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 30, 2020—9:30 AM EDT] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.1% from its last close. In Asia, the MSCI Asia Apex 50 closed up 0.6% from its prior close. Chinese markets were higher, with the Shanghai Composite up 0.8% from the prior close and the Shenzhen Composite up 1.9%. U.S. equity index futures are signaling a flat open.

U.S. risk assets are little changed today as encouraging economic data out of China is being largely offset by reports of renewed coronavirus outbreaks and lockdowns in many key U.S. states and some foreign localities. At the same time, geopolitics are rising to the forefront again, with China passing its new national security law for Hong Kong and Australia boosting its cyber-defenses against Chinese aggression. We present all the key news below.

COVID-19: Official data show confirmed cases have risen to 10,417,063 worldwide, with 509,474 deaths and 5,255,829 recoveries. In the United States, confirmed cases rose to 2,682,897, with 129,544 deaths and 705,203 recoveries. Here is the interactive chart from the *Financial Times* that allows you to compare cases and deaths among countries, scaled by population.

Virology

- Surging coronavirus cases in California, Arizona, Texas and Florida are reportedly straining hospital systems and maxing out the capacity of their intensive care units. In Phoenix, where ICU units at several hospitals are already full, some are reportedly refusing to admit patients arriving by ambulance to the emergency room. When a community's health system is overwhelmed, it tends to prompt government officials to take action they otherwise wouldn't take, and it can have a significant negative impact on people's confidence. The development could prompt renewed economic restrictions and undermine political support for current incumbents in key localities, so it's an important risk for the equity markets.
- Just as Florida and Texas did last week, Arizona has responded to the surge in caseloads and stress on the hospital system by putting its economic reopening into reverse. Governor Ducey said yesterday that the state would immediately close all bars, gyms and cinemas for at least one month. Separately, New Jersey halted plans to allow indoor restaurant operations and New York's governor said he is considering a similar move, while Tennessee's government said its state of emergency would be extended. Curiously, even as states continue to stretch their traditional health and welfare responsibilities into stringent economic lockdowns, few of the new announcements touched on the imperfect

but much simpler and less costly measure of requiring people to wear facemasks in public.

- Meanwhile, in Britain, the city of Leicester and surrounding areas have been placed under renewed lockdown in response to a resurgence in COVID-19 cases. Health Secretary Matt Hancock said non-essential shops had been told to close on Tuesday and schools asked to shut their doors to the majority of their pupils from Thursday. Classes will remain open for vulnerable children and children of critical workers.
- In India, the government said schools would stay shut for another month and restrictions would be extended until the end of July on nonessential services and movement of persons in containment zones—coronavirus hot spots where lockdowns are still in effect. A nighttime curfew will also be kept in place across the country.
- The FDA today will outline its conditions for approving a COVID-19 vaccine, including a requirement that any vaccine be at least 50% more effective than a placebo in preventing the disease. According to the *Wall Street Journal*, the agency will also say that a vaccine won't be approved simply if it leads to antibodies in the bloodstream of patients, on grounds that it is not known what level of antibodies will confer protection. The guidance will also reportedly say that no vaccine would be approved unless a vaccine company had "clearly demonstrated" proof of a vaccine's safety and effectiveness through a clinical study.
- WHO Director General Ghebreyesus warned that the virus pandemic is far from over and the worst could yet come. He also said the WHO would send a second team to China to investigate the source of the pathogen.

U.S. Policy Response

- Federal Reserve Chair Powell and Treasury Secretary Mnuchin will testify before the House Financial Services Committee today on the coronavirus crisis and the policies implemented to fight it, as required by economic support legislation passed in March. According to his prepared remarks, Powell will say that even though the economy appears to have bounced back faster than previously expected, there is still significant uncertainty as to whether the virus will be kept in check and how the economy will grow from here. If Powell sticks to that theme, it will probably be interpreted as confirmation that monetary policy will remain extraordinarily accommodative, which would be supportive of the markets.

Foreign Policy Response

- In an effort to build momentum for the European Commission's proposed €750 billion post-coronavirus recovery fund, which would be financed with common EU debt, German Chancellor Merkel assured the "frugal four" nations opposed to the idea that all EU countries must also be willing to reform their economies and make them more "future-proof." Merkel expressed confidence that EU leaders would reach agreement on the fund and on the bloc's new budget at a summit due to be held in July, although she admitted there is still a "long way to go." If Merkel's gambit helps push the recovery fund forward, it will likely be positive for European assets and negative for the dollar, at least in part because the common EU debt would help create conditions for the euro to eventually become a true reserve currency to rival the greenback.

China-Hong Kong: In an extraordinary meeting, China's rubber-stamp legislature gave final approval to a new national security law for Hong Kong and President Xi immediately signed it, though full details are still to be released. Demonstrating how swiftly the new law is affecting Hong Kong politics, anti-China activist Joshua Wong disbanded his Demosisto opposition party and urged pro-democracy leaders to use "more flexible" methods to resist Chinese influence on Hong Kong.

China-India: New Delhi announced it would ban dozens of Chinese mobile apps from being downloaded or used in India, citing this month's China-India border clashes in the Himalayas and the possibility that the apps could be used to monitor and profile Indian citizens. According to a senior Indian official, "This is India's first salvo to China after the border clashes, showing that India has a diverse range of retaliatory options." The move deprives some of China's biggest and most important technology firms from accessing India's large, fast-growing market. It may therefore encourage similar moves by the U.S. or other countries that are concerned about China's growing assertiveness.

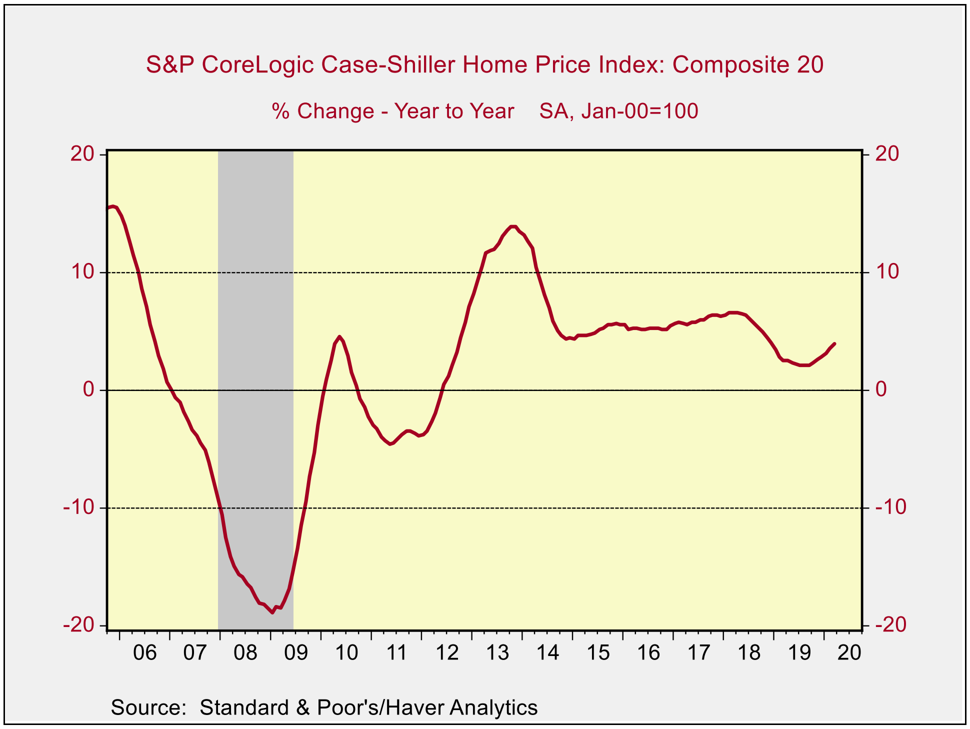
China-Australia: The Australian government is recruiting 500 additional cyber spies and making its largest-ever investment in digital security after a breakdown in diplomatic relations with China and mutual allegations of espionage activity. The investment of almost $1 billion over a decade follows a warning from Prime Minister Morrison that the nation's government, companies and educational institutions have been under sustained attack from a "sophisticated state actor."

Russia-Libya: The Russian government is sending additional fighters, weapons and cash to Libyan opposition leader Khalifa Haftar, who is on the defensive after a failed effort to topple the country's UN-backed government. In an effort to maintain influence in the country in case Haftar loses further support, the Russians are reportedly also building relationships with alternative opposition leaders, including Aguila Saleh.

United States: A nonprofit higher education research organization said overall enrollment at U.S. colleges and universities this spring was down 1.7% from a year earlier, marking the seventh straight year of annual declines. The drop was most severe for four-year, for-profit institutions and smaller, nonprofit schools. Many large public and private nonprofit schools saw increased enrollment.

U.S. Economic Releases

Home prices in the U.S. and in the Top 20 cities continued to rise in April. According to S&P CoreLogic, U.S. home prices rose 4.73% from the prior year compared to expectations of a rise 4.50%. The report for March was revised upward from 4.35% to 4.55%. Meanwhile, home prices in the Top 20 cities rose 3.98% from the prior year compared to expectations of a 3.80% rise. The report for March was revised downward from 3.92% to 3.91%.



The chart above shows the annual change in the S&P CoreLogic U.S. Home Price Index.

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	MNI Chicago PMI	m/m	Jun	45.0	32.3	***
10:00	Conference Board Consumer Confidence	m/m	Jun	91.5	86.6	***
10:30	Conference Board Present Situation	m/m	Jun		96.9	**
10:00	Conference Board Expectations	m/m	Jun		71.1	**
Fed Speakers or Events						
	Speaker or event	**District or position**				
11:00	John Williams Speaks on Central Banking in the Age of COVID	President of the Federal Reserve Bank of New York				
11:05	Lael Brainard Discusses a Decade of Dodd-Frank	Member of the Board of Governors				
12:30	Jerome Powell and Steve Mnuchin Speak before House Financial Panel	Chairman of Board of Governors of Federal Reserve				
14:00	Raphael Bostic and Neel Kashkari Takes Part in Panel on Diversity	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								
China	Composite PMI	m/m	Jun	54.2	53.4		**	Equity bullish, bond bearish
	Manufacturing PMI	m/m	Jun	50.9	50.6	50.5	**	Equity bullish, bond bearish
	Non-manufacturing PMI	m/m	Jun	54.4	53.6	53.6	**	Equity bullish, bond bearish
Japan	Jobless Rate	m/m	May	2.9%	2.6%	2.8%	***	Equity and bond neutral
	Job-To-Applicant Ratio	m/m	May	1.20	1.32	1.22	**	Equity and bond neutral
	Industrial Production	y/y	May P	-25.9%	-15.0%	-23.1%	***	Equity bearish, bond bullish
	Vehicle Production	y/y	Apr	-46.1%			*	Equity and bond neutral
	Housing Starts	y/y	May	-12.3%	-12.9%	-14.4%	**	Equity and bond neutral
	Annualized Housing Starts	y/y	May	0.807m	0.797m	0.788m	**	Equity and bond neutral
	Construction Orders	y/y	May	-6.1%	-14.2%		**	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Confidence	w/w	28-Jun	93.0	97.5		**	Equity and bond neutral
	Private Sector Credit MoM	m/m	May	-0.1%	0.0%	0.0%	**	Equity and bond neutral
New Zealand	ANZ Business Confidence	m/m	Jun	-34.4	-33.0		***	Equity and bond neutral
	ANZ Activity Outlook	m/m	Jun	-25.9	-29.1		**	Equity and bond neutral
Europe								
Eurozone	CPI Estimate	y/y	Jun	0.3%	0.1%	0.2%	***	Equity and bond neutral
	CPI Core	y/y	Jun	0.8%	0.9%	0.8%	***	Equity and bond neutral
France	CPI EU Harmonized	y/y	Jun	0.1%	0.4%	0.5%	***	Equity and bond neutral
	CPI	y/y	Jun	0.1%	0.4%	0.4%	***	Equity and bond neutral
	PPI	y/y	May	-4.1%	-4.7%		**	Equity and bond neutral
	Consumer Spending	y/y	May	-8.3%	-34.1%	-13.5%	***	Equity and bond neutral
Italy	CPI NIC incl. tobacco	y/y	Jun	-0.2%	-0.1%	-0.2%	***	Equity and bond neutral
	CPI EU Harmonized	y/y	Jun	-0.4%	-0.3%	-0.3%	***	Equity and bond neutral
	PPI	y/y	May	-7.2%	-6.7%		**	Equity and bond neutral
UK	GDP	y/y	1Q	-1.7%	-1.6%	0.0	***	Equity and bond neutral
Switzerland	Retail Sales Real	m/m	May	6.6%	-19.9%		**	Equity and bond neutral
	KOF LEI	m/m	Jun	59.4	53.2	77.0	**	Equity and bond neutral
AMERICAS								
Brazil	Bloomberg Nanos Confidence	w/w	26-Jun	46.0	45.4		**	Equity bullish, bond bearish
	Industrial Product Price	m/m	May	1.2%	-2.3%	2.7%	**	Equity and bond neutral
	Building Permits	m/m	May	20.2%	-17.1%	10.4%	***	Equity bullish, bond bearish
	Raw Materials Price Index	m/m	May	16.4%	-13.4%	30.0%	***	Equity and bond neutral
Brazil	Formal Job Creation Total	m/m	May	-331901	-869503	-900000	***	Equity and bond neutral

China: The official June PMI for manufacturing rose to 50.9, beating both the expected reading of 50.5 and the May reading of 50.6. In fact, the June figure was the highest in three months, marking the fourth straight monthly reading above the 50 level that indicates expanding activity. The main fly in the ointment was that several key subindexes remained below 50, including the subindexes on new export orders and employment. Separately, the official June PMI for services and construction activity jumped to a seven-month high of 54.4 compared with 53.6 in May.

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)	13	14	-1	Neutral
TED spread (bps)	18	17	1	Up
U.S. Libor/OIS spread (bps)	6	6	0	Up
10-yr T-note (%)	0.63	0.62	0.01	Neutral
Euribor/OIS spread (bps)	-41	-40	-1	Neutral
EUR/USD 3-mo swap (bps)	8	8	0	Down
Currencies	**Direction**			
dollar	Up			Down
euro	Down			Up
yen	Down			Up
pound	Down			Down
franc	Flat			Up

Commodity Markets

The commodity section below shows some of the commodity prices and their change from the prior trading day, with commentary on the cause of the change highlighted in the last column.

	Price	Prior	Change	Explanation
Energy Markets				
Brent	$41.23	$41.71	-1.15%	Supply Optimism
WTI	$39.18	$39.70	-1.31%	
Natural Gas	$1.71	$1.71	0.23%	
Crack Spread	$10.80	$10.27	5.22%	
12-mo strip crack	$10.39	$10.16	2.30%	
Ethanol rack	$1.43	$1.43	0.03%	
Metals				
Gold	$1,770.33	$1,772.82	-0.14%	
Silver	$17.86	$17.86	0.03%	
Copper contract	$271.75	$269.25	0.93%	
Grains				
Corn contract	$ 328.00	$ 328.75	-0.23%	
Wheat contract	$ 482.25	$ 486.50	-0.87%	
Soybeans contract	$ 861.50	$ 861.50	0.00%	
Shipping				
Baltic Dry Freight	1794	1749	45	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-0.8		
Gasoline (mb)		-1.7		
Distillates (mb)		0.7		
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 Pacific and southeastern regions. 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 over the next 48 hours.

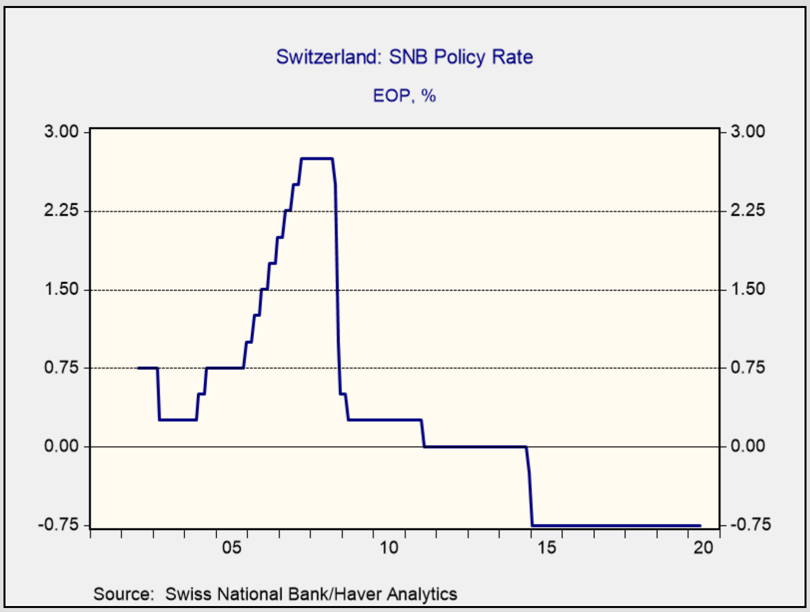
Asset Allocation Weekly

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.

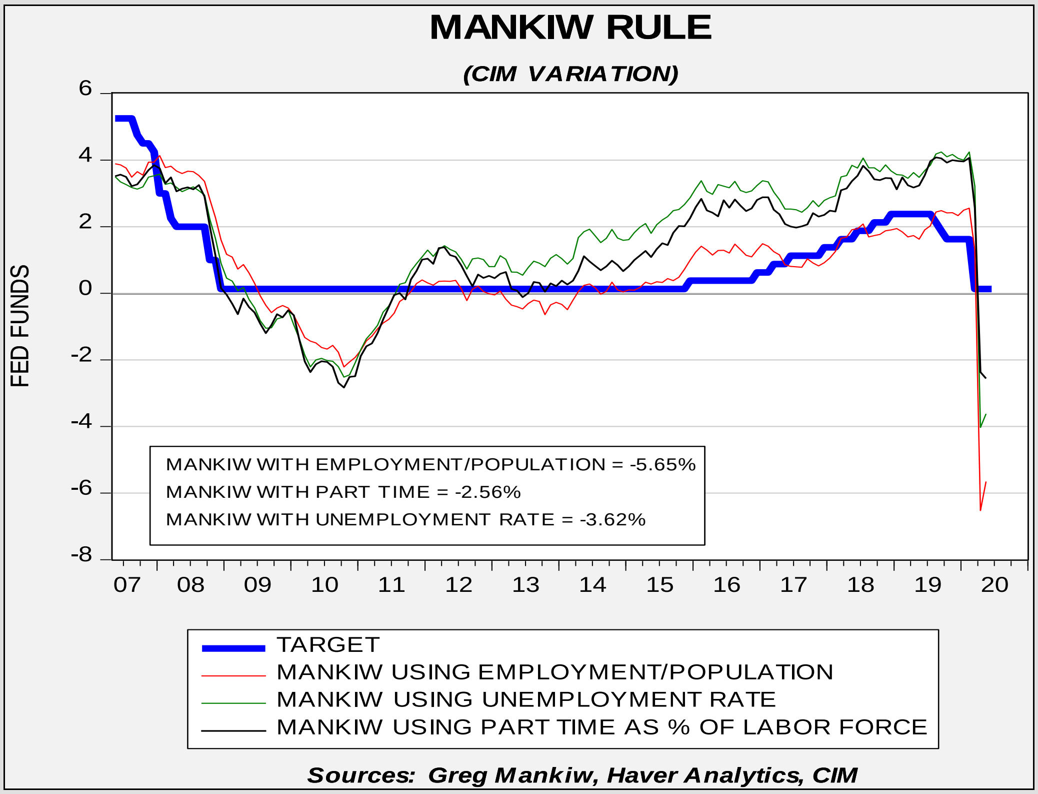


Why would a central bank consider implementing a negative policy rate? If economic conditions warranted easing and inflation was low,[1] it may be impossible to use low but positive interest rates as a policy tool. In that case, negative interest rates or some other unconventional monetary policy may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

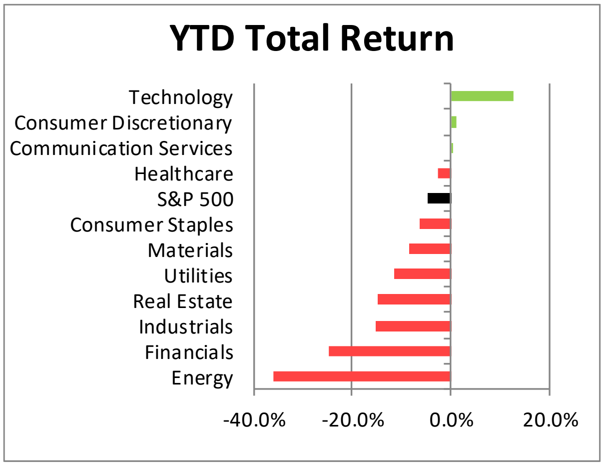
So, why is the FOMC opposed to negative interest rates? The most likely reason is the structure of the U.S. financial system. The U.S. system has an extensive non-bank financial system; unlike banks, this system isn't funded by deposits but by repo and money markets. The non-bank financial system, also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

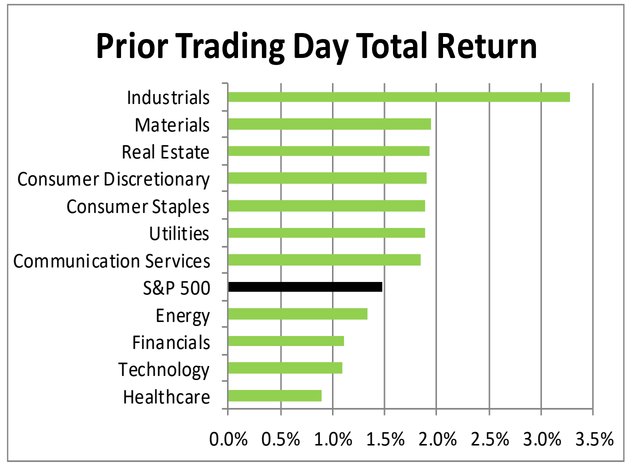
And so, additional policy stimulus, if necessary, will come from further expansion of the balance sheet and forward guidance. Another possibility would be yield curve control, which was implemented during WWII into the early 1950s. In this policy, the Fed will set the desired rate of some or all of the 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.

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 6/29/2020 close)

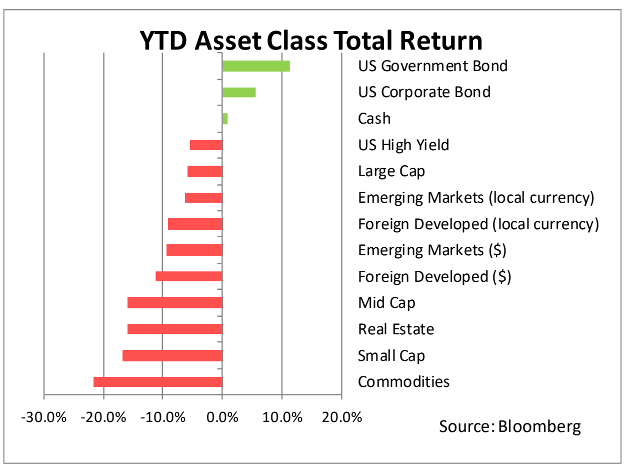




(Source: Bloomberg)

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 6/29/2020 close)

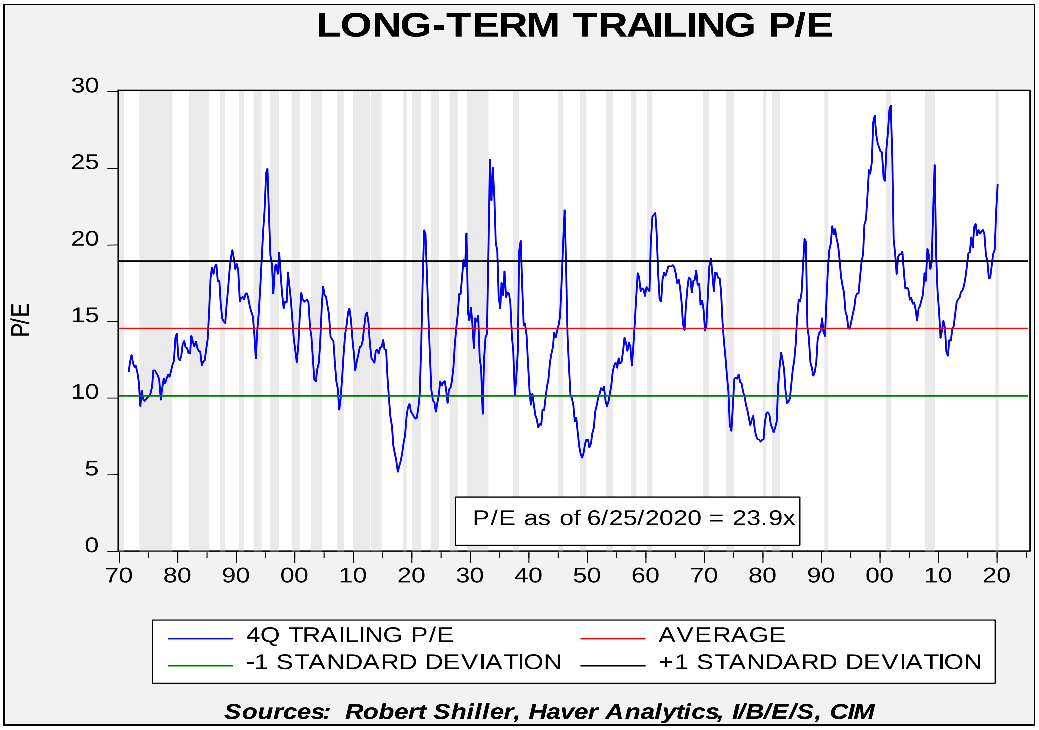


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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[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.