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 6, 2023—9:30 AM EDT] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is up 0.9% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 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:

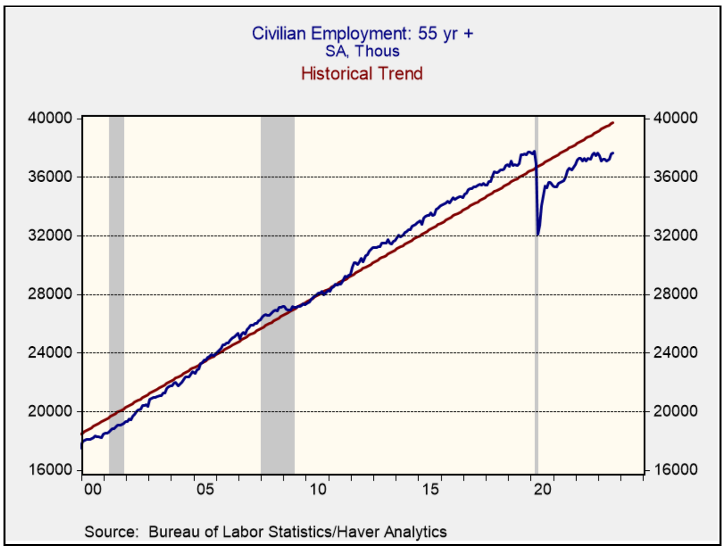
- *Bi-Weekly Geopolitical Report* (10/2/2023) (with associated podcast): "The Oil Weapon Returns"
- *Weekly Energy Update* (10/5/2023): Oil prices have been correcting from recent highs, most likely reflecting concerns surrounding the impact of rising interest rates on the economy. We note that U.S.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

Good morning! Our *Comment* begins with a discussion about whether the Fed can deliver a soft landing, Russia's decision to reverse course on oil exports, and why investors should pay attention to Mexican politics. As usual, our report also provides an overview of the latest domestic and international data releases.

Landing in Limbo: Investors are divided on whether the economy will achieve a soft or hard landing, but they agree that the labor market will be a key factor in determining the outcome.

- A week after the Federal Open Market Committee (FOMC) released its economic projections which showed upward revisions to GDP and interest rates, investors have expressed skepticism about the FOMC's optimistic outlook. The FOMC's forecast contrasts starkly with [CEO and consumer predictions of an 84% and 69% chance of a U.S. recession in 2024,] respectively. The uncertainty has rattled financial markets, with the S&P 500 falling nearly 5.0% since September 1, as investors lock in gains and position themselves for a possible correction. This cautiousness may persist until investors see clearer signs of the U.S. economy's direction.

- The labor market is the biggest source of contention, as it has remained stable despite other signs of economic weakness. Employment levels are high, and initial claims and unemployment have remained near historic lows, even as the Federal Reserve has raised interest rates to their highest level since 2007. This strong labor market has fed optimism that a recession is unlikely in the near term. However, below-trend growth in labor force participation from workers over the age of 55 has led to concerns that the data is still being impacted by pandemic distortions.



- Recessions are notoriously difficult to predict because economic conditions can change rapidly and without warning. This uncertainty explains why investors have cooled on government bonds, as mixed data has complicated efforts to price in risk. Next year will be another test of forecasters' accuracy, as many still believe the country will enter a recession in the first half of 2024. That said, despite evidence of decelerating economic activity, especially in consumer spending, we remain optimistic that the expansion still has a lot of gas left in the tank.

Trouble in Moscow? Russia has begun to ease some of its oil export restrictions in a sign that the government is seeking to increase its revenue.

- The Kremlin announced that domestic producers would resume seaborne exports of diesel on Thursday, reversing a three-week ban imposed due to domestic supply concerns. The decision was likely an attempt to prevent rising fuel prices from becoming a political liability ahead of the March 2024 elections. The U-turn comes days after a report showed that Saudi Arabia and Russia, the leaders of the OPEC+ oil production cuts, increased crude exports last month, allowing Moscow to inflate its profit margins at a time when it is seeking to increase its military spending in Ukraine.

- The increased availability of Russian oil should help relieve some of the tightness in the crude market. Over the past few months, fuel prices have risen as refiners struggled to make up for the shortfall created by Russia and Saudi Arabia's decision to cut crude production. This has led to a strain in crude inventories in many countries, including the United States. In August, global commercial inventories declined by 60 million barrels, with the U.S. seeing a drawdown in Cushing for 12 out of the previous 13 weeks. Diesel prices in Europe fell 3.0% after reports of Russia's policy shift.

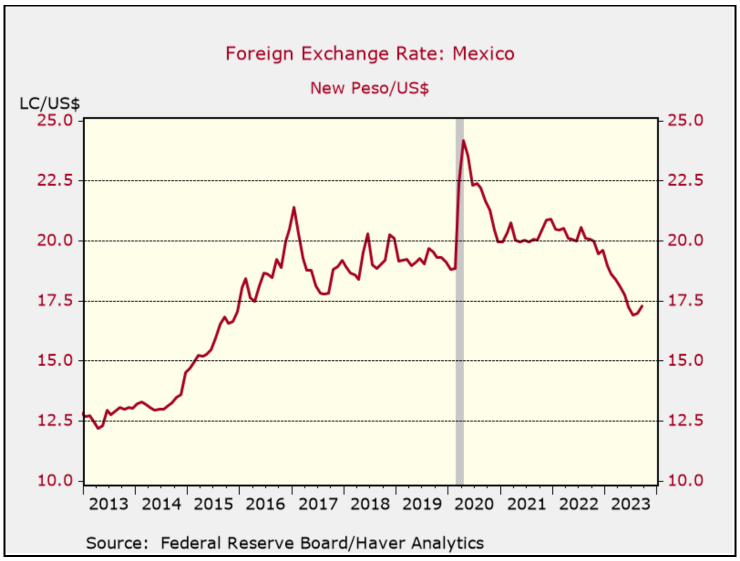
- That said, a potential economic slowdown may have bolstered Russia's decision to reverse course. Oil prices were approaching $100 a barrel a few weeks ago, but anxiety about future demand due to growth concerns has caused prices to fall. This week, Brent prices fell below $85 a barrel, erasing the gains made in September. The price slump will likely hurt Russian efforts to increase the budget by 26% in its next fiscal year. Last month, it was able to run a surplus in oil sales, but it is unclear whether this will persist if prices continue to fall.

AMLO Is Not Your Friend: With a little over a year left in his presidency, President Andrés Manuel López Obrador (AMLO) continues to rattle investors.

- Mexican President AMLO surprised investors with an unexpected change to airport concession agreements. The new arrangement changes the tariff system which affects passenger fees, airport services for the use of runways, and leasing spaces to airlines and suppliers. The move appears to be driven by AMLO's long-running feud with the airline industry and his desire to nationalize the sector. In 2018, AMLO canceled the construction of a new airport, only to reopen an alternative hub in a former military air base three years later. Earlier this year, he announced the revival of the state-run airline

Mexicana de Aviación and transferred the operations of Benito Juarez International Airport to the Navy.

- Mexican assets tumbled after the surprise change to airport concession agreements, as investors were shocked by the government's decision to challenge previous agreements and feared that other industries could be next. The country's benchmark stock index fell 4.4% on Thursday, and the Mexican peso (MXN), one of the world's best-performing currencies, fell 1.7% against the dollar. The sell-off reflects uncertainty about AMLO's next moves before he leaves office. Last month, the president spooked markets by submitting a budget proposal that would triple the current year's outlays to their largest level since 1988. As a result, investors offloaded bonds across the various maturities, fearing that AMLO was no longer committed to fiscal conservatism.

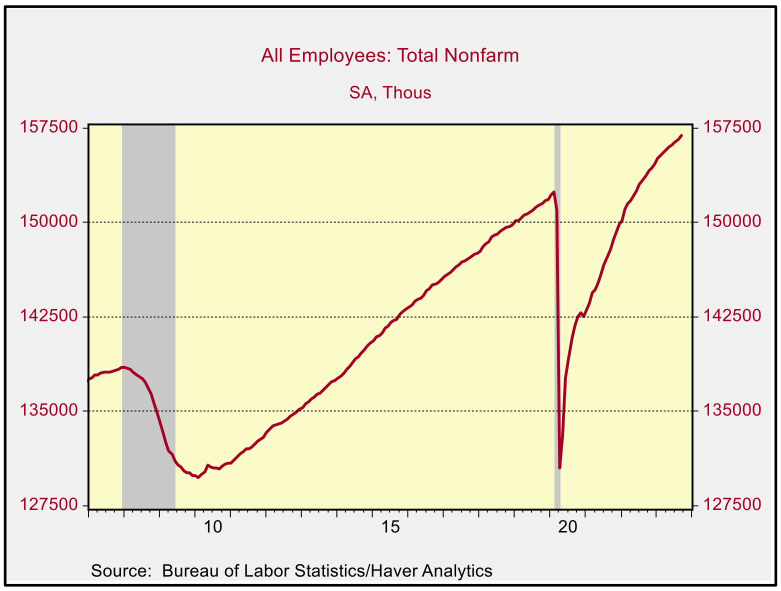


- Mexico's situation illustrates the political risks associated with reshoring manufacturing. AMLO's efforts to rein in wasteful spending and inefficiencies were widely viewed as positive by investors, and his reputation as a fiscal hawk has contributed to investor optimism that the business environment may improve once he leaves office. However, recent initiatives and AMLO's political influence suggest that his draconian measures may have been a ruse to usher in a new era of Cardenismo (Mexican nationalist populism), rather than any desire to promote government soundness. Investors should, therefore, pay close attention to Mexico's elections next year, as AMLO's successor will likely be pressured to continue his policies.

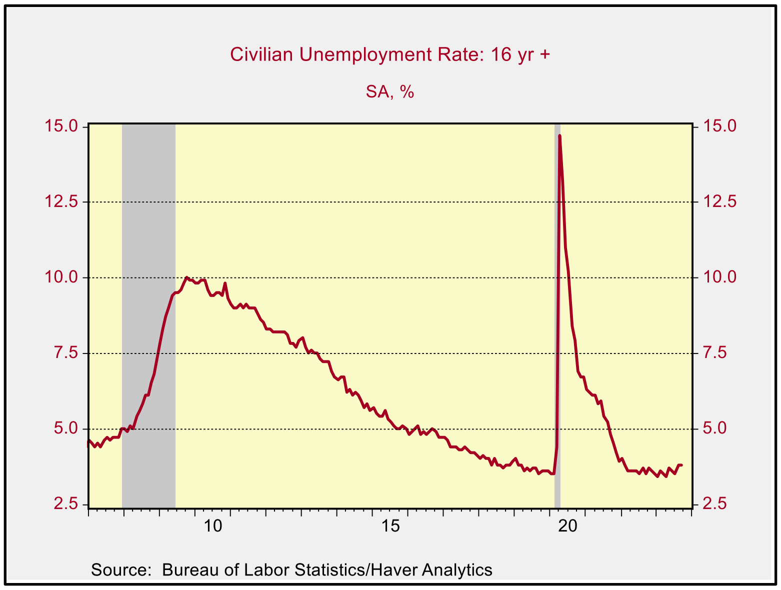
Ins and Outs: The U.S. shot down a Turkish drone in Syria after military officials believed it posed a threat to American forces. While it is unclear whether this will rupture U.S.-Turkey relations, it does highlight the two countries' disagreement over Syrian Kurds, whom Ankara views as a threat. President Trump's influence in Congress is growing after he endorsed Jim Jordan (R-OH) to take over as House Speaker. Jordan's selection could raise the likelihood of a government shutdown in November. Workers at an LNG plant in Australia will resume their strike, which poses a threat to energy markets, particularly in Europe where Australia is the third largest supplier.

U.S. Economic Releases

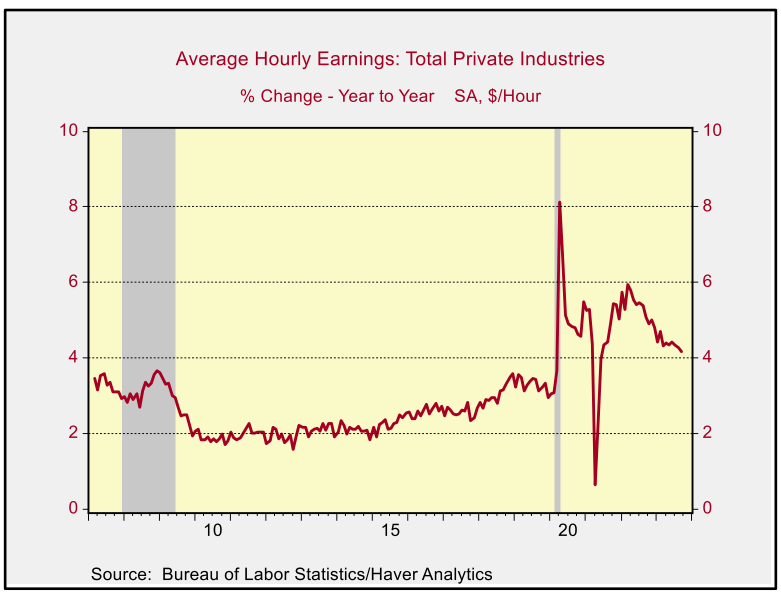
September ***nonfarm payrolls*** jumped by a seasonally adjusted 336,000, almost double the expected gain of 170,000 and far more than the upwardly revised August increase of 227,000. About 73,000 of the increase in September was in the government sector, suggesting part of the rise reflected teachers going back to work for the new school year. Nevertheless, the robust job increases in the private sector will certainly add to the evolving narrative that the economy is unexpectedly re-accelerating despite the Fed's interest-rate hikes. The news will therefore increase concerns that the monetary policymakers will keep raising rates and/or hold them at high levels for longer than previously anticipated. The chart below shows the change in nonfarm payrolls since shortly before the Great Financial Crisis.



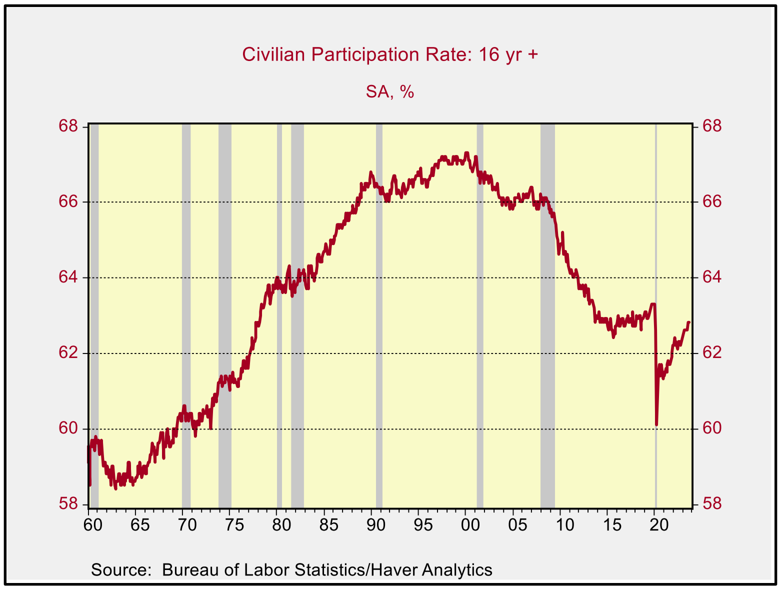
Despite the strong job gains, the September ***unemployment rate*** remained at 3.8%, rather than falling to 3.7% as anticipated. That came because the number of new workers captured by the household survey was far below the number in the employers' survey used for the nonfarm payrolls number. The chart below shows how the unemployment rate has evolved since just before the GFC.



With the demand for labor high and the "inventory" of unemployed workers low, wage rates continued to move higher. ***Average hourly earnings*** in September rose to a seasonally adjusted $33.88, up 4.2% from the same month one year earlier. However, that increase was a bit cooler than expectations that the year-over-year rise would stay at the 4.3% registered in August. The chart below shows the year-over-year growth in average hourly earnings since just before the GFC.



A final key indicator in the monthly employment report focuses on the share of the adult, civilian, noninstitutionalized population that is either working or looking for work. The September ***labor force participation rate (LFPR)*** held steady at a seasonally adjusted 62.8%. The chart below shows how the LFPR has changed over the last several decades.



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**
15:00	Consumer Credit	m/m	Aug	$11.700b	$10.399b	*
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
12:00	Chris Waller Speaks About Payments System	Member of the Board of Governors				

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	Labor Cash Earnings	y/y	Aug	1.1%	1.3%	1.1%	**	Equity and bond neutral
	Household Spending	y/y	Aug	-2.5%	-5.0%	-3.9%	*	Equity bullish, bond bearish
	Leading Economic Index	m/m	Aug P	109.5	108.2	109.1	**	Equity and bond neutral
South Korea	Foreign Reserves	m/m	Sep	414.12b	$418.30b		*	Equity and bond neutral
EUROPE								
Germany	Factory Orders WDA	y/y	Aug	-4.2%	-10.5%	-10.1%	***	Equity bullish, bond bearish
France	Trade Balance	m/m	Aug	-8202m	-8089m	-8106m	**	Equity and bond neutral
	Current Account Balance	m/m	Aug	-0.8b	-2.0b	-1.8b	**	Equity and bond neutral
Italy	Retail Sales	y/y	Aug	2.4%	2.7%	2.80%	**	Equity and bond neutral
Switzerland	Unemployment Rate	m/m	Sep	2.0%	2.0%	2.0%	**	Equity and bond neutral
	Foreign Currency Reserves	m/m	Sep	678.4b	694.3b	694.0b	***	Equity and bond neutral
Russia	Money Supply, Narrow Definition	w/w	29-Sep	18.55t%	18.67t		*	Equity and bond neutral
	Gold and Forex Reserves	m/m	29-Sep	$568.4b	$576.0b		***	Equity and bond neutral
AMERICAS								
Canada	Net Change in Employment	m/m	Sep	63.8k	39.9k	20.0k	***	Equity bullish, bond bearish
	Unemployment Rate	m/m	Sep	5.5%	5.5%	5.6%	***	Equity and bond neutral
	Participation Rate	m/m	Sep	65.6%	65.5%	65.6%	*	Equity and bond neutral
	International Merchandise Trade	m/m	Aug	0.72b	-0.99b	-0.44b	**	Equity and bond neutral
Brazil	FGV Inflation IGP-DI	y/y	Sep	-5.34%	-6.91%	-5.50%	**	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	568	0	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	540	1	Up
U.S. Libor/OIS spread (bps)	542	542	0	Up
10-yr T-note (%)	4.74	4.72	0.02	Flat
Euribor/OIS spread (bps)	397	396	1	Up
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Up			Down
Yen	Down			Down
Pound	Up			Down
Franc	Up			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
RBI Cash Reserve Ratio	4.500%	4.500%	4.500%	On Forecast
RBI Repurchase Rate	6.500%	6.500%	6.500%	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	$84.07	$84.07	0.00%	
WTI	$82.35	$82.31	0.05%	
Natural Gas	$3.21	$3.17	1.36%	
Crack Spread	$20.40	$19.29	5.75%	
12-mo strip crack	$23.22	$22.68	2.39%	
Ethanol rack	$2.47	$2.48	-0.05%	
Metals				
Gold	$1,821.04	$1,820.30	0.04%	
Silver	$21.08	$20.97	0.50%	
Copper contract	$360.35	$355.20	1.45%	
Grains				
Corn contract	$498.25	$497.50	0.15%	
Wheat contract	$579.75	$578.25	0.26%	
Soybeans contract	$1,287.00	$1,280.75	0.49%	
Shipping				
Baltic Dry Freight	1,827	1,778	49	
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)	86	94	-8	

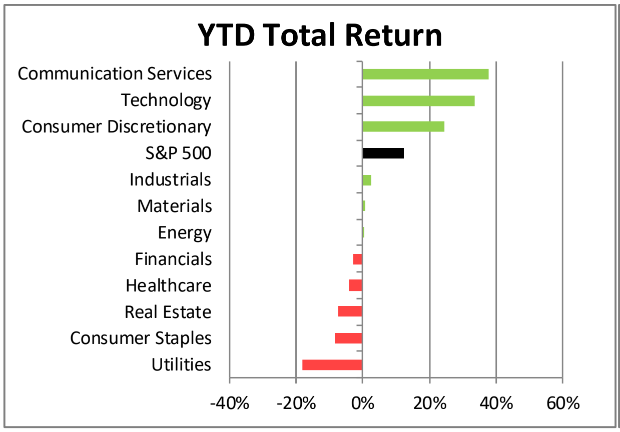
Weather

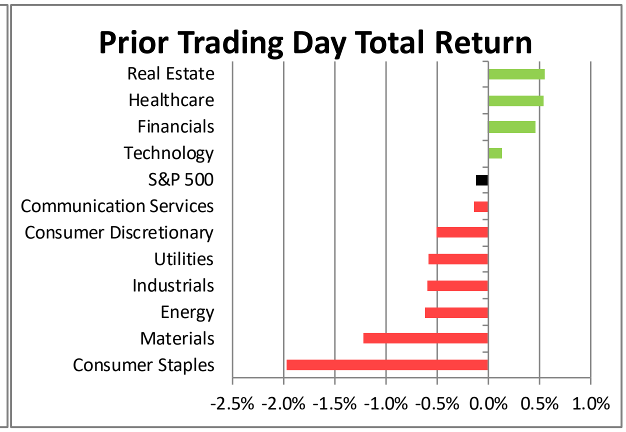
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for the entire country west of the Mississippi River, with cooler-than-normal temperatures only in the Northeast. The forecasts call for wetter-than-normal conditions in the Pacific Northwest and along the East Coast,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

Only one atmospheric disturbance is now active in the Atlantic Ocean. Tropical Storm Philippe is moving northward off the Carolinas and is expected to soak Bermuda today and New England over the weekend. On average, Atlantic hurricane activity peaks on September 15.

Data Section

U.S. Equity Markets – (as of 10/5/2023 close)

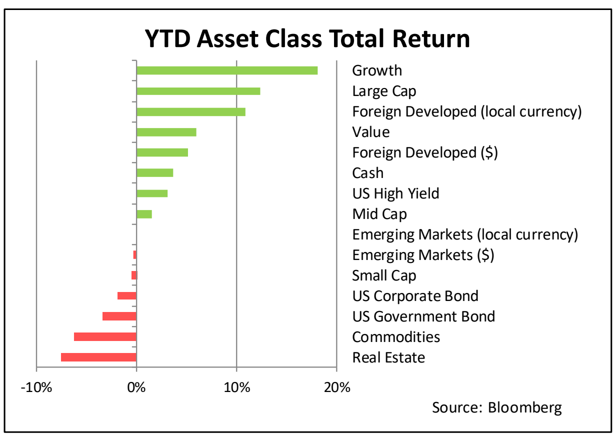




(Source: Bloomberg)

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 10/5/2023 close)

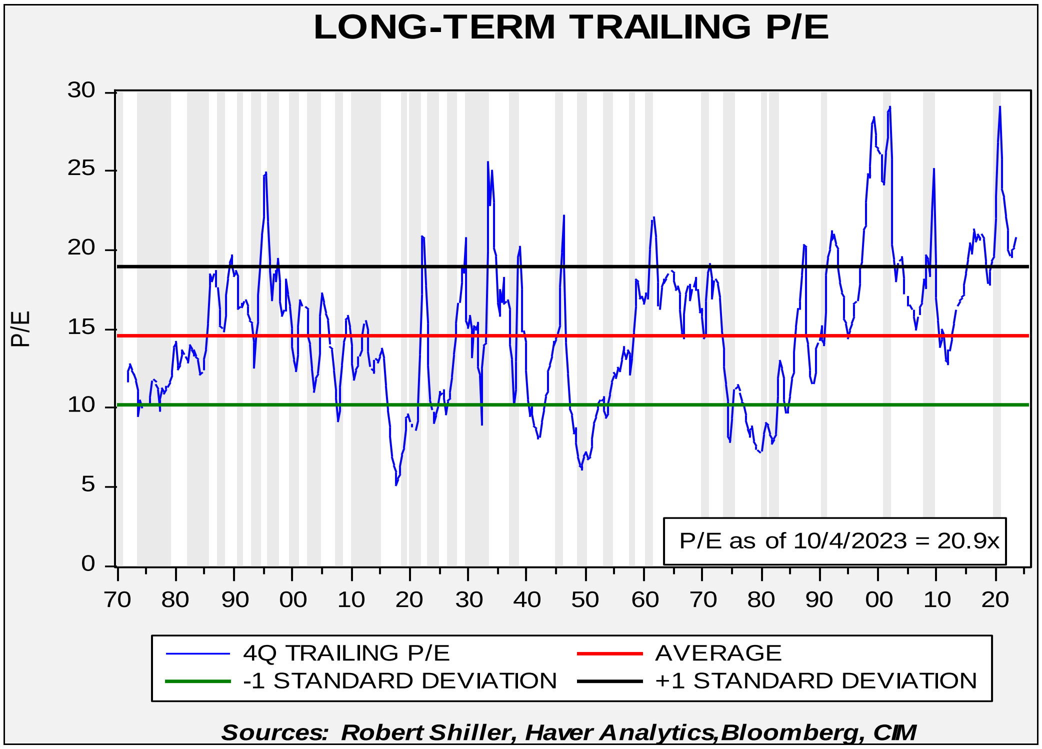


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.