# 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 6, 2020—9:30 AM EDT]** Global equity markets are higher this morning. The EuroStoxx 50 is up 1.9% from its last close. In Asia, the MSCI Asia Apex 50 closed up 1.7% from its prior close. Chinese markets were higher, with the Shanghai Composite up 5.7% from the prior close and the Shenzhen Composite up 3.9%. U.S. equity index futures are signaling a higher open.

Good morning, and happy Monday! U.S. equity futures and global equity markets are moving higher this morning led by China after comments in the state media suggested it's good to buy stocks. We update the pandemic news. China has several news items of note. Overseas, we have a new PM in France and elections in Croatia. Here are the details:

**COVID-19:** The number of reported cases is 11,470,637 with 534,784 deaths and 6,193,538 recoveries. In the U.S., there are 2,888,729 confirmed cases with 129,947 deaths and 906,763 recoveries. For those who like to keep score at home, the *FT* has created a nifty interactive chart that allows one to compare cases across nations using similar scaling metrics. The latest $R_0$ data suggest the majority of states are seeing a rise in the pace of infections. Additionally, this link gives a single source for the testing progress of treatments and vaccines.

***Virology***:

- Temperature checks are the most common way that companies screen customers or employees. However, smell checks, where the person is asked to determine a scent may be more effective. The most common symptom of COVID-19 is a loss of the sense of smell.
- Although studies are in the early stages, vitamin D may prove to offer at least some protection against COVID-19.
- Hospital systems are approaching capacity in some southern and southwestern states.
- One of the more frustrating elements in monitoring this pandemic has been a surfeit of research papers published, many of dubious value. The media tends to report on the most sensational headlines but almost never touches on the retractions. China has been publishing a great deal of research; a recent analysis suggests that researchers there are reusing data, which allows for the fast publication of reports that probably don't add much to the pool of knowledge.
- Apple and cherry farms usually hire seasonal workers to pick their crops. Reports indicate these workers have been hit by the pandemic, putting the harvest at risk.

**China news:**

- For the first time in six years, the U.S. has sent two carrier groups into the South China Sea. China is in the midst of a five day drill around the Paracel Islands; Vietnam and the Philippines have protested against the military exercise. The U.S. has also expressed concern. This region has been under stress for some time, as China asserts its right to an area of control that is not recognized by any other power.
- U.S. security policy has been steadily shifting toward Asia, especially China. The U.K. is formulating its security policy and a similar pivot toward Asia is likely in the offing. At the same time, the U.K. has clearly cooled on using Chinese 5G technology for its next generation of telecommunications.
- As Beijing implements the crackdown on Hong Kong, Taiwan is deciding how open it will be in allowing Hong Kongers to emigrate. The more open Taipei is to allowing dissidents to flee, the angrier the PRC will be and the greater the threat to the island. Meanwhile, Australia is planning to become much more welcoming to Hong Kongers looking to exit.
- Zhou Li, a former deputy director of the CPC's International Liaison department, warned Chinese leaders that they should decouple from the dollar system in anticipation that the U.S. will use the dollar's reserve status to harm China's economy. If China were to make this shift, it would no longer need, in fact it should avoid, trade with the U.S. This is because trade will generate dollar balances it wants to avoid.
- Flooding is raising worries about the stability of the Three Gorges Dam. Taiwan media reports earthquakes have occurred in the region around the dam, triggering landslides. So far, nothing official has come from Beijing, but a problem at this dam could be a catastrophe for the areas downstream.
- We have noted that China has relaxed its "one-child" policy for Han Chinese. According to reports, it is implementing aggressive tactics to reduce the birth rate of its Uighur population, including forced abortions, sterilizations and IUD's.

**Policy news:**

- One of the issues we are watching carefully is state and local government spending. Unlike Federal government spending, which can be countercyclical, state and local governments are pro-cyclical. When economic activity slows, state and local governments usually see a decline in revenue with leads to falling spending. If the Federal government or the Fed refuse to take action to counter this issue, the impact of fiscal and monetary stimulus will be blunted due to a drop in state and local government spending.
- Sen Hawley (R-MO) proposed a bill to force the U.S. to exit the WTO. Reports indicate that parliamentary maneuvering will prevent the bill from coming to a vote before the elections, sparing incumbents a potentially problematic vote.

**Foreign news:**

- July is the critical month for Brexit. The Johnson government has indicated that it will not ask for an extension, so negotiators will need to have a deal done by July 31 or it will not give enough time for the EU to sign off on an agreement. Meanwhile, negotiators have failed to meet a deadline of June 30 for finishing an assessment of the financial system regulatory regimes, meaning that U.K. banks and asset managers may lose access to the EU's financial markets.
- The Johnson government is proposing to exempt most home purchases from taxes in a bid to boost homebuilding.
- President Macron of France is implementing a cabinet shakeup, naming a new prime minister, Jean Castex. Other new members of his government are expected to be named throughout the day.
- A couple of months ago, the German Constitutional Court threatened the ECB's unconventional monetary policy. The Merkel government and the Bundesbank, through their actions, appear to be deciding for the court that the ECB's policy is legal.
- Last week's WGR explored the notion of a true Eurobond and the potential for the euro to become a much more significant reserve competitor to the dollar. For that threat to emerge, Chancellor Merkel must negotiate the difficult differences of opinion between the northern and southern European nations. Greece's PM warns that his country won't agree to the plan if it faces conditions on the funding.
- Elections were held over the weekend in Croatia. The incumbent center-right Croatian Democratic Union won a plurality of seats but will need to create a coalition to form a majority government. PM Andrej Plenkovic called early elections and the gamble worked.
- In the wake of the USMCA, Japanese car manufacturers have opted to triple the pay of Mexican workers, rather than move production to the U.S.
- The Swedish ruling coalition is fracturing over the issue of immigration and asylum. The current government is already a minority as the Swedish political landscape is so divided that forming a majority government proved impossible. Thus, if we see a member of the current coalition exit, it may not trigger elections.
- Sharp declines in worker remittances are having a negative impact on numerous frontiers and emerging economies.
- We may see a rare snap election in Malaysia as PM Yassin attempts to solidify support.

**U.S. Economic Releases**

There were no Fed events prior to the publication of this report. The table below lists the economic releases scheduled for the rest of the day.

| Economic Releases | | | | | | |
|---|---|---|---|---|---|---|
| EDT | Indicator | | | Expected | Prior | Rating |
| 9:45 | Markit Services PMI | m/m | Jun | 47.0 | 46.7 | ** |
| 9:45 | Markit Composite PMI | m/m | Jun | | 46.8 | ** |
| 10:00 | ISM Non-Manufacturing Index | m/m | Jun | 50.0 | 45.4 | ** |
| 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 | | | | | | | | |
| Australia | Melbourne Institute Inflation | y/y | Jun | 0.7% | 0.1% | | ** | Equity bullish, bond bearish |
| | ANZ Job Advertisments | m/m | Jun | 42% | 0.5% | | ** | Equity bullish, bond bearish |
| New Zealand | ANZ Commodity Price | m/m | Jun | -0.7% | -0.1% | | * | Equity bearish, bond bullish |
| Europe | | | | | | | | |
| Eurozone | Sentix Investor Confidence | m/m | Jul | -18.2 | -24.8 | -10.4 | *** | Equity bearish, bond bullish |
| | Retail Sales | m/m | May | 17.8% | -11.7% | 15.0% | ** | Equity bullish, bond bearish |
| Germany | Factory Orders | m/m | May | 10.4% | -25.8% | 15.4% | ** | Equity and bond neutral |
| | Markit Germany Construction PMI | m/m | Jun | 41.3 | 40.1 | | ** | Equity and bond neutral |
| UK | New Car Registrations | y/y | Jun | -34.9% | -89.0% | | * | Equity bullish, bond bearish |
| | Markit/CIPS UK Construction PMI | m/m | Jun | 55.3 | 28.9 | 46.0 | ** | Equity bullish, bond bearish |
| | Domestic Sight Deposits CHF | w/w | 3-Jul | 605.9b | 602.5b | | * | Equity and bond neutral |
| | Total Sight Deposits CHF | w/w | 3-Jul | 687.0b | 683.0b | | * | Equity and bond neutral |
| AMERICAS | | | | | | | | |
| Brazil | Markit Brazil PMI Composite | m/m | Jun | 40.5 | 28.1 | | ** | Equity bullish, bond bearish |
| | Markit Brazil PMI Services | m/m | Jun | 35.9 | 27.6 | | ** | Equity bullish, bond bearish |
| Mexico | Gross Fixed Investment | m/m | Apr | -36.9% | -11.0% | -27.8% | *** | Equity bearish, bond bullish |

## 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)** | 28 | 30 | -2 | Down |
| **3-mo T-bill yield (bps)** | 13 | 14 | -1 | Neutral |
| **TED spread (bps)** | 15 | 17 | -2 | Up |
| **U.S. Libor/OIS spread (bps)** | 7 | 7 | 0 | Up |
| **10-yr T-note (%)** | 0.69 | 0.67 | 0.02 | Neutral |
| **Euribor/OIS spread (bps)** | -44 | -43 | -1 | Neutral |
| **EUR/USD 3-mo swap (bps)** | 9 | 10 | -1 | Down |
| **Currencies** | **Direction** | | | |
| dollar | Down | | | Down |
| euro | Up | | | Up |
| yen | Flat | | | 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 | $43.38 | $42.80 | 1.36% | Optimism about the Global Economy |
| WTI | $40.76 | $40.65 | 0.27% | |
| Natural Gas | $1.86 | $1.73 | 7.15% | |
| Crack Spread | $12.04 | $11.68 | 3.15% | |
| 12-mo strip crack | $10.87 | $10.57 | 2.92% | |
| Ethanol rack | $1.53 | $1.53 | 0.07% | |
| **Metals** | | | | |
| Gold | $1,775.53 | $1,772.05 | 0.20% | |
| Silver | $18.17 | $18.02 | 0.85% | |
| Copper contract | $275.40 | $274.85 | 0.20% | |
| **Grains** | | | | |
| Corn contract | $ 348.00 | $ 343.50 | 1.31% | |
| Wheat contract | $ 493.50 | $ 492.00 | 0.30% | |
| Soybeans contract | $ 908.00 | $ 896.75 | 1.25% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 1894 | 1823 | 71 | |

## Weather

The 6-10 and 8-14 day forecasts currently call for warmer temperatures for most of the country, with cool conditions expected in Washington state and its surrounding areas. Dry conditions are expected for the majority of the country, with wet conditions expected in the New England region. There is some cyclone activity near the Florida panhandle, and Tropical Storm Edouard has developed east of New Jersey and is not expected to make landfall in North America.

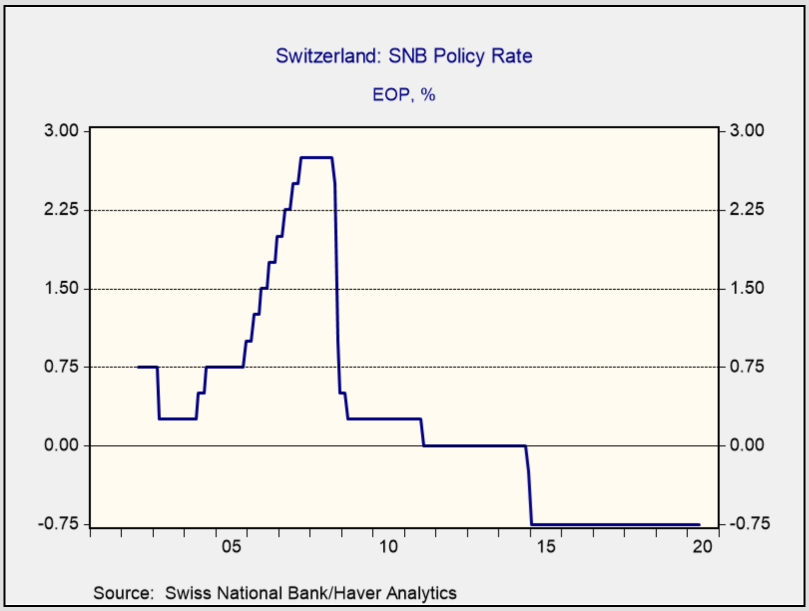
## Asset Allocation Weekly

*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.

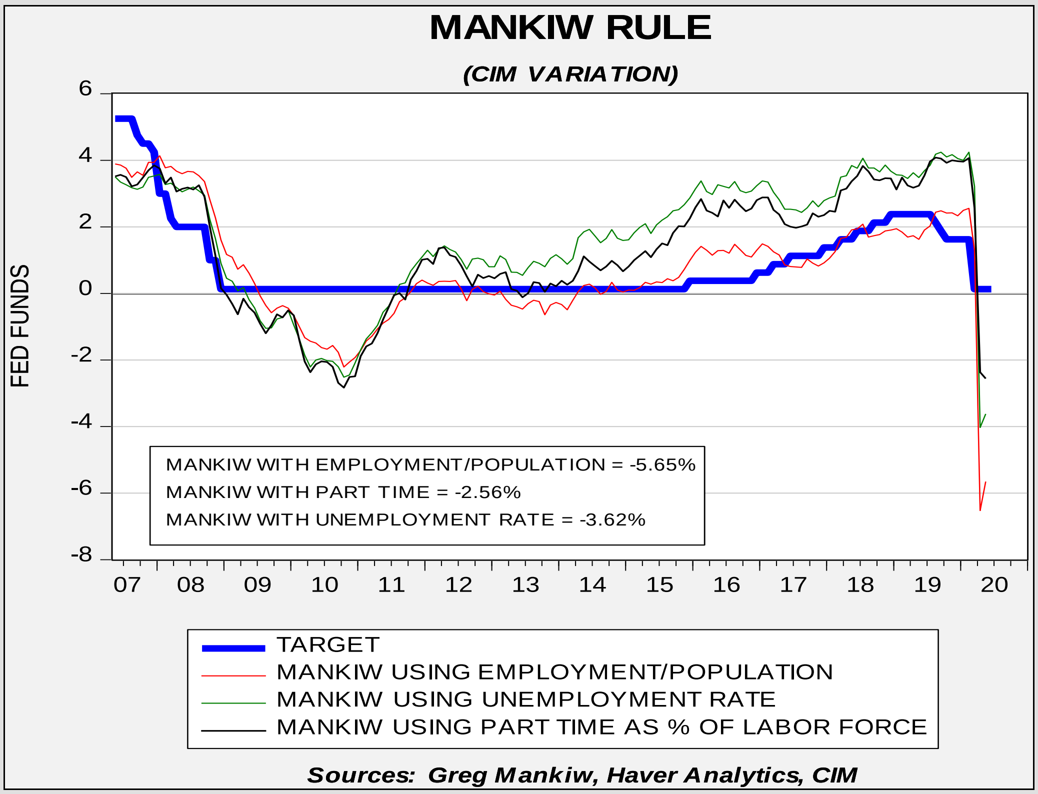



Why would a central bank consider implementing a negative policy rate? If economic conditions warranted easing and inflation was low,[1] it may be impossible to use low but positive interest rates as a policy tool. In that case, negative interest rates or some other unconventional monetary policy may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

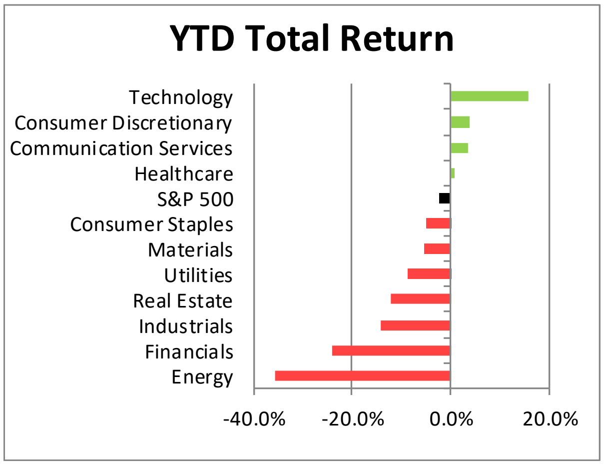
In 2008 through most of 2011, these variations of the Mankiw Rule suggested the policy rate should have been below zero. That is the case today. So far, the FOMC has rejected a negative policy rate and instead relies on expanding the balance sheet and forward guidance. The current program of balance 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.

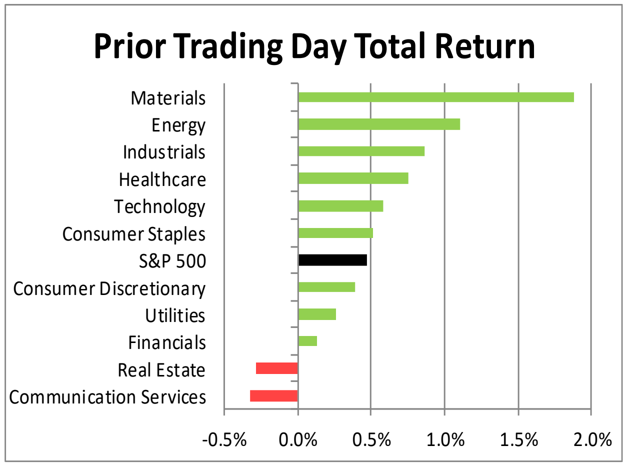
So, why is the FOMC opposed to negative interest rates? The most likely reason is the structure of the U.S. financial system. The U.S. system has an extensive non-bank financial system; unlike banks, this system isn't funded by deposits but by repo and money markets. The non-bank financial system, also 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 7/2/2020 close)

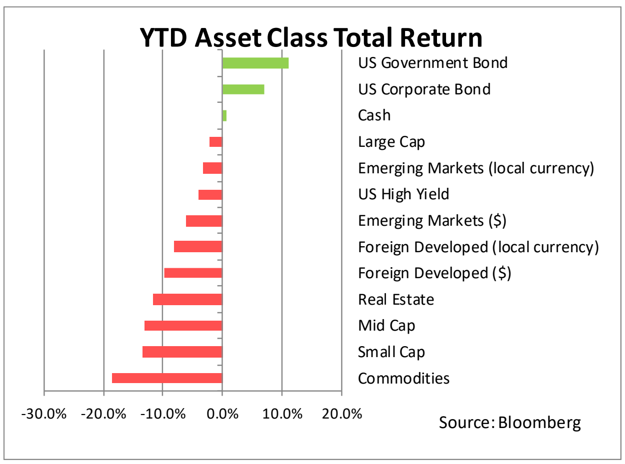



(Source: Bloomberg)

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 7/2/2020 close)

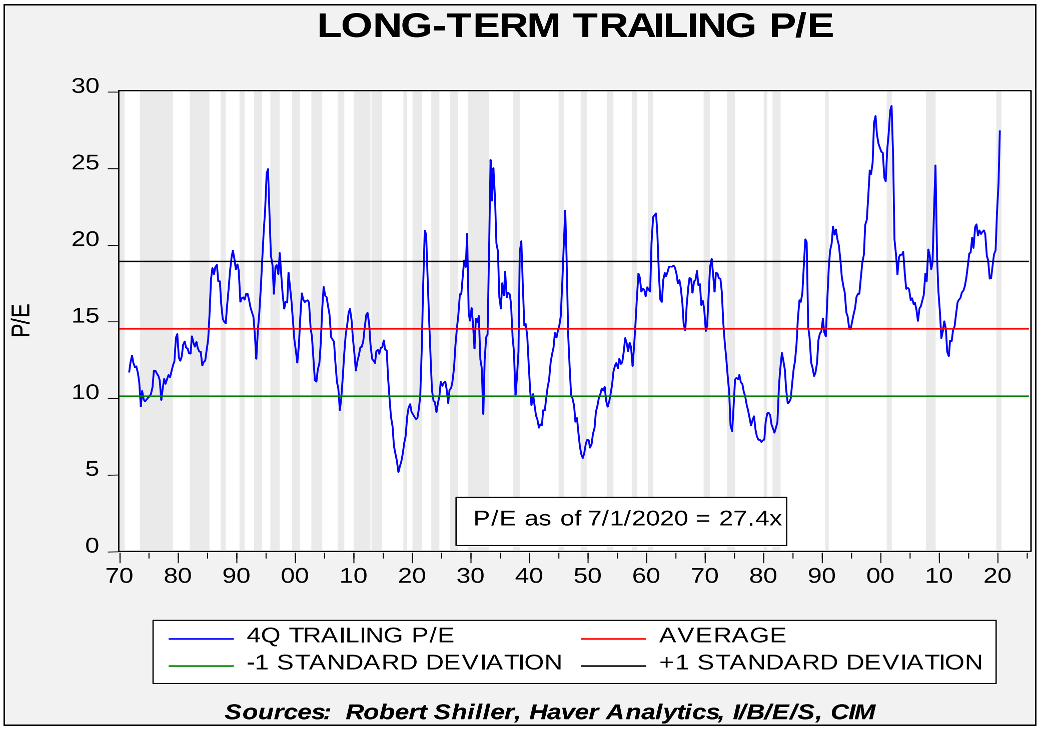



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 2, 2020




Based on our methodology,[2] the current P/E is 27.4x, up 3.5x from last week. The jump in the P/E is due to the onset of Q3; we adjust the price to the average for the quarter (essentially the current price) and shift the earnings total as noted below. Although this calculation of earnings is higher than before, we note that the index level is also higher, leading to the rise in the multiple. It is not at all unusual for the multiple to expand in recessions. In fact, in the past three recessions, the multiple has increased markedly; this is because investors expect earnings to recover in the coming quarters which leads to multiple contraction.



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[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 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.