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 20, 2023—9:30 AM EDT] Global equity markets are mixed 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 1.5%. Chinese markets were lower, with the Shanghai Composite down 0.5% and the Shenzhen Composite down 0.3%. U.S. equity index futures are signaling a flat 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* (3/6/2023) (with associated podcast) "Enter the Petroyuan"
- *Weekly Energy Update* (3/16/2023): We discuss the Chinese engineered "detente" between Saudi Arabia and Iran and the Willow project in Alaska.
- *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 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.
- *Asset Allocation Bi-Weekly* (3/13/2023) (with associated podcast): "The Importance of the Policy Mix"
- *Confluence of Ideas* podcast (3/8/2023): "Reflections on Inflation"

Our *Comment* today opens with an update on the global banking crisis, where Warren Buffett has reportedly been in contact with government officials in the U.S., and Swiss authorities have forced a merger of their top two banks. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including signs of continued tensions between the West and China and various items related to the U.S. economy.

U.S. Banking Crisis: Reports indicate that Warren Buffett, the billionaire chief of Berkshire Hathaway (BRK-B, $293.51), has reached out to the Biden administration in recent days, potentially signaling that he is ready to intervene in the regional banking crisis. Buffett has a long history of stepping-in to aid banks in crisis, leveraging his cult investing status and financial heft to restore confidence in ailing firms. As troubled regional First Republic Bank (FRC, $23.03) is trading sharply lower today after its debt was downgraded by S&P, it is possible that

Buffet will swoop in to rescue it or some other bank in an effort to shore up confidence in the sector. In any case, we continue to note that despite the sharp price declines for many regional bank stocks, the overall equity markets continue to handle the crisis fairly well, probably at least in part because the crisis has raised hopes that the Federal Reserve will slow, stop, or even reverse its campaign to hike interest rates to reduce inflation.

- Over the weekend, fresh reporting shows that the Federal Reserve had been aware of the risky operations at Silicon Valley Bank (SIVB, $106.04) long before it collapsed and touched off the broader banking crisis. The reports indicate that as early as 2021, regulators from the San Francisco FRB issued six warnings to the bank, but the bank didn't fix the problems. By July 2022, the bank was in a full supervisory review and was ultimately rated deficient for governance and controls, which precluded it from growing through acquisitions.
- In the European collateral damage, Swiss banking giant UBS (UBS, $18.20) has agreed to buy ailing Credit Suisse (CS, $2.01) for approximately $3.2 billion, under pressure from the country's regulators. To facilitate the deal and help restore confidence in the Swiss banking sector, the Swiss National Bank will lend over $100 billion to UBS, while the Swiss financial regulator takes other steps to hasten the deal.
    - Credit Suisse's equities today are trading sharply lower, in line with the low price that UBS is paying. Other global bank stocks are being dragged lower as well.
    - Interestingly, the UBS-Credit Suisse deal also wipes out billions of dollars of Credit Suisse's riskiest "additional Tier 1" bonds. That means that those bond holders could actually do worse than the bank's stock holders and threaten some $250 billion in similar bonds in Europe.

China-Japan-United States: Based on rumors swirling among investors in Shanghai and Shenzhen, it appears the West's next move to suppress China's information technology sector will be for Japan to ban China-bound exports of photoresist chemicals needed to produce advanced semiconductors. Chinese investors have responded by piling into the shares of domestic chemical companies that might be able to produce any chemicals cut off by Japan.

- Such an embargo by Japan would be consistent with the way it has been cooperating in the U.S.-led effort to slow Beijing's military technology development. In another sign of Japan's stepped-up cooperation with the U.S.'s anti-China efforts, Japanese Foreign Minister Hayashi visited the Solomon Islands yesterday in an effort to help peel its government away from its recent security deal with Beijing.
- If Tokyo does impose its ban on photoresist chemicals, it would mark yet another step in the technological decoupling of the evolving U.S.-led geopolitical bloc and the China-led bloc. That will further boost tensions between the blocs and present headwinds for investors.

China-Russia-United States: On Friday, the U.S. confirmed that Chinese-made ammunition has been discovered on Ukrainian battlefields and has apparently been used by Russian forces to carry out their invasion of the country. U.S. officials say they have notified their allies of the findings, although they stress that they haven't confirmed that China sent the ammunition directly to Russia. The news comes as Chinese President Xi visits Russian President Putin in Moscow for three days beginning today.

- Meanwhile, we've seen reports that Turkey may be backing away from its support of Russia over the course of the war.
- For example, the unconfirmed reports suggest Ankara has now clamped down on sanctioned exports to Russia, has stopped servicing Russian airliners, and has prohibited its businesses from buying fuel from Russian entities.

France: President Macron, over the weekend, faced burgeoning protests and riots across the country over his decree from last week to raise the country's retirement age. According to the Interior Ministry, some 70,000 protestors participated. Macron's government also faces a vote of no confidence today, although losing the vote itself wouldn't necessarily push Macron from power or force the cancellation of the hike in the retirement age.

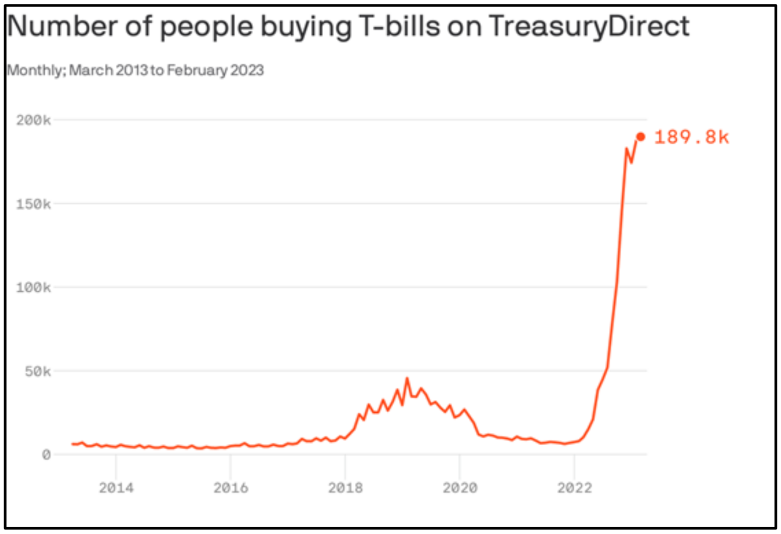
Thailand: Prime Minister Prayuth Chan-o-cha has issued a decree to dissolve parliament, paving the way for elections in May. Prayuth, a former coup leader who rules with the military's backing, is deeply unpopular because of last year's consumer price inflation. In theory, he's also prevented from being reelected because of constitutional term limits. All the same, Prayuth is hoping he can be reelected on the strength of his post-pandemic stimulus measures, a rebound in tourism, and the formation of a new, conservative royalist-military party created to get around term limits. That sets up a likely period of political uncertainty in Thailand over the coming months.

South Africa: The country is preparing for a national strike today launched by the radical opposition Economic Freedom Fighters in a bid to unseat President Cyril Ramaphosa. Since South Africa is a major producer of mineral commodities, a successful strike that impinges on output could potentially boost commodity prices.

Latin America: The new chief of the UN Economic Commission on Latin America and the Caribbean, José Manuel Salazar-Xirinachs, warned that the region's economic growth in the decade to 2023 will come in at an average of just 0.8% per year, even worse than the 2.0% growth rate in the "lost decade" of the 1980s and far below the 5.9% growth rate in the 1970s.

- Salazar-Xirinachs ascribed the poor performance mostly to weak investment, low productivity, and inadequate education.
- Of course, individual firms in the region can still offer attractive investment prospects, but the statement does highlight the economic and financial challenges facing the region.

U.S. Fiscal Policy: The Treasury Department reports that the number of people buying Treasury bills directly from the government on TreasuryDirect.gov is skyrocketing (see chart below). The surge is exactly what you would expect with T-bills yielding approximately 5% and banks offering far less than that on deposits. As Democrats and Republicans in Congress prep for a battle over raising the federal debt limit in the coming months, the surge of direct T-bill holders creates a new constituency of individuals who would be angered by a debt default, potentially reducing the risk of a default happening.



U.S. Monetary Policy: The Federal Reserve will hold its latest policymaking meeting this week on Tuesday and Wednesday, with its decision due on Wednesday afternoon. Despite the strong economic data for January and February, we suspect the recent banking crisis in the U.S. and Europe will keep them from hiking their benchmark fed funds rate by anything more than a modest 25 basis points. Many investors and observers are even expecting them to hold rates steady.

- To maintain global dollar liquidity as the banking crisis boils, the Fed and five other major central banks said they would immediately launch daily currency swap lines. The swap lines will run at least until the end of April.
- However, reporting so far this morning suggests there has been little demand for dollars through the swap lines. That's a positive sign that the crisis remains relatively contained.

U.S. Labor Market: The nation's major movie studios and the Writer's Guild of America, which represents 11,500 screenwriters, will launch negotiations today for a new contract to replace the one that expires May 1. Because of expected frictions over pay, including royalty payments in the age of streaming, the negotiations have spurred concern about a possible strike like the one in 2007, in which screenwriters walked off the job for more than three months.

U.S. Economic Releases

No major U.S. economic reports have been released so far today, and there are no economic releases or Fed events scheduled for the rest of the day.

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
EUROPE								
Eurozone	Trade Balance SA	m/m	Feb	-11.3b	-18.1b	-13.4b	**	Equity and bond neutral
Germany	PPI	y/y	Feb	15.8%	17.8%	17.6%	**	Equity bullish, bond bearish
Uk	Rightmove House Prices YoY	y/y	Mar	3.0%	3.9%		*	Equity bullish, bond bearish
Switzerland	Domestic Sight Deposits CHF	w/w	17-Mar	499.9b	496.5b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	17-Mar	515.1b	510.8b		*	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)	500	496	4	Up
3-mo T-bill yield (bps)	425	429	-4	Down
TED spread (bps)	75	67	8	Widening
U.S. Sibor/OIS spread (bps)	476	476	0	Up
U.S. Libor/OIS spread (bps)	477	477	0	Up
10-yr T-note (%)	3.37	3.43	-0.06	Flat
Euribor/OIS spread (bps)	275	265	10	Up
Currencies	**Direction**			
Dollar	Down			Flat
Euro	Up			Up
Yen	Up			Up
Pound	Up			Up
Franc	Down			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
PBOC 1-Year Loan Prime Rate	3.650%	3.650%	3.650%	On Forecast
PBOC 5-Year Loan Prime Rate	4.300%	4.300%	4.300%	On Forecast

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.

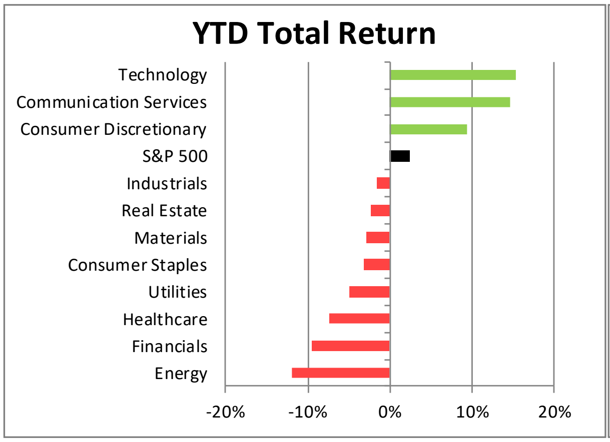
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$71.79	$72.97	-1.62%	
WTI	$65.59	$66.74	-1.72%	
Natural Gas	$2.38	$2.34	1.88%	
Crack Spread	$40.87	$40.88	-0.02%	
12-mo strip crack	$29.88	$29.99	-0.36%	
Ethanol rack	$2.36	$2.35	0.44%	
Metals				
Gold	$1,983.10	$1,989.25	-0.31%	
Silver	$22.51	$22.60	-0.42%	
Copper contract	$393.00	$389.25	0.96%	
Grains				
Corn contract	$627.50	$634.25	-1.06%	
Wheat contract	$698.75	$710.50	-1.65%	
Soybeans contract	$1,468.25	$1,476.50	-0.56%	
Shipping				
Baltic Dry Freight	1,535	1,560	-25	

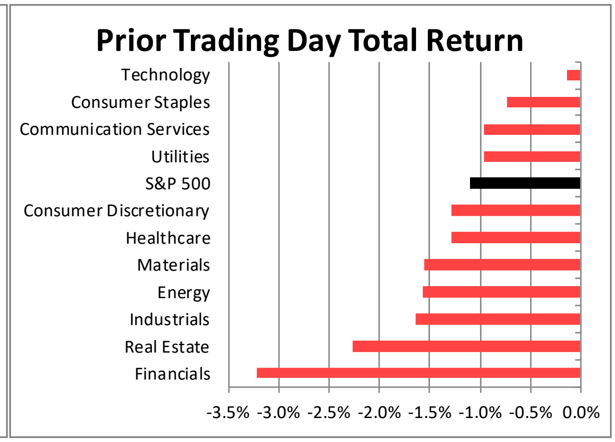
Weather

The 6-10 and 8-14 day forecasts currently call for colder-than-normal temperatures for most of the country, with warmer-than-normal temperatures anticipated in the Southeast. The forecasts show wetter-than-normal conditions across the nation, with dry conditions expected in western Texas.

Data Section

U.S. Equity Markets – (as of 3/17/2023 close)

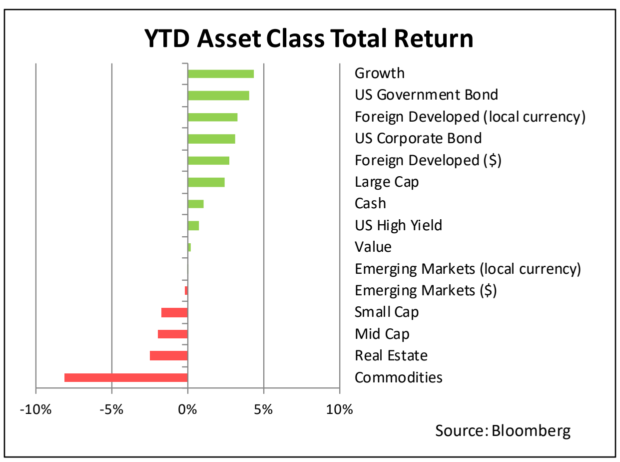




(Source: Bloomberg)

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 3/17/2023 close)

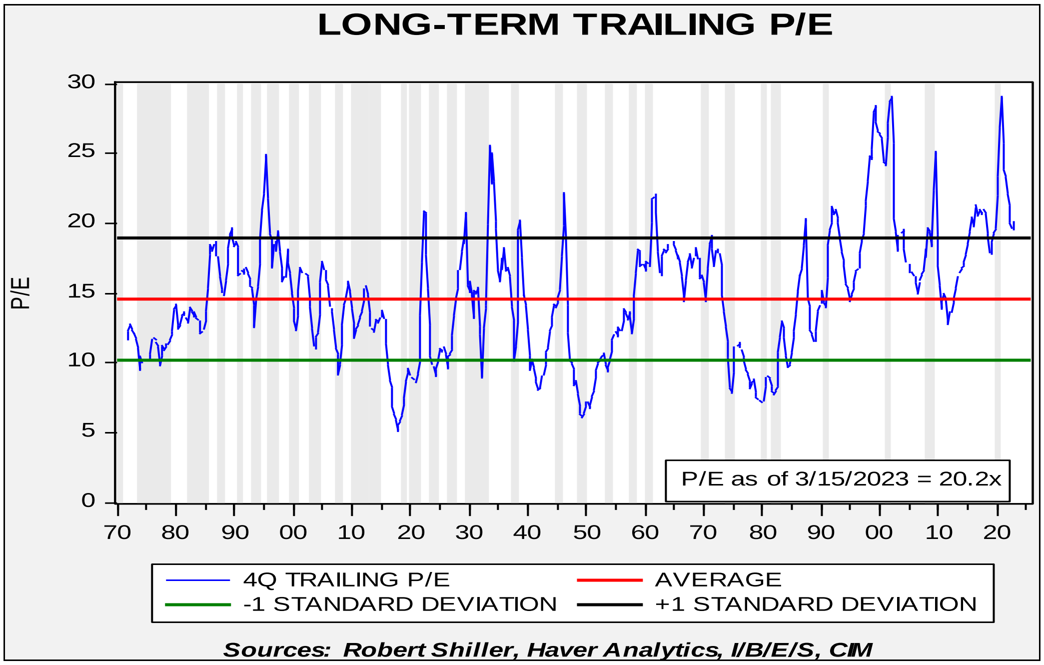


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 16, 2023



Based on our methodology,[1] the current P/E is 20.2x, down 0.1 from last week. Falling index values led to the decline.

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 three actual quarters (Q2, Q3 and Q4) and estimate (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.