Confluence INVESTMENT MANAGEMENT

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.

The* Daily Comment *will go on hiatus beginning Wednesday, November 22, and will return on Monday, November 27.

[Posted: November 17, 2023—9:30 AM EST] Global equity markets are mostly higher this morning. In Europe, the Euro Stoxx 50 is up 0.8% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.1%. Chinese markets were higher, with the Shanghai Composite up 0.1% from its previous close and the Shenzhen Composite up 0.4%. U.S. equity index futures are signaling a higher open.

With 471 companies having reported so far, S&P 500 earnings for Q3 are running at $58.50 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* (11/13/2023) (with associated podcast): "The Archetypes of American Foreign Policy: A Reprise"
- *Weekly Energy Update* (11/16/2023): After the EIA delayed last week's data, we are seeing higher crude oil inventories. The Gaza conflict remains contained. The IEA boosts its demand forecasts.
- *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! Oil prices fell into bear market territory on Friday due to a jump in U.S. inventories and demand pessimism. In other news, Shohei Ohtani, formerly of the Angels, and the Braves' Ronald Acuna Jr. were named the most valuable players in their respective leagues. Today's *Comment* begins with our thoughts about holiday spending this year. We then discuss why governments are struggling to find ways to fund initiatives, and then detail Argentina's run-off election to be held Sunday. As always, our report includes a summary of the latest domestic and international data releases.

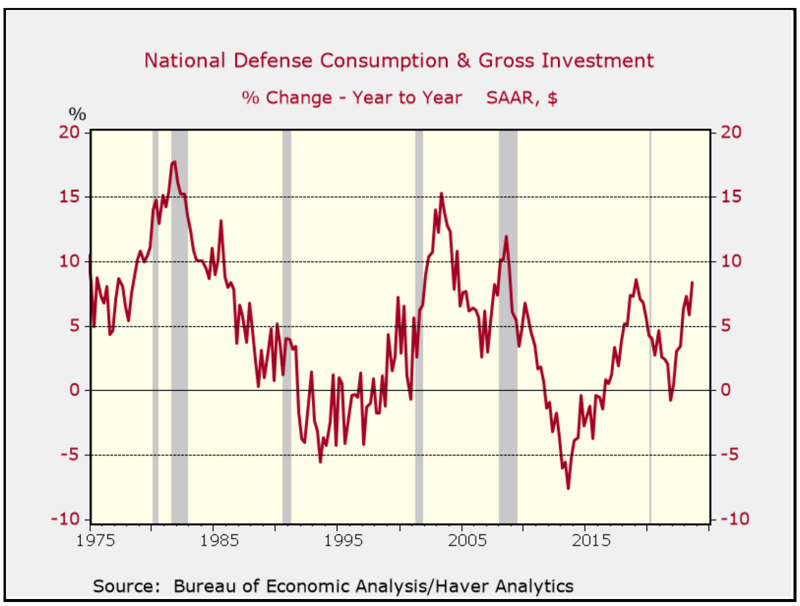
Holiday Cheers? Major retailers are concerned that Christmas spending may slow this year.

- This week several major retailers reported higher profit margins with tighter inventory but lower revenue. The decline in sales mirrors the impact of rising prices on consumer spending. Walmart's (WMT, $156.04) report further underscored this trend, indicating a "softening" and "uneven sales" pattern since October. Shares of the company stock plummeted 8% on Wednesday due to the pessimistic outlook. At the same time, Target (TGT, $129.94) indicated that it believes consumers are delaying purchases until the last minute, while Macy's (M, $13.33) results demonstrated that consumers may be receptive to purchases if prices are reduced.
- Recent economic data provides some clues about how holiday spending might unfold. October retail receipts indicate a significant slowdown in consumer spending compared to its peak in 2021. When adjusted for inflation, the data shows a year-over-year decline of 0.73%. This decline is likely attributed to a confluence of factors, including rising prices and high-interest rates dampening consumer spending. The trend is expected to persist as more households resort to increasingly expensive credit cards to finance purchases. The data indicates that real spending has not yet declined significantly enough to raise major concerns about the economy, but time will tell whether this will hold up over the next few months.

- The upcoming holiday season will serve as a critical test of consumer sentiment and spending patterns. Stronger-than-expected sales would provide reassurance that consumption remains resilient heading into 2024. Conversely, a weaker-than-expected performance would likely raise further concerns about the economy and could lead to more predictions of a downturn. In an effort to boost sales, firms may consider decreasing prices, which could offer a potential double benefit of stronger sales and lower inflation. However, it is important to acknowledge that price reductions may carry the risk of further cooling in the labor market. At this time, we remain optimistic that consumption will continue to be an engine of economic growth.

Fiscal Deficits: Governments are struggling to find a way to meet their spending plans without exacerbating their growing deficits.

- In the absence of a comprehensive spending bill, the Pentagon faces a potential $82 billion budget cut over the next two fiscal years. This mandate stems from a provision embedded in June's debt limit legislation, which requires all federal departments and agencies to trim their budgets by 1% from 2023 levels for the subsequent two fiscal periods if no funding agreement is reached before the new year. The potential budget cut could hamper Washington's efforts to bolster its presence and influence in the Indo-Pacific region, where it seeks to counter China's growing dominance.
- Similarly, Germany's top court has struck down a plan to fund climate change initiatives using off-budget funds, jeopardizing about 770 billion euros ($837 billion) in spending plans. The ruling, which comes as a blow to the country's three-party coalition government, means that the government will have to find alternative ways to finance its ambitious climate goals. While the government has vowed to find a solution, there will likely be some bickering among members of the coalition. German Finance Minister Christian Lindner has said that it is possible to fund the budget without using additional debt or raising taxes; however, the climate fund has been frozen in the meantime.



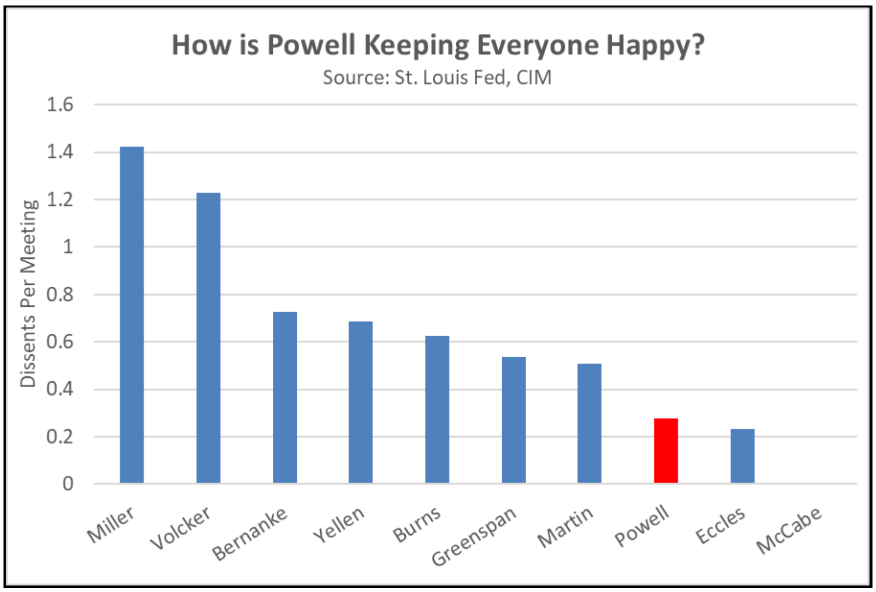
- The pandemic's burden on government finances, coupled with escalating geopolitical tensions, will necessitate further defense spending while potentially curtailing other initiatives. Climate change initiatives face heightened scrutiny as households hesitate to embrace costly transitions to a low-carbon economy. Governments are unlikely to completely abandon their commitment to climate change mitigation, but they may be forced to postpone some deadlines in the face of budgetary constraints. Defense spending is likely to remain strong as there appears to be a consensus that the world is becoming a more dangerous place. Hence, we do not view the budget tightening as a potential threat to portfolio positions within Aerospace and Defense.

Where Will Argentina Swing? Investors will be closely watching the Argentine elections on Sunday to gauge the political climate in South America.

- The two candidates represent opposing ends of the political spectrum, with Javier Milei's campaign drawing comparisons to former U.S. President Donald Trump and former Brazilian President Jair Bolsonaro due to his skepticism of central banks and his focus on law and order. Conversely, his opponent, Sergio Massa, despite being considered "the least Peronist of the Peronists," has emphasized his party's legacy of welfare spending and subsidies and is expected to seek support from radical leftists. The outcome is considered close, but Massa is favored to win given his strong performance in the general election.
- Geopolitical considerations also loom over this election, as China seeks to strengthen ties with Argentina to safeguard its access to the country's resources. Last month, the People's Bank of China extended a $6.5 billion currency swap line to Argentina, enabling Buenos Aires to intervene in currency markets and settle imports in yuan (CNY) rather than dollars, which will prevent it from falling into arears with the International Monetary Fund. This move was widely perceived as a political favor for Sergio Massa, the current finance minister, as he seeks to convince voters of his ability to steer the country away from the brink of collapse.

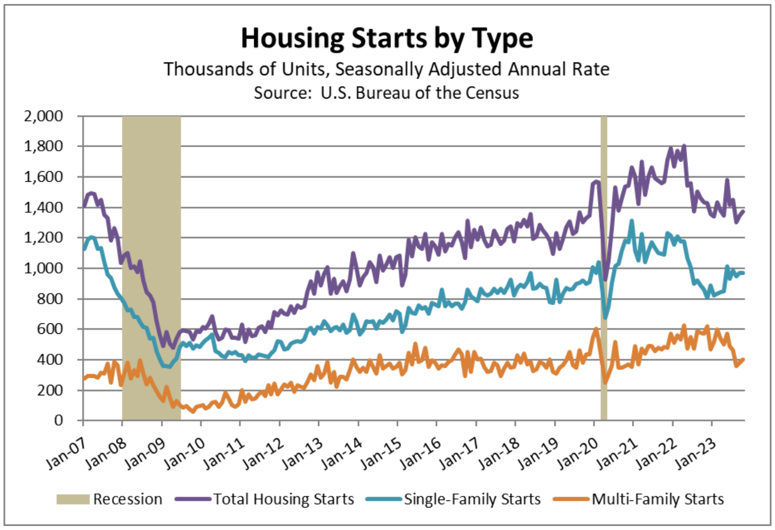
- The outcome of the election will shape the trajectory of a country grappling with persistently high inflation and an ever-growing debt burden. A Massa victory is likely to be favored by markets, as he is expected to pursue more conventional economic policies than his opponent. Conversely, a Milei win could potentially align with U.S. efforts to maintain regional influence, as he has shown that he is less willing to cooperate with China. Although the election may not have major impact on markets, it may provide further signs as to how the world is breaking into geopolitical blocs as the world moves away from globalization and towards regionalization.

Other News: Iran maintains that it does not want the Israel and Hamas conflict to spread but has warned that it may take action if the assault on Gaza continues. The message is a positive sign that there is a communication between Washington and Tehran, which should reduce the chance of miscalculation. Spanish Prime Minister Pedro Sánchez won another term after securing an amnesty deal with the Catalan separatists. It is unclear how long he will be able to maintain his coalition as there has been public outcry following the appeasement of the separatists. Powell's firm grip on the Fed is further evidenced by his exceptionally low dissent rate. Our analysis reveals that Powell has had the fewest dissents per meeting of any Fed chair since Thomas B. McCabe.



U.S. Economic Releases

October ***housing starts*** rose to a seasonally adjusted, annualized rate of 1.372 million units, beating the expected rate of 1.350 million units and the revised September rate of 1.346 million units. The rate of housing starts in October was up 1.9% from the rate in the previous month. October ***housing permits*** rose to a rate of 1.487 million units, beating their anticipated rate of 1.450 million units and the revised September rate of 1.471 million units. In October, permits issued for new housing units were up 1.1% from September. Compared with the same month one year earlier, housing starts in October were down 5.1%, while permits were down 0.4%. The chart below shows the growth in new home starts by type of property since just before the Great Financial Crisis.



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**
11:00	Kansas City Fed Services Activity	m/m	Nov		-1	*
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
9:30	Mary Daly Speaks in Frankfurt	President of the Federal Reserve Bank of San Francisco				
9:45	Austan Goolsbee Speaks on Economy	President of the Federal Reserve Bank of Chicago				

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
EUROPE								
Eurozone	CPI	y/y	Oct F	2.9%	4.3%	4.3%	***	Equity bullish, bond bearish
	Core CPI	y/y	Oct F	4.2%	4.2%	4.2%	**	Equity and bond neutral
UK	Retail Sales	y/y	Oct	-2.7%	-1.0%	-1.3%	***	Equity and bond neutral
	Retail Sales Ex-Auto Fuel	y/y	Oct	-2.4%	-1.2%	-1.5%	**	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	10-Nov	$577.3b	$577.0b		***	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	10-Nov	18.43t	18.48t		*	Equity and bond neutral
AMERICAS								
Brazil	FGV inflation IGP-10	m/m	Nov	0.52%	0.52%	0.52%	*	Equity and bond neutral
	Economic Activity Index	y/y	Sep	0.32%	1.28%	1.19%	**	Equity bearish, bond bullish

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	565	-2	Down
3-mo T-bill yield (bps)	523	524	-1	Down
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	537	537	0	Down
U.S. Libor/OIS spread (bps)	537	537	0	Down
10-yr T-note (%)	4.41	4.44	-0.03	Flat
Euribor/OIS spread (bps)	400	399	1	Up
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Flat
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.

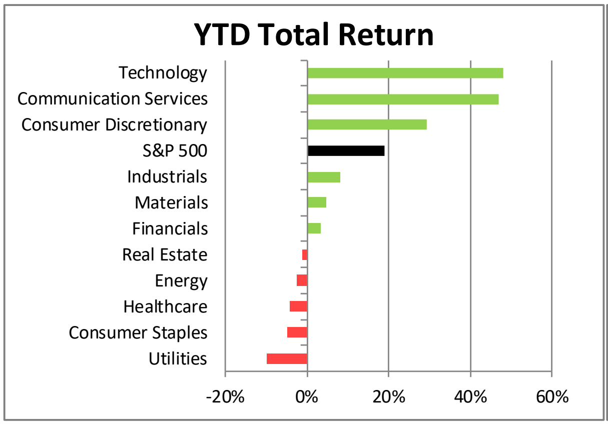
weco	Price	Prior	Change	Explanation
Energy Markets				
Brent	$78.49	$77.42	1.38%	
WTI	$73.82	$72.90	1.26%	
Natural Gas	$3.07	$3.06	0.36%	
Crack Spread	$24.49	$24.52	-0.13%	
12-mo strip crack	$24.04	$23.88	0.70%	
Ethanol rack	$2.09	$2.09	0.00%	
Metals				
Gold	$1,989.84	$1,980.90	0.45%	
Silver	$24.05	$23.75	1.28%	
Copper contract	$374.35	$373.70	0.17%	
Grains				
Corn contract	$491.00	$493.25	-0.46%	
Wheat contract	$577.50	$581.00	-0.60%	
Soybeans contract	$1,357.00	$1,360.25	-0.24%	
Shipping				
Baltic Dry Freight	1,758	1,688	70	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	3.6	2.0	1.6	
Gasoline (mb)	-1.5	1.5	-3.0	
Distillates (mb)	-1.4	-1.1	-0.3	
Refinery run rates (%)	0.9%	0.6%	0.3%	
Natural gas (bcf)	60	42	18	

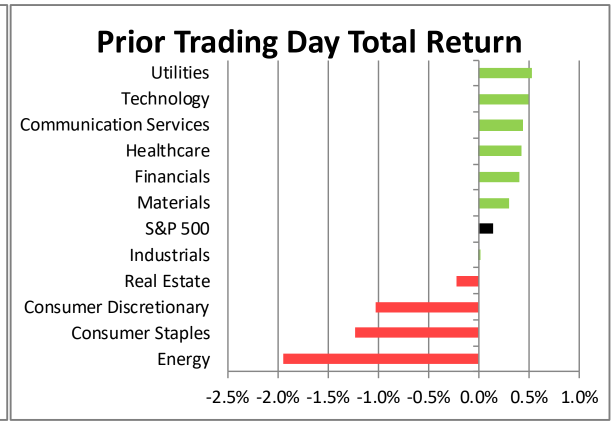
Weather

The 6-10 and 8-14 day forecasts currently call for cooler-than-normal temperatures from the Rocky Mountains eastward, with warmer-than-normal conditions in the West Coast states. The forecasts are calling for wetter-than-normal conditions along the Gulf Coast and in the Southeast, with dry conditions expected in the Far West and Midwest.

Data Section

U.S. Equity Markets – (as of 11/16/2023 close)

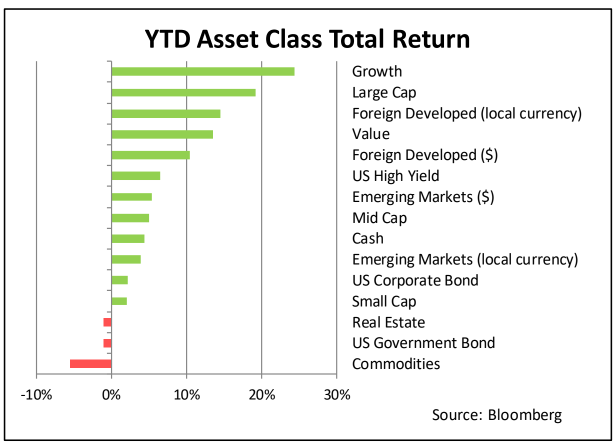




(Source: Bloomberg)

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 11/16/2023 close)

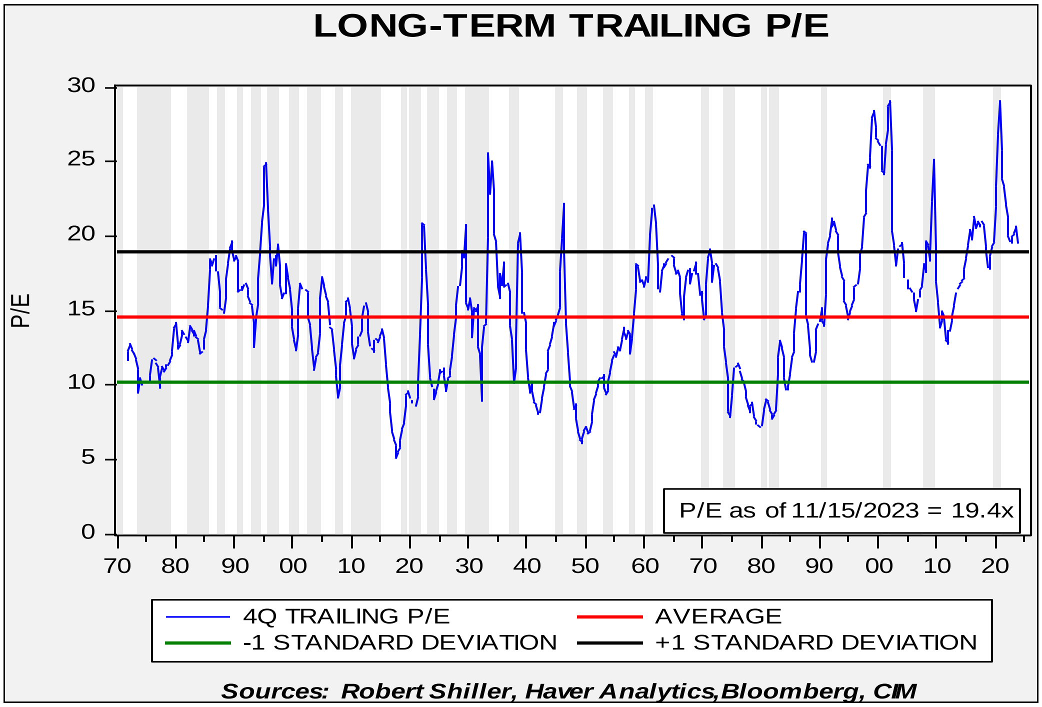


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 16, 2023



Based on our methodology,[1] the current P/E is 19.4x, up 0.1x from last week. The multiple rose on the 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.