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.

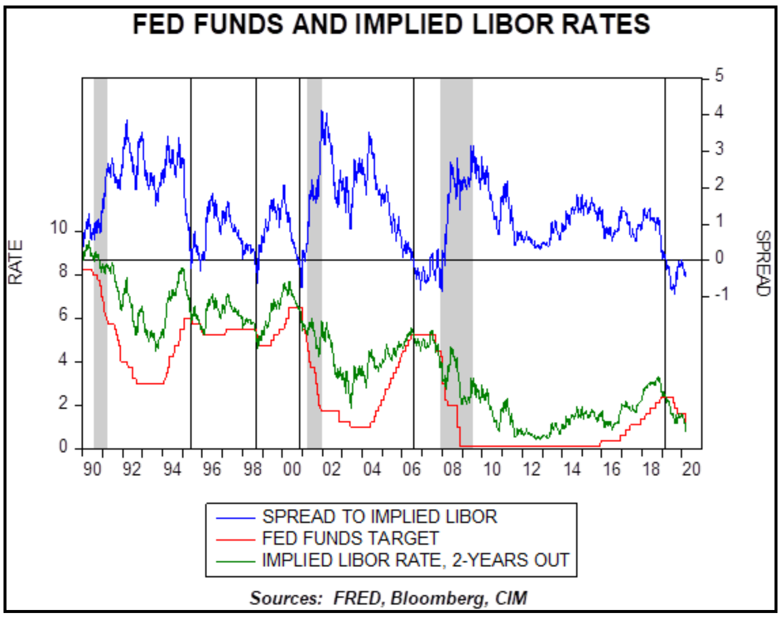
[Posted: March 4, 2020—9:30 AM EST] Global equity markets are higher this morning. The EuroStoxx 50 is currently up 1.5% from its last close. In Asia, the MSCI Asia Apex 50 closed relatively up 0.7%. Chinese markets were higher, with the Shanghai Composite up 0.6% and the Shenzhen Composite up 0.4%. U.S. equity index futures are signaling a higher open. With 483 companies having reported, the S&P 500 Q4 earnings stand at $42.00, higher than the $40.59 forecast for the quarter. The forecast reflects a 2.0% decrease from Q4 2018 earnings. Thus far this quarter, 71.4% of the companies have reported earnings above forecast, while 20.7% have reported earnings below forecast.

After yesterday's wild rollercoaster ride in the markets, we're looking for a happier Wednesday. We provide an update to the COVID-19 panic and the confusing policy responses, as well as a recap of yesterday's Super Tuesday primaries. On a less positive note, it seems the U.S.-Taliban peace deal is already at risk, while a new migrant crisis continues to threaten the EU.

COVID-19: Official data show confirmed cases have risen to 94,250 worldwide, with 3,214 deaths and 51,026 recoveries. In the United States, confirmed cases rose to 128, with nine deaths and eight recoveries. Those figures still pale in comparison with the typical impact from influenza every year, but the COVID-19 virus is still a novel, unknown threat, and world markets have been buffeted by waves of fear and worry that even powerful policymakers may be ineffective in their fight against it.

- ***Federal Reserve.*** Over the last 24 hours, the key event in the COVID-19 panic was the Fed's decision to slash its benchmark fed funds interest rate to a range of 1.00% to 1.25%. Not only was the cut unusually large (50 basis points), but it also came sooner than expected. In fact, it was the first cut outside a regular policy meeting since 2008. The aggressive action initially prompted strong stock buying, but the aggressiveness itself seemed incongruous with the Fed's recent signaling that the economy is in good shape. Even worse, Fed Chair Powell warned in a post-decision press conference that the virus and measures to contain it will still weigh on the global economy in the future, and Cleveland Fed President Mester later reiterated that idea. This begs the question as to why policymakers felt the need to move so soon, undercutting the "coordinated" action that global officials had been hinting at. Does the Fed know something that we don't know, perhaps from the business contacts that contribute to the Beige Book? Did policymakers cave to political pressure from the White House? Or, after years of monetary policy coming to the rescue of the economy and markets, did the bungled messaging finally wake up investors to the fact that low interest rates and central bank asset purchases can't cure all ills. Sometimes, they're merely anesthesia. In any case, the market's judgement turned negative quickly, pushing stock prices down sharply.

- ***Bond Market Action.*** Amidst the drop in stocks, safe-haven Treasuries surged, pushing the yield on the benchmark 10-year note down to a record intraday low of 0.91% and a record closing low of 1.01%. Strong buying during a stock rout is no surprise, but there was probably more to it than that. We note that the Fed's big cut still wasn't enough for the fed funds rate to catch up with one of our favorite indicators: the implied LIBOR rate two years out. That figure suggests the Fed would have to cut rates by about 50 more bps soon. Just as important, multiple structural issues ranging from slower population growth and population aging to deregulation and globalization still seem likely to hold down inflation in the near term. At this point, it's hard to see a need for serious rate hikes in the foreseeable future. Some snap-back in longer yields wouldn't be a surprise, but a dramatic and sustained rebound may not be in the cards.



- ***Other Central Banks.*** Like the Fed, other major central banks have been signaling their willingness to loosen policy to cushion the impact of COVID-19, but they may wait a bit longer. The ECB may be the next move, with markets pricing in a cut of 10 bps when it meets on March 12. The Fed holds its next regular policy meeting March 17-18, at which point it could cut again, while the Bank of Japan holds its next meeting on March 18-19 and Bank of England policymakers meet on March 26.

- ***Economic Impact.*** Even though public health officials' draconian measures to stem the epidemic have so far proven much more economically disruptive than the disease itself, a new IPSOS poll shows people around the world are comfortable with quarantining whole cities. In the U.S., the poll found fully 70% of respondents comfortable with citywide quarantines. That support is probably one reason why public officials and private firms alike continue to take dramatic steps that can seem excessive compared with the risk of the disease. Conferences and business travel plans are being cut at a historic rate. The

NCAA even says it's open to banning fans from attending the men's basketball championship tournament. Such cancellations could increase if a well-known personality is sickened or dies from the virus; rumors are already swirling that Pope Francis has been infected with COVID-19. With global manufacturing still nursing its wounds from last year's trade war, the hit to the service sector is a key risk. As shown below, data today showed a big drop in the PMI for services in both China and Japan. Of course, manufacturing workers in China and elsewhere have borne much of the brunt of the epidemic's disruptions, but the generally lower pay, lower skill level, and lack of unionization among service-sector workers in industries like air travel and lodging mean their income and spending could quickly come to a hard stop as the disruptions continue.

Super Tuesday: In yesterday's Democratic primaries, former Vice President Joe Biden did much better than anticipated, winning multiple states outright and surging past Vermont Sen. Bernie Sanders in committed delegates to the party's summer convention. Biden showed particular strength in the South, Midwest, and New England, while Sanders won California, Utah, Colorado, and Vermont. Former New York Mayor Bloomberg and Massachusetts Sen. Warren walked away with little to show for their efforts. With the moderate Biden now leading what has become a two-man race, and with Bloomberg promising to richly fund whichever Democrat wins the nomination, the results are likely to be a positive for equities today.

Turkey-Syria-EU: Rushing to take advantage of President Erdogan opening Turkey's border with Greece, thousands of Middle Eastern refugees are streaming across Turkey to cross into the EU. However, Greek officials continue to block the migrants, and EU leaders are demanding that Turkey comply with its 2016 agreement to keep them bottled up in return for aid. While Erdogan hopes to use the EU's fear of a new migrant crisis as leverage for additional aid and help in Turkey's fight against Syrian troops, EU officials are showing no sign of caving to his demands just yet.

United Kingdom: Home Secretary Priti Patel's position in the government appears to be hanging by a thread after multiple senior civil servants have accused her of using an abusive, bullying management style. Given the Home Secretary's high profile in British government, a Patel resignation would be politically damaging to Prime Minister Johnson.

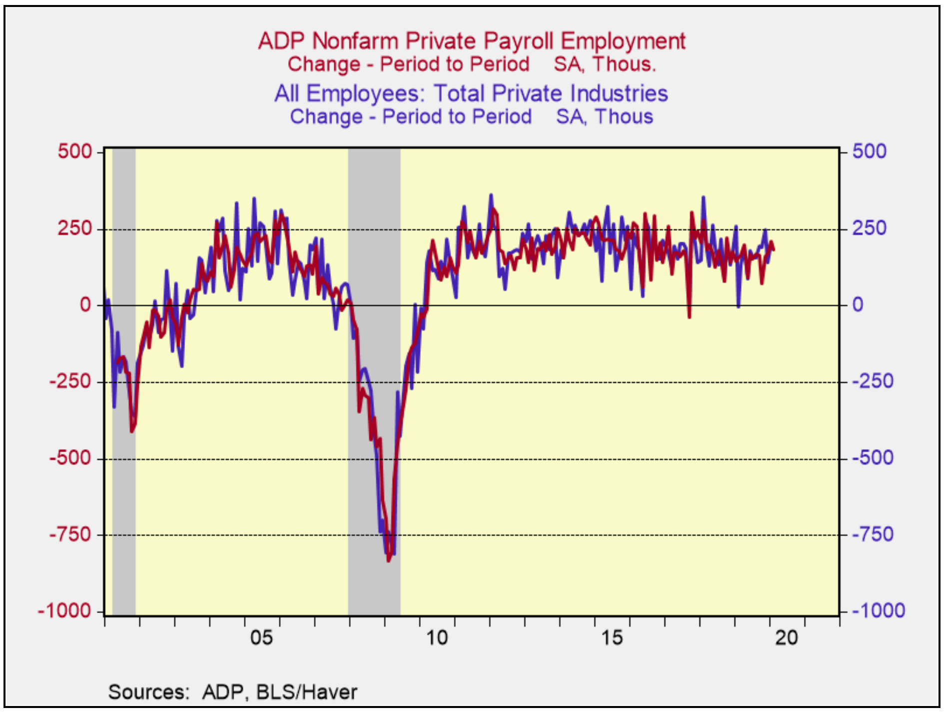
United States-Afghanistan: Just days after the U.S. and the Taliban signed a deal to end U.S. involvement in Afghanistan, yesterday Taliban fighters carried out dozens of attacks on Afghan security checkpoints in Helmand province alone, prompting a U.S. airstrike against the Taliban. The violence suggests the U.S.-Taliban deal is already at risk. If the deal fails, it could leave the U.S. with no good option to withdraw from the country and cause a significant political liability for President Trump in the run-up to the November election.

Iran: The International Atomic Energy Agency said yesterday that Iran has tripled its stockpile of enriched uranium and is barring international inspectors from two undeclared nuclear sites. The moves follow Iran's announcement last year that it will stop adhering to aspects of the international nuclear agreement in response to the U.S. re-imposing sanctions. This news will further ratchet up tensions with the West and potentially bring Israel closer to taking unilateral military action.

U.S. Economic Releases

MBA mortgage applications rose 15.1% from the prior week. Purchases fell 2.7% from the prior week, while refinancing rose by 26%. The average 30-year fixed rate mortgage fell by 16 bps from 3.73% to 3.57%, the biggest drop in nine years.

ADP employment change came in above expectations at 183k compared to the forecast of 170k. The prior report was revised downward from 291k to 209k.



The chart above shows the data from the ADP report and U.S. non-farm payrolls. The ADP report provides insight into the payroll numbers, so a strong ADP report signals that payrolls may also be strong.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	Markit Services PMI	m/m	Feb	49.4	49.4	**
9:45	Markit Composite PMI	m/m	Feb		49.6	**
10:00	ISM Non-Manufacturing	m/m	Feb	54.9	55.5	**
Fed Speakers or Events						
	Speaker or event	**District or position**				
14:00	US Federal Reserve Releases Beige Book	Members of the Board of Governors				
18:30	James Bullard Discusses Economy and Monetary Policy	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	Caixin China PMI Composite	m/m	Feb	27.5	51.9		**	Equity bearish, bond bearish
	Caixin China PMI Services	m/m	Feb	26.5	51.8	48.0	**	Equity bearish, bond bearish
Japan	Jibun Bank Japan PMI Services	m/m	Feb	38.4	39.1	38.1	**	Equity bearish, bond bearish
	Jibun Bank Japan PMI Composite	m/m	Feb	47.0	47.0		**	Equity bearish, bond bearish
India	Markit India PMI Composite	m/m	Feb	57.6	56.3		**	Equity bullish, bond bearish
	Markit India PMI Services	m/m	Feb	57.5	55.5		**	Equity bullish, bond bearish
Australia	AiG Performance of Construction Index	m/m	Feb	42.7	41.3		**	Equity bearish, bond bearish
	CBA Australia PMI Services	m/m	Feb	49.0	48.4		**	Equity and bond neutral
	CBA Australia PMI Composite	m/m	Feb	49.0	48.3		**	Equity and bond neutral
	GDP	y/y	4Q	2.2%	1.7%	2.0%	***	Equity bullish, bond bearish
New Zealand	QV House Prices	y/y	Feb	5.3%	4.4%		**	Equity bullish, bond bearish
	Building Permits	m/m	Jan	-2.0%	9.9%		**	Equity bearish, bond bearish
	ANZ Commodity Price	m/m	Feb	-2.1%	0.9%		**	Equity bearish, bond bearish
EUROPE								
Eurozone	Markit Eurozone Services PMI	m/m	Feb	52.6	52.8	52.8	**	Equity and bond neutral
	Markit Eurozone Composite PMI	m/m	Feb	51.6	51.6	51.6	**	Equity and bond neutral
	Retail Sales	y/y	Feb	1.7%	1.3%	1.1%	***	Equity bullish, bond bearish
Germany	Markit Germany Services PMI	m/m	Feb	52.5	53.3	53.3	**	Equity and bond neutral
	Markit Germany Composite PMI	m/m	Feb	50.7	51.1	51.1	**	Equity and bond neutral
	Retail Sales	y/y	Jan	1.8%	0.8%	1.5%	***	Equity bullish, bond bearish
Italy	Markit Italy Services PMI	m/m	Feb	52.1	51.4	51.3	**	Equity bullish, bond bearish
	Markit Italy Composite PMI	m/m	Feb	50.7	50.4	50.1	**	Equity bullish, bond bearish
	GDP	y/y	4Q	0.1%	0.0%	0.0%	**	Equity bullish, bond bearish
UK	Official Reserves Changes	m/m	Feb	$1.809 Bil	$2.162 Bil		**	Equity and bond neutral
	Markit/CIPS UK Services PMI	m/m	Feb	53.2	53.3	53.3	**	Equity and bond neutral
	Markit/CIPS UK Composite PMI	m/m	Feb	53.0	53.3	53.3	**	Equity and bond neutral
Switzerland	CPI	y/y	Feb	-0.1%	0.2%	0.1%	***	Equity bullish, bond bearish
	CPI EU Harmonized	y/y	Feb	-0.2%	0.2%	0.1%	***	Equity bullish, bond bearish
	CPI Core	y/y	Feb	0.2%	0.2%	0.2%	***	Equity and bond neutral
Russia	Markit Russia PMI Services	m/m	Feb	52.0	54.1	53.6	**	Equity and bond neutral
	Markit Russia PMI Composite	m/m	Feb	50.9	52.6		**	Equity and bond neutral
AMERICAS								
Mexico	Vehicle Domestic Sales	m/m	Feb	104328	104832		**	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)	125	146	-21	Up
3-mo T-bill yield (bps)	88	92	-4	Neutral
TED spread (bps)	38	55	-17	Neutral
U.S. Libor/OIS spread (bps)	75	79	-4	Up
10-yr T-note (%)	0.98	1.00	-0.02	Neutral
Euribor/OIS spread (bps)	-46	-43	-3	Neutral
EUR/USD 3-mo swap (bps)	10	-13	23	Down
Currencies	**Direction**			
dollar	Up			Neutral
euro	Down			Down
yen	Down			Down
pound	Down			Down
franc	Flat			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Canada Rate Decision		1.750%	1.500%	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	$52.63	$51.86	1.48%	Possible Central Bank Easing
WTI	$47.95	$47.18	1.63%	
Natural Gas	$1.80	$1.80	-0.17%	
Crack Spread	$17.41	$17.25	0.89%	
12-mo strip crack	$13.90	$13.86	0.31%	
Ethanol rack	$1.43	$1.43	0.02%	
Metals				
Gold	$1,646.69	$1,640.90	0.35%	
Silver	$17.27	$17.22	0.30%	
Copper contract	$259.55	$257.30	0.87%	
Grains				
Corn contract	$ 381.75	$ 381.25	0.13%	
Wheat contract	$ 523.50	$ 527.25	-0.71%	
Soybeans contract	$ 908.00	$ 903.50	0.50%	
Shipping				
Baltic Dry Freight	549	539	10	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.0		
Gasoline (mb)		-2.0		
Distillates (mb)		-1.5		
Refinery run rates (%)		-0.40%		
Natural gas (bcf)		-111.0		

Weather

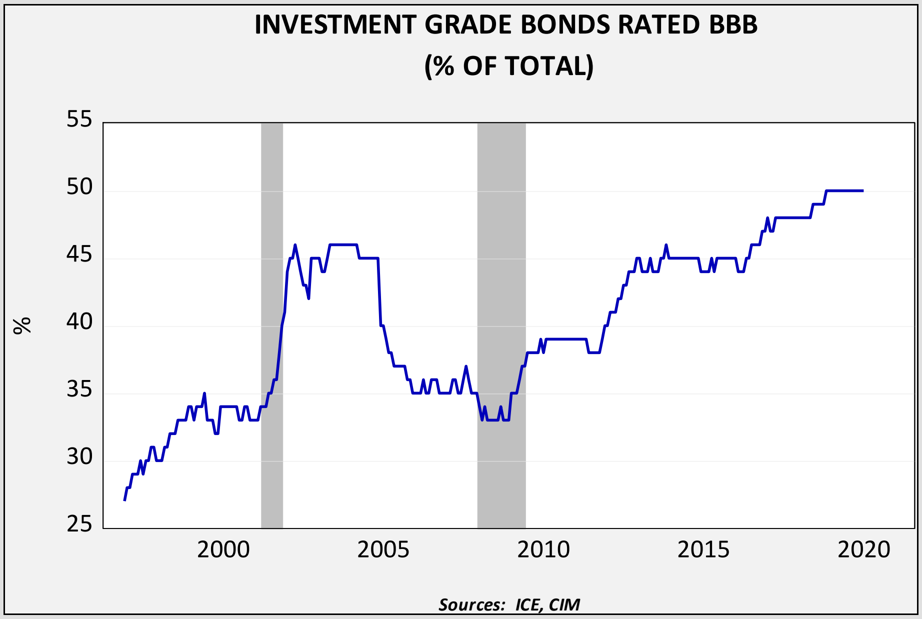
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for most of the country, with colder-than-normal temperatures in the northern Pacific regions. Wet conditions are expected for nearly all of the country except the Rocky Mountain region.

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.

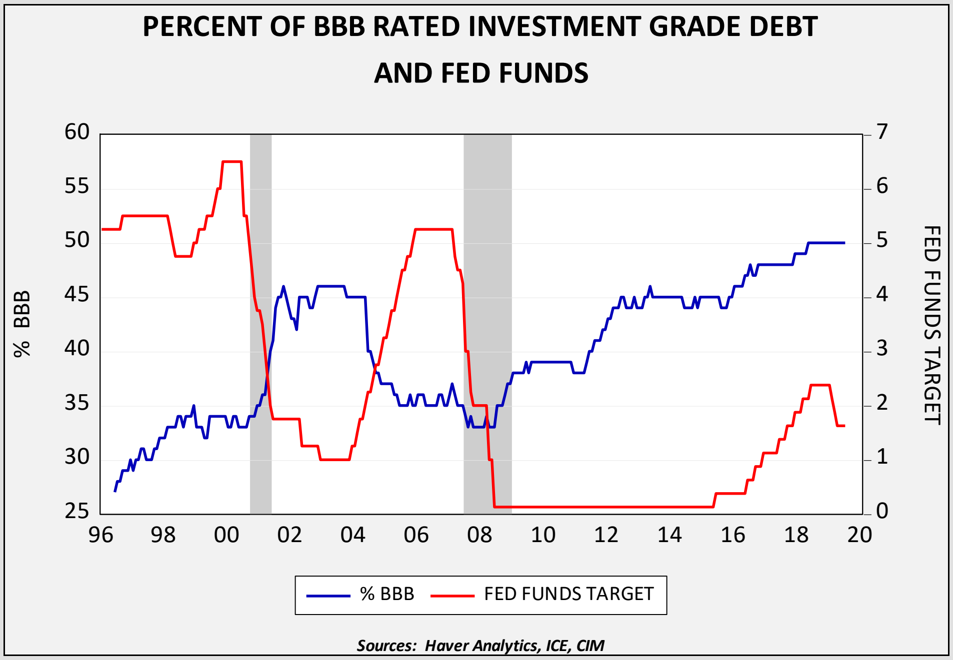
February 28, 2020

Since the end of the Financial Crisis, there has been a steady deterioration in investment-grade credit quality.



This chart shows the percentage of investment-grade bonds rated at BBB. Since late 2018, this portion has represented half of outstanding investment-grade credit. This rating is the lowest end of investment-grade credit, so the dominance of this segment raises questions about the stability of these corporate bonds under deteriorating financial conditions.

History tends to show that monetary policy has the most significant impact on the percentage of BBB debt.



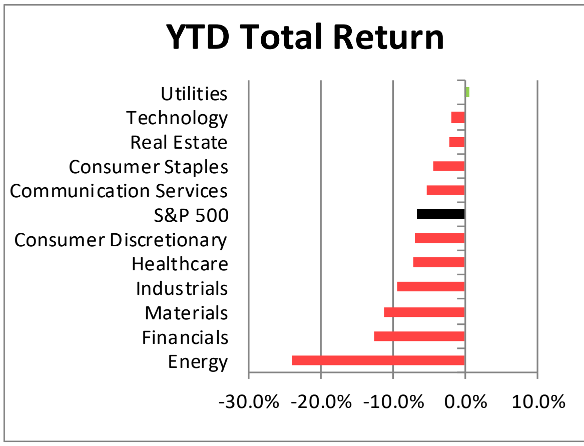
A rising policy rate between 2004 into 2006 coincided with a sizeable decline in the percentage of BBB-rated debt in the investment-grade category. Low rates since 2008 led to a steady rise in the percentage of BBB-rated debt. Most notably, the policy tightening from 2016 into last year did not slow the rise, suggesting investors did not believe that monetary policy would lead to concerns about credit quality.

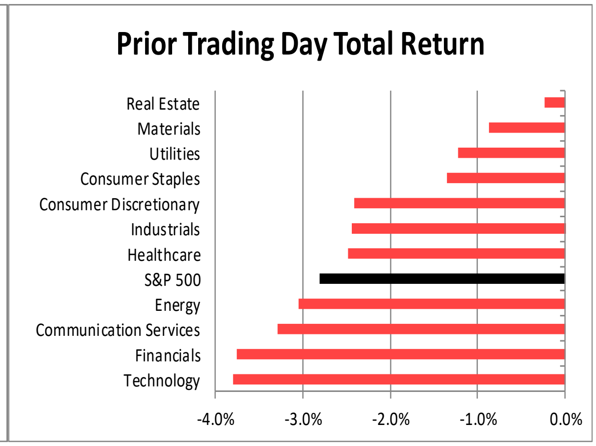
This data suggests a couple of issues. First, the current high level of low-rated debt in investment-grade is a concern if the economy weakens or policymakers overtighten. Second, investors appear confident that neither outcome is likely in the short run and, if anything, the FOMC will react quickly to protect the economy from trouble. The risk, of course, is that either this confidence is misplaced or a circumstance will develop to which no amount of policy stimulus can prevent credit deterioration.

In response to this deterioration of credit quality, we have reduced our overall exposure to investment-grade credit in our allocations to fixed income. However, we remain overweight to investment-grade, in part, due to expectations that a recession or a credit event isn't imminent.

Data Section

U.S. Equity Markets – (as of 3/3/2020 close)

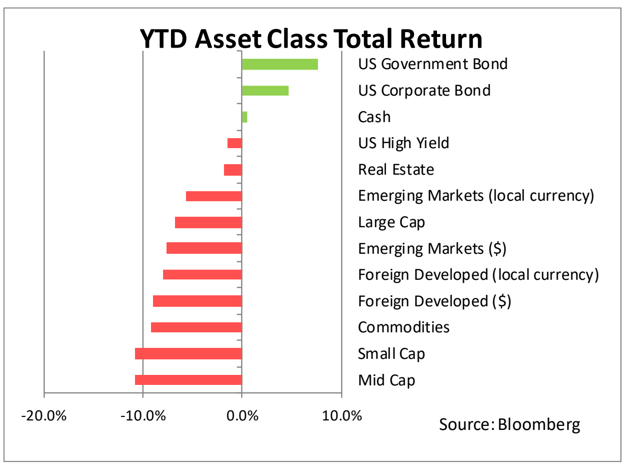




(Source: Bloomberg)

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 3/3/2020 close)

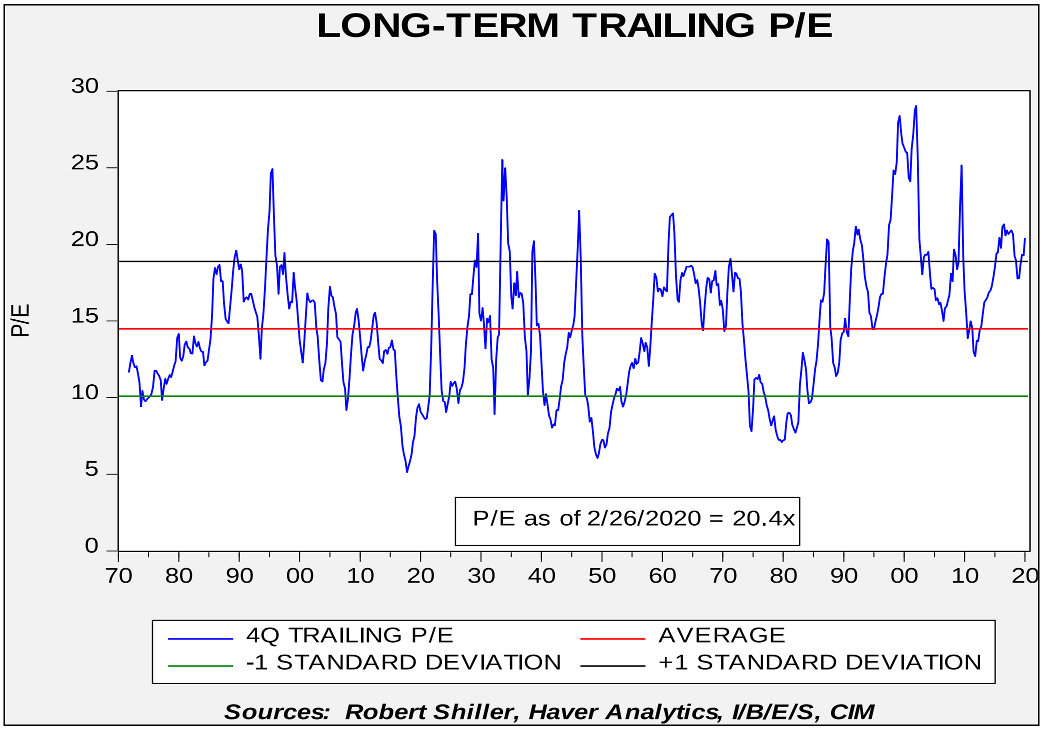


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

February 27, 2020



Based on our methodology,[1] the current P/E is 20.4x, unchanged from last week.

This report was prepared by Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change. This is not a solicitation or an offer to buy or sell any security.

[1] This chart offers a running snapshot of the S&P 500 P/E in a long-term historical context. We are using a specific measurement process, similar to *Value Line*, which combines earnings estimates and actual data. We use an adjusted operating earnings number going back to 1870 (we adjust as-reported earnings to operating earnings through a regression process until 1988), and actual operating earnings after 1988. For the current quarter, we use the I/B/E/S estimates which are updated regularly throughout the quarter; currently, the four-quarter earnings sum includes two actual quarters (Q2 and Q3) and two estimates (Q4 and Q1, 2020). 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.