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.

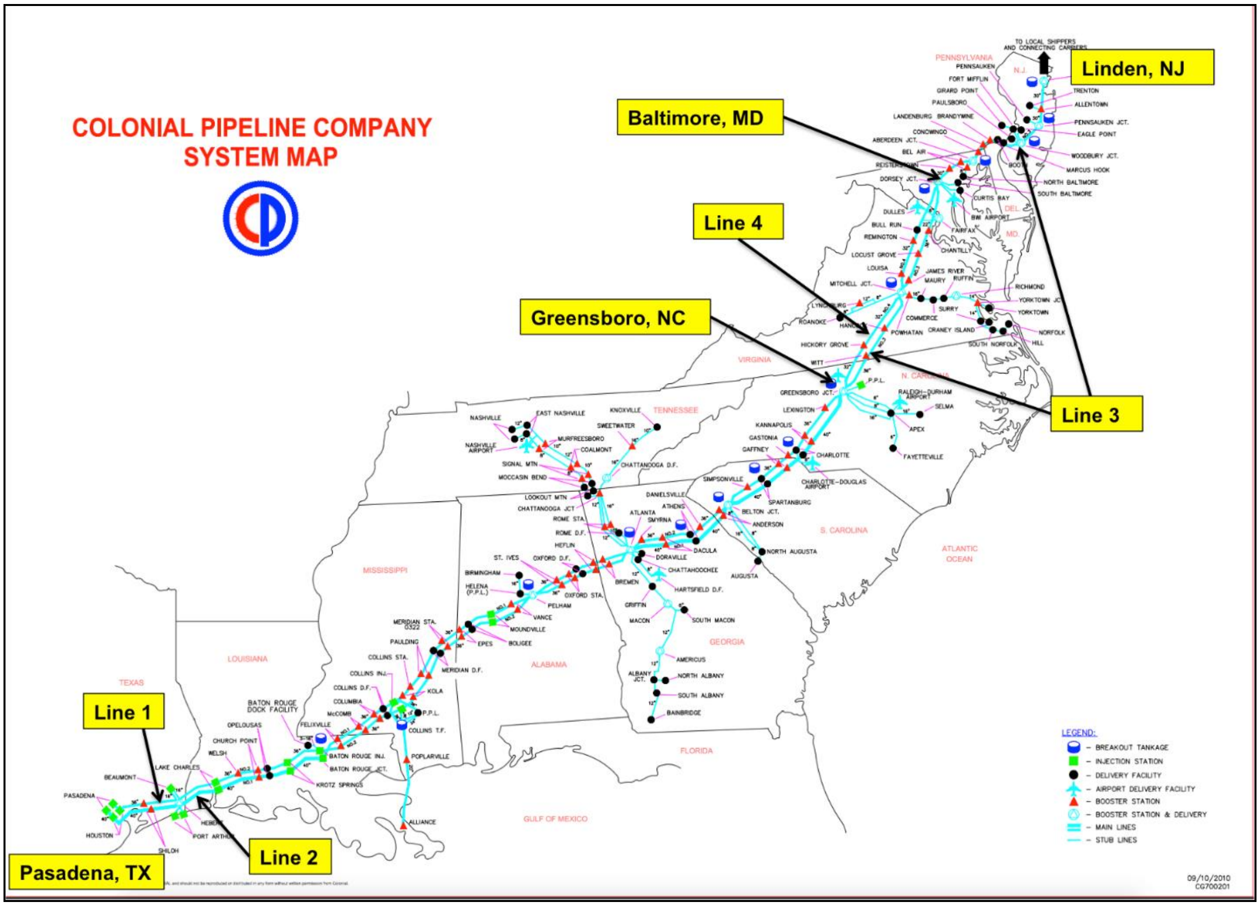
[Posted: May 10, 2021—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is currently down 0.4% from its prior close. In Asia, the MSCI Asia Apex 50 closed down 0.2%. Chinese markets were higher, with the Shanghai Composite up 0.3% from its prior close and the Shenzhen Composite up 0.2%. U.S. equity index futures are signaling a flat open. With 439 companies having reported, the S&P 500 Q1 2021 earnings stand at $48.20, higher than the $37.94 forecast for the quarter. The forecast reflects a 23.3% increase from Q1 2020 earnings. Thus far this quarter, 87.2% of the companies have reported earnings above forecast, while 11.0% 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, and happy Monday! What an active weekend! After spending time watching the skies, worried about falling Chinese space debris, U.S. equity futures are mostly higher this morning. We begin with the Colonial Pipeline cyberattack. Up next are some thoughts about last Friday's employment report. We then have some information about the U.K. elections. On Wednesday, we get the CPI report, so a few comments about inflation are in order. General economics and policy news are up next. China news follows, and international news comes after. We close with pandemic coverage.

The Colonial pipeline: The Colonial pipeline is a key piece of U.S. energy infrastructure; about 45% of all product flow from Houston to the Eastern Seaboard moves on this 5,500-mile pipeline. The pipeline transports about 2.5 mbpd of products from refineries in Texas and Louisiana to the states shown below.



(Source: RBN Energy)

On Friday, the system was hit by a cyberattack that involved ransomware. Reports suggest that hackers took data on Thursday before deploying the ransomware. In a sense, this was a two-part attack. The stolen data was used to threaten the company with a data dump while hackers encrypted parts of the network, demanding payment to decrypt. The last official statement indicates that the four main lines are still closed. However, as the map shows, there are numerous lateral lines, and some of them have resumed operations. Although the culprit hasn't been officially determined, the Darkside ransomware group is thought to be involved. It is an eastern European criminal organization that has struck infrastructure before. The fact that it is a criminal group doesn't necessarily mean a state sponsor isn't involved. This is by far the most extreme attack on U.S. infrastructure and raises concerns that this and other critical infrastructure may be vulnerable to similar actions.

As of this morning, the pipeline remains closed, and there is no clear restart time. The government has declared a state of emergency that will ease regulations on shipping fuel, and officials are working with the company to restart operations. If the shutdown persists, gasoline, diesel, and jet fuel prices in the affected states will likely rise. Over time, the U.S. can ship fuel by railcar and tanker, but these solutions will be costly, and the logistics will take time to manage. The market reaction thus far has been modest. Although we did see a spike in product futures prices yesterday evening, prices have been drifting lower since. If the outage is contained this week, markets should remain calm. However, if we are not back online by Friday, we will expect higher retail product prices.

The employment report: Friday's employment report caught the market off guard. Pundits, economists, and strategists are all creating narratives to account for the surprise. Friday's report may be the largest true forecast miss we have ever seen. Although the March 2020 miss was epic, it also occurred while lockdowns were being implemented. Most of the forecasts were in place pre-lockdown. Here are a few thoughts:

- The employment data is a volatile report. It is not uncommon for misses to occur, and the "misses" then absolved in later revisions. You don't get much out of one month's report. It would probably be a mistake to read too much into this surprise.
- Of course, that didn't stop the narrative machines from churning out reasons for the disappointing data. It is important to remember that there are several cross-currents at work in the labor markets.
    - In Friday's *Daily Comment*, for example, we showed the sharp drop in over 65 labor participation from the pre-pandemic level. The loss of older workers, which had been a rapidly growing part of the labor market, could be contributing to worker shortages.
    - We suspect underlying changes are occurring in the labor markets from the pandemic. Jobs in foodservice and retailing can be grueling. The work is hard; the hours are uncertain, and facing the public can be challenging. Many of these workers lost their jobs in the pandemic and found other ones. They may have decided they aren't going back. That means retailers and restaurants may be forced to improve working conditions and pay to find workers. Anecdotal reports are appearing that suggest this may be the case. We are always careful with such information, but it can signal emerging changes.
    - Some states are ending Federal government COVID-19 benefits. This will act as a natural experiment to see if it was high transfer payments that were keeping workers away from jobs.
- There is some evidence to suggest the Bureau of Labor Statistics may have a seasonal adjustment problem. The non-seasonally adjusted non-farm payroll report was up 1.089 million compared to the seasonally adjusted data of 266 thousand. The pandemic has clearly played havoc with the payroll data, and we suspect that the BLS is struggling to separate the seasonal effects that may be skewed due to the pandemic recovery.

U.K. elections: It was good news and bad news for PM Johnson. The good news was that the Tories continue to dominate Labor. The bad news was that the SNP in Scotland narrowly missed an outright majority (it captured 64 seats with 65 being a majority), but since it is widely expected to make a government with the separatist Green Party, it will control 74 seats in the 129 seat legislature.[1] It is also expected that Nicola Sturgeon, the head of the SNP, will use this

[1] We also note that the breakaway party of Alex Salmond, the Alba party, failed to secure a seat. This will be taken as clear evidence Sturgeon is the leader of the separatist movement.

election as a springboard for an independence referendum. PM Johnson has called for crisis talks on this issue.

So, what happens now? Expect a long, drawn-out process for a referendum. PM Johnson opposes granting a separation vote and will use every option to delay it. Expect Johnson to argue that since the SNP didn't win an outright majority, it really doesn't have a mandate. It will be difficult for Johnson to postpone a vote indefinitely, but the SNP's lack of an outright win will likely give him fodder to slow the process.

The primary issue driving Scottish independence is the EU. Scotland wanted to remain; England wanted to leave. Of course, in any issue like this, personalities matter, and Johnson's divisive persona makes Sturgeon's position easier to sell. However, don't underestimate the difficulties of independence. Scotland may want out, but the EU might be reluctant to let it in. Leaving will require Scotland to accept some of the U.K. debt. The amount will be negotiated, but its debt level could be high enough to give the EU pause. In addition, Spain has been reluctant to accept Scotland, fearing its Catalan independence movement would be bolstered by such an event. The vote to accept a member requires unanimous consent, so Spanish opposition could doom the effort. Scotland would not have a currency before it joins the EU. Sturgeon says the country would continue to use the GBP, but that would give the BOE control of its monetary policy without any input. And, joining the EU doesn't make entering the Eurozone automatic. Current polls suggest a narrow plurality would rather stay in the U.K. However, undecided voters are around 8%, so there is room for the vote to go in either direction. Although this issue will be on the minds of investors going forward, the GBP is higher this morning on the fact that the SNP didn't win an outright majority.

Inflation: We will get our first inflation reading that will matter on Wednesday; this will be the first one that takes into account the base effects of last year's drop in prices. Much of the price pressure we see is coming from supply constraints. Bottlenecks and production disruptions are clearly leading to higher prices. The unknown is whether households, flush with cash, will spend the money to buy things that cost more or balk at the increases and reduce spending. Obviously, some items are staples and hard to economize. Nevertheless, we could see changes in spending patterns as prices increase.

There is no doubt we are seeing reflation and debasement. The Fed has made it abundantly clear that the focus on inflation control, the policy emphasis since Volcker, has been reversed. This 1970s-style inflation requires a change in attitude, a fear that prices will be higher in the future, and thus the only option is to buy now, which will solidify price increases. As we noted last week, it also requires a change in the thinking about inventories. Stockpiles need to be seen as an asset instead of a cost to be managed. Our take is that this current inflation event, to paraphrase Obi-Wan Kenobi, "is not the inflation you are looking for." We suspect consumers will wait out these price increases, and as supply chains normalize, inflation pressures will ease. That doesn't mean inflation isn't going to be a serious issue in the future.

Economics and policy: European bond markets and contemplating the end of easy money are in the news.

- There are some oddities developing in the European bond markets.

  - Some European governments are moving to cap the amounts of new sovereign issues that hedge funds can buy. Apparently, hedge funds, which like using leverage, are purchasing large amounts of new issues only to sell them to the ECB at a small profit. The ECB is not allowed to purchase new issues (that would be debt monetization, something that bothers Germans and other northern Europeans greatly) and must buy in the secondary market. This situation creates an opportunity for private buyers to buy at the auction and quickly sell to the ECB. Since is it common for the price to be a bit below par at the auction, the likelihood of quick profit emerges. Countries prefer buyers to be of the type that holds the bonds for a long period to dampen potential price volatility, not hedge funds looking to hold the bonds for a few hours.
  - Is the German Bund becoming the new widow maker? For years, traders have shorted Japanese government bonds and have nothing but massive losses to show for their efforts. As expectations of higher yields emerge, traders are betting that the Bunds, with their low yields, will offer the best opportunity to profit from higher interest rates. The risk? There are primarily two. First, any whiff of trouble in the Eurozone sends money to Bunds for safety. Second, the ECB will likely limit the rise in this key bond market.
- The northern European nations tend to support hard money policies. So, we were surprised to see Olli Rehn, the governor of the Bank of Finland, suggest the ECB should mimic the Fed's policy on inflation and accept periodic "overshoots" of the target. We suspect he is worried about an overly strong EUR.
- As interest rates rise, the boom in refinancing mortgages is fading. Paradoxically, this is helping homebuyers, as mortgage brokers are cutting fees to attract business. However, this benefit is usually fleeting; over time, mortgage brokers will begin to reduce capacity by laying off personnel.
- Now that workers are fleeing the high-cost tech cities, secondary cities are starting to benefit.
- Regulators are cracking down on the widening crypto markets, especially the ones that represent an equity interest.
- The common theme lifting financial markets is easy monetary policy. Once this policy ends, the fallout could be a problem.

China: The EU is steadily expanding its toolbox to contain China's influence.

- The EU is facing a China that has multiple tactics and policies to expand its reach. The EU is reacting by creating numerous trade responses to address these actions. It has created a set of policies that will allow members to react to China's subsidies which expand their exports. Anti-dumping rules have been bolstered. Technology restrictions have been put into place. It has rules in place that force EU firms to enforce European labor standards. However, the real problem is both the EU and China use export promotion economic models. They both need nations to be willing to absorb their exports, and when neither is open to that sort of policy, frictions naturally develop.
- U.S. military leaders are increasingly concerned about China's expansion into Africa.

- The PRC is restricting phone news notifications to limit the flow of information.

International roundup: Tensions are rising in Israel and the EU, and India starts trade talks.

- Israel is planning to evict some Palestinians from East Jerusalem to house Israeli settlers. This decision has led to widespread violent protests, which will delay the evictions for now.
- The EU and India, likely in response to worries about China, have agreed to restart trade negotiations. The two countries had talks from 2007 to 2013 but failed to make progress in several areas, so discussions were suspended.

COVID-19: The number of reported cases is 158,400,711 with 3,294,657 fatalities. In the U.S., there are 32,708,028 confirmed cases with 581,755 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 329,843,825 doses of the vaccine have been distributed with 259,716,989 doses injected. The number receiving at least one dose is 152,116,963, while the number of second doses, which would grant the highest level of immunity, is 114,258,244. The *FT* has a page on global vaccine distribution.

- The idea of global herd immunity is fading. The uneven rollout of vaccines and the rapid evolution of new variants is pointing to a situation where COVID-19 becomes endemic. That means that some degree of caution will remain in place, but the current level of concern will likely fade over time.
- As vaccine cards become a passport to various activities, a market for fraudulent cards is emerging.
- On the vaccine front, the WHO has approved China's Sinopharm (SHTDF, USD, 3.35) vaccine. Some nations are changing guidance for the use of the AstraZeneca (AZN, USD, 53.81) vaccine. The most likely decision is to limit distribution among those under 40.
    - Although vaccine distribution in the U.S. has slowed, the pace of infections is falling.
    - The pace of vaccinations in Europe is rising.
    - Erie County in Pennsylvania is finding a way to overcome vaccine hesitancy: free beer.

U.S. Economic Releases

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

Economic Releases		
	No economic releases today	
Fed Speakers or Events		
EST	**Speaker or event**	**District or position**
14:00	Charles Evans Discusses Economic Outlook	President of the Federal Reserve Bank of Chicago

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								
Australia	NAB Business Conditions	m/m	Apr	32.0	25.0		**	Equity bullish, bond bearish
	NAB Business Confidence	m/m	Apr	26.0	15.0		**	Equity bullish, bond bearish
	Retail Sales Ex Inflation	q/q	1Q	-0.5%	2.5%	-0.4%	**	Equity bearish, bond bullish
	Retail Sales	m/m	Mar	1.3%	1.4%	1.4%	**	Equity and bond neutral
EUROPE								
Eurozone	Sentix Investor Confidence	m/m	May	21.0	13.1	15.0	***	Equity bullish, bond bearish
Switzerland	Domestic Sight Deposits CHF	w/w	7-May	634.1b	634.0b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	7-May	705.0b	701.4b		*	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)	16	16	0	Up
3-mo T-bill yield (bps)	1	1	0	Neutral
TED spread (bps)	15	15	0	Up
U.S. Libor/OIS spread (bps)	8	8	0	Up
10-yr T-note (%)	1.58	1.58	0.00	Neutral
Euribor/OIS spread (bps)	-53	-53	0	Neutral
EUR/USD 3-mo swap (bps)	2	2	0	Down
Currencies				
dollar	Flat			Down
euro	Down			Up
yen	Down			Up
pound	Up			Up
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.

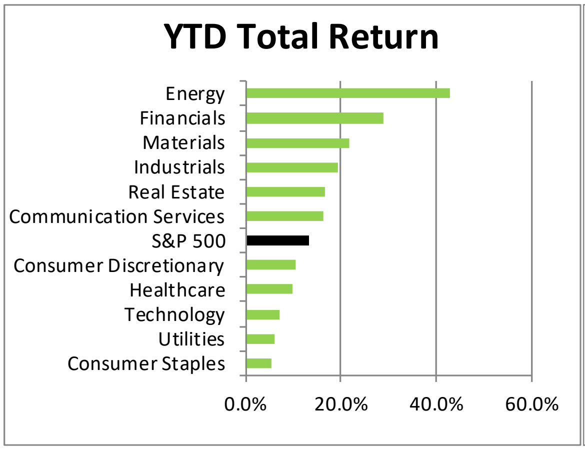
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$68.64	$68.28	0.53%	
WTI	$65.20	$64.90	0.46%	
Natural Gas	$2.94	$2.96	-0.74%	
Crack Spread	$23.43	$23.00	1.87%	
12-mo strip crack	$20.84	$20.72	0.58%	
Ethanol rack	$2.81	$2.78	1.02%	
Metals				
Gold	$1,837.33	$1,831.24	0.33%	
Silver	$27.72	$27.45	0.99%	
Copper contract	$487.35	$474.85	2.63%	
Grains				
Corn contract	$726.00	$732.25	-0.85%	
Wheat contract	$750.75	$761.75	-1.44%	
Soybeans contract	$1,585.50	$1,589.75	-0.27%	
Shipping				
Baltic Dry Freight	3183	3212	-29	

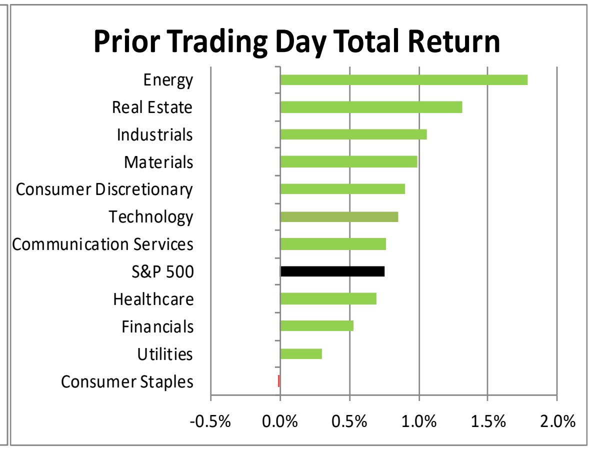
Weather

The 6-10 and 8-14 day forecasts currently call for warmer than normal temperatures for most of the country, with cooler than normal temperatures on the West Coast. The forecast calls for wet conditions in the North Central region of the country, with drier conditions throughout the Southwest and East Coast regions.

Data Section

U.S. Equity Markets – (as of 5/7/2021 close)

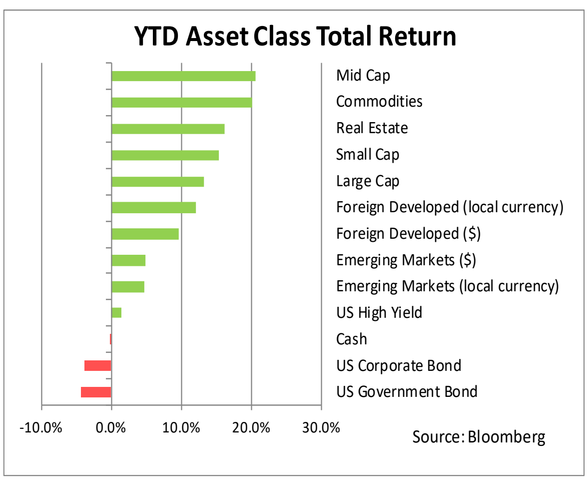




(Source: Bloomberg)

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 5/7/2021 close)

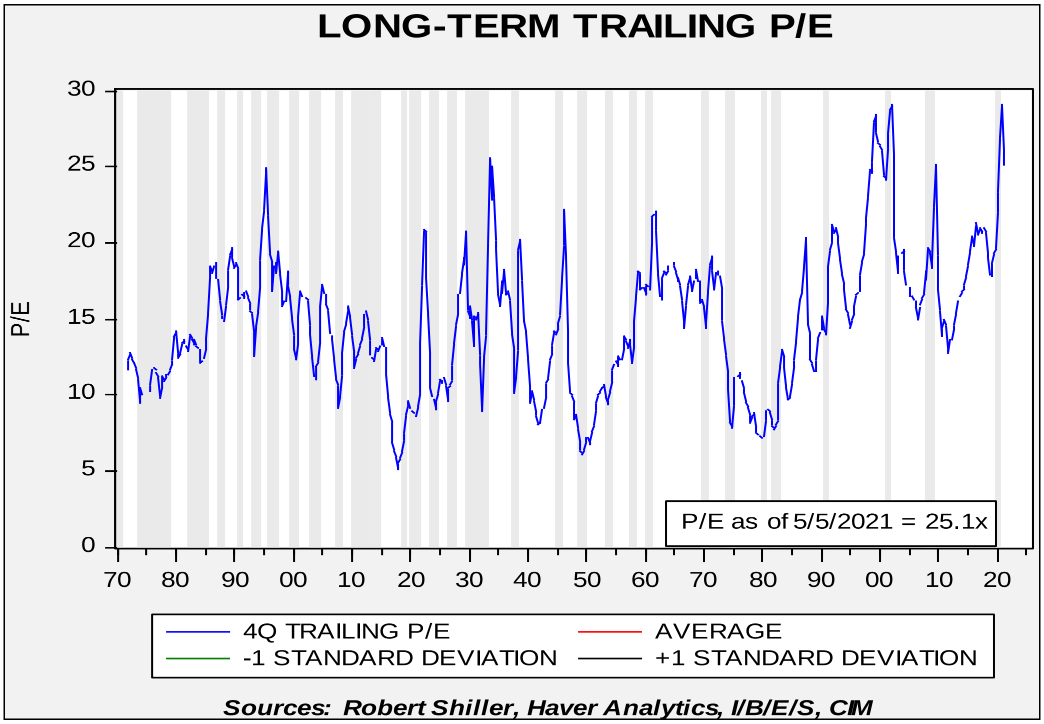


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[2] 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.

[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 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.