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: September 23, 2020—9:30 AM EDT] Global equity markets are higher this morning. The EuroStoxx 50 is up 1.7% from its last close. In Asia, the MSCI Asia Apex 50 closed up 0.2%. Chinese markets were high, with the Shanghai Composite up 0.2%, and the Shenzhen Composite up 0.8%. U.S. equity index futures are signaling a higher open.

Our *Daily Comment* today discusses the state-of-play on Supreme Court politics in the U.S. and the initial passage of a vote that is keeping the federal government funded through December. Those developments are positive and are probably helping to give risk markets a boost so far this morning. However, we also note several continued risks, such as a potential problem for the TikTok deal and worsening coronavirus infections around the world.

U.S. Supreme Court: After Senator Romney's commitment yesterday to immediately consider and vote for President Trump's next Supreme Court nominee, it appears the Democrats won't be able to stop a quick vote on the pick. In fact, many Republicans are now pushing to vet and vote on Trump's eventual nominee before the election on November 3. Trump is expected to name his nominee on Saturday. Even though such a quick confirmation process has the potential to anger and energize Democratic voters more than Republicans, the White House may have decided the risk was worth it. This will put an additional conservative judge on the panel in case a disputed election has to be decided by the Supreme Court. In any event, the moves highlight the growing risk of disruptive, confidence-sapping political disputes and delayed election results that the markets will have to contend with over the next few months. It should not be a surprise if the financial markets remain volatile until things get sorted out.

U.S. Fiscal Policy: The House of Representatives last night passed a short-term spending bill keeping the federal government funded through December 11. The Senate is now expected to approve the bill next week, averting a partial shutdown when the government's funding expires on September 30. Given that the economic recovery from the coronavirus has been losing steam, a government shutdown could have been a crippling blow to confidence. We therefore consider the likely passage of the bill to be a notable positive for the markets.

U.S.-China Relations: Critical editorials published by several Chinese state-media outlets suggest Beijing might not approve last weekend's deal to sell a stake in Chinese social media app TikTok to U.S. investors in an effort to avoid a Trump administration ban on the app due to data security concerns. Coupled with apparent disagreements over the deal's ownership and control provisions, it looks like TikTok is not out of the woods yet. If the deal fails, it would further add to U.S.-China frictions that have unnerved financial markets over the last couple of years.

Separately, in his video speech to the U.N. General Assembly yesterday, President Trump again called out China for its role in allowing the coronavirus pandemic to start, and he demanded that Beijing be "held accountable" for its actions.

Russia: Opposition activist Alexei Navalny has been discharged from the German hospital where he was treated for poisoning by the Russian chemical weapon Novichok. According to officials at the hospital, Navalny has a chance of "complete recovery," which suggests he will be able to carry on as a political thorn in President Putin's side once he returns to Russia.

Global auto industry: Tesla (TSLA, 424.23) held its big "Battery Day" event yesterday, with CEO Elon Musk predicting that advances in cell manufacturing and chemistry would allow the firm to slash battery costs and eliminate the price advantage of gasoline-powered cars in about three years. Investors were evidently disappointed in that timeline, but that shouldn't detract from the major impact electric vehicles are likely to have on the world economy if Musk is right. Given the auto industry's huge economic footprint, the implied switchover to electric vehicles could portend a major restructuring of the world's industrial sector and labor market.

COVID-19: Official data show confirmed cases have risen to 31,647,930 worldwide, with 971,711 deaths and 21,776,599 recoveries. In the United States, confirmed cases rose to 6,897,661, with 200,818 deaths and 2,646,959 recoveries. Here is the interactive chart from the *Financial Times* that allows you to compare cases and deaths among countries, scaled by population.

Virology

- Confirmed U.S. infections rose by only about 39,000 yesterday, but the seven-day moving average of new infections remained on its recent uptrend and topped 43,000. New deaths linked to the virus remain at approximately 750 per day. Elsewhere, major European countries continue to face resurgent infections, raising the risk of targeted new lockdowns and financial market disruptions.
- Johnson & Johnson (JNJ, 144.21) said it has started a 60,000 person clinical trial of its single-dose COVID-19 vaccine on three continents. That means Johnson & Johnson has the fourth experimental vaccine to enter final-stage testing in the U.S., further increasing the odds that a viable vaccine will be available, at least in limited quantities, in the coming months. The company's single-dose format could be especially important in easing logistics for getting people vaccinated and increasing uptake of the shot.
- The Food and Drug Administration has reportedly developed draft guidelines that would require any new COVID-19 vaccine to meet strict safety and effectiveness standards before it could gain quick use authorization. Among the proposed requirements is that a coronavirus shot reduce the rate of infections by 50% compared with a placebo, which the regulators have already required for regular approval of any COVID-19 vaccines.
    - The White House must sign off on the plan, but if it does so, it would make it difficult for a vaccine to be authorized for emergency use before Election Day.
    - Some observers have accused the federal government of politicizing its virus policy and guidelines. We take no position on that issue, but we do note that if

quickly approved vaccines are seen as having been rushed to market without proper testing, many people might be reluctant to get the shot.
    - If uptake of the vaccine is low, the virus could continue to spread and disrupt economic activity longer than would otherwise be the case, with negative implications for risk assets.

Economic Impacts

- The IHS Markit flash composite purchasing managers index for the Eurozone unexpectedly declined to a seasonally adjusted 50.1 in September, only slightly above the 50-level that signifies increasing economic activity (see data tables below). The figure for September was a significant decline from the 51.9 reading for August. On the bright side, the sub-index on manufacturing rose to a two-year high of 53.7 from 51.7 in the previous month. The problem was that the sub-index on the service sector, which has been hit especially hard by the pandemic, fell all the way to 47.6 from 50.5.
    - In the U.K., the IHS Markit/CIPS flash PMI fell to 55.7, from a 72-month high of 59.1 in August, as business leaders reported a fall in optimism and consumer confidence. Some flash PMIs in Asia also pointed to a faltering recovery.
    - Taken together, the data appear to reflect the negative impact from Europe's resurgent coronavirus cases, in addition to the natural moderation in growth following the big bounce after severe restrictions were lifted over the summer.

U.S. Policy Response

- A day after testifying with Treasury Secretary Mnuchin before the House Banking Committee, Federal Reserve Chair Powell today testifies before a House committee monitoring the government's response to the coronavirus crisis.

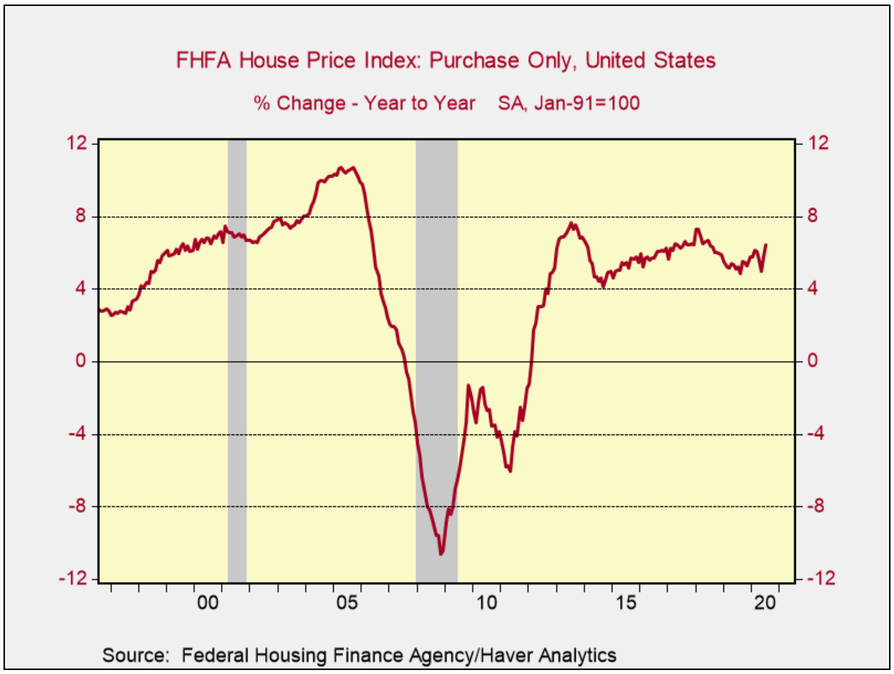
Foreign Policy Response

- The European Central Bank has urged the EU to consider making its new €750 billion pandemic recovery fund permanent in order to ensure "stronger economic support for more vulnerable countries."
    - Not even including the loans in the program, ECB economists estimated the €390 billion in grants would provide a net benefit worth more than 10% of the pre-crisis Croatian and Bulgarian GDP and almost 9% for Greece. Other net beneficiaries of the grants include Portugal, which would gain 5.4% of its pre-crisis economy, Spain with a gain of 3.4%, and Italy with a gain of 1.9%.
    - As we've argued before, the introduction of common EU debt backed by the full faith and credit of the bloc's member states, which is how the recovery fund is to be financed, would go far toward making the euro a more viable reserve currency. If making the fund permanent implies continued large-scale borrowing over time, the impact would be even greater, and the euro could start to appreciate even further compared with the greenback.

U.S. Economic Releases

For the week ending September 18, MBA mortgage applications rose 6.8% from the prior week. Home purchase and refinancing applications rose 3.4% and 8.8%, respectively. The average 30-year fixed-rate mortgage rose 3 bps from 3.07% to 3.10%.

Home prices continue to rise at a steady pace according to the FHFA. In July, the FHFA Home Price Index rose 1.0% from the prior month compared to expectations of a rise of 0.5%.



The chart above shows the annual change in the FHFA Home Price Index. Home price rose 6.5% from the previous year.

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	Markit US Manufacturing PMI	m/m	Sep	53.5	53.1	**
10:00	Markit US Services PMI	m/m	Sep	54.5	55.0	**
10:00	Markit US Composite PMI	m/m	Sep		54.6	**
Fed Speakers or Events						
	Speaker or event	**District or position**				
10:00	Jerome Powell Appear Before House Panel on COVID-19	Chairman of Board of Governors of Federal Reserve				
11:00	Charles Evans Discusses the U.S. Economy and Monetary Policy	President of the Federal Reserve Bank of Chicago				
13:00	Eric Rosengren Discusses U.S. Economy	President of the Federal Reserve Bank of Boston				
13:00	Neel Kashkari Discusses Public Health	President of Federal Reserve Bank of Minneapolis				
13:00	Raphael Bostic Speaks to Hale County Chamber of Commerce	President of the Federal Reserve Bank of Atlanta				
14:00	Randal Quarles Gives Speech on the Economic Outlook	Federal Reserve Vice Chairman of Supervision				
15:00	Mary Daly Discusses Labor Force Implications of COVID-19	President of the Federal Reserve Bank of San Francisco				

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								
Japan	Jibun Bank Japan PMI Mfg	m/m	Sep	47.3	47.2		**	Equity bullish, bond bearish
	Jibun Bank Japan PMI Services	m/m	Sep	45.6	45.0		**	Equity bullish, bond bearish
	Jibun Bank Japan PMI Composite	m/m	Sep	45.5	45.2		**	Equity bullish, bond bearish
	All Industry Activity Index	m/m	Jul	1.3%	6.1%	1.3%	*	Equity and bond neutral
Australia	CBA Australia PMI Mfg	m/m	Sep	55.5	53.6		**	Equity bullish, bond bearish
	CBA Australia PMI Services	m/m	Sep	50.0	49.0		**	Equity bullish, bond bearish
	CBA Australia PMI Composite	m/m	Sep	50.5	49.4		**	Equity bullish, bond bearish
Europe								
Eurozone	Markit Eurozone Manufacturing PMI	m/m	Sep	53.7	51.7	51.9	**	Equity bullish, bond bearish
	Markit Eurozone Services PMI	m/m	Sep	47.6	50.5	50.6	**	Equity bearish, bond bullish
	Markit Eurozone Composite PMI	m/m	Sep	50.1	51.9	51.9	**	Equity bearish, bond bullish
France	Markit France Manufacturing PMI	m/m	Sep	50.9	49.8	50.6	**	Equity and bond neutral
	Markit France Services PMI	m/m	Sep	47.5	51.5	51.5	**	Equity bearish, bond bullish
	Markit France Composite PMI	m/m	Sep	48.5	51.6	51.9	**	Equity bearish, bond bullish
Germany	GfK Consumer Confidence	m/m	Oct	-1.6	-1.8	-0.8	**	Equity bearish, bond bullish
	Markit/BME Germany Manufacturing PMI	m/m	Sep	56.6	52.2	52.5	**	Equity and bond neutral
	Markit Germany Services PMI	m/m	Sep	49.1	52.5	53.0	**	Equity bearish, bond bullish
	Markit/BME Germany Composite PMI	m/m	Sep	53.7	54.4	54.0	**	Equity and bond neutral
UK	Markit UK PMI Manufacturing SA	m/m	Sep	54.3	55.2	54.0	**	Equity and bond neutral
	Markit/CIPS UK Services PMI	m/m	Sep	55.1	58.8	55.9	**	Equity bearish, bond bullish
	Markit/CIPS UK Composite PMI	m/m	Sep	55.7	59.1	56.1	**	Equity bearish, bond bullish
AMERICAS								
Mexico	International Weekly Reserves	w/w	18-Sep	$19.379b	$19.332b		**	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	23	-1	Down
3-mo T-bill yield (bps)	9	9	0	Neutral
TED spread (bps)	14	14	0	Up
U.S. Libor/OIS spread (bps)	8	8	0	Up
10-yr T-note (%)	0.67	0.67	0.00	Neutral
Euribor/OIS spread (bps)	-51	-51	0	Neutral
EUR/USD 3-mo swap (bps)	3	2	1	Down
Currencies	**Direction**			
dollar	Flat			Down
euro	Flat			Up
yen	Down			Up
pound	Flat			Down
franc	Flat			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
SNB Sight Deposit Interest Rate		-0.750%	-0.750%	On forecast
SNB Policy Rate		-0.750%	-0.750%	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	$41.92	$41.72	0.48%	
WTI	$39.93	$39.80	0.33%	
Natural Gas	$1.84	$1.83	0.49%	
Crack Spread	$7.96	$8.73	-8.78%	
12-mo strip crack	$10.27	$10.26	0.08%	
Ethanol rack	$1.54	$1.54	-0.09%	
Metals				
Gold	$1,894.45	$1,900.21	-0.30%	
Silver	$23.72	$24.40	-2.78%	
Copper contract	$304.25	$306.10	-0.60%	
Grains				
Corn contract	$ 367.50	$ 369.25	-0.47%	
Wheat contract	$ 556.50	$ 558.00	-0.27%	
Soybeans contract	$ 1,020.50	$ 1,019.75	0.07%	
Shipping				
Baltic Dry Freight	1364	1314	50	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.8		
Gasoline (mb)		-0.8		
Distillates (mb)		1.0		
Refinery run rates (%)		0.85%		
Natural gas (bcf)		77.0		

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 half. Wet conditions are expected to move from New England to the eastern half of the country. Tropical Storm Beta and Hurricane Teddy have been downgraded to post-tropical storms.

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.

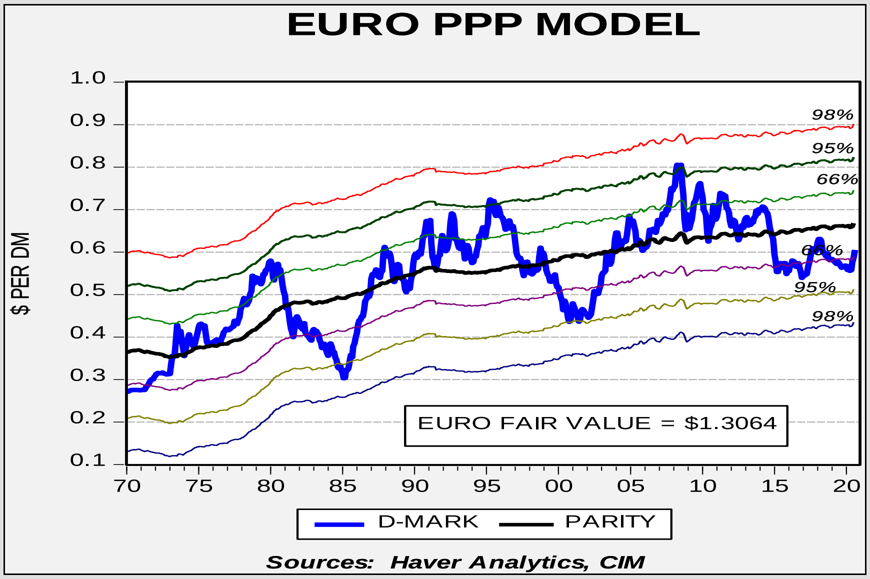
September 18, 2020

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.

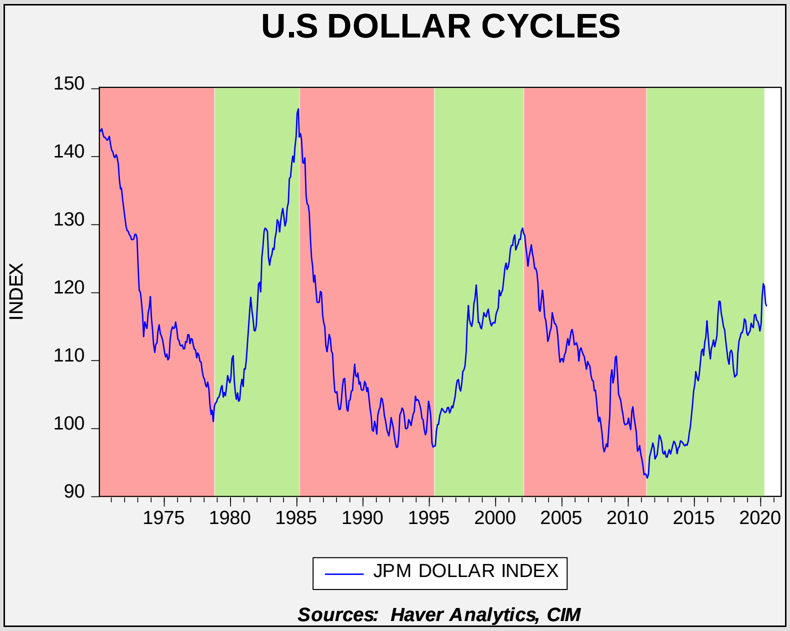
It is important to note that we view the introduction of a Eurobond as a catalyst for a change in trend but the primary reason for a new dollar bear market is valuation. Against most major currencies, the dollar is deeply overvalued.

[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*

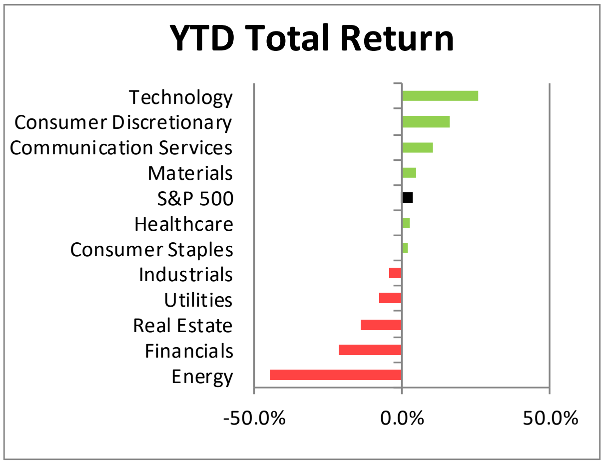
This table uses the dollar cycle dates and compares the MSCI U.S. Index with the MSCI World ex-U.S. Index. We use the yearly change in monthly data, averaged over each cycle. On average, the latter index outperforms the U.S. in dollar bear markets, whereas the U.S. outperforms during dollar bull markets. 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.

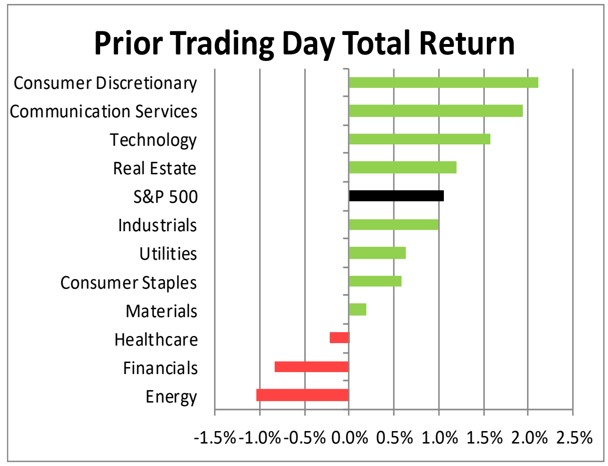
[2] Countries that conduct more trade with the U.S. are weighted more heavily in the index.

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.

Data Section

U.S. Equity Markets – (as of 9/22/2020 close)

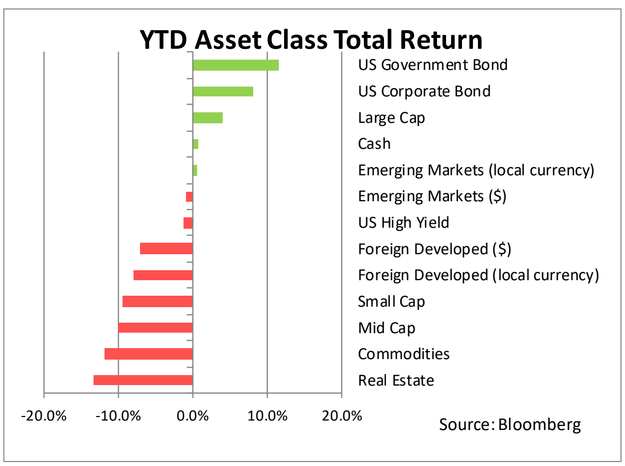




(Source: Bloomberg)

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 9/22/2020 close)

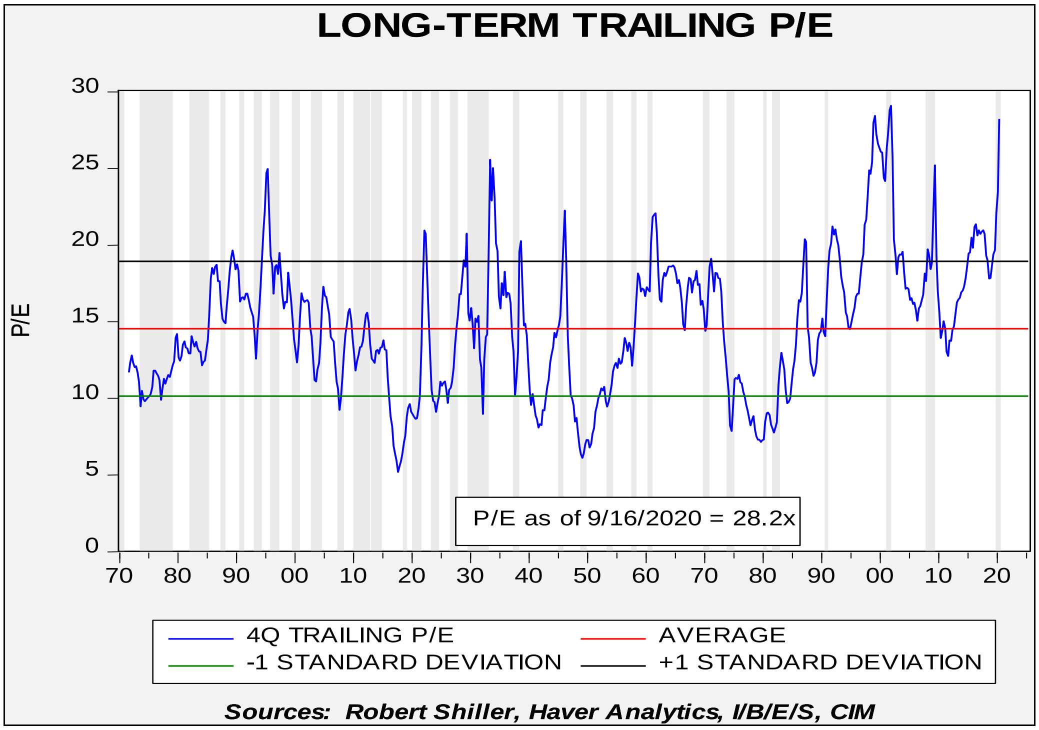


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.