Confluence INVESTMENT MANAGEMENT

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 17, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is currently up 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.3%. Chinese markets were mixed, with the Shanghai Composite down 0.2% and the Shenzhen Composite closing up 0.3%. U.S. equity index futures are signaling a higher open.

With 460 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, 77.8% have exceeded expectations while 18.70% 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* (5/15/2023) (with associated podcast) "Opportunities and Risks in a Tripolar World"
- *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 Q2 2023 Rebalance Presentation* (5/11/2023): 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 hawkish statement by Bank of England Governor Bailey that suggests British interest rates are likely to go higher. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including a new technology-theft scandal that will probably further worsen U.S.-China relations and news that commercial office buildings are starting to be sold at fire-sale prices.

United Kingdom: Bank of England Governor Bailey warned that he is prepared to keep raising interest rates as much as necessary to fight what he called a wage-price spiral and bring consumer price inflation down to the institution's target of 2%. Despite optimism that the Federal Reserve will now pause U.S. interest rates, Bailey's comments serve as a reminder that "second-round" inflation pressures are probably in place around the world and could still require the major central banks to hike rates higher and keep them there for longer than currently anticipated.

China-United States-South Korea: Yesterday, the U.S. Department of Justice's new task force focused on protecting critical technologies from being stolen by foreign governments charged a Chinese citizen, Weibao Wang, with stealing trade secrets from Apple (AAPL, $172.07). While Wang worked for Apple in California on a project related to driverless-car technology, he simultaneously took a job at the U.S. subsidiary of a Chinese company developing driverless cars. Prior to informing Apple that he was quitting, he allegedly stole thousands of documents and other information before fleeing to China. Other recent reports show Chinese firms and spy services are ramping up their effort to steal technology secrets from South Korea and other advanced countries in the West.

- While many Western business elites continue to resist decoupling with China for fear of losing financial and economic opportunities, we think Beijing's continued program of getting Western technology "by hook or by crook" will ultimately undermine their position. China's aggressive military build-up will probably also justify decoupling.
- Indeed, Western leaders in recent months have noticeably shifted their rhetoric to emphasize protecting national security over trade and investment with China.

Taiwan: The island's largest opposition party has picked Hou Yu-ih, the popular mayor of New Taipei City, as its candidate in January's presidential election. To contrast himself with the independence-minded ruling party, the Kuomintang party's Hou opposes a formal breakaway from China but also doesn't support operating under Beijing's "One China, Two Systems" arrangement as it is applied in Hong Kong. That stance may make him more palatable than other Kuomintang politicians who want the island to be closer to China, but it remains to be seen whether it will be enough to win the election.

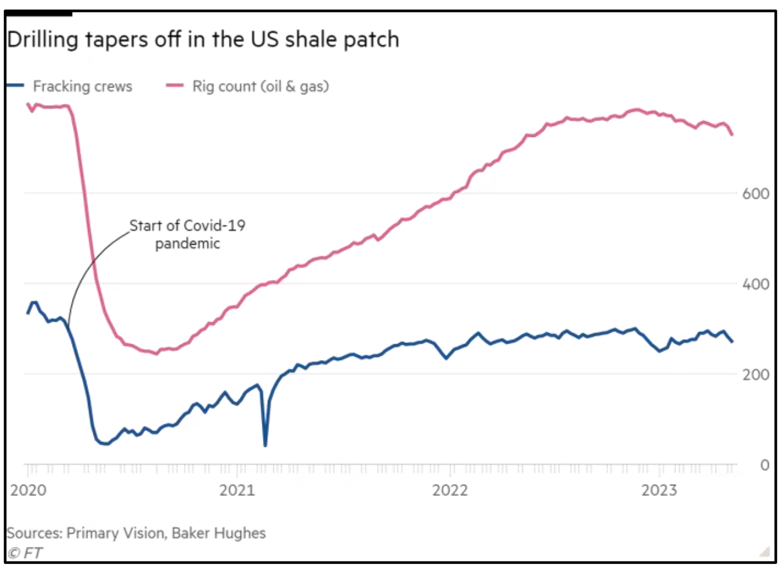
Indonesia: The chief executive of the country's sovereign wealth fund said the fund will deploy some $3 billion into Indonesian infrastructure, digital assets, and other domestic opportunities in 2023, including funds from international co-investors. The announcement is being seen as a sign of Indonesia's attractiveness as an investment destination as investors sour on China, and Indonesia positions itself as a key supplier for materials related to green technologies.

Turkey: The united opposition group that unexpectedly lost the first round of Sunday's election to President Erdoğan accused the electoral authorities of large-scale irregularities but admitted that it would have lost the first round anyway. Since Erdoğan very nearly snagged the 50% of the vote needed to win outright, he appears to be in the driver's seat to win the second and final round of voting on May 28. The likelihood that Erdoğan's unorthodox economic policies will remain in place continue to weigh on Turkish assets so far this week.

Brazil: State-owned oil giant Petrobras (PBR, $11.78) said it will end its longstanding practice of pegging the domestic price of its fuels to global prices. The move appears to clear the way for leftist President Luiz Inácio Lula da Silva to keep domestic prices artificially low for his own political purposes. If that comes to pass, it could portend expensive new subsidies to be paid from the government budget. The loss of fiscal discipline would likely be negative for Brazil's stocks, bonds, and currency.

U.S. Monetary Policy: Consistent with our earlier comments on the Bank of England's policy, Cleveland FRB President Mester yesterday warned that she hasn't seen enough evidence that U.S. inflation pressures have eased to the point where the Fed should stop hiking interest rates. However, Chicago FRB President Goolsbee and Atlanta FRB President Bostic both signaled they want to hold rates steady now to avoid over-tightening and potentially sparking a financial crisis. We continue to believe the Fed is at least close to the end of its tightening cycle, if it's not there already, but continued inflation pressures mean rates in the U.S. and in other developed countries could still go higher.

U.S. Energy Industry: Data from Baker Hughes (BKR, $27.44) confirms that U.S. oil and gas exploration has suddenly cooled since the beginning of the year. The figures show the number of oil and gas drilling rigs in operation has fallen some 6% so far in 2023 to just 731. The drop in exploration likely reflects multiple factors, including lower energy prices, investors demands that energy companies exercise capital discipline, and concerns about regulation and the green-energy transition. As we noted in our *Comment* yesterday, the fall-off in global output comes at a time of rising energy demand in China and other developing countries, which could spark a rebound in prices later in the year.



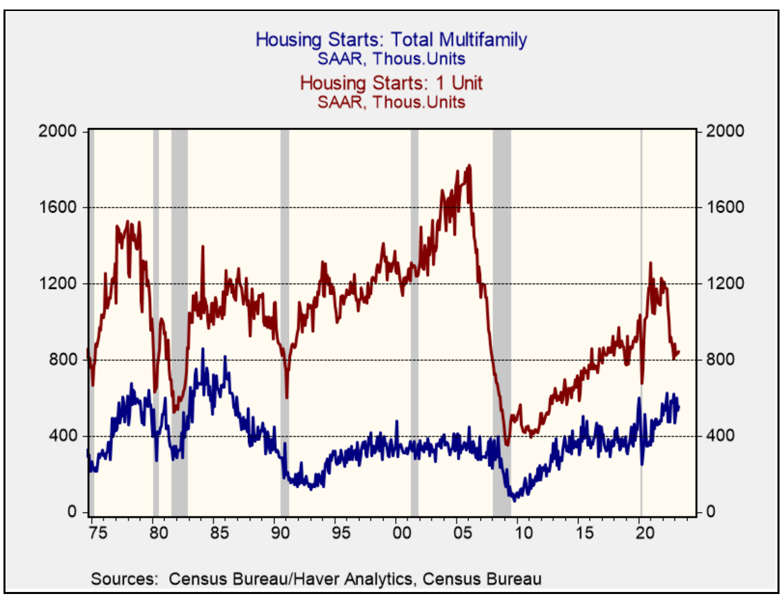
U.S. Commercial Real Estate Market: Several sizable office buildings around the country have recently been sold at fire-sale prices, suggesting the work-from-home movement and high interest rates are causing increasing stress in the commercial real estate market. Importantly, building owners now appear to have capitulated to the idea that weak prices are here to stay. Distressed sales are expected to keep increasing in the coming months.

- Of course, some firms are starting to insist that workers pare back their WFH time. For example, giant asset manager BlackRock (BLK, $633.83) yesterday told its employees that they will only be allowed to work remotely one day per week starting September 11.
- Despite such efforts, however, employee resistance and today's tight labor market will likely keep office usage much lower than before the pandemic. Any significant rebound in office occupancy, rents, and building values seems a long way off.

U.S. Economic Releases

Residential loan demand slumped last week after borrowing costs rose to a two-month high. According to an index tracked by the Mortgage Bankers Association, mortgage applications fell 5.7% in the week ending May 12. The sharp decline in requests for loans reflects growing concerns regarding home affordability. Last week, the average 30-year fixed-rate mortgage increased by 9 bps to 6.57%, its highest level since mid-March. As a result, the MBA tracker for purchases fell 4.8% from the prior week, while the refinance tracker fell 7.7% in the same period.

Despite elevated interest rates, homebuilders ramped up construction for new dwellings in April. Housing starts accelerated from an annualized rate of 1371k in March to 1401k in the following month, according to data released by the Census Bureau. Although homebuilders have increased the number of construction projects, recession concerns have slowed plans for future starts. As a result, the annual rate of building permits slipped from 1437k to 1416k in April.



The chart above shows the annualized rate of housing starts for multi- and single-family homes. Last month, multi-family homes accelerated from 538k to 555k, while single-family dwellings increased from 833k to 846k.

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**
14:30	Senate Banking Hearing on Strengthening Fed Accountability	Senate Committee on Banking, Housing, and Urban Affairs

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	GDP SA	q/q	1Q P	0.4%	0.0%	0.2%	***	Equity and bond neutral
	GDP Deflator	y/y	1Q P	2.0%	1.2%	2.1%	***	Equity and bond neutral
	Industrial Production YoY	y/y	Mar F	-0.6%	-0.7%		***	Equity and bond neutral
	Capacity Utilization MoM	m/m	Mar	0..8%	3.9%		**	Equity bearish, bond bullish
Australia	Wage Price Index	y/y	Q1	3.7%	3.3%	3.4%	**	Equity and bond neutral
EUROPE								
Eurozone	CPI	y/y	Apr F	7.0%	6.9%	7.0%	***	Equity and bond neutral
	Core CPI	y/y	Apr F	5.6%	5.6%	5.6%	**	Equity and bond neutral
AMERICAS								
Canada	Manufacturing Sales	m/m	Mar	0.7%	-3.6%	0.7%	**	Equity and bond neutral
	CPI	y/y	Apr	4.4%	4.3%	4.1%	**	Equity and bond neutral
Mexico	International Reserves Weekly	w/w	12-May	$203451m	$203510m		*	Equity and bond neutral
Brazil	FGV Inflation IGP-10	m/m	May	-1.53%	-0.58%	-1.25%	*	Equity and bond neutral
	Retail Sales	y/y	Mar	3..2%	1.0%	1.1%	***	Equity bearish, bond bullish

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	532	1	Up
3-mo T-bill yield (bps)	505	503	2	Up
TED spread (bps)	29	29	0	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 (%)	3.52	3.54	-0.02	Flat
Euribor/OIS spread (bps)	338	336	2	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Down			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.

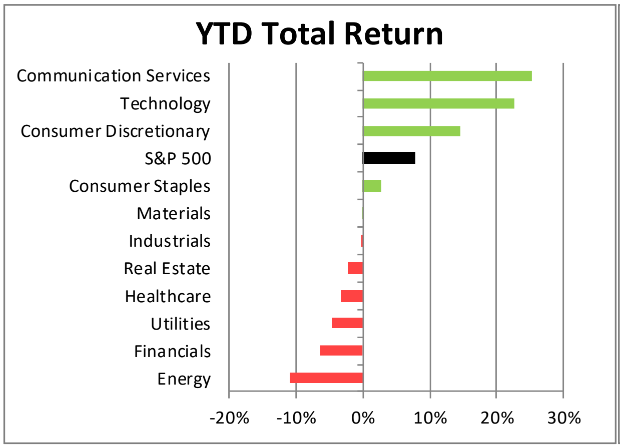
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$75.12	$74.91	0.28%	
WTI	$71.06	$70.86	0.28%	
Natural Gas	$2.42	$2.38	1.89%	
Crack Spread	$31.98	$31.80	0.58%	
12-mo strip crack	$25.23	$25.22	0.06%	
Ethanol rack	$2.57	$2.57	-0.06%	
Metals				
Gold	$1,987.57	$1,989.17	-0.08%	
Silver	$23.69	$23.75	-0.27%	
Copper contract	$371.70	$366.70	1.36%	
Grains				
Corn contract	$570.75	$581.25	-1.81%	
Wheat contract	$641.50	$647.50	-0.93%	
Soybeans contract	$1,354.25	$1,364.00	-0.71%	
Shipping				
Baltic Dry Freight	1,476	1,522	-46	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.0		
Gasoline (mb)		-2.0		
Distillates (mb)		-1.5		
Refinery run rates (%)		0.60%		
Natural gas (bcf)		109		

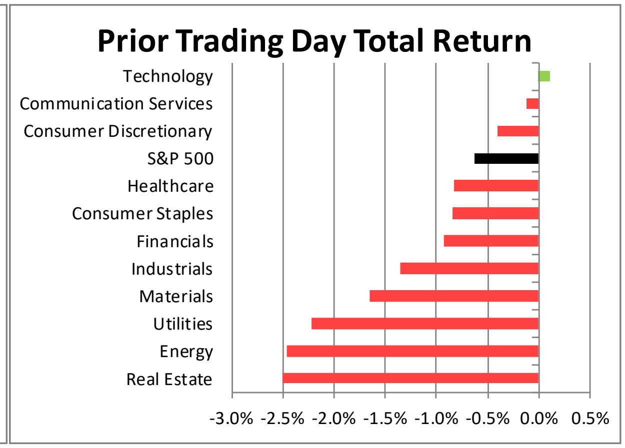
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for most of the country, with mostly below and near normal temperatures throughout the South. Additionally, the precipitation outlook is calling for wetter-than-normal conditions for most of the country, with dry conditions expected in New England and the Midwest.

Data Section

U.S. Equity Markets – (as of 5/16/2023 close)

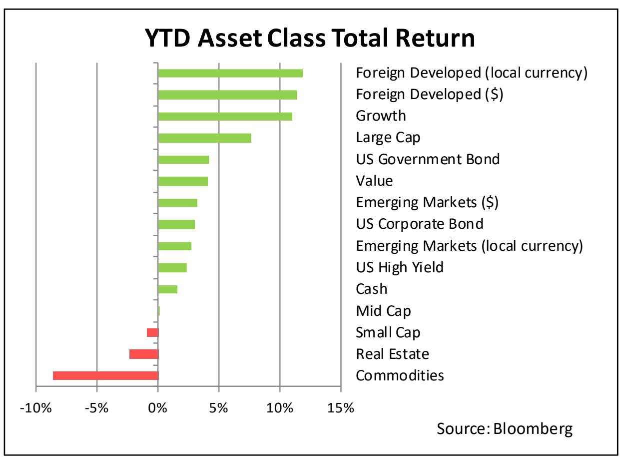




(Source: Bloomberg)

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 5/16/2023 close)

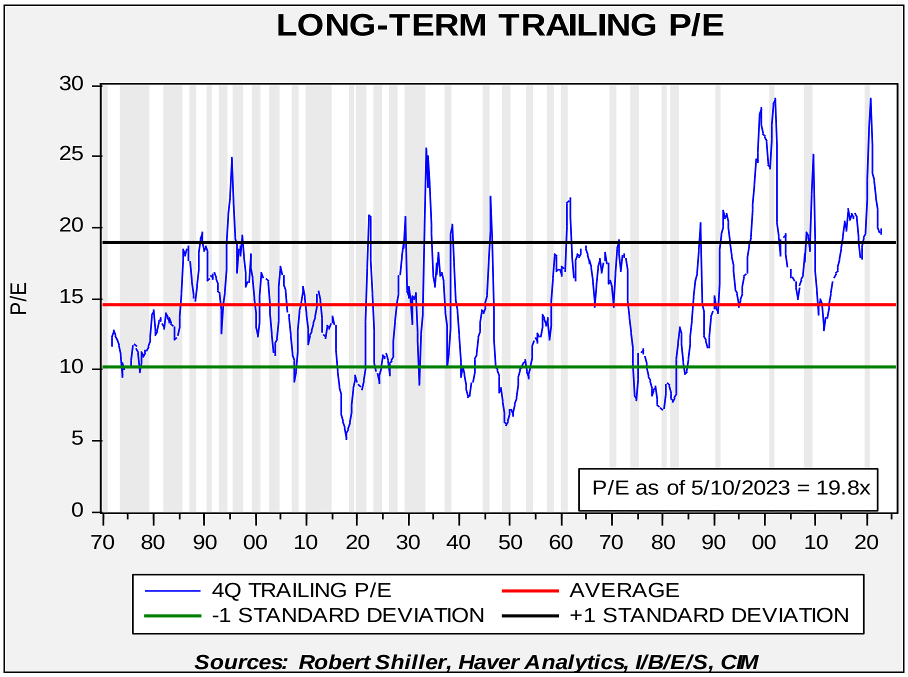


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.