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 5, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is currently up 0.5% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.4%. Chinese markets were lower, with the Shanghai Composite down 0.5% from its previous close and the Shenzhen Composite down 0.8%. U.S. equity index futures are signaling a higher open.

With 419 companies having reported so far, S&P 500 earnings for Q1 are running at $53.10 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, 79.0% have exceeded expectations while 17.2% have fallen short of expectations.

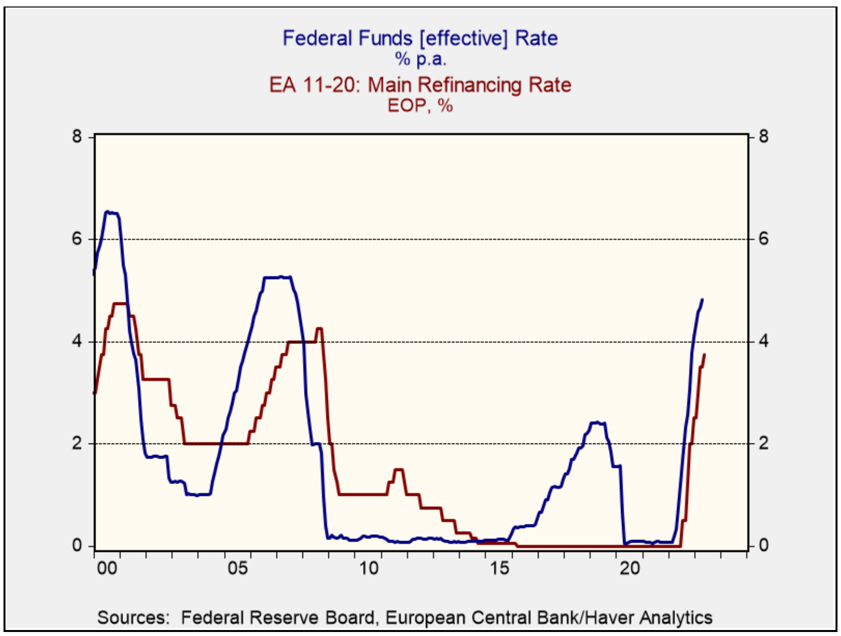
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (5/1/2023) (with associated podcast) "Implications of the Iran-Saudi Arabia Détente"
- *Weekly Energy Update* (5/4/2023): We note the recent weakness in oil prices, which appears to be due to worries about global growth. We also note a surprising proponent of nuclear power.
- *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"

Good morning! Today's *Comment* starts with our thoughts about the recent changes to monetary policy in Europe and the U.S. Next, we explain why safe-haven assets have become more attractive over the last few days. Finally, the report ends with a discussion about why the rivalry between the U.S. and China has spilled over into Africa.

Next Stage? Global monetary tightening may be heading toward a close as central bankers focus their attention on a potential downturn.

- Investors are not convinced that the Federal Reserve and the European Central Bank are willing to continue to raise interest rates until inflation is tamed. A day after the Fed removed mention of "additional policy firming" from its statement, ECB President Christine Lagarde tried to reassure markets that the ECB was not going to halt its hiking cycle anytime soon. However, investors fear that the banking turmoil in the U.S. could force most central banks to rethink future policy decisions. Despite hawkish rhetoric from Lagarde, the EUR fell 0.41% to $1.1018 on Thursday.
- The market expects the ECB and Fed to cut rates later this year, regardless of their comments that they won't. The latest Euro Area Bank Lending Survey for Q1 2023 showed that the net percentage of financial institutions restricting credit has risen to its highest level since the European Sovereign Debt Crisis. At the same time, the Federal Reserve's Senior Loan Officer Opinion Survey is expected to show similar results on Monday. Expectations of a lending slowdown have added to concerns that policymakers will need to pivot to prevent a severe recession. The CME FedWatch Tool predicts that the Fed will continue to raise rates until November, at the latest. Meanwhile, Euribor future prices suggest that the ECB will take its foot off the pedal this fall.

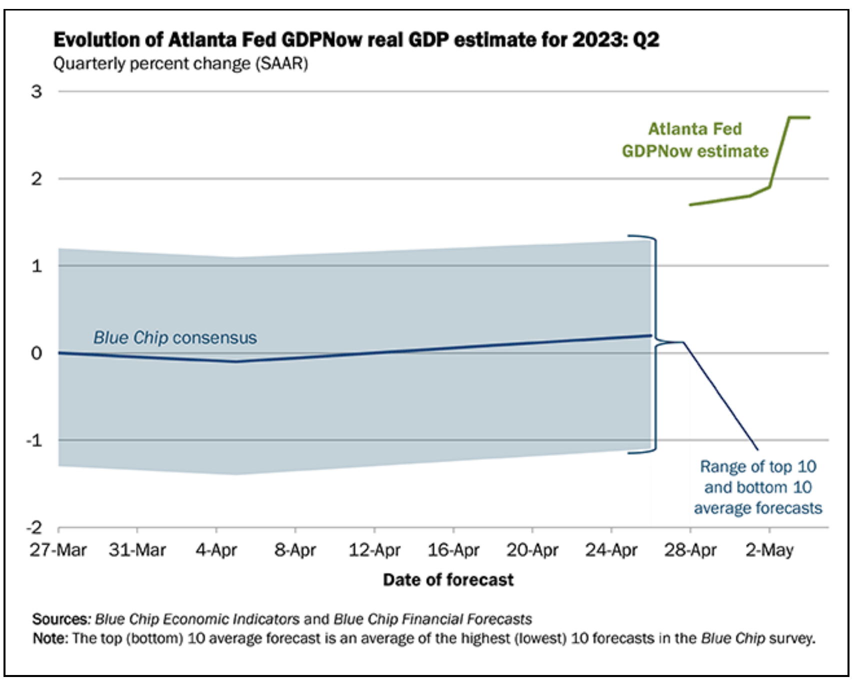


- Although a recession will likely force the ECB and the Fed to prematurely end their hiking cycle, we expect EU policymakers to be less aggressive. European banks are relatively healthy when compared to their American counterparts. This is mostly because there are fewer banks for depositors to choose from. Additionally, European banks are required to regularly mark to market their securities holdings. Hence, they are unlikely to have the same maturity mismatch problems that plagued Silicon Valley Bank (SIVBQ, $0.41) and First Republic Bank (FRCB, $0.32). The differences between the American and European banking systems will likely mean that the banking turmoil will have less of an impact on ECB policy which should be bullish for the EUR and supportive of European equities.

- Additionally, the ECB has typically been slower to cut rates than the Fed, as the previous chart shows.

Risk Aversion: Uncertainty over the state of the economy and the future path of U.S. interest rates have investors retreating to safety.

- Investors are still worried that problems within the regional banking system will spill over to the broader economy. On Thursday, several regional lenders ran into financial trouble. PacWest (PACW, $3.17) shares tanked after it confirmed that it was exploring strategic options including a possible sale. Meanwhile, Western Alliance's (WAL, $18.20) stock took a hit following a now debunked report stating that it was considering a sale. At the same time, a deal for TD Bank (TD, $60.33) to take over First Horizon (FHN, $10.06) collapsed. This overall weakness in the regional banks has led to a steep drop in the sector's benchmark KBW index.
- Wary investors have sought comfort in traditional safe-haven assets in response to the higher volatility. The recent bank fiasco helped push gold prices close to their all-time high on Thursday, while yields on the two-year Treasury fell 15 bps in the same period. The flight-to-safety response comes amidst rising uncertainty after a week of subpar economic data which led investors to question the health of the economy. The number of workers applying for initial jobless claims hit a six-week high last week; meanwhile, labor productivity was shown to have contracted in the first three months of the year. On Thursday, concerns about the economy helped push the VIX index past the critical level of 20.



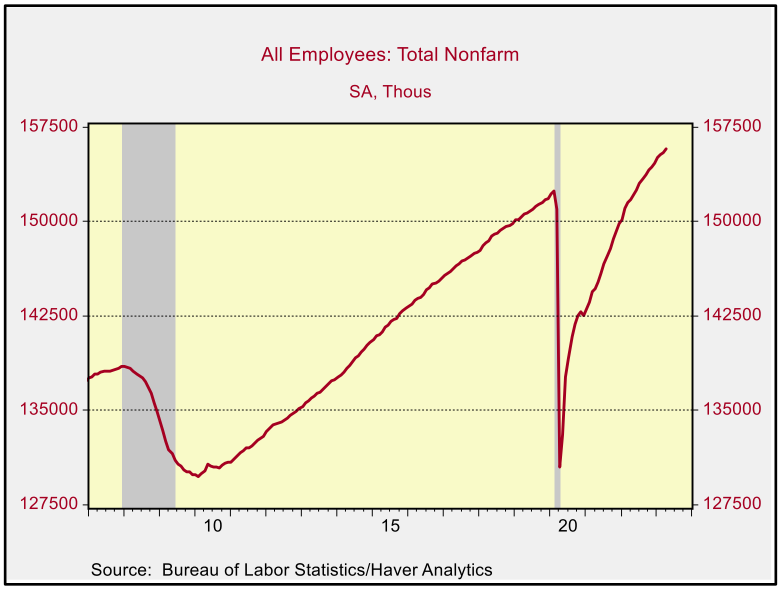
- The shift away from riskier assets reflects overall concerns about an imminent downturn. Luckily, these worries have yet to fully materialize in the data. The latest nowcast model from the Federal Reserve Bank of Atlanta estimates a 2.7% annualized rise in GDP for Q2. Additionally, April's jobs report shows that the economy is still adding 200k+ jobs a month. As a result, the Federal Reserve may be more inclined to hike rates at its next meeting than the market realizes. That said, safe-haven investments, particularly in precious metals, may be a way to protect against a sharp reversal in economic activity.

African Spotlight: Influence over the commodity-rich continent is becoming increasingly important as the U.S.- and China-led blocs search for additional resources to fuel their economies.

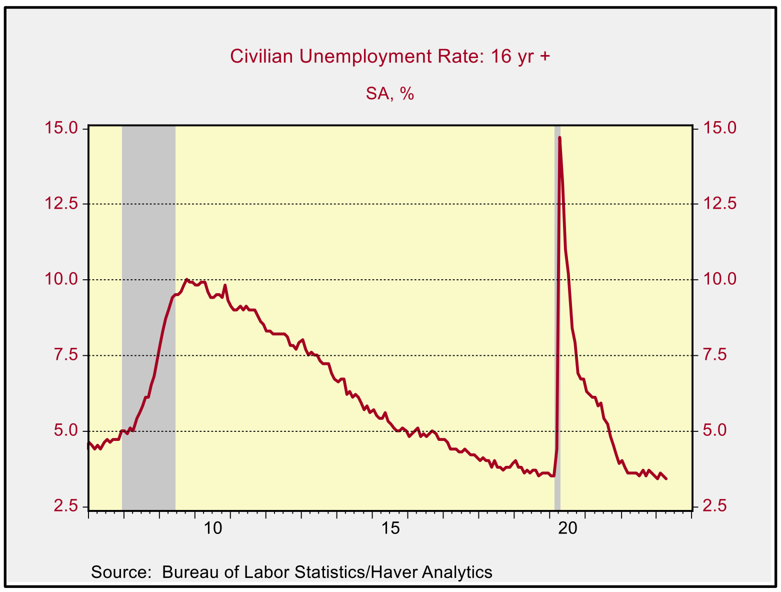
- After years of neglect, the West is now looking to reengage African countries. German Chancellor Olaf Scholz started his three-day trip across the continent earlier this week and is expected to push for deeper Western integration. Meanwhile, Japanese Prime Minister Fumio Kishida told African leaders that G-7 countries are prepared to cooperate to help resolve the conflict in Sudan and would like to invest more in the region. The new attention on African nations is meant to offset the inroads made by China and Russia as the major blocs look to secure access to the continent's energy commodities and growing market.
- However, the West has a long way to go before it is able to catch up to China. Beijing's Belt and Road Initiative has invested over $155 billion in the continent over the span of two decades. In comparison, the U.S. has financed roughly $14 billion worth of projects from 2007 to 2020. The funding gap has led to concerns that the West may not be able to convince African governments to join the U.S.-led bloc. For example, it was reported that South Africa allowed a sanctioned Russian aircraft to land on one of its bases earlier this week.
- Africa may not have many investment opportunities at this time, but it still has much potential. The continent's population is expected to account for 20% of the world by 2030 and could reach 25% in 2050. The massive jump in people will help fuel GDP growth in a region that has largely been ignored by market participants. As the world breaks into regional blocs, we suspect commodity firms in Africa may be attractive for investors looking to broaden their exposure to emerging markets.

U.S. Economic Releases

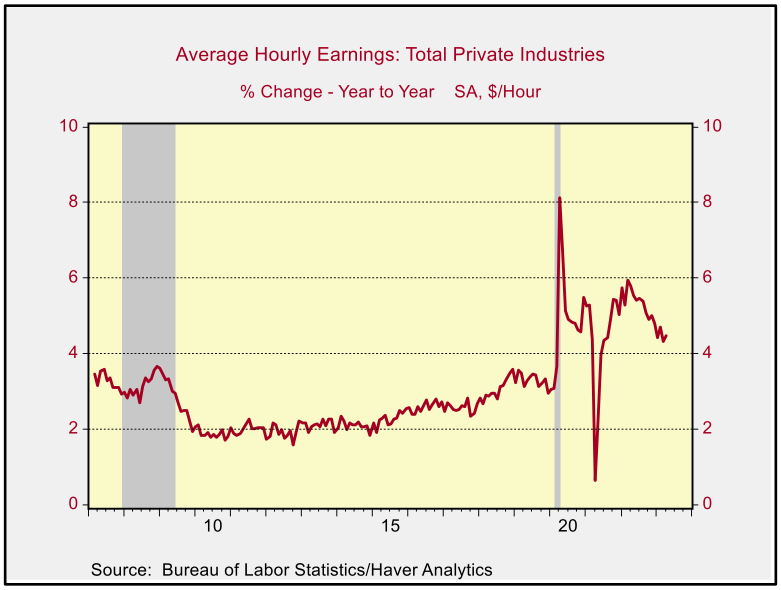
April ***nonfarm payrolls*** rose by a seasonally adjusted 253,000, far above the expected increase of 185,000 and March's revised gain of 165,000. The figure will likely be taken as a sign that the demand for labor remains extraordinarily strong, which could potentially prompt the Fed to keep hiking interest rates. The following chart shows the change in nonfarm payrolls since shortly before the previous recession.



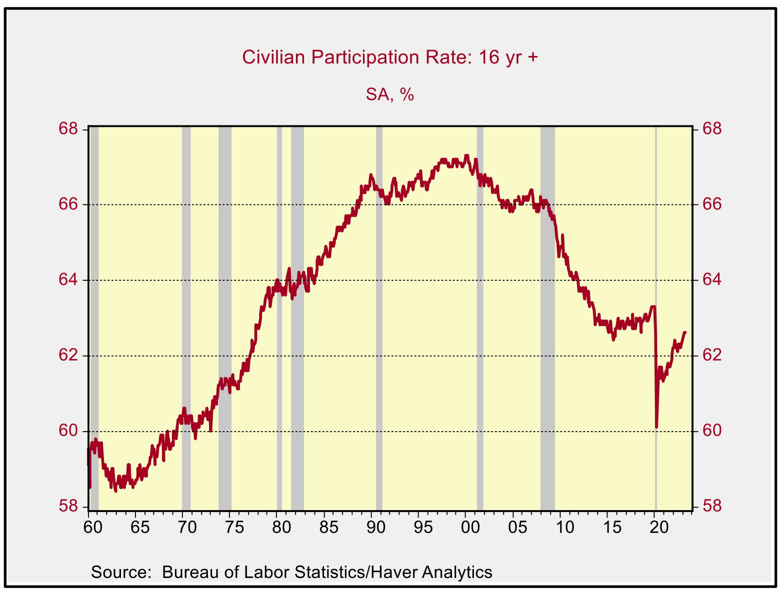
The April ***unemployment rate*** fell to a seasonally adjusted 3.4%, lower than both the anticipated rate of 3.6% and the February rate of 3.5%. In fact, it was the lowest rate of joblessness since May 1969. The chart below shows how the unemployment rate has evolved since just before the prior recession.



With the demand for labor high and the "inventory" of unemployed workers low, it should be no surprise that wage rates remain high. ***Average hourly earnings*** in April rose to a seasonally adjusted $33.36, up 4.4% from the same month one year earlier. The following chart shows the year-over-year growth in average hourly earnings since just before the prior recession.



A final key indicator in the monthly employment report focuses on the share of the adult, civilian, noninstitutionalized population that is either working or looking for work. The April ***labor force participation rate (LFPR)*** was unchanged at a seasonally adjusted 62.6%., exactly as anticipated. The chart below shows how the LFPR has changed over the last several decades.



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
15:00	Consumer Credit	m/m	Mar	$17.000b	42.0%	*
Federal Reserve						
EST	Speaker or Event	District or Position				
13:00	James Bullard Discusses Economic Outlook	President of the Federal Reserve Bank of St. Louis				
13:00	Lisa Cook Gives Commencement Address	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								
Australia	Foreign Reserves	m/m	Apr	A$92.4b	A$87.5b		*	Equity and bond neutral
China	Caixin Composite PMI	m/m	Apr	53.6	54.5		**	Equity and bond neutral
China	Caixin Services PMI	m/m	Apr	56.4	57.8	57.0	**	Equity and bond neutral
EUROPE								
Eurozone	Retail Sales	y/y	Mar	-3.8%	-3.0%	-2.4%	*	Equity bearish, bond bullish
Germany	HCOB Germany Construction PMI	m/m	Apr	42.0	42.9	0.0	*	Equity and bond neutral
	Factory Orders WDA	y/y	Mar	-11.0%	-5.7%	-6.0%	***	Equity bearish, bond bullish
France	Industrial Production	y/y	Mar	-0.1%	1.3%	0.9%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	Mar	0.7%	2.2%	1.8%	**	Equity bearish, bond bullish
Italy	Retail Sales	y/y	Mar	5.8%	5.8%		**	Equity and bond neutral
UK	S&P Global/CIPS Construction PMI	m/m	Apr	51.1	50.7	51.0	**	Equity and bond neutral
Switzerland	Unemployment Rate	m/m	Apr	2.0%	2.0%	1.9%	**	Equity and bond neutral
	CPI	y/y	Apr	2.6%	2.9%	2.8%	***	Equity and bond neutral
	Core CPI	y/y	Apr	2.2%	2.2%	2.3%	*	Equity and bond neutral
	Foreign Currency Reserves	m/m	Apr	732.2b	742.7b	743.0b	*	Equity and bond neutral
Russia	Money Supply, Narrow Definition	w/w	28-Apr	17.35t	17.28t		*	Equity and bond neutral
AMERICAS								
Brazil	S&P Global Composite PMI	m/m	Apr	51.8	50.7		***	Equity and bond neutral
	S&P Global Services PMI	m/m	Apr	54.5	51.8		**	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)	533	534	-1	Up
3-mo T-bill yield (bps)	506	508	-2	Up
TED spread (bps)	26	26	0	Tightening
U.S. Sibor/OIS spread (bps)	507	505	2	Up
U.S. Libor/OIS spread (bps)	508	506	2	Up
10-yr T-note (%)	3.40	3.38	0.02	Flat
Euribor/OIS spread (bps)	328	328	0	Up
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Flat			Up
Yen	Flat			Down
Pound	Up			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.

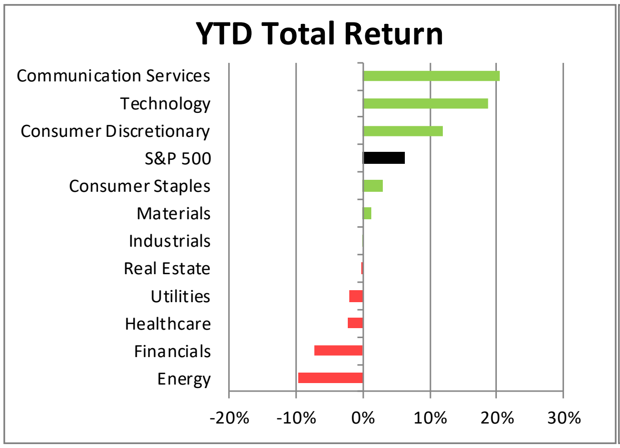
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$74.64	$72.50	2.95%	Supply Pessimism
WTI	$70.72	$68.56	3.15%	Supply Pessimism
Natural Gas	$2.11	$2.10	0.38%	
Crack Spread	$28.04	$27.81	0.83%	
12-mo strip crack	$23.62	$23.27	1.53%	
Ethanol rack	$2.55	$2.55	-0.20%	
Metals				
Gold	$2,034.87	$2,050.28	-0.75%	
Silver	$25.81	$26.05	-0.91%	
Copper contract	$385.85	$386.30	-0.12%	
Grains				
Corn contract	$593.00	$589.00	0.68%	
Wheat contract	$648.75	$645.00	0.58%	
Soybeans contract	$1,428.50	$1,417.75	0.76%	
Shipping				
Baltic Dry Freight	1,545	1,558	-13	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-1.3	-0.5	-0.8	
Gasoline (mb)	1.7	-1.5	3.2	
Distillates (mb)	-1.2	-0.8	-0.4	
Refinery run rates (%)	-0.6%	0.55%	-1.2%	
Natural gas (bcf)	54	52	2	

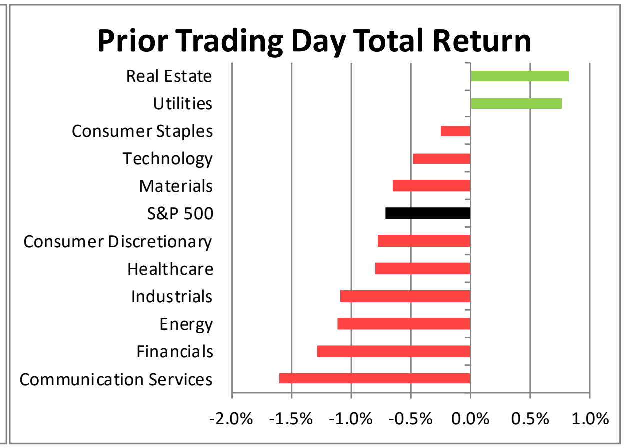
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in the Pacific Northwest, the Northern Rockies, and the rest of the country from the Great Plains eastward, with cooler-than-normal temperatures in the Southwest. The forecasts are calling for wetter-than-normal conditions in the Great Plains, Texas, and the Southeast, with dry conditions expected in the Pacific Northwest.

<u>Data Section</u>

U.S. Equity Markets – (as of 5/4/2023 close)

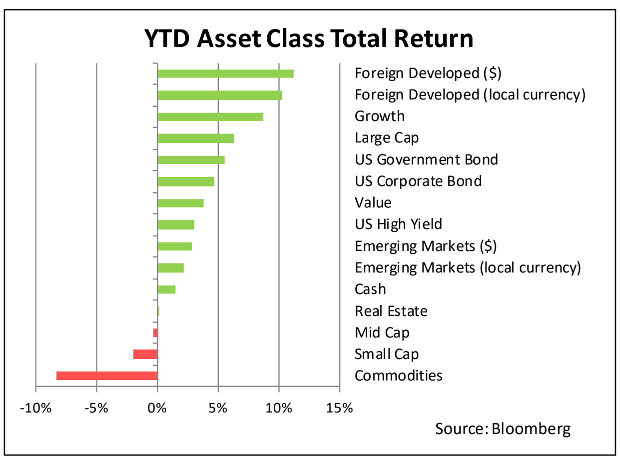




(Source: Bloomberg)

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 5/4/2023 close)

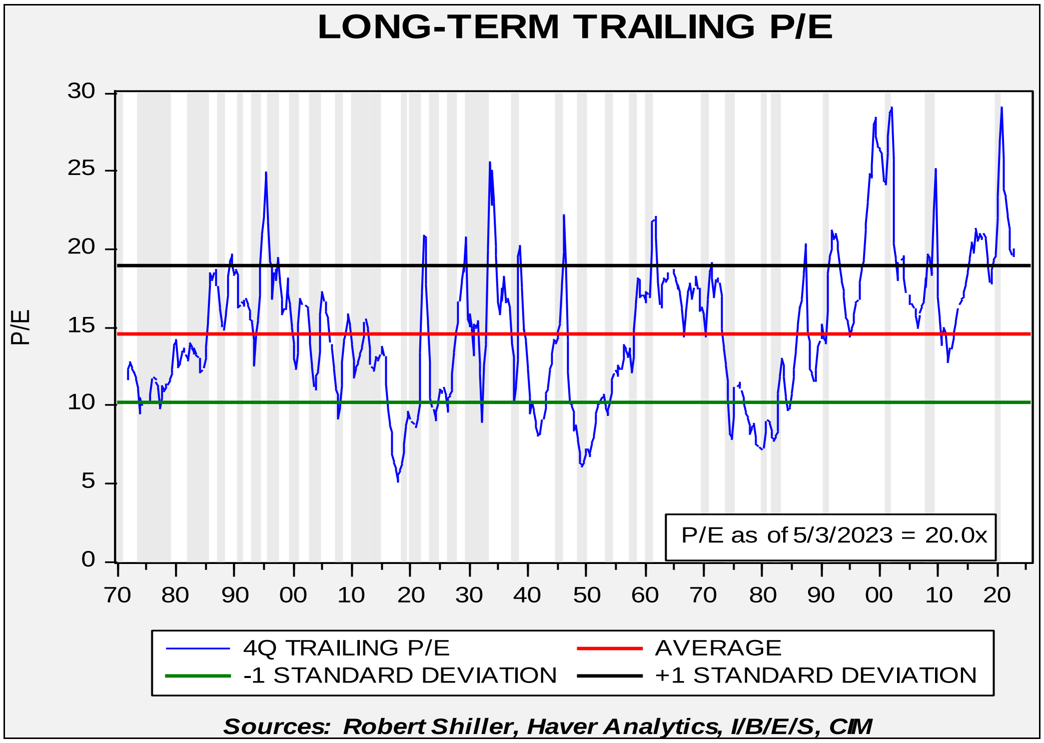


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

May 4, 2023



Based on our methodology,[1] the current P/E is 20.0x, unchanged from last week.

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.