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 24, 2020—9:30 AM EST] Global equity markets are mixed this morning. The EuroStoxx 50 is up 1.1% from its last close. In Asia, the MSCI Asia Apex 50 remained unchanged. Chinese markets were lower, with the Shanghai Composite down 0.3% from the prior close and the Shenzhen Composite down 0.3%. U.S. equity index futures are signaling a higher open. With 473 companies having reported, the S&P 500 Q3 earnings stand at $39.20, higher than the $33.68 forecast for the quarter. The forecast reflects a 21.0% decrease from Q3 2019 earnings. Thus far this quarter, 84.8% of the companies have reported earnings above forecast, while 12.7% have reported earnings below forecast.

Our *Daily Comment* today opens with news related to the presidential election and transition. The Trump administration is now allowing Vice President Biden's team to access federal resources for the transition of power, and the resulting reduction in uncertainty is giving a boost to risk assets from equities to crude oil. We also discuss developments overseas and the latest on the coronavirus. ***As a reminder, for Thanksgiving, the Daily Comment will take a couple of days off, with no comment after today. We will return on Monday, November 30. There will also be no Asset Allocation Weekly (AAW) or Weekly Energy Update (WEU) next week.***

U.S. Presidential Election: Michigan certified Vice President Biden's win in that state, and the Pennsylvania Supreme Court declined to invalidate thousands of mail-in and absentee ballots with minor errors that favored Biden. As late as yesterday, President Trump vowed to continue his long-shot legal challenges to overturn Biden's win, but his already-low chance of success continues to decline as his campaign has failed to produce credible, admissible evidence of significant electoral irregularities. In a sign that companies are already shifting their behavior in response to Trump's loss, General Motors (GM, 44.77) said it will no longer back the Trump administration's legal battle to strip California of its authority to set its own fuel-efficiency regulations. Instead, GM said its goals for green cars are aligned with the state and the incoming Biden administration.

U.S. Presidential Transition: Against the backdrop of the developments in Michigan and Pennsylvania, General Services Administration chief Emily Murphy yesterday determined that Vice President Biden has qualified for the resources and services available to the winner of the presidential election. The decision allows Biden and his team to begin the formal transition of power in the normal manner. Even before that news came out, however, the Biden team disclosed several key picks for the president-elect's cabinet. Overall, the picks noted below, as well as others that have also been disclosed, point to a relatively centrist, establishment-oriented economic and foreign policy team that is deeply experienced and knowledgeable about how

Washington works. The team members, many of whom have a history of working closely with Biden, are also committed to U.S. global leadership and constructing a broad coalition of allied democracies as the best way to channel China's rise and counter its malign geopolitical and economic moves around the world. However, it remains quite unclear how effectively the team will be able to counter calls for global retrenchment from populists on both the left and the right. The key picks include:

- Treasury Secretary: Janet Yellen, formerly Federal Reserve Governor and, before that, Chief of the White House Council of Economic Advisors. Yellen has recently been advocating for continued fiscal support to help get the economy over the remaining months of the coronavirus pandemic, so her appointment is cheering equity investors but contributing to a modest pullback in the dollar so far this morning.
- Secretary of State: Anthony Blinken, former Deputy Secretary of State and Biden's national security advisor during the Obama administration
- National Security Advisor: Jake Sullivan, former Director of Policy Planning at the State Department and another national security advisor for Biden during his years as vice president
- Secretary of Homeland Security: Alejandro Mayorkas, a former deputy director of the department and federal prosecutor

Brexit: As the United Kingdom and the European Union approach the year-end negotiating deadline for a post-Brexit trade deal, officials on both sides are making a late push to ensure a smooth transition for financial markets. For example, European regulators yesterday finalized a change seeking to avoid chaos in £15 trillion of derivatives contracts held between U.K. and EU counterparties. Goldman Sachs (GS, 228.83) said it would set up a trading hub in Paris for Sigma X, its private European stock market, in order to ensure that its clients can still trade seamlessly, even after a hard Brexit.

Germany: Spurred in part by the collapse of payment company Wirecard (WCAGY, 0.3425) because of a multibillion-dollar fraud, the DAX-30 index of German stocks is expanding to 40 members and will now require all potential members to achieve positive operating profit for two full years before joining. In another rule change, DAX companies must have an audit committee that adheres to the German Corporate Governance Code. To the extent that the rule changes tighten up listing standards, the moves could be positive for German equities going forward.

European Union-Turkey: A German navy frigate trying to enforce the EU's embargo on arms shipments to Libya was forced to abandon its search of a Turkish cargo ship suspected of delivering weapons to Libya after the Turkish government raised objections. The incident will likely further hike tensions between the EU and Turkey, which have been exacerbated by Turkey's aggressive territorial claims in the Mediterranean Sea and its activities in the Libyan civil war.

Yemen-Saudi Arabia: Yemen's Iranian-backed Houthi rebels claim to have damaged an oil facility in the Saudi port city of Jeddah in a rocket attack. If true, the assault would demonstrate the rebels' ability to strike deep into Saudi Arabia and damage large portions of its key oil

production infrastructure. Along with news pointing to a more certain U.S. presidential transition, the attack is helping boost global oil prices so far today.

COVID-19: Official data show confirmed cases have risen to 59,342,857 worldwide, with 1,399,373 deaths. In the United States, confirmed cases rose to 12,421,993 with 257,707 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 169,190 yesterday, while the seven-day moving average stood at 172,118 and the 14-day moving average came in at 163,225. Just as important, the number of U.S. hospitalizations rose to a record high of 85,836. Deaths related to the virus totaled 889. The U.S. and Europe remain the regions most afflicted by the new resurgence of the virus.
- According to the University of Washington's Institute for Health Metrics and Evaluation, the virus is now killing around 0.6% of the people it infects compared with about 0.9% at the beginning of the crisis in April. Some scientists believe the actual death rate is currently only about 0.15%; the death rate is 0.10% for seasonal influenza. In any case, today's much lower death rates reflect factors like younger, healthier populations getting infected and much-improved treatment protocols. The problem is that the death rate could climb again with the latest nationwide rise in cases as patients overwhelm hospitals, straining their capacity and staff, and lowering the quality of care.
- Although there are several vaccine candidates close to getting approval for emergency use around the world, one big issue will be whether the trade-offs between their different characteristics will give some of them an edge over the others. For example, the financial backers and developers of Russia's Sputnik-V vaccine say its two shots required to vaccinate one person will cost "less than $20" on international markets and will be free of charge for Russian citizens. That compares with a total cost of about $18 for the highly effective vaccine being developed by Pfizer (PFE, 36.52), which also requires difficult ultra-cold storage. In contrast, the somewhat less effective vaccine being developed by AstraZeneca (AZN, 54.70) and Oxford University will reportedly be sold in Europe for around $3 per shot and will only require normal refrigeration.

Economic Impacts
- Now that there are three major vaccine candidates that appear to be safe and effective, there is a debate arising about future inflation trends. Some economists believe a strong economic rebound in 2021 and 2022 will boost price increases for an extended period, while others believe any inflation spurt would soon be overwhelmed by longer-term disinflationary trends like slowing population growth.

U.S. Policy Response
- The Small Business Administration is beginning to ask some Paycheck Protection Program borrowers to document why they needed the loans, drawing concern from

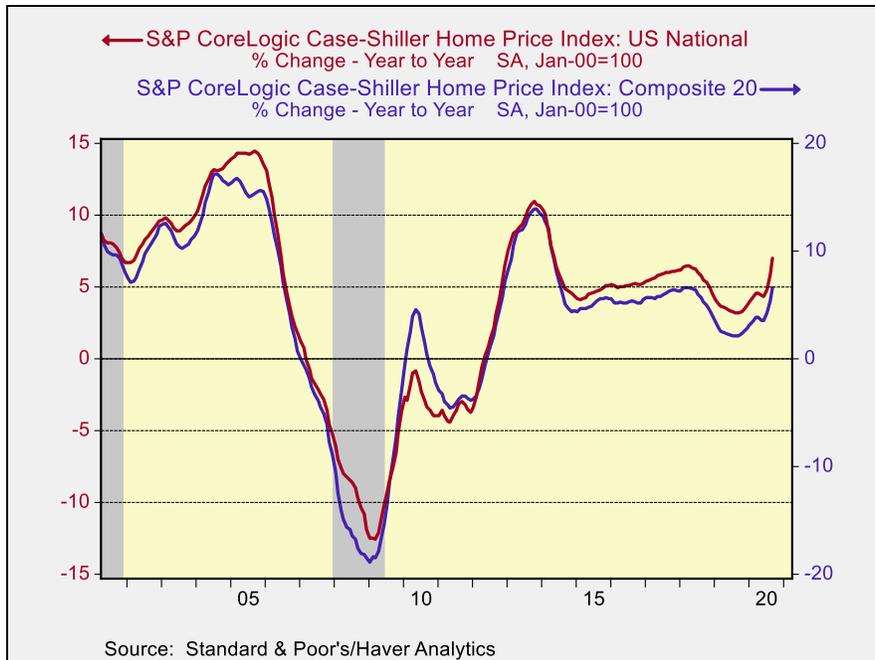advocacy and trade groups that say such disclosures weren't required when the businesses applied for aid.

U.S. Economic Releases

Low interest rates continue to support higher home prices throughout the country. In September, the FHFA House Price Index rose 1.7% from the prior month compared to expectations of a 0.8% rise. In the 3Q, home prices rose 3.1% from the prior quarter.

The chart above shows the annual change in the FHFA House Price Index. Home prices rose 8.04% from the prior year.

The S&P CoreLogic index for 20-Cities rose 6.57% from the prior year compared to expectations of 5.30%. Nationally, the index rose 6.96% from the prior year.

S&P CoreLogic Case-Shiller Home Price Index: US National
% Change - Year to Year   SA, Jan-00=100
S&P CoreLogic Case-Logic Home Price Index: Composite 20
% Change - Year to Year   SA, Jan-00=100

Source: Standard & Poor's/Haver Analytics

The chart above shows the annual change in the S&P CoreLogic national and 20-city index.

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

EDT	Indicator			Expected	Prior	Rating
10:00	Conf. Board Consumer Confidence	m/m	Nov	97.9	100.9	**
10:00	Conf. Board Present Situation	m/m	Nov		104.6	**
10:00	Conf. Board Expectations	m/m	Nov		98.4	**
10:00	Richmond Fed Manufact. Index	m/m	Nov	20.0	29.0	**
Fed Speakers or Events						
	Speaker or event	District or position				
11:00	James Bullard Discusses Monetary Policy Challenges	President of the Federal Reserve Bank of St. Louis				
12:00	John Williams Takes Part in Moderated Discussion	President of the Federal Reserve Bank of New York				
12:45	Richard Clarida Speaks on IMF Panel	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								
Japan	Tokyo Dept Store Sales	y/y	Oct	-4.1%	-35%		**	Equity bullish, bond bearish
	Nationwide Dept Sales	y/y	Oct	-1.7%	-34%		**	Equity bullish, bond bearish
Australia	ANZ Roy Morgan Weekly Consumption	w/w	22-Nov	104.5	106.6		**	Equity and bond neutral
Europe								
Germany	GDP SA	q/q	3Q	8.5%	8.2%	8.2%	***	Equity and bond neutral
	IFO Business Climate	m/m	Nov	90.7	92.7	90.2	**	Equity and bond neutral
	IFO Expectations	m/m	Nov	91.5	95.0	93.5	**	Equity and bond neutral
	IFO Current Assessment	m/m	Nov	90.0	90.3	87.5	**	Equity bullish, bond bearish
France	Business Confidence	m/m	Nov	79.0	90.0	84.0	**	Equity and bond neutral
	Manufacturing Confidence	m/m	Nov	92.0	93.0	91.0	**	Equity bullish, bond bearish
	Production Outlook Indicator	m/m	Nov	-39.0	-12.0	-14.0	**	Equity bearish, bond bullish
	Own-Company Production Outlook	m/m	Nov	-10.0	4.0	2.0	**	Equity bearish, bond bullish
UK	CBI Retailing Reported Sales	m/m	Nov	-25	-23.0	-35.0	**	Equity and bond neutral
	CBI Total Dist. Reported Sales	m/m	Nov	-21	-23		**	Equity and bond neutral
AMERICAS								
Brazil	Trade Balance Weekly	w/w	22-Nov	$936m	$572m		**	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)	20	21	-1	Down
3-mo T-bill yield (bps)	7	8	-1	Neutral
TED spread (bps)	13	13	0	Up
U.S. Libor/OIS spread (bps)	8	8	0	Up
10-yr T-note (%)	0.86	0.86	0.00	Neutral
Euribor/OIS spread (bps)	-52	-53	1	Neutral
EUR/USD 3-mo swap (bps)	19	20	-1	Down
Currencies	**Direction**			
dollar	Down			Down
euro	Up			Up
yen	Up			Up
pound	Up			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	$46.54	$46.06	1.04%	Vaccine Optimism
WTI	$43.57	$43.06	1.18%	
Natural Gas	$2.73	$2.71	0.63%	
Crack Spread	$9.34	$8.94	4.48%	
12-mo strip crack	$11.54	$11.28	2.26%	
Ethanol rack	$1.50	$1.50	-0.03%	
Metals				
Gold	$1,811.38	$1,837.86	-1.44%	
Silver	$23.17	$23.60	-1.83%	
Copper contract	$332.85	$327.80	1.54%	
Grains				
Corn contract	$ 424.75	$ 433.25	-1.96%	
Wheat contract	$ 602.00	$ 604.50	-0.41%	
Soybeans contract	$ 1,183.50	$ 1,191.50	-0.67%	
Shipping				
Baltic Dry Freight	1169	1148	21	
DOE inventory report				
	Actual	Expected	Difference	
Crude (mb)		0.0		
Gasoline (mb)		1.0		
Distillates (mb)		-2.5		
Refinery run rates (%)		0.60%		

Weather

The 6-10 and 8-14 day forecasts currently call for warmer temperatures for most of the country, with cooler temperatures in the Southeast. Dry conditions are expected throughout most of the country, with wet conditions expected along the New England coast.

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 20, 2020

In the aftermath of the election and favorable news on vaccine progress, we have seen a notable backup in interest rates. The 10-year T-note yield is flirting with 1%. In this report, we will examine the future path of long-duration interest rates.

We start with our 10-year T-note yield model.
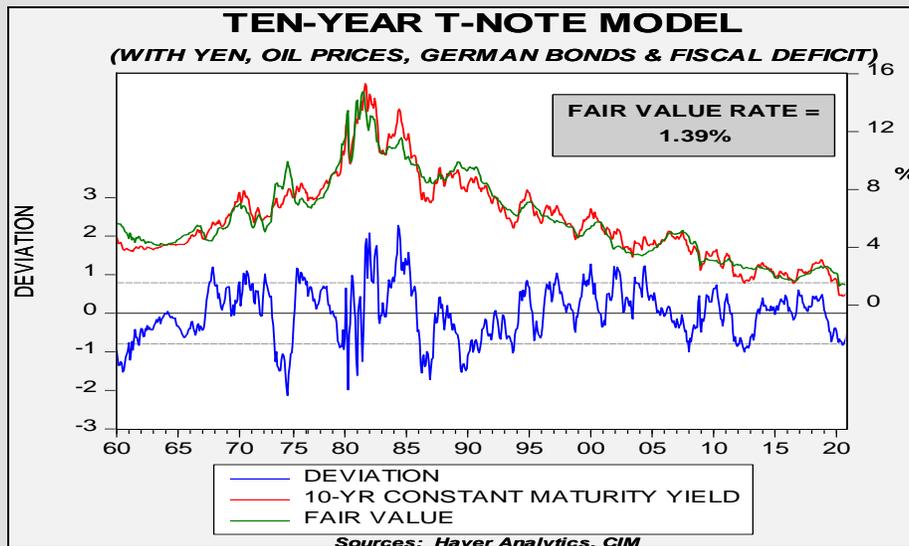
The model, which uses fed funds, the 15-year average of CPI (an inflation expectations proxy), the JPY/USD exchange rate, oil prices, German 10-year bond yields, and the fiscal deficit, suggests the fair value yield is near 140 bps. Although this fair value is historically low, it is well above the current rate of around 90 bps. In the absence of outside interference, it would not be unreasonable to expect yields to continue to drift higher. However, we do expect weaker economic growth in Q4 2020 and Q1 2021, so the pace of increases may slow.

However, the potential for outside intervention is high. The issue comes down to Federal Reserve policy. The U.S. central bank has hinted at the possibility of yield curve control. So far, the Fed has not taken concrete steps to implement fixing long-duration interest rates. But a rapid rise in such rates would not be welcome because it would have an adverse effect on the mortgage and housing markets.

SPREAD BETWEEN THE 30-YEAR MORTGAGE RATE AND
10-YEAR T-NOTE

Source: Haver Analytics
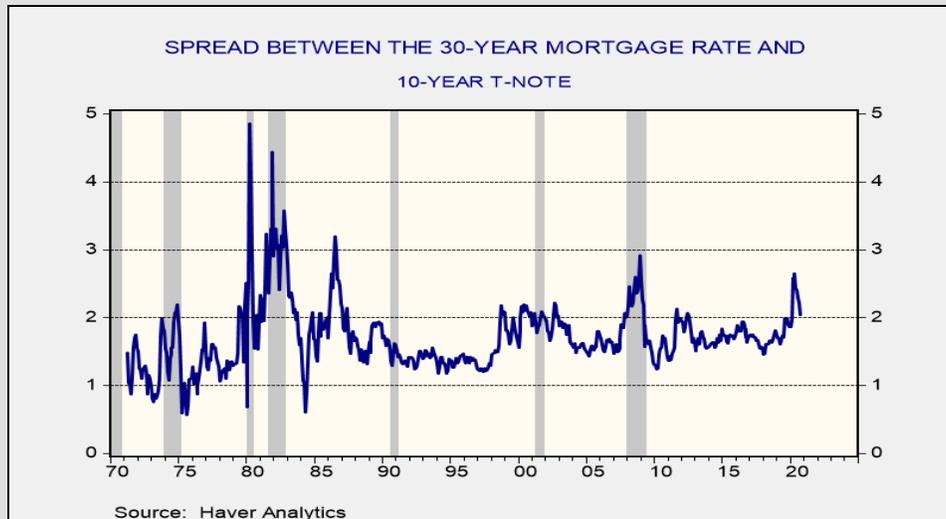
Mortgage rates, relative to the 10-year Treasury, spiked in April. The spread has narrowed since then but remains above 2%, which is elevated. If rising T-note rates lead to higher mortgage rates, it will tend to stifle part of the economy that is showing promise. This may lead the Fed to try to slow the rise in long-duration interest rates.

At the same time, a low interest rate regime tends to act as a headwind for banks. This factor may encourage the Fed to allow long-term rates to rise modestly. But we doubt that policymakers would be comfortable with a 10-year T-note yield in excess of 1.25%. If rates approach that level soon, we would not be surprised to see the Fed signal it isn't pleased with the development. And so, we may see a further rise in long-term interest rates, but a move to revert to the rate levels seen before 2008 is improbable.

Data Section

U.S. Equity Markets – (as of 11/23/2020 close)
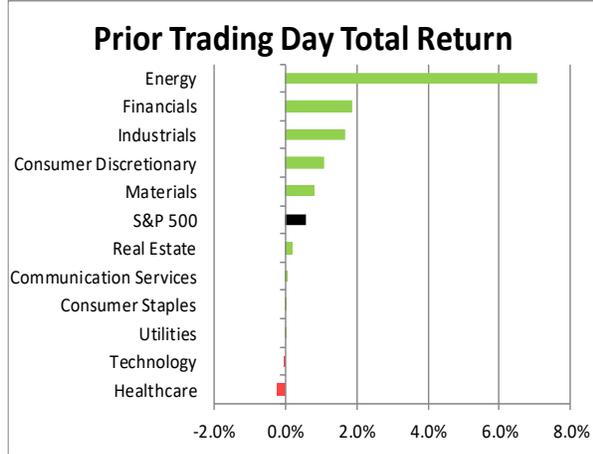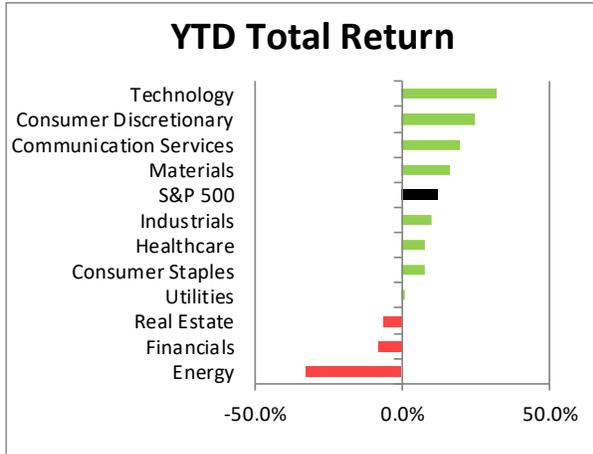
(Source: Bloomberg)

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.

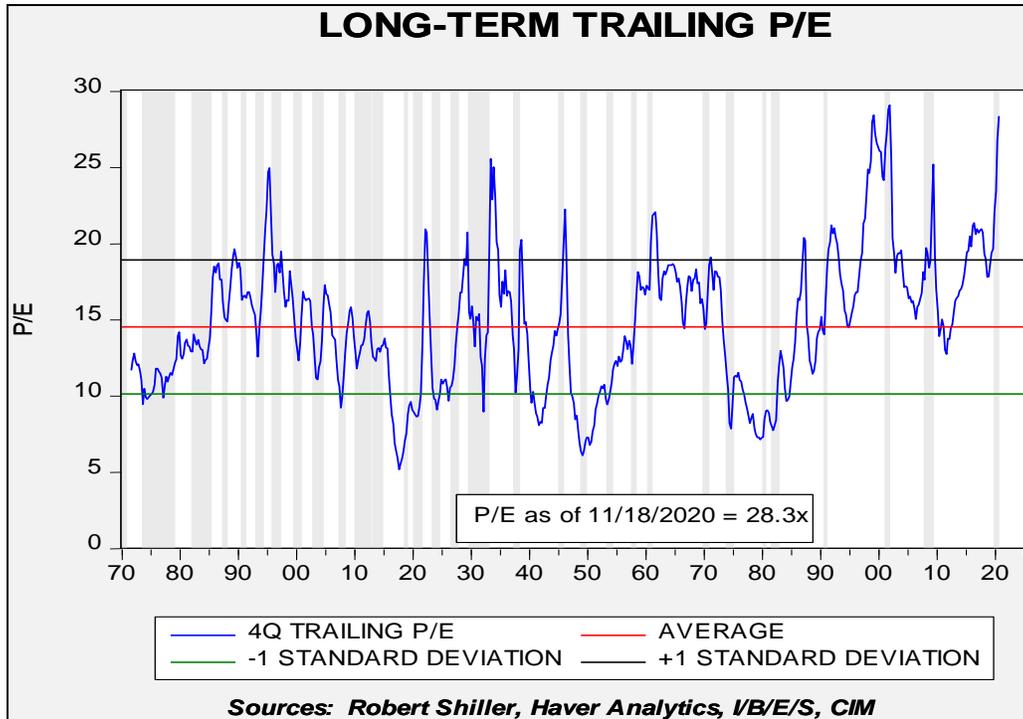**Asset Class Performance** – (as of 11/23/2020 close)
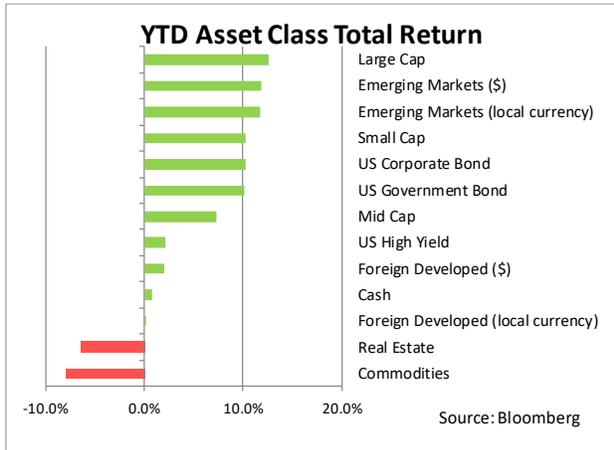
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 19, 2020

LONG-TERM TRAILING P/E

P/E as of 11/18/2020 = 28.3x

4Q TRAILING P/E — AVERAGE — -1 STANDARD DEVIATION — +1 STANDARD DEVIATION

Sources: Robert Shiller, Haver Analytics, I/B/E/S, CIM

Based on our methodology,[1] the current P/E is 28.3x, unchanged from last week.

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.