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 11, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is currently up 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.4%. Chinese markets were mixed, with the Shanghai Composite down 0.3% from its previous close and the Shenzhen Composite up 0.2%. U.S. equity index futures are signaling a lower 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.

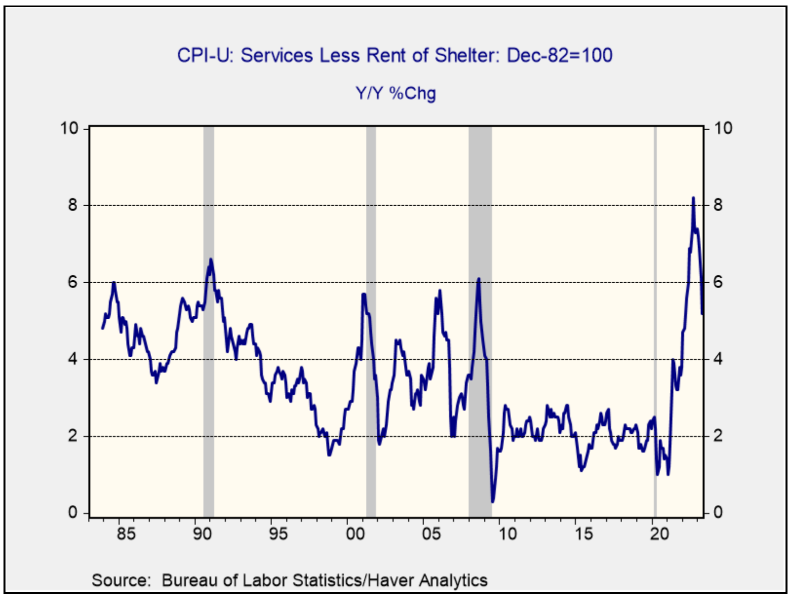
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (5/1/2023) (with associated podcast) "Implications of the Iran-Saudi Arabia Détente"
- ***Weekly Energy Update*** **(5/11/2023): We update the weekly data and note that streamlining the permitting process has allies from both the fossil fuel and alternative energy industries**.
- *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"

Good morning! Today's *Comment* starts with a discussion about why the market reacted so positively to a subtle drop in U.S. inflation. Next, we provide our thoughts on the latest developments in debt ceiling talks and how they impact U.S. Treasuries. Lastly, we provide an update on the ongoing competition between China and the West.

Now a Pause? A key inflation indicator bolstered investor confidence that the Federal Reserve is close to ending its hiking cycle.

- Consumer price data showed that the Fed is making progress in its inflation fight, despite only a modest decline in price pressures. Last month, the consumer price index rose 4.9% from the prior year. Although the increase only slightly beat consensus estimates of 5.0%, a deeper look into the data tells a different story. Non-housing core services inflation, [Fed Chair Jerome Powell's favorite indicator](), declined to 5.2% last month from a peak of 8.2% in September 2022. The price indicator is viewed as a gauge of the wage pressures within the inflation data. Thus, its decline could give Fed officials the greenlight to pause in their next meeting.
- Speculation about the end of the interest rate hike lifted market sentiment. The NASDAQ Composite Index rose 1.04% on Wednesday as tech stocks were favored by traders looking to take on more risk. Additionally, the market is now convinced that the Fed will pause rates in June. The latest CME FedWatch Tool projects that there is more than a 90% chance that the central bank will hold rates at their current levels. Assuming the forecast is right, this may explain the strong performance in risk assets.

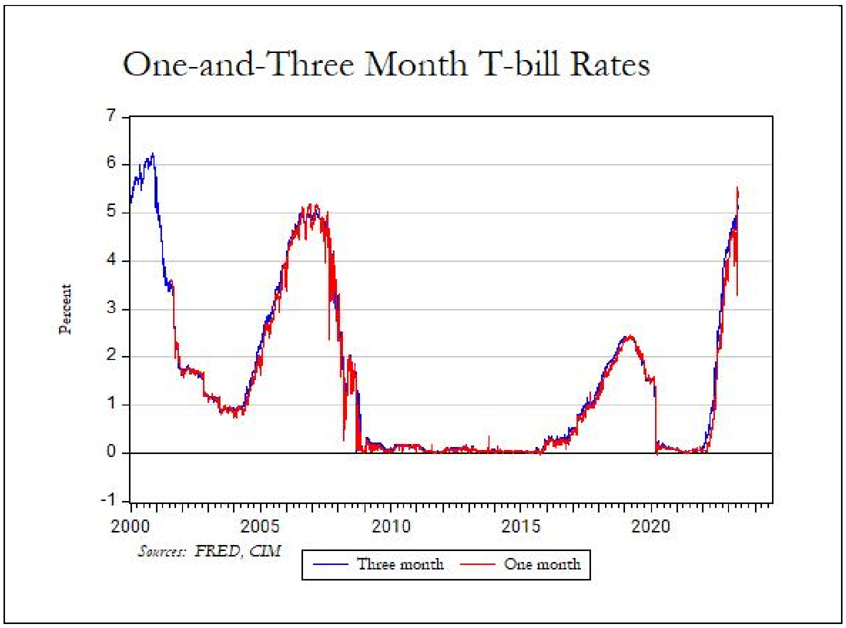


- At this time, there is a fundamental disagreement between the market and the Fed over the next policy steps. The market wants the Fed to cut rates as the economy slows down. In contrast, Powell insists that the FOMC should maintain rates in restrictive territory until inflation is under control. So far, there has been no sign that the Fed is ready to pivot interest rates; thus, it is still likely that it will keep rates elevated throughout the year. As a result, the market will likely see a lot of uncertainty over the next few months.

Debt Fiasco: The ongoing dispute over raising the debt ceiling is already starting to spill into financial markets.

- The two major parties continue to use the threat of triggering a potential crisis as the debt deadline approaches. On Wednesday, former President Donald Trump urged Republicans to push the country into an unprecedented default unless the Democrats commit to massive spending cuts. Meanwhile, his successor has floated the possibility of using the 14th Amendment to remove the debt ceiling. Congress has only six scheduled legislative days left, and there does not seem to be a pathway toward an agreement.

- Uncertainty over whether the U.S. will default on its debts has caused disarray within the Treasury market. One-month Treasury-bill yields have surpassed three-month government yields at levels not seen since one-month Treasury bills were introduced in 2001. This divergence is related to investors' discomfort with the political brinkmanship over raising the debt ceiling. There is growing fear that the two sides will be unlikely to come to an agreement before the debt limit's June 1 deadline. Failure to raise the debt limit could have catastrophic consequences for the U.S. economy and will undoubtedly push the country into recession.



- Congress will likely feel pressured to act on the debt ceiling when the market friction moves from the Treasury bills into equities. The lack of equity movement related to the standoff is due to market confidence that lawmakers will eventually come to an agreement even if it includes a few defections. Thus, market participants have been able to focus their attention on other market-related events. This dynamic will change over the next couple of weeks as the impasse draws more attention from investors. At this time, we suspect government officials may look for a temporary solution to avoid a default.

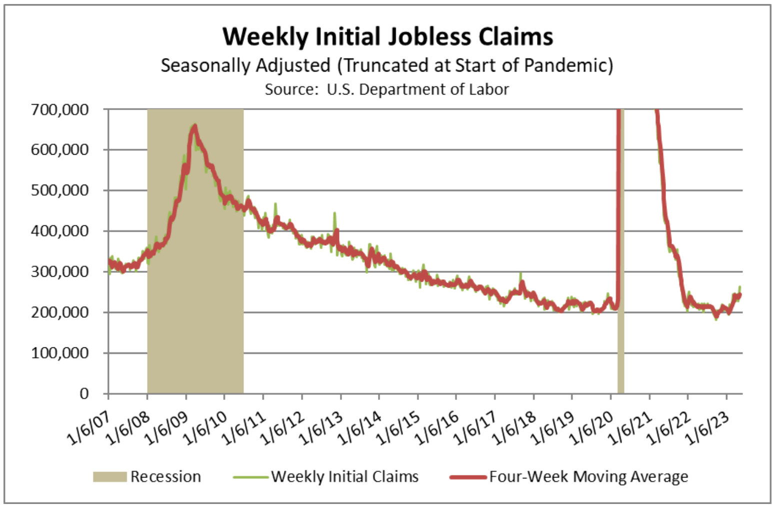
Beijing Pivot: As the West reduces its dependency on China, Beijing is looking to build ties with emerging market countries.

- Government officials in Europe are slowly distancing themselves from the world's second-largest economy. Italy is expected to hold talks about a possible exit from China's Belt and Road Initiative. At the same time, German Chancellor Olaf Scholz has described Beijing as being a "systemic rival" and has urged other EU countries to scale back their reliance on China. European countries' decision to create “strategic distance" is related to concerns that China is looking to replace the global system with something that reflects its own ideology.

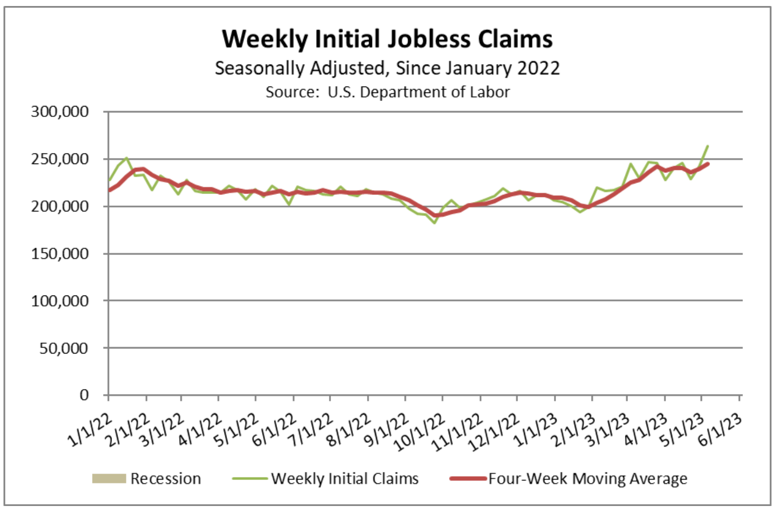
- China has looked to developing countries to hedge against its potential decoupling from the West. On Thursday, Ecuador signed a free trade agreement with China that would boost non-oil exports. However, the deal will likely face resistance as it makes its way through the legislature. Across the Pacific, local governments in China have looked to raise capital from sovereign wealth funds in the Middle East. Officials have held talks with the Qatar Investment Authority, subsidiaries of Saudi Arabia’s Public Investment Fund, and the Abu Dhabi Investment Authority. The recent outreach in the Middle East and South America shows how China is prepared to recruit from areas within the U.S.’s sphere of influence.
- Neither the West nor China wants an abrupt end to the trading relationship. Despite President Biden’s tough rhetoric, his administration has been aggressive in pushing the two Major Powers to reengage in talks. Secretary of State Antony Blinken is preparing to set up a visit to China later this year. At the same time, Defense Secretary Lloyd Austin has expressed interest in meeting China’s new defense minister Li Shangfu at an upcoming summit in Singapore. So far, China has rebuffed offers for communication as it describes Washington’s attempts at dialogue contradictory to its broader goal of Chinese containment. However, its lackluster recovery following the end of its Zero-COVID policy may force China to eventually relent to talks.
    - We believe that the markets will welcome any sign of an easing of tensions between the West and China but talks alone won’t lead to an overall improvement in the relationship.

U.S. Economic Releases

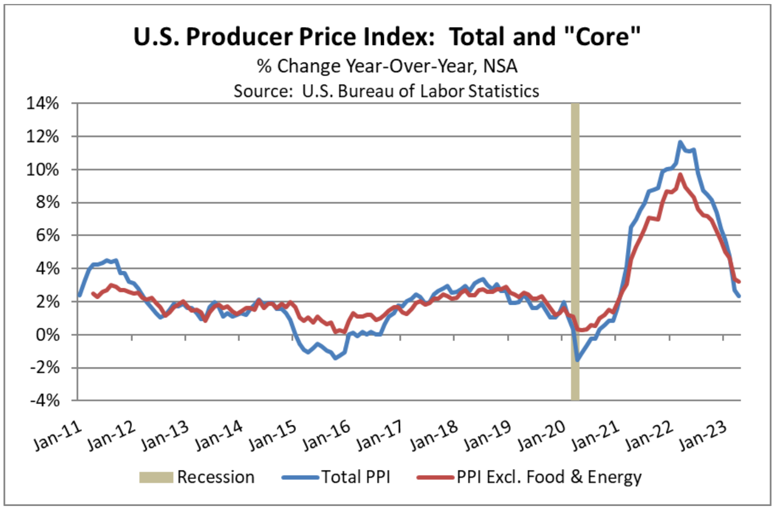
In the week ending May 6, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 264,000, above both the expected level of 245,000 and the previous week’s level of 242,000. In fact, initial claims last week were at the highest level since late October 2021. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 245,250, reaching its highest level since late November 2021. These figures would suggest a material weakening in labor demand, cooler wage gains, and less upward pressure on interest rates. On the other hand, a separate aspect of the report was less positive. In the week ending April 29, the number of ***continuing claims for unemployment benefits*** (i.e, people continuing to draw benefits) rose only slightly to 1.813 million, below the expected reading of 1.820 million and only modestly above the previous week’s revised reading of 1.801 million. The following chart shows how initial jobless claims have fluctuated since just before the prior recession. The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



To provide more detail on recent trends, the chart below shows how initial jobless claims have changed just since the beginning of 2022.



The April ***producer price index (PPI)*** rose by a seasonally adjusted 0.2%, weaker than the anticipated rise of 0.3% but still enough to reverse half of the revised 0.4% decline from March. Excluding the volatile food and energy components, the April ***"core" PPI*** also rose 0.2%, as expected, following a flat reading in the previous month. The overall PPI in April was up 2.3% from the same month one year earlier, while the core PPI was up 3.2%. Both those annual gains were the weakest since early 2021, offering more encouragement that the Fed could soon feel more comfortable that inflation pressures have eased. The following chart shows the year-over-year change in the PPI and the core PPI over the last decade or so.



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**
10:15	Chris Waller Discusses Financial Stability and Climate Change	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	Leading Economic Index	m/m	Mar P	97.5	98.0	98.2	**	Equity bearish, bond bullish
	BoP Current Account Balance	m/m	Mar	¥2278.1b	¥2197.2b	¥2890.7b	***	Equity and bond neutral
	BoP Trade Balance	m/m	Mar	-¥454.4b	-¥604.1b	-¥450.0b	**	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	5-May	¥373.1b	¥342.9b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	5-May	-¥216.5b	¥41.6b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	5-May	-¥455.4b	¥173.1b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	5-May	-¥635.2b	-¥1059.5b		*	Equity and bond neutral
New Zealand	REINZ House Sales	y/y	Apr	-15.3%	-15.0%		**	Equity and bond neutral
	Food Prices	m/m	Apr	0.5%	0.8%		***	Equity and bond neutral
China	Aggregate Financing CNY	y/y	Apr	1220.0b	5380.0b	2000.0b	*	Equity and bond neutral
	Money Supply M2	y/y	Apr	12.4%	12.7%	12.5%	***	Equity and bond neutral
	Money Supply M0	y/y	Apr	10.7%	11.0%		*	Equity and bond neutral
	New Yuan Loans	m/m	Apr	718.8b	3890.0b	1400.0b	**	Equity and bond neutral
	Money Supply M1	y/y	Apr	5.3%	5.1%	5.1%	*	Equity and bond neutral
China	CPI	y/y	Apr	0.1%	0.7%	0.3%	***	Equity and bond neutral
	PPI	y/y	Apr	-3.6%	-2.5%	-3.3%	**	Equity and bond neutral
EUROPE								
UK	RICS House Price Balance	m/m	Apr	-39.0%	-43.0%	-40.0%	**	Equity and bond neutral
Russia	Official Reserve Assets	m/m	Apr	595.8b	593.9b		*	Equity and bond neutral
AMERICAS								
Canada	Building Permits	m/m	Mar	11.3%	8.6%	-2.2%	**	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	534	0	Up
3-mo T-bill yield (bps)	506	508	-2	Up
TED spread (bps)	28	25	3	Tightening
U.S. Sibor/OIS spread (bps)	507	508	-1	Up
U.S. Libor/OIS spread (bps)	507	508	-1	Up
10-yr T-note (%)	3.39	3.43	-0.04	Flat
Euribor/OIS spread (bps)	330	327	3	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Up			Down
Pound	Down			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of England Bank Rate	4.500%	4.250%	4.500%	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.

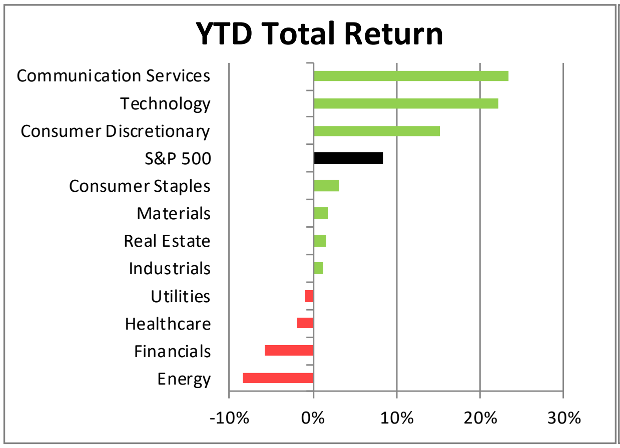
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$76.21	$76.41	-0.26%	
WTI	$72.33	$72.56	-0.32%	
Natural Gas	$2.20	$2.19	0.41%	
Crack Spread	$30.76	$30.64	0.39%	
12-mo strip crack	$25.09	$24.98	0.46%	
Ethanol rack	$2.55	$2.54	0.35%	
Metals				
Gold	$2,037.38	$2,030.09	0.36%	
Silver	$24.96	$25.40	-1.76%	
Copper contract	$374.25	$384.10	-2.56%	
Grains				
Corn contract	$590.50	$594.00	-0.59%	
Wheat contract	$637.00	$641.25	-0.66%	
Soybeans contract	$1,397.00	$1,404.00	-0.50%	
Shipping				
Baltic Dry Freight	1,640	1,598	42	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	3.0	-2.5	5.5	
Gasoline (mb)	-3.2	-1.5	-1.7	
Distillates (mb)	-4.2	-1.0	-3.2	
Refinery run rates (%)	0.3%	0.60%	-0.3%	
Natural gas (bcf)		78		

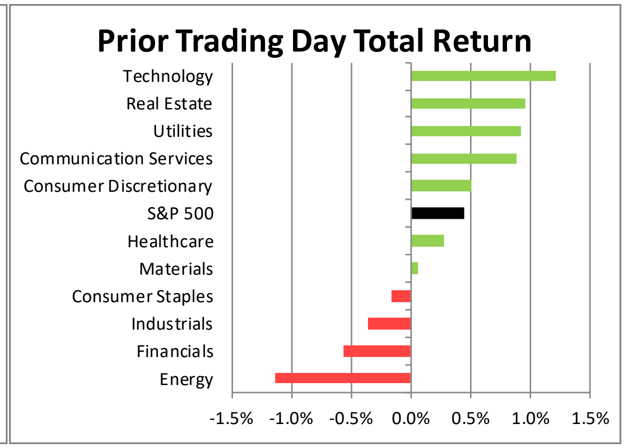
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures along the West Coast, in the northern Rocky Mountain region, and in Florida, with cooler-than-normal temperatures in the Southwest and Midwest. The forecasts are calling for wetter-than-normal conditions in the Southwest, Texas, and the Southeast, with dry conditions expected in most of the Pacific Northwest and the Upper Midwest.

Data Section

U.S. Equity Markets – (as of 5/10/2023 close)

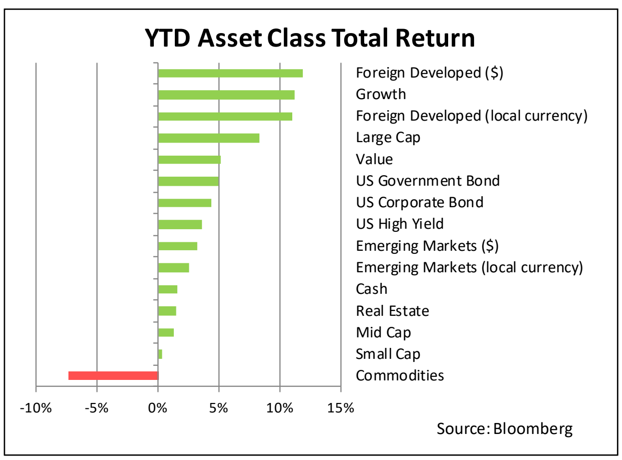




(Source: Bloomberg)

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 5/10/2023 close)

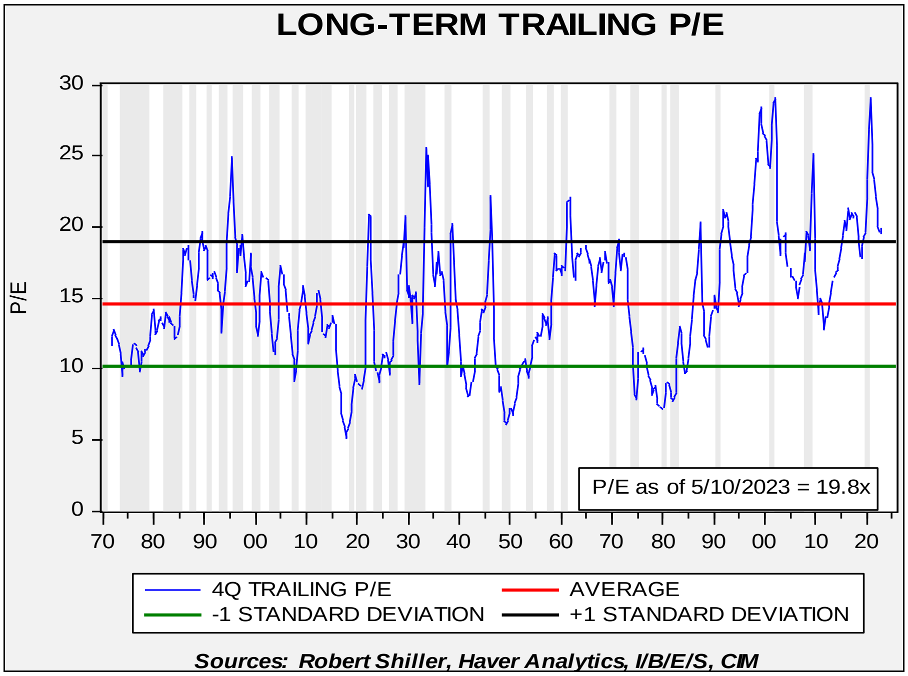


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 11, 2023



Based on our methodology,[1] the current P/E is 19.8x, down 0.2x from last week. Improved earnings led to the lower multiple.

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.