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 16, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.1%. Chinese markets were lower, with the Shanghai Composite closing down 0.5% and the Shenzhen Composite closing down 1.1%. U.S. equity index futures are signaling a higher open.

With 32 companies having reported so far, S&P 500 earnings for Q3 are running at $56.00 per share, compared to estimates of $57.42, which is up 1.7% from Q2 2023. Of the companies that have reported thus far, 87.5% have exceeded expectations while 9.4% have fallen short of expectations.

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"

With last week's events in Israel serving as a reminder of how the world is becoming more violent and chaotic as the post-Cold War era comes to an end, today's *Comment* opens with an update on the all-important risk of a Chinese move to take control over Taiwan. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including more signs that the Bank of Japan may soon intervene to support the yen (JPY) and the latest developments in the U.S. labor market.

China-Taiwan: Kyodo News recently carried a nice summary of the strategy options Beijing is likely considering to eventually achieve its long-held goal of taking control over Taiwan. Consistent with our view, the article discounts the likelihood that the People's Liberation Army would launch an amphibious invasion of the island. Rather, the PLA's recent exercises suggest it would establish a naval, air, and missile "quarantine" around Taiwan to cut the island off from needed supplies and pressure its government to submit to Chinese authority.

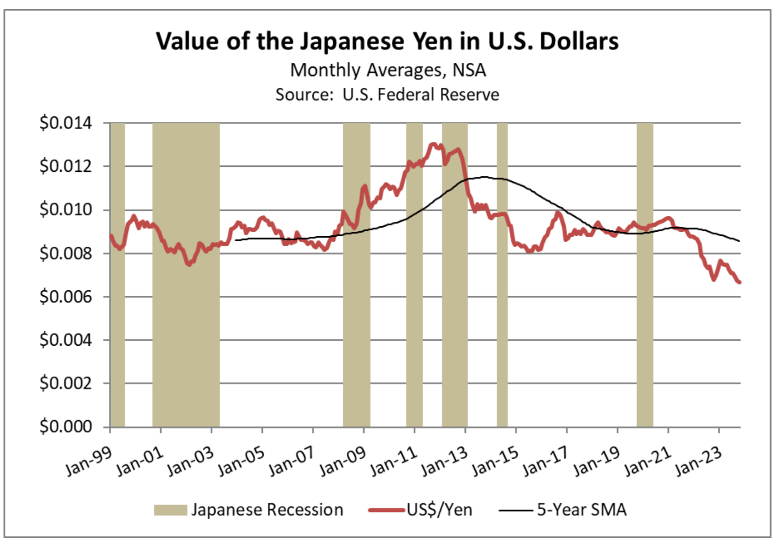
- Rather than calling the operation a "blockade," which is an act of war against a foreign country, Beijing would say it is merely controlling access to its own territory. That assertion would aim to make it politically difficult for the U.S., Japan, South Korea, and their allies to intervene.
    - Beijing could also start off with only occasional or targeted quarantine actions, perhaps using coast guard forces on ostensibly "law enforcement" missions.
    - The goal for such actions would be to raise shipping insurance costs and otherwise discourage maritime traffic to the island without necessarily sparking a military response from the U.S. and its allies.
- A major risk for Beijing is that a quarantine strategy would allow the U.S. and its allies time to build up their forces in the region and develop a strategy to defeat the quarantine. Nevertheless, given China's much closer proximity to Taiwan, it would find it much easier to sustain itself in a long stand-off.
    - Even if the U.S. and its allies rapidly build up their forces and use their superior technology to sink the PLA Navy and down the PLA Air Force, China's trump card is probably its enormous missile arsenal.
    - Even after losing many ships and aircraft, China could saturate Taiwan and its nearby shipping corridors with ground-attack and anti-ship missiles to keep the quarantine in place. Chinese missiles could also threaten U.S. and allied military bases in places like Okinawa, the Philippines, and Guam. Taking out those missiles would require a U.S. or allied attack on Chinese territory, potentially sparking a nuclear war.
- In sum, Beijing has big strategic and tactical advantages around Taiwan, along with regional military superiority. If Washington wants to meet its security commitment to the island, maintain the U.S. alliance structure, and protect U.S. interests, the U.S. and allied militaries will have to be rebuild to a scale sufficient to deter China from throwing its military weight around.
    - As we have noted before, Western defense spending will likely rise for years, and domestic reindustrialization will probably continue.
    - That will likely create important new investment opportunities in the industrial and defense-related technology sectors.

United States-China: White House officials say President Biden will issue new rules this week to further limit the sale of advanced semiconductors and related equipment to China. The new rules will supplement the draconian controls issued by the administration in October 2022 and in August 2023, which aim to keep Beijing from gaining a military edge from artificial intelligence and other advanced information technologies.

- The Biden administration's technology controls also supplement the tariffs and other broad trade barriers against China that were imposed by the Trump administration and largely remain in place.
- As we have written so many times before, the clampdown on bilateral trade, investment, and technology flows are symptoms of the worsening tensions between the U.S. geopolitical bloc and the China/Russia bloc. Those tensions, and the potential for new bilateral restrictions, continue to pose risks for investors.

Japan-China: In a sign the Japanese government is becoming more concerned about Chinese aggression in the near term, Defense Minister Kihara said Japan will start buying the U.S.'s advanced Tomahawk cruise missiles in its fiscal year starting March 2025, one year earlier than previously planned. To further underscore Japan's urgency to get the missiles sooner rather than later, the earlier acquisition date requires Japan to accept certain compromises in capabilities. The FY 2025 purchase means the first 200 missiles bought will be current Tomahawk models, while only the remaining 200 missiles, to be bought in FY 2028 and later, will be the latest Block 4 model.

Japan: At a Group of 20 meeting on Friday, Finance Minister Suzuki warned that Tokyo may need to intervene to support the yen (JPY) as tightening monetary policy around the world continues to drive the currency lower. The statement, which followed a separate warning earlier this month, came as the JPY depreciated anew to close the week at 149.56 per dollar ($0.00669), very close to the rate of 150.00 per dollar ($0.00667) that has long been seen as the point at which Japan would step in to support the currency.



New Zealand: In parliamentary elections over the weekend, the center-right National Party came in first with about 39% of the vote, followed by its preferred coalition partner, the ACT Party, with 9%. That should allow NP leader and former business executive Christopher Luxon to become prime minister as head of a government consisting of NP, ACT, and possibly the populist New Zealand First Party.

- The new right-wing government would replace the center-left Labor Party that has ruled since 2020.
- In his campaign, Luxon said his government would emphasize fighting crime, reducing road congestion, and increasing personal responsibility.

Saudi Arabia-Israel: Sources say Saudi Arabia has now formally notified the U.S. that it will suspend its negotiations with Israel for normalizing ties between the two countries. The notification came as Israel continued to prepare for a massive ground attack on Gaza and its Hamas government to retaliate for the big Hamas terrorist attack on Israel last week. The Saudis' suspension of normalization talks was probably a top goal for Hamas.

- Separately, Iran warned Israel over the weekend that while it doesn't want to see further escalation of the conflict between Israel and Hamas, it will intervene if Israel proceeds with a major ground attack on Gaza. Reports also say Iranian-backed Hezbollah fighters in southern Lebanon have stepped up their missile and artillery strikes on Israel in recent days.
- The developments underscore the continuing risk that the conflict will spread. The worst-case scenario would be a regional conflict involving several states, which would likely be very negative for risk assets but positive for the dollar and crude oil.

Poland: In elections yesterday, the ruling right-wing Law and Justice Party (PiS) came in first with almost 37% of the vote, but that may not provide enough seats in parliament to stay in power, even in coalition with the country's far-right parties. If that is borne out in the final count, it would open the door for former Prime Minister Donald Tusk and his Civic Platform Party to return to power. Since Tusk is known to be business-friendly and pro-European Union, Polish stock prices have surged so far today, as has the Polish currency.

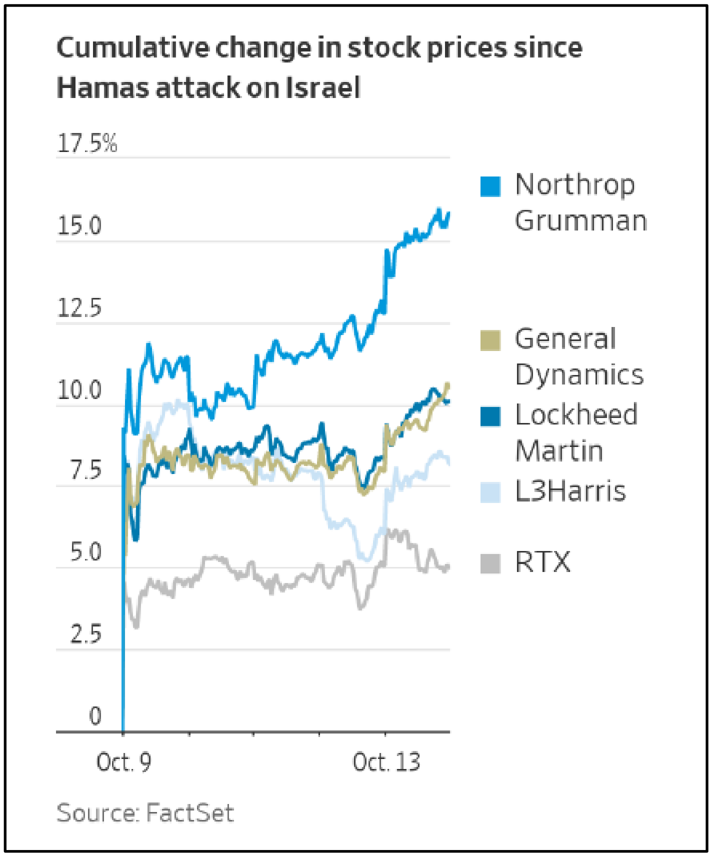
Ecuador: In a run-off election over the weekend, center-right businessman Daniel Noboa won the presidency with approximately 52% of the vote, beating his leftist rival Luisa González. Noboa, who is only 35 years old, campaigned on a platform of encouraging foreign investment and creating better employment opportunities for younger workers.

U.S. Monetary Policy: In an interview with the *Financial Times*, Chicago FRB President Goolsbee insisted that U.S. price pressures are on a sustainable downtrend, despite fluctuations in the inflation data. He also said Federal Reserve policymakers are "rapidly approaching" the point where they will shift from discussing the need to raise interest rates further to discussing how long to hold rates at their current high levels. That is consistent with our view that the Fed's monetary policy is almost as tight as it will get, but that it may remain tight for some time.

U.S. Labor Market: Healthcare giant Kaiser Permanente and its striking unions late last week reached a tentative deal on a new labor contract. We have yet to see details on the agreement, but we note that the workers had been demanding not only higher wages, but also improved staffing at Kaiser's facilities to improve work conditions.

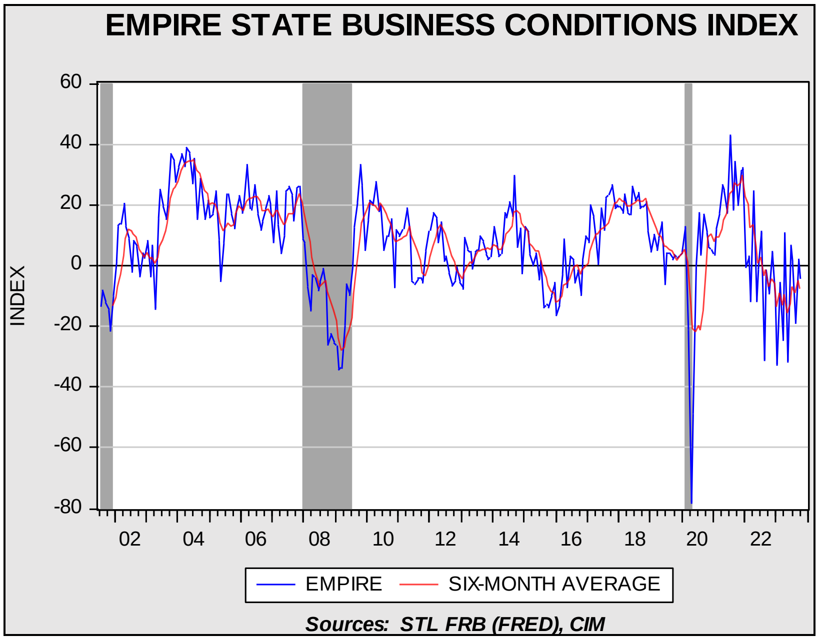
- Although demand continues to outstrip supply for relatively lesser-skilled workers, hiring for "knowledge workers" in areas like technology, finance, and consulting has fallen.
- As a result, an unusually large proportion of second-year MBA students are still without job offers and are starting to look for positions in other industries.

U.S. Defense Stocks: The *Wall Street Journal* today carries a nice summary of the current challenges and future opportunities in defense stocks. Despite some current headwinds, such as uncertain funding amid the political polarization in Washington, the article echoes our view that longer-term trends toward a more chaotic, tension-filled world will likely be positive for defense stocks going forward (although we think the new, fractured, tension-filled world will also be positive for firms in defense-related technology, energy, mining, and commodities).



U.S. Economic Releases

Factory activity contracted in the state of New York, according to an index tracked by the New York Fed. The regional central bank's Empire State Index came in at -4.9 in October. The reading was well below expectations of -0.6 and previous month's reading of +1.9.



The chart above shows the Empire Manufacturing Index and it's six-month moving average. The latest reading led to a decline in the moving average from -5.07 to -7.63.

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	-$150.0b	-$429.8b	**
Federal Reserve						
EST	Speaker or Event	District or Position				
10:30	Patrick Harker Speaks on the Economic Outlook	President of the Federal Reserve Bank of Philadelphia				
16:30	Patrick Harker Speaks about the 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	Industrial Production	y/y	Aug F	-4.4%	-3.8%		***	Equity bearish, bond bullish
Japan	Capacity Utilization	m/m	Aug	0.5%	-2.2%		**	Equity bullish, bond bearish
India	Wholesale Prices	y/y	Sep	-0.26%	-0.52%	0.40%	**	Equity bearish, bond bullish
EUROPE								
Eurozone	Trade Balance SA	m/m	Aug	11.9b	2.9b	3.5b	**	Equity bullish, bond bearish
Germany	Wholesale Price Index	y/y	Sep	-4.1	-2.7		*	Equity and bond neutral
Italy	CPI, EU Harmonized	y/y	Sep F	5.6%	5.7%	5.7%	***	Equity and bond neutral
UK	Rightmove House Prices	y/y	Oct	-0.8%	-0.4%		***	Equity and bond neutral
Switzerland	Domestic Sight Deposits CHF	w/w	13-Oct	474..9b	469.1b	--	*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	13-Oct	483.8b	479.9b	--	*	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	566	0	Up
3-mo T-bill yield (bps)	533	533	0	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)	541	540	1	Up
10-yr T-note (%)	4.69	4.61	0.08	Flat
Euribor/OIS spread (bps)	399	397	2	Up
Currencies	**Direction**			
Dollar	Down			Up
Euro	Flat			Down
Yen	Up			Down
Pound	Flat			Down
Franc	Up			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
PBOC 1-Year Med-Term Lending Facility	2.500%	2.500%	2.500%	On Forecast
PBOC 1-Year Med-Term Lending (Bil.)	789.0b	591.0b	590.0b	Above 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	$90.68	$90.89	-0.23%	
WTI	$87.58	$87.69	-0.13%	
Natural Gas	$3.15	$3.24	-2.72%	
Crack Spread	$21.02	$20.73	1.39%	
12-mo strip crack	$23.52	$23.38	0.61%	
Ethanol rack	$2.45	$2.45	0.03%	
Metals				
Gold	$1,916.82	$1,932.82	-0.83%	
Silver	$22.62	$22.72	-0.44%	
Copper contract	$359.55	$357.10	0.69%	
Grains				
Corn contract	$494.25	$493.25	0.20%	
Wheat contract	$588.00	$579.75	1.42%	
Soybeans contract	$1,283.25	$1,280.25	0.23%	
Shipping				
Baltic Dry Freight	1,945	1,935	10	

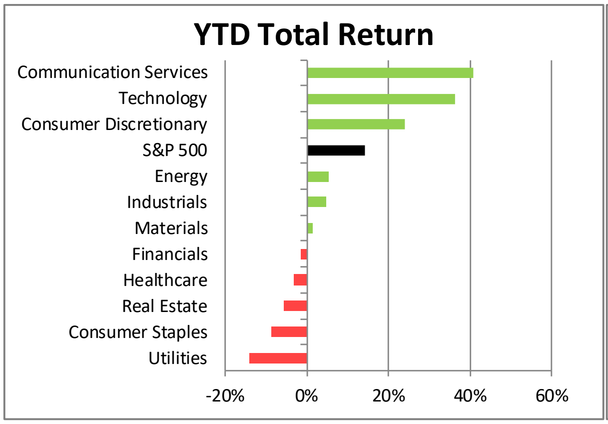
Weather

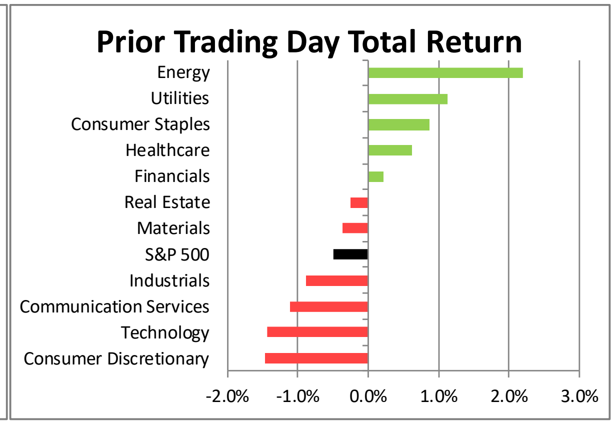
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for most of the country, with cooler temperatures in the Mid-Atlantic and Southeast. The precipitation outlook is calling for wetter-than-normal conditions in most states, with dry conditions along the East Coast and Southeast.

There is one atmospheric disturbance in the Atlantic Ocean. The storm is located in the central Atlantic between the Windward Islands and West Africa. It has only a 30% 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 10/13/2023 close)

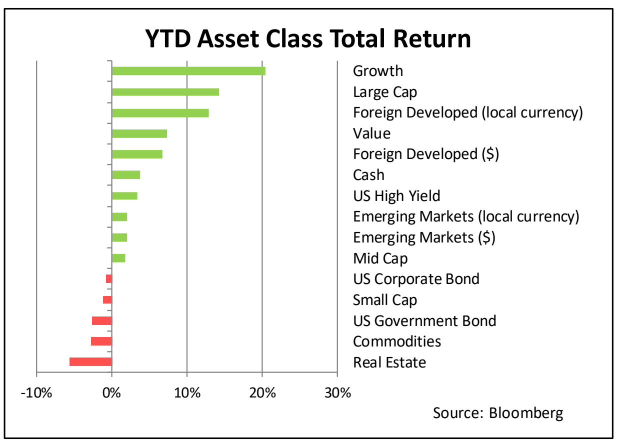




(Source: Bloomberg)

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 10/13/2023 close)

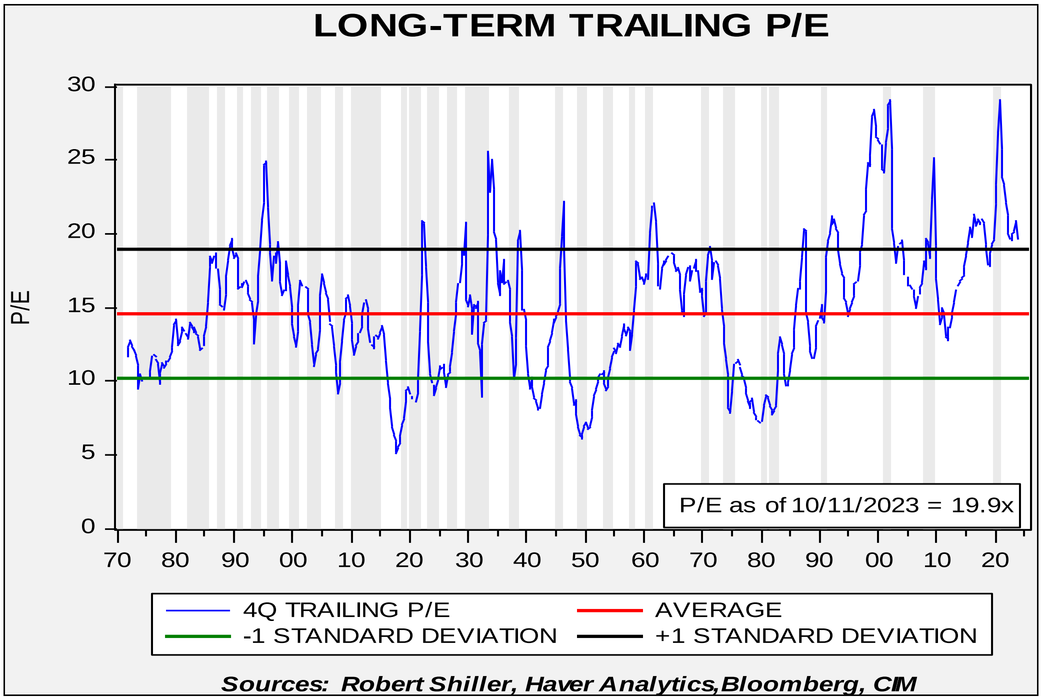


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.