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: August 15, 2023—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is down 1.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.6%. Chinese markets were lower, with the Shanghai Composite down 0.1% from its previous close and the Shenzhen Composite down 0.7%. U.S. equity index futures are signaling a lower open.

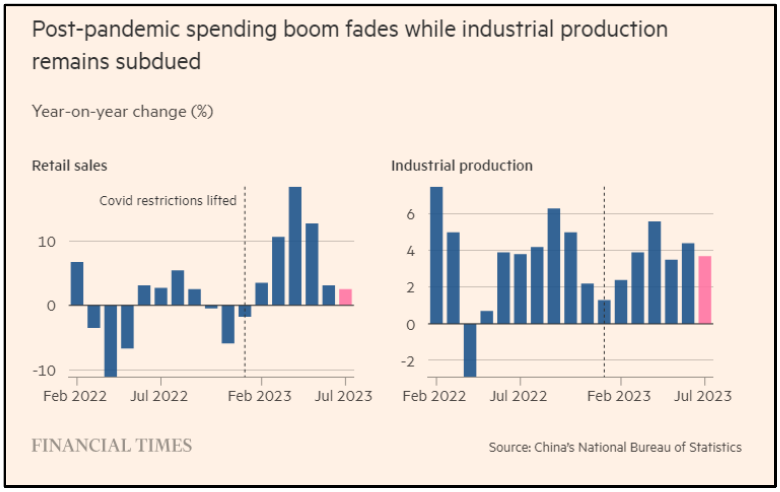
With 456 companies having reported so far, S&P 500 earnings for Q2 are running at $54.00 per share, compared to estimates of $53.55 (a decline of 6.8% from Q2 2022). Of the companies that have reported thus far, 80.3% have exceeded expectations while 14.9% have fallen short of expectations.

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* (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 disappointing news on the Chinese economy. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including data showing Japan's economic growth is now far surpassing that of the U.S. and China and other reports of new regulatory trends in the U.S.

China: The National Bureau of Statistics released several data points today showing continued deterioration in the economy. For example, July industrial production was up just 3.7% from the same month one year earlier, far weaker than the expected rise of 4.6% and the increase of 4.4% in the year to June. The agency also said July retail sales were up just 2.5% year-over-year, weaker than both the anticipated rise of 4.4% and the June increase of 3.1%. The July unemployment rate rose to 5.3%, marking its first increase since February.



- In response, the People's Bank of China cut several of its key policy interest rates. For instance, it cut the rate on its one-year medium-term lending facility to 2.50% from 2.65% previously. It also cut its rate on seven-day reverse repurchase operations to 1.80% from 1.90% and pumped the equivalent of $28.1 billion in new loans into the banking system at the new, lower rate.
- In a less helpful response, the statistics agency said it would no longer publish an unemployment rate for youth aged 16 to 24, ostensibly because that series has been distorted by the large number of students in that cohort. The new hide-the-ball tactic illustrates how the government appears to be prioritizing perception control over policies that would stabilize the economy and set it up for stronger growth again.
- So far this morning, the data and associated policy actions have served to weaken the renminbi (CNY) to a rate of 7.2848 per dollar, down 0.4%. Since the weak data bodes poorly for the global economy, many key global stock markets are trading down so far this morning. However, one exception is Japan, which has not only reported better-than-expected economic growth today, but its stocks have also been driven higher by investors fleeing the Chinese markets.
- Today's flows out of Chinese assets exacerbate longer-term outflows. For example, Connecticut-based Bridgewater Associates, the world's largest hedge fund, said in a regulatory filing yesterday that it liquidated almost one-third of its Chinese stock holdings in the second quarter. Even though Chinese electric vehicles have recently taken the world by storm, Bridgewater also slashed its holdings of Li Auto (LI, $39.95) and XPeng (XPEV, $16.24). The moves mark Bridgewater's most drastic pullback from China since it dumped a number of the country's top technology stocks one year ago.

The activity is consistent with our oft-stated view that rising U.S.-China geopolitical tensions, slowing Chinese economic growth, and Beijing's increasing intrusions into the economy have significantly raised the risks of owning Chinese assets.

Russia: Following our story in yesterday's *Comment* about the weakening ruble (RUB) and how it has prompted some Russian officials to blame the central bank, the institution today held an emergency policy meeting and jacked up its benchmark interest rate to 12.0%, compared with 8.5% previously. Nevertheless, the move has given little boost to the currency, which is being pushed down in part by concerns that the war in Ukraine and Russia's economic and political isolation will continue for the foreseeable future.

Japan: In contrast with the bad economic news out of the China/Russia bloc, the Cabinet Office today said Japanese gross domestic product expanded at an annualized rate of 6.0% in the second quarter, smashing through expectations and accelerating smartly from the growth rate of 3.7% in the first quarter. Excluding the distorted period around the coronavirus pandemic, it was Japan's strongest economic growth since 2015. It also marked a rare quarter in which Japanese growth exceeded that of the U.S. (at 2.4%) and China (about 3.6%). The good economic performance will likely give a further boost to Japanese stocks going forward.

United Kingdom: Average total pay (including bonuses) in April through June was up 8.2% year-over-year, accelerating from the rise of 7.2% in the three months ended in May and marking the biggest annual rise ever recorded outside of the pandemic period. Excluding bonuses, regular pay in April through June was up a record 7.8% year-over-year. The strong wage growth will prompt fears of even more consumer price inflation and a need for further aggressive interest-rate hikes by the Bank of England.

U.S. Environmental Regulation: A judge in Montana has ruled the state can be sued for failing to take climate change into account when approving fossil fuel projects, based on language in the state constitution that guarantees residents "the right to a clean and healthful environment" and stipulates that the state and individuals are responsible for maintaining and improving the environment "for present and future generations."

- The state government said it will appeal the ruling to the Montana supreme court, but there is probably still a chance that the ruling will stand. If so, it would put new responsibilities on the state and potentially set a precedent for climate-change regulation in other states.
- Only a few state constitutions have similar language related to the environment, so commentators are taking a sanguine view of the decision. Nevertheless, it's useful to remember how the modernized state constitutions put into place in the 1960s and 1970s eventually spurred a movement which boosted education funding and channeled billions of dollars into economically disadvantaged school districts based on their broad, aspirational guarantees of an equal education. There is probably some risk that if the Montana ruling stands, activists will be more successful than expected in finding broad, aspirational language in other state constitutions that could support new climate regulations.

U.S. Financial Market Regulation: According to lawyers, the Securities and Exchange Commission has recently sent subpoenas and other document requests to several asset managers regarding their environmental, social, and governance investment marketing. The document requests point to a potential new SEC crackdown looming for ESG funds, with an apparent focus on conventional investment funds that have re-purposed themselves as sustainable funds.

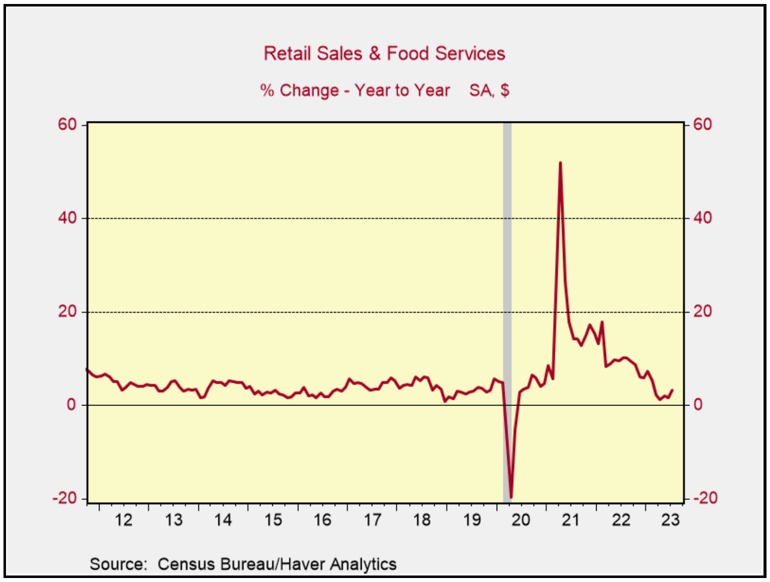
U.S. Bank Regulation: In a speech yesterday, Federal Deposit Insurance Corporation Chairman Gruenberg signaled that the FDIC will soon propose a requirement that regional banks with around $100 billion or more in assets be required to file "living wills," or plans for how they would be sold in an orderly manner if they run into a crisis. The speech offers further evidence that U.S. regional banks are heading for increased regulation similar to that of the very largest banks.

U.S. Homebuilding Industry: Warren Buffett's Berkshire Hathaway (BRK.B, $358.48) said in a regulatory filing yesterday that it has initiated several new positions in homebuilder stocks. That's consistent with our view that a decade of under-building after the Great Financial Crisis has left the nation's housing inventory much too small, which will probably spur strong makeup homebuilding in the coming years. On top of that, many homeowners today are reluctant to put their existing home on the market because they've locked in very low interest rates with 30-year, fixed-rate mortgages. The lack of existing home inventory is producing a boom in new home construction and strong pricing for newly built houses, despite today's high mortgage interest rates.

U.S. Critical Minerals Industry: A mining start-up backed by the U.S. government and focused on critical minerals such as nickel and lithium has raised $200 million in fresh equity, setting it up to become a "unicorn" with a valuation of more than $1 billion. The company, Dublin-based TechMet, illustrates how industrial policy funds and the government's interest in securing critical supply chains has the potential to spawn important new companies in industries of the future.

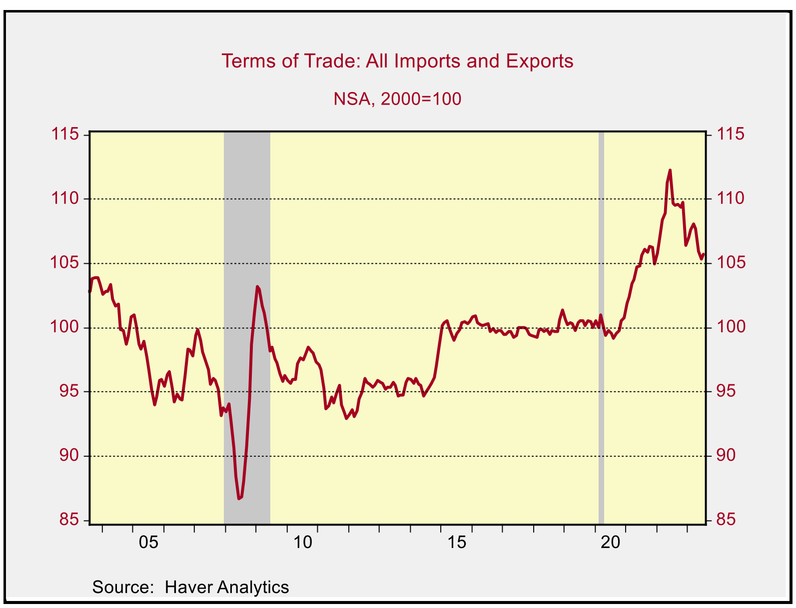
U.S. Economic Releases

Consumer spending exceeded expectations in July, with retail sales rising 0.7% from the previous month, according to the U.S. Department of Commerce. The increase was driven by a spike in online purchases, as well as strong spending on other goods and services. Excluding volatile components such as autos and gas, retail sales rose a more robust 1.0%. The retail control group, which also excludes building materials, also rose 1.0%.



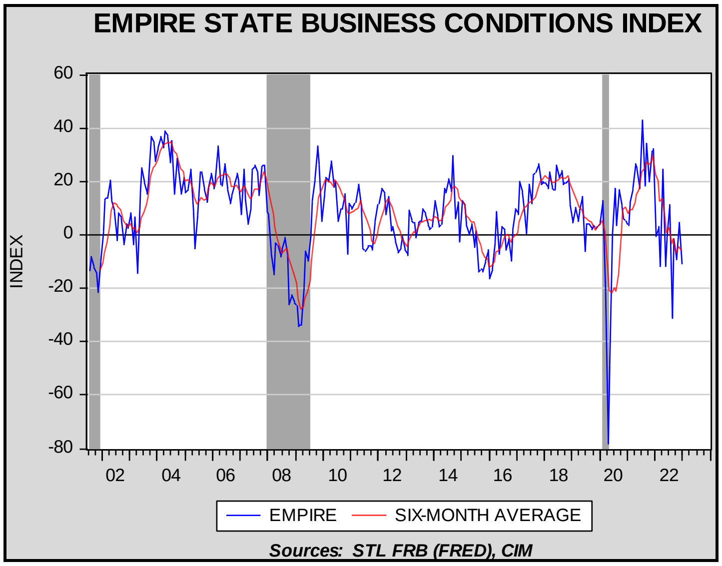
The chart above shows the annual change in retail sales, which rose 3.2% since July 2022. The sharp increase in consumer purchases will add to sentiment that the economy may have averted a recession. That said, it is worth noting that a bulk of spending happened during Amazon Prime day, with an increase in the number of customers using "buy now pay later (BNPL)." Hence, household budgets may be more strained than the retail sales data suggests.

Meanwhile higher energy prices from abroad have added to concerns that the Federal Reserve's inflation fight may not be over. The Bureau of Labor Statistics' Import Price Index rose 0.4% in July, above expectations of 0.2% and the previous month's decline of 0.2%. Excluding petroleum goods, the index was unchanged but was higher than expectations of a decline of 0.2% from the prior month. At the same time, export prices were much stronger than estimates, rising 0.7% from the previous month, compared to expectations of a rise of 0.2%.



The previous chart shows the U.S. Terms of Trade Index, which measures the relative price changes in the export and import price indexes. The index has risen slightly, from 105.3 to 105.6 in July, but is down significantly from its peak last September.

Lastly, the New York Fed's Empire Manufacturing survey severely disappointed in August. The corresponding index came in at -19.0, well below expectations of -1.0 and the previous month's reading of 1.1. The weakness in the index came primarily from a decline in new orders and shipments as producers grapple with a lack of demand.



The chart above shows the New York Fed's General Business Conditions Index along with its six-month moving average. The moving average is currently below the recession signal of zero at -6.25.

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	Business Inventories	m/m	Jun	0.1%	0.2%	*
10:00	NAHB Housing Market Index	m/m	Aug	56.0	56.0	*
16:00	Net Long-Term TIC Flows	m/m	Jun		$25.8b	**
16:00	Total Net TIC Flows	m/m	Jun		-$167.6b	**
Federal Reserve						
EST	Speaker or Event	District or Position				
11:00	Neel Kashkari at API Conference	President of the Federal Reserve Bank of Minneapolis				

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	GDP SA	q/q	2Q P	6.0%	0.7%	3.7%	***	Equity bullish, bond bearish
	GDP Deflator	y/y	2Q P	3.4%	2.0%	3.8%	***	Equity and bond neutral
	Industrial Production YoY	y/y	Jun F	0.0%	-0.4%		***	Equity and bond neutral
	Capacity Utilization MoM	m/m	Jun	3.8%	-6.3%		**	Equity bullish, bond bearish
Australia	Wage Price Index YoY	y/y	Q2	3.6%	3.7%	3.7%	**	Equity and bond neutral
New Zealand	REINZ House Sales	y/y	Jul	1.6%	14.6%		**	Equity bearish, bond bullish
China	Industrial Production	y/y	Jul	3.7%	4.4%	4.3%	***	Equity bearish, bond bullish
	Retail Sales	y/y	Jul	2.5%	3.1%	4.0%	*	Equity bearish, bond bullish
India	CPI	y/y	Jul	7.4%	4.8%	6.5%	***	Equity bearish, bond bearish
India	Imports	y/y	Jul	-17.0	-17.5		**	Equity and bond neutral
	Exports	y/y	Jul	-15.9%	-22.0%		**	Equity and bond neutral
	Trade Balance	m/m	Jul	-$20668.5m	-$20130.0m	-$20950.0m	*	Equity and bond neutral
India	Wholesale Prices	y/y	Jul	-1.4%	-4.1%	-2.5%	**	Equity bearish, bond bullish
EUROPE								
Eurozone	ZEW Survey Expectations	m/m	Aug	-5.5	-12.2		*	Equity bullish, bond bearish
Germany	ZEW Survey Expectations	m/m	Aug	-12.3	-14.7	-14.9	**	Equity bullish, bond bearish
	ZEW Survey Current Situation	m/m	Aug		-62.1	-59.5	**	Equity and bond neutral
UK	Claimant Count Rate	m/m	Jul	4.0%	4.0%		***	Equity and bond neutral
	Jobless Claims Change	m/m	Jul	29.0k%	25.7k		***	Equity and bond neutral
	ILO Unemployment Rate 3Mths	m/m	Jun	4.0%	4.0%	4.0%	***	Equity and bond neutral
Switzerland	Producer & Import Prices	y/y	Jul	-0.6%	-0.6%		**	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)	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 (%)	4.24	4.19	0.05	Flat
Euribor/OIS spread (bps)	380	378	2	Up
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Up
Yen	Flat			Down
Pound	Up			Up
Franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Russia Key Rate	12.000%	8.500%		Above Forecast
PBOC 1-Year Med-Term Lending Facility	2.500%	2.650%	2.650%	Below Forecast
PBOC 1-Year Med-Term Lending (Bil.)	401.0b	103.0b	410.0b	Below 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	$85.32	$86.21	-1.03%	
WTI	$81.44	$82.51	-1.30%	
Natural Gas	$2.74	$2.80	-1.82%	
Crack Spread	$42.77	$41.92	2.01%	
12-mo strip crack	$30.97	$30.45	1.73%	
Ethanol rack	$2.35	$2.35	0.01%	
Metals				
Gold	$1,902.74	$1,907.10	-0.23%	
Silver	$22.43	$22.60	-0.76%	
Copper contract	$370.45	$375.85	-1.44%	
Grains				
Corn contract	$485.50	$487.75	-0.46%	
Wheat contract	$635.50	$641.50	-0.94%	
Soybeans contract	$1,319.25	$1,326.00	-0.51%	
Shipping				
Baltic Dry Freight	1,135	1,129	6	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.3		
Gasoline (mb)		-0.2		
Distillates (mb)		0.4		
Refinery run rates (%)		0.1%		
Natural gas (bcf)		23		

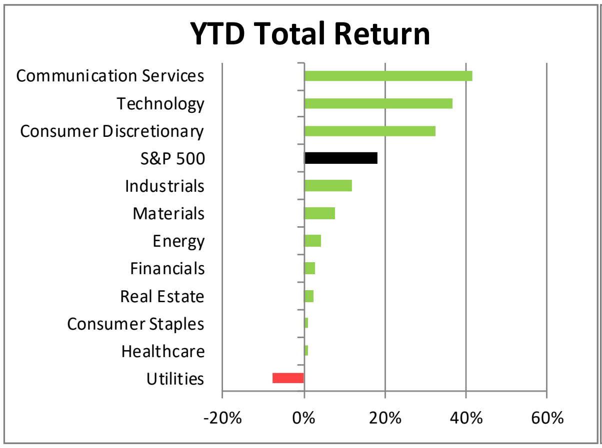
Weather

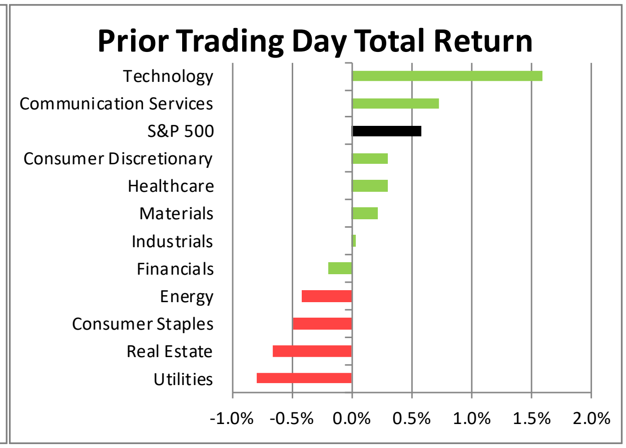
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout most of the country, with cooler-than-normal temperatures only in the Southwest. The precipitation outlook calls for wetter-than-normal conditions in the Pacific and the Rocky Mountain regions, with dry conditions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

There are two disturbances located off the coast of West Africa. The National Hurricane Center (NHC) has given both disturbances a less than 1% chance of developing into tropical cyclones within the next 48 hours.

Data Section

U.S. Equity Markets – (as of 8/14/2023 close)

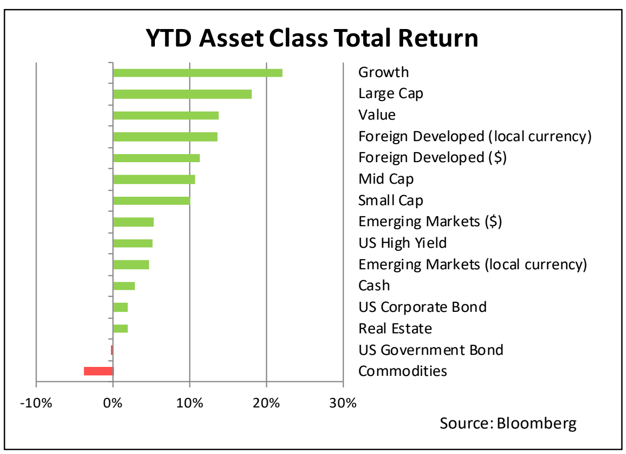




(Source: Bloomberg)

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 8/14/2023 close)

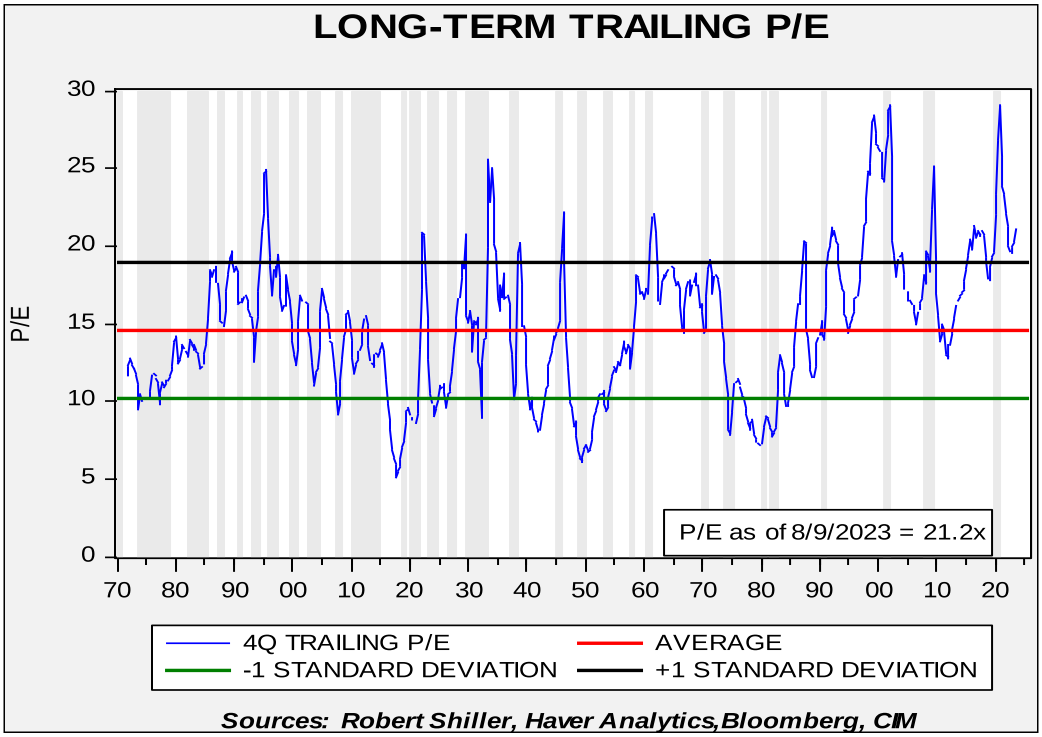


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.