Daily Comment

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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 29, 2023—9:30 AM EDT] Global equity markets are mostly 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 1.0%. Chinese markets were higher, with the Shanghai Composite up 1.2% from its previous close and the Shenzhen Composite up 2.7%. In contrast, U.S. equity index futures are signaling a lower open.

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* (8/28/2023) (there will be no podcast for this report): "Examining the Rise in T-Note Yields"
- *Confluence of Ideas* podcast (8/22/2023): "The Economics of Defense in Great Power Competition"
- *Business Cycle Report* (8/24/23)

Our *Comment* today opens with concerns about a new El Niño event that could further boost global food prices and other global data showing a decline in alternative investments. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including a renewed commitment by the European Union to expand by 2030 and an analysis suggesting the U.S. labor force participation rate is now being held down mostly by demographics rather than the impact of the coronavirus pandemic.

Global Agriculture Markets: An expected warming of waters in the Pacific Ocean, known as El Niño, has officials and investors bracing for weather disruptions such as increased heat in Central America and increased rain in the Andes. Importantly, an El Niño event typically distorts crop cycles and could exacerbate today's existing food supply issues, such as Ukraine's grain export challenges because of Russia's invasion and India's ban on exports after heavy rains damaged its rice crop. The results could include higher food prices around the world, boosting overall consumer price inflation and interest rates, and might also lead to political unrest in poorer countries.

Global Alternative Investment Market: Data from Preqin shows that alternative investment funds—which invest in assets ranging from private equity and hedge funds to real estate and private credit—have raised just $740 billion since the start of this year, down 27% from the $1.02 trillion raised in same period last year. The drop in fundraising reflects the impact of higher global interest rates, weak stock markets late last year, and a tepid market for initial public offerings.

European Union: European Council President Charles Michel said in a speech that the EU should be ready to admit Ukraine, various Balkan states, and other countries into the bloc by 2030. Michel argued that setting a specific target date would force current EU members to grapple with the changes needed to admit new members while also galvanizing reforms in aspirant countries.

Germany: Average wages in the second quarter were up a record 6.6% from the same period one year earlier, slightly beating the consumer price inflation of 6.5% over the same timeframe and accelerating from a wage rise of 5.6% in the year ended in the first quarter. Amid Germany's broader, structural economic challenges, the figures suggest that German workers are at least no longer facing a decline in their real purchasing power. Nonetheless, the figures also bolster concerns about on-going price pressures and the potential for further monetary tightening by the European Central Bank.

Brazil: Leftist President Luiz Inácio Lula da Silva is reportedly close to striking a deal with two right-wing parties formerly allied with his defeated rival, Former President Jair Bolsonaro, in a move aimed at overcoming Congressional opposition to his initiatives to hike public spending and pass greater protections for workers, minorities, and the environment. The deal would cede cabinet posts and potentially other roles in return for support in Congress, where the coalition led by Lula and his Workers' Party does not command a majority.

China: Photographs on social media show that the Chinese navy has finally launched the first of its Type 054B frigates, which sport an advanced phased-radar system, a stealth mast aimed at allowing it to sail undetected through the seas along China's coast, an integrated electric propulsion system that will allow it to power a wider range of weapons, and an active towed-sonar system designed to identify U.S. and allied submarines. The ship is also the largest Type 054 variant, with an estimated length of 482 feet and a width of almost 60 feet.

- As we have mentioned before, China now has the world's largest navy, with a combat force of approximately 350 ships. The U.S. Navy is now a distant second, with about 295 ships.
- Importantly, as this report illustrates, China also continues to make steady progress in increasing the size and capabilities of its vessels.

An image posted on China's social media demonstrates the size of (from left) the Type 054B, 054A and the original 054. Photo: Weibo

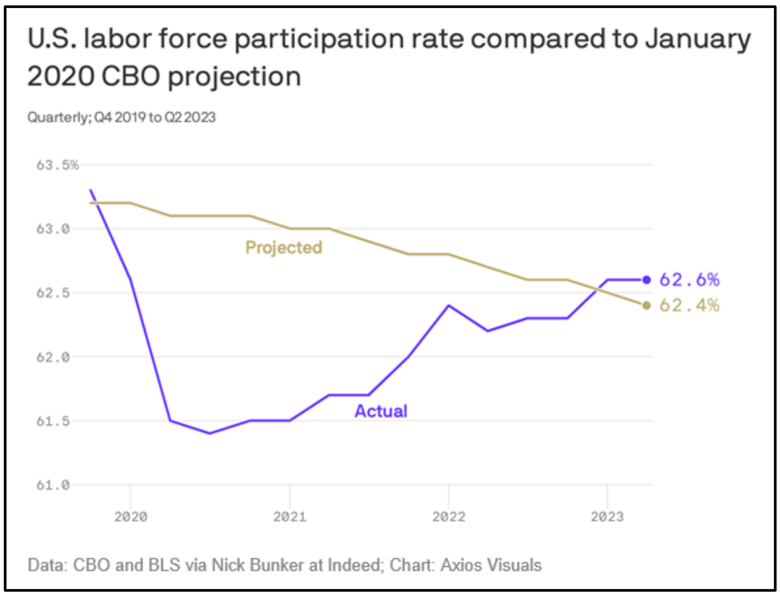
United States-China: Commerce Secretary Raimondo today tried to counterbalance her Monday statements that the U.S. would prioritize national security and protect its workers, saying the country was nevertheless not intending to "decouple" from China. The reporting on the second day also indicates that U.S. and Chinese officials have agreed to regular information-sharing meetings designed to ease economic tensions.

- While certain members of the Biden administration have taken a tough stance against the geopolitical and economic threat from China, the administration has recently tried to use bilateral meetings to ease tensions. At least in part, that probably reflects pressure from foreign allies and the left wing of the domestic political system.
- Nevertheless, we suspect that bilateral meetings, information-sharing sessions, and the like can only go so far in easing tensions. China's economic imperatives probably still include steps to boost its trade and investment activity around the world, often at the expense of established Western companies and their workers. More important, we think China's increasingly aggressive military activity and the continued build-up in its conventional and nuclear arsenal (see above) will ultimately spoil any benefit from eased economic tensions.

U.S. Industrial Sector: The *Wall Street Journal*'s "Heard on the Street" column has recently run at least few stories extolling U.S. industrial and basic materials firms as likely beneficiaries of the re-industrialization and factory building boom that we've been writing about. Last week, the column featured industrial machine maker Rockwell Automation (ROK, $309.05), and today it features steelmaker U.S. Steel (X, $29.92). We don't necessarily endorse the specific analyses or recommendations regarding those stocks. All the same, we do think the articles illustrate how the investor class is swinging around to our view that the industrial sector is attractive as the world fractures into relatively separate geopolitical and economic blocs, and as more production is shifted out of China and back to the U.S. or to U.S. allies.

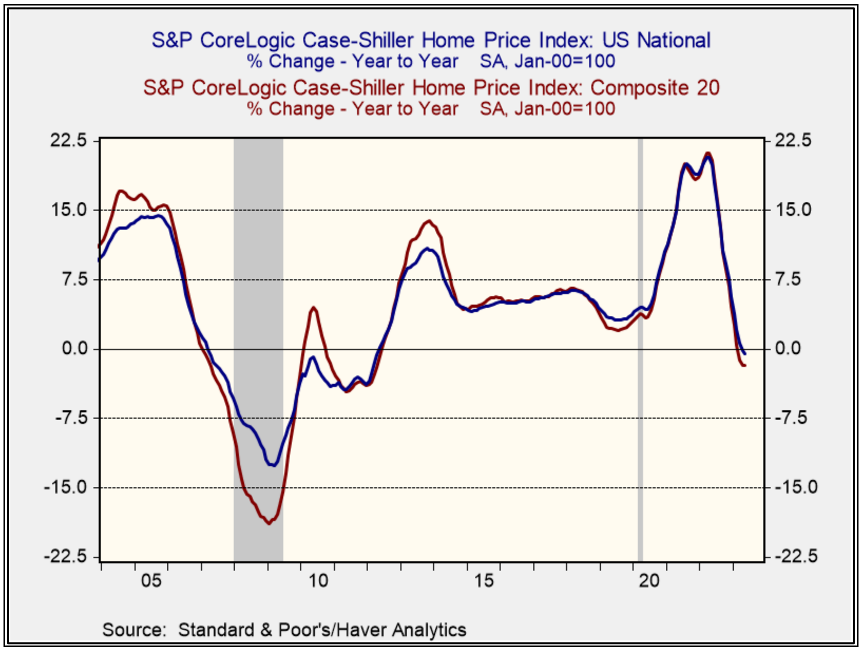
U.S. Labor Market: Analysis from Axios shows the labor force participation rate has recently been exceeding the Congressional Budget Office's early-2022 forecast for this period. The LFPR (the share of adult, non-institutionalized civilians who are working or seeking work) has stood at 62.6% for several months, versus a CBO forecast of 62.4%. The coronavirus pandemic certainly drove the LFPR way below forecast for almost three years, sparking big labor shortages across the economy. Nevertheless, the new analysis suggests that today's labor shortages are largely the result of long-standing trends in population aging and high levels of retirement.

- Today's labor shortages, strong wage growth, and high consumer price pressures, therefore, look to remain in place for the foreseeable future.
- Of course, that will also tend to make today's high consumer price inflation "sticky" and encourage the Federal Reserve to keep interest rates high for an extended period.



U.S. Economic Releases

Residential home prices picked up in June but still remain below 2022 levels, according to two data sources. The Federal Housing Finance Agency Home Price Index, rose 0.3% from the prior month, compared to expectations of 0.6%. Meanwhile, the S&P CoreLogic 20-City Composite rose 0.9% to from the previous month. The rise was above expectations of 0.8% but below the previous month's reading of 1.0%.



The chart above shows the annual change in the S&P CoreLogic National and 20-City Index. The National Index was relatively unchanged from the previous year, while the 20-City Index fell 1.2% in the same period.

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	JOLTS Job Openings	m/m	Jul	9450k	9582k	**
10:00	Conf. Board Consumer Confidence	m/m	Aug	116.0	117.0	***
10:00	Conf. Board Present Situation	m/m	Aug		160.0	**
10:00	Conf. Board Expectations	m/m	Aug		88.3	**
10:30	Dallas Fed Services Activity	m/m	Aug		-4.2	**
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
15:00	Michael Barr Speaks About Banking Services	Federal Reserve Board Vice Chair for Supervision				

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	Jobless Rate	m/m	Jul	2.7%	2.5%	2.5%	***	Equity and bond neutral
	Job-To-Applicant Ratio	m/m	Jul	1.3%	1.3%	1.3%	**	Equity and bond neutral
South Korea	Depart. Store Sales	y/y	Jul	2.1%	0.3%		*	Equity and bond neutral
	Retail Sales	y/y	Jul	5.9%	6.6%		**	Equity bearish, bond bullish
	Discount Store Sales	y/y	Jul	2.6%	0.3%		*	Equity bullish, bond bearish
EUROPE								
Germany	GfK Consumer Confidence	m/m	Sep	-25.5%	-24.4%	-24.6%	**	Equity bearish, bond bullish
France	Consumer Confidence	m/m	Aug	85.0	85.0	85.0	**	Equity and bond neutral
AMERICAS								
Mexico	GDP NSA	y/y	2Q F	3.6%	3.7%	3.7%	***	Equity and bond neutral
	Economic Activity IGAE	y/y	Jun	4.1%	4.31%	4.19%	**	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)	567	565	2	Up
3-mo T-bill yield (bps)	529	531	-2	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	542	542	0	Up
U.S. Libor/OIS spread (bps)	544	544	0	Up
10-yr T-note (%)	4.22	4.20	0.02	Flat
Euribor/OIS spread (bps)	377	379	-2	Up
Currencies	Direction			
Dollar	Flat			Flat
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	$84.99	$84.42	0.68%	
WTI	$80.60	$80.10	0.62%	
Natural Gas	$2.54	$2.58	-1.36%	
Crack Spread	$35.37	$35.85	-1.35%	
12-mo strip crack	$29.58	$29.66	-0.26%	
Ethanol rack	$2.40	$2.39	0.26%	
Metals				
Gold	$1,917.07	$1,920.17	-0.16%	
Silver	$24.21	$24.23	-0.09%	
Copper contract	$380.50	$379.20	0.34%	
Grains				
Corn contract	$493.50	$496.25	-0.55%	
Wheat contract	$610.75	$617.00	-1.01%	
Soybeans contract	$1,393.25	$1,405.75	-0.89%	
Shipping				
Baltic Dry Freight	1,080	1,110	-30	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.2		
Gasoline (mb)		-1.3		
Distillates (mb)		-1.0		
Refinery run rates (%)		0.5%		
Natural gas (bcf)		31		

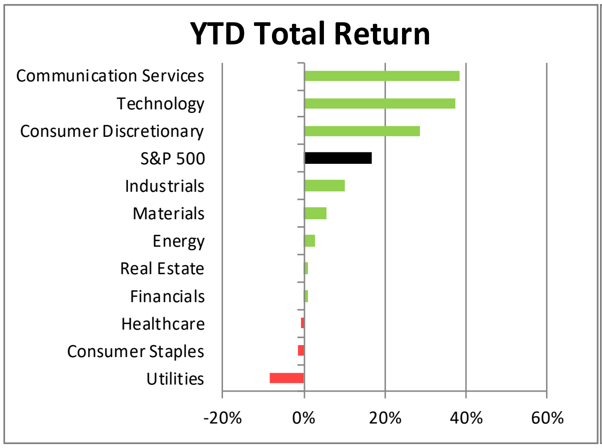
Weather

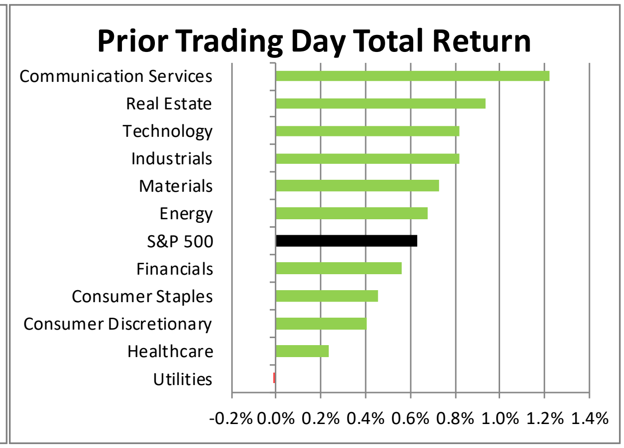
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for most of the country, with below-normal temps in the Pacific. The precipitation outlook shows dry conditions are expected in most states, with wet conditions in the northern Pacific region.

There are four atmospheric disturbances in the Atlantic Ocean. Hurricane Franklin, a Category 2 storm, is expected to make landfall in Bermuda later today before moving northward. Hurricane Idalia is moving along the Florida Gulf Coast and is expected to make landfall in the state on Wednesday. The other two disturbances are deep in the Atlantic and have at most a 50% chance of cyclone formation within the next 48 hours.

Data Section

U.S. Equity Markets – (as of 8/28/2023 close)

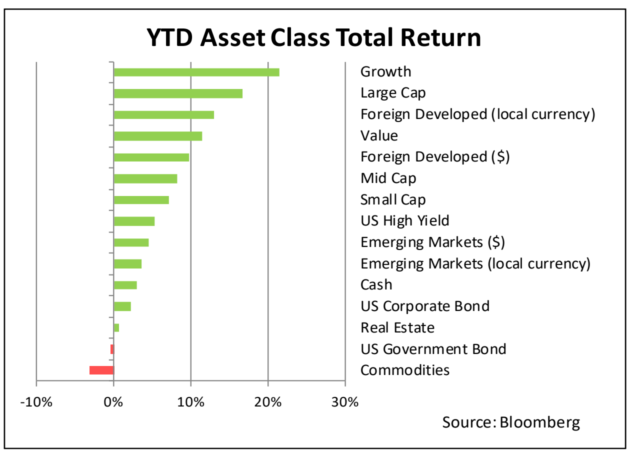




(Source: Bloomberg)

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 8/28/2023 close)

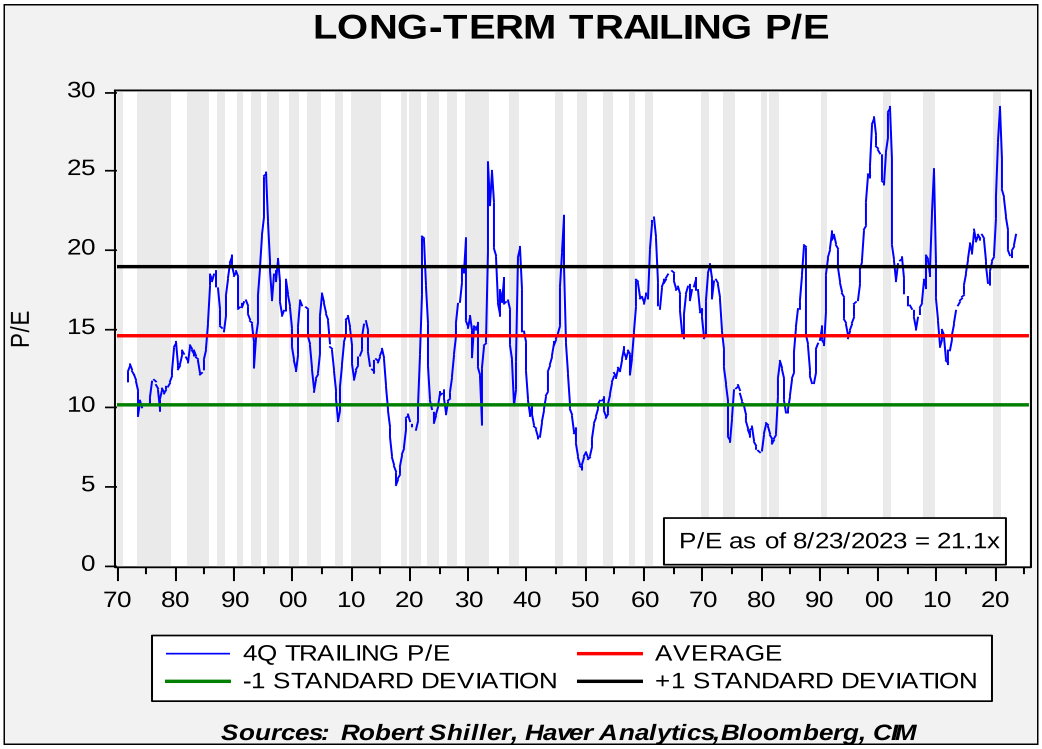


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.