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 5, 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 up 0.7%. Chinese markets are closed for Golden Week. U.S. equity index futures are signaling a lower 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:

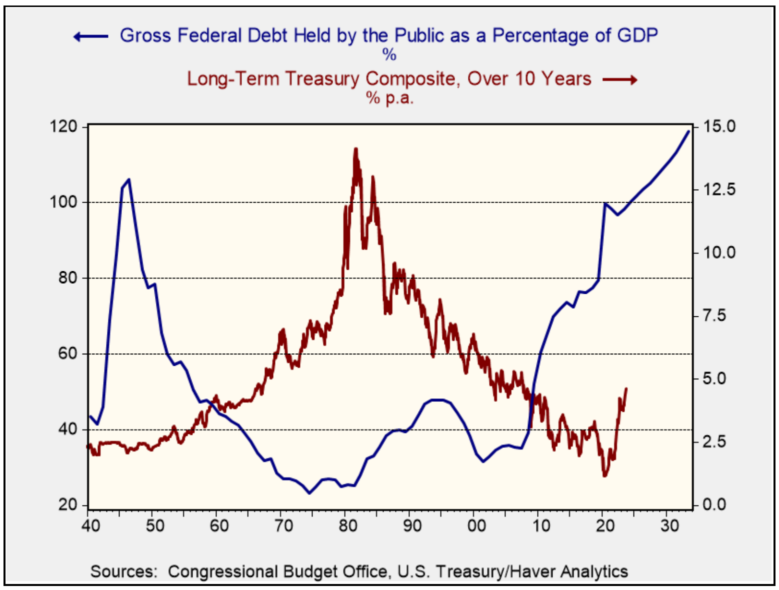
- *Bi-Weekly Geopolitical Report* (10/2/2023) (with associated podcast): "The Oil Weapon Returns"
- ***Weekly Energy Update*** **(10/5/2023): Oil prices have been correcting from recent highs, most likely reflecting concerns surrounding the impact of rising interest rates on the economy. We note that U.S. commercial inventories are falling despite falling refinery operations due to seasonal maintenance.**
- *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)

Happy Fat Bear Week! We've already filled out a bracket, and our money is on #32 Chunk to take the crown as the fattest bear. Today's *Comment* discusses the recent rise in global bond yields, the ongoing dollar drought, and problems with funding for Ukraine. As usual, our report also provides an overview of the latest domestic and international data releases.

Bond Bears Roar: Yields are increasing due to uncertainty over the future of monetary and fiscal policy, but this is likely to be temporary.

- Partisan governments and soaring inflation in advanced economies are making it difficult for investors to price future risks as governments struggle to find a clear path back to normalcy. This is particularly evident in Europe, where governments are built on fragile coalitions and Spain has been unable to form a government, and in the United States, where the House of Representatives ousted Speaker Kevin McCarthy (R-CA). Meanwhile, a slowdown in global economic activity and elevated inflation have complicated the central bankers' ability to conduct monetary policy as policymakers struggle to reach a consensus on a path forward.

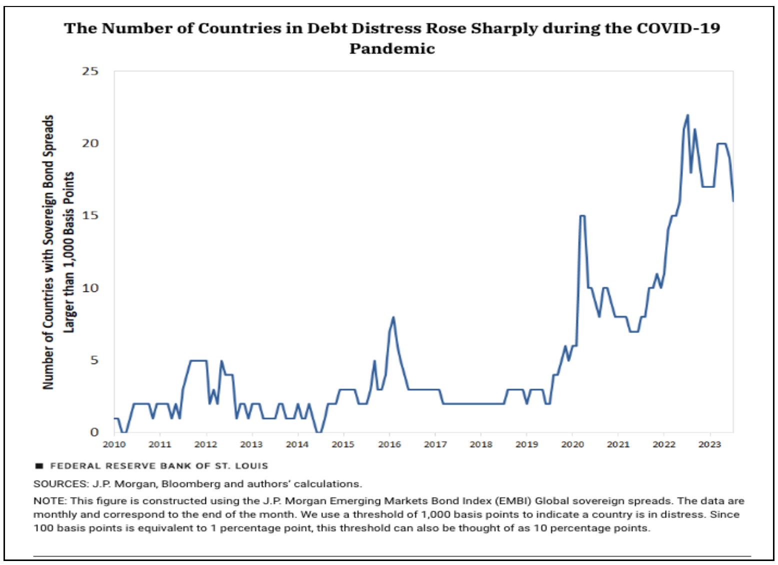
- Missed economic growth forecasts and unclear plans for addressing pandemic deficits have weighed heavily on investor sentiment. At the start of the year, many expected the U.S. and Europe to enter recessions in 2023, but the labor market has remained resilient in both regions. This has led the central bankers and investors to push up their expectations for policy rates as they look to keep inflation from becoming sticky. On the fiscal side, the EU has struggled to get governments, such as Italy and France, to comply with deficit targets that will come into effect in 2024. At the same time, U.S. budget projections show that the deficit is expected to exceed GDP over the next few years unless lawmakers decide to cut spending or raise taxes.



- Interest rates are unlikely to return to pandemic levels anytime soon, but yield pressures could ease in the coming weeks. Weaker economic data could reduce inflation expectations and prompt policymakers to pivot, leading to a decline in the yields of 10-year German Bunds and U.S. Treasuries. This expectation was evident in the recent decline in global bond yields following disappointing euro area retail sales and ADP private payrolls data. However, concerns over widening deficits and volatile inflation may temper any drop in yields, as lawmakers struggle to address budget shortfalls without political blowback.

When The Fed Sneezes: A shortage of U.S. dollars is cascading through emerging markets, causing widespread disruptions.

- Countries in Africa, Asia, and South America are reeling due to the lack of dollar liquidity. The shortage of available greenbacks has made it difficult for countries to pay for imports and repay debts, leading to a series of economic and political shocks throughout the developing world. The Pakistani government has imposed capital controls that restrict profit repatriation. Nigeria's currency has plummeted against the dollar. At the same time, political instability in Bolivia has deepened amid soaring inflation and economic hardship. It is estimated that poorer countries owe around $200 million to their wealthier counterparts.
- The U.S. dollar shortage is a direct result of the Federal Reserve's quantitative tightening policy. Last month, the central bank's balance sheet fell under $8 trillion for the first time since June 2021. This drawdown has been particularly difficult for commodity-dependent countries, which have struggled to export their goods due to the recent global economic slowdown. As a result, governments have been forced to reduce spending and have asked creditors to restructure their debt payments. This has left some countries with reduced credit ratings and higher interest rates to compensate for the new risk. A JPMorgan index showed that 16 countries, or 23% of the index, had yields 10% or higher than those of the United States and Germany.

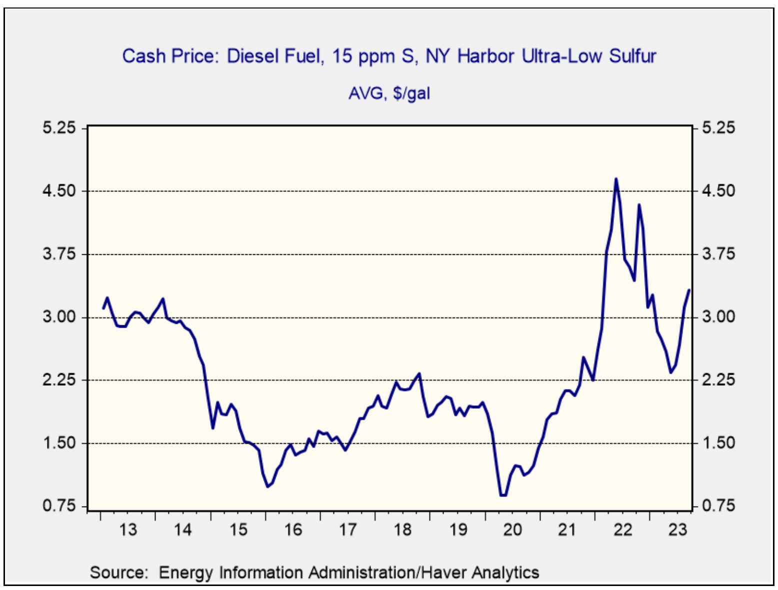


(Source: Federal Reserve Bank of Saint Louis)

- The situation in emerging markets may worsen but should not spillover to the U.S. Only 11 countries have defaulted in the past few years, far lower than the 1980's peak of 58. Additionally, the debt issues are less of a problem for larger developing nations such as Brazil and India. However, that does not mean there will be no negative effects for certain sectors of the American economy. An increase in defaults could make it difficult for grain and commodity exporters to sell goods to affected nations, which could lead to increased hunger and social unrest.

Putin's Waiting Game: The Russian president has been biding his time in hopes that the West will drop its support for Ukraine.

- Funding the war in Ukraine is causing frictions throughout the West, especially as governments struggle with widening budget deficits. In the U.S., a dispute over new funding for the war has contributed to a standoff in budget negotiations. Meanwhile, in Europe, sympathy for Russia is rising, particularly in Eastern European countries such as Slovakia, Bulgaria, and Hungary. This new resistance comes at a time when Ukraine's much anticipated counteroffensive has finally shown signs of life following weeks of making only slight progress. The dispute over funds highlights the growing fatigue of the fight.
- The main contention of the war is its economic fallout, both in terms of its cost and its impact on trade. American lawmakers argue that spending on the war is complicating efforts to reduce the budget deficit. Eastern European countries complain that preferential treatment to Ukrainian exports has come at the expense of their own agricultural industries. Rising dissatisfaction with the war is impacting elections, with more voters selecting candidates who favor a shift away from Kyiv. This situation could worsen if gasoline prices remain high in the coming months. That said, Moscow is also facing funding issues.

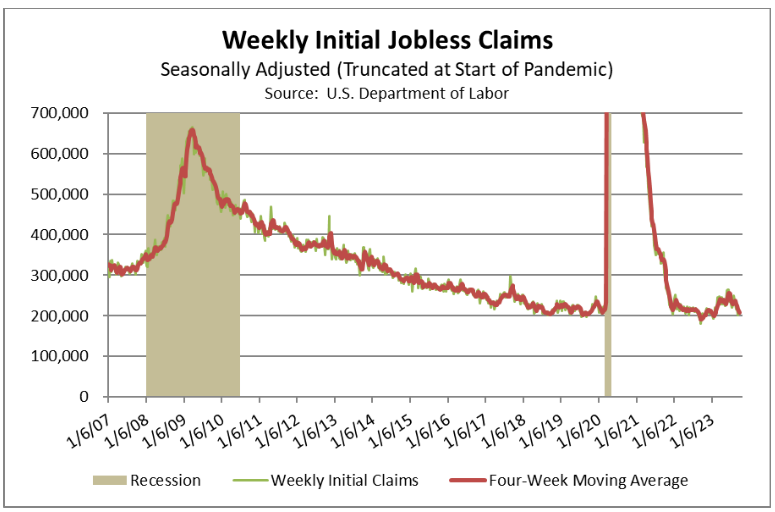


- The longer the war rages on, the greater the risk of Ukraine losing support. While the West insists that peace can only come with a Russian withdrawal, markets care little about the actual outcome of the war, just that it ends. Any resolution that leads to an end to the conflict should calm investors' concerns about commodity volatility and pave the way for the West to relax increasingly ineffective sanctions. European equities could be one of the biggest beneficiaries of this outcome, as they may be able to regain access to Russian energy. However, the path of normalization of ties between Brussels and Moscow remains uncertain.

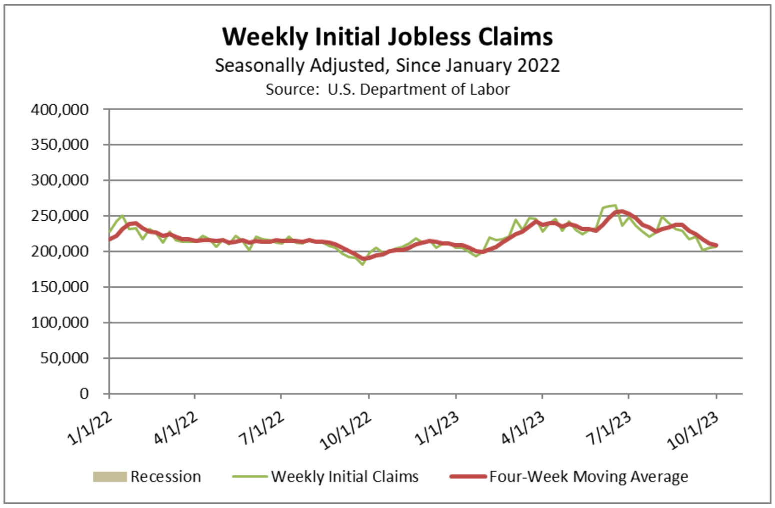
Ins and Outs: Accusations of industrial espionage by Chinese tech giant Alibaba (BABA, $83.17) are likely to worsen the growing distrust between the West and China. Saudi Arabia's exploration of a theme park is further evidence that the country is seeking to diversify its portfolio as the world transitions to a more sustainable economy. [The Biden administration's reversal of the border wall construction] highlights its growing concern over the rise in illegal immigration. Rising yields and declining imports add to concerns [that the Fed may not be able to avoid a hard landing.]

U.S. Economic Releases

In the week ended September 30, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 207,000, short of the expected level of 210,000 but slightly higher than the previous week's revised level of 205,000. The four-week moving average of initial claims, which helps smooth some of the volatility in the series, fell to a nearly eight-month low of 208,750. Taken together, the figures suggest labor demand has strengthened and layoffs have declined again. The report also included other figures that point to healthy demand for workers. In the week ended September 23, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) edged down to 1.664 million, below both the anticipated reading of 1.671 million and the prior week's revised reading of 1.665 million. The chart below shows how initial jobless claims have fluctuated since just before the Great Financial Crisis. The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



To provide more detail on recent trends, the chart below shows how initial jobless claims have changed just since the beginning of 2022.



In a separate report today, the August ***trade balance*** showed a seasonally adjusted deficit of $58.3 billion, modestly better than the expected shortfall of $59.8 billion and far narrower than the revised July deficit of $64.7 billion. According to the data, ***exports*** of goods and services in August rose 1.7% from the previous month, while ***imports*** fell 0.7%. Compared with the same month one year earlier, exports in August were down 2.1%, but imports were down an even sharper 4.4%. The chart below shows the monthly value of U.S. exports and imports 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		
	No economic releases for the rest of today	
Federal Reserve		
EST	**Speaker or Event**	**District or Position**
9:00	Loretta Mester Speaks at Chicago Payments Symposium	President of the Federal Reserve Bank of Cleveland
10:40	Neel Kashkari Moderates Q&A at Conference	President of the Federal Reserve Bank of Minneapolis
11:30	Thomas Barkin Speaks on Economic Outlook	President of the Federal Reserve Bank of Richmond
12:00	Mary Daly Speaks at Economic Club of New York	President of the Federal Reserve Bank of San Francisco
12:15	Michael Barr Speaks on Cyber Risk in the Banking Sector	Federal Reserve Board Vice Chair for Supervision

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	Foreign Buying Japan Stocks	w/w	29-Sep	¥71.0b	-¥3025.3b	-¥3025.5b	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	29-Sep	¥721.0b	-¥6.2b	-¥23.1b	*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	29-Sep	¥297.1b	-¥544.4b	-¥541.6b	*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	29-Sep	¥25.8b	-¥2025.1b	-¥2020.6b	*	Equity and bond neutral
Australia	Exports	m/m	Aug	4.0%	-2.0%		*	Equity and bond neutral
	Imports	m/m	Aug	0.0%	3.0%		*	Equity and bond neutral
	Trade Balance	m/m	Aug	A$8700m	A$8039m	A$7324m	***	Equity and bond neutral
New Zealand	ANZ Commodity Price	m/m	Sep	1.3	-2.9		**	Equity and bond neutral
South Korea	CPI	y/y	Sep	3.7%	3.4%	3.5%	***	Equity and bond neutral
India	S&P Composite PMI	m/m	Sep	61.0	60.9	--	**	Equity and bond neutral
	S&P Services PMI	m/m	Sep	61.0	60.1	--	**	Equity and bond neutral
EUROPE								
Germany	Trade Balance SA	y/y	Aug	16.6b	15.9b	16.0b	*	Equity and bond neutral
	Exports SA MoM	y/y	Aug	-1.2%	-0.9%	-1.6%	*	Equity and bond neutral
	Imports SA MoM	y/y	Aug	-0.4%	1.4%	-1.3%	*	Equity bullish, bond bearish
	HCOB Germany Construction PMI	y/y	Sep	39.3	41.5		*	Equity and bond neutral
France	Industrial Production	y/y	Aug	-0.5%	2.7%	2.5%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	Aug	-1.1%	2.7%	2.6%	**	Equity bearish, bond bullish
UK	New Car Registrations	y/y	Sep	21.0%	24.4%		*	Equity bearish, bond bullish
	S&P/CIPS Construction PMI	m/m	Sep	45.0	50.8	50.0	**	Equity bearish, bond bullish
Russia	GDP	q/q	2Q F	4.90%	4.90%	4.90%	**	Equity and bond neutral
AMERICAS								
Brazil	S&P Global Brazil Services PMI	m/m	Sep	48.7	50.6		**	Equity and bond neutral
	S&P Global Brazil Composite PMI	m/m	Sep	49.0	50.6		**	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)	568	565	3	Up
3-mo T-bill yield (bps)	533	534	-1	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	542	0	Up
10-yr T-note (%)	4.71	4.73	-0.02	Flat
Euribor/OIS spread (bps)	396	396	0	Up
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
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.

DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$84.54	$85.81	-1.48%	
WTI	$82.83	$84.22	-1.65%	
Natural Gas	$3.02	$2.96	1.82%	
Crack Spread	$19.61	$19.52	0.45%	
12-mo strip crack	$22.94	$22.89	0.23%	
Ethanol rack	$2.48	$2.48	-0.28%	
Metals				
Gold	$1,821.51	$1,821.36	0.01%	
Silver	$21.08	$21.01	0.35%	
Copper contract	$356.50	$358.90	-0.67%	
Grains				
Corn contract	$483.75	$486.00	-0.46%	
Wheat contract	$563.25	$560.00	0.58%	
Soybeans contract	$1,264.50	$1,273.00	-0.67%	
Shipping				
Baltic Dry Freight	1,778	1,780	-2	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.2	0.1	-2.3	
Gasoline (mb)	6.5	-0.3	6.8	
Distillates (mb)	-1.3	-0.1	-1.2	
Refinery run rates (%)	-2.2%	-0.5%	-1.8%	
Natural gas (bcf)		94		

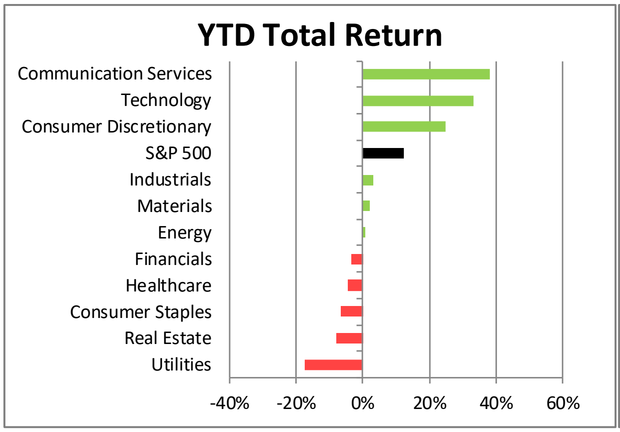
Weather

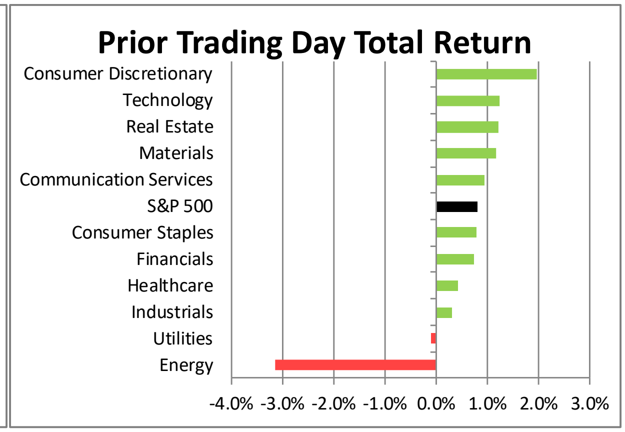
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in virtually the entire country west of the Mississippi River, with cooler-than-normal temperatures only in the Northeast. The forecasts call for wetter-than-normal conditions in the Pacific Northwest and along the Gulf Coast and East Coast, with dry conditions in the Southwest.

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

Data Section

U.S. Equity Markets – (as of 10/4/2023 close)

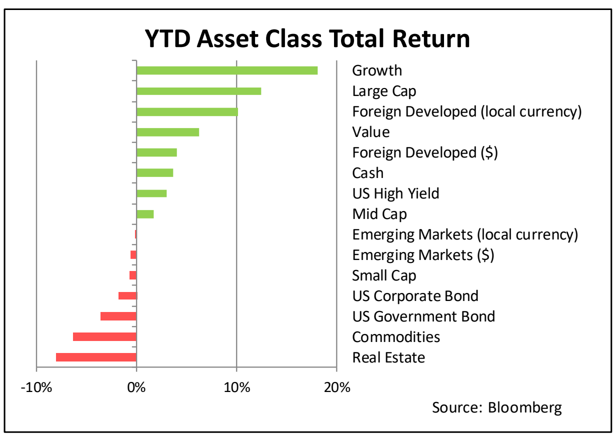




(Source: Bloomberg)

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 10/4/2023 close)

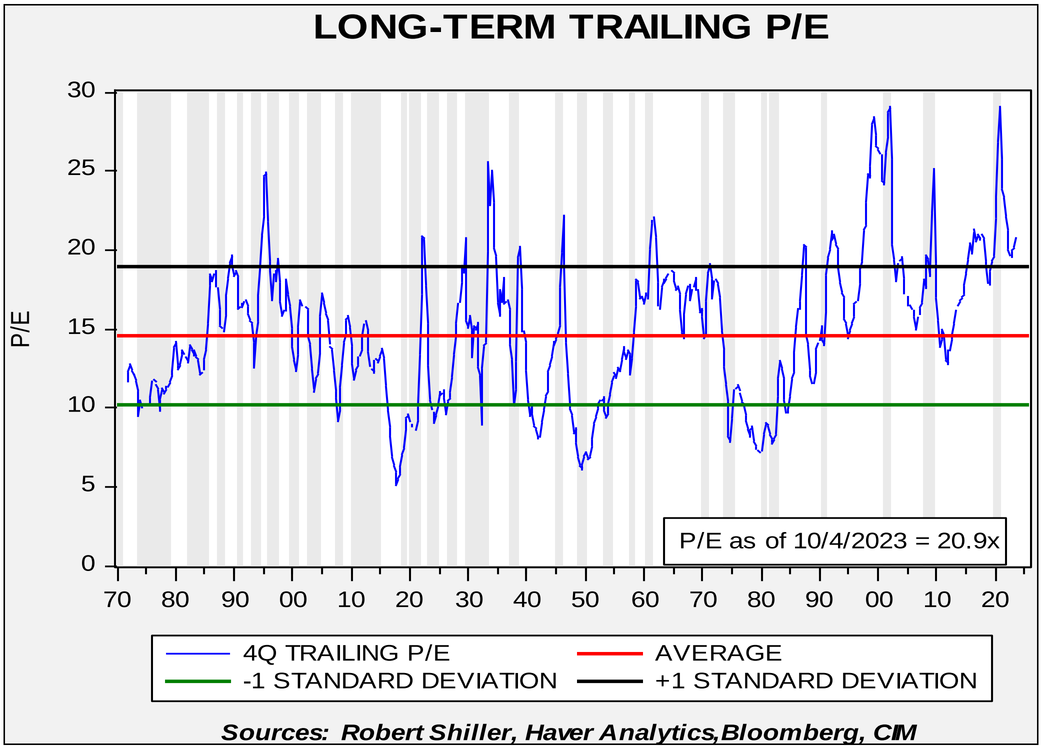


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

October 5, 2023



Based on our methodology,[1] the current P/E is 20.9x, down 0.3x from last week. The decline in the multiple is mostly due to rolling to Q4.

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.