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 13, 2023—9:30 AM EST] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is currently up 0.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.6%. Chinese markets were higher, with the Shanghai Composite closing up 0.7% from its prior close and the Shenzhen Composite closing up 1.2%. U.S. equity index futures are signaling a higher open.

With 345 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, 70.1% have exceeded expectations, while 25.2% 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* (2/13/2023) (there will be no accompanying podcast with this report): "Reflections on Inflation"**
- *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"

Our *Comment* today opens with a number of observations regarding China's relations with the rest of the world, driven by the wave of Chinese surveillance balloons belatedly discovered in North American airspace (although we don't delve into why the North American Defense Command (NORAD) can track a small sleigh and eight reindeer every Christmas but can't seem to locate a 200-foot-high balloon). We next review a wide range of other international and U.S.

developments with the potential to affect the financial markets today, including improved economic forecasts for the European Union and the stock market implications of the Kansas City Chiefs' win in the Super Bowl last night.

United States-China: As U.S.-China tensions continue to spiral, the U.S. is set to expand its economic measures against China to include restrictions on direct investments and private equity stakes in certain Chinese technology sectors. The new rules will add to the U.S.'s big tariffs against Chinese imports, its clampdown on data and technology transfers to China (an effort that was expanded Friday with the naming of six additional Chinese firms that will be shut off from U.S. exports due to their work on China's surveillance balloon program), and its hurdles to investing in the publicly traded stocks of certain Chinese companies, such as those that don't share their accounting data with U.S. regulators and those related to the Chinese military. The restraint on direct investments and private equity will reportedly apply to Chinese sectors such as artificial intelligence and supercomputing.

- The new rules could be issued within two months, after the Treasury Department finishes reaching out to other governments, including the EU, to ensure that they don't rush in to provide similar financing to China after the U.S. cuts it off.
- U.S. firms reportedly are still trying to resist the new restrictions, but the report suggests the new limitation is virtually a foregone conclusion. Of course, big U.S. technology and finance firms are among the most active private equity investors in China, and the new rules will likely cut them off from many opportunities in the country.
    - This illustrates yet another way in which investors are likely to be caught in the crossfire as U.S.-China tensions worsen.
    - With the recent discovery of Chinese surveillance balloons in North American airspace, the latest of which was apparently shot down by the U.S. on Sunday, the risk of outright conflict and further harm to investors appears to be growing. That's especially true now that the Chinese are saying they've spotted unidentified flying objects over their own territory and are ready to shoot them down if needed. The situation seems ripe for a trigger-happy fighter pilot or missile operator to shoot down a manned vehicle (or, God forbid, an airliner) from one side or the other, which in these tense conditions could easily spiral out of control.

China-Africa: Not only is China facing a broad economic counteroffensive from the U.S., but it is also running into pushback against its influence-building campaign in less developed countries. A new report shows that Chinese infrastructure development loans to sub-Saharan Africa under its signature Belt and Road Initiative fell by 54% to just $7.5 billion in 2022. The lending decline reflects both new Chinese caution after several previous loans went sour and borrower fears that China is deliberately pushing them into debt traps.

- The ongoing pullback in BRI lending is notable, given that the program provided almost $1 trillion in infrastructure development loans primarily to developing countries over the last decade.

- The drop in BRI lending is probably slowing China's effort to build influence in less developed countries, but the country still has plenty of other economic carrots in the form of export opportunities, cheap imports, and direct investments. We suspect China will continue using those incentives to attempt to bring more developing countries into its evolving geopolitical and economic bloc.

China-South America: As evidence that China's BRI stumbles are not stopping it from trying to build alliances with less developed countries, last week, the Chinese and Brazilian central banks signed a memorandum of understanding to set up yuan-clearing arrangements in Brazil. The deal shows how China continues attempting to establish the CNY as a reserve currency for its evolving bloc (perhaps in a digital, resource-backed form in the future). We note that Brazilian President Lula da Silva has recently called for a free-trade agreement between China and the Mercosur economic area composed of Brazil, Argentina, Uruguay, and Paraguay.

Japan: Investors continue trying to assess the surprise announcement that independent academic economist Kazuo Ueda will be named as the next Bank of Japan governor. Amid concerns that Ueda may be more willing to abandon Japan's longstanding yield-curve control and allow bond yields to rise, Japanese stocks are trading down so far this morning. The JPY has also weakened today, apparently reflecting concerns that Ueda would still not be able to close the gap between Japan and U.S. interest rates.

European Union: The European Commission today boosted its forecast for EU economic growth in 2023 to 0.8%, compared with an expectation of just 0.3% last November. It lifted its forecast for the Eurozone's growth to 0.9% from 0.3%. In each case, the organization now believes there will be no recession this year, matching private forecasts and validating the recent outperformance in European stocks.

Germany: The conservative Christian Democratic Union (CDU) won Berlin's municipal elections over the weekend, dealing an embarrassing defeat to Chancellor Scholz's center-left Social Democratic Party (SPD) and pushing it out of the city's government for the first time in decades. The CDU may have trouble forming a coalition capable of governing the city, but the results still illustrate how Scholz and the SPD have been politically damaged by a range of missteps over the last year.

Turkey: Following last week's big earthquakes and complaints about the government's response, President Erdoğan has ordered the arrest of dozens of architects, engineers, and others potentially involved in shoddy construction that led to the building collapses. With the death toll from the quakes now approaching 30,000, the president is apparently trying to divert attention from his government as he prepares for the elections upcoming in May.

U.S. Defense Industry: Last week, the Defense Department released a targeted list of weapons it's willing to purchase under long-term contracts, which defense firms argue would be necessary in order for them to invest in expanded production capacity. The list includes weapons such as specialized air defense systems, long-range missiles, and rockets.

- Shifting toward multi-year contracts from single-year orders is becoming a key demand of defense contractors as they bump up against factory capacity constraints in their struggle to boost output and make up for the weapons and ammunition being sent to Ukraine for its defense against Russia. Longer-term funding commitments by the Defense Department may also be needed to boost defense industry expansion as the U.S. prepares for a potential future conflict with China.
- Nevertheless, as shown in a hearing by the House Armed Services Committee last week, multi-year contracts alone would not be a panacea for any U.S. rearmament program. Defense contractors also warn that such multi-year orders also need to include inflation adjustments. The contractors also say their ability to surge production is being hampered by other factors, such as a lack of skilled workers and supply disruptions.
- In any case, the increased policy debate on expanding the defense industrial base is consistent with our view that U.S. and allied defense spending is likely on a prolonged upswing that should be a boon for traditional defense contractors and the producers of dual civilian-military goods and technology.

U.S. Cryptocurrency Regulation: The New York Department of Financial Services has ordered Paxos Trust, which issues and lists Binance's dollar-pegged cryptocurrency, to stop creating more of its BUSD token, although it can continue redeeming the stablecoin. The order reflects the ongoing crackdown on crypto assets in the U.S., following a year of widespread bankruptcies and other issues in the sector.

U.S. Super Bowl Indicator: With the Kansas City Chiefs' 38-35 win in the Super Bowl yesterday, adherents of the "Super Bowl Indicator" will be looking for a further down-leg in U.S. stock prices. The indicator supposedly shows that a win for a team from the American Football Conference is historically associated with a bear market in stocks in the coming year. We continue to believe that the impeding recession is the more likely reason for a potential further decline in stocks.

U.S. Economic Releases

No major U.S. economic reports have been released so far today. 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								
India	CPI	y/y	Jan	6.5%	5.7%	6.0%	***	Equity and bond neutral
EUROPE								
Germany	Current Account Balance	m/m	Dec	24.3b	16.9b	17.5b	*	Equity and bond neutral
Switzerland	Domestic Sight Deposits CHF	w/w	10-Feb	511.2b	509.7b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	10-Feb	525.6b	528.1b		*	Equity and bond neutral
	CPI	y/y	Jan	3.3%	2.8%	3.1%	***	Equity and bond neutral
	Core CPI	y/y	Jan	2.2%	2.0%		*	Equity and bond neutral
Russia	CPI	y/y	Jan	11.77%	11.94%	11.63%	***	Equity and bond neutral
	Core CPI	y/y	Jan	13.72%	14.31%		**	Equity and bond neutral
AMERICAS								
Canada	Net Change in Employment	m/m	Jan	150.0k	104.0k	15.0k	***	Equity bullish, bond bearish
	Participation Rate	m/m	Jan	65.7%	65.0%	65.4%	*	Equity and bond neutral
	Unemployment Rate	m/m	Jan	5.0%	5.0%	5.1%	***	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)	487	487	0	Up
3-mo T-bill yield (bps)	462	464	-2	Up
TED spread (bps)	25	23	2	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 (%)	3.73	3.74	-0.01	Flat
Euribor/OIS spread (bps)	262	261	1	Up
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Down			Up
Pound	Up			Up
Franc	Up			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.

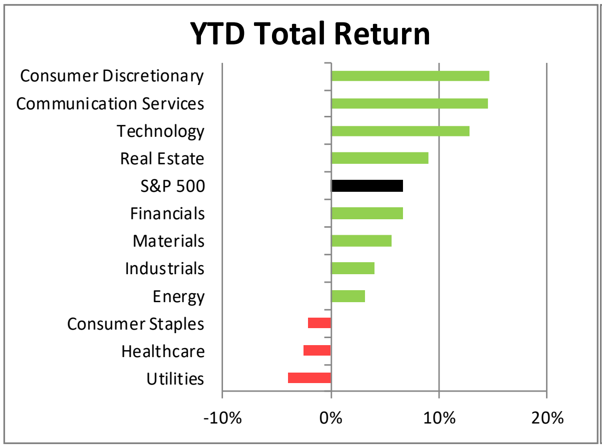
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$86.34	$86.39	-0.06%	
WTI	$79.68	$79.72	-0.05%	
Natural Gas	$2.53	$2.51	0.72%	
Crack Spread	$30.51	$30.38	0.44%	
12-mo strip crack	$28.62	$28.47	0.53%	
Ethanol rack	$2.33	$2.34	-0.25%	
Metals				
Gold	$1,860.34	$1,865.57	-0.28%	
Silver	$21.99	$22.00	-0.07%	
Copper contract	$404.85	$401.65	0.80%	
Grains				
Corn contract	$679.25	$680.50	-0.18%	
Wheat contract	$789.75	$795.75	-0.75%	
Soybeans contract	$1,543.00	$1,542.50	0.03%	
Shipping				
Baltic Dry Freight	602	592	10	

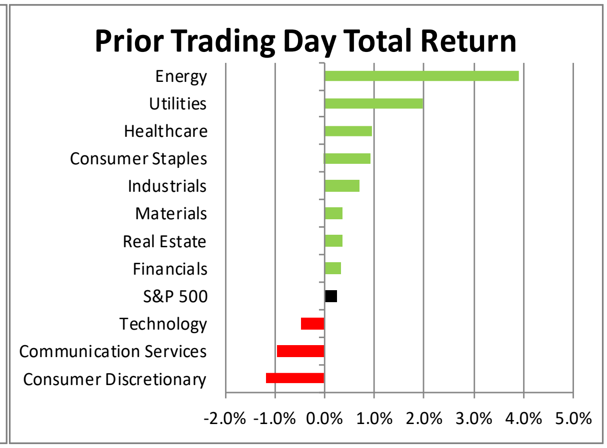
Weather

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 Pacific and Rocky Mountains states. The forecasts show wetter-than-normal conditions throughout most of the country, with dry conditions in Florida.

Data Section

U.S. Equity Markets – (as of 2/10/2023 close)

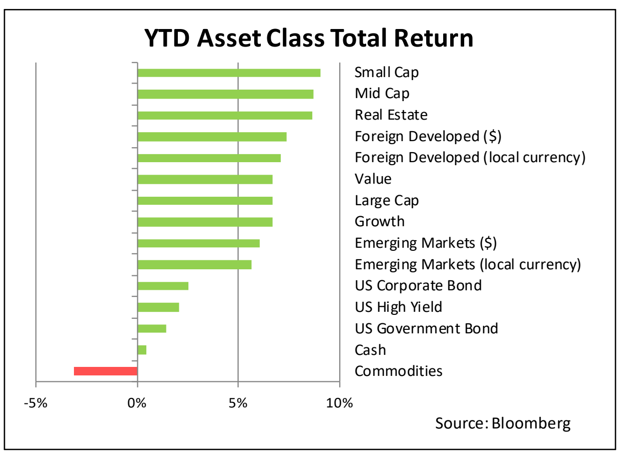




(Source: Bloomberg)

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 2/10/2023 close)

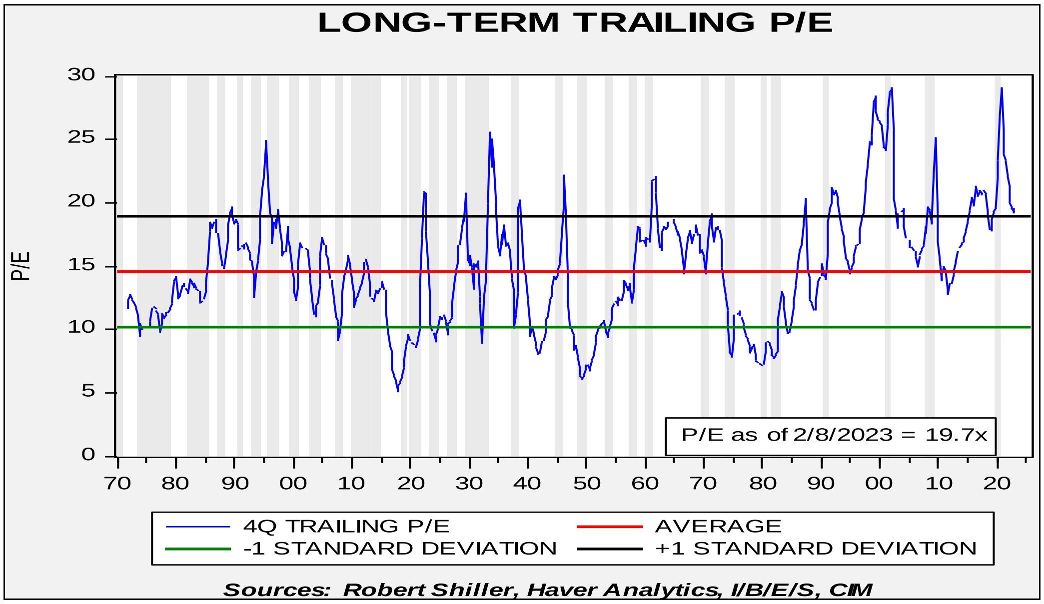


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.