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 23, 2023—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is currently down 0.6% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.7%. Chinese markets were lower, with the Shanghai Composite closing down 1.5% from its previous close and the Shenzhen Composite closing down 1.0%. U.S. equity index futures are signaling a lower open.

With 474 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, 78.1% have exceeded expectations while 18.6% 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:

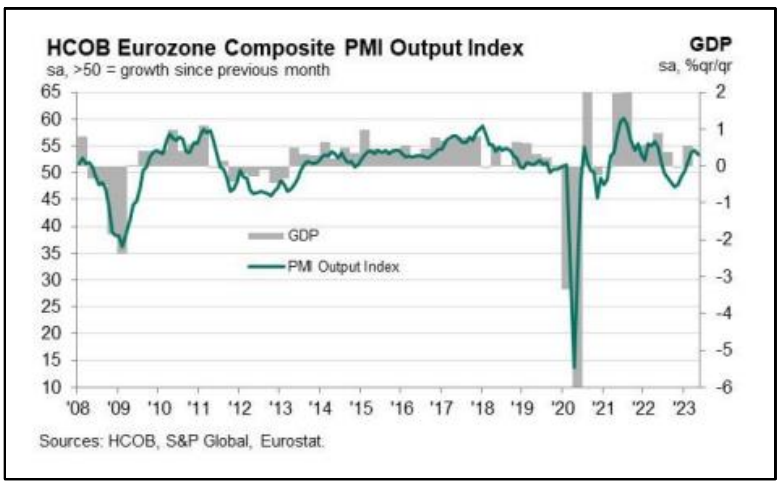
- *Bi-Weekly Geopolitical Report* (5/15/2023) (with associated podcast) "Opportunities and Risks in a Tripolar World"
- *Weekly Energy Update* (5/18/2023): Gasoline stockpiles are low going into the summer, raising the odds of stronger refinery runs and higher prices. Global oil supplies are currently 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 some key data showing how reduced demand for goods is slowing the global economy, even as post-pandemic demand for services continues to grow. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including more signs of tension and decoupling between the West and China.

Global Economy: Maritime research consultant Drewry has released data showing the world's production of shipping containers has slumped dramatically in response to the falling demand for goods now that countries have eased their pandemic restrictions. With consumers shifting their spending back to services instead of goods, shipping activity has declined, leaving a glut of containers around the globe. Transportation dynamics often reflect the strength of economic activity, so the drop in container production helps confirm that the global economy is slowing.

Eurozone: S&P Global said its May "flash" purchasing managers' index for manufacturing fell to a 36-month low of 44.6, compared with 45.8 in April. Like all major PMIs, this one is designed so that readings below 50.0 point to declining activity.

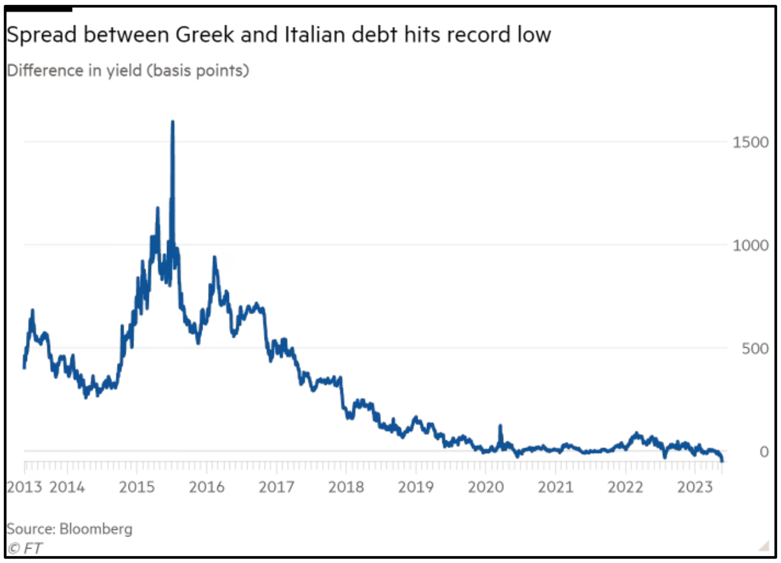
- The recent readings, therefore, indicate that the Eurozone's factory output remains in a deep slump.
- On a more positive note, however, the May flash PMI for the service sector merely pulled back to 55.9 from 56.2 in the previous month. That illustrates how service activity in the bloc continues to grow smartly.
- The increased activity in the service sector is keeping the overall Eurozone economy growing despite the post-pandemic pullback in manufacturing. Illustrating that, the May flash composite PMI stood at 53.3, down only modestly from 54.1 in April.



United Kingdom: The International Monetary Fund reported in an updated forecast that it no longer expects British economic activity to slip into recession this year. The institution now expects gross domestic product to expand 0.4% in 2023 and 1.0% in 2024, reflecting stronger wage growth, more supportive fiscal policy, and an easing of global energy prices and supply chain blockages. All the same, the IMF forecasters warned that consumer price inflation is likely to be elevated for some time to come.

Greece: As we flagged in our *Comment* yesterday, conservative Prime Minister Mitsotakis called new parliamentary elections for June 25, rather than trying to form a coalition government after winning a plurality, but not a majority, in Sunday's elections. Because of how the seats in parliament will be allocated in the second election, Mitsotakis and his New Democracy Party will have a good shot at forming a government by themselves.

- Coupled with the economy's rebounding tourism and transportation activity, Mitsotakis' business-friendly policies have given a boost to Greek assets.
- Greek sovereign bonds rallied further yesterday on the election news, driving their yield to a record low against comparable Italian bonds.



Bulgaria: After having five elections since 2021 that have ended inconclusively or resulted in short-lived governments, the country's two main political parties have agreed to a power-sharing deal aimed at finally producing an effective government. Under the deal, the two rival parties will form a coalition government with rotating prime ministers. The agreement could help the country finally make progress on important issues like cutting inflation, clamping down on corruption, reducing economic dependency on Russia, and joining the Eurozone.

Japan-China: Semiconductor manufacturers in China say they are worried that Japan's new rules on selling advanced semiconductor-manufacturing equipment to the country could be tougher than the U.S. and Dutch restrictions. If so, the executives said the restrictions could crimp China's output of basic, relatively unsophisticated chips like those used in automobiles or kitchen appliances. As we've warned many times before, investors remain at risk as the West and China try to decouple from each other economically and technologically.

United Kingdom-China: In a member survey last month, the British Chamber of Commerce in China said only 8% of its members were pessimistic about their prospects in the country, down from 42% at the beginning of China's post-pandemic opening last December. However, fully 70% of the members said they were still taking a wait-and-see approach to new investments in the country because of continued regulatory uncertainty. The survey shows how President Xi's drive to bring the economy under stricter state control and clamp down on security risks is also playing into the decoupling phenomenon.

United States-China: Several Chinese residents and a real estate firm filed a federal lawsuit to block a new Florida law restricting the sale of real estate to citizens of China, Russia, Iran, and other "countries of concern." The suit seeks to invalidate the law on grounds that it violates the Constitution's equal protection clause and intrudes on the federal government's right to manage national security, international affairs, and international commerce.

- The new Florida legislation was championed and recently signed into law by Governor Ron DeSantis, a prospective Republican presidential candidate.
- We think passage of the law illustrates how both Republicans and Democrats will likely compete to look toughest on China in the run-up to next year's elections. If so, there could be a spiral of aggressive measures and proposals against China, which would likely make U.S.-China tensions even worse than they are at present.

U.S. Fiscal Policy: In their latest face-to-face negotiation over raising the federal debt limit yesterday, President Biden and House Speaker McCarthy failed to reach an agreement, but McCarthy indicated the discussion was productive and that he expects to keep talking with Biden daily until they reach a deal. The key sticking points now appear to be how much to raise the debt ceiling and at what level to cap federal spending in the upcoming fiscal year. We continue to believe a deal will be reached and passed into law before the government loses its ability to pay its bills, but brinksmanship over the next couple of weeks could lead to heightened volatility in the financial markets.

U.S. Consumer Sentiment: In the Federal Reserve's annual survey of financial well-being, conducted last October, some 73% of U.S. adults said they were doing OK or living comfortably, down from 78% in 2021. Importantly, a record 35% of the respondents said they were worse off financially than one year before, with more than half citing price inflation as a major challenge. The survey underscores how the pain of rising prices was more than enough to offset the impact of low unemployment and rising wages last year. It also reveals a likely reason why polls show that President Biden's job approval ratings are so low despite high levels of employment.

U.S. Economic Releases

Services activity in the region overseen by the Federal Reserve Bank of Philadelphia improved slightly in May but remains sluggish. The central bank's nonmanufacturing activity index increased from -22.8 to -16.0. A jump in new orders and a rise in sales lifted the indicator. That said, firm business activity continues to drag on the index. The FRB Philadelphia nonmanufacturing index may not be a heavily cited metric for tracking recessions, but it reinforces market expectations that economic activity in the country is slowing.

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
9:45	S&P Manufacturing PMI	m/m	May P	50.0	50.2	***
9:45	S&P Services PMI	m/m	May P	52.5	53.6	**
9:45	S&P Composite PMI	m/m	May p	53.0	53.4	**
10:00	New Home Sales - Annualized Selling Rate	m/m	Apr	665k	683k	***
10:00	New Home Sales - Monthly Change	m/m	Apr	-2.6%	9.6%	**
10:00	Richmond Fed Manufact. Index	m/m	May		-27.0	**
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								
Japan	Jibun bank Composite PMI	m/m	May P	54.9	52.9		*	Equity bullish, bond bearish
	Jibun Bank Manufacturing PMI	m/m	May P	50.8	49.5		***	Equity bullish, bond bearish
	Jibun Bank Services PMI	m/m	May P	56.3	55.4		**	Equity bullish, bond bearish
	Nationwide Dept Sales	y/y	Apr	8.6%	9.8%		*	Equity bearish, bond bullish
EUROPE								
Eurozone	HCOB Manufacturing PMI	m/m	May P	44.6	45.8	46.0	***	Equity bearish, bond bullish
	HCOB Composite PMI	m/m	May P	53.3	54.1	53.5	*	Equity and bond neutral
	HCOB Services PMI	m/m	May P	55.9	56.2	55.5	**	Equity and bond neutral
	Consumer Confidence	m/m	Mar	-17.4	-17.5	-16.8	**	Equity bearish, bond bullish
Germany	HCOB Manufacturing PMI	m/m	May P	42.9	44.5	45.0	***	Equity bearish, bond bullish
	HCOB Services PMI	m/m	May P	57.8	56.0	55.0	**	Equity bullish, bond bearish
	HCOB Composite PMI	m/m	May P	54.3	54.2	53.2	*	Equity bullish, bond bearish
France	HCOB Composite PMI	m/m	May P	51.4	52.4	52.0	*	Equity bearish, bond bullish
	HCOB Manufacturing PMI	m/m	May P	46.1	45.6	46.0	***	Equity and bond neutral
	HCOB Services PMI	m/m	May P	52.8	54.6	54.0	**	Equity bearish, bond bullish
UK	Public Sector Net Borowing	m/m	Apr	24.7b	20.7b	20.0b	*	Equity and bond neutral
	PSNB ex Banking Groups	m/m	Apr	25.6b	21.5b	20.8b	**	Equity and bond neutral
	S&P/CIPS Manufacturing PMI	m/m	May P	46.9	47.8	48.0	***	Equity and bond neutral
	S&P/CIPS Services PMI	m/m	May P	55.1	55.9	55.5	**	Equity and bond neutral
	S&P/CIPS Composite PMI	m/m	May P	53.9	54.9	54.6	**	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)	539	538	1	Up
3-mo T-bill yield (bps)	512	513	-1	Up
TED spread (bps)	27	25	2	Widening
U.S. Sibor/OIS spread (bps)	517	517	0	Up
U.S. Libor/OIS spread (bps)	518	517	1	Up
10-yr T-note (%)	3.74	3.72	0.02	Flat
Euribor/OIS spread (bps)	341	342	-1	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.

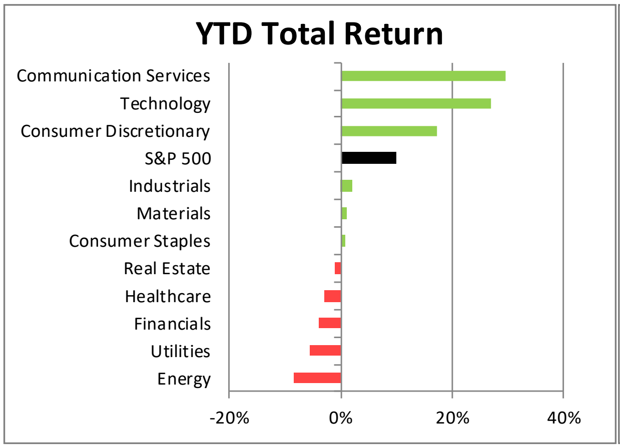
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$76.87	$75.99	1.16%	
WTI	$72.93	$72.05	1.22%	
Natural Gas	$2.38	$2.40	-0.67%	
Crack Spread	$32.48	$36.00	-9.79%	Economic Pessimism
12-mo strip crack	$25.24	$26.00	-2.92%	Economic Pessimism
Ethanol rack	$2.57	$2.55	0.59%	
Metals				
Gold	$1,961.87	$1,971.86	-0.51%	
Silver	$23.20	$23.63	-1.82%	
Copper contract	$362.85	$368.50	-1.53%	
Grains				
Corn contract	$576.25	$571.00	0.92%	
Wheat contract	$611.00	$606.25	0.78%	
Soybeans contract	$1,340.25	$1,341.25	-0.07%	
Shipping				
Baltic Dry Freight	1,365	1,384	-19	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.5		
Gasoline (mb)		-1.7		
Distillates (mb)		0.3		
Refinery run rates (%)		0.55%		
Natural gas (bcf)		101		

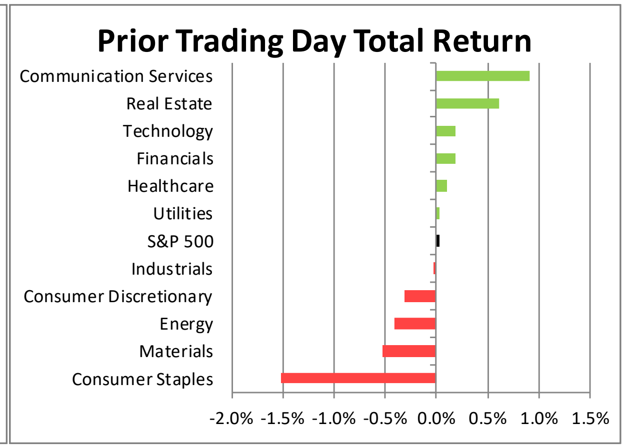
Weather

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 for most of the country, with dry conditions expected in the Great Lakes and New England regions.

Data Section

U.S. Equity Markets – (as of 5/22/2023 close)

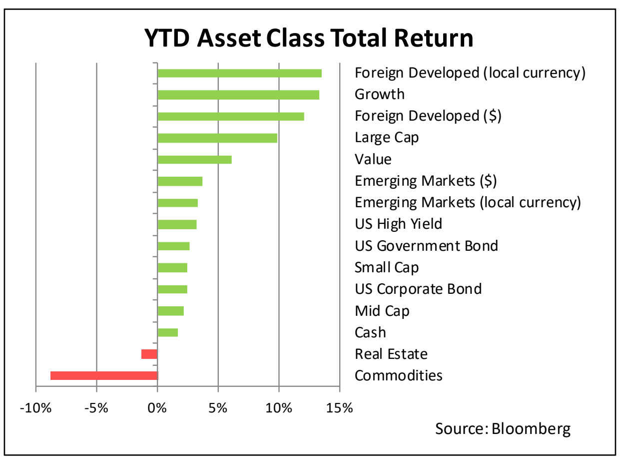




(Source: Bloomberg)

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 5/22/2023 close)

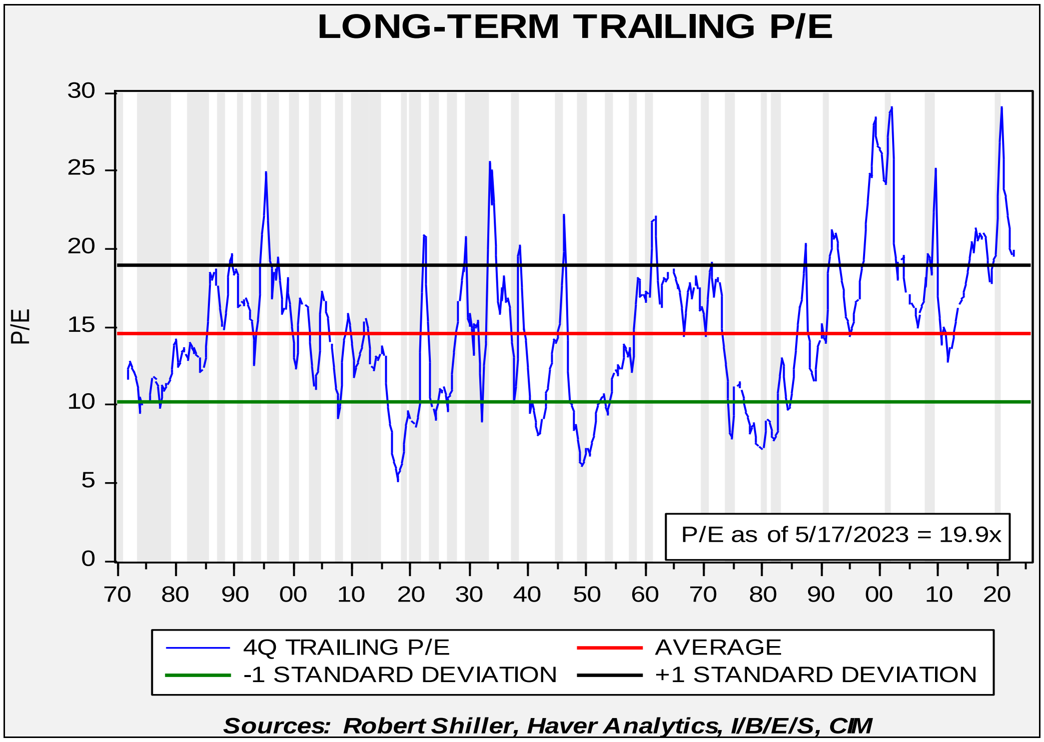


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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[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.