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: June 15, 2021—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the EuroStoxx 50 is up 0.5% from its prior close. In Asia, the MSCI Asia Apex 50 closed up 0.1%. Chinese markets closed lower, with the Shanghai Composite down 0.9% from its prior close and the Shenzhen Composite also down 0.8%. U.S. equity index futures are signaling a higher open.

The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- ***Weekly Geopolitical Report*** **(6/14/2021): The Geopolitics of the Colonial Pipeline Ransomware Attack: Part I**
- *Weekly Energy Update* (6/10/2021): Oil majors are facing increasing investor pressure to reduce carbon output.
- *Asset Allocation Q2 2021 Rebalance Presentation* (5/20/2021): video discussion of our asset allocation process, portfolio changes in Q2, and the macro environment
- *Asset Allocation Weekly* (6/11/2021) (with associated podcast and chart book): we discuss the relationship between inflation expectations and actual inflation
- *Confluence of Ideas* podcast (4/30/2021): "The U.S.-China Balance of Power: Part II"

In today's *Comment*, we open with news related to President Biden's trip to Europe. Not only is there a lot of political news in Europe, but European stocks have posted a string of records. We also discuss the start of the latest policy meeting at the Federal Reserve and other noteworthy U.S. and international developments. We end with news related to the coronavirus pandemic.

NATO-Russia-China: At the end of their big summit meeting yesterday, President Biden and the other NATO leaders issued a lengthy communique highlighting their intent to stand up to both Russia and China. In the background, however, much of the discussion revolved around how to balance the alliance's response to the traditional, longstanding threat from Russia versus its response to the more novel and recent issue of China's geopolitical and economic aggression. In an important innovation, the communique also stated that Article 5, the principle of collective defense enshrined in the treaty that established NATO in 1949, can be invoked on a case-by-case basis in response to a cyberattack.

- Regarding Russia, the communique criticized Moscow's military buildup, cyber and disinformation attacks aimed at the West, and its annexation of Crimea from Ukraine. Biden also warned of consequences if jailed Russian opposition politician Alexei

Navalny dies. In a news conference at the end of the summit, Biden said, "Navalny's death would be another indication that Russia has little or no intention of abiding by basic fundamental human rights . . . . It would be a tragedy. It would do nothing but hurt his relationships with the rest of the world, in my view, and with me."

- Regarding China, the communique said China presents "systemic challenges to the rules-based international order." The communique also highlighted concerns over Beijing's rapidly expanding nuclear arsenal and military cooperation with Russia.
- Over time, it appears that the Biden administration is heading toward an updated version of the 1990s-style doctrine of being able to defend against two major regional conflicts at the same time. The major difference is that Russia and China don't just represent regional threats. They both have the power to represent true global threats, and they are increasingly finding themselves very much aligned in terms of international security goals and perspectives. Although Biden is probably oversimplifying when he casts today's geopolitics as a competition between liberal democracies and authoritarian leaders, it is probably true that Russian President Putin and Chinese President Xi perceive an opportunity to make the world safe for authoritarians. The U.S. and the other liberal democracies have their work cut out for them in terms of figuring out how to balance their responses to those two threats.

China-Taiwan-United States: In an apparent show of defiance against the U.S. push for a stronger stance against China in Europe, the Chinese military yesterday sent 28 warplanes into Taiwan's air defense identification zone — the largest-known incursion to date. According to Taiwan's defense ministry, the latest mission included 14 J-16 and six J-11 fighter jets and four H-6 heavy bombers, capable of carrying nuclear weapons, as well as various surveillance and early warning aircraft.

- The ministry said Taiwanese aircraft were dispatched to warn away the Chinese warplanes, while missile systems were also deployed to monitor them.
- Separately, a U.S. aircraft carrier group led by the Japan-based *USS Ronald Reagan* has entered the South China Sea in what the Navy said is a routine mission.

United States-European Union: At their summit today, President Biden and EU leaders are expected to sign off on a deal to end the 17-year-old U.S.-EU dispute over aircraft subsidies. Although details are still sketchy, earlier reporting suggests it will involve a five-year agreement to limit the types of financial support each side can give to its major aircraft manufacturers. Of key importance, the deal would also lift the punitive tariffs each side has imposed on each other. If it is indeed confirmed, the agreement would remove a major irritant in the U.S.-EU relationship and help unify their positions on other important global issues, even if the two sides have other disagreements.

U.S. Monetary Policy: The Fed kicks off its latest policy meeting today, with a decision scheduled to be released when the meeting ends tomorrow. The officials are widely expected to leave their benchmark interest rate unchanged at essentially 0% and make no immediate adjustment to their asset purchase program.

- However, investors will be looking for any hint that the policymakers might bring forward their plans for policy tightening.
    - Importantly, the officials will release an update of the "dot chart" laying out when they think they will have to implement policy changes in the coming few years. The last update, in March, showed the policymakers expected to hold policy steady through 2023.
    - Tomorrow's update may reveal that the policymakers now expect to lift interest rates somewhat earlier.
    - Naturally, equity and bond markets could face a bout of volatility if investors get confirmation that the policymakers now expect to hike interest rates and cut their bond purchases earlier than expected. Nevertheless, we still expect the officials to stay on the sidelines for some time. For the time being, monetary policy will remain loose, which should tend to support risk assets.
- The policymakers are also likely to address growing concerns that the flood of money in the financial system may drive U.S. interest rates into negative territory. Resurgent flows into money market funds coupled with reduced issuance of short-term Treasury securities have pushed many fund managers to turn to the Fed's reverse repo, which pays no interest at all.
    - Some market participants want the central bank to jolt short-term rates higher by agreeing to pay more than zero on the RRP.
    - It could also raise the rate it pays banks on excess reserves that they hold at the Fed.

United Kingdom-Australia: British Prime Minister Johnson and Australian Prime Minister Morrison signed off on the broad terms of a post-Brexit trade deal. In addition to lowering tariffs and quotas between the countries, including agriculture, the deal would make it easier for individuals to work and travel between the two countries.

- If the trade deal can be finalized and signed before the end of the year, it would mark the first substantial bilateral agreement entirely negotiated by the U.K. since it left the EU in early 2020.
- Deals announced with Japan and Norway were built upon existing arrangements negotiated while the U.K. was a member of the EU.

Belarus-Lithuania: The foreign minister of Lithuania has accused the Belarusian government of weaponizing illegal immigration in retaliation for Lithuania's welcoming political dissidents from Belarus and supporting EU sanctions against Minsk. According to the official, Belarus is enticing migrants with package deals from a state-owned tourist agency that includes flights from Baghdad or Istanbul, as well as travel to the Lithuanian border. So far this year, Lithuania has detained almost double the number of migrants who crossed the frontier from Belarus than the combined total for the three previous years.

COVID-19: Official data show confirmed cases have risen to 176,329,887 worldwide, with 3,813,679 deaths. In the United States, confirmed cases rose to 33,475,305 with 599,960 deaths.

Vaccine doses delivered in the U.S. now total 374,398,105, while the number of people who have received at least their first shot totals 174,234,573. Finally, here is the interactive chart from the *Financial Times* that allows you to compare cases and deaths among countries, scaled by population.

Virology

- According to the latest CDC data, 52.5% of the U.S. population has now received at least one dose of a vaccine, and 43.7% of the population is fully vaccinated.
- In the U.K., Prime Minister Johnson pushed forward England's planned economic reopening to mid-July due to resurgent infections stemming from the Delta mutation first identified in India. That variant, which is much more transmissible and dangerous than the original coronavirus, has been spreading rapidly among young, unvaccinated Britons and those who have only had one dose of a vaccine.
    - The decision to push out the reopening for one month illustrates the risk from the Delta variant, even in countries with high vaccination rates. It also shows the downside of Britain's decision early this year to delay the second dose of the vaccine in order to maximize the number of people receiving at least one dose.
    - Scientific advisors recommended the U.K. government delay vaccinations to younger age groups to ensure older people have received the double dose needed for maximum protection.
    - Separate studies from researchers in England and Scotland published Monday found that while protection against the Delta infection was somewhat diminished compared with more established variants, two doses of the vaccine offered considerable protection against severe illness and hospitalization.
- Meanwhile, the COVID-19 antibody treatment under development by AstraZeneca (AZN, $58.76) failed to meet targets in its latest trial, even though it did show that it could prevent people exposed to the virus from developing the disease if administered early enough.
- In Japan, the government is considering placing Tokyo under a quasi-state of emergency during the Olympic Games starting there on July 23, given that a number of health experts have expressed concern over a potential spike in COVID-19 cases resulting from the influx of participants and spectators.

Economic and Financial Market Impacts

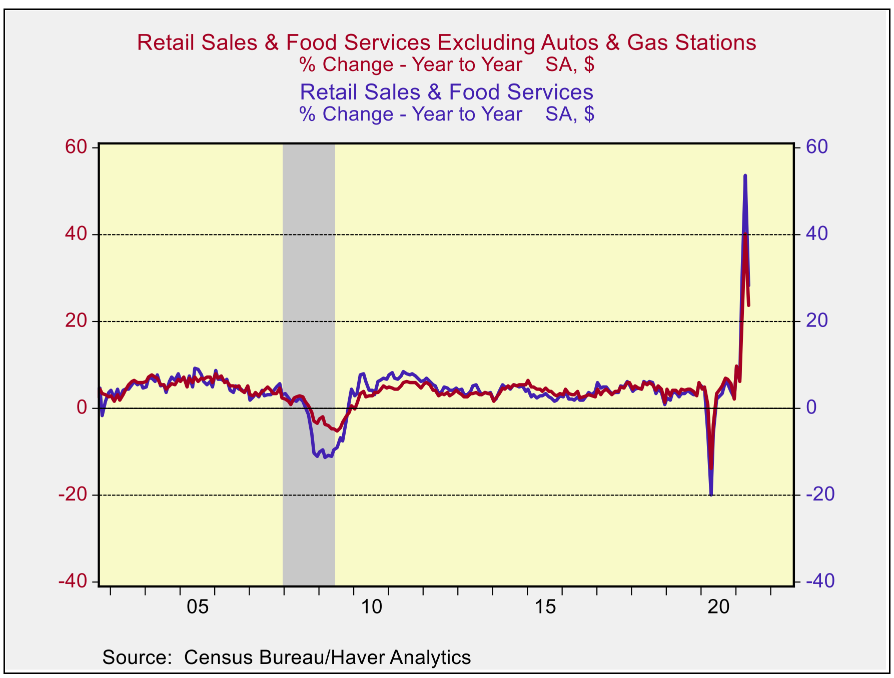
- Although it seems like just yesterday that we were reporting on record-high prices for lumber, the cost of wood has now plunged by almost half since the beginning of May. Some market participants are even suggesting prices could fall much further as supply bottlenecks get resolved and some hoarding behavior reverses. The rapid change in course is a reminder that today's inflation pressure could well prove transitory, as the Fed suggests, once companies and consumers adjust to the normalizing post-pandemic economy.
- Although many economic sectors, such as travel and leisure, are facing boom times as the economy reopens, office towers and nearby businesses in central business districts are

missing out on the strong economic recovery, largely because the rise in vaccinations and easing of mask restrictions haven't propelled most employees back to work.

- On a more positive note, the chief of the entertainment division at NBCUniversal, a unit of Comcast (CMCSA, $57.28), said pent-up demand for major sporting events could make the company's broadcast of the Tokyo Olympics its most profitable ever.
- Despite the positive progress on reducing infections and boosting vaccinations in many countries, the pandemic and its negative impact on oil prices, until recently, has produced an intense strain on Algeria's economy.

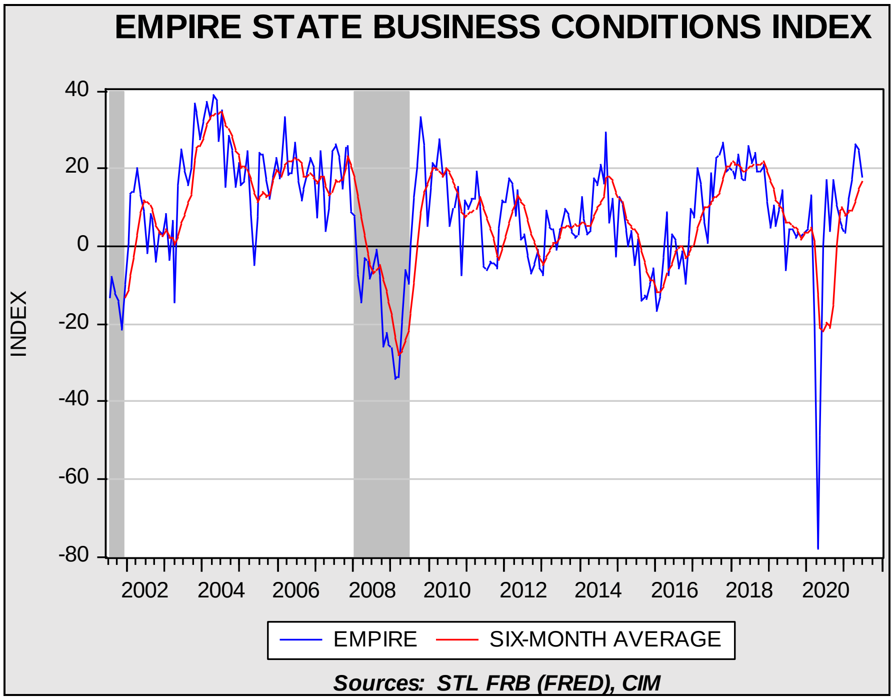
U.S. Economic Releases

U.S. retail sales fell more than expected in May as the fiscal stimulus appears to be wearing off. The value of retail sales fell 1.3% from the prior month compared to expectations of a drop of 0.7%. Excluding autos, the value of retail sales fell 0.7% from the prior month compared to expectations of a 0.4% rise. The core retail sales, which excludes autos and gasoline sales, fell 0.8% from the prior month compared to expectations of remaining unchanged. The retail sales control group, which excludes auto, gas, and building material sales fell 0.7% from the prior month compared to expectations of a drop of 0.5%.



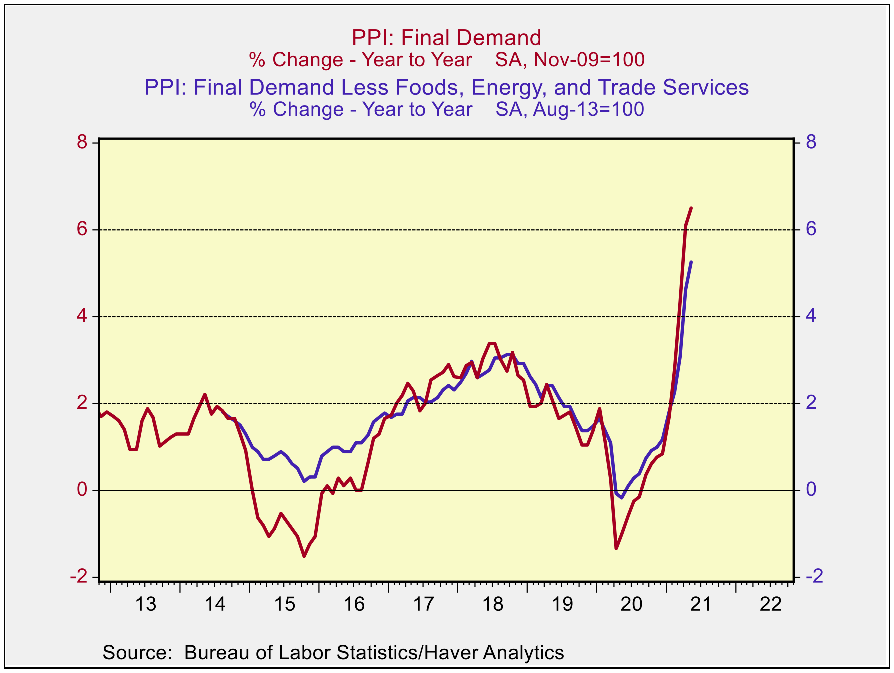
The chart above shows the annual change in retail sales and core retail sales. Overall retail sales and core retail sales rose 28.2% and 23.6%, respectively.

Business activity in New York state slowed in June but continues to expand at a solid pace, according to the Federal Reserve Bank of New York. The Empire Manufacturing Business Conditions Index came in at 17.4 compared to expectations of 22.7.



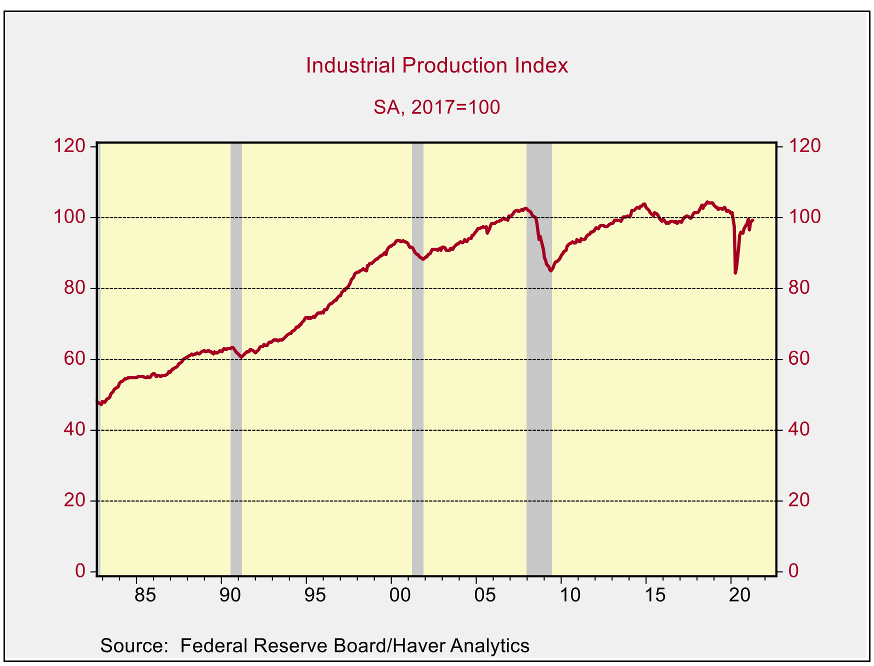
The chart above shows the Empire Manufacturing Index and its six-month moving average. The six-month moving average is 16.8, well above the recession indicator.

Supply chain disruptions continue to hurt producers. In May, the prices paid by suppliers for goods and services rose at a faster than expected pace. The Producer Price Index (PPI) rose 0.8% from the prior month compared to expectations of 0.5%. Excluding food and energy, producer prices rose 0.7% from the prior month compared to expectations of 0.5%. Core PPI, which excludes food, energy, and trade prices, rose 0.7% from the prior month compared to expectations of 0.5%.



The chart above shows the annual change in the headline PPI and core PPI. Headline PPI rose 6.5% from the prior year, while core PPI rose 5.5% from the prior year. Firms reopening at the same time has led to an increase in demand for inputs. At this time, it appears that firms have been reluctant to pass those costs on to the consumer.

Manufacturing production has picked up the pace signaling a possible improvement in economic activity. The Industrial Production Index rose from 99.0 to 99.9, a rise of 0.8% from the prior month. Expectations were for a reading of 0.7%. Manufacturing production rose from 97.4 to 98.2 a rise of 0.9% from the prior month. Lastly, capacity utilization rose from 74.6% to 75.2%.



The chart above shows the level of the Industrial Production Index. The base year from the index changed from 2012 to 2017.

The table below shows the domestic releases scheduled for the rest of the day.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Business Inventories	m/m	Apr	-0.001	0.003	**
10:00	NAHB Housing Market Index	m/m	Jun	83	83	**
16:00	Total Net TIC Flows	m/m	Apr		$146.4b	**
16:00	Net Long-term TIC Flows	m/m	Apr		$262.2b	***
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								
Japan	Tertiary Industry Index	m/m	Apr	-0.7%	1.1%	-0.6%	**	Equity and bond neutral
India	CPI	y/y	May	6.3%	4.3%	5.4%	***	Equity bearish, bond bullish
Australia	House Price Index	y/y	1Q	7.5%	3.6%	7.6%	**	Equity and bond neutral
New Zealand	REINZ House Sales	y/y	May	81.4%	419.7%		**	Equity and bond neutral
	Food Prices	m/m	May	0.4%	1.1%		***	Equity and bond neutral
EUROPE								
Eurozone	Trade Balance SA	m/m	Apr	9.4b	13.0b	15.0b	**	Equity bearish, bond bullish
Germany	CPI	y/y	May	2.5%	2.5%	2.5%	***	Equity and bond neutral
	CPI EU Harmonized	y/y	May	2.4%	2.4%	2.4%	***	Equity and bond neutral
France	Bank of France Ind. Sentiment	m/m	May	107	107	108	**	Equity and bond neutral
	CPI EU Harmonized	y/y	May	1.8%	1.8%	1.8%	***	Equity and bond neutral
	CPI	y/y	May	1.4%	1.4%	1.4%	***	Equity and bond neutral
Italy	CPI EU Harmonized	y/y	May	1.2%	1.3%	1.3%	***	Equity and bond neutral
	General Government Debt	m/m	Apr	2680.5b	2650.9b		**	Equity and bond neutral
UK	Claimant Count Rate	m/m	May	6.2%	7.2%		**	Equity bullish, bond bearish
	Jobless Claims Change	m/m	May	-92.6k	-15.1k		**	Equity and bond neutral
	Average Weekly Earnings 3M	y/y	Apr	5.6%	4.0%	4.9%	**	Equity and bond neutral
	Weekly Earnings ex Bonus 3M	y/y	Apr	5.6%	4.6%	5.3%	**	Equity and bond neutral
	ILO Unemployment Rate 3Mths	m/m	Apr	4.7%	4.8%	4.7%	**	Equity and bond neutral
	Employment Change 3M/3M	m/m	Apr	113k	84k	135k	**	Equity and bond neutral
AMERICAS								
Brazil	Economic Activity	m/m	Apr	0.4%	-1.6%	1.4%	***	Equity bearish, bond bullish
	Trade Balance Weekly	m/m	13-Jun	$2775m	$2425m		**	Equity and bond neutral
Canada	Bloomberg Nanos Confidence	w/w	11-Jun	66	65.9		**	Equity and bond neutral
	Manufacturing Sales	m/m	Apr	-2.1%	3.5%	-1.1%	**	Equity bearish, bond bullish

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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)	12	12	0	Up
3-mo T-bill yield (bps)	1	2	-1	Neutral
TED spread (bps)	11	10	1	Neutral
U.S. Libor/OIS spread (bps)	8	8	0	Up
10-yr T-note (%)	1.49	1.50	-0.01	Neutral
Euribor/OIS spread (bps)	-55	-55	0	Neutral
EUR/USD 3-mo swap (bps)	4	3	1	Down
Currencies	**Direction**			
dollar	Up			Down
euro	Flat			Up
yen	Down			Up
pound	Down			Up
franc	Flat			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
PCOB Lending Facilities 1 Year Rate	2.950%	2.950%	2.950%	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.

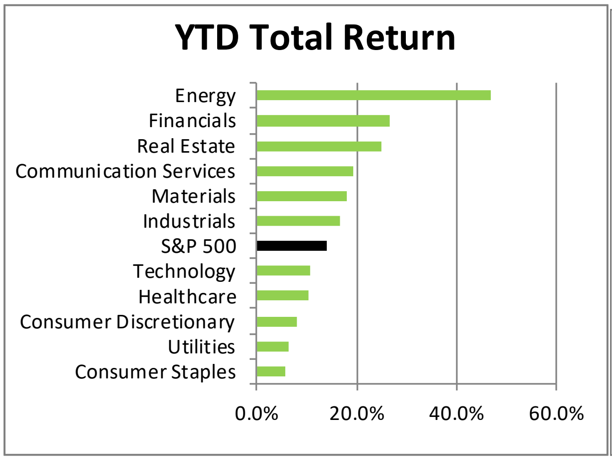
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$73.70	$72.86	1.15%	Rising Global Demand
WTI	$71.84	$70.88	1.35%	
Natural Gas	$3.36	$3.35	0.18%	
Crack Spread	$19.13	$19.49	-1.85%	
12-mo strip crack	$19.39	$19.57	-0.89%	
Ethanol rack	$2.57	$2.59	-0.53%	
Metals				
Gold	$1,865.15	$1,866.18	-0.06%	
Silver	$27.65	$27.86	-0.74%	
Copper contract	$435.60	$452.70	-3.78%	
Grains				
Corn contract	$ 570.50	$ 581.25	-1.85%	
Wheat contract	$ 662.25	$ 679.00	-2.47%	
Soybeans contract	$ 1,387.75	$ 1,395.25	-0.54%	
Shipping				
Baltic Dry Freight	2944	2857	87	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.0		
Gasoline (mb)		2.4		
Distillates (mb)		2.4		
Refinery run rates (%)		0.40%		

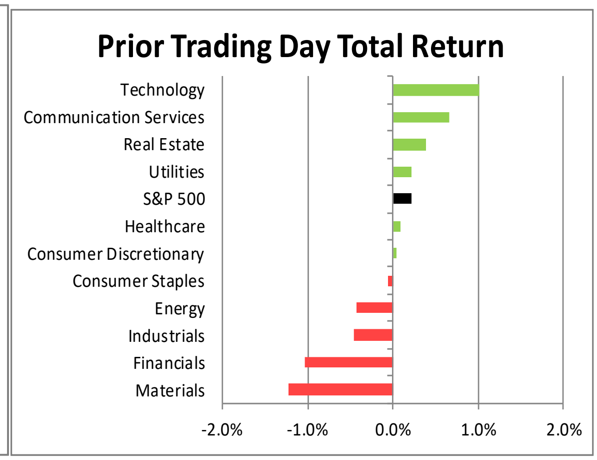
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-to-normal temperatures throughout the country. The forecast calls for wet conditions throughout most of the eastern half of the country, and dry conditions in the Northern Pacific and Rocky Mountain Regions.

Data Section

U.S. Equity Markets – (as of 6/14/2021 close)

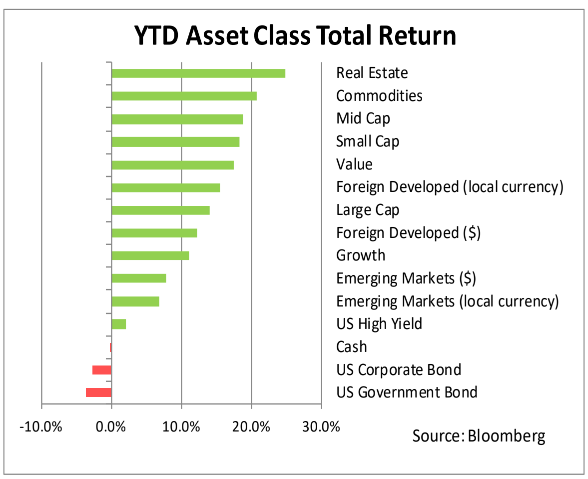




(Source: Bloomberg)

These S&P 500 and sector return charts are designed to provide the reader with an easy overview of the year-to-date and prior trading day total return. Sectors are ranked by total return; green indicating positive and red indicating negative return, along with the overall S&P 500 in black. These charts represent the new sectors following the 2018 sector reconfiguration.

Asset Class Performance – (as of 6/14/2021 close)

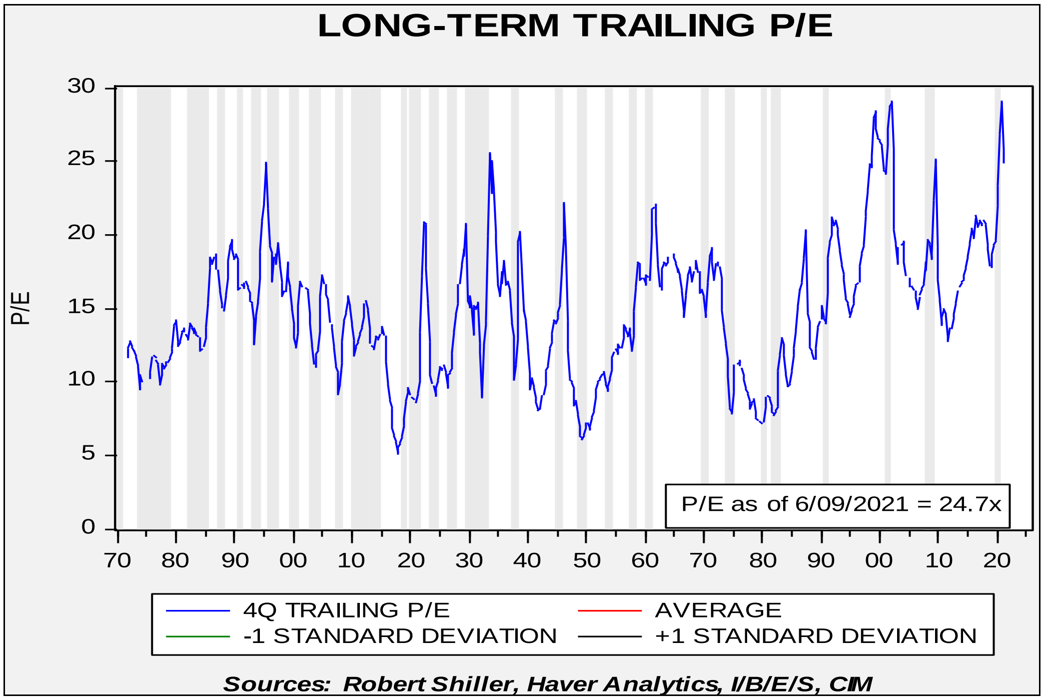


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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), Value (S&P 500 Value), Growth (S&P 500 Growth).

P/E Update

June 10, 2021



Based on our methodology,[1] the current P/E is 24.7x, unchanged from last week.

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 (Q3 and Q4) and two estimates (Q1 and Q2). We take the S&P average for the quarter and divide by the rolling four-quarter sum of earnings to calculate the P/E. This methodology isn't perfect (it will tend to inflate the P/E on a trailing basis and deflate it on a forward basis), but it will also smooth the data and avoid P/E volatility caused by unusual market activity (through the average price process). Why this process? Given the constraints of the long-term data series, this is the best way to create a long-term dataset for P/E ratios.