Confluence INVESTMENT MANAGEMENT

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: January 9, 2023—9:30 AM EST] Global equity markets are mostly higher this morning. In Europe, the Euro Stoxx 50 is up 0.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 3.4%. Chinese markets were higher, with the Shanghai Composite closing up 0.6% and the Shenzhen Composite closing up 0.7%. In contrast, U.S. equity index futures are signaling a higher open.

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* (12/12/2022) (associated podcast is available) "The 2023 Geopolitical Outlook"
- *Weekly Energy Update* (12/15/2022): In this week's report, we discuss President Xi's visit to Saudi Arabia and mention the news on nuclear fusion.
- *Asset Allocation Quarterly – Q4 2022* (10/18/2022): Discussion of our asset allocation process, Q4 2022 portfolio changes, and our outlook for the markets.
- *Asset Allocation Bi-Weekly* (12/05/2022) (with associated podcast): "Forecasting Financial Stress." *The next* AABW *report will be published on January 16, 2023.*
- *Asset Allocation Q4 2022 Rebalance Presentation* (11/14/2022): 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 (12/19/2022): "The 2023 Geopolitical Outlook"

Our *Comment* today opens with an update on the post-pandemic landscape in China, where the relaxation of pandemic lockdowns continues to reverberate throughout the domestic, regional, and global economies. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including the weekend's big capital riot in Brazil and the election of Kevin McCarthy as Speaker of the House.

China Reopening: As of Sunday, the Chinese government has removed most of its COVID-19 restrictions on international travel, prompting tens of thousands of air arrivals and departures. The move could eventually help the tourism industry in countries that had become dependent on Chinese visitors before the pandemic, especially in Asia, but outbound Chinese tourism won't immediately rise to its pre-pandemic levels given that many foreign countries have slapped testing requirements on them to keep China's surging infections from spreading. It may also take the airlines some time to re-orient their fleets toward China again.

- Separately, the reopening of the economy appears to be boosting global oil prices today, even though the relaxation of pandemic lockdowns has led to a current surge in infections and is actually crimping current economic activity.
- So far this morning, front-month Brent crude oil futures are trading up some 2.9% at $80.82 per barrel.

China Regulatory Policy: The China Securities Regulatory Commission is reportedly preparing to cease allowing local companies in certain sectors to list on the Shanghai or Shenzhen stock exchanges so that the government can channel funding into strategic industries. The sectors to be "red lighted" will reportedly include food and beverage chains and COVID-19 testing firms. The CSRC will also name a number of "yellow light" sectors, such as apparel and furniture, where initial public offering requests could come under heavy scrutiny if their growth relies heavily on debt for expansion.

- Over the last few years, the government has clamped down hard on big economic sectors that leaders felt had become too powerful, wasteful, or simply at odds with President Xi's vision of good communist values. The real estate development, information technology, and on-line tutoring industries were prime targets, and their investors paid a heavy price.
- The new red-light and yellow-light rules mark a further blow to China's free markets. In turn, they will likely contribute to rising investor skepticism about China and could potentially drive more foreign investors elsewhere.

Russia-Ukraine War: Fighting continues along the front lines running from eastern to southern Ukraine, with the Russian military continuing to stage air attacks against critical Ukrainian energy infrastructure. To sustain its air attacks even as it has depleted much of its own conventional and advanced missiles and artillery, Russian officials say they are about to begin domestic production of Iranian-designed kamikaze drones.

- Separately, a new Atlantic Council survey found that 46% of the 167 foreign policy analysts polled thought that Russia could become a failed state or break up by 2033.
- Also in the survey, 40% pointed to Russia as a country they expected to break up for reasons including "revolution, civil war or political disintegration" over that time.

NATO Expansion: Swedish Prime Minister Kristersson warned that his government can't meet some of the demands Turkey is making before it would lift its veto over Sweden entering the North Atlantic Treaty Organization. Turkey's demands focus on Sweden's alleged ties to Kurdish separatists in Turkey. It is not clear whether Ankara will finally acquiesce to Sweden and Finland joining NATO after Turkey's presidential elections sometime in the coming months.

France: After abandoning his first effort to reform the country's pension system due to the COVID-19 pandemic, tomorrow President Macron plans to propose a new reform that would increase the minimum pension but raise the age at which retirees can get the full benefit. The aim is to cut the massive fiscal cost of the country's pension system and boost the incentive to work. However, most French voters object to the proposed reforms, and labor leaders have threatened a series of strikes to oppose them.

United Kingdom: As the country continues to reel from economically damaging work stoppages across the railroad and healthcare sectors, Prime Minister Sunak's government is planning to meet union leaders today in an effort to avert further strikes. Of great importance is a threatened teachers' strike. Since the beginning of the year, Sunak has somewhat moderated his stance toward the strikers, although he still insists he will keep any resolution of the strikes from overly burdening the government's budget or further boosting inflation.

Brazil: Thousands of supporters of the country's right-wing former president, Jair Bolsonaro, stormed the presidential palace, national parliament, and supreme court buildings yesterday and demanded that the military remove newly inaugurated leftist President Lula da Silva, who beat Bolsonaro in the October presidential elections by 51% to 49%. Bolsonaro has refused to concede defeat in the elections, but the military, so far, has not shown signs that it supports his argument that the elections were marred by fraud.

- Bolsonaro has decamped to Florida, as has his former justice minister, who had been named as the federal district's public security chief.
- The presence of both Bolsonaro and the federal district's public security chief in Florida will likely raise concerns that the storming of the capitol was preplanned and that the two men left the country in an effort to distance themselves from the action. However, Bolsonaro eventually condemned the rioting and claimed no connection with it.
- In any case, the storming will likely raise concern about the resilience of Brazil's democracy. Investors certainly have concerns about the leftist president's economic policies, but political instability would add to the headwinds for Brazil's stock market.

U.S. Congressional Politics: The new Republican majority in the House of Representatives finally elected Rep. Kevin McCarthy as Speaker of the House early Saturday morning, but only after he made a series of concessions to far-right wing members of his party that will leave him severely weakened. The 15 rounds of voting needed to elect McCarthy as well as his compromises are widely being panned as another sign that political polarization is leaving the U.S. ungovernable.

U.S. Monetary Policy: At a conference on Friday, Richmond FRB President Barkin warned that the Federal Reserve is likely to continue raising interest rates because its mandate to control inflation will trump the risk of causing a recession. The statement marks a further Fed effort to keep business leaders cautious even though some investors and analysts are already looking for a potential monetary loosening.

U.S. Weather and Drought: California is preparing for yet another major rain and snow storm today, but scientists warn that the recent torrents aren't nearly enough to end the state's drought. Continued water-use restrictions are therefore likely to continue weighing on California's economy.

U.S. Economic Releases

There were no economic releases prior to the publication of this report. 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
15:00	Consumer Credit	m/m	Nov	$25.000b	$27.08b	*
Federal Reserve						
EST	Speaker or Event	District or Position				
12:30	Raphael Bostic Takes Part in Moderated Discussion	President of the Federal Reserve Bank of Atlanta				
12:30	Mary Daly Interviewed in WSJ Live Event	President of the Federal Reserve Bank of San Francisco				

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								
Australia	Building Approvals	m/m	Nov	-9.0%	-6.0%	-5.6%	***	Equity bearish, bond bullish
China	Foreign Reserves	m/m	Dec	$3.128t	$3.117t	$3.150t	**	Equity and bond neutral
EUROPE								
Eurozone	Unemployment Rate	m/m	Nov	6.5%	6.5%	6.5%	**	Equity and bond neutral
Germany	Industrial Production WDA	y/y	Nov	-0.4%	0.0%	-0.2%	**	Equity and bond neutral
France	Trade Balance	m/m	Nov	-€13.766b	-€12.15b	-€11.592b	**	Equity and bond neutral
Italy	Unemployment Rate	m/m	Nov	7.8%	7.8%	7.8%	**	Equity and bond neutral
Switzerland	Domestic Sight Deposits CHF	w/w	6-Jan	487.3b	491.9b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	6-Jan	533.5b	539.2b		*	Equity and bond neutral
	Unemployment Rate	m/m	Dec	2.1%	2.0%	2.0%	**	Equity and bond neutral
	Foreign Currency Reserves	m/m	Dec	784.0b%	790.0b		***	Equity and bond neutral
AMERICAS								
Mexico	CPI	y/y	Dec	7.82%	7.80%	7.84%	***	Equity and bond neutral
	Core CPI	y/y	Dec	8.35%	8.51%	8.35%	**	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)	481	481	0	Up
3-mo T-bill yield (bps)	446	449	-3	Up
TED spread (bps)	35	32	3	Up
U.S. Sibor/OIS spread (bps)	462	462	0	Up
U.S. Libor/OIS spread (bps)	464	464	0	Up
10-yr T-note (%)	3.60	3.56	0.04	Down
Euribor/OIS spread (bps)	225	218	7	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.

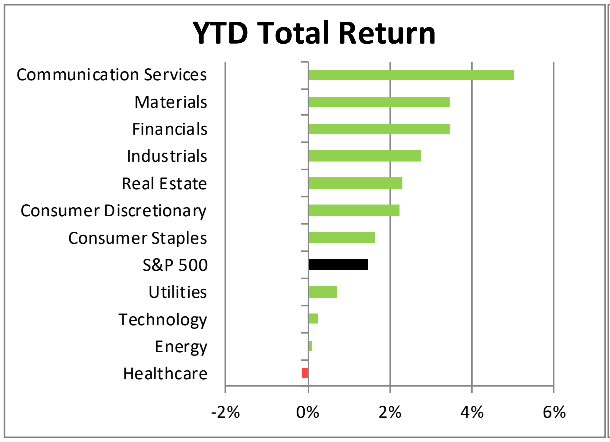
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$80.91	$78.57	2.98%	
WTI	$76.15	$73.77	3.23%	
Natural Gas	$3.82	$3.71	2.94%	
Crack Spread	$32.16	$31.57	1.86%	
12-mo strip crack	$28.69	$28.27	1.46%	
Ethanol rack	$2.45	$2.46	-0.63%	
Metals				
Gold	$1,874.11	$1,865.69	0.45%	
Silver	$23.90	$23.83	0.31%	
Copper contract	$398.05	$391.10	1.78%	
Grains				
Corn contract	$652.50	$654.00	-0.23%	
Wheat contract	$744.75	$743.50	0.17%	
Soybeans contract	$1,494.50	$1,492.50	0.13%	
Shipping				
Baltic Dry Freight	1,130	1,146	-16	

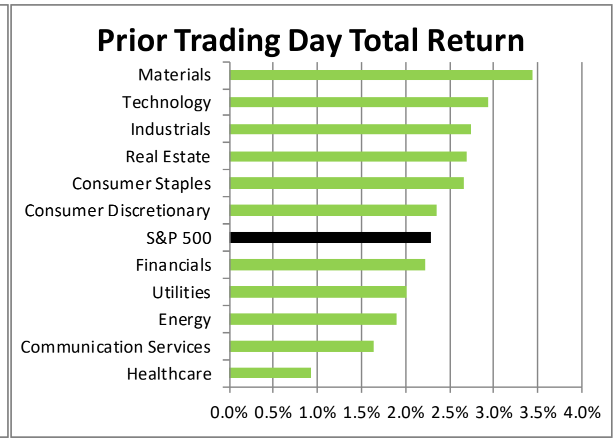
Weather

The 6-10 and 8-14 day forecasts show warmer-than-normal temperatures throughout almost the entire country, with cool-to-normal temperatures in the Pacific region. Wet conditions are expected throughout the nation, with dry conditions expected in south Texas.

Data Section

U.S. Equity Markets – (as of 1/6/2023 close)

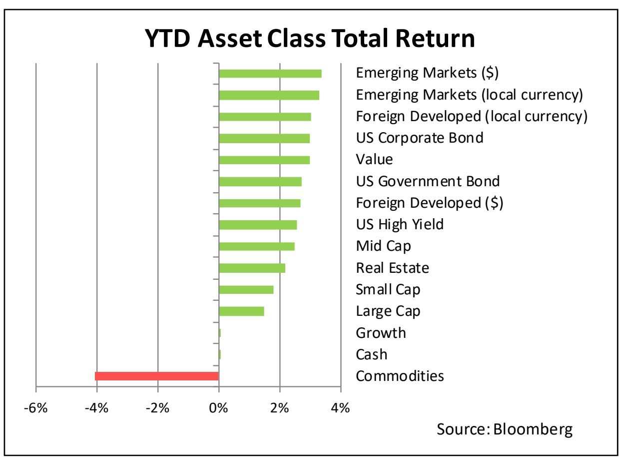




(Source: Bloomberg)

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 1/6/2023 close)

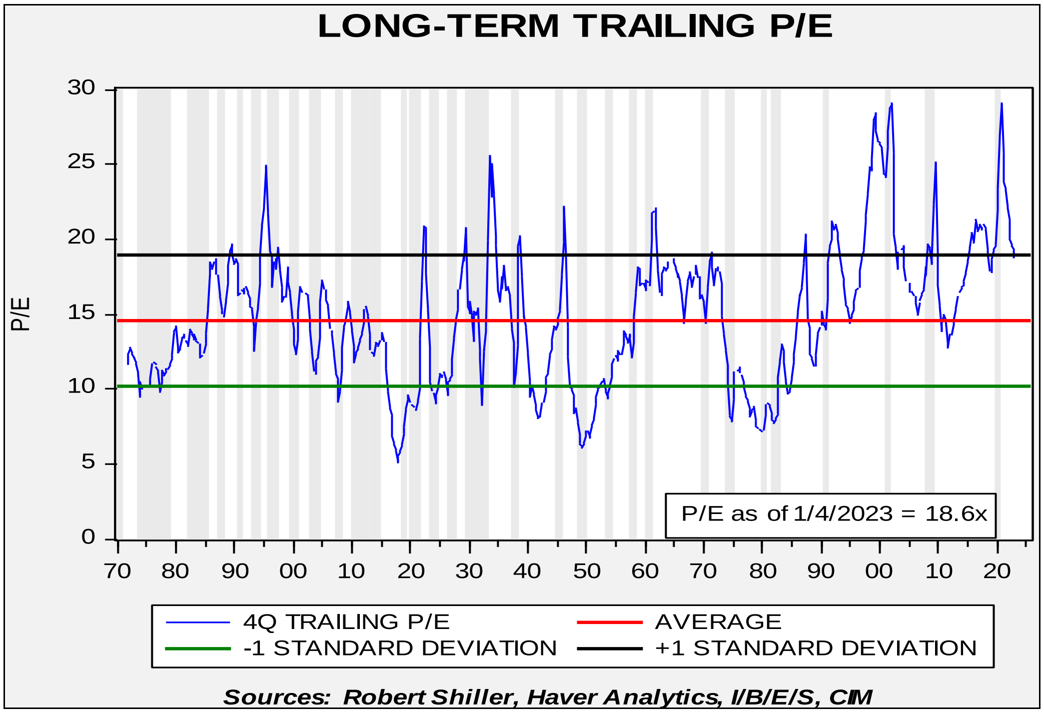


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

January 5, 2023



Based on our methodology,[1] the current P/E is 18.6x, down 0.6x from our last report. We have moved to Q1 data, as noted below.

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.