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 27, 2021—9:30 AM EDT] Global equity markets are generally lower this morning. In Europe, the EuroStoxx 50 is down 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 closed down 1.3%. Chinese markets were lower, with the Shanghai Composite down 1.0% from its prior close and the Shenzhen Composite down 1.1%. U.S. equity index futures are signaling a flat open. With 144 companies having reported, the S&P 500 Q3 2021 earnings stand at $51.70, higher than the $50.34 forecast for the quarter. The forecast reflects a 27.5% increase from Q3 2020 earnings. Thus far this quarter, 81.3% of the companies have reported earnings above forecast, while 14.6% have reported earnings below forecast.

The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Weekly Geopolitical Report* (10/25/2021): "Here Comes China!"
- *Weekly Energy Update* (10/21/2021): Oil prices move higher as there was a surprise inventory decline.
- *Asset Allocation Q3 2021 Rebalance Presentation* (8/26/2021): A video discussion of our asset allocation process, portfolio changes in Q3, and the macro environment
- *Asset Allocation Weekly* (10/22/2021) (with associated podcast): We recap the annual cost-of-living increase in Social Security payments.
- *Confluence of Ideas* podcast (7/7/2021): "The Geopolitics of Taiwan and the Issue of Globalization"

We open today's *Comment* with U.S. news related to fiscal policy and potential new regulatory risks for the technology sector. Next is a discussion regarding the Chinese debt crisis and a range of other foreign news that could affect the financial markets today. We conclude with the latest developments related to the coronavirus pandemic.

U.S. Fiscal Policy: Key Democratic Senators yesterday proposed a minimum corporate income tax of 15% to help pay for President Biden's planned social-spending and climate-change program. Although details were not provided, the sponsors said the plan would apply to about 200 large companies and raise hundreds of billions of dollars without raising the corporate income tax rate above the current 21%.

- Manufacturers and technology companies could be among those hit hardest by the plan since the tax breaks they currently benefit from (such as expensing capital investments or stock options) would effectively be limited.

- The proposed levy differs from the 15% global minimum tax the U.S. has been pushing in international negotiations. That plan, which is also likely to be included in the Democrats' tax-and-spending bill, focuses on U.S. companies' foreign income, and it would require them to pay at least 15% in each foreign country where they operate. Some companies could be affected by both taxes.
- In any case, the proposed minimum corporate tax and billionaire's levy show that higher taxes on corporations and wealthy families remain a risk, even though some Democratic Senators have opposed them. Investors may not be too worried at the moment, as experience has taught that tax proposals can morph dramatically at the last minute, and it doesn't necessarily pay to react early. However, if a bill ultimately passes with these types of tax hikes, the markets would be at risk of a quick adjustment.

U.S. Technology Regulation: As major news outlets continue to publish exposés about operating practices at Facebook (FB, $315.81), Federal Trade Commission staffers have begun looking into disclosures that the company's internal company research had identified ill effects from its products.

- Specifically, the officials are looking into whether Facebook's research documents indicate it might have violated a 2019 settlement with the agency over privacy concerns, for which the company paid a record $5 billion penalty.
- The FTC investigation shows how the exposés could lead to new regulatory risks for Facebook and other technology companies, even beyond the alleged abuses they aim to highlight.

Chinese Debt Crisis: China's National Development and Reform Commission, the state's economic planning agency, issued a statement this morning that companies should prepare to pay the principal and interest on their offshore bonds to maintain their reputation and calm the market. The statement comes days ahead of another big payment deadline for major real estate developer Evergrande (EGRNY, $8.26). Multiple defaults by smaller real estate firms likely represent the government's effort to maintain the reputation of Chinese firms and calm international markets as it tries to get control over excess investment and debt in the country's real estate sector. As we've described many times previously, that effort presents three key risks for investors:

- Even if the government successfully reduces real estate investment and debt levels to more reasonable levels without sparking a financial crisis, the result will be slower economic growth. Since so many countries around the world depend on China as a major export market, that would likely have some negative impact on global economic activity and take some of the wind out of commodity prices.
- If the government clamps down too hard on new investment projects or new borrowing, it risks touching off a whole series of defaults even beyond what we've seen so far. If that happened, the domestic and international economic impacts discussed above could be more severe, which goes far toward explaining why global investors have been so worried about the travails at Evergrande.

- Of course, based on historical experience, there is also some chance that Chinese officials will get cold feet as they come to appreciate how a clampdown could slow the economy and potentially spark a wave of financial problems. That's especially true against the backdrop of President Xi's crackdown on Chinese technology companies, which could also weigh on economic activity. The big problem, in this case, is that by kicking the can down the road, the officials could be setting China up for even more bad investment, higher debt levels, and a potentially worse crisis in the future.

Japan Elections: According to a new Kyodo News poll on voter plans for the general election on Sunday, the ruling Liberal Democratic Party may lose seats in the House of Representatives but should retain a comfortable majority with its coalition partner Komeito. The LDP and Komeito together could win more than 261 of the 465 seats in the chamber, which would be enough to effectively control all standing committees and push their legislative agenda forward.

Japan Stock Market: The Tokyo Stock Exchange (TSE) said it plans to extend its trading day by 30 minutes. With the change, trading in Tokyo will run from 9:00 am to 3:30 pm local time, with a lunch break from 11:30 am to 12:30 pm (in the U.S., the new end time will be equivalent to 2:30 am ET). The extension of trading is expected to make the Japanese somewhat more competitive with other major Asian markets with longer trading days.

Russia-European Union: Natural gas storage at European facilities is generally low for the period heading into winter. Contributing to the EU's skyrocketing gas prices, new industry analysis indicates that storage at facilities owned or controlled by Russian state-backed gas monopoly Gazprom is especially low.

- The figures will feed concerns that the Russian government is deliberately withholding gas from the EU in order to drive up prices and pressure its leaders to grant final approval for the Nord Stream 2 gas pipeline from Russia to Germany.
- As further evidence that Russia is leveraging its position as Europe's top gas source for its own geopolitical goals, another report indicates Gazprom offered Moldova lower gas prices if the country amended its tariff-free trade deal with the EU and delayed the implementation of EU rules that require gas markets to be more competitive.

Iran: An apparent cyberattack that officials ascribed to a "foreign country" has disrupted the sale of fuel across Iran by targeting its electronic card payment system. The shutdown of the system has forced motorists to form long queues at gas stations nationwide and sparked sharp criticism of the government, which, of course, may have been the intent of the attack.

Afghanistan: Despite a Taliban pledge that it would not allow Afghanistan to be used as a springboard for jihadi groups, U.S. intelligence officials believe Isis-K would have the capability to conduct external strikes, including on U.S. soil, within six to 12 months. The officials believe it would take al-Qaeda one to two years to reach a similar capability.

COVID-19: Official data show confirmed cases have risen to 244,662,153 worldwide, with 4,966,122 deaths. In the United States, confirmed cases rose to 45,616,157, with 738,883 deaths.

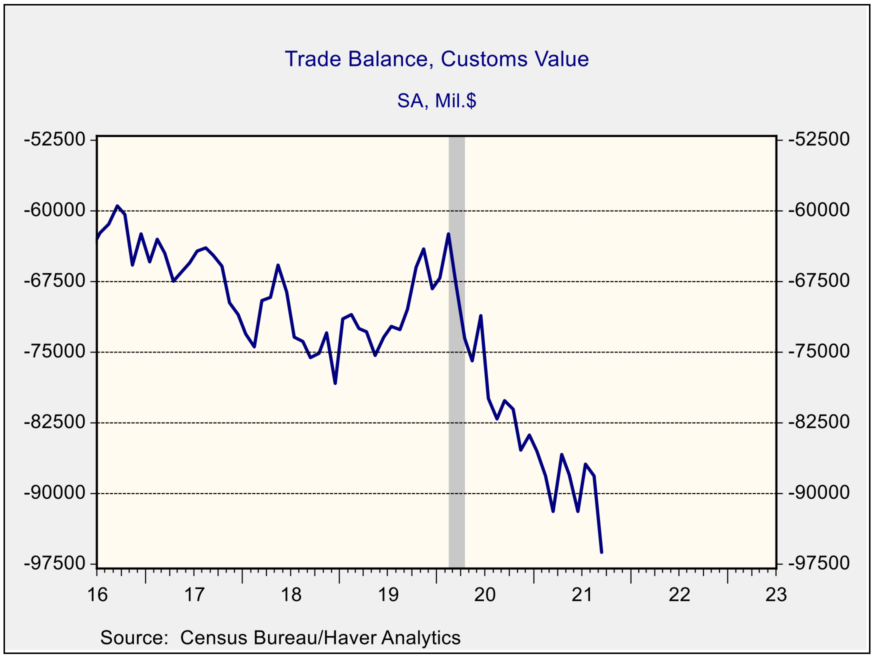
Vaccine doses delivered in the U.S. now total 504,584,715, while the number of people who have received at least their first shot totals 220,648,845. Finally, here is the interactive chart from the *Financial Times* that allows you to compare cases and deaths among countries, scaled by population.

- According to the latest CDC data, 66.5% of the U.S. population has now received at least one dose of a vaccine, and 57.5% of the population is fully vaccinated.
- Yesterday, an FDA advisory panel of outside experts recommended authorizing the vaccine developed by Pfizer (PFE, $43.56) and BioNTech (BNTX, $292.39) for children aged 5 to 11.
    - The FDA is expected to decide in the coming days or weeks to authorize the shots for young children. Health officials have said the shots are likely to become available in November.
    - Since the U.S. has approximately 28 million children in that age group, vaccinating a substantial number of them could have a big impact on boosting the country's overall vaccination rate.
- A new study by the National Bureau of Economic Research indicates that financial incentives, public-health messages, and other tactics used by state and local governments and employers to encourage people to get vaccinated didn't have a noticeable impact on vaccination rates among those who already were hesitant about getting the shot.
- Merck (MRK, $82.25) has signed a landmark voluntary licensing deal with the UN-backed Medicines Patent Pool to expand access to its COVID-19 antiviral pill throughout the developing world. By licensing generic manufacturing of the pill, the deal promises to make it available at low cost in poorer countries.
- In Britain, the government is considering imposing a set of new "Plan B" restrictions, including mandatory mask-wearing, but officials are holding out hope that a recent decline in new infections could allow them to avoid the politically unpopular step.

U.S. Economic Releases

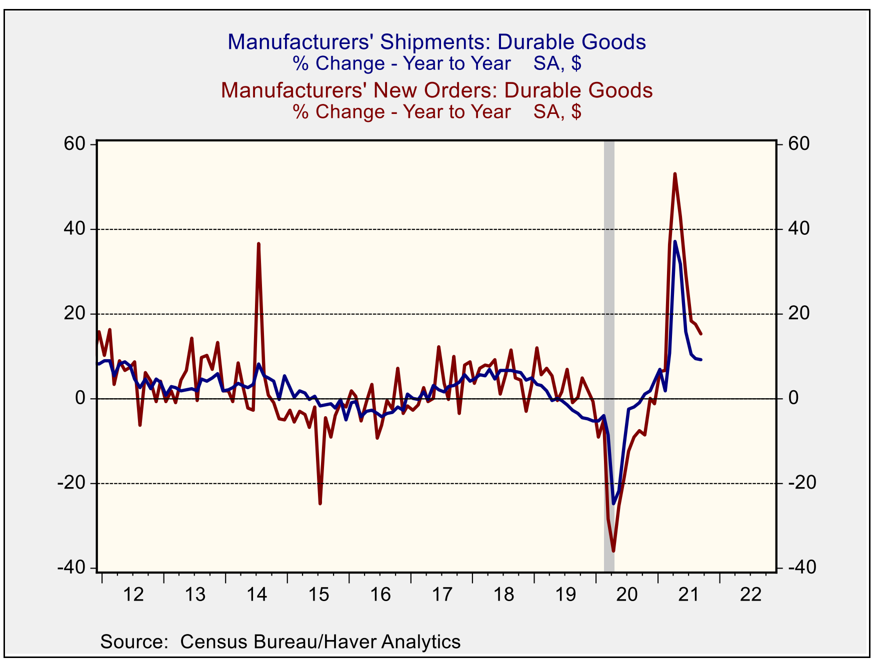
Mortgage applications rose last week, according to the Mortgage Brokers Association. In the week ending October 15, The MBA mortgage applications index rose 0.3% from the prior week. The applications index for refinancing fell 1.6% from the prior week, while the applications index for home purchases rose 3.5%. The average 30-year fixed-rate mortgage rose 7 bps from 3.23% to 3.30%.

The U.S. international trade deficit in goods surged to a record high in September due to a decrease in exports, according to the Census Bureau. The trade deficit came in at $96.3B compared to expectations of $88.3B. The prior report was revised from $87.6B to $88.2B. The increased deficit can be attributed to firms doing their best to boost inventory in preparation for the holiday season. As a result, wholesale inventories rose 1.1% from the prior month, while retail inventories fell 0.2%.



The chart above shows the level of the U.S. advance goods trade balance.

New orders for U.S. manufactured durable goods fell less than expected in September, according to the Commerce Department. Durable goods orders fell 0.4% from the prior month compared to expectations of a 1.1% drop. Excluding durable goods orders rose in line with expectations, rising 0.4% from the prior month. Nondefense capital goods orders excluding aircraft rose 0.8% from the previous month compared to expectations of 0.5%. Meanwhile, shipments for nondefense capital goods excluding air rose 1.4% from the prior month compared to expectations of 0.5%



The chart above shows the annual change in durable goods orders and shipments. From the prior year, durable goods shipments rose 9.22%, new orders rose 15.28%, unfilled orders rose 4.73%, and inventories rose 7.93%.

There are no economic releases or Fed events scheduled for the rest of the day.

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	Industrial Profits	y/y	Sep	16.3%	10.1%		**	Equity bullish, bond bearish
Australia	CPI	q/q	3Q	0.8%	0.8%	0.8%	***	Equity and bond neutral
New Zealand	Trade Balance NZD	m/m	Sep	-2171m	-2144m		**	Equity and bond neutral
	ANZ Activity Outlook	m/m	Oct	21.7	26.2		**	Equity bearish, bond bullish
	ANZ Business Confidence	m/m	Oct	-13.4	-8.6		**	Equity bearish, bond bullish
EUROPE								
Eurozone	M3 Money Supply	y/y	Sep	7.4%	7.9%	7.4%	**	Equity and bond neutral
France	Consumer Confidence	m/m	Oct	99	102	101	***	Equity bearish, bond bullish
	PPI	y/y	Sep	11.6%	10.0%		**	Equity and bond neutral
Germany	Import Price Index	m/m	Sep	1.3%	1.4%	1.5%	**	Equity bearish, bond bullish
	GfK Consumer Confidence	m/m	Nov	0.9	0.3	-0.5	***	Equity bullish, bond bearish
UK	BRC Shop Price Index YoY	y/y	Oct	-0.4%	-0.5%		*	Equity and bond neutral
Switzerland	Credit Suisse Survey Expectations	m/m	Oct	15.6	25.7		**	Equity and bond neutral
AMERICAS								
Brazil	FIPE CPI - Weekly	w/w	23-Oct	1.0%	1.1%	1.1%	***	Equity and bond neutral
	FGV Construction Costs MoM	m/m	Oct	0.80%	0.56%	0.40%	**	Equity and bond neutral
	IBGE Inflation IPCA-15 MoM	m/m	Oct	1.2%	1.1%	1.0%	**	Equity and bond neutral
	Formal Job Creation Total	m/m	Sep	313902	372265	350000	**	Equity and bond neutral
	National Unemployment Rate	m/m	Aug	13.2%	13.7%	13.4%	***	Equity and bond neutral
Mexico	International Reserves Weekly	w/w	22-Oct	$198546m	$198522m		*	Equity and bond neutral
	Trade Balance	m/m	Sep	-2398.4m	-3902.2m	-2822.0m	**	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.

Fixed Income	Today	Prior	Change	Trend
3-mo Libor yield (bps)	13	12	1	Down
3-mo T-bill yield (bps)	5	5	0	Neutral
TED spread (bps)	9	7	2	Neutral
U.S. Libor/OIS spread (bps)	8	7	1	Down
10-yr T-note (%)	1.59	1.61	-0.02	Down
Euribor/OIS spread (bps)	-55	-55	0	Neutral
EUR/USD 3-mo swap (bps)	22	24	-2	Down
Currencies	**Direction**			
dollar	Flat			Neutral
euro	Flat			Up
yen	Up			Neutral
pound	Down			Neutral
franc	Down			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Canada Rate Decision		0.250%	0.250%	On forecast

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.

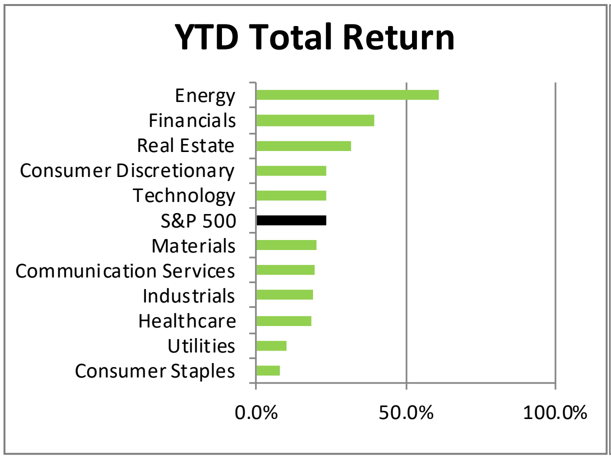
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$85.39	$86.40	-1.17%	Bullish API report
WTI	$83.46	$84.65	-1.41%	
Natural Gas	$5.84	$5.88	-0.80%	
Crack Spread	$19.55	$19.69	-0.75%	
12-mo strip crack	$21.74	$21.98	-1.06%	
Ethanol rack	$2.92	$2.88	1.61%	
Metals				
Gold	$1,786.81	$1,792.91	-0.34%	
Silver	$23.95	$24.16	-0.87%	
Copper contract	$443.00	$448.60	-1.25%	
Grains				
Corn contract	$540.50	$543.50	-0.55%	
Wheat contract	$748.50	$752.25	-0.50%	
Soybeans contract	$1,238.75	$1,247.50	-0.70%	
Shipping				
Baltic Dry Freight	4,056	4,257	-201	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.8		
Gasoline (mb)		-2.3		
Distillates (mb)		-2.3		
Refinery run rates (%)		0.00%		
Natural gas (bcf)		88.0		

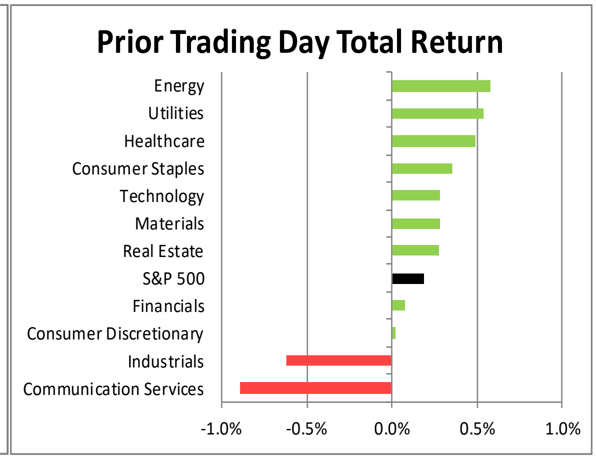
Weather

The 6-10 day and 8-14 day forecasts currently call for cooler-than-normal temperatures for most of the country, with warmer-than-normal temperatures throughout the Pacific and New England regions. The forecast calls for wet conditions for the Northern Pacific region, Texas, and Louisiana. Meanwhile, dry conditions are expected throughout most of the country. There is a tropical disturbance moving along the eastern coastline, and so far, it is not expected to develop into a tropical storm. We are now approaching the end of hurricane season, which concludes on November 30.

Data Section

U.S. Equity Markets – (as of 10/26/2021 close)

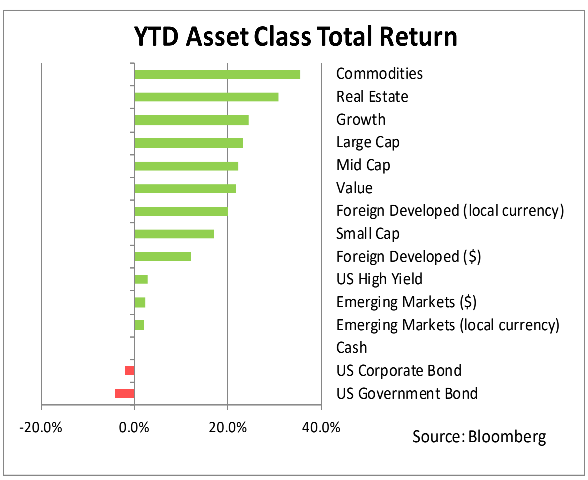




(Source: Bloomberg)

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 10/26/2021 close)

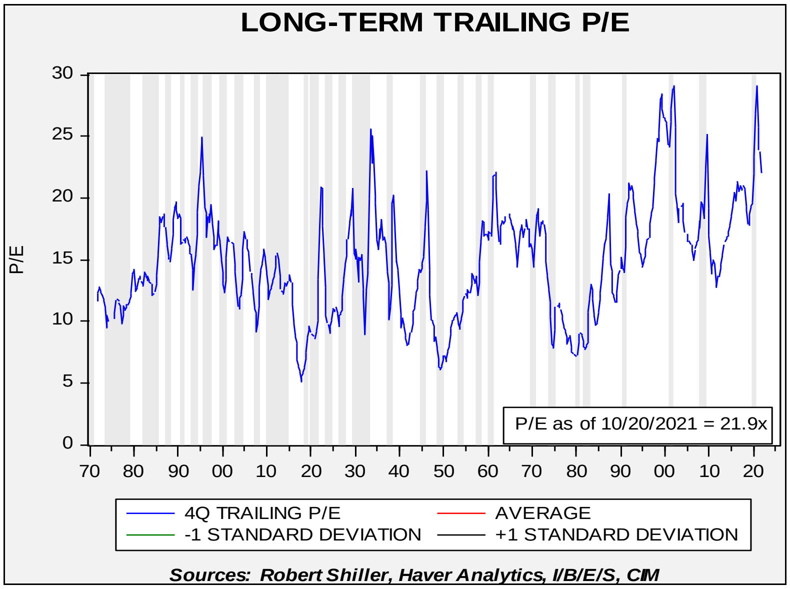


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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), Value (S&P 500 Value), Growth (S&P 500 Growth).

P/E Update

October 21, 2021



Based on our methodology,[1] the current P/E is 21.9x, up 0.1x from last week. The rise in the multiple is mostly due to increasing index values offsetting strong earnings.

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.