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 20, 2023—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.5% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.6%. Chinese markets were lower, with the Shanghai Composite down 0.5% 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* (9/18/2023) (with associated podcast): "Goodbye Prigozhin"
- *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 the evolving relationship between the European Union and China. We next review a range of other international and U.S. developments with the potential to affect the financial markets today, including a short military operation in the Caucasus country of Azerbaijan that has apparently thwarted ethnic-Armenian separatists who had been supported by Russia, and a preview of the Federal Reserve's interest-rate decision today.

China-European Union: Jens Eskelund, president of the EU Chamber of Commerce in China, issued a statement defending the European Commission's decision last week to launch an anti-subsidy investigation into China's exports of electric vehicles. Because of the past experience when the EU's solar panel industry was decimated by cheap Chinese imports, Eskelund said it should be "understandable" that the EU now wants to prevent the same thing from happening with EVs.

- Eskelund suggested the problem is excess EV manufacturing capacity in China, which the government should address by supporting domestic consumption.
- That's consistent with the analysis of many economists, including us at Confluence, who believe the Chinese economy is riddled with excess capacity and high debt. In contrast, Chinese consumer spending remains weak, and savings rates are very high.
- All the same, Communist Party ideology and political habits find it difficult to countenance policies aimed at greater consumption and increased consumer choice. President Xi, therefore, is unlikely to give up on China's export-led, neo-colonialist economic policies anytime soon.

China: While China's excess capacity in sectors such as EVs and residential real estate is widely recognized, the country also has a lot of excess office space. Recent data shows office vacancies in 18 major Chinese cities reached almost 24.0% in June, even worse than the U.S. vacancy rate of 18.2%. The difference is that China's excess office space simply reflects massive over-building by developers and tepid uptake as economic growth slows. The U.S. problem is more tied to the rapid shift toward employees working from home following the coronavirus pandemic.

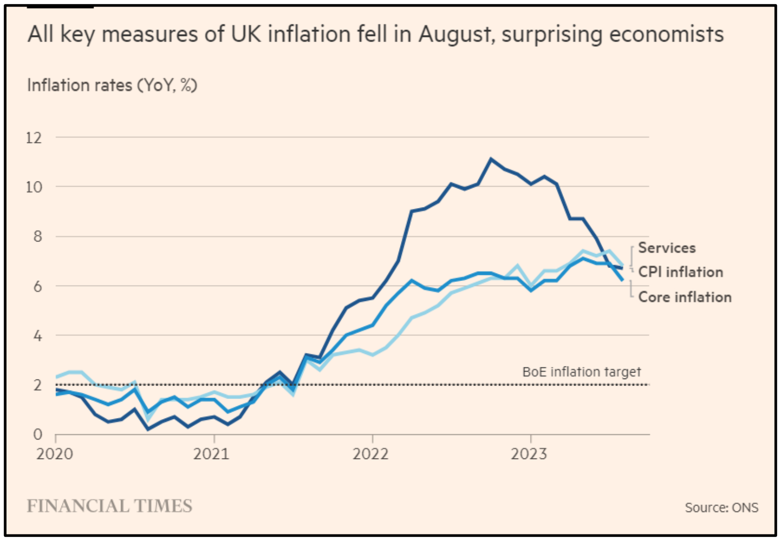
European Union: EU lawmakers this week will start negotiating over the final text of their proposed "Platform Work Directive," a law that would designate gig workers as de facto employees. In response, officials from ride-hailing giant Uber (UBER, $47.59) warned that if the law isn't sufficiently flexible, it would force the company to pull out of many smaller cities in Europe and raise prices as much as 40%.

France: The Rassemblement National Party, led by right-wing populist Marine Le Pen, announced that it has paid back the remaining 6 million euros ($6.4 million) or so that it owed to a Russian company. The loan has been a political liability for the party since it was taken out in 2014, as it has raised concern that the party was under the influence of Russia and President Putin. Paying off the loan, therefore, puts the party in a better position to contest future elections, especially as right-wing sentiment grows throughout Europe.

United Kingdom: The August consumer price index was up 6.7% from the same month one year earlier, much better than the expected increase of 7.0% and down from 6.8% in July. The August "core" CPI—which in the U.K. excludes food, energy, alcohol, and tobacco—was up just 6.2% year-over-year, beating expectations that it would be up 6.9%, just as it was in the year ended in July.

- The better-than-expected figures have boosted hopes that the Bank of England can pause its interest-rate hikes at its next policy meeting on Thursday.
- In turn, that has driven down British bond yields today, with the yield on the two-year Gilt falling to 4.84%.

- That has given a boost to interest-sensitive sectors of the country's stock market today, such as homebuilders and real estate firms.
- The drop in bond yields has also driven down the attractiveness of the pound (GBP). At this writing, the GBP is trading at $1.2379, down about 0.1% for the day.



Russia-Ukraine War: Two weeks after Ukrainian President Zelensky fired his former defense minister for corruption, the government sacked six deputy defense ministers who were apparently involved in the scandal. The effort to clean house suggests Zelensky is intent on presenting the Ukrainian government in the best possible light as he works to maintain foreign military support from the U.S. and other allies and keep up domestic political support at home.

Azerbaijan-Armenia: The former Soviet republic of Azerbaijan yesterday launched what it called "anti-terrorist" military strikes in its breakaway region of Nagorno-Karabakh, where the largely ethnic-Armenian population has long worked to join neighboring Armenia. The strikes follow several weeks in which Azerbaijan carried out a military buildup on the region's borders and imposed a blockade apparently aimed at forcing ethnic Armenians out. With the Armenians' Russian supporters distracted by the war in Ukraine, reports this morning say they have already capitulated, likely setting the stage for Nagorno-Karabakh to be re-integrated into Azerbaijan.

- In international political terms, Russia's unwillingness or inability to protect the Armenians is a further blow to Moscow's prestige and influence. That will also likely push the country of Armenia closer into the embrace of the U.S.
- The outcome is also probably a positive for Turkey, which has longstanding disputes with the Armenians and has supported Azerbaijan.

U.S. Monetary Policy: The Federal Reserve will wrap up its latest policy meeting today, with its decision on interest rates due at 2:00 PM EDT. The officials are widely expected to hold the benchmark fed funds rate steady at its current range of 5.25% to 5.50%. The question is whether they'll provide any guidance on future policy changes. Many investors continue to look for rate cuts in the coming months, but we think they'll be disappointed. We think the Fed will try to keep policy tight for an extended period to make sure consumer price inflation is dead.

- As investors increasingly come around to the idea that the Fed will likely keep rates higher for longer, they continue to sell longer-maturity obligations.
- The yield on the benchmark 10-year Treasury note yesterday closed at 4.366%, reaching its highest level since 2007. The yield on the two-year Treasury rose to 5.109%, for its highest level since 2006.

U.S. Regulatory Policy: Ahead of a new zero-emissions rule in California for commercial trucks that kicks in January 1, truckers are accelerating their shift to electric trucks and stocking up on diesel rigs they soon won't be able to buy. Since California's market is so large, the buying activity could spur a noticeable increase in the national demand for electric trucks, charging stations, and even diesel rigs.

- Specifically, the rule will require that trucks purchased in 2024 and later can serve the state's ports only if they are zero-emission vehicles.
- Diesel rigs won't be able to serve California ports at all starting in 2035.

U.S. Economic Releases

Residential loan demand surged last week, offering a glimmer of hope in a challenging housing market. Mortgage applications rose 5.4% in the week ending September 15, suggesting that the market may have rebounded from its recent low, despite higher borrowing costs. The MBA refinancing and purchasing indexes were also up 2% and 13%, respectively, from the previous week. However, the 30-year fixed-rate mortgage ticked up 4 basis points to 7.31%.

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

Economic Releases		
	No economic releases for the rest of today	
Federal Reserve		
EST	**Speaker or Event**	**District or Position**
14:30	Fed Chair Holds Press Conference Following FOMC Meeting	Chairman of the Board of Governors

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	Trade Balance	m/m	Aug	-¥930.5b	-¥78.7b	-¥66.3b	***	Equity and bond neutral
	Exports	m/m	Aug	-0.8%	-0.3%	-2.1%	*	Equity and bond neutral
	Imports	m/m	Aug	-17.8%	-13.5%	-13.6%	*	Equity and bond neutral
Australia	Westpac Leading Index	m/m	Aug	-0.04%	-0.03%	0.01%	**	Equity bearish, bond bullish
New Zealand	BoP Current Account Balance	q/q	2Q	-4.208b	-5.215b	-4.662b	**	Equity and bond neutral
	Current Account GDP Ratio YTD	q/q	2Q	-7.5	-8.5	-8.2	*	Equity bullish, bond bearish
South Korea	PPI	y/y	Aug	1.0%	-0.2%	0.0%	**	Equity bullish, bond bearish
EUROPE								
Eurozone	EU27 New Car Registrations	y/y	Aug	21.0%	15.2%		***	Equity bullish, bond bearish
	Construction output	y/y	Jul	1.0%	-0.3%	-0.8%	*	Equity bullish, bond bearish
Germany	PPI	y/y	Aug	-12.6%	-6.0%	-12.5%	**	Equity and bond neutral
UK	CPI	y/y	Aug	6.7%	6.8%	7.0%	***	Equity and bond neutral
	Core CPI	y/y	Aug	6.2%	6.9%	6.8%	***	Equity and bond neutral
	Retail Price Index	m/m	Aug	376.6	374.2	377.3	**	Equity and bond neutral
	RPI YoY	y/y	Aug	9.1%	9.0%	9.3%	**	Equity and bond neutral
AMERICAS								
Canada	CPI	m/m	Aug	4.0%	3.3%	3.8%	***	Equity and bond neutral
Mexico	International Reserves Weekly	w/w	15-Sep	204178m	$203920m		*	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	566	0	Up
3-mo T-bill yield (bps)	531	529	2	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 (%)	4.35	4.36	-0.01	Flat
Euribor/OIS spread (bps)	393	390	3	Up
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Up			Down
Yen	Flat			Down
Pound	Down			Down
Franc	Up			Flat
Central Bank Action	**Current**	**Prior**	**Expected**	
PBOC 1-Year Loan Prime Rate	3.450%	3.450%	3.450%	On Forecast
PBOC 5-Year Loan Prime Rate	4.200%	4.200%	4.200%	On 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	$93.56	$94.34	-0.83%	
WTI	$90.44	$91.20	-0.83%	
Natural Gas	$2.75	$2.85	-3.37%	
Crack Spread	$29.74	$30.56	-2.69%	
12-mo strip crack	$28.15	$28.93	-2.69%	
Ethanol rack	$2.49	$2.49	-0.33%	
Metals				
Gold	$1,932.71	$1,931.36	0.07%	
Silver	$23.32	$23.20	0.52%	
Copper contract	$376.95	$374.70	0.60%	
Grains				
Corn contract	$477.25	$476.25	0.21%	
Wheat contract	$591.50	$584.00	1.28%	
Soybeans contract	$1,315.25	$1,315.50	-0.02%	
Shipping				
Baltic Dry Freight	1,526	1,439	87	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.7		
Gasoline (mb)		1.1		
Distillates (mb)		1.1		
Refinery run rates (%)		-1.0%		
Natural gas (bcf)		66		

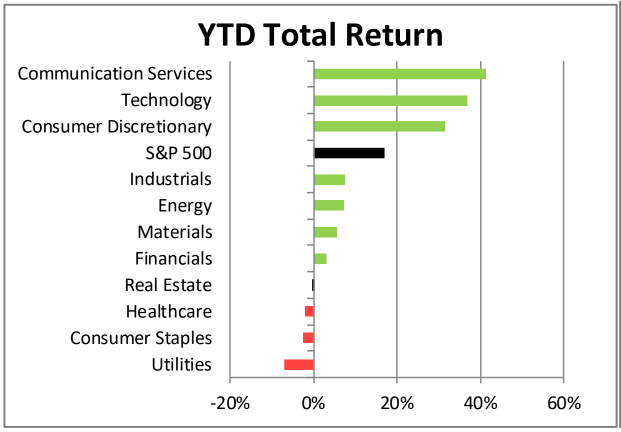
Weather

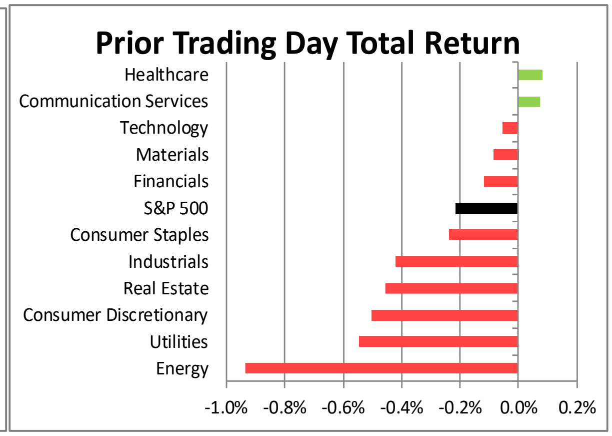
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout most of the country, with below-normal temperatures throughout the southern Pacific region. The precipitation outlook calls for wetter-than-normal conditions in the Northwest and Midwest, while the states along the Mississippi River are expected to remain dry.

There are currently two atmospheric disturbances in the Atlantic Ocean, but only one is a major storm. Hurricane Nigel is moving through the central Atlantic; however, it is not expected to make landfall. Additionally, there is a disturbance developing off the West African Coast. We note that Atlantic hurricane activity peaks, on average, September 15.

Data Section

U.S. Equity Markets – (as of 9/19/2023 close)

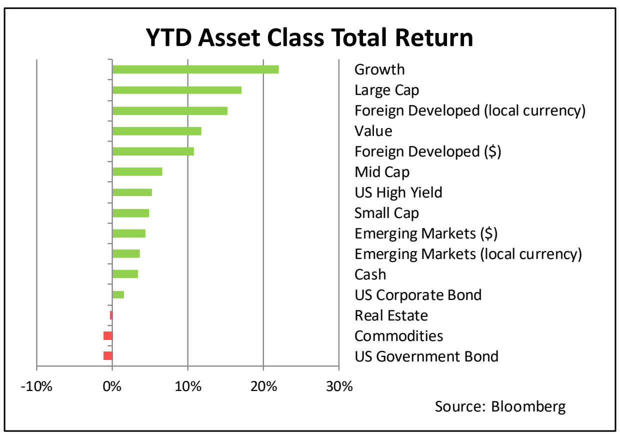




(Source: Bloomberg)

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 9/19/2023 close)

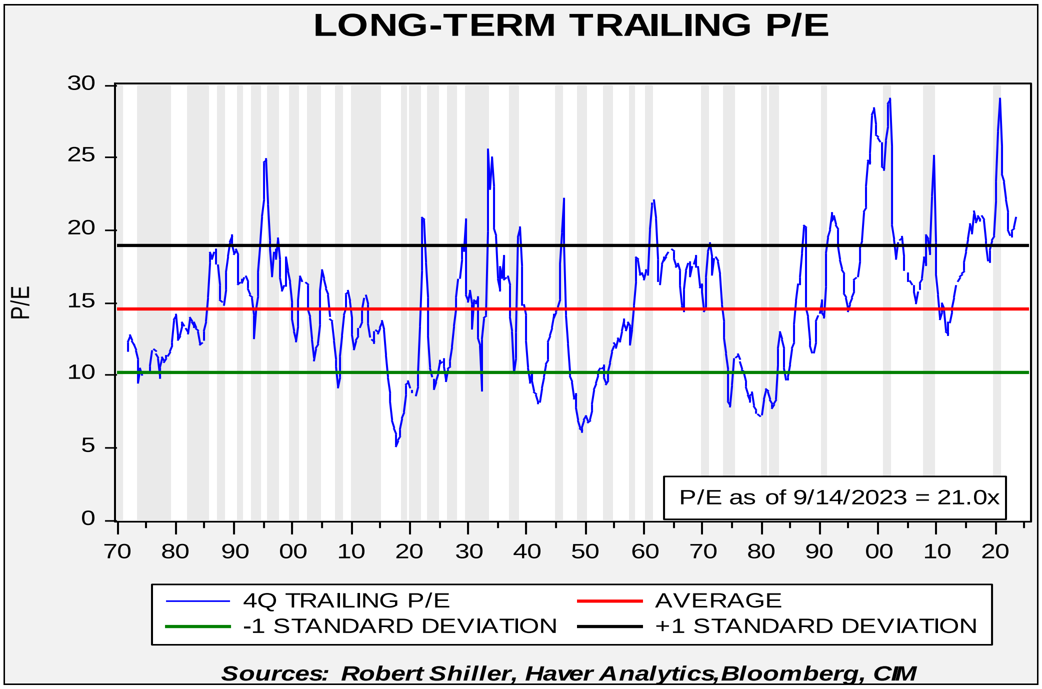


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.