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: July 1, 2020—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.3% from its last close. In Asia, the MSCI Asia Apex 50 closed up 0.8% from its prior close. Chinese markets were higher, with the Shanghai Composite up 1.4% from the prior close and the Shenzhen Composite up 0.8%. U.S. equity index futures are signaling a lower open.

A slew of purchasing managers' indexes from around the world today show manufacturing activity is either growing again, or declining at a much milder pace than at the initial peak of the coronavirus crisis (see tables below). However, renewed infection outbreaks and lockdowns are taking the wind out of investors' sails, as are renewed tensions with China after its imposition of a new national security law on Hong Kong. We present all the key news below.

COVID-19: Official data show confirmed cases have risen to 10,501,482 worldwide, with 511,909 deaths and 5,378,800 recoveries. In the United States, confirmed cases rose to 2,636,538, with 127,425 deaths and 720,631 recoveries. Here is the interactive chart from the *Financial Times* that allows you to compare cases and deaths among countries, scaled by population.

Virology

- In his testimony before a Senate committee, top infectious disease official Dr. Anthony Fauci warned yesterday that new U.S. infections could surge from their current rate of about 40,000 per day to more than 100,000 per day if people continue to ignore advice on social distancing and using face masks.
- Highlighting the disparate response of some state governments as they face rebounding infections, Florida Gov. Ron DeSantis said his state was "not going back" after reopening because its increase in cases was caused by young people out socializing rather than people visiting businesses. Massachusetts Gov. Charlie Baker relaxed his state's 14-day self-quarantine mandate for visitors by exempting those from seven nearby states, including New York and New Jersey, but New York Gov. Andrew Cuomo extended quarantine requirements enacted last week to include people coming from California, Georgia, Iowa, Idaho, Louisiana, Mississippi, Nevada and Tennessee.
- Even after months of experience with the virus, emergency room physicians also disagree on the best way to treat victims and are taking a wide variety of approaches. The disparity in approaches even extends to the proper settings to use on ventilators.

Economic Impact

- Even though a lot of global economic data points to an economic recovery as lockdowns ease, some figures suggest the recovery could already be hitting a plateau. For example, data from the digital timecard firm Homebase show the number of small-business employees working in late June was lower than earlier in the month.
- European airliner giant Airbus (EADSY, 17.85) said it would cut 15,000 jobs across its commercial aircraft division, citing what it expects to be a years-long impact on the aviation sector from the pandemic. The cuts will amount to about 11% of the company's total workforce.
- German auto giant Volkswagen (VWAGY, 16.17) said it would cancel plans to build a new factory in Turkey because of the severe decline in auto demand caused by the virus crisis. The plant was slated to start producing 300,000 cars per year in 2022.

U.S. Policy Response

- In their testimony before the House Financial Services Committee yesterday, Federal Reserve Chair Powell and Treasury Secretary Mnuchin said they would consider additional relief measures to prevent lasting damage to labor markets and businesses, as more states struggle to suppress a rebound in the coronavirus pandemic. Despite the concerns generated by renewed outbreaks and lockdowns, the policymakers' willingness to keep adding monetary and fiscal support should offer significant support for risk assets.

China-Hong Kong: The Hong Kong municipal government officially published the text of the new national security law imposed on it by Beijing yesterday, putting the legislation into effect just one hour before today's 23rd anniversary of Britain's handover of Hong Kong to China. The full text of the law, which can be found here, is largely consistent with the hints and summaries provided by Chinese officials over the last few weeks. In other words, the legislation seems as bad as feared, which will further tamp down anti-China political opposition in Hong Kong and exacerbate tensions with the U.S. and other Western democracies. Police in Hong Kong today made their first arrests under the law when a group of protestors tried to hold a demonstration marking the 1997 handover of Hong Kong to China. Under the law;

- Secessionist, subversive, and terrorist activities against China or Hong Kong are criminalized beginning today, as are acts of collusion with foreign forces that endanger national security. The collusion offenses include espionage and efforts to impose sanctions against China or Hong Kong, as well as inciting hatred against the central or local government. Punishments include jail terms up to life in prison.

- Any person who commits offenses defined by the legislation are subject to the law's provisions, even if they are outside Hong Kong and aren't permanent residents of the territory. It wasn't clear how this provision would be implemented.

- China's central government is empowered to supervise the policing of subversive activities in Hong Kong and, in some cases, intervene directly. Its provisions would supersede Hong Kong legislation should there be inconsistencies between them.

- A special council formed by Hong Kong officials and led by the city's chief executive has responsibility for enforcing the law. Their work will be confidential, with decisions not subject to judicial reviews.
- Within the municipal police force, a special unit will be set up to handle national security cases. Beyond the police's usual powers in criminal investigations, the law allows the special police unit to put suspects under secret surveillance with authorization from the city's chief executive.
- Hong Kong's government is also required to strengthen its scrutiny and management of schools, civic organizations, media and the Internet, and use these platforms to educate local residents on matters related to national security.
- A dedicated central-government office in Hong Kong will oversee national-security affairs, and its personnel are empowered to gather and analyze intelligence, as well as advise and supervise local authorities on security matters. Its personnel won't be subjected to Hong Kong law when they are carrying out their duties.

China-Hong Kong-United States: Just after the publication of the new Hong Kong security law, a bipartisan group of U.S. senators and representatives introduced legislation that would offer refugee status to Hong Kong residents at risk of persecution under it. The legislation would require the State Department to give special status to Hong Kong residents and certain family members who suffered persecution, or have a well-founded fear of it, due to their expression of political opinions or peaceful participation in political activities. The paperwork could be completed in Hong Kong or in a third country, and refugees would then be able to apply for permanent residency and citizenship. The opportunity, which wouldn't be restricted by the current U.S. cap on refugees, would be valid for five years from the date of the bill's passage.

Russia: The country will finish voting today on a series of constitutional changes that would allow President Putin to run for two more terms in office and stay in power until 2036. To sweeten the pot, the amendments also include a range of social and nationalist goodies such as guaranteeing social benefits and a ban on "belittling the significance" of Russia's victory over Nazi Germany in World War II (though voters can only vote for or against the entire package). And in case that's not enough to drive participation, posters and mass text messages are promising Muscovites "a million prizes" through raffles in exchange for voting, officials are pressuring public employees to vote and large state companies are offering their own prizes for doing so via QR codes that could be used to track people at polling stations. A positive outcome for Putin seems little in doubt.

Germany: Defense Minister Annegret Kramp-Karrenbauer is dissolving a unit of the country's special forces, known as the Kommando Spezialkräfte (KSK) after some of its members were found to have radical right-wing sympathies. The KSK will also be restructured and stripped of control over its training.

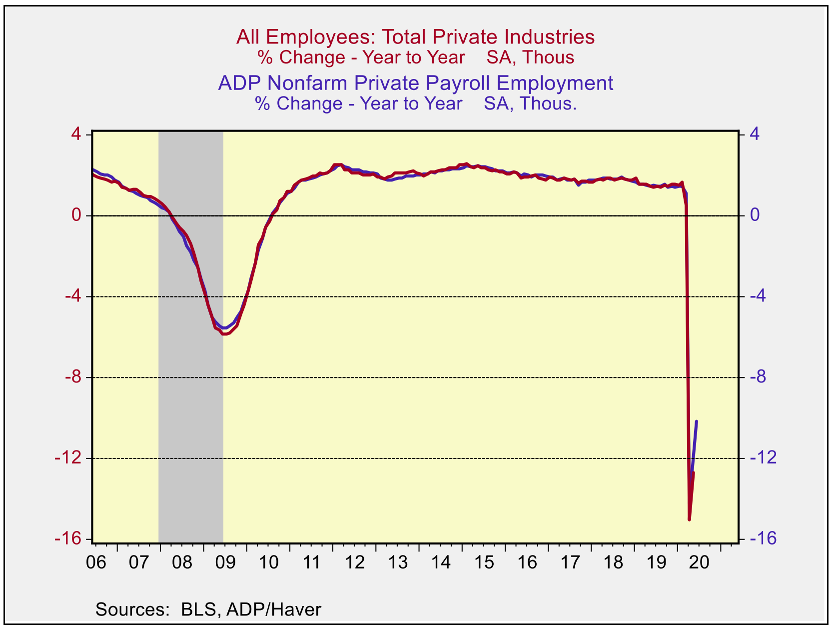
United States-Mexico-Canada: The new U.S.-Mexico-Canada (USMCA) trade agreement, which updated the previous NAFTA deal, officially went into effect today.

U.S. Economic Releases

For the week ending June 26, MBA applications fell 1.8% from the prior week. Applications for purchases and refinancing fell 1.3% and 2.2%, respectively. The average 30-year fixed rate fell from 3.30% to 3.29%, a new low.

In June, the Challenger job cuts index rose 305.5% from the prior year. The index tracks the posting of planned future layoffs as reported by warn notices and similar filings. That said, planned future layoffs do not necessarily mean that the layoffs are final.

The ADP employment change came in at 2.369 MM compared to expectations of 2.900 MM. The prior report was revised upward from -2.760 MM to 3.065 MM.



The chart above shows the annual change in ADP nonfarm payrolls and BLS nonfarm payrolls. Despite the sharp rise in payrolls, we still haven't replaced the total amount of jobs lost due to the pandemic. That said, ADP payrolls suggests that the payroll numbers will be strong.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Markit US Manufacturing PMI	m/m	Jun	49.6	49.6	***
10:00	ISM Manufacturing	m/m	Jun	49.7	43.1	***
10:00	ISM Prices Paid	m/m	Jun	51.9	31.8	**
10:00	ISM New Orders	m/m	Jun	44.6	40.8	**
10:00	ISM Employment	m/m	Jan		32.1	**
10:00	Construction Spending	m/m	May	1.0%	2.9%	**
	Wards Total Vehicle Sales	m/m	Jun	13.000m	12.100m	**
Fed Speakers or Events						
	Speaker or event	**District or position**				
13:00	FOMC Rate Decision	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.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
China	Caixin China PMI Mfg	m/m	Jun	51.2	50.7	50.5	**	Equity bullish, bond bearish
Japan	Tankan Large Mfg Index	q/q	2Q	-34.0	-8.0	-31.0	**	Equity and bond neutral
	Tankan Large Non-Mfg Index	q/q	2Q	-17.0	8.0	-20.0	**	Equity and bond neutral
	Tankan Large Mfg Outlook	q/q	2Q	-27.0	-11.0	-24.0	**	Equity and bond neutral
	Tankan Large Non-Mfg Outlook	q/q	2Q	-14.0	-1.0	-15.0	**	Equity and bond neutral
	Tankan Large All Industry Capex	q/q	2Q	3.2%	1.8%	1.3%	**	Equity bullish, bond bearish
	Jibun Bank Japan PMI Mfg	m/m	Jun	40.1	37.8		*	Equity bullish, bond bearish
	Vehicle Sales	y/y	Jun	-26.0%	-40.2%		**	Equity and bond neutral
	Consumer Confidence Index	m/m	Jun	28.4	24.0	28.0	***	Equity bullish, bond bearish
India	Eight Infrastructure Industries	m/m	May	-23.4%	-38.1%		**	Equity and bond neutral
	BoP Current Account Balance	q/q	1Q	$0.600b	-$1.400b	-$3.000b	**	Equity and bond neutral
	Markit India PMI Mfg	m/m	Jun	47.2	30.8		**	Equity bullish, bond bearish
New Zealand	AiG Perf of Manufacturing Index	m/m	Jun	51.5	41.6		***	Equity bullish, bond bearish
	Building Approvals	m/m	Jun	-16.4%	-1.8%	-7.8%	**	Equity bearish, bond bullish
	Commodity Index AUD	m/m	Jun	95.8	103.9		**	Equity bearish, bond bullish
Europe								
Eurozone	Markit Eurozone Manufacturing PMI	m/m	Jun	47.4	46.9	46.9	**	Equity bullish, bond bearish
	Markit France Manufacturing PMI	m/m	Jun	52.3	52.1	52.1	**	Equity bullish, bond bearish
Germany	Retail Sales NSA	y/y	May	3.8%	-6.5%	-3.2%	***	Equity bullish, bond bearish
	Markit/BME Germany Manufacturing PMI	m/m	Jun	45.2	44.6	44.6	**	Equity bullish, bond bearish
	Unemployment Change (000's)	m/m	Jun	69.0k	238.0k	120.0k	***	Equity and bond neutral
	Unemployment Claims Rate SA	m/m	Jun	6.4%	6.3%	6.5%	***	Equity and bond neutral
Italy	Markit Italy Manufacturing PMI	m/m	Jun	47.5	45.4	47.8	**	Equity and bond neutral
UK	Nationwide House Px	m/m	Jun	-1.4%	-1.7%	-0.6%	***	Equity and bond neutral
	Markit UK PMI Manufacturing SA	m/m	Jun	50.1	50.1	50.1	**	Equity and bond neutral
Switzerland	PMI Manufacturing	m/m	Jun	41.9	42.1	48.0	**	Equity and bond neutral
Russia	Markit Russia PMI Mfg	m/m	Jun	49.4	36.2	45.0	**	Equity bullish, bond bearish
AMERICAS								
Canada	GDP	y/y	Apr	-17.1%	-5.8%	-17.1%	***	Equity and bond neutral
Mexico	Unemployment Rate Telephone	m/m	May	4.2%	4.7%		**	Equity and bond neutral
Brazil	National Unemployment Rate	m/m	May	12.9%	12.6%	13.1%	***	Equity bullish, bond bearish
	Net Debt % GDP	m/m	May	55.0%	52.7%	54.6%	***	Equity bullish, bond bearish

Germany: May retail sales were up by a record 13.9% from the previous month and 3.8% from May 2019, suggesting a huge amount of pent-up demand was released when the country started to ease its coronavirus lockdown. The figures are the latest evidence that the German economy is rebounding from its low point when the pandemic was in full force, despite the fact that social-distancing rules remain in place and many large-scale public events are closed.

United Kingdom: Highlighting the disparate experiences of countries as they begin to come out of their coronavirus lockdowns, the Nationwide House Price Index showed British home prices in June were down 0.1% from June 2019, marking their first annual decline since 2012.

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)	31	31	0	Down
3-mo T-bill yield (bps)	13	14	-1	Neutral
TED spread (bps)	18	17	1	Up
U.S. Libor/OIS spread (bps)	6	6	0	Up
10-yr T-note (%)	0.63	0.62	0.01	Neutral
Euribor/OIS spread (bps)	-41	-40	-1	Neutral
EUR/USD 3-mo swap (bps)	8	8	0	Down
Currencies	**Direction**			
dollar	Up			Down
euro	Down			Up
yen	Up			Up
pound	Flat			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	$42.30	$41.27	2.50%	Bullish API
WTI	$40.27	$39.27	2.55%	
Natural Gas	$1.72	$1.75	-1.94%	
Crack Spread	$11.45	$10.99	4.12%	
12-mo strip crack	$10.65	$10.40	2.38%	
Ethanol rack	$1.45	$1.44	0.33%	
Metals				
Gold	$1,781.85	$1,780.96	0.05%	
Silver	$18.25	$18.21	0.25%	
Copper contract	$273.65	$272.85	0.29%	
Grains				
Corn contract	$ 344.75	$ 341.50	0.95%	
Wheat contract	$ 495.75	$ 491.75	0.81%	
Soybeans contract	$ 887.25	$ 882.25	0.57%	
Shipping				
Baltic Dry Freight	1799	1794	5	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-0.8		
Gasoline (mb)		-1.7		
Distillates (mb)		0.7		
Refinery run rates (%)		0.50%		
Natural gas (bcf)		78.0		

Weather

The 6-10 and 8-14 day forecasts currently call for warmer temperatures for most of the country, with cool conditions expected in the Pacific and southeastern regions. Wet conditions are expected for the majority of the country, with dry conditions in the Rocky Mountain and Mid-Atlantic regions. There is no tropical cyclone activity expected over the next 48 hours.

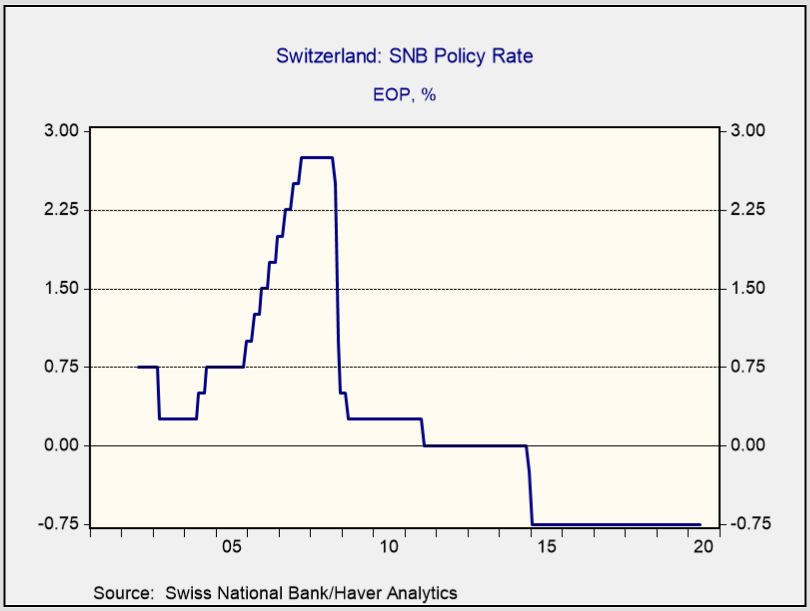
Asset Allocation Weekly

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.

June 26, 2020

(N.B. Due to the Independence Day holiday, the next report will be issued on July 10, 2020.)

Since 2008, some central banks have implemented negative policy interest rates. Standard economics suggests that negative nominal rates on deposits are impossible because holders could simply liquidate the deposit and "put the money under the mattress." We have observed that there are costs to holding cash in large amounts, so banks can implement a negative rate (perhaps best thought of as a fee) on holding cash. Although there are limits to how low negative rates can go (at some point, the cost of providing safekeeping exceeds the benefits), we note the Swiss National Bank has had a policy rate of -0.75% since December 2014.

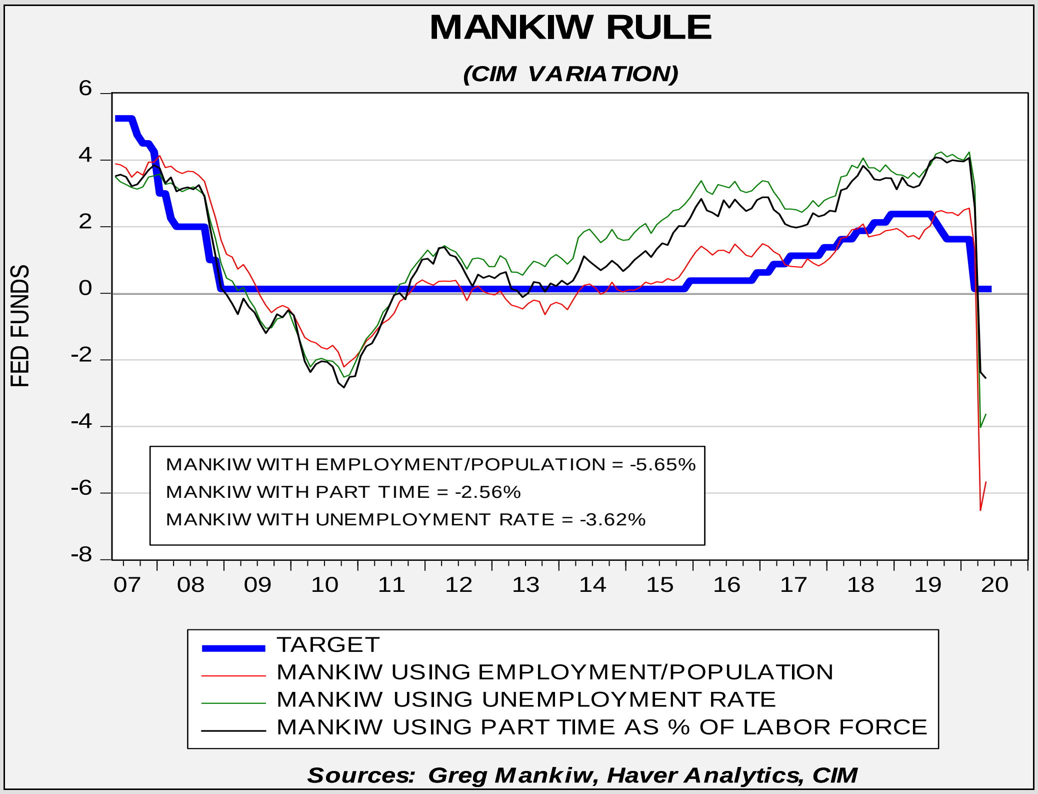


Why would a central bank consider implementing a negative policy rate? If economic conditions warranted easing and inflation was low,[1] it may be impossible to use low but positive interest rates as a policy tool. In that case, negative interest rates or some other unconventional monetary policy may be necessary.

Are conditions similar in the U.S.? Our analysis of the policy rate, using the Mankiw Rule, a variation on the Taylor Rule, suggests that the FOMC could consider negative policy rates. The Taylor Rule is designed to calculate the neutral policy rate given core inflation and the measure of slack in the economy. John Taylor measured slack using the difference between actual GDP and potential GDP. The Taylor Rule assumes that the Fed should have an inflation target in its policy and should try to generate enough economic activity to maintain an economy near full

[1] For example, Switzerland's May CPI was -1.3% from last year.

utilization. The rule will generate an estimate of the neutral policy rate; in theory, if the current fed funds target is below the calculated rate, the central bank should raise rates. Greg Mankiw, a former chair of the Council of Economic Advisors in the Bush White House and current Harvard professor, developed a similar measure that substitutes the unemployment rate for the difficult-to-observe potential GDP measure. We have taken the original Mankiw Rule and created three other variations. Specifically, our models use core CPI and either the unemployment rate, the employment/population ratio, involuntary part-time employment or yearly wage growth for non-supervisory workers. In this report, we are not using the wage growth variation because it is yielding a sharply positive policy rate; wages have increased because lower paid workers have been laid off in greater numbers than higher paid workers.



As the recession developed, the unemployment rate jumped, the employment/population ratio fell, and the number of involuntary part-time workers rose. Complicating matters further, inflation declined. All these factors pointed to the need for policy stimulus. In fact, in the worst case, the employment/ population ratio variation, the nominal rate should be as low as -5.65%.

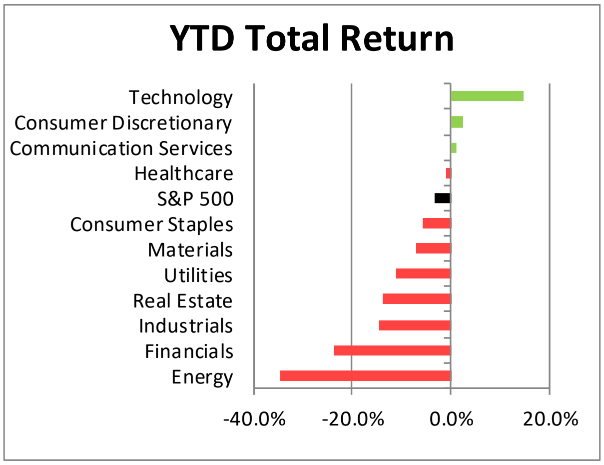
In 2008 through most of 2011, these variations of the Mankiw Rule suggested the policy rate should have been below zero. That is the case today. So far, the FOMC has rejected a negative policy rate and instead relies on expanding the balance sheet and forward guidance. The current program of balance sheet expansion is historically unique; for the first time, we are seeing the Fed buy an assortment of financial assets that expose it to credit risk. These include corporate and high yield bonds. As we noted last week, the current QE is reducing credit spreads, but, like forward guidance, the actual stimulative impact is uncertain.

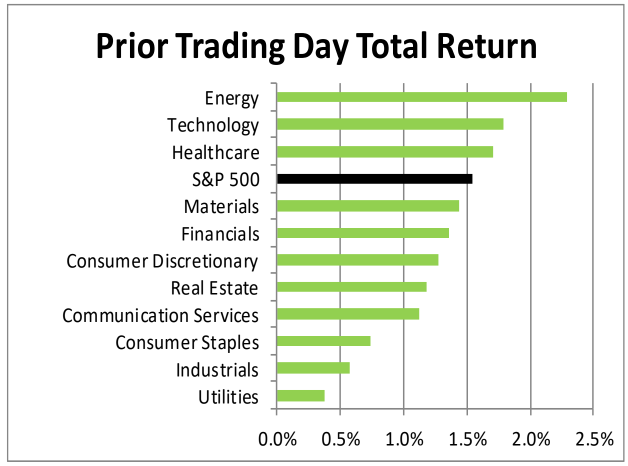
So, why is the FOMC opposed to negative interest rates? The most likely reason is the structure of the U.S. financial system. The U.S. system has an extensive non-bank financial system; unlike banks, this system isn't funded by deposits but by repo and money markets. The non-bank financial system, also known as the "shadow banking system," finances large swaths of the U.S. economy. Although it is difficult to estimate the size, there are reports it may be as large as $1.2 trillion. The fear is that negative deposit rates would likely cause the money market funds to "break the buck" to account for the below-zero yield. That could lead to difficult-to-determine outcomes, but it is plausible that the non-bank financial system may find itself without a source of funding. Since there is no Fed backstop to the non-bank financial system, there could be a run on the loan providers. Other nations have much smaller non-bank systems and thus can manage negative policy rates. The U.S. probably can't.

And so, additional policy stimulus, if necessary, will come from further expansion of the balance sheet and forward guidance. Another possibility would be yield curve control, which was implemented during WWII into the early 1950s. In this policy, the Fed will set the desired rate of some or all of the Treasury curve, absorbing all the Treasury borrowing that the market won't buy, thus fixing the interest rate. The Bank of Japan and Reserve Bank of Australia are currently running such policies. Although the FOMC hasn't taken this step yet, it is being considered by Fed policymakers. The conclusion—monetary policy will likely remain historically accommodative well into 2021.

Data Section

U.S. Equity Markets – (as of 6/30/2020 close)

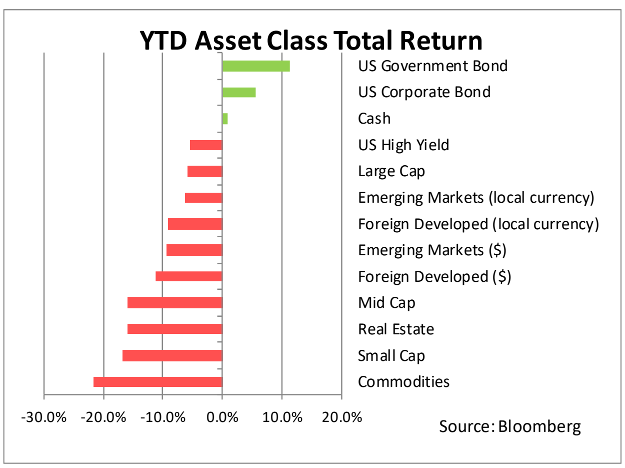




(Source: Bloomberg)

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 6/30/2020 close)

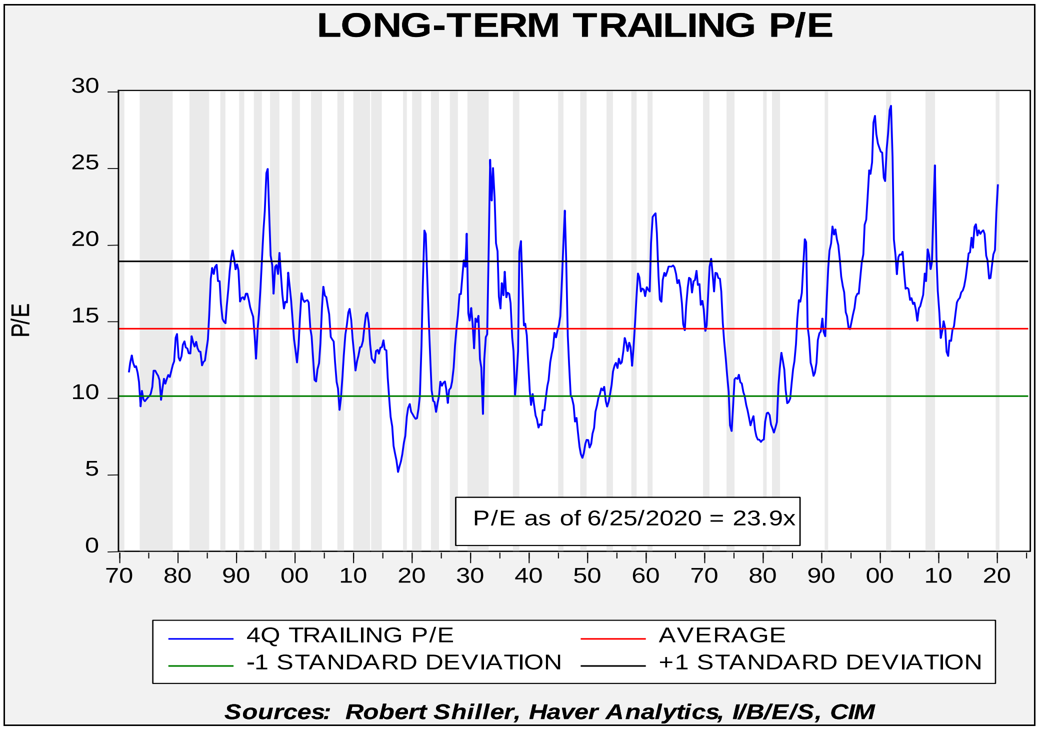


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

June 25, 2020



Based on our methodology,[2] the current P/E is 23.9x, up 0.1x from last week. Rising index values for Q2 caused the rise in 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.

[2] 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 (Q3, Q4 and Q1) and one estimate (Q2). 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.