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: October 9, 2020—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 0.2% from its last close. In Asia, the MSCI Asia Apex 50 closed up 0.3%. Chinese markets were higher, with the Shanghai Composite up 1.7% and the Shenzhen Composite up 3.1%. U.S. equity index futures are signaling a higher open.

Good morning and happy Friday. Hurricane Delta is expected to make landfall in Louisiana today. U.S. equity futures continue to trend higher this morning. Since stimulus hopes are supporting the rally, we begin with commentary on the state of negotiations. World news is next; we cover EU sanctions on Russia, U.S. sanctions on Iran, rising tensions in Cyprus, North Korea's Saturday parade, and an update on Brexit. With China still working through its Golden Week holiday, news flow is unusually slow, but we are seeing the CNY rally. We wrap up comments with our COVID-19 update. Being Friday, a new Asset Allocation Weekly, podcast, and chart book are available. Here are the details:

Stimulus talks: Although the two sides continue to talk, we are getting so close to the election that it is about impossible to get something passed before November 3. In some respects, the basic outlines of a deal remain in place—House Democrats want a large fiscal program, while the Senate is much less enthused. The White House continues to vacillate between no talks to wanting a big deal. The current ploy is to offer small, targeted aid, e.g., to the airline or restaurant industries. House Democrats are willing to consider such aid but only if it is part of a large package. So, if the odds of a deal are so long, why are equities continuing to trade as if something is coming? The consensus is that whoever wins in November will make stimulus his first order of business. We agree with this idea, but getting an actual deal done may not be as easy as it looks. The lack of stimulus is having an impact on the economy; there is growing evidence that the Q3 bounce[1] is stalling and economists are now estimating that the labor market won't reach the last cycle peak until 2023. The inability to pass legislation will probably lead to a pause in growth. Equity markets are assuming that (a) the next government will be successful in lifting fiscal spending, and (b) the Fed will probably resume aggressive balance sheet expansion as the economy slows.

World news: Lots of news on this front. Here are the details:

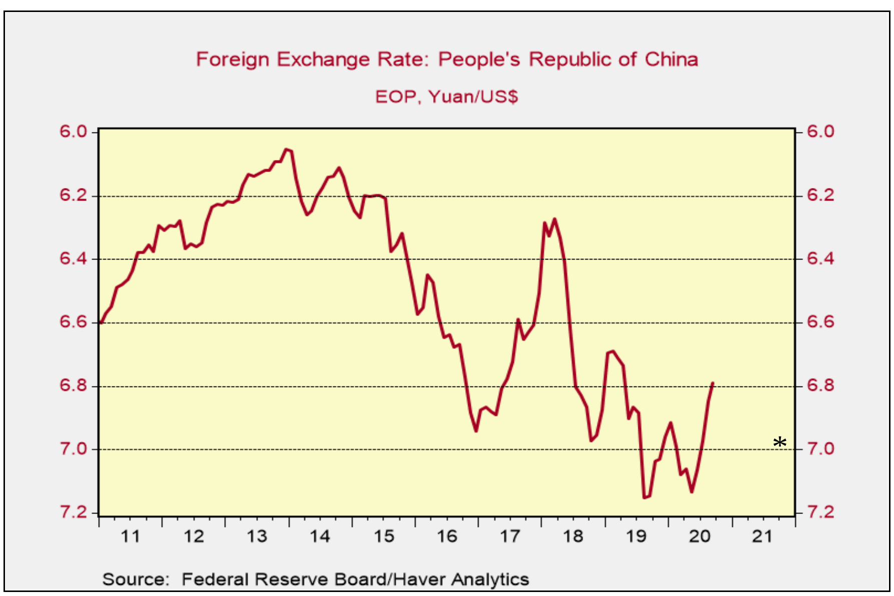
- The U.S. announced sanctions on 18 Iranian banks, including the Middle East Bank, which manages Iran's food and medicine imports. Although such imports are exempt

[1] Using the NY FRB Weekly Economic Index, the current projection for Q3 annualized GDP is +27.8%

from sanctions, including this bank will probably affect imports of these goods. We doubt that Tehran will retaliate in front of the U.S. elections, hoping for a thaw if Biden wins. In the meantime, China will likely expand its business with Iran as Beijing is less worried about American sanctions.

- In 2015, hackers launched a cyberattack on the German Bundestag; the EU is preparing sanctions against Russian military officers said to be involved in the action.
- Cyprus is divided; the northern part of the island is controlled by Turkish Cypriots, the south by Greek Cypriots. The northern government opened a section of beach that has been effectively closed for years. This is mostly a symbolic move, but it exacerbates tensions with the southern government and will likely involve the EU and Turkey.
- North Korea will hold a military parade on Saturday, marking the 75th anniversary of the founding of the Workers' Party. Analysts will be watching to see if Pyongyang unveils any new missiles and other hardware. There will be a special emphasis on indigenous hardware, including launch vehicles. Although we don't know for sure which candidate Kim Jong Un would prefer, we do note that last year state media referred to VP Biden as a "rabid dog" who should be "beaten to death."
- Although there is still little definitive news on EU/U.K. trade talks, optimism for an agreement remains elevated. Meetings between PM Johnson and EU Commission President von der Leyen have lifted hopes. In some respects, the parties had better negotiate a deal; MPs report that the majority of businesses are unprepared for a hard Brexit and are essentially wagering that the sides will reach an agreement

China: The CNY is rallying. China's economic recovery is outpacing much of the rest of the world, and it appears that it has been able to manage the virus.



This chart shows the CNY/USD exchange rate on an inverted scale; a rising number indicates a stronger CNY. We have placed a star at the current exchange rate. Interestingly enough, a stronger currency will make tariffs increasingly effective. Note that since early 2018, when the

U.S. began implementing widespread tariffs on China, the CNY depreciated, offsetting much of the effect of the tariffs. The recent recovery in the Chinese currency will tend to enhance the trade impact of the tariffs.

COVID-19: The number of reported cases is 36,565,929 with 1,062,636 deaths and 25,484,014 recoveries. In the U.S., there are 7,607,890 confirmed cases with 212,789 deaths and 3,021,252 recoveries. 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 is showing an increase in states with rising infections; 13 states are showing falling infections, while 38 states and the District of Columbia are exhibiting rising infections.

Virology:

- The *WSJ* has an investigative report showing that COVID-19 was circulating in the U.S. as early as mid-January, well before officials were able to confirm that infections were taking place in real time. This data makes sense. The first cases appeared in California, a state well connected to China. New York, New Jersey, Florida, and Texas were close behind. All four are globally integrated and thus would be vulnerable to foreign transmission. Tomas Pueyo, who has been commenting on the pandemic and penned the famous "The Hammer and the Dance," recently wrote a *NYT* op-ed calling for stricter border controls. Simply put, if you want to contain the virus, don't let outsiders in. This prescription is a direct threat to globalization, but Pueyo makes a strong case for "fences." The *WSJ* report tends to confirm Pueyo's position.
- The data on the virus is becoming increasingly clear; young people are more likely to contract the virus, but older people are more likely to die from it. Essentially, the young have become a vector for their grandparents.
- There are a number of firms testing antibody treatments, including some with high concentrations of these antibodies.
- The WHO has a program to try to distribute vaccines to less developed nations. China has decided to join the effort, most likely as a public relations move.

U.S. Economic Releases

There were no domestic releases prior to the publication of this report. The table below lists the economic releases scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	Wholesale Inventories	m/m	Aug	0.5%	0.5%	**
10:00	Wholesale Trade Sales	m/m	Aug		4.6%	**
Fed Speakers or Events						
No speakers or events scheduled						

Foreign Economic News

We monitor numerous global economic indicators on a continuous basis. The most significant international news that was released overnight is outlined below. Not all releases are equally significant, thus we have created a star rating to convey to our readers the importance of the various indicators. The rating column below is a three-star scale of importance, with one star being the least important and three stars being the most important. We note that these ratings do change over time as economic circumstances change. Additionally, for ease of reading, we have also color-coded the market impact section, which indicates the effect on the foreign market. Red indicates a concerning development, yellow indicates an emerging trend that we are following closely for possible complications and green indicates neutral conditions. We will add a paragraph below if any development merits further explanation.

	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
China	Caixin China PMI Composite	m/m	Sep	54.5	55.1		**	Equity and bond neutral
	Caixin China PMI Services	m/m	Sep	54.8	54.0	54.3	**	Equity and bond neutral
Japan	Labor Cash Earnings	y/y	Aug	-1.3%	-1.3%	-1.2%	**	Equity and bond neutral
	Real Cash Earnings	y/y	Aug	-1.4%	-1.6%	-1.4%	**	Equity and bond neutral
	Household Spending	y/y	Aug	-6.9%	-7.6%	-6.7%	**	Equity and bond neutral
Australia	Home Loans Value	m/m	Aug	12.6%	8.9%	1.9%	**	Equity bullish, bond bearish
	Owner-Occupier Loan Value	m/m	Aug	13.6%	10.7%	-1.0%	**	Equity bullish, bond bearish
	Investor Loan Value	m/m	Aug	9.3%	3.5%		**	Equity and bond neutral
New Zealand	ANZ Truckometer Heavy	m/m	Sep	4.1%	-6.5%		**	Equity bullish, bond bearish
Europe								
France	Industrial Production	m/m	Aug	1.3%	3.8%	1.7%	***	Equity and bond neutral
	Manufacturing Production	m/m	Aug	1.0%	4.5%	2.4%	***	Equity and bond neutral
Italy	Industrial Production	m/m	Aug	7.7%	7.4%	1.4%	***	Equity and bond neutral
UK	Monthly GDP	m/m	Aug	2.1%	6.6%	4.6%	***	Equity and bond neutral
	Industrial Production	m/m	Aug	0.3%	5.2%	2.5%	***	Equity bearish, bond bullish
	Manufacturing Production	m/m	Aug	0.7%	6.3%	3.0%	***	Equity bearish, bond bullish
	Construction Output	m/m	Aug	3.0%	17.6%	5.0%	**	Equity and bond neutral
	Index of Services	m/m	Aug	7.1%	-8.1%	7.0%	**	Equity bullish, bond bearish
	Trade Balance GBP/Mn	m/m	Aug	£1364m	£1074m	£0m	**	Equity bullish, bond bearish
Russia	Money Supply Narrow Def	w/w	2-Oct	13.30t	13.27t		*	Equity and bond neutral
AMERICAS								
Mexico	CPI	y/y	Sep	4.0%	4.1%	4.1%	***	Equity bullish, bond bearish
Canada	Housing Starts	m/m	Sep	209.0k	262.4k	240.0k	***	Equity and bond neutral
Brazil	Retail Sales	y/y	Aug	6.1%	5.5%	6.0%	**	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)	23	23	0	Down
3-mo T-bill yield (bps)	9	9	0	Neutral
TED spread (bps)	14	14	0	Up
U.S. Libor/OIS spread (bps)	8	8	0	Up
10-yr T-note (%)	0.77	0.79	-0.02	Neutral
Euribor/OIS spread (bps)	-51	-51	0	Neutral
EUR/USD 3-mo swap (bps)	10	10	0	Down
Currencies	**Direction**			
dollar	Down			Down
euro	Up			Up
yen	Up			Up
pound	Flat			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	$42.92	$43.34	-0.97%	
WTI	$40.71	$41.19	-1.17%	
Natural Gas	$2.67	$2.63	1.56%	
Crack Spread	$9.67	$9.95	-2.82%	
12-mo strip crack	$10.56	$10.80	-2.18%	
Ethanol rack	$1.53	$1.53	0.11%	
Metals				
Gold	$1,915.94	$1,893.82	1.17%	
Silver	$24.31	$23.84	1.99%	
Copper contract	$307.00	$304.20	0.92%	
Grains				
Corn contract	$ 391.25	$ 387.00	1.10%	
Wheat contract	$ 602.75	$ 595.25	1.26%	
Soybeans contract	$ 1,060.00	$ 1,050.00	0.95%	
Shipping				
Baltic Dry Freight	1970	2044	-74	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	0.5	-1.2	1.7	
Gasoline (mb)	-1.4	-0.5	-0.9	
Distillates (mb)	-1.0	-1.1	0.1	
Refinery run rates (%)	1.30%	0.05%	1.25%	
Natural gas (bcf)	75.0	73.0	2.0	

Weather

The 6-10 and 8-14 day forecasts currently call for warmer temperatures for most of the country, with cooler temperatures in the eastern half. Dry conditions are expected for most of the country, with wet conditions in New England. Hurricane Delta is currently moving throughout the Gulf of Mexico.

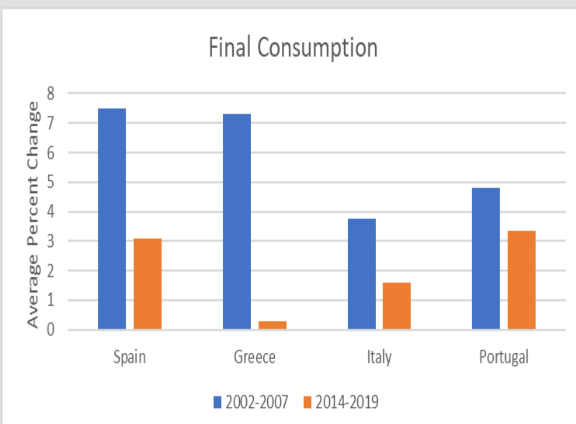
Asset Allocation Weekly

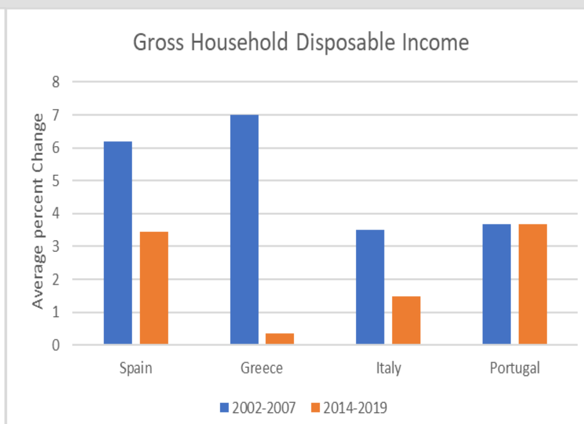
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday. Note that this report is also offered as a separate document on our website.

October 9, 2020

Later this month, the European Union will begin auctioning off bonds to facilitate its economic recovery from the pandemic. In all, the EU plans to raise up to €850 billion over the next 5-7 years, with €750 billion still awaiting approval from the European Parliament. If approved, as we expect, the funds will be backed by the full faith and credit of the European Union members and will come in two parts, the Support to mitigate Unemployment Risks in an Emergency (SURE) program and the Next Generation EU (NGEU) program.

The latter will be aimed disproportionately at supporting the most vulnerable and indebted countries within the union such as Greece, Italy, Portugal, and Spain (GIPS). If successful, this program could provide these countries with a needed boost in consumption and income, something these countries have lacked since the start of the financial crisis.





Over the past few years, the GIPS countries were forced to run an export-focused growth model to help repay loans from their respective bailout agreements. This reliance on exports allowed GIPS to boost their internal savings, which made these countries more solvent. However, despite the improvement in internal savings, the removal of labor protections, fiscal protections, and higher taxes in these countries led to deteriorating living conditions and strained public spending. As a result, prior to the pandemic most of these countries were, by design, growing slowly.

In addition, by having an export-focused growth model, GIPS were sensitive to shocks to the global economy. When the pandemic hit, international travel and global trade collapsed. Lockdown and travel restrictions decimated tourism, which provides a significant source of revenue for these countries, and halted production of manufactured goods. Additionally, the drop in world growth has stunted the demand for global exports. Although the world economy has started to recover, it is unclear when global trade and travel will normalize.

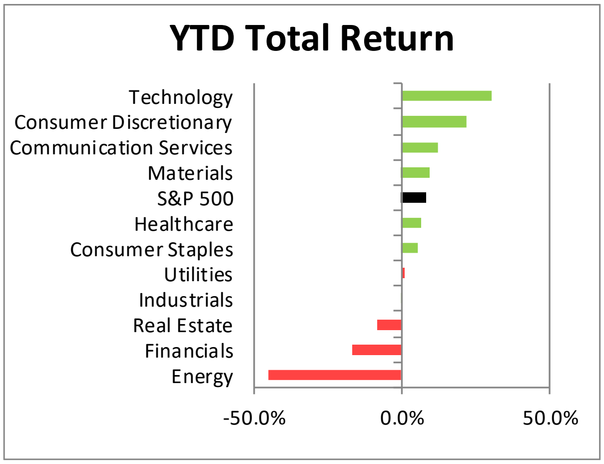
With citizens unwilling to undergo additional austerity and GIPS lacking monetary independence, the recovery fund will likely ease some political angst, which has led to increasing populism in Europe. Even before the pandemic, GIPS were struggling to find ways to appease their citizens who have grown tired of constrained growth. In fact, it is possible that if the EU didn't ease some of its restraints some of these countries would have withdrawn from the EU and the Eurozone. Fears of political unrest that could undermine the integrity of the EU led the richer northern European nations to agree to the bailout package.

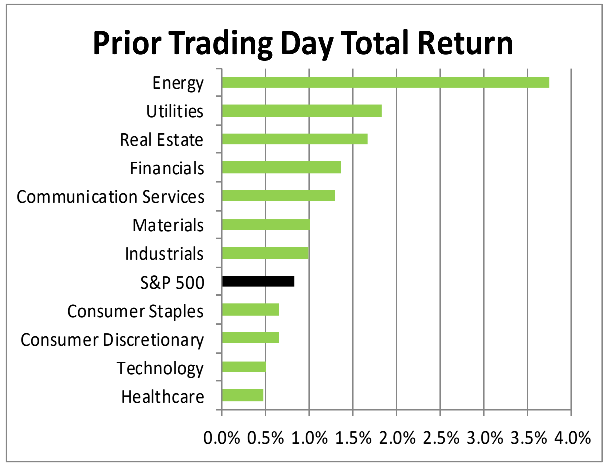
This new spending will allow these countries to boost investment in infrastructure projects, healthcare, and digital technology. Additionally, the fund has also set aside money to invest in green technology. Given the lack of consumption over the past few years due to the restrictions of deficit, these countries have been limited in their ability to invest in their respective economies. The €750 billion of funds, of which €390 billion will be used as grants, will likely provide a notable boost in GDP.

The funds are expected to be disbursed in 2021 and in 2022. In the meantime, countries have access to the €100 billion SURE program to help support local businesses and provide unemployment benefits. That being said, assuming the money from the recovery fund is used wisely, we expect the stimulus could make European equities attractive as we believe that years of austerity have led to a lot of pent-up demand in the GIPS countries. As a result, consumer discretionary and real estate could be of some interest.

Data Section

U.S. Equity Markets – (as of 10/8/2020 close)

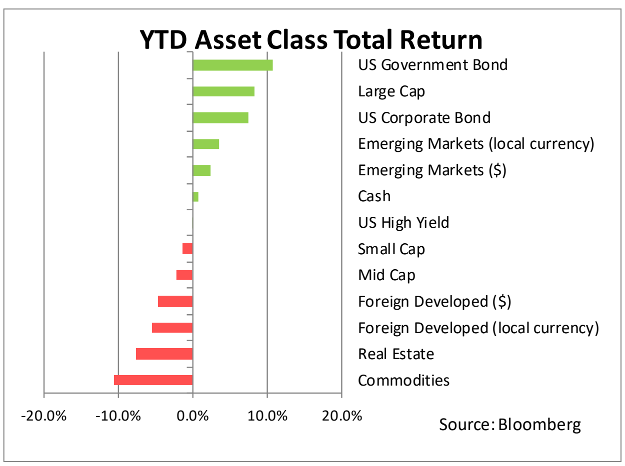




(Source: Bloomberg)

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 10/8/2020 close)

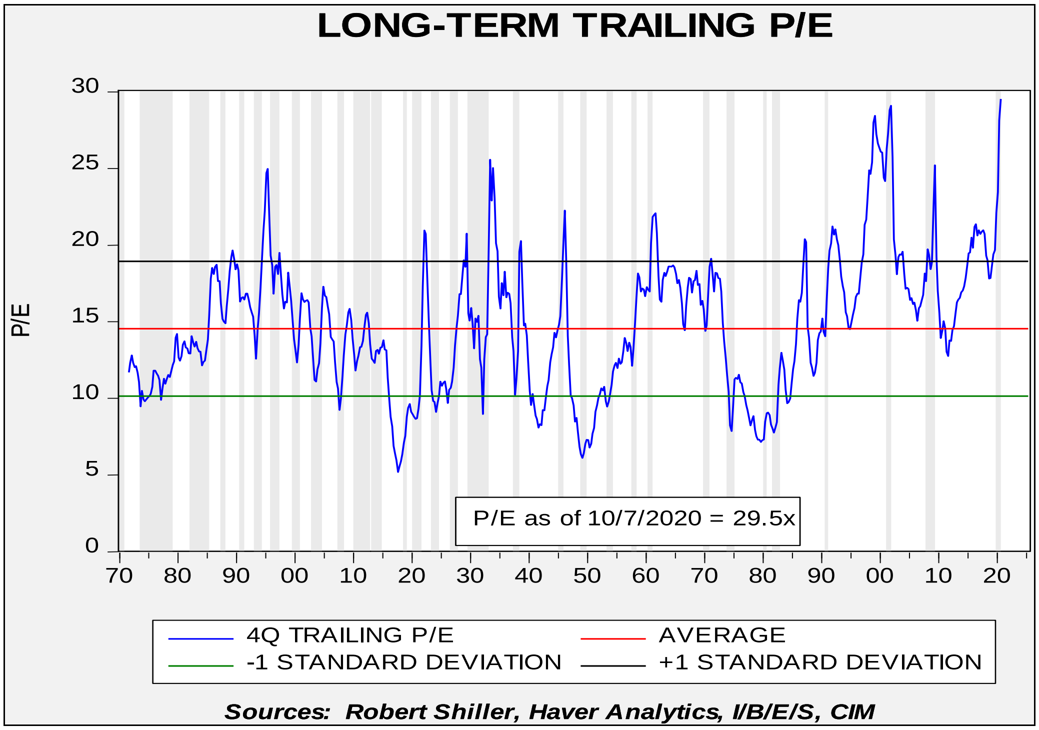


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

Asset classes are defined as follows: Large Cap (S&P 500 Index), Mid Cap (S&P 400 Index), Small Cap (Russell 2000 Index), Foreign Developed (MSCI EAFE (USD and local currency) Index), Real Estate (FTSE NAREIT Index), Emerging Markets (MSCI Emerging Markets (USD and local currency) Index), Cash (iShares Short Treasury Bond ETF), U.S. Corporate Bond (iShares iBoxx $ Investment Grade Corporate Bond ETF), U.S. Government Bond (iShares 7-10 Year Treasury Bond ETF), U.S. High Yield (iShares iBoxx $ High Yield Corporate Bond ETF), Commodities (Bloomberg total return Commodity Index).

P/E Update

October 8, 2020



Based on our methodology,[2] the current P/E is 29.5x, up 1.4x from last week. As we roll to Q4, the four-quarter sum is covering all of 2020, no longer including any of 2019. Given the decline in earnings this year, the combination of falling earning and high equity values has led to a spike in the multiple. It is not at all unusual for a multiple spike around recessions. But, in Q1, when we roll off Q1 2020, we will see a sharp rise in the rolling four quarter earnings numbers, which will likely lead to a fall in the multiple.

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[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.