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 10, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is currently down 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.5%. Chinese markets were mixed, with the Shanghai Composite down 1.2% from its previous close and the Shenzhen Composite up 0.3%. U.S. equity index futures are signaling a higher open.

With 452 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, 77.4% have exceeded expectations while 19.0% 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 an overview of the devastating heatwave in Southeast Asia and the latest on the Russia-Ukraine war. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including political and economic upheavals in key Latin American countries and new reports on the health of the U.S. banking system.

Southeast Asia: Countries including Vietnam, Thailand, Cambodia, and Laos have been suffering from a historic heat wave in recent weeks, leading to melted roadways, school closures, and business disruptions. The new record-high temperatures include 112°F in Vietnam's northern Tuong Duong district and 110°F in the popular Laotian tourist destination of Luang Prabang. Since the populations in these countries are largely poor and less able to cope, the heat wave and the region's unusually dry winter will likely have an outsized impact on the affected economies.

Russia-Ukraine War: Russian and Ukrainian officials say that at least one large Russian military unit has been destroyed in the embattled city of Bakhmut, potentially reflecting the Kremlin's failure to provide enough equipment and ammunition to the Wagner Group mercenaries fighting there. The unit's destruction, which apparently prompted Russian forces to pull back from part of the city, could also reflect improved resources provided by the West to the Ukrainians ahead of their widely anticipated spring counteroffensive.

- Separately, the U.K. Ministry of Defense estimated that Russia's total population declined by about two million people more than expected over the last three years because of both COVID-19 and the war in Ukraine. The ministry estimates that about 1.3 million people emigrated from Russia in 2022, including many young, highly educated people in high-value industries. In fact, about 10% of the country's entire IT workforce left.
- Finally, new reporting discusses how the war has been a boon for small, technology-oriented defense companies around the world.

Turkey: The top opposition candidate in Sunday's presidential election, Kemal Kılıçdaroğlu, said he will reinvigorate the country's democratic checks and balances and strengthen its role in the North Atlantic Treaty Organization if he wins. In recent opinion polling, Kılıçdaroğlu has held a slight lead over incumbent President Erdoğan but not necessarily enough to avoid a run-off election later in May.

Colombia: The country's new finance minister, Ricardo Bonilla, said he and leftist President Gustavo Petro plan to cut Colombia's reliance on producing mineral commodities and instead nurture basic manufacturing in areas like textiles, fertilizers, metalworking, and pharmaceuticals. Bonilla has also vowed to rein in the country's budget deficit, but his statement on restructuring the economy suggests Petro's recent cabinet reshuffle will push Colombian policy leftward, which could be a headwind for Colombian financial markets.

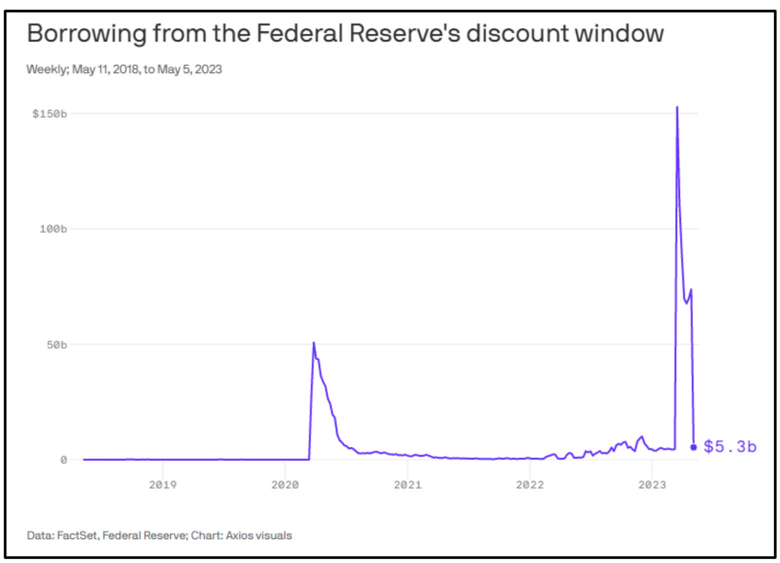
- We would note that Bonilla's plan to boost domestic manufacturing is also in sync with industrial policy trends in key developed countries, including the U.S., which in recent years has instituted more trade barriers against China and approved hundreds of billions of dollars in subsidies to help boost favored industries such as semiconductors and green technology.
- Bonilla's plan, therefore, runs counter to free-market ideology. On the other hand, it's possible to argue that the massive boom in Chinese manufacturing since 2001, driven in part by Beijing's subsidies and other unfair policies, unfairly short-circuited efforts by Colombia and other emerging markets to develop via manufacturing investment. One

could almost say that when the Chinese economy burst onto the world stage, it forced many emerging markets off the road to manufacturing and instead pushed them onto the road of being dependent on commodity production, with all the volatility, environmental damage, and other issues associated with it. It would not be a surprise to see more developing countries adopting policies like Colombia's in the future.

Ecuador: The national assembly yesterday voted to move ahead with an impeachment trial of President Lasso over charges of corruption. Under the constitution, however, Lasso could first dissolve congress and trigger presidential and legislative elections. In any case, the country is likely to face weeks or months of heightened political uncertainty that will likely weigh on Ecuador's financial markets and currency.

U.S. Fiscal Policy: President Biden, House Speaker McCarthy, and other congressional leaders met yesterday in an initial effort to resolve the dispute over raising the federal debt limit, but the meeting ended with little apparent progress. After the meeting, Biden reiterated his stance that the politicians should work to cut the budget deficit, but without tying that effort to raising the debt limit. McCarthy expressed his frustration that Biden had not met with him on the issue earlier and reiterated his view that raising the debt ceiling must be accompanied by steep spending cuts. As we mentioned in our *Comment* yesterday, we expect the discussions, and brinksmanship, to continue in the coming weeks ahead of the June 1 deadline at which time the government may not be able to pay its bills.

U.S. Banking-Discount Window Borrowing: New data from the Federal Reserve shows that bank borrowing from its discount window plunged to $5.3 billion last week, down from more than $150 billion at the height of the banking crisis in March. The plunge in discount window borrowing last week is a welcome signal that the worst of the banking crisis has passed, although we believe banks will suffer a prolonged period of "disintermediation" as customers gradually pull their deposits to redeploy them to higher-yielding investments such as Treasury bills and money market funds.

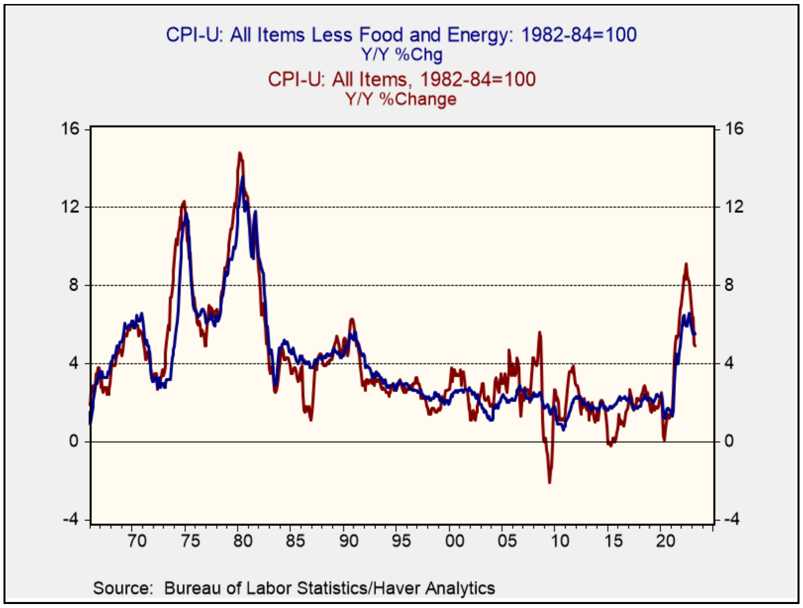


U.S. Banking-Lending Standards: Consistent with the loss of deposits because of disintermediation, the Fed's latest senior loan officer survey showed banks tightened lending standards for both large and small corporate borrowers in the first quarter. That merely continues a trend of stingier lending that began a year ago, but we note that the tightness is now at the levels often seen in recessions. The data suggests that if the economy isn't in the expected downturn already, it is rapidly approaching it.

U.S. Economic Releases

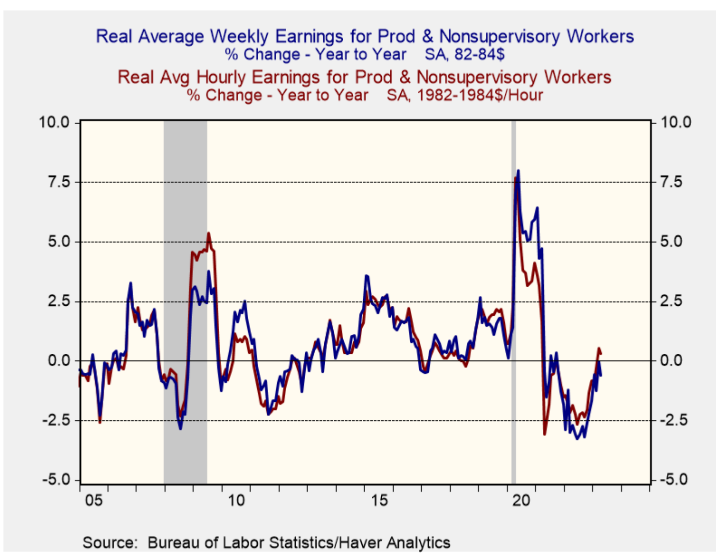
Residential loan demand rose last week even as elevated borrowing costs continues to crimp home affordability. Data collected by the Mortgage Bankers' Association (MBA) shows that the number of mortgage applications rose 6.3% in the week ending May 5. The rise in loan requests is related to a modest drop in interest rates. The average 30-year fixed-rate mortgage fell by 2 bps from 6.50% to 6.48%. As a result, the MBA tracker for purchases rose 4.8% from the prior week, while the refinance tracker increased 10.0% in the same period.

In other news, U.S. inflation eased in April but remains significantly above the Federal Reserve's 2% target. According to the Bureau of Labor Statistics, the consumer price index (CPI) decelerated from 5.0% from the prior year in March to 4.9% in the following month. The reading was slightly below expectations of 5.0%. The relief in price pressures can be attributed to a decline in commodity values. Excluding volatile food and energy, the CPI rose 5.5% since April 2022, in line with forecasts.



The chart above shows the year-over-year change in core and headline CPI. Although inflation remains high, the data showed that shelter prices have finally showed signs of decelerating. Last month, shelter prices slowed from 8.2% to 8.1%. If this trend continues, we could see further decline in CPI.

That said, elevated inflation still weighs on labor wages as inflation-adjusted pay remains lower than it was a year ago. Real average weekly earnings fell 1.1% from the prior year, while real hourly earnings declined 0.5% in the same period.



The chart above shows the annual change in real wages for nonsupervisory and production workers. Despite weekly earnings falling 0.6% from the prior year, hourly earnings rose 0.3% in the same period. The two readings suggest that firms may be offsetting higher pay by decreasing working hours. Hence, wage pressures on inflation may start to wane in the coming months.

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
14:00	Monthly Budget Statement	m/m	Mar	$235.0b	-$378.1b	**
Federal Reserve						
	No Fed speakers or events for the rest of today					

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								
South Korea	BoP Goods Balance	m/m	Mar	-$1125.1m	-$1295.7m		*	Equity and bond neutral
	BoP Current Account Balance	m/m	Mar	-$267.9m	-$518.4m		**	Equity and bond neutral
	Unemployment Rate	m/m	Apr	2.6%	2.7%	2.9%	**	Equity bullish, bond bearish
EUROPE								
Germany	CPI	y/y	Apr F	7.2%	7.2%	7.2%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Apr F	7.6%	7.6%	7.6%	**	Equity and bond neutral
France	Trade Balance	m/m	Mar	-£8.023b	-£9.904b	-£9.302b	**	Equity and bond neutral
Italy	Industrial Production WDA	y/y	Mar	-3.2%	-2.3%	-1.7%	***	Equity bearish, bond bullish
AMERICAS								
Mexico	International Reserves Weekly	w/w	5-May	$203510	$203104m		*	Equity and bond neutral
Brazil	Industrial Production	y/y	Mar	0.9%	-2.4%	0.6%	***	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)	510	508	2	Up
TED spread (bps)	24	25	-1	Tightening
U.S. Sibor/OIS spread (bps)	512	511	1	Up
U.S. Libor/OIS spread (bps)	512	511	1	Up
10-yr T-note (%)	3.50	3.52	-0.02	Flat
Euribor/OIS spread (bps)	327	331	-4	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Flat			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.

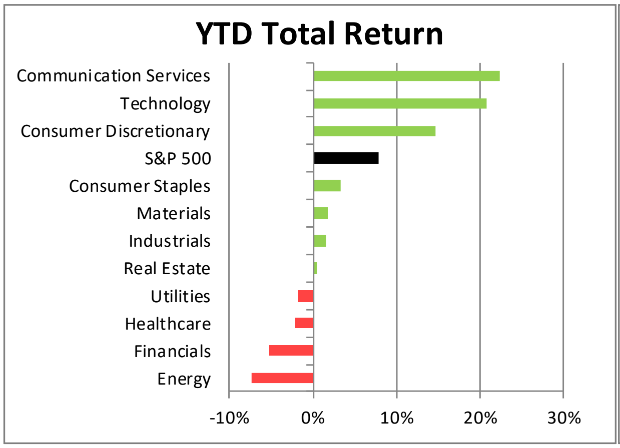
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$76.57	$77.44	-1.12%	
WTI	$72.82	$73.71	-1.21%	
Natural Gas	$2.22	$2.27	-2.16%	
Crack Spread	$29.78	$29.48	1.01%	
12-mo strip crack	$24.63	$24.62	0.05%	
Ethanol rack	$2.53	$2.54	-0.21%	
Metals				
Gold	$2,029.59	$2,034.56	-0.24%	
Silver	$25.52	$25.60	-0.33%	
Copper contract	$385.10	$390.15	-1.29%	
Grains				
Corn contract	$579.25	$584.75	-0.94%	
Wheat contract	$634.50	$643.50	-1.40%	
Soybeans contract	$1,403.75	$1,414.25	-0.74%	
Shipping				
Baltic Dry Freight	1,598	1,558	40	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.5		
Gasoline (mb)		-1.5		
Distillates (mb)		-1.0		
Refinery run rates (%)		0.60%		
Natural gas (bcf)		79		

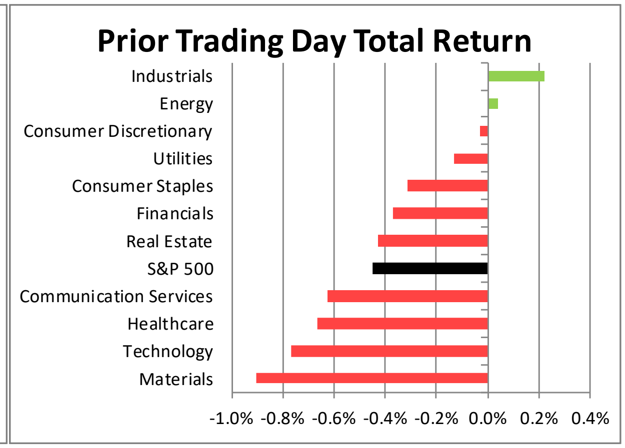
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for most of the Pacific region, Rocky Mountains, and East Coast, 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 5/9/2023 close)

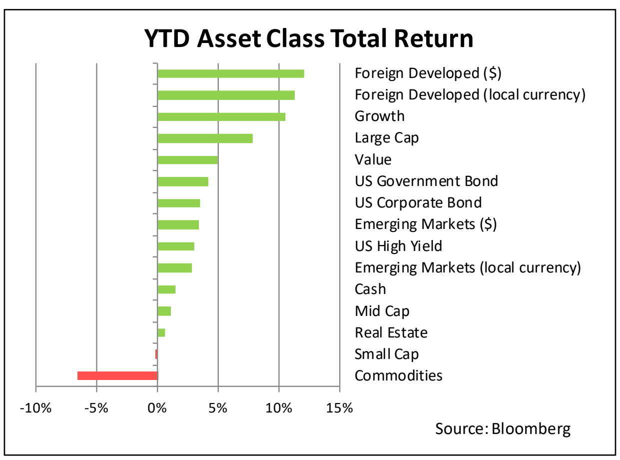




(Source: Bloomberg)

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 5/9/2023 close)

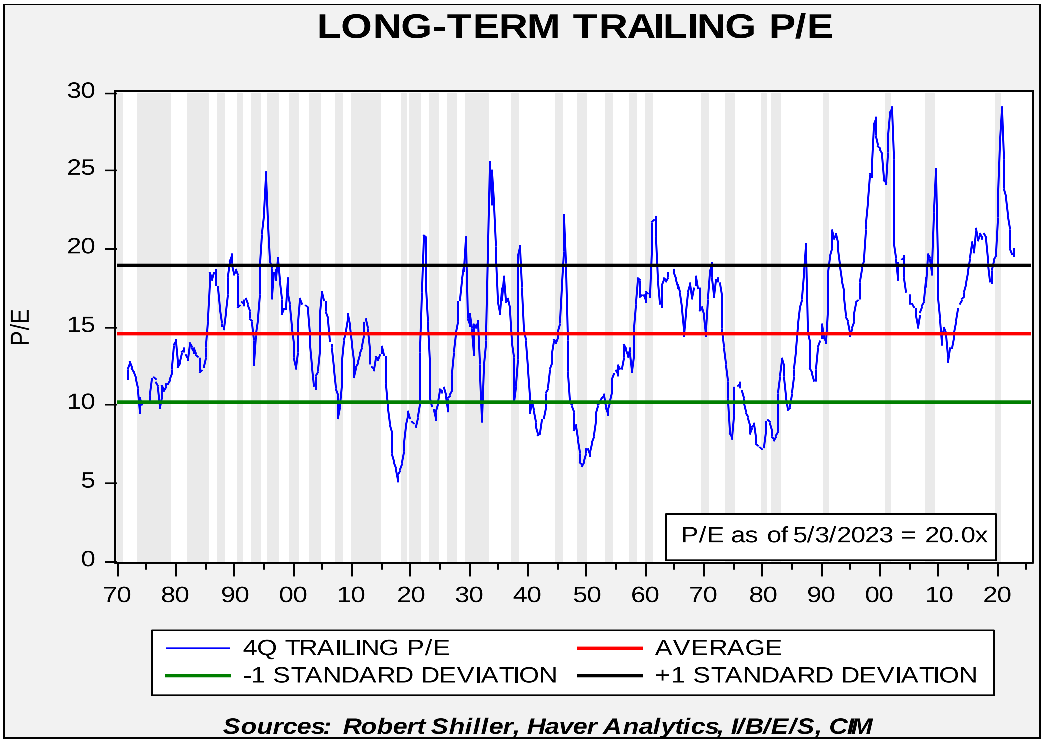


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.