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[Posted: May 7, 2021—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is currently up 0.6% from its prior close. In Asia, the MSCI Asia Apex 50 closed up 0.4%. Chinese markets were lower, with the Shanghai Composite down 0.7% from its prior close and the Shenzhen Composite down 1.6%. U.S. equity index futures are signaling a higher open. With 399 companies having reported, the S&P 500 Q1 2021 earnings stand at \$48.10, higher than the \$37.94 forecast for the quarter. The forecast reflects a 23.3% increase from Q1 2020 earnings. Thus far this quarter, 87.7% of the companies have reported earnings above forecast, while 10.3% have reported earnings below forecast.

The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our [website](#). We highlight recent publications below, with new items of the day emphasized in bold:

- [Weekly Geopolitical Report](#) (5/3/2021): The Geopolitics of Taiwan: Part I
- [Weekly Energy Update](#) (5/6/2021)
- **[Asset Allocation Weekly](#) (with associated [podcast](#) and [chart book](#)) (5/7/2021)**
- [Confluence of Ideas podcast](#) (4/30/2021): “The U.S.-China Balance of Power: Part II”

Good morning, all! U.S. equities are expected to open higher this morning as the jobs report continues to support market optimism; we will go into further detail in the economic releases section of this report. Our report starts off with a summary of the Financial Stability Report. International news follows, with details about the Pentagon’s plan to leave Afghanistan, Morocco’s decision to recall its ambassador to Berlin, the U.S.-Iran nuclear talks, and more. Economics and policy are up next, including the Biden administration’s decision to limit U.S. investment in China and Biden lowering his tax rate demands. China news follows, and we close with our pandemic coverage.

The Fed: The Federal Reserve released its Financial Stability Report on Thursday. Here are the highlights:

Asset Valuations: Although the rise in asset prices is generally backed by an improvement in the economic outlook, the Fed fears that much of the rise may be due to an increase in risk appetites. The report cites declining corporate spreads, particularly for firms that were negatively impacted by the pandemic, as evidence of elevated risk appetites. As a result, the Federal Reserve believes that asset prices could fall following a setback in the recovery such as a relapse in virus containment, a market scare, or possibly a slowdown in the recovery.

Borrowing by Businesses and Households: Debt for businesses and households continues to fall, but still remains elevated, particularly for small businesses. Funding for smaller firms appears to have tightened, thus making it harder for these firms to maintain day-to-day operations. Generally, smaller firms are given less priority than larger firms for credit access. As a result, these firms are vulnerable to shocks and are financially strained even after receiving government support.

Leverage in the Financial Sector: Leverage for banks and broker-dealers remains low, while leverage is elevated for hedge funds and life insurance companies. Although the Fed did mention that life insurance leverage is high, its primary concern was with the leverage of hedge funds. Particularly, it argues that the lack of transparency has made it difficult to determine the level of risk hedge funds pose to the financial system. To support this claim, the Fed highlighted the losses hedge funds took due to the “meme stock episode” in January 2021 and the market turmoil caused by Archegos Capital Management. Their concern is that hedge funds could potentially be a source of financial distress.

Funding Risk: Large banks have relatively low risk of liquidity and maturity mismatches, while money market funds as well as bond and bank loan mutual funds remain a source of concern. Specifically, investors are finding it difficult to meet their liquidity needs when they have trouble selling their underlying assets (such as commercial paper and short-term government notes). Additionally, bond and bank loan mutual funds may have a hard time meeting their liquidity needs due to increased holdings of U.S. corporate bonds. The Fed is currently working with other international organizations to address these concerns.

International news: The Pentagon terminating contracts, Morocco recalls ambassador, and U.S.-Iran nuclear talks.

- The Pentagon has started the process of [removing all contractors working with the U.S. from Afghanistan](#). The removal of contractors is seen as the first step taken by the Biden administration to withdraw all U.S. forces from Afghanistan by September 11.
 - The U.S. is considering [training Afghan forces in different countries](#) after it fully withdraws from Afghanistan.
- Morocco recalled [its ambassador to Berlin in response to Germany’s stance regarding Western Sahara](#). Following the U.S. decision to recognize Morocco’s claim over the disputed territory in December, Germany called a United Nations Security Council meeting to discuss the issue further. Additionally, Morocco has accused Germany of sharing intelligence with an alleged Jihadist.
- The U.S. and Iran are still engaged in nuclear talks. The two sides remain far apart on [securing a deal](#) as Iran would like more sanctions to be lifted before agreeing to comply with restrictions on its nuclear program. The two countries would like to have an agreement before the Iranian elections on June 18 as it is believed it may be harder for the two sides to agree afterward.
- Rising currency pressure has led a member of [Taiwan's central bank to imply that over the next two years the bank could allow the currency to appreciate](#). Taiwanese firms have seen an influx of investment as rising trade tensions between the U.S. and China have

incentivized U.S. companies to diversify their supply chains. The increased investment has put upward pressure on the Taiwan dollar.

- Norway's central bank governor, Oystein Olsen, has expressed hesitancy [in removing the country's monetary support in the near future](#) as Europe continues to struggle with the vaccine rollout.

Economics and policy: The U.S. continues the investment ban, corporate tax rate demand drops, and vaccine/pandemic policy updates.

- The [ban on U.S. investments in Chinese companies with links to the Chinese military](#) is expected to remain in place under the Biden administration. The restrictions were initially imposed by the preceding administration and have heightened tensions between Beijing and Washington.
- President Biden [announced that he is willing to lower his demand of a 28% corporate tax rate down to 25%](#) on Thursday. Increasing corporate taxes is one of the ways the Biden administration has sought to fund the \$2.3 billion infrastructure proposal.
- The intellectual property (IP) [waiver for vaccines isn't expected to resolve shortages in the near future](#). The process that is needed to lift the patent protections could take months or even years as it will likely involve intense negotiations. Germany's [resistance to the proposal](#) will likely complicate the issue further. The removal of IP is designed to help developing countries produce the vaccine domestically as these countries have lacked the shots needed.
- South Carolina is the second state to [announce it will end pandemic unemployment benefits early to address labor shortages](#); Montana was the first state. Governor Henry McMaster has ordered pandemic-related unemployment programs to end June 30.

China: Conflict in the South China Sea and Chinese census delay.

- The Philippines [rejected China's fishing ban in the South China Sea](#). The dispute regarding claims over the South China Sea has complicated China's relationship with countries in Southeast Asia. On Thursday, the National Task Force for the West Philippine Sea had to disperse several Chinese militia vessels in the Sabina Shoal.
- The Chinese census is expected [to be delayed as the country has struggled to track migrant workers](#). The report was supposed to be released sometime in April but has now been postponed indefinitely.
- China's Long March 5B rocket is [expected to re-enter the earth's atmosphere this weekend](#). U.S. Defense Secretary Lloyd Austin has stated that the Pentagon has no plan to shoot down the rocket upon its re-entry. The debris from the rocket is not expected to cause any harm.

COVID-19: The [number of reported cases](#) is 155,425,409 with 3,246,844 fatalities. In the U.S., there are 32,573,436 confirmed cases with 579,572 deaths. For illustration purposes, the *FT* has created an [interactive chart](#) that allows one to compare cases across nations using similar scaling metrics. The *FT* has also issued an [economic tracker](#) that looks across countries with high-frequency data on various factors. The [CDC reports](#) that 321,549,335 doses of the vaccine have been distributed with 249,566,820 doses injected. The number receiving at least one dose is

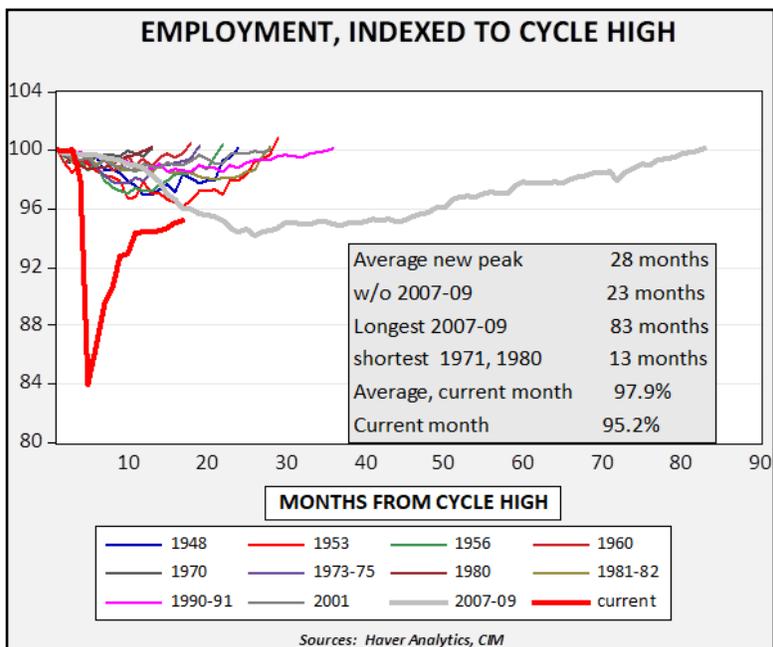
148,562,891, while the number of second doses, which would grant the highest level of immunity, is 107,346,533. The *FT* has a page on [global vaccine distribution](#). The [weekly Axios map](#) shows rising cases in about half the country.

Virology

- Due to a shortage of critical ingredients, [Brazil could possibly run out of the CoronaVac vaccine](#) as soon as next week. The shortage is believed to be related to a growing rift between Brazil and China. Over the last few months, Brazilian President Jair Bolsonaro has angered many in Beijing due to his assertion that the virus may have been an act of biological warfare. More than 410,000 Brazilians have died of complications related to the virus, second only to the U.S.
- The Indian virus variant has been detected in the [African countries of Kenya, Uganda, and Morocco](#).
- New York baseball [stadiums will be open to all baseball fans starting May 19](#). The New York Yankees and Mets will create separate sections for vaccinated and unvaccinated fans. The vaccinated section will be allowed to sit together at full capacity, while the unvaccinated sections will be required to wear masks and sit six feet apart.
- Quality control problems at a Baltimore plant have [forced countries to halt the distribution of the Johnson & Johnson vaccine \(JNJ, \\$167.18\)](#). The pause will be in place while countries ensure the vaccines are safe following a contamination in March. None of the Johnson & Johnson vaccines administered in the U.S. came from this plant.
- Assuming enough people get vaccinated, the Centers for Disease Control and Prevention has stated it believes [the pandemic could be under control by July](#).
- Japan is expected [to extend the virus state of emergency until the end of May](#). The move comes as Japan tries to slow the virus in preparation for the Olympics. Most major cities are now operating under states of emergency, including Tokyo.

U.S. Economic Releases

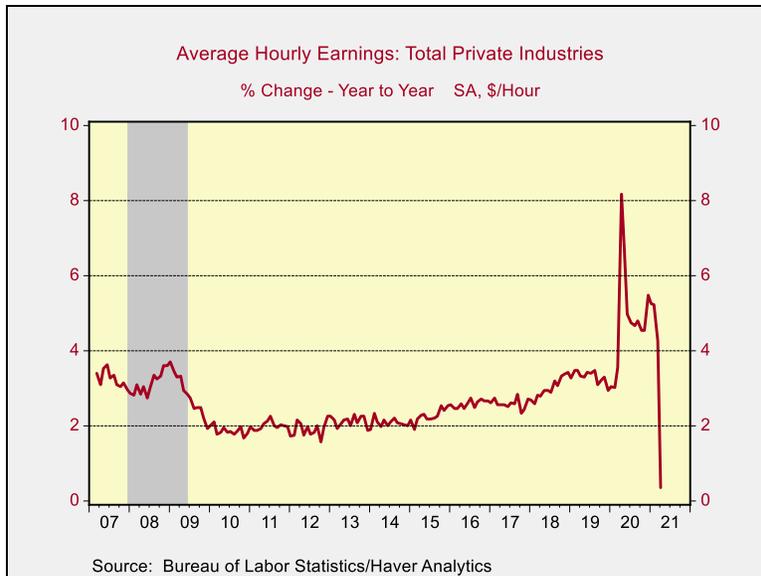
In today's key report, April nonfarm payrolls increased by a seasonally adjusted 266,000, well short of the expected gain of 1,000,000. On top of that, March payrolls were revised downward to show an increase of just 770,000, rather than the originally reported 916,000; the downward revision was only partially offset by an upward adjustment to the February jobs gain. The chart below shows that with the modest increase in payrolls in April, jobs remain far below where they were at their previous peak.



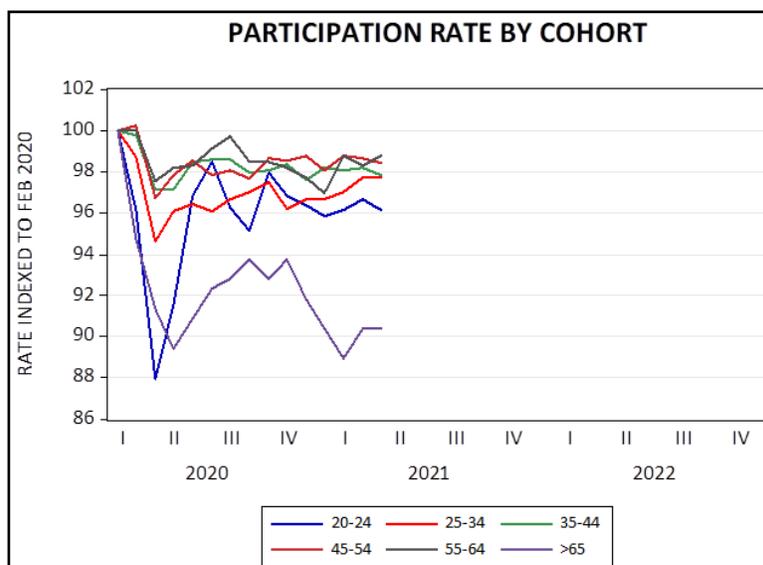
The report also showed that the April unemployment rate rose to 6.1%, rather than falling to 5.8% as anticipated. The chart below shows the history of the U.S. unemployment rate since just before the prior recession.



Finally, average hourly earnings in April rose to \$30.17, up 0.3% year-over-year. That level was actually a bit better than anticipated, since the average was expected to be pulled down due to legions of lower-paid service workers getting back to their jobs. The light hiring suggests that didn't happen, so average hourly earnings weren't pulled down as much as anticipated. All the same, the annual gain was a big slowdown from the 4.2% rise in the year to March. The chart below shows the year-over-year rise in average hourly earnings since just before the prior recession.



Despite all the disappointing aspects of the report, it did contain some positive features. For example, as more people get back to work and firms keep struggling to fully staff up, the average work week unexpectedly rose to 35.0 hours. In addition, in a sign that more people are being drawn back into the labor market, the labor force participation rate ticked up to 61.7%. The fly in the ointment is that participation remains well below the previous level, especially for those aged 65 and over. This suggests that not only are many workers staying out of the labor force because of health concerns, lack of childcare, and attractive unemployment benefits, but many older workers may have taken the opportunity to retire. Those workers may never come back into the labor force. That would constrain the availability of workers going forward, although it could also help raise wages and open up new promotion opportunities for younger workers. The chart below shows how the labor force participation rate has changed by age cohort.



The table below lists the domestic releases and Fed events scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Wholesale Inventories	m/m	Mar F	1.4%	1.4%	***
10:00	Wholesale Trade Sales	m/m	Mar F	-0.8%	1.0%	*
15:00	Consumer Credit	m/m	Mar	\$20.000b	\$27.578b	*
Fed Speakers or Events						
EST	Speaker or event	District or position				
9:00	Thomas Barkin Takes Part in Online Discussion	President of the Federal Reserve Bank of Richmond				

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	Labor Cash Earnings	y/y	Mar	0.2%	-0.4%	-0.2%	**	Equity bullish, bond bearish
	Monetary Base	y/y	Apr	24.3%	20.8%		**	Equity bullish, bond bearish
	Jibun Bank Services PMI	m/m	Apr F	49.5	48.3		**	Equity bullish, bond bearish
Australia	Jibun Bank Composite PMI	m/m	Apr F	51.0	50.2		**	Equity bullish, bond bearish
	AiG Perf of Services Index	m/m	Apr	61.0	58.7		*	Equity bullish, bond bearish
New Zealand	Foreign Reserves	m/m	Apr	A\$61.5b	A\$63.2b		**	Equity and bond neutral
	2-Year Inflation Expectation	q/q	2Q	2.1%	1.9%		**	Equity and bond neutral
South Korea	BoP Current Account Balance	m/m	Mar	\$7816.0m	\$7942.1m		**	Equity and bond neutral
	BoP Goods Balance	m/m	Mar	\$7920.4m	\$5973.9m		*	Equity and bond neutral
China	Caixin Services PMI	m/m	Apr	56.3	54.3	54.2	**	Equity bullish, bond bearish
	Caixin Composite PMI	m/m	Apr	54.7	53.1		**	Equity bullish, bond bearish
	Trade Balance	m/m	Apr	\$42.85b	\$13.80b	\$27.70b	***	Equity bullish, bond bearish
	Exports	y/y	Apr	32.3%	30.6%	24.1%	**	Equity bullish, bond bearish
	Imports	y/y	Apr	43.1%	38.1%	44.0%	**	Equity and bond neutral
	Foreign Reserves	m/m	Apr	\$3198.1b	\$3170.0b	\$3200.0b	**	Equity and bond neutral
EUROPE								
Germany	Industrial Production WDA	y/y	Mar	5.1%	-6.8%	5.7%	**	Equity bearish, bond bullish
	Trade Balance	m/m	Mar	20.5b	18.2b	21.1b	**	Equity bearish, bond bullish
	Exports	m/m	Mar	1.2%	1.0%	0.5%	*	Equity bullish, bond bearish
	Imports	m/m	Mar	6.5%	3.6%	0.8%	*	Equity and bond neutral
France	Trade Balance	m/m	Mar	-6067m	-5249m	-5500m	*	Equity bearish, bond bullish
	Industrial Production	m/m	Mar	13.7%	-6.6%	15.2%	***	Equity bearish, bond bullish
	Manufacturing Production	m/m	Apr	15.7%	-7.1%	16.9%	**	Equity bearish, bond bullish
Italy	Retail Sales	y/y	Mar	22.9%	-5.7%		**	Equity and bond neutral
UK	Markit/CIPS Construction PMI	m/m	Apr	61.6	61.7	62.1	**	Equity and bond neutral
Switzerland	Unemployment Rate SA	m/m	Apr	3.1%	3.3%	3.3%	**	Equity bullish, bond bearish
	Foreign Currency Reserves	m/m	Apr	914.1b	930.3b		***	Equity and bond neutral
AMERICAS								
Canada	Net Change in Employment	m/m	Apr	-201.1k	303.1k	-150.0k	***	Equity bearish, bond bullish
	Unemployment Rate	m/m	Apr	8.1%	7.5%	8.0%	***	Equity bearish, bond bullish
Mexico	CPI	y/y	Apr	6.1%	4.7%	6.0%	***	Equity and bond neutral
	CPI	m/m	Apr	0.3%	0.8%	0.3%	***	Equity and bond neutral
	Core CPI	m/m	Apr	0.4%	0.5%	0.3%	**	Equity and bond neutral
Brazil	Retail Sales	y/y	Mar	2.4%	-3.8%	-1.6%	***	Equity bullish, bond bearish
	Retail Sales Broad	y/y	Mar	10.1%	-1.9%	5.7%	*	Equity bullish, bond bearish
	FGV IGP-DI Inflation	y/y	Apr	33.5%	30.6%	32.9%	**	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)	17	18	-1	Up
3-mo T-bill yield (bps)	1	1	0	Neutral
TED spread (bps)	16	16	0	Up
U.S. Libor/OIS spread (bps)	8	8	0	Up
10-yr T-note (%)	1.56	1.57	-0.01	Neutral
Euribor/OIS spread (bps)	-53	-53	0	Neutral
EUR/USD 3-mo swap (bps)	3	1	2	Down
Currencies				
dollar	Down			Down
euro	Flat			Up
yen	Flat			Up
pound	Up			Up
franc	Down			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.

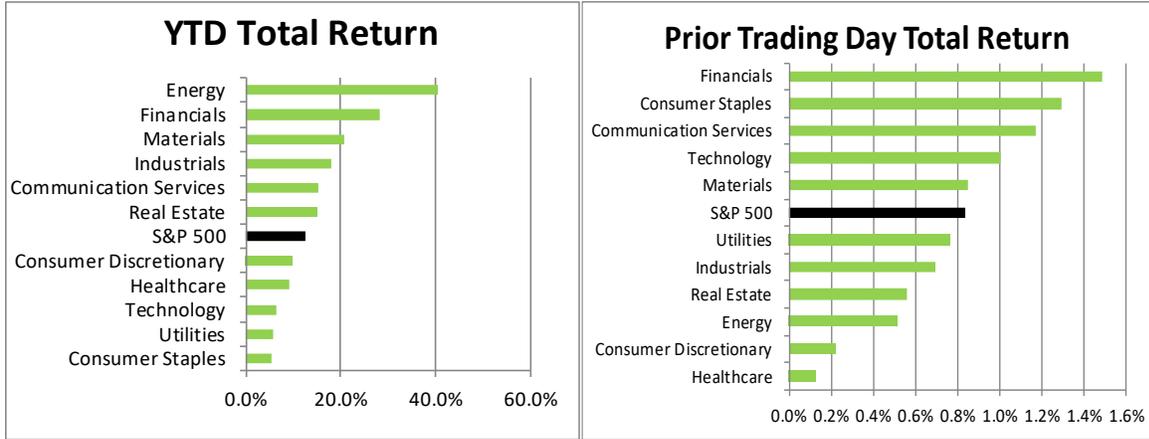
	Price	Prior	Change	Explanation
Energy Markets				
Brent	\$68.16	\$68.09	0.10%	
WTI	\$64.75	\$64.71	0.06%	
Natural Gas	\$2.94	\$2.93	0.34%	
Crack Spread	\$22.36	\$22.29	0.31%	
12-mo strip crack	\$20.13	\$20.11	0.10%	
Ethanol rack	\$2.75	\$2.74	0.67%	
Metals				
Gold	\$1,820.17	\$1,815.22	0.27%	
Silver	\$27.32	\$27.31	0.03%	
Copper contract	\$471.40	\$460.25	2.42%	
Grains				
Corn contract	\$728.00	\$718.75	1.29%	
Wheat contract	\$764.00	\$753.25	1.43%	
Soybeans contract	\$1,581.50	\$1,569.50	0.76%	
Shipping				
Baltic Dry Freight	3212	3266	-54	
DOE inventory report				
	Actual	Expected	Difference	
Crude (mb)	-8.0	-2.0	-6.0	
Gasoline (mb)	0.7	0.7	0.0	
Distillates (mb)	-2.9	-1.3	-1.6	
Refinery run rates (%)	1.10%	0.50%	0.60%	
Natural gas (bcf)	60.0	66.0	-6.0	

Weather

The 6-10 and 8-14 day forecasts currently call for cooler than normal temperatures throughout the eastern half of the country, with warmer than normal temperatures in most of the West. The forecast calls for wet conditions in Texas and the Southeast, with drier conditions in the Rockies.

Data Section

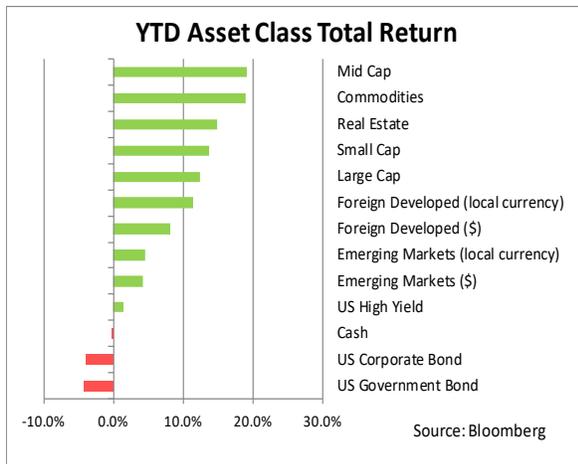
U.S. Equity Markets – (as of 5/6/2021 close)



(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 5/6/2021 close)

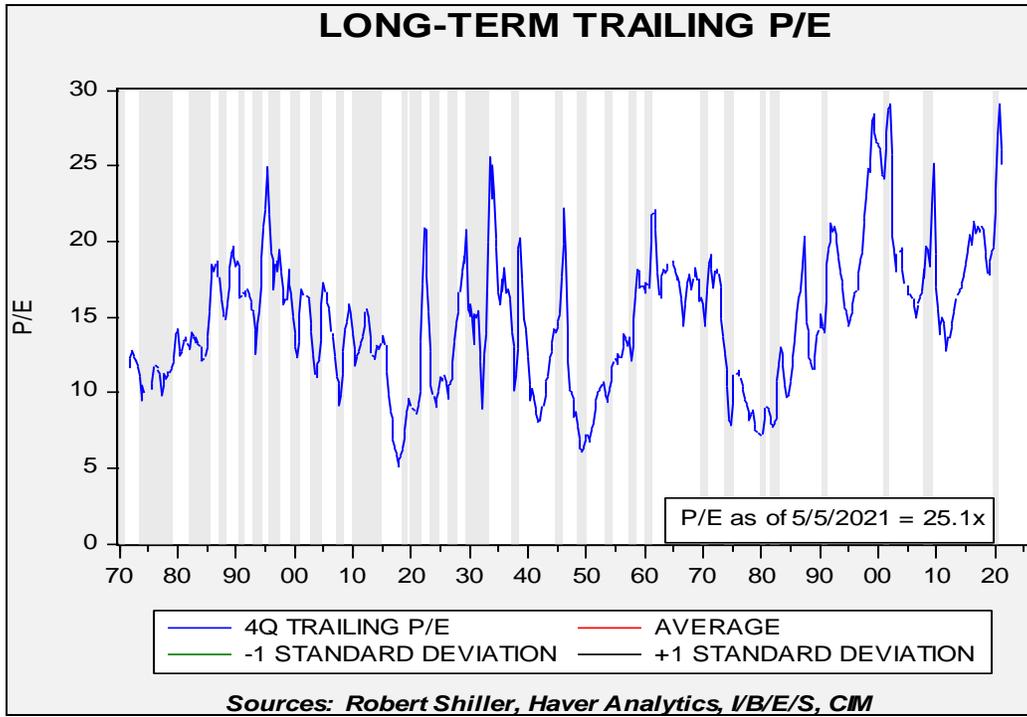


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

May 6, 2021



Based on our methodology,¹ the current P/E is 25.1x, down 0.5x from last week. Rising earnings led to the decline 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.

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 (Q3 and Q4) and two estimates (Q1 and 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.