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 2, 2023—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is down 0.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 2.3%. Chinese markets were lower, with the Shanghai Composite down 0.9% from its previous close and the Shenzhen Composite down 0.3%. U.S. equity index futures are signaling a lower open.

With 313 companies having reported so far, S&P 500 earnings for Q2 are running at $53.00 per share, compared to estimates of $53.55 (a decline of 6.8% from Q2 2022). Of the companies that have reported thus far, 82.7% have exceeded expectations while 12.8% have fallen short of expectations.

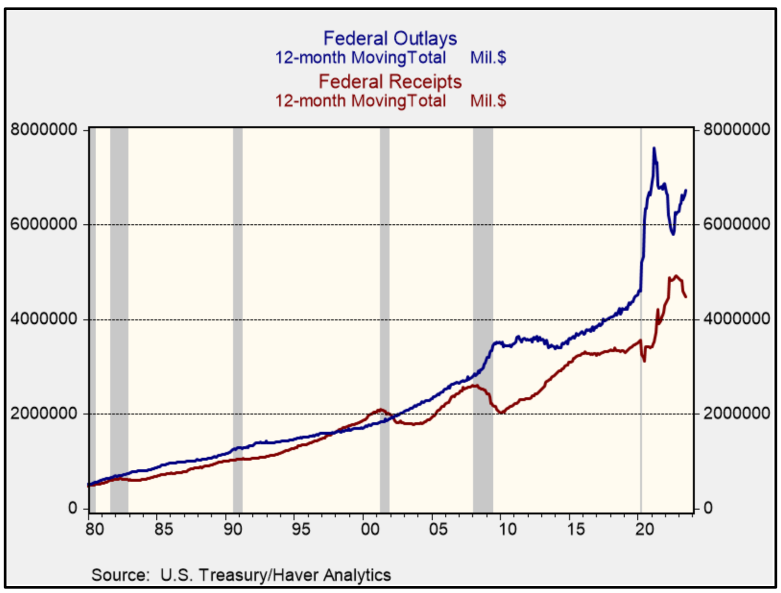
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (7/24/2023) (with associated podcast): "China's Collapsing Population"
- *Weekly Energy Update* (7/27/2023): The SPR sales appear to have ended, and the U.S. is sending additional military assets to the Middle East.
- *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* (7/31/2023) (with associated podcast): "Part-Time Troubles"
- *Confluence of Ideas* podcast (7/10/2023): "The 2023 Mid-Year Geopolitical Outlook"

Our *Comment* today opens with a discussion of Fitch's decision to cut the U.S. government's bond rating to one notch below its highest score. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including news of possible new U.S. restrictions on Chinese semiconductors and rising global food prices as Russia attacks Ukraine's grain-export facilities.

U.S. Treasury Market: After market close yesterday, Fitch Ratings cut its assessment of U.S. Treasury bonds to AA+, down from its top rating of AAA. Fitch attributed the downgrade to growing U.S. fiscal deficits, high debt, and political dysfunction. The Fitch downgrade is the first such action by a ratings firm since a similar move by Standard & Poor's in 2011.

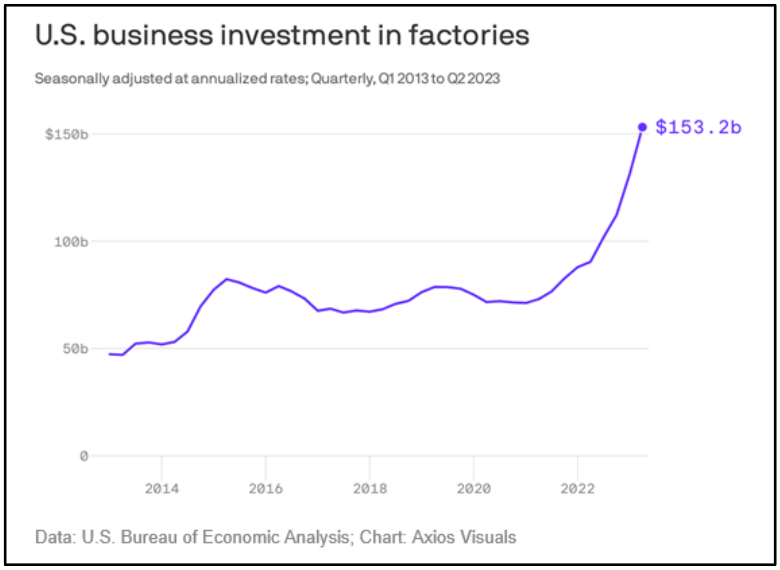
- At this point, it appears the downgrade has not produced any considerable disruptions in the Treasury market. We have not been able to identify any major Treasury holder that would be forced to sell the obligations because of the downgrade. Other analysts and observers that we track also seem to be taking a relatively sanguine view of Fitch's actions. Indeed, so far this morning, Treasury prices are up across almost the entire yield curve, pushing yields lower. The yield on the benchmark 10-year note has fallen slightly to 4.014%.
- Nevertheless, having two of the three major bond assessment firms rating the U.S. government below their top rating has the potential to erode faith in Treasury obligations over time, potentially driving up yields in the future. More immediately, the rating cut has undermined sentiment toward risk assets today, and major stock market indices are modestly lower.



United States-China: U.S. officials are growing concerned that China is rapidly ramping up its production of less-advanced, highly commoditized semiconductors in order to dump them on the world market and put competitors in the U.S.-led bloc out of business, as it has done with solar panels and other industries. That would put China in control of the important market (even though the semiconductors at issue are relatively less advanced, they are still critical to a wide range of industries).

- The Chinese move could be retaliation for the Biden administration's draconian crackdown on selling advanced semiconductor technology to China last October.
- U.S. officials are reportedly starting to consider moves to block the Chinese threat, but no measures are imminent.

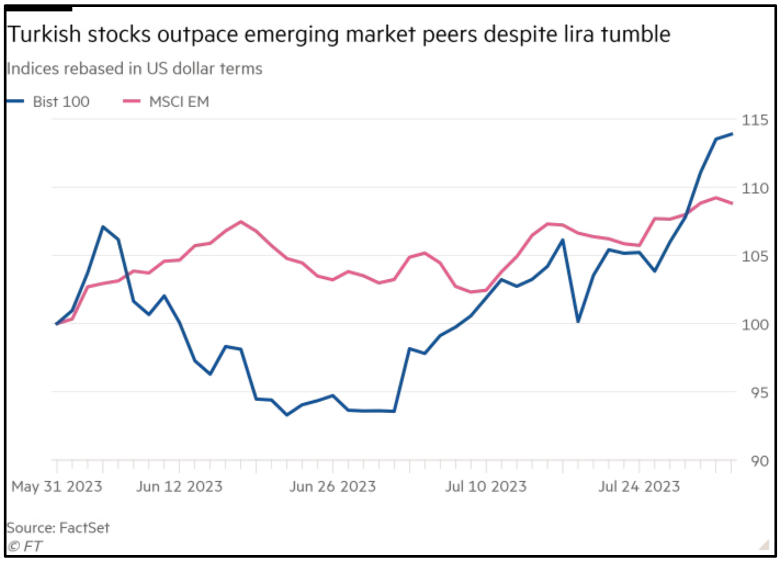
U.S. Industrial Sector: Consistent with our recent analyses, incoming data points to continued strong investment in new factory construction. Data out yesterday showed that nonresidential construction (which would include manufacturing facilities) rose 17% in the second quarter from the previous three months. According to last week's report on gross domestic product, second-quarter business investment in "manufacturing structures," aka factories, was up nearly 70% from the same period one year earlier.



Russia-Ukraine War: Russia launched another salvo of missile and drone strikes against Ukrainian port facilities and grain storage infrastructure last night, partially reversing the decline in key grain prices over the last week or so. Nearby wheat futures are trading up 1.1% to $6.5925 per bushel so far this morning, while corn futures are up 0.5% to $5.0925 per bushel.

- Just as important, we note that the facilities Russia struck last night are on the Danube River, just across from NATO-member Romania. On top of that, the Polish government yesterday said military helicopters from Russian ally Belarus violated its airspace, forcing Poland to rush more of its armed forces to the border.
- The Russian attacks on Ukraine's grain facilities are raising the prospects for accidental damage to Romanian territory, which would threaten to bring NATO forces directly into the conflict.

Turkey: Now that President Erdoğan has won re-election and is shifting his economic policy in a more orthodox direction, foreign purchases of Turkish stocks have rebounded and helped push the country's stock market indices higher. Adding fuel to the fire, the policy change has pushed the lira (TRY) sharply lower, adding to inflation pressures and pushing more Turks into the market. With strong buying from both foreign and domestic investors, the benchmark BIST 100 stock price index is up 46% since the end of May in TRY terms, and 14% in USD terms.

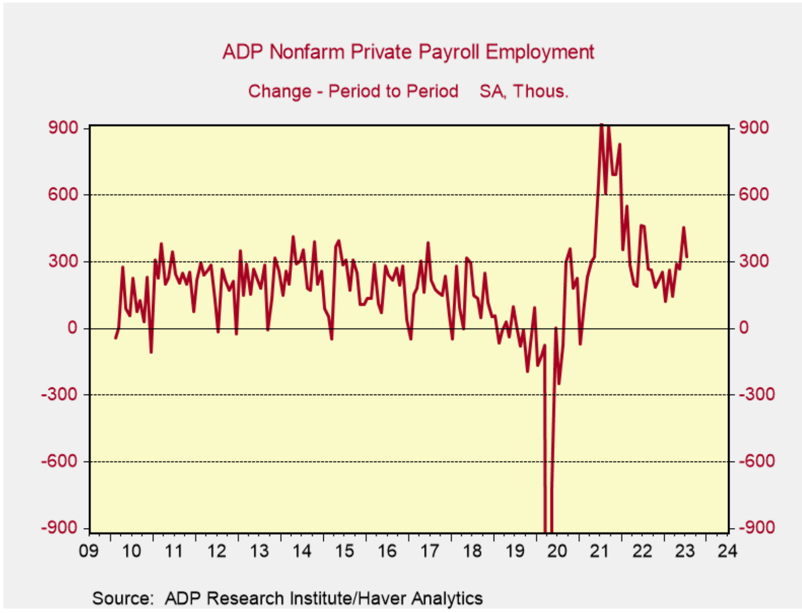


India: Ethnic and religious violence [has been surging in India in the run-up to next year's elections](), in which Prime Minister Modi and his Hindu-nationalist Bharatiya Janata Party will be trying to retain power. In the latest incident, Hindu-Muslim clashes broke out on Monday near a key business district on the outskirts of New Delhi. The growing violence threatens to undermine investors' recent focus on India as they pivot away from China because of its slowing economic growth, state interference in the economy, and tensions with the West.

U.S. Economic Releases

Elevated borrowing costs weighed on residential loan demand. According to an index tracked by the Mortgage Bankers Association (MBA), mortgage applications fell 3.0% in the week ending July 28. The drop in loan requests is related to a subtle rise in interest rates. The average 30-year fixed-rate mortgage rose from 6.87% to 6.93%. As a result, the MBA tracker for purchases declined 3.2% from the prior week, while the tracker for refinancing fell 2.5% in the same period.

Separately, private payrolls expanded at a stronger than expected pace. Data collected from data payroll management firm ADP, showed that the country added 324k jobs in July. The reading is well above expectations of 187k, but lower than the previous month's increase of 497k.



The chart above shows the monthly change in ADP private payrolls. A strong jobs report would suggest that the labor market remains tight. If Friday's BLS report shows a similar rise in job creation, the Federal Reserve may be encouraged to raise interest rates at least one more time this year.

There are no economic releases or Fed events scheduled for the rest of the day.

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	Monetary Base	y/y	Jul	-1.3%	-1.0%		**	Equity and bond neutral
	Monetary Base, End of Period	m/m	Jul	¥668.9t	¥670.6t		*	Equity and bond neutral
New Zealand	Employment Change	m/m	2Q	4.0%	2.5%	2.9%	**	Equity bullish, bond bearish
South Korea	CPI	y/y	Jul	2.3%	2.7%	2.4%	***	Equity and bond neutral
EUROPE								
Switzerland	Manufacturing PMI	m/m	Jul	38.5	44.9	44.0	***	Equity bearish, bond bullish
AMERICAS								
Canada	S&P Global Manufacturing PMI	m/m	Jul	49.6	48.8		***	Equity bullish, bond bearish
Mexico	S&P Global Manufacturing PMI	m/m	Jul	53.2	46.6		***	Equity bullish, bond bearish
	International Reserves Weekly	w/w	28-Jul	$204.1b	$204.2b		*	Equity and bond neutral
Brazil	S&P Global Manufacturing PMI	m/m	Jul	47.8	46.6		***	Equity bullish, bond bearish
	Trade Balance	m/m	Jul	$9035m	$10592m	$10592m	**	Equity and bond neutral
	Exports	m/m	Jul	$29062m	$30094m	$30094m	*	Equity and bond neutral
	Imports	m/m	Jul	$20027m	$19502m	$20250m	*	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.

Fixed Income	Today	Prior	Change	Trend
3-mo Libor yield (bps)	563	563	0	Up
3-mo T-bill yield (bps)	524	526	-2	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	536	536	0	Up
U.S. Libor/OIS spread (bps)	539	539	0	Up
10-yr T-note (%)	4.02	4.03	-0.01	Flat
Euribor/OIS spread (bps)	372	372	0	Up
Currencies	Direction			
Dollar	Flat			Up
Euro	Flat			Down
Yen	Up			Down
Pound	Flat			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	$85.38	$84.91	0.55%	
WTI	$81.89	$81.37	0.64%	
Natural Gas	$2.53	$2.56	-1.02%	
Crack Spread	$42.14	$42.03	0.27%	
12-mo strip crack	$30.68	$30.90	-0.73%	
Ethanol rack	$2.43	$2.44	-0.62%	
Metals				
Gold	$1,950.50	$1,944.29	0.32%	
Silver	$24.39	$24.31	0.34%	
Copper contract	$388.30	$390.85	-0.65%	
Grains				
Corn contract	$509.00	$507.25	0.34%	
Wheat contract	$658.75	$652.25	1.00%	
Soybeans contract	$1,327.75	$1,341.25	-1.01%	
Shipping				
Baltic Dry Freight	1,150	1,127	23	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.1		
Gasoline (mb)		-1.6		
Distillates (mb)		0.1		
Refinery run rates (%)		-0.6%		
Natural gas (bcf)		18		

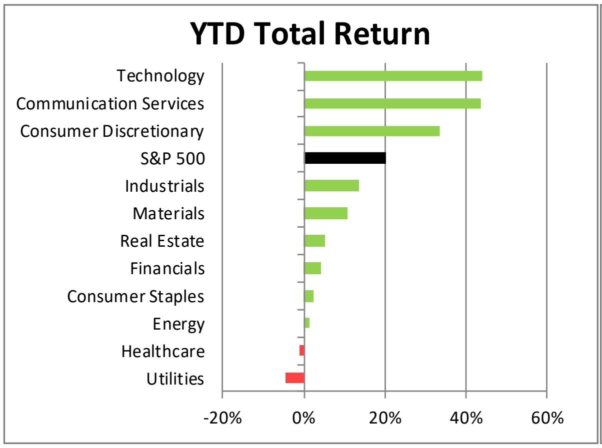
Weather

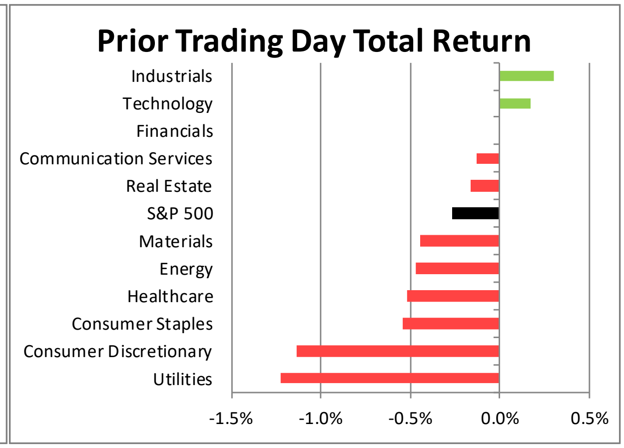
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in the Deep South and Pacific region, with cooler-than-normal temperatures expected for the rest of the country. The precipitation outlook calls for wetter-than-normal conditions in most states, with dry conditions expected in the Southwest.

There is one disturbance in the Atlantic Ocean that has a chance of developing into a tropical cyclone. The storm is located southeast of Bermuda and has less than a 10% chance of cyclone formation within the next 48 hours.

Data Section

U.S. Equity Markets – (as of 8/1/2023 close)

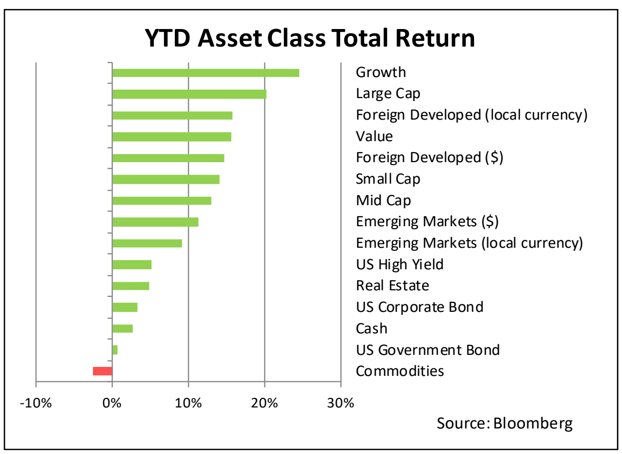




(Source: Bloomberg)

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 8/1/2023 close)

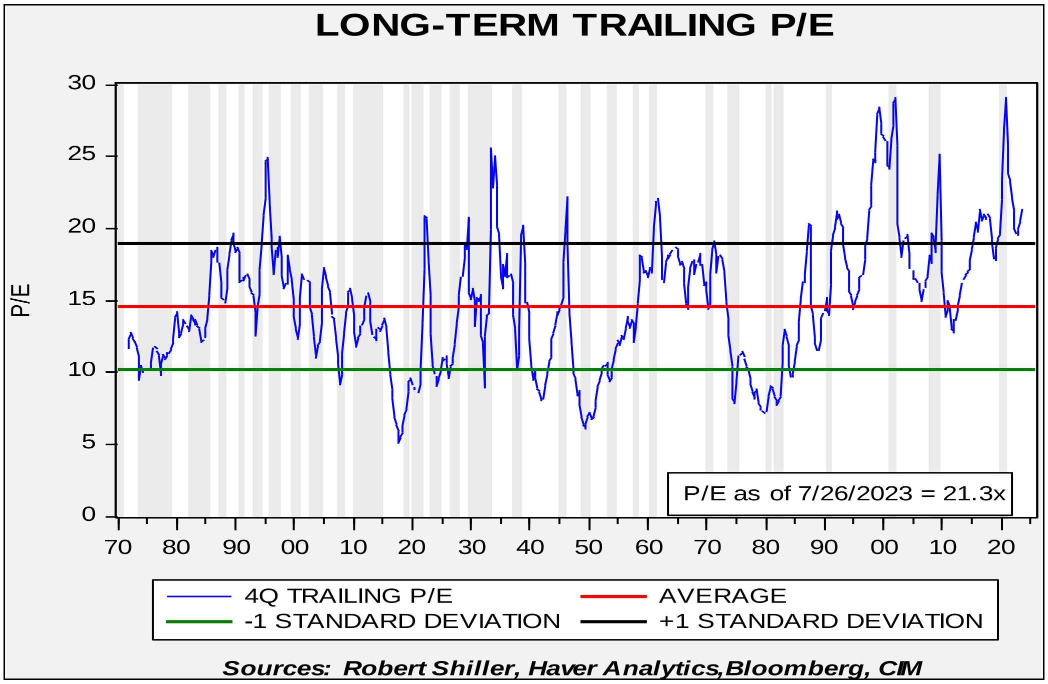


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

July 27, 2023



Based on our methodology,[1] the current P/E is 21.3x, down 0.1x from last week. Better earnings lowered 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.

[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.