

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 18, 2020—9:30 AM EDT] Global equity markets are generally lower this morning. The EuroStoxx 50 is relatively unchanged from its last close. In Asia, the MSCI Asia Apex 50 closed up 0.3%. Chinese markets were higher, with the Shanghai Composite up 2.1%, and the Shenzhen Composite up 1.5%. U.S. equity index futures are signaling a flat open.

Good morning and happy Friday! It's a quadruple "witching day," the day when stock index futures, single stock futures and their associated options expire. It is not unusual to see heightened volatility on such days. [Equity markets are mostly stable, so far, this morning](#). We begin our coverage with yesterday's Bank of England meeting, which ended after we wrote yesterday's report. China comes next, with more on TikTok. We update the pandemic news, followed by the latest on Brexit. A wrap-up of world news comes next and we close with economic news. Being Friday, there is a new [Asset Allocation Weekly](#), along with the associated [podcast](#) and [chart book](#). Here are the details:

Bank of England: Normally, we don't comment on the proceedings of this particular bank; although the U.K. financial system is important to the world, the British economy doesn't have an enormous impact any longer. On the other hand, the U.K. is sometimes a harbinger of trends that affect the U.S. For example, the rise of Tony Blair coincided with a similar figure, Bill Clinton. And, Brexit itself was a reflection of the rise of American populism. Although policy didn't change, the [Monetary Policy Committee warned that a return of the virus could trigger another downturn](#), which led the leadership to hint that the bank was "[exploring](#)" negative nominal policy rates. The GBP fell on the news. The BoE has, up until now, followed the Fed path, using QE and forward guidance in lieu of negative rates. The idea that the BoE appears to be preparing the markets for negative policy rates is new. Although we don't expect the Fed to follow this path (negative nominal rates bring havoc to the shadow banking system by effectively making money market funds untenable), the fact that the BoE is considering it raises the idea that this may become a trend here as well.

China news:

- The ongoing issue with TikTok continues. The company [has accepted U.S. changes](#) to the deal, which mostly center around data security. Hurdles remain, however. There are elements of the administration that want majority U.S. ownership of the company. [Congress is weighing in as well](#). According to reports, the company is proposing [two separate entities](#), a global and U.S. company, both domiciled in the U.S. It's the global entity that will have both [Oracle \(ORCL, 60.18\)](#) and [Walmart \(WMT, 136.69\)](#)

[investments](#). TikTok's current owner, ByteDance, is [offering to go public in the U.S.](#) in a bid to woo Washington to agree to the deal. There is one other issue; [Beijing has yet to weigh in on the arrangement](#) and may scotch the deal. Despite all these efforts, the [Commerce Department has ordered a ban on transactions over TikTok and WeChat](#) starting Sunday.

- Yesterday, we noted that [General Secretary Xi is pressing for greater control](#) over private sector firms. Communism in China is steadily evolving into a form of corporatism, where firms remain nominally private but will, at times, [have their corporate goals subsumed by the state](#). In return, the [government has promised aid and support](#).
- As tensions rise between the U.S. and China, [direct foreign investment is declining](#). Beijing is trying to shift its focus to Europe [but is struggling there as well](#). Meanwhile, [Congress is considering legislation to assist the economy in decoupling from China](#).

COVID-19: The [number of reported cases](#) is 30,205,226 with 946,673 deaths and 20,548,561 recoveries. In the U.S., there are 6,676,410 confirmed cases with 197,655 deaths and 2,540,334 recoveries. 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 R_t data](#) show that 22 states have a reading less than one (infections are not spreading) while 28 are showing the opposite condition. Hawaii has the lowest reading, Delaware the highest.

Virology:

- Moderna (MRNA, 67.89) and Pfizer (PFE, 36.82) [have revealed their vaccine testing plans](#), an unusual step; these are normally a closely guarded secret. [Moderna's timeline will still be testing into late this year and maybe early next year](#), although [some results](#) may be ready by late October or early November. All this suggests that a vaccine before year's end is less likely. At the same time, [vaccine distribution plans for the U.S. remain unresolved](#). It will take a while for the vaccine supply to increase and governments have to determine a plan of access while supplies are limited.
- WHO is warning [European governments that a second surge](#) in COVID-19 cases may be underway.
- As the odds of a winter surge in cases increases, the [medical sector is better prepared](#) due to advances in treatment protocols. One of the reasons hospitals were overwhelmed earlier this year was attributed to a [focus on efficiency](#) that left them with less surge capacity. [We discussed this issue](#) in general terms earlier this year.

Brexit: The U.S., on [a bipartisan basis](#), [is warning](#) PM Johnson not to create a border crisis in Northern Ireland. One of the more interesting facets of the U.K.'s recent Internal Market Bill is that it may not have been necessary. [There is a mechanism in the Withdrawal Bill for making adjustments](#). In fact, the EU has made several changes to which the U.K. has already agreed. The Johnson government could have raised its concerns within the current arrangement. The fact it didn't may mean the U.K. didn't think the EU would agree or Johnson may have simply made a mistake. British creditability has taken a hit, and its behavior may make it more difficult to make future trade agreements.

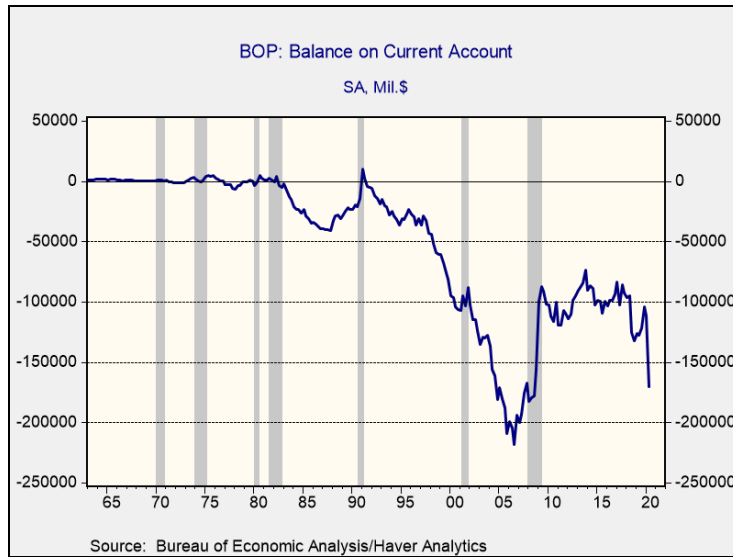
World news: Belarus is planning to [close its border with Poland and Lithuania](#), although reports from the frontiers suggest it hasn't occurred yet. It isn't clear why the borders are being closed, although we suspect Lukashenko is worried about activists fleeing the country. This announcement may be a precursor for a crackdown. [Peru's president is facing an impeachment vote](#); Martin Vizcarra has been under scrutiny over an influence-peddling scandal. [Aleksei Navalny was poisoned in his hotel by a water bottle](#) testing positive for Novichok. A [rare hurricane level storm](#) has formed in the Mediterranean; it is expected to make landfall in Greece.

Economy and policy news:

- The [governor of Illinois is warning that budget cuts may be looming](#) due to a drop in revenue. This is an issue we have worried about for some time, [that falling state and local government spending could weaken economic growth](#). Some members of Congress are [criticizing the Fed for not using the muni backstop](#) more aggressively. These backstops are a source of confusion, in part because the Fed hasn't done a good job in explaining their purpose. The media tended to treat the Fed's creation of various facilities as direct aid; the Fed seems to view them as an expansion of Bagehot's dictum about offering support during a financial crisis at ample levels but with a penalty rate. In other words, the backstops are there to ensure a market will exist when the dealers won't make a market. It isn't designed to bypass Congress in making fiscal decisions.
- Congress is [apparently close to a deal to avert a budget shutdown](#); although there are backchannel talks on another stimulus package, nothing concrete has emerged. [Airlines are indicating that without additional government support, furloughs are likely to begin October 1](#).
- In recent years we have seen a remarkable recovery in home prices; many homeowners find themselves with home equity that is tough to make liquid. [Wall Street is preparing to buy these homes](#), giving liquidity to these homeowners and turning the homes into rental property.
- The NY FRB has [created an index](#) that one can use to estimate current quarter GDP. Using this index, we estimate Q3 GDP will rise 22.6% on an annualized basis.

U.S. Economic Releases

A significant drop in exports due to the pandemic led to a substantial decline in the current account balance. The current account balance came in at -\$170.5B compared to the forecast of -\$160.0B.



The chart above shows the level of the current account balance. We expect the current account deficit to shrink in the following quarter.

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

| Economic Releases | | | | | | |
|------------------------|---|--|-------|----------|---------|--------|
| EDT | Indicator | | | Expected | Prior | Rating |
| 10:00 | Leading Index | m/m | Aug | 1.3% | 1.4% | ** |
| 10:00 | U. of Mich. Sentiment | m/m | Sep P | 75.0 | 74.1 | ** |
| 10:00 | U. of Mich. Current Conditions | m/m | Sep P | 83.1 | 82.9 | ** |
| 10:00 | U. of Mich. Expectations | m/m | Sep P | 67.2 | 6850.0% | ** |
| 10:00 | U. of Mich. 1 Yr Inflation | m/m | Sep P | 3.0% | 3.1% | ** |
| 10:00 | U. of Mich. 5-10 Yr Inflation | m/m | Sep P | | 2.7% | ** |
| Fed Speakers or Events | | | | | | |
| | Speaker or event | District or position | | | | |
| 10:00 | James Bullard Takes Part in Virtual Discussion on Economy | President of the Federal Reserve Bank of St. Louis | | | | |
| 12:00 | Raphael Bostic Speaks to Economic Club of Florida | President of the Federal Reserve Bank of Atlanta | | | | |
| 15:00 | Neel Kashkari Take Part in Virtual Panel on Covid | President of Federal Reserve Bank of Minneapolis | | | | |

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 | FX Net Settlement - Client CNY | m/m | Aug | -16.7b | 22.5b | | ** | Equity and bond neutral |
| Japan | National CPI | m/m | Aug | 0.2% | 0.3% | 0.2% | *** | Equity and bond neutral |
| | National CPI ex Food, Energy | m/m | Aug | -0.1% | 0.0% | -0.1% | *** | Equity and bond neutral |
| Europe | | | | | | | | |
| Eurozone | ECB Current Account SA | m/m | Jul | 16.6b | 20.7b | | ** | Equity and bond neutral |
| France | Wages | q/q | 1Q | 1.0% | 0.9% | | *** | Equity and bond neutral |
| Germany | PPI | m/m | Aug | 0.0% | 0.2% | | ** | Equity and bond neutral |
| Italy | Industrial Sales | m/m | Jul | 8.1% | 13.4% | | ** | Equity and bond neutral |
| | Industrial Orders | m/m | Jul | 3.7% | 23.4% | | ** | Equity and bond neutral |
| | Current Account Balance | m/m | Jul | 9308m | 3431m | | ** | Equity and bond neutral |
| UK | Retail Sales Ex Auto Fuel | m/m | Aug | 0.6% | 2.0% | 0.4% | ** | Equity and bond neutral |
| | Retail Sales Inc Auto Fuel | m/m | Aug | 0.8% | 3.6% | 0.8% | ** | Equity and bond neutral |
| Russia | Gold and Forex Reserve | m/m | 11-Sep | 598.1b | 591.7b | | * | Equity and bond neutral |
| | Money Supply Narrow Def | w/w | 11-Sep | 13.28t | 13.19t | | * | Equity and bond neutral |
| AMERICAS | | | | | | | | |
| Canada | CPI | y/y | Aug | 0.1% | 0.1% | 0.4% | *** | Equity bullish, bond bearish |
| | International Securities Transactions | m/m | Jul | -8.52b | 13.52b | | ** | Equity bearish, bond bullish |
| | Existing Home Sales | m/m | Aug | 6.2% | 26.0% | 8.0% | ** | 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) | 23 | 25 | -2 | Down |
| 3-mo T-bill yield (bps) | 8 | 9 | -1 | Neutral |
| TED spread (bps) | 15 | 16 | -1 | Up |
| U.S. Libor/OIS spread (bps) | 8 | 8 | 0 | Up |
| 10-yr T-note (%) | 0.68 | 0.69 | -0.01 | Neutral |
| Euribor/OIS spread (bps) | -49 | -49 | 0 | Neutral |
| EUR/USD 3-mo swap (bps) | 4 | 4 | 0 | Down |
| Currencies | Direction | | | |
| dollar | Down | | | Down |
| euro | Flat | | | Up |
| yen | Up | | | Up |
| pound | Up | | | Down |
| franc | Flat | | | 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 | \$43.16 | \$43.30 | -0.32% | |
| WTI | \$40.84 | \$40.97 | -0.32% | |
| Natural Gas | \$1.97 | \$2.04 | -3.53% | |
| Crack Spread | \$9.42 | \$9.56 | -1.52% | |
| 12-mo strip crack | \$10.77 | \$10.86 | -0.84% | |
| Ethanol rack | \$1.56 | \$1.56 | 0.01% | |
| Metals | | | | |
| Gold | \$1,952.37 | \$1,944.44 | 0.41% | |
| Silver | \$27.03 | \$27.04 | -0.03% | |
| Copper contract | \$309.10 | \$307.10 | 0.65% | |
| Grains | | | | |
| Corn contract | \$ 378.50 | \$ 375.25 | 0.87% | |
| Wheat contract | \$ 561.25 | \$ 556.25 | 0.90% | |
| Soybeans contract | \$ 1,041.00 | \$ 1,028.50 | 1.22% | |
| Shipping | | | | |
| Baltic Dry Freight | 1281 | 1289 | -8 | |
| DOE inventory report | | | | |
| | Actual | Expected | Difference | |
| Crude (mb) | -4.4 | 2.3 | -6.7 | |
| Gasoline (mb) | -0.4 | -0.6 | 0.2 | |
| Distillates (mb) | 3.5 | -0.3 | 3.7 | |
| Refinery run rates (%) | 4.00% | 1.50% | 2.50% | |
| Natural gas (bcf) | 89.0 | 78.0 | 11.0 | |

Weather

The 6-10 and 8-14 day forecasts currently call for warmer temperatures for most of the country, with cooler temperatures in the eastern third. Dry conditions are expected for most of the country. There are several cyclone formations moving throughout the Atlantic Ocean and the Gulf of Mexico, most of which aren't close to the U.S. Tropical Depression Sally has slowed to a post-tropical cyclone. It is currently moving along the border of North Carolina and South Carolina. A tropical depression has formed in the Gulf of Mexico and is expected to develop into a tropical storm over the next few days. At this time, it is too early to tell where the storm might hit, but it is likely to make landfall along the Mexico-Texas coast.

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](#).

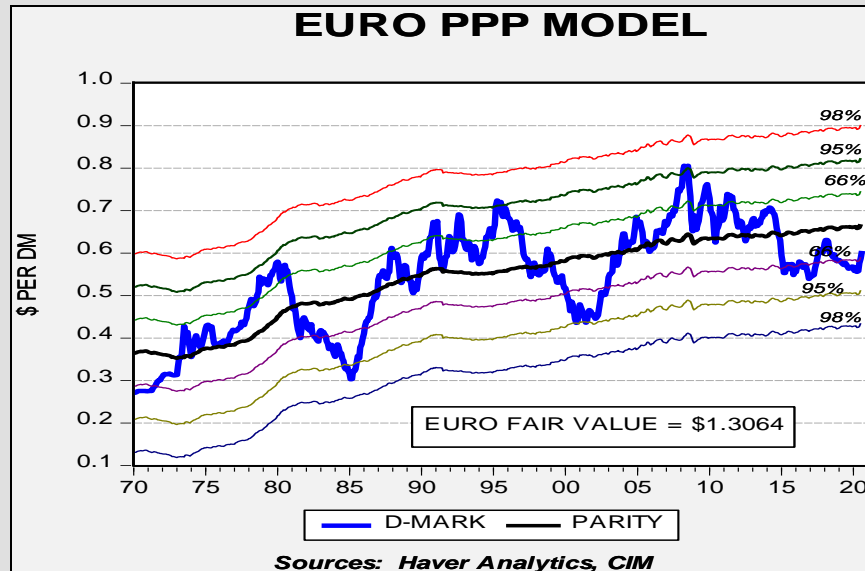
September 18, 2020

In June, [we published a WGR](#) on the EU’s decision to issue a Eurobond, a financial instrument backed by the full faith and credit of all the member states of the European Union. One of the reasons the U.S. dollar remains the global reserve currency is because the world financial system works on a dollar/Treasury standard. The U.S. has open trade and capital markets. Because of America’s willingness to accept persistent trade deficits, foreign countries can acquire dollars through trade and easily hold those dollars in reserve in the deep American financial markets. The premier reserve instrument has been the U.S. Treasury; in fact, it could be argued that the Treasury is America’s greatest export product.

The attractiveness of the dollar as a reserve instrument is relative; American management of the reserve currency is far from ideal. When the world shifted from the dollar/gold to dollar/Treasury, Europeans complained that the U.S. was exporting inflation through a weaker currency. Treasury Secretary Connally noted that the dollar “[is our currency but it’s your problem](#).” Volcker’s anti-inflation policies of the early 1980s was a major contributor to the Latin American debt crisis and the “lost decade” of the 1980s for South America. Since 9/11, the U.S. has used financial sanctions as a foreign policy tool. Restricting access to the U.S. financial system has proven to be very effective in crippling foreign economies.¹ But, these sanctions are not popular with foreign governments. Dissatisfaction with dollar management has not reached a level adequate to overcome the network effects that keep the dollar as the reserve asset.

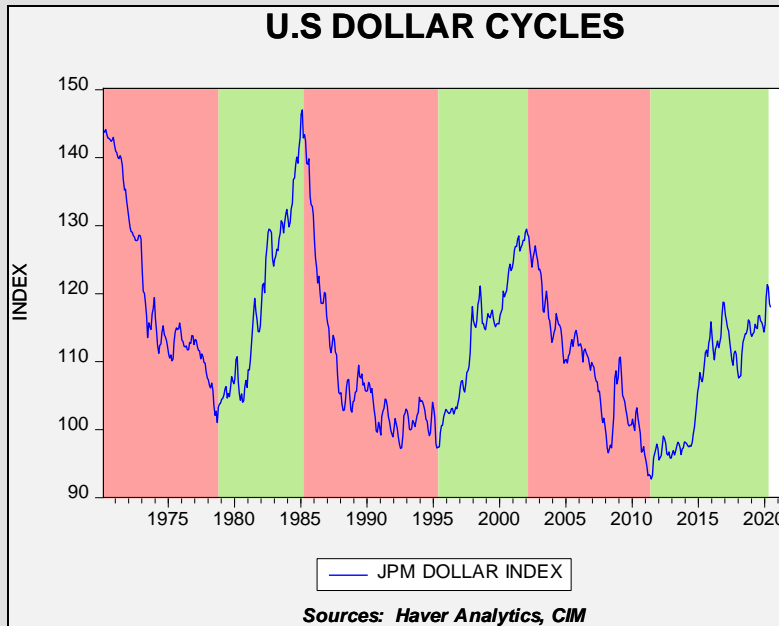
It is important to note that we view the introduction of a Eurobond as a catalyst for a change in trend but the primary reason for a new dollar bear market is valuation. Against most major currencies, the dollar is deeply overvalued.

¹ Iran can attest to this assertion.



Our primary valuation model for currencies is purchasing power parity. This model uses relative inflation to value currencies. It is not a trading model; exchange rates tend to vacillate around the forecast parity level. But, at extremes, it can signal that the exchange rate is vulnerable to a reversal. In general, dollar bull markets tend to end with a catalyst. The 1970s dollar bear market began with the closing of the gold window. The 1985 bull market ended with the Plaza Accord. The 2002 trend reversal began with statements pressing for a weaker dollar from the U.S. Treasury secretary. As is true of many markets, valuation alone doesn't cause reversals, but it creates conditions where a reversal is more likely.

Perhaps another way of thinking about the dollar is that the exchange rate creates winners and losers. A strong dollar adversely affects exporters and industries that compete with imports. It supports importers and solely domestic industries. A weak dollar has the opposite impact. Thus, over time, when a sector is harmed a political reaction will follow which leads to a reversal in trend. With the dollar, the cycles tend to be long, meaning that the level needs to be extreme to trigger a policy response.



This chart shows the JP Morgan Dollar Index, which is adjusted for inflation and is trade weighted.² Bull markets are colored in green, and bear markets in mauve. For a U.S. dollar investor, the path of the dollar’s exchange rate is a critical component of foreign investing.

| USD bull | | USD bear | | STDEV | | |
|----------|-------------|----------|-------------|-------|------|-------------|
| Months | CYCLES | US | WORLD/EX US | Diff | US | WORLD/EX US |
| 103 | 70/03-78/10 | 2.0 | 9.8 | -7.8 | 16.4 | 20.6 |
| 76 | 78/11-85/03 | 8.9 | 8.7 | 0.2 | 15.3 | 15 |
| 121 | 85/04-95/05 | 11.7 | 17.5 | -5.8 | 12.6 | 26.7 |
| 80 | 95/06-02/02 | 15.8 | 3.3 | 12.5 | 18.5 | 14.3 |
| 110 | 02/03-11/05 | 2.7 | 6.9 | -4.2 | 19.6 | 23.6 |
| 109 | 11/06-20/07 | 11.0 | 1.9 | 9.1 | 8.8 | 12 |
| 111 | Averages | 5.47 | 11.4 | -5.9 | 16.2 | 23.6 |
| 88 | | 11.9 | 4.6 | 7.3 | 14.2 | 13.8 |

This table uses the dollar cycle dates and compares the MSCI U.S. Index with the MSCI World ex-U.S. Index. We use the yearly change in monthly data, averaged over each cycle. On average, the latter index outperforms the U.S. in dollar bear markets, whereas the U.S. outperforms during dollar bull markets. There are two other characteristics of note. First, cycles last a while; the average dollar bear market lasts 111 months (just over nine years) and dollar bull markets last 88 months (eight years). Second, dollar bear markets tend to have higher levels of volatility.

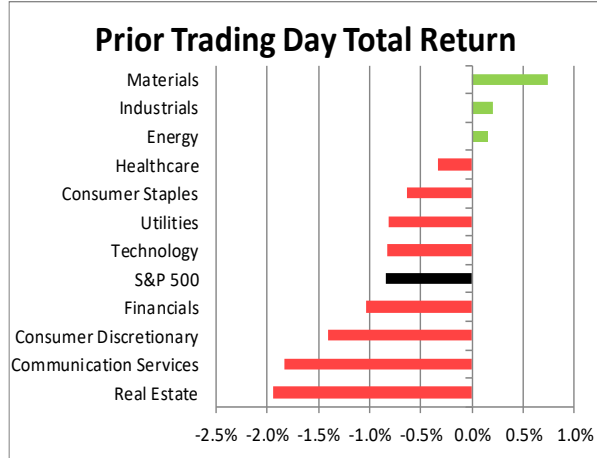
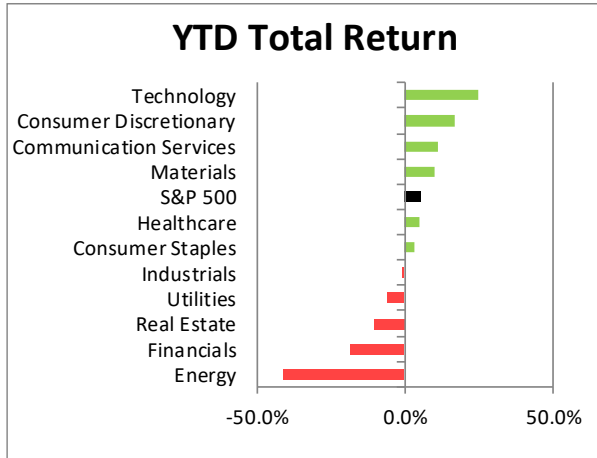
² Countries that conduct more trade with the U.S. are weighted more heavily in the index.

If our postulate is correct and the dollar is about to enter a bear market, the outlook for foreign stocks relative to domestic stocks improves. Although there is no certainty that our position is correct, the combination of an overvalued currency, a lengthy bull market, and a Eurobond catalyst increases the odds that a reversal is likely. If so, the outlook for foreign equities should improve.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

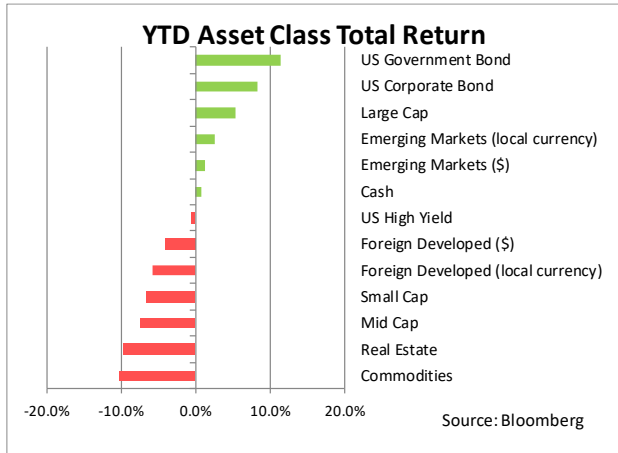
U.S. Equity Markets – (as of 9/17/2020 close)



(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 9/17/2020 close)

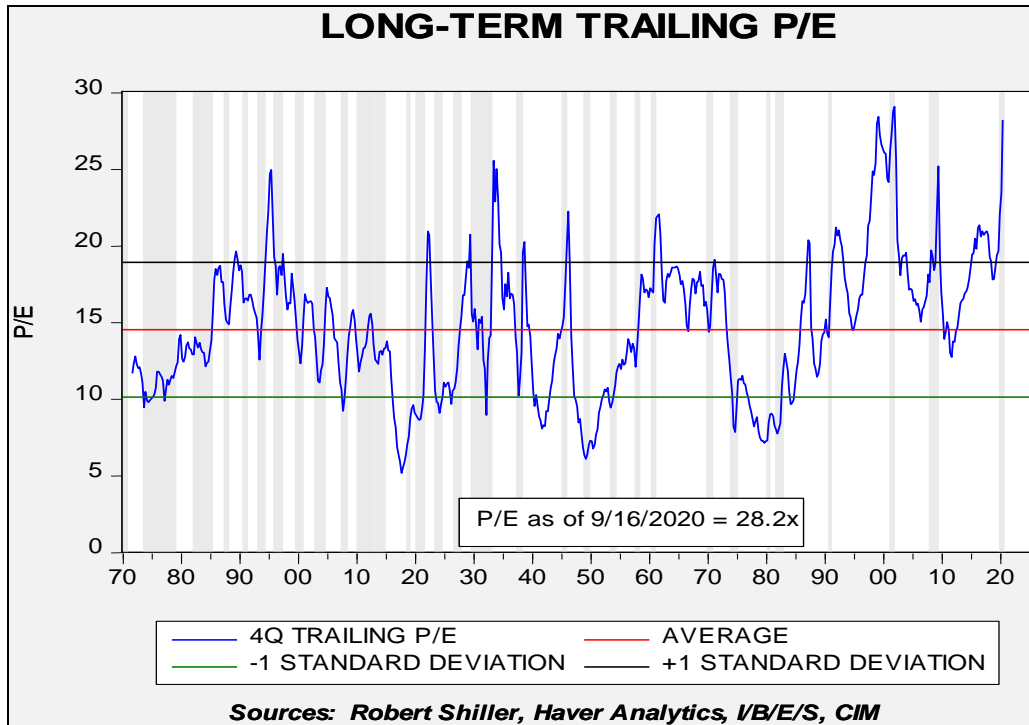


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

September 17, 2020



Based on our methodology,³ the current P/E is 28.2x, up 0.1x from last week.

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.

³ 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.