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 25, 2023—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is currently down 0.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.8%. Chinese markets were lower, with the Shanghai Composite closing down 0.3% from its previous close and the Shenzhen Composite closing down 1.7%. U.S. equity index futures are signaling a lower open.

With 96 companies having reported so far, S&P 500 earnings for Q1 are running at $50.90 per share compared to the estimate of $50.89, which is down 7.3% from Q1 2022. Of the companies that have reported thus far, 78.1% have exceeded expectations while 19.8% 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* (4/24/2023) (with associated podcast): "The Fed's Employment Surprise"
- *Confluence of Ideas* podcast (3/8/2023): "Reflections on Inflation"

Our *Comment* today opens with a leading global investor's view on the economic implications of climate change and the world's responses to it (spoiler: the result is more inflation). We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including a big U.S. technology firm's effort to appease European antitrust regulators and multiple new signs of weakening demand in the U.S.

Global Economics of Climate Change: In an interview with the *Financial Times*, the chief of Norway's massive sovereign wealth fund warned that global warming and the responses to it will contribute to higher price inflation in the coming years. According to Nicolai Tangen, the changing climate is already disrupting food production, but societies will also face higher costs as they shift their energy mix to greener sources and invest in new infrastructure to mitigate the impact of warming temperatures.

- Here at Confluence, we have long argued that the fracturing of the world into relatively separate geopolitical and economic blocs will tend to push up both inflation and inflation volatility. The key inflation drivers in this world include shortened and less efficient supply chains, the need to invest in new and more resilient production facilities, commodity trade embargos by rival blocs, and insufficient past investment in new sources of energy and other commodities.
- Tangen's observations suggest the impacts of climate change will be an additional source of inflation, as will slowing birth rates and continued labor shortages in many countries.
- If inflation does remain relatively high as we expect, interest rates will probably also be elevated. For investors, that means bonds are likely entering a long-lasting bear market, while commodities will likely be buoyed.

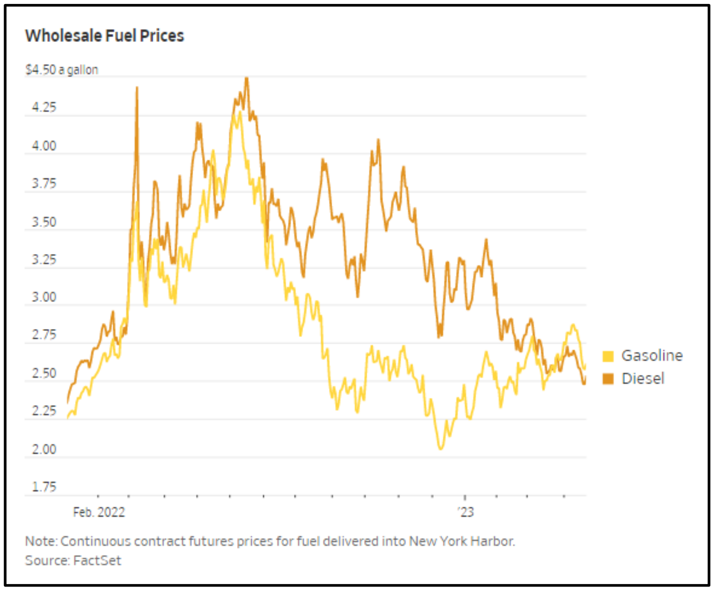
Global Defense Spending: The Stockholm International Peace Research Institute reported that global defense spending in 2022 reached an all-time high of $2.24 trillion, up 3.7% from the previous year after stripping out inflation. Much of the increase reflected a 13% rise in Europe which was related to Russia's ongoing invasion of Ukraine. The data is consistent with our view that global fracturing and increased geopolitical tensions will drive higher defense spending in the coming years.

EU Antitrust Regulation: Microsoft (MSFT, $281.77) has reportedly decided to stop bundling its Teams video conferencing and messaging app with its Office suite of software products in an effort to avoid an official antitrust probe by European Union regulators. Microsoft will now make Teams an optional additional app that a business can purchase when buying Office. The decision illustrates how the EU's tough efforts to regulate big U.S. technology firms have been effective in changing their behavior.

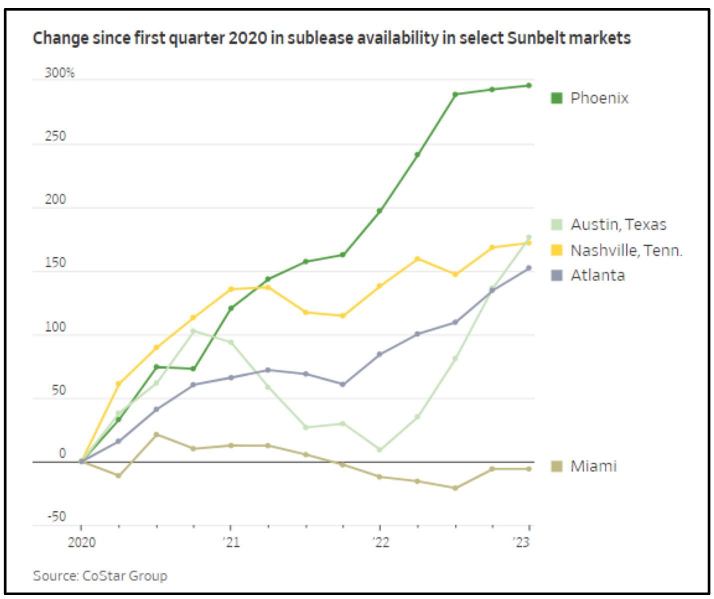
South Korea-Japan: The South Korean government has reinstated Japan to its "white list" of preferred trading partners, signaling a further cooling of tensions after years of acrimony over Japan's treatment of Koreans before and during World War II. The move will significantly cut the red tape South Korean manufacturers must deal with in order to sell to Japan. Better Japan-Korea trade ties will also bolster U.S. efforts to reduce China's role in global supply chains and build a close-knit alliance of liberal democracies to thwart China's geopolitical aggressiveness.

Australia: Yesterday, the government released a new "defense strategic review" that calls for the country to revamp its armed forces to combat threats faster, farther away, and alongside regional partners amid concerns over China's rapid military build-up. For example, the review calls for cutting planned investments in armored vehicles geared for use on Australian territory to free up funds for new, long-range precision strike missiles and nuclear-powered attack submarines under the AUKUS agreement with the U.S. and Britain.

U.S. Diesel Demand: Wholesale diesel prices have now fallen more than 43% since their peak last summer, reaching approximately $2.53 per gallon. The big decline largely reflects much weaker trucking activity, which in turn provides more evidence that U.S. economic growth is faltering rapidly ahead of the much-anticipated recession.



U.S. Office Demand: In another sign of spreading economic weakness, new data shows the decline in office demand is now spreading from the big, expensive coastal cities like New York and San Francisco to cities in the Sun Belt. Asking rents in the Sun Belt are beginning to stagnate, and floorspace available for sublease is surging. The data adds to the signs that the economy is weakening ahead of the expected recession.



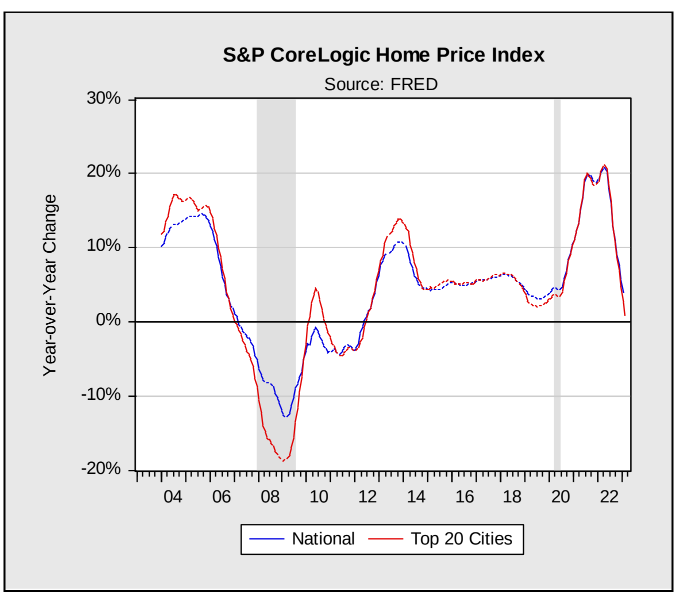
U.S. Financial Markets: Official data shows individuals bought $48.4 billion of U.S. Treasury bills through accounts on the Treasury department's website in March. Direct individual purchases reportedly have remained strong in April, illustrating how people are pulling deposits out of the banking system in search of higher yields elsewhere. We continue to believe that this process of "disintermediation" adds to the risk of slower bank lending and even weaker economic growth.

- Separately, medium-sized California lender First Republic Bank (FRC, $16.00) reported yesterday that its customers withdrew more than $100 billion of their deposits amid last month's banking scare. First Republic's stock is down some 20% today in pre-market trading.
- Of course, First Republic's sudden hemorrhaging of deposits mostly reflected customer concerns about the bank's stability. Nevertheless, the firm said deposits have been continuing to drift lower this month, suggesting that customers continue to look for higher returns in mutual funds, Treasury bills, and the like.

U.S. Economic Releases

Service-related activity slumped in the region overseen by the Federal Reserve Bank of Philadelphia. The non-manufacturing index from the Third District of the Federal Reserve fell from -12.8 to -22.8 in April. A sharp decline in new orders and sales weighed on the index.

Housing was stronger than expected in February according to two separate sources. Government data from the Federal Housing Financing Agency showed that residential prices rose 0.5% from the previous month. The reading was well above expectations of -0.1% and previous month's rise of 0.2%. Additionally, statistics collected by ratings agency Standard & Poor's showed that nationwide home prices increased 2.1% since February 2022, while residential prices in the top 20 cities rose 0.4% in the same period.



The previous chart shows the annual change in S&P CoreLogic Index for the nation and top 20 cities. The persistent deceleration in home prices reflects the impact that Fed policy is having on residential investment.

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	New Home Sales (monthly change)	m/m	Mar	632k	640k	**
10:00	New Home Sales (annualized selling rate)	m/m	Mar	-1.3%	1.1%	***
10:00	Conf. Board Expectations	m/m	Apr	104.0%	104.2	**
10:00	Conf. Board Present Situation	m/m	Apr		151.1	**
10:00	Conf. Board Present Situation	m/m	Apr		73.0	**
10:00	Richmond Fed Manufact. Index	m/m	Apr	-8	-5	***
10:00	Richmond Fed Business Conditions	m/m	Apr		-17	**
10:30	Dallas Fed Services Activity	m/m	Apr		-18.0	**
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	Services PPI	y/y	Mar	1.6%	1.8%	1.7%	*	Equity and bond neutral
	Nationwide Dept Sales YoY	y/y	Mar	9.8%	20.4%		*	Equity bearish, bond bullish
South Korea	Depart. Store Sales	y/y	Mar	9.5%	8.6%		*	Equity and bond neutral
	Retail Sales	y/y	Mar	6.4%	7.9%		**	Equity bearish, bond bullish
	Discount Store Sales	y/y	Mar	1.2%	5.8%		*	Equity bearish, bond bullish
South Korea	GDP	y/y	1Q A	0.8%	1.3%	0.9%	**	Equity and bond neutral
EUROPE								
UK	Public Sector Net Borowing	m/m	Mar	20.7b	15.9b	12.5b	*	Equity bearish, bond bullish
	PSNB ex Banking Groups	m/m	Mar	21.5b	16.7b	13.3b	**	Equity bearish, bond bullish
Switzerland	Real Exports	m/m	Mar	2.6%	-2.7%	-3.2%	*	Equity bearish, bond bullish
	Real Imports	m/m	Mar	0.0%	-0.5%	-0.4%	*	Equity bullish, bond bearish
AMERICAS								
Mexico	Economic Activity IGAE	y/y	Feb	3.8%	4.43%	4.00%	**	Equity and bond neutral
Brazil	FGV Consumer Confidence	y/y	Apr	86.8	87.0		*	Equity and bond neutral
	Current Account Balance	m/m	Mar	$286m	-$2.815b	-$3.030b	**	Equity and bond neutral
	Foreign Direct Investment	m/m	Mar	$7.673b	$6.451b	$9.850b	**	Equity and bond neutral
	Retail Sales	y/y	Feb	1.0%	2.6%	0.9%	***	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)	526	527	-1	Up
3-mo T-bill yield (bps)	492	494	-2	Up
TED spread (bps)	33	33	0	widening
U.S. Sibor/OIS spread (bps)	507	506	1	Up
U.S. Libor/OIS spread (bps)	509	509	0	Up
10-yr T-note (%)	3.45	3.49	-0.04	Flat
Euribor/OIS spread (bps)	329	326	3	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Flat			Down
Pound	Down			Up
Franc	Flat			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.

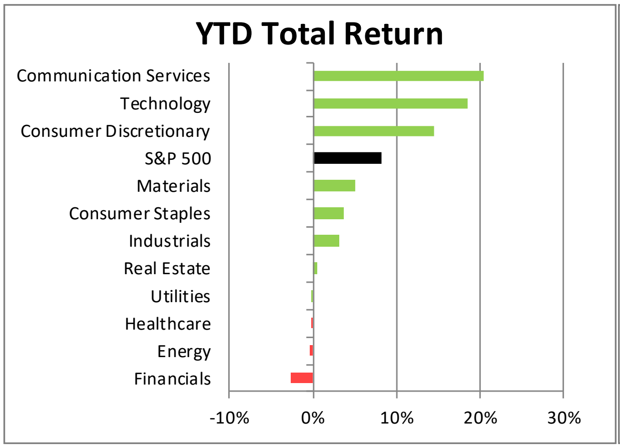
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$82.00	$82.73	-0.88%	
WTI	$78.02	$78.76	-0.94%	
Natural Gas	$2.18	$2.27	-3.92%	
Crack Spread	$30.07	$29.61	1.57%	
12-mo strip crack	$25.29	$25.06	0.94%	
Ethanol rack	$2.54	$2.54	0.10%	
Metals				
Gold	$1,979.15	$1,989.14	-0.50%	
Silver	$24.54	$25.16	-2.45%	
Copper contract	$387.65	$396.45	-2.22%	
Grains				
Corn contract	$606.50	$607.50	-0.16%	
Wheat contract	$655.50	$657.00	-0.23%	
Soybeans contract	$1,432.75	$1,436.00	-0.23%	
Shipping				
Baltic Dry Freight	1,517	1,504	13	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-0.3		
Gasoline (mb)		-1.3		
Distillates (mb)		-0.9		
Refinery run rates (%)		0.70%		
Natural gas (bcf)		70		

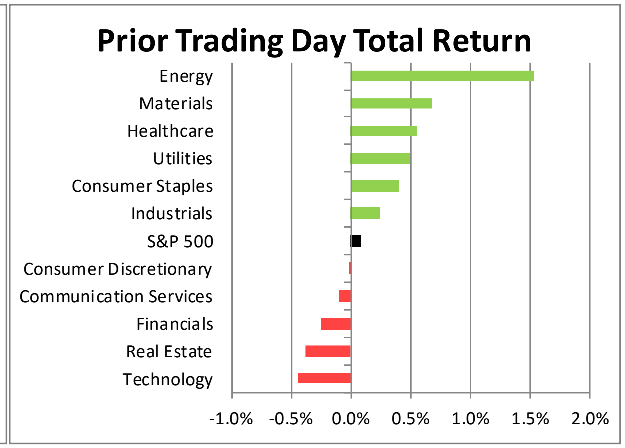
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in the Pacific region, with cooler-than-normal temperatures for the rest of the country. The forecasts are calling for wetter-than-normal conditions for most states, with dry conditions in the Rocky Mountain, Midwest, New England, and Great Lakes regions.

Data Section

U.S. Equity Markets – (as of 4/24/2023 close)

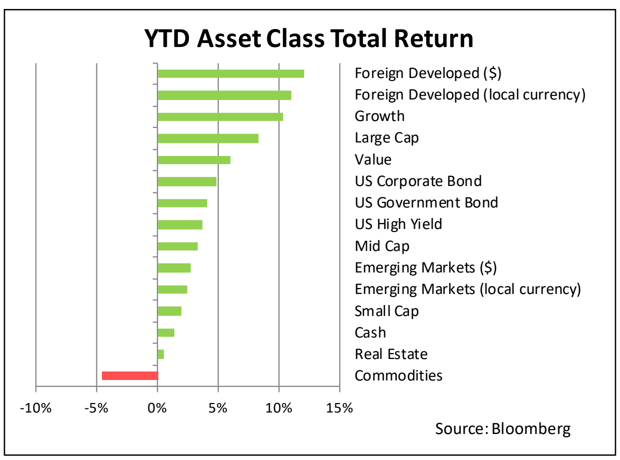




(Source: Bloomberg)

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 4/24/2023 close)

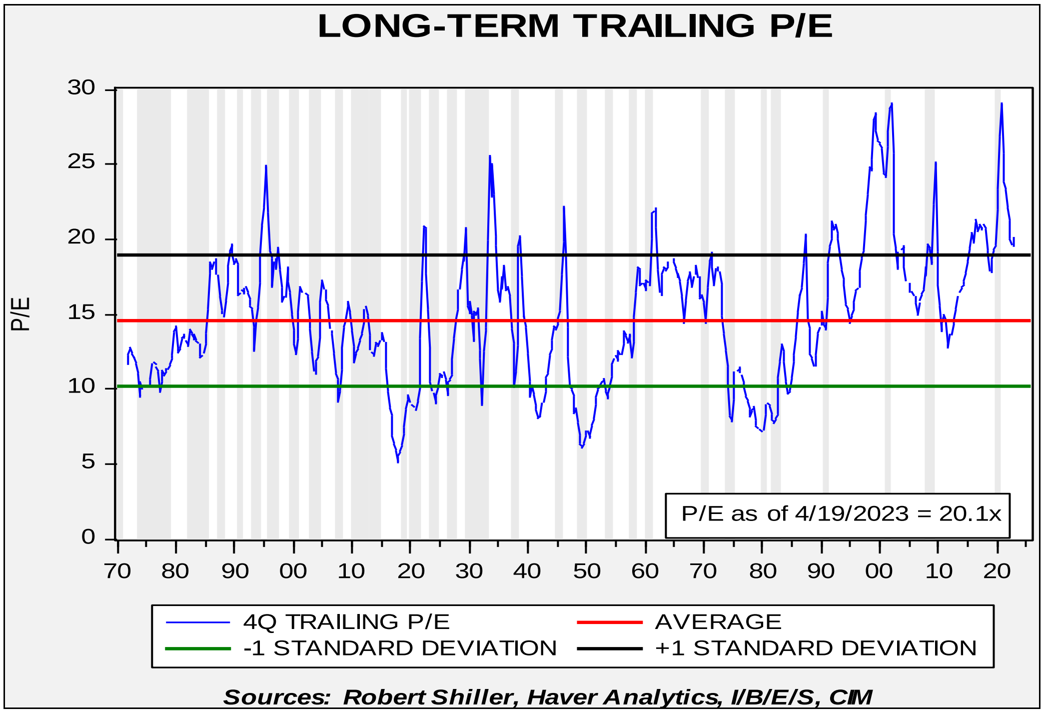


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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 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.