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: July 6, 2023—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is currently down 1.6% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 2.2%. Chinese markets were down, with the Shanghai Composite closing down 0.5% from its previous close and the Shenzhen Composite down 0.4%. 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:

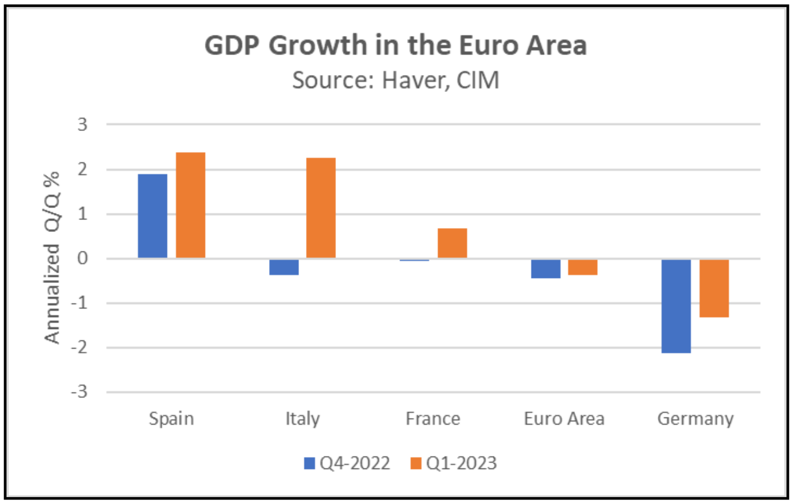
- *Bi-Weekly Geopolitical Report* (6/26/2023) (with associated podcast): "Distinguishing My Wife From a Hat, an AI Story"
- *Weekly Energy Update* (6/29/2023): *This week's report is delayed until tomorrow due to Independence Day.*
- *Asset Allocation Quarterly – Q2 2023* (4/25/2023): Discussion of our 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)

Good morning! Today's *Comment* begins with a discussion about friction between policymakers in the U.S. and Europe over the pace and direction of interest rate changes. We will then discuss why households are not as confident in the economy as the data suggests. Finally, we will explain why China may be able to make a comeback later in the year.

Less United: Central bankers in Europe and the United States are still undecided about when to end the ongoing hiking cycle.

- The Federal Open Market Committee was divided on whether to pause rates in June, according to the latest meeting minutes. Despite the lack of any dissents to last month's pause, some policymakers argued for an increase of 25 basis points in the central bank's benchmark policy rate. Members who favored a rate hike pointed to recent data showing that the labor market remains tight and inflation remains elevated. Despite the disagreement, Fed officials have left the door open for future hikes, with the market pricing in another quarter-point hike toward the end of the month.

- Despite the economic contraction in the Euro area, members of the European Central Bank are still divided as to whether to increase rates again this year. Earlier this week, Joachim Nagel, a member of the ECB's Governing Council, advocated for additional rate hikes due to elevated inflation. In contrast, Italian governor Ignazio Visco has cautioned against additional increases in the policy rate as the region continues to assess the damage from previous tightening. The tensions between members of the ECB Governing Council reflect growing anxiety about the state of the Eurozone economies. Most countries in the bloc are showing signs of slowing, which raises the political and economic costs of higher interest rates.

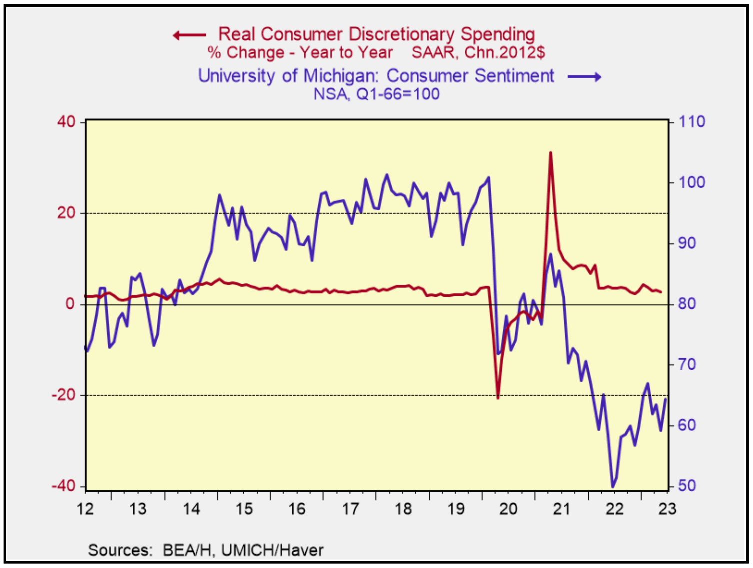


- It will be difficult for central banks to justify their hawkish stance as price pressures continue to ease. Producer prices in the U.S. fell well below 2% in June, a sign that producers are feeling less need to pass on costs to consumers. Similarly, Spain has also seen inflation fall well below 2%, making it the first major Eurozone country to do so. This progress suggests that central bankers are getting closer to achieving price stability. However, it is still unlikely that either the ECB or the Fed will cut rates this year as both central banks fear the return of inflation.

Not Sure: Although the government data shows that the economy remains resilient, households are still worried about a potential downturn.

- Middle-class people are becoming more concerned about an imminent recession. Americans making between $45,000 and $180,000 annually and wealth between $100,000 and $1 million reported higher levels of anxiety regarding the economy, according to polls conducted by Bloomberg. The findings showed that only 39% of survey respondents expect their economic situation to improve within the next year. This report comes amidst a series of positive economic surprises showing that the country is stronger than most analysts believed at the start of the year. The rising anxiety among middle-class Americans is a reminder that the economy is not always as it seems.

- Although consumer spending has reverted to pre-pandemic levels, households are still expressing concerns about their present situation. This reality reflects the growing angst that households are feeling in an economy with rising interest rates and elevated inflation. That said, it does appear the data may be catching up to household perceptions of the state of the business cycle. Average weekly hours have fallen in three out of the last four months, meanwhile initial claims data has been trending higher over that same period. These trends generally serve as a precursor to a weakening labor market. As a result, we still believe that it is too early to say whether or not the economy has averted a downturn as some analysts believe.

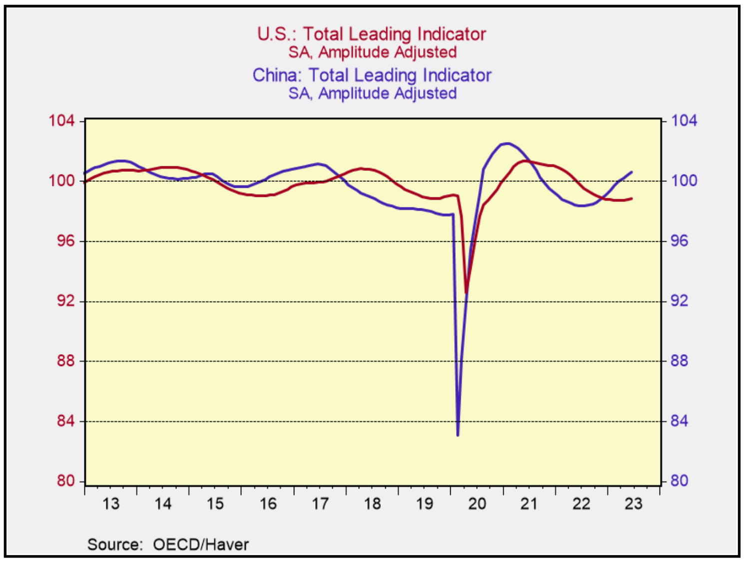


- The Fed's reliance on government data could be its Achilles heel, as it may be limiting its perspective. Initiation rates, which measure the percentage of respondents who agree to participate in a survey, have fallen well below pre-pandemic levels. For example, Fed officials have often cited strong payroll data as a reason to keep monetary policy tight. However, initiation rates for establishment surveys have dropped from 67.0% in February 2020 to 38.5% as of April 2023. This decline in initiation rates raises doubts about the accuracy of the Fed's data-driven decision-making as it shows that policymakers may not have a complete picture of the economy as it sets interest rate policy. Therefore, the likelihood of a Fed mistake is still somewhat elevated.
  - During the last Fed meeting, policymakers also raised doubts as to whether the payroll data accurately reflects the strength of the labor market.

New Day, New Way: Despite its weak start to the year, China still may be able to finish the year strong.

- Top leaders are expected to hold off from making major economic reforms at the July Politburo meeting. The meeting of the 24 most influential Communist Party leaders is likely to set the stage for economic policy in the second half of the year. Investors will be keen to see how the Chinese government plans to respond to the disappointing economic recovery following the end of pandemic restrictions. Additionally, onlookers will be paying close attention to a potential thaw in tensions with the U.S. as well as the outlook for the Chinese property market.

- Despite the recent misses, there is still optimism that China will be able to turn things around in the second half of the year. The People's Bank of China (PBoC) has reassured markets that it has ample tools to prevent a severe depreciation of the yuan (CNY) against the U.S. dollar (USD). At the same time, there is hope that U.S. Treasury Secretary Janet Yellen's visit to Beijing may improve diplomatic ties between the two largest economies in the world. This possible change in trajectory is also reflected in the data. According to the OECD leading economic indicator, the Chinese economy is currently gaining momentum and is outperforming the U.S.

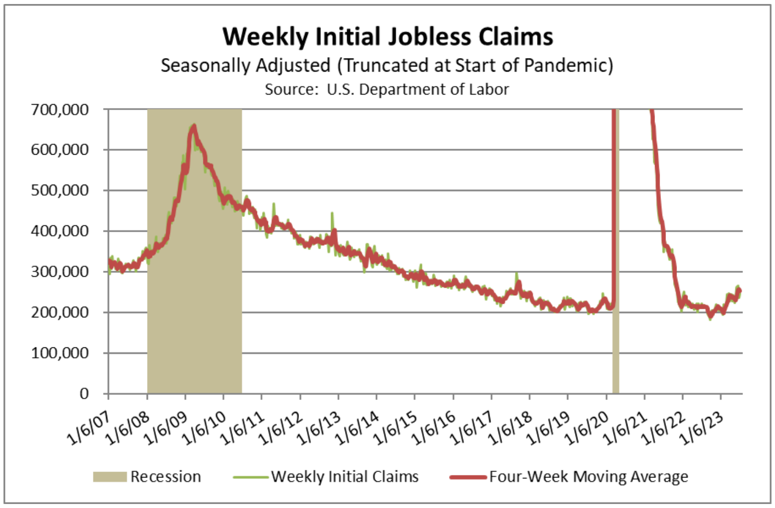


- The changing geopolitical landscape has made it more difficult to predict China's long-term trajectory. However, there is still a reasonable chance of a market recovery over the next 6-12 months. There are a few factors that suggest this could be the case. First, the government does not appear to be in a rush to sever ties with the West. In fact, it is trying to maintain relations with Europe. Additionally, China may be reluctant to completely isolate itself from the U.S. as it seeks to restore confidence in its economy. Second, it is still possible that the government will implement large-scale stimulus later in the year, as it has in previous major downturns. These factors suggest that China may be better positioned than it was at the start of the year.

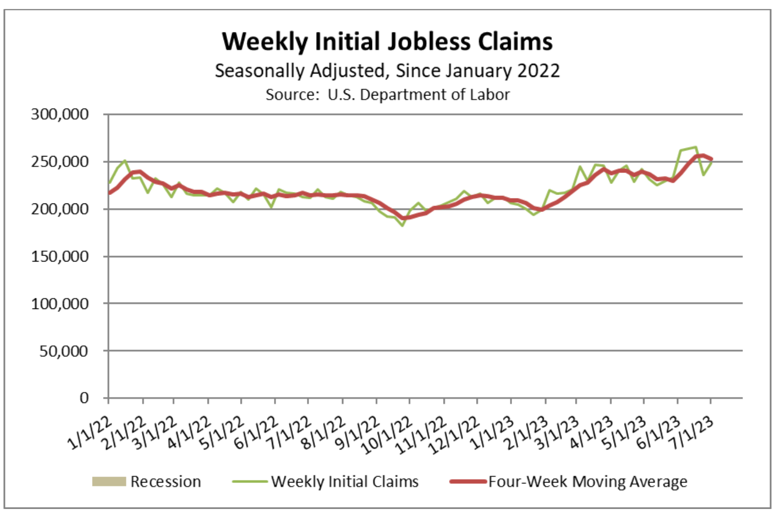
U.S. Economic Releases

The Mortgage Bankers Association said mortgage applications in the week ended July 1 fell by a seasonally adjusted 4.4%, erasing the prior week's 3.0% increase. Applications for home purchase mortgages fell 4.6%, erasing their gain of 2.8% in the previous week. Applications for refinancing mortgages declined 4.1%, wiping out their 3.3% rise in the preceding week. The average interest rate on a 30-year, fixed-rate mortgage rose to 6.85%.

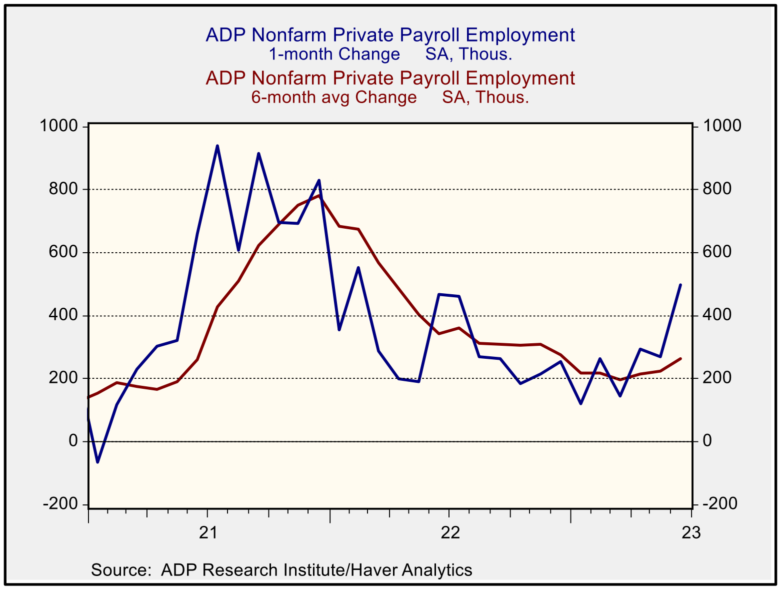
In other data for the week ended July 1, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 248,000, above expectations of 245,000 and significantly higher than the previous week's revised level of 236,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell slightly to 253,250, but remains near a five-year high when excluding the distortions of the pandemic era. On a more positive note, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) in the week ended June 24 fell back to 1.720 million, much better than both the anticipated reading of 1.737 million and the prior week's revised reading of 1.733 million. The chart below shows how initial jobless claims have fluctuated since just before the prior recession. The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



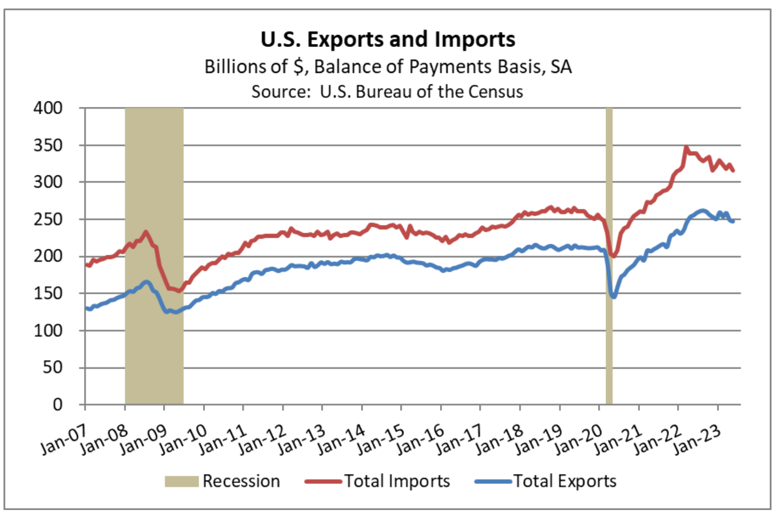
To provide more detail on recent trends, the chart below shows how initial jobless claims have changed just since the beginning of 2022.



Separately, the ADP Research Institute estimated that June ***private payroll employment*** jumped by a seasonally adjusted 497,000, blowing past expectations for a rise of just 225,000 and coming in much higher than the revised increase of 267,000 in May. ADP's estimate is widely seen as an indicator of what to expect when the Labor Department releases its measure of nonfarm payrolls on Friday. The chart below shows ADP's estimate of private payrolls since the beginning of 2021.



In a final report so far today, the May ***trade balance*** came in at a seasonally adjusted deficit of $69.0 billion, precisely matching expectations and narrowing from a revised April shortfall of $74.4 billion. According to the data, total exports fell 0.8% in May, but imports fell by an even greater 2.3%. Compared with the same month one year earlier, exports in May were down 3.2%, while imports were down 6.8%. The chart below shows the monthly value of U.S. exports and imports since just before the previous recession.



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 Services PMI	m/m	Jun F	54.1	54.1	**
9:45	S&P Composite PMI	m/m	Jun F		53.0	**
10:00	JOLTS Job Openings	m/m	May	9.968m	10.103m	**
10:00	ISM Nonmanufacturing PMI	m/m	Jun	51.2	50.3	***
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	Foreign Buying Japan Stocks	w/w	30-Jun	¥195.0b	-¥543.8b	-¥542.4b	*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	30-Jun	¥484.7b	-¥560.9b	-¥562.1b	*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	30-Jun	¥1252.7b	¥155.6b	¥162.3b	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	30-Jun	-¥158.9b	¥70.4b	¥69.8b	*	Equity and bond neutral
Australia	Exports	m/m	May	4.0%	-5.0%	-6.0%	*	Equity and bond neutral
	Imports	m/m	May	2.0%	2.0%		*	Equity and bond neutral
	Trade Balance	m/m	May	A$11.791b	A$11.158b	A$10.454b	***	Equity and bond neutral
India	S&P Global Composite PMI	m/m	Jun	59.4	61.6		**	Equity and bond neutral
	S&P Global Services PMI	m/m	Jun	58.5	61.2		**	Equity and bond neutral
EUROPE								
Eurozone	Retail Sales	y/y	May	-2.9%	-2.6%	-2.9%	*	Equity and bond neutral
Germany	Factory Orders WDA	y/y	May	-4.3%	-9.9%	-9.3%	***	Equity and bond neutral
	HCOB Construction PMI	m/m	Jun	41.4	43.9		***	Equity and bond neutral
UK	S&P Global/CIPS Construction PMI	m/m	Jun	48.9	51.6	51.0	**	Equity and bond neutral
AMERICAS								
Brazil	S&P Global Composite PMI	m/m	Jun	51.5	52.3		**	Equity and bond neutral
	S&P Global Services PMI	m/m	Jun	53.3	54.1		**	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)	553	553	0	Up
3-mo T-bill yield (bps)	519	521	-2	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	528	527	1	Up
U.S. Libor/OIS spread (bps)	529	529	0	Up
10-yr T-note (%)	3.97	3.93	0.04	Flat
Euribor/OIS spread (bps)	359	361	-2	Up
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
Yen	Up			Down
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.

DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$76.83	$76.65	0.23%	
WTI	$72.07	$71.79	0.39%	
Natural Gas	$2.67	$2.66	0.49%	
Crack Spread	$33.34	$33.66	-0.95%	
12-mo strip crack	$25.81	$26.02	-0.81%	
Ethanol rack	$2.59	$2.61	-1.00%	
Metals				
Gold	$1,926.79	$1,915.30	0.60%	
Silver	$23.21	$23.11	0.45%	
Copper contract	$375.90	$376.85	-0.25%	
Grains				
Corn contract	$498.00	$493.50	0.91%	
Wheat contract	$665.25	$674.25	-1.33%	
Soybeans contract	$1,358.75	$1,355.00	0.28%	
Shipping				
Baltic Dry Freight	994	1,044	-50	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.0		
Gasoline (mb)		0.0		
Distillates (mb)		0.1		
Refinery run rates (%)		0.5%		
Natural gas (bcf)		65		

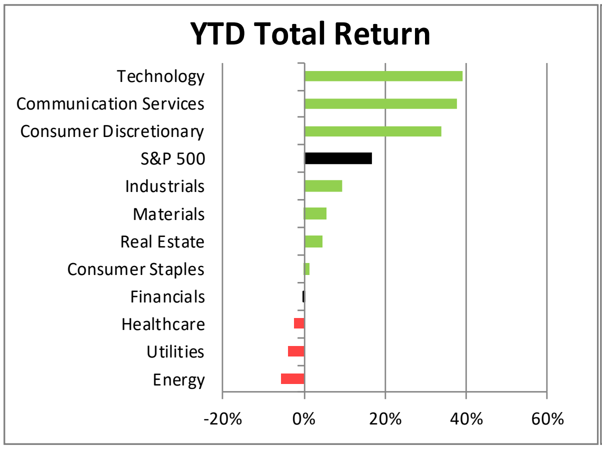
Weather

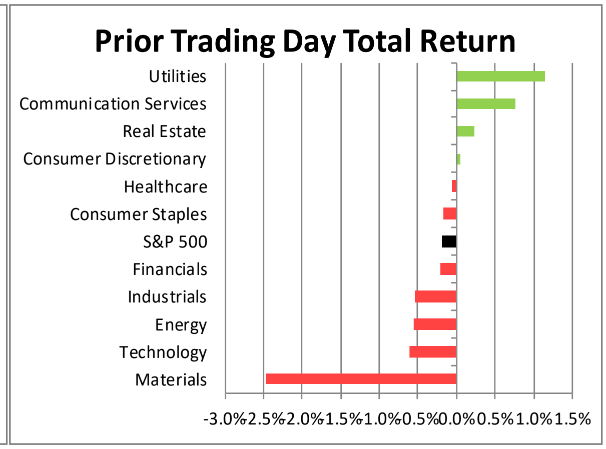
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in the Far West, Texas, the Deep South, and New England, with cooler-than-normal temperatures expected only in the Upper Midwest. The forecasts call for wetter-than-normal conditions in the Midwest and Northeast, with dry conditions in the Rocky Mountain region and Texas.

There are no tropical cyclone formations expected in the Atlantic Ocean area within the next 48 hours.

Data Section

U.S. Equity Markets – (as of 7/5/2023 close)

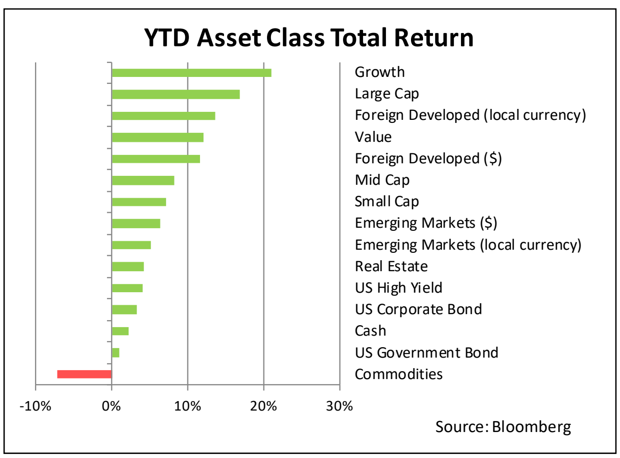




(Source: Bloomberg)

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 7/5/2023 close)

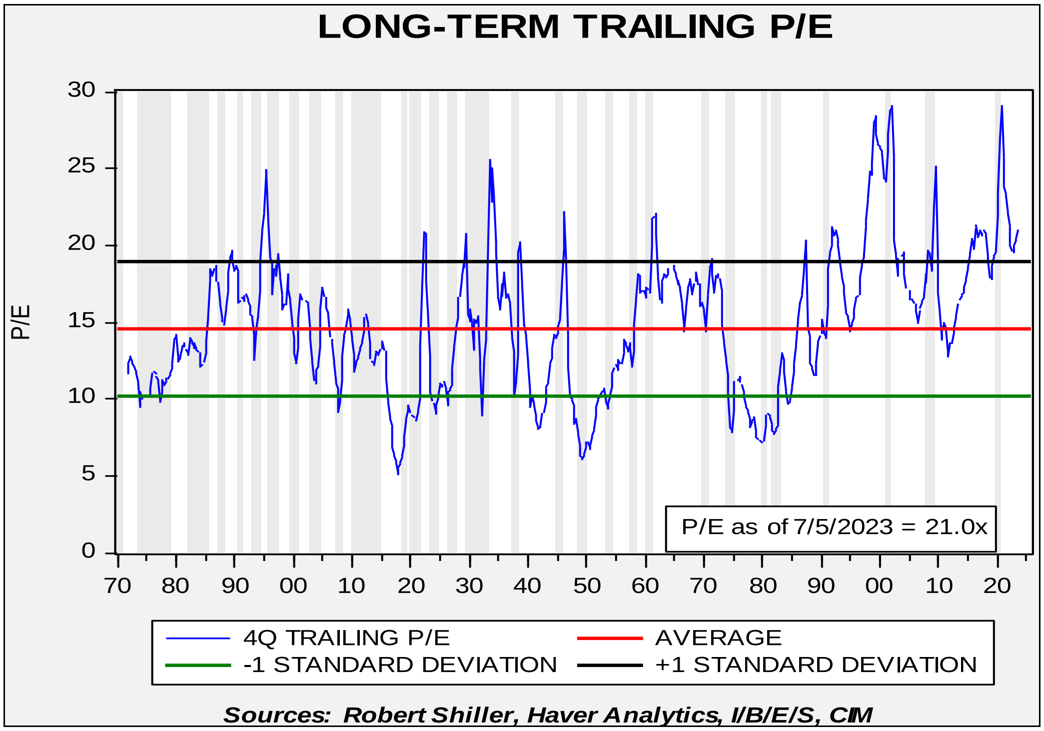


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

July 6, 2023



Based on our methodology,[1] the current P/E is 21.0x, up 0.7x from last week. Moving to Q3 has 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.