Confluence INVESTMENT MANAGEMENT

Daily Comment

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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 8, 2023—9:30 AM EST] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.6%. Chinese markets were mixed, with the Shanghai Composite down 0.2% from its previous close and the Shenzhen Composite up 0.1%. U.S. equity index futures are signaling a higher open.

With 424 companies having reported so far, S&P 500 earnings for Q3 are running at $58.30 per share compared to estimates of $57.42, which is up 1.7% from Q2 2023. Of the companies that have reported thus far, 81.8% 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"

Good morning. Equity markets are mostly treading water this morning, and Chair Powell will speak later today. Interest rates are also mostly steady, but commodities are mixed as oil and gold are lower while grains are higher.

In today's *Comment,* we start our coverage with a recap of yesterday's state and local elections. Next is our update on the situation in Gaza. A roundup of economic and financial news follows. China is next on the docket, and we close with our international overview.

Elections: Democrats generally did well last night. Meanwhile, budgets and AI are background issues.

- Going into last night's elections, there was a general level of concern among Democrats due to recent adverse polling. However, for the most part, the party outperformed expectations.
    - Abortion continues to bring out voters for Democrats. Ohio voters chose to put abortion access into the state's constitution, for example.
    - Governor Beshear was re-elected in Kentucky, a deeply red state.
    - In Pennsylvania, voters supported Democrats in local elections despite weak poll numbers in that state for President Biden.
    - In Virginia, Democrats gained control of the statehouse, thwarting Governor Youngkin's goal of a Republican takeover. This loss may dim his national aspirations.
- The House GOP can't seem to agree on a plan of action to deal with the fiscal budget. One idea being floated is a series of continuing resolutions, essentially creating a series of "fiscal cliffs." To some extent, the budget talks have an air of "rearranging the deck chairs on the Titanic" in that the deficit is spiraling in an unsustainable path, and there is little evidence either party is paying attention.
- We are about a year away from presidential elections, and there are reports that AI generated videos are becoming indistinguishable from real ones, which means that video disinformation may become just about impossible to control. Not only does this create conditions where political operatives can generate mayhem, but it also gives foreign actors outsized influence. We have been monitoring this issue for some time, and the speed of development has been surprising. It is unclear how this will affect elections next year, but this factor adds to an already unsettling political environment.

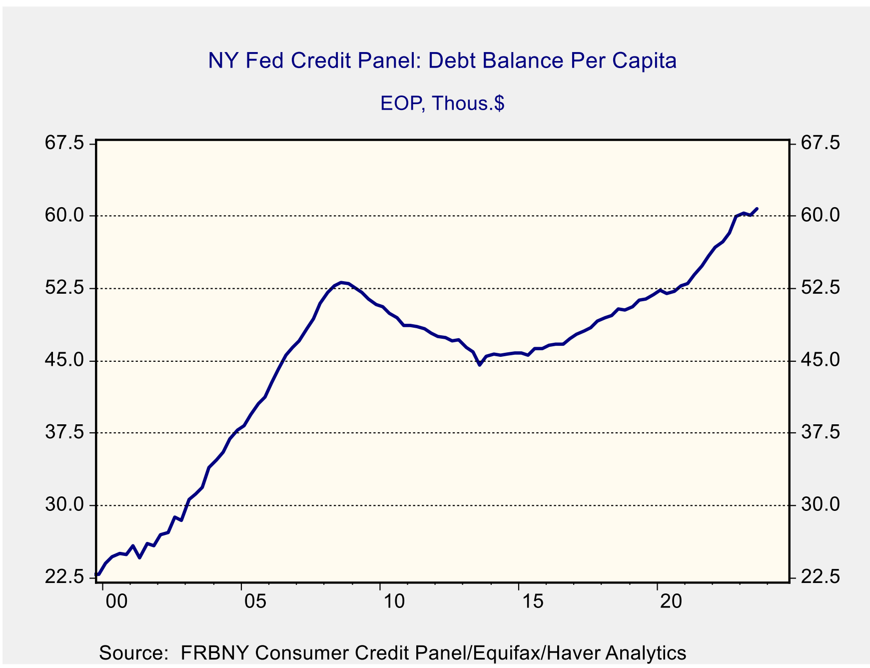
Gaza: IDF has entered Gaza city, and the U.S. is warning Israel against taking control of Gaza.

- According to reports, Israeli forces have entered Gaza City. This battle will be difficult for the Israelis, since in general terms, defense is easier than offense. Complicating matters further is that urban warfare is difficult, and Hamas is well prepared for this attack with a well-established tunnel system. We would expect the conflict to become bogged down from this point forward.
- The U.S. is warning Israel that it probably isn't a good idea to occupy Gaza. Given how rapidly this situation is evolving (it was a month ago that Hamas attacked Israel), it appears that the Netanyahu government hasn't sorted out what its plans are. We note that SoS Blinken downplayed the notion of occupation. The fact of the matter is that there are no good solutions to this situation which is why the government is struggling with a plan.

- Arab states are increasing their calls for a ceasefire. China and Russia are echoing these calls in a bid to improve their status in the region.
- The EU is facing an increase in terrorist violence, likely in response to the conflict in Gaza. Extremist activity in the U.K., Belgium, Germany, and France has been reported. The violence appears to be having an impact on immigration policy (see below in International Roundup).
- One of the factors that may have triggered Hamas's attack was normalization between Israel and Saudi Arabia. The Abraham Accords, for the most part, ignored the Palestinian situation and the fact that Arab states signed on suggests that the Palestinians were not a key factor in relations. Initially, Riyadh backed away from normalization talks. However, there are reports the Saudis are still interested in making a deal. If talks go forward, it suggests that the Palestinians have very little leverage in the region.

Economic and Financial News: The NY FRB's household debt data was released yesterday, showing an uptick in borrowing. Commodities are mixed: oil is lower, while beef and grain prices are rising.

- The NY FRB household debt data showed a modest rise in Q3. The debt balance per capita is just above $60k.



- Company reports are hinting that consumer spending may be slowing down. If so, economic activity will likely also decline.
- Oil prices have declined to the levels last seen before the Gaza event. Although there are worries that the conflict will spread, every day that passes with the war staying in Gaza, the fears clearly dissipate.

- Last summer was dry and hot in the central U.S. These conditions create a problem for ranchers, as it forces them to buy hay to feed their animals instead of using grass, and the hay costs rise due to drought. The bottom line is that beef costs are slated to rise further. The CPI for beef was up 7% in September.
- China is increasing its purchases of U.S. soybeans; this buying is boosting soybean prices.

China Update: The IMF upgrades its forecasts for China's economic growth while raising concerns over its real estate situation. Beijing is putting additional controls on the exporting of rare earths.

- The IMF raised its forecasts for this year's growth to 5.4% from 5.0% and lifted next year's forecast GDP to 4.6% from 4.2%. At the same time, the IMF warned that China's housing sector remains a risk to the economy. China has boosted infrastructure spending to lift growth. We view this action as problematic, but the spending is likely better than allowing for a downturn.
- China announced new measures to control exports of rare earths, along with other major commodities such as oil and iron ore. China has been aggressively building oil stockpiles in recent months. Some of this rebuilding is taking advantage of sanctions on Russia and Iran, which have depressed prices for their crude oil. Adding controls is consistent with China's functioning in a multipolar world.
- China is building its stockpile of semiconductor equipment prior to U.S./EU restrictions.
- Polling in China suggests some softening in hostility towards the U.S. This change may reflect the impact of recent meetings.

International Roundup: NATO and the U.S. are suspending a 1990 treaty that limited conventional forces in Europe. Portugal's PM is out, and we include a note on immigration.

- The U.S. and NATO have formally suspended their participation in a treaty that limited conventional forces in Europe, effective December 7. This action follows Russia's withdrawal from the treaty. The treaty was a landmark at the time, signaling a formal end to the Cold War. The pact limited troop levels and armor that could be held by NATO and the Warsaw Pact states. It also forced both parties to inform the other where troops were deployed. However, Russia suspended the treaty in 2007, and it's unclear why NATO and the U.S. waited so long to retaliate. The slow response is an indication of policymakers' denial of Russia's intentions.
- PM Costa of Portugal resigned yesterday after police raided his residence as part of a corruption investigation. The president of Portugal will either need to appoint a new PM or call for elections. The probe concerns how EU funds were spent on green investments.
- Immigration has been a "hot button" issue in the EU for some time. Much of the immigration is coming from Northern Africa and the Middle East. These immigrants, mostly Muslim, have struggled with integrating into Europe and the social disruption has caused political upheaval in the EU, elevating right-wing parties. Part of the problem is that Europe is facing a demographic deficit and needs immigrants, but worries about

cultural disruptions remain unsolved. As tensions have risen, individual nations in Europe are taking action, making a EU-wide policy difficult to implement. The fear is that individual states will try to force the costs of immigration onto other nations, creating fissures within the EU. At this point, we don't see how Brussels can contain this trend, meaning that the immigration issue will likely worsen.

U.S. Economic Releases

Mortgage loan demand picked up slightly last week. Mortgage loan applications rose 2.5% in the week ending November 3, according to the Mortgage Bankers Association. The rise was related to a sharp decline in the average 30-year fixed-rate mortgage which fell from 7.86% to 7.61%. As a result, the applications index for refinancing and purchases rose 1.6% and 3.0%, from the prior week, respectively.

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	Wholesale Trade Sales	m/m	Sep	0.9%	1.8%	**
10:00	Wholesale Inventories	m/m	Sep F	0.0%	0.0%	***
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
9:15	Jerome Powell Delivers Opening Remarks	Chair of the Board of Governors				
13:40	John Williams Delivers Keynote at Fed Research Conference	President of the Federal Reserve Bank of New York				
14:00	Michael Barr Speaks on Community Reinvestment Act	Federal Reserve Board Vice Chair for Supervision				
16:45	Phiip Jefferson Delivers Closing Remarks	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	Leading Economic Index	m/m	Sep P	108.7	109.2	108.8	**	Equity and bond neutral
Australia	Foreign Reserves	m/m	Oct	A$92.1b	A$90.4b		***	Equity and bond neutral
New Zealand	2-Year Inflation Expectations	q/q	4Q	2.76%	2.83%		**	Equity bullish, bond bearish
South Korea	BoP Current Account Balance	m/m	Sep	$5420.7m	$4809.8m	$4984.6m	**	Equity and bond neutral
EUROPE								
Eurozone	Retail Sales	y/y	Sep	-2.9%	-2.1%	-1.8%	*	Equity bearish, bond bullish
Germany	CPI	y/y	Oct F	3.8%	3.8%	3.8%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Oct F	3.0%	3.0%	3.0%	**	Equity and bond neutral
France	Trade Balance	m/m	Sep	-8917m	-8202m	-8330m	**	Equity and bond neutral
	Current Account Balance	m/m	Sep	-2.5b	-0.8b	-1.1b	**	Equity and bond neutral
Italy	Retail Sales	y/y	Sep	1.3%	2.4%		**	Equity bearish, bond bullish
Russia	Official Reserve Assets	m/m	Oct	576.1b	569.0b	--	*	Equity and bond neutral
AMERICAS								
Canada	International Merchandise Trade	m/m	Sep	2.04b	0.72b	1.00b	*	Equity and bond neutral
Mexico	International Reserves Weekly	w/w	3-Nov	$204984m	$204220m		*	Equity and bond neutral
Brazil	FGV Inflation IGP-DI	y/y	Oct	-4.27%	-5.34%	-4.24%	**	Equity and bond neutral
	Net Debt % GDP	y/y	Sep	60.00%	59.90%	59.80%	**	Equity and bond neutral
	Retail Sales	y/y	Sep	3.3%	2.3%	2.4%	***	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)	563	564	-1	Flat
3-mo T-bill yield (bps)	527	527	0	Flat
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	537	536	1	Up
U.S. Libor/OIS spread (bps)	538	538	0	Flat
10-yr T-note (%)	4.58	4.57	0.01	Flat
Euribor/OIS spread (bps)	397	396	1	Up
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Down
Yen	Down			Down
Pound	Down			Down
Franc	Flat			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.

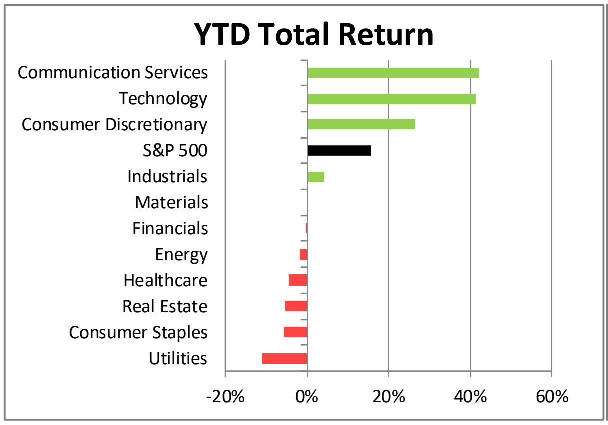
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$80.48	$81.61	-1.38%	
WTI	$76.19	$77.37	-1.53%	
Natural Gas	$3.11	$3.14	-1.08%	
Crack Spread	$23.02	$23.01	0.02%	
12-mo strip crack	$23.91	$24.05	-0.55%	
Ethanol rack	$2.09	$2.11	-0.81%	
Metals				
Gold	$1,962.59	$1,969.45	-0.35%	
Silver	$22.41	$22.64	-0.98%	
Copper contract	$367.05	$367.90	-0.23%	
Grains				
Corn contract	$472.75	$468.50	0.91%	
Wheat contract	$579.00	$570.25	1.53%	
Soybeans contract	$1,380.50	$1,362.00	1.36%	
Shipping				
Baltic Dry Freight	1,559	1,523	36	

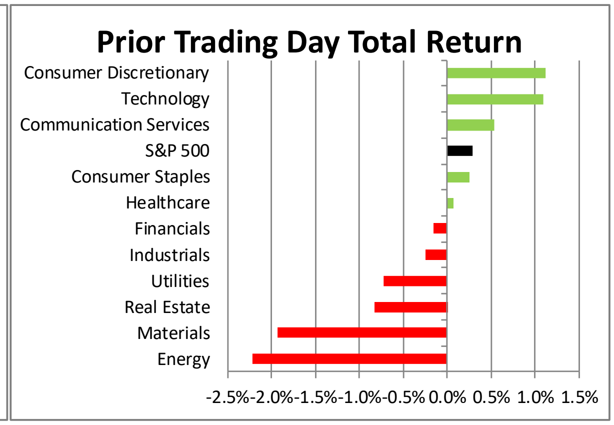
Weather

The 6-10 and 8-14 day forecasts predict warmer-than-normal temperatures for most of the country, with cooler temperatures expected on the West Coast and New England regions. 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 on the New England coast.

Data Section

U.S. Equity Markets – (as of 11/7/2023 close)

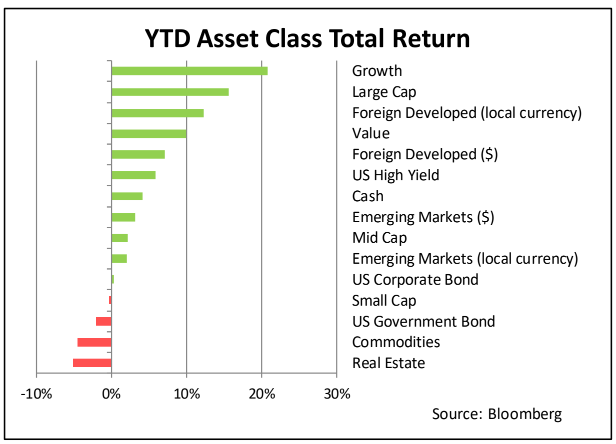




(Source: Bloomberg)

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 11/7/2023 close)

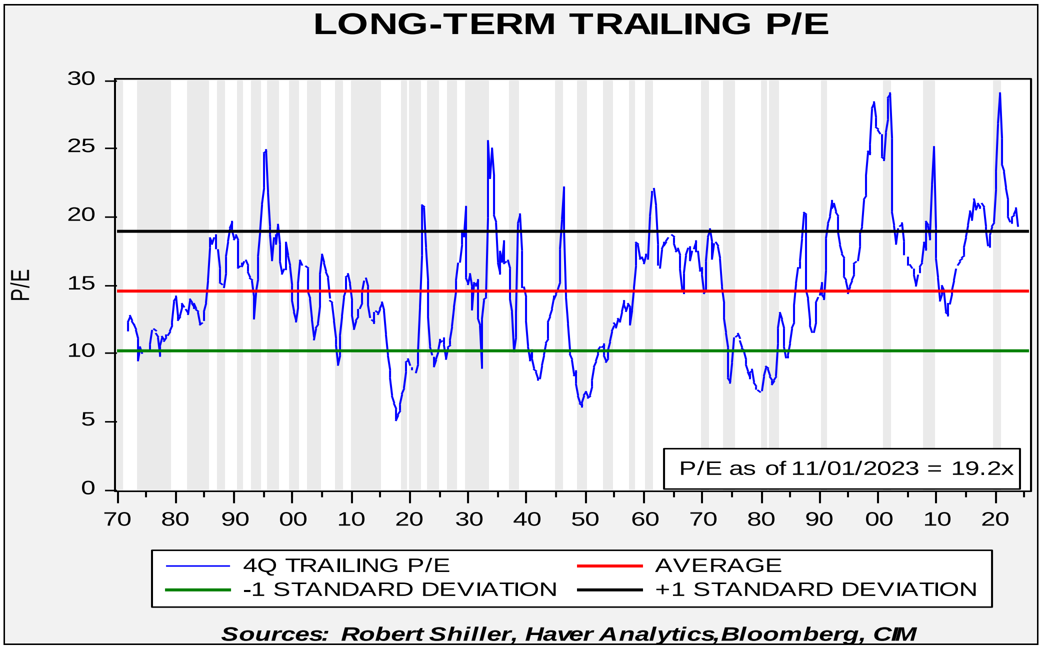


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.