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 23, 2023—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is currently down 0.5% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.0%. Chinese markets are closed for the Dragon Boat Festival holiday. 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:

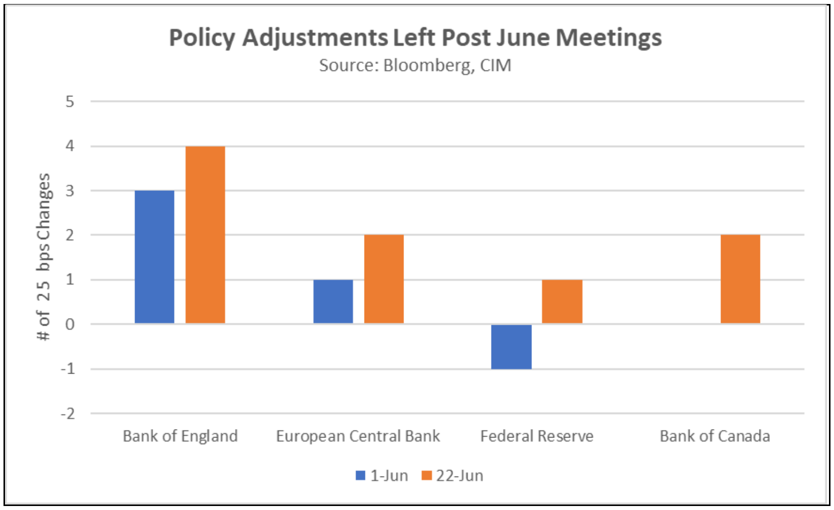
- *Bi-Weekly Geopolitical Report* (6/12/2023) (with associated podcast) "The Issue of the Terms of Trade"
- ***Weekly Energy Update* (6/22/2023): We discuss how the war in Ukraine has changed the global energy market and update the weekly oil inventory data.**
- *Asset Allocation Quarterly – Q2 2023* (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* (6/20/2023) (with associated podcast): "The Great Divergence"
- *Confluence of Ideas* podcast (3/8/2023): "Reflections on Inflation"

Good morning! Today's *Comment* begins with a discussion about the growing hawkishness of central banks in advanced economies. Next, we give our thoughts on the disappointing economic data coming out of Europe. Finally, we'll explain how the rivalry between the U.S. and China is leading countries to change their trade relationships.

Keeping Up the Fight: Markets are learning to accept that rates will be higher for longer.

- On Thursday, the Bank of England stunned investors with a larger-than-expected 50 basis point rate hike. It is the BOE's 13th rate hike since it began tightening its monetary policy in late 2021, and it is unlikely to be the last. Under fire due to concerns over the economic impact, BOE Governor Andrew Bailey warned that if the central bank does not get tough now, inflation could possibly get worse. Bailey's remarks reflect a hawkish trend among central banks in the developed world, as they grapple with the challenge of taming inflation without tipping their economies into recession.

- Equities dipped on Thursday as investors grew more convinced that central banks are serious about fighting inflation. The Euro Stoxx 50 and FTSE 100 finished the day down 0.5% and 0.8%, respectively. Meanwhile, the S&P 500 Equal Weight Index fell 0.4%, reflecting weakening sentiment among investors. The poor performance in stocks is related to market fears that interest rate hikes will hinder global GDP growth. Overnight index swaps show that traders have revised their expectations up for year-end hikes. As the chart below shows, major central banks are expected to end the year with policy rates of 25 bps or higher than their current levels.

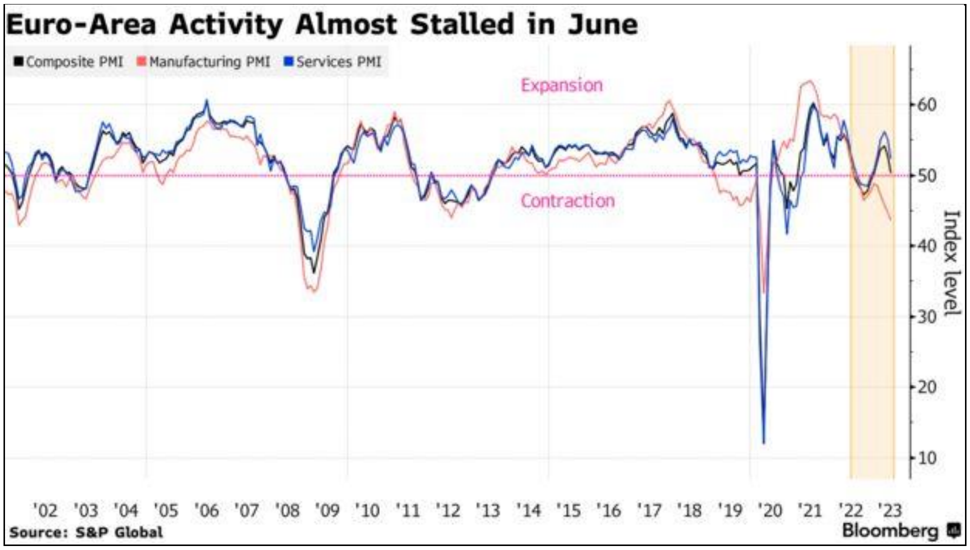


- Rising interest rates will encourage firms to be more profitable and provide investors with more value. This is because investors are increasingly prioritizing profitability over growth, as stocks now have a viable alternative in government bonds. However, growth companies are not completely out of the race. As the recent craze over AI has demonstrated, investors are still willing to buy stocks with a lot of upside potential. In the meantime, stocks should start to look more attractive over the next few months and should provide investors with opportunities in the medium- and long-term.

Recession Fears Abound: Property prices are under pressure, and economic activity is slowing in Europe.

- Higher interest rates are starting to weigh on real estate markets around the world. In Germany, the year-over-year change in housing prices fell 6.8% in the first quarter. The United States is also facing high levels of distress in commercial real estate properties, while the United Kingdom is trying to prevent a potential mortgage crisis. These problems are a reflection of the negative impact that the current monetary policy is having on the world economy, and they may be a potential sign that financial conditions are becoming too tight.
- The purchasing managers' index (PMI) from the eurozone is on the brink of contraction. The flash reading for the June composite PMI for the euro area slowed from 52.8 to 50.3,

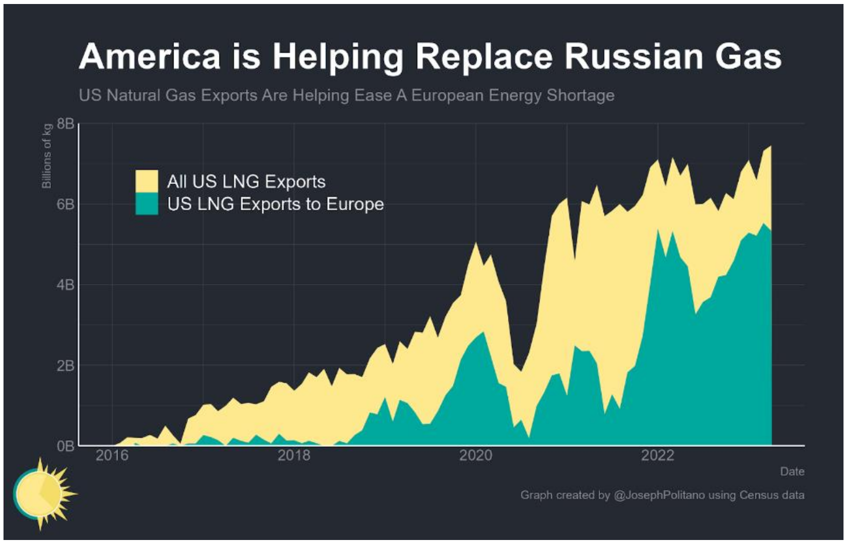
just above the 50-point threshold that separates growth from contraction. The slowdown was driven by a steep decline in manufacturing activity. Industrial output has been struggling as demand for goods has started to weaken. The drop in manufacturing activity will contribute to the decline in the economic output and may worsen if the country's energy supply is strained this winter.



- European central bankers are facing a difficult balancing act. They are concerned about inflation, which is well above the central bank's 2% target. However, they also worry that raising interest rates could further damage the eurozone economy. Fears that it may cause harm to consumers have led policymakers to push banks to increase the pay savers for their deposits. The potential income effect due to higher deposit rates could encourage the central bank to tighten for longer; however, it is not clear whether banks will listen.

Choosing Friends: The growing rivalry between the United States and China is pushing Asian and European allies to diversify their trade relationships and strengthen their security ties

- This is evident in South Korea, which has imported more goods from the United States than it has from China for the first time in almost two decades, and reflects the country's need to protect itself from a growingly hostile China. Beijing has pressured South Korea to reduce its reliance on the U.S. and Japan, but the country is resisting these efforts. In addition to improving trade ties with the U.S., South Korea has also looked to deepen defense ties with Japan.
- As Germany weans itself off Russian gas, it has signed a deal with the United States for liquefied natural gas (LNG). This is a significant shift in Germany's energy policy and shows how the country is looking to distance itself from Moscow following its invasion of Ukraine. The deal is also an example of the United States' emergence as an energy-exporting power. It has been a net exporter of natural gas since 2016 and is expected to export more oil than it imports later this year. The U.S.'s growing influence in the energy space will likely play a role in its ability to keep its trade partners on its side as it looks to compete with China.



[(Source: Joseph Politano)](#)

- We expect that China and the United States will use a carrot-and-stick approach to win over countries. The carrot will likely come in the form of increased market access and foreign direct investment for friendly countries. In contrast, the stick may come in the form of sanctions and trade restrictions. Even though many countries will look to resist having to choose a side between the two major powers, most will ultimately have to do so. This may mean that certain countries could face some backlash. At this time, it does not appear that either Washington or Beijing is willing to use its full might against potential detractors, but that could change over the next few years.

U.S. Economic Releases

There were no domestic releases scheduled prior to the publication of this report. 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
9:45	S&P Global Manufacturing PMI	m/m	Jun P	48.5	48.4	***
9:45	S&P Services PMI	m/m	Jun P	54.0	54.9	**
9:45	S&P Composite PMI	m/m	Jun P	53.5	54.3	**
11:00	Kansas City Fed Services Activity	m/m	Jun	--	3	*
Federal Reserve						
EST	Speaker or Event	District or Position				
14:00	Loretta Mester Delivers Closing Remarks at Policy Summit	President of the Federal Reserve Bank of Cleveland				

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	May	3.2%	3.5%	3.2%	***	Equity and bond neutral
	National CPI Ex-Fresh Food	y/y	May	3.2%	3.4%	3.1%	**	Equity and bond neutral
	National CPI Ex-Fresh Food & Energy	y/y	May	4.3%	4.1%	4.2%	*	Equity and bond neutral
	Jibun bank Composite PMI	m/m	Jun P	52.3	54.3		*	Equity and bond neutral
	Jibun Bank Manufacturing PMI	m/m	Jun P	49.8	50.6		***	Equity and bond neutral
	Jibun Bank Services PMI	m/m	Jun P	54.2	55.9		**	Equity and bond neutral
	Nationwide Dept Sales	y/y	May	6.3%	8.6%		*	Equity bearish, bond bullish
EUROPE								
Eurozone	HCOB Manufacturing PMI	m/m	Jun P	43.6	44.8	44.8	***	Equity bearish, bond bullish
	HCOB Composite PMI	m/m	Jun P	50.3	52.8	42.5	**	Equity bearish, bond bullish
	HCOB Services PMI	m/m	Jun P	52.4	55.1	54.5	**	Equity bearish, bond bullish
Germany	HCOB Manufacturing PMI	m/m	Jun P	41.0	43.2	43.5	***	Equity bearish, bond bullish
	HCOB Composite PMI	m/m	Jun P	50.8	53.9	53.3	*	Equity bearish, bond bullish
	HCOB Services PMI	m/m	Jun P	54.1	57.2	56.3	**	Equity bearish, bond bullish
France	HCOB Manufacturing PMI	m/m	Jun P	45.5	45.7	45.3	***	Equity and bond neutral
	HCOB Composite PMI	m/m	Jun P	47.3	51.2	51.0	*	Equity bearish, bond bullish
	HCOB Services PMI	m/m	Jun P	48.0	52.5	52.1	**	Equity bearish, bond bullish
UK	Retail Sales	y/y	May	-2.1%	-3.0%	-3.4%	***	Equity bullish, bond bearish
	Retail Sales Ex-Auto Fuel	y/y	May	-1.7%	-2.6%	-3.0%	**	Equity bullish, bond bearish
	S&P/CIPS Manufacturing PMI	m/m	Jun P	46.2	47.1	46.8	***	Equity and bond neutral
	S&P/CIPS Services PMI	m/m	Jun P	53.7	55.2	54.8	**	Equity bearish, bond bullish
	S&P/CIPS Composite PMI	m/m	Jun P	52.8	54.0	53.6	**	Equity bearish, bond bullish
Russia	Gold and Forex Reserves	m/m	16-Jun	$587.5b	$585.7b		***	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	16-Jun	17.9t	17.82t		*	Equity and bond neutral
AMERICAS								
Mexico	Aggregate Supply and Demand	y/y	1Q	5.4%	4.1%	4.2%	*	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)	554	552	2	Up
3-mo T-bill yield (bps)	512	514	-2	Up
TED spread (bps)	42	38	4	Tightening
U.S. Sibor/OIS spread (bps)	524	524	0	Up
U.S. Libor/OIS spread (bps)	524	524	0	Up
10-yr T-note (%)	3.74	3.80	-0.06	Flat
Euribor/OIS spread (bps)	360	357	3	Up
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Up
Yen	Flat			Down
Pound	Down			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Mexico Overnight Rate	11.25	11.250%	11.250%	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	$73.46	$74.14	-0.92%	
WTI	$68.73	$69.51	-1.12%	
Natural Gas	$2.62	$2.61	0.61%	
Crack Spread	$33.31	$33.47	-0.50%	
12-mo strip crack	$24.99	$25.18	-0.75%	
Ethanol rack	$2.80	$2.80	-0.14%	
Metals				
Gold	$1,919.49	$1,914.01	0.29%	
Silver	$22.38	$22.25	0.61%	
Copper contract	$384.20	$390.05	-1.50%	
Grains				
Corn contract	$605.00	$620.75	-2.54%	
Wheat contract	$742.00	$752.75	-1.43%	
Soybeans contract	$1,314.00	$1,339.50	-1.90%	
Shipping				
Baltic Dry Freight	1,216	1,138	78	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-3.8	0.5	-4.3	
Gasoline (mb)	0.5	0.8	-0.3	
Distillates (mb)	0.4	1.0	-0.6	
Refinery run rates (%)	-0.6%	-0.1%	-0.5%	
Natural gas (bcf)	95	90	5	

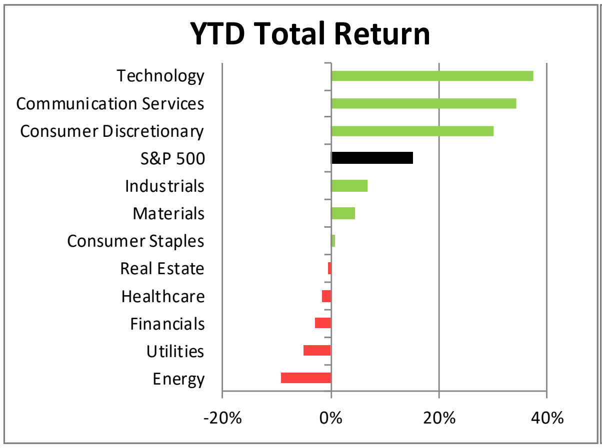
Weather

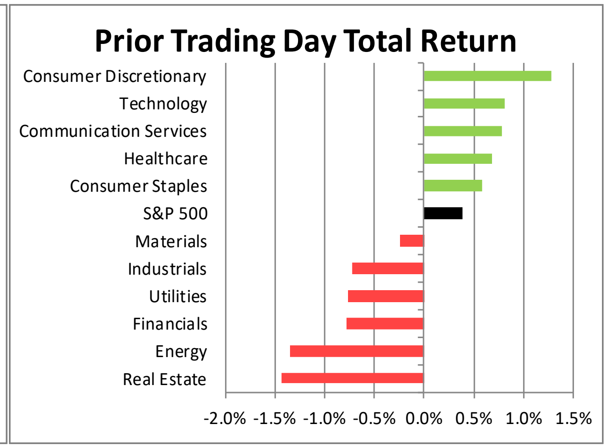
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for most of the country, with cooler-than-normal temperatures expected in the Mid-Atlantic. The precipitation outlook predicts wetter-than-normal conditions for most of the country, with drier conditions expected in the Southwest and Pacific regions.

There are two tropical cyclone formations in the Atlantic Ocean. TS Bret has moved into the Caribbean Sea and is headed toward the Windward Islands, meanwhile TS Cindy is moving northward but is not expected to make landfall.

Data Section

U.S. Equity Markets – (as of 6/22/2023 close)

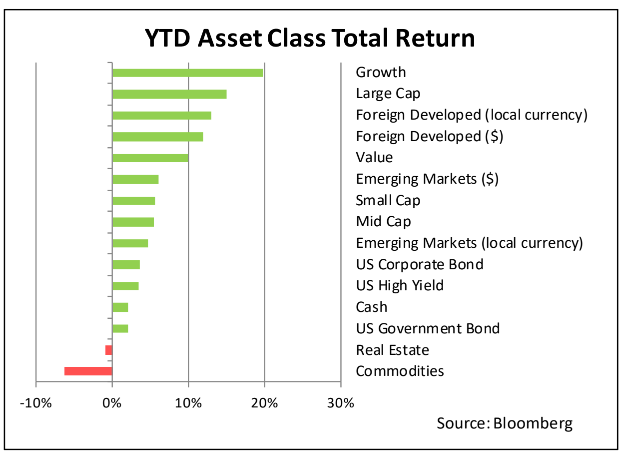




(Source: Bloomberg)

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 6/22/2023 close)

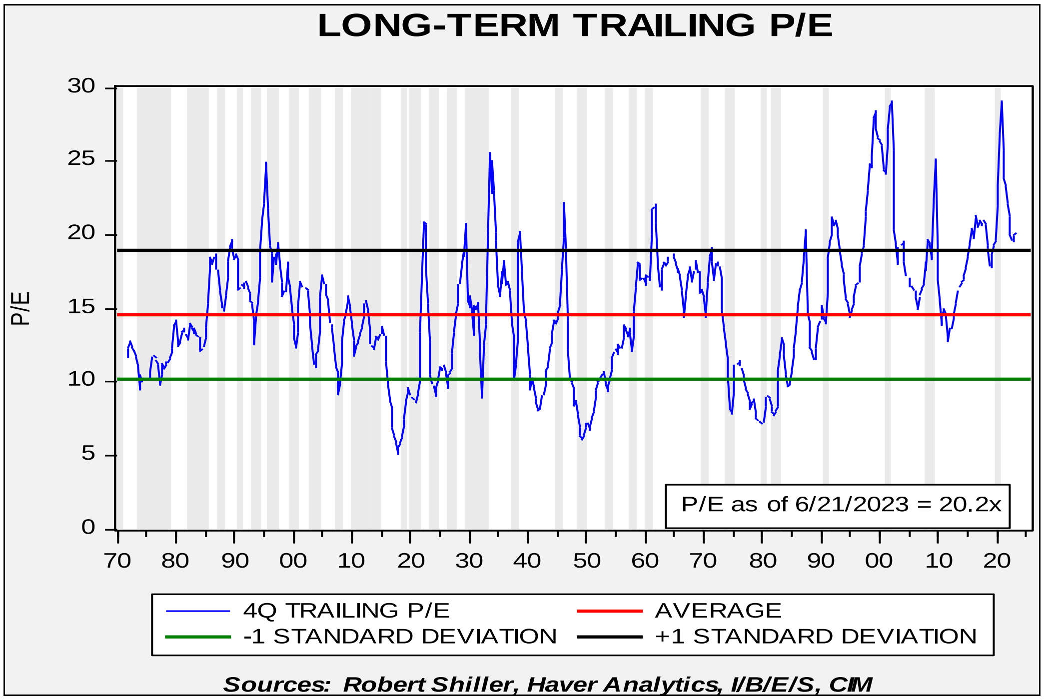


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 22, 2023



Based on our methodology,[1] the current P/E is 20.2x 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.