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 22, 2020—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.8% from its last close. In Asia, the MSCI Asia Apex 50 closed down 1.4% from its prior close. Chinese markets were higher, with the Shanghai Composite up 0.4% from the prior close and the Shenzhen Composite up 0.8%. U.S. equity index futures are signaling a lower open. With 58 companies having reported, the S&P 500 Q2 earnings stand at $23.30, lower than the $23.72 forecast for the quarter. The forecast reflects a 43.8% decrease from Q2 2019 earnings. Thus far this quarter, 81.0% of the companies have reported earnings above forecast, while 19.0% have reported earnings below forecast.

A new *Confluence of Ideas* podcast episode is available, titled "The 2020 Election: Part 3." This is the final episode looking at the 2020 election. In this episode, we handicap the election based on the tools of prediction, polling and decision markets. We examine the geopolitics of the election, focusing on what countries are likely to intervene in our election, their capabilities and their goals. We also touch on what we expect to see in terms of policy if we get a new president or if the incumbent wins, and likely market reaction in either scenario.

Global financial markets are facing some headwinds today from new U.S.-China tensions and signs that the negotiations over the next U.S. coronavirus relief bill may be tougher than previously expected. We review all the key news below.

United States-China: Following the Justice Department's indictment yesterday of two Chinese hackers for attempting to steal sensitive information from U.S. firms (see below), the State Department said it has ordered the Chinese government to close its consulate in Houston within 72 hours "to protect American intellectual property and Americans' private information." The Chinese government said it would retaliate if the move isn't reversed. It also complained that the U.S. has been opening its confidential diplomatic pouches in recent months, and in a sign that it fears more intrusive moves by the U.S., media reports from Houston this morning said firefighters were called to the consulate after neighbors noticed people burning paper in trashcans within the consulate courtyard—evidence of emergency document destruction to protect secret information. The U.S. order to close the consulate represents a further escalation of tensions on top of the two countries' trade war, disagreements over technology, and concerns about China's aggressive geopolitical maneuvering. As Western countries wake up to the challenge of a rising China, they are adopting more and more measures to counter and contain it. Moves like the closure of the Chinese consulate in Houston provide evidence that those measures continue to be taken, and even more are likely in the pipeline as President Trump seeks to bolster his anti-China credentials for the November election and many foreign governments show signs of coalescing into a coordinated, allied approach to China. Further efforts to isolate China could be disruptive economically and geopolitically, so the U.S. move today has taken wind out of risk markets and pushed down the renminbi.

Chinese hackers: As mentioned above, the Department of Justice yesterday unsealed indictments against two Chinese hackers for trying to steal sensitive information worth hundreds of millions of dollars from U.S. defense contractors, research institutions, and healthcare companies, including at least two working on coronavirus vaccines and testing. The hackers, who sometimes worked privately but at other times worked under the direction of the Chinese Ministry of State Security, are evidently still in China and therefore out of the reach of U.S. law enforcement. Nevertheless, the indictment is likely a way to put pressure on China for its cyber warfare against the U.S. and to encourage U.S. firms to boost their cyber defenses.

COVID-19: Official data show confirmed cases have risen to 14,976,453 worldwide, with 617,297 deaths and 8,499,299 recoveries. In the United States, confirmed cases rose to 3,902,377, with 142,080 deaths and 1,182,018 recoveries. Here is the interactive chart from the *Financial Times* that allows you to compare cases and deaths among countries, scaled by population.

Virology

- As President Trump resumed coronavirus briefings at the White House yesterday, he warned the crisis will "get worse before it gets better." However, when questioned whether he would be held responsible for any worsening, he reverted back to his previous position that the virus will simply "disappear." He also encouraged people to wear facemasks to combat the disease, though he didn't wear one himself.
- Meanwhile, even as the rate of newly identified infections appears to be stabilizing at a high level in the U.S., the rate of daily coronavirus deaths is now on a clear uptrend as experts have long predicted would happen. Over 1,000 coronavirus deaths were recorded in the U.S. yesterday.
- The U.S. government has signed a commitment to spend $1.95 billion for 100 million doses of a potential vaccine being developed by Germany's BioNTech (BNTX, 91.60) and U.S. pharmaceutical giant Pfizer (PFE, 36.69). The deal also includes an option to purchase a further 500 million doses, if needed. Once the vaccine receives regulatory approval and enters into mass production, the doses would be distributed free of charge to American citizens.
- Japanese Economy Minister Yasutoshi Nishimura said the government will postpone relaxing attendance limits for major events until end of August in a bid to help curb the country's recent rebound in coronavirus infections. Separately, reports today indicate Osaka has become the first prefecture outside of Tokyo to report more than 100 new infections in a single day.

Foreign Policy Response

- New details on the €750 billion coronavirus relief program agreed upon by the EU yesterday provide some indication of how the funds will be allocated among the member countries. Since the funds will be disbursed to countries based on the damage they've suffered from the crisis, the allotted amounts will be a more significant share of GDP for the relatively smaller, harder-hit southern countries like Spain and Italy. Preliminary figures suggest those two countries would each receive almost 20% of the funds, while France would receive around 10% and Poland would receive about 8%.

  - If the final allotment is anything close to the preliminary figures, the funding for Spain and Italy would equal around 10% of their GDP in 2019. That could be a significant boost to those economies, although it's important to remember that the funding would be spread over three years.
  - For most of the other EU countries, the allotments would amount to a much less significant share of economic activity.

- As we've mentioned before, a key innovation in the new EU coronavirus relief program is the issuance of common EU bonds to finance it. Those bonds will be backed by the full faith and credit of the EU, rather than just individual countries. For a useful primer on these upcoming bonds, click here.
- Despite the EU leaders' approval of the coronavirus program, it's becoming clear that at least one major political fault line remains. Some officials, led by European Commission President Ursula von der Leyen, insist that EU budget funding for countries will depend on their adherence to the EU's rule-of-law standards, which would punish countries like Poland and Hungary. Other officials insist Brussels has backed down from those demands.

U.S. Policy Response

- President Trump's desire for a payroll tax cut is turning into a sticking point as the administration and congressional leaders work to hash out the next coronavirus relief bill. While the tax cut would help encourage hiring, many economists and lawmakers see it as inefficient because it would primarily benefit those who haven't lost their jobs during the crisis.
- Separately, a Senate Republican proposal for the next coronavirus bill will reportedly include $70 billion for K-12 schools, with half that amount reserved for schools that reopen fully for in-person instruction.

United States: The Senate Banking Committee yesterday approved President Trump's latest nominees to the Federal Reserve's Board of Governors and sent their nominations to the full Senate for a final confirmation vote. The vote was 18-7 for Christopher Waller, a mainstream economist and current director of research at the St. Louis Fed. It was a much closer 13-12 vote for Judy Shelton, an unorthodox gold bug with a reputation for more politicized policy positions. Shelton's nomination has generated pushback from multiple observers, but it is important to remember that as only one of seven Fed governors, her influence on Fed policy would be limited. For example, emergency lending programs of the sort implemented during the coronavirus pandemic require the votes of at least five Fed governors, so Shelton alone couldn't sway Fed policy into new directions unless two current governors depart.

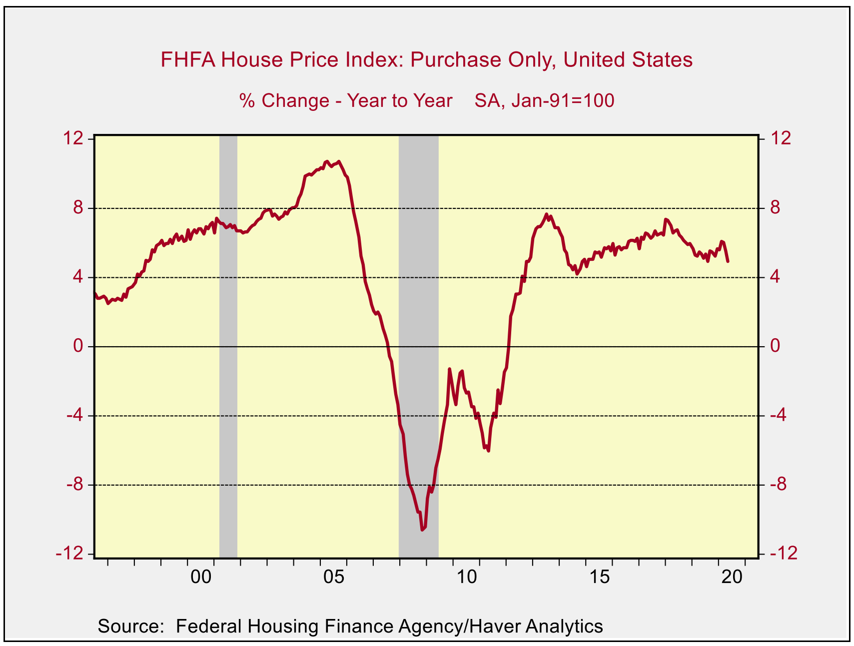
United States-United Kingdom: Senior British officials have reportedly given up on their goal of reaching a comprehensive post-Brexit trade deal with the U.S. this summer. On top of the delays arising from the coronavirus crisis, the two sides are still struggling to deal with contentious issues such as the amount of U.S. agricultural products to be allowed into Britain. Perhaps more importantly, British officials see little hope of significant compromise on those issues ahead of the U.S. presidential election in November.

Russia: President Putin's bid to snuff out protests in the far eastern region of Khabarovsk by naming an opposition politician as governor appears to be falling short. Hundreds of protestors continue to demonstrate today, marking the 11th straight day of unrest.

U.S. Economic Releases

For the week ending July 17, MBA mortgage applications rose 4.1% from the prior week. Applications for purchases and refinancing rose 1.8% and 5.3% from the prior week, respectively. The average 30-year fixed rate rose by 1 bp from 3.19% to 3.20%.

U.S. home prices fell unexpectedly in May, according to the Federal Housing Finance Agency (FHFA). Home prices fell 0.3% from the prior month, well below expectations of a 0.3% rise. The prior month's report was revised from 0.2% to 0.1%. The decline in home prices was broadly felt throughout the country, with the South Atlantic region being the only exception.



Despite the drop in May, home prices are still higher than they were a year ago. In May, home prices rose 4.88% from the prior year.

The table below lists the other economic releases scheduled for today.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Existing Home Sales	m/m	Jun	4.75m	3.91m	**
10:00	Existing Home Sales	m/m	Jun	21.5%	-9.7%	**

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								
Japan	Jibun Bank Japan PMI Mfg	m/m	Jul	42.6	40.1		**	Equity bullish, bond bearish
	Jibun Bank Japan PMI Services	m/m	Jul	45.2	45.0		**	Equity bullish, bond bearish
	Jibun Bank Japan PMI Composite	m/m	Jul	43.9	40.8		**	Equity bullish, bond bearish
	Supermarket Sales	y/y	Jun	3.4%	1.3%		**	Equity bullish, bond bearish
Australia	Westpac Leading Index	m/m	Jun	0.4%	0.2%		**	Equity bullish, bond bearish
AMERICAS								
Mexico	International Reserves Weekly	w/w	17-Jul	$191.468b	$191.122b		**	Equity and bond neutral
Canada	Retail Sales	m/m	May	18.7%	-26.4%	20.0%	**	Equity and bond neutral
	Retail Sales ex Auto	m/m	May	10.6%	-22.0%	11.9%	**	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)	26	27	-1	Down
3-mo T-bill yield (bps)	11	11	0	Neutral
TED spread (bps)	15	16	-1	Up
U.S. Libor/OIS spread (bps)	8	8	0	Up
10-yr T-note (%)	0.59	0.60	-0.01	Neutral
Euribor/OIS spread (bps)	-45	-44	-1	Neutral
EUR/USD 3-mo swap (bps)	7	8	-1	Down
Currencies	**Direction**			
dollar	Down			Down
euro	Up			Up
yen	Flat			Up
pound	Down			Down
franc	Flat			Up

Commodity Markets

The commodity section below shows some of the commodity prices and their change from the prior trading day, with commentary on the cause of the change highlighted in the last column.

	Price	Prior	Change	Explanation
Energy Markets				
Brent	$43.79	$44.32	-1.20%	Bearish API report
WTI	$41.33	$41.92	-1.41%	
Natural Gas	$1.64	$1.68	-2.03%	
Crack Spread	$11.38	$12.06	-5.61%	
12-mo strip crack	$10.99	$11.04	-0.46%	
Ethanol rack	$1.48	$1.48	-0.38%	
Metals				
Gold	$1,858.57	$1,841.91	0.90%	
Silver	$21.96	$21.30	3.08%	
Copper contract	$293.40	$295.80	-0.81%	
Grains				
Corn contract	$ 332.00	$ 330.75	0.38%	
Wheat contract	$ 528.50	$ 527.75	0.14%	
Soybeans contract	$ 890.50	$ 893.00	-0.28%	
Shipping				
Baltic Dry Freight	1594	1678	-84	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-0.8		
Gasoline (mb)		-1.5		
Distillates (mb)		0.8		
Refinery run rates (%)		0.50%		
Natural gas (bcf)		36.0		

Weather

The 6-10 and 8-14 day forecasts currently call for warmer temperatures across the country. Wet conditions are expected throughout the South and Midwest regions. There is some cyclone formation in the Gulf of Mexico, but it is not expected to develop into a tropical storm.

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.

July 17, 2020

One of the burning issues about the current path of policy is its inflationary impact. In other words, will the massive increase in fiscal spending and the Fed's balance sheet lead to higher price levels? To discuss this issue, we return to the equation of exchange:

$$\mathbf{M \times V = P \times Q}$$

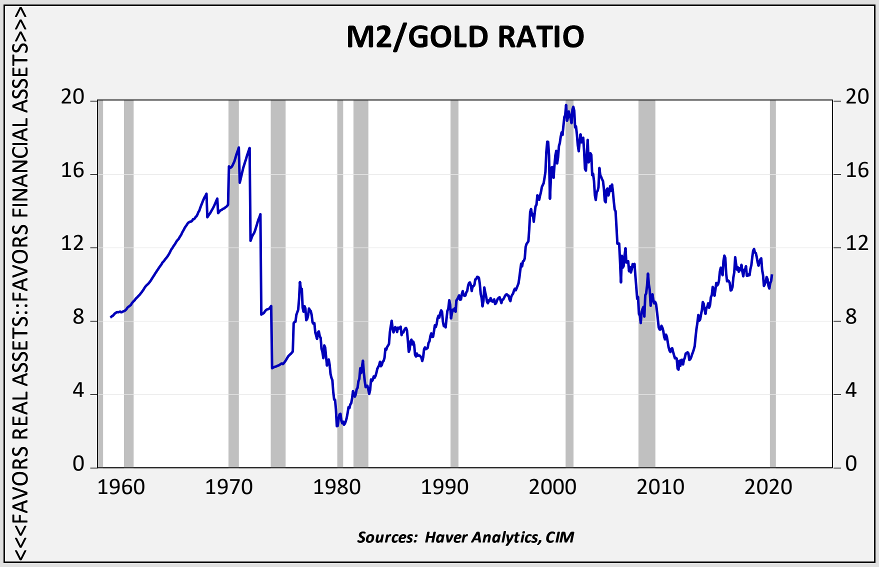
The money supply times velocity is equal to the price level times goods and services produced. This equation is an identity; simply put, it will always be true. But, the direction of causality of the variables comes from theory. Classical economists and their philosophic progeny, monetarists, argued that V and Q were fixed, so changes in price levels were due to changes in money supply. Keynesians and their most recent variation, modern monetary theorists, argue that Q can be below its capacity and V is variable, so increases in M may not necessarily lead to higher price levels but could result in a decline in V or a rise in Q. Essentially, the Keynesians and their modern versions argue that if Q is below capacity, increasing M can boost the economy without triggering inflation.

The problem with both of the major theories is that there is a psychological element to the equation that tends to be downplayed. The problem for the Classical construct is that even at full employment (Q) rising M might simply lead to falling V. Complacency about future inflation or fears about the future growth path of the economy might lead households and businesses to simply hold larger cash balances. Confounding the Keynesians is the potential outcome where P rises even with Q below capacity when M is increased if economic actors fear future inflation. In fact, higher price levels can result even without a rise in M if V rises. The most extreme case of this condition is hyperinflation, where V rises rapidly as households and businesses rush to convert cash to real goods that will hold their value.

Therefore, determining if there is an inflation problem from current policy is tricky because there is a psychological element that is difficult to estimate. It is easy to measure money supply, output or price levels, but the psychology of velocity is hard to measure and potentially prone to sudden shifts.

Reframing the question can simplify this problem. If a household receives a notable sum of money, let's say, $10,000, what does it do with it? If the householder fears future price increases, it would make sense to use that money to buy inventory. In other words, they may take part of it to buy food, perhaps consumer durables, art, gold, or other items that might hold their value. On the other hand, if there is little fear of future inflation, the household may be content to simply hold the cash as savings or place it in other financial assets.

One way to answer this question is to compare the money supply to gold prices. If some money supply, say, M^2, rises faster than gold, it would suggest that economic actors are not afraid of future inflation. A rising ratio of M^2/gold would be a positive signal for financial assets; on the other hand, a falling ratio would likely be bearish. Now, it is possible that a contracting money supply could distort the measure. The monthly change in M^2 since 1959 has only been negative 4.4% of the time. Over that same time frame, it has never been negative on a yearly change basis.

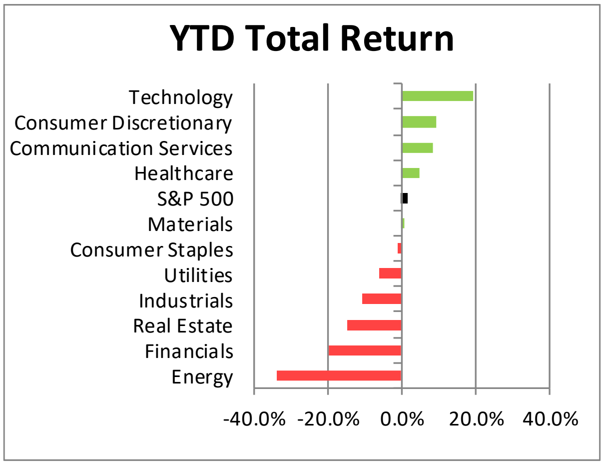


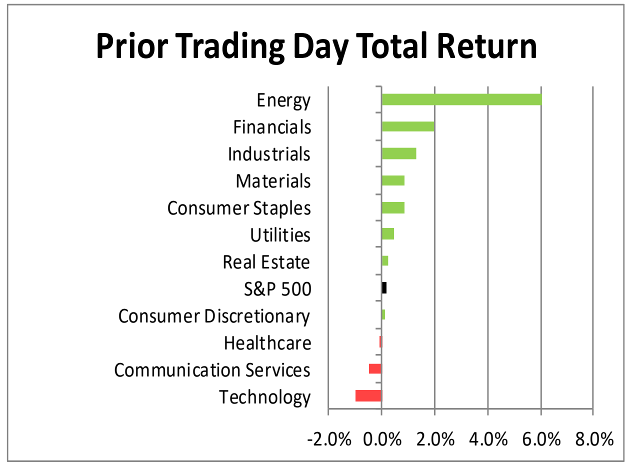
Anyone familiar with financial market history can note that equity markets tend to outperform when this ratio rises, but equities tend to suffer when the ratio declines. The ratio captures that when the supply of money is rising relative to gold (the proxy for real assets), economic actors tend to put this excess liquidity into financial assets. A declining ratio suggests a preference for real assets.

In general, the ratio has been mostly steady for the past four years. Despite a rally in gold, the ratio hasn't declined. Put another way, we haven't seen households and firms show significant inflation fears despite a massive increase in liquidity. Gold prices have been mostly rising with M^2 but not accelerating faster than the money supply. And so, in a portfolio, gold has been acting as a diversification asset without unduly hampering performance. As the Fed has boosted liquidity, funds have been going into both stocks and gold at a pace where neither has signaled a particular bias. If inflation fears escalate, we would expect this ratio to decline and equity markets to show signs of weakness. But, for now, easy monetary policy is supportive for both gold and equities.

Data Section

U.S. Equity Markets – (as of 7/21/2020 close)

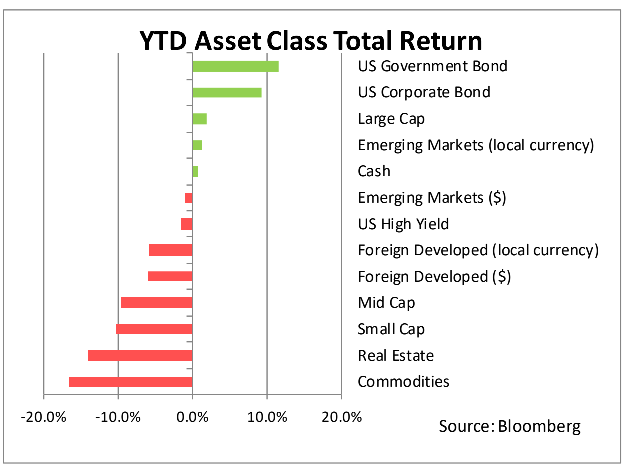




(Source: Bloomberg)

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 7/21/2020 close)

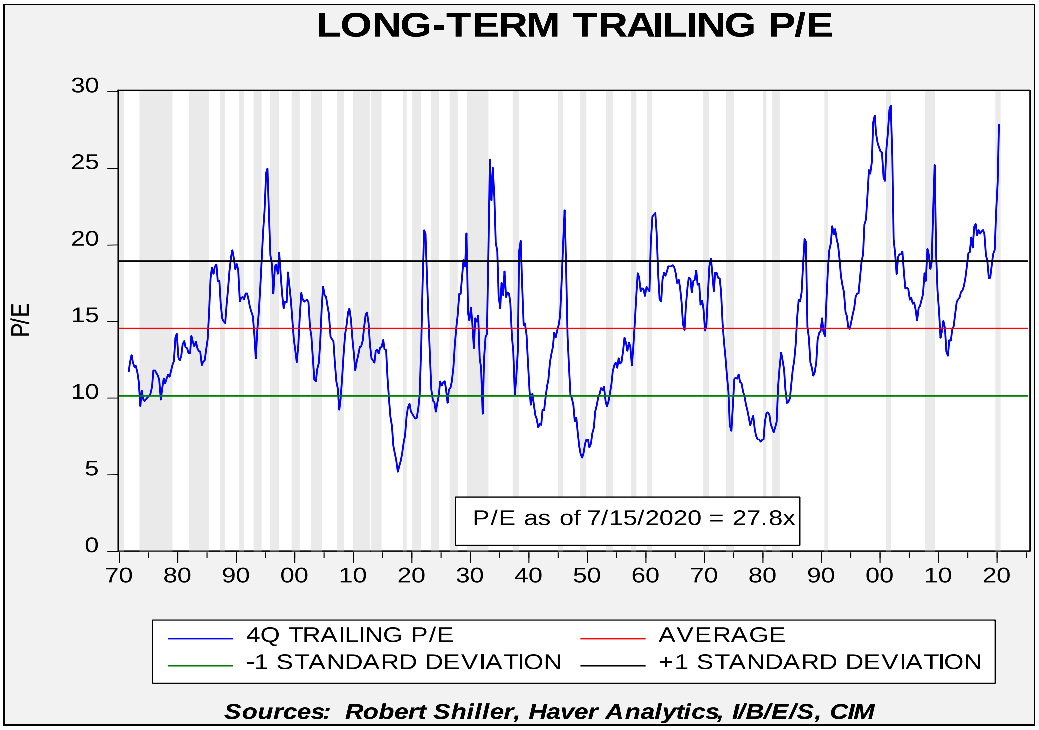


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

July 16, 2020



Based on our methodology,[1] the current P/E is 27.5x, up 0.1x from last week. The rise in the multiple is due to the continued lift in the index.

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.

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