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 21, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is currently down 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.7%. Chinese markets were lower, with the Shanghai Composite down 0.1% from its previous close and the Shenzhen Composite down 0.2%. In contrast, U.S. equity index futures are signaling a higher open.

With 77 companies having reported so far, S&P 500 earnings for Q2 are running at $52.80 per share, compared to estimates of $53.55 (a decline of 6.8% from Q2 2022). Of the companies that have reported thus far, 79.2% have exceeded expectations while 15.6% 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 – Q3 2023* (7/20/2023): Discussion of our asset allocation process, Q3 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.

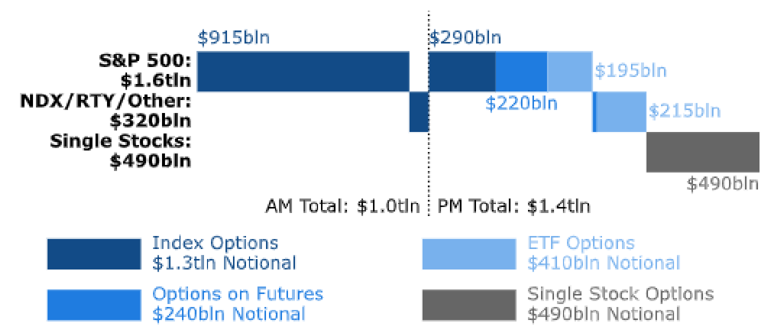
Good morning! Today's *Comment* begins with an explanation of why today could be a rocky day for markets. Next, we will discuss two major developments that may reshape international finance. Finally, we will share our thoughts on the Spanish elections occurring on Sunday.

Triple the Effect: A trifecta of events will weigh on market activity on Friday: a reshuffling of a popular tech index, the expiration of option contracts, and the release of corporate earnings.

- The tech-heavy Nasdaq 100 index is undergoing a special rebalance today to address concerns about the weighting of mega tech companies. The index is typically rebalanced quarterly, but an exception was made earlier this month due to the growing dominance of these companies. Boosted by the excitement of artificial intelligence, the top five tech companies now account for over 50% of the index, significantly higher than the 40% cap typically preferred by the providers. The special rebalance will reduce the weightings of these companies and increase the influence of smaller companies. This will likely lead to increased volatility in the market as investors adjust their portfolios accordingly.
- In addition to the Nasdaq 100 rebalance, an estimated $2.4 trillion worth of options tied to stocks and indexes are set to mature. The expiration of these contracts will likely impact trading activity as investors decide whether they would like to roll over existing positions or start new ones. July has been the slowest month of trading in two years, and there is speculation that investors may be sitting on the sidelines until there is more clarity about the future direction of monetary policy. If investors do decide to roll over their options, it could lead to a surge in trading volume and volatility. However, if investors decide to start new positions, it could lead to more sustained performance.

Exhibit 12: $2.4tln notional of US equity options expire this Friday

Notional open interest of equity index options, ETF options, single stock options, and options on equity index futures expiring 21-Jul-2023

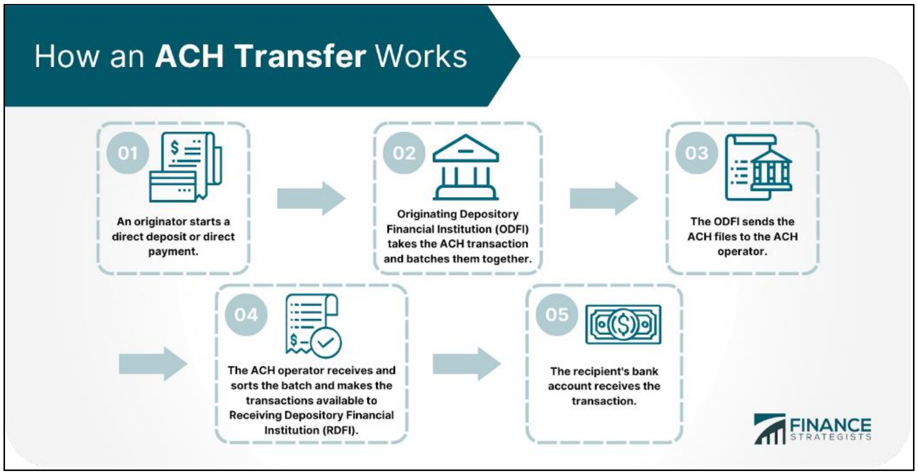


Sources: Asym 500, ORATS, Bloomberg Finance L.P.

- Finally, the day is likely to be heavily influenced by corporate earnings releases. Several companies are expected to report their results, including regional lenders Comerica (CMA, $52.93) and Regions (RF, $20.35), as well as credit card company American Express (AXP, $177.11). Comerica and Regions are expected to give insights into the deposit market, important information given the fears of disintermediation. At the same time, American Express's earnings will provide information on the discretionary spending habits of consumers. The results could have a significant impact on the direction of the market in the coming weeks as it may give investors a better sense of the state of the economy.

Institutional Shifts: The World Bank and the Federal Reserve have made major announcements that suggest both organizations are looking to modernize.

- The Chinese-backed [Asian Infrastructure Investment Bank (AIIB) has joined forces with the World Bank](). The deal with the AIIB will help alleviate the World Bank's financial constraints. However, this new partnership is likely to raise eyebrows, as it comes weeks after reports that [members of the Chinese Communist Party infiltrated the bank](). Suspicions of Chinese involvement in the World Bank led Canada to withdraw its membership from the multilateral organization. The move also comes as the two supranational financial institutions [look to restructure the debt of emerging market companies.]()
- The Federal Reserve in the United States [has upgraded its payment system to make it easier for Americans to transfer money](). FedNow is a much-needed shift in a banking system where people still rely on paper checks and cash to send payments through Automated Clearing House (ACH) transfers, which can take several days to process. Although banks still need to sign up for the new system, its implementation is expected to lead to some disruption. The real-time payment system network should increase competition among credit card companies and offer new opportunities for fintech companies.

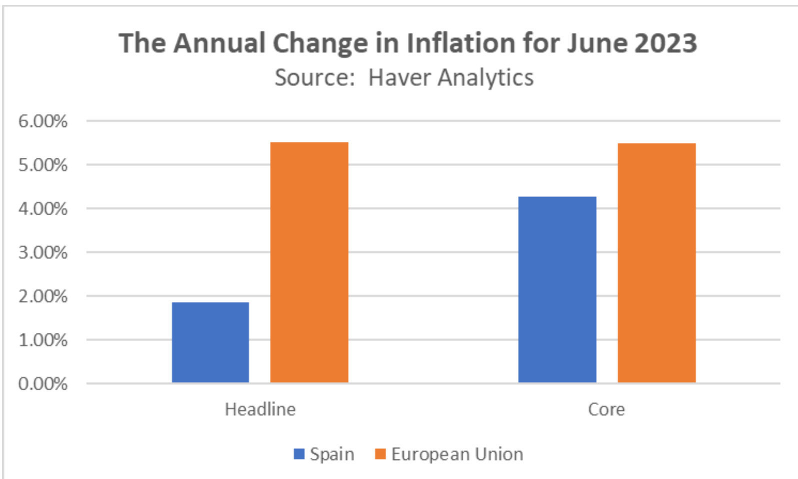


- These two developments show how the world is slowly adapting to a new normal. China is one of the world's largest creditors, and its partnership with the World Bank makes sense given its influence in developing countries. Meanwhile, the U.S.'s current payment system is antiquated and needed to be improved to keep up with the demands of a world that is increasingly dominated by digital transactions. Taken together, these reports reflect how difficult it is for the financial system to keep up with changing trends as one could argue that both events should have happened much earlier.

¿A La Derecha? The upcoming Spanish election is widely expected to result in a rightward shift in the country's political landscape.

- Recent polls suggest that the Popular Party (PP), led by [Alberto Núñez Feijóo, is poised to win the most votes in the upcoming Spanish election]() taking place on Sunday. This would put the PP in a strong position to form a government. However, there is speculation that Feijóo may seek to form a coalition with the controversial Vox party. The far-right group has been accused of racism, xenophobia, and Islamophobia. If Feijóo were to form a coalition with Vox, it would be a significant shift in Spanish politics, as it would give a far-right party a seat in parliament for the first time since the end of Francisco Franco's rule in 1975.

- The rise of populist parties in the European Union is linked to the bloc's encouragement of unpopular reforms. In Spain, for example, the government barely passed a labor reform in order to unlock pandemic funds last year. Similarly, pressure to push through reforms in Italy helped lead to the ouster of Mario Draghi from the premiership. Meanwhile, French President Emmanuel Macron's controversial pension reforms have boosted support for his political rival, Marine Le Pen. This situation will likely worsen as the European Central Bank plows ahead with rate increases despite signs that inflation is slowing, and the region narrowly avoided a technical recession in Q2 of 2023.



- The European Union's inability to adapt to each country's individual needs is a major weakness that could undermine the bloc's ability to function in the future. This is evident in the fact that Spain will be subject to tighter monetary policy despite the fact that it is making better progress in its inflation fight than other countries. This lack of flexibility could lead to more populist leaders being elected in the EU, who would likely look to protect their countries' interests, even if it means going against the bloc. As a result, if this trend continues, it could lead to a much weaker euro in the future.

U.S. Economic Releases

No U.S. economic releases or Fed events are scheduled for 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	National CPI	y/y	Jun	3.3%	3.2%	3.2%	***	Equity and bond neutral
	National CPI Ex-Fresh Food	y/y	Jun	3.3%	3.2%	3.3%	**	Equity and bond neutral
	National CPI Ex-Fresh Food & Energy	y/y	Jun	4.2%	4.3%	4.2%	*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	14-Jul	-¥411.4b	¥705.0b	--	*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	14-Jul	-¥77.4b	-¥956.0b	--	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	14-Jul	-¥673.2b	-¥950.8b	--	*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	14-Jul	¥238.6b	¥181.7b	--	*	Equity and bond neutral
South Korea	PPI	y/y	Jun	-0.2%	0.5%		**	Equity and bond neutral
EUROPE								
Eurozone	Consumer Confidence	m/m	Jul P	-15.1	-16.1	-15.8	**	Equity bullish, bond bearish
France	Retail Sales SA	y/y	Jun	-2.0%	-5.4%		*	Equity bullish, bond bearish
UK	GfK Consumer Confidence	m/m	Jul	-30	-24	-25	**	Equity bearish, bond bullish
	Retail Sales	y/y	Jun	-1.0%	-2.3%	-1.6%	***	Equity bullish, bond bearish
	Retail Sales Ex-Auto Fuel	y/y	Jun	-0.9%	-1.9%	-1.6%	**	Equity bullish, bond bearish
	Public Finances (PSNCR)	m/m	Jun	12.0b	3.7b	--	*	Equity and bond neutral
	Public Sector Net Borowing	m/m	Jun	20.1b	17.0b	20.6b	*	Equity and bond neutral
	PSNB ex Banking Groups	m/m	Jun	18.5b	16.6b	22.0b	**	Equity and bond neutral
Switzerland	M3 Money Supply	y/y	Jun	-1.2%	-1.3%	--	**	Equity and bond neutral
Russia	Money Supply, Narrow Definition	w/w	14-Jul	18.36t	18.18t	--	*	Equity and bond neutral
AMERICAS								
Canada	Retail Sales	m/m	May	0.2%	1.0%	0.5%	**	Equity bearish, bond bullish
	Retail Sales Ex-Autos	m/m	May	0.0%	1.2%	0.2%	**	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)	560	559	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	535	0	Up
U.S. Libor/OIS spread (bps)	536	536	0	Up
10-yr T-note (%)	3.82	3.85	-0.03	Flat
Euribor/OIS spread (bps)	370	365	5	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Flat			Up
Yen	Down			Down
Pound	Down			Up
Franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Russia Key Rate	8.500%	7.500%	8.000%	Above 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	$80.75	$79.64	1.39%	
WTI	$76.74	$75.65	1.44%	
Natural Gas	$2.75	$2.76	-0.29%	
Crack Spread	$37.96	$38.76	-2.06%	
12-mo strip crack	$28.73	$29.25	-1.79%	
Ethanol rack	$2.67	$2.68	-0.20%	
Metals				
Gold	$1,964.81	$1,969.53	-0.24%	
Silver	$24.80	$24.76	0.17%	
Copper contract	$382.70	$383.45	-0.20%	
Grains				
Corn contract	$535.50	$546.25	-1.97%	
Wheat contract	$707.75	$727.00	-2.65%	
Soybeans contract	$1,392.25	$1,404.75	-0.89%	
Shipping				
Baltic Dry Freight	977	1,004	-27	
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)	41	44	-3	

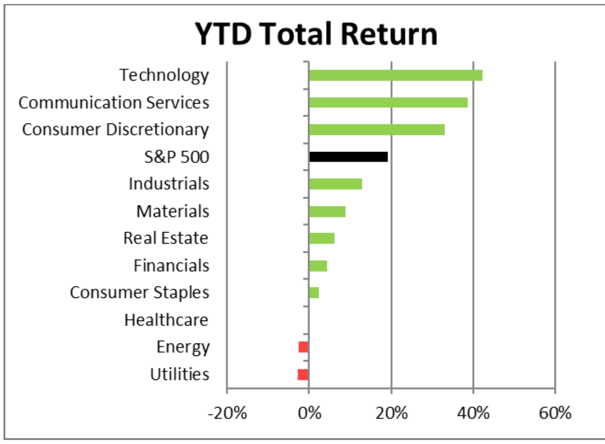
Weather

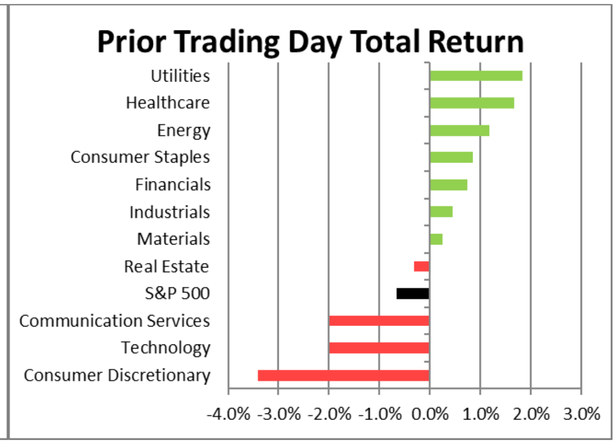
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout the Far West, the Great Plains, and the Southeast, with cooler-than-normal temperatures only in the Midwest. The forecasts call for wetter-than-normal conditions in the Southwest, the Mississippi Valley region, and the Northeast, with dry conditions in the Pacific Northwest.

Tropical Storm Don remains at the very center of the Atlantic Ocean and is not expected to threaten any land mass. A disturbance has also formed in the eastern Atlantic Ocean off the coast of Africa, but it is assessed to have only a 20% chance of evolving into a cyclonic formation within the next 48 hours.

Data Section

U.S. Equity Markets – (as of 7/20/2023 close)

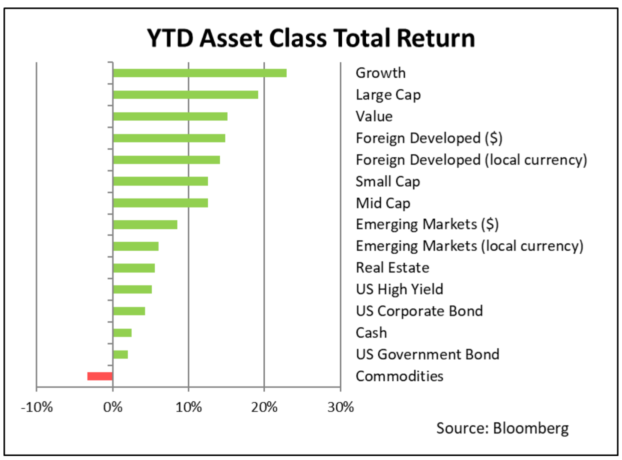




(Source: Bloomberg)

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 7/20/2023 close)

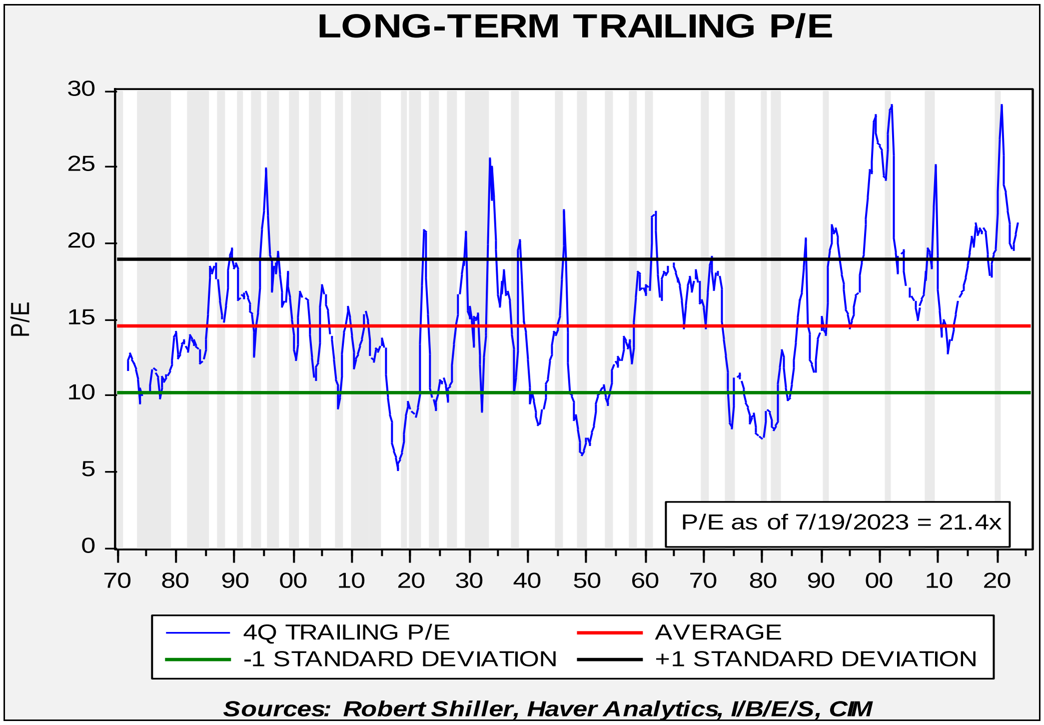


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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.