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 28, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is currently down 0.8% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.4%. Chinese markets were higher, with the Shanghai Composite up 1.1% from its previous close and the Shenzhen Composite closing up 1.4%. U.S. equity index futures are signaling a lower open.

With 260 companies having reported so far, S&P 500 earnings for Q1 are running at $52.20 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, 80.8% have exceeded expectations while 15.4% have fallen short of expectations.

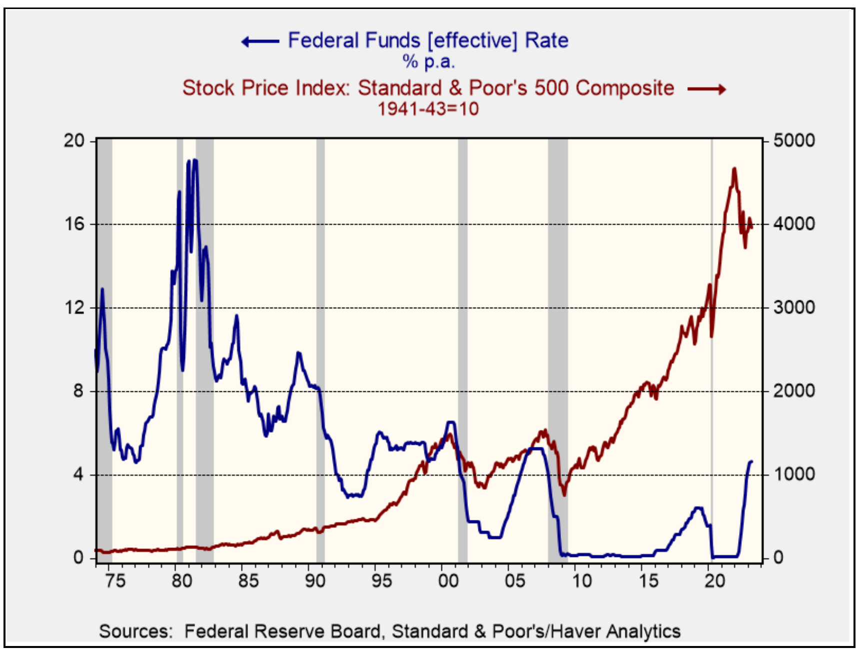
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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 a deep dive into the GDP data and why we believe that the economy may still be headed for a recession. Next, we give our thoughts on the Bank of Japan’s recent policy decision. Lastly, we discuss the yuan’s (CNY) rising prominence on the global stage.

Growth Moderation: The U.S. economy skirted recession in the first quarter of 2023; however, problems remain under the surface

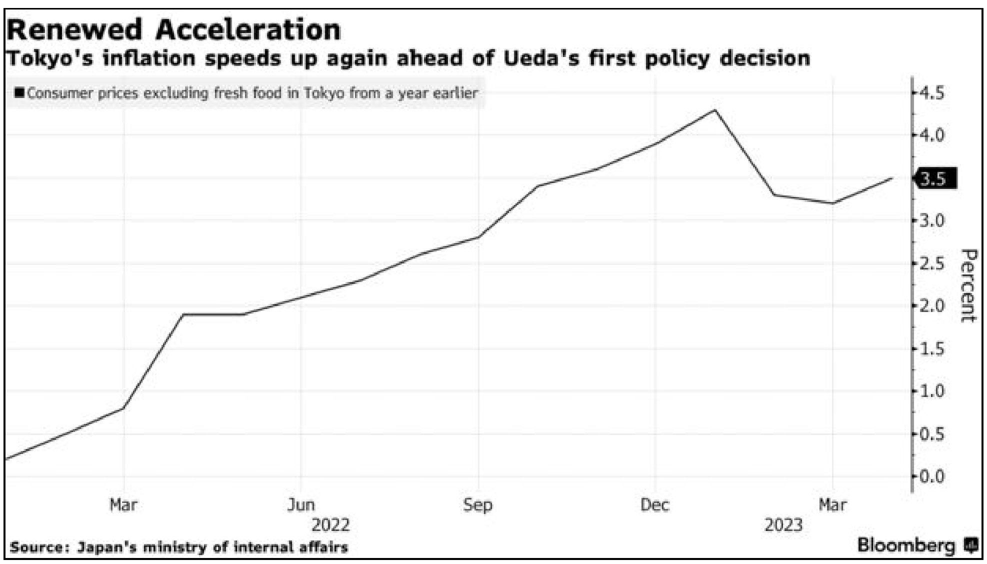
- Strong spending from households helped prevent the economy from contracting. According to the Bureau of Economic Analysis, U.S. GDP grew 1.1% at an annual rate in the first three months of the year. The most significant gains came from consumption which accelerated from 1.0% in Q4 2022 to 3.7% in the following quarter. The improvement in the level of spending was related to a sharp pick-up in demand for motor vehicles, which expanded at a pace not seen in the pre-pandemic era.
- Although it is never good to bet against the U.S. consumer, it is unclear how long spending can continue to save the day. Last week, earnings reports from the four major banks reported an increase in customer delinquencies. At the same time, the Bank of America Institute stated that credit card spending slowed to its weakest pace in two years. The increase in defaults and the decrease in spending will likely worsen throughout the year as the Federal Reserve keeps interest rates elevated to combat inflation. Additionally, the slow rise in jobless benefits suggests that the labor market is finally starting to loosen up.



- The major unknown is how the Federal Reserve will react once the economy enters recession. The market is accustomed to the Fed cutting rates aggressively during a downturn, but with inflation still elevated, policymakers may instead decide to hold rates steady. The central bank has cut rates below 2% in response to the previous three recessions. As the chart above shows, this aggressive easing has helped fuel market rallies in each of those cycles. The expectation of possible rate cuts helps explain why NASDAQ has gotten off to a solid start for the year. However, the Fed's failure to repeat this trend could lead investors to readjust their portfolios to reflect the elevated risk associated with tighter-than-normal policy.

No Rush: The Bank of Japan is not close to ending yield curve control (YCC) even as data shows that price pressures are building in the economy.

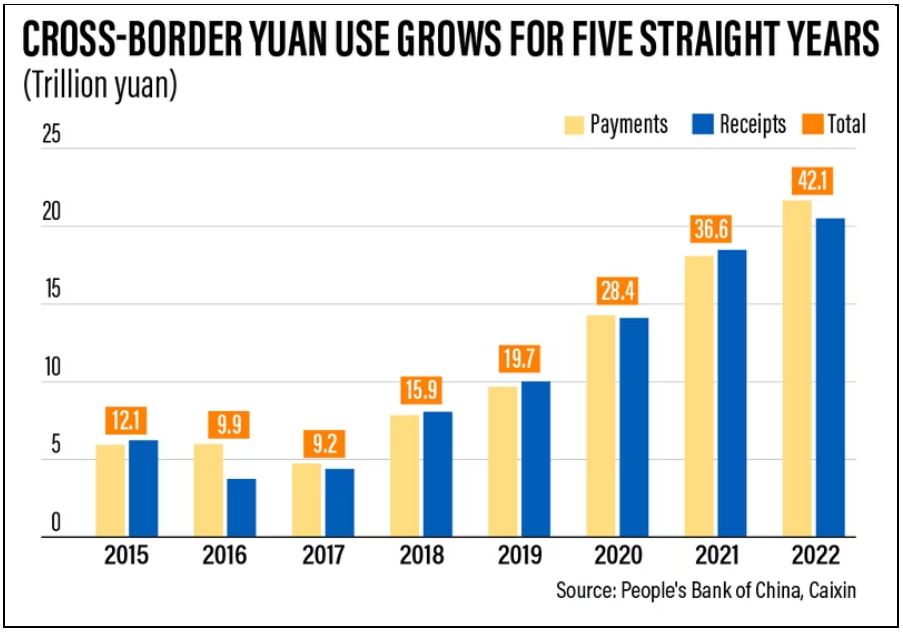
- In his first meeting, newly appointed BOJ Governor Kazuo Ueda didn't surprise markets but paved the way for an eventual pivot. The BOJ left its ultra-accommodative monetary policy unchanged, removed guidance on the future path of policy, and included plans to conduct a long-term policy review. The market widely expected the decision to keep rates intact as investors assumed Ueda would not want to make significant changes to interest rates given the ongoing market turmoil. However, his plan to release the findings on the review of the central bank's ultra-accommodative policy sometime in 2024 has added to speculation that he is not ready to pivot toward more hawkish policy.
- That said, the central bank's lack of guidance on future policy suggests that it has not fully committed to maintaining YCC. Its latest statement scrapped references to keeping rates at "current or lower levels," indicating that it seeks policy flexibility. The softening of its stance comes amidst mounting evidence that price pressures are becoming sticky. Consumer prices, excluding fresh food in the country's largest city, accelerated from 3.2% to 3.5% in April. Investor concerns about rising inflation and easy monetary policy led to JPY depreciation against other peer currencies following the BOJ's announcement.



- Keeping rates low prevents disruption to the international financial system but incentivizes speculative attacks on the 10-year JGB. The popularity of the yen-carry trade, in which traders try to earn arbitrage profits by borrowing at low rates in one country to invest in higher yielding assets in another, has meant that many traders are exposed to exchange rate risk. The International Monetary Fund has warned that an abrupt end to YCC may have spillover effects on global financial markets. However, doubts about whether the BOJ can credibly maintain its peg may lead to central bank intervention. As a result, the JPY may have less upside now than we thought at the beginning of the year.

Renminbi Rising: In a sign that China is looking to set up a parallel trading system, its currency has increased in popularity.

- Beijing is encouraging more countries to use the yuan (CNY) to pay for Chinese goods. On Wednesday, the Argentine Prime Minister announced that his government would use CNY instead of USD for transactions with China. The switch in currency preferences was designed to prevent a drain on Argentinian foreign reserves which have been strained by high debt servicing costs and rising import prices. The CNY is already the most popular traded currency in Russia and is now being considered by Saudi Arabia to price oil sales.
- The war in Ukraine has fueled Beijing's ambition to make CNY a global currency. According to the Standard Charter's Renminbi Globalization Index (RGI), usage of the Chinese currency increased by 26.6% in 2022. Although cross-border CNY payments have increased for five consecutive years, transactions in this currency have more than doubled their pre-pandemic level. In March of this year, local cross-border payments surpassed the greenback for the first time on record. These statistics suggest that China is becoming more aggressive in reducing its dependency on the U.S. dollar as it fears possible isolation.

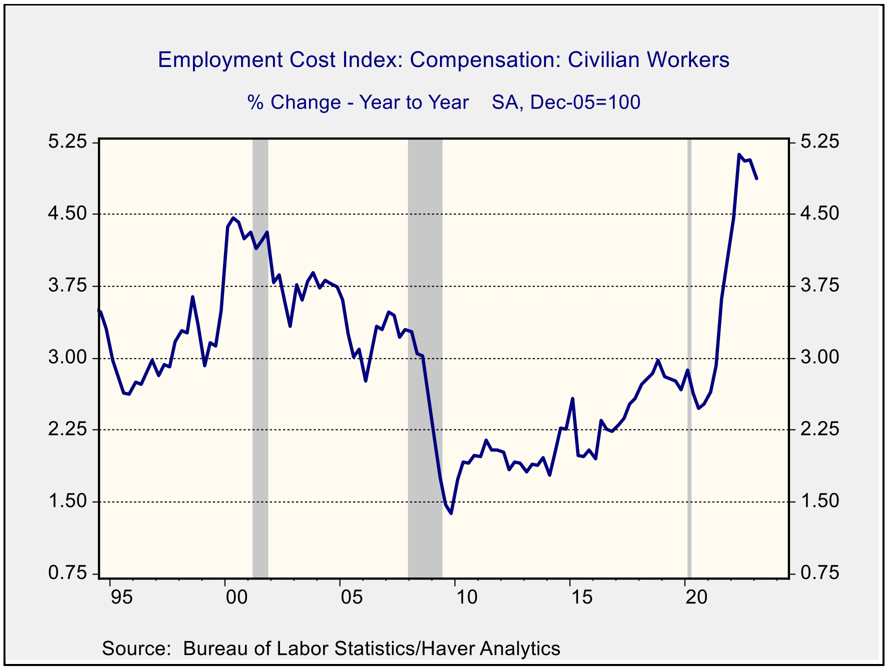


(Source: The National News)

- The rising demand for CNY reinforces our view that the U.S. dollar is headed for a secular decline. As regional blocs begin to form worldwide, countries may be forced to hold on to both Chinese and American currencies. We suspect that dual holdings will be most prevalent in countries that find themselves on the wrong side of U.S. sanctions. Thus, the CNY should be popular in authoritarian states. That said, China's unwillingness to open its capital account will prevent its currency from emerging as a true challenger to the greenback. As a result, we still believe that concerns about the dollar losing its hegemonic status are overblown.

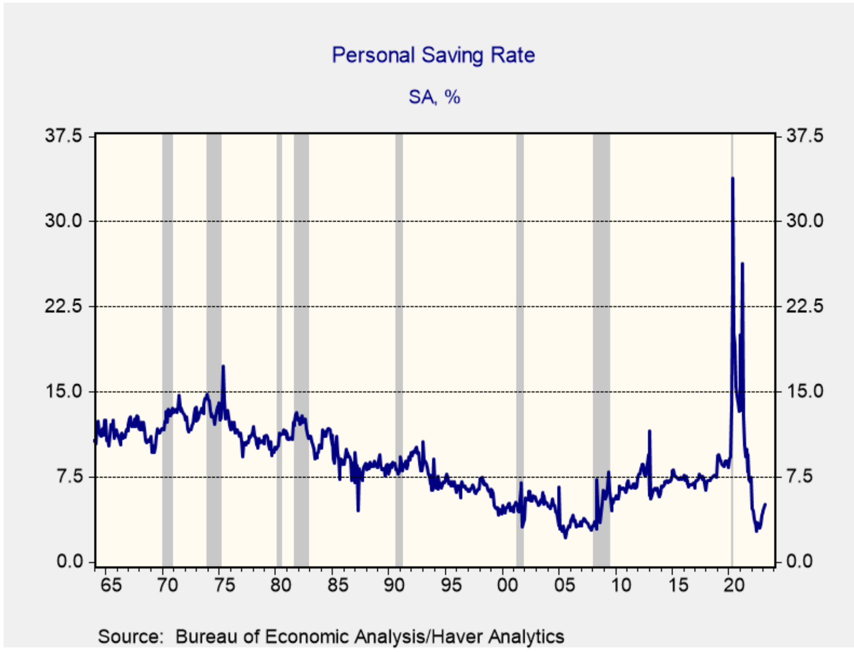
U.S. Economic Releases

Firm compensation for workers rose at a faster-than-expected pace in the first three months of 2023. The Bureau of Labor Statistics' employment cost index, a gauge of wages and benefits, rose 1.2% in the first quarter. The reading was above estimates of 1.1% and the previous quarter's rise of 1.0%.



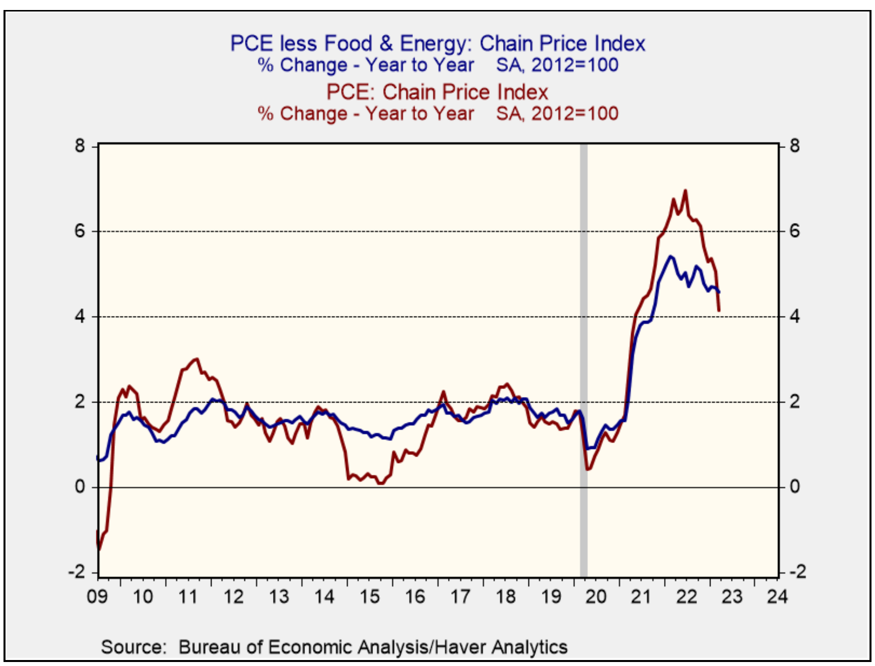
The chart above shows the annual change in the employment cost index. The modest deceleration of the index reflects persistent wage pressures and may encourage the Fed to tighten in its next meeting.

Meanwhile, the uptick in earnings and moderation spending in March has added to concerns about the economy. According to the Bureau of Economic Analysis, personal income rose 0.3% from the prior month. The rise was slightly above consensus estimates of 0.2% and relatively unchanged from the previous month's reading. At the same time, personal spending slowed from 0.2% in March to barely above zero in the following month. However, the reading was above forecasts of a decline of 0.1%.



The chart above shows the annual change in personal savings rate. The combination of higher income and a moderation in spending helped lift the savings rate from 4.8% to 5.1%. The increase in savings may be a reflection of households preparing for a downturn.

Lastly, the price pressures remain sticky as core goods and services rose and made no downward progress. According to the Bureau of Economic Analysis, PCE deflator rose 4.2% from the prior year, slightly above expectations of 4.1%, but below previous month's rise of 5.0%. Excluding volatile energy and food prices, the PCE rose 4.6% since March 2022, consistent with the previous month's rise.



The previous chart shows the year-over-year change in the core and headline PCE. Although the annual numbers will make most of the headlines in the media, annualized monthly core and headline inflation rose 3.4% and 0.9%, respectively. Hence, the Fed is making some progress toward its 2% target.

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**
9:45	MNI Chicago PMI	m/m	Apr	43.6	43.8	***
10:00	U. of Michigan Consumer Sentiment	m/m	Apr F	63.5	63.5	***
10:00	U. of Michigan Current Conditions	m/m	Apr F	68.6	68.6	**
10:00	U. of Michigan Future Expectations	m/m	Apr F	60.4	60.3	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Apr F		4.6%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Apr F		2.9%	*
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
11:00	Fed Issues Report on SVB Supervision	Federal Reserve Board				

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	Jobless Rate	m/m	Mar	2.8%	2.6%	2.5%	***	Equity and bond neutral
	Job-To-Applicant Ratio	m/m	Mar	1.32%	1.34%	1.34%	**	Equity and bond neutral
	Tokyo CPI	y/y	Apr	3.5%	3.3%	3.3%	**	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food	y/y	Apr	3.5%	3.2%	3.2%	***	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food & Energy	y/y	Apr	3.8%	3.4%	3.5%	*	Equity and bond neutral
	Retail Sales	y/y	Mar	7.2%	6.6%	6.5%	**	Equity bullish, bond bearish
	Depart. Store & Supermarket Sales	y/y	Mar	3.2%	4.7%		*	Equity bearish, bond bullish
	Industrial Production	y/y	Mar P	-0.7%	-0.5%	-1.2%	***	Equity and bond neutral
	Housing Starts	y/y	Mar	-3.2%	-0.3%	-3.9%	**	Equity and bond neutral
	Annualized Housing Starts	y/y	Mar	0.877m	0.859m	0.875m	*	Equity and bond neutral
Australia	Private Sector Credit	y/y	Mar	6.8%	7.6%		**	Equity and bond neutral
	PPI	y/y	1Q	5.2%	5.8%		**	Equity and bond neutral
New Zealand	ANZ Consumer Confidence	m/m	Apr	79.3	77.7		**	Equity and bond neutral
South Korea	Industrial Production	y/y	Mar	-7.6%	-8.1%	-8.0%	***	Equity and bond neutral
EUROPE								
Eurozone	GDP	y/y	Q1 A	1.3%	1.8%	1.4%	***	Equity and bond neutral
Germany	Import Price Index	y/y	Mar	-3.8%	2.8%	-3.6%	**	Equity and bond neutral
	Unemployment Change	m/m	Apr	24.0k	16.0k	19.0k	***	Equity bearish, bond bullish
	Unemployment Claims Rate	m/m	Apr	5.6%	5.6%	5.6%	**	Equity and bond neutral
	GDP NSA	y/y	Q1 P	0.2%	0.3%	0.2%	**	Equity and bond neutral
	GDP WDA	y/y	Q1 P	-0.1%	0.9%	0.8%	**	Equity and bond neutral
	CPI	y/y	Apr P	7.2%	7.4%	7.3%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Apr P	7.6%	7.8%	7.8%	**	Equity and bond neutral
France	CPI	y/y	Apr P	5.9%	5.7%	5.8%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Apr P	6.9%	6.7%	6.7%	**	Equity and bond neutral
	PPI	y/y	Mar	12.9%	15.7%	15.8%	*	Equity bearish, bond bullish
	GDP	y/y	Q1 P	0.8%	0.5%	0.4%	**	Equity and bond neutral
Italy	GDP WDA	y/y	Q1 P	1.8%	1.4%	1.4%	**	Equity and bond neutral
Switzerland	KOF Leading Indicator	m/m	Apr	96.4	98.2	99.2	**	Equity bearish, bond bullish
	Real Retail Sales	y/y	Mar	-1.9%	0.3%	-0.5%	**	Equity bearish, bond bullish
Russia	Gold and Forex Reserves	m/m	21-Apr	$597.1b	$600.2b		***	Equity and bond neutral
AMERICAS								
Mexico	GDP NSA	y/y	Q1 P	3.9%	3.6%	3.3%	***	Equity bullish, bond bearish
Brazil	Net Debt % GDP	y/y	Mar	57.2%	56.6%	57.0%	***	Equity and bond neutral
	National Unemployment Rate	m/m	Mar	8.8%	8.6%	8.9%	*	Equity and bond neutral
	Economic Activity Index	y/y	Feb	2.76%	3.03%	2.99%	**	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	529	-2	Up
3-mo T-bill yield (bps)	499	502	-3	Up
TED spread (bps)	28	27	1	Widening
U.S. Sibor/OIS spread (bps)	508	508	0	Up
U.S. Libor/OIS spread (bps)	510	511	-1	Up
10-yr T-note (%)	3.47	3.52	-0.05	Flat
Euribor/OIS spread (bps)	325	324	1	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Down			Down
Pound	Down			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Russia Key Rate	7.500%	7.500%	7.500%	On Forecast
Bank of Japan Policy Balance Rate	-0.100%	-0.100%	-0.100%	On Forecast
Bank of Japan 10-Yr Yield Target	0.000%	0.000%	0.000%	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.

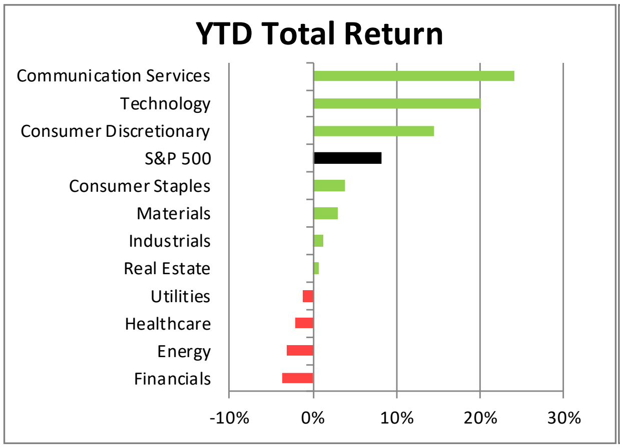
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$79.11	$78.37	0.94%	
WTI	$75.20	$74.76	0.59%	
Natural Gas	$2.30	$2.36	-2.42%	
Crack Spread	$27.91	$28.23	-1.15%	
12-mo strip crack	$23.69	$23.80	-0.43%	
Ethanol rack	$2.54	$2.55	-0.42%	
Metals				
Gold	$1,983.63	$1,987.78	-0.21%	
Silver	$24.83	$24.93	-0.40%	
Copper contract	$390.05	$388.40	0.42%	
Grains				
Corn contract	$578.75	$581.50	-0.47%	
Wheat contract	$628.75	$629.25	-0.08%	
Soybeans contract	$1,409.25	$1,403.75	0.39%	
Shipping				
Baltic Dry Freight	1,581	1,536	45	
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)	79	76	3	

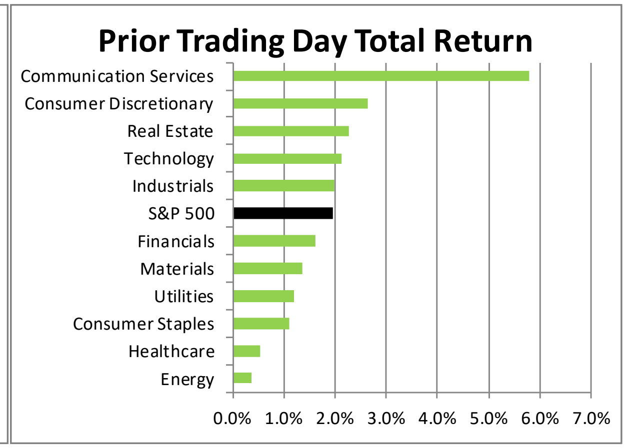
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in the Pacific and Southwest regions, 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 4/27/2023 close)

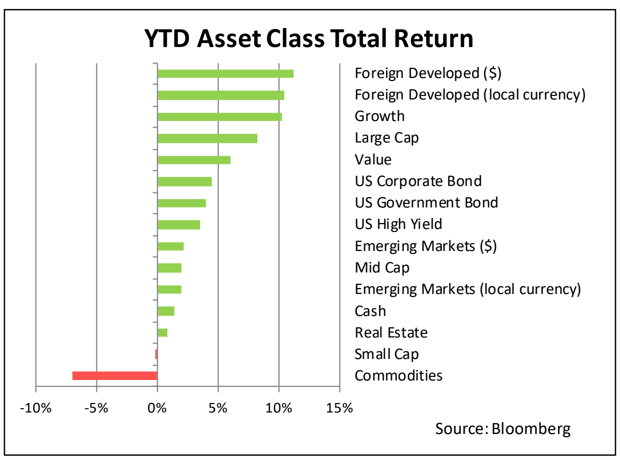




(Source: Bloomberg)

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 4/27/2023 close)

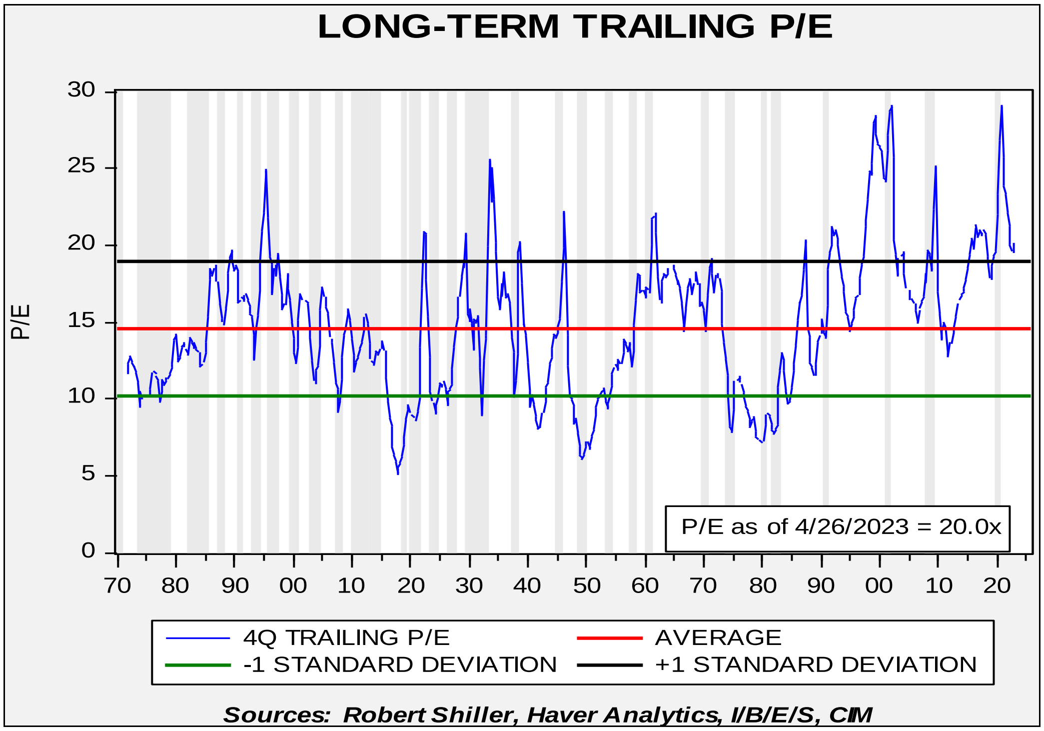


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.