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 17, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is down 0.4% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.9%. Chinese markets were generally higher, with the Shanghai Composite closing up 0.3% and the Shenzhen Composite essentially unchanged. U.S. equity index futures are signaling a lower open.

With 33 companies having reported so far, S&P 500 earnings for Q3 are running at $55.90 per share, compared to estimates of $57.42, which is up 1.7% from Q2 2023. Of the companies that have reported thus far, 87.9% have exceeded expectations while 9.1% 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*** **(10/16/2023) (with associated podcast): "What Shall We Call the New Era?"**
- *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"

Our *Comment* today opens with a discussion of how difficult it is for countries to abandon the U.S. dollar for international trade. We next review a range of other international and U.S. news with the potential to affect the financial markets today, including new geopolitical tensions between China and Canada and a survey showing economists now see less risk of a near-term recession in the U.S.

Russia-India-U.S. Dollar: As India's state-owned refiners continue to gorge on cheap Russian crude oil, New Delhi has reportedly clamped down on their use of Chinese renminbi (CNY) to pay for some shipments that otherwise would be subject to Western sanctions. Although China and other members of its geopolitical bloc are trying to reduce their use of the U.S. dollar, prompting some Western observers to predict a massive depreciation in the greenback, the Indian clampdown on CNY payments illustrates several hurdles to replacing the dollar:

- While Indian buyers initially paid for some shipments in rupees (INR), Russian sellers pushed back on the practice after realizing there was little they could buy with their growing rupee stockpiles.
- Russian sellers and Indian buyers have experimented with a number of different currencies for payment, including Emirati dirhams (AED), but the market hasn't been able to agree on a dollar alternative.
- Although New Delhi has implied that its clampdown on CNY payments is related to their extra cost, the reality is that India probably wants to avoid anything that would buttress Chinese financial power and influence.

China-Canada: Ottawa has issued a protest saying Chinese fighter jets harassed a Canadian surveillance plane that was flying in international airspace to help enforce UN sanctions against North Korea. One of the Chinese jets reportedly came within five meters of the Canadian aircraft. The incident serves as a reminder that the Chinese military is becoming more aggressive, not only against U.S. forces, but also the forces of its allies.

Israel-Hamas: Ahead of a summit tomorrow involving President Biden and Middle Eastern leaders, Jordan's King Abdullah warned that the region is at the edge of an "abyss" because of the conflict between Israel and the Gaza-based terrorist group Hamas. Abdullah called for humanitarian aid to the civilian population in Gaza, which Israel is besieging, but he insisted Jordan and Egypt would not accept waves of Palestinian refugees who might never leave. By emphasizing the way massive refugee waves could destabilize Jordan and Egypt, the king's statement helps clarify the many ways the conflict could spread and cause problems throughout the Middle East.

Russia-Ukraine: While the world has been focused on the Israel-Hamas conflict over the last week, Russian forces have launched a large-scale attack to seize the small city of Avdiivka in eastern Ukraine. The Russian forces have made some minimal gains in the area, but the latest reports suggest they've done so at a high cost in both equipment and personnel. If the attack aimed to swing momentum of the war back to Russia, it appears to have failed. In the near term, at least, that suggests the Russians will fall back on their previous stance of defending territory and sending waves of missiles, drones, and artillery against the Ukrainian power grid over the winter.

United Kingdom: New data shows average total pay in the three months ended in August was up 8.1% from the same period one year earlier, decelerating modestly from the 8.5% gain in the three months ended in July. Excluding bonuses, the annual pay gain in the three months to August slowed to 7.8% from 7.9% in the previous period.

- The annual gains remain close to record highs, but their deceleration could point to lower price pressures in the coming months and a lesser need for the Bank of England to keep raising interest rates.
- In response, British stock values are up about 0.4% so far today, while the pound (GBP) has fallen 0.6% to $1.2147.

Italy: The right-wing government of Prime Minister Giorgia Meloni said its budget for 2024 will include 24 billion EUR ($25.3 billion) in tax cuts and public-sector pay hikes to spur consumption and boost economic growth, despite investors' concerns about Italy's fiscal balance.

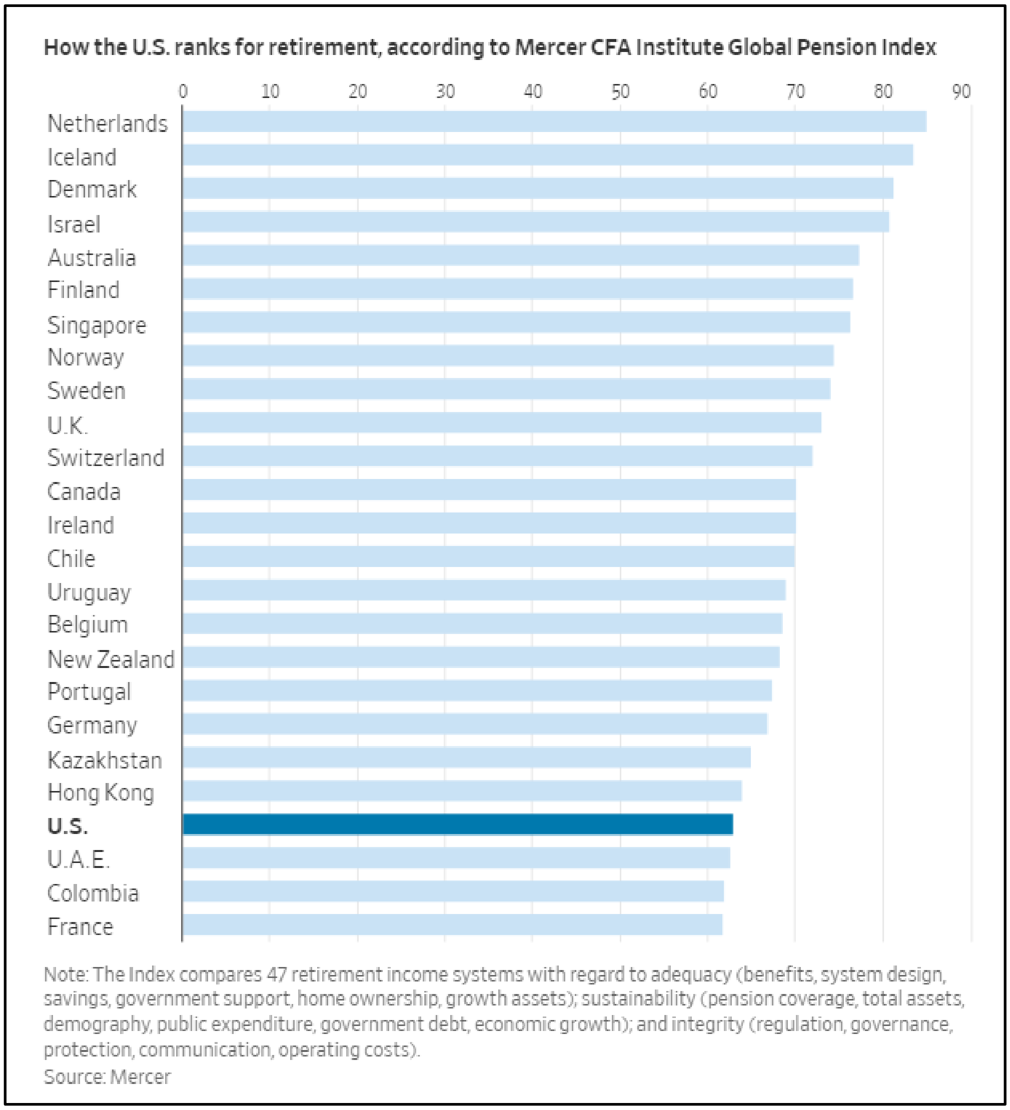
- The announcement follows the government's decision last month to allow the fiscal deficit to rise to 4.3% of gross domestic product, versus its April target of 3.7% and the eurozone's standard of 3.0%.
- The spread between Italian government bond yields and German yields widened slightly on the news to 4.77%.

Poland: Final figures from Sunday's elections confirm that the business-friendly, pro-EU former Prime Minister Donald Tusk and his Civic Platform and allied parties will have 248 of the 460 seats in the next parliament. Since the ruling right-wing Law and Justice Party won the most votes in the election, it will get first crack at forming a government. However, the seat count for Tusk's coalition makes it clear that he will regain power.

- Tusk's return to power in Poland will likely mark a return to more orthodox economic and social policies and better relations with EU leaders in Brussels.
- That will help accelerate an important but little-noticed shift in the EU, i.e., the growing power and influence of countries in the eastern part of the EU.

United States-Venezuela: U.S. and Venezuelan officials have reportedly struck a deal in which Caracas will allow more competitive, monitored elections in return for the U.S. partially lifting its sanctions on the authoritarian country's oil industry. The deal illustrates how the Biden administration is looking for any way it can to boost global oil supplies and hold down energy costs. However, it's important to note that even with a fuller lifting of sanctions, the Venezuelans probably can't boost their oil output significantly in the near term.

U.S. Retirement System: The latest Global Pension Index from Mercer and the CFA Institute ranks the quality of the U.S. retirement system just 22nd out of the 47 countries studied. The study ranks the U.S. system just below those of Kazakhstan and Hong Kong, and just above those of the United Arab Emirates and Colombia. The study finds that the U.S. system—based on corporate pensions, 401(k) accounts, and individual retirement accounts—provides uneven coverage and is subject to insolvency problems. (Of course, one way that individuals can try to overcome those challenges is simply to save and invest more.)

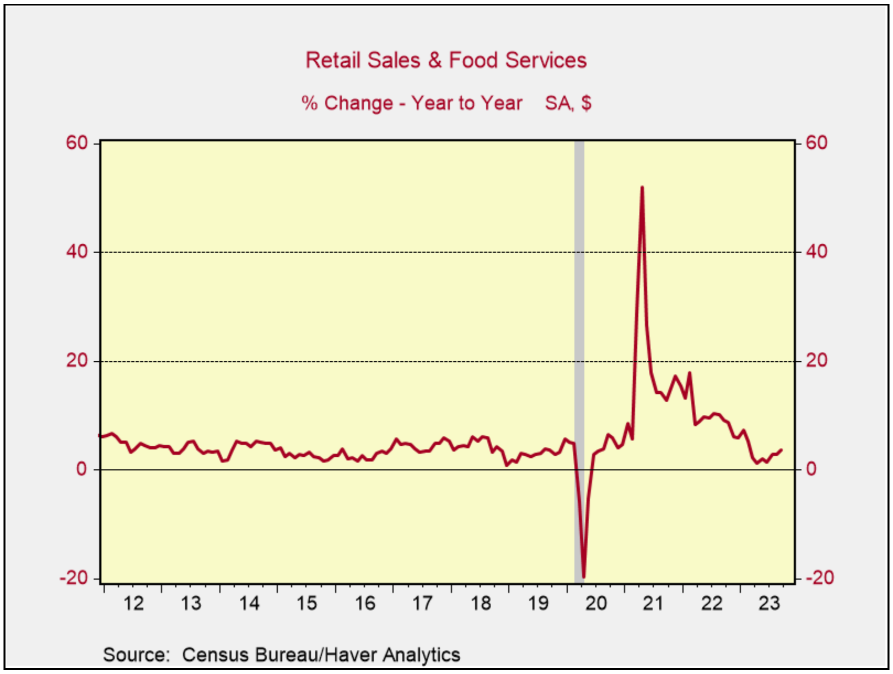


U.S. Economic Growth: The latest survey of economists in the *Wall Street Journal* showed the average probability of a recession within the next year has fallen to 48%, down from 54% in July. On average, the surveyed economists now also believe that the Federal Reserve is done raising interest rates, and that consumer price inflation will continue to cool.

- We also believe that the risk of recession has fallen to some extent, that the Fed is at least close to ending its rate-hiking campaign, and that inflation will moderate further in the near term.
- However, even if the economy doesn't fall into an outright contraction, growth is cooling noticeably, creating a "slow bicycle economy" in which the momentum is so weak that an unexpected crisis could tip it into a downturn.

U.S. Economic Releases

September retail receipts suggests consumption remains strong. Retail sales rose 0.7% last month. The reading was above expectations of 0.3%, but below the previous month's reading of 0.8%. Excluding the volatile components of gas and autos, retail sales rose 0.6% from the prior month, above the previous month's rise of 0.3%, and the forecast of 0.1%



The chart above shows the annual change in retail sales, which increased 3.8% from the previous year. The steady uptick in demand was driven by online retailers and specialty stores. This report likely boosts the case for the Fed to raise rates by another 25 bps before the end of the year.

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
9:15	Industrial Production	m/m	Sep	0.0%	0.4%	***
9:15	Industrial Capacity Utilization	m/m	Sep	79.6%	79.7%	**
10:00	Business Inventories	m/m	Aug	0.3%	0.0%	*
10:00	NAHB Housing Market Index	m/m	Oct	44.0	45	*
16:00	Net Long-term TIC Flows	m/m	Aug		$8.8b	**
16:00	Total Net TIC Flows	m/m	Aug		$140.6b	**
Federal Reserve						
EST	Speaker or Event	District or Position				
9:20	Michelle Bowman Speaks on Innovation in Payments	Member of the Board of Governors				
10:45	Thomas Barkin Speaks on the Economic Outlook	President of the Federal Reserve Bank of Richmond				
17:00	Neel Kashkari Participates in a Moderated Discussion	President of the Federal Reserve Bank of Minneapolis				

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.

ASIA-PACIFIC								
Japan	Tertiary Industry Index	m/m	Aug	-0.1%	0.9%	1.1%	**	Equity bearish, bond bullish
New Zealand	Non Resident Bond Holdings	m/m	Sep	62.1%	62.4%		*	Equity and bond neutral
	CPI	y/y	Q3	5.6%	6.0%	5.9%	**	Equity and bond neutral
South Korea	Export Price Index	y/y	Sep	-8.9%	-7.9%		*	Equity and bond neutral
	Import Price Index	y/y	Sep	-9.6%	-9.0%		*	Equity and bond neutral
EUROPE								
Eurozone	ZEW Survey Expectations	m/m	Oct	2.3%	-8.9		**	Equity bullish, bond bearish
Germany	ZEW Survey Expectations	m/m	Oct	-1.1%	-11.4	-9.0	**	Equity and bond neutral
	ZEW Survey Current Situation	m/m	Oct	-79.9	-79.4	-80.0	**	Equity and bond neutral
UK	Average Weekly Earnings 3M/YoY	m/m	Aug	8.1%	8.5%	8.3%	**	Equity and bond neutral
AMERICAS								
Canada	Manufacturing Sales	m/m	Aug	0.7%	1.6%	1.0%	**	Equity and bond neutral
Brazil	FGV Inflation IGP-10	m/m	Oct	0.52%	0.18%	0.40%	**	Equity bearish, bond bullish
	IBGE Services Volume	y/y	Aug	0.9%	3.5%	3.6%	*	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)	566	566	0	Up
3-mo T-bill yield (bps)	532	532	0	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 (%)	4.76	4.71	0.05	Flat
Euribor/OIS spread (bps)	398	399	-1	Up
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
Yen	Flat			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	$89.94	$89.65	0.32%	
WTI	$86.83	$86.66	0.20%	
Natural Gas	$3.12	$3.11	0.29%	
Crack Spread	$20.96	$21.17	-1.00%	
12-mo strip crack	$23.51	$23.66	-0.66%	
Ethanol rack	$2.42	$2.43	-0.28%	
Metals				
Gold	$1,924.31	$1,920.20	0.21%	
Silver	$22.70	$22.61	0.38%	
Copper contract	$354.90	$358.20	-0.92%	
Grains				
Corn contract	$489.00	$490.00	-0.20%	
Wheat contract	$570.75	$577.25	-1.13%	
Soybeans contract	$1,290.25	$1,286.25	0.31%	
Shipping				
Baltic Dry Freight	1,972	1,945	27	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		0.0		
Gasoline (mb)		-1.2		
Distillates (mb)		-1.5		
Refinery run rates (%)		-0.3%		
Natural gas (bcf)		81		

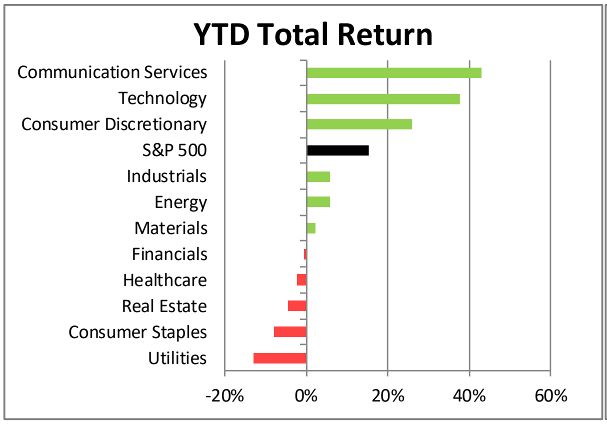
Weather

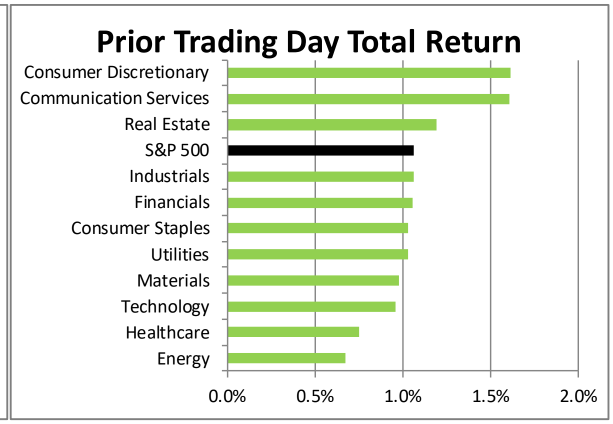
The 6-10 and 8-14 day forecasts predict warmer-than-normal temperatures for most of the eastern United States, with cooler-than-normal temperatures expected to spread from the West Coast to the Rocky Mountains. Most states can expect wetter-than-normal conditions, while the East Coast and Southeast will likely experience dry conditions.

There is one atmospheric disturbance in the Atlantic Ocean. The storm is located in the central Atlantic about 100 miles east of the Windward Islands. It has a 60% 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 10/16/2023 close)

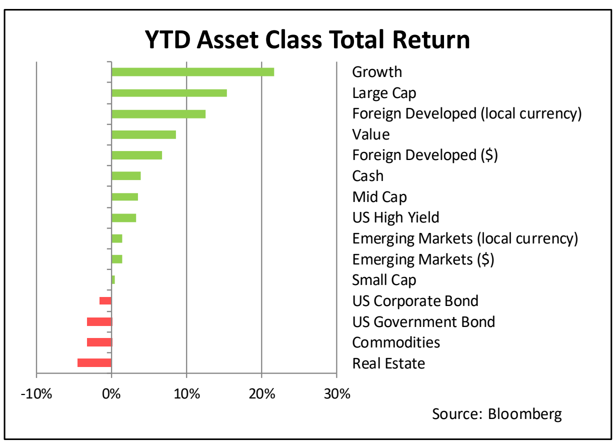




(Source: Bloomberg)

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 10/16/2023 close)

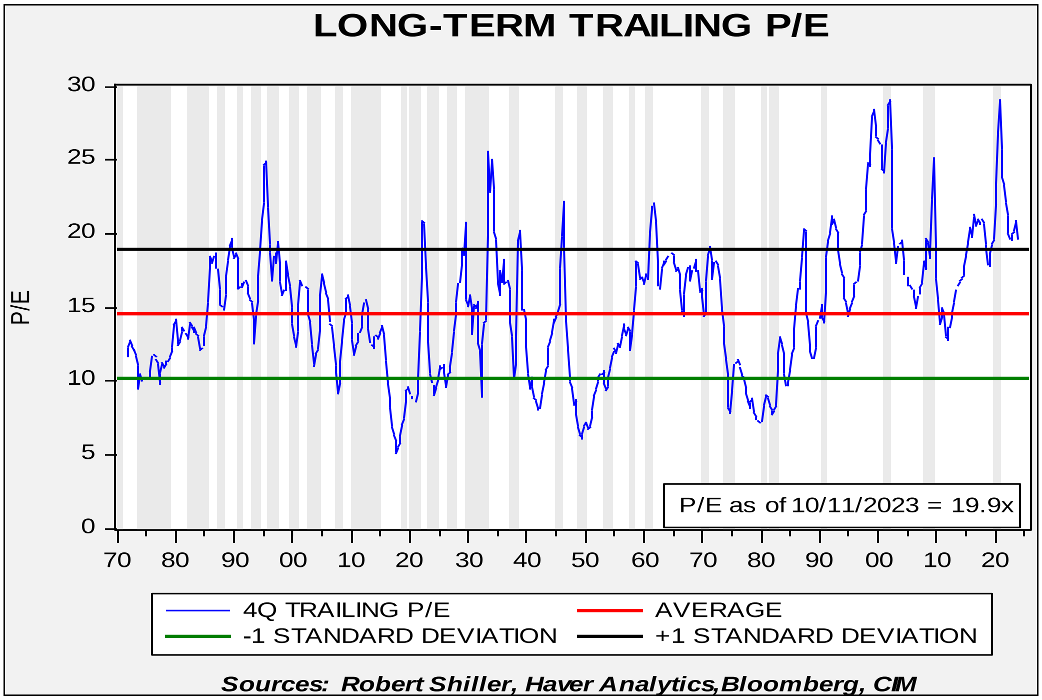


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.