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 18, 2023—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is down 0.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.7%. Chinese markets were lower, with the Shanghai Composite down 0.8% from its previous close and the Shenzhen Composite also down 1.5%. U.S. equity index futures are signaling a lower open.

With 42 companies having reported so far, S&P 500 earnings for Q3 are running at $55.70 per share, compared to estimates of $57.42, which is up 1.7% from Q2 2023. Of the companies that have reported thus far, 88.1% have exceeded expectations while 9.5% 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 news of further U.S. restrictions on the sales of advanced semiconductors and related equipment and services to China—a move that is sure to put additional strains on the U.S.-China relationship and keep investors on edge. 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 conflict, sticky consumer price inflation in the U.K., and the prospect for new financial regulation in the U.S.

United States-China: As we flagged in our *Comment* on Monday, the Biden administration issued new rules yesterday to further limit the sales of advanced semiconductors and related equipment and services to China. According to the administration, the new rules are designed to maintain the effectiveness of the draconian controls issued by the administration in October 2022 and August 2023. They are also designed to close loopholes in those rules and ensure they remain durable over time. Overall, the evolving controls aim to keep Beijing from gaining a military edge from artificial intelligence and other advanced information technologies.

- The new rules will ban the export of additional types of semiconductor manufacturing equipment to China and expand the licensing requirements for shipping such equipment.
- It appears that the tightened requirements will be especially hard-hitting for high-flying chipmaker Nvidia (NVDA, $439.38), whose stock price has surged this year on the strength of its advanced chips used in artificial intelligence applications. Last year, Nvidia began offering Chinese customers chips specifically designed to get around the original controls, but these new rules appear to close off that option.
- As we noted on Monday, the new controls not only update the technology-transfer rules issued last year, but they also supplement the tariffs and other broad trade barriers against China that were imposed by the Trump administration, which largely remain in place.
- As we have written many times before, the clampdown on bilateral trade, investment, and technology flows are a symptom 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.

United States-Marshal Islands-China: In another move to hinder China's growing military and political power in the southwestern Pacific Ocean, the U.S. this week struck a deal with the Marshal Islands to renew the two countries' longstanding security relationship. Under the updated pact, the U.S. will provide $2.3 billion in aid to the archipelago over the next 20 years in return for continued military access to its land, air, and maritime territories. The new deal follows the renewal of similar pacts with Palau and Micronesia earlier this year.

China: Key sectors in the country's domestic economy continue to falter, with major real estate developer Country Garden (CTRYY, $2.39) today apparently missing its final deadline to make a $15.4-million interest payment on one of its dollar-denominated bonds. That's likely to spark a wave of cross-defaults on the rest of its $15.2 billion or so of international bonds and loans. In turn, that will likely further undermine confidence in China's huge property sector, hold back investment, and weigh on the country's asset values.

- Despite Country Garden's default, regular data out today showed some modest near-term improvement in economic activity. According to official data, gross domestic product rose by a seasonally adjusted 1.3% in the third quarter, after a rise of just 0.8% in the second quarter. GDP in the third quarter was up 4.9% from the same period one year earlier.

- In September, consumer lending jumped by approximately $44 billion, suggesting an improvement in mortgage lending and home purchases. The growth in retail sales also accelerated, while the unemployment rate ticked down slightly.

Israel-Hamas: Last night, Jordan canceled the planned Wednesday summit between President Biden and regional leaders after an explosion reportedly killed hundreds of civilians at a hospital in Gaza. Both Israel and Palestinian leaders in Gaza blamed each other for the apparent missile strike. In addition, Muslim countries ranging from Turkey to Saudi Arabia pinned the blame on Israel, and Palestinians in the West Bank launched massive protest demonstrations, all of which illustrate the risk that the event will lead to broader regional hostilities.

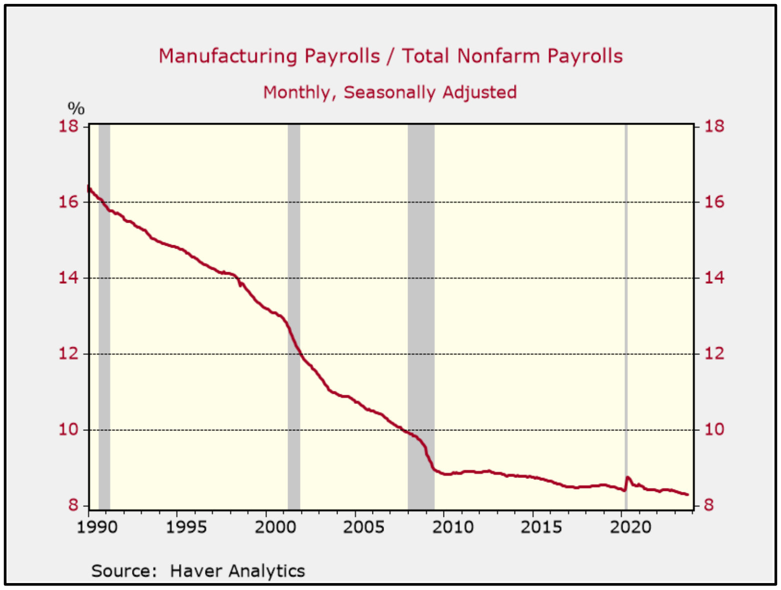
- Upon his arrival in Israel today, President Biden said he believes the Palestinians were responsible for the blast and suggested the U.S. has at least some intelligence pointing in that direction.
- Some observers have suggested that the hospital blast could have come from a misfired Palestinian rocket. Hamas militants also have a reputation for hiding weapons in hospitals and using civilians as human shields.
- In any case, Biden's continued strong support for Israel is probably working for him in political terms right now, both internationally and domestically. He is therefore likely to keep supporting Israel in the near term. Nevertheless, the risk of the conflict broadening out to the rest of the region remains significant.

United Kingdom: The September consumer price index was up 6.7% from the same month one year earlier, matching the rise in the year to August and dashing expectations that the inflation rate would decline a bit to 6.6%. Excluding the volatile food and energy categories, the September core CPI was up just 6.1%, decelerating from the 6.2% rise in the year to August, but the report was still seen as encouragement for the Bank of England to keep hiking interest rates.

U.S. Bond Market: Yesterday's strong report on September retail sales prompted investors to bail out of bonds, boosting the yield on the two-year Treasury note to a 17-year high of 5.20%. The yield on the 10-year Treasury note rose to 4.85%, also near its highest level since 2006. The retail report has rekindled fears that continuing supply-chain disruptions, labor shortages, rising wage rates, and high demand will keep price inflation high and prompt the Federal Reserve to keep hiking interest rates.

U.S. Financial Market Regulation: The Fed yesterday said it will hold a meeting next week on whether to revise its cap on the fees that merchants pay to debit card issuers when customers make purchases with their cards. Under the Fed's current rules, merchants pay large card issuers up to $0.21 plus 0.05% of the transaction amount, but the policymakers are considering lowering that cap. If the Fed proposes to cut the fees, it would modestly reduce costs for sellers but would likely generate strong pushback by card issuers and some members of Congress.

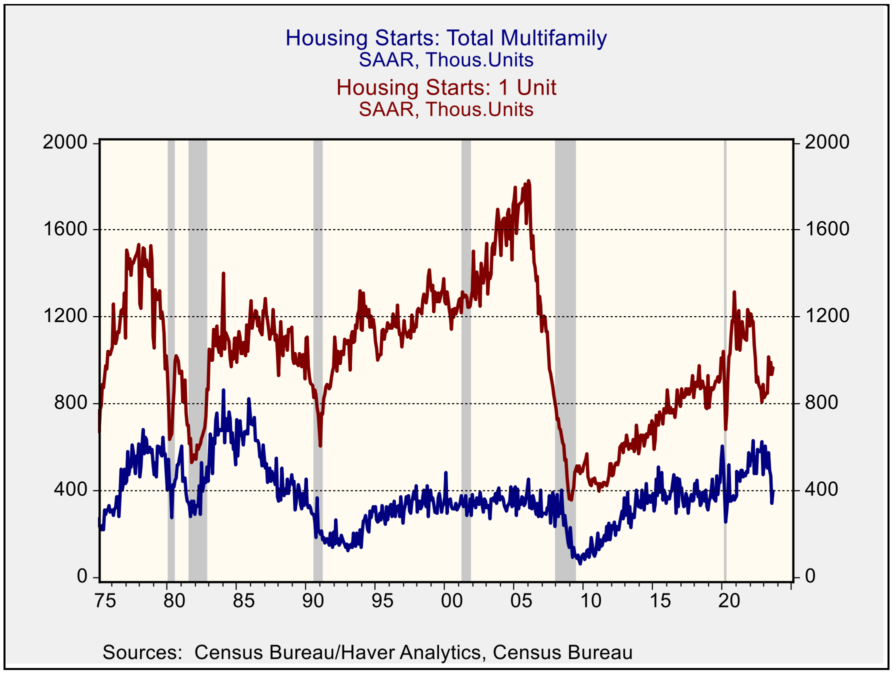
U.S. Labor Market: In an interview with the *Financial Times*, a member of the White House Council of Economic Advisors predicted that the current boom in U.S. factory construction, which we've been reporting on, will produce further gains in well-paid manufacturing jobs. Indeed, the employment report for September showed the number of U.S. manufacturing jobs has surpassed 13 million for the first time since 2008. Nevertheless, we would note that manufacturing employment as a share of total nonfarm payrolls hasn't yet started to turn up.



U.S. Economic Releases

Residential loan demand slowed for the fourth consecutive week, as high interest rates discouraged potential homebuyers. Mortgage applications fell 6.9% in the week ending October 13, according to the Mortgage Bankers Association (MBA). The drop in loan requests was related to an increase in 30-year fixed mortgage rates, which rose 3 basis points from 7.67% to 7.70%. As a result, the MBA tracker for purchase and refinance applications fell 5.6% and 9.9% from the prior week, respectively.

New housing construction accelerated at a slower than expected pace in September. Housing starts expanded an annualized rate of 1358k last month, according to the U.S. Census Bureau. The reading was below expectations of 1383k but above last month's pace of 1283k. Meanwhile, applications for new building permits slowed from an annual pace of 1543k in August to 1473k in the following month, slightly above expectations of 1450k.



The chart above shows the housing starts of multi- and single-family homes. Total multi-family home starts expanded at an annual rate of 395k in September, while single-family home starts expanded at 963k.

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						
EST	Indicator			Expected	Prior	Rating
14:00	Monthly Budget Statement	m/m	Sep	-$166.0b	-$429.8b	**
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				
12:00	Chris Waller Speaks About Economic Outlook in London	Member of the Board of Governors				
12:30	John Williams Participates in Moderated Discussion	President of the Federal Reserve Bank of New York				
13:00	Michelle Bowman Delivers Opening Remarks at Fed Listens Event	Member of the Board of Governors				
13:00	Thomas Barkin Speaks at Fed Listens Event	President of the Federal Reserve Bank of Richmond				
14:00	U.S. Federal Reserve Releases Beige Book	Federal Reserve Board				
15:15	Patrick Harker Speaks on Workforce Challenges	President of the Federal Reserve Bank of Philadelphia				
18:55	Lisa Cook Speaks About the Fed's Mandate	Member of the Board of Governors				

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								
Australia	Westpac Leading Index	m/m	Sep	0.07%	-0.04%		**	Equity and bond neutral
China	GDP	y/y	3Q	4.9%	6.3%	4.5%	***	Equity and bond neutral
	Industrial Production	y/y	Sep	4.5%	4.5%	4.4%	***	Equity and bond neutral
	Retail Sales	y/y	Sep	5.5%	4.6%	4.9%	*	Equity bullish, bond bearish
EUROPE								
Eurozone	CPI	y/y	Sep F	4.3%	4.3%	5.30%	***	Equity bullish, bond bearish
	Core CPI	y/y	Sep F	4.5%	4.5%	4.5%	**	Equity and bond neutral
	Construction output	y/y	Aug	-0.1%	1.0%	1.2%	*	Equity bearish, bond bullish
UK	CPI	y/y	Sep	6.7%	6.7%	6.6%	***	Equity and bond neutral
	Core CPI	y/y	Sep	6.1%	6.2%	6.0%	***	Equity and bond neutral
	Retail Price Index	m/m	Sep	378.4	376.6	378.4	**	Equity and bond neutral
	RPI YoY	y/y	Sep	8.9%	9.1%	8.8%	**	Equity and bond neutral
AMERICAS								
Canada	Int'l Securities Transactions	m/m	Aug	-8.47b	11.62b	13.93b	*	Equity bearish, bond bullish
	CPI YoY	m/m	Sep	3.8%	4.0%	4.0%	***	Equity and bond neutral
Mexico	International Reserves Weekly	w/w	13-Oct	$204,127	$203497m		*	Equity and bond neutral
Brazil	Retail Sales	y/y	Aug	2.3%	2.4%	1.2%	***	Equity bullish, bond bearish

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	534	-1	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	541	541	0	Up
U.S. Libor/OIS spread (bps)	542	542	0	Up
10-yr T-note (%)	4.82	4.84	-0.02	Flat
Euribor/OIS spread (bps)	397	398	-1	Up
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Down			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	$91.86	$89.90	2.18%	
WTI	$88.68	$86.66	2.33%	
Natural Gas	$3.10	$3.08	0.68%	
Crack Spread	$20.64	$21.13	-2.33%	
12-mo strip crack	$23.44	$23.74	-1.28%	
Ethanol rack	$2.42	$2.42	-0.23%	
Metals				
Gold	$1,945.99	$1,923.18	1.19%	
Silver	$23.20	$22.81	1.71%	
Copper contract	$361.45	$357.85	1.01%	
Grains				
Corn contract	$493.00	$489.00	0.82%	
Wheat contract	$577.25	$570.50	1.18%	
Soybeans contract	$1,307.50	$1,296.75	0.83%	
Shipping				
Baltic Dry Freight	2,058	1,972	86	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-0.6		
Gasoline (mb)		-0.1		
Distillates (mb)		-1.0		
Refinery run rates (%)		-0.2%		
Natural gas (bcf)		81		

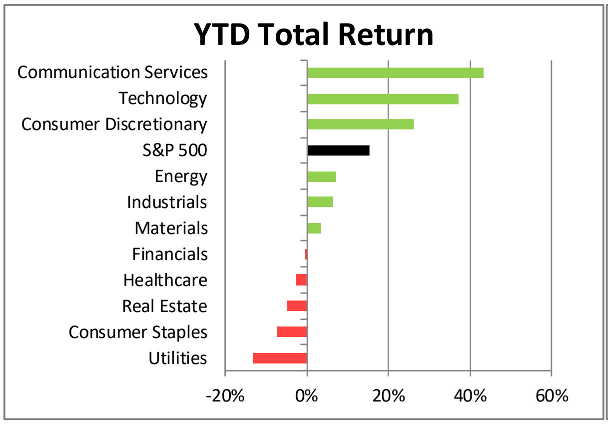
Weather

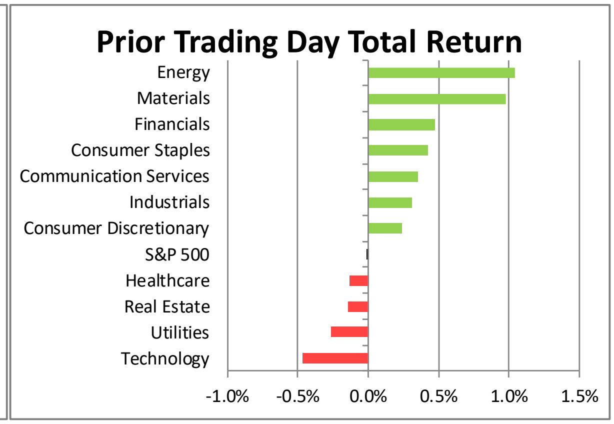
The 6-10 and 8-14 day forecasts predict warmer-than-normal temperatures for most of the eastern United States, with cooler-than-normal temperatures expected to spread from the West Coast to the Great Plains. Most states can expect wetter-than-normal conditions, while the East Coast and northern Pacific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

There is one atmospheric disturbance in the Atlantic Ocean. The storm is located in the central Atlantic and is moving toward the Lesser Antilles. It has an 80% 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 10/17/2023 close)

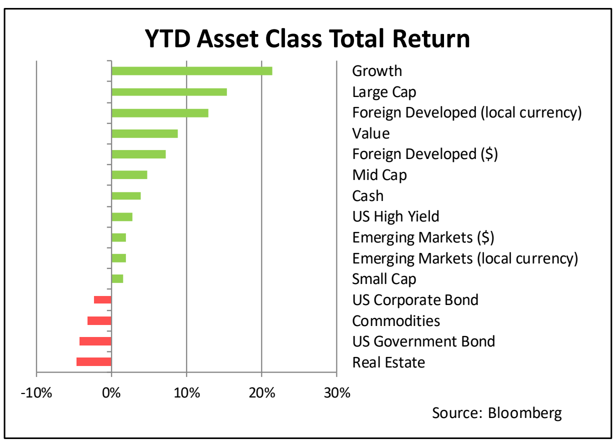




(Source: Bloomberg)

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 10/17/2023 close)

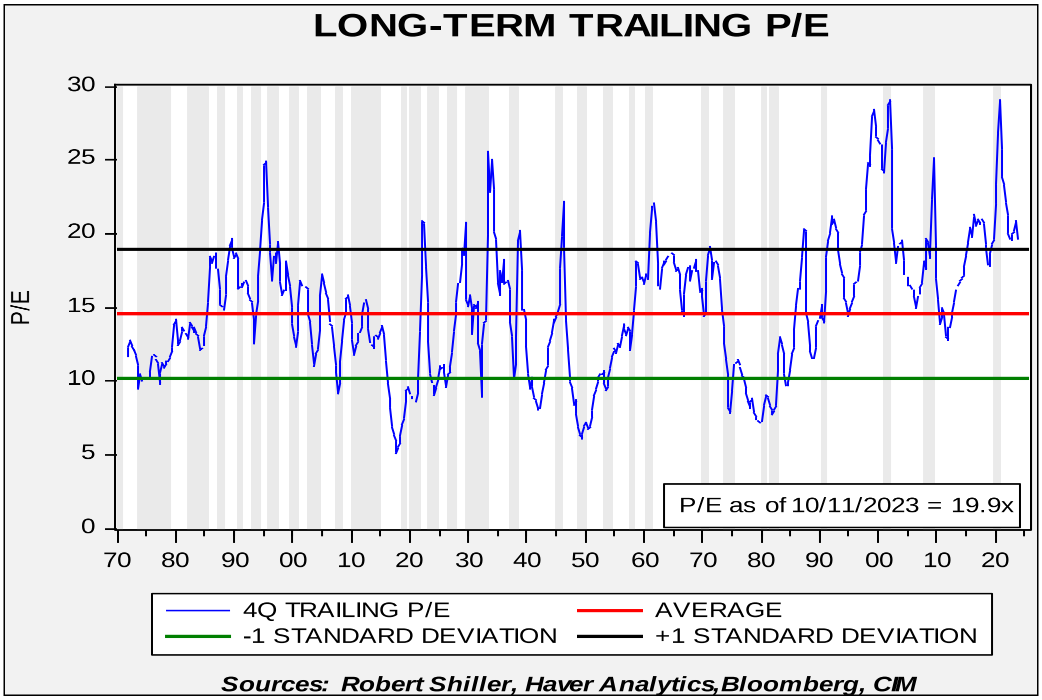


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.