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 29, 2020—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is up 0.2% from its last close. In Asia, the MSCI Asia Apex 50 closed down 0.7% from its prior close. Chinese markets were lower, with the Shanghai Composite down 0.6% from the prior close and the Shenzhen Composite down 0.4%. U.S. equity index futures are signaling a flat open.

Good morning, and happy Monday! U.S. equity futures are currently pointing to a modest rise in a holiday-shortened week. We update the COVID-19 news. In foreign news, we cover the Poland elections and a new government in Ireland. The end of stimulus measures is looming in the U.S. We update weather news. Here are the details:

COVID-19: The number of reported cases is 10,154,984 with 502,048 deaths and 5,147,436 recoveries. In the U.S., there are 2,549,069 confirmed cases with 125,803 deaths and 685,164 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. State infection rates are showing a definite rise.

Virology:

- We have been monitoring reports that the virus may be mutating. A paper out of China suggests that COVID-19 has indeed mutated from its form in China to a more virulent form in Europe. A mutation, named D614G, increases the number of spikes on the virus, enhancing its ability to infect. The mutation has made the virus more contagious by increasing its shedding. This development may explain why the virus initially seemed to be about as problematic as influenza and has become something worse. There are also reports that the virus has developed in such a way that it sends out "fingers" that increase the pace of infection.
- Last week, in the face of rising infections, Texas and Florida took the aggressive actions to close bars, ban the sale of alcohol consumption and limit restaurant seating. The population infected in the South does appear different than what we saw in the Northeast. The current infections are hitting younger Americans and thus we are seeing fewer fatalities per infection.
- Doctors are finding that even asymptomatic patients with COVID-19 are showing signs of lung damage. How serious the damage is remains uncertain.

- Health officials are considering a new testing strategy, pool testing. In a pool test, a single test is administered to a group of people. If all test negative, it is assumed the entire pool is infection free. This method allows for a much larger testing base with the same level of resources, and, with careful sorting, can even increase the power of the testing. It has two downsides. First, a false negative means a much larger problem because it means the entire pool is considered safe, but it may not be. Second, the process of pooling itself can dilute the sample, increasing the odds of a false negative.
- There is evidence that COVID-19 is causing psychiatric and neurological problems in patients. The symptoms include strokes, encephalitis, and encephalopathy. Some patients exhibited evidence of dementia and psychosis.
- There remains hope that a vaccine will be developed by late 2020. We remain skeptical that it will occur in this short time frame. However, a vaccine isn't the only path to reducing the risk of the virus. Antiviral treatments could also reduce the virulence of the disease; AIDS has been controlled by this path. Three[1] new anti-viral drugs are being tested; all three are currently used in treating cancer, so if they work on COVID-19, they could be deployed rapidly.

Policy news:

- State and local governments who have seen their expenditures rise and revenue decline are searching for new sources of funds to make up for budget shortfalls. We consider this sector to be a risk factor for the economy. Without aid from the Federal government, state and local governments will have no choice but to cut services and raise taxes which will act as a drag on growth.
- As households deferred loan payments, credit rating agencies have not been reporting their payment gaps as delinquent. Banks, worried that they can't tell if a borrower is merely postponing payments or not intending to pay, have been tightening lending standards. If this continues, it will tend to exacerbate the downturn.
- One of the worries that will likely begin to affect investor sentiment is if income support ends next month. The boost to unemployment insurance and the $1200 income checks are scheduled to end at the end of July. If they are not extended, or at least adjusted, we could see a drop in economic activity.
- The Federal Reserve has listed the corporate bonds it purchased recently. It appears that automakers and tech firms made up the bulk of the buying.
- The Fed continues to be actively looking at yield curve control and is examining Australia's experience.

China news:

[1] https://xospata.com/, https://ascopubs.org/doi/abs/10.1200/JCO.2019.37.15_suppl.5537, https://www.prnewswire.com/news-releases/senhwa-biosciences-silmitasertib-named-as-potential-covid-19-therapy-301032362.html

- China has been aggressively building out its 5G network. Although the U.S. has been working to reduce Chinese tech firms' ability to sell 5G products abroad, China also needs to import products for its domestic build out. Apparently, Japanese firms have been aiding this effort. We will be watching to see if Washington takes steps to end this practice.
- The PBOC is promising to take stronger measures to support the Chinese economy.

Technology news:

- Although we haven't seen much of an impact yet, the EU's increasing aggressive actions in regulating technology bears watching. First, their actions may affect how these firms operate. Second, they may become a model for U.S. regulators.

Foreign news:

- Andrzej Duda won a plurality in this weekend's election in Poland but not a majority. A second round of elections will be held on July 12th, where he will face Warsaw Mayor Rafał Trzaskowski, who won second place.
- Ireland has a new PM, Macheal Martin; he will govern a three-party coalition of Fianna Fail, Leo Varadkar's Fine Gael and the Green Party. Sinn Fein, the political arm of the IRA, will be the official opposition. The current PM, Varadkar, will be deputy PM and will take over the PM jog in 30 months. This is a "grand coalition" of sorts; for the first time since the founding of the modern Irish republic, Fianna Fail and Fane Gael will form a coalition. This is mostly because neither could agree to form a government with Sinn Fein.
- Russia is increasing its arms sales to Turkey and India. The former is a member of NATO and a long-time U.S. ally; the arms relationship with Russia has been an unwelcome development. India, on the other hand, is a long-term client of Russia's arms industry but is being courted by the U.S. in a bid to contain China. The arms sales will likely not cause problems for New Delhi, but we would expect U.S. arms makers to try and encourage India to begin using U.S. platforms. This will be especially the case if relations become closer.
- Despite U.S. opposition, it appears the EU will be moving ahead to implement digital taxes. The U.S. opposes this move because it is seen as a threat to the American tech firms.
- The EU has also slapped tariffs on an Egyptian fiberglass firm that was built in conjunction with the Chinese "one belt, one road" project. This action will be seen as a snub to Beijing.
- Lebanon is in the midst of a debt and currency crisis. The currency has lost 75% of its value in the unofficial market and its external debt is over 186% of GDP and the country is in default. Demonstrations took place late last week to protest declining living conditions. Although the level of anger is palpable, it is not clear at all how the situation will be resolved.

- The State Department says Iran has become a haven for al Qaeda. Although we doubt much will come from this news, it could be used as a pretext for retaliation, either kinetic or financial, by the U.S.
- Late last year, Congress passed the Caesar Act, makes sanctions mandatory for anyone who facilitates the Assad regime's acquisition of goods and services among other actions that support the current regime in Syria. The U.S. has begun implementing that act, putting additional sanctions on Syria and could add more to Iran as well. Lebanon will also face a sanction threat from the law. The other important characteristic of the Caesar Act is that it applies sanction pressure directly on Syrian Alawites, the base of Assad's support.
- We are monitoring reports of elevated levels of radioactive particles in Northern Europe. The current levels are not a health risk but the inability to pinpoint the source is a worry. There are concerns that the elevated levels may signal a problem due to a Russian nuclear power facility, Russia claims that no problems exist.

U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below lists the economic releases and Fed events scheduled for the rest of the day.

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	New Home Sales	m/m	May	18.0%	-21.8%	**
10:00	New Homes Sales	m/m	May	-22.0%	-34.6%	**
10:30	Dallas Fed Manf. Activity	m/m	Jun	-22.0	-49.2	**
Fed Speakers or Events						
	Speaker or event	**District or position**				
11:00	Mary Daly Takes Part in a Panel on College Attainment	President of the Federal Reserve Bank of San Francisco				
15:00	John Williams and IMF'S Georgieva Speak to Economic Summit	President of the Federal Reserve Bank of New York				

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	Industrial Profits	y/y	May	6.0%	-4.3%		**	Equity bullish, bond bearish
Japan	Retail Sales	y/y	May	-12.3%	-13.7%	-11.6%	**	Equity bearish, bond bullish
	Department Store, Supermarket Sales	y/y	May	-16.7%	-22.1%	-18.2%	**	Equity and bond neutral
Europe								
Eurozone	Economic Confidence	m/m	Jun	75.7	67.5	80.0	***	Equity and bond neutral
	Industrial Confidence	m/m	Jun	-21.7	-27.5	-19.7	***	Equity bearish, bond bullish
	Services Confidence	m/m	Jun	-35.6	-43.6	-25.4	***	Equity bearish, bond bullish
UK	Net Consumer Credit	m/m	May	-4.6b	-7.4b	-3.0b	**	Equity bearish, bond bullish
	Consumer Credit	y/y	May	-3.0%	-0.4%		**	Equity bearish, bond bullish
	Net Lending Sec. on Dwellings	m/m	May	1.2b	0.3b	-1.0b	**	Equity bullish, bond bearish
	Mortgage Approvals	m/m	May	9.3k	15.8k	25.0k	**	Equity bearish, bond bullish
	Money Supply M4	m/m	May	2.0%	1.5%		**	Equity and bond neutral
	M4 Money Supply	y/y	May	11.9%	9.5%		*	Equity and bond neutral
	M4 Ex IOFCs 3M Annualised	m/m	May	30.8%	21.6%		*	Equity and bond neutral
Switzerland	Domestic Sight Deposits CHF	w/w	26-Jun	602.5b	598.9b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	26-Jun	683.0b	680.1b		*	Equity and bond neutral
AMERICAS								
Brazil	Total Outstanding Loans	m/m	May	3.596b	3.587b		**	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)	31	31	0	Down
3-mo T-bill yield (bps)	11	14	-3	Neutral
TED spread (bps)	20	17	3	Up
U.S. Libor/OIS spread (bps)	7	7	0	Up
10-yr T-note (%)	0.65	0.64	0.01	Neutral
Euribor/OIS spread (bps)	-40	-40	0	Neutral
EUR/USD 3-mo swap (bps)	8	9	-1	Down
Currencies	**Direction**			
dollar	Down			Down
euro	Up			Up
yen	Up			Up
pound	Flat			Down
franc	Up			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	$40.84	$41.02	-0.44%	
WTI	$38.38	$38.49	-0.29%	
Natural Gas	$1.60	$1.54	3.50%	
Crack Spread	$9.36	$9.73	-3.81%	
12-mo strip crack	$9.75	$9.86	-1.18%	
Ethanol rack	$1.43	$1.43	-0.17%	
Metals				
Gold	$1,770.83	$1,771.29	-0.03%	
Silver	$17.90	$17.81	0.51%	
Copper contract	$269.45	$267.90	0.58%	
Grains				
Corn contract	$ 321.25	$ 319.25	0.63%	
Wheat contract	$ 479.00	$ 475.75	0.68%	
Soybeans contract	$ 858.50	$ 861.25	-0.32%	
Shipping				
Baltic Dry Freight	1749	1738	11	

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 and South Eastern region. Wet conditions are expected for the majority of the country, with dry conditions in the Rocky Mountain and Mid-Atlantic regions. There is no tropical cyclone activity expected for the next 48 hours.

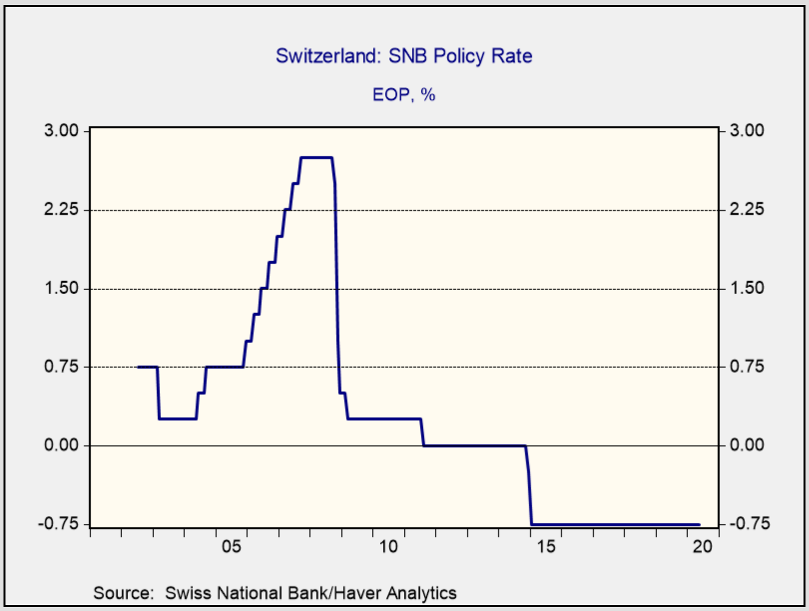
Asset Allocation Weekly

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.

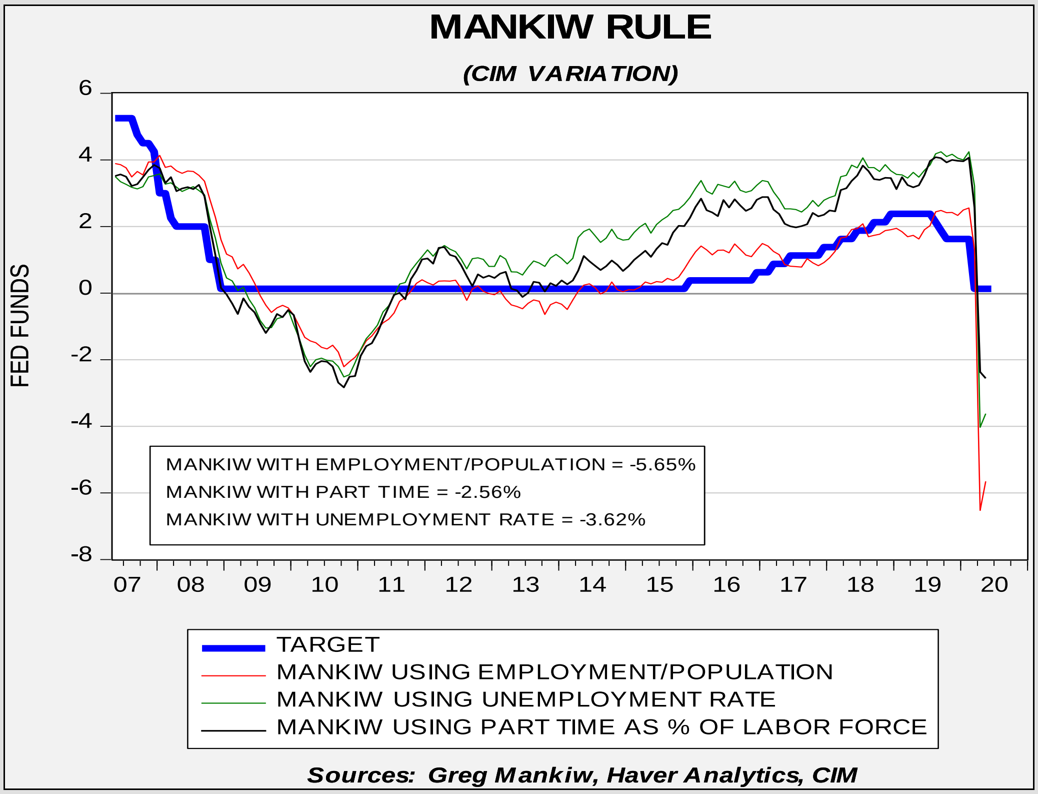


Why would a central bank consider implementing a negative policy rate? If economic conditions warranted easing and inflation was low,[2] it may be impossible to use low but positive interest rates as a policy tool. In that case, negative interest rates or some other unconventional monetary policy may 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

[2] 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%.

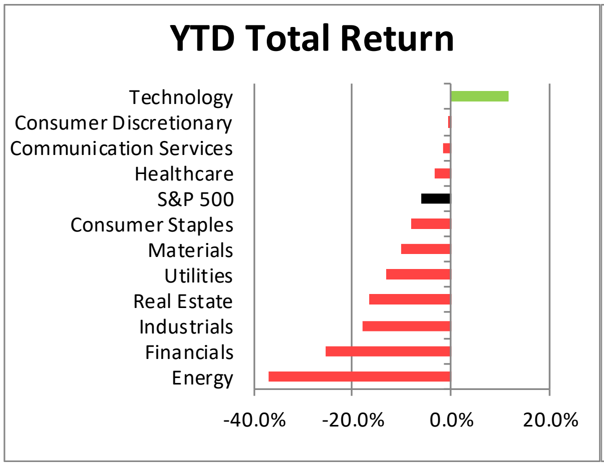
In 2008 through most of 2011, these variations of the Mankiw Rule suggested the policy rate should have been below zero. That is the case today. So far, the FOMC has rejected a negative policy rate and instead relies on expanding the balance sheet and forward guidance. The current program of balance 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.

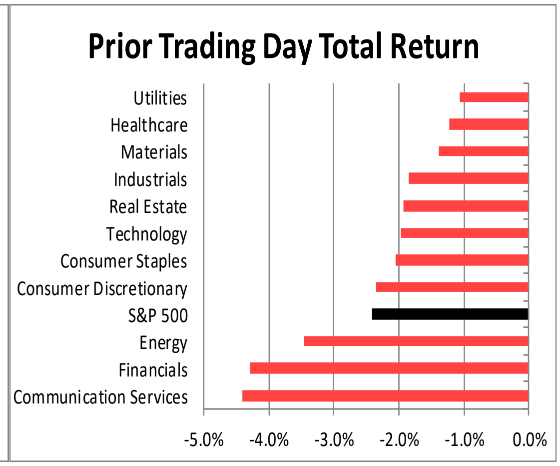
So, why is the FOMC opposed to negative interest rates? The most likely reason is the structure of the U.S. financial system. The U.S. system has an extensive non-bank financial system; unlike banks, this system isn't funded by deposits but by repo and money markets. The non-bank financial system, also 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 6/26/2020 close)

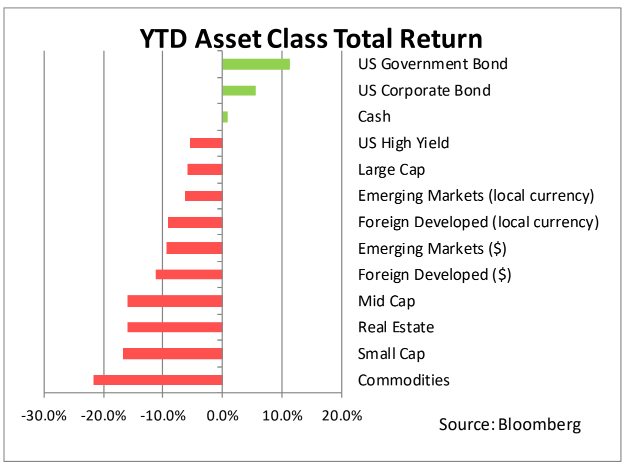




(Source: Bloomberg)

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 6/26/2020 close)

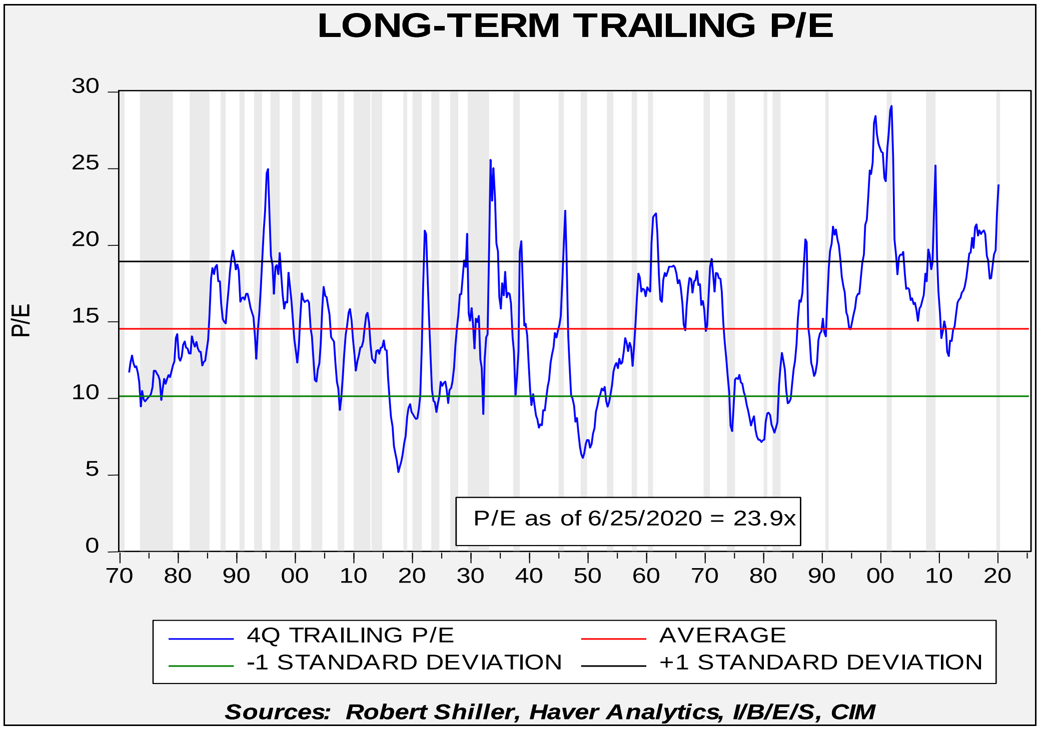


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[3] 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.

[3] 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.