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, 2021—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the EuroStoxx 50 is up 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 closed down 0.2%. Chinese markets were lower, with the Shanghai Composite down 1.3% from its prior close and the Shenzhen Composite down 1.5%. U.S. equity index futures are signaling a flat open. With 192 companies having reported, the S&P 500 Q3 2021 earnings stand at $52.90, 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 13.5% 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* (10/28/2021): **Oil prices ease on inventory builds in excess of expectations**.
- *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"

Good morning! It's a big day today. Q3 GDP is out (quick take—the data was weaker than expected, with very weak investment and a larger drag from net exports); we cover it in detail below. The ECB meeting is also today. As expected, there was no change in policy, but the European bank is getting out of step with the rest of the world. For example, the Bank of Canada surprised everyone by (a) abruptly ending its QE program and (b) signaling rate hikes as early as Q2 2022. Oil execs are on Capitol Hill today. Meanwhile, markets are mixed. U.S. equity futures are trending higher, while oil prices are in retreat. Our coverage begins with the ECB. Economics and policy are next. China and international news will follow. We close with Crypto and pandemic news.

The ECB: Policy, as expected, didn't change, but the leadership of the bank is facing increasing pressure to tighten credit. It is, like the Fed, arguing that the inflation rise is temporary. Market reaction has been muted, suggesting there were no surprises in the news.

Economics and policy: The budget and the Fed lead the news.

- The White House presented a "framework" to move the budget and infrastructure plan through Congress. We will be watching to see if it is enough. Major progressive goals are falling out of the bill; paid leave is the latest proposal to be excluded. Progressive anger is rising, and we are still skeptical that a deal is in the offing. The odds are that we are still talking about this in November.

- Although Chair Powell has implemented new trading guidelines for the FOMC members, Congress is considering a law that would enforce a financial penalty if the rules are violated.

- President Biden has seen his approval ratings falling since summer. Confidence in his ability to engineer a strong economic recovery is declining.

- One standard answer to low pay is that workers should get training to make themselves more valuable. It seems that workers are taking that message to heart, with interesting consequences. There is a surge in job interest in IT, media, civil engineering, and software. On the other hand, nobody wants to work in childcare, restaurants, warehousing, and home health areas. We appear to have forgotten the wisdom of Judge Smails. If this trend continues, those undesirable jobs will either need automating or generate higher wages.

China news: More on the reaction to the hypersonic missile test, the real estate situation, and shortages.

- General Milley, chair of the Joint Chiefs of Staff, publicly compared China's recent hypersonic test to a near-"Sputnik" moment. The Chinese test continues to reverberate, with the U.S. intelligence community being caught off guard by the scope of the Chinese test. Calling the test a Sputnik moment will trigger memories of the U.S.S.R.'s satellite launch in 1956 that also caught the U.S. by surprise and launched a scramble by the U.S. to catch up on science and missile technology. If this characterization holds, look for defense budgets to be expanded in the coming years.

- We are starting to hear rumbles about debt restructuring for China's troubled real estate industry. This outcome is to be expected. There are assets available but not enough income to service the debt. Lowering the debt service is a time-honored way to address the problem *if it is a liquidity issue*. If the problem is solvency, restructuring is futile. Caixin published an editorial calling on the government to maintain its crackdown on the sector.

- Inflation is a key factor in Chinese history. The Nationalist government failed, in part, due to runaway inflation. Tiananmen Square coincided with a spike in price levels. The Xi government, acutely aware of history, likely understands this issue. We are watching a number of developments on the price front. One-way authoritarian regimes deal with higher prices is to prevent them from being published. That appears to be occurring in the coal industry. However, the lack of price transparency will likely lead to a cession of trading, not lower prices. When households face higher prices, they often "trade down" in their purchases; beef gives way to pork. One way that is often used is to reduce protein consumption and eat more vegetables. However, prices on these items are

soaring as well. The risk of unrest is rising. The other sensitive commodity is gasoline. Reports of shortages are emerging, which will exacerbate the tensions.

- The EU has been reluctant to press against China. Much of this hesitancy is due to Germany's massive investments in China. However, there is some evidence that German industry is becoming jaded with China, too. If so, this development could pave the way for a tougher EU stance on China.
  - o A recent trip from a Taiwanese official to Brussels has angered Beijing.
- One issue we constantly monitor is the disconnect between the U.S. business sector and the political class in China. The former tends to want to maintain open and friendly relations; the latter has moved to an adversarial position. Although it's not a foregone conclusion who will win out, the odds favor a decoupling. However, that isn't stopping China from trying to use the differences as a wedge to improve its position. A recent meeting to woo U.S. chip firms to build capacity in China is an audacious example of this situation.
- The FBI raided the U.S. offices of PAX Technology (PXGYF, USD, 1.00), a Chinese firm that manufactures point-of-sale devices. The investigation appears to be examining data transfers of purchasing information.
- China's foreign direct investment is often criticized by foreign host nations because Beijing usually imports Chinese workers to build the project instead of using local labor. Apparently, it's no bed of roses for the Chinese workers either.

International roundup: Poland and the EU lead today's news.
- The European Court of Justice is accessing a €1.0 million per day fine on Poland until it complies with a court ruling, which will change how Warsaw oversees its judiciary. The EU will be able to collect the payments by reducing transfers to Poland. Evidently, Chancellor Merkel's policy of avoiding confrontation didn't hold.
- France and the U.K. are having yet another spat concerning fishing rights. Both sides are making threats.
- Portugal's minority government has failed. Elections will be coming soon.
- The recent flare-up over diplomats in Turkey is having longer-term effects. Erdogan remains mercurial. He still wants U.S. warplanes but feels he doesn't need to cooperate with Washington.
- U.S. intelligence agencies warn that the U.S. could face terrorist events emanating from Afghanistan.

Crypto: The SEC spikes leveraged bitcoin ETFs for now.
- Although the current bitcoin ETF has been very popular, the SEC is, for now, delaying the approval of leveraged products.
- The CFTC looks to increase its policing of the crypto products.
- In related news, global regulators are backing tougher money laundering rules related to crypto transactions. Crypto has become the currency of choice for nefarious activities.

COVID-19: The number of reported cases is 245,179,357, with 4,975,680 fatalities. In the U.S., there are 45,705,087 confirmed cases with 741,242 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. The CDC reports that 507,637,305 doses of the vaccine have been distributed, with 416,154,424 doses injected. The number receiving at least one dose is 220,936,118, while the number receiving second doses, which would grant the highest level of immunity, is 190,990,750. For the population older than 18, 69.1% of the population has been vaccinated. The *FT* has a page on global vaccine distribution. The Axios map shows that infection rates are falling across most of the U.S.

- Although vaccines have gotten most of the media's attention, anti-viral treatments are also critically important. It is abundantly clear that vaccines won't prevent infections. There is strong evidence they reduce hospitalization, but people are still getting sick. Having treatments to reduce the impact of infection will move us further along in the process of leaving the pandemic and entering the endemic phase.
    - The antidepressant fluvoxamine has shown promise in reducing hospitalizations. The drug is inexpensive and could be attractive to the developing world.
    - Merck (MRK, USD, 81.54) has indicated it will grant licenses for molnupiravil at no cost to developing nations.
- China has maintained a "zero tolerance" policy on COVID-19, which has led to rolling shutdowns across the economy. We expect the policy to be maintained through the Winter Olympics, which are 100 days away.
- Germany is likely to end its national emergency related to the pandemic at the end of November.
- New studies indicate that meatpackers were much harder hit by the pandemic.
- We continue to monitor the externalities of the lockdowns. The most recent insight is that lockdowns increased smoking.

U.S. Economic Releases

Jobless claims fell for the fifth consecutive week, according to the Department of Labor. For the week ending October 16, initial claims came in at 281K compared to expectations of 289K. The prior report was revised from 290K to 291K. Continuing claims for the week ending October 9 came in at 2,243K compared to expectations of 2,420K. The previous report was revised from 2,481K to 2,480K.
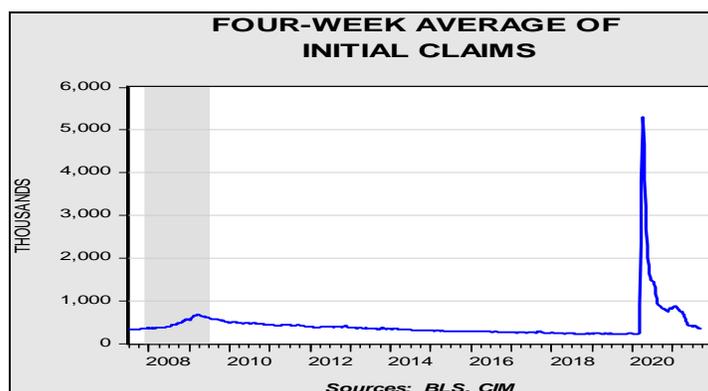
The chart above shows the four-week moving average of initial claims. The moving average fell from 320.00K to 299.25K.

Additionally, the economy expanded at a slower than expected pace in the third quarter of 2021, according to the Bureau of Economic Analysis. Last quarter, GDP expanded at an annualized pace of 2.0% from the previous quarter compared to expectations of 2.6%. Personal consumption expanded at an annualized pace of 1.6% from the prior quarter compared to expectations of 0.8%. The GDP price index rose 5.7% from the prior quarter, while core PCE rose 4.5%.

Source: Bureau of Economic Analysis/Haver Analytics
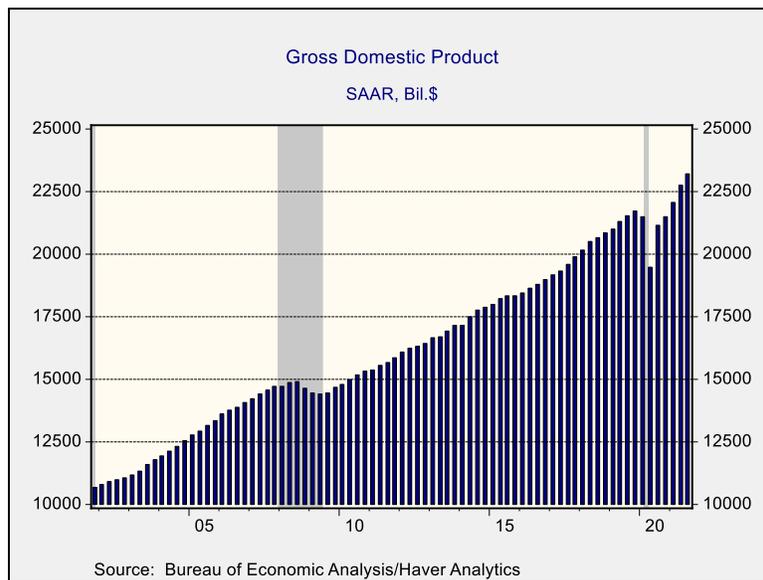
The chart above shows the level of GDP. For Q3 2021, GDP in current dollars sits at $23.173T.

	Q3 2021 Prelim Reading	Q2 2021 Final Reading	Difference
GDP	2.0%	6.7%	-4.7%
Consumption	1.1%	7.9%	-6.8%
Investment	1.9%	-0.6%	2.6%
Inventories	2.1%	-1.3%	3.3%
Net Exports	-1.1%	-0.2%	-1.0%
Government	0.1%	-0.3%	0.5%

The table above shows the contributions to GDP. The biggest drag on GDP came from net exports, as the supply chain likely slowed production, leading to a decrease in exports. Additionally, the drop in consumption is probably the result of higher prices, reducing overall demand for goods and services. We note durable goods consumption subtracted 270 bps from GDP.

Net Exports
Consumption
Investment
Government

Source: Bureau of Economic Analysis/Haver Analytics
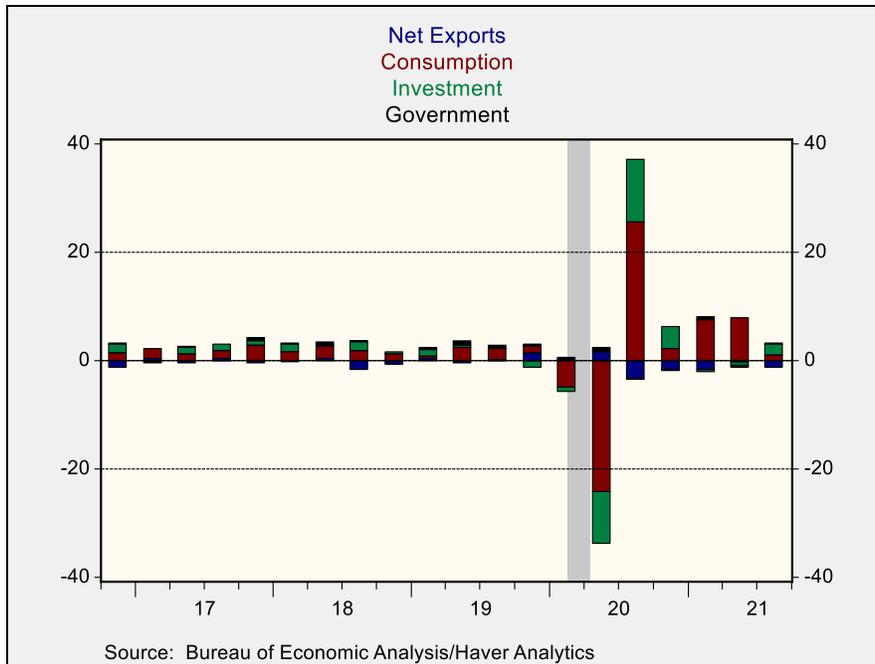
The chart above shows the contributions visually. Despite the slowdown in net exports and consumption, investment spending strengthened in the third quarter.

The table below lists the economic releases and/or Fed events scheduled for the rest of the day.

Economic Releases							
EDT	**Indicator**				**Expected**	**Prior**	**Rating**
9:45	Langer Consumer Comfort	w/w	24-Oct			49.7	**
10:00	Pending Home Sales	m/m	Sep		0.5%	8.1%	**
10:00	Pending Home Sales NSA	m/m	Sep		-3.0%	-6.3%	**
11:00	Kansas City Fed Manf. Activity	m/m	Oct		20.0	22.0	**
Fed Speakers or Events							
	No Fed speakers or events today						

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	Retail Sales	y/y	Sep	-0.6%	-3.2%	-2.4%	***	Equity bullish, bond bearish
	Dept. Store, Supermarket Sales	y/y	Sep	-1.3%	-4.7%	-3.3%	**	Equity bullish, bond bearish
	Japan Buying Foreign Bonds	w/w	22-Oct	-¥604.5b	¥1221.3b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	22-Oct	¥120.5b	¥64.7b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	22-Oct	-¥372.7b	¥623.9b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	22-Oct	¥229.7b	¥960.1b		*	Equity and bond neutral
Australia	Import Price Index	q/q	3Q	5.4%	1.9%	3.4%	**	Equity bearish, bond bullish
	Export Price Index	q/q	3Q	6.2%	13.2%	6.5%	**	Equity and bond neutral
EUROPE								
Eurozone	Consumer Confidence	m/m	Oct	-4.8	-4.8		***	Equity and bond neutral
	Economic Confidence	m/m	Oct	118.6	117.8	116.7	***	Equity bullish, bond bearish
	Industrial Confidence	m/m	Oct	14.2	14.1	12.9	**	Equity bullish, bond bearish
	Services Confidence	m/m	Oct	18.2	15.1	14.6	**	Equity bullish, bond bearish
Germany	Unemployment Change (000's)	m/m	Oct	-39.0k	-30.0k	-20.0k	***	Equity and bond neutral
	Unemployment Claims Rate SA	m/m	Oct	5.4%	5.5%	5.4%	***	Equity and bond neutral
Italy	Consumer Confidence Index	m/m	Oct	118.4	119.6	118.5	***	Equity and bond neutral
	Manufacturing Confidence	m/m	Oct	114.9	113.0	112.3	**	Equity bullish, bond bearish
	Economic Sentiment	m/m	Oct	115.0	113.8		**	Equity bullish, bond bearish
	Hourly Wages	m/m	Sep	0.1%	0.2%		**	Equity and bond neutral
	PPI	m/m	Sep	1.9%	0.4%		**	Equity bearish, bond bullish
AMERICAS								
Brazil	Federal Debt Total	m/m	Sep	5443b	5481b		*	Equity bullish, bond bearish
Canada	CFIB Business Barometer	m/m	Oct	60.5	57.8		**	Equity bullish, bond bearish
	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)	14	13	1	Down
3-mo T-bill yield (bps)	4	5	-1	Neutral
TED spread (bps)	9	8	1	Neutral
U.S. Libor/OIS spread (bps)	8	8	0	Down
10-yr T-note (%)	1.55	1.54	0.01	Down
Euribor/OIS spread (bps)	-56	-55	-1	Neutral
EUR/USD 3-mo swap (bps)	25	22	3	Down
Currencies	**Direction**			
dollar	Flat			Neutral
euro	Flat			Up
yen	Up			Neutral
pound	Up			Neutral
franc	Flat			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
BOJ Policy Balance Rate	-0.100%	-0.100%	-0.100%	On forecast
BOJ 10-Yr Yield Target	0.000%	0.000%	0.000%	On forecast
Bank of Canada Rate Decision	0.250%	0.250%	0.250%	On forecast
Brazilian Selic Rate	7.750%	6.250%	7.750%	On forecast
ECB Main Refinancing Rate	0.000%	0.000%	0.000%	On forecast
ECB Marginal Lending Facility	0.250%	0.250%	0.250%	On forecast
ECB Deposit Facility Rate	-0.500%	-0.500%	-0.500%	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	$83.53	$84.58	-1.24%	Bearish EIA report
WTI	$81.62	$82.66	-1.26%	
Natural Gas	$6.11	$6.20	-1.44%	
Crack Spread	$18.84	$19.12	-1.42%	
12-mo strip crack	$21.28	$21.50	-0.99%	
Ethanol rack	$3.03	$2.99	1.47%	
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)	4.3	1.8	2.5	
Gasoline (mb)	-2.0	-2.3	0.3	
Distillates (mb)	-0.4	-2.3	1.8	
Refinery run rates (%)	0.40%	0.00%	0.40%	
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 Pacific region. Meanwhile, dry conditions are expected throughout most of the Great Lakes and Southwest regions. 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 10/27/2021 close)
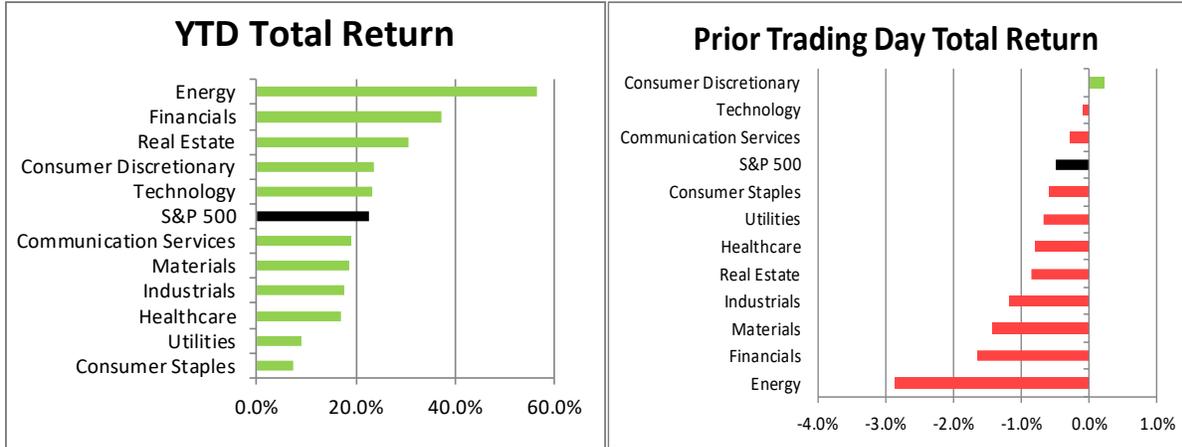
(Source: Bloomberg)

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 10/27/2021 close)
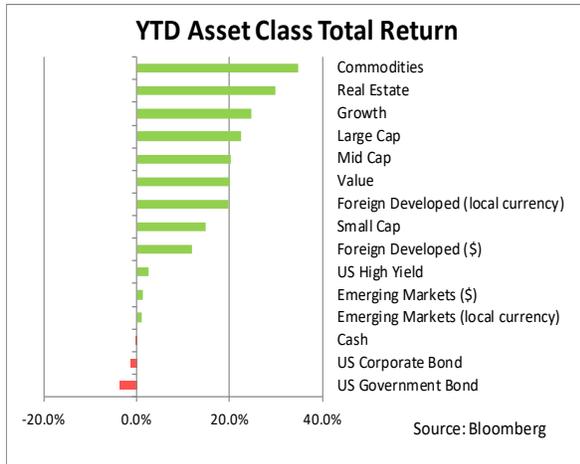
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 28, 2021

LONG-TERM TRAILING P/E
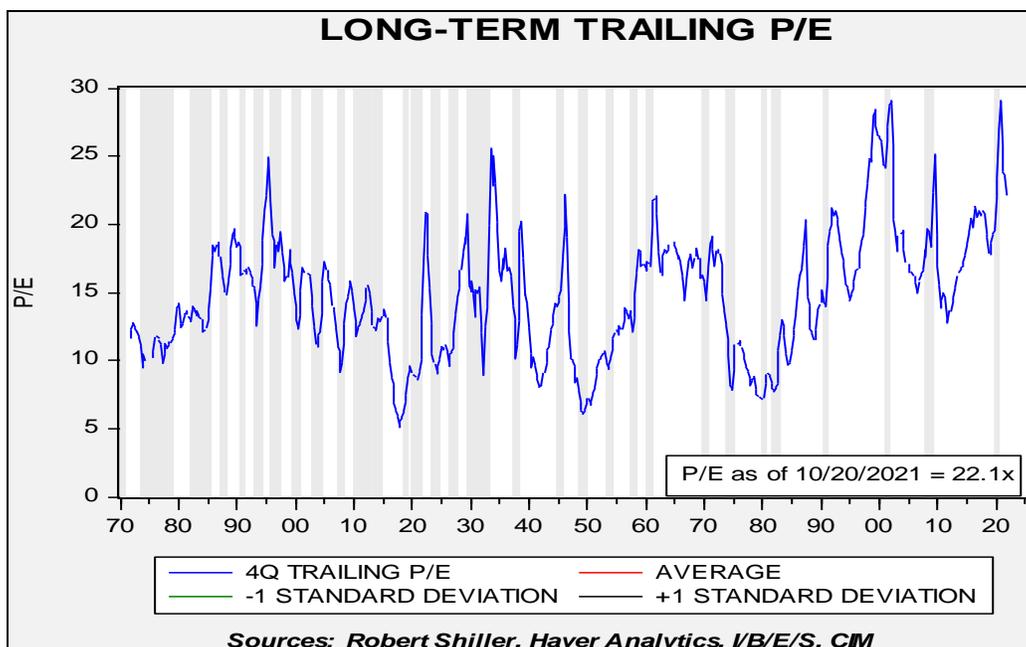
Based on our methodology,[1] the current P/E is 22.1x, up 0.2x from last week. The rise in the multiple is mostly due to increasing index values offsetting strong earnings.

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.

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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.