Confluence INVESTMENT MANAGEMENT

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 19, 2023—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is down 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.7%. Chinese markets were lower, with the Shanghai Composite down 1.7% from its previous close and the Shenzhen Composite down 1.5%. U.S. equity index futures are signaling a lower open.

With 53 companies having reported so far, S&P 500 earnings for Q3 are running at $55.80 per share, compared to estimates of $57.42, which is up 1.7% from Q2 2023. Of the companies that have reported thus far, 84.9% have exceeded expectations while 13.2% have fallen short of expectations.

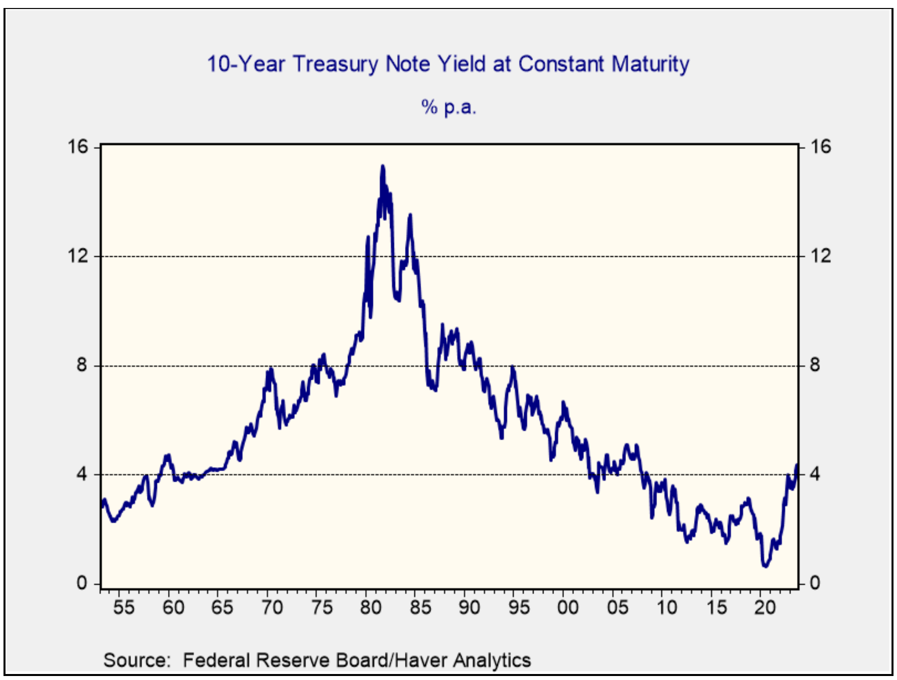
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (10/16/2023) (with associated podcast): "What Shall We Call the New Era?"
- ***Weekly Energy Update*** **(10/19/2023): The situation in the Middle East remains fraught with risk, supporting crude oil prices. Despite continued record crude oil production, commercial inventories declined this week while refinery activity rose modestly.** ***Note: the next edition of this report will be published on November 2.***
- *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"
- ***Keller Quarterly*** **(October 2023)**

Good morning! Equities are mixed this morning, and the Las Vegas Aces are the new WNBA champions. Today's *Comment* begins with our thoughts on why investors will be paying close attention to Powell's speech today. Next, we explain why investors have preferred commodities over bonds, how China and Russia are teaming up to woo countries in the Middle East, and we conclude with other news. As usual, our report also provides an overview of the latest domestic and international data releases.

Investors All Ears: After months of convincing the market that he will not shy away from the inflation mandate, Powell will now need to assure investors that the Fed will not overdo it.

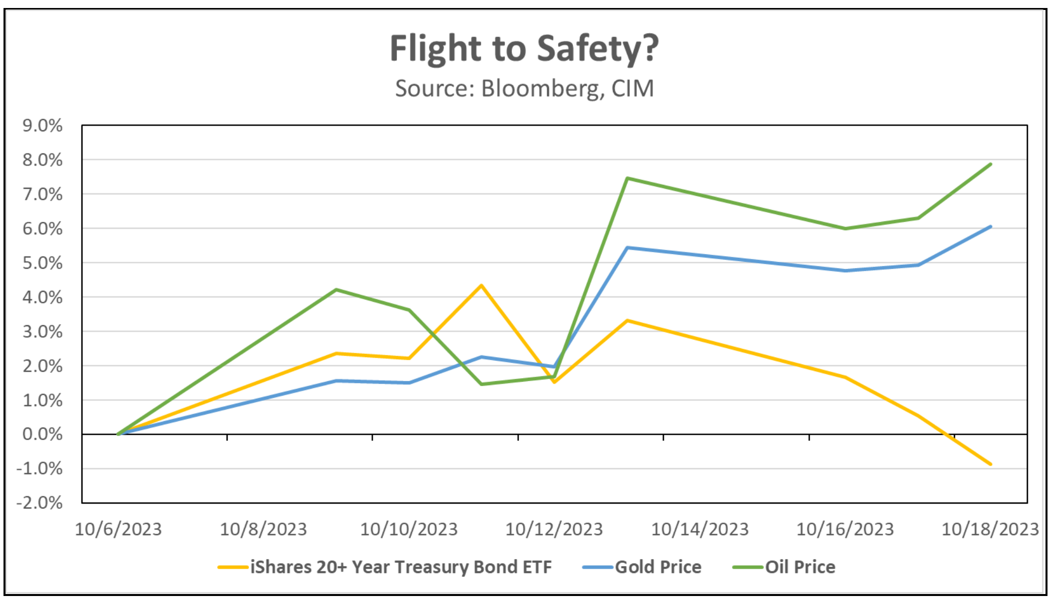
- Fed Chair Jerome Powell is set to speak at the Economics Club of New York today. Investors will closely follow his remarks to gauge the Federal Reserve's appetite for more rate hikes as it seeks to bring inflation back to its 2% target. Strong economic data, such as retail sales and September's job numbers, have led to speculation that the economy may be running too hot for comfort for members of the Federal Open Market Committee. These concerns have caused a steady rise in Treasury yields, with 10-year bonds now approaching 5% for the first time since 2006.
- Momentum is growing for a pause in Fed rate hikes. The Beige Book released on Wednesday showed that economic activity is slowing in the United States. Investors who are betting on a slowdown saw this as a positive, as it could deter policymakers from raising rates further. Additionally, dovish comments from Federal Reserve Board member Chris Waller and New York Fed President John Williams have boosted optimism that the Fed may be nearing the end of its hiking cycle, as higher interest rates in long-duration Treasuries have convinced some policymakers that they have done their job.



- Powell's speech is unlikely to change the Fed's “higher for longer” mantra, which will likely carry over into 2024. The latest forecast from the CME FedWatch Tool suggests a more than 60% chance that the Fed will keep rates unchanged through the end of the year and then cut rates by a combined 50 basis points in 2024, which is roughly in line with the latest FOMC dot plots. We expect policymakers to cut rates once in June and once again after the election to avoid being accused of partisanship, but a severe recession could lead the central bank to act more aggressively.

Gold Is Back? U.S. government bonds have lost their appeal as a safe-haven asset, as investors are more worried about tighter monetary policy and political uncertainty.

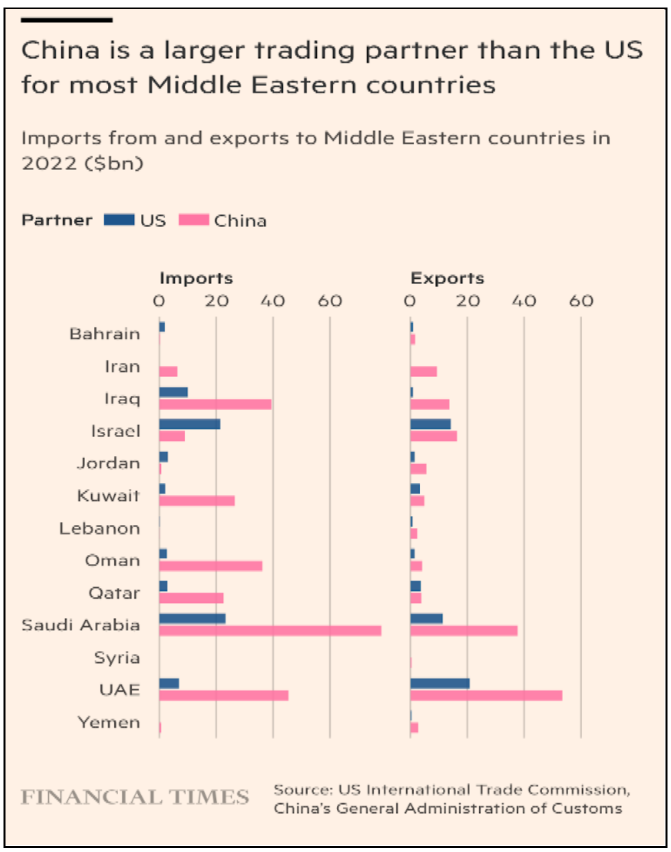
- Oil prices have surged 7.9% since the start of the Israeli-Hamas conflict on October 7. The rally in fuel prices reflects investor fears that expanding strife in the Middle East will lead to supply disruptions and trade tensions. Following reports of the bombing of a Gaza hospital, Iran has called on Middle Eastern countries to halt oil shipments to Israel. Meanwhile, hopes of a diplomatic resolution were dashed after Jordan and Egypt refused to meet with President Biden following the atrocity. While U.S. intelligence suggests that Israel was not responsible for the bombing, it is unclear whether other countries agree.
- Despite a historical preference for 10-year Treasury notes during crises, investors have opted for gold instead in response to the conflict in the Middle East. The yield on the 10-year U.S. Treasury note jumped 10 bps since the outbreak of war, compared with a decline of 25 bps following the Silicon Valley Bank collapse earlier this year. Some of this discrepancy may be related to Fed policy expectations. A war in the Middle East could increase oil prices, leading to inflation; thus, prompting the policymakers to raise interest rates. Meanwhile, the drop in yields following SVB's collapse was due to optimism that the Fed would back out of its hiking cycle as a way to prevent further damage to the economy.



- In addition to the uncertainty over Fed policy, congressional dysfunction has also weighed on bond prices. On Wednesday, the House failed for the third time to nominate a speaker, erasing some of the intraday gain in 10-year bonds after the release of the Beige book. The situation may improve over the next few days, as bipartisan support has emerged for empowering Speaker Pro Tempore Patrick McHenry to enable Congress to resume budget talks and send aid to Israel and Ukraine. While electing a House speaker would calm nerves, investors are likely to wait for the Fed to assure them that its policy path has not changed before they return to government bonds.

Closer Than Ever? Russia and China have formed closer ties as they try to recruit more countries to join their bloc against the West.

- Russian President Vladimir Putin and his Chinese counterpart Xi Jinping met on Wednesday at the Belt and Road Initiative forum. The two leaders reaffirmed their "no limits partnership" and sought to portray themselves as alternatives to the West. Unlike the United States and Europe, they have yet to condemn the Hamas attack and have instead criticized Israel's response. There is speculation that Putin and Xi are using the Middle East conflict to win over developing countries with a history of colonialism. Saudi Arabia is likely their biggest target, as they can leverage the Saudis' relationship with the Palestinians to draw them into their orbit.
- Over the past few years, Xi Jinping has been trying to convince countries within the Middle East to become less dependent on the West for economic support by expanding China's investment reach through the Belt and Road Initiative (BRI) and through the expanding the members of its BRICS group. By increasing its economic reach, it has been able to build new relationships with countries within the Middle East and has become a major player in the region. In March, China was able to broker a deal between Iran and Saudi Arabia, ending their long-standing feud. Meanwhile, Egypt issued its first Panda bonds earlier this week, taking advantage of Chinese credit markets.

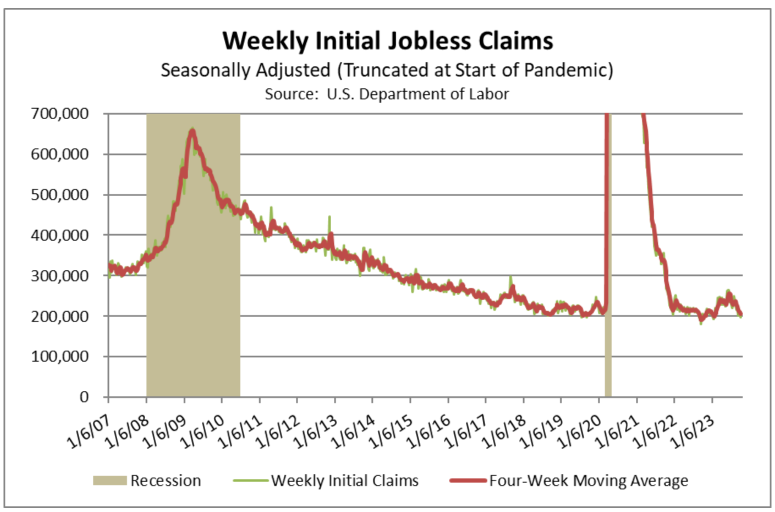


- The battle for influence in the Middle East is still tilted in the West's favor, but Russia and China are making gains. China is now the largest trading partner for most countries in the region, and its BRI is expected to increase its investment in the region. If Middle Eastern countries embrace Beijing, the United States will need to spend more resources to keep its allies in the region on its side. This could push Washington to delay its pivot toward Asia. Over time, competition among major powers for influence in the Middle East and other emerging markets could make equities in those regions more attractive.

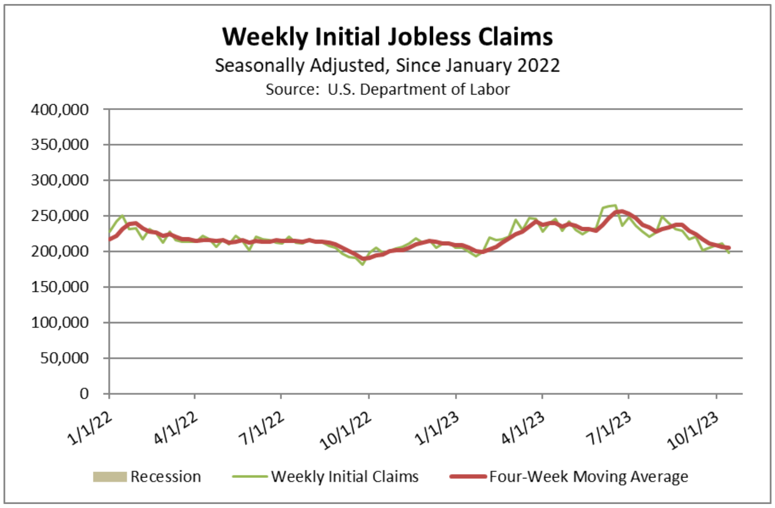
  Other News: Household wealth soared during the pandemic. The increase explains why the economy has been more resilient even as borrowing costs soared over the last few months.

U.S. Economic Releases

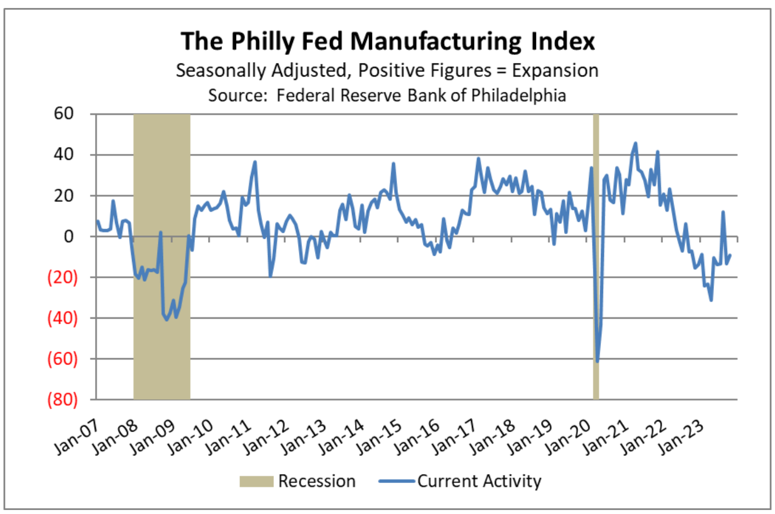
In the week ended October 14, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 198,000, well below both the expected level of 210,000 and the previous week's revised level of 211,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, declined to a fresh eight-month low of 205,750. Meanwhile, in the week ended October 7, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to 1.743 million, significantly higher than the anticipated reading of 1.706 million and the prior week's revised reading of 1.705 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 following chart shows how initial jobless claims have changed just since the beginning of 2022.



Separately, the Philadelphia FRB said its October ***Philly Fed Index*** improved to a seasonally adjusted -9.0, not quite as high as the expected reading of -7.0 but well above the September reading of -13.5. The index, officially designated as the Philadelphia FRB Manufacturing Activity Index, is designed so that positive readings point to expanding factory activity in the mid-Atlantic region. At its current level, the index suggests mid-Atlantic manufacturing remains in contraction, but the rate of decline may be slowing. The chart below shows how the index has fluctuated since just before the GFC.



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	Existing Home Sales (annualized selling rate)	m/m	Sep	3.89m	4.04m	***
10:00	Existing Home Sales (monthly change)	m/m	Sep	-3.7%	-0.7%	**
10:00	Leading Index	m/m	Sep	-0.4%	-0.4%	***
14:00	Monthly Budget Statement	m/m	Sep	-$166.0b	-$429.8b	**
Federal Reserve						
EST	Speaker or Event	District or Position				
9:00	Phiip Jefferson Delivers Welcoming Remarks	Vice Chair of the Board of Governors				
12:00	Jerome Powell Speaks at the Economic Club of New York	Chair of the Board of Governors				
13:20	Austan Goolsbee Participates in Moderated Q&A	President of the Federal Reserve Bank of Chicago				
13:30	Michael Barr Speaks About Stress Testing	Federal Reserve Board Vice Chair for Supervision				
16:00	Raphael Bostic Speaks at the New School	President of Federal Reserve Banks of Atlanta				
17:30	Patrick Harker Speaks on Economic Outlook	President of the Federal Reserve Bank of Philadelphia				
18:40	Lorie Logan Speaks in New York	President of the Federal Reserve Bank of Dallas				

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	Trade Balance	m/m	Sep	¥62.4b	-¥930.5b	-¥937.8b	***	Equity and bond neutral
	Exports	m/m	Sep	4.3%	-0.8%	3.0%	*	Equity and bond neutral
	Imports	m/m	Sep	-16.3%	-17.8%	-17.7%	*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	13-Oct	¥1259.9b	¥1436.1b	¥1437.5b	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	13-Oct	¥178.6b	¥45.2b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	13-Oct	¥794.0b	¥183.4b	¥185.4b	*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	13-Oct	¥947.8b	-¥643.6b	-¥643.7b	*	Equity and bond neutral
Australia	NAB Business Confidence	m/m	3Q	-1	-3	-4	**	Equity bullish, bond bearish
	Employment Change	m/m	Sep	6.7k	64.9k	63.3k	***	Equity bearish, bond bullish
	Unemployment Rate	m/m	Sep	3.6%	3.7%		***	Equity and bond neutral
	Participation Rate	m/m	Sep	66.7%	67.0%	67.0%	**	Equity and bond neutral
EUROPE								
Eurozone	Current Account	m/m	Aug	27.7b	20.9b	21.0b	*	Equity and bond neutral
France	Business Confidence	m/m	Oct	98	100	99	**	Equity and bond neutral
	Manufacturing Confidence	m/m	Oct	98	99	98	*	Equity and bond neutral
Switzerland	Real Exports	m/m	Sep	3.6%	5.9%	6.6%	*	Equity bearish, bond bullish
	Real Imports	m/m	Sep	-1.0%	1.5%	2.5%	*	Equity bearish, bond bullish
Russia	PPI	m/m	Sep	16.70%	10.60%		*	Equity bullish, bond bearish
AMERICAS								
Canada	Housing Starts	m/m	Sep	270.5k	252.8k	250.4k	**	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)	532	533	-1	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	541	540	1	Up
U.S. Libor/OIS spread (bps)	542	541	1	Up
10-yr T-note (%)	4.98	4.92	0.06	Flat
Euribor/OIS spread (bps)	399	397	2	Up
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
Yen	Flat			Down
Pound	Down			Down
Franc	Up			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Korea Base Rate	3.500%	3.500%	3.500%	On 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	$90.47	$91.50	-1.13%	
WTI	$87.46	$88.32	-0.97%	
Natural Gas	$3.01	$3.06	-1.51%	
Crack Spread	$21.51	$21.67	-0.73%	
12-mo strip crack	$23.83	$24.06	-0.96%	
Ethanol rack	$2.43	$2.43	0.38%	
Metals				
Gold	$1,951.41	$1,947.55	0.20%	
Silver	$22.89	$22.84	0.22%	
Copper contract	$359.95	$358.70	0.35%	
Grains				
Corn contract	$491.50	$492.00	-0.10%	
Wheat contract	$579.50	$580.25	-0.13%	
Soybeans contract	$1,315.50	$1,311.00	0.34%	
Shipping				
Baltic Dry Freight	2,105	2,058	47	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-4.5	-0.6	-3.9	
Gasoline (mb)	-2.4	-0.1	-2.3	
Distillates (mb)	-3.2	-1.0	-2.2	
Refinery run rates (%)	0.4%	-0.2%	0.6%	
Natural gas (bcf)		81		

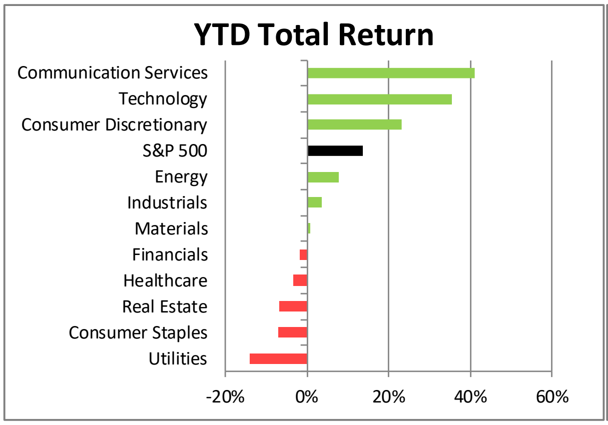
Weather

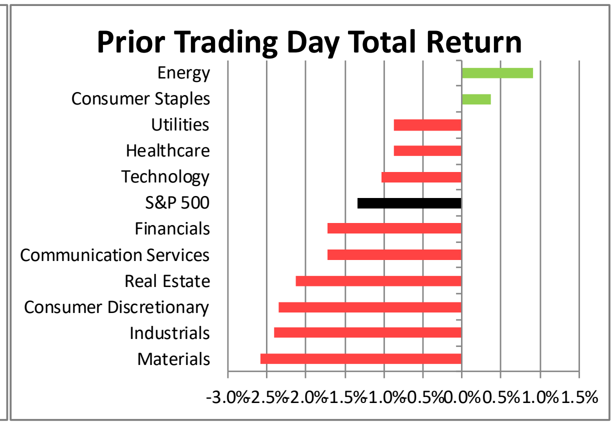
The 6-10 and 8-14 day forecasts predict warmer-than-normal temperatures for most of the country from the Mississippi Valley region eastward, with cooler-than-normal temperatures in the Rocky Mountains and northern Great Plains. The forecasts call for wetter-than-normal conditions throughout the Pacific Northwest, the Rocky Mountains, and the Upper Midwest, with dry conditions on the West and East Coasts.

There is currently one atmospheric disturbance in the Atlantic Ocean. Tropical Storm Tammy is located east of the Windward Islands and is heading toward the Virgin Islands and Puerto Rico. On average, Atlantic hurricane activity peaks on September 15.

Data Section

U.S. Equity Markets – (as of 10/18/2023 close)

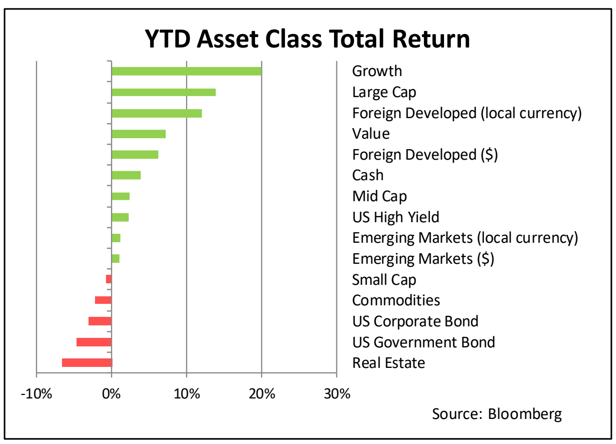




(Source: Bloomberg)

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 10/18/2023 close)

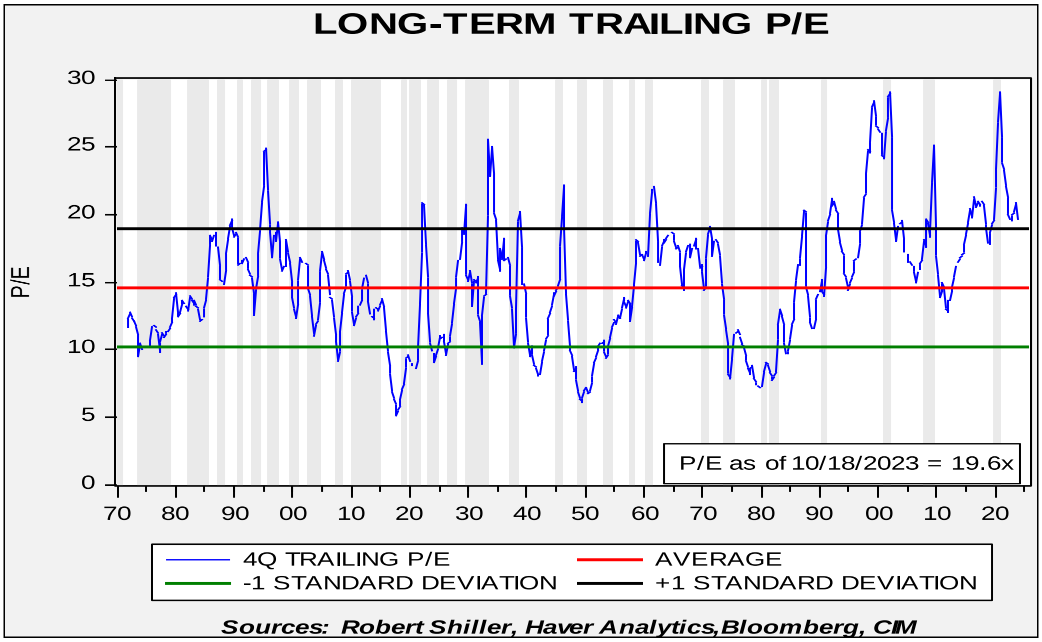


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 19, 2023



Based on our methodology,[1] the current P/E is 19.6x, down 0.3x 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.