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: February 1, 2023—9:30 AM EST] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is currently up 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.4%. Chinese markets are higher with the Shanghai Composite closing up 0.9% from prior close and the Shenzhen Composite closing up 1.5% in the same period. U.S. equity index futures are signaling a higher open.

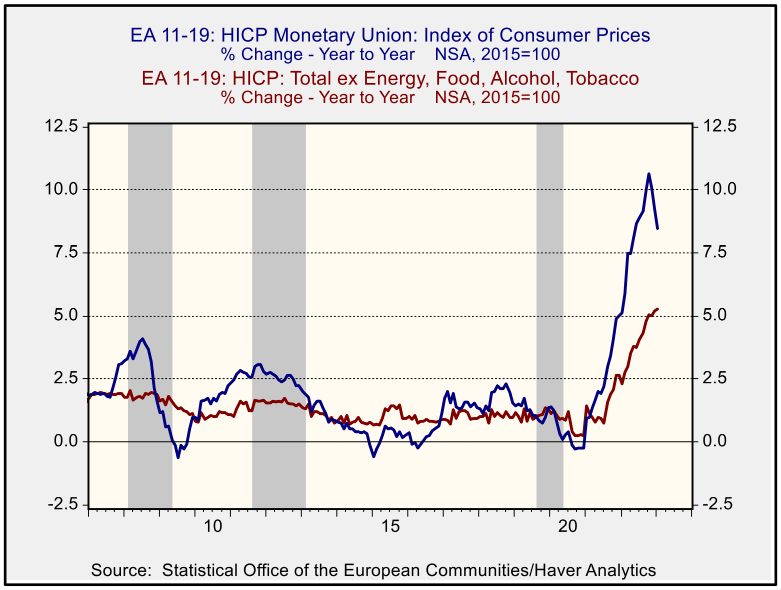
With 166 companies having reported so far, S&P 500 earnings for Q4 are running at $54.20 per share, compared to estimates of $52.85. Of the companies that have reported thus far, 72.3% have exceeded expectations while 24.1% have fallen short of expectations.

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* (1/23/2023) (with associated podcast) "The New German Problem"
- *Weekly Energy Update* (1/26/2023): For the second straight week, the SPR was steady. Refineries are slowly returning after the December cold snap while refining margins widen. The oil market is navigating the bullish reopening of China against the looming global recession.
- *Asset Allocation Quarterly – Q1 2023* (1/19/2023): Discussion of our asset allocation process, Q1 2023 portfolio changes, and our outlook for the markets.
- *Asset Allocation Bi-Weekly* (1/30/2023) (associated podcast will be available later this week): "Secular Trends in Bond Yields"
- *Asset Allocation Q4 2022 Rebalance Presentation* (11/14/2022): Video presentation featuring the Asset Allocation Committee as they review our asset allocation strategies, recent portfolio changes, and the current macro environment.
- *Confluence of Ideas* podcast (12/19/2022): "The 2023 Geopolitical Outlook"

Our *Comment* today opens with more good news on global price inflation. Data today showed that the Eurozone's consumer inflation has again cooled modestly, though probably not enough to prompt the European Central Bank to slow its aggressive interest-rate hikes. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including a discussion of the Czech Republic's controversial new president and a preview of today's interest-rate decision from the Federal Reserve.

Eurozone: The January Consumer Price Index (CPI) was up 8.5% from one year earlier, marking a small improvement from the 9.2% increase in the year to December. However, much of the improvement stemmed from the recent pullback in European energy prices because of the mild winter. Stripping out the volatile food and energy components, the January Core CPI was up 5.2% year-over-year, essentially the same annual increase as in the prior month. The report is therefore unlikely to dissuade the ECB from implementing another aggressive interest-rate hike tomorrow as it continues to battle high inflation in the Eurozone.



Czech Republic: Petr Pavel, the unaffiliated former leader of the Czech army and the former chief of the NATO military committee, has been declared the winner in last weekend's presidential election. Running on a platform embracing the EU and NATO, Pavel handily beat populist Former Prime Minister Andrej Babiš.

- Although the Czech presidency is largely symbolic and has no executive powers, Pavel's win is being seen as an important political victory over populism and pro-Russian sympathies in the country.
- Pavel has already risked confrontation with China by taking a congratulatory phone call from Taiwanese President Tsai Ing-wen. He therefore became one of the few elected European leaders who has recently risked Beijing's ire in such a way. The gesture in support of Taiwan could encourage other European leaders to take a more assertive stance against China's geopolitical aggression.
- In an interview with the *Financial Times* published today, Pavel was even more blunt, saying, "This is what we have to be very clear about: China and its regime is not a friendly country at this moment, it is not compatible with western democracies in their strategic goals and principles… This is simply a fact that we have to recognize."

Russia-Ukraine War: Although the front lines running from eastern to southern Ukraine remain largely static, albeit with heavy fighting in some areas, the Ukrainian government has again warned that it has intelligence that the Russians are planning a major new offensive soon, potentially to coincide with the one-year anniversary of their invasion on February 24. Among the signs of such a new offensive, the Ukrainians note the Russian military's increased mobilization of resources and intensified troop training.

India: Ahead of the next parliamentary elections in Spring 2024, the government of Prime Minister Modi has released a proposed budget for the fiscal year beginning April 1 that cuts taxes for the upper and middle classes and massively boosts infrastructure spending. The budget assumes Indian GDP will grow between 6.0% and 6.8% in the coming fiscal year, allowing the budget deficit to decline to 5.9% of GDP from an estimated 6.4% of GDP in the current year.

United States-Russia: In a report sent to Congress yesterday, the State Department said Russia has violated the New START treaty, which cut long-range nuclear arms, by refusing to allow on-site inspections and rebuffing the U.S.'s requests to meet to discuss its compliance concerns. With spot checks no longer possible, the U.S. can no longer verify the weapon counts reported by Russia. The violations, which Russia denies, raise the risk that New START, the only remaining Cold War-era arms limitation treaty still in force, will not be renewed when it expires in 2026.

- As important as the New START treaty is in limiting the U.S. and Russian nuclear arsenals, the agreement doesn't include China at all. China's strategic nuclear arsenal remains far smaller than the U.S. and Russian arsenals, but it is rapidly building up its inventory of nuclear weapons and could approach the numbers in the U.S. stockpile in several years.
- Abrogation of New START could therefore free the U.S. to expand its nuclear arsenal as needed to meet the new challenge of deterring a potentially combined Chinese-Russian nuclear attack.

United States-China: In a possible retaliation for the U.S.'s stringent new controls on exporting its advanced semiconductor technologies, China is reportedly considering a ban on exporting its own advanced solar energy technologies. If the plan is adopted, Chinese solar manufacturers would be required to obtain a license from their provincial commerce authorities to export such technologies. If put into place, the Chinese restrictions could crimp efforts to expand solar generating facilities and solar equipment manufacturing in the U.S., Europe, and developed Asian countries in the coming years.

United States-India: This week, the Biden administration hosted U.S. business leaders and an Indian delegation led by New Delhi's national security advisor to discuss ways to shift key technology supply chains away from China and toward India. The meetings are another instance of how seriously the U.S. government, with bipartisan support in Congress, is seeking to decouple from China and its evolving geopolitical bloc in terms of key technologies and commodities.

U.S. Monetary Policy: Fed officials wrap up their latest two-day monetary policy meeting today, with their decision due to be released at 2:00 PM ET. The officials are widely expected to slow their rate hikes at the meeting to just 25 basis points, bringing the benchmark fed funds rate to a range of 4.50% to 4.75%. However, they are also expected to signal that they won't be finished tightening policy until they make more progress in bringing down inflation.

- We continue to believe the continued rate hikes will help push the U.S. economy into recession in the very near future. That suggests U.S. stock prices could well turn downward again, despite their rally in recent weeks.
- The ECB and the Bank of England will hold policy meetings tomorrow, but they are expected to keep hiking their benchmark interest rates by an aggressive 50 basis points. The narrowing differential between the U.S. and European benchmark rates will probably put continued downward pressure on the dollar.

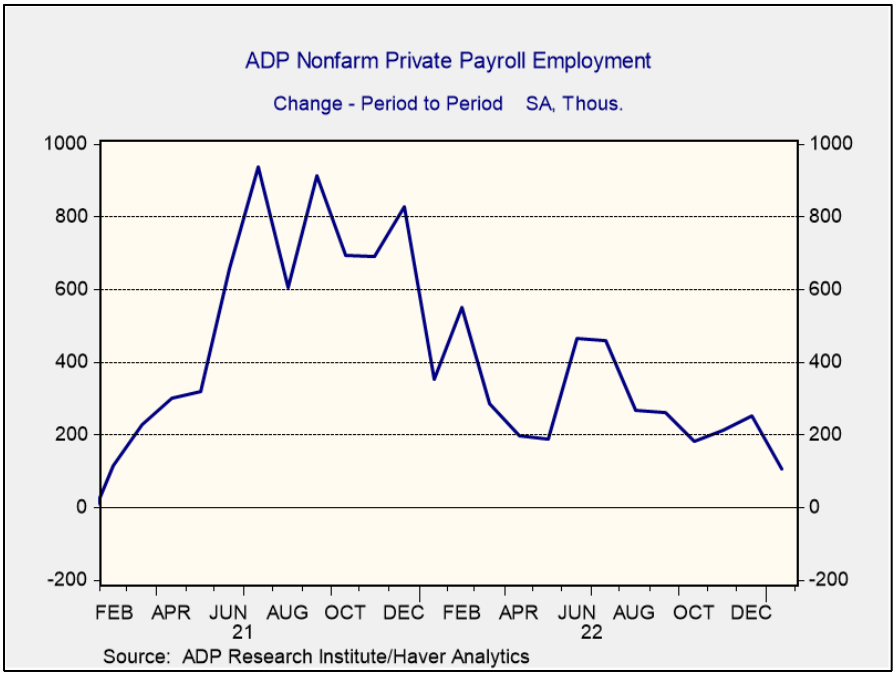
U.S. Fiscal Policy: President Biden and House Speaker McCarthy will meet today to discuss a range of issues and, more importantly, to begin negotiating a deal to raise the federal debt ceiling. Any lack of results could rekindle concerns about a potential U.S. debt default and spark additional market volatility.

U.S. Regulatory Policy: The Consumer Financial Protection Bureau plans to propose a rule today that would limit the late fees credit-card companies can charge, bringing penalties down to $8 from as much as $41 currently. The rule, which doesn't require Congressional approval, could go into effect as early as 2024. The expected new rule illustrates the Biden administration's relatively more aggressive regulatory initiatives.

U.S. Economic Releases

Demand for residential home loans fell for the first time in four weeks. According to an index tracked by the Mortgage Bankers' Association, applications fell 9% in the week ending January 27. The drop in applications may have been due to concerns about the economy. Although the average 30-year fixed-rate mortgage fell 1 bp from 6.20% to 6.19%, an unexpected drop in January's consumer confidence report suggests households fear an imminent downturn. As a result, the MBA tracker for purchases fell 10.3% from the prior week, while the refinancing tracker dropped 7.1% in the same period.

Private data shows that firms pulled back in hiring. According to payroll management firm ADP, firms added 106k new workers to their payrolls in January. The reading was well below expectations of 180k, but lower than the previous revised figure of 253k. Although the reading may not reflect the official government figures, it does provide hints about Friday's report.



The chart above shows the change in the employment payrolls for ADP. The slowdown in hiring will likely indicate to the Fed that it can pause its hiking of rates. There are reports that suggest the central bank will halt its hiking cycle in May if inflation continues to decline.

The table below lists the economic releases and/or Federal Reserve events scheduled for the rest of the day.

Economic Releases						
No economic releases for the rest of today						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	S&P GlobalManufacturing PMI	m/m	Jan F	46.8	46.8	***
10:00	Construction Spending MoM	m/m	Dec	0.0%	0.2%	**
10:00	ISM Manufacturing PMI	m/m	Jan	48	48.4	**
10:00	ISM Manufacturing PMI - Employment	m/m	Jan		51.4	*
10:00	ISM Manufacturing PMI - New Orders	m/m	Jan		45.2	**
10:00	ISM Manufacturing PMI - Prices Paid	m/m	Jan	40.4	39.4	**
10:00	JOLTS Job Openings	m/m	Dec	10.300m	10.458m	**
14:00	FOMC Rate Decision (Lower Bound)	w/w	1-Feb	4.50%	4.25%	***
14:00	FOMC Rate Decision (Upper Bound)	w/w	1-Feb	4.75%	4.50%	***
14:00	Interest on Reserve Balances Rate	w/w	2-Feb	4.65%	4.40%	**
	Wards Total Vehicle Sales	m/m	Jan	15.50m	13.31m	***
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
14:30	Jerome Powell Holds Conference Following FOMC Meeting	Chairman of the Board of Governors				

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	Jibun Bank Manufacturing PMI	m/m	Jan F	48.9	48.9		***	Equity and bond neutral
New Zealand	CoreLogic House Prices	y/y	Jan	-7.2%	-5.0%		*	Equity bearish, bond bullish
	Unemployment Rate	m/m	4Q	3.4%	3.3%	3.3%	**	Equity and bond neutral
	Employment Change	q/q	4Q	1.3%	1.2%	1.5%	*	Equity and bond neutral
South Korea	S&P Global Manufacturing PMI	m/m	Jan	48.5	48.2		***	Equity and bond neutral
	Trade Balance	m/m	Jan	-$12.690b	-$4.689b	-$4.692b	*	Equity bearish, bond bullish
	Exports	y/y	Jan	-16.6%	-9.5%	-9.6%	***	Equity bearish, bond bullish
	Imports	y/y	Jan	-2.6%	-2.4%	-2.5%	**	Equity and bond neutral
China	Caixin Manufacturing PMI	m/m	Jan	49.2	49.0	49.8	***	Equity and bond neutral
India	S&P Global Manufacturing PMI	m/m	Jan	55.4	57.8		***	Equity and bond neutral
EUROPE								
Eurozone	S&P Global Manufacturing PMI	m/m	Jan F	48.8	48.8	48.8	***	Equity and bond neutral
	CPI	y/y	Jan	8.5%	9.2%	8.9%	***	Equity and bond neutral
	Core CPI	y/y	Jan P	5.2%	5.2%	5.1%	**	Equity and bond neutral
	Unemployment Rate	m/m	Dec	6.6%	6.5%	6.5%	**	Equity and bond neutral
Germany	S&P Global/BME Manufacturing PMI	m/m	Jan F	47.3	47.0	47.0	***	Equity and bond neutral
France	S&P Global Manufacturing PMI	m/m	Jan F	50.5	50.8	50.8	***	Equity and bond neutral
Italy	S&P Global Manufacturing PMI	m/m	Jan	50.4	48.5	49.5	***	Equity bullish, bond bearish
	CPI, EU Harmonized	y/y	Jan P	10.9%	12.3%	10.7%	***	Equity and bond neutral
	CPI NIC Including Tobacco	y/y	Jan P	10.1%	11.6%	10.2%	**	Equity and bond neutral
UK	Nationwide House Price Index	y/y	Jan	1.1%	2.8%	1.9%	***	Equity bullish, bond bearish
	S&P Global/CIPS Manufacturing PMI	m/m	Jan F	47.0	46.7	46.7	***	Equity and bond neutral
Switzerland	Manufacturing PMI	m/m	Jan	49.3	54.1	54.5	***	Equity bearish, bond bullish
Russia	S&P Global Manufacturing PMI	m/m	Jan	52.6	53.0		***	Equity and bond neutral
AMERICAS								
Mexico	International Reserves Weekly	w/w	27-Jan	$200.995b	$200.889b		*	Equity and bond neutral
Brazil	S&P Global Manufacturing PMI	m/m	Jan	47.5	44.2		***	Equity and bond neutral
	Formal Job Creation	m/m	Dec	-431.011m	135.495m	-130.545	**	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)	481	483	-2	Up
3-mo T-bill yield (bps)	453	455	-2	Up
TED spread (bps)	28	28	0	Neutral
U.S. Sibor/OIS spread (bps)	469	468	1	Up
U.S. Libor/OIS spread (bps)	471	471	0	Up
10-yr T-note (%)	3.48	3.51	-0.03	Up
Euribor/OIS spread (bps)	251	248	3	Up
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Up			Up
Pound	Flat			Up
Franc	Flat			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.

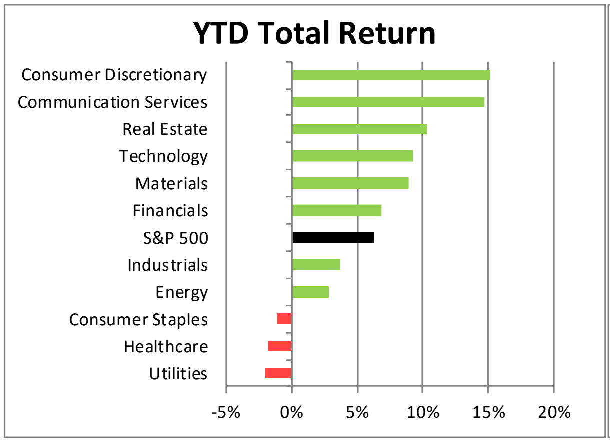
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$85.72	$85.46	0.30%	
WTI	$79.30	$78.87	0.55%	
Natural Gas	$2.68	$2.68	-0.04%	
Crack Spread	$36.24	$36.71	-1.29%	
12-mo strip crack	$31.28	$31.46	-0.59%	
Ethanol rack	$2.34	$2.34	0.00%	
Metals				
Gold	$1,928.19	$1,928.36	-0.01%	
Silver	$23.53	$23.73	-0.85%	
Copper contract	$417.55	$422.60	-1.19%	
Grains				
Corn contract	$676.25	$679.75	-0.51%	
Wheat contract	$759.25	$761.25	-0.26%	
Soybeans contract	$1,538.75	$1,538.00	0.05%	
Shipping				
Baltic Dry Freight	681	680	1	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.0		
Gasoline (mb)		2.0		
Distillates (mb)		-1.5		
Refinery run rates (%)		1.0%		
Natural gas (bcf)		-147		

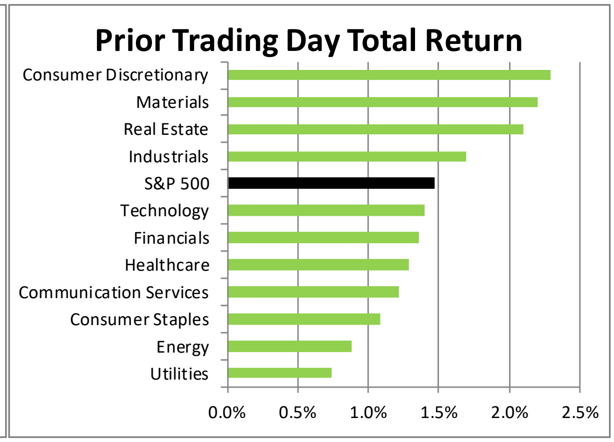
Weather

The 6-10 and 8-14 day forecasts show warmer-than-normal temperatures throughout most of the country, with cooler temperatures in the Pacific region. Additionally, the forecast shows wetter-than-normal conditions throughout the majority of the nation.

Data Section

U.S. Equity Markets – (as of 1/31/2023 close)

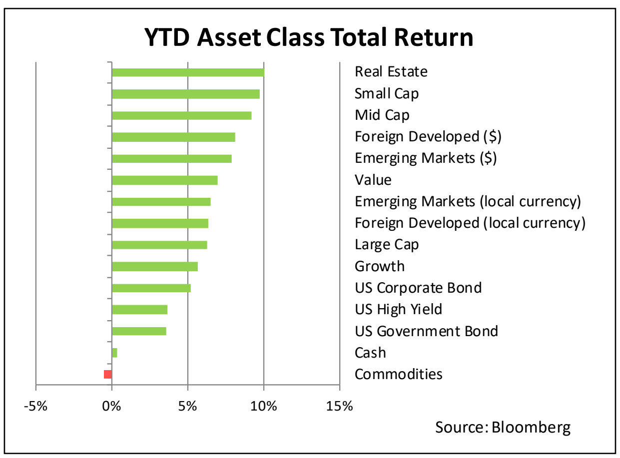




(Source: Bloomberg)

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 1/31/2023 close)

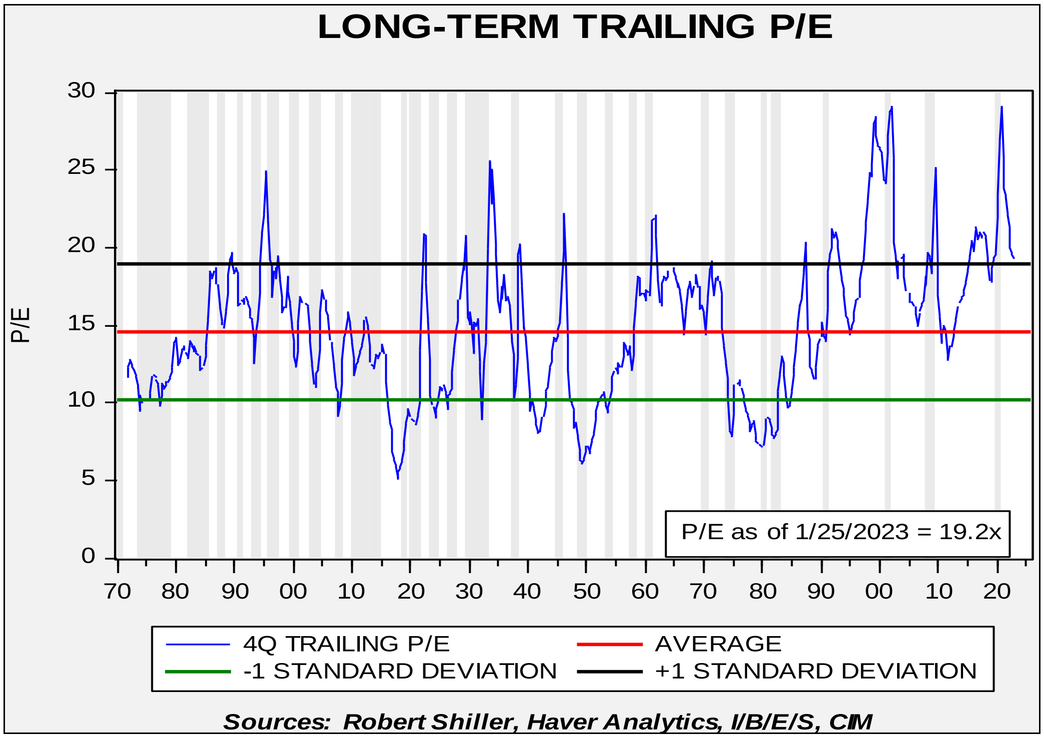


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

January 26, 2023



Based on our methodology,[1] the current P/E is 19.2x, steady with 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 I/B/E/S estimates which are updated regularly throughout the quarter; currently, the four-quarter earnings sum includes two actual quarters (Q2 and Q3) and two estimates (Q4 and Q1). 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.