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 26, 2020—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is up 1.5% from its last close. In Asia, the MSCI Asia Apex 50 closed down 0.2% from its prior close. Chinese markets were closed for the Dragon Boat Festival. U.S. equity index futures are signaling a flat open.

The 13th episode of the *Confluence of Ideas* podcast is available; it is our first in a series of reports on the November elections. Additionally, there is something new! As usual, we have a new Asset Allocation Weekly in today's report (which we also post as a standalone report), but we are adding two new features to this report: an associated podcast and an automated chart book! Check them out!

Good morning and happy Friday! Equity futures are mostly marking time this morning. Personal income and spending are out today; we detail the numbers below. In the economics section, we look at the drop in global trade and the problem of college sports. There was news on banking policy; we go over the details below, but, in short, "the Fed giveth and the Fed taketh away." China had something akin to a bank run. We update the pandemic, including the "Duff's map." We also take a look at tech. Here are the details:

Economic news:

- The Netherlands Bureau for Economic Policy Analysis has developed a global trade monitor. In April, it fell an "unprecedented" 12.1% on a sequential basis. It was down 16.2% from the prior year. It is not surprising that trade fell in April; this was the month when nearly all the developed world was in lockdown. What we will be watching is the speed of recovery.
- We are starting to see more commentary shifting from the recession to the recovery. We discussed this issue about a month ago in the May 29 edition of the AAW. As we noted in that report, we expected this recession to be deep but short, with an elongated recovery. That doesn't necessarily bode ill for equities, as a slow recovery will tend to support continued policy stimulus.
- College sports has seen a wave of program cancellations. It's no secret that football funds the rest of the athletic program at major universities. Most colleges are assuming (hoping?) for a normal season with packed stadiums this fall. If that isn't possible, we could see a near collapse of college athletics, which would have significant effects on numerous sports.

- One of the factors that is slowing the return to work is the lack of childcare. Providers have been slow to reopen, or are doing so with less capacity; the informal system, which often includes grandma and grandpa may not be available either due to the vulnerability of the elderly. If this issue isn't resolved, it will further weaken the recovery.
- The pandemic has apparently prevented us from taking our coins to the bank for counting. As a result, the Fed is reporting a growing shortage of coins in the economy.
- Smaller banks have been supporting the commercial real estate industry, granting forbearance as rent payments are delayed. If this continues, the Fed may need to offer additional support to these institutions.

Policy news:

- As noted, the Fed reported on its banking stress tests yesterday. The test has variations for the recovery— "U," "V" and "W"—and as one would expect, it did best with a "V." The worst case showed about $700 billon of loan losses and a decline in capital ratios of 12%. Generally speaking, the results suggest the system would likely hold up, but to shore up capital, the Fed did announce it was restricting buybacks and dividend growth.
- On the "giveth" side, regulators have relaxed elements of the "Volcker Rule" that restricted bank's ability to use insured deposits to buy and hold financial assets. The goal of the rule was to ensure that banks didn't take excessive risks with government insured money; in practice, it has reduced their market making capacity and reduced market liquidity.
- Regulators have eased rules on drilling leases on Federal land. Under normal circumstances, oil companies have a time constraint on a lease. If they don't drill before the deadline, they lose the lease. The Bureau of Land Management has been liberally granting drilling suspensions to avoid forcing these firms to drill on the land to avoid losing their claims.

China news:

- Chinese households, like their counterparts in Japan, Europe and the U.S., have been in search of yield for their savings. In China, trust companies have emerged to satisfy this demand. The industry holds CNY 21.0 trillion ($3 trillion); it is estimated that around CNY 625 billion of these assets are distressed. However, financial institutions that are sound can face liquidity problems if depositors demand liquidity simultaneously. Small scale protests have broken out in Chengdu, Sichuan, after Sichuan Trust told investors that it would "struggle to make principal and interest payments" on about CNY 13 billion of assets. China's debt growth has been of concern for some time. It has been noted that Chinese policy support from the pandemic has been modest compared to what we saw after the Financial Crisis, leading to concerns about China's debt capacity. This situation bears watching; if Chinese investors begin to fear the stability of the financial system, we could see purchases of bitcoin, gold and capital flight.

COVID-19: The number of reported cases is 9,632,969 with 489,854 deaths and 4,859,744 recoveries. In the U.S., there are 2,422,312 confirmed cases with 124,415 deaths and 663,562 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. Additionally, one way of monitoring reopening is by the number of beer taps operated relative to capacity, or as we like to call it, the "Duff's map."

Virology:

- Texas is suffering through a rise in COVID-19 cases, leading the governor to scale back his state's reopening. Elective surgeries have been suspended to open up hospital capacity for COVID-19 cases in some counties.
- South America has seen a tripling of cases over the past month.
- Germany, who had seen cases fall, is now seeing a rise, as lockdown restrictions ease.
- Antibody tests are used to see if a person has been infected. If the test signals positive, it would suggest that person has some degree of immunity, and thus could return to circulation. However, there are two problems that have emerged. First, the tests, so far, are so inaccurate that they can't be relied upon to determine if a person has been infected. Second, it isn't clear how long immunity lasts.
- The CDC indicated that the number of cases in the U.S. may be 10x higher than reported. It isn't obvious where that figure was derived, but we suspect the government is assuming a 0.5% fatality rate, with 124,415 deaths attributed to COVID-19, a 24 MM infection rate would be consistent with that number.

Technology news:

- The DOJ is continuing to move forward on antitrust investigations. The department also opposed a tech firm cable link between Hong Kong and mainland China. At the same time, the White House is considering Federal support to ensure American development of 5G.
- Google (GOOG, 1441.33) has agreed to pay for news content with several news providers, a significant development for content providers.
- As the U.S. restricts work visas, Canada is opening its doors to these foreign workers.

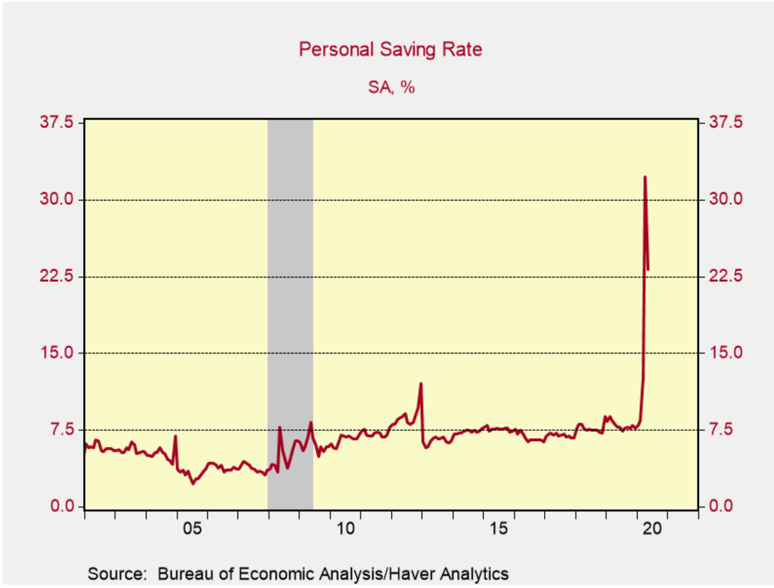
Foreign news:

- Iran is developing a capacity to make aluminum powder, a key ingredient for solid rocket fuel.
- Polish voters go to the polls on Saturday.

U.S. Economic Releases

The U.S. consumer spending surged in May, as households were eager to shop following several weeks of lockdown. Meanwhile, personal income slowed as a vast number of Americans remain unemployed. Lastly, consumer prices remained relatively soft as firms were reluctant to sell unsold inventory at a loss.

Last month, consumer spending rose 8.2% from the prior month, compared to expectations of a rise of 9.2%. The prior month's loss was revised downward from 13.6% to 12.6%. Real personal spending, which adjusts for inflation, rose 8.1% from the prior month, compared to expectations of a rise of 8.7%.

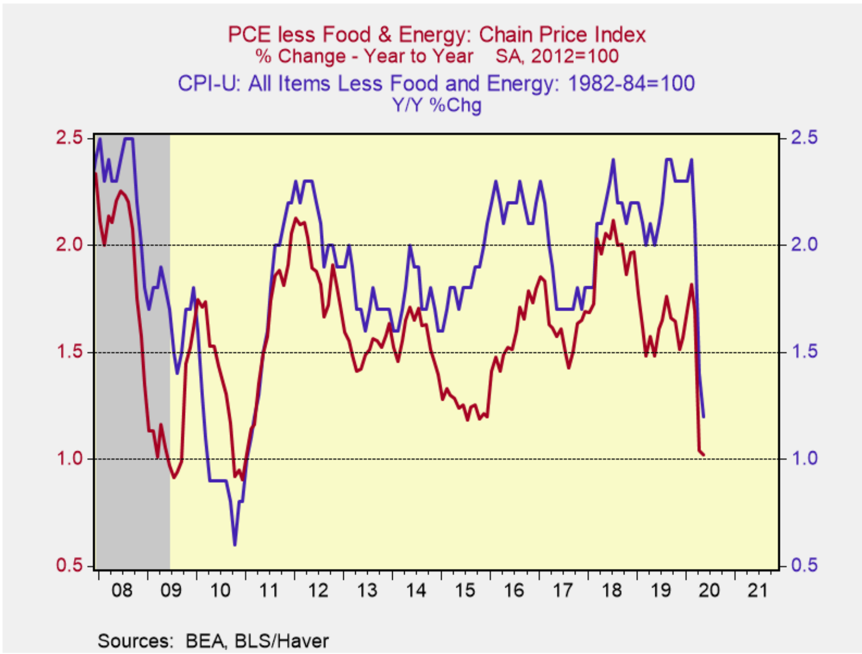


The chart above shows the personal savings rate. Although the personal savings rate dropped sharply in May as stores opened their door for consumers, it still remains relatively elevated. The high savings rate could be showing that consumers may still be cautious.

Personal income fell 4.2% from the prior month, compared to expectations of a fall of 6.0% from the prior month.

The chart above shows the annual change in personal income. The decline in personal income is likely the result of a reduction in transfer payments, as the government did not provide additional stimulus for households.

The PCE deflator and the PCE core deflator rose 0.1% from the previous month, respectively. Both were expected to remain unchanged from the prior month.



The chart above shows the annual change in core PCE and core CPI. A deceleration in prices could support further monetary easing and fiscal stimulus to restart the economy.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Economic Expectations	w/w	21-Jun		40.2	**
10:00	Kansas City Fed Manufacturing Index	m/m	Jun	-3	-39	**
Fed Speakers or Events						
11:00	Raphael Bostic Holds Virtual Discussion About Economy	President of the Federal Reserve Bank of Atlanta				

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	Tokyo CPI	y/y	Jun	0.3%	0.4%	0.3%	***	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food	y/y	Jun	0.2%	0.2%	0.2%	***	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food, Energy	y/y	Jun	0.4%	0.5%	0.4%	***	Equity and bond neutral
New Zealand	ANZ Consumer Confidence	m/m	Jun	7.4%	14.7%		***	Equity and bond neutral
Europe								
Eurozone	M3 Money Supply	y/y	May	8.9%	8.3%	8.7%	***	Equity bullish, bond bearish
France	Consumer Confidence	m/m	Jun	97.0	93.0	95.0	***	Equity bullish, bond bearish
Germany	GfK Consumer Confidence	m/m	Jul	-9.6	-18.9	-12.0	**	Equity and bond neutral
	Import Price Index	y/y	May	-7.0%	-7.4%	-6.9%	**	Equity and bond neutral
Italy	Deficit to GDP YTD	q/q	1Q	10.8%	1.6%		***	Equity bullish, bond bearish
	Consumer Confidence Index	m/m	Jun	100.6	94.3	97.5	***	Equity bullish, bond bearish
	Manufacturing Confidence	m/m	Jun	79.8	71.2	80.0	**	Equity and bond neutral
	Economic Sentiment	m/m	Jun	65.4	51.1		**	Equity bullish, bond bearish
Russia	Gold and Forex Reserves	w/w	19-Jun	567.8b	570.8b		*	Equity and bond neutral
AMERICAS								
Mexico	Economic Activity IGAE	y/y	Apr	-19.9%	-2.3%	-22.0%	***	Equity and bond neutral
	Trade Balance	m/m	May	-3.523b	-3.087b	1.327b	**	Equity bearish, bond bullish
Brazil	IBGE Inflation IPCA-15	m/m	Jun	0.0%	-0.6%	-0.1%	***	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	30	0	Down
3-mo T-bill yield (bps)	12	14	-2	Neutral
TED spread (bps)	18	16	2	Up
U.S. Libor/OIS spread (bps)	7	7	0	Up
10-yr T-note (%)	0.66	0.68	-0.02	Neutral
Euribor/OIS spread (bps)	-40	-41	1	Neutral
EUR/USD 3-mo swap (bps)	12	12	0	Down
Currencies	**Direction**			
dollar	Down			Down
euro	Flat			Up
yen	Up			Up
pound	Down			Down
franc	Flat			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Mexican Overnight Rate	5.000%	5.500%	5.000%	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	$41.46	$41.05	1.00%	
WTI	$39.02	$38.72	0.77%	
Natural Gas	$1.44	$1.48	-2.63%	
Crack Spread	$11.43	$11.15	2.45%	
12-mo strip crack	$10.80	$10.69	1.08%	
Ethanol rack	$1.44	$1.44	-0.33%	
Metals				
Gold	$1,762.76	$1,763.79	-0.06%	
Silver	$17.83	$17.80	0.15%	
Copper contract	$269.30	$267.80	0.56%	
Grains				
Corn contract	$ 322.00	$ 320.50	0.47%	
Wheat contract	$ 487.50	$ 488.25	-0.15%	
Soybeans contract	$ 868.00	$ 868.25	-0.03%	
Shipping				
Baltic Dry Freight	1738	1705	33	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	1.4	2.0	-0.6	
Gasoline (mb)	-1.7	-1.7	0.0	
Distillates (mb)	-0.2	-0.5	0.3	
Refinery run rates (%)	0.80%	0.50%	0.30%	
Natural gas (bcf)	120.0	108.0	12.0	

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 no tropical cyclone activity expected for the next 48 hours.

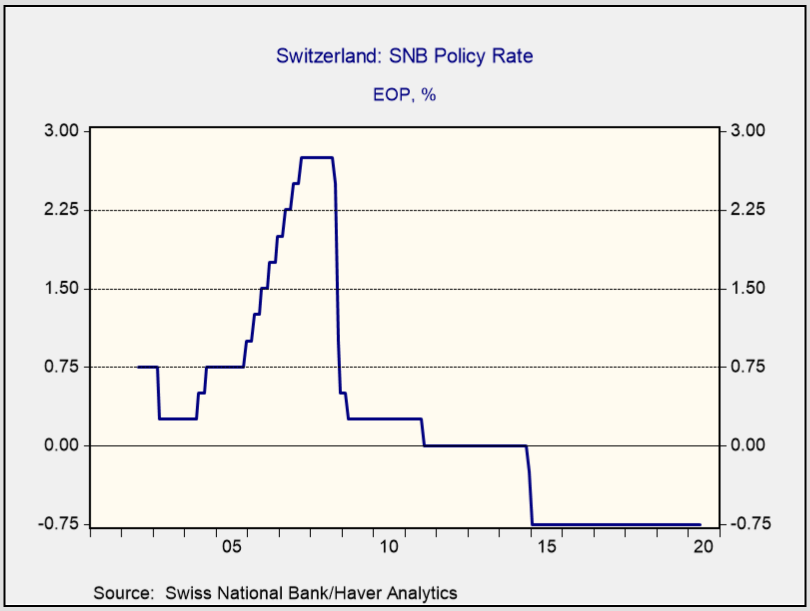
Asset Allocation Weekly

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 26, 2020

(N.B. Due to the Independence Day holiday, the next report will be issued on July 10, 2020.)

Since 2008, some central banks have implemented negative policy interest rates. Standard economics suggests that negative nominal rates on deposits are impossible because holders could simply liquidate the deposit and "put the money under the mattress." We have observed that there are costs to holding cash in large amounts, so banks can implement a negative rate (perhaps best thought of as a fee) on holding cash. Although there are limits to how low negative rates can go (at some point, the cost of providing safekeeping exceeds the benefits), we note the Swiss National Bank has had a policy rate of -0.75% since December 2014.

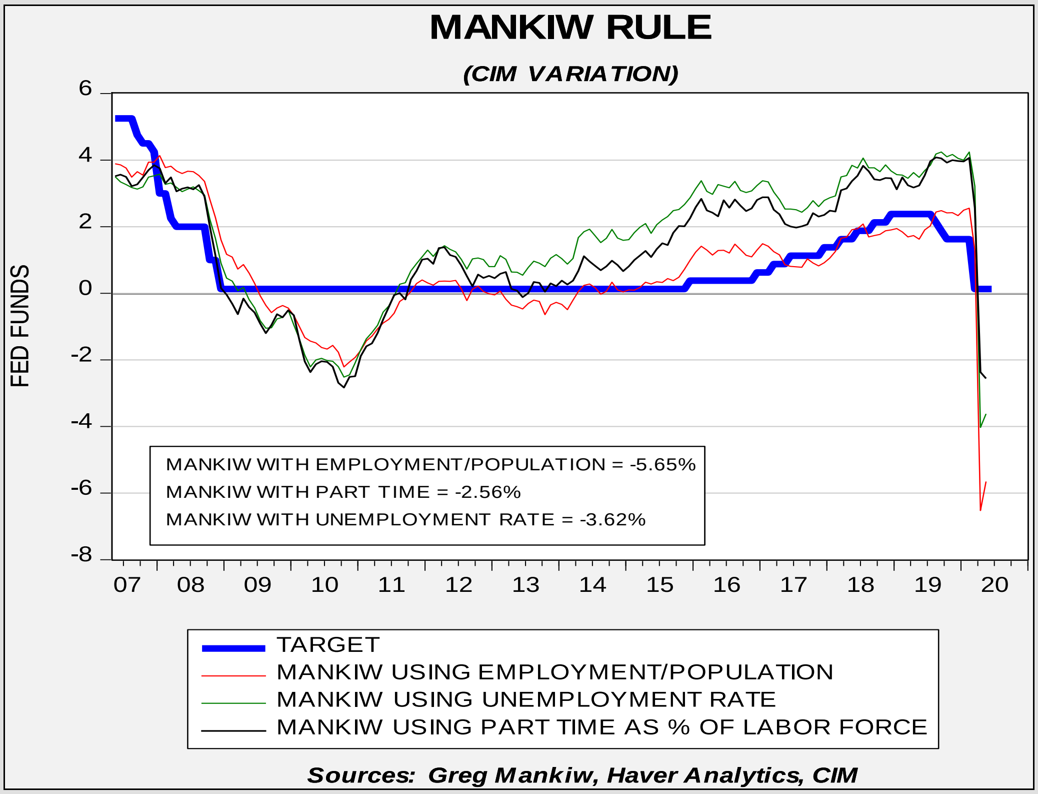


Why would a central bank consider implementing a negative policy rate? If economic conditions warranted easing and inflation was low,[1] it may be impossible to use low but positive interest rates as a policy tool. In that case, negative interest rates or some other unconventional monetary policy may be necessary.

Are conditions similar in the U.S.? Our analysis of the policy rate, using the Mankiw Rule, a variation on the Taylor Rule, suggests that the FOMC could consider negative policy rates. The Taylor Rule is designed to calculate the neutral policy rate given core inflation and the measure of slack in the economy. John Taylor measured slack using the difference between actual GDP and potential GDP. The Taylor Rule assumes that the Fed should have an inflation target in its policy and should try to generate enough economic activity to maintain an economy near full

[1] For example, Switzerland's May CPI was -1.3% from last year.

utilization. The rule will generate an estimate of the neutral policy rate; in theory, if the current fed funds target is below the calculated rate, the central bank should raise rates. Greg Mankiw, a former chair of the Council of Economic Advisors in the Bush White House and current Harvard professor, developed a similar measure that substitutes the unemployment rate for the difficult-to-observe potential GDP measure. We have taken the original Mankiw Rule and created three other variations. Specifically, our models use core CPI and either the unemployment rate, the employment/population ratio, involuntary part-time employment or yearly wage growth for non-supervisory workers. In this report, we are not using the wage growth variation because it is yielding a sharply positive policy rate; wages have increased because lower paid workers have been laid off in greater numbers than higher paid workers.



As the recession developed, the unemployment rate jumped, the employment/population ratio fell, and the number of involuntary part-time workers rose. Complicating matters further, inflation declined. All these factors pointed to the need for policy stimulus. In fact, in the worst case, the employment/ population ratio variation, the nominal rate should be as low as -5.65%.

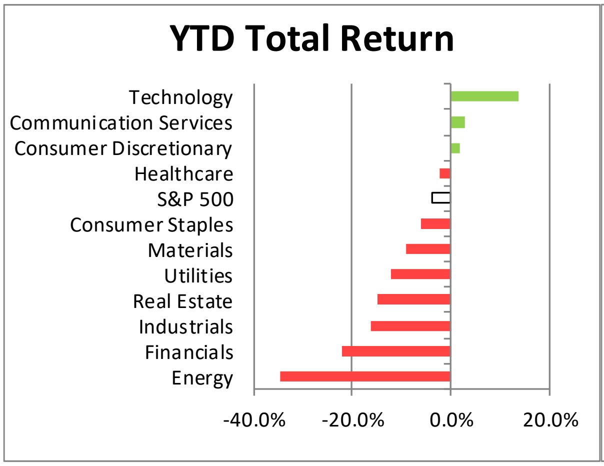
In 2008 through most of 2011, these variations of the Mankiw Rule suggested the policy rate should have been below zero. That is the case today. So far, the FOMC has rejected a negative policy rate and instead relies on expanding the balance sheet and forward guidance. The current program of balance sheet expansion is historically unique; for the first time, we are seeing the Fed buy an assortment of financial assets that expose it to credit risk. These include corporate and high yield bonds. As we noted last week, the current QE is reducing credit spreads, but, like forward guidance, the actual stimulative impact is uncertain.

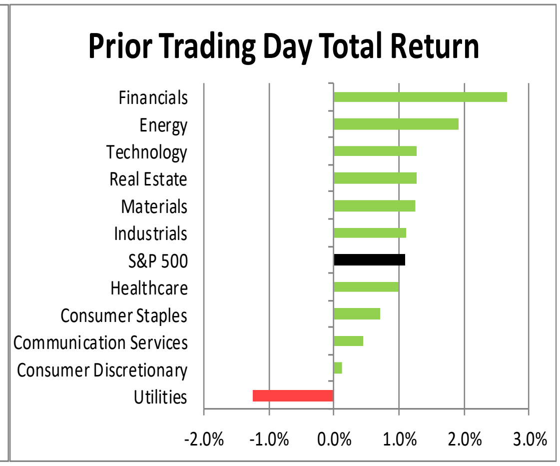
So, why is the FOMC opposed to negative interest rates? The most likely reason is the structure of the U.S. financial system. The U.S. system has an extensive non-bank financial system; unlike banks, this system isn't funded by deposits but by repo and money markets. The non-bank financial system, also known as the "shadow banking system," finances large swaths of the U.S. economy. Although it is difficult to estimate the size, there are reports it may be as large as $1.2 trillion. The fear is that negative deposit rates would likely cause the money market funds to "break the buck" to account for the below-zero yield. That could lead to difficult-to-determine outcomes, but it is plausible that the non-bank financial system may find itself without a source of funding. Since there is no Fed backstop to the non-bank financial system, there could be a run on the loan providers. Other nations have much smaller non-bank systems and thus can manage negative policy rates. The U.S. probably can't.

And so, additional policy stimulus, if necessary, will come from further expansion of the balance sheet and forward guidance. Another possibility would be yield curve control, which was implemented during WWII into the early 1950s. In this policy, the Fed will set the desired rate of some or all of the Treasury curve, absorbing all the Treasury borrowing that the market won't buy, thus fixing the interest rate. The Bank of Japan and Reserve Bank of Australia are currently running such policies. Although the FOMC hasn't taken this step yet, it is being considered by Fed policymakers. The conclusion—monetary policy will likely remain historically accommodative well into 2021.

Data Section

U.S. Equity Markets – (as of 6/24/2020 close)

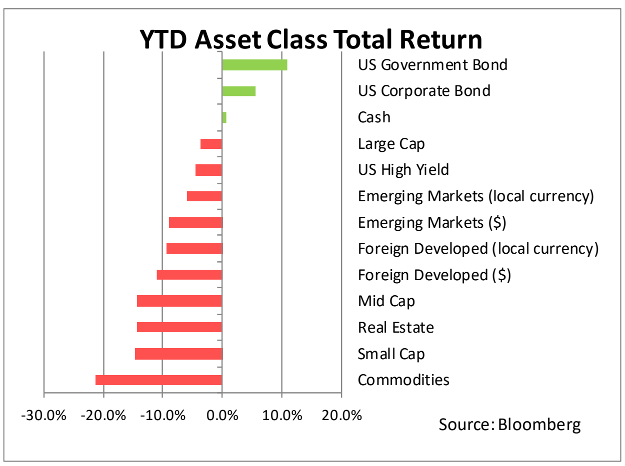




(Source: Bloomberg)

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 6/24/2020 close)

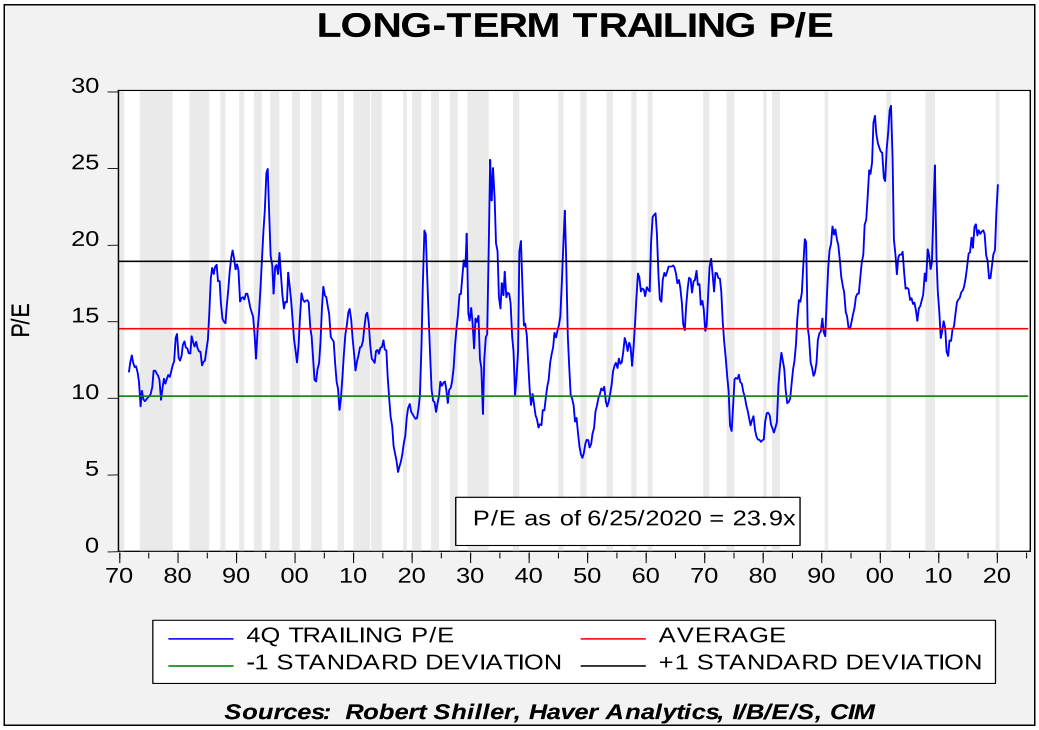


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 25, 2020



Based on our methodology,[2] the current P/E is 23.9x, 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.

[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.