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 4, 2020—9:30 AM EST] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.1% from its last close. In Asia, the MSCI Asia Apex 50 closed up 0.5%. Chinese markets were higher, with the Shanghai Composite up 0.2% from the prior close and the Shenzhen Composite up 0.3%. U.S. equity index futures are signaling a higher open. With 361 companies having reported, the S&P 500 Q3 earnings stand at $38.10, higher than the $33.68 forecast for the quarter. The forecast reflects a 21.0% decrease from Q3 2019 earnings. Thus far this quarter, 87.5% of the companies have reported earnings above forecast, while 10.0% have reported earnings below forecast.

Our *Daily Comment* today opens with the latest on the U.S. election situation, including a detailed recap of market action in the key asset classes overnight. Believe it or not, there has also been news overseas while we've all been preoccupied with the U.S. polling. We focus on a major development in China's stance toward financial regulation. As always, we review the latest coronavirus news.

U.S. Elections: As of this writing, the presidential election remains too close to call. Out of the 270 electoral college votes needed to win, news organizations have called some 238 for Vice President Biden and 213 for President Trump. However, counting continues in key battleground states such as Wisconsin, Michigan, and Pennsylvania. This is actually normal; counting usually continues after Election Day itself. What's not normal is that the huge surge in absentee and mail-in voting means the counting will likely continue for days. Officials in Nevada, where only about 86% of the ballots have been counted so far, said they won't even release updated totals until Thursday. The most important development is that the expected "blue wave" of votes for Biden after the polls closed has not materialized, leaving increased uncertainty regarding where things stand. As we suggested yesterday, we all need to remain patient as election officials count our votes and the votes of our fellow citizens.

- Shortly after 2 a.m., President Trump told supporters gathered in the White House's East Room that he felt he had already won the election. He also hinted he would ask the Supreme Court to stop ongoing counting. Speaking in Delaware before hundreds of vehicles in a car rally, Biden promised his supporters that their patience would ultimately be rewarded and said, "We believe we're on track to win this election."
- In addition to the absence of a blue wave for Biden, it is looking like the Democrats' hopes of taking control of the Senate will be dashed. As with the presidential race, however, counting continues, and the final totals won't be known for days.

- Market volatility has been extremely high as the votes have come in and various trends have arisen and fallen back. Here is what we've seen in the key asset classes:
  - ***Equities.*** As the polls began to close, it became increasingly obvious that Biden's "blue wave" wasn't coming. Investors who were complacent about a Biden win are now adjusting portfolios for the prospect that President Trump could remain in office. With the idea that the path of policy would be more of the same, NASDAQ futures roared higher (around 9:00 pm CST), actually going limit up and forcing a trading halt for two minutes. As the evening wore on, this index, dominated by tech firms, has held up (see graph below). This market is betting that any future stimulus will be modest at best.

  - ***The Dollar.*** The dollar tells a similar story. When the GOP was outperforming, the dollar jumped. But, as we head into the morning and the possibility that Biden might win after all, the likelihood of dollar-bearish policy has led to a drop in the greenback (see chart below).

- *Gold.* The market action with gold has been a near mirror image of the action in the dollar (see graph below).

- *Bonds.* Long-duration bond prices also had a wild night. Prices initially fell on expectations of a blue wave, but as those expectations dissipated, long-term yields fell sharply and remain depressed. Safe-haven buying, along with reduced chances of a massive fiscal stimulus bill out of Congress, [are combining to keep Treasury yields sharply lower so far today]. The 10-year Treasury-note yield broke above 0.90% early in the evening, but it has now fallen back into the 0.70% area.

China: The key non-U.S. news yesterday was that the Shanghai Stock Exchange [suspended the blockbuster initial public offering by Ant Financial that was scheduled for Thursday]. According to the exchange, the suspension was necessary because of a "changing regulatory environment" after billionaire founder Jack Ma was hauled into a closed-door meeting with four key financial regulators on Monday. The suspension forced Ant, which owns the Chinese digital payments platform Alipay, to also suspend the half of the IPO that was supposed to launch in Hong Kong on Thursday.

- The sudden roadblock was especially surprising because the Hong Kong and Shanghai exchanges, as well as China's securities regulator, had earlier green-lighted Ant's plans to go public. The largest ever IPO would also have been a major feather in the cap of Shanghai's fledgling Nasdaq-style Science and Technology Innovation Board, known as the STAR Market, which is a pet project of Chinese President Xi Jinping.
- News reports suggest the reason for the suspension was the Chinese regulators' demands for Ant to make a bigger commitment to low-profit microlending. However, the timing of the action, just days before the planned IPO, suggests something else is going on. Some have speculated the problem was with statements Mr. Ma made at a recent conference, which were interpreted as an insult to Chinese regulators. If so, the incident will paint Chinese financial markets as an unsophisticated venue where political sensitivities reign supreme, which in turn would undermine investor confidence in Chinese markets. In any case, the New York shares of Alibaba Group (BABA, 285.57), which owns a 33% stake in Ant, fell 8.1% on Tuesday following the IPO suspension.

U.S. Technology Sector: A new analysis by the Wall Street Journal shows that while the U.S. and Europe produced more than three-quarters of the world's semiconductors in 1990, they now produce less than one quarter. The analysis suggests the epicenter of chip production has shifted in part because governments outside the U.S. offered often hefty financial incentives for factory construction to build up their domestic industries. Chip companies have also been attracted by growing networks of suppliers outside of the U.S., in addition to an expanding workforce of skilled engineers capable of operating expensive manufacturing machinery.

Europe: A series of technology glitches at stock exchange group Euronext is feeding concerns that its efforts to build a central role in the region's capital markets could intensify risks around a single point of failure. On Monday, trading in warrants across Euronext's network halted for an hour, just two weeks after a chaotic day disrupted trading across equities, exchange-traded funds, derivatives, and other markets.

Brazil. Prosecutors have filed graft charges against the son of President Bolsonaro. The move ratchets up pressure on the conservative leader, who came to power on the promise of stamping out corruption. The increase in political risk could also be a new headwind for Brazilian assets.

Ethiopia: Prime Minister Abiy Ahmed said he sent federal troops to quell a rebellion in the northern region of Tigray. This escalation of tensions brings Africa's second-most populous country to the brink of civil war.

COVID-19: Official data show confirmed cases have risen to 47,555,607 worldwide, with 1,216,173 deaths. In the United States, confirmed cases rose to 9,385,505, with 232,638 deaths. Here is the interactive chart from the *Financial Times* that allows you to compare cases and deaths among countries, scaled by population.

Virology

- New confirmed U.S infections totaled more than 91,500 yesterday, lifting the seven-day moving average to 86,363 and the 14-day moving average to 79,124. New deaths related to the virus totaled 1,130, and the number of people hospitalized nationally for the disease topped 50,000. Europe is also fighting an autumn wave of new infections, with mass economic lockdowns being imposed again in several countries. Without a doubt, the new infections and restrictions will slow the current recovery from the first wave of infections, posing at least some headwind for risk assets.
- In France, shopkeepers are revolting against the government's renewed lockdowns, complaining that closures make it impossible to compete against major online retailers that can still sell via the internet.

Economic Impacts

- In Europe, the renewed lockdowns associated with the autumn infection wave have already shown up in service sector data. Spain's October IHS Markit Purchasing Managers' Index for services fell to a five-month low of 41.4, while Italy's index fell to a four-month low of 46.7. The overall services PMI for the Eurozone fell to 46.9 in October from 48.0 in September. Like all major PMIs, the indexes are designed so that readings below 50 point to falling activity.
- The wave of new restrictions on service activities, like restaurant service, is creating surging demand and supply shortages for outdoor heaters.
- Saudi Arabia and other OPEC members are considering deeper oil production cuts as rebounding COVID-19 cases in the West and fresh economic lockdowns in Europe threaten to curb oil demand further.

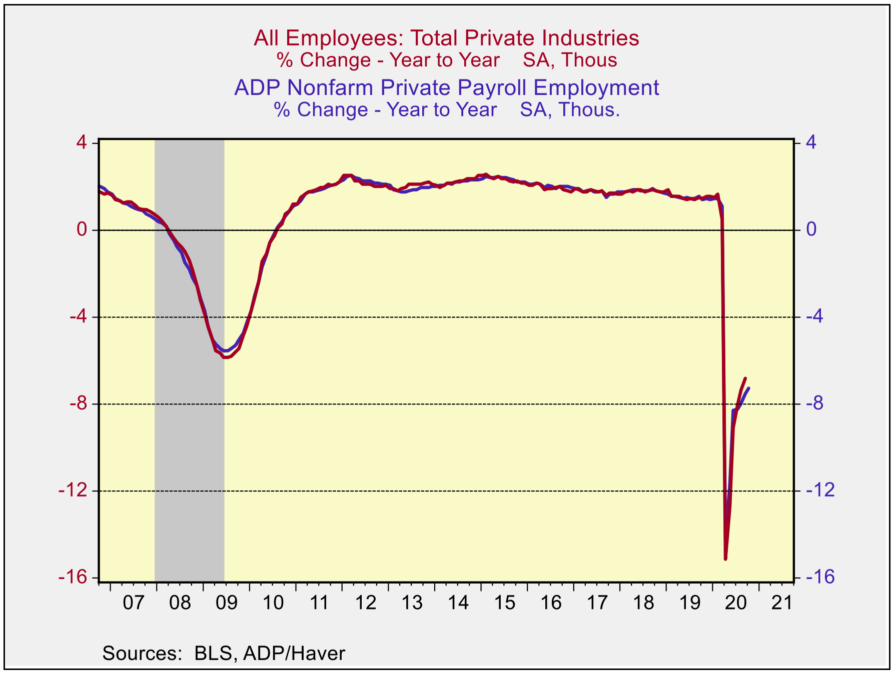
U.S. Policy Response

- The Federal Reserve's latest policy meeting starts today and will end tomorrow. No significant change is expected in the ultra-loose monetary policy put into place earlier this year to counter the economic impact of the pandemic, but officials have hinted they may start discussing adjustments to their asset purchase programs.

U.S. Economic Releases

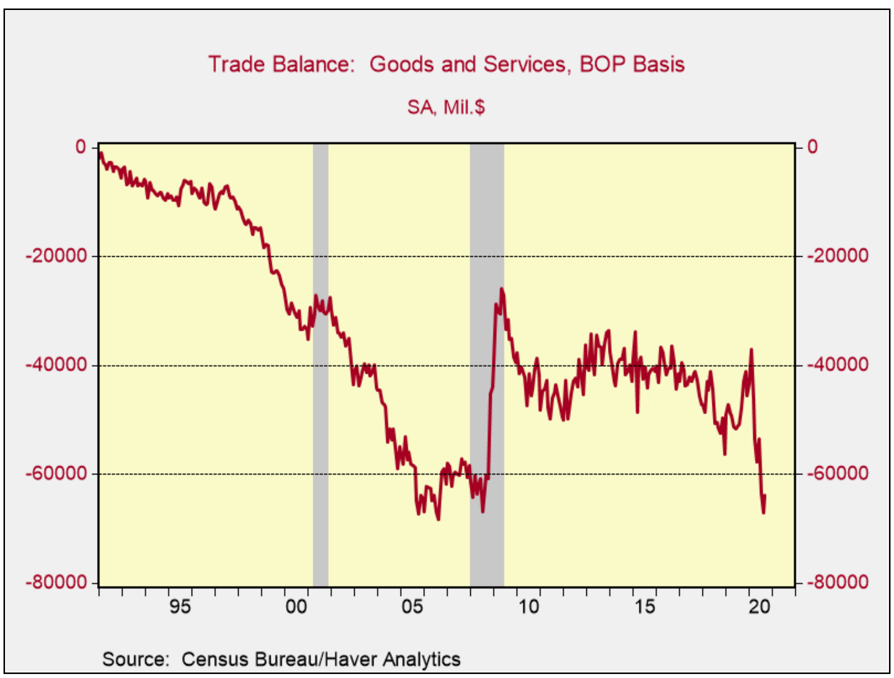
For the week ending October 30, mortgage applications rose 3.8% from the prior week. Applications for mortgages were down 1.3% from the prior week, while applications for refinances rose 6.4%. The average 30-year fixed-rate mortgage application rose 1 bp from 3.00% to 3.01%.

The ADP Research Institute showed a slowdown in private payrolls. In October, it reported private payrolls rising 365K from the prior month compared to expectations of 650K.



The chart above shows the annual change in private payrolls, as reported by ADP and BLS. If ADP serves as a guide, the BLS report should come in at around 550K on Friday.

In September, the trade balance narrowed due to a rise in exports outpacing the rise in imports. Last month, the trade deficit shrank from \$67.0B to \$63.1B, in line with expectations.



The chart above shows the trade balance.

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 Services PMI	m/m	Oct	56.0	56.0	**
9:45	Markit US Composite PMI	m/m	Oct		55.5	**
10:00	ISM Services Index	m/m	Oct	57.5	57.8	**
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 PMI Composite	m/m	Oct	55.7	54.5		**	Equity bullish, bond bearish
	Caixin China PMI Services	m/m	Oct	56.8	54.8	55.0	**	Equity bullish, bond bearish
Japan	Monetary Base	y/y	Oct	16.3%	14.3%		**	Equity bullish, bond bearish
	Monetary Base End of period	m/m	Oct	¥608.3t	¥606.0t		**	Equity bullish, bond bearish
India	Markit India PMI Composite	m/m	Oct	58.0	54.6		**	Equity bullish, bond bearish
	Markit India PMI Services	m/m	Oct	54.1	49.8		**	Equity bullish, bond bearish
Australia	AiG Perf of Construction Index	m/m	Oct	52.7	45.2		**	Equity bullish, bond bearish
	Markit Australia PMI Services	m/m	Oct	53.7	53.8		**	Equity and bond neutral
	Markit Australia PMI Composite	m/m	Oct	53.5	53.6		**	Equity and bond neutral
	Retail Sales Ex Inflation	q/q	3Q	6.5%	-3.4%	6.0%	**	Equity bullish, bond bearish
	Retail Sales	m/m	Sep	-1.1%	-4.0%	-1.5%	**	Equity and bond neutral
New Zealand	Average Hourly Earnings QoQ	q/q	3Q	1.4%	0.4%	0.3%	**	Equity bullish, bond bearish
	Employment Change QoQ	q/q	3Q	-0.8%	-0.4%	-0.7%	***	Equity bearish, bond bullish
	Participation Rate	q/q	3Q	70.1%	69.7%	70.0%	**	Equity and bond neutral
	Pvt Wages Ex Overtime QoQ	q/q	3Q	0.4%	0.2%	0.2%	**	Equity bullish, bond bearish
	Pvt Wages Inc Overtime QoQ	q/q	3Q	0.4%	0.2%	0.3%	***	Equity bullish, bond bearish
	Unemployment Rate	q/q	3Q	5.3%	4.0%	5.3%	***	Equity and bond neutral
	ANZ Commodity Price	m/m	Oct	1.9%	-0.2%		**	Equity and bond neutral
Europe								
Eurozone	Markit Eurozone Services PMI	m/m	Oct	46.9	46.2	46.2	**	Equity bullish, bond bearish
	Markit Eurozone Composite PMI	m/m	Oct	50.0	49.4	49.4	**	Equity bullish, bond bearish
	PPI	y/y	Sep	0.3%	-2.5%	-2.4%	**	Equity bullish, bond bearish
Italy	Markit Italy Services PMI	m/m	Oct	46.7	48.8	47.0	**	Equity bearish, bond bullish
	Markit Italy Composite PMI	m/m	Oct	47.5	50.4	49.2	**	Equity bearish, bond bullish
France	Markit France Services PMI	m/m	Oct	46.5	46.5	46.5	**	Equity and bond neutral
	Markit France Composite PMI	m/m	Oct	47.5	47.3	47.3	**	Equity and bond neutral
Germany	Markit Germany Services PMI	m/m	Oct	49.5	48.9	48.9	**	Equity bullish, bond bearish
	Markit/BME Germany Composite PMI	m/m	Oct	55.0	54.5	54.5	**	Equity bullish, bond bearish
UK	Official Reserves Changes	m/m	Oct	$0.915m	-$81m		***	Equity and bond neutral
	Markit/CIPS UK Services PMI	m/m	Oct	51.4	52.3	52.3	**	Equity and bond neutral
	Markit/CIPS UK Composite PMI	m/m	Oct	52.1	52.9	52.9	**	Equity and bond neutral
AMERICAS								
Mexico	Remittances Total	m/m	Sep	$3568.5m	$3574.2m	$3447.0m	**	Equity and bond neutral
	Markit Mexico PMI Mfg	m/m	Oct	43.6	42.1		**	Equity and bond neutral
Canada	Markit Brazil PMI Manufacturing	m/m	Oct	66.7	64.9		**	Equity bullish, bond bearish
	Trade Balance Monthly	m/m	Oct	$5473m	$6164m	$6100m	***	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)	22	22	0	Down
3-mo T-bill yield (bps)	9	9	0	Neutral
TED spread (bps)	13	13	0	Up
U.S. Libor/OIS spread (bps)	8	8	0	Up
10-yr T-note (%)	0.90	0.85	0.05	Neutral
Euribor/OIS spread (bps)	-52	-52	0	Neutral
EUR/USD 3-mo swap (bps)	15	14	1	Down
Currencies	**Direction**			
dollar	Flat			Down
euro	Flat			Up
yen	Flat			Up
pound	Down			Down
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	$40.58	$39.71	2.19%	Weather Conditions
WTI	$38.47	$37.66	2.15%	
Natural Gas	$3.03	$3.06	-1.01%	
Crack Spread	$8.11	$8.04	0.87%	
12-mo strip crack	$9.52	$9.50	0.16%	
Ethanol rack	$1.64	$1.64	0.08%	
Metals				
Gold	$1,889.09	$1,909.17	-1.05%	
Silver	$23.64	$24.23	-2.43%	
Copper contract	$305.35	$309.25	-1.26%	
Grains				
Corn contract	$ 399.75	$ 401.00	-0.31%	
Wheat contract	$ 604.25	$ 608.00	-0.62%	
Soybeans contract	$ 1,064.50	$ 1,064.25	0.02%	
Shipping				
Baltic Dry Freight	1263	1284	-21	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.2		
Gasoline (mb)		-0.8		
Distillates (mb)		-2.5		
Refinery run rates (%)		-0.50%		
Natural gas (bcf)		-34.0		

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. Hurricane Eta is moving along the Yucatan Peninsula.

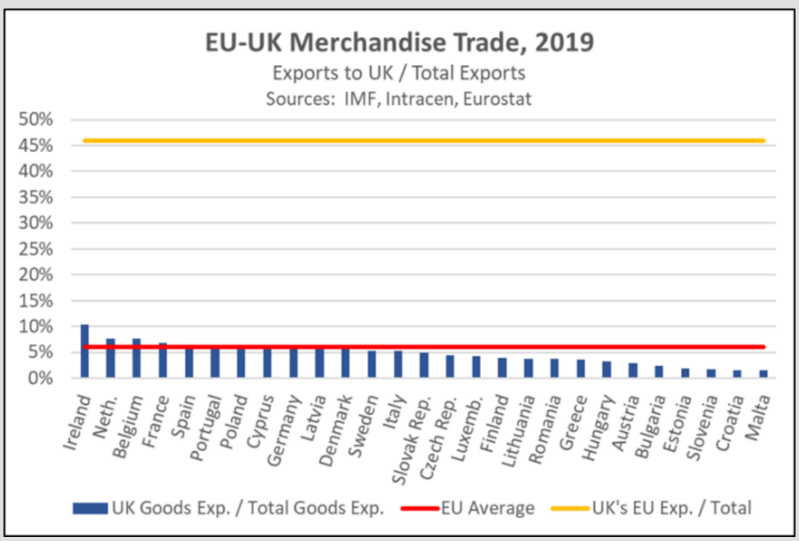
Asset Allocation Weekly

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.

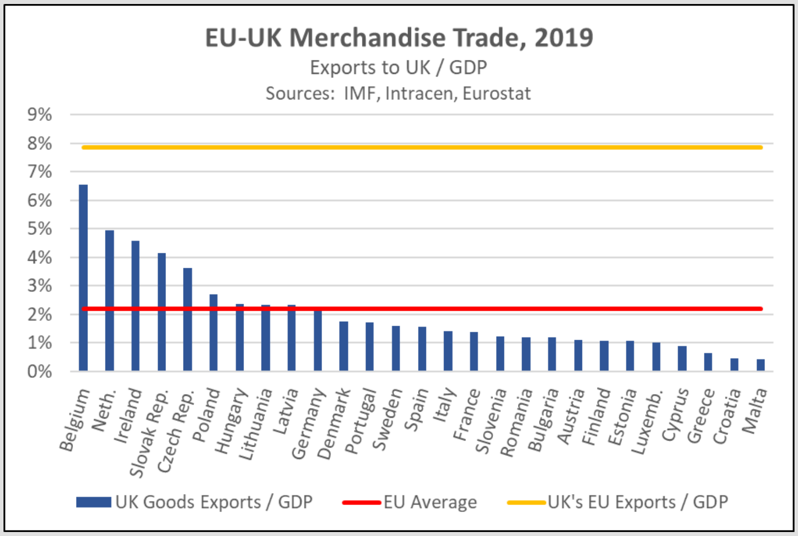
October 30, 2020

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.

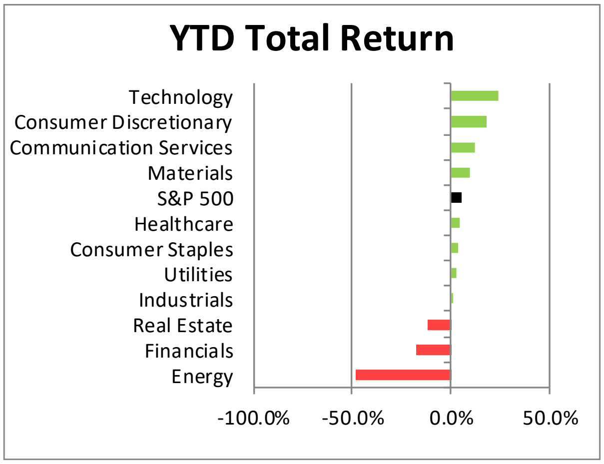


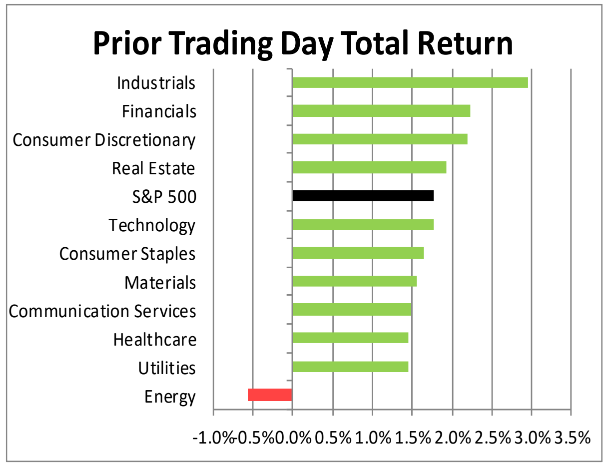
The Central Europeans clearly have a strong interest in maintaining close EU trade ties with the U.K. The Poles and Hungarians have also recently been at odds with the EU leadership over what some see as their authoritarian political and judicial policies. In other words, even if the EU leadership in 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.

<u>Data Section</u>

U.S. Equity Markets – (as of 11/3/2020 close)

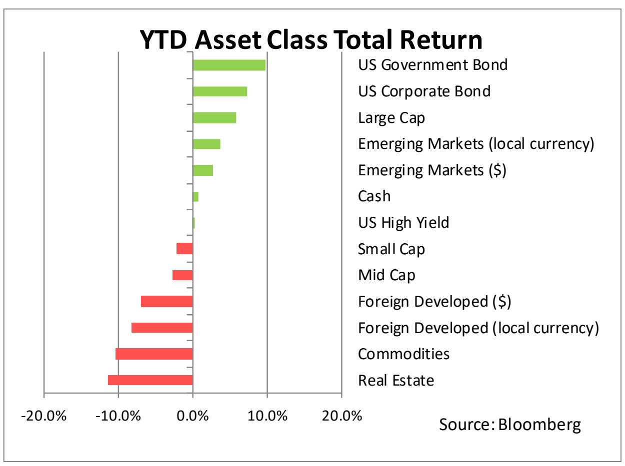




(Source: Bloomberg)

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 11/3/2020 close)

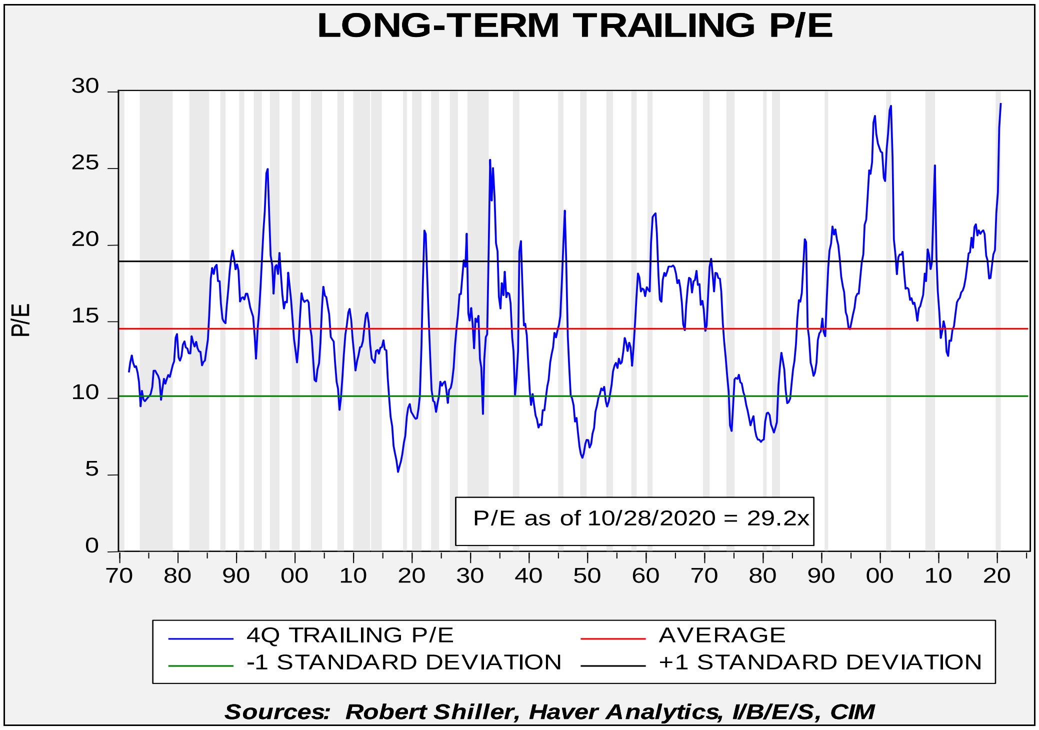


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.