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 9, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 1.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.6%. Chinese markets were lower, with the Shanghai Composite down 0.4% from its previous close and the Shenzhen Composite down 0.6%. U.S. equity index futures are signaling a higher open.

With 451 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, 80.3% have exceeded expectations while 14.9% 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 the latest news on China's deteriorating relations with the West and the problems in its domestic economy. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including reports of rising inflation expectations in the eurozone and negative signs regarding the current labor contract talks in the U.S. auto sector.

China-Taiwan-Japan: During a rare visit to Taiwan by a high-ranking Japanese official, former Prime Minister and current Vice President of the ruling Liberal Democratic Party Tarō Asō said the current period of peace in the region is now "tilting toward a time of emergency." Without specifically naming China and its intention to retake control of Taiwan, he warned that Japan, the U.S., and their allies would only be able to maintain peace in the Taiwan Strait if they bulk up their armed forces enough to deter any military action from a third country. The warning is consistent with the analysis in our latest *Bi-Weekly Geopolitical Report*, published on Monday.

China-United States: In the U.S.'s latest effort to keep the Chinese military from acquiring cutting-edge technology, President Biden will sign an executive order today requiring U.S. investors to report any private-equity or venture-capital stakes that they take in Chinese firms involved with semiconductors, quantum computing, or artificial intelligence. Under the order, U.S. investors would also be banned outright from making direct investments in specific areas of those sectors.

- The new rules will reportedly be less stringent than China hawks in Congress and the military advocated, probably because of lobbying by business elites and some in the administration who want to limit tensions with China.
- Nevertheless, coming less than a year after the administration's tough restrictions on sending advanced semiconductor technologies to China, the new rules will surely be seen by Beijing as a further attempt to hamstring China's economic development. U.S. investment in China has fallen sharply in recent years, but the new rules could push it down even further.
- In any case, the new rules will worsen U.S.-China tensions further, which we continue to believe will dramatically affect the global economy and create risks for U.S. investors in the coming years.

China: In the latest bad omen for China's domestic economy, the July consumer price index was down 0.2% from the same month one year earlier, marking the first bout of deflation since 2020. Unlike the U.S. and many other developed countries, China experienced little inflation amid the supply disruptions at the end of the coronavirus pandemic, at least in part because the government never provided much financial aid to help households get through the crisis. Now that the pandemic has passed, however, many consumers are focused on rebuilding their savings rather than buying.

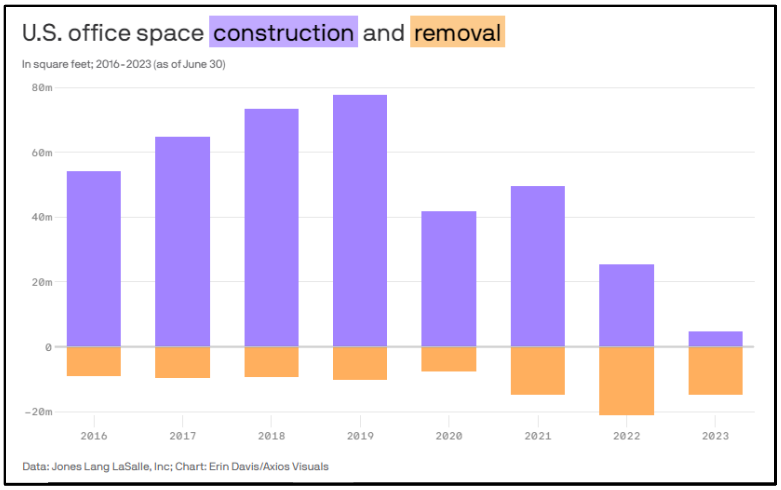
- Weak consumption demand and government interference in the economy are also discouraging investment, as is weak demand for Chinese exports. The situation is making it increasingly difficult for Chinese firms to hike prices.
- For the global economy, Chinese deflation translates into lower export prices which may help hold down inflation around the world. On a less positive note, however, low-priced Chinese goods dumped on the global market could weigh on foreign corporate margins.

Eurozone: Despite the deflation in China, a popular gauge of future inflation expectations in the eurozone suggests investors are becoming more pessimistic about price hikes there. The region's "five-year, five-year forward inflation swap — a measure of the markets' expectation of price growth over the second half of the next decade — hit 2.66% this week," compared with the eurozone's average inflation rate of about 1.3% in the decade before the coronavirus pandemic.

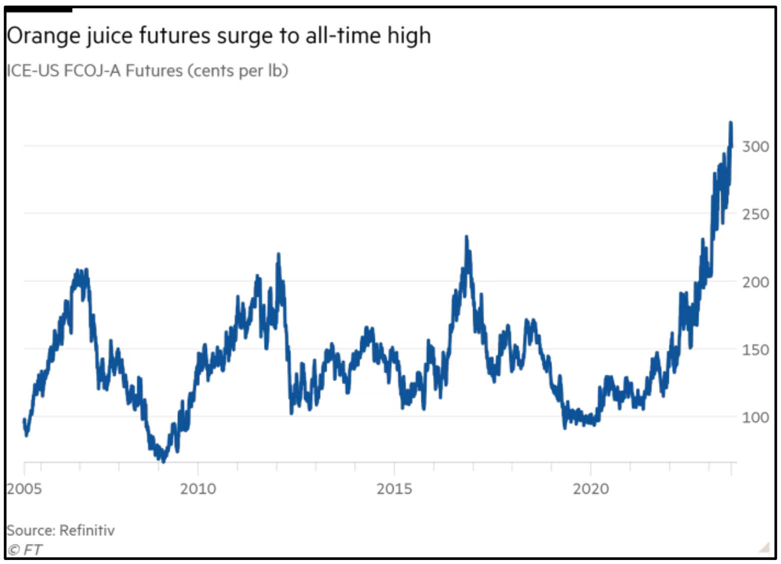
Italy: Prime Minister Meloni's right-wing populist government was forced to partially backtrack on its surprise windfall profits tax on lending institutions, which we described in our *Comment* yesterday. It appears the government was unsettled by the big drop in Italian bank stocks yesterday, so it has instead said the tax will be capped at 0.1% of the banks' risk-weighted capital. That's about one-fifth of the originally estimated hit.

U.S. Labor Market: In a worrisome sign for the ongoing contract negotiations between the United Autoworkers Union and Stellantis (STLA, $19.34), UAW chief Shawn Fain has complained that concessions demanded by the automaker are a "slap in the face" to union workers. Coupled with militant statements by other UAW officials recently, Fain's statement underscores that the union is likely to drive a very tough bargain, as workers and their representatives know they have increased leverage amid today's tight labor market. We suspect the major U.S. automakers will need to agree to significant pay increases and improved benefits to avoid a strike this fall.

U.S. Commercial Real Estate Market: New figures from Jones Lang LaSalle (JLL, $175.05) show real estate developers demolished 14.7 million square feet of office space in the first half of 2023, while breaking ground on only 4.8 million square feet. That marks the first time in recent memory in which developers tore down more office space than they built. The data provides further evidence of today's pessimism regarding the prospects for commercial office space.



U.S. Orange Juice Market: Nearby futures for frozen concentrated orange juice have hit a record high above $3.00 per pound, reflecting a dramatic decline in Florida's citrus crop due to a string of hurricanes and tree blight in recent years. Production in the state has fallen from about 240 million boxes per year two decades ago to just 18 million boxes this year.



U.S. Economic Releases

Elevated interest rates weighed on demand for residential loans last week. According to an index tracked by the Mortgage Bankers Association, mortgage applications fell 3.0% in the week ending August 4. The drop in loan requests is related to a sharp jump in bond yields that resulted in an increase in borrowing costs. The average 30-year fixed-rate mortgage rose 16 bps from 6.93% to 7.09%. As a result, the MBA tracker for purchases and refinancing fell 2.7% and 4.0% from the prior week, respectively.

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	Money Stock M2	y/y	Jul	2.4%	2.6%		**	Equity and bond neutral
	Money Stock M3	y/y	Jul	1.9%	2.1%		**	Equity and bond neutral
	Machine tool orders	y/y	Jul P	-19.8%	-21.1%		**	Equity bullish, bond bearish
Australia	Foreign Reserves	m/m	Jul	A$91.0b	A$89.4b		**	Equity and bond neutral
New Zealand	2-Year Inflation Expectations	q/q	3Q	2.83%	2.79%		**	Equity and bond neutral
South Korea	Unemployment Rate	m/m	Jul	22.8%	2.6%	2.7%	**	Equity and bond neutral
China	CPI	y/y	Jul	-0.3%	0.0%	-0.4%	***	Equity and bond neutral
	PPI	y/y	Jul	-4.4%	-0.5%	-4.0%	**	Equity and bond neutral
EUROPE								
France	Trade Balance	m/m	Jun	-€6.713b	-€8.418b	-€7.939b	**	Equity and bond neutral
AMERICAS								
Canada	Int'l Merchandise Trade	m/m	Jun	-3.73b	-3.44b	-2.68b	**	Equity and bond neutral
Mexico	International Reserves Weekly	w/w	4-Aug	$203889m	$204099m		*	Equity and bond neutral
Brazil	Retail Sales	y/y	Jun	1.3%	-1.0%	-1.1%	***	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)	527	528	-1	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	537	536	1	Up
U.S. Libor/OIS spread (bps)	539	539	0	Up
10-yr T-note (%)	4.03	4.03	0.00	Flat
Euribor/OIS spread (bps)	377	375	2	Up
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Up			Up
Yen	Flat			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	$86.98	$86.17	0.94%	
WTI	$83.81	$82.92	1.07%	
Natural Gas	$2.86	$2.78	3.06%	
Crack Spread	$40.46	$39.85	1.53%	
12-mo strip crack	$30.57	$30.30	0.88%	
Ethanol rack	$2.40	$2.40	-0.02%	
Metals				
Gold	$1,922.88	$1,925.24	-0.12%	
Silver	$22.71	$22.78	-0.30%	
Copper contract	$379.50	$376.65	0.76%	
Grains				
Corn contract	$501.00	$498.75	0.45%	
Wheat contract	$675.00	$681.50	-0.95%	
Soybeans contract	$1,316.75	$1,306.00	0.82%	
Shipping				
Baltic Dry Freight	1,142	1,145	-3	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.3		
Gasoline (mb)		-0.2		
Distillates (mb)		0.4		
Refinery run rates (%)		0.1%		
Natural gas (bcf)		23		

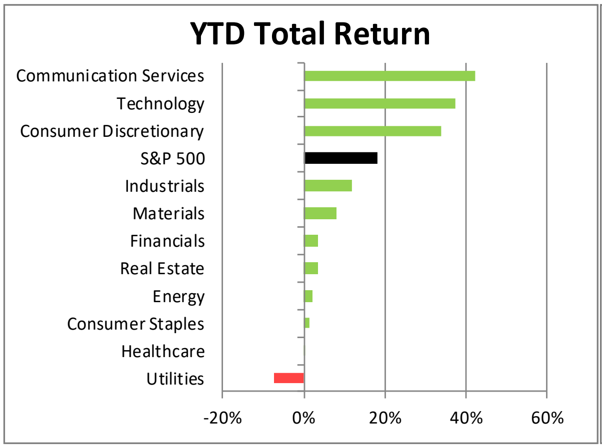
Weather

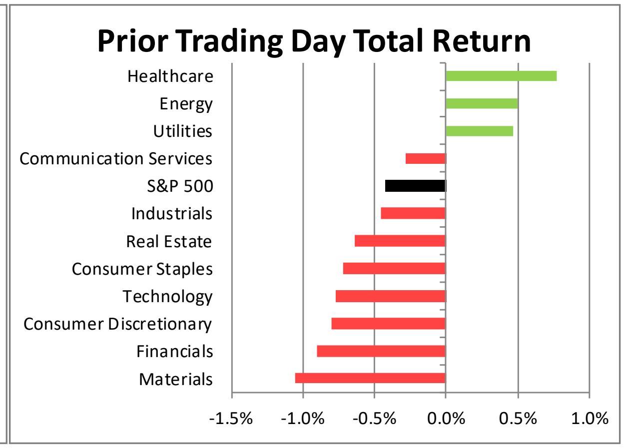
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout most of the country, with cooler-than-normal temperatures in the Rocky Mountain and Midwest regions. The precipitation outlook calls for wetter-than-normal conditions in the majority of states, with drier conditions 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 8/8/2023 close)

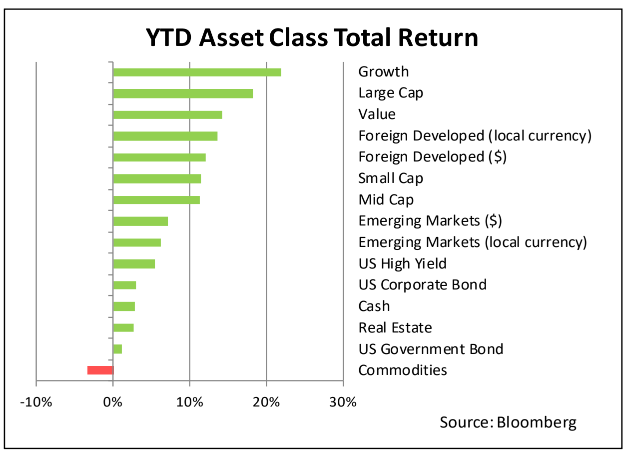




(Source: Bloomberg)

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 8/8/2023 close)

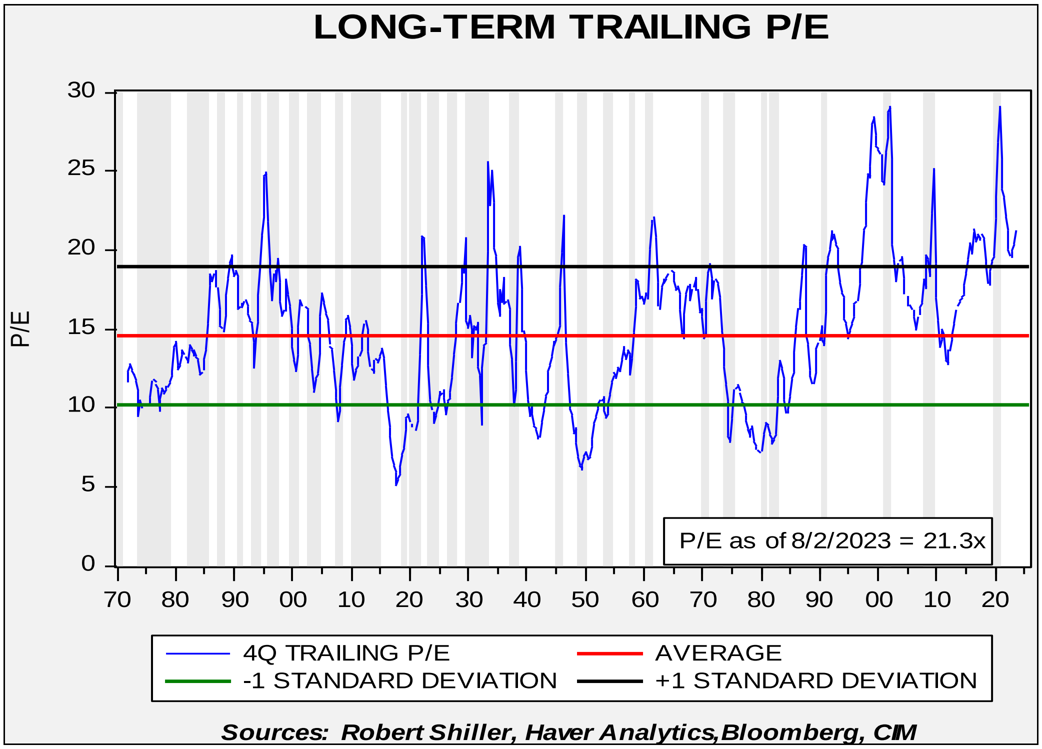


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.