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 18, 2020—9:30 AM EST] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.1% from its last close. In Asia, the MSCI Asia Apex 50 closed up 0.6%. Chinese markets were mixed, with the Shanghai Composite up 0.2% from the prior close and the Shenzhen Composite down 0.3%. U.S. equity index futures are signaling a higher open. With 464 companies having reported, the S&P 500 Q3 earnings stand at $39.00, higher than the $33.68 forecast for the quarter. The forecast reflects a 21.0% decrease from Q3 2019 earnings. Thus far this quarter, 84.7% of the companies have reported earnings above forecast, while 12.7% have reported earnings below forecast.

Our *Daily Comment* today opens with the latest news regarding the U.S. presidential election and transition. In sum, all trends in terms of legal challenges and transition procedures appear to be moving in favor of Vice President Biden. We also note a number of policy developments, including new difficulties concerning Judy Shelton's nomination to the Federal Reserve's Board of Governors. We end with the latest developments surrounding the coronavirus pandemic.

U.S. Presidential Election: President Trump has fired Chris Krebs, the top U.S. election security official, after he contradicted the president by saying the November 3 election had been the "most secure" in history. Separately, the Wayne County Board of Canvassers in Michigan unanimously certified Vice President Biden's win in the area around Detroit after an initial deadlock on the decision. Finally, the Pennsylvania Supreme Court dealt another legal setback to the Trump campaign by ruling that the city of Philadelphia allowed ballot observers to watch the vote count in accordance with election law. The ruling demonstrates how the Trump campaign is struggling to come up with evidence of significant election irregularities that can hold up in court. With every such ruling, it is becoming ever more certain that Vice President Biden will be inaugurated in January as scheduled. That certainty, in turn, should buttress the financial markets, at least in the near term.

U.S. Presidential Transition: As the Trump administration continues to withhold information and resources from President-elect Biden, some national security officials are considering unofficially meeting at off-site locations with members of Biden's team and providing unclassified information, which they would be allowed to do. Separately, Biden named several members of his White House staff, including:

- Jen O'Malley Dillon, Biden's campaign manager, as his deputy chief of staff.
- Mike Donilon, a chief strategist on the campaign, as a senior adviser to the president.
- Steve Ricchetti, Biden's campaign chairman, as a counselor to the president.

- Rep. Cedric Richmond, a national co-chair of the Biden campaign, as a senior adviser to the president and director of the White House Office of Public Engagement.

U.S. Federal Reserve: Faced with a likely vote against President Trump's nomination of Judy Shelton to the Fed's Board of Governors due to some Republican senators being out sick with COVID-19, Senate Majority Leader McConnell postponed the vote until later in the week. However, even if the missing legislators are back by then, the confirmation could be scuttled if only one additional Republican defects on top of the three that have already declared they will vote against Shelton for her unorthodox beliefs regarding monetary policy.

United States-China: Republicans on the Senate Foreign Relations Committee today will release a report recommending that the U.S. work more closely with European partners, the United Nations, and other market-led democracies in order to counter China's rise and malign international behavior. Since that strategy dovetails well with Vice President Biden's approach, it suggests at least a modest rejuvenation of the U.S.'s traditional allied approach to international challenges. However, because of the U.S. population's continued preference to step back from the country's hegemonic role, it's not clear how broad or how far such a new system of alliances can go.

Israel-Syria: The Israeli military said it struck Iranian and Syrian military targets in Syria after Iran-backed fighters placed improvised explosive devices on the fence separating Israel and Syria. As always when there is military action in the oil-producing region, the risk of a widening conflict that could disrupt oil production may give a boost to global crude prices today.

COVID-19: Official data show confirmed cases have risen to 55,769,818 worldwide, with 1,341,209 deaths. In the United States, confirmed cases rose to 11,361,394 with 248,707 deaths. Here is the interactive chart from the *Financial Times* that allows you to compare cases and deaths among countries, scaled by population.

Virology

- Newly confirmed U.S. infections totaled 161,934 yesterday, while hospitalizations rose to 76,823. Those in intensive care units also remained high, as did deaths. The new wave continues to push various states toward tighter restrictions ranging from mask mandates to the closure of some businesses, although the lock downs so far remain less stringent than during the first wave in the spring. Similar trends continue in much of Europe, with a few exceptions like Norway and Finland.
- With additional data on their experimental vaccine now in hand, Pfizer (PFE, 36.04) and BioNTECH (BNTX, 86.93) said the compound was 95% effective and produced no safety issues. According to the report, the vaccine offers protection against both mild and severe infections, and it's 94% effective in older populations that are at greater risk from the disease.
    - The companies said they will apply to the FDA for emergency use authorization for the vaccine "within days."

    - While the Pfizer/BioNTECH compound still has some ease-of-use disadvantages compared with the shot under development by Moderna (MRNA, 93.15), the additional data should bolster optimism about the vaccines, even as concerns about resurgent infections cloud the short-term outlook for the economy.
    - Naturally, the vaccines aren't just boosting investor optimism about longer-term economic prospects, but also about the pharmaceutical firms themselves. However, one cautionary note is offered by South Korea, which revealed that it will push off signing contracts for the new vaccines until it can get better pricing. That serves as a reminder that some Asian countries that have long since gotten the virus under control may not be large, lucrative markets for the drug makers.
- A group of developing countries, led by South Africa and India, said they will press at the World Trade Organization this week to free COVID-19 vaccines from patent protections, so they can be more accessible and affordable for poor countries. The proposed waiver pits the developing nations against the U.S., the European Union, Japan, and other wealthier countries, as well as Western pharmaceutical companies, which say respecting intellectual property rights is key to promoting the rapid development of the vaccines.

Economic Impacts

- With the Fed pinning interest rates close to 0% and the budding economic recovery pushing inflation higher in recent months, "real" yields in the U.S. have fallen deeply into negative territory again, prompting increasing demand for high-yield bonds and pushing spreads back down to levels last seen in February. Looking forward, however, trends in the market for TIPS suggest investors still expect inflation to remain under wraps in the longer term, reflecting not only the disinflationary impacts of the virus but also structural issues like slowing population growth. The ten-year break-even inflation rate in the TIPS market now stands at approximately 1.72%, nearly the same as in February.
- With China being first in and then first out of the pandemic crisis, and with its strongly rebounding economy as the U.S. and other major Western countries face a resurgence in infections, foreign investors are plowing money into the Chinese economy. Official data show foreign direct investment in China rose in October for the seventh straight month, jumping 18% year-over-year to approximately $11.8 billion. While that number is significant in itself, the overall trend also suggests that once the pandemic is a thing of the past, China will have improved its global economic and geopolitical position at the expense of the West. In turn, that will make any effort to roll back China even more difficult and costly than it would have been before.

U.S. Policy Response

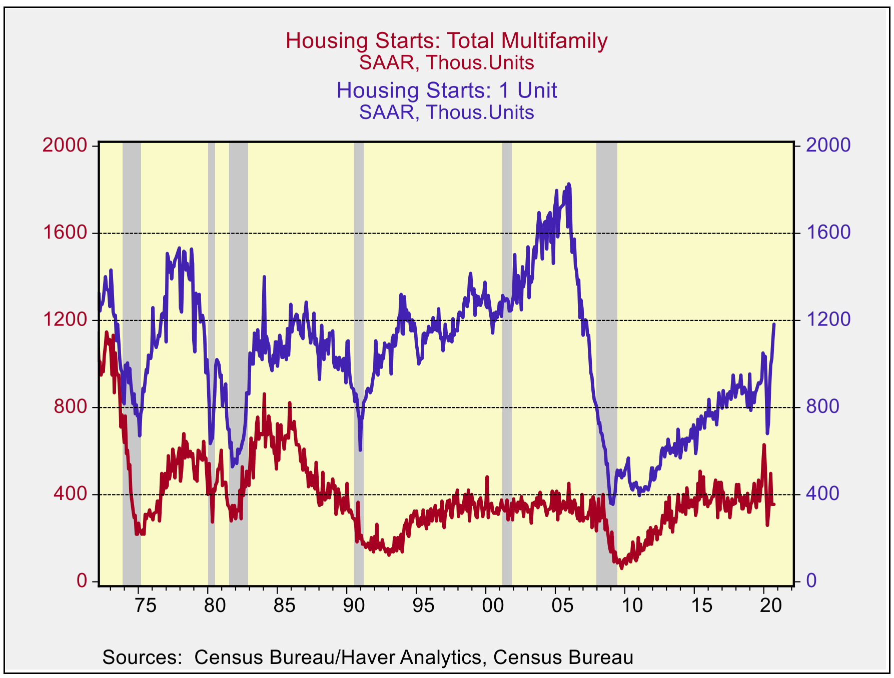
- In an online event yesterday, Fed Chair Powell said that the resurgence of the coronavirus poses an important risk to the economy in the months ahead, and that it was too soon to say how a potential vaccine would change the outlook. In Powell's view, the recent news about successful vaccine trials was "certainly good news, particularly in the medium term, [but] in the near term there are significant challenges and uncertainties."

- Democratic leaders in Congress have sent a letter to Senate Majority Leader McConnell [requesting that negotiations on another coronavirus relief bill restart this week] after months of stalemate. However, McConnell is even more opposed to a large new relief package than Treasury Secretary Mnuchin, who is now largely sidelined from the negotiations because of President Trump's apparent reelection loss. Prospects for a major new bill, therefore, remain questionable in the near term.

U.S. Economic Releases

For the week ending November 13, mortgage applications fell 0.3% from the prior week. Applications for home purchases rose 3.5% from the prior week, while refinances fell 1.8%. The average 30-year fixed mortgage rate rose by 1 bp from 2.98% to 2.99%.

U.S. construction strengthened in October as low interest rates continue to fuel optimism about future demand for single-family homes. Housing starts rose 4.9% to a 1.530MM annualized rate from the prior month; estimates were 1.460MM. Building permits remained unchanged at a 1.545MM annual rate compared to expectations of 1.567MM. The prior month's report was revised from 1.553MM to 1.545MM.



The chart above shows the annualized rate of residential construction for single and multi-family homes. Single-family homes came in at 1.179 MM annualized, while multi-family came in at 0.351MM annualized.

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**
12:15	John Williams Takes Part in Webinar Discussion	President of the Federal Reserve Bank of New York
13:20	James Bullard Discusses Economic Outlook	President of the Federal Reserve Bank of St. Louis
18:00	Robert Kaplan Moderates a Panel Discussion	President of the Federal Reserve Bank of Dallas
19:00	Raphael Bostic Takes Part in Fed Education Event	President of the Federal Reserve Bank of Atlanta

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								
Japan	Trade Balance	m/m	Oct	¥872.9b	¥675.0b	¥300.0b	**	Equity bullish, bond bearish
Australia	Westpac Leading Index	m/m	Oct	0.1%	0.2%		**	Equity and bond neutral
	Wage Price Index	q/q	3Q	0.1%	0.2%	0.2%	***	Equity and bond neutral
New Zealand	PPI Input	q/q	3Q	0.6%	-1.0%		**	Equity bearish, bond bullish
	PPI Output	q/q	3Q	-0.3%	-0.3%		**	Equity and bond neutral
Europe								
Eurozone	EU27 New Car Registrations	m/m	Oct	-7.8%	3.1%		**	Equity bearish, bond bullish
	CPI	y/y	Oct	-0.3%	-0.3%	-0.3%	***	Equity and bond neutral
	CPI Core	y/y	Oct	0.2%	0.2%	0.2%	***	Equity and bond neutral
UK	CPI	y/y	Oct	0.7%	0.5%	0.5%	***	Equity bearish, bond bullish
	CPI Core	y/y	Oct	1.5%	1.3%	1.3%	***	Equity bearish, bond bullish
	RPI	y/y	Oct	1.3%	1.1%	1.2%	**	Equity and bond neutral
	RPI Ex Mort Int.Payments	y/y	Oct	1.5%	1.4%	1.4%	**	Equity and bond neutral
	PPI Input NSA	y/y	Oct	-1.3%	-3.7%	-2.6%	**	Equity bullish, bond bearish
	PPI Output NSA	y/y	Oct	-1.3%	-0.9%	-0.7%	**	Equity and bond neutral
	PPI Output Core NSA	y/y	Oct	0.5%	0.3%	0.4%	**	Equity and bond neutral
	House Price Index	y/y	Sep	4.7%	2.5%	2.9%	**	Equity bullish, bond bearish
Russia	Industrial Production	y/y	Oct	-5.9%	-0.05	-5.5%	***	Equity and bond neutral
AMERICAS								
Canada	Housing Starts	m/m	Oct	214.9k	209.0k	220.0k	***	Equity and bond neutral
	Wholesale Trade Sales	m/m	Sep	0.9%	0.3%	0.4%	**	Equity bullish, bond bearish
	Int'l Securities Transactions	m/m	Sep	4.46b	15.51b		**	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)	7	8	-1	Neutral
TED spread (bps)	15	14	1	Up
U.S. Libor/OIS spread (bps)	8	8	0	Up
10-yr T-note (%)	0.86	0.86	0.00	Neutral
Euribor/OIS spread (bps)	-52	-52	0	Neutral
EUR/USD 3-mo swap (bps)	13	13	0	Down
Currencies	**Direction**			
dollar	Down			Down
euro	Up			Up
yen	Up			Up
pound	Up			Down
franc	Up			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	$44.22	$43.75	1.07%	
WTI	$41.83	$41.43	0.97%	
Natural Gas	$2.76	$2.69	2.60%	
Crack Spread	$8.28	$8.37	-1.04%	
12-mo strip crack	$10.46	$10.48	-0.18%	
Ethanol rack	$1.53	$1.54	-0.68%	
Metals				
Gold	$1,874.88	$1,880.38	-0.29%	
Silver	$24.43	$24.49	-0.25%	
Copper contract	$323.70	$320.95	0.86%	
Grains				
Corn contract	$ 426.50	$ 426.75	-0.06%	
Wheat contract	$ 605.00	$ 603.00	0.33%	
Soybeans contract	$ 1,173.75	$ 1,169.75	0.34%	
Shipping				
Baltic Dry Freight	1112	1111	1	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.6		
Gasoline (mb)		0.7		
Distillates (mb)		-1.5		
Refinery run rates (%)		0.60%		
Natural gas (bcf)		22.0		

Weather

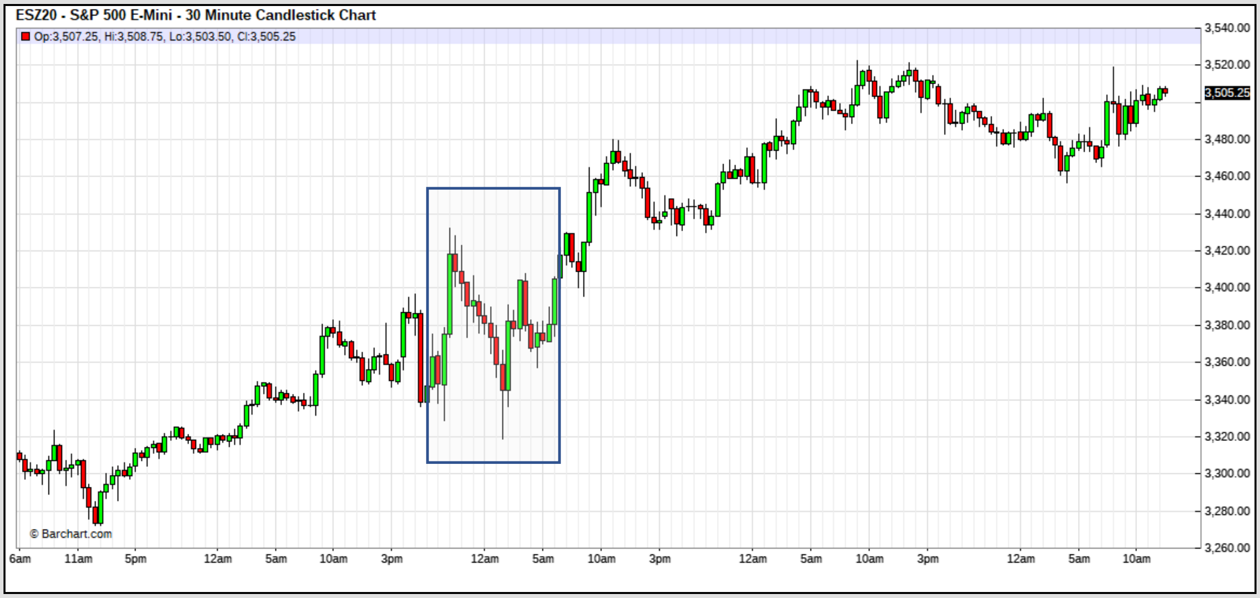
The 6-10 and 8-14 day forecasts currently call for warmer temperatures for most of the country, with cooler temperatures throughout the West. Dry conditions are expected throughout the Rocky Mountains and Southwest, with wet conditions expected for the rest of the country. Hurricane Iota has been downgraded to Tropical Depression and is currently moving across Central America.

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)

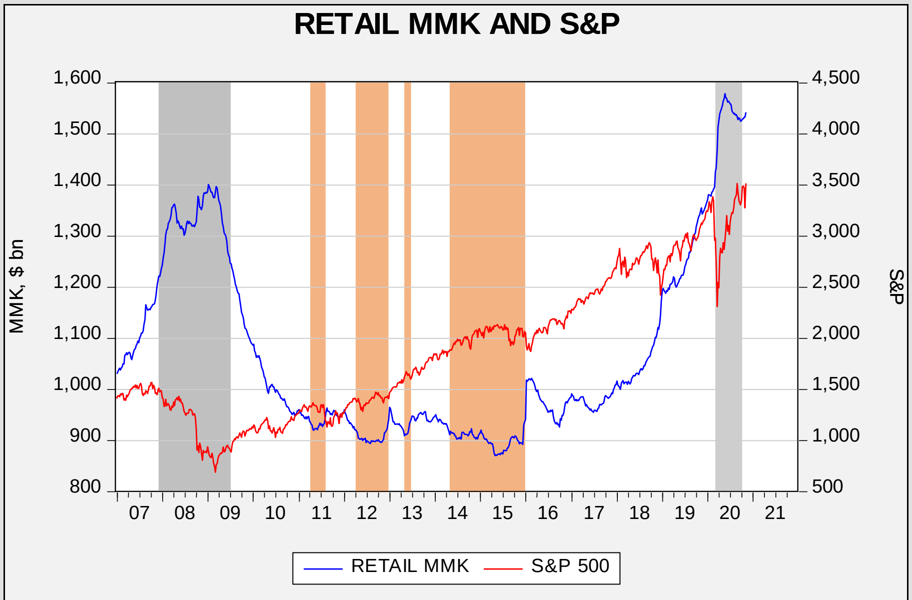
This is a five-day chart of the December S&P futures contract. We have placed a box on election night. Market volatility was clearly elevated as we saw sizable rallies and pullbacks. But, for the rest of the week, equity prices have continued to recover.

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.

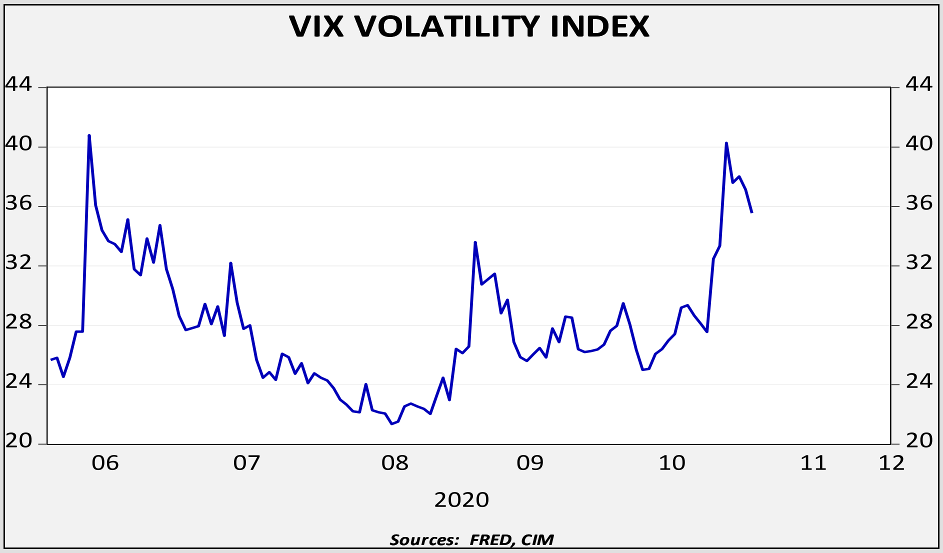
Although equities generally held their value through the election (prices peaked around Labor Day and were rangebound thereafter), there were two areas where there was clear evidence of risk mitigation. The first was accumulation of cash.



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.

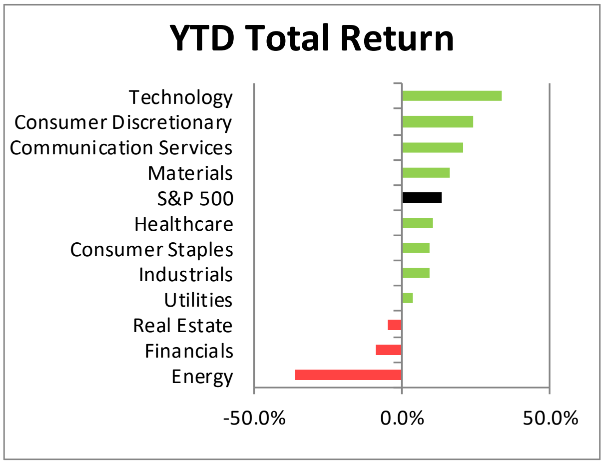


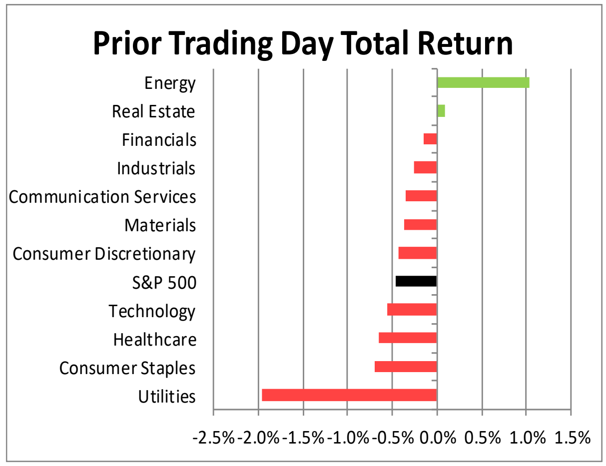
The “VIX” is a measure of implied volatility from the S&P 500 options market. When option buyers pay higher prices for options, it gets translated as higher implied volatility. Essentially, if they are buying put options, they are protecting for a wider dispersion of prices. This chart shows daily prices 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 11/17/2020 close)

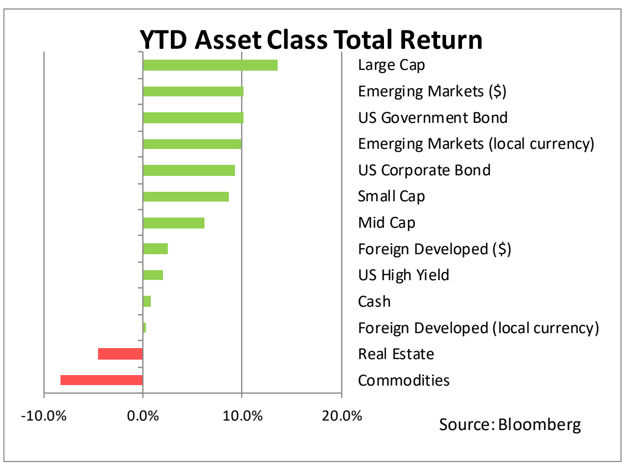




(Source: Bloomberg)

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 11/17/2020 close)

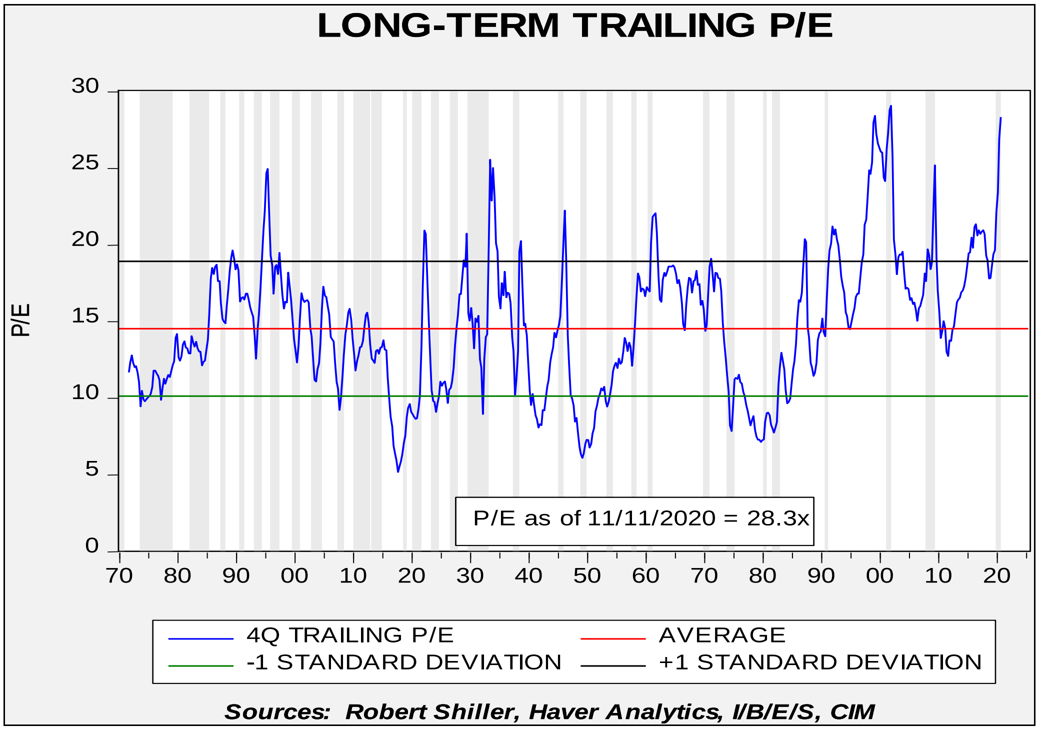


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.