Daily Comment

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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 14, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.3%. Chinese markets were lower, with the Shanghai Composite down 0.3% from its previous close and the Shenzhen Composite down 0.1%. U.S. equity index futures are signaling a higher 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*** **(8/14/2023) (with associated podcast): "Where's the Recession? Examining Employment"**
- *Confluence of Ideas* podcast (7/10/2023): "The 2023 Mid-Year Geopolitical Outlook"

Our *Comment* today opens with new evidence that China's slowing economy may be setting the scene for a potential financial crisis. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including a right-wing electoral win in Argentina's weekend elections and the latest on last week's Maui wildfire.
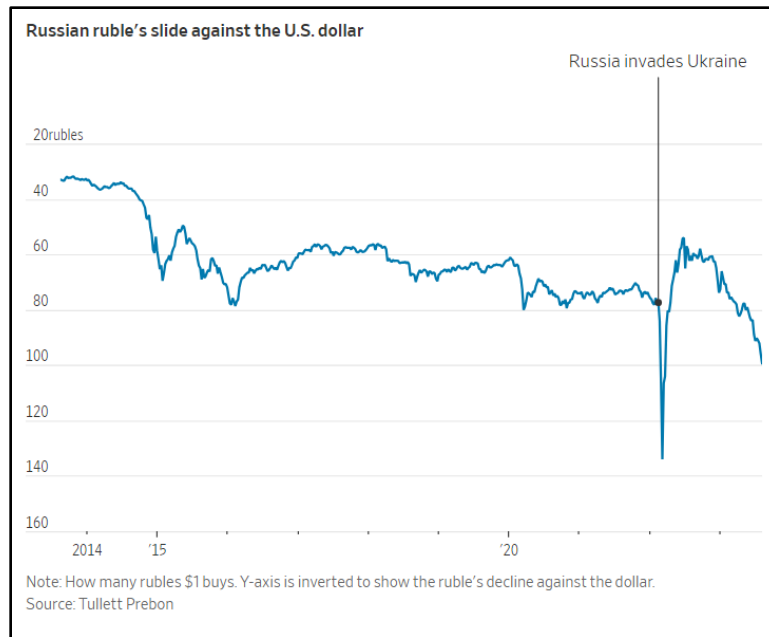
China: Two new developments are raising concerns today about China's faltering economy and the risk of a financial crisis in the country. Along with challenges such as slowing global demand for Chinese exports, bad demographics, and government intrusion into the economy, the growing risk of a financial crisis could slow the economy further, weighing on global economic growth and creating further headwinds for Chinese stocks.

- Following on its missed international bond payments last week, real estate developer Country Garden (CTRYY, $3.23) suspended trading in at least 10 of its mainland bonds. That move has been especially concerning because the company, until now, had weathered the government's debt crackdown relatively well. It now appears that developers are in a new crisis, pushing their stocks down sharply so far today.

- In the second concerning development, reports have surfaced that a number of units of conglomerate Zhongzhi (3737.HK, HKD, 1.17) have recently failed to make payments on the high-yield investment funds they offered. The news has raised concerns that the problems in China's real estate sector are now spreading to the rest of the economy.

China-Taiwan-United States: On Saturday, Taiwanese Vice President Lai Ching-te, the leading candidate for president in next year's election, touched down in the U.S. on his way to a meeting in South America. The transit through U.S. territory is being interpreted as provocative by China and could potentially prompt Beijing to take dangerous retaliatory steps, such as increased naval and air sorties around Taiwan.

Russia-Ukraine War: The Ukrainian military over the weekend again targeted Russia's supply lines to its troops in Crimea, with at least two more missile attacks on the bridge connecting Russia proper to the peninsula. In recent weeks, the Ukrainians have targeted multiple bridges and other infrastructure running to Crimea and the Russian forces occupying southeastern Ukraine. Some evidence suggests the effort has weakened the Russian forces, but not enough to have a major impact on the war, at least so far. Meanwhile, Russia launched more missile strikes against Ukraine's Black Sea port of Odesa this morning, as it continues trying to choke off Ukrainian grain exports.
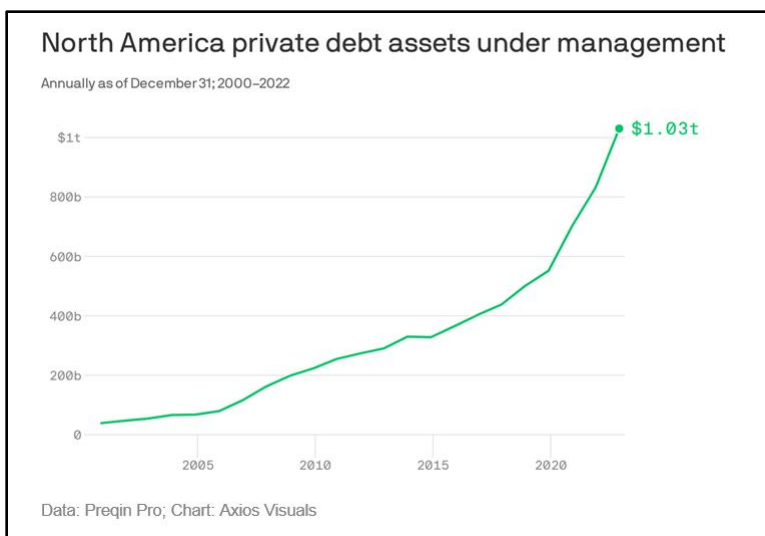
- Separately, the Russian currency has extended its recent depreciation, weakening to a rate of more than 100 per dollar today. The ruble (RUB) has now lost more than 25% of its value against the dollar this year.

- The plunging RUB has sparked public infighting among top Russian officials, with a senior economic advisor to President Putin and a top legislator both castigating the central bank for keeping monetary policy too loose, despite its interest-rate hike last month.

Russian ruble's slide against the U.S. dollar

Russia invades Ukraine

Note: How many rubles $1 buys. Y-axis is inverted to show the ruble's decline against the dollar.
Source: Tullett Prebon

Brazil: The government of left-wing populist President Luiz Inácio Lula da Silva has proposed a 371 billion BRL ($76 billion) public works program aimed at spurring economic growth and protecting the environment. If the program spurs additional investment by state-owned firms and the private sector, the government believes it will channel a total of 1.4 trillion BRL ($287 billion) into new construction, infrastructure repair, and environmental projects.

Argentina: In a primary election over the weekend, radical libertarian Javier Milei and his Freedom Advances party took first place with a strong 30.1% of the vote, beating right-wing Patricia Bullrich and her Together for Change party, which ended up with 28.3%. The results illustrate the extent to which Argentines have soured on the left-wing populism of Peronism and Kirchnerism. Milei has even called for extreme austerity and dollarizing the economy. However, even though the election results point to a shift toward more orthodox economic policies in Argentina, Milei's proposals are considered so radical that they could be destabilizing, so it's not clear that the results will spark a lasting appreciation in Argentine assets.

U.S.–Private Debt Market: New data shows that private lending, which was already growing strongly before this year, has accelerated even further after the bank crisis this spring. In part fueled by impending new capital standards being imposed on the traditional banking industry, the increasing amount of lightly regulated lending is raising concerns about further bank disintermediation and growing financial risks.

North America private debt assets under management

Annually as of December 31; 2000–2022

Data: Preqin Pro; Chart: Axios Visuals

U.S.–Maui Wildfire: Federal, state, and local officials continue to search for victims of last week's devastating fire and investigate how it became such a disaster. Almost 100 fatalities have been tallied so far, making it the deadliest wildfire in the U.S. in about a century. Importantly, officials and residents are urging vacationers to skip travel to the island for the time being in order to free up lodging resources for the newly homeless and reduce pressure on other local resources.

U.S. Economic Releases

There were no domestic releases prior to the publication of this report, and 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								
China	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 M0	y/y	Jul	9.9%	9.8%		*	Equity and bond neutral
	Money Supply M1	y/y	Jul	2.3%	3.1%	3.0%	*	Equity and bond neutral
India	Imports	y/y	Jul	-17.0%	-17.5%		**	Equity and bond neutral
	Exports	y/y	Jul	-22.0%	-15.9%		**	Equity bearish, bond bullish
	Trade Balance	m/m	Jul	$20670m	-$20130.0m	-$21000.0m	*	Equity and bond neutral
EUROPE								
Germany	Current Account Balance	m/m	Jun	29.6b	8.9b	8.2b	**	Equity bullish, bond bearish
	Wholesale Price Index	y/y	Jul	-2.8	-2.9		*	Equity and bond neutral
Switzerland	Domestic Sight Deposits CHF	w/w	11-Aug	474.7b	477.4b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	11-Aug	484.8b	493.0b		*	Equity and bond neutral
Russia	GDP	y/y	2Q A	4.90%	-1.80%	3.90%	**	Equity bullish, bond bearish
AMERICAS								
Brazil	Economic Activity Index	y/y	Jun	2.10%	2.15%	2.29%	**	Equity bearish, bond bullish

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)	526	527	-1	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 (%)	4.17	4.16	0.01	Flat
Euribor/OIS spread (bps)	378	379	-1	Up
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Down			Up
Yen	Down			Down
Pound	Down			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	$86.39	$86.81	-0.48%	
WTI	$82.72	$83.19	-0.56%	
Natural Gas	$2.76	$2.77	-0.36%	
Crack Spread	$43.04	$43.03	0.03%	
12-mo strip crack	$30.89	$30.91	-0.07%	
Ethanol rack	$2.36	$2.37	-0.61%	
Metals				
Gold	$1,910.64	$1,913.76	-0.16%	
Silver	$22.64	$22.69	-0.20%	
Copper contract	$371.10	$371.90	-0.22%	
Grains				
Corn contract	$483.00	$487.25	-0.87%	
Wheat contract	$646.00	$653.75	-1.19%	
Soybeans contract	$1,315.75	$1,307.50	0.63%	
Shipping				
Baltic Dry Freight	1,129	1,137	-8	

Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout most of the country, with cooler-than-normal temperatures only in the Southwest. The precipitation outlook calls for wetter-than-normal conditions in the Pacific and the Rocky Mountain regions, with dry conditions expected in the Midwest and East Coast.

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

Data Section

U.S. Equity Markets – (as of 8/11/2023 close)
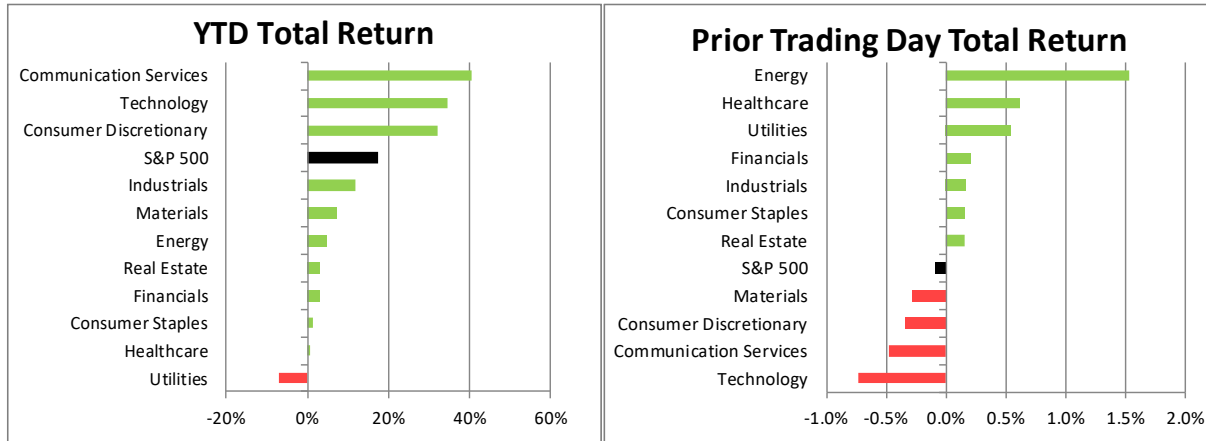
(Source: Bloomberg)

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 8/11/2023 close)
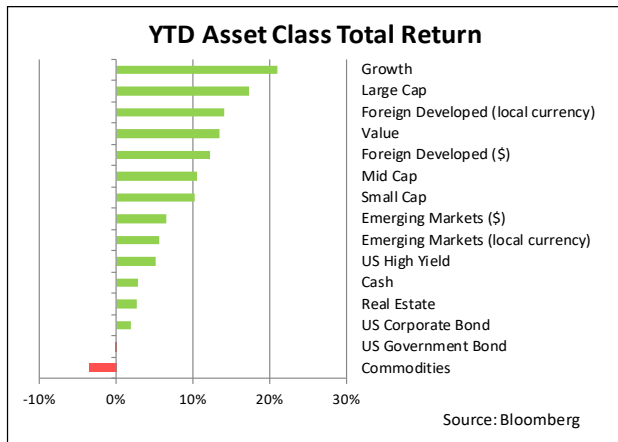
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

LONG-TERM TRAILING P/E

Sources: Robert Shiller, Haver Analytics, Bloomberg, CIM
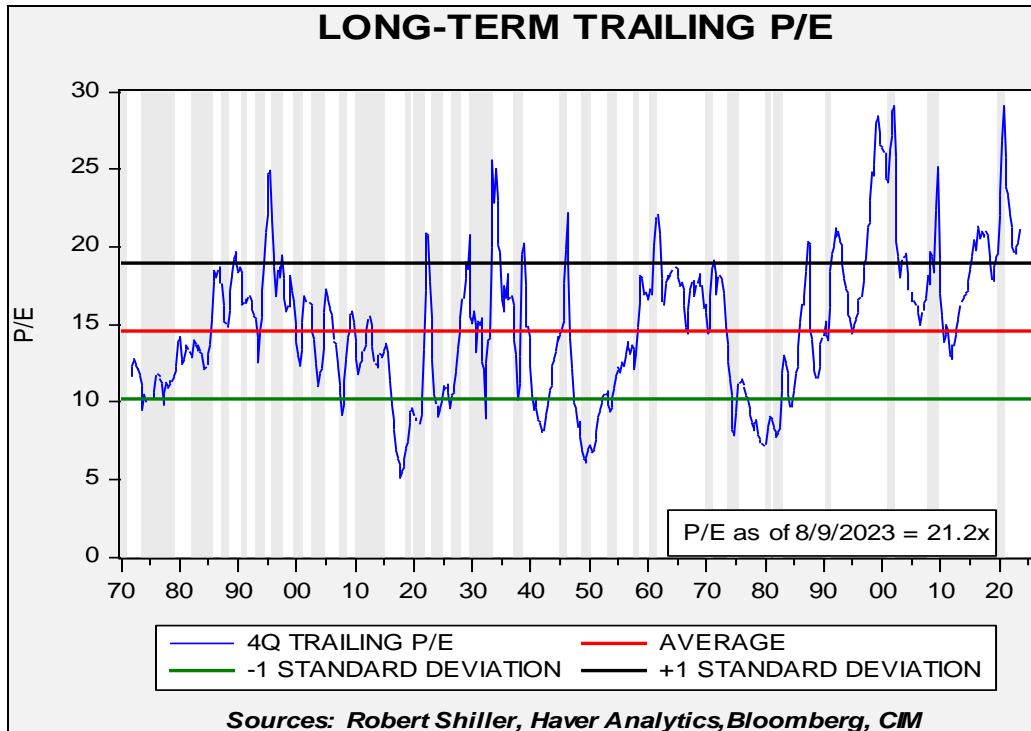
Based on our methodology,[1] the current P/E is 21.2x, -0.1x from last week. Stronger earnings led to the drop in the multiple.

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.