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 10, 2023—9:30 AM EST] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is currently down 1.4% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.4%. Chinese markets were lower, with the Shanghai Composite closing down 0.3% from its prior close and the Shenzhen Composite closing down 0.4%. U.S. equity index futures are signaling a lower open.

With 342 companies having reported so far, S&P 500 earnings for Q4 are running at $54.30 per share compared to estimates of $52.85. Of the companies that have reported thus far, 70.2% have exceeded expectations, while 25.4% 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* (2/6/2023) (with associated podcast) "Is Japan's Sun Rising Again?"
- *Weekly Energy Update* (2/9/2023): We take a look at the gasoline situation; although inventories are below normal, gasoline demand is in a secular decline. Tight stocks are a concern, but without a major spike in crude oil prices, gasoline prices will likely be contained. We also note how the world oil markets are steadily accommodating Russian sanctions.
- *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) (with associated podcast): "Secular Trends in Bond Yields"
- *Asset Allocation Q1 2023 Rebalance Presentation* (2/2/2023): 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! Today's *Comment* begins with Russia's latest response to the Western price cap and sanctions. Next, the report discusses what the deepening yield curve says about the financial market. The report concludes with our thoughts on the likely new Governor of the Bank of Japan.

Russia Retaliates: Moscow will drastically reduce its oil output in response to EU sanctions on Russian oil, and there are rumors of Russian belligerence toward a NATO ally.

- The Kremlin will cut its oil production by 500,000 barrels a day next month. The move comes as Russia hits back at the West for implementing a price cap on its petroleum. The decision was unusual as it was done in isolation of the Organization of Petroleum Exporting Countries, although it is likely that the group was warned before the announcement. Members within OPEC may make up for the drop in production at their next meeting. However, the size of the cut and the group's alignment with Russia makes the likelihood of a complete offset relatively low.
- Moscow's reaction shows that Western sanctions on its commodities are hurting its economy. The restriction has limited Russia's ability to fund its government expenditure. The country's current account surplus shrank by 58.2% in January, largely due to a sharp drop in export volumes. The lack of revenue from oil will make it more difficult for Russia to ramp up its war efforts in Ukraine. The pullback in production also creates the risk that some of its oil wells will permanently be idled. As a result, this drop in oil output could have a lasting effect on crude markets.
    - This may be a game of chicken. U.S. officials wagered that keeping oil prices above Russia's break-even of $60-$70 a barrel would possibly incentivize Russia to keep production flowing despite the price cuts. Therefore, Russia's decision to cut output may be a way for it to pressure Washington to abandon this strategy.
- A Ukrainian newspaper reports that two missiles entered a NATO member's airspace. The *Kyiv Independent* claims that two Russian Kalibr cruise missiles entered Romanian airspace after crossing the border between Ukraine and Moldova. If true, the incident could spark a direct confrontation between NATO and Russia. The incident comes a day after a journalist accused the U.S. of blowing up parts of the Nord Stream pipelines. So far, none of the major media outlets are carrying the story, and thus, there is a possibility that this may not be true.

Bond Warning: The Treasury market has been signaling that a recession is imminent for months, and investors are worried about what that may mean for the next downturn

- The yield-curve inversion fell to its deepest level in over 40 years. The gap between the two-year and 10-year Treasury yields widened as much as 86 bps, indicating that financial conditions are deteriorating. The spread is related to investor beliefs that the Federal Reserve will continue to raise rates until inflation is under control. Therefore, the inversion was driven by short-term interest rates rising faster than long-term rates. The underlying belief of bondholders is that the Federal Reserve will eventually win the fight against inflation.
- The fast rise in the short end of the yield curve relative to the long end has worried equity holders. Hence, the deep inversion equities were sold off as investors feared Fed tightening could worsen a recession. The S&P 500 fell 0.9% from the previous day, and tech stocks led the decline as the NASDAQ fell 1.1% in the same period. Meanwhile, optimism that the Fed will eventually be able to curb inflation has led to a rise in the

greenback. The U.S. Dollar Index (DXY) rose 0.6% on Thursday, driven mainly by the decline in the EUR.

- Equity traders and bondholders are working from two different narratives of the war on inflation. Stock traders assume that the Fed will eventually blink and end tightening before inflation falls to its 2% target. Meanwhile, bond investors are operating on the assumption that the Fed will succeed in reducing price pressures. The winner of this debate will have an impact on portfolios. If the equity market is correct, it means that interest rates on the long end are way too low and should begin to rise to a new high. On the other hand, the S&P 500 may experience a new low if the bond market is proven correct.

The Chosen: Haruhiko Kuroda's successor has finally been selected; however, markets are still unsure about what this may mean for the JPY.

- Japanese Prime Minister Fumio Kishida nominated Kazuo Ueda to take over the country's central bank. Ueda is a professor and former Bank of Japan member. The move came as a shock to the market as it was widely expected that Deputy Governor Masayoshi Amamiya would be selected for the job. Ueda is seen as more hawkish than Amamiya, and as a result, the JPY rallied following his surprise nomination as investors speculated that he would pave the way for the end of yield-curve control.
- Moments after his nomination, Ueda stated that the current monetary policy is appropriate. This led to a trimming of much of the gains made in the JPY and suggested that the bank may still need to finish implementing its ultra-accommodative monetary policy. That said, his remarks may have also been meant to prevent another speculative attack on the peg of its 10-year bonds. Therefore, the Bank of Japan may intervene in the bond market to ensure that the 10-year yield cap remains within the 50 bps target.
- Rising inflation and a weaker JPY will continue to lead to expectations that the BOJ will pivot. The bank has earned a reputation as a widow maker for its willingness to clamp down on traders wanting to challenge its policies. Although it is likely safe to assume that the central bank is ready to move away from the nearly seven years of yield-curve control, they will certainly do it on their terms and not the markets. Consequently, the transition's timing and pace will not be known for some time. However, the switch will likely lead to an increase in demand for Japanese bonds.

U.S. Economic Releases

No major U.S. economic reports have been released so far today. The table below lists the economic releases and/or Federal Reserve events scheduled for the rest of the day.

Economic Releases						
EST	Indicator			Expected	Prior	Rating
10:00	U. of Michigan Consumer Sentiment	m/m	Feb P	65.0	64.9	***
10:00	U. of Michigan Current Conditions	m/m	Feb P	68.0	68.4	**
10:00	U. of Michigan Future Expectations	m/m	Feb P	63.1	62.7	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Feb P	4.0%	3.9%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Feb P	2.9%	2.9%	*
14:00	Monthly Budget Statement	m/m	Jan	-$55.0b	-118.7b	**
Federal Reserve						
12:30	Chris Waller Speaks at Crypto Conference	Member of the Board of Governors				
16:00	Patrick Harker Speaks at Crypto Conference	President of the Federal Reserve Bank of Philadelphia				

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	PPI	y/y	Jan	9.5%	10.2%	10.5%	**	Equity bearish, bond bullish
New Zealand	BusinessNZ Manufacturing PMI	m/m	Jan	47.2	47.2	47.8	***	Equity and bond neutral
China	New Yuan Loans	m/m	Jan	4.900t	1.400t	4.200t	**	Equity and bond neutral
	Money Supply M0	y/y	Jan	7.9%	15.3%		*	Equity and bond neutral
	Money Supply M1	y/y	Jan	6.7%	3.7%	4.7%	*	Equity and bond neutral
	Money Supply M2	y/y	Jan	12.6%	11.8%	11.7%	***	Equity and bond neutral
	PPI	y/y	Jan	-0.8%	-0.7%	-0.5%	**	Equity and bond neutral
	CPI	y/y	Jan	2.1%	1.8%	2.1%	***	Equity and bond neutral
India	Industrial Production	y/y	Dec	4.3%	7.1%	7.3%	***	Equity bearish, bond bullish
EUROPE								
Italy	Industrial Production WDA	y/y	Dec	0.1%	-3.7%	-3.4%	*	Equity bullish, bond bearish
UK	Industrial Production	y/y	Dec	-4.0%	-5.1%	-4.3%	***	Equity and bond neutral
	Manufacturing Production	y/y	Dec	-5.7%	-5.9%	-5.6%	**	Equity and bond neutral
	Visible Trade Balance	m/m	Dec	-£19271m	-£15623m	-£17300m	**	Equity and bond neutral
	Trade Balance	m/m	Dec	-£7150m	-£1802m	-£2800m	**	Equity and bond neutral
	GDP	y/y	4Q P	0.4%	1.9%	0.4%	***	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	3-Feb	601.0b	597.7b		***	Equity and bond neutral
AMERICAS								
Mexico	Industrial Production	y/y	Dec	3.0%	3.2%	3.5%	***	Equity and bond neutral
	Manufacturing Production	y/y	Dec	2.7%	4.6%	4.7%	*	Equity and bond neutral
Brazil	IBGE Services Volume	y/y	Dec	6.0%	6.3%	6.5%	*	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)	486	485	1	Up
3-mo T-bill yield (bps)	462	463	-1	Up
TED spread (bps)	24	21	3	Widening
U.S. Sibor/OIS spread (bps)	476	476	0	Up
U.S. Libor/OIS spread (bps)	479	479	0	Up
10-yr T-note (%)	3.70	3.66	0.04	#VALUE!
Euribor/OIS spread (bps)	261	261	0	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Up			Up
Pound	Down			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Russia Key Rate	7.500%	7.500%	7.500%	On Forecast
Bank of Mexico Overnight Rate	11.000%	10.500%	10.750%	Above 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.

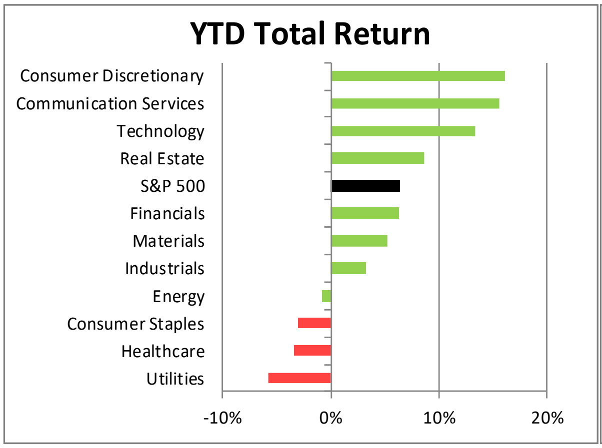
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$86.37	$84.50	2.21%	
WTI	$79.78	$78.06	2.20%	
Natural Gas	$2.45	$2.43	0.78%	
Crack Spread	$30.65	$30.12	1.76%	
12-mo strip crack	$28.56	$28.30	0.93%	
Ethanol rack	$2.33	$2.34	-0.25%	
Metals				
Gold	$1,864.74	$1,861.78	0.16%	
Silver	$22.11	$21.98	0.61%	
Copper contract	$405.05	$409.70	-1.13%	
Grains				
Corn contract	$673.75	$670.75	0.45%	
Wheat contract	$766.00	$757.25	1.16%	
Soybeans contract	$1,521.25	$1,519.25	0.13%	
Shipping				
Baltic Dry Freight	592	603	-11	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	2.4	2.0	0.4	
Gasoline (mb)	5.0	1.6	3.4	
Distillates (mb)	2.9	1.0	1.9	
Refinery run rates (%)	2.2%	0.5%	1.7%	
Natural gas (bcf)	-217	-201	-16.0	

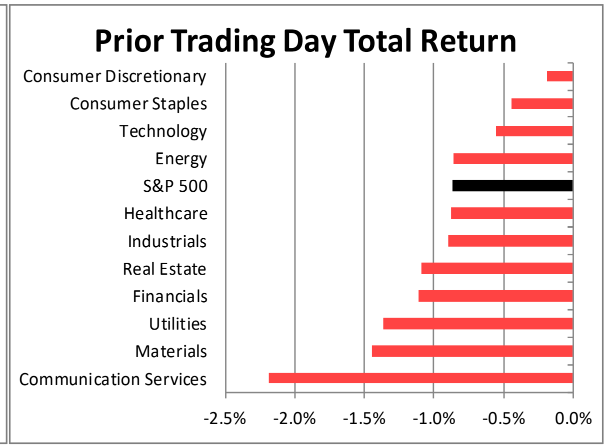
Weather

The 6-10 and 8-14 day forecasts again show warmer-than-normal temperatures for the entire country east of the Mississippi River, with cooler-than-normal temperatures in the far West. The forecasts show wetter-than-normal conditions throughout most of the country, but especially in the Upper Midwest and the Pacific Northwest, with dry conditions in Texas.

Data Section

U.S. Equity Markets – (as of 2/9/2023 close)

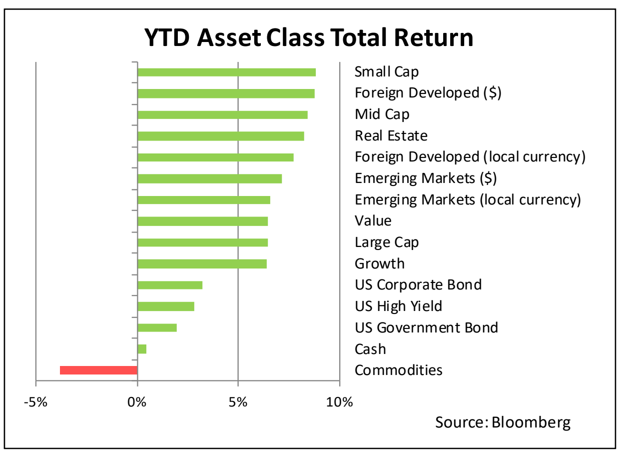




(Source: Bloomberg)

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 2/9/2023 close)

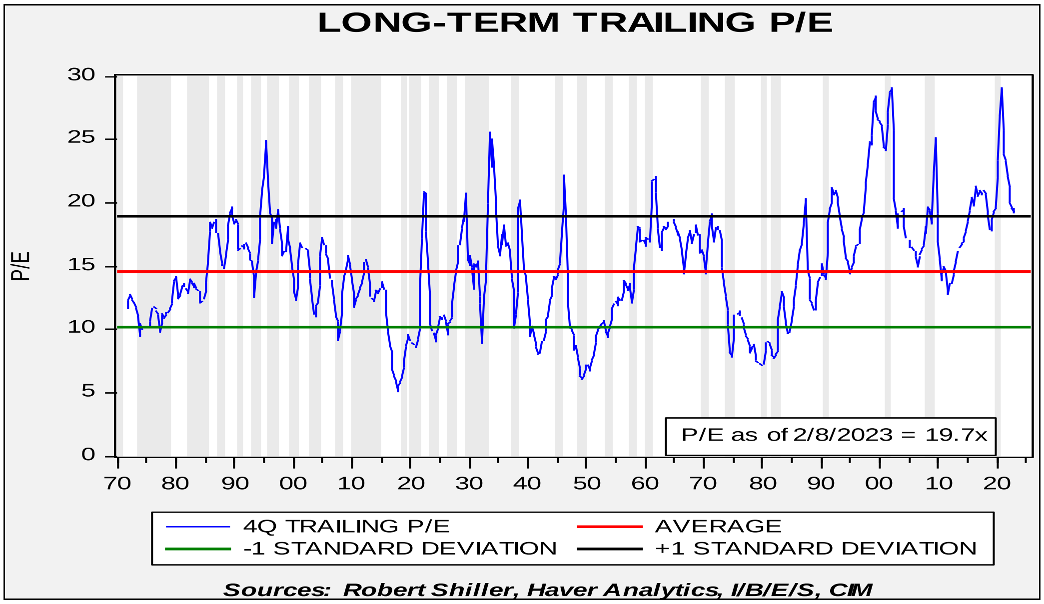


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 9, 2023



Based on our methodology,[1] the current P/E is 19.7x, which is up 0.3x 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.

[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.