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 3, 2023—9:30 AM EDT] Global equity markets are mixed 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 0.5%. Chinese markets were higher, with the Shanghai Composite up 0.6% from its previous close and the Shenzhen Composite up 0.3%. U.S. equity index futures are signaling a lower open.

With 335 companies having reported so far, S&P 500 earnings for Q2 are running at $53.20 per share, compared to estimates of $53.55 (a decline of 6.8% from Q2 2022). Of the companies that have reported thus far, 82.4% have exceeded expectations while 12.5% have fallen short of expectations.

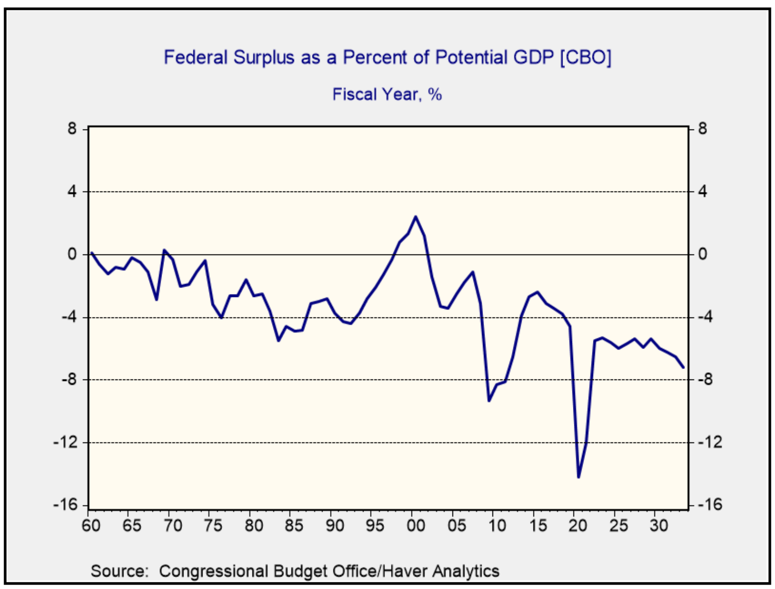
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (7/24/2023) (with associated podcast): “China’s Collapsing Population”
- ***Weekly Energy Update*** **(8/3/2023): The unusually large draw in crude oil stocks failed to lift prices. Fears of rising interest rates offset the bullish inventory data. We cover that data and other news in this week’s report**.
- *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”

Good morning! Today's *Comment* will explore three key topics: the U.S. deficit, central bank policy, and the U.K.'s post-Brexit economy. First, we will discuss the U.S. deficit and what it may mean for bond yields. Second, we will explain why other central banks may follow Brazil as it moves away from tight monetary policy. Finally, we will discuss why the Bank of England may be helping boost the British pound.

Downgrade Trouble: The downgrade by Fitch Ratings of the U.S.'s credit rating and the announcement of another round of debt issuance has investors concerned about the country's ballooning deficit.

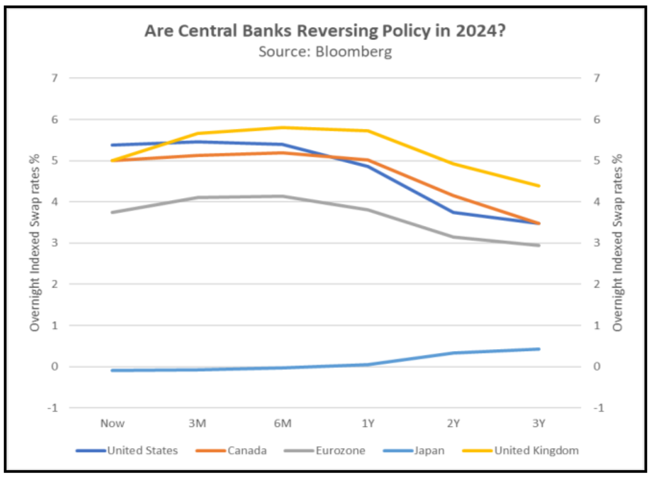
- On Wednesday, [the U.S. Treasury Department announced that it would auction off $103 billion in new bonds] this quarter in order to resolve a shortfall between tax revenue and government spending. The move has made investors uneasy, as it is unclear whether the market is capable of absorbing such a large amount of issuance. This report comes a day after [Fitch Ratings Agency downgraded U.S. credit ratings] from its top level. Making matters worse, [lawmakers broke for their August recess] earlier this week without coming to a resolution on funding the government for the next fiscal year. This has raised concerns about the possibility of a government shutdown in October, which would further strain the U.S. economy.
- Investors are worried that partisan gridlock in Washington will prevent lawmakers from adequately addressing the U.S. budget deficit. This uncertainty has led to a sharp rise in the 10-year Treasury yield, which has risen nearly 20 basis points since August 1. Higher yields threaten to push up borrowing costs for firms, which could weigh on corporate earnings and stock prices. The S&P 500 index has dropped almost 1.7% since the Fitch downgrade. According to the Congressional Budget Office, the government deficit is expected to deteriorate over the next 10 years.



- In 1994, President Clinton's advisor James Carville once quipped, "that if there were reincarnation, [he] would like to come back as the bond market" because then he could "intimidate everybody." This week's market reaction to U.S. debt woes is a good example of how relevant his words are today. That said, we believe that in the long run, yields on long-duration Treasuries will have to rise as investors adjust to a new normal with higher inflation volatility and less Federal Reserve involvement. This should lead to slower economic growth as higher borrowing costs tend to reduce consumption.

Who's Next? The Central Bank of Brazil was one of the first to raise interest rates in response to the COVID-19 pandemic, and it is now one of the first to pivot away from hawkish policy.

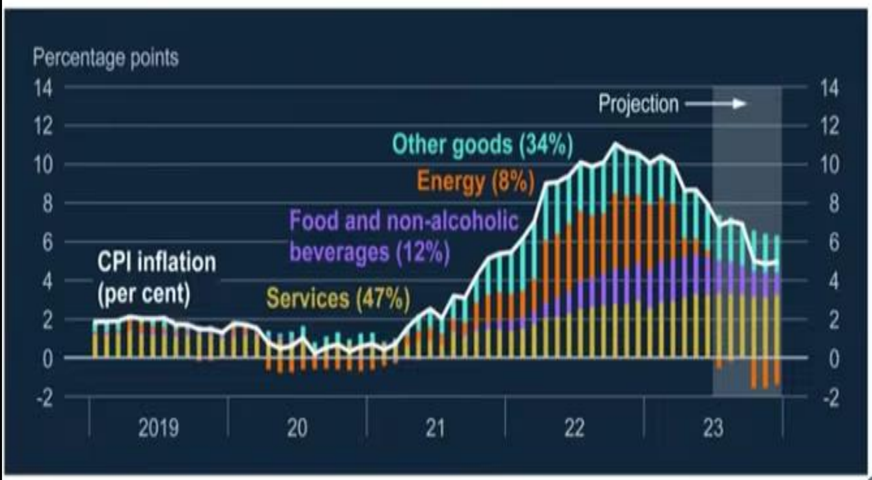
- Brazil's central bank cut its benchmark interest rates by 50 bps to 13.25% on Wednesday. The decision came amid pressure from President Luiz Inácio Lula da Silva and his economic team to ease monetary policy in an effort to boost the economy. Although the unemployment rate remains well below the country's long-run trend of 9.5%, a gauge for gross domestic product showed that economic activity dropped 2% in May. Businesses and consumers will likely welcome lower rates. However, it will be the first test to see if the lower rates will lead to a return to inflation.
- Other central banks are expected to follow suit, as overnight indexed swaps rates suggest that benchmark interest rates will decline in most major economies by 2024. The switch to monetary easing is likely a reflection of a global decline in price pressures. The IMF expects global inflation to fall from 8.7% last year to 6.8% in 2023. Additionally, central bankers are facing pressure from politicians to ease monetary policy, as the high-interest rates are harming households. In the U.K., the Bank of England is on the verge of triggering a potential mortgage crisis; meanwhile, higher interests rates have disproportionately hurt homeowners in southern Europe who are now relying on savings to make monthly payments.



- Generally speaking, central banks in developed countries have made gradual changes when raising rates and more dramatic cuts when lowering them. However, this time may be different. Advanced economies have proven to be more resilient than experts expected at the start of the year. This could lead policymakers to be more cautious with easing monetary policy, as they may be concerned about a return to higher inflation. This approach is typical in emerging markets where inflation is more volatile. This may mean that investors should be more cautious during this easing cycle than the previous one when deciding to add more risk to their portfolios.

U.K. Path: The Bank of England (BOE) may keep monetary policy tight in order to restore confidence in the British pound (GBP).

- The Bank of England raised its benchmark interest rates by 25 bps on Thursday to a 15-year high of 5.25%. This is the bank's 14th consecutive hike and reflects its continued fight to bring inflation down toward its 2% target. During his press conference, BOE Governor Andrew Bailey predicted that July inflation has decelerated to around 7%, much lower than last year's peak of 11%. He added that the central bank plans to continue to raise interest rates further as policymakers aim to push inflation down to 5% by the end of the year. The central bank now forecasts inflation to fall to 4.9%.
- The Bank of England does not seem to be willing to take its foot off the pedal. There were two policymakers within the BOE's Monetary Policy Committee that pushed for a 50 bps hike in interest rates, with one vote for keeping rates unchanged. This voting breakdown suggests that British policymakers remain relatively more hawkish than their Western counterparts. While the heads of the European Central Bank and the Federal Reserve suggested last week that they may be nearing the end of their hiking cycles, Bank of England Governor Andrew Bailey offered no such reassurances. Instead, he maintained that "in order to get inflation back to target, [the BOE] is going to have to keep this stance of monetary policy."



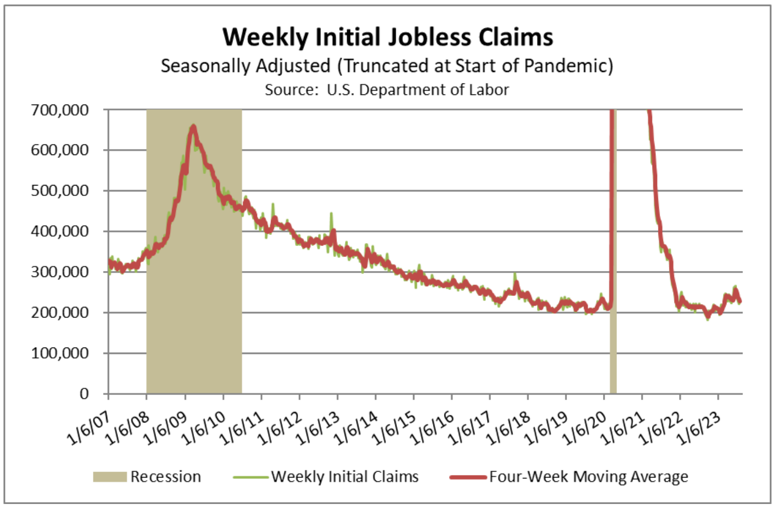
Source: Bloomberg Finance L.P., Department for Energy Security and Net Zero, ONS and Bank calculation

- After breaking away from the European Union, the United Kingdom will now have to prove that it can stand on its own. One way it may do this is by legitimizing the value of its currency. Over the last two weeks, the GBP has risen around 4% against the dollar, even as other peer currencies, as measured against the U.S. Dollar Index (DXY), declined about 3% in the same period. This divergence suggests that investors are confident that the Bank of England is willing to take steps to bring down inflation, even if it means causing economic pain. A strong GBP, particularly against major trading partners, will help to quell price pressures by making imports cheaper.

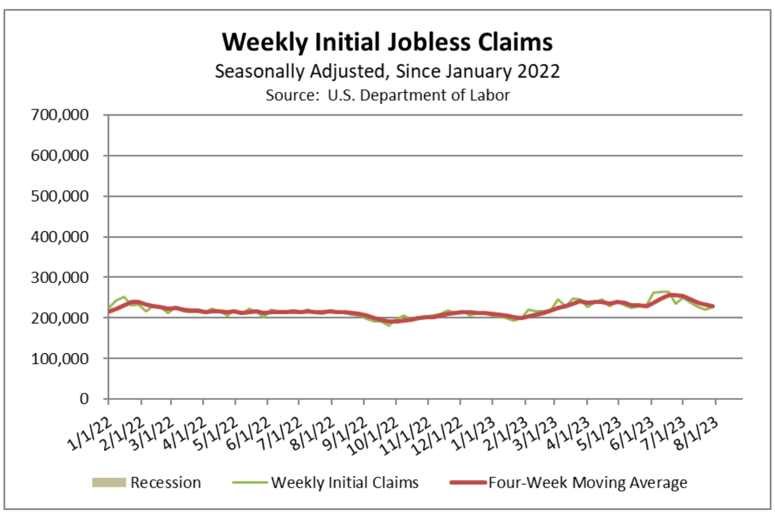
Fed News: Kansas City Fed has hired Jeffrey Schmid to take over as President and Chief Executive Officer. He is a former bank executive and has experience in bank regulation.

U.S. Economic Releases

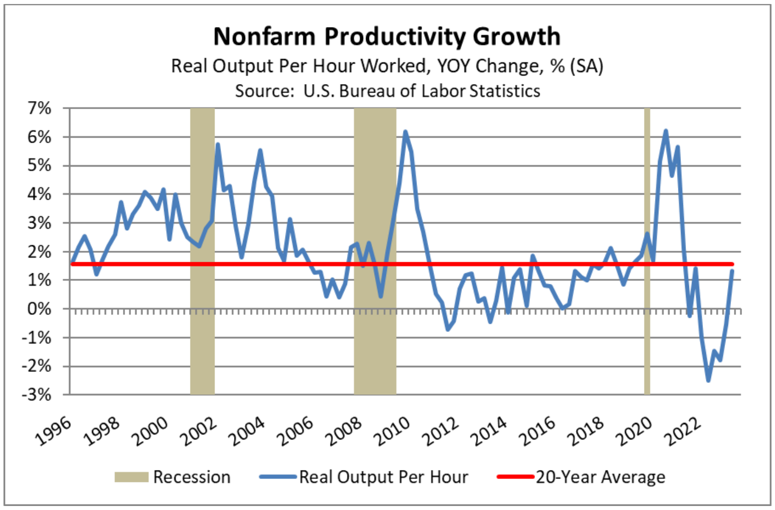
In the week ending July 29, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 227,000, slightly above the expected level of 225,000 and up from 221,000 in the previous week. However, because of declines in the previous weeks, the four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell back to 228,250. The four-week moving average is now at its lowest level since mid-March, suggesting the apparent uptick in layoffs from late spring to early summer has ended. In the week ending July 22, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to 1.700 million, below that anticipated reading of 1.705 million but above the prior week's revised reading of 1.679 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.



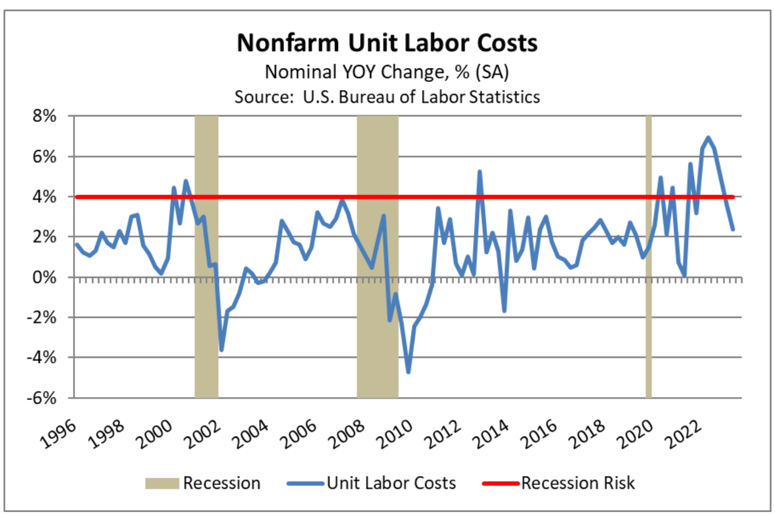
To provide more detail on recent trends, the chart below shows how initial jobless claims have changed just since the beginning of 2022.



Another report today focused on the productivity of U.S. workers, defined as the average value of output per hour worked. After stripping out price changes and normal seasonal fluctuations, second-quarter ***nonfarm productivity*** rose at an annualized rate of 3.7%, smashing past expectations for a growth rate of 2.2% and more than enough to reverse the first quarter's revised rate of decline of 1.2%. Taking into account the fluctuations in each of the last four quarters, productivity in the second quarter was up 1.3% from the same period one year earlier, almost reaching the 20-year average of 1.5%. Productivity growth is key to boosting living standards and supporting higher wages, so the figures today are a welcome development. The chart below shows the year-over-year growth in real productivity over the last quarter-century or so.



Reflecting the strong productivity numbers, second-quarter ***unit labor costs*** rose at an annualized rate of just 1.6%, far below both the anticipated growth rate of 2.5% and the first quarter's strong growth rate of 3.3%. Unit labor costs in the second quarter were up just 2.4% year-over-year, close to the labor cost gains in the years right before the coronavirus pandemic and well below the 4.0% gains that have often helped kick the economy into recession. The chart below shows the year-over-year growth in unit labor costs since 1996.



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	S&P Services PMI	m/m	Jul F	52.4	52.4	**
9:45	S&P Composite PMI	m/m	Jul F		52.0	**
10:00	Factory Orders	m/m	Jun	2.3%	0.3%	***
10:00	Factory Orders Ex Trans	m/m	Jun	0.1%	-0.5%	*
10:00	Durable Goods Orders	m/m	Jun F	4.7%	4.7%	***
10:00	Durable Goods Orders Ex Transportation	m/m	Jun F	0.6%	0.6%	**
10:00	Cap Goods Orders Nondef Ex Air	m/m	Jun F		0.2%	*
10:00	Cap Goods Ship Nondef Ex Air	m/m	Jun F		0.0%	*
10:00	ISM Services Index	m/m	Jul	53	53.9	**
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	Foreign Buying Japan Bonds	w/w	28-Jul	-¥166.1b	-¥1204.2b	-¥1203.9b	*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	28-Jul	208.9b	-¥973.8b	-¥964.1b	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	28-Jul	-¥12.2b	-¥445.3b	-¥417.7b	*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	28-Jul	¥196.0b	¥101.0b	¥101.1b	*	Equity and bond neutral
	Jibun bank Composite PMI	m/m	Jul F	52.2	52.1	--	*	Equity and bond neutral
	Jibun Bank Services PMI	m/m	Jul F	53.8	53.9	--	**	Equity and bond neutral
Australia	Exports	m/m	Jun	-2.0%	4.0%	3.0%	*	Equity bearish, bond bullish
	Imports	m/m	Jun	-4.0%	2.0%	3.0%	*	Equity bearish, bond bullish
	Trade Balance	m/m	Jun	A$11321m	A$11791m	A$10497m	***	Equity and bond neutral
New Zealand	ANZ Commodity Price	m/m	Jul	-2.6	-2.3	-1.7	**	Equity and bond neutral
China	Caixin Composite PMI	m/m	Jul	51.9	52.5		**	Equity bearish, bond bullish
	Caixin Services PMI	m/m	Jul	54.1	53.9	52.4	**	Equity and bond neutral
India	S&P Global Composite PMI	m/m	Jul	61.9	59.4		**	Equity bullish, bond bearish
	S&P Global Services PMI	m/m	Jul	62.3	58.5		**	Equity bullish, bond bearish
EUROPE								
Eurozone	HCOB Services PMI	m/m	Apr P	50.9	55.6	55.0	**	Equity bearish, bond bullish
	HCOB Composite PMI	m/m	Apr P	48.6	54.9	53.9	*	Equity bearish, bond bullish
	PPI	y/y	Jun	-3.4%	-1.5%	-1.6%	**	Equity bearish, bond bullish
Germany	Trade Balance SA	m/m	Jun	18.7b	14.4b	14.6b	**	Equity and bond neutral
	Exports SA	m/m	Jun	0.1%	-0.1%	0.1%	*	Equity and bond neutral
	Imports SA	m/m	Jun	-3.4%	1.7%	1.4%	*	Equity bearish, bond bullish
	HCOB Services PMI	m/m	Jul F	52.3	52.0	52.0	**	Equity and bond neutral
	HCOB Composite PMI	m/m	Jul F	48.5	48.3	48.3	*	Equity and bond neutral
France	HCOB Services PMI	m/m	Jul F	47.1	47.4	47.4	**	Equity and bond neutral
	HCOB Composite PMI	m/m	Jul F	46.6	46.6	46.6	*	Equity and bond neutral
Italy	HCOB Composite PMI	m/m	Jul	48.9	49.7	49.5	*	Equity bearish, bond bullish
	HCOB Services PMI	m/m	Jul	51.5	52.2	52.2	**	Equity bearish, bond bullish
	Retail Sales	y/y	Jun	3.6%	3.0%		**	Equity bullish, bond bearish
UK	S&P/CIPS Services PMI	m/m	Jul F	51.5	51.5	51.5	**	Equity and bond neutral
	S&P/CIPS Composite PMI	m/m	Jul F	50.8	50.7	50.7	**	Equity and bond neutral
Switzerland	CPI	y/y	Jul	1.6%	1.7%	1.6%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Jul	2.1%	1.8%		**	Equity and bond neutral
	Core CPI	y/y	Jul	1.7%	1.8%	1.8%	*	Equity and bond neutral
Russia	Retail Sales	m/m	Jun	10.0%	9.3%	9.5%	**	Equity and bond neutral
	Unemployment Rate	m/m	Jun	3.10%	3.20%	3.30%	***	Equity and bond neutral
	S&P Global Services PMI	m/m	Jul	54.0	56.8		**	Equity bearish, bond bullish
	S&P Global Composite PMI	m/m	Jul	53.3	55.8		**	Equity bearish, bond bullish

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	527	-3	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)	539	539	0	Up
10-yr T-note (%)	4.13	4.08	0.05	Flat
Euribor/OIS spread (bps)	373	372	1	Up
Currencies	**Direction**			
Dollar	Up			Up
Euro	Flat			Down
Yen	Up			Down
Pound	Down			Up
Franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of England Bank Rate	5.250%	5.000%	5.250%	On Forecast
Brazil Selic Rate	13.250%	13.750%	13.500%	Below 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	$83.09	$83.20	-0.13%	
WTI	$79.43	$79.49	-0.08%	
Natural Gas	$2.50	$2.48	1.09%	
Crack Spread	$38.44	$40.32	-4.65%	
12-mo strip crack	$29.47	$30.56	-3.54%	
Ethanol rack	$2.40	$2.41	-0.34%	
Metals				
Gold	$1,933.71	$1,934.45	-0.04%	
Silver	$23.51	$23.72	-0.85%	
Copper contract	$382.90	$384.35	-0.38%	
Grains				
Corn contract	$499.25	$500.50	-0.25%	
Wheat contract	$641.00	$640.00	0.16%	
Soybeans contract	$1,327.50	$1,321.25	0.47%	
Shipping				
Baltic Dry Freight	1,123	1,150	-27	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-1.7	-1.1	-0.7	
Gasoline (mb)	1.5	-1.6	3.0	
Distillates (mb)	-0.8	0.1	-0.9	
Refinery run rates (%)	-0.7%	-0.6%	-0.2%	
Natural gas (bcf)		19		

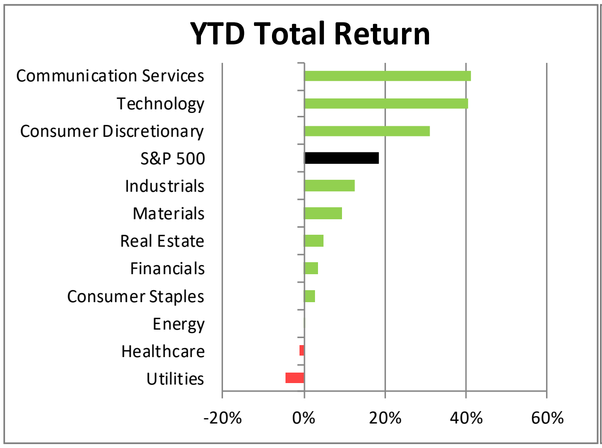
Weather

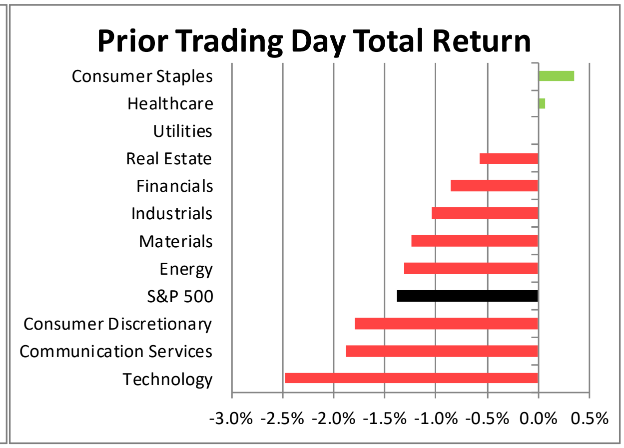
The 6-10 and 8-14 day forecasts are currently calling for warmer-than-normal temperatures in the West Coast, Southwest, Texas, and Deep South regions, with cooler-than-normal temperatures in the northern Rockies, the northern Great Plains, and the Upper Midwest. The forecasts call for wetter-than-normal conditions throughout the northern two-thirds of the country, with dry conditions expected in the Southwest.

There are currently no tropical disturbances or cyclones being tracked in the Atlantic Ocean area.

Data Section

U.S. Equity Markets – (as of 8/2/2023 close)

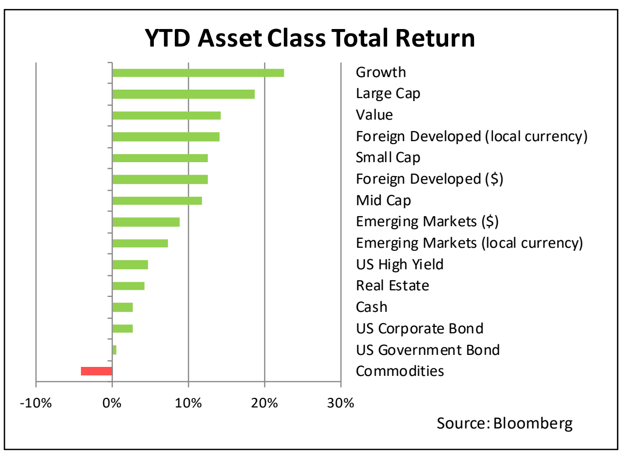




(Source: Bloomberg)

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 8/2/2023 close)

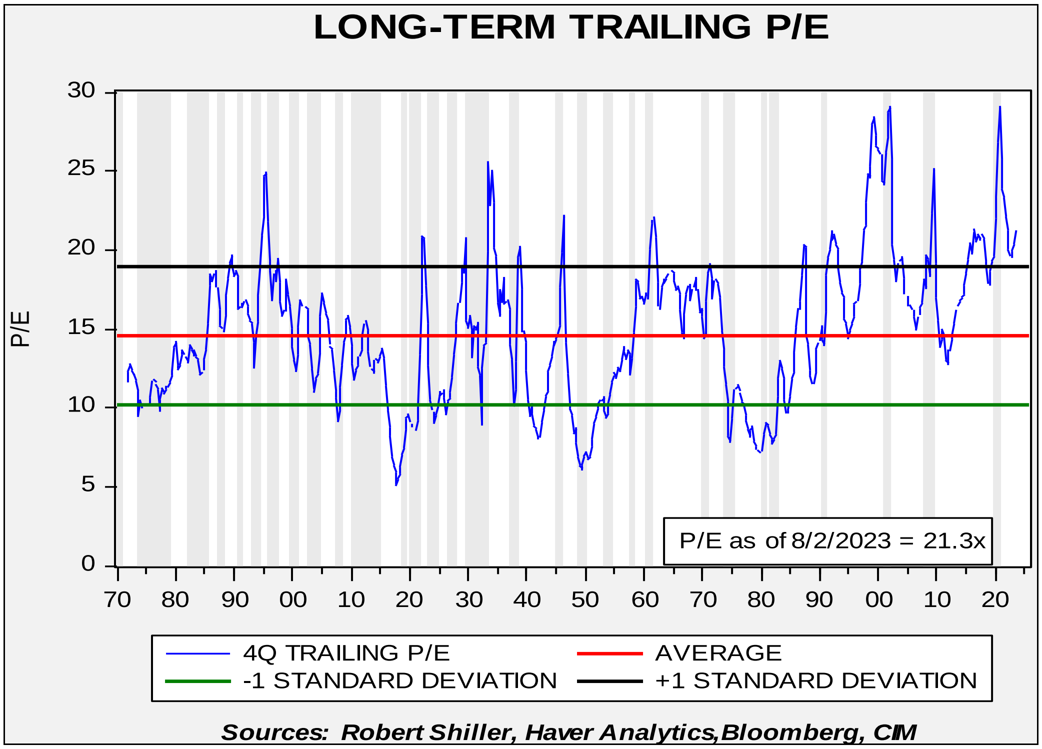


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 3, 2023



Based on our methodology,[1] the current P/E is 21.3x, 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.