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 12, 2023—9:30 AM EDT] Global equity markets are generally lower this morning. In Europe, the Euro Stoxx 50 is down 0.5% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.1%. Chinese markets were lower, with the Shanghai Composite down 0.2% from its previous close and the Shenzhen Composite down 0.1%. U.S. equity index futures are signaling a lower 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"

Today's *Comment* opens with a discussion of new irritants in the China-India relationship and what they mean for investors. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including indications that the Bank of Japan could end its negative interest-rate policy by year's end and signs of progress in the negotiations for new labor contracts in the U.S. auto industry.

India-China: India yesterday imposed anti-dumping tariffs on some Chinese steel imports, responding to a flood of foreign steel and complaints from local producers in recent months. From April through July, government data shows steel imports into India were up 23% from the same period one year earlier, with imports from China alone up 63%. The anti-dumping duties are scheduled to last for five years.

- From China's perspective, India's new tariffs will only add to the growing list of irritants in the countries' bilateral relationship. Some other irritants on that list include:
    - Territorial disputes, including fatal clashes, in the Himalaya mountains;
    - Increasing Indian support for the Philippines in its territorial dispute with China in the South China Sea;
    - Indian pressure on Sri Lanka to avoid allying too closely with China;
    - India's growing participation in the U.S.-led "Quad" security grouping;
    - Indian restrictions on Chinese social media apps based on national security concerns; and
    - Recent efforts by Prime Minister Modi to establish India as the leader of the "Global South," i.e., poorer countries in South Asia, South America, and Africa.
- Along with the recent reprimand that Chinese President Xi received from senior Communist Party leaders over his domestic and international performance, these irritants probably help explain why Xi declined to attend last weekend's G20 meeting, which Modi hosted in New Delhi.
- In any case, it is clear that the China-India relationship is souring. To further peel India away from China and bring it closer to the U.S.-led bloc, Washington is likely to encourage that estrangement, including with economic incentives that could help make India more attractive for investors. Nevertheless, our quantitative, objective methodology for assigning countries to the world's evolving geopolitical and economic camps currently puts India in the "Leaning China" bloc, mostly because of India's membership in the China-led Shanghai Cooperation Organization and its relatively modest trade relationship with the U.S. versus China. India's continued presence in our "Leaning China" bloc, at least for now, serves as a reminder that there could be delays and speed bumps before India swings more fully into the U.S.-led bloc.

Chinese Economy: Two of the largest cities in Shandong province, China's second-most populous region, said they have lifted their restrictions on home purchases. That adds to the list of major local governments in China that have taken steps to boost their housing markets after being encouraged to do so by the central government. Nevertheless, the piecemeal regulatory moves are widely viewed as insufficient to spark a significant improvement in home purchases or general economic growth.

Chinese Military: Satellite imagery and social media posts show a large, nearly completed new drydock and basin at a major shipyard known for producing China's top amphibious assault vessels. The new facilities suggest Beijing has given the order to move forward with the construction of its massive, new Type 076 "landing helicopter docks." The new LHDs will be able to launch both helicopters and drones, aided by state-of-the-art electromagnetic catapults like those on China's newest aircraft carrier and the U.S.'s new Gerald Ford-class carriers.

- Even though China already has the world's largest navy, the new LHD program shows that Beijing intends to expand it further and increase its capabilities in preparation for a potential takeover of Taiwan and/or war with the U.S. On a related note, the Chinese navy today is launching its biggest-ever exercise with an aircraft carrier in the waters around Taiwan, the Philippines, and Guam.
- We continue to believe that China's unceasing military buildup and modernization program will spark ever-greater concerns among Western officials, drowning out those business elites who argue for maintaining trade and investment ties with China. The result will be further risk for those who invest in companies based in China or who are dependent on the Chinese market.

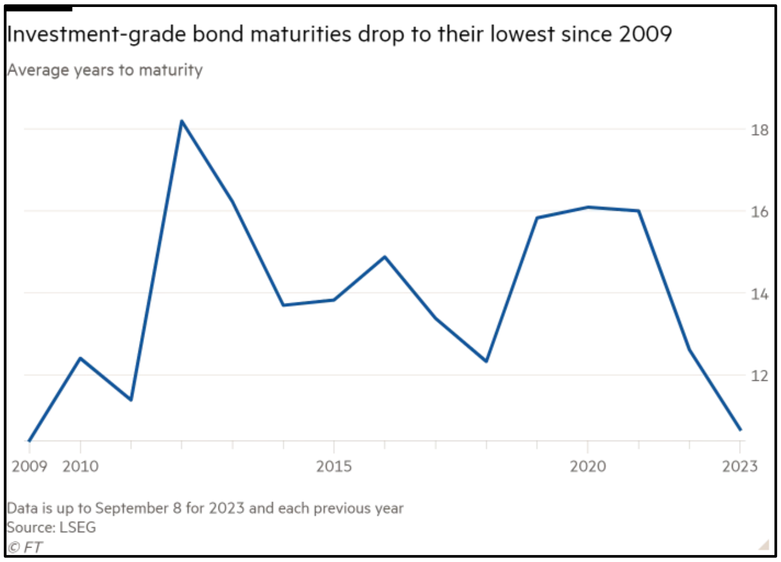
Japan: In a recent press interview, Bank of Japan Governor Ueda said his policymakers could be in a position to end their negative interest-rate policy by the end of the year, so long as there is continued growth in the country's consumer prices and wage rates. Coupled with the BOJ's recent decision to allow longer-term bond yields to fluctuate more widely, the statement provides further confirmation that the policymakers are edging toward tighter monetary policy after years of extraordinarily loose policy.

- In response, the yield on longer-term Japanese government bonds has climbed smartly in recent days. The yield on the benchmark 10-year JGB yesterday closed at 0.705%, up from 0.589% one month ago and 0.251% one year ago.
- The value of the Japanese currency has also sharply appreciated. The JPY yesterday closed at 146.51 per dollar ($0.0068), for an appreciation of almost 1.0% from its level just one week ago.

United Kingdom: In the three months ended in July, average wages excluding bonuses were up a record 7.8% year-over-year, while average total pay was up 8.5%. The figures show British pay has now grown faster than the 6.8% rise in the consumer price index over the last year, which should boost consumer purchasing power and tempt the Bank of England to hike interest rates further. On the other hand, the monetary policymakers will be concerned about a separate report today showing that in the three months to June, the value of residential mortgage in arrears was up a full 28.8% year-over-year, as rising interest rates put pressure on homeowners with floating-rate mortgages.

Libya: Mediterranean Cyclone Daniel has devastated areas of coastal Libya, causing massive flooding and at least 5,000 deaths. Libya is not a major economy, but the destruction could drive more Libyans toward migrating to Europe, potentially causing a new, politically divisive migration crisis in that important economy.

U.S. Bond Market: New data from LSEG shows corporate bonds issued so far in 2023 will come due in an average of 10.0 years, marking the shortest average maturity in more than a decade. The average maturity for investment-grade bonds has fallen to about 10.5 years, while the average for junk bonds has fallen to 6.0 years. The shorter maturities suggest firms are betting that the Federal Reserve will soon be cutting interest rates.



U.S. Defense Industry: As we've tracked rising U.S.-China tensions and resulting growth in U.S. defense budgets, we've noted that the relatively small, post-Cold War defense industrial base is bumping up against capacity constraints that are slowing the effort to rebuild allied defenses. However, recent articles in *Defense News* illustrate how the Defense Department is helping address those problems.

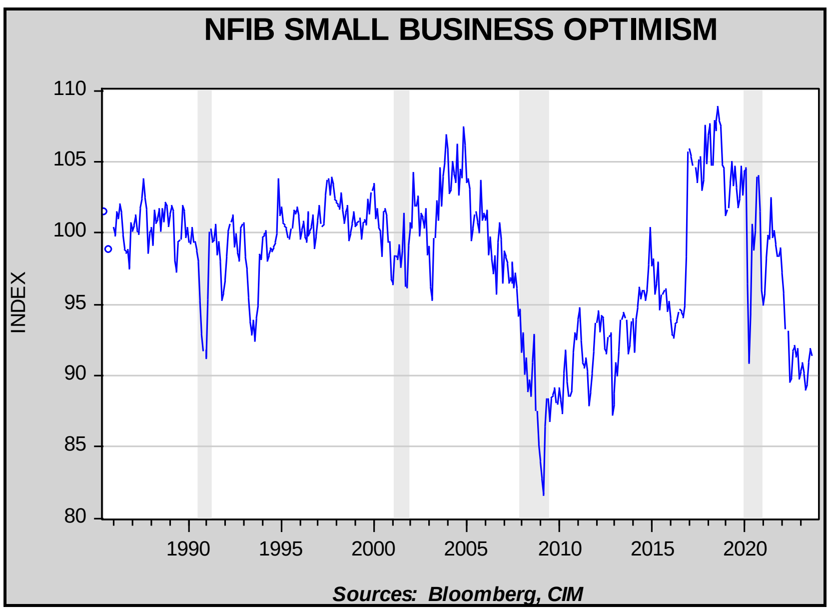
- To accelerate the output of submarines, for example, the Navy since 2018 has spent some $2.3 billion on initiatives such as:
  - Promoting "strategic outsourcing," which removes bottlenecks by shifting heavy subcomponent manufacturing out of the shipyards, and with those modules produced elsewhere, the shipyards can focus on final assembly, outfitting, and testing;
  - Providing funds to help expand and modernize the two existing shipyards that produce ballistic missile submarines and attack submarines; and
  - Expanding the supplier base by providing capital investment funds to smaller private firms so they can begin producing submarine-certified components.
- As these examples illustrate, the effort to expand the defense industrial base will help feed the re-industrialization of the U.S. economy that we've been writing about. As we've argued, re-industrialization will likely boost investment prospects in the industrial sector.

U.S. Auto Industry: Automaker Stellantis (STLA, $18.69) said it has made progress in its negotiations for a new labor contract with the United Auto Workers, just days before the Thursday expiration of the current contract and the potential start of a disruptive strike. The referenced progress probably relates, at least in part, to the company's industry-leading offer of a 14.5% pay raise and the UAW's modest cut in its demands to a pay hike of about 35%. Still, UAW chief Shawn Fain complained that Stellantis and the other major automakers have waited until the last moment to make their economic offers, indicating he will keep up pressure on the firms in the hope of extracting large pay increases and other benefits.

Global Oil Market: Fatih Birol, chief of the International Energy Agency, argues in an opinion article today that the world is coming to the end of the fossil fuel era, as the agency for the first time forecasts that global demand for petroleum oil, natural gas, and coal will peak before 2030. According to Birol, the new, earlier forecast for peak consumption of fossil fuels can be attributed to the greater-than-expected investments in renewable energy projects over the last year.

U.S. Economic Releases

U.S. small business owners have become more pessimistic about the state of the economy. The National Federation of Independent Business Optimism Index fell from 91.9 to 91.3 in August. The reading was slightly lower than expectations of 91.5 and the previous year's level of 91.8. The net share of firms reported being less confident about boosting sales and expect an increase in their compensation costs.



The chart above shows the NFIB Small Business Optimism Index.

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								
Australia	Westpac Consumer Conf Index	m/m	Sep	79.7	81		**	Equity and bond neutral
	Westpac Consumer Conf SA	m/m	Sep	-1.5%	-0.4%		**	Equity and bond neutral
	NAB Business Confidence	m/m	Aug	2	2	1	**	Equity and bond neutral
Australia	NAB Business Conditions	m/m	Aug	13	10	11.0%	**	Equity and bond neutral
India	Industrial Production	y/y	Jul	5.7%	3.7%	5.3%	***	Equity and bond neutral
	CPI	y/y	Aug	6.8%	7.4%	7.1%	***	Equity and bond neutral
EUROPE								
Eurozone	ZEW Survey Expectations	m/m	Sep	-8.9	-5.5		*	Equity bearish, bond bullish
Germany	ZEW Survey Expectations	m/m	Sep	-11.4	-12.3	-15.0	*	Equity bullish, bond bearish
	ZEW Survey Current Situation	m/m	Sep	-79.4	-71.3	-75.5	**	Equity bearish, bond bullish
UK	Claimant Count Rate	m/m	Aug	4.0%	4.0%		***	Equity and bond neutral
	Jobless Claims Change	m/m	Aug	0.9k	29.0k	7.3k	***	Equity and bond neutral
	ILO Unemployment Rate 3Mths	m/m	Jul	4.3%	4.2%	4.3%	***	Equity and bond neutral
AMERICAS								
Brazil	IBGE Inflation IPCA	y/y	Aug	4.61%	3.99%	4.66%	***	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)	526	528	-2	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)	543	543	0	Up
10-yr T-note (%)	4.28	4.29	-0.01	Flat
Euribor/OIS spread (bps)	382	380	2	Up
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Down
Yen	Down			Down
Pound	Down			Down
Franc	Down			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	$91.28	$90.64	0.71%	
WTI	$88.06	$87.29	0.88%	
Natural Gas	$2.66	$2.61	2.15%	
Crack Spread	$35.02	$36.02	-2.77%	
12-mo strip crack	$29.82	$30.40	-1.93%	
Ethanol rack	$2.46	$2.45	0.15%	
Metals				
Gold	$1,912.19	$1,922.30	-0.53%	
Silver	$22.90	$23.08	-0.76%	
Copper contract	$379.20	$380.70	-0.39%	
Grains				
Corn contract	$484.75	$485.75	-0.21%	
Wheat contract	$580.50	$584.50	-0.68%	
Soybeans contract	$1,362.75	$1,369.00	-0.46%	
Shipping				
Baltic Dry Freight	1,209	1,186	23	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.0		
Gasoline (mb)		-1.0		
Distillates (mb)		1.0		
Refinery run rates (%)		0.0%		
Natural gas (bcf)		41		

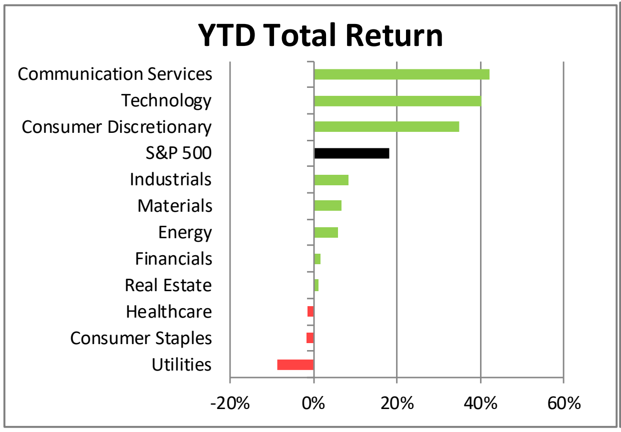
Weather

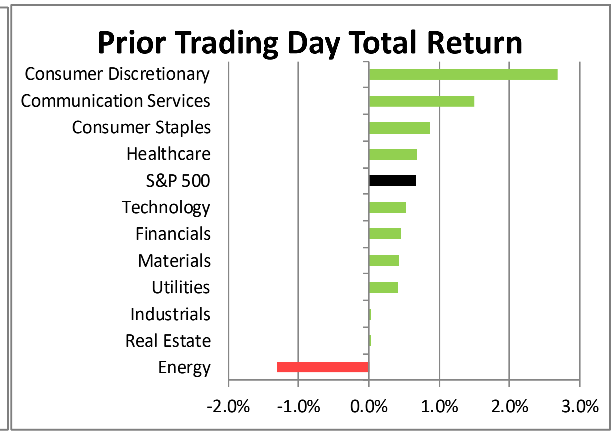
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for most of the country, with below-normal temperatures in the Midwest and parts of California. The precipitation outlook shows wetter-than-normal conditions in most states west of the Mississippi and Maine.

There are currently three atmospheric disturbances in the Atlantic Ocean, but only two are major storms. Hurricane Lee is currently causing dangerous surf and rip currents in the Virgin Islands and Puerto Rico. It will then move northward and is expected to make landfall on the northern East Coast by the end of the week. Meanwhile, Hurricane Margot, which formed as a tropical storm last week, has strengthened into a Category 1 hurricane and is moving northward through the central Atlantic Ocean. The other 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 9/11/2023 close)

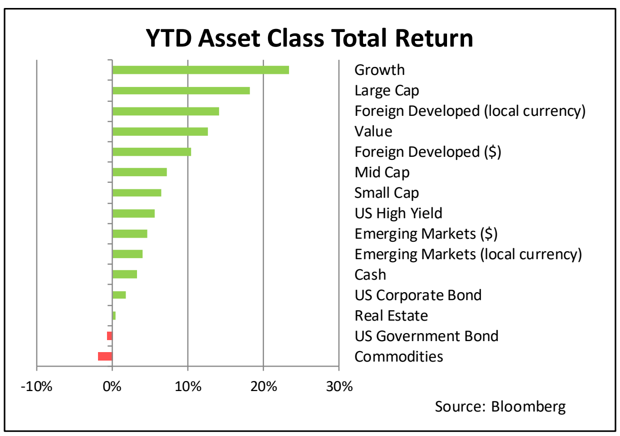




(Source: Bloomberg)

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 9/11/2023 close)

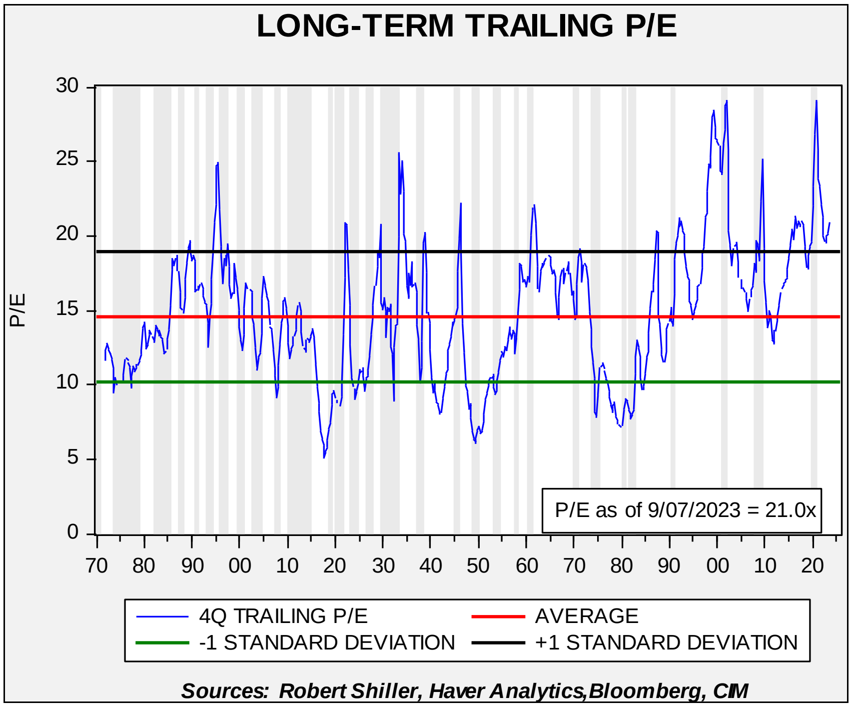


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.