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 21, 2020—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.8% from its last close. In Asia, the MSCI Asia Apex 50 closed up 0.5%. Chinese markets were lower, with the Shanghai Composite down 0.1% from the prior close and the Shenzhen Composite down 1.1%. U.S. equity index futures are signaling a flat open. With 71 companies having reported, the S&P 500 Q3 earnings stand at $34.20, higher than the $33.68 forecast for the quarter. The forecast reflects a 21.0% decrease from Q3 2019 earnings. Thus far this quarter, 84.5% of the companies have reported earnings above forecast, while 15.5% have reported earnings below forecast.

Our *Daily Comment* today again opens with coronavirus news, based on investors' strong interest in negotiations over a possible new pandemic relief bill out of Congress. The big news there is simply that the talks are continuing. After the pandemic news, we provide a recap of some foreign developments on what appears to be a pretty slow news day so far.

COVID-19: Official data show confirmed cases have risen to 40,877,528 worldwide, with 1,126,251 deaths. In the United States, confirmed cases rose to 8,275,168, with 221,083 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 topped 60,000 yesterday, lifting the seven-day moving average to 58,397 and the 14-day moving average to 53,970. The average of daily deaths from the virus held steady at approximately 700, but the number of hospitalizations rose to a two-month high of 39,230.
- In a report yesterday, the CDC said the pandemic has left about 299,000 more people dead in the U.S. than would be expected in a typical year. According to the report, about two-thirds of the excess deaths can be attributed directly to COVID-19, while the rest reflect other causes.
- Studies in Germany and Norway, as well as two reviews focusing on education globally, suggest widespread school closures would have a limited effect on curbing the pandemic. The research adds to evidence that schools are not necessarily a major vector in spreading the coronavirus. That's probably bullish for equities because it bolsters the argument for reopening schools, which would help bolster economic activity and allow more people to go back to work.

- Given the importance of the vaccines under development, health authorities, hospitals and pharmaceutical companies are storing them in secure, undisclosed locations and taking other steps to protect the shots from theft.
- California's Health and Human Services Secretary, Mark Ghaly, has announced guidelines that said large theme parks can reopen at limited capacity once nearby community spread of the new coronavirus has been officially deemed "minimal." However, Walt Disney Co. (DIS, 124.95) blasted the protocols on the grounds that they would significantly complicate the company's efforts to reopen Disneyland.

Economic Impacts

- New data on labor market dynamics during September suggest the decline in the unemployment rate last month came as much from jobless people giving up and dropping out of the labor force as from people finding new work. The figures can be volatile. Problems in the seasonal adjustment process could be a source of inaccuracy, but the data is still consistent with other indicators suggesting the robust post-lockdown recovery to date is probably losing steam.
- New York Governor Cuomo warned that his state's governments and authorities will face $59 billion of revenue shortfalls through 2022 because of the pandemic. According to Cuomo, the shortfall means that services will be cut, and taxes will increase if Congress doesn't pass another relief package.

U.S. Policy Response

- The Trump administration and House Speaker Pelosi yesterday said they had made enough progress on a new coronavirus relief deal to warrant further talks on Wednesday, and White House Chief of Staff Mark Meadows suggested the two sides are now aiming for an agreement by the weekend. However, that timeline may not be enough to allow a bill to be passed before the November 3 election.
    - According to Pelosi, two policy issues remained the biggest sticking points: how much funding to include for state and local governments, and what kind of legal protections to provide businesses and other entities operating during the pandemic.
    - If a deal can be reached between the Trump administration and the House, the prospect of a roughly $2 trillion package has galvanized new opposition from Senate Republicans.
    - It's now increasingly unlikely that a deal will get passed through Congress before the election. Investors appear to be taking solace in the apparent seriousness of the ongoing talks and/or the likelihood of a significant new stimulus bill shortly after the polling is done. However, it's important to remember that action could be held up by a contested election and the need to seat new legislators in January.

Foreign Policy Responses

- With governments around the world now reluctant to reimpose draconian, nationwide economic lockdowns to combat resurgent infections, it's becoming clear that imposing targeted, localized lockdowns is no picnic, either. One problem is that the local communities targeted for lockdowns can argue they're being discriminated against. In the U.K., that has prompted the national government to offer compensation for those communities, touching off difficult negotiations and tempting officials to game each other. This week, the government forced the Greater Manchester government to accept the highest level of lockdown after compensation talks fizzled. Today, South Yorkshire in northern England agreed to enter the highest level of lockdown in return for £41 million to support businesses that will have to close and extra council funding to tackle the spread of the virus. All in all, it sounds like a mess that underlines the importance of finding safe and effective vaccines to tackle the pandemic.

Financial Market Responses

- With China recovering from the pandemic much faster than most other countries, the renminbi has appreciated to 6.64 per dollar so far today. That marks the currency's strongest level in more than two years, which could increase pressure on Beijing to arrest the rapid rise.

European Union-United Kingdom: Seeking to break the logjam in EU-U.K. negotiations for a post-Brexit trade deal, the EU's top Brexit negotiator, Michel Barnier, offered assurances that a deal was "within reach" and that the EU was still willing to compromise if needed to get it in place before the current temporary deal runs out at the end of the year. Just as important, the British government responded favorably to Barnier's comment. That keeps alive the chance of a deal that would avoid a "hard Brexit," which should be positive for British and EU stocks today.

Nagorno-Karabakh: U.S. Secretary of State Pompeo announced that he will host the foreign ministers of Armenia and Azerbaijan in Washington on Friday in an effort to settle the fighting over Azerbaijan's ethnic-Armenian controlled enclave of Nagorno-Karabakh. The meeting will come two days after the Armenians and Azeris meet today with Russian President Putin in Moscow, but the real focus will probably be on whether the U.S. can put pressure on Turkey to tone down its support for the Azeris.

Nigeria: Several people were killed as Nigerian soldiers opened fire on protestors demonstrating against police brutality in the major oil-producing nation. Because of Nigeria's large role in the world's oil supply, any worsening in the violence that might threaten the country's oil production could put upward pressure on global crude prices.

U.S. Economic Releases

For the week ending October 16, mortgage applications fell 0.6% from the prior week. Applications for purchases fell 2.1% from the prior week, while refinancing applications rose 0.2%. The average 30-year fixed-rate rose by 2 bps from 3.00% to 3.02%.

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

Economic Releases		
No economic releases today		
Fed Speakers or Events		
	Speaker or event	**District or position**
10:00	Loretta Mester Discusses Monetary Policy and Virtual Event	President of the Federal Reserve Bank of Cleveland
12:00	Neel Kashkari Discusses Constitutional Amendement for Students	President of Federal Reserve Bank of Minneapolis
12:00	Robert Kaplan Speaks to Houston Hispanic Chamber of Commerce	President of the Federal Reserve Bank of Dallas
13:00	Thomas Barkin Takes Part in Panel on Rural Virginia's Recovery	President of the Federal Reserve Bank of Richmond
13:00	Randal Quarles Takes Part in Panel on Financial Stabiliyu	Federal Reserve Vice Chairman of Supervision
14:00	U.S. Federal Reserve Beige Book	Federal Reserve Board
16:45	James Bullard Discusses U.S. Economy	President of the Federal Reserve Bank of St. Louis

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.

ASIA-PACIFIC								
Japan	Supermarket Sales	y/y	Sep	-4.6%	3.3%		**	Equity and bond neutral
Australia	Westpac Leading Index	m/m	Sep	0.2%	0.5%		**	Equity and bond neutral
New Zealand	Credit Card Spending	y/y	Sep	-9.9%	-11.9%		**	Equity and bond neutral
Europe								
UK	CPI	y/y	Sep	0.5%	0.2%	0.6%	**	Equity bullish, bond bearish
	CPI Core	y/y	Sep	1.3%	0.9%	1.3%	**	Equity bearish, bond bullish
	RPI	m/m	Sep	0.3%	-0.3%	0.3%	**	Equity and bond neutral
	RPI Ex Mort Int.Payments	y/y	Sep	1.4%	0.8%	1.4%	**	Equity and bond neutral
	PPI Input NSA	y/y	Sep	-3.7%	-5.8%	-5.40%	**	Equity and bond neutral
	PPI Output NSA	y/y	Sep	-0.9%	-0.9%	-0.9%	**	Equity and bond neutral
	PPI Output Core NSA	y/y	Sep	0.3%	0.0%	0.1%	***	Equity and bond neutral
	Public Finances (PSNCR)	m/m	Sep	31.5b	25.7b		**	Equity and bond neutral
	Central Government NCR	m/m	Sep	25.2b	21.7b		**	Equity and bond neutral
	Public Sector Net Borrowing	m/m	Sep	35.4b	35.2b	32.4b	**	Equity and bond neutral
	PSNB ex Banking Groups	m/m	Sep	36.1b	35.9b	33.6b	**	Equity and bond neutral
	House Price Index	y/y	Aug	2.5%	2.3%	3.0%	**	Equity and bond neutral
Switzerland	Money Supply M3	m/m	Sep	4.1%	4.0%		**	Equity and bond neutral
AMERICAS								
Mexico	Unemployment Rate	m/m	Sep	5.1%	5.2%	5.3%	***	Equity and bond neutral
Canada	Teranet /National Bank	y/y	Sep	6.7%	5.7%		**	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	22	0	Down
3-mo T-bill yield (bps)	9	10	-1	Neutral
TED spread (bps)	13	12	1	Up
U.S. Libor/OIS spread (bps)	8	8	0	Up
10-yr T-note (%)	0.78	0.77	0.01	Neutral
Euribor/OIS spread (bps)	-51	-51	0	Neutral
EUR/USD 3-mo swap (bps)	12	11	1	Down
Currencies	**Direction**			
dollar	Down			Down
euro	Up			Up
yen	Down			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	$42.45	$43.16	-1.65%	Economic Pessimism
WTI	$40.98	$41.70	-1.73%	
Natural Gas	$2.98	$2.91	2.13%	
Crack Spread	$7.73	$8.26	-6.35%	
12-mo strip crack	$9.76	$9.68	0.80%	
Ethanol rack	$1.59	$1.59	0.30%	
Metals				
Gold	$1,916.02	$1,906.95	0.48%	
Silver	$24.95	$24.64	1.25%	
Copper contract	$317.80	$314.80	0.95%	
Grains				
Corn contract	$ 411.75	$ 408.75	0.73%	
Wheat contract	$ 633.50	$ 632.00	0.24%	
Soybeans contract	$ 1,073.00	$ 1,063.75	0.87%	
Shipping				
Baltic Dry Freight	1350	1409	-59	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		0.5		
Gasoline (mb)		-1.5		
Distillates (mb)		-2.0		
Refinery run rates (%)		0.90%		
Natural gas (bcf)		52.0		

Weather

The 6-10 and 8-14 day forecasts currently call for cooler temperatures for most of the country, with warmer temperatures on the East and West Coasts. Wet conditions are expected for most of the country, with dry conditions expected in the Southwest. Hurricane Epsilon is expected to touch down in Bermuda on Thursday.

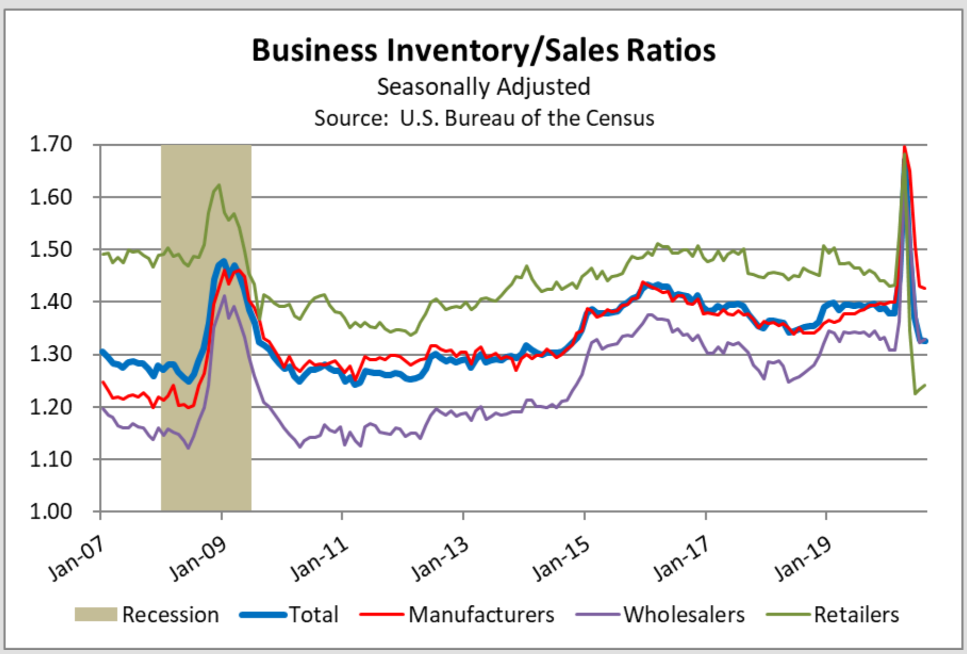
Asset Allocation Weekly

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 16, 2020

Of all the different economic indicators published by the government and private entities, one of the least followed, but potentially very enlightening, is the Census Bureau's monthly report on business inventories. The report tracks the value of inventories on hand each month at the retail, wholesale, and manufacturing levels and compares those values to the amount of sales at each level. The resulting inventory/sales ratio can help us predict business behavior in the coming months. For example, if the inventory/sales ratio is higher than normal, it may mean firms are saddled with excess stockpiles and will cut prices or hold back on new orders to their suppliers. When the inventory/sales ratio is lower than normal, it could portend increased orders and higher prices. The inventory/sales ratio fluctuates over time because of changes in technology and management practices, but it can still provide important insights over the short term.

As shown by the heavy blue line in the chart below, the overall inventory/sales ratio fluctuated between about 1.35 and 1.40 during the five years leading up to the coronavirus pandemic. When the pandemic shutdowns hit, many firms saw their sales plummet, leaving their inventories sitting on shelves in their shuttered stores or warehouses. The overall inventory/sales ratio surged to 1.67 in April. With the recent reopening of most of the economy, however, the overall ratio has now fallen to 1.33. Since the current ratio is lower than in the recent past, it may suggest firms would be eager to rebuild their stockpiles if they became more confident that the economic recovery will continue. Lean inventories may also encourage price hikes or discourage price cuts, helping to alleviate fears of excessively low inflation.

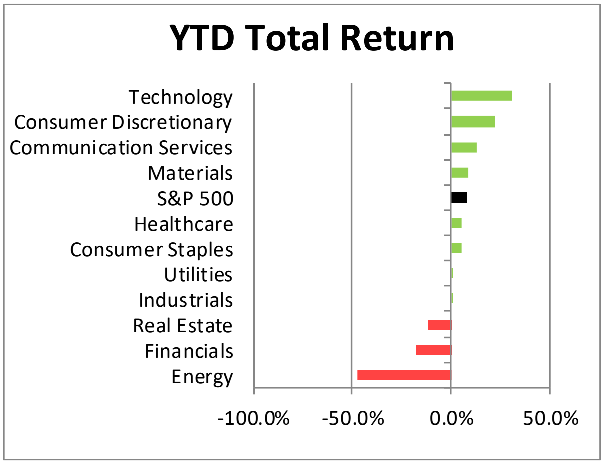


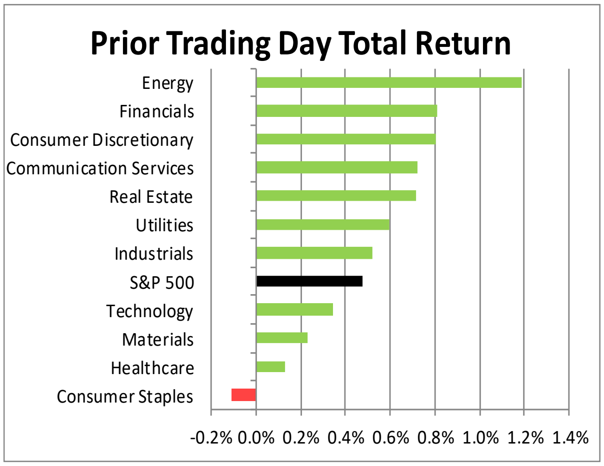
A close look at the detail in the chart is even more encouraging. Note that before the pandemic, retailers typically carried $1.45 to $1.50 of inventory for every dollar of monthly sales. In August, however, retailers had just $1.24 of inventory for every dollar of sales, marking their lowest inventory/sales ratio in at least 25 years. If you've finally started to go out shopping again after the lockdowns, you may have noticed that many stores have very little inventory on their shelves. In part, that may reflect retail managers' lack of confidence in future demand. It could also be partly unplanned, reflecting an inability to get new inventories because of supply chain disruptions or reduced financing by skeptical lenders. In any case, it's hard to believe retailers would keep their stockpiles this low when the economy returns to normal. Rather, one would expect an eventual inventory restocking and strongly rebounding orders.

In contrast with the situation for retailers, factory inventories are a bit high compared with recent history. Rather than carrying inventories worth $1.38 to $1.40 per dollar of sales, as they did before the pandemic, manufacturers recently had about $1.43 of inventory per dollar of sales. That means that if retail restocking leads to a rebound in manufacturing orders, there could be a modest delay in new production (since the wholesale inventory/sales ratio is right at its recent average, we are ignoring it for purposes of this analysis). All the same, it probably wouldn't take long for the small excess in factory stockpiles to get used up. Manufacturers and raw material suppliers might need to ramp up production quickly, which in turn could require faster hiring. It's probably too much to say the economy is a coiled spring ready to snap back to normal. We still think it will take some time to get over the drag from the pandemic. All the same, even a gradual normalization process could produce a big acceleration in factory activity, helping boost corporate profits and supporting further stock market gains.

Data Section

U.S. Equity Markets – (as of 10/20/2020 close)

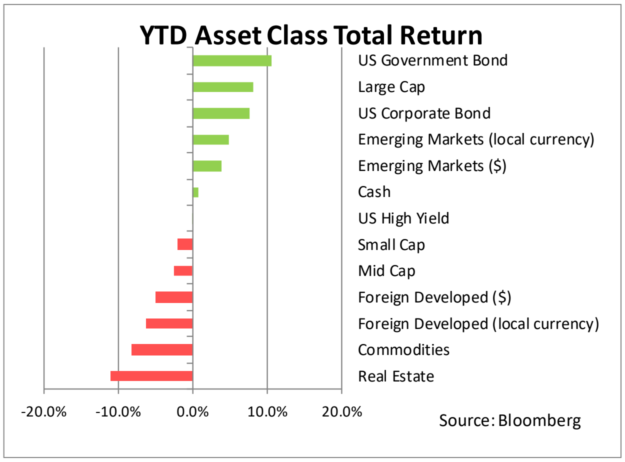




(Source: Bloomberg)

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 10/20/2020 close)

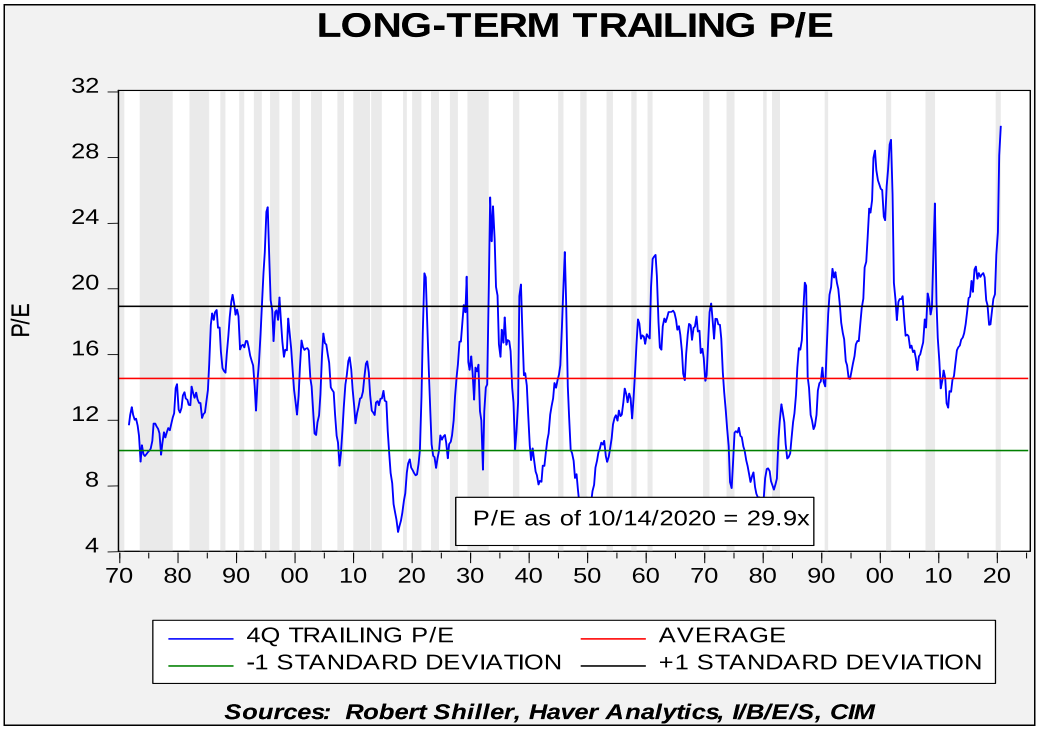


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 15, 2020



Based on our methodology,[1] the current P/E is 29.9x, up 0.4x from last week. Although earnings have generally been stronger than expected, index values have anticipated the improvement, leading to a lofty multiple. It is not uncommon for P/Es to rise during recessions but, as the chart shows, the current multiple is elevated. Given the low level of interest rates, this isn't a huge concern, although it bears watching.

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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.