# Daily Comment

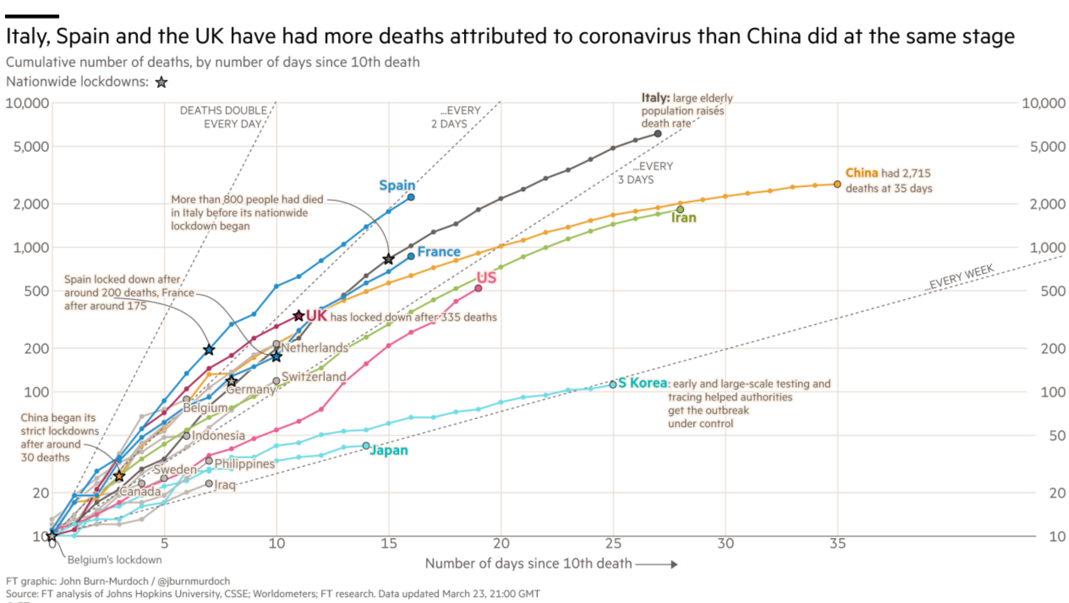
*By Bill O'Grady, Thomas Wash, and Patrick Fearon-Hernandez, CFA*

*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 24, 2020—9:30 AM EDT]** Global equity markets are higher this morning. The EuroStoxx 50 is currently up 5.7% from its last close. In Asia, the MSCI Asia Apex 50 closed up 4.8%. Chinese markets were higher, with the Shanghai Composite up 2.3% and the Shenzhen Composite up 2.4%. U.S. equity index futures are signaling a higher open.

As Tuesday dawns and financial markets surge, it's important to remember that true market stabilization amidst the pandemic would probably require three things: 1) full support for the economy and financial markets by the Federal Reserve and other major central banks; 2) a credible fiscal support package from the U.S. Congress to cushion the economic impact; and 3) a slowdown in the rate of infections that would take pressure off national health systems. Investors today are encouraged by yesterday's progress on the first factor after digesting it overnight, but there is still work to do on the second and the third, as discussed below.

**COVID-19:** Official data show confirmed cases have risen to 392,331 worldwide, with 17,156 deaths and 102,972 recoveries. In the United States, confirmed cases rose to 46,450, with 593 deaths and 17 recoveries. According to a new IPSOS poll, just 1% of Americans say they've been able to get tested for the virus, but 5% say they know someone who tested positive. Here is the latest chart of fatalities from the *Financial Times*:



The key takeaway from the chart is that the rate of infections continues to grow exponentially, with hospitalizations and deaths rising in tandem. Spain had more than 500 deaths from the virus in the last day. In Belgium, new hospitalizations moderated a bit, but the number of victims going into intensive care surged.

- ***Real Economy.*** As discussed in greater detail below, IHS Markit said its "flash" composite PMI for the Eurozone plunged to a record low of 31.4 in March from 51.6 in February. According to IHS Markit, the figures are "indicative of an 8% annualized decline in Eurozone GDP, and it is unlikely that the index has hit rock bottom yet."
  - German Finance Minister Sholz said the pandemic will reduce German GDP by 5% this year.
  - British Prime Minister Johnson finally succumbed to pressure and announced a stay-at-home order for all of the U.K., arguing, in part, that the move was necessary to keep the National Health System from being overwhelmed. Officially, the lockdown is for three weeks, but Johnson aides have admitted privately that it could last until May or even beyond.
  - Japanese Prime Minister Abe succumbed to pressure to postpone the Tokyo Summer Olympics until 2021 at the latest.
  - Major U.S. airlines are drafting plans for a potential voluntary shutdown of virtually all passenger flights across the U.S. Government agencies are considering ordering such a shutdown as COVID-19 cases make it harder and harder to staff the nation's air-traffic control system.
  - In contrast with the job losses in travel, tourism, and small businesses, major retailers facing a surge in demand for food and household products and have announced plans to hire at least 500,000 new workers in the coming weeks.
  - Highlighting the improved situation in China, authorities said they will soon relax travel restrictions into and out of the hard-hit Hubei province. However, there is some concern that the move could be premature, especially as China and other Asian countries report a surge in imported infections that could lead to new waves of the epidemic.

- ***Financial System.*** Real estate investment trusts that specialize in buying mortgage-backed securities are playing a prominent role in the current market turmoil, dumping their holdings in response to margin calls by their banks. Expectations are that the financial system will see a surge in missed mortgage payments as more people lose their jobs. Separately, major credit-rating firms have issued a wave of downgrades for corporate and government bonds, eliminating some triple-A designations and cutting many below investment grade. In addition, reports now say powerhouses Goldman Sachs (GS, 134.97) and Bank of New York Mellon (BK, 27.49) both had to put money into their money market funds to keep from "breaking the buck," which we see as the modern-day equivalent of a bank run.

- ***Fiscal Policy Response.*** For the second straight day, Senate Republicans and Democrats couldn't agree on the Phase III economic support package. Showing they've learned the lessons of the corporate bailouts in 2008, the Democrats continue to insist that the support be weighted toward assistance for workers rather than working capital for companies. Even though the failure to reach an agreement sent markets lower, it's encouraging that all participants continue to express optimism that a deal will soon be made. Separately:

- EU finance ministers today formally approved a suspension of the Eurozone's deficit and debt limits in order to allow countries full scope to boost spending to combat the epidemic.
- A dozen countries in the Middle East, North Africa and central Asia have already approached the IMF for financial assistance to help limit the human and financial cost of the coronavirus.

- ***Monetary Policy Response.*** Although the massive new asset purchases announced by the Fed yesterday weren't enough to offset the disappointment over the failed fiscal support bill, we think they could end up being seen as a turning point in the crisis. In general, the Fed is now saying it will do whatever it takes to support the economy and financial markets in the midst of the crisis. Indeed, the program has appeared to have some modest success in the debt, precious metals and currency markets. Now that more details are available, we think the key elements in the program, which will be backstopped by the fiscal program from Congress, are as follows:

  - To ensure sufficient liquidity in the financial system, the Fed will now buy U.S. Treasuries and mortgage-backed securities without limit;
  - To support the multi-family housing sector, the Fed will now begin purchasing commercial mortgage-backed securities issued by government-supported entities;
  - To support the consumer and business lending markets, the Fed will now relaunch the Term Asset-Backed Securities Loan Facility (TALF) of 2008, under which it will lend money to investors to buy securities backed by credit-card loans and other consumer debt;
  - To support the market for new, highly rated corporate debt, the Fed will wade into commercial banking by offering corporations bridge loans of up to four years, with limits on dividends and stock buybacks for firms that defer interest payments on their loans;
  - To unblock the market for existing corporate debt, the Fed will now purchase bonds already issued by highly rated companies and eligible exchange-traded funds;
  - To support the markets for municipal bonds, the Fed will expand last week's commercial paper facility to purchase high-quality, short-term obligations of state and local governments;
  - To further support municipal obligations, the Fed will expand last week's money market facility to purchase high-quality, ultrashort-term obligations of state and local governments.

**Odds and ends:** After failing to convince Afghanistan's rival presidents to form a national unity government, Secretary of State Pompeo said the U.S. will slash $1 billion from its aid budget for the country. Secretary of Defense Esper says the U.S. military has conducted a raid in Honduras to rescue a U.S. citizen facing an undisclosed danger.

### U.S. Economic Releases

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

| Economic Releases | | | | | | |
|---|---|---|---|---|---|---|
| EDT | Indicator | | | Expected | Prior | Rating |
| 9:45 | Markit Manufacturing PMI | m/m | Mar | 42.8 | 50.7 | ** |
| 9:45 | Markit Services PMI | m/m | Mar | 42.0 | 49.4 | ** |
| 9:45 | Markit Composite PMI | m/m | Mar | | 49.6 | ** |
| 10:00 | New Home Sales | m/m | Feb | -2.0% | 7.9% | ** |
| 10:00 | New Homes Sales | m/m | Feb | 750k | 764k | ** |
| 10:00 | New Homes | m/m | Feb | -1.8% | 3.6% | ** |
| 10:00 | Richmond Fed Manufacturing Index | m/m | Mar | -9 | -2 | *** |

### 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 | Japan Manufacturing PMI | m/m | Mar | 44.8 | 47.8 | | ** | Equity and bond neutral |
| | Japan Services PMI | m/m | Mar | 32.7 | 46.8 | | ** | Equity bearish, bond bearish |
| | Core CPI | y/y | Feb | 0.2% | 0.3% | | *** | Equity and bond neutral |
| | Leading Index | m/m | Mar | 90.5 | 91.0 | 90.3 | *** | Equity bullish, bond bearish |
| EUROPE | | | | | | | | |
| Eurozone | Eurozone Manufacturing PMI | m/m | Mar | 44.8 | 49.2 | 39.0 | ** | Equity bullish, bond bearish |
| | Eurozone Services PMI | m/m | Mar | 28.4 | 52.6 | 39.0 | ** | Equity bearish, bond bearish |
| | Eurozone Composite PMI | m/m | Mar | 31.4 | 51.6 | 39.0 | ** | Equity bearish, bond bearish |
| France | France Manufacturing PMI | m/m | Mar | 42.9 | 49.8 | 40.0 | ** | Equity bullish, bond bearish |
| | France Services PMI | m/m | Mar | 29.0 | 52.5 | 42.0 | ** | Equity bearish, bond bearish |
| | France Composite PMI | m/m | Mar | 30.2 | 52.0 | 39.8 | ** | Equity bearish, bond bearish |
| Germany | Germany Manufacturing PMI | m/m | Mar | 45.7 | 48.0 | 39.6 | ** | Equity bullish, bond bearish |
| | Germany Services PMI | m/m | Mar | 34.5 | 52.5 | 42.3 | ** | Equity bearish, bond bearish |
| | Germany Composite PMI | m/m | Mar | 37.2 | 50.7 | 40.6 | ** | Equity bearish, bond bearish |
| UK | UK Manufacturing PMI | m/m | Mar | 48.0 | 51.7 | 45.0 | ** | Equity bullish, bond bearish |
| | UK Services PMI | m/m | Mar | 35.7 | 53.2 | 45.0 | ** | Equity bearish, bond bearish |
| | UK Composite PMI | m/m | Mar | 37.1 | 53.0 | 45.1 | ** | Equity bearish, bond bearish |

**Eurozone:** IHS Markit said its "flash" composite PMI for the Eurozone plunged to a record low of 31.4 in March from 51.6 in February. The sub-index for services fell to 28.4, while the sub-index for manufacturing fell to 44.8. Like all major PMIs, the index is designed so that readings under 50 point to contracting activity. According to IHS Markit, the figures are "indicative of an 8% annualized decline in Eurozone GDP, and it is unlikely the index has hit rock bottom yet."

## 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)** | 120 | 120 | 0 | Up |
| **3-mo T-bill yield (bps)** | -2 | -1 | -1 | Neutral |
| **TED spread (bps)** | 124 | 118 | 6 | Up |
| **U.S. Libor/OIS spread (bps)** | 11 | 10 | 1 | Up |
| **10-yr T-note (%)** | 0.74 | 0.85 | -0.11 | Neutral |
| **Euribor/OIS spread (bps)** | -37 | -37 | 0 | Neutral |
| **EUR/USD 3-mo swap (bps)** | -12 | -12 | 0 | Down |
| **Currencies** | **Direction** | | | |
| dollar | Down | | | Neutral |
| euro | Up | | | Up |
| yen | Up | | | Up |
| pound | Up | | | 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 | $27.83 | $27.03 | 2.96% | Possible Fiscal Stimulus |
| WTI | $23.87 | $23.36 | 2.18% | |
| Natural Gas | $1.64 | $1.60 | 2.18% | |
| Crack Spread | $5.75 | $5.25 | 9.52% | |
| 12-mo strip crack | $5.35 | $4.89 | 9.36% | |
| Ethanol rack | $1.24 | $1.23 | 0.81% | |
| **Metals** | | | | |
| Gold | $1,591.65 | $1,553.23 | 2.47% | |
| Silver | $13.74 | $13.27 | 3.58% | |
| Copper contract | $217.45 | $210.45 | 3.33% | |
| **Grains** | | | | |
| Corn contract | $ 340.50 | $ 343.50 | -0.87% | |
| Wheat contract | $ 552.50 | $ 562.50 | -1.78% | |
| Soybeans contract | $ 872.75 | $ 884.00 | -1.27% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 617 | 617 | 0 | |
| **DOE inventory report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | | 3.0 | | |
| Gasoline (mb) | | -2.3 | | |
| Distillates (mb) | | -1.6 | | |
| Refinery run rates (%) | | 0.00% | | |

## Weather

The 6-10 and 8-14 day forecasts currently call for a cold front to recede westward into Washington State, with warmer-than-normal conditions remaining in the rest of the country. Wet conditions are expected to move from the east into the southeast region of the country.

## **Asset Allocation Weekly**

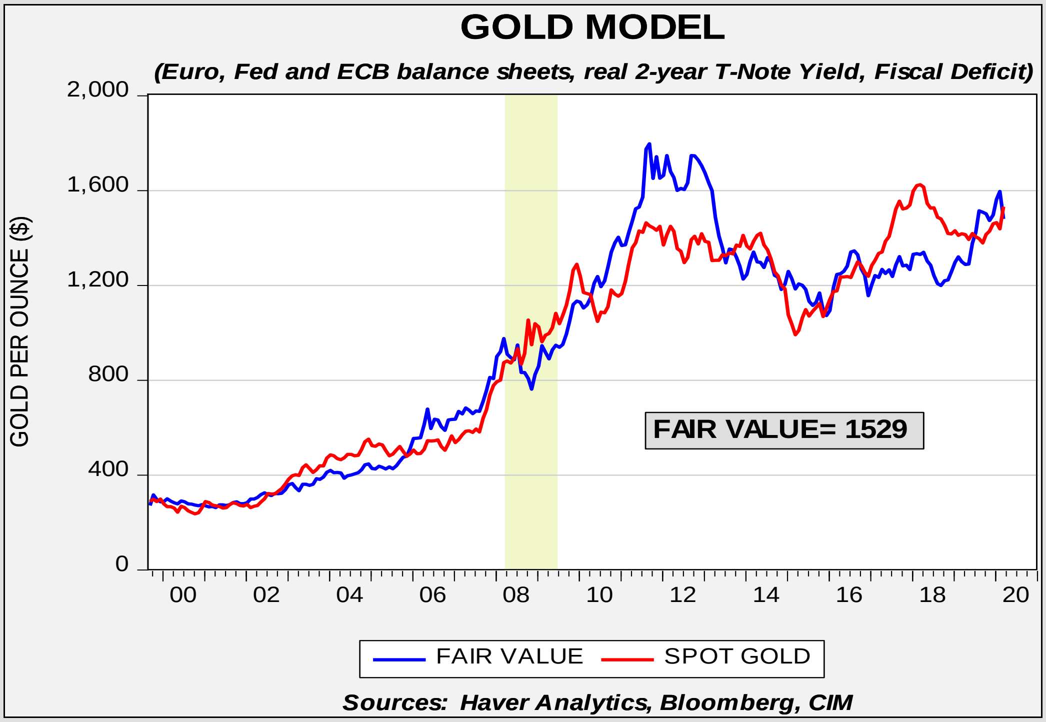
*Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday. Note that this report is also offered as a separate document on our [website](website).*

March 20, 2020

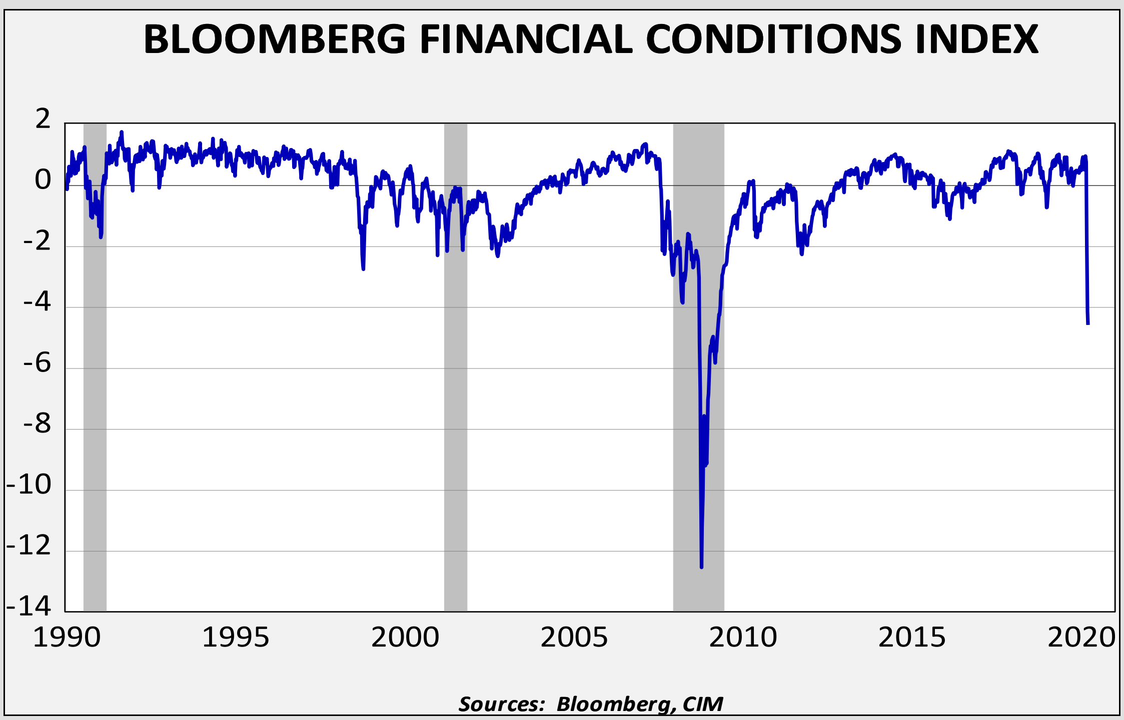
During the recent market tumult, gold has performed rather well, until lately.

(Source: Barchart.com)

This chart shows the nearest gold futures contract over the past year. From mid-January, when reports of COVID-19 began to circulate, gold prices marched steadily higher, making an intraday high of $1,704.30. Since then, this has declined by over $250 per ounce. This drop is occurring despite a series of measures designed that would normally support gold prices, e.g., the return of zero fed funds, new quantitative easing, plans for massive fiscal spending, etc.




This is a chart of our gold model. Fair value has increased to $1,529 per ounce and prices have dropped below that level. We suspect the recent weakness is related to a rapid tightening of financial conditions.

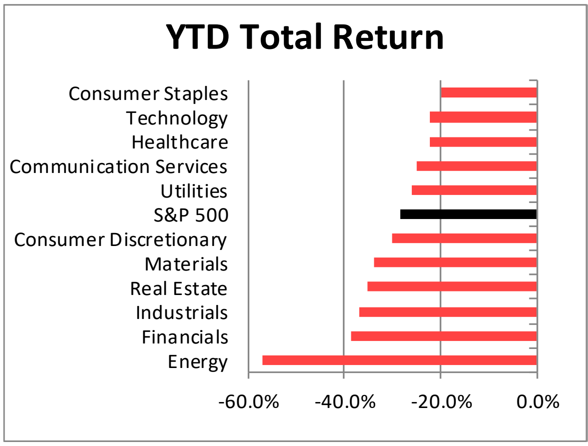


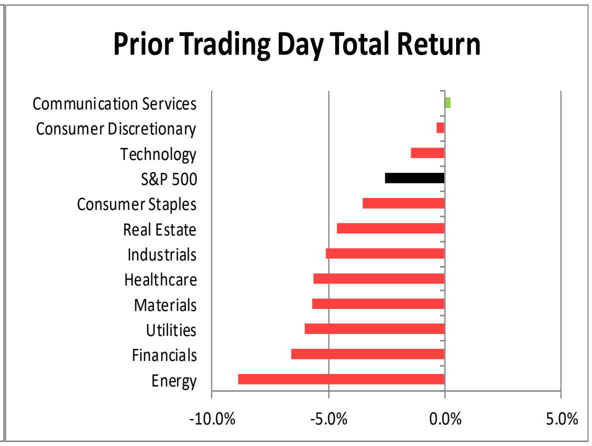

This chart shows the Bloomberg Financial Conditions Index. A negative reading suggests higher levels of financial stress. When financial stress rises to high levels, investors often are scrambling for cash, selling what they can and not necessarily what they should. In other words, the investors may be selling gold to raise funds because it is a liquid asset.

Returning to the gold model chart, we highlighted the area in yellow that represents the 2008 Great Financial Crisis. In the worst of that situation, gold also underperformed fair value. However, once the liquidating stopped, gold began a multi-year bull market. Although we are not necessarily expecting a similar move in prices, we do expect the aggressive expansion of liquidity via fiscal and monetary policy to create favorable conditions for gold in the coming years.

## Data Section

**U.S. Equity Markets** – (as of 3/23/2020 close)
(Due to technical difficulties, YTD refers to yesterday's data)

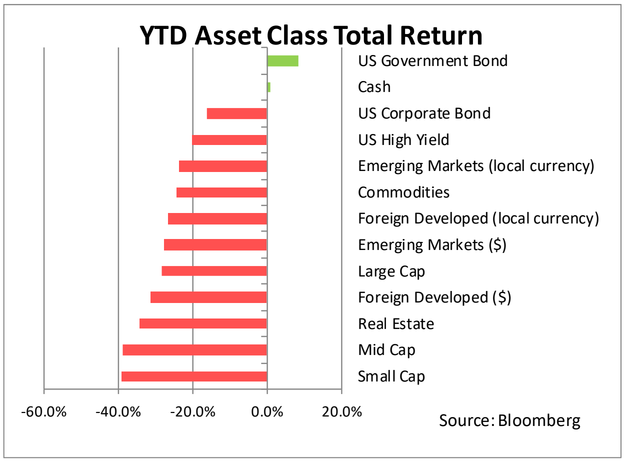



(Source: Bloomberg)

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 3/23/2020 close)

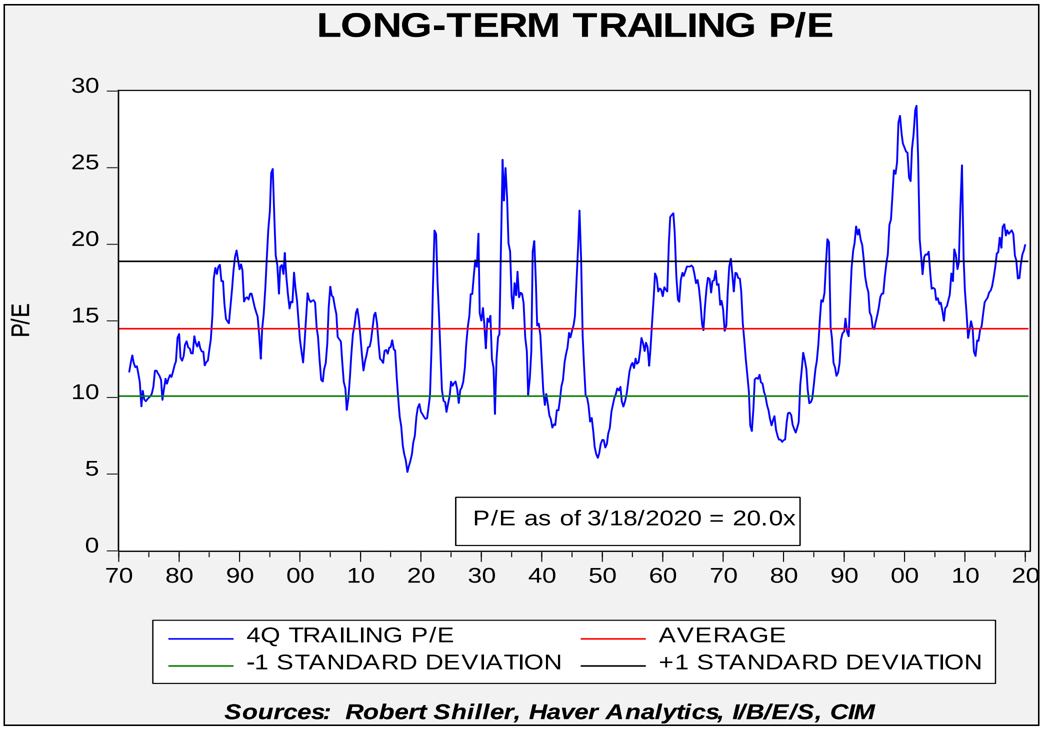



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 19, 2020




Based on our methodology,[1] the current P/E is 20.0x, down 0.4x 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.*

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[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 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.