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 18, 2023—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is down 0.9% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.4%. Chinese markets were lower, with the Shanghai Composite down 1.0% from its previous close and the Shenzhen Composite down 1.7%. U.S. equity index futures are signaling a lower open.

With 468 companies having reported so far, S&P 500 earnings for Q2 are running at $54.30 per share, compared to estimates of $53.55 (a decline of 6.8% from Q2 2022). Of the companies that have reported thus far, 80.8% have exceeded expectations while 14.5% 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* covers three main themes: 1) The impact of better-than-expected growth on global interest rates; 2) How China's economic troubles are not going away anytime soon; 3) Why investors will be paying close attention to gatherings in South Africa and Jackson Hole, Wyoming, next week.

Party's Over? Stronger-than-expected economic growth has kept central banks from cutting interest rates, leading to tighter financial conditions.

- Global bond yields have surged to their highest level since 2008 as investors price in additional rate hikes. The IMF had previously forecast that there was a 90% chance of a U.S. and European recession by the end of 2023. However, after two consecutive quarters of expansion, both economies seem on track to finish 2023 in expansion. Additionally, stubbornly high inflation rates suggest that banks may need to keep interest rates in restrictive territory for longer. These higher rates are likely to put a strain on the global financial system, which could spill over into bond markets.
- This higher-for-longer sentiment has weighed on investor appetite for risk, sending the S&P 500 down 2.0% and the NASDAQ 100 down 3.2% since Monday. The major shift away from riskier assets is related to the growing attractiveness of higher-yielding safe assets, such as inflation-adjusted U.S. 10-year Treasuries, which surged to a 14-year high of 1.89%. The rise in yields has also impacted mortgage rates. According to the Mortgage Banker Association, the average 30-year mortgage rate has risen to its highest level since 2002 at 7.09%.

- Despite the economy being more resilient than investors thought at the start of the year, the strong economic performance is not likely to persist indefinitely. One of the primary reasons for the economy's good run over the last few quarters is that fiscal and monetary policies have likely made households less sensitive to changes in interest rates. Over 60% of homeowners have mortgage rates below 4%, and firms were able to take advantage of favorable credit conditions to extend the duration of their loans before interest rates rose to their current levels. According to the Fed Small Business Credit Survey, over 58% of firms applied for new financing in 2022, which reduced their need for new loans.

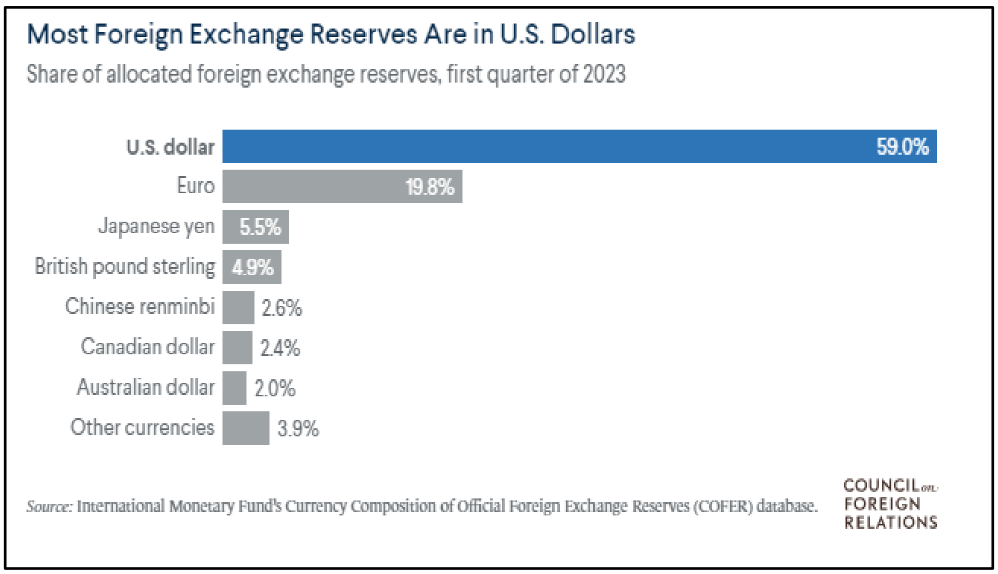
China Worries Spreads: There is mounting evidence that China is still facing a severe property crisis.

- The Chinese financial system is coming under scrutiny after several institutions were unable to repay their debts. Zhongrong International Trust Co., which considerable real estate exposure, has missed payments on several products and currently has no immediate plan to make creditors whole. The situation has led to a spate of protests as clients look to hold the trust accountable. At the same time, China Evergrande Group filed for bankruptcy in New York and is currently working on restructuring its debt in Hong Kong. The ongoing turmoil shows that China's property problems are likely worsening.
- The situation is likely to exacerbate China's economic woes. Earlier this month, it was revealed that Chinese exports had fallen by the largest amount since the start of the pandemic. Meanwhile, consumer confidence remains near all-time lows. Additionally, Beijing's resistance to providing additional stimulus is also likely to hamper the country's economic growth and investor sentiment. The ongoing troubles have led to increasing calls for the People's Bank of China (PBOC) to provide more aggressive policy easing to address these issues. The PBOC has already cut policy rates twice in three months and may offer more easing if the economic situation continues to deteriorate.

- The financial instability in China is currently isolated from the rest of the world. However, the global markets may still feel the spillover effects. Much of the domestic demand is expected to decline as China deals with its debt burdens. This problem could become more acute if Beijing forces households to absorb the losses from the property fallout. As a result, this could have a negative impact on international trade, as the lack of Chinese demand will weigh on commodity prices and make the country's exports relatively cheap. This could help to reduce global inflation.

A New Chapter: Next week, two major conventions will take place, one in South Africa and the other in the United States.

- The 15th BRICS summit will take place in Johannesburg, South Africa on August 22-24, 2023. Leaders are expected to discuss the development of a new common currency backed by the commodities of the group members. There is also speculation that the bloc may be expanding to include more countries. While the group has denied that it is trying to create a rival to Western dominance in international trade, it is clear that they are at least interested in providing an alternative to the current order. As a result, the event will be closely watched by the global community.
- Meanwhile, central bankers from around the world will be gathering in Jackson Hole, Wyoming, for the annual meeting of the Federal Reserve Bank of Kansas City. The meeting is traditionally a forum for central bankers to share their views on the global economy and monetary policy. This year's meeting is likely to be particularly important as policymakers grapple with the challenge of tightening monetary policy without triggering a recession. Federal Reserve Chair Jerome Powell is set to speak at the summit, and his remarks will be closely watched for clues about the Fed's future policy plans.



- The upcoming BRICS summit and the Jackson Hole Economic Policy Symposium may have major ramifications for interest rate expectations. The potential for BRICS to issue bonds backed by a non-U.S. currency could sap future demand for U.S. Treasuries, making it more expensive for the U.S. government to borrow money. Although this is unlikely to happen, it is a risk that investors will be watching closely. Powell's speech at Jackson Hole is also likely to be closely scrutinized by investors. While he is widely expected to remain vague about the Federal Open Market Committee's next rate decision, he could give investors some insight into the inner thinking of policymakers. Any hints about the direction of future rate hikes could have a significant impact on financial markets.

Odds and Ends: President Trumps said that he would not reappoint Powell if reelected. There are over 2.2 trillion options set to expire today.

U.S. Economic Releases

No major U.S. economic reports or Fed events have been scheduled for 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	National CPI	y/y	Jul	3.3%	3.3%	3.3%	***	Equity and bond neutral
	National CPI Ex-Fresh Food	y/y	Jul	3.1%	3.3%	3.1%	**	Equity and bond neutral
	National CPI Ex-Fresh Food & Energy	y/y	Jul	4.3%	4.2%	4.3%	*	Equity and bond neutral
EUROPE								
Eurozone	Construction output	y/y	Jun	-0.3%	0.1%	0.3%	*	Equity bearish, bond bullish
	CPI	y/y	Jul F	5.3%	5.3%	5.3%	***	Equity and bond neutral
	Core CPI	y/y	Jul F	5.5%	5.5%	5.5%	**	Equity and bond neutral
UK	Retail Sales	y/y	Jul	-3.2%	-1.0%	-1.6%	***	Equity bearish, bond bullish
	Retail Sales Ex-Auto Fuel	y/y	Jul	-3.4%	-0.9%	-1.6%	**	Equity bearish, bond bullish
Switzerland	Industrial Output WDA	y/y	2Q	-0.8%	3.4%	4.2%	*	Equity bearish, bond bullish
Russia	Money Supply, Narrow Definition	w/w	11-Aug	18.6t	18.5t		*	Equity and bond neutral
	Gold and Forex Reserves	m/m	11-Aug	$585.8b	$586.6b		***	Equity and bond neutral
AMERICAS								
Canada	Int'l Securities Transactions	m/m	Jun	12.56b	11.16b	10.21b	*	Equity and bond neutral
Mexico	Retail Sales	y/y	Jun	5.9%	2.6%	3.0%	***	Equity bullish, bond bearish

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	564	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)	540	540	0	Up
10-yr T-note (%)	4.22	4.28	-0.06	Flat
Euribor/OIS spread (bps)	382	380	2	Up
Currencies	**Direction**			
Dollar	Flat			Flat
Euro	Flat			Up
Yen	Up			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	$83.60	$84.12	-0.62%	
WTI	$79.92	$80.39	-0.58%	
Natural Gas	$2.57	$2.62	-1.91%	
Crack Spread	$41.36	$41.82	-1.10%	
12-mo strip crack	$30.76	$30.73	0.09%	
Ethanol rack	$2.29	$2.30	-0.24%	
Metals				
Gold	$1,894.30	$1,889.43	0.26%	
Silver	$22.78	$22.69	0.39%	
Copper contract	$370.70	$372.95	-0.60%	
Grains				
Corn contract	$488.75	$485.75	0.62%	
Wheat contract	$626.00	$615.25	1.75%	
Soybeans contract	$1,344.25	$1,330.00	1.07%	
Shipping				
Baltic Dry Freight	1,247	1,233	14	
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	34	1	

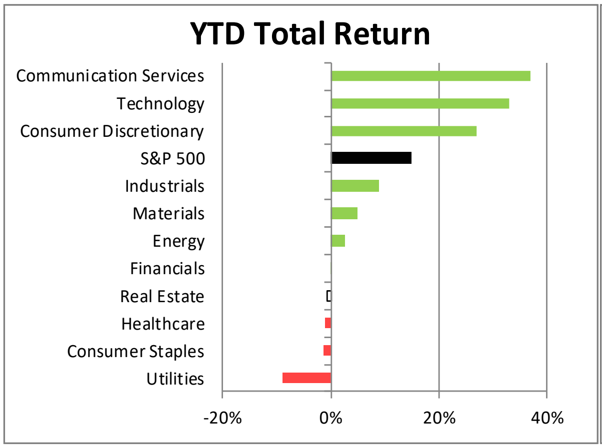
Weather

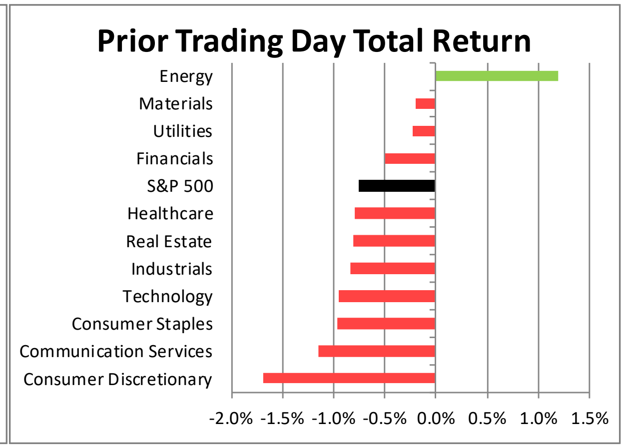
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in the Pacific Northwest, the southern Great Plains, and the Southeast, with cooler-than-normal temperatures in the Southwest and New England. The forecasts call for wetter-than-normal conditions throughout the Far West and New England, with dry conditions expected in the entire Mississippi Valley region.

There are now several atmospheric disturbances in the Atlantic region. Two disturbances in the central Atlantic Ocean off the western coast of Africa are now assessed to have at least a 40% probability of developing cyclonic characteristics in the next 48 hours, while another, off the northeastern coast of South America, is assessed to have a probability of 10%. Another disturbance has developed off the northeast coast of Cuba, but it is seen as having no chance of developing into a cyclone in the next 48 hours. Meanwhile, in the Pacific Ocean, hurricane Hilary is off the southern tip of Baja California and moving northward. Between now and Monday, it is expected to cause flooding and bring high winds to Baja California and the Southwest region of the U.S.

Data Section

U.S. Equity Markets – (as of 8/17/2023 close)

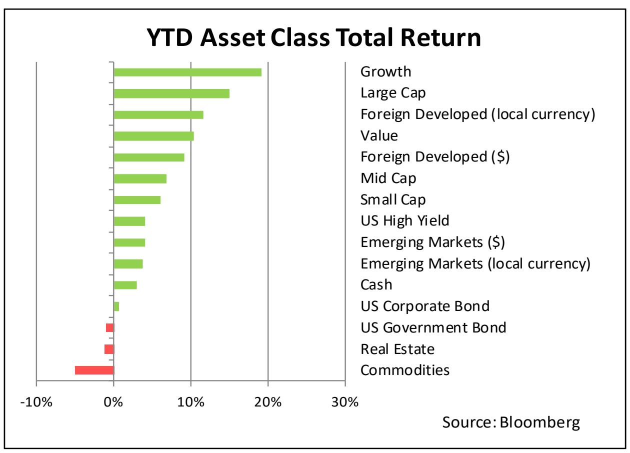




(Source: Bloomberg)

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 8/17/2023 close)

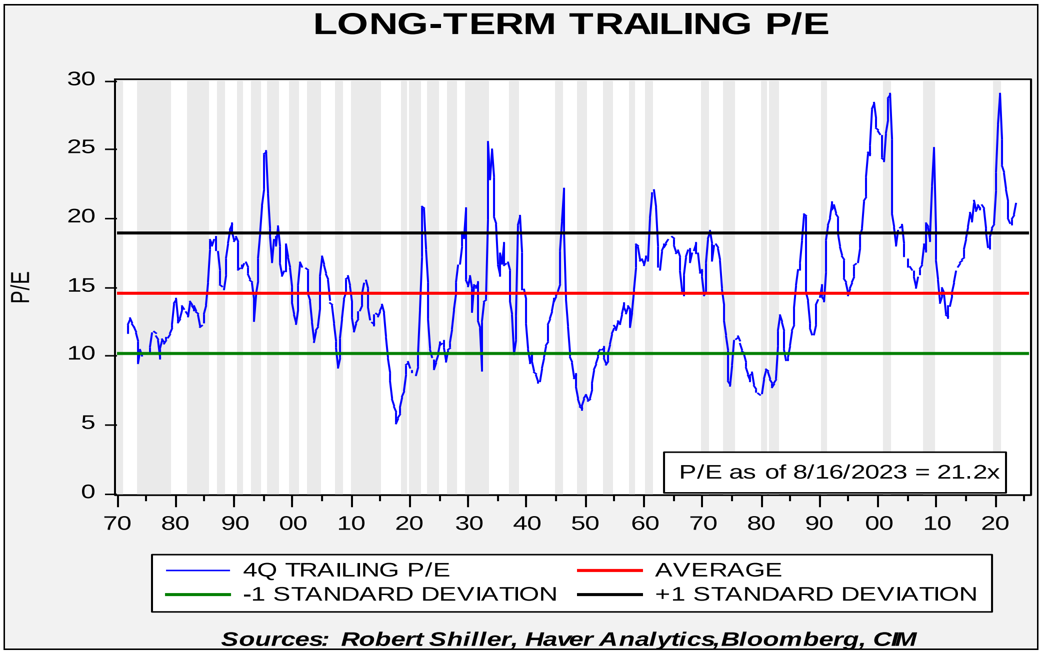


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.