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 7, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is relatively unchanged from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.0%. Chinese markets were mixed, with the Shanghai Composite closing up 0.1% from its previous close and the Shenzhen Composite down 0.2%. 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* (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"

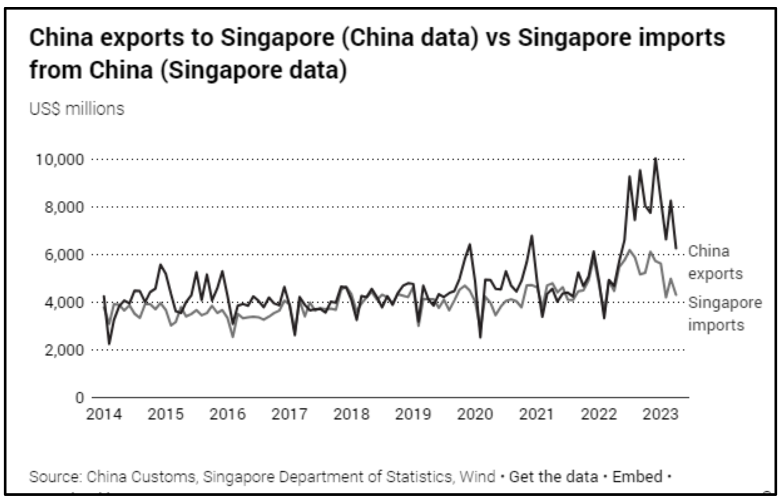
Our *Comment* today opens with new, upgraded forecasts for global economic growth from the World Bank. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including a big slide today in the Turkish lira (TRY) as the country's new finance minister begins shifting polices and the prospect for another big labor action in the U.S.

Global Economy: In its latest *Global Economic Prospects* report, the World Bank said it now expects global economic output to increase an inflation-adjusted 2.1% in 2023, up from its forecast of 1.7% in January but still weaker than the 3.1% expansion last year. Nevertheless, it also cut its forecast for 2024 to 2.4%, versus its January estimate of 2.7%.

- The revised forecasts essentially reflect how the U.S. and other key countries have maintained their economic momentum better than anticipated at the start of the year, which will likely push much of their slowdown or recession into next year.
- Prolonged economic momentum may be good for labor demand, but the institution warned that the resulting interest-rate hikes by the Federal Reserve and other central banks are causing increasing strains on many less-developed countries.

China: Despite the World Bank's upwardly revised growth forecasts for 2023, the faltering recovery in China remains a concern for global investors. New analyses suggest the government may be fudging its export data upward to show national growth is better than it really is. The analyses show discrepancies between China's official export data and a range of other export indicators. Faltering demand growth in China would likely be a major headwind for overall global growth and the financial markets.

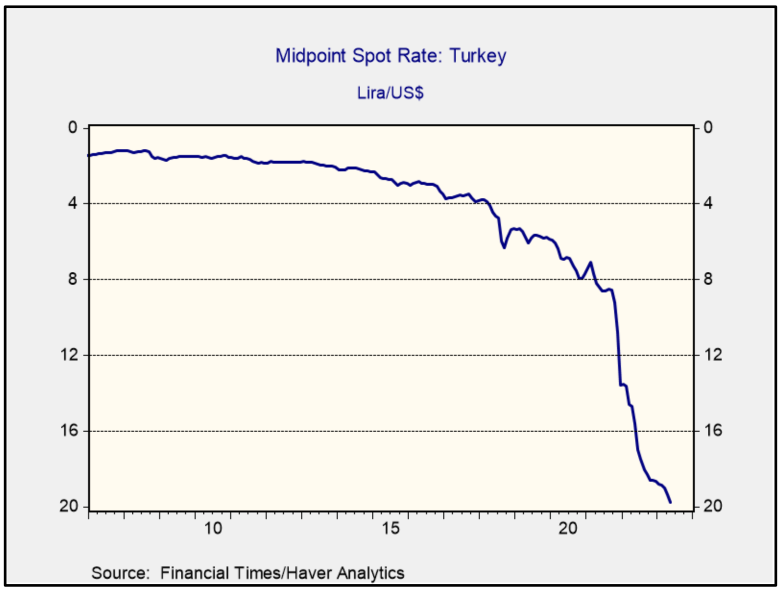
- In official data released today, China's May exports were down 7.5% year-over-year, after a rise of 8.5% in the year to April. The reported decline for May was much worse than analysts anticipated, but that won't necessarily stop the concerns about inaccurate reporting to make the economy look better than it really is.
- Meanwhile, May imports were reportedly down 4.5% on the year, after a fall of 7.9% in the year to April. Falling imports also point to weakening demand in China.



China-United States: In a sign that bilateral relations could be stabilizing, U.S. Secretary of State Blinken will reportedly visit China later this month. That would mark a rescheduling of the meeting Blinken planned to make in February before it was derailed by that month's Chinese spy balloon incident over the U.S. Any resumption of high-level contact between U.S. and Chinese leaders could help ease the acrimony between the countries, but we believe the overall rivalry will continue to sharpen over time and drive further global fracturing, re-industrialization in the U.S., shortened global supply chains, and higher inflation and interest rates.

United Kingdom: Mortgage lender Halifax said the average British home price in May was down 1.0% from one year earlier, marking the first year-over-year decline since 2012. The decline in home values comes as the Bank of England reports that the country's average mortgage interest rate has topped 4.5% for the first time since the Great Financial Crisis, with more hikes by the central bank expected in the coming months.

Turkey: The Turkish lira (TRY) is down approximately 7% against the U.S. dollar so far this morning, recently trading at around 23 per greenback. In contrast with the currency's previous sharp drops, this one doesn't appear to stem from concern about new, unorthodox economic policies or the threat of a financial crisis. On the contrary, today's decline appears to reflect a move toward better economic policies by newly installed Finance Minister Şimşek. Specifically, today's fall appears to reflect the government reducing its support for the currency and letting it trade more freely.



U.S. Fiscal Policy: Investors are becoming increasingly worried that the Treasury Department will have to auction as much as $850 billion in bills between now and September to replenish its coffers and make up for the months when it was constrained by the recent standoff over a new debt limit. As we've warned before, massive make-up issuance will drain liquidity out of the financial markets, potentially pushing down asset prices at least in the near term.

- Separately, some defense hawks in Congress are unhappy with the military budget's minimal 3.3% increase under the deal to lift the debt limit. Hawks in both the House and the Senate have floated the idea of an immediate supplemental appropriation bill to boost defense spending further in the coming fiscal year.
- However, House Speaker McCarthy threw cold water on that idea earlier this week. It remains to be seen whether he will be able to hold the line on the defense budget as Congress gets to work on its appropriation bills in the coming weeks.

U.S. Retailing Industry: While we continue to believe that global geopolitical fracturing will make re-industrialization of the U.S. economy a key trend in the coming years, as discussed in our *Comment* on Monday, new reporting suggests it will also lead to changes in U.S. retailing.

As foreign retailers become more wary about investing in China and its bloc, many that have only a small presence in the U.S. right now are reportedly planning to open large numbers of new stores here in the coming years. Besides creating new competition for U.S. retailers, the expansion could help those foreign firms make up for lost opportunities in the China bloc.

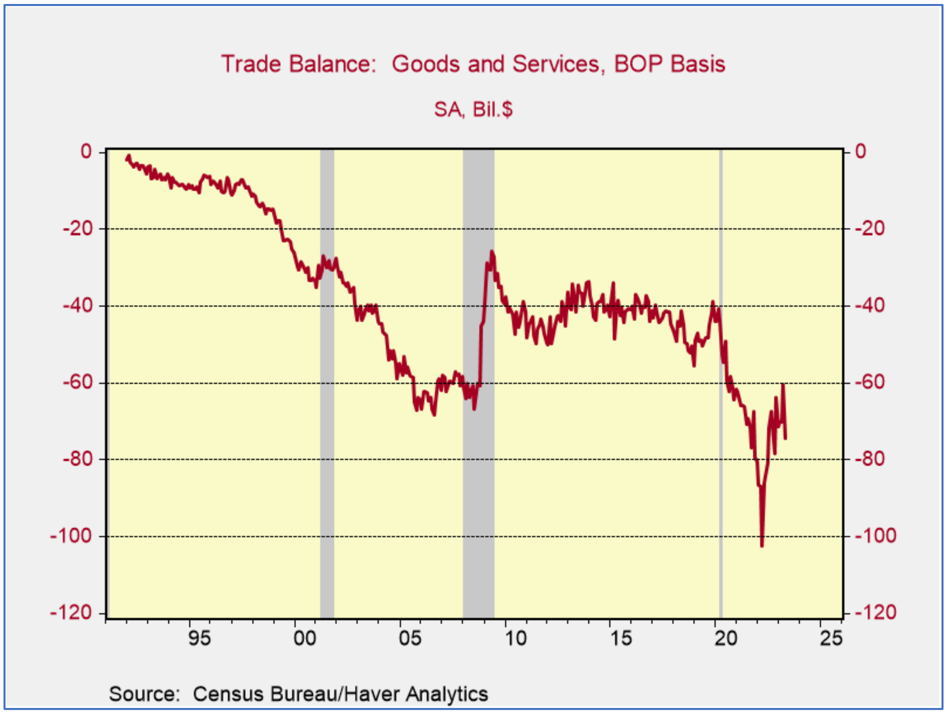
U.S. Labor Market: Teamsters President Sean O'Brien warned that his union will take a highly demanding, "militant approach" to negotiations with employers, including the upcoming talks for a new contract with UPS (UPS, $167.59). That contract expires on July 31, and O'Brien specifically warned that he would take the union out on strike if the company doesn't agree to universal pay rises, the end of an existing two-tier pay system, the installation of air conditioning into trucks, and other demands.

- The contract between the Teamsters and UPS is the country's biggest labor deal, covering some 340,000 drivers and package handlers.
- A strike at UPS could therefore have a significant impact on the economy, not only by disrupting activity for businesses and individuals, but also by further signaling to workers their improved bargaining power amid today's labor shortages.

U.S. Economic Releases

Residential demand remains subdued as interest rates continue to dissuade potential homebuyers. According to an index tracked by the Mortgage Bankers Association, mortgage applications fell 1.4% in the week ending June 2. The decline in loan requests is related to potential applicants not willing to pay the high borrowing costs. Last week, the average 30-year fixed-rate mortgage fell by 10 bps from 6.91% to 6.81%, close to a seven-month high. As a result, the MBA tracker for purchase applications fell 1.7% from the prior week, while refinance application fell 0.7% in the same period.

The U.S. deficit in goods and services widened less than expected in April. The trade shortfall widened from a revised $60.6 billion in March to $74.6 billion the following month. Consensus estimates showed that analysts were expecting a reading of $75.8 billion. The deficit grew due to an increase in imports and a decline in exports. In April, the value of goods and services imports rose 1.5% to $323.6 billion, while exports fell 3.6% to $249 billion.



The chart above shows the level of the trade balance. A widening trade deficit is a drag on GDP growth; thus, it raises the likelihood that the economy will contract in the second quarter. That said, a jump in imports reflects an increase in consumption which may be a signal that U.S. demand is still strong.

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**
15:00	Consumer Credit	m/m	Apr	$22.000b	$26.514b	*
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	Leading Economic Index	m/m	Apr P	97.6	977.0	96.9	**	Equity and bond neutral
Australia	GDP	q/q	1Q	2.3%	2.7%	2.6%	***	Equity and bond neutral
	Foreign Reserves	m/m	May	A$88.9b	A$92.4b		**	Equity and bond neutral
China	Foreign Reserves	m/m	May	$3176.5	$3204.80b	$3188.00b	**	Equity and bond neutral
	Exports	y/y	May	-7.5%	-8.5%	-1.8%	**	Equity bearish, bond bullish
	Imports	y/y	May	-4.5%	-7.9%	-8.0%	**	Equity bullish, bond bearish
	Trade Balance	m/m	May	$65.81b	$90.21b	$95.45b	***	Equity bearish, bond bullish
EUROPE								
Germany	Industrial Production WDA	y/y	Apr	1.6%	1.8%	2.3%	**	Equity bearish, bond bullish
France	Trade Balance	m/m	Apr	-9710m	-8023m	-8393m	**	Equity and bond neutral
	Current Account Balance	m/m	Apr	0.1b	1.4b	0.3b	**	Equity and bond neutral
Italy	Retail Sales	y/y	Apr	3.2%	5.8%		**	Equity bearish, bond bullish
Switzerland	Unemployment Rate	m/m	May	1.9%	2.0%	1.9%	**	Equity and bond neutral
	Foreign Currency Reserves	m/m	May	734.1b	732.2b		***	Equity and bond neutral
AMERICAS								
Canada	Building Permits	m/m	Apr	-18.8%	11.3%	-5.0%	**	Equity bearish, bond bullish
Mexico	International Merchandise Trade	m/m	Apr	203.020b	202.512b		**	Equity and bond neutral
Brazil	IBGE Inflation IPCA	y/y	May	3.94%	4.18%	4.04%	***	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)	551	550	1	Up
3-mo T-bill yield (bps)	513	513	0	Up
TED spread (bps)	38	37	1	Tightening
U.S. Sibor/OIS spread (bps)	523	522	1	Up
U.S. Libor/OIS spread (bps)	524	522	2	Up
10-yr T-note (%)	3.68	3.66	0.02	Flat
Euribor/OIS spread (bps)	348	349	-1	Up
Currencies	Direction			
Dollar	Down			Down
Euro	Up			Up
Yen	Up			Down
Pound	Up			Up
Franc	Up			Up

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.

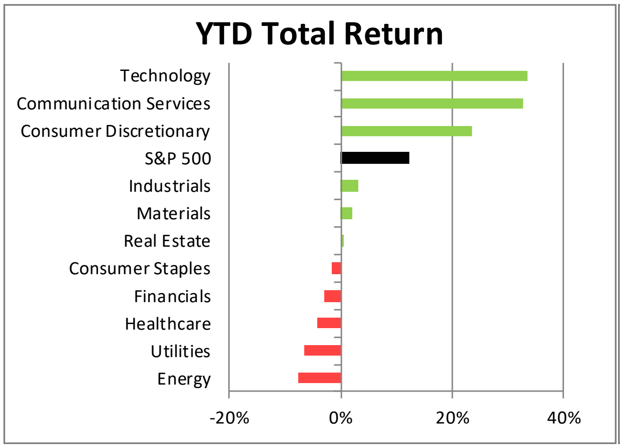
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$77.02	$76.29	0.96%	
WTI	$72.48	$71.74	1.03%	
Natural Gas	$2.31	$2.26	2.03%	
Crack Spread	$32.78	$32.71	0.23%	
12-mo strip crack	$25.34	$25.30	0.14%	
Ethanol rack	$2.61	$2.61	0.02%	
Metals				
Gold	$1,960.97	$1,963.52	-0.13%	
Silver	$23.59	$23.57	0.09%	
Copper contract	$378.65	$376.85	0.48%	
Grains				
Corn contract	$609.00	$608.00	0.16%	
Wheat contract	$629.25	$627.75	0.24%	
Soybeans contract	$1,358.00	$1,353.25	0.35%	
Shipping				
Baltic Dry Freight	1,016	939	77	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.5		
Gasoline (mb)		1.0		
Distillates (mb)		1.2		
Refinery run rates (%)		0.50%		
Natural gas (bcf)		116		

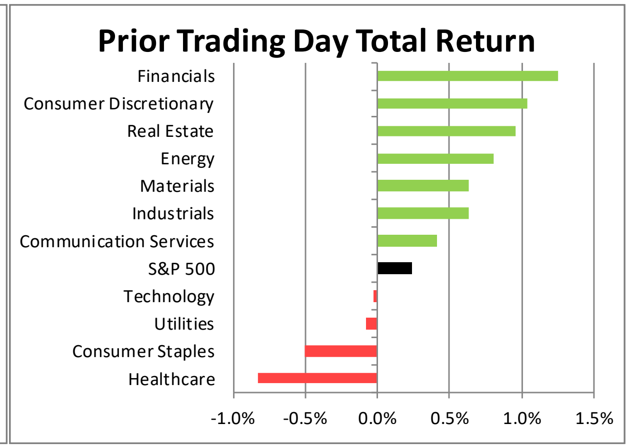
Weather

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 and Great Lakers region.

Data Section

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

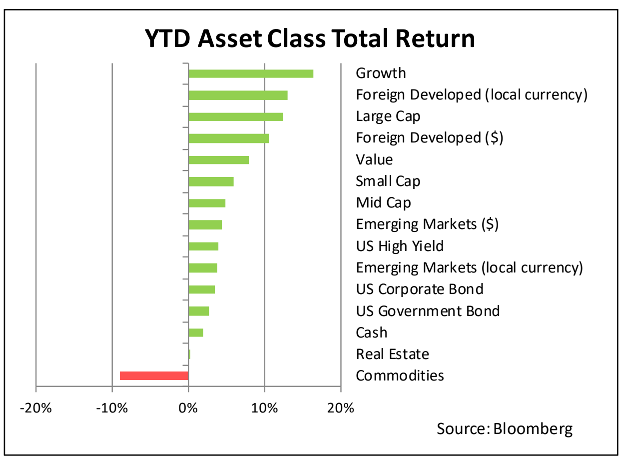




(Source: Bloomberg)

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 6/6/2023 close)

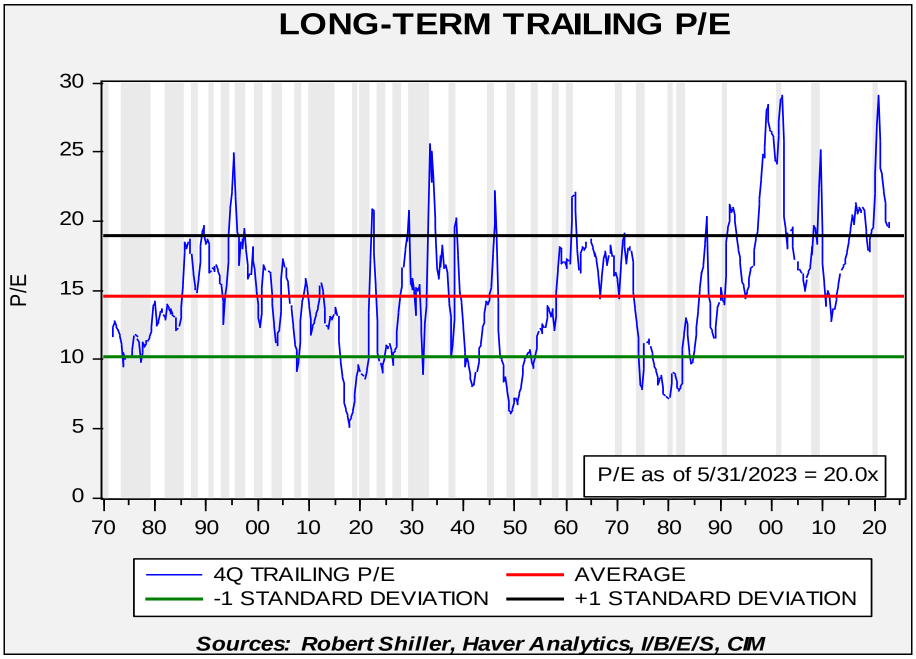


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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.