Daily Comment

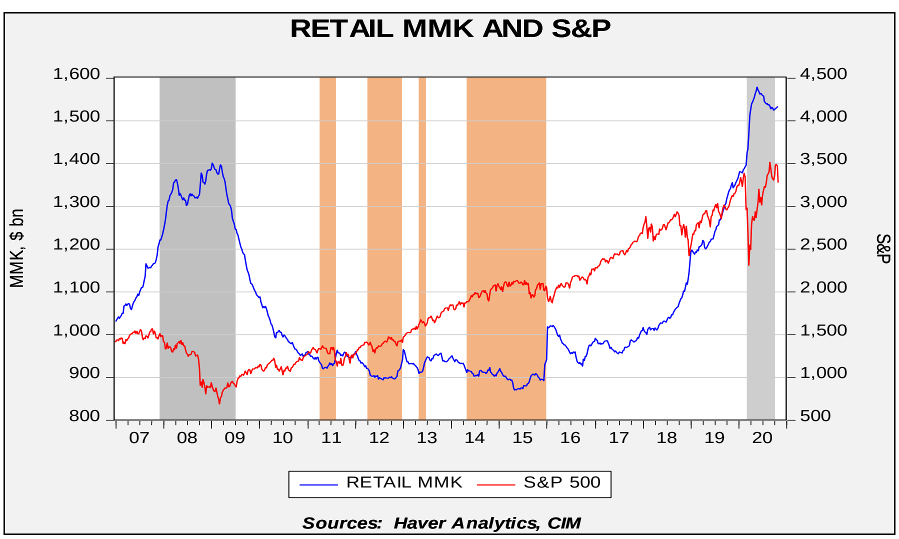
By Bill O'Grady, Thomas Wash, and Patrick Fearon-Hernandez, CFA

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: November 2, 2020—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is up 1.8% from its last close. In Asia, the MSCI Asia Apex 50 closed up 1.0%. Chinese markets were mixed, with the Shanghai Composite relatively unchanged from the prior close and the Shenzhen Composite up 1.2%. U.S. equity index futures are signaling a higher open. With 317 companies having reported, the S&P 500 Q3 earnings stand at $37.80, higher than the $33.68 forecast for the quarter. The forecast reflects a 21.0% decrease from Q3 2019 earnings. Thus far this quarter, 87.7% of the companies have reported earnings above forecast, while 10.4% have reported earnings below forecast.

Good morning and happy Monday. It's November, we have switched to standard time in much of the country, and tomorrow is election day. Super Typhoon Goni passed through the Philippines over the weekend. Global equities are higher this morning. We start our coverage with the election. Pandemic news is next. The Fed meets this week; we look at what the central bank may be thinking. We update China and close with odds and ends. Here are the details:

Election news: Although we are seeing a recovery in risk assets this morning, equities have been under pressure for much of October. Cash levels remain elevated and have risen in the past three weeks.



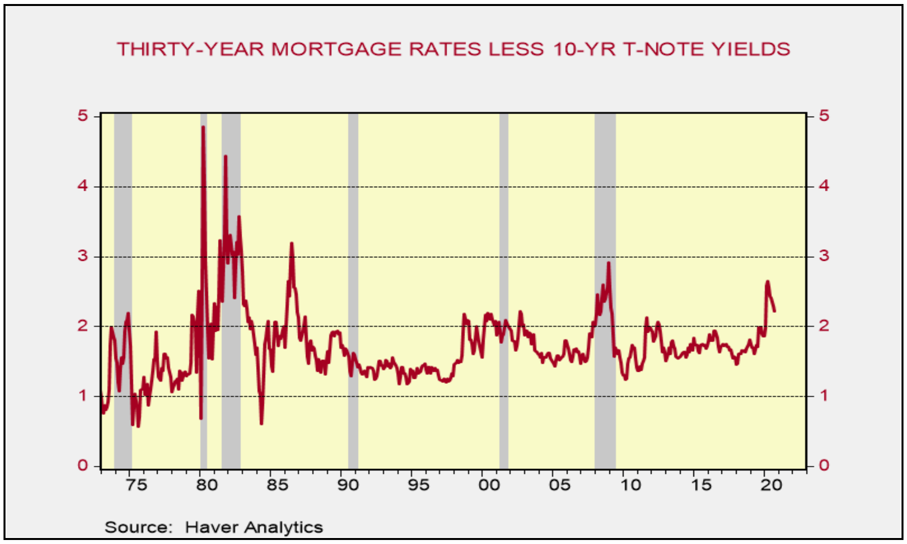
Our read on sentiment is that there is a high level of concern, which is not unreasonable. We probably won't know the outcome of the election with certainty when we go to bed tomorrow night. It may be a week before we know for sure. Disinformation will be circulating from a myriad of sources. But, the levels of cash suggest that a good bit of fear has already been discounted. If conditions turn out to be less than feared, a relief rally is likely. We will continue to monitor the political situation in the coming days.

COVID-19: The number of reported cases is 46,618,804 with 1,201,833 deaths. In the U.S., there are 9,208,9544 confirmed cases with 231,833 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.

Virology:

- Europe is tightening its restrictions as infections increase. Germany has instituted a four-week partial shutdown. U.K. lockdowns are spreading. Across Europe, hospitals are estimating when they will face capacity constraints. Compared to the spring, this cycle of lockdowns is facing a political backlash. Spain was rocked with violence in response to new measures. We suspect much of the backlash is due to the belief that the burden of lockdowns disproportionately affects less affluent groups. This is especially true of service workers.
    - The lockdowns are affecting growth estimates. Forecasts for Q4 GDP are turning negative.
- On a positive note, Israel's infections are falling rapidly, even though the recent lockdown was not as strict as the spring and compliance was poor. However, Israel did implement fines for not wearing masks, and this factor seems to be the primary reason for the sharp fall in infections.
- One of the mysteries of COVID-19 is the wide disparity of symptoms. Most of those infected have mild symptoms; others become very sick and don't survive. However, there is another trend that has researchers concerned—the so called "long COVID" cases. Some of those infected who had only mild symptoms are plagued with long-term problems. These include heart ailments, fatigue, and memory lapses that seem to linger for months or longer. There is evidence COVID-19 triggers an autoimmune response that is similar to lupus. There is another factor; with the exception of the oldest Americans, men tend to have higher fatality rates than women.
- A study of Regeneron on seriously ill COVID-19 patients has been halted after the drug was ineffective with this particular group.

The FOMC: The Fed meets this week, with the meeting concluding on Wednesday. We do not expect any change in policy, although a discussion about the maturity structure of purchases is likely. The U.S. is enjoying a boom of sorts in durables purchases and housing investment. Rising long-term interest rates could put these areas at risk. However, the Fed could support the housing market by increasing their purchases of mortgages.



The spread of mortgage rates to the 10-year T-Note is elevated, so it's 50 bps above average. The Fed could try to narrow this spread by driving mortgage rates toward the current 10-year yield level.

China: A couple items of note. First, China's PMI data confirms that the recovery remains in place. All the major subcategories are above the 50-expansion line. Not only has manufacturing shown improvement, but the services index is up to its highest level since 2013. Second, Chinese officials are continuing to expand foreign access to its financial markets. The most recent measure is to allow foreigners the ability to trade in China's futures markets. Opening up financial markets will reduce Beijing's ability to control such markets, but it will make it more difficult for the U.S. to isolate China. In addition, greater access will internationalize the CNY, improving its stature.

Odds and ends: These were items we noted:

- Airlines, facing rising infections and lower travel, are going BOGO—buy one ticket, get one free! The airlines are cutting prices aggressively to try to lure a reluctant public back to air travel. Cutting prices is always tricky, because in the short run, a firm is never sure what elasticity of demand it is facing. If the demand curve is elastic, cutting prices is a good strategy; under such conditions, a 1% drop in prices should lead to a greater than 1% rise in demand. But, more often, firms face an inelastic demand curve, which means that cutting prices only leads to falling revenue.
- Over the weekend, Moldova held presidential elections. No candidate won a majority, triggering a runoff election. So far, the pro-EU challenger is leading.

U.S. Economic Releases

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Markit US Manufacturing PMI	m/m	Oct	53.3	53.3	**
10:00	ISM Manufacturing	m/m	Oct	55.8	55.4	**
10:00	ISM New Orders	m/m	Oct	62	60.2	**
10:00	ISM Prices Paid	m/m	Oct	60.5	62.8	**
10:00	ISM Employment	m/m	Oct		49.6	**
10:00	Construction Spending	m/m	Sep	1.0%	1.4%	**
Fed Speakers or Events						
No speakers or events scheduled						

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.

	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
China	Caixin China Mfg PMI	m/m	Oct	53.6	53.0	52.8	**	Equity bullish, bond bearish
Japan	Jibun Bank Japan PMI Mfg	m/m	Oct	48.7	48.0		**	Equity bullish, bond bearish
	Vehicle Sales	y/y	Oct	31.6%	-15.6%		**	Equity bullish, bond bearish
India	Markit India PMI Mfg	m/m	Oct	58.9	56.8		**	Equity bullish, bond bearish
Australia	AiG Perf of Mfg Index	m/m	Oct	56.3	46.7		**	Equity bullish, bond bearish
	Markit Australia PMI Mfg	m/m	Oct F	54.2	54.2		**	Equity bullish, bond bearish
	CoreLogic House Px	m/m	Oct	0.2%	-0.2%		**	Equity and bond neutral
	Melbourne Institute Inflation	m/m	Oct	-0.1%	0.1%		**	Equity and bond neutral
	ANZ Job Advertisements	m/m	Oct	9.4%	7.8%		**	Equity and bond neutral
	Building Approvals	m/m	Sep	15.4%	-1.6%	1.5%	**	Equity bullish, bond bearish
	Commodity Index SDR	y/y	Oct	-0.3%	-5.8%		**	Equity and bond neutral
New Zealand	CoreLogic House Prices	m/m	Oct	8.0%	7.6%		**	Equity and bond neutral
	Building Permits	m/m	Sep	3.6%	0.3%		***	Equity bullish, bond bearish
Europe								
Eurozone	Markit Eurozone Manufacturing PMI	m/m	Oct	54.8	54.4	54.4	***	Equity and bond neutral
Germany	Markit/BME Germany Manufacturing PMI	m/m	Oct	58.2	58.0	58.0	***	Equity and bond neutral
France	Markit France Manufacturing PMI	m/m	Oct	51.3	51.0	51.0	***	Equity and bond neutral
Italy	Markit Italy Manufacturing PMI	m/m	Oct	53.8	53.2	53.7	***	Equity and bond neutral
UK	Markit UK PMI Manufacturing	m/m	Oct	53.7	53.3	53.3	***	Equity and bond neutral
Switzerland	PMI Manufacturing	m/m	Oct	52.3	53.1	53.5	***	Equity bearish, bond bullish
	Domestic Sight Deposits	y/y	Oct	636.0b	634.7b		*	Equity and bond neutral
	Total Sight Deposits	y/y	Oct	707.6b	706.9b		*	Equity and bond neutral
Russia	Markit Russia PMI Mfg	m/m	Oct	46.9	48.9	49.1	**	Equity bearish, bond bullish
AMERICAS								
Mexico	GDP NSA	y/y	3Q	-8.6%	-18.7%	-8.9%	*	Equity and bond neutral
	Net Outstanding Loans	m/m	Sep	4772b	4810b		**	Equity and bond neutral
	Budget Balance YTD	m/m	Sep	-308.4b	-275.0b		***	Equity and bond neutral
Brazil	GDP	m/m	Aug	1.20%	3.00%	0.90%	***	Equity and bond neutral
	Industrial Product Price	m/m	Sep	-0.1%	0.3%	0.1%	**	Equity bearish, bond bullish
	Raw Materials Price Index	m/m	Sep	-2.2%	3.2%	0.3%	**	Equity bearish, bond bullish

Financial Markets

The table below highlights some of the indicators that we follow on a daily basis. Again, the color coding is similar to the foreign news description above. We will add a paragraph below if a certain move merits further explanation.

	Today	Prior	Change	Trend
3-mo Libor yield (bps)	22	21	1	Down
3-mo T-bill yield (bps)	8	9	-1	Neutral
TED spread (bps)	13	13	0	Up
U.S. Libor/OIS spread (bps)	8	8	0	Up
10-yr T-note (%)	0.86	0.87	-0.01	Neutral
Euribor/OIS spread (bps)	-52	-52	0	Neutral
EUR/USD 3-mo swap (bps)	15	13	2	Down
Currencies	**Direction**			
dollar	Flat			Down
euro	Flat			Up
yen	Down			Up
pound	Down			Down
franc	Flat			Up
Central Bank Action		**Prior**	**Expected**	On forecast
RBA Cash Rate Target		0.250%	0.100%	On forecast
RBA 3-Yr Yield Target		0.250%	0.100%	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	$37.15	$37.94	-2.08%	Lockdown fears
WTI	$34.87	$35.79	-2.57%	
Natural Gas	$3.28	$3.35	-2.09%	
Crack Spread	$7.89	$8.34	-5.40%	
12-mo strip crack	$9.24	$9.63	-4.05%	
Ethanol rack	$1.63	$1.64	-0.15%	
Metals				
Gold	$1,887.94	$1,878.81	0.49%	
Silver	$23.95	$23.66	1.24%	
Copper contract	$305.25	$304.75	0.16%	
Grains				
Corn contract	$ 394.75	$ 398.50	-0.94%	
Wheat contract	$ 593.75	$ 598.50	-0.79%	
Soybeans contract	$ 1,048.25	$ 1,056.25	-0.76%	
Shipping				
Baltic Dry Freight	1283	1297	-14	

Weather

The 6-10 and 8-14 day forecasts currently call for cooler temperatures for most of the country, with warmer temperatures expected in the eastern third of the country. Dry conditions are expected for Southeast Coast and the Rocky Mountain region, with wet conditions expected for the rest of the country.

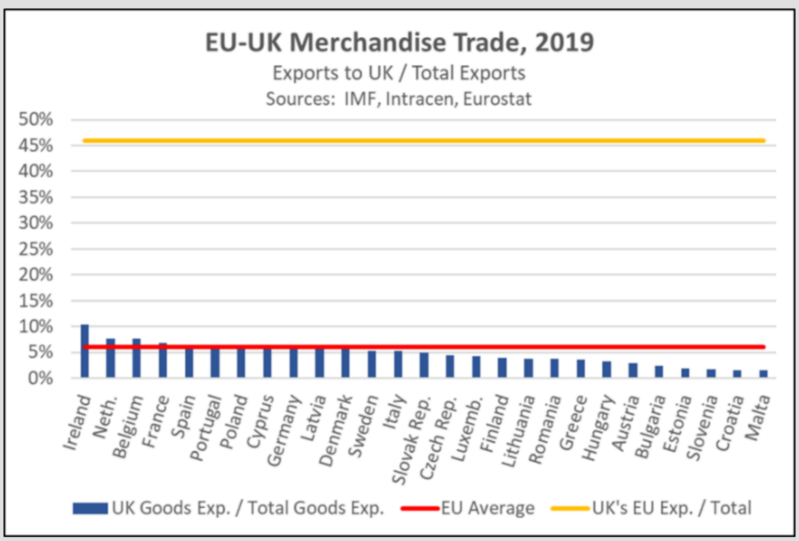
Asset Allocation Weekly

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.

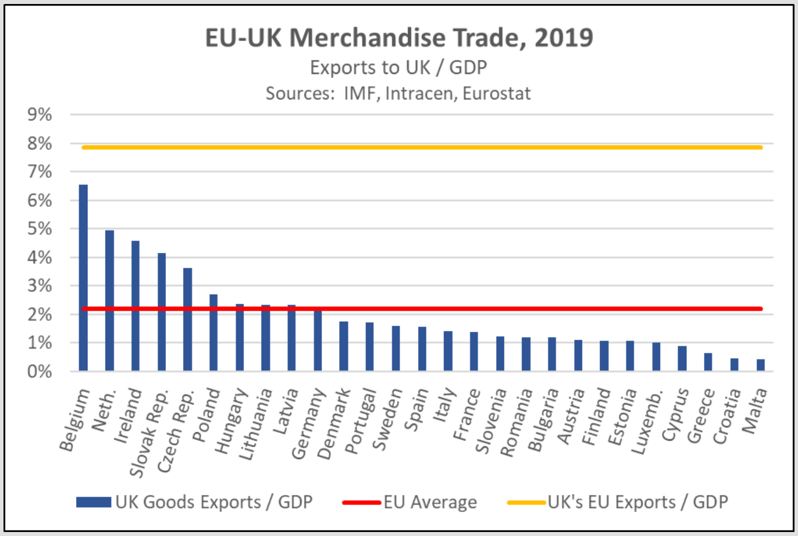
October 30, 2020

Many investment managers think of "foreign equities" as one big, monolithic asset class and leave it at that. When setting a portfolio's asset allocation strategy, many simply assign a certain percentage to the asset class and implement it by investing in a broad international index fund. Here at Confluence, we go a step further by identifying individual countries that may be attractive based on our analysis of their geopolitical power, economic performance, social developments, and financial dynamics. We think the current negotiations for a post-Brexit trade deal between the European Union and the United Kingdom offer especially rich insights into the relative power and prospects of the various EU member states and the U.K. Our analysis suggests the EU's Central European members and the U.K. may be especially well placed to outperform economically in the coming years.

At first glance, the EU would seem to have immense leverage in the post-Brexit trade talks because its exports to the U.K. make up only a small part of its total trade and economic activity. In theory, the EU could easily walk away from the negotiations and accept any trade barriers that would snap into place under a "hard Brexit." In contrast, the U.K. would stand to lose a huge chunk of its exports and economic activity, which would supposedly force it to make significant concessions. To illustrate, the chart below shows that only about 6.0% of the EU's merchandise exports went to the U.K. in 2019 (the red line in the chart). For Ireland and a few other big EU members, the U.K. represented as much as 10.3% of exports (the blue columns), but no EU member came close to the U.K.'s dependence on cross-Channel trade. Fully 46.0% of the U.K.'s foreign merchandise sales went to the EU (the gold line).



Despite the EU's apparent negotiating advantage, however, all indications are that the U.K. is holding its own in the talks. Last week, for example, a British threat to walk away from the negotiations brought the EU back to the table with promises that it would be willing to compromise on the remaining issues of fisheries and corporate subsidies. A close look at the following graph suggests why the EU may have less leverage than expected. The red line in this graph shows that, on average, EU members' exports to the U.K. represent only 2.2% of their gross domestic product (GDP). The gold line shows that the U.K.'s exports to the EU represent fully 7.6% of its GDP. But the key story is revealed by the blue columns, which show each individual EU member's merchandise exports to the U.K. as a share of its GDP. Besides the obvious dependency of close neighbors like Ireland, Belgium, and the Netherlands, what's notable is that the Central European states like Slovakia, the Czech Republic, Poland, and Hungary are also unusually dependent on shipments to the U.K.

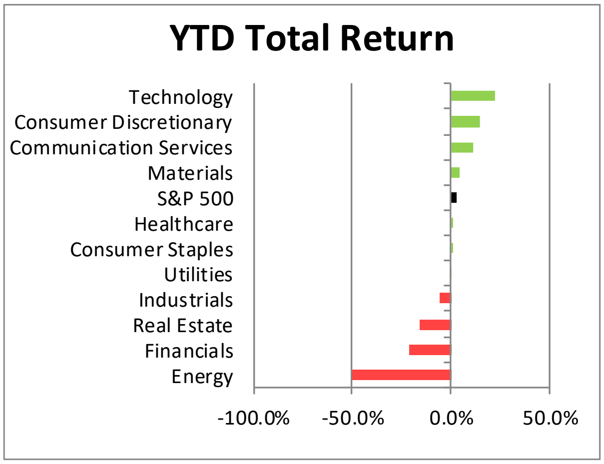


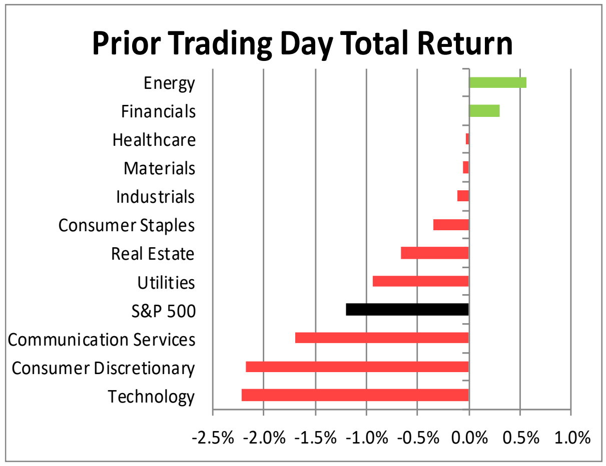
The Central Europeans clearly have a strong interest in maintaining close EU trade ties with the U.K. The Poles and Hungarians have also recently been at odds with the EU leadership over what some see as their authoritarian political and judicial policies. In other words, even if the EU leadership in Brussels would prefer to play tough with the U.K. and risk a hard Brexit, the Central Europeans would probably oppose the move. But do the Central Europeans really have the power to thwart Brussels? The answer is "yes." The reason is that most major EU decisions ultimately need to be approved by all member states. The Central Europeans have leverage over Brussels because they can threaten to withhold their approval for major legislation, budgets, trade deals, and the like, whether they're related to the issue at hand or not. The EU negotiators therefore have to be cognizant of the Central Europeans' interests and likely can't risk being so tough on the U.K. that a trade deal falls apart.

More broadly, the need for unanimous decisions means the EU as a bloc will continue to be hamstrung politically. Indeed, former European Commissioner Romano Prodi recently said in an interview that, "Europe's enemy is unanimity. . . In this moment I'm pessimistic about [change.] Unanimity will go on in the major issues, at least in the foreseeable period of time, unless there will be a quick realization that this will kill Europe." On a more positive note, however, these dynamics suggest the Central Europeans will continue to use their leverage to win economic and political concessions from Brussels. Meanwhile, the U.K. and other countries negotiating with the EU on various issues will probably learn that they can exact concessions by "playing the Central European card." In sum, these political dynamics suggest the U.K. could well end up with a favorable post-Brexit trade deal and the Central Europeans will likely be able to protect their economic interests fairly well in the coming years, making both more attractive investment destinations than would otherwise be the case.

Data Section

U.S. Equity Markets – (as of 10/30/2020 close)

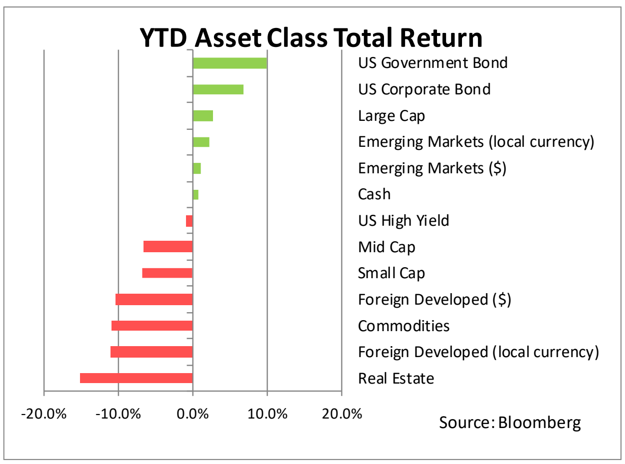




(Source: Bloomberg)

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 10/30/2020 close)

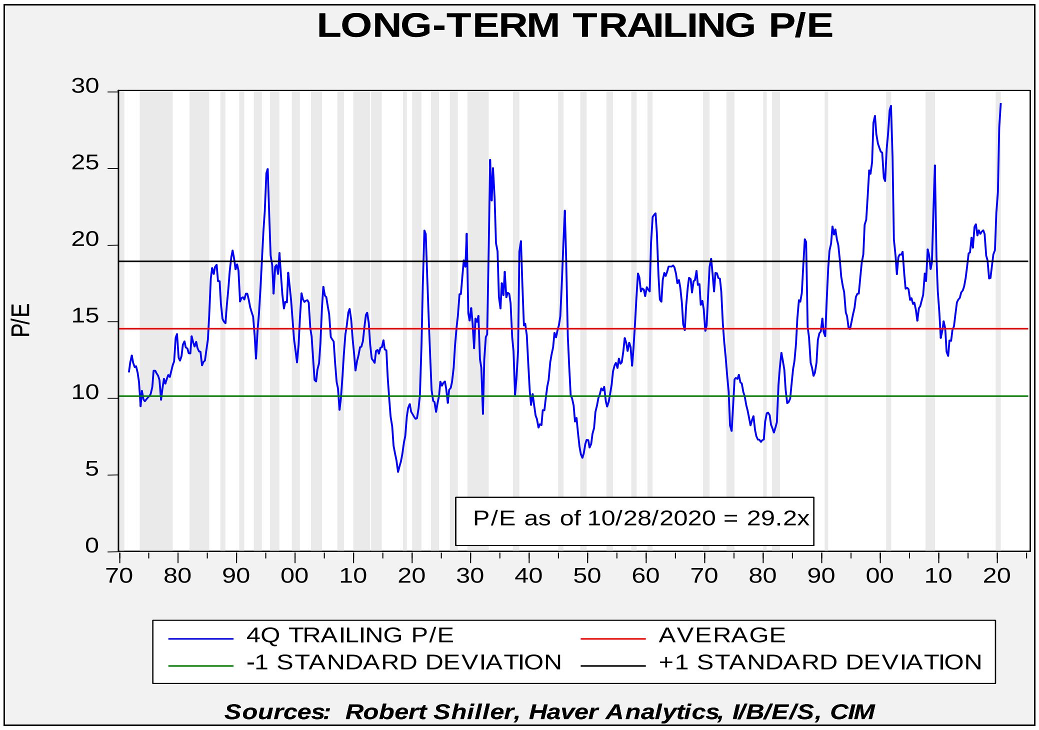


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

October 29, 2020



Based on our methodology,[1] the current P/E is 29.2x, down 0.3x from last week. Better than expected earnings and a weaker equity index have reduced 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 (Q1 and Q2) and two estimates (Q3 and Q4). 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.