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 31, 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 0.8%. Chinese markets were higher, with the Shanghai Composite closing up 0.4% and the Shenzhen Composite closing up 0.8%. 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* (3/30/2023): We discuss China's growing influence on the Middle East and the recent détente between Iran and the KSA. The usual data update is provided; this week, we saw a large rise in refinery operations which contributed to an unexpected slide in commercial oil inventories.
- *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"
- **Business Cycle Report (3/30/2023)**

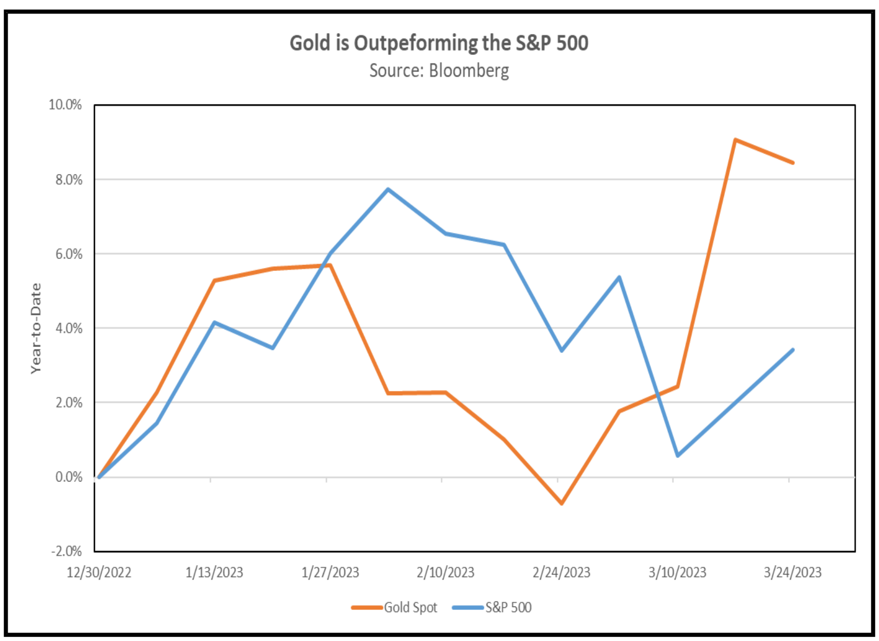
Good morning! Today's *Comment* begins with an update on the ongoing banking crisis and how it may impact the real estate sector. Next, we review why precious metals, such as gold, have been able to perform well during a time of heightened uncertainty in the market. Lastly, the report discusses the ongoing friction between the U.S.-led and China-led blocs.

Back to Banks: Deposit withdrawals are becoming less of a problem; however, it is still too soon to say that the banking crisis is over.

- There is growing evidence that banks are in need of less cash. The latest data from the Federal Reserve shows that the U.S. bank liquidity problem is slightly improving. Emergency loans to banks from the Federal Reserve backstops declined from $163.9 billion to $152.6 billion in the week ending March 29. Meanwhile, European Central Bank official Isabel Schnabel noted that deposit outflows were not a problem for European banks. Research published by Jefferies Group (JEF, $30.58) went further and argued that the average European bank could lose 38% of its deposits before having to sell any of its government bonds at a loss.
- Despite improving financial conditions, some central bankers remain wary about the health of the banking system. Minneapolis Fed President Neel Kashkari hinted that the banking crisis might not be over. Given his experience working at the Treasury during the financial crisis, he explained that strains in banking may take a while to work themselves out. He added that the ongoing crisis could extend longer than many people realize. His colleague at the Richmond Fed, Thomas Barkin, also cautioned that it is too soon to tell whether the banking turmoil will lead to tighter credit conditions.
- That said, deposit flight remains a major threat to commercial real estate. According to JPMorgan (JPM, $129.57), European banks have as much as €1.9 trillion ($2.07 trillion) worth of commercial real estate exposure, while U.S. banks have $1.7 trillion. This asset class has been the hardest hit since the pandemic due to the drop in demand for office space and would be severely impacted by a credit crunch. Hawkish central bank policy worsens the problem by incentivizing depositors to move their money out of banks and into money market funds and U.S. Treasuries. As a result, we advise investors to pay close attention to their real estate exposure as this banking situation plays out.
    - The European real estate market is already showing signs of weakness due to the banking turmoil. The MSCI Europe Real Estate Index of large and mid-cap property companies has dipped to its lowest level since 2009.

Gold Great Again? Precious metals have performed well amidst the growing market turmoil.

- Concerns over the financial system and the economy have led investors to retreat temporarily from equities and move into safer assets. Gold has outperformed the S&P 500 this year, 8.5% to 3.4%. Similarly, the Bloomberg Commodity Precious Metals Subindex has rallied 10.9% since March 8, despite being down in the first three months of the year. The preference for precious metals over equities is related to uncertainty over interest rates. As inflation remains elevated and a recession approaches, investors are unsure of what the Fed's next moves will be and have sought safety in real assets.
- Central banks have expressed a willingness to hike policy rates, but the market doesn't buy it. On Thursday, Boston Fed President Susan Collins insisted that the banking system remains sound and that the Federal Reserve is still focused on taming inflation. Meanwhile, stickier core inflation in Europe has complicated efforts by the ECB to conclude its tightening cycle. Because of the central bank's insistence on raising rates, financial market participants anticipate a cut later this year. The CME Fed Funds Watch Tool shows that there is an 80% chance of a cut in the Federal Reserve policy rate by the end of 2023, while the overnight index swap curve for the EUR shows that the ECB will also cut within that period.
- Although there is much to be worried about in markets, there is still a lot of opportunity to earn solid returns. Precious metals are an attractive option as they are relatively more liquid when compared to digital currencies and have a solid reputation for being a hedge against market uncertainty. Additionally, the movement into cash and cash equivalents could also lead to sub-optimal portfolio returns. That is why we would like to caution investors away from fleeing the market, as there is a realistic possibility that they could miss many attractive opportunities. As the saying goes, there is no great reward without at least some risk.

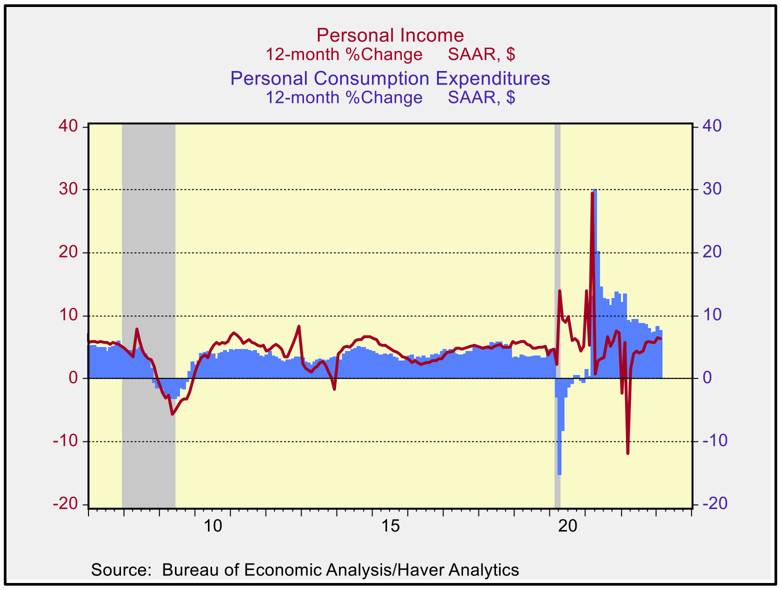


Beijing Shuffle: China and Russia are looking for ways to outmaneuver the West as they seek to avoid being isolated from the rest of the world.

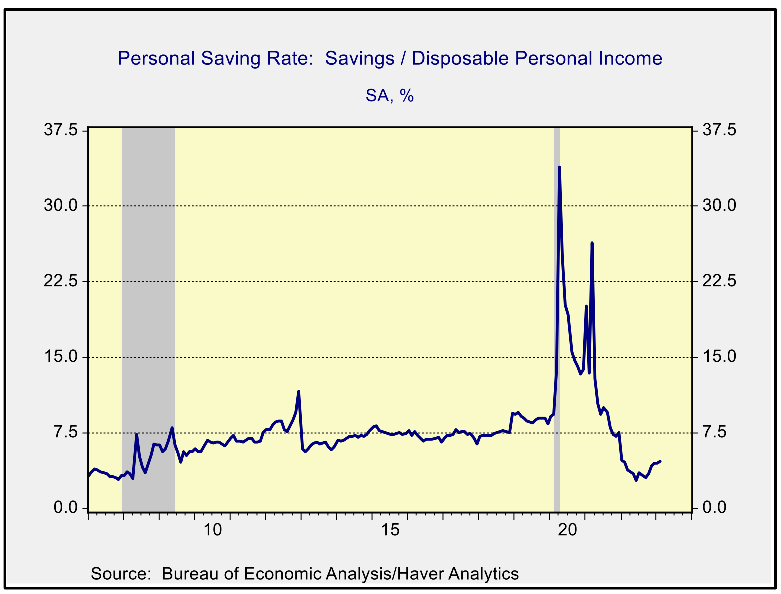
- The U.S. and its allies continue to form a united front against China and Russia. On Thursday, the Turkish parliament approved Finland's petition to join NATO. Turkey's consent removes a significant hurdle for the military alliance as it looks to deter Moscow from further aggression by adding new members. Meanwhile, European Commission President Ursula von der Leyen has urged EU countries to back restrictions on the transfer of sensitive technologies to China. The remarks come amidst pressure from the U.S. to have EU members support trade restrictions on goods that can potentially boost Beijing's defense capabilities.
- The ostracization of China and Russia has made it difficult for their economies to recover. Beijing is still working to boost GDP growth following its stringent Zero-COVID policies and a wave of infections that limited consumption. Recent PMI data shows the economy is improving, but consumer confidence indicates that sentiment remains stubbornly low. At the same time, President Vladimir Putin recently admitted that Western sanctions are starting to negatively impact the Russian economy. The isolation of these two countries has made them draw closer to one another as they look to work together to reduce their dependence on Western markets.
- The rivalry between the U.S.-led and China-led blocs shows how trade can quickly devolve into a zero-sum game. As the two sides look to decouple from one another, we expect that, in the long term, the rest of the world will split into two camps that prioritize trade ties with one of the major blocs. Although a few countries, such as Turkey and Brazil, will be able to find some middle ground to work with both blocs, we suspect that others will be forced to choose. As noted in previous reports, China is looking to build alliances with major commodity producers, while the U.S. prefers to build security ties with other advanced economies.
    - At some point, there may be a direct confrontation between the two sides; however, that time remains in the distant future.

U.S. Economic Releases

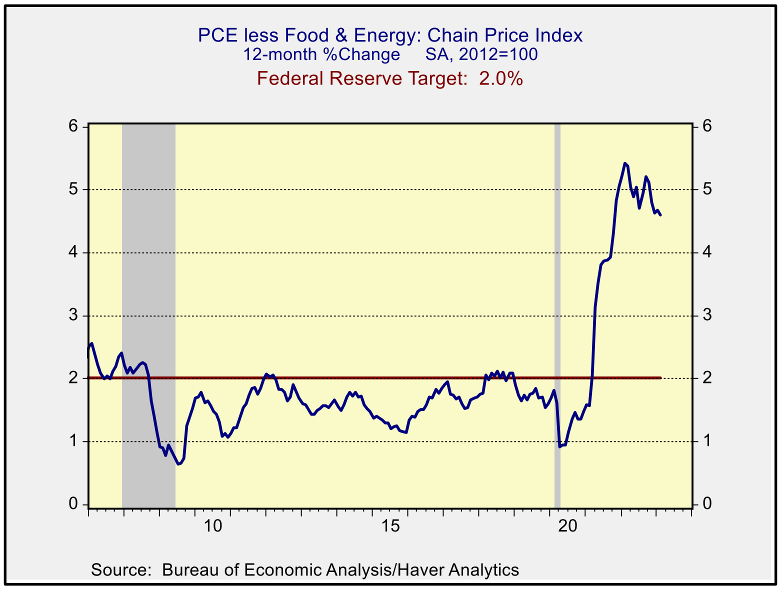
February ***personal income*** increased by a seasonally adjusted 0.3%, beating expectations that they would rise just 0.2% but still rising only half as fast as the 0.6% gain in January. February ***personal consumption expenditures (PCE)*** rose 0.2%, falling short of their anticipated increase of 0.3% and rising far more slowly than their revised 2.0% gain in the previous month. Compared with February 2022, personal income was up 6.2%, while PCE was up 7.6%. The following chart shows the year-over-year change in personal income and PCE since just before the prior recession.



The personal income and spending report also includes a measure of personal saving, defined as disposable (after tax) income less consumption spending on goods and services. The February ***personal savings rate*** rose to a seasonally adjusted 4.6%, compared with 4.4% in each of the previous two months. The chart below shows how the personal savings rate has fluctuated since just before the previous recession.



Finally, the income and spending report includes the Fed's preferred measure of consumer price inflation. After stripping out the volatile food and energy components, the ***Core PCE Deflator*** for February was up 4.6% from the same month one year earlier, a bit better than expectations that the annual rise would come in at 4.7%, just as it did in January. The following chart shows the year-over-year change in the Core PCE Deflator since just before the prior 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	MNI Chicago PMI	m/m	Mar	43.0	43.6	***
10:00	U. of Michigan Consumer Sentiment	m/m	Mar F	63.3	63.4	***
10:00	U. of Michigan Current Conditions	m/m	Mar F	66.4	66.4	**
10:00	U. of Michigan Future Expectations	m/m	Mar F	61.4	61.5	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Mar F	3.8%	3.8%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Mar F	2.8%	2.8%	*
Federal Reserve						
EST	Speaker or Event	District or Position				
15:05	John Williams Speaks at Housatonic Community College	President of the Federal Reserve Bank of New York				
17:45	Lisa Cook Discusses US Economy and Monetary Policy	Member of the Board of Governors				
22:00	Chris Waller Discusses the Phillips Curve	Member 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	Jobless Rate	m/m	Feb	2.6%	2.4%	2.4%	***	Equity and bond neutral
	Job-To-Applicant Ratio	m/m	Feb	1.3%	1.4%	1.4%	**	Equity and bond neutral
	Tokyo CPI	y/y	Mar	3.3%	3.4%	3.2%	**	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food	y/y	Mar	3.2%	3.3%	3.1%	***	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food & Energy	y/y	Mar	3.4%	3.2%	3.2%	*	Equity and bond neutral
	Retail Sales	y/y	Feb	6.6%	6.3%	5.8%	**	Equity bullish, bond bearish
	Depart. Store & Supermarket Sales	y/y	Feb	4.7%	5.3%		*	Equity bearish, bond bullish
	Industrial Production	y/y	Feb P	-0.6%	-3.1%	-2.4%	***	Equity bullish, bond bearish
	Housing Starts	y/y	Feb	-0.3%	6.6%	-0.5%	**	Equity and bond neutral
	Annualized Housing Starts	y/y	Feb	0.859m	0.893m	0.861m	*	Equity and bond neutral
Australia	Private Sector Credit	y/y	Feb	7.6%	8.0%		**	Equity and bond neutral
New Zealand	ANZ Consumer Confidence Index	m/m	Mar	77.7%	79.8%		*	Equity bearish, bond bullish
	ANZ Consumer Confidence	m/m	Mar	-2.6%	-4.3%		*	Equity bullish, bond bearish
South Korea	Industrial Production	y/y	Feb	-8.1%	-12.7%	-13.0%	***	Equity bullish, bond bearish
China	Official Composite PMI	m/m	Mar	57.0	56.4		*	Equity and bond neutral
	Official Manufacturing PMI	m/m	Mar	51.9	52.6	51.6	***	Equity and bond neutral
	Official Services PMI	m/m	Mar	58.2	56.3	55.0	**	Equity bullish, bond bearish
EUROPE								
Eurozone	Unemployment Rate	m/m	Feb	6.6%	6.7%	6.6%	**	Equity and bond neutral
	CPI	y/y	Mar P	6.9%	8.5%	7.1%	***	Equity and bond neutral
	Core CPI	y/y	Mar P	5.7%	5.6%	5.7%	**	Equity and bond neutral
Germany	Import Price Index	y/y	Feb	2.8%	6.6%	4.2%	**	Equity bearish, bond bullish
	Retail Sales	y/y	Feb	-7.0%	-4.6%	-4.0%	*	Equity bearish, bond bullish
	Unemployment Change	m/m	Mar	16.0k	2.0k	6.0k	***	Equity bearish, bond bullish
	Unemployment Claims Rate	m/m	Mar	5.6%	5.5%	5.5%	**	Equity and bond neutral
France	CPI	y/y	Mar P	5.6%	6.3%	5.5%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Mar P	6.6%	7.3%	6.5%	**	Equity and bond neutral
	PPI	y/y	Feb	15.7%	17.9%	17.6%	*	Equity bullish, bond bearish
Italy	Industrial Sales WDA	y/y	Jan	8.6%	14.9%		*	Equity bearish, bond bullish
	CPI, EU Harmonized	y/y	Mar P	8.2%	9.8%	8.8%	***	Equity bullish, bond bearish
	CPI NIC Including Tobacco	y/y	Mar P	7.7%	9.2%	8.2%	**	Equity and bond neutral
UK	Nationwide House Price Index	y/y	Mar	-0.8%	-0.5%	-0.3%	***	Equity and bond neutral
	GDP	y/y	4Q F	0.6%	0.4%	0.4%	***	Equity and bond neutral
Switzerland	Real Retail Sales	y/y	Feb	0.3%	-2.2%	-1.7%	**	Equity bullish, bond bearish
Russia	Gold and Forex Reserves	m/m	24-Mar	$594.6b	$585.8b		***	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	24-Mar	16.88t	16.94t		*	Equity and bond neutral
AMERICAS								
Mexico	Unemployment Rate NSA	m/m	Feb	2.72%	3.00%	3.04%	***	Equity and bond neutral
Brazil	Net Debt % GDP	m/m	Feb	56.6%	56.6%	56.1%	***	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)	516	516	0	Up
3-mo T-bill yield (bps)	459	471	-12	Flat
TED spread (bps)	57	46	11	Widening
U.S. Sibor/OIS spread (bps)	493	491	2	Up
U.S. Libor/OIS spread (bps)	494	493	1	Up
10-yr T-note (%)	3.54	3.55	-0.01	Flat
Euribor/OIS spread (bps)	305	302	3	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Down			Down
Pound	Flat			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Mexico Overnight Rate	11.250%	11.000%	11.250%	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.

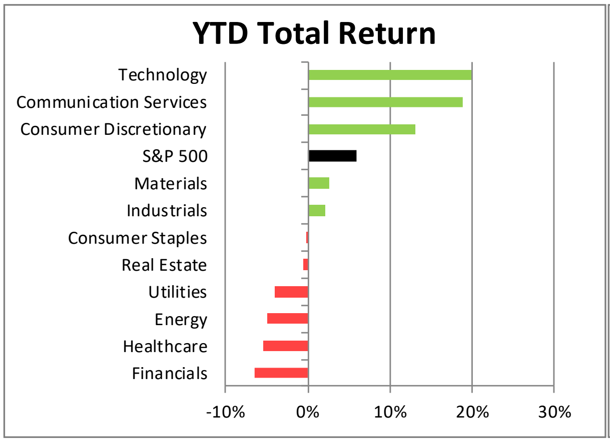
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$79.50	$79.27	0.29%	
WTI	$74.97	$74.37	0.81%	
Natural Gas	$2.10	$2.10	-0.33%	
Crack Spread	$34.86	$35.21	-0.99%	
12-mo strip crack	$26.97	$27.12	-0.55%	
Ethanol rack	$2.48	$2.48	-0.19%	
Metals				
Gold	$1,980.11	$1,980.37	-0.01%	
Silver	$23.89	$23.90	-0.05%	
Copper contract	$405.60	$409.15	-0.87%	
Grains				
Corn contract	$651.25	$649.50	0.27%	
Wheat contract	$689.25	$692.25	-0.43%	
Soybeans contract	$1,478.50	$1,474.50	0.27%	
Shipping				
Baltic Dry Freight	1,403	1,407	-4	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-7.5	1.8	-9.2	
Gasoline (mb)	-2.9	-2.3	-0.7	
Distillates (mb)	0.3	-1.6	1.8	
Refinery run rates (%)	1.7%	0.6%	1.2%	
Natural gas (bcf)	-47	-54	7	

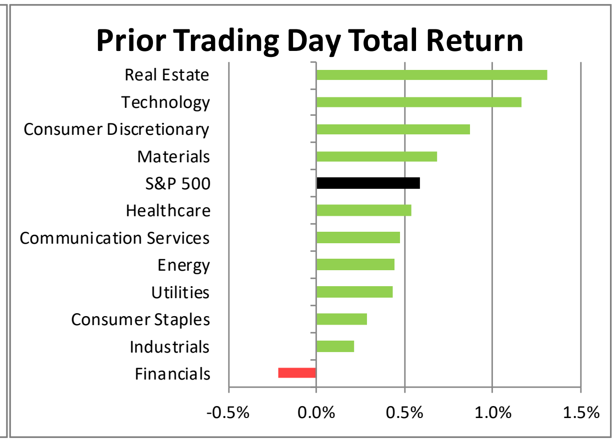
Weather

The 6-10 and 8-14 day forecasts currently call for colder-than-normal temperatures in the Rocky Mountain region and the Great Plains, with warmer-than-normal temperatures anticipated along the East Coast. The forecasts are calling for wetter-than-normal conditions in Texas, the Southeast, and the Mid-Atlantic region, with dry conditions in the Far West.

Data Section

U.S. Equity Markets – (as of 3/30/2023 close)

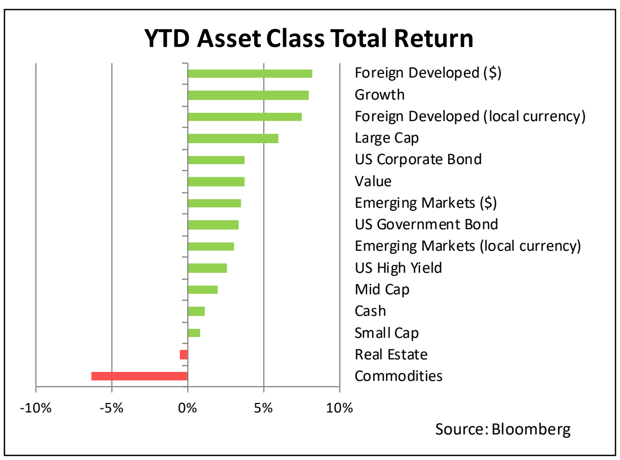




(Source: Bloomberg)

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 3/30/2023 close)

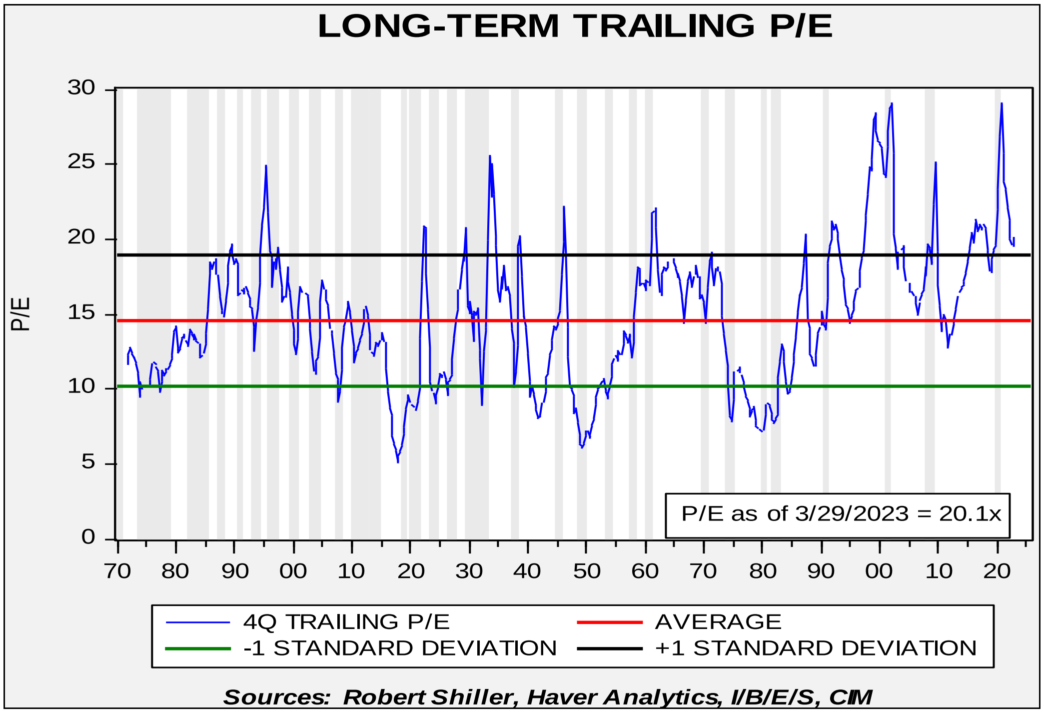


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 30, 2023



Based on our methodology,[1] the current P/E is 20.1x, 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.