Daily Comment

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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 13, 2023—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is down 0.8% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.1%. Chinese markets were lower, with the Shanghai Composite down 0.5% from its previous close and the Shenzhen Composite down 1.1%. 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"

Our *Comment* today opens with the latest news on souring relations between the West and China. 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 Russia-Ukraine war and U.S. inflation and banking dynamics.

United States-China: The House Select Committee on the Chinese Communist Party has been holding hearings and meetings on Wall Street this week to put further pressure on U.S. financial and business elites who have been reluctant to sever ties with China. In a statement that we think investors should heed, the Republican chairman of the committee, Mike Gallagher of Wisconsin, and the Democratic vice-chairman, Raja Krishnamoorthi of Illinois, both said they favor new laws to restrict U.S. investment in publicly traded stocks and bonds of certain Chinese firms.

- The new legislation mentioned by Gallagher and Krishnamoorthi would go beyond the current U.S. restrictions on bilateral trade, investment, and technology flows, illustrating the risks to investors as U.S.-China geopolitical tensions worsen.
- As a reminder that China is also clamping down on bilateral business, the Chinese government today said it has "noticed reports" of "security incidents" related to iPhones made by U.S. technology giant Apple (AAPL, $176.30). The government emphasized that it is still committed to protecting the rights of foreign businesses and supporting free markets. Nevertheless, since the statement followed so closely on Beijing's recent directive which curbed the use of iPhones by certain government workers, it is being taken as a warning that China is prepared to undermine key U.S. economic interests to retaliate for the U.S. pushback.

European Union-China: As advanced, low-cost electric vehicles from China start to flood Europe's auto market, European Commission President von der Leyen today announced that she is launching an investigation into the subsidies paid to Chinese producers. Complaining that European-made autos are often blocked from other markets, von der Leyen signaled Brussels will take a tough approach on subsidized Chinese EVs.

- The move is a reminder that von der Leyen and other leaders in Europe have swung behind the U.S. effort to push back against China's growing geopolitical and economic aggressiveness.
- In response to von der Leyen's speech, shares in high-flying Chinese EV companies have fallen sharply today, with Warren Buffett-invested BYD (BYDDY, $65.62) losing 2.8% of its value and rival Xpeng (XPEV, $18.65) losing about 2.5%.

United Kingdom-China: Just days after British police said they had arrested two people, including a parliament researcher, on charges of spying for China, press reports say the authorities are preparing to arrest several more people in the coming months on charges that they have been secretly working to undermine Britain's democracy under the direction of the Chinese government. The news points to a further rupture in China-U.K. relations, which could potentially include new, U.S.-style restrictions on bilateral trade, investment, and technology flows.

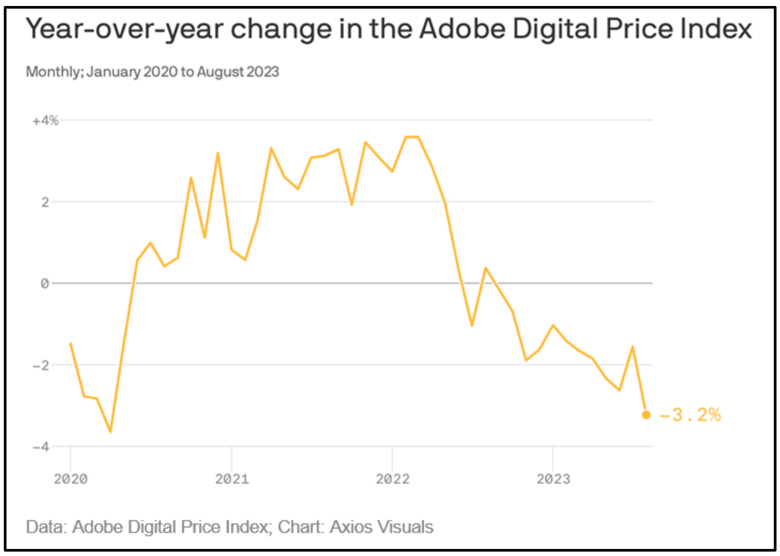
Russia-North Korea-Ukraine: Russian President Putin and North Korean Supreme Leader Kim met today at a Russian space-launch facility in Vladivostok, with both pledging to deepen their cooperation on security and economic issues. The two leaders are widely expected to strike a deal under which North Korea will sell weaponry to Russia to help it continue its invasion of Ukraine.

- Separately, reports today say Ukrainian missiles struck a shipyard in Russian-occupied Crimea, heavily damaging or destroying two Russian navy vessels in drydock.
- The successful attack reflects how Ukraine's military reach has been extended now that it has received long-range missiles from countries such as France and the U.K.

Sweden: The center-right government this week proposed a 2024 budget that would hike military spending by approximately 28%. The proposed budget would put Sweden on track to meet the North Atlantic Treaty Organization's standard of spending at least 2% of gross domestic product on defense, even though the country is still waiting to be accepted into the alliance.

U.S. Military: U.S. Air Force Secretary Kendall has announced that the service will miss its annual recruiting goal by about 10% when the fiscal year ends on September 30, marking the first such shortfall since 1999. The deficit shows how most of the military is struggling to keep up troop levels because of factors such as the strong civilian job market, lingering disruptions from the coronavirus pandemic, and difficulties in finding enough young people who can meet today's physical and intellectual standards.

U.S. On-Line Prices: While investors today will focus on the headline Consumer Price Index (see U.S. Economic Releases below), a separate private index shows on-line prices are falling in year-over-year terms. The Adobe Digital Price Index for August was down a full 3.2% from the same month one year earlier, including annual price declines of 7.3% for appliances, 7.0% for sporting goods, and 11.6% for electronics.

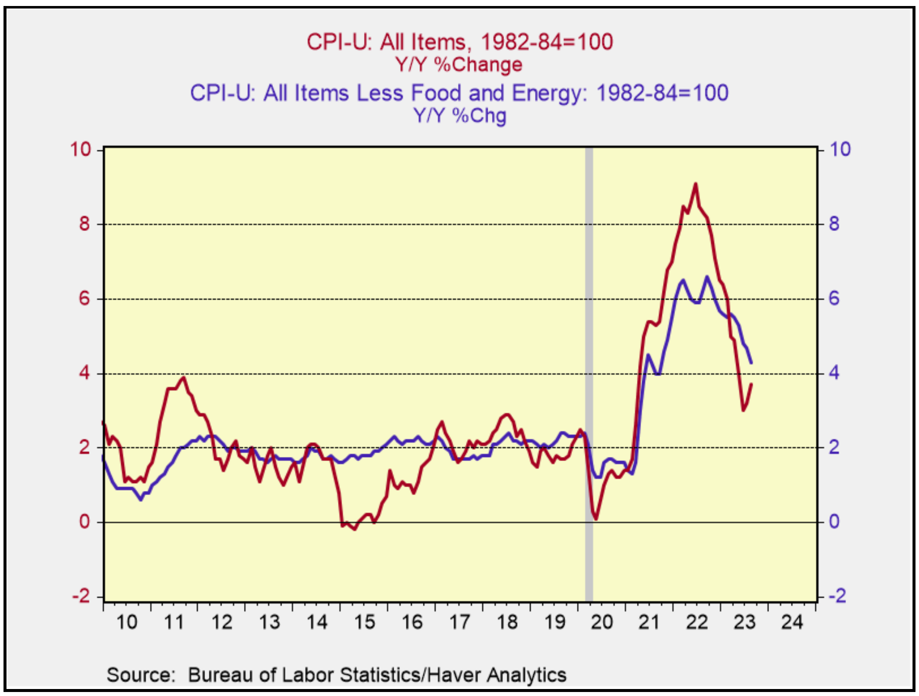


U.S. Banking Industry: Incoming data shows net new bank lending has slowed to a crawl, with outstanding loans growing at an annualized, seasonally adjusted rate of just 3.6% so far in the third quarter, compared with average growth of about 7.0% over the long term. Of course, part of the slowdown reflects weaker loan demand now that the Federal Reserve has hiked interest rates so aggressively since last year. In addition, however, the slow growth reflects cautious lending as banks worry about rising deposit costs and asset values. Importantly, slow lending could also help to finally push the economy into the recession that we've been expecting all year.

U.S. Economic Releases

Elevated borrowing costs continue to weigh on demand for residential loans. The Mortgage Bankers Associations mortgage applications index fell 0.8% in the week ending September 8. Potential homebuyers have been deterred from taking out new mortgages due to rates being very high. Last week, the average 30-year fixed-rate mortgage rose 6 bps from 7.21% to 7.27%. As a result, the MBA tracker for purchases rose a modest 1.2% from the prior week, while the MBA tracker for refinancing fell 5.4% in the same period.

Separately, U.S. consumer prices accelerated faster than expected in August due to a pickup in energy prices. The Consumer Price Index (CPI) has risen 3.7% since August 2022, above expectations of 3.5% and the previous month's annual rise of 3.2%. Core CPI, which excludes food and energy, rose 4.3% from the previous year. This was in line with the forecast of 4.3% but lower than previous month's reading of 4.7%.



The chart above shows the annual change in the headline and core CPI. Although core inflation shows that underlying price pressures are starting to ease, supply side factors are proving to be a thorn in the Fed's efforts to bring inflation down to its 2% target.

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
14:00	Monthly Budget Statement	m/m	Aug	-$258.2b	-$220.8b	**
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	PPI	y/y	Aug	3.2%	3.6%	3.4%	**	Equity and bond neutral
New Zealand	REINZ House Sales	y/y	Aug	9.2%	1.6%		**	Equity bullish, bond bearish
New Zealand	Food Prices	m/m	Aug	0.5%	-0.5%		***	Equity bearish, bond bullish
South Korea	Export Price Index	y/y	Aug	-7.9%	-12.8%		*	Equity and bond neutral
	Import Price Index	y/y	Aug	-9.0%	-13.5%	-13.6%	*	Equity and bond neutral
	Unemployment Rate	m/m	Aug	2.4%	2.8%	2.9%	**	Equity bullish, bond bearish
EUROPE								
Eurozone	Industrial Production WDA	y/y	Jul	-2.2%	-1.2%	-1.1%	**	Equity bearish, bond bullish
UK	Industrial Production	y/y	Jul	0.4%	0.7%	-4.0%	***	Equity and bond neutral
	Manufacturing Production	y/y	Jul	3.0%	3.1%	2.7%	**	Equity and bond neutral
	Trade Balance	m/m	Jul	-£3446m	-£15455m	-£15900m	**	Equity and bond neutral
	Visible Trade Balance	m/m	Jul	-£14064m	-£4787m	-£4500m	**	Equity and bond neutral
AMERICAS								
Mexico	International Reserves Weekly	w/w	8-Sep	$203920m	$204247m		*	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	529	0	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	542	1	Up
10-yr T-note (%)	4.31	4.28	0.03	Flat
Euribor/OIS spread (bps)	382	382	0	Up
Currencies	**Direction**			
Dollar	Flat			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	$92.49	$92.06	0.47%	
WTI	$89.28	$88.84	0.50%	
Natural Gas	$2.74	$2.74	0.04%	
Crack Spread	$34.00	$33.79	0.60%	
12-mo strip crack	$29.77	$29.55	0.75%	
Ethanol rack	$2.46	$2.46	0.05%	
Metals				
Gold	$1,912.18	$1,913.67	-0.08%	
Silver	$22.89	$23.07	-0.74%	
Copper contract	$379.10	$379.20	-0.03%	
Grains				
Corn contract	$480.00	$476.50	0.73%	
Wheat contract	$596.25	$587.50	1.49%	
Soybeans contract	$1,345.00	$1,346.50	-0.11%	
Shipping				
Baltic Dry Freight	1,235	1,209	26	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.5		
Gasoline (mb)		-0.9		
Distillates (mb)		1.4		
Refinery run rates (%)		-0.7%		
Natural gas (bcf)		54		

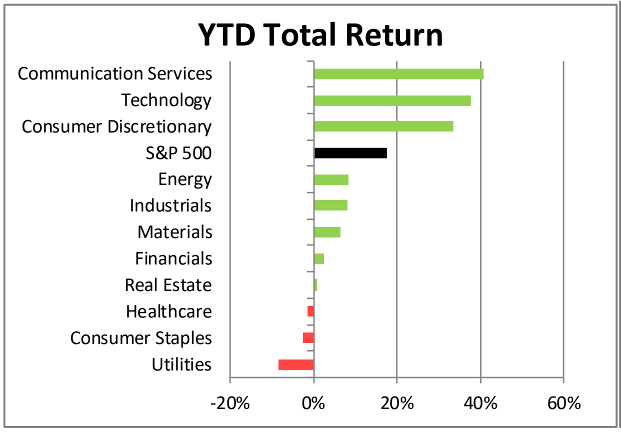
Weather

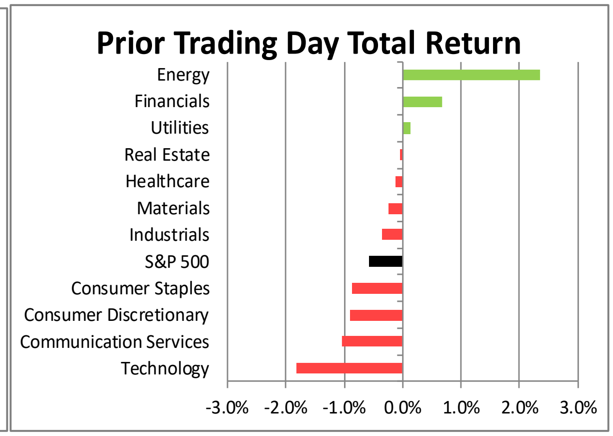
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for most of the country, with below-normal temperatures in the Midwest and parts of the Pacific region. The precipitation outlook shows wetter-than-normal conditions in Maine and most states west of the Mississippi, with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

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 storm has a 50% chance of developing into a major storm but is not expected to make landfall. We note that Atlantic hurricane activity peaks, on average, September 15.

Data Section

U.S. Equity Markets – (as of 9/12/2023 close)

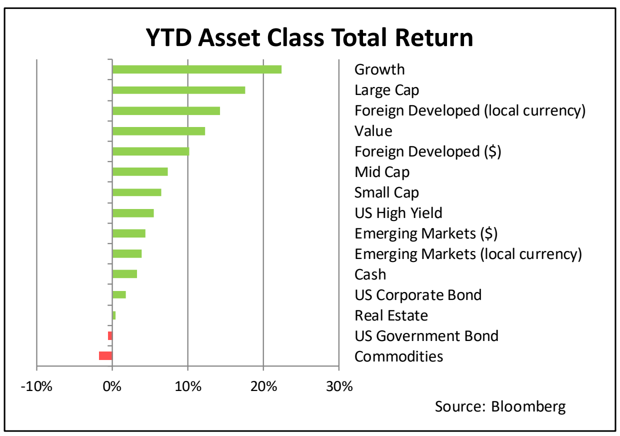




(Source: Bloomberg)

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 9/12/2023 close)

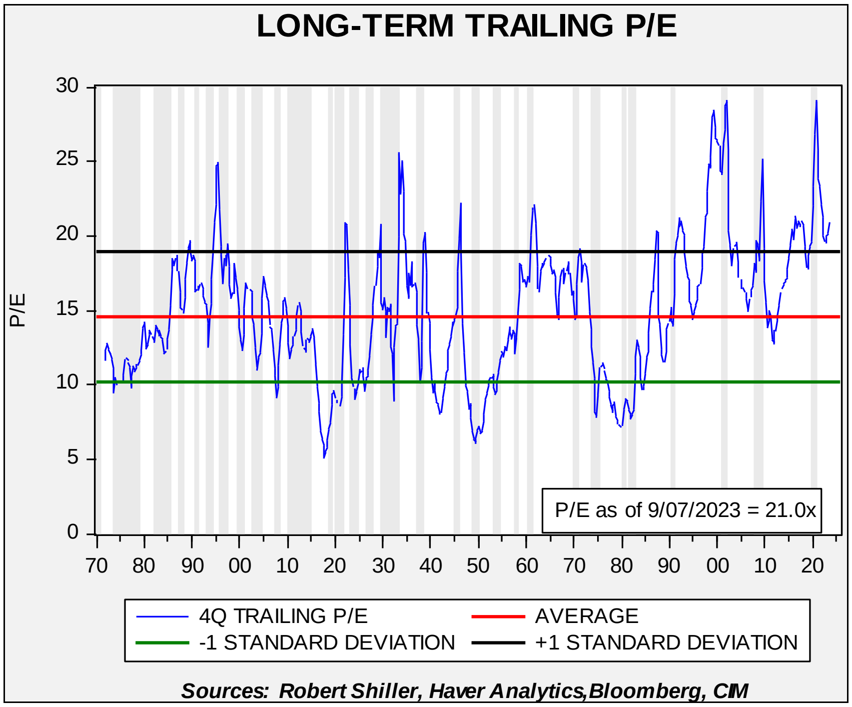


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.