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 13, 2023—9:30 AM EDT] Global equity markets are mostly lower this morning. In Europe, the Euro Stoxx 50 is down 0.8% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.8%. Chinese markets were lower, with the Shanghai Composite closing down 0.6% and the Shenzhen Composite closing down 0.8%. In contrast, 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:

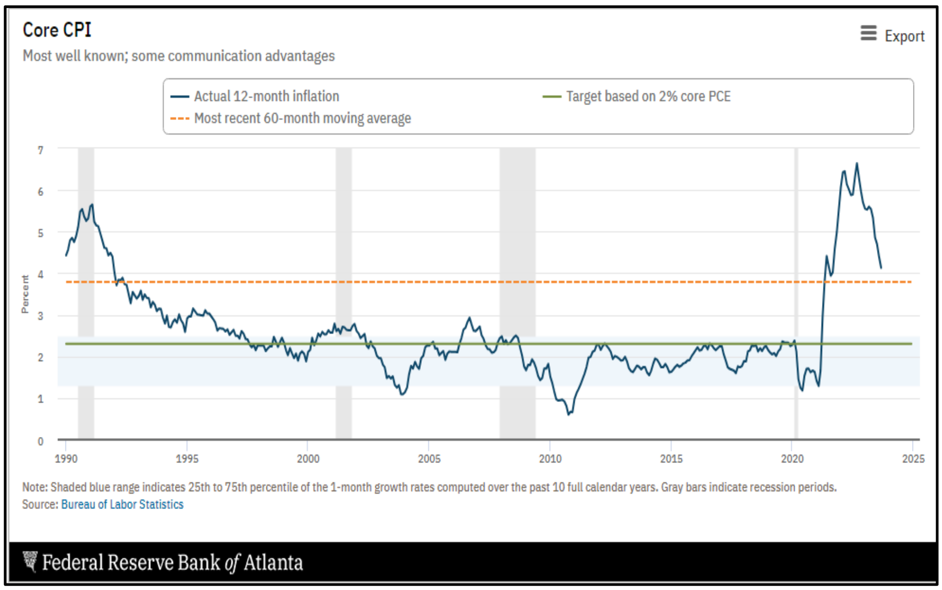
- *Bi-Weekly Geopolitical Report* (10/2/2023) (with associated podcast): "The Oil Weapon Returns"
- ***Weekly Energy Update*** **(10/13/2023): In addition to examining the impact of the Hamas invasion on oil prices, we also take a look at the recent plunge in U.S. gasoline demand. We also note the Exxon merger with Pioneer and its potential impact on the U.S oil industry**.
- *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 up slightly, and the Atlanta Braves are out of the playoffs. Today's *Comment* starts with our thoughts on the inflation report. We then follow with discussions on rising global borrowing costs, the Polish Parliamentary elections, and provide an update on Hamas/Israel. As usual, our report also provides an overview of the latest domestic and international data releases.

Inflation Losing Momentum? September's CPI report spooked investors, raising concerns that stubborn price pressures could persist.

- Consumer prices rose 3.7% in September, unchanged from August and above expectations. Treasury yields rose sharply following the report, with the 10-year yield increasing 11 basis points to 4.71% on Thursday. The S&P 500 and Nasdaq Composite fell roughly 1% on the day. The sell-off in financial assets reflects investors' concerns that the Federal Reserve will continue to tighten monetary policy to combat inflation. The CME FedWatch Tool now projects a 30% chance of another rate hike before the end of the year, up from 25% the day before.

- Despite the market's negative reaction, the CPI report offers some grounds for optimism about inflation. The surprise increase in shelter prices, which spiked 0.6% last month, was a key contributor to the overall rise in inflation. However, we are skeptical that this trend will continue into next year. The core CPI, which excludes volatile food and energy prices, continued its downward trend, with the year-over-year change falling from 4.3% in August to 4.1% in September. Additionally, if the trend of the past six months continues, inflation is likely to fall below its five-year average within the next few months.

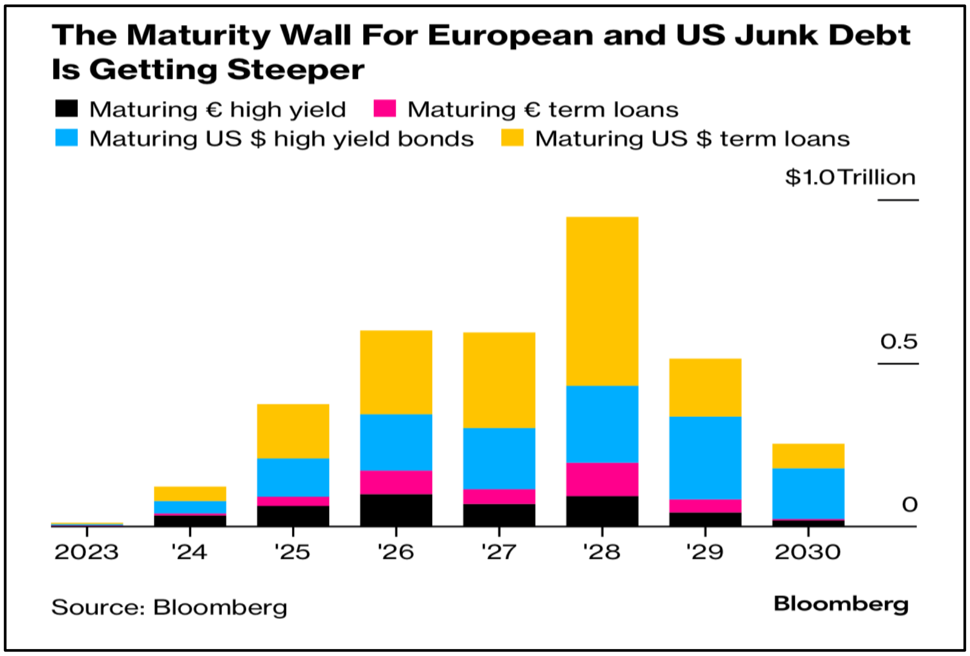


- The Federal Reserve is likely to face turbulence as it works to move core inflation below 4%, which is expected to happen this year. Fed officials are aware of this and will likely plan to hold rates steady before gradually reducing them over time. However, the decision to hike rates again could change if the October and/or November job reports continue to show that the labor market remains strong. As a result, the latest CPI report is unlikely to be enough to shift the sentiment of policymakers, and another rate hike cannot be completely ruled out.

Global Credit Squeeze: The lack of available liquidity is starting to impact major economies.

- Countries are struggling to cope with rising global interest rates. UBS (UBS, $24.50) warned on Friday that the rapid increase in unsecured personal loans in India raises the likelihood of a rise in defaults. Bank of England Governor Andrew Bailey has warned that U.K. interest rates have risen to "restrictive" levels and that he will be closely monitoring how policy impacts the country's mortgage market. Meanwhile, Italian bond yields have surged over the last few weeks, raising concerns that the European Central Bank may [need to scale back plans to shrink its balance sheet] to prevent financial fragmentation.

- Although the largest economies have avoided recession so far, there are signs of growing financial stress. S&P Global projects that the U.S. junk bond [default rates will jump from 3.2% to as high as 6.5%] by June 2024, while European junk bond defaults may jump to 5.5% next year from the current 3.1%. This unexpected surge in charge-offs assumes that interest rates remain relatively high, and that economic growth decelerates in the coming months. However, the doomsday scenario may be avoided if central banks are able to act quickly enough.

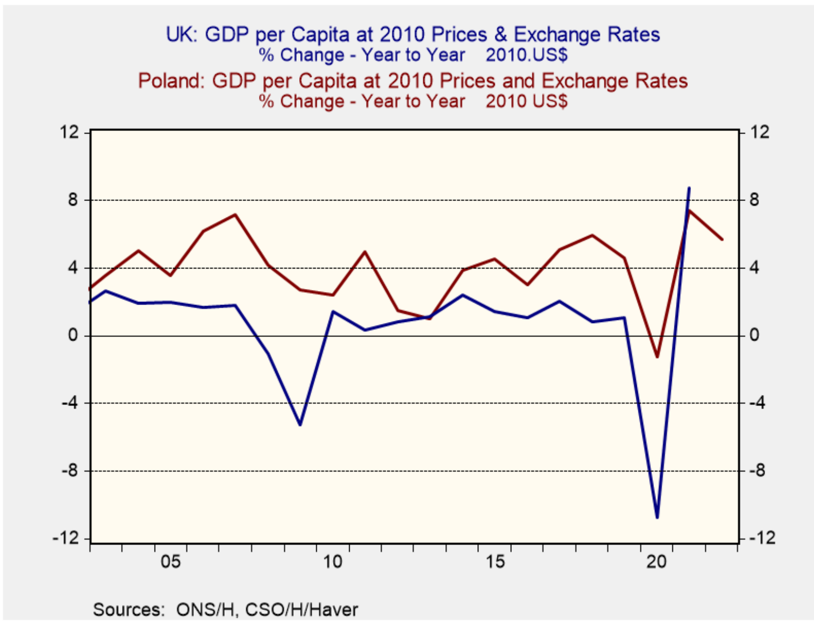


- One of the biggest mysteries since central banks began tightening monetary policy is how policymakers will react if inflation remains high and the economy falls into recession. Adding to the uncertainty is the expectation that refinancing activity will surge in 2024 to compensate for the loans that are expected to come due that year. Data collected by Bloomberg suggests that firms are in for a rude awakening if rates remain elevated. So far, policymakers have consistently denied that they are considering pivoting away from their current hawkish stance and have only signaled the possibility of a pause in rate hikes. However, their tone may change if economies start to fall into recession.

Polish Elections: Parliamentary elections will happen this weekend in Poland, in what could be the most divisive election since the fall of communism.

- Poland's upcoming parliamentary election will be a clash of two opposing ideologies: the right-wing, populist Law and Justice (PiS) party and the centrist, pro-European Civic Platform (PO) party. A win for the former could see the country slide further away from democracy, while a win for the latter would likely bring it back in line with European norms. Neither party is expected to win an outright majority, so the outcome of the election is likely to depend on the performance of smaller parties.

- Dethroning the PiS will likely be a difficult task, but it will be necessary for Poland to regain access to much-needed EU funding. In 2019, Poland passed laws that undermined the independence of its Supreme Court, drawing the ire of the European Commission. These laws prevent judges from assessing each other's compliance with EU standards and questioning the composition of a tribunal, and they give the disciplinary chamber of the Supreme Court the power to penalize judicial officials for the content of their verdicts. Warsaw claims that the changes were necessary to prevent the return of communism, but the European Court of Justice has ruled against it and has fined the Polish government.

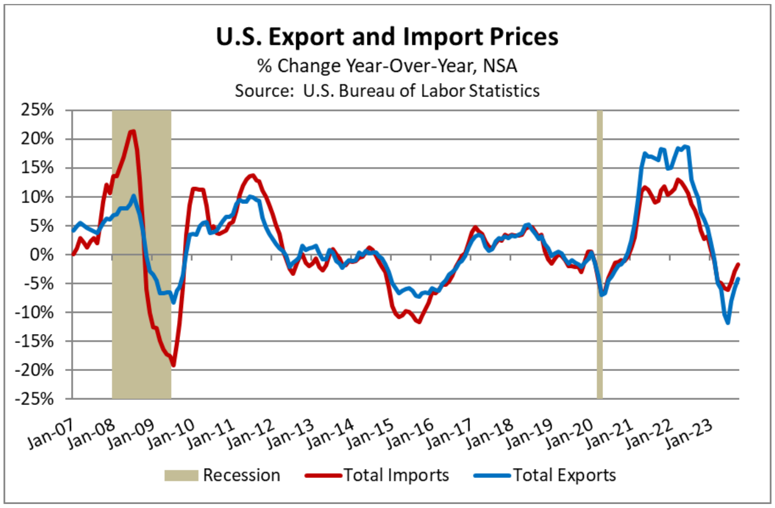


- Despite its relatively small size, Poland has the fifth-largest economy in the European Union, and its GDP per capita is expected to overtake that of the U.K. in a little over a decade. However, if it continues on its current path toward authoritarianism, it may become the second country to leave the bloc, and the first to be forced out. An exit of Poland could further undermine the bloc's legitimacy, as the decline in membership will raise questions about whether it can remain together. Additionally, having a potentially hostile country outside the bloc will likely need to be addressed. As a result, a victory by the PiS could negatively impact the euro.

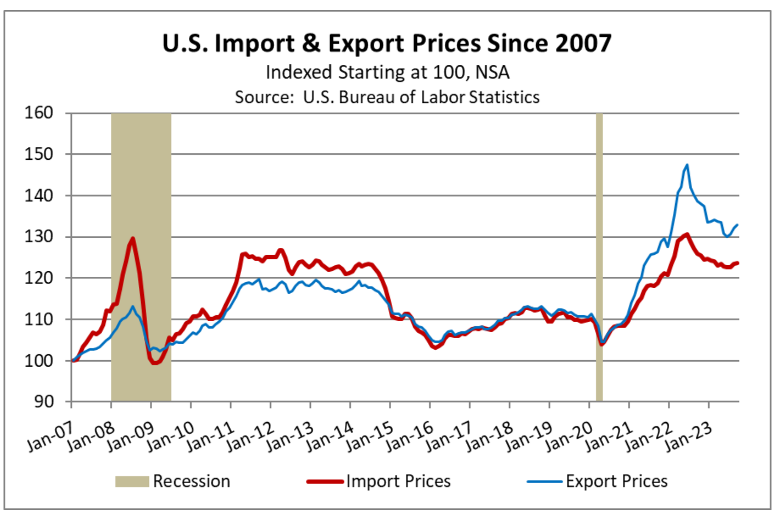
Israel/Hamas Update: Israel has told people to leave Gaza as tensions rise in the region. The announcement reflects escalating tensions in the Middle East and raises the likelihood of a broader conflict. Iran and Saudi Arabia are in constant communication to prevent miscalculation by either side. Meanwhile, Jordan has cautioned Palestinians from going to Egypt.

U.S. Economic Releases

September ***import prices*** were up 0.1% from the previous month, far less than the expected rise of 0.5% and the revised August increase of 0.6%. Of course, import prices are often driven by volatility in the petroleum fuels category. September ***import prices excluding fuels*** were down 0.3%, falling much more than expectations that they would fall at the same 0.1% pace as in the previous month. Overall import prices in September were down 1.7% year-over-year, while import prices excluding fuels were down 0.8%. The chart below shows the year-over-year change in import prices since just before the Great Financial Crisis.



According to the report, ***export prices*** in September were down 4.1% from one year earlier, in large part because of the key agriculture category. Comparing the annual change in export prices versus import prices provides a sense of the U.S. "terms of trade," or the relative advantage or disadvantage the country is facing because of trends in international trade prices. The chart below compares the year-over-year change in U.S. export and import prices 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
10:00	U. of Michigan Consumer Sentiment	m/m	Oct P	67.0	68.1	***
10:00	U. of Michigan Current Conditions	m/m	Oct P	70.3	71.4	**
10:00	U. of Michigan Future Expectations	m/m	Oct P	65.7	66.0	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Oct P	3.2%	3.2%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Oct P	2.8%	2.8%	*
Federal Reserve						
EST	Speaker or Event	District or Position				
9:00	Patrick Harker Speaks on the 2023 Economic Outlook	President of the Federal Reserve Bank of Philadelphia				

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	6-Oct	¥1436.1b	¥71.0b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	6-Oct	¥45.2b	¥721.0b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	6-Oct	¥183.4b	¥297.1b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	6-Oct	-¥643.6b	¥25.8b		*	Equity and bond neutral
	Money Stock M2	y/y	Sep	2.4%	2.5%		**	Equity and bond neutral
	Money Stock M3	y/y	Sep	1.8%	1.9%		**	Equity and bond neutral
New Zealand	BusinessNZ Manufacturing PMI	m/m	Sep	45.3	46.1	--	***	Equity bearish, bond bullish
South Korea	Unemployment Rate	m/m	Sep	2.6%	2.4%	2.6%	**	Equity and bond neutral
China	Aggregate Financing CNY	m/m	Sep	4120.0b	3123.7b	3700.0b	*	Equity bullish, bond bearish
	New Yuan Loans	m/m	Sep	2310.0b	1358.0b	2500.0b	**	Equity bearish, bond bullish
	Money Supply M0	y/y	Sep	10.7%	9.5%	--	*	Equity and bond neutral
	Money Supply M1	y/y	Sep	2.1%	2.2%	2.4%	*	Equity and bond neutral
	Money Supply M2	y/y	Sep	10.3%	10.6%	10.6%	***	Equity and bond neutral
	Trade Balance	m/m	Sep	$77.71b	$68.20b	$70.60b	***	Equity bullish, bond bearish
	Exports	y/y	Sep	-6.2%	-8.8%	-7.5%	**	Equity bullish, bond bearish
	Imports	y/y	Sep	-6.2%	-7.3%	-6.0%	**	Equity and bond neutral
	CPI	y/y	Sep	0.0%	0.1%	0.2%	***	Equity bearish, bond bullish
	PPI	y/y	Sep	-2.5%	-3.0%	-2.4%	**	Equity bearish, bond bullish
India	Trade Balance	m/m	Sep	-$19377.0m	-$24160.0m	-$232000.0m	*	Equity bullish, bond bearish
	Exports	y/y	Sep	-2.6%	-6.9%	--	**	Equity bullish, bond bearish
	Imports	y/y	Sep	-15.0%	-5.2%	--	**	Equity bearish, bond bullish
EUROPE								
Eurozone	Industrial Production WDA	y/y	Aug	-5.1%	-1.3%	-3.5%	**	Equity bearish, bond bullish
France	CPI	y/y	Sep F	4.9%	4.9%	4.9%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Sep F	5.7%	5.6%	5.6%	**	Equity and bond neutral
Switzerland	Producer & Import Prices	y/y	Sep	-1.0%	-0.8%	--	**	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	6-Oct	$562.8b	$568.4b	--	***	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	6-Oct	18.58t	18.55t	--	*	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)	566	569	-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)	540	540	0	Up
U.S. Libor/OIS spread (bps)	541	541	0	Up
10-yr T-note (%)	4.62	4.70	-0.08	Flat
Euribor/OIS spread (bps)	397	395	2	Up
Currencies	**Direction**			
Dollar	Down			Up
Euro	Flat			Down
Yen	Up			Down
Pound	Flat			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	$89.55	$86.00	4.13%	
WTI	$86.41	$82.91	4.22%	
Natural Gas	$3.26	$3.34	-2.39%	
Crack Spread	$20.48	$20.22	1.30%	
12-mo strip crack	$22.98	$22.73	1.10%	
Ethanol rack	$2.45	$2.46	-0.35%	
Metals				
Gold	$1,897.73	$1,868.90	1.54%	
Silver	$22.29	$21.83	2.10%	
Copper contract	$358.25	$359.10	-0.24%	
Grains				
Corn contract	$497.25	$496.00	0.25%	
Wheat contract	$581.50	$571.50	1.75%	
Soybeans contract	$1,295.00	$1,290.00	0.39%	
Shipping				
Baltic Dry Freight	1,935	1,948	-13	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	10.2	-1.4	11.6	
Gasoline (mb)	-1.3	-1.0	-0.3	
Distillates (mb)	-1.8	-1.0	-0.8	
Refinery run rates (%)	-1.6%	-0.5%	-1.1%	
Natural gas (bcf)	84	84	0	

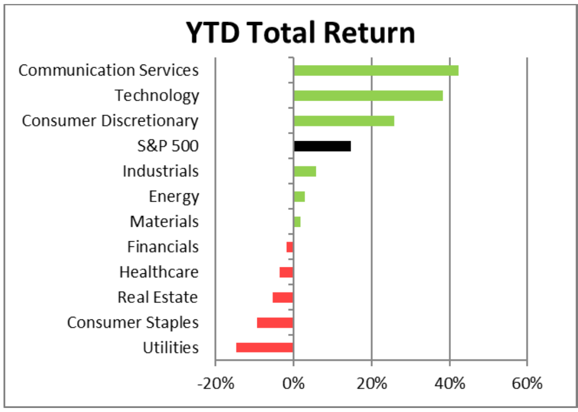
Weather

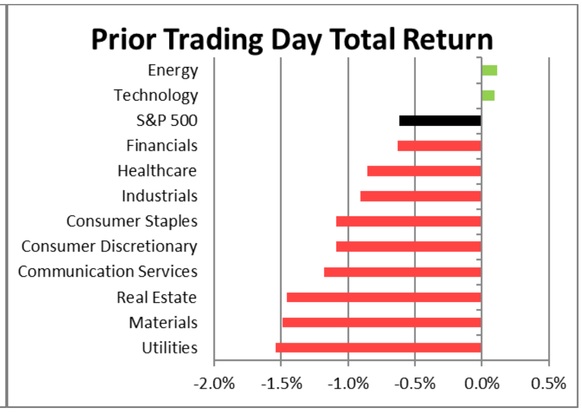
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures from the Great Plains westward, with cooler-than-normal temperatures in the Deep South. The forecasts are calling for wetter-than-normal conditions in Florida and New England, with dry conditions in the Far West and the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

There are currently 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 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 10/12/2023 close)

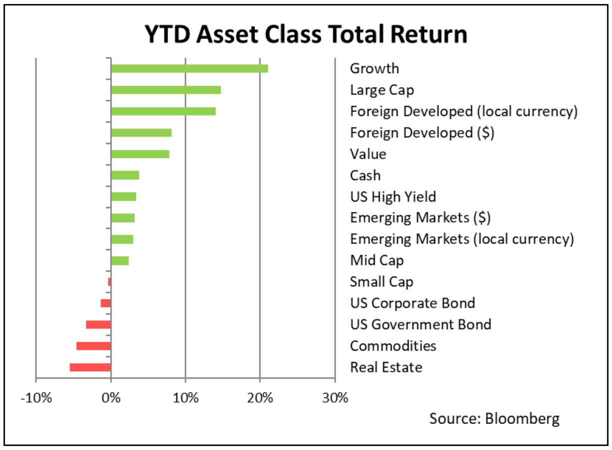




(Source: Bloomberg)

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 10/12/2023 close)

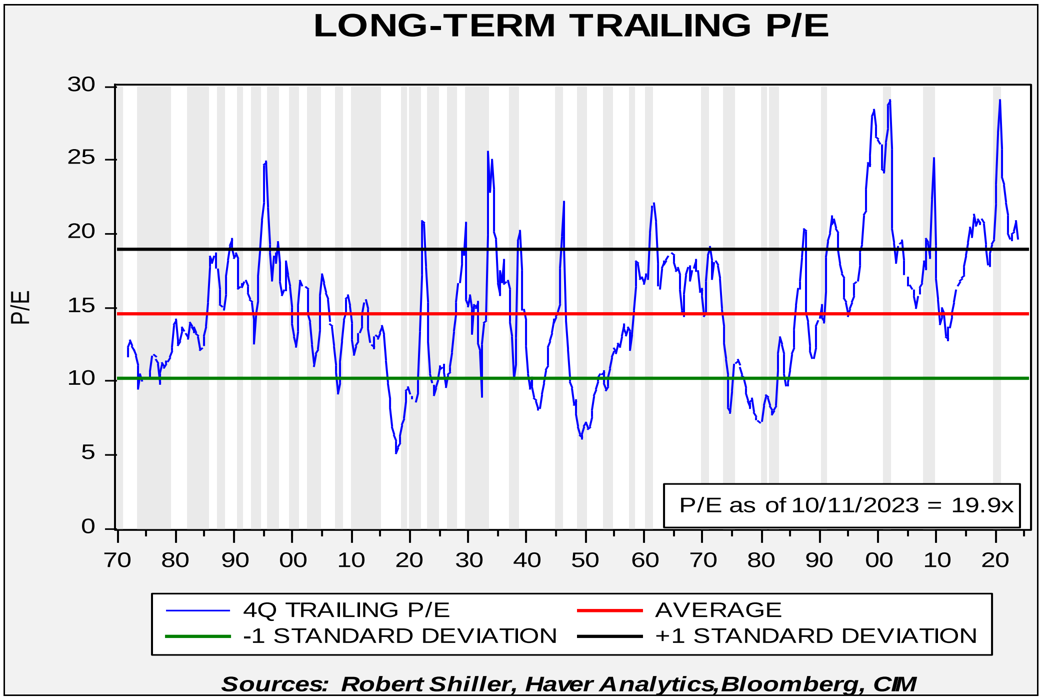


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.