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 31, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.5%. Chinese markets were lower, with the Shanghai Composite down 0.6% from its previous close and the Shenzhen Composite also down 0.6%. U.S. equity index futures are signaling a higher open.

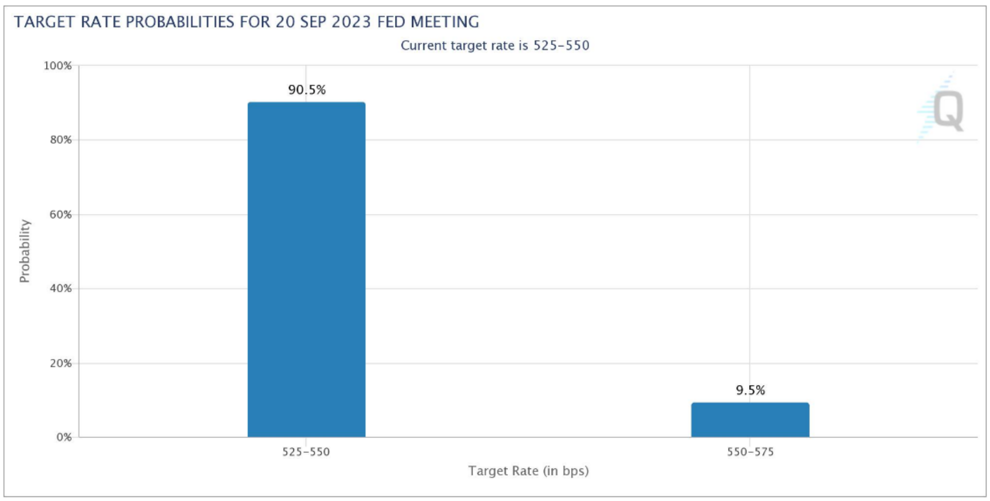
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (8/21/2023) (there will be no podcast for this report): "Reflections on the New Cold War"
- ***Weekly Energy Update*** **(8/31/2023): We take a short look at the forecasts for oil demand and note that a major oil ETF is reverting to an earlier method of managing its investment in various contract months. We also note that one reason why Iran prefers to live under sanctions is that it benefits those in power. Saudi Arabia is wooing both the U.S. and China to build nuclear power. Also, a coming battery glut may be looming as China steps up production**.
- *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)

Good morning! Today's *Comment* has three main themes: 1) Why markets are rethinking expectations that the U.S. was in recovery; 2) How regulators are looking to rein in banks with new regulations; and 3) How El Niño may be a problem for the rest of the world but could lead to lower energy costs in the U.S.

Optimism Fading: Data continues to show a mixed picture of the current state of the economy.

- Revision to the gross domestic product (GDP) and a release of private payroll information suggest that the economic activity is slowing. According to the Bureau of Economic Analysis, the economy expanded at an annual rate of 2.1% in Q2 2023, slower than the 2.4% in the previous report. On the same day, ADP private payrolls showed that the economy added 177k jobs in August, significantly lower than the previous month's revised reading of 371k. The disappointing data has challenged the assumption that the worst is behind us and has raised hopes that the Federal Reserve will pause in September.
- Investors welcomed the report, with many dreaming of a possible end to the rate-hiking cycle. The S&P 500 closed higher on Wednesday, while the yield on the 10-year Treasury fell to a three-week low. This shift in sentiment comes a day ahead of the release of the BLS payrolls report. If the report shows another setback in job growth, it will likely strengthen expectations that the Federal Reserve is done raising rates. The latest CME FedWatch Tool suggests that the FOMC is 90% likely to hold rates in September, and there is a nearly 60% chance of rates rising before the end of the year.

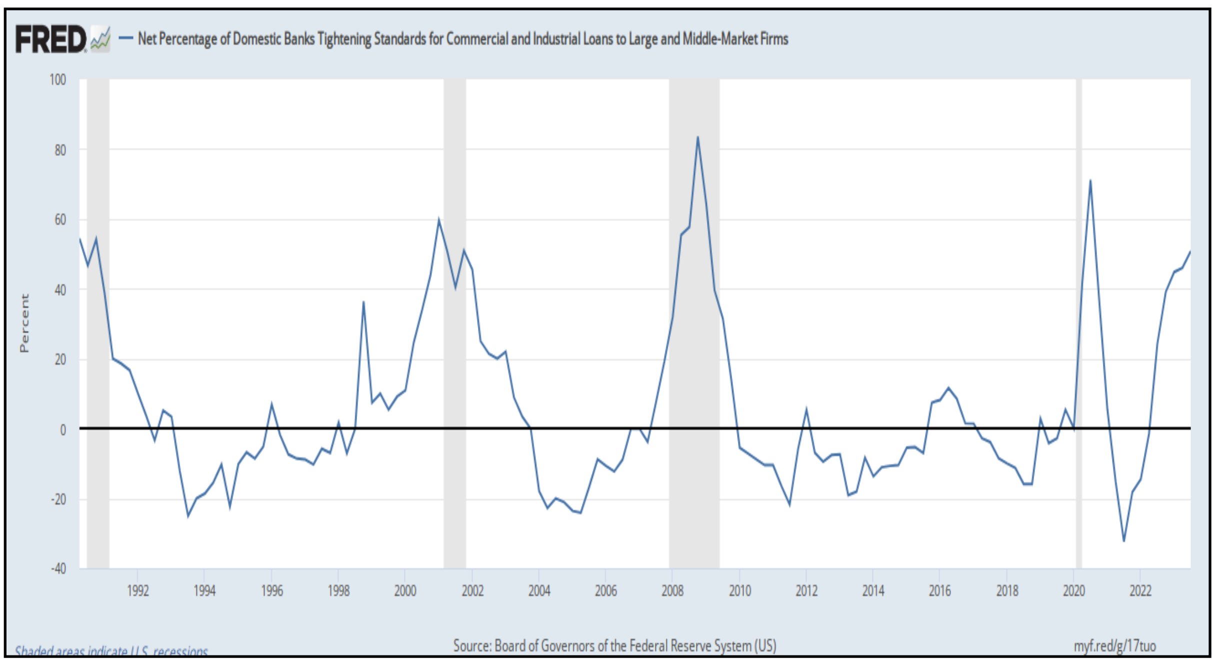


(Source: CME Group)

- The economic outlook is becoming increasingly uncertain and complex. While it was widely expected that rapidly rising interest rates would hinder GDP growth, the fiscal and monetary response has altered this dynamic. Stimulus checks helped households pay down debt, while easy monetary policy allowed consumers to extend maturities and improve balance sheets. President Biden's Inflation Reduction Act and infrastructure bills are also likely to mitigate the economic impact of tighter monetary policy. As a result, we are becoming more optimistic that the economy may be able to narrowly avoid a recession in 2023. This may also mean that the Fed may be persuaded to maintain tighter policy for longer.

Policing Banks: Lawmakers and regulators are tightening regulations on banks in an effort to mitigate the risk of future economic disruptions.

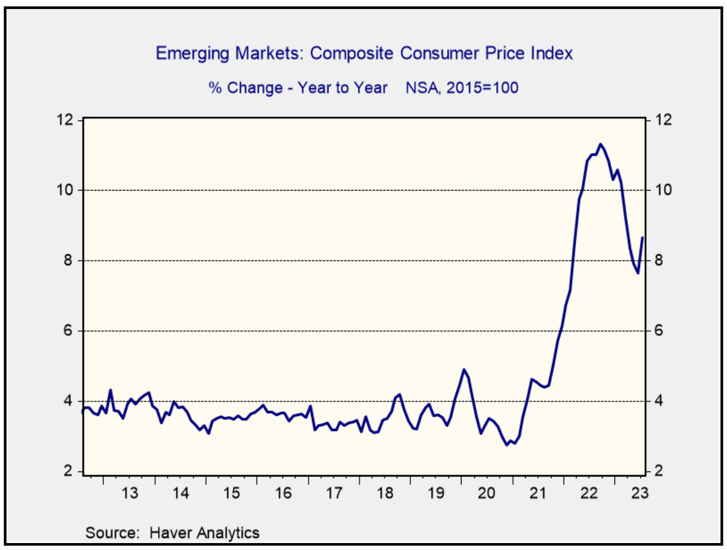
- The Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) unveiled [plans to force banks with $100 million in assets to set up living wills] and to issue enough long-term debt to cover capital losses in times of severe stress. The proposal is designed to make it easier for banks to dissolve during a potential collapse. Regulators have wasted little time ensuring that banks fall into compliance with these new rules. Several regional banks, including Citizens Financial Group Inc. (CFG, $27.99), Fifth Third Bancorp (FITB, $26.16), and M&T Bank Corp (MTB, $126.43) have received warnings about failing to meet requirements. This increase in oversight is likely to add to the woes of a banking system still recovering from the March turmoil.
- These new regulations are being implemented at a time when banks are paying higher interest rates on deposits and are tightening their lending standards. S&P Global Market Intelligence reported that net interest margins contracted in the second quarter of 2023, as funding costs rose at a faster pace than earning asset yields. The median taxable equivalent net interest margin of the banking industry fell to 3.40%, down 20 basis points from its peak in Q4 2022. Additionally, lending standards for the banking industry have risen to the highest level since the pandemic recession.



- Major banks also face increased scrutiny from politicians over plans to increase credit card swipe fees. The fee increases, scheduled to take effect in October and April, have been criticized for their potential to increase inflation and hurt small businesses. Lawmakers have used the planned fee hike to promote their Credit Card Competition Act, which will force large banks to offer alternatives to Visa (V, $247.18) and Mastercard (MA, $415.10) for networks to process transactions. The legislation, if passed, could hurt revenue for both credit card providers and banks. A Nilson report, an industry publication, showed merchants paid $160.70 on average last year, while research from a merchant consulting company showed the new fees could cost retailers another $500.00 a year.

Weather Worries: El Niño could cause disruptions in some parts of the world, but its impact on the U.S. may be less severe.

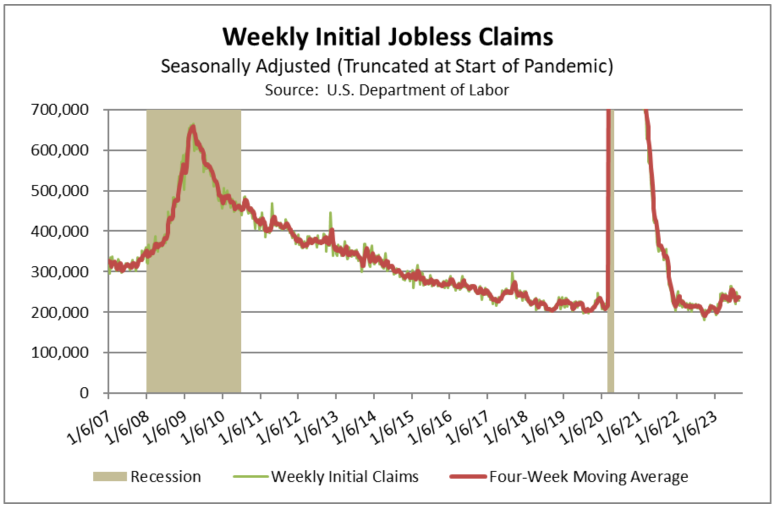
- El Niño conditions in the central and eastern Pacific Ocean are increasing the likelihood of more extreme weather events, such as droughts, floods, and wildfires. We are already seeing the early signs of this impact, with Hong Kong preparing for its strongest typhoon in five years, Greece battling the largest wildfire in EU history, and droughts in Southeast Asia threatening harvests. The impact of El Niño has already cost many countries billions of dollars, and the effects are expected to strengthen until it peaks sometime between December and February.
- El Niño is expected to exacerbate the upward pressure on commodity prices in the coming months. Food prices have already been hurt by India's export ban on non-basmati rice and Russia's decision to pull out of the grain deal. This is likely to be felt by developing countries the most, as they rely on food imports. The pessimistic outlook on food prices has led to concerns that central banks in other countries may not be able to cut rates as prices may be on the rise. Despite making progress in the first six months of the year, emerging markets have seen a reacceleration in inflation.



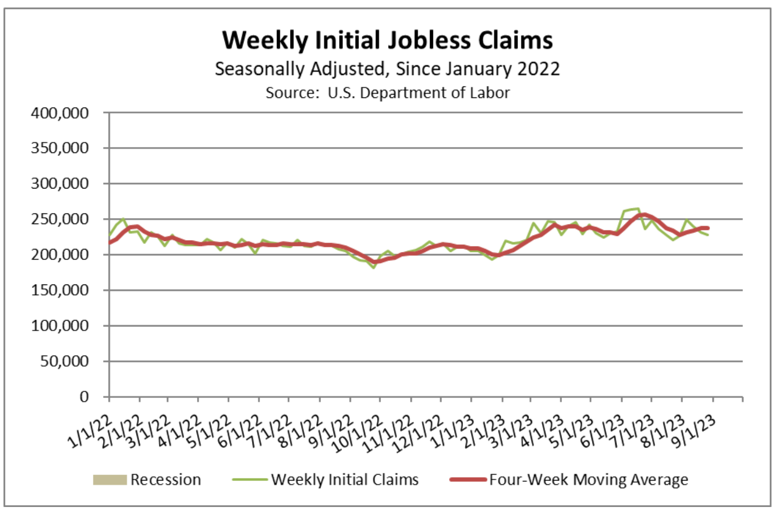
- In the U.S., El Niño conditions in the summer are typically weak, but it can cause wetter and warmer conditions in the South and drier conditions in the North. As El Niño strengthens, it is possible that these effects could become more pronounced. The prospect of a stronger El Niño has so far led to lower gas prices, as households are likely to use less energy as a result. This could weigh on inflation in the U.S. and could lead the Fed to follow through on its pause in interest rate hikes.

U.S. Economic Releases

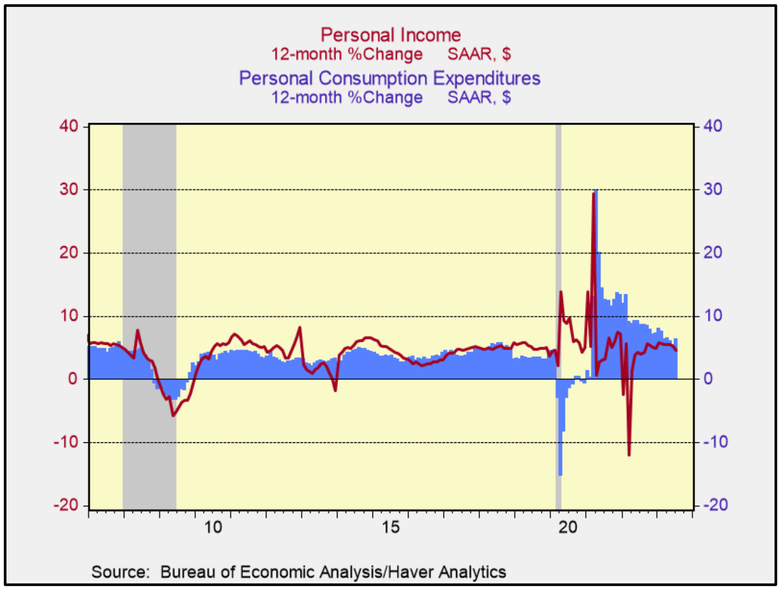
In the week ended August 26, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 228,000, below both the expected level of 235,000 and the previous week's revised level of 232,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 237,500. Meanwhile, in the week ended August 19, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to 1.725 million, above the anticipated reading of 1.706 million and the prior week's revised reading of 1.697 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.



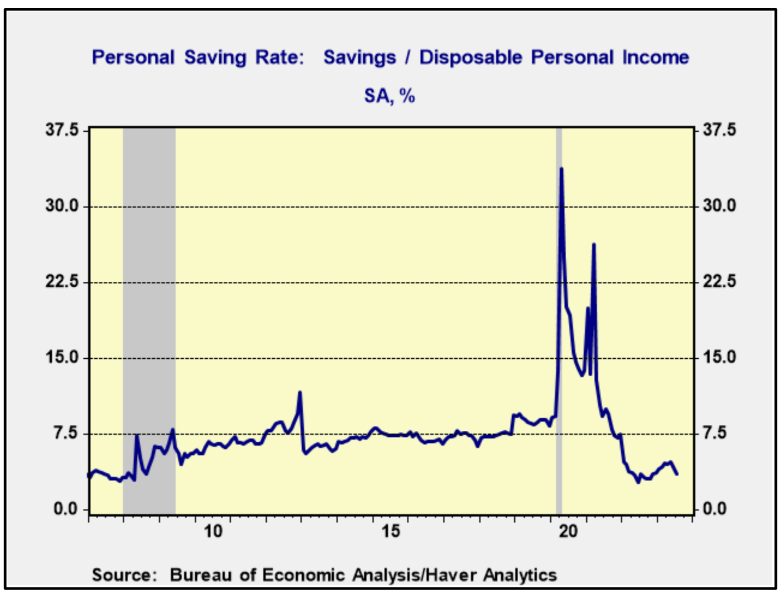
To provide more detail on recent trends, the chart below shows how initial jobless claims have changed just since the beginning of 2022.



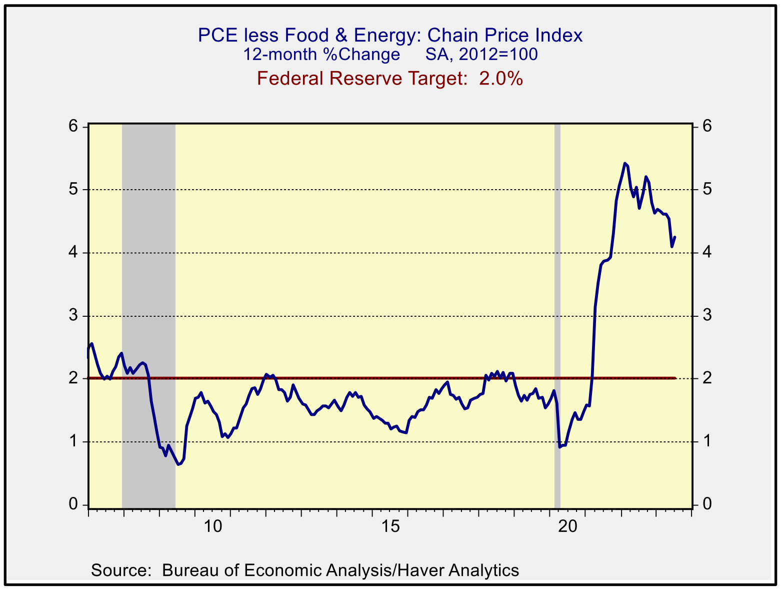
Separately, July ***personal income*** rose by a seasonally adjusted 0.2%, missing expectations that it would increase at the same 0.3% pace as in June. All the same, the miss could be taken as a welcome sign that wage gains are moderating, and that the Fed might be able to avoid more interest-rate hikes. On the other hand, July ***personal consumption expenditures (PCE)*** jumped 0.8%, slightly overshooting the expected rise of 0.7% and accelerating from the gain of 0.6% in June. The rise in PCE during last month was the biggest since January, pointing to continued strong consumer spending. In July, personal income was up 4.6% from the same month one year earlier, while PCE was up 6.4%. The chart below shows the year-over-year change in personal income and PCE since just before the prior recession.



The personal income and spending report also includes a measure of personal saving, defined as disposable (after tax) income less consumption spending on goods and services. The July ***personal savings rate*** fell to a seasonally adjusted 3.5%, an eight-month low. The chart below shows how the personal savings rate has fluctuated since just before the previous recession.



Finally, the income and spending report includes the Fed's preferred gauge of consumer price inflation. Excluding the volatile food and energy components, the ***Core PCE Deflator*** for July was up 4.2% from the same month one year earlier, matching expectations but accelerating slightly from its 4.1% gain in the year to June. The chart below shows the year-over-year change in the Core PCE Deflator since just before the prior recession.



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
9:45	MNI Chicago PMI	m/m	Aug	44.1	42.8	***
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	Retail Sales	y/y	Jul	6.8%	5.9%	5.6%	**	Equity bullish, bond bearish
	Depart. Store & Supermarket Sales	y/y	Jul	5.5%	4.1%		*	Equity bullish, bond bearish
	Industrial Production	y/y	Jul P	-2.5%	0.0%	-1.4%	***	Equity bearish, bond bullish
	Foreign Buying Japan Bonds	w/w	25-Aug	-¥551.5b	¥1131.5b	¥1129.0b	*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	25-Aug	¥425.1b	-¥263.2b	-¥275.2b	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	25-Aug	-¥218.5b	¥185.6b	¥177.7b	*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	25-Aug	-¥603.8b	-¥740.7b	-¥740.8b	*	Equity and bond neutral
	Housing Starts	y/y	Jul	-6.7%	-4.8%	-1.3%	**	Equity bearish, bond bullish
	Annualized Housing Starts	y/y	Jul	0.778m	0.811m	0.824m	*	Equity and bond neutral
Australia	Private Sector Credit	y/y	Jul	5.3%	5.5%	5.6%	**	Equity and bond neutral
	Private Capital Expenditure	y/y	2Q	2.8%	2.4%	3.7%	**	Equity and bond neutral
New Zealand	ANZ Activity Outlook	m/m	Aug	11.2	0.8		**	Equity bullish, bond bearish
	ANZ Business Confidence	m/m	Aug	-3.7	-13.1		**	Equity bullish, bond bearish
	CoreLogic House Prices	y/y	Aug	-8.7%	-10.1%		*	Equity bullish, bond bearish
South Korea	Industrial Production	y/y	Jul	-8.0%	-5.6%	-5.9%	***	Equity bearish, bond bullish
China	Official Composite PMI	m/m	Aug	51.3	51.1		*	Equity and bond neutral
	Official Manufacturing PMI	m/m	Aug	49.7	49.3	49.2	***	Equity and bond neutral
	Official Services PMI	m/m	Aug	51.0	51.5	51.2	**	Equity and bond neutral
India	GDP	m/m	2Q	7.8	6.1	7.8	*	Equity and bond neutral
EUROPE								
Eurozone	CPI	y/y	Aug	5.3%	5.3%	5.1%	***	Equity and bond neutral
	Core CPI	y/y	Aug P	5.3%	5.5%	5.3%	**	Equity and bond neutral
	Unemployment Rate	m/m	Jul	6.4%	6.4%	6.4%	**	Equity and bond neutral
Germany	Retail Sales	y/y	Jul	-2.4%	0.1%	0.9%	*	Equity bearish, bond bullish
	Unemployment Change	m/m	Aug	18k	-4.0k	1.0k	***	Equity bearish, bond bullish
	Unemployment Claims Rate	m/m	Aug	5.7%	5.6%	5.7%	**	Equity and bond neutral
France	CPI	y/y	Aug P	4.8%	4.3%	4.6%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Aug P	5.7%	5.1%	5.4%	**	Equity and bond neutral
	PPI	y/y	Jul	0.9%	3.0%	3.1%	*	Equity and bond neutral
	GDP	y/y	2Q F	1.0%	0.9%	0.9%	**	Equity and bond neutral
Italy	Unemployment Rate	m/m	Jul	7.6%	7.4%	7.5%	**	Equity and bond neutral
	CPI, EU Harmonized	y/y	Aug P	5.5%	6.3%	5.6%	***	Equity and bond neutral
	CPI NIC Including Tobacco	y/y	Aug P	5.5%	6.0%	5.9%	**	Equity and bond neutral
Switzerland	Real Retail Sales	y/y	Jul	-2.2%	1.8%	1.0%	**	Equity bearish, bond bullish
Russia	Unemployment Rate	m/m	Jul	3.00%	3.10%	3.10%	***	Equity and bond neutral
AMERICAS								
Mexico	Unemployment Rate NSA	m/m	Jul	3.13%	2.65%	2.90%	***	Equity and bond neutral
Brazil	Net Debt % GDP	m/m	Jul	59.60%	59.10%	59.50%	*	Equity and bond neutral
	National Unemployment Rate	m/m	Jul	7.9%	8.0%	8.0%	*	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)	568	567	1	Up
3-mo T-bill yield (bps)	529	532	-3	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	540	540	0	Up
U.S. Libor/OIS spread (bps)	542	542	0	Up
10-yr T-note (%)	4.10	4.12	-0.02	Flat
Euribor/OIS spread (bps)	380	378	2	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			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	$86.60	$85.86	0.86%	
WTI	$82.32	$81.63	0.85%	
Natural Gas	$2.83	$2.80	1.32%	
Crack Spread	$33.64	$33.19	1.34%	
12-mo strip crack	$28.72	$28.55	0.61%	
Ethanol rack	$2.43	$2.43	0.37%	
Metals				
Gold	$1,944.39	$1,942.32	0.11%	
Silver	$24.52	$24.62	-0.37%	
Copper contract	$380.50	$384.40	-1.01%	
Grains				
Corn contract	$481.75	$480.75	0.21%	
Wheat contract	$599.00	$607.00	-1.32%	
Soybeans contract	$1,388.25	$1,386.75	0.11%	
Shipping				
Baltic Dry Freight	1,094	1,107	-13	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-10.6	-2.2	-8.4	
Gasoline (mb)	-0.2	-1.3	1.0	
Distillates (mb)	-1.2	-1.0	-0.2	
Refinery run rates (%)	-1.2%	0.5%	-1.7%	
Natural gas (bcf)		29		

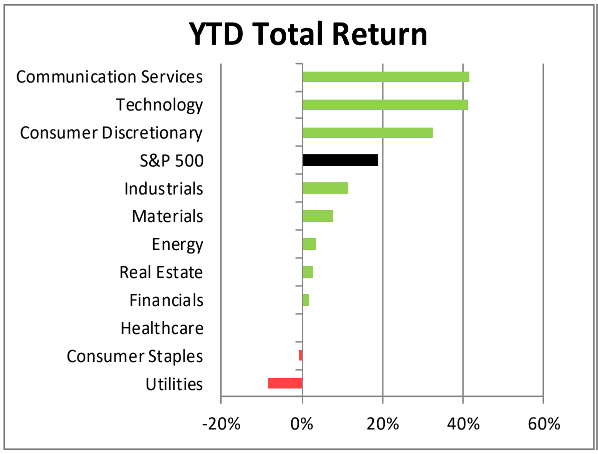
Weather

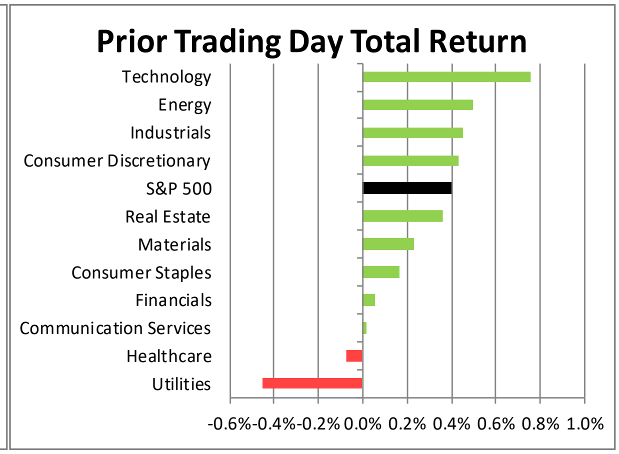
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for the entire country from the Rocky Mountains eastward, with below-normal temperatures strictly in the Pacific Northwest. The forecasts call for wetter-than-normal conditions in the Pacific Northwest, with dry conditions precipitation outlook in the Southwest and Southeast.

There are currently five atmospheric disturbances in the Atlantic Ocean area. Most important, Hurricane Idalia has now been downgraded to a tropical storm, and today it is moving up the coast of North Carolina before its expected turn out to sea. Hurricane Franklin is off Bermuda and heading northwesterly. Tropical Storm Jose is moving northward through the central Atlantic Ocean, and to the east of it, there is a disturbance that is assessed to have a 30% chance of developing into a cyclone within the next 48 hours. Finally, there is a disturbance off the coast of western Africa that is assessed to have a 70% chance of developing into a cyclone in the next 48 hours.

Data Section

U.S. Equity Markets – (as of 8/30/2023 close)

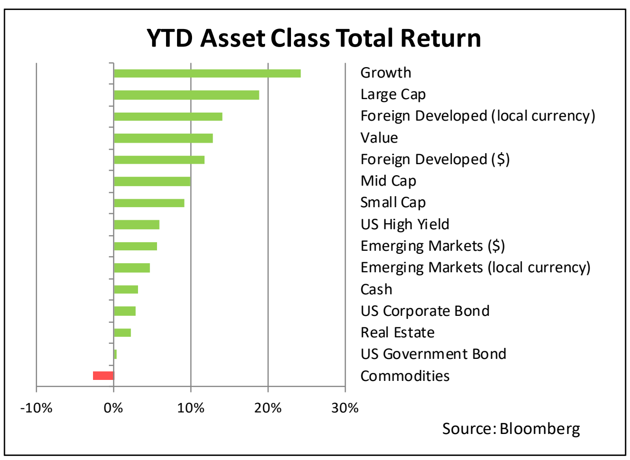




(Source: Bloomberg)

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 8/30/2023 close)

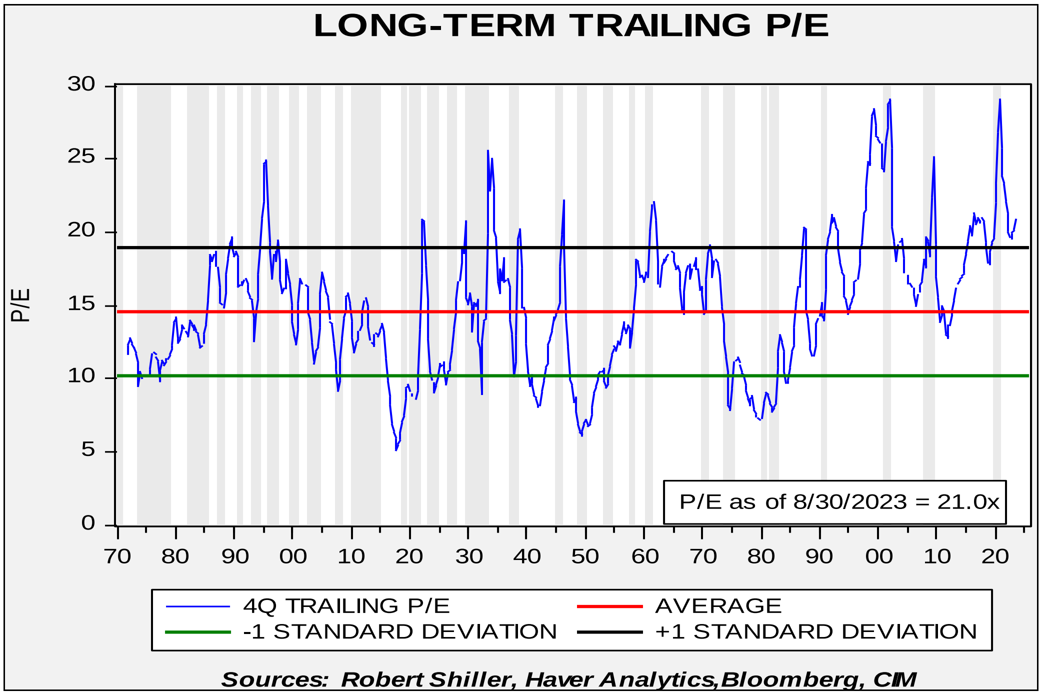


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 31, 2023



Based on our methodology,[1] the current P/E is 21.0x, 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.

[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.