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 3, 2023—9:30 AM EST] Global equity markets are mostly 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 up 0.8%. Chinese markets were more mixed, with the Shanghai Composite closing up 0.8% and the Shenzhen Composite closing essentially unchanged. U.S. equity index futures are signaling a higher open.

With 496 companies having reported so far, S&P 500 earnings for Q4 are running at $54.30 per share compared to estimates of $52.85. Of the companies that have reported thus far, 69.2% have exceeded expectations, while 25.0% 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"
- ***Business Cycle Report* (3/2/2023)**

Today's *Comment* begins with our thoughts on the Fed's overreliance on economic data to dictate policy. Next, we review signs that interest rates are finally starting to weigh on the economy. We end the report by discussing the ongoing feud between Brazilian President Luiz Inácio Lula da Silva and his central bank.

Market Choppiness: Noisy economic data and conflicting views from central bankers have made it difficult for investors to parse out the future path of policy rates.

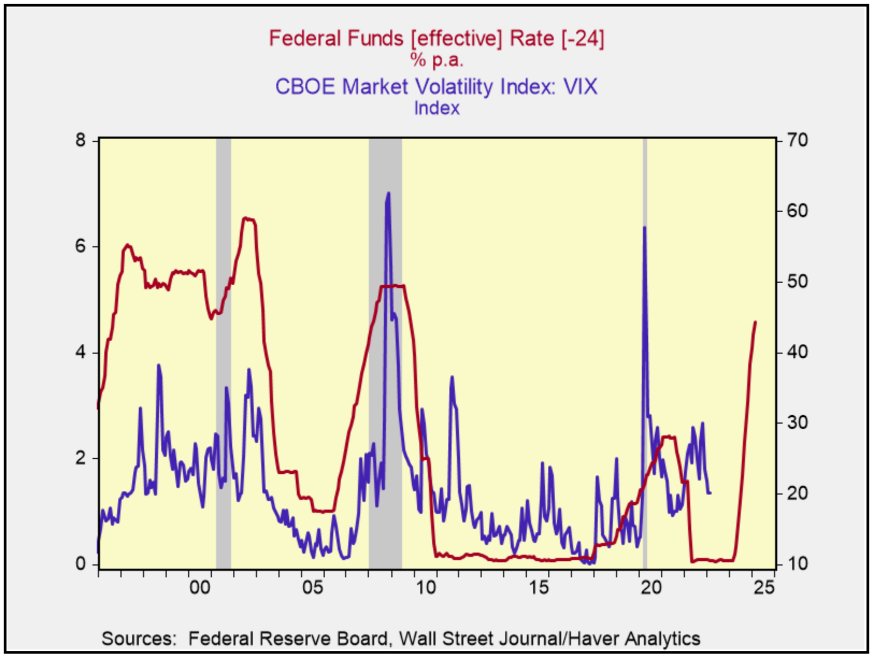
- Fed officials refuse to commit to future rate decisions. On Thursday, Federal Governor Christopher Waller and Atlanta Fed President Raphael Bostic offered conditional support for maintaining the current policy path. Bostic stated that he would prefer a 25 bps rate hike in March, while Waller argued that a peak rate between 5.1% and 5.4% would make sense if inflation cools. These estimates are roughly in line with the latest Fed dot plot. However, both officials have argued for higher rates if inflation begins to reaccelerate. Their comments led to a sharp, but likely temporary, jump in the S&P 500 yesterday as investors reacted positively to Fed officials not ruling out a pause before the end of the year.
- Economic statistics are still distorted due to pandemic-related anomalies. For instance, labor hoarding and delays in termination have made employment data look good on the surface. Last month's blockbuster 517k jobs number was elevated due to seasonal adjustments related to fewer layoffs than in a typical January. Meanwhile, many tech job cuts are slated to take effect in March, meaning that they won't show up in the employment report until the following month. The lack of accuracy in the data suggests that the Fed may be slow to react to real-time changes in the business cycle.
    - As a side note, markets will be closed when April's job report is released, since it falls on Good Friday. Coincidence? We think not.
- The Fed wants to keep its options open when deciding future policy. It may fear that if it stops hiking too soon, inflation expectations could become unanchored. Although the Fed's position is understandable, it puts investors in an awkward position as they await a signal that it is a good time to jump back into the market. So far, investors have allocated a record $4.8 trillion of their funds to money market accounts. The elevated level of cash holdings should fuel a strong rally toward the end of the year. In the meantime, we expect Fed policy uncertainty to keep equities relatively stagnant in the short-term and possibly even the medium-term.

Tightening Pain: A strong start to the year has overshadowed underlying problems within the U.S. economy

- The housing market is firmly in contraction. Data from Redfin has shown that U.S. home sale prices had their first annual decline in over a decade. The average sale price for a home fell 0.6% from the prior year in the final four weeks ending February 26. The price declines come as higher mortgage rates hinder home affordability for new home buyers. Although homebuilders reported higher confidence in the housing market in February, it was largely based on the idea that financial conditions would continue to ease. However, the upward movement of 10-year Treasury yields above 4% will likely dent hopes of a sudden resurgence in the demand for homes.
- Meanwhile, high lending rates have also hurt the auto market. Car prices have slumped over the last few months due to higher inventory and weaker demand. The decline in auto value has increased the number of car owners with negative equity in their vehicles, which will make it harder for households to get out of debt and could sap future vehicle

demand. Additionally, those who bought cars at peak demand in 2021 may be incentivized to stop making payments. The resulting defaults and repossessions could flood the used car market, possibly exacerbating the decline in auto prices.

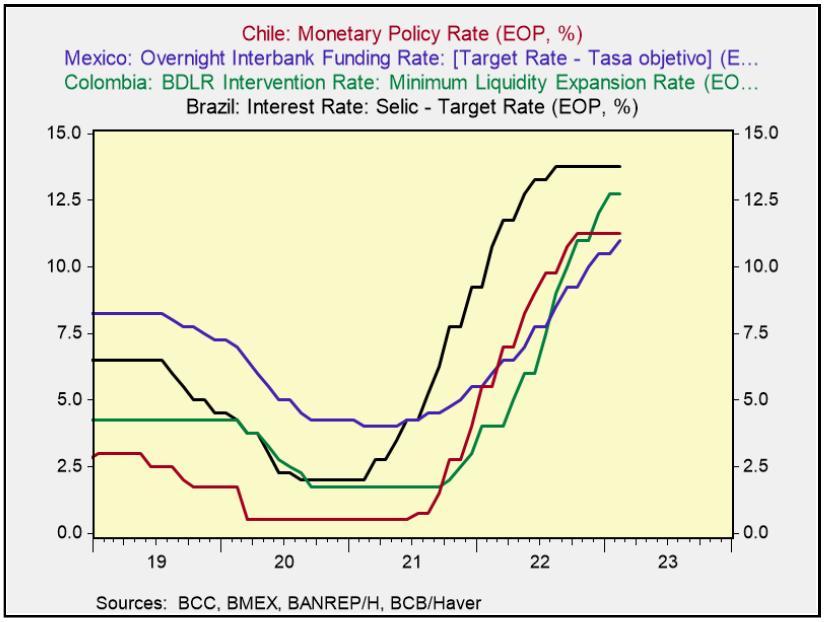
- The U.S. economy's resiliency has bolstered optimism that the Fed may be able to avoid a hard landing. The ability of the financial system to avoid the blowback from the crypto fallout, thus far, has added to this confidence. However, there are reasons to be worried that the Fed has overplayed its hand. The housing and auto markets are two areas where we notice trouble lurking, but we also believe that traditional indicators may be masking trouble. For example, the CBOE Volatility Index (VIX), also known as the fear gauge, remains below its complacency level of 20 despite the recent pull back in equities and the rise in bond yields.



Lula Headaches: The new Brazilian president is having trouble achieving his objectives to boost living standards and reduce poverty.

- The Brazilian economy contracted in the final three months of the year. Gross domestic product fell 0.2% in Latin America's largest economy with weak services and shrinking industrial output driving the quarterly decline. Mining remained the bright spot in the report, as oil production prevented a deeper decline in industrial activity. High-interest rates may weigh on economic activity further throughout the year as the Central Bank of Brazil tries it best to return inflation to its 3.25% target.

- Brazil was among the first and most aggressive central banks to hike its benchmark policy rate. At 13.75%, it currently has the second-highest policy rate out of the top five Latin American economies, trailing only Argentina. Elevated interest rates have angered Lula, who believes the Central Bank of Brazil policies will prevent him from realizing his campaign pledges. He has blamed Central Bank Chief Roberto Campos Neto for the economic slowdown. To Lula's credit, Campos Neto has voiced concerns that the new government's spending plan could undermine the central bank's progress in fighting inflation.



- We will be paying close attention to the ongoing spat between Lula and the Central Bank of Brazil. Campos Neto has vowed to finish out his term as the head of the central bank, which is set to expire in December 2024. However, his ongoing feud with Lula and his left-wing allies threatens the central bank's credibility. It has been speculated that the government could raise the inflation target to a higher level to pressure the central bank to begin easing policy. That said, any extreme move by the government to impact the central bank authority will likely negatively impact the Brazilian real (BRL).

U.S. Economic Releases

No major U.S. economic reports have been released so far today. The table below lists the economic releases and/or Federal Reserve events scheduled for the rest of the day.

Economic Releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	S&P Services PMI	m/m	Feb F	50.5	50.5	**
9:45	S&P Composite PMI	m/m	Feb F		50.2	**
10:00	ISM Services Index	m/m	Feb	54.5	55.2	**
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
11:00	Lorie Logan Makes Opening Remarks at Event	President of the Federal Reserve Bank of Dallas				
12:00	Raphael Bostic Discusses Racial Inequality Research	President of the Federal Reserve Bank of Atlanta				
15:00	Michelle Bowman Chairs Panel at Conference	Member of the Board of Governors				
16:15	Thomas Barkin Speaks at Stanford conference	President of the Federal Reserve Bank of Richmond				

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.

ASIA-PACIFIC								
Japan	Tokyo CPI	y/y	Feb	3.4%	4.4%	3.4%	**	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food	y/y	Feb	3.3%	4.3%	3.3%	***	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food & Energy	y/y	Feb	3.2%	3.0%	3.1%	*	Equity and bond neutral
	Jobless Rate	m/m	Jan	2.4%	2.5%	2.5%	***	Equity and bond neutral
	Job-To-Applicant Ratio	m/m	Jan	1.4%	1.4%	1.4%	**	Equity and bond neutral
	Jibun bank Composite PMI	m/m	Feb F	51.1	50.7		*	Equity and bond neutral
	Jibun Bank Services PMI	m/m	Feb F	54.0	53.6		**	Equity and bond neutral
China	Caixin Composite PMI	m/m	Feb	54.2	51.1		**	Equity and bond neutral
	Caixin Services PMI	m/m	Feb	55.0	52.9	54.5	**	Equity and bond neutral
India	S&P Global Composite PMI	m/m	Feb	59.0	57.5		**	Equity bullish, bond bearish
	S&P Global Services PMI	m/m	Feb	59.4	57.2		**	Equity bullish, bond bearish
EUROPE								
Eurozone	S&P Global Composite PMI	m/m	Feb F	52.0	52.3	52.3	*	Equity and bond neutral
	S&P Global Global Services PMI	m/m	Feb F	52.7	53.0	53.0	**	Equity and bond neutral
	PPI	y/y	Jan	15.0%	24.6%	24.5%	**	Equity bullish, bond bearish
Germany	Trade Balance	m/m	Jan	16.7b	10.0b	11.0b	**	Equity and bond neutral
	Exports	m/m	Jan	2.1%	-6.3%	-6.3%	*	Equity bullish, bond bearish
	Imports	m/m	Jan	-3.4%	-6.1%	-5.6%	*	Equity bullish, bond bearish
	S&P Global Services PMI	m/m	Feb F	50.9	51.3	51.3	**	Equity bearish, bond bullish
	S&P Global Composite PMI	m/m	Feb F	50.7	51.1	51.1	**	Equity bearish, bond bullish
France	Industrial Production	y/y	Jan	-2.2%	1.4%	1.8%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	Jan	-0.7%	3.6%	3.3%	**	Equity bearish, bond bullish
	S&P Global Composite PMI	m/m	Feb F	51.7	51.6	51.6	**	Equity and bond neutral
	S&P Global Services PMI	m/m	Feb F	53.1	52.8	52.8	**	Equity and bond neutral
Italy	S&P Global Composite PMI	m/m	Feb	52.2	51.2	52.0	**	Equity and bond neutral
	S&P Global Services PMI	m/m	Feb	51.6	51.2	52.2	**	Equity and bond neutral
	GDP WDA	y/y	4Q F	1.4%	1.7%	1.7%	**	Equity and bond neutral
UK	S&P Global/CIPS Services PMI	m/m	Feb F	53.5	53.3	53.3	**	Equity and bond neutral
	S&P Global/CIPS Composite PMI	m/m	Feb F	53.1	53.0	53.0	**	Equity and bond neutral
Russia	S&P Global Services PMI	m/m	Feb	53.1	48.7		**	Equity bullish, bond bearish
	S&P Global Composite PMI	m/m	Feb	53.1	49.7		**	Equity bullish, bond bearish
	Money Supply, Narrow Definition	w/w	22-Feb	16.70t	16.60t		*	Equity and bond neutral
AMERICAS								
Brazil	S&P Global Composite PMI	m/m	Feb	49.7	49.9		**	Equity and bond neutral
	S&P Global Services PMI	m/m	Feb	49.8	50.7		**	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)	498	497	1	Up
3-mo T-bill yield (bps)	468	473	-5	Up
TED spread (bps)	30	24	6	Widening
U.S. Sibor/OIS spread (bps)	493	492	1	Up
U.S. Libor/OIS spread (bps)	496	495	1	Up
10-yr T-note (%)	4.02	4.06	-0.04	Flat
Euribor/OIS spread (bps)	280	278	2	Up
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Up			Up
Pound	Up			Down
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.

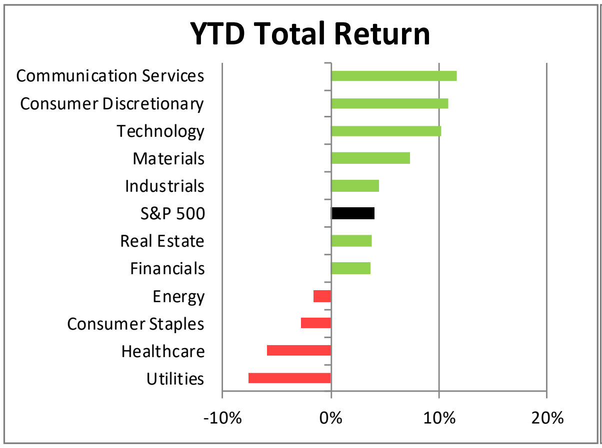
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$84.28	$84.75	-0.55%	
WTI	$77.79	$78.16	-0.47%	
Natural Gas	$2.82	$2.77	2.03%	
Crack Spread	$37.28	$37.47	-0.49%	
12-mo strip crack	$29.78	$29.97	-0.62%	
Ethanol rack	$2.30	$2.29	0.18%	
Metals				
Gold	$1,844.77	$1,835.87	0.48%	
Silver	$21.04	$20.90	0.67%	
Copper contract	$409.65	$407.60	0.50%	
Grains				
Corn contract	$633.50	$633.75	-0.04%	
Wheat contract	$713.25	$712.75	0.07%	
Soybeans contract	$1,513.50	$1,509.25	0.28%	
Shipping				
Baltic Dry Freight	1,145	1,099	46	
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)	-81	-76	-5.0	

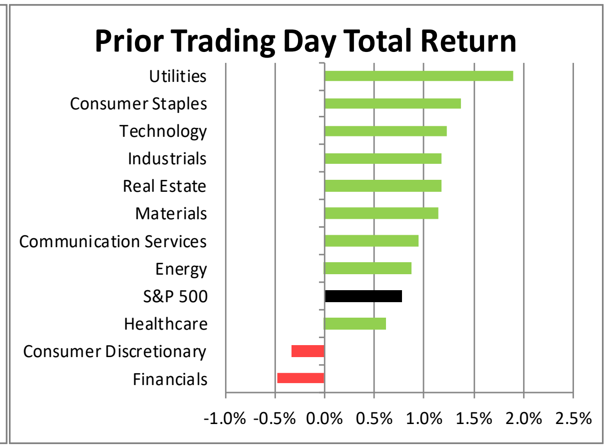
Weather

The 6-10 and 8-14 day forecasts show colder-than-normal temperatures for virtually the entire country north of the Gulf of Mexico. The forecasts call for warmer-than-normal temperatures only in southern Texas and Florida. The forecasts show wetter-than-normal conditions throughout most of the country except for the Midwest and New England. Dry conditions are expected in northern Wisconsin and Michigan.

Data Section

U.S. Equity Markets – (as of 3/2/2023 close)

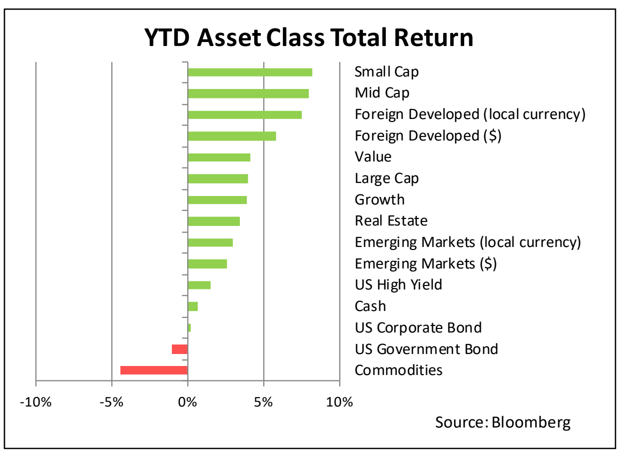




(Source: Bloomberg)

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 3/2/2023 close)

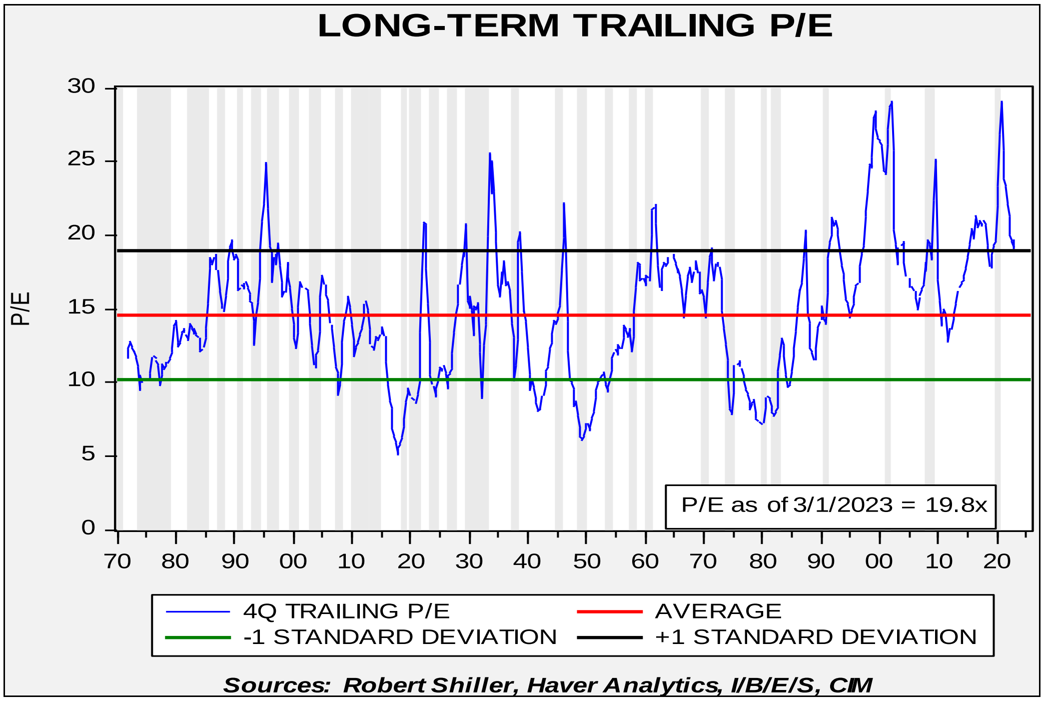


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.