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 23, 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 0.7%. Chinese markets were lower, with the Shanghai Composite down 1.5% from its previous close and the Shenzhen Composite down 1.9%. U.S. equity index futures are signaling a lower open.

With 86 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, 74.4% have exceeded expectations while 20.9% 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*** **(10/23/2023) (with associated podcast): "A Regime Change in Bonds?"**
- *Confluence of Ideas* podcast (8/22/2023): "The Economics of Defense in Great Power Competition"
- *Keller Quarterly* (October 2023)

Our *Comment* today opens with the latest on the Israel-Hamas fighting, where we continue to keep our eyes open for signs that it could spread into a broader regional conflict. We next review a wide range of other international and U.S. developments with the potential to affect the

financial markets today, including new tensions between China and the West, and a new selloff in U.S. bonds, which has finally pushed the yield on the 10-year Treasury note decisively above the 5% mark.

Israel-Hamas Conflict: Among the top news items related to the conflict, the Israeli military continues to launch airstrikes against Hamas targets in Gaza, as well as against Hezbollah fighters in southern Lebanon in response to their missile attacks across the border into Israel. Pro-Palestinian demonstrations also continue in countries neighboring Israel, further raising the risk that attacks on Israeli interests will prompt a wider conflict, potentially including Iran. Meanwhile, the U.S. and key allies are urging the Israelis to delay their expected ground incursion into the Gaza Strip to root out the Hamas leadership and military organization there.

- Separately, the *Wall Street Journal* over the weekend released a detailed video analysis providing further evidence that the October 17 explosion at Gaza's Al-Ahli Arab Hospital stemmed from an errant Hamas missile rather than an Israeli attack.

- The *New York Times* today acknowledged that in its initial reporting of the hospital explosion, it relied too heavily on Hamas' statements that it was caused by an Israeli airstrike and didn't make it sufficiently clear that those claims couldn't be verified.

China-United States: China's Ministry of State Security released a video purportedly revealing another arrest of a CIA spy. According to the video, the spy was recruited while he was a visiting scholar at a U.S. university and then passed secrets to the CIA when he returned home to China and began working for an important defense industry firm in the province of Sichuan. After recent moves to tighten its counterespionage laws and encourage everyday citizens to report suspected spies, the MSS has revealed numerous cases of CIA spies caught in the act.

- Publication of the successful counterespionage cases is most likely aimed at making Chinese citizens more aware of the risk of spies among them.
  - It's impossible to know if these cases are real or not. If the stories are true, they suggest that the U.S. has had some success in recruiting visiting Chinese students to spy for the U.S. once they return home.
  - On the other hand, such arrests could also mean that the CIA is facing another devastating loss of its spy network in China, similar to when it lost some 30 spies from 2010 to 2012, apparently because of a Chinese mole at the CIA.

- China also continues to pressure foreign businesses with tax and regulatory probes. Today, for example, we've seen reports that the Shanghai municipal government has arrested several employees and former employees who worked at a unit of London-based advertising firm WPP (WPP, $41.43) on suspicion of bribery. Other reports say various provincial governments are conducting tax probes of Taiwan Semiconductor Manufacturing (TSM, $91.31).

China-Philippines: According to officials in Manila, a Chinese coast guard ship on Sunday collided with a resupply ship trying to reach Philippine marines stationed on a shoal in the disputed Spratly Islands. The Chinese coast guard and maritime militia forces have long been harassing and trying to prevent such missions as part of their effort to assert Chinese sovereignty

over the area, but the event this weekend was the most serious confrontation between Chinese and Philippine forces. The incident highlights the risk of a more serious military confrontation in the region.

China-Australia: In contrast with China's clearly deteriorating relations with the U.S. and the Philippines, there are new signs that relations between Beijing and Canberra are improving again. Australian Prime Minister Albanese said he will travel to China next month for a meeting with President Xi. In addition, Albanese said the Chinese government has agreed to "review" the punitive tariffs it slapped on Australian wine in 2020 to retaliate for former Prime Minister Morrison's suggestion that China be investigated for its role in the global coronavirus pandemic. Since China is such a large export market for Australia, the continued improvement in relations and reduced trade barriers should be bullish for Australian stocks.

China: Chinese stock values fell as much as 1.3%, leaving them down about 15% for the year to date. The key stock indexes are also now at their lowest level since before the coronavirus pandemic. The Chinese economy and financial markets continue to struggle with a range of headwinds ranging from poor consumer demand and high debt levels to bad demographics and trade and investment tensions with the West.

China's stock market drops to lowest level since 2019
CSI 300 index
Source: Bloomberg
© FT
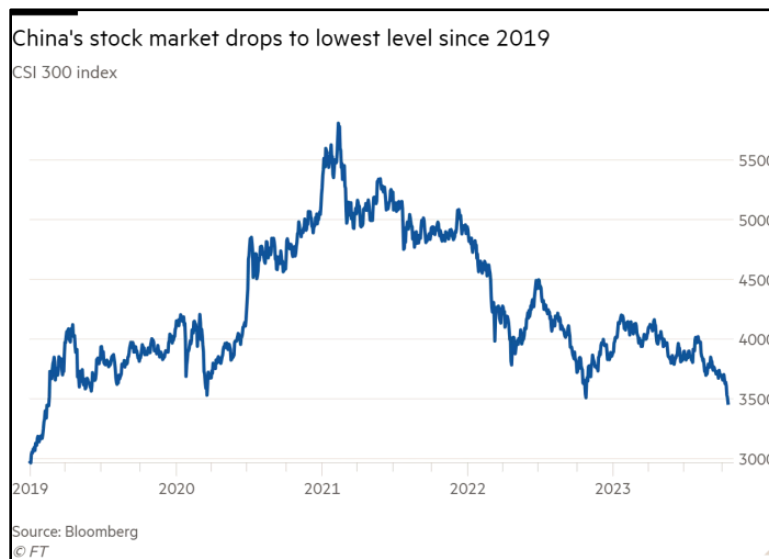
Switzerland: In parliamentary elections yesterday, the right-wing populist Swiss Peoples' Party (SVP) was projected to come in first with 29.1% of the vote, which would be its second-best showing ever. In contrast, the liberal pro-business FDP came in with just 14.5%, its worst showing. The combined share for the country's two big Green parties fell to 16% from 21% previously.

- The parties will now embark on a period of negotiating on the makeup of parliament and the Federal Council, the country's executive branch.

- The election results suggest Swiss policy could now shift toward greater skepticism toward Europe's support for Ukraine in its effort to defend itself from Russia's invasion. The SVP will likely also push harder to limit immigration into Switzerland.

Argentina: In yesterday's first-round presidential election, Economy Minister Sergio Massa of the ruling Peronist Party unexpectedly came in first with 36.3% of the ballots, while radical libertarian Javier Milei, the leader in pre-election opinion polls, came in second with 30.1%. The conservative coalition's candidate, Patricia Bullrich, came in third with 23.8% of the vote.

- Massa and Milei will now face off in the final round of voting on November 19.

- That sets up a contest between the statist Peronist Party, which has presided over years of poor economic growth, increased state intervention into the economy, and high inflation, against Milei and his call for radical budget cuts and the dollarization of the economy.

U.S. Politics: The House of Representatives remains in limbo as the majority of Republicans in the chamber continue struggling to agree on a new speaker. The Republicans today plan to hold a candidate forum for the half-dozen or more of its members who have thrown their hat into the ring following the recent failed candidacies of moderate Steve Scalise and right-wing firebrand Jim Jordan. The party plans to hold a new vote on the speaker's position on Tuesday.

U.S. Bond Market: After falling just short of the 5% barrier last week, the yield on the benchmark 10-year Treasury note this morning has finally broken through that barrier. As of this writing, the yield stands at 5.021%, up from approximately 3.800% at the beginning of the year. As we note in our latest *Asset Allocation Bi-Weekly Report*, published today, the recent surge in bond yields could well reflect a broad-based change in the overall market regime, with global geopolitical and economic fracturing pushing up inflation and interest rates over time.
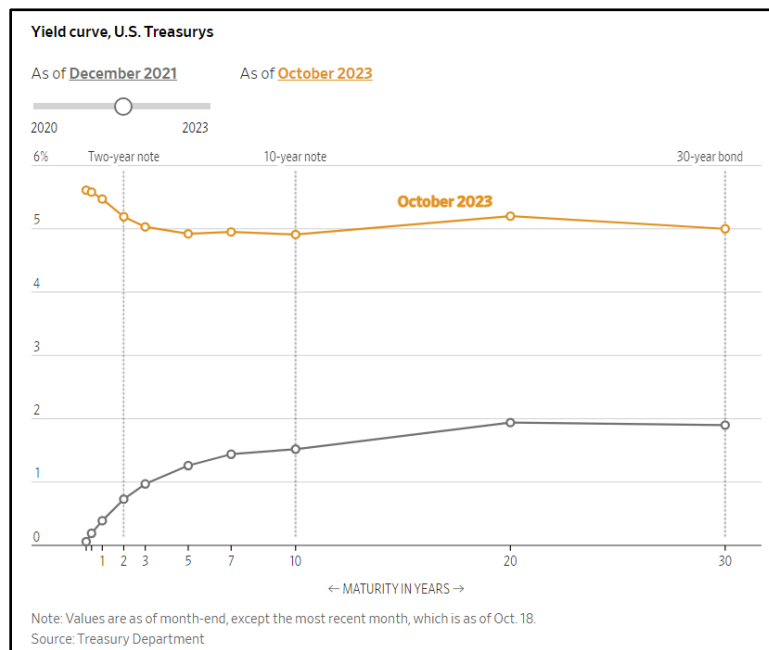
U.S. Economic Releases

No major U.S. data has been released so far today, and there are no economic releases or Fed events scheduled for the rest of the day.

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
EUROPE								
Switzerland	M3 Money Supply	y/y	Sep	-2.7%	-2.1%	-2.2%	**	Equity and bond neutral
	Domestic Sight Deposits CHF	w/w	20-Oct	469.7b	474.9b	--	*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	20-Oct	478.8b	483.8b	--	*	Equity and bond neutral
AMERICAS								
Canada	Retail Sales	m/m	Aug	-0.1%	0.3%	-0.1%	**	Equity and bond neutral
	Retail Sales Ex-Autos	m/m	Aug	0.1%	1.0%	-0.1%	**	Equity and bond neutral
Mexico	Economic Activity IGAE	y/y	Aug	3.7%	3.19%	3.40%	**	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	567	-1	Up
3-mo T-bill yield (bps)	530	530	0	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	538	537	1	Up
U.S. Libor/OIS spread (bps)	539	539	0	Up
10-yr T-note (%)	4.98	4.92	0.06	Flat
Euribor/OIS spread (bps)	397	400	-3	Up
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Up			Down
Yen	Flat			Down
Pound	Flat			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	$91.78	$92.16	-0.41%	
WTI	$87.57	$88.08	-0.58%	
Natural Gas	$2.89	$2.90	-0.38%	
Crack Spread	$20.97	$21.81	-3.87%	
12-mo strip crack	$23.94	$24.13	-0.75%	
Ethanol rack	$2.45	$2.46	-0.23%	
Metals				
Gold	$1,981.40	$1,981.40	0.00%	
Silver	$23.25	$23.37	-0.53%	
Copper contract	$355.45	$356.30	-0.24%	
Grains				
Corn contract	$493.50	$495.50	-0.40%	
Wheat contract	$585.75	$586.00	-0.04%	
Soybeans contract	$1,308.50	$1,320.25	-0.89%	
Shipping				
Baltic Dry Freight	2,046	2,071	-25	

Weather

The 6-10 and 8-14 day forecasts predict cooler-than-normal temperatures for most of the country, with warmer-than-normal temperatures expected on the West Coast and in the Southeast. The precipitation outlook shows wetter-than-normal temperatures for most states west of the Mississippi, and dry conditions in the northern Rockies.

There are currently two atmospheric disturbances in the Atlantic Ocean. Hurricane Tammy is moving through the British Virgin Islands and is expected to track northward. The other storm is in the Gulf of Mexico and has a 60% chance of cyclone formation within the next 48 hours. On average, Atlantic hurricane activity peaks on September 15.

Data Section

U.S. Equity Markets – (as of 10/20/2023 close)

YTD Total Return

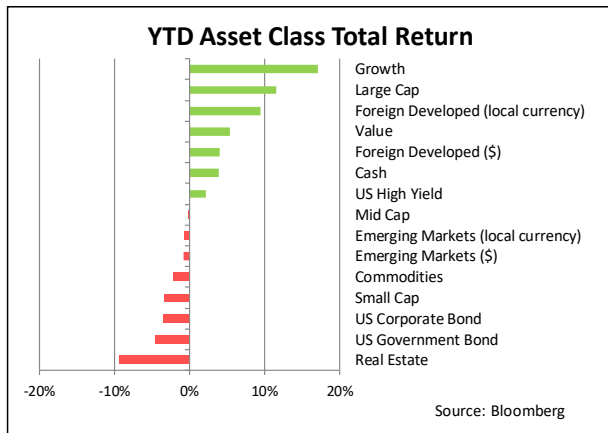| Sector	
Communication Services	(green, ~40%)
Technology	(green, ~33%)
Consumer Discretionary	(green, ~18%)
S&P 500	(black, ~11%)
Energy	(green, ~6%)
Industrials	(green, ~2%)
Materials	(~0%)
Financials	(red)
Healthcare	(red)
Consumer Staples	(red)
Real Estate	(red)
Utilities	(red)

Axis: -20%, 0%, 20%, 40%, 60%

Prior Trading Day Total Return

Sector	
Consumer Staples	(red, ~-0.3%)
Healthcare	(red, ~-0.4%)
Real Estate	(red, ~-0.7%)
Communication Services	(red, ~-0.9%)
Industrials	(red, ~-1.0%)
Utilities	(red, ~-1.0%)
Materials	(red, ~-1.2%)
S&P 500	(black, ~-1.3%)
Financials	(red, ~-1.5%)
Consumer Discretionary	(red, ~-1.6%)
Energy	(red, ~-1.7%)
Technology	(red, ~-1.7%)

Axis: -2.0%, -1.5%, -1.0%, -0.5%, 0.0%

(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 10/20/2023 close)

YTD Asset Class Total Return

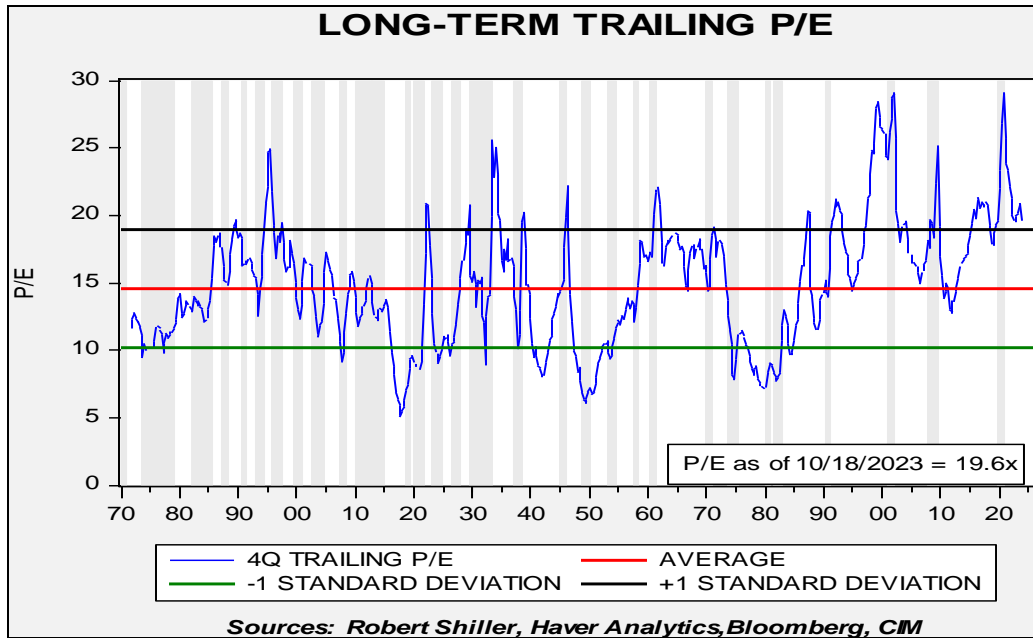| Asset Class	
Growth	(green, ~18%)
Large Cap	(green, ~12%)
Foreign Developed (local currency)	(green, ~10%)
Value	(green, ~5%)
Foreign Developed ($)	(green, ~4%)
Cash	(green, ~4%)
US High Yield	(green, ~2%)
Mid Cap	(~0%)
Emerging Markets (local currency)	(~0%)
Emerging Markets ($)	(red)
Commodities	(red)
Small Cap	(red)
US Corporate Bond	(red)
US Government Bond	(red)
Real Estate	(red, ~-9%)

Axis: -20%, -10%, 0%, 10%, 20%

Source: Bloomberg

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

LONG-TERM TRAILING P/E

P/E as of 10/18/2023 = 19.6x

Legend: 4Q TRAILING P/E — AVERAGE — -1 STANDARD DEVIATION — +1 STANDARD DEVIATION

Sources: Robert Shiller, Haver Analytics,Bloomberg, CIM

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.