Daily Comment

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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 24, 2023—9:30 AM EDT] Global equity markets are mostly lower this morning. In Europe, the Euro Stoxx 50 is currently down 2.5% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.6%. Chinese markets were mixed, with the Shanghai Composite closing down 0.6% and the Shenzhen Composite closing up 0.3%. U.S. equity index futures are signaling a lower 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* (3/23/2023): We take a look at the recent weakness in oil prices and update the weekly DOE data.
- *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"

Good morning! Today's *Comment* begins with an overview of our thoughts on the Congressional hearings for both TikTok and Treasury Security Janet Yellen. Next, we discuss why central banks have decided to raise interest rates in the face of an ongoing banking crisis. Lastly, we explore the reasoning behind China and Russia's new interest in the Middle East.

Congressional Attention: Lawmakers are looking to bolster their reputation of being tough on big banks and China during hearings on the Hill.

- TikTok CEO Shou Chew testified before a hostile Congress on Thursday, as officials weigh a potential ban of the social media app. During the hearing, politicians did not shy away from confrontation. Chew, who tried to walk a tight line between being vague and honest, was challenged on his company's ability to remain independent of Beijing. In one exchange a politician implied that Chew was committing perjury when he refused to say that the social media site does not disseminate material that would upset Beijing. The row over TikTok is likely the first of many fights over whether Chinese firms pose threats to U.S. national security.

  - Chinese authorities have raided the Beijing office of Mintz Group, a U.S. due diligence firm. The raid may signal that Beijing is willing to crack down on U.S. firms and comes just a week before the country hosts Tim Cook of Apple (AAPL, $158.93) and Noel Quinn of HSBC (HSBC, $33.48) for its annual investor conference.

- Meanwhile, Treasury Secretary Janet Yellen's flip-flop regarding efforts to insure U.S. bank deposits without the approval of Congress has added to concerns that the government may need to rescue the banking system. While speaking to Congress, Yellen walked back remarks that suggested that the Treasury Department was not prepared to expand deposit insurance. Any rescue plan without congressional consent will likely meet pushback as politicians would view unilateral executive action as evidence that banking officials are not being forthright about the severity of the banking crisis. Investors have been paying close attention to Yellen's remarks for signs of a possible bailout for regional banks.
- The two separate hearings on banks and Chinese companies reflect a trend away from the Bork rule that defined the period between 1970-2010. Named after former Federal Judge Robert Bork, the rule stipulates that regulations should not be used to interfere with economic efficiency or consumer welfare. This sentiment has been the bedrock of elitist thinking regarding the government's approach to business but is showing signs of eroding. As the congressional hearings demonstrate, lawmakers would like to prioritize policies that favor state objectives such as national security and bank stability over economic efficiency. If we are correct, this will likely lead to a higher inflationary environment as firms look to push the cost of burdensome regulations onto the consumer.

Interest Rate Fallout: Major central banks still decided to raise rates despite the ongoing banking crisis.

- The decision to raise rates indicates that monetary policymakers are hesitant to stop tightening without solid evidence that the banking system's health has no other fix. Recent liquidity injections by the Federal Reserve and Swiss National Bank have given officials confidence that the worst of the crisis has peaked. In individual statements, the Bank of England, Federal Reserve, and European Central Bank all offered reassurances that the banking system remains resilient amidst the turmoil. Additionally, each bank maintained that they remain committed to bringing down inflation and preserving financial stability.
- Although central bankers signaled that they are not considering rate cuts, the market seems to believe otherwise. The CME FedWatch tool shows an 80% chance that the Fed will cut rates by its July meeting. Meanwhile, the overnight index swap rates for the GBP and EUR suggest that the BOE and ECB will look to stop hiking around June or September of this year. Movements within the bond market also suggest that investors

believe that policy will begin to normalize. As of Thursday, the inversion spread between the 10- and two-year Treasury narrowed by 42 bps since the start of the month.

- Monetary policymakers want to raise rates but do not want to destabilize the financial system. The usage of the backstops has offered banks some relief from deposit outflows. The latest figures from the Fed show that U.S. banks borrowed $53.7 billion from the Fed's new Bank Term Funding Facility. However, there is still no guarantee that the turmoil in banking will end anytime soon. The sudden spike in Deutsche Bank's (DB, $9.65) default insurance costs will likely add worries that the financial system remains fragile. As a result, it is still reasonable to assume that central banks could consider easing monetary policy this year if the banking issues persist.

Middle East Problems: The China-Russia pivot toward the Middle East complicates the efforts of the U.S. to exit the region.

- Russia and China are working to mediate tensions between Arab countries to help reduce the region's dependence on U.S. security. On Wednesday, Moscow had announced it was close to restoring diplomatic ties between Saudi Arabia and Syria. The move comes on the heels of several recent successes of China and Russia to calm violence in the region, highlighting the U.S.'s declining importance. Last week, China assisted in restoring diplomatic ties between Saudi Arabia and Iran. Moscow and Beijing may be looking to build their influence in the Middle East to disrupt efforts by the West to isolate them.
- U.S. foreign policy within the Middle East continues to show signs of disarray. Despite efforts to reduce the U.S. forces within the region, the Pentagon carried out airstrikes in Syria against an Iranian rebel group. The U.S. has about 900 troops in Syria to help with Syrian fighters' efforts against Islamic State militants. Meanwhile, Israeli Prime Minister Benjamin Netanyahu's efforts to undermine the country's Supreme Court and other democratic institutions have frustrated Washington. The Biden administration expressed concerns about the changes to Israeli law earlier this week. The ongoing friction will complicate cooperation efforts between the two countries as they look to take on Iran and expand the Abraham Accords.
- As the U.S. looks to focus its attention on expanding its influence in the Indo-Pacific, it appears that Russia and China are looking to deepen their ties with Middle Eastern countries. The China-Russia pivot toward the region will aid efforts to reduce their respective reliance on the West. It will also ensure that China can maintain its access to commodities even as its relationship with the U.S. deteriorates, while Russia can use its relationship with Arab countries to undermine the West's efforts to slow its petro sales through price ceilings.
    - The biggest loser in this scenario may be the European Union, as it is stuck between kowtowing to authoritarian governments that challenge its value or being forced to accept U.S. foreign policy that often challenges its strategic interests.

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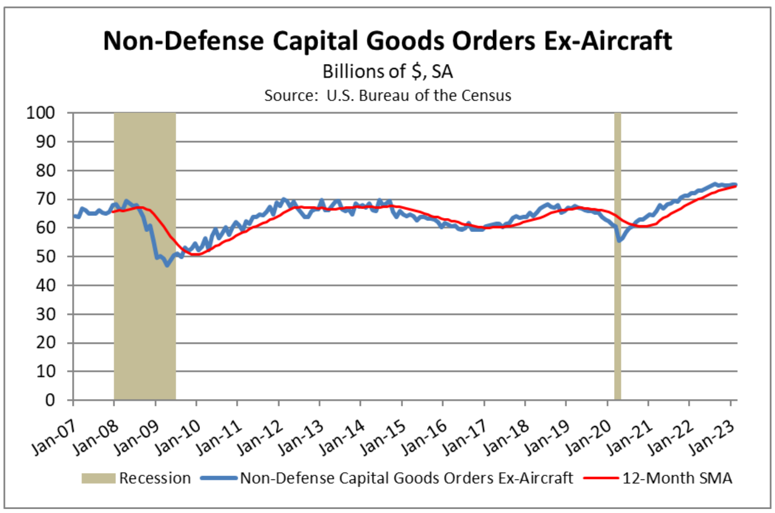
U.S. Economic Releases

February ***durable goods orders*** fell by a seasonally adjusted 1.0%, far worse than their expected rise of 0.2%. In addition, January orders were revised downward to show a decline of 5.0%, versus the original estimate that they had fallen 4.5%. However, durable goods orders are often driven by transportation equipment, where just a few airliner orders can have a big impact, and that was certainly the case last month. February ***durable goods orders excluding transport*** were unchanged from the previous month, only modestly undershooting the anticipated rise of 0.2% and the revised January increase of 0.4%.

The durable goods report includes a key proxy for corporate capital investment. In February, ***nondefense capital goods orders ex-aircraft*** rose 0.2%, beating expectations that they would fall 0.2%, although the rise in February still marked a deceleration from their gain of 0.3% in January. Compared with the same month one year earlier, overall durable goods orders in February were up 1.0%, while durable orders ex-transport were up 1.2%. Nondefense capital goods orders ex-aircraft were up 3.2% year-over-year. The positive annual rise in nondefense capital goods orders ex-aircraft would suggest that companies are still investing a lot in new facilities and equipment. That spending has hit a plateau in recent months, but it has not yet declined as would be expected in a recession. The chart below shows the progression of nondefense capital goods orders ex-aircraft since just before the previous recession.



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**
9:45	S&P Global Manufacturing PMI	m/m	Mar P	47.0	47.3	***
9:45	S&P Services PMI	m/m	Mar P	50.3	50.6	**
9:45	S&P Composite PMI	m/m	Mar P	49.5	50.1	**
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
9:45	James Bullard Speaks at Greater St. Louis Inc. Event	President of the Federal Reserve Bank of St. Louis				

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	National CPI	y/y	Feb	3.3%	4.3%	3.3%	***	Equity and bond neutral
	National CPI Ex-Fresh Food	y/y	Feb	3.1%	4.2%	3.1%	**	Equity and bond neutral
	National CPI Ex-Fresh Food & Energy	y/y	Feb	3.5%	3.2%	3.4%	*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	17-Mar	¥3334.8b	¥909.5b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	17-Mar	¥4095.7b	-¥156.8b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	17-Mar	¥118.2b	-¥169.7b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	17-Mar	-¥1080.6b	-¥834.2b		*	Equity and bond neutral
	Jibun bank Composite PMI	m/m	Mar P	51.9	51.1		*	Equity and bond neutral
	Jibun Bank Manufacturing PMI	m/m	Mar P	48.6	47.7		***	Equity and bond neutral
	Jibun Bank Services PMI	m/m	Mar P	54.2	54.0		**	Equity and bond neutral
EUROPE								
Eurozone	Consumer Confidence	m/m	Mar P	-19.2	-19.0	-19.1	**	Equity and bond neutral
	S&P Global Manufacturing PMI	m/m	Mar P	47.1	48.5	49.0	***	Equity bearish, bond bullish
	S&P Global Services PMI	m/m	Mar P	54.1	52.0	52.0	**	Equity bullish, bond bearish
	S&P Global Composite PMI	m/m	Mar P	55.6	52.7	52.5	*	Equity bullish, bond bearish
Germany	S&P Global Manufacturing PMI	m/m	Mar P	44.4	46.3	47.0	***	Equity bearish, bond bullish
	S&P Global Services PMI	m/m	Mar P	53.9	50.9	51.1	**	Equity bullish, bond bearish
	S&P Global Composite PMI	m/m	Mar P	52.6	50.7	51.0	**	Equity bullish, bond bearish
France	S&P Global Composite PMI	m/m	Mar P	54.0	51.7	51.6	**	Equity and bond neutral
	S&P Global Manufacturing PMI	m/m	Mar P	47.7	47.4	48.0	***	Equity and bond neutral
	S&P Global Services PMI	m/m	Mar P	55.5	53.1	52.5	**	Equity and bond neutral
UK	GfK Consumer Confidence	m/m	Mar	-36.0%	-38.00	-36.00		Equity and bond neutral
	Retail Sales	y/y	Feb	-3.5%	-5.10%	-5.20%	***	Equity bearish, bond bullish
	Retail Sales Ex-Auto Fuel	y/y	Feb	-3.3%	-5.30%	-5.40%	**	Equity bearish, bond bullish
	S&P/CIPS Manufacturing PMI	m/m	Mar P	48.0	49.3	49.7	***	Equity and bond neutral
	S&P/CIPS Services PMI	m/m	Mar P	52.8	53.5	53.0	**	Equity and bond neutral
	S&P/CIPS Composite PMI	m/m	Mar P	52.2	53.1	52.7	**	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	17-Mar	$585.8b	$573.3b		***	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	17-Mar	16.94t	16.83t		*	Equity and bond neutral
AMERICAS								
Mexico	Economic Activity IGAE	y/y	Jan	4.43%	2.62%	3.00%	**	Equity bearish, bond bullish
Brazil	IBGE Inflation IPCA - 15	y/y	Mar	5.4%	5.6%	5.3%	*	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)	508	502	6	Up
3-mo T-bill yield (bps)	439	453	-14	Down
TED spread (bps)	69	49	20	Widening
U.S. Sibor/OIS spread (bps)	482	486	-4	Up
U.S. Libor/OIS spread (bps)	483	487	-4	Up
10-yr T-note (%)	3.31	3.43	-0.12	Flat
Euribor/OIS spread (bps)	299	300	-1	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Up			Up
Pound	Down			Up
Franc	Down			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.

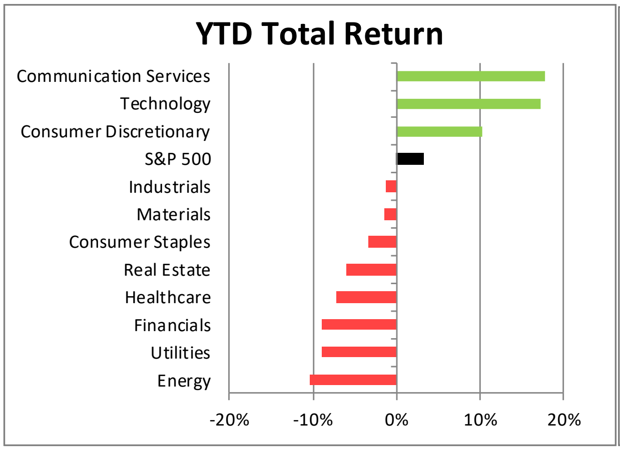
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$73.11	$75.91	-3.69%	
WTI	$67.23	$69.96	-3.90%	
Natural Gas	$2.21	$2.15	2.41%	
Crack Spread	$38.33	$38.05	0.76%	
12-mo strip crack	$29.04	$29.01	0.12%	
Ethanol rack	$2.41	$2.41	0.05%	
Metals				
Gold	$1,993.89	$1,993.40	0.02%	
Silver	$23.17	$23.10	0.28%	
Copper contract	$406.65	$412.35	-1.38%	
Grains				
Corn contract	$632.75	$631.75	0.16%	
Wheat contract	$671.75	$662.00	1.47%	
Soybeans contract	$1,409.25	$1,419.50	-0.72%	
Shipping				
Baltic Dry Freight	1,484	1,456	28	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	1.1	-1.8	2.9	
Gasoline (mb)	-6.4	-2.4	-4.0	
Distillates (mb)	-3.1	-1.5	-1.6	
Refinery run rates (%)	0.4%	1.0%	-0.6%	
Natural gas (bcf)	-72	-72	0.0	

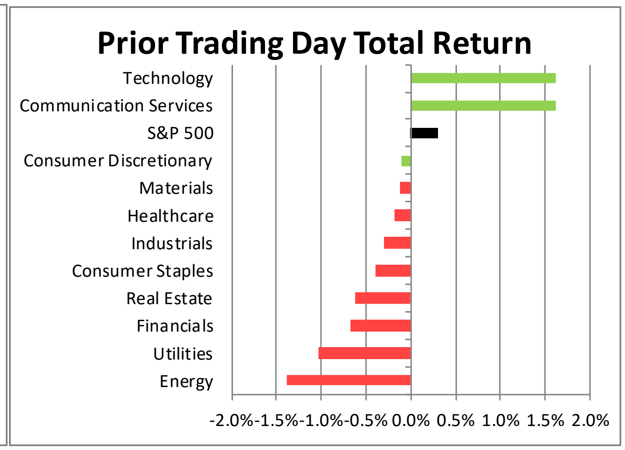
Weather

The 6-10 and 8-14 day forecasts currently call for colder-than-normal temperatures along the West Coast and in the Rocky Mountain states, the northern Great Plains, and New England, with warmer-than-normal temperatures anticipated in the Deep South. The forecasts are calling for wetter-than-normal conditions along the West Coast and throughout the Mississippi Valley region, with dry conditions expected in the central Great Plains and southern Florida.

Data Section

U.S. Equity Markets – (as of 3/23/2023 close)

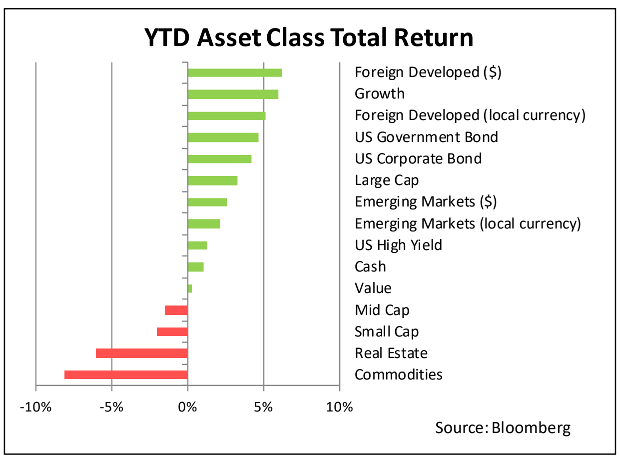




(Source: Bloomberg)

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 3/23/2023 close)

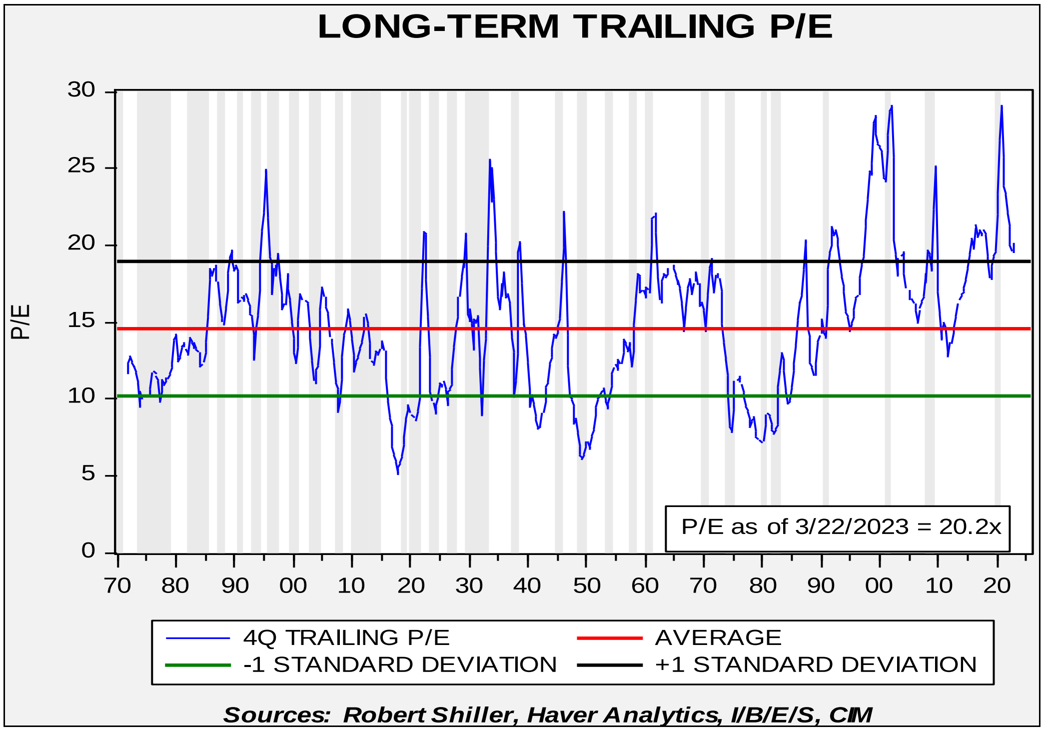


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 23, 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.