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 24, 2020—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 1.9% from its last close. In Asia, the MSCI Asia Apex 50 closed up 0.4% from its prior close. Chinese markets were mixed, with the Shanghai Composite up 0.3% from the prior close and the Shenzhen Composite relatively unchanged. U.S. equity index futures are signaling a lower open.

Good morning! The 13th episode of the *Confluence of Ideas* podcast is available; the topic is the first in a series of episodes on the November elections.

Equity futures are lower this morning; market talk suggests it's due to rising COVID-19 infections, but a good, old-fashioned "pause to refresh" is just as likely. Poland's President Duda visits the White House today just before elections in his country. The Segway is done. We update the news from China. We offer some thoughts on reports that the administration is considering additional stimulus and other measures. There is growing concern about commercial real estate. Tech leaders are opposed to immigration restriction measures. Our usual commentary on COVID-19 is available. Here are the details:

China news:

- It appears that India and China are reducing recent border tensions. This is the usual pattern; we have seen a cycle of rising tensions followed by steps to prevent a broader war. The risk is, of course, that the border tensions, at some juncture, do lead to something worse. One area of concern is that PM Modi has less ability to control public opinion in India, compared to Chairman Xi; it is not inconceivable that an Indian PM at some point in the future may not be able to contain the groundswell and may be forced into a conflict. In an upcoming WGR, we will look at the history of this issue.
- For the past few days, we have been commenting on the recent EU/China videoconference. In the aftermath, it is clear that EU leaders are unhappy with China's behavior, but are also reluctant to press too hard on Beijing for fear of hurting trade and investment relations. The recent row over comments from Peter Navarro suggests similar sentiment exists in the U.S. as well. The closest historical parallel, in our view, to China's relations with the U.S., or the EU too, was between the U.K. and Germany from 1870 to 1914. There was a growing geopolitical rivalry, but deep economic ties as well.

Economic and policy news:

- June and the end of Q2 are coming soon, and several stimulus measures are about to expire. The measures were put in place with fairly short endpoints because the expectations were that the economy would be returning to normal in short order. It is true that there is ample evidence of the economy improving, but making new peaks in GDP will probably take until H2 2021. As it becomes apparent that that a new expansion is going to take a while, policymakers are rethinking their ideas on allowing various measures to expire next month.
    - The first round of stimulus checks worked pretty well; renters were remarkably current on making payments and spending levels have shown signs of recovery. The president is apparently on board with another round of stimulus checks. Although there will be opposition, we would not be surprised to see a second round soon.
    - The tax deadline may be extended again, past July 15th.
    - President Trump would also like an infrastructure bill, to the tune of $1.0 trillion, but he doesn't appear to be getting much support from either Congress or the rest of his administration.
    - There are growing concerns about commercial real estate; policymakers are pushing for a new Fed facility to support this market. There are reports that some mall operators are pressing small retailers for rent payments for months when the malls were closed. This problem highlights the problems in the payment chain; as commercial rents don't get paid, cash shortages develop to operators and eventually bondholders.
    - Overall, we do expect new measures to be forthcoming. However, as is normal with policymaking, look for there to be much "11th hour" type brinkmanship before anything gets passed.
- The U.S. is contemplating $3.1 billion of new tariffs on the EU and U.K. if they proceed with a digital tax. Canada is facing new tariffs on aluminum as Washington tries to cope with rising supplies. This move is coming just before USMCA goes into effect on July 1. Congress is planning a vote on leaving the WTO next month. The measure appears to be jointing led by right- and left-wing populists in Congress.
- There has been a run on plexiglass as shields for COVID-19.

Foreign news:

- The EU is considering banning U.S. travelers from the bloc due to concerns about COVID-19. Interestingly enough, the ban would not exclude China.
- North Korea has engaged in a number of provocative acts recently. It appears that Kim Jong Un may be dialing back some of the tensions. To some extent, what we have seen recently is consistent with North Korea's behavior. Pyongyang often takes aggressive actions and raises tensions, then promises to behave better if it gets sanctions relief, or aid. What might be different this time is that this news may signal a reengagement of Kim Jong Un; there has been some evidence to suggest he has been sidelined and his sister, Kim Yo Jong, has been driving policy. She appears to be much more hawkish than

her brother. Knowing what is happening in North Korea is always a challenge, but it is possible we are seeing a divided leadership.

- Russia is holding its military parades today that it usually holds on May 9. These parades were delayed due to the pandemic. Tomorrow, Russians vote to extend Putin's rule; we expect him to win.
- British landlords and tenants are facing an end to support, reflecting similar worries in the U.S.

Tech news:

- The U.S. has suspended work visas for several classes of workers due to high unemployment. The tech industry is upset by the decision as is India.
- The DOJ and states' attorneys general are meeting to discuss antitrust action against some tech firms.

COVID-19: The number of reported cases is 9,273,773 with 478,160 deaths and 4,645,628 recoveries. In the U.S., there are 2,347,102 confirmed cases with 121,225 deaths and 647,548 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.

Virology:

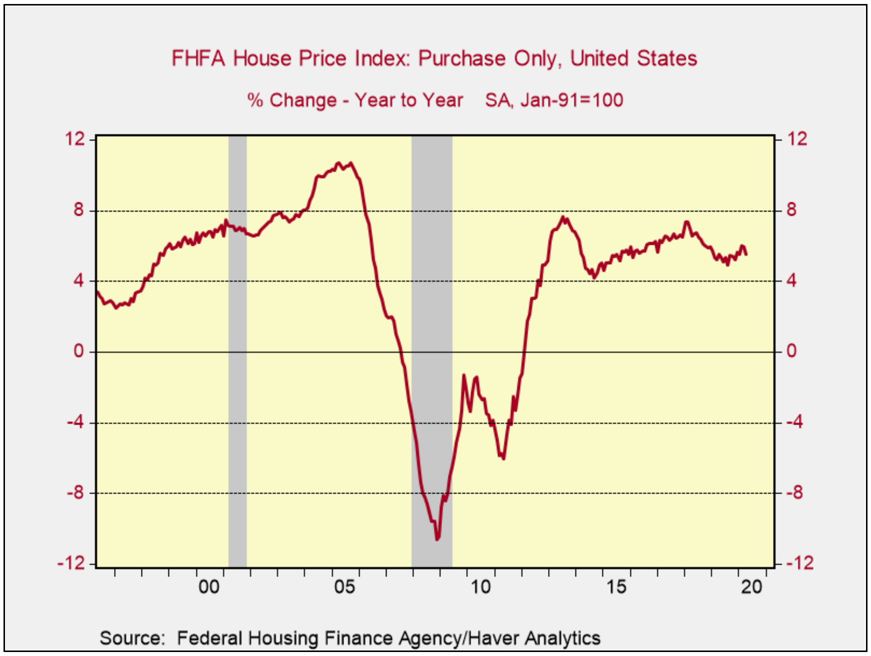
- As lockdowns ease, there has been a rise in infections, not only in the U.S., but around the world. South America has been especially hard hit. Nursing homes have been a particular area of risk, and Canada has been hit hard.
- There are reports some Chinese nationals in Russia are using forged COVID-19 tests showing a negative result so they can return to China.

Finally, there are reports of soaring temperatures in Siberia. Although it hasn't been verified, the city of Verkhoyansk reported a high temperature of just 100° Fahrenheit on Saturday. The Russian Arctic is also seeing higher temperatures, with temperatures rising about 0.69° Fahrenheit every decade, compared to world temperatures rising about 0.18° Fahrenheit every decade. The rise in temperatures is thawing permafrost and contributed to a recent diesel fuel spill, as weakening permafrost damaged a storage tank. One way this change affects U.S. weather is that it weakens the jet stream and can leave weather systems "parked" over parts of the U.S., leading to extended heat waves, or rainfall and flooding.

U.S. Economic Releases

For the week ending June 19, MBA mortgage applications fell 8.7% from the prior week. Applications for home purchases and refinancing fell 3.0% and 11.7%, respectively. Meanwhile, the average 30-year fixed rate held steady at 3.30%.

In April, home prices were able to rise modestly possibly due to consumers taking advantage of lower interest rates. According to the FHFA home price index, home prices rose 0.2% from the prior month, compared to expectations of a rise of 0.3%.



The chart above shows the annual change in the home price index. Home prices rose 5.5% from the prior year.

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

Economic Releases		
No economic releases today		
Fed Speakers or Events		
	Speaker or event	**District or position**
12:30	Charles Evans Takes Part in Virtual Discussion on Economy	President of the Federal Reserve Bank of Chicago
15:00	James Bullard Discusses the Economy and COVID-19	President of the Federal Reserve Bank of St. Louis

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	BoP Current Account Balance	q/q	1Q	-$33.700b	-$29.700b		**	Equity and bond neutral
Japan	PPI Services	y/y	May	0.8%	1.0%	0.8%	**	Equity and bond neutral
	Leading Index CI	m/m	Apr	77.7	76.2		**	Equity and bond neutral
	Coincident Index	m/m	Apr	80.1	81.5		**	Equity and bond neutral
Australia	Skilled Vacancies	m/m	May	-8.7%	-16.4%		**	Equity and bond neutral
Europe								
Germany	IFO Business Climate	m/m	Jun	86.2	79.5	85.0	**	Equity bullish, bond bearish
	IFO Expectations	m/m	Jun	91.4	80.1	87.0	**	Equity bullish, bond bearish
	IFO Current Assessment	m/m	Jun	81.3	78.9	84.0	**	Equity and bond neutral
France	Business Confidence	m/m	Jun	78.0	59.0	72.0	***	Equity bullish, bond bearish
	Manufacturing Confidence	m/m	Jun	77.0	70.0	79.0	***	Equity and bond neutral
	Production Outlook Indicator	m/m	Jun	-15.0	-49.0	-30.0	**	Equity and bond neutral
	Own-Company Production Outlook	m/m	Jun	19.0	-12.0		**	Equity bullish, bond bearish
Switzerland	Credit Suisse Survey Expectations	m/m	Jun	48.7	31.3		**	Equity bullish, bond bearish
AMERICAS								
Mexico	International Reserves Weekly	w/w	19-Jun	$188.277b	$188.105b		**	Equity and bond neutral
	Consumer Confidence Telephone	m/m	May	31.1	32.2		***	Equity and bond neutral
Brazil	Tax Collections	m/m	May	77.415b	101.154b	79.800b	**	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)	30	31	-1	Down
3-mo T-bill yield (bps)	12	14	-2	Neutral
TED spread (bps)	17	16	1	Up
U.S. Libor/OIS spread (bps)	7	7	0	Up
10-yr T-note (%)	0.71	0.71	0.00	Neutral
Euribor/OIS spread (bps)	-41	-40	-1	Neutral
EUR/USD 3-mo swap (bps)	11	11	0	Down
Currencies	**Direction**			
dollar	Flat			Down
euro	Flat			Up
yen	Flat			Up
pound	Flat			Down
franc	Flat			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
RBNZ Official Cash Rate	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	$42.01	$42.63	-1.45%	Rise in Virus Outbreaks
WTI	$39.64	$40.37	-1.81%	
Natural Gas	$1.63	$1.64	-0.37%	
Crack Spread	$13.04	$13.19	-1.11%	
12-mo strip crack	$11.80	$12.10	-2.45%	
Ethanol rack	$1.46	$1.47	-0.25%	
Metals				
Gold	$1,777.77	$1,768.41	0.53%	
Silver	$17.94	$17.94	-0.04%	
Copper contract	$265.95	$266.85	-0.34%	
Grains				
Corn contract	$ 330.25	$ 329.00	0.38%	
Wheat contract	$ 490.50	$ 491.00	-0.10%	
Soybeans contract	$ 874.50	$ 874.00	0.06%	
Shipping				
Baltic Dry Freight	1617	1558	59	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.0		
Gasoline (mb)		-1.7		
Distillates (mb)		-0.5		
Refinery run rates (%)		0.50%		
Natural gas (bcf)		108.0		

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 Pacific region. Wet conditions are expected for the majority of the country, with dry conditions in the Southwest and New England regions. There is a tropical depression in the Atlantic Ocean, but it is not expected to make landfall.

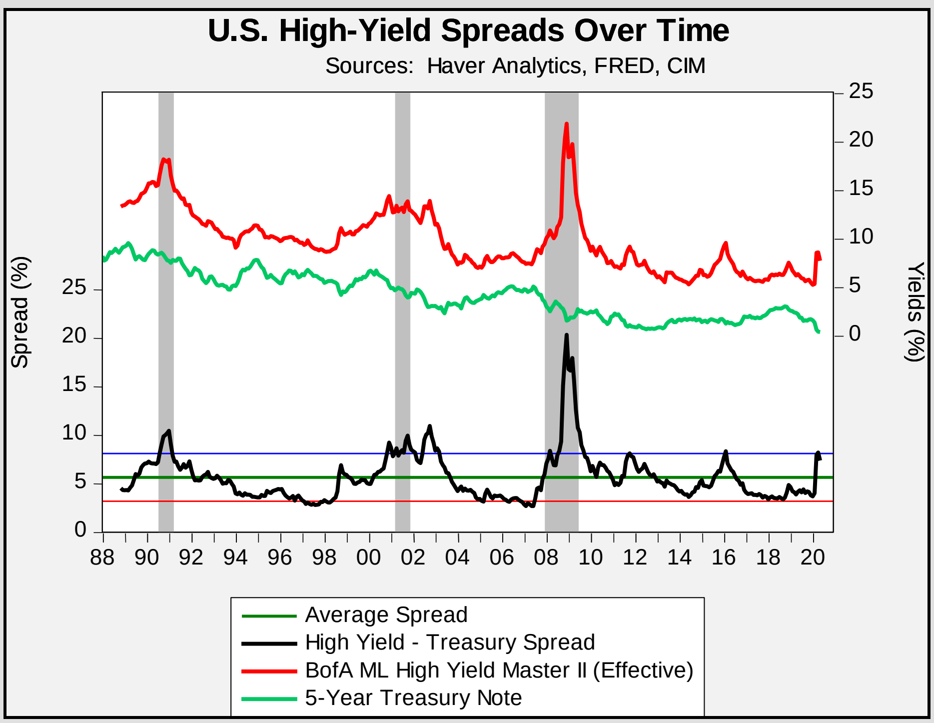
Asset Allocation Weekly

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 19, 2020

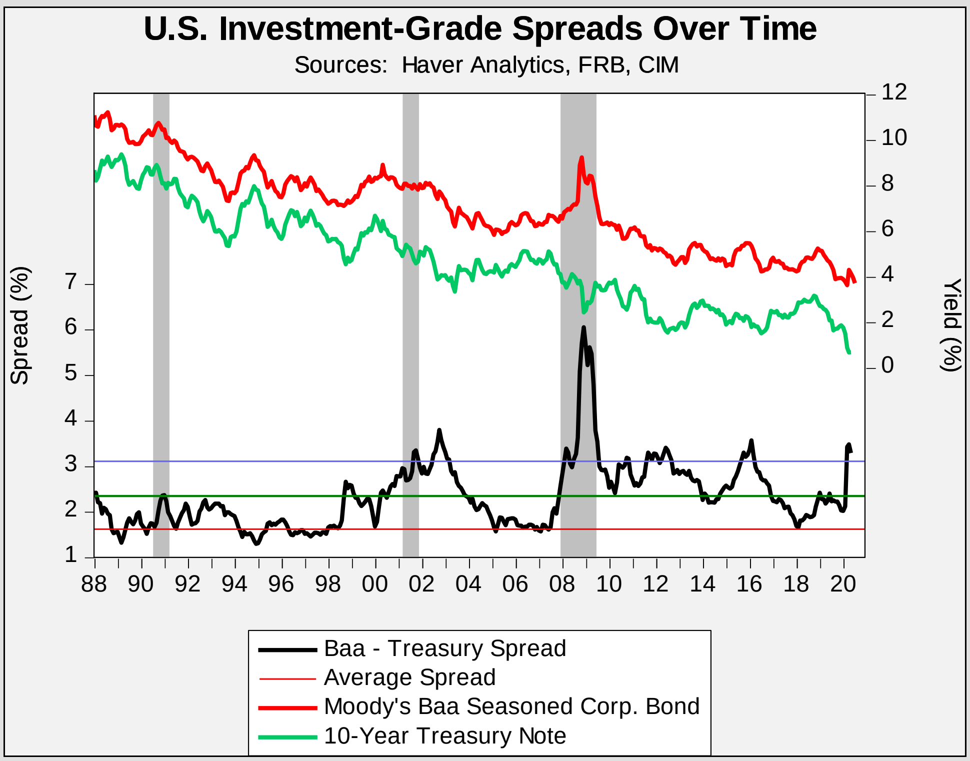
By now, investors have rightly come around to the idea that the equity market's strong rebound since late March can be largely ascribed to the aggressive monetary and fiscal policies put in place to counter the coronavirus crisis. The economic downturn from the pandemic lockdown has been severe, pushing unemployment to its highest level since the Great Depression and freezing demand for most products. All the same, the Federal Reserve's massive bond-buying and the federal government's gigantic spending programs have convinced many people that the public sector is doing what's necessary to support a quick recovery and minimize the long-term damage. Investors have bid up stocks in response. The technology-heavy NASDAQ has even reached a new record high.

What's gotten less attention is that the policy moves have also helped limit the damage in the debt markets. That's especially clear in the market for riskier debt that the credit rating firms consider to be below-investment grade, i.e., "high yield" or "junk" bonds. One way to measure the demand for that kind of debt is to compare the yield investors are requiring for that kind of bond versus the yield on a risk-free bond of similar maturity, such as the five-year Treasury note. As shown in the chart below, the effective yield on the BofA Merrill Lynch High-Yield Master II Index spiked to as much as 8.57% at the peak of the coronavirus crisis in March and April. At the same time, safe-haven buying drove down the yield on the five-year Treasury note to just 0.39%. That boosted the high-yield spread over the five-year Treasury all the way to 8.18% compared with an average spread of 5.61% over the last several decades.



As shown in the chart, the April spread of 8.18% was one full standard deviation above the average spread since 1988. But instead of rising even further above the one-standard deviation mark as typically happens during a recession, the spread has fallen modestly in May and June. We think that's a clear indication that investor nerves have been calmed by the aggressive monetary and fiscal policy already put into place. One particularly helpful move was the Fed's decision to purchase corporate debt, ultimately including debt that had been downgraded to junk status after March 22 and corporate bond ETFs that might hold high-yield obligations.

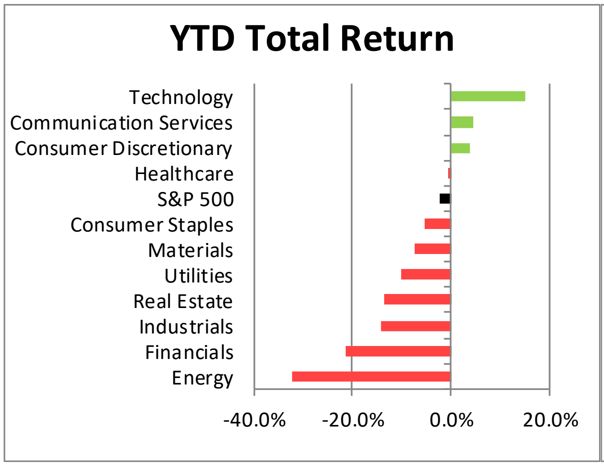
By pumping liquidity into the economy and helping many firms avoid bankruptcy, the U.S. policy moves have helped bolster not only junk bonds, but also investment-grade bonds and equities. For example, the chart below shows how the spread of corporate investment-grade yields over the 10-year Treasury also initially spiked and then narrowed after the policy moves were implemented. The pattern looks very similar to the narrowing of high-yield spreads. Although the financial markets remain volatile and credit spreads could widen again, we think the early signs of credit spread narrowing support increasing exposure to corporate credit in portfolios.

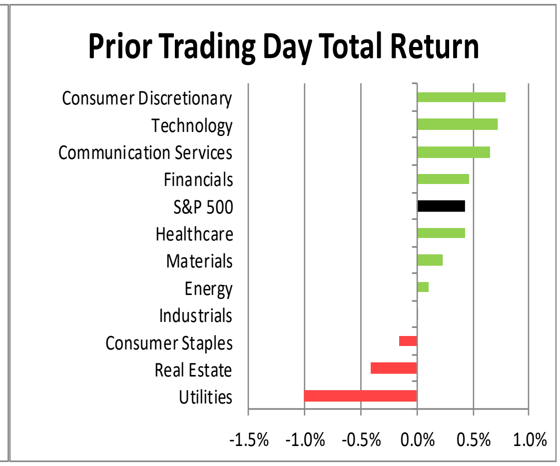


Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors 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 6/23/2020 close)

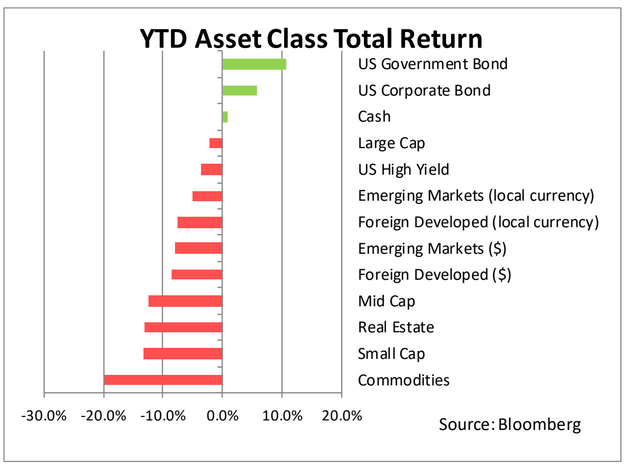




(Source: Bloomberg)

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 6/23/2020 close)

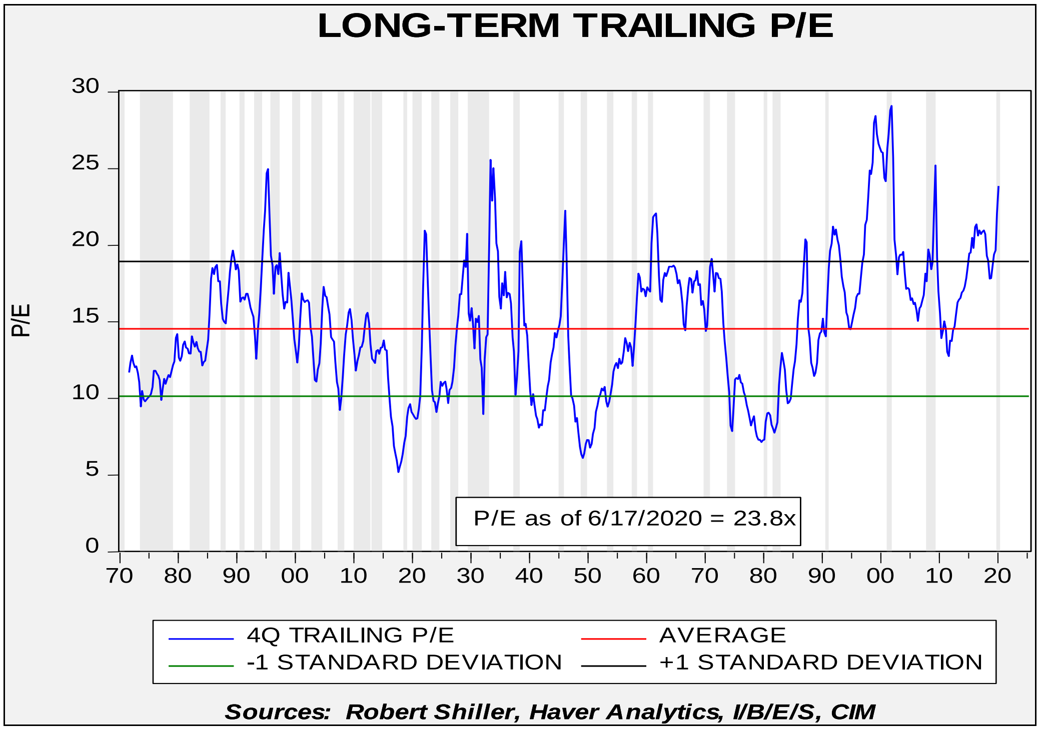


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 18, 2020



Based on our methodology,[1] the current P/E is 23.7x, up 0.1x from last week. Rising index values 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.

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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.