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 11, 2023—9:30 AM EDT] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is currently up 0.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.8%. Chinese markets were higher, with the Shanghai Composite closing up 0.6% from its previous close and the Shenzhen Composite up 0.8%. 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*** **(7/10/2023) (see podcast link below): "The 2023 Mid-Year Geopolitical Outlook: The Polycrisis"**
- *Weekly Energy Update* (7/6/2023): OPEC+ is promising supply cuts; so far, the market's reaction has been underwhelming. We also discuss the impact of supply concerns surrounding EV minerals.
- *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 (7/10/2023): "The 2023 Mid-Year Geopolitical Outlook"**

Our *Comment* today opens with news that Turkey has agreed to support Sweden's accession to NATO, creating an even more formidable military bulwark in response to Russia's invasion of Ukraine. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including today's voting on a controversial environmental law in Europe and new statements about interest rates by several policymakers at the Federal Reserve.

North Atlantic Treaty Organization: Just ahead of today's big NATO summit, the Turkish government yesterday unexpectedly released its veto on Sweden's accession to the alliance. According to NATO Secretary-General Stoltenberg, Turkish President Erdoğan agreed to forward Sweden's accession to the Turkish parliament "as soon as possible" after achieving several concessions from Sweden and NATO. Those concessions apparently included steps aimed at aiding Turkey's fight against Kurdish terrorists and the U.S. unlocking the sale of advanced F-16 fighter jets to Turkey. The Hungarian government has also recently said it would lift its veto of Sweden's accession.

- The Turkish move helps ensure that the NATO summit will project heightened unity and new strength in response to Russia's aggression against Ukraine.
- Over the longer term, this year's accession of both Sweden and Finland to NATO will give the alliance increased overall military strength, better insight into Russian activities in northwestern Europe, and the potential to strangle civilian and military shipping in the Baltic Sea in the event of war with Russia.

China-Taiwan: In a new sign that Taipei is getting more serious about defending against possible Chinese aggression, the government is holding its biggest civil defense drill in decades today. This year's version of the Wan'an air raid drill will take place in districts across the country and include practice evacuations of civilians to bomb shelters.

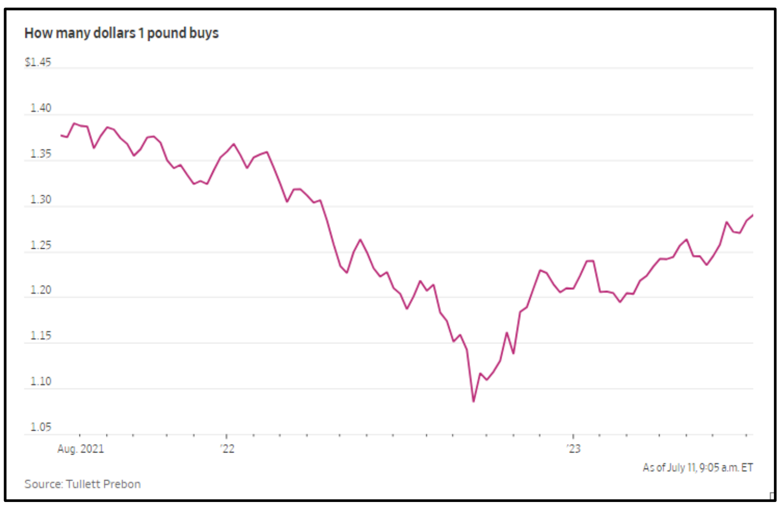
China: The China Passenger Car Association yesterday said domestic Chinese brands made up 54% of the country's wholesale shipments in the first half of 2023, up from 48% in the same period one year earlier. That marked the second consecutive half in which domestic automakers sold more vehicles than foreign makers did.

- As we have been discussing recently, the surge in domestic brands comes mostly from their sudden improvement in electric vehicles.
- That has sapped the profitability of foreign brands operating in China and serves as a harbinger of the competitive threat that Chinese electric vehicles are likely to pose as they begin to be sold in the rich, highly advanced countries of the world.

European Union: The European Parliament today and tomorrow will be voting on a divisive nature-restoration law that would require setting aside land to encourage the return of healthy ecosystems. The law, proposed by the European Commission under the leadership of Ursula von der Leyen, has been criticized for potentially undermining farmers' livelihoods, preventing wind farms from being built, and putting EU food security at risk.

- Ahead of EU parliamentary elections in June 2024, von der Leyen's own center-right European People's Party has come out against the legislation. EPP leaders appear to be concerned that the law would play into the hands of far-right politicians, who are already gaining influence through Europe.
- In an interview with the *Financial Times*, European Parliament President Metsola, who is also a member of the EPP, has warned that parliament members should refrain from crossing an "invisible line" between ambitious green policies and citizens' support for the changes imposed on their lives.

United Kingdom: Average weekly earnings in March through May were up 7.3% from the same period one year earlier, significantly more than anticipated and matching the record gain in the three months to April. The strong wage growth has prompted even stronger expectations that the Bank of England will keep hiking interest rates, which in turn has given a further boost to the pound (GBP). So far this morning, sterling is trading up 0.3% to a 15-month high of about $1.2895.



U.S. Monetary Policy: At events yesterday, San Francisco FRB President Daly and Cleveland FRB President Mester both signaled interest rates should go at least a bit higher, with Mester saying a "somewhat tighter" policy stance would help strike the right balance between tightening too much and tightening too little in the face of price inflation. The statements are consistent with the rising market expectation that the Fed will raise its benchmark short-term interest rate one or two more times, although perhaps with another pause interspersed.

- Separately, New York FRB President Williams reiterated in a *Financial Times* interview that he sees a need for a few more rate hikes. In his view, the labor market remains tight enough to drive up wages and inflation, even though he sees signs that labor demand is gradually cooling.

- Williams also noted that he doesn't currently have a recession in his forecast. Nevertheless, he admitted that he sees "pretty slow growth" in the coming quarters.

U.S. Bank Regulation: Michael Barr, the Fed's vice chair for regulation, said in a speech yesterday that larger U.S. banks should further strengthen their capital cushions after the crisis among mid-sized lenders this spring. According to Barr, a recent Fed review of big banks' capital requirements suggested they should be required to boost their capital/risk-weighted asset ratio by about 2%. The speech is being taken as a signal that Fed regulators will formally propose the change later this summer.

U.S. Labor Market: Amid a general shortage of workers, a number of companies have said in recent earnings reports that a shortage of accountants is hampering their efforts to address weaknesses in financial reporting and control. The lack of accountants reflects both a recent fall in the number of young people pursuing accounting degrees and a growing share of established accountants who are retiring.

Global Gold Market: A survey by Invesco (IVZ, $17.37) found that global central banks not only boosted their purchases of gold in 2022 and early 2023, but they also shifted toward buying the physical asset instead of derivatives and opted to hold their gold in their own country. As we've been arguing, the U.S.'s move to freeze Russia's foreign reserves over its invasion of Ukraine last year has prompted many central banks to purchase more of the yellow metal for their own financial security. Along with our expectations of higher average price inflation in the future, strong central bank buying is a key reason why we think gold will produce good returns in the medium-to-long term.

Global Green-Tech Minerals Market: The International Energy Agency has issued a report saying global investment in green-technology mineral resources is starting to catch up with the growing demand for those materials. According to the IEA, worldwide investment in green-tech mineral facilities rose 30% to more than $40 billion in 2022, building on a 20% increase in 2021.

- Still, the report also cited some negative trends. For example, the rise in investment in 2022 was driven by China, which already dominates the production and refining of key green-tech materials.
- The report also noted that the supply of some of these minerals, such as lithium and cobalt, remains too concentrated.

U.S. Economic Releases

There were no domestic releases prior to the publication of this report. There are no economic releases or Fed events scheduled for the rest of the day.

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	Machine tool orders	y/y	Jun	-21.7%	-22.1%		**	Equity and bond neutral
	Money Stock M2	y/y	Jun	2.6%	2.7%		**	Equity and bond neutral
	Money Stock M3	y/y	Jun P	2.1%	2.1%		**	Equity and bond neutral
Australia	Westpac Consumer Conf SA	m/m	Jul	2.7%	0.2%		**	Equity and bond neutral
	Westpac Consumer Conf Index	m/m	Jul	81.3	79.2		**	Equity and bond neutral
	NAB Business Confidence	m/m	Jun	0	-4	-3	**	Equity bullish, bond bearish
	NAB Business Conditions	m/m	Jun	9	8	9	**	Equity and bond neutral
China	New Yuan Loans	m/m	Jun	3050.0b	1360.0b	1362.8b	**	Equity and bond neutral
	Money Supply M2	y/y	Jun	11.3%	11.6%	11.2%	***	Equity and bond neutral
	Money Supply M1	y/y	Jun	3.1%	4.7%	4.5%	*	Equity bearish, bond bullish
	Money Supply M0	y/y	Jun	9.8%	9.6%		*	Equity and bond neutral
EUROPE								
Eurozone	ZEW Survey Expectations	m/m	Jul	-12.2	-10.0		*	Equity and bond neutral
Germany	CPI	y/y	Jun F	6.4%	6.4%	6.4%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Jun F	6.8%	6.8%	6.8%	**	Equity and bond neutral
	ZEW Survey Expectations	m/m	Jun F	-14.7	-8.5	-10.6	*	Equity bearish, bond bullish
	ZEW Survey Current Situation	m/m	Jul	-59.5	-56.5	-62.0	**	Equity bullish, bond bearish
Italy	Industrial Production WDA	y/y	May	-3.7%	-7.2%	-7.4%	***	Equity and bond neutral
UK	Claimant Count Rate	m/m	Jun	4.0%	3.9%		***	Equity and bond neutral
	Jobless Claims Change	m/m	Jun	25.7k	-13.6k	-22.5k	***	Equity bearish, bond bullish
	ILO Unemployment Rate 3Mths	m/m	May	4.0%	3.8%	3.8%	***	Equity and bond neutral
AMERICAS								
Canada	Building Permits	m/m	May	10.5%	-18.8%	-21.0%	**	Equity bullish, bond bearish
Brazil	IBGE Inflation IPCA	y/y	Jun	3.16%	3.94%	3.14%	***	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)	556	554	2	Up
3-mo T-bill yield (bps)	519	523	-4	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	530	530	0	Up
U.S. Libor/OIS spread (bps)	531	531	0	Up
10-yr T-note (%)	3.96	4.00	-0.04	Flat
Euribor/OIS spread (bps)	366	364	2	Up
Currencies	**Direction**			
Dollar	Down			Down
Euro	Down			Up
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	$78.16	$77.69	0.60%	
WTI	$73.48	$72.99	0.67%	
Natural Gas	$2.72	$2.67	1.84%	
Crack Spread	$35.05	$34.69	1.03%	
12-mo strip crack	$27.14	$26.99	0.54%	
Ethanol rack	$2.62	$2.61	0.38%	
Metals				
Gold	$1,935.82	$1,925.35	0.54%	
Silver	$23.15	$23.13	0.08%	
Copper contract	$379.20	$378.45	0.20%	
Grains				
Corn contract	$505.75	$499.50	1.25%	
Wheat contract	$659.50	$646.25	2.05%	
Soybeans contract	$1,364.75	$1,345.50	1.43%	
Shipping				
Baltic Dry Freight	1,024	1,009	15	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.0		
Gasoline (mb)		-1.0		
Distillates (mb)		-0.5		
Refinery run rates (%)		0.6%		
Natural gas (bcf)		50		

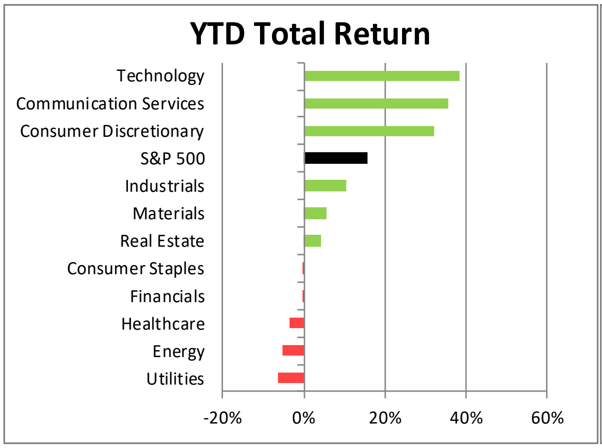
Weather

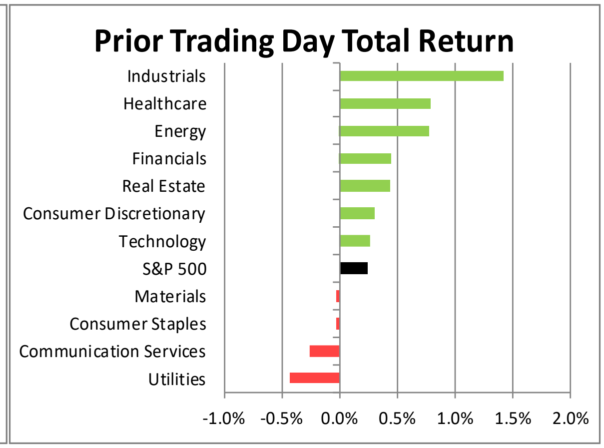
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout most of the country. The precipitation outlook calls for wetter-than-normal conditions in the Midwest and Northeast, with dry conditions in the Pacific region and Texas.

There is a disturbance forming in the Atlantic Ocean, but it is not expected to develop into a tropical cyclone within the next 48 hours.

Data Section

U.S. Equity Markets – (as of 7/10/2023 close)

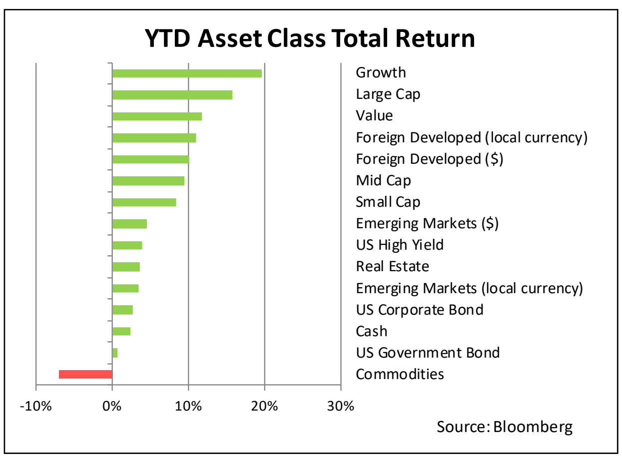




(Source: Bloomberg)

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 7/10/2023 close)

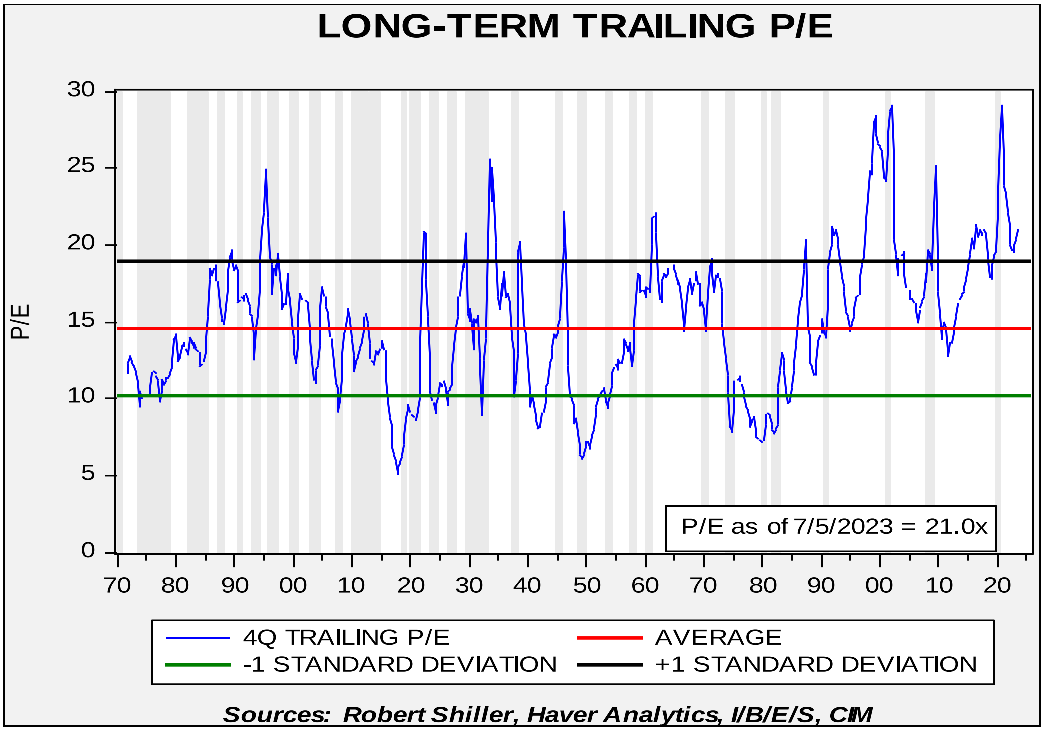


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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 (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.