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 7, 2020—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 1.3% from its last close. In Asia, the MSCI Asia Apex 50 closed down 0.9% from its prior close. Chinese markets were higher, with the Shanghai Composite up 0.4% from the prior close and the Shenzhen Composite up 1.7%. U.S. equity index futures are signaling a lower open.

Risk assets are under pressure this morning in part because of multiple reports pointing to the reimposition of coronavirus lockdowns in some locales and the risk of halting, prolonged economic recovery. On top of that, geopolitical tensions between the Western democracies and China and Russia remain high. We outline all the key news below.

COVID-19: Official data show confirmed cases have risen to 11,648,268 worldwide, with 538,828 deaths and 6,328,930 recoveries. In the United States, confirmed cases rose to 2,938,750, with 130,310 deaths and 924,128 recoveries. Here is the interactive chart from the *Financial Times* that allows you to compare cases and deaths among countries, scaled by population.

Virology

- U.S. medical centers have reported more than 5,000 cases of patients likely catching the coronavirus once admitted for other conditions between May 14 and June 21 alone, on top of any staff members who may have caught the disease while working in the facilities. The spread of the disease within health facilities illustrates how health workers have struggled to learn the best way to deal with the novel virus. The continuing spread of the disease to staff members is particularly concerning as it effectively reduces the facility's capacity to treat victims and could hasten the point when the facility becomes overwhelmed.
- New York City entered its third phase of reopening its economy yesterday, allowing some personal care services such as nail salons and tattoo parlors to open at limited capacity. Indoor dining at restaurants was also supposed to be part of phase three, but city and state officials have indefinitely postponed those plans because of rising cases of the new coronavirus in other states and a lack of social distancing in the city.
- Illustrating how some localities have been forced to backtrack on their reopening while others loosen restrictions, Miami-Dade County Mayor Giménez rolled back his area's

reopening and ordered gyms to close and restaurants to limit service to takeout and delivery, although office buildings, retailers and grooming services will remain open.

- In Australia, which had been seen as a leader in managing the pandemic, a rebound in infections in the Melbourne area has prompted authorities to reimpose a lockdown in that area. For the next six weeks, people will be allowed to leave their homes only for essential shopping, exercise, medical care or work. Restaurants and cafés, which had begun to reopen with social distancing measures in place, will now only be allowed to service takeaway food and drinks.
- In Brazil, President Bolsonaro said he has been tested for the virus after showing symptoms consistent with the disease, including fever. Bolsonaro said his test results will be made public Tuesday.
- Regeneron Pharmaceuticals (REGN, 627.25) said the small Phase I safety study of its experimental coronavirus drug received a positive review from the company's independent data-monitoring committee, so it now plans to launch a much larger, combined Phase II and III study to delve deeper into the drug's safety and effectiveness. The drug, REGN-COV2, is among the most advanced in a class of medicines known as monoclonal antibodies being developed to treat the disease.

Economic Impact

- The OECD issued a new employment outlook calling for the overall jobless rate in advanced countries to decline to 9.4% at the end of 2020 and 7.7% at the end of 2021, assuming there is no major second wave of the pandemic. That would leave the unemployment rate at the end of this year at its highest level since the 1930s. As if that isn't bad enough, the organization said unemployment in the advanced countries will rise to 12.6% at the end of 2020 and only fall to 8.6% in 2021, if there is a second wave and countries reimpose some of their lockdown measures.
    - For the U.S. alone, the OECD forecasts unemployment of 11.3% at year-end 2020 and 8.5% in 2021, if there is no sustained second wave.
    - The organization sees U.S. unemployment at 12.9% at year-end 2020 and 11.5% in 2021 in a scenario where it does experience a second wave.
- Separately, the European Commission issued an updated economic forecast showing the EU's gross domestic product will shrink a record 8.3% this year, even worse than its earlier forecast for a drop of 7.4%.
    - The officials ascribed the downgrade mostly to a slower-than-expected economic reopening after virus resurgences led to lockdowns being tightened again in some localities.
    - The commission also lowered its forecast for a potential economic rebound in 2021, estimating a growth of 5.8%, compared with their previous forecast of 6.1%.
- In an interview with the *Financial Times*, Atlanta FRB President Bostic warned that the rebound in U.S. economic activity is in danger of stalling as a result of the recent spike in coronavirus infections in the South and West. Bostic said he was most concerned by high-frequency data showing a "levelling off" of business openings and mobility. Echoing Fed Chair Powell, he also called on Congress to pass another significant round

of fiscal support for the economy to help prevent permanent business closures and job losses.

- In China, an upmarket Chinese real estate developer failed to repay yuan bonds worth about $214 million that were due Monday, saying it had been hit by a property downturn that was worsened by the coronavirus pandemic, which exacerbated its large debts, high financing costs and the concentrated maturity of its debts. The news highlights the risks inherent in China's heavy debt ratios.
- Despite the U.S. economic rebound to date and the associated rise in commodity demand, there's still too much natural gas for the market to absorb.

Foreign Policy Response

- British chancellor of the Exchequer Rishi Sunak will face MPs in the Commons this morning as he prepares to announce a long list of coronavirus-fueled spending items in tomorrow's "Summer Economic Update." The expected measures include bringing forward an immediate stamp duty holiday and providing £3 billion to make homes and public buildings more energy efficient, with homeowners to receive cash grants of up to £5,000 each to fund insulation and heating systems.

China-India-Bhutan: Chinese and Indian troops started to withdraw from disputed areas along the two countries' Himalayan border, following talks between senior diplomats and military commanders to calm tensions. The moves should help end the fistfights between the two sides, which caused at least 20 deaths among Indian troops last month. However, Indian media reports say China has now begun designating part of the border with Bhutan as disputed. The new pressure may be a way to keep pressure on New Delhi, which is a key Bhutanese ally. In any case, Chinese territorial aggressiveness appears alive and well, which will keep up geopolitical tensions in the region.

China-Germany: Chancellor Merkel is facing criticism in Germany for failing to take a tough line on China over the new national security law it has imposed on Hong Kong, with politicians from both opposition and government parties accusing her of being too soft on Beijing.

China-United States: The U.S. Chamber of Commerce, the Business Roundtable and other business groups issued a public letter urging the U.S. and China to fully implement their January "Phase I" trade deal. The letter reflects growing concern that Chinese purchases of U.S. goods are running far short of the pace required under the deal. China has made decent progress with its ramp-up of U.S. agricultural goods, but that probably just reflects President Xi's belief that President Trump would be so satisfied with increased farm exports that he would overlook China's failure to implement other parts of the deal. That could be a miscalculation, as China's failure to meet its obligations could generate enough anger among U.S. conservatives that Trump would walk away from the deal. A formal breakdown of the deal would signal even worse U.S.-China tensions and more trade conflict, which would likely be very negative for global risk assets.

United Kingdom-Russia: Britain has imposed sanctions on more than two dozen Russian individuals in connection with the 2009 death of lawyer Sergei Magnitsky, signaling it may become more active in imposing U.S.-style economic sanctions against authoritarian regimes for their destabilizing acts. The Kremlin said it would hit the U.K. with "reciprocal measures" in response.

Russia: An adviser to the chief of Russia's Roskosmos state space agency, Ivan Safronov Jr., has been detained on a charge of high treason for passing classified military information to an unspecified NATO country.

France: As part of his cabinet reshuffle, President Macron has promoted a young lieutenant, Gérald Darmanin, to replace Interior Minister Christopher Castaner, who was criticized for his handling of the anti-government *gilets jaunes* protests last year. More recently, the police also lost faith in Castaner for not doing enough to protect them from criticism by Black Lives Matters protesters. In other aspects of the reshuffle, Finance Minister Le Maire kept his job, as did the foreign, defense and health ministers. However, with the post-coronavirus economic recovery central to Macron's re-election hopes, the president named new labor and environment chiefs.

U.S. Economic Releases

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	JOLTS Job Openings	m/m	May	4500	5046	**
Fed Speakers or Events						
	Speaker or event	**District or position**				
13:00	Randal Quarles Discusses Stress Testing	Federal Reserve Vice Chairman of Supervision				
14:00	Mary Daly Takes Part in a Panel on College Attainment	President of the Federal Reserve Bank of San Francisco				

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	Labor Cash Earnings	y/y	May	-2.1%	-0.6%	-1.0%	**	Equity bearish, bond bullish
	Real Cash Earnings	y/y	May	-2.1%	-0.7%	-0.8%	**	Equity bearish, bond bullish
	Household Spending	y/y	May	-16.2%	-11.1%	-11.8%	**	Equity bearish, bond bullish
	Official Reserve Assets	m/m	Jun	$1383.2b	$1378.2b		**	Equity and bond neutral
	Leading Index CI	m/m	May	79.3	77.7	79.3	**	Equity and bond neutral
	Coincident Index	m/m	May	74.6	80.1	74.6	**	Equity and bond neutral
Australia	AiG Perf of Manufacturing Index	m/m	Jun	31.5	31.6		**	Equity and bond neutral
	ANZ Roy Morgan Weekly Consumption	w/w	5-Jul	92.1	93.0		**	Equity and bond neutral
	Foreign Reserves	m/m	Jun	A$61.5b	A$60.8b		*	Equity and bond neutral
Europe								
Germany	Industrial Production SA	m/m	May	7.8%	-17.9%	11.1%	***	Equity and bond neutral
France	Bank of France Ind. Sentiment	m/m	Jun	89	83	90	***	Equity and bond neutral
	Trade Balance	m/m	May	-7051m	-5021m	-5500m	**	Equity bearish, bond bullish
	Current Account Balance	m/m	May	-8.5b	-5.4b		**	Equity and bond neutral
Italy	Retail Sales	m/m	May	24.3%	-10.5%	15.0%	**	Equity bullish, bond bearish
UK	Output Per Hour	y/y	1Q	-0.6%	-2.9%		**	Equity and bond neutral
	Unit Labor Costs	y/y	1Q	6.2%	2.4%		**	Equity bullish, bond bearish
Switzerland	Foreign Currency Reserves	m/m	Jun	850.1b	816.3b		*	Equity and bond neutral
Russia	Light Vehicle Car Sales	y/y	Jun	-14.6%	-51.8%	-25.0%	*	Equity and bond neutral
AMERICAS								
Mexico	Vehicle production	m/m	Jun	238946	22119		**	Equity bullish, bond bearish
	Vehicle Exports	m/m	Jun	196173	15088		**	Equity bullish, bond bearish
Brazil	Vehicle Production Anfavea	m/m	Jun	98708	43080		**	Equity bullish, bond bearish
	Vehicle Sales Anfavea	m/m	Jun	132818	62190		**	Equity bullish, bond bearish
	Vehicle Exports Anfavea	m/m	Jun	19405	3870		**	Equity bullish, bond bearish
	Trade Balance Weekly	w/w	5-Jul	$1380m	$878m		**	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)	28	30	-2	Down
3-mo T-bill yield (bps)	13	15	-2	Neutral
TED spread (bps)	14	16	-2	Up
U.S. Libor/OIS spread (bps)	7	7	0	Up
10-yr T-note (%)	0.68	0.68	0.00	Neutral
Euribor/OIS spread (bps)	-44	-44	0	Neutral
EUR/USD 3-mo swap (bps)	10	9	1	Down
Currencies	**Direction**			
dollar	Up			Down
euro	Down			Up
yen	Down			Up
pound	Up			Down
franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
RBA Cash Rate Target	0.250%	0.250%	0.250%	On forecast
RBA 3-Yr Yield Target	0.250%	0.250%	0.250%	On forecast

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	$42.60	$43.10	-1.16%	Demand Concerns
WTI	$40.05	$40.63	-1.43%	
Natural Gas	$1.88	$1.83	2.84%	
Crack Spread	$11.71	$11.62	0.79%	
12-mo strip crack	$10.81	$10.79	0.18%	
Ethanol rack	$1.62	$1.58	2.59%	
Metals				
Gold	$1,776.93	$1,784.68	-0.43%	
Silver	$18.06	$18.27	-1.17%	
Copper contract	$275.30	$277.45	-0.77%	
Grains				
Corn contract	$ 342.50	$ 346.50	-1.15%	
Wheat contract	$ 493.00	$ 493.25	-0.05%	
Soybeans contract	$ 901.25	$ 906.25	-0.55%	
Shipping				
Baltic Dry Freight	1956	1894	62	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.0		
Gasoline (mb)		1.0		
Distillates (mb)		0.5		
Refinery run rates (%)		0.50%		

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 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, but is not expected to make landfall in North America.

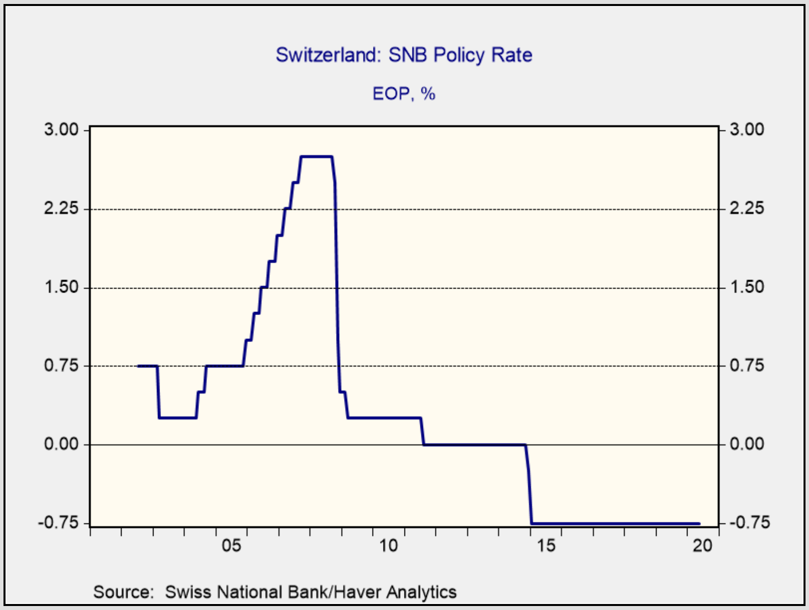
Asset Allocation Weekly

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.

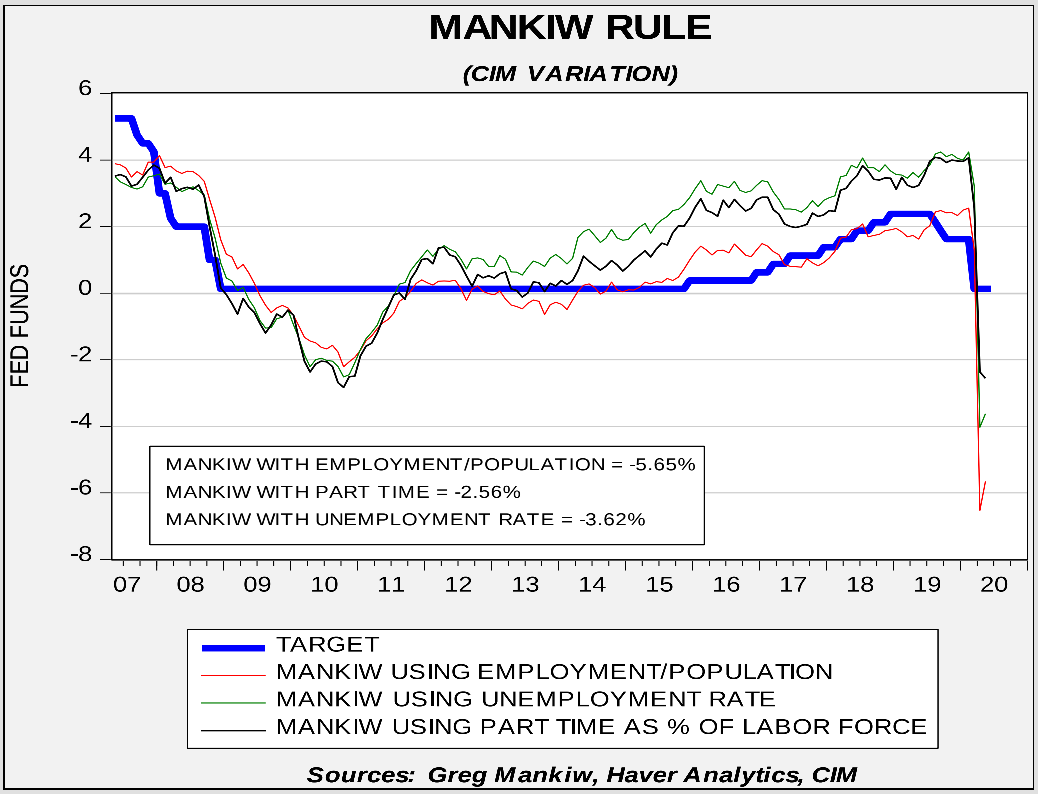


Why would a central bank consider implementing a negative policy rate? If economic conditions warranted easing and inflation was low,[1] it may be impossible to use low but positive interest rates as a policy tool. In that case, negative interest rates or some other unconventional monetary policy may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

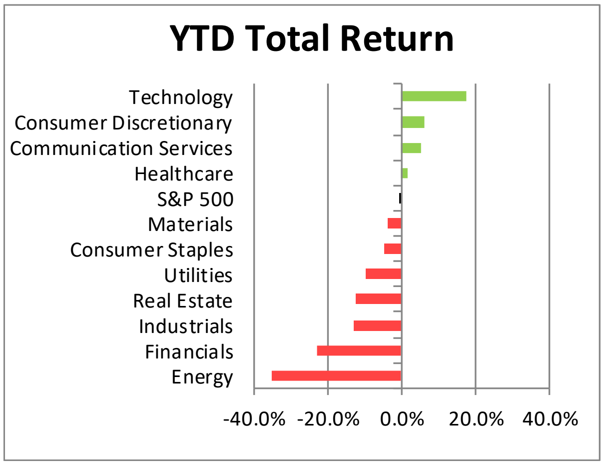
In 2008 through most of 2011, these variations of the Mankiw Rule suggested the policy rate should have been below zero. That is the case today. So far, the FOMC has rejected a negative policy rate and instead relies on expanding the balance sheet and forward guidance. The current program of balance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

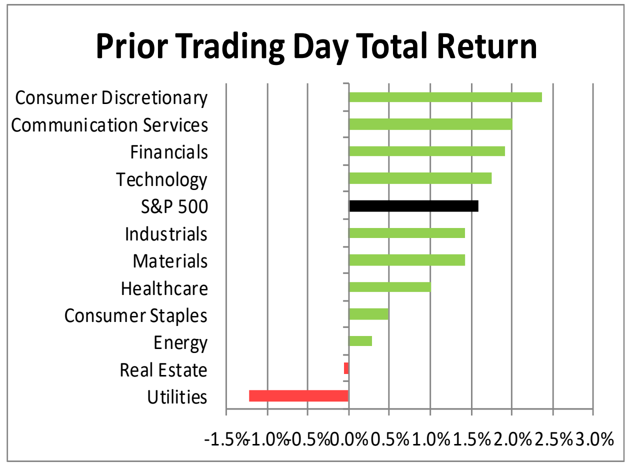
So, why is the FOMC opposed to negative interest rates? The most likely reason is the structure of the U.S. financial system. The U.S. system has an extensive non-bank financial system; unlike banks, this system isn't funded by deposits but by repo and money markets. The non-bank financial system, also 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 7/6/2020 close)

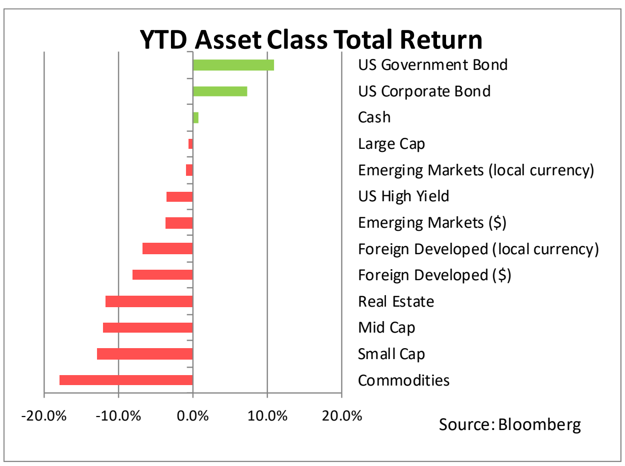




(Source: Bloomberg)

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 7/6/2020 close)

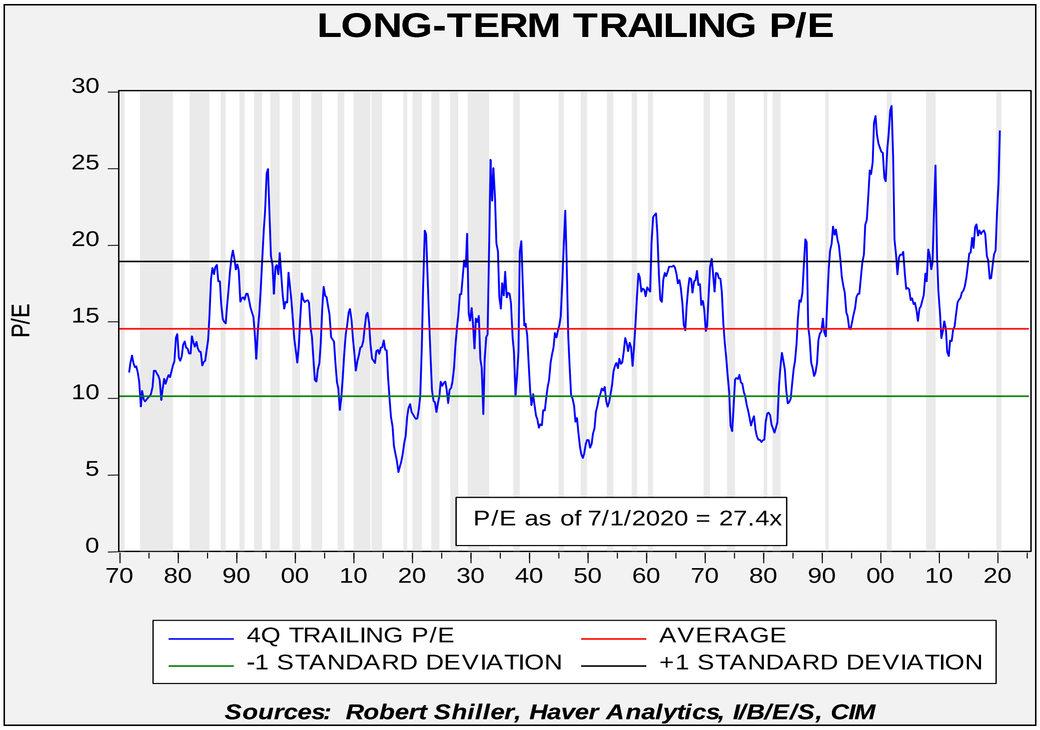


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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[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.