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 15, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 1.0% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.7%. Chinese markets were lower, with both the Shanghai and Shenzhen Composites down 0.3% from their previous close. 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:

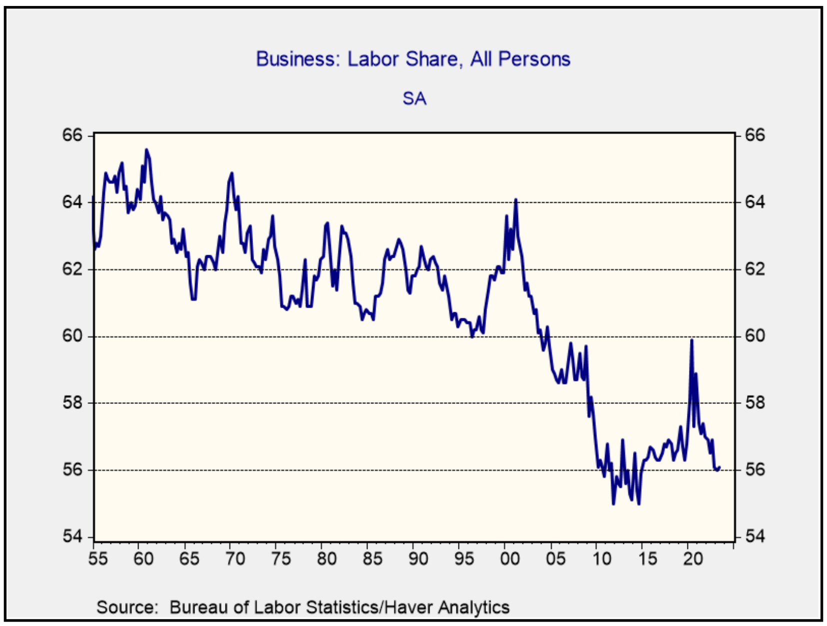
- *Bi-Weekly Geopolitical Report* (8/21/2023) (there will be no podcast for this report and there is no report for 9/4 due to the holiday): "Reflections on the New Cold War"
- *Weekly Energy Update* (9/14/2023): Oil prices continue their surge higher. The executive director of the IEA suggests we are 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* will be broken into three sections: 1) Why unions are starting to grow in popularity; 2) Why long-duration Treasury yields are likely to rise over the next few years; and 3) Why the market should be cautiously optimistic about the data coming out of China.

Labor Fights Back: Unions are back in fashion as more workers demand higher wages and better terms.

- The United Auto Workers (UAW) announced a strike against the Big Three automakers in one of the biggest labor disputes in recent memory. The strike could weigh on economic growth if it lasts long enough. The union rejected the carmakers' last-minute bids to end the impasse, with the most significant sticking points being the UAW's demands for defined-benefit pension plans, a 32-hour workweek, and other work incentives. The automakers have rejected these demands, believing that they would hurt business profitability. Ford (F, $12.62) estimates that the proposal could push it into bankruptcy.

- The long-simmering tension between unions and firms is likely to continue, as firms have been reluctant to share more of their profits with workers. Although most of the pushback against labor unions is coming from industries that are already unionized, there is growing support for labor unions overall. Recent Gallup polling data shows that approval ratings for labor unions have reached their highest point since 1965. This evolving sentiment is exemplified by the recent actions of basketball players at Dartmouth College, who have initiated proceedings to establish a local union. This shift in perspective comes amid a significant decline in labor's share of economic output from its pandemic peak.

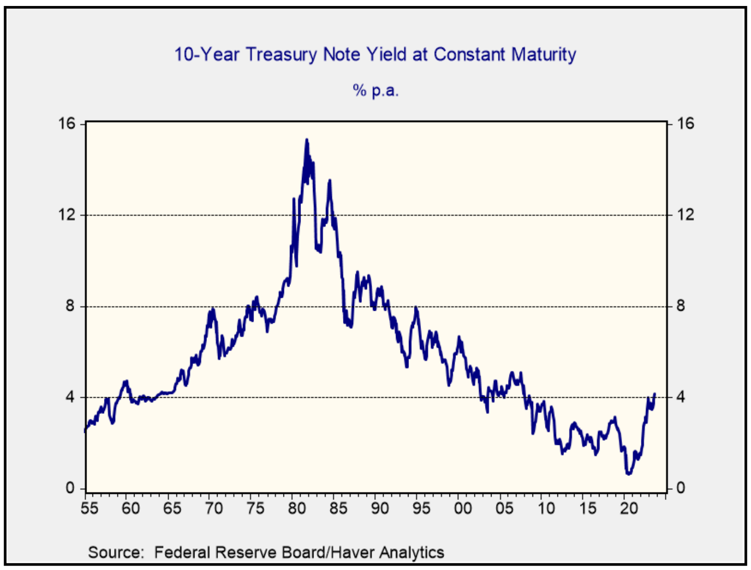


- Over the next thirty years, the bargaining power of unions is likely to weigh on company margins, as labor groups gain influence and extract more concessions from firms, such as higher wages, better benefits, and more job security. These concessions could reduce company efficiency, leading to lower productivity and greater inflation volatility. In this environment, large companies are typically better positioned to absorb losses and capitalize on technological substitutes such as artificial intelligence. However, the trend will likely be drawn out and bumpy, so there is no immediate cause for action.

Bond Bears Return: Long-term Treasury yields hit a post-GFC high as traders weigh hawkish Fed policy and government budget wrangling.

- Bond yields have risen due to uncertainty over fiscal and monetary policy. President Biden warned on Thursday that the government could shut down at the end of September if Congress doesn't reach an agreement on a new budget. House Speaker Kevin McCarthy (R-CA) [has struggled to convince fellow Republicans to keep the government funded.] Meanwhile, stronger-than-expected retail sales data and a steady decline in jobless claims have added to speculation that the Federal Reserve may pursue a hawkish pause at its next meeting. The FOMC is expected to leave rates unchanged next week but signal its readiness to raise them further in the future.

- Ten-year Treasury yields have risen over 100 basis points since April, to levels not seen since 2006. This massive jump in interest rates reflects investor concerns about the Federal Reserve's ability to maintain price stability and the government's ability to meet its debt obligations. Although the recent CPI report showed signs of improvement in underlying price pressures, rising energy prices have raised concerns that some of this progress will be reversed. Additionally, growing partisanship prevents Congress from passing legislation to address the growing government deficit. As a result, investors are demanding higher yields to compensate for the increased risk.



- Long-duration bond prices are likely to face significant headwinds due to structural shifts in the global economy, particularly the transition from an economy that favors efficiency to one that favors resilience. This transition could lead to increased inflation volatility and supply chain disruptions, as the lack of imports makes it more difficult to meet domestic demand. Additionally, the growing government debt burden will continue to raise concerns about the sustainability of public finances. However, this transition will be uneven, with periods of fluctuating yields.

Chinese Surprise: Beijing received some welcome news, as economic data showed that the economy is starting to rebound.

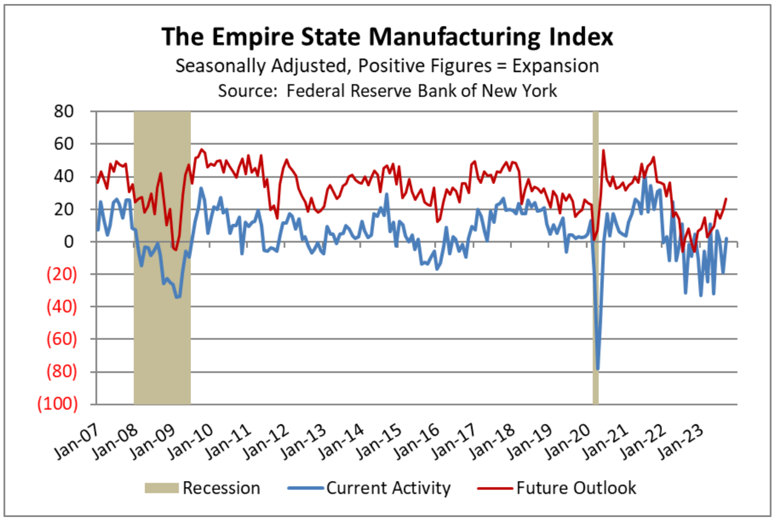
- Industrial production and retail sales figures beat expectations in August, showing that the limited policy stimulus is having an impact on the economy. Factory output increased by 4.5% year-over-year, well above expectations of 3.9% and the previous month's increase of 3.7%. Retail receipts jumped 4.6% year-over-year, well above the July increase of 2.5% and the consensus estimate of 3.0%. This progress is likely to boost optimism among investors who feared that the country was in a prolonged slump, which could persuade some that the worst is likely behind. As a result, the Chinese yuan (CNY) gained on the U.S. dollar.

- The positive economic reports show that China's pro-growth initiatives are working. In recent weeks, Beijing has implemented measures to boost consumer and investor sentiment, including the People's Bank of China's most significant rate cut in three years, a slash in stamp duties on stock transactions, and a cut in the reserve requirement ratio to free up liquidity for lending. The measures follow statements made by Beijing officials in July that the government would provide stimulus to help support the economy following years of COVID restrictions. That said, there is still concern that Beijing's work isn't finished.

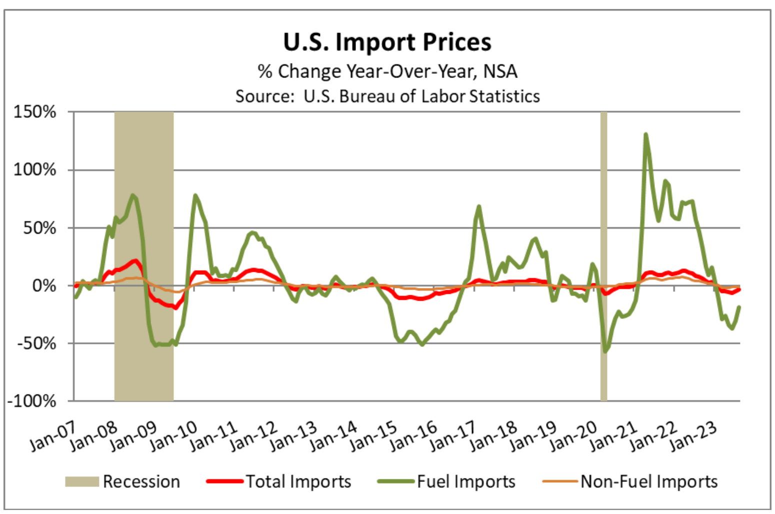
- It is never a good idea to read too deeply into a single month of economic data, and this is no different. China is still working its way through a property meltdown and a municipal debt problem. Additionally, not all of the economic data coming out of China is rosy. For example, the housing price index was down 0.1% from the prior year, and urban youth unemployment has risen above 21%. Thus, China is far from being out of the woods. However, if the growth in consumption does start to pick up, this should aid equities in countries with exposure to the second-largest economy.

U.S. Economic Releases

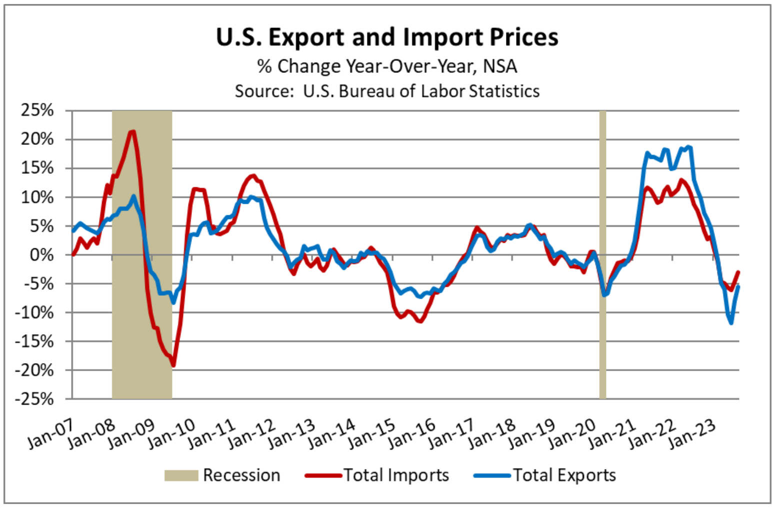
The New York FRB said its September ***Empire State Manufacturing Index*** rose to a seasonally adjusted 1.9, far better than the expected reading of -10.0 and the August reading of -19.0. This index is designed so that positive readings point to expanding factory activity in New York state. At its current level, the index suggests manufacturing in the Empire State has started growing again. The chart below shows how the index has fluctuated since just before the Great Financial Crisis.



Separately, August ***import prices*** were up 0.5% from the previous month, far more than the expected increase of 0.3% and the downwardly revised increase of 0.1% in July. Of course, import prices are often driven by volatility in the petroleum fuels category, and that certainly was the case this time. August ***import prices excluding fuels*** were flat, exactly as anticipated, and exactly as they were in the previous month. Overall import prices in August were down 3.0% year-over-year, while import prices excluding fuels were down 0.8%. The chart below shows the year-over-year change in import prices since just before the Great Financial Crisis.



According to the report, ***export prices*** in August were down 5.5% from one year earlier, in large part because of the key agriculture category. Comparing the annual change in export prices versus import prices provides a sense of the U.S. "terms of trade," or the relative advantage or disadvantage the country is facing because of trends in international trade prices. The chart below compares the year-over-year change in U.S. export and import prices since just before the Great Financial Crisis.



The table below lists the economic releases and/or Fed events scheduled for the rest of the day.

EST	Indicator			Expected	Prior	Rating
Economic Releases						
No economic releases for the rest of today						
9:15	Industrial Production	m/m	Aug	0.1%	1.0%	***
9:15	Industrial Capacity Utilization	m/m	Aug	79.3%	79.3%	**
10:00	U. of Michigan Consumer Sentiment	m/m	Aug	69.0	69.5	***
10:00	U. of Michigan Current Conditions	m/m	Sep P	74.8	75.7	**
10:00	U. of Michigan Future Expectations	m/m	Sep P	65.0	65.5	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Sep P	3.5%	3.5%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Sep P	3.0%	3.0%	*
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	Tertiary Industry Index	m/m	Jul	0.9%	-0.4%	-0.7%	**	Equity bullish, bond bearish
New Zealand	BusinessNZ Manufacturing PMI	m/m	Aug	46.1	46.3	46.6	***	Equity bearish, bond bullish
China	Industrial Production	y/y	Aug	4.5%	3.7%	3.9%	***	Equity bullish, bond bearish
	Retail Sales	y/y	Aug	4.6%	2.5%	3.0%	*	Equity bullish, bond bearish
India	Exports	y/y	Aug	-6.9%	-15.9%	--	**	Equity and bond neutral
	Imports	y/y	Aug	-5.2%	-17.0%	--	**	Equity and bond neutral
	Trade Balance	m/m	Aug	-$24160.0m	-$20670.0m	-$21000.0m	*	Equity and bond neutral
EUROPE								
Eurozone	Trade Balance SA	m/m	Jul	2.9b	12.5b	8.6b	**	Equity and bond neutral
France	CPI	y/y	Aug F	4.9%	4.8%	4.8%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Aug F	5.7%	5.7%	5.7%	**	Equity and bond neutral
	CPI Ex-Tobacco Index	m/m	Aug	118.00	116.81	117.99	*	Equity and bond neutral
Italy	CPI, EU Harmonized	y/y	Aug F	5.5%	5.5%	5.5%	***	Equity and bond neutral
Russia	Money Supply, Narrow Definition	w/w	15-Sep	$576.6b	$583.5b		*	Equity and bond neutral
AMERICAS								
Canada	Wholesale Sales ex Petroleum	m/m	Jul	0.2%	-2.8%	1.4%	**	Equity bearish, bond bullish
Brazil	Retail Sales	y/y	Jul	2.4%	1.3%	1.4%	***	Equity bullish, bond bearish

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	541	1	Up
10-yr T-note (%)	4.32	4.29	0.03	Flat
Euribor/OIS spread (bps)	387	385	2	Up
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Up			Down
Yen	Down			Down
Pound	Flat			Down
Franc	Down			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Russia Key Rate	13.000%	12.000%	12.000%	Above Forecast
PBOC 1-Year Med-Term Lending Facility	2.500%	2.500%	2.500%	On Forecast
PBOC 1-Year Med-Term Lending (Bil.)	591.0b	401.0b		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	$94.01	$93.70	0.33%	
WTI	$90.53	$90.16	0.41%	
Natural Gas	$2.72	$2.71	0.37%	
Crack Spread	$34.49	$34.94	-1.27%	
12-mo strip crack	$30.20	$30.27	-0.24%	
Ethanol rack	$2.60	$2.57	0.87%	
Metals				
Gold	$1,919.88	$1,910.79	0.48%	
Silver	$23.18	$22.65	2.36%	
Copper contract	$381.25	$382.15	-0.24%	
Grains				
Corn contract	$479.50	$480.50	-0.21%	
Wheat contract	$594.75	$593.75	0.17%	
Soybeans contract	$1,353.75	$1,360.50	-0.50%	
Shipping				
Baltic Dry Freight	1,340	1,290	50	
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)	57	52		

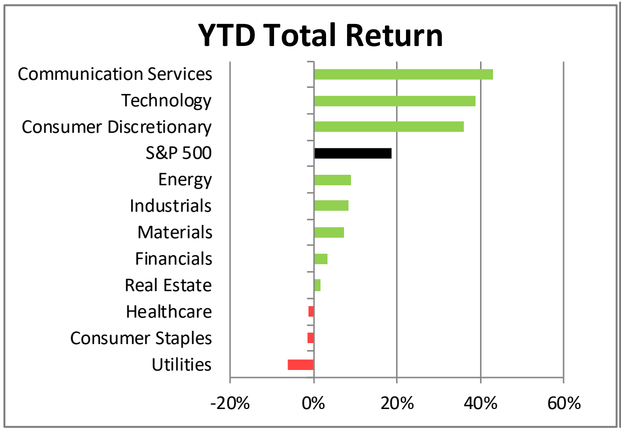
Weather

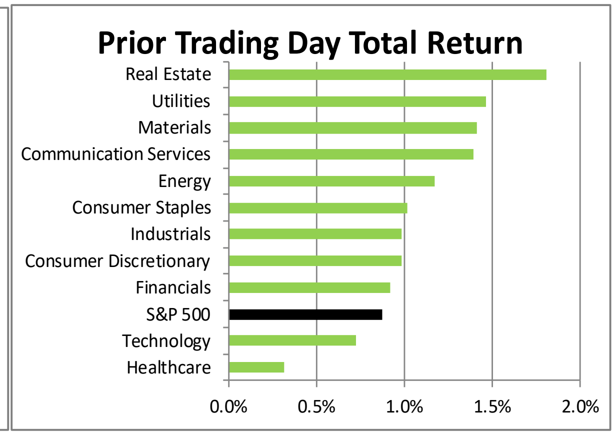
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout the entire country east of the Rocky Mountains, with below-normal temperatures throughout the Far West. The forecasts are calling for wetter-than-normal conditions in the Pacific Northwest, the northern Rocky Mountains, and the Great Plains, with dry conditions expected in the Southwest and Northeast.

There are currently three atmospheric disturbances in the Atlantic Ocean area. Hurricane Lee is currently east of Virginia and traveling northward, threatening to bring heavy rainfall and strong winds to New England and Atlantic Canada later today. Hurricane Margot, which has now been downgraded to a tropical storm, is largely stationary in the central Atlantic, west of the Azores. There is also a disturbance midway between South America and Africa, which 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 9/14/2023 close)

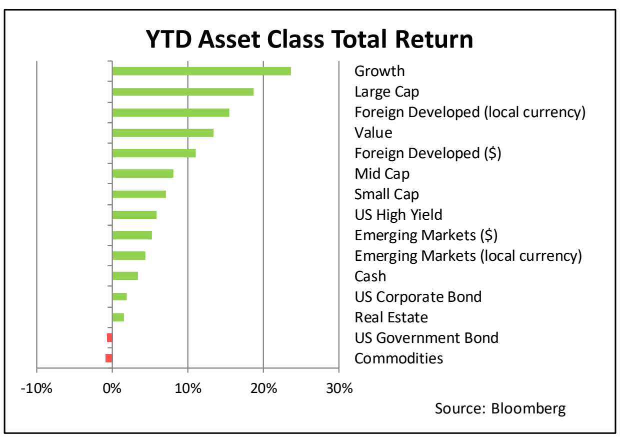




(Source: Bloomberg)

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 9/14/2023 close)

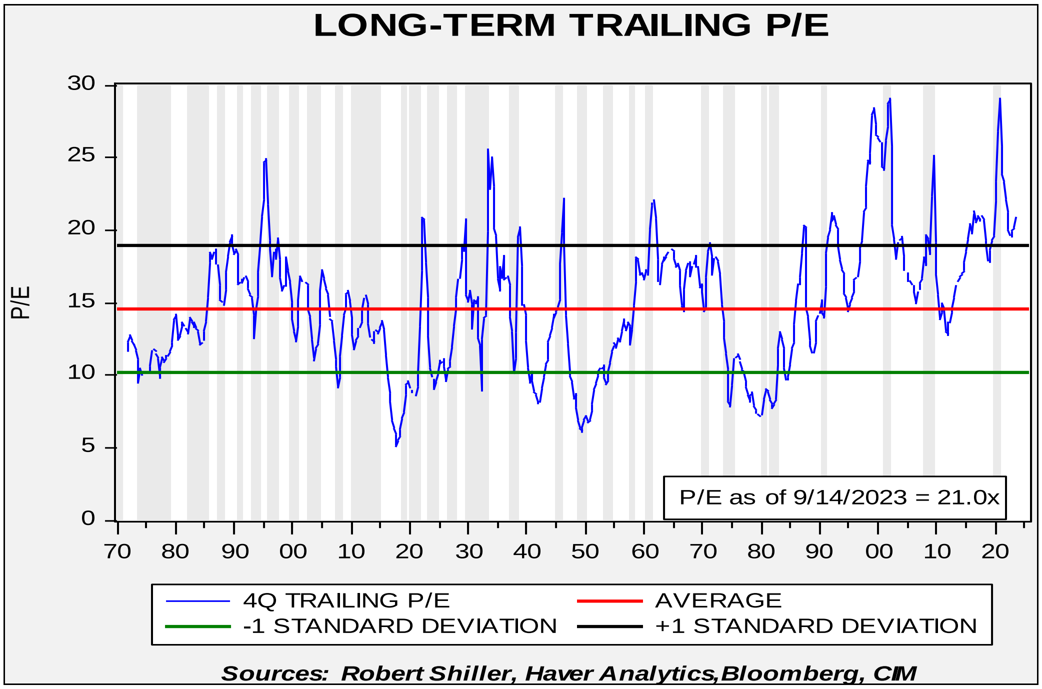


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.