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 28, 2023—9:30 AM EST] Global equity markets are generally higher this morning. In Europe, the Euro Stoxx 50 is currently up 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.7%. Chinese markets were higher, with the Shanghai Composite and the Shenzhen Composite closing up 0.7%, respectively. U.S. equity index futures are signaling a higher open.

With 475 companies having reported so far, S&P 500 earnings for Q4 are running at $54.20 per share compared to estimates of $52.85. Of the companies that have reported thus far, 68.4% 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:

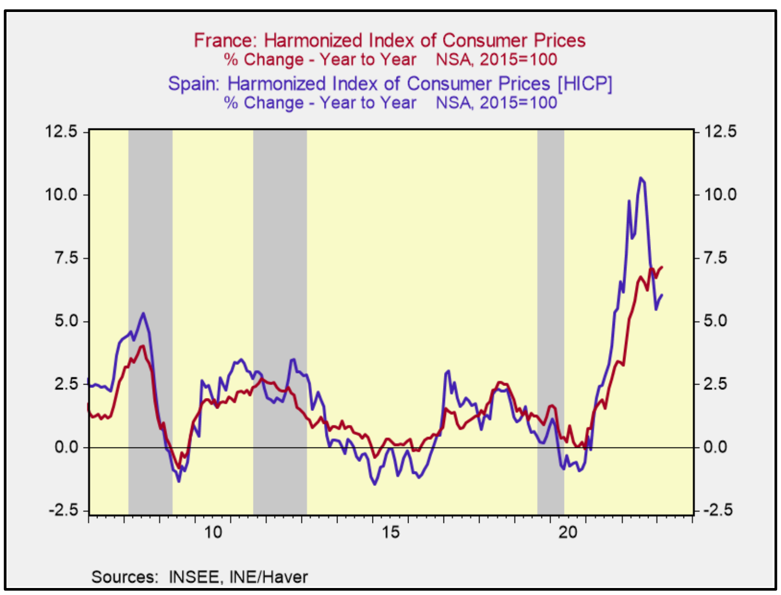
- *Bi-Weekly Geopolitical Report* (2/21/2023) (with associated podcast) "*Chip War*: Book Review"
- *Weekly Energy Update* (2/23/2023): We continue to chronicle the rise in commercial crude oil inventory and comment on the IAEA news that Iran is dangerously close to weapons-grade uranium enrichment. 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* (2/27/2023) (with associated podcast): "Federal Reserve Policymakers in 2023: Hawks or Doves?"
- *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 deal between the European Union and the United Kingdom to resolve their disagreement on how to handle Northern Ireland under Brexit. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including signs of a disappointing rebound in consumer price inflation in Europe and data showing a slowdown in India's economic growth. We end with an in-depth discussion of the new U.S. industrial policy to support advanced semiconductor manufacturing.

European Union-United Kingdom: At Windsor Castle yesterday, European Commission President von der Leyen and British Prime Minister Sunak unveiled their deal to adjust the Brexit withdrawal agreement's Northern Ireland Protocol, which regulates U.K. shipments to Northern Ireland that might enter the EU's single market. Under the revised plan, goods from Great Britain destined only for Northern Ireland will travel on a new "green lane" with fewer checks, while goods at risk of continuing on to the Republic of Ireland (i.e., entering the EU's single market) will move through a separate "red lane" with more stringent checks. The deal will also ease customs paperwork for individuals, normalize some taxes, and allow the Northern Ireland legislature to control some changes to the rules.

- If implemented, the "Windsor Framework" would likely ease EU-U.K. tensions. However, despite Sunak's success in striking the deal, there is still a strong chance that the far-right wing of his Conservative Party will oppose it on sovereignty and nationalism grounds. It could also still be rejected by unionists in Northern Ireland.
- Either event could destabilize the Sunak government, potentially prompting some of his ministers to resign and encouraging unionists in Northern Ireland to continue blocking the formation of a coalition government for the province.

Eurozone: France's February consumer price index was up 7.2% from the same month one year earlier, worse than expectations that it would be up just 7.0%, as it was in January. Just as disappointing, Spain's February CPI was up 6.1% on the year, accelerating from its inflation rate of 5.9% in the previous month. The figures have sparked concerns that the Eurozone's inflation will be more persistent than hoped for and that the European Central Bank will have to hike interest rates even more than planned. The chart below shows the year-over-year change in the French and Spanish CPIs since just before the Great Financial Crisis.



- Swap markets now suggest that investors expect the ECB to hike its benchmark interest rate to a record 3.85% by November, compared with 2.50% currently.

- As a result, government bond yields in the Eurozone have risen so far this morning. The yield on Germany's two-year notes has risen to 3.10%, their highest level since 2008, while the yield on its 10-year notes has reached 2.65%, which is their highest since 2011. The yield on Italy's 10-year notes has risen to 4.53%.

Russia-Ukraine War: Ukrainian officials say their forces are finding it increasingly difficult to hold the northeastern Ukrainian city of Bakhmut, despite inflicting enormous casualties on the Russian regular and mercenary forces attacking it. We suspect that the statements could be aimed at preparing their country and allies for an eventual decision to abandon the city. The current Russian offensive has been only marginally successful, and Russia will probably continue to struggle to generate significant combat power. However, the Ukrainians may want to limit their potential losses in Bakhmut so they can redeploy their troops for a planned spring offensive of their own.

Russia-China: Western sanctions meant to punish Russia for its invasion of Ukraine are pushing Moscow into a closer relationship with Beijing, and new reporting indicates that Russia is using the yuan more frequently for trade and investment. Russian energy exporters are increasingly being paid in the Chinese currency, some companies have borrowed in yuan, and the Russian sovereign wealth fund is now allocating more of its funds to yuan assets. The development is consistent with our view that China will probably try to push its evolving geopolitical and economic bloc to use some version of the yuan as its reserve currency, which will likely attempt to undermine the dollar at some point in the future.

Hong Kong: Chief Executive John Lee announced that the city will finally drop its COVID-19 mask mandate beginning on Wednesday. Hong Kong has been slow to relax its pandemic measures, but it is now making a concerted effort to ease them in order to bring back businesses and tourists to revive the economy.

India: After stripping out price changes, gross domestic product in the fourth quarter of 2022 was up just 4.4% from the same period one year earlier, marking a pronounced slowdown from the increase of 6.3% in the year ending in the third quarter and 13.2% in the year ending in the second quarter. The big slowdown at the end of 2022 stemmed primarily from weaker consumption as consumers struggled with high inflation.

U.S. Economic Growth: A new survey by the National Association of Business Economists shows that 58% of the 48 top economists believe the U.S. will enter into a recession by the end of 2023, the same proportion as in the previous survey in December. However, only about one-quarter think the recession will start by the end of March, about half as many as did in December. The survey results are consistent with our current view that the economy will slip into recession this year, most likely around mid-year or later.

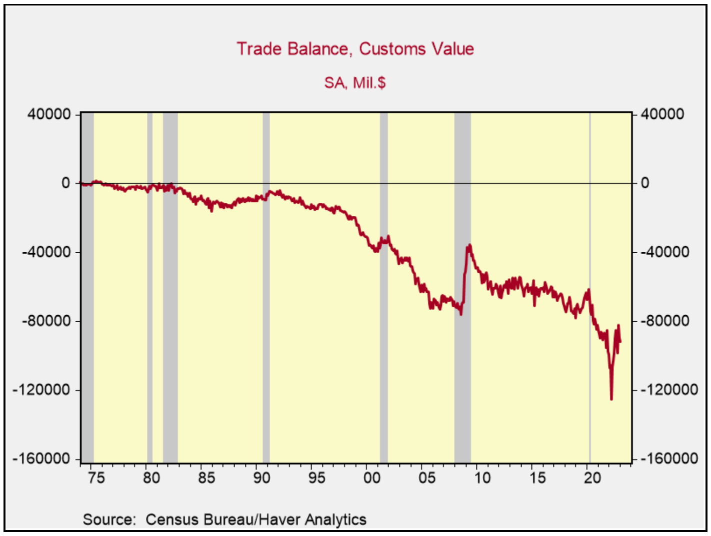
U.S. Fiscal Policy: With state governments still flush with cash ahead of an expected economic slowdown, more than a dozen are planning or implementing a range of tax cuts. In the latest example, today New Jersey Governor Phil Murphy will propose another $2 billion in property-tax rebate checks as part of his proposed $53 billion state budget.

U.S. Industrial Policy: Yesterday, the Commerce Department released the rules it will use in awarding the $39 billion in subsidies for advanced semiconductor manufacturing under last year's Chips and Science Act. Among the notable provisions, semiconductor manufacturers receiving the funds will be prohibited from expanding their operations in China for the following ten years. They would also be restricted from any joint research or licensing deals with Chinese entities if they involve sensitive technology. Other strings attached to the funding will restrict the recipient companies from using the money for stock buybacks or dividends. To the extent that the funding produces profits over a certain threshold, they will also be required to refund some of the money to the government.

- The Chips and Science Act aims to create a U.S. industry capable of mass-producing leading-edge semiconductors, most of which are currently made in Taiwan. The Act's $39 billion in subsidies reportedly could be leveraged to generate another $75 billion in federal funding, for total support of more than $100 billion. The Act also includes another $13 billion for research and development, as well as workforce support.
    - In an interview, Commerce Secretary Raimondo stressed that one key goal of the Act was to ensure the U.S. military has secure access to the cutting-edge computer chips it needs for its warplanes, drones, missiles, and other weaponry.
    - Raimondo also revealed that, since the Act is a national security initiative, the Commerce Department will count on input from Defense Secretary Austin and the defense and intelligence communities as it begins implementing the program this week.
- Coupled with the administration's stringent new prohibitions on sending advanced semiconductor technologies to China, the U.S. is clearly trying to maintain the biggest possible technological lead over China.

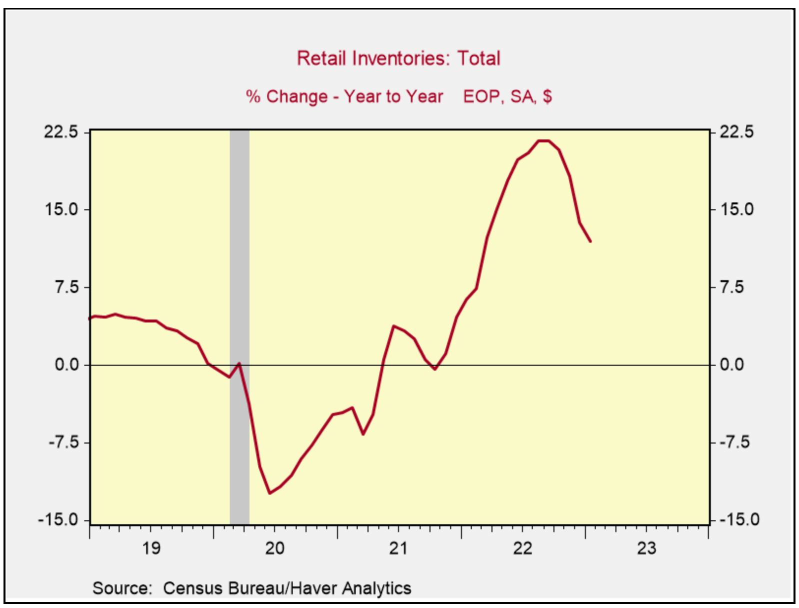
U.S. Economic Releases

The U.S. trade deficit in goods increased slightly last month. According to preliminary data from the Census Bureau, the U.S. trade shortfall in goods increased from $89.7 billion to $91.5 billion. The deficit reading was slightly above estimates of $91.0 billion.



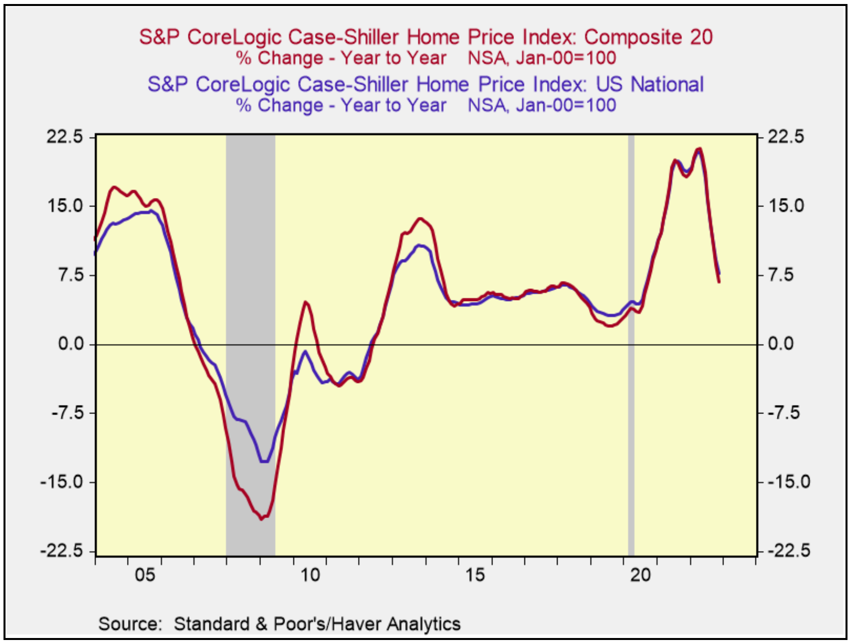
The chart above shows the level of U.S. trade balance in goods.

Firm stocks of excess goods rose modestly in January. According to data from the Census Bureau, retail inventory growth slowed from a 0.5% rise in December 2022 to a 0.3% rise for the following month. Meanwhile, wholesale inventories contracted 0.4% from the previous month, well below the previous month's rise of 0.1%.



The chart above shows the annual change in retail inventories. Inventories rose 12% from the prior year but they are clearly slowing.

Lastly, residential property prices slumped at the end of the year as elevated interest rates dissuaded prospective homebuyers. According to the Federal Housing Finance Agency, home prices rose 0.3% in the final quarter but fell 0.3% in December. This monthly decline in property values was mirrored in the data collected by Standard & Poor's Home Price Index. The latest reading showed home prices in the top-20 cities fell 0.5% from the prior month, while the national home prices fell 0.4% in the same period.



Despite the monthly decline in home prices, residential property values are still higher than they were a year ago. For the top-20 cities, home prices are up 4.7% from the prior year, meanwhile national home prices are up 5.8%.

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
9:45	MNI Chicago PMI	m/m	Feb	45.0	44.3	***
10:00	Richmond Fed Manufact. Index	m/m	Feb	-5.0	-11.0	**
10:00	Conf. Board Consumer Confidence	m/m	Feb	108.5	107.1	***
10:00	Conf. Board Present Situation	m/m	Feb	--	150.9	**
10:00	Conf. Board Expectations	m/m	Feb	--	77.8	**
Federal Reserve						
EST	Speaker or Event	District or Position				
14:30	Austan Goolsbee Speaks at Community College	President of the Federal Reserve Bank of Chicago				

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	Industrial Production	y/y	Jan P	-2.3%	-2.4%	-0.7%	***	Equity bearish, bond bullish
	Retail Sales	y/y	Jan	6.3%	3.8%	4.0%	**	Equity bullish, bond bearish
	Depart. Store & Supermarket Sales	y/y	Jan	5.3%	3.6%		*	Equity bullish, bond bearish
	Housing Starts	y/y	Jan	6.6%	-1.7%	1.1%	**	Equity bullish, bond bearish
	Annualized Housing Starts	y/y	Jan	0.893M	0.846m	0.850m	*	Equity and bond neutral
Australia	BoP Current Account Balance	m/m	4Q	A$14.1b	-A$2.3b	A$0.8b	**	Equity bullish, bond bearish
	Retail Sales	y/y	Jan	1.9%	-3.9%	-0.4%	**	Equity bullish, bond bearish
	Private Sector Credit	y/y	Jan	8.0%	8.3%		**	Equity and bond neutral
New Zealand	ANZ Activity Outlook	m/m	Feb	-9.2	-15.8		**	Equity bullish, bond bearish
	ANZ Business Confidence	m/m	Feb	-43.3	-52.0		**	Equity bullish, bond bearish
India	GDP	y/y	4Q	4.4%	6.3%	4.7%	**	Equity and bond neutral
EUROPE								
France	CPI, EU Harmonized	y/y	Feb P	7.2%	7.0%	7.0%	**	Equity and bond neutral
	CPI	y/y	Feb P	6.2%	6.0%	6.1%	***	Equity and bond neutral
	PPI	y/y	Jan	17.9%	20.7%	20.5%	*	Equity bullish, bond bearish
	GDP	y/y	4Q F	0.5%	0.5%	0.5%	**	Equity and bond neutral
Italy	Industrial Sales WDA	y/y	Dec	14.9%	11.5%	11.4%	*	Equity bullish, bond bearish
Switzerland	GDP	y/y	4Q	0.8%	0.5%	0.8%	**	Equity and bond neutral
AMERICAS								
Brazil	National Unemployment Rate	m/m	Dec	7.9%	8.1%	8.0%	*	Equity and bond neutral
	Net Debt % GDP	m/m	Jan	56.6%	57.5%	57.6%	*	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)	495	496	-1	Up
3-mo T-bill yield (bps)	464	470	-6	Up
TED spread (bps)	31	25	6	Widening
U.S. Sibor/OIS spread (bps)	489	489	0	Up
U.S. Libor/OIS spread (bps)	492	492	0	Up
10-yr T-note (%)	3.93	3.92	0.01	Flat
Euribor/OIS spread (bps)	272	270	2	Up
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Flat			Up
Yen	Down			Up
Pound	Up			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.

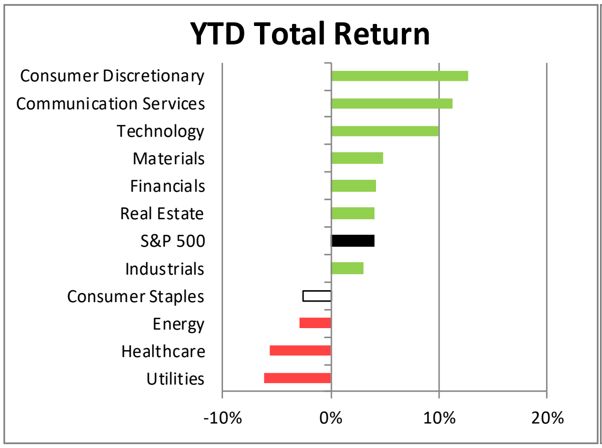
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$83.40	$82.45	1.15%	
WTI	$76.81	$75.68	1.49%	
Natural Gas	$2.70	$2.73	-1.06%	
Crack Spread	$35.53	$35.77	-0.68%	
12-mo strip crack	$28.58	$28.83	-0.86%	
Ethanol rack	$2.30	$2.31	-0.26%	
Metals				
Gold	$1,808.44	$1,817.14	-0.48%	
Silver	$20.53	$20.63	-0.50%	
Copper contract	$402.90	$401.10	0.45%	
Grains				
Corn contract	$642.00	$643.50	-0.23%	
Wheat contract	$709.00	$710.00	-0.14%	
Soybeans contract	$1,502.25	$1,512.75	-0.69%	
Shipping				
Baltic Dry Freight	935	883	52	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.8		
Gasoline (mb)		0.9		
Distillates (mb)		1.2		
Refinery run rates (%)		-0.2%		
Natural gas (bcf)		-62		

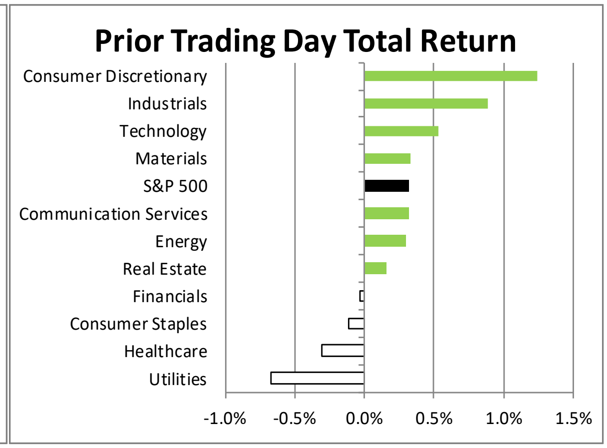
Weather

The 6-10 and 8-14 day forecasts show colder-than-normal temperatures for most of the country, with warmer-than-normal temperatures in the Deep South. The forecasts show wetter-than-normal conditions throughout the majority of the nation, with dry conditions along the East Coast.

Data Section

U.S. Equity Markets – (as of 2/27/2023 close)

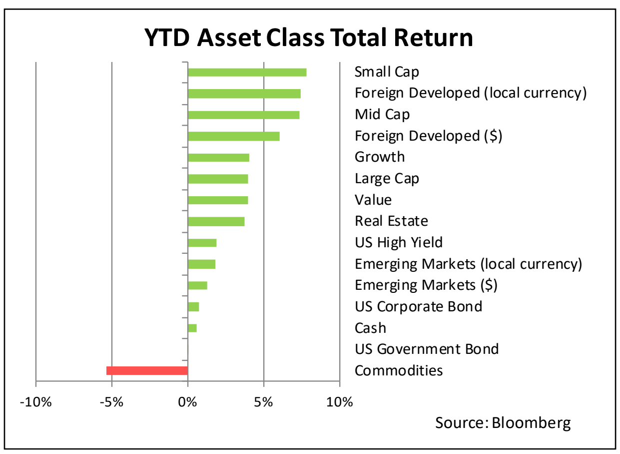




(Source: Bloomberg)

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 2/27/2023 close)

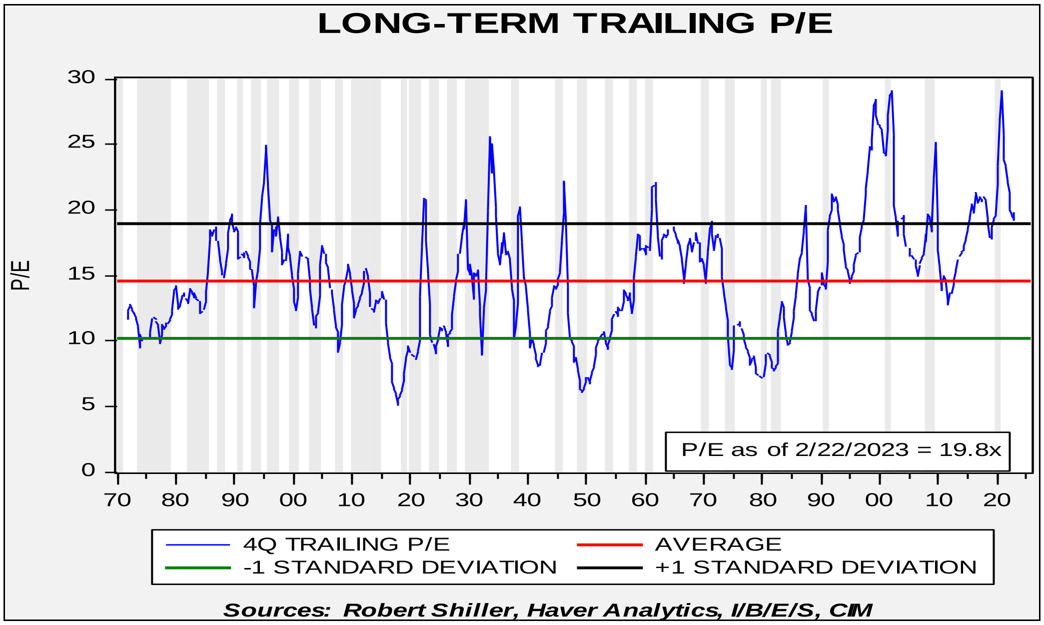


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.