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 18, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is down 1.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.7%. Chinese markets were higher, with the Shanghai Composite up 0.3% from its previous close and the Shenzhen Composite up 0.5%. 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* (9/14/2023): 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"

Our *Comment* today opens with signs that the Chinese government is working to prevent further financial market contagion related to its faltering real estate sector. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including a desire by the U.K.'s opposition leader to improve relations with the EU and new warnings about debt-financed short positions in the market for short-term U.S. Treasury futures.

Chinese Real Estate Market: Shadow-banking giant Zhongrong International Trust, which sparked concerns about a financial crisis when it missed payments on some of its trust products over the summer, said it has engaged two state-owned financial companies to help fix its operational problems. The company insists that the arrangement isn't a government bailout and that the two state-owned firms won't have responsibility to make up the missed payments to investors.

- Nevertheless, the deal is likely to be interpreted as a bailout in all but name, with the government trying to quietly stem any contagion from the country's faltering real estate market and failing developers.
- Chinese economic growth continues to struggle against what we call the ***Four Ds***: Weak consumer ***demand***, high ***debt*** levels, poor ***demographics***, and ***de-coupling*** by foreign countries. Massive excess production and high debts among the country's major real estate developers are a particular problem.

Chinese Gold Market: The central bank has lifted its temporary ban on gold imports into the country, which was imposed in August to reduce selling pressure on the renminbi (CNY). We have recently been noting stronger central-bank purchases of gold around the world, and we believe those purchases have been instrumental in buoying the price of the yellow metal. Stronger personal demand for gold in China could add to the upward pressure on gold prices.

India-China: An India-based official of iPhone assembler Foxconn (HNHPF, $6.54) said the company aims to double its workforce, investment, and activity in India in the coming year, as part of its effort to diversify production out of China. That would help keep the company on track to produce half of its iPhones in India by 2027. The plan is a further reflection of how companies are increasingly trying to hedge their bets by moving production out of China amid worsening tensions between China and the West. We believe India will be a prime beneficiary of that trend.

United Kingdom-European Union: In a *Financial Times* interview, Keir Starmer, the leader of the U.K.'s opposition Labor Party, said he would seek a major re-write of the Brexit agreement between the UK and the EU if his party wins the next election. According to Starmer, his goal in such a re-write would be to improve the U.K.'s economic relations with the EU as a way to boost economic growth. For example, he would seek to improve the deal's veterinary standards to ease U.K.-EU trade in animals and farm products.

U.S. Fiscal Policy: Consistent with our latest *Bi-Weekly Asset Allocation Report*, more analysts are starting to focus on the end of the pandemic-era moratorium on student loan payments on October 1. Over the weekend, an article in the *Wall Street Journal* estimated that re-starting student loan payments will cut overall consumer demand by about $100 billion in the coming year, as millions of consumers with student loans have to start paying $200 to $300 on their education debt again. The drop in consumer demand has the potential to finally bring about the long-expected recession, with the associated negative implications for corporate earnings and stock values.

U.S. Monetary Policy: The Federal Reserve will begin its latest policy meeting tomorrow, with its decision on interest rates due on Wednesday at 2:00 PM EDT. The policymakers are widely expected to hold the benchmark fed funds rate steady at its current range of 5.25% to 5.50%. The more important question is whether they will provide any guidance on future policy changes. While many investors continue to look for outright rate cuts in the coming months, we continue to believe they will be disappointed. We believe Chair Powell should be taken at his word when he says he will try to keep policy tight for an extended period to make sure consumer price inflation is really snuffed out.

U.S. Bond Market: Against the backdrop of the Fed's hawkish monetary policy, we're seeing more official warnings about "basis trades" by hedge funds. In its quarterly report today, the Bank for International Settlements said the associated buildup in debt-financed short positions on two-year U.S. Treasury futures could spark chaotic trading. According to the BIS, "Margin deleveraging, if disorderly, has the potential to dislocate core fixed-income markets." We will continue to monitor the situation closely.

U.S. Labor Market: Last week, the U.S. Army said it met its annual re-enlistment goal early, allowing it to suspend retention bonuses paid to re-enlisting troops at least until the end of the federal fiscal year on September 30. The U.S. Navy said it will miss its recruiting goal by about 7,000 sailors, but that is actually better than the 13,000 shortfall it expected at the beginning of the fiscal year.

- Over the last couple of years, strong labor demand in the civilian economy has made it difficult for all the services to recruit new personnel or keep current troops from leaving.
- The better-than-expected re-enlistment and recruiting figures could reflect weakening in the civilian labor market, potentially leading to slower wage growth, reduced price pressures, and an end to the Federal Reserve's long campaign of interest-rate hikes.

U.S. Auto Industry: After launching their strike against the Big Three automakers last Friday, the United Auto Workers said it resumed negotiations for a new labor contract with each of the companies over the weekend. The union suggested in a statement that it is making its best progress with Ford (F, $12.61). However, in a test of the union's novel tactic of simultaneously striking just one assembly plant at each of automakers, the firms began to warn that the strikes will force them to stop production and furlough workers at related plants. We suspect the UAW would see that as an effort to "divide and conquer," prompting the union to expand the strike.

U.S. Real Estate Industry: Demand for office space in downtown San Francisco has reportedly started to recover from its deep plummet during the coronavirus pandemic. The stronger leasing activity and renewed office-building sales stem partly from increased demand by firms in the fast-growing artificial intelligence space. Nevertheless, some of the increased building sales also reflect the fact that some owners have capitulated on price, selling their properties at steep losses.

U.S. Economic Releases

There were no economic releases prior to the publication of this report. 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	NAHB housing market Index	m/m	Sep	49	50	*
16:00	Net Long-Term TIC Flows	m/m	Jul		$195.9b	**
16:00	Total Net TIC Flows	m/m	Jul		$147.8b	**
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								
New Zealand	Non Resident Bond Holdings	m/m	Aug	62.4%	62.2%		*	Equity and bond neutral
EUROPE								
UK	Rightmove House Prices	m/m	Sep	-0.4%	-0.1%		**	Equity and bond neutral
Switzerland	Domestic Sight Deposits CHF	w/w	15-Sep	463.6b	459.5b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	15-Sep	473.0b	468.9b		*	Equity and bond neutral
AMERICAS								
Canada	Manufacturing Sales	m/m	Jul	1.6%	-1.7%	0.7%	**	Equity bullish, bond bearish
Mexico	Aggregate Supply and Demand	y/y	2Q	4.8%	5.4%	5.0%	*	Equity and bond neutral
Brazil	FGV Inflation IGP-10	m/m	Sep	0.18%	-0.13%	0.28%	*	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.

Fixed Income	Today	Prior	Change	Trend
3-mo Libor yield (bps)	566	567	-1	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)	539	539	0	Up
U.S. Libor/OIS spread (bps)	541	541	0	Up
10-yr T-note (%)	4.34	4.33	0.01	Flat
Euribor/OIS spread (bps)	388	387	1	Up
Currencies	Direction			
Dollar	Flat			Up
Euro	Flat			Down
Yen	Up			Down
Pound	Flat			Down
Franc	Flat			Flat

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	$94.43	$93.93	0.53%	
WTI	$91.28	$90.77	0.56%	
Natural Gas	$2.64	$2.64	-0.11%	
Crack Spread	$31.17	$32.48	-4.04%	Supply Optimism
12-mo strip crack	$28.75	$29.27	-1.77%	
Ethanol rack	$2.57	$2.58	-0.43%	
Metals				
Gold	$1,926.37	$1,923.91	0.13%	
Silver	$23.12	$23.04	0.38%	
Copper contract	$378.70	$380.10	-0.37%	
Grains				
Corn contract	$476.00	$476.25	-0.05%	
Wheat contract	$594.75	$604.25	-1.57%	
Soybeans contract	$1,337.25	$1,340.25	-0.22%	
Shipping				
Baltic Dry Freight	1,381	1,340	41	

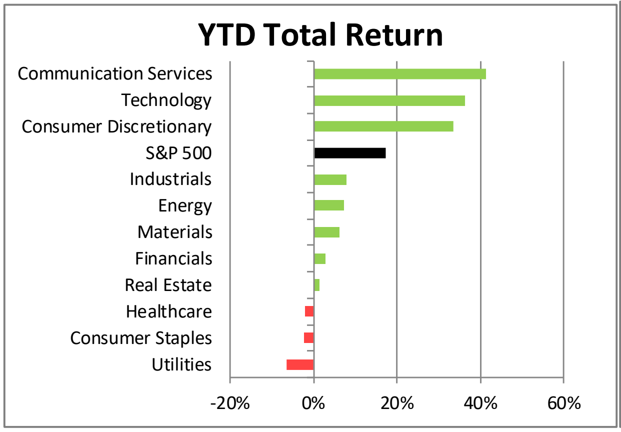
Weather

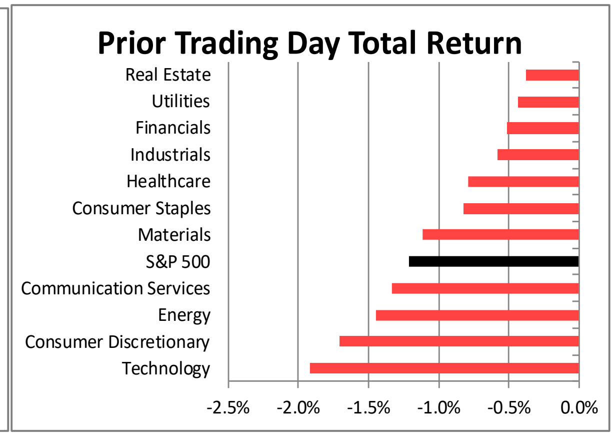
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout most of the country, with below-normal temperatures throughout the southern Pacific. The precipitation outlook is calling for wetter-than-normal conditions in most states east of the Rockies and in the northern Pacific, with dry conditions expected in the Southwest and Great Lakes region.

There is currently one atmospheric disturbance in the Atlantic Ocean area. Hurricane Nigel is moving through the central Atlantic; however, it is not expected to make landfall. We note that Atlantic hurricane activity peaks, on average, September 15.

<u>Data Section</u>

U.S. Equity Markets – (as of 9/15/2023 close)

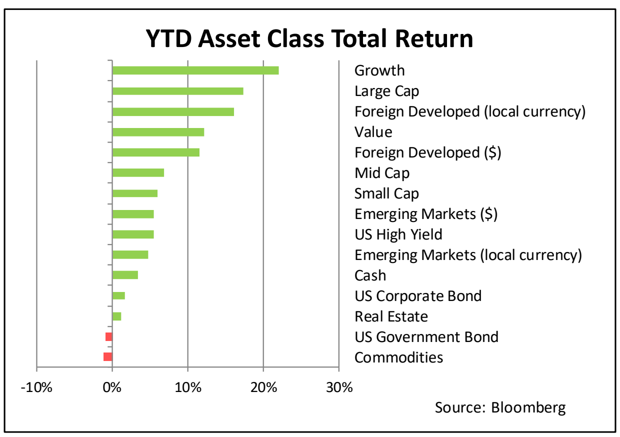




(Source: Bloomberg)

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 9/15/2023 close)

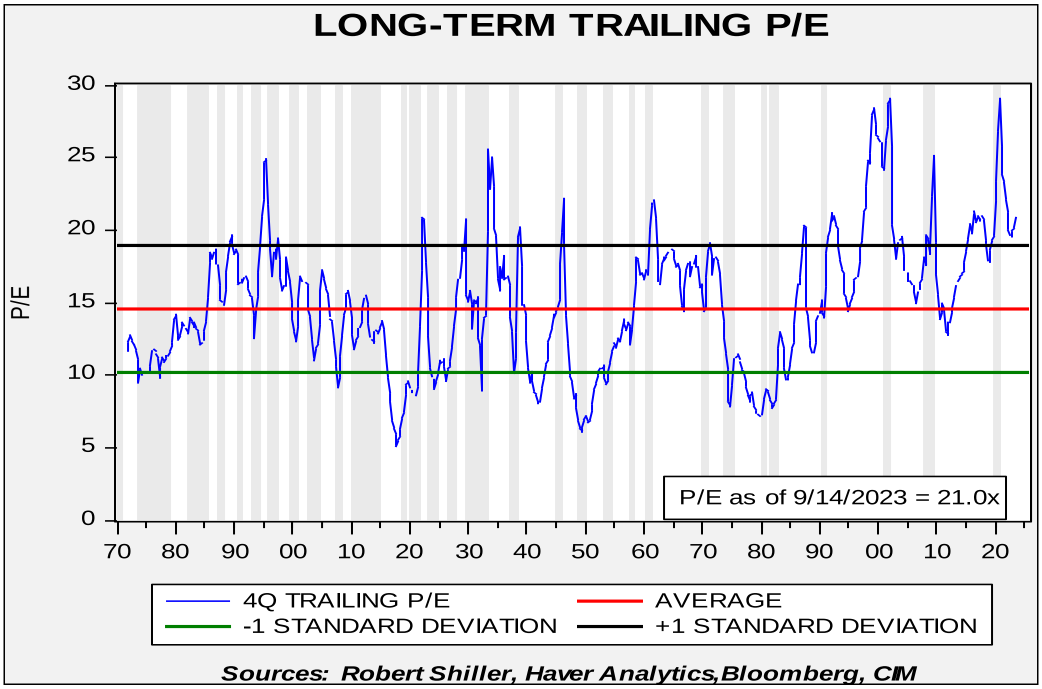


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.