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 26, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is currently down 0.9% 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 relatively unchanged from its previous close and the Shenzhen Composite closing up 0.3%. U.S. equity index futures are signaling a higher open.

With 138 companies having reported so far, S&P 500 earnings for Q1 are running at $51.50 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, 81.2% have exceeded expectations while 15.9% 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 – Q2 2023* (4/25/2023): Discussion of our asset allocation process, Q2 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"

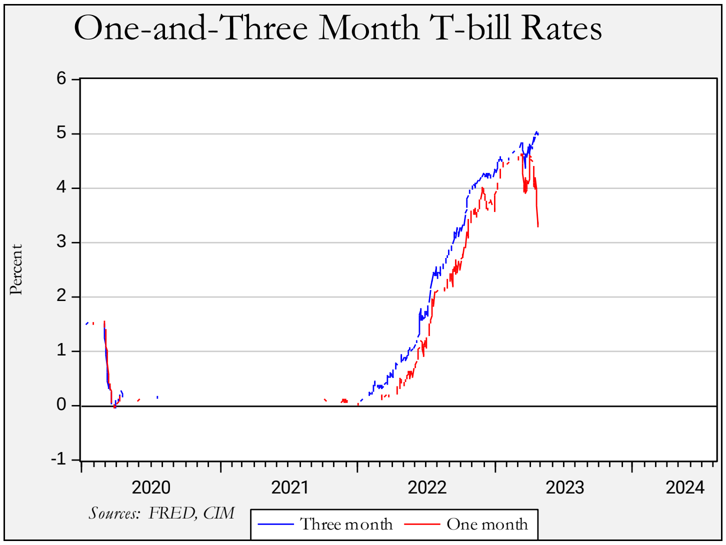
Good morning! It's a mixed market this morning after a rough day yesterday. The dollar and interest rates are lower, while S&P futures were higher but have seen gains erode as the morning wears on.

In today's *Comment,* we open with President Biden's announcement of his second and last campaign. From there, we move to financial news, with a focus on the banking system (again). China news is next (spoiler alert—Xi has talked to Zelensky). International news comes after, and we close with economic news.

Biden's Last Campaign: As widely anticipated, President Biden formally announced he is running for a second term. Although polling shows little enthusiasm for this news, there isn't really an obvious alternative for the Democrats at this point. Beyond the spoiler candidate of Robert Kennedy, we don't expect a serious challenge to this nomination. What is getting a good deal of focus is the president's decision to keep Kamala Harris as this running mate. Harris has had a rocky tenure as VP and given Biden's advance age, there is a higher-than-normal chance she could become president if Biden is reelected. Usually, the VP candidate doesn't garner this amount of attention, but that doesn't appear to be the case for now.

Financial News: First Republic Bank (FRC, $8.10) is in trouble and Microsoft's purchase of Activision has been scotched. We also note the curious case of one-month T-bill yields.

- Equity markets were rocked yesterday as FRC shares plummeted after the bank released its Q1 results. The loss of $100 billion of deposits is what raised fears about the soundness of the bank. There are clear worries about the ability of the bank to continue operations. Essentially, the bank is holding assets that have fallen in value due to rising interest rates and is facing a jump in funding costs. The bank is attempting to sell off assets (although it will probably be at a loss), but will likely need some sort of government support to remain in business. Although this news has rekindled worries about the banking system, we note that this bank is part of a handful of banks that made aggressive investments in long duration assets. It doesn't appear that this practice was widely adopted. Still, bank runs are psychological events, and we will be watching to see if this news spurs another jump in money market assets.
- Microsoft's (MSFT, $275.42) acquisition of Activision Blizzard (ATVI, $86.74) has been blocked by U.K. regulators. This would have been Microsoft's largest acquisition to date.
- In the wake of the Great Financial Crisis, leveraged loans became the preferred vehicle for leveraged buyouts, supplanting high yield bonds and other similar instruments. These leveraged loans were considered senior debt to bonds and so in bankruptcy, the loans tended to be safer. However, a recent court ruling has upset the "capital stack" which has forced these loans into the pool of more junior debt. This ruling is upsetting the leveraged loan market and could lead to widening credit spreads.
- Short duration Treasuries tend to be one of the sleeper parts of the financial system. These short-term government obligations are nearly cash like and constitute much of the "plumbing" of the non-bank financial system. Recent behavior in the one- and three-month T-bill market is raising worries.



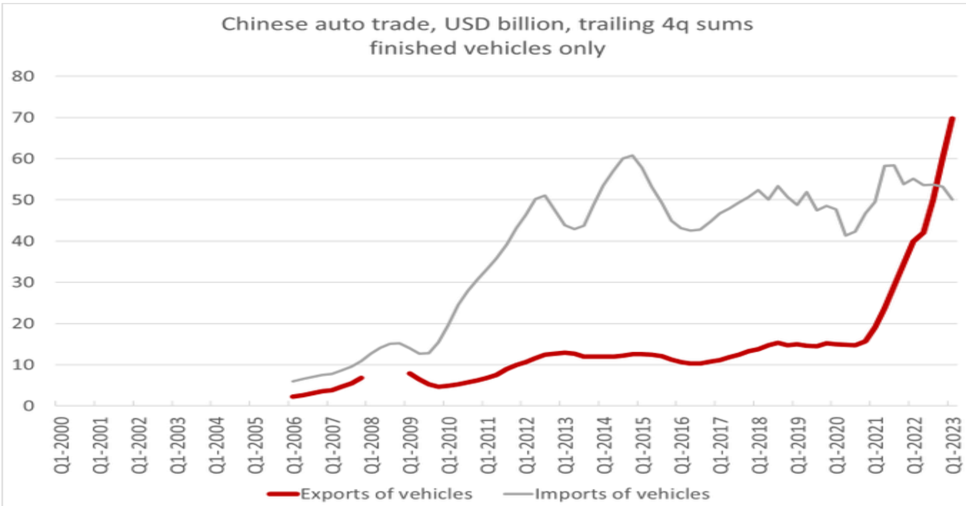
- Most of the time, the difference in rates between these two instruments is negligible, although the one-month rate has lagged the three-month since early last year. Recently, though, we have seen a sharp divergence between the two rates. It is generally thought that the drop in one-month yields is tied to the debt ceiling issue (see below). The government may not be able to issue short-debt as it runs out of borrowing capacity, leading to scarcity. The market expects the situation to be resolved shortly though, and so three-month rates are holding up. However, we do worry that this divergence may be signaling something less benign. We could be seeing a scramble for collateral that is often used in repo transactions, and the drive to secure this collateral is leading to a drop in yields on this short-dated paper. Given the turmoil in the banking system, a problem in the non-bank system could be a significant worry. Again, it is hard to separate the debt ceiling issues from other issues, but this is a situation we will be monitoring closely.
- Remember SPACs? It is becoming clear those were a function of easy money.

China News: As we noted above, Xi has spoken to Zelensky. China is crawling toward implementing a property tax, and Chancellor Scholz has invited Premier Li to Berlin amid a major revolution in the car market.

- For years, the CPC leadership has considered implementing a property tax. The government recently announced that it has built a real estate register, an important step in applying a property tax. However, putting a property tax in place is fraught with risk. First of all, it is widely believed that high ranking CPC officials hold lots of property surreptitiously. Property is still the preferred method of holding assets in China and party officials who may have acquired cash in unorthodox ways[1] often invest in real estate under false names or under the names of other family members. A tax would reveal this practice and likely trigger another purge and capital flight. Second, a tax would almost certainly trigger additional losses in property, something that would hurt the economy. So, for now, we don't expect a tax, but at some point, the need for revenue will probably overcome these objections.

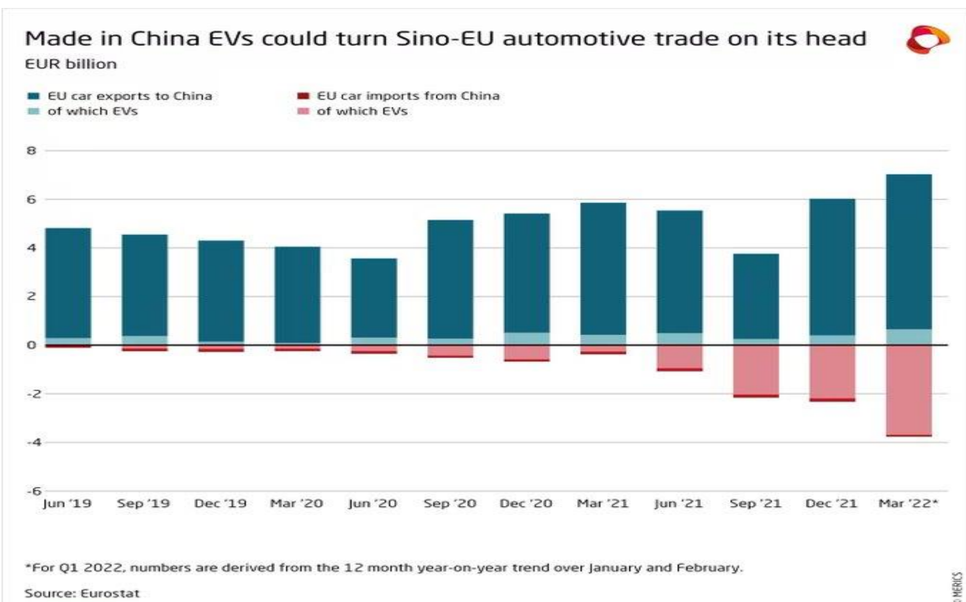
[1] Otherwise known as bribes.

- Chancellor Scholz has invited Chinese Premier Li Qiang to Berlin in a bid to ease tensions. We note that something is developing in the auto market that could be a serious problem for Germany's auto industry. In fact, there are twin developments underway. First, Chinese car quality standards have been improving and there is growing evidence that Chinese car companies are boosting export sales.



(Source: Brad Setzer)

This development may be especially problematic for the EU in general and Germany in particular.



Now, this isn't just gasoline cars. EVs sales are growing rapidly, especially in China, and given China's dominance in battery production and rare earths, Chinese automakers have a strong advantage in this area. German automakers have been slower to adopt EVs and could face an onslaught of Chinese EV imports.

- Although French President Macron's recent comments on EU relations with China have been widely panned, he may not be as much of an outlier as portrayed. The U.K. foreign secretary gave a speech opposing isolating China, for example. Although we believe the world is evolving into competing blocs, there will be those who oppose this development, or prefer to work between the blocs to maintain the benefits of wider trade.

- China's development model was based on investment and exports. This model of development isn't unique to China as Japan and Germany used it after WWII, and to some extent, the U.S. did too, from 1870 to 1930. Once a certain level of development is achieved, the model ceases to work, because at some point, diminishing returns on investment occur and foreign nations tire of absorbing imports. There are a few paths of transition with the most durable being to shift to domestic consumption (the U.S. path after the Great Depression) or colonization (the U.K. after its industrial revolution or Germany with the Eurozone). Japan never made the transition and has suffered economic stagnation for three plus decades. We believe this is where China is now. The Belt and Road initiative is a form of imperialism and one potential path. Still, giving up on the development model is hard, and we note that China is rolling out an export promotion plan that will be hard to execute given how fraught relations have become with the West.

- In our 2023 Bi-Weekly Geopolitical Outlook, we noted that a new space race was underway. China has unveiled a three-stage project to have a moon base operational by 2050. The U.S. sees China's activities as a serious national security threat.

Markets, Economics and Policy: There is a glimmer of hope that the House will pass a budget bill.

- The GOP holds a slim five-vote majority in the House, meaning that passing legislation is devilishly hard, given the divided nature of the party. The party needs to pass a budget bill to begin negotiations on the debt ceiling. Without a budget bill, there is nothing to negotiate, so Speaker McCarthy knows he needs the budget bill to start the process. He has a bill in place, which would cut spending, and he claims to have the votes to pass it after making a deal with some elements of his caucus.

- There is virtually no chance that this budget will pass into law. The GOP doesn't control the Senate or the White House. However, it could become the basis of difficult negotiations and could force the White House to accept some spending cuts. And, more importantly for markets, it raises the odds of a debt crisis and potentially a temporary default. If, on the other hand, the budget fails to pass, the House would likely be forced to accept a "clean" increase in the debt ceiling. Although financial markets expect a resolution, there are concerns growing (see T-bill commentary above) that a disruption is possible.

International News: South Korea and the U.S. discuss nuclear deterrence, and Sudan remains tense.

- During the Cold War, the U.S. and the U.S.S.R. controlled the bulk of the world's nuclear weapons, however, they weren't the only nuclear powers. France, the U.K., and China also had small programs, and Israel has a well-known, but officially denied, program.

For the most part, though, France and the U.K. operated under American doctrine, and China was subservient to the Soviets. The key to nuclear deterrence is that a nuclear power can never be forced into unconditional surrender, since if a nuclear power fears it is about to fail, it can threaten to launch against its adversary. Both major nuclear powers had numerous nations under their "nuclear umbrella." Although these nations didn't have warheads themselves, there was a credible threat from an allied nuclear power that if the umbrella nation were to be invaded, then the nuclear power would prevent surrender. For the nation under the umbrella, there was always a worry that, at the 11th hour, the nuclear power would balk at deployment.

- South Korea is facing this problem. North Korea has nuclear weapons and likely the ability to deliver them, and the South Korean leadership is increasingly worried that the U.S. will "sacrifice Seoul for San Francisco." In other words, if North Korea threatens the South with nukes, or even with conventional invasion, the U.S. won't use nuclear weapons to protect it, due to worries that America could be bombed by Pyongyang. Thus, South Korea has suggested it would like nuclear weapons on its soil to counter the North Korean threat.
- For obvious reasons, the U.S. is reluctant to take that step, but when South Korean President Yoon comes to the U.S. this week, the administration is expected to provide assurances to the South Koreans.

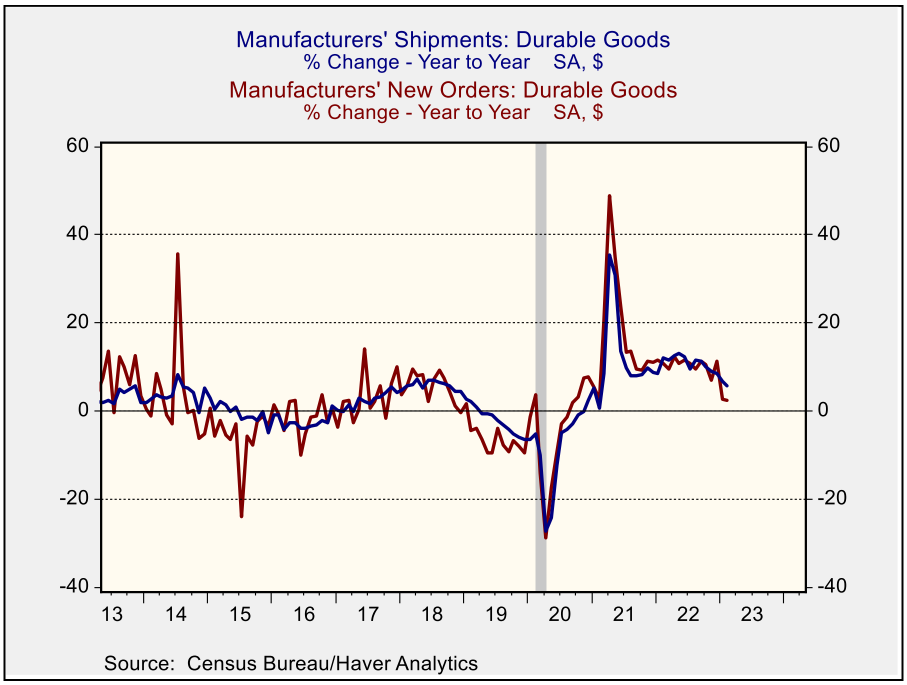
- A shaky ceasefire in Sudan appears to have broken down. Western nations are struggling to evacuate citizens during the continued violence.
- There is growing evidence that the long-awaited Ukraine spring offensive may be about to start. Continued Western support will likely require some degree of success.
- There is a continued debate over Ukraine grain supplies. Neighboring nations are facing a glut of grain from Ukraine, who has struggled to export grain via the Black Sea. There is a program to export grain, but it looks like it may expire soon. The EU is trying to stop neighboring nations from freezing imports of grain from Ukraine, but the farm sectors in these nations are reeling from falling prices.
- Quietly, the EU is looking to ease rules on government spending. Although Germany remains reluctant to change regulations, the current rules tend to trigger austerity during recessions.
- We are noting widespread military exercises in the Far East. These appear to involve multiple carrier groups. Although nothing will likely come of these actions, so many warships floating in a small area does bear watching.
- Japan's lunar mission failed.

U.S. Economic Releases

Borrowers rushing to lock in rates prior to next week's Federal Open Market Committee meeting led to a surge in residential loan demand. According to an index tracked by the Mortgage Bankers' Association, mortgage applications rose 3.7% in the week ending April 21. The jump in mortgage requests is related to concerns that the Federal Reserve will lift interest rates on May

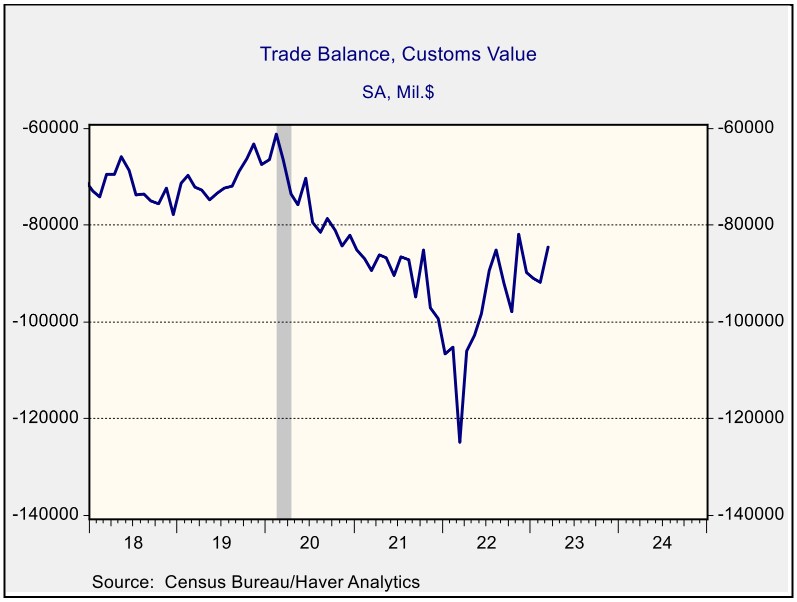
3, prompting borrowers to be proactive. As a result, the MBA tracker for purchases and refinancing rose 5.0% and 2.0% from the prior week, respectively. The average 30-year fixed-rate mortgage rose 12 bps from 6.43% to 6.55% last week.

A proxy for business spending picked up in March suggesting a slight rebound in investment activity. Durable goods orders rose 3.2% from the prior month. The reading was above expectations of 0.5% and the previous month's revised decline of 1.2%. Excluding transportation, which is volatile, durable goods orders rose 0.3% from the prior month, compared to expectations of a decline of 0.2%. Meanwhile, nondefense durable goods orders excluding transportation, also known as core capital goods, fell 0.4% from the prior month.



The chart above shows deceleration in the annual change in durable goods orders and shipments. New orders slowed from a gain of 2.54% to 2.23%, while the increase in shipments moderated from 6.46% to 5.54%. The reduction in the pace of orders and shipments reflects a downward trend in investment spending in anticipation of an economic slowdown.

The U.S. trade deficit in merchandise narrowed more-than-expected in March. Last month, the trade gap in goods declined from $92.0 billion to $84.6 billion. The reading was below estimates of $89 billion. The decrease in the goods deficit is related to a decline in imports as consumers reduce their spending on industrial supplies. At the same time, retail and wholesale inventories rose 0.4% and 0.1%, respectively.



The chart above shows the U.S. trade balance. A drop decline in the trade balance should improve Q2 GDP figures but may reflect a decrease in discretionary spending.

There are no economic releases or Fed events scheduled for the rest of the day.

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								
Australia	CPI	y/y	Q1	7.0%	7.8%	6.9%	**	Equity and bond neutral
New Zealand	Imports NZD	m/m	Mar	7.78b	5.95b	5.86b	**	Equity and bond neutral
	Exports NZD	m/m	Mar	6.51b	5.23b	5.06b	**	Equity and bond neutral
	Trade Balance NZD	m/m	Mar	-1273m	-714m	-796m	**	Equity and bond neutral
South Korea	Consumer Confidence	y/y	Apr	95.1	92		*	Equity bullish, bond bearish
EUROPE								
Germany	GfK Consumer Confidence	m/m	May	-25.7	-29.5	-29.3	**	Equity bullish, bond bearish
France	Consumer Confidence	m/m	Apr	83.0	81.0	82.0	**	Equity and bond neutral
Switzerland	Credit Suisse Survey Expectations	m/m	Apr	-33.3	-41.3		**	Equity and bond neutral
AMERICAS								
Mexico	International Reserves Weekly	w/w	21-Apr	$202673m	$202991m		*	Equity and bond neutral
Brazil	Total Outstanding Loans	m/m	Mar	5361b	5319b	5322b	**	Equity and bond neutral
	IBGE Inflation IPCA - 15	y/y	Apr	4.16%	5.36%	4.20%	**	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)	527	526	1	Up
3-mo T-bill yield (bps)	496	491	5	Up
TED spread (bps)	31	35	-4	Tightening
U.S. Sibor/OIS spread (bps)	504	503	1	Up
U.S. Libor/OIS spread (bps)	506	505	1	Up
10-yr T-note (%)	3.42	3.40	0.02	Flat
Euribor/OIS spread (bps)	327	329	-2	Up
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Flat			Down
Pound	Up			Up
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.

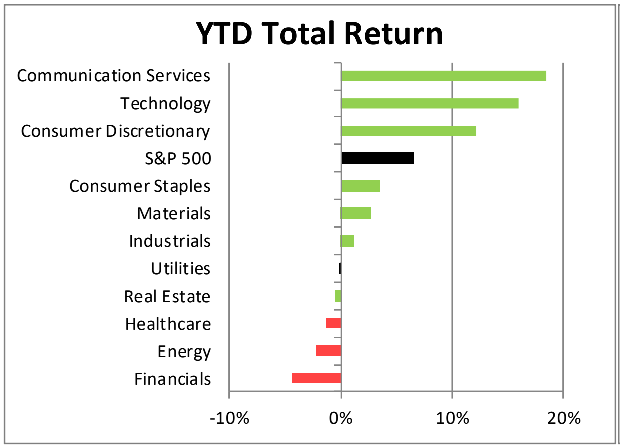
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$80.09	$80.77	-0.84%	
WTI	$76.74	$77.07	-0.43%	
Natural Gas	$2.21	$2.31	-4.33%	Warm weather expectations, reduced demand
Crack Spread	$28.39	$28.93	-1.87%	
12-mo strip crack	$24.21	$24.64	-1.75%	
Ethanol rack	$2.55	$2.54	0.03%	
Metals				
Gold	$1,996.02	$1,997.39	-0.07%	
Silver	$25.03	$25.01	0.07%	
Copper contract	$388.95	$386.50	0.63%	
Grains				
Corn contract	$609.50	$607.75	0.29%	
Wheat contract	$655.50	$653.00	0.38%	
Soybeans contract	$1,420.75	$1,417.50	0.23%	
Shipping				
Baltic Dry Freight	1,510	1,517	-7	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.5		
Gasoline (mb)		-1.5		
Distillates (mb)		-1.1		
Refinery run rates (%)		0.50%		
Natural gas (bcf)		77		

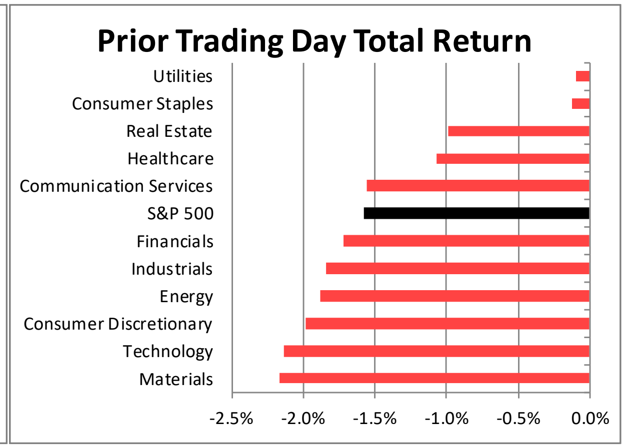
Weather

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 4/25/2023 close)

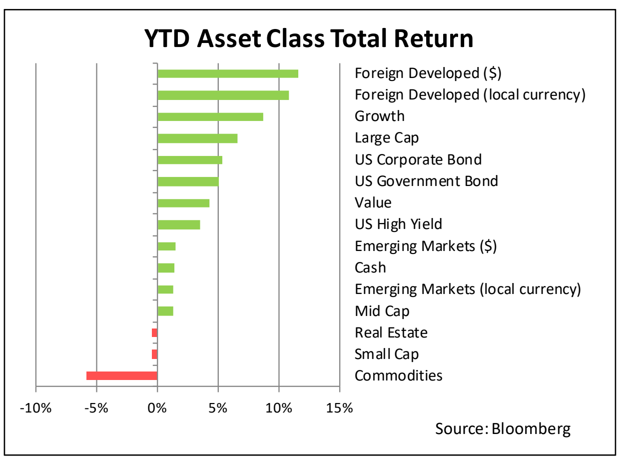




(Source: Bloomberg)

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 4/25/2023 close)

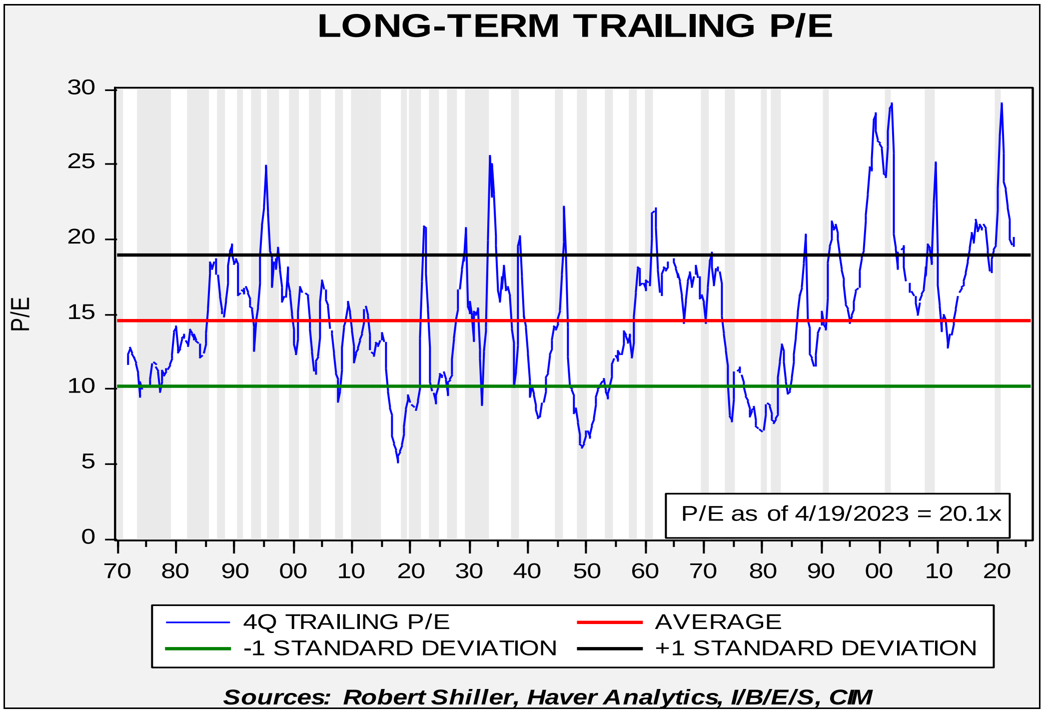


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[2] 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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[2] 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.