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 24, 2023—9:30 AM EST] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is currently down 0.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 2.1%. Chinese markets were lower, with the Shanghai Composite closing down 0.6% from its prior close and the Shenzhen Composite closing down 0.7%. U.S. equity index futures are signaling a lower open.

With 467 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, 68.7% have exceeded expectations, while 25.1% have fallen short of expectations.

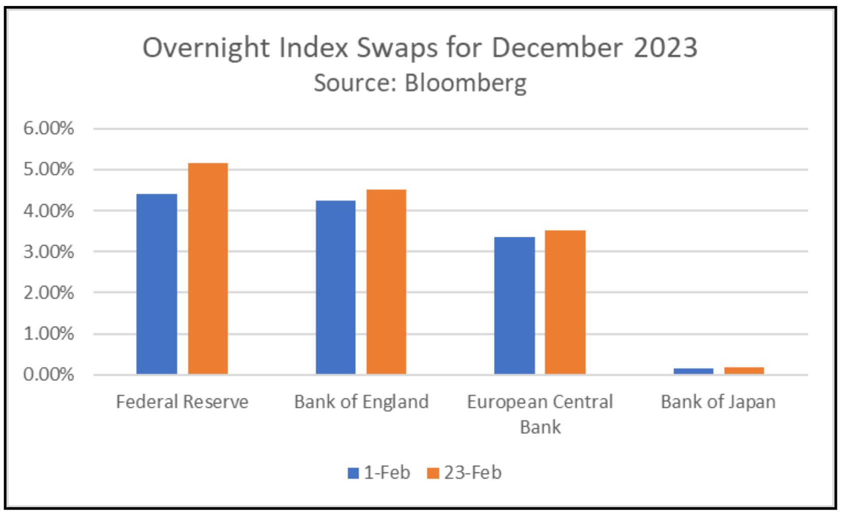
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (2/21/2023) (with associated podcast) "*Chip War*: Book Review"
- ***Weekly Energy Update*** **(2/23/2023): We continue to chronicle the rise in commercial crude oil inventory and comment on the IAEA news that Iran is dangerously close to weapons-grade uranium enrichment. We also note how oil and gas markets are adjusting to the war in Ukraine, now one year since it began**.
- *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 potential for a bond rally in 2023. Next, we discuss how revisions to economic data may impact our timeline for a recession in both the U.S. and Europe. We end the report with our views on whether the U.S.-led bloc can remain united against Russia and China.

Will the Rally Return? Expectations of higher policy rates have called a potential rally in global bonds into question.

- Investors were convinced that a steady decline in inflation and an increased risk of a global recession would force major central banks to moderate their policy stance in 2023. After falling 16.2% in 2022, the Bloomberg EuroAgg Index, which tracks government and corporate bonds within the EU, has climbed 2.2% in the first month of the year. Meanwhile, the Vanguard Total Bond Market ETF, which tracks U.S. fixed-income assets, rose 4.1% in January after falling 13.4% the previous year. These assumptions were turned on their head after a relatively warm January led to stronger-than-expected economic data, and China's reopening led to upward revisions for global growth.
- Hawkish comments from central bankers have led investors to ratchet up their interest rate expectations. Members of the Federal Reserve and the European Central Bank's Governing Council have argued that strong January data provides evidence that central banks can raise policy rates further. A similar view is shared among members of the Bank of England's Monetary Policy Committee. Meanwhile, there is speculation that the Bank of Japan is engaging in stealth tightening. Traders have not ignored these changes to central bank sentiment. Overnight index swap rates of four major banks have increased throughout February, suggesting that the market expects global financial conditions to tighten throughout the year.



- However, there is still a good chance that bonds could rally this year. Last year's decline was so deep that any reversal in policy rates could lead to a disproportionate jump in bond demand. The market's sensitivity to changes in interest rates can partially explain why the U.S. Treasury yield curve has remained inverted for so long. Investors don't believe that the Fed will keep rates high for long enough to warrant a change in long-run borrowing costs. As a result, fixed-income assets, such as investment grade and government securities, will likely look more attractive as the central bank approaches the end of its hiking cycle.

Recession Fears Are Back: New economic data suggests that Gross Domestic Product growth was slower than investors initially thought in the final quarter of 2022.

- Revised figures showed that consumption was less robust than originally estimated, and fixed investment spending continued to be a drag on growth. Although the U.S. economy remained in expansion territory in Q4 2022, revisions have shown that Germany's economy contracted toward the end of the year. The downward revision in the data suggests that businesses and households had been less active in the economy than sentiment surveys had indicated. Therefore, the risk of a hard landing is now elevated in the U.S. and Europe

- That said, all hope isn't lost for central banks to navigate a soft landing. Governments have attempted to offset some of the negative impacts that rising energy prices and interest rates have had on the economy. In December, the German government approved gas and power subsidies to mitigate the impact of a potential energy crisis for households and firms. Meanwhile, the U.S. is looking at ways to reduce the cost of owning a home. The Biden administration plans to boost homebuying by reducing mortgage insurance costs for some new homeowners. These measures alone may not be enough to prevent a downturn, but they could help delay and/or moderate a future one.

- The U.S. and European economies are not deteriorating at the same pace. Downward revisions have not changed our forecast for when a potential U.S. recession could take place. We still suspect a downturn could happen in the second half of the year. A European recession could occur sooner, though, since the region's higher inflation has caused a greater pullback in consumer spending, and it will be difficult for Europe to stimulate growth while also fighting inflation. It is too soon to tell whether central bank officials will factor in the slower growth in their next policy meetings; however, tighter monetary conditions may raise the likelihood of a deeper recession.

Anniversary of the War in Ukraine: The next year will offer a new durability test for the Western alliance.

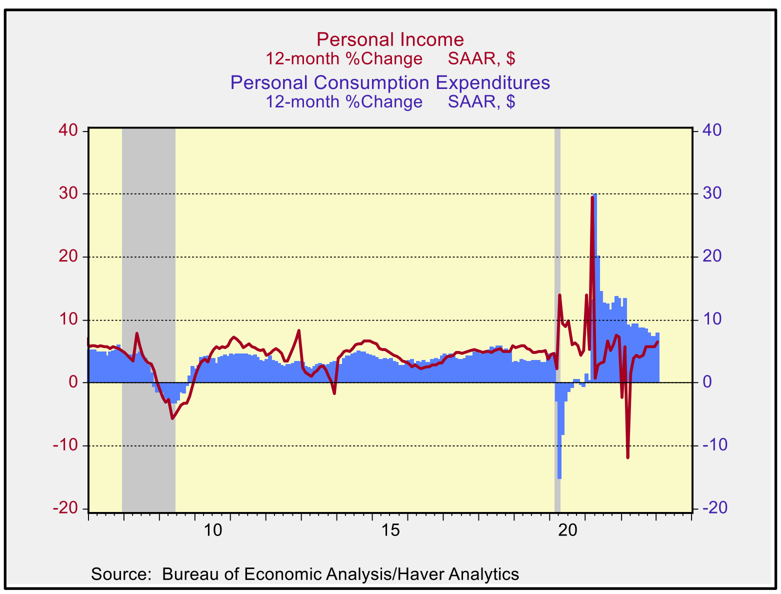
- The coalition between the U.S. and Europe has held up much better than both Russia and China had anticipated. At the beginning of the war, there was much skepticism about whether the West could remain a united front against Moscow. Russian President Vladimir Putin believed that Europe's dependency on Russian energy was a key vulnerability of the Western alliance. A multitude of sanctions and billions of dollars' worth of military equipment proved his thesis wrong. The sanctions may have left much to be desired, but the weapons and equipment sent to Ukraine were critical in slowing Moscow's territorial ambitions.

- China is still the elephant in the room. Although Europe has been willing to sever ties with Russia, they have been less willing to do the same with China. This is not only seen with Germany's wooing of Beijing last year but also in the reluctance of Dutch chipmaker AMSL($638.09) to participate in U.S.-led export controls against China. Additionally, the reopening of the world's second-largest economy has provided a major tailwind for Europe. China has noticed this weakness within the alliance and has been trying to play up its role as a peacekeeper to curry additional favor with Europe. Hence, we suspect the U.S. will have a difficult time convincing Europe to clamp down on Beijing without hard evidence of China's involvement in the war in Ukraine.

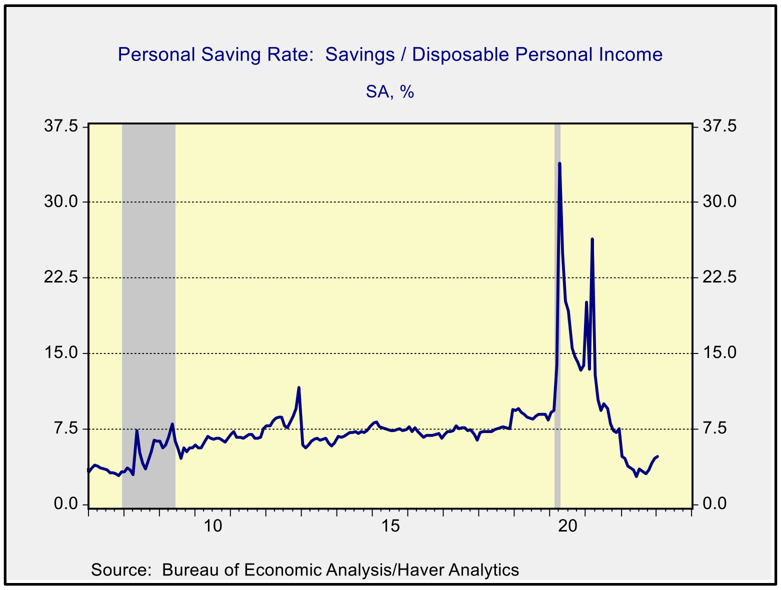
- Make no mistake about it, there are major divisions within the U.S.-led bloc. However, these differences have not been able to prevent countries from working together to prevent Russia's advancement in Ukraine. Confronting China will likely provide fresh challenges as the country remains a major export market for European countries. As a result, the U.S. may need to provide Europe with additional assistance if it wants to ensure that the Western alliance remains intact. We are confident that Europe offers many opportunities for investors looking for international exposure. However, this outlook may change if China supplies Russia with lethal weapons.

U.S. Economic Releases

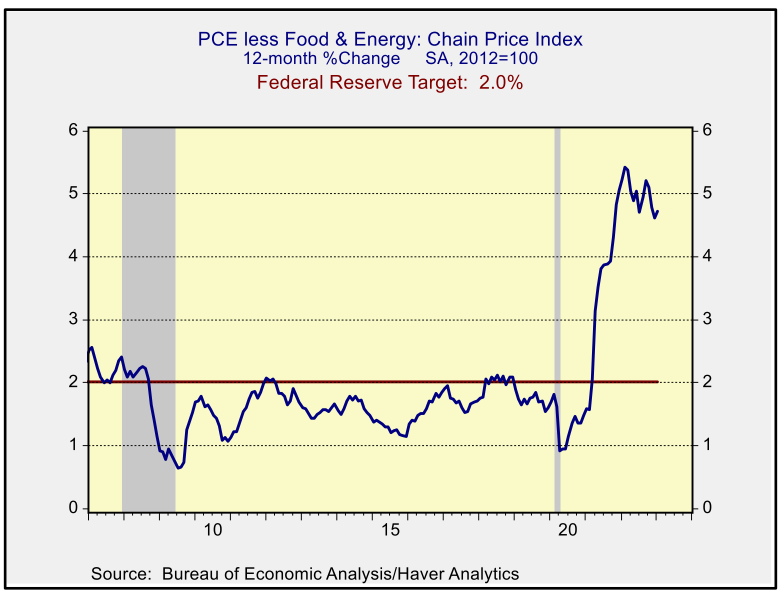
January ***personal income*** rose by a seasonally adjusted 0.6%, modestly underperforming the expected increase of 1.0% but still marking a big acceleration from the revised December increase of 0.3%. Meanwhile, January ***personal consumption expenditures (PCE)*** surged 1.8%, handily beating the anticipated rise of 1.4% and much more than needed to reverse the revised decline of 0.1% in December. Excluding the topsy-turvy fluctuations during the COVID-19 pandemic, the jump in PCE in January was the biggest since October 2001. Personal income in January was up 6.4% compared with the same month one year earlier, while PCE was up 7.9%. The chart below shows the year-over-year change in personal income and PCE since just before the prior recession.



The personal income and spending report also includes a measure of personal savings, defined as disposable (after tax) income less consumption spending on goods and services. The January ***personal savings rate*** rose to a seasonally adjusted 4.7%, perhaps reflecting some people husbanding resources ahead of a possible recession later in 2023. The following chart shows how the personal savings rate has fluctuated since just before the previous recession.



Finally, the income and spending report includes the Federal Reserve's preferred measure of consumer price inflation. After stripping out the volatile food and energy components, the key ***Core PCE Deflator*** for January was up 4.7% from the same month one year earlier, marking a slight acceleration from the rise of 4.6% in the year to December and far worse than the expected increase of 4.3%. Coupled with the extraordinary rise in PCE during January, the uptick in this measure of inflation will likely rekindle investor concerns that the Fed will keep hiking interest rates and hold them at a high level for longer than previously expected. The chart below shows the year-over-year change in the Core PCE Deflator since just before the prior 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	New Home Sales - Annualized Selling Rate	m/m	Jan	620k	616k	***
10:00	New Home Sales - Monthly Change	m/m	Jan	0.7%	2.3%	**
10:00	U. of Michigan Consumer Sentiment	m/m	Feb F	66.4	66.4	***
10:00	U. of Michigan Current Conditions	m/m	Feb F	72.7	72.6	**
10:00	U. of Michigan Future Expectations	m/m	Feb F	62.5	62.3	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Feb F	4.2%	4.2%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Feb F	2.9%	2.9%	*
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
10:15	Philip Jefferson and Loretta Mester discuss paper on managing	Fed Governor and Pres of the Federal Reserve Bank of Cleveland				
10:15	Loretta Mester Speaks on Panel at New York Conference	President of the Federal Reserve Bank of Cleveland				
11:30	James Bullard Discusses Inflation	President of the Federal Reserve Bank of St. Louis				
13:30	Susan Collins gives recorded remarks on US Monetary Policy	President of the Federal Reserve Bank of Boston				
13:30	Chris Waller discusses inflation	Member 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	National CPI	y/y	Jan	4.3%	4.0%	4.3%	***	Equity and bond neutral
	National CPI Ex-Fresh Food	y/y	Jan	4.2%	4.0%	4.3%	**	Equity and bond neutral
	National CPI Ex-Fresh Food & Energy	y/y	Jan	3.2%	3.0%	3.3%	*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	17-Feb	¥2693.3b	¥716.5b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	17-Feb	¥197.7b	¥105.1b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	17-Feb	¥229.5b	-¥59.3b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	17-Feb	¥202.0b	-¥836.7b		*	Equity and bond neutral
	Nationwide Department Store Sales	y/y	Jan	15.1%	4.0%		*	Equity and bond neutral
EUROPE								
Germany	GDP NSA	y/y	4Q F	0.3%	0.5%	0.5%	**	Equity and bond neutral
	GDP WDA	y/y	4Q F	0.9%	1.1%	1.1%	**	Equity and bond neutral
	GfK Consumer Confidence	m/m	Mar	-30.5	-33.9	-33.8	**	Equity and bond neutral
France	Consumer Confidence	m/m	Feb	82.0	80.0	83.0	**	Equity and bond neutral
UK	GfK Consumer Confidence	m/m	Feb	-38.0	-45.0	-43.0	**	Equity bullish, bond bearish
AMERICAS								
Mexico	Economic Activity IGAE	y/y	Dec	2.62%	3.28%	3.38%	**	Equity bearish, bond bullish
Mexico	GDP NSA	y/y	4Q F	3.6%	3.5%	3.5%	***	Equity and bond neutral
Brazil	IBGE Inflation IPCA - 15	y/y	Feb	5.63%	5.87%	5.59%	*	Equity and bond neutral
	Current Account Balance	m/m	Jan	-$8.791b	-$10.878b	-$11.117b	**	Equity and bond neutral
	Foreign Direct Investment	m/m	Jan	$6.877b	$5.570b	$b7.600b	**	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)	493	492	1	Up
3-mo T-bill yield (bps)	467	470	-3	Up
TED spread (bps)	26	23	3	Widening
U.S. Sibor/OIS spread (bps)	489	489	0	Up
U.S. Libor/OIS spread (bps)	491	491	0	Up
10-yr T-note (%)	3.90	3.88	0.02	Flat
Euribor/OIS spread (bps)	269	268	1	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Down			Up
Pound	Down			Down
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.

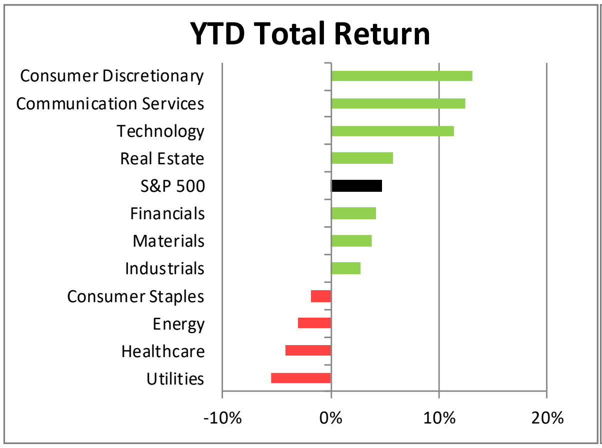
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$82.76	$82.21	0.67%	
WTI	$75.89	$75.39	0.66%	
Natural Gas	$2.38	$2.31	2.81%	
Crack Spread	$34.72	$34.85	-0.38%	
12-mo strip crack	$28.14	$28.17	-0.11%	
Ethanol rack	$2.33	$2.33	-0.18%	
Metals				
Gold	$1,817.07	$1,822.28	-0.29%	
Silver	$21.09	$21.31	-1.01%	
Copper contract	$402.15	$405.60	-0.85%	
Grains				
Corn contract	$657.00	$659.25	-0.34%	
Wheat contract	$741.75	$750.50	-1.17%	
Soybeans contract	$1,530.75	$1,527.25	0.23%	
Shipping				
Baltic Dry Freight	816	674	142	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	7.6	2.8	4.8	
Gasoline (mb)	-1.9	0.9	-2.8	
Distillates (mb)	2.7	-1.2	3.9	
Refinery run rates (%)	-0.6%	-0.2%	-0.4%	
Natural gas (bcf)	-71	-62	-9.0	

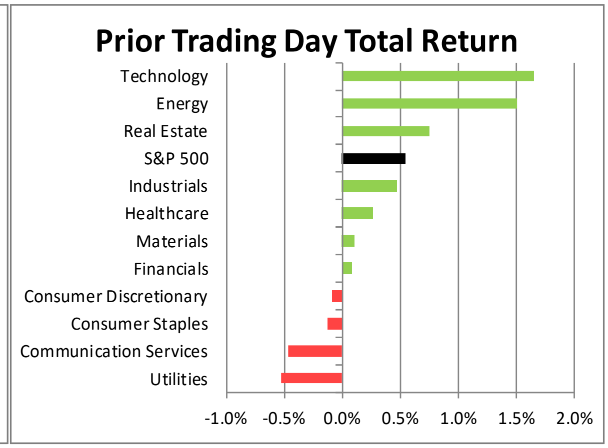
Weather

The 6-10 and 8-14 day forecasts show colder-than-normal temperatures along the West Coast and in the Rocky Mountain region, with warmer-than-normal temperatures in the Midwest, the deep South, and the Mid-Atlantic region. The forecasts show wetter-than-normal conditions throughout the entire northern half of the country, with dry conditions in Texas and Florida.

Data Section

U.S. Equity Markets – (as of 2/23/2023 close)

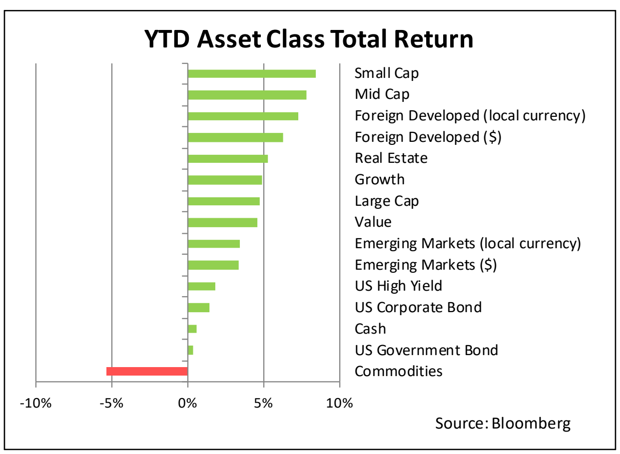




(Source: Bloomberg)

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 2/23/2023 close)

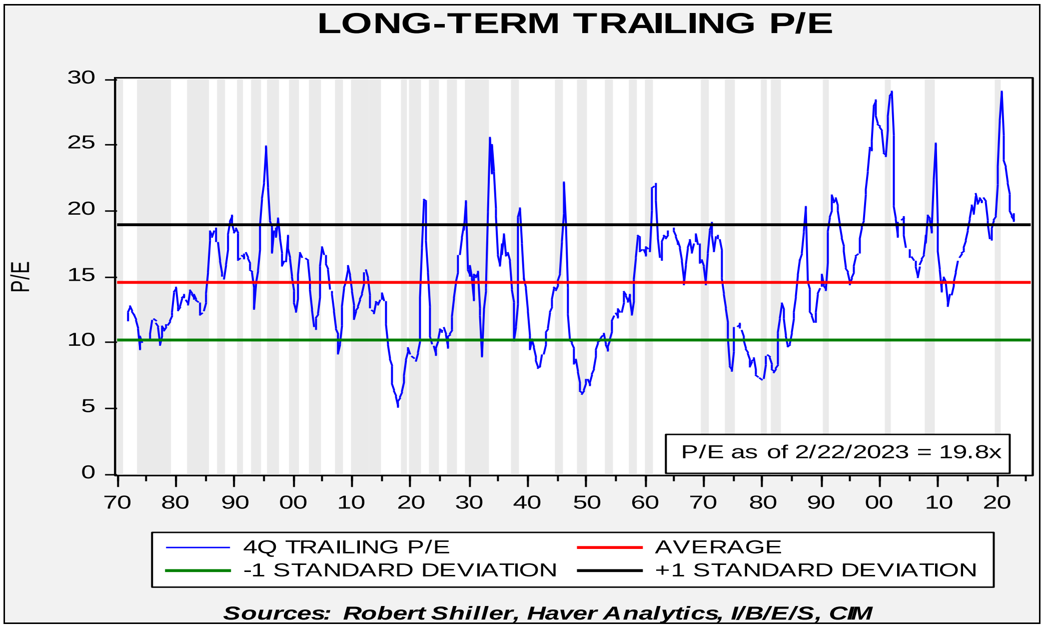


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 23, 2023



Based on our methodology,[1] the current P/E is 19.8x, unchanged from 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.