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 26, 2023—9:30 AM EDT] Global equity markets are generally lower this morning. In Europe, the Euro Stoxx 50 is currently up 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.5%. Chinese markets were down, with the Shanghai Composite closing down 1.5% from its previous close and the Shenzhen Composite down 1.8%. 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"

Our *Comment* today opens, understandably, with our observations on the rebellion in Russia over the weekend. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including a sharp drop in the value of the renminbi as the Chinese economy slows and expected details today on tens of billions of dollars in new subsidies for high-speed internet infrastructure in the U.S.

Russian Rebellion: The world this morning continues to digest the short-lived rebellion in Russia that was called off on Saturday. As we have often noted in our *Comment*, financier and oligarch Yevgeniy Prigozhin has had considerable success wielding his Wagner Group mercenaries in support of Russia's invasion of Ukraine, but he had increasingly come into tension with the leadership of the formal Russian military, most notably Defense Minister Shoigu and Chief of the General Staff Gerasimov. In recent weeks, President Putin appeared to throw his support more toward Shoigu and Gerasimov, leading to a presidential directive that would have brought the Wagner troops under their control starting July 1. In an apparent preemptive strike, Prigozhin and thousands of his soldiers on Friday launched a "march for justice" toward Moscow with the professed aim of removing Shoigu and Gerasimov. As Prigozhin and his troops took control of the headquarters of the Russian armed forces' Southern Military District, Putin denounced the march as "treason" and called for Prigozhin's arrest. However, with the Wagner troops almost two-thirds of the way from Ukraine to Moscow, Belarussian President Lukashenko mediated an agreement in which Putin lifted the arrest warrant and agreed to let Prigozhin escape to Belarus, while Prigozhin ended his march and agreed to allow at least some Wagner troops to be absorbed into the Russian military. The latest press reports indicate the Wagner troops are indeed returning southward.

- While the crisis has apparently been defused for the moment, it is not entirely clear that it is over for good. As of this writing, it appears that Shoigu, Gerasimov, and Prigozhin have still not made any new public appearances. It is also not entirely clear what the Putin-Prigozhin agreement entailed. We've seen at least one report saying that Prigozhin will be paid an enormous sum of money to go away, but it's entirely possible he has merely made a tactical retreat. Another report today suggested he still might be prosecuted for the insurrection.
- In very broad terms, the rebellion weakens Russia and probably helps Ukraine by undermining Russian troop morale. Below, we take a first cut at the losers and winners in the crisis, intertwined with some investment implications:
    - ***Russian President Putin: Strong Loser.*** The president's quick about-face in lifting his arrest warrant for Prigozhin, and his military's inability to stop the Wagner column from advancing northward, will likely weaken Putin severely. To the extent that the power-hungry clans around him smell blood in the water, Putin will now be more likely to face further political threats in the future. For investors, it's important to remember that Putin could well be replaced by an even more aggressive, nationalist leader, which would be negative for global assets.
    - ***Defense Minister Shoigu and Gen. Gerasimov: Losers.*** The price for Prigozhin's capitulation could well be that Shoigu and/or Gerasimov will be replaced in the near future. Whoever replaces them could notably shift Russia's approach to the war in Ukraine.
    - ***Wagner Chief Prigozhin: Modest Loser.*** Prigozhin's apparent cold feet and his acquiescence to allowing some of his troops to be brought under control of the formal military probably weakens him politically. He is also now possibly at elevated risk of being poisoned, pushed out of a window, or otherwise assassinated by Putin, Shoigu, Gerasimov, or their supporters. On the other hand, Prigozhin probably benefits if Shoigu and Gerasimov are indeed replaced. Prigozhin also benefits in terms of popular support. After all, it's notable that he and his troops apparently faced no popular opposition during the rebellion. Indeed, in video of his withdrawal from the Southern Military District headquarters, local citizens mobbed him like he was a rock star – a scene that will be most uncomfortable for Putin.

- *Chinese President Xi: Modest Loser.* As we've written many times before, Russia has become the junior partner in the evolving China-led geopolitical and economic bloc. After declaring a "no limits" partnership, President Xi now must face facts that Putin is a problem child that reflects poorly on China and could spark instability on China's northern border. On the other hand, a weakened Russia makes it easier for Xi to increase China's influence over the resource-rich states of Central Asia.
- ***Ukrainian President Zelensky: Modest Winner.*** Putin's weakness and Prigozhin's complaint that the invasion was made under false pretenses play into the hands of Ukraine and President Zelensky. Not only could the chaos of the rebellion offer an attractive opportunity to strike at the Russian invasion troops, but Zelensky will also be able to milk it for more political and military support from the West.
- ***Belarussian President Lukashenko: Winner.*** After several years when he was especially dependent on Russian support against his domestic political foes, Lukashenko's service in brokering the truce will probably make him a bit less subservient to Putin going forward.
- ***NATO: Winner.*** This new, dramatic example of Russian instability will probably further improve cohesion among the NATO members. Importantly, President Orban of Hungary and President Erdogan of Turkey may be forced to temper their sympathetic policies toward Russia. Erdogan could even become more inclined to lift his veto on Sweden's accession to NATO.
- ***Oil Prices: Winner.*** Political chaos in a major oil producer such as Russia is likely to heighten concerns over the stability of supplies. In turn, that's likely to boost global oil prices. So far this morning, Brent crude is trading higher by approximately 0.5% to $74.41 per barrel.

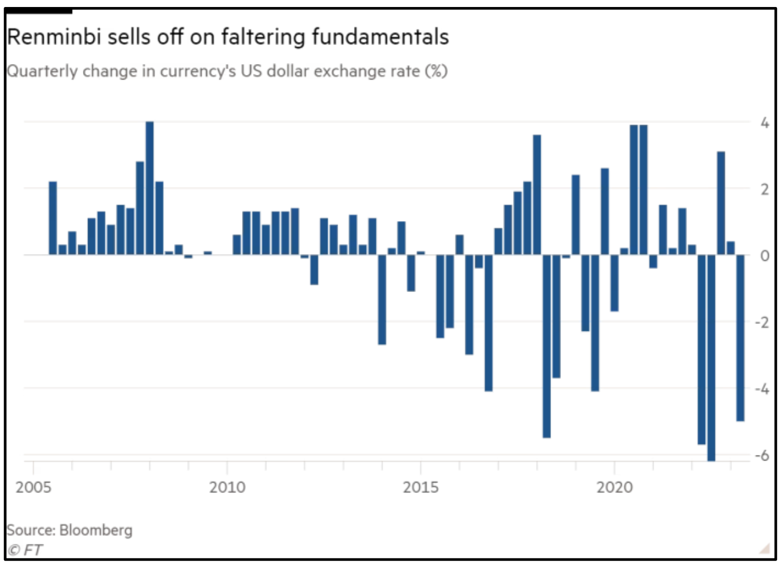
Turkey: The central bank yesterday eased its "security maintenance requirement," which requires banks to hold lira-denominated securities to back up their foreign-currency deposits. As one of President Erdogan's many unorthodox economic policies, the security maintenance requirement had aimed to discourage demand for foreign currencies and support the lira. The easing of the requirement is consistent with the way Erdogan's new finance minister and central bank chief have started to shift Turkish economic policy toward a more orthodox stance to help bring down inflation and stabilize the economy. We think the improvement in policy will be positive for Turkish assets going forward.

Greece: In parliamentary elections yesterday, the conservative New Democracy Party of Prime Minister Mitsotakis won an outright majority in parliament with 40.6% of the vote. Preliminary results suggest the left-wing opposition party Syriza came in second with 17.8% of the vote, which will probably prompt its leader, former Prime Minister Aléxis Tsípras, to resign. The center-left Pasok Party finished third with 11.9% of the vote. The results confirm that right-wing parties are now in the ascendency throughout much of Europe.

Guyana-OPEC: After recent discoveries of a huge oil field under their tiny nation on the northeastern coast of South America, officials in Guyana are reportedly fending off pressure to join the Organization of the Petroleum Exporting Countries (OPEC). The officials say their goal is to pump as much oil as quickly as possible in case electrification and green policies push down oil demand in the future. They fear that being a member of OPEC could require them to hold back output in order to boost prices.

- Major international oil companies already have more than $40 billion in oil projects planned for Guyana. Five of those projects alone are expected to pump more than one million barrels per day combined by the end of the decade.
- In contrast, a recent survey by the Dallas FRB showed that U.S. shale drillers are rapidly cutting their planned near-term expansions based on fears of falling commodity prices as the economy slows. In confirmation of that trend, other recent data show a decline in the number of drilling rigs operating in the U.S.

China: The renminbi today has fallen to a seven-month low versus the dollar, reflecting continued concerns about faltering Chinese economic growth. Slowing growth has already prompted the People's Bank of China to cut some key interest rates, even as the major developed country central banks keep hiking rates. So far this morning, the currency is down 0.7% to 7.2307 per dollar.



U.S. Defense Budget: In a letter to Defense Secretary Austin, several founders and investors in defense-focused technology companies warned that the Pentagon must improve how it procures high-technology systems from private firms to avoid falling behind U.S. adversaries such as China. The signatories propose a series of recommendations, such as providing $20 billion in additional spending toward corporate research and development projects and the creation of a $250 million bridge fund to help companies further develop technology that has been proven to work. The letter serves as a reminder that the long-term uptrend in defense budgets that we expect will benefit not only traditional defense contractors, but also software and other technology firms.

U.S. Broadband Subsidies: The White House today is expected to announce how much each state will receive out of the 2021 infrastructure bill's $42.5 billion in subsidies for broadband development. As required by the law, the disbursement plan will be based on a new, more accurate map of where high-speed internet service is missing. Funds are expected to start flowing to states and territories early next year and could fund projects as soon as mid-2024.

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
10:30	Dallas Fed Manufacturing Activity	m/m	Jun	-20.0	-29.1	**
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	PPI Services	m/m	May	1.6%	1.6%	1.8%	**	Equity and bond neutral
EUROPE								
Germany	IFO Business Climate	m/m	Jun	88.5	91.7	91.5	***	Equity bearish, bond bullish
	IFO Current Assessment	m/m	Jun	93.7	94.8	93.0	**	Equity and bond neutral
	IFO Expectations	m/m	Jun	83.6	88.6	88.3	**	Equity and bond neutral
Switzerland	Domestic Sight Deposits CHF	w/w	23-Jun	496.6b	499.9b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	23-Jun	508.0b	510.6b		*	Equity and bond neutral
AMERICAS								
Mexico	Economic Activity IGAE	y/y	Apr	2.2%	2.70%		**	Equity bearish, bond bullish
Brazil	FGV Consumer Confidence	y/y	Jun	92.3	88.2		*	Equity and bond neutral
	Current Account Balance	m/m	May	$649m	-$1680m	-$1250m	**	Equity and bond neutral
	Foreign Direct Investment	m/m	May	$5380m	$3312m	$6750m	**	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	554	0	Up
3-mo T-bill yield (bps)	513	514	-1	Up
TED spread (bps)	41	40	1	Tightening
U.S. Sibor/OIS spread (bps)	523	523	0	Up
U.S. Libor/OIS spread (bps)	524	523	1	Up
10-yr T-note (%)	3.69	3.74	-0.05	Flat
Euribor/OIS spread (bps)	361	360	1	Up
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Up			Down
Pound	Flat			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	$74.41	$73.85	0.76%	
WTI	$69.62	$69.16	0.67%	
Natural Gas	$2.73	$2.73	-0.04%	
Crack Spread	$32.60	$32.48	0.38%	
12-mo strip crack	$24.68	$24.64	0.17%	
Ethanol rack	$2.79	$2.79	-0.13%	
Metals				
Gold	$1,931.76	$1,921.20	0.55%	
Silver	$22.83	$22.43	1.81%	
Copper contract	$382.35	$381.55	0.21%	
Grains				
Corn contract	$587.50	$588.00	-0.09%	
Wheat contract	$765.25	$746.50	2.51%	
Soybeans contract	$1,319.00	$1,310.00	0.69%	
Shipping				
Baltic Dry Freight	1,240	1,216	24	

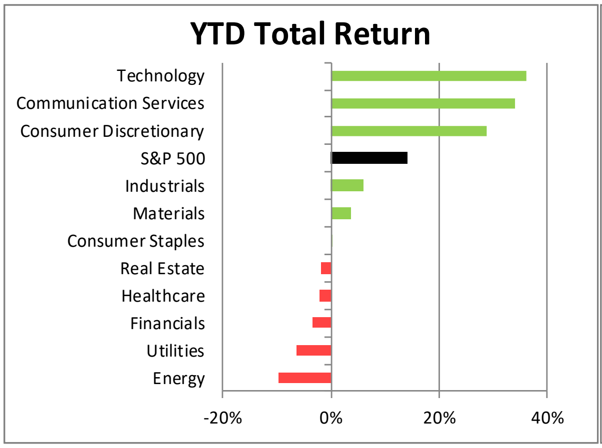
Weather

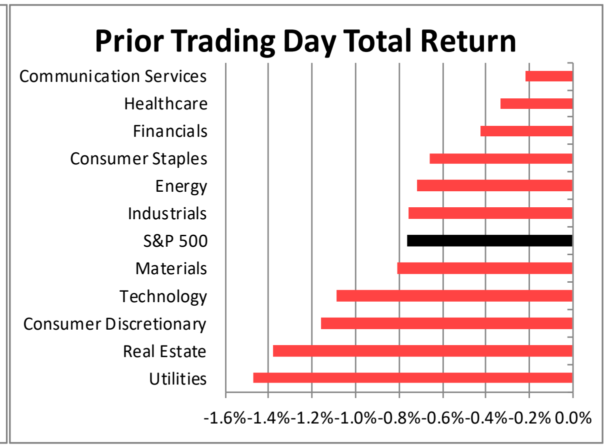
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for most of the country, with cooler-than-normal temperatures expected in the Mid-Atlantic and Great Plains regions. The precipitation outlook predicts wetter-than-normal conditions for most of the country, with drier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

There are currently no cyclone formations expected within the next 48 hours.

Data Section

U.S. Equity Markets – (as of 6/23/2023 close)

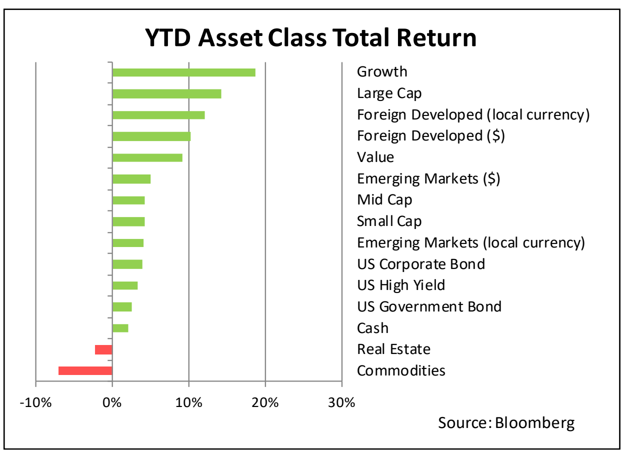




(Source: Bloomberg)

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 6/23/2023 close)

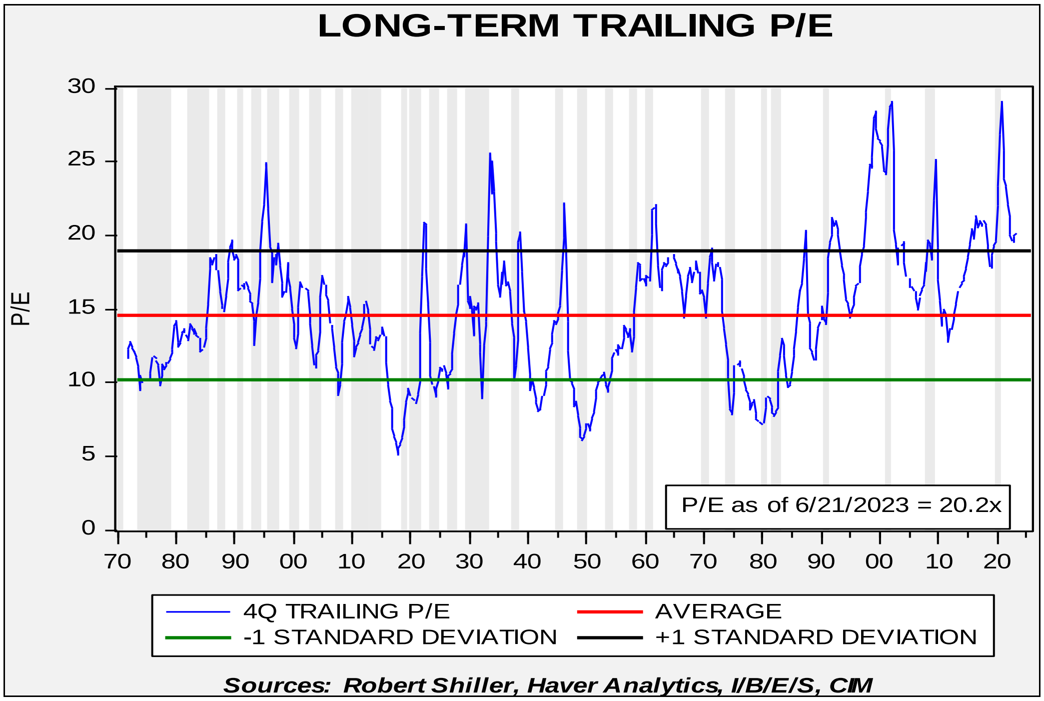


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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.