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 29, 2020—9:30 AM EDT] Global equity markets are mixed this morning. The EuroStoxx 50 is down 0.3% from its last close. In Asia, the MSCI Asia Apex 50 closed down 0.1%. Chinese markets were higher, with the Shanghai Composite up 0.2%, and the Shenzhen Composite up 1.0%. U.S. equity index futures are signaling a flat open.

Our *Daily Comment* today provides a brief introduction to tonight's presidential debate, the anticipation of which could keep a lid on the markets throughout the day. We also discuss several geopolitical tensions involving Eastern Europe, as well as the latest developments related to the coronavirus epidemic.

U.S. Elections: President Trump and Joe Biden will meet face to face tonight in the first of three scheduled debates before the presidential election. The action starts at 9:00 pm ET and is scheduled to last an hour and a half. With Biden narrowly leading in many key polls and prediction markets, we would expect him to work hard at maintaining a calm, presidential air while attacking Trump on issues like the coronavirus pandemic, income and social inequalities, and the president's tax records. We would expect Trump to hammer away at Biden's age and the left wing of the Democratic Party. If the result is perceived to be a draw, the event could have little or no discernible impact on the financial markets. However, if one side or the other scores a body blow or suffers a major gaffe, markets could react significantly on Wednesday. In fact, if that happens, the resulting market moves could indicate what to expect over the coming month as the election dynamics play out.

United States-Russia: As talks over extending the last remaining U.S.-Russia strategic arms control agreement remain deadlocked, the Trump administration has reportedly asked the military to assess how quickly it could pull U.S. nuclear weapons out of storage and load them onto bombers and submarines if the treaty expires in February. The request was part of a strategy to heap pressure on Russia in renegotiating the New START treaty ahead of the U.S. election.

European Union: Amid negotiations over the EU's long-term budget and its proposed new €750 billion pandemic relief fund, Germany proposed rules that, in some circumstances, would suspend disbursements to countries violating the bloc's rules on judicial independence and respect for democracy. However, several northern European member states criticized the move as too weak, even though it is likely to be too intrusive for eastern members like Hungary and Poland. The prolonged impasse is important because it could undermine the relief fund's massive new mutualized EU debt obligations backed by the full faith and credit of the member countries.

France-Belarus: In his visit to the Baltic states of Latvia and Lithuania this week, French President Macron met with exiled Belarussian opposition leader Svetlana Tikhanovskaya and promised to help negotiate the release of other opposition leaders imprisoned by Belarussian President Aleksander Lukashenko. The intervention into Belarus, which Russian President Putin considers to be in Russia's rightful sphere of interest, is an additional sign that Macron may be giving up on his efforts to draw Europe closer to Moscow.

- Macron also promised to help shield the Baltic states from Russian cyberattacks and disinformation campaigns, and he has condemned Russia's apparent poisoning of opposition leader Alexei Navalny (one senior French official claimed the use of a chemical weapon against him crossed "a red line"). All in all, the move reflects Macron's ongoing effort to bolster French influence in international relations.
- Meanwhile, Russian President Vladimir Putin is using the Belarussian crisis to press Lukashenko for the right to put a Russian military bases on Belarusian territory.

Azerbaijan-Armenia-Turkey: New reporting indicates Turkey has been facilitating the Azeri government's fight against rebels in its ethnic Armenian enclave of Nagorno-Karabakh. According to the BBC, the Turkish assistance includes military equipment, military advisors, and transporting in Syrian mercenaries to help in the fight. If so, it marks another aggressive, risky new international move by President Erdogan to assert Turkey into the region's politics (for a fuller discussion of Erdogan's policies, see our latest *WGR*, published yesterday). That move is likely to irritate Russian President Putin, who considers both Armenia and Azerbaijan as important allies, and he prefers they maintain peaceful relations. Even though the UN Security Council is scheduled to discuss the conflict later today, the fighting could also worry oil markets, as it could endanger supplies from the Caspian fields.

Precious Metals Market: An article in today's *Wall Street Journal* offers a nice overview of the forces pushing up gold prices this year. Despite the recent pullback in precious metals prices, we continue to believe that factors like extremely low interest rates and expansive fiscal policy should be bullish for gold and silver in the coming years.

COVID-19: Official data show confirmed cases have risen to 33,401,514 worldwide, with 1,002,676 deaths and 23,183,669 recoveries. In the United States, confirmed cases rose to 7,150,165, with 205,091 deaths and 2,794,608 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 33,000 yesterday, but the seven-day average remained well above 40,000. The seven-day average of daily deaths remained at approximately 750. New cases continue to surge in the Upper Midwest, especially in North Dakota, South Dakota, and Wisconsin, as well as in parts of New York City.

Overseas, several days of lower infection and death figures in India raised hopes that the pandemic may be moderating in that country.

- The World Health Organization has announced plans to make 120 million inexpensive COVID-19 antigen tests available to lower and middle-income countries, seeking to limit the spread of coronavirus in the developing world.
- As a reminder that not all of the dozens of vaccines under development will face smooth sailing, Inovio Pharmaceuticals (INO, 12.14) was forced to delay the planned Phase 2/3 trial of its compound because of concerns raised by the FDA. The company suggested the concerns don't relate to the vaccine itself, which would be the first synthetic DNA vaccine ever brought to market, but rather to the delivery equipment required to inject it. Nevertheless, the setback drove the company's stock down sharply yesterday, even as most of the market was surging.

Economic Impacts

- United Airlines (UAL, 35.94) said its pilots union narrowly agreed to operating efficiencies that would reduce the number of layoffs the carrier must make if no additional federal financial aid is provided.
    - According to the company, total compulsory layoffs can now be held to just 12,000 non-pilot staff members, compared with 16,000 pilots and non-pilots planned previously and 36,000 initially projected in July.
    - The dramatic revision to planned layoffs could mean United is using the pandemic and the threat of job losses to wring concessions out of organized labor. We'll be watching closely to see if that might be happening in other sectors as well.
- A report by professional services firm BDO indicates retail bankruptcies, liquidations, and store closings in the U.S. reached record numbers in the first half of 2020 as the pandemic accelerated industry changes like the shift to online shopping.
- Meanwhile, Manhattan office employees are returning to work at a much slower pace than those in most other major U.S. cities, raising the risk that New York faces a more protracted and painful recovery from the coronavirus pandemic than much of the rest of the country.

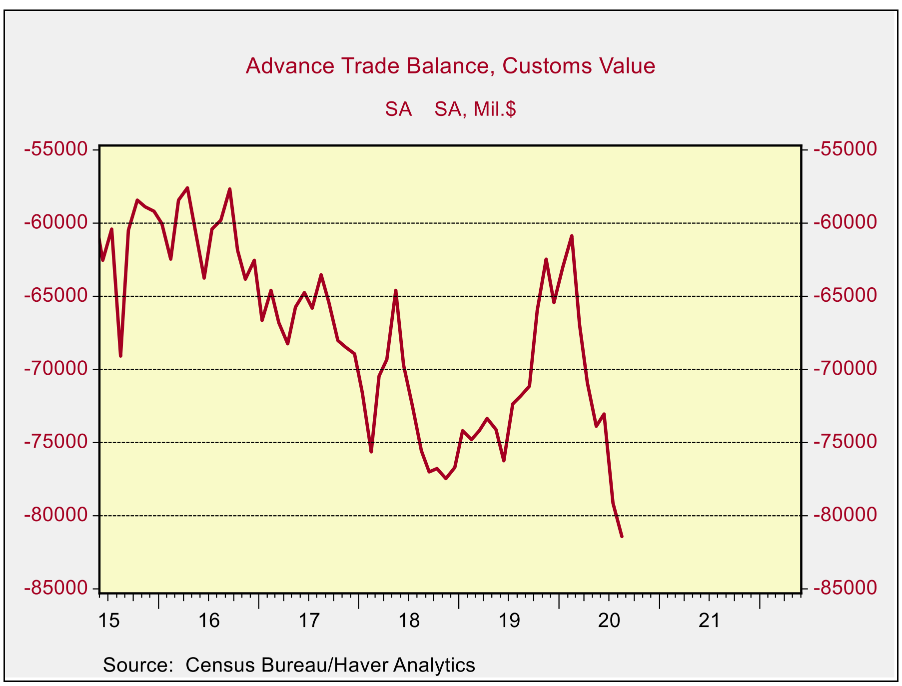
U.S. Policy Response

- Democratic leaders in the House of Representatives unveiled a $2.2 trillion pandemic relief bill that could come to a vote as early as Thursday. According to press reports, Speaker Pelosi and Treasury Secretary Mnuchin have already discussed the proposal last night, and they are scheduled to discuss it again this morning. Even if the measure passes the House, it is likely to be blocked in the Senate by Republicans opposed to further big increases in the budget deficit. The Democratic leadership in the House may not really want the bill passed into law anyway as it would give President Trump the opportunity to claim a fiscal victory just before the election.

- In any case, press reports indicate that key components of the new House bill would:
  - Provide a new round of direct stimulus checks in the amount of $1,200 per taxpayer and $500 per dependent;
  - Restore the supplemental federal unemployment benefit of $600 per week that expired at the end of July;
  - Increase food stamp benefits by 15%;
  - Extend the Paycheck Protection Program to encourage firms to keep employees on their payrolls;
  - Provide $436 billion in financial aid to state and local governments; and,
  - Provide $28 billion in funding for vaccinations.
- Even though the proposal isn't likely to become law, the fact that Speaker Pelosi and Secretary Mnuchin are actively in discussion may offer some encouragement that further fiscal support is possible. That is likely to be positive for risk assets in the near term.

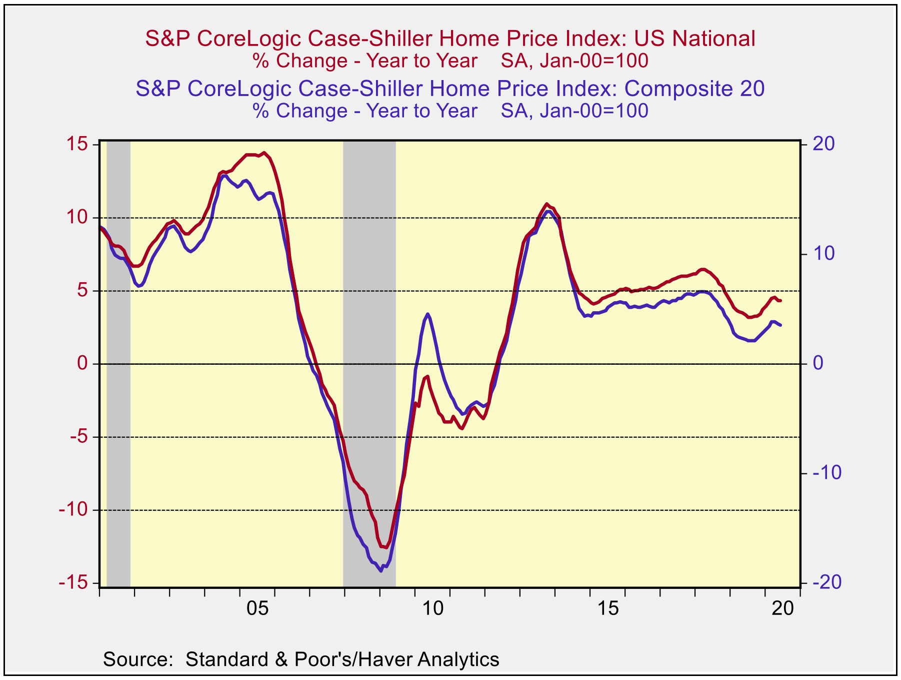
U.S. Economic Releases

The U.S. deficit in merchandise expanded to its highest amount in six years as imports continue to surge. The advance trade in goods deficit came in at $82.9B, above estimates of $81.8B. The prior report was revised upward from $79.3B to $80.1B. Wholesale merchandise trade inventories rose 0.5% from the prior month compared to expectations of a drop of 0.1%. Retail trade inventories rose 0.8% from the previous month compared to expectations of a rise of 1.1%.



The chart above shows the seasonally adjusted advance trade balance.

U.S. home prices continue to rise due to stronger than expected demand. The S&P CoreLogic Home Price Index for the top 20 cities rose 0.55% from the prior month, above expectation of a rise of 0.10%.



The chart above shows the annual change in the S&P CoreLogic Index for the U.S. and the top 20 cities. The national index rose 4.24% from the prior year, while the 20-City Home Price Index rose 3.95%. Low interest rates likely supported a rise in home prices following the pandemic. We expect the easy monetary policy will support home prices.

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

Economic Releases						
EDT	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Conference Board Consumer Confidence	m/m	Sep	90	84.8	**
10:00	Conference Board Present Situation	m/m	Sep		84.2	**
10:00	Conference Board Expectations	m/m	Sep		85.2	**
Fed Speakers or Events						
	Speaker or event	**District or position**				
11:40	Richard Clarida to Moderate Panel on Treasury Market	Vice Chairman of Board of Governors of Federal Reserve				
13:00	John Williams Takes Part in Fireside Chat	President of the Federal Reserve Bank of New York				
13:00	Randal Quarles to Speak on Panel on Financial Regulation	Federal Reserve Vice Chairman of Supervision				
15:00	Randal Quarles to Speak on Panel on Financial Stability Webinar	Federal Reserve Vice Chairman of Supervision				

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	Tokyo CPI	y/y	Sep	0.2%	0.3%	0.1%	***	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food	y/y	Sep	-0.2%	-0.3%	-0.3%	***	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food, Energy	y/y	Sep	0.0%	-0.1%	-0.2%	***	Equity and bond neutral
Australia	ANZ Roy Morgan Weekly Consumption	w/w	27-Sep	95.0	93.5		**	Equity and bond neutral
Europe								
Eurozone	Economic Confidence	m/m	Sep	91.1	87.7	89.0	***	Equity bullish, bond bearish
	Industrial Confidence	m/m	Sep	-11.1	-12.7	-10.0	***	Equity and bond neutral
	Services Confidence	m/m	Sep	-11.1	-17.2	-16.3	***	Equity bullish, bond bearish
	Consumer Confidence	m/m	Sep	-13.9	-13.9		***	Equity and bond neutral
Italy	PPI	m/m	Aug	0.1%	0.4%		**	Equity and bond neutral
	Central Government NCR	m/m	Aug	21.7b	25.5b		**	Equity and bond neutral
	Public Sector Net Borrowing	m/m	Aug	35.2b	25.9b	39.5b	**	Equity and bond neutral
	PSNB ex Banking Groups	m/m	Aug	35.9b	26.7b	38.0b	**	Equity and bond neutral
UK	Net Consumer Credit	m/m	Aug	0.3b	1.2b	1.5b	**	Equity bearish, bond bullish
	Consumer Credit	y/y	Aug	-3.9%	-3.6%		**	Equity and bond neutral
	Net Lending Sec. on Dwellings	m/m	Aug	3.1b	2.7b	3.8b	**	Equity and bond neutral
	Mortgage Approvals	m/m	Aug	84.7k	66.3k	71.3k	**	Equity bullish, bond bearish
	Money Supply M4	m/m	Aug	-0.4%	0.9%		**	Equity bearish, bond bullish
	M4 Money Supply	y/y	Aug	12.1%	13.5%		**	Equity and bond neutral
	M4 Ex IOFCs 3M Annualised	m/m	Aug	7.0%	17.7%		**	Equity and bond neutral
AMERICAS								
Mexico	Trade balance	m/m	aug	6.116b	5.799b	5.025b	**	Equity bullish, bond bearish
	Unemployment Rate	m/m	aug	5.2%	5.4%	5.6%	***	Equity bullish, bond bearish
Canada	Bloomberg Nanos Confidence	w/w	25-Sep	53.2	53.1		**	Equity and bond neutral
Brazil	Outstanding Loans	m/m	Aug	1.9%	1.0%	1.2%	**	Equity bullish, bond bearish
	Total Outstanding Loans	m/m	Aug	3737b	3666b	3700b	**	Equity bullish, bond bearish
	Personal Loan Default Rate	m/m	Aug	4.80%	5.10%		**	Equity bullish, bond bearish
	Federal Debt Total	m/m	Aug	4412b	4345b		**	Equity bullish, bond bearish

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	10	-1	Neutral
TED spread (bps)	13	14	-1	Up
U.S. Libor/OIS spread (bps)	8	8	0	Up
10-yr T-note (%)	0.65	0.65	0.00	Neutral
Euribor/OIS spread (bps)	-49	-50	1	Neutral
EUR/USD 3-mo swap (bps)	17	5	12	Down
Currencies	**Direction**			
dollar	Down			Down
euro	Up			Up
yen	Down			Up
pound	Up			Down
franc	Up			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	$42.25	$42.43	-0.42%	
WTI	$40.37	$40.60	-0.57%	
Natural Gas	$2.74	$2.80	-1.93%	
Crack Spread	$9.41	$9.49	-0.83%	
12-mo strip crack	$10.71	$10.83	-1.11%	
Ethanol rack	$1.53	$1.53	0.14%	
Metals				
Gold	$1,885.37	$1,881.48	0.21%	
Silver	$23.78	$23.68	0.42%	
Copper contract	$297.10	$299.00	-0.64%	
Grains				
Corn contract	$ 365.25	$ 366.75	-0.41%	
Wheat contract	$ 550.50	$ 550.25	0.05%	
Soybeans contract	$ 993.00	$ 996.25	-0.33%	
Shipping				
Baltic Dry Freight	1654	1667	-13	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.0		
Gasoline (mb)		-1.2		
Distillates (mb)		-1.0		
Refinery run rates (%)		-0.50%		

Weather

The 6-10 and 8-14 day forecasts currently call for warmer temperatures for most of the country, with cooler temperatures in the eastern half. Dry conditions are expected for most of the country. There are no tropical storms expected for the next 48 hours.

Asset Allocation Weekly

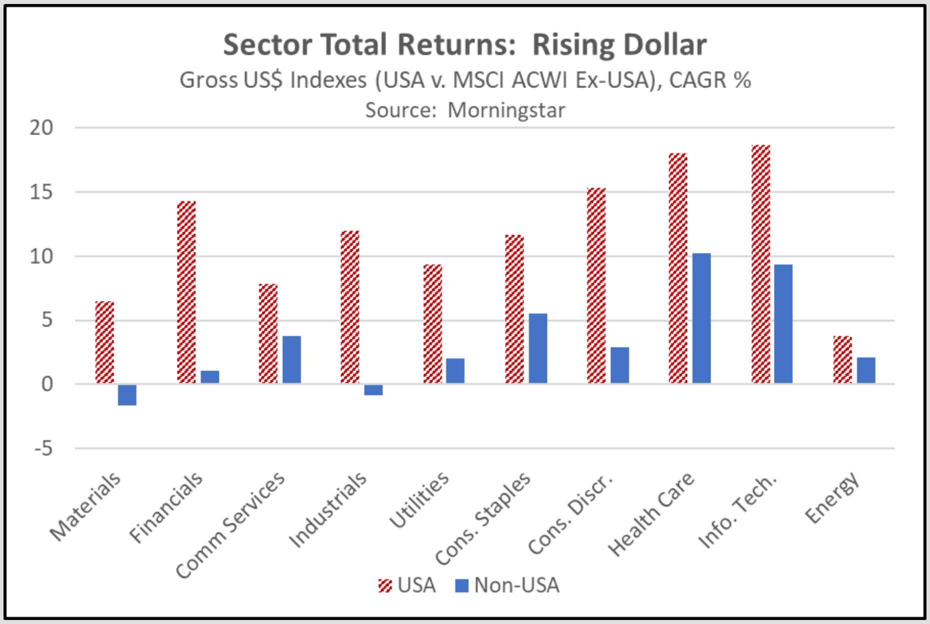
Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday. Note that this report is also offered as a separate document on our [website](#).

September 25, 2020

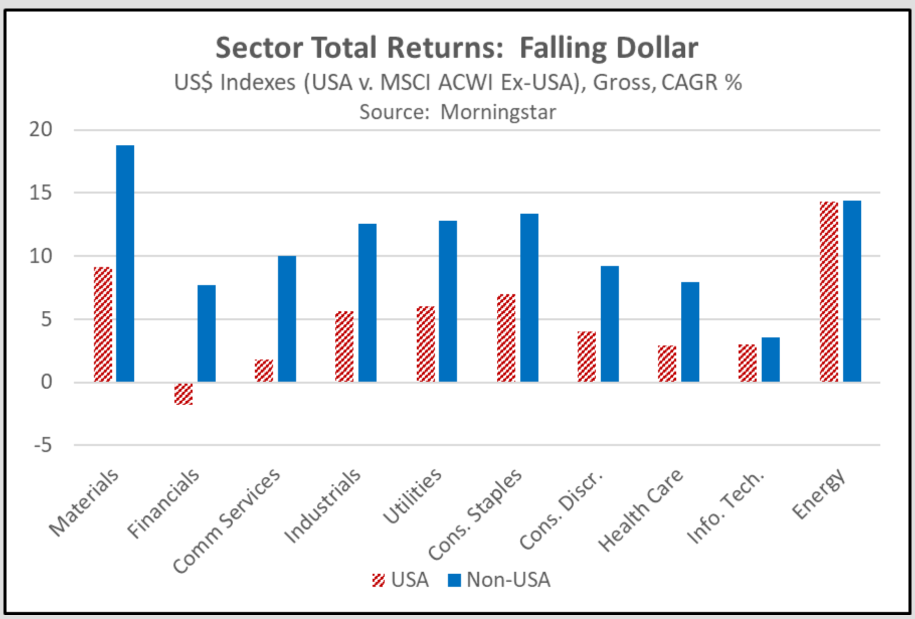
For more than a decade, U.S. investors who diversified their risk assets to include foreign equities have been sorely disappointed in the results. Since September 2010, for example, the S&P 500 Index of large cap U.S. stocks has provided an average annual total return of approximately 13.9%, but the MSCI ACWI ex-U.S. Index of foreign stocks has provided a total return averaging just 4.6%. At those rates of return, an all-U.S. stock portfolio would have doubled in value every 5.2 years or so, whereas an all-foreign stock portfolio would have taken about 15.7 years to double. Even a broad index of U.S. corporate bonds would have beaten the broad foreign stock market over the last decade, with only about one-third as much volatility! It should be no wonder that many investors have chosen to exclude foreign stocks from their portfolios.

But if you understand the key drivers behind the U.S. outperformance and foreign underperformance in recent years, it can clarify your thinking about the proper asset allocation strategy for the coming years. As we've argued repeatedly, much of the difference in U.S. versus foreign stock returns can be traced to the foreign exchange value of the U.S. dollar. When the greenback is strong and appreciating, the broad U.S. stock indexes tend to show better returns than the foreign indexes. Indeed, the dollar was generally rising from mid-2011 to mid-2020, explaining much of the U.S. outperformance over the last decade. In contrast, when the greenback is weak and falling, foreign indexes tend to outperform. That's important because it appears the dollar has recently rolled over and begun what could well be an extended slide. If so, the coming period is likely to strongly favor foreign stocks.

Of course, some of the recent outperformance of U.S. stocks simply reflects the preponderance of large cap Technology and Health Care names in the U.S. indexes. Those stocks have been particularly in vogue and have shown extraordinary growth in recent years. Nevertheless, taking a deeper dive into the relative performance of U.S. and foreign stock market sectors shows that the strength of the dollar is the predominant factor. If foreign stocks outperform U.S. stocks across a wide variety of sectors during a weak-dollar period, it should help confirm that the relationship is the most useful guidepost, and that is indeed what the data shows. This can be seen by examining the first chart below, which shows the outperformance of U.S. stocks (represented by striped red columns) versus foreign stocks (solid blue columns) over the last two strong-dollar periods from May 1995 to February 2002 and from May 2011 to July 2020. During these periods, U.S. total returns roundly beat foreign stock returns in all sectors for which comparable data was available (the data exclude real estate).



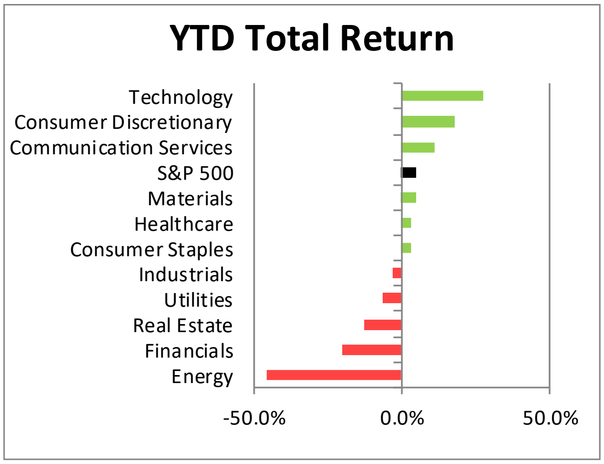
In contrast, the chart below shows how dramatically foreign stocks turned the tables during the period of dollar weakness from February 2002 to May 2011. In this period, foreign stocks handily beat U.S. returns in almost all sectors. The sectors are shown, from left to right, in the order by which the foreign returns beat the U.S. returns. The graph clearly demonstrates how dramatically foreign Materials, Financials, Communication Services, and Industrials stocks outperformed their U.S. counterparts as the dollar declined. Given the significantly greater exposure to Materials, Financials, and Industrials in the foreign indexes, those sectors account for most of the overall foreign outperformance during the weak-dollar period. In the high-growth Information Technology and Health Care sectors, foreign stocks also outperformed their U.S. counterparts as the dollar declined, but the relative underrepresentation of those stocks abroad kept the foreign outperformance smaller than it otherwise would have been.

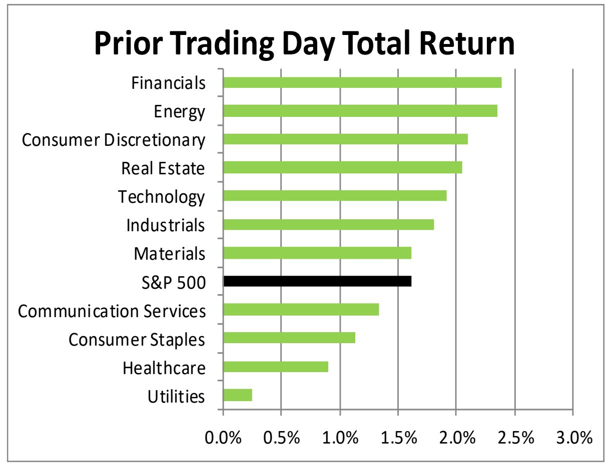


Although the data set used in this study only began in 1995, covering just two rising-dollar periods and one falling-dollar period, the relationships described above make logical sense. For example, a low or falling dollar tends to support commodity prices, so foreign Materials firms should see improved finances when the greenback is sliding. Our analysis also indicates that foreign emerging market stocks have an even more pronounced advantage in a falling-dollar phase. In sum, the analysis indicates that if the dollar is indeed falling into a prolonged downtrend like we think, the new investment environment is likely to favor a wide swath of foreign equities in the coming years.

Data Section

U.S. Equity Markets – (as of 9/28/2020 close)

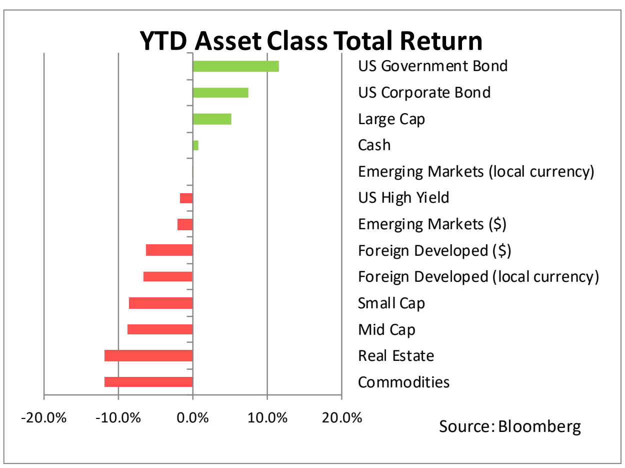




(Source: Bloomberg)

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 9/28/2020 close)

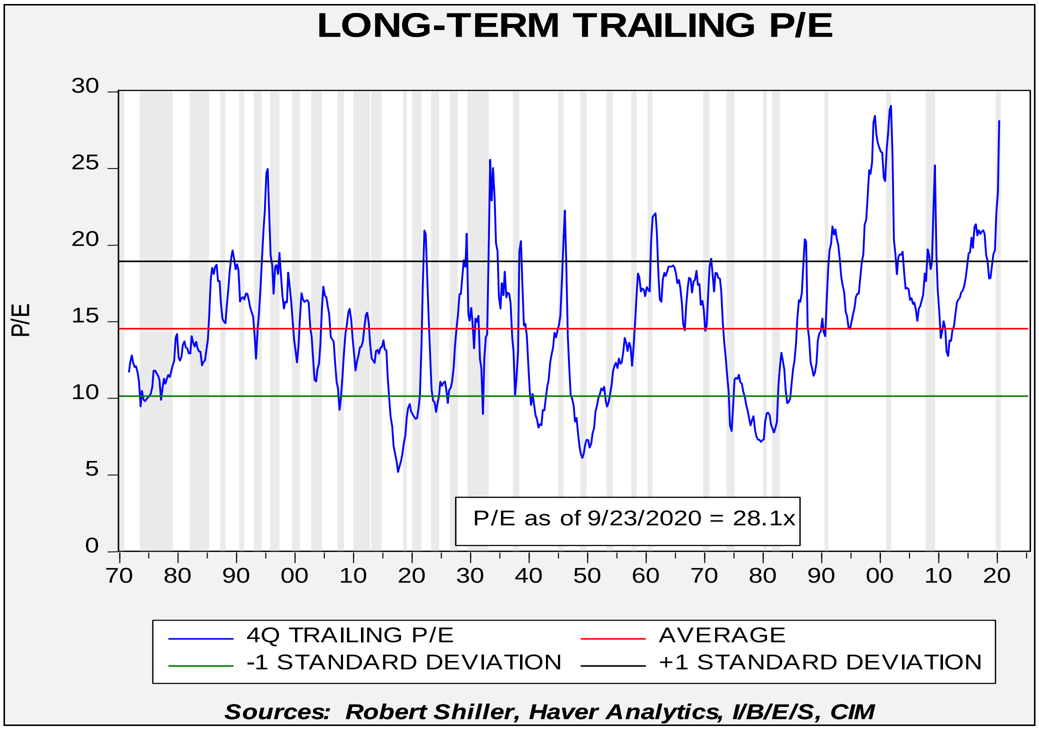


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 24, 2020



Based on our methodology,[1] the current P/E is 28.2x, down 0.1x from last week. Falling index values and higher earnings led to the decline.

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.