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 25, 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 0.6%. Chinese markets were lower, with the Shanghai Composite closing down 0.1% from its previous close and the Shenzhen Composite closing down 0.2%. U.S. equity index futures are signaling a higher open.

With 480 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, 78.3% have exceeded expectations while 18.3% have fallen short of expectations.

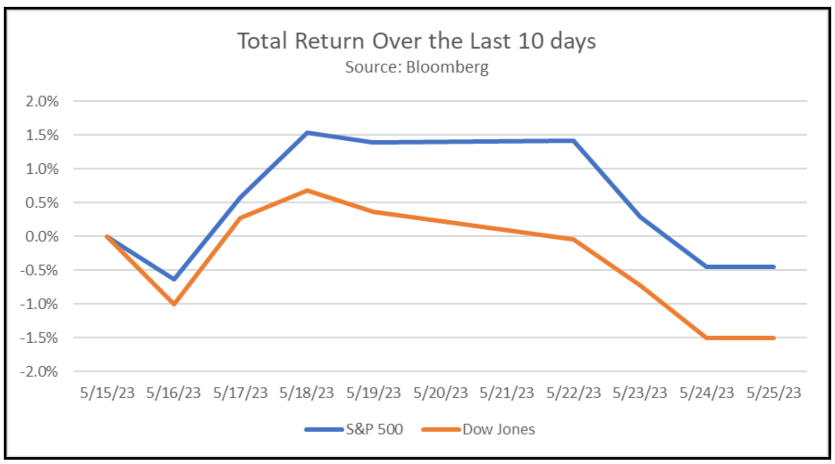
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (5/15/2023) (with associated podcast) "Opportunities and Risks in a Tripolar World"
- ***Weekly Energy Update*** **(5/25/2023): We continue to monitor China's dominance in EV metals and examine the weekly oil inventory data which recorded a massive drop in stockpiles**.
- *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"
- ***Business Cycle Report*** **(5/25/2023)**

Good morning! Today's *Comment* starts with an update on the debt ceiling negotiations. Next, we argue that the Fed may pause this year but is not likely to pivot. We end the report with our thoughts about the rising likelihood of a hard split between the U.S. and China.

Debt Ceiling: Ongoing talks between President Joe Biden and House Speaker Kevin McCarthy have yet to yield results, and investors are worried.

- American lawmakers are under pressure to reassure investors that they will raise the debt ceiling in a timely manner. The credit rating agency Fitch Ratings has placed the U.S. triple-A rating on watch for a possible downgrade due to concerns that political brinkmanship could prevent the government from honoring its debts. Despite progress made by negotiators, it is unclear when Congress will raise the debt limit to avoid a catastrophic default. The standoff is expected to continue today, but we are still confident that an agreement will be reached before the June 1 deadline. That said, the market may get a bit choppy as traders respond to the latest developments regarding negotiations.
- Uncertainty over lifting the debt cap has unnerved markets. The S&P 500 and Dow Jones Industrial Index are both trading lower this week (see chart below). At the same time, yields on Treasury bills expiring in the first eight days of June have risen above 7%. Anxiety over when the debt ceiling will be raised has led to a surge in market volatility. On Wednesday, the CBOE Volatility Index (VIX) surpassed 20 suggesting an unusual amount of fear amongst traders. The strong reaction highlights the significant risk a potential default will have on the U.S. economy.

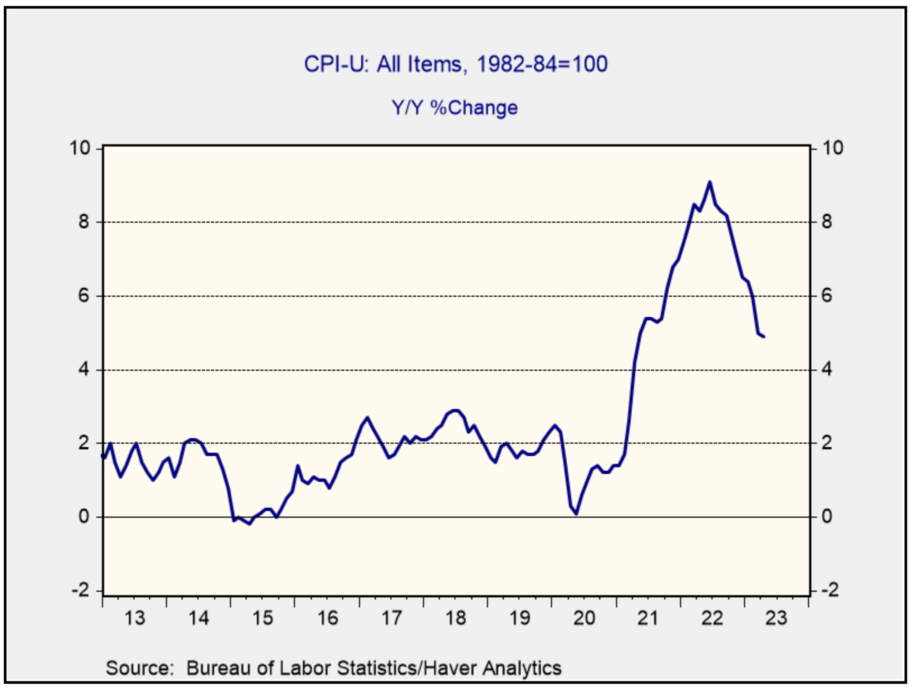


- We are confident that an agreement will be reached with bipartisan votes but suspect that the deal will push the country closer to recession. Despite speculation that McCarthy will need to win unanimous support from his party to get a spending bill through Congress, there are Democrats willing to fill the gap if needed. However, the combination of a liquidity drain and spending cuts from the new deal will remove fiscal stimulus from the economy. As a result, we still believe a recession is likely to happen within the next few quarters, even if the U.S. avoids default.

Hold Not Cut: The release of the latest Federal Open Market Committee meeting minutes has led investors to boost bets about a possible Fed pause.

- According to the May minutes, tighter financial conditions have led some Fed officials to question the need for additional rate hikes. The notes showed that central bank officials expressed a willingness to keep their options open as the committee determines whether it wants to raise rates further. The decision to maintain policy flexibility is related to concerns that inflation risks remain tilted to the upside. The latest staff projections for the annual change of personal consumption expenditure price index (PCE) were revised upward from 2.8% to 3.1% for 2023. That said, some policymakers argued that the committee should be patient before raising rates further.

- Recent speeches from officials suggest that the committee may be split between those favoring another hike and others preferring a pause. Earlier this month, Federal Reserve Governor Christopher Waller and Cleveland Fed President Loretta Mester advocated for additional rate hikes. Meanwhile, Chicago Fed President Austan Goolsbee and Federal Reserve Chair Jerome Powell expressed support for a pause at the June meeting. The conflicting reports have led traders to become less optimistic regarding a Fed pause. The latest CME FedWatch Tool now forecasts a 56.4% chance that the Fed will hold rates at their current levels at the time of this writing, much lower than the 90.1% prediction from three weeks ago.



- As the chart above shows, the Fed is still far away from achieving its 2% inflation target. The lack of progress in achieving price stability suggests that policymakers will likely keep rates higher for longer than the market anticipates. As a result, the risk of a hard landing is relatively elevated as Fed officials will likely not pivot anytime soon. That said, we still believe the central bank is close to ending its tightening cycle and is more likely to seek a potential off ramp as the country heads toward a recession.

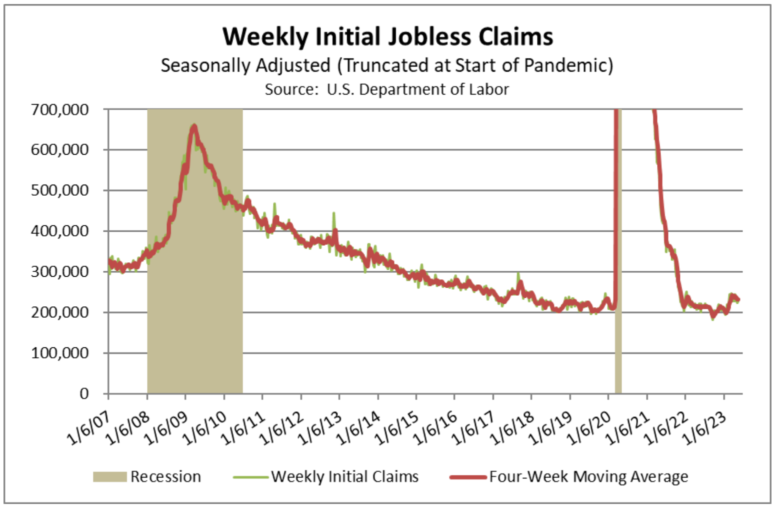
Chinese Rivalry: From spying to resource hoarding, Beijing is leaving no stone unturned as it prepares for its eventual decoupling from the U.S.

- Chinese state-sponsored hackers have implanted malware on critical infrastructure in the U.S. and Guam, according to Microsoft (MSFT, $313.85). The breach was designed to disrupt communications links between America and Asian countries in the event of a potential conflict. Although spying between the two countries is routine, experts believe this was the widest Chinese espionage campaign ever against American infrastructure. This is the second time this year that Chinese spy attempts were discovered and will likely prevent a thaw in tensions between the major powers. Following the report, Chinese stocks erased gains made in 2023 as investors prepared for additional headwinds.

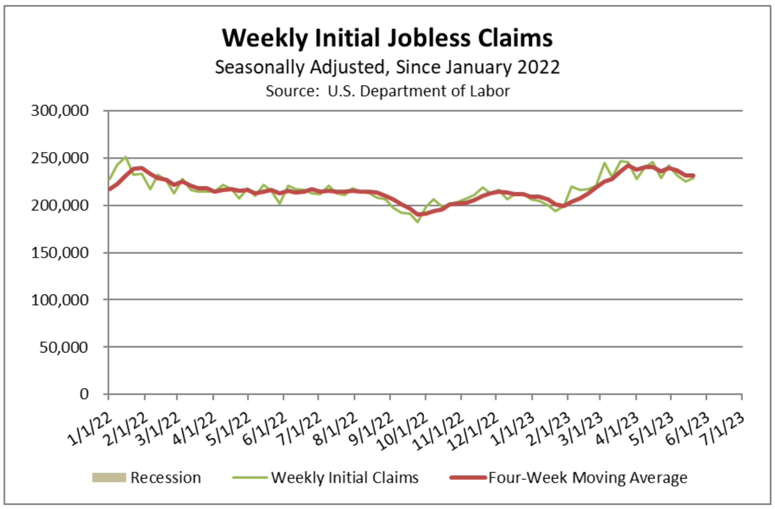
- On a related note, China is building relationships with authoritarian governments as it seeks to avoid being denied access to key resources. Chinese firms have spent $4.5 billion to acquire stakes in lithium mining firms in Latin America and Africa. Those investments are somewhat risky given the security threat within these countries. However, Chinese firms have little choice but to work with these authoritarian governments as Beijing attempts to dominate the electric vehicle market. Additionally, China's decision to deepen ties with Russia is also evidence of the country's willingness to work with authoritarian governments to guarantee that it has the commodities it needs to sustain economic growth.
- The rift between the two major powers continues to reinforce our view that the world is likely to split into regional blocs. Although China still offers some attractive opportunities, we believe that investors have options if they seek to maintain their exposure to the second-largest economy without having to invest directly in the country. For example, nations that have a lot of trade exposure to China, such as Japan and the countries of Europe, have had strong stock market rallies following the end of China's Zero-COVID policies. That said, as the largest economies start to diverge, the need for diversification will likely be necessary to hedge against unexpected changes in the geopolitical landscape. Hence, investors should be wary of putting all of their eggs in one basket.

U.S. Economic Releases

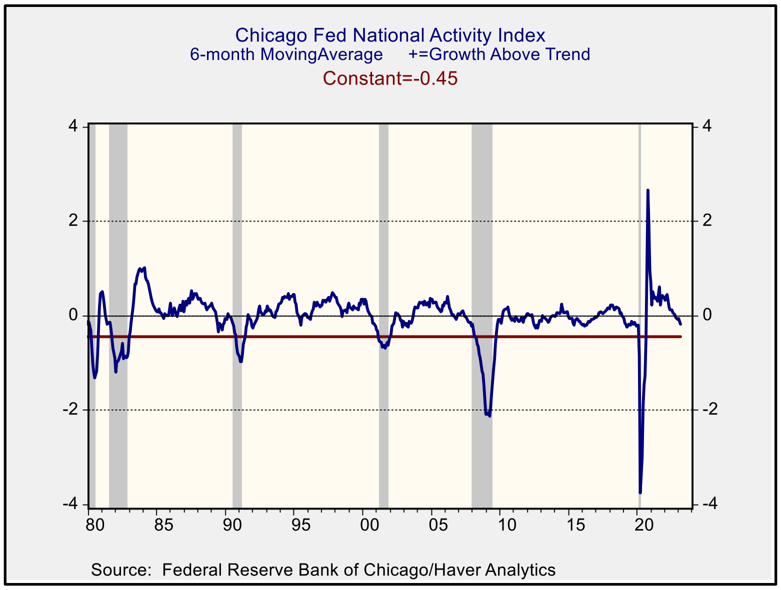
In the week ending May 20, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 229,000, below the expected level of 245,000 but still higher than the previous week's revised level of 225,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, was unchanged at 231,750. Importantly, the four-week average of initial claims remains at its lowest since the beginning of March, suggesting the softening in labor demand early in 2023 may have already run its course. Consistent with that idea, in the week ending May 13, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) fell to 1.794 million, coming in below expectations for a reading of 1.800 million and lower than the previous week's reading of 1.799 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.



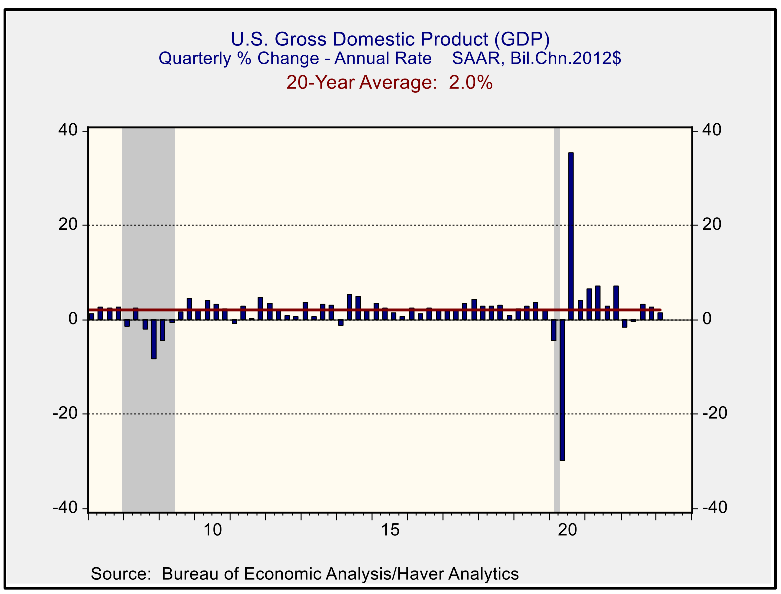
To provide more detail on recent trends, the chart below shows how initial jobless claims have changed just since the beginning of 2022.



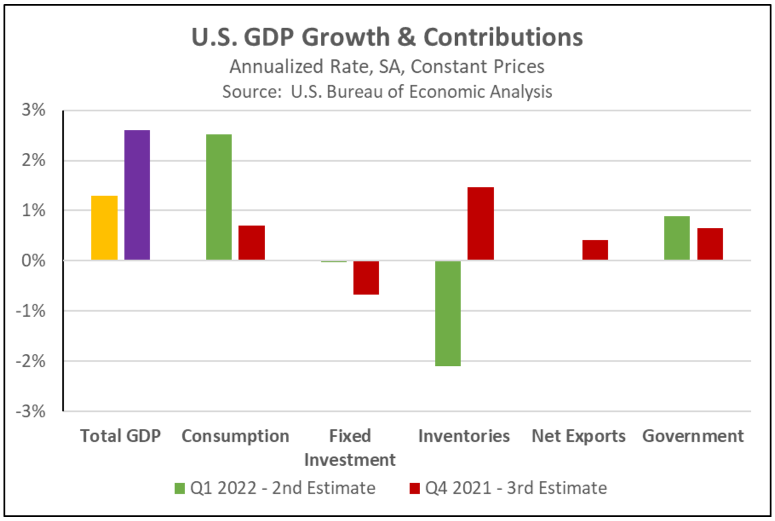
Separately, the Chicago Fed said its April ***National Activity Index (CFNAI)*** rose to 0.07, much better than the anticipated reading of -0.20, but the March reading was revised sharply downward to -0.37. The CFNAI, which encompasses dozens of separate indicators to capture all aspects of current economic activity, is designed so that readings above 0.00 reflect the economy growing at trend. Our analysis shows that when the six-month moving average of the CFNAI falls below about -0.45, it suggests the economy is in recession. With the latest reading, the index suggests the economy is still not in recession, but it continues to trend in that direction. The following chart shows how the CFNAI has fluctuated over the last several decades.



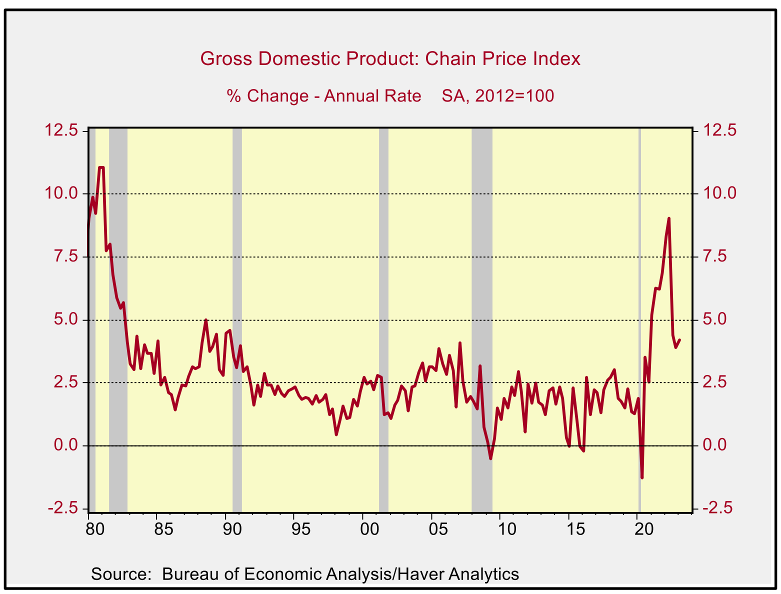
In a final major report so far this morning, the Commerce Department released its second estimate of economic activity in January through March. After stripping out seasonal factors and price changes, first-quarter ***gross domestic product (GDP)*** rose at an annualized rate of 1.3%, modestly better than expectations that the growth rate would be unchanged from the previous estimate of 1.1%, but still only half the growth rate of 2.6% in the fourth quarter of 2022. The chart below shows the annualized growth rate of U.S. GDP since just before the previous recession.



A close look at the details in the report shows that the main source of growth in the first quarter was personal consumption spending, which accounted for 2.5% of growth. The main drag on activity was a rundown in inventories as companies worked to eliminate excess stockpiles, which detracted 2.1% from the rate of increase. The chart below shows the contributions to the annualized growth rate in the first quarter.



The GDP report also includes the broadest measure of U.S. price inflation. The first-quarter ***GDP Price Index*** rose at a rate of 4.2%, slightly worse than expectations that the rate of increase would be unchanged from the initial estimate of 4.0%. The chart below shows the annualized rate of change in the GDP Price Index over the last several decades.



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
10:00	Pending Home Sales	m/m	Apr	1.0%	-5.2%	**
10:00	Pending Home Sales NSA	y/y	Apr	-20.1%	-23.3%	**
11:00	Kansas City Fed Manfacturing Activity	m/m	May	-9	-10	*
Federal Reserve						
EST	Speaker or Event	District or Position				
9:50	Thomas Barkin Speaks at Southwest Virginia Economic Forum	President of the Federal Reserve Bank of Richmond				
10:30	Susan Collins Speaks at Community College of Rhode Island	President of the Federal Reserve Bank of Boston				

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	Foreign Buying Japan Stocks	w/w	19-May	¥867.5b	¥808.3b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	19-May	¥1105.7b	¥1075.5b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	19-May	¥964.7b	¥1121.6b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	19-May	¥-0.4b	¥9.6b		*	Equity and bond neutral
South Korea	PPI	y/y	Apr	1.6%	3.3%		**	Equity bearish, bond bullish
EUROPE								
Germany	GDP NSA	y/y	Q1 F	-0.2%	0.2%	0.2%	**	Equity and bond neutral
	GDP WDA	y/y	Q1 F	-0.5%	-0.1%	-0.1%	**	Equity and bond neutral
	GfK Consumer Confidence	m/m	Jun	-24.2%	-25.7%	-25.8%	**	Equity bearish, bond bullish
France	Business Confidence	m/m	May	1000	102	101	**	Equity and bond neutral
	Manufacturing Confidence	m/m	May	99	101	100	*	Equity and bond neutral
Russia	PPI	y/y	Apr	-12.70%	-10.70%	-13.70%	*	Equity bullish, bond bearish
AMERICAS								
Mexico	Trade Balance	m/m	Apr	-1508.5m	$1168.7m	-$1719.8m	**	Equity and bond neutral
	Exports	m/m	Apr	$47733m	$53558m		*	Equity and bond neutral
	Imports	m/m	Apr	$46224m	$52389m		*	Equity and bond neutral
Brazil	IBGE Inflation IPCA - 15	y/y	May	4.07%	4.16%	4.21%	*	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)	540	537	3	Up
3-mo T-bill yield (bps)	518	520	-2	Up
TED spread (bps)	21	18	3	Widening
U.S. Sibor/OIS spread (bps)	524	523	1	Up
U.S. Libor/OIS spread (bps)	524	523	1	Up
10-yr T-note (%)	3.75	3.74	0.01	Flat
Euribor/OIS spread (bps)	342	342	0	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Down			Down
Pound	Flat			Up
Franc	Flat			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Korea 7-Day Repo Rate	3.500%	3.500%	3.500%	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.

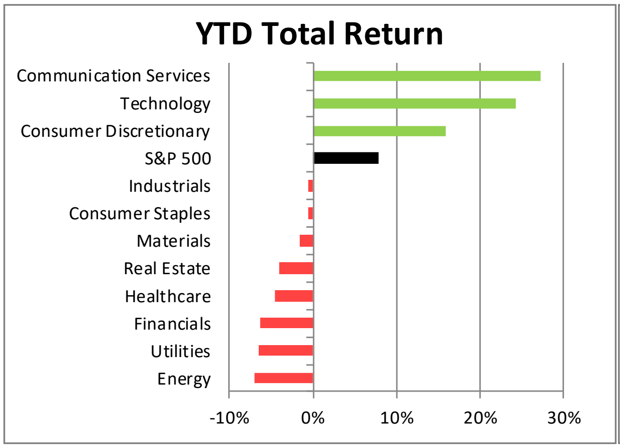
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$76.95	$78.36	-1.80%	
WTI	$72.89	$74.34	-1.95%	
Natural Gas	$2.36	$2.40	-1.42%	
Crack Spread	$32.12	$32.41	-0.88%	
12-mo strip crack	$25.13	$25.21	-0.32%	
Ethanol rack	$2.61	$2.60	0.39%	
Metals				
Gold	$1,962.25	$1,957.16	0.26%	
Silver	$23.08	$23.06	0.10%	
Copper contract	$359.10	$356.15	0.83%	
Grains				
Corn contract	$587.75	$587.25	0.09%	
Wheat contract	$604.75	$606.25	-0.25%	
Soybeans contract	$1,321.25	$1,324.50	-0.25%	
Shipping				
Baltic Dry Freight	1,295	1,348	-53	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-12.5	2.0	-14.5	
Gasoline (mb)	-2.1	-1.6	-0.5	
Distillates (mb)	-0.6	0.5	-1.1	
Refinery run rates (%)	-0.3%	0.60%	-0.9%	
Natural gas (bcf)		100		

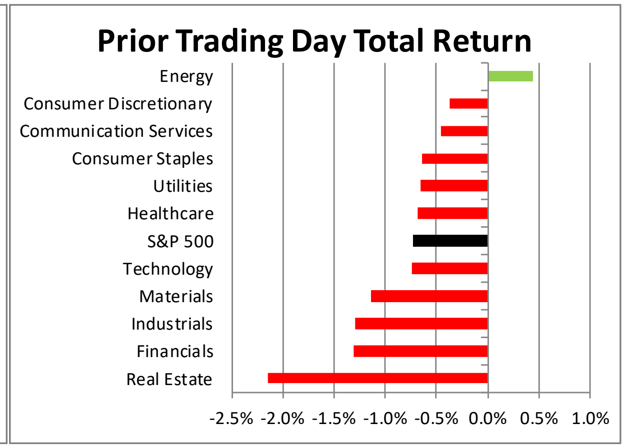
Weather

The 6-10 and 8-14 day forecasts currently call for mostly warmer-than-normal temperatures across the Northern Tier states, the Midwest, and the Mississippi Valley, with cooler-than-normal temperatures in the Southwest. The forecasts call for wetter-than-normal conditions in the Rocky Mountain and Southeast regions, with dry conditions expected in the Upper Midwest and New England.

Data Section

U.S. Equity Markets – (as of 5/24/2023 close)

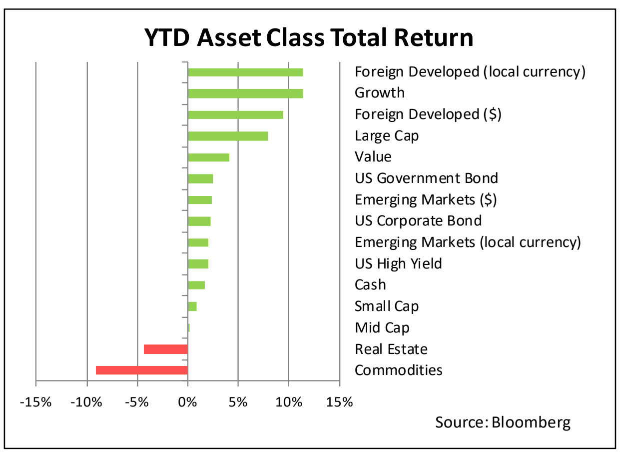




(Source: Bloomberg)

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 5/24/2023 close)

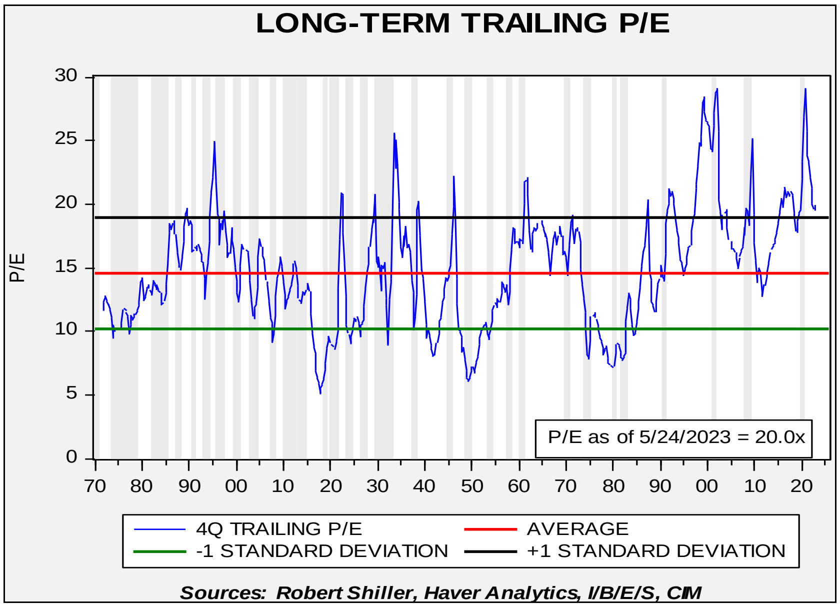


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 25, 2023



Based on our methodology,[1] the current P/E is 20.0x, 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.