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 21, 2023—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is down 1.5% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.7%. Chinese markets were lower, with the Shanghai Composite down 0.8% from its previous close and the Shenzhen Composite also down 0.8%. 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* (9/18/2023) (with associated podcast): "Goodbye Prigozhin"
- ***Weekly Energy Update*** **(9/21/2023): Crude oil prices remain elevated due to the recent OPEC+ supply restrictions. The Iranian prisoner swap has been completed, but Iran's relations with the IAEA remain strained due to the expelling of about a third of the nuclear weapons inspectors.**
- *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"

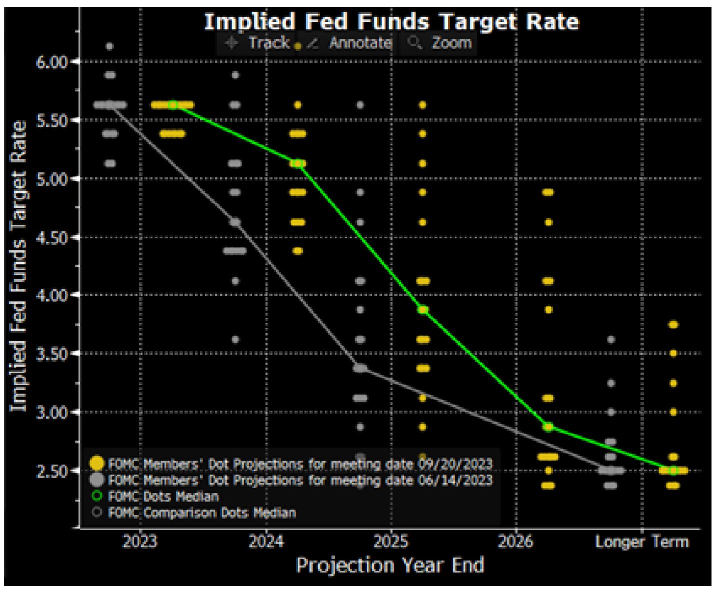
Good morning! Today's *Comment* is split into three sections: 1) How the Federal Reserve's latest rate decision will impact its policy for next year; 2) Why governments may be forced to moderate some of their climate goals; and 3) Why support for Ukraine may face more resistance as the war rages on.

Hawkish Pause? The Fed held rates steady at its September 19-20 meeting but signaled the possibility of another hike before the year's end.

- The Federal Open Market Committee (FOMC) kept rates unchanged at 5.25%-5.50% at its September 19-20 meeting, pausing its aggressive rate-hike campaign. Fed Chair

Jerome Powell said the committee will look at the data before deciding whether to adjust policy. The latest FOMC dot plots showed that policymakers are divided on whether to hold rates at their current level or increase them again. Traders, though, are optimistic that the Fed has ended its tightening cycle, projecting a nearly 54% likelihood of a pause in rates, according to the latest forecast from the CME FedWatch Tool.

- Policymakers are more optimistic about the economy in 2024, revising up their June projections for GDP growth from 1.1% to 1.5% and the unemployment rate down from 4.5% to 4.1%, according to the Summary of Economic Projections (SEP). However, the Fed statement acknowledges that it expects the tighter financial conditions on households and businesses are likely to weigh on economic activity and hiring. During the press conference, Powell suggested that the central bank's goal is a soft landing and implied that the committee may adjust policy if conditions change. This cautious optimism may explain why officials left inflation expectations largely unchanged for 2024.



(Source: Bloomberg)

- The improved outlook for 2024 likely explains the Federal Reserve's hawkish tilt in the latest dot plots. The median fed funds targets were revised upwards for 2024, 2025, and the longer-term, reflecting policymakers' belief that the economy is still too hot for comfort. Additionally, this may suggest that Fed officials are willing to keep interest rates restrictive for longer in order to bring inflation under control as long as the economic data remains positive. It is possible that if economic conditions start to deteriorate, then the Fed may pivot. That said, Fed officials still project that rates will be 25 basis points below their current levels by the end of 2024, while the market projects a decline of 50 basis points.

Net Zero Reality: The United Kingdom walked back its climate change plans, and we suspect other countries may follow.

- British Prime Minister Rishi Sunak is delaying key green initiatives, citing concerns about over-ambitious targets. Sunak has delayed the ban on new petrol and diesel cars and oil boilers until 2035, relaxed the phaseout target for gas boilers, and abandoned efficiency rules for landlords. These policy reversals appear to be a way for him to distinguish himself from the opposition ahead of elections in late 2024 or early 2025. The Conservative Party plans to portray the Labour Party as out of touch with everyday households after the Labour Party vowed to reinstate the target once elected, despite the potential costs it will have on consumers.
- The U.K. is not alone in its reconsideration of climate change policy, particularly when it comes to electric vehicles. In the United States, Republican frontrunner Donald Trump has criticized his rival Joe Biden's EV mandate, believing that it will kill the auto industry. Meanwhile, the countries in the European Union are struggling to cope with the influx of Chinese EVs as it aims to ban the sale of combustion engine cars in a little over a decade. To contain the fallout, the EU Commission has launched a probe into Chinese dumping claims.
- The green transition, particularly towards electric vehicles, is a key part of achieving energy independence and reducing reliance on authoritarian governments for resources. The recent production cuts by Russia and Saudi Arabia have shown the dangers of importing oil. The quickest way to reach energy independence would be to import Chinese vehicles, but this would lead to a greater dependency on another potential rival. The other alternative is to develop electric vehicles domestically, which would provide greater stability but is a slower and more arduous process. We believe that the latter option is more likely to succeed in the long term, but it will require significant political will and investment.

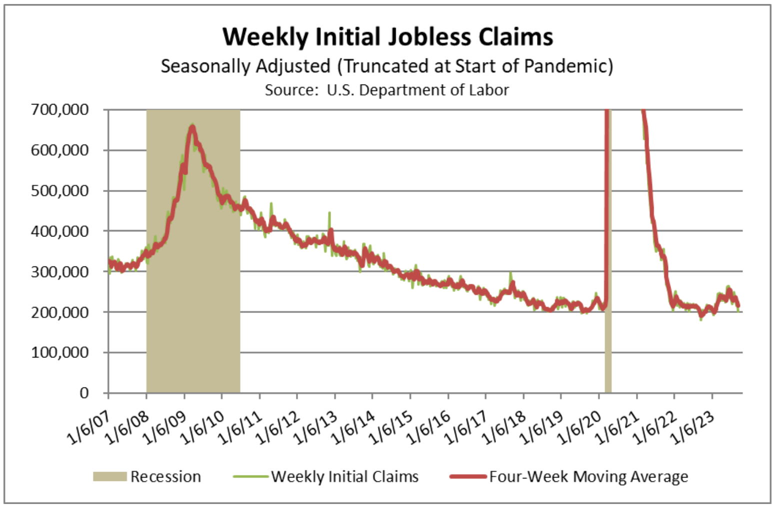
War in Ukraine: The ongoing row between Ukraine and several Eastern European countries highlights flaws in the West's support for Ukraine.

- Ukraine announced that it will sue Poland, Hungary, and Slovakia over their bans on Ukrainian agricultural goods, which were imposed after the EU allowed bloc-wide restrictions to expire. The three countries claim that the bans are necessary to protect their local producers from foreign competition, but Ukraine argues that they are illegal and could undermine a key source of revenue for the country as it defends itself from Russia. In retaliation, Poland has signaled that it may halt weapons transfers to Ukraine and is considering additional protectionist measures.
- The dispute comes at a perilous time for Ukraine. Its counteroffensive has yet to achieve significant victories, and outside countries are finding it harder to justify the cost of the war as they try to control their budget deficits. The United States has given Ukraine nearly $80 billion in aid since the invasion began in February 2022, while the EU has given nearly $30 billion. Ukrainian President Volodymyr Zelensky is set to meet with Congressional leaders on Thursday to convince Republicans to back away from their demand to reduce security aid as a condition of passing a new government budget. Although Zelensky is likely to receive a warm reception, he is unlikely to sway some of the hawkish lawmakers.

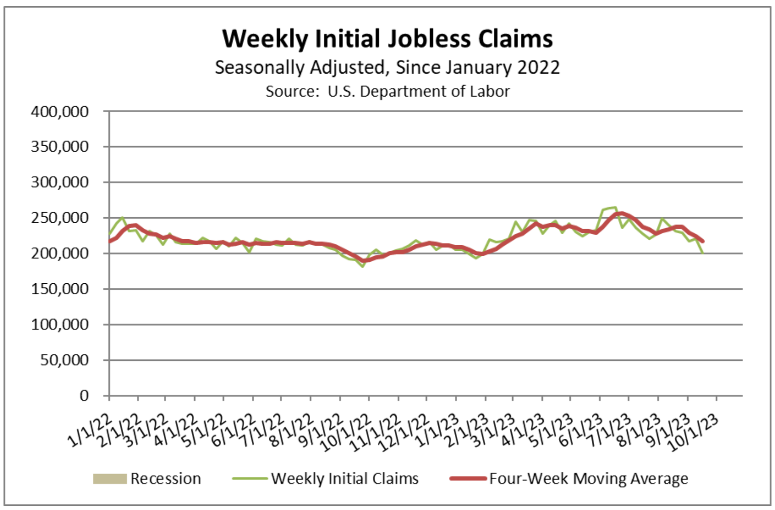
- The dispute over imports is the most visible sign of disunity regarding the backing of Ukraine. Despite largely urging countries in the European Union to reverse their bans on Ukrainian products, the EU is also considering helping to defend these governments from Ukraine's lawsuit. At the same time, U.S. policy toward Ukraine is increasingly in disarray, with more politicians urging for a more domestic shift in policy. While it is unlikely that the West will pull its support anytime soon, it is becoming evident that patience is wearing thin. A potential end to the war could lead to a boost in equities as it reduces market uncertainty over commodity prices.

U.S. Economic Releases

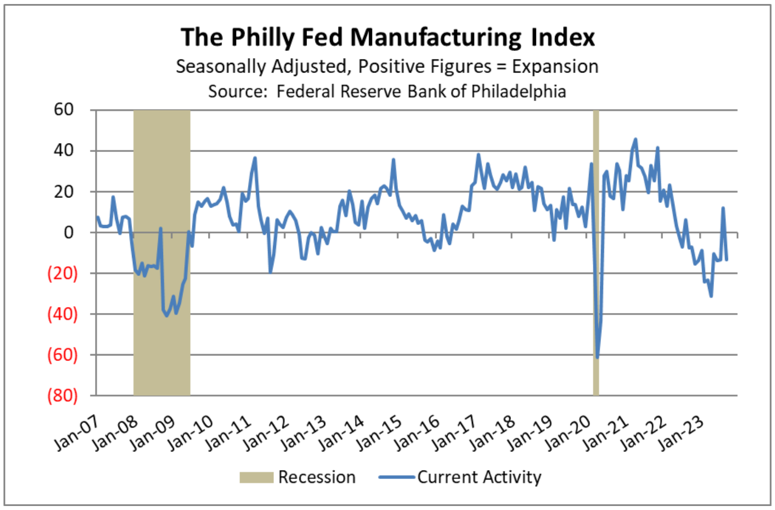
In the week ended September 16, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 201,000, below the expected 225,000 and the prior week's revised 221,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to a seven-month low of 217,000. In the week ended September 9, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) declined to 1.662 million, far below the anticipated 1.692 million and the previous week's revised reading of 1.683 million. Together, the figures point to some new tightening in the labor market, which could help sustain the Fed's hawkish stand on monetary policy for the time being. The following chart 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.



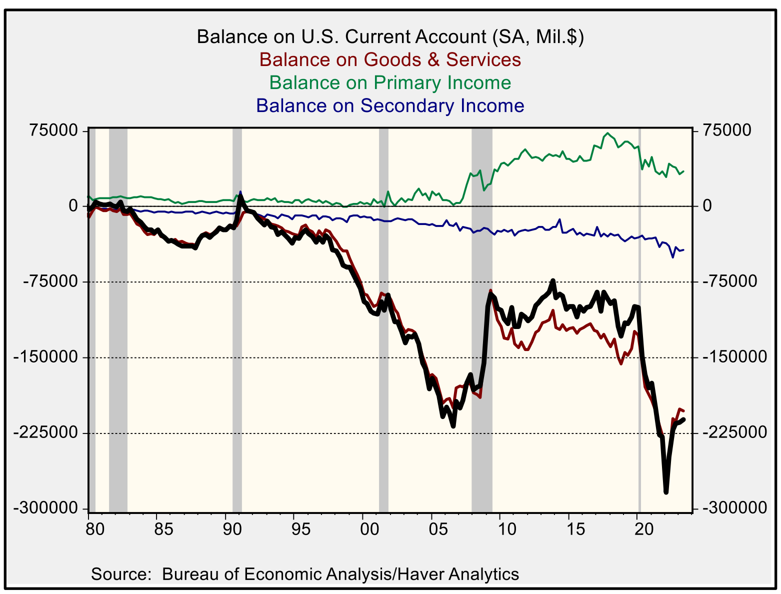
To provide more detail on recent trends, the chart below shows how initial jobless claims have changed just since the beginning of 2022.



Separately, the Philadelphia FRB said its September ***Philly Fed Index*** fell to a seasonally adjusted -13.5, even worse than the expected level of -1.0 and the August level of 12.0. The index, officially called the Philadelphia FRB Manufacturing Activity Index, is designed so that positive readings point to expanding factory activity in the mid-Atlantic region. At its current level, the index suggests mid-Atlantic manufacturing has slipped back into contraction. The following chart shows how the index has fluctuated since just before the Great Financial Crisis.



Another report today focused on the country's overall balance of international current transactions. The second-quarter ***current account balance*** showed a deficit of $212.1 billion, better than the anticipated shortfall of $220.0 billion and the first quarter's revised shortfall of $214.5 billion. The overall current account balance has been in deficit almost constantly since globalization really began to take hold at the beginning of the 1980s, mostly reflecting the U.S. trade deficit. The chart below shows the overall current account balance since 1980, along with each of its three components: the balance on trade in goods and services, primary income (mostly income on foreign investments), and secondary income (gifts, remittances, personal transfers, etc.).



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	Leading Index	m/m	Aug	-0.5%	-0.4%	***
10:00	Existing Home Sales (monthly change)	m/m	Aug	4.10m	4.07m	**
10:00	Existing Home Sales (annualized selling rate)	m/m	Aug	0.7%	-2.2%	***
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								
New Zealand	GDP	q/q	2Q	1.8%	2.2%	1.2%	**	Equity bullish, bond bearish
EUROPE								
France	Business Confidence	m/m	Sep	100	99	100	**	Equity and bond neutral
	Manufacturing Confidence	m/m	Sep	99	96	97	*	Equity and bond neutral
	Production Outlook Indicator	y/y	Sep	-6	-9	-9	*	Equity and bond neutral
	Retail Sales	y/y	Aug	-4.0%	-2.1%	-1.8%	*	Equity bearish, bond bullish
UK	House Price index	y/y	Jul	0.6	1.7	1.9	**	Equity bearish, bond bullish
Switzerland	M3 Money Supply	y/y	Aug	-2.1%	-1.6%		**	Equity and bond neutral
Russia	PPI	m/m	Aug	10.60%	4.10%		*	Equity and bond neutral
AMERICAS								
Mexico	Retail Sales	y/y	Jul	5.1%	5.9%	4.9%	***	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	532	-1	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	540	539	1	Up
U.S. Libor/OIS spread (bps)	542	541	1	Up
10-yr T-note (%)	4.47	4.41	0.06	Flat
Euribor/OIS spread (bps)	393	393	0	Up
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Down
Yen	Up			Down
Pound	Down			Down
Franc	Down			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
FOMC Rate Decision (Lower Bound)	5.250%	5.250%	5.250%	On Forecast
FOMC Rate Decision (Upper Bound)	5.500%	5.500%	5.500%	On Forecast
FOMC Rate on Reserve Balances	5.400%	5.400%	5.400%	On Forecast
BOJ Policy Balance Rate	-0.100%	-0.100%	-0.100%	On Forecast
BOJ 10-yr Yield Target	0.000%	0.000%	0.000%	On Forecast
Bank of England Bank Rate	5.250%	5.250%	5.500%	Below Forecast
Swiss National Bank Policy Rate	1.750%	1.750%	2.000%	Below Forecast
Brazil Selic Rate	12.750%	13.250%	12.750%	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	$93.40	$93.53	-0.14%	
WTI	$89.61	$89.66	-0.06%	
Natural Gas	$2.71	$2.73	-0.73%	
Crack Spread	$29.22	$29.66	-1.48%	
12-mo strip crack	$28.23	$28.16	0.27%	
Ethanol rack	$2.49	$2.49	-0.13%	
Metals				
Gold	$1,918.40	$1,930.30	-0.62%	
Silver	$23.02	$23.24	-0.94%	
Copper contract	$366.35	$377.60	-2.98%	
Grains				
Corn contract	$478.75	$482.25	-0.73%	
Wheat contract	$585.00	$588.75	-0.64%	
Soybeans contract	$1,305.50	$1,320.00	-1.10%	
Shipping				
Baltic Dry Freight	1,584	1,526	58	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.1	-1.7	-0.4	
Gasoline (mb)	-0.8	1.1	-1.9	
Distillates (mb)	-2.9	1.1	-3.9	
Refinery run rates (%)	-1.8%	-1.0%	-0.8%	
Natural gas (bcf)		65		

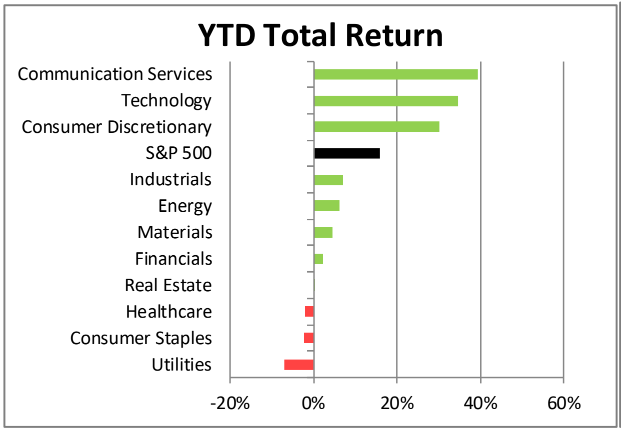
Weather

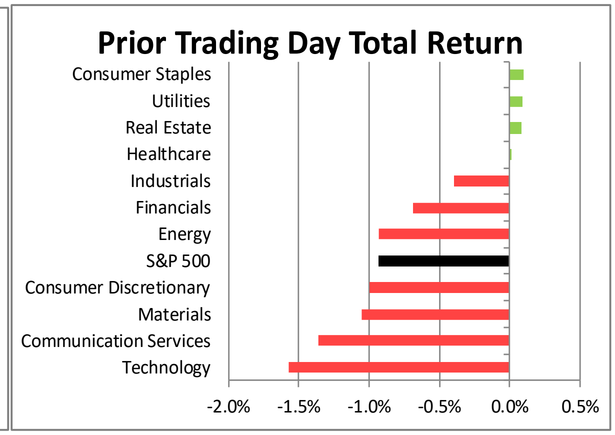
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout the Great Plains and Mississippi Valley regions, with below-normal temperatures only along the West Coast. The forecasts call for wetter-than-normal conditions in the Pacific Northwest, the northern Rocky Mountains, and the northern Great Plains with dry conditions throughout the Mississippi Valley region and the Northeast.

There are currently three atmospheric disturbances in the Atlantic Ocean. Hurricane Nigel is situated in the central Atlantic and moving northeasterly, but it is not expected to make landfall. There is also a disturbance off the eastern coast of Florida, which is assessed to have a 30% chance of developing into a cyclone. A disturbance off the western coast of Africa is assessed to have a 20% chance of developing into a cyclone. On average, Atlantic hurricane activity peaks on September 15.

Data Section

U.S. Equity Markets – (as of 9/20/2023 close)

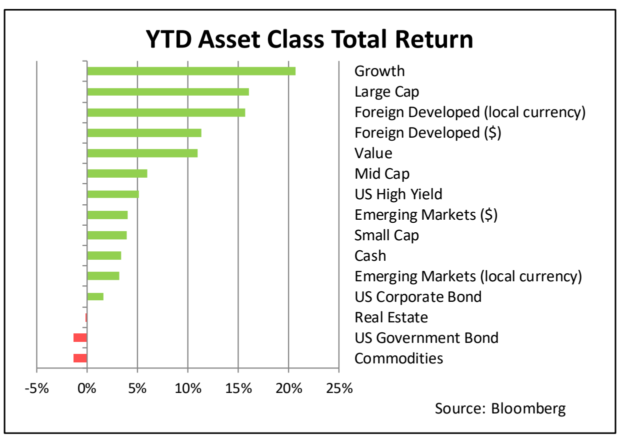




(Source: Bloomberg)

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 9/20/2023 close)

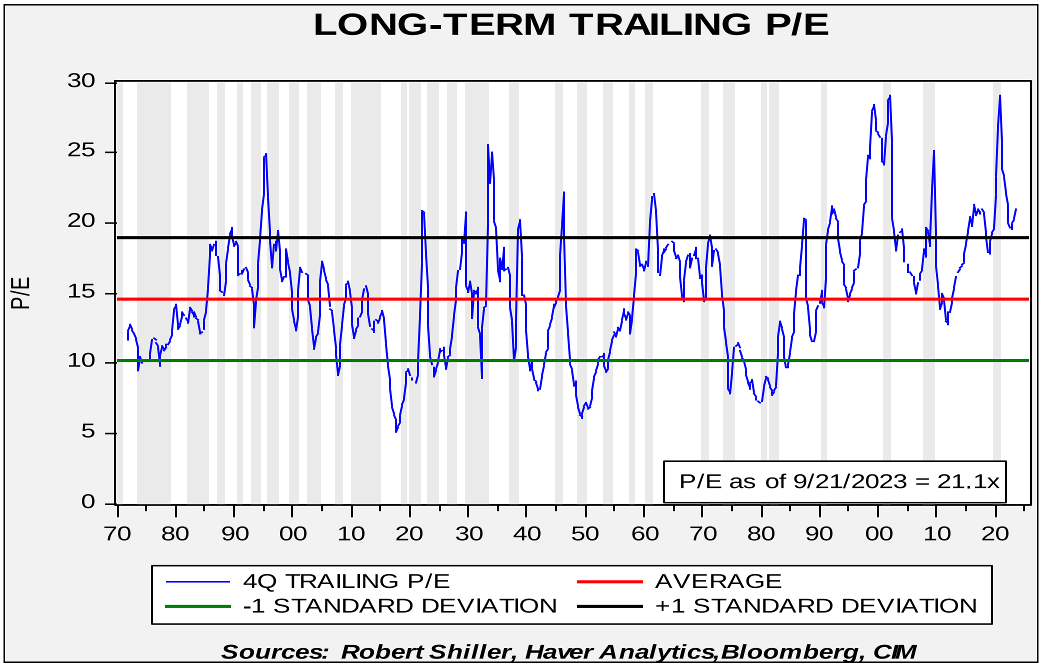


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 21, 2023



Based on our methodology,[1] the current P/E is 21.1x, up 0.1x from last week. Weaker earnings estimates led to the rise in the multiple.

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.