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 16, 2020—9:30 AM EST] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.6% from its last close. In Asia, the MSCI Asia Apex 50 closed up 1.6%. Chinese markets were higher, with the Shanghai Composite up 1.1% from the prior close and the Shenzhen Composite up 0.9%. U.S. equity index futures are signaling a higher open. With 461 companies having reported, the S&P 500 Q3 earnings stand at $38.90, higher than the $33.68 forecast for the quarter. The forecast reflects a 21.0% decrease from Q3 2019 earnings. Thus far this quarter, 84.6% of the companies have reported earnings above forecast, while 12.8% have reported earnings below forecast.

Good morning and happy Monday! U.S. equity futures are higher again this morning on positive vaccine news (see below). We start our coverage this morning with the new Asian trade agreement. Political turmoil in Peru is up next. There is a lot of news surrounding COVID-19 as infections rise across the country; rural areas have been hit especially hard. China news follows. We close with a look at grain prices, the election, and odds and ends. Here are the details:

Trade: Over the weekend, 15 Asia-Pacific nations signed a large trade deal covering one-third of the world's population. Conspicuous in their absence are India and the U.S. The Regional Comprehensive Economic Partnership (RECP) is a combination of the Association of Southeast Asian Nations (ASEAN) along with Australia, China, Japan, and South Korea. It took eight years of negotiations to build the pact. Although it is large, it isn't all that comprehensive. It doesn't include services or agriculture, and it only eliminates 90% of tariffs, unlike the TPP, which gets rid of 100%. However, it does unify rules of origin, which will help facilitate trade. The deal is likely to give China a stronger position to dominate regional trade, especially with India's decision to opt out. It also highlights the retreat of the U.S. from hegemony; there is little political support for a trade deal in the U.S., but without participation America is ceding ground to China. At the same time, much of the retreat is visual. In reality, the RECP isn't strong enough to be a major tool for Chinese influence.

Peru: Peru is in the midst of a major constitutional crisis. Last week, on November 9, the legislature removed President Martin Vizcarra, using a 19th-century law that allows the legislature to remove a president for "permanent moral incapacity." Vizcarra is accused of taking $630,000 in bribes when he was a provincial governor in 2011-14. There have been no charges filed. Manuel Merino, the head of Congress, was installed as interim president. He didn't last long—he resigned over the weekend as Peru was hit with massive civil unrest. Peru has had three presidents in the past four years. It is not obvious how the government will move forward. Although the turmoil hasn't affected Peru's neighbors yet, the region is already dealing

with a massive refugee problem caused by Venezuela, and without resolution, it isn't inconceivable that another one could occur.

COVID-19: The number of reported cases is 54,495,858 with 1,318,884 fatalities. In the U.S., there are 11,038,998 confirmed cases with 246,224 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:
- Let us start with the good news—Moderna (MNRA, USD, 89.39) announced its experimental vaccine had an effectiveness rate of 94.5%. This news triggered a rally in equities. Both Moderna and Pfizer (PFE, USD, 38.62)/BioNTech's vaccines have shown high effectiveness. These vaccines use the novel mRNA method that has never been used before (here's a primer); because mRNA is fragile and breaks down quickly in normal temperatures, distribution of this vaccine will require a super-cold supply chain that may mean this method will be the first, but probably not the last, in the vaccine saga. Nevertheless, progress is really good news.
- Another bit of good news: in a weekend book review of Nicholas Christakis's new book on the pandemic, near the end of the review, there is an analysis of how COVID-19 may evolve. Around 1890, there was a pandemic called the Russian flu. Although history has treated it as an influenza, new research suggests it was likely a coronavirus that moved from cows to humans. Influenza usually kills, as the "tails" of age, the old and the young. However, COVID-19 is most deadly among the elderly, and so was the Russian flu. There is a coronavirus called OC43; it accounts for 30% of all common colds. There is some speculation that the Russian flu was, in fact, OC43, which started as a deadly coronavirus that mutated into a much less deadly form. Although we are clearly not through this current pandemic yet, there is hope, even if an effective vaccine isn't found, that COVID-19 may become a lesser issue over time.
- Now the bad news. Infection rates are rising rapidly, and this time around it's hitting much of the country. Unlike the event in the spring, rural areas, which have fewer resources to cope, are facing the brunt of infections. Rural nursing homes are especially vulnerable. States are issuing new orders for partial lockdowns and other measures.
- VP Biden's campaign indicated that he doesn't plan to issue national lockdown orders. The increase in infection rates will likely hurt Q4 growth. Even after the pandemic ends, it looks like it will leave permanent changes in its wake. At least some degree of work from home will stay in place, and that will undermine public transit systems. It has also fostered digital commerce, which will probably continue as well.
- There are reports that North Korea and Russia are trying to hack COVID-19 research firms.
- Although PM Johnson did recover from an early bout of COVID-19, he is self-quarantining due to a recent exposure.

China: China's economy continues to outperform and will likely finish the year on an uptrend. In a rather surprising development, vulture funds are buying up distressed debt from China's SOEs on the assumption that state governments won't allow the firms to default completely. This is likely a heroic assumption.

U.S. agriculture: Although the U.S. grain crops were large, prices have continued to rise. Some of the strength is tied to Chinese imports. China is buying crops as part of the Phase I deal with the U.S., and it is rebuilding its hog herd after the African Swine Fever led to mass culling. At the same time, Americans stuck at home have been on a baking binge, which is boosting wheat demand. Also, we are in a period of the year where South American stockpiles are dwindling, and the U.S. harvest isn't quite complete. In addition, weather in South America has been dry, and Argentina is considering export tariffs, leading farmers there to store rather than sell their grain.

The election: Although this election won't be resolved until early December at the earliest (December 8 is the key date—that is the "safe harbor" day that certifies electors to the Electoral College), we are watching to see who VP Biden is leaning toward for key spots. We have been paying close attention to Jared Bernstein, who was an economic advisor to Biden when he was VP in the Obama administration. He is apparently under consideration for leading the National Economic Council. He has an op-ed in the *WP* that discusses how low interest rates make a high federal debt easier to manage. Although he hasn't been tied officially to MMT, policies from that theory would fit this position. Bernstein has called for an end to the dollar's reserve status, and we would view his official appointment as a potential signal of a bearish dollar policy from a Biden administration.

Odds and ends: Brexit talks continue, and the deadline of year's end is looming. We expect a deal to be struck, but it may not be close to comprehensive. In other news:
- Bulgaria is threatening to block North Macedonia's entry into the EU. As is the case in this part of Europe, ethnic populations spill over state boundaries. North Macedonia claims minorities in Bulgaria, which is making Sofia uncomfortable.
- In the Moldova runoff election, Maia Sandu, who is friendly to the EU, appears to be the winner.

U.S. Economic Releases

The New York Fed's Empire Manufacturing Index Survey for November signaled worsening manufacturing conditions. The index came in at 6.3, well below expectations of 13.8.

EMPIRE STATE BUSINESS CONDITIONS INDEX

Sources: STL FRB (FRED), CIM
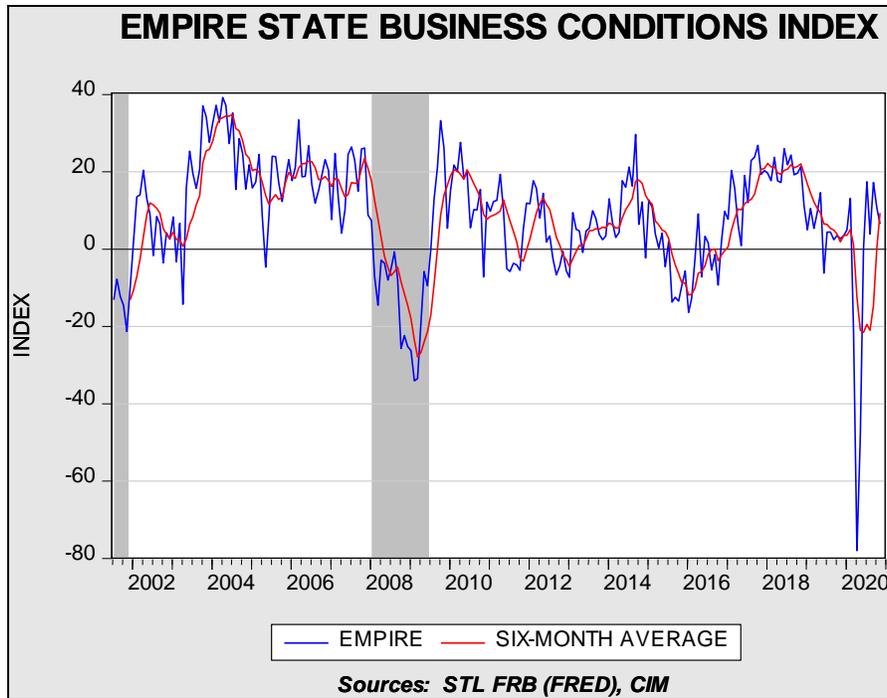
The chart above shows the Empire State Manufacturing Index along with its six-month moving average.

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

No economic releases today	
Fed Speakers or Events	
Speaker or event	**District or position**
13:45 Mary Daly Discusses a More Inclusive Society	President of the Federal Reserve Bank of San Francisco
14:00 Richard Clarida Discusses the 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								
China	New Home Prices	m/m	Oct	0.2%	0.3%		**	Equity and bond neutral
	Industrial Production	y/y	Oct	6.9%	6.9%	6.7%	***	Equity and bond neutral
	Retail Sales	y/y	Oct	4.3%	3.3%	5.0%	**	Equity bearish, bond bullish
	Fixed Assets Ex Rural YTD	y/y	Oct	1.8%	0.8%	1.6%	**	Equity bullish, bond bearish
	Property Investment YTD	y/y	Oct	6.3%	5.6%	6.0%	**	Equity bullish, bond bearish
	Surveyed Jobless Rate	m/m	Oct	5.3%	5.4%	5.3%	**	Equity and bond neutral
Japan	GDP SA	q/q	3Q	5.0%	-7.9%	4.4%	***	Equity bullish, bond bearish
	Inventory Contribution % GDP	q/q	3Q	-0.2%	0.3%	-0.3%	***	Equity and bond neutral
	Industrial Production	m/m	sep	3.9%	4.0%		***	Equity and bond neutral
	Capacity Utilization	m/m	sep	6.4%	2.9%		***	Equity and bond neutral
India	Wholesale Prices	y/y	Oct	1.5%	1.3%	1.5%	**	Equity and bond neutral
New Zealand	Performance Services Index	m/m	Oct	51.4	50.3		**	Equity bullish, bond bearish
Europe								
Italy	CPI EU Harmonized	y/y	Oct	-0.6%	-0.6%	-0.6%	***	Equity and bond neutral
	General Government Debt	m/m	Sep	2582.6b	2578.9b		**	Equity and bond neutral
UK	Rightmove House Prices	y/y	Nov	6.3%	5.5%		***	Equity bullish, bond bearish
Switzerland	Domestic Sight Deposits CHF	w/w	13-Nov	644.5b	638.7b		**	Equity and bond neutral
	Total Sight Deposits CHF	w/w	13-Nov	707.9	707.6b		***	Equity and bond neutral
AMERICAS								
Brazil	Economic Activity	y/y	Sep	-0.8%	-3.9%	-1.3%	***	Equity bullish, bond bearish
	FGV CPI IPC-S	w/w	15-Nov	0.6%	0.6%	0.6%	**	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)	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 (%)	0.88	0.90	-0.02	Neutral
Euribor/OIS spread (bps)	-51	-51	0	Neutral
EUR/USD 3-mo swap (bps)	15	16	-1	Down
Currencies	**Direction**			
dollar	Flat			Down
euro	Flat			Up
yen	Down			Up
pound	Flat			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	$43.54	$42.78	1.78%	Economic Optimism
WTI	$40.93	$40.13	1.99%	
Natural Gas	$2.87	$3.00	-4.07%	
Crack Spread	$8.14	$8.18	-0.51%	
12-mo strip crack	$10.30	$10.30	-0.02%	
Ethanol rack	$1.57	$1.58	-0.79%	
Metals				
Gold	$1,890.91	$1,889.20	0.09%	
Silver	$24.83	$24.67	0.64%	
Copper contract	$324.75	$318.50	1.96%	
Grains				
Corn contract	$ 420.50	$ 419.50	0.24%	
Wheat contract	$ 596.00	$ 602.00	-1.00%	
Soybeans contract	$ 1,150.50	$ 1,148.00	0.22%	
Shipping				
Baltic Dry Freight	1115	1124	-9	

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 the 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.

RETAIL MMK AND S&P

Sources: Haver Analytics, CIM
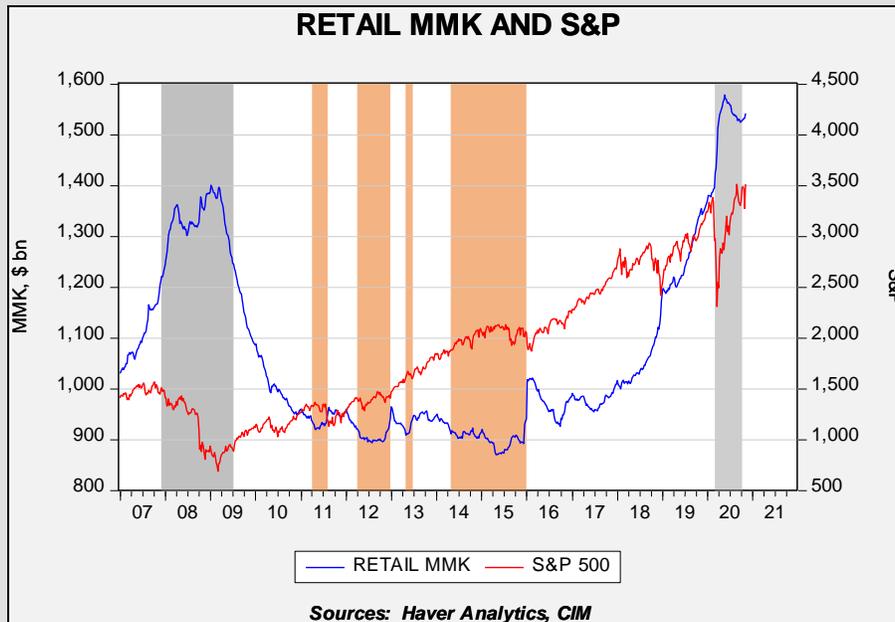
This chart shows retail money market funds (RMMK) and the S&P 500 on a weekly basis. Retail investors started building cash positions in 2018 around the onset of trade tensions with China and aggressively added to cash this year. Although RMMK did ease with the recovery in the S&P, levels remain elevated 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.

VIX VOLATILITY INDEX

Sources: FRED, CIM

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 11/13/2020 close)
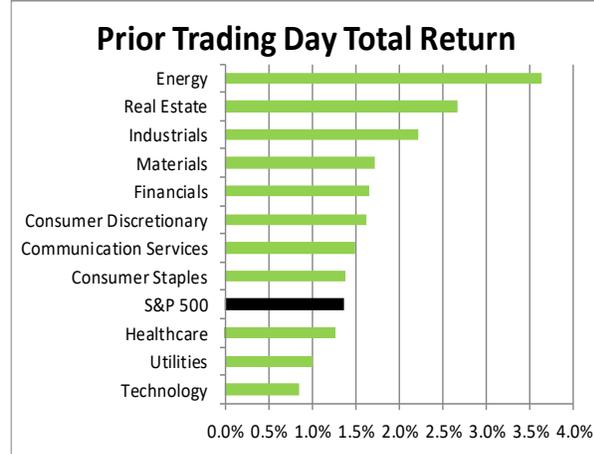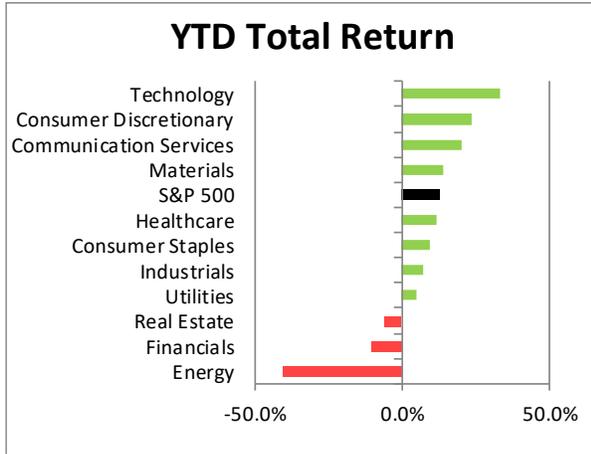
(Source: Bloomberg)

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 11/13/2020 close)
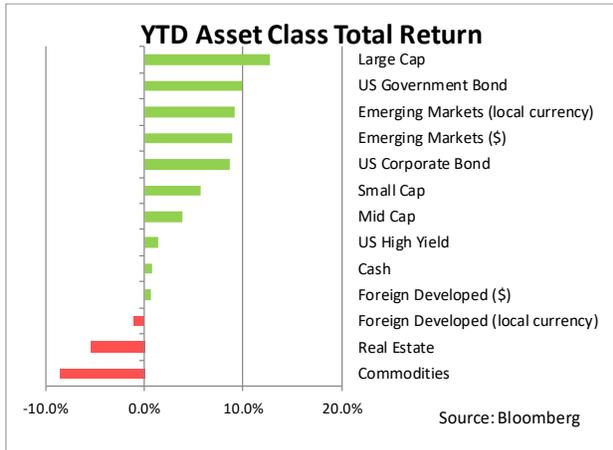
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

November 12, 2020
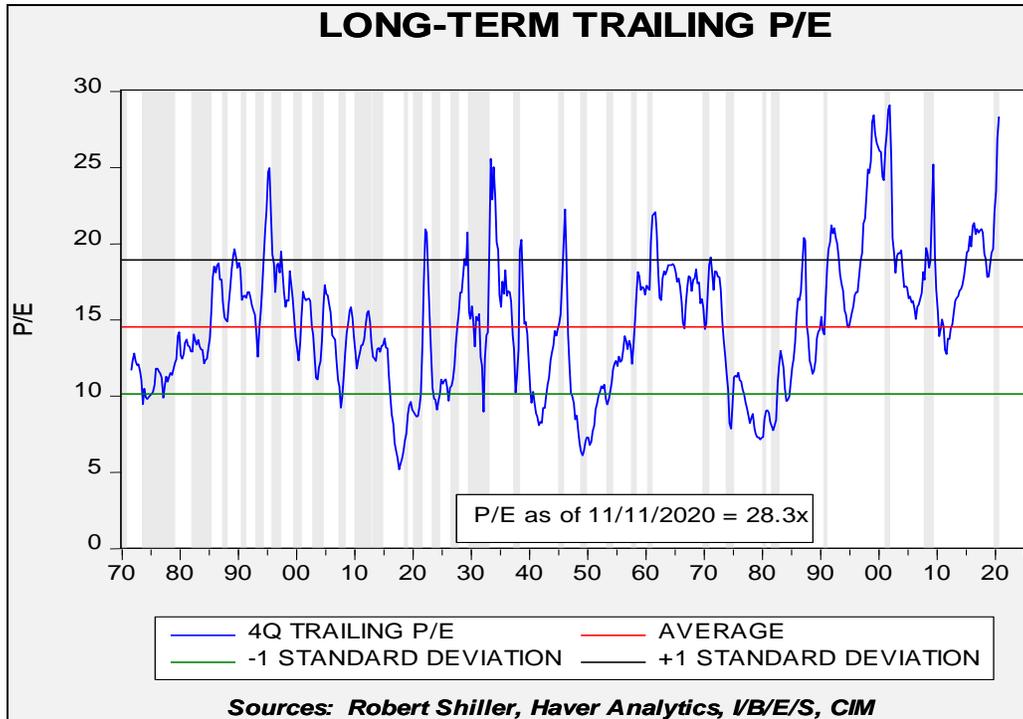
Based on our methodology,[1] the current P/E is 28.3x, down 0.8x from last week. Strong Q3 earnings reduced the multiple.

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.

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[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.