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: November 2, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 1.9% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 2.0%. Chinese markets were lower, with the Shanghai Composite down 0.5% from its previous close and the Shenzhen Composite down 1.0%. U.S. equity index futures are signaling a higher open.

With 340 companies having reported so far, S&P 500 earnings for Q3 are running at $58.00 per share, compared to estimates of $57.42, which is up 1.7% from Q2 2023. Of the companies that have reported thus far, 81.2% have exceeded expectations while 15.6% have fallen short of expectations.

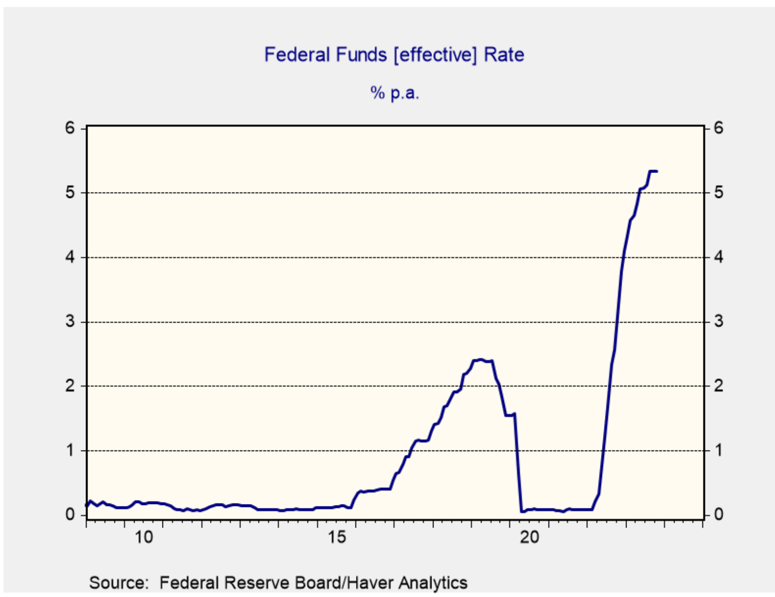
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (10/30/2023) (with associated podcast): "Investment Implications of the Israel-Hamas Conflict"
- ***Weekly Energy Update* (11/02/2023): The weekly data was modestly bullish this week, although we do note that refining activity remains depressed due to seasonal maintenance. The conflict in Gaza continues, but so far, the fighting has remained contained. *Note: the next edition of this report will be published on November 16 as the DOE is delaying its data reporting due to system upgrades*.**
- *Asset Allocation Quarterly – Q4 2023* (10/19/2023): Discussion of our asset allocation process, Q4 2023 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q4 2023 Rebalance Presentation* (10/30/2023): Video presentation featuring the Asset Allocation Committee as they review the asset allocation strategies, recent portfolio changes, and the current macro environment.
- *Asset Allocation Bi-Weekly* (10/23/2023) (with associated podcast): "A Regime Change in Bonds?"

Good morning! Equities are off to a great start and the Texas Rangers are the new World Series champions. Today's *Comment* starts with a discussion about the latest FOMC meeting, followed by our thoughts on the dollar, and an update on the bomb cyclone that is expected to make landfall in Europe. As always, our report includes an overview of the latest domestic and international data releases.

No More Hikes? Markets bet on peak policy rates after the Federal Open Market Committee (FOMC) voted to hold rates at a 22-year high.

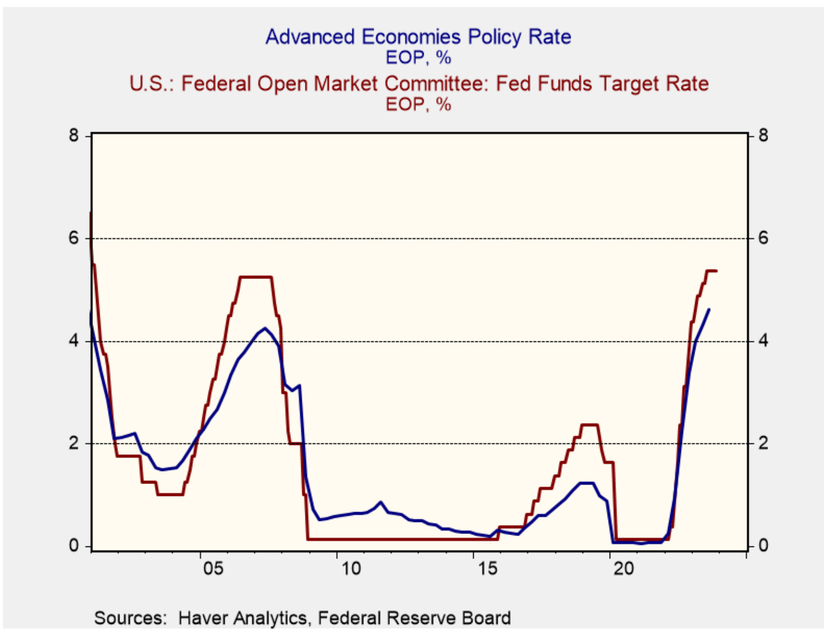
- Fed policymakers held rates steady at 5.25% to 5.50% at their October 31-November 1 meeting, citing concerns about tighter financial conditions. The announcement comes just over a week after the 10-year Treasury yield exceeded 5% for the first time since 2007. At the press conference, Fed Chair Jerome Powell reiterated the central bank's commitment to a 2% inflation target and said it remains prepared to raise rates if economic conditions warrant, adding that officials are not considering cutting rates anytime soon. However, he said the committee expects the economy to show signs of weakening as interest rates take hold.
- Markets cheered Powell's remarks, with the S&P 500 closing up 1.0% on Wednesday and bonds rallying across the curve, with the yield on the 10-year Treasury falling 18 bps. Though some of the sentiment was driven by the Treasury's decision to slow the pace of long-dated bond issuance, there was also hope that the Fed officials were finished with their hiking cycle. The CME FedWatch Tool now projects an 84.5% chance of steady rates in December and a nearly 70% chance of a rate cut by June 2024, up from 69.1% and 50.6%, respectively, last week.



- The Federal Reserve will keep its options open over the next few months, but all signs suggest it is done raising interest rates. Policymakers are likely to focus their efforts on making sure that rates do not remain too high for too long and begin impacting the real economy. So far, the Fed has been fortunate in keeping rates high for a sustained period without any negative consequences. However, it is unclear how long this good luck will last. Current default rates suggest that the default spread should be wider, indicating that investors are not adequately pricing in risk. This may change as more debt approaches maturity and needs to be refinanced at higher interest rates.

Greenback's Resistance: After months of persistent growth, momentum in the U.S. dollar is showing signs of waning.

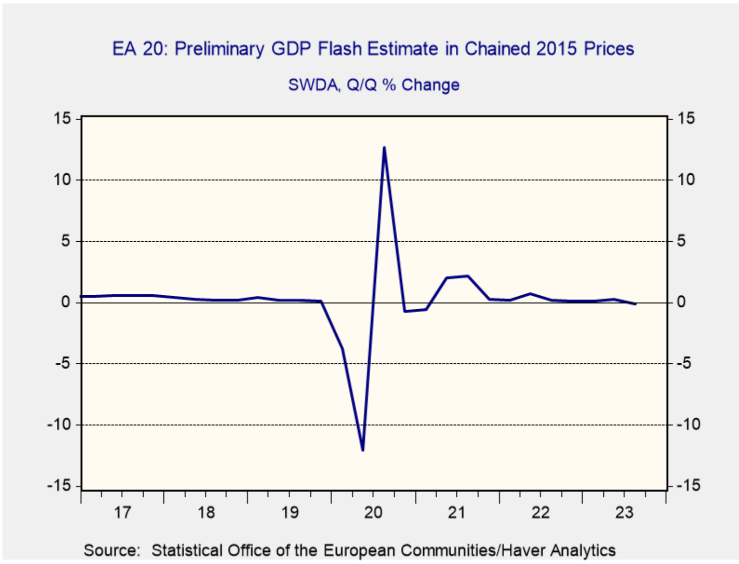
- Technical analysis shows that the U.S. Dollar Index has breached its 20-day moving average of 106.25, suggesting that the dollar trend may be close to reversing. The index has hovered in the 106-107 range over the past month, lacking upward pressure as market participants anticipate that central banks around the world are entering a new phase in their monetary policies. This lack of exchange rate movement comes as the market grows more confident that the policy rate differential between the Federal Reserve and its peers will not widen over the next few months.
- Over the past week, policymakers have signaled their reluctance to outdo the Fed in dovishness. The European Central Bank, the Bank of England, and the Bank of Canada all voted to hold rates steady for the second consecutive meeting, while the Bank of Japan took steps toward policy tightening. This cautious approach to a policy pivot reflects concerns that inflationary pressures may return if policymakers ease prematurely. Swap markets show that most central banks are expected to hold rates steady until the end of the year but may hike again in the first quarter of 2024.



- Historically, the Federal Reserve has hiked and eased more aggressively than its peers, suggesting that if the Fed is indeed done, then the downtrend in USD may start to take hold. This trend could benefit international equities as it should ease the debt burden and inflation pressures of countries that have exposure to the dollar. That said, investors should not become complacent as persistently strong economic data could lead the Fed to restart its hiking cycle, which would lead to renewed strength in the dollar. A weak jobs report on Friday should be enough to convince investors of a sustained trend, but another upward surprise may encourage investors to await more guidance from the Fed before abandoning their USD positions.

European Bomb Cyclone: A rapidly intensifying storm heads toward Europe this week, compounding its economic woes.

- Extreme Storm Ciarán is expected to make landfall in Britain first, becoming the first major country to be hit by the storm. The U.K. Met Office has warned of violent winds and possible flooding in several areas in the country. Afterward, the storm is expected to make its way to France carried by a "sting jet," which is expected to lead to severe winds with speeds up to 130 km/h. Meanwhile, southern European countries such as Spain and Portugal are also expected to be impacted by strong winds. The storm has led to preemptive measures such as school closures as they prepare for the storm's potential damage.
- These adverse weather conditions are coming at a bad time for Europe. Despite better-than-expected inflation data in October, with CPI falling below 3% for the first time since August 2021, economic activity in Europe has started to slow. GDP growth for the third quarter contracted at a seasonally adjusted annual rate of 0.1%, driven by a sharp decline in exports. The storm will likely lead to further economic disruptions, but any necessary rebuilding from the destruction could lead to a pickup in activity.



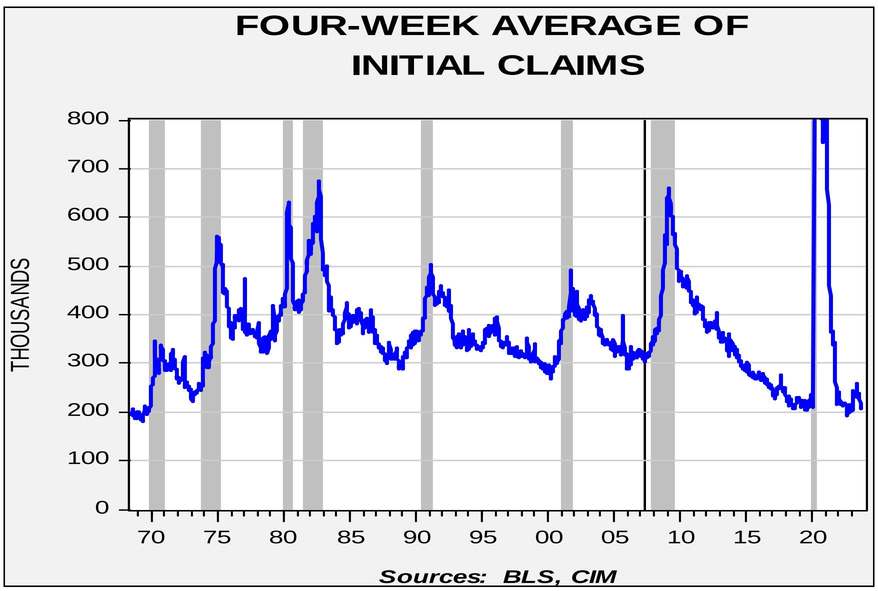
- Natural disasters are typically detrimental to local areas as opposed to the overall country, but the impact may vary depending on the event. There are several factors that influence the possible scale of the weather event, including the magnitude and duration of the event, the structure of the local economy, the population base, and the time of day the event occurs. That said, even in the case of major events, costs are typically overstated. In short, this storm may cause short-term disruptions, but it is unlikely to have a lasting impact on the growth prospects of Europe.

Other news: President Biden has asked the Israeli government to halt its forces to help with the hostage situation. The announcement highlights the potential risks of violence escalating throughout the Middle East.

U.S. Economic Releases

The October Challenger Job Cuts Report showed an 8.8% rise on an annual basis, down from September's 58.2%. Year-to-date, job cuts are up 164% over the same period last year. So, although the job market is perceived to be strong, there are some areas of concern. We note that the technology sector has seen the highest levels of cuts, with a rise of 462% from last year. That's the second highest level for this sector since 2001. Hiring plans are also down some 46% year-to-date. Overall, this survey, as noted above, does suggest some weakening in the labor markets. Of course, we get the BLS data for October tomorrow.

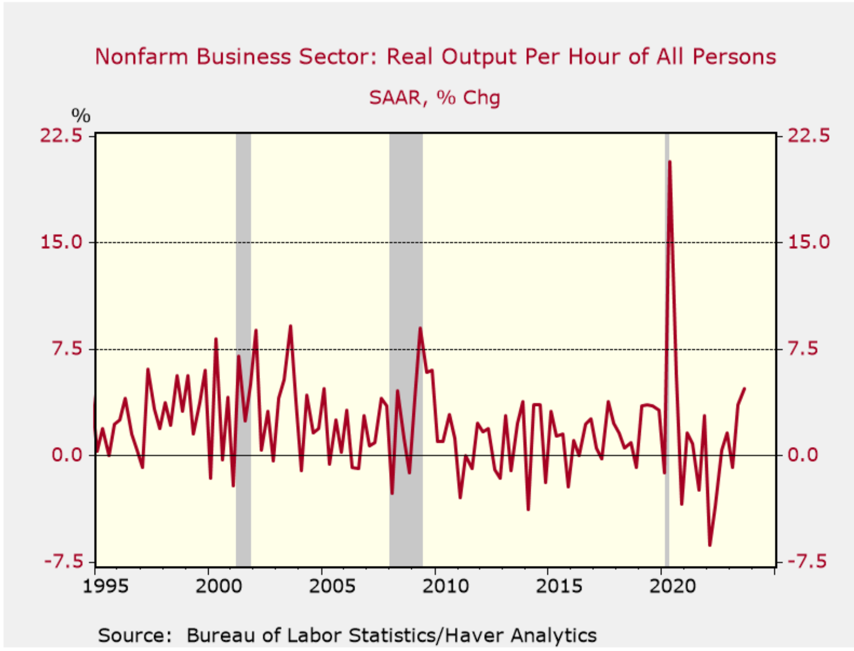
Initial claims rose modestly to 217k compared to expectations of 210k. Last week was revised up to 212k from the initial report of 210k. Although these numbers are a bit higher than forecast, claims remain remarkably low.



This chart shows the claims data smoothed with a four-week average. Note that claims remain well below levels usually seen during recessions.

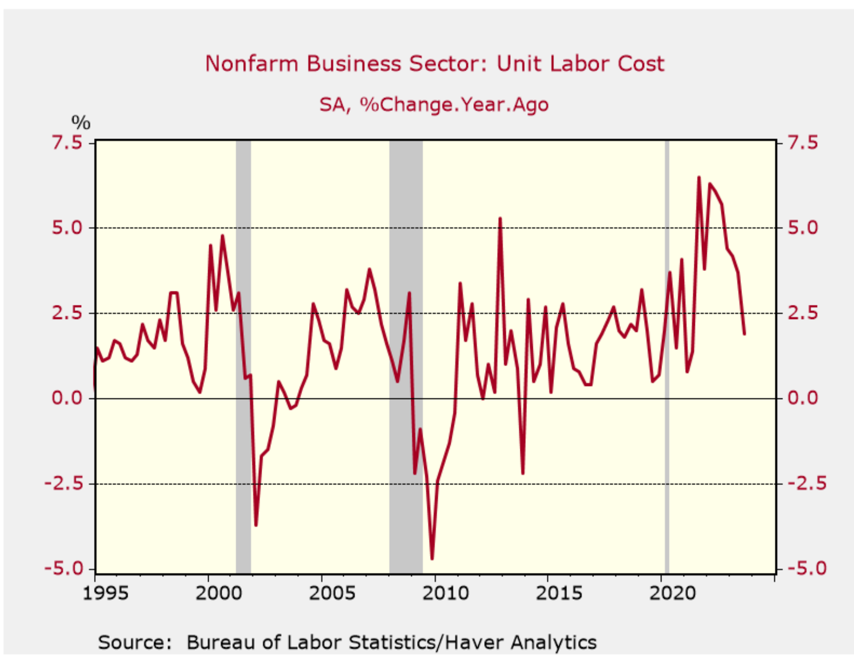
Our first look at Q3 productivity is also positive. Non-farm productivity rose 4.7%, better than the 4.3% forecast. Last quarter's productivity was revised to +3.6% from the last report of +3.5%. Unit labor costs, labor costs adjusted for productivity, fell 0.8% on an annualized basis compared to expectations of a +0.3% reading.

This chart shows productivity's quarterly growth rate annualized.

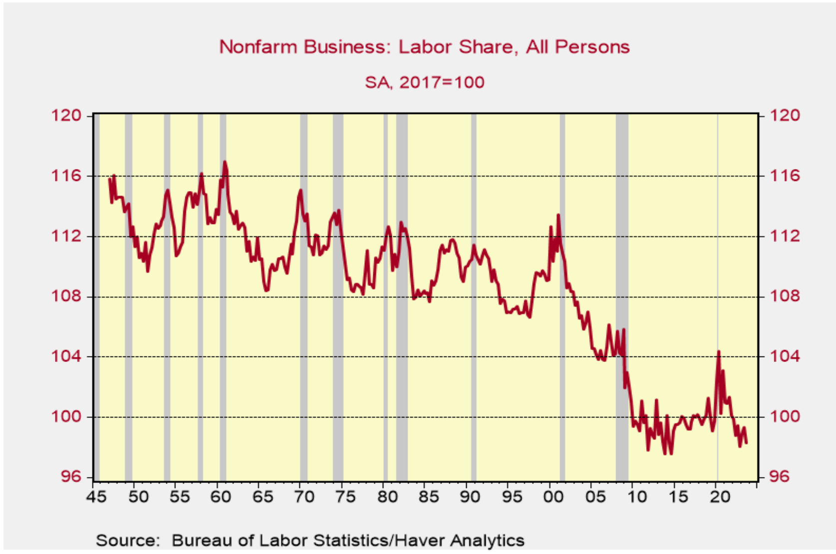


Since 1995, the average growth rate of productivity is +2.1%, so the current reading is very strong.

Unit labor costs on an annual basis is +1.9%; there is a definitive downward trend in these costs.

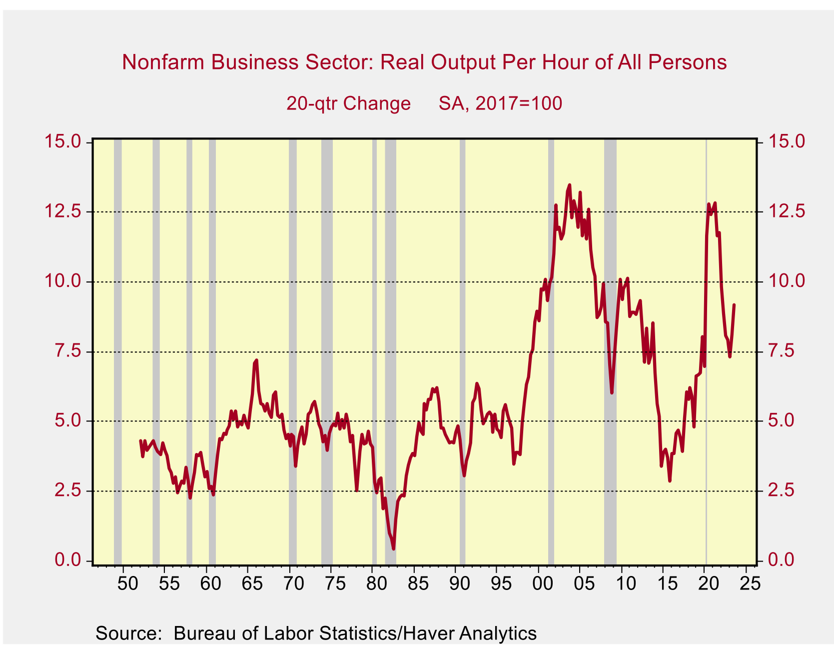


Finally, labor share weakened.



Since 2000, labor share has been under pressure; this is the mirror image of profitability. Recent strike activity reflects, to a degree, the response to labor's loss of power.

Overall, productivity is perhaps the only "free lunch" in economics. Rising productivity means that output is rising faster than what can be explained by the mere inputs of capital and labor. When productivity rises, both labor and capital can increase their "take" without triggering inflation. Although Fed officials have not said a lot about productivity lately, we note that Alan Greenspan famously held off tightening policy in the late 1990s because he was convinced that there was a productivity boom. This situation is best seen using a five-year average of productivity.



Note the large rise seen in the late 1990s. We are seeing something similar now. Although there was a sharp drop during the pandemic, productivity is recovering now. In general, rising productivity should dampen inflation over time, and thus, it might make sense for the FOMC to wait a bit longer to decide if further rate increases are necessary.

Overall, today's data tends to confirm the risk-on tone of the market. Claims are up a bit, but are not signaling recession, and the productivity data is quite positive.

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	Factory Orders	m/m	Sep	2.3%	1.2%	***
10:00	Factory Orders Ex Transportation	m/m	Sep	0.8%	1.4%	**
10:00	Durable Goods Orders	m/m	Sep F	4.7%	4.7%	***
10:00	Durable Goods Orders Ex Transportation	m/m	Sep F	0.5%	0.5%	**
10:00	Nondefense Capital Goods Orders Ex Aircraft	m/m	Sep F	0.6%	0.6%	**
10:00	Nondefense Capital Goods Ship Ex Aircraft	m/m	Sep F		0	**
Federal Reserve						
EST	Speaker or Event	District or Position				
18:30	Kathleen O'Neill Paese Delivers Welcoming Remarks	Interim President of the Federal Reserve Bank of St. Louis				

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	Monetary Base	y/y	Oct	9.0%	5.6%		**	Equity and bond neutral
	Monetary Base, End of Period	m/m	Oct	¥677.3t	¥672.6t		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	27-Oct	¥10.6b	¥214.7b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	27-Oct	¥311.4b	¥82.7b	¥48.6b	*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	27-Oct	¥238.5b	-¥151.7b	-¥147.8b	*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	27-Oct	-¥1672.7b	-¥904.2b	-¥905.2b	*	Equity and bond neutral
South Korea	CPI	y/y	Oct	3.8%	3.7%	3.6%	***	Equity and bond neutral
EUROPE								
Eurozone	HCOB Eurozone Manufacturing PMI	m/m	Oct F	43.1	43.0	43.0	***	Equity and bond neutral
Germany	Unemployment Change	m/m	Oct	30.0k	10.0k	12.0k	***	Equity bearish, bond bullish
	Unemployment Claims Rate	m/m	Oct	5.8%	5.7%	5.8%	**	Equity and bond neutral
	HCOB Germany Manufacturing PMI	m/m	Oct F	40.8	40.7	40.7	**	Equity and bond neutral
France	HCOB France Manufacturing PMI	m/m	Oct F	42.8	42.6	42.6	**	Equity and bond neutral
Italy	HCOB Italy Manufacturing PMI	m/m	Oct	44.9	46.8	46.3	***	Equity bearish, bond bullish
Switzerland	CPI	y/y	Oct	1.7%	1.7%	1.7%	***	Equity and bond neutral
	CPI EU Harmonized YoY	y/y	Oct	2.0%	2.0%		*	Equity and bond neutral
	Core CPI	y/y	Oct	1.5%	1.3%	1.4%	*	Equity and bond neutral
Russia	Real Retail Sales	y/y	Sep	12.2%	11.0%	10.9%	***	Equity bullish, bond bearish
	Unemployment Rate	m/m	Sep	3.0%	3.0%	3.0%	***	Equity and bond neutral
AMERICAS								
Canada	S&P Global Canada Manufacturing PMI	m/m	Oct	48.6	47.5		***	Equity bullish, bond bearish
Mexico	S&P Manufacturing PMI	m/m	Oct	52.1	49.8		***	Equity bullish, bond bearish
Brazil	S&P Global Brazil Manufacturing PMI	m/m	Oct	48.6	49.0		***	Equity and bond neutral
	Trade Balance	m/m	Oct	$8959m	$8904m	$9100m	**	Equity and bond neutral
	Exports	m/m	Oct	$29484m	$28431m	$30150m	*	Equity and bond neutral
	Imports	m/m	Oct	$20525m	$19527m	$21050m	*	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)	564	564	0	Up
3-mo T-bill yield (bps)	529	530	-1	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	538	538	0	Up
U.S. Libor/OIS spread (bps)	539	539	0	Flat
10-yr T-note (%)	4.70	4.74	-0.04	Flat
Euribor/OIS spread (bps)	395	397	-2	Up
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
Yen	Up			Down
Pound	Up			Down
Franc	Up			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
FOMC Rate Decision (Lower Bound)	5.250%	5.250%	5.250%	On Forecast
FOMC Rate Decision (Upper Bound)	5.500%	5.500%	5.500%	On Forecast
Bank of England Bank Rate	5.250%	5.250%	5.250%	On Forecast
Brazil Selic Rate	12.250%	12.750%	12.250%	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	$85.66	$84.63	1.22%	
WTI	$81.43	$80.44	1.23%	
Natural Gas	$3.41	$3.49	-2.52%	
Crack Spread	$22.46	$22.13	1.48%	
12-mo strip crack	$23.81	$23.64	0.71%	
Ethanol rack	$2.17	$2.18	-0.47%	
Metals				
Gold	$1,988.32	$1,982.53	0.29%	
Silver	$23.04	$22.95	0.39%	
Copper contract	$366.75	$364.90	0.51%	
Grains				
Corn contract	$476.00	$475.00	0.21%	
Wheat contract	$560.00	$561.75	-0.31%	
Soybeans contract	$1,323.25	$1,315.00	0.63%	
Shipping				
Baltic Dry Freight	1,401	1,459	-58	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	0.8	1.8	-1.0	
Gasoline (mb)	0.1	-0.1	0.2	
Distillates (mb)	-0.8	-1.0	0.2	
Refinery run rates (%)	-0.2%	0.2%	-0.4%	
Natural gas (bcf)		79		

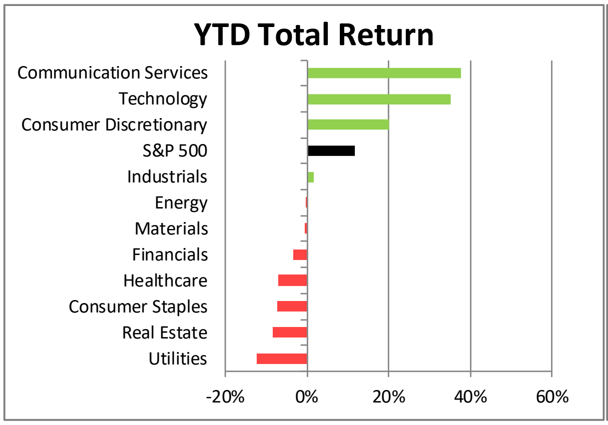
Weather

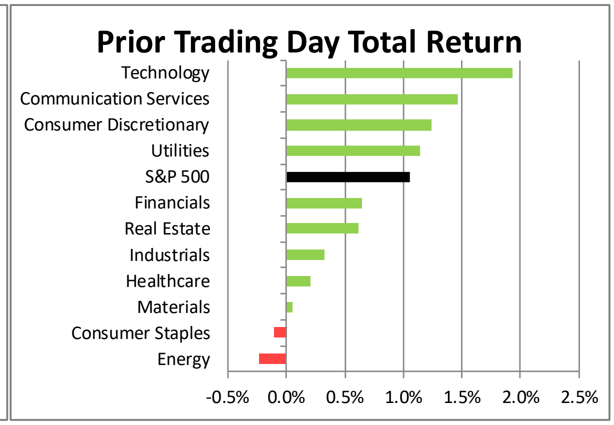
The 6-10 and 8-14 day forecasts predict warmer-than-normal temperatures for most of the country, with cooler temperatures expected in New England, the Midwest, and the Rocky Mountains. The precipitation outlook shows wetter-than-normal conditions in most states, with dry conditions expected in the Southwest.

There is one atmospheric disturbance in the Atlantic Ocean, but it is not expected to develop into a major storm within the next 48 hours. Located in the central Caribbean Sea, the disturbance has a 20% chance of cyclone formation. On average, Atlantic hurricane activity peaks on September 15. Now that we are past November 1, the semi-official end of the hurricane season, we will end our tropical reporting until June 1, 2024. However, if any storms develop and appear to affect markets, we will report such information here.

Data Section

U.S. Equity Markets – (as of 11/1/2023 close)

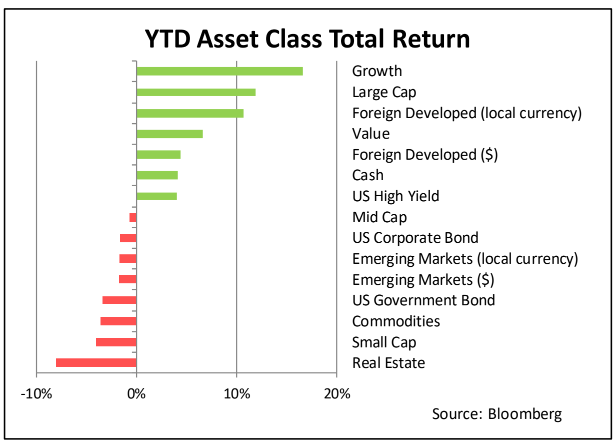




(Source: Bloomberg)

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 11/1/2023 close)

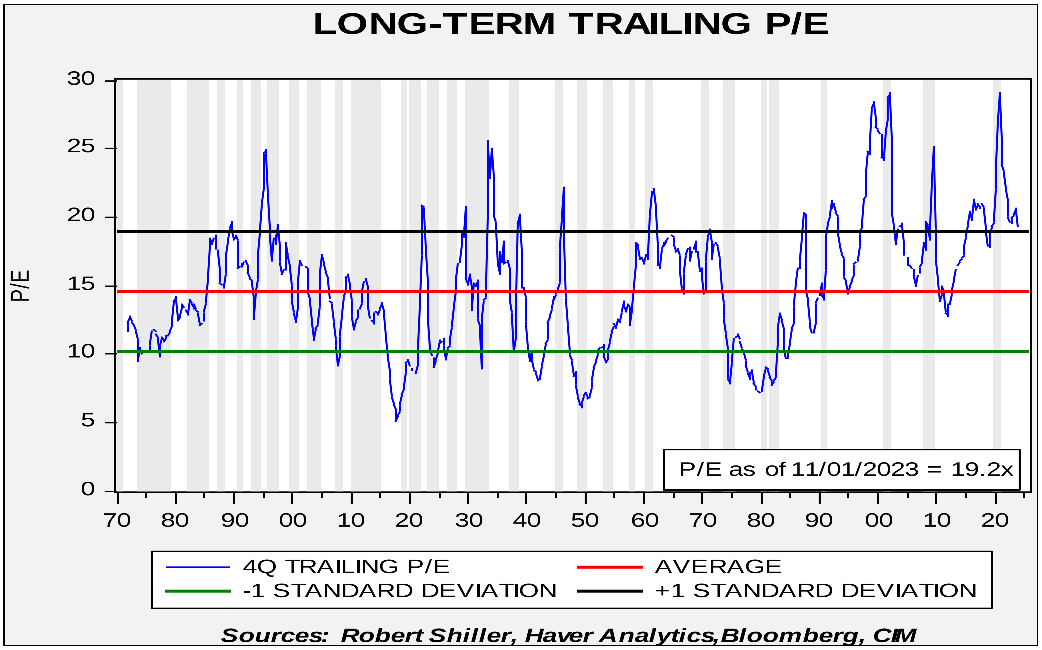


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

November 2, 2023



Based on our methodology,[1] the current P/E is 19.2x, down 0.3x from last week. The multiple contracted due to falling index values and improved earnings.

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 Bloomberg estimates which are updated regularly throughout the quarter; currently, the four-quarter earnings sum includes two actual quarters (Q1 and Q2) and two estimates (Q3 and Q4). 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.