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 14, 2020—9:30 AM EDT] Global equity markets are lower this morning. The EuroStoxx 50 is down 1.9% from its last close. In Asia, the MSCI Asia Apex 50 closed down 1.0% from its prior close. Chinese markets were lower, with the Shanghai Composite down 1.0% from the prior close and the Shenzhen Composite down 0.9%. U.S. equity index futures are signaling a flat open. With 446 companies having reported, the S&P 500 Q1 earnings stand at $33.70, lower than the $35.51 forecast for the quarter. The forecast reflects a 10.0% decrease from Q1 2019 earnings. Thus far this quarter, 66.8% of the companies have reported earnings above forecast, while 28.3% have reported earnings below forecast.

Good morning! Equity markets continue under pressure this morning. We update the COVID-19 news. The Weekly Energy Update is available. Here are the details:

COVID-19: The number of reported cases is 4,364,172 with 297,491 deaths and 1,418,656 recoveries. In the U.S., there are 1,390,764 confirmed cases with 84,136 deaths and 243,430 recoveries. For those who like to keep score at home, the *FT* has created a nifty interactive chart that allows one to compare cases and fatalities between nations, scaled by population. Here is another map from Axios, showing the growth of new cases by state.

The virus news:
- The good news:
  - One of the tools being developed in the fight against the virus is blood antibodies. These drugs are developed either from the blood of humans who have recovered from COVID-19 or from animals who have been immunized. This report from the *FT* is a primer on the process.
  - We have been reporting on new UV light processes to disinfect public areas. A robot equipped with a UV light has been able to disinfect hospital rooms.
  - Researchers at Yale say they have found that saliva is superior to nasal swabs to test for COVID-19 infection. If true, this would make the testing process much easier.
  - Border controls and social distancing measures are being relaxed.
    - In a bid to save the tourism season, Europe is reopening its borders.
    - Mexico is easing distancing and border measures. One of the problems for some American businesses has been the disruption of trade flows with Mexico. These measures should ease those concerns.

- The bad news:
  - Wuhan has [launched a mass testing drive](#) after a series of new infections from COVID-19 were reported.
  - [South America](#) is seeing a surge in cases without the resources to cope with the economic fallout from the virus.
  - Although children usually have mild cases of COVID-19, there are [reports from New York of 100 cases of an inflammatory syndrome that comes from the virus](#). It is unclear if this development represents yet another mutation of the virus.
  - The medical establishment is working feverishly to create a vaccine for COVID-19. However, there is the [possibility that a vaccine may not be accepted by part of the public](#). This would slow herd immunity if this outcome develops. Meanwhile, data from Spain suggests only about 5% of the population has been infected with COVID-19 and thus herd immunity is much further off (70% is considered a minimum for herd immunity).
  - The WHO's chief scientist, [Soumya Swaminathan](#), told a group yesterday that it may take four to five years to get COVID-19 under control, depending on medical developments and virus mutations.
    - Although one would wish for something different, it is also likely that the virus will simply need to be accommodated. Broad lockdowns do blunt the initial rise of the disease but are not a permanent solution. After all, [economic disruption and social isolation](#) carry [their own dangers](#). What Swaminathan is really getting at is that society will need to learn to cope with the virus, similar to how we accommodate influenza and other infectious diseases.
    - This may mean that [vulnerable populations](#) will take greater precautions than others.
    - One of the more disturbing, but not surprising, elements of the current situation is that COVID-19 has become politized. This leads to binary thinking—either you open the economy full bore and risk rising infections or stay locked down for good and have no growth. But, in reality, this isn't the only set of choices. We can build safety into our economy without complete social distancing and have vulnerable populations take additional measures without having those who are less at risk carry the same burden. Will things be different? Sure. Airplanes may need to build different seating arrangements. Some things may cost more. A generation may learn to cook at home. [Hotels are figuring out how to sanitize](#) so patrons will return. But, people and societies are remarkably adaptable. This will get figured out.

The policy news:
- [Chair Powell warned yesterday that further stimulus measures will likely be necessary](#) from both [fiscal authorities and the Fed](#) to [offset the weakness](#) in the economy. [He backed further Congressional action](#) to stimulate growth. He expressed worry that a deep and long recession would have long-lasting negative effects on the economy which

policymakers should make every effort to avoid. The tone of his comments weakened investor demand and pushed stocks lower yesterday.

- o The Fed may curb bank dividends due to the pandemic.
- o The Fed is easing conditions on its Term Asset-Backed Loan Facility (TALF), which is designed to allow CLO managers to finish deals that were negotiated prior to the economic downturn.

- Although the Fed continues to downplay the likelihood of negative interest rates, President Trump remains a fan.

- Congress is considering a bill that would give states more leeway in how they spend their stimulus money. It would not be allowed for funding retirement programs, but it would give states some latitude to use the money for non-virus-related spending. President Trump expressed support for the measure.

- Tax breaks and deferrals are helping companies bear the economic slump. This factor is one of the parts of the stimulus that has generally been less appreciated.

- On-the-fly changes to the payroll protection program is worrying some small businesses that have taken the loans, fearing they could run afoul of changes that occurred after they took the money. There is always a tension between oversight and speed. The more oversight one has, usually the less fast money can get distributed. The problem with post-hoc changes is that potential recipients will be leery of accepting such programs in the future.

The economic news:
- Colleges are facing a serious problem in the fall. Offer only online courses and students (and their parents) may wonder why they are paying a mountain of tuition when online should be much cheaper. Open up campus, and there is the potential of virus outbreaks. Some state schools have already decided that online is their best option. At the same time, most college students would rather go back to campus.

- Advertisers are questioning whether they should continue ad campaigns when consumer spending is falling. Media outlets will almost certainly face less ad revenue as the year progresses.

- Borrowers are trying to get forbearance from their lenders. They are finding the lenders are overwhelmed with demand and are struggling to respond.

- About 3% of restaurants have closed for good and another 11% may close permanently in the next 30 days according to a recent survey. More than 3k retail stores have closed as well. It is estimated that 100k small businesses have closed due to the downturn triggered by the pandemic.

- COVID-19 has caused significant disruptions to food distribution. We have noted the shutdowns to meat processors and are starting to see local news reports about much higher meat prices. The disruption of food distribution is a global problem; in some areas, food goes to waste because processors are trying to shift from making restaurant sized packages to smaller ones for households. In other parts of the world, food shortages are developing. As lockdowns ease, some of this problem will subside. But there will simply be some food lost due to this crisis.

- After the Great Financial Crisis, there was great fear that the expansion of the Fed's balance sheet and the fiscal deficits would trigger an inflation problem. Those fears turned out to be baseless, in part because households engaged in austerity; they boosted saving and reduced their debt. Companies are preparing for another round of household austerity in the wake of the COVID-19 crisis. After all, the lessons since 2008 for households is that having savings is necessary and avoiding debt is not a bad thing either.
- The *WSJ* survey of economists had no big surprises; the majority expect a "swoosh" recovery and the levels of uncertainty are high. Nevertheless, growth is expected to recover as the year wears on.

The market news:
- Two areas of the debt market are starting to raise concerns among investors:
  - Collateralized loan obligations (CLO) are structured loan products with various degrees of risk. The first cut of payments tends to be highly rated; the last cut tends to be near junk. However, as we found during the 2008 financial crisis, no matter how one cuts up something, a bad loan is simply a bad loan. There are worries that we may be facing another round of trouble in this complex market.
  - The slump in emerging markets is raising concerns about emerging debt.
- The U.S. is pressing chipmakers to move production out of China and into the U.S. Taiwan is under specific pressure in this arena.
- The IEA monthly report projects global demand fell 21.5 mbpd in May but did indicate market conditions are starting to improve.
- Fitch is warning that its downgrades of financial and corporate debt are on pace for a record.

The foreign news:
- News out of China has been coming fast and furious. Here is a rundown:
  - Increasing pressure on China from the U.S. has foreign exchange traders leaning toward a weaker CNY. Currency weakness would undermine the Phase 1 deal and weaken the impact of tariffs.
  - China, upset with Australia's position on an investigation of the origins of the pandemic, has suspended some beef imports. Beijing is threatening other measures as well.
  - New Zealand is facing similar threats over its support of Taiwan.
  - As we noted yesterday, the U.S. is restricting federal retirement programs from buying Chinese equities. Beijing is worried that further measures may be forthcoming.
  - President Trump has indicated he has no interest in renegotiating the Phase 1 trade agreement, despite the pressure brought by the pandemic. Meanwhile, China has granted waivers on some tariffs of U.S. goods. China is increasing its soybean purchases as well. However, China's imports of Brazilian soybeans hit a record in April, raising doubts that Beijing will meet its Phase 1 targets with the U.S. The Phase 1 deal has a target of $36.5 bn of agricultural products in 2020; so far, about $3.0 bn have been purchased. Why is China buying from Brazil?

The BRL has been making new record lows; in CNY, Brazilian beans cost about 20% less.

- o The U.S. has extended its ban on U.S. companies using equipment made by Huawei (002502, CNY 2.99).
- o Vietnam is encouraging its fishermen to defy China's fishing ban in the South China Sea. China implements a seasonal ban to build fish stocks; however, if other nations comply, it is granting China sovereignty over these waters, which other nations dispute. In related news, the U.S. Navy is boosting its presence in the seas off Malaysia to support that nation in its maritime disputes with Beijing.

- Conditions in Turkey continue to deteriorate. The lira has been weakening, foreign reserves are falling and COVID-19 is hitting the country. President Erdogan is warning of a coup, although there isn't much evidence to support this concern.

- There are elements of supports for Brazilian President Bolsonaro who are backing a military coup. Essentially, it appears they want to end the democracy and implement rule by decree.

WTO: The head of the WTO has resigned a year before his term ended. The WTO leadership has been under great strain due to rising trade tensions, and Roberto Azevedo has apparently decided to move on.

Islamic State: Islamic State is becoming active again in the area on the Iraq/Syrian frontier. This region is generally not controlled by either Damascus or Baghdad, and with the U.S. reducing its troop strength it appears the group is coming alive again. One sign of activity is that Islamic State is being blamed for a series of crop fires in Iraq.

U.K.: In anticipation of trade talks with the U.S., Westminster is planning to cut agricultural goods tariffs on U.S. farm exports. As one would expect, there is opposition from British farmers to the news.

German courts: Although Chancellor Merkel was (as expected) non-committal, the judges of Germany's Constitutional Court are holding firm on their position in the fight over ECB QE. If Germany continues on this path, the Eurozone will either (a) acquiesce to German hegemony over the Eurozone, or (b) likely accelerate the breakup of the single currency. This is a very difficult dilemma.

U.S. Economic Releases

In April, the import price index fell 2.6% from the prior month compared to expectations of a drop of 3.2%. Although the decline in import prices was relatively steep, it was primarily due to cheaper oil. Excluding oil, the import price index fell 0.5% from the prior month, in line with expectations. Meanwhile, the export price index fell 3.3% from the prior month.

Export Price Index: All Exports
% Change - Year to Year NSA, 2000=100
Import Price Index: All Imports
% Change - Year to Year NSA, 2000=100

Source: Bureau of Labor Statistics/Haver Analytics

The chart above shows the annual change in the import and export price indexes. The export price index and the import price index fell 7.0% and 6.7%, respectively.

For the week ending May 9, initial claims came in at 2.981 mm compared to expectations of 2.500 mm. The prior report was revised from 3.169 mm to 3.176 mm.

FOUR-WEEK AVERAGE OF
INITIAL CLAIMS

Sources: BLS, CIM
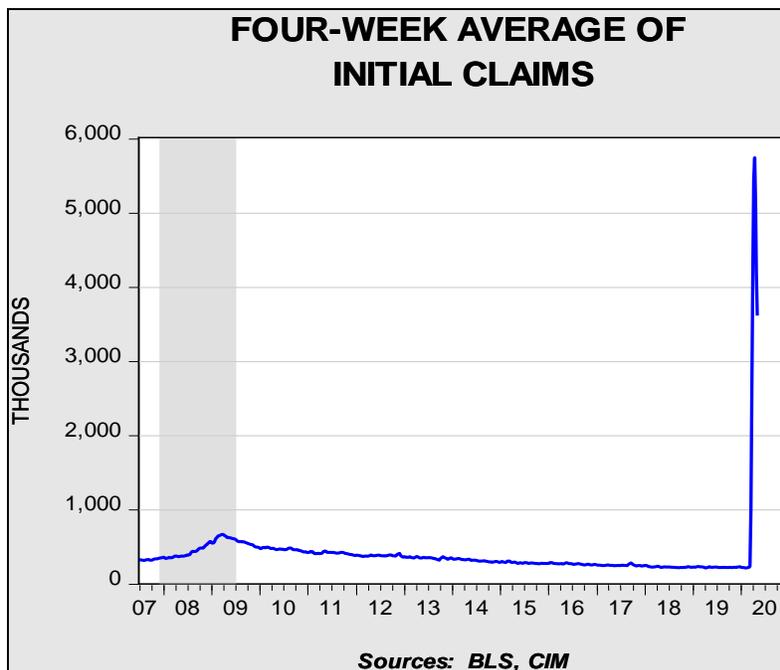
The chart above shows the four-week moving of initial claims. The four-week moving average of initial jobless claims fell from 4.173 mm to 3.610 mm. This is the fourth consecutive week of declines in initial claims, indicating the country is showing some signs of improvement.

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

Economic Releases						Expected	Prior	Rating
EDT	**Indicator**							
9:45	Bloomberg Consumer Comfort			w/w	10-May		36.9	**
Fed Speakers or Events								
	Speaker or event			**District or position**				
13:00	Neel Kashkari Speaks to the Economic Club of Minneapolis			President of Federal Reserve Bank of Minneapolis				
15:00	Raphael Bostic Discusses the Economy and COVID-19			President of the Federal Reserve Bank of Atlanta				
18:00	Robert Kaplan Takes Part in Moderated Discussion			President of the Federal Reserve Bank of Dallas				

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	Foreign Direct Investment	y/y	Apr	11.8%	-14.1%		**	Equity bullish, bond bearish
Japan	Money Stock M2	y/y	Apr	3.7%	3.3%	3.4%	**	Equity bullish, bond bearish
	Money Stock M3	y/y	Apr	3.0%	2.7%	2.8%	**	Equity bullish, bond bearish
	Japan Buying Foreign Bonds	w/w	8-May	¥239.1 Bil			*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	8-May	¥66.1 Bil			*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	8-May	-¥66.1 Bil			*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	8-May	-¥86.6 Bil			*	Equity and bond neutral
	Machine Tool Orders	y/y	Apr P	-48.3%	-40.7%		*	Equity and bond neutral
Australia	Consumer Inflation Expectation	m/m	May	3.4%	4.6%		***	Equity and bond neutral
	Employment Change	m/m	Apr	-594.3k	5.9k	-575.0k	***	Equity and bond neutral
	Unemployment Rate	m/m	Apr	6.2%	5.2%	8.2%	***	Equity bullish, bond bearish
	Participation Rate	m/m	Apr	63.5%	66.0%	65.3%	**	Equity and bond neutral
New Zealand	Net Migration	m/m	Mar	9700	8250		**	Equity and bond neutral
Europe								
Germany	Wholesale Price Index	m/m	Apr	-1.4%	-0.4%		**	Equity bullish, bond bearish
	CPI EU Harmonized	m/m	Apr	0.4%	0.4%	0.4%	***	Equity and bond neutral
	CPI	m/m	Apr	0.4%	0.3%	0.3%	***	Equity and bond neutral
France	ILO Unemployment Rate	m/m	1Q	7.8%	8.1%	8.5%	***	Equity bullish, bond bearish
	ILO Mainland Unemployment Rate	m/m	1Q	7.6%	7.9%	8.3%	***	Equity bullish, bond bearish
Italy	Trade Balance EU	m/m	Mar	603 Mil	1016 Mil		**	Equity and bond neutral
	Trade Balance Total	m/m	Mar	5685 Mil	6085 Mil		**	Equity and bond neutral
Switzerland	Producer & Import Prices	y/y	Apr	-4.0%	-2.7%		**	Equity bullish, bond bearish
AMERICAS								
Mexico	ANTAD Same-Store Sales	y/y	Apr	-22.9%	1.1%		**	Equity bearish, bond bullish
Canada	CFIB Business Barometer	m/m	May	53.2	46.4		**	Equity bullish, bond bearish
Brazil	Retail Sales	y/y	Mar	-1.2%	4.7%	-3.9%	***	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)	42	43	-1	Down
3-mo T-bill yield (bps)	11	12	-1	Neutral
TED spread (bps)	31	31	0	Up
U.S. Libor/OIS spread (bps)	5	5	0	Up
10-yr T-note (%)	0.62	0.65	-0.03	Neutral
Euribor/OIS spread (bps)	-25	-25	0	Neutral
EUR/USD 3-mo swap (bps)	10	10	0	Down
Currencies	Direction			
dollar	Up			Neutral
euro	down			Up
yen	down			Up
pound	down			Down
franc	down			Up
Central Bank Action	Current	Prior	Expected	
Mexican Overnight Rate		6.000%	5.500%	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	$30.47	$29.19	4.39%	Bullish EIA report and Demand Optimism
WTI	$26.66	$25.29	5.42%	
Natural Gas	$1.63	$1.62	1.05%	
Crack Spread	$9.71	$10.01	-3.06%	
12-mo strip crack	$9.55	$9.32	2.46%	
Ethanol rack	$1.28	$1.28	-0.14%	
Metals				
Gold	$1,718.04	$1,716.28	0.10%	
Silver	$15.58	$15.58	-0.02%	
Copper contract	$233.50	$234.60	-0.47%	
Grains				
Corn contract	$ 317.75	$ 318.25	-0.16%	
Wheat contract	$ 497.75	$ 501.75	-0.80%	
Soybeans contract	$ 836.75	$ 839.50	-0.33%	
Shipping				
Baltic Dry Freight	398	433	-35	
DOE inventory report				
	Actual	Expected	Difference	
Crude (mb)	-0.1	5.0	-5.1	
Gasoline (mb)	-3.5	-2.5	-1.0	
Distillates (mb)	3.5	4.5	-1.0	
Refinery run rates (%)	-2.60%	0.50%	-3.10%	

Weather

The 6-10 and 8-14 day forecasts currently call for warmer temperatures for most of the country, with cool conditions expected in the Pacific region. Precipitation is expected for most of the country, with dry conditions in the eastern third of the country. The Atlantic hurricane season officially runs from June 1 to October 31; however, for the second straight year, we may see the first named storm of the year before the official start date. Here is the National Hurricane Center's report.

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](#).

May 8, 2020

The U.S. economy has been hit with shelter-in-place orders that have depressed consumption and reduced production. The economic readings on Q2 will be historically bad, perhaps even worse than the Great Depression. However, based on the assumptions that (a) aggressive policy support will continue, and (b) the pandemic will wane over time, either due to natural herd immunity or medical intervention, financial markets are assuming the impact of COVID-19 will be severe in impact but short in duration. Although we mostly agree with that assessment, the rebound has much to do with how GDP is reported. The common way is to annualize the quarterly change. Thus, if we get a large decline in Q2, a very modest rise in GDP in Q3 will tend to look quite large. This is not the only way to measure the change in GDP. The year-on-year change will look less onerous in Q2 but won't look as impressive in Q3.

Another way we like to look at the GDP data is against its long-term trend. To forecast Q2 GDP, we are taking advantage of a [new high-frequency index created by the New York FRB](#). The index is designed to measure the yearly change in GDP—how much GDP has changed compared to Q2 2019. It is currently forecasting about a 12% yearly change.[1] We can then take that number and calculate what the level of GDP looks like compared to its long-term trend.

REAL GDP AND THE LONG-TERM TREND

Sources: Haver Analytics, Philadelphia FRB, CIM

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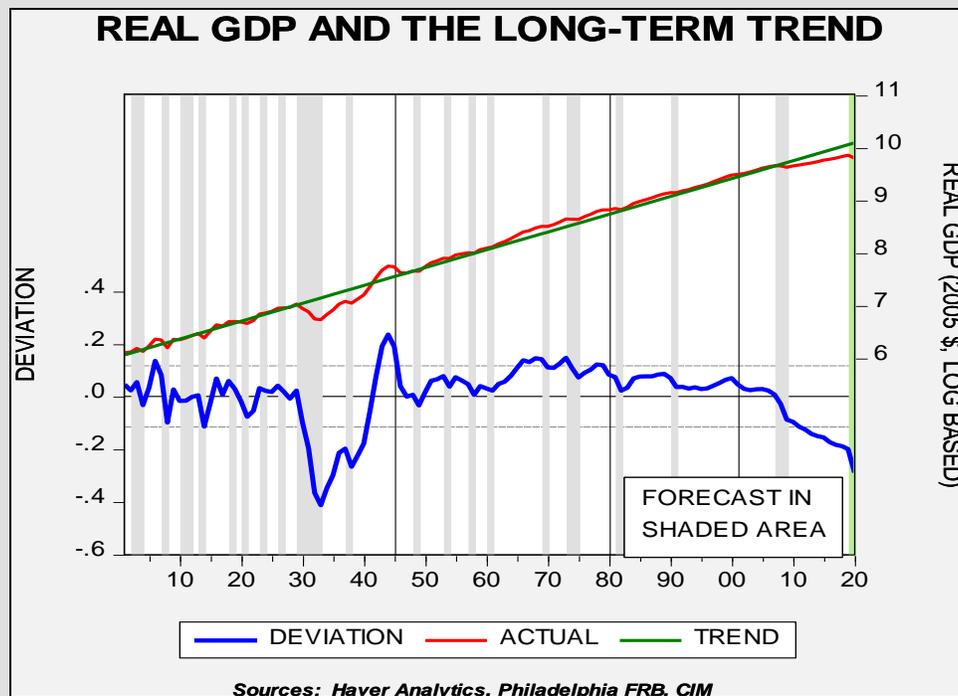
[1] Although this is not the focus of this report, the forecast level of decline is consistent with a 35% drop in annualized GDP in Q2.

To generate this chart, we log-transform real annual GDP and regress a time trend through the data. The important line is the lower deviation line. There are two periods when GDP was well below trend; the Great Depression and the post-Great Financial Crisis to the present. The Great Depression showed a massive drop in the level of GDP that took until 1942 to return to trend. Although fiscal and monetary policy were expanding after 1932, it took war spending to finally bring the economy back to trend. What has been disconcerting about the past expansion is that it was much slower than the long-term trend. And so, the level of GDP continued to fall compared to trend; our estimate for GDP in the COVID-19 recession shows a downleg in growth that is rivaling levels seen in 1935.

The point of this analysis is that the trend should represent some degree of capacity. It is possible the trajectory for GDP that held from 1901 to 2008 is no longer possible. But, if that trendline does represent a normal level for GDP, it would suggest the economy can absorb aggressive fiscal and monetary policy expansion before inflation becomes a problem. If inflation starts to rise before the trendline is achieved, it would confirm that the trendline is no longer valid; however, for the political class, it would seem natural to find out if the long-term trend line remains a measure of capacity. In other words, we would expect even more deficit spending and easy monetary policy until inflation returns. Given how far GDP remains below trend, the return of inflation may take a rather long time.

Data Section

U.S. Equity Markets – (as of 5/13/2020 close)
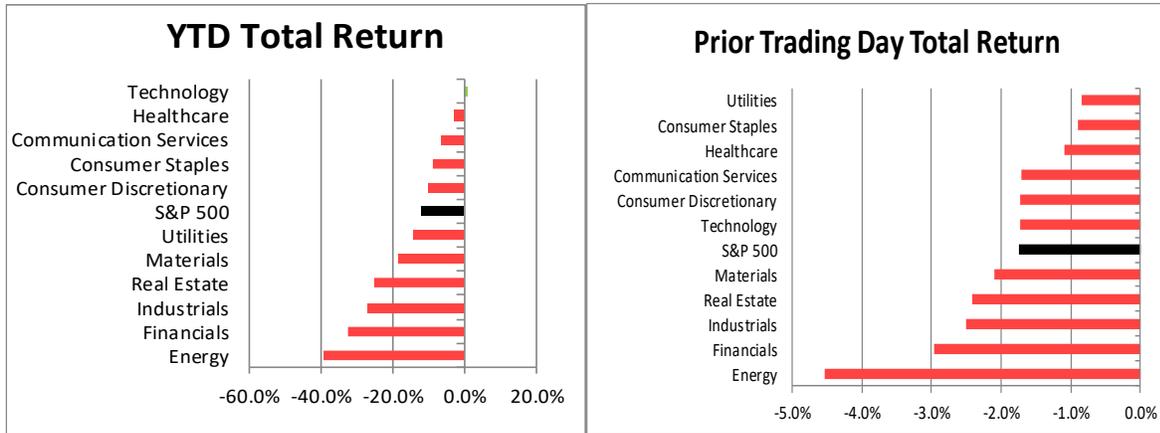
(Source: Bloomberg)

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.

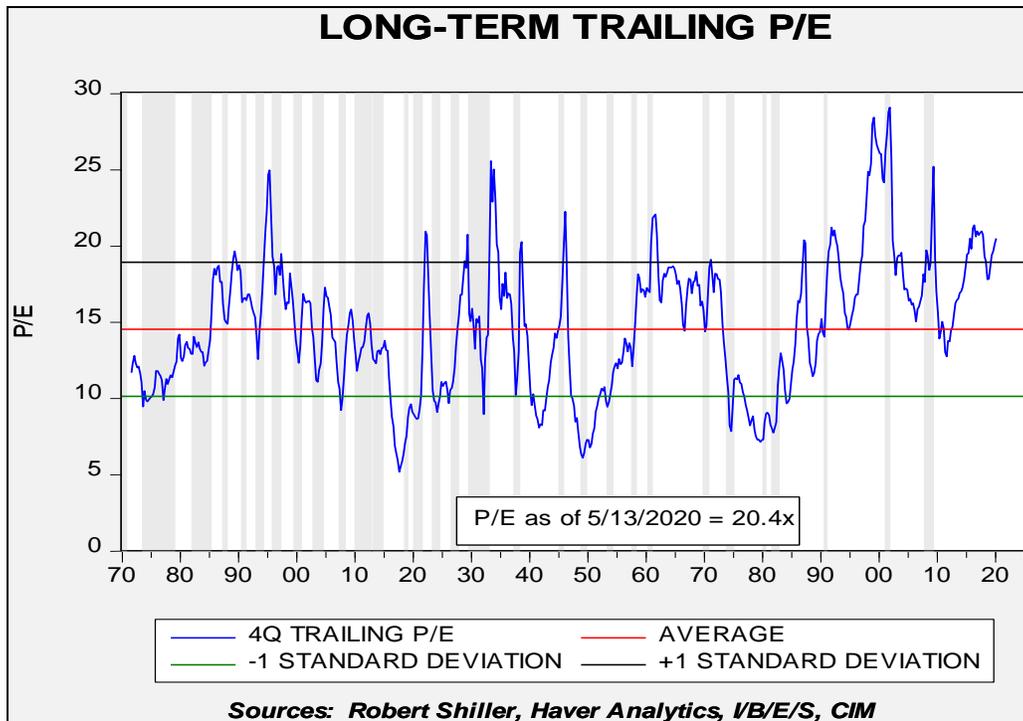**Asset Class Performance** – (as of 5/13/2020 close)
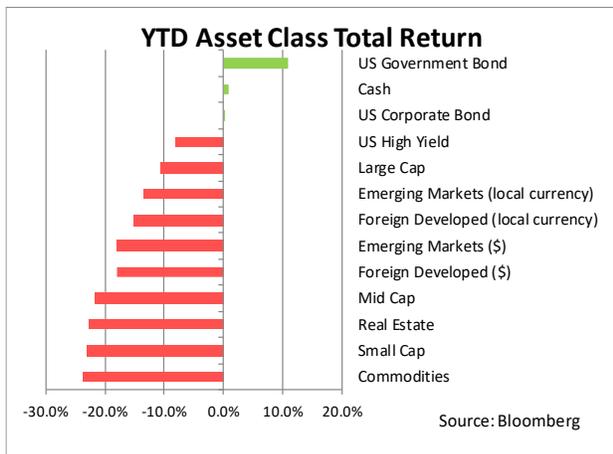
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

May 14, 2020

LONG-TERM TRAILING P/E

P/E as of 5/13/2020 = 20.4x

4Q TRAILING P/E — AVERAGE
-1 STANDARD DEVIATION — +1 STANDARD DEVIATION

Sources: Robert Shiller, Haver Analytics, I/B/E/S, CIM

Based on our methodology,[2] the current P/E is 20.4x, down 1.1x from last week. The drop in the P/E was due to upward revisions to Q1 earnings.

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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[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). 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.