# 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 12, 2023—9:30 AM EDT]** Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is up 0.6% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.4%. Chinese markets were higher, with the Shanghai Composite closing up 0.9% and the Shenzhen Composite closing up 0.7%. U.S. equity index futures are signaling a higher open.

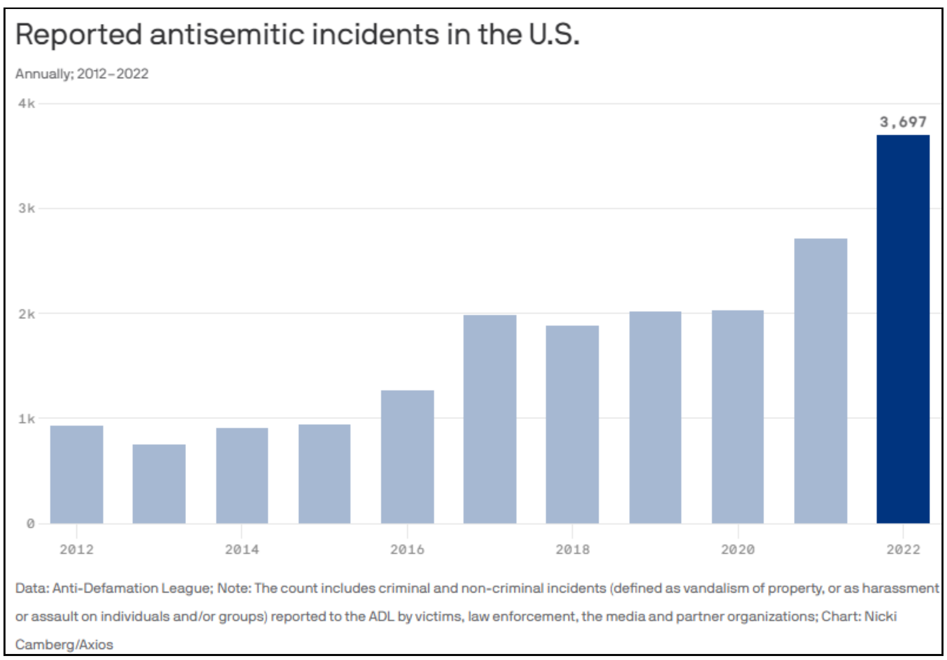
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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. *Due to the holiday, this report will be delayed until Friday.*
- *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! Equities are off to a great start and the Dodgers are out of the playoffs. Today's *Comment* begins with a discussion of the increased scrutiny facing social media companies, our analysis of the latest FOMC meeting minutes, and an update on ongoing bank woes. As usual, our report also provides an overview of the latest domestic and international data releases.

**Silicon Valley Headaches:** Sovereign states are once again warning companies to crack down on the spread of disinformation, a hot topic that is only becoming more pressing as the conflict between Israel and Hamas continues.

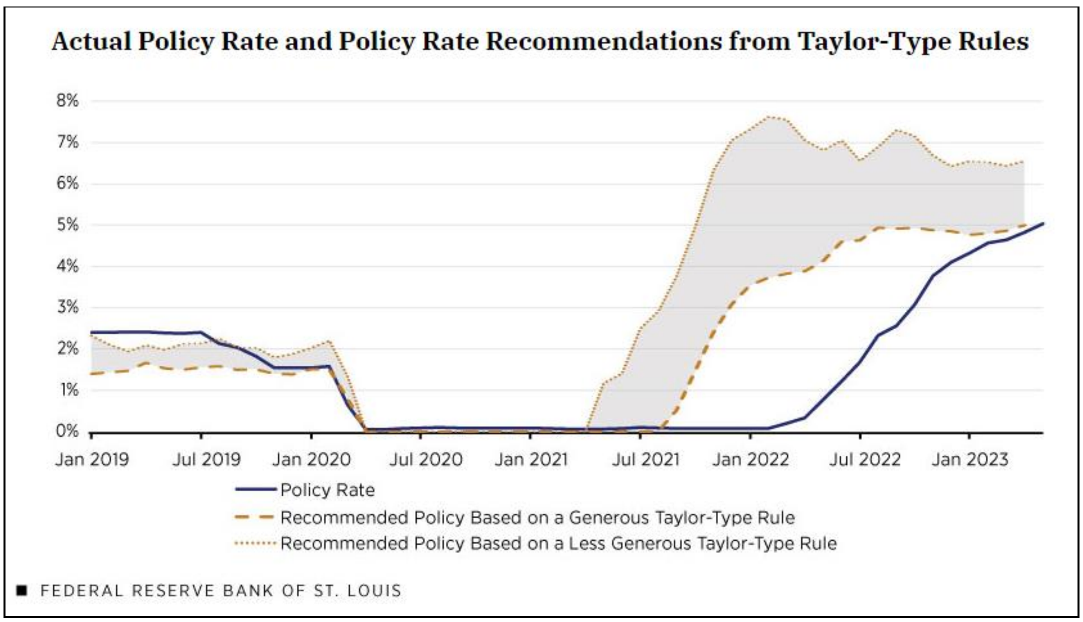
- European Commissioner Thierry Breton has warned social media giants Meta (META, $327.82) and X (formerly Twitter), to crack down on disinformation surrounding the Israeli-Hamas conflict. His warning reflects the growing concern over the spread of false and inflammatory content, such as clips from video games, older videos of conflict, and extreme rhetoric from posters looking to stir tensions between the two sides. The controversy surrounding these posts has revived the debate over the responsibility of tech firms to moderate content on their platforms, especially as hate crimes are on the rise and deepfakes are becoming more prevalent.
- The scrutiny of social media firms poses a threat to tech earnings as governments around the world look to curb controversial speech. Tech firms in the U.S. have been able to shield themselves from legal liability for user-generated content under Section 230 of the Communications Decency Act. However, this loophole may come under renewed scrutiny if Israeli-Hamas misinformation leads to an increase in the harassment of underrepresented groups. Meanwhile, the European Union has already threatened to fine these companies under its Digital Services Act for not taking down certain content. On Wednesday, EU regulators gave X and Meta 24 hours to remove terroristic content from their platform to avoid a penalty.




- The pressure on social media companies to find a balance between free speech and content moderation is likely to grow in the coming year, when both the European Union parliamentary elections and the U.S. presidential election are scheduled to take place. Failure to meet these standards could pose a threat to companies' earnings, as they may be forced to pay fines or face litigation over posts. While the probability of this severely impacting the trajectory of the sector over the next few months is low, it does reflect the regulatory risks that social media firms face in the future as governments become increasingly skeptical of their influence over the public.

**Policy is Different:** Although the Fed minutes showed that policymakers favored at least one more rate hike, the market remained unconvinced.

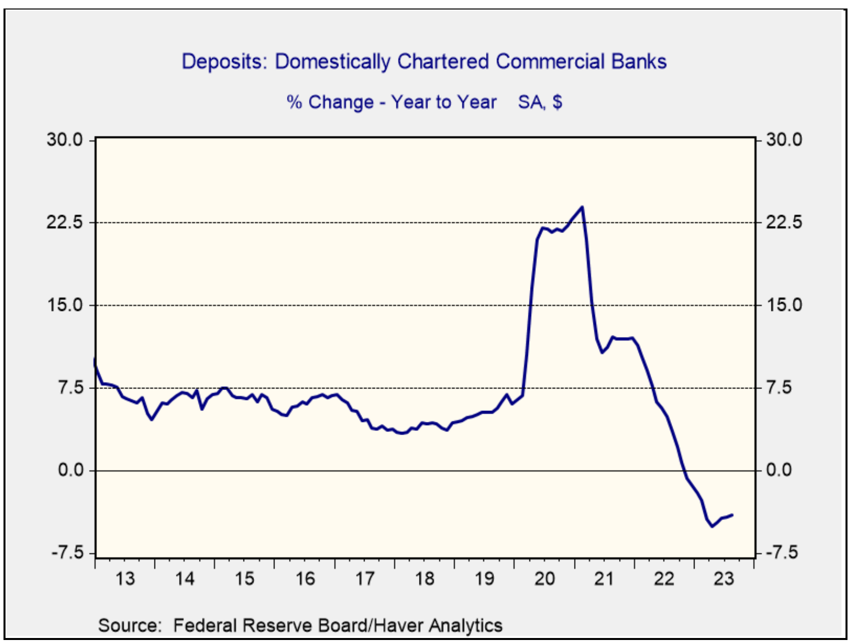
- Minutes from the September 19-20 Federal Open Market Committee (FOMC) meeting showed that a majority of policymakers agreed that another rate hike would be needed before the end of the year to keep inflation on a downward trajectory. While all FOMC members agreed that rates should remain at a restrictive level, they also stressed the need to proceed cautiously and be data-dependent over the next few meetings. This shift in central bank thinking reflects that policymakers are now more focused on when to stop hiking rates instead of how high to raise rates.
- The market largely shrugged off the FOMC minutes, as investors seem to believe that the economic environment has changed since the group last met. Following Friday's job report, which showed the economy added over 300,000 jobs in September, interest rates on long-duration Treasury bonds rose to a near two-decade high, leading some central bankers to argue that further rate hikes may not be necessary. Additionally, the risk of a broad Middle Eastern conflict has raised concerns that the economy could be susceptible to an oil price shock. As a result, the latest forecast from fed futures contracts shows that investors still believe that there is a more than 70% chance that policymakers are finished hiking, remaining relatively unchanged from the previous day.




- That said, we suspect that the Fed's talk of "higher for longer" may be less hawkish than some investors fear. Depending on how neutrality is measured, the restrictive rate could vary depending on the model used to gauge policy tightness. Former St. Louis Fed President James Bullard's model suggests that restrictive territory may be closer to 5.0%, while current San Francisco Fed President Mary Daly, a voter on next year's committee, estimates that the range is likely above 3.0%. This suggests that investors should not rule out the possibility that the Fed could cut rates next year by more than the forecasted 50 bps outlined in the latest Fed dot plots.

**Banks Woes:** Financial institutions are starting to feel the squeeze of higher interest rates as credit quality deteriorates.

- The four biggest banks are expected to write off more loans in the third quarter than any other period since the start of the pandemic. According to data collected by Bloomberg, the banks, which are scheduled to release their earnings reports starting on Friday, are expected to write off nearly $5.3 billion in loans. The increase in net charge-offs is due to concerns that higher interest rates will make it more difficult for banks to find qualified borrowers. Citigroup (C, $41.33) CEO Jane Fraser said that higher interest rates have been particularly burdensome for borrowers with weak credit scores and shrinking savings.
- Rising interest rates are making it more expensive for banks to attract and retain deposits, as savers seek out higher yields elsewhere. While deposits have stabilized in recent months, they remain below pre-March regional bank turmoil levels, according to Federal Reserve data. To attract and retain savers, banks have been forced to sacrifice some of their net interest margin by raising deposit rates. This adjustment has hurt financial institutions, as they were not prepared for a rapid increase in borrowing costs, having purchased long-dated Treasuries when rates were low. Some of the major banks, despite their greater sophistication, were also caught off guard by the rapid rise in interest rates.



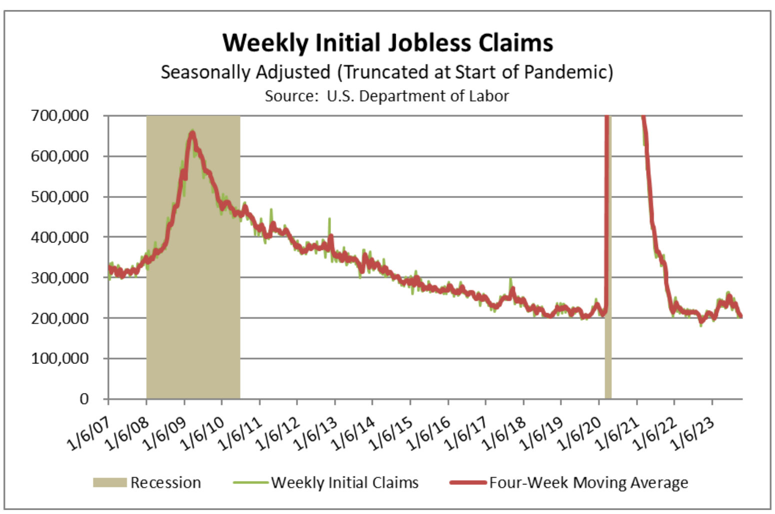

- Despite challenges within the banking sector, there is still little evidence of an imminent crisis. In March, the Federal Reserve showed its willingness to provide banks with as much liquidity as needed to stay afloat, reducing the likelihood of another 2008 event. Additionally, government regulations have forced banks to have contingency plans in case of a possible run. However, policymakers are closely monitoring the rise in charge-offs, as the Fed may be forced to act if default rates start to spread throughout the economy. The chances of this happening this year are not great, but they will increase as long as the central bank keeps interest rates high.

**Update on the Israeli-Hamas Conflict:** National security officials are increasingly concerned that the war in Israel could expand, with Iran potentially targeting U.S. troops. At the same time, border clashes have led to speculation that Hezbollah may join the conflict. The U.S. has sent officials over to help mitigate the risk of a broader conflict. While we remain optimistic that the conflict will be contained, we acknowledge that the risk of a wider war is elevated.

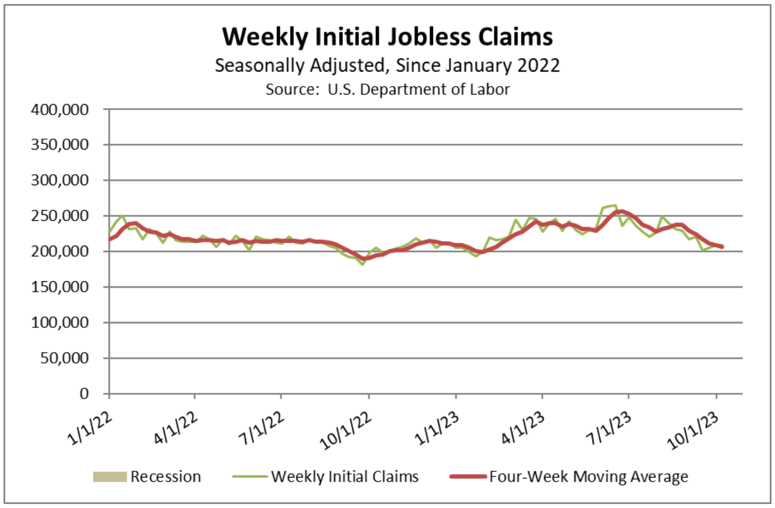
**Other News:** House Republicans have nominated Steve Scalise to take over as speaker; however, it is unclear if he has enough support in his party to take over the job. Congressional members' inability to choose a leader boosts the chances of another government shutdown, which could hurt bond prices. Additionally, it appears that Hollywood actors and studios are struggling to come to an agreement on a new contract. The ongoing discussion reflects a broad trend in labor relations and shows how firms may struggle to increase profit margins without increasing their prices.

**U.S. Economic Releases**

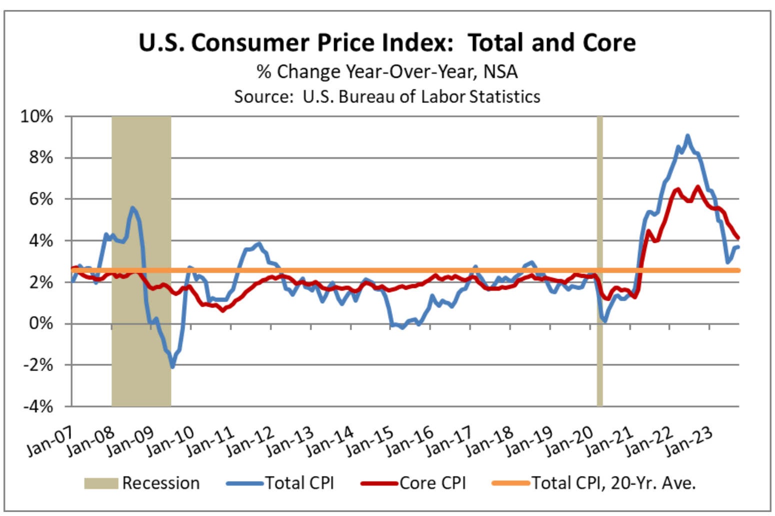
In the week ended October 7, ***initial claims for unemployment benefits*** came in at a seasonally adjusted 209,000, slightly better than the expected level of 210,000 and equal to the prior week's revised level. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, declined to an eight-month low of 206,250. The figures suggest that the demand for labor remains high, and layoffs are still at minimal levels. Meanwhile, in the week ended September 30, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to 1.702 million, substantially above the anticipated reading of 1.675 million and the previous week's revised reading of 1.672 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.




Separately, the September ***consumer price index (CPI)*** rose by a seasonally adjusted 0.4%, a bit more than the expected increase of 0.3% but still less than the August rise of 0.6%. Excluding the volatile food and energy components, the ***"core" CPI*** rose 0.3%, matching expectations that it would rise at the same pace as in the previous month. The overall CPI in September was up 3.7% from the same month one year earlier, while the core CPI was up 4.1%. Importantly, inflation as measured by the core CPI is now at its lowest level since September 2021, which could help persuade the policymakers at the Fed to stop raising interest rates soon, even if they continue to keep rates elevated for an extended period. The chart below shows the year-over-year change in the CPI and the core CPI 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 | | | | | | |
|---|---|---|---|---|---|---|
| EST | Indicator | | | Expected | Prior | Rating |
| 14:00 | Monthly Budget Statement | m/m | Sep | -$146.0b | -$429.8b | ** |
| **Federal Reserve** | | | | | | |
| EST | Speaker or Event | District or Position | | | | |
| 10:00 | Lorie Logan Delivers Welcoming Remarks | President of the Federal Reserve Bank of Dallas | | | | |
| 13:00 | Raphael Bostic Delivers Welcoming Remarks | President of the Federal Reserve Bank of Atlanta | | | | |
| 16:00 | Susan Collins Speaks at Banking Conference | 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 | PPI | y/y | Sep | 2.0% | 3.3% | 2.4% | ** | Equity bearish, bond bearish |
| | Core Machine Orders | y/y | Aug | -7.7% | -13.0% | -6.7% | *** | Equity bearish, bond bullish |
| New Zealand | REINZ House Sales | y/y | Sep | 5.1% | 9.2% | -- | ** | Equity bearish, bond bullish |
| | Food Prices | m/m | Sep | -0.4% | 0.5% | -- | *** | Equity and bond neutral |
| India | Industrial Production | y/y | Aug | 10.3% | 6.0% | 9.1% | *** | Equity bullish, bond bearish |
| | CPI | y/y | Sep | 5.0% | 6.8% | 5.4% | *** | Equity and bond neutral |
| **EUROPE** | | | | | | | | |
| UK | Industrial Production | y/y | Aug | 1.3% | 1.0% | 1.7% | *** | Equity bearish, bond bullish |
| | Manufacturing Production | y/y | Aug | 2.8% | 3.1% | 3.5% | ** | Equity bearish, bond bullish |
| | Visible Trade Balance | m/m | Aug | -£15950m | -£13905m | -£14950m | ** | Equity bearish, bond bullish |
| | Trade Balance | m/m | Aug | -£3415m | -£1418m | -£3700m | ** | Equity and bond neutral |
| **AMERICAS** | | | | | | | | |
| Mexico | Industrial Production | y/y | Aug | 5.2% | 4.8% | 4.5% | *** | Equity bullish, bond bearish |
| | Manufacturing Production | y/y | Aug | -0.6% | 0.8% | 0.1% | * | Equity bearish, bond bullish |

## 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) | 569 | 567 | 2 | 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) | 539 | 539 | 0 | Up |
| U.S. Libor/OIS spread (bps) | 540 | 540 | 0 | Up |
| 10-yr T-note (%) | 4.56 | 4.56 | 0.00 | Flat |
| Euribor/OIS spread (bps) | 395 | 399 | -4 | Up |
| **Currencies** | **Direction** | | | |
| Dollar | Down | | | Up |
| Euro | Flat | | | Down |
| Yen | Flat | | | Down |
| Pound | Flat | | | Down |
| Franc | Down | | | 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 | $86.99 | $85.82 | 1.36% | |
| WTI | $84.46 | $83.49 | 1.16% | |
| Natural Gas | $3.34 | $3.38 | -1.24% | |
| Crack Spread | $20.15 | $20.26 | -0.55% | |
| 12-mo strip crack | $22.99 | $23.03 | -0.17% | |
| Ethanol rack | $2.47 | $2.47 | 0.01% | |
| **Metals** | | | | |
| Gold | $1,883.95 | $1,874.36 | 0.51% | |
| Silver | $22.17 | $22.04 | 0.59% | |
| Copper contract | $363.45 | $361.20 | 0.62% | |
| **Grains** | | | | |
| Corn contract | $488.25 | $488.00 | 0.05% | |
| Wheat contract | $557.25 | $556.00 | 0.22% | |
| Soybeans contract | $1,260.50 | $1,252.50 | 0.64% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 1,948 | 1,983 | -35 | |
| **DOE Inventory Report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | | -1.4 | | |
| Gasoline (mb) | | -1.0 | | |
| Distillates (mb) | | -1.0 | | |
| Refinery run rates (%) | | -0.5% | | |
| Natural gas (bcf) | | 84 | | |

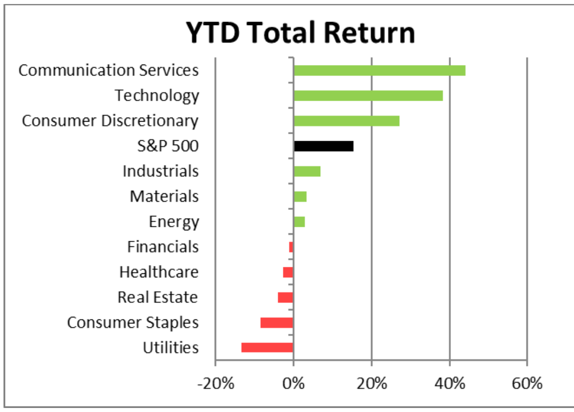
**Weather**

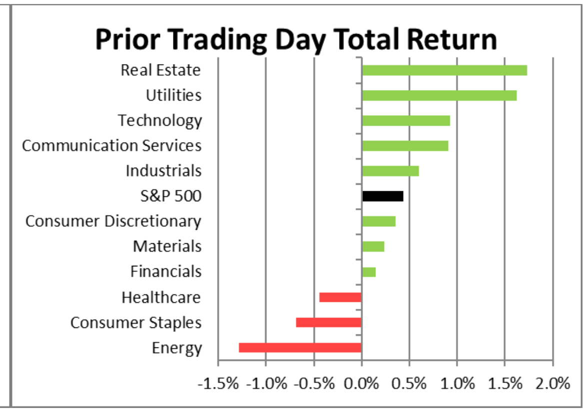
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures from the Great Plains westward, with cooler-than-normal temperatures in the Deep South. The forecasts are calling for wetter-than-normal conditions in Florida and New England, with dry conditions in the Far West and Great Plains region.

There are now two atmospheric disturbances in the Atlantic Ocean. Tropical Storm Sean is in the central Atlantic, but it is not expected to make landfall. Another storm is off the western coast of Africa, but it is assessed to have only a 20% 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 10/11/2023 close)

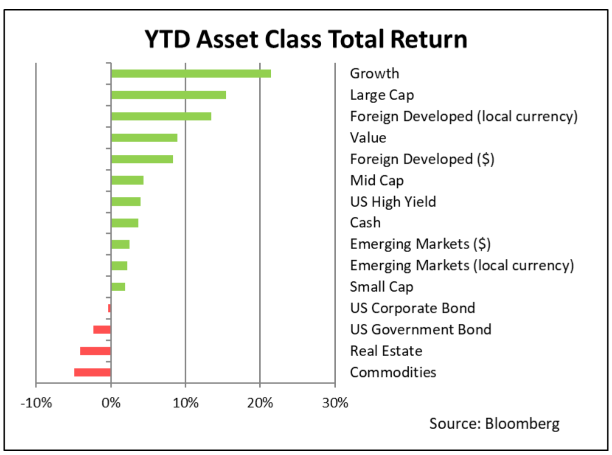



(Source: Bloomberg)

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 10/11/2023 close)

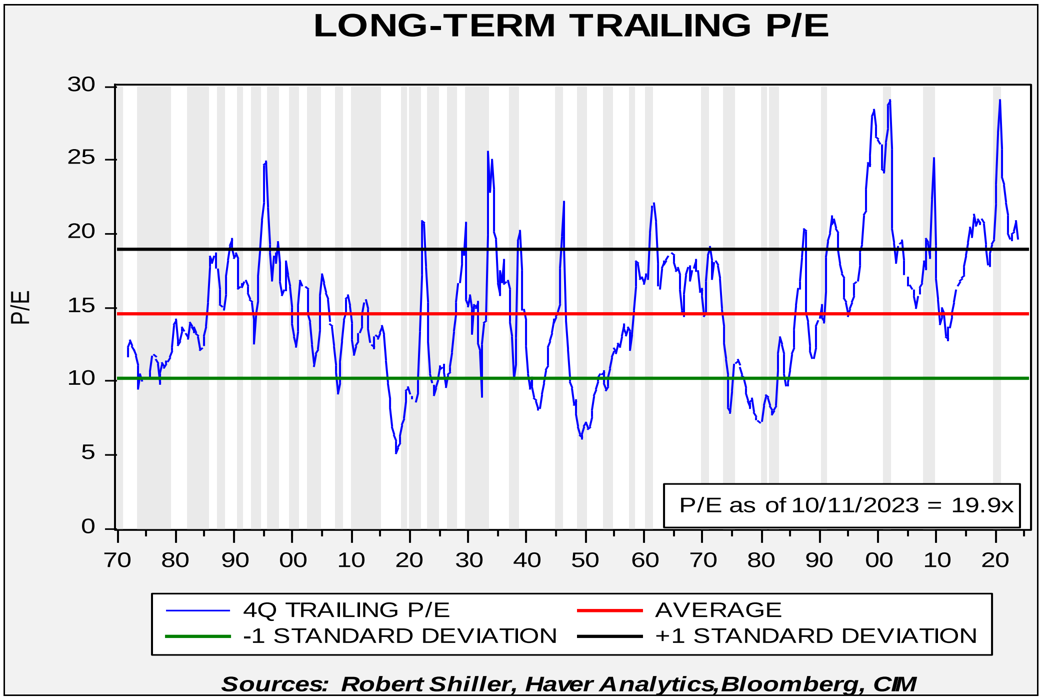



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 12, 2023




Based on our methodology,[1] the current P/E is 19.9x, down 1.0x from last week. The decline in the multiple is mostly due to lower index values although earnings estimates were modestly higher as well.

*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.