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 2, 2023—9:30 AM EST] Global equity markets are mostly higher this morning. In Europe, the Euro Stoxx 50 is currently up 0.8% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.6%. Chinese markets were little changed, with the Shanghai Composite closing up less than 0.1% from its prior close and the Shenzhen Composite closing down less than 0.1%. U.S. equity index futures are signaling a higher open.

With 203 companies having reported so far, S&P 500 earnings for Q4 are running at $54.10 per share, compared to estimates of $52.85. Of the companies that have reported thus far, 70.4% have exceeded expectations while 25.1% 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*** **(2/2/2023): In addition to our usual updates of the weekly storage data, we discuss the recent attacks in Iran and Germany's plans to build storage for natural gas.**
- *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 (2/1/2023): "The 2023 Outlook"**

Good morning! Our *Comment* begins with the latest Federal Open Market Committee meeting, including the decision to raise rates. Next, we cover the rate decisions of the European Central Bank and the Bank of England. Finally, we discuss Germany's recent moves to position itself for a greener world.

Not Convinced: Fed Chair Jerome Powell insisted that the Fed will hold rates in the restrictive territory, but the market isn't buying it.

- The Federal Reserve raised its benchmark interest rate by 25 bps to 4.50%-4.75%, as expected. The increase was a downshift from the previous meeting and has led to speculation that the Fed is close to ending its hiking cycle. After announcing the rate hike, Powell emphasized that the central bank plans to hike more throughout the year. He argued that core services, which exclude shelter prices, and employment remain elevated and may lead to a wage-price spiral if left unchecked. He also opined that the economy is strong enough to withstand additional rate hikes.
- Equity prices surged, and bonds rallied as investors posited that the next rate hike would probably be the last. The S&P 500 rose to an intraday high of 1.8%. Meanwhile, the NASDAQ, which tracks tech stocks, closed 2% higher than the previous day. However, the bigger news came from bonds. The yield on 10-year Treasuries dropped by 12 bps which suggests that bond traders are confident that the Fed will reverse course if inflation heats back up. The latest FedWatch tools show that 30-day fed funds futures predict another 25 bps hike in March with a 66% chance that there won't be an increase in rates above 4.75-5.00% at the following meeting.
- The last few cycles have shown that the Fed typically uses steps when it raises rates but takes the elevator down when cutting them. Thus, Thursday's market reaction likely reflects investors' hopes of a Fed pivot sometime this year. If the market is correct, we could see equities flourish. However, if it is wrong and the Fed decides to hike rates, equities may stagnate or drop. The direction of inflation will likely determine where the market will go. If inflation continues to climb, the Fed could pause or possibly cut in time to prevent a significant downturn.

Not Far Behind: The European Central Bank and the Bank of England had bigger hikes than the Fed; however, neither is committed to raising rates in a downturn.

- The European Central Bank and the Bank of England both pushed up their respective policy by half a percentage point. The markets anticipated the moves as central bank officials had been hinting at the change for several weeks. Although the ECB maintained that it would stay the course of its policy, it signaled along with the BOE that future rate hikes will depend on economic data. The varying responses from these central banks highlight the pressures policymakers are under to consider the economy as they look to tame inflation.
- The EUR and the GBP were sold off as investors questioned the ECB and BOE's commitment to fighting inflation. The markets' reactions suggest that investors believe that the central banks could end their hiking cycle as their respective economies head into recession. The spread between 10-year government bonds for Italy and Germany, a gauge of European financial stress, narrowed as borrowing costs are less likely to rise for distressed European economies. Therefore, lending conditions could improve in the Eurozone.
- The market likely interpreted the BOE and ECB as being more dovish than they actually were. Policymakers are likely to continue pushing rates higher as long as the economy remains relatively strong. Although a recession is widely expected in both regions, stronger-than-expected GDP growth in Q4 2022 indicates that it is likely further in the

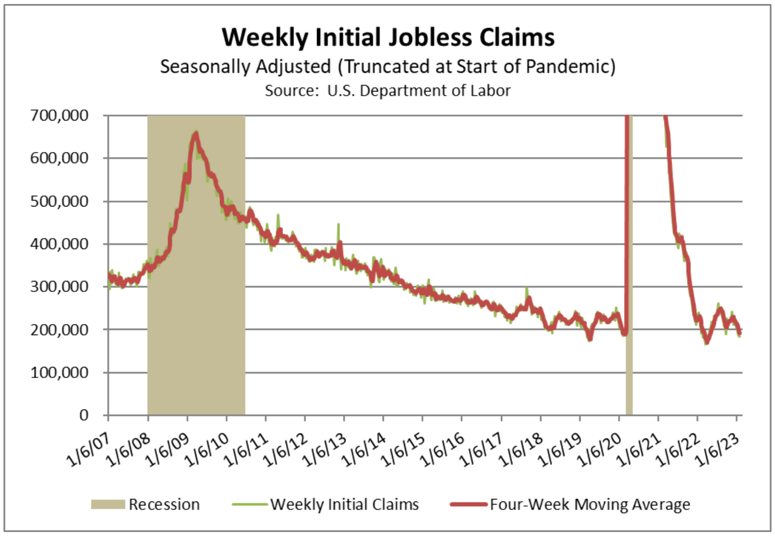
future than originally thought. As a result, central bank policy may begin to tighten as these policymakers look to maintain credibility. That said, the recent comments from these banks suggest that they are not fully committed to remaining hawkish, which means that global financial conditions will likely ease throughout the year.

The German Problem: As Berlin positions its country to adapt to a new normal, it is resisting a major change in the status quo of Europe.

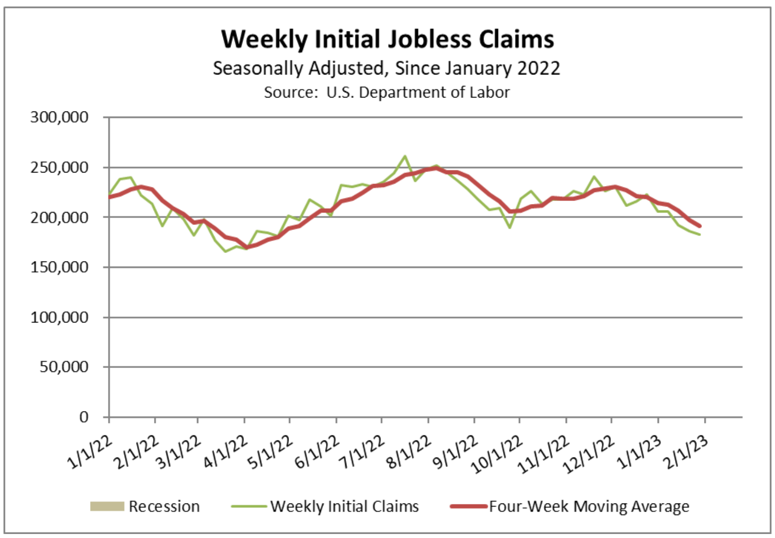
- Chancellor Olaf Scholz racked up two wins in his race to refocus the German economy toward semiconductors. Apple (AAPL, $145.43) announced plans to invest $1.2 billion in Germany to set up a new European silicon design center and improve research and development. The new investment will help build out the country's 5G capabilities and enhance its wireless technologies. Additionally, American manufacturer Wolfspeed, Inc (WOLF, $83.01) agreed to produce chips for electric vehicles in Saarland. The two investments show that Germany aims to support the country's technological shift away from traditional manufacturing and toward greener technologies.
- Despite attempts to improve its own industry, Germany has set up hurdles for other European countries to make the same transition. The European Union is expected to miss its March deadline for reforms to the Stability and Growth Pact. The changes would allow countries to offer subsidies to compete with the U.S. Inflation Reduction Act. Without these changes to the debt limit rules within the pact, countries will have to make painful budgetary adjustments if they want to offer energy incentives for green projects. Germany insists that any changes to the rules should not impact governments' efforts to reduce debt loads. As a result, Europe's Green Deal Industrial Plan will likely be put on hold as officials argue out the details.
- Germany will always support and put its own interests first, even at the expense of its European allies. As we have mentioned in previous reports, Berlin does not want to fully align its interests with the West since it depends on commodity imports from Russia and trade with China. Germany's reluctance is also related to wanting a head start on its European counterparts. Thus, it will also likely use the additional time to position itself as a premier European hub for energy manufacturing.

U.S. Economic Releases

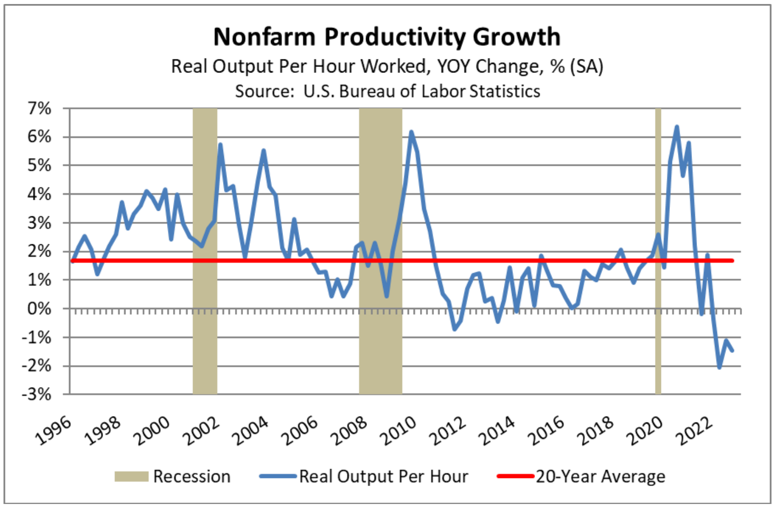
Initial applications for unemployment benefits in the week ending January 28 fell to a seasonally adjusted 183,000, below both the expected level of 195,000 and the previous week's extraordinarily low level of 186,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to a nearly nine-month low of 191,750. Meanwhile, the number of people continuing to draw benefits in the week ending January 21 fell to 1.655 million, below both the anticipated reading of 1.684 million and the prior week's revised reading of 1.666 million. The following chart shows how initial jobless claims have fluctuated since just before the prior recession. The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



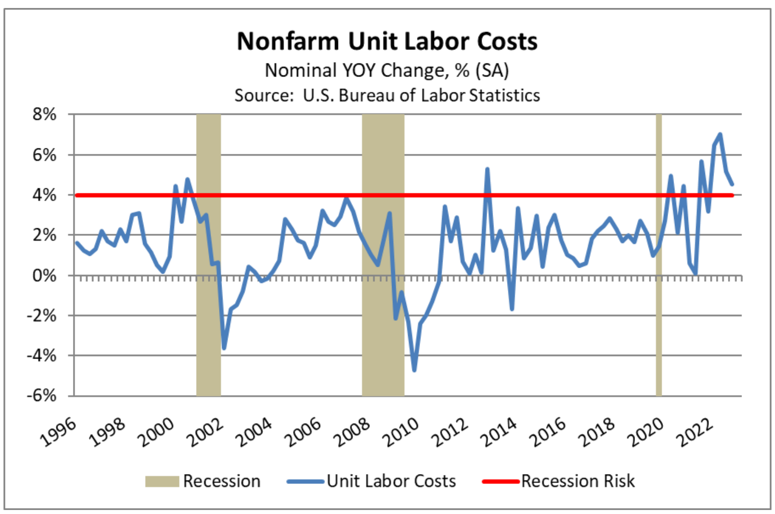
To provide more detail on recent trends, the chart below shows how initial jobless claims have changed just since the beginning of 2022.



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, Q4 nonfarm productivity rose at an annualized rate of 3.0%, substantially better than the expected growth rate of 2.4% and more than double the revised Q3 rate of 1.4%. Because of big productivity declines in early 2022, output per hour in Q4 was still down 1.5% from the same period one year earlier. All the same, the better productivity numbers in late 2022 are a positive for the economy because productivity growth is key to boosting living standards and supporting higher wages without exacerbating inflation. The following chart shows the year-over-year growth in real productivity over the last quarter-century or so.



Reflecting the strong productivity growth late last year, Q4 unit labor costs rose at an annualized rate of just 1.1%, much better than the expected growth rate of 1.5% and only about half as fast as the revised 2.0% growth rate in the prior quarter. However, because of the fast increases in early 2022, unit labor costs in Q4 were still up 4.5% year-over-year, exceeding the 4.0% increase that has often been associated with recessions in the past. The chart below shows the year-over-year growth in unit labor costs since 1996.



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
10:00	Factory Orders	m/m	Dec	2.3%	-1.8%	***
10:00	Durable Goods Orders	m/m	Dec F	5.6%	5.6%	***
10:00	Durable Goods Orders Ex Transportation	m/m	Dec F	-0.1%	-0.1%	**
10:00	Cap Goods Orders Nondef Ex Air	m/m	Dec F		-0.2%	**
10:00	Cap Goods Ship Nondef Ex Air	m/m	Dec F		-0.4%	**
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	Japan Buying Foreign Bonds	w/w	27-Jan	-¥715.4b	-¥344.2b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	27-Jan	¥12.4b	-¥131.3b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	27-Jan	-¥101.3b	¥260.3b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	27-Jan	¥379.5b	-¥83.0b		*	Equity and bond neutral
	Monetary Base	y/y	Jan	-3.8%	-6.1%		**	Equity and bond neutral
	Monetary Base, End of Period	m/m	Jan	¥651.9t	¥632.4t		*	Equity and bond neutral
Australia	Building Approvals	m/m	Dec	18.5%	-9.0%	-8.8%	***	Equity bullish, bond bearish
New Zealand	Building Permits	m/m	Dec	-7.2%	7.0%	6.70	**	Equity bearish, bond bullish
South Korea	CPI	y/y	Jan	5.2%	5.0%	5.0%	**	Equity and bond neutral
	CPI Core	y/y	Jan	5.0%	4.8%		**	Equity and bond neutral
EUROPE								
Russia	Industrial Production	y/y	Dec	-4.3%	-1.8%	-3.1%	**	Equity bearish, bond bullish
	Gold and Forex Reserves	m/m	27-Jan	$597.7b	$594.6b		***	Equity and bond neutral
AMERICAS								
Canada	S&P Global Manufacturing PMI	m/m	Jan	51.0	49.2		***	Equity and bond neutral
Mexico	S&P Global Manufacturing PMI	m/m	Jan	48.9	51.3		***	Equity and bond neutral
Brazil	Trade Balance Monthly	m/m	Jan	$2.717b	$4.779b	$3.000b	**	Equity and bond neutral
	FIPE CPI	m/m	Jan	0.63%	0.54%	0.73%	*	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)	481	481	0	Up
3-mo T-bill yield (bps)	449	453	-4	Up
TED spread (bps)	32	28	4	Widening
U.S. Sibor/OIS spread (bps)	470	468	2	Up
U.S. Libor/OIS spread (bps)	472	470	2	Up
10-yr T-note (%)	3.39	3.42	-0.03	Up
Euribor/OIS spread (bps)	248	251	-3	Up
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Down			Up
Yen	Up			Up
Pound	Down			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
FOMC Rate Decision (Upper Bound)	4.750%	4.500%	4.750%	On Forecast
FOMC Rate Decision (Lower Bound)	4.500%	4.250%	4.500%	On Forecast
ECB Main Refinancing Rate	3.000%	2.500%	3.000%	On Forecast
ECB Marginal Lending Facility	3.250%	2.750%	3.250%	On Forecast
ECB Deposit Facility Rate	2.500%	2.000%	2.500%	On Forecast
Bank of England Bank Rate	4.000%	3.500%	4.000%	On Forecast
Brazil Selic Rate	13.750%	13.750%	13.750%	On 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.

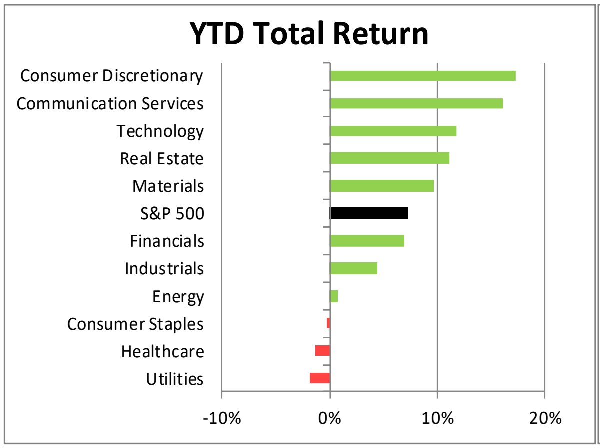
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$82.30	$82.84	-0.65%	
WTI	$76.01	$76.41	-0.52%	
Natural Gas	$2.50	$2.47	1.42%	
Crack Spread	$33.47	$33.64	-0.50%	
12-mo strip crack	$29.90	$30.11	-0.70%	
Ethanol rack	$2.34	$2.34	0.00%	
Metals				
Gold	$1,954.10	$1,950.52	0.18%	
Silver	$24.38	$23.98	1.65%	
Copper contract	$414.85	$411.10	0.91%	
Grains				
Corn contract	$682.75	$681.00	0.26%	
Wheat contract	$761.75	$759.75	0.26%	
Soybeans contract	$1,530.25	$1,520.25	0.66%	
Shipping				
Baltic Dry Freight	668	681	-13	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	4.1	-1.0	5.1	
Gasoline (mb)	2.58	2.0	0.6	
Distillates (mb)	2.3	-1.5	3.8	
Refinery run rates (%)	-0.4%	1.0%	-1.4%	
Natural gas (bcf)		-144		

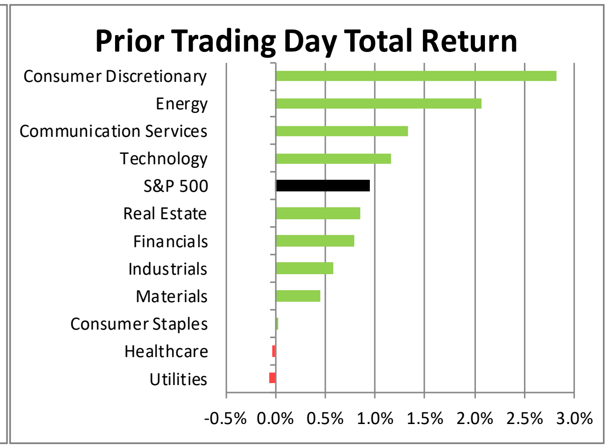
Weather

The 6-10 and 8-14 day forecasts show warmer-than-normal temperatures throughout the entire country from the Great Plains eastward, with cooler-than-normal temperatures in the Southwest. The forecasts show wetter-than-normal conditions in the Pacific Northwest, the Midwest, and the Southeast, with dry conditions expected in the Southwest.

Data Section

U.S. Equity Markets – (as of 2/1/2023 close)

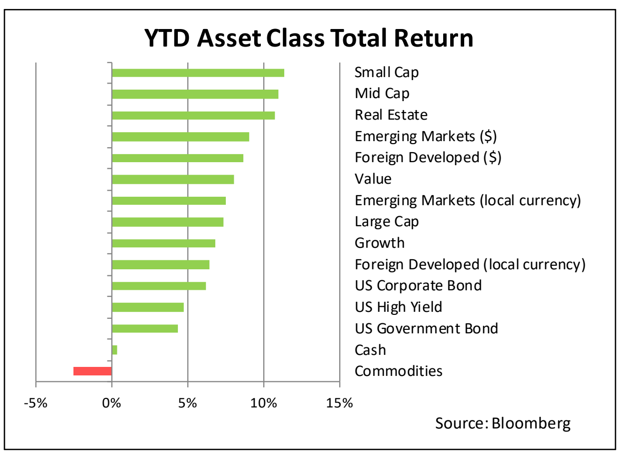




(Source: Bloomberg)

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 2/1/2023 close)

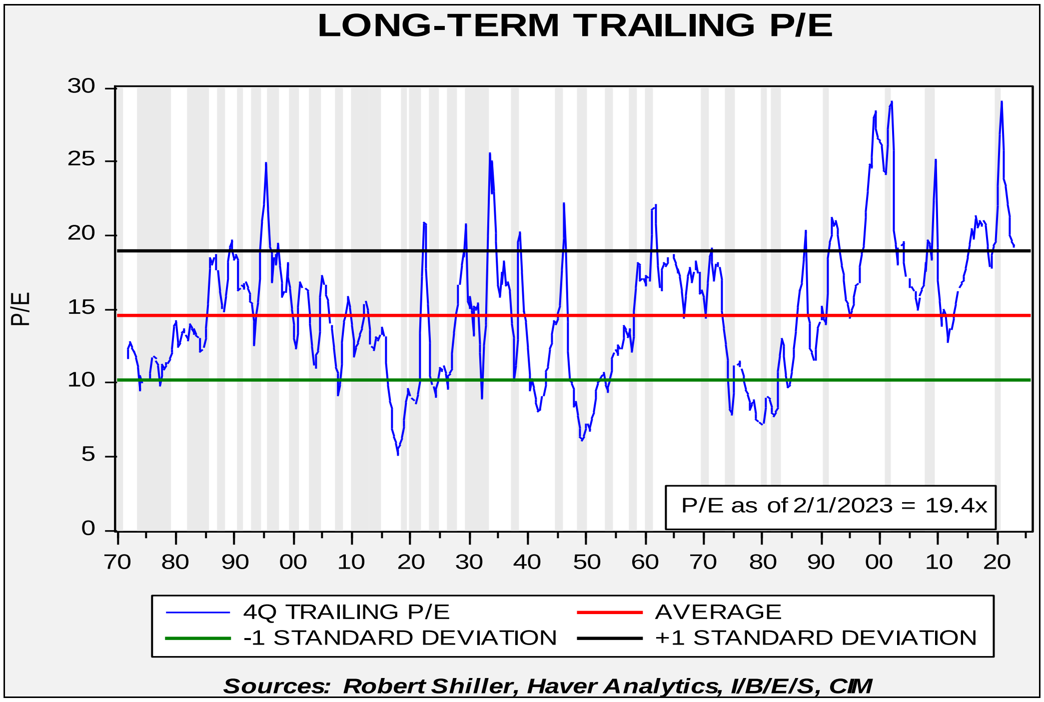


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

February 2, 2023



Based on our methodology,[1] the current P/E is 19.4x, which is up 0.2x from last week. Falling earnings estimates and rising index values led to the rise.

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.