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 20, 2023—9:30 AM EDT] Global equity markets are mostly lower this morning. In Europe, the Euro Stoxx 50 is currently down marginally from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.5%. Chinese markets were lower, with the Shanghai Composite down 0.9% from its previous close and the Shenzhen Composite down 1.1%. U.S. equity index futures are signaling a lower open.

With 61 companies having reported so far, S&P 500 earnings for Q2 are running at $52.70 per share, compared to estimates of $53.55 (a decline of 6.8% from Q2 2022). Of the companies that have reported thus far, 82.0% have exceeded expectations while 11.5% have fallen short of expectations.

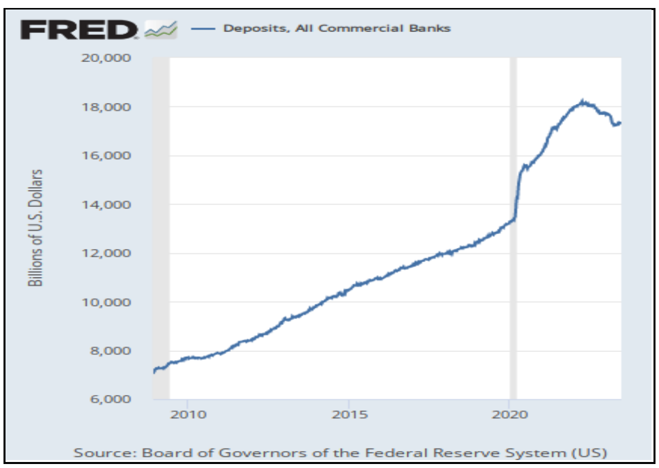
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (7/10/2023) (see podcast link below): "The 2023 Mid-Year Geopolitical Outlook: The Polycrisis"
- ***Weekly Energy Update*** **(7/20/2023): We discuss the hot weather, with an analysis of why it just isn't climate change that's having an impact. Sunspots and the ENSO cycle are likely lifting temperatures as well.**
- *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* (7/17/2023) (with associated podcast): "Are Higher Interest Rates Bearish for Risk Assets?"
- *Confluence of Ideas* podcast (7/10/2023): "The 2023 Mid-Year Geopolitical Outlook"
- ***Keller Quarterly*** **(July 2023): Mark Keller's (CEO/CIO) letter to investors.**

Good morning! Today's *Comment* begins with our concerns about the banking sector. We then discuss how the war in Ukraine and El Niño could impact Fed policy. Finally, we explain why the recent improvement in U.S.-China relations may be short-lived.

Deposit Flight: While banks have mostly recovered from the March fiasco, disintermediation remains a challenge.

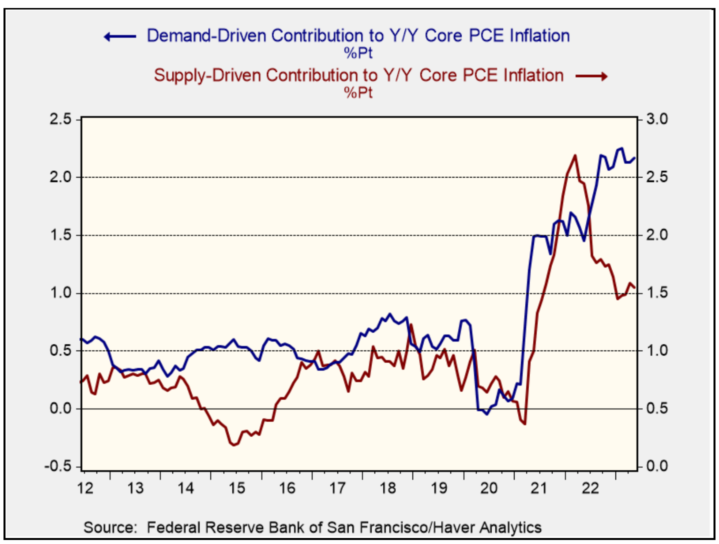
- Three of the country's biggest banks by assets were able to beat expectations in the second quarter. JP Morgan (JPM, $154.25), Citigroup (C, $47.52), and Wells Fargo (WFC, $46.26) made a combined profit of $22.3 billion going into the year's second half, thanks in part to hawkish Fed policy. The surge in interest rates have benefited banks in two ways. First, they were able to charge more for loans, which increased their net interest income. Second, the banking crisis in March led to an increase in deposits at major banks as savers fled regional banks. This surge in new clients made it easier for banks to lend out capital. However, it is unclear whether this trend will continue into the third quarter.
- Several major headwinds are expected to plague banks over the next few months. First, as interest rates rise, customers are pushing for more compensation for their deposits. In fact, institutional depositors are already moving their savings to higher-yielding accounts. Second, the prospect of new regulations and loan losses from commercial real estate is forcing banks to shore up their balance sheets. For example, U.S. Bancorp (USB, $38.68) announced that it has increased its Common Equity Tier 1 (CET1) by 60 basis points, offloaded assets, and securitized auto loans in order to reduce its balance sheet exposure. On top of that, banks have noticed that households are holding back on spending, and credit card losses are increasing.



- The good news is that deposits at commercial banks have stabilized since the fall of Silicon Valley Bank. However, these holdings will be under threat as long as the Fed keeps raising rates. Regional lenders are the most sensitive to interest rate changes, as evidenced by the deposit outflows reported by U.S. Bancorp, Citizens (CFG, $31.06), M&T Bank (MTB, $138.08), and Charles Schwab (SCHW, $66.00) in the second quarter. Even Bank of America (BAC, $31.40), the second-largest bank by assets, saw a deposit flight. If bankers are forced to pay more on deposits, it could lead to even higher borrowing costs and further weigh on consumer spending. As a result, we are still paying close attention to the banking system.

It's Hot in Here: Adverse weather conditions and the war in Ukraine could complicate Fed efforts to ease monetary policy.

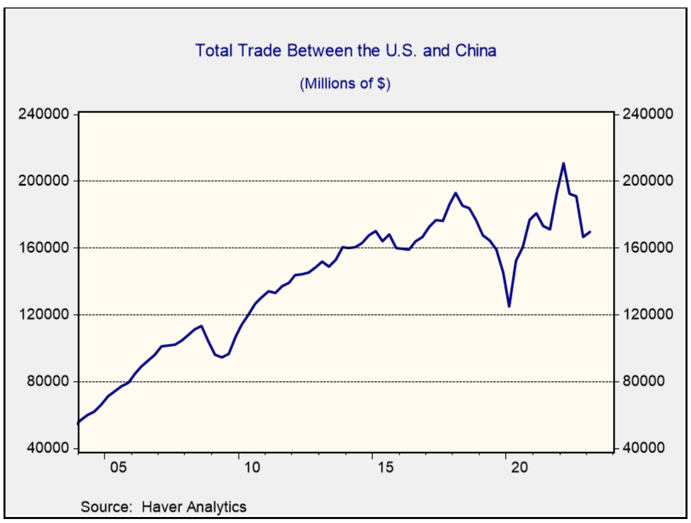
- Temperatures in the United States, Europe, and Asia have reached record highs this year, driven by relatively strong El Niño conditions. Global ocean temperatures have exceeded the 20th-century average by 1.89 F, according to the National Oceanic and Atmospheric Administration. The unusually hot weather has pushed up energy consumption in the United States, with power demand in Texas and Arizona expected to set records. The unprecedented heatwave has also led to wildfires in Greece and Canada. Additionally, there are concerns that poor conditions could hurt crop yields.
- At the same time, the war in Ukraine is also leading to uncertainty regarding food prices. On Wednesday, Russia announced it would consider all vessels headed to Ukrainian ports to be military threats. The declaration comes a week after Moscow pulled out of the Black Sea grain deal. Wheat futures surged 8% following the report as investors expect grain supply to fall. So far, grain prices remain lower than at the start of the year; however, they could rise if shipments are disrupted or become more expensive to insure. This may lead to an increase in food inflation just as cost pressures were trending downward.



- Adverse weather conditions and the war in Ukraine are likely to dissuade talks of policy cuts. Central banks appear to be indifferent as to whether inflation is supply- or demand-driven. They are instead focused on containing price pressures, regardless of the source. As the chart above shows, most of the progress made in U.S. inflation has come from supply-side factors. Hence, supply disruptions could reverse some of the gains made in the inflation fight. While this does not necessarily mean that they will continue to raise interest rates, they are less likely to consider a cut if there is a chance of inflation accelerating.

There Is a Glimmer: Despite ongoing friction between the two global superpowers, there are signs that both sides are willing to de-escalate and avoid direct conflict.

- The U.S. and China are taking tentative steps to improve relations while trying to avoid actions that could provoke the other side. On Thursday, Washington officials rebuked Taiwanese presidential frontrunner Lai Ching-te's assertion that his country's political goal is to "enter the White House." The "One China" policy prohibits top Taiwanese officials from making official visits to Washington. Meanwhile, Beijing has finally started holding diplomatic talks with U.S. representatives. Special Presidential Envoy John Kerry agreed with his Chinese counterpart to continue to hold discussions about climate change goals. Additionally, Chinese President Xi Jinping met with former Secretary of State Henry Kissinger to discuss warmer U.S.-China ties.
- That said, the two largest economies in the world will continue to take steps to protect their own interests. On Wednesday, China's envoy to Washington warned that his country would respond if the U.S. proceeds with pushing through laws that hurt China's advancement in military technology. The threat comes amidst speculation that the Biden administration is considering limiting investment into companies linked to the Chinese defense industry. Although White House officials maintain that the restrictions will be limited in scope, it is possible that the measure could pave the way for more discussion regarding the topic, especially going into the 2024 election.

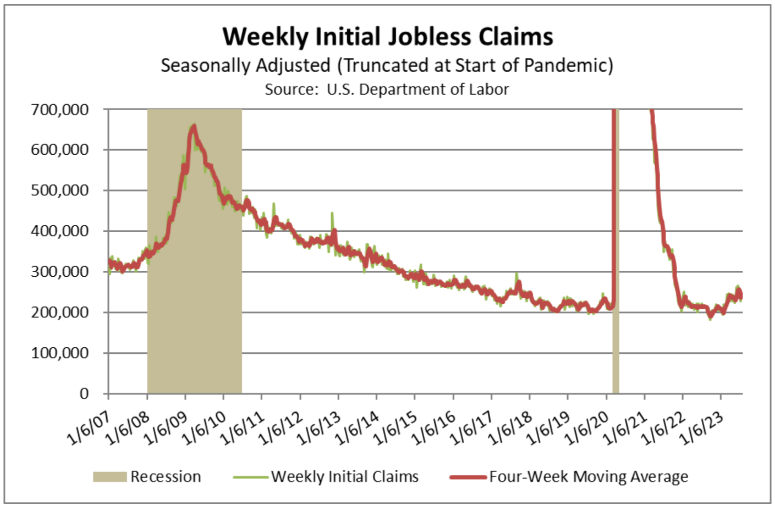


- A deceleration in the global economy is likely to slow the pace of the decoupling between the United States and China, but it is unlikely to disrupt it entirely. The two countries are deeply interconnected, and both would suffer if there were a complete break in economic ties. China's economic recovery will receive a boost from an increase in exports to the United States and maintaining access to China's supply chains and materials will help the United States with its green energy transition and prevent trade disruptions. However, trade between the two countries is unlikely to return to its pre-pandemic pace anytime soon.

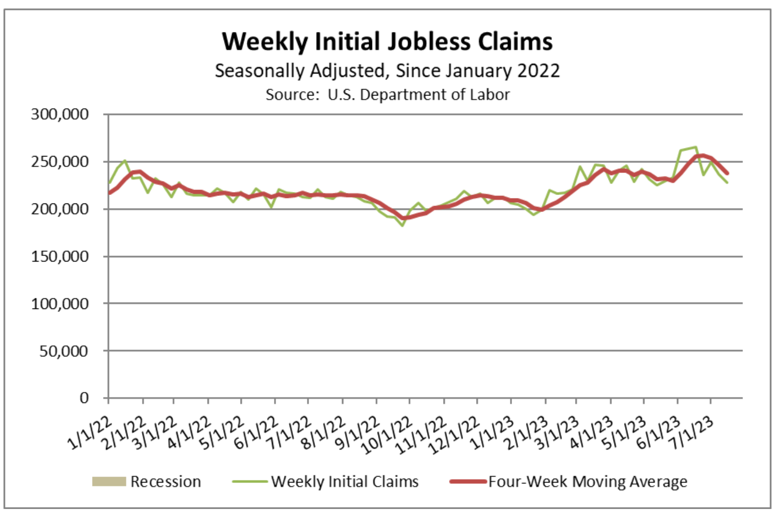
U.S. Economic Releases

In the week ending July 15, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 228,000, below both the expected level of 240,000 and the prior week's level of

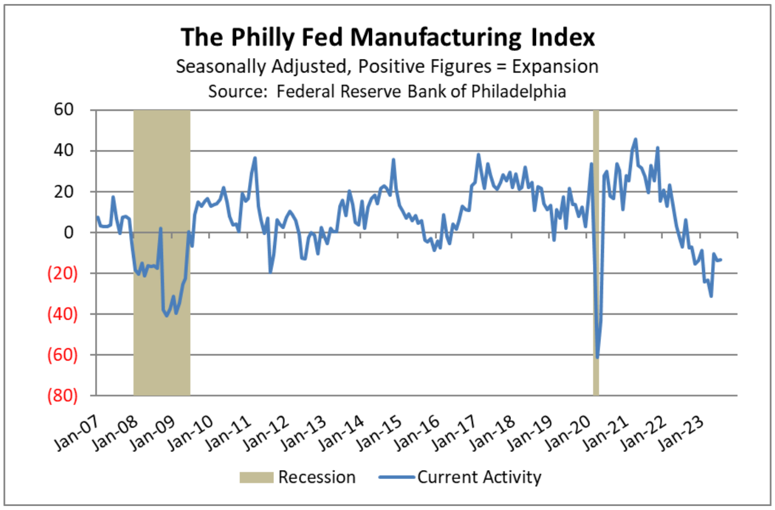
237,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to a six-week low of 237,500. However, other figures in the report weren't so positive. In the week ending July 8, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to 1.754 million, well above the anticipated reading of 1.722 and the previous week's revised reading of 1.721 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 Philadelphia FRB said its July ***Philly Fed Manufacturing Activity Index*** rose very slightly to a seasonally adjusted -13.5, far weaker than the expected reading of -10.0 but above the June reading of -13.7. The Philly Fed Index is designed so that positive readings point to expanding factory activity in the mid-Atlantic region. At its current level, the index suggests mid-Atlantic manufacturing remains in recessionary territory. The chart below shows how the index has fluctuated since just before the prior recession.



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

Economic Releases						
EST	Indicator			Expected	Prior	Rating
10:00	Existing Home Sales (annualized selling rate)	m/m	Jun	4.20m	4.30m	***
10:00	Existing Home Sales (monthly change)	m/m	Jun	-2.3%	0.2%	**
10:00	Leading Index	m/m	Jun	-0.6%	-0.7%	***
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	Trade Balance	m/m	Jun	¥43.0b	-¥1372.5b	-¥1381.9b	***	Equity bullish, bond bearish
	Exports	y/y	Jun	1.5%	0.6%	2.4%	*	Equity bearish, bond bullish
	Imports	y/y	Jun	-12.9%	-9.8%	-11.3%	*	Equity bearish, bond bullish
	Machine tool orders	y/y	Jun F	-21.1%	-21.7%	--	**	Equity bearish, bond bullish
Australia	NAB Business Confidence	q/q	2Q	-3	-4	--	**	Equity and bond neutral
	Employment Change	m/m	Jun	32.6k	75.9k	15.0k	***	Equity bullish, bond bearish
	Participation Rate	m/m	Jun	66.8%	66.9%	66.9%	**	Equity and bond neutral
	Unemployment Rate	m/m	Jun	3.5%	3.5%	3.6%	***	Equity bullish, bond bearish
EUROPE								
Eurozone	ECB Current Account SA	m/m	May	9.1b	3.6b	--	*	Equity bullish, bond bearish
Germany	PPI	y/y	Jun	0.1%	1.0%	0.0%	**	Equity and bond neutral
France	Business Confidence	m/m	Jul	100	100	100	**	Equity and bond neutral
	Manufacturing Confidence	m/m	Jul	100	100	100	*	Equity and bond neutral
Switzerland	Real Exports	m/m	Jun	-0.9%	5.3%	--	*	Equity bearish, bond bullish
	Real Imports	m/m	Jun	1.8%	-0.3%	--	*	Equity and bond neutral
Russia	PPI	y/y	Jun	0.00%	-3.60%		***	Equity and bond neutral
AMERICAS								
Mexico	Retail Sales	y/y	May	2.6%	3.8%	3.5%	***	Equity bearish, bond bullish

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)	559	558	1	Up
3-mo T-bill yield (bps)	525	525	0	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	535	534	1	Up
U.S. Libor/OIS spread (bps)	536	535	1	Up
10-yr T-note (%)	3.81	3.75	0.06	Flat
Euribor/OIS spread (bps)	365	371	-6	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Down			Down
Pound	Down			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
PBOC 1-Year Loan Prime Rate	3.550%	3.550%	3.550%	On Forecast
PBOC 5-Yr Prime Rate	4.200%	4.200%	4.200%	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	$79.71	$79.46	0.31%	
WTI	$75.50	$75.35	0.20%	
Natural Gas	$2.68	$2.60	3.11%	
Crack Spread	$37.40	$37.87	-1.25%	
12-mo strip crack	$28.35	$28.72	-1.26%	
Ethanol rack	$2.69	$2.69	-0.09%	
Metals				
Gold	$1,978.18	$1,976.64	0.08%	
Silver	$25.17	$25.15	0.08%	
Copper contract	$388.25	$381.40	1.80%	
Grains				
Corn contract	$553.50	$553.00	0.09%	
Wheat contract	$732.50	$727.75	0.65%	
Soybeans contract	$1,404.75	$1,408.75	-0.28%	
Shipping				
Baltic Dry Freight	1,004	1,037	-33	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	0.7	-2.5	3.2	
Gasoline (mb)	-1.1	-1.5	0.4	
Distillates (mb)	0.0	1.0	-1.0	
Refinery run rates (%)	0.6%	0.0%	0.6%	
Natural gas (bcf)		44		

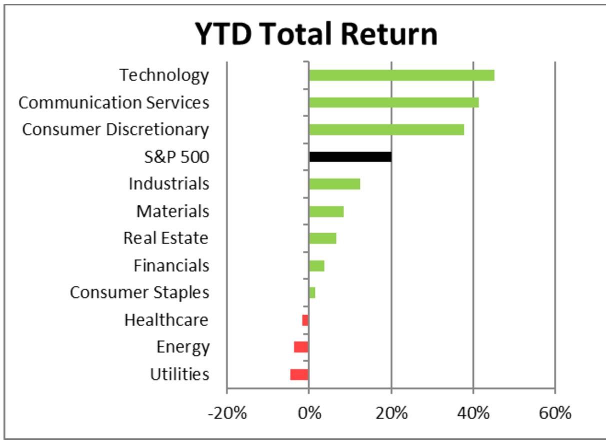
Weather

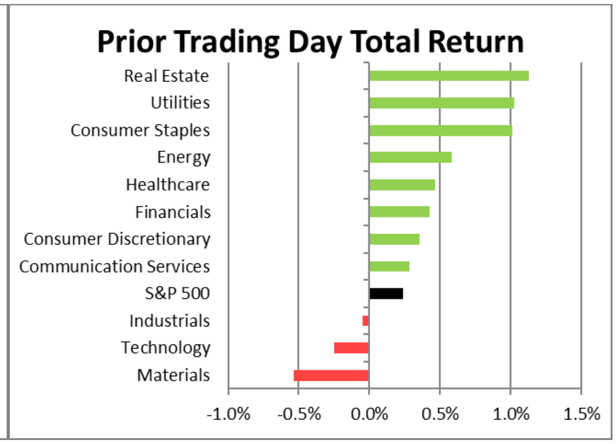
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in almost the entire Continental U.S., with cooler-than-normal temperatures only in the Pacific Northwest. The forecasts call for wetter-than-normal conditions in the Midwest, with dry conditions in the Far West, Texas, and the Southeast.

Tropical Storm Don has been downgraded to a depression at the very center of the Atlantic Ocean and is currently moving slowly northward. It is not expected to threaten any land mass.

Data Section

U.S. Equity Markets – (as of 7/19/2023 close)

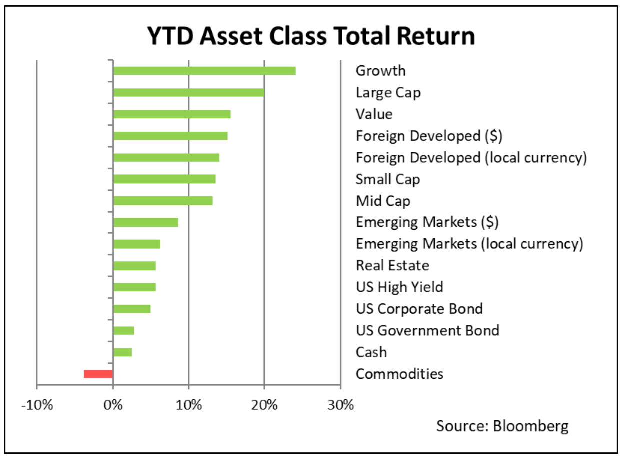




(Source: Bloomberg)

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 7/19/2023 close)

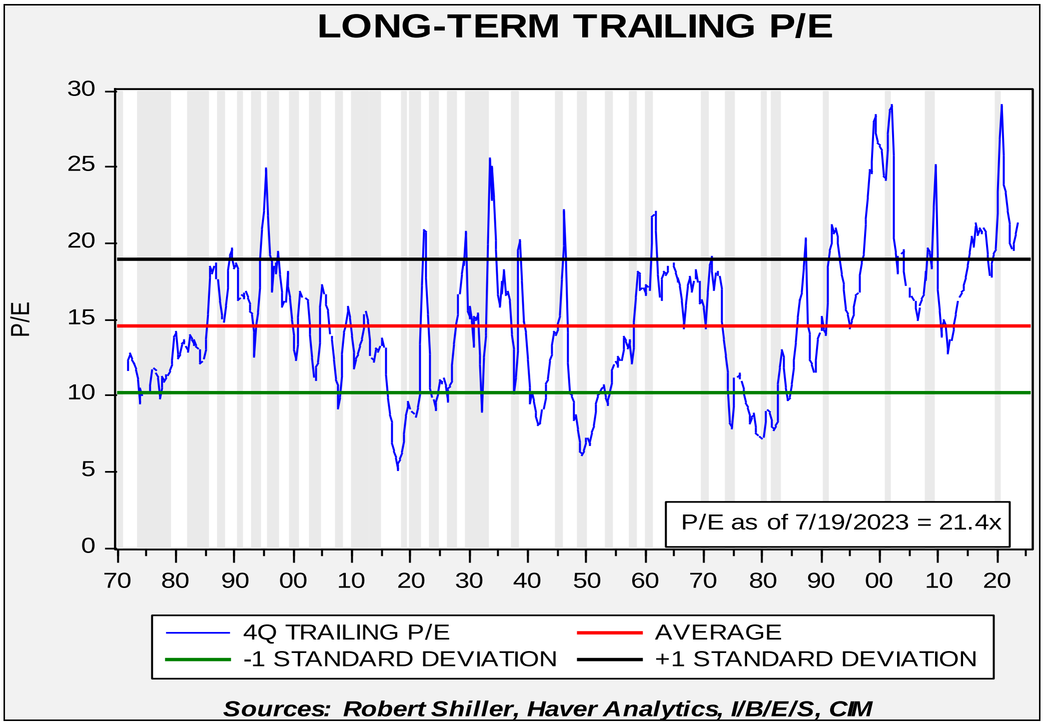


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 20, 2023



Based on our methodology,[1] the current P/E is 21.4x, up 0.5x from last week. Weaker earnings and rising index values led to the multiple expansion.

[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.