Confluence INVESTMENT MANAGEMENT

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 31, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.9% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.2%. Chinese markets were lower, with the Shanghai Composite down 0.1% from its previous close and the Shenzhen Composite down 0.5%. U.S. equity index futures are signaling a higher open.

With 259 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, 78.4% 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*** **(10/30/2023) (with associated podcast): "Investment Implications of the Israel-Hamas Conflict"**
- *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 Q4 2023 Rebalance Presentation* (10/30/2023): 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)

Our *Comment* today opens with a note about the Pentagon's annual report on Chinese military power. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including the latest on the Israel-Hamas conflict, a loosening of the Bank of Japan's yield-curve control policy, and what to expect from this week's Federal Reserve policy meeting.

Chinese Military Power: As is usual at this time of year, the U.S. Department of Defense last week released its annual report on Chinese military power, which is the basis for much of our analysis regarding U.S.-China relations (and our popular in-person presentation on global fracturing, geopolitical blocs, and their investment implications, which we provide to financial advisors and their clients all over the country). The DOD report does a deep dive into all aspects of Chinese military power, and we'll be incorporating the latest information in our writings and presentations over the coming weeks. Today, we want to stress that the report also provides a useful discussion of what's driving Chinese leaders. As we continually write about the increased geopolitical aggressiveness of General Secretary Xi and the rest of the Chinese Communist Party, and how that has ushered in a new, riskier era for investors, the DOD report helps explain ***why*** they're acting the way they are. As you read our discussions of China, we encourage you to keep in mind the following:

- In both public pronouncements and private documents, Xi and the CCP have said that their ***overarching mission*** is to achieve the "great rejuvenation of the Chinese nation" by 2049 (the centenary of the People's Republic of China). This mission encompasses:
    - Reclaiming China's traditional status as the world's richest, most powerful, most culturally advanced nation, and
    - Erasing the "Century of Humiliation" from the mid-1800s to the mid-1900s, when China was dominated and nearly dismembered by foreign powers.
- To achieve their mission, Xi and the CCP have adopted the following ***priorities***:
    - Defending and advancing sovereignty, especially over Hong Kong and Taiwan,
    - Ensuring the security of China, and of the CCP's rule, and
    - Protecting China's economic development interests.
- To achieve the "great rejuvenation" by 2049, Xi and the CCP have selected certain subsidiary and interim ***goals***, including:
    - Protect the CCP's monopoly on power,
    - Develop the economy and become a technology leader,
    - Revise the global political and economic system to serve China's rejuvenation,
    - Leverage tribalism, i.e., the sense that "East is rising, West is declining,"
    - Create a global "community of shared future" dependent on China, and
    - Build a "world class military" that can "fight and win" wars, including a conflict with a "strong adversary" (a euphemism for the U.S.), by 2049.
- Finally, we note that these missions, priorities, and goals stem from deeply ingrained, longstanding instincts that have evolved over millennia to help humans survive in a dangerous, challenging world: the drive for status, the resistance to being dominated, the

sense of security that comes from being a part of a strong group, and the motivation that comes from casting the adversary group as evil (in-group vs. out-group thinking). To the extent that Xi and the CCP are operating on the basis of these deep motivations, China's new aggressiveness is likely to be long-lasting and could extend even to the point of conflict with the U.S. and its evolving geopolitical bloc, with big implications for investors.

Chinese Economic Growth: The official purchasing managers' index for manufacturing declined to 49.5 in October, down from 50.2 in September. The PMIs for construction and services also fell, leaving the October composite PMI at just 50.7. Like most major PMIs, the official Chinese gauges are designed so that readings above 50 point to expanding activity.

- At their current levels, the figures suggest the Chinese economy continues to struggle against headwinds such as weak consumer demand, high debt, poor demographics, and foreign decoupling.
- Given the huge size of China's economy, its current weak growth will likely be a headwind for businesses around the world. That could help mollify global inflation pressures, but it could also take some wind out of global asset values.

Israel-Hamas Conflict: Dashing hopes for a more limited ground offensive, the Israel Defense Forces have ratcheted up their infantry attacks and airstrikes on Gaza over the last 24 hours. IDF tanks, troops, jet fighters, and other forces are actively engaging Hamas fighters in a wider area of the enclave, with a focus on destroying the extensive tunnel network used by Hamas to hide and protect its fighters and move supplies and equipment from place to place. Along with Islamist attacks on Israel from Lebanon and Syria, and retaliatory Israeli strikes against them, the risk of the conflict spreading regionally remains.

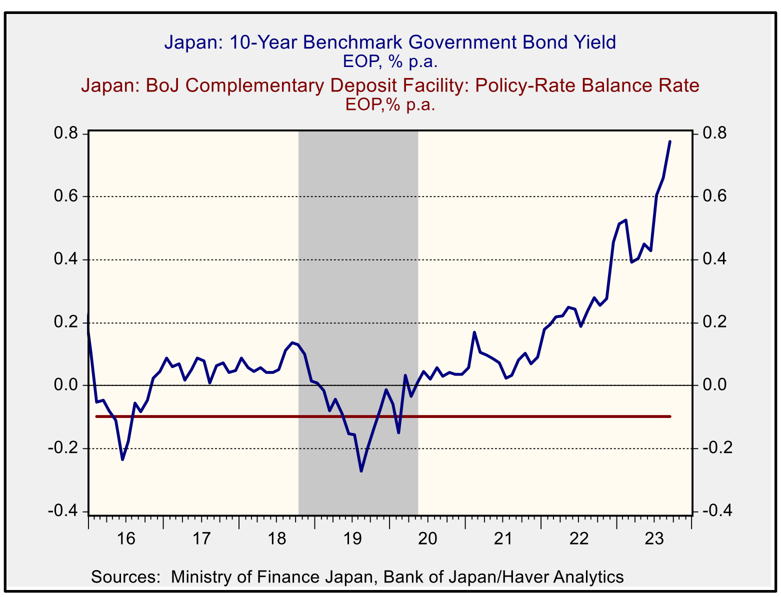
Venezuela: The country's top court, which is packed with supporters of the authoritarian Maduro government, has "suspended" the opposition's recent primary election, throwing a wrench into the recent deal in which Venezuela agreed to allow free and fair elections next year in return for the U.S. to relax sanctions on its energy industry. If the move prompts the U.S. to reimpose its sanctions, it could lead to new oil supply challenges and put upward pressure on prices.

Eurozone: Third quarter gross domestic product fell at a seasonally adjusted, annualized rate of 0.4%, erasing most of the annualized 0.6% increase in the second quarter. In contrast with the U.S.'s third-quarter growth rate of 4.9%, the figures illustrate how the eurozone economy is now faring much worse because of headwinds such as high inflation, rising interest rates, and a crisis of confidence in the face of geopolitical tensions.

- On a more positive note, the eurozone's October consumer price index was up just 2.9% from the same month one year earlier, after a 4.3% rise in the year to September.
- Excluding the volatile food and energy components, the October Core CPI was up 4.2% year-over-year, compared with 4.5% in September.

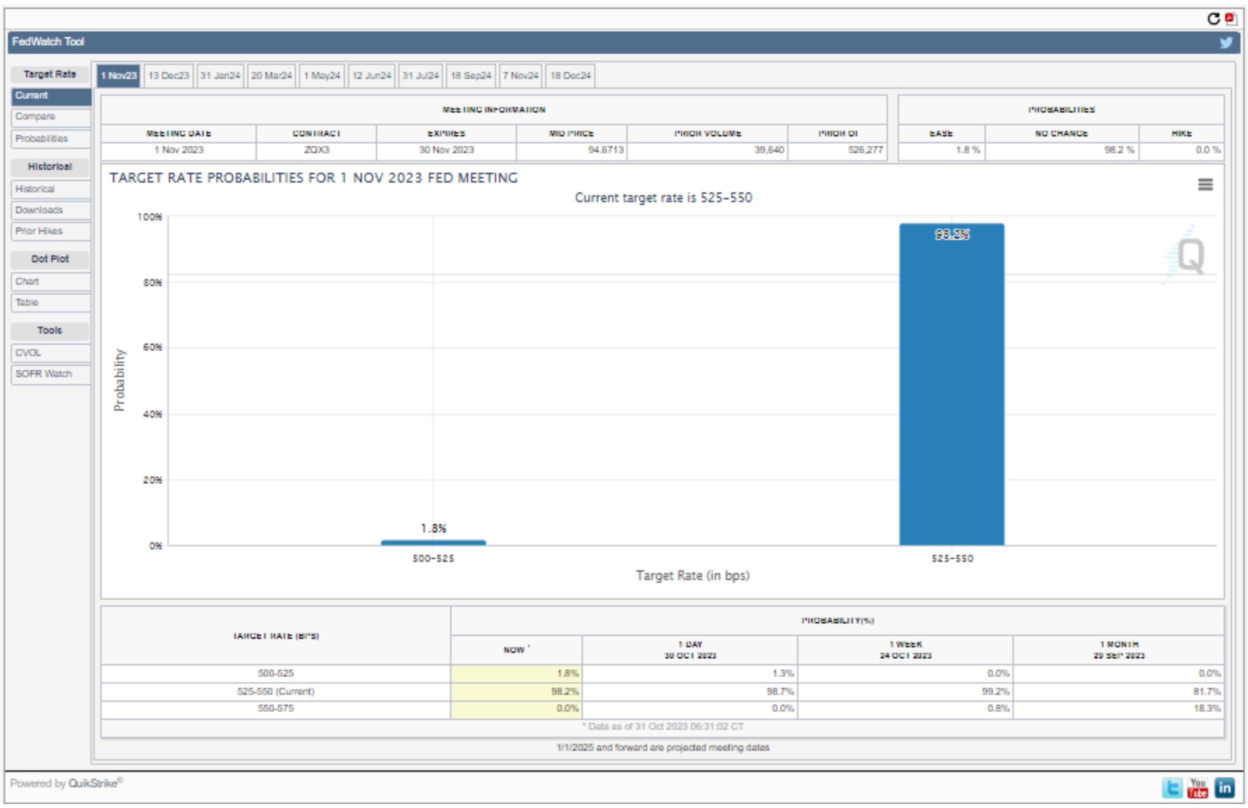
Japan: As previewed in our *Comment* yesterday, the Bank of Japan today held its benchmark short-term interest rate steady at -0.1% but said that it will now consider its 1.0% upper bound for 10-year Japanese government bond yields to be merely a "reference rate" rather than a hard limit. Since investors were looking for a more substantial loosening or even abandonment of the BOJ's yield-curve control policy, both the 10-year JGB yield and the yen (JPY) fell back after an initial jump. Separately, as if to emphasize that the era of ultra-low consumer price inflation in Japan is over, the policymakers also projected that annual price increases would remain close to 3.0% until 2025.

- The yield on the 10-year JGB ended trading in Tokyo at 0.95%, compared with 0.774% at the end of September.
- The JPY closed at 150.70 per dollar ($0.0066), compared with its September close of 147.85 per dollar ($0.0068).



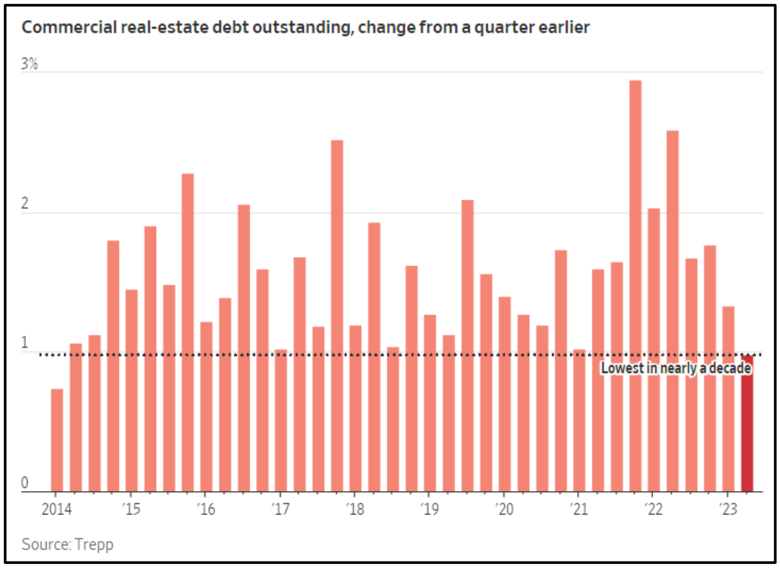
U.S. Monetary Policy: The Federal Reserve [begins its latest two-day policy meeting today, with the decision due to be released tomorrow at 3:00 PM EDT]. As shown in the chart below, the popular CME FedWatch Tool (based on 30-day fed funds futures prices) indicates investors are nearly unanimous in believing the policymakers will hold the benchmark short-term interest rate unchanged at 5.25% to 5.50%. The focus will therefore be on any guidance regarding future rate changes in the committee's statement or in Chair Powell's post-meeting press conference.

- No new economic projections are due to be released at this meeting.
- Nevertheless, the statement and Powell's discussion could well express a bias toward further tightening, consistent with Powell's "higher for longer" mantra.
- We think it makes sense to take Powell at his word. Even though we think U.S. interest rates are probably near their peak, we continue to believe the Fed will try to hold them at elevated levels for an extended period to wring inflation out of the economy.



U.S. Regulatory Policy: The Securities and Exchange Commission [is suing information technology company SolarWinds (SWI, $9.31) in connection with the company's failure to stop Russian hackers from infiltrating its systems], a scandal discovered in 2020. According to the SEC, the company mislead investors about its cybersecurity and failed to disclose known risks. The lawsuit illustrates how cyber breaches not only put companies at operational and reputational risk, but also at regulatory risk.

U.S. Commercial Real Estate Industry: According to data provider Trepp, net new bank lending for commercial real estate is now growing at historically low levels. Commercial real estate loans held by banks were only up about 1% from the same period one year earlier. Since banks are the top source of funding for the sector, the slowdown in lending bodes poorly for commercial borrowers' ability to roll over their loans as they come due, probably adding to the stress in the market today and pulling down commercial real estate values even further.

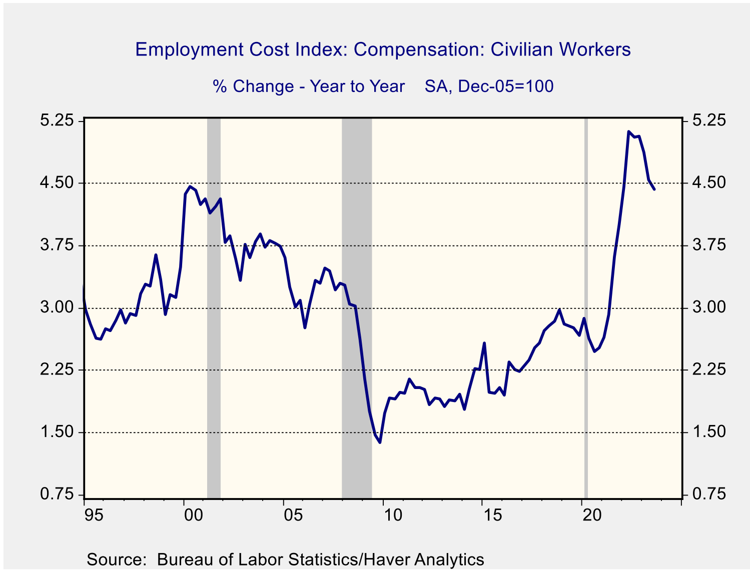


U.S. Auto Industry: As we flagged in our *Comment* yesterday, the United Auto Workers on Monday struck a tentative deal for a new labor contract with General Motors (GM, $27.36), the last of the Big Three U.S. automakers it was striking. The tentative deals mean that workers at GM, Ford (F, $9.77), and Stellantis (STLA, $18.00) can go back to work immediately.

- If approved by the companies' UAW workers, the deals will raise wage rates by about 25% over the four-year life of the contracts, improve job security, and increase benefits.
- That will put pressure on the firms to cut other costs, potentially by investing in new labor-saving technologies.
- The deals may also encourage labor organizing, strikes, and higher wage demands beyond the auto industry.
- In any case, the deals will probably add to pressures shifting the share of national income toward workers and away from capital owners.

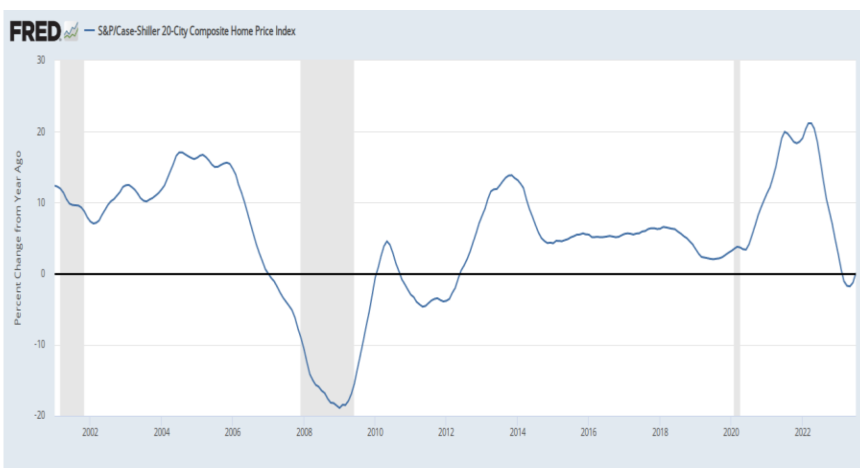
U.S. Economic Releases

Worker-related expenses increased slightly above expectations in the third quarter. The employment cost index rose 1.1% in the previous three months, above expectations of 1.0%. The increase in costs has largely been driven by wages, which have risen 1.2% between July and September.



The chart above shows the annual change in the employment cost index. Employment costs have risen 4.42% since third quarter 2022, lower than previous quarter's rise of 4.54%.

Home prices are starting to show signs of moderation. The FHFA Home Price Index rose 0.6% in August 2023, slightly above expectations of 0.5% but below the previous month's rise of 0.8%. The sentiment was also reflected in the S&P Global CoreLogic Index, which showed that national and top-20 cities both rose 0.4% in August.



The chart above shows the annual change in the top-20 cities index. Home prices in major cities have risen 0.1% since August 2022.

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	MNI Chicago PMI	m/m	Oct	45.0	44.1	***
10:00	Conf. Board Consumer Confidence	m/m	Oct	100.5	103.0	***
10:00	Conf. Board Present Situation	m/m	Oct		147.1	**
10:00	Conf. Board Expectations	m/m	Oct		73.7	**
10:30	Dallas Fed Services Activity	m/m	Oct		-8.6	**
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	Jobless Rate	m/m	Sep	2.6%	2.7%	2.6%	***	Equity and bond neutral
	Job-To-Applicant Ratio	m/m	Sep	1.29	1.29	1.29	**	Equity and bond neutral
	Retail Sales	y/y	Sep	5.8%	7.0%	5.9%	**	Equity and bond neutral
	Depart. Store & Supermarket Sales	y/y	Sep	4.5%	6.0%		*	Equity and bond neutral
	Industrial Production	y/y	Sep P	-4.6%	-4.4%	-2.3%	***	Equity bearish, bond bullish
	Housing Starts	y/y	Sep	-6.8%	-9.4%	-6.4%	**	Equity and bond neutral
	Annualized Housing Starts	y/y	Sep	0.800m	0.812m	0.821m	*	Equity and bond neutral
	Consumer Confidence	m/m	Oct	35.7	35.2	35.0	*	Equity bullish, bond bearish
Australia	Private Sector Credit	y/y	Sep	4.9%	5.1%	5.2%	**	Equity bearish, bond bullish
New Zealand	Building Permits	m/m	Sep	-4.7%	-6.7%	-7.0%	***	Equity bullish, bond bearish
	CoreLogic House Px	y/y	Oct	-5.7%	-7.3%		*	Equity and bond neutral
	ANZ Activity Outlook	m/m	Oct	23.1	10.9		*	Equity and bond neutral
	ANZ Business Confidence	m/m	Oct	23.4	1.5		**	Equity and bond neutral
South Korea	Industrial Production	y/y	Sep	3.0%	-0.5%	-0.8%	***	Equity bullish, bond bearish
China	Official Composite PMI	m/m	Oct	50.7	52.0		*	Equity bearish, bond bullish
	Official Manufacturing PMI	m/m	Oct	49.5	50.2	50.2	***	Equity bearish, bond bullish
	Official Services PMI	m/m	Oct	50.6	51.7	52.0	**	Equity bearish, bond bullish
EUROPE								
Eurozone	CPI	y/y	Oct P	0.1%	0.3%	0.3%	***	Equity and bond neutral
	Core CPI	y/y	Oct	4.2%	4.5%	4.2%	**	Equity and bond neutral
	GDP SA	q/q	3Q A	0.1%	0.5%	0.2%	***	Equity and bond neutral
Germany	Import Price Index	y/y	Sep	-14.3%	-16.4%	-15.5%	**	Equity bullish, bond bearish
	Retail Sales	y/y	Sep	-4.6%	-1.9%	-3.4%	*	Equity bearish, bond bullish
	CPI	y/y	Oct P	3.8%	4.5%	4.0%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Oct P	3.0%	4.3%	3.3%	**	Equity and bond neutral
France	GDP	y/y	3Q P	0.7%	1.0%	1.1%	**	Equity and bond neutral
	CPI	y/y	Oct P	4.0%	4.9%	4.0%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Oct P	4.5%	5.7%	4.5%	**	Equity and bond neutral
	PPI	y/y	Sep	-1.7%	-1.4%		*	Equity and bond neutral
Italy	GDP WDA	y/y	3Q P	0.0%	0.4%	0.3%	**	Equity and bond neutral
	CPI, EU Harmonized	y/y	Oct P	1.9%	5.6%	2.2%	***	Equity and bond neutral
	CPI NIC Including Tobacco	y/y	Oct P	1.8%	5.3%	2.2%	**	Equity and bond neutral
	PPI	y/y	Sep	-18.3%	-16.1%		**	Equity bearish, bond bullish
Switzerland	Real Retail Sales	y/y	Sep	-0.6%	-1.8%	-2.2%	**	Equity bullish, bond bearish
AMERICAS								
Mexico	GDP NSA	y/y	3Q P	3.3%	3.6%	3.2%	***	Equity and bond neutral
Brazil	National Unemployment Rate	m/m	Sep	7.7%	7.8%	7.7%	*	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	565	-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	538	0	Up
U.S. Libor/OIS spread (bps)	540	540	0	Up
10-yr T-note (%)	4.82	4.90	-0.08	Flat
Euribor/OIS spread (bps)	397	395	2	Up
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Up			Down
Yen	Down			Down
Pound	Flat			Down
Franc	Flat			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
BOJ Policy Balance Rate	-0.100%	-0.100%	-0.100%	On Forecast
BOJ 10-yr Yield Target	0.000%	0.000%	0.000%	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	$88.24	$87.45	0.90%	
WTI	$83.11	$82.31	0.97%	
Natural Gas	$3.40	$3.35	1.34%	
Crack Spread	$20.47	$20.28	0.94%	
12-mo strip crack	$23.37	$23.43	-0.24%	
Ethanol rack	$2.26	$2.27	-0.49%	
Metals				
Gold	$1,999.17	$1,996.10	0.15%	
Silver	$23.19	$23.34	-0.63%	
Copper contract	$366.75	$365.85	0.25%	
Grains				
Corn contract	$478.75	$478.25	0.10%	
Wheat contract	$559.75	$566.00	-1.10%	
Soybeans contract	$1,307.25	$1,307.25	0.00%	
Shipping				
Baltic Dry Freight	1,502	1,563	-61	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.0		
Gasoline (mb)		-1.0		
Distillates (mb)		-1.0		
Refinery run rates (%)		0.2%		
Natural gas (bcf)		79		

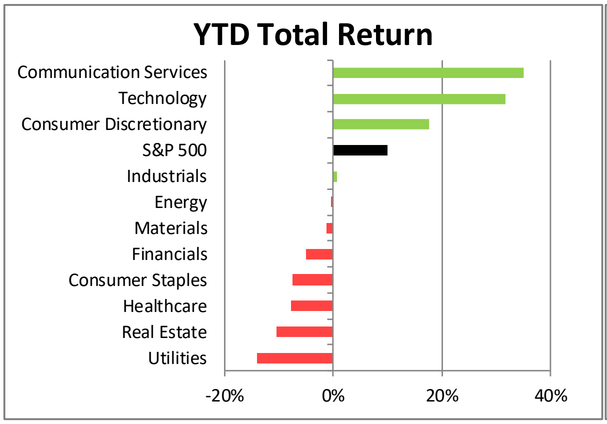
Weather

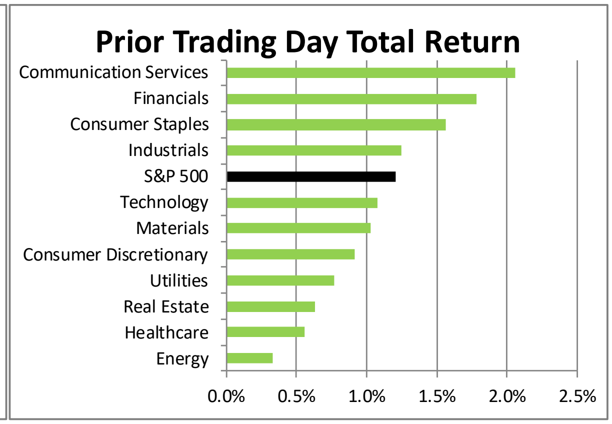
The 6-10 and 8-14 day forecasts predict warmer-than-normal temperatures for most of the country, with cooler temperatures expected in New England. The precipitation outlook shows wetter-than-normal conditions in most states, with dry conditions expected in the Southwest and northern Pacific.

There is one atmospheric disturbance in the Atlantic Ocean, but it is not expected to develop into a major storm within the next 48 hours. Located in the southeastern Caribbean Sea, the disturbance has a 30% chance of cyclone formation. On average, Atlantic hurricane activity peaks on September 15.

Data Section

U.S. Equity Markets – (as of 10/30/2023 close)

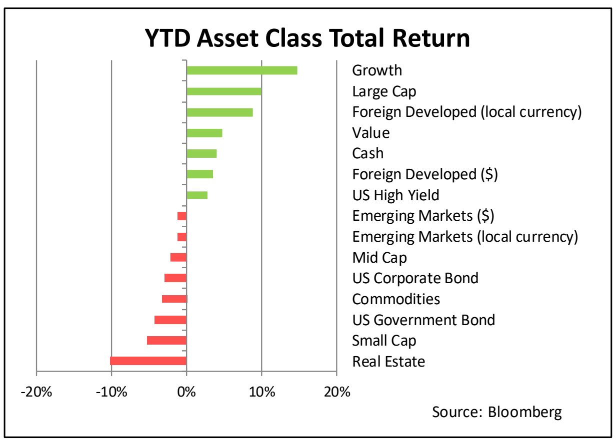




(Source: Bloomberg)

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 10/30/2023 close)

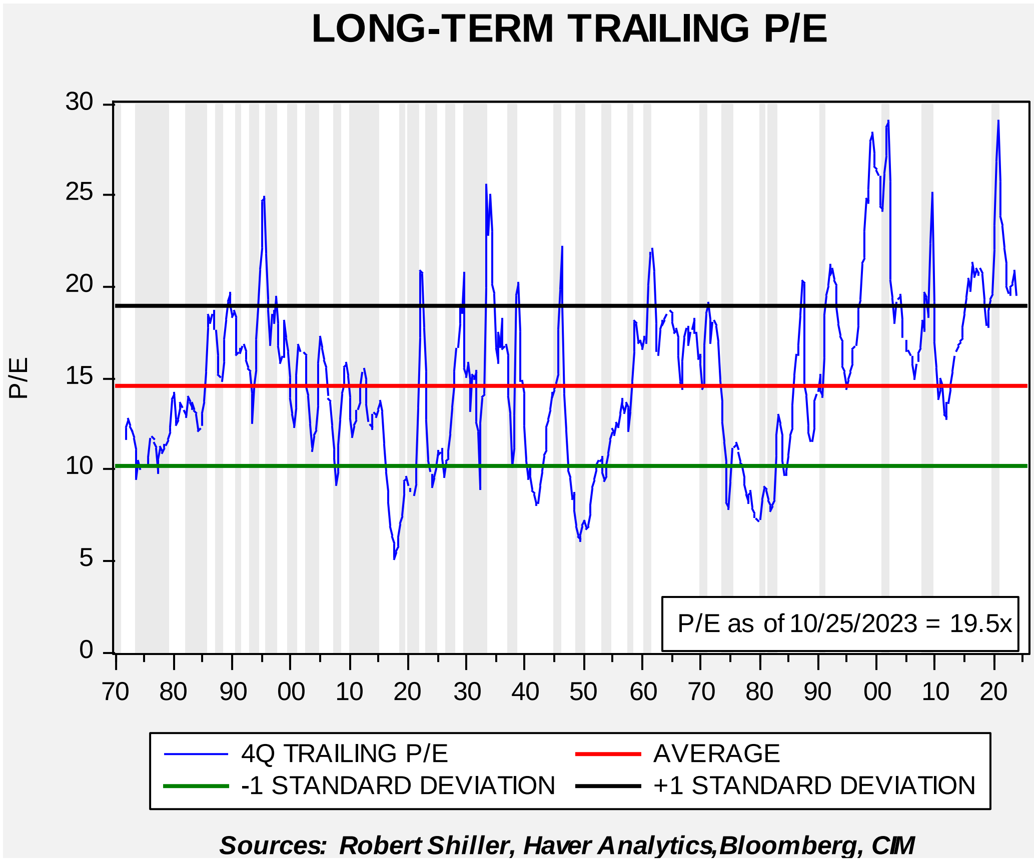


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.