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: September 11, 2023—9:30 AM EDT] Global equity markets are generally higher this morning. In Europe, the Euro Stoxx 50 is up 0.3% 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 0.9%. U.S. equity index futures are signaling a higher open.

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* (8/21/2023) (there will be no podcast for this report and there is no report for 9/4 due to the holiday): "Reflections on the New Cold War"
- *Weekly Energy Update* (9/8/2023): Russia and Saudi Arabia's decision to extend production cuts boosted prices. Seasonally we should be reaching the end of the summer withdraw for crude oil. If stockpiles continue to decline it will add to bullish sentiment.
- *Asset Allocation Quarterly – Q3 2023* (7/20/2023): Discussion of our asset allocation process, Q3 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* (9/11/2023) (with associated podcast): "Fiscal Tightening Looms"**
- *Confluence of Ideas* podcast (8/22/2023): "The Economics of Defense in Great Power Competition"

Our *Comment* today opens with news about Chinese domestic politics and the country's currency, the renminbi. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including news of a cut in the European Union's economic growth forecast and increased concerns about a potential federal government shutdown in the U.S.

Chinese Domestic Politics: According to insider reports, influential Communist Party officials unexpectedly warned President Xi at their annual Beidaihe leadership retreat that if China's political, economic, and social turmoil continues without any effective countermeasures being taken, the party could lose public support, posing a threat to its rule. The reports say Xi was stunned by the reprimand and bitterly complained about it to his confidential advisors afterward.

- The reports could help explain why Xi failed to attend the Group of 20 (G20) summit in India over the weekend, why he missed a key speech at the recent BRICS summit, and why he appears to be backing away from a visit to the U.S. later this month.
- Rather than expressing his disdain for U.S.-founded international organizations, as pundits have suggested, Xi might be pulling back from such meetings to avoid being pressed on Chinese security and economic policies. In other words, Xi may have pulled back from these venues not for deliberate strategic reasons, but because of domestic political challenges.
- The reports serve as a reminder that Xi must still contend with domestic political pushback against his policies, even if he has done a good job solidifying his power. Going forward, that may force him to temper some of his policies and provide more stimulus to the economy despite his aim to rein in debt and control the private sector.
- All the same, other reporting suggests he is doubling down on at least some of his initiatives. In several recent speeches, for example, he has urged government officials to prepare for "worst case scenarios" and "extreme circumstances," which some outsiders have interpreted to mean he is preparing for war with the U.S.

Chinese Economy: The People's Bank of China today issued a warning against speculating against the renminbi (CNY), saying PBOC officials "are capable of and feel confident in . . . keeping the renminbi exchange rate at a reasonably stable level." In response, the currency has rallied as much as 1.0% to 7.2698 per dollar ($0.1376). Nevertheless, the renminbi is still trading close to a 16-year low as investors fret over China's ongoing economic slowdown and worsening tensions with the West.

India: As foreign investors sour on the Chinese economy, India is reportedly ramping up its infrastructure investment to increase its attractiveness as a place to do business. For example, the country now has approximately 90,000 miles of national freeways, almost double the mileage one decade earlier. The expansion and upgrading of India's infrastructure will probably encourage even more foreign direct investment and portfolio investment.

Japan: Another Asian country that appears to be benefiting from China's malaise is Japan. The *Wall Street Journal* today carries a useful examination of what's been driving the Japanese stock market higher after many years in the doldrums. Besides investors' shift in focus away from China, the article cites positive developments such as improved corporate governance in the country, recent investments by Warren Buffett, and low valuations.

European Union: The European Commission today cut its forecast for EU economic growth this year, saying it now expects gross domestic product to grow 0.8% in 2023, rather than the 1.0% it expected in May. The Commission also said GDP will grow just 1.4% in 2024, down from 1.7% previously.

- The revised forecasts reflect headwinds such as high consumer price inflation and a big slowdown in German industrial output.
- Importantly, the new forecasts could help convince the European Central Bank's policymakers to hold interest rates steady at their meeting on Thursday, rather than hiking them further in their continued fight against inflation.

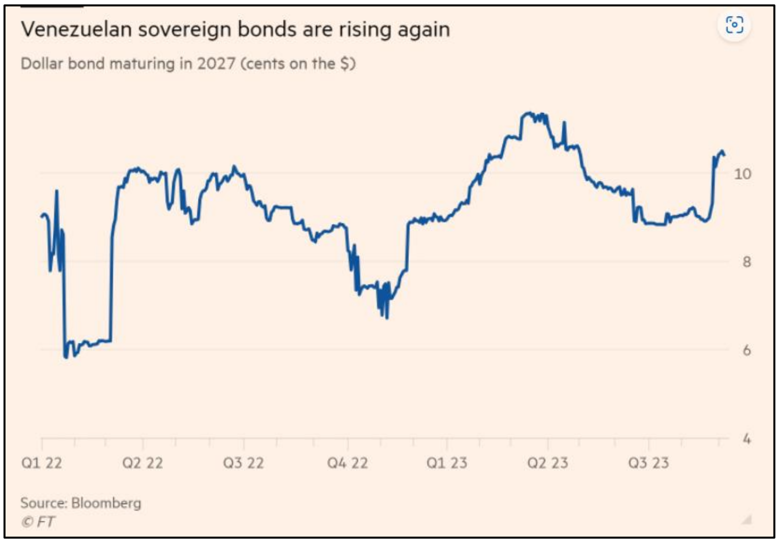
United Kingdom-China: In a bilateral meeting between British Prime Minister Sunak and Chinese Premier Li Qiang at the weekend's G20 summit, Sunak said he personally expressed his "very strong concerns" to Li about China's interference in the U.K.'s parliamentary democracy. Sunak's announcement followed news that British authorities in March arrested two men on charges related to spying for China. One of those arrested was a long-time researcher in the U.K. parliament who had close contacts with Conservative Party politicians.

United States-Vietnam: At their weekend summit, President Biden and Vietnamese leader Nguyễn Phú Trọng signed an agreement elevating their countries' relationship to that of a "comprehensive strategic partnership." The agreement lays the groundwork for increased defense cooperation between the countries and establishes a joint semiconductor supply program to boost Vietnamese computer chip manufacturing in support of U.S. businesses.

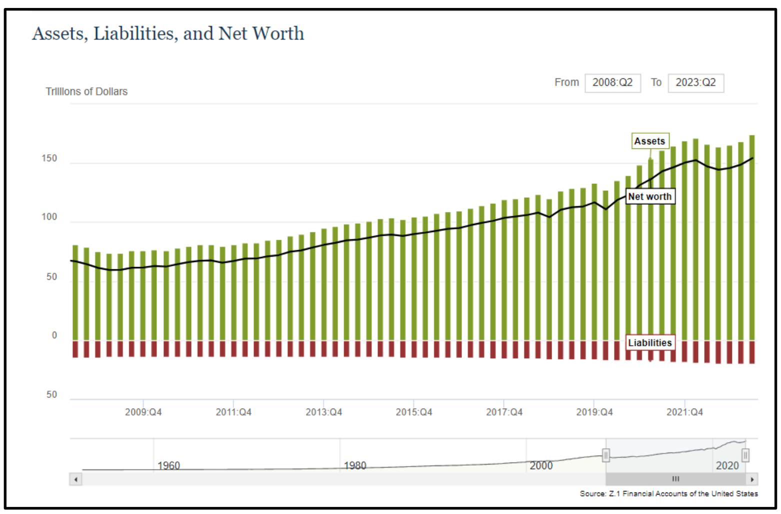
- Previously, Vietnam had signed such strategic partnership agreements with only four other countries: China, Russia, India, and South Korea.
- The deal shows that China's geopolitical aggressiveness in the South China Sea is pushing Vietnam into Washington's embrace, just as it has done to the Philippines, and as it is likely to do to other countries in the Indo-Pacific region.
- Based on our objective methodology for assigning countries to the world's evolving geopolitical and economic blocs, we currently assess Vietnam to be in the "Neutral" bloc. For example, note that even as Vietnam tiptoes into a closer relationship with the U.S., it is also continuing to seek weapon imports from Russia to build its defense capability against China. However, if Washington and Hanoi continue to cooperate more closely,

Vietnam could eventually shift to the "Leaning U.S." camp, or even to the "U.S.-led bloc."

United States-Venezuela: Rumors that secret talks between Washington and Caracas will lead to détente and reduced economic restrictions have given a boost to Venezuelan bonds recently. Although the debt still trades at a tiny fraction of its face value, the hope of renewed cross-border investment has pushed the value of the benchmark 2027 bond up above 10 cents on the dollar.



U.S. Household Wealth: Data from the Federal Reserve shows the net worth of U.S. households and nonprofits rose to a record $154.3 trillion in the second quarter, driven about equally by the rebound in stock prices and rising real estate values. The rise in net worth comes despite moderating economic growth and concerns about an impending recession.



U.S. Labor Market: The United Auto Workers union continues to negotiate for a new labor contract with the top three U.S. automakers—Ford (F, $12.30), General Motors (GM, $32.95), and Stellantis NV (STLA, $18.23)—with the current contract expiring Thursday night at midnight. In simplistic terms, the auto manufacturers want to channel much of their recent profits into new electric vehicles, but the union, with new leverage because of labor shortages, wants them to share their proceeds with employees to make up for significant concessions they granted over the last decade.

U.S. Policymaking: The House of Representatives is back in session this week after its summer recess, and all eyes are on the increasing frictions between Speaker McCarthy and the right wing of his Republican Party. The increasing acrimony has raised concerns about a destabilizing leadership battle and the possibility of a partial shutdown of the federal government. Such a shutdown could happen if the right-wing of McCarthy's party prevents passage of the appropriations bills needed to fund the government once the current fiscal year ends on September 30. Coming just as more pandemic stimulus programs are set to end (including the moratorium on student loan payments and subsidies for childcare centers), a government shutdown could help to finally push the economy into the long-expected recession.

U.S. Economic Releases

There were no domestic releases prior to the publication of this report. 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
ASIA-PACIFIC								
Japan	Money Stock M2	y/y	Aug	2.5%	2.4%	2.5%	**	Equity and bond neutral
	Money Stock M3	y/y	Aug	1.9%	1.9%		**	Equity and bond neutral
	Machine tool orders	y/y	Aug P	-17.6%	-19.7%		**	Equity and bond neutral
China	Aggregate Financing CNY	m/m	Aug	3120.0b	528.2b	2690.0b	*	Equity and bond neutral
	Money Supply M2	y/y	Aug	10.6%	10.7%	10.7%	***	Equity and bond neutral
	Money Supply M1	y/y	Aug	2.2%	2.3%	2.4%	*	Equity and bond neutral
	Money Supply M0	y/y	Aug	9.5%	9.9%		*	Equity and bond neutral
China	CPI	y/y	Aug	0.1%	-0.3%	0.1%	***	Equity and bond neutral
	PPI	y/y	Aug	-3.0%	-4.4%	-2.9%	**	Equity and bond neutral
EUROPE								
Italy	Industrial Production WDA	y/y	Jul	-2.1%	-0.8%	-0.7%	***	Equity bearish, bond bullish
Switzerland	Domestic Sight Deposits CHF	w/w	8-Sep	459.5b	458.0b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	8-Sep	468.9b	467.6b		*	Equity and bond neutral
Russia	CPI	y/y	Aug	5.15%	4.30%	5.10%	***	Equity and bond neutral
	Core CPI	y/y	Aug	3.95%	3.18%		**	Equity and bond neutral
	GDP	y/y	2Q P	4.90%	4.90%		**	Equity and bond neutral
AMERICAS								
Canada	Net Change in Employment	m/m	Aug	39.9k	-6.4k	20.0k	***	Equity bearish, bond bullish
	Unemployment Rate	m/m	Aug	5.5%	5.5%	5.6%	***	Equity and bond neutral
	Participation Rate	m/m	Aug	65.5%	65.6%	65.6%	*	Equity and bond neutral
Mexico	Industrial Production NSA	y/y	Jul	4.8%	3.7%	4.0%	***	Equity bullish, bond bearish
	Manufacturing Production NSA	y/y	Jul	0.8%	0.8%		*	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.

doe	Today	Prior	Change	Trend
3-mo Libor yield (bps)	567	567	0	Up
3-mo T-bill yield (bps)	529	530	-1	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	541	541	0	Up
U.S. Libor/OIS spread (bps)	542	543	-1	Up
10-yr T-note (%)	4.30	4.27	0.03	Flat
Euribor/OIS spread (bps)	380	380	0	Up
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
Yen	Up			Down
Pound	Up			Flat
Franc	Up			Up

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	$90.36	$90.65	-0.32%	
WTI	$86.97	$87.51	-0.62%	
Natural Gas	$2.55	$2.61	-2.11%	
Crack Spread	$34.03	$33.05	2.99%	
12-mo strip crack	$29.57	$29.24	1.13%	
Ethanol rack	$2.44	$2.44	-0.08%	
Metals				
Gold	$1,925.10	$1,919.08	0.31%	
Silver	$23.09	$22.93	0.70%	
Copper contract	$377.90	$371.65	1.68%	
Grains				
Corn contract	$485.50	$483.75	0.36%	
Wheat contract	$593.00	$595.75	-0.46%	
Soybeans contract	$1,368.50	$1,363.00	0.40%	
Shipping				
Baltic Dry Freight	1,186	1,141	45	

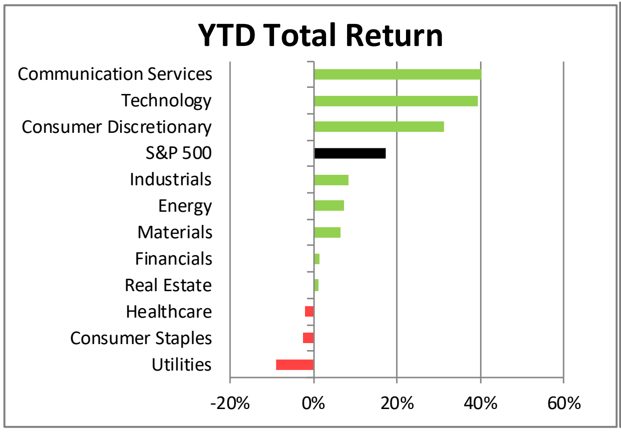
Weather

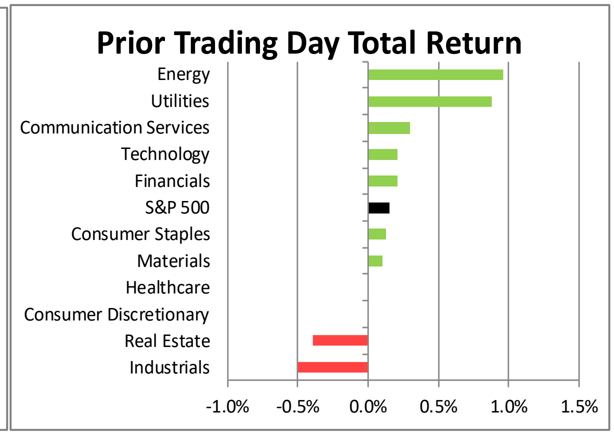
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for the western half of the country and the Gulf states, with below-normal temperatures for the Mid-Atlantic and the Midwest. The forecasts call for wetter-than-normal conditions in most of New England, the Southwest, and California with dry conditions in the Midwest and Pacific Northwest.

There are currently four atmospheric disturbances in the Atlantic Ocean, but only two are major storms. Hurricane Lee is well north of the Virgin Islands and Puerto Rico. It is too early to say how strong the storm will be when it makes possible landfall on the East Coast. Tropical Storm Margot is located in the Central Atlantic Ocean and is expected to move northward. The other two storms are not expected to develop into cyclones within the next 48 hours. We note that Atlantic hurricane activity peaks, on average, September 15.

Data Section

U.S. Equity Markets – (as of 9/8/2023 close)

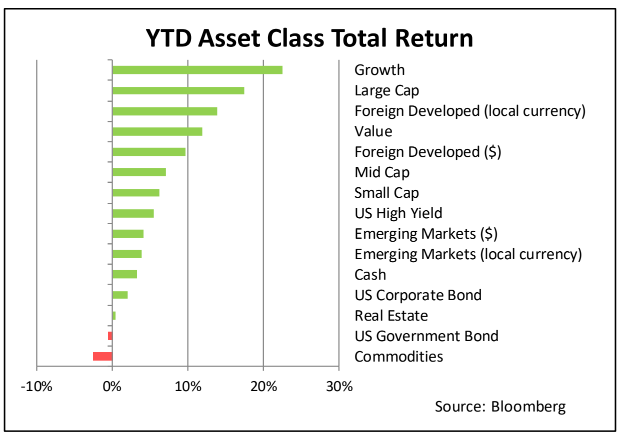




(Source: Bloomberg)

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 9/8/2023 close)

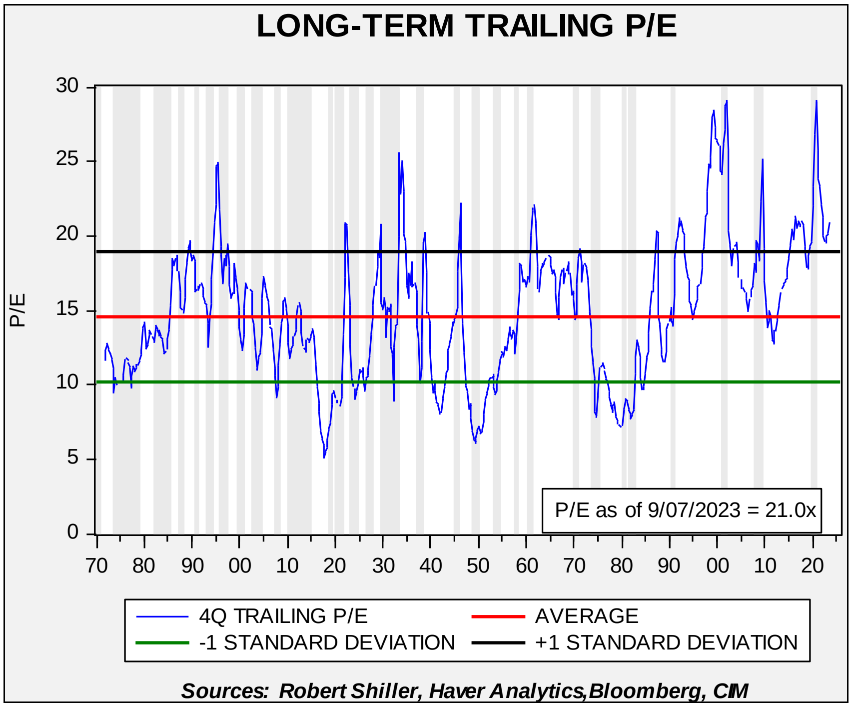


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

September 7, 2023



Based on our methodology,[1] the current P/E is 21.0x, unchanged from last week.

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 (Q3 and Q4) and two estimates (Q1 and Q2). 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.