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 13, 2023—9:30 AM EST] Global equity markets are generally higher this morning. In Europe, the Euro Stoxx 50 is up 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.0%. Chinese markets were higher, with the Shanghai Composite up 0.3% from its previous close and the Shenzhen Composite up 0.6%. In contrast, U.S. equity index futures are signaling a lower 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"

Our *Comment* today opens with the latest on the West's slowing demand for electric vehicles. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including an easing of data regulations in China and a proposal by House Speaker Johnson for a two-step stopgap funding bill to keep the federal government functioning after the current stopgap expires on Friday.

Global Electric Vehicle Industry: As incoming data continues to point to a slowdown in the West's demand for electric vehicles, new research by HSBC (HSBC, $37.03) indicates dealers in key markets now have to offer discounts from the vehicles' suggested retail price. For example, the average discount in October was 11% in the U.K., 10% in the U.S., and 7% in Germany.

- The slowdown in demand reflects a range of factors, from the high price for EVs, rising interest rates, concerns about recharging and safety, and political attacks.
- If it continues, the slowdown threatens to undermine what has been seen by some as a promising new investment sector and a source of new economic growth.
- Nevertheless, at least some companies are continuing to invest in the sector. In news this morning, oil giant Exxon (XOM, $103.75) announced it is starting to drill for lithium in Arkansas and aims to become a major U.S. supplier for makers of EV batteries by 2030.

United States-China: When President Biden and General Secretary Xi meet on Wednesday at the Asia-Pacific Economic Cooperation summit in San Francisco, they will reportedly announce an agreement not to incorporate artificial intelligence into autonomous weapons, such as drones, or into the command and control of nuclear weapons. We haven't seen any details on the deal, but if it is substantive, it would suggest that U.S. and Chinese diplomats have been able to make more progress on cooling bilateral tensions than earlier expected.

- On the other hand, any ban on military AI announced at the meeting could be much less than meets the eye. One big hurdle to such a ban is that verification might be difficult. If neither side can verify with confidence that the other side isn't deploying military AI, the deal could have little practical effect.
- Moreover, it is questionable whether Beijing would countenance or abide by such restrictions. Chinese military doctrine and official statements make clear that the People's Liberation Army not only intends to bulk up to the point where it can compete with the U.S., but also intends to fully leverage AI and other technologies to bolster its warfighting capabilities.

China: Information provider Qichacha announced that the Cyberspace Administration of China has approved its data export security plan, which will allow the company to offer databases of Chinese corporate information in other countries. The approval of Qichacha's plan is a sign that Beijing may be easing its recent draconian limits on providing Chinese information to foreigners.

- Coupled with a range of other government intrusions into business operations, the data export limits have helped sour foreign businesses on China, likely contributing to the recent sharp drop in foreign direct investment into China.
- Easing up on the data export rules and other regulations may be an effort by Beijing to reattract foreign capital and reverse China's ongoing slowdown in economic growth.

Spain: Over the weekend, tens of thousands of protestors marched in cities across the country to register their anger at Prime Minister Sánchez's gambit to win parliamentary support for his Socialist Party government by offering amnesty to Catalan separatists. The move has sparked especially strong condemnation by right-wing populists, who accuse the prime minister of allowing the Catalan separatists, who held an illegal referendum on independence in 2017, to achieve a "coup." The political crisis could potentially weigh on Spanish assets despite the country's relatively good economic performance recently.

United Kingdom: Prime Minister Sunak today replaced Home Secretary Suella Braverman, a controversial right-wing firebrand, with Foreign Secretary James Cleverly. He also named former Prime Minister David Cameron, a moderate who campaigned against Brexit and resigned when the measure passed in 2016, to take over the foreign ministry.

- The moves apparently aim to drag the Conservative Party back toward the political center and close its massive polling gap with the Labor Party ahead of the next election.
- Nevertheless, they could spark increased chaos in the Conservative Party, as Braverman now seems likely to launch a bid to replace Sunak as prime minister.

Israel-Hamas Conflict: Illustrating many of issues involved in the fighting, the Israel Defense Forces are focusing much of their invasion force on Gaza's Al-Shifa hospital to destroy what they say is a Hamas command post located in the facility and in tunnels underneath it. The IDF has demanded that Hamas abandon the hospital, but the militants have refused. Meanwhile, the hospital has virtually run out of fuel, electricity, food, and medical supplies.

- The IDF claims it delivered supplies to a location about 1,000 feet from the hospital, but they were not retrieved. Hospital officials say the fighting has been too intense to collect the supplies, but it isn't clear whether Hamas actually prevented them from doing so.
- Separately, a key foreign policy advisor to the president of the United Arab Emirates warned that Israel's "unparalleled" and "disproportionate" attacks on civilians threaten to spark increased radicalization in the region.
- Indeed, Iran-backed Hezbollah fighters and other Islamist groups continue to attack Israel from the north, keeping alive the risk that the conflict will spread regionally.

U.S. Military: The Air Force's future heavy bomber, the B-21 "Raider," made its first test flight on Friday, about two years later than initially planned. The sixth-generation bomber, with its flying-wing design and advanced capability to network with other platforms, is designed to replace the aging B-1 and B-2 starting later this decade. Its mission will be to deliver either strategic-nuclear or conventional weapons around the world to deter U.S. adversaries such as China, Russia, Iran, and the rest of Beijing's geopolitical bloc.

- The Air Force currently plans to buy at least 100 units of the B-21, at a projected cost of about $750 million each.
- The Defense Department continues struggling to ramp up the output of weapons, ammunition, and supplies as geopolitical tensions rise, but the launch of the B-21 is a reminder that it is making some progress. Other ongoing programs to modernize the U.S. strategic deterrent force include replacing the Air Force's Minuteman III intercontinental ballistic missile with a new "Sentinel" missile and replacing the Navy's Ohio-class ballistic missile submarines with new "Columbia-class" subs.

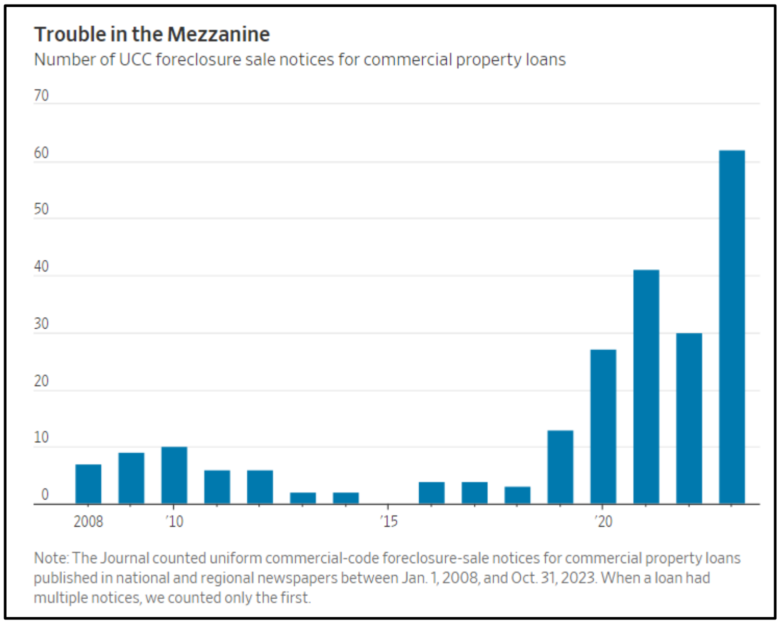
U.S. Fiscal Policy: As Congress continues to bicker over fiscal policy ahead of this Friday's expiration of the current stopgap spending authorization, Moody's (MCO, $344.57) at the end of last week cut its outlook on U.S. Treasury debt from "stable" to "negative." Moody's remains the last of the major credit-scoring firms to give the Treasury its top debt rating, but it warned that the outlook is worsening because of political polarization, expanding federal budget deficits, and worsening debt sustainability.

- With federal spending rising rapidly while tax revenues wither, the widening budget shortfall was probably a contributing factor to the run-up in longer-maturity bond yields over the last couple of months.
- With the current stopgap funding bill set to expire on Friday, newly installed Speaker of the House Mike Johnson has proposed a "laddered" new stopgap measure that would keep the government funded at current levels until early 2024. Under the proposal, some departments would be funded at their current levels until late January, while others would be funded at their current levels until early February.
    - The new continuing resolutions would give lawmakers more time to come up with a deal on funding for the rest of the fiscal year, which runs to September 30.
    - A vote on Johnson's proposal could come as early as Tuesday.

U.S. Labor Market: New analysis by the Federal Reserve Bank of Atlanta shows lower-skilled workers are now seeing much more moderate wage growth than in the first two years of the post-pandemic period. For example, average hourly earnings for workers in the bottom quartile of the wage distribution were up just 5.9% in the year to October, versus a 7.2% rise in the year to January.

- The end of out-sized wage gains for lower-skilled workers suggests the economy is continuing to normalize from the pandemic era's disruptions.
- Nevertheless, their exceptionally large previous wage gains mean that those workers are now capturing a larger share of total wage income, potentially reducing wage inequality and allowing them to consume more in the coming years.

U.S. Commercial Real Estate Market: New analysis by the *Wall Street Journal* shows that lenders this year have issued a record number of foreclosure notices on mezzanine loans and similarly risky loans connected with commercial properties. Mezzanine loans, similar to second mortgages, can be foreclosed much more quickly than first mortgages, so the rapidly rising number of foreclosures provides a more real-time view into the financial stresses caused by rising vacancies and higher interest rates. As the Federal Reserve raises interest rates or keeps them higher for longer, the commercial real estate and/or private debt sectors are probably the most likely domestic source of financial crisis or a recession.



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
14:00	Monthly Budget Statement	m/m	Oct	-$65.0b	-$171.0b	**
Federal Reserve						
No Fed speakers or events for the rest of today						

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	PPI	y/y	Oct	0.8%	2.0%	1.0%	***	Equity bearish, bond bullish
	Machine tool orders	y/y	Oct P	-20.6%	-11.2%		**	Equity bearish, bond bullish
China	New Yuan Loans CNY	m/m	Oct	738.4b	2310.0b	2311.8b	**	Equity and bond neutral
	Money Supply M2	y/y	Oct	10.3%	10.3%	10.3%	***	Equity and bond neutral
	Money Supply M1	y/y	Oct	1.9%	2.1%	2.5%	*	Equity bearish, bond bullish
	Money Supply M0	y/y	Oct	10.3%	10.7%		*	Equity and bond neutral
India	CPI	y/y	Oct	4.87%	5.02%	4.80%	***	Equity and bond neutral
EUROPE								
UK	Rightmove House Prices	y/y	Nov	-1.3%	-0.8%		**	Equity and bond neutral
Switzerland	Domestic Sight Deposits CHF	w/w	10-Nov	467.5b	465.0b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	10-Nov	476.3b	474.6b		*	Equity and bond neutral
Russia	CPI	y/y	Oct	6.7%	6.0%	6.7%	***	Equity and bond neutral
	Core CPI	y/y	Oct	5.5%	4.6%		***	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	563	1	Up
3-mo T-bill yield (bps)	525	525	0	Flat
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	539	538	1	Up
U.S. Libor/OIS spread (bps)	539	539	0	Flat
10-yr T-note (%)	4.64	4.65	-0.01	Flat
Euribor/OIS spread (bps)	399	399	0	Up
Currencies	Direction			
Dollar	Flat			Up
Euro	Down			Down
Yen	Down			Down
Pound	Up			Down
Franc	Down			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.

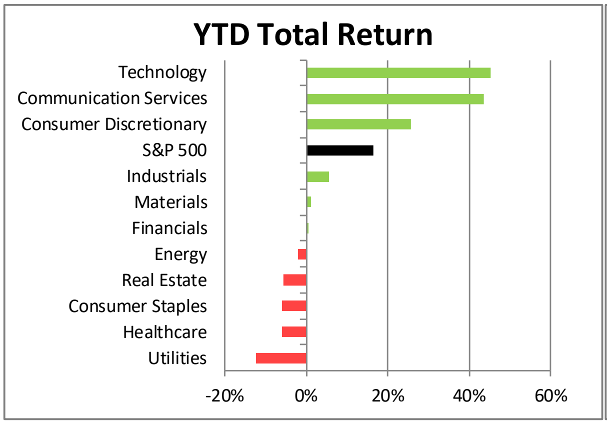
weco	Price	Prior	Change	Explanation
Energy Markets				
Brent	$81.64	$81.43	0.26%	
WTI	$77.27	$77.17	0.13%	
Natural Gas	$3.20	$3.03	5.37%	Demand Optimism
Crack Spread	$22.83	$22.39	1.94%	
12-mo strip crack	$23.80	$23.46	1.43%	
Ethanol rack	$2.09	$2.10	-0.24%	
Metals				
Gold	$1,935.19	$1,940.20	-0.26%	
Silver	$22.09	$22.27	-0.81%	
Copper contract	$362.95	$358.70	1.18%	
Grains				
Corn contract	$462.75	$464.00	-0.27%	
Wheat contract	$572.00	$575.25	-0.56%	
Soybeans contract	$1,351.75	$1,347.50	0.32%	
Shipping				
Baltic Dry Freight	1,643	1,598	45	

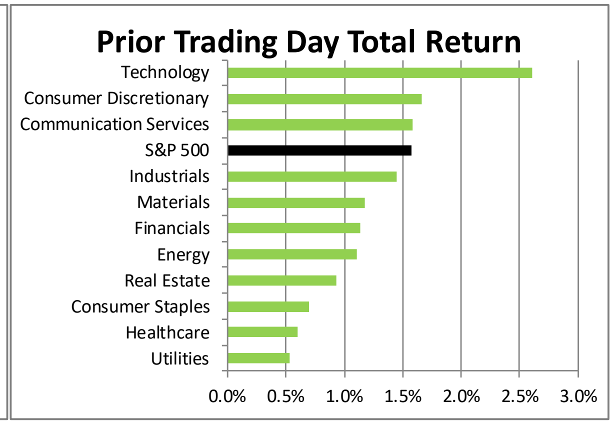
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for most of the country with cooler temperatures in the Pacific and Great Plains region in the latter half of the forecast period. Meanwhile, the precipitation outlook calls for wetter-than-normal conditions in every state.

Data Section

U.S. Equity Markets – (as of 11/10/2023 close)

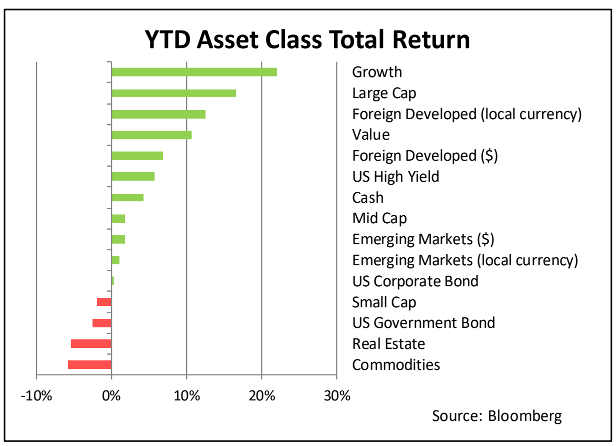




(Source: Bloomberg)

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 11/10/2023 close)

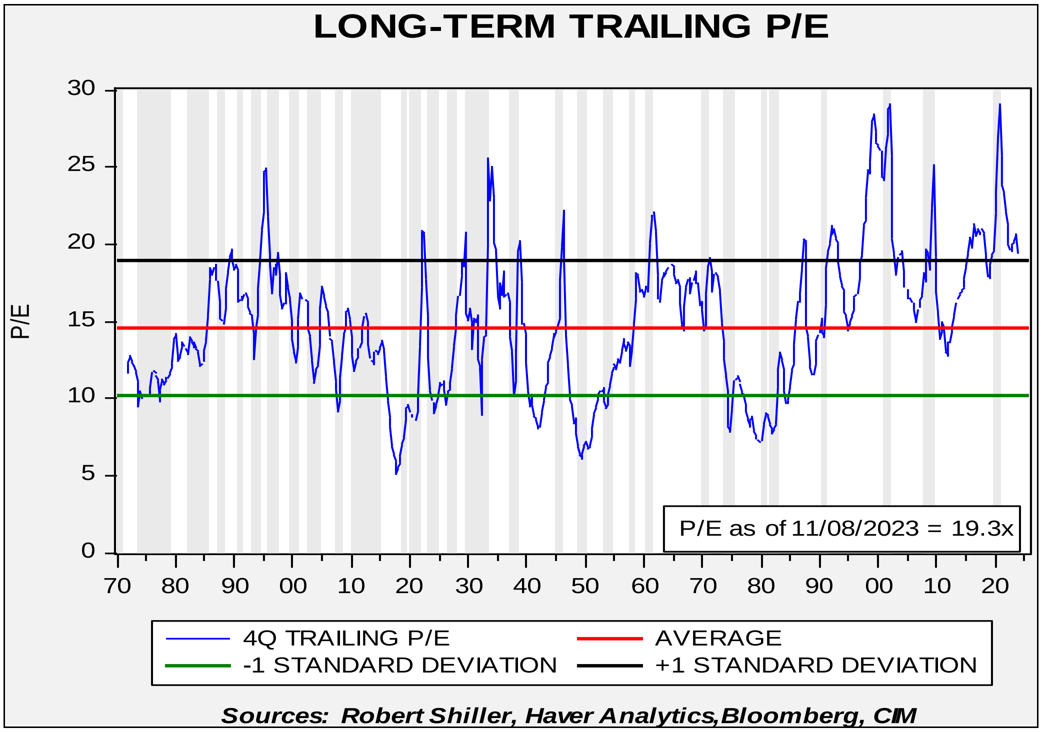


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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.