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 10, 2023—9:30 AM EST] Global equity markets are mostly lower this morning. In Europe, the Euro Stoxx 50 is down 0.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.2%. Chinese markets were lower, with the Shanghai Composite down 0.5% from its previous close and the Shenzhen Composite down 0.4%. In contrast, U.S. equity index futures are signaling a higher open.

With 458 companies having reported so far, S&P 500 earnings for Q3 are running at $58.40 per share compared to estimates of $57.42, which is up 1.7% from Q2 2023. Of the companies that have reported thus far, 81.9% 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:

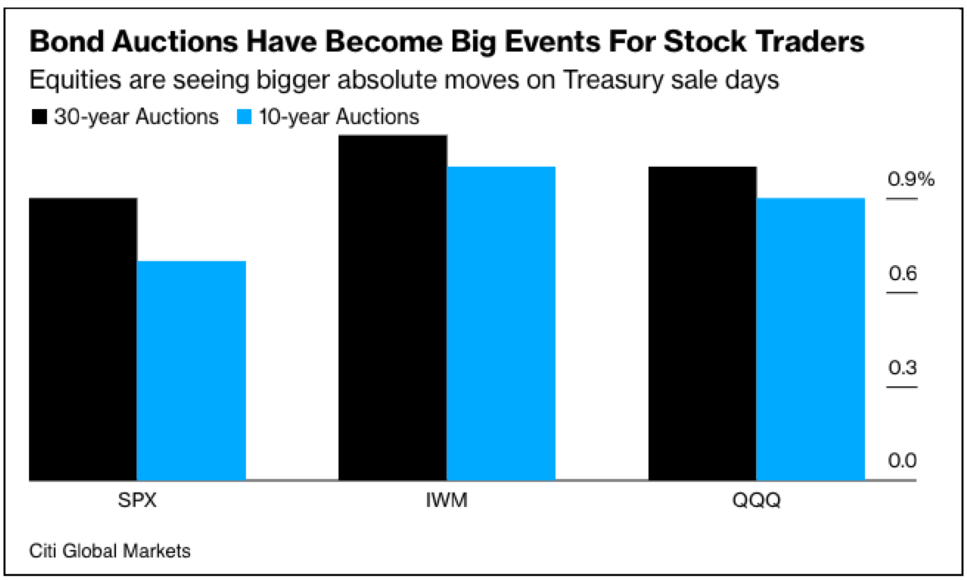
- *Bi-Weekly Geopolitical Report* (10/30/2023) (with associated podcast): "Investment Implications of the Israel-Hamas Conflict"
- *Weekly Energy Update* (11/2/2023): The weekly data was modestly bullish this week, although we do note that refining activity remains depressed due to seasonal maintenance. 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! Gold has retreated on Powell's monetary policy comments, and the National Women's Soccer League has signed major TV deals. Today's *Comment* begins with our thoughts on declining demand for U.S. government bonds. We then discuss the impact of geopolitical competition on the semiconductor industry, and the political ramifications of Senator Joe

Manchin's (D-WV) decision not to run for re-election. As always, our report includes a summary of the latest domestic and international data releases.

Auction Flop: A Treasury bond auction drew weaker-than-expected demand, raising concerns about the path of interest rates.

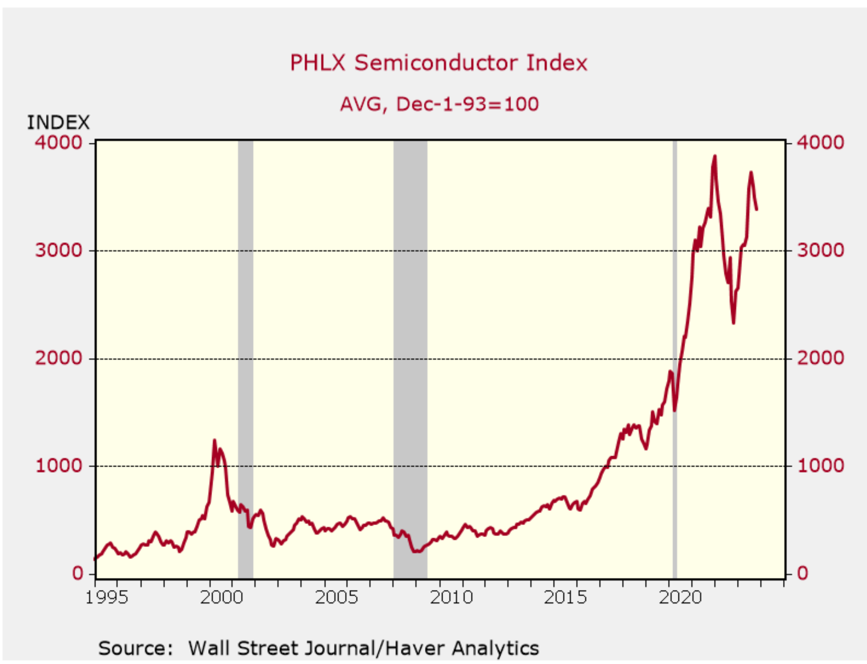
- Thursday's auction of 30-year government bonds yielded 4.769%, 5 basis points higher than the start of pre-auction trading, reflecting investors' reluctance to buy long-duration debt. Wednesday's Treasury auction also underwhelmed expectations. This poor performance has raised concerns that the bond market may be struggling to absorb new U.S. debt issuance. Following the auction, the S&P 500 sank 0.8% and the NASDAQ fell 0.9%, ending the duo's longest winning streaks in almost two decades. The market reaction suggests that investors are concerned about the Federal deficit and the lack of participation from the Federal Reserve in the bond market.
- Treasury auctions have become more important than employment data in recent months, according to research from Citi Global Markets. After analyzing 22 Treasury auctions, the bank found that equity sales have fluctuated more after Treasury auctions than on the day the jobs data is released. This may explain why the stock market rallied earlier this month after the Treasury announced that it would sell $112 billion in fixed-income securities, less than the $114 billion primary dealers had expected. The growing importance of Treasury sales underscores concerns that bondholders' appetite for U.S. debt is waning.



- The scarcity of bond buyers is likely to push up interest rates and tighten financial conditions, as investors demand higher yields to compensate for the liquidity risk. This trend will persist unless policymakers take steps to control the federal deficit, or the Fed expands its balance sheet. Policy rate cuts may also relieve some of this pressure on long-duration securities by discouraging investors from purchasing shorter-duration bonds. Uncertainty about high interest rates will likely lead to increased scrutiny of risky assets, as investors assess the potential impact of higher borrowing costs on corporate earnings. However, the lack of demand for Treasury issuance reduces the chance of another rate hike from the Federal Reserve.

Semiconductor Slump: Despite a strong start to the year fueled by excitement about AI, chipmakers' profits have slipped due to weak demand and a growing supply of semiconductors.

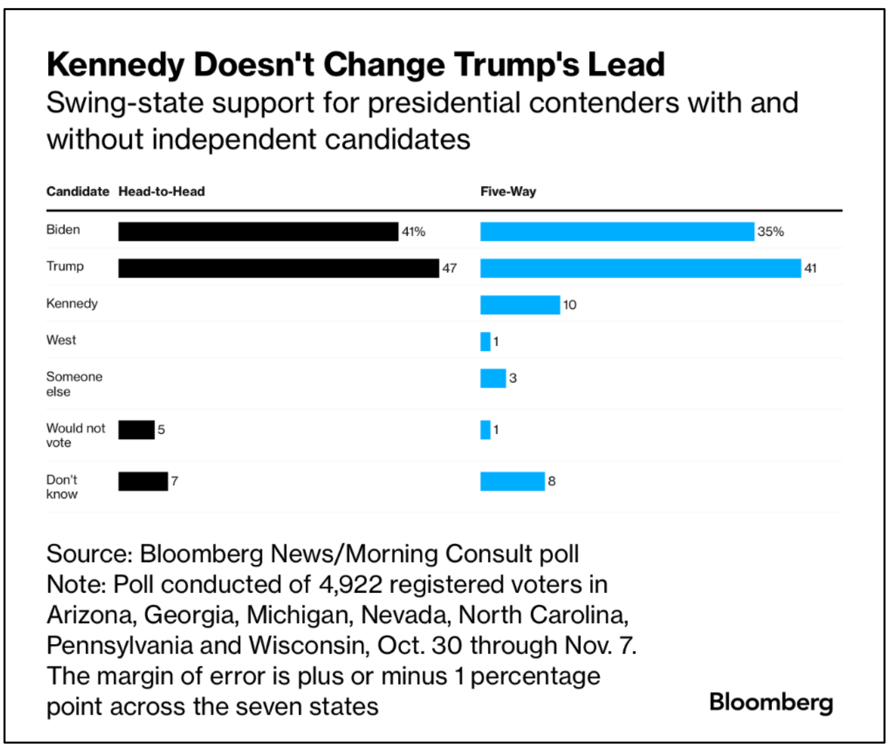
- The PHLX Semiconductor Sector Index has plummeted 11% from its peak in August 2023, drastically outpacing the 3% decline in the S&P 500 from the same period. This is driven by a pessimistic outlook after last year's chip shortage turned into a glut. However, recent earnings reports from Samsung Electronics Co.(005930.KS, KRW, 70,500) and Taiwan Semiconductor Manufacturing Co.(TSM, $91.62) have offered a glimmer of hope for a reversal, as both companies suspect that the market is inching closer to balancing. Meanwhile, Chinese chipmaker Semiconductor Manufacturing International Corp. (SMIC) has voiced concerns that growing geopolitical competition within the space could lead to overcapacity.
- SMIC's concerns appear to be a veiled criticism of U.S. efforts to stifle China's advancement in chipmaking. The Biden administration has imposed export controls that make it more difficult for China to develop chips for military technology. Additionally, the U.S. has allocated resources to build its own domestic chip fabs to reduce its reliance on Taiwan, a major chipmaking hub. China has responded by increasing its spending on semiconductor production. This increased competition has led to a surge in investment in semiconductor production, as both countries seek to insulate themselves from possible supply chain disruptions.



- The easing of tensions between the United States and China is unlikely to improve the outlook for the semiconductor industry, as both sides are seeking to reduce their reliance on the other. As a result, chipmakers are likely to face increased competition, as the massive investments in semiconductors should lead to a battle for market share. This could make technology more affordable in the long term, as firms struggle to maintain market power in an environment where new entrants are likely to emerge. However, the lack of market dominance could also make it difficult for firms to maintain healthy profit margins.

Senate Majority in Danger? West Virginia Senator Joe Manchin's decision not to seek reelection in 2024 gives Republicans a prime opportunity to flip a Senate seat.

- Manchin’s decision not to seek reelection in 2024 jeopardizes the Democratic Party's control of the U.S. Senate. The party will struggle to find a replacement for the moderate Manchin, as there is no apparent frontrunner in the race. West Virginia has a long history of favoring Republican candidates, and former President Donald Trump won the state by a nearly 40% margin in 2020. If the Democrats lose Manchin's seat, the Senate will likely fall into Republican hands. The seat is favored to switch to Conservative West Virginia Governor Jim Justice, and it isn’t clear whether the Democrats will look to save it.
- Senator Manchin's decision not to run for re-election may be related to the growing demand for a third-party challenger in the 2024 presidential election. He has long been associated with the bipartisan No Labels political party, and in his announcement, he mentioned a desire to test the level of support for a candidate who could bring the middle together. So far, several challengers have thrown their hats in the ring, including Harvard Professor Cornel West, environmentalist Jill Stein, and environmental lawyer Robert Kennedy. While third-party candidates are often seen as spoilers, it is unclear whether any of these candidates can swing the election.



- The entrance of third-party candidates increases the likelihood of a contingent election, in which no candidate wins the 270 electoral votes required to win the presidency outright, which has not occurred since 1877. In this case, the Constitution requires the House of Representatives to choose from the top three candidates who received the most electoral votes. Each state gets one delegate, and a candidate needs to receive at least 26 delegates to secure the nomination. The last time this happened, the Democratic and Republican candidates agreed to give the presidency to Republican Rutherford B. Hayes in exchange for the end of Reconstruction in the South. Markets would likely react poorly to this outcome, as it would call the legitimacy of the government into question.

Other News: China is investigating a ransomware attack on the U.S. unit of the Industrial and Commercial Bank of China. The attack on U.S. Treasuries disrupted trading and reflects the ongoing battle to develop the cyber infrastructure needed to prevent hackers from accessing sensitive information. Israel is concerned over a possible war with Hezbollah, in another example of the risk of a spreading Middle East conflict. Cleveland Fed President Lorretta Mester is set to resign in 2024, and she will likely be replaced by another policy hawk. Fed Chair Jerome Powell has warned that Fed officials may look beyond data when determining whether inflation is improving.

U.S. Economic Releases

No major U.S. economic reports have been released so far today. 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	Nov P	63.8	63.8	***
10:00	U. of Michigan Current Conditions	m/m	Nov P	70.3	70.6	**
10:00	U. of Michigan Future Expectations	m/m	Nov P	61.0	59.3	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Nov P	4.0%	4.2%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Nov P	3.0%	3.0%	*
Federal Reserve						
EST	Speaker or Event	District or Position				
9:00	Raphael Bostic Speaks About Economic Mobility	President of the Federal Reserve Bank of Atlanta				
13:00	Mary Daly Speaks on CNBC	President of the Federal Reserve Bank of San Francisco				

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	Money Stock M2	y/y	Oct	2.4%	2.4%		**	Equity and bond neutral
	Money Stock M3	y/y	Oct	1.8%	1.8%		**	Equity and bond neutral
New Zealand	BusinessNZ Manufacturing PMI	m/m	Oct	42.5	45.3	45.1	***	Equity bearish, bond bullish
India	Industrial Production	y/y	Sep	5.8%	10.3%	7.0%	***	Equity bearish, bond bullish
EUROPE								
Italy	Industrial Production WDA	y/y	Sep	-2.0%	-4.2%		*	Equity bullish, bond bearish
UK	Industrial Production	y/y	Sep	1.5%	1.3%	1.5%	***	Equity and bond neutral
	Manufacturing Production	y/y	Sep	3.0%	2.8%	3.0%	**	Equity and bond neutral
	Visible Trade Balance GBP/Mn	m/m	Sep	-£14288m	-£15950m	-£15300m	**	Equity and bond neutral
	Trade Balance GBP/Mn	m/m	Sep	-£1574m	-£3415m	-£2550m	**	Equity and bond neutral
	GDP	y/y	3Q P	0.6%	0.6%	0.5%	***	Equity and bond neutral
Russia	Money Supply, Narrow Definition	w/w	3-Nov	18.48t	18.47t		*	Equity and bond neutral
	Gold and Forex Reserves	m/m	3-Nov	$577.0b	$575.5b		***	Equity and bond neutral
	Trade Balance	m/m	Sep	15.3b	11.0b	10.6b	**	Equity and bond neutral
	Exports	m/m	Sep	40.0b	36.4b	36.1b	*	Equity and bond neutral
	Imports	m/m	Sep	24.7b	25.4b	25.5b	*	Equity and bond neutral
AMERICAS								
Mexico	Manufacturing Production	y/y	Sep	0.8%	-0.6%	-1.1%	*	Equity bullish, bond bearish
	Industrial Production	y/y	Sep	3.9%	5.2%	4.7%	***	Equity bearish, bond bullish
Brazil	IBGE Inflation IPCA	y/y	Oct	--	5.2%	4.9%	***	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)	563	563	0	Flat
3-mo T-bill yield (bps)	526	527	-1	Flat
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 (%)	4.60	4.63	-0.03	Flat
Euribor/OIS spread (bps)	399	397	2	Up
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Up			Down
Yen	Flat			Down
Pound	Flat			Down
Franc	Flat			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Mexico Overnight Rate	11.250%	11.250%	11.250%	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.

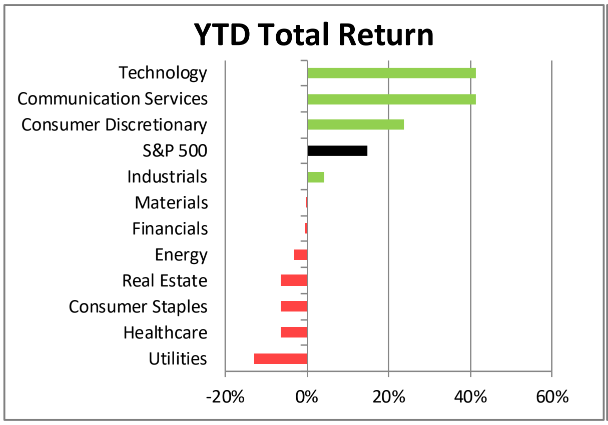
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$80.96	$80.01	1.19%	
WTI	$76.59	$75.74	1.12%	
Natural Gas	$3.02	$3.04	-0.62%	
Crack Spread	$23.34	$23.01	1.44%	
12-mo strip crack	$23.95	$23.86	0.38%	
Ethanol rack	$2.11	$2.12	-0.18%	
Metals				
Gold	$1,947.02	$1,958.55	-0.59%	
Silver	$22.52	$22.64	-0.50%	
Copper contract	$361.90	$364.05	-0.59%	
Grains				
Corn contract	$467.00	$468.00	-0.21%	
Wheat contract	$580.00	$580.75	-0.13%	
Soybeans contract	$1,341.00	$1,343.50	-0.19%	
Shipping				
Baltic Dry Freight	1,598	1,530	68	

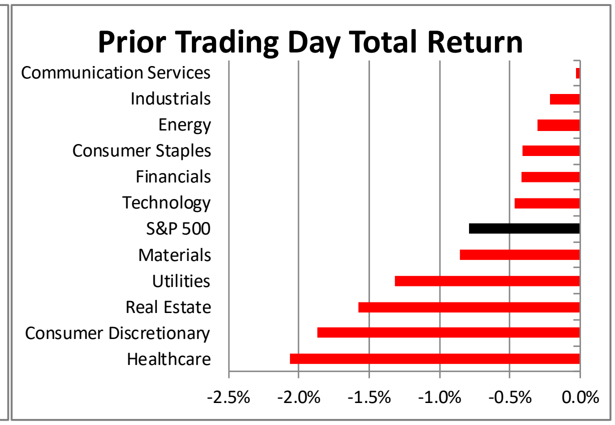
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures from the Rocky Mountains eastward, with cooler-than-normal temperatures in Southern California. The forecasts call for wetter-than-normal conditions in the Far West, the Deep South, and Florida, with dry conditions only in the Upper Midwest.

<u>Data Section</u>

U.S. Equity Markets – (as of 11/9/2023 close)

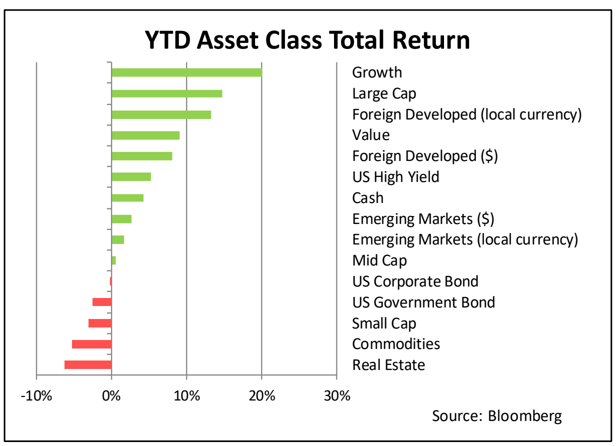




(Source: Bloomberg)

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 11/9/2023 close)

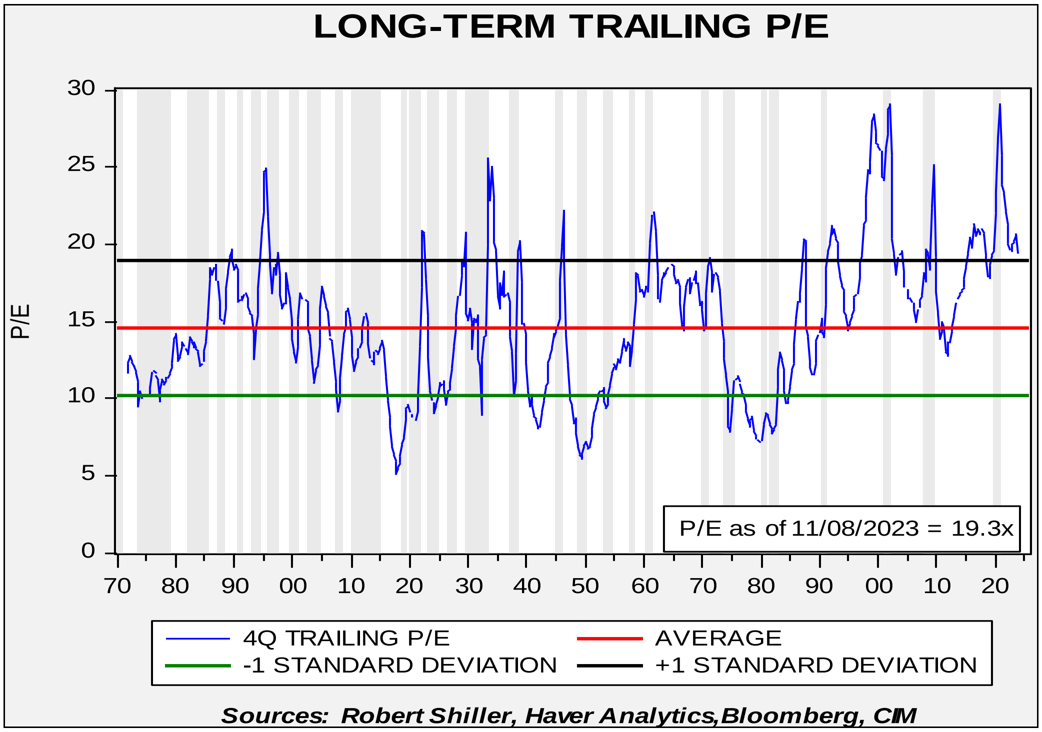


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 10, 2023



Based on our methodology,[1] the current P/E is 19.3x, up 0.1x from last week. The multiple rose on the modest rise in index values.

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.