Confluence INVESTMENT MANAGEMENT

Daily Comment

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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 11, 2023—9:30 AM EDT] Global equity markets are mostly higher this morning. In Europe, the Euro Stoxx 50 is down 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.7%. Chinese markets were higher, with the Shanghai Composite closing up 0.1% and the Shenzhen Composite closing up 0.4%. 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* (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"

Our *Comment* today opens with a warning from the International Monetary Fund about global public finances. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including the latest on the Israel-Hamas war, a potentially important corruption scandal at a Chinese electric vehicle firm, and some thoughts on the U.S. bond market.

Global Fiscal Policy: In its latest *Fiscal Monitor* report, the International Monetary Fund warned that governments around the world must take steps to address their worsening fiscal deficits and burgeoning debt. According to the IMF, government leaders seeking to tackle those problems should consider both revenue increases and spending cuts. While painful, the organization said taking the medicine would help preserve financial stability and reduce the need for central banks to keep hiking interest rates.

Israel-Hamas-United States: President Biden yesterday confirmed that more than a dozen U.S. citizens were killed in the Hamas attack on Israel over the last several days. According to the White House, 20 or more U.S. citizens are also missing, suggesting that some or all of them could be among the hostages that Hamas has taken back to the Gaza Strip. The announcement likely ensures that the U.S. will have to get more involved in the conflict as it plays out in the coming days, weeks, and potentially months.

Japan-China: In a recent opinion poll conducted in both Japan and China, fully 92% of surveyed Japanese said their impression of China was "not good," up from 87% last year and the second-highest since the annual survey began in 2005. In contrast, only about 63% of Chinese respondents said they had a negative view of Japan, almost the same as last year. The results help rationalize the Japanese government's recent ratcheting up of rhetoric against China and its increased investment in military capabilities.

China-Australia: The Chinese government today released an Australian citizen it had been holding for three years on suspicion of disclosing state secrets. The release of journalist Cheng Lei is another step in the ongoing easing of tensions between China and Australia, which has already led to reduced Chinese barriers to some Australian exports. If the cooling of tensions continues, a broader range of Australian companies could regain access to the Chinese market.

China: Fast-growing electric vehicle firm Xpeng (XPEV, $16.94) said it has suspended its vice president of supply chain procurement on suspicion of corruption. Xpeng is seen as a potential threat to Tesla (TSLA, $263.62) and BYD (BYDDY,$ 61.75), so it is a high-profile firm in China. The accusation raises concerns that the government may be turning its anti-corruption sights to the rapidly advancing EV industry.

- China's EV industry seems poised to take the world by storm with its inexpensive, high-quality vehicles, at least if the European Union and other markets don't impose trade restrictions to protect domestic jobs.
- All the same, it's important to remember that President Xi's past anti-corruption initiatives have seriously tripped up other key sectors. If the Xpeng move is only the tip of an anti-corruption iceberg, it would be a further red flag for Chinese economic growth going forward.

Finland-Estonia: Authorities in Helsinki and Tallin said they suspect sabotage after discovering damage to a key natural gas pipeline and communications cables running between the countries under the Baltic Sea. If the damage did result from deliberate sabotage, a likely suspect would be Russia, which probably wants to punish Finland for recently joining the North Atlantic Treaty Organization and Estonia for the support it has rendered to Ukraine as that country seeks to fight off Russia's invasion.

Canada-India: The Indian government's deadline for Canada to slash its diplomatic presence in New Delhi expired yesterday with the two countries still negotiating on how to deal with the crisis sparked by Canada's accusation that India helped assassinate a Canadian citizen and Sikh separatist leader in British Columbia in June. Although it isn't yet clear how the negotiations will go, the fact that the two sides are hashing things out could be a welcome sign that they are trying to halt the downward spiral in their relations.

Canada: The Unifor auto workers' strike against General Motors (GM, $30.99), which we mentioned in yesterday's *Comment*, ended abruptly last night after the union and the company tentatively agreed on a new labor contract that would boost wage rates by as much as 25% over three years and also increase the company's pension contributions. The quick capitulation suggests GM wants to avoid a "two-front war" while it also faces the strike by the United Auto Workers in the U.S. Since one target of the Canadian strike was GM's lucrative pickup products, it also suggests that the UAW would have greater leverage if it extends the strike in the U.S. to those types of factories.

U.S. Politics: As of this writing, Republicans in the House of Representatives still plan to vote on a new Speaker today, choosing between current Majority Leader Scalise and Judiciary Committee Chair Jordan. However, it appears that neither Scalise nor Jordan has locked up the votes needed to win, raising the distinct possibility that the issue won't be resolved today.

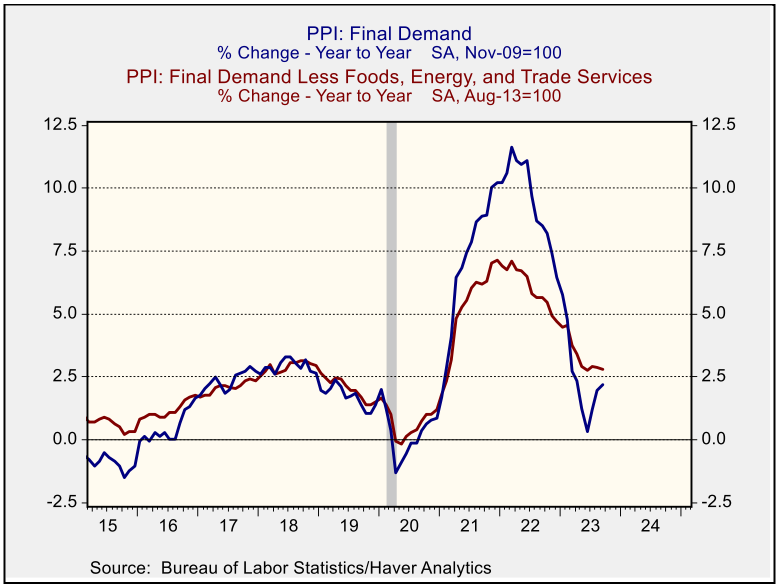
U.S. Bond Market: New analysis suggests that part of the recent weakness in the bond market may reflect the cumulative impact of reduced buying by the Federal Reserve, China, and Japan. The Fed's policy of allowing Treasury obligations on its balance sheet to mature without replacing them has reduced its holdings of Treasury bonds by about $650 billion over the last year. China and Japan have also reduced their holdings as they periodically try to support their currencies. And, of course, China continues trying to diversify its foreign reserves away from the greenback.

U.S. Regulatory Policy: Today, the Federal Trade Commission and the Consumer Financial Protection Bureau jointly proposed a set of new rules to clamp down on junk fees that are poorly disclosed or sprung on consumers at checkout. The proposed rules will now begin a 60-day public comment period before they can be formally adopted.

U.S. Economic Releases

Mortgage applications rose 0.6% in the week ending October 6, according to the Mortgage Bankers Association. The weakness in demand for new loans is related to an increase in the 30-year fixed-rate mortgage which rose 14 bps to 7.67%. As a result, the trackers for purchase and refinance applications rose 1.0% and 0.3%, respectively.

Producer price pressures eased in September. The Producer Price Index (PPI) rose 0.5% from the previous month, according to the Bureau of Labor Statistics. The reading was below expectations of 0.7%. Excluding food and energy, PPI rose 0.3%, above the expectations of 0.2%. Core PPI, which excludes food, energy, and trade, rose 0.2%, compared to expectations of 0.3%.



The chart above shows the annual change in headline and core PPI. Headline PPI rose 2.2% since September 2022, while core PPI rose 2.8%.

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**
10:15	Chris Waller Holds Fireside Chat	Member of the Board of Governors
12:15	Raphael Bostic Speaks to the Metro Atlanta Chamber	President of the Federal Reserve Bank of Atlanta
14:00	FOMC Meeting Minutes	Federal Reserve Board
16:30	Susan Collins Speaks at Wellesley College	President of the Federal Reserve Bank of Boston

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	Machine tool orders	y/y	Sep P	-11.2%	-17.6%		**	Equity and bond neutral
South Korea	BoP Goods Balance	m/m	Aug	$5038.0m	$4280.2m		*	Equity bullish, bond bearish
	BoP Current Account Balance	m/m	Aug	$4733.8m	$3578.8m		**	Equity bullish, bond bearish
EUROPE								
Germany	CPI	y/y	Sep F	4.5%	4.5%	4.5%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Sep F	4.3%	4.3%	4.3%	**	Equity and bond neutral
Russia	Current Account Balance	q/q	3Q P	9482m	9562m		**	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	Down			Up
Euro	Up			Down
Yen	Down			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	$86.83	$87.65	-0.94%	
WTI	$85.04	$85.97	-1.08%	
Natural Gas	$3.34	$3.38	-1.15%	
Crack Spread	$19.57	$19.67	-0.51%	
12-mo strip crack	$22.84	$23.22	-1.67%	
Ethanol rack	$2.49	$2.49	-0.23%	
Metals				
Gold	$1,873.19	$1,860.40	0.69%	
Silver	$22.07	$21.84	1.02%	
Copper contract	$363.05	$363.40	-0.10%	
Grains				
Corn contract	$484.25	$485.50	-0.26%	
Wheat contract	$552.50	$558.50	-1.07%	
Soybeans contract	$1,265.75	$1,271.50	-0.45%	
Shipping				
Baltic Dry Freight	1,983	1,991	-8	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-0.4		
Gasoline (mb)		-1.5		
Distillates (mb)		-1.5		
Refinery run rates (%)		-2.2%		
Natural gas (bcf)		86		

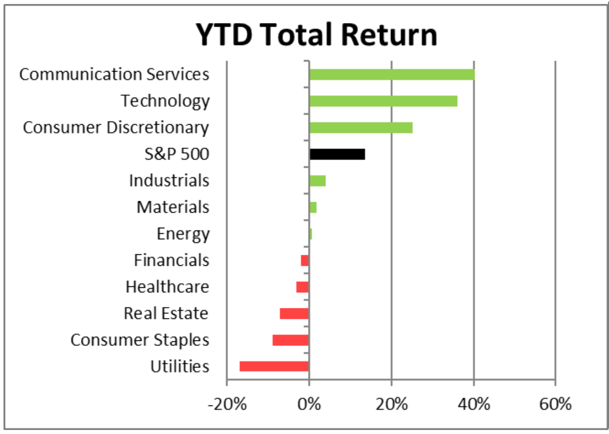
Weather

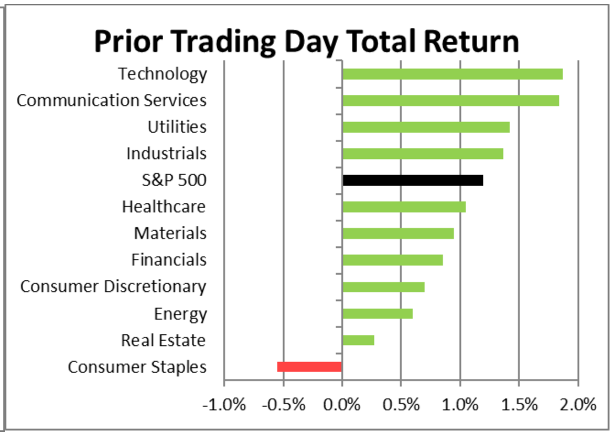
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout the Pacific which is then expected to expand into most of the country, with cooler-than-normal temperatures in the Deep South and the Mid-Atlantic. The forecasts call for wetter-than-normal conditions in the Pacific Northwest, Great Plains, and Texas with dry conditions in the Great Lakes region.

There are two atmospheric disturbances currently active in the Atlantic Ocean. Tropical Storm Sean is located in the central Atlantic Ocean, but it is not expected to make landfall. There is another storm off the West African coast which has a 10% chance of forming into a cyclone in the next 48 hours. On average, Atlantic hurricane activity peaks on September 15.

Data Section

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

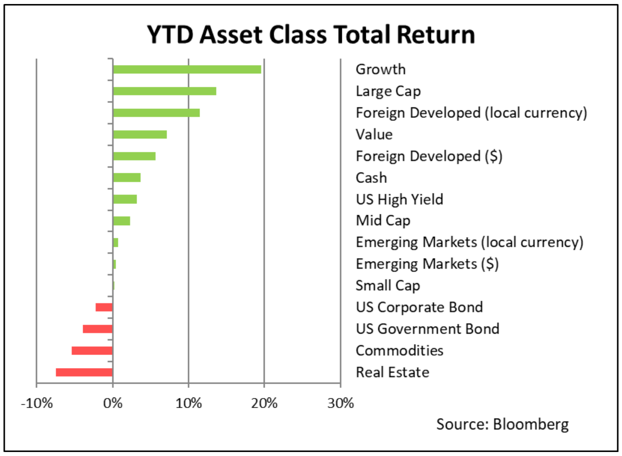




(Source: Bloomberg)

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 10/10/2023 close)

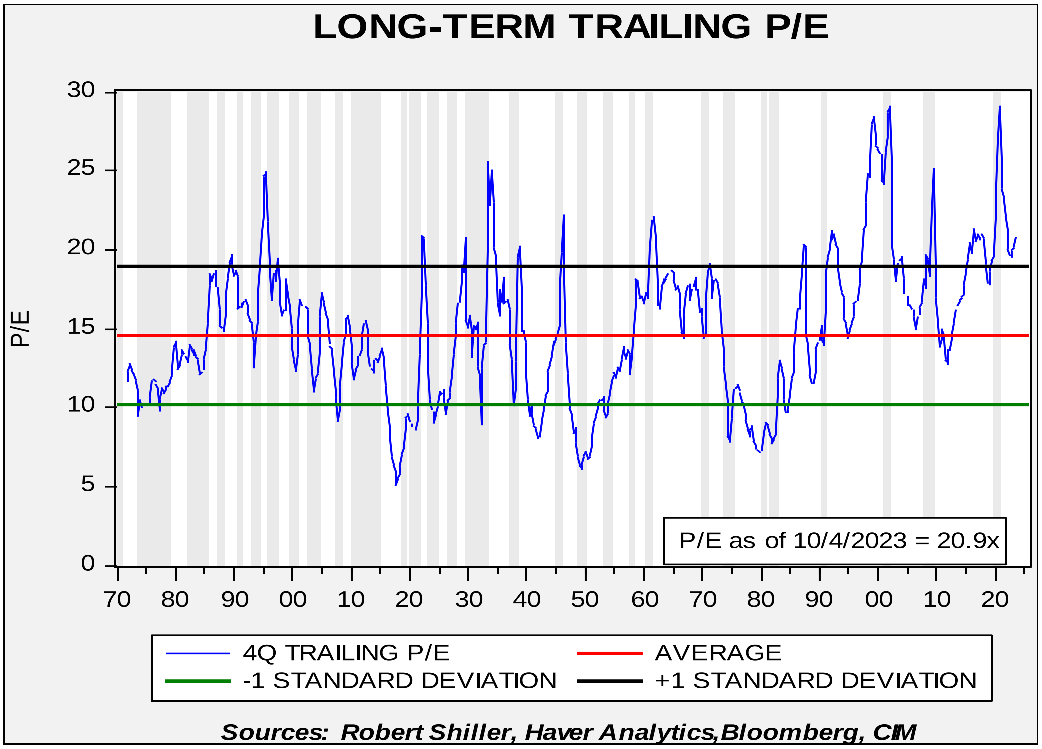


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.