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: March 2, 2023—9:30 AM EST] Global equity markets are mixed 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 0.7%. Chinese markets were lower, with the Shanghai Composite closing down 0.1% and the Shenzhen Composite closing down 0.5%. U.S. equity index futures are signaling a lower open.

With 489 companies having reported so far, S&P 500 earnings for Q4 are running at $54.20 per share compared to estimates of $52.85. Of the companies that have reported thus far, 68.9% have exceeded expectations, while 25.2% have fallen short of expectations.

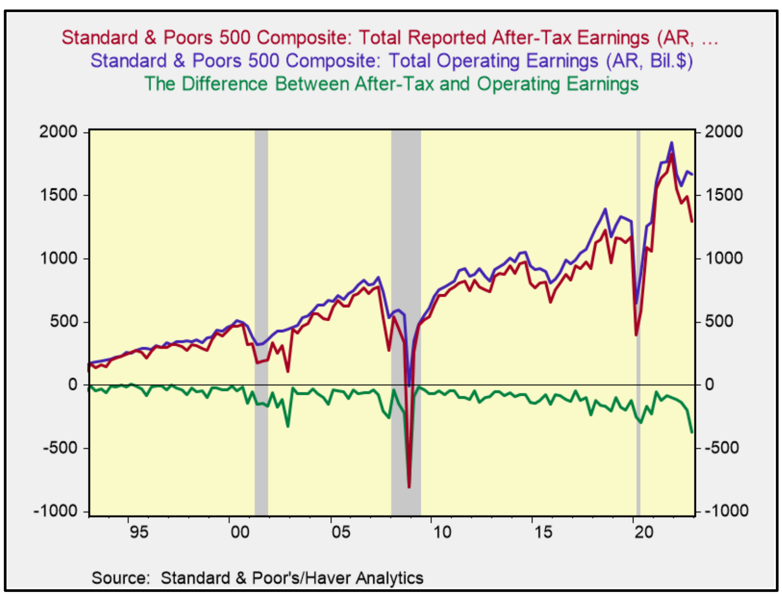
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (2/21/2023) (with associated podcast) "*Chip War*: Book Review"
- ***Weekly Energy Update* (3/2/2023): We provide an update for the natural gas market. Meteorological analysis suggests a rising probability of an El Niño this year, and so we offer maps showing the potential impact of such an event.**
- *Asset Allocation Quarterly – Q1 2023* (1/19/2023): Discussion of our asset allocation process, Q1 2023 portfolio changes, and our outlook for the markets.
- *Asset Allocation Bi-Weekly* (2/27/2023) (with associated podcast): "Federal Reserve Policymakers in 2023: Hawks or Doves?"
- *Asset Allocation Q1 2023 Rebalance Presentation* (2/2/2023): Video presentation featuring the Asset Allocation Committee as they review our asset allocation strategies, recent portfolio changes, and the current macro environment.
- *Confluence of Ideas* podcast (2/1/2023): "The 2023 Outlook"

Good morning! Today's *Comment* begins with a discussion on how earnings may not provide an accurate picture of the business environment and what that could mean for the economy. Next, we give our thoughts on the recent increase in interest rate expectations and how it affects stocks and bonds. Finally, we end with a review of the dollar's impact on emerging markets.

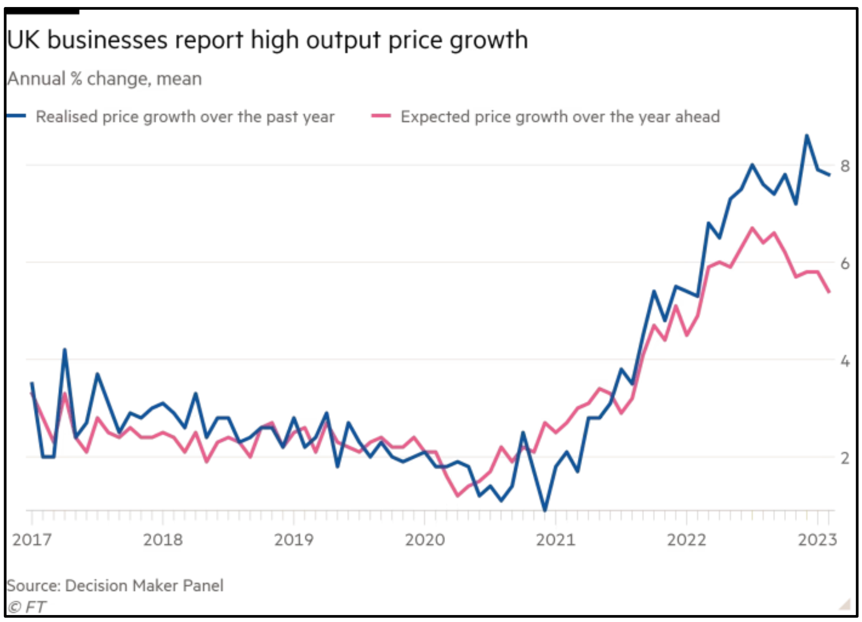
Earnings Mismatch: Solid Q4 earnings boosted market optimism at the beginning of the year but concerns over quality have forced investors to rethink their outlook for 2023.

- Most S&P 500 companies performed better than expected in the final quarter of 2022. Despite recession concerns, almost 70% of firms reported positive earnings per share and positive revenue surprises. The numbers were far from spectacular but were enough to show that firms were resilient in the face of elevated inflation. This sentiment was reinforced by a FactSet document search showing that the number of S&P 500 firms citing "inflation" in earnings calls fell to its lowest level since February 2021. The strong results helped lift investor confidence that the market may have discounted the worst of a possible recession and buoyed bets of a market rally for when the Fed finishes tightening.
- Unfortunately, last year's earnings numbers may be misleading. The discrepancy can be seen when comparing after-tax earnings with operating earnings. In Q4 2022, the difference between total after-tax and operating earnings widened to a level not seen since the financial crisis. The gap is related to a massive jump in restructuring costs. Firms generally incur these costs when reorganizing their businesses to make them more efficient. Examples of these one-time expenses include furloughs, layoffs, and plant closures.
    - Similarly, the divergence between operating cash flows and profits suggests that earnings quality has also fallen.
- The market will eventually sort out the inconsistencies in earnings. Going into a recession, managers look for alternative ways to show that their firms remain profitable to compensate for higher borrowing costs and slowing demand. This is seen when firms exclude costs associated with a reorganization or soften revenue recognition standards. Luckily, investors respond to low earnings quality by paying less for stocks. The S&P 500's retreat below 4000 partially reflects the market's skepticism about the true profitability of firms. That said, the decline in equities suggests that stocks are positioned for a strong rally once the market is able to value these earnings correctly.



Interest Rate Expectations: Fears over a resurgence of inflation have sent markets into a frenzy as investors try to decide what central banks will do.

- Investors were forced to revise interest rate predictions after a faster-than-expected rise in inflation, and strong economic data added to concerns that central banks are not done tightening. Core inflation data in the Eurozone rose 5.6% in the year ending in February, above January's rise of 5.3%. The strong readings in Europe have contributed to concerns that the U.S. consumer price index may also come in hot later this month. Meanwhile, the U.S. purchasing manager index (PMI) showed improvements in February despite remaining in contraction territory, and Eurozone PMI data showed that output passed the growth threshold last month.
- The unexpected rise in inflation and an improvement in manufacturing activity have led investors to revise forecasts of when the Federal Reserve and the European Central Bank will set peak interest rates. Markets predict that the Fed could push rates to 5.5% by September, above a projected peak of just under 5.0% following last month's Federal Open Market Committee rate announcement. Meanwhile, the European Central Bank is forecast to set rates at 4.0%, their highest level on record. The Bank of England has blunted this trend as comments from BOE Governor Andrew Bailey led investors to revise down peak expectations; however, Thursday's report of strong wage growth may lead to upward revisions in the BOE's benchmark policy rate.



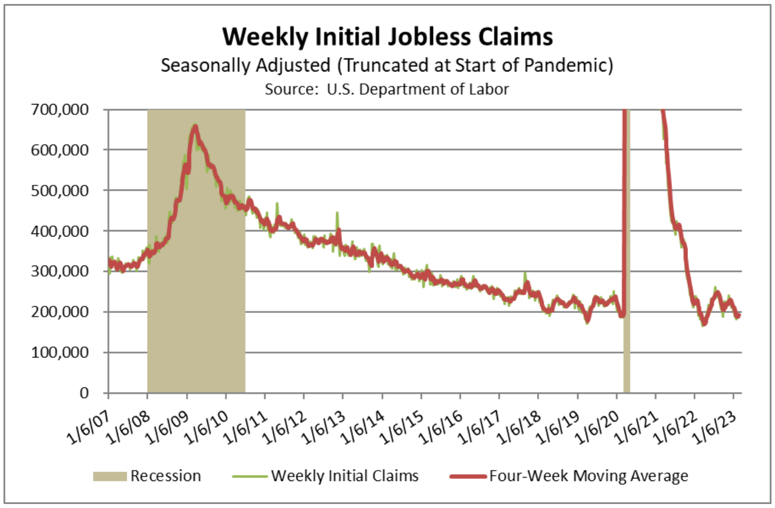
- Equity and bond markets do not agree on the path of policy rates. Despite modest adjustments over the last few weeks, the Euro Stoxx 50 is up 9.2% to begin the year, while the S&P 500 rose 3.3% in the same period. The resilience in equities indicates that stock traders still believe that the worst is behind them. Meanwhile, the rise in longer-duration bond yields suggests that fixed-income traders are unconvinced. The 10-year U.S. Treasury yield rose above 4.00% for the first time in 16 years on Wednesday, while today similar duration German government bond yields reached a 12-year high at 2.75%.

Dollar Problems: The U.S. greenback has stagnated over the past few weeks, denying a potential tailwind for emerging markets.

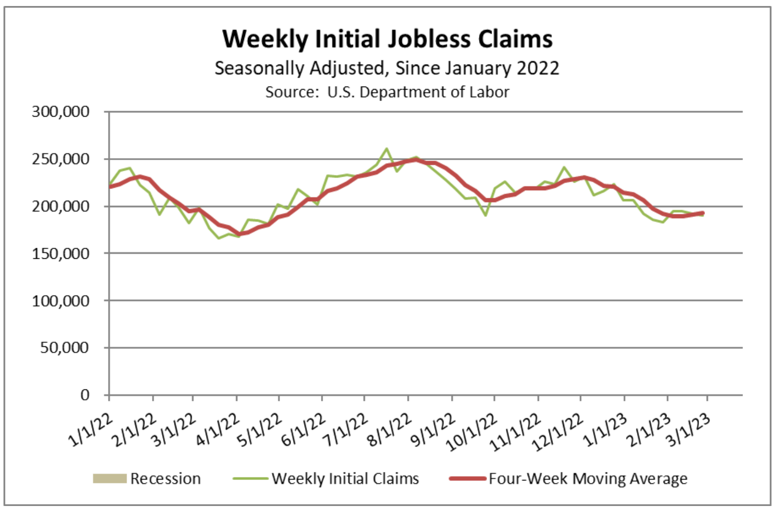
- Foreign investors in troubled countries are rushing to purchase U.S. dollars to protect their savings from losing value. In Iran, a collapse in sanctions relief talks has led the Iranian rial (IRR) to lose a fifth of its value since last week. The Turkish lira (TRY) may also face pressure after the upcoming elections as the government may be unable to offer the same level of support to the currency. Last month, options were pricing in a 60% likelihood that the TRY would lose 25% of its value by year end. Saver skepticism is shown in the recent outflow from Turkish FX-protected accounts.
- Dollar appreciation could lead to higher inflation in emerging market countries. Many foreign transactions are priced in dollars, and thus, currency depreciation will lead to an increase in import prices in items such as fuel and food. Although governments are willing to intervene in markets, their involvement comes at a great cost. Currency support generally leads to some sort of depletion of reserve assets, whether it be gold, monetary reserves, or other liquid securities. This method provides some relief to households, but it also prevents governments from being able to shield economies from the negative impacts of a downturn.
- Although the dollar has stagnated, it still poses risks to emerging markets as it blocks countries from the added relief from price pressures related to greenback depreciation. As a result, central banks may be forced to raise rates in certain countries where inflation remains stubbornly high. This does not mean that all is lost for certain countries. MSCI South Korea (3.45%) has seen its equities outperform the S&P 500 (3.30%) year-to-date, despite the South Korean won's (KRW) depreciation against the dollar. However, we believe that investors will need to be more vigilant when looking at emerging markets as long as the greenback remains elevated.

U.S. Economic Releases

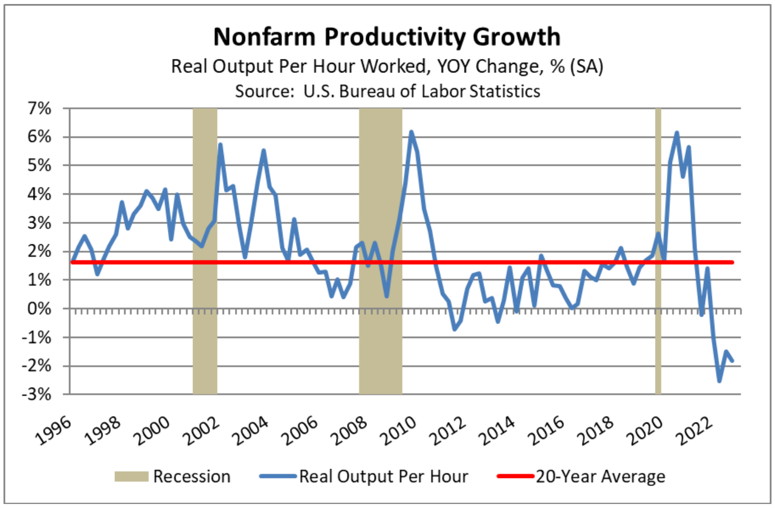
Initial applications for unemployment benefits in the week ending February 25 fell to a seasonally adjusted 190,000, modestly lower than both the expected level of 195,000 and the previous week's level of 192,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose slightly to 193,000. The number of people continuing to draw benefits in the week ending February 18 fell to 1.655 million, below both the anticipated reading of 1.669 million and the prior week's revised reading of 1.660 million. The following chart shows how initial jobless claims have fluctuated since just before the prior recession. The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



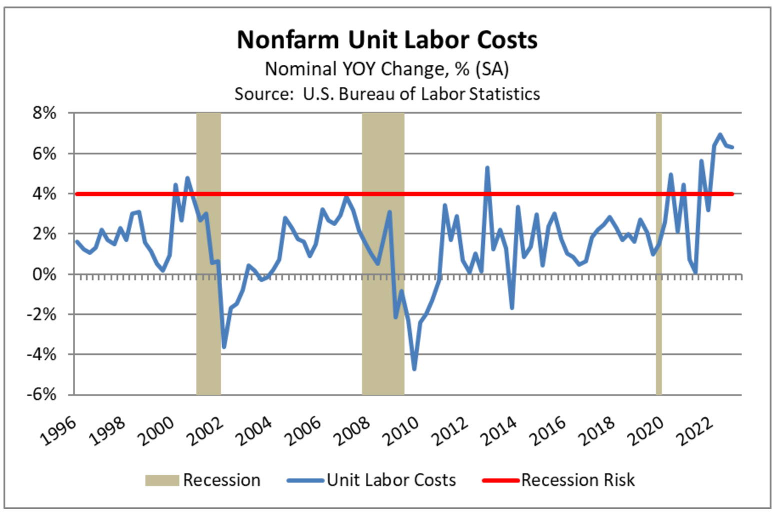
To provide more detail on recent trends, the chart below shows how initial jobless claims have changed just since the beginning of 2022.



Another report today focused on the productivity of U.S. workers, defined as the average value of output per hour worked. After stripping out price changes and normal seasonal fluctuations, revised fourth-quarter nonfarm productivity rose at an annualized rate of just 1.7%, short of expectations it would come in at 2.5% and much worse than the initial estimate of 3.0%. The figure still marked an acceleration from the growth rate of 1.2% in the third quarter, but because of the big declines in the first half of 2022, productivity in the fourth quarter was still down 1.8% from the same period one year earlier. Productivity growth is key to boosting living standards and supporting higher wages, so a continued rebound and eventual return to year-over-year growth will be critical to future U.S. economic prospects. The following chart shows the year-over-year growth in real productivity over the last quarter-century or so.



Since productivity growth came in much worse than expected, fourth-quarter unit labor costs jumped at an annualized rate of 3.2%, twice the anticipated rate of 1.6% and almost three times the initially estimated rare of 1.1%. The fourth-quarter growth rate for unit labor costs was less than half the growth rates in the first three quarters of 2022, but unit labor costs in the fourth quarter were up a painful 6.3% year-over-year. In the past, annual unit labor cost growth above 4.0% has often been associated with an impending recession. The chart below shows the year-over-year growth in unit labor costs since 1996.



The table below lists the economic releases and/or Federal Reserve 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**
14:00	Chris Waller Discusses Economic Outlook	Member of the Board of Governors
18:00	Neel Kashkari Discusses Race, justice and the Economy	President of the Federal Reserve Bank of Minneapolis

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	Capital Spending	y/y	4Q	7.7%	9.8%	7.1%	***	Equity bullish, bond bearish
	Monetary Base	y/y	Feb	-1.6%	-3.8%		**	Equity and bond neutral
	Monetary Base, End of Period	m/m	Feb	¥651.8t	¥651.9t		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	24-Feb	¥211.6b	¥2693.3b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	24-Feb	-¥403.0b	¥197.7b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	24-Feb	-¥208.9b	¥229.5b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	24-Feb	-¥440.4b	-¥202.0b		*	Equity and bond neutral
Australia	Building Approvals	m/m	Jan	-27.6%	18.5%	15.3%	***	Equity bearish, bond bullish
New Zealand	Terms of Trade	q/q	4Q	1.8%	-3.4%	-3.40	**	Equity bullish, bond bearish
South Korea	Industrial Production	y/y	Jan	-12.7%	-7.3%	-10.5%	***	Equity bearish, bond bullish
	S&P Global Manufacturing PMI	m/m	Feb	48.5	48.5		***	Equity and bond neutral
EUROPE								
Eurozone	CPI	y/y	Feb	8.5%	8.6%	8.3%	***	Equity and bond neutral
	Core CPI	y/y	Feb P	5.6%	5.3%	5.3%	**	Equity and bond neutral
	Unemployment Rate	m/m	Jan	6.7%	6.6%	6.7%	**	Equity and bond neutral
Italy	Unemployment Rate	m/m	Jan	7.9%	7.8%	7.8%	**	Equity and bond neutral
	CPI, EU Harmonized	y/y	Feb P	9.9%	10.7%	9.5%	***	Equity and bond neutral
	CPI NIC Including Tobacco	y/y	Feb P	9.2%	10.1%	8.9%	**	Equity and bond neutral
Russia	Retail Sales	m/m	Jan	-6.6%	-10.5%	-10.7%	**	Equity bullish, bond bearish
	Unemployment Rate	m/m	Jan	3.6%	3.7%	3.9%	***	Equity and bond neutral
	Gold and Forex Reserves	m/m	24-Feb	$580.7b	$582.1b		***	Equity and bond neutral
AMERICAS								
Canada	S&P Global Manufacturing PMI	m/m	Feb	52.4	51.0		***	Equity and bond neutral
Mexico	Unemployment Rate	m/m	Jan	3.00%	2.76%	3.10%	***	Equity and bond neutral
Brazil	Trade Balance	m/m	Feb	$2837m	$2717m	$2491m	**	Equity and bond neutral
	Exports	m/m	Feb	$20560m	$23137m	$20400m	*	Equity and bond neutral
	Imports	m/m	Feb	$17723m	$20420m	$17700m	*	Equity and bond neutral
	GDP	y/y	4Q	1.9%	3.6%	2.2%	**	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)	497	496	1	Up
3-mo T-bill yield (bps)	469	473	-4	Up
TED spread (bps)	28	23	5	Widening
U.S. Sibor/OIS spread (bps)	492	492	0	Up
U.S. Libor/OIS spread (bps)	495	494	1	Up
10-yr T-note (%)	4.03	4.00	0.03	Flat
Euribor/OIS spread (bps)	278	274	4	Up
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Up
Yen	Down			Down
Pound	Down			Down
Franc	Down			Down

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.

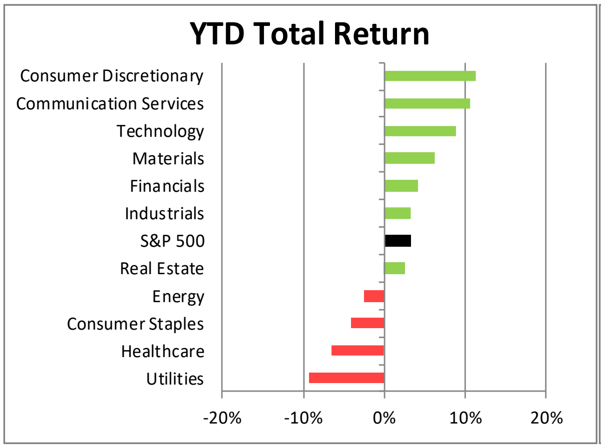
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$84.71	$84.31	0.47%	
WTI	$78.11	$77.69	0.54%	
Natural Gas	$2.76	$2.81	-1.92%	
Crack Spread	$37.71	$37.37	0.89%	
12-mo strip crack	$30.07	$29.97	0.31%	
Ethanol rack	$2.29	$2.29	0.06%	
Metals				
Gold	$1,833.11	$1,836.72	-0.20%	
Silver	$20.83	$20.99	-0.79%	
Copper contract	$406.35	$416.00	-2.32%	
Grains				
Corn contract	$640.75	$635.75	0.79%	
Wheat contract	$716.75	$710.00	0.95%	
Soybeans contract	$1,496.50	$1,494.25	0.15%	
Shipping				
Baltic Dry Freight	1,099	990	109	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	1.2	1.9	-0.7	
Gasoline (mb)	-0.9	-1.0	0.1	
Distillates (mb)	0.2	-0.5	0.7	
Refinery run rates (%)	-0.1%	-0.3%	0.2%	
Natural gas (bcf)		-76		

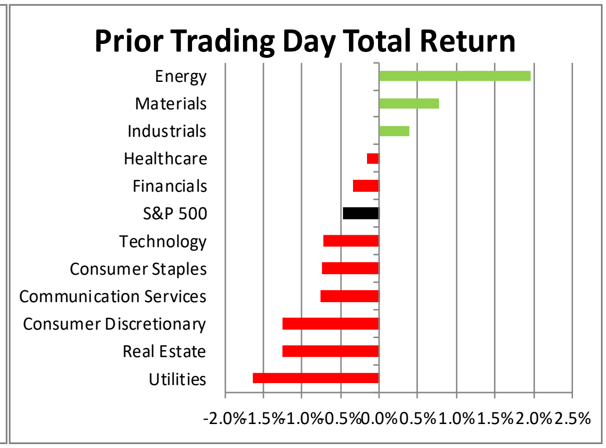
Weather

The 6-10 and 8-14 day forecasts show colder-than-normal temperatures for virtually the entire country north of Texas and Florida. The forecasts show wetter-than-normal conditions throughout most of the country except for the Midwest, with dry conditions expected in New England.

Data Section

U.S. Equity Markets – (as of 3/1/2023 close)

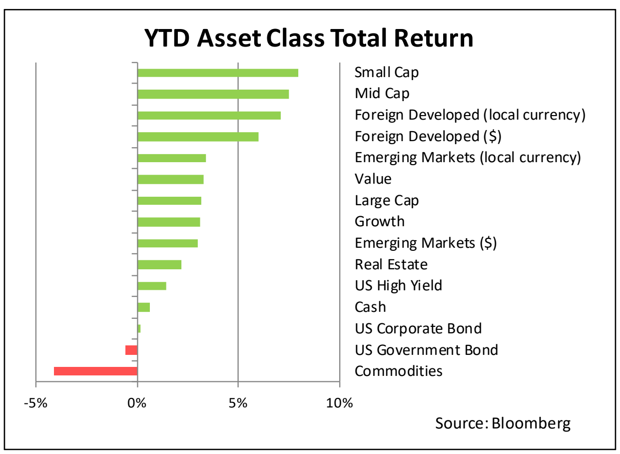




(Source: Bloomberg)

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 3/1/2023 close)

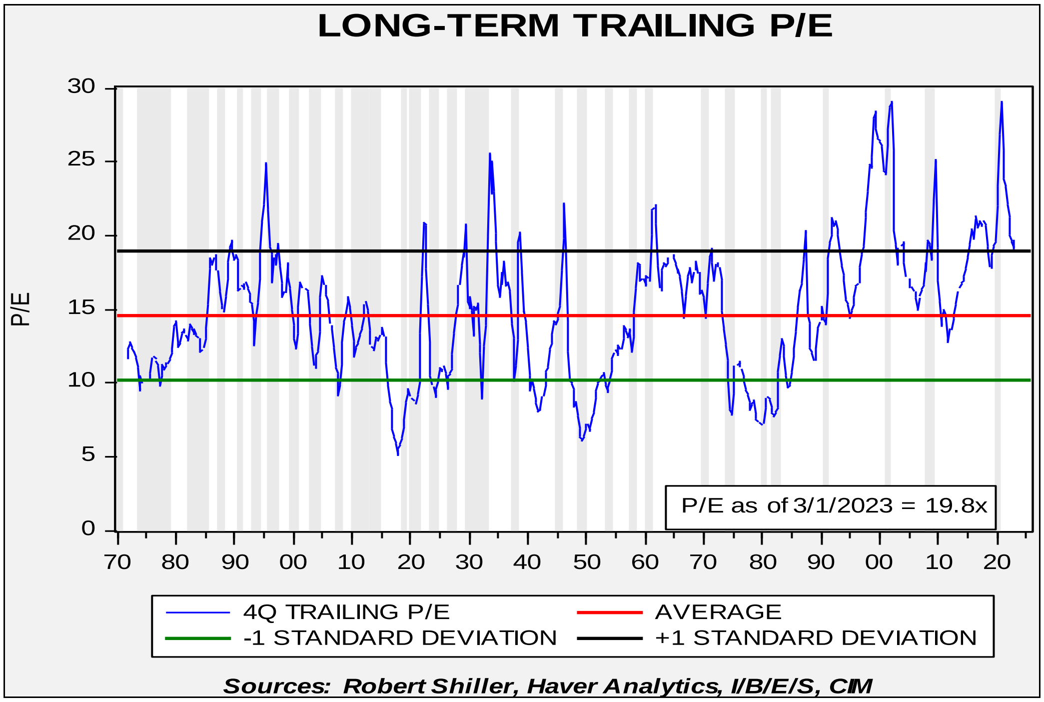


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

March 2, 2023



Based on our methodology,[1] the current P/E is 19.8x, 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 (Q2 and Q3) and two estimates (Q4 and Q1). 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.