# 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 27, 2020—9:30 AM EDT]** Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.1% from its last close. In Asia, the MSCI Asia Apex 50 closed up 1.2% from its prior close. Chinese markets were higher, with the Shanghai Composite up 0.3% from the prior close and the Shenzhen Composite up 0.3%. U.S. equity index futures are signaling a higher open. With 128 companies having reported, the S&P 500 Q2 earnings stand at $24.00, higher than the $23.72 forecast for the quarter. The forecast reflects a 43.8% decrease from Q2 2019 earnings. Thus far this quarter, 82.0% of the companies have reported earnings above forecast, while 16.4% have reported earnings below forecast.

Happy Monday! Baseball is back, and the NHL and NBA are close as well. Our friends on the Texas coast had to cope with Hurricane Hanna over the weekend. Equity markets are moving higher, the dollar is softening and the bull trend in gold is starting to accelerate. This is one of the busiest weeks for Q2 earnings. We lead with policy news, followed by the pandemic update. Let's get to it:

**Policy news:**

- The GOP will unveil its stimulus plan today, but internal dissention is running high. It isn't clear the Senate could pass this bill with GOP votes alone, even though the party is in the majority. The White House wanted a payroll tax cut, but it doesn't look like that provision made it. There is a debate over the $600 per week extra unemployment benefit. There is no doubt that some workers are staying home because unemployment insurance pays about the same or better than any job available. However, the problem with drastically reducing this benefit is that for those workers without any job available, the proposed reduction to 75% of their previous wage will lead to a drop in spending.
    - The last JOLTS report suggests that the inability to attract workers may not be as big of an impediment as the anecdotal evidence would suggest. In May, hires outpaced openings, 6.487 million to 5.397 million. What is probably happening is that lower paid jobs in the service industries are struggling to get their workers back under current unemployment insurance provisions. But, if you cut the insurance payments, not every laid-off worker may be able to find a job (openings were running 7.0 million prior to the pandemic).
    - The mere threat to reduce the $600 per week supplement could lead lower paid households to try to save as much as possible before the aid is restricted. If the goal of the extra cash is to support spending, this precautionary saving works against that aim.

- We suspect the financial markets are looking through the current political morass and expecting the Democrats to dictate terms, meaning we will likely see a total package of $1.5 trillion to $2.0 trillion.
- Congress isn't the only body dealing with stimulus policy. The Fed meets this week and is trying to chart a path forward. We don't expect any new measures to be announced but the internal debate will be important. Namely, the Fed will try to figure out how to explain any changes to its reaction function; in English, that's how long will the Fed wait to react to higher price levels. Since Volcker, the policy has been to react pre-emptively to potential inflation. That policy was designed for a period of elevated inflation expectations. That period is probably behind us, so allowing inflation to overshoot becomes stimulative. Exactly how to do that remains uncertain.
    - It appears the *WSJ* has realized that the recent decline in the Fed's balance sheet was not a sign that the central bank was withdrawing support. This is the topic of this week's Asset Allocation Weekly (AAW).
- But wait…there's more. Tech leaders are visiting Capitol Hill on Wednesday to testify before the House Antitrust Committee. We don't expect much more than posturing at this meeting, but if there is a threat to big tech, antitrust is perhaps the most potent. Since the mid-1980s, the operating theory of antitrust has been that if consumers are not harmed, size or market control alone should not trigger regulatory action. The tech firms have taken this legal theory to heart and have become behemoths, sometimes through mergers, other times through predatory behavior. Nevertheless, it is clear that consumers have faced little harm. So, who has paid the cost of their behavior? Labor, from Steve Jobs's plan to avoid "poaching" other tech workers (a clear plan to suppress wages) to tales of harsh working conditions at some tech companies. A new antitrust era is likely coming, but it won't necessarily be bad for shareholders (although such reports will become more common as the situation evolves). The breakup of Standard Oil proved to be a huge benefit for shareholders as the value of the company in parts was greater than as a whole. However, it is possible that the fear of regulation could adversely affect the tech giants and, given their dominance in the indexes, a negative impact is possible.
- Finally, although it isn't happening here yet, the U.K. is already starting to discuss what to do with the bad debt that will come from loan programs to support companies in the pandemic. Some of the companies that have been supported will fail; how the bad debt is handled will be interesting to watch. Will the bad debt remain on bank balance sheets? Will a "bad bank," such as the Resolution Trust Corporation, be created? Will the government simply socialize the debt? Stay tuned.

**COVID-19:** The number of reported cases is 16,264,048 with 648,966 deaths and 9,407,977 recoveries. In the U.S., there are 4,234,140 confirmed cases with 146,935 deaths and 1,297,863 recoveries. For those who like to keep score at home, the *FT* has created an interactive chart that allows one to compare cases across nations using similar scaling metrics.

*Virology:*

- North Korea has instituted an aggressive lockdown at the border city of Kaesong after a COVID-19 infection was reported. This would be the country's first confirmed case. A former defector apparently decided to return to North Korea; Pyongyang has indicated that the person was infected, but South Korean officials, who have a strong contact tracing regime in place, indicate that he was not carrying the virus. It isn't clear if South Korea is wrong on the infection status, or whether North Korea, which probably does have cases, is using this as a way to reveal it has infections and thus blame Seoul for the outbreak.

- New cases are springing up in areas that had previously brought the virus under control. The rise in new cases is disappointing, suggesting that it was lockdowns, and not herd immunity, that was keeping caseloads low.
- The vaccine news is a mixed bag:
  - There are numerous areas in the U.S. where the virus is spreading rapidly. Paradoxically, that could accelerate vaccine trials, which need a large population to test and to be surrounded with infections to determine potency. If a vaccine is tested in an area with few infections, it is more difficult to know if the vaccine is effective.
  - Given the huge number of vaccines being tested, it seems likely that one of them will prove to work. However, as we have noted earlier, one of the great unknowns is how long the immunity will last. Sadly, that may simply be an "empirical question," where we will need to see if those who have been vaccinated become ill six months to a year later. The key to longer-term immunity will be the T and B cells.
  - History tells us that getting a vaccine is an important step but doesn't fully end the crisis. Until it is widely distributed and time passes, we won't know for sure how long the immunity lasts. Anti-vaccine resistance is strong and will slow the development of herd immunity. The government will need to determine the order of distribution; if they get it wrong, it could reduce the effectiveness of the campaign. However, it is worth noting that markets tend to discount the future and will likely look past these problems, which could lead to a further disconnect between the economy and financial markets.

**Foreign news:**

- Brexit concerns continue, although we still do see an arrangement coming. And, the Johnson government has admitted that its plan to get a quick trade deal with the U.S., ostensibly to pressure the EU to make an agreement, is not going to happen.
- Widespread protests continue in eastern Russia. Ukraine and Russia have confirmed a ceasefire in the Donbass region.

**Market and Economy news:**

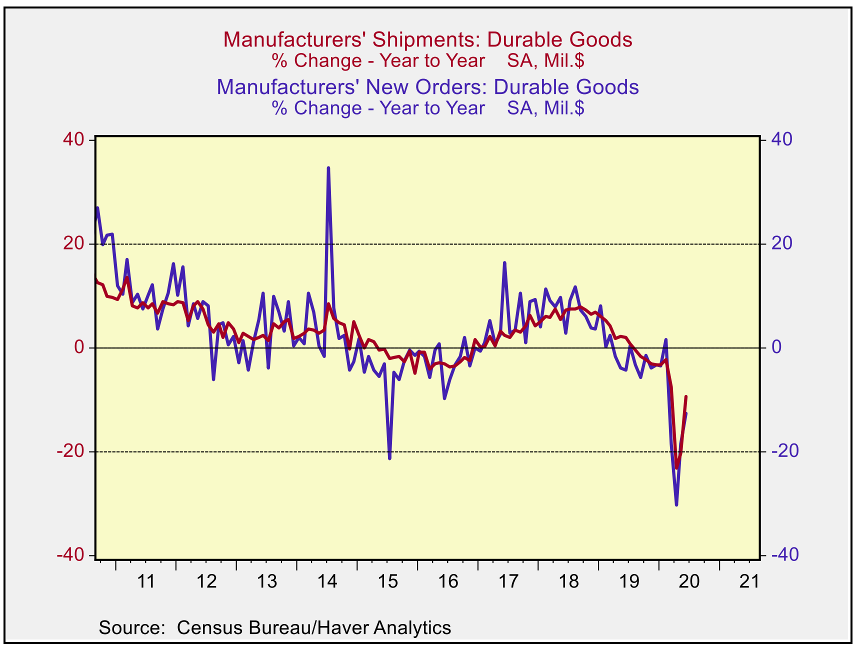
- Economic recovery in Europe is starting to outpace the U.S. This may be due, in part, to the fact that most European nations have gotten a better handle on the pandemic. We are seeing broad dollar weakness, and stronger growth abroad will add to that factor.
- Gold prices have been strong recently. The combination of low nominal interest rates, general unrest and now a weaker dollar is all conspiring to send gold prices to new highs.

**China news:**

- [Shandong Gold Mining (CNY 43.98) is making a bid to purchase TMAC Resources](), (CAD 1.48), a Canadian gold mining corporation in the Arctic. The Chinese company is one of the largest in China and is considered a state-owned enterprise (SOE). The Canadian government is considering blocking the merger.
- [Apple (APPL, 370.46) is building the iPhone 11 in India]().

**U.S. Economic Releases**

U.S durable goods orders rose modestly last month. In June, durable goods orders rose 7.3% from the previous month, above expectations of a 7.0% rise. The prior report's gain was revised downward from 15.7% to 15.1%. Excluding transportation, durable goods orders rose 3.3% from the prior month, below expectations of a 3.6% rise. The prior report's gain was revised downward from 3.7% to 3.6%. Nondefense capital goods orders excluding air rose 3.3% from the prior month, above expectations of 2.2%. Lastly, nondefense capital goods shipments excluding air rose 3.4% from the prior month, above expectations of 2.4%.




The chart above shows the annual change in durable goods orders and shipments. Although orders and shipments have picked up over the past few months, orders are still below their levels in the previous year. Durable goods orders and shipments fell 12.7% and 9.5% from the prior year, respectively.

The table below lists the economic releases scheduled for today.

| Economic Releases | | | | | | |
|---|---|---|---|---|---|---|
| EDT | Indicator | | | Expected | Prior | Rating |
| 9:30 | Dallas Fed Manf. Activity | m/m | Jul | -4.9 | -6.1 | ** |
| 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.

| Country | Indicator | | | Current | Prior | Expected | Rating | Market Impact |
|---|---|---|---|---|---|---|---|---|
| ASIA-PACIFIC | | | | | | | | |
| China | Industrial Profits | y/y | Jun | 11.5% | 6.0% | | ** | Equity and bond neutral |
| Europe | | | | | | | | |
| Eurozone | M3 Money Supply | y/y | Jun | 9.2% | 8.9% | 9.3% | * | Equity and bond neutral |
| Germany | IFO Business Climate | m/m | Jul | 90.5 | 86.2 | 89.3 | ** | Equity and bond neutral |
| | IFO Expectations | m/m | Jul | 97.0 | 91.4 | 93.4 | ** | Equity bullish, bond bearish |
| | IFO Current Assessment | m/m | Jul | 84.5 | 81.3 | 85.0 | ** | Equity bullish, bond bearish |
| France | Total Jobseekers | m/m | 2Q | 4149.3k | 3333.8k | | ** | Equity bullish, bond bearish |
| Switzerland | Domestic Sight Deposits | w/w | 24-Jul | 622.5b | 618.5b | | ** | Equity and bond neutral |
| | Total Sight Deposits | w/w | 24-Jul | 692.6b | 691.5b | | ** | Equity and bond neutral |
| AMERICAS | | | | | | | | |
| Brazil | IBGE Inflation IPCA | y/y | Jul | 2.13% | 1.92% | 2.36% | *** | Equity bullish, bond bearish |
| Mexico | Trade Balance | m/m | Jun | 5.547b | -3.523b | 1.547b | ** | Equity bullish, bond bearish |

## Financial Markets

The table below highlights some of the indicators that we follow on a daily basis. Again, the color coding is similar to the foreign news description above. We will add a paragraph below if a certain move merits further explanation.

| | Today | Prior | Change | Trend |
|---|---|---|---|---|
| 3-mo Libor yield (bps) | 25 | 24 | 1 | Down |
| 3-mo T-bill yield (bps) | 9 | 11 | -2 | Neutral |
| TED spread (bps) | 16 | 14 | 2 | Up |
| U.S. Libor/OIS spread (bps) | 7 | 7 | 0 | Up |
| 10-yr T-note (%) | 0.57 | 0.59 | -0.02 | Neutral |
| Euribor/OIS spread (bps) | -45 | -45 | 0 | Neutral |
| EUR/USD 3-mo swap (bps) | 7 | 8 | -1 | Down |
| Currencies | Direction | | | |
| dollar | Down | | | Down |
| euro | Up | | | Up |
| yen | Up | | | Up |
| pound | Up | | | Down |
| franc | Up | | | Up |

## Commodity Markets

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

| | Price | Prior | Change | Explanation |
|---|---|---|---|---|
| **Energy Markets** | | | | |
| Brent | $43.20 | $43.34 | -0.32% | |
| WTI | $41.18 | $41.29 | -0.27% | |
| Natural Gas | $1.77 | $1.81 | -2.38% | |
| Crack Spread | $11.12 | $11.64 | -4.51% | |
| 12-mo strip crack | $10.63 | $11.00 | -3.35% | |
| Ethanol rack | $1.49 | $1.50 | -0.23% | |
| **Metals** | | | | |
| Gold | $1,938.77 | $1,902.02 | 1.93% | |
| Silver | $24.09 | $22.77 | 5.80% | |
| Copper contract | $289.45 | $289.25 | 0.07% | |
| **Grains** | | | | |
| Corn contract | $ 335.75 | $ 335.00 | 0.22% | |
| Wheat contract | $ 533.75 | $ 539.50 | -1.07% | |
| Soybeans contract | $ 900.50 | $ 899.25 | 0.14% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 1317 | 1388 | -71 | |

## Weather

The 6-10 and 8-14 day forecasts currently call for warmer temperatures for most of the country, with cooler temps in the Midwest. Wet conditions are expected throughout the South and Midwest regions. Tropical Storm Hanna was downgraded to a Tropical Depression.

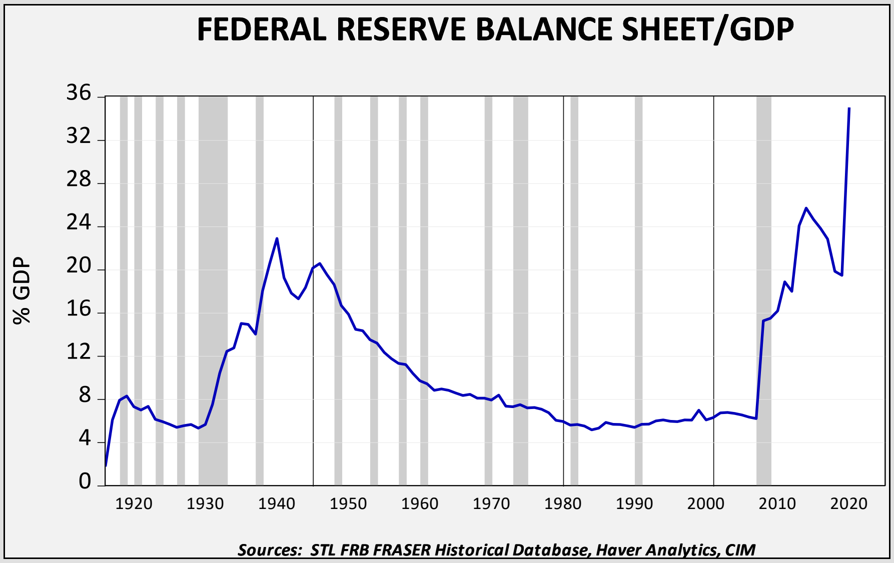
## Asset Allocation Weekly

*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 24, 2020

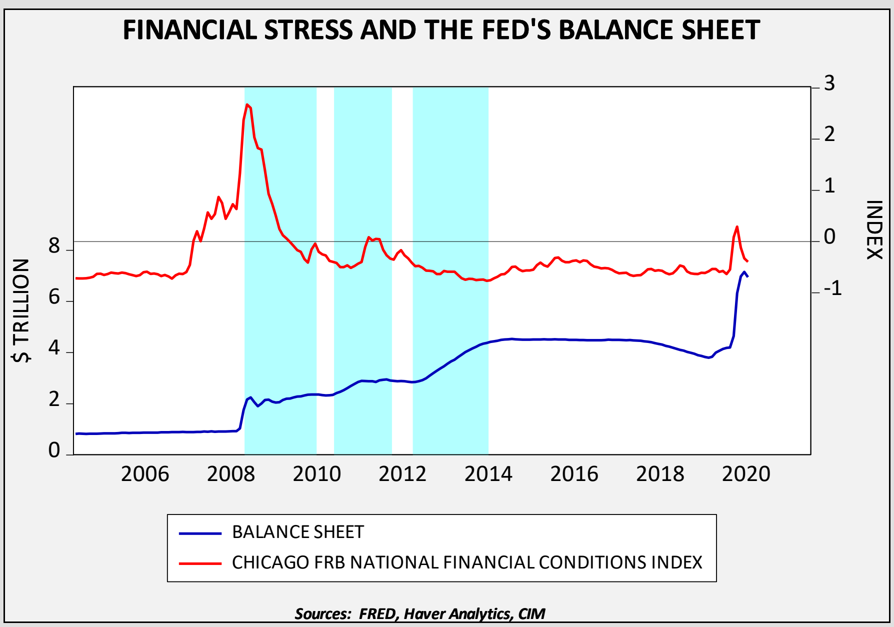
In the Federal Reserve's 107-year history, it has used a number of different methods to manage monetary policy. In its early years, it relied on the discount rate and reserve requirement adjustments as policy tools. During WWII, it managed the yield curve to a specific interest rate to support Treasury borrowing to fund the war effort. In the early 1950s, monetary policy became independent of government borrowing. From this period into the late 1970s, the Fed managed monetary policy by setting a target rate for fed funds. Chair Volcker moved to target the money supply in a bid to bring down inflation; monetary targeting ended by 1987. From 1987 until 2008, the primary tool of monetary policy was the fed funds policy rate. If the banking system was oversupplied with reserves, the fed funds rate would decline below target. The Fed would engage in open market operations to reduce the level of reserves to lift the effective fed funds rate. Under conditions of an undersupplied market, banks would be bidding up rates to acquire reserves; the Fed would inject money into the banking system to prevent the effective fed funds rate from overshooting the target rate. During the Great Financial Crisis, the U.S. central bank flooded the banking system with reserves to ensure ample liquidity; this action led to a massive level of bank reserves rendering the traditional fed funds rate management impossible. The level of reserves would have anchored the fed funds rate at zero. To allow for rate flexibility, the Fed began paying interest on reserves.

In March, when the pandemic triggered financial stress, the FOMC responded quickly. Not only were rates cut but the Fed announced a series of actions designed to provide liquidity to various parts of the financial system. In an unprecedented step, the central bank bought corporate bonds, including some that were below investment grade. It purchased municipal bonds. It also offered broad support for money markets and commercial paper. And, it increased and broadened swap lines with foreign central banks to provide global dollar liquidity. All these actions led to a massive rise in the Fed's balance sheet.




This chart shows the Federal Reserve's balance sheet relative to nominal GDP. Note that the current level of the balance sheet is at all-time highs.

Recently, the Fed's balance sheet has contracted; this change has raised concerns that the central bank may be withdrawing stimulus which would be bearish for the economy and financial markets.



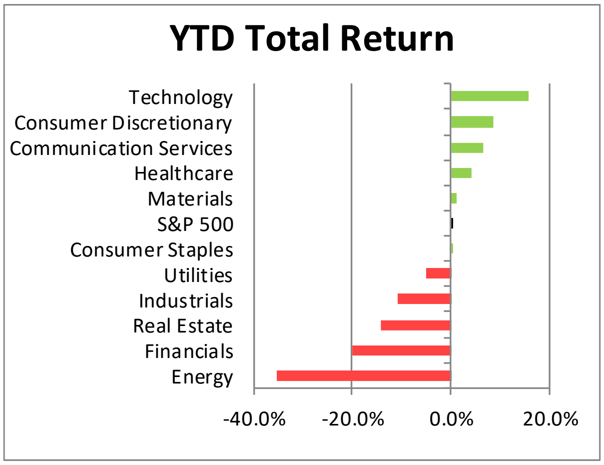

This fear is misplaced, but understandable. This chart shows the balance sheet along with the Chicago FRB's National Financial Conditions Index. A rising index number indicates increasing financial system stress. We have shaded three periods of quantitative easing. It is notable that the first two cycles had specific levels of asset purchases. In other words, a given level of buying and a definitive end date was established. The third cycle was more open ended in time but initially fixed in terms of purchases.

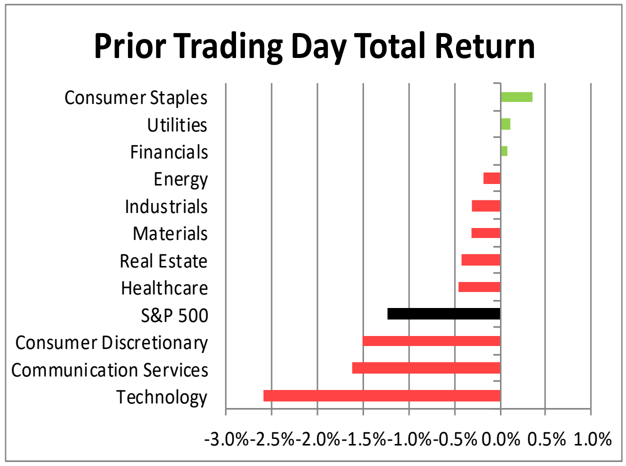
The recent rise in the balance sheet is less about supporting the economy and more about suppressing financial stress. And so, as the level of stress has declined, the demand for Fed support has as well, leading to a decline in the balance sheet. This isn't due to the Fed withdrawing support; it is, in fact, evidence of the Fed's success. It should be noted, however, that the facilities remain in place. If stress rises, the Fed has policies in place to suppress it.

The central bank's next step will likely be to add accommodation. In other words, additional actions will likely be necessary to encourage economic recovery. Potential policies might entail yield curve control, "QE for people," or direct payment from the Fed to households. The important point is that one should not mistake the recent decline in the balance sheet as a sign of tightening.

## Data Section

**U.S. Equity Markets** – (as of 7/24/2020 close)

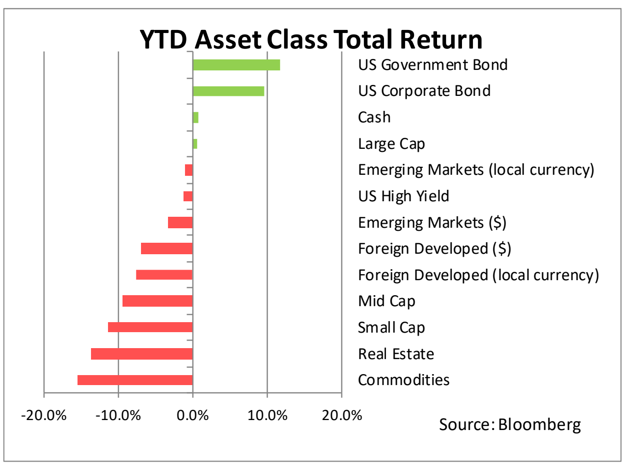



(Source: Bloomberg)

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 7/24/2020 close)

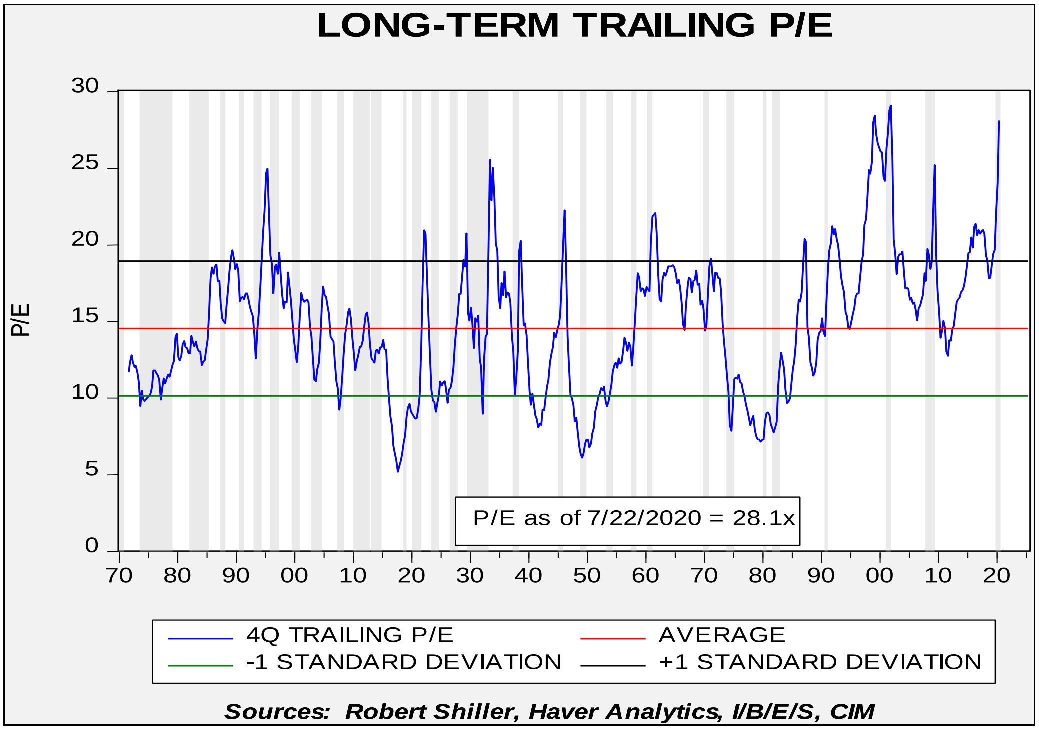



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 23, 2020




Based on our methodology,[1] the current P/E is 28.1x, up 0.6x from last week. The rise in the multiple is due to the continued lift in the index and steady earnings forecasts.

*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 (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.