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 27, 2023—9:30 AM EDT] Global equity markets are generally higher this morning. In Europe, the Euro Stoxx 50 is down 0.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.2%. Chinese markets were higher, with the Shanghai Composite up 1.0% from its previous close and the Shenzhen Composite up 1.8%. U.S. equity index futures are signaling a higher open.

With 233 companies having reported so far, S&P 500 earnings for Q3 are running at $57.60 per share, compared to estimates of $57.42, which is up 1.7% from Q2 2023. Of the companies that have reported thus far, 79.4% have exceeded expectations while 15.9% 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:

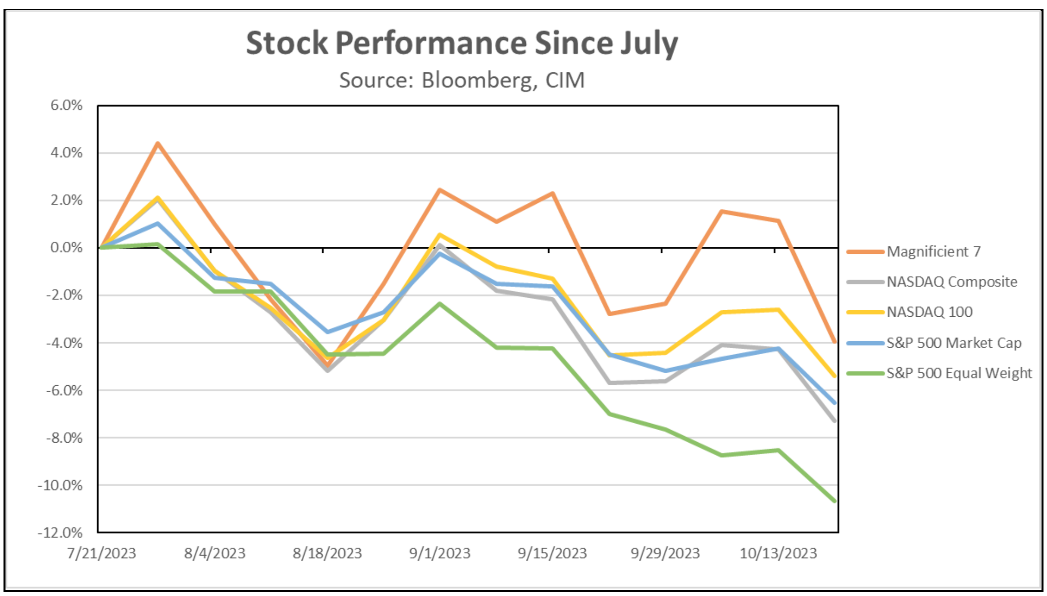
- *Bi-Weekly Geopolitical Report* (10/16/2023) (with associated podcast): "What Shall We Call the New Era?"
- *Weekly Energy Update* (10/19/2023): The situation in the Middle East remains fraught with risk, supporting crude oil prices. Despite continued record crude oil production, commercial inventories 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)
- ***Business Cycle Report*** **(10/26/23)**

Good morning! Equities are off to a great start, and the Diamondbacks look to prove doubters wrong in the first game of the World Series. Today's *Comment* begins with our analysis of the

S&P 500's recent poor performance, followed by a closer look at the GDP data and rising geopolitical risks in the Middle East and the South China Sea. As always, our report includes an overview of the latest domestic and international data releases.

Correction Coming? After getting off to a strong start to the year, large caps may have finally hit an inflection point.

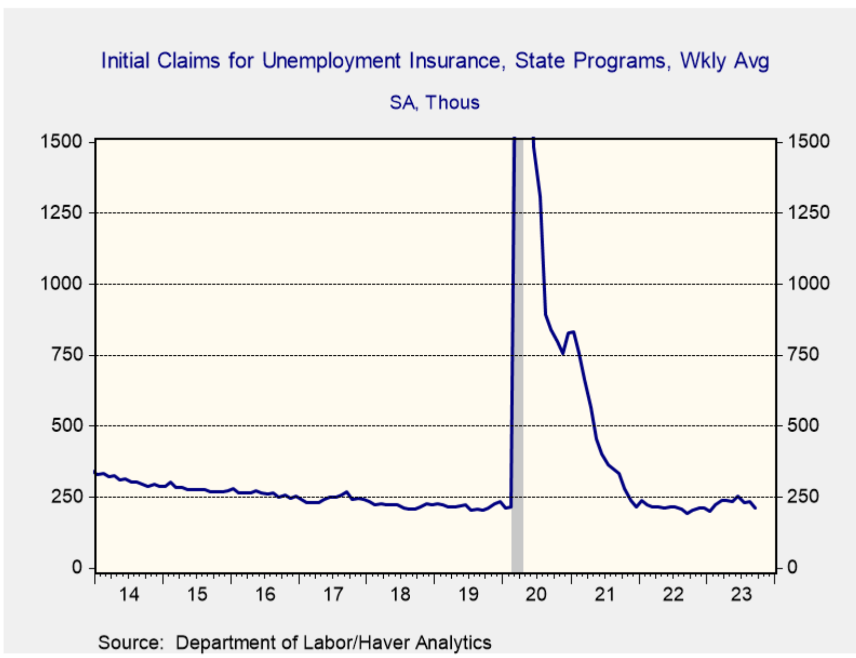
- The S&P 500 closed below its 200-day moving average of 4,238.41 on Thursday, ending the day at 4,179.50. This dip below a key technical level has historically signaled a broader sell-off. The index's fall was related to a confluence of negative factors, including rising yields on long-duration Treasuries, a war in the Middle East, and a deteriorating outlook for tech stocks. The last of the three has come under scrutiny due to their high valuations relative to earnings, as investors have been willing to pay a premium for companies with strong AI capabilities.
- The *Magnificent Seven*—Alphabet (GOOG, $123.44), Amazon (AMZN, $119.57), Apple (AAPL, $166.89), Meta (META, $288.35), Microsoft (MSFT, $327.89), Nvidia (NVD, $388.65), and Tesla (TSLA, $205.76)—have seen the least amount of losses since July 21, 2023, outperforming the broader tech sector and the overall S&P 500. Their strong performance is likely due to investor confidence in these companies' ability to capture market share given their size and expertise. According to an analyst at Bernstein Quantitative, the Magnificent Seven are projected to have profit growth of 33.1% and revenue growth of 10.9% year-over-year, while the remaining companies are predicted to have profit contraction of 8.6% and revenue growth of 0.3%.



- Despite their strong performances, the Magnificent Seven remain more vulnerable to fluctuations than investors may realize, due to their sensitivity to idiosyncratic risk. This was evident in the sell-off in Alphabet and Meta stocks this week, despite both companies reporting strong overall earnings. Alphabet's cloud business is struggling to meet investor expectations, while Meta's forward guidance was weakened by changes in the macroeconomic landscape. Investors should keep in mind that the Magnificent Seven's strong year-to-date performance is due in part to lofty expectations, and it is unclear whether these companies can live up to them. As a result, investors may find value by focusing on other companies with strong fundamentals that are being ignored.

Blowout Q3: The latest GDP report showed that the economy surged in the third quarter in another sign that a recession is not imminent.

- The U.S. economy grew at a robust 4.9% annual rate in the period from April to September, a significant increase from the 2.1% growth in the preceding three months. This sharp rise has raised doubts about the possibility of a recession, as the report showed that consumption remains strong even in the face of rising interest rates. Strong retail sales have boosted optimism that households have not yet run down their pandemic savings, raising the likelihood of a spillover effect into the following quarter. The report was also supported by strong inventories, but this is unlikely to persist.
- Despite strong consumption, GDP data shows that spending has shifted to smaller ticket items. Expensive and interest-sensitive goods like new and used vehicles declined in Q3, while recreational goods like TVs and PCs jumped. This may reflect households having more spending power due to higher wages, as firms compete to retain workers. The stubbornly low jobless claims reinforce this view as they show that labor hoarding is still rife throughout the economy. Assuming our assessment is correct, the economy may be more resilient to higher interest rates than investors realize.



- Despite the strong reading, the report is unlikely to sway policymakers at next week's Federal Open Market Committee meeting. The yield on the 10-year Treasury fell 4 bps to 4.91%. Meanwhile, [the CME FedWatch Tool shows that there is an 80% chance that the Federal Reserve will hold rates steady] for the rest of the year. The indifference to the report reflects the broader sentiment that the market expects Fed officials to enter a new phase in its policy stance, in which it looks to navigate a soft landing. Projections show that the Fed will look to cut interest rates in the second half of 2024.

Rising Geopolitical Tensions: The chances of a broadening conflict in the Middle East are increasing, while tensions between the U.S. and China show no signs of abating.

- Israeli forces have undertaken another operation in Northern Gaza, with the aim of neutralizing Hamas fighters and disabling their anti-tank weaponry, as they prepare for an imminent ground invasion. Simultaneously, the U.S. military conducted airstrikes against two facilities located in eastern Syria, which were suspected of having connections with Iran-backed militia groups. These actions by the Israeli and U.S. governments have sparked concerns about the potential for escalating violence across the Middle East, which could result in disruptions in the sales of essential commodities. Following the report, Brent oil prices surged $2 per barrel overnight, hitting $90 per barrel.
- Across the Pacific, the U.S. and China have accused each other of provocations in the South China Sea. The situation started after a Chinese vessel collided with a Philippine boat on Sunday near the disputed Second Thomas Shoal. After the incident, President Joe Biden warned Beijing that the U.S. was willing to defend the Philippines from Chinese aggression. The row escalated on Thursday after a Chinese fighter jet was recorded flying within 10 feet of a U.S. Air Force B-52 bomber. China responded to the allegation by showing a video of a U.S. ship harassing a Chinese navy task group during routine training in the South China Sea.

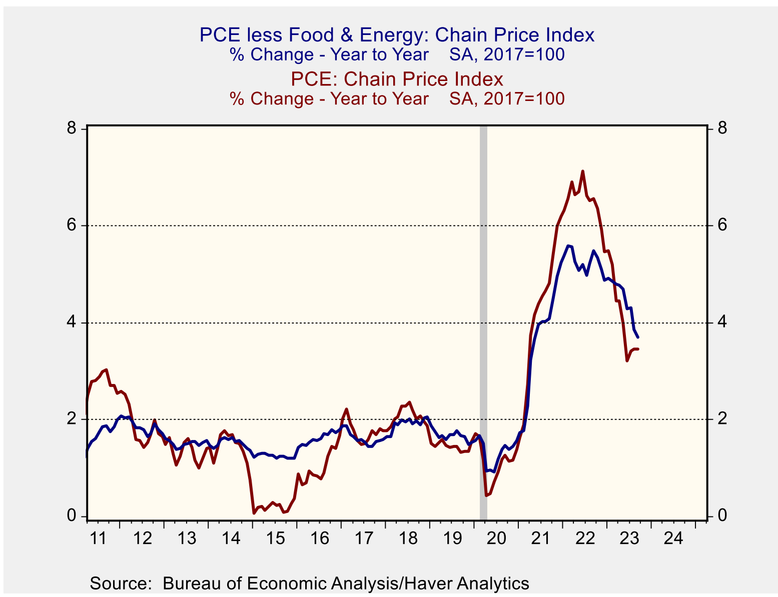
- Despite strong advocacy for diplomatic mediation, geopolitical tensions and the ever-present risk of miscalculation loom large, significantly heightening the possibility of a major conflict. The situation in the Middle East remains precarious, with uncertainty surrounding the extent of Israel's invasion of Gaza, while incidents in the South China

Sea threaten a more extensive conflict in the Pacific region. Despite recent promising developments, such as a delay in Israel's invasion and high-level talks between Washington and Beijing, the mounting geopolitical tensions underscore the potential for defense companies to deliver substantial value to investors in the coming years.

Other News: China's former premier, [Li Keqiang, died on Friday](). He was seen as a rival of President Xi Jinping and as an advocate of the business class in China.

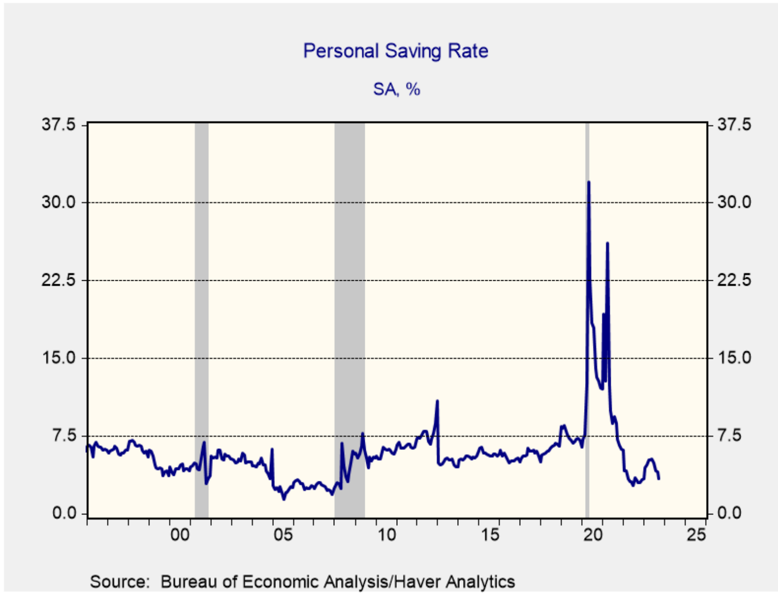
U.S. Economic Releases

The Federal Reserve's preferred inflation gauge showed that price pressures eased last month. In September, the Personal Consumption Expenditure Price Index rose 0.4% from the prior month, in line with market expectations. Excluding food and energy, the index rose 0.3% last month, above the previous month's reading of 0.1%.



The chart above shows the year-over-year change in the headline and core PCE. Headline PCE rose 3.4% from the prior year, down from the August reading of 3.5%. While core PCE increased 3.7% in September, also below the previous month's increase of 3.8%.

Separately, data from the Bureau of Economic Analysis shows that household consumption remains strong. In September, personal spending rose 0.7% from the previous month, well above expectations of 0.5%. The increase in spending may be partially attributed to an increase in household earnings. Last month, personal income rose 0.3%, slightly below expectations of 0.4%.



The chart above shows the personal savings rate. Households have been able to maintain consumption by drawing down on their savings. This suggest that current levels of spending may not be sustainable.

The table below lists the economic releases and/or Fed events scheduled for the rest of the day.

Economic Releases						
10:00	U. of Michigan Consumer Sentiment	m/m	Oct F	63.0	63.0	***
10:00	U. of Michigan Current Conditions	m/m	Oct F		66.7	**
10:00	U. of Michigan Future Expectations	m/m	Oct F		60.7	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Oct F	3.8%	3.8%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Oct F	3.0%	3.0%	*
11:00	Kansas City Fed Services Activity	m/m	Oct		2	*
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
9:00	Michael Barr Delivers Opening Remarks at Payments Conference	Federal Reserve Board Vice Chair for Supervision				

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	Tokyo CPI	y/y	Oct	3.3%	2.8%	2.8%	**	Equity bearish, bond bearish
	Tokyo CPI Ex-Fresh Food	y/y	Oct	2.7%	2.5%	2.5%	***	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food & Energy	y/y	Oct	3.8%	3.8%	3.9%	*	Equity and bond neutral
Australia	PPI	y/y	3Q	3.8%	3.9%		**	Equity and bond neutral
New Zealand	ANZ Consumer Confidence Index	m/m	Oct	2.0	1.6		*	Equity and bond neutral
China	Industrial Profits	y/y	Sep	11.9%	17.2%		*	Equity bearish, bond bullish
EUROPE								
France	Consumer Confidence	m/m	Oct	84.0	83.0	82.0	**	Equity bullish, bond bearish
Italy	Consumer Confidence	m/m	Oct	101.6	105.4	105.2	***	Equity bearish, bond bullish
	Manufacturing Confidence	m/m	Oct	96.0	96.4	96.0	***	Equity and bond neutral
	Economic Sentiment	m/m	Oct	103.9	104.9		**	Equity and bond neutral
	Industrial Sales WDA	y/y	Aug	-5.0%	-1.6%		*	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	20-Oct	$573.2b	$569.6b		***	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	20-Oct	18.59t	18.64t	--	*	Equity and bond neutral
AMERICAS								
Mexico	Imports	y/y	Sep	51140m	53737m		*	Equity and bond neutral
	Exports	y/y	Sep	49658m	52360m		*	Equity and bond neutral
	Trade Balance	m/m	Sep	1481.4m	-1377.1m	-437.0m	**	Equity bullish, bond bearish

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)	565	564	1	Up
3-mo T-bill yield (bps)	530	531	-1	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	539	0	Flat
10-yr T-note (%)	4.87	4.85	0.02	Flat
Euribor/OIS spread (bps)	395	394	1	Up
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Down
Yen	Up			Down
Pound	Down			Down
Franc	Down			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Russia Key Rate	15.000%	13.000%	14.000%	Above 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	$89.26	$87.93	1.51%	
WTI	$84.45	$83.21	1.49%	
Natural Gas	$3.36	$3.21	4.39%	Supply Pessimism and increasing demand
Crack Spread	$20.73	$20.87	-0.69%	
12-mo strip crack	$23.34	$23.59	-1.06%	
Ethanol rack	$2.32	$2.33	-0.58%	
Metals				
Gold	$1,981.99	$1,984.71	-0.14%	
Silver	$22.74	$22.80	-0.24%	
Copper contract	$362.10	$358.45	1.02%	
Grains				
Corn contract	$481.75	$479.25	0.52%	
Wheat contract	$578.00	$579.50	-0.26%	
Soybeans contract	$1,313.00	$1,300.25	0.98%	
Shipping				
Baltic Dry Freight	1,662	1,832	-170	
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)	74	79	-5	

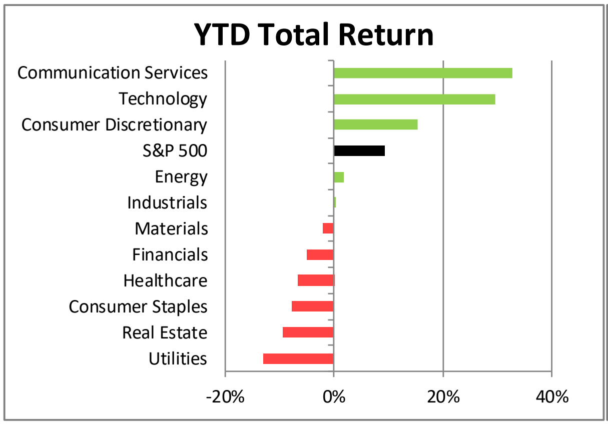
Weather

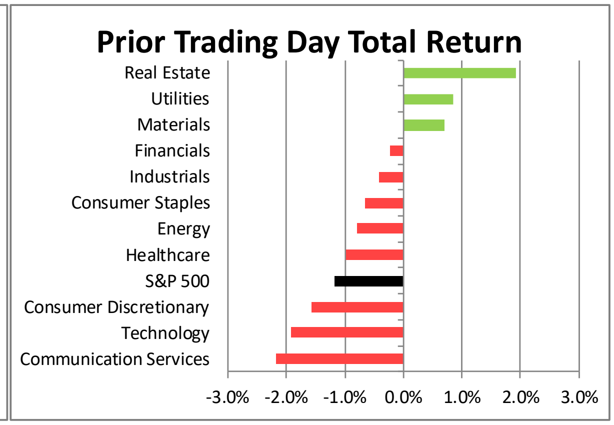
The 6-10 and 8-14 day forecasts predict warmer-than-normal temperatures that are expected to spread from the West Coast into most of the country, with cooler conditions expected in New England and the northern Rockies. The precipitation outlook shows wetter-than-normal temperatures throughout the northern Pacific, Mid-Atlantic, and Southeast, with dry conditions expected for the Southwest and Great Plains.

There is currently one atmospheric disturbance in the Atlantic Ocean, and it has a 70% chance of developing into major storm within the next 48 hours. On average, Atlantic hurricane activity peaks on September 15.

Data Section

U.S. Equity Markets – (as of 10/26/2023 close)

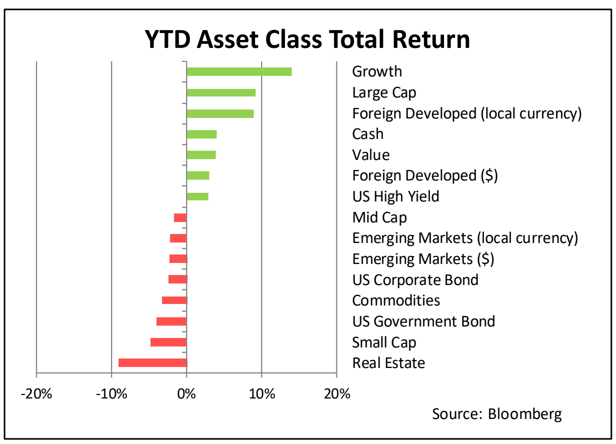




(Source: Bloomberg)

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 10/26/2023 close)

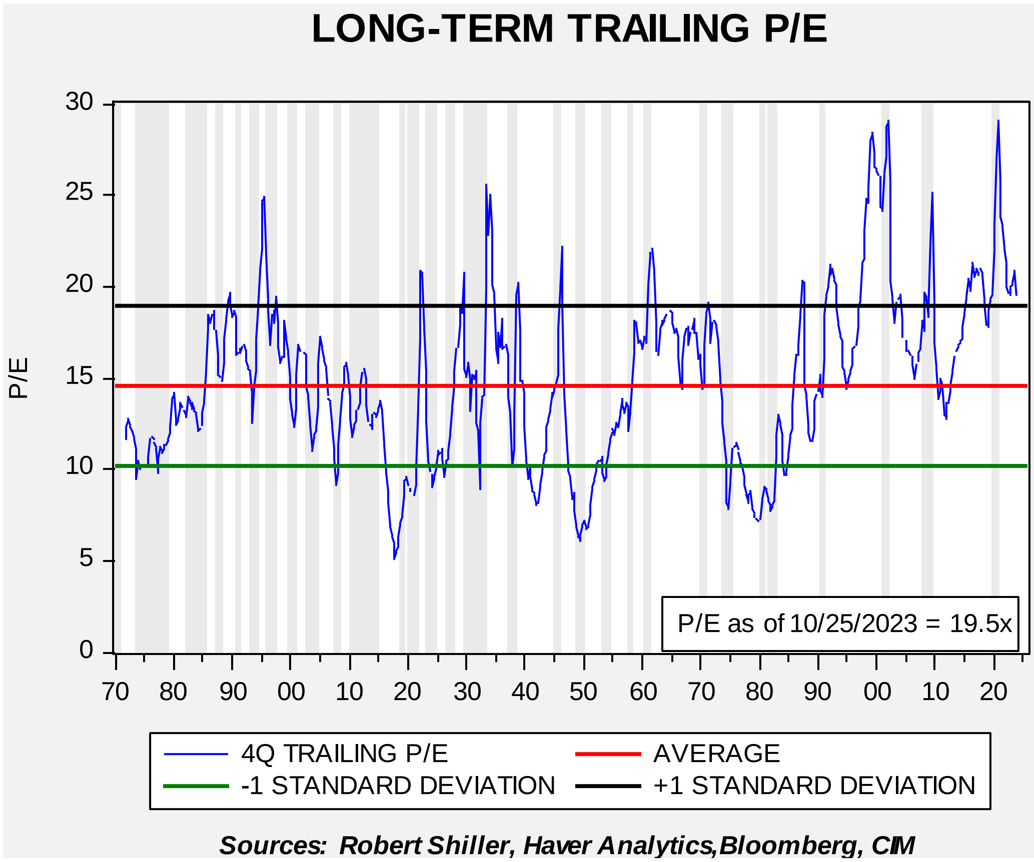


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.