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 24, 2023—9:30 AM EDT] Global equity markets are mostly higher this morning. In Europe, the Euro Stoxx 50 is up 0.4% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.1%. Chinese markets were higher, with the Shanghai Composite up 0.8% from its previous close and the Shenzhen Composite up 1.4%. U.S. equity index futures are signaling a higher open.

With 92 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, 76.1% have exceeded expectations while 19.6% 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 an update on the Israel-Hamas conflict. We next review a range of other international and U.S. developments with the potential to affect the financial markets today, including weak economic indicators in the eurozone and the United Kingdom, and a discussion of the U.S. government's deficit situation as shown in a new data release.

Israel-Hamas Conflict: The Israeli air forces and intelligence services continue working to set conditions for their expected ground assault against Hamas in the Gaza Strip, while Western leaders urge steps to minimize civilian casualties. Meanwhile, U.S. Defense Department said the USS *Dwight D. Eisenhower* and her strike group will now be sent to the waters around the Persian Gulf and Red Sea, rather than joining the USS *Gerald R. Ford* and her strike group in the eastern Mediterranean as originally planned. The U.S. will also deploy additional air defense systems to the region.

- The moves follow a series of small attacks on U.S. forces in Syria, Iraq, and near Yemen. They also highlight how the Israeli-Hamas fighting could broaden if regional Islamist groups escalate their sympathy attacks on U.S. interests or military units in the region.
- In the event of a substantial Islamist attack on U.S. interests or military units in the region, a self-defensive or retaliatory attack by U.S. forces could potentially prompt Iranian forces to join the fray. And even worse scenario would be if the half-dozen or so Chinese navy ships in the region came to the aid of the Iranians or the Islamist fighters.

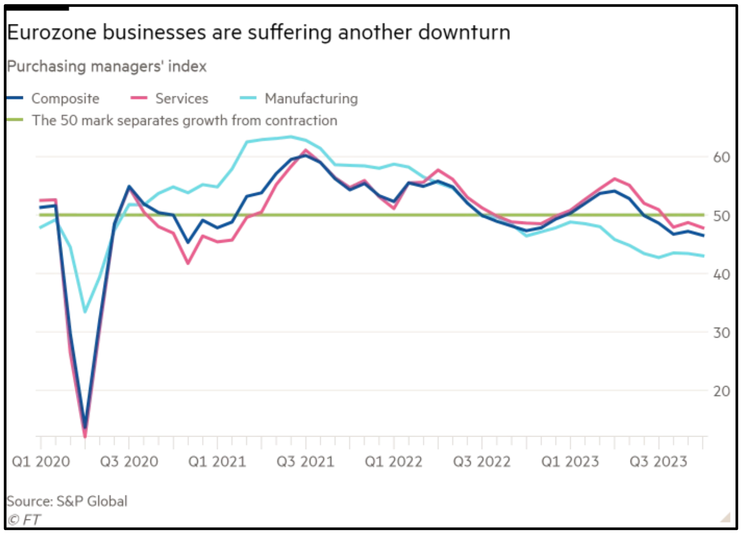
China: President Xi today officially signed an order firing Defense Minister Li Shangfu, nearly two months after he disappeared from public view. Xi also signed an order removing former Foreign Minister Qin Gang, who was sacked in a similar way in July, from the State Council. The Li and Qin cases have sparked rumors of corruption and misbehavior, but they could also reflect internal power politics. Given China's opaque leadership, it is impossible to know for sure at this point.

Hong Kong: Recent data shows Western firms are increasingly leaving Hong Kong on fears that it is being subsumed into the Chinese economy and legal system. The city's own data shows the number of U.S. companies operating in Hong Kong has now fallen for four straight years, to 1,258 in June 2022. Mainland Chinese firms with regional headquarters in Hong Kong now outnumber U.S. firms with regional offices there, for the first time in at least three decades. While we often note how China's geopolitical, economic, and legal environment are becoming less amenable to investment, it appears that Hong Kong is now in a similar situation.

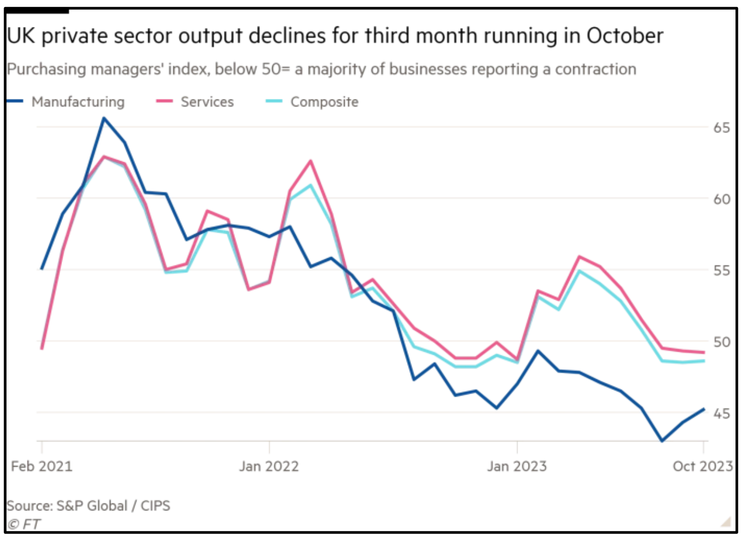
Eurozone: The S&P Global "flash" composite purchasing managers index for October fell to a 35-month low of 46.5, significantly below the consensus expectation of 47.4 (all in seasonally adjusted terms). As shown in our "Foreign Economic News" section below, the decline in the composite index reflected weaker readings in both the manufacturing and the service-sector indexes. Like most major PMIs, this one is designed so that readings below 50 indicate declining activity.

- Today's reading will therefore raise concerns about a further economic slowdown in Europe and stronger headwinds for European stocks because of factors such as high inflation and high interest rates.

- The data [is adding to speculation that the European Central Bank will hold interest rates steady at its meeting later this week](). Nevertheless, ECB chief Lagarde continues to suggest rates will remain high and won't be cut again for some time.



United Kingdom: Similar to the eurozone's data, the U.K.'s S&P Global/CIPS composite PMI for October came in at a seasonally adjusted 48.6, nearly as weak as the September reading of 48.5 and enough to indicate continued weakness in the British economy.



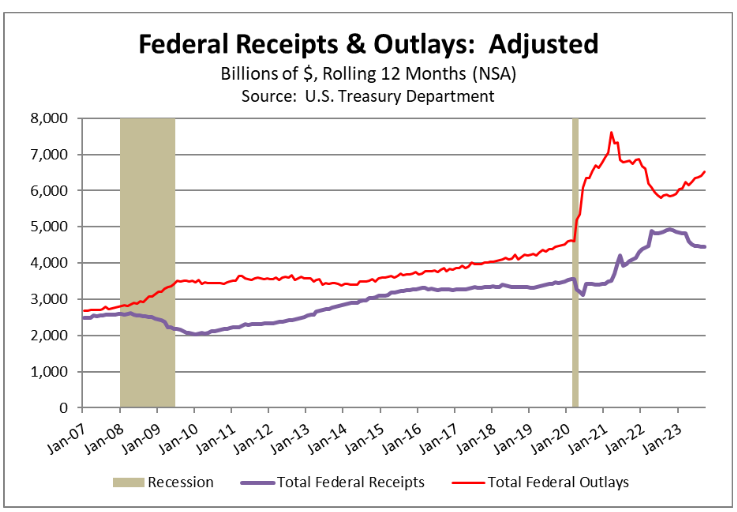
U.S. Politics: In the House of Representatives, the majority Republicans yesterday held a forum for the nine candidates now seeking to be speaker, with each laying out their strategy for pushing forward party priorities such as cutting federal spending.

- No single candidate appeared to have a lock on the party, but press reports say the strongest support is swinging toward:
    - House Majority Whip Tom Emmer of Minnesota,

- Republican Study Committee Chair Rep. Kevin Hern of Oklahoma,
    - House Republican Conference Vice Chair Rep. Mike Johnson of Louisiana, and
    - Byron Donalds of Florida, an ally of former President Donald Trump.
- The Republicans will vote to select their candidate for Speaker this morning, with a floor vote planned in the coming days.

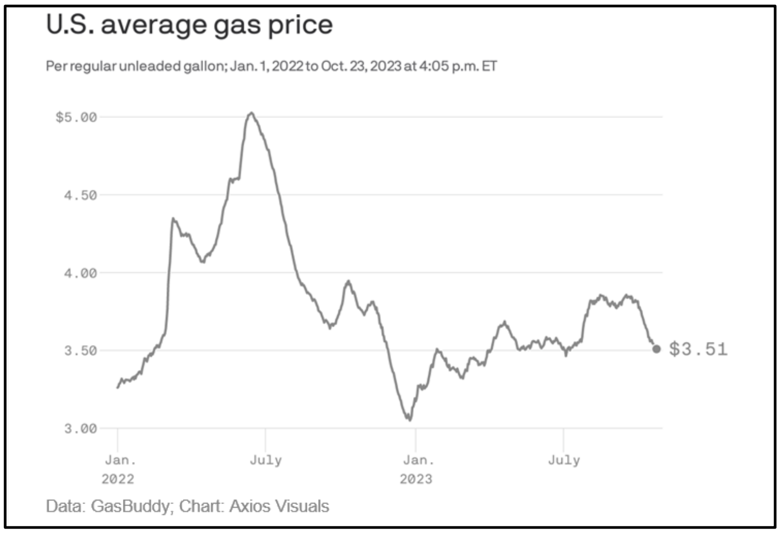
U.S. Fiscal Policy: The Treasury Department has finally released its report on federal revenues, outlays, and deficits for the fiscal year ended in September. However, the overall deficit figures for FY 2023 and the prior year are distorted because of the way the department accounted for the entire cost of the administration's proposed student-loan forgiveness program in just one month, i.e., September 2022, as we showed in a recent *Asset Allocation Bi-Weekly Report*. After the courts negated that program, the department reversed its accrual all in August 2023. The budget deficit therefore looks bigger in FY 2022 than it really was on a cash-accounting basis, and narrower in FY 2023.

- As reported, federal receipts in FY 2023 totaled $4.439 trillion, down 9.3% from the previous year. Federal outlays totaled $6.134 trillion, down 2.2% from the prior year. That resulted in a reported deficit of $1.695 trillion, versus a shortfall of $1.375 trillion in FY 2022.
- One simplistic way to correct for the student-loan program's accrual accounting would be to strip out its recognized cost of about $383 billion from the monthly figure for September 2022 and add it back in August 2023. Doing so would result in a FY 2022 deficit of roughly $1.312 billion and a FY 2023 deficit of about $1.758 billion. The chart below shows how the rolling 12-month totals for federal receipts and outlays would look with this adjustment.
- The adjusted chart clearly shows the widening gap between federal outlays and receipts. As we noted in our *Asset Allocation Bi-Weekly Report*, we still think there will be some fiscal tightening in the coming quarters from developments like the end of the temporary student-loan payment moratorium. Nevertheless, the current expansion in the federal deficit is likely an important reason for the recent surge in bond yields.



U.S. Labor Market: The United Auto Workers yesterday announced the union would expand its strike against the major automakers to include the largest pickup-truck factory of Stellantis (STLA, $18.94). The move came despite the company's offer last Thursday to boost wages by 23% over the life of the new contract being negotiated, and to increase the firm's retirement plan contributions by 50%, along with added job security. The UAW's tough bargaining reflects how the tight labor market has strengthened labor's bargaining power and likely portends continued sharp increases in wage rates and higher consumer price inflation in the coming years.

U.S. Energy Markets: Helped on by the seasonal transition to cheaper winter blends, average prices for unleaded gasoline have fallen recently to just $3.51 per gallon, close to the lowest levels of the year. The fall in gas prices could help offset the recent rise in interest rates and student loan repayments, thereby buoying consumer spending in the coming months.



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**
9:45	S&P Global Manufacturing PMI	m/m	Oct P	49.4	49.8	***
9:45	S&P Services PMI	m/m	Oct P	49.9	50.1	**
9:45	S&P Composite PMI	m/m	Oct P	50.0	50.2	**
10:00	Richmond Fed Manufact. Index	m/m	Oct	3	5	**
Federal Reserve						
No Fed speakers or events for the rest of today						

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	Jibun bank Composite PMI	m/m	Oct P	49.9	52.1		*	Equity and bond neutral
	Jibun Bank Manufacturing PMI	m/m	Oct P	448.5	48.5		***	Equity and bond neutral
	Jibun Bank Services PMI	m/m	Oct P	51.1	53.8		**	Equity and bond neutral
	Nationwide Dept Sales YoY	y/y	Sep	9.2	0.1		***	Equity and bond neutral
South Korea	PPI	y/y	Sep	1.3%	1.0%		**	Equity and bond neutral
EUROPE								
Eurozone	HCOB Eurozone Manufacturing PMI	m/m	Oct P	43.0	43.4	43.7	***	Equity bearish, bond bullish
	HCOB Eurozone Services PMI	m/m	Oct P	47.8	48.7	48.6	**	Equity bearish, bond bullish
	HCOB Eurozone Composite PMI	m/m	Oct P	46.5	47.2	47.4	*	Equity bearish, bond bullish
Germany	GfK Consumer Confidence	m/m	Nov	-28.1	-26.5	-27	**	Equity bearish, bond bullish
	HCOB Germany Manufacturing PMI	m/m	Oct P	40.7	39.6	40.1	**	Equity bullish, bond bearish
	HCOB Germany Services PMI	m/m	Oct P	48.0	50.3	50.0	**	Equity bearish, bond bullish
	HCOB Germany Composite PMI	m/m	Oct P	45.8	46.4	46.6	*	Equity bearish, bond bullish
France	HCOB France Manufacturing PMI	m/m	Oct P	42.6	44.2	44.5	**	Equity bearish, bond bullish
	HCOB France Services PMI	m/m	Oct P	46.1	44.4	45.0	**	Equity bullish, bond bearish
	HCOB France Composite PMI	m/m	Oct P	45.3	44.1	44.6	*	Equity bullish, bond bearish
UK	Claimant Count Rate	m/m	Sep	4.0%	4.0%	3.9%	***	Equity and bond neutral
	Jobless Claims Change	m/m	Sep	20.4k	0.9k	-9.0k	***	Equity bearish, bond bullish
	S&P/CIPS Manufacturing PMI	m/m	Oct P	45.2	44.3	44.7	**	Equity and bond neutral
	S&P/CIPS Services PMI	m/m	Oct P	49.2	49.3	49.3	**	Equity and bond neutral
	S&P/CIPS Composite PMI	m/m	Oct P	48.6	48.5	48.5	**	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)	529	529	0	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)	540	539	1	Up
10-yr T-note (%)	4.86	4.85	0.01	Flat
Euribor/OIS spread (bps)	396	397	-1	Up
Currencies	Direction			
Dollar	Up			Up
Euro	Down			Down
Yen	Flat			Down
Pound	Down			Down
Franc	Down			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	$90.05	$89.83	0.24%	
WTI	$85.70	$85.49	0.25%	
Natural Gas	$2.95	$2.93	0.72%	
Crack Spread	$20.81	$20.96	-0.74%	
12-mo strip crack	$23.71	$23.86	-0.64%	
Ethanol rack	$2.41	$2.42	-0.53%	
Metals				
Gold	$1,961.67	$1,972.85	-0.57%	
Silver	$22.82	$22.98	-0.68%	
Copper contract	$358.35	$358.65	-0.08%	
Grains				
Corn contract	$487.75	$490.25	-0.51%	
Wheat contract	$583.00	$587.25	-0.72%	
Soybeans contract	$1,311.00	$1,305.50	0.42%	
Shipping				
Baltic Dry Freight	2,017	2,046	-29	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.0		
Gasoline (mb)		-1.5		
Distillates (mb)		-2.0		
Refinery run rates (%)		0.4%		
Natural gas (bcf)		81		

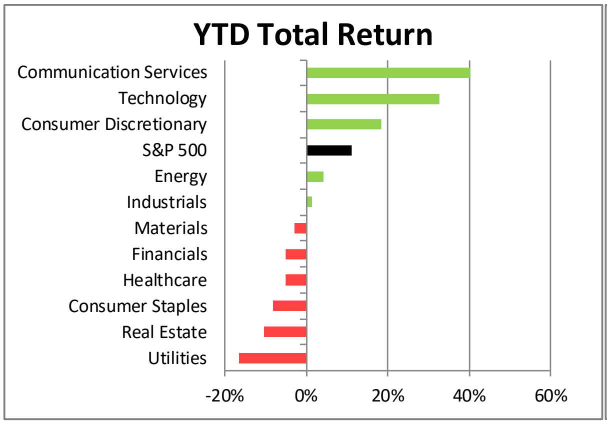
Weather

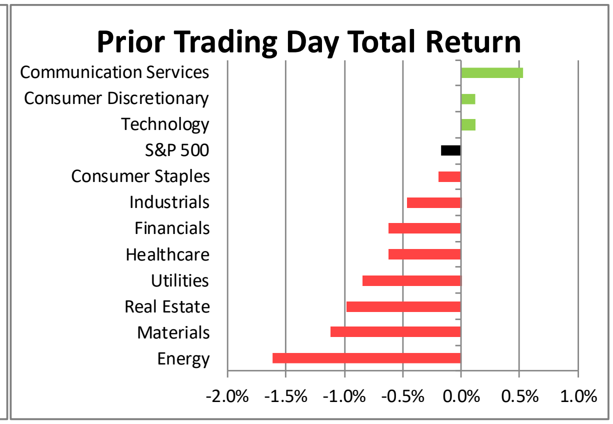
The 6-10 and 8-14 day forecasts predict cooler-than-normal temperatures for most of the country, with warmer-than-normal temperatures expected on the West Coast and in the Southeast. The precipitation outlook shows wetter-than-normal temperatures throughout the Pacific, Mid-Atlantic, and southern half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

There are currently two atmospheric disturbances in the Atlantic Ocean. Hurricane Tammy is tracking northward through the central Atlantic Ocean, while Tropical Depression Twenty-One is moving across Nicaragua. On average, Atlantic hurricane activity peaks on September 15.

Data Section

U.S. Equity Markets – (as of 10/23/2023 close)

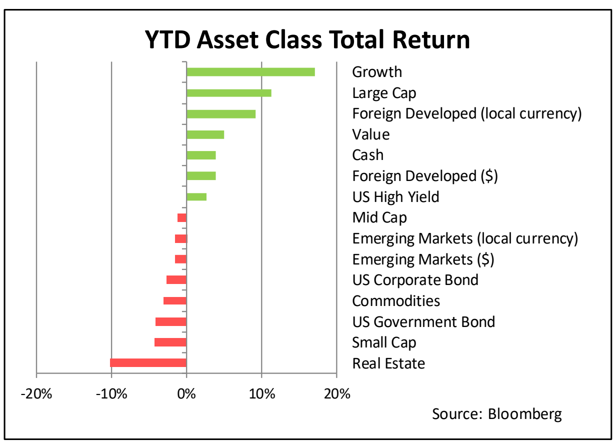




(Source: Bloomberg)

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 10/23/2023 close)

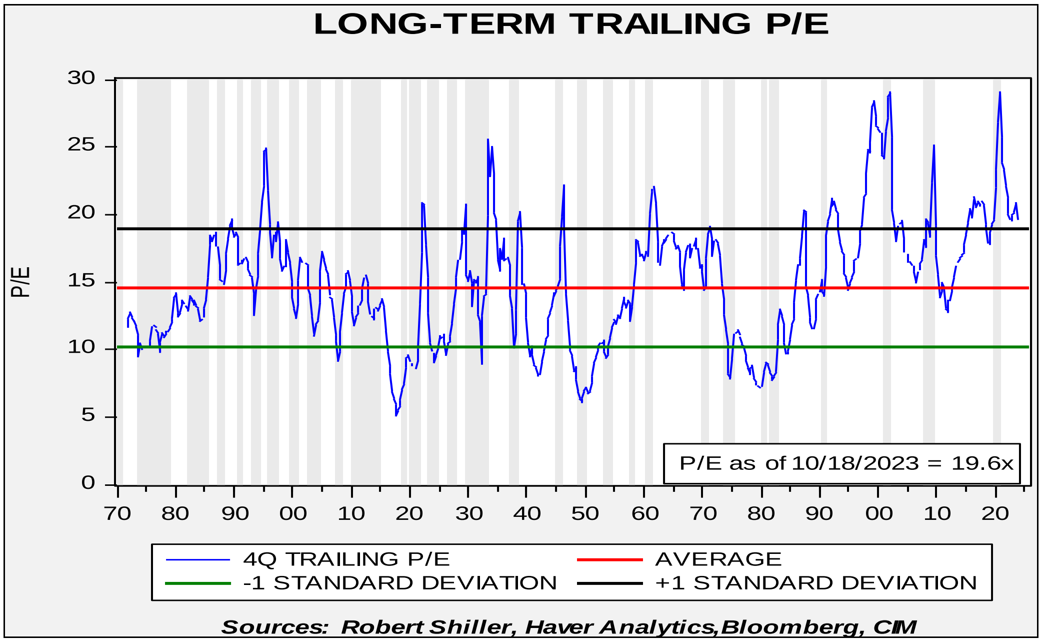


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.