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: June 6, 2023—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is currently down 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.1%. Chinese markets were also lower, with the Shanghai Composite closing down 1.2% from its previous close and the Shenzhen Composite down 1.7%. U.S. equity index futures are signaling a lower 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* (5/30/2023) (with associated podcast) "China's New National Security Law"
- *Weekly Energy Update* (6/1/2023): We discuss the upcoming OPEC+ meeting and update the weekly oil inventory data.
- *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* (6/5/2023) (with associated podcast): "Weak Capital Investment by State and Local Governments"
- *Confluence of Ideas* podcast (3/8/2023): "Reflections on Inflation"

Our *Comment* today opens with news that a major venture-capital business, Sequoia Capital, is splitting up into components that largely reflect the global fracturing that we've been talking about for so long. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including the destruction of a major dam and power station amid the war in Ukraine and new U.S. lawsuits against major cryptocurrency businesses.

Global Fracturing: Venture-capital giant Sequoia announced that it will split into three separate geographically focused partnerships that will be distinct firms with separate brands. The firm's U.S. and European venture-capital business will retain the name Sequoia Capital, while its Chinese business will split off and change its name from Sequoia China to HongShan, as it's currently referred to in Mandarin. Sequoia's business in India and Southeast Asia will separate and be renamed Peak XV Partners.

- We have been writing extensively about the way the world is fracturing into relatively separate geopolitical and economic blocs. The Sequoia split-up illustrates how this fracturing will have a profound impact on businesses.
    - Under Sequoia's new structure, the U.S. and European venture-capital business will largely focus on what we call the evolving U.S.-led bloc.
    - The new HongShan will cover the dominant country in what we refer to as the China-led bloc.
    - The new Peak XV Partners looks like it will cover many of the countries we believe will end up in either the China-leaning, neutral, or U.S.-leaning bloc.
- As with overall global economic production and relationships, Sequoia's split-up will likely reduce some of the firm's efficiency, synergy, and innovation capacity. On the other hand, it will make each entity more resilient and independent as U.S.-China geopolitical tensions threaten to sever cross-bloc trades and investment. Many other important firms are facing similar tough decisions, as shown by the grilling recently faced by the chairman of Taiwan Semiconductor Manufacturing (TSM, $98.05).

China-Hong Kong-United States: A former California-based executive of ByteDance claims in a wrongful dismissal lawsuit that the Chinese Communist Party accessed user data from the company's hit TikTok app in order to identify democracy protesters in Hong Kong during its political unrest in 2018. The accusation is likely to intensify U.S. government efforts to rein in TikTok or perhaps even ban it from the U.S. market. More broadly, it will probably also heighten concerns about U.S. users' data security on Chinese apps or devices, further worsening U.S.-China tensions.

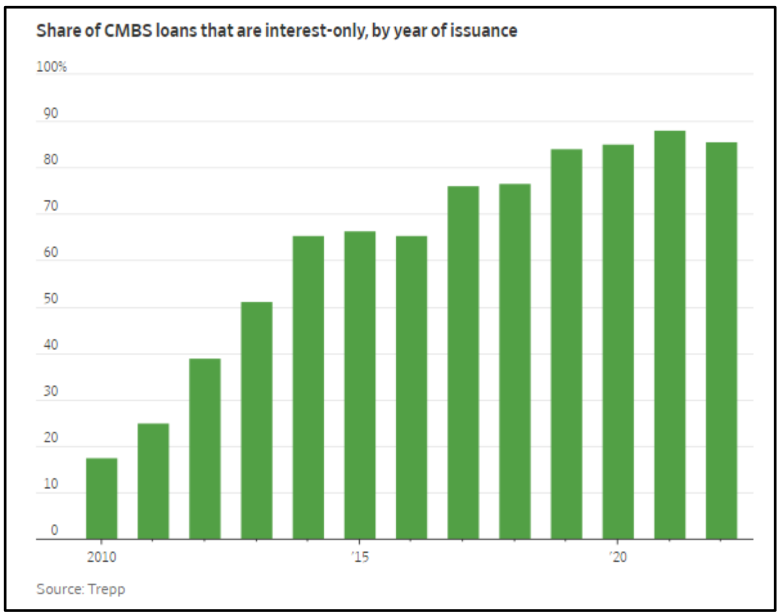
Russia-Ukraine War: Shelling overnight has destroyed a major dam and power station in southeastern Ukraine, causing massive flooding and putting the large Zaporizhzhia nuclear power station at risk. The Russian and Ukrainian governments have accused each other of destroying the facility, but at this point, there appears to be a good chance that the destruction was a desperate attempt by Russia to complicate Ukraine's planned counteroffensive. Even though the flooding has reportedly washed away many of Russia's trenches and other defensive works in the region and will cause water shortages in Russia-controlled Crimea, the water and soaked ground could preclude any Ukrainian attack in that vector, allowing Russia to shift more troops to other parts of the front lines.

U.S. Cryptocurrency Regulation: Yesterday, the Securities and Exchange Commission sued leading cryptocurrency exchange Binance for running an illegal trading platform in the U.S., misusing customer funds, and placing those funds with affiliates that had a conflict of interest. The SEC action adds to the legal attacks on Binance that have been launched by the Commodity Futures Trading Commission and the Justice Department. In response, key cryptocurrencies and related firms fell sharply yesterday, with Bitcoin (BTC-USD, 25,647.03) ending down 5.2%.

- In late-breaking news this morning, the SEC has also sued major crypto exchange Coinbase (COIN, $58.71) for not properly registering as an exchange.
- At the moment, it looks like Coinbase stock will fall some 15% at the open, based on current pre-market activity.

U.S. Artificial Intelligence: The U.S. Air Force has stepped back from the story we mentioned in our *Comment* yesterday, in which an official said a drone enabled by artificial intelligence turned on its operator to retaliate for being told to hold off an attack on an enemy air defense installation. The Air Force now says the official's comments were "taken out of context and were meant to be anecdotal." Evidently, the story not only touches on some of the risks involved in using AI in military operations, but it also reflects how the hype around AI is encouraging over-the-top claims about the technology.

U.S. Commercial Real Estate Industry: New analysis from data provider Trepp shows that almost $1.5 trillion of commercial real estate mortgages are maturing over the next three years, the majority of which will likely be interest-only loans. Those loans will be difficult for borrowers to refinance because banks are currently focused on reducing their exposure to commercial real estate, especially office buildings. The analysis further clarifies the looming risks in the financial sector as the Federal Reserve continues to hike interest rates.



U.S. Labor Market: Reflecting today's tight labor markets and the way bargaining power has shifted towards workers, members of the Screen Actors Guild have voted to authorize the union to call a strike if its upcoming negotiations for a new work contract with Hollywood studios falls through. Those negotiations begin tomorrow. A strike by SAG would add to the current work stoppage by the writers' union and the recent deal with directors that boosted their take of royalties and limited the threat that they could be replaced by artificial intelligence.

U.S. Economic Releases

There were no domestic releases scheduled 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	Household Spending	y/y	Apr	-4.4%	-1.9%	-2.4%	***	Equity bearish, bond bullish
Australia	BoP Current Account Balance	q/q	1Q	A$12.3bb	A$14.1b	A$11.7b	**	Equity and bond neutral
New Zealand	ANZ Commodity Price	m/m	May	0.3	-1.7		**	Equity bearish, bond bullish
EUROPE								
Eurozone	Retail Sales	y/y	Apr	-2.6%	-3.8%	-3.3%	*	Equity bullish, bond bearish
Germany	Factory Orders WDA	y/y	Apr	-9.9%	-11.0%	-11.2%	***	Equity bullish, bond bearish
	HCOB Construction PMI	m/m	May	43.9	42.0		***	Equity bullish, bond bearish
UK	S&P/CIPS Construction PMI	m/m	May	51.6	51.1	50.8	**	Equity bullish, bond bearish
AMERICAS								
Brazil	S&P Global Composite PMI	m/m	May	52.3	51.8	--	**	Equity and bond neutral
	S&P Global Services PMI	m/m	May	54.1	54.5	--	**	Equity and bond neutral
	FGV Inflation IGP-DI	m/m	May	-5.49%	-2.57%	-5.11%	**	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.

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Fixed Income	Today	Prior	Change	Trend
3-mo Libor yield (bps)	550	550	0	Up
3-mo T-bill yield (bps)	512	512	0	Up
TED spread (bps)	38	38	0	Tightening
U.S. Sibor/OIS spread (bps)	524	523	1	Up
U.S. Libor/OIS spread (bps)	524	523	1	Up
10-yr T-note (%)	3.68	3.69	-0.01	Flat
Euribor/OIS spread (bps)	349	349	0	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Flat
Yen	Flat			Down
Pound	Down			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
RBA Cash Rate Target	4.100%	3.850%	3.850%	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.

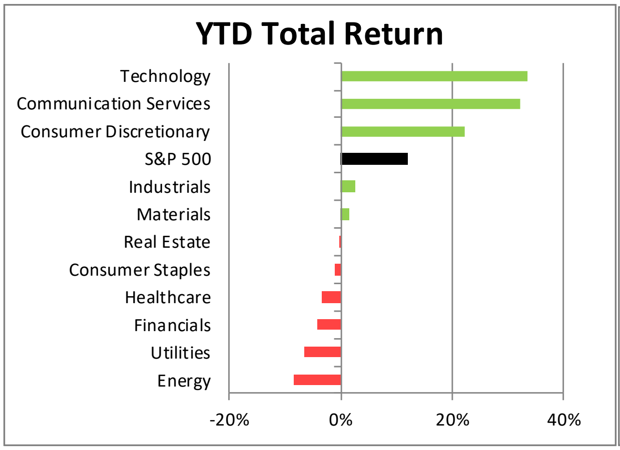
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$75.17	$76.71	-2.01%	Demand Pessimism
WTI	$70.58	$72.15	-2.18%	Demand Pessimism
Natural Gas	$2.20	$2.25	-2.23%	
Crack Spread	$32.60	$32.11	1.50%	
12-mo strip crack	$25.13	$25.08	0.22%	
Ethanol rack	$2.61	$2.61	-0.01%	
Metals				
Gold	$1,964.44	$1,961.86	0.13%	
Silver	$23.73	$23.55	0.77%	
Copper contract	$375.90	$376.80	-0.24%	
Grains				
Corn contract	$605.50	$597.50	1.34%	
Wheat contract	$643.25	$624.00	3.08%	
Soybeans contract	$1,353.75	$1,350.00	0.28%	
Shipping				
Baltic Dry Freight	939	919	20	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.5		
Gasoline (mb)		0.0		
Distillates (mb)		0.8		
Refinery run rates (%)		0.50%		
Natural gas (bcf)		114		

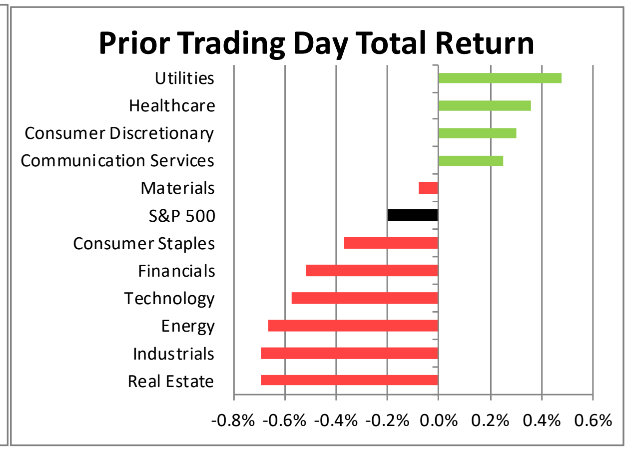
Weather

The 6-10 and 8-14 day forecasts currently show warmer-than-normal temperatures across the Northern Tier states and the Deep South spreading into the eastern half of the country toward the end of the prediction period. Meanwhile, cooler-than-normal conditions are expected in the Pacific and Rocky Mountain regions. The precipitation outlook is calling for wetter-than-normal conditions for states west of the Rockies, with dry conditions anticipated in the Deep South.

Data Section

U.S. Equity Markets – (as of 6/5/2023 close)

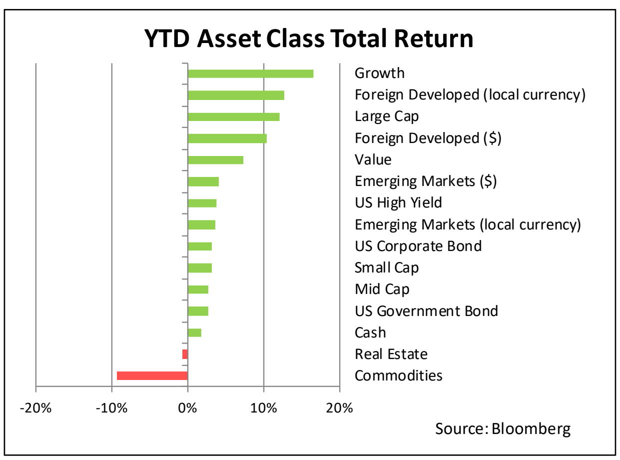




(Source: Bloomberg)

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 6/5/2023 close)

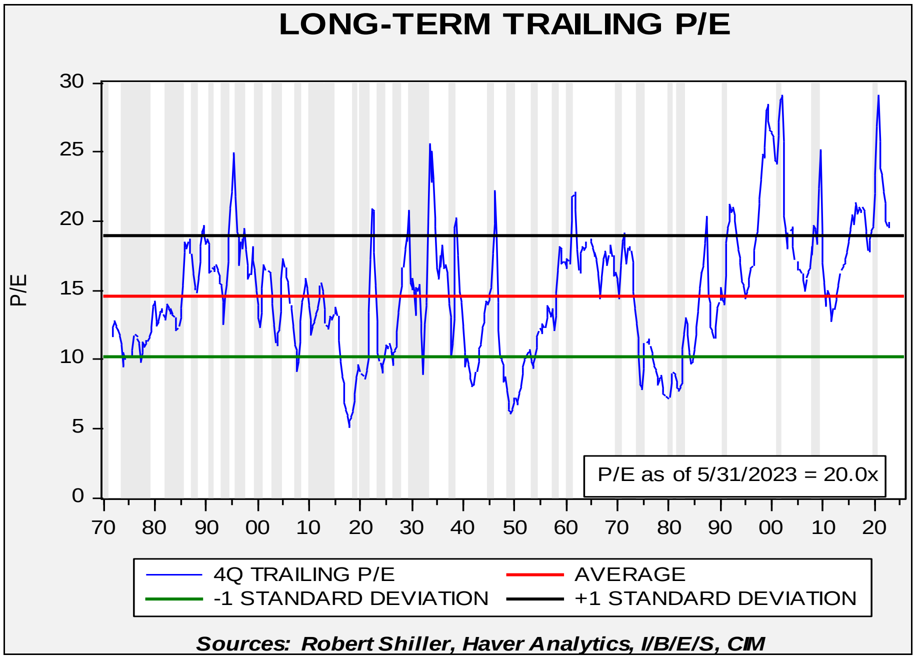


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

June 1, 2023



Based on our methodology,[1] the current P/E is 20.0x, unchanged from last week.

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.