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 24, 2023—9:30 AM EDT] Global equity markets are higher 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 up 2.3%. Chinese markets were higher, with the Shanghai Composite up 0.1% from its previous close and the Shenzhen Composite up 0.5%. U.S. equity index futures are signaling a higher open.

With 483 companies having reported so far, S&P 500 earnings for Q2 are running at $54.50 per share compared to estimates of $53.55 (a decline of 6.8% from Q2 2022). Of the companies that have reported thus far, 81.0% have exceeded expectations, while 14.5% have fallen short of expectations.

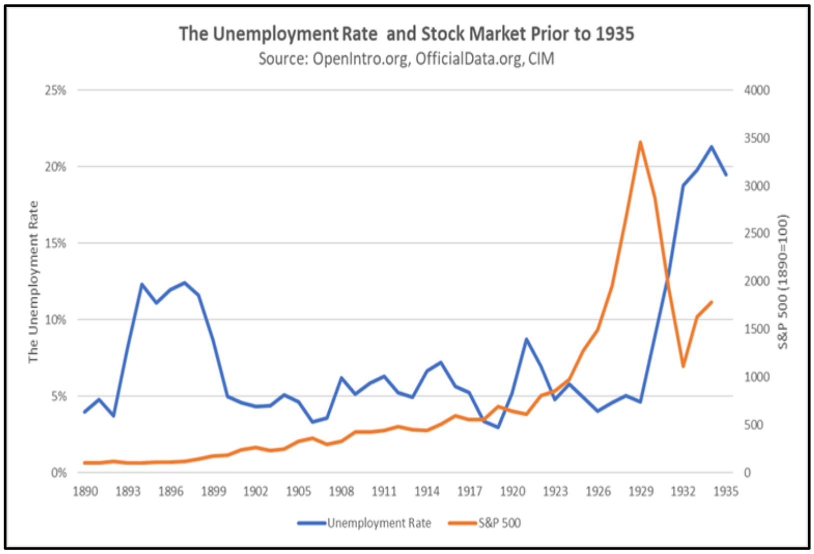
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (8/21/2023) (there will be no podcast for this report): "Reflections on the New Cold War"
- ***Weekly Energy Update*** **(8/24/2023): European LNG prices are swinging due to the combination of ample storage and worries about shortages this winter. Tensions in the Middle East remain high; although the Gulf State and Iran have been making diplomatic overtures, overall improvements in relations remain scarce**.
- *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 Q3 2023 Rebalance Presentation* (8/18/2023): Video presentation featuring the Asset Allocation Committee as they review the 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 (8/22/2023): "The Economics of Defense in Great Power Competition"

Good morning! Today's *Comment* focuses on three major themes: 1) Why mixed data shows that it is too soon to rule out the possibility of a recession; 2) How the GOP debates may be more important than people realize; and 3) Why Russian President Vladimir Putin will look to burnish his reputation going into the 2024 election.

Bad News Is Good News: Recent economic data has raised concerns about the possibility of a recession.

- Economic activity in the United States and Europe appears to be slowing, according to a preliminary survey. The [August S&P Composite PMI for the United States came in at 50.2,] just above the 50 threshold that separates expansion from contraction. The eurozone and the U.K. also saw their PMIs fall into contractionary territory, with readings of 47.0 and 47.9, respectively. While the manufacturing sector has seen the worst of the slowdown, there are also signs that the service sector is starting to feel the pinch.
- Surprisingly, the market responded positively to the disappointing results as it added to speculation that central banks will pause at their next meetings. The S&P 500 had its best day since June, closing the day higher by 1.1%. Meanwhile, the yield on the 10-year Treasury, which hit its highest level since 2007 earlier this week, fell 13 bps. The rise in optimism is related to investors' beliefs that the central bank may not make matters worse by raising benchmark interest rates. The CME FedWatch Tool predicts that there is an almost 90% chance that the Federal Reserve will stand pat at its September meeting.

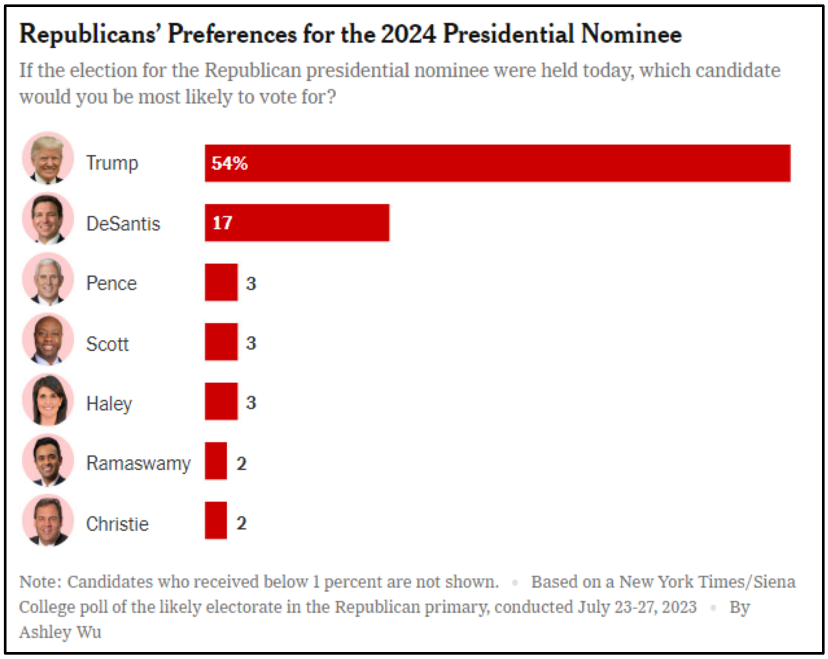


- It is not uncommon for a flurry of positive economic data to be released in the run-up to a recession. In fact, prior to the 2001 recession and the Great Financial Crisis, there was talk among experts that a downturn had been averted. Looking even further back, government data released before the Great Depression also did not provide much warning of the impending downturn. While we do not believe that the U.S. is currently in a recession, we are hesitant to say that the worst is over especially as central banks continue to raise interest rates.

First Face Off: GOP candidates had their first debate in Wisconsin on Wednesday in a test to see whom the new face of the party could be.

- The Republican presidential debate kicked off without much fanfare, as the candidates played it safe and avoided controversy. However, Nikki Haley stood out from the pack by highlighting her international experience and offering a different perspective on the country's problems. In a surprising move, she blamed her own party for the inflation crisis and accused her rival Vivek Ramaswamy of being soft on China by supporting Russia. Former President Donald Trump, who was not in attendance, is likely to keep his front-runner status, as no candidate was willing to directly take him on in the debate.

- President Trump's decision to skip the debate may not have been in his best interest. Debates are a chance for candidates to shape the national conversation on important issues, connect with voters, and defend their records. By not attending, Trump missed an opportunity to control the political narrative and shape the conversation on issues such as U.S. economic policy and border security. Trump has been a vocal critic of U.S. interventionism and is unlikely to support fiscal reforms that would disproportionately burden his voter base. As a result, President Trump may be forced to play defense when he finally enters the political arena.

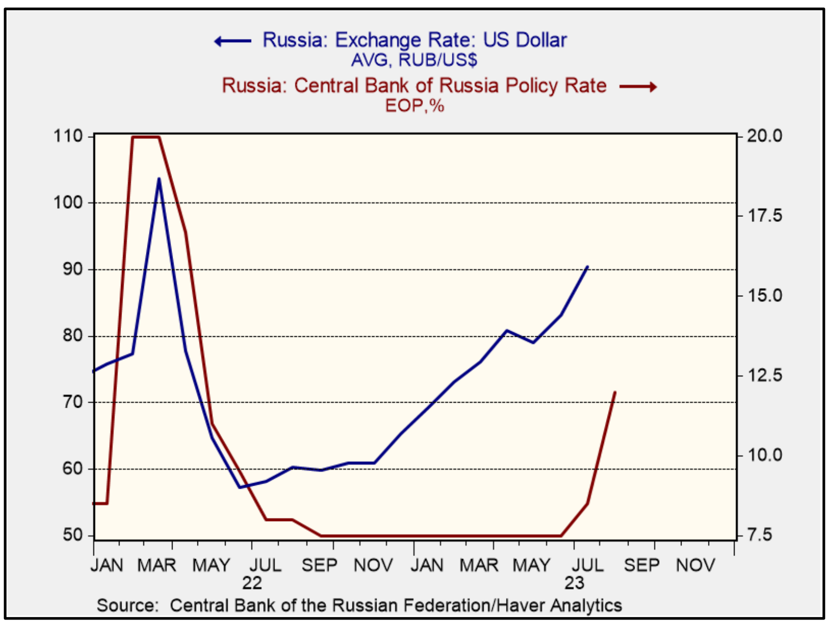


(Source: New York Times)

- One of the most pressing issues facing the next U.S. president will be how to deal with the global shift towards regional blocs. At the recent BRICS summit, Beijing and other members of the bloc pushed for emerging markets to join their group as a counter to the G7. In addition to dealing with China, the next U.S. president will also need to address the issue of how to navigate toward an economy built around resiliency as opposed to efficiency. The 2024 U.S. presidential election is still a long way off; therefore, investors have not priced in its potential outcome. If the candidates are perceived as being more hawkish towards China, or less committed to free trade, then financial markets could become more volatile.

Putin's Positioning: Russian President Vladimir Putin is seeking to position himself as a capable and decisive leader as he prepares for reelection in March 2024.

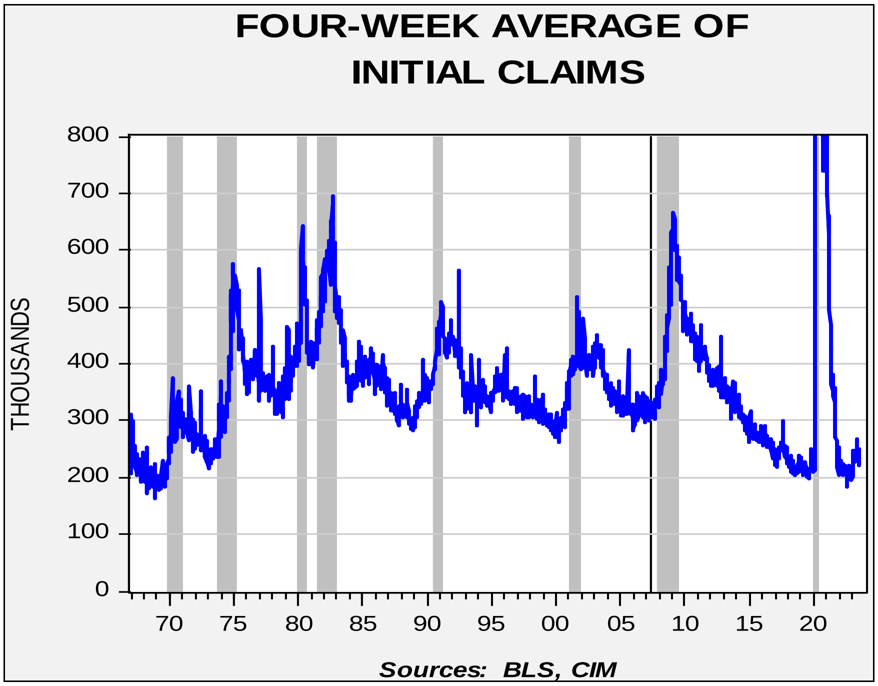
- Yevgeny Prigozhin, a potential rival to Russian President Vladimir Putin, died in a plane crash on Wednesday. Prigozhin was the leader of the mercenary Wagner Group that launched a failed mutiny in June. He was also formerly a close ally of Putin. The plane crash occurred as Prigozhin was traveling from Moscow to St. Petersburg. The cause of the crash is still under investigation, but it is believed that a Russian anti-aircraft defense system may have shot down the plane. Prigozhin's death is a significant development as he was seen as a potential threat to Putin's leadership.
- However, Putin still has a lot to worry about as he looks to boost his leadership credentials. The Russian economy is in freefall, with the ruble (RUB) down nearly 30% against the dollar since the start of the war in Ukraine. Also, Russia's current account balance has deteriorated considerably, and interest rates have surged. The country's oil and gas revenues have kept the country afloat, but they have shrunk by almost 50% in the first six months of the year. These poor economic indicators are likely to dampen sentiment among the Russian populace, especially as the pain of economic sanctions continues to hurt households. Putin will need to find ways to address these economic challenges if he wants to maintain his high approval ratings.



- In the face of a prolonged war effort, an attempted coup, and increasingly challenging economic conditions, Russian President Vladimir Putin appears poised to secure a fifth term in office come March 2024. Yet, lingering uncertainties persist regarding the extent of his support within the military ranks. Approaching the upcoming election, Putin is likely to adopt a more daring approach to reaffirm his strongman image, taking calculated risks to fortify his credentials. This dynamic environment introduces the potential for trade disruptions as the conflict continues to unfold, posing a significant risk to regional stability and economic activities.

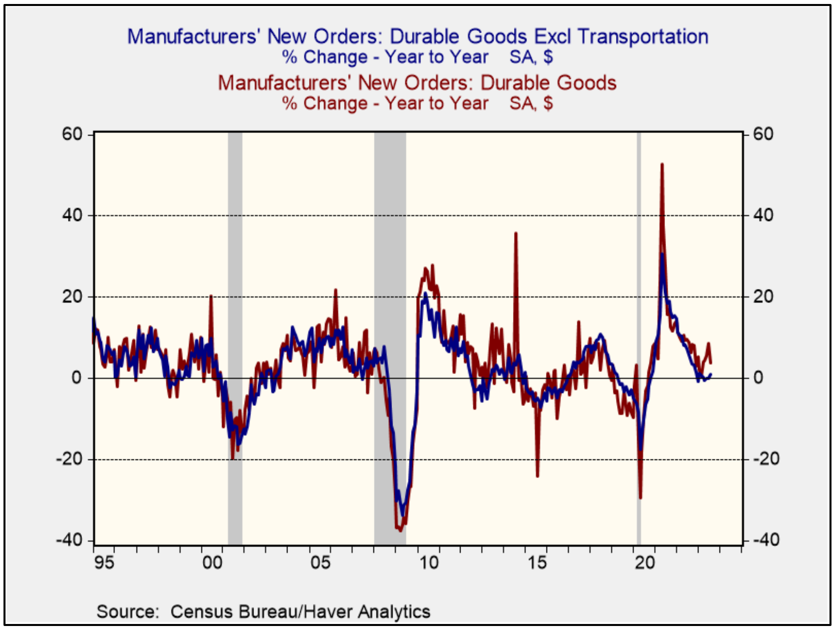
U.S. Economic Releases

Initial claims for the week ending August 19 came in lower than forecast at 230k, compared to expectations of 240k. Last week's report was revised to 239k from 240k. The four-week average of claims fell 4k to 236k.



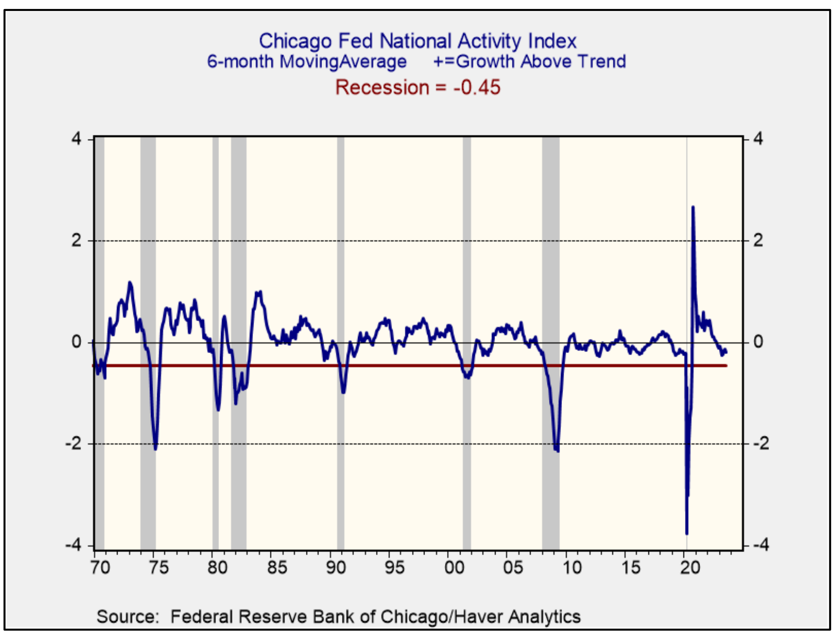
This chart shows the four-week average of claims going back to the mid-1960s. The upturn in claims, which began about a year ago, is consistent with a downturn in the business cycle. Nonetheless, it's not high enough yet to indicate a recession is underway. As we will note below, the Chicago FRB National Activity index is signaling something similar.

Durable goods orders for July came in much weaker than expected, falling 5.2% on a monthly basis compared to expectations of a 4.0% decline. The prior month was revised slightly higher to 4.6% from 4.2% initially reported. However, with this report, details do matter. This series is particularly sensitive to aircraft orders, and excluding transportation, orders rose 0.5%, better than the 0.2% expected. Non-defense capital goods orders excluding aircraft, a good proxy for manufacturing investment, rose 0.1%. Overall, this data is consistent with very slow, but steady, growth.



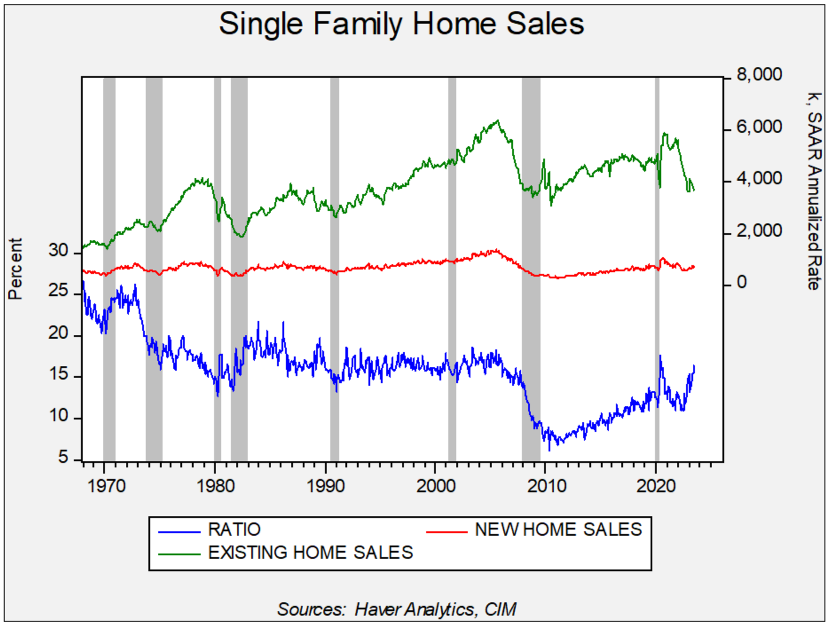
This chart shows the yearly change in overall durable goods orders and orders excluding transportation. As the data show, the economy is far from booming but isn't in recession either.

The Chicago FRB National Activity index for July came in much better than forecast, at 0.12 compared to expectations of -0.22. There are four components of this index: production and income; employment, unemployment, and hours; personal consumption and housing; and sales, orders, and inventories. In the report, production and income dominated while the other three were essentially flat.



We smooth the data with a six-month moving average. As with all the reports today, the data shows a soft economy but one that isn't in recession. The average reading is currently -0.19, above the recession signal of -0.45.

Finally, we wanted to note yesterday's new home sales data, particularly the difference between new and existing home sales.



The ratio line shows that new home sales are taking a larger share of total sales. But, for the most part, this recent rise is more of a normalization back to pre-financial crisis areas. Current homeowners are mostly stuck in their homes due to the difference in the mortgage rate they pay relative to the current rate. This difference has created an opening for new home construction that is being filled by the homebuilders.

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
11:00	Kansas City Fed Manfacturing Activity	m/m	Aug	-10	-11	*
Federal Reserve						
EST	Speaker or Event	District or Position				
10:00	Patrick Harker Interview With CNBC	President of the Federal Reserve Bank of Philadelphia				
11:15	Susan Collins Speaks on yahoo! Finance	President of the Federal Reserve Bank of Boston				

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	Foreign Buying Japan Bonds	w/w	18-Aug	¥1131.5bb	-¥871.1b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	18-Aug	-¥263.2b	-¥334.6b	-¥333.6b	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	18-Aug	¥185.6b	-¥54.7b	-¥54.2b	*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	18-Aug	-¥740.7b	¥227.2b	¥226.2b	*	Equity and bond neutral
South Korea	PPI	y/y	Jul	-0.2%	-0.2%	-0.3%	**	Equity and bond neutral
EUROPE								
Eurozone	Consumer Confidence	m/m	Aug P	-16.0	-15.1	-14.5	**	Equity bearish, bond bullish
France	Business Confidence	m/m	Aug	99	100	100	**	Equity bearish, bond bullish
	Manufacturing Confidence	m/m	Aug	96	100	101	*	Equity bearish, bond bullish
Russia	Industrial Production	y/y	Jul	4.9%	6.5%	5.8%	***	Equity bearish, bond bullish
AMERICAS								
Canada	Retail Sales	m/m	Jun	0.1%	0.2%	0.1%	**	Equity and bond neutral
	Retail Sales Ex-Autos	m/m	Jun	-0.8%	0.0%	-0.3%	**	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	564	0	Up
3-mo T-bill yield (bps)	529	529	0	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	539	539	0	Up
U.S. Libor/OIS spread (bps)	542	541	1	Up
10-yr T-note (%)	4.22	4.19	0.03	Flat
Euribor/OIS spread (bps)	383	381	2	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Down			Down
Pound	Down			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Korea Base Rate	3.500%	3.500%	3.500%	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	$83.32	$83.21	0.13%	
WTI	$78.93	$78.89	0.05%	
Natural Gas	$2.44	$2.50	-2.32%	
Crack Spread	$36.92	$36.38	1.47%	
12-mo strip crack	$30.02	$29.82	0.66%	
Ethanol rack	$2.36	$2.34	0.59%	
Metals				
Gold	$1,915.67	$1,915.48	0.01%	
Silver	$24.15	$24.31	-0.65%	
Copper contract	$380.70	$383.75	-0.79%	
Grains				
Corn contract	$489.25	$490.50	-0.25%	
Wheat contract	$639.75	$639.75	0.00%	
Soybeans contract	$1,367.25	$1,360.50	0.50%	
Shipping				
Baltic Dry Freight	1,151	1,194	-43	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-6.1	-3.0	-3.1	
Gasoline (mb)	1.5	-0.5	1.9	
Distillates (mb)	0.9	0.7	0.2	
Refinery run rates (%)	-0.2%	0.5%	-0.7%	
Natural gas (bcf)		29		

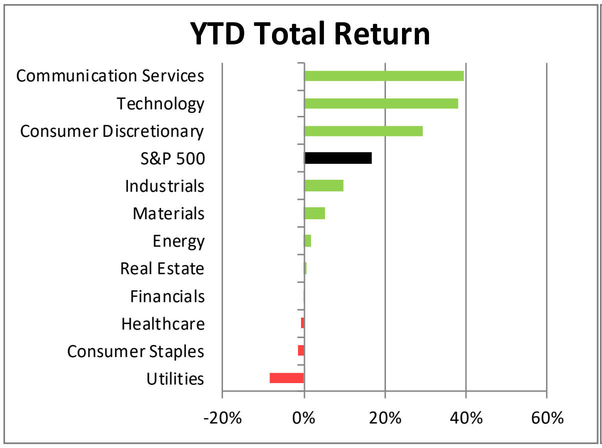
Weather

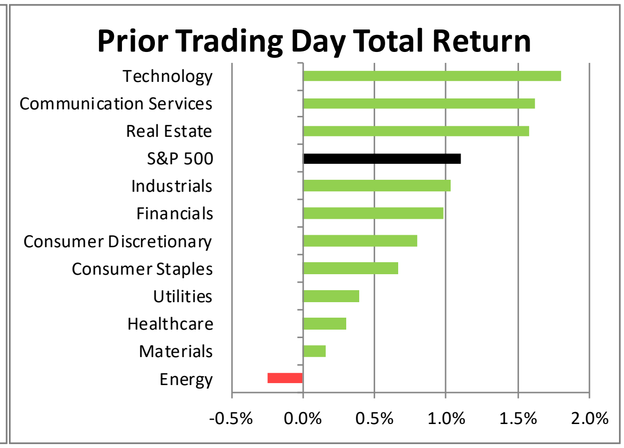
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for the western two-thirds of the nation, with below normal temps for New England into the Ohio Valley. A warming trend is expected to return in early September. Dry conditions dominate the Midwest, which might spur early harvest activity.

The Atlantic Ocean is currently showing four atmospheric disturbances, but only one remains a named storm. Tropical Storm Franklin has moved away from Turks and Caicos and is forecast to move directly north, threatening the Eastern Seaboard early next week. Two disturbances are in the central Atlantic Ocean, but only one is likely to achieve storm status. However, it probably won't be a threat to any land areas.

Data Section

U.S. Equity Markets – (as of 8/23/2023 close)

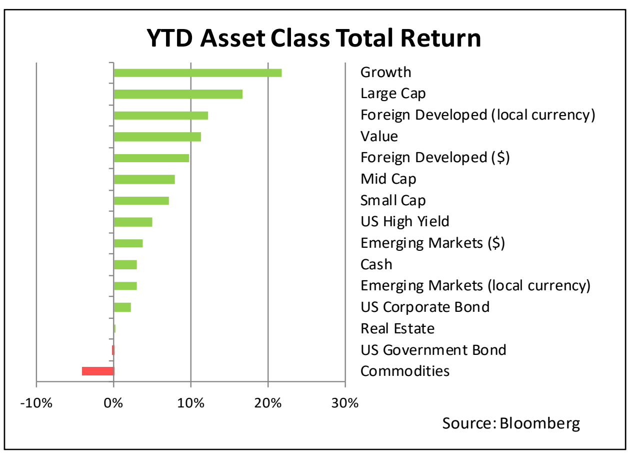




(Source: Bloomberg)

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 8/23/2023 close)

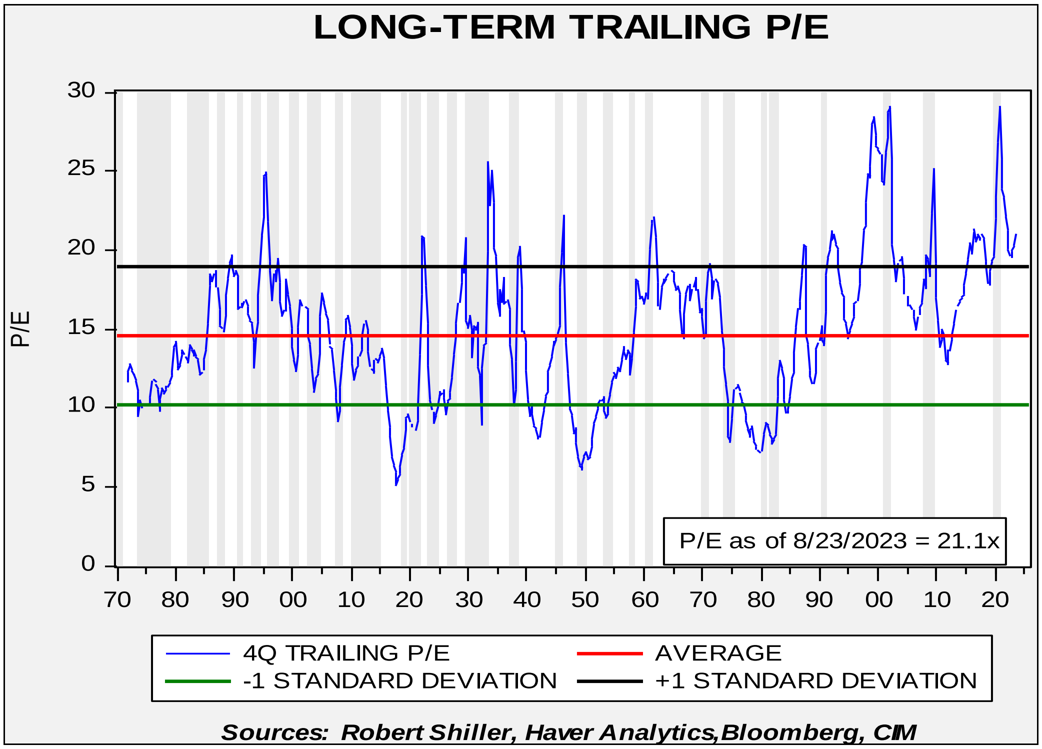


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 24, 2023



Based on our methodology,[1] the current P/E is 21.1x, down 0.1x from last week. Improved earnings coupled with falling index values led to the modest decline 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.