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 17, 2023—9:30 AM EST] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is currently down 0.8% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.7%. Chinese markets were lower, with the Shanghai Composite closing down 0.8% from its prior close and the Shenzhen Composite closing down 1.2%. U.S. equity index futures are signaling a lower open.

With 404 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, 68.6% have exceeded expectations, while 25.5% 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* (2/16/2023): We comment on the Seymour Hersh article, note Iran's visit to China, and discuss the SPR sale announcement. We also report on the big jump in crude oil inventories last week.
- *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"

Good morning! Today's *Comment* begins with our thoughts about the mixed signals coming from central bank policymakers concerning future rate decisions. Next, we explain how the transition away from COVID policies and restrictions will affect the West and China differently. Finally, we discuss how potential talks between the U.S. and China could impact the eventual disentanglement of the two economies.

Rate Hike Uncertainty: Future central bank policy is becoming harder to predict as policymakers and investors disagree on the best path forward.

- Monetary policymakers around the world are becoming more hawkish. Regional Fed Presidents James Bullard and Loretta Mester are entertaining the possibility of future 50 bps hikes. Although neither Fed member has a vote on the Federal Open Market Committee, investors have adjusted their estimate for a new peak in the Fed's target range of its benchmark rate. Investors now expect rates to hit 5.2% by July, up from 4.9% two weeks ago. The S&P 500 fell 1.4% on Thursday following the comments as investors offloaded risk assets.
- European policymakers are sending conflicting messages about their potential policy path after their March meeting. Chief Economist Philip Lane, a noted dove, urged fellow policymakers to bear in mind that the increase in inflation has yet to be felt throughout the economy. Meanwhile, European Central Bank hawk Joachim Nagel insists that borrowing costs have not yet risen to a level that would injure the economy. The ECB is expected to raise interest rates by 50 bps in March and will then discuss future rate increases on a meeting-by-meeting basis. The rate uncertainty led to a 1% decline in the Stoxx Europe 600 and a 1.1% decline in the German DAX on Thursday.
- There is growing angst concerning when the Bank of Japan will pivot. With inflation above the central bank's 2% target, the market anticipates that the BOJ will tighten policy this year. Newly nominated central bank governor Kazuo Ueda has publicly stated that he would like to maintain the bank's ultra-accommodative policy. However, investors are betting that the BOJ will wind down its yield curve control by April or mid-July at the latest. In anticipation of the policy change, the JPY has rallied against the USD to start the year.
    - The bank plans to launch a pilot of its central bank digital currency beginning in April. The transition will give the central bank more flexibility when making policy decisions.

Pandemic Past: Countries are ending the last vestiges of COVID-19 policies as the pandemic enters a new phase.

- China has declared a "decisive victory" over the virus as the country continues to pivot away from its controversial Zero-COVID policies. Beijing claims, without supporting evidence, that the country's death toll has dropped to the lowest in the world since the government ended many of its COVID restrictions. Officials cautioned that although the situation is improving, the virus is still circulating. Therefore, China still plans to continue its vaccination program. The self-proclaimed victory is another example of how the country is attempting to control the narrative surrounding its controversial policies as its moves to reopen its economy.
- In the U.S., Johns Hopkins University has ended its COVID tracker program. The initiative provided users with a simple and understandable interface for information on the pandemic. It was designed to make the data from the Centers for Disease Control and Prevention accessible and transparent to the masses. It was one of the most widely cited

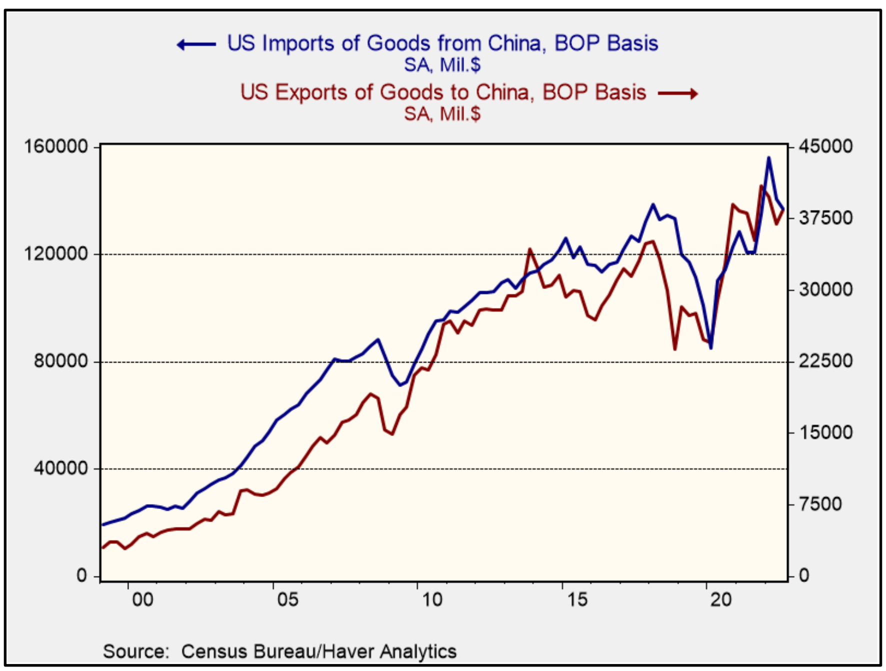
pandemic databases in the country, and thus, its end reflects how far the country has come since the pandemic began.

- Policy differences between the West and China will affect how they each transition toward a post-pandemic normal. An exodus of older workers has contributed to labor shortages in the U.S. and Europe, while the extensive COVID measures have led to a growing distrust of the government. These challenges have impacted fiscal and monetary decisions as government officials look to return their countries to the pre-pandemic normal. A tight labor market in the West has allowed central banks to maintain hawkish monetary policy to bring down inflation caused by the pandemic. China, on the other hand, has ramped up fiscal stimulus to help boost consumer confidence, which is near an all-time low.
    - The differences may mean that in the long run China may have an inflation problem, but until then, its markets should benefit. That said, hawkish policy in the West should make equity markets more resilient after inflation is under control.

Another Attempt: Chinese and U.S. officials are scheduled to meet again as the two countries look to move past their row over spy balloons.

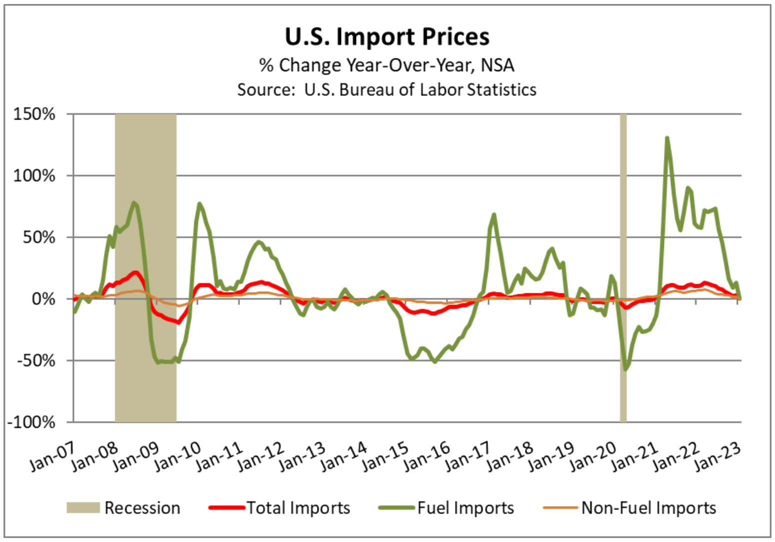
- Secretary of State Antony Blinken and his Chinese counterpart Wang Li will both attend the Munich Security Conference. Although there has been no formal announcement, there is speculation that the two will meet at the conference. The potential encounter would be the first high-level meeting between the two countries since the discovery of the spy balloon. Before that incident, the officials were scheduled to work on a thaw in relations between the two countries. Tensions between the major powers have simmered over the last two years due to concerns regarding Taiwan, Russia, and technology restrictions. A major breakthrough is not likely to take place, but we do believe that the meeting could lay the groundwork for future talks.

- The mutual antagonism will probably persist. The Pentagon announced that its top China defense minister arrived in Taiwan on Friday. The move will likely upset Beijing, which views military contact with Taipei as undermining the "One China Policy." Moreover, China plans to respond to U.S. restrictions on semiconductors by limiting the U.S.'s access to its clean energy technology. China's new technology czar acknowledged that his country might not be able to bypass U.S. controls on key chip technology but could still flex its muscles in other ways. Beijing's decision to review the CATL-Ford deal to ensure that critical battery technology isn't transferred is a prime example of the czar's new strategy.
- The decoupling between the major powers will not be a smooth process. Trade ties between the two sides remain as strong as ever despite their growing mistrust. U.S. exports and imports with China remain near an all-time high, even as the countries attempt to reduce their dependence on one another. In other words, the talk has been cheap about a potential split over the last few years. What isn't cheap, though, is the political landscape. There is a growing animosity among lawmakers within these countries. We suspect that the spy balloon may have been sent by Chinese officials to prevent a possible thaw in U.S.-China relations. Therefore, we believe the two are still on the path to divorce.

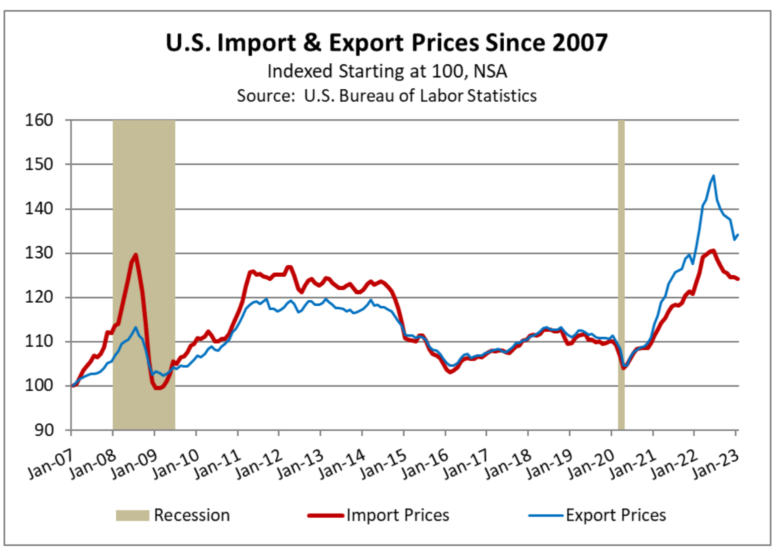


U.S. Economic Releases

January import prices were down 0.2% from the previous month, retreating even more than the expected 0.1%, and December import prices were revised downward from a rise of 0.4% to a decline of 0.1%. Of course, import prices are often driven by volatility in the petroleum fuels category, and that was the case last month. January import prices excluding fuels were up 0.2%, marking a disappointment compared with the anticipated decline of 0.3%, but the increase was still much better than the revised jump of 0.7% the previous month. Overall import prices in January were up 0.8% year-over-year, while import prices excluding fuels were also up 0.8%. The chart below shows the year-over-year change in import prices since just before the previous recession.



According to the report, export prices in January were up 2.3% from one year earlier, in large part because of the key agriculture category. Comparing the annual change in export prices versus import prices provides a sense of the U.S. "terms of trade," or the relative advantage or disadvantage the country is facing because of trends in international trade prices. The chart below compares the year-over-year change in U.S. export and import prices since just before the previous recession.



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	Leading Index	m/m	Jul	-0.3%	-0.8%	***
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								
EUROPE								
Eurozone	ECB Current Account SA	m/m	Dec	€15.9 bn	€13.6 bn	€12.8 bn	*	Equity and bond neutral
Germany	PPI	y/y	Jan	17.8%	21.6%		**	Equity bullish, bond bearish
France	CPI	y/y	Jan F	6.0%	6.0%	6.0%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Jan F	7.0%	7.0%	7.0%	**	Equity and bond neutral
UK	Retail Sales	y/y	Jan	-5.1%	-5.8%	-6.1%	***	Equity bullish, bond bearish
	Retail Sales Ex-Auto Fuel	y/y	Jan	-5.3%	-6.1%	-6.5%	**	Equity bullish, bond bearish
Russia	Money Supply, Narrow Definition	w/w	10-Feb	589.0b	601.0b		*	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)	488	487	1	Up
3-mo T-bill yield (bps)	466	468	-2	Up
TED spread (bps)	22	19	3	Widening
U.S. Sibor/OIS spread (bps)	482	481	1	Up
U.S. Libor/OIS spread (bps)	485	484	1	Up
10-yr T-note (%)	3.89	3.86	0.03	Flat
Euribor/OIS spread (bps)	270	268	2	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Down			Up
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.

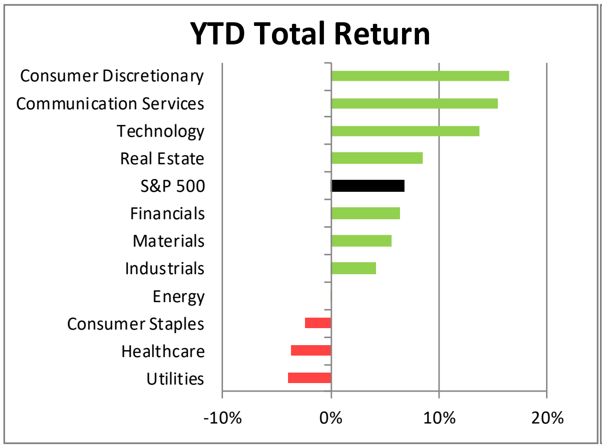
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$82.72	$85.14	-2.84%	
WTI	$76.12	$78.49	-3.02%	
Natural Gas	$2.33	$2.39	-2.55%	
Crack Spread	$27.87	$28.70	-2.88%	
12-mo strip crack	$27.83	$28.30	-1.68%	
Ethanol rack	$2.33	$2.32	0.07%	
Metals				
Gold	$1,826.99	$1,836.36	-0.51%	
Silver	$21.35	$21.58	-1.07%	
Copper contract	$407.05	$412.15	-1.24%	
Grains				
Corn contract	$676.50	$675.00	0.22%	
Wheat contract	$774.50	$776.25	-0.23%	
Soybeans contract	$1,525.50	$1,521.25	0.28%	
Shipping				
Baltic Dry Freight	530	541	-11	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	16.3	2.0	14.3	
Gasoline (mb)	2.3	1.5	0.8	
Distillates (mb)	-1.3	1.0	-2.3	
Refinery run rates (%)	-1.4%	0.8%	-2.2%	
Natural gas (bcf)	-100	-109	9.0	

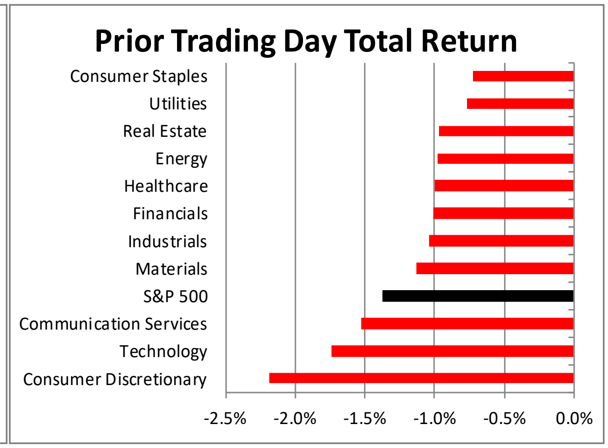
Weather

The 6-10 and 8-14 day forecasts show colder-than-normal temperatures along the West Coast, in the northern Rocky Mountains, and the northern Great Plains, with warmer-than-normal temperatures in Texas and the deep South. The forecasts show wetter-than-normal conditions along the West Coast and in the Midwest, with dry conditions in Texas and the deep South.

Data Section

U.S. Equity Markets – (as of 2/16/2023 close)

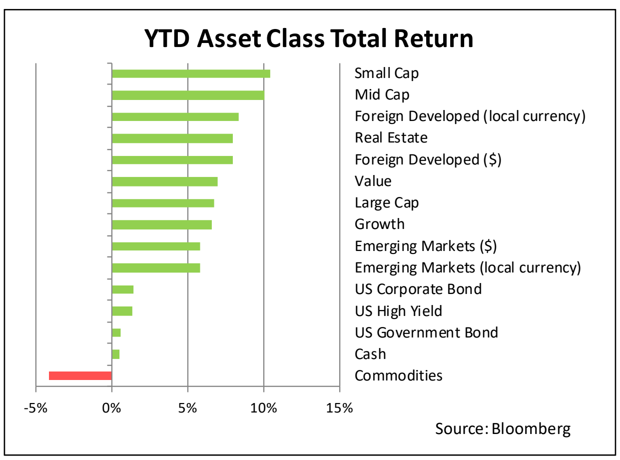




(Source: Bloomberg)

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 2/16/2023 close)

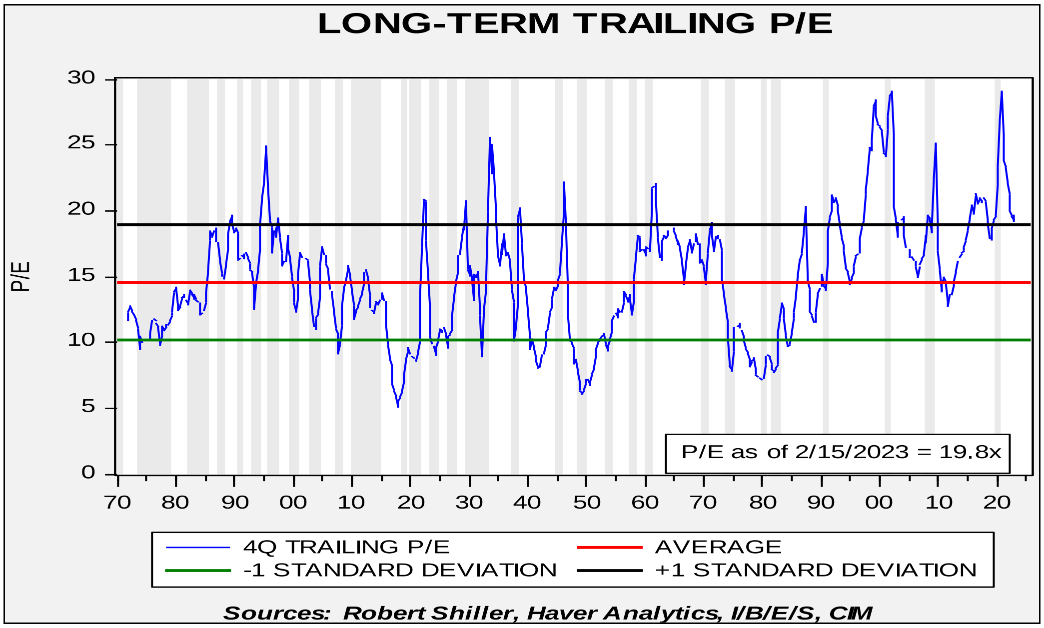


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 16, 2023



Based on our methodology,[1] the current P/E is 19.8x, which is up 0.1x from last week. Falling earnings estimates for Q1 2023 account for the rise in the multiple.

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.