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 6, 2023—9:30 AM EST] Global equity markets are mostly higher this morning. In Europe, the Euro Stoxx 50 is down 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 2.7%. Chinese markets were higher, with the Shanghai Composite up 0.9% from its previous close and the Shenzhen Composite up 2.1%. U.S. equity index futures are signaling a higher open.

With 405 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, 82.0% have exceeded expectations while 14.6% 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:

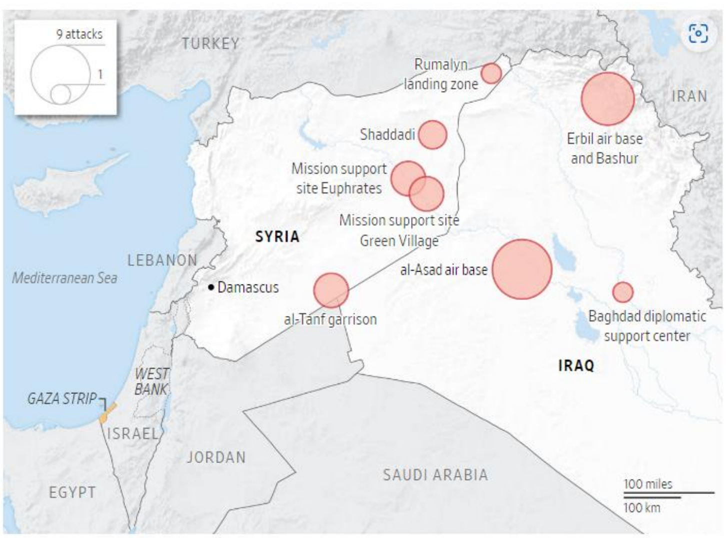
- *Bi-Weekly Geopolitical Report* (10/30/2023) (with associated podcast): "Investment Implications of the Israel-Hamas Conflict"
- *Weekly Energy Update* (11/2/2023): The weekly data was modestly bullish this week, although we do note that refining activity remains depressed due to seasonal maintenance. 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* (11/6/2023) (with associated podcast): "The Inflation Adjustment for Social Security Benefits in 2024"**

Our *Comment* today opens with an update on the Israel-Hamas conflict, where we continue to see a risk that the fighting could expand regionally and potentially even draw in the U.S. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including a new ban on short selling in South Korea and additional signs of softer labor demand in the U.S.

Israel-Hamas Conflict: The Israel Defense Forces continue to attack Hamas forces in the Gaza Strip, with a focus on stand-off attacks against the entry and exit points of the extensive tunnel network the terrorist government has built throughout the enclave. The strikes have reportedly trapped many Hamas fighters in the tunnels with no electricity, light, or air conditioning. Meanwhile, Iranian-backed groups in the region continue to launch drone, missile, and air attacks against Israel and U.S. forces in the region (see map below). In an effort to reassure allies that the U.S. will carefully calibrate its response to those attacks, Secretary of State Blinken made a surprise trip to several regional capitols over the weekend.

- The IDF reportedly plans to continue its strikes on the tunnel network until at least 65% of its entry and exit points have been destroyed. Outside analysts currently estimate about 50% have been destroyed.
- The continuing rise in reported civilian casualties suggests that Hamas has built many of those entry and exit points under residential and commercial buildings. The IDF insists that it gives fair warning for civilians to evacuate before each strike, but many civilians with no place to go still die in the airstrikes or artillery and tank fire.
- The mounting civilian casualties and growing anger at Israel around the world will probably raise the risk of retaliation, against both Israel and the U.S., by Iranian-backed Islamist groups such as Hezbollah in southern Lebanon. If they continue, they could potentially even prompt attacks on Israel by regional states, including Iran. In other words, there is still a risk that the conflict will expand into a dangerous regional war that could crimp global oil supplies and drive-up energy prices.

Attacks against U.S. and Coalition Forces



Note: Data shows attacks between Oct. 17 and Nov. 4.
Source: the Pentagon

Israel: As we have warned, the fight against Hamas is now starting to have palpable negative effects for Israeli businesses, with firms struggling to deal with plummeting demand, the loss of workers called up for reserve duty, and consumers in border areas fearful to go out on shopping trips. Prime Minister Netanyahu has promised vast, pandemic-style cash transfers to affected firms and workers, but the aid package is already being criticized as too small.

Japan: Now that the Bank of Japan has softened its yield curve control policy and signaled it will let longer-term yields rise, several major Japanese banks have raised the (still miniscule) interest rates they offer on time deposits. For example, Sumitomo Mitsui Trust Bank, a unit of Sumitomo Group (SSUMY, $21.11) said it will hike the annual interest paid on five-year noncancelable deposits to 0.10% from 0.01% previously. (So far, we have seen no reports of Japanese depositors dancing for joy in the streets.)

South Korea: The Financial Services Commission today issued a blanket ban on short selling listed stocks until June 2024. In a statement, the Commission claimed the ban was necessary to ensure "fair price formation in the domestic market" following "repeated illegal naked short selling by global institutional investors." Nevertheless, the move is being seen as a sop to retail investors ahead of next year's parliamentary elections. In response, Korean stock-price indexes today have surged as much as 6%.

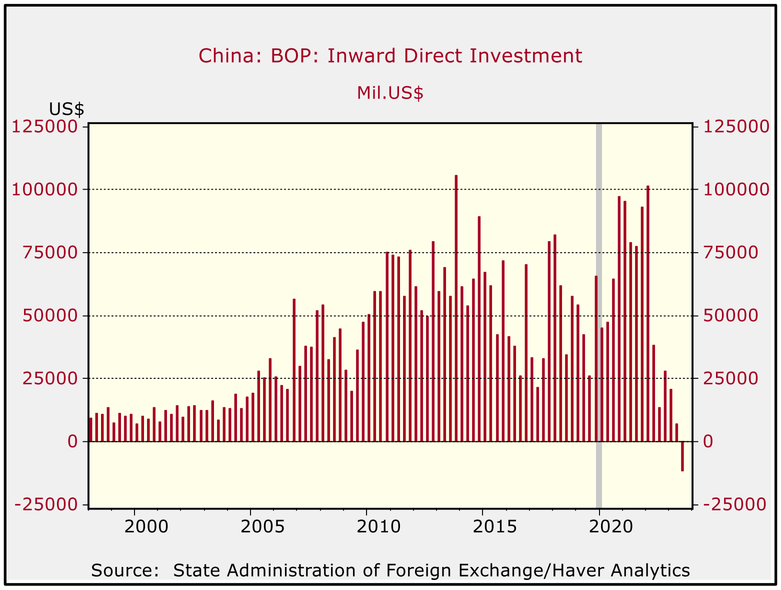
China-Russia: On Friday, the Commercial Aircraft Corp. of China, otherwise known as Comac, gave an update on the development progress of its long-delayed widebody jet, the C929, without mentioning its Russian joint-venture partner, United Aircraft Corp. (UAC). That marks the second time in two months that Comac has given an update without mentioning the Russian firm, which suggests UAC has dropped out of the project.

- If the Russian firm has indeed dropped out of the C929 project, it could signal that the firm is a casualty of the Western sanctions on Russia for its invasion of Ukraine.
- After similarly long delays, Comac's single-aisle C919 aircraft, designed to compete with the 737 from Boeing (BA, $195.05), began flying commercially only in May.
- Despite China's successful industrial policies to develop products such as electric vehicles and mid-range semiconductors, it continues to struggle with large civilian airliners. For now, that suggests the global market for such aircraft will remain a duopoly between Boeing and Europe's Airbus (EADSY, $34.59).

China: New analysis of Chinese data suggests foreign companies pulled more than $160 billion of earnings out of the country over the six successive quarters ended in September. Reflecting that, net foreign direct investment in China in the third quarter of 2023 turned negative for the first time in a quarter-century, and the value of the yuan (CNY) fell to its lowest level in a decade.

- The withdrawal of foreigners' earnings reflects a range of factors, such as rising interest rates in the West, slowing growth as the Chinese economy matures, and headwinds from poor consumer demand, high debt levels, bad demographics, and disincentives arising from the government's increasingly intrusive control over business.
- In addition, the economy is slowing from foreign decoupling, i.e., new barriers to trade, capital, and technology flows with China. In other words, the pull-out of earnings is also

another example of how the world is fracturing into relatively separate geopolitical and economic blocs, as we've written about in depth.



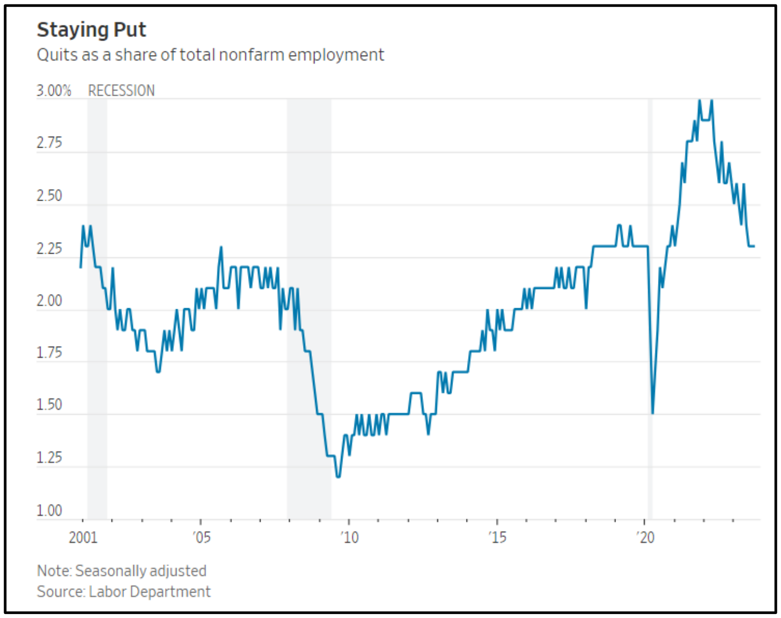
European Union: In an interview with the *Financial Times*, EU Transportation Commissioner Adina Vălean said Brussels has launched an investigation into the big fare increases of 30% or more that European airlines imposed during the summer. The European Commission has no authority to regulate airfares, but the probe is a useful reminder that governments around the world may not rely solely on tight monetary policy to fight inflation. Executive and legislative branches of government can also put regulatory pressure on firms, perhaps including price caps.

Germany: Tesla (TSLA, $219.96) last week reportedly announced big pay increases for the workers at its "Gigafactory" near Berlin. Chief executive Elon Musk also promised the workers that they will build the firm's next-generation electric vehicle. The moves come as Tesla is trying to fend off an organization effort at the plant by Germany's powerful IG Metall union. If the plant is successfully unionized, it would likely encourage efforts to organize other Tesla facilities around the world.

Sweden: Separate from the German situation, the IF Metall trade union that launched a strike against Tesla in late October claims the company will open talks with it today. Although Tesla doesn't manufacture autos in heavily unionized Sweden, it does employ about 120 mechanics at its service centers there, and those workers have been agitating for a union. If the company ultimately acquiesces to the mechanics' demands, it could also potentially encourage further unionization efforts elsewhere.

U.S. Labor Market: In contrast with the post-pandemic "Great Resignation," when employers reported big jumps in voluntary quits, the softening white-collar labor market has now pushed turnover down steeply. The latest JOLTS report from the Labor Department shows the quits rate is now back down to where it was just before the pandemic. As a result, some businesses are over-staffed, which will heighten the risk of bigger layoffs as the economy slows.

- In a further sign of softer demand for white-collar workers, major consulting firms such as McKinsey and Bain & Co. say they are freezing starting pay for new graduates they will hire in 2024.
- Nevertheless, the firms continue to pay rich salaries to new employees. McKinsey, for example, offers a base pay of $192,000 per year for fresh MBA graduates.



U.S. Economic Releases

There were no economic releases prior to the publication of this report.
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**
11:00	Lisa Cook Speaks on Financial Stability	Member of the Board of Governors

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	Jibun bank Composite PMI	m/m	Oct F	50.5	49.9		*	Equity and bond neutral
	Jibun Bank Services PMI	m/m	Oct F	51.6	51.1		**	Equity and bond neutral
Australia	Melbourne Institute Inflation	y/y	Oct	5.1%	5.7%		**	Equity and bond neutral
New Zealand	ANZ Commodity Price	m/m	Oct	2.9	1.3	1.4	**	Equity bearish, bond bullish
EUROPE								
Eurozone	HCOB Eurozone Services PMI	m/m	Oct F	47.8	47.8	47.8	**	Equity and bond neutral
	HCOB Eurozone Composite PMI	m/m	Oct F	46.5	46.5	46.5	*	Equity and bond neutral
Germany	Factory Orders WDA	y/y	Sep	-4.3%	-4.2%	-6.3%	***	Equity bullish, bond bearish
	HCOB Germany Services PMI	m/m	Oct F	48.2	48.0	48.0	**	Equity and bond neutral
	HCOB Germany Composite PMI	m/m	Oct F	45.9	45.8	45.8	*	Equity and bond neutral
France	HCOB France Services PMI	m/m	Oct F	45.2	46.1	46.1	**	Equity bearish, bond bullish
	HCOB France Composite PMI	m/m	Oct F	44.6	45.3	45.3	*	Equity bearish, bond bullish
Italy	HCOB Italy Composite PMI	m/m	Oct	47.0	49.2	47.7	*	Equity bearish, bond bullish
	HCOB Italy Services PMI	m/m	Oct	47.7	49.9	48.5	**	Equity bearish, bond bullish
UK	New Car Registrations	y/y	Oct	14.3%	21.0%		*	Equity bearish, bond bullish
	S&P Global/CIPS UK Construction PMI	m/m	Oct	45.6	45.0	46.0	**	Equity and bond neutral
Switzerland	Domestic Sight Deposits CHF	w/w	3-Nov	465.0b	463.1b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	3-Nov	474.6b	472.1b		*	Equity and bond neutral
AMERICAS								
Canada	Net Change in Employment	m/m	Oct	17.5k	63.8k	25.0k	***	Equity and bond neutral
	Unemployment Rate	m/m	Oct	5.7%	5.5%	5.6%	***	Equity and bond neutral
	S&P Global Canada Services PMI	m/m	Oct	46.6%	47.8%		*	Equity and bond neutral
	S&P Global Canada Composite PMI	m/m	Oct	46.7%	47.4%		***	Equity and bond neutral
Mexico	Consumer Confidence	m/m	Oct	46.0%	46.8%		*	Equity and bond neutral
Brazil	Current Account Balance	m/m	Sep	-$1375m	-$778m	-$740m	**	Equity and bond neutral
	Foreign Direct Investment	m/m	Sep	$3752m	$4270m	$4550m	**	Equity and bond neutral
	S&P Global Brazil Composite PMI	m/m	Oct	50.30%	49.00%		***	Equity and bond neutral
	S&P Global Brazil Services PMI	y/y	Oct	51.00%	48.70%		**	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	565	-1	Up
3-mo T-bill yield (bps)	525	525	0	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	536	536	0	Flat
U.S. Libor/OIS spread (bps)	538	537	1	Down
10-yr T-note (%)	4.60	4.57	0.03	Flat
Euribor/OIS spread (bps)	396	397	-1	Up
Currencies	Direction			
Dollar	Flat			Up
Euro	Up			Down
Yen	Down			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.

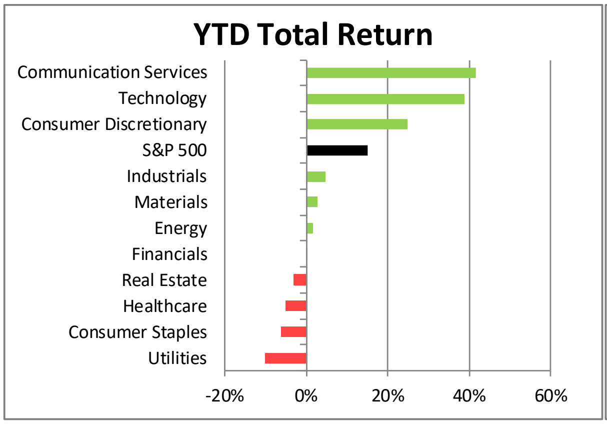
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$85.95	$84.89	1.25%	
WTI	$81.66	$80.51	1.43%	
Natural Gas	$3.36	$3.52	-4.30%	Supply Optimism
Crack Spread	$22.01	$21.65	1.65%	
12-mo strip crack	$23.66	$23.41	1.07%	
Ethanol rack	$2.18	$2.17	0.47%	
Metals				
Gold	$1,984.84	$1,992.65	-0.39%	
Silver	$23.13	$23.21	-0.35%	
Copper contract	$370.80	$368.15	0.72%	
Grains				
Corn contract	$478.25	$477.25	0.21%	
Wheat contract	$567.75	$572.50	-0.83%	
Soybeans contract	$1,365.25	$1,351.75	1.00%	
Shipping				
Baltic Dry Freight	1,462	1,385	77	

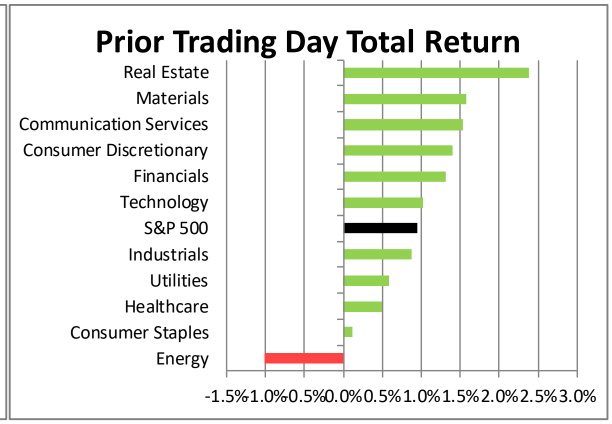
Weather

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 that wetter-than-normal conditions are expected to spread from the West and South to most of the country, while dry conditions are expected in New England.

Data Section

U.S. Equity Markets – (as of 11/3/2023 close)

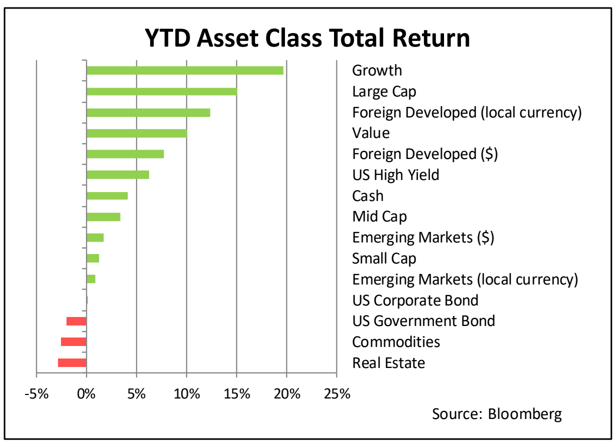




(Source: Bloomberg)

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 11/3/2023 close)

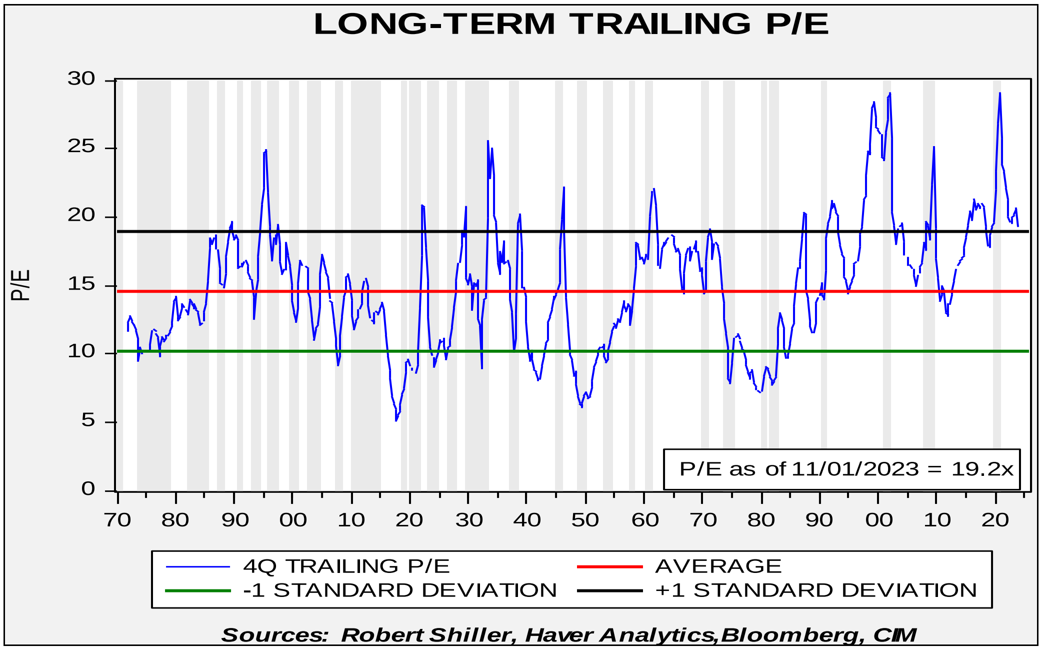


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.