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 30, 2023—9:30 AM EDT] Global equity markets are generally higher this morning. In Europe, the Euro Stoxx 50 is currently up 0.8% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.1%. Chinese markets were up, with the Shanghai Composite closing up 0.6% from its previous close and the Shenzhen Composite up 1.08%. 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* (6/26/2023) (with associated podcast): "Distinguishing My Wife From a Hat, an AI Story"
- *Weekly Energy Update* (6/29/2023): Although the attempted coup in Russia made headlines, its impact on the oil markets was barely noticed. Guyana is rejecting OPEC membership, and oil inventories continue to decline.
- *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"
- ***Business Cycle Report* (6/29/2023)**

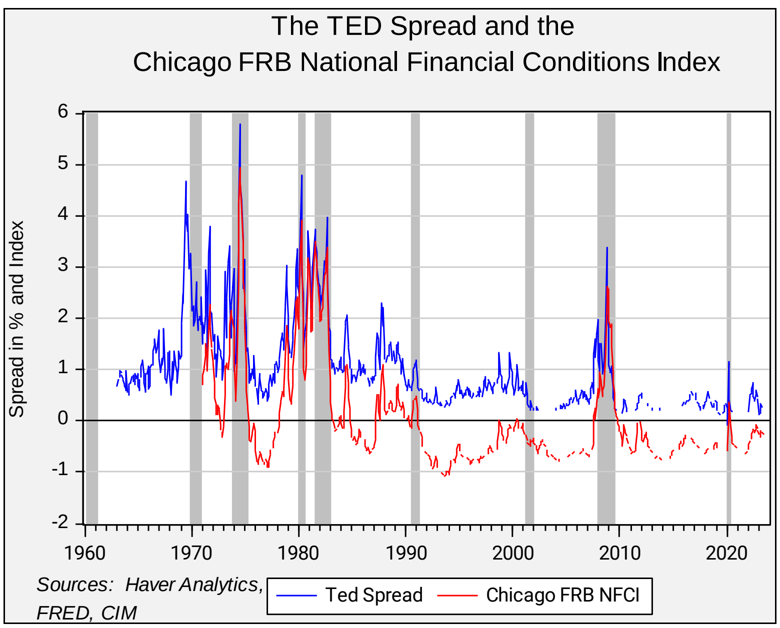
Good morning! Today's *Comment* begins with a farewell to LIBOR and ends with a few comments on the overnight news.

The End of LIBOR: As of today, the use of the London Interbank Offering Rate, or LIBOR, will end. LIBOR developed in London as an ad hoc arrangement in 1969 to set the rate on an $80 million syndicated loan to the Shah of Iran. By the mid-1980s, the process of establishing the LIBOR rate was formalized by the British Bankers Association (BBA). A set of London banks would submit their borrowing rates for 15 different maturities and up to 10 different currencies. The LIBOR rate originally was tied to the Eurodollar market, which represented unregulated dollar deposits held offshore, but over time (especially with the end of Regulation Q in the U.S., which set deposit rates), LIBOR was designed to reflect bank cost of funds. The BBA would calculate a trimmed-mean average by removing the top and bottom four rates.

During the Great Financial Crisis, it was discovered that banks were manipulating the submissions to help their respective institutions and, in the most egregious cases, encouraging other banks to do the same as "a favor." Because LIBOR was the rate tied to the Eurodollar futures market, this manipulation ran afoul of U.S. commodity trading regulations. In the wake of the scandal, the Federal Reserve and other regulators moved to end LIBOR and shifted to the Secured Overnight Financing Rate (SOFR). And so, effective today, LIBOR is no longer being calculated and will not be available for loans.

What are the ramifications?

We lose a market indicator: For years, one of the key indicators of market stress was the T-bill over Eurodollar spread, commonly called the "TED spread." Since LIBOR represented non-government guaranteed dollar deposits, there was credit risk embedded in the rate. Market participants began to notice that when credit stress developed in the financial markets, the TED spread would widen, with LIBOR rates rising above T-bill rates.



The Chicago FRB National Financial Conditions index rises when financial stress develops. As the chart shows, the TED spread tends to widen when stress increases; in fact, the two series are correlated at 92.6%. Since the SOFR rate is secured lending, meaning it is collateralized by a safe asset, it should not exhibit the same reaction to financial stress. Essentially, the SOFR/T-bill spread will not likely exhibit the same characteristics as the TED spread, meaning that traders and investors will lose the TED spread as a market indicator.

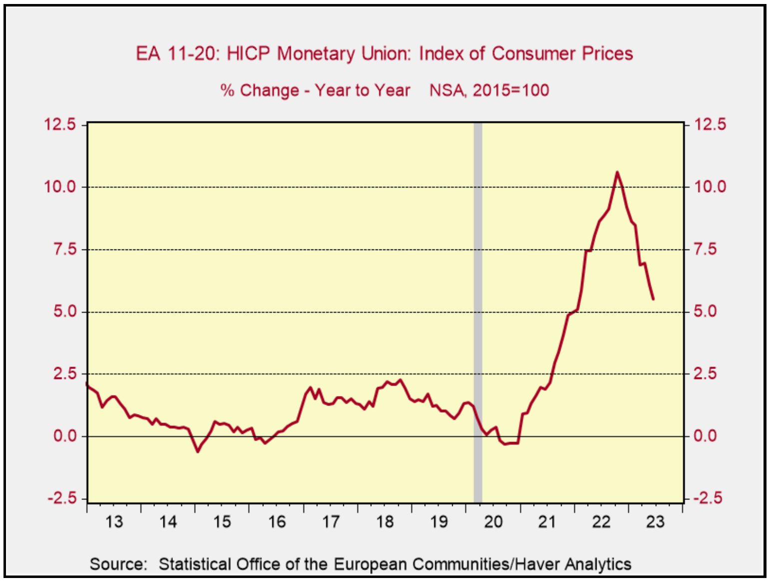
Banks will lose a buffer: Bank loans are often tied to LIBOR as a base rate. A typical floating loan is LIBOR plus a spread. Since LIBOR rates would rise during periods of financial stress, banks were provided a modicum of protection from such events. In other words, the rate on LIBOR-based loans would rise as stress levels rose. Assuming the borrower remains current, the rise in the loan's rate would exceed the level of the risk-free rate by a wider margin. This protection would allow banks to offer more competitive rates to borrowers, knowing that the lender had some protection from financial stress events. Since SOFR is collateralized, the rate relative to the risk-free rate shouldn't rise when credit conditions deteriorate. Eventually, we would expect loan pricing to change to reflect the shift.

Credit lines could be utilized during periods of stress: Banks routinely issue credit lines to corporate borrowers, assuming few will use them. Tying the credit line to a LIBOR rate tended to discourage credit line use because (as noted above) the LIBOR rate would rise when credit conditions weakened. Since SOFR is secured, the rate probably won't rise when stress emerges, which may encourage the use of credit lines just at the moment when banks would rather see them lay dormant.

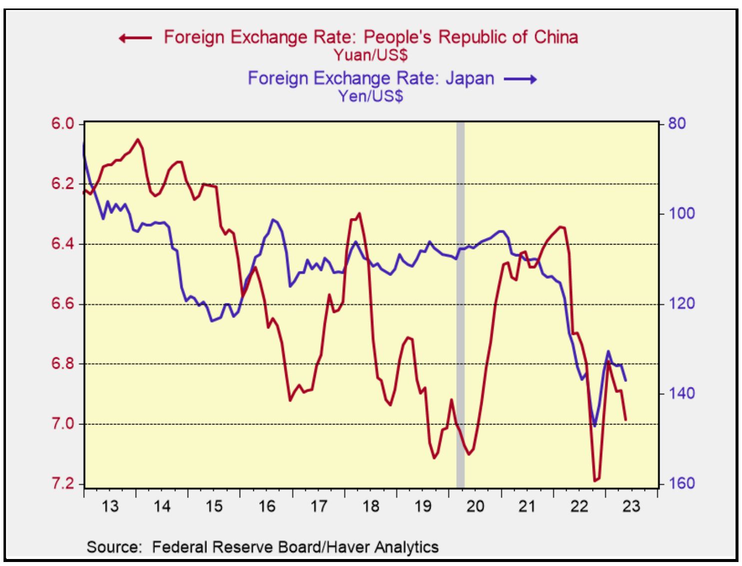
At the end of May, some $700 billion of high-yield loans remained priced at LIBOR. We do expect some loans will slip through the deadline. The rate behavior of these loans will depend on the loan covenants in place. It is not inconceivable that the loans become essential fixed rate at today's closing LIBOR rate. Although the financial industry has had ample time to adjust and prepare, some issues may still emerge. But, as we note above, the bigger issue is that this change could lead banks to inadvertently take risk. From our perspective, the loss of the TED spread is a disappointment; although other credit signals exist, the TED spread was an easily accessible way to view financial stress. *Adieu*, TED…

In Other News: Inflation is falling in the Eurozone, and currencies in the two largest Asian economies are plummeting against the dollar. Meanwhile, France is still trying to get protests under control.

- June CPI for the Eurozone declined from 6.1% to 5.5%. The reading was lower than the consensus estimate of 5.6% but still above the European Central Bank's 2% target. Although the decline will be welcomed by the central bank, it is unlikely to dissuade policymakers from further tightening. The ECB has raised rates in eight consecutive meetings and is expected to do so again in July and September. Futures contracts show that traders are pricing in an additional rate increase of 50 bps by the end of the year.

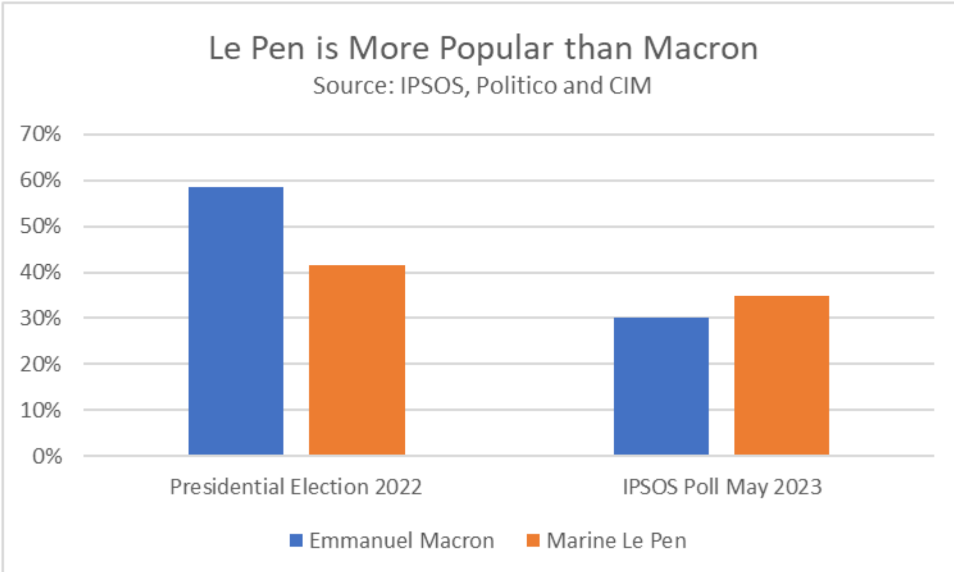


- Japanese and Chinese currencies are weakening relative to the dollar for opposite reasons. The yen is weakening as traders doubt that the Bank of Japan (BOJ) will tighten monetary policy to counteract rising inflation. In contrast, the yuan has dropped as China's central bank, the People's Bank of China (PBOC), refuses to provide sufficient stimulus to support its struggling economy. The currency weakness has led the PBOC to [intervene through fixing to support the yuan] and is expected to lead to action from the BOJ.



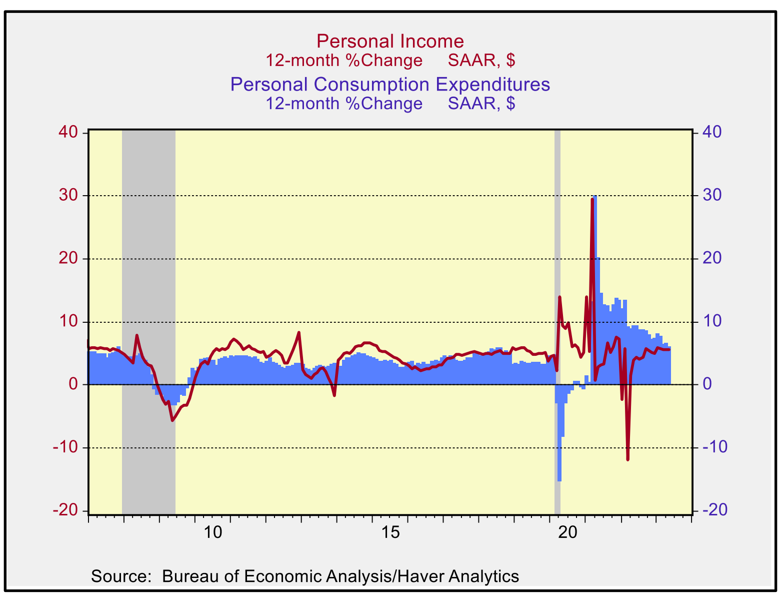
The chart above is inverted to show that an increase in the price of a U.S. dollar in another currency reflects a depreciation.

- In France, President Emmanuel Macron is struggling to contain protests following a police shooting of an unarmed teenager. [Over 875 people were arrested in France on Friday] in the third consecutive night of protests. Prime Minister Elisabeth Borne is considering setting up a crisis meeting to deal with the situation. The unrest in France is likely to further diminish President Macron's popularity, which was already hurt by his handling of pension reforms and other protests.

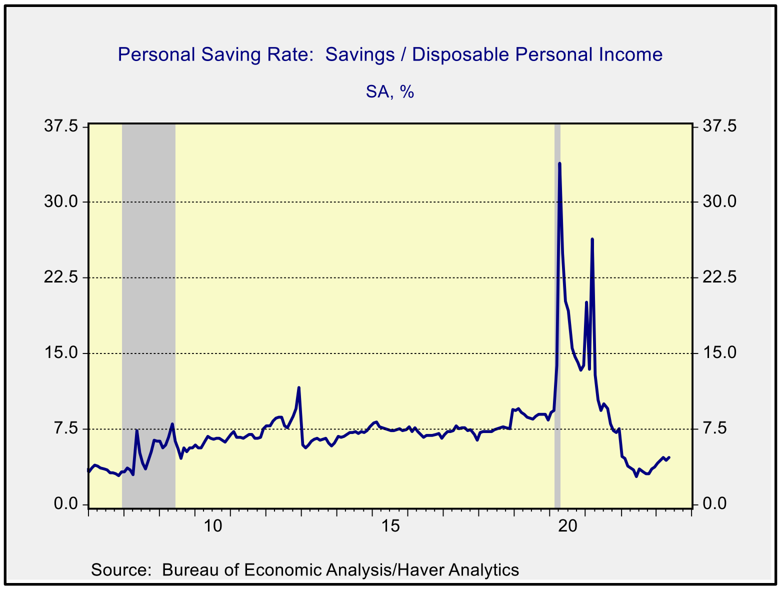


U.S. Economic Releases

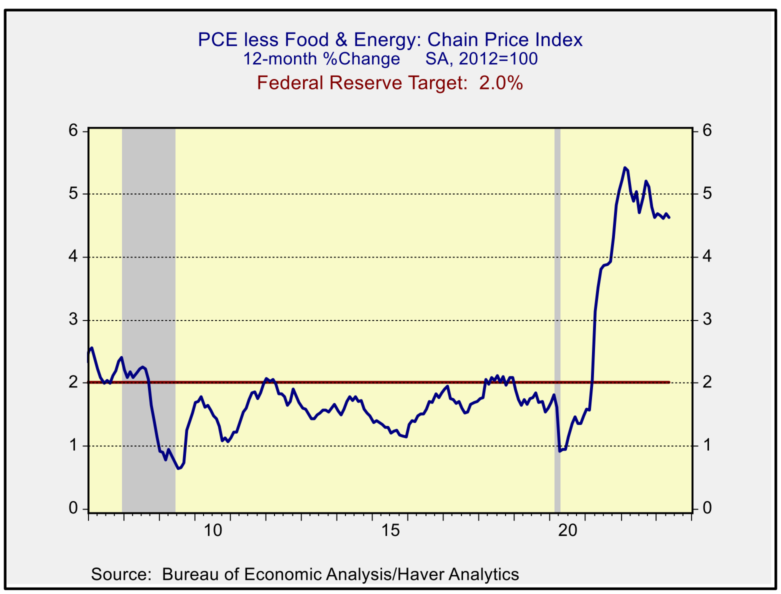
May ***personal income*** rose by a seasonally adjusted 0.4%, beating expectations that it would merely match the previous month's revised increase of 0.3%. In contrast, the report showed that May ***personal consumption expenditures (PCE)*** rose just 0.1%, short of the anticipated rise of 0.2% and much weaker than the revised April rise of 0.6%. Compared with May 2022, personal income was up 5.5%, while PCE was up 6.0%. The chart below shows the year-over-year change in personal income and PCE since just before the prior recession.



The personal income and spending report also includes a measure of ***personal saving***, defined as disposable (after-tax) income less consumption spending on goods and services. With incomes up more than spending, the May personal savings rate rose to a seasonally adjusted 4.6%. The chart below shows how the personal savings rate has fluctuated since just before the previous recession.



Finally, the income and spending report includes the Federal Reserve's preferred measure of consumer price inflation. After stripping out the volatile food and energy components, the report showed that the ***Core PCE Deflator*** for May was up 4.6% from the same month one year earlier, which was slightly better than expectations that the year-over-year rise would match the 4.7% registered in April. Nevertheless, inflation measured by the Core PCE Deflator remains far above the Fed's target of 2.0%. The chart below shows the year-over-year change in the Core PCE Deflator since just before the prior recession.



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

Economic Releases						
9:45	MNI Chicago PMI	m/m	Jun	43.8	40.4	***
10:00	U. of Michigan Consumer Sentiment	m/m	Jun F	63.9	63.9	***
10:00	U. of Michigan Current Conditions	m/m	Jun F	68.0	68.0	**
10:00	U. of Michigan Future Expectations	m/m	Jun F	61.3	61.3	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Jun F	3.3%	3.3%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Jun F	3.0%	3.0%	*
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	Jobless Rate	m/m	May	2.6%	2.6%	2.6%	***	Equity and bond neutral
	Job-To-Applicant Ratio	m/m	May	1.31	1.32	1.32	**	Equity and bond neutral
	Tokyo CPI	y/y	Jun	3.1%	3.2%	3.4%	**	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food	y/y	Jun	3.2%	3.2%	3.1%	***	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food & Energy	y/y	Jun	3.8%	3.9%	4.0%	*	Equity and bond neutral
	Industrial Production YoY	y/y	May P	4.7%	-0.7%	4.3%	***	Equity and bond neutral
	Housing Starts	y/y	May	3.5%	-11.9%	-2.7%	**	Equity bullish, bond bearish
	Annualized Housing Starts	y/y	May	-0862m	0.771m	0.818m	*	Equity and bond neutral
Australia	Private Sector Credit	y/y	May	6.2%	6.6%	6.7%	**	Equity and bond neutral
South Korea	Industrial Production	y/y	May	-7.3%	-8.9%	-9.0%	***	Equity bullish, bond bearish
China	Official Manufacturing PMI	m/m	Jun	49.0	48.8	49.0	***	Equity and bond neutral
	Official Services PMI	m/m	Jun	53.2	54.5	53.5	**	Equity and bond neutral
EUROPE								
Eurozone	CPI	y/y	Jun	5.5%	6.1%	5.6%	***	Equity and bond neutral
	Core CPI	y/y	Jun P	5.4%	5.3%	5.5%	**	Equity and bond neutral
	Unemployment Rate	m/m	May	6.5%	6.5%	6.5%	**	Equity and bond neutral
Germany	Import Price Index	y/y	May	-9.1%	-7.0%	-9.2%	**	Equity and bond neutral
	Retail Sales	y/y	May	-5.1%	-8.6%	-8.4%	*	Equity bullish, bond bearish
Germany	Unemployment Change	m/m	Jun	28.0k	9.0k	13.0k	***	Equity bearish, bond bullish
	Unemployment Claims Rate	m/m	Jun	5.7%	5.6%	5.6%	**	Equity and bond neutral
France	CPI	y/y	Jun P	4.5%	5.1%	4.6%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Jun P	5.3%	6.0%	5.4%	**	Equity and bond neutral
	PPI	y/y	May	5.8%	7.0%		*	Equity bearish, bond bullish
Italy	Unemployment Rate	m/m	May	7.6%	7.8%	7.9%	**	Equity and bond neutral
UK	Nationwide House Price Index	y/y	Jun	-3.5%	-3.4%	-4.0%	***	Equity and bond neutral
	GDP	y/y	1Q F	0.2%	0.2%	0.2%	***	Equity and bond neutral
Switzerland	KOF Leading Indicator	m/m	Jun	90.8	90.2	91.4	**	Equity bearish, bond bullish
	Real Retail Sales	y/y	May	-1.1%	-3.7%	-4.0%	**	Equity bullish, bond bearish
Russia	Gold and Forex Reserves	m/m	23-Jun	$586.9b	$587.5b		***	Equity and bond neutral
AMERICAS								
Mexico	Unemployment Rate NSA	m/m	May	2.93%	2.82%	2.80%	***	Equity and bond neutral
Brazil	Formal Job Creation	m/m	May	155.7m	180.0m	190.5m	**	Equity and bond neutral
	Net Debt % GDP	m/m	May	57.8	57.2	57	**	Equity and bond neutral
	National Unemployment Rate	m/m	Mar	8.3%	8.5%	8.3%	*	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	553	1	Up
3-mo T-bill yield (bps)	517	518	-1	Up
TED spread (bps)	37	34	3	Neutral
U.S. Sibor/OIS spread (bps)	527	526	1	Up
U.S. Libor/OIS spread (bps)	528	527	1	Up
10-yr T-note (%)	3.87	3.84	0.03	Flat
Euribor/OIS spread (bps)	359	360	-1	Up
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Flat			Up
Yen	Flat			Down
Pound	Up			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	$74.43	$74.34	0.12%	
WTI	$69.89	$69.86	0.04%	
Natural Gas	$2.66	$2.70	-1.41%	
Crack Spread	$33.61	$33.76	-0.45%	
12-mo strip crack	$25.21	$25.25	-0.15%	
Ethanol rack	$2.68	$2.70	-0.70%	
Metals				
Gold	$1,905.40	$1,908.20	-0.15%	
Silver	$22.42	$22.56	-0.63%	
Copper contract	$370.90	$369.90	0.27%	
Grains				
Corn contract	$529.50	$528.50	0.19%	
Wheat contract	$670.00	$667.50	0.37%	
Soybeans contract	$1,279.50	$1,265.75	1.09%	
Shipping				
Baltic Dry Freight	1,112	1,138	-26	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-9.6	-1.5	-8.1	
Gasoline (mb)	0.6	1.0	-0.4	
Distillates (mb)	0.1	0.9	-0.8	
Refinery run rates (%)	-0.9%	0.4%	-1.3%	
Natural gas (bcf)	76	82	-6	

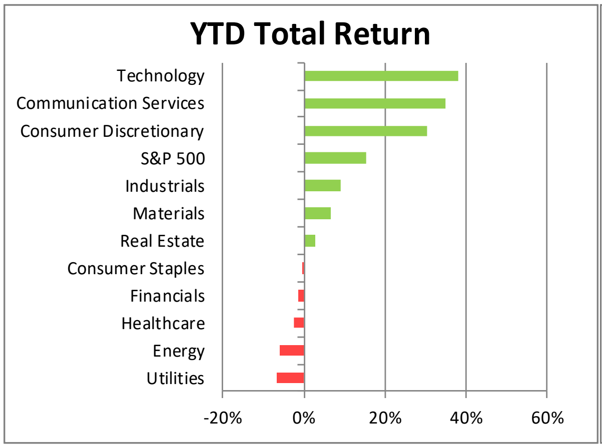
Weather

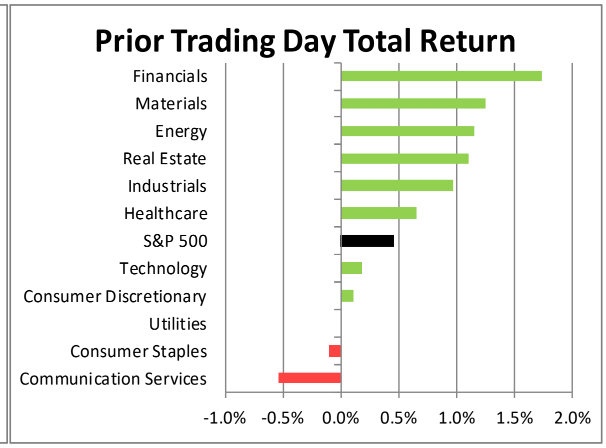
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in the Pacific Northwest, the Southwest, and the Southeast, with cooler-than-normal temperatures expected in the Great Plains. The forecasts call for wetter-than-normal conditions in the eastern two-thirds of the country, with dry conditions in the Southwest.

There is currently a tropical disturbance far off the East Coast, but it is assessed to have only a 10% chance of forming a cyclone within the next 48 hours.

Data Section

U.S. Equity Markets – (as of 6/29/2023 close)

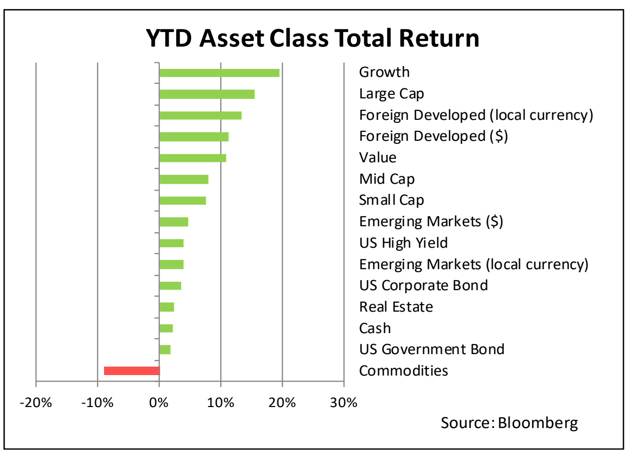




(Source: Bloomberg)

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 6/29/2023 close)

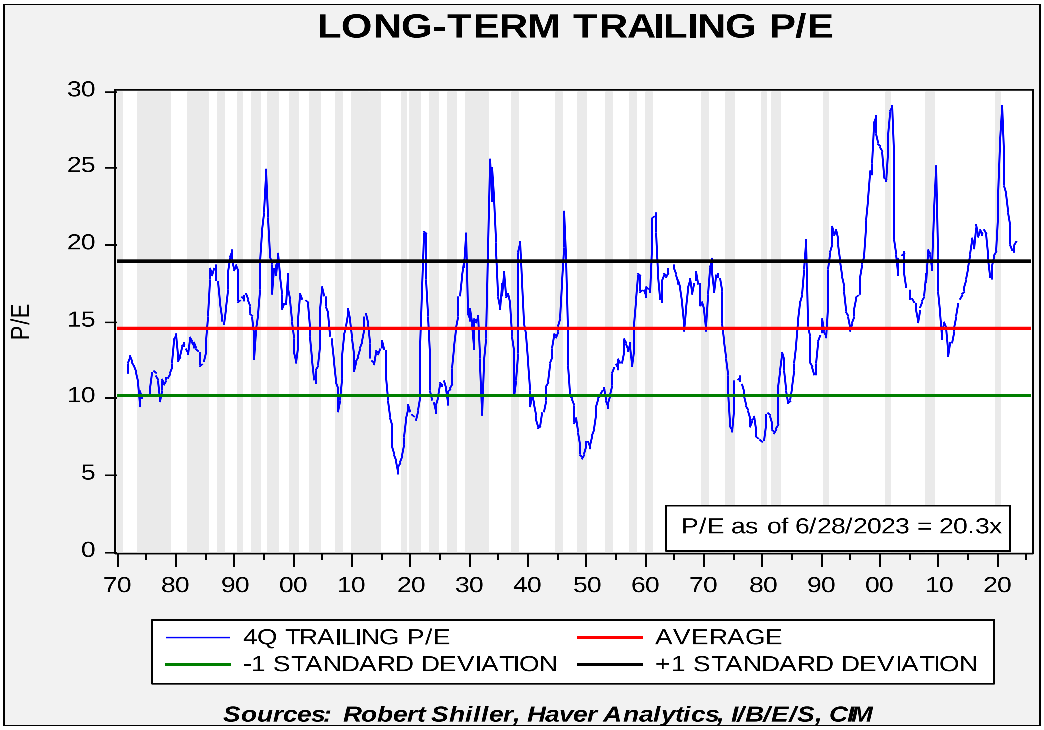


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 29, 2023



Based on our methodology,[1] the current P/E is 20.3x, up 0.1x 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.

[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.