Confluence
INVESTMENT MANAGEMENT

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 20, 2023—9:30 AM EDT] Global equity markets are lower 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 1.2%. Chinese markets were down, with the Shanghai Composite closing down 0.5% from its previous close and the Shenzhen Composite down 0.1%. 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* (6/12/2023) (with associated podcast) "The Issue of the Terms of Trade"
- *Weekly Energy Update* (6/15/2023): The IEA is forecasting that we are near peak oil demand. We update the latest on the Nord Stream Pipeline sabotage and reports that Iran and the U.S. are talking about the nuclear deal.
- *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* (6/20/2023) (with associated podcast): "The Great Divergence"**
- *Confluence of Ideas* podcast (3/8/2023): "Reflections on Inflation"

Our *Comment* today opens with many China-related reports, including a recap of U.S. Secretary of State Blinken's weekend meetings in Beijing with top Chinese officials and a new report that Beijing and Havana are negotiating to establish a joint military training base in Cuba. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including a new conservative government in Finland and welcome signs that the U.S. financial markets are comfortably digesting the massive issuance of Treasury bills now that the federal debt limit has been lifted.

United States-China: In a bid to ease U.S.-China tensions, U.S. Secretary of State Blinken visited Beijing over the holiday weekend and held meetings with Foreign Minister Qin Gang, top diplomat Wang Yi, and President Xi Jinping. Afterward, both sides described the marathon talks as "candid" and "constructive." The meetings do look like they could cool tensions, but we doubt that they will appreciably shift the overall trajectory in bilateral relations, in which U.S. leaders feel like they have to respond to China's growing military and economic power and increasingly aggressive geopolitical stance. As we've written before, increased tensions are likely to further disrupt trade, investment, and technology flows, putting investors at risk.

- One key goal for the U.S. was to get bilateral communications back on track to reduce the risk of miscalculation and accident as Washington and Beijing compete ever more sharply in the military, diplomatic, economic, and technological spaces. The Chinese officials emphasized their commitment to taking back control of Taiwan and demanded that the U.S. not interfere with their development strategy.
- In something of a win for the U.S., the Chinese side agreed to send Qin to Washington for a reciprocal visit at an undetermined time in the future. However, they repeatedly rebuffed U.S. requests to re-establish military-to-military communications.
- The results of the meeting also look set to be overshadowed by a new example of Chinese aggressiveness reported this morning. According to the *Wall Street Journal*, Beijing and Havana are negotiating the establishment of a joint military training base on Cuba's northern coast. Such a base would imply that Chinese troops would be stationed less than 100 miles from Florida.
    - This and other recent developments suggest Chinese officials believe that taking ever more aggressive military steps against the U.S., even at the U.S. doorstep, will scare Washington into backing off China in the Indo-Pacific region.
    - Given that Republicans and Democrats in Washington share a strong and growing bipartisan sentiment that China is a threat, Beijing's approach is ripe for miscalculation. Faced with an aggressive move such as rotating Chinese combat troops through Cuba, domestic U.S. political pressure could conceivably force the administration to act. We therefore cannot discount the risk of an outright U.S.-China military crisis at some point, along with further disruptions in bilateral economic and financial ties.
- Finally, it's useful to remember that the risks for Western businesses in China don't all come from government action. New reporting shows Chinese consumers have also begun to shift their buying toward domestic brands, at least in part because those brands have improved their quality, service, and marketing techniques.

European Union-China: The European Commission today released a new economic security strategy that included a call for EU member states to consider restricting outbound investment into countries that could be a security risk. Although the document didn't specifically name China as a target, it was widely interpreted as being another example of how Brussels has swung around to embrace U.S. concerns about China, even if many of the EU's national governments are still resisting any substantial efforts to restrict trade or investment ties with Beijing.

China: Separately, Chinese officials continue to signal they plan to roll out a big economic stimulus package as the post-"Zero COVID" recovery peters out. For example, the State Council said its Friday meeting considered several new policies aimed at boosting "effective demand" in a "more powerful way." Such policies would buttress the central bank's interest-rate cuts last week and today's cut in bank prime loan rates. The question is whether President Xi will be willing to unleash enough new lending and spending to really rev up the economy, since doing so would worsen the structural challenges, like high debt, that Xi wants to bring under control. Reflecting the limited policy space for stimulus, several Western financial institutions have cut their forecast for Chinese economic growth in 2023, sparking a risk-off stance in markets today.

- Over the weekend, Goldman Sachs (GS, $338.31) cut its forecast for Chinese growth this year to 5.4%, compared with its earlier forecast of 6.0%.
- Similarly, UBS (UBS, $20.41) cut its forecast to 5.2% from 5.7% previously.

Finland: A coalition of right-wing parties has agreed to form a government with Petteri Orpo, the leader of the conservative National Coalition Party, as prime minister. Besides the NCP, the government will include the right-wing populist Finns Party, the Swedish People's Party, and the Christian Democratic Party. Altogether, the four parties hold 108 of the 200 seats in parliament.

U.S. Financial Markets: The Federal Reserve reported that utilization of its facility for reverse repurchase agreements, which allows money market funds to park cash with the Fed, last week fell below $2 trillion for the first time since June 2022. The drop in usage of the facility suggests money market funds have instead been buying up the large amounts of fresh U.S. Treasury bills that the government has been selling following the recent lifting of the federal debt limit.

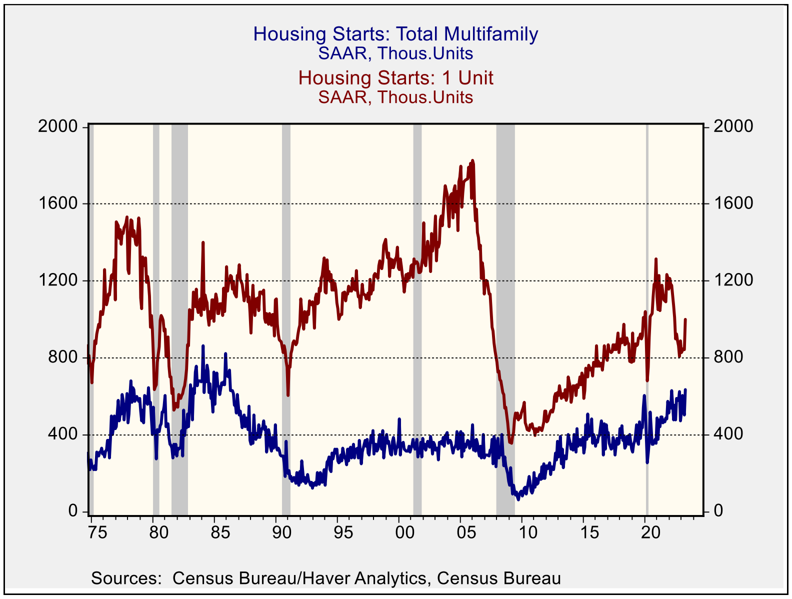
- Money market fund managers have likely been enticed by the yields of approximately 5.15% available on Treasury bills maturing in one or two months, since that beats the current repo rate of 5.05%. The bill buying by money market funds could help ease fears that high Treasury issuance to replenish government coffers might disrupt the markets.
- Nevertheless, risks remain, especially as the bulk of the new Treasury issuance is still to come. If money market funds and other investors can't digest all the new issuance, interest rates could jump to the point where they cause instability. In addition, if the Fed hikes its benchmark fed funds interest-rate target further, the reverse repo rate would also rise and might draw funds again from the money market funds and the banking system.

U.S. Defense Industry: According to data from PitchBook, venture capitalists in the U.S. have closed more than 200 defense and aerospace deals worth about $17 billion just in the first five months of 2023. That's more than all the deals in the sector in full-year 2019, illustrating how the war in Ukraine and the prospect of higher global defense spending has heightened investor interest in military-focused startups. We continue to believe that the trends will benefit both new and mature defense industry firms going forward, especially those focused on cutting-edge technologies.

- Notably, the wave of VC funding into defense startups is reportedly rivaling the activity in artificial intelligence.
- We find the VC surge into defense and artificial intelligence especially notable because high interest rates have sapped dealmaking in a wide range of other sectors.

U.S. Economic Releases

Residential construction activity accelerated in May by the most since 2016. The number of annualized housings starts increased from 1340k to 1631k last month, according to the Census Bureau. Meanwhile, building permits rose at annualize rate of 1491k in May, up from 1417k in the previous month. Both permits and starts beat consensus estimates of 1425k and 1400k, respectively.



The chart above shows the level of housing starts for multi- and single-family homes. New construction for multi-family dwellings jumped from 499k to 634k, while starts for single-family homes rose from 841k to 997k. The sharp increase reflects homebuilder confidence in future demand. Surveys collected by the National Association of Home Builders show that homebuilder sentiment is at its highest level in nearly a year.

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

Economic Releases		
No economic releases for the rest of today		
Federal Reserve		
EST	**Speaker or Event**	**District or Position**
11:45	John Williams and Michael Barr Speak on Leadership at NY Fed Event	New York FED President and FED Vice Chair

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	Industrial Production YoY	y/y	Apr F	0.7%	-0.3%		***	Equity bullish, bond bearish
	Capacity Utilization MoM	m/m	Apr	3.0%	0.8%		**	Equity bullish, bond bearish
	Machine tool orders	y/y	May F	-22.1%	-22.2%		**	Equity and bond neutral
New Zealand	Wespac Consumer Confidence	m/m	Q2	83.1	77.7		*	Equity and bond neutral
EUROPE								
Eurozone	Construction output	y/y	Apr	0.2%	-1.5%	-0.7%	*	Equity and bond neutral
Germany	PPI	y/y	Feb	1.0%	4.1%	1.7%	**	Equity and bond neutral
UK	Rightmove House Prices	m/m	Jun	1.1%	1.5%		**	Equity and bond neutral
Switzerland	Domestic Sight Deposits CHF	w/w	16-Jun	499.9b	498.3b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	16-Jun	510.6b	509.8b		*	Equity and bond neutral
	Real Exports	m/m	May	4.5%	-5.2%	-5.9%	*	Equity bullish, bond bearish
	Real Imports	m/m	May	-0.1%	-3.3%	-3.2%	*	Equity bullish, bond bearish
Russia	Gold and Forex Reserves	m/m	9-Jun	$585.7b	$585.0b		***	Equity and bond neutral
AMERICAS								
Canada	Industrial Product Price	m/m	May	-1.0%	-0.2%	-0.6%	**	Equity and bond neutral
	Raw Materials Price Incex	m/m	May	-4.9%	2.9%	1.8%	*	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)	551	551	0	Up
3-mo T-bill yield (bps)	506	508	-2	Up
TED spread (bps)	45	44	1	Tightening
U.S. Sibor/OIS spread (bps)	522	522	0	Up
U.S. Libor/OIS spread (bps)	523	522	1	Up
10-yr T-note (%)	3.76	3.77	-0.01	Flat
Euribor/OIS spread (bps)	355	357	-2	Up
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Flat			Up
Yen	Up			Down
Pound	Down			Up
Franc	Down			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.

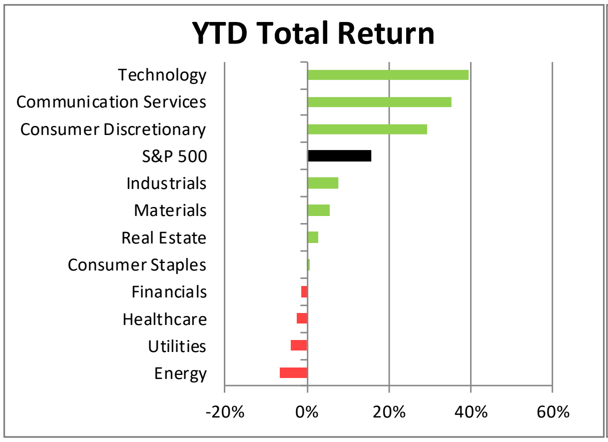
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$76.85	$76.09	1.00%	
WTI	$71.75	$71.78	-0.04%	
Natural Gas	$2.69	$2.63	2.05%	
Crack Spread	$37.64	$38.35	-1.84%	
12-mo strip crack	$26.89	$27.41	-1.92%	
Ethanol rack	$2.68	$2.68	0.07%	
Metals				
Gold	$1,951.49	$1,950.48	0.05%	
Silver	$23.81	$23.95	-0.60%	
Copper contract	$388.35	$389.85	-0.38%	
Grains				
Corn contract	$592.25	$597.50	-0.88%	
Wheat contract	$691.25	$701.50	-1.46%	
Soybeans contract	$1,332.00	$1,342.25	-0.76%	
Shipping				
Baltic Dry Freight	1,065	1,076	-11	

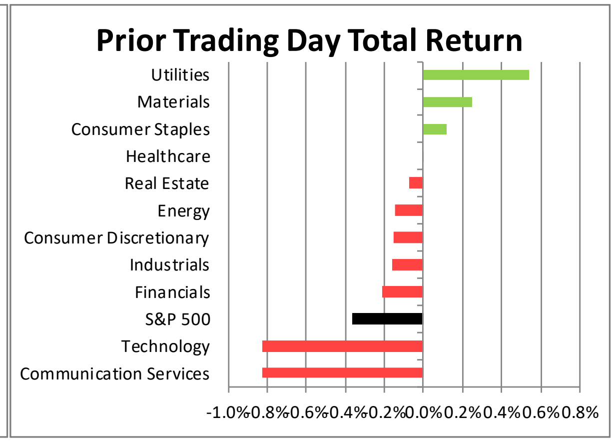
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout most of the country, with cooler-than-normal temps expected in the Mid-Atlantic region and Northern California. The precipitation outlook shows wetter-than-normal conditions in the Pacific Northwest, Midwest, and the New England regions, with dry conditions in the Southwest. There are two cyclone formations in the Atlantic Ocean but neither are expected to make landfall within the next 48 hours.

Data Section

U.S. Equity Markets – (as of 6/16/2023 close)

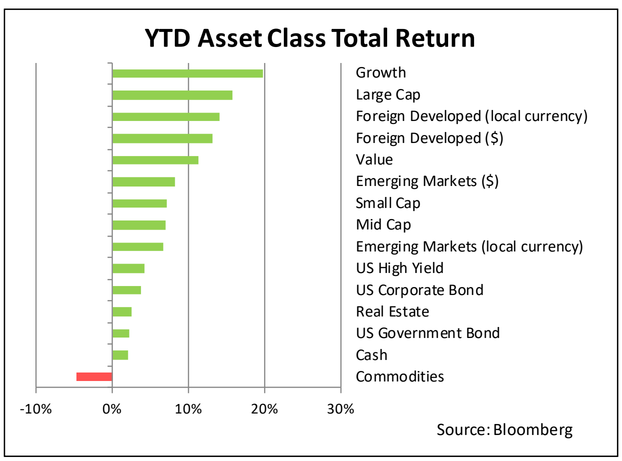




(Source: Bloomberg)

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 6/16/2023 close)

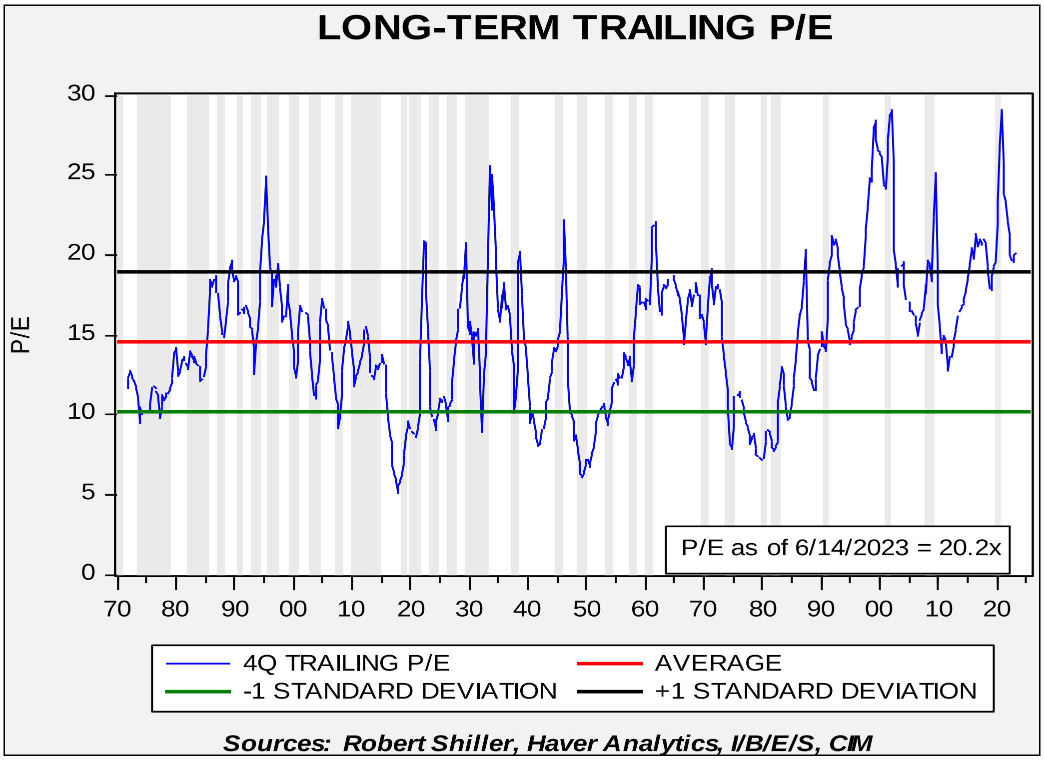


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 15, 2023



Based on our methodology,[1] the current P/E is 20.2x, up 0.2x from last week. Higher index values lifted 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.

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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.