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 13, 2023—9:30 AM EDT] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is currently up 0.9% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 2.2%. Chinese markets were higher, with the Shanghai Composite closing up 1.3% from its previous close and the Shenzhen Composite up 1.4%. 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:

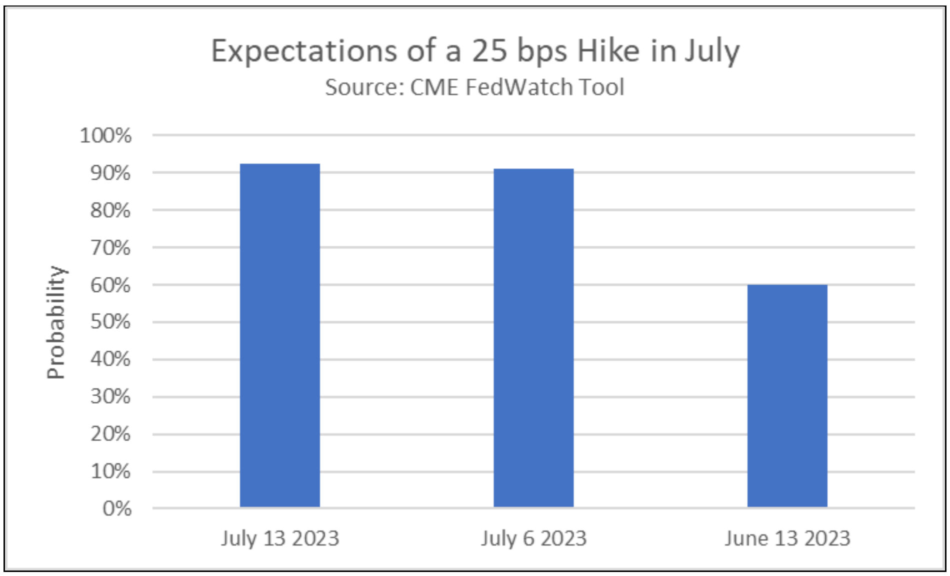
- *Bi-Weekly Geopolitical Report* (7/10/2023) (see podcast link below): "The 2023 Mid-Year Geopolitical Outlook: The Polycrisis"
- ***Weekly Energy Update*** **(7/13/2023): Hot weather continues to dominate in much of the southern U.S. The race for EV battery materials continues**.
- *Asset Allocation 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"

Today's *Comment* begins with our thoughts about the better-than-expected inflation report. Next, we explain how tight policy abroad may impact domestic economies. Lastly, the report discusses how tensions within NATO may not necessarily doom the military alliance.

Inflation Cools: Investors are hopeful that the positive CPI report will convince the Fed to hold off on further rate hikes.

- The year-over-year change in the consumer price index fell to its lowest level since March 2021. According to the Bureau of Labor Statistics, the price paid for consumer goods rose 3.1% from a year ago. Meanwhile Core CPI, which excludes energy and food, rose 4.8% in the same period. The deceleration in prices has led to speculation that the Fed may be nearing the end of its hiking cycle. As a result, the dollar weakened against the EUR, JPY, and GBP. Nonetheless, Fed officials still seem wary of abandoning their inflation fight.

- Despite the positive reading, some policymakers still want the Federal Reserve to push forward with rate hikes. On Wednesday, Richmond Fed President Thomas Barkin insisted that inflation remains too high. Meanwhile, his Minneapolis counterpart, Neel Kashkari, argued that the central bank needs to succeed in bringing inflation back to target before it can declare victory. The hawkish remarks from Fed officials may explain why Fed futures contracts were virtually unaffected by the surprise in the inflation report. The CME FedWatch Tool shows that 30-day Fed futures contracts are pricing in a rate hike at the end of month.

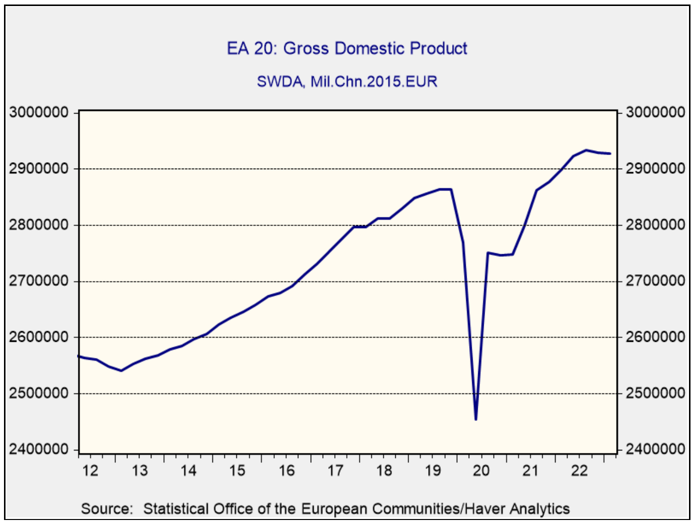


- The path toward 2% inflation is likely to be a slow and bumpy ride. The Cleveland Fed expects headline inflation to reaccelerate in July by rising from a year-over-year change of 3.0% to 3.3%. While monthly inflation has been volatile, ranging from 0.1% to 0.5% in the first six months of the year, annualized inflation has risen at a more consistent pace of 3.5%. That said, an average monthly change of 0.16% is consistent with the Fed's target of 2%. The central bank's ability to achieve its target will likely be related to its ability to bring down shelter price inflation which represents nearly a third of the index and remains well above its historical average.

Everybody Else: Speculation that the Fed may be close to ending its inflation fight has led to a focus on other central banks.

- Investors expect central banks in advanced economies to take a more hawkish stance in the coming months. The Bank of Canada raised interest rates to their highest level in 22 years on Wednesday, and the European Central Bank and the Bank of England are both considering additional rate hikes. There is also speculation that the Bank of Japan will end its yield-curve-control program later this year. The expectation of a possible narrowing interest differential between the United States and other advanced economies led to a broad decline in the U.S. dollar, with the U.S. Dollar Index falling to its lowest level since April 2022 following the release of the June CPI report.

- The effects of persistent central bank tightening are starting to impact the real economy. The U.K., for example, is on the cusp of a mortgage crisis due to rising borrowing costs. Typically, British homeowners borrow at fixed two- or five-year rates and then remortgage at a fixed or variable rate afterward. Hence, the brunt of the tighter monetary policy will likely be felt by more households over the coming months. Additionally, higher interest rates in the eurozone will hinder countries from preventing an economic slowdown within the bloc. The region fell into a technical recession in Q1 of this year.

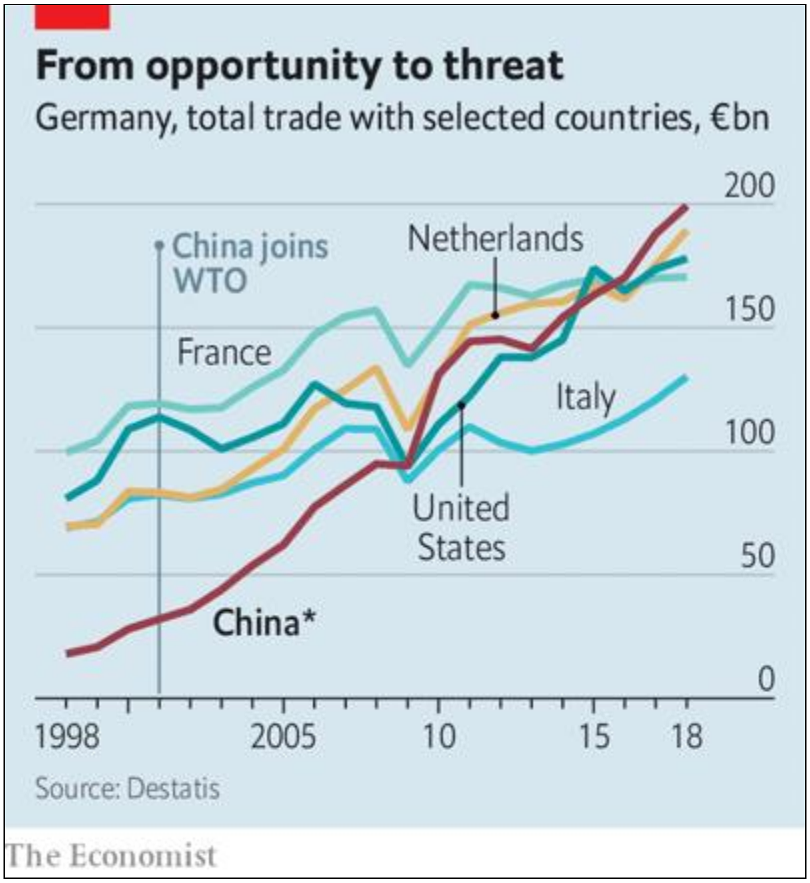


- That said, we currently do not see any signs of an imminent financial meltdown. The quick response by policymakers during the U.K. pension crisis in 2022, as well as the regional bank turmoil in the U.S. earlier this year has shown that central banks are better prepared than they were in the previous decade. Consequently, this may mean that central bankers are more willing to keep policy tighter for longer. If we are correct, this should lead to an increase in bond yields, especially if there is a notable increase in inflation volatility.

Intergroup Tensions: Ukraine's recent success has not been enough to get NATO members on the same page as to the best way to tackle threats from China and Russia.

- Although there was some progress at the summit in Vilnius, NATO leaders failed to articulate a clear vision for foreign policy going forward. The meeting led to Turkey's acquiescence to allow Sweden to proceed with its application to join NATO, and to an agreement to repair its relations with Greece. This is likely related to backroom dealings between Turkey and other NATO members and reflects Turkey's growing importance within the alliance. Yet, the group failed to elaborate on Ukraine's path to joining NATO. The communiqué stated that Ukraine belongs in NATO but implied that the country needs to meet certain conditions before it can be admitted.

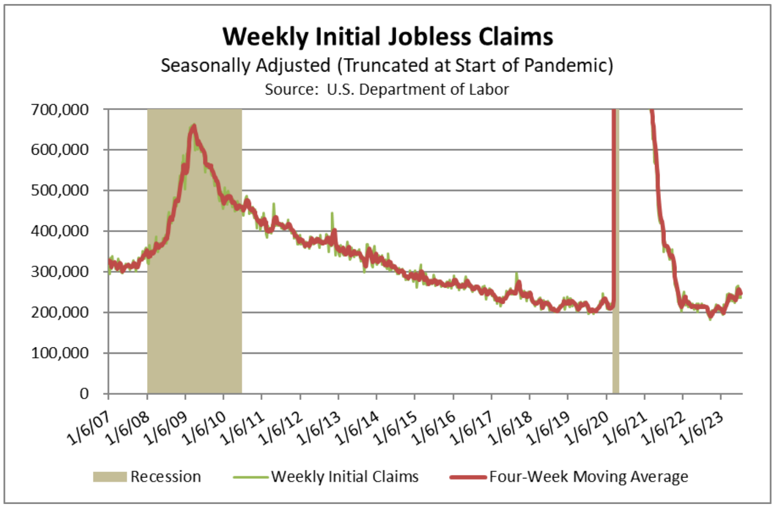
- Strains within the NATO alliance were also made apparent outside of the summit, especially regarding China. U.K. security officials scolded their American counterparts [for not adequately addressing Chinese spying]. It was revealed earlier this week that Chinese hackers [gained access to emails of government officials]. Meanwhile, other countries within the military group remain uncertain in how to address Beijing. On Thursday, Germany released a [statement acknowledging its concerns about China's growing assertiveness] in the Indo-Pacific. However, the statement did not provide any details about how Germany plans to "de-risk" from its dependence on the world's second-largest economy. Last year, Germany's total trade with China was nearly $300 billion.



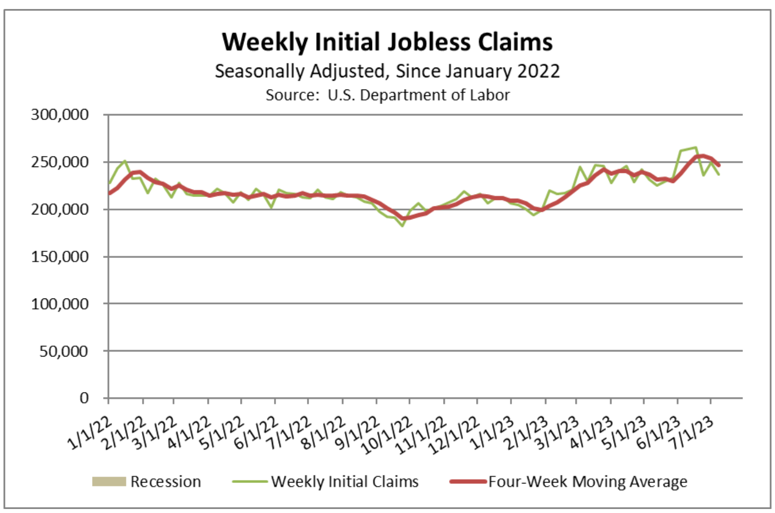
- Strains within NATO may become worse as economies begin to slowdown, but it is unlikely that the group will fracture. The bright spot of the war in Ukraine is that it reminded members of the importance in maintaining the military bloc. As a result, we expect that there will be increased coordination and cooperation between NATO members, which could come in the form of boosted weapon sales and investment, as well as the broadening of trade relations. This should be favorable for defense and aerospace firms. So far this year, XAR ETF, which tracks aerospace and defense stocks, has outpaced the S&P 500, excluding tech, 11.48% to 8.24%, respectively.

U.S. Economic Releases

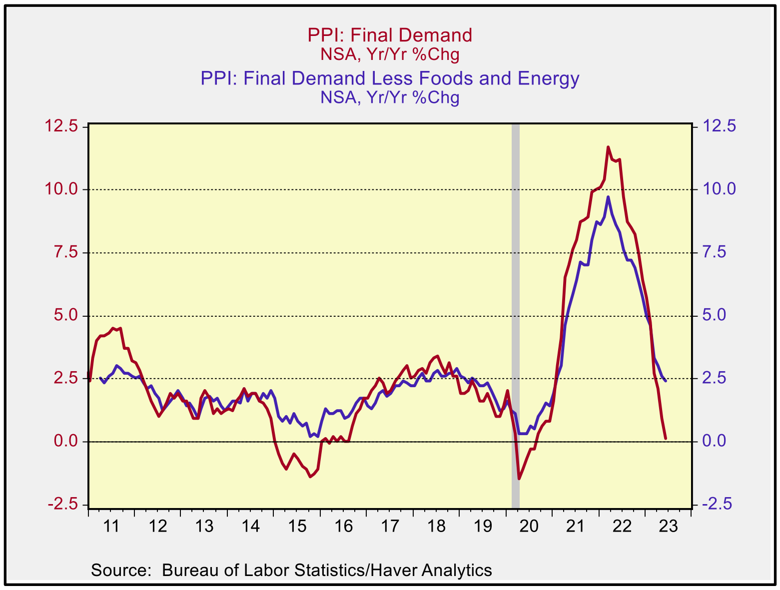
In the week ending July 8, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 237,000, much lower than both the expected level of 250,000 and the previous week's revised level of 249,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to a five-week low of 246,750. In contrast, in the week ending July 1, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to 1.729 million, above the anticipated reading of 1.720 million and the previous week's revised reading of 1.718 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 June ***producer price index (PPI)*** rose by a seasonally adjusted 0.1%, weaker than the expected increase of 0.2% but still enough to offset part of the revised May decline of 0.4%. Excluding the volatile food and energy components, the June ***"core" PPI*** also rose just 0.1%., below its anticipated rise of 0.2% but equal to its revised increase in May. The overall PPI in June was up just 0.1% from the same month one year earlier, while the core PPI was up 2.4%. These weak figures for price inflation at the wholesale level should further bolster hopes that overall inflation pressures are coming down rapidly. The chart below shows the year-over-year change in the PPI and the core PPI over the last decade or so.



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
14:00	Monthly Budget Statement	m/m	Jun	-$182.0b	-$240.3b	**
Federal Reserve						
EST	Speaker or Event	District or Position				
11:10	Mary Daly Interviewed on CNBC	President of the Federal Reserve Bank of San Francisco				
18:45	Chris Waller Speaks on Economic Outlook	Member of the Board of Governors				

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 Bonds	w/w	7-Jul	¥705.0b	¥484.7b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	7-Jul	-¥950.5b	¥1252.7b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	7-Jul	-¥951.0b	-¥158.9b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	7-Jul	¥181.7b	¥195.0b		*	Equity and bond neutral
New Zealand	BusinessNZ Manufacturing PMI	m/m	Jun	47.5	48.9	48.7	***	Equity bearish, bond bullish
New Zealand	REINZ House Sales	y/y	Jun	14.6%	-0.4%		**	Equity bullish, bond bearish
	Food Prices	m/m	Jun	1.6%	0.3%		***	Equity bearish, bond bullish
South Korea	Export Price Index	y/y	Jun	-14.7%	-11.2%	-11.3%	*	Equity bearish, bond bullish
	Import Price Index	y/y	Jun	-15.7%	-12.0%	-12.3%	*	Equity bearish, bond bullish
China	Trade Balance	m/m	Jun	$70.62b	$65.81b	$65.79b	***	Equity and bond neutral
	Exports	y/y	Jun	-12.4%	-7.5%	-10.0%	**	Equity and bond neutral
	Imports	y/y	Jun	-6.8%	-4.5%	-4.1%	**	Equity and bond neutral
India	Trade Balance	m/m	Jun	$70.62b	$65.81b	$65.79b	*	Equity and bond neutral
EUROPE								
Eurozone	Industrial Production WDA	y/y	May	-2.2%	0.2%	-1.2%	**	Equity bearish, bond bullish
France	CPI	y/y	Jun F	4.5%	4.5%	4.5%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Jun F	5.3%	5.3%	5.3%	**	Equity and bond neutral
UK	Industrial Production	y/y	May	-2.3%	-1.9%	-1.6%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	May	-1.2%	-0.9%	-0.1%	**	Equity bearish, bond bullish
	Visible Trade Balance	m/m	May	-£18.723b	-£14.996b	-£14.639b	**	Equity and bond neutral
	Trade Balance	m/m	May	-£16.578b	-£1.518b	-£2.463b	**	Equity and bond neutral
Russia	CPI	y/y	Jun	3.25%	2.51%	3.30%	***	Equity and bond neutral
	Core CPI	y/y	Jun	2.44%	2.12%		**	Equity and bond neutral
AMERICAS								
Mexico	Manufacturing Production	y/y	May	1.9%	1.4%		*	Equity and bond neutral
	Industrial Production	y/y	May	3.9%	0.7%	1.6%	***	Equity bullish, bond bearish

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)	521	523	-2	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)	532	531	1	Up
10-yr T-note (%)	3.82	3.86	-0.04	Flat
Euribor/OIS spread (bps)	366	367	-1	Up
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Down			Down
Pound	Up			Up
Franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Korea 7-Day Repo Rate	3.500%	3.500%	3.500%	On Forecast
Bank of Canada Rate Decision	5.000%	4.750%	5.000%	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	$80.09	$80.11	-0.02%	
WTI	$75.59	$75.75	-0.21%	
Natural Gas	$2.66	$2.63	0.95%	
Crack Spread	$35.02	$35.52	-1.41%	
12-mo strip crack	$27.37	$27.70	-1.21%	
Ethanol rack	$2.61	$2.61	-0.21%	
Metals				
Gold	$1,954.97	$1,957.35	-0.12%	
Silver	$24.25	$24.12	0.54%	
Copper contract	$388.85	$385.30	0.92%	
Grains				
Corn contract	$487.00	$483.75	0.67%	
Wheat contract	$633.25	$632.75	0.08%	
Soybeans contract	$1,348.75	$1,327.75	1.58%	
Shipping				
Baltic Dry Freight	1,088	1,032	56	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	5.9	-0.1	6.0	
Gasoline (mb)	0.0	-1.4	1.3	
Distillates (mb)	4.8	-0.8	5.6	
Refinery run rates (%)	2.6%	0.3%	2.3%	
Natural gas (bcf)		50		

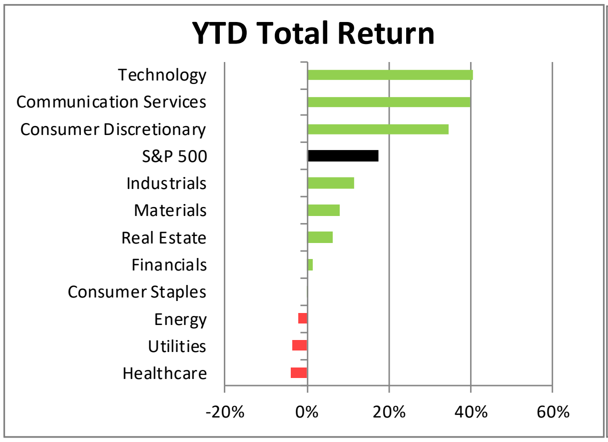
Weather

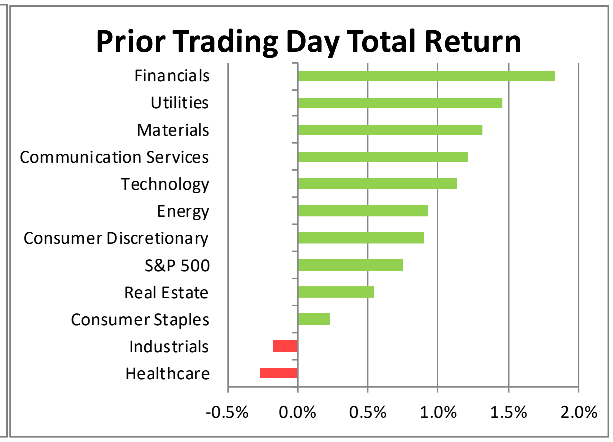
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout the northern two-thirds of the country, with near-normal temperatures elsewhere. The forecasts call for wetter-than-normal conditions in the Southwest and Northeast, with dry conditions in the Pacific Northwest and Texas.

There is currently a disturbance forming in the middle of the Atlantic Ocean to the east of Bermuda, but it is assessed to have only a 50% chance of developing into a tropical cyclone within the next 48 hours.

Data Section

U.S. Equity Markets – (as of 7/12/2023 close)

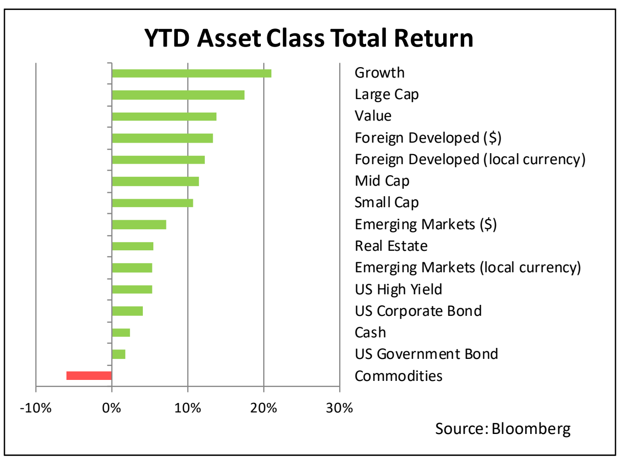




(Source: Bloomberg)

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 7/12/2023 close)

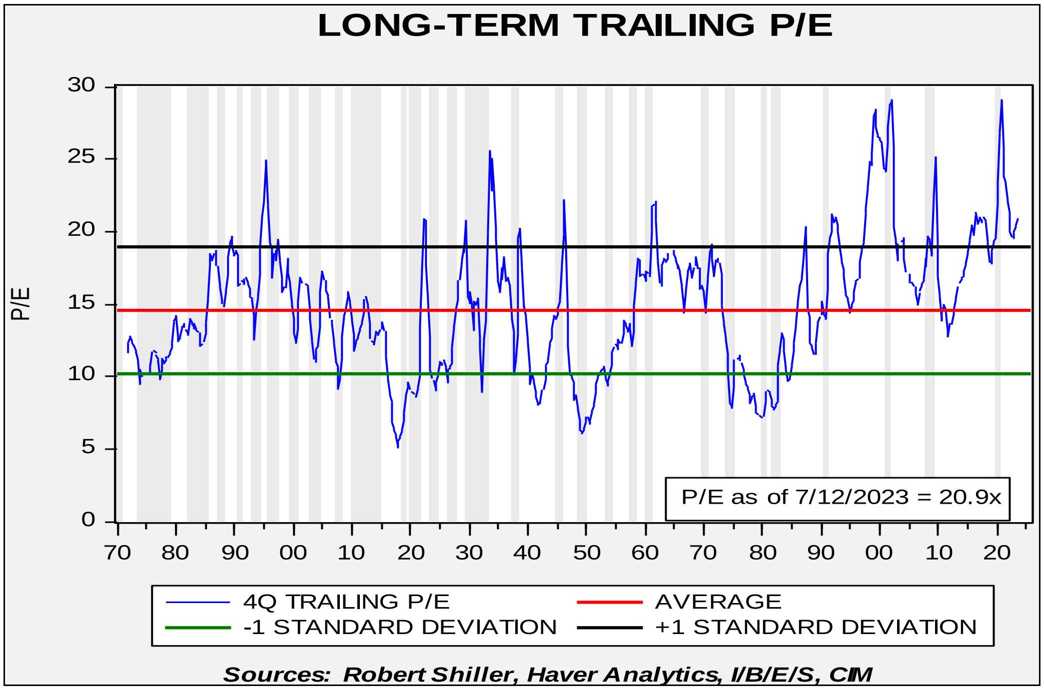


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 13, 2023



Based on our methodology,[1] the current P/E is 20.9x, down 0.1x from last week. The modest decline in the index led to the decline in 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.