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 3, 2023—9:30 AM EDT] Global equity markets are mostly higher this morning. In Europe, the Euro Stoxx 50 is essentially unchanged from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 2.0%. Chinese markets were higher, with the Shanghai Composite up 0.7% from its previous close and the Shenzhen Composite up 1.2%. U.S. equity index futures are signaling a higher open.

With 399 companies having reported so far, S&P 500 earnings for Q3 are running at $58.10 per share compared to estimates of $57.42, which is up 1.7% from Q2 2023. Of the companies that have reported thus far, 81.7% have exceeded expectations while 14.8% have fallen short of expectations.

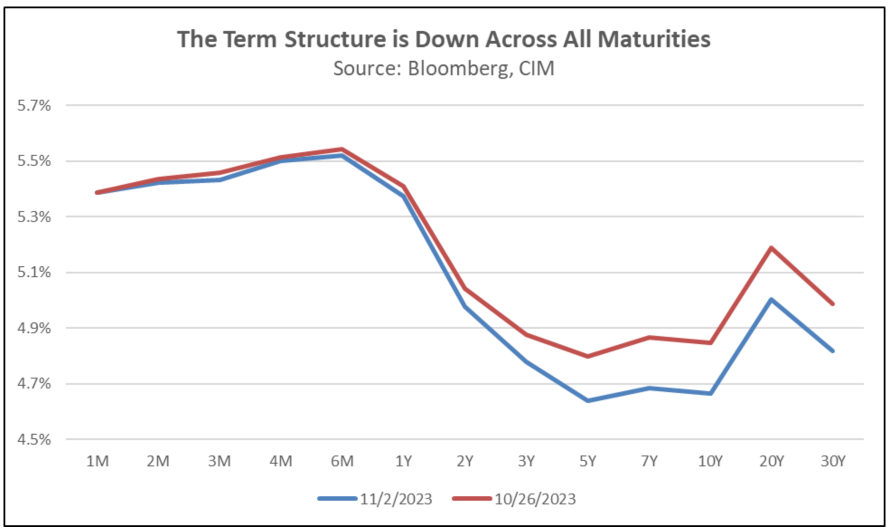
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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 surging due to the employment data, and Victor Wembanyama has proved that being tall and mobile makes it easier to score points in basketball. Today's *Comment* begins with a discussion on how central bank policy impacts bond yields, examines a new rift over government funding, and concludes with a preview of the Xi-Biden meeting. As always, our report also includes a summary of the latest domestic and international data releases.

Will Rates Stay Down? Declining interest rate expectations have caused longer-duration U.S. Treasury yields to fall.

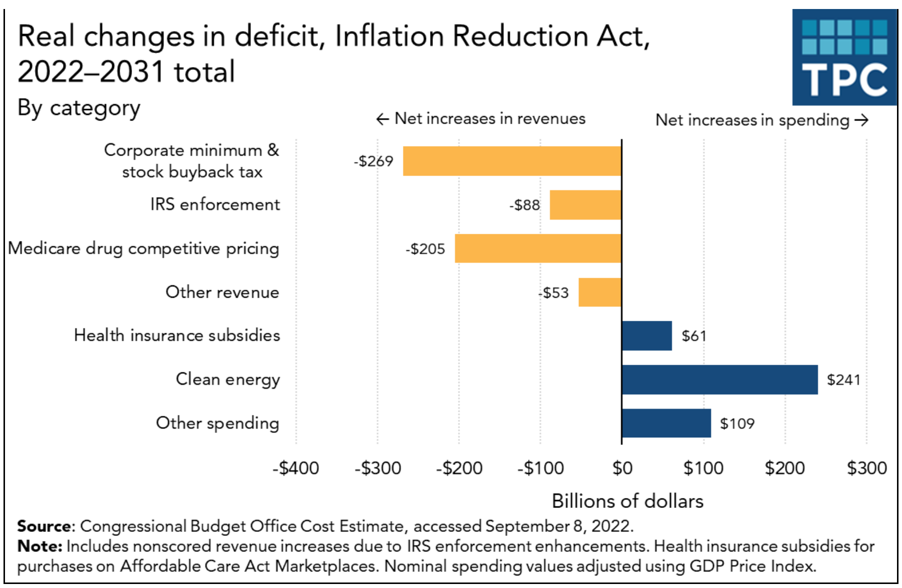
- Investors seem confident that central banks have finished raising interest rates, with four of the five G-7 rate-setting bodies holding rates unchanged in the past 10 days. The European Central Bank, Federal Reserve, Bank of Canada, and Bank of England have signaled that policy rates may already be sufficiently restrictive to bring down inflation and will take a wait-and-see approach before raising again. This comes after central banks hiked policy rates to multi-decade highs in an effort to restore price stability. The more accommodative stance is due to concerns about a recession as PMI manufacturing readings show that economic output in G-7 countries has slowed.
- This shift in sentiment has increased investors' appetite for longer-duration assets, such as fixed income and growth stocks. The yield on the 10-year Treasury, a benchmark for global asset prices, has fallen by more than 30 basis points over the last two days, one of the biggest drops since the regional banking turmoil in March. Furthermore, the drop in interest rates also supported an equity rally, with the S&P 500 and Nasdaq Composite rising 3.0% and 3.5%, respectively, since the Fed's rate decision. Investment-grade bonds also reflected this risk-on behavior, with the Markit CDX North American Investment Grade Index, a gauge of credit risk, falling the most in 10 weeks.



- While central banks have paused rate hikes, this does not signal a readiness to pivot. The Fed has cited tight financial conditions as a reason to keep rates steady, suggesting that policymakers may delay easing even if conditions improve. The recent rally in global bonds means that borrowing costs are starting to fall, thus paving the way for more lending. Moreover, core inflation remains above target in many countries, and progress could be reversed if demand starts to pick up. It is important to remember that bondholders were wrongfooted earlier this year; thus, investors shouldn't rule out another head fake.

Bidenomics Pushback: New House Speaker Mike Johnson (R-LA) is preparing for a confrontation with the Biden administration over the president's flagship legislation.

- The U.S. House of Representatives passed a bill on Thursday to provide $14.3 billion in aid to Israel and cut funding for the Internal Revenue Service. Despite its slim chances of passing the Senate or surviving a White House veto, the bill signals a shift in stance as the two parties prepare for another round of talks on the U.S. government budget. The move to tie military aid to spending cuts is an unusual gambit, given that providing assistance to allies has typically been bipartisan and without conditions. However, Johnson's latest ploy will likely further divide Congress as the two sides look to prevent a government shutdown on November 17.
- Johnson's insistence on spending cuts suggests that Republicans' ultimate strategy in budget talks is to rein in the recent spending packages passed by Congress. The Inflation Reduction Act's $80 billion increase in funding for the IRS was designed to give the agency more tools to pursue tax evaders. According to the Congress Budget Office, the investment should increase government revenue by approximately $200 billion and lead to a net deficit reduction of $114 billion over 10 years. Its inclusion in the IRA passed in 2022 was designed to offset much of the increased deficit spending included in the legislation. As a result, the lack of funding suggests that Democrats will have to find cuts elsewhere if they want to keep initiatives intact.

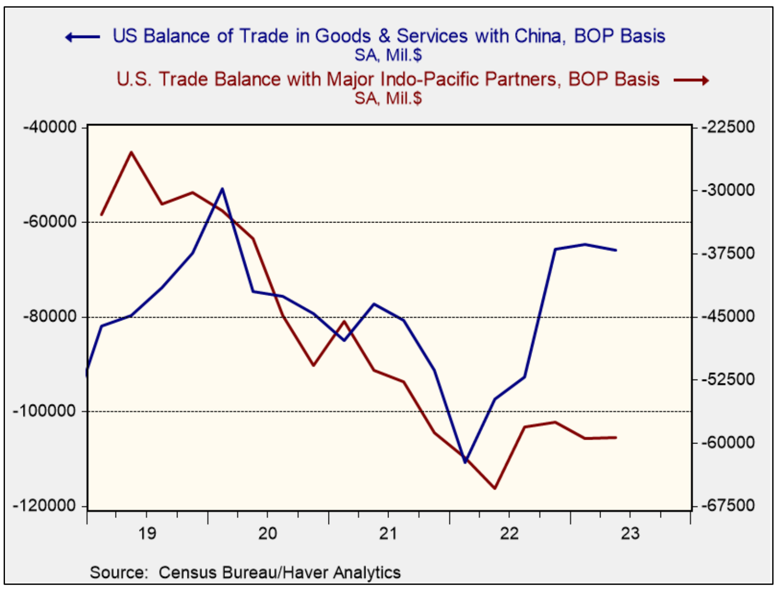


(Source: Tax Policy Center)

- Controlling the federal budget deficit is likely to play a key role in the upcoming presidential elections. Over the past five years, the country has seen an unusually sharp rise in spending due to the pandemic response, funding for clean energy, and tax cuts. The position by House Speaker Johnson suggests that he plans to push for more spending cuts to resolve the budget shortfall, while Democrats in the Senate are likely to push for tax increases to fill the gap. The upcoming elections could hinge on whether the country is willing to give up Trump's tax cuts, which expire in 2025, or fund Biden's energy transition, which will require significant spending in 2024.

U.S. and China Face Off: Leaders of the largest economies are set to meet in San Francisco on Monday in an effort to dial back tensions.

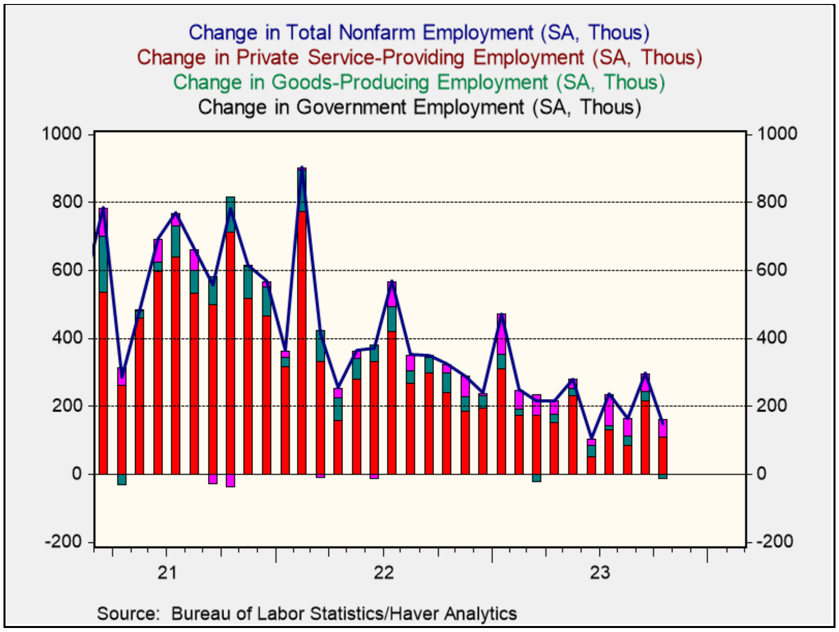
- The two leaders will focus on the deteriorating U.S.-China relationship, which is evident in China's growing assertiveness in the Indo-Pacific, close ties to Russia, neutral stance on the Israeli-Palestinian conflict, and other issues. While the meeting is unlikely to produce any breakthroughs, the hope is that it will allow the leaders to put their differences on the table and prevent miscalculations that could lead to conflict. Last week, President Biden reaffirmed the U.S. government's commitment to defending the Philippines in the event of an attack by China in the South China Sea. Beijing responded by warning the United States to stay out of other countries' affairs.
- Despite factions in both countries that favor cooperation, the U.S. and China appear to be drifting apart. American companies still rely heavily on China for sales growth. For example, Apple (AAPL, $177.57) shares fell 3.0% after reporting weak sales in China, the world's second-largest economy. At the same time, Chinese factories could lose market share to foreign competitors due to U.S. reshoring efforts. Nevertheless, the de-risking trend is accelerating as evidenced by the 14% decline in Chinese holdings of U.S. Treasury securities and the sharp drop in U.S. imports of Chinese goods and services to their lowest level since late 2020.



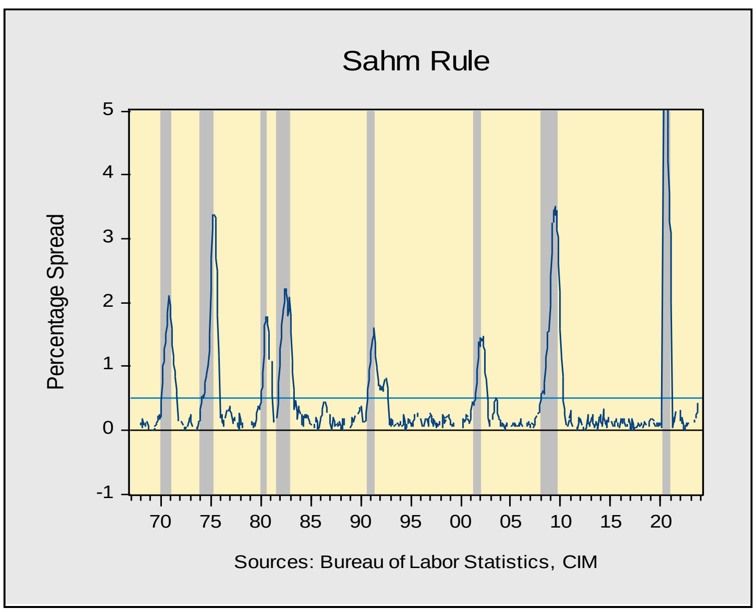
- The divorce between the world's two largest economies is likely to unfold over the next few years, with the biggest impact on large companies with significant revenue exposure abroad. Small and medium-sized businesses, which are typically domestically focused, are somewhat insulated from the uncertainty surrounding the U.S.-China relationship. However, countries such as Mexico and Poland are well-positioned to take advantage of the shift as they have the manufacturing capacity and skilled labor needed to fill the output void from companies looking to reduce their reliance on China.

U.S. Economic Releases

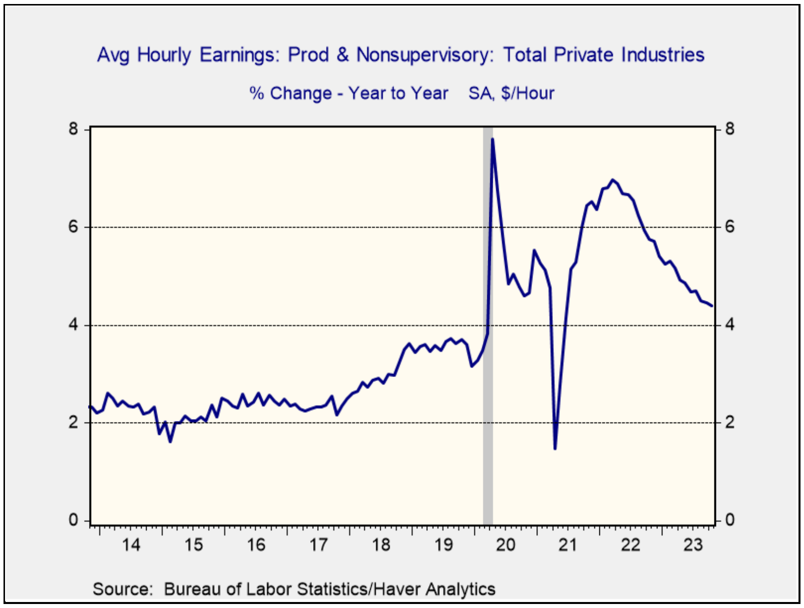
The U.S. labor market finally showed signs of slowing in October, with nonfarm payrolls rising 150k, according to the Bureau of Labor Statistics. The report missed market expectations of 180k and the previous month's revised increase of 297k. Most of the gains came from the private sector, which added 99k jobs last month, led by education and health services. The weak report was heavily influenced by the number of workers on strike, so payrolls may see a bounce in next month's report.



The household survey in October reinforced the bleak view of the labor market, with the unemployment rate rising to 3.9%. This was above estimates of 3.8% but slightly below the Salm Rule indicator of 4.0%, which signals a recession when the three-month moving average of the unemployment rate rises 50 basis points or more above its 12-month low.



Additionally, the labor participation rate fell slightly from 62.8% to 62.7%, while underemployment rose from 7.0% to 7.2%. That said, the labor market remains relatively tight, which has supported higher wages for workers. The average hourly earnings rose to a seasonally adjusted $34.00, up 4.1% since October 2022, while production and nonsupervisory workers saw a seasonally adjusted increase of 4.4% to $29.19 last month.



The less-than-stellar jobs report likely supports the Fed's pause on rate hikes as higher interest rates are starting to impact the labor market. This could lead to a sharp increase in risk-on trading behavior as investors price in a possible peak in policy rates.

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 Services PMI	m/m	Oct F	50.9	50.9	**
9:45	S&P Composite PMI	m/m	Oct F	--	51.0	**
10:00	ISM Services Index	m/m	Oct	53	53.6	**
Federal Reserve						
EST	Speaker or Event	District or Position				
10:00	Thomas Barkin Speaks on CNBC	President of the Federal Reserve Bank of Richmond				
12:45	Neel Kashkari Speaks at Economic Club of Minnesota	President of the Federal Reserve Bank of Minneapolis				
15:30	Michael Barr Speaks About Community Reinvestment Act	Federal Reserve Board Vice Chair for Supervision				
15:30	Raphael Bostic Speaks on BTV	President of the Federal Reserve Bank of Atlanta				

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								
South Korea	Foreign Reserves	y/y	Oct	41287.0%	$414.12b		*	Equity and bond neutral
China	Caixin Composite PMI	m/m	Oct	50.0	50.9		**	Equity and bond neutral
	Caixin Services PMI	m/m	Oct	50.4	50.2		**	Equity and bond neutral
India	S&P Composite PMI	m/m	Oct	58.4	61.0		**	Equity bearish, bond bullish
	S&P Services PMI	m/m	Oct	58.4	61.0		**	Equity bearish, bond bullish
EUROPE								
Eurozone	Unemployment Rate	m/m	Sep	6.5%	6.4%	6.4%	**	Equity and bond neutral
France	Industrial Production	y/y	Sep	-0.1%	-0.5%	-0.3%	***	Equity and bond neutral
	Manufacturing Production	y/y	Sep	-0.9%	-1.1%	-0.9%	**	Equity and bond neutral
Italy	Unemployment Rate	m/m	Sep	7.4%	7.3%	7.4%	**	Equity and bond neutral
UK	S&P/CIPS Services PMI	m/m	Oct F	49.5	49.2	49.2	**	Equity and bond neutral
	S&P/CIPS Composite PMI	m/m	Oct F	48.7	48.6	48.6	**	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	27-Oct	$575.5b	$573.2b		***	Equity and bond neutral
	S&P Global Russia Services PMI	m/m	Oct	53.6	55.4		**	Equity bearish, bond bullish
	S&P Global Russia Composite PMI	m/m	Oct	53.6	54.7		**	Equity bearish, bond bullish
	Money Supply, Narrow Definition	w/w	27-Oct	18.47t%	18.59t		*	Equity and bond neutral
AMERICAS								
Mexico	Gross Fixed Investment	y/y	Aug	32.0%	29.1%	28.0%	**	Equity bullish, bond bearish

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)	565	564	1	Up
3-mo T-bill yield (bps)	526	527	-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)	540	539	1	Up
10-yr T-note (%)	4.64	4.66	-0.02	Flat
Euribor/OIS spread (bps)	397	395	2	Up
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
Yen	Up			Down
Pound	Up			Down
Franc	Up			Down

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	$87.10	$86.85	0.29%	
WTI	$82.86	$82.46	0.49%	
Natural Gas	$3.48	$3.47	0.20%	
Crack Spread	$22.51	$22.54	-0.10%	
12-mo strip crack	$24.06	$24.04	0.10%	
Ethanol rack	$2.14	$2.15	-0.82%	
Metals				
Gold	$1,987.85	$1,985.78	0.10%	
Silver	$22.63	$22.77	-0.58%	
Copper contract	$366.80	$367.25	-0.12%	
Grains				
Corn contract	$468.25	$470.00	-0.37%	
Wheat contract	$566.00	$565.50	0.09%	
Soybeans contract	$1,334.75	$1,328.25	0.49%	
Shipping				
Baltic Dry Freight	1,385	1,401	-16	
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	79	0	

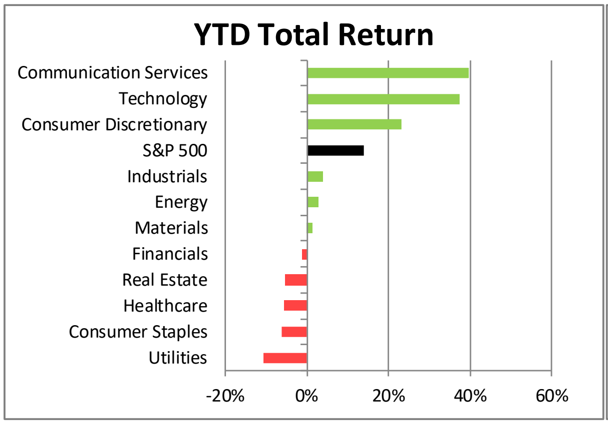
Weather

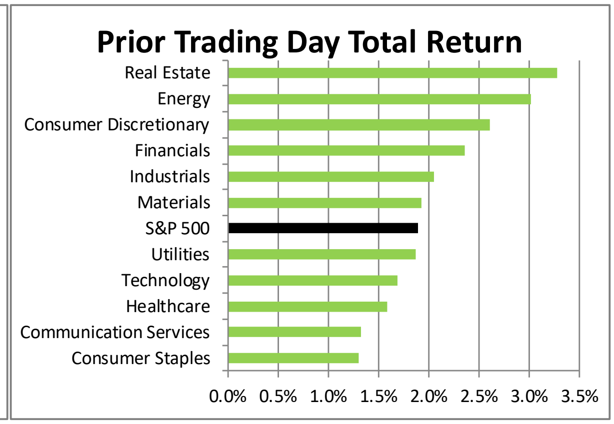
The 6-10 and 8-14 day forecasts predict warmer-than-normal temperatures for most of the country, with cooler temperatures expected in New England. The precipitation outlook shows wetter-than-normal conditions in most states, with dry conditions expected in the Rocky Mountain and Central Pacific regions.

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 10% 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 11/2/2023 close)

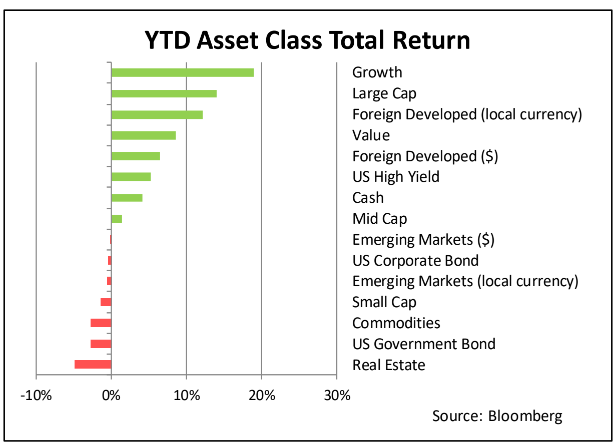




(Source: Bloomberg)

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 11/2/2023 close)

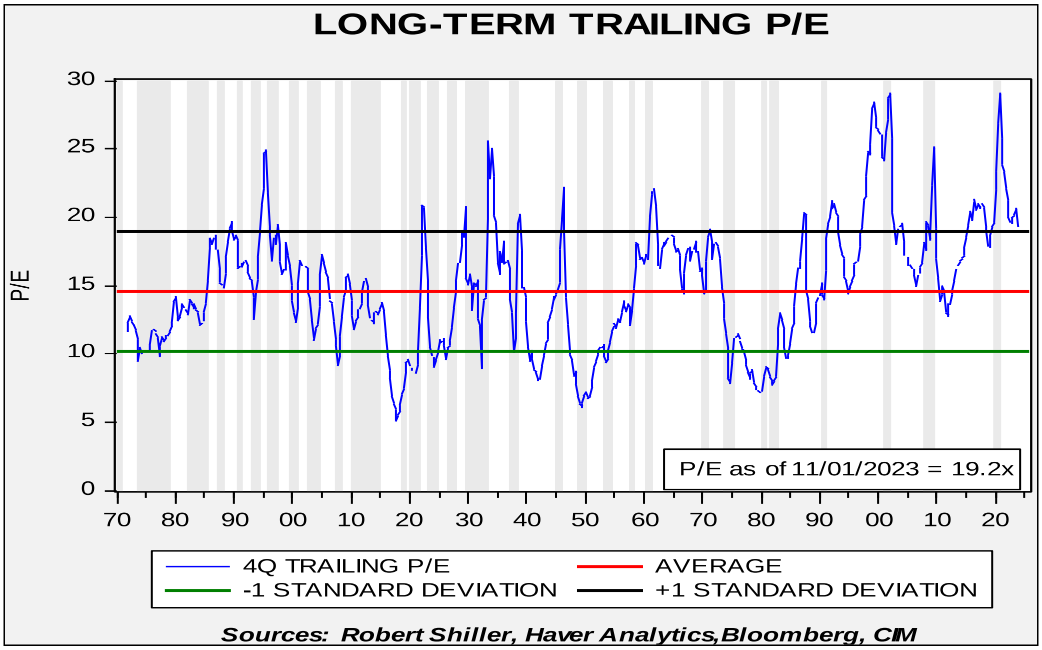


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.