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 26, 2023—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is down 0.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.3%. Chinese markets were lower, with the Shanghai Composite down 0.4% from its previous close and the Shenzhen Composite down 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* (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* (9/25/2023) (with associated podcast): "Where's the Recession? A Recap"
- *Confluence of Ideas* podcast (8/22/2023): "The Economics of Defense in Great Power Competition"

Our *Comment* today opens with a new report from the International Energy Agency that could further discourage needed investments in fossil fuel supplies and could help drive energy prices even higher in the coming years. We then review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including additional confirmation that the European Union intends to clamp down on its trade with China and signs of preparations for a partial shutdown of the U.S. government which could begin on Saturday.

Global Climate Change Policy: The International Energy Agency has issued a new report estimating that global use of fossil fuels would have to fall 25% by 2030 in order for nations to meet their goal of net-zero greenhouse gas emissions and realize their hopes of limiting global temperature increases. The report comes amid intensifying pushback against the IEA from the world's oil and natural gas industry, which is accusing the agency of being too alarmist and too reckless in discouraging the fossil energy investments needed to fuel the world until greener technologies are ready for wider use. We have also noted that many governments around the world, especially in Europe, have started to step back from their most aggressive climate-stabilization policies amid pushback from voters.

- While the report also called for faster deployment of green energy technologies, it warned they may not be ready soon enough. Therefore, "Prolonged high prices would result if the decline in fossil fuel investment in this scenario were to precede the expansion of clean energy." In the IEA's view, an orderly transition is "far from guaranteed."
- Coupled with potential supply disruptions associated with the U.S.-China geopolitical rivalry, we think the regulatory and financial-market headwinds against fossil-fuel exploration and development will likely crimp supplies going forward. That's a key reason why we think mineral commodities will be in a prolonged bull market in the coming years, once we get past the soft growth or recession that seems likely in the near term.

Saudi Arabia: Energy Minister Prince Abdulaziz bin Salman told the annual conference of the International Atomic Energy Agency that the Kingdom of Saudi Arabia will adopt a strict "Comprehensive Safeguards Agreement" with the agency that will allow IAEA inspectors to monitor Saudi nuclear activities. The move provides more evidence that Saudi Arabia is pushing hard to win a U.S.-run nuclear processing facility as part of its price for normalizing relations with Israel. Besides the nuclear processing facility, the Saudis are also seeking security guarantees from the U.S.

- Saudi-U.S.-Israeli negotiations toward normalization are continuing.
- In the meantime, it is increasingly clear that the Saudis are holding down crude oil production to boost global energy prices and heap additional pressure on President Biden for concessions.
- Along with the recent dearth in new fossil fuel development, the cut in production by Saudi Arabia and its allies continues to boost global oil prices. So far this morning, Brent crude is trading down 0.7% at $91.29 per barrel, but that's still up dramatically from only about $71.75 in early summer.
- The rise in energy prices has also increased worries that consumer price inflation will prove stickier than earlier thought, prompting the Fed to keep interest rates higher for longer. As a result, the yield on the benchmark 10-year Treasury note closed yesterday at a multi-year high of 4.541%.

European Union-China: During a speech in Beijing, EU Trade Commissioner Dombrovskis warned yesterday that China's "lack of reciprocity and a level playing field [in trade], coupled with wider geopolitical shifts, has [sic] forced Europe to become more assertive." Coming so soon after EU Commission President von der Leyen's recent announcement of an anti-subsidy probe into Chinese electric vehicle exports, and shortly before Dombrovskis was scheduled to meet Chinese Vice Premier He Lifeng, the trade commissioner's statement helped confirm that the EU has swung around to a more protectionist stance regarding trade and investment with China.

- Dombrovskis also warned today that the EU's anti-subsidy investigation would include vehicles made by Western companies in China.
- Although Chinese-made EVs currently account for only a modest share of European sales, their rapidly advancing quality and lower costs are expected to help them capture a huge amount of market share in the coming years.
- Almost all of the Chinese-made EVs currently sold in Europe are from Chinese-owned European brands such as Britain's MG, owned by China's SAIC (600104.SS, CNY, 14.86), or from joint ventures between European and Chinese companies.

South Korea: Lee Bok-hyun, governor of the Financial Supervisory Service, said he thinks South Korea has now met most of the conditions to be included in the FTSE Russell World Government Bond Index. The index managers are expected to meet soon to decide on any changes in index constituents. If they decide to include South Korea, the country is expected to account for up to 2.5% of the index, which would likely translate into around $65 billion of additional purchases of the country's government bonds.

United States-South Pacific Islands: President Biden yesterday hosted the leaders of 16 different South Pacific nations at the White House as part of an effort to keep them from falling for China's recent diplomatic, military, and economic overtures. At the meeting, Biden announced several new embassies and aid programs for the region. However, Solomon Islands Prime Minister Sogavare failed to show up for the meeting, illustrating his increasing alignment with Beijing.

U.S. Government Shutdown: Some lawmakers are reportedly working on an emergency bill to protect active-duty troops from losing their pay in the event of a partial government shutdown which could start on Saturday. As during the shutdown of October 2013, the legislation would aim to protect troop morale and avoid imposing financial difficulties on military families. However, unlike the legislation in 2013, this bill would also apply to members of the Coast Guard.

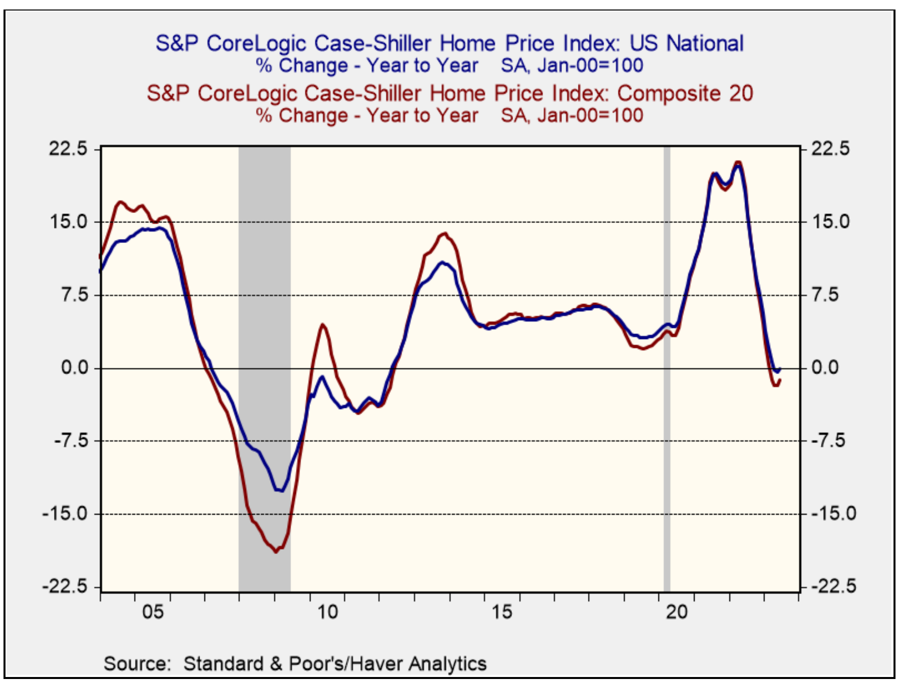
- Even if troop pay is protected, more than half of the Defense Department's large civilian workforce would likely be furloughed.
- That illustrates how the economy could face a large hit to demand in the event of a partial shutdown. In addition, Moody's (MCO, $322.81), the last major credit assessment firm with a AAA rating on Treasury debt, warned yesterday that it would consider a shutdown to be "credit negative" for U.S. obligations.
- As we argued in our *Comment* yesterday, a shutdown could potentially have a big impact on today's "slow bicycle economy," which has likely lost enough momentum to become more susceptible to recession even if there is only a modest hit to demand or confidence.

U.S. Electrical Vehicle Industry: Ford Motor (F, $12.58) announced it will pause construction of a controversial factory in Dearborn, Michigan, where it planned to make electric vehicle batteries using technology from Chinese green-tech giant Contemporary Amperex Technology, or CATL (300750.SZ, CNY, 206.27). Ford said the pause was caused in part by the on-going United Auto Workers' strike, but it also cited unspecified other issues. That could mean the company has gotten cold feet after being criticized for relying on Chinese technology and seeing how many governments around the world are stepping back from their climate-change regulations.

- Regarding the strike, today both President Biden and Former President Trump will visit the UAW picket lines in Michigan to show their support for the workers. Biden's visit will mark the first time a sitting president has ever joined the strikers on a picket line.
- Of course, the visits by such high-stature politicians are likely to further encourage the strikers. Despite the UAW being happy with some recent concessions by Ford in the negotiations, it doesn't look like the work stoppage will end anytime soon.

U.S. Economic Releases

U.S. home prices continue to accelerate despite rising mortgage rates. The Federal Housing Finance Agency House Price Index rose 4.6% since July 2022. The increase was above expectations of 2.9% and faster than the previous month's rise of 3.1%. At the same time, the S&P CoreLogic National and Top 20-City Home Price Index rose 1.0% and 0.10%, respectively, within the same period.



The chart above shows the annual change in the S&P CoreLogic Top 20-City and National Home Price Indexes. Home prices have surged again in recent months due to high interest rates which are discouraging potential sellers from putting their homes on the market. This lack of supply, combined with sustained demand, is driving housing inflation.

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	New Home Sales - Annualized Selling Rate	m/m	Aug	698k	714k	***
10:00	New Home Sales - Monthly Change	m/m	Aug	-2.2%	4.4%	**
10:00	Conf. Board Consumer Confidence	m/m	Sep	105.5	106.1	***
10:00	Conf. Board Present Situation	m/m	Sep		144.8	**
10:00	Conf. Board Expectations	m/m	Sep		80.2	**
10:00	Richmond Fed Manufact. Index	m/m	Sep	-7	-7	**
10:30	Dallas Fed Services Activity	m/m	Sep		-2.7	**
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
13:30	Michelle Bowman Delivers Welcoming Remarks	Member 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	Services PPI	y/y	Aug	2.1%	1.7%	1.8%	*	Equity bearish, bond bullish
South Korea	Consumer Confidence	y/y	Sep	99.7	103.1		*	Equity bearish, bond bullish
South Korea	Retail Sales	y/y	Aug	3.3%	5.9%		**	Equity bearish, bond bullish
	Depart. Store Sales	y/y	Aug	-4.9%	2.1%		*	Equity bearish, bond bullish
	Discount Store Sales	y/y	Aug	-5.4%	2.6%		*	Equity bearish, bond bullish
AMERICAS								
Brazil	IBGE Inflation IPCA - 15	y/y	Sep	5.00%	4.24%	5.02%	*	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)	530	530	0	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	539	538	1	Up
U.S. Libor/OIS spread (bps)	541	540	1	Up
10-yr T-note (%)	4.50	4.54	-0.04	Flat
Euribor/OIS spread (bps)	398	396	2	Up
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Flat			Down
Yen	Flat			Down
Pound	Down			Down
Franc	Flat			Down

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	$92.52	$93.29	-0.83%	
WTI	$88.91	$89.68	-0.86%	
Natural Gas	$2.58	$2.64	-2.27%	Supply Pessimism
Crack Spread	$24.26	$24.84	-2.34%	
12-mo strip crack	$25.84	$26.32	-1.84%	
Ethanol rack	$2.51	$2.51	-0.01%	
Metals				
Gold	$1,911.59	$1,915.92	-0.23%	
Silver	$23.01	$23.14	-0.57%	
Copper contract	$366.30	$367.00	-0.19%	
Grains				
Corn contract	$480.50	$481.25	-0.16%	
Wheat contract	$592.75	$589.00	0.64%	
Soybeans contract	$1,303.50	$1,297.75	0.44%	
Shipping				
Baltic Dry Freight	1,614	1,593	21	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.0		
Gasoline (mb)		-1.0		
Distillates (mb)		-2.0		
Refinery run rates (%)		-0.7%		
Natural gas (bcf)		66		

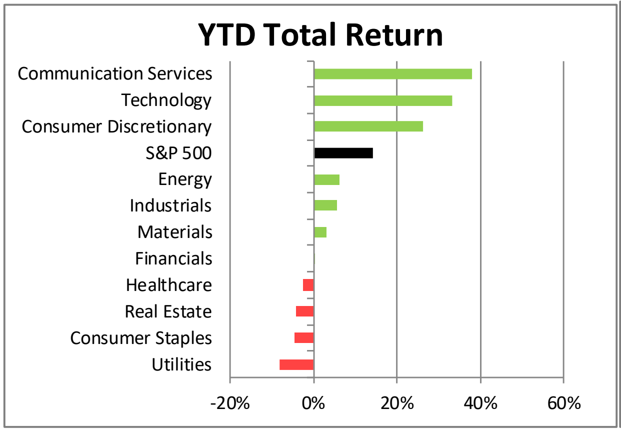
Weather

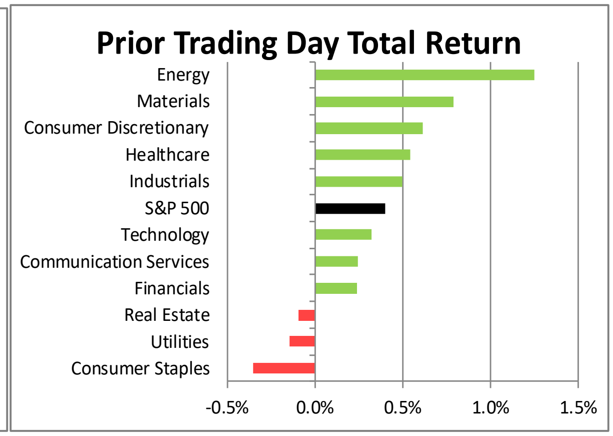
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout most of the country with below-normal temperatures in the Far West. The precipitation outlook calls for wetter-than-normal conditions for most states west of the Mississippi River with dry conditions in the parts of the Southeast, Midwest, and New England.

Two atmospheric disturbances are currently active in the Atlantic Ocean, with one already a major storm and another likely to form within the next 48 hours. Tropical Storm Philippe is in the central Atlantic Ocean and is expected to weaken to a depression as it approaches Puerto Rico. The other disturbance is also located in the central Atlantic Ocean and away from any nearby landmasses. It has a 70% chance of forming into a cyclone in the next two days. On average, Atlantic hurricane activity peaks on September 15.

Data Section

U.S. Equity Markets – (as of 9/25/2023 close)

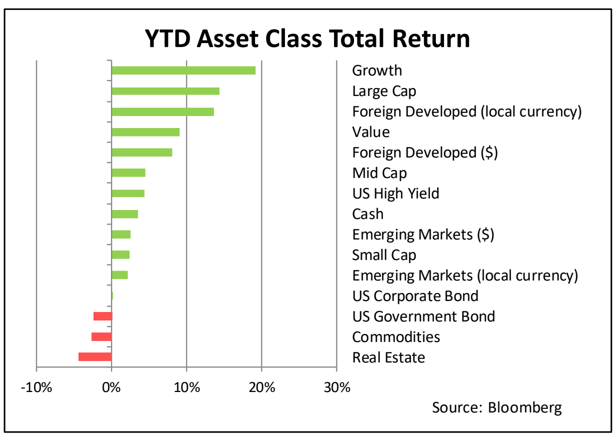




(Source: Bloomberg)

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 9/25/2023 close)

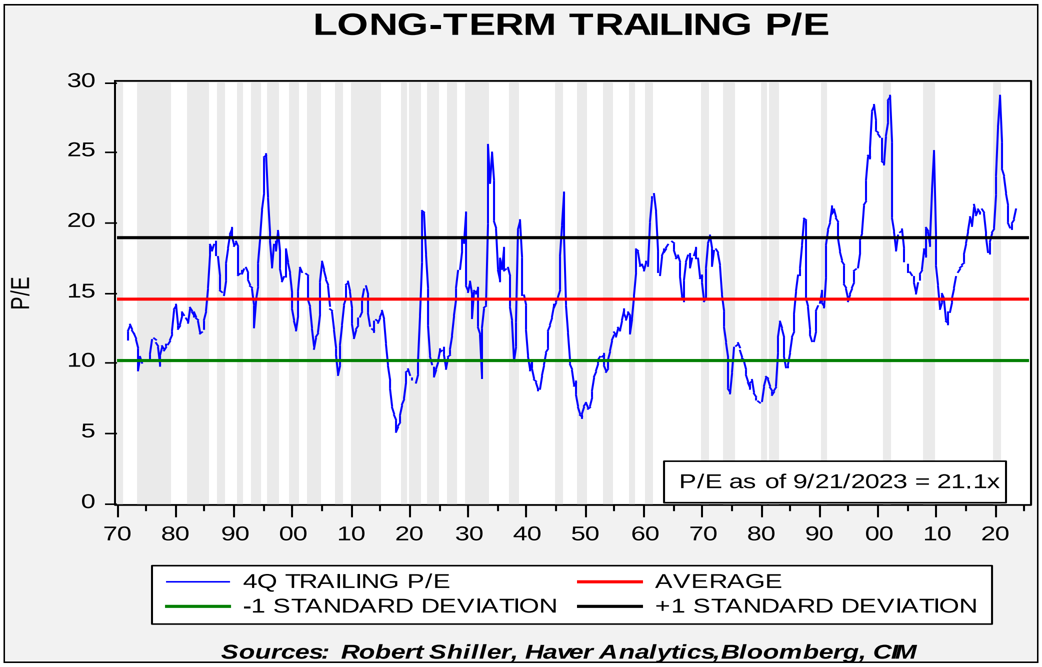


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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.