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 9, 2023—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is currently down 0.9% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.2%. Chinese markets were lower, with the Shanghai Composite down 1.1% from its previous close and the Shenzhen Composite down 1.2%. U.S. equity index futures are signaling a lower open.

With 431 companies having reported so far, S&P 500 earnings for Q1 are running at $53.01 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, 78.2% have exceeded expectations while 18.1% 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* (5/8/2023) (with associated podcast): "Why We Are Keeping Duration Short"
- *Confluence of Ideas* podcast (3/8/2023): "Reflections on Inflation"

Our *Comment* today opens with a key report on Chinese international trade that points to an early slowdown in the Chinese and global economies. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including the nomination of left-leaning officials to the Brazilian central bank's policy board and a discussion of the Federal Reserve's latest report on financial stability.

China: The April trade surplus rose to more than $90 billion, but details in the report showed that exports in April were up just 8.5% year-over-year, marking a substantial slowdown from the 14.8% rise in the year to March and adding to concerns that slowing demand around the globe will mean an early demise for China's post-pandemic economic revival. Adding to the concerns, imports in April were down 7.9% on the year. The figures serve as a reminder that world economic growth is already starting to slow. We continue to believe that the U.S., in particular, is heading for a recession, most likely a bit later in the year.

Canada-China: The Canadian government designated a diplomat at China's consulate in Toronto as *persona non grata* for his effort to gather information about Conservative parliament member Michael Chong and his family in China. Intelligence officials believe the diplomat's aim was to "make an example" of Chong and deter other Canadian officials from taking anti-China political positions. The expulsion will undoubtedly lead to further China-Canada tensions, and, it has already prompted China to expel a Canadian diplomat based in Shanghai.

Pakistan: Former Prime Minister Imran Khan was arrested this morning on charges of corruption. The popular conservative politician was ousted by parliament last April amid an economic crisis, prompting months of mass protests by his supporters. The arrest is widely expected to prolong and deepen Pakistan's political tensions, making it even harder for the country to overcome its economic challenges.

Eurozone: As if the European Central Bank didn't have enough challenges with price inflation and rising wage rates in the bloc, union workers at the ECB have forced the institution to launch a pay review that could lead it to institute semiautomatic wage hikes when prices rise. The move puts the ECB in an awkward political position after it has spent months trying to convince the bloc's employers and workers not to push prices or wage rates too high.

Ireland: With the government awash in corporate tax receipts, Finance Minister McGrath today will formally propose setting up a sovereign wealth fund to channel its bumper surpluses into infrastructure and debt-reduction programs. The "scoping paper" to be given to the cabinet will examine similar plans in Norway, Japan, and Australia. It will also set out criteria for the fund, which is to be managed by the National Treasury Management Agency.

Russia-Ukraine War: Today is Victory Day, when Russians celebrate the surrender of Nazi Germany in World War II. At the scaled down military parade in Moscow's Red Square, President Putin used the occasion to bizarrely cast the war in Ukraine as a Western attack on Russia. Separately, Russian concern over possible Ukrainian attacks prompted the cancellation of the usual parades and other celebrations in at least 20 cities. Importantly, some observers believe the Ukrainians could launch their counteroffensive today, or at least other major attacks, to spoil the Russians' big celebration.

Brazil: Leftist President Luiz Inácio Lula da Silva, who has been attacking the Banco do Brasil (BDORY, $8.67) for its tight monetary policy despite the formal autonomy granted to the central bank in 2021, appointed two allies to the institution's nine-member monetary policy committee yesterday. If confirmed by the Senate, Deputy Finance Minister Gabriel Galípolo, a 40-year-old former bank executive, will serve as the central bank's new monetary policy director, while Ailton Aquino dos Santos, a career central bank employee, will be director of supervision.

- To bring down inflation, Banco do Brasil is currently holding its benchmark Selic short-term interest rate at a punishing 13.75%. Lula has called for the central bank to cut interest rates to boost economic growth.
- Lula's lobbying for lower interest rates has raised concerns that he will push for overly loose economic policies. That prospect has weighed on Brazilian equities and the currency in recent weeks.

Chile: Voters over the weekend elected conservatives to 33 of the 51 seats in a constituent assembly that will draft a new constitution to be voted on by the end of the year. The election results mark an about face when compared to the previous 2019 effort to re-write the constitution. The previous process produced a constituent assembly that was heavily weighted towards liberals and resulted in a draft constitution that was voted down in 2022 for being too leftist.

- The voting for the new assembly further weakens leftist President Boric and suggests the new constitution will preserve most, if not all, of the current document's private-property protections, free-market rules, and other conservative measures.
- The vote is therefore being taken as a positive for the Chilean economy and financial markets, giving a boost to Chilean stocks and the Chilean peso (CLP).

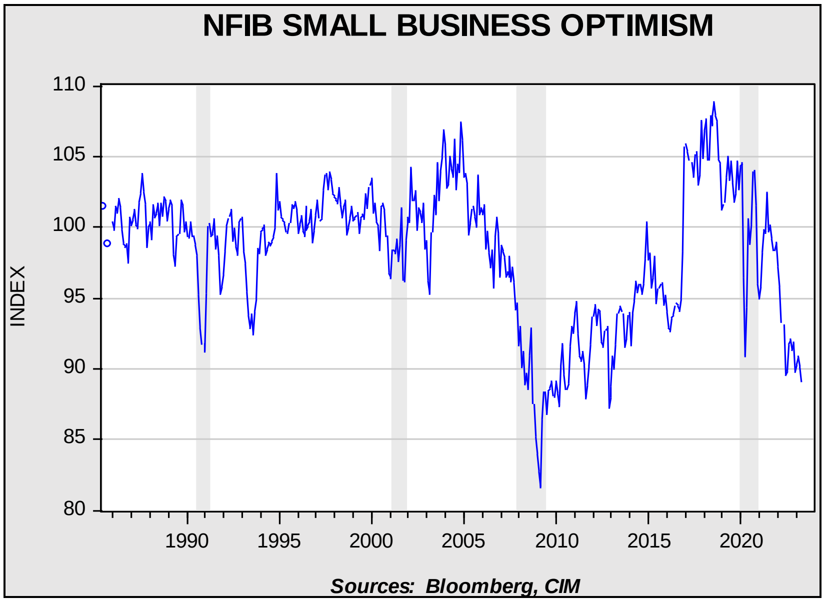
U.S. Fiscal Policy: President Biden and members of his administration will meet today with House Speaker McCarthy and other congressional leaders to discuss how to raise the federal debt limit. The meeting is expected to kick off weeks of discussions ahead of June 1, when Treasury Secretary Yellen has warned that the government will no longer be able to pay its bills or make debt service on its debt. We continue to believe that brinksmanship surrounding the debt ceiling could prompt elevated volatility in the financial market as we approach the deadline.

U.S. Banking Sector: Yesterday, in its semiannual *Financial Stability Report*, the Fed said its aggressive interest-rate hikes over the last year have increased risks in the commercial real estate sector. In particular, the Fed analysts noted the chance that borrowers might have trouble rolling over their mortgage debt, and that property values could fall sharply enough to cause problems for lenders. The authors asserted that the Fed has responded to the risks by intensifying its monitoring of real estate loan performance and expanding its examination procedures for banks with large commercial real estate exposures.

U.S. Retailing Sector: While we've already written a great deal about the challenges for commercial real estate, especially office buildings and downtown retail stores, new analysis shows that suburban retail stores are benefiting from the work-from-home movement. Some restaurants and retail businesses that used to focus on bustling urban locations are now moving to the 'burbs. With more people spending time closer to home in the suburbs, even regional malls are reporting improved foot traffic.

U.S. Economic Releases

Small business confidence fell to its lowest level in over a decade last month, according to a trade group survey. The National Federation of Independent Business (NFIB) Small Business Optimism Index dipped from 90.1 to 89.0 in April. The drop was lower than consensus estimates of 89.7, suggesting that sentiment was worse than forecasters expected. The poor reading can be attributed to a pullback in investment plans and a decrease in sales expectations.



The chart above shows the level of the NFIB Small Business Optimism Index. The persistent decline in the indicator reflects growing concerns about the broader economy and may add to speculation that the country is headed toward recession.

The table below lists the economic releases and/or Fed events scheduled for the rest of the day.

Economic Releases		
No economic releases for the rest of today		
Federal Reserve		
EST	**Speaker or Event**	**District or Position**
12:05	John Williams Speaks to Economic Club of New York	President of the Federal Reserve Bank of New York

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	Household Spending	y/y	Mar	-1.9%	1.6%	0.8%	***	Equity bearish, bond bullish
Australia	Retail Sales Ex Inflation	q/q	1Q	-0.60%	-0.20%	-0.30%	***	Equity and bond neutral
China	Exports	y/y	Apr	8.5%	14.8%	8.0%	**	Equity and bond neutral
	Imports	y/y	Apr	-7.9%	-1.4%	-0.2%	**	Equity bearish, bond bullish
	Trade Balance	m/m	Apr	$90.21b	$88.19b	$71.25b	***	Equity and bond neutral
EUROPE								
France	Trade Balance	m/m	Mar	-£8.023b	-£9.904b	-£9.302b	**	Equity and bond neutral
	Current Account Balance	m/m	Mar	$1.4b	-$3.0b		**	Equity and bond neutral
AMERICAS								
Mexico	CPI	y/y	Apr	6.25%	6.85%	6.22%	***	Equity and bond neutral
	Core CPI	y/y	Apr	7.67%	8.09%	7.70%	**	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)	534	532	2	Up
3-mo T-bill yield (bps)	507	508	-1	Up
TED spread (bps)	27	24	3	Tightening
U.S. Sibor/OIS spread (bps)	509	509	0	Up
U.S. Libor/OIS spread (bps)	510	510	0	Up
10-yr T-note (%)	3.48	3.51	-0.03	Flat
Euribor/OIS spread (bps)	331	328	3	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Up			Down
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.

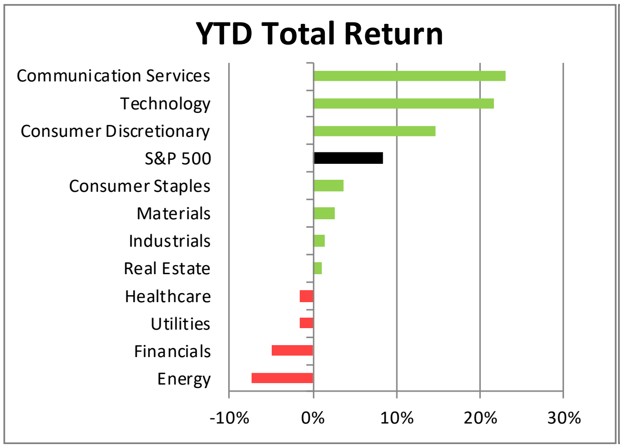
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$76.26	$77.01	-0.97%	
WTI	$72.42	$73.16	-1.01%	
Natural Gas	$2.23	$2.24	-0.54%	
Crack Spread	$28.88	$28.72	0.59%	
12-mo strip crack	$24.25	$24.13	0.49%	
Ethanol rack	$2.55	$2.55	-0.14%	
Metals				
Gold	$2,031.09	$2,021.16	0.49%	
Silver	$25.49	$25.55	-0.24%	
Copper contract	$390.55	$392.95	-0.61%	
Grains				
Corn contract	$589.25	$596.50	-1.22%	
Wheat contract	$643.50	$654.00	-1.61%	
Soybeans contract	$1,425.00	$1,433.75	-0.61%	
Shipping				
Baltic Dry Freight	1,558	1,545	13	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.5		
Gasoline (mb)		-1.8		
Distillates (mb)		-1.0		
Refinery run rates (%)		0.55%		
Natural gas (bcf)		76		

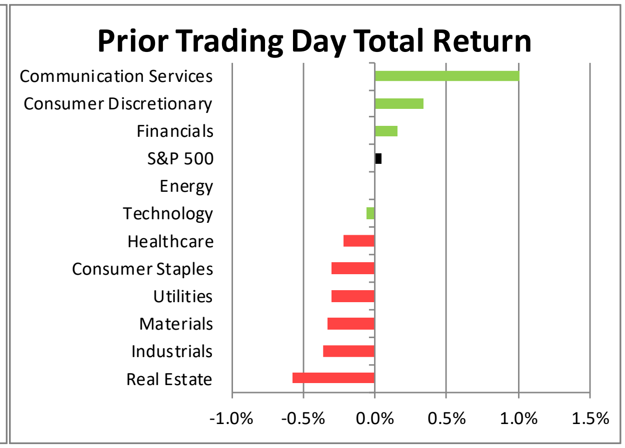
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for most of the Pacific and Rocky Mountain regions, with cooler-than-normal temperatures in the Southwest and Midwest. Additionally, the precipitation outlook is calling for wetter-than-normal conditions throughout the South and Mid-Atlantic region, with dry conditions expected in most of the northern states.

Data Section

U.S. Equity Markets – (as of 5/8/2023 close)

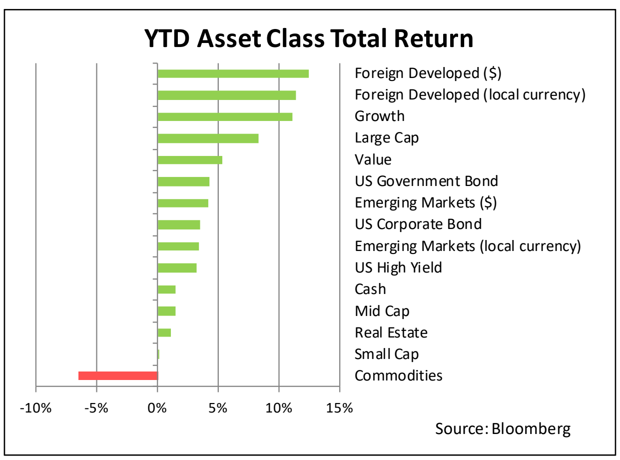




(Source: Bloomberg)

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 5/8/2023 close)

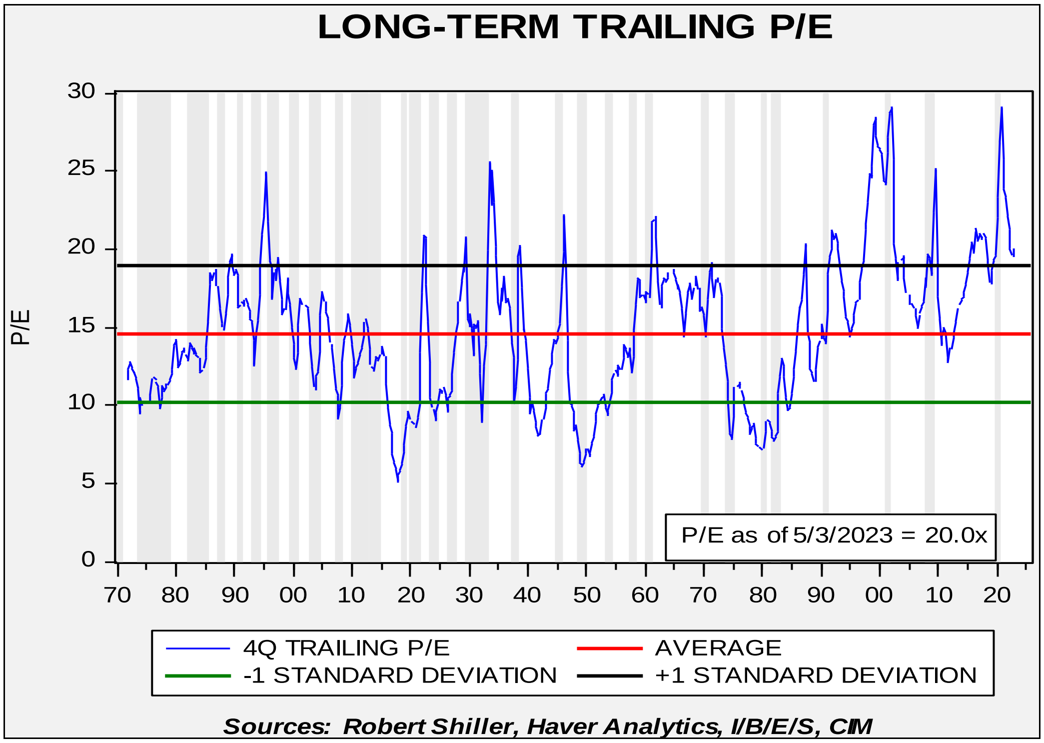


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.