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 8, 2020—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.4% from its last close. In Asia, the MSCI Asia Apex 50 closed up 0.2% from its prior close. Chinese markets were mixed, with the Shanghai Composite up 0.2% from the prior close and the Shenzhen Composite remained relatively unchanged. U.S. equity index futures are signaling a flat open.

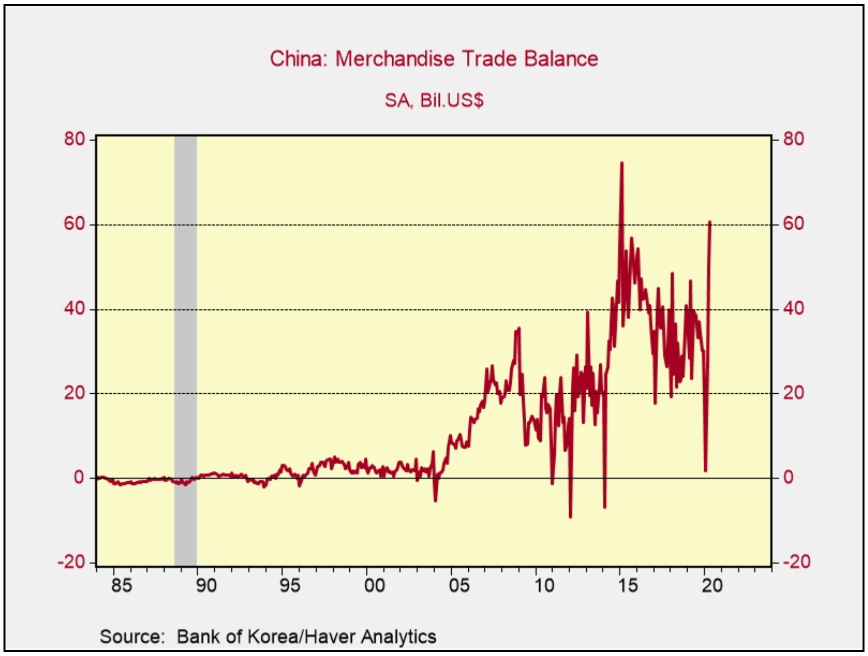
Our newest podcast episode, "The Long-Term Effects of COVID-19," is available. In this episode, we discuss how the COVID-19 pandemic will likely accelerate the reversal of the equality/efficiency cycle toward equality.

Good morning and happy Monday! Global stocks are mixed; Europe is lower on disappointing German data, while U.S. equity futures are ticking higher. Tropical Depression Cristobal hit Louisiana over the weekend and remnants are expected in St. Louis on Tuesday. The Fed meets this week; we will get forecasts and maybe a dots plot. Brexit fears are rising; we look at the looming trade deadline and other European trade issues. We update on China and touch on its trade data. The U.S. is pulling troops from Germany. OPEC+ has a deal and oil prices are higher. We update COVID-19, focusing on U.S. and global reopening from lockdown. Additionally, we have some Monday charts! Here is the update:

Policy news: The Fed meets this week. There is absolutely no mystery on the policy rate; since the FOMC has made it clear it doesn't want negative fed funds, there really isn't more to be done on that front. Instead, we expect the debate to be over yield curve control. This isn't exactly new for the Fed; during WWII, the central bank fixed rates across the entire yield curve to control Treasury borrowing costs. However, the impact of such control would be significant. For example, the Treasury curve would no longer be a forecasting tool; we might be able to use the corporate curve, but even there, one would expect some relationship to the risk-free rate. The other issue we will be watching for are forecasts for the economy and the policy rate. ***The bigger issue here is that if the Fed goes this far, it has essentially ceded its independence.*** It can get it back at some point, but it will be a war because no president wants to be in office when the Fed stops the stimulus. Harry Truman would concur, we suspect.

Brexit and trade: Although the actual exit date isn't until year's end, if the U.K. is going to ask the EU for an extension of Brexit negotiations, it must do so by June 30. By all accounts, PM Johnson has made it clear that he will not ask for an extension, so the odds of a hard break are rising. Trade officials and businesses are beginning to count the costs of a hard border with Europe. A concern has been that British negotiators don't seem clear on what they want from an agreement with the EU. One of the benefits of a hard break is that the U.K. can make trade deals with other nations; Westminster is looking to make a deal with the U.S. in short order. The U.S. has made it clear that such a deal would include U.S. agriculture, including the infamous "chlorine chickens." The issue of the U.S. and EU food regulation and trade is nothing new, but could become an issue when the U.S. and U.K. begin trade talks.

China: A sharp decline in imports offset a drop in exports, expanding China's global trade surplus.



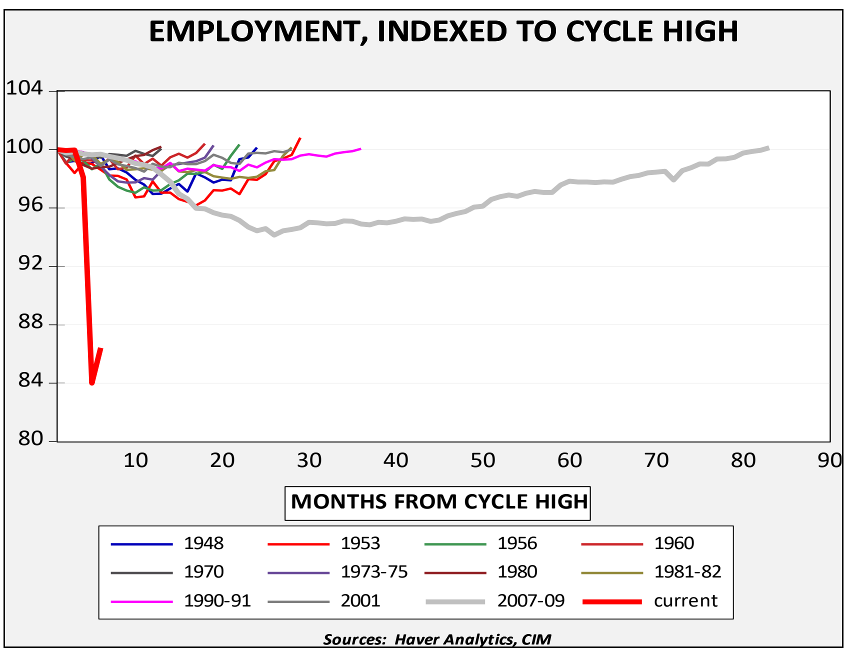
Meanwhile, analysts are questioning China's employment data, suggesting it is painting too rosy a picture of China's recovery. Recent policy statements seem to confirm this notion. Lastly, China's drive to semiconductor self-sufficiency has been lagging badly.

Foreign news: The U.S. announced over the weekend that nine thousand U.S. troops will be leaving Germany. Relations between Berlin and Washington have been strained for some time; while some commentators are suggesting this decision is supportive for Russia, that may not be the case. Poland is hoping that the U.S. will move these forces to its soil. The U.S. is threatening both the EU and China over lobster tariffs. EU support has, for now, reduced financial stress in Italy.

OPEC: As expected, OPEC and Russia have reached a deal to extend supply cuts. Russia and Saudi Arabia were able to corral some of the smaller producers in OPEC, which have been overproducing; of course agreeing is one thing, cutting is another.

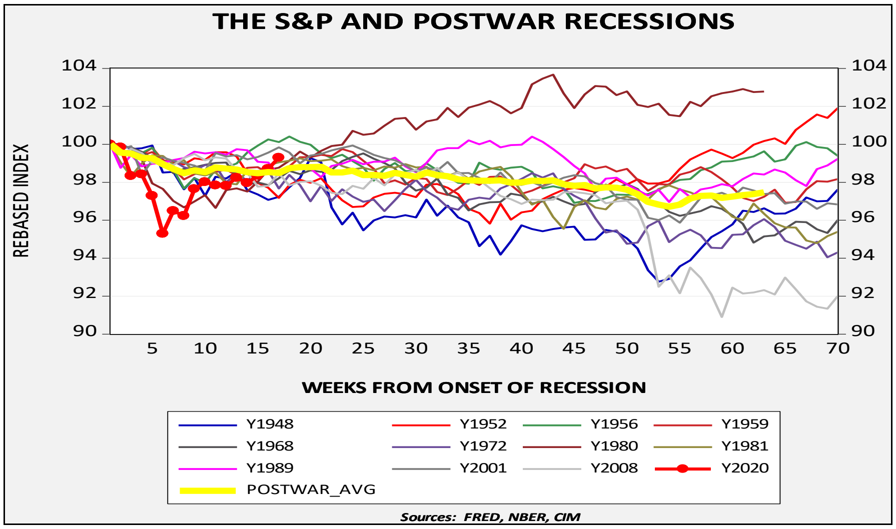
COVID-19: The number of reported cases is 7,036,623 with 403,131 deaths and 3,153,223 recoveries. In the U.S., there are 1,942,363 confirmed cases with 108,211 deaths and 506,367 recoveries. For those who like to keep score at home, the *FT* has created a nifty interactive chart that allows one to compare cases across nations using similar scaling metrics. The news surrounding the virus, across the world, is the next phase of the crisis—the reopening. Europe is easing restrictions; British pubs are scheduled to reopen June 22. As we are seeing in the U.S., there are regional differences, with some European nations opening to all travelers, others creating travel bubbles, allowing free entry of some nations, restrictions from others. Meanwhile, in the U.S., New York is starting to reopen. In the U.S., there is evidence that as social distancing restrictions ease, infections are rising. This should be no surprise. The point of the lockdowns were to control the rise of infections so the health system could cope. However, the economic costs of the lockdowns were high and, barring a mutation in the virus that turns it into something with a fatality ratio similar to smallpox, we doubt we will see broad lockdowns repeated. Thus, the fear of the "rise in autumn" that is often discussed is probably not that great of a risk to the economy. Instead, we expect to see targeted measures, which would protect the most vulnerable from infection while leaving the rest of the economy to normalize. In Brazil, the government is limiting the release of virus data.

Monday charts: Here are three charts we have been working on. First, Friday's employment data raised great hopes that a recovery is underway. We tend to agree with that idea; as we stated in a recent Asset Allocation Weekly, recoveries start when conditions stop getting worse. Given the catastrophic drop in growth, it should be no surprise that conditions are improving. However, it is important not to confuse the trough with the path of the recovery. The economy is in a deep hole that will take a long time to dig out of.

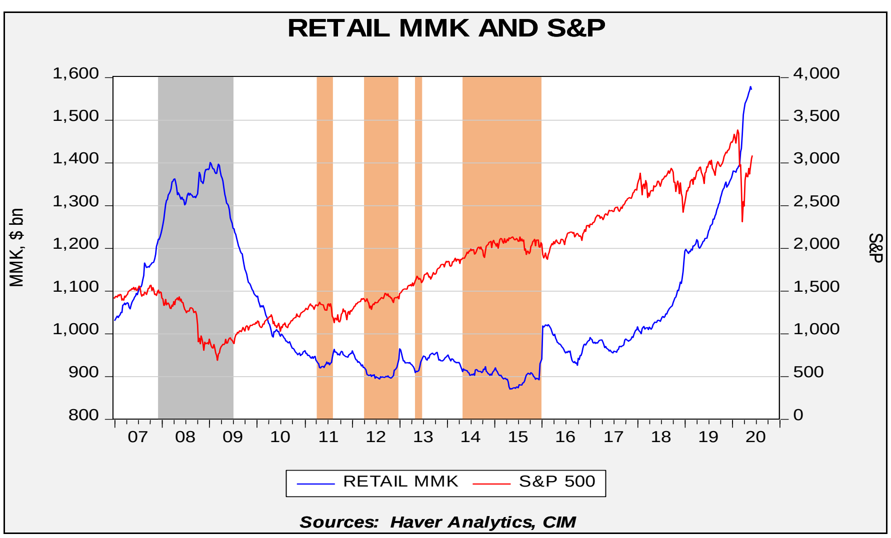


In this chart, we index the level of employment to the peak before the onset of recession. Each recession is measured to see how long it takes before the previous cycle high is met. There is nothing in the postwar experience that matches what we are seeing here. So, if policymakers take Friday's data as a reason to hold off on additional stimulus, it could be an epic mistake.

Meanwhile, the recovery in equities has been surprising. This chart shows the weekly Friday closes from the onset of recession; we rebased the S&P to the market peak prior to the beginning of each recession.



Two things are notable about the current cycle. First, the decline was the fastest in the postwar experience. The cascading decline in February and March was extremely fast. Second, the recovery has been remarkable as well. Only two earlier recessions, the 2001 and 1956, have the index higher than we are currently. The 2001 recession was very mild; the 1956 recession occurred during the Asian flu pandemic, although the drop was mostly attributed to monetary policy. The 1956 recession was very deep but short, which is similar to what we are expecting. Here is a note of caution; the average line shows that sideways performance tends to follow once the initial bounce occurs. We would not be surprised to see markets consolidate at some point. On the other hand, we have never seen this degree of policy support in the postwar world.



Finally, this is the weekly S&P chart compared to retail MMK fund levels[1]; the orange bars show periods where MMK fell below $920 billion, which tended to coincide with market consolidations. We have been noting rising caution among retail investors since 2018 when the trade conflict with China escalated. Even with the strong rally in equities from Q3 2018 into Q3 2019, retail MMK continued to rise. Cash levels have continued to rise through the recent decline and recovery in the S&P. Note that the bull market that began in March 2009 was fueled by a decline in retail MMK; if a similar pattern develops in this cycle, we could see further gains in equities.

U.S. Economic Releases

There were no economic releases or Fed events scheduled prior to the publication of this report.

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.

[1] We are aware that the lack of scaling of MMK does overemphasize the degree of cash levels. The problem is figuring out the proper scaling variable. Using household financial assets is mostly affected by the level of equities; there is no doubt that if we had available data on household assets, it would show a high level of cash. We have also examined consumption, but MMK does behave somewhat differently than overall household cash. In other words, cash held as savings or as a precaution is often kept in checking or saving accounts. MMK seems to be used more by investors, so the rise in MMK is, in our humble opinion, to be more likely to return to stocks or bonds.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
Japan	Bank Lending Incl Trusts YoY	y/y	May	4.8%	3.0%		**	Equity bullish, bond bearish
	Bank Lending Ex-Trusts YoY	y/y	May	5.1%	3.1%		**	Equity bullish, bond bearish
	GDP Annualized SA QoQ	q/q	1Q F	-2.2%	-3.4%	-2.1%	**	Equity and bond neutral
	BoP Current Account Balance	m/m	Apr	¥262.7 Bil	¥1971.0 Bil	¥377.2 Bil	**	Equity and bond neutral
	BoP Current Account Adjusted	m/m	Apr	¥252.4 Bil	¥942.3 Bil	¥331.6 Bil	**	Equity and bond neutral
	Trade Balance BoP Basis	m/m	Apr	-¥966.5 Bil	¥103.1 Bil	-¥965.6 Bil	**	Equity and bond neutral
	Bankruptcies YoY	m/m	May	-54.8%	15.2%		**	Equity bearish, bond bullish
	Eco Watchers Survey Current SA	m/m	May	15.5	7.9	12.1	**	Equity bullish, bond bearish
	Eco Watchers Survey Outlook SA	m/m	May	36.5	16.6	20.2	**	Equity bullish, bond bearish
New Zealand	Volume of All Buildings SA	q/q	1Q	-5.7%	-0.8%	-3.0%	**	Equity bearish, bond bullish
Europe								
Eurozone	Sentix Investor Confidence	m/m	Jun	-24.8	-41.8	-22.0	***	Equity bearish, bond bullish
Germany	Industrial Production	m/m	Apr	-17.9%	-9.2%	-16.5%	***	Equity bearish, bond bullish
Switzerland	Domestic Sight Deposits CHF	m/m	May	594.5 Bil	597.9 Bil		*	Equity and bond neutral
	Total Sight Deposits CHF	m/m	May	680.1 Bil	681.6 Bil		*	Equity and bond neutral
Russia	Wellbeing Fund	m/m	May	$171.9 Bil	$168.4 Bil		*	Equity and bond neutral
AMERICAS								
Mexico	Net Change in Employment	m/m	May	289.6k	-1993.8k	-500.0k	***	Equity bullish, bond bearish
	Hourly Wage Rate	y/y	May	10.0%	10.5%	10.5%	**	Equity and bond neutral
	Full Time Employment Change	m/m	May	219.4	-1472.0		**	Equity and bond neutral
	Part Time Employment Change	m/m	May	70.3	-521.9		***	Equity and bond neutral
	Unemployment Rate	m/m	May	13.7%	13.0%	15.0%	**	Equity bullish, bond bearish
	Participation Rate	m/m	May	61.4%	59.8%	59.1%	**	Equity bullish, bond bearish
	Ivey Purchasing Managers Index SA	m/m	May	39.1	22.8		**	Equity bullish, bond bearish

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)	31	32	-1	Down
3-mo T-bill yield (bps)	15	15	0	Neutral
TED spread (bps)	17	17	0	Up
U.S. Libor/OIS spread (bps)	7	7	0	Up
10-yr T-note (%)	0.91	0.90	0.01	Neutral
Euribor/OIS spread (bps)	-35	-35	0	Neutral
EUR/USD 3-mo swap (bps)	15	14	1	Down
Currencies	**Direction**			
dollar	Up			Down
euro	Down			Up
yen	Up			Up
pound	Down			Down
franc	Flat			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	$41.21	$39.99	3.05%	OPEC agreement
WTI	$38.31	$37.41	2.41%	
Natural Gas	$1.83	$1.82	0.33%	
Crack Spread	$10.37	$9.78	6.06%	
12-mo strip crack	$10.34	$9.89	4.52%	
Ethanol rack	$1.39	$1.38	0.61%	
Metals				
Gold	$1,695.90	$1,685.06	0.64%	
Silver	$17.64	$17.42	1.31%	
Copper contract	$255.30	$255.55	-0.10%	
Grains				
Corn contract	$ 333.75	$ 331.25	0.75%	
Wheat contract	$ 515.50	$ 515.25	0.05%	
Soybeans contract	$ 867.75	$ 867.75	0.00%	
Shipping				
Baltic Dry Freight	679	632	47	

Weather

The 6-10 and 8-14 day forecasts currently call for cooler temperatures for most of the country, with warm conditions expected in the Southwest and Rocky Mountain regions. Precipitation is expected in most of the Northwest region, with dry conditions expected for the rest of the country. Tropical Depression Cristobal made its way to Louisiana over the weekend.

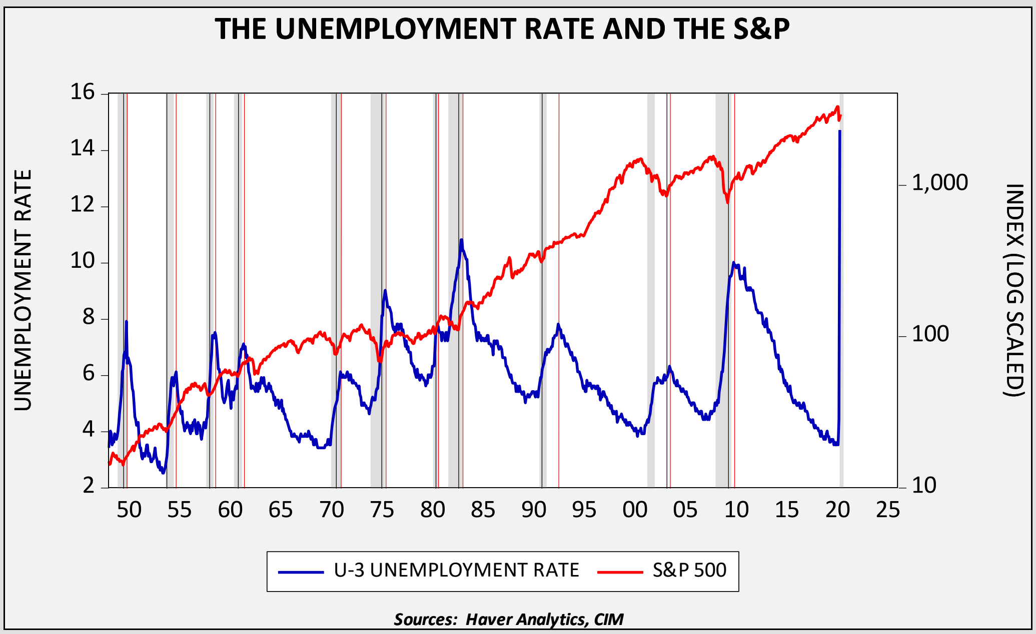
Asset Allocation Weekly

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 5, 2020

Last week, we discussed how equity markets, because of their anticipatory nature, tend to bottom in advance of the end of recessions. Assuming that condition continues, if our expectations for a short recession (but probably a long recovery) are correct, it would make sense that the equity market would have already bottomed. That historical pattern, coupled with extraordinarily supportive monetary policy, is supporting equity values.

The view of the economy for most Americans is the job market. In general, the common belief is that a good economy is one with a good job market. Economists tend to take a broader view and assume that the economy is more than just jobs. And so, when overall economic activity recovers, recessions are declared over. However, there are numerous cases where the economy and equity markets are doing fine, while the labor markets are still sluggish.



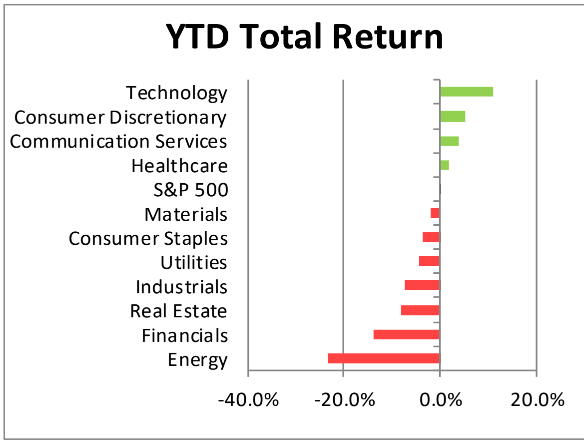
This chart shows the S&P 500 with the unemployment rate. We have placed black vertical lines at the trough of the equity index (using S&P 500 monthly averages) and a red line at the peak of unemployment. Here is a table of the results.

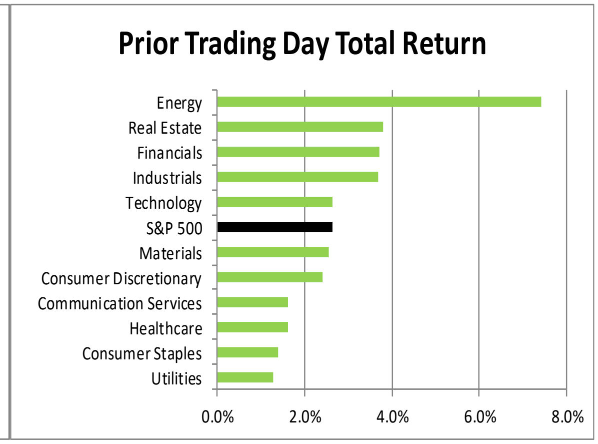
	EQUITY	U=3	
RECESSION	**TROUGH**	**PEAK**	**MONTHS**
1948-49	6/1/1949	10/1/1949	4
1953-54	9/1/1953	8/1/1954	11
1957-58	12/1/1957	7/1/1958	8
1960-61	10/1/1960	5/1/1961	7
1970	6/1/1970	12/1/1970	6
1973-75	12/1/1974	5/1/1975	6
1980	4/1/1980	7/1/1980	3
1981-82	7/1/1982	12/1/1982	5
1990-91	10/1/1990	6/1/1992	20
2001	2/1/2003	6/1/2003	4
2007-09	3/1/2009	10/1/2009	7
2020			
AVERAGE			7

This table shows that equities trough about seven months before the peak of the unemployment rate. Thus, if the unemployment rate has peaked the turn in equity markets seen in recent weeks would be consistent with that pattern. The full recovery in the labor markets will take much longer, but we do expect labor market conditions will steadily improve.

Data Section

U.S. Equity Markets – (as of 6/5/2020 close)

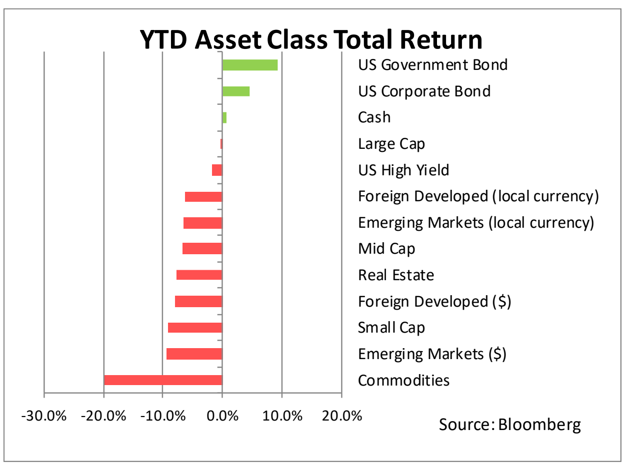




(Source: Bloomberg)

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 6/5/2020 close)

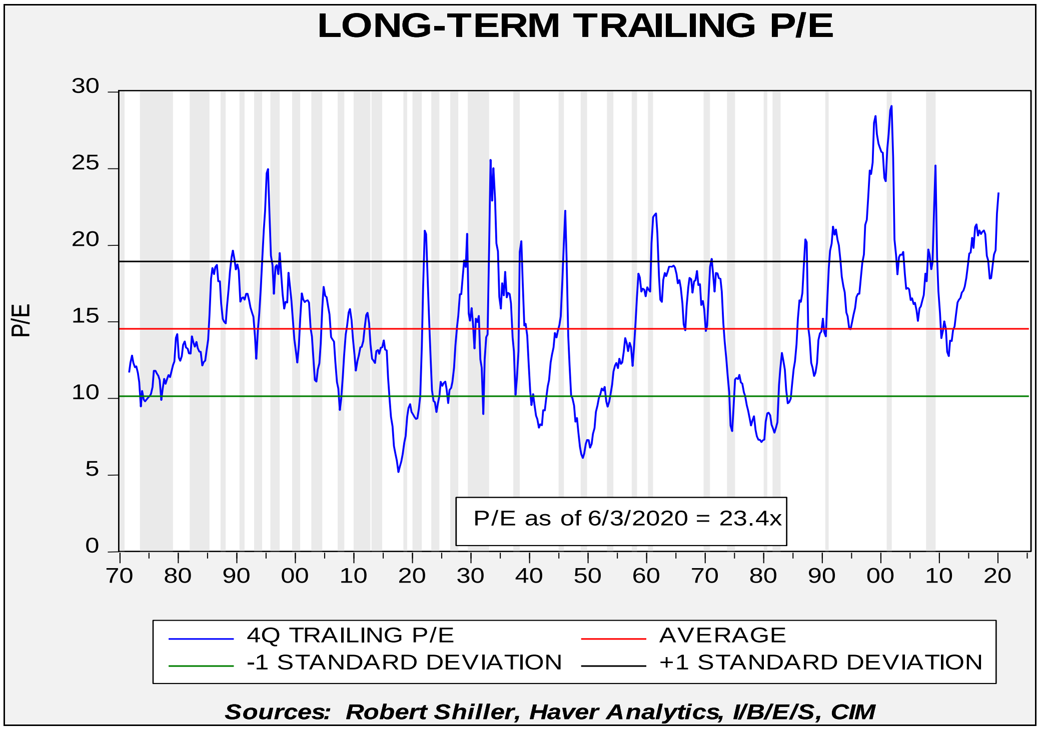


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[2] 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.

[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 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.