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 18, 2020—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is currently down 5.7% from its last close. In Asia, the MSCI Asia Apex 50 closed down 3.3%. Chinese markets were lower, with the Shanghai Composite down 1.8% and the Shenzhen Composite down 1.6%. U.S. equity index futures are signaling a lower open.

Well, it's Wednesday, and we face another day right out of a post-apocalyptic zombie movie. While there is still no sign of zombie armies marching on Washington, there is a more worrying sign that global financial markets are seizing up in a desperate scramble for liquidity. Policymakers around the world are pledging in unison to do "whatever it takes" to rescue the global economy, which is a good thing, but markets will remain volatile until real results are visible. Below we review all the key news from the crisis and beyond.

COVID-19: Official data show confirmed cases have risen to 203,529 worldwide, with 8,205 deaths and 82,107 recoveries. In the United States, confirmed cases rose to 6,496, with 114 deaths and 17 recoveries. Most disconcerting, the slowdown in the real economy is exposing or exacerbating financial weaknesses. There are increasing worries about businesses and individuals not only having trouble paying their everyday bills, but also covering the high levels of debt they took on during the boom of the last decade.

- ***Real Economy Impact.*** In a *Financial Times* Op-Ed, former Fed Chairs Yellen and Bernanke warned the world's central bankers and governments to focus on making the virus crisis as short-lived as possible. In their view, the main danger is that if the crisis is prolonged, established economic relationships will get broken and healthy businesses will go bankrupt. Then, it would be difficult for people to find the same jobs, for businesses to get new credit lines, and for the economy to get back to the way it was. They emphasized that the central banks need to make sure credit remains widely available for firms and individuals under stress. The Yellen/Bernanke warning comes as reports show imported infections spiking in some Asian countries where it previously seemed the pandemic had been brought under control. Preventing imported cases will likely become even more difficult now that the pandemic is spreading even in Africa and Latin America. Even as imported infections loom, a survey shows one-third of manufacturers in southern China are facing supply shortages despite the recent sense that the country had passed the worst of the crisis.
- ***Financial System Impact.*** Despite the loosened monetary policy around the world, we continue to see signs of a desperate dash for dollars. Fund managers are selling even the

most liquid safe-haven assets to raise cash, so government bond prices are slumping all over the world this morning. The selling is reportedly being exacerbated by investors' concern about burgeoning debt issuance in the coming months as governments seek to fund their crisis fiscal plans. At the same time, heavy selling has left both Vanguard's and Blackrock's total bond market ETFs trading at steep discounts to NAV. Commodities, including gold and other precious metals, are also being sold off to raise cash. As long as margin calls and debt repayment concerns persist, even the supposedly safe-haven assets could remain volatile and under pressure.

- ***Fiscal Policy Response.*** The Trump administration yesterday said it was working with Senate Republicans on a Phase III economic support package totaling some $1 trillion. That would include up to two direct payments to individuals costing $250 billion each, some $50 billion in aid to the airline industry and as much as $500 billion to help small businesses and cover other expenses. The first payment to individuals would come around the end of April and would be means tested so it doesn't advantage the wealthy. Some Republicans are still uncomfortable with the provisions, but Senate Majority Leader McConnell is pushing for passage, saying, "My counsel is to gag and vote for it anyway." The Phase III legislation would supplement the Phase II package consisting mostly of paid sick leave, which has already passed the House, and the earlier Phase I package of about $8 billion focused on vaccine research and other medical initiatives. In contrast, investors are increasingly worried that Chinese policymakers don't have the stomach to launch a big, new monetary or fiscal stimulus like they did in 2008.

- ***Monetary Policy Response.*** To help ease financial conditions, yesterday the Fed said it would revive the Primary Dealer Credit Facility used in the 2008 financial crisis. The facility is designed to expand cheap loans to primary dealers (the 24 large financial institutions that serve as the Treasury's exclusive counterparties in financial transactions), by allowing them to borrow against some stocks, municipal debt and higher-rated corporate bonds. However, just as with fiscal policy, some major institutions are hesitating about how far to push monetary measures. In controversial remarks published today, Austrian Central Bank Governor Holzmann said that the ECB shouldn't step in to support the bonds of heavily indebted countries like Italy, and that a recession might have a useful "cleansing" effect on the economy. In a stunning throwback to the traditional Austrian school of economics, Holzmann said, "One should be careful that only the firms capable of surviving do survive, and that others that would have failed even without a crisis don't survive." Eurozone leaders are also at odds over using the ECB's massive, €500 billion "European Stability Mechanism" to offer credit lines to multiple states. Germany and the Netherlands, in particular, are resisting the move.

United States: In yesterday's Democratic Party primary elections, former Vice President Biden won all three key races. With his wins in Florida, Illinois and Arizona, it appears he would only have to win 42.8% of the remaining delegates to the party's summer convention in order to win outright in the first ballot. The wins heap even more pressure on Vermont Sen. Bernie Sanders to drop out of the race.

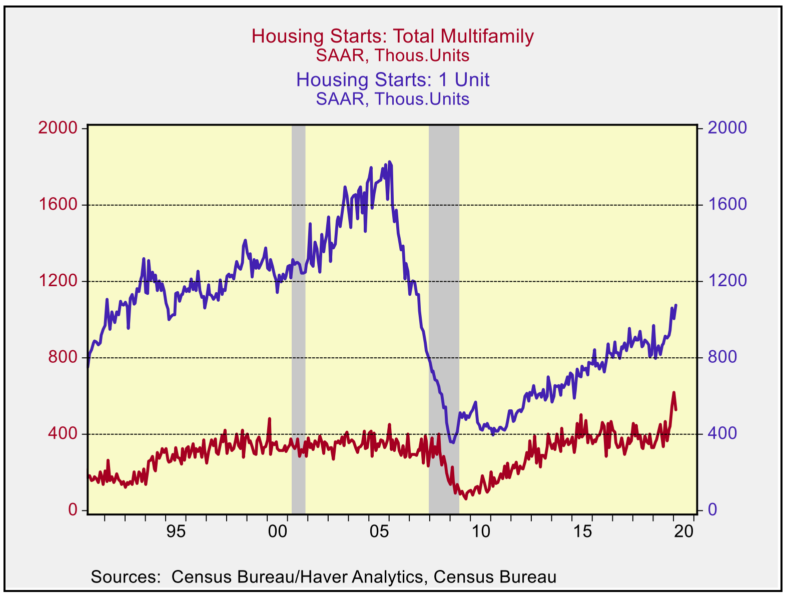
Argentina: President Alberto Fernández has proposed a further hike in the country's soybean export tax to 33%, just months after he increased the tax to 30% from the previous 25%.

However, the powerful farmers' lobby is now starting to push back by launching protests. Along with the global coronavirus panic, the tension is negative for Argentine stocks and bonds.

U.S. Economic Releases

MBA mortgage application fell 8.4% from the prior week. Purchases and refinancing fell 0.9% and 10.4%, respectively. The average 30-year fixed rate rose 27 bps from 3.47% to 3.74%.

Housing starts came in above expectations at 1,599k compared to estimates of 1,500k. The prior report was revised upward from 1,567k to 1,624k. Meanwhile, housing permits came in below expectations at 1,464k compared to estimates of 1,500k.



The chart above shows the level of housing starts for multi-family and single-family homes. In February, single-family home starts rose from 1,005k to 1,072k from the prior month, while multi-family home starts fell from 619k to 527k in that same period. This graph highlights the growing optimism homebuilders had about the economy prior to the coronavirus pandemic. As the economic impact of the virus slowly unfolds, it seems unlikely that construction will be able to continue at its current pace. There have been calls for construction companies to suspend building and yesterday Mike Pence asked construction companies to donate all of their N95 masks to hospitals.

There are no other economic releases or Fed events scheduled for the rest of the day.

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	Trade Balance	m/m	Feb	¥1.110 Tril	-¥1.313 Tril	¥0.930 Tril	**	Equity bullish, bond bearish
Australia	Westpac Leading Index	m/m	Feb	-0.4%	0.1%		**	Equity bearish, bond bearish
New Zealand	BoP Current Account Balance	q/q	4Q	-2.657 Bil	-6.351 Bil	-2.833 Bil	**	Equity and bond neutral
	Current Account GDP Ratio	ytd	4Q	-3.0%	-3.3%	-3.1%	***	Equity and bond neutral
EUROPE								
Eurozone	Trade Balance	m/m	Jan	17.300 Bil	22.200 Bil	19.200 Bil	**	Equity and bond neutral
	CPI	y/y	Feb	1.2%	1.2%	1.2%	**	Equity and bond neutral
	EU27 New Car Registration	m/m	Feb	-7.4%	-7.5%		**	Equity and bond neutral
Italy	Industrial Sales	y/y	Jan	3.8%	-1.4%		**	Equity and bond neutral
	Industrial Orders	y/y	Jan	-1.8%	6.0%		**	Equity and bond neutral
	Trade Balance EU	m/m	Jan	0.830 Bil	-0.748 Bil		**	Equity and bond neutral
	Trade Balance Total	m/m	Jan	0.542 Bil	5.013 Bil		**	Equity and bond neutral
AMERICAS								
Canada	International Securities Transactions	m/m	Jan	17.01 Bil	-9.57 Bil		**	Equity bullish, bond bearish
	Manufacturing Sales	m/m	Jan	-0.2%	-0.7%	-0.6%	**	Equity and bond neutral
Brazil	Trade Balance Weekly	w/w	15-Mar	$0.329 Bil	$1.040 Bil		**	Equity bearish, bond bullish

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)	89	84	5	Up
3-mo T-bill yield (bps)	12	16	-4	Neutral
TED spread (bps)	77	69	8	Up
U.S. Libor/OIS spread (bps)	13	13	0	Up
10-yr T-note (%)	1.11	1.08	0.03	Neutral
Euribor/OIS spread (bps)	-41	-41	0	Neutral
EUR/USD 3-mo swap (bps)	15	42	-27	Down
Currencies	**Direction**			
dollar	Up			Neutral
euro	Flat			Up
yen	Up			Up
pound	Down			Down
franc	Flat			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Brazil Selic Rate		4.250%	3.750%	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	$27.73	$28.73	-3.48%	
WTI	$25.39	$26.95	-5.79%	
Natural Gas	$1.67	$1.73	-3.18%	
Crack Spread	$9.02	$7.84	15.01%	
12-mo strip crack	$7.81	$7.05	10.82%	
Ethanol rack	$1.28	$1.29	-1.13%	
Metals				
Gold	$1,498.12	$1,528.30	-1.97%	
Silver	$12.37	$12.62	-1.94%	
Copper contract	$221.15	$231.35	-4.41%	
Grains				
Corn contract	$ 337.00	$ 344.00	-2.03%	
Wheat contract	$ 497.50	$ 499.25	-0.35%	
Soybeans contract	$ 831.75	$ 824.25	0.91%	
Shipping				
Baltic Dry Freight	612	623	-11	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.5		
Gasoline (mb)		-3.8		
Distillates (mb)		-4.0		
Refinery run rates (%)		-0.30%		
Natural gas (bcf)		-3.0		

Weather

The 6-10 and 8-14 day forecasts currently call for a cold front to recede westward into the Great Plains region, with warmer-than-normal conditions remaining in most of the eastern region. Wet conditions are expected throughout most of the country except for Texas and Florida.

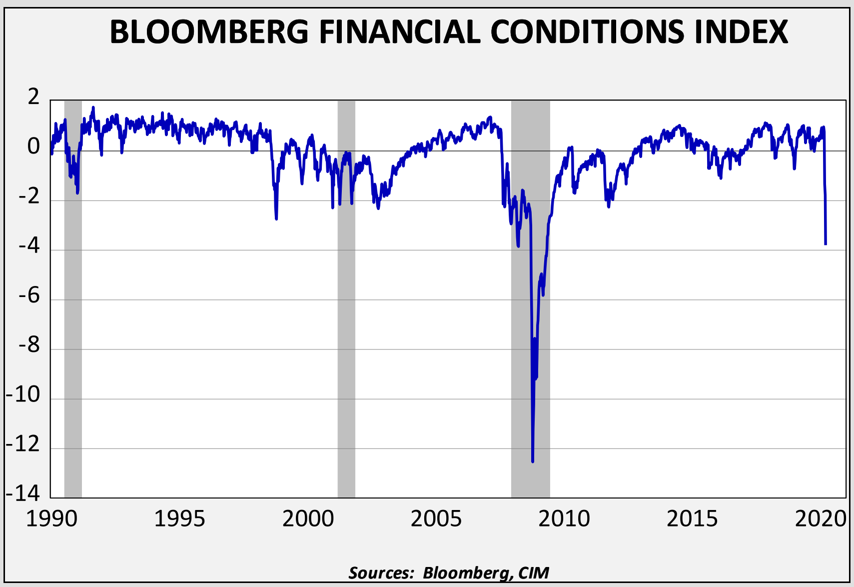
Asset Allocation Weekly

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.

March 13, 2020

Our baseline position has been that the COVID-19 virus would have a significant impact in terms of magnitude but be of limited duration and thus would probably not put the economy into recession. Over the past week, two events have occurred which put this position into question. The first is the oil market collapse triggered by a market share war between Russia and Saudi Arabia.[1] The second issue is that the financial system is exhibiting symptoms of liquidity problems.

We have noted a sudden decline in financial conditions as measured by the Bloomberg Financial Conditions Index for the U.S.



Our data uses the Friday closes for the index. The index is composed of eight variables[2] which are standardized and totaled. The more negative the reading, the greater the level of financial stress. The index was positive until the last week of February. The current level of stress is about on par with March 2008 during the collapse of Bear Stearns.

This data suggests a serious level of financial problems in the financial system. We have noted difficulties in the funding markets since September. Although the Fed has consistently claimed there was nothing systemic in the rise of repo rates, the persistence of the funding shortages despite the expansion of the Fed's balance sheet by $400 billion argues otherwise.

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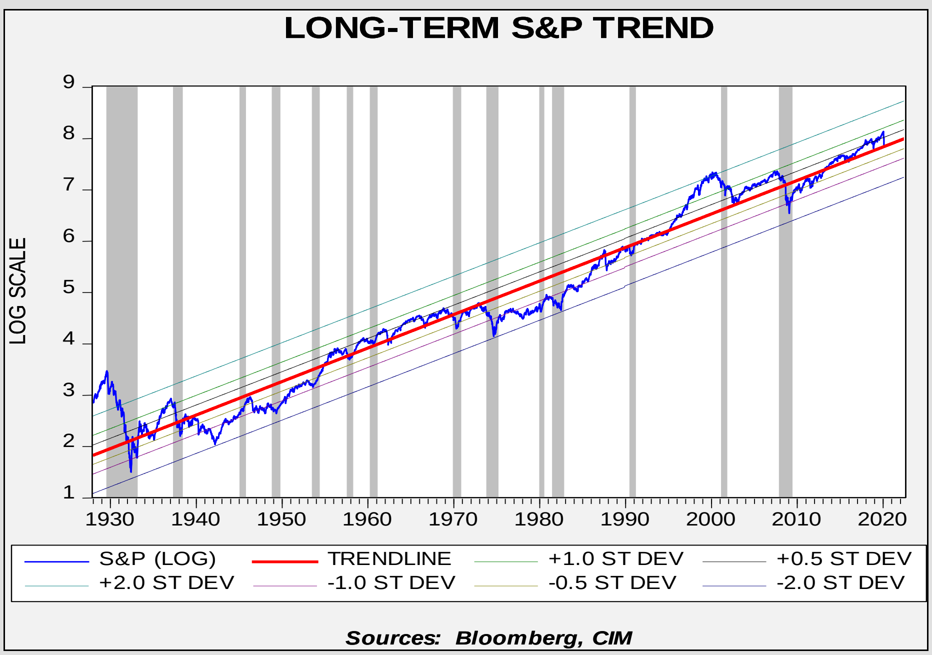
[1] We discussed this issue in our most recent Weekly Energy Update.

[2] TED spread, LIBOR/OIS spread, commercial paper/T-bill spread, Baa/10-year T-Note spread, Muni/10-year T-Note spread, swap volatility, the S&P 500 and the VIX. There are other similar indices with a larger set of variables, but the Bloomberg variation is calculated daily, whereas the others are calculated weekly or monthly.

What is the nature of the financial stress? Its roots most likely lay with interest rates being too low for too long; investors had to extend their portfolio risk to find attractive yields. The financial services industry took steps to provide financial products with more attractive yields. Some of this product creation went to the non-bank financing system which funds itself in the repo markets. If repo markets are disrupted, they can no longer service the debt they used to own the higher yielding assets and liquidations occur. If no liquid market exists for these products, the owners may be forced to sell other assets (gold, Treasuries, equities, investment grade bonds) to find necessary liquidity. Recent weakness in "risk off" assets would tend to confirm rising levels of financial stress. A contributing factor is the plunge in oil prices, which raises default risk among energy companies.

The Federal Reserve should be able to corral this problem if it moves aggressively enough to force liquidity into the financial system. Unfortunately, as we saw in 2008, it may be difficult to pinpoint exactly where the funding problems lie. But, the key lesson from 2008 is that enforcing moral hazard is a bad idea; we doubt such a policy will be executed in this event. Although a few of our economic indicators have moved to signal recession, the preponderance have not. On the other hand, the yield curve did invert last year, and we have been on "recession watch" for some time.[3]

How does all this affect equity markets? The chart below can offer some guidance. This chart shows the weekly close of the S&P 500 going back to late 1927. We log-transform the index and regress a time trend through the data. The parallel lines represent various standard error levels from trend; the gray bars show recessions. It is obvious that, with the exception of 1945, every recession has led to some degree of stock market weakness.



[3] Hence the title of our 2020 outlook, "Storm Watch."

To compare recessions, we measured the high reached before the recession to the low in the index during the downturn in terms of movements in standard errors. Here is a table of the events.

	LOG SCALED	LOG SCALED	LOG SCALED	
RECESSION	HIGH DEVIATION FROM TREND	LOW DEVIATION FROM TREND	RANGE FROM HIGH TO LOW DEVIATION	PROJECTION
1929-33	4.165	-1.674	5.839	383.31
1936-37	1.399	-0.782	2.180	1485.43
1949	-0.843	-1.572	0.729	2541.87
1953	-0.437	-0.917	0.480	2787.37
1957	0.637	-0.240	0.876	2407.30
1960	0.630	0.072	0.558	2708.13
1970	0.558	-0.798	1.355	2015.90
1973-75	0.106	-1.967	2.074	1545.20
1980	-1.188	-1.653	0.465	2803.13
1981-82	-0.857	-1.975	1.118	2201.12
1990	0.113	-0.549	0.662	2605.69
2001	1.689	-0.011	1.700	1774.60
2007-09	0.908	-1.571	2.479	1329.69
now	0.786	-0.037	0.823	
Average				2045.29
Normal Recession				2455.50
Deep Recession				1388.95
w/o Depression				1640.36

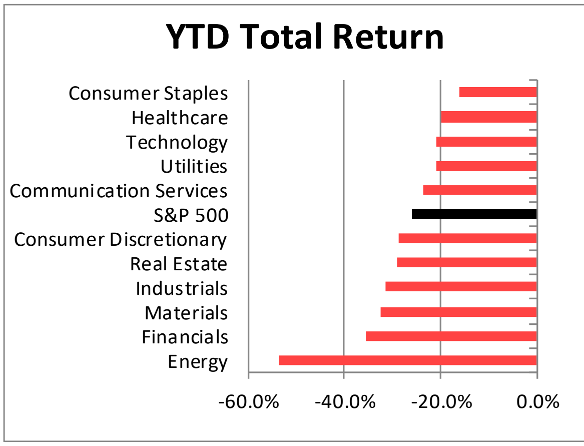
Range represents the change in standard error from high to low. So, the Great Depression saw the market fall nearly six standard errors, a true "six-sigma" event. The current decline is consistent with a normal recession, so if policymakers can secure the financial system and absorb the quarantine effect of COVID-19, then equity markets should stabilize soon. A deep recession (but not including the Great Depression) would put the S&P 500 around 1640, a much more profound decline.

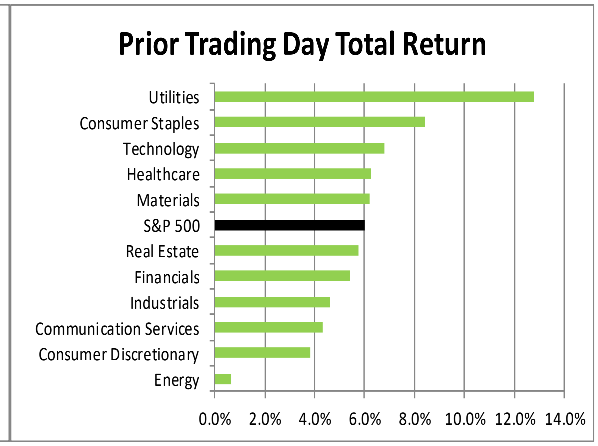
The postwar experience doesn't support two consecutive deep recessions, which is why we have argued that another 2008 is unlikely. Of course, we did have consecutive deep recessions in the 1930s: the 1936-37 recession was caused by profoundly inept policy when the Roosevelt administration tightened fiscal policy while the Federal Reserve raised rates. The odds of a similar event occurring in the current situation is improbable; both fiscal and monetary policy are accommodative and will almost certainly become more so. About the only way we have a deep recession is if the policy response is strikingly underwhelming. Although possible, that is a low probability outcome.

So, the bottom line is that we will likely see a few weeks of churning and perhaps a decline toward 2300, but the worst of this downturn is probably over. Liquidity injections and the natural waning of COVID-19 should improve sentiment over time. We are probably very close to the low in terms of price but not in terms of time. It will probably take a few weeks of basing before a durable recovery can develop.

Data Section

U.S. Equity Markets – (as of 3/17/2020 close)

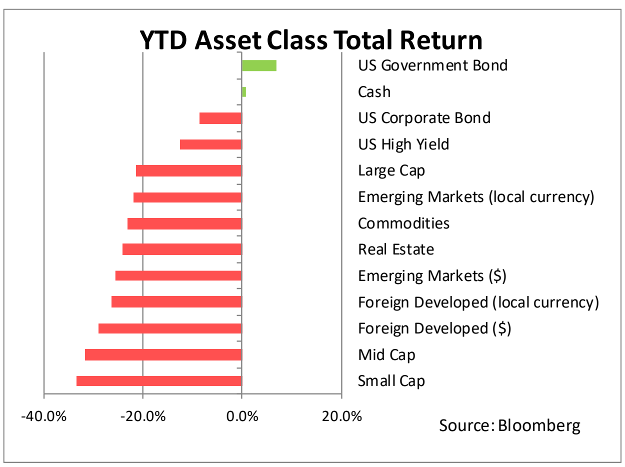




(Source: Bloomberg)

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 3/17/2020 close)

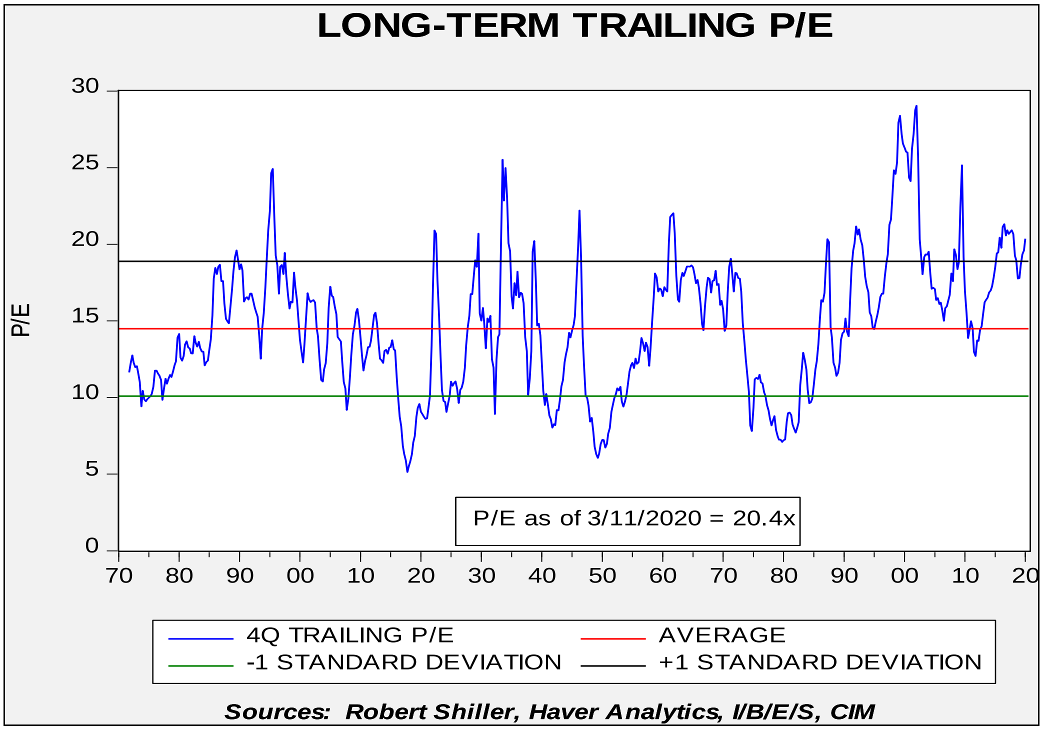


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

March 12, 2020



Based on our methodology,[4] the current P/E is 20.4x, down 0.2x from last week. The decline in the P/E was caused by falling index values.

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.

[4] 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 (Q2, Q3 and Q4) and one estimate (Q1). 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.