

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: September 15, 2021—9:30 AM EDT] Global equity markets are generally lower this morning. In Europe, the EuroStoxx 50 is currently down 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 closed down 1.0%. Chinese markets were lower, with the Shanghai Composite down 0.2% from its prior close and the Shenzhen Composite down 0.1%. U.S. equity index futures are signaling a higher open.

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](#) (9/13/2021): “Afghanistan, Part I: History”
- [Weekly Energy Update](#) (9/10/2021): Ida caused a sharp decline in refinery operations, China is releasing strategic reserve oil to lower prices, and natural gas prices are on a tear.
- [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](#) (9/10/2021) (with associated [podcast](#)): we discuss the likelihood of Fed Chair Powell’s renomination, the opposition in Congress, and what that opposition could mean for Fed independence
- [Confluence of Ideas podcast](#) (7/7/2021): “The Geopolitics of Taiwan and the Issue of Globalization”

Good morning. [U.S. equity futures are exhibiting a familiar pattern](#) of being stronger overnight and [fading into the opening](#). It is clear that market momentum is waning. We think this action is a correction of sorts, but it will be difficult to push the market much lower with so much liquidity available. Our coverage begins with a look at China, focusing on the continuing financial situation. We then have a few political notes. Economics and policy are up next, followed by the international roundup, and we close with the pandemic update.

China: Evergrande (EGRNF, USD, 0.40) remains in the news.

- Is Evergrande going to trigger a Minsky moment in China (and elsewhere)? The [shadow of default](#) is looming ever greater. We have learned over the past 25 years that when financial systems are deregulated, the debt of a troubled company can end up in places regulators and market participants don’t expect. U.S. regulators loath to bail out Lehman because they had already rescued Bear Stearns and thought other firms would take that

experience as a warning. However, bailouts create a moral hazard, and China has mostly avoided defaults. Thus, investors really don't take credit quality into account.

- So how bad could it get? In reality, as one of my undergrad professors used to say, "it's an empirical problem," which is a polite way of saying, "hold my beer." Until we actually see default, we won't know how bad it can get. We know the company has over [\\$300 billion in debt](#). We are watching the following:
 - What has the debt been used for? We know [Chinese banks hold much of the debt](#), meaning the government has mechanisms to manage a default. The banks can restructure the debt over time. A bigger concern is whether bonds and commercial paper are held in other non-bank entities. Given the high yield on the paper, it is possible that other shadow banking entities hold it as an asset. In that case, a default could ripple into other parts of the economy (including outside China). [There are rumors in financial, social media](#) that Tether, the stablecoin, has Evergrande commercial paper as an asset. This allegation is not confirmed, [but if true, it could have widespread effects on crypto assets](#).
 - Another rumor is that more than 128 banks and 121 non-banks have some degree of exposure to Evergrande's debt.
 - The [problems of Evergrande](#) could [trigger similar concerns among other Chinese real estate developers](#).
 - "*Behind every great fortune is a crime*"—Balzac. Since Deng, there has been an undercurrent of corruption in China. We have seen it described as "good" corruption, which includes bribes and gifts designed to overcome the web of regulation. We have also seen "bad" corruption, which is doing, well, bad things. Most in business have likely relied on some form of corruption. Xu Jiayin, the chair of Evergrande, is known for his "[gifts](#)." If he goes down, he very well may take a large number of officials with him.
 - Yesterday, we showed clips of civil disorder among the holders of wealth management products. If Evergrande fails, not only will these holders become upset, but owners of real estate could as well. Beijing is really good at quelling unrest, but this might be a challenge.
- To conclude, we don't know how this will play out, but there is the potential for dislocation. The dollar and Treasuries will likely benefit the most.
- As we note below, [China's economic data released overnight was weak](#). Spending activity slowed, perhaps [due to the recent outbreaks of COVID-19](#). Industrial output was also slow. Under normal circumstances, we would expect the PBOC to start stimulating, but if Xi has decided to attack the bad debt problem, the response might be slow.
- It is reported that President Biden suggested a summit with General Secretary Xi. [Xi demurred](#).
- [According to reports](#), Chinese hackers attacked Israeli tech companies and the government. They took pains to masquerade as Iranian, even using Farsi in their coding.

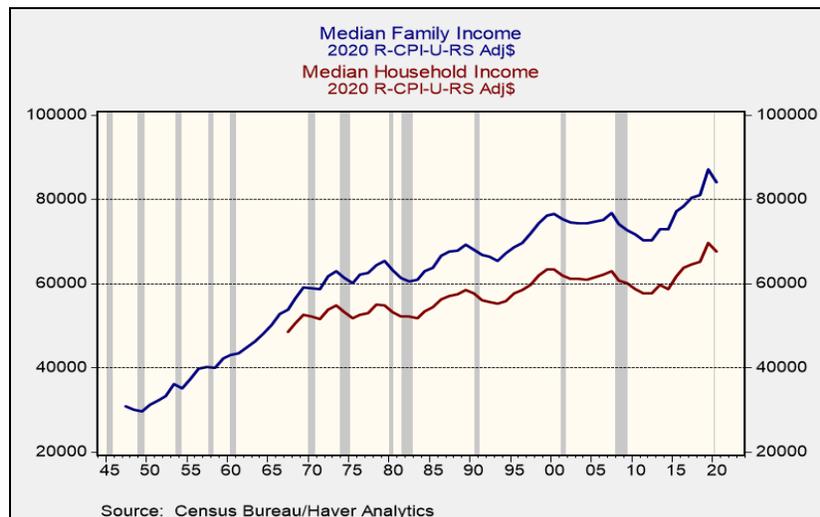
- Over the past 18 months, we have noted the swings in China’s hog market, which was hit hard by the African Swine fever virus. As prices rose, new entrants entered the market, lured by low-interest rates and government subsidies. U.S. microeconomic textbooks used to have a section on the “hog cycle,” describing how the price would rise, leading to herd expansion and resulting in lower prices. [That is what is happening in China; hog prices have plunged, and deeply indebted ranchers are in trouble.](#)

Political notes: Here are a couple of items that caught our attention.

- In Woodward and Costa’s new book, [it is reported that SoS Blinken and SoD Austin tried to extend the U.S. presence in Afghanistan.](#) It is clear the exit from Afghanistan was chaotic and poorly planned. The opposition to exit from Austin and Blinken may have led to less than diligent efforts to exit on the assumption that there would be more time.
- One undercurrent we watch in American politics is gerrymandering, the process of shaping Congressional districts for a party’s advantage. Good government would argue that non-partisan allocation would offer better representation, but political parties exist for the sole purpose of winning elections. Although the GOP is widely accused of gerrymandering, [we note that Democratic leaders in New York appear poised to use the practice to their advantage.](#)

Economics and policy: Real household income declined last year, and there is a threat to banks.

- [Real median household income fell last year, so did family income.](#)



Household income measures all household groups, including those who are unrelated. Family income measures incomes of households where the members are related by kinship or marriage.

- The tax proposal churn continues. [There is an apparent proposal to apply the wash sale rules to crypto, currencies, and commodities.](#) The wash sale rule currently applies to equities. Although the goal is to apply the rule to crypto, catching currencies and commodities is a new twist. This action doesn’t make much sense for commodities. Tax rules require the payment on unrealized gains at year’s end and making a trader wait

would be a severe disadvantage. We doubt this rule will be included, but it bears watching.

- Meanwhile, [progressives are starting to realize that most of their goals](#) for taxes are not going to make it into the final legislation.
- [Elizabeth Warren wants the Fed to break up Wells Fargo](#) (WFC, USD, 46.05). It appears she wants to return to a Glass-Steagall world. Under normal circumstances, we wouldn't comment on such things, as the request would fall on deaf ears. However, progressives want to oust Chair Powell, and this request could be a litmus test. If he agrees with the proposal, she will support his renomination. If he rejects or ignores it, she will oppose it. We doubt we can return to a Glass-Steagall world, but this might be an interesting test case.
- [Former intelligence officials argue that using anti-trust against tech firms will hurt the U.S. in the race against Chinese tech](#). We are not surprised to see such sentiment; the political establishment benefits from tech and doesn't want to see it disturbed. We are not sure this makes sense for either regulators or the firms themselves. If it is imperative they be allowed to hold near-monopoly positions, it makes sense to regulate them similar to utilities. It is not necessarily the case that breaking them up would hurt the U.S. technology effort. It might hurt the companies but make the industry stronger (e.g., the breakup of Standard Oil).
 - Apparently, Facebook's (FB, USD, 376.53) [Instagram is bad for teen girls](#), and the company knows it. [The Senate has questions](#).

International roundup: We get the State of the EU today, and Russia holds legislative elections over the weekend.

- European Commission President Ursula von der Leyen will hold her [State of the Union address today](#).
- Catalan independence has been on the backburner due to the pandemic. [But the issue returns as talks begin today](#).
- [The most recent Eurobond was oversubscribed 11 times](#).
- Russia will hold the State Duma elections this weekend. [We see an aggressive crackdown on opposition parties](#), and it is unclear what Putin is worried about.
- [The army in Myanmar is continuing its war against former protesters](#), which is evolving into a low-grade civil war.
- [Lithuanian angered Beijing by effectively giving Taiwan an embassy](#). [Slovenia says the EU should support Vilnius](#). Germany would not likely help this effort.
- [Islamic State is returning to Syria](#).

COVID-19: The [number of reported cases](#) is 225,924,019, with 4,651,193 fatalities. In the U.S., there are 41,367,771 confirmed cases with 663,963 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 458,771,465 doses of the vaccine have been distributed with 381,453,265 doses injected. The number receiving at least one dose

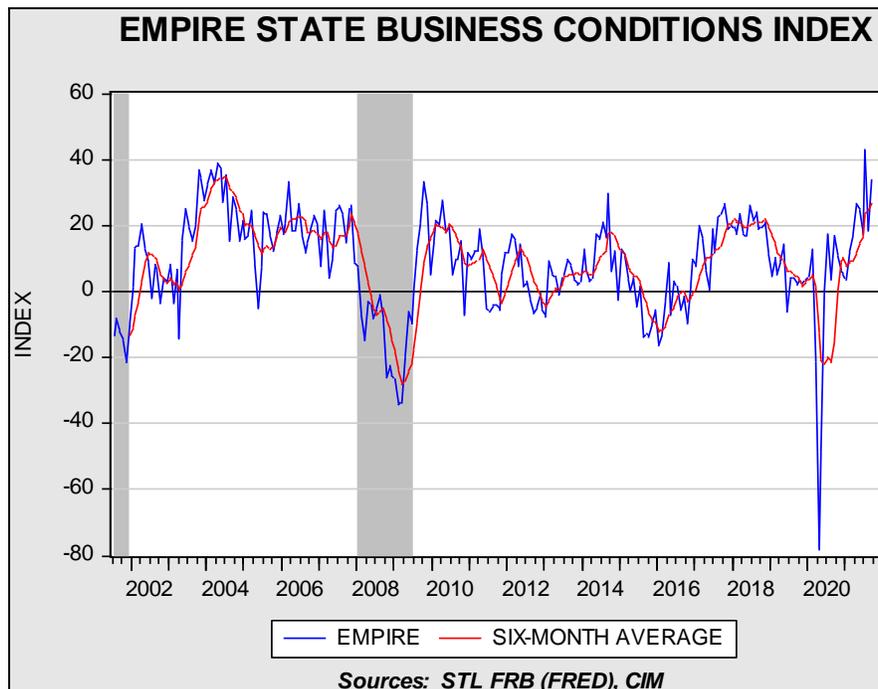
is 209,982,936, while the number receiving second doses, which would grant the highest level of immunity, is 179,289,983. For the population older than 18, 65.1% have been vaccinated. The *FT* has a page on [global vaccine distribution](#).

- When India had a massive rise in cases earlier this year, it suspended vaccine exports. Now that its cases have declined, [there is pressure on Delhi to resume exports](#). India is a major exporter of drugs and vaccines.
- The U.K. will [begin distributing booster shots next week](#).
- [President Putin is in quarantine](#) after being exposed to the virus by a member of his court.

U.S. Economic Releases

Mortgage application rose in the week ending September 10, according to the Mortgage Brokers Association. The MBA mortgage applications index rose 0.3% from the prior week. The index for refinancing fell 3.2% from the prior week, while home purchases rose 7.5%. The average 30-year fixed-rate mortgage remained unchanged from the prior week at 3.03%.

Manufacturing activity in New York state rose unexpectedly in September according to the U.S. Empire State Manufacturing Survey of General Business Activity. The General Business Activity Index came in at 34.3 compared to expectations of 17.9. The rise in the index was due to a huge jump in the number of orders and shipments. Additionally, the prices received rose to an all-time high of 47.8.



The chart above shows the six-month moving average of the Empire State Business Conditions Index. The six-month average rose from 24.45 to 27.27.

Trade conditions improved for U.S. consumers and producers in August as import prices fell and export prices rose. The Import Price Index fell 0.3% from the prior month compared to expectations of a rise of 0.2%. Excluding petroleum, the Import Price Index fell 0.2% from the prior month compared to expectations of a 0.2% rise. The Export Price Index rose 0.4% from the prior month, in line with expectations.



The chart above shows the Terms of Trade Index for all imports and exports. It has been used to gauge the benefits of trade. An increase in the index signals trade has improved the living conditions of a country, while a decrease in the index signals the opposite. The index currently is 106.18, which is the highest level in 10 years. Although inflation is a real concern, the trade front is providing some relief.

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

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:15	Industrial Production	m/m	Aug	0.5%	0.9%	**
9:15	Capacity Utilization	m/m	Aug	76.4%	76.1%	***
9:15	Manufacturing (SIC) Production	m/m	Aug	0.4%	1.4%	**
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.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
China	New Home Prices	m/m	Aug	0.2%	0.3%		**	Equity and bond neutral
	Retail Sales	y/y	Aug	2.5%	8.5%	7.0%	***	Equity bearish, bond bullish
	Industrial Production	y/y	Aug	5.3%	6.4%	5.8%	***	Equity bearish, bond bullish
	Fixed Assets Ex Rural YTD	y/y	Aug	8.9%	10.3%	9.0%	*	Equity and bond neutral
	Surveyed Jobless Rate	m/m	Aug	5.1%	5.1%	5.1%	***	Equity and bond neutral
India	Trade Balance	m/m	Aug	-\$13800.0m	-\$10970.0m	-\$13870.0m	**	Equity bearish, bond bullish
Australia	Westpac Consumer Conf SA	m/m	Sep	2.0%	-4.4%		***	Equity bullish, bond bearish
New Zealand	BoP Current Account Balance NZD	q/q	2Q	-1.396b	-2.895b	-1.750b	**	Equity and bond neutral
	Current Account GDP Ratio YTD	q/q	2Q	-3.3%	-2.2%	-3.3%	**	Equity and bond neutral
EUROPE								
Eurozone	Industrial Production SA	m/m	Jul	1.5%	-0.3%	0.6%	***	Equity bullish, bond bearish
	Labour Costs	y/y	2Q	-0.1%	1.5%		**	Equity and bond neutral
France	CPI EU Harmonized	y/y	Aug F	2.4%	2.4%	2.4%	***	Equity and bond neutral
	CPI	y/y	Aug F	1.9%	1.9%	1.9%	***	Equity and bond neutral
Italy	CPI EU Harmonized	y/y	Aug F	2.5%	2.6%	2.6%	***	Equity and bond neutral
	General Government Debt	m/m	Jul	2725.9b	2696.2b		**	Equity and bond neutral
UK	CPI	y/y	Aug	3.2%	2.0%	2.9%	***	Equity bearish, bond bullish
	CPI Core	y/y	Aug	3.1%	1.8%	2.9%	***	Equity bearish, bond bullish
	RPI	y/y	Aug	4.8%	3.8%	4.7%	**	Equity and bond neutral
	RPI Ex Mort Int. Payments	y/y	Aug	4.9%	3.9%	4.7%	**	Equity and bond neutral
	PPI Output NSA	y/y	Aug	5.9%	4.9%	5.4%	**	Equity and bond neutral
	PPI Input NSA	y/y	Aug	11.0%	9.9%	10.3%	*	Equity and bond neutral
	House Price Index	y/y	Jul	8.0%	13.2%	12.5%	**	Equity bearish, bond bullish
AMERICAS								
Brazil	IBGE Services Sector Volume	y/y	Jul	17.8%	21.1%	18.0%	**	Equity and bond neutral
Canada	Manufacturing Sales	m/m	Jul	-1.5%	2.1%	-1.1%	**	Equity and bond neutral
Mexico	International Reserves Weekly	w/w	10-Sep	\$198538m	\$205559m		*	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)	12	12	0	Down
3-mo T-bill yield (bps)	3	4	-1	Neutral
TED spread (bps)	9	8	1	Neutral
U.S. Libor/OIS spread (bps)	8	8	0	Down
10-yr T-note (%)	1.28	1.29	-0.01	Down
Euribor/OIS spread (bps)	-55	-54	-1	Neutral
EUR/USD 3-mo swap (bps)	4	3	1	Down
Currencies	Direction			
dollar	Down			Down
euro	Up			Up
yen	Up			Neutral
pound	Up			Neutral
franc	Up			Neutral
Central Bank Action	Current	Prior	Expected	
Chinese Medium-Term Lending Rate	2.950%	2.950%		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	\$74.65	\$73.60	1.43%	Bullish IEA report
WTI	\$71.55	\$70.46	1.55%	
Natural Gas	\$5.46	\$5.26	3.84%	
Crack Spread	\$20.72	\$20.60	0.63%	
12-mo strip crack	\$20.54	\$20.34	0.95%	
Ethanol rack	\$2.62	\$2.61	0.51%	
Metals				
Gold	\$1,802.05	\$1,804.51	-0.14%	
Silver	\$23.82	\$23.86	-0.15%	
Copper contract	\$436.05	\$432.10	0.91%	
Grains				
Corn contract	\$ 525.75	\$ 520.25	1.06%	
Wheat contract	\$ 705.00	\$ 700.75	0.61%	
Soybeans contract	\$ 1,292.00	\$ 1,282.50	0.74%	
Shipping				
Baltic Dry Freight	4221	4163	58	
DOE inventory report				
	Actual	Expected	Difference	
Crude (mb)		-3.6		
Gasoline (mb)		-3.0		
Distillates (mb)		-2.0		
Refinery run rates (%)		2.50%		
Natural gas (bcf)		76.0		

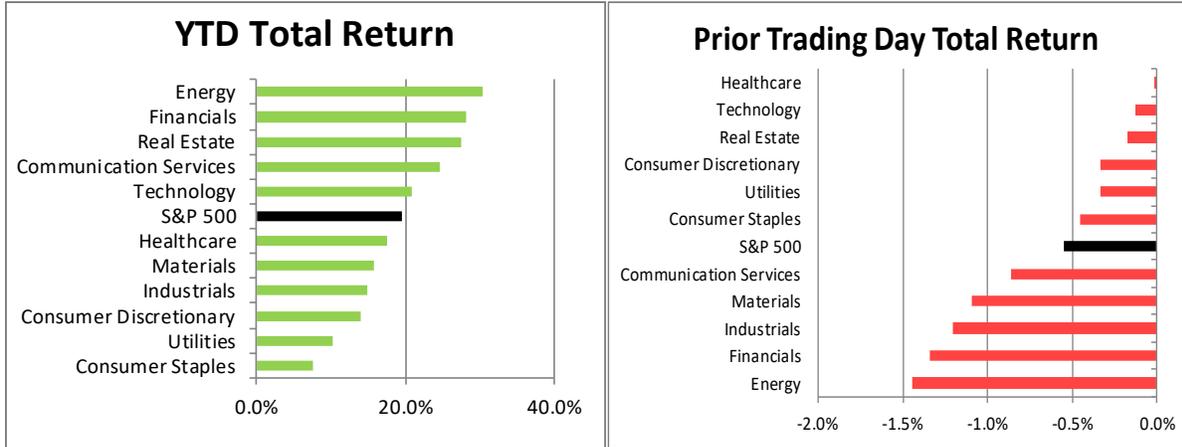
Weather

The 6-10 day and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout the entire eastern two-thirds of the country, with cooler temperatures throughout the Pacific region. The forecast calls for wetter-than-normal conditions in the South, the Northeast, and the Pacific Northwest, with dry conditions in the Great Plains.

There are currently three cyclonic disturbances in the Atlantic region and one off the coast of West Africa. One, Tropical storm Nicholas has been downgraded to a Tropical Depression as it makes landfall on the Louisiana coastline. The other two disturbances in the Atlantic Ocean are expected to develop into tropical storms within the next 48 hours. Neither storm is expected to make landfall in the U.S. We are past the normal peak of hurricane activity, which occurs on September 10.

Data Section

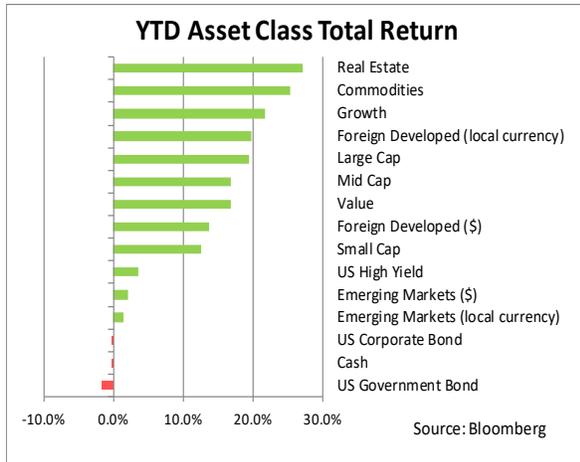
U.S. Equity Markets – (as of 9/14/2021 close)



(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 9/14/2021 close)

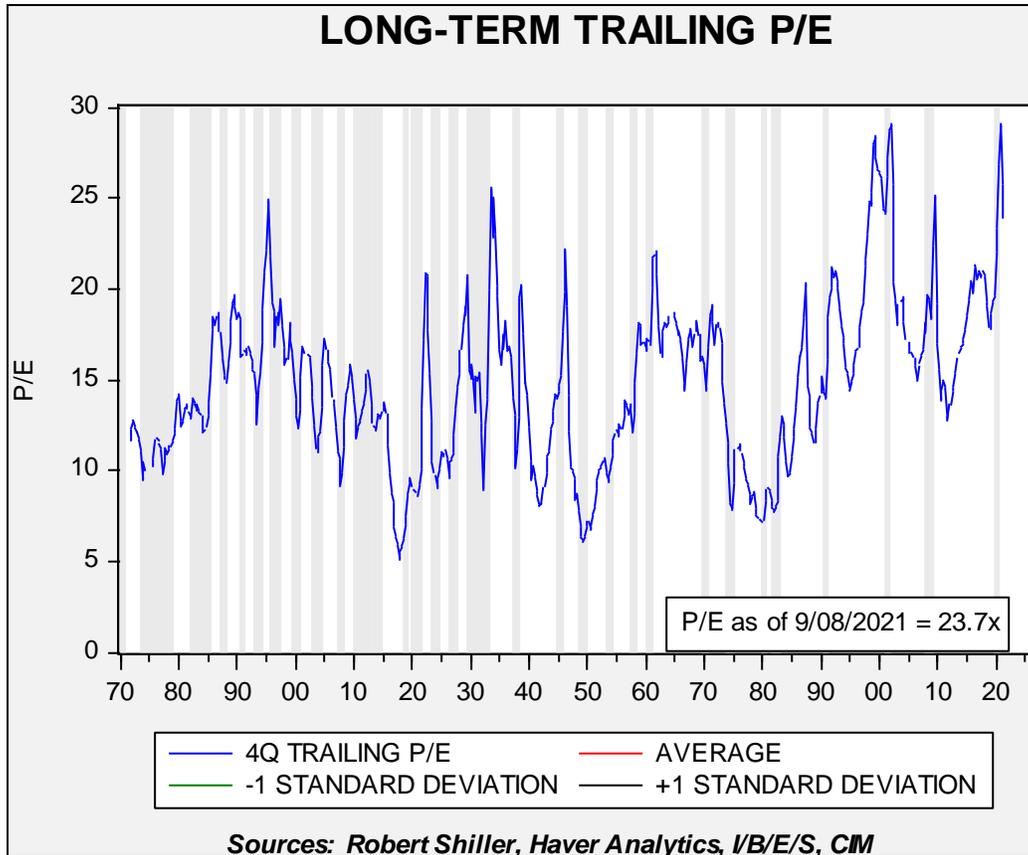


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

September 9, 2021



Based on our methodology,¹ the current P/E is 23.7x, up 0.1x from last week. Higher index values led to the rise in 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 three actual quarters (Q4, Q1 and Q2) and one estimate (Q3). 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.