# 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 22, 2023—9:30 AM EDT]** Global equity markets are 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 1.8%. Chinese markets were higher, with the Shanghai Composite up 0.3% and the Shenzhen Composite up 0.6%. 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* (3/20/2023) (with associated podcast) "Update on the U.S.-China Military Balance of Power"
- *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 U.S. and European banking crises and what they mean for monetary policy going forward (we also note that the Federal Reserve will release its latest interest-rate decision this afternoon at 2:00 PM EDT). We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including an encouraging rapprochement between Japan and South Korea and the latest on the China-Russia summit in Moscow.

**U.S. Banking Crisis:** In a speech to the American Bankers Association yesterday, Treasury Secretary Yellen signaled that she and other federal officials stand ready to intervene in the banking system again if more banks suffer deposit runs that threaten to spark contagion to other banks. That appeared to mark a reversal for Yellen, since she had previously said the federal government would guarantee banks' uninsured deposits only if the officials again invoked emergency powers to protect them. In any case, the crisis continues to show signs of dissipating, with bank stocks and other equities having strong price gains yesterday. All the same, we remain worried that additional stresses are building in the bank sector, especially among smaller banks which have substantial exposure to the possibility of mass defaults in commercial real estate. The concerns about issues in commercial real estate have recently been rising sharply.

- Yellen's statement is part of a burgeoning debate on whether the government should fully insure all bank deposits, or at least raise the insured amount above the current cap of $250,000 per depositor, per bank.

- The maximum FDIC-insured amount hasn't changed since 2008. However, even if that cap were raised substantially, it still might not cover much of a large company's deposits. Large corporate deposits can run well into the millions of dollars, or even hundreds of millions of dollars, as shown by the collapse of Silicon Valley Bank (SIVB, $106.04). Companies withdrawing their deposits *en masse* can destabilize a bank just as surely as individuals can.

- That helps explain why much of the current reform talk centers on the possibility of insuring all bank deposits. However, many Republicans in Congress are pushing back strongly against the idea, largely on moral hazard grounds. While we do expect the crisis will eventually lead to new regulatory reforms, it's still tough to predict exactly what will happen with the insured amount.

**U.S. Monetary Policy:** The Federal Reserve wraps up its latest policymaking meeting today, with its decision due out at 2:00 PM EDT. Despite the strong economic data for January and February, we suspect the banking crises in the U.S. and Europe will discourage the policymakers 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.

**U.S. Stock Market:** With the banking crisis encouraging hopes for lower interest rates, many technology stocks and other "long duration" equities have gotten a boost in recent days. Nevertheless, new data shows that the combined weighting of Apple (AAPL, $159.28) and Microsoft (MSFT, $273.78) in the S&P 500 has now reached a record high of 13.3%. Other big technology stocks have recently somewhat recovered from the beating they took from the Fed's interest-rate hikes over the last year, but the new data underscores how Apple and Microsoft are now in a class by themselves in terms of market dominance.

**European Banking Crisis:** Debate continues to rage about Swiss regulators' decision to zero out the additional Tier 1(AT1) capital bonds of Credit Suisse (CS, $0.9681) as part of its rescue over the weekend. Although AT1 bonds are designed to absorb losses in a bank failure, essentially making them junior to the bank's equities, some of Credit Suisse's AT1 holders are reportedly considering legal action against the regulators' move. In any case, the write-down of the bonds is expected to undermine their value throughout Europe, boosting funding costs for banks.

- As noted above, many investors continue to hope the current banking crises will prompt the main central banks to stop, slow, or even reverse their campaigns to hike interest rates in order to fight inflation. However, they were disappointed by the European Central

Bank's decision last week to hike its benchmark short-term interest rate by an aggressive 50 basis points.

- In a sign that the ECB could continue to hike rates aggressively, German central bank Governor Joachim Nagel discounted any fears that the banking crises would have broad effects on the European banking system and called for the monetary policymakers to be "stubborn" in their rate hikes to fight inflation.
- Nagel also showed no sympathy for the holders of Credit Suisse's AT1 bonds, saying those who profited from their opportunity should be prepared to shoulder the risk they took. However, he did confirm that the ECB would not follow the Swiss decision to bail in AT1s before a bank's equity was wiped out.

**United Kingdom:** The February consumer price index was up a full 10.4% year-over-year, an acceleration from the 10.1% rise in the year to January and far above the expected annual increase of 9.9%. Much of the unexpected acceleration reflected a jump in service prices. While investors before the report had been evenly split on whether the Bank of England would keep hiking its benchmark interest rate at its meeting on Thursday, they are now pricing in a likely hike of 25 bps.

**Japan-South Korea:** President Yoon Suk-yeol of South Korea yesterday said that he would order his government to return Japan to its "white list" of countries with fast-track trade status after a summit with Japanese Prime Minister Kishida last week. Yoon also expressed his confidence that Japan would soon reciprocate the gesture. The countries have black-listed each other since 2019 because of a dispute over Japan's treatment of Koreans during World War II.

- The diplomatic thaw and improved trade ties between Japan and South Korea reflect their realization that they need to stand together, along with the U.S. and other allies, to resist China's increasing geopolitical aggressiveness.
- The upside for investors is that increased trade between Japan and South Korea should be good for both countries' economies, and for their stocks.

**Sri Lanka:** The International Monetary Fund (IMF) gave final approval for a $3-billion bailout loan for the country this week, after the government instituted a number of fiscal reforms and convinced key bilateral lenders, including China, to sign onto a debt restructuring program. The IMF deal unlocks $4 billion in other emergency lending and will help alleviate Sri Lanka's lack of foreign currency reserves and deep recession, although it doesn't necessarily allow the country to tap global financial markets again.

**China-Russia:** During their summit meeting in Moscow yesterday, Chinese President Xi and Russian President Putin agreed to "significantly increase" trade between their two countries by 2030, and Putin threw his weight behind the greater use of CNY in trade. Putin noted that about two-thirds of China-Russia trade is now in the Chinese currency, although much of that reflects the fact that Russian exports to the West have been severely crimped by sanctions.

- Separately, the Russian government said it will start using new benchmark oil prices to calculate the taxes its oil firms pay on their exports. Although the G7 countries have imposed a price ceiling of $60 per barrel on Russian oil, recent statistics suggest Russian firms are often getting more than that.

- The tax revamp is reportedly geared to increase the Russian government's oil revenue by about $8 billion annually.

## U.S. Economic Releases

A decline in interest rates led to a surge in residential loan demand. According to an index tracked by the Mortgage Bankers Association, mortgage applications rose 3.0% on a seasonally adjusted basis in the week ending March 17. The jump in loan requests is related to a sharp decline in borrowing costs. The average 30-year fixed-rate mortgage dropped to 6.5%, its lowest level in a month. As a result, the tracker for purchases rose 2.0% from the prior week, while the refinance tracker rose 5.0% in the same period.

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

| Economic Releases | | | | | | |
|---|---|---|---|---|---|---|
| EST | Indicator | | | Expected | Prior | Rating |
| 14:00 | FOMC Rate Decision (Lower Bound) | w/w | 22-Mar | 4.75% | 4.50% | *** |
| 14:00 | FOMC Rate Decision (Upper Bound) | w/w | 22-Mar | 5.00% | 4.75% | *** |
| 14:00 | Interest on Reserve Balances Rate | w/w | 23-Mar | 4.90% | 4.65% | ** |
| Federal Reserve | | | | | | |
| EST | Speaker or Event | District or Position | | | | |
| 14:00 | FOMC Concludes Two-Day Meeting | Federal Reserve Board | | | | |
| 14:30 | Jerome Powell Holds Press Conference Folloiwng FOMC Meeting | Chairman of the Board of Governors | | | | |

## 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 | Machine tool orders | y/y | Feb F | -10.7% | -10.7% | | ** | Equity and bond neutral |
| Australia | Westpac Leading Index | m/m | Feb | -0.1% | -0.1% | -0.12 | ** | Equity and bond neutral |
| New Zealand | Wespac Consumer Confidence | m/m | Q1 | 77.7 | 75.6 | | * | Equity bullish, bond bearish |
| EUROPE | | | | | | | | |
| UK | CPI | y/y | Feb | 10.4% | 10.1% | 9.9% | *** | Equity bearish, bond bearish |
| | Core CPI | y/y | Feb | 6.2% | 5.8% | 5.7% | * | Equity bearish, bond bearish |
| | Retail Price Index | y/y | Feb | 364.50 | 360.30 | 362.60 | | Equity and bond neutral |
| | RPI YoY | y/y | Feb | 13.8% | 13.4% | 13.3% | | Equity bearish, bond bullish |
| | House Price Index | y/y | Jan | 6.3% | 9.8% | 9.3% | *** | Equity bullish, bond bearish |
| AMERICAS | | | | | | | | |
| Canada | CPI | y/y | Feb | 5.20% | 5.90% | 5.40% | *** | Equity and bond neutral |
| Mexico | Aggregate Supply and Demand | y/y | 4Q | 4.1% | 6.4% | 4.3% | * | 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) | 495 | 500 | -5 | Up |
| 3-mo T-bill yield (bps) | 458 | 455 | 3 | Up |
| TED spread (bps) | 37 | 45 | -8 | Widening |
| U.S. Sibor/OIS spread (bps) | 491 | 489 | 2 | Up |
| U.S. Libor/OIS spread (bps) | 492 | 490 | 2 | Up |
| 10-yr T-note (%) | 3.63 | 3.61 | 0.02 | Flat |
| Euribor/OIS spread (bps) | 291 | 289 | 2 | Up |
| **Currencies** | **Direction** | | | |
| Dollar | Down | | | Down |
| Euro | Up | | | Up |
| Yen | Down | | | Down |
| Pound | Up | | | Up |
| Franc | Flat | | | 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.

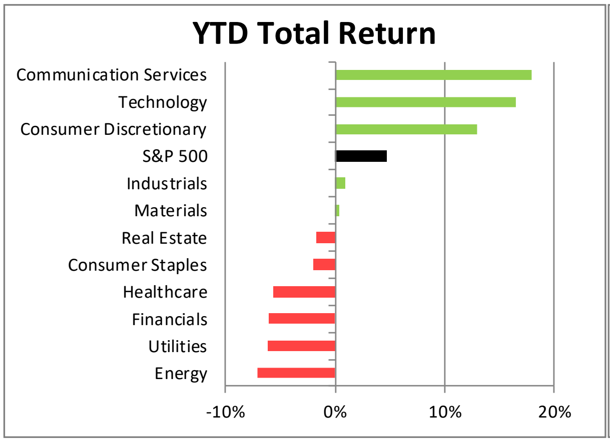
| DOE Inventory Report | Price | Prior | Change | Explanation |
|---|---|---|---|---|
| **Energy Markets** | | | | |
| Brent | $75.01 | $75.32 | -0.41% | |
| WTI | $69.32 | $69.67 | -0.50% | |
| Natural Gas | $2.23 | $2.35 | -5.15% | Demand Pessimism |
| Crack Spread | $36.86 | $39.15 | -5.87% | |
| 12-mo strip crack | $28.53 | $29.21 | -2.32% | |
| Ethanol rack | $2.37 | $2.37 | 0.07% | |
| **Metals** | | | | |
| Gold | $1,941.41 | $1,940.07 | 0.07% | |
| Silver | $22.33 | $22.39 | -0.25% | |
| Copper contract | $404.45 | $399.40 | 1.26% | |
| **Grains** | | | | |
| Corn contract | $627.00 | $630.00 | -0.48% | |
| Wheat contract | $668.00 | $683.25 | -2.23% | |
| Soybeans contract | $1,461.25 | $1,467.00 | -0.39% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 1,512 | 1,542 | -30 | |
| **DOE Inventory Report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | | -1.8 | | |
| Gasoline (mb) | | -2.4 | | |
| Distillates (mb) | | -1.5 | | |
| Refinery run rates (%) | | 1.0% | | |
| Natural gas (bcf) | | -76 | | |

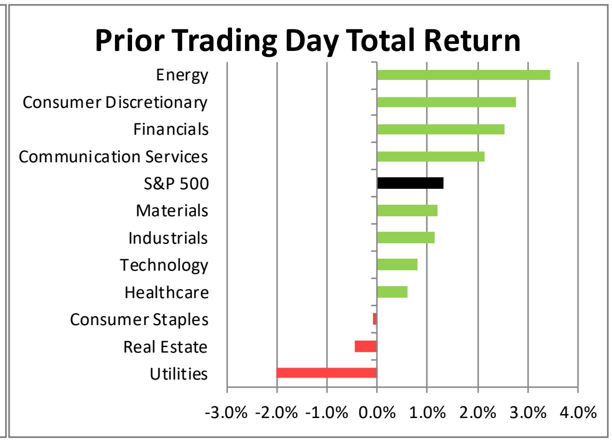
**Weather**

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 and Texas. The forecasts show wetter-than-normal conditions across the Midwest and Pacific and Eastern regions, with dry conditions expected in the Rocky Mountain region.

## Data Section

**U.S. Equity Markets** – (as of 3/21/2023 close)

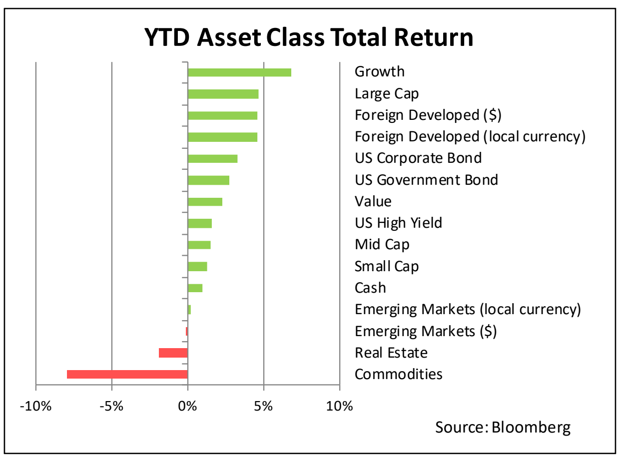



(Source: Bloomberg)

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 3/21/2023 close)

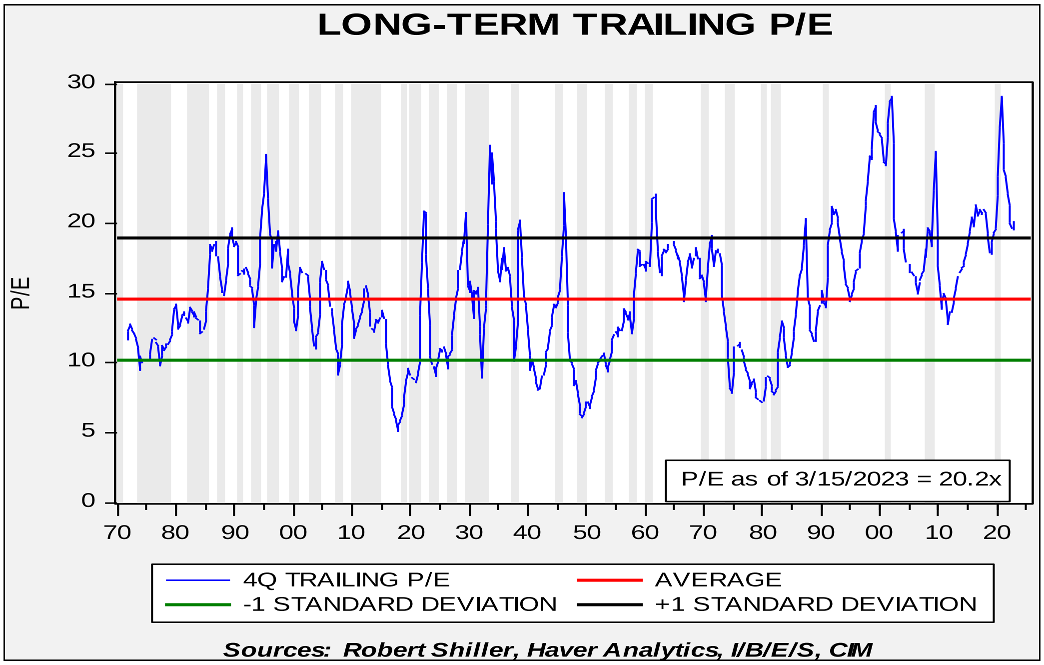



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.