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 20, 2023—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is down 1.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.2%. Chinese markets were lower, with the Shanghai Composite down 0.7% from its previous close and the Shenzhen Composite down 1.0%. U.S. equity index futures are signaling a lower open.

With 80 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, 75.0% have exceeded expectations while 20.0% have fallen short of expectations.

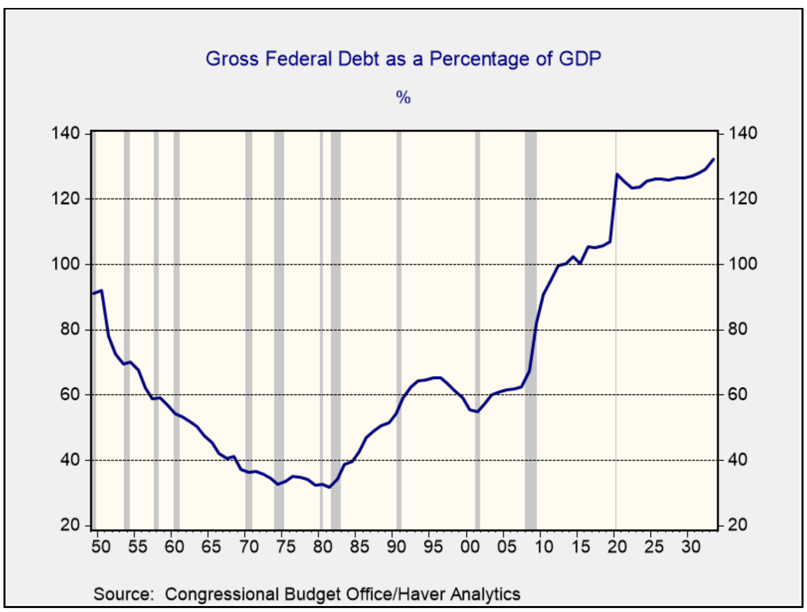
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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 – Q4 2023* (10/19/2023): Discussion of our asset allocation process, Q4 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 off to a rough start, while the Houston Astros and Texas Rangers are tied in the ALCS. Today's *Comment* begins with our analysis of Fed Chair Jerome Powell's comments at the Economic Club of New York. We then explain why forecasters have become more optimistic about the economy, discuss the upcoming presidential election in Argentina, and provide other financial market news. As always, our report includes an overview of the latest domestic and international data releases.

Powell's Message: During his speech at the Economic Club of New York, Fed Chair Jerome Powell sent mixed messages about the path of future policy.

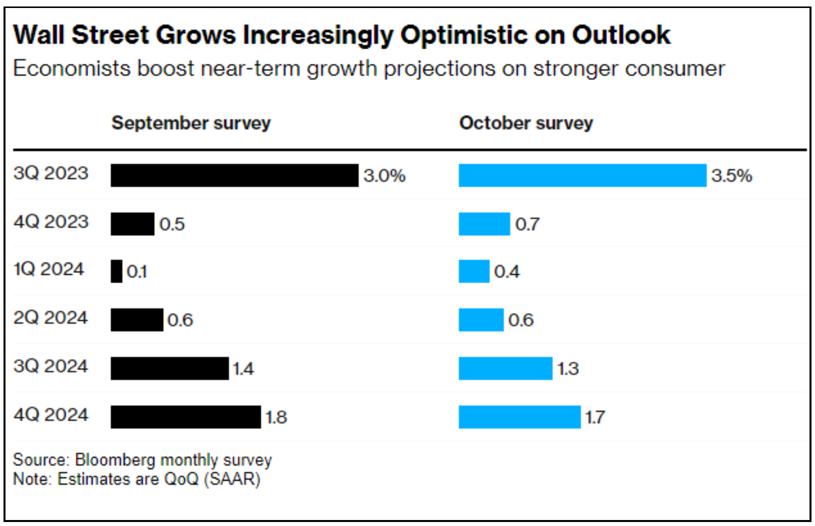
- Powell signaled that the central bank is unlikely to raise interest rates again unless economic growth clearly undermines progress on inflation. He also said that he does not believe current rates are too tight, suggesting that the Fed may not be finished with its hiking cycle. The Fed Chair's comments reassured investors that the Fed will likely hold rates steady at its next meeting, but they did little to clarify the path of policy for the following year. Markets initially responded positively to his comments but then turned negative over the course of the day. The S&P 500 dropped by 0.8% on the day, while yields on the 10-year Treasury rose sharply.
- Policymakers are likely to pay close attention to several market events before deciding whether to pause or hike interest rates. One key event to watch is the conflict in Israel, which has expanded outside of Gaza and into Lebanon, prompting the U.S., U.K., and Germany to advise their citizens to leave the region. Conflict in the Middle East can potentially lead to a reacceleration of inflation. Additionally, Thursday's initial jobless claims data suggests that the labor market may be too tight for policymakers to take their foot off the pedal. Lastly, Powell may also be paying close attention to government debt talks as he has mentioned that the fiscal path is unsustainable.



- Fed Chair Jerome Powell is likely to remain tight-lipped over the next few months about his plans, as investors eagerly await any signs of a pivot. Powell has stated that the Fed intends to keep rates higher for longer, but he has not explained what that means in practice. The September FOMC dot plots shows that members are aiming to cut rates by 50 basis points next year, suggesting that policymakers' "higher-for-longer" stance does not mean they will not cut rates, but rather that they will be cautious in easing policy. As a result, investors should not expect rates to fall significantly over the next few months unless there is a major crisis.

Economic Resilience: Economists have dialed back recession fears as data consistently surprises to the upside.

- Several GDP forecasts have been revised up for the third quarter of 2023, suggesting that the U.S. economy grew strongly during that period. Bloomberg surveys show that analysts have raised their estimates for Q3 GDP growth from 3.0% in September to 3.5% in October. These revisions reflect the optimism generated by the Atlanta GDP Nowcast, which estimates that the economy grew 5.4% from July to September. Much of the optimism is related to expectations that consumption rebounded after slowing to a seasonally adjusted annualized rate of 0.8% in the second quarter.
- A growing shift in recession expectations is underway. At the start of the year, most economists expected the U.S. to fall into recession sometime in 2023. However, with two months remaining in the year, economists are becoming more optimistic about avoiding a recession altogether, thanks in part to the continued tightness of the labor market. The latest surveys show that the consensus estimate is the U.S. economy will not contract until at least 2025. While some economists still believe that a mild recession could occur in late 2023 or early 2024, the overall outlook has improved significantly.



- Investors should keep in mind that predicting recessions is a very difficult task, and no one has perfect timing. A 2018 study by the International Monetary Fund (IMF) found that public and private sector forecasters missed a majority of the 153 recessions that occurred in 63 countries between 1992 and 2014. While economists cannot predict recessions with perfect accuracy, they can identify conditions that would make an economy more vulnerable to a recession. For example, the 1990 and 2000 recessions may have been avoided if it weren't for the 9/11 terrorist attacks and the Gulf War. As a result, investors should still be vigilant, as geopolitical and domestic risks still pose a threat to the expansion.

Argentine Elections: Investors are already seeking safety assets in anticipation of a controversial candidate winning the presidency.

- Far-right candidate Javier Milei is currently leading in the polls, closely followed by Sergio Massa and Patricia Bullrich. Milei is an extreme candidate who has vowed to ditch the Argentine peso (ARS) for the U.S. dollar. Additionally, he has also promised to privatize state-owned businesses and get rid of the country's central bank. His potential victory has concerned investors since his policies are so extreme. Companies have halted sales, fearing that the election result could lead to a drop in currency values, which will wipe out their revenues. Additionally, exchange-traded funds tracking Argentine stocks have experienced their biggest outflow in more than two years as investors flee for safety.
- The next president of Argentina will inherit a struggling economy, with triple-digit inflation, a recession, and a growing risk of government debt default. The other two candidates, Patricia Bullrich from the center-right Juntos por el Cambio coalition and Sergio Massa from the center-left Unión por la Patria coalition, have offered more traditional solutions to the economy, such as implementing austerity to reduce inflation or cutting taxes for businesses to boost growth. However, a growing share of the population, particularly young men, are drawn to anti-establishment candidates like Javier Milei. Polls show that he is most popular among men under the age of 44.

- Despite his popularity, Javier Milei's victory in Argentina's presidential election is far from assured. To avoid a runoff, he would need to win over 45% of the vote outright, or 40% with a 10-point lead over his closest rival. The most optimistic polls show that Milei has a 3% lead over Massa and a 10% advantage over Bullrich. However, another poll shows that he is down 5% against Massa and is virtually tied with Bullrich. Surveys show that Milei would defeat Massa by 2 points in a run-off but lose to Bullrich by 5 points in a runoff. An upset loss for Milei would likely lead to a rally in the country's stock market and currency.

Other news: Delinquencies are rising in the U.S. as borrowers struggle to repay pandemic loans, suggesting that households are under increasing strain despite rising consumption. The United Nations is having a hard time sending aid to Gaza, thus raising the likelihood of a humanitarian crisis in the Middle East and refugee problems for neighboring countries Egypt and Jordan. Republican nominee Jim Jordan is expected to fail in his third bid for House speaker, exacerbating concerns about growing U.S. political dysfunction and raising the likelihood of another credit downgrade.

U.S. Economic Releases

No major U.S. data has been released so far today. 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
16:00	Monthly Budget Statement	m/m	Sep	-$166.0b	-$429.8b	**
Federal Reserve						
EST	Speaker or Event	District or Position				
9:00	Patrick Harker Speaks on Economic Outlook	President of the Federal Reserve Bank of Philadelphia				
12:15	Loretta Mester Speaks at Manhattan Institute for Policy Research	President of the Federal Reserve Bank of Cleveland				

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	National CPI	y/y	Sep	3.0%	3.2%	3.0%	***	Equity and bond neutral
	National CPI Ex-Fresh Food	y/y	Sep	2.8%	3.1%	2.7%	**	Equity and bond neutral
	National CPI Ex-Fresh Food & Energy	y/y	Sep	4.2%	4.3%	4.1%	*	Equity and bond neutral
New Zealand	Trade Balance NZD	m/m	Sep	-2329m	-2291m	-2273m	**	Equity and bond neutral
	Exports NZD	m/m	Sep	4.87b	4.99b	4.97b	**	Equity and bond neutral
	Imports NZD	m/m	Sep	7.20b	7.28b	7.24b	**	Equity and bond neutral
EUROPE								
Eurozone	EU27 New Car Registrations	y/y	Sep	9.2%	21.0%		*	Equity and bond neutral
Germany	PPI	y/y	Sep	-17.7%	-12.6%	-14.1%	**	Equity bearish, bond bullish
UK	Retail Sales	y/y	Sep	-1.0%	-1.4%	-1.3%	***	Equity and bond neutral
	Retail Sales Ex-Auto Fuel	y/y	Sep	-1.2%	-1.4%	-1.3%	**	Equity and bond neutral
	PSNB ex Banking Groups	m/m	Sep	14.3b	11.6b	11.4b	**	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	13-Oct	$569.6b	$562.8b		***	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	13-Oct	18.64t%	18.58t		*	Equity and bond neutral
AMERICAS								
Canada	Industrial Product Price	m/m	Sep	0.4%	1.3%	0.3%	**	Equity and bond neutral
	Raw Materials Price Index	m/m	Sep	3.5%	3.0%	1.7%	*	Equity bearish, bond bullish
Mexico	Retail Sales	y/y	Aug	3.2%	5.1%	4.4%	***	Equity bearish, bond bullish
Brazil	Economic Activity Index	y/y	Aug	1.28%	0.66%	0.83%	**	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)	568	566	2	Up
3-mo T-bill yield (bps)	530	532	-2	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	538	538	0	Up
U.S. Libor/OIS spread (bps)	539	540	-1	Up
10-yr T-note (%)	4.95	4.99	-0.04	Flat
Euribor/OIS spread (bps)	400	399	1	Up
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Flat			Down
Yen	Down			Down
Pound	Flat			Down
Franc	Flat			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
PBOC 1-Year Loan Prime Rate	3.450%	3.450%	3.450%	On Forecast
PBOC 5-Year Loan Prime Rate	4.200%	4.200%	4.200%	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	$93.60	$92.38	1.32%	
WTI	$90.60	$89.37	1.38%	
Natural Gas	$2.96	$2.96	-0.07%	
Crack Spread	$21.44	$20.66	3.81%	
12-mo strip crack	$24.00	$23.80	0.82%	
Ethanol rack	$2.46	$2.45	0.35%	
Metals				
Gold	$1,977.45	$1,974.46	0.15%	
Silver	$23.10	$23.05	0.23%	
Copper contract	$356.40	$360.10	-1.03%	
Grains				
Corn contract	$505.00	$505.00	0.00%	
Wheat contract	$597.50	$594.00	0.59%	
Soybeans contract	$1,311.50	$1,315.50	-0.30%	
Shipping				
Baltic Dry Freight	2,071	2,105	-34	
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)	97	81	16	

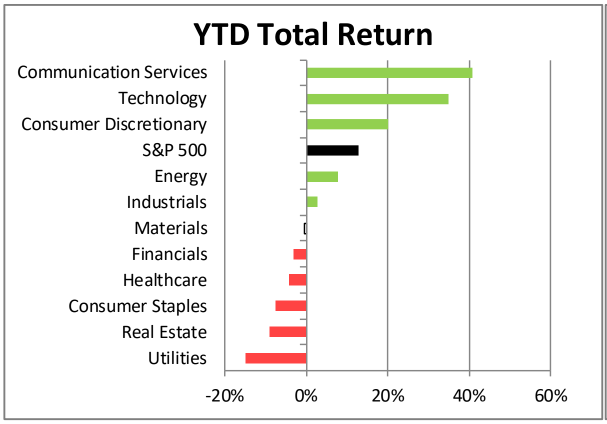
Weather

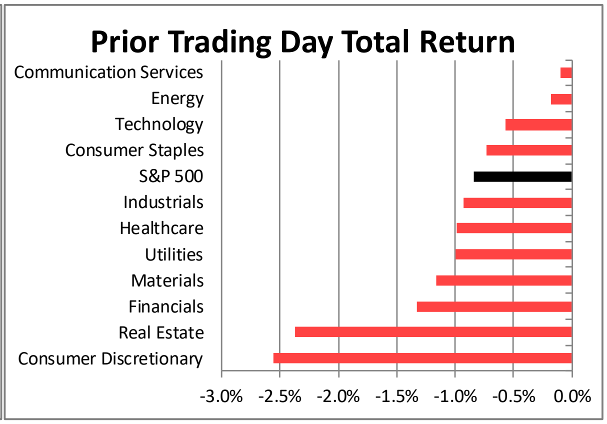
The 6-10 and 8-14 day forecasts predict warmer-than-normal temperatures for the West Coast and the region from the Mississippi River eastward, with cooler-than-normal temperatures in the Northern Tier states and the Great Plains. The forecasts call for wetter-than-normal conditions throughout the entire central part of the country, with dry conditions on the East Coast.

There is currently one atmospheric disturbance in the Atlantic Ocean. Tropical Storm Tammy is located east of the Caribbean Sea and is expected to turn into a hurricane by tomorrow as it skirts the Leeward Islands and turns northward. On average, Atlantic hurricane activity peaks on September 15.

Data Section

U.S. Equity Markets – (as of 10/19/2023 close)

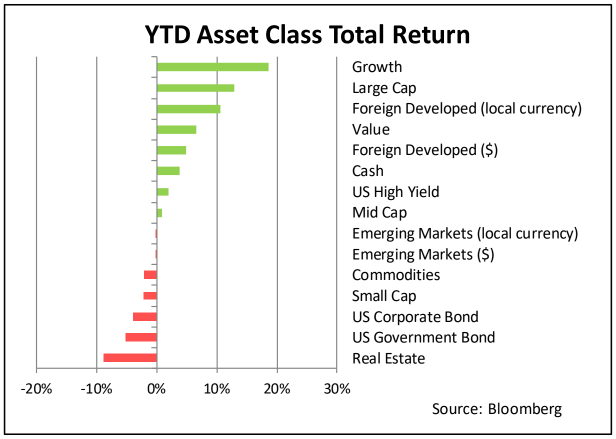




(Source: Bloomberg)

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 10/19/2023 close)

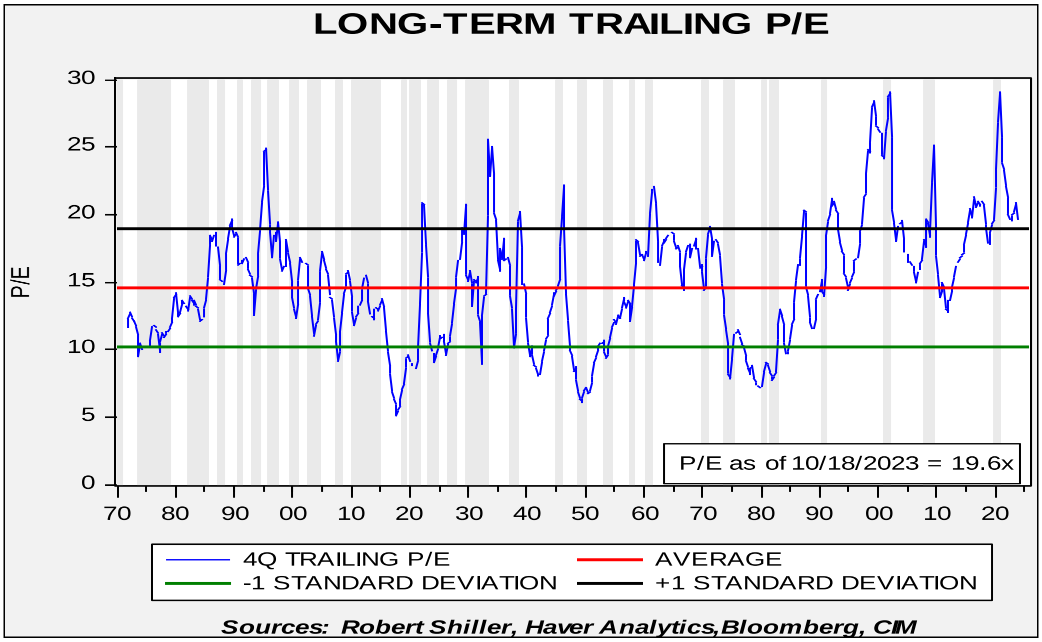


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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.