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: August 11, 2023—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is down 1.0% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.1%. Chinese markets were lower, with the Shanghai Composite down 2.0% from its previous close and the Shenzhen Composite down 1.9%. U.S. equity index futures are signaling a lower open.

With 456 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, 80.3% have exceeded expectations while 14.9% have fallen short of expectations.

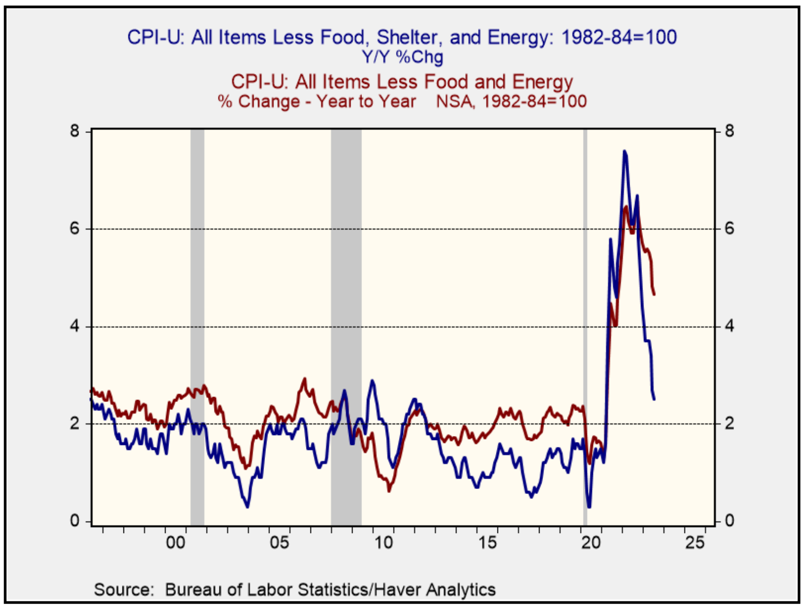
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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"

Today's *Comment* discusses the following key topics: why the Federal Reserve may be closer to reaching its 2% inflation target than investors realize, our concerns about the regional banking system, and how rising crime in South America complicates U.S. efforts to build closer ties in the region.

It Gets Better: Thursday's CPI report not only reinforced investors' views that the Fed may be nearing the end of its hiking cycle, but also suggests that monetary policy may need to ease next year.

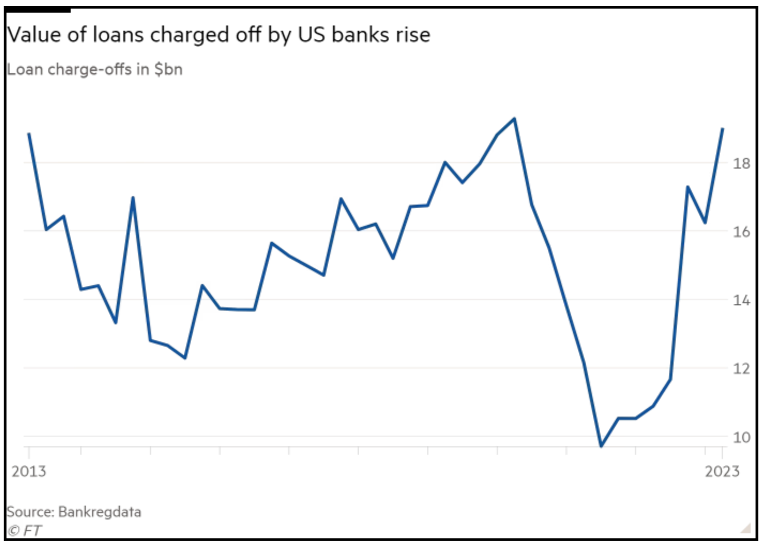
- The Consumer Price Index (CPI) increased 3.2% in July from the previous year, according to the Bureau of Labor Statistics. The reading was above the previous month's increase of 3.0% but below consensus estimates of 3.3%. Core inflation numbers were also impressive, declining from 4.8% to 4.7%. The reacceleration in the headline inflation number is likely due to base effect changes, which may not carry over to the next month. Meanwhile, the core CPI continues to be propped up by reporting lags in shelter data.
- Despite both price gauges being well above the Fed's inflation target of 2.0%, there is growing optimism that the Federal Reserve may not need to raise rates again this year. The monthly reading shows that headline inflation rose at an annual rate consistent with 2.3%, while core inflation rose at a pace consistent with 1.9%. The market took the CPI report positively as traders loaded up on bets that the central bank was going to pause in September. The CME FedWatch Tool shows that there is over a 90% chance that policymakers will leave rates unchanged at their next meeting.



- Inflation is falling more quickly than most people realize. The July report shows that consumer prices have only risen 2.5% from the previous year after removing shelter, which accounts for over a third of the index weight, from core CPI. This discrepancy may continue going into next year, as it typically takes about 12-18 months for housing data to make its way into the CPI index. Additionally, if the San Francisco Fed is correct that shelter prices will fall into negative territory in 2024, it could mean that central bank policymakers may need to cut rates to avoid deflation.

Regional Bank Troubles: Nearly five months after the collapse of Silicon Valley Bank (SIVBQ, $0.15), small and midsized banks are still struggling to stand on their own.

- Moody's has downgraded the credit ratings of several regional lenders following a review of their financial positions. The credit rating agency justified its decision by citing several factors, including slowing deposit growth, rising funding costs, and deteriorating asset quality, particularly in real estate. Although the banks maintained their investment-grade ratings, the weak valuations suggest that the banking system still poses a threat to the economy. So far, banks have been able to cling to life by relying on loans from the Federal Home Loan Banks and the new Fed loan facility.
- The latest Senior Loan Officer Opinion Survey (SLOOS) revealed that banks are more cautious than ever about lending. The net percentage of domestic banks tightening their lending standards rose to 50.8% in the third quarter of 2023, the highest reading in the post-pandemic era. This decision to restrict lending is related to the rising risks that banks are having to absorb when lending at higher rates. Many U.S. banks have accumulated heavy losses on their books, and it has reached the point where lenders have been offloading property loans at fire sale prices.



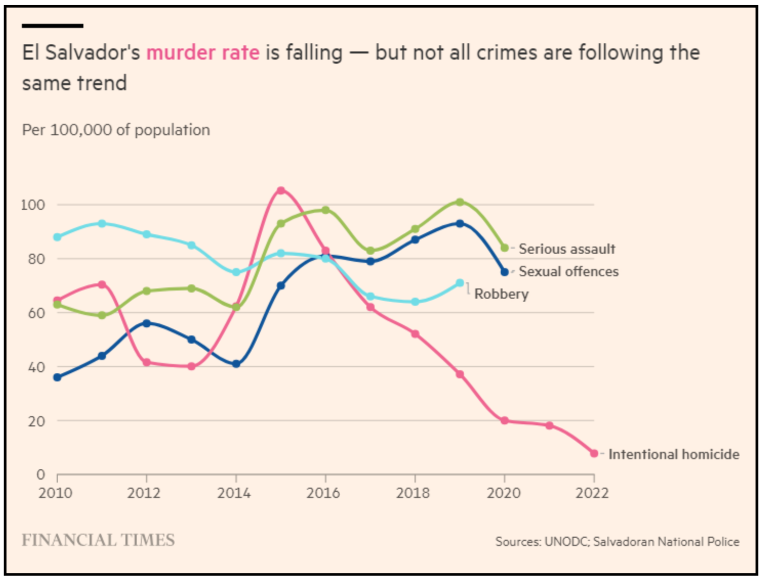
- Regional banks will continue to struggle as long as the Federal Reserve keeps interest rates in restrictive territory. This is because higher interest rates force banks to increase the amount they pay for deposits, which lowers their net interest margins. As a result, banks are not able to lend at the same levels, which could lead to slower economic growth. However, if the Fed commits to offering banks liquidity, it is unlikely that there will be a financial crisis any time soon. That said, regional banks' inability to offer attractive savings rates to maintain deposits will leave them vulnerable to disintermediation.

Southern Uncertainty: Rising crime in South America is making it more difficult for the United States to build alliances with countries in the region that share its belief in democracy.

- A surge in gang violence has added to concerns about a societal breakdown in South America. On Thursday, Ecuadorian presidential candidate Fernando Villavicencio was assassinated at a campaign event. Once considered a relatively peaceful and stable country, Ecuador has emerged as a hot spot for criminal activity in recent years.

Homicides have risen by more than 86% just between 2021 and 2022, as criminal groups use violent tactics to intimidate locals and further their political goals. The recent killing of Villavicencio, an outspoken critic of organized crime, is a stark reminder of how gang activity is spilling over into politics.

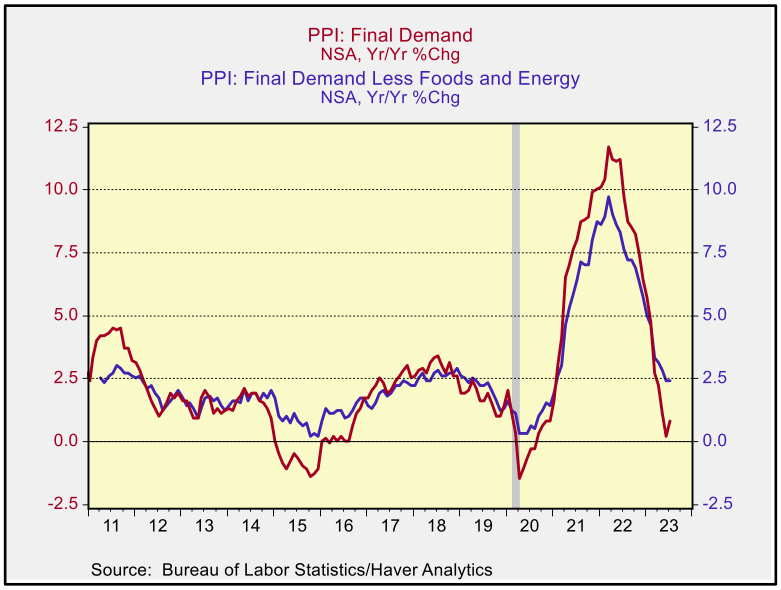
- The rise of gang violence in South America is likely to pave the way for more authoritarian leaders like Nayib Bukele, the president of El Salvador. Bukele has consolidated power by removing term limits, purging the Supreme Court, and replacing the attorney general with an ally. Despite these actions, he remains widely popular throughout South America. A recent poll found that he has an approval rating of 87% in his home country. He is also more popular than the pope in Chile, Venezuela, Ecuador, Guatemala, and Honduras. Bukele is hardly an anomaly, as it appears that Venezuelan President Nicolás Maduro, once considered a pariah on the continent, is now on the brink of a comeback.



- Rising violence within South America complicates the Biden administration's efforts to expand its regional influence. President Biden has made "democracy versus autocracy" the organizing principle of his foreign policy, and his administration has made it clear that it will not support countries that backslide from democratic norms. This is likely why Biden refused to invite Cuba, Nicaragua, and Venezuela to the recent Summit of the Americas. As a result, the Biden administration is at risk of losing influence in the region to China, which has been more willing to overlook human rights abuses in order to expand its economic and political reach.

U.S. Economic Releases

The July ***producer price index (PPI)*** rose by a seasonally adjusted 0.3%, above the expected increase of 0.2% and far worse than the previous month's revised flat performance. Excluding the volatile food and energy components, the July ***"core" PPI*** rose 0.3% as well, exceeding its anticipated rise of 0.2% and reversing the prior month's revised decline of 0.1%. Nevertheless, wholesale pricing still suggests there has been a dramatic drop in cost-push price pressures. The overall PPI in July was up just 0.8% from the same month one year earlier, while the core PPI was up 2.4%. The chart below shows the year-over-year change in the PPI and the core PPI over the last decade or so.



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	U. of Michigan Consumer Sentiment	m/m	Aug P	71.3	71.6	***
10:00	U. of Michigan Current Conditions	m/m	Aug P	76.9	76.6	**
10:00	U. of Michigan Future Expectations	m/m	Aug P	67.3	68.3	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Aug P	3.5%	3.4%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Aug P	3.0%	3.0%	*
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								
New Zealand	BusinessNZ Manufacturing PMI	m/m	Jul	46.3	47.5	47.4	***	Equity bearish, bond bullish
	Food Prices	m/m	Jul	-0.5%	1.6%		***	Equity bullish, bond bearish
China	Aggregate Financing CNY	m/m	Jul	1100.0b	4220.0b	4224.1b	*	Equity and bond neutral
	New Yuan Loans CNY	m/m	Jul	345.9b	3050.0b	3049.5b	**	Equity and bond neutral
	Money Supply M2	y/y	Jul	10.7%	11.3%	11.0%	***	Equity and bond neutral
	Money Supply M1	y/y	Jul	2.3%	3.1%	3.0%	*	Equity and bond neutral
	Money Supply M0	y/y	Jul	9.9%	9.8%		*	Equity and bond neutral
India	Industrial Production	y/y	Jun	3.7%	5.2%	5.1%	***	Equity bearish, bond bullish
EUROPE								
France	CPI	y/y	Jul F	4.3%	4.3%	4.3%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Jul F	5.1%	5.0%	5.0%	**	Equity and bond neutral
Italy	Trade Balance	m/m	Jun	7718m	4711m	4767m	*	Equity and bond neutral
UK	Industrial Production	y/y	Jun	0.7%	-2.3%	-2.1%	***	Equity bullish, bond bearish
	Manufacturing Production	y/y	Jun	3.1%	-1.2%	-0.6%	**	Equity bullish, bond bearish
	Visible Trade Balance	m/m	Jun	-£15455m	-£18723m	-£18411m	**	Equity and bond neutral
	Trade Balance	m/m	Jun	-£4787m	-£6578m	-£7657m	**	Equity and bond neutral
	GDP	y/y	2Q P	0.4%	0.2%	2.0%	***	Equity bearish, bond bullish
Russia	Gold and Forex Reserves	m/m	4-Aug	$586.6b	$594.0b		***	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	4-Aug	18.0t	18.41t		*	Equity and bond neutral
AMERICAS								
Mexico	Industrial Production	y/y	Jun	3.7%	3.9%	2.9%	***	Equity bullish, bond bearish
	Manufacturing Production	y/y	Jun	0.8%	1.9%	1.6%	*	Equity bearish, bond bullish
Brazil	IBGE Inflation IPCA	y/y	Jul	4.0%	3.2%	3.9%	*	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.

doe	Today	Prior	Change	Trend
3-mo Libor yield (bps)	563	563	0	Up
3-mo T-bill yield (bps)	527	528	-1	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	536	536	0	Up
U.S. Libor/OIS spread (bps)	539	539	0	Up
10-yr T-note (%)	4.10	4.11	-0.01	Flat
Euribor/OIS spread (bps)	379	376	3	Up
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Up			Up
Yen	Up			Down
Pound	Up			Up
Franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Mexico Overnight Rate	11.250%	11.250%	11.250%	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	$86.85	$86.40	0.52%	
WTI	$83.18	$82.82	0.43%	
Natural Gas	$2.81	$2.76	1.77%	
Crack Spread	$43.55	$42.67	2.06%	
12-mo strip crack	$31.13	$30.84	0.94%	
Ethanol rack	$2.39	$2.39	-0.16%	
Metals				
Gold	$1,918.68	$1,912.48	0.32%	
Silver	$22.73	$22.70	0.12%	
Copper contract	$370.45	$376.50	-1.61%	
Grains				
Corn contract	$495.75	$496.25	-0.10%	
Wheat contract	$660.50	$663.75	-0.49%	
Soybeans contract	$1,323.25	$1,318.25	0.38%	
Shipping				
Baltic Dry Freight	1,137	1,144	-7	
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)	29	23	6	

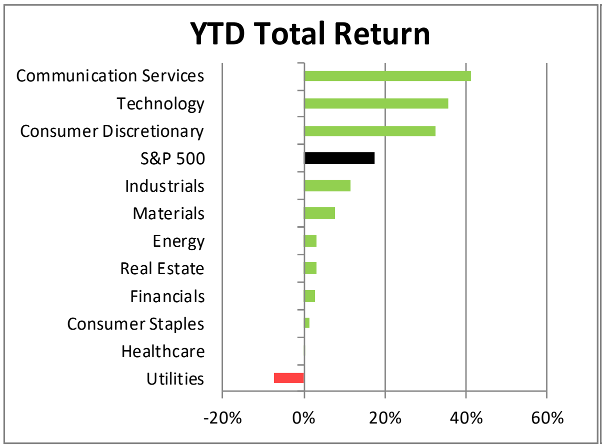
Weather

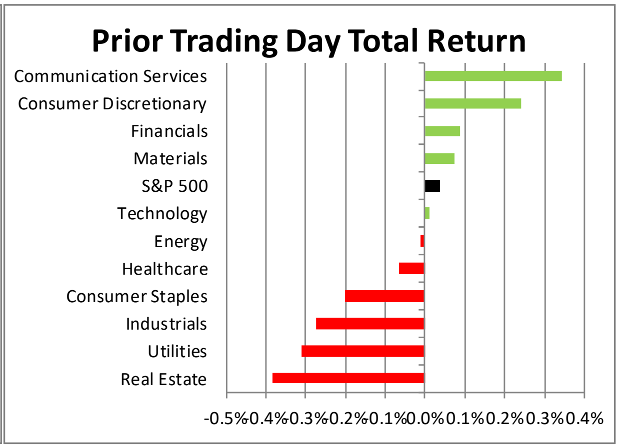
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in virtually the entire country, with cooler-than-normal temperatures only in the Upper Midwest. The forecasts call for wetter-than-normal conditions in California and the Rocky Mountain region, with dry conditions expected in Texas and the southern Great Plains.

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

Data Section

U.S. Equity Markets – (as of 8/10/2023 close)

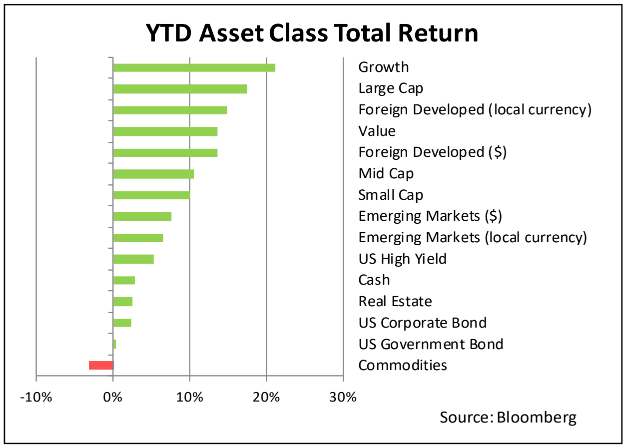




(Source: Bloomberg)

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 8/10/2023 close)

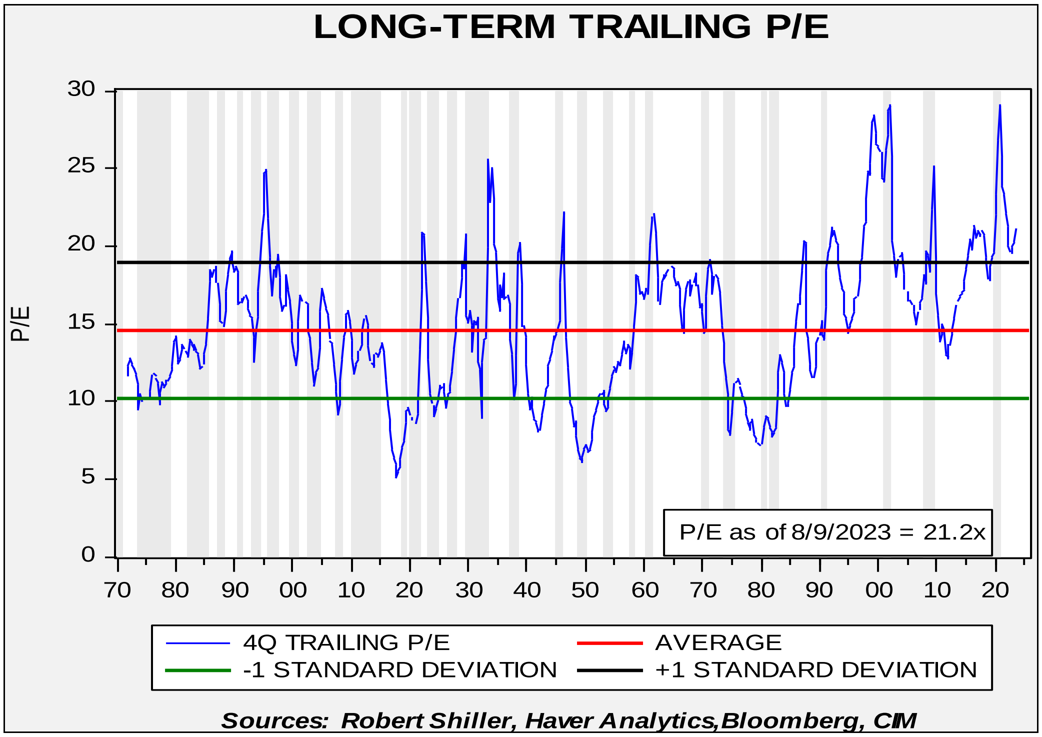


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.