Confluence Investment Management

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 20, 2023—9:30 AM EDT] Global equity markets are mostly lower this morning. In Europe, the Euro Stoxx 50 is currently down 0.6% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed essentially flat. Chinese markets were lower, with the Shanghai Composite closing down 0.1% from its previous close and the Shenzhen Composite closing down 0.4%. U.S. equity index futures are signaling a lower open.

With 40 companies having reported so far, S&P 500 earnings for Q1 are running at $50.80 per share, compared to estimates of $50.89. Of the companies that have reported thus far, 80.0% have exceeded expectations while 20.0% have fallen short of expectations.

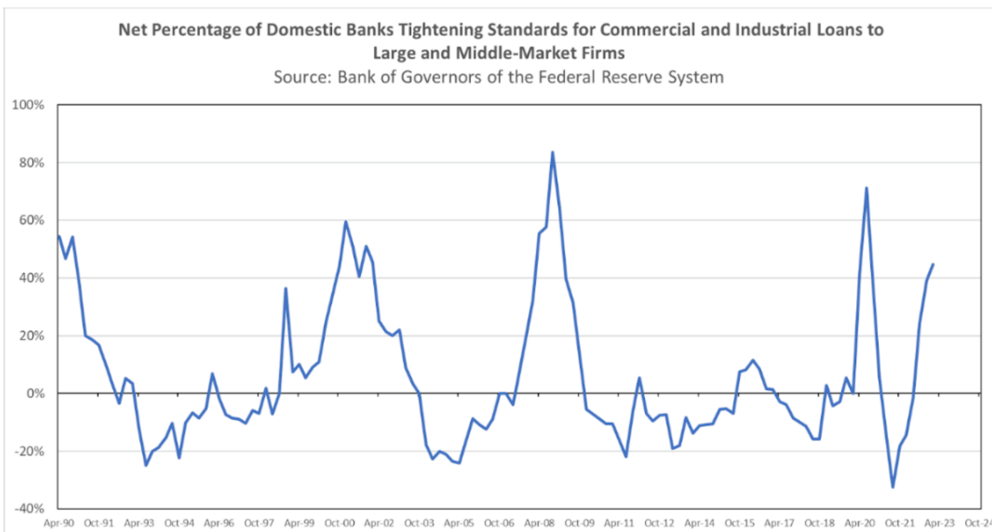
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (4/17/2023) (with associated podcast) "U.S. Intelligence Sharing as a Tool of International Relations"
- ***Weekly Energy Update*** **(4/20/2023): Thinking about an EV? Wondering what models qualify for a tax credit? We have a link to the government website to see if the car you are considering qualifies for the incentive. We also update 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* (4/10/2023) (with associated podcast): "Increasing Concerns About Commercial Real Estate"
- *Confluence of Ideas* podcast (3/8/2023): "Reflections on Inflation"

Good morning! Today's *Comment* begins with a discussion about concerns regarding bank lending. Next, we explain why stubborn inflation has led to greater scrutiny of the central banks. Lastly, we give our thoughts on supply chain efficiencies and the performance of the U.S. dollar as tensions between the U.S. and China continue to escalate.

Lending Sentiment Sours: The latest earnings report has added to concerns that a credit crunch is imminent.

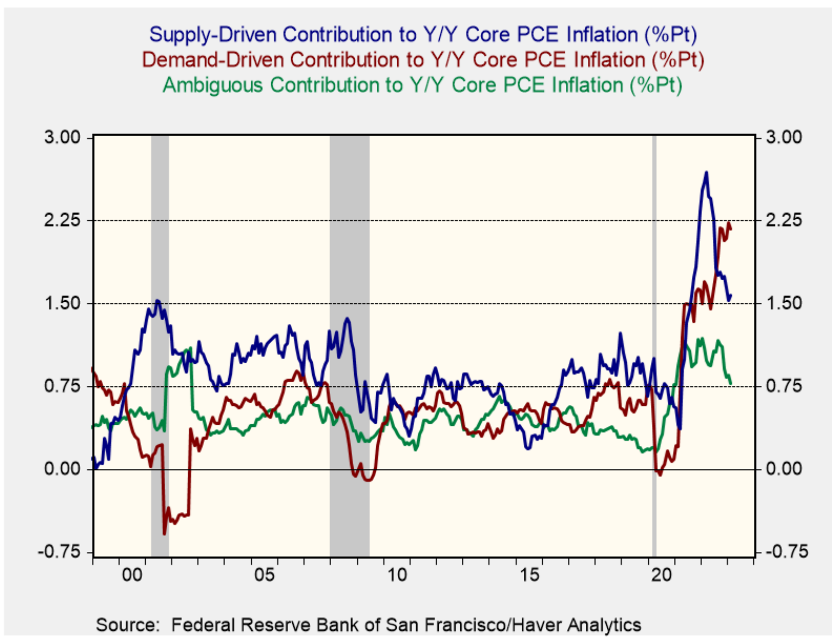
- Despite the four largest banks showing strong earnings in the first quarter of 2023, there are still concerns about the financial system. On Wednesday, Morgan Stanley (MS, $90.25) announced an increase in the company's provision of credit losses to $234 million, up from $57 million a year ago. The upward revision in its loss expectations is related to concerns about commercial real estate and the overall economy. Goldman Sachs (GS, $335.91) announced that its profits fell 18% in the year's first three months due to a slump in dealmaking and bond trading. Additionally, Zions Bank (ZION, $32.72), US Bancorp (USB, $36.01), and Citizens Financial Group (CFB, $30.50) each reported declines in deposits, primarily from their wealthier clients.
    - On a positive note, Western Alliance (WAL, $40.35) had an unexpected rebound in deposits.
- Lenders were already tightening their lending standards before March's SVB debacle. In February, a Fed survey showed that senior loan officers were restricting the amount of credit due to worries about demand weakness and deteriorating loan quality in the final quarter of 2022. The report showed that the net percentage of respondents tightening standards has risen to its highest level since the pandemic. Although the next report on senior loan officer sentiment will not be released until May, the latest Beige Book shows that banks are increasingly reluctant to issue credit given the recent banking crisis.



- Tightening credit conditions raises the likelihood of a hard landing. The Federal Reserve is expected to raise its target range for interest rates to 5.00%-5.25% in May. The Fed's decision to increase borrowing costs will raise transaction expenses for bank dealmaking and reduce the value of bond holdings, thus weighing on the profitability of financial institutions. The Fed's new emergency facility did relieve pressure on the regional banks from needing to lift rates in order to keep borrowers, but banks may still be reluctant to lend due to interest rate uncertainty. As a result, businesses and consumers may be unable to obtain loans when they need them as the economy slows.

It's Getting Sticky: Stubborn inflation adds to concerns that the central banks are not finished tightening monetary policy.

- The lack of progress toward price stability has hurt the credibility of the central banks. The current board of the Reserve Bank of Australia is set to lose responsibility for setting interest rates because it has come under scrutiny for its poor guidance. The task will be given to a separate board within the RBA that will specialize in managing monetary policy. Several months before it started its most aggressive tightening cycle in three decades, the RBA had stated that a rate hike was unlikely before 2024. Additionally, its inflation forecast failed to detect the acceleration in price pressures. The revamp of the central bank is expected to take place in July of this year after the RBA Act is amended.
- Australia is not the only country with a central bank currently under pressure. The Bank of England, the European Central Bank, and the Fed have all moderated expectations of a pause due to higher-than-expected inflation. Their inability to succeed in reining in price pressures may be related to demand-side inflation. The chart below breaks down inflation by demand, supply, and ambiguous contributors, as determined by the U.S. personal consumption expenditure price index. The series suggests that improvements in the supply chain are the primary drivers in the recent decline of price pressures.
    - The chart may reflect issues with containing service-related inflation figures.

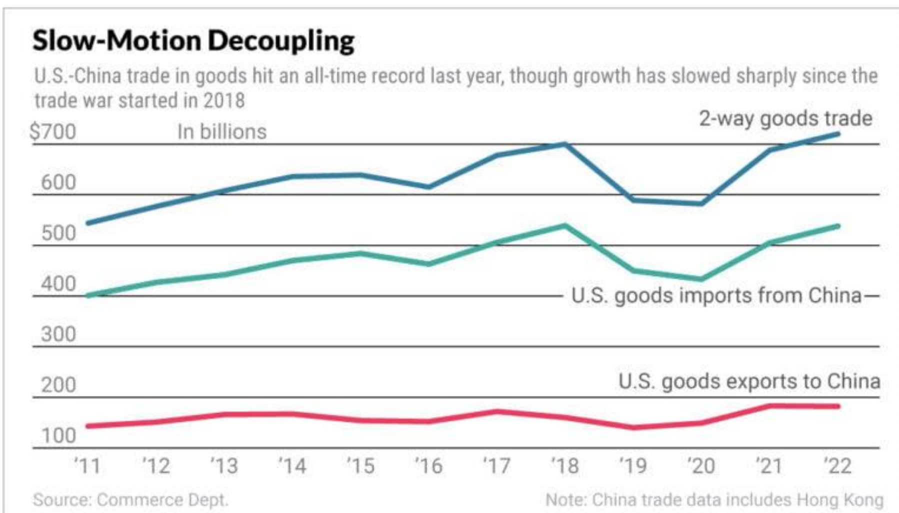


- A tight labor market and a resilient economy have given central banks more leeway to increase benchmark interest rates. The Federal Reserve Beige Book, which provides anecdotal information on economic conditions within regional Fed districts, showed that the country is not currently in a recession. Meanwhile, better-than-expected growth from China has boosted confidence that a global recession is not imminent. These positive signs have forced market participants to push back their expectations of a shift in central bank policy. The latest CME FedWatch Tool now forecasts a Fed pause or cut in interest rates to take place at the September meeting, a month later than investors were predicting last week. Overnight index swaps for the EUR and GBP have also shown a similar trend.

  - That said, we believe that many central banks will be finished hiking rates by the third quarter.

The Great Decoupling: Supply chain efficiency and the dominance of the U.S. dollar may be casualties as the world splits into separate blocs.

- Companies are accepting that they may have to prioritize supply chain resiliency over efficiency as a way to hedge against geopolitical risks from rising U.S.-China tensions. India appears to be an attractive destination target. A day after opening its first store in India, Apple (AAPL, $167.63) CEO Tim Cook met with Indian Prime Minister Narendra Modi to discuss plans for future investment in the country. The iPhone maker is expected to double or triple its investment expenditure in Asia's second-biggest economy which could pave the way for more companies to follow suit.
- The decision to broaden supply chains comes amidst heightened rhetoric from the U.S. regarding China. Treasury Secretary Janet Yellen is expected to warn Beijing of a U.S. response if it continues unfair trade practices. Her remarks will reinforce the notion that China and the U.S. are headed for a divorce as the two sides grapple with disagreements over human rights, support for Russia, and accusations of industrial espionage. Although U.S.-China trade increased to an all-time high last year, it is now showing signs of slowing.

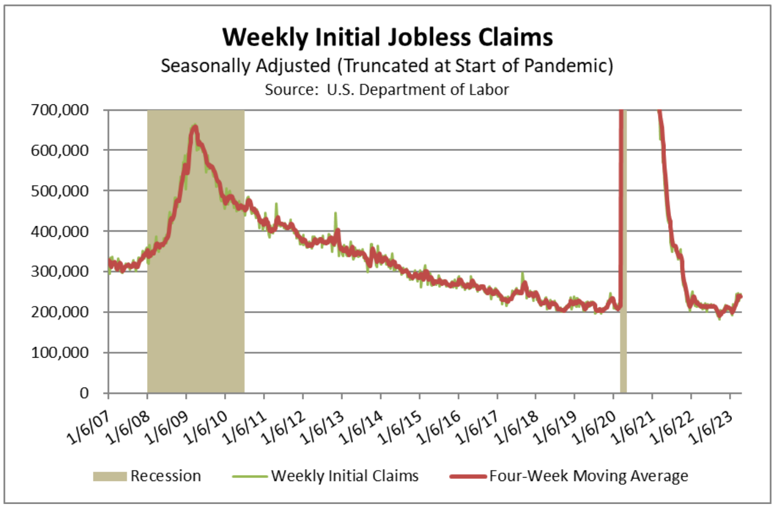


Source: Investors.com

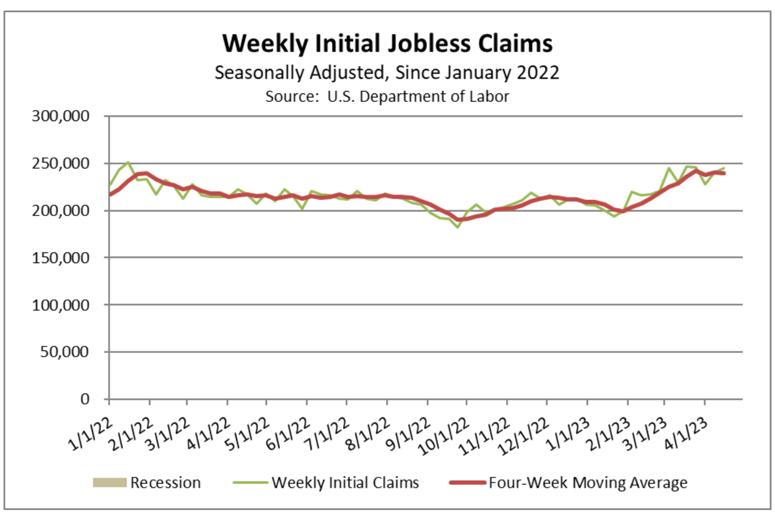
- Frictions between the U.S. and China will lead to a decline in the usage of the dollar for global trade. Beijing has already gotten a head start in this process as its foreign exchange reserves have declined from nearly $4 trillion in 2014 to slightly above $3 trillion as of March of this year. Meanwhile, Brazilian President Lula has called on emerging economy countries to reduce their reliance on the U.S. greenback for trade. We suspect countries that align with China will be persuaded to use other currencies for trade, especially if they want access to the world's second-largest economy. If we are correct, the U.S. dollar should be headed toward a secular decline against other global currencies.

U.S. Economic Releases

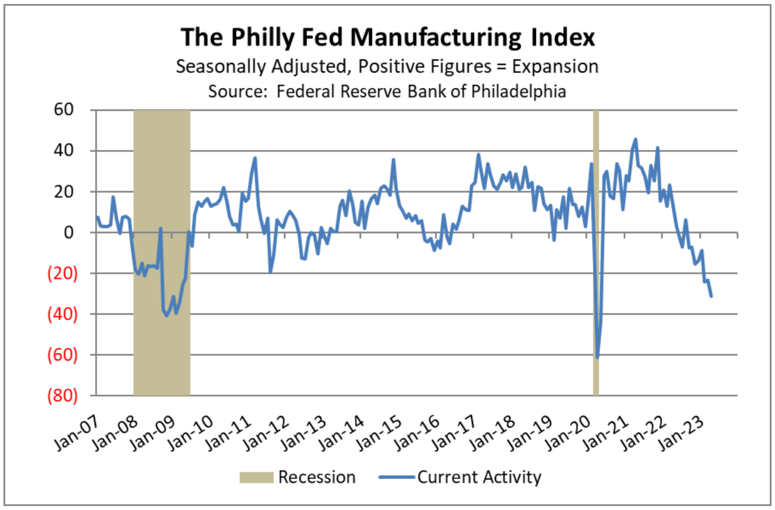
In the week ending April 15, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 245,000, above expectations that they would remain at the previous week's revised level of 24,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to 239,750 and still points to strong labor demand. On the other hand, in the week ending April 8, the number of ***continuing claims for unemployment benefits*** (i.e., people continuing to draw benefits) rose to 1.865 million, well above both the anticipated level of 1.825 million and the previous week's revised level of 1.804 million. The continuing claims figures may suggest that once people are laid off these days, it may be taking them longer to find a new job. The chart below shows how initial jobless claims have fluctuated since just before the prior recession. The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



To provide more detail on recent trends, the chart below shows how initial jobless claims have changed just since the beginning of 2022.



Separately, the Philadelphia FRB said its ***April Manufacturing Activity Index*** declined to a seasonally adjusted -31.3, dashing expectations that it would improve to -19.3 from the March reading of -23.2. The Philly Fed Index is designed so that positive readings point to expanding factory activity in the mid-Atlantic region. At its current level, the index suggests the region's factory sector has slowed significantly and remains very weak. The chart below shows how the index has fluctuated since just before the prior recession.



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**
10:00	Leading Economic Indicators	m/m	Mar	-0.7%	-0.3%	***
10:00	Existing Home Sales (monthly change)	m/m	Mar	4.50m	4.58m	**
10:00	Existing Home Sales (annualized selling rate)	m/m	Mar	-1.8%	14.5%	***
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
12:00	Chris Waller Discusses Discusses Financial Innovation	Member of the Board of Governors				
12:20	Loretta Mester Discusses the Economic and Policy Outlook	President of the Federal Reserve Bank of Cleveland				
15:00	Michelle Bowman Takes Part in Fed Listens Event	Member of the Board of Governors				
15:00	Lorie Logan Speaks at Fed Listens Event	President of the Federal Reserve Bank of Dallas				
17:00	Raphael Bostic Discusses Economic Conditions	President of Federal Reserve Bank of Atlanta				
19:45	Patrick Harker Discusses the Economic Outlook	President of the Federal Reserve Bank of Philadelphia				

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	14-Apr	¥1876.4b	¥2368.9b	--	*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	14-Apr	¥9.4b	¥1311.1b	--	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	14-Apr	¥500.2b	-¥788.8b	--	*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	14-Apr	-¥65.3b	¥28.2b	--	*	Equity and bond neutral
	Trade Balance	m/m	Mar	-¥754.5b	-¥898.1b	-¥1294.8b	***	Equity bullish, bond bearish
	Exports	m/m	Mar	4.3%	6.5%	2.4%	*	Equity and bond neutral
	Imports	m/m	Mar	7.3%	8.3%	11.6%	*	Equity and bond neutral
Australia	NAB Business Confidence	q/q	1Q	-4	-1	--	**	Equity bearish, bond bullish
EUROPE								
Germany	PPI	y/y	Mar	7.5%	15.8%	9.8%	**	Equity and bond neutral
France	Business Confidence	m/m	Apr	102	103	103	**	Equity bearish, bond bullish
	Manufacturing Confidence	m/m	Apr	101	104	103	*	Equity bearish, bond bullish
Russia	PPI	y/y	Mar	-10.70%	-7.50%		*	Equity and bond neutral
AMERICAS								
Mexico	Retail Sales	y/y	Feb	3.4%	5.3%		***	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)	525	527	-2	Up
3-mo T-bill yield (bps)	496	499	-3	Up
TED spread (bps)	29	28	1	widening
U.S. Sibor/OIS spread (bps)	507	506	1	Up
U.S. Libor/OIS spread (bps)	509	508	1	Up
10-yr T-note (%)	3.55	3.59	-0.04	Flat
Euribor/OIS spread (bps)	321	320	1	Up
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Up			Down
Pound	Up			Up
Franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
PBOC 1-Year Med-Term Lending Facility	4.300%	4.300%	4.300%	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.

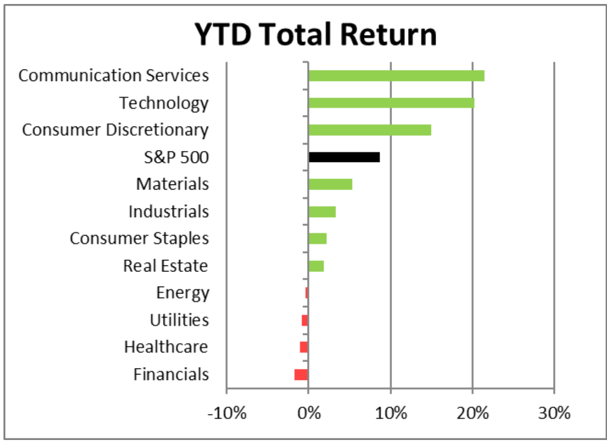
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$81.77	$83.12	-1.62%	
WTI	$77.90	$79.16	-1.59%	
Natural Gas	$2.24	$2.22	0.95%	
Crack Spread	$29.93	$30.62	-2.25%	
12-mo strip crack	$25.12	$25.52	-1.60%	
Ethanol rack	$2.53	$2.54	-0.50%	
Metals				
Gold	$2,006.61	$1,994.93	0.59%	
Silver	$25.41	$25.29	0.48%	
Copper contract	$405.85	$408.10	-0.55%	
Grains				
Corn contract	$627.50	$636.50	-1.41%	
Wheat contract	$682.75	$692.75	-1.44%	
Soybeans contract	$1,466.50	$1,478.75	-0.83%	
Shipping				
Baltic Dry Freight	1,372	1,368	4	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-4.6	-0.9	-3.7	
Gasoline (mb)	1.3	-2.0	3.3	
Distillates (mb)	-0.4	-1.2	0.8	
Refinery run rates (%)	1.7%	-0.30%	2.0%	

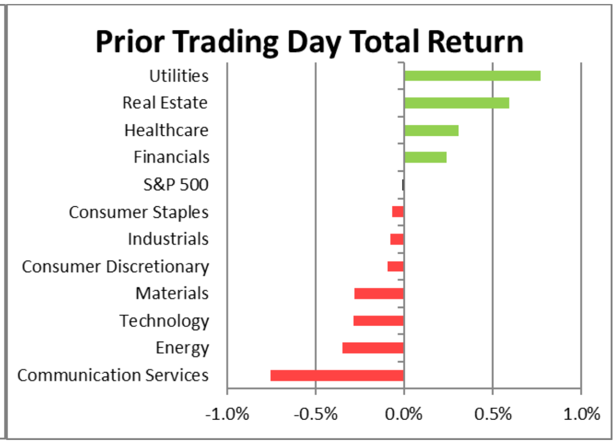
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in the Far West and Florida, with cooler-than-normal temperatures in the Upper Midwest and lower Mississippi Valley regions. The forecasts are calling for wetter-than-normal conditions in the South and along the East Coast, with dry conditions in the Far West.

Data Section

U.S. Equity Markets – (as of 4/19/2023 close)

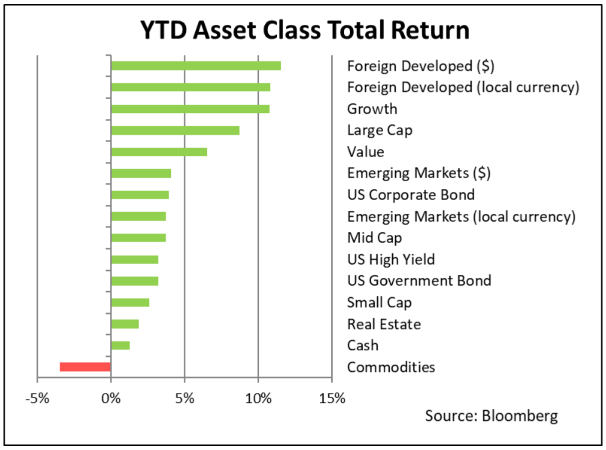




(Source: Bloomberg)

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 4/19/2023 close)

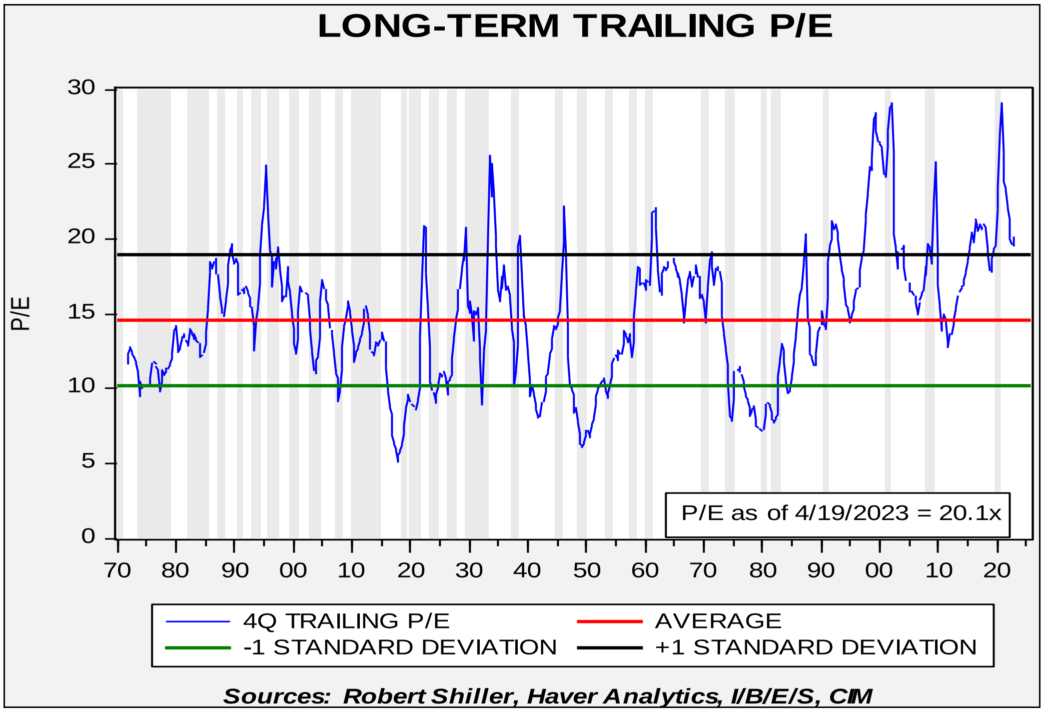


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 20, 2023



Based on our methodology,[1] the current P/E is 20.1x, up 0.1x from last week. Rising index values mostly accounted for the modest uptick.

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.