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 4, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is down 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.1%. Chinese markets were higher, with the Shanghai Composite up 0.2% from its previous close and the Shenzhen Composite up 0.5%. U.S. equity index futures are signaling a higher open.

With 417 companies having reported so far, S&P 500 earnings for Q2 are running at $53.90 per share, compared to estimates of $53.55 (a decline of 6.8% from Q2 2022). Of the companies that have reported thus far, 80.8% have exceeded expectations while 14.1% have fallen short of expectations.

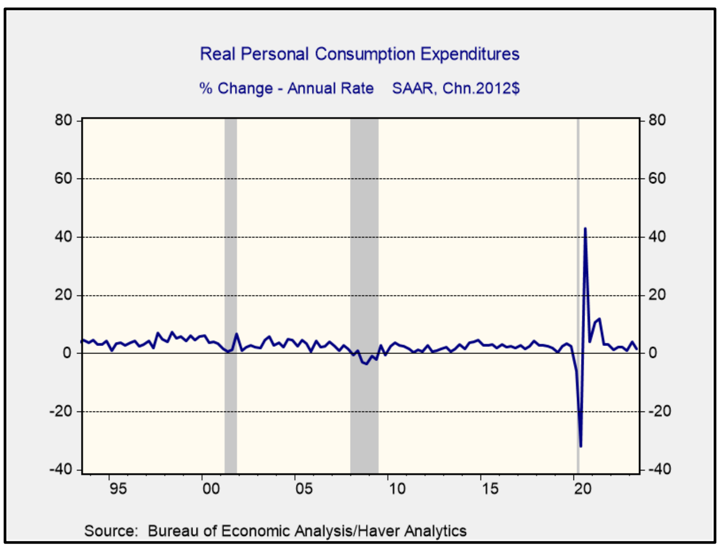
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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 discuss three topics: recent optimism about the global economy, the Bank of Japan's recent intervention in bond markets, and the increase in global defense spending due to the rift between the U.S. and China.

Turning Tide: While a possible recession was a hot topic at the start of the year, there is now growing optimism that the economy may be more resilient than previously thought.

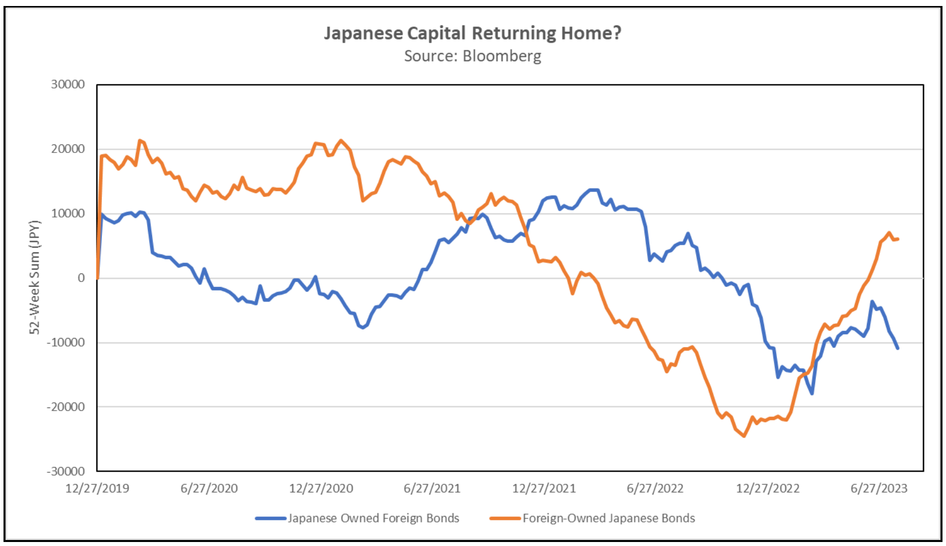
- Persistently strong economic data has shifted the conversation from an imminent downturn to sustained growth. Earlier this week, Bank of America (BA, $31.41) concluded that a recession is unlikely to occur in 2023. Meanwhile, Richmond Fed President Thomas Barkin expressed confidence that the Federal Reserve may be able to achieve a soft landing if inflation continues to ease. This increased confidence is supported by a wave of positive economic data, which suggests that the labor market remains tight, and spending remains robust despite rising borrowing costs. However, this does not mean there is no risk of a downturn.
- Despite some encouraging signals, the state of the business cycle remains uncertain, as there are still several risks. The government's inability to agree on a budget agreement will likely impact bond yields, which could lead to higher borrowing costs over the next few weeks. At the same time, there appears to be a notable deceleration in the rate of consumption and hiring. The latest GDP report showed a significant slowdown in consumption from an annual pace of 4.16% in the first quarter of 2023 to 1.64% in Q2. At the same time, the jobs report showed that job creation disappointed for the second consecutive month.



- During the pandemic, households and firms took advantage of transfer payments and lower interest rates to pay down debt and extend loan duration. As a result, consumers were prepared and able to absorb higher prices in the months following, while firms were less pressed for financing. This dynamic explains why monetary tightening has not yet led to a sharp increase in defaults. However, it is unclear how long the economy can keep this up, as the farther away we move from the pandemic, the more vulnerable households and firms will be to rising borrowing costs. This may mean that the economy will slow down this year, even if it is able to avoid a recession.

Not So Fast! A week after its historic shift in monetary policy, the Bank of Japan (BOJ) is signaling that it is not ready to be completely hands-off.

- On Thursday, the Bank of Japan (BOJ) made an unscheduled intervention in the bond market for the second time this week, by offering to buy $2.09 billion of bonds with five to 10 years left until maturity in an effort to control the rise in yields. The announcement came in response to a sudden rise in 10-year Japanese government bonds, which saw yields rise to a nine-year high of 0.65%. The purchases highlight the central bank's unwillingness to tolerate a massive spike in interest rates following its decision to loosen its grip on 10-year debt yields.
- Investors were confused by the BOJ's actions, as it was unclear how much the bank was willing to tolerate in terms of the pace of the increase in yields. Although the central bank's intervention led to a modest decline in yields, the bond market was not significantly impacted as rates quickly returned to their previous level. A similar situation occurred in the currency market, as the yen (JPY) bounced back after initially depreciating against the dollar. However, equities were negatively affected, with the TOPIX index ending the day down 1.45%.

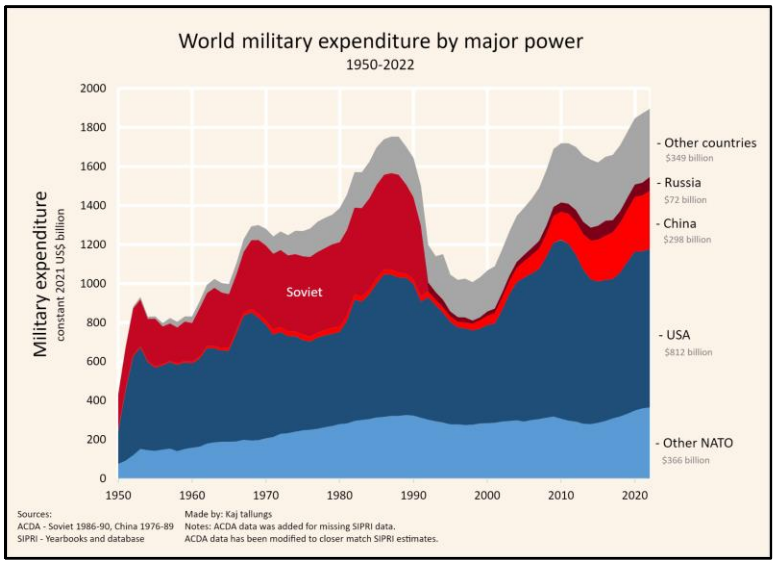


- As the world's largest creditor, Japan's monetary policy significantly impacts the global economy. Data from the Japanese Ministry of Finance shows that foreign investors have been increasing their holdings of Japanese long-term debt since the BOJ first tweaked its policy in December 2022. Simultaneously, Japanese investors have been offloading their holdings in the weeks leading up to the central bank's latest rate decision. As short-term rates in Japan begin to rise, we expect higher yields will encourage residents to bring capital back home. However, this shift is likely to take time to materialize, as rates in the United States and Europe remain attractive.

Military Rising: The United States and its allies are continuing to increase their military spending in an effort to create a stronger deterrent to China in the Pacific.

- The U.S. plans on investing in more sophisticated missile technology in the next spending bill. Last week, lawmakers revealed a bill that earmarked $13 million to expand and manufacture chemical compounds that can be used to propel missiles or replace the explosive material in warheads. Similarly, the White House plans to ask Congress to fund arms for Taiwan as part of its supplemental budget request for Ukraine. Although officials still need to come to an agreement on the final spending package, there does seem to be a bipartisan consensus that the government needs to do more to counter China in the Indo-Pacific.

- Across the ocean, Japan and New Zealand are also looking to increase their defense spending. Japanese lawmakers are considering selling some of the government's stakes in major companies to fund additional military spending. This is intended to avoid raising taxes or increasing the national debt, as the country seeks to expand its defense capabilities. Meanwhile, a government review of New Zealand's military capabilities found that the country is not prepared to deal with the growing challenges in the Indo-Pacific region. As a result, the report recommended that the government increase its military budget.

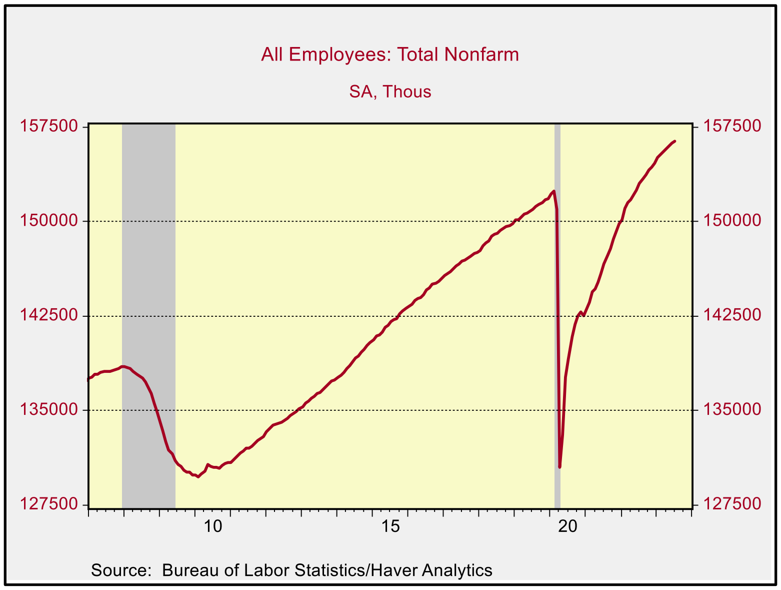


(Source: Wikimedia Commons)

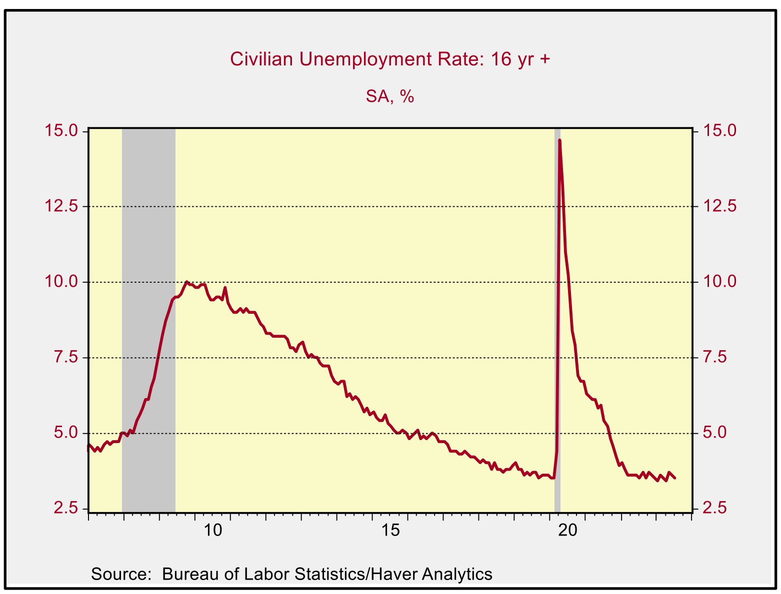
- The growing rivalry between the United States and China is driving a global arms race. Countries are ramping up spending on defense as they look to choose sides and protect their own interests. Rising military demand will likely benefit the defense and aerospace industries, as they will likely be the recipients of much of this new spending. However, the major obstacle to this increase in investment is the need to generate the necessary revenue to pay for new weapons. As a result, we believe that the world's shift towards building up military capacity will likely be gradual.

U.S. Economic Releases

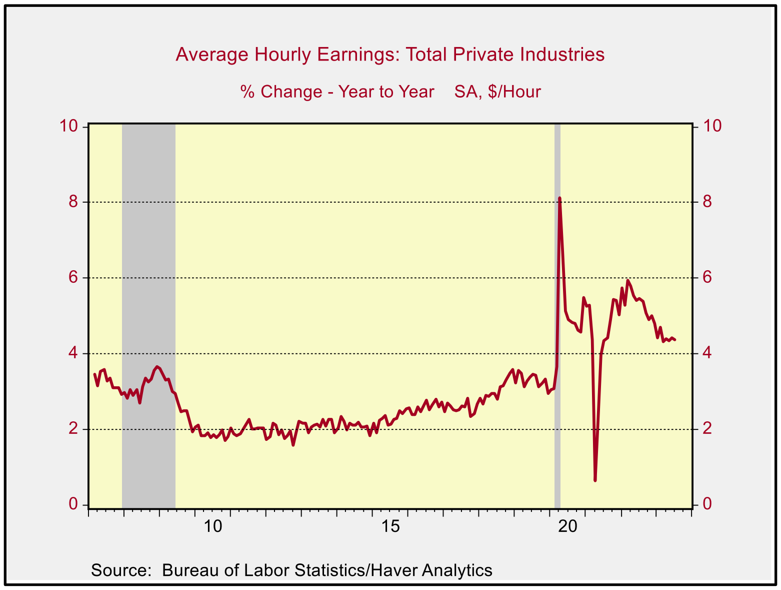
July ***nonfarm payrolls*** rose by a seasonally adjusted 187,000, short of the expected gain of 200,000 but a bit more than the downwardly revised rise of 185,000 in June. Job gains have continued to moderate in recent months, with the six-month average gain now at 223,000, but that is still significantly higher than the average of 163,000 in 2019, before the coronavirus pandemic. The overwhelming majority of the job gains in July were in private-sector services, while manufacturing jobs fell slightly. The chart below shows the change in nonfarm payrolls since shortly before the Great Financial Crisis.



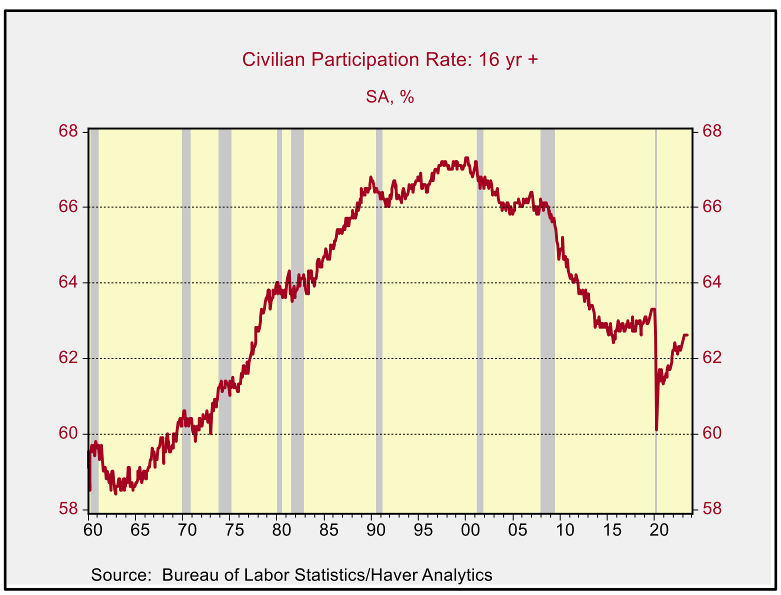
The July ***unemployment rate*** fell to a seasonally adjusted 3.5%, rather than staying at the June rate of 3.6% as anticipated. That leaves the jobless rate almost at the multi-decade low of 3.4% reached in several recent months. The chart below shows how the unemployment rate has evolved since just before the Great Financial Crisis.



With the demand for labor high and the "inventory" of unemployed workers low, wage rates remain high. ***Average hourly earnings*** in July rose to a seasonally adjusted $33.74, up a strong 4.4% from the same month one year earlier. Continuing out-sized wage gains are important because they could keep consumer spending high and exacerbate price inflation, possibly prompting the Fed to keep raising interest rates. The chart below shows the year-over-year growth in average hourly earnings since just before the Great Financial Crisis.



A final key indicator in the monthly employment report focuses on the share of the adult, civilian, noninstitutionalized population that is either working or looking for work. The July ***labor force participation rate (LFPR)*** was unchanged at a seasonally adjusted 62.6% for a fifth straight month, as expected. Largely because so many Baby Boomers dropped out of the labor force in the pandemic, the LFPR has stagnated well below its level in 2019, helping create labor shortages and driving up wage rates. The chart below shows how the LFPR has changed over the last several decades.



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
EUROPE								
Eurozone	Retail Sales	y/y	Jun	-1.4%	-2.9%	-2.4%	*	Equity bullish, bond bearish
Germany	Factory Orders WDA	y/y	Jun	3.0%	-4.3%	-4.4%	***	Equity bearish, bond bullish
	HCOB Construction PMI	m/m	Jul	41.0	41.4		***	Equity and bond neutral
France	Industrial Production	y/y	Jun	-0.3%	2.6%	2.2%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	Jun	-0.2%	2.9%	2.4%	**	Equity bearish, bond bullish
Italy	Industrial Production WDA	y/y	Jun	-0.8%	-3.7%	-3.5%	***	Equity bullish, bond bearish
UK	New Car Registrations	y/y	Jul	28.3%	25.8%		*	Equity bullish, bond bearish
	S&P/CIPS Construction PMI	m/m	Jul	51.7	48.9	48.0	**	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	28-Jul	$594.0b	$595.9b		***	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	28-Jul	18.41t	18.44t		*	Equity and bond neutral
AMERICAS								
Mexico	Gross Fixed Investment	y/y	May	17.4%	6.1%	9.7%	**	Equity bullish, bond bearish
Brazil	S&P Global Composite PMI	m/m	Jul	49.6	51.5		**	Equity bearish, bond bullish
	S&P Global Services PMI	m/m	Jul	50.2	53.3		**	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	526	-2	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 (%)	4.19	4.18	0.01	Flat
Euribor/OIS spread (bps)	372	373	-1	Up
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Flat			Down
Yen	Flat			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	$85.55	$85.14	0.48%	
WTI	$81.95	$81.55	0.49%	
Natural Gas	$2.57	$2.57	0.08%	
Crack Spread	$40.00	$39.39	1.55%	
12-mo strip crack	$30.20	$30.12	0.27%	
Ethanol rack	$2.40	$2.40	-0.22%	
Metals				
Gold	$1,932.85	$1,934.06	-0.06%	
Silver	$23.42	$23.57	-0.63%	
Copper contract	$383.90	$389.95	-1.55%	
Grains				
Corn contract	$504.75	$493.50	2.28%	
Wheat contract	$647.00	$627.00	3.19%	
Soybeans contract	$1,339.75	$1,325.25	1.09%	
Shipping				
Baltic Dry Freight	1,128	1,123	5	
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)	14	18	-4	

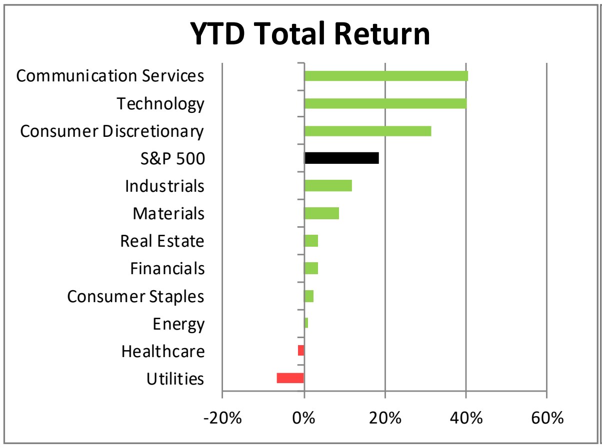
Weather

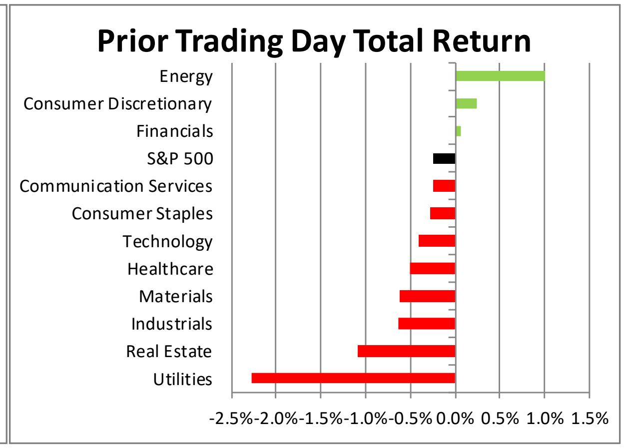
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures along the West Coast and in the Southwest, Texas, and Deep South regions, with cooler-than-normal temperatures in the northern Rockies, the northern Great Plains, and the Upper Midwest. The forecasts call for wetter-than-normal conditions everywhere except Florida, where normal conditions are expected, and the Southwest, where drier-than-normal conditions are expected.

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

Data Section

U.S. Equity Markets – (as of 8/3/2023 close)

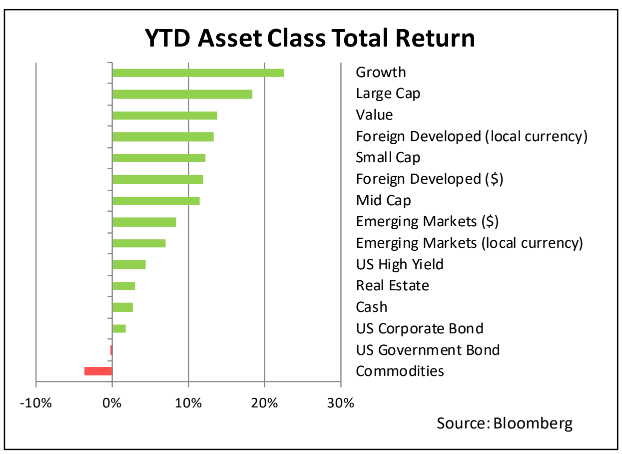




(Source: Bloomberg)

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 8/3/2023 close)

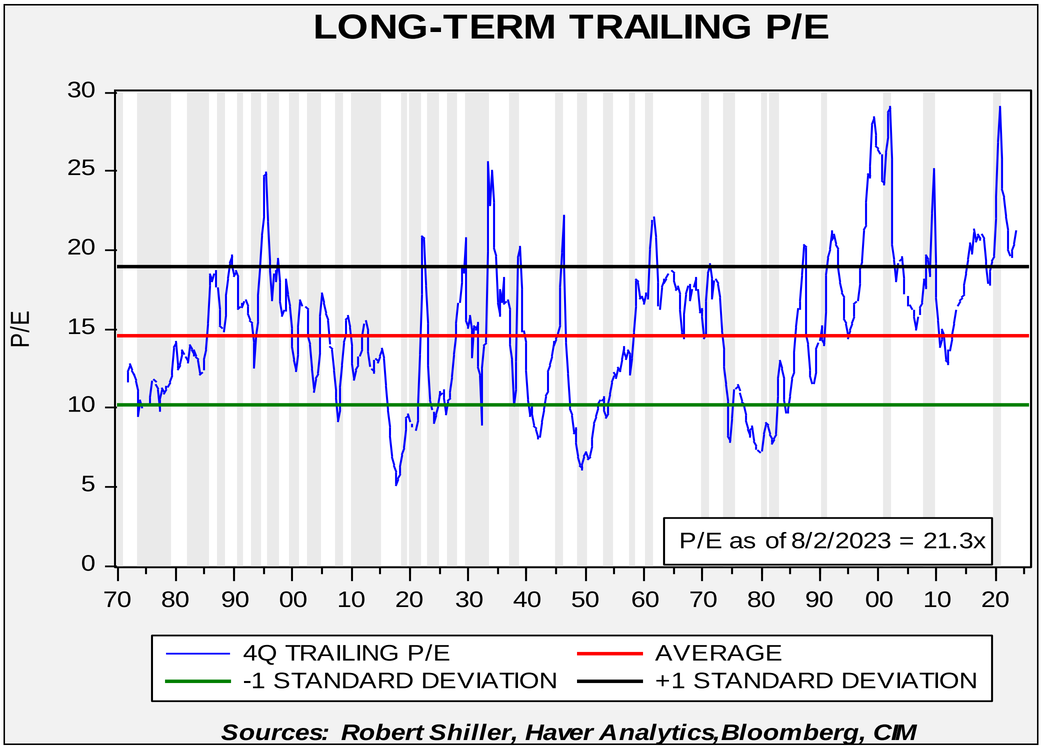


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.