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 17, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is down 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed relatively unchanged. Chinese markets were higher, with the Shanghai Composite up 0.4% from its previous close and the Shenzhen Composite up 0.9%. U.S. equity index futures are signaling a higher open.

With 466 companies having reported so far, S&P 500 earnings for Q2 are running at $54.20 per share, compared to estimates of $53.55 (a decline of 6.8% from Q2 2022). Of the companies that have reported thus far, 80.9% have exceeded expectations while 14.4% have fallen short of expectations.

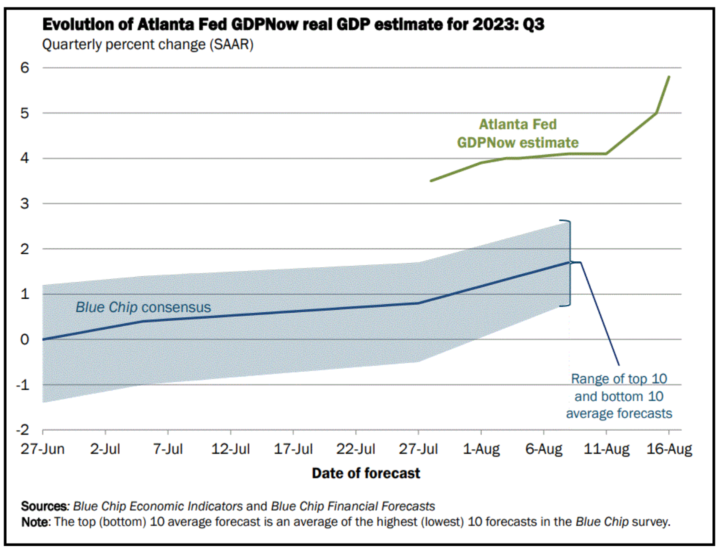
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (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*** **(8/17/2023): The U.S. and Iran are continuing to discuss a prisoner release that may have more parts to the agreement. We also saw another modest increase in the SPR last week**.
- *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"

Good morning! Today's *Comment* will cover three key themes: what the latest FOMC meeting minutes could mean for monetary policy going forward, an update on the latest complaints regarding artificial intelligence, and why the upcoming Argentine election in October has investors on edge.

Is the Fed Done? The hawkish Fed minutes weighed on market sentiment as investors pulled back on bets of a Fed pause.

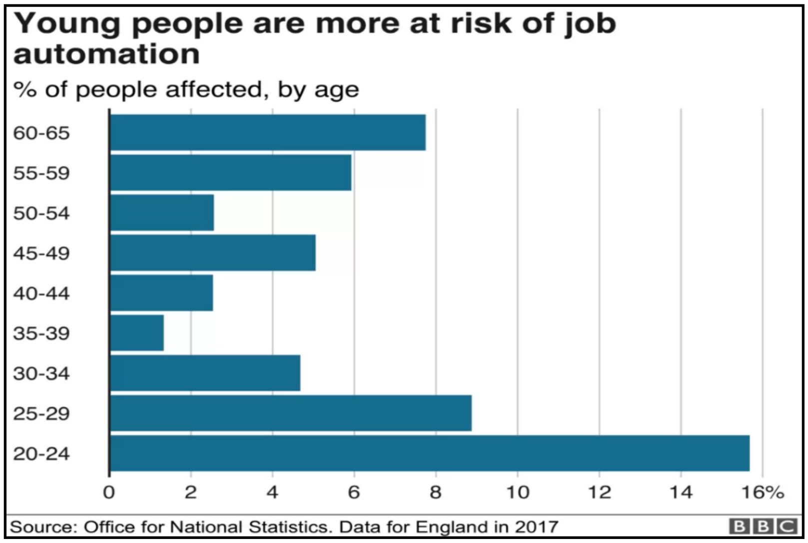
- The minutes of the Federal Open Market Committee's (FOMC) July 25-26 meeting revealed that most members believed that there was a significant upside risk to inflation, which could warrant additional rate hikes. This hawkish tone suggests that, despite the progress made in bringing down inflation, policymakers are not yet confident that inflation has peaked and are willing to take a more aggressive approach in tightening monetary policy. However, there were also a few more optimistic members of the FOMC. Two officials favored leaving rates unchanged or "could have supported such a proposal." Although there were no dissenting votes, it is clear that not all policymakers are on the same page.
- Investor sentiment soured following the release of the FOMC minutes, as the market could not rule out the possibility of a hard landing. The S&P 500 closed yesterday down nearly 0.8%, while the U.S. Dollar Index (DXY) rallied. Despite the disappointing news, investors did not severely change their rate expectations. The yield on the 10-year Treasury rose a paltry 5 basis points, and the CME FedWatch Tool's expectation of a September hike increased only modestly from 10% to 12.5%. This suggests that investors still believe that the Fed is near the end of its hiking cycle.



- Despite the market's reaction, it is too soon to rule out another rate hike this year. As the chart above shows, the economy is projected to accelerate in the third quarter, making it difficult for the Fed to justify easing policy any time soon. This may explain why investors sold off after the report, as they may have wanted to lock in their gains from earlier this year. However, we will be paying close attention to Fed Chair Jerome Powell's speech at Jackson Hole next week for any hints as to how the Fed is leaning. Our expectation is that Powell will likely keep his options open.

AI Presence Expanding: Generative artificial intelligence (AI) is receiving flak after author Jane Friedman found books generated by the technology that were claimed to have been written by her.

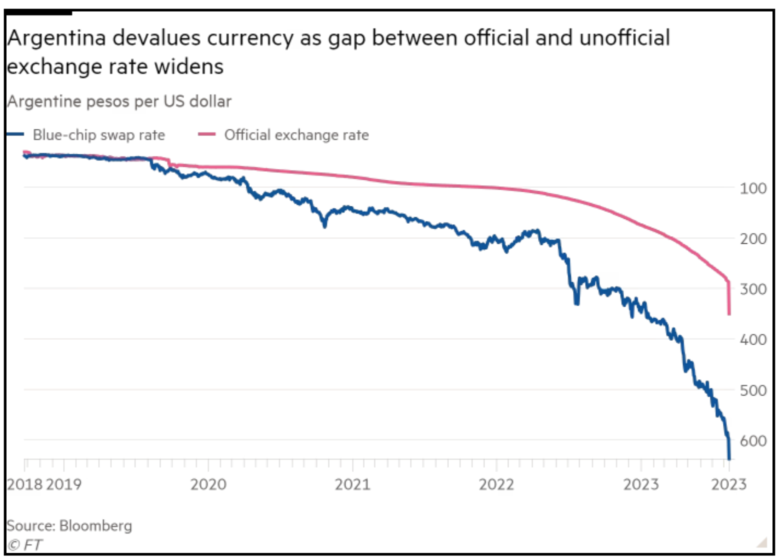
- The rise of AI-generated content has sparked controversy with some people concerned that it will displace human workers. This is because AI models are trained on massive datasets of text and code, including the work of authors. Without proper attribution, this can lead to accusations of plagiarism and copyright infringement. A survey by the Authors Guild found that 90% of writers believe they should be compensated for their work used to train AI models. Others argue that the rising popularity of AI-generated content threatens to crowd out quality work from human writers.
- Generative AI content-generating applications are at the heart of the Hollywood writers' and actors' strikes, and their concerns could easily spread to other industries. The strike has gone on for over 100 days, and it appears that studios have already made some concessions, such as crediting writers for work used by the models and using more human-generated content. However, it remains to be seen whether these concessions will be enough to satisfy the picketers. Regardless of the outcome of the strikes, it is clear that AI is here to stay in Hollywood. A recent survey found that over 96% of media executives plan to increase their spending on AI technology.



- The ongoing dispute between Hollywood writers and actors is an example of how workers are concerned about the potential for technology to displace low-skill and middle-skill white-collar workers, particularly among young people. Without adequate regulations in place, the growing ubiquity of AI could lead to a knowledge gap and inequality in the workforce. As a result, we suspect that the technology will likely face increased scrutiny in the coming months as concerns about its disruptive potential enter the national conversation. Investors should be aware of the uncertain regulatory landscape for the technology and how this may impact company earnings in the future.

Argentina in the Spotlight: The presidential front-runner in Argentina unveiled controversial proposals to overhaul the Argentine economy that have left many investors worried.

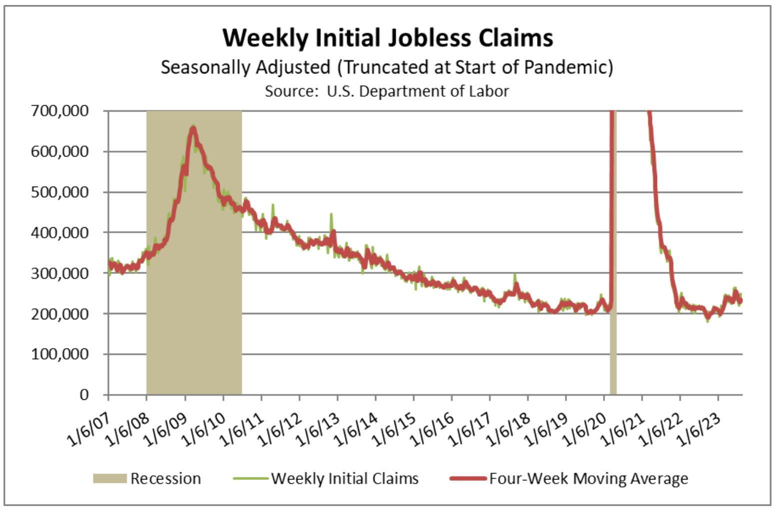
- Libertarian presidential candidate Javier Milei has proposed a sweeping set of free-market policies to jumpstart the Argentine economy. In a two-hour interview, he promised to slash government spending by at least 13% of GDP by 2025, shutter the country's central bank, and replace the national currency with the U.S. dollar. These policies are designed to help rebrand Argentina as a stable and attractive destination for investment, following years of economic turmoil. Argentina narrowly avoided default earlier this year after it was able to restructure nearly $22 billion of domestic debt, extending the maturity into 2024 and 2025. The event led S&P to slash Argentina's national rating to *SD* from *raCCC+*.
- In addition to radically reforming the economy, the new leader vowed to distance Argentina from socialist countries, including its two largest trading partners: Brazil and China. According to the Observatory of Economic Complexity, these two countries imported more than $17 billion worth of Argentine goods in 2021, which is more than the next three countries combined. Milei's remarks are likely to be a major shift in the country's trade policy as it has often relied on China for exports and debt relief. Growing uncertainty regarding the impact of his policies led to a steep decline in the Argentine peso (ARS).



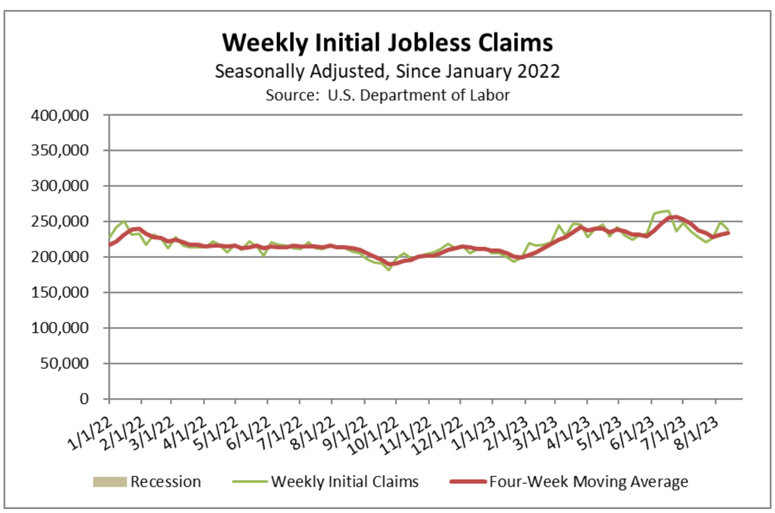
- The rise of Javier Milei is a reminder of how volatile Latin American politics can be. The region has typically swung between left-wing and right-wing governments, each promising to bring about a better future. However, as the world moves towards regional blocs, we see the same volatility in foreign and trade policy. For example, Brazil's relationship with China was very contentious before Lula took over the presidency, since former President Jair Bolsonaro had blamed China for the pandemic. As a result, investors should keep in mind that these blocs will be fluid, especially as the world moves away from globalization.

U.S. Economic Releases

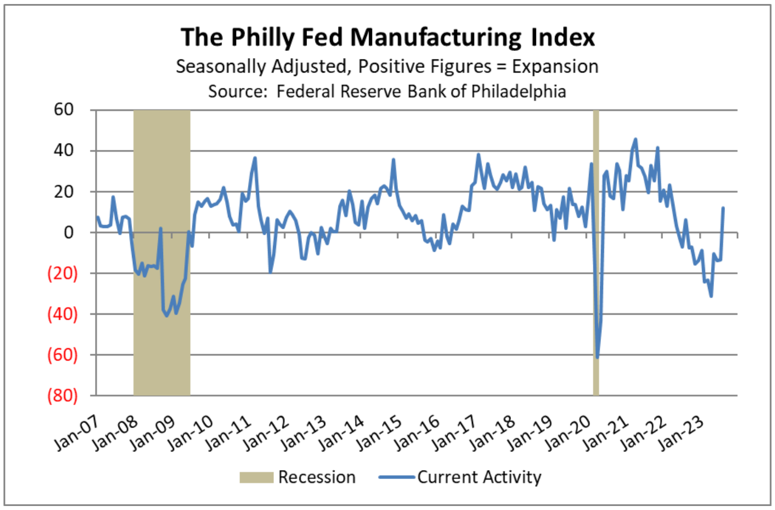
In the week ended August 12, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 239,000, just below the expected level of 240,000 and significantly lower than the prior week's revised level of 250,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, edged up to 234,250. Meanwhile, in the week ended August 5, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to 1.716 million, above the anticipated reading of 1.700 million and the previous week's reading of 1.684 million. 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 Philadelphia FRB said its ***August Manufacturing Activity Index*** rose to a seasonally adjusted 12.0, much better than both the expected reading of -10.4 and the July reading of -13.5. The Philly Fed Index is designed so that positive readings point to expanding factory activity in the mid-Atlantic region. At its current level, the index suggests manufacturing in the region is now experiencing at least a temporary recovery. The chart below shows how the index has fluctuated since just before the Great Financial Crisis.



The table below lists the economic releases and/or Fed events scheduled for the rest of the day.

Economic Releases						
No economic releases for the rest of today						
EST	Indicator			Expected	Prior	Rating
10:00	Leading Index	m/m	Jul	-0.4%	-0.7%	***
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								
Japan	Trade Balance	m/m	Jul	-¥78.7b	¥43.0b	¥43.1b	***	Equity bearish, bond bullish
	Exports	m/m	Jul	-0.3%	1.5%	0.2%	*	Equity bearish, bond bullish
	Imports	m/m	Jul	-13.5%	-12.9%	-15.2%	*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	11-Aug	-¥871.1b	-¥1966.0b	-¥1964.1b	*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	11-Aug	-¥334.6b	¥438.8b	¥1119.5b	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	11-Aug	-¥54.7b	-¥352.2b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	11-Aug	¥227.2b	-¥59.4b	-¥59.6b	*	Equity and bond neutral
	Core Machine Orders	y/y	Jun	-5.8%	-8.7%	-5.8%	**	Equity and bond neutral
	Tertiary Industry Index	m/m	Jun	-0.4%	1.2%	1.0%	**	Equity bearish, bond bullish
Australia	Employment Change	m/m	Jul	-14.6k	32.6k	31.6k	***	Equity and bond neutral
	Unemployment Rate	m/m	Jul	3.7%	3.5%	3.5%	***	Equity and bond neutral
	Participation Rate	m/m	Jul	66.7%	66.8%	66.8%	**	Equity and bond neutral
South Korea	Export Price Index	y/y	Jul	-12.8%	-14.7%	-15.0%	*	Equity bullish, bond bearish
	Import Price Index	y/y	Jul	-13.5%	-15.7%	-16.1%	*	Equity bearish, bond bullish
EUROPE								
Eurozone	Trade Balance SA	m/m	Jun	12.5b	-0.9b	0.2b	**	Equity and bond neutral
Russia	PPI	y/y	Jul	4.10%	0.00%		***	Equity bullish, bond bearish
AMERICAS								
Canada	Housing Starts	m/m	Jul	225.0k	281.4k	283.5k	**	Equity and bond neutral
Brazil	FGV Inflation IGP-10	m/m	Aug	-0.13%	-1.10%	-0.29%	*	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)	564	563	1	Up
3-mo T-bill yield (bps)	527	529	-2	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	538	538	0	Up
U.S. Libor/OIS spread (bps)	540	540	0	Up
10-yr T-note (%)	4.29	4.25	0.04	Flat
Euribor/OIS spread (bps)	380	379	1	Up
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Up
Yen	Up			Down
Pound	Up			Up
Franc	Up			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	$84.20	$83.45	0.90%	
WTI	$80.11	$79.38	0.92%	
Natural Gas	$2.59	$2.59	-0.15%	
Crack Spread	$43.15	$42.83	0.76%	
12-mo strip crack	$31.19	$30.76	1.40%	
Ethanol rack	$2.32	$2.33	-0.46%	
Metals				
Gold	$1,900.48	$1,891.81	0.46%	
Silver	$22.82	$22.42	1.81%	
Copper contract	$374.65	$369.55	1.38%	
Grains				
Corn contract	$478.25	$481.50	-0.67%	
Wheat contract	$616.00	$623.00	-1.12%	
Soybeans contract	$1,322.50	$1,323.50	-0.08%	
Shipping				
Baltic Dry Freight	1,233	1,166	67	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-6.0	-2.5	-3.5	
Gasoline (mb)	-0.3	-1.1	0.8	
Distillates (mb)	0.3	-0.5	0.8	
Refinery run rates (%)	0.9%	0.5%	0.4%	
Natural gas (bcf)		35		

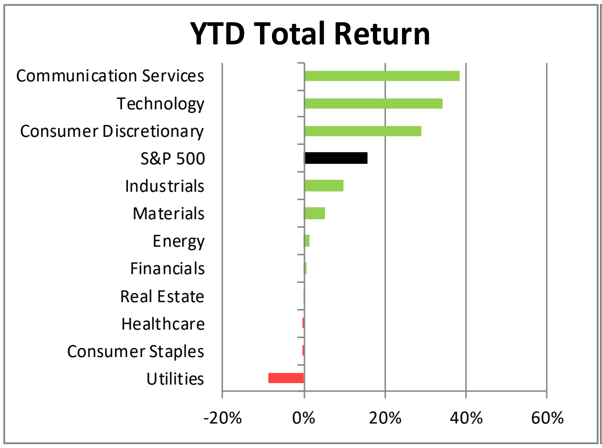
Weather

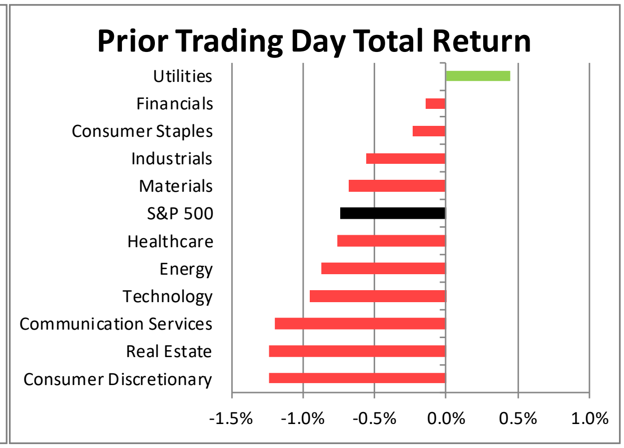
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in a wide band running from the Pacific Northwest through the Rocky Mountains and Great Plains to the Southeast, with cooler-than-normal temperatures only in the Southwest and New England. The forecasts call for wetter-than-normal conditions throughout the Far West, New England, and Florida, with dry conditions expected in the entire Mississippi Valley region.

There are currently two atmospheric disturbances located off the coast of West Africa. The National Hurricane Center (NHC) has assessed each to have about a 40% chance of developing into a tropical cyclone within the next 48 hours.

Data Section

U.S. Equity Markets – (as of 8/16/2023 close)

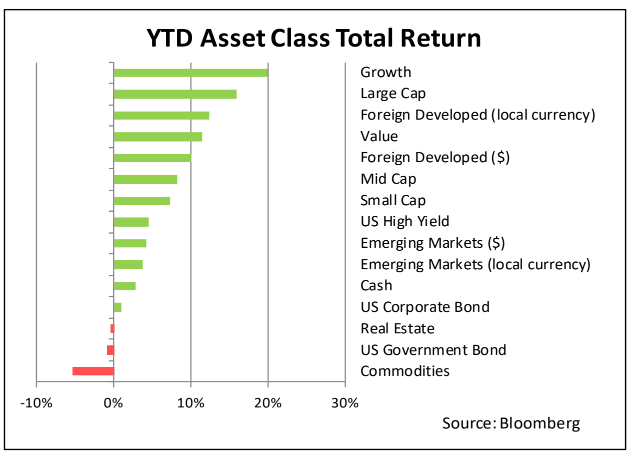




(Source: Bloomberg)

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 8/16/2023 close)

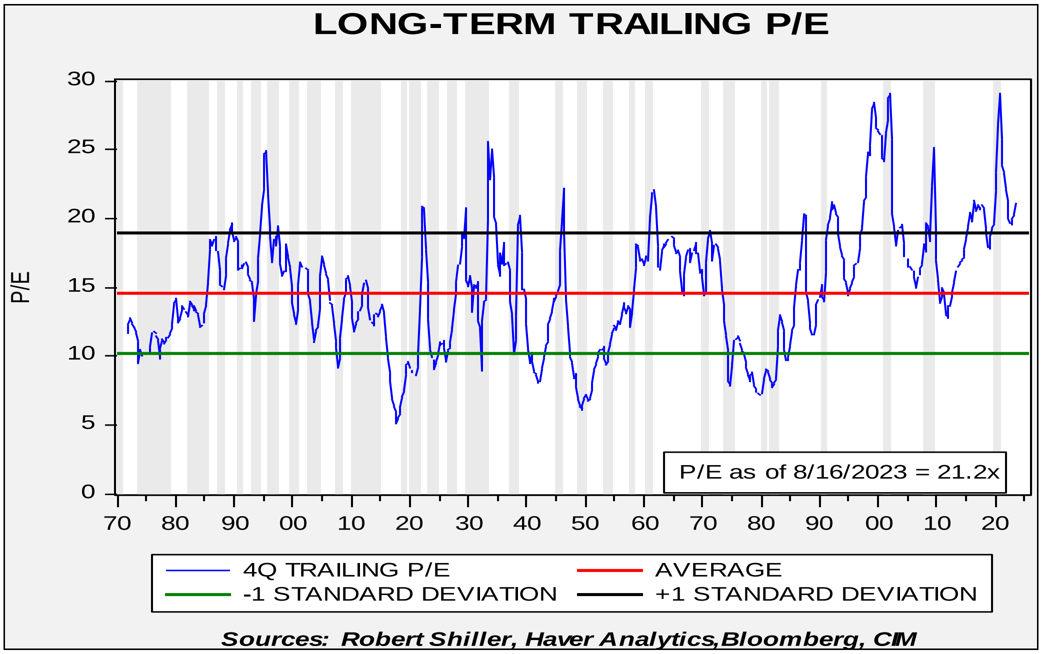


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 17, 2023



Based on our methodology,[1] the current P/E is 21.2x, unchanged from last week.

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.