Confluence Investment Management

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 26, 2020—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is down 2.0% from its last close. In Asia, the MSCI Asia Apex 50 closed down 0.1%. Chinese markets were mixed, with the Shanghai Composite down 0.8% from the prior close and the Shenzhen Composite up 0.5%. U.S. equity index futures are signaling a lower open. With 134 companies having reported, the S&P 500 Q3 earnings stand at $34.90, higher than the $33.68 forecast for the quarter. The forecast reflects a 21.0% decrease from Q3 2019 earnings. Thus far this quarter, 85.8% of the companies have reported earnings above forecast, while 12.7% have reported earnings below forecast.

It's Monday, the last week of October. U.S. equity futures are weaker this morning. A big reason has been a global resurgence of the virus. It leads off our coverage this morning. Next up is international news. In this week's Asset Allocation Weekly, we discussed how the economy has been shaped by the pandemic; the bottom line is that there has been a definite shift to goods and away from face-to-face services. We update the economy next. And finally, we close with China news, where leaders are meeting to discuss the 14th 5-year plan. Here are the details:

COVID-19: The number of reported cases is 43,117,883 with 1,154,703. In the U.S., there are 8,636,995 confirmed cases with 225,239 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:

- Europe is reeling from a surge in new cases—here are the details:
  - Spain has declared a national emergency and a nationwide curfew.
  - Italy has adopted new measures, including early closing hours for restaurants and the closure of gyms and cinemas.
  - Brussels has extended its curfew and closed arenas and cultural venues. It has also banned trick or treating.
  - Sweden, who famously avoided national lockdowns, isn't completely immune; the region of Uppsala has instituted a voluntary lockdown.
- Meanwhile, the U.S. is also seeing an upswing in cases. The majority of new cases are occurring away from the coasts, for the most part.
  - VP Pence's office has reported that several members have tested positive.

    - In an interview over the weekend, Chief of Staff Meadows indicated that the Federal government is not planning any new national measures. To a great extent, his comments likely reflect the fact that there is widespread fatigue over new measures.
- The Oxford/AstraZeneca (AXNCF, USD, 105.21) vaccine trial reports a robust response from its vaccine on the elderly, which is good news. Those over 60 are particularly vulnerable to the disease, so triggering an immune response from this age group would tend to reduce fatalities from COVID-19.

International news: There was a plethora of international news over the weekend. Here is the latest:

- The U.S. has brokered a ceasefire between Azerbaijan and Armenia; although one earlier this month failed almost immediately, so far, this one does appear to be holding for now. We view this ceasefire as a temporary halt in hostilities.
- President Erdogan of Turkey has suggested that President Marcon of France may need "mental" treatment after the latter supported measures to uphold France's secularist laws, which allow for actions that Muslims view as offensive. France recalled its ambassador in response to the remarks. Erdogan has called for a boycott of French goods.
- Last week, DEA agents arrested the former defense minister of Mexico on drug charges. The U.S. has evidence that General Salvador Cienfuegos aided drug cartels operating in Mexico. Despite this evidence, State and Justice Department officials worry that the arrest may severely damage relations and undermine future U.S./Mexican cooperation on illicit drugs.
- Although Sudan did not give Israel full diplomatic recognition, it indicated it was willing to have talks with Israel on improving economic relations. The U.S. took Sudan off the State Sponsors of Terrorism list. Still, issues surrounding the bombing of the USS Cole and Sudan's role in supporting Osama bin Laden in the attacks of 9/11 have not been fully resolved. Thus, there was some movement toward greater recognition of Israel in the Middle East, but the one with Sudan remains complicated.
    - The UAE will be able to purchase the F-35.
- Chile has voted overwhelmingly to write a new constitution. However, it is still unknown what will change in the new set of laws. We do believe this action increases the risk of investing in Chile.
- The opposition in Venezuela continues to fray. One of its main leaders, Leopoldo Lopez, who has been holed up on the Spain's embassy for over 18 months, has left the country and joined the rest of his family in Spain. His departure makes it clear that President Maduro maintains his hold on the country.
- Protests continue in Belarus; the next move is a general strike.

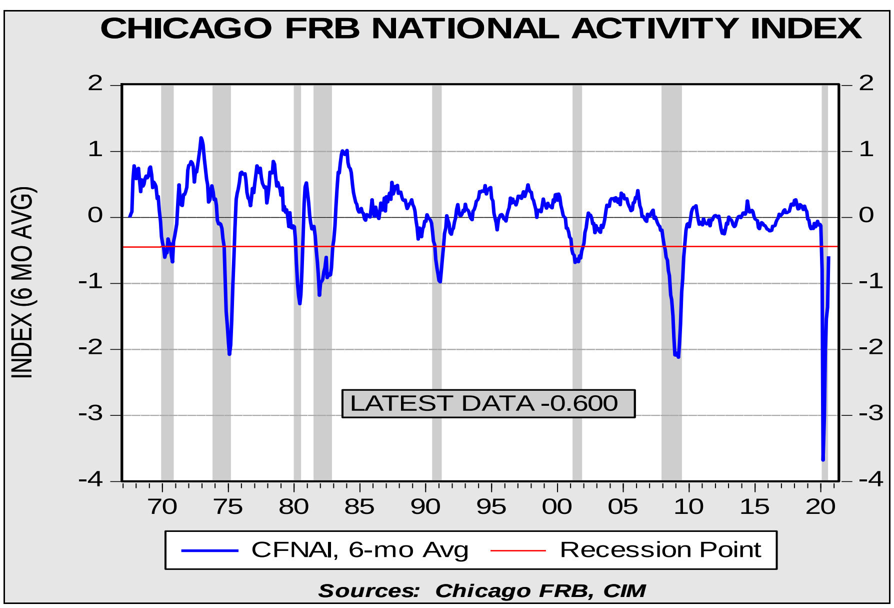
China: Communist governments have set out their economic plans in five-year increments. The Soviets implemented their first one in 1928. Interestingly enough, the Gorbachev government set the 13th one in place in 1990, but it lasted only one year, as the U.S.S.R. dissolved in 1991. China's first 5-year plan was established in 1953 under Mao, adopting the Soviet structure.

Despite the reliance on market structures since 1979, China continues to establish 5-year plans. Leaders are meeting to discuss China's 14th 5-year plan (note that this one would exceed the Soviet number); a couple of ideas have been circulating. First, General Secretary Xi has discussed a "dual circulation" plan that would maintain exports but try to lift domestic consumption. Such a policy is in direct contradiction to the macroeconomic identities, as lifting domestic consumption will tend to reduce exports. We suspect Xi doesn't want to suffer the drop in growth as the economy transitions from exports to domestic demand. Thus, he wants a bit of both, which probably means he will end up with a bit of neither. Second, the U.S. threat to cut off China's semiconductor supply will likely trigger a goal of tech self-reliance.

Keeping up with the shift: In this week's AAW, we noted the historic reversal in the long-standing trend of goods and services consumption. Since the end of WWII, there has been a steady increase in relative services consumption to goods consumption. The pandemic has led to what is probably a temporary, but still notable, increase in relative goods consumption. There are increasing reports that goods producers are scrambling to boost production to meet this new demand. This situation is leading to a disconnect; services, such as restaurants, travel, etc. continue to struggle while factories are looking for workers. Although we do expect the long-term trends to eventually return, in the meantime, the economy will tend to find support from goods production.

U.S. Economic Releases

US economic activity slowed in September, according to the Chicago National Activity Index. The index came in at 0.27 compared to expectations of 0.73. The prior report was revised from 0.79 to 1.11.



The chart above shows the six-month moving average of the Chicago National Activity Index. It continues to improve and suggests the recession ended in the spring.

The table below lists the economic releases scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
10:00	New Home Sales	m/m	Sep	1025k	1011k	**
10:00	New Home Sales	m/m	Sep	1.30%	4.80%	**
10:30	Dallas Fed Manf. Activity	m/m	Oct	13.3	13.6	**
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								
Japan	PPI Services	y/y	Sep	1.3%	1.0%	1.0%	**	Equity bearish, bond bullish
	Leading Index CI	m/m	Aug	88.4	88.8		***	Equity and bond neutral
	Coincident Index	m/m	Aug	79.2	79.4		***	Equity and bond neutral
Europe								
Germany	IFO Business Climate	m/m	Oct	92.7	93.4	93	**	Equity bearish, bond bullish
	IFO Expectations	m/m	Oct	95.0	97.7	96.5	**	Equity bearish, bond bullish
	IFO Current Assessment	m/m	Oct	90.3	89.2	89.8	**	Equity and bond neutral
Switzerland	Domestic Sight Deposits CHF	w/w	23-Oct	634.7b	632.2b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	23-Oct	706.9b	705.1b		*	Equity and bond neutral
AMERICAS								
Brazil	FGV CPI IPC-S	w/w	22-Oct	0.79%	1.01%		***	Equity and bond neutral
	FGV Consumer Confidence	m/m	Oct	82.4	83.4		***	Equity and bond neutral
	IBGE Inflation IPCA-15	m/m	Oct	0.9%	0.5%	0.8%	**	Equity and bond neutral
	Current Account Balance	m/m	Sep	$2320m	$3721m	$3000m	**	Equity and bond neutral
	Foreign Direct Investment	m/m	Sep	$1597m	$1430m	$2000m	**	Equity and bond neutral
Mexico	Retail Sales	y/y	Aug	-10.8%	-12.5%	-9.7%	**	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	21	1	Down
3-mo T-bill yield (bps)	8	9	-1	Neutral
TED spread (bps)	13	13	0	Up
U.S. Libor/OIS spread (bps)	8	8	0	Up
10-yr T-note (%)	0.81	0.84	-0.03	Neutral
Euribor/OIS spread (bps)	-51	-51	0	Neutral
EUR/USD 3-mo swap (bps)	15	13	2	Down
Currencies	**Direction**			
dollar	Up			Down
euro	Down			Up
yen	Down			Up
pound	Up			Down
franc	Down			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	$40.63	$41.77	-2.73%	
WTI	$38.71	$39.85	-2.86%	
Natural Gas	$2.99	$2.97	0.61%	
Crack Spread	$8.00	$7.92	0.97%	
12-mo strip crack	$9.90	$9.94	-0.47%	
Ethanol rack	$1.66	$1.65	0.70%	
Metals				
Gold	$1,902.55	$1,902.05	0.03%	
Silver	$24.23	$24.61	-1.54%	
Copper contract	$311.00	$312.90	-0.61%	
Grains				
Corn contract	$ 417.00	$ 419.25	-0.54%	
Wheat contract	$ 624.50	$ 632.75	-1.30%	
Soybeans contract	$ 1,081.00	$ 1,081.00	0.00%	
Shipping				
Baltic Dry Freight	1415	1401	14	

Weather

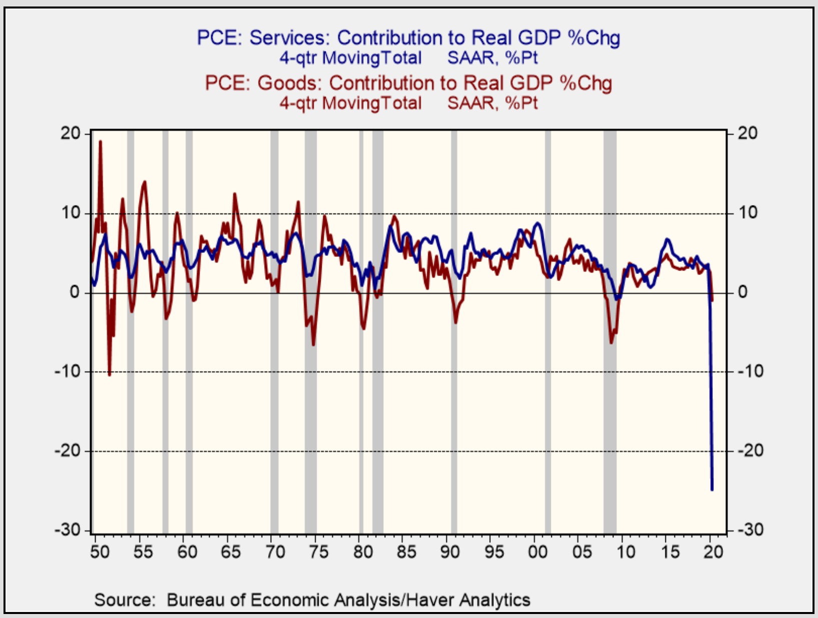
The 6-10 and 8-14 day forecasts currently call for warmer temperatures for most of the country, with cooler temperatures expected in the eastern half of the country. Dry conditions are expected for most of the country, with wet conditions expected in Florida. Today, Hurricane Zeta has developed in the Caribbean Sea and is expected to move into the Gulf of Mexico. The tropical season ends on Halloween; we will stop reporting on tropical events on a daily basis at that time but will note if any storms develop in November.

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 23, 2020

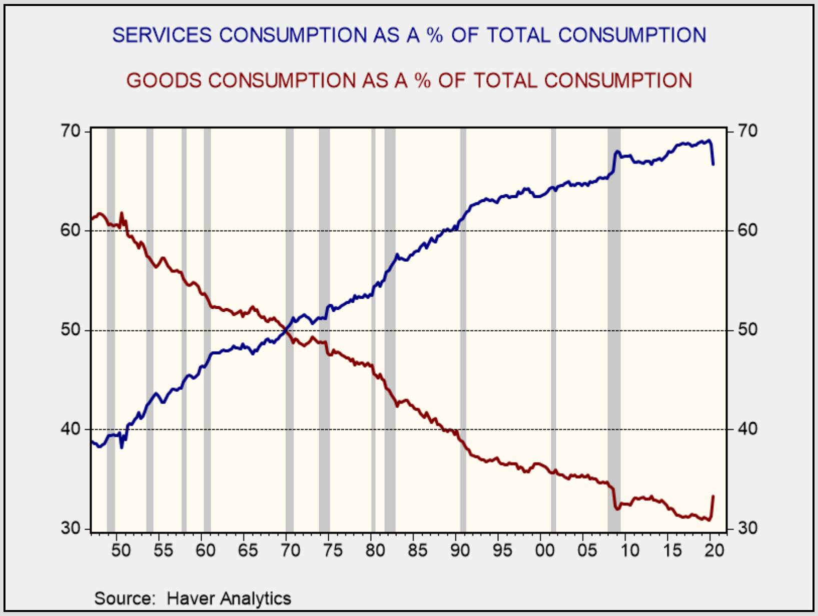
The measures adopted to combat the spread of COVID-19 caused one of the most unusual recessions in American economic history. Although all recessions have their own unique characteristics, the recession that began in February was historically deep; it is likely already over too, making it one of the shortest on record. To a great extent, this is because this recession was caused by the disruptions due to the pandemic, not by the more usual factors, such as geopolitical events or monetary policy error. Business cycles are broken into three phases: recession, recovery, and expansion. The onset of recession is defined as the peak of the economy. The recession occurs during the decline in business activity and ends when the cycle troughs. The recovery begins at this point and lasts until the previous peak in business activity is exceeded, starting the next expansion. Given the deep initial decline in business activity, the recovery is now underway. Accordingly, economic analysis is now focused on the path of recovery. In this report, we are going to focus on how the pandemic has caused a services recession which will complicate the recovery.



This chart shows the four-quarter sum of the contribution to GDP from services and goods consumption. In the 11 recessions that have occurred since 1950, a negative contribution from goods consumption has occurred in all but two (1970, 2001). A negative reading from services has only occurred twice, in the last two recessions. But clearly this recession is unlike any in the postwar experience. Goods consumption has turned negative, but barely so; the decline in services, on the other hand, is unprecedented.

Because goods can be held in inventory, any lost sales in the near term can be facilitated in the future by providing the goods out of stockpiles. Eventually, inventory is exhausted and will need to be rebuilt. Last week's AAW addressed this issue directly. One consistent factor we see in recoveries is that contribution from inventory, but services really can't be inventoried. A forgone haircut or an evening at a restaurant won't be recouped in the future. If one takes two cruises a year, it isn't likely that one will take four in the first year of the vaccine; the two not taken will likely be lost consumption. Another way to consider this issue is that inventory in services is labor. Within the constraints of a restaurant, for example, the way one increases capacity is by hiring wait staff and cooks. To adjust to less traffic, the way a firm would reduce inventory is through layoffs.

At the same time, households are not just holding their savings; there has been a definite shift in spending—away from services and toward goods.

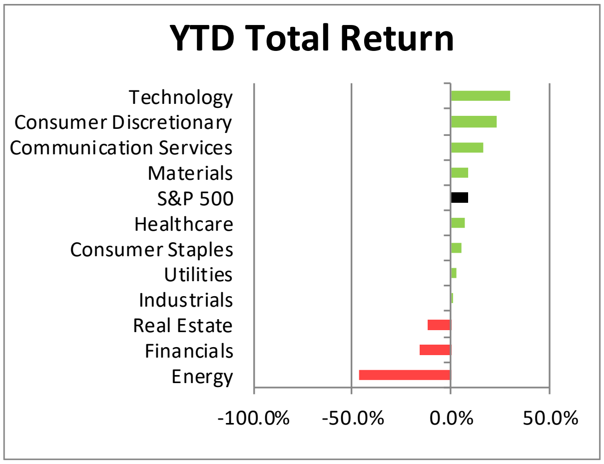


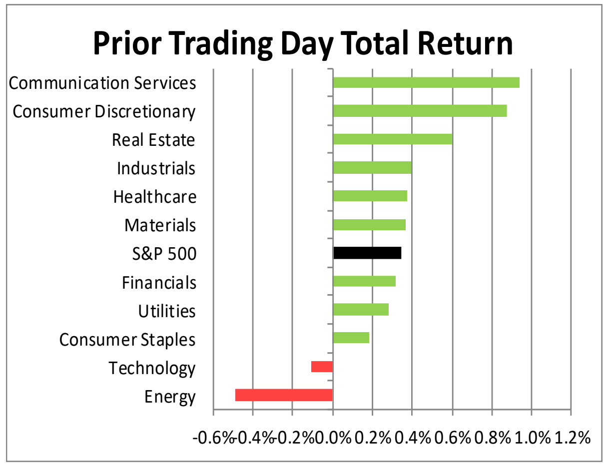
After WWII, goods consumption was just over 60% of all consumption, while services was just under 40%. By 1970, the two had equalized and, in Q4 2019, the divergence had made a new record—69.1% of consumption had gone to services and 30.9% to goods. Since then, goods have risen to 33.3% and services has declined to 66.7%. Although we would expect the secular trend to resume at some point, until a vaccine emerges and/or a reliable antiviral therapy is developed, the bias toward goods consumption will likely remain in place.

Given the likely overcapacity in services (as seen in the job losses in services industries), we would expect that the lack of demand will tend to act as an overhang on the economy and lead to a slow recovery. If we are correct in this assessment, it should keep monetary policy accommodative and inflation under control. As we will also show in this report's accompanying chartbook, restaurants, gasoline, and recreation have suffered tremendous losses that will be difficult to recover from, while housing is getting a significant boost due to changes in office attendance.

Data Section

U.S. Equity Markets – (as of 10/23/2020 close)

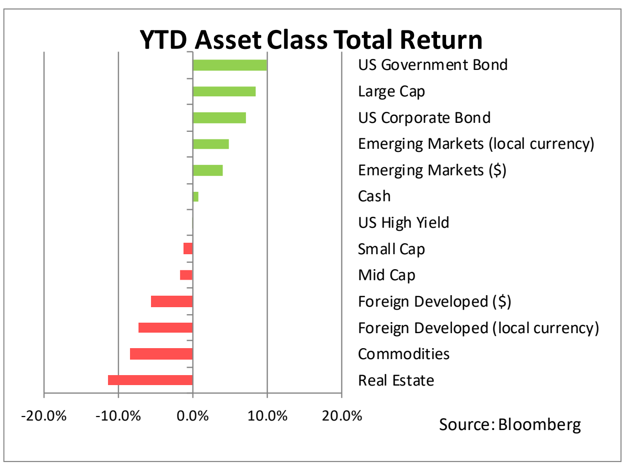




(Source: Bloomberg)

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 10/23/2020 close)

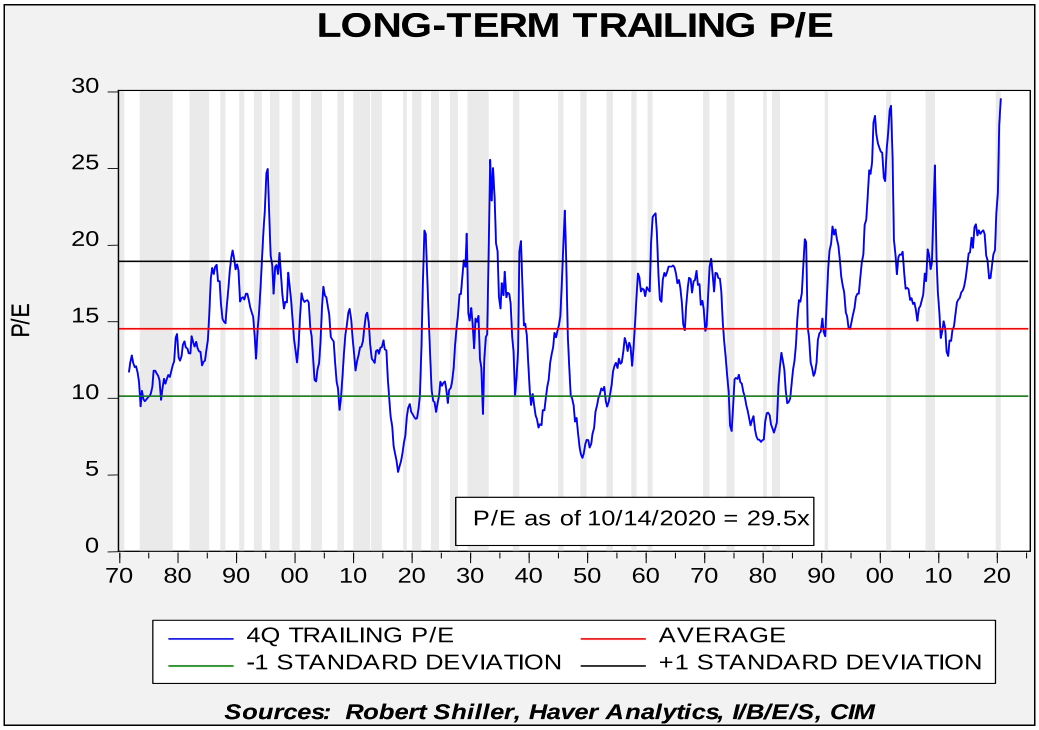


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

October 22, 2020



Based on our methodology,[1] the current P/E is 29.5x, down 0.4x from last week. Better than expected earnings have 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.