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 28, 2020—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 2.6% from its last close. In Asia, the MSCI Asia Apex 50 closed up 0.2%. Chinese markets were higher, with the Shanghai Composite up 0.5% from the prior close and the Shenzhen Composite up 0.7%. U.S. equity index futures are signaling a lower open. With 180 companies having reported, the S&P 500 Q3 earnings stand at $35.50, higher than the $33.68 forecast for the quarter. The forecast reflects a 21.0% decrease from Q3 2019 earnings. Thus far this quarter, 84.4% of the companies have reported earnings above forecast, while 13.3% have reported earnings below forecast.

Before turning to the daily news, we want to note that our Asset Allocation Rebalance Chart Book for the fourth quarter is now available on Vimeo. In this video, we review our asset allocation process, detail our quarterly portfolio adjustments, and offer a deep dive into the macro-environment that underlies our decisions.

Our *Daily Comment* today focuses on the coronavirus pandemic since the recent resurgence in infections is having such a negative impact on investor sentiment. Not only are increasing infections raising the threat of renewed economic lockdowns, but they're even sparking violent protests in Europe. Following our review of the coronavirus developments, we take a quick look at other news items, several of which revolve around U.S.-China tensions.

COVID-19: Official data show confirmed cases have risen to 44,067,588 worldwide, with 1,168,693 deaths. In the United States, confirmed cases rose to 8,779,993, with 226,733 deaths. Here is the interactive chart from the *Financial Times* that allows you to compare cases and deaths among countries, scaled by population.

Virology

- New confirmed U.S. infections totaled more than 73,200 yesterday, lifting the seven-day moving average to another all-time high of 69,967. Hospitalizations related to the coronavirus remained over 40,000 for the seventh day in a row, while daily deaths rose further to 985. New infections and deaths continue to surge in Europe as well, putting its daily deaths-per-million count on par with the U.S.
    - The figures are further feeding fears that authorities across the developed world may be forced to re-impose mass economic lockdowns as they did in the spring, even though they're trying hard to keep restrictions targeted and localized.

    - With a new U.S. pandemic relief bill off the table, possibly until early 2021, investors are becoming much more concerned about new, mass lockdowns that could undermine the weakening economic recovery and weigh further on corporate profits, all of which helps explain the renewed weakness in risk assets.
- As France emerges as the new epicenter of infections in Europe, its coronavirus-related deaths reached a six-month high of 523 yesterday. Aides said President Macron is considering imposing earlier curfews in many parts of the country and weekend lockdowns that would sharply curtail individuals' movements in hot spots such as Paris. In Germany, local health authorities are also starting to become overwhelmed. In the U.K., the government's scientific advisors are warning that while peak deaths in that country's new wave probably won't exceed the first wave's peak, deaths will remain high for much longer and result in a higher total death toll than in the first wave. The analysis is raising fears of an England-wide lockdown by Christmas.
- The renewed restrictions have also sparked a wave of anti-lockdown protests across Europe. Thousands of furious demonstrators clashed with police in cities in Italy and Spain as they urge their governments to abandon new restrictions on their freedom.
- Meanwhile, the Chinese government has issued a warning that handling imported frozen or refrigerated foods could increase the risk of contracting the virus. The warning came after epidemiological investigators pinned down the outbreak in Beijing in June, involving 335 cases, to imported salmon sold from a booth in a wholesale food market.
- At the individual level, scientists and physicians are learning that a COVID-19 infection can leave people with a range of physical problems that last long after they've recovered.

Economic Impacts

- Even though consumer spending has recovered more strongly than expected, and even though online purchases have surged throughout the pandemic, it turns out that they've still kept a lid on their credit card debt balances.

Foreign Policy Response

- With infections surging again in Europe, and with Friday's price data expected to show a third straight month of deflation in the Eurozone, the pressure is likely rising on ECB policymakers to launch new monetary stimulus measures.
    - Many officials and investors fear that Europe is becoming bogged down in a Japanese-style cycle of weak growth, negative interest rates, and sub-zero inflation.
    - It's still probably too early to expect new measures after Thursday's policy meeting, but the increasing prospects for new European stimulus measures and the surging case counts around the developed world are already giving at least a temporary boost to the dollar today.

U.S. Property Taxes: Even though next week's elections have us all focused on the presidential and Senate races, it's important to remember there are also important state-level issues to watch. In California, for example, Proposition 15 would ease some restrictions on commercial property tax valuations. Under the measure, assessments on private residential property would continue to be strictly limited, but local governments could begin assessing commercial property based on its current value, rather than capping increases from the last time it was sold. If passed, the measure could be an additional blow to some REITs holding property in California, which have already faced declining occupancy and rent arrears because of the coronavirus pandemic. The measure could also hurt non-REIT property owners and their tenants, since many leases require tenants to cover property taxes.

United States-China: The U.S. and China have narrowly sidestepped a potentially major diplomatic dispute after four political dissidents entered the U.S. consulate in Hong Kong to request asylum but were refused. The incident happened just hours after the Hong Kong police department's national security unit arrested the former leader of a pro-independence group as he was planning a similar move.

United States-India: The U.S. and India yesterday signed an agreement to share geospatial intelligence, paving the way for deeper military cooperation between the two countries as they confront an increasingly assertive China.

China-India: New reporting reveals that after the China-India military scuffles over disputed borderlands in the Himalaya mountains this summer, New Delhi quietly sent one of its warships into the South China Sea to send the message: "Don't mess around in my backyard or I'll mess around in yours." Last week, India also invited Australia to join the U.S. and Japan in its annual Malabar naval exercises in the Indian Ocean. The moves illustrate the surprising extent to which New Delhi is shedding its reticence to unleash India's maritime power and strengthen its security partnerships as it seeks to counter what it considers Chinese aggressions on its land border.

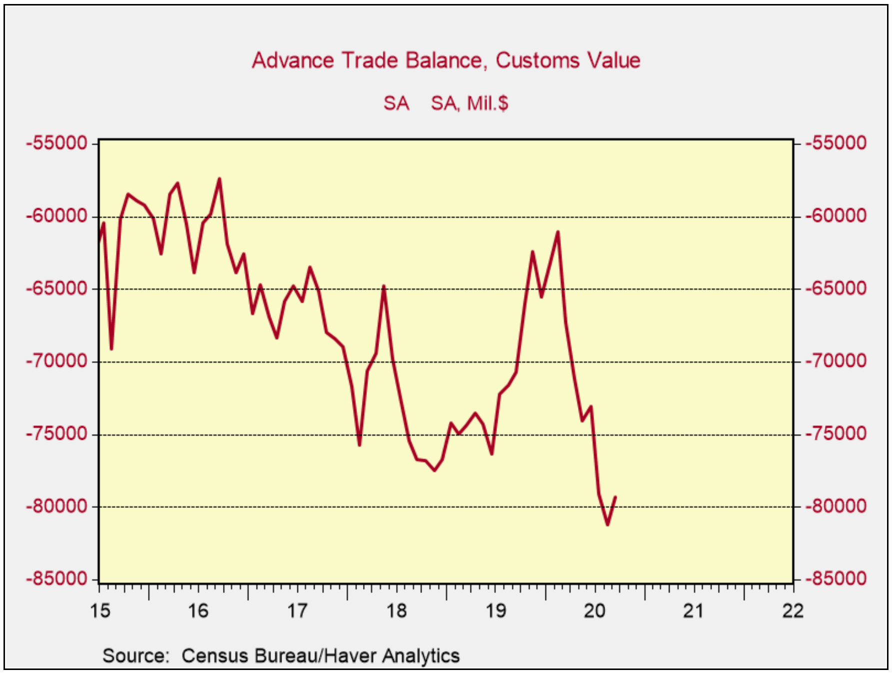
China: The China Foreign Exchange Trade System, an arm of the central bank, announced that a countercyclical factor is no longer being used to set the central value of the renminbi for purposes of domestic trading. The factor made the renminbi's value more stable than it otherwise would have been, so the move is seen as a liberalization designed to make the currency more appealing to investors. All the same, as the renminbi continues to appreciate, its recent strength is probably being driven more by China's early success in overcoming the coronavirus pandemic and its continuing recovery from it.

Nagorno-Karabakh: Clashes between Armenian and Azeri forces continue despite the recent U.S.-brokered ceasefire. Importantly, it now appears that Azerbaijan has taken control of significant territory that could allow it to cut a road linking Armenia to the ethnic Armenian-controlled enclave. The Azeri success evidently owes much to high-tech drones provided to Azerbaijan by Turkey, which have devastated Armenia's outdated tanks. That success illustrates Turkey's ability to make trouble throughout the region as President Erdogan works to increase his influence in the area.

U.S. Economic Releases

For the week ending October 23, mortgage applications rose 1.7% from the prior week. Applications for purchases rose 0.2% from the prior week, while refinancing applications rose 2.5%. The average 30-year fixed-rate mortgage application fell by 2 bps from 3.02% to 3.00%.

The trade balance narrowed unexpectedly in September as a rise in exports outweighed the rise in imports. Last month, the trade deficit narrowed from $83.1B to $79.0B, while estimates showed the trade deficit widening to $84.5B. Additionally, wholesale inventories rose 0.1% from the prior month compared expectations of a rise of 0.4%. Retail inventories rose 1.6% from the prior month compared to expectations of a rise of 0.5%.



The chart above shows the historical trade balance. The narrowing trade balance likely suggests a higher reported Q3 GDP.

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**
18:00	Robert Kaplan Moderates a Panel Discussion with Mark Carney	President of the Federal Reserve Bank of Dallas

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								
Australia	CPI	y/y	3Q	0.7%	-0.3%	0.6%	**	Equity and bond neutral
Europe								
Germany	Import Price Index	m/m	Sep	0.3%	0.1%	-0.3%	**	Equity bullish, bond bearish
France	Consumer Confidence	m/m	Oct	94	95	93	**	Equity and bond neutral
Italy	PPI	m/m	Sep	0.30%	0.10%		**	Equity and bond neutral
UK	BRC Shop Price Index	y/y	Oct	-1.2%	-1.6%		*	Equity and bond neutral
Switzerland	Credit Suisse Survey Expectations	m/m	Oct	2.3	26.2		*	Equity bearish, bond bullish
AMERICAS								
Mexico	Trade Balance	m/m	Sep	4384.7m	6115.7m	3559.5m	***	Equity and bond neutral
	International Reserves Weekly	w/w	23-Oct	$194471m	$194029m		***	Equity and bond neutral
Brazil	Federal Debt Total	m/m	Sep	4527b	4412b		**	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	22	0	Down
3-mo T-bill yield (bps)	9	9	0	Neutral
TED spread (bps)	13	13	0	Up
U.S. Libor/OIS spread (bps)	8	8	0	Up
10-yr T-note (%)	0.75	0.77	-0.02	Neutral
Euribor/OIS spread (bps)	-51	-51	0	Neutral
EUR/USD 3-mo swap (bps)	15	15	0	Down
Currencies	**Direction**			
dollar	Up			Down
euro	Down			Up
yen	Up			Up
pound	Flat			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	$39.86	$41.20	-3.25%	Economic Pessimism
WTI	$37.98	$39.57	-4.02%	
Natural Gas	$3.01	$3.02	-0.20%	
Crack Spread	$8.36	$8.21	1.85%	
12-mo strip crack	$10.06	$10.00	0.55%	
Ethanol rack	$1.68	$1.68	0.10%	
Metals				
Gold	$1,899.98	$1,907.99	-0.42%	
Silver	$24.24	$24.37	-0.55%	
Copper contract	$308.40	$309.35	-0.31%	
Grains				
Corn contract	$ 410.75	$ 416.00	-1.26%	
Wheat contract	$ 606.75	$ 615.75	-1.46%	
Soybeans contract	$ 1,067.25	$ 1,076.50	-0.86%	
Shipping				
Baltic Dry Freight	1413	1402	11	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.5		
Gasoline (mb)		-0.6		
Distillates (mb)		-1.8		
Refinery run rates (%)		0.50%		

Weather

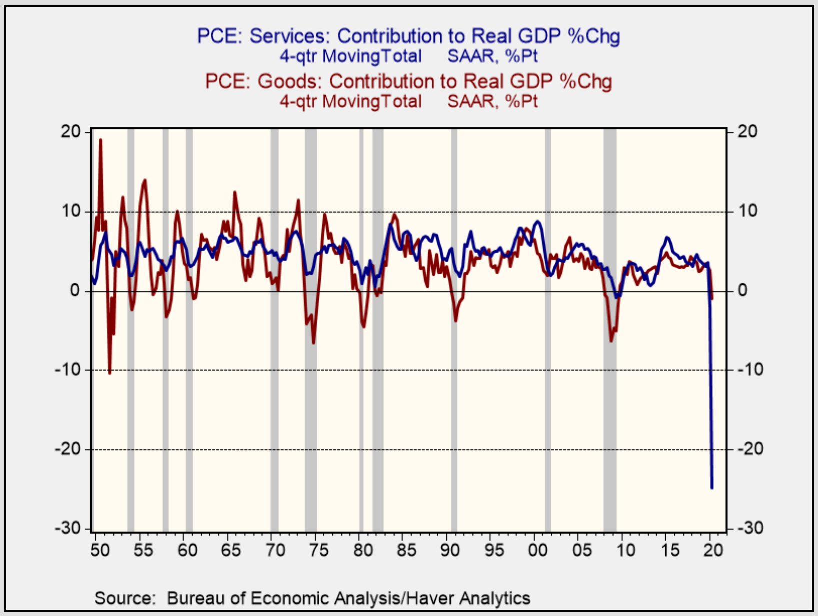
The 6-10 and 8-14 day forecasts currently call for warmer temperatures for most of the country, with cooler temperatures expected in the eastern half of the country. Dry conditions are expected for most of the country, with wet conditions expected in the Rocky Mountains region. Today, Tropical Storm Zeta has strengthened to a hurricane and is expected to make landfall along the Louisiana coast. 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

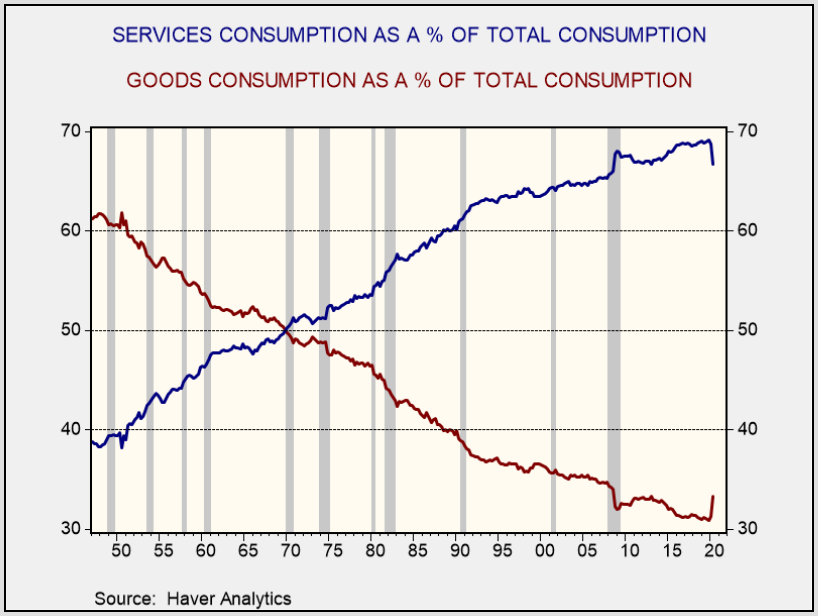
The measures adopted to combat the spread of COVID-19 caused one of the most unusual recessions in American economic history. Although all recessions have their own unique characteristics, the recession that began in February was historically deep; it is likely already over too, making it one of the 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.

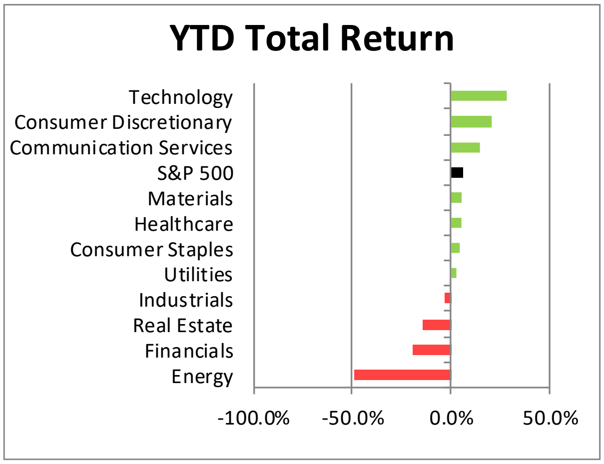


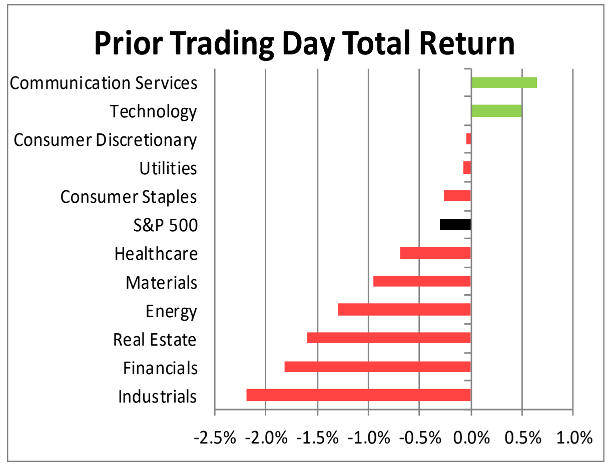
After WWII, goods consumption was just over 60% of all consumption, while services was just under 40%. By 1970, the two had equalized and, in Q4 2019, the divergence had made a new record—69.1% of consumption had gone to services and 30.9% to goods. Since then, goods have risen to 33.3% and services 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 10/27/2020 close)

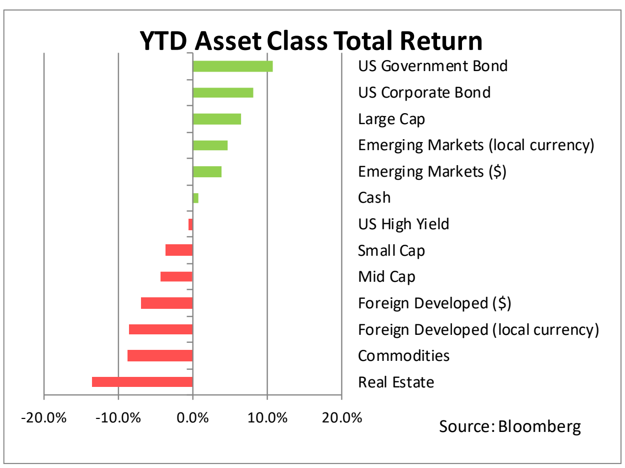




(Source: Bloomberg)

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 10/27/2020 close)

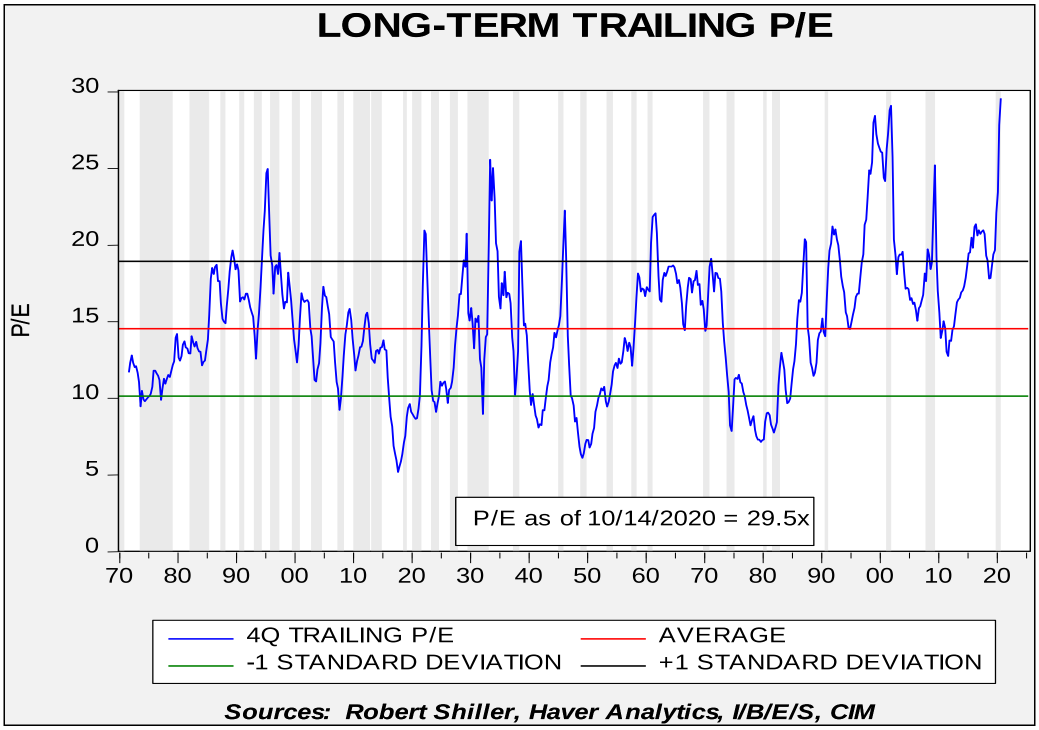


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.