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 27, 2023—9:30 AM EDT] Global equity markets are mostly higher this morning. In Europe, the Euro Stoxx 50 is currently up 0.5% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.3%. Chinese markets were higher, with the Shanghai Composite up 0.7% from its previous close and the Shenzhen Composite closing up 0.1%. U.S. equity index futures are signaling a higher open.

With 189 companies having reported so far, S&P 500 earnings for Q1 are running at $51.70 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, 82.5% have exceeded expectations while 15.3% have fallen short of expectations.

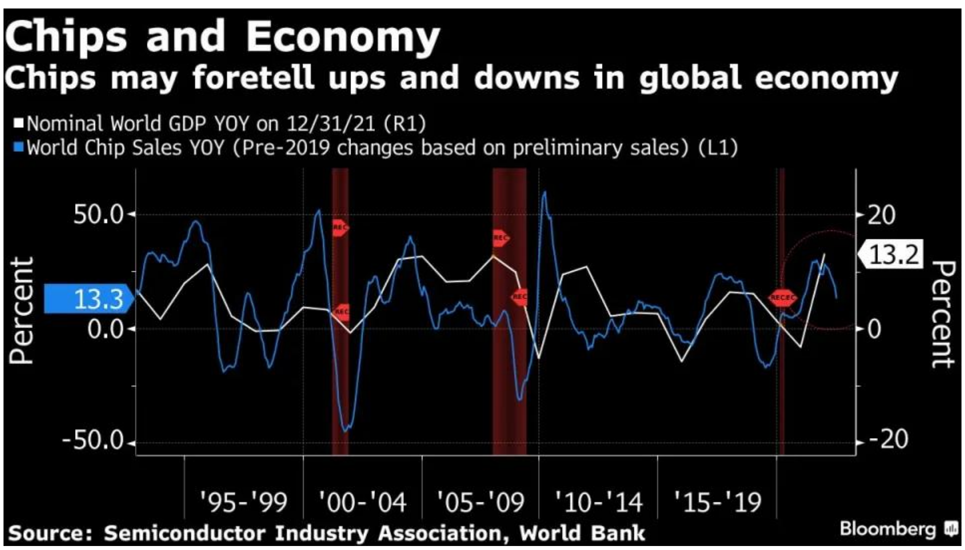
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (4/17/2023) (with associated podcast) "U.S. Intelligence Sharing as a Tool of International Relations"
- ***Weekly Energy Update*** **(4/27/2023): Along with our usual update of the weekly DOE data, we also show how EV sales are rising rapidly and could materially displace oil demand by the end of the decade.**
- *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! Today's *Comment* begins with our thoughts about the positive news regarding Big Tech and why it may not relieve concerns about a possible downturn. Next, we discuss the controversy regarding regional banks and the Federal Reserve's new lending facility. Lastly, the report provides an overview of the ongoing debt ceiling debate and its impact on bond volatility.

Why the Gloom? Earnings are better than expected, but recession fears weigh on investor sentiment.

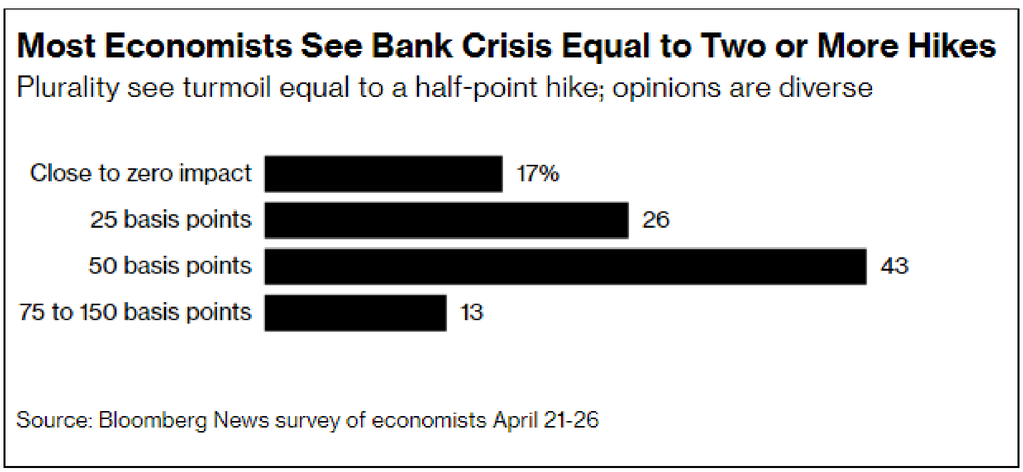
- The Tech-heavy NASDAQ Composite rose 0.5% Wednesday after Microsoft (MSFT, $295.36), Alphabet (GOOGL, $103.67), and Meta (META, $209.40) reported earnings and revenue that beat expectations. Microsoft's fiscal Q3 2023 results showed that the company's cloud service business slowed but not as much as investors had feared. Alphabet's Google search engine was able to generate solid ad sales. Meanwhile, Meta added 37 million daily users to its flagship Facebook app. The tech behemoths' strong performances have boosted confidence in the sector as layoffs and restructuring have helped make the companies leaner and more efficient. That said, market participants are not convinced that the worst has already come to pass.
- Despite the strong performance by Big Tech companies, there are concerns from the market of further trouble ahead. The S&P 500 closed down 0.4% on Wednesday on investors fear that quarterly earnings are reinforcing views that consumers are reining in their spending. Dutch Semiconductor equipment maker ASM International (ASMIY, $347.99) reported a drop in first-quarter earnings and stated that the company expected sales to decline in the second half of 2023. Similarly, South Korean company Samsung Electronics (SSNLF, $40.60) posted a record $3.4 billion loss in chip sales in Q1 2023. The decline in semiconductor sales is related to a slump in demand for consumer electronics, which has been associated with changes in the business cycle.



- Although the S&P 500 is up 6% this year, a few stocks have driven much of the gain. Microsoft and Apple (AAPL, $163.76) accounted for 40% of the increase and now account for a record 13.3% of the index. The lack of market breadth has led to concerns that this year's rally may not be sustainable. The recent banking turmoil has worsened those concerns. That said, investors should remember that much of the recession fears have already been priced into the market, suggesting that equities remain fertile for long-term investment growth.

Now the Zombies! First Republic's deposit exodus has put the Federal Reserve's new emergency lending facility into focus.

- First Republic Bank's (FRC, $5.45) troubles are still weighing on investor sentiment. On Monday, the bank disclosed that it had lost $100 billion in deposits last quarter. Although in March First Republic Bank was able to replace some of the lost holdings with $30 billion in deposits from major banks, the new injections were not enough. In order to shore up its cash position, First Republic has now decided to sell assets, likely at a discount. Its precarious situation has led regulators to consider downgrading their assessment of the bank, which would limit the firms' access to the Federal Reserve's lending facilities, if it can't find a quick solution to its woes.
- The struggles of First Republic Bank are a reminder of the tensions caused by fractional reserve banking. Banks convert deposits, which depositors view as "money," into loans and securities, which pay a higher interest rate. This model relies on a normally sloped yield curve. When central banks tighten policy, yield curves tend to invert, meaning that funding costs for banks (those short-term deposits) may now be paying a higher rate than the loans and securities held by the bank. What we have seen recently is that a few banks have held long-duration risk on the asset side (loans and securities) as policy tightening has threatened their solvency. As long as deposits "stay put," the bank can continue to operate, however, if depositors withdraw their funds, the bank is in trouble. As we mentioned in yesterday's report, unlike Silicon Valley Bank, most regional banks don't have a high level of exposure to long-term Treasuries, but deposit outflows remain a problem. So far, the smaller financial institutions have been able to depend on Federal Reserve backstops for relief, but even that solution has its flaws.

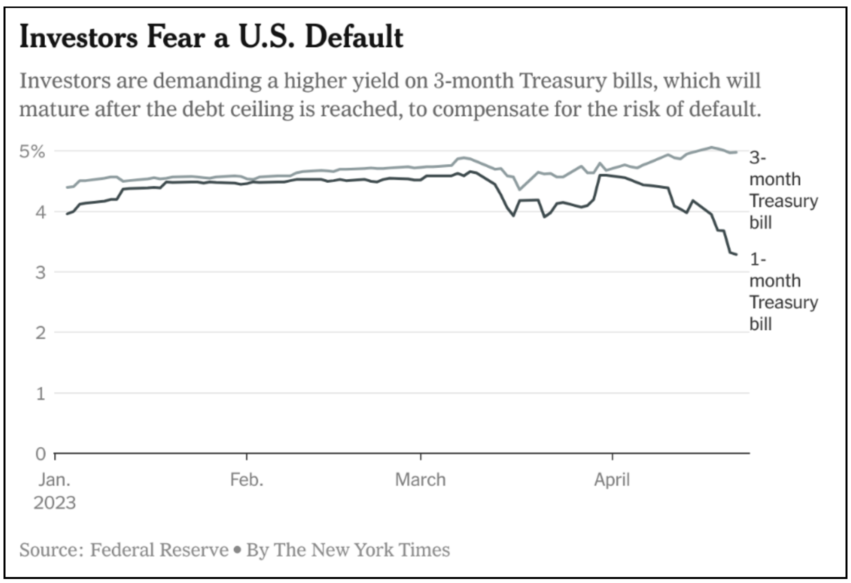


- The new lending facilities give the banks funding by offering cash for their securities at par. This feature allows them to meet deposit withdrawals without selling the securities at a loss, but it doesn't solve the disintermediation problem. If banks keep deposit rates low, then those deposits are still at risk of leaving for better yielding alternatives. The long-term solution is lower short term interest rates, which discourages disintermediation. However, that solution conflicts with the Fed's goal of raising rates to contain inflation.

- As a disclaimer, we note that the regional banking system is relatively stable today, and thus zombie banks are a worst-case scenario that is very unlikely to materialize.

McCarthy's Opening Salvo: Republicans raised the stakes in their stand-off with President Joe Biden after narrowly passing their debt ceiling bill through the House of Representatives on Wednesday.

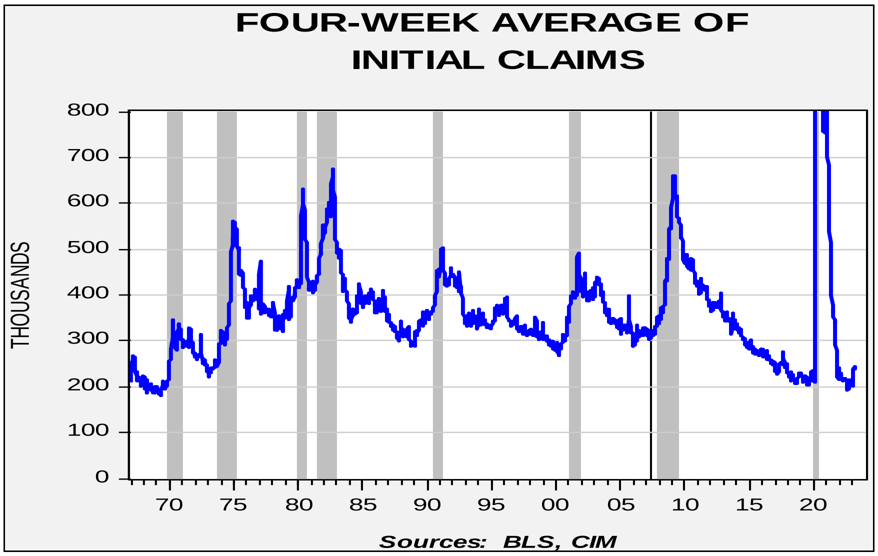
- The bill will not be made into law but suggests that debt talks will likely extend into the summer. Voted primarily on partisan grounds, the bill passed 217 to 215, with four Republicans refusing to back it. The legislation would increase the U.S. debt ceiling by $1.5 trillion in exchange for $4.8 trillion in budget cuts. Additionally, the bill would push back the potential default date to March 31, 2024, at the latest, setting up a potential battle during the election year. President Biden has vowed to veto the bill if it comes to his desk.
- The Biden administration has made it clear that they prefer a "clean" increase in the government's borrowing authority. As a result, President Biden has refused to hold negotiations with his Republican counterparts. White House officials argue that it is the responsibility of Congress to raise the debt ceiling, and thus, should come with no conditions. The president had released his own budget proposal in March. His plan would cut the deficit by $2.9 billion over a decade and raise $4.7 trillion primarily from higher taxes on corporations and wealthy households.



- There is unlikely to be much incentive to come to an agreement now. Typically, the stand-off over raising the debt ceiling comes down to the wire, and that is when both sides eventually start making concessions. The focus on the debt ceiling has taken on increased importance due to the impact it may be having on Treasury bills. The yield on one-month Treasuries jumped 26 bps on Wednesday; meanwhile, the spread between three- and one-month treasuries continues to widen. The sudden interest rate change is possibly indicating that investors are worried about not being repaid. Although we think the risk of a government default remains relatively low, uncertainty over the debt ceiling could lead to increased volatility within the financial markets.

U.S. Economic Releases

Weekly claims for unemployment insurance fell 16k to 230k for the week ending April 22. This number was well below expectations of 248k. The four-week moving average of inflation fell 4k to 236k.



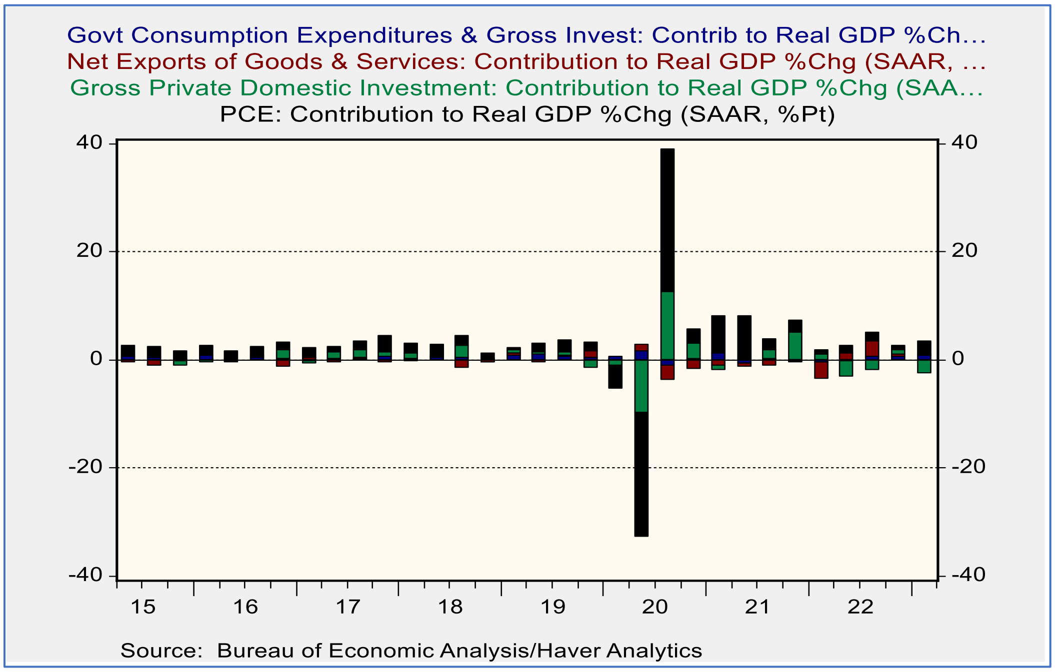
Claims are off their lows, but we wouldn't expect a recession with claims less than 300k.

The first look at Q1 GDP showed growth of 1.1%, well below the forecast of 1.9%. The table below shows the contribution from the four components of GDP.

	Q1 2023 - 1st Estimate	Q4 2022 Q4 - Final	Difference
Total GDP	1.1%	2.6%	-1.5%
Consumption	2.5%	0.7%	1.8%
Investment	-2.3%	0.8%	-3.1%
Inventories	-2.3%	1.5%	-3.8%
Net Exports	0.1%	0.4%	-0.3%
Government	0.8%	0.7%	0.1%

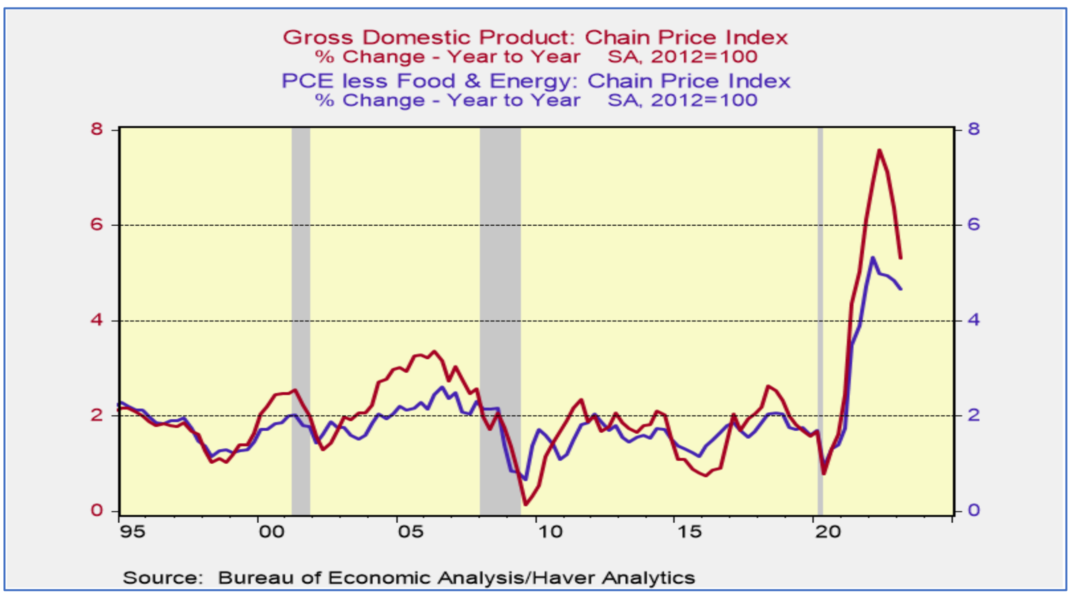
The primary drag on Q1 GDP came from inventory liquidation. GDP measures current production and consumption of goods and services. Inventories are goods that are produced earlier but not consumed. In the period where we consume the inventory, it detracts from GDP and is then captured in consumption, so not counting inventory means we are avoiding double counting. Consumption was strong, up 3.7% from Q4, but below expectations of 4.0%.

This chart shows the contribution to GDP from its components.



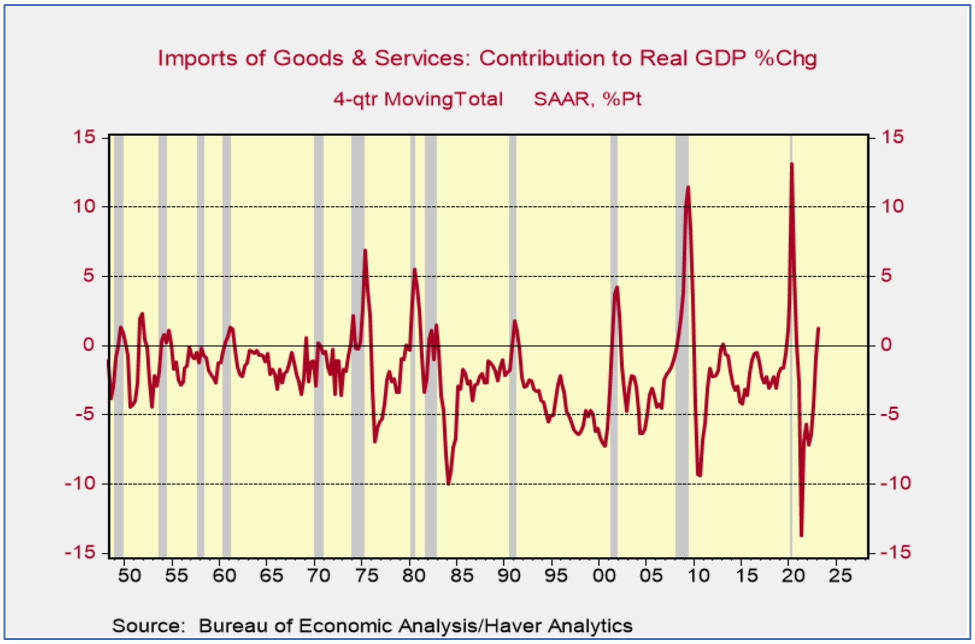
As noted, investment was the most significant negative factor.

The other major surprise was in the price deflators.



The overall price deflator came in at 5.3%, down from 6.4% in Q4. The core deflator came in at 4.7%, down from 4.8% in Q4. Consumption deflators were a bit higher than forecast, and the quarterly annualized core PCE deflator rose 4.0%, above expectations of 3.7%. Interest rates rose off this number.

Finally, we note that the four-quarter average of the contribution from imports rose this quarter.



Since imports are not produced in the country, they act as a negative factor for GDP (they get consumed or invested, and so giving them a negative sign avoids double counting). As the above chart shows, most of the time, the contribution from imports is negative. When it turns positive, it is consistent with recession.

Overall, the report is a modest negative for financial markets. Inflation remains sticky and growth is slowing. Of course, the inventory drain will likely be reversed, but the positive contribution from imports is a warning for a downturn.

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	Pending Home Sales MoM	m/m	Mar	-20.7	-21.1	**
11:00	Kansas City Fed Manfacturing Index	m/m	Apr	-2	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	Foreign Buying Japan Stocks	w/w	21-Apr	¥342.94b	¥1876.4b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	21-Apr	¥41.6b	¥9.4b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	21-Apr	-¥1059.5b	¥500.2b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	21-Apr	¥173.1b	-¥65.3b		*	Equity and bond neutral
	Leading Economic Index	m/m	Feb F	98.0	97.7		**	Equity and bond neutral
New Zealand	ANZ Activity Outlook	m/m	Apr	-7.6	-8.5		**	Equity and bond neutral
	ANZ Business Confidence	m/m	Apr	-43.8	-43.4		**	Equity and bond neutral
South Korea	Business Survey -Non- Manufacturing	m/m	May	76	75		**	Equity and bond neutral
	Business Survey - Manufacturing	m/m	May	72	69		*	Equity and bond neutral
EUROPE								
Eurozone	Economic Confidence	m/m	Apr	99.3	99.3	99.2	***	Equity and bond neutral
	Industrial Confidence	m/m	Apr	-2.6	-0.2	-0.5	***	Equity and bond neutral
	Services Confidence	m/m	Apr	10.5	9.4	9.6	**	Equity and bond neutral
	Consumer Confidence	m/m	Apr F	-17.5	-17.5		**	Equity and bond neutral
Italy	Consumer Confidence	m/m	Apr	105.5	105.1	105.0	***	Equity and bond neutral
	Manufacturing Confidence	m/m	Apr	103.0	104.2	104.1	***	Equity bearish, bond bullish
	Economic Sentiment	m/m	Apr	110.5	110.2	110.1	**	Equity and bond neutral
Russia	Industrial Production	y/y	Mar		-1.7%	-1.5%	***	Equity and bond neutral
AMERICAS								
Mexico	Trade Balance	m/m	Mar	$1168.7m	-$1.844b	-$0.806b	**	Equity and bond neutral
Brazil	FGV Inflation IGPM	y/y	Apr	-2.17%	0.17%	-1.93%	***	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)	529	527	2	Up
3-mo T-bill yield (bps)	498	499	-1	Up
TED spread (bps)	31	28	3	Widening
U.S. Sibor/OIS spread (bps)	506	504	2	Up
U.S. Libor/OIS spread (bps)	508	507	1	Up
10-yr T-note (%)	3.47	3.45	0.02	Flat
Euribor/OIS spread (bps)	324	327	-3	Up
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Flat			Up
Yen	Up			Down
Pound	Flat			Up
Franc	Down			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	$78.01	$77.69	0.41%	
WTI	$74.63	$74.30	0.44%	
Natural Gas	$2.30	$2.31	-0.22%	
Crack Spread	$29.06	$29.24	-0.61%	
12-mo strip crack	$24.29	$24.39	-0.39%	
Ethanol rack	$2.56	$2.56	0.29%	
Metals				
Gold	$1,997.20	$1,989.04	0.41%	
Silver	$25.00	$24.88	0.48%	
Copper contract	$384.15	$386.15	-0.52%	
Grains				
Corn contract	$595.75	$601.00	-0.87%	
Wheat contract	$632.50	$642.00	-1.48%	
Soybeans contract	$1,406.25	$1,414.75	-0.60%	
Shipping				
Baltic Dry Freight	1,536	1,510	26	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-5.1	-1.5	-3.6	
Gasoline (mb)	-2.4	-1.5	-0.9	
Distillates (mb)	-0.6	-1.1	0.5	
Refinery run rates (%)	0.3%	0.50%	-0.2%	
Natural gas (bcf)		75		

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.

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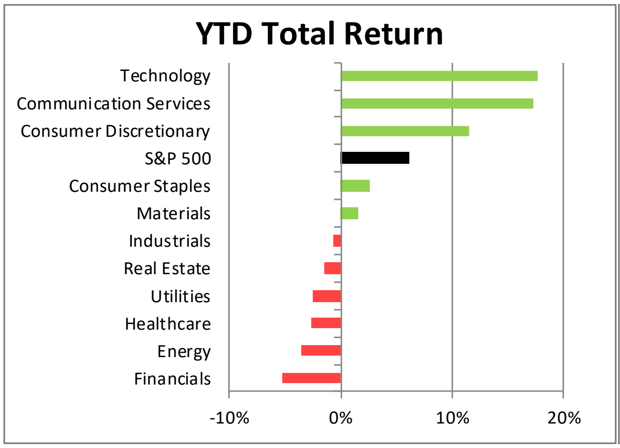
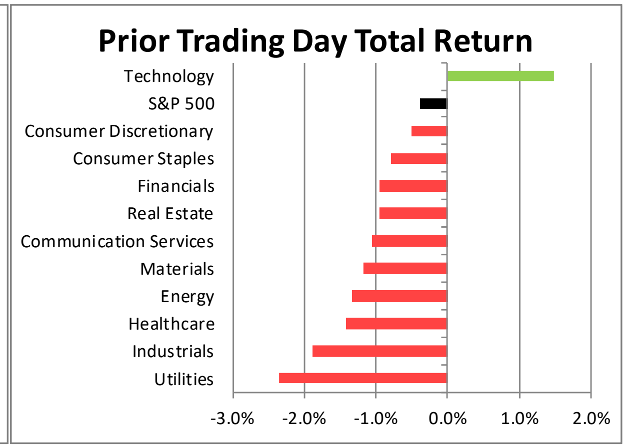
Data Section

U.S. Equity Markets – (as of 4/26/2023 close)

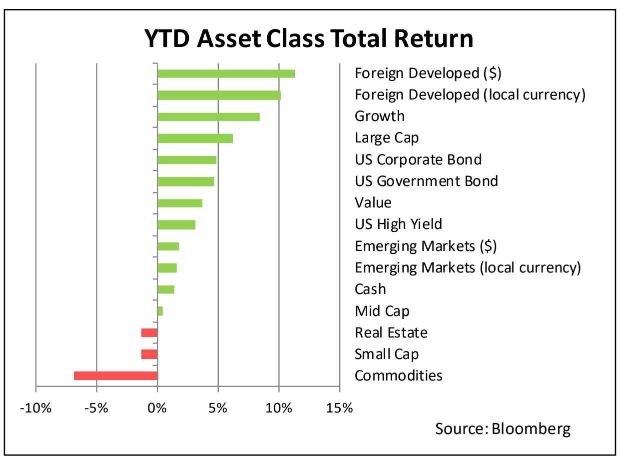




(Source: Bloomberg)

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 4/26/2023 close)

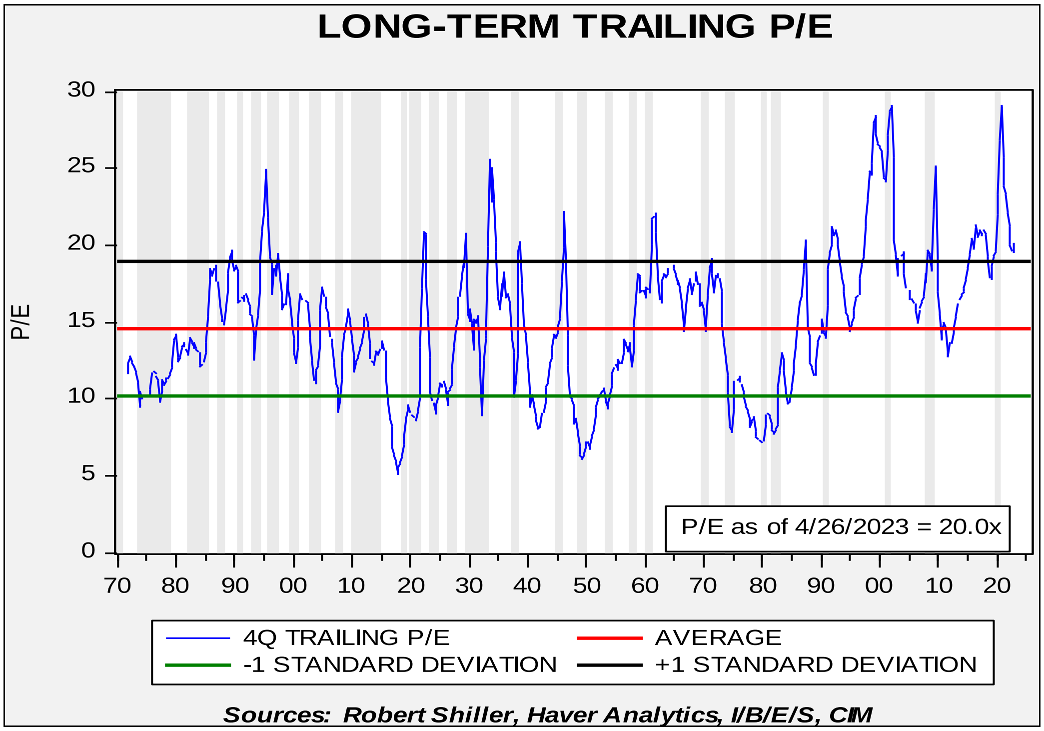


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 27, 2023



Based on our methodology,[1] the current P/E is 20.0x, down 0.1x from last week. Rising earnings accounted for the modest downtick.

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.