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 26, 2023—9:30 AM EDT] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is currently up 0.5% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.2%. Chinese markets were higher, with the Shanghai Composite closing up 0.4% from its previous close and the Shenzhen Composite up 0.3%. U.S. equity index futures are signaling a higher open.

With 486 companies having reported so far, S&P 500 earnings for Q1 are running at $53.34 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 18.3% have fallen short of expectations.

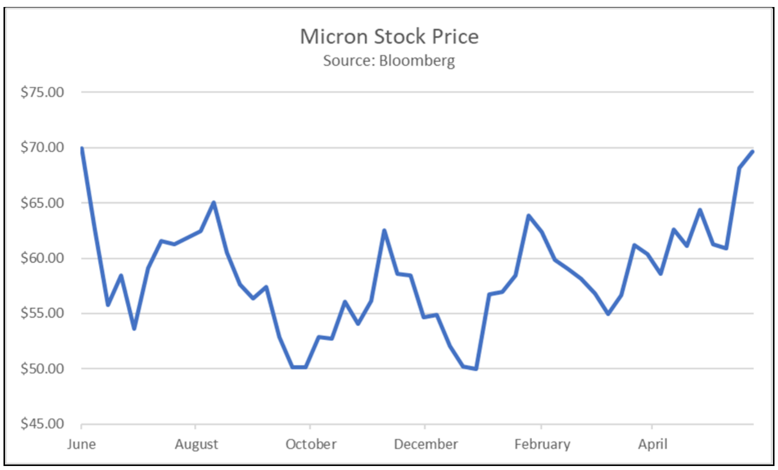
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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 our thoughts about the potential benefits and risks associated with generative artificial intelligence (AI). Next, we examine the impact that a German recession would have on the European Central Bank's policy rate decision. Finally, we discuss the Turkish election and what it may mean for markets.

More Chips: As investors clamor for AI-related stocks, regulators are seeking to contain risks associated with the technology.

- Chipmakers are confident that they can capitalize on the generative AI craze. Semiconductor producer Nvidia (NVDA, $379.80) projected second-quarter sales of $11 billion. Nvidia's strong guidance and positive earnings report boosted sentiment in the tech sector, sending the company's share price up 24.37% on the day. Meanwhile, the tech-heavy NASDAQ surged 1.7% on Thursday, and the S&P 500 closed up 0.9%. Optimism that the sector will revolutionize the way companies generate profits has outweighed concerns regarding regulatory risks and potential geopolitical disruptions.
- Government authorities are finding it difficult to balance the interests of shareholders with national security concerns. European regulators have proposed new rules that would limit AI companies' abilities to use copyrighted material and to make critical decisions such as granting loans and hiring. Additionally, friction between the U.S. and China continues to pave the way for tit-for-tat restrictions on chips. Earlier this week, Beijing banned some Chinese companies from purchasing chips from semiconductor company Micron (MU, $69.61). The move is likely in retaliation for U.S. export restrictions of advanced chips to the country and may lead to a response from the Biden administration.

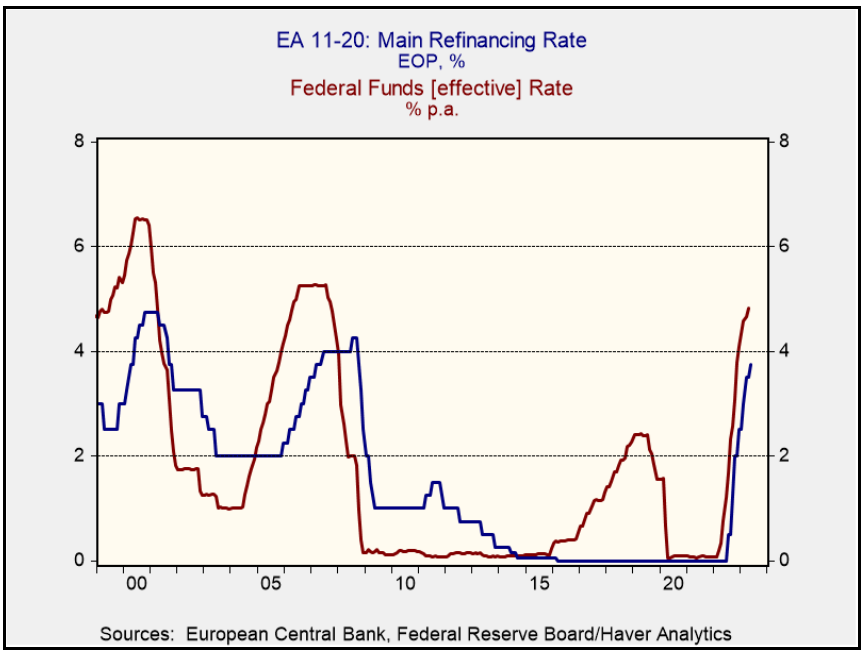


- Concerns over regulation and geopolitical tensions is not likely to sway investors from buying tech shares. This is best seen in the performance of Micron Technology. Despite the company's shares plunging more than 4% following the news of the ban, its stock price is now trading at its highest level in almost a year. This is likely not a one-off. The fear of missing out may encourage investors to overlook many of the risks associated with AI and semiconductors. That said, we suspect many of the dangers associated with the AI boom will likely play out over time and should not lead to the overall change in outlook for the industry in the short- and medium-term.

Recession or Not: The European Central Bank is expected to raise interest rates at its next meeting, despite data showing that the eurozone's largest economy is in a recession.

- Germany's economy shrank 0.3% in the first quarter of 2023, driven by weak consumer spending and a slowdown in exports. This was the second consecutive quarter of contraction; thus, it meets the formal definition of a recession. The lack of growth is related to shoppers reining in their spending to cope with rising inflation. Household final consumption expenditure fell 1.2% in the first three months of 2023. Meanwhile, the overall price level of goods and services has risen 7.1% since April 2022. Despite the recession, the European Central Bank is expected to raise interest rates at its next meeting in June.

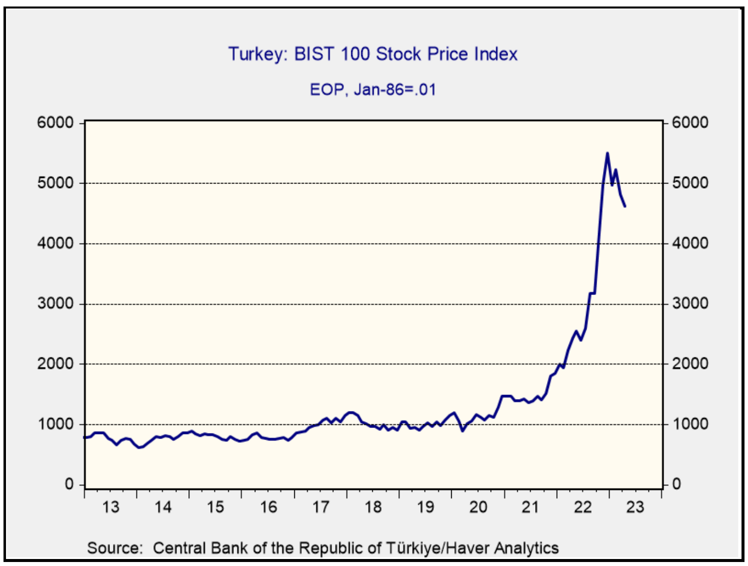
- Inflation concerns have kept European Central Bank officials hawkish as they look to restore price stability. Hours after German GDP figures were released, ECB Vice President Luis de Guindos advocated for central bank officials to maintain their fight against inflation. Later that day, Dutch Governing Council member Klaas Knot argued that interest rates should increase until at least July and stay there for some time. Central bankers' insistence on maintaining policy tightening will make it difficult for countries to recover from a downturn. However, we suspect that hawkish ECB policy may offer support for the EUR, especially if the Federal Reserve holds its interest rates steady at its next meeting as expected.



- If history serves as a guide, the ECB will be less aggressive in easing policy than its American counterpart. As the chart above shows, the ECB did not raise interest rates as fast as the Federal Reserve, but it was also much slower to cut. Overnight index swaps show that traders expect European interest rates to rise by 50 bps and American rates to fall by 25 bps by the end of the year. The narrowing of interest rate differentials should allow the EUR to appreciate against the USD, making European assets relatively more attractive.

Final Round: Markets are worried that another five years of Recep Tayyip Erdoğan as President will be damaging to the Turkish economy.

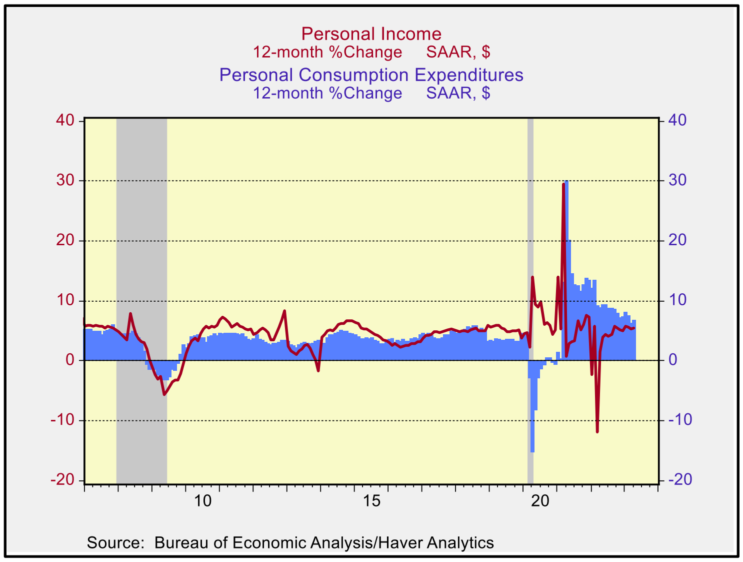
- After months of speculation about the potential end of his reign, Erdoğan is currently poised as the frontrunner to win the upcoming presidential run-off on Sunday. However, the backlash from victims of the devastating earthquakes combined with the mismanagement of the country's economy could still hurt his chances of securing a victory. Interestingly, prior to emerging as the top vote-getter in the first round of the election, Erdoğan was trailing behind his rival Kemal Kılıçdaroğlu, with opinion polls indicating a gap of 43.7% to 49.3%. However, with the recent endorsement from the third-place candidate Sinan Oğan, Erdoğan now enjoys increased support and is heavily favored to win, much to the disappointment of investors.
- The market is bracing for another Erdoğan presidency, and as a result, it is expecting the Turkish lira (TRY) to decline in value after the election. Market participants are concerned that Erdoğan will continue to steer the country in a negative direction. Mounting inflation, a burdensome debt load, and sluggish economic growth weighed on investor sentiment. The iShares MSCI Turkey ETF has already fallen by 12% since the first round of elections. As a result, Turkey will need to undergo a significant and comprehensive transformation in order to rebuild the trust of investors.



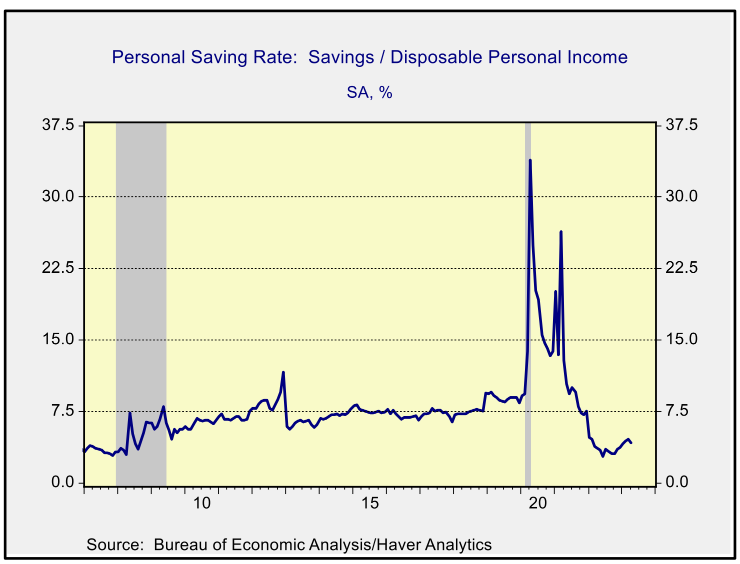
- However, it is important to acknowledge that Turkish equities have demonstrated the ability to defy expectations in the past. This is evidenced by the remarkable 110% surge in dollar terms of the Borsa Istanbul 100 index last year, compared to a 20% decline in the S&P 500. Although some of those gains have been retracted, this rally highlights the possibility that investors may not always adhere strictly to conventional wisdom. From our perspective, Turkey's strategic geographic location, robust military capabilities, and growing industrial base position it as an enticing prospect, provided the country manages to address its internal challenges. Only time will reveal if Turkey can fulfill its potential and capitalize on these advantages.

U.S. Economic Releases

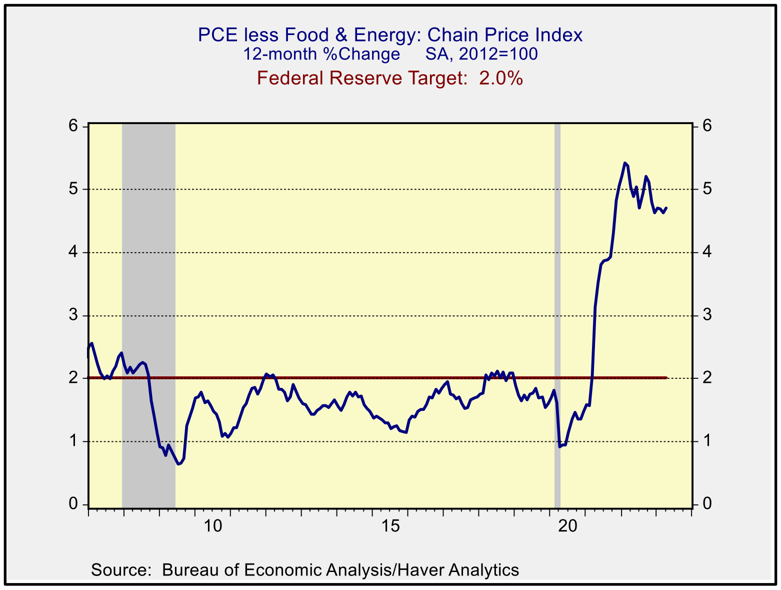
April ***personal income*** rose by a seasonally adjusted 0.4%, matching expectations and marking a modest acceleration from the increase of 0.3% in March. On an even more positive note, April ***personal consumption expenditures (PCE)*** jumped 0.8%, blowing past the expected increase of 0.5% and marking a big acceleration from the revised gain of 0.1% in the previous month. Personal income in April was up 5.4% from the same month one year earlier, while PCE was up 6.7%. The chart below shows the year-over-year change in personal income and PCE since just before the prior recession.



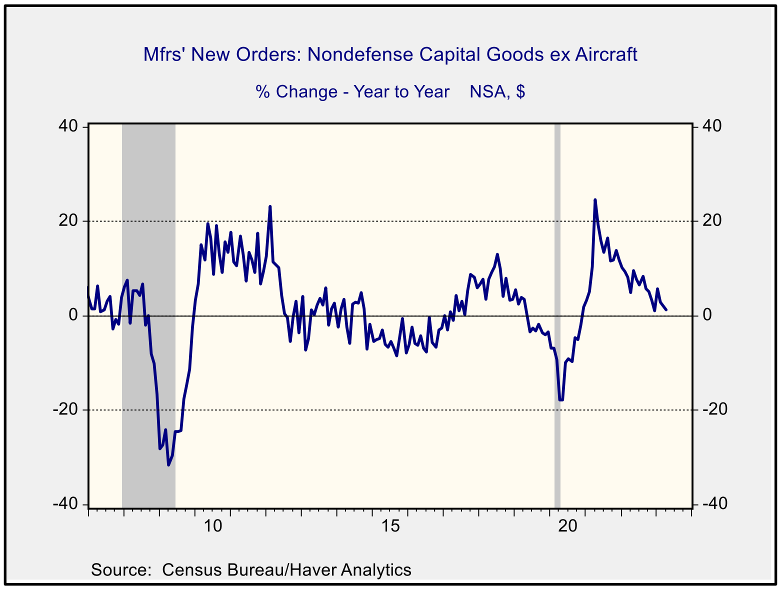
The personal income and spending report also includes a measure of personal saving, defined as disposable (after tax) income less consumption spending on goods and services. The April ***personal savings rate*** fell back to a seasonally adjusted 4.1%. The chart below shows how the personal savings rate has fluctuated since just before the previous recession.



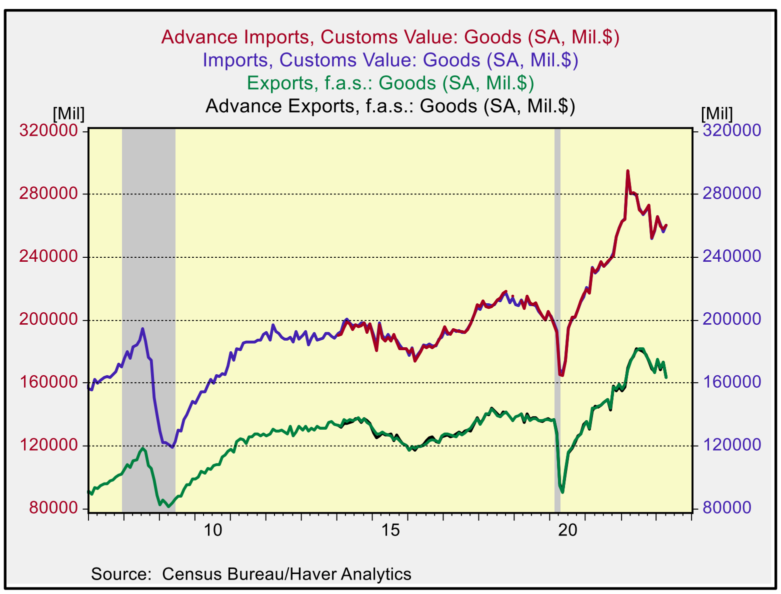
The income and spending report also includes the Fed's preferred measure of consumer price inflation. After stripping out the volatile food and energy components, the ***Core PCE Deflator*** for April was up 4.7% from the same month one year earlier. That was a bit worse than expectations that this measure of inflation would be unchanged from the 4.6% registered in the year to March. The chart below shows the year-over-year change in the Core PCE Deflator since just before the prior recession.



Separately, April ***durable goods orders*** rose by a seasonally adjusted 1.1%, far better than the anticipated decline of 1.0% but still a significant slowdown from the revised 3.3% rise in March. Durable goods orders are often driven by transportation equipment, where just a few airliner orders can have a big impact. Indeed, it appears that was exactly what happened last month. April ***durable goods orders excluding transportation*** fell 0.2%, a bit worse than the anticipated decline of 0.1% and almost enough to erase the revised increase of 0.3% in March. Finally, the durable goods report also includes an important proxy for corporate capital investment. In April, ***nondefense capital goods orders ex-aircraft*** jumped 1.4%, marking a big positive surprise compared with the anticipated decline of 0.1% and more than offsetting the revised fall of 0.6% in March. Compared with the same month one year earlier, overall durable goods orders in April were up 2.9%, while durable orders ex-transport were down 2.0%. Nondefense capital goods orders ex-aircraft were up 1.1%. The following chart shows the year-over-year change in nondefense capital goods orders ex-aircraft since just before the previous recession.



In a final major report so far this morning, an initial estimate showed the U.S. ***trade balance*** in April came in at a seasonally adjusted deficit of $96.8 billion. That was far worse than the expected deficit of $85.9 billion and the revised March deficit of $82.7 billion. According to the data, total merchandise exports fell 5.5%, while imports rose 1.1%. Compared with the same month one year earlier, exports in April were down 6.2%, while imports were down 8.0%. The chart below shows the monthly value of U.S. exports and imports since just before the previous recession.



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	U. of Michigan Consumer Sentiment	m/m	May F	58.0	57.7	***
10:00	U. of Michigan Current Conditions	m/m	May F		64.5	**
10:00	U. of Michigan Future Expectations	m/m	May F		53.4	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	May F	4.5%	4.5%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	May F	3.1%	3.2%	*
11:00	Kansas City Fed Services Activity	m/m	May		7	*

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	Tokyo CPI	y/y	May	3.2%	3.5%	3.4%	**	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food	y/y	May	3.2%	3.5%	3.4%	***	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food & Energy	y/y	May	3.9%	3.8%	3.9%	*	Equity and bond neutral
Australia	Retail Sales	m/m	Apr	0.00%	0.40%	0.30%	***	Equity and bond neutral
EUROPE								
France	Consumer Confidence	m/m	May	83.0	83	84	**	Equity and bond neutral
Italy	Consumer Confidence	m/m	May	105.1	105.5	105.0	***	Equity and bond neutral
	Manufacturing Confidence	m/m	May	101.4	103.0	102.8	***	Equity and bond neutral
	Economic Sentiment	m/m	May	108.7	110.5	110.4	**	Equity bearish, bond bullish
UK	Retail Sales	y/y	Apr	-3.0%	-3.1%	-3.9%	***	Equity bearish, bond bullish
	Retail Sales Ex-Auto Fuel	y/y	Apr	-2.6%	-3.2%	-4.0%	**	Equity bearish, bond bullish
Russia	Gold and Forex Reserves	m/m	19-May	$589.3b	$599.5b		***	Equity and bond neutral
Russia	Money Supply, Narrow Definition	w/w	19-May	17.59t	17.52t		*	Equity and bond neutral
AMERICAS								
Mexico	GDP NSA	y/y	Q1 F	3.7%	3.9%	3.8%	***	Equity and bond neutral
	Economic Activity IGAE	y/y	Mar	2.7%	3.84%	3.80%	**	Equity bearish, bond bullish
Brazil	Current Account Balance	m/m	Apr	-$1680m	$286m	$139m	**	Equity and bond neutral
	Foreign Direct Investment	m/m	Apr	$3.31b	$7.67b	$4.60b	**	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)	542	540	2	Up
3-mo T-bill yield (bps)	513	516	-3	Up
TED spread (bps)	29	23	6	Widening
U.S. Sibor/OIS spread (bps)	524	527	-3	Up
U.S. Libor/OIS spread (bps)	524	527	-3	Up
10-yr T-note (%)	3.79	3.82	-0.03	Flat
Euribor/OIS spread (bps)	346	342	4	Up
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Flat			Down
Pound	Up			Up
Franc	Up			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.

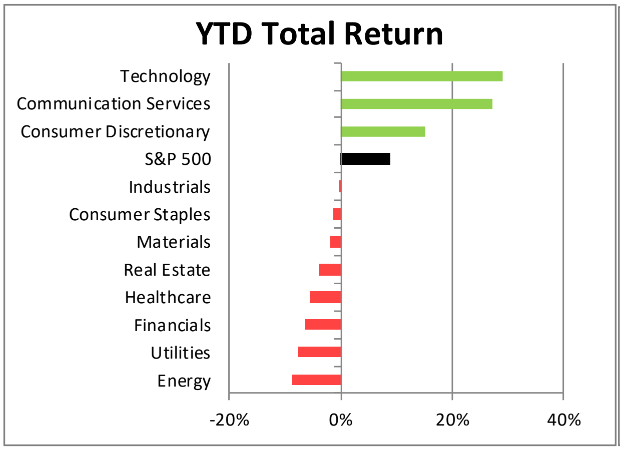
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
76.91	$76.84	$76.26	0.76%	
72.63	$72.53	$71.83	0.97%	
2.27	$2.26	$2.31	-1.86%	
32.565	$32.64	$32.25	1.21%	
25.235	$25.28	$24.98	1.19%	
2.6292	$2.63	$2.63	0.16%	
1953.4	$1,953.50	$1,941.41	0.62%	
23.212	$23.22	$22.74	2.09%	
366.95	$366.75	$358.80	2.22%	
595.5	$593.50	$590.75	0.47%	
613.25	$612.50	$604.25	1.37%	
1338.75	$1,337.75	$1,324.00	1.04%	
1215	1,215	1,295	-80	
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)	96	101	-5	

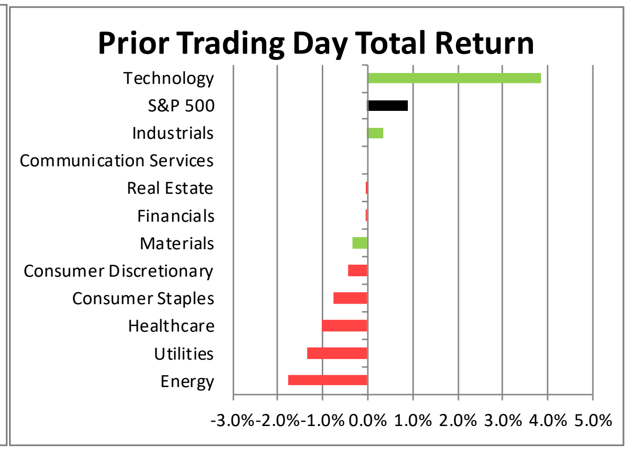
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures across the Northern Tier states, the Midwest, the Mississippi Valley, and New England, 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 5/25/2023 close)

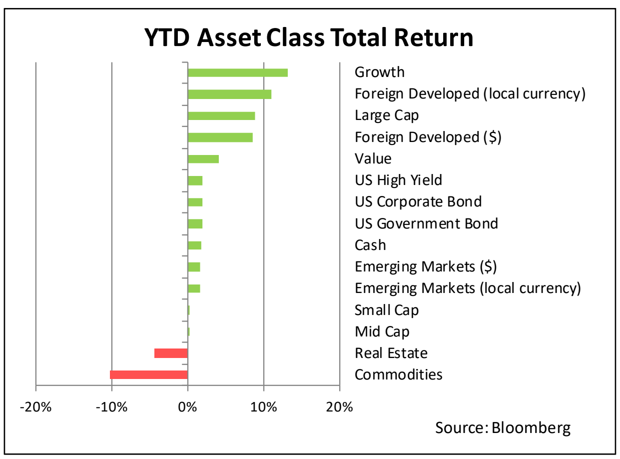




(Source: Bloomberg)

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 5/25/2023 close)

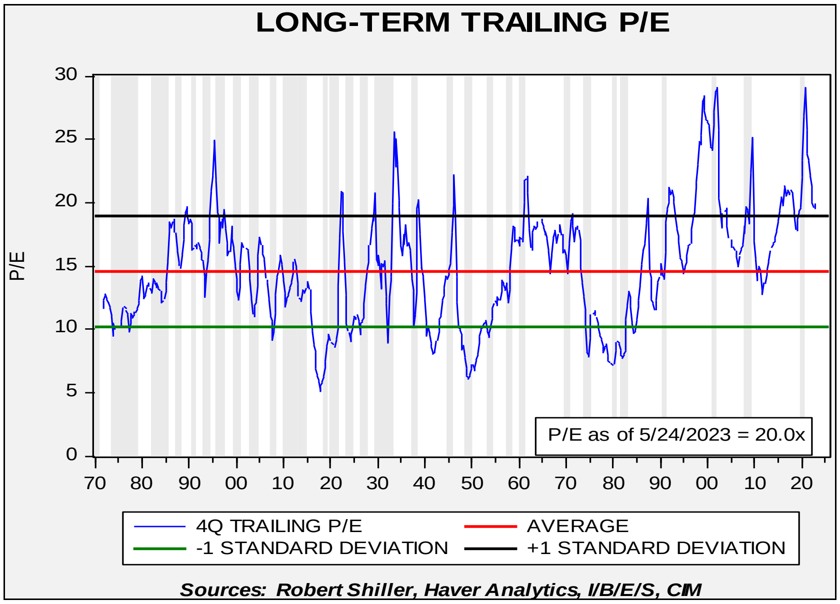


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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.