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 9, 2023—9:30 AM EDT] Global equity markets are mostly lower this morning. In Europe, the Euro Stoxx 50 is down 0.6% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed essentially flat. Chinese markets were lower, with the Shanghai Composite closing down 0.4% and the Shenzhen Composite closing down 0.1%. 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* (10/9/2023) (with associated podcast): "The FOMC in 2024"**
- *Confluence of Ideas* podcast (8/22/2023): "The Economics of Defense in Great Power Competition"

Good morning. Financial markets have been roiled by events in the Middle East, which we will discuss. We are seeing market reactions typical with such geopolitical events, such as a stronger dollar, higher oil prices, a surge in gold, and a decline in equities. However, we have seen most of these markets correct since their most extreme levels of the overnight session. As a reminder, this is a bank holiday, so cash Treasury trading is closed and there won't be any government data releases.

In today's *Comment*, we start our coverage with the Hamas attack and our take on the event. Up next is our international overview, and then we look at economic news.

The Second Yom Kippur War: Nearly fifty years ago, Egypt and Syria, along with other Arab states, launched a surprise attack on Israel. After initial successes, Israel halted the Arab offensive and counterattacked. However, the war did nearly bring the U.S. and USSR into a direct confrontation, and a major side effect of the conflict was the first unveiling of the Arab OPEC oil weapon.

This attack was a surprise as well. Hamas fighters launched a multipronged attack on several towns surrounding the Gaza Strip. The attack appeared to catch Israel completely off guard. Although the situation remains fluid, it appears that over 100 Israelis are being held hostage and over 600 Israelis have died in the assault, with the total death toll exceeding 1,000. It is reported that Americans and Europeans are also being held or have died in the assault. Israel appears to be preparing for a major assault on Hamas as it has called up 300k reservists. The towns captured by Hamas are being retaken. The Gaza Strip is under siege, and their utilities have been cut off. Given that the situation is continuing to evolve, we won't try to report the latest news, but instead, we will note our observations of the event.

A failure of intelligence: Israel's model of managing the Palestinian areas was to isolate them with walls and checkpoints, regulate the economies of the Palestinian controlled West Bank and Gaza Strip, and use a deep intelligence network to snuff out unrest and potential attacks. The Israeli government had mostly given up on occupation, as occupying Gaza was difficult, and so isolating and controlling was seen as a better solution. This attack was broad and sophisticated. Not only were there a large number of Hamas fighters involved, but there were also large caches of weapons that had been accumulated and stored. The fact that Hamas was able to put this offensive together without losing operational security is remarkable. Coupled with this intelligence failure was the relatively slow response to the attack by the military and the government. How did Hamas pull this off? It seems to have done so by persistently signaling that the Hamas leadership had no interest in any sort of confrontation with Israel. Essentially, Israeli intelligence fell victim to "narrative capture," which is when analysts become so convinced of a narrative that they ignore evidence that contradicts the accepted wisdom.

Israel and the U.S. respond: PM Netanyahu has declared a state of war on Hamas and the Israeli government has approved "significant military steps." The U.S. announced that the USS *Gerald Ford* carrier group will move to the Eastern Mediterranean. The group was already conducting exercises with the Italian Navy. The U.S. is reviewing the sending of additional assistance to Israel. The large number of hostages taken by Hamas will be difficult to manage.

The conflict could widen: There have been reports of rocket attacks in northern Israel, likely carried out by Hezbollah. As the U.S. moves to support Israel, we will be watching to see if Iran or other regional powers, such as Turkey, try to resupply Hamas. While a regional conflict is a low-probability event, when something like this occurs, there is still a chance for expansion. For example, we note that China is now calling for a Palestinian state, and although we doubt Beijing has the ability to project power into the region, a broader proxy conflict could emerge if outside powers begin taking sides. At the same time, China's tone-deaf response to the Hamas attack on Israeli civilians will likely fall flat with parties in the region. In addition, given that Iran benefits from this conflict (see next point), Israel may decide to directly retaliate against Tehran.

The role of Iran is a key to whether this conflict expands: There appears to be broad evidence of Iranian involvement. The *WSJ* is reporting that the Islamic Revolutionary Guard Corps was deeply involved in the planning of the attack and approved the operation. Other sources corroborate this assertion. Iran claims it was not involved. We also note that the Biden administration is clearly trying to avoid tying the operation to Iran. As we have discussed in our *Weekly Energy Update*, the Biden administration has been trying to resurrect the Iran nuclear agreement (JCPOA) since coming into office. Its most recent decision to unfreeze Iranian assets for hostages will be politically difficult to manage. SoS Blinken has indicated that the $6.0 billion of assets were not used for Hamas. Although that might be technically true, the political optics are not favorable. The ongoing investigation of Robert Malley raises concerns that Iran has penetrated the administration. The initial reaction of the Biden administration appears to be to "slow walk" the issue of Iranian involvement. However, that stance will be difficult to maintain, as there appears to be sufficient evidence to point to Iranian involvement, and thus, some sort of retaliation is likely.

The Israeli/Saudi normalization is in peril: Saudi Arabia and Israel, supported by the U.S., have been in talks with the intent to normalize relations. Riyadh's stipulations are major (formal U.S. security guarantee, nuclear power transfer, peace in Palestine), which has made a deal difficult to achieve, but, as we have noted in our *Weekly Energy Update*, progress was being made. However, a deal now looks unlikely. Although we think the timing of this assault was to coincide with Yom Kippur, the fact that the hostilities will likely scuttle normalization is a major benefit for Iran. Thus, the attack coming when talks were making progress suggests possible coordination with Iran.

Market ramifications: Here is what we expect from markets:

Oil prices: After running up to just over $95 per barrel, WTI has endured a stiff correction, likely on fears that rising interest rates would hurt the global economy and weaken demand. However, there was also a chance that a successful Israeli/Saudi normalization could have encouraged Riyadh to boost production as part of the contribution to the deal with Washington. Saudi Arabia has 2.0 mbpd of excess capacity, and therefore represents the most bearish factor to the market. Since the attacks are likely to end or dramatically postpone normalization, we don't see any other reason why the Saudis would lift output. In fact, if Iran is implicated, we could see actions by the West to curtail Iranian oil flows. In addition, given the fact that the U.S. SPR has already been aggressively tapped, it will be risky to authorize another drawdown. If there is a crackdown on Iranian oil shipments, it is possible that the Saudis will offset those barrels, but, barring a significant economic slowdown, this event will likely put a floor under oil prices at a minimum and could lead to higher prices.

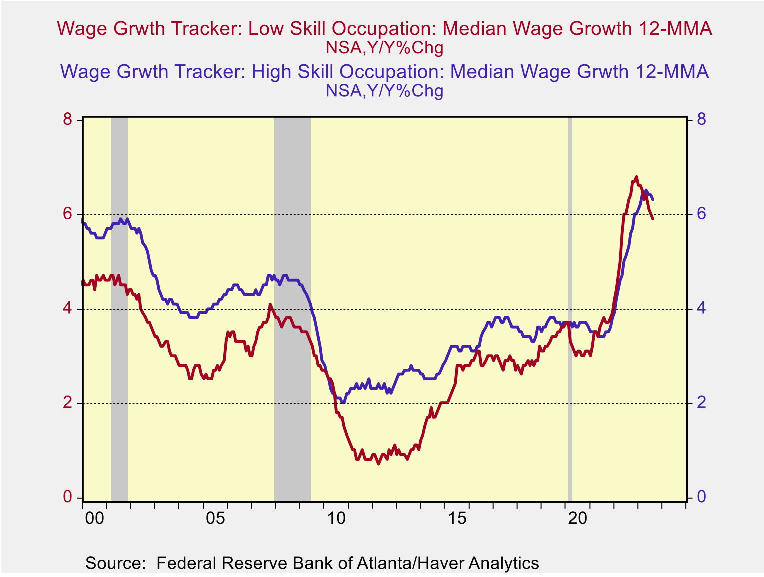
The dollar: If we are right on oil prices, the dollar should rally too. As we noted in our *June 12 Bi-Weekly Geopolitical Report*, as the U.S. has shifted from a petroleum importer to exporter, America's terms of trade have flipped as well. Higher oil prices lead to an improvement in the terms of trade and thus a stronger dollar. In addition, when crises hit, it is normal for the dollar to appreciate.

Treasuries: Usually, such events lead to the safety buying of Treasuries. We are seeing some of that this morning, but given the other concerns surrounding this market, the rally is unlikely to persist.

Equities: Equities are risk assets and events such as this raise risk perceptions. Thus, it's a bearish factor for stocks, at least in the short term.

Economic Roundup: Labor actions continue, Boomers support the economy, and we continue to watch the bond market.

- Health care workers in California have returned to work without a contract, but given the state of negotiations, labor action might return. On the other hand, the UAW is expanding its strike to Mack Trucks (VLVLY, $20.58) after workers rejected the company's offer.
- One of the reasons consumption is holding up so well is due to the spending of older Americans. As the U.S. population ages, more households are living off their accumulated assets and Social Security. This spending is less sensitive to the job market and is turning out to be a surprising source of support for the economy.
- In the 1980s, there were concerns about the size of deficits and the market's ability to absorb the borrowing. The market did clear, but at rates much higher than what we have seen for the past two decades. There are renewed fears that the market won't easily absorb the wave of borrowing that the Treasury is planning, and these fears have been a factor behind the recent rise in longer-duration yields.
- Texas cities are reporting high numbers of office vacancies. It isn't work-from-home that is the problem, but overbuilding. Although this is bad news for real estate owners, it does indicate that a strong Texas economy won't be adversely affected by rising rents.
- One of the surprises of this rate hiking cycle has been the tame behavior of credit spreads. Normally, tighter monetary policy leads to spikes in credit spreads. What appears to be happening is that private credit has replaced bonds and bank loans for lending. Since private credit spreads are not easily observable, problems in this area may not be observable either.
- Large company bankruptcies are on the rise. Higher interest rates are playing a role.
- The post pandemic labor market has exhibited an unusual characteristic—higher wage growth for less skilled workers.



Recently, the premium for skill appears to have returned. However, anecdotal evidence suggests that higher skilled workers are facing a sluggish job market.

International Roundup: Russia moves to end its compliance with the nuclear test ban, the ruling coalition in Germany takes a drubbing in local elections, and there was an earthquake in Afghanistan.

- Russia claims it will end its compliance with the nuclear test ban treaty. Although this is making headlines, the treaty was never ratified by the U.S. and the agreement was never in force because too few nations agreed to it. But because the U.S. and Russia have abided by the terms, the announcement could lead to a resumption of testing.
  - Russia withdrew its Black Sea ships from Crimea due to Ukrainian drone attacks.
- Conservative parties in Germany scored major wins in local elections. The AfD, a populist right-wing party, did surprisingly well. These wins are a signal to the ruling government that their policies are unpopular.
- Poland will hold elections later this week. This report details the parties and their leaders.
- There was a massive earthquake in Afghanistan with a death toll exceeding 2,400.
- The Maduro government in Venezuela has issued an arrest warrant for Juan Guaido, a major opposition leader. Guaido lives in the U.S, and he probably won't be extradited, but given how the U.S. has eased sanctions on Venezuela, there is a chance Washington might send him off.

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		
No economic releases for the rest of today		
Federal Reserve		
EST	**Speaker or Event**	**District or Position**
9:00	Lorie Logan Speaks on US Outlook, Monetary Policy	President of the Federal Reserve Bank of Dallas
9:15	Michael Barr Speaks at American Bankers Association Conference	Federal Reserve Board Vice Chair for Supervision
12:50	Phiip Jefferson Speaks at NABE Conference	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								
China	Foreign Reserves	m/m	--	$3115.00b	$3160.10b	$3125.00b	**	Equity and bond neutral
EUROPE								
Germany	Industrial Production WDA	y/y	Aug	-2.0%	-1.7%	-1.5%	**	Equity bearish, bond bullish
Switzerland	Domestic Sight Deposits CHF	w/w	6-Oct	469.1b	--	--	--	Equity and bond neutral
	Total Sight Deposits CHF	w/w	6-Oct	479.9b	--	--	--	Equity and bond neutral
AMERICAS								
Mexico	CPI	y/y	Sep	4.45%	4.64%	--	***	Equity and bond neutral
	Core CPI	y/y	Sep	5.76%	6.08%	--	**	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)	567	567	0	Up
3-mo T-bill yield (bps)	535	535	0	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	542	540	2	Up
U.S. Libor/OIS spread (bps)	544	542	2	Up
10-yr T-note (%)	4.80	4.80	0.00	Flat
Euribor/OIS spread (bps)	398	397	1	Up
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Down
Yen	Up			Down
Pound	Down			Down
Franc	Flat			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	$87.96	$84.58	4.00%	
WTI	$86.26	$82.79	4.19%	
Natural Gas	$3.36	$3.34	0.54%	
Crack Spread	$18.52	$19.28	-3.97%	
12-mo strip crack	$22.33	$22.59	-1.15%	
Ethanol rack	$2.49	$2.48	0.15%	
Metals				
Gold	$1,845.88	$1,833.01	0.70%	
Silver	$21.60	$21.60	0.00%	
Copper contract	$364.70	$362.75	0.54%	
Grains				
Corn contract	$494.75	$492.00	0.56%	
Wheat contract	$579.50	$568.25	1.98%	
Soybeans contract	$1,272.00	$1,266.00	0.47%	
Shipping				
Baltic Dry Freight	1,929	1,827	102	
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	

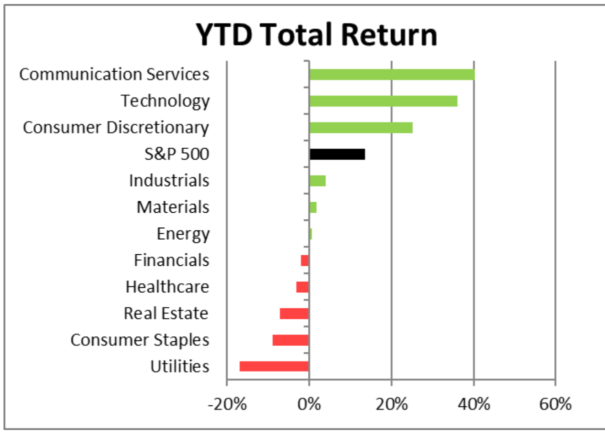
Weather

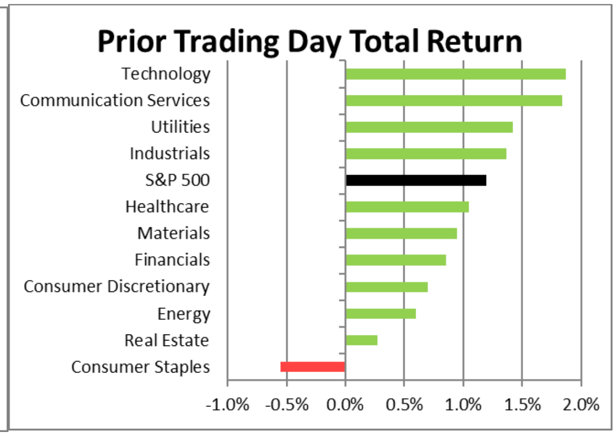
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout the Far West, with cooler-than-normal temperatures in the Deep South and the Northeast. The forecasts call for wetter-than-normal conditions in the Pacific Northwest and along the East Coast, with dry conditions in the Rocky Mountains, the Great Plains, and the Mississippi Valley region.

One atmospheric disturbance is now active in the Atlantic Ocean, off the western coast of Africa. It is assessed to have a 60% chance of forming into a cyclone in the next 48 hours. On average, Atlantic hurricane activity peaks on September 15.

<u>Data Section</u>

U.S. Equity Markets – (as of 10/6/2023 close)

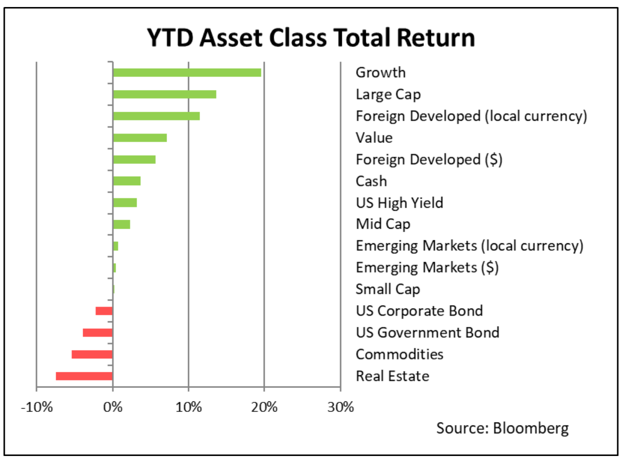




(Source: Bloomberg)

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 10/6/2023 close)

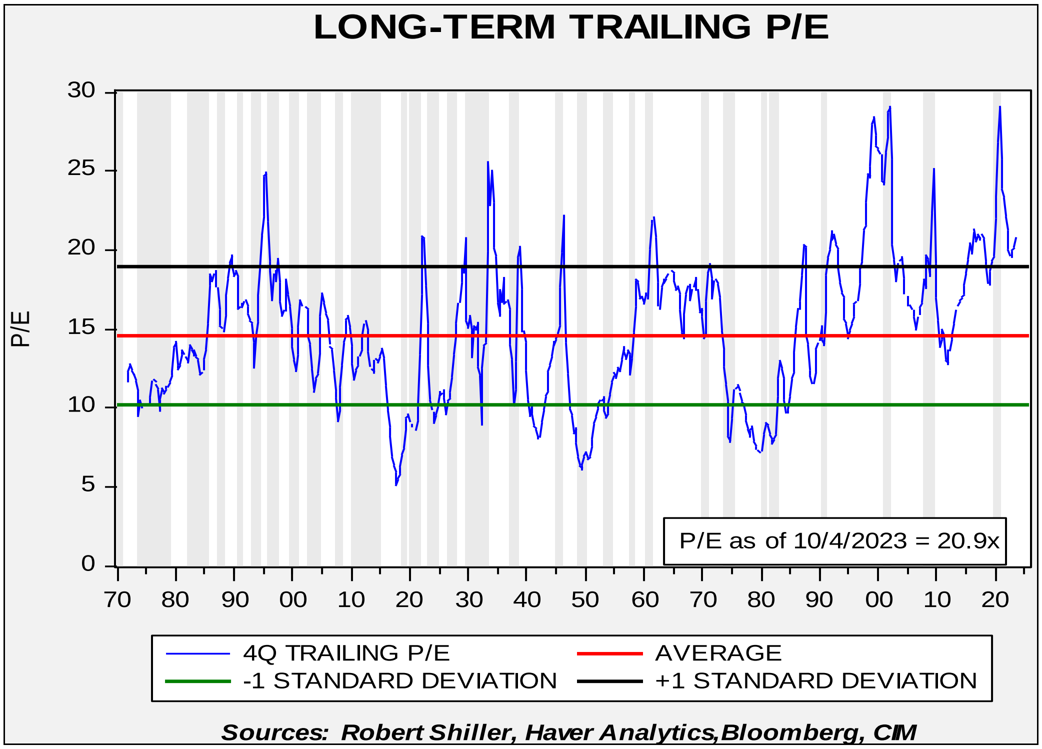


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.