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: May 2, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 Index closed down 0.4%. In Asia, the MSCI Asia Apex 50 Index closed up 0.2%. Chinese markets were higher, with the Shanghai Composite up 1.1% from its previous close and the Shenzhen Composite closing up 1.4%. U.S. equity index futures are signaling a lower open.

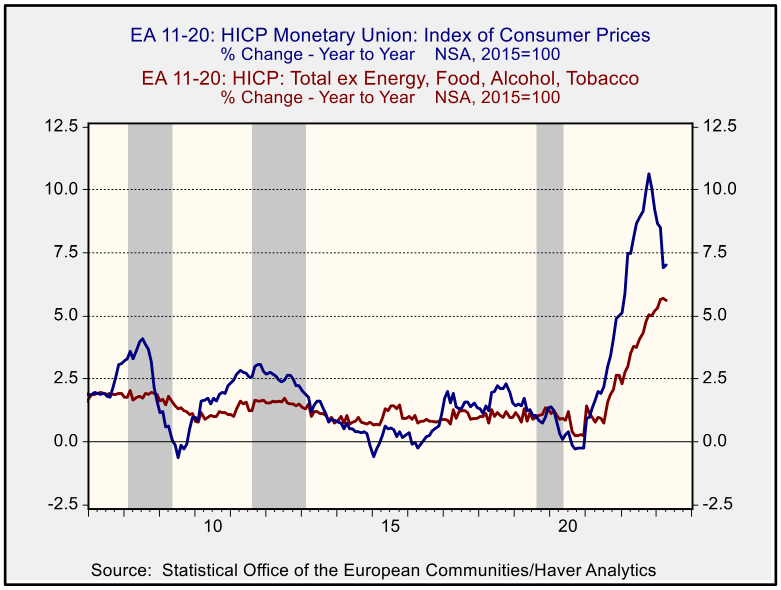
With 286 companies having reported so far, S&P 500 earnings for Q1 are running at $52.30 per share compared to the estimate of $50.89, which is down 7.3% from Q1 2022. Of the companies that have reported thus far, 79.7% have exceeded expectations while 16.8% have fallen short of expectations.

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*** **(5/1/2023) (with associated podcast) "Implications of the Iran-Saudi Arabia Détente"**
- *Weekly Energy Update* (4/27/2023): Along with our usual update of the weekly DOE data, we also show how EV sales are rising rapidly and could materially displace oil demand by the end of the decade.
- *Asset Allocation Quarterly – Q2 2023* (4/25/2023): Discussion of our asset allocation process, Q2 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* (4/24/2023) (with associated podcast): "The Fed's Employment Surprise"
- *Confluence of Ideas* podcast (3/8/2023): "Reflections on Inflation"

Our *Comment* today opens with a report showing an acceleration in the Eurozone's consumer price inflation. While the acceleration was modest, it could still encourage a more aggressive interest-rate hike by the European Central Bank at its policy meeting on Thursday. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including an unexpected resumption of rate hikes in Australia and a warning by U.S. Treasury Secretary Yellen that the federal government could be unable to pay its bills by June 1 if Congress doesn't act to raise the federal debt limit.

Eurozone: The April consumer price index was up 7.0% from the same month one year earlier, dashing expectations that annual inflation would be unchanged at 6.9%. The acceleration in headline price growth could encourage the European Central Bank to again hike its benchmark short-term interest rate aggressively at its policy meeting on Thursday. That's especially the case given that a separate key measure of inflation also remains worrying. Excluding the volatile components of food and energy and the government-influenced prices for alcohol and tobacco, the April core CPI was up 5.6% on the year. That marks somewhat cooler core inflation than in March, when the core CPI was up 5.7%, but it was no cooler than the 5.6% increase in the year to February.

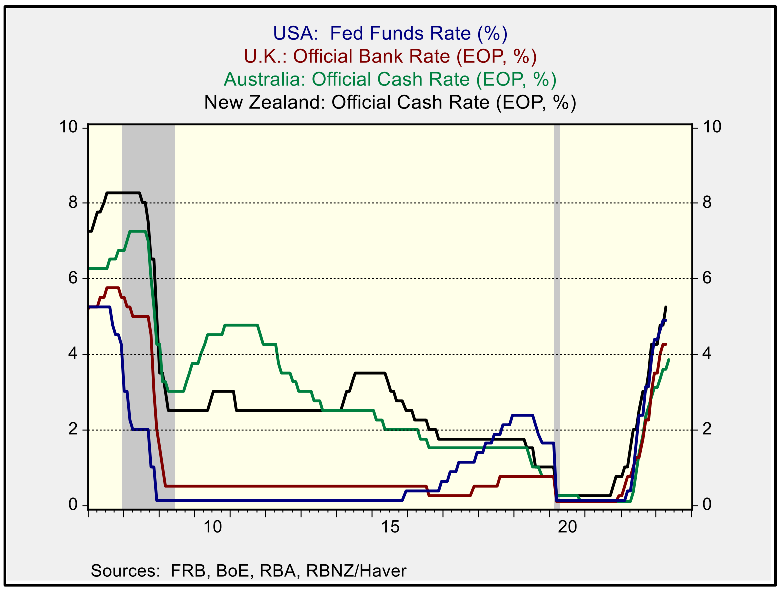


Italy: The right-wing populist government of Prime Minister Meloni has issued a decree aimed at making it easier for companies to hire new workers. The decree will reduce the country's "basic income" support for people who can work and ease regulations to make it easier to hire short-term workers. In a modest effort to encourage more births, the policy also includes a cut in payroll and benefit taxes for workers with children. None of the changes are revolutionary, but they could have a small impact on Italy's labor market, and they could signal further, more substantial moves by Meloni later, despite opposition by labor groups.

Russia-Ukraine War: The U.S. released a new, unclassified estimate that Russian forces fighting in Ukraine have suffered approximately 100,000 total casualties since December, including about 20,000 killed in action. According to the report, about half the fatalities were members of the Wagner mercenary group with half of those being prisoners who had been enticed to join up in return for their freedom if they survived a six-month tour of duty. The enormous losses show how the Russians' strategy has caused a depletion in their combat strength just as the Ukrainians look set to launch a new counteroffensive.

Australia: The Reserve Bank of Australia (RBA) unexpectedly resumed its monetary tightening cycle by boosting its benchmark short-term rate 0.25% to 3.85% to help bring consumer price inflation back down to target. The hike by the RBA was its first since a similarly sized increase in March.

- The RBA's rate hike underscores that many major central banks remain committed to monetary tightening despite nascent signs that inflation is cooling. The rate hike is a signal that investors should be prepared for the possibility that rates could go higher than anticipated, and possibly stay there, in key countries around the world.
- As a result of the RBA hike today, Australian bonds have sold off, boosting the yield on 10-year government obligations to 3.456%. In contrast, the Australian dollar (AUD) has jumped 1.01% to $0.6697.



Canada: The Canadian government and its main public-employee union yesterday reached an agreement on a new labor contract that will end the workers' strike. Under the deal, the government will boost wage rates by 12% over four years and provide a one-time, lump-sum payment equal to 3.7% of annual pay. The agreement hewed close to what the unions initially demanded, reflecting the bargaining power they had amid the country's tight labor market.

U.S. Labor Market: As we warned in our *Comment* yesterday, Hollywood screen writers failed to strike a deal for a new labor contract last night with the major networks and studios, prompting them to announce a strike. As the 11,500 members of the Writers Guild of America walk off the job, late-night and variety shows are likely to be the first affected. The strike reflects both concerns about the impact of streaming technology on writers, and the increased bargaining power workers have in today's tight labor market.

U.S. Monetary Policy: The Fed's policy making committee will begin its latest meeting today, with its decision due tomorrow afternoon at 2:00 pm ET. The policymakers are widely expected to hike their benchmark fed funds interest rate by another 0.25%, to a 16-year high of 5.00% to

5.25%. However, as we mentioned in our *Comment* yesterday, the focus for investors will likely be on the post-meeting statement and comments by Fed Chair Powell to see if they provide any hints that the rate hikes are finished.

- Given the damage inflicted on the economy from the current rate-hiking cycle, any hint of a pause could give a boost to equities.
- Also, any strong signal of a pause in U.S. interest rates would likely be a further negative for the dollar. Factors such as slowing U.S. economic growth and the prospect of continued interest-rate hikes abroad have now pushed the greenback lower by 8.6% from its most recent peak last September.

U.S. Fiscal Policy: Yesterday, Treasury Secretary Yellen warned that the federal government could be unable to pay all its obligations, including Treasury debt service, as early as June 1 if Congress doesn't raise the debt limit. In addition, the bipartisan Congressional Budget Office brought forward its deadline of when the government could default, saying lower-than-expected tax receipts this spring could leave the government unable to pay its bills by early June.

- The new forecasts raise the risk of a near-term default on government debt, which would likely be a significant negative for U.S. asset values.
- President Biden later invited the Republican and Democratic leaders of Congress to meet next week to discuss a way forward.

U.S. Bank Regulation: Responding to the recent U.S. bank failures, the Federal Deposit Insurance Corporation yesterday recommended a boost in the business deposit amount that would be insured as one way to help prevent bank runs. According to the FDIC, a targeted rise in deposit insurance for businesses' everyday operating accounts would be more cost-effective and less likely to promote risky behavior by bank bosses than just eliminating the $250,000 cap in place on deposit insurance.

- The FDIC didn't specify how much the coverage cap should be raised for business transaction accounts.
- However, it did calculate that raising the insurance cap to $2.5 million would likely cover what most small and medium-sized companies need to keep in their accounts to cover payroll.
- In any case, any such change in the deposit amount covered by insurance would require approval by Congress.

U.S. Defense Industry: As major U.S. defense contractors released their quarterly reports over the last couple of weeks, some company officials said on their earnings calls that they are facing far fewer supply chain problems than they did over the last two years. Greg Hayes, the CEO of Raytheon (RTX, $100.33), even gushed that, "It's getting a hell of a lot better."

- The officials noted that defense supply chains are still not back to normal, but the situation is far better than it was, and revenue growth now looks set to accelerate sharply.

- We continue to believe that increasing geopolitical tensions will drive military budgets higher around the world. Due to issues like bureaucratic lethargy, labor shortages, and supply chain disruptions, the expected growth in revenues and profits will probably only become notable in the next couple of years.

U.S. Economic Releases

There were no domestic releases scheduled prior to the publication of this report. 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	JOLTS Job Openings	m/m	Mar	9736k	9931k	**
10:00	Factory Orders	m/m	Mar	1.3%	-0.7%	***
10:00	Factory Orders Ex Transportation	m/m	Mar	--	-0.3%	**
10:00	Durable Goods Orders	m/m	Mar F	3.2%	3.2%	***
10:00	Durable Goods Orders Ex Transportation	m/m	Mar F	0.3%	0.3%	**
10:00	Cap Goods Orders Nondef Ex Air	m/m	Mar F	-0.4%	-0.4%	**
10:00	Cap Goods Ship Nondef Ex Air	m/m	Mar F		-0.4%	**
	Wards Total Vehicle Sales	m/m	Apr	15.10m	14.82m	*
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
10:00	FOMC Begins Two-Day Meeting	Federal Reserve Board				

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	Monetary Base	y/y	Apr	-1.7%	-1.0%	-1.3%	**	Equity and bond neutral
	Monetary Base, End of Period	m/m	Apr	¥680.4tt	¥675.8t		*	Equity and bond neutral
South Korea	CPI	y/y	Apr	3.7%	4.2%	3.7%	***	Equity and bond neutral
	Core CPI	y/y	Apr	4.6%	4.8%		**	Equity and bond neutral
	S&P Global Manufacturing PMI	m/m	Apr	48.1	47.6		***	Equity and bond neutral
India	S&P Global Manufacturing PMI	m/m	Apr	57.2	56.4		***	Equity and bond neutral
EUROPE								
Eurozone	HCOB Eurozone Manufacturing PMI	m/m	Apr F	45.8	45.5	45.5	***	Equity and bond neutral
	M3 Money Supply	y/y	Mar	2.5%	2.9%	2.4%	***	Equity and bond neutral
	CPI	y/y	Apr	7.0%	6.9%	6.9%	***	Equity and bond neutral
	Core CPI	y/y	Apr P	5.6%	5.7%	5.6%	**	Equity and bond neutral
Germany	Retail Sales NSA	y/y	Mar	-6.5%	-7.0%	-5.8%	*	Equity bearish, bond bullish
	HCOB Germany Manufacturing PMI	m/m	Apr F	45.5	44.0	44.0	***	Equity bullish, bond bearish
France	HCOB France Manufacturing PMI	m/m	Apr F	45.6	45.5	45.5	***	Equity and bond neutral
Italy	HCOB Italy Manufacturing PMI	m/m	Apr	46.8	51.1	49.5	***	Equity bearish, bond bullish
	CPI, EU Harmonized	y/y	Apr P	8.8%	8.1%	8.0%	***	Equity bearish, bond bearish
	CPI NIC Including Tobacco	y/y	Apr P	8.3%	7.7%	7.4%	**	Equity bearish, bond bearish
	PPI	y/y	Mar	3.0%	10.0%		**	Equity bearish, bond bullish
UK	Nationwide House Price Index	y/y	Apr	-2.7%	-3.1%	-3.7%	***	Equity bullish, bond bearish
	S&P/CIPS Manufacturing PMI	m/m	48	47.8	46.6	46.6	***	Equity bullish, bond bearish
Switzerland	Manufacturing PMI	m/m	Apr	45.3	47.0	47.3	***	Equity and bond neutral
	Domestic Sight Deposits CHF	w/w	28-Apr	506.5b	520.4b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	28-Apr	523.9b	538.4b		*	Equity and bond neutral
Russia	S&P Global Manufacturing PMI	m/m	Apr	52.6	53.2		***	Equity and bond neutral
AMERICAS								
Canada	S&P Global Manufacturing PMI	m/m	Apr	50.2	48.6		***	Equity bullish, bond bearish

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)	530	530	0	Up
3-mo T-bill yield (bps)	503	503	0	Up
TED spread (bps)	28	27	1	Widening
U.S. Sibor/OIS spread (bps)	513	511	2	Up
U.S. Libor/OIS spread (bps)	514	513	1	Up
10-yr T-note (%)	3.53	3.57	-0.04	Flat
Euribor/OIS spread (bps)	327	325	2	Up
Currencies	**Direction**			
Dollar	Flat			Flat
Euro	Flat			Up
Yen	Up			Down
Pound	Down			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
RBA Cash Rate Target	3.850%	3.600%	3.600%	Above 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.

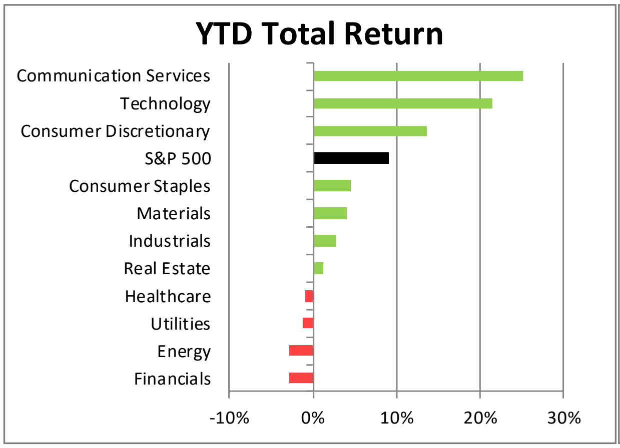
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$79.14	$79.31	-0.21%	
WTI	$75.45	$75.66	-0.28%	
Natural Gas	$2.28	$2.32	-1.47%	
Crack Spread	$29.07	$29.10	-0.10%	
12-mo strip crack	$24.20	$24.21	-0.05%	
Ethanol rack	$2.55	$2.55	0.02%	
Metals				
Gold	$1,987.77	$1,982.56	0.26%	
Silver	$24.73	$24.99	-1.04%	
Copper contract	$390.90	$393.40	-0.64%	
Grains				
Corn contract	$586.00	$584.50	0.26%	
Wheat contract	$619.00	$618.25	0.12%	
Soybeans contract	$1,439.75	$1,427.50	0.86%	
Shipping				
Baltic Dry Freight	1,576	1,581	-5	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.5		
Gasoline (mb)		-1.5		
Distillates (mb)		-0.7		
Refinery run rates (%)		0.55%		
Natural gas (bcf)		55		

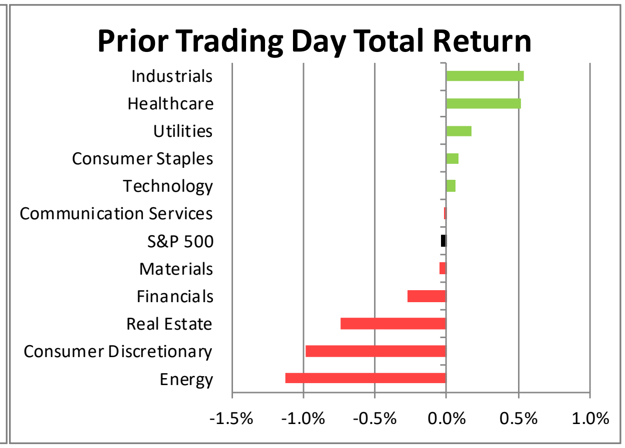
Weather

The 6-10 and 8-14 day forecasts currently call for cooler-than-normal temperatures in the Pacific region, with warmer-than-normal temperatures for the rest of the country. The forecasts are calling for wetter-than-normal conditions for most states, with dry conditions expected in the New England, Great Lakes, and Southwest regions.

Data Section

U.S. Equity Markets – (as of 5/1/2023 close)

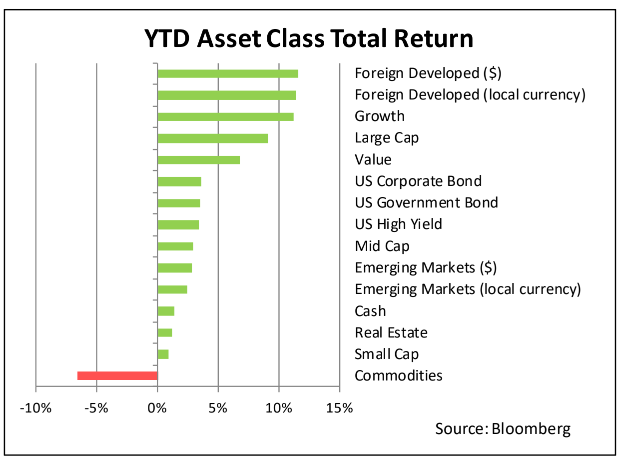




(Source: Bloomberg)

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 5/1/2023 close)

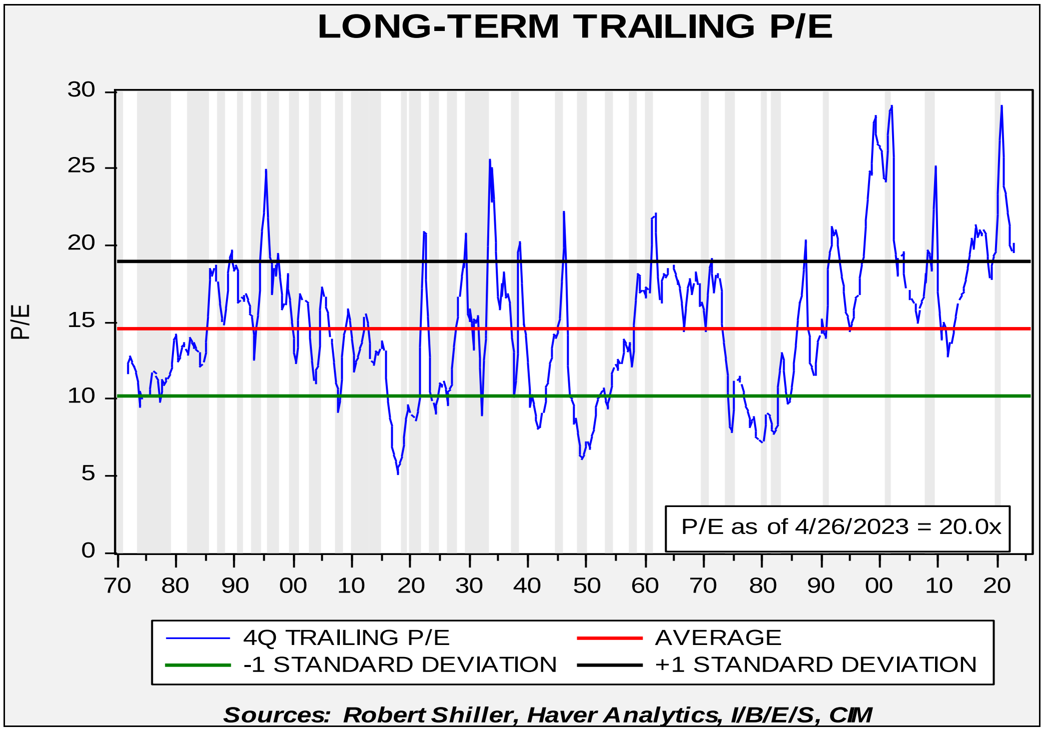


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

April 27, 2023



Based on our methodology,[1] the current P/E is 20.0x, down 0.1x from last week. Rising earnings accounted for the modest downtick.

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 two actual quarters (Q3 and Q4) and two estimates (Q1 and Q2). 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.