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: October 4, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.4% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.1%. Chinese markets are closed for Golden Week. U.S. equity index futures are signaling a higher open.

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* (10/2/2023) (with associated podcast): "The Oil Weapon Returns"
- *Weekly Energy Update* (9/28/2023): Crude oil prices continue to rise as inventories decline. In the latest reporting week, crude oil stockpiles fell despite falling refining activity. We also discuss Europe's rapid moves to prevent Chinese EVs from swamping their automobile markets.
- *Asset Allocation Quarterly – Q3 2023* (7/20/2023): Discussion of our asset allocation process, Q3 2023 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q3 2023 Rebalance Presentation* (8/18/2023): 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* (9/25/2023) (with associated podcast): "Where's the Recession? A Recap"
- *Confluence of Ideas* podcast (8/22/2023): "The Economics of Defense in Great Power Competition"
- *Business Cycle Report* (9/28/2023)

Our *Comment* today opens with U.S. news, with a focus on last night's historic vote in Congress to remove House Speaker McCarthy. We next review a wide range of other international developments with the potential to affect the financial markets today, including a bond market intervention by the Bank of Japan and big, new military spending plans by Russia.

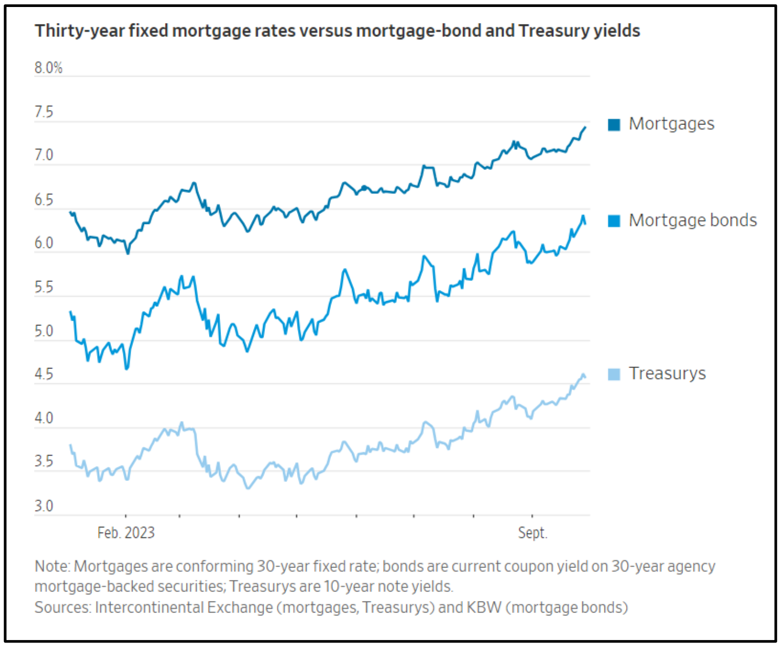
U.S. Politics: In a historic vote last night, the House of Representatives voted to end Republican Kevin McCarthy's tenure as Speaker, leaving the chamber in chaos. As is tradition, all 208 voting Democrats cast their ballot to remove McCarthy, but they were also joined by eight far-right Republican rebels who have criticized McCarthy for being insufficiently committed to sharp cuts in federal spending and other conservative causes. The votes against McCarthy totaled 216, just enough to beat the 210 Republicans who voted to keep him in his position.

- McCarthy quickly announced that he will not try to reclaim his post, and House Republicans said they would leave Washington and return next week to vote on a new Speaker. That leaves the chamber without a leader for the time being.
- McCarthy had earlier named North Carolina Rep. Patrick McHenry as the *pro tempore* Speaker, but McHenry will not have the full powers of the office.
- The result will likely be another messy Republican battle for the Speakership. Currently, the front-runners are probably McHenry, along with the Republicans' #2 and #3 leaders in the chamber: Rep. Steve Scalise of Louisiana and Rep. Tom Emmer of Minnesota. It isn't clear whom the hard-right Republican rebels would support.
- Press reports indicate the Democrats' decision not to save McCarthy stemmed largely from anger over his efforts to placate the hard-right members of his caucus. Going forward, key questions include whether the Republicans' chaos will discredit their party and boost the Democrats politically.
- For the economy and financial markets, a central question is how the leadership vacuum will affect the negotiations over the federal budget for Fiscal Year 2024. The weekend's stopgap spending bill has authorized federal outlays at FY 2023 levels only until the middle of November. If the Republicans and Democrats can't agree on appropriations after that, there would be renewed risk of a partial government shutdown.

U.S. Bond Market: Investors continue to sell off fixed-income assets, pushing prices lower and boosting the yield on the benchmark 10-year Treasury note to a fresh 16-year high of 4.831%. The two-year Treasury note has risen more tepidly to about 5.159%, narrowing the 10-2 yield inversion at just 32 basis points. As we had long warned, investors are finally repricing bonds downward after realizing the obligations had been priced too richly in the face of persistent inflation pressures and the Fed's intention to hold interest rates higher for longer.

- Separately, CBOE Global Markets (CBOE, $157.24) and S&P Dow Jones (SPGI, $356.42) said they will launch four new indexes aimed at tracking the volatility of U.S. and European corporate bonds. The indexes will launch next week.
- The companies hope the new indexes will match the success of the original VIX for stocks. Over time, options or other financial products tied to the new bond VIX indexes are likely to become available.

U.S. Housing Market: With bond yields rising, investors probably expect the interest rate on residential mortgages to be rising in tandem. In reality, mortgage rates have been rising even faster than the yield on the 10-year Treasury note, which is their typical benchmark. The reason is that even as Treasury yields have been rising, the Federal Reserve and commercial banks have been actively unloading their holdings of the mortgage-backed securities, driving up MBS yields. Since MBS issuance funds so much of the nation's mortgages, the result is that residential mortgage rates could well be on their way to 8% or more.



Global Airline Industry: Reports say airlines around the world are dealing with a potentially costly scandal in which they inadvertently bought engine replacement parts with falsified safety certificates from what appears to be a phantom company in the U.K. The airlines are now scrambling to identify and replace any uncertified parts that have been installed on their aircraft. The questionable parts have been found on approximately 100 planes so far, forcing the airlines to take them out of service, pull their engines, and replace the parts.

Japanese Bond Market: As Japanese bond yields rise along with the upward trend in U.S. yields, today the Bank of Japan offered to buy an extraordinary 1.9 trillion JPY ($12.7 billion) of Japanese government bonds with maturities ranging up to 10 years. The unexpectedly large purchases appeared to be tied to the BOJ's controversial yield curve control policy, in which it is keeping short-term interest rates negative while capping the yield on the 10-year JGB at 1%.

- Despite the intervention, however, the yield on the 10-year JGB rose to 0.783%, as investors increasingly bet that the central bank will soon have to abandon its YCC policy.
- Meanwhile, the yen today strengthened by 1.8% to 147.3 JPY per dollar ($0.0068), compared with yesterday's value of 150 JPY per dollar ($0.0067).

Japanese Industrial Policy: As Tokyo continues working to secure a domestic supply of advanced semiconductors in the face of China's growing geopolitical threat, the Industry Ministry yesterday announced it will provide up to 192 billion JPY ($1.3 billion) in additional subsidies for U.S. semiconductor manufacturer Micron Technology (MU, $67.83) for its new memory-chip factory in Hiroshima Prefecture. That comes on top of the 46.5 billion JPY ($310 million) in aid to Micron that the government announced previously. Tokyo also continues to provide enormous subsidies to build up a domestic supply of advanced logic chips.

European Union: The *Financial Times* carries an interesting report today saying that some home buyers who used to flock to places like Portugal, Spain, or the South of France for the warm, sunny weather are now eying properties in northern regions seen as less susceptible to global warming. After a summer of unusually hot weather and wildfires in southern Europe, northern regions like Brittany in France offer not only cooler weather but also much cheaper prices—for now. The article is a reminder that even if you're skeptical about climate change, the markets you participate in could be affected by others who are trying to respond to it.

United Kingdom: In a speech at the Conservative Party's annual conference, Prime Minister Sunak offered several red-meat policy changes for the right wing, including cancellation of an expensive rail line extension to the northern city of Manchester, tighter standards for secondary education, and tougher restrictions on youth smoking. The proposals come just weeks after Sunak got a bump in the opinion polls from easing Britain's climate-stabilization policies. Nevertheless, Sunak and the Conservatives continue to trail the support for Keir Starmer and his Labor Party.

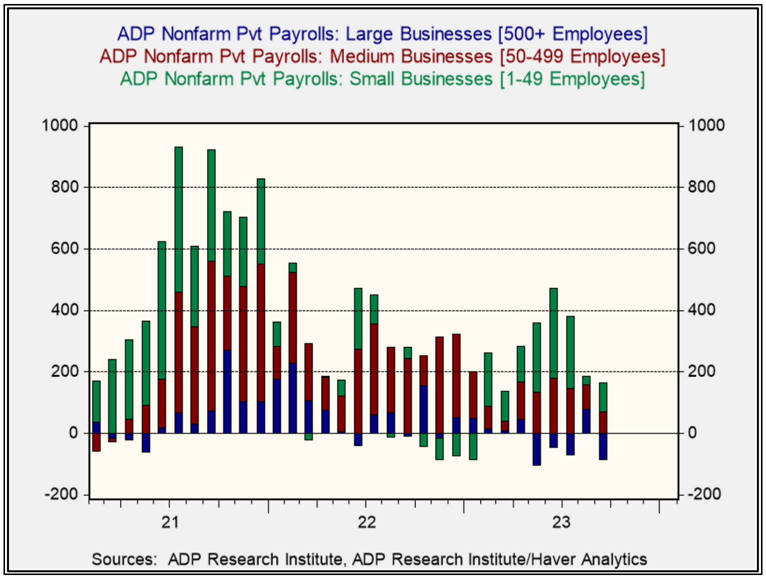
Russia: The government's draft budget for 2024 indicates the military will get 29.4% of all spending, equal to about $109 billion. That's more than double the 14.4% of the budget that the military got in 2021, before the Kremlin launched its invasion of Ukraine. In RUB terms, the proposed military spending in 2024 would be about three times greater than in 2021.

- Since Russia has a long history of hiding some military spending in ostensibly civilian budget accounts and off-budget, it is likely that the country's true military spending is even greater than indicated.
- As such, Russia's defense burden is now clearly a strain on Russian state finances. To fund the enormous new military outlays associated with the war in Ukraine, Russian officials have said they will freeze spending on healthcare and education, while cutting spending on infrastructure and other economic development projects. They have also indicated they will have to increase borrowing.

U.S. Economic Releases

Higher borrowing costs weighed on the demand for new residential loans last week. Mortgage applications fell 6% in the week ending September 29, according to the Mortgage Bankers Association. The drop in loan requests is likely related to the 12-bps increase in the 30-year fixed-rate mortgage which rose to 7.53%. As a result, the MBA tracker for purchase applications fell 5.7% from the previous week, while the tracker for refinancing applications fell 6.6%.

Separately, job growth in the U.S. is showing signs of slowing. U.S. firms added 89k new employees to their payrolls in September, according to Automatic Data Processing, Inc. The reading was nearly half of last month's reading of 177k and well below estimates of 153k.



Sharp declines in private payrolls by firm size signal a potential slowdown in the labor market. Over the last few months, large-size firms have slowed hiring, and this trend may spread to smaller firms in the coming months. If this is reflected in the government data on Friday, it could lead to a reassessment of the current path of monetary policy.

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**
9:45	S&P Services PMI	m/m	Sep F	50.2	50.2	**
9:45	S&P Composite PMI	m/m	Sep F	50.1	50.1	**
10:00	Factory Orders	m/m	Aug	0.3%	-2.1%	***
10:00	Durable Goods Orders	m/m	Aug F	0.2%	0.2%	***
10:00	Durable Goods Orders Ex Transportation	m/m	Aug F	0.4%	0.4%	**
10:00	ISM Nonmanufacturing PMI	m/m	Sep	53.5	54.5	***
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
10:25	Michelle Bowman Speaks at Community Banking Research Conference	Member of the Board of Governors				
10:30	Austan Goolsbee Speaks at Chicago Payments Symposium	President of the Federal Reserve Bank of Chicago				
15:00	Austan Goolsbee Moderates Discussion with Raghuram Rajan	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
ASIA-PACIFIC								
Japan	Jibun bank Composite PMI	m/m	Sep F	52.1	51.8		*	Equity bullish, bond bearish
	Jibun Bank Services PMI	m/m	Sep F	53.8	53.3		**	Equity and bond neutral
South Korea	Industrial Production	y/y	Aug	-0.5%	-8.0%	-8.1%	***	Equity bullish, bond bearish
	S&P Manufacturing PMI	m/m	Sep	49.9	48.9		***	Equity bullish, bond bearish
EUROPE								
Eurozone	HCOB Eurozone Services PMI	m/m	Sep F	48.7	48.4	48.4	**	Equity and bond neutral
	HCOB Eurozone Composite PMI	m/m	Sep F	47.2	47.1	47.1	*	Equity and bond neutral
	Retail Sales	y/y	Aug	-2.1%	-1.0%	-1.0%	*	Equity bearish, bond bullish
	PPI	y/y	Aug	-11.5%	-7.6%	-11.5%	*	Equity and bond neutral
Germany	HCOB Germany Services PMI	m/m	Sep F	50.3	49.8	49.8	**	Equity and bond neutral
	HCOB Germany Composite PMI	m/m	Sep F	46.4	46.2	46.2	*	Equity and bond neutral
France	HCOB France Services PMI	y/y	Sep F	44.4	43.9	43.9	**	Equity and bond neutral
	HCOB France Composite PMI	y/y	Sep F	44.1	43.5	43.5	**	Equity bullish, bond bearish
Italy	HCOB Italy Composite PMI	m/m	Sep	49.2	48.2	48.7	**	Equity and bond neutral
	HCOB Italy Services PMI	m/m	Sep	49.9	49.8	50.2	**	Equity and bond neutral
UK	S&P/CIPS UK Services PMI	m/m	Sep F	49.3	47.2	47.2	**	Equity bullish, bond bearish
	S&P/CIPS UK Composite PMI	m/m	Sep F	48.5	46.8	46.8	**	Equity bullish, bond bearish
Russia	S&P Russia Services PMI	m/m	Sep	55.4	57.6		**	Equity bearish, bond bullish
	S&P Russia Composite PMI	m/m	Sep	54.7	55.9		**	Equity bearish, bond bullish
AMERICAS								
Mexico	International Reserves Weekly	w/w	29-Sep	$203768m	$204141m		*	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)	565	566	-1	Up
3-mo T-bill yield (bps)	533	533	0	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	541	541	0	Up
U.S. Libor/OIS spread (bps)	542	543	-1	Up
10-yr T-note (%)	4.78	4.80	-0.02	Flat
Euribor/OIS spread (bps)	396	395	1	Up
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
Yen	Flat			Down
Pound	Up			Down
Franc	Up			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
RBNZ Official Cash Rate	5.500%	5.500%	5.500%	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	$89.26	$90.92	-1.83%	
WTI	$87.45	$89.23	-1.99%	
Natural Gas	$2.98	$2.95	1.15%	
Crack Spread	$20.51	$20.72	-1.01%	
12-mo strip crack	$23.50	$23.68	-0.75%	
Ethanol rack	$2.50	$2.50	-0.03%	
Metals				
Gold	$1,825.36	$1,823.02	0.13%	
Silver	$21.22	$21.17	0.21%	
Copper contract	$361.20	$362.10	-0.25%	
Grains				
Corn contract	$486.00	$487.50	-0.31%	
Wheat contract	$559.00	$568.50	-1.67%	
Soybeans contract	$1,279.75	$1,272.75	0.55%	
Shipping				
Baltic Dry Freight	1,780	1,737	43	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		0.1		
Gasoline (mb)		-0.3		
Distillates (mb)		-0.1		
Refinery run rates (%)		-0.5%		
Natural gas (bcf)		98		

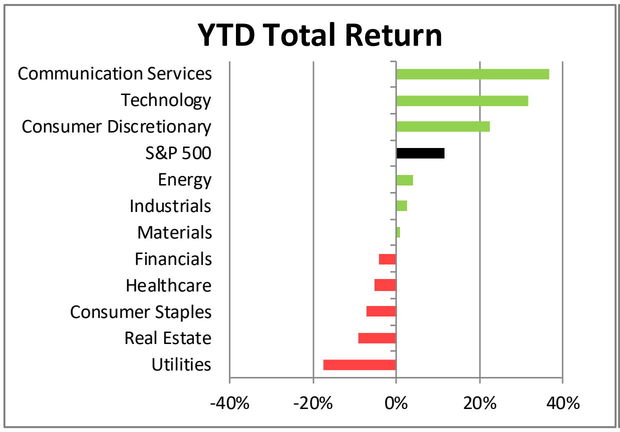
Weather

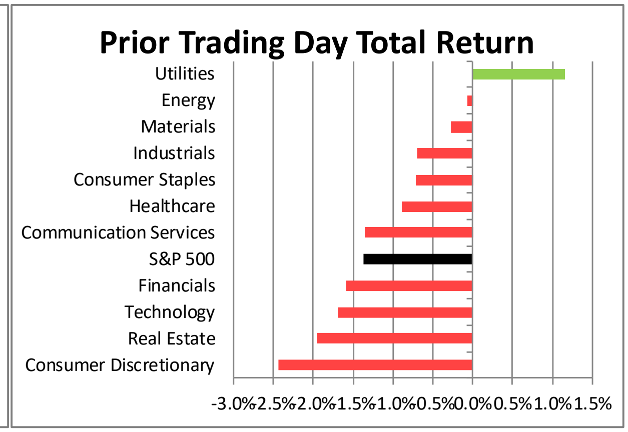
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures to spread from the Rocky Mountains and Great Plains toward the Midwest, with cooler-than-normal temperatures expected for the rest of the country. The precipitation outlook calls for wetter-than-normal conditions in the Pacific Northwest, Rocky Mountain, and Southeast regions, with dry conditions in the Midwest, Northeast, and Great Plains.

There is only one atmospheric disturbance active in the Atlantic Ocean. Tropical Storm Philippe is moving across the British Virgin Islands and is expected to touchdown in Bermuda later this week. On average, Atlantic hurricane activity peaks on September 15.

Data Section

U.S. Equity Markets – (as of 10/3/2023 close)

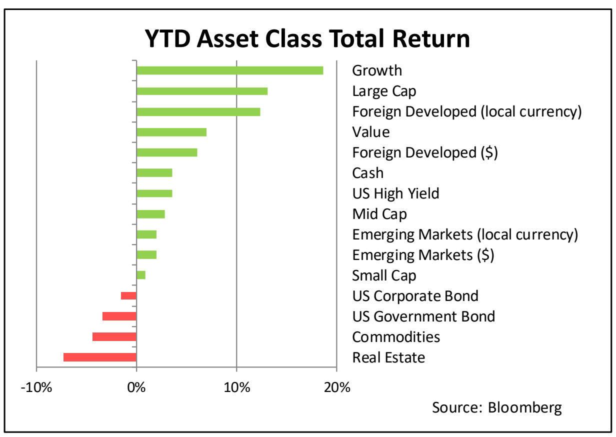




(Source: Bloomberg)

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 10/3/2023 close)

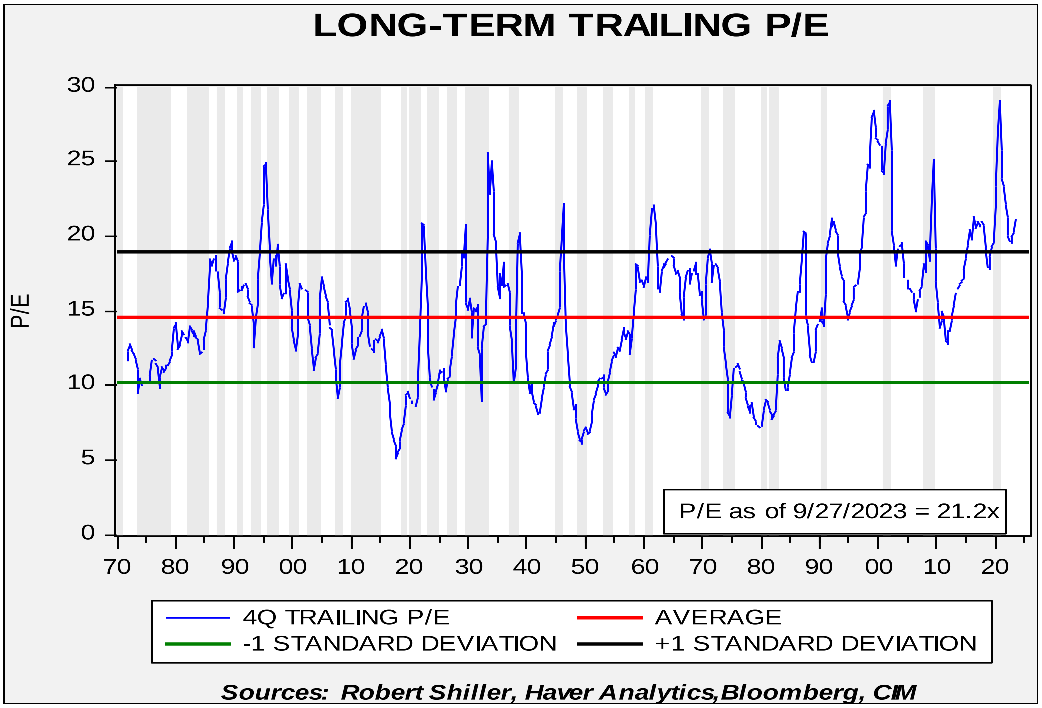


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

September 28, 2023



Based on our methodology,[1] the current P/E is 21.2x, up 0.1x from last week. Weaker earnings estimates led to the rise in the multiple.

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 (Q3 and Q4) and two estimates (Q1 and Q2). 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.