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 14, 2023—9:30 AM EDT] Global equity markets are generally higher this morning. In Europe, the Euro Stoxx 50 is up 0.4% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.8%. Chinese markets were mixed, with the Shanghai Composite up 0.1% from its previous close and the Shenzhen Composite down 0.6%. 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:

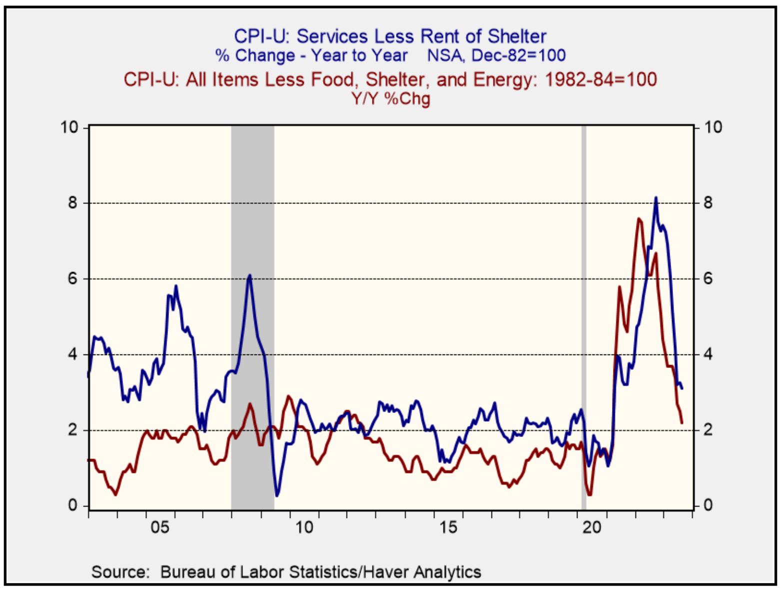
- *Bi-Weekly Geopolitical Report* (8/21/2023) (there will be no podcast for this report and there is no report for 9/4 due to the holiday): "Reflections on the New Cold War"
- ***Weekly Energy Update* (9/14/2023): Oil prices continue their surge higher. The executive director of the IEA suggests we are approaching peak oil demand; as we note in our report, this announcement will likely push crude oil prices higher.**
- *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"

Good morning! Today's *Comment* is split into three sections: 1) Why rising energy prices will complicate the Fed's efforts to project future policy rates; 2) Why European policymakers may be finished with their hiking cycle; and 3) Why the green transition is leading governments to push for more domestic manufacturing.

Where Do They Stand? The disappointing consumer price index (CPI) report may lead to further divisions within the Federal Open Market Committee (FOMC).

- Rising energy prices pushed headline CPI above expectations in August, leading investors to adjust their interest rate expectations. Consumer prices rose 3.7% from the previous year, above economists' expectations of 3.5% and July's reading of 3.3%. The rise was driven by a 5.6% surge in petrol prices from the previous month, which accounted for more than half of the month-over-month increase. Energy prices have picked up following efforts by Saudi Arabia and Russia to prop up oil prices through production cuts. The sudden reversal of inflationary pressures has led to investors' pricing in a near 50% chance of another hike by the end of the year.

- Despite the recent surge in headline inflation, there are some encouraging signs that underlying inflation pressures may be easing. The year-over-year change in core CPI, which excludes food and energy, fell from 4.7% to 4.3% in August. Meanwhile, the frequently cited core services inflation, which excludes goods and shelter, also eased in August, declining from 3.3% in July to 3.1%. Additionally, supercore inflation, which excludes food, shelter, and energy, rose by 2.2% in the same period but was modestly above its 20-year historical average of 1.9%. Therefore, there is still a case for the Fed to stand pat, at least for now.

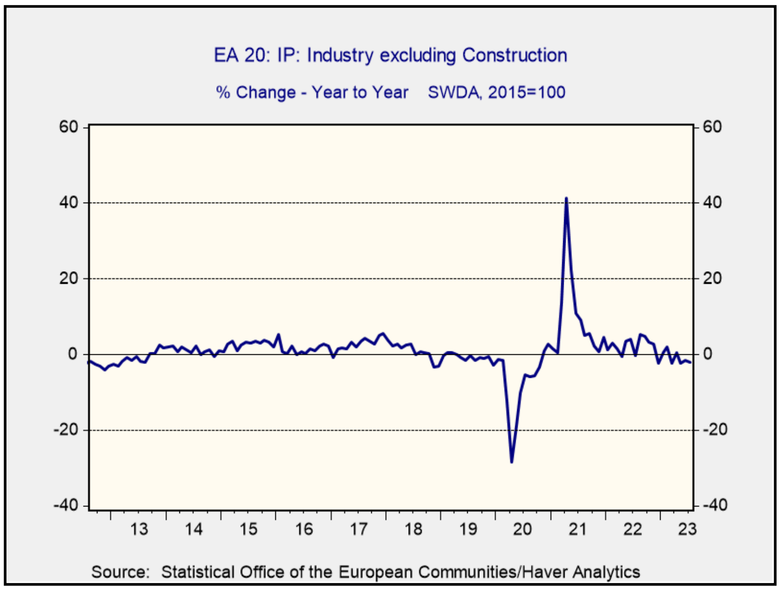


- The latest CPI report is unlikely to have a significant impact on the FOMC's decision of whether to keep interest rates unchanged during its next meeting on September 19-20. Although policymakers have not commented on how they would vote in the meeting, members have expressed concern regarding the level of tightness in the labor market. The committee is 25 bps shy of meeting its fed funds target outline in the latest dot plots. As a result, we will be paying close attention to the latest FOMC projection materials and Fed speeches for evidence of the committee's thinking on future rate hikes.

Policy Pushback: Economic woes are prompting policymakers to reconsider rate hikes amid slowing output and lawmaker complaints.

- The European Central Bank (ECB) raised its benchmark policy rates by 25 bps on Thursday. The increase comes amidst signs that inflation is starting to return to normal but still remains well above the central bank's 2% mandate. Despite the decision to tighten monetary policy, markets believe that the central bank is likely finished hiking rates. During the press conference, ECB president Christine Lagarde suggested that rates are currently in sufficiently restrictive territory but stopped short of ruling out an additional hike. As a result, the euro (EUR) fell against the USD and Japanese yen (JPY).

- Unlike the United States, the eurozone economy is more fragile, partly due to its greater reliance on exports, which are being hurt by China's economic slowdown. European Central Bank officials downgraded their growth expectations for the next three years and hinted at the possibility of recession. At the same time, high interest rates have hurt manufacturing activity throughout the bloc, with industrial production falling 2.2% from the prior year in August. These troubles are not likely to go away anytime soon as the ECB projects that rates will likely stay above 3% in 2024, making it harder for them to justify rate cuts.

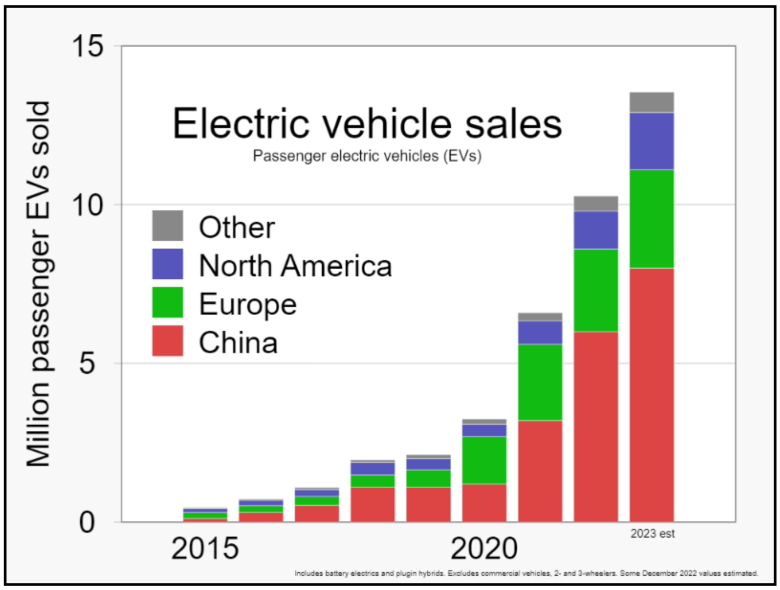


- Meanwhile, European governments have begun to express their frustration with the ECB's tight monetary policy. Italian Prime Minister Giorgia Meloni has doubled down on a windfall tax on Italian banks (against the wishes of the ECB Governing Council) in a bid to prevent the banks from profiting at the expense of households due to monetary policy. A similar measure passed in Spain is currently being challenged in court. As the effects of the rate hikes start to work their way through the economy, policymakers will likely face political pressure to cut rates, thus leading to more downward pressure on the EUR.

Return of the Industrial State? Governments are becoming more assertive in protecting domestic industries as the world begins to fracture into blocs.

- The G-7 are increasingly becoming more protectionist as they look to prevent China from dominating the electric vehicle market. On Wednesday, European Commission President Ursula von der Leyen announced that the EU will launch an investigation into allegations of the Chinese dumping of electric vehicles. The probe paves the way for tariffs on foreign manufacturers that are in breach of trade rules. In the U.S., where there is already a 27.5% levy on Chinese made cars, regulators are considering a possible crackdown on EV battery imports from China, as lawmakers are trying to deter American carmakers from relying on China for the critical components of their vehicles.

- The pressure to reduce reliance on Chinese green technology is being driven by governments' desire to avoid a repeat of the solar panel industry in the 2010s. During this period, Chinese companies backed by state aid undercut domestic producers, forcing many solar companies in the U.S. and Europe into insolvency. Given China's dominance in EV batteries, automakers may be at risk of a similar outcome. China controls 76% of global battery cell production capacity and accounts for two-thirds of the world's registered electric vehicles. Concerns over American supply chain exposure to China have led lawmakers to pressure Ford Motor Company (F, $12.64) to abandon its use of Chinese technology for its batteries.

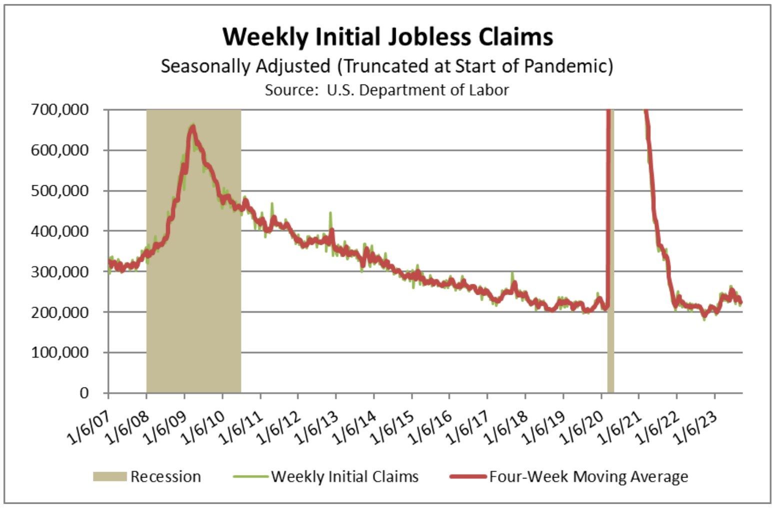


(Source: Wikimedia Commons)

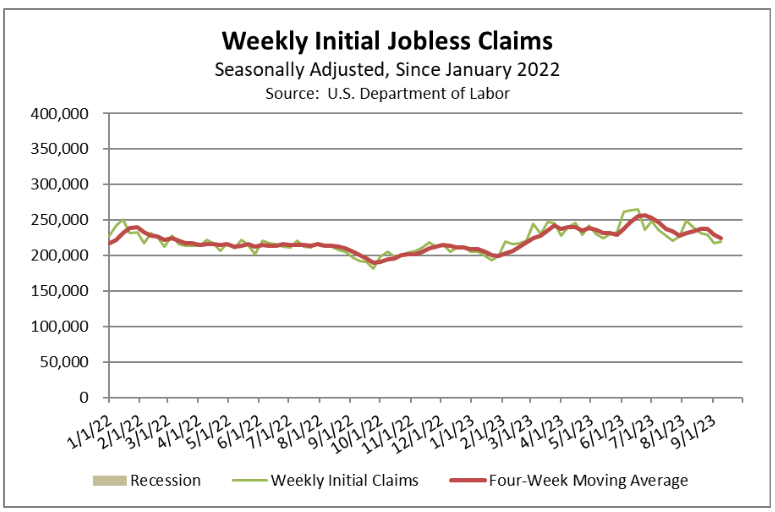
- Governments in advanced economies are likely to play a more active role in the economy than investors are used to, reflecting a long-term trend of supporting domestic firms to compete with foreign competitors. This is already evident in the Inflation Reduction Act, which uses tax subsidies to build domestic manufacturing in the U.S., and in similar incentives offered by the EU. While this shift may help businesses subsidize their research efforts, it could also lead to higher inflation and borrowing costs due to inefficiencies associated with firms being unable to use outside suppliers.

U.S. Economic Releases

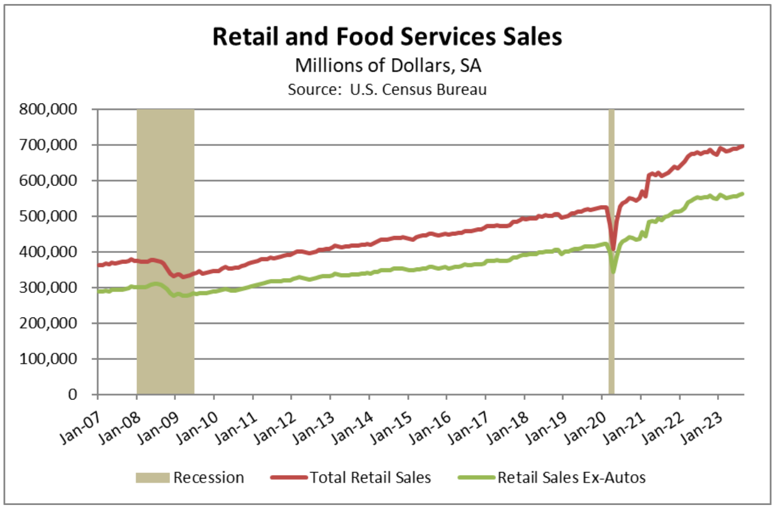
In the week ended September 9, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 220,000, below the expected level of 225,000 but slightly above the previous week’s revised level of 217,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, nevertheless fell back to a six-month low of 224,500. In the week ended September 2, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to 1.688 million, below the anticipated reading of 1.690 million but above the prior week's revised reading of 1.684 million. The chart below shows how initial jobless claims have fluctuated since just before the Great Financial Crisis. The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



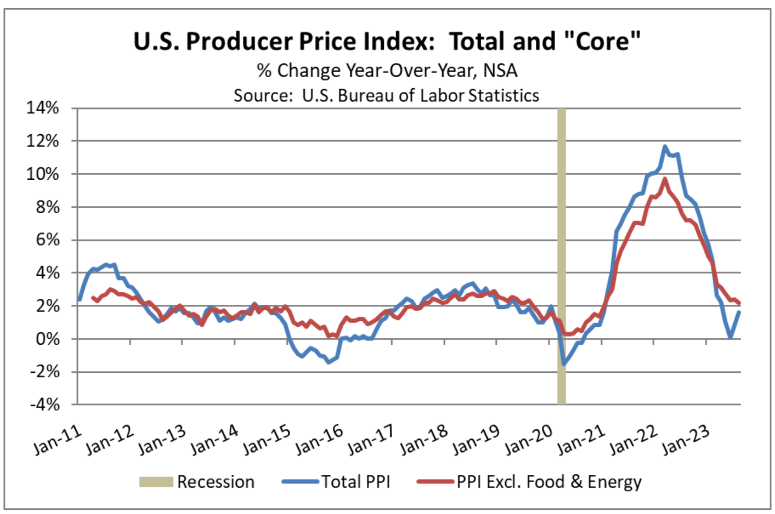
To provide more detail on recent trends, the chart below shows how initial jobless claims have changed just since the beginning of 2022.



Separately, August ***retail sales*** rose by a seasonally adjusted 0.6%, beating both the expected increase of 0.1% and the revised July rise of 0.5%. Overall retail sales are often driven by the volatile auto and auto parts sector, which makes up almost one-fifth of the total, but that wasn't the case this time. August ***retail sales excluding autos and auto parts*** were up also up 0.6%, beating their anticipated rise of 0.4% but slowing a bit from their revised July gain of 0.7%. Overall retail sales in August were up 2.9% from the same month one year earlier, while sales excluding autos and auto parts were up 2.5%. The following chart shows how retail sales have changed since just before the Great Financial Crisis.



In another key report this morning, the August ***producer price index (PPI)*** rose by a seasonally adjusted 0.7%, far more than expectations that the rise would match July's gain of 0.4%. Excluding the volatile food and energy components, the August ***"core" PPI*** rose a more modest 0.2%, matching expectations and cooling from its July increase of 0.4%. The overall PPI in August was up 1.6% from the same month one year earlier, while the core PPI was up 2.2%. The chart below shows the year-over-year change in the PPI and the core PPI over the last decade or so.



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
10:00	Business Inventories	m/m	May	1.4%	1.2%	*
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	Foreign Buying Japan Bonds	w/w	8-Sep	¥79.3b	¥926.6b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	8-Sep	¥3631.9b	¥90.7b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	8-Sep	¥96.6b	¥749.6b	¥749.5b	*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	8-Sep	-¥854.7b	¥531.9b	¥532.1b	*	Equity and bond neutral
	Core Machine Orders	y/y	Jul	-13.0%	-5.8%	-10.3%	**	Equity bearish, bond bullish
	Industrial Production YoY	y/y	Jul F	-2.3%	-2.5%		***	Equity and bond neutral
	Capacity Utilization MoM	m/m	Jul	-2.2%	3.8%		**	Equity and bond neutral
Australia	Employment Change	m/m	Aug	64.9k	-14.6k	-1.4k	***	Equity bullish, bond bearish
	Unemployment Rate	m/m	Aug	3.7%	3.7%	3.7%	***	Equity and bond neutral
	Participation Rate	m/m	Aug	67.0%	66.7%	66.9%	**	Equity and bond neutral
India	Wholesale Prices	y/y	Aug	-0.5%	-1.4%	-0.6%	**	Equity and bond neutral
EUROPE								
UK	RICS House Price Balance	y/y	Aug	-68%	-53%	-55%	*	Equity bullish, bond bearish
Switzerland	Producer & Import Prices	y/y	Aug	-0.8%	-0.6%		**	Equity and bond neutral
AMERICAS								
Brazil	IBGE Services Volume	y/y	Jul	3.5%	4.1%	4.0%	*	Equity bearish, bond bullish

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)	567	567	0	Up
3-mo T-bill yield (bps)	529	531	-2	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	540	540	0	Up
U.S. Libor/OIS spread (bps)	542	542	0	Up
10-yr T-note (%)	4.27	4.25	0.02	Flat
Euribor/OIS spread (bps)	385	382	3	Up
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Down			Down
Yen	Up			Down
Pound	Down			Down
Franc	Flat			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
ECB Main Refinancing Rate	4.500%	4.250%	4.250%	Above Forecast
ECB Marginal Lending Facility	4.750%	4.500%	4.500%	Above Forecast
ECB Deposit Facility Rate	4.000%	3.750%	3.750%	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	$93.14	$91.88	1.37%	
WTI	$89.83	$88.52	1.48%	
Natural Gas	$2.81	$2.68	4.85%	Supply Pessimism
Crack Spread	$35.69	$36.06	-1.04%	
12-mo strip crack	$30.45	$30.58	-0.44%	
Ethanol rack	$2.56	$2.52	1.48%	
Metals				
Gold	$1,908.06	$1,908.12	0.00%	
Silver	$22.59	$22.84	-1.09%	
Copper contract	$383.80	$379.30	1.19%	
Grains				
Corn contract	$482.00	$482.25	-0.05%	
Wheat contract	$592.00	$597.25	-0.88%	
Soybeans contract	$1,354.25	$1,349.75	0.33%	
Shipping				
Baltic Dry Freight	1,290	1,235	55	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	4.0	-2.5	6.4	
Gasoline (mb)	5.6	-0.9	6.4	
Distillates (mb)	3.9	1.4	2.5	
Refinery run rates (%)	-0.2%	-0.7%	0.5%	
Natural gas (bcf)		51		

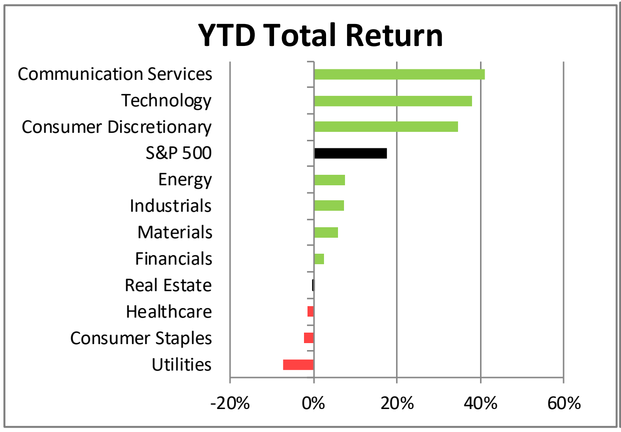
Weather

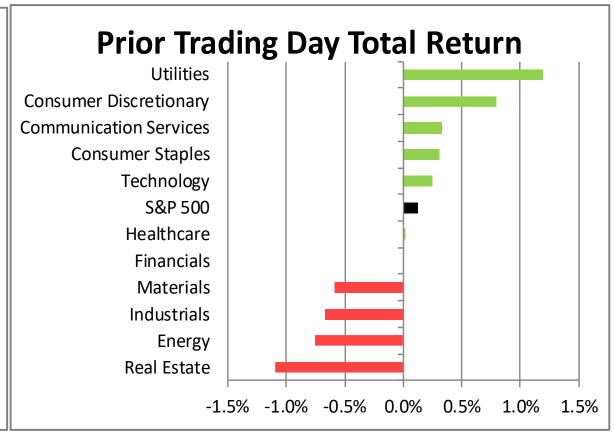
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in a band stretching from the Upper Midwest through the Mississippi Valley and into Texas and the Southeast, with below-normal temperatures throughout the Far West. The forecasts are calling for wetter-than-normal conditions in the Rocky Mountains and Great Plains, with dry conditions expected in the Northeast.

There are currently three atmospheric disturbances in the Atlantic Ocean area. Hurricane Lee is currently east of the Bahamas and traveling northward, threatening to bring heavy rainfall and strong winds to New England and Atlantic Canada by the weekend. Hurricane Margot is in the central Atlantic, west of the Azores, and traveling slowly northward. There is also a disturbance off the western coast of Africa that is assessed to have a 90% chance of developing into a hurricane in the next 48 hours. We note that Atlantic hurricane activity peaks, on average, September 15.

Data Section

U.S. Equity Markets – (as of 9/13/2023 close)

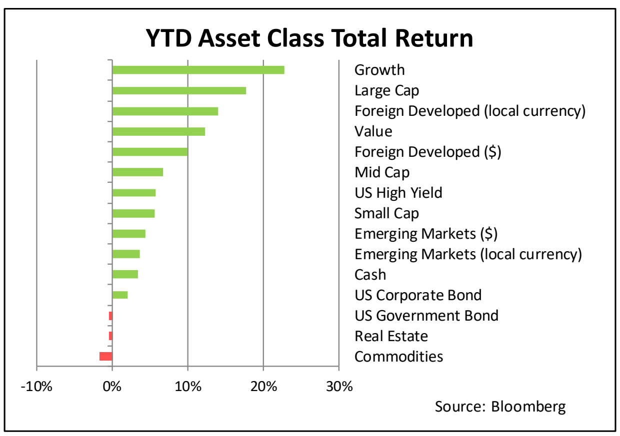




(Source: Bloomberg)

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 9/13/2023 close)

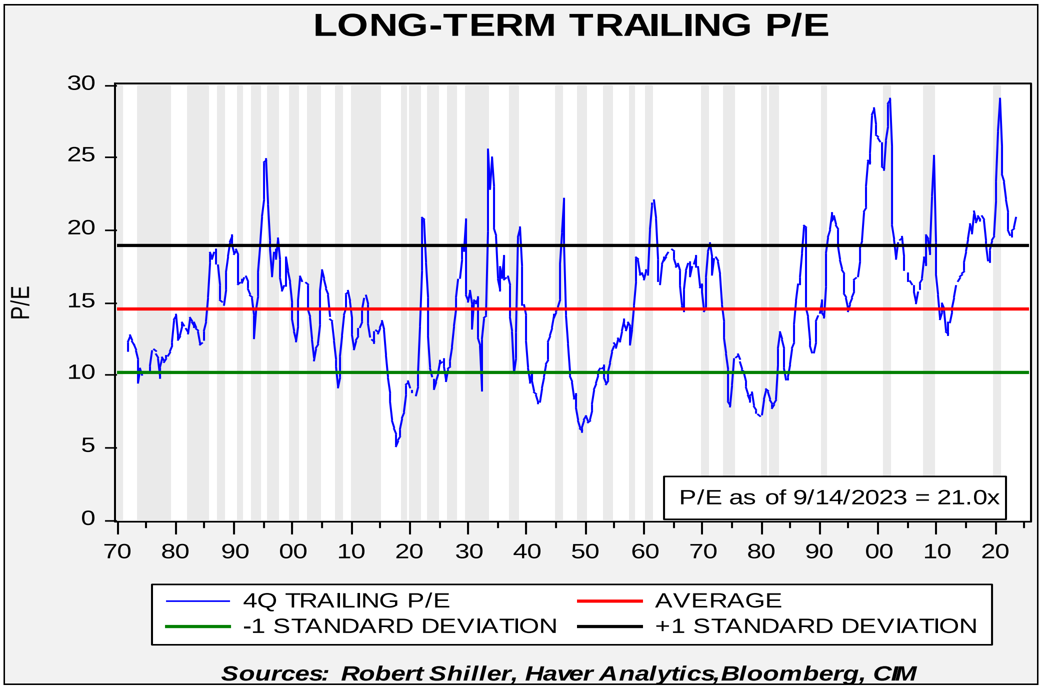


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 14, 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.