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 24, 2023—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is currently down 1.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.1%. Chinese markets were lower, with the Shanghai Composite closing down 1.3% from its previous close and the Shenzhen Composite closing down 0.5%. U.S. equity index futures are signaling a lower open.

With 478 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 few new developments in Russia's invasion of Ukraine. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including new evidence of the threat from China's hypersonic missiles and economic retaliation against other Western countries, plus a few items of note on the U.S. financial markets.

Russia-Ukraine War: Two right-wing Russian militias that support Ukraine reportedly attacked and occupied at least one Russian village less than a mile from the Ukrainian border earlier this week. The groups were then surrounded and destroyed by Russian forces yesterday. Ukrainian officials acknowledged they were aware of the incursion but denied any involvement in it beyond "cooperating" with the groups. All the same, reports yesterday said the groups had used U.S.-made military vehicles in the raid, including at least two M1224 MaxxPro armored vehicles and several Humvees. The State Department responded to the allegation by reiterating that the U.S. doesn't "enable or encourage" Ukrainian attacks on Russia itself. The attack could marginally help the Ukrainians by diverting Russian military resources to the border area and undermining the Russians' sense of security within their own country. Nevertheless, we believe the use of U.S. equipment in the incident raises the risk of U.S.-Russian conflict.

- Separately, in an effort to bolster the U.S.'s commitment to aiding Ukraine, former British Prime Minister Boris Johnson gave a pro-Ukrainian speech on Monday to a group of prominent conservative politicians, donors, and business executives in Dallas. In his speech, Johnson said, "I just urge you all to stick with it . . . . It will pay off massively in the long run."
- In another effort to address pushback against the U.S.'s support for Ukraine, a new media commentary directly addresses the controversy as to whether the U.S.'s aid to Kyiv is undermining its ability to deter China from seizing Taiwan.
    - The article notes that most of the U.S. military equipment sent to Ukraine so far was designed for a major ground war, leaving most of the naval and air assets needed to deter China in the Indo-Pacific region untouched.
    - The article argues that even if aid to Ukraine has depleted some of the U.S. arsenal, it may actually increase the country's deterrence against China by signaling the U.S.'s resolve to protect fellow democracies from territorial aggression.

China-United States: Speaking of a potential U.S.-China conflict, a Chinese technology magazine this month published details of a People's Liberation Army war game in which just 24 hypersonic missiles were able to destroy a U.S. aircraft carrier and its strike group. Using a complex three-way attack strategy, the missiles were reportedly able to sink the entire U.S. force in each of the 20 iterations of the game. Of course, the report can't be independently verified, and it may not be indicative of China's true hypersonic capabilities. Nevertheless, it does underscore China's head start in hypersonic technology even as the U.S. continues to struggle with its program and with its decision whether to emphasize the hypersonic technology itself or just anti-hypersonic missile defense.

- Separately, the *USS George Washington*, one of the U.S. Navy's 11 aircraft carriers, embarked on Monday for sea trials following a full six years out of service due to major maintenance.

- The vessel's maintenance period was expected to be four years, but it was disrupted due to issues such as the COVID-19 pandemic, cannibalization of some systems for spare parts to be used on other carriers, a shortfall in maintenance funds, and its unexpectedly bad condition when it entered the maintenance period.
- Once the ship is back in service, it could help relieve the shortage in carrier availability as geopolitical threats continue to worsen. The table below shows the current status of all U.S. aircraft carriers. (Note that none are anywhere close to the Persian Gulf and its critical oil supply lanes.)

U.S. Hegemonic Power Projection Tracker
Confluence Investment Management
2023-05-23
Sources: www.marinevesseltraffic.com, www.seaforces.org, www.gonavy.jp

Asset	Home Port / Base	Current Status	Approximate Location
USS Dwight D. Eisenhower (CVN 69)	Norfolk, VA	Moored	Norfolk, VA
USS Carl Vinson (CVN 70)	San Diego, CA	Moored	San Diego, CA
USS George H. W. Bush (CVN 77)	Norfolk, VA	Moored	Norfolk, VA
USS Nimitz (CVN 68)	Kitsap-Bremerton, WA	Deployed - At Sea	Philippine Sea
USS Theodore Roosevelt (CVN 71)	San Diego, CA	Deployed - At Sea	Southern California Operating Areas
USS Gerald R. Ford (CVN 78)	Norfolk, VA	Deployed - At Sea	North Atlantic - Off Coast of Norway
USS Ronald Reagan (CVN 76)	Yokosuka, Japan	Maintenance / Selected Restricted Availability	Yokosuka, Japan
USS Abraham Lincoln (CVN 72)	San Diego, CA	Maintenance / Selected Restricted Availability	San Diego, CA
USS Harry S. Truman (CVN 75)	Norfolk, VA	Maintenance / Selected Restricted Availability	Norfolk/Portsmouth Shipyard
USS John C. Stennis (CVN 74)	Norfolk, VA	Refueling and Complex Overhaul (RCOH)	Newport News Shipyard
USS George Washington (CVN 74)	Norfolk, VA	Post-RCOH Sea Trials	Atlantic Ocean Operating Area

Germany: The latest trade statistics show German exports to China in January through April were down a whopping 11.3% from the same period one year earlier. The drop reflects German automakers' reduced market share in China, high costs for German chemical producers and other energy-intensive manufacturers, and the euro's recent appreciation versus the dollar.

- However, the drop in Chinese demand could also reflect explicit or implicit retaliation for the European Union's recent hawkishness against China.
- If so, it would provide more evidence that the world is indeed fracturing into relatively separate geopolitical and economic blocs, as we have been arguing.

United Kingdom: In a speech today, Chancellor of the Exchequer Jeremy Hunt warned that persistently high inflation will prevent the government from cutting taxes anytime soon, based on concerns that tax cuts would provide extra stimulus to the economy and boost prices further. The chancellor offered assurances that he wanted to cut the U.K.'s tax burden—currently the highest since World War II—but he first had to create economic conditions where it was safe to do so.

- Hunt's speech came on the same day that the U.K. statistics agency issued its latest report on consumer price inflation. The April consumer price index was up 8.7% from the same month one year earlier, suggesting inflation cooled significantly from the 10.1% increase in the year to March. However, the April CPI still overshot expectations, which had been that inflation would cool to 8.4%.

- The chancellor's speech reflects how inflation is discouraging tax cuts in many developed countries; at the same time, politicians are loathe to use tax hikes to cool demand and bring down inflation.

Pakistan: The country's anti-terrorism court yesterday granted Former Prime Minister Khan bail on his corruption and terrorism charges, marking another step in the seesaw legal battle between Khan and the government. The arrest of Khan and the government's effort to prosecute him continue to rile the country's politics, making it even more difficult to address Pakistan's economic and financial crisis.

Mexico: President Andrés Manuel López Obrador said his administration is considering buying retail bank Banamex, the country's fourth-largest bank and a unit of Citigroup (C, $45.91) which the U.S. financial giant put up for sale last year. A well-known Mexican businessman has already bid for Banamex, but the leftist-nationalist president indicated that if the private bid fell through, he would have the government buy it in a public-private partnership to make sure it stays in Mexican hands.

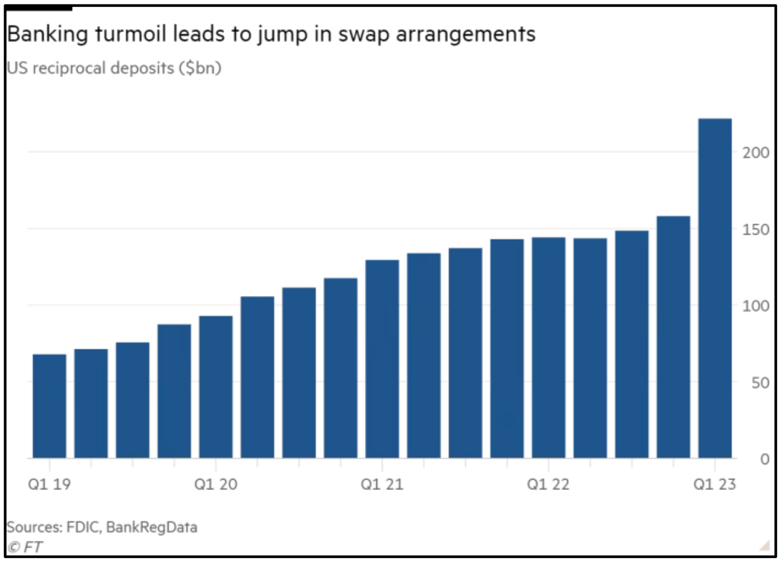
- Any such government purchase of Banamex would increase concerns about AMLO's penchant for nationalizing businesses.
- That would likely be a further headwind for Mexican stocks, which otherwise would probably be benefiting more from the way global companies are "near-sourcing" production away from China.

U.S. Fiscal Policy: Staff-level negotiators from the Biden administration and the office of House Speaker McCarthy met yesterday to hash out the details of a deal to raise the federal debt limit and avoid a potentially devastating default, but they reportedly made little, if any, progress. Other reports this morning suggest Biden and McCarthy will talk later today. Direct talks between Biden and McCarthy will likely be necessary to secure a deal before the apparent deadline of June 1, when the federal government may no longer be able to pay its bills without taking on new debt.

U.S. Stock Market: Even though institutional and individual investors have cooled their stock purchases in the face of rising interest rates and recession fears, data from Birinyi Associates shows companies in the Russell 3000 have announced plans to buy back more than $600 billion of their own stock so far this year, matching last year's record pace. If actual purchases for the full year come in above $1 trillion, as the first-half pace implies, the buybacks could provide an important support for stock values despite the current headwinds in the market.

U.S. Banking Industry: To hold on to large depositors with account balances well above the insured amount of $250,000, many regional banks have reportedly boosted their offerings of "reciprocal accounts." In these accounts, a customer's large deposit balance is divvied up and shared among partner banks so that each carries just the insured amount.

- The goal is to keep the customers who were spooked by this spring's bank failures from moving their money elsewhere.
- According to bank data firm BankRegData, deposits in reciprocal accounts soared to a new record high of $221 billion at the end of the first quarter, up from $158 billion at the end of 2022.



U.S. Economic Releases

Residential loan demand dipped for the second consecutive week. According to an index tracked by the Mortgage Bankers Association, mortgage applications fell 4.8% in the week ending May 19. The decline in loan requests is related to elevated borrowing costs pushing out potential homebuyers. The average 30-year fixed-rate mortgage rose 12 bps from 6.57% to 6.69% last week. As a result, the MBA tracker for purchases and refinancing applications fell 4.0% and 5.0%, respectively, from the prior week.

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**
12:10	Chris Waller Discusses the Economic Outlook	Member of the Board of Governors
14:00	FOMC Meeting Minutes	Federal Reserve Board

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	Machine tool orders	y/y	Apr F	-14.4%	-14.4%		**	Equity and bond neutral
Australia	Westpac Leading Index	y/y	Apr	0.0%	-0.1%	1.0%	**	Equity and bond neutral
New Zealand	Retail Sales Ex Inflation	q/q	1Q	-1.4%	-0.6%	-1.0%	**	Equity and bond neutral
South Korea	Business Survey - Manufacturing	m/m	Jun	73	72		**	Equity and bond neutral
	Business Survey - Non-Manufacturing	m/m	Jun	78	76		*	Equity and bond neutral
EUROPE								
Germany	IFO Business Climate	m/m	May	91.7	93.6	93.4	***	Equity and bond neutral
	IFO Current Assessment	m/m	May	94.8	95.0	95.1	**	Equity and bond neutral
	IFO Expectations	m/m	May	88.6	92.2	91.7	**	Equity bearish, bond bullish
UK	CPI	y/y	Apr	8.7%	10.1%	8.2%	***	Equity bearish, bond bearish
	Core CPI	y/y	Apr	6.8%	6.2%	6.2%	*	Equity and bond neutral
	Retail Price index	y/y	Apr	382.8	367.2	371.7	***	Equity and bond neutral
	RPI	y/y	Apr	11.4%	13.5%	11.1%	*	Equity and bond neutral
AMERICAS								
Canada	Industrial Product Price	m/m	Apr	-0.2%	0.1%	0.1%	**	Equity and bond neutral
	Raw Materials Price Incex	m/m	Apr	2.9%	-1.7%	0.7%	*	Equity bearish, bond bullish
Mexico	International Reserves Weekly	w/w	19-May	$202832m	$203451m		*	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)	537	539	-2	Up
3-mo T-bill yield (bps)	514	513	1	Up
TED spread (bps)	24	27	-3	Tightening
U.S. Sibor/OIS spread (bps)	520	518	2	Up
U.S. Libor/OIS spread (bps)	520	519	1	Up
10-yr T-note (%)	3.67	3.69	-0.02	Flat
Euribor/OIS spread (bps)	342	341	1	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Flat			Up
Yen	Up			Down
Pound	Down			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
RBNZ Official Cash Rate	5.500%	5.250%	A	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.

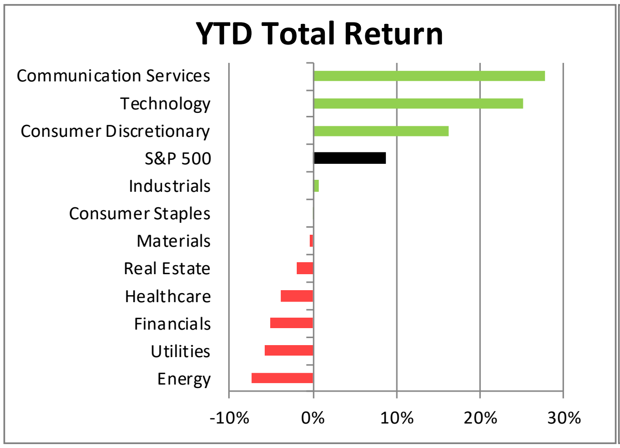
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$78.06	$76.84	1.59%	
WTI	$74.19	$72.91	1.76%	
Natural Gas	$2.32	$2.32	0.09%	
Crack Spread	$31.90	$32.15	-0.78%	
12-mo strip crack	$24.99	$25.11	-0.48%	
Ethanol rack	$2.59	$2.58	0.25%	
Metals				
Gold	$1,981.67	$1,975.23	0.33%	
Silver	$23.47	$23.45	0.08%	
Copper contract	$360.25	$365.45	-1.42%	
Grains				
Corn contract	$575.50	$577.50	-0.35%	
Wheat contract	$614.25	$622.25	-1.29%	
Soybeans contract	$1,317.25	$1,322.50	-0.40%	
Shipping				
Baltic Dry Freight	1,348	1,365	-17	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.0		
Gasoline (mb)		-1.6		
Distillates (mb)		0.5		
Refinery run rates (%)		0.60%		
Natural gas (bcf)		101		

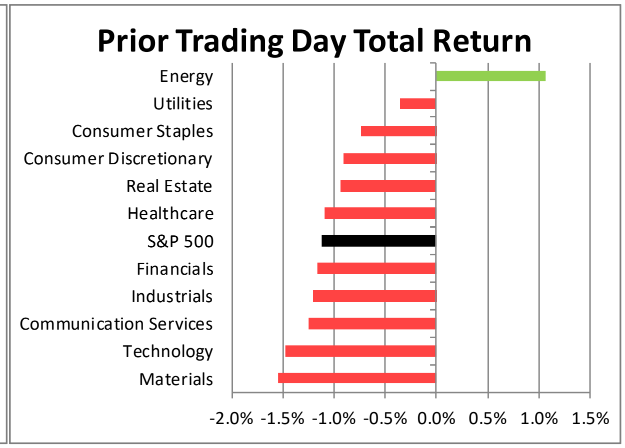
Weather

The 6-10 and 8-14 day forecasts currently call for mostly warmer-than-normal temperatures throughout the entire country, with below-normal-temperatures in the South. 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 5/23/2023 close)

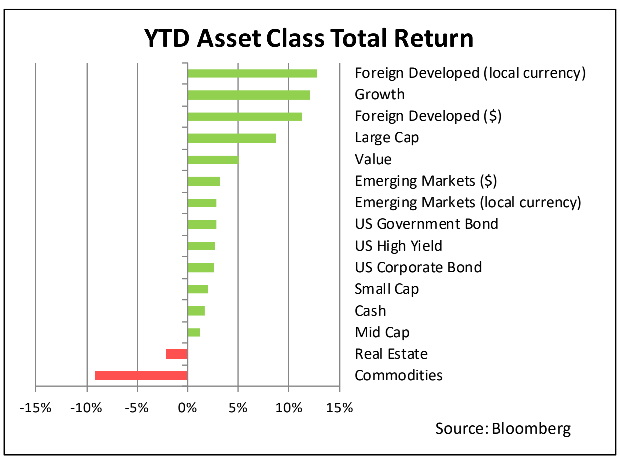




(Source: Bloomberg)

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 5/23/2023 close)

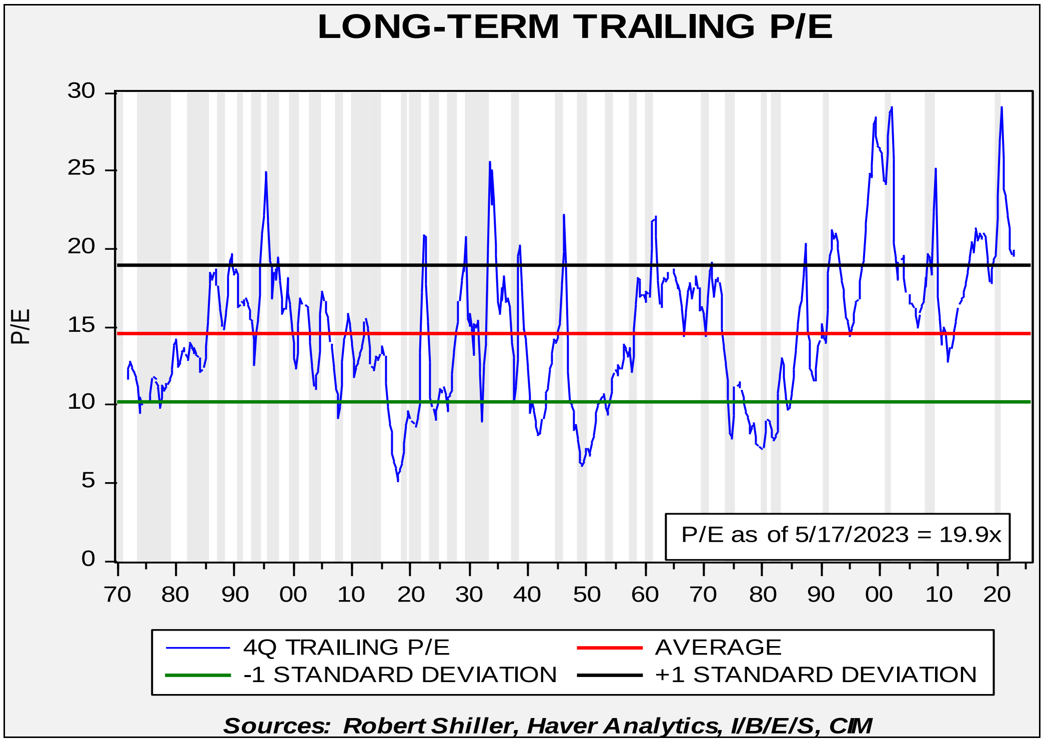


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.