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 8, 2023—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is down 1.5% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.8%. Chinese markets were lower, with the Shanghai Composite down 0.3% from its previous close and the Shenzhen Composite also down 0.3%. U.S. equity index futures are signaling a lower open.

With 427 companies having reported so far, S&P 500 earnings for Q2 are running at $54.10 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 14.3% 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:

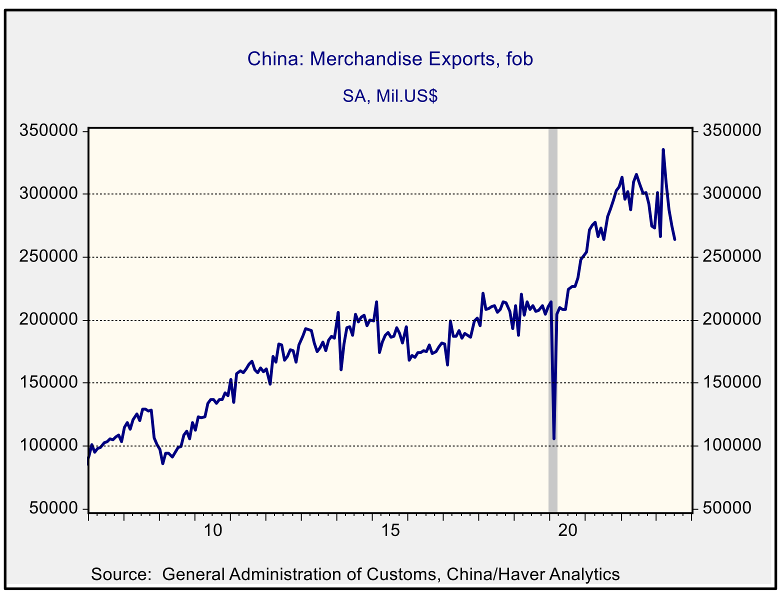
- ***Bi-Weekly Geopolitical Report*** **(8/7/2023) (podcast available later this week in the** ***Confluence of Ideas*** **series): "The Economics of National Defense in Great Power Competition"**
- *Weekly Energy Update* (8/3/2023): The unusually large draw in crude oil stocks failed to lift prices. 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"

Our *Comment* today opens with new evidence of military aggressiveness from the China/Russia bloc, which we continue to believe will produce risks for investors exposed to China or to companies dependent on China. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including a surprise windfall profits tax on Italian banks and a credit-rating cut on several regional banks in the U.S.

China-Russia-United States: It was reported yesterday that [almost a dozen Chinese and Russian navy vessels sailed close to the Aleutian Islands off Alaska last week](), in what is believed to be the largest such joint operation ever. In response, the U.S. Navy dispatched four destroyers and a surveillance plane to shadow the flotilla.

- Even though the Chinese and Russian ships did not enter U.S. territorial waters and have since left the area, officials are considering it unusually brazen and provocative.
- The incident also highlights our concern about the potential for increased Chinese and Russian naval cooperation.
    - Even though China now has the world's largest navy in terms of the number of its combat ships, it still consists mostly of smaller vessels geared toward defending the waters along China's coast. Over time, China intends to build a "blue water" navy that can project power globally, but that remains a work in process.
    - In contrast, the Russian navy, which ranks as the world's third-largest (just behind the U.S. Navy) has long been able to project power globally, especially via its advanced submarines. Many of its ocean-going surface ships have also been modernized with highly capable cruise missiles, as shown in the war in Ukraine.
    - If the Chinese and Russian navies set their minds to cooperating more fully and building synergies, and if they build up enough bases or port rights in friendly countries, they could potentially help the China/Russia bloc become a much more formidable military force around the world.

China: July exports were down a whopping 14.5% from the same month one year earlier, after June exports were down 12.4% year-over-year. Along with similarly bad export declines for other Asian economies, such as South Korea, the figures show how regional economies are being hurt as Western consumers shift from pandemic-driven goods consumption to post-pandemic services. For China, the export challenges also exacerbate domestic issues, such as the state's increasing interference in the economy and worsening demographics.



Russia-Ukraine War: As Ukraine's forces continue their slow, plodding counteroffensive against the Russians in the eastern parts of the country, new reports suggest that the U.S.'s recent provision of "cluster munitions" has helped improve their progress. The new munitions are reportedly helping the Ukrainians hit concentrations of Russian infantry, groups of vehicles, and other targets, allowing Kyiv's forces to make better progress than before.

Pakistan: Prime Minister Sharif said he plans to dissolve parliament on Wednesday and transfer power to a caretaker administration, a step that would normally lead to new elections within 90 days. However, a Sharif-led committee on Saturday also said it would redraw the country's electoral districts in response to Pakistan's latest census, potentially pushing the next elections into next year.

- If the elections are postponed until early 2024, it would produce a prolonged period in which the country is led by a government not backed by parliament.
- Coupled with the recent jailing of opposition leader and former Prime Minister Khan, the moves suggest Pakistan's democracy is being steadily undermined. In turn, that could produce further political and social instability.

Italy: The right-wing populist government of Prime Minister Meloni unexpectedly announced a windfall tax on bank profits generated by higher interest rates. According to the government, the tax proceeds will be used to provide relief to families hurt by higher interest costs. The move follows Meloni's recent criticism that banks have been too slow to boost interest payments to depositors. As might be expected, the announcement is weighing heavily on Italian banking stocks so far this morning.

U.S. Energy Prices: With global crude oil prices trending up again in response to OPEC+ supply cuts and stronger-than-expected demand, retail gasoline prices last week rose to an average of $3.87 per gallon, reaching their highest level since last November. If gasoline prices continue to rise, they could start to put ever more upward pressure on the consumer price index, potentially reversing some of the recent moderation in overall price inflation.

U.S. Banking Industry: Moody's (MCO, $342.41) said it has cut the credit ratings of 10 key regional banks and is reviewing the ratings of six other institutions, based on concerns that the Fed's continued interest-rate hikes will undermine their funding and impinge on their capital. Each cut was only one notch, and all the banks kept their investment-grade rating. Nevertheless, the move has rekindled concerns about mid-sized lenders like those that failed in March. That's helping push down the value of risk assets so far this morning.

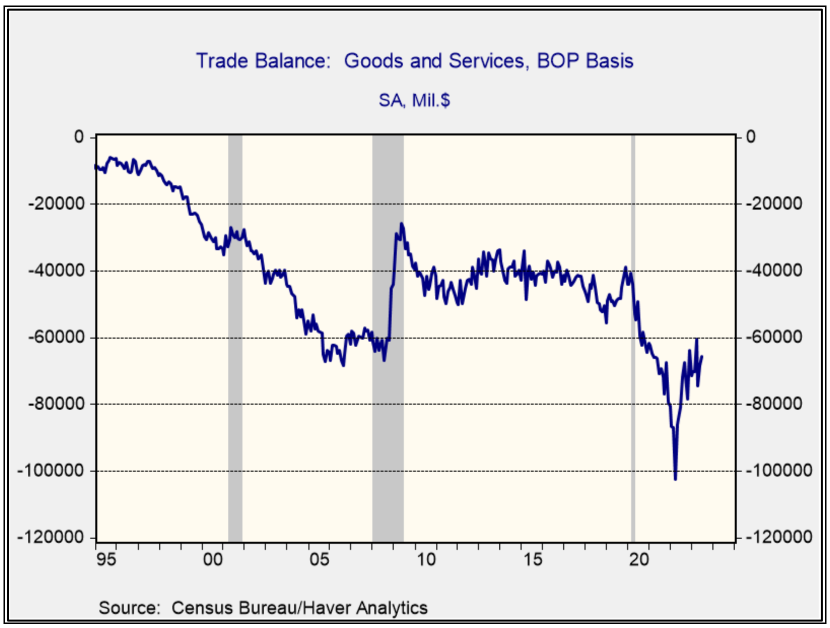
U.S. Commercial Real Estate Industry: Leading mortgage real estate investment trusts Blackstone Mortgage Trust (BXMT, $22.79) and KKR Real Estate Finance Trust (KREF, $12.51) said they extended no new commercial mortgage loans in the first half of 2023. Before this year's problems in the sector, the firms would have likely provided billions of dollars of new loans each quarter.

- The REITs' pullback in lending offers further evidence of just how much investors have soured on the prospects for commercial real estate, especially office buildings.

- Eventually, the sentiment on commercial real estate will hit rock bottom and potentially produce great bargains in the REIT sector. However, we believe it's still too early for that to happen.

U.S. Economic Releases

The U.S. trade deficit in goods and services narrowed to $65.5 billion in June, from $68.3 billion in May. The reading was slightly above expectations of a shortfall of $65.0 billion. The deficit shrank as consumers decreased their foreign purchases. Imported goods and services fell from $316.1 billion to $313.0 billion. Meanwhile, exported goods and services decreased slightly from $247.8 billion to $247.5 billion.



The chart above shows the level of the trade balance. A decline in the trade deficit is a mixed blessing. A shrinking deficit means that net exports will contribute positively to GDP. However, a drop in foreign purchases is also a sign that consumption spending may be weakening.

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	Wholesale Trade Sales	m/m	Jun	-0.2%	-0.2%	**
10:00	Wholesale Inventories	m/m	Jun F	-0.3%	-0.3%	***
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	Household Spending	y/y	Jun	-4.2%	-4.0%	-3.6%	***	Equity bearish, bond bullish
	BoP Current Account Balance	m/m	Jun	¥1508.8b	¥1862.4b	¥1500.0b	***	Equity and bond neutral
	BoP Trade Balance	m/m	Jun	-¥328.7b	-¥1186.7b	¥192.7b	**	Equity and bond neutral
Australia	Westpac Consumer Conf SA	m/m	Aug	-0.4%	2.7%		**	Equity bearish, bond bullish
	Westpac Consumer Conf Index	m/m	Aug	81	81.3		**	Equity and bond neutral
	NAB Business Confidence	m/m	Jul	2	0	-1	**	Equity bullish, bond bearish
	NAB Business Conditions	m/m	Jul	10	9	11	**	Equity bearish, bond bullish
South Korea	BoP Goods Balance	m/m	Jun	$3984.6m	$1815.0m		*	Equity and bond neutral
	BoP Current Account Balance	m/m	Jun	$5873.7m	$1927.2m		**	Equity and bond neutral
China	Exports	y/y	Jul	-14.5%	-12.4%	-13.2%	**	Equity bearish, bond bullish
	Imports	y/y	Jul	-12.4%	-6.8%	-5.6%	**	Equity bearish, bond bullish
	Trade Balance	m/m	Jul	80.60b	$70.62b	70.0b	***	Equity and bond neutral
EUROPE								
Germany	CPI	y/y	Jul F	6.2%	6.2%	6.2%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Jul F	6.5%	6.5%	6.5%	**	Equity and bond neutral
France	Trade Balance	m/m	Jun	-6713m	-8418m	-7939m	**	Equity and bond neutral
	Current Account Balance	m/m	Jun	0.8b	-0.7b	-0.6b	**	Equity bullish, bond bearish
Russia	Official Reserve Assets	m/m	Jul	590.0b	582.4b		*	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	527	-3	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 (%)	4.00	4.09	-0.09	Flat
Euribor/OIS spread (bps)	375	374	1	Up
Currencies	Direction			
Dollar	Up			Up
Euro	Down			Down
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	$83.53	$85.34	-2.12%	
WTI	$80.13	$81.94	-2.21%	
Natural Gas	$2.71	$2.73	-0.70%	
Crack Spread	$38.60	$39.16	-1.45%	
12-mo strip crack	$29.13	$29.67	-1.82%	
Ethanol rack	$2.40	$2.40	-0.15%	
Metals				
Gold	$1,924.20	$1,936.56	-0.64%	
Silver	$22.87	$23.13	-1.16%	
Copper contract	$373.85	$383.50	-2.52%	
Grains				
Corn contract	$491.50	$495.75	-0.86%	
Wheat contract	$645.75	$657.50	-1.79%	
Soybeans contract	$1,284.25	$1,302.00	-1.36%	
Shipping				
Baltic Dry Freight	1,145	1,136	9	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.0		
Gasoline (mb)		-1.0		
Distillates (mb)		0.3		
Refinery run rates (%)		0.4%		
Natural gas (bcf)		18		

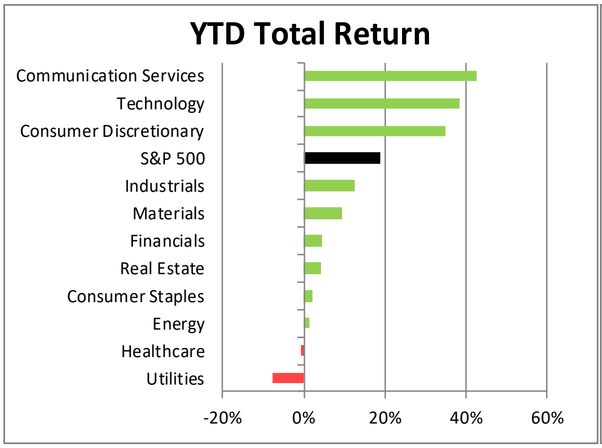
Weather

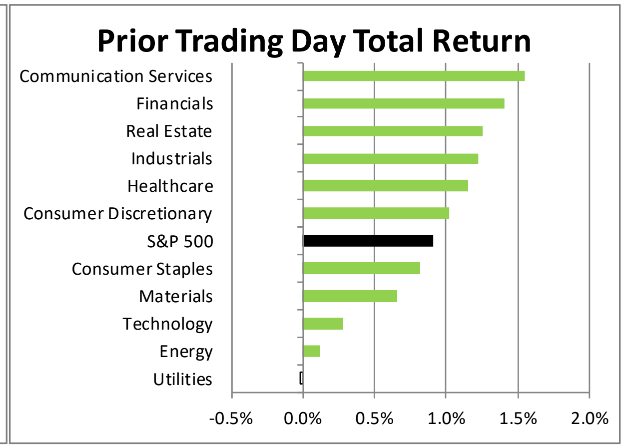
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout most of the country, with cooler-than-normal temperatures in the northern Rockies. The precipitation outlook calls for wetter-than-normal conditions in the majority of states, with drier conditions expected just in the northern Pacific region.

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

Data Section

U.S. Equity Markets – (as of 8/7/2023 close)

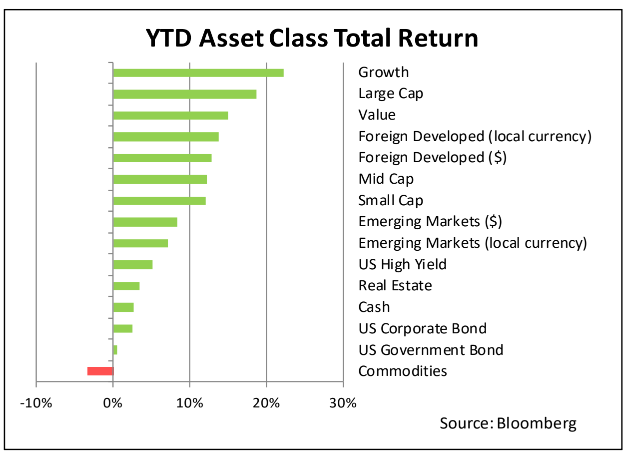




(Source: Bloomberg)

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 8/7/2023 close)

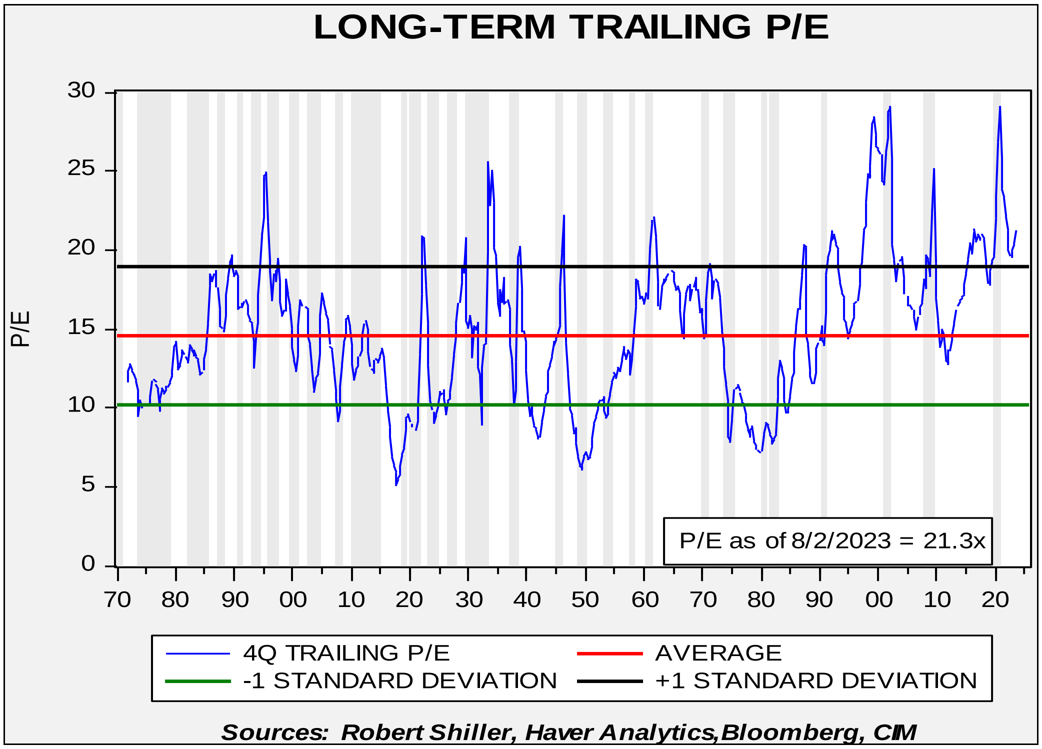


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.