Daily Comment

*By Patrick Fearon-Hernandez, CFA,
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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: August 10, 2023—9:30 AM EDT] Global equity markets are generally higher this morning. In Europe, the Euro Stoxx 50 is up 0.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.1%. Chinese markets were higher, with the Shanghai Composite up 0.3% from its previous close and the Shenzhen Composite up 0.1%. U.S. equity index futures are signaling a higher open.

With 455 companies having reported so far, S&P 500 earnings for Q2 are running at $54.00 per share, compared to estimates of $53.55 (a decline of 6.8% from Q2 2022). Of the companies that have reported thus far, 80.2% have exceeded expectations while 14.9% have fallen short of expectations.

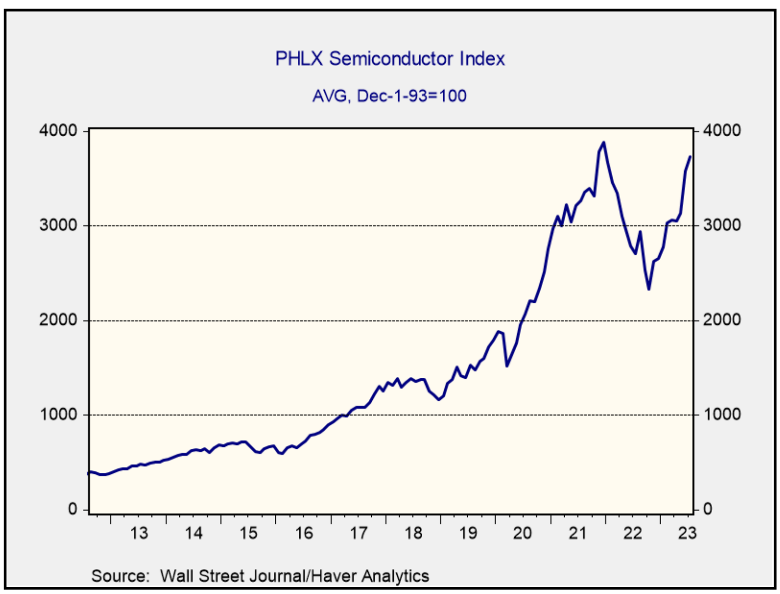
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (8/7/2023) (podcast available later this week in the *Confluence of Ideas* series): "The Economics of National Defense in Great Power Competition"
- ***Weekly Energy Update*** **(8/10/2023): The DOE reported a large increase in U.S. oil production. Also, there was a 1.0 mb injection into the Strategic Petroleum Reserve. The U.S. is considering placing U.S. troops on commercial vessels in the Persian Gulf to discourage Iranian attacks on shipping**.
- *Asset Allocation Quarterly – Q3 2023* (7/20/2023): Discussion of our asset allocation process, Q3 2023 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q2 2023 Rebalance Presentation* (5/11/2023): 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* (7/31/2023) (with associated podcast): "Part-Time Troubles"
- *Confluence of Ideas* podcast (7/10/2023): "The 2023 Mid-Year Geopolitical Outlook"

Good morning! Today's *Comment* will focus on three key topics: the growing rift between the U.S. and China over semiconductors, possible threats to the European energy markets, and the White House's latest attempt to mediate ties between Saudi Arabia and Israel.

Another Salvo in the Chip War: The U.S.-China rivalry in artificial intelligence (AI) took a new turn after the U.S. government announced investment restrictions on Chinese tech companies.

- The White House issued an executive order that will restrict U.S. investment in Chinese companies developing quantum computing, advanced chips, and artificial intelligence. It will largely affect private equity and venture capital firms and will not take effect until January 1, 2024. This measure is the latest in a series of attempts by Washington to prevent China's military from advancing its technology ambitions. In 2017, the People's Republic of China declared that becoming a world leader in artificial intelligence by 2030 is a national priority. After the restrictions were released, China announced that it was considering retaliation.
- The tit-for-tat between the U.S. and China sent tech stocks tumbling on Wednesday, with the Philadelphia Stock Exchange Semiconductor Index (SOX) falling nearly 2%. Investors are concerned that the rivalry will hurt profitability as the U.S. looks to close ranks with other Western countries in a bid to contain China's technological ambitions. The move by both the U.S. and China to restrict semiconductor exports will add to the headwinds for chipmakers, who are already working their way through a supply glut that is not expected to be resolved until later this year or early next. However, Chinese internet giants have already begun stockpiling chips in anticipation of future restrictions, which should lead to a temporary bump in sales.

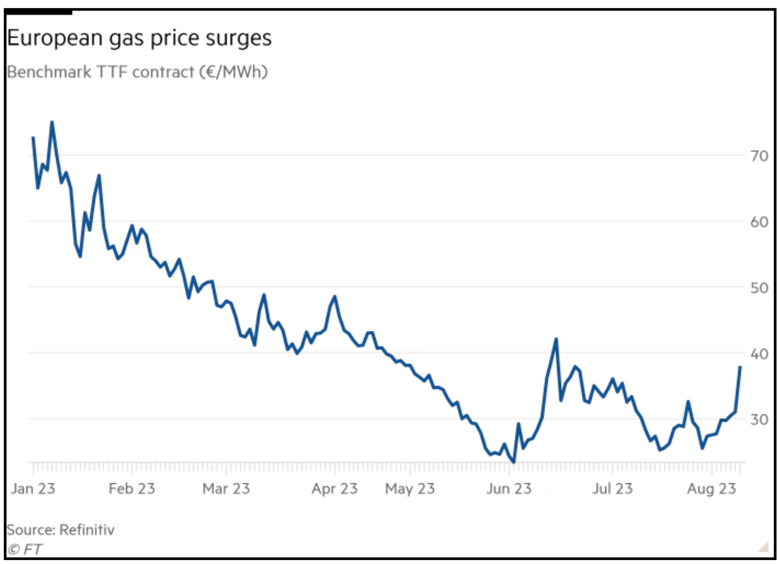


- Despite recent moves by the Biden administration to "de-risk" the relationship between the United States and China, the process is likely to be slow and arduous. China accounts for the largest share of the revenue for companies in the S&P 500 outside of North America, and Beijing's shift toward deleveraging means that it is becoming more reliant on foreign investment for capital. As a result, there are strong incentives for both countries to keep the relationship going, even as tensions rise. Thus, these actions by the

Biden administration are steps toward the long-term trajectory of the relationship, but it is unlikely to have a substantial impact on companies in the short- to medium-term.

Eurozone Energy Concerns: After narrowly avoiding a recession in the last quarter, high energy prices are likely to put the eurozone economy back in focus for investors.

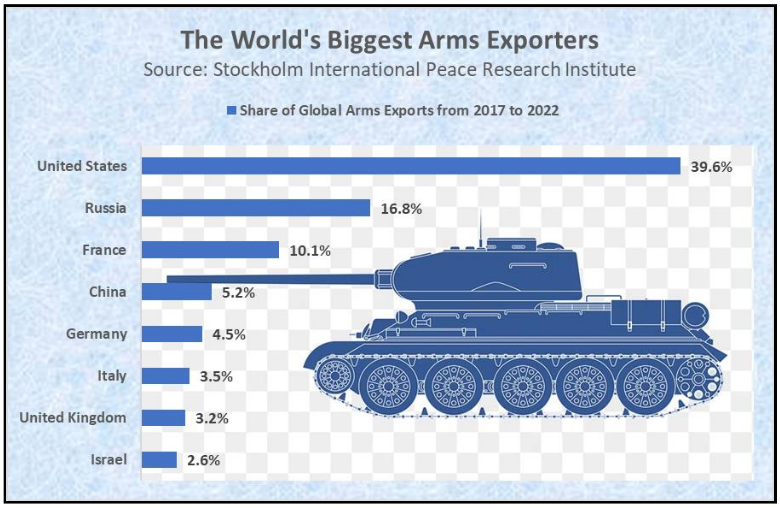
- Earth's hottest month on known record was July 2023, with global temperatures averaging 62.51 F, six-tenths of a degree higher than the previous record set in July 2019. This was largely due to El Niño conditions, which cause warmer ocean temperatures and more extreme weather events. The effects of El Niño on Europe are less consistent than in other regions, but northern countries could experience colder temperatures during the winter months, while southern countries in the region may experience wetter conditions. Potentially hazardous weather conditions could lead to a rise in energy demands.
- The war in Ukraine and possible labor protests in Australia have added to the energy uncertainty. Russia and Ukraine have launched attacks near each other's energy infrastructure. On Wednesday, a Russian drone strike hit an oil depot in Ukraine, while Ukrainian drone strikes in the Black Sea have raised concerns about potential supply disruptions, as they could damage shipping vessels carrying oil and gas. Simultaneously, natural gas prices in the region surged almost 40% following reports that workers at important LNG plants in Australia are planning a strike for higher pay and better job security. The issues in Ukraine and Australia raise the likelihood of supply shortages.



- Although the euro area has made significant progress in building up its energy storage for the winter, there are still risks that could lead to energy spikes. A prominent German utility company has cautioned lawmakers against becoming overconfident in the region's energy security. He warned that there is still much uncertainty concerning the upcoming winters, which could potentially lead to an energy crisis. A possible shortage of natural gas will weigh heavily on the struggling European economy and may push it into recession.

Middle East Pivot: The White House has made a breakthrough with Saudi Arabia and is now hopeful of reaching a similar agreement with Israel.

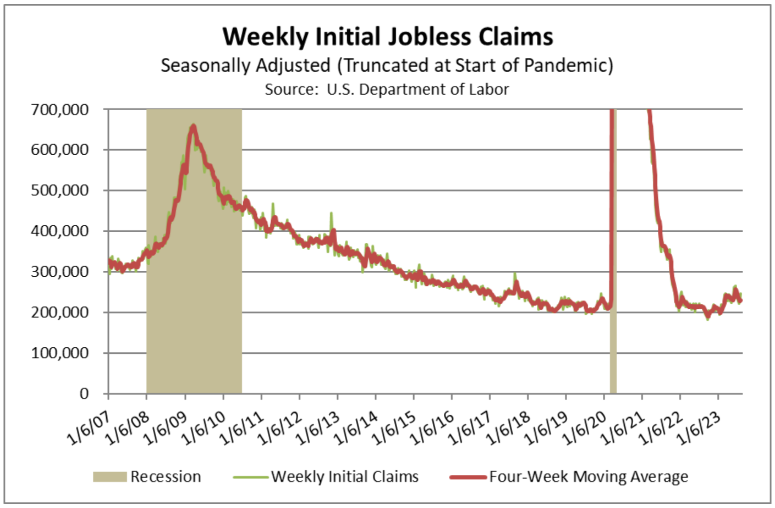
- Saudi Arabia agreed to terms that would allow it to recognize Israel in exchange for progress on the Palestinian issue and security guarantees. The details of the arrangement are still being negotiated, but U.S. officials are optimistic that a deal can be reached within the next year or so. Additionally, Washington is also urging Riyadh to impose limits on its relationship with China. In response to the agreement, Israel has also requested a defense pact with the U.S. to join the deal with Saudi Arabia, as it seeks protection from a growingly assertive Iran.
- The U.S.'s efforts to resolve tensions between Saudi Arabia and Israel are a sign that it still wants to be a major player in the Middle East, even as it pivots toward the Indo-Pacific. This agreement will likely help counter the inroads China has made in the region. Over the last year or so, Beijing has engaged in talks with Riyadh over creating a petroyuan and has played a crucial role in restoring ties between Saudi Arabia and Iran. Resolving tensions between the two sides will likely build on the progress made with the Abraham Accords by paving the way for more peaceful relations in the Middle East.



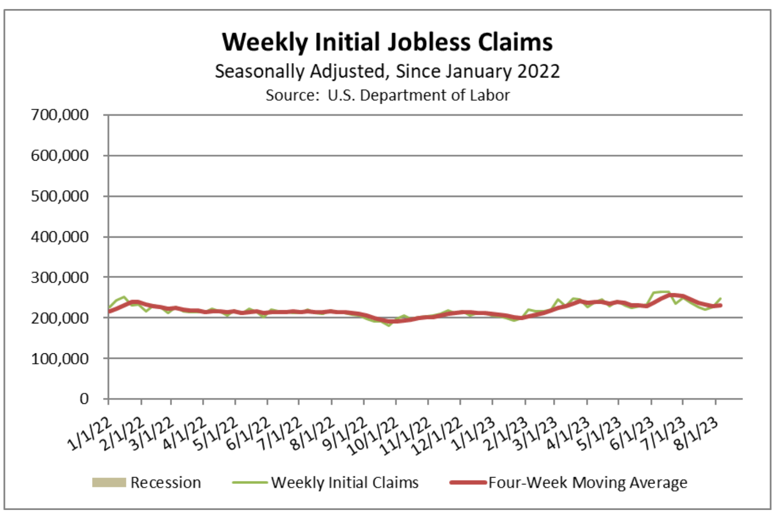
- As the U.S. moves away from its role as an importer of last resort, it will likely continue to provide defense assistance to other countries to maintain its influence. This could take the form of intelligence sharing, joint military exercises, or weapon exports. We have already seen some of this play out in Ukraine and Taiwan, and it is possible that the U.S. would be willing to do the same in the Middle East. American defense and aerospace industries are well-positioned to capitalize on the global rearmament trend, as they have a long history of providing arms to allies and partners around the world.

U.S. Economic Releases

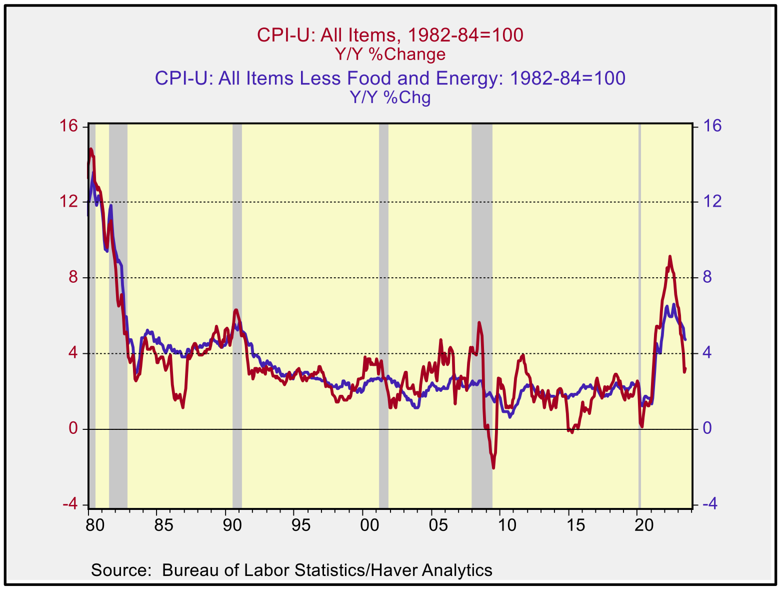
In the week ending August 5, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 248,000, well above the expected level of 230,000 and up from 227,000 in the previous week. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 231,000. On a more positive note, in the week ending July 29, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) fell to 1.684 million, better than the anticipated reading of 1.707 million and down from a revised 1.692 million in the prior week. The chart below shows how initial jobless claims have fluctuated since just before the Great Financial Crisis. 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 July ***consumer price index (CPI)*** rose by a seasonally adjusted 0.2%, matching expectations that monthly inflation would remain at the 0.2% rate seen in June. Excluding the volatile food and energy components, the ***"core" CPI*** rose by 0.2% as well, matching its anticipated increase and its rise in June. The overall CPI in July was up 3.2% from the same month one year earlier, accelerating a bit from the 3.0% increase in the year to June. The core CPI was up 4.7% year-over-year, cooling from the rise of 4.8% in the year to June and marking the lowest annual core inflation since October 2021. The following chart shows the year-over-year change in the CPI and the core CPI since 1980.



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
14:00	Monthly Budget Statement	m/m	Jul	-135.0t	-$211.1b	**
Federal Reserve						
EST	Speaker or Event	District or Position				
11:00	Mary Daly Speaks on Yahoo Finance	President of the Federal Reserve Bank of San Francisco				
15:00	Raphael Bostic Gives Remarks at Event About Employment	President of the Federal Reserve Bank of Atlanta				
16:15	Patrick Harker Speaks on Employment	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	Foreign Buying Japan Bonds	w/w	4-Aug	-¥1966.0b	-¥166.1b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	4-Aug	¥438.8b	¥208.9b	¥211.7b	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	4-Aug	-¥352.2b	-¥12.2b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	4-Aug	-¥59.4b	¥196.0b	¥195.7b	*	Equity and bond neutral
	PPI	y/y	Jul	3.6%	4.1%	4.3%	***	Equity bullish, bond bearish
EUROPE								
Italy	CPI, EU Harmonized	y/y	Jul F	6.3%	6.4%	6.4%	***	Equity and bond neutral
Russia	CPI	y/y	Jul	4.30%	3.25%	4.30%	***	Equity and bond neutral
AMERICAS								
Canada	Building Permits	m/m	Jun	6.1%	10.5%	-3.5%	**	Equity bullish, bond bearish
Mexico	CPI	y/y	Jul	4.79%	5.06%	4.79%	***	Equity and bond neutral
	Core CPI	y/y	Jul	6.64%	6.89%	6.66%	**	Equity and bond neutral
Brazil	IBGE Services Volume	y/y	Jun	4.1%	4.7%	4.2%	*	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)	563	563	0	Up
3-mo T-bill yield (bps)	526	528	-2	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	537	537	0	Up
U.S. Libor/OIS spread (bps)	539	539	0	Up
10-yr T-note (%)	4.00	4.01	-0.01	Flat
Euribor/OIS spread (bps)	376	377	-1	Up
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Up
Yen	Flat			Down
Pound	Up			Up
Franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
RBI Cash Reserve Ratio	4.500%	4.500%	4.500%	On Forecast
RBI Repurchase Rate	6.500%	6.500%	6.500%	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	$87.25	$87.55	-0.34%	
WTI	$83.92	$84.40	-0.57%	
Natural Gas	$2.96	$2.96	-0.10%	
Crack Spread	$42.10	$42.86	-1.77%	
12-mo strip crack	$30.96	$31.51	-1.72%	
Ethanol rack	$2.40	$2.40	-0.01%	
Metals				
Gold	$1,921.64	$1,914.46	0.38%	
Silver	$22.78	$22.66	0.52%	
Copper contract	$380.90	$378.35	0.67%	
Grains				
Corn contract	$495.75	$494.25	0.30%	
Wheat contract	$663.75	$661.75	0.30%	
Soybeans contract	$1,316.50	$1,308.50	0.61%	
Shipping				
Baltic Dry Freight	1,144	1,142	2	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	5.9	2.3	3.6	
Gasoline (mb)	-2.7	-0.2	-2.5	
Distillates (mb)	-1.7	0.4	-2.1	
Refinery run rates (%)	1.1%	0.1%	1.1%	
Natural gas (bcf)		24		

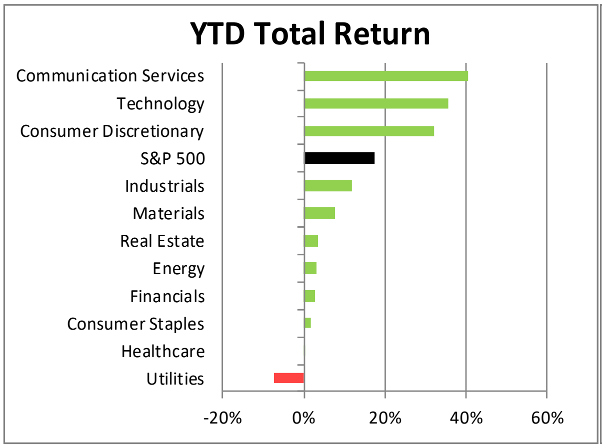
Weather

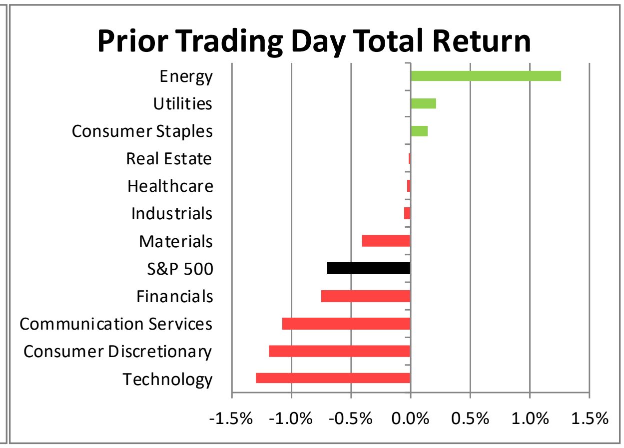
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout the West Coast, Southwest, and Texas regions, and throughout the area east of the Mississippi River, with cooler-than-normal temperatures only in the northern Rocky Mountains and the Upper Midwest. The forecasts are calling for wetter-than-normal conditions in California, the Rocky Mountain region, the Upper Midwest, and the Northeast, with dry conditions expected in Texas and the Southeast.

There are currently no tropical disturbances or cyclones being tracked in the Atlantic Ocean area.

Data Section

U.S. Equity Markets – (as of 8/9/2023 close)

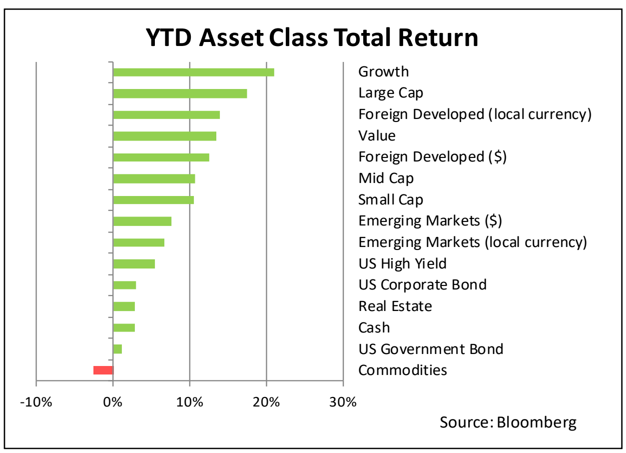




(Source: Bloomberg)

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 8/9/2023 close)

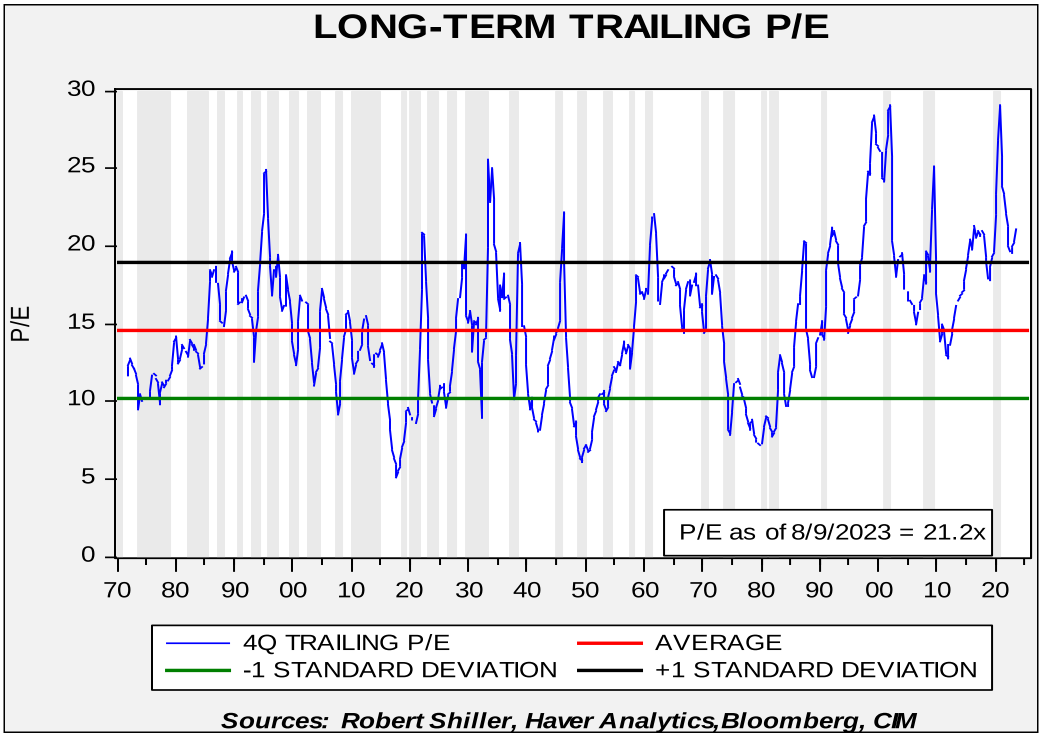


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

August 10, 2023



Based on our methodology,[1] the current P/E is 21.2x, -0.1x from last week. Stronger earnings led to the drop in the multiple.

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 Bloomberg 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.