Daily Comment

By Patrick Fearon-Hernandez, CFA, and Thomas Wash

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: April 5, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is currently down 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.3%. Chinese markets were mixed, with the Shanghai Composite closing up 0.5% and the Shenzhen Composite closing down 0.4%. U.S. equity index futures are signaling a lower 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:

- *Bi-Weekly Geopolitical Report* (4/3/2023) (with associated podcast) "The Windsor Framework"
- *Weekly Energy Update* (3/30/2023): We discuss China's growing influence on the Middle East and the recent détente between Iran and the KSA. The usual data update is provided; this week, we saw a large rise in refinery operations which contributed to an unexpected slide in commercial oil inventories.
- *Asset Allocation Quarterly – Q1 2023* (1/19/2023): Discussion of our asset allocation process, Q1 2023 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q1 2023 Rebalance Presentation* (2/2/2023): Video presentation featuring the Asset Allocation Committee as they review our asset allocation strategies, recent portfolio changes, and the current macro environment.
- *Asset Allocation Bi-Weekly* (3/27/2023) (with associated podcast): "Have Policymakers Solved the Tinbergen Problem?"
- *Confluence of Ideas* podcast (3/8/2023): "Reflections on Inflation"

Our *Comment* today opens with the latest signs and implications of worsening U.S.-China tensions, including an important admission by a top U.S. business leader that China poses major economic threats to the U.S. and must be confronted. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including a surprisingly aggressive interest-rate hike in New Zealand, hawkish statements by a key Federal Reserve official, and evidence that the Fed's own policies are helping draw deposits out of the U.S. banking system.

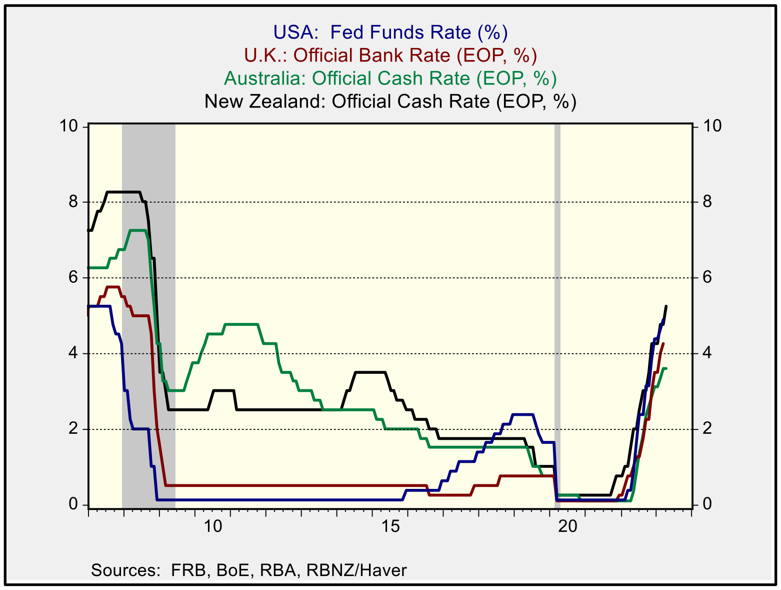
United States-China: The U.S. Department of Defense stated in a recent report that China is now, for the first time ever, keeping at least one of its six Jin-class ballistic missile submarines on patrol in the South China Sea on a 24/7 basis. According to the report, the subs are also now carrying China's new JL-3 missile, which can deliver multiple independently targeted nuclear warheads all the way to the U.S. mainland. The enhanced operating tempo suggests that the Chinese sub force is making important strides in communications, command and control, logistics, and other operational skills. Even though the Jin-class subs are relatively noisy and therefore easy to detect, keeping them in China's well-protected South China Sea bastion could help them survive any initial conventional or nuclear attack from the U.S., giving China an enhanced ability to launch a retaliatory second strike. That will likely force the U.S. to increase the deployment of its nuclear hunter-killer attack subs, surface ships, and sub-hunting aircraft to the region to track the Chinese vessels and prepare to destroy them if needed in time of conflict. In turn, that will presumably further increase the current strain on the U.S. military and defense industry and worsen U.S.-China tensions.

- Separately, Chief of Naval Operations Admiral Michael Gilday said this week that the U.S. Navy's updated force structure analysis will probably show that it needs even more ships than its current target of 373 to carry out its global responsibilities and counter the growing threat from China. The Navy's actual current inventory is only 296 ships. The updated force structure analysis is due to Congress by mid-June.
- Additionally, Jamie Dimon, CEO of JPMorgan Chase (JPM, $128.42), warned in his widely followed annual letter to shareholders that China is now in a position to disrupt the supply of critical commodities and products to the U.S. and its allies, and that it must not be allowed to do so.
    - In Dimon's words, "China, using subsidies and its economic muscle to dominate batteries, rare earths, semiconductors or [electric vehicles], could eventually imperil national security by disrupting our access to these products and materials. We cannot cede these important resources and capabilities to another country."
    - Dimon's comments are notable because he, like many other top U.S. business leaders, had previously been a champion of tighter U.S.-China economic relations. Dimon's about-face suggests that business leaders may finally be swinging around to the consensus view that China is an increasingly dangerous military, economic, and diplomatic threat to the U.S. and should be countered.

United States-Taiwan-China: Taiwanese President Tsai Ing-wen meets House Speaker McCarthy in California today. The meeting is expected to prompt strong responses from China, including at least accusations that the U.S. is abandoning its "one China" policy and probably some sort of aggressive, retaliatory military exercises around Taiwan in the coming days. If those drills happen, they will raise the risk of an accidental conflict. At the very least, they would worsen U.S.-China tensions, potentially putting investors in the cross-fire.

New Zealand: The Reserve Bank of New Zealand announced an unexpectedly big increase in its benchmark short-term interest rate to 5.25% from 4.75% previously. The hike was especially surprising because recent data has shown that New Zealand's economy is weakening and may be on the verge of a recession. The aggressive rate hike also marks a contrast with the Fed and the

Bank of England, which have slowed their rate-hiking campaigns. The Bank of Canada and the Reserve Bank of Australia have both recently paused their rate hikes.



Mexico: The Mexican government said it has [reached a deal to buy most of the electricity-generating assets owned in the country by Spanish utility Iberdola (IBDRY, $50.15) for $6 billion]. The deal marks a victory for leftist President Andrés Manuel López Obrador, who had long pressured Iberdola to sell as part of his "new nationalization" program. As such, the deal also illustrates the government's strong nationalist and left-wing populist bent, which has prevented Mexico from taking full advantage of the trend of "near shoring" production to be closer to the U.S.

U.S. Monetary Policy: Cleveland FRB President Mester today [warned that consumer price inflation remains too high and stubborn, and that it could take until 2025 to bring it down] to the Fed's 2% target. Mester stressed that the Fed will continue to focus on inflation despite the need to address the recent mid-sized bank crisis. The statement reinforces our view that the Fed is probably not yet ready to stop tightening monetary policy, although it is probably getting close to that point.

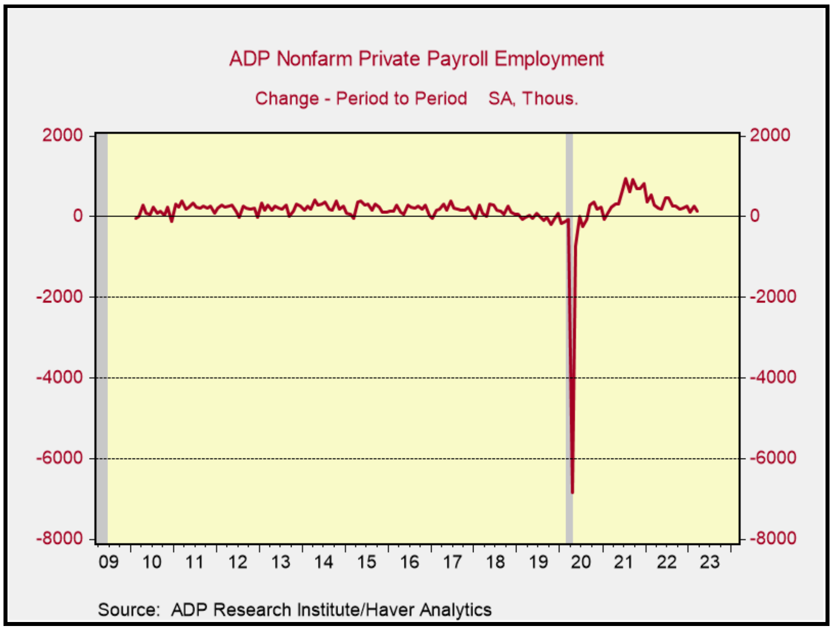
U.S. Banking Crisis: Concerns about sudden bank runs have dissipated, and analysts (including those at Confluence) are now focusing on the new risk that banks are facing—a slow-motion loss of deposits as individuals and businesses look for higher-yielding places to store their funds. One place these depositors are shifting to are money market funds, [which are putting increasing amounts of money to work in the Fed's "reverse repo" facility].

- In turn, that's generating concern that the Fed itself is exacerbating the outflow of deposits from banks because of the relatively high interest rates it pays to money market funds in the reverse repo facility.
- More broadly, the outflow of deposits from banks could eventually help prompt the Fed to begin cutting its benchmark fed funds interest rate.

U.S. Economic Releases

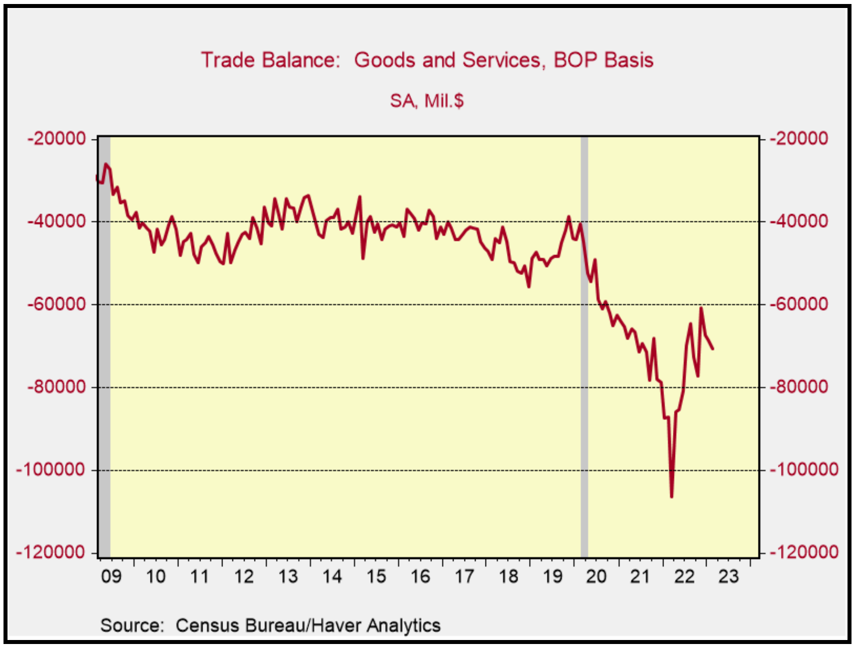
The demand for residential loan applications slowed last week. According to an index tracked by the Mortgage Bankers Association, mortgage applications fell 4.1% in the week ending March 31. The application tracker for home purchases and refinancing fell 3.5% and 5.4%, respectively, in that same period. Despite weaker demand for mortgages, borrowing costs fell last week. The average 30-year fixed rate fell 5 bps from 6.45% to 6.40%.

Private payrolls expanded at a slower-than-expected pace in March. U.S. firms created 145k new jobs last month, according to data collected by payroll firm ADP. Although solid, the number was below estimates of 215k, suggesting that the economy may be slowing.



The chart above shows the monthly change in ADP private payrolls. Although the ADP report can provide guidance into the BLS numbers, differences in sampling and methodology often lead to divergences between the two series. Hence, an underwhelming ADP number does not necessarily mean that the Friday's job report will also be weak.

The U.S. trade deficit widened slightly in February. According to the Census Bureau, the U.S. trade shortfall grew from a revised $68.7 billion to $70.5 billion last month. The increase was slightly above estimates of $68.8 billion and was driven primarily by a drop in exports.



The chart above shows the level of the U.S. trade balance. An increase in the trade deficit is a drag on growth.

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

Economic Releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	S&P Global Manufacturing PMI	m/m	Mar F	53.8	53.8	***
9:45	S&P Services PMI	m/m	Mar F	53.3	53.3	**
10:00	ISM Nonmanufacturing PMI	m/m	Mar	54.4	55.1	***
10:00	ISM Manufacturing PMI - Prices Paid	m/m	Mar		65.6	**
10:00	ISM Manufacturing PMI - Employment	m/m	Mar		54	*
10:00	ISM Manufacturing PMI - New Orders	m/m	Mar		62.6	**
Federal Reserve						
No Fed speakers or events for the rest of 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								
Japan	Jibun bank Composite PMI	m/m	Mar F	52.9	51.9		*	Equity and bond neutral
	Jibun Bank Services PMI	m/m	Mar F	55.0	54.2		**	Equity and bond neutral
South Korea	Foreign Reserves	m/m	Mar	$426.07b	$425.29b		**	Equity and bond neutral
India	S&P Global Composite PMI	m/m	Mar	58.4	59.0		**	Equity and bond neutral
	S&P Global Services PMI	m/m	Mar	57.8	59.4		**	Equity bearish, bond bullish
EUROPE								
Eurozone	S&P Global Composite PMI	m/m	Mar F	53.7	54.1	54.1	*	Equity and bond neutral
	S&P Global Services PMI	m/m	Mar F	55.0	55.6	55.6	**	Equity and bond neutral
Germany	Factory Orders WDA	y/y	Feb	-5.7%	-10.9%	-12.0%	***	Equity bullish, bond bearish
	S&P Global Services PMI	m/m	Mar F	53.7	53.9	53.9	**	Equity and bond neutral
	S&P Global Composite PMI	m/m	Mar F	52.6	52.3	52.6	**	Equity and bond neutral
France	Industrial Production	y/y	Feb	1.3%	-2.2%	-1.5%	***	Equity bullish, bond bearish
	Manufacturing Production	y/y	Feb	2.2%	-0.7%	-0.5%	**	Equity bullish, bond bearish
	S&P Global Composite PMI	m/m	Mar F	52.7	54.0	54.0	**	Equity bearish, bond bullish
	S&P Global Services PMI	m/m	Mar F	53.9	55.5	55.5	**	Equity bearish, bond bullish
Italy	S&P Global Composite PMI	m/m	Mar	55.2	52.2	53.2	**	Equity bullish, bond bearish
	S&P Global Services PMI	m/m	Mar	55.7	51.6	53.7	**	Equity bullish, bond bearish
	Retail Sales	y/y	Feb	5.8%	6.2%	6.0%	**	Equity and bond neutral
UK	S&P/CIPS Services PMI	m/m	Mar F	52.9	52.8	52.8	**	Equity and bond neutral
	S&P/CIPS Composite PMI	m/m	Mar F	52.2	52.2	52.2	**	Equity and bond neutral
Russia	S&P Global Services PMI	m/m	Mar	58.1	53.1		**	Equity bullish, bond bearish
	S&P Global Composite PMI	m/m	Mar	56.8	53.1		**	Equity bullish, bond bearish
AMERICAS								
Canada	Building Permits	m/m	Feb	8.6%	-4.0%	2.0%	**	Equity bullish, bond bearish
Mexico	International Reserves Weekly	w/w	31-Mar	$202.388b	$202.469b		*	Equity and bond neutral
	Gross Fixed Investment	y/y	Jan	7.9%	9.4%	8.3%	**	Equity and bond neutral
	CPI	y/y	Mar	6.85%	7.62%	6.89%	***	Equity and bond neutral
	Core CPI	y/y	Mar	8.09%	8.29%	8.07%	**	Equity and bond neutral

Financial Markets

The table below highlights some of the indicators that we follow on a daily basis. Again, the color coding is similar to the foreign news description above. We will add a paragraph below if a certain move merits further explanation.

Fixed Income	Today	Prior	Change	Trend
3-mo Libor yield (bps)	522	519	3	Up
3-mo T-bill yield (bps)	463	468	-5	Down
TED spread (bps)	59	52	7	Widening
U.S. Sibor/OIS spread (bps)	491	490	1	Up
U.S. Libor/OIS spread (bps)	492	491	1	Up
10-yr T-note (%)	3.35	3.34	0.01	Flat
Euribor/OIS spread (bps)	305	305	0	Up
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Down			Up
Yen	Up			Up
Pound	Down			Up
Franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
RBNZ Official Cash Rate	5.250%	4.750%	5.000%	Above 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.

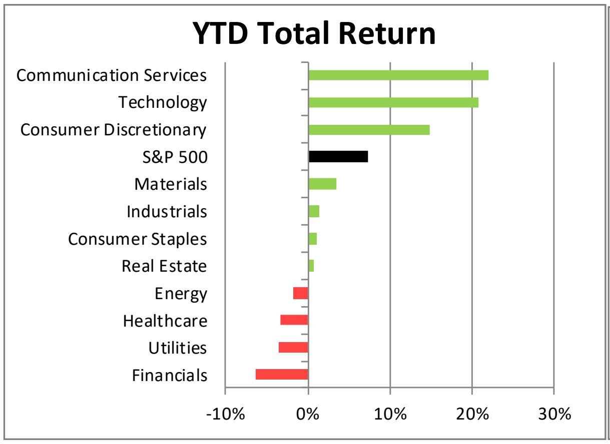
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$84.88	$84.94	-0.07%	
WTI	$80.66	$80.71	-0.06%	
Natural Gas	$2.11	$2.11	0.05%	
Crack Spread	$33.79	$33.82	-0.09%	
12-mo strip crack	$26.60	$26.90	-1.13%	
Ethanol rack	$2.57	$2.57	0.07%	
Metals				
Gold	$2,023.37	$2,020.42	0.15%	
Silver	$24.75	$25.01	-1.02%	
Copper contract	$396.95	$397.10	-0.04%	
Grains				
Corn contract	$649.00	$653.75	-0.73%	
Wheat contract	$676.00	$691.50	-2.24%	
Soybeans contract	$1,508.75	$1,517.50	-0.58%	
Shipping				
Baltic Dry Freight	1,473	1,412	61	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.8		
Gasoline (mb)		-2.0		
Distillates (mb)		-1.0		
Refinery run rates (%)		0.4%		
Natural gas (bcf)		-54		

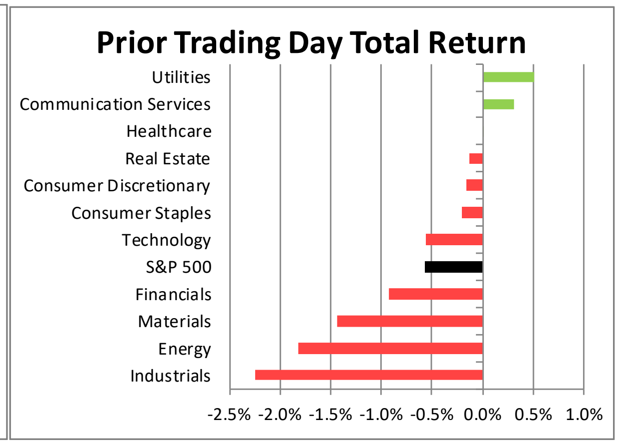
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout the entire country, with cooler temps only in the Pacific region. Additionally, the forecasts are calling for wetter-than-normal conditions to move eastward from the Northern Pacific to the Midwest. Drier-than-normal temperatures are expected for most of the eastern third of the country.

Data Section

U.S. Equity Markets – (as of 4/4/2023 close)

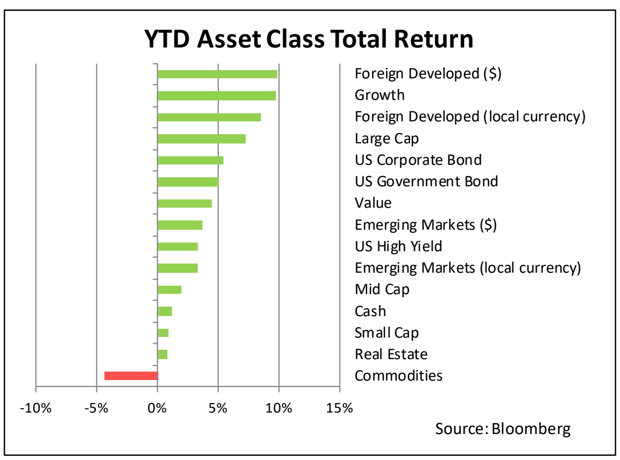




(Source: Bloomberg)

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 4/4/2023 close)

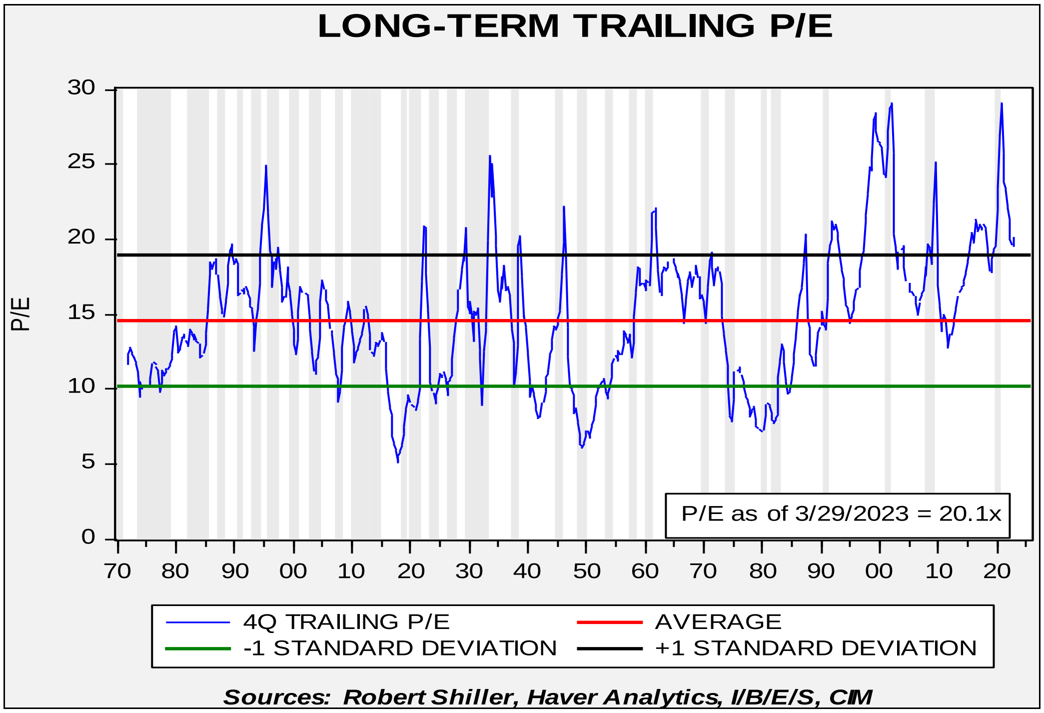


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

March 30, 2023



Based on our methodology,[1] the current P/E is 20.1x, down 0.1 from last week. Falling index values 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.

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[1] This chart offers a running snapshot of the S&P 500 P/E in a long-term historical context. We are using a specific measurement process, similar to *Value Line*, which combines earnings estimates and actual data. We use an adjusted operating earnings number going back to 1870 (we adjust as-reported earnings to operating earnings through a regression process until 1988), and actual operating earnings after 1988. For the current quarter, we use the I/B/E/S estimates which are updated regularly throughout the quarter; currently, the four-quarter earnings sum includes three actual quarters (Q2, Q3 and Q4) and estimate (Q1). 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.