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 6, 2023—9:30 AM EST] Global equity markets are generally higher this morning. In Europe, the Euro Stoxx 50 is currently up 0.4% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.6%. Chinese markets were mixed, with the Shanghai Composite closing down 0.2% 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)

Our *Comment* today opens with some observations on the important high-level government meetings that began in China over the weekend and included an announcement that China will target a relatively modest economic growth rate of just 5% in 2023. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including a new statement by European Central Bank President Lagarde which pointed to further aggressive interest-rate hikes in the Eurozone and signs that the U.S. junk bond market is weakening again ahead of a likely recession.

China: Over the weekend, the country opened its annual "two sessions," consisting of key meetings of the National People's Congress and the People's Political Consultative Conference. Among the key decisions already reported, outgoing Premier Li Keqiang announced a relatively conservative economic growth target of "around 5%" in 2023, compared with about 5.5% in 2022, while the proposed national budget would hike Chinese military spending by 7.2%.

- Later in the meetings and potentially this week, President Xi is expected to secure a precedent-breaking third term in office to go along with his October success in gaining a third consecutive term as head of the Communist Party.
- The meetings are also likely to approve a new set of top government officials and agency restructurings that would further consolidate power into Xi's hands, including the establishment of a new data regulator.

China-Hong Kong: The Shanghai, Shenzhen, and Hong Kong stock markets have jointly announced the stocks that will participate in China's expanded "Stock Connect" program, which allows mainland investors to buy certain equities in Hong Kong, and vice versa. About 80 additional foreign stocks trading in Hong Kong will now be available to mainland investors, including the stocks of British bank Standard Chartered (SCBFY, $19.03) and Australian coal miner Yancoal Australia (YACAF, $4.15). Foreign investors will gain access to hundreds of additional yuan-denominated stocks trading in Shanghai and Shenzhen. Nevertheless, as the U.S.-China geopolitical competition intensifies and the countries squeeze the capital flows between them, the expanded program may have little practical effect for U.S. firms or investors.

United States-China: U.S.-China relations continued to fray over the last week, as the Biden administration placed 28 additional Chinese firms on its "Entity List" of companies that are off limits for U.S. exporters. Under law, the Commerce Department has the authority to put foreign companies on the list and cut them off from U.S. exports if they are working against U.S. interests. Many of the hundreds of Chinese companies now on the list are there because they provide advanced technologies and computing services to China's surveillance, intelligence, and military systems. As we have reported many times in the past, the U.S. has also taken aggressive steps to restrict the flow of advanced technology and investment capital to China as a way to suppress its ability to establish itself as the new global hegemon.

- At the same time, China continues to impose its own restrictions on trade and capital flows. In an interview with Fox Business last week, billionaire investor Mark Mobius said Chinese authorities are preventing him from withdrawing and repatriating personal funds that he has at a bank in Shanghai.
- Even though Mobius was the longtime chief of emerging market investments at Franklin Templeton and a recognized China bull, he stated in the interview that investors should be "very, very careful" now about investing in China due to the government's tight control over the economy. Instead, Mobius said he is increasing his exposure to other emerging markets such as India and Brazil.

Japan-South Korea: The governments of Japan and South Korea appear to be nearing a deal to resolve a conflict over Japan's use of forced labor from South Korea in World War II. Under the developing agreement, the South Korean government would ensure compensation payments to Koreans who were forced to work for Japan through a government-backed foundation, instead of asking Japanese companies to do so. In return, Japan would lift restrictions on certain technology exports to South Korea and agree on the resumption of reciprocal visits by the countries' leaders.

- The potential rapprochement between the two countries is driven in part by a shared concern about China's growing geopolitical aggressiveness. Our analysis suggests that both Japan and South Korea will be key members of the evolving U.S.-led geopolitical and economic bloc.
- If an agreement is reached, it could significantly improve relations between Japan and South Korea, potentially boosting trade and investment between the two countries.

Iran: International Atomic Energy Agency Chief Grossi visited Iran on Saturday to address concerns over evidence that Tehran has been processing uranium to near-weapons grade purity levels. However, all he appears to have gained was Iranian promises to voluntarily allow the IAEA to reinstall some cameras and other monitoring devices that Iran shut down last year. With Iran still appearing intent on advancing its nuclear program, the stage is increasingly being set for a potential Israeli attack on Iran that would attempt to stop Tehran from achieving a workable nuclear weapon.

Pakistan: In an apparent effort to muzzle Former Prime Minister Khan and end his calls for early elections, the government of Prime Minister Sharif sent police to arrest Khan yesterday on what appear to be trumped-up charges of corruption, but Khan refused to meet with them. The standoff suggests that Pakistan will continue to face political paralysis even as it tries to secure an important IMF loan to stave off default on its foreign debts.

Eurozone: In an interview with Spanish newspaper *El Correo*, European Central Bank President Lagarde warned that the upward pressure on consumer prices in the Eurozone will remain sticky for the foreseeable future and could require further interest-rate hikes to bring them under control. To limit the damage to the region's economy, she also urged banks to reschedule debt repayments for households struggling to cope with soaring borrowing costs on variable-rate mortgages.

Estonia: Prime Minister Kaja Kallas and her liberal Reform Party won the biggest share of votes in yesterday's parliamentary election, putting her in position to remain in power with a new, refreshed governing coalition. The result ensures that the Estonian government will remain strongly pro-Western and anti-Russian, and that it will retain its current center-left stance.

Russian Invasion of Ukraine: Russian forces continue to make incremental gains in their effort to surround the northeastern Ukrainian town of Bakhmut, even as they keep launching artillery, missile, and air attacks on infrastructure elsewhere around Ukraine. Despite a range of analysts judging that the Russians would not be able to capture Bakhmut in the near term, Ukrainian forces still appear to be considering a tactical withdrawal from the town in order to conserve troops and equipment for a potential offensive elsewhere later in the spring.

U.S. Junk Bond Market: Various indicators suggest that the rebound in junk bond prices during January and February is already reversing course as overall bond yields began rising again. Any renewed weakness in junk bond prices, with the associated rise in yields, would likely put added pressure on financially weaker companies as the economy hurtles toward a likely recession.

U.S. Labor Market: New research posted by the National Bureau of Economic Research confirms that wage growth among lower-paid and less-educated workers has outstripped wage growth among the better-paid and more highly educated since the onset of the COVID-19 pandemic. The research suggests lower-paid, less-educated workers have benefited not only from stronger demand for their services, but also from the way the pandemic forced people out of their old jobs and made the labor market more dynamic.

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**
10:00	Factory Orders	m/m	Jan	-1.8%	1.8%	***
10:00	Factory Orders ex Trans	m/m	Jan	1.0%	-1.2%	
10:00	Durable Goods Orders	m/m	Jan F	-4.5%	-4.5%	***
10:00	Durable Goods Orders Ex Transportation	m/m	Jan F	0.7%	0.7%	**
10:00	Cap Goods Orders Nondef Ex Air	m/m	Jan F		0.8%	**
10:00	Cap Goods Ship Nondef Ex Air	m/m	Jan F		1.1%	**
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								
Australia	Melbourne Institute Inflation	y/y	Feb	6.3%	6.4%		*	Equity and bond neutral
New Zealand	ANZ Commodity Price	m/m	Feb	1.3%	-1.0%	-0.90	**	Equity bearish, bond bullish
South Korea	Foreign Reserves	m/m	Feb	$425.29b	$429.97b		**	Equity and bond neutral
	CPI	y/y	Feb	4.8%	5.2%	5.0%	**	Equity and bond neutral
	CPI Core	y/y	Feb	4.8%	5.0%		**	Equity and bond neutral
EUROPE								
Eurozone	Retail Sales	y/y	Jan	-2.3%	-2.8%	-1.8%	*	Equity and bond neutral
Germany	S&P Global Construction PMI	m/m	Feb	48.6	43.3		*	Equity bullish, bond bearish
UK	New Car Registrations	y/y	Feb	26.2%	14.7%		*	Equity bullish, bond bearish
	S&P/CIPS Construction PMI	m/m	Feb	54.6	48.4	48.6	**	Equity bullish, bond bearish
Switzerland	CPI	y/y	Feb	3.4%	3.3%	3.1%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Feb	3.2%	3.2%		*	Equity and bond neutral
	Core CPI	y/y	Feb	2.4%	2.2%		*	Equity and bond neutral
	Domestic Sight Deposits CHF	w/w	3-Mar	502.0b	506.0b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	3-Mar	519.4b	520.7b		*	Equity and bond neutral
AMERICAS								
Canada	Building Permits	m/m	Jan	-4.0%	-7.3%	1.5%	**	Equity bearish, bond bullish
Mexico	Gross Fixed Investment	y/y	Dec	9.4%	6.6%	7.4%	**	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	499	-1	Up
3-mo T-bill yield (bps)	469	473	-4	Up
TED spread (bps)	30	26	4	Widening
U.S. Sibor/OIS spread (bps)	495	494	1	Up
U.S. Libor/OIS spread (bps)	498	497	1	Up
10-yr T-note (%)	3.92	3.95	-0.03	Flat
Euribor/OIS spread (bps)	285	280	5	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Flat			Up
Yen	Down			Up
Pound	Down			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.

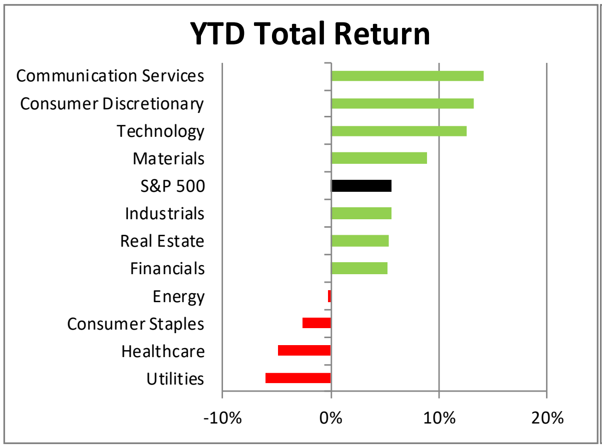
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$84.65	$85.83	-1.37%	
WTI	$78.56	$79.68	-1.41%	
Natural Gas	$2.68	$3.01	-10.80%	Supply Optimism
Crack Spread	$37.59	$37.96	-0.97%	
12-mo strip crack	$30.03	$30.43	-1.30%	
Ethanol rack	$2.34	$2.32	0.56%	
Metals				
Gold	$1,851.78	$1,856.48	-0.25%	
Silver	$21.17	$21.26	-0.42%	
Copper contract	$402.65	$406.70	-1.00%	
Grains				
Corn contract	$635.75	$639.75	-0.63%	
Wheat contract	$697.50	$708.75	-1.59%	
Soybeans contract	$1,513.50	$1,518.75	-0.35%	
Shipping				
Baltic Dry Freight	1,211	1,145	66	

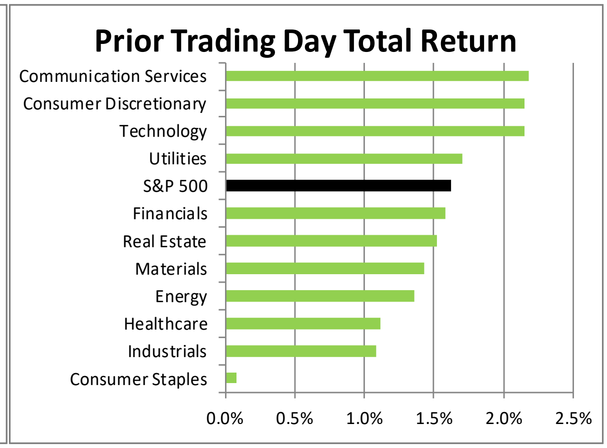
Weather

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 Arizona. The forecasts show wetter-than-normal conditions throughout most of the country except for the Midwest and New England.

Data Section

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

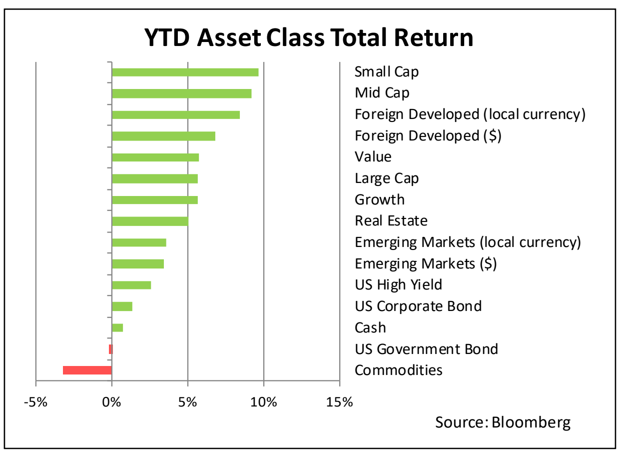




(Source: Bloomberg)

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 3/3/2023 close)

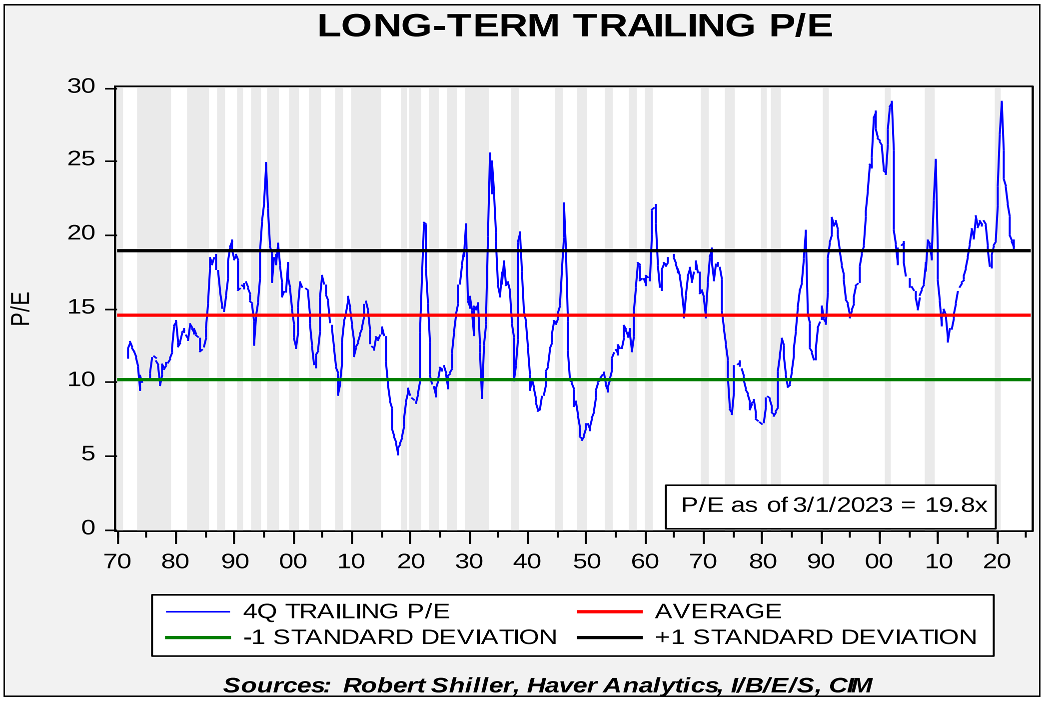


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.