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 29, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is currently up 1.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.5%. Chinese markets were mixed, with the Shanghai Composite closing down 0.4% and the Shenzhen Composite closing up 0.1%. U.S. equity index futures are signaling a higher 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* (3/27/2023) (with associated podcast): "Have Policymakers Solved the Tinbergen Problem?"
- *Confluence of Ideas* podcast (3/8/2023): "Reflections on Inflation"

Our *Comment* today opens with an update on the U.S. banking crisis, where the Senate Banking Committee took testimony yesterday from Federal Reserve Vice Chair for Supervision Barr and other top bank regulators. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including this week's big break-up of a major Chinese internet-commerce company and increasing weakness in the Russian economy.

U.S. Banking Crisis: In his testimony to the Senate Banking Committee yesterday, Fed Vice Chair for Supervision Barr revealed that the central bank regulators had issued numerous warnings to Silicon Valley Bank (SIVB, $106.04) about its asset and liability risks over more than a year, virtually up until the time that the bank failed earlier this month. Nevertheless, the Senators on the committee castigated the Fed for not following through on those warnings and not forcing the bank to take action. Barr and other top bank regulators will testify today before the House.

- When asked how quickly a bank should respond to supervisory directives from the Fed, Supervisory Chair Barr, incredibly, said he didn't know the time frame for such action.
- The hearing showed that legislators are not only considering making more banks subject to the stricter regulatory regime imposed on the biggest banks, but they may also consider new supervisory rules and procedures for the Fed itself.

U.S. Labor Market: With multiple state and local governments now requiring that job listings include pay ranges, new research suggests the added information can incentivize employees to work harder, so long as they believe the pay system is fair. The research helps ease some employers' concerns that the new pay transparency could spark tension in their workforce and cause lower productivity.

U.S. Artificial Intelligence Industry: Elon Musk and more than 1,000 other technology executives and researchers have signed a public letter calling for a six-month pause in the development of advanced artificial intelligence systems, such as OpenAI's ChatGPT, in order to halt what they call a "dangerous" arms race. According to the letter, the advanced AI systems which are now being developed so quickly are beyond what humans can understand, predict, or reliably control.

- The signatories hope that a break would allow for the development of safety protocols and other controls for the technology.
- If the pause can't be put into place voluntarily and verifiably, the signatories urge a government-mandated moratorium.
- While we doubt such a pause will be implemented, we think the letter does reflect the extraordinarily rapid development of the technology, which is already transforming everything from key industries to military strategy.

China-Taiwan-United States: As Taiwanese President Tsai Ing-wen prepares to embark on her 10-day visit to the U.S. and Central America, the Chinese government warned that her planned meeting with House Speaker McCarthy would be "another provocation" and that China would "resolutely hit back". When then House Speaker Pelosi visited Taiwan last year, the Chinese responded with an aggressive series of military exercises around the island. The coming "transits" through the U.S. and the meeting with McCarthy could well spark a repeat of those exercises or other potentially dangerous responses.

China: Internet commerce giant Alibaba (BABA, $98.40) announced yesterday that it will reorganize into a holding company with six independently-run units for cloud computing, Chinese e-commerce, global e-commerce, digital mapping and food delivery, logistics, and media and entertainment. Each of the units could seek their own initial public offerings of stock.

- In all probability, the breakup was ordered by the Chinese government as part of President Xi's continuing effort to rein in the country's technology giants and bring them to heel. While that effort has diminished the companies' power, it could also be a positive for investors. Alibaba's shares have surged in response to the reorganization.

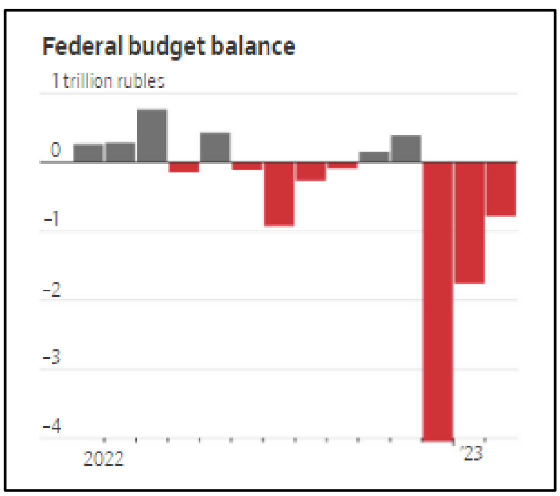
- Government officials and investors here at home have also called for some big U.S. technology giants to be broken up on antitrust and freedom of speech concerns, which could likewise unlock a lot of value. However, authoritarian governments like the one in China have much more power to do so. In a democracy like the U.S., bringing such break-ups into effect can be much more difficult due to the diffuse power structure and multiple political actors that would need to agree.

United States-Russia: Attempting to retaliate in a calibrated manner against Russia's recent decision to suspend its participation in the New START nuclear arms control treaty, the U.S. yesterday said it will stop sharing certain detailed data on its strategic nuclear forces with Russia.

- The move will likely lead to a further weakening of the last remaining Cold War-era arms control agreement between the U.S. and Russia.
- Full abrogation of the treaty would allow the U.S. to boost its nuclear arsenal to account for China's rapid nuclear build-up, but that would also likely set off a risky nuclear arms race between the U.S., China, Russia, and potentially other countries.

Russia: Although the Russian economy initially appeared to be weathering the Western sanctions imposed after the Kremlin launched its invasion of Ukraine, it now appears that it is starting to suffer more substantially. Since global oil and gas prices have retreated from their post-invasion highs, the resulting revenue declines and big military expenditures have left the government with huge budget deficits. The ruble has also started to decline sharply, while emigration and mass conscription have produced labor shortages.

- The intensifying difficulties are likely a harbinger of continued economic weakness in the long term.
- As we have long argued, Russia's economic problems will also force it ever more deeply into China's embrace, making it a key-but-junior partner in China's evolving geopolitical and economic bloc.



Source: Russian Finance Ministry via CEIC Data

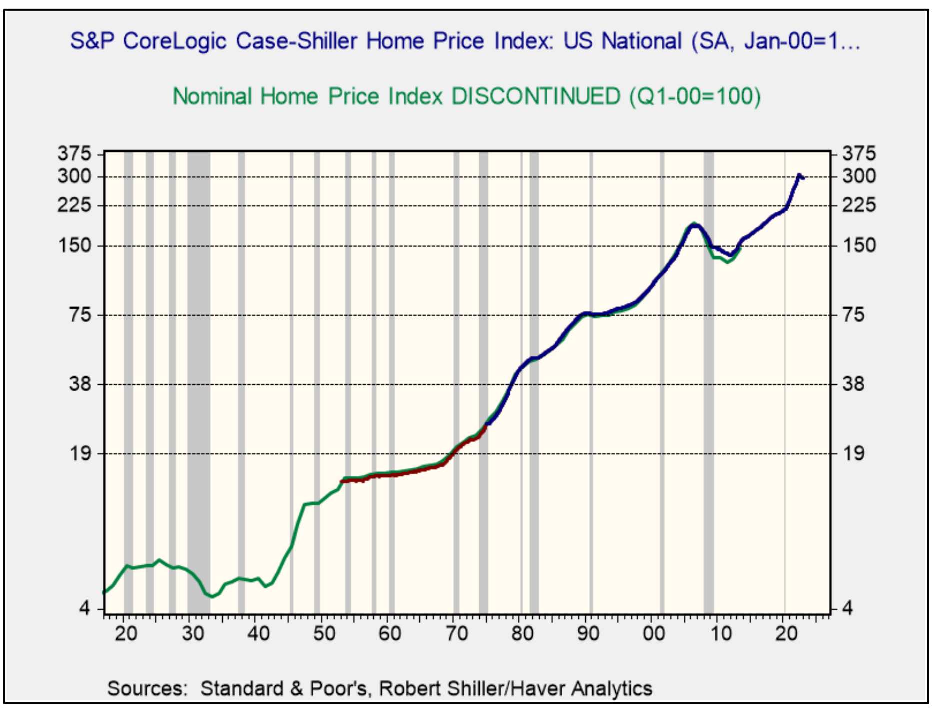
United Kingdom: Yesterday, the pro-independence Scottish National Party narrowly elected Humza Yousaf to replace Nicola Sturgeon as its leader. The election also puts Yousaf in line to be elected as Scotland's first minister in the coming days. Because of the narrowness of Yousaf's win and the attacks he endured over his past roles as Scotland's transport, justice, and health minister, he may not be a strong advocate for independence in the coming years. If he does prove to be a weak leader for the SNP, the resulting political stability could be a positive for British stocks.

Brazil: Former President Bolsonaro plans to return to Brazil tomorrow for the first time since he fled to Florida after losing his bid for re-election in last year's elections. Bolsonaro will face a number of probes into corruption and his role in the post-election takeover of the capitol by rioters, but he will also reportedly attempt to re-energize Brazil's right-wing movement and undermine his successor and political nemesis, leftwing leader Luiz Inácio Lula da Silva. Any resulting political instability would likely be negative for Brazilian stocks.

U.S. Economic Releases

Weekly mortgage applications rose 2.9% from last week. Purchase applications rose 2.0% while refinancing applications rose 4.8%. The 30-year fixed-rate mortgage yield fell to 6.45% compared to last week's 6.48%. Housing finance has stabilized in recent weeks, but it is worth noting that mortgage applications are down 35% from the previous year.

Yesterday, we discussed the S&P CoreLogic Home Price Index. This chart offers a long-term perspective on home prices.



The chart melds three similar series from Robert Schiller. The key point here is that home prices on a national level rarely fall. There have only been two episodes of significant declines, from 1925 into the Great Depression, and from 2005 into the Great Financial Crisis. Needless to say, both events were hugely important. The current decline, so far, is modest, but falling home prices represent a significant risk to the economy and is something we are watching very closely. Unlike the 2005 event, there is little forced selling pressure as the homeowners locked-in to low mortgage rates are mostly "stuck" in their homes. If all goes well, we are in for years of stagnant prices. But, if a recession leads to job losses and forced selling, then a wider problem could develop.

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
10:00	Pending Home Sales	m/m	Feb	-3.0%	8.1%	**
10:00	Pending Home Sales NSA	y/y	Feb		-22.4%	**
Federal Reserve						
EST	Speaker or Event	District or Position				
10:00	Michael Barr Appears Before the House Financial Services Panel	Federal Reserve Board Vice Chair for Supervision				

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	CPI	y/y	Feb	6.8%	7.4%	7.2%	*	Equity and bond neutral
South Korea	Consumer Confidence	m/m	Mar	92.0	90.2		**	Equity and bond neutral
EUROPE								
Germany	GfK Consumer Confidence	m/m	Apr	-29.5%	-30.5%	-30.6%	**	Equity and bond neutral
France	Consumer Confidence	m/m	Mar	81.0	82.0	81.0	**	Equity and bond neutral
UK	Mortgage Approvals	m/m	Feb	43.5k	39.6k	41.3k	***	Equity and bond neutral
AMERICAS								
Mexico	International Reserves Weekly	w/w	24-Mar	$202.469b	$201.972b		*	Equity and bond neutral
Brazil	Total Outstanding Loans	m/m	Feb	5319b	5317b	5354b	**	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)	514	510	4	Up
3-mo T-bill yield (bps)	451	458	-7	Down
TED spread (bps)	63	52	11	Widening
U.S. Sibor/OIS spread (bps)	488	489	-1	Up
U.S. Libor/OIS spread (bps)	489	490	-1	Up
10-yr T-note (%)	3.56	3.57	-0.01	Flat
Euribor/OIS spread (bps)	299	301	-2	Up
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Up			Up
Yen	Down			Up
Pound	Up			Up
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.

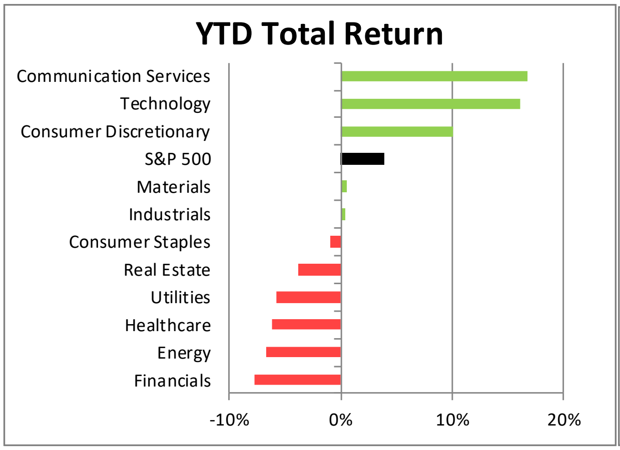
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$79.27	$78.65	0.79%	
WTI	$73.93	$73.20	1.00%	
Natural Gas	$2.00	$2.03	-1.72%	
Crack Spread	$38.24	$38.41	-0.45%	
12-mo strip crack	$28.81	$28.88	-0.24%	
Ethanol rack	$2.48	$2.48	0.15%	
Metals				
Gold	$1,964.02	$1,973.54	-0.48%	
Silver	$23.18	$23.33	-0.65%	
Copper contract	$411.50	$408.55	0.72%	
Grains				
Corn contract	$652.00	$647.25	0.73%	
Wheat contract	$715.25	$699.75	2.22%	
Soybeans contract	$1,468.50	$1,467.75	0.05%	
Shipping				
Baltic Dry Freight	1,402	1,456	-54	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.8		
Gasoline (mb)		-2.3		
Distillates (mb)		-1.6		
Refinery run rates (%)		0.6%		
Natural gas (bcf)		-55		

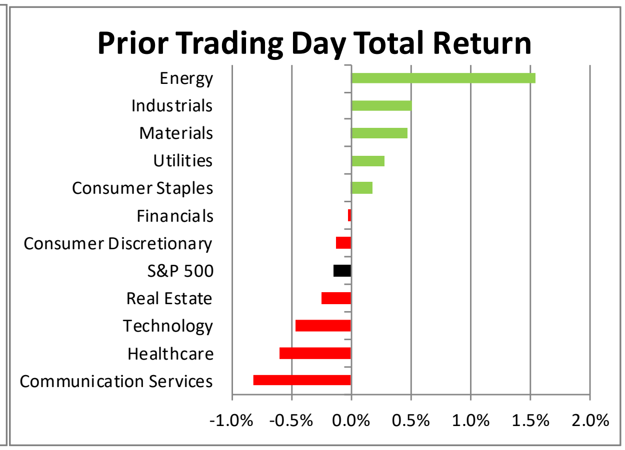
Weather

The 6-10 and 8-14 day forecasts currently call for colder-than-normal temperatures along the West Coast, 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 for most of the country, with dry conditions expected in the central Great Plains.

Data Section

U.S. Equity Markets – (as of 3/28/2023 close)

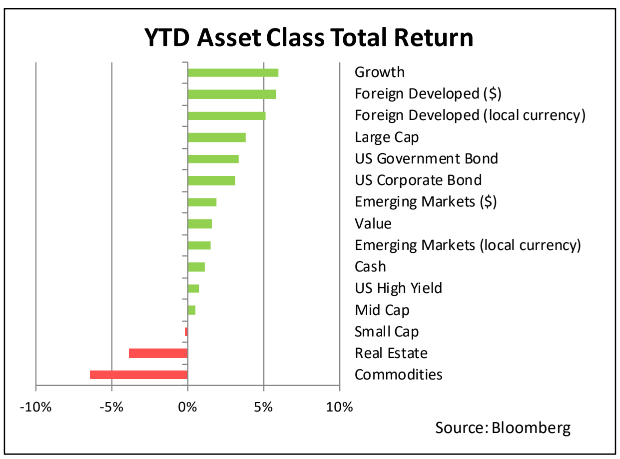




(Source: Bloomberg)

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 3/28/2023 close)

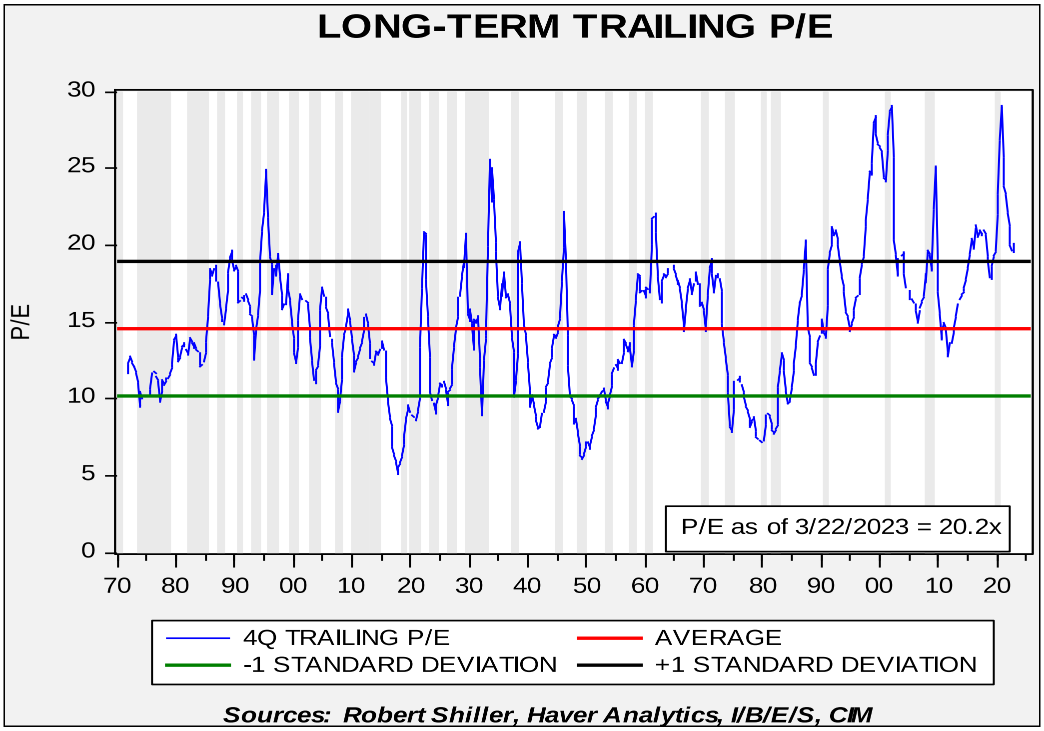


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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 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.