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 6, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is currently up 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.5%. Chinese markets were essentially flat, with the Shanghai Composite closing unchanged and the Shenzhen Composite closing down 0.04%. U.S. equity index futures are signaling a slightly higher open.

The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (4/3/2023) (with associated podcast) "The Windsor Framework"
- ***Weekly Energy Update*** **(4/6/2023): We examine the surprise OPEC+ decision to cut output and provide our usual update of the weekly data**.
- *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"

Happy Maundy Thursday! Today's *Comment* starts with our thoughts about tomorrow's job report. Next, we discuss possible substitutes to the equity and futures markets to gauge investor reaction to the labor market data. Lastly, we review the latest development in the conflict between the U.S. and China.

Good Friday? Markets will be closed tomorrow when the March employment numbers are released by the Bureau of Labor Statistics, but investors will still be on high alert.

- Signs of a cooling labor market could pave the way for a Fed pause or pivot. On Wednesday, private payroll data from ADP showed U.S. firms added 145,000 jobs last month, well below the consensus forecast of 210,000. The slowdown in hiring was also reflected in the manufacturing survey reported by the Institute for Supply Management and BLS data that showed a sharp drop in job openings in February. The Federal Reserve has consistently pointed to the tight labor market as evidence that it still has room to raise interest rates. Thus, a weak BLS jobs report could pressure the central bank to conclude its hiking cycle before the end of the year.

- Despite Wednesday's data supporting a more dovish monetary policy, investors are worried about the state of the economy. The service activity index tracked by the ISM showed a sharper-than-expected drop. The index came in at 51.2, well below expectations of 54.5, and the previous month's reading of 55.1. The subpar economic number weighed on equities as investors looked to lock in temporary gains made earlier in the week. Led by tech stocks, the S&P 500 fell 0.25% on Wednesday, while the NASDAQ sank 1.1% in the same period.
- A disappointing jobs number may convince the Fed to rethink its interest rate strategy. Over the last few weeks, Fed officials have appeared less committed to raising rates. Regional Fed President Neel Kashkari and Thomas Barkin have both been reluctant to advocate for another rate hike in the May meeting. Meanwhile, Cleveland Fed President Loretta Mester has emphasized that the central bank must be "judicious" as it conducts policy going forward. The shift in tone may be related to uncertainty regarding the economy following the downfall of Silicon Valley Bank (SIVB, $106.04) and Signature Bank (SBNY, $0.16) in March. As of this writing, the market has priced in a 67% chance that the Fed will stop hiking rates by June.

Still Open Most Hours: Equity markets may not be open on Friday; however, currencies and bonds will still be trading.

- With it trading until 5 PM EDT on Friday, the forex market will likely be a great place to see reactions to the jobs number. The U.S. Dollar Index shows that the greenback is down 1.5% against global currencies for the year. Its steady decline has been driven by concerns that a looming recession will force the Fed to halt and possibly reverse its policy stance. If the jobs number is softer than expected, global currencies will likely rally against the greenback. However, strong employment data could see the opposite or no reaction at all. Although the DXY Index is based on futures contracts and thus won't be traded on Friday, movements in the EUR, GBP, and JPY will likely reflect a broader decline in the U.S. dollar relative to its peer currencies.
- Although hours will be limited, fixed income will be another market to gauge investors' perceptions of the U.S. labor market. The yields on two-year Treasuries have fallen 132 bps since March 7 of this year, while 10-year Treasuries have decreased by 77 bps in the same period. Similar to the DXY Index, the normalization of the yield curve shows that the market believes the central bank is just about finished with its hiking cycle. Additionally, fixed-income securities have been noticeably more sensitive to changes in Fed interest rate expectations. As a result, a strong jobs report may be bearish for bonds, while a weak report may be favorable.
- Fixed income and currencies will give hints to how the market may open on Monday. This year, risk assets have generally rallied whenever data supported a possible moderation in central bank policy. Investors' increased risk appetites explain why Bitcoin has surged 69% since the beginning of the year. Thus, a lower-than-expected jobs

number could lead to an overall surge in equities on Monday. In the meantime, barring a significant event, we expect that markets will be relatively tame on the final trading day of the week.

The Saga Continues: The Washington and Beijing feud continues despite growing momentum for peace talks between Russia and Ukraine.

- A senior Ukrainian official has expressed his country's openness to holding talks with Russia to end the territorial conflict. Prior to these comments, Ukraine President Volodymyr Zelenskyy dismissed the potential for talks until Russia removed all of its forces from his country, including Crimea. The change in sentiment is related to rising confidence that the Ukrainian military will be able to retake land along the administrative border of Crimea. The possible de-escalation of tensions between the two countries will be welcomed by Europe, who feared that Ukraine might overplay its hand if it tries to retake Crimea.
- Meanwhile, China is broadening its influence in the Middle East as Beijing positions itself to decouple from the U.S. On Thursday, government officials from Saudi Arabia and Iran met in Beijing for the first time since the countries agreed to restore diplomatic ties. The Chinese-brokered agreement reflects Beijing's strategic pivot toward the Middle East and Africa as it looks to maintain its access to key raw materials. At the same time, U.S. Vice President Kamala Harris concluded her trip to Africa this week. She had one message to her African counterparts: America is your friend, and China is not.
- It is too soon to say whether the war between Russia and Ukraine is close to a conclusion. Both sides have much to lose if the conflict ends without a decisive victory for their respective side. That said, the end of the conflict could help ramp up the competition between the U.S. and China. The European Union's deep trade ties with China have made it reluctant to completely sever ties with America's top rival. French President Emmanuel Macron's pestering of his Chinese counterpart to mediate tensions between Russia and Ukraine reflects Europe's eagerness to maintain strong ties with China despite pressure from Washington. Hence, if Beijing is able to use its influence to end the war in Ukraine, EU countries may be less inclined to support U.S. trade restrictions.

U.S. Economic Releases

Initial applications for unemployment benefits in the week ending April 1 came in at a seasonally adjusted 228,000, well above the expected level of 200,000 but lower than the prior week's revised level of 246,000. However, it's important to note that this release included updated seasonal adjustment factors going back five years. The new seasonal adjustment factors explain much of the over-shoot compared with expectations. Importantly, the four-week moving average of initial claims, which helps smooth out some of the volatility in the series, actually fell slightly to 237,750. Separately, the number of people continuing to draw benefits in the week ending March 25 jumped to 1.823 million, far above the anticipated reading of 1.700 million, but that also was largely due to the updated seasonal adjustment factors. The level of continuing claims last week was only marginally higher than the previous week's revised reading of 1.817 million.

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

Economic Releases		
No economic releases for the rest of today		
Federal Reserve		
EST	**Speaker or Event**	**District or Position**
10:00	James Bullard Discusses the Economic Outlook	President of the Federal Reserve Bank of St. Louis

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	Japan Buying Foreign Bonds	w/w	31-Mar	-¥483.4b	¥1182.0b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	31-Mar	¥944.1b	-¥1682.6b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	31-Mar	¥390.3b	-¥42.2b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	31-Mar	¥62.2b	-¥1285.8b		*	Equity and bond neutral
Australia	Trade Balance	m/m	Feb	A$13.870b	A$11.688b	A$11.266b	***	Equity and bond neutral
	Exports	m/m	Feb	-3.0%	1.0%		*	Equity bearish, bond bullish
	Imports	m/m	Feb	-9.0%	5.0%		*	Equity bearish, bond bullish
New Zealand	ANZ Commodity Price	m/m	Mar	1.3%	1.3%	1.40	*	Equity and bond neutral
China	Caixin Composite PMI	m/m	Mar	54.5	54.2		**	Equity and bond neutral
	Caixin Services PMI	m/m	Mar	57.8	55.0	55.0	**	Equity bullish, bond bearish
EUROPE								
Germany	Industrial Production WDA	y/y	Feb	0.6%	-1.6%	-2.0%	**	Equity bullish, bond bearish
	S&P Global Construction PMI	m/m	Mar	42.9	48.6		*	Equity bearish, bond bullish
UK	S&P/CIPS Construction PMI	m/m	Mar	50.7	54.6	53.5	**	Equity bearish, bond bullish
Switzerland	Unemployment Rate	m/m	Mar	2.0%	2.1%	2.0%	**	Equity and bond neutral
	Foreign Currency Reserves	m/m	Mar	742.7b	770.6b		***	Equity and bond neutral
AMERICAS								
Canada	International Merchandise Trade	m/m	Feb	0.42b	1.92b	1.20b	**	Equity bearish, bond bullish
Brazil	S&P Global Composite PMI	m/m	Mar	50.7	49.7		**	Equity bullish, bond bearish
	S&P Global Services PMI	m/m	Mar	51.8	49.8		**	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.

Fixed Income	Today	Prior	Change	Trend
3-mo Libor yield (bps)	522	522	0	Up
3-mo T-bill yield (bps)	461	470	-9	Down
TED spread (bps)	61	52	9	Widening
U.S. Sibor/OIS spread (bps)	490	490	0	Up
U.S. Libor/OIS spread (bps)	491	492	-1	Up
10-yr T-note (%)	3.28	3.31	-0.03	Flat
Euribor/OIS spread (bps)	306	305	1	Up
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Up			Up
Yen	Down			Up
Pound	Up			Up
Franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
RBI Repurchase Rate	6.500%	6.500%	6.750%	Below Forecast
RBI Cash Reserve Ratio	45.000%	4.500%	4.500%	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.

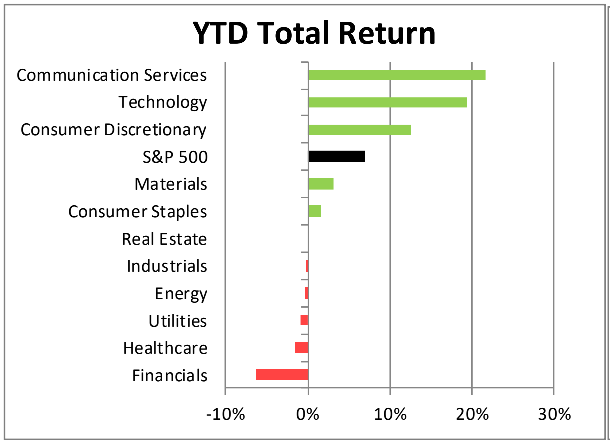
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$85.18	$84.99	0.22%	
WTI	$80.70	$80.61	0.11%	
Natural Gas	$2.17	$2.16	0.70%	
Crack Spread	$36.54	$36.83	-0.78%	
12-mo strip crack	$28.02	$28.28	-0.92%	
Ethanol rack	$2.57	$2.57	-0.01%	
Metals				
Gold	$2,018.07	$2,020.73	-0.13%	
Silver	$24.93	$24.94	-0.06%	
Copper contract	$401.85	$398.65	0.80%	
Grains				
Corn contract	$648.25	$652.75	-0.69%	
Wheat contract	$680.75	$682.00	-0.18%	
Soybeans contract	$1,502.00	$1,511.00	-0.60%	
Shipping				
Baltic Dry Freight	1,525	1,473	52	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-3.7	-1.7	-2.0	
Gasoline (mb)	-4.1	-2.0	-2.1	
Distillates (mb)	-3.6	-1.0	-2.6	
Refinery run rates (%)	-0.7%	0.4%	-1.1%	
Natural gas (bcf)		-22		

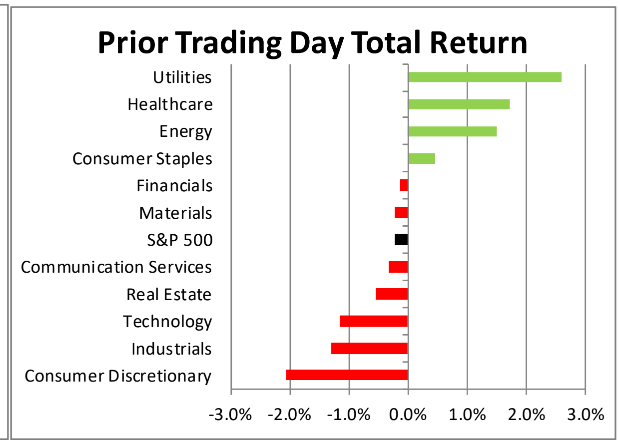
Weather

The 6-10 and 8-14 day forecasts currently call for cooler-than-normal temperatures along the West Coast and in the Rocky Mountain region, with warmer-than-normal temperatures across the entire eastern half of the country. The forecasts are calling for wetter-than-normal conditions throughout the Rocky Mountain and Great Plains regions, with dry conditions expected for most of the country east of the Mississippi River.

Data Section

U.S. Equity Markets – (as of 4/5/2023 close)

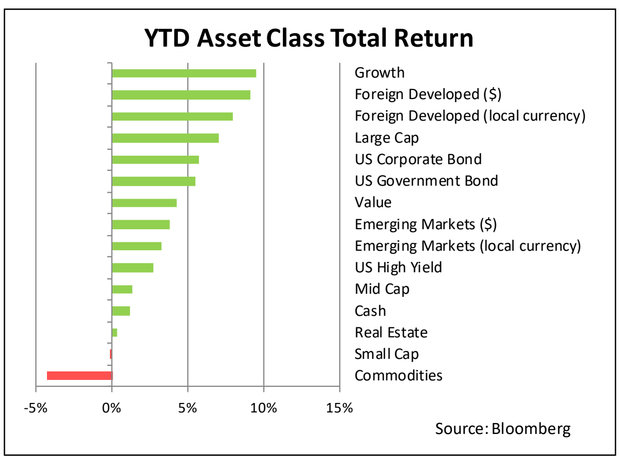




(Source: Bloomberg)

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 4/5/2023 close)

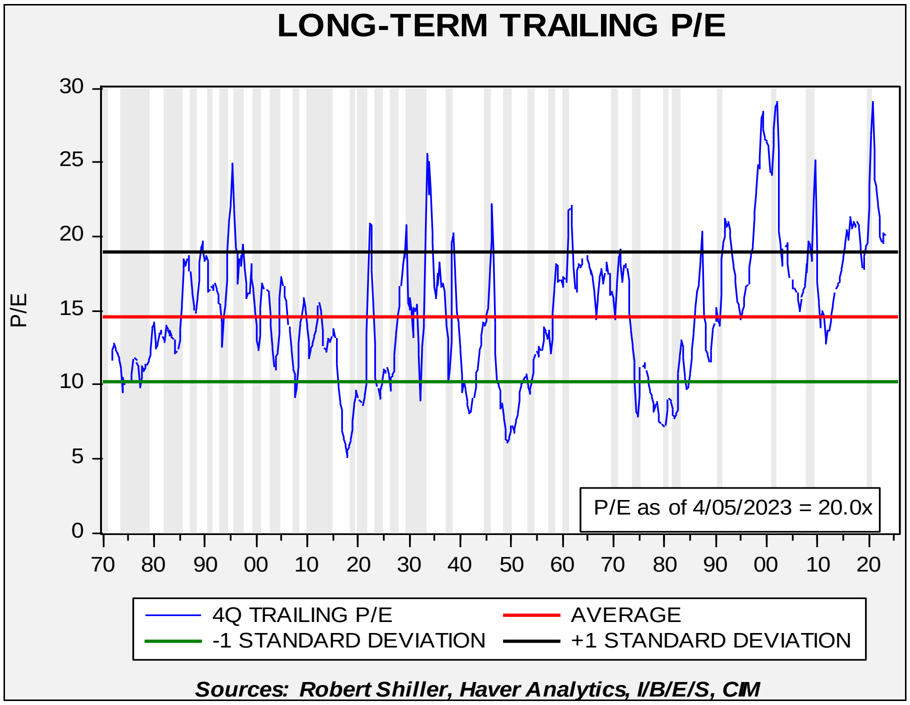


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

April 6, 2023



We move to Q2 this week; based on our methodology,[1] the current P/E is 20.0x, down 0.1 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.

[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 two actual quarters (Q3 and Q4) and two estimates (Q1 and Q2). 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.