that the zero threshold generates. Nevertheless, the fact that this variation of the indicator is below zero raises caution.

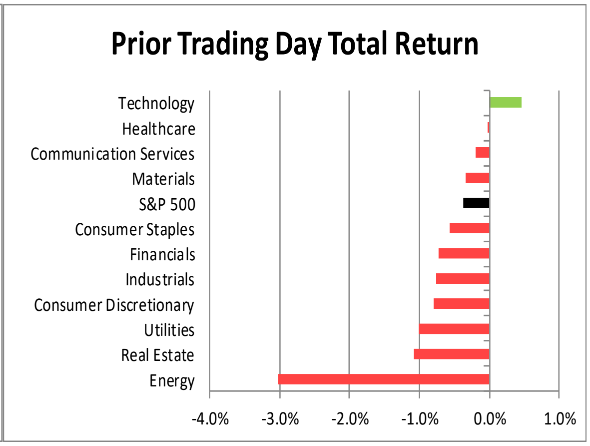
What does the indicator say now? The economy has been decelerating but conditions have improved over the past three months, lifting this indicator back to near-zero. Thus, the improvement does suggest that investors should remain in equities based on the idea that economic conditions remain supportive. In past updates, we have expressed caution that at least rebalancing of portfolios was in order. This update would indicate that further defensive action should be put on hold for now.

*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 2/26/2020 close)

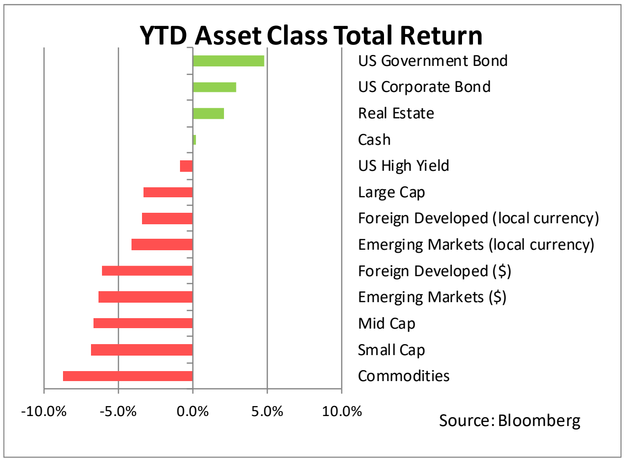



(Source: Bloomberg)

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 2/26/2020 close)

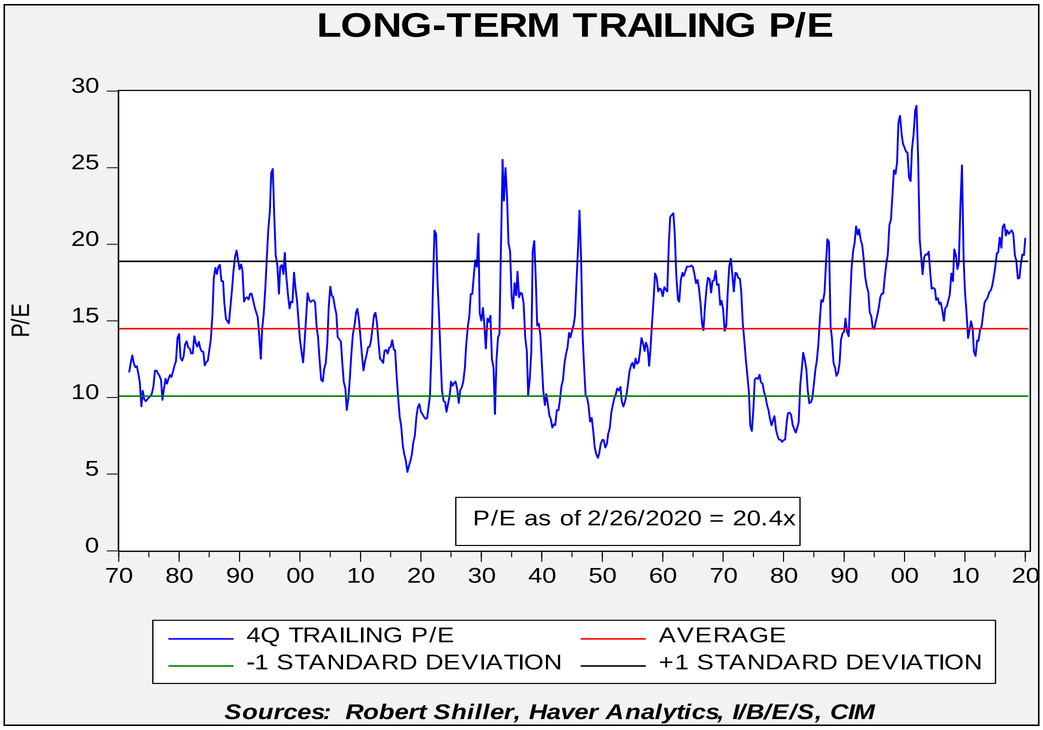



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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**

February 27, 2020




Based on our methodology,[1] the current P/E is 20.4x, 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, 2020). 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.