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 13, 2020—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is up 0.3% from its last close. In Asia, the MSCI Asia Apex 50 closed up 1.3%. Chinese markets were lower, with the Shanghai Composite down 0.9% from the prior close and the Shenzhen Composite down 0.2%. U.S. equity index futures are signaling a higher open. With 455 companies having reported, the S&P 500 Q3 earnings stand at $38.80, higher than the $33.68 forecast for the quarter. The forecast reflects a 21.0% decrease from Q3 2019 earnings. Thus far this quarter, 84.5% of the companies have reported earnings above forecast, while 12.9% have reported earnings below forecast.

Good morning and happy Friday the 13th! U.S. equity futures are rebounding after a drop yesterday. We lead off with the Fed, with a recant of yesterday's thoughts about the two open governor positions; we also note the comments from Chair Powell in a forum of central bank leaders. China news is next, including new restrictions on Chinese investment. Pandemic news follows, and we close with Brexit news. As we promised yesterday, the Weekly Energy Update is available today after being delayed by the Veterans Day holiday. Being Friday, there is a new Asset Allocation Weekly, along with the associated podcast and chart book. ***Starting in January, in a bid to shorten this report, we will no longer publish the AAW at the bottom of the Daily. It will be available only as a stand-alone report but will be linked within the Daily Comment***. Here are the details:

The Federal Reserve: Let's start with a lesson we apparently forgot yesterday.

"It's tough to make predictions, especially about the future."

--Yogi Berra, although attributed to many others

Yesterday, we noted that President Trump would probably not fill the remaining two governor positions. We clearly spoke too soon. According to Senator Cornyn (R-TX), the two candidates could come up for a Senate-wide vote next week. Chris Waller is non-controversial; he is a Fed system economist at the St. Louis FRB and expected to be a dovish voter. Judy Shelton is another matter. She has supported the gold standard and suggested that Fed independence was unnecessary.[1] Her previous comments would have suggested she would be an extreme hawk, but she seemed to reverse that stance when she was nominated. We view her as a political leaning governor; she would support policy accommodation under a GOP White House but propose

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[1] Actually, if the goal is reflation, Fed independence is a hinderance. However, it is hard to square support for the gold standard and reflation.

tightening with a Democratic White House. We could be wrong—after all, we were yesterday. However, that is where her pervious comments seem to lean. So, will she get the nod? Two GOP senators, Romney (R-UT) and Collins (R-ME) have indicated they will vote against her. If all the other GOP members approve, she will pass 51-49. It behooves the Senate leadership to move quickly. Mark Kelly will be sworn in on Nov. 30 for the Arizona seat, and he would likely vote against Shelton. With two GOP senators already opposing Shelton, waiting for Kelly could put her confirmation at a tie, which could be broken by VP Pence. However, we noted in September, Senator Thune (R-SD) suggested Shelton didn't have enough votes to be confirmed. We suspect something has changed, because Majority Leader McConnell rarely brings up a vote that he isn't sure will prevail.

Will Shelton matter? Yes, insofar as all governors matter. They make speeches and vote on every policy decision. At the same time, Fed Chairs have had to deal with difficult governors in the past and managed to conduct policy. Dissents have become less common over time, but they used to occur often. Henry Wallich holds the record for most dissents, at 27, when he was governor from 1974 to 1986. If Shelton dissents at each meeting, it isn't likely to change the path of policy. And once financial markets realize that she isn't swaying policy, her comments won't matter all that much. If she gets confirmed, look for mainstream economists to react negatively, but for markets, it's probably not a major issue. It's also notable that she is replacing a current term, which will end in 2024. Thus, her impact may be short. At the same time, as we have noted before, the Fed releases full transcripts of each meeting with a five-year delay. Although going through the transcripts requires a lot of reading (each meeting is around 200 to 250 pages, and there are at least eight per year), they give a clear picture of the personal conflicts that are part of any committee. If Shelton is on the committee, it should make for interesting reading in 2026…something to look forward to!

- Yesterday, the heads of the ECB, BOE and the Fed were on a panel at the ECB's Forum on Central Banking. The consensus among the bankers is that the medium-term outlook is favorable, but the next three months could be a problem. The resurgence of the virus and the lack of fiscal action will slow growth and affect those with the fewest resources to respond. Chair Powell also noted that the pandemic will have longer-term effects that are still not clear.
- In the U.S., emergency aid programs tied to the pandemic expire at year's end. If allowed to expire, there will likely be a negative impact on the economy.

China: Investment bans and TikTok gets a reprieve.

- President Trump issued an executive order yesterday banning U.S. investors from holding shares with ties to the Chinese military. Chinese telecom firms plunged on the news. There are 20 companies on the initial list; several other state owned firms have been added. This action by the White House is consistent with other measures designed to restrict China's access to U.S. capital markets. We would expect a Biden administration to keep the ban in place. Investors have a year to remove the firms from their portfolios. As expected, Beijing took a dim view of the order.
- As the deadline loomed, the Commerce Department gave TikTok a reprieve, delaying implementation of the order to remove the firm's content from the U.S. internet. The company has been granted a temporary injunction against the ban, so the Commerce

Department decision likely reflected the injunction. So, for now, TikTok remains available.

- Next week's WGR will discuss the situation with Ant Group. We note that financial regulators appear to be cracking down on excessive debt. Although China's debt situation has been on watch for years, authorities have tended to "extend and pretend," allowing large firms, often state owned, to continue operations. It is not obvious why regulatory concern has increased, but we have noticed a drive by Beijing to emphasize stability. It may be that there are fears of financial stress that could increase unrest.
- Beijing has congratulated VP Biden.

COVID-19: The number of reported cases is 52,864,762 with 1,295,403 fatalities. In the U.S., there are 10,557,451 confirmed cases with 242,436 deaths. For the first time, new cases in the U.S. rose over 150,000 yesterday. 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 R_t data looks much like last week. Every state and territory, with the exception of Mississippi, has a reading above 1.0, meaning that infections are increasing. Maine had the worst reading.

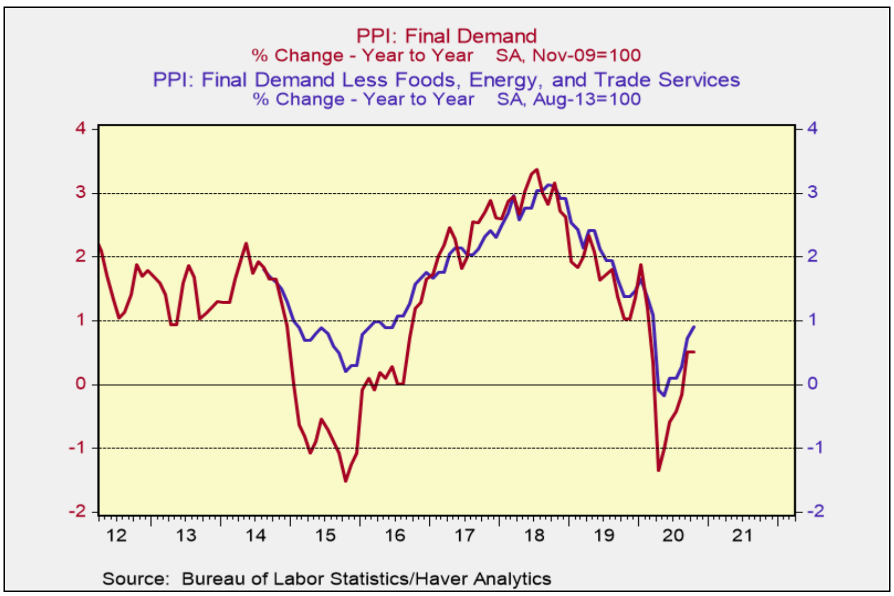
Virology:

- As the virus surges around the world, governments are reluctantly tightening social measures.
  - In the U.S., several states have issued various lockdown restrictions, with Illinois perhaps being the most stringent. Governors and mayors are trying to avoid full lockdowns and widespread stay-at-home orders due to the economic fallout. Large urban school districts are contemplating the return to full on-line classes.
  - In Europe, France has extended a full lockdown until the end of November. Meanwhile, the mink cull in Denmark has turned into a political disaster.
- Testing laboratories are warning that the rise in testing could lead to longer delays in getting results. Delays were a problem earlier this year; in general, a delay of five days renders testing ineffective.
- On the economic front, as mobility declines, grocers are bringing back purchase limits on some goods, primarily paper goods and disinfectants. As the exodus from urban centers increase, Manhattan landlords are making concessions to renters. In recent years, there has been a trend among builders to erect multi-generational homes. That trend has accelerated with the pandemic, as families are increasingly reluctant to put older relatives in nursing facilities, which have become vulnerable to COVID-19.

Brexit: Earlier this week, Lee Cain resigned from the Johnson government. Cain was director of communications and was rumored to become the next chief of staff. Dominic Cummings was a key advisor to PM Johnson; he has announced his exit as well. To a great extent, these resignations are part of the internal machinations of the PM's staff, and it is impossible to separate policy from personality. The bottom line is that Cain and Cummings were hard line Brexit supporters. Their departure would give Johnson room to compromise with the EU to get a deal done. Although there is widespread rejection of this theory in comments from Johnson's staff, we suspect that there is something to it. However, that doesn't mean removing the hard Brexit group is the only factor. There is no doubt that personality clashes played a role. But, from a policy and market perspective, the personality issues are secondary. The exit of Cain and Cummings should be bullish for the GBP.

U.S. Economic Releases

The prices paid by producers for inputs rose modestly in October, boosted primarily by food and energy prices. Overall, headline PPI index rose 0.3% from the prior month compared to expectations of a 0.2% rise. Excluding food and energy, PPI rose 0.1% from the prior month compared to expectations of a 0.2% rise. Lastly, core PPI, which excludes food, energy, and trade, rose 0.2% from the prior month in line with expectations.



The chart above shows the annual change in PPI final demand and Core PPI final demand. PPI final demand rose 0.5% from the prior year, while core PPI rose 0.9%.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	U. of Michigan Sentiment	m/m	Nov	82	81.8	**
10:00	U. of Michigan Current Conditions	m/m	Nov	88.3	85.9	**
10:00	U. of Michigan Expectations	m/m	Nov	79.1	79.2	**
10:00	U. of Michigan 1 yr Inflation	m/m	Nov		2.6%	**
10:00	U. of Michigan 5-10 Yr Inflation	m/m	Nov		2.4%	**
Fed Speakers or Events						
	Speaker or event	**District or position**				
14:00	Richard Clarida Gives Speech on Economic Outlook	Vice Chairman of Board of Governors of Federal Reserve				

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								
New Zealand	BusinessNZ Manufacturing	m/m	Oct	51.7	54.0		**	Equity bearish, bond bullish
	Food Prices	m/m	Oct	-0.7%	-1.0%		**	Equity bearish, bond bullish
Europe								
Eurozone	Employment	y/y	3Q	-2.0%	-3.1%		***	Equity and bond neutral
	Trade Balance SA	m/m	Sep	24.0b	21.9b	22.5b	**	Equity bullish, bond bearish
	GDP SA	q/q	3Q	12.6%	12.7%	12.7%	***	Equity and bond neutral
Germany	Wholesale Price Index	m/m	Oct	-0.2%	0.0%		**	Equity bullish, bond bearish
France	CPI EU Harmonized	m/m	Oct	0.0%	-0.1%	-0.1%	***	Equity and bond neutral
	CPI	y/y	Oct	0.0%	0.0%	0.0%	***	Equity and bond neutral
Switzerland	Producer and import prices	m/m	Sep	0.0%	0.1%		*	Equity and bond neutral
Russia	Gold and Forex Reserve	w/w	6-Nov	587.6b	584.0b		*	Equity and bond neutral
	GDP	m/m	3Q	-3.6%	-8.0%	-4.0%	***	Equity and bond neutral
	Money Supply Narrow Def	w/w	6-Nov	13.41t	13.33t		*	Equity and bond neutral
AMERICAS								
Mexico	Formal Job Creation Total	m/m	Oct	200.6k	113.9k		***	Equity bullish, bond bearish

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)	14	13	1	Up
U.S. Libor/OIS spread (bps)	8	8	0	Up
10-yr T-note (%)	0.90	0.88	0.02	Neutral
Euribor/OIS spread (bps)	-51	-52	1	Neutral
EUR/USD 3-mo swap (bps)	16	15	1	Down
Currencies	**Direction**			
dollar	Down			Down
euro	Up			Up
yen	Up			Up
pound	Up			Down
franc	Flat			Up
Central Bank Action		**Prior**	**Expected**	
Mexican Overnight Rate	4.250%	4.250%	4.000%	Above 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	$43.23	$43.53	-0.69%	
WTI	$40.71	$41.12	-1.00%	
Natural Gas	$2.99	$2.98	0.54%	
Crack Spread	$8.42	$8.41	0.10%	
12-mo strip crack	$10.42	$10.37	0.50%	
Ethanol rack	$1.60	$1.61	-0.91%	
Metals				
Gold	$1,877.95	$1,876.83	0.06%	
Silver	$24.23	$24.28	-0.20%	
Copper contract	$315.80	$314.50	0.41%	
Grains				
Corn contract	$ 416.50	$ 418.25	-0.42%	
Wheat contract	$ 594.50	$ 597.25	-0.46%	
Soybeans contract	$ 1,147.00	$ 1,145.50	0.13%	
Shipping				
Baltic Dry Freight	1124	1141	-17	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	4.3	-2.0	6.3	
Gasoline (mb)	-2.3	1.0	-3.3	
Distillates (mb)	-5.4	1.6	-7.0	
Refinery run rates (%)	-0.80%	0.60%	-1.40%	
Natural gas (bcf)		-3.0		

Weather

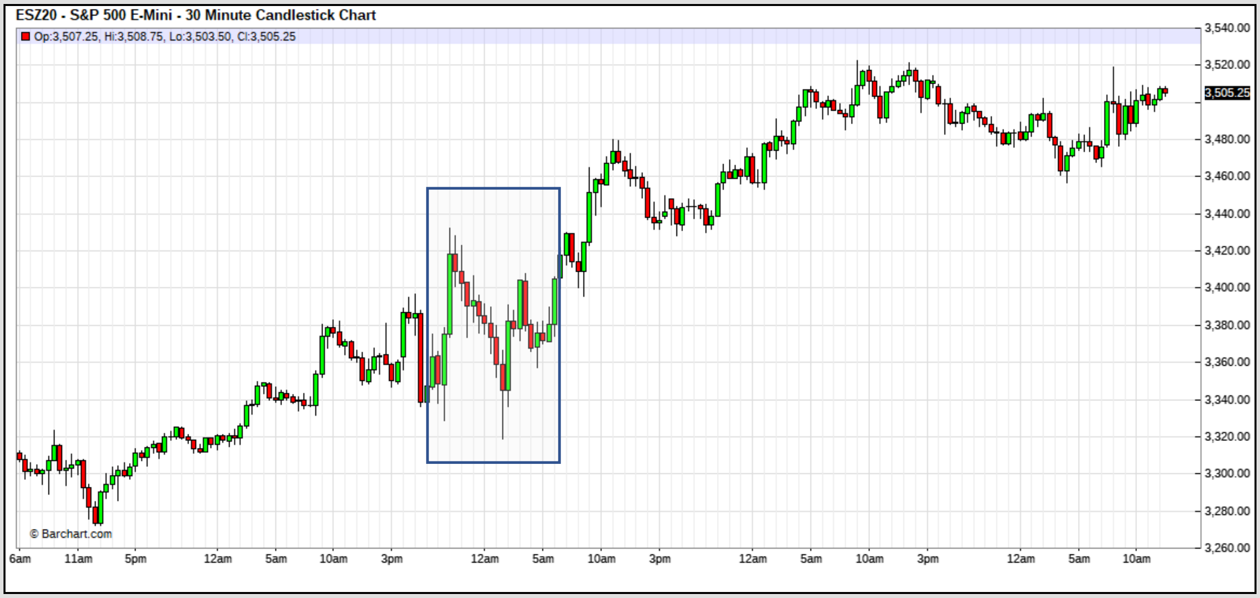
The 6-10 and 8-14 day forecasts currently call for warmer temperatures for most of the country, with cooler temperatures around Washington State. Dry conditions are expected for eastern third of the country, with wet conditions expected for the rest of the country. There is some cyclone formation that is expected to develop into a tropical storm in the Caribbean Sea.

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.

November 13, 2020

In our most recent Asset Allocation quarterly rebalance, we addressed the potential for election-related market disruption. In the end, we made only modest defensive adjustments to the portfolios and instead focused our allocations on continued policy support and economic recovery. In this week's report, we will look at the current impact of the election on equity markets.



(Source: Barchart.com)

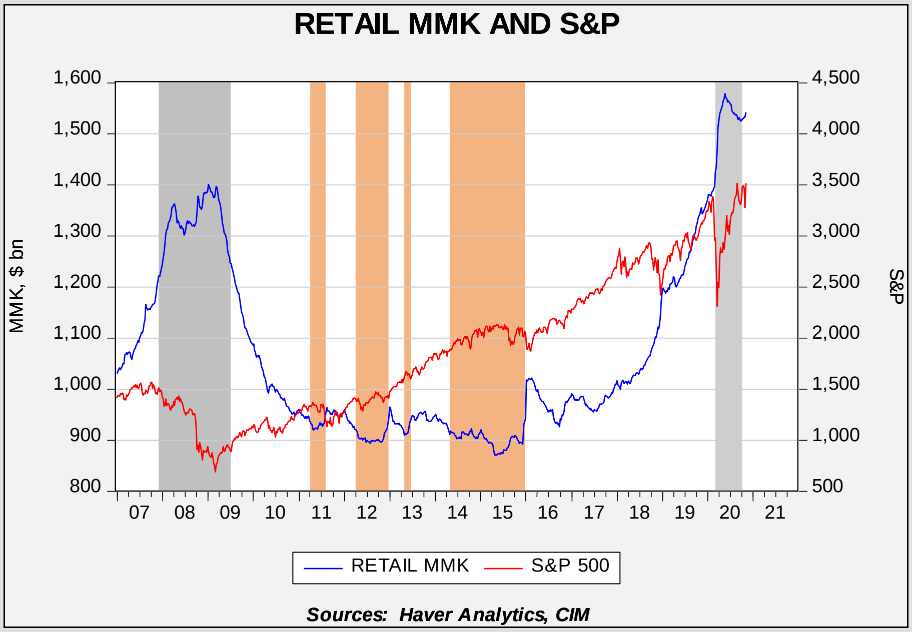
This is a five-day chart of the December S&P futures contract. We have placed a box on election night. Market volatility was clearly elevated as we saw sizable rallies and pullbacks. But, for the rest of the week, equity prices have continued to recover.

One of the questions we have been getting is, given all the turmoil and uncertainty, why are equities rising? The key point is that equities were pricing in some element of a "tail risk" outcome—a hung election and widespread civil unrest. Media reports that retailers were boarding up windows suggested that these concerns were not idle. Gun sales were at historic levels going into the election. So, clearly, fear levels were high.

One of the more difficult issues for a young analyst is understanding the discounting power of financial markets. In many respects, financial markets account for the sum of our fears. And so, it is not uncommon that even when an event occurs as expected, financial market prices will reverse from what a casual observer would assume would occur. The adage is "buy rumor, sell fact." In the spring, when we first began investigating the potential for a hung election and a

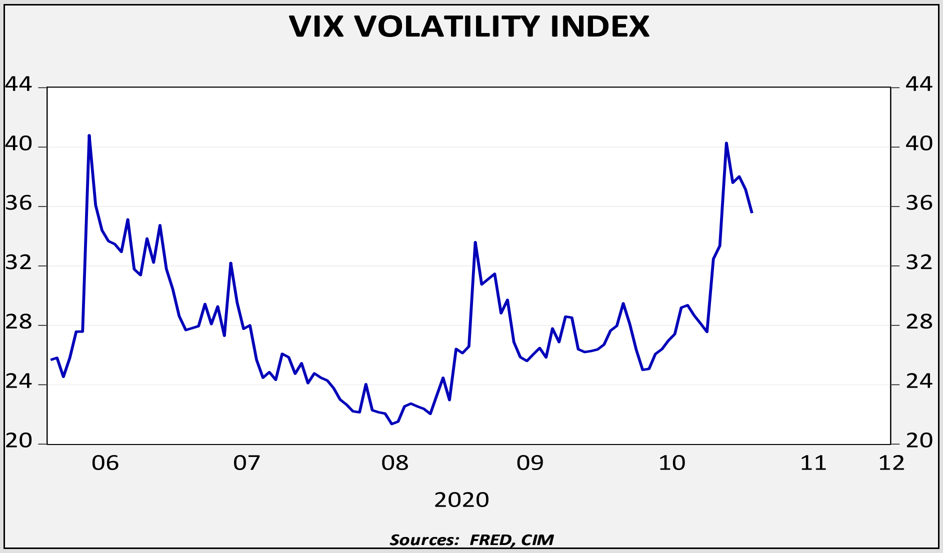
Constitutional crisis, the topic was still rather obscure. By Labor Day, it had become "common knowledge." When an issue becomes common knowledge, financial markets quickly discount the event.

Although equities generally held their value through the election (prices peaked around Labor Day and were rangebound thereafter), there were two areas where there was clear evidence of risk mitigation. The first was accumulation of cash.



This chart shows retail money market funds (RMMK) and the S&P 500 on a weekly basis. Retail investors started building cash positions in 2018 around the onset of trade tensions with China and aggressively added to cash this year. Although RMMK did ease with the recovery in the S&P, levels remain elevated and suggest high levels of fear. If we get through the election without significant civil strife, there is ample liquidity to support equities.

The second area was volatility futures.

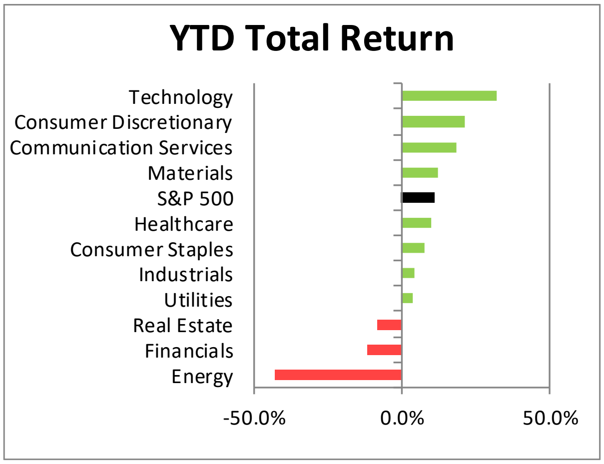


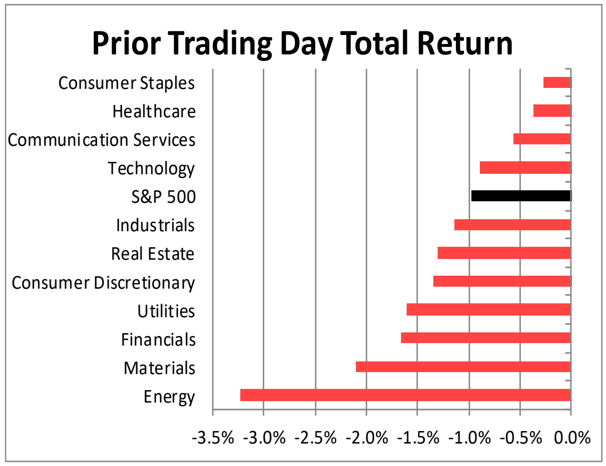
The "VIX" is a measure of implied volatility from the S&P 500 options market. When option buyers pay higher prices for options, it gets translated as higher implied volatility. Essentially, if they are buying put options, they are protecting for a wider dispersion of prices. This chart shows daily prices for the index; in the third week of October, the VIX rose sharply as the election approached, suggesting rising levels of fear.

If the worst of the election risk has passed, these "insurance" positions will likely be unwound. If so, that would tend to support higher equity prices in the coming months. In other words, the return of cash to the markets and the reduction of put-buying would be supportive.

Data Section

U.S. Equity Markets – (as of 11/12/2020 close)

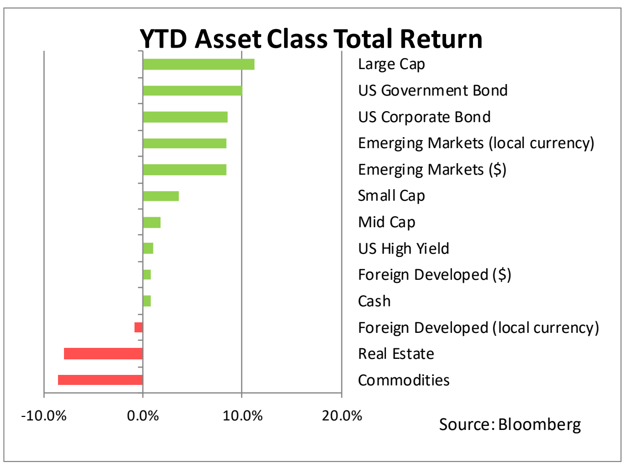




(Source: Bloomberg)

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 11/12/2020 close)

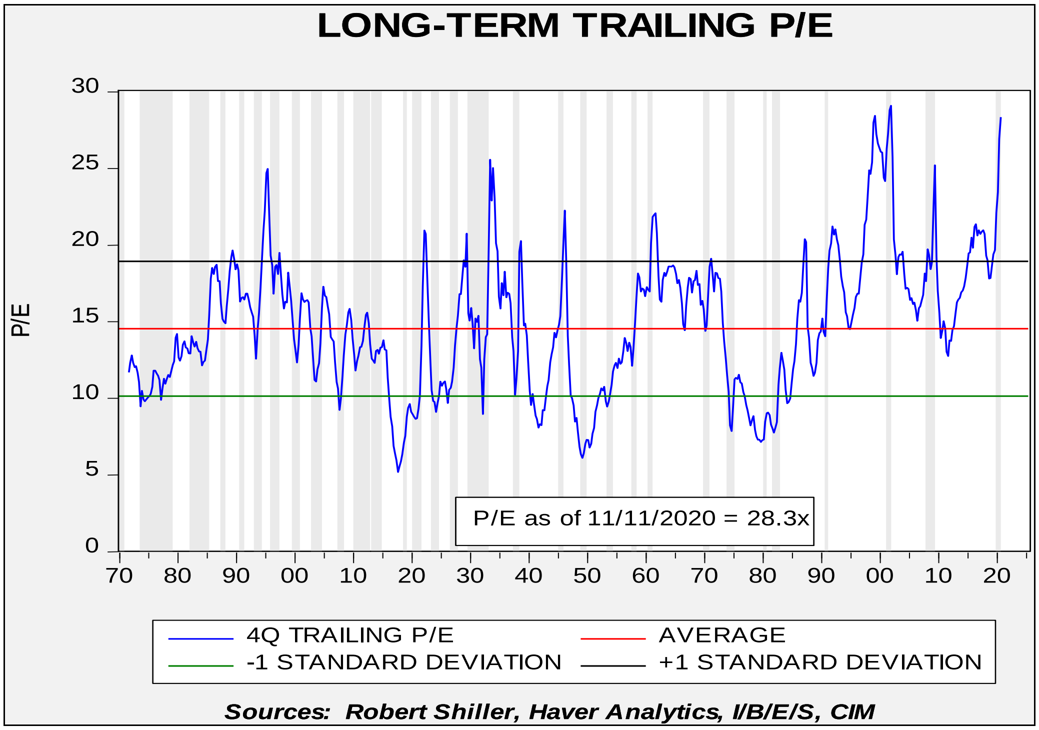


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

November 12, 2020



Based on our methodology,[2] the current P/E is 28.3x, down 0.8x from last week. Strong Q3 earnings 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.

[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 (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.