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 26, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is down 1.0% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.2%. Chinese markets were higher, with the Shanghai Composite up 0.5% from its previous close and the Shenzhen Composite also up 0.5%. U.S. equity index futures are signaling a lower open.

With 167 companies having reported so far, S&P 500 earnings for Q3 are running at $56.70 per share, compared to estimates of $57.42, which is up 1.7% from Q2 2023. Of the companies that have reported thus far, 77.8% have exceeded expectations while 17.4% have fallen short of expectations.

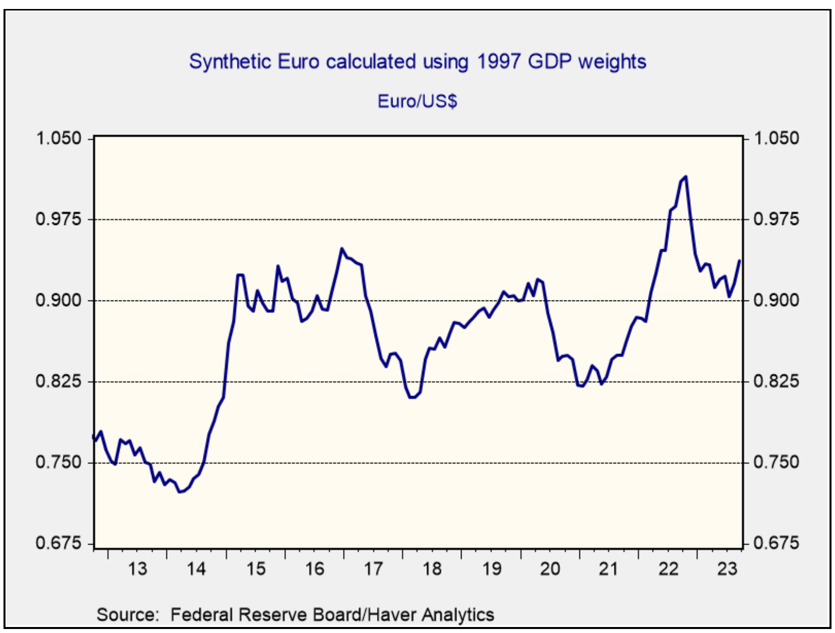
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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)

Good morning! Concerns over earnings are weighing on equities, and Astros manager Dusty Baker announced that he is retiring. Today's *Comment* begins with a discussion about the ECB's latest rate decision. Next, we analyze the recent plunge in the yen and assess how political realignment may impact support for Ukraine. As always, our report includes an overview of the latest domestic and international data releases.

Throwing in the Towel? With high inflation and a looming recession, the European Central Bank is reluctant to predict the future path of policy.

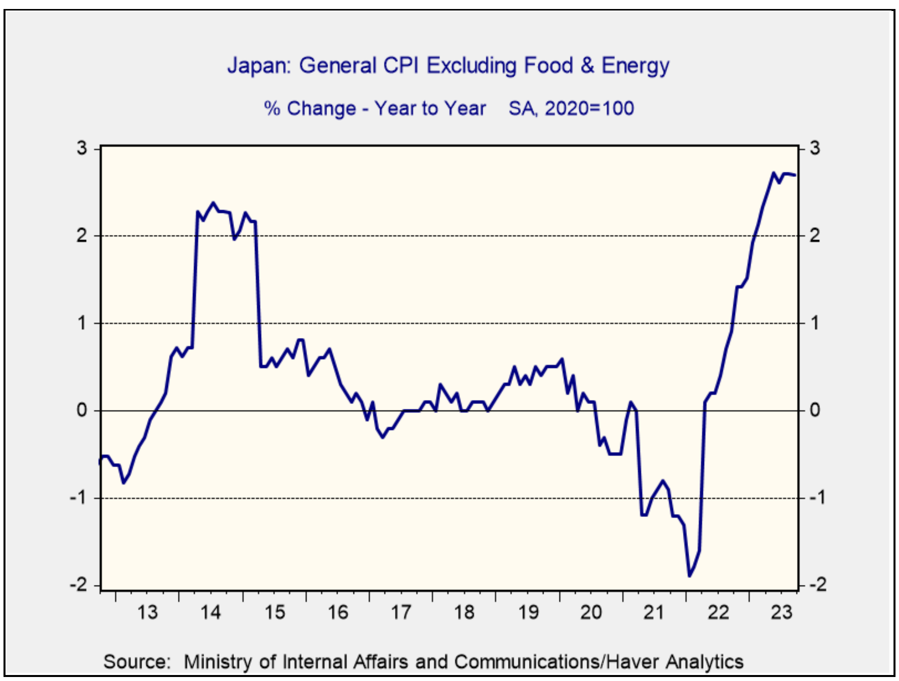
- European policymakers held policy rates steady at their October 26 meeting, following 10 consecutive hikes. The decision to keep rates at their current levels comes amidst signs that euro area inflation has dropped. In September, the consumer price index rose 4.27% year-over-year, well below the previous month's rise of 5.01%. At the press conference, ECB President Christine Lagarde reiterated the central bank's commitment to containing inflation and its readiness to raise rates if necessary. While confident that inflation will continue to make progress, ECB President Christine Lagarde stated that the central bank will take a wait-and-see approach before deciding whether to hike rates again.
- In addition to interest rate uncertainty, the European Union faces concerns about implementing a bloc-wide 3% deficit-to-GDP target and a 60% debt-to-GDP ratio by its self-imposed January 2024 deadline. Although there isn't an agreement in place, the plan is for EU members to resume their deficit and debt targets, which were temporarily suspended during the pandemic, and amend the fiscal rules to allow governments more flexibility in meeting targets over four years, with a possible seven-year extension in exchange for reforms and investments. Details of the arrangements are still being negotiated, with the sides far apart. The lack of guidance may force policymakers to hold rates tighter for longer to prevent inflation from arising from fiscal spending.



- The European Central Bank faces a more precarious predicament than the Federal Reserve when deciding future policy. Eurozone inflation is higher and growth is slower than in the United States, limiting policymakers' flexibility to raise rates. On the other hand, policymakers may be reluctant to ease monetary policy on concerns that currency depreciation due to interest rate differentials could counterintuitively push up inflation. As a result, the ECB is more likely to hold policy steady for longer than the Federal Reserve, and rely more on other tools for tightening, such as raising the minimum reserve requirement.

Yen Troubles? The Japanese currency dropped to a 33-year low against the dollar on Wednesday, raising the likelihood of intervention from the Bank of Japan (BOJ) and a policy shift.

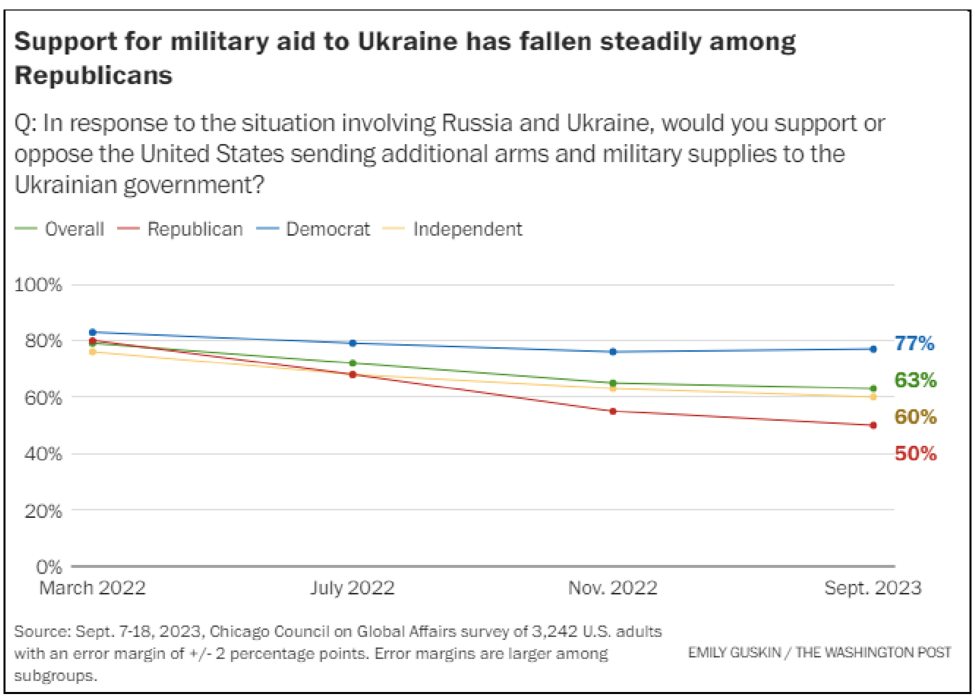
- The yen (JPY) closed at 150.25 per dollar on Wednesday, its lowest level since August 1990. The BOJ has stated that it was willing to intervene in exchange rate markets to prevent extreme swings in currency movements. Last October, the Bank of Japan intervened by selling dollars and buying yen, worth about $42 billion, after the JPY breached 150 to the dollar. Although BOJ officials have been mum about whether it is weighing another intervention, the central bank's reputation of being the "widowmaker" has prevented analysts from betting big against the currency.
- The BOJ may tweak its yield curve control (YCC) policy at its next meeting on Monday, as currency weakness and rising inflation have fueled speculation about an end to its ultra-accommodative monetary policy. The 10-year Japanese government bond (JGB) yield is trading at 0.87%, its highest level in over 13 years, with the current YCC band set at 1.0%. A possible readjustment to the YCC band could reduce pressure on the currency and inflation, while also signaling to the market that the BOJ is transitioning away from its ultra-accommodative stance.



- The BOJ is likely to phase out its ultra-accommodative monetary policy in 2024, as inflation becomes a political problem for the ruling party. Earlier this week, the government announced that it plans to extend utility and gasoline subsidies through April to protect households from rising price pressures. This shift will impact global bond yields, as JGBs will offer more competition to other government debt, such as the U.S. Treasury. It will also hurt investors in the yen carry trade, as the resulting currency appreciation will make debt payments more expensive for borrowers that hold foreign currencies. Additionally, the change should act as a headwind for the USD.

War Fatigue? Political parties pushing to reduce financial support for Ukraine in its conflict with Russia are gaining popularity across the West.

- The U.S. elected its new House speaker following the end of a 22-day stand-off. Republican Representative Mike Johnson from Louisiana won the election to become the 56th Speaker of the House. Despite having a relatively low profile prior to his win, he has been labeled the most conservative speaker by some publications. After taking the gavel, his first move was to approve aid for Israel in its conflict with Hamas. He is also expected to hold budget talks with the White House, which will likely include discussions on aid for Ukraine. While he has expressed support for Ukraine, he has been skeptical of using U.S. taxpayer money without proper oversight.
- Speaker Johnson is not alone in expressing concerns about how aid to Ukraine is being spent, as politicians in the United States and abroad have also raised doubts. Republican presidential candidate Vivek Ramaswamy has made opposing aid one of the tenets of his presidential campaign. Meanwhile, Germany's populist AfD party has seen a surge of support in recent months and Slovakia has elected a president that is likely to push back against additional aid to Ukraine. While public support for Ukraine remains strong, public interest is waning.

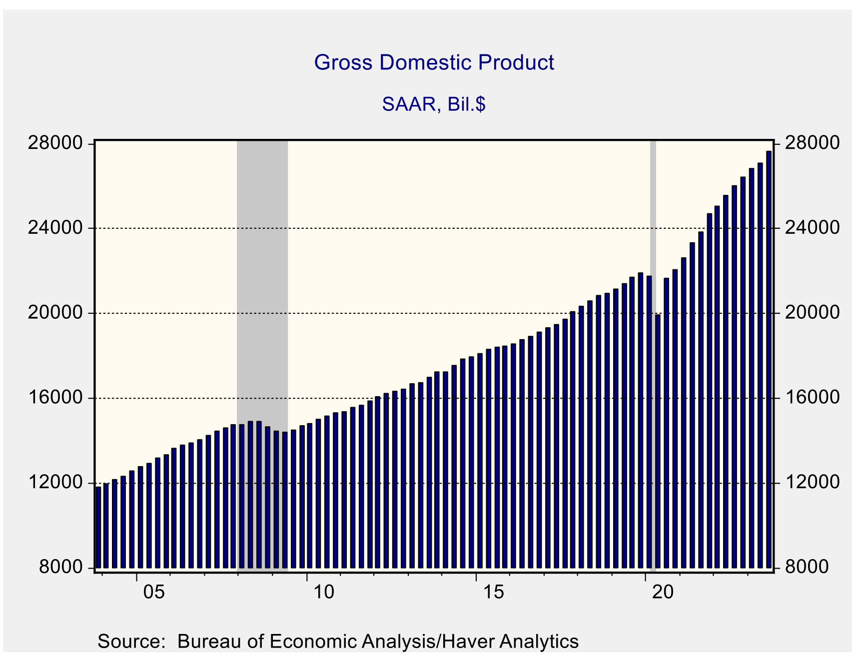


- War funding is poised to become a central issue in the coming months, as governments grapple with a slowing global economy and elevated budget deficits. The U.S. budget talks will provide a glimpse into how other governments will handle this issue. If U.S. lawmakers struggle to reach a consensus, given their resilient economy, it will be even more difficult for EU countries on the brink of recession to do so. It is too early to gauge the West's long-term support for Ukraine, but next year's U.S. presidential election and EU parliamentary elections may provide some clues. Regardless of the outcome, the market will likely favor a quick resolution.

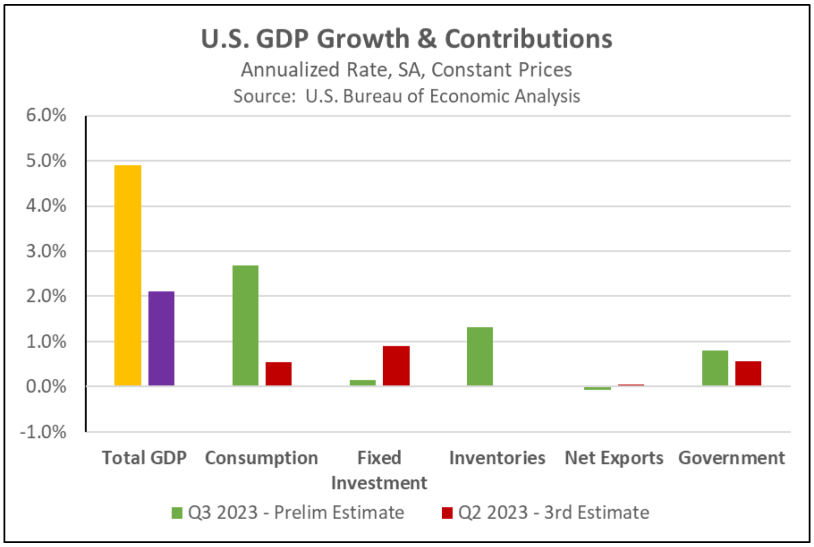
Other News: The U.S. found that a chip made by Huawei may have been made using machines subject to export controls. This discovery suggests that China may not have made as much advancement in semiconductor manufacturing as once feared, but it also raises questions about the effectiveness of export restrictions. Separately, the United Auto Workers (UAW) has reached a tentative agreement with Ford Motor Company (F, $11.54). The deal is likely to pressure other automakers to reach agreements with the UAW as well. Lastly, Israel is preparing to carry out its ground invasion of Gaza. The move raises the likelihood of a broader Middle Eastern conflict.

U.S. Economic Releases

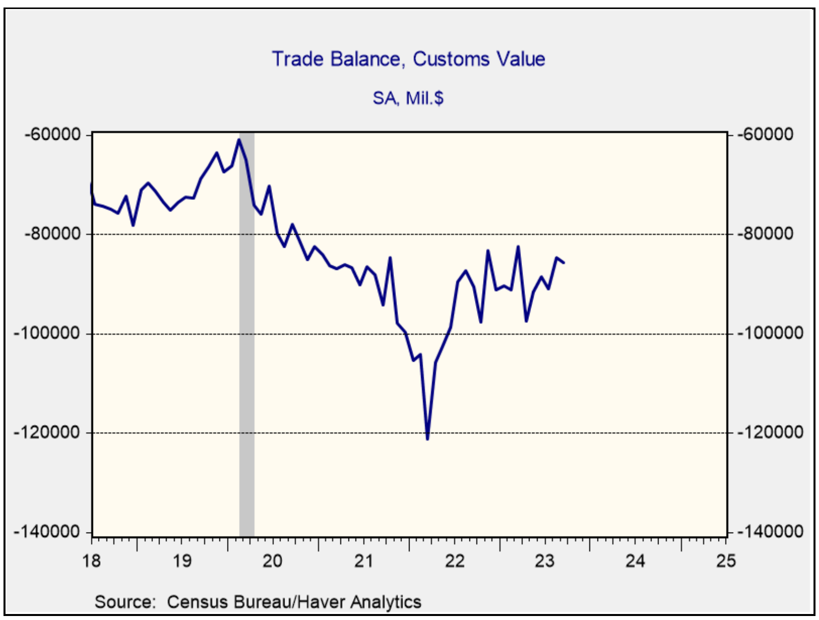
The U.S. economy expanded in the third quarter at the fastest pace in nearly two years. Gross domestic product rose at annualized pace of 4.9% in the third quarter, well above estimates of 4.5% and the previous quarter's reading of 2.1%. Much of the growth came from personal consumption which rose at annual pace of 4.0% from the previous quarter, up from the previous reading of 0.8%. Meanwhile, the GDP price index and core PCE price index rose 3.5% and 2.4%, respectively, from the previous quarter.



The previous chart shows the level of nominal GDP. The biggest contributors to GDP were consumption and government spending.



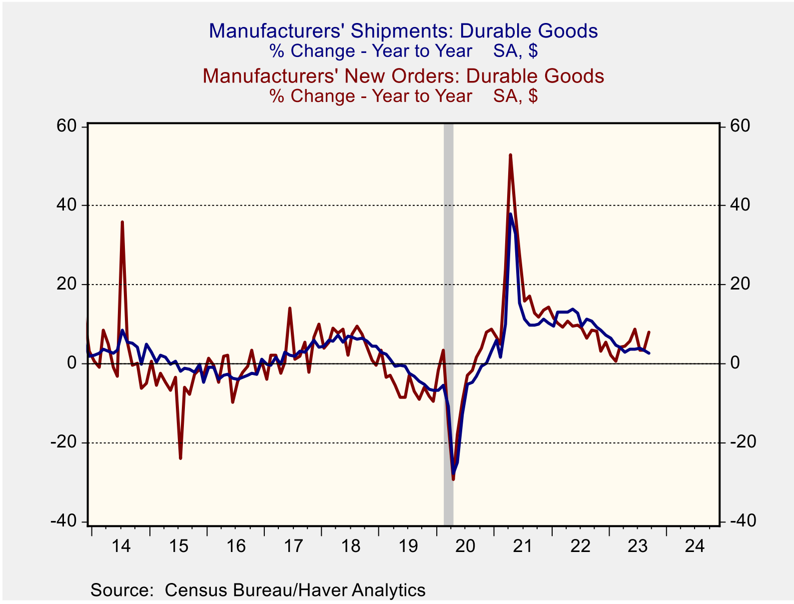
The U.S. trade deficit in goods widened in September, driven by a sharp increase in imports. The deficit rose to $85.8 billion, up from a revised $84.6 billion in August, beating estimates of $86.0 billion.



The chart above shows the level of the U.S. trade deficit.

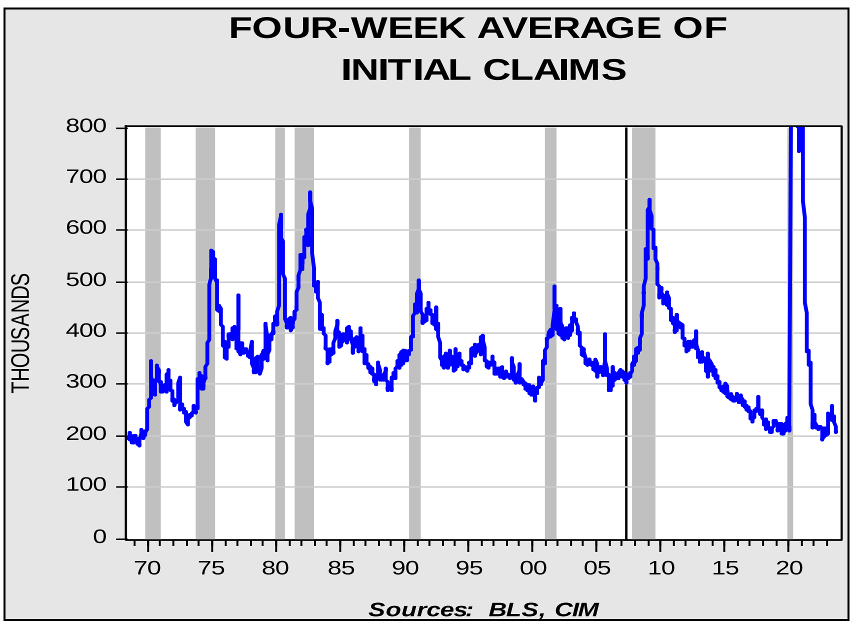
Separately, a proxy for business investment has started to pick up in September. Durable goods orders rose 4.7% from the prior month, well above expectations of 1.8%. Excluding transportations, durable goods orders rose 0.5% from the previous month, above estimates of

0.2%. Meanwhile, nondefense capital goods orders excluding aircraft rose 0.6% from the prior month, above estimates of them remaining unchanged.



The chart shows the annual change in durable goods orders and shipments. Orders are up 7.8% from the prior year, while shipments have increased 2.6% in the same period.

Jobless claims suggests that the labor market remains tight. Initial jobless claims rose to 210k in the week ending October 21, above expectations of 207k and the previous week's reading of 200k.



The previous chart shows the four-week moving average of initial claims. The four-week moving average rose from 206.25k to 207.50k.

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	Pending Home Sales	m/m	Sep	-2.0%	-7.1%	**
10:00	Pending Home Sales NSA	y/y	Sep	-14.6%	-18.8%	**
11:00	Kansas City Fed Services Activity	m/m	Oct		-8	*
Federal Reserve						
EST	Speaker or Event	District or Position				
9:00	Chris Waller Delivers Opening Remarks at Payments Conference	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								
Japan	Services PPI	y/y	Sep	2.1%	2.1%	2.0%	*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	20-Oct	¥214.7b	¥1259.9b	¥1263.9b	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	20-Oct	¥82.7b	¥178.6b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	20-Oct	-¥151.7b	¥794.0b	¥808.1b	*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	20-Oct	-¥904.2b	¥947.8b		*	Equity and bond neutral
	Machine tool orders	y/y	Sep F	-11.2%	-11.2%		**	Equity and bond neutral
South Korea	Business Survey - Non-Manufacturing	m/m	Nov	69	77		*	Equity bearish, bond bullish
	Business Survey - Manufacturing	m/m	Nov	69	67		**	Equity bullish, bond bearish
	GDP	y/y	3Q A	1.4%	0.9%	1.1%	**	Equity bullish, bond bearish
EUROPE								
Russia	Industrial Production YoY	y/y	Sep	5.6	5.4	5.6	***	Equity and bond neutral
AMERICAS								
Mexico	Unemployment Rate NSA	m/m	Sep	2.88%	2.96%	2.93%	***	Equity bullish, bond bearish
Brazil	IBGE Inflation IPCA - 15	y/y	Oct	5.1%	5.0%	5.0%	*	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)	564	564	0	Up
3-mo T-bill yield (bps)	532	532	0	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	539	539	0	Up
U.S. Libor/OIS spread (bps)	540	540	0	Up
10-yr T-note (%)	4.96	4.96	0.00	Flat
Euribor/OIS spread (bps)	394	394	0	Up
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Down
Yen	Down			Down
Pound	Down			Down
Franc	Down			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
ECB Main Refinancing Rate	4.500%	4.500%	4.500%	On Forecast
ECB Marginal Lending Facility	4.750%	4.750%	4.750%	On Forecast
ECB Deposit Facility Rate	4.000%	4.000%	4.000%	On Forecast
Bank of Canada Rate Decision	5.000%	5.000%	5.000%	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	$87.85	$90.13	-2.53%	
WTI	$82.86	$85.39	-2.96%	
Natural Gas	$3.03	$3.01	0.50%	
Crack Spread	$20.40	$19.42	5.01%	
12-mo strip crack	$23.43	$23.01	1.82%	
Ethanol rack	$2.34	$2.35	-0.40%	
Metals				
Gold	$1,984.23	$1,979.72	0.23%	
Silver	$22.94	$22.87	0.32%	
Copper contract	$360.20	$359.10	0.31%	
Grains				
Corn contract	$480.25	$480.00	0.05%	
Wheat contract	$575.75	$568.50	1.28%	
Soybeans contract	$1,312.75	$1,308.50	0.32%	
Shipping				
Baltic Dry Freight	1,832	1,949	-117	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	1.4	-0.5	1.8	
Gasoline (mb)	0.2	-1.3	1.4	
Distillates (mb)	-1.7	-1.8	0.1	
Refinery run rates (%)	-0.5%	0.6%	-1.1%	
Natural gas (bcf)		79		

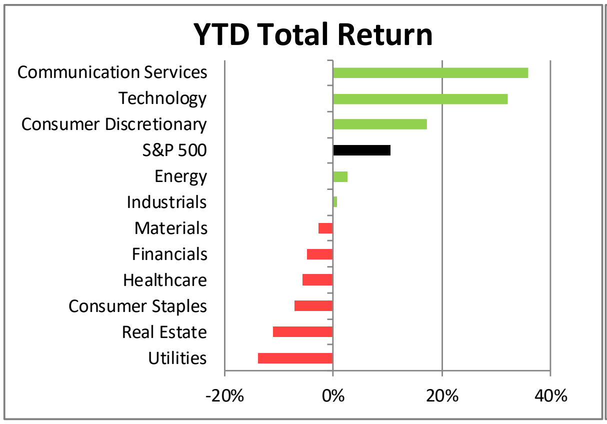
Weather

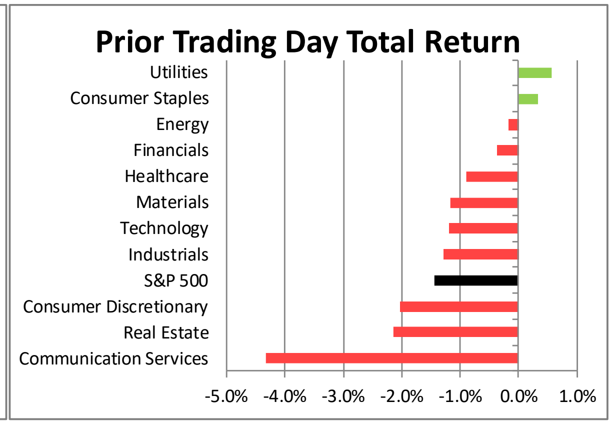
The 6-10 and 8-14 day forecasts predict cooler-than-normal temperatures for most of the country, with warmer-than-normal temperatures expected to spread from the West Count into the Great Plains. The precipitation outlook shows wetter-than-normal temperatures throughout the northern Pacific and Southeast regions, with dry conditions expected for the Midwest, New England, and Great Plains regions.

There is currently one atmospheric disturbance in the Atlantic Ocean. Hurricane Tammy, now a post-tropical cyclone, is track northward through the central Atlantic Ocean. On average, Atlantic hurricane activity peaks on September 15.

Data Section

U.S. Equity Markets – (as of 10/25/2023 close)

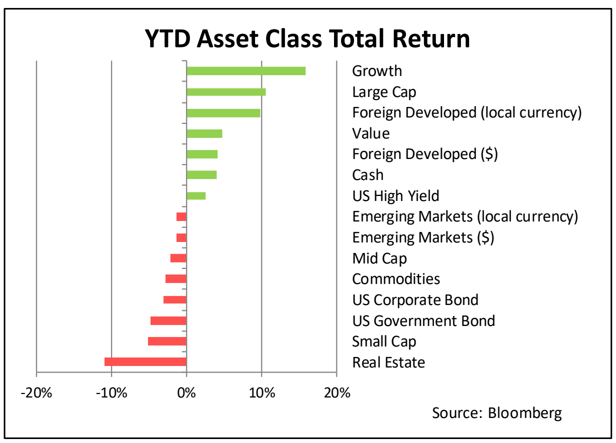




(Source: Bloomberg)

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 10/25/2023 close)

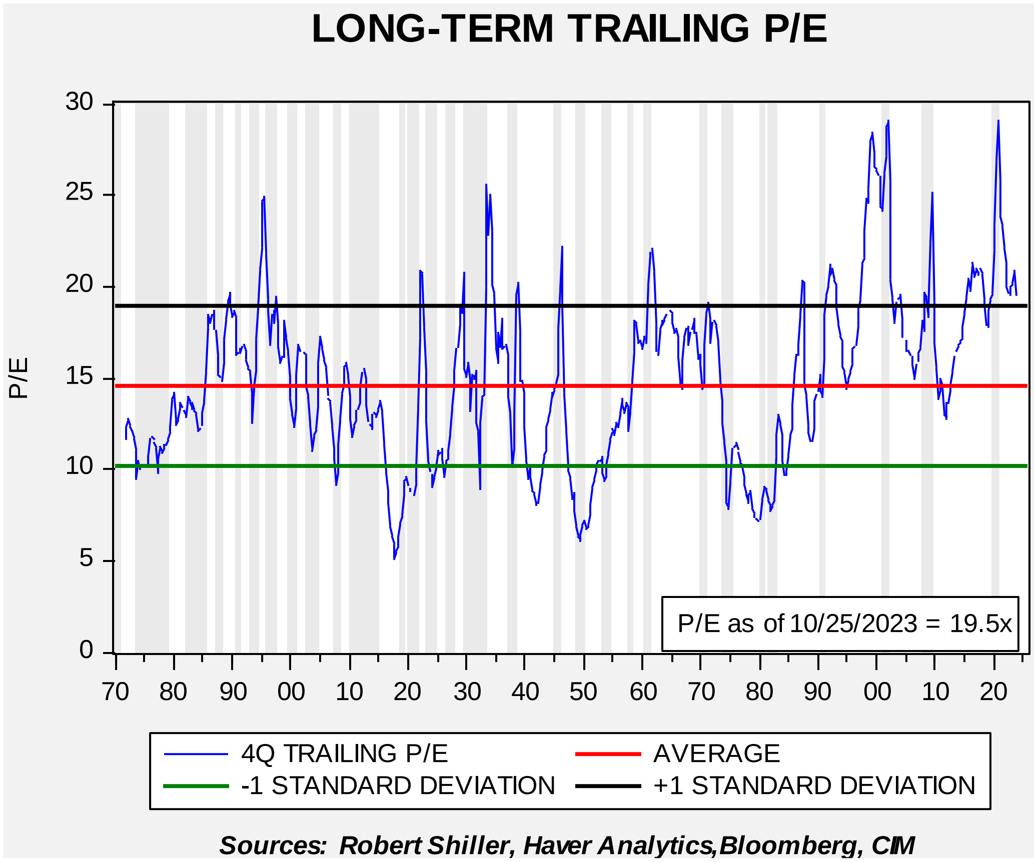


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 26, 2023



Based on our methodology,[1] the current P/E is 19.5x, down 0.1x from last week. The multiple contracted modestly on improved earnings.

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.