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 22, 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 up 0.9%. Chinese markets were higher, with both the Shanghai and the Shenzhen Composites closing up 0.4%. U.S. equity index futures are signaling a lower open.

With 473 companies having reported so far, S&P 500 earnings for Q1 are running at $53.30 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 18.4% 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* (5/18/2023): Gasoline stockpiles are low going into the summer, raising the odds of stronger refinery runs and higher prices. Global oil supplies are currently ample due to continued Russian output, although the IEA is projecting much tighter markets in the second half of the year.
- *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* (5/22/2023) (with associated podcast): "The Case for New Home Sales"**
- *Confluence of Ideas* podcast (3/8/2023): "Reflections on Inflation"

Our *Comment* today opens with a short recap of the Group of Seven (G7) summit in Japan, which finished over the weekend. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including more Chinese retaliation against the U.S.'s clampdown on advanced technology flows and the latest on the negotiations over the U.S. federal debt limit.

G7 Summit: Wrapping up their annual summit over the weekend, the G7 countries (the U.S., Japan, Germany, France, the U.K., Italy, and Canada) said they will work to insulate themselves from Chinese economic coercion and block the transfer of sensitive technology to China. The statement reflects a growing realization of the way Beijing weaponizes other countries' dependency on trade or capital flows with China, as we have described extensively in our various publications.

- Despite the tough communiques, however, President Biden said in a post-summit news conference that he wants more open lines of communication with China.
- Biden also predicted that U.S.-China relations would soon thaw, suggesting that there has been some sort of quiet diplomacy going on between the countries.

China-United States: Although President Biden hinted at the G7 summit about an imminent thaw in U.S.-China relations, the Cyberspace Administration of China said yesterday that products made by U.S. memory chip maker Micron Technology (MU, $68.17) failed its network security review and that it would bar Chinese operators of key infrastructure from buying Micron's chips. The Chinese officials provided no details, and they didn't say exactly which of the firm's products would be affected. In any case, Seoul said it didn't plan to stop South Korea's big memory chip makers from filling the gap left by Micron, in spite of U.S. entreaties.

- The Chinese move against Micron is widely believed to be retaliation for the U.S.'s draconian restrictions on the sale of advanced semiconductors and related goods and services, which were announced last October.
- Other suspected retaliatory measures include China's recent clampdown on foreign consulting firms operating in China and the arrests of foreign business executives in the country.
- China's belated retaliation for the U.S. technology clampdown illustrates the U.S.-China decoupling that is gathering force, at least in the realm of technology. As the U.S. begins to focus more on China's increasing military threat, such decoupling is likely to expand, creating significant risks for U.S. investors.

European Union-United States: Regulators in the EU imposed a record fine of $1.3 billion on Facebook parent Meta Platforms, Inc. (META, $245.64) for storing European user data in the U.S. in violation of the bloc's privacy rules. At issue is the regulators' belief that European user data stored in the U.S. could be accessed by U.S. spy agencies with insufficient protections. Meta said it would appeal the ruling, and the regulators said they would allow such data transfers if the EU and U.S. reach an accord on the protection of personal data.

United Kingdom: Prime Minister Sunak is facing another headache after news was reported over the weekend that last summer Home Secretary Suella Braverman tried to use her then-position as attorney general to avoid standard penalties for a speeding ticket. Sunak today will consult his independent adviser on ministerial ethics after being urged to investigate the matter. The scandal comes as Sunak continues to battle high inflation, public-sector strikes, a controversial immigration proposal, and his Conservative Party's poor results in recent local elections.

Greece: In elections yesterday, the conservative New Democracy party of Prime Minister Mitsotakis won the most votes but not enough for a majority in parliament. Since Mitsotakis then derided the possibility of negotiating a coalition deal to form a government, it appears Greece will face a new election sometime in the coming weeks.

- Given the way that parliamentary seats would be allocated in a second vote, Mitsotakis and New Democracy stand a better chance of winning a majority in parliament in that election.
- In anticipation that the business-friendly conservatives will win a new mandate, Greek assets are trading higher so far this morning.

India: The Reserve Bank of India announced that it will take all of its largest denomination bills out of circulation by the end of September. The move, which is reminiscent of a 2016 currency reform that eliminated smaller bills overnight, has sparked fear among consumers even though the central bank offered assurances that the bills would remain legal tender until September. In fact, the large bills that are now subject to elimination were introduced amid the chaos touched off by the 2016 reform, which in turn was ostensibly aimed at undermining illicit activity. The move appears to be weighing very slightly on the value of the rupee (INR) in foreign exchange trading so far today.

U.S. Fiscal Policy: President Biden and House Speaker McCarthy have agreed to meet on Monday afternoon to try to overcome their impasse over raising the federal debt limit. However, Treasury Secretary Yellen reiterated her view that the government would be unable to pay its bills by June 1 if there is no deal to raise the limit, saying the date is a "firm deadline." That underscores the risk that the government could default on its debt and leave many of its bills unpaid, potentially sparking economic havoc and calling into question the U.S.'s role as the foundation of the global financial system.

- All the same, we still suspect that the administration and Congress will reach a deal at the last moment and avert such an outcome.
- One key reason for optimism is that both Biden and McCarthy have already made some concessions to each other—a fact that's easy to miss amid the political rhetoric.
    - Press reports say Biden, for example, has expressed his willingness to claw back unused pandemic relief funding, tighten work requirements for some social safety-net programs, reform permitting for energy infrastructure, and freeze spending in this year's budget.
    - Meanwhile, McCarthy and his team haven't pushed their earlier calls to undo provisions of last year's Inflation Reduction Act and student debt relief. They also insist on increasing the budget for the armed forces, veterans, and border security.

U.S. Monetary Policy: In a Friday interview with the *Wall Street Journal*, Minneapolis FRB President Kashkari said he would be open to holding the Fed's benchmark fed funds interest rate steady in June to give officials more time to assess the effects of past rate increases and the inflation outlook. Considering that other Fed officials have recently indicated they're leaning toward at least one more rate hike in June, the statement by Kashkari illustrates how the June decision is basically too close to call at this time.

U.S. Oil Market: In a new effort to refill the nation's Strategic Petroleum Reserve after massive sales from it last year because of the Russia-Ukraine war, the Energy Department has revamped how it will accept bids from oil companies. In contrast with its tender for fixed-price bids earlier this year, which failed because of the price risk it imposed on oil producers during the two weeks needed to evaluate the bids, the department will now request bids based on a less volatile measure of price spreads.

- If completed, the tender will result in the government purchasing about 3 million barrels of domestically produced sour crude, with more to be purchased later.
- Amid weakening demand and softer crude pricing as the economy slides toward recession, the purchases could provide some support for crude values.

U.S. Labor Market: In its annual report on foreign-born workers, the Labor Department said immigrants made up 18.1% of the labor force in 2022, the highest level ever in records dating back to 1996. Of the 164 million in the U.S. labor force (people working or looking for work), 29.8 million were born abroad, for an increase of 1.8 million from the previous year. That means immigrants accounted for more than half the increase in the labor force last year.

- The analysis suggests the increased weight of foreign-born workers in the work force reflects both the pull of strong labor demand by companies and the high level of retirements and other withdrawals from work by native-born workers.
- Amid strong labor demand and company complaints about worker shortages, the influx of foreign-born workers probably helped hold down average wage rates, potentially helping to limit inflation pressures. Nevertheless, many will likely see the rise in immigrant labor as competition for native-born workers, so the report could feed into the current backlash against immigration.

U.S. Economic Releases

There were no domestic releases scheduled prior to the publication of this report. 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**
11:05	Raphael Bostic and Thomas Barkin Discuss Technology-Enabled Disruption	Presidents of Federal Reserve Banks of Atlanta and Richmond
11:05	Mary Daly Speaks at NABE/Bank of France Economic Symposium	President of the Federal Reserve Bank of San Francisco

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	Core Machine orders	y/y	Mar	-3.5%	9.8%	1.3%	**	Equity bearish, bond bullish
EUROPE								
Eurozone	Construction Output	y/y	Mar	-1.5%	2.3%	2.1%	*	Equity and bond neutral
UK	Rightmove House Prices	m/m	May	1.5%	1.7%		**	Equity and bond neutral
Switzerland	M3 Money Supply	y/y	Apr	-0.3%	-0.8%	-0.6%	**	Equity and bond neutral
	Domestic Sight Deposits CHF	w/w	19-May	504.5b	507.1b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	19-May	515.7b	520.1b		*	Equity and bond neutral
AMERICAS								
Canada	Retail Sales	m/m	Mar	-1.4%	-0.2%	-1.4%	**	Equity and bond neutral
	Retail Sales Ex-Autos	m/m	Mar	-0.3%	-0.7%	-0.8%	**	Equity and bond neutral
Mexico	Retail Sales	y/y	Mar	2.5%	3.4%	2.9%	***	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)	539	538	1	Up
3-mo T-bill yield (bps)	509	511	-2	Up
TED spread (bps)	30	27	3	Widening
U.S. Sibor/OIS spread (bps)	515	514	1	Up
U.S. Libor/OIS spread (bps)	515	515	0	Up
10-yr T-note (%)	3.67	3.68	-0.01	Flat
Euribor/OIS spread (bps)	342	338	4	Up
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Flat			Up
Yen	Down			Down
Pound	Flat			Up
Franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
PBOC 1-Year Loan Prime Rate	3.650%	3.650%	3.650%	On Forecast
PBOC 5-Year Loan Prime Rate	3.650%	4.300%	4.300%	Below 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.

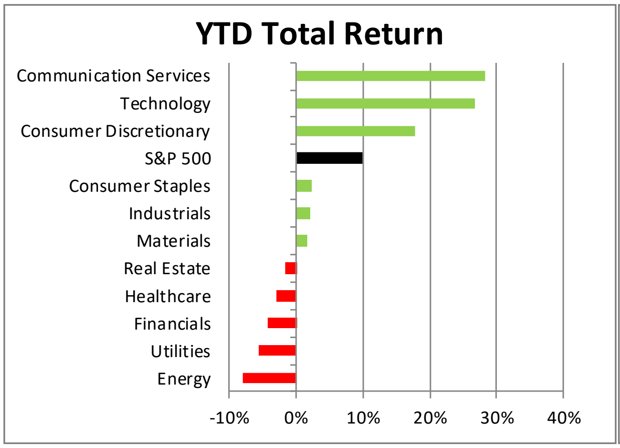
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$75.73	$75.58	0.20%	
WTI	$71.62	$71.55	0.10%	
Natural Gas	$2.53	$2.59	-2.24%	Supply Optimism
Crack Spread	$33.60	$33.70	-0.31%	
12-mo strip crack	$25.41	$25.39	0.10%	
Ethanol rack	$2.54	$2.55	-0.16%	
Metals				
Gold	$1,972.65	$1,977.81	-0.26%	
Silver	$23.75	$23.85	-0.42%	
Copper contract	$368.75	$373.20	-1.19%	
Grains				
Corn contract	$557.25	$554.50	0.50%	
Wheat contract	$598.75	$605.00	-1.03%	
Soybeans contract	$1,316.00	$1,307.25	0.67%	
Shipping				
Baltic Dry Freight	1,384	1,402	-18	

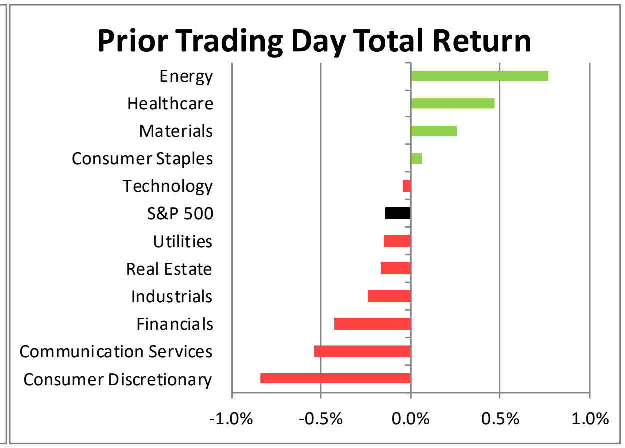
Weather

The 6-10 and 8-14 day forecasts currently call for mostly warmer-than-normal temperatures throughout the entire country, with below-normal-temperatures only in the Southwest. The forecasts call for wetter-than-normal conditions to move from the Mississippi Valley toward the Southeast and into parts of the Midwest.

Data Section

U.S. Equity Markets – (as of 5/19/2023 close)

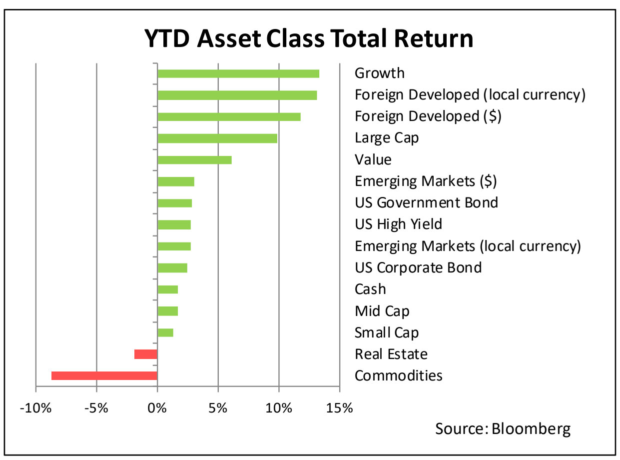




(Source: Bloomberg)

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 5/19/2023 close)

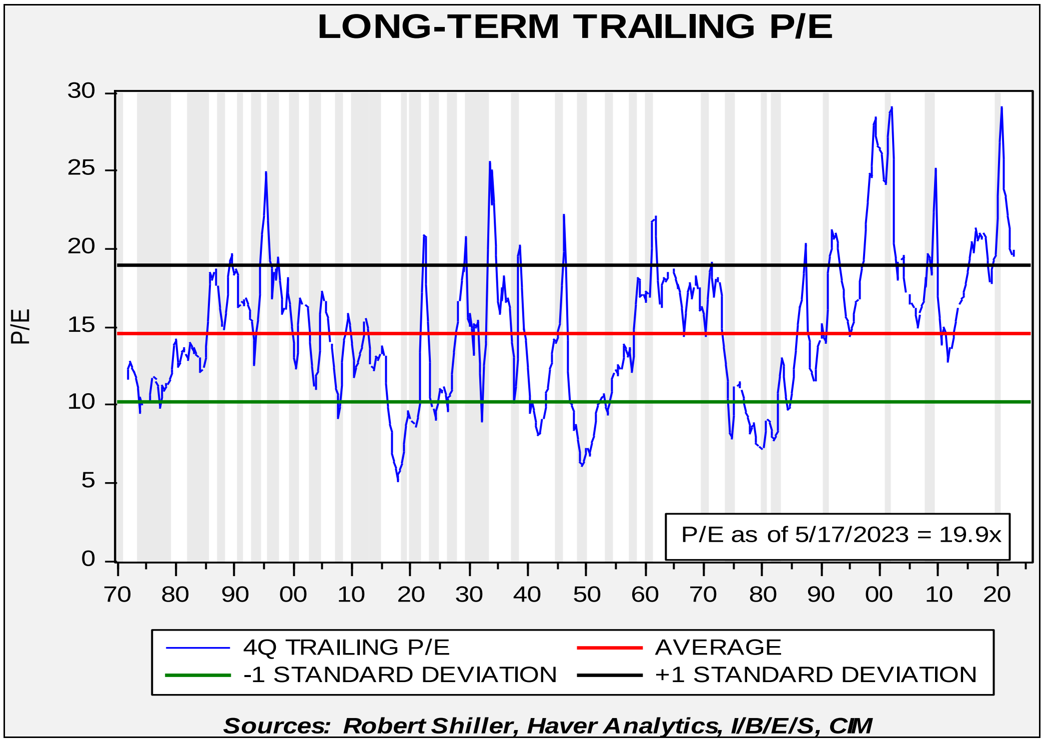


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 18, 2023



Based on our methodology,[1] the current P/E is 19.9x, up 0.1x from last week. Weaker 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.