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 4, 2020—9:30 AM EDT] Global equity markets are generally mixed this morning. The EuroStoxx 50 is down 0.6% from its last close. In Asia, the MSCI Asia Apex 50 closed up 0.5% from its prior close. Chinese markets were mixed, with the Shanghai Composite down 0.1% from the prior close and the Shenzhen Composite up 0.3%. U.S. equity index futures are signaling a lower 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 pushing the process forward. The eventual outcome is higher inflation, although it may take several years for higher price levels to become evident.

Good morning. It's ECB day! The ECB continues to support the EU economy. It's June 4, the 31st anniversary of the Tiananmen Square Massacre; we note China is playing up the current U.S. civil unrest as a counterpoint to Beijing's actions in Hong Kong. Global equities are mostly lower this morning, as risk markets take a breather from recent strength; however, we have seen some recovery on the ECB news. We cover the ECB meeting and look at the latest with China. As usual, we update what we know about COVID-19. We have a new Weekly Energy Update, with a special look at natural gas. Let's get to it…

ECB: In its prepared statement, the European Central Bank announced it will expand its emergency QE by €600 billion. Interest rates remained unchanged. It also said purchases will continue into June 2021. Market reaction was swift; as the global risk-on rally has been supported by central bank action, news of the ECB's move lifted global equities. In something of a surprise, the EUR rallied as well. Usually, QE is bearish for a currency. In the press conference, ECB President Lagarde didn't offer any major surprises

China: Lots of China news:

- On the 31st anniversary of Tiananmen Square, China has reacted by quashing usual memorial ceremonies in Hong Kong. Despite the crackdown in Hong Kong, protests continue and security forces have reacted with arrests. China is deflecting the usual annual criticism by pointing to the current unrest in the U.S.

- PM Johnson has indicated he will admit 3.0 million Hong Kong residents to live in the U.K. with a potential path to citizenship if China implements its national security law. Beijing is not happy with the development.
- One of the features of Hong Kong compared to the rest of China is that the former was less affected by China's "Great Firewall." Tech companies put virtual private networks (VPN) in Hong Kong to prevent Beijing from interfering in internet traffic. There are growing worries that the new national security law will put Hong Kong within the firewall and thus implement censorship. Of course, there are also worries that the new law will stifle free speech.
- So far, China has not reacted strongly to the U.S. actions taken with regard to the national security law. It may be that Beijing wants to see what the U.S. will actually do; if the response remains mild, it may signal that China feels the actions taken by the U.S. are not significant.
- The U.S. has threatened to block Chinese airlines from coming to the U.S. as China has denied American airlines from flying to China. This morning, China relented and will allow limited flights by international carriers.
- It is evident that the Chinese economy has been hit hard by the trade war with the U.S. and the pandemic. Thus far, the policy reaction has been rather subdued. We note that the central government announced it will send money directly to local governments, a sign Beijing is growing worried about slowing growth (and rising unemployment).
- Huawei (002502.SZ, CNY 2.900) has been having a tough run of news recently. As we reported last week, the CFO lost her bid to avoid the extradition process as a Canadian court ruled she must stand for the proceedings. There is confirmation that the company did, in fact, evade U.S. sanctions on Iran (which is why the CFO is under house arrest). The U.K., which was open to restricted use of the company's products in its 5G network, is reversing course in the aftermath of Hong Kong and strong U.S. pressure. All this is bad news for the company.
- China has cancelled some U.S. farm shipments, increasing the odds it will fail to meet its Phase One agreements.
- The U.S. is expected to designate at least four Chinese state-run media companies as foreign embassies, which will restrict reporters' ability to operate.
- A new bill is circulating in the Senate that would restrict foreign access to U.S. research.

Civil unrest: The widespread civil unrest is further delaying the reopening of small businesses.

Foreign news:

- Germany has unveiled a second COVID-19 stimulus package of €130 billion, bringing Germany's total fiscal spending to €1.3 trillion. Given the degree of German stimulus, we will be watching to see if Germany's trade surplus reverses as slower-growth Eurozone nations send exports to Germany. If this continues, it would suggest that

Germany is taking on a regional hegemonic role, a reversal of previous behavior. The EU has been aggressive in spending during this downturn.

- PM Johnson and European Commission President von der Leyen are likely to engage in direct talks to break the current deadlock on a new trade deal.

COVID-19: The number of reported cases is 6,530,067 with 386,392 deaths and 2,820,488 recoveries. In the U.S., there are 1,851,520 confirmed cases with 107,175 deaths and 479,258 recoveries. For those who like to keep score at home, the *FT* has created a nifty interactive chart that allows one to compare cases and fatalities between nations, scaled by population. Axios has updated its U.S. infection map.

- The good news:
    - When thinking about a problem, it is helpful to know more about the issue one is trying to resolve. For the most part, medical researchers have been treating COVID-19 as primarily a respiratory disease. This led to the crash production of ventilators and the search for antiviral medicines. However, there is growing evidence that although the virus spreads through the lungs, the biggest impact may be vascular. The virus's primary impact may be to infect the endothelial cells in blood vessels. When these cells become inflamed, it could lead to microclotting and would explain the wide variety of symptoms. Unlike seasonal flu or SARS, which tend to remain in the lungs, COVID-19 spreads throughout the body, causing damage to kidneys, conditions close to frostbite in toes, and strokes.
        - If this is how the virus works, the best protection may come from ACE inhibitors, statins and blood thinners. There are trials now underway to see if losartan, a common high blood pressure drug, may prevent the worst symptoms of the disease. In other words, if taking cardiovascular medicine prevents fatalities and hospitalizations, we could treat COVID-19 with common drugs and extreme measures to avoid the disease may not be necessary.
    - Scientists are studying patterns to see if there is a genetic basis that might explain the wide variation seen in the reaction to infection. There is evidence to suggest that there are sizeable numbers of asymptomatic cases and, at the same time, fatalities. If a common genetic threat could be found, it may allow for less stringent lockdowns and could help in determining who should get vaccinated before others. A recent European study suggests that having Type A blood increases the likelihood of a more serious reaction to infection.
    - The U.S. has selected five firms as vaccine finalists. Narrowing the list will allow the government to focus its efforts on producing a vaccine once an effective candidate emerges. In related news, Eli Lilly (LLY, 152.53) is testing a new drug that is derived from antibodies developed from patients infected with the virus.
- The bad news:
    - When I was in the Jesuits (Bill talking here), one of "ours," a missionary in Belize, had suffered an auto accident. He recovered from his injuries with one

problem: he had no sense of taste. Although he would get hungry, he was completely indifferent to what he ate. It led to some rather odd dinner situations. The loss of taste and smell is noted as an effect of COVID-19 and some cases indicate the change may be long-lasting.

  - Sweden's social distancing policy was more relaxed than what was seen elsewhere. The primary leader behind that policy has admitted the policy probably wasn't strict enough, allowing for too many fatalities.
  - Recent studies confirm what the anecdotal evidence suggested: nursing homes have been especially hard hit by COVID-19.

Policy news:

- Europe is unveiling new digital services taxes, which the U.S. views as unfairly targeting American tech firms. So, the U.S. is considering tariff retaliation if the EU continues toward implementing such taxes. In related news, the EU is also considering changing the rules for online content, making social media firms accept greater accountability for content.
- The Fed's direct lending program to business has had few takers, in part on borrower concerns of the stigma of taking federal money. Overcoming this issue has been a persistent problem with direct government lending. During the 2008 financial crisis, the Fed and Treasury forced the major banks to take funding to avoid this problem.
- Meanwhile, Illinois has decided to tap the Fed's municipal bond program with an issue of $1.2 billion of one-year notes.
- The DOJ has indicted executives in the chicken processing industry for price fixing. Consumers have been complaining about high meat prices for some time; this move by the government may partially explain why prices have been elevated.

Finance news:

- The Labor Department will allow private equity into 401k programs.
- Japanese regulators are warning banks about their positions in U.S. CLOs. Japanese banks, in a search for yield, own about 20% of this U.S. market. Fears over credit quality triggered the warning.

Economy news:

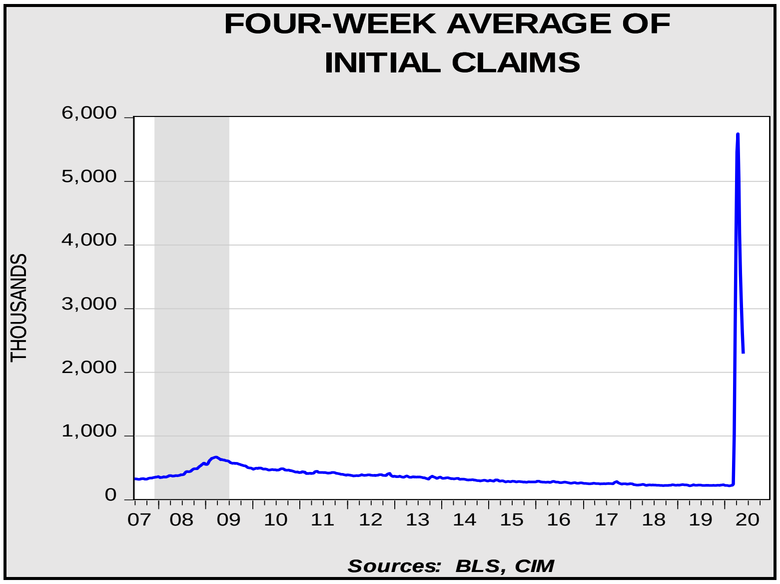
- Although businesses are starting to reopen, factories are finding their supply chains are disrupted, which is hampering their ability to ramp up output.
- As noted before, we continue to closely watch for "gaps" in the supply/payment chain that could disrupt the financial markets. One area of concern is rent payments. Small businesses that have been closed are unable to make their rent. This loss of payment is a risk to landlords, who face their own creditors. We expect that either the Fed or Congress will need to inject funding to support this part of the economy at some point; if support doesn't occur, it may raise the risk of economic disruption.
- Another area of concern is small non-bank lenders; these firms may need to raise capital in the coming weeks or be forced to reduce their lending.

- As the rich world economies weakened, foreign remittances from workers sending money home to the emerging markets have collapsed. This drop is having a negative impact on EM economies.

U.S. Economic Releases

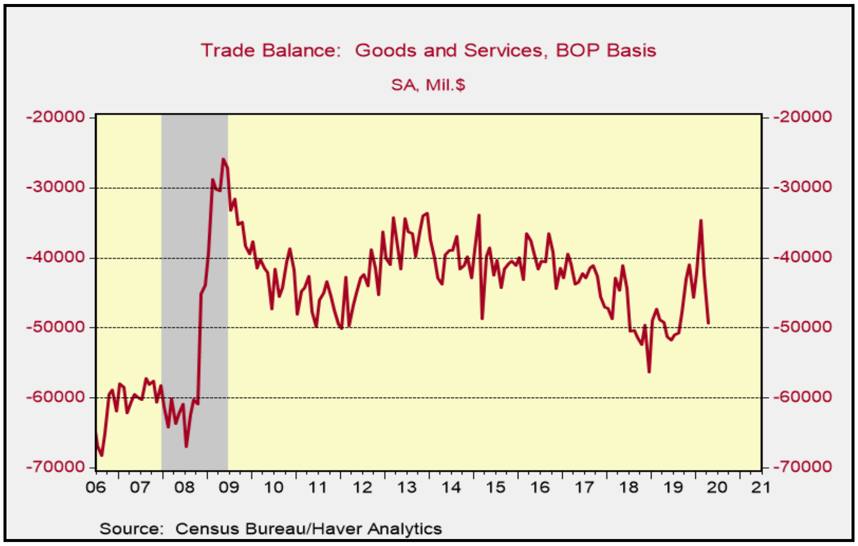
The challenger job cuts rose 577.8% from the prior year. This number reflects the amount of job cut announcements, which does not necessarily translate to the equivalent amount of layoffs.

For the week ending May 30, initial jobless claims came in at 1.877 million compared to expectations of 1.833 million. The high number of initial claims, in spite of a reopening economy, is likely due to the impact the pandemic has had on businesses. At the same time, we are seeing a decline in claims, which does suggest some improvement in the economy.



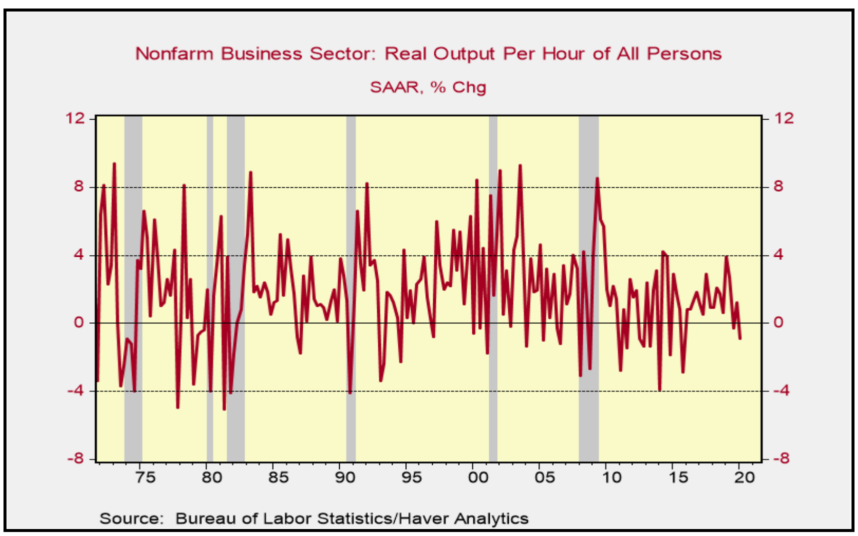
The chart above shows the four-week moving average for initial jobless claims. The four-week average fell from 2.608 million to 2.284 million.

In April, the trade deficit came in line with expectations, widening from $42.3 billion in the previous month to $49.4 billion.



The chart above shows the trade deficit. The widening of the deficit is the result of the decline in exports outweighing the decline in imports. In April, imports fell from $232.5 billion in the previous month to $200.7 billion, while exports fell from $190.2 billion to $151.3 billion.

In Q1, the drop in overall output was greater than the drop of overall employee hours. As a result, nonfarm productivity fell 0.9% annualized compared to expectations of a 2.7% decline.



The chart above shows the annual change in nonfarm productivity.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Consumer Comfort	w/w	31-May		35.5	***
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	Japan Buying Foreign Stocks	w/w	29-May	¥185.2 Bil	¥813.4 Bil		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	29-May	-¥499.3 Bil	-¥432.9 Bil		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	29-May	-¥38.0 Bil	¥75.4 Bil		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	29-May	¥157.9 Bil	¥551.4 Bil		*	Equity and bond neutral
Australia	Trade Balance	m/m	Apr	A$8800 Mil	A$10602 Mil	A$7500 Mil	**	Equity bullish, bond bearish
	Exports	m/m	Apr	-11.0%	15.0%	-14.0%	**	Equity and bond neutral
	Imports	m/m	Apr	-10.0%	-4.0%	-6.0%	**	Equity and bond neutral
	Retail Sales	m/m	Apr	-17.7%	8.5%	-17.9%	**	Equity and bond neutral
New Zealand	ANZ Commodity Price	m/m	May	-0.1%	-1.1%		**	Equity and bond neutral
Europe								
Eurozone	Retail Sales	m/m	May	-11.7%	-11.2%	-15.0%	**	Equity and bond neutral
Germany	Markit Germany Construction	m/m	May	40.1	31.9		**	Equity bullish, bond bearish
UK	New car registrations	m/m	May	-89.0%	-97.3%		*	Equity and bond neutral
	Markit/CIPS UK Construction PMI	m/m	May	28.9	8.2	29.4	**	Equity and bond neutral
Switzerland	CPI	m/m	May	0.00%	-0.40%	0.10%	***	Equity and bond neutral
	CPI EU Harmonized	m/m	May	-0.20%	0.10%		***	Equity and bond neutral
	CPI Core	y/y	May	-0.60%	-0.50%	-0.60%	***	Equity and bond neutral
Russia	Light Vehicle Car Sales	m/m	May	-51.8%	-72.4%	-55.4%	**	Equity and bond neutral
AMERICAS								
Canada	Labor Productivity	q/q	1Q	3.4%	-0.1%	2.0%	**	Equity bullish, bond bearish
Brazil	Industriall Production	m/m	Apr	-18.8%	-9.1%	-28.3%	***	Equity and bond neutral
	Markit Brazil PMI Composite	m/m	May	28.1	26.5		**	Equity and bond neutral
	Markit Brazil PMI Services	m/m	May	27.6	27.4		**	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)	33	34	-1	Down
3-mo T-bill yield (bps)	14	15	-1	Neutral
TED spread (bps)	19	19	0	Up
U.S. Libor/OIS spread (bps)	6	6	0	Up
10-yr T-note (%)	0.74	0.75	-0.01	Neutral
Euribor/OIS spread (bps)	-34	-33	-1	Neutral
EUR/USD 3-mo swap (bps)	14	13	1	Down
Currencies	**Direction**			
dollar	Up			Down
euro	Down			Up
yen	Up			Up
pound	Down			Down
franc	Flat			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Canada Rate Decision	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	$38.82	$39.57	-1.90%	Concerns over OPEC unity
WTI	$35.99	$36.81	-2.23%	
Natural Gas	$1.81	$1.78	1.97%	
Crack Spread	$9.74	$9.45	3.09%	
12-mo strip crack	$9.89	$9.70	1.89%	
Ethanol rack	$1.36	$1.36	0.23%	
Metals				
Gold	$1,721.47	$1,727.70	-0.36%	
Silver	$17.94	$18.07	-0.73%	
Copper contract	$249.05	$249.10	-0.02%	
Grains				
Corn contract	$ 322.25	$ 324.25	-0.62%	
Wheat contract	$ 509.50	$ 508.00	0.30%	
Soybeans contract	$ 853.25	$ 850.50	0.32%	
Shipping				
Baltic Dry Freight	546	520	26	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.1	3.0	-5.1	
Gasoline (mb)	2.8	-0.4	3.1	
Distillates (mb)	9.9	3.2	6.8	
Refinery run rates (%)	0.50%	0.88%	-0.38%	

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

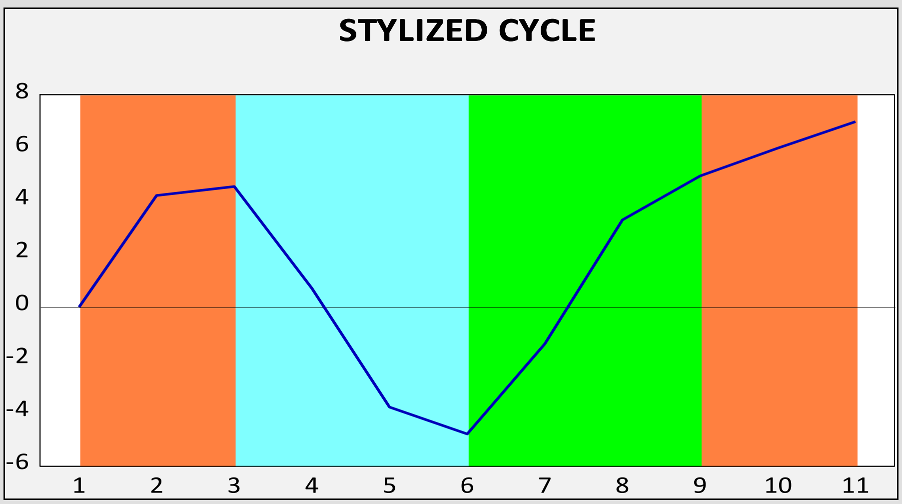
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday. Note that this report is also offered as a separate document on our website.

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.

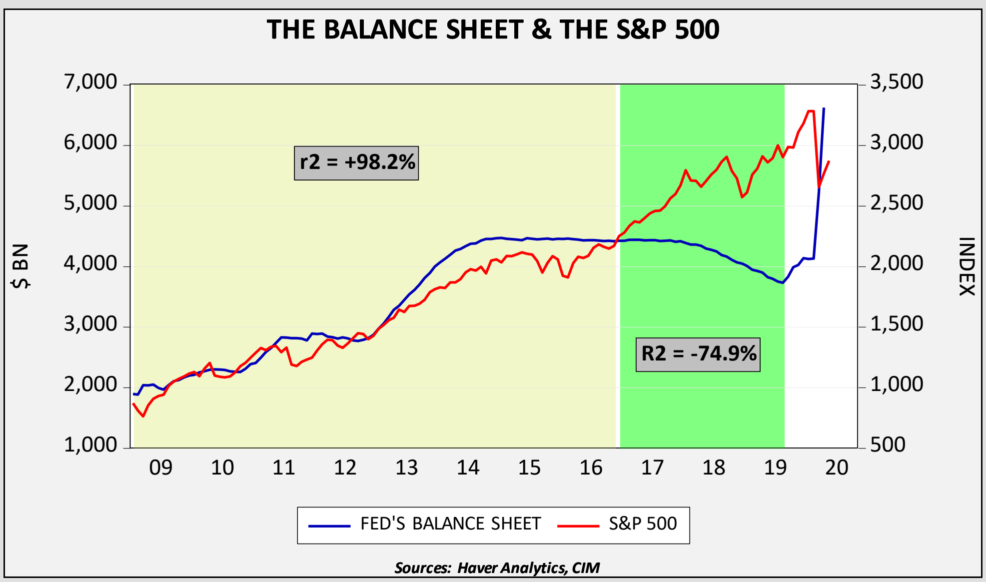
We expect this recession to end quickly because the trough will probably occur in Q2. However, the recovery will be long and likely dictated by the path of the virus. We currently estimate the new expansion will start in H2 2021.

	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%

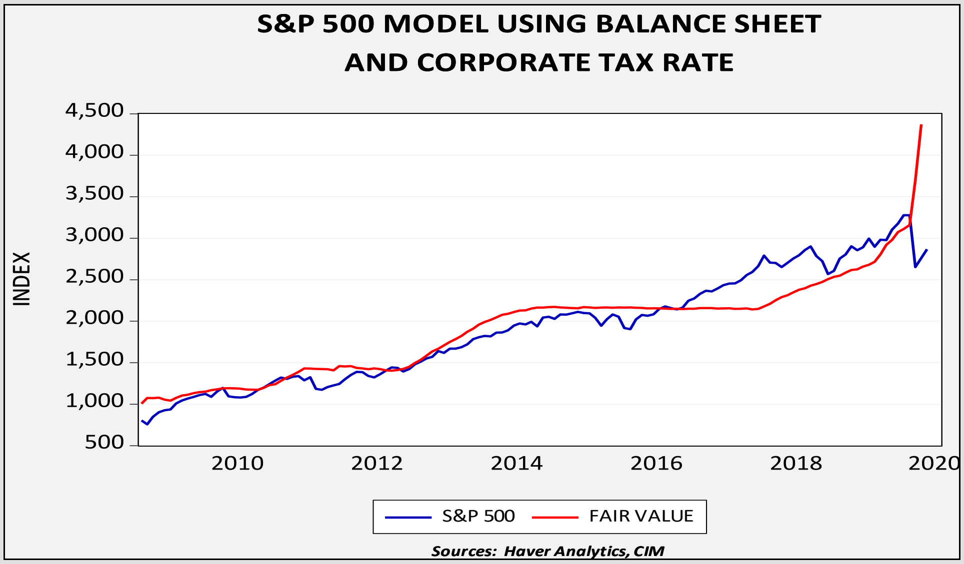
(Data source: Haver Analytics)

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.

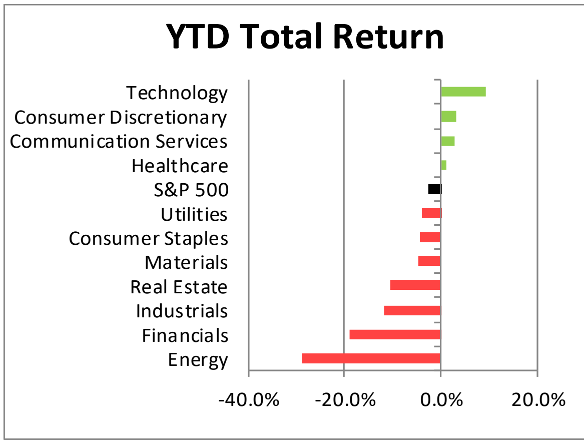


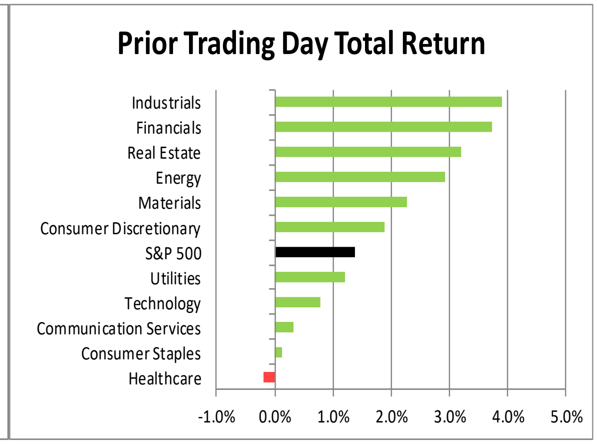
Fair value is derived from smoothing the higher marginal rate of the corporate tax and the balance sheet. Adding the impact of the tax cut accounts for some of the rally in equities. The sharp rise in the fair value in recent months reflects the massive expansion of the balance sheet.

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.

Data Section

U.S. Equity Markets – (as of 6/3/2020 close)

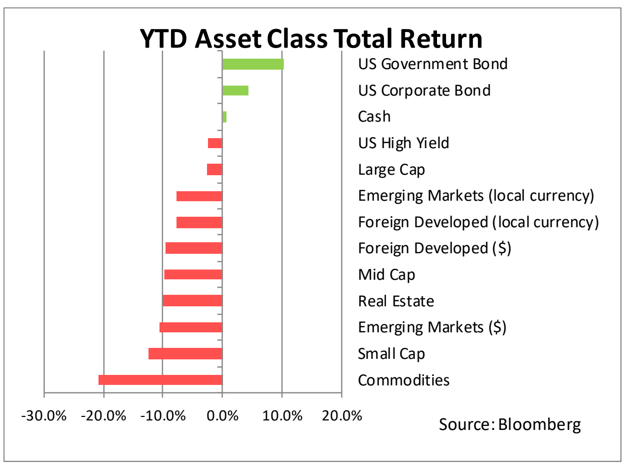




(Source: Bloomberg)

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 6/3/2020 close)

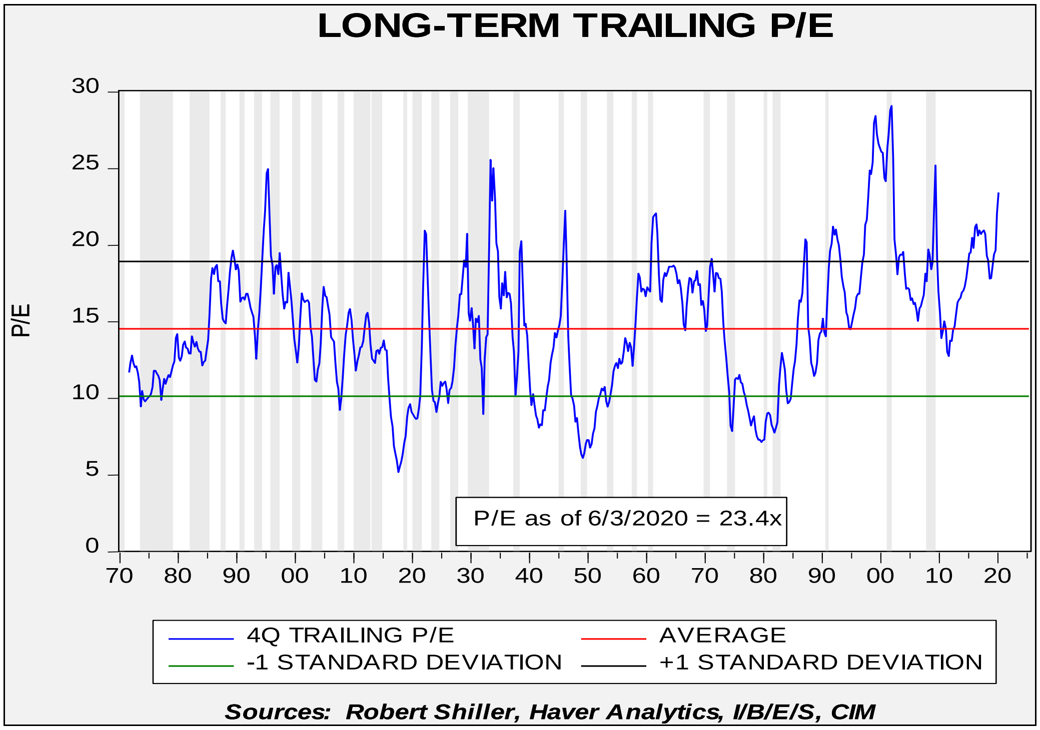


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

June 4, 2020



Based on our methodology,[1] the current P/E is 23.4x, up 0.3x from last week. Rising index values and falling earnings expectations for Q2 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.

[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.