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 16, 2020—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 3.0% from its last close. In Asia, the MSCI Asia Apex 50 closed up 2.4% from its prior close. Chinese markets were higher, with the Shanghai Composite up 1.5% from the prior close and the Shenzhen Composite up 1.8%. U.S. equity index futures are signaling a higher open.

Risk assets are on a tear so far today in response to a blockbuster report on U.S. retail sales suggesting that the economy may be rebounding from the coronavirus crisis more rapidly than expected. At the same time, officials across the globe continue to signal more monetary and fiscal stimulus, though geopolitical risks are also rising on the China-India border. As always, we review all the key news below.

United States: Federal Reserve Chair Powell will testify before Congress this morning. While the Fed's recent forecasts calling for a long post-coronavirus recovery have buttressed expectations that monetary policy will remain extremely accommodative, we'll be watching closely for any sign that today's better-than-expected retail sales data may have shifted his views or policy preferences.

COVID-19: Official data show confirmed cases have risen to 8,058,427 worldwide, with 437,473 deaths and 3,893,780 recoveries. In the United States, confirmed cases rose to 2,114,026, with 116,127 deaths and 576,334 recoveries. Here is the interactive chart from the *Financial Times* that allows you to compare cases and deaths among countries, scaled by population.

Virology

- An analysis by the *Wall Street Journal* found that COVID-19 infections are now accelerating again in more than a dozen states. Some of the increase reflects broader testing. However, some of it also appears to reflect increased infection rates, since the share of tests rendering a positive result is increasing in many localities.
    - In spite of the rebound in infections, some localities are no longer aggressively enforcing their social distancing policies.
    - In New York, Governor Cuomo threatened to reverse reopenings in parts of his state that aren't following or enforcing safety rules. According to Cuomo, the state had received 25,000 reports of reopening violations, predominantly in Manhattan and the Hamptons on Long Island.

- The Department of Transportation said it would allow Chinese airlines to make a total of four round-trip flights per week, doubling the level it had set earlier this month after China backed off its plan to limit U.S. carriers to just two weekly flights each. The news is positive for the financial markets because it suggests the two countries may be trying to cool tensions.
- The FDA said it has revoked its emergency-use authorization for the anti-malaria drugs chloroquine and hydroxychloroquine for the treatment of COVID-19.
    - The decision was apparently based on recent clinical studies that have failed to show the drugs are effective in treating or preventing the disease.
    - Those studies are separate from another recent report showing both a lack of effectiveness and a risk of heart problems and death, which was subsequently retracted because of inconsistencies in the data.

Real Economy

- In its monthly oil-market report, the International Energy Agency said that while the world's demand for crude oil will drop by 8.1 million barrels a day this year (slightly less than forecast in last month's report), demand in 2021 will rebound by a record 5.7 million barrels a day. Coupled with the current massive production cuts by major producing countries, the IEA said the rebound in demand could help rebalance the global oil market by late next year.

U.S. Policy Response

- The Fed announced moves to significantly broaden its Secondary Market Corporate Credit Facility beyond its current focus on corporate bond ETFs. Starting Tuesday, the Fed will also buy individual corporate bonds based on a broad, diversified index of U.S. corporate obligations. The target index would consist of substantially all corporate bonds in the secondary market that: a) were issued by U.S. firms rated as investment-grade in late March, and b) have a maturity of five years or less.
    - The Fed said it would recalculate its "broad market index" every four or five weeks to add bonds that newly meet the eligibility requirements and to remove those that no longer meet them. Going forward, purchases of ETF shares would be limited to 20% of any given fund.
    - The moves would give the Fed greater flexibility to ramp up purchases if the markets seize up again. The announcement underlines the Fed's commitment to aggressively support the economy amidst the virus crisis, which we think is a significant positive for equities.
- The Fed also outlined a proposal to include nonprofit organizations in its previously introduced Main Street Lending Program for small and mid-sized businesses disrupted by the pandemic. The central bank indicated it wants the nonprofit loan terms to be broadly similar to the MSLP's five-year maturities at a rate of 3% above short-term rates.
- Finally, in the realm of fiscal policy, the Trump administration is reportedly considering a $1 trillion infrastructure program to help jumpstart the economic recovery.

Foreign Policy Response

- In a move that would align the ECB's monetary policies more closely with the Fed's policies, ECB Executive Director Fabio Panetta offered assurances that his central bank would consider buying "fallen angel" bonds that have recently lost their investment-grade rating, if necessary, to combat the financial fallout from the coronavirus crisis. Even though the ECB increased the size of its bond-buying program to €1.35 trillion earlier this month, Panetta said it still hasn't unleashed the "full monty" of its available stimulus.

European Union-United Kingdom: In their video summit yesterday, top leaders from the U.K. and the EU agreed to redouble their efforts to strike a post-Brexit trade deal in the coming weeks. The surprisingly cordial post-summit statements from the likes of British Prime Minister Johnson and European Council President Michel are reassuring, but we note that there is still some risk that the two sides won't come to an agreement and Britain could be facing a sudden stop in its trade with the EU at the end of the year. Naturally, such a hard break would be negative for European, and particularly British, stocks.

United States-European Union: Following a preliminary investigation, the European Commission said it has opened two formal antitrust investigations into Apple (AAPL, 342.99). The investigations will look into the company's practice of charging media firms' large commissions to sell their products through its App Store and Apple Pay payment system, even as it uses the information gleaned to promote its own music and book services. The launch of yet another regulatory move against a major U.S. technology firm is likely to further sour U.S.-EU relations. The move is also likely to sit badly with Washington because, at the same time, the EU is loosening its state-aid rules to make it easier for member governments to help their own tech start-ups.

United States-China: As more evidence of cooling U.S.-China tensions, the Department of Commerce yesterday slightly loosened its sanctions against Chinese telecom equipment giant Huawei (002502.SZ, 2.87). The move will allow U.S. firms to collaborate with Huawei on setting technical standards for 5G and other emerging technologies. Separately, U.S. Secretary of State Pompeo and Chinese Foreign Minister Yang Jiechi will meet tomorrow in Hawaii.

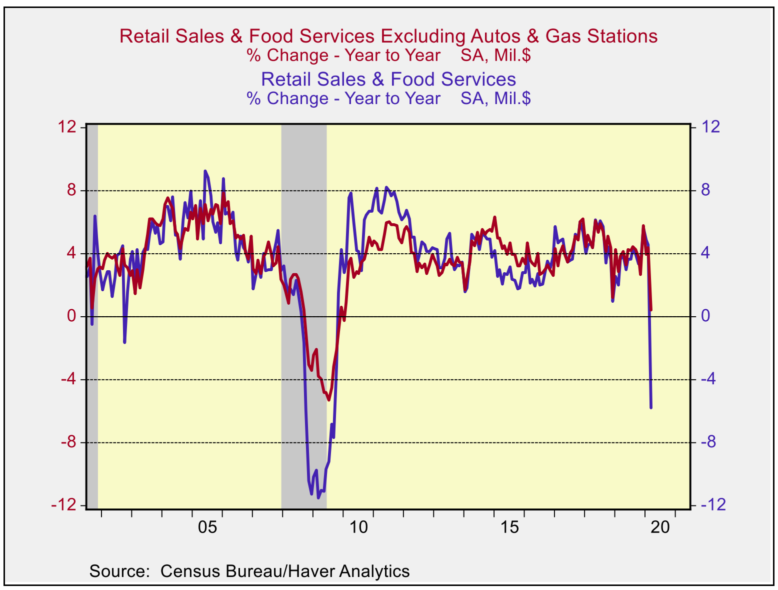
China-India: In a dangerous escalation of tensions, the Indian military said three of its soldiers have been killed in clashes with Chinese troops along the countries' disputed border high in the Himalayan mountains. The deaths, which were the first since the 1970s in the two countries' long-running border dispute, came despite multiple rounds of talks by Indian and Chinese military commanders intended to de-escalate tensions. Those talks had pointed to some easing in the latest round of tensions, but the surprising deaths are a sign that things aren't going as well as previously thought. Therefore, the news has weighed on Indian stocks so far today.

North Korea: In a dramatic display of its frustration with the stalled denuclearization talks and continued sanctions, North Korea has blown up the inter-Korean liaison office near the country's border with South Korea. The explosion came just hours after North Korea said via state media that its military would potentially enter border areas that had been disarmed after a 2018 summit between Kim Jong Un and South Korean President Moon Jae-in.

U.S. Economic Releases

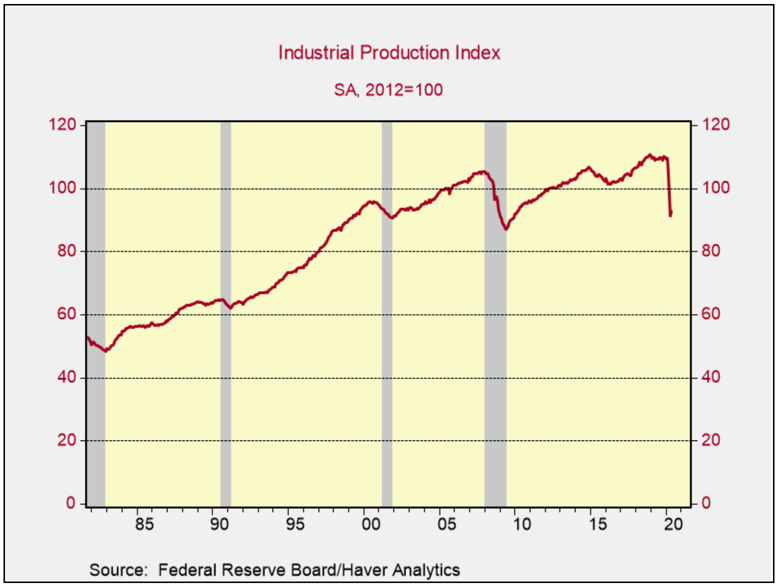
As expected, retail sales bounced back as consumers were able to finally return to shopping following several weeks of lockdown. Revisions showed that the April report slightly exaggerated the decline in sales. A large reason for the jump in sales is due to an increase in auto and restaurant receipts as consumers felt comfortable splurging following the lockdown. Together, autos and restaurants accounted for more than half of the overall gain.

In May, the advance report shows that retail sales rose 17.7% from the prior month compared to expectations of a rise of 8.4%. The previous month's report was revised from -16.4% to -14.7%. Excluding gas, retail sales rose 12.4% from the prior month compared to expectations of a 5.5% rise. The previous report was revised from -17.2% to -15.2%. Meanwhile, retail sales excluding autos and gas rose 12.4% from the prior month compared to expectations of a rise of 5.2%. The previous report was revised from -16.2% to -14.4%. Lastly, the retail sales control group, which excludes autos, gas and building supplies, rose 11.0% from the prior month compared to expectations of a rise of 5.1%. The previous month's report was revised from -15.3% to -12.4%.



The chart above shows the annual change in retail sales and retail sales excluding autos and gas. Although retail sales fell 5.8% from the prior year, this was largely due to a substantial drop in sales at gas stations. Retail sales excluding autos and gas stations rose 0.3% from the prior year.

Industrial production rose 1.4% from the prior month compared to expectations of a rise of 3.0%. The prior report was revised downward from -11.2% to -12.5%. Capacity utilization rose from 64.0% to 64.8%.



The chart above shows the historical level of the industrial production index. The index increased from 91.3 to 92.6.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Business Inventories	m/m	Apr	-1.0%	-0.2%	**
10:00	NAHB Housing Market Index	m/m	Jun	45.0	37.0	**
Fed Speakers or Events						
	Speaker or event	**District or position**				
10:00	Jerome Powell Delivers Semi-Annual Report to Senate Panel	Chairman of Board of Governors of Federal Reserve				
12:30	Richard Clarida Discusses Economic and Policy Outlook	Vice Chairman of Board of Governors of Federal Reserve				

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								
India	Trade Balance	m/m	May	-$3.150 Bil	-$6.760 Bil	-$7.050 Bil	**	Equity bullish, bond bearish
Australia	ANZ Roy Morgan Weekly Consumption	w/w	14-Jun	97.5	97.0		***	Equity bullish, bond bearish
	House Price Index	y/y	1Q	7.4%	2.5%	8.1%	**	Equity and bond neutral
New Zealand	Westpac Consumer Confidence	q/q	2Q	97.2	104.2		**	Equity bearish, bond bullish
Europe								
Eurozone	Labour Costs	q/q	1Q	3.4%	2.4%		***	Equity and bond neutral
	ZEW Survey Expectations	m/m	Jun	58.6	46.0		***	Equity and bond neutral
Germany	Wholesale Price Index	y/y	May	-4.3%	-3.5%		**	Equity and bond neutral
	CPI EU Harmonized	y/y	May	0.5%	0.5%	0.5%	***	Equity and bond neutral
	CPI	y/y	May	0.6%	0.6%	0.6%	***	Equity and bond neutral
	ZEW Survey Expectations	m/m	Jun	63.4	51.0	60.0	**	Equity bullish, bond bearish
	ZEW Survey Current Situation	m/m	Jun	-83.1	-93.5	-82.0	**	Equity bearish, bond bullish
UK	Claimant Count Rate	m/m	May	7.8%	5.8%		***	Equity bearish, bond bullish
	Jobless Claims Change	m/m	May	528.9k	856.5k		***	Equity and bond neutral
	Average Weekly Earnings 3M	y/y	Apr	1.0%	2.4%	1.3%	**	Equity bearish, bond bullish
	Weekly Earnings ex Bonus 3M	y/y	Apr	1.7%	2.7%	1.9%	**	Equity bearish, bond bullish
	ILO Unemployment Rate 3Mths	m/m	Apr	3.9%	3.9%	4.7%	**	Equity and bond neutral
	Employment Change	m/m	Apr	6k	210k	-110k	**	Equity and bond neutral
AMERICAS								
Canada	Manufacturing Sales	m/m	Apr	-28.5%	-9.2%	-20.0%	**	Equity and bond neutral
	Existing Home Sales	m/m	May	56.9%	-56.8%		**	Equity bullish, bond bearish
Brazil	Trade Balance Weekly	w/w	14-Jun	$1.599 Bill	$1.787 Bil		**	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)	32	31	1	Down
3-mo T-bill yield (bps)	14	16	-2	Neutral
TED spread (bps)	18	15	3	Up
U.S. Libor/OIS spread (bps)	9	9	0	Up
10-yr T-note (%)	0.73	0.72	0.01	Neutral
Euribor/OIS spread (bps)	-37	-36	-1	Neutral
EUR/USD 3-mo swap (bps)	19	19	0	Down
Currencies	**Direction**			
dollar	Flat			Down
euro	Flat			Up
yen	Flat			Up
pound	Flat			Down
franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
BOJ Policy Balance Rate	-0.100%	-0.100%	-0.100%	On forecast
BOJ 10-yr Yield Target	0.000%	0.000%	0.000%	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	$40.37	$39.72	1.64%	Economic Optimism
WTI	$37.66	$37.12	1.45%	
Natural Gas	$1.66	$1.67	-0.54%	
Crack Spread	$11.90	$11.66	2.08%	
12-mo strip crack	$11.03	$10.95	0.74%	
Ethanol rack	$1.42	$1.42	0.49%	
Metals				
Gold	$1,731.38	$1,725.16	0.36%	
Silver	$17.44	$17.38	0.32%	
Copper contract	$261.80	$258.75	1.18%	
Grains				
Corn contract	$ 337.50	$ 333.75	1.12%	
Wheat contract	$ 510.25	$ 509.75	0.10%	
Soybeans contract	$ 878.75	$ 876.00	0.31%	
Shipping				
Baltic Dry Freight	973	923	50	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		0.8		
Gasoline (mb)		-1.0		
Distillates (mb)		3.0		
Refinery run rates (%)		0.50%		

Weather

The 6-10 and 8-14 day forecasts currently call for warmer temperatures for most of the country, with cool conditions expected in the Rocky Mountains region. Dry conditions are expected for the majority of the country. There is some cyclone formation along the Carolina coast, but it is not expected to develop into a tropical storm.

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 12, 2020

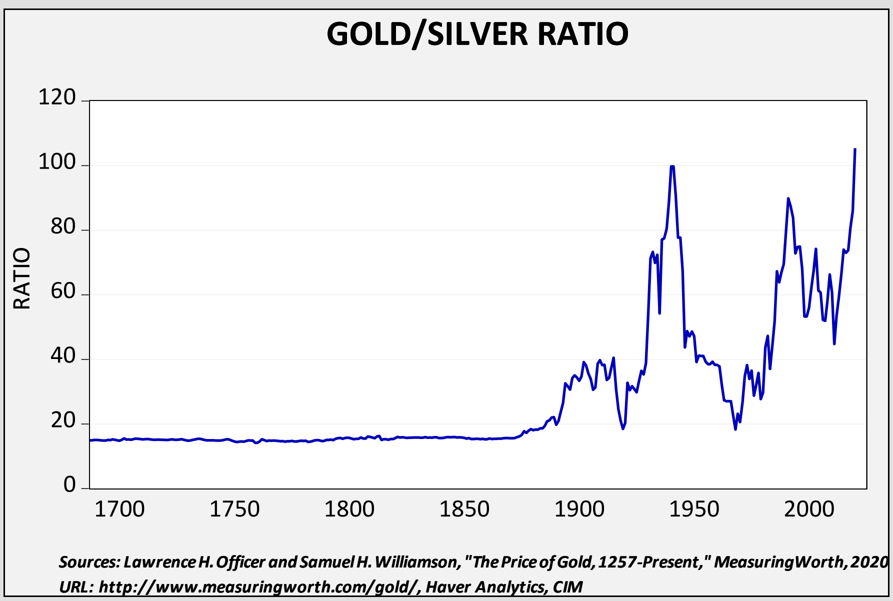
Although gold is the primary precious metal for investors, platinum, palladium and silver also can fulfill that role. Complicating matters is that these three metals are dual-use products. Unlike gold, which has few uses outside of monetary (store of value) purposes and jewelry, these other three have industrial uses as well. About 55% of silver consumption is in electronics, while 39% is used for jewelry, silverware and monetary reasons. The remaining 6% of silver consumption is in associated industrial use, including solar panels. Industry and automotive demand accounts for about 60% of platinum demand, with jewelry absorbing about 30% and investment demand the remainder. Palladium, which has been in the news lately due to strong price behavior, is mostly used in automobile exhaust systems; nearly 84% of the metal goes into cars, with other industrial uses taking up nearly all the remaining demand.

Thus, unlike gold, the other three precious metals are much more sensitive to industrial activity. Supply factors are different as well. Silver is mostly a byproduct of base metal and precious metal mining; only about 28% of silver comes from primary silver mines. The rest comes from the mining activities of lead, zinc, copper and gold. Thus, the supply of new silver is affected by the demand for these other metals. In contrast, platinum and palladium both have limited sources; nearly 75% of new supply of platinum comes from South Africa, whereas 40% of the world's palladium comes from Russia.

Both gold and silver prices began to rally in the early part of the 2000s after being in the doldrums from the mid-1980s through the 1990s. High real interest rates depressed demand as policy was designed to contain inflation. But, around 2003, gold began to rally, and by 2005, silver did as well. This rally continued into 2011 when silver prices began to fall, and gold followed in 2012. A stronger dollar weighed on precious metals prices during this period.

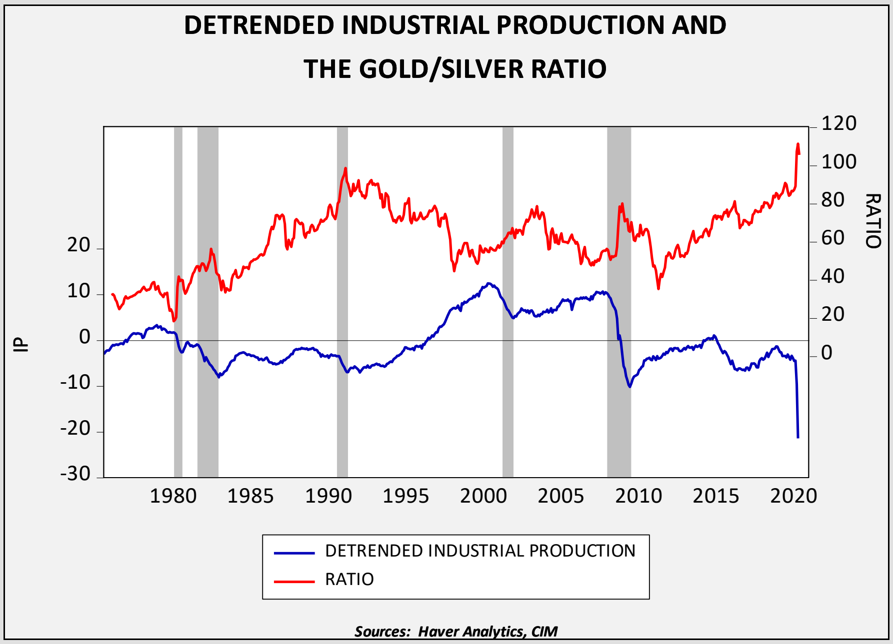
Since 2017, gold prices have clearly outpaced silver, but since August 2018, gold's outperformance has been substantial.

The gold/silver ratio has been a longstanding way of measuring the relative value of the two metals.



During the gold standard years, many nations conducted a bimetallic system, where gold and silver could be used for money. The common exchange was 15:1. The relative scarcity of gold relative to silver led to a widening ratio after the Civil War into WWI. During WWI, silver prices rose due to expanding industrial activity for the war effort. The change in the official price of gold by the Roosevelt administration led the ratio to widen out during the 1930s into WWII. Steadily rising silver prices reduced the ratio to 20:1 by late 1960; in response, the Coinage Act of 1965 dramatically reduced the use of silver in U.S. coins, easing the demand for silver and causing the ratio to rise.

The end of Bretton Woods ended the last remnants of the gold standard, leading to much higher prices for both metals. Since the mid-1970s, the gold/silver ratio has generally tracked the path of industrial production. This relationship reflects the industrial demand for silver that doesn't exist to the same extent for gold.

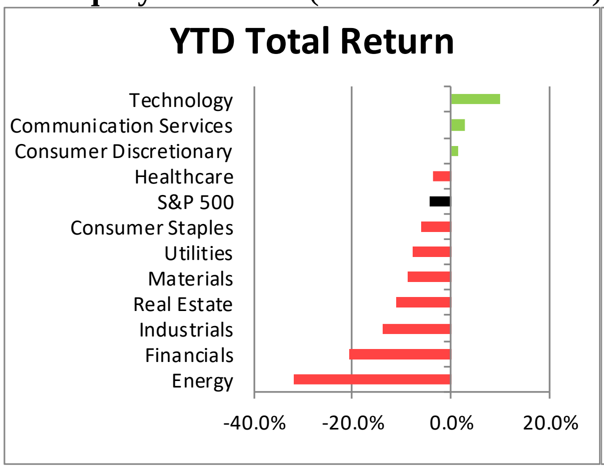


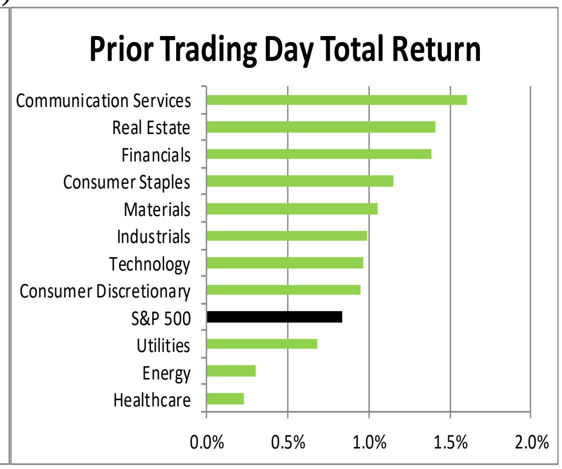
The upper line on the chart shows the monthly gold/silver ratio; the lower line shows detrended U.S. industrial production. Although the relationship isn't perfect, in general, stronger industrial production has tended to coincide with a lower ratio, whereas falling and below-trend industrial production benefits gold in the ratio. The current ratio is near its all-time highs, reflecting (a) generally weak industrial production in the latest business cycle, and (b) the recent collapse in production due to the pandemic shutdowns.

Although there remains a great deal of uncertainty surrounding the path of the recovery, as we detailed recently, the most likely path of this business cycle will be a deep but short recession followed by a lengthy recovery. If this assessment is correct, industrial activity should rebound in the coming months. Given the historic level of the gold/silver ratio, coupled with our overall positive position on gold, we believe silver is also attractively valued at current prices if our expectations about the economy are correct. Therefore, for risk-tolerant investors, silver may be an attractive allocation at this time.

Data Section

U.S. Equity Markets – (as of 6/15/2020 close)

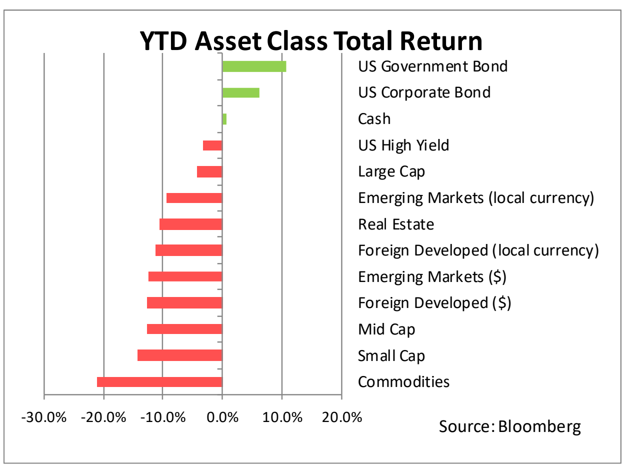




(Source: Bloomberg)

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 6/15/2020 close)

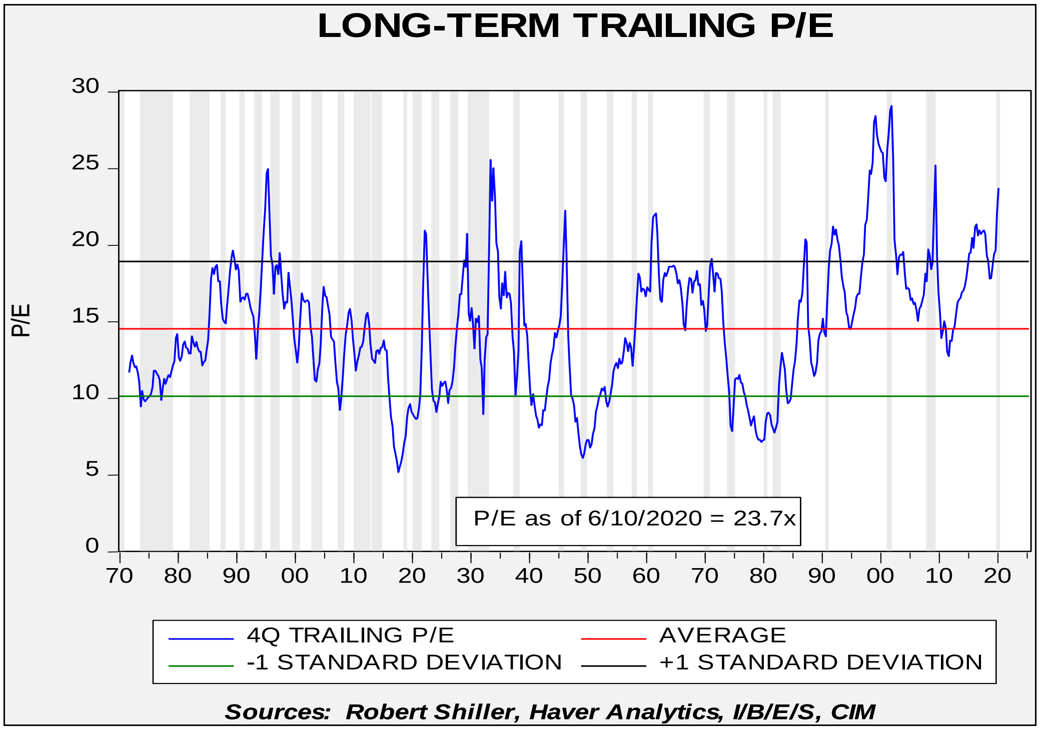


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 11, 2020



Based on our methodology,[1] the current P/E is 23.7x, 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.