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 3, 2020—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 1.8% from its last close. In Asia, the MSCI Asia Apex 50 closed up 1.9% from its prior close. Chinese markets were mixed, with the Shanghai Composite up 0.1% from the prior close and the Shenzhen Composite unchanged. U.S. equity index futures are signaling a higher open. With 487 companies having reported, the S&P 500 Q1 earnings stand at $33.60, lower than the $35.51 forecast for the quarter. The forecast reflects a 10.0% decrease from Q1 2019 earnings. Thus far this quarter, 65.5% of the companies have reported earnings above forecast, while 29.8% have reported earnings below forecast.

Our newest podcast episode, "The Long-Term Effects of COVID-19," is available. We continue to build on themes discussed in the previous episode, "The Lessons of History," in which we examined the effects of earlier pandemics. In this episode, we discuss how the COVID-19 pandemic will likely accelerate the reversal of the equality/efficiency cycle toward equality. Deglobalization is a key element of that shift. Although we believe the world has been steadily moving toward equality, this pandemic is moving the process forward. The eventual outcome is higher inflation, although it may take several years for higher price levels to become evident.

Turning to the latest news, it appears the U.S. civil rights protests eased notably last night, but risk assets are rallying today mostly on optimism regarding an eventual coronavirus vaccine, a potential recovery in the economy and labor market, and additional monetary and fiscal stimulus. We discuss all the key developments below.

United States: The latest reports suggest the intense civil rights protests of the last week eased somewhat on Tuesday night, possibly because many cities toughened their curfews and state and local officials began taking action to address protestors' anger over law enforcement practices and a perceived impunity for police brutality. In Minnesota, where the protests first erupted, Governor Tim Walz said the state is launching a civil rights investigation into "systemic discriminatory practices" by the Minneapolis Police Department. State officials also said the economic cost of the violence in Minnesota alone was at least $1 billion, not including the impact of lost jobs and looting. As we've mentioned previously, investors have generally overlooked the violence on the assumption that it will be short-lived. The more salient issue is that the violence could have political implications for the November elections. If the protests continue to ease, the political impact will become less likely.

COVID-19: Official data show confirmed cases have risen to 6,411,023 worldwide, with 380,880 deaths and 2,750,891 recoveries. In the United States, confirmed cases rose to

1,831,821, with 106,181 deaths and 463,868 recoveries. Here is the interactive chart from the *Financial Times* that allows you to compare cases and deaths among countries, scaled by population.

Virology

- The administration's top infectious disease official, Dr. Anthony Fauci, said the ability of the human body to naturally overcome COVID-19, in most cases, is strong evidence that a protective vaccine can be developed for the disease. In fact, he expressed cautious optimism that several successful vaccine candidates would prove effective "within a reasonable period of time." In his view, the key question is how long those vaccines will be effective.
- Still, despite the progress on vaccines and treatments, and falling infections in most major developed countries, cases continue to surge in many large developing countries. India reported a fourth straight day in which new, confirmed cases of COVID-19 exceeded 8,000, bringing the country's cumulative total to more than 200,000.
- In Iran, daily infections have now rebounded almost back to their highs from late March. Despite the rebound in infections, however, Tehran continues to ease the lockdown measures that helped push the caseload lower over the last two months.
- Just weeks after a staggered reopening of schools in Israel, a surge of infections has forced the government to quarantine around 10,000 students and teachers. The outbreak has also pushed the country's new infections to almost 100 cases a day for the first time since early May, close to the threshold at which health officials have indicated some lockdown restrictions would be re-imposed. This development is important because it undermines a growing sentiment around the world that young people's relative lack of susceptibility to COVID-19 means schools and universities can safely reopen.

Real Economy

- Even though the OPEC+ group of oil-producing countries is expected this week to extend its massive output cut of 9.7 million barrels per day to early autumn, Saudi Arabia is reportedly so confident that the cut has helped restore order to the market that it will soon reverse its supplemental cut of 1 million barrels per day. Nevertheless, the expected extension of the baseline cuts continues to buoy crude prices.
- In New Zealand, Prime Minister Ardern released details of a possible loosening of restrictions that would mean the country's businesses could return to normal with no gathering limits or social-distancing requirements as early as June 10.
- Sweden's top epidemiology official, Anders Tegnell, said in an interview that even though the country's relatively light coronavirus lockdown helped minimize the damage to the Swedish economy, the government should have imposed tighter restrictions to avoid having such a high death toll. The government said on Monday that it would appoint a commission to investigate the country's approach to the pandemic, bowing to pressure from opposition politicians.

Financial Markets

- While the U.S. yield curve as measured by the 10-year Treasury versus the two-year note or the three-month bill has recently held steady, with both spreads in the range of 50-60 basis points, the less popular 30-year/five-year spread has widened to almost 120 basis points for the first time since 2017. Traders ascribe the widening to a greater supply of longer-term debt and moderating Fed purchases due to the relative stabilization in the economy.

- Ten weeks after the Fed calmed the corporate bond market by promising to buy up to $750 billion of individual businesses' debt obligations, not a single company has signed up for the program. The Fed's sole purchases in the market have been $3 billion in corporate bond ETFs. Echoing the traditional reluctance of banks to access Fed backstops, it turns out that companies are reluctant to sign up for Fed purchases because such a move could be seen as a sign of weakness during the market's rebound.

U.S. Policy Response

- President Trump will meet this week with his top economic advisors to discuss policy options for the next economic support bill. Although the scope of the plan is still in flux, reports suggest a wide variety of measures are under consideration:
  - One top focus will be on ways to encourage people to go back to work, including a proposal to cut the federally funded enhanced unemployment benefit from $600 per week now to as little as $250 per week through the second half of the year.
  - The administration is also discussing a tourism tax deduction, or credit for people who take a vacation somewhere in the U.S. in the next three to six months.
  - The president and his aides also continue to push proposals for which they have long been advocating, including a payroll tax holiday and a capital gains tax cut.
  - A longer-term priority will be measures to encourage companies to do business in the U.S., including making certain rules permanent that allow firms to deduct the cost of relocating manufacturing operations from China and other countries.

Foreign Policy Response

- As Europe continues to play catch-up with the aggressive monetary and fiscal programs put into place by the U.S. to support the economy during the coronavirus crisis, the ECB is expected to unveil some €500 billion in additional bond purchases at its policy meeting tomorrow. That would boost its total firepower to almost €1.5 trillion, or $1.68 trillion, putting it on a par with the U.S.'s spending plan and setting the stage for the central bank to buy most of the new debt that Eurozone governments will issue this year to fight the crisis.

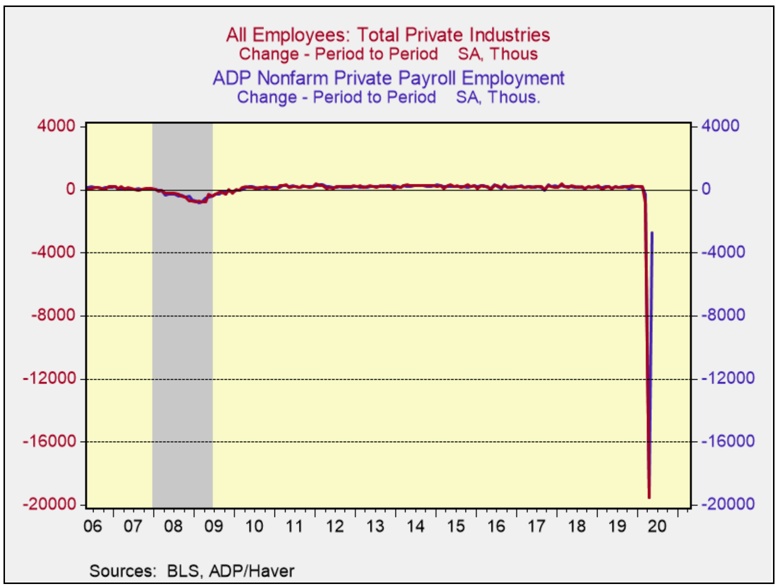
United States-Venezuela: The Trump administration further increased its economic pressure on the Venezuelan government by imposing sanctions on four shipping firms allegedly involved in supplying the country with fuel products.

United States-China: Adding to the general trend of U.S.-China decoupling, Senator Rob Portman (R-Ohio) and Senator Tom Carper (D-Del.) today plan to introduce legislation to stop China and other "malign state actors" from stealing U.S. taxpayer-funded research at universities by enhancing the authority of federal agencies to monitor and punish the schools and scientists.

U.S. Economic Releases

For the week ending May 29, MBA mortgage applications fell 3.9% from the prior week. Applications for home purchases rose 5.3% from the prior week, while refinancing fell 8.6%. The average 30-year fixed rate fell 5 bps from 3.42% to 3.37%.

The ADP employment change came in above expectations at -2.760 million compared to expectations of -9.000 million. The prior month's report was revised from -20.236 million to -19.557 million. Despite this being the second biggest job loss, only beaten by the previous month, this month's report shows sharp improvement in the labor market.



The chart above shows the monthly change in employment payrolls based on BLS and ADP reports. Because the ADP and BLS private payrolls are highly correlated, we expect Friday's BLS report to show a similar slowdown in job losses.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Markit US Services PMI	m/m	May	37.3	36.9	***
9:45	Markit US Composite PMI	m/m	May		36.4	***
10:00	ISM Non-Manufacturing Index	m/m	May	44.4	41.8	**
10:00	Factory Orders	m/m	Apr	-13.4%	-10.3%	***
10:00	Factory Orders Ex Trans	m/m	Apr		-3.7%	**
10:00	Durable Goods Orders	m/m	Apr	-17.2%	-17.2%	**
10:00	Durables Ex Transportation	m/m	Apr	-7.4%	-7.4%	**
10:00	Cap Goods Orders Nondef Ex Air	m/m	Apr	-5.8%	-5.8%	**
10:00	Cap Goods Ship Nondef Ex Air	m/m	Apr		-5.4%	**
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								
China	Caixin China PMI Composite	m/m	May	54.5	47.6		**	Equity bullish, bond bearish
	Caixin China PMI Services	m/m	May	55.0	44.4	47.3	**	Equity bullish, bond bearish
Japan	Jibun Bank Japan PMI Services	m/m	May	26.5	25.3		**	Equity and bond neutral
	Jibun Bank Japan PMI Composite	m/m	May	27.8	27.4		**	Equity and bond neutral
India	Markit India PMI Composite	m/m	May	14.8	7.2		**	Equity and bond neutral
	Markit India PMI Services	m/m	May	12.6	5.4		**	Equity and bond neutral
Australia	AiG Perf of Construction Index	m/m	May	24.9	21.6		**	Equity and bond neutral
	CBA Australia PMI Services	m/m	May	26.9	25.5		**	Equity and bond neutral
	CBA Australia PMI Composite	m/m	May	28.1	26.4		**	Equity and bond neutral
	GDP SA	q/q	1Q	-0.3%	0.5%	-0.4%	**	Equity and bond neutral
	Building Approvals	m/m	Apr	-1.8%	-4.0%	-10.7%	**	Equity and bond neutral
New Zealand	QV House Prices	m/m	May	7.7%	7.1%		**	Equity and bond neutral
Europe								
Eurozone	Markit Eurozone Services PMI	m/m	May	30.5	28.7	28.7	**	Equity bullish, bond bearish
	Markit Eurozone Composite PMI	m/m	May	31.9	30.5	30.5	**	Equity bullish, bond bearish
	PPI	m/m	Apr	-2.0%	-1.5%	-1.8%	**	Equity bullish, bond bearish
	Unemployment Rate	m/m	Apr	7.3%	7.4%	8.2%	***	Equity bullish, bond bearish
France	Markit France Services PMI	m/m	May	31.1	29.4	29.4	**	Equity and bond neutral
	Markit France Composite PMI	m/m	May	32.1	30.5	30.5	**	Equity and bond neutral
Germany	Markit Germany Services PMI	m/m	May	32.6	31.4	31.4	**	Equity and bond neutral
	Markit/BME Germany Composite PMI	m/m	May	32.3	31.4	31.4	**	Equity and bond neutral
	Unemployment Change (000's)	m/m	May	238.0k	373.0k	190.0k	***	Equity and bond neutral
	Unemployment Claims Rate SA	m/m	May	6.3%	5.8%	6.2%	***	Equity bearish, bond bullish
Italy	Markit Italy Services PMI	m/m	May	28.9	10.8	26.1	**	Equity and bond neutral
	Markit Italy Composite PMI	m/m	May	33.9	10.9	28.5	**	Equity and bond neutral
	Unemployment Rate	m/m	Apr	6.3%	8.4%	9.3%	***	Equity bullish, bond bearish
Switzerland	GDP SA	m/m	May	-1.3%	1.5%	-0.9%	***	Equity bearish, bond bullish
Russia	Markit Russia Services PMI	m/m	May	35.9	12.2	21.5	**	Equity bullish, bond bearish
	Markit Russia Composite PMI	m/m	May	35.0	13.9		**	Equity bullish, bond bearish
AMERICAS								
Mexico	International Reserves Weekly	w/w	29-May	$187.316 Mil	$187.172 Mil		**	Equity and bond neutral
Canada	MLI Leading Indicator	m/m	Apr	-2.8%	-1.7%		**	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)	34	34	0	Down
3-mo T-bill yield (bps)	14	15	-1	Neutral
TED spread (bps)	20	20	0	Up
U.S. Libor/OIS spread (bps)	5	5	0	Up
10-yr T-note (%)	0.70	0.69	0.01	Neutral
Euribor/OIS spread (bps)	-33	-33	0	Neutral
EUR/USD 3-mo swap (bps)	13	13	0	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	$39.02	$39.57	-1.39%	Doubt about OPEC cut
WTI	$36.60	$36.81	-0.57%	
Natural Gas	$1.79	$1.78	0.56%	
Crack Spread	$9.48	$9.45	0.34%	
12-mo strip crack	$9.72	$9.70	0.18%	
Ethanol rack	$1.36	$1.36	0.23%	
Metals				
Gold	$1,718.97	$1,727.70	-0.51%	
Silver	$17.90	$18.07	-0.91%	
Copper contract	$248.85	$249.10	-0.10%	
Grains				
Corn contract	$ 322.75	$ 324.25	-0.46%	
Wheat contract	$ 510.75	$ 508.00	0.54%	
Soybeans contract	$ 854.00	$ 850.50	0.41%	
Shipping				
Baltic Dry Freight	546	520	26	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.0		
Gasoline (mb)		-0.4		
Distillates (mb)		3.2		
Refinery run rates (%)		0.9%		
Natural gas (bcf)		109.0		

Weather

The 6-10 and 8-14 day forecasts currently call for warmer temperatures for most of the country, with cool conditions in the northern Pacific region. Precipitation is expected in most of the country, with dry conditions expected for the Southwest and New England regions. Tropical Storm Cristobal is expected to move north across the Gulf of Mexico and will possibly touch down along the U.S. Gulf Coast.

Asset Allocation Weekly

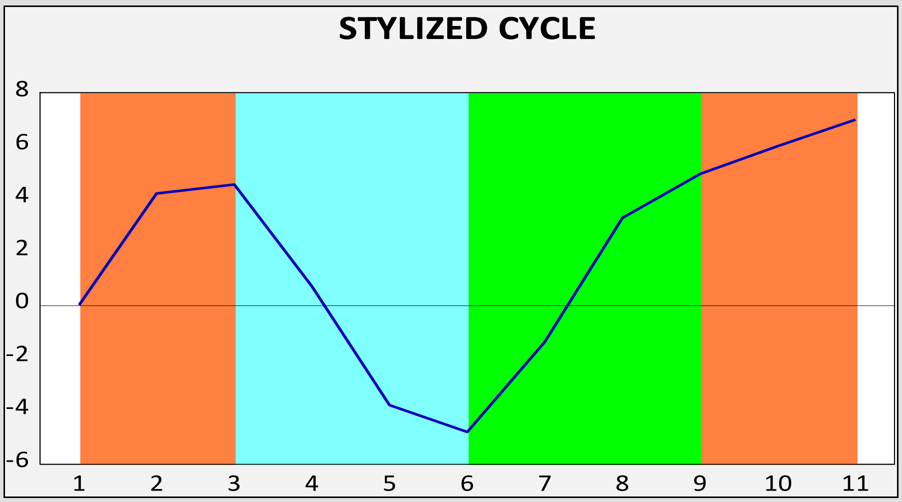
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday. Note that this report is also offered as a separate document on our website.

May 29, 2020

The recent strong rally in equities has befuddled investors—how can equities rally with such vigor when the economy is historically weak? We suspect there are two reasons for this recovery:

1. Although the drop in economic activity is deep, it will likely be short.
2. Supportive monetary policy is a powerful elixir for equities.

Equity markets are forward-looking; investors put their money to work on expectations of future economic conditions and earnings, not based on what is occurring today. The current downturn is historic. The decline in the economy has been very fast and deep, but it will likely be short. In fact, the recovery should begin by midsummer at the latest. We use these words to mean something specific.



This chart shows a stylized path of the business cycle. Orange represents expansion, when the economy is making new peaks in an indicator. This can be GDP, industrial production, coincident indicators, etc. Blue is recession and is measured from peak to trough. Green is recovery, which lasts from trough until a new peak occurs. Finally, once a new peak is made, a new expansion is underway.

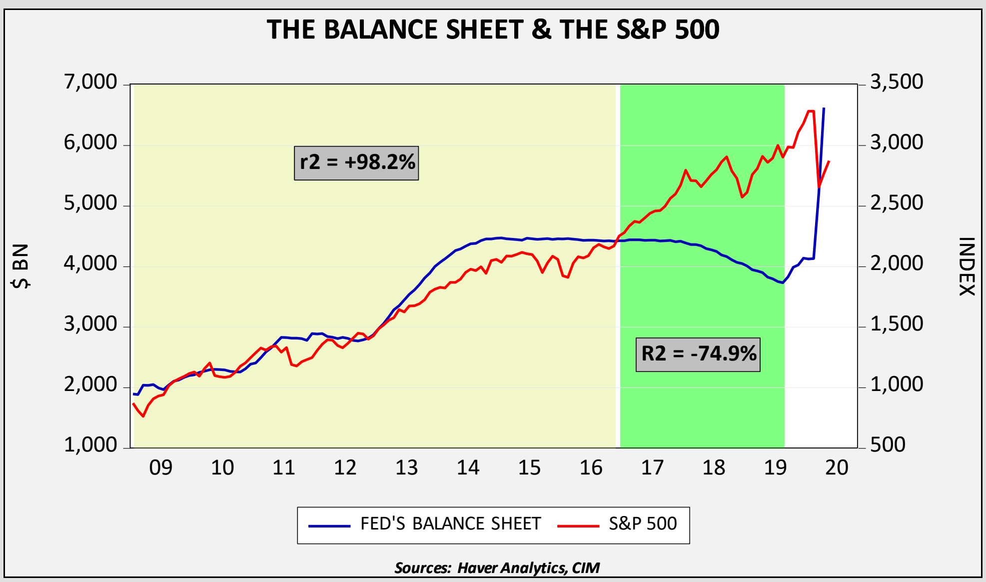
We expect this recession to end quickly because the trough will probably occur in Q2. However, the recovery will be long and likely dictated by the path of the virus. We currently estimate the new expansion will start in H2 2021.

	Peak to recession	high to low %	high to low months	Low after Recession	Low to recovery	Low to recovery %
1948	5	-11.3%	12	7	5	8.5%
1953	6	-12.3%	8	2	9	23.5%
1957	1	-19.6%	5	4	5	11.4%
1960	9	-6.8%	15	6	5	19.1%
1969	13	-16.2%	18	5	7	24.9%
1973	11	-48.0%	22	11	7	35.0%
1980	4	-9.6%	7	3	4	22.9%
1981	8	-26.2%	20	12	5	34.6%
1990	0	-18.3%	3	3	7	26.8%
2001	7	-36.5%	13	6	3	16.3%
2007	2	-56.2%	16	14	5	28.6%
2020	1	-24.0%	1	1		
mean: all	6	-23.7%	12	6	6	22.9%
mean: deep	7	-43.5%	19	12	6	32.8%
mean: normal	6	-16.3%	10	5	6	19.2%

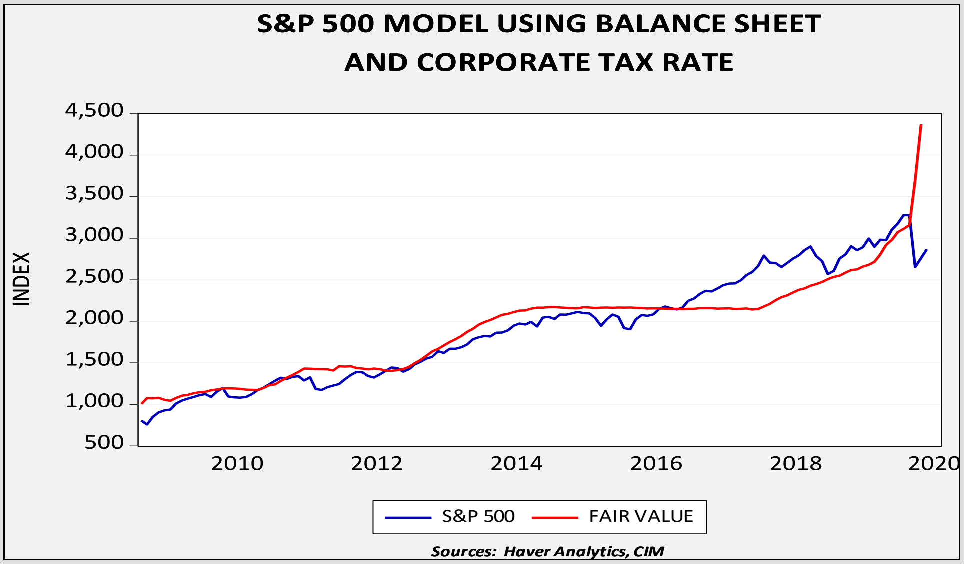
(Data source: Haver Analytics)

This table shows the declines in the S&P 500 for the postwar recessions. On average, equities tend to peak about six months before the onset of the economic downturn, while the low occurs about six months after the peak in economic activity. From the market low to recovery, the S&P 500 usually rebounds by about 20%. But, notice from deep recessions that the rebound from the low is about 33%. The rebound we have witnessed thus far is in line with a deep downturn, but it appears unusual due to the compressed nature of the current recession.

Also noted above are the aggressive actions taken by the FOMC. Below is a chart that will be familiar to regular readers.



From early 2009 until November 2016, the path of the S&P 500 closely matched the Fed's balance sheet. There was always concern that the relation was a spurious correlation, and the behavior from December 2016 into August 2019 suggested it was. However, it is important to note that equities were buoyed by expectations of a massive corporate tax cut. Taking the balance sheet and incorporating the tax cut gives us a model that offers some insight into the impact of current monetary policy.



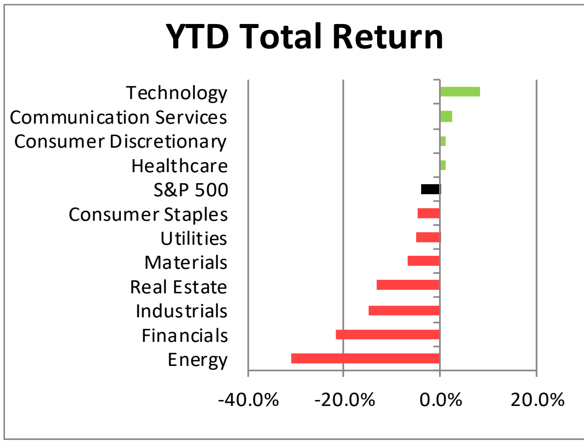
Fair value is derived from smoothing the higher marginal rate of the corporate tax and the balance sheet. Adding the impact of the tax cut accounts for some of the rally in equities. The sharp rise in the fair value in recent months reflects the massive expansion of the balance sheet.

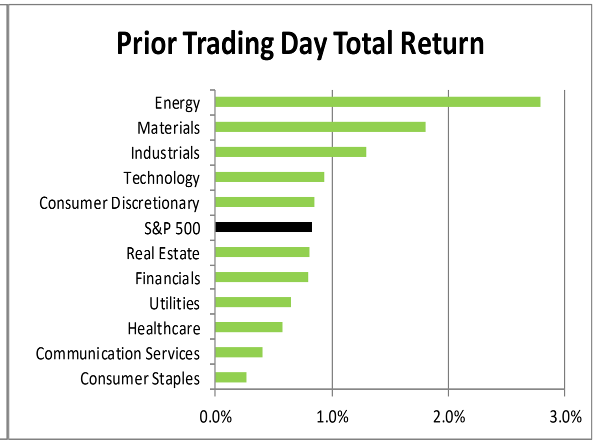
This is not our forecast for the S&P 500, but it does offer some insight into how powerful the Fed's actions have been. We doubt the equity index will track this model due to the level of uncertainty surrounding the path of the economy. Nevertheless, a projected short, sharp downturn coupled with the most rapid increase in the balance sheet since WWII have created strong support for equities that will likely prevent significant corrections, barring a major policy error or an unexpected negative turn in the toxicity of the virus.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

U.S. Equity Markets – (as of 6/2/2020 close)

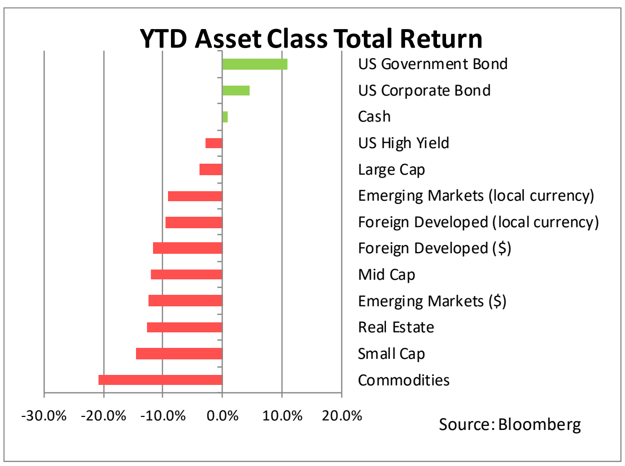




(Source: Bloomberg)

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 6/2/2020 close)

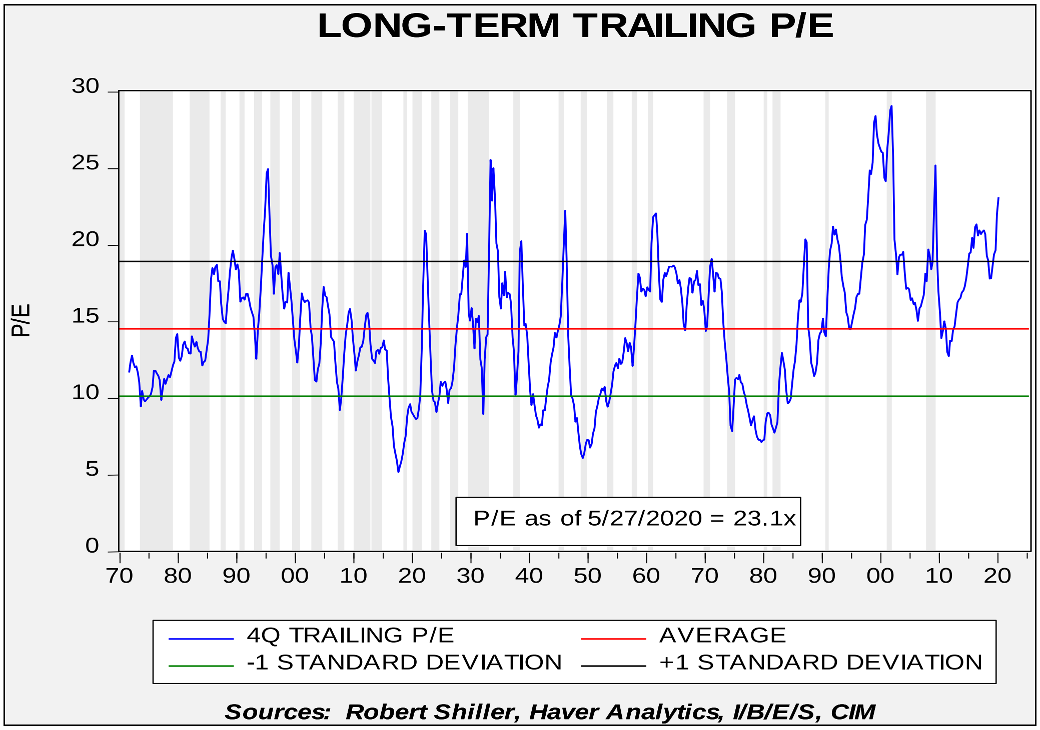


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

May 28, 2020



Based on our methodology,[1] the current P/E is 23.1x, up 0.2x from last week. Rising index values caused the rise in the multiple.

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 three actual quarters (Q3, Q4 and Q1) and one estimate (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.