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.

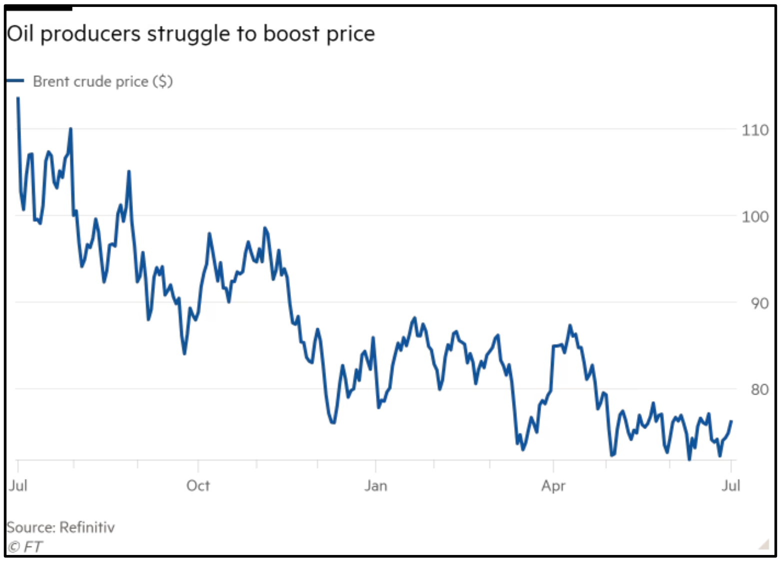
[Posted: July 3, 2023—9:30 AM EDT] Global equity markets are mostly higher this morning. In Europe, the Euro Stoxx 50 is currently up 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.8%. Chinese markets were up, with the Shanghai Composite closing up 1.3% from its previous close and the Shenzhen Composite up 0.5%. U.S. equity index futures are signaling a lower 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* (6/26/2023) (with associated podcast): "Distinguishing My Wife From a Hat, an AI Story"
- *Weekly Energy Update* (6/29/2023): Although the attempted coup in Russia made headlines, its impact on the oil markets was barely noticed. Guyana is rejecting OPEC membership, and oil inventories continue to decline.
- *Asset Allocation Quarterly – Q2 2023* (4/25/2023): Discussion of our asset allocation process, Q2 2023 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q2 2023 Rebalance Presentation* (5/11/2023): Video presentation featuring the Asset Allocation Committee as they review our asset allocation strategies, recent portfolio changes, and the current macro environment.
- ***Asset Allocation Bi-Weekly* (7/3/2023) (with associated podcast): "The Green Shoots of Re-Industrialization"**
- *Confluence of Ideas* podcast (3/8/2023): "Reflections on Inflation"
- *Business Cycle Report* (6/29/2023)

Our *Comment* today opens with energy news, including further oil output cuts by Saudi Arabia and Russia, as well as a spate of negative prices for wholesale electricity in Europe. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including further EU support for "de-risking" its supply chains with China and yet another significant strike in the U.S. labor market.

Global Oil Market: The governments of Saudi Arabia and Russia today announced they will further cut their oil production in August to boost prices as global demand slows. Russia alone will cut its output by an additional 500,000 barrels per day. Nevertheless, slowing economic growth and expectations of a recession in the U.S. continue to weigh on prices for oil and some other commodities. So far this morning, nearby Brent crude futures are trading at $76.03 per barrel, up just 0.8% on the day.



European Union: Another commodity with weak pricing these days is wholesale electricity in the EU. Prices were negative for much of the weekend and for an entire day in Germany, reflecting ample natural gas supplies and a surge of new solar and other green energy sources amid sunny weather. The negative prices can complicate finances for utility firms and will likely spur more interest in batteries and other storage mechanisms.

European Union-China: At their summit on Friday, the EU's 27 national leaders formally supported European Commission President Von der Leyen's call to "de-risk" supply chains with China. Although the leaders also stressed that they don't want to completely "de-couple" from China, the statement illustrates how EU leaders continue to shift toward the U.S. position of taking a stronger stance toward China's political, economic, and military aggressiveness. As we have noted many times before, these de-risking policies and China's reaction to them are growing risks for investors.

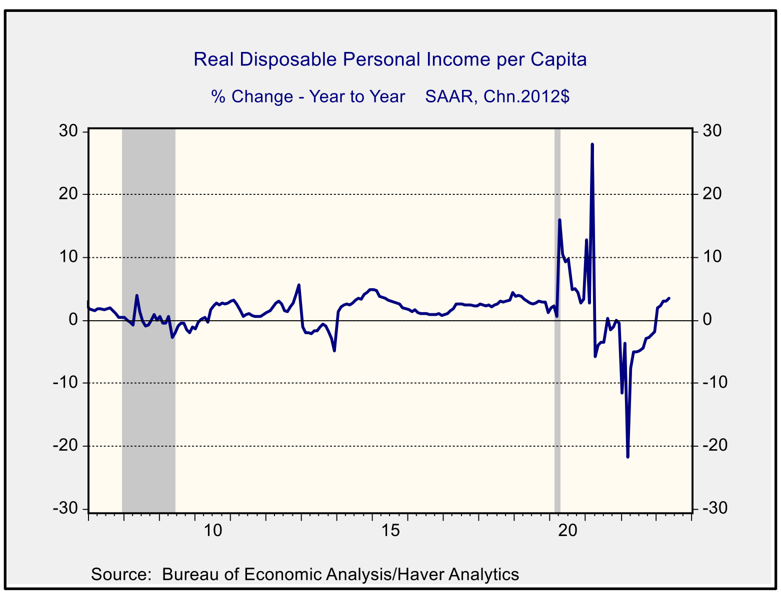
- On a related note, the Dutch government has tightened its restrictions on selling advanced semiconductor manufacturing equipment to China, as requested by the U.S. Starting September 1, top equipment maker ASML (ASML, $724.75), which is headquartered in the Netherlands, will be required to get a license before selling its most advanced immersion deep ultraviolet (DUV) lithography systems to customers in China.
- On China's side, the country's new anti-espionage law went into effect on Sunday. The law potentially criminalizes the release of even basic economic and corporate financial information. It also could compel locally employed Chinese nationals of Western companies to assist in Chinese intelligence efforts.

China: The Communist Party has named Pan Gongsheng, head of the State Administration of Foreign Exchange, to be its new party chief at the People's Bank of China. Not only does the appointment highlight how President Xi has pushed for stronger party representation in public and private organizations, but it has also raised speculation that the central bank could be preparing to defend the renminbi, which has recently weakened to a seven-month low against the dollar.

Brazil: The country's top electoral court on Friday convicted right-wing Former President Bolsonaro of abusing his political power and misusing the media ahead of last year's election. The decision bans Bolsonaro from running again for any political office until 2030, which would likely end his political career, but the former president is likely to appeal to the Supreme Court. In sum, the electoral court's decision and ongoing criminal investigations against Bolsonaro suggest the Brazilian investment environment will remain unstable in the near term.

U.S. Labor Market: Thousands of hotel workers in Los Angeles went on strike for higher pay and better benefits yesterday. Along with the many other strikes we've reported on recently, the hotel workers' strike reflects the increased cost of living and workers' realization that they have greater bargaining power amidst today's labor shortages.

- Over much of the last two years, galloping price inflation was more than enough to offset the jump in wage rates. The resulting drop in inflation-adjusted compensation or "real" purchasing power goes far toward explaining today's worker activism, low consumer sentiment, and the Biden administration's low approval ratings.
- We would note, however, that the modest cooling in inflation in recent months has started to boost real income. This chart shows that disposable personal income (i.e., income after taxes) is now up about 3.5% year-over-year even after stripping out taxes. That could potentially cool worker dissatisfaction and help Biden politically going forward.



U.S. Travel Market: AAA estimates that 43.2 million people will travel by automobile for the Independence Day holiday this year, which is 4% higher than the previous all-time high of 41.5 million in 2019. The organization's analysis suggests the jump in travel will come largely from the fact that gasoline prices this year are about 30% lower than their peak early last summer, at a national average of $3.49 per gallon.

U.S. Student Loan Market: Despite the slowdown in inflation and the jump in consumer purchasing power at the present, we're increasingly focused on the risk that consumption demand could suddenly slow in October, when the pandemic-era pause on student loan repayments ends and 27 million people have to start writing those checks again. In addition, the Supreme Court on Friday invalidated President Biden's student loan forgiveness plan, which would have cancelled up to $20,000 of debt for some particularly low-income borrowers. Even though the administration is reportedly working on rules to ease the transition back to normal, the shock of sudden new debt service payments could well undermine consumption spending and finally bring about the recession that we've been expecting for some time.

LIBOR's Demise: Finally, we think it's important to remind investors that use of the London Interbank Offering Rate, or LIBOR, ended on Friday. We provided a detailed analysis of LIBOR's demise and its implications in our *Comment* on Friday, but to reiterate the main points:

- During the Great Financial Crisis, it was discovered that banks were manipulating their reported interest rates to help their respective institutions and, in the most egregious cases, encouraging other banks to do the same as "a favor." Because LIBOR was the rate tied to the Eurodollar futures market, this manipulation ran afoul of U.S. commodity trading regulations. In the wake of the scandal, the Federal Reserve and other regulators moved to end LIBOR and shifted to the Secured Overnight Financing Rate (SOFR) as of Friday.
- One important implication is that the market therefore loses a key data point. For years, one of the key indicators of market stress was the T-bill over Eurodollar spread, commonly called the "TED spread." Since LIBOR represented non-government guaranteed dollar deposits, there was credit risk embedded in the rate. Market participants began to notice that when credit stress developed in the financial markets, the TED spread would widen, with LIBOR rates rising above T-bill rates. The SOFR/T-bill spread will not likely exhibit the same characteristics as the TED spread, meaning that traders and investors will lose the TED spread as a market indicator.
- Bank loans will also lose a buffer. Bank loans are often tied to LIBOR as a base rate. A typical floating loan is LIBOR plus a spread. Since LIBOR rates would rise during periods of financial stress, banks were provided a modicum of protection from such events. In other words, the rate on LIBOR-based loans would rise as stress levels rose. Assuming the borrower remains current, the rise in the loan's rate would exceed the level of the risk-free rate by a wider margin. This protection would allow banks to offer more competitive rates to borrowers, knowing that the lender had some protection from financial stress events. Since SOFR is collateralized, the rate relative to the risk-free rate shouldn't rise when credit conditions deteriorate. Eventually, we would expect loan pricing to change to reflect the shift.
- Credit lines could be utilized during periods of stress. Banks routinely issue credit lines to corporate borrowers, assuming few will use them. Tying the credit line to a LIBOR rate tended to discourage credit line use because (as noted above) the LIBOR rate would rise when credit conditions weakened. Since SOFR is secured, the rate probably won't rise when stress emerges, which may encourage the use of credit lines just at the moment when banks would rather see them lay dormant.

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 Fed events scheduled for the rest of the day.

Economic Releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	S&P Global Manufacturing PMI	m/m	Jun F	46.3	46.3	***
10:00	Construction Spending MoM	m/m	May	0.5%	1.2%	**
10:00	ISM Manufacturing PMI	m/m	Jun	47.2	46.9	**
10:00	ISM Manufacturing PMI - Prices Paid	m/m	Jun	44.0	44.2	**
10:00	ISM Manufacturing PMI - Employment	m/m	Jun		51.4	*
10:00	ISM Manufacturing PMI - New Orders	m/m	Jun		42.6	**
	Wards Total Vehicle Sales	m/m	Jun	15.30m	15.05m	***
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								
Japan	Tankan Large Manufacturing Index	q/q	2Q	5	1	3	***	Equity and bond neutral
	Tankan Large Non-Manufacturing Index	q/q	2Q	23	20	22	***	Equity and bond neutral
	Tankan Large Manufacturing Outlook	q/q	2Q	9	3	4	***	Equity bullish, bond bearish
	Tankan Large Non-Manufacturing Outlook	q/q	2Q	20	15	21	***	Equity and bond neutral
	Tankan Large All-Industry Capex	q/q	2Q	13.4%	3.2%	10.0%	***	Equity bullish, bond bearish
	Jibun Bank Manufacturing PMI	m/m	Jun F	49.8	49.8		***	Equity and bond neutral
Australia	Melbourne Institute Inflation	m/m	Jun	0.1	0.9		***	Equity bullish, bond bearish
	Building Approvals	m/m	May	20.6%	-8.1%	-6.8%	***	Equity bullish, bond bearish
New Zealand	Building Permits	m/m	May	-2.2%	-2.6%		**	Equity and bond neutral
South Korea	Trade Balance	m/m	Jun	$1.130b	-$2.100b	-$2.117b	*	Equity and bond neutral
	Exports	y/y	Jun	-6.0%	-15.2%	-3.6%	***	Equity and bond neutral
	Imports	y/y	Jun	-11.7%	-14.0%	-10.1%	**	Equity and bond neutral
	S&P Global Global Manufacturing PMI	m/m	Jun	47.8	48.4		***	Equity and bond neutral
China	Caixin Manufacturing PMI	m/m	Jun	50.5	50.9	50.0	***	Equity and bond neutral
EUROPE								
Eurozone	HCOB Manufacturing PMI	m/m	Jun F	43.4	43.6	43.6	***	Equity and bond neutral
Germany	HCOB Manufacturing PMI	m/m	Jun F	40.6	41.0	41.0	***	Equity and bond neutral
France	HCOB Manufacturing PMI	m/m	Jun F	46.0	45.5	45.5	***	Equity and bond neutral
Italy	HCOB Manufacturing PMI	m/m	Jun	43.8	45.9	45.3	***	Equity and bond neutral
UK	S&P Global/CIPS Manufacturing PMI	m/m	Jun F	46.5	46.2	46.2	***	Equity and bond neutral
Switzerland	CPI	y/y	Jun	1.7%	2.2%	1.8%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Jun	1.8%	2.2%		**	Equity and bond neutral
	Core CPI	y/y	Jun	1.8%	1.9%		*	Equity and bond neutral
	Manufacturing PMI	m/m	Jun	44.9	43.2	42.8	***	Equity bullish, bond bearish
	Domestic Sight Deposits CHF	w/w	30-Jun	480.2b	496.6b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	30-Jun	491.9b	508.0b		*	Equity and bond neutral
Russia	S&P Global Manufacturing PMI	m/m	Jun	52.6	53.5		***	Equity and bond neutral
AMERICAS								
Canada	GDP	y/y	Apr	1.7%	1.7%	1.9%	**	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)	555	553	2	Up
3-mo T-bill yield (bps)	513	515	-2	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	527	526	1	Up
U.S. Libor/OIS spread (bps)	528	527	1	Up
10-yr T-note (%)	3.86	3.84	0.02	Flat
Euribor/OIS spread (bps)	358	359	-1	Up
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Flat
Yen	Down			Down
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.

DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$76.10	$75.41	0.91%	
WTI	$71.40	$70.64	1.08%	
Natural Gas	$2.70	$2.80	-3.65%	Demand pessimism and ample supply
Crack Spread	$34.10	$34.81	-2.03%	
12-mo strip crack	$25.72	$26.25	-2.00%	
Ethanol rack	$2.64	$2.66	-0.53%	
Metals				
Gold	$1,912.68	$1,919.35	-0.35%	
Silver	$22.78	$22.77	0.03%	
Copper contract	$378.55	$375.95	0.69%	
Grains				
Corn contract	$501.00	$494.75	1.26%	
Wheat contract	$651.00	$651.00	0.00%	
Soybeans contract	$1,382.00	$1,343.25	2.88%	
Shipping				
Baltic Dry Freight	1,091	1,112	-21	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-9.6	-1.5	-8.1	
Gasoline (mb)	0.6	1.0	-0.4	
Distillates (mb)	0.1	0.9	-0.8	
Refinery run rates (%)	-0.9%	0.4%	-1.3%	
Natural gas (bcf)	76	82	-6	

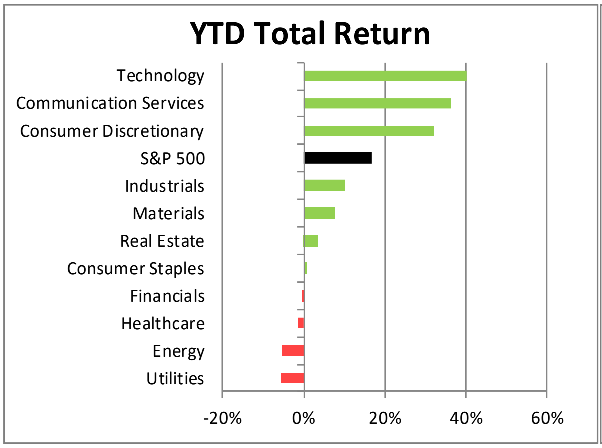
Weather

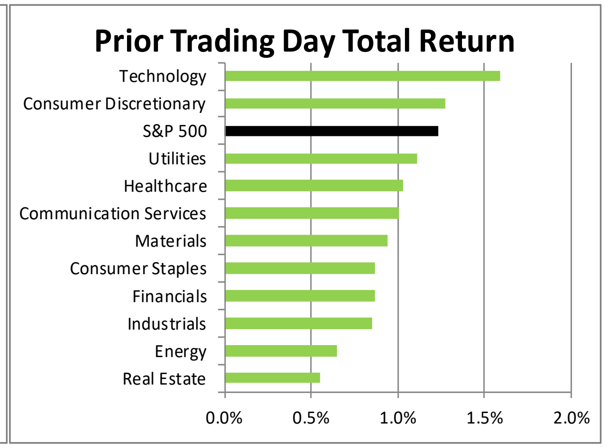
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout most of the country, with cooler-than-normal temperatures expected in the Midwest and New England regions. Meanwhile, the precipitation outlook calls for wetter-than-normal conditions in the eastern two-thirds of the country, with dry conditions in the Southwest.

There are no tropical cyclone formations expected within the next 48 hours.

Data Section

U.S. Equity Markets – (as of 6/30/2023 close)

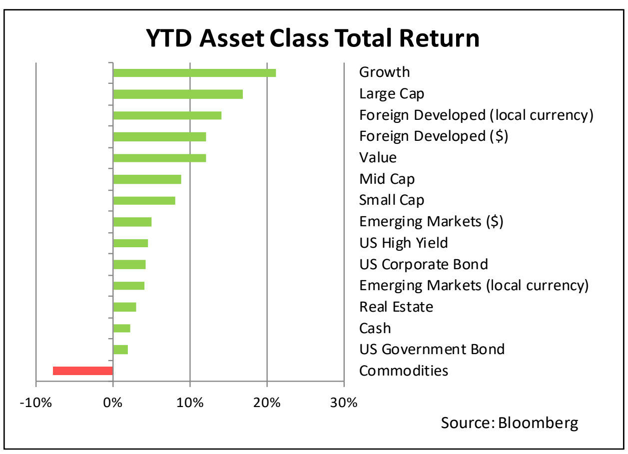




(Source: Bloomberg)

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 6/30/2023 close)

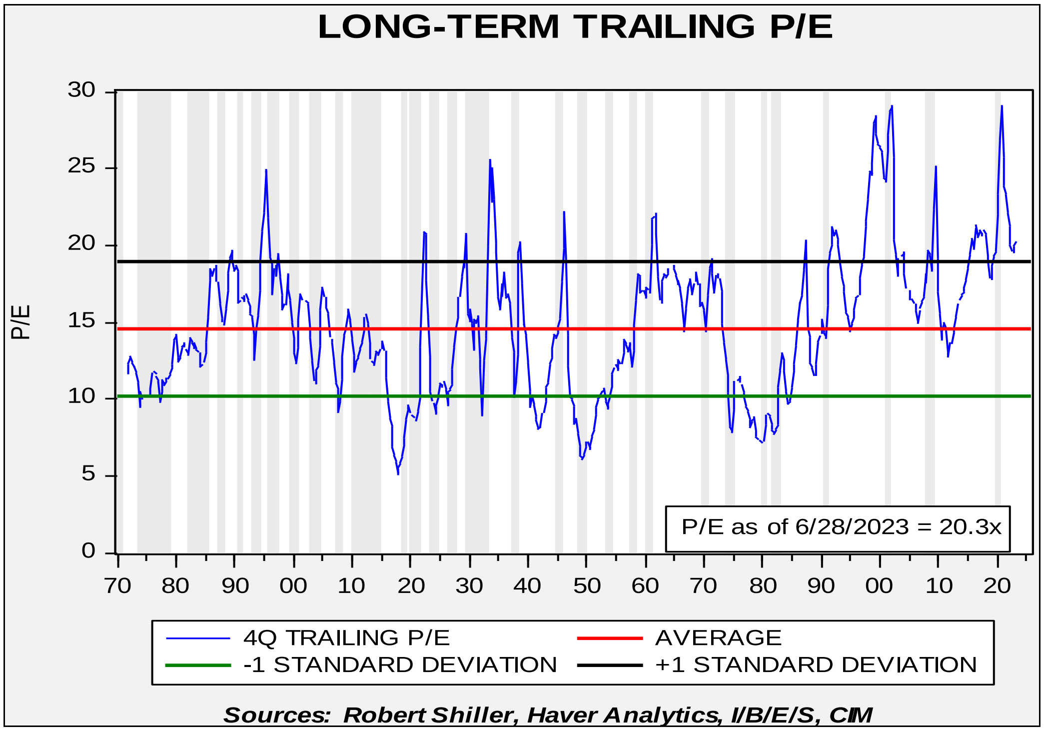


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

June 29, 2023



Based on our methodology,[1] the current P/E is 20.3x, up 0.1x from last week. Higher index values lifted 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 (Q3 and Q4) and two estimates (Q1 and Q2). 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.