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 12, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is currently up 1.0% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.0%. Chinese markets were lower, with the Shanghai Composite closing down 0.8% from its previous close and the Shenzhen Composite down 1.1%. 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"

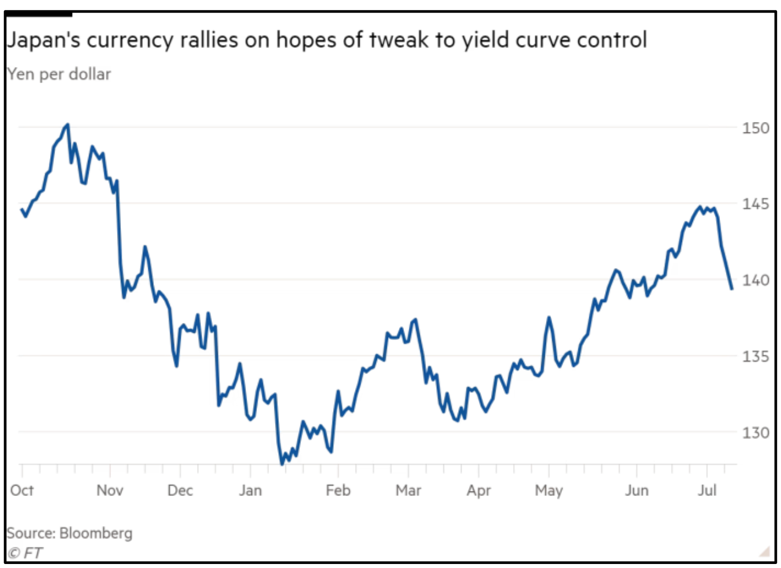
Our *Comment* today opens with notes on global asset allocation strategy among hedge funds and new developments in the global race for electric-vehicle minerals. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including a jump in the value of the yen and the opening of important negotiations for a new labor contract for U.S. automakers.

Global Asset Allocation Strategy: Brokerage data from Goldman Sachs (GS, $320.88) shows hedge funds currently have their lowest exposure to the U.S. stock market since records began in 2013, while their allocation to European stocks is at a record high. The low asset allocation to the U.S. is driven largely by concerns that many of the country's key technology stocks are overvalued. We share that concern, although we also think the broader U.S. economy is likely to perform better than the European economy in the coming quarters.

Global Mining Industry: Automobile manufacturers Volkswagen (VWAGY, $16.90) and Stellantis (STLA, $18.00) have announced plans to contribute $100 million each to form a new, publicly-traded mining company producing nickel and copper in Brazil. The plan is to join the firm with a special-purpose acquisition company run by a well-known mining executive who hopes to do more deals to build a large battery-metals company. The deal illustrates the frenzy to find and develop electric vehicle materials and shows how the trend is pushing auto firms to vertically integrate to lock up their own supplies.

Japan: As investors begin to focus on the Bank of Japan's next policy meeting on July 28, they are increasingly pricing in a chance that the officials could adjust or abandon their yield-curve control policy and allow bond yields to rise. In response, the yen so far today has strengthened about 1.0% to 138.99 JPY per dollar, meaning it has now essentially reversed all of its depreciation since early June.

- The market reversal appears to stem largely from a statement by BOJ Deputy Governor Shinichi Ushida last week.
- According to Ushida, the BOJ is now seeking "a balanced decision [on yield-curve control] with an eye on monetary interventions and market functions."
- An adjustment to the yield-curve control policy is also more likely now that BOJ Governor Ueda has been in his position for three months. Ueda indicated at his appointment that he would more slowly and cautiously on any change in policy, but the longer he is in his position, the freer he would likely feel to move forward.



North Korea-Japan: North Korea today fired an intercontinental ballistic missile that flew approximately 600 miles before splashing down in the waters between the Korean peninsula and Japan. Besides being the latest example of North Korea's belligerence, the launch is a reminder of the kinds of destabilizing events that could periodically transpire between Russia and Ukraine if their war eventually cools into a Korean-style "frozen conflict," as we think is likely.

China-Mexico: Mexican President Andrés Manuel López Obrador said his government is considering whether to impose tariffs against Chinese shoe imports to slow their proliferation in the country and protect local manufacturers. The move underscores an important dynamic between China and the other so-called emerging markets—once China's ultra-low-cost producers gained access to the global market in the early 2000s, they tripped up many other developing countries' industrialization efforts and forced them to focus on more volatile, less profitable commodity production.

China-United States: Researchers at Microsoft (MSFT, $332.47) said Chinese hackers have broken into email accounts at more than two dozen organizations, including some U.S. government agencies, in what appears to be a major new espionage effort. Officials said the hackers didn't gain access to classified information, but they continue to investigate whether sensitive information was stolen.

U.S. Antitrust Regulation: A federal judge yesterday said Microsoft (MSFT, $332.47) can move ahead with its acquisition of videogame maker Activision Blizzard (ATVI, $90.99), ruling against the Federal Trade Commission's contention that the merger would hurt competition. The FTC may continue a separate administrative effort to block the acquisition, and regulators in the U.K. are looking at the deal as well. Nevertheless, the judge's decision shows how the Biden administration's effort to tighten big-tech antitrust regulation has had only spotty success so far.

U.S. Labor Market: Officials from Ford (F, $15.23), General Motors (GM, $39.97), and Stellantis are meeting with the United Auto Workers union this week to work on a new labor contract to replace the one that expires September 14. By all accounts, the new leadership at the UAW is intent on winning back the cost-of-living adjustments its workers lost following the Great Financial Crisis and protecting jobs as the automakers shift toward producing less-labor-intensive electric vehicles.

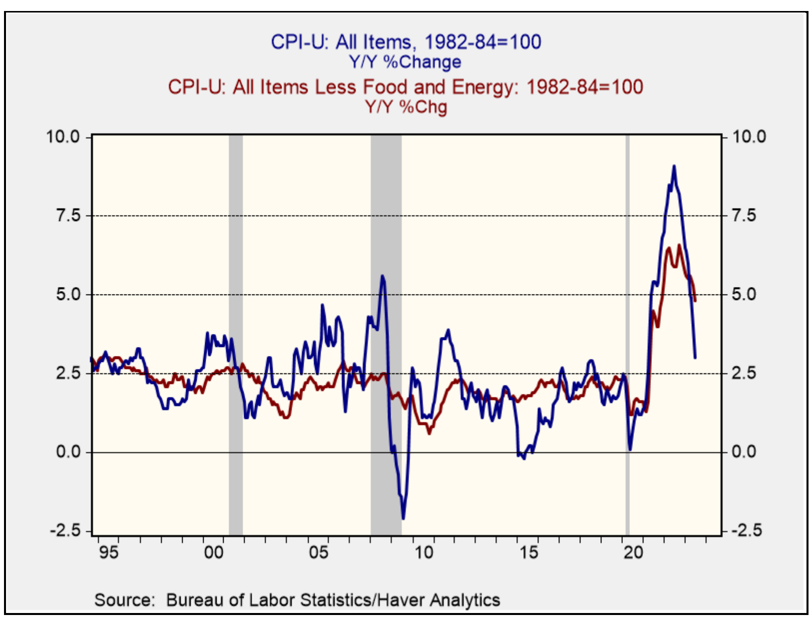
- Ahead of the elections in 2024, the pro-union Biden administration is also likely to put outside political pressure on the negotiators to strike a deal favorable to workers, despite concerns that high wage growth is boosting consumer price inflation.
- In any case, there is a considerable chance that the negotiators will fail to strike a deal and the UAW's 400,000 could go out on strike, as they did at the last contract expiration in 2019.

U.S. Economic Releases

Mortgage loan demand rose slightly despite interest rates rising to their highest level in eight months. According to an index tracked by the Mortgage Bankers Association, mortgage applications rose 0.9% in the week ending July 7. The subtle increase in mortgage requests was driven by an increase in the number of potential homebuyers. The MBA tracker for purchases rose 1.8% from the week, meanwhile, the refinance tracker fell 1.3% in the same period.

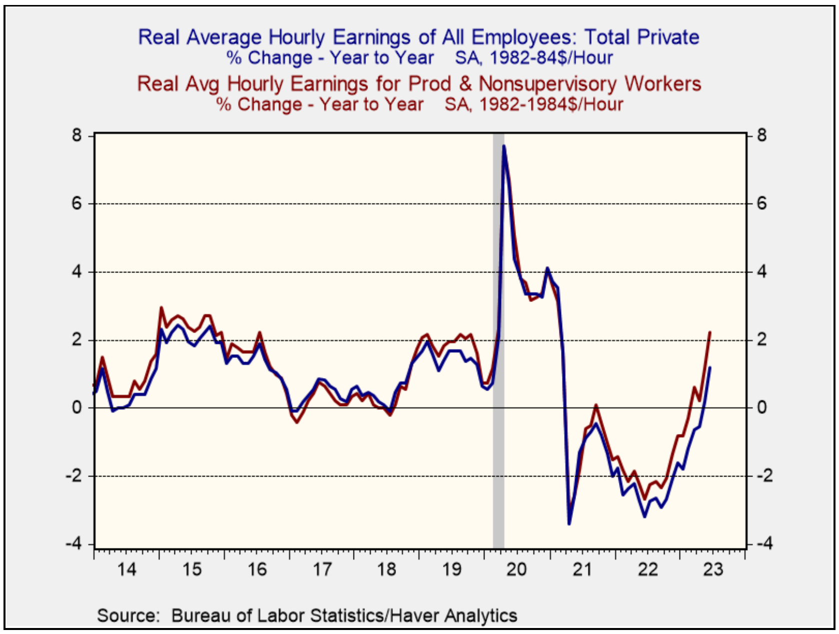
Tight housing supply and rising interest rates are creating a challenging market for both buyers and sellers. Last week, the average 30-year fixed-rate mortgage rate jumped 22 bps from 6.85% to 7.07%. Higher borrowing costs are discouraging homeowners from selling their homes. Potential sellers do not want to give up their low interest rate loans unless they get paid a premium to sell their current homes. This is leading to an overall increase in home prices.

Inflation decelerated faster than expected in June, adding to speculation that the Fed may not raise rates at the end of the month. According to the Bureau of Labor Statistics, the consumer price index rose 3.0% from the prior year. The increase was below expectation of 3.1% and the previous month's rise of 4.0%. Core inflation also beat expectations. Excluding energy and food, the index rose 4.8% from the prior year. The reading was below consensus estimates of a rise of 5.0% and previous month's reading of 5.3%.



The deceleration in consumer prices has been driven by energy and transportation services, which have slowed dramatically from their 2022 pace. This is likely due to a combination of factors, including the easing of supply chain disruptions and the decline in oil prices. Although the Federal Reserve is likely to raise interest rates at the end of the month, the positive report on inflation reduces the likelihood of another increase later this year.

The slowdown in inflation has boosted the purchasing power of workers. Real hourly earnings rose 1.2% from the prior year, compared to an increase of 0.2% in the previous month. Meanwhile, inflation adjusted weekly earnings rose 0.6% since June 2022, much higher than the previous month's decline of 0.7%.



The chart above shows the annual change in real average hourly earnings for production and nonsupervisory workers. Wages for this group have risen 2.2% since June 2022. The increase suggests that low skill workers are benefiting the most from a slowdown in inflation.

The table below lists the economic releases and/or Fed events scheduled for the rest of the day.

Economic Releases		
	No economic releases for the rest of today	
Federal Reserve		
EST	**Speaker or Event**	**District or Position**
9:45	Neel Kashkari Discusses Monetary Policy, Banking Solvency	President of the Federal Reserve Bank of Minneapolis
13:00	Raphael Bostic Speaks at Atlanta Fed Payments Forum	President of the Federal Reserve Bank of Atlanta
14:00	U.S. Federal Reserve Releases Beige Book	Federal Reserve Board
14:00	Senate Banking Committee Holds Executive Meeting on Fed Nominations	United States Senate
16:00	Loretta Mester Speaks on FedNow	President of the Federal Reserve Bank of Cleveland

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	PPI	y/y	Jun	4.1%	5.1%	4.4%	**	Equity and bond neutral
	Core Machine Orders	y/y	May	-8.7%	-5.9%	0.1%	**	Equity and bond neutral
South Korea	Unemployment Rate	m/m	Jun	2.6%	2.5%	2.6%	**	Equity and bond neutral
India	Industrial Production	y/y	May	5.2%	4.2%	5.0%	***	Equity and bond neutral
	CPI	y/y	Jun	4.8%	4.3%	4.6%	**	Equity and bond neutral
EUROPE								
Russia	Current Account Balance	m/m	2Q P	5400m	14786m	10500m	*	Equity and bond neutral
AMERICAS								
Mexico	Industrial Production	y/y	May	3.9%	0.7%	1.6%	***	Equity bullish, bond bearish
	Manufacturing Production	y/y	May	1.9%	1.4%		*	Equity and bond neutral
Mexico	International Reserves Weekly	w/w	7-Jul	$203071m	$203209m		*	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	556	0	Up
3-mo T-bill yield (bps)	523	524	-1	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	531	530	1	Up
U.S. Libor/OIS spread (bps)	532	532	0	Up
10-yr T-note (%)	3.95	3.97	-0.02	Flat
Euribor/OIS spread (bps)	367	366	1	Up
Currencies	**Direction**			
Dollar	Down			Flat
Euro	Flat			Up
Yen	Up			Down
Pound	Down			Up
Franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
RBNZ Official Cash Rate	5.500%	5.500%	5.500%	On Forecast

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	$79.60	$79.40	0.25%	
WTI	$75.13	$74.83	0.40%	
Natural Gas	$2.69	$2.73	-1.50%	
Crack Spread	$34.95	$34.61	0.99%	
12-mo strip crack	$27.15	$27.05	0.35%	
Ethanol rack	$2.63	$2.62	0.06%	
Metals				
Gold	$1,934.17	$1,932.23	0.10%	
Silver	$23.17	$23.12	0.21%	
Copper contract	$379.70	$376.60	0.82%	
Grains				
Corn contract	$503.00	$501.50	0.30%	
Wheat contract	$655.00	$660.50	-0.83%	
Soybeans contract	$1,372.50	$1,360.25	0.90%	
Shipping				
Baltic Dry Freight	1,032	1,024	8	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-0.1		
Gasoline (mb)		-1.4		
Distillates (mb)		-0.8		
Refinery run rates (%)		0.3%		
Natural gas (bcf)		50		

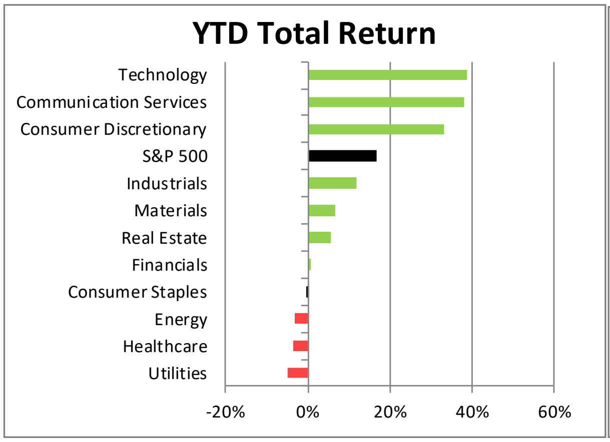
Weather

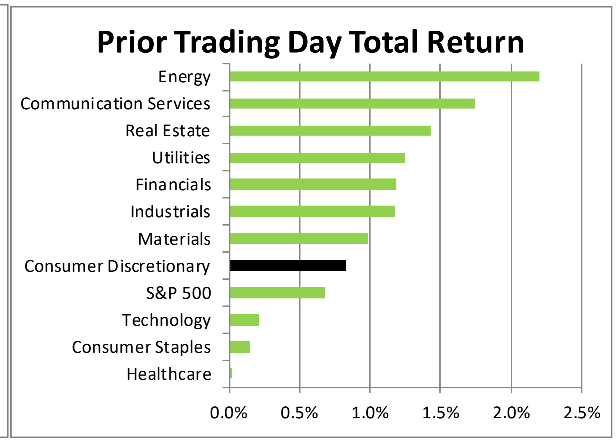
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout most of the country. The precipitation outlook calls for wetter-than-normal conditions in the Midwest and Northeast, with dry conditions in the Pacific region and Texas.

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 7/11/2023 close)

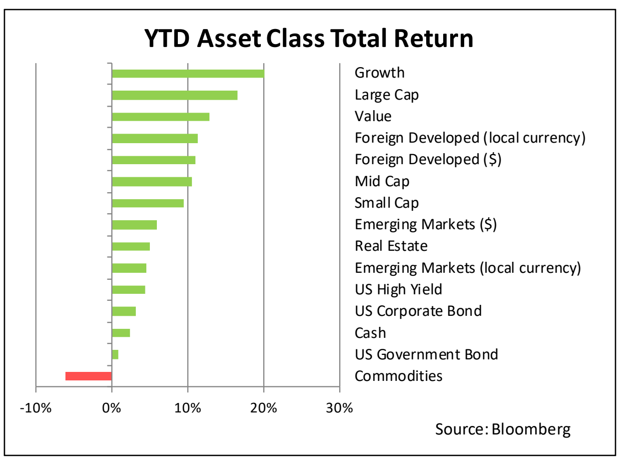




(Source: Bloomberg)

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 7/11/2023 close)

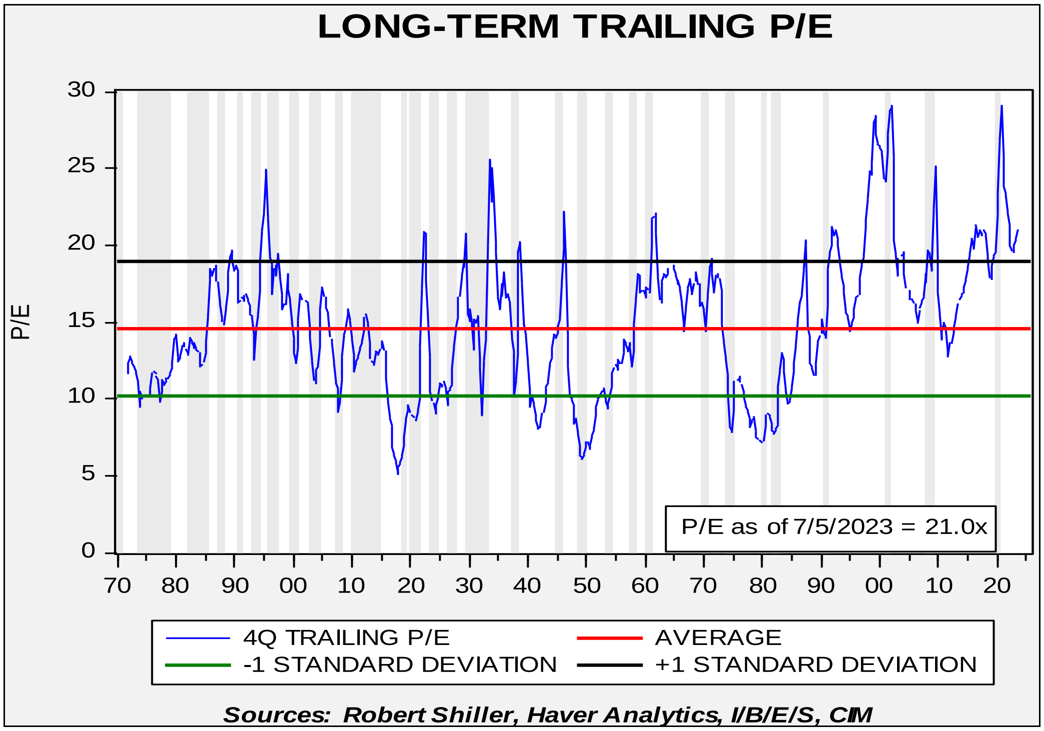


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.