# 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 29, 2023—9:30 AM EDT]** Global equity markets are higher 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 1.4%. Chinese markets were closed for the Mid-Autumn Festival. 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:

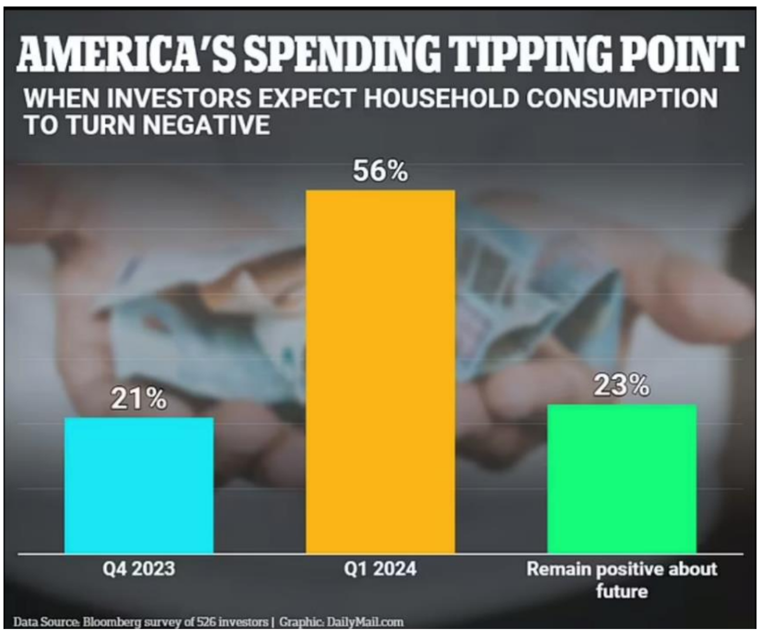
- *Bi-Weekly Geopolitical Report* (9/18/2023) (with associated podcast): "Goodbye Prigozhin"
- *Weekly Energy Update* (9/28/2023): Crude oil prices continue to rise as inventories decline. In the latest reporting week, crude oil stockpiles fell despite falling refining activity. We also discuss Europe's rapid moves to prevent Chinese EVs from swamping their automobile markets.
- *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"
- ***Business Cycle Report* (9/28/2023)**

Good morning! Today's *Comment* will begin with a discussion of the potential for a soft landing, Europe's budget problems, and an update on government shutdown talks. As usual, our report also provides an overview of the latest domestic and international data releases.

**New Economic Fears:** As investors embrace the possibility of a soft landing, there are growing signs that economic expansion is losing steam.

- The pandemic did not distort the economy as much as many had feared, according to a benchmark revision. Average U.S. economic activity growth between 2017 and 2022 was revised upwards from 2.1% to 2.2%. This slight upward revision suggests that the reporting during that period was relatively accurate. However, the underlying details show that there were still some noticeable changes. Household savings levels were revised downwards by about $1.1 trillion, although much of this update happened in the years prior to the pandemic. Meanwhile, the personal consumption price index showed that inflation rose 4.1% in 2022, above the previously reported 3.7%.

- Despite the slight change in GDP figures which reaffirmed economists' beliefs that the economy has been more resilient since leaving the pandemic, the future remains less clear. Consumption has remained stable throughout 2023 but has decelerated in four of the five previous quarters. This shift in purchases reflects households switching from expensive durable goods to cheaper services. As a result, over 56% of the economists surveyed believe that consumption will decline in the first quarter of 2024, while 21% believe that the contractions could start as soon as the final quarter of 2023. Since it accounts for a little over a third of GDP, a significant drop in consumer spending may push the economy into a downturn.



(Source: DailyMail)

- Persistent strikes, rising oil prices, and delays in the impact of interest rates raise the risk of a hard landing. These headwinds are likely to exacerbate an already vulnerable economy. However, barring an outlier event, such as a war or a government default on its debt, the next recession may not be as bad as the previous two. The pandemic drop in the labor force suggests that workers who are laid off will have an easier time finding work than in typical downturns, and business investment will likely receive a boost from manufacturing. As a result, we are optimistic that equities are unlikely to be severely affected by a slowdown in economic activity.

**What Deficit?** The euro bloc may face challenges in getting its members to comply with budget limits by its desired deadline.

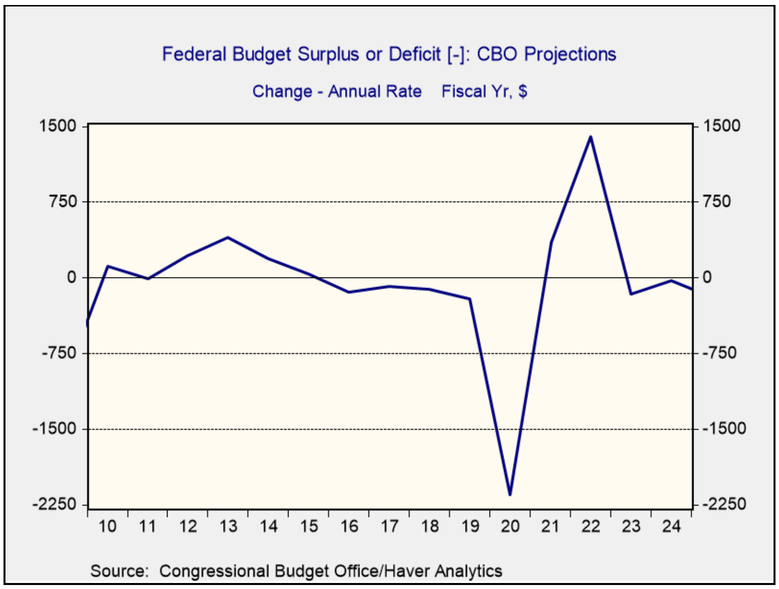
- The eurozone is expected to reinstate its 3% deficit target in early 2024, but two major economies, Italy and France, are not ready. Italy's deficit is projected to be 4.4% of GDP, and France's is projected to be around 4.3%. These shortfalls come as the eurozone prepares to return to rules that were put on hold due to the pandemic. French President [Emmanuel Macron has struggled to pass a budget] due to his party lacking a majority. Meanwhile, Italian Prime Minister [Giorgia Meloni's right-wing party still plans to follow through on its tax cut promises]. It is not clear how strictly the bloc will enforce the rules, but it is likely to lead to significant friction between members.
- Concerns over rising deficits in the eurozone have led to a jump in European bond yields. The spread between the Italian and German 10-year government bonds, a gauge of financial stress, has climbed to a six-month high. The sharp increase in interest rates is due to concerns that the European Central Bank (ECB) will have to keep rates higher for longer to fight inflation, as well as the potential for an oil price shock. The rise in borrowing will likely exacerbate concerns that the region is headed for recession over the next coming months.


- Though a downturn is widely anticipated, governments have limited options to soften the blow. Policymakers at the ECB are hesitant to pivot from their hawkish stance, as inflation shows signs of returning. Government budget constraints will likely prevent another round of fiscal stimulus. The outlook for Europe over the next three months is bleak, and any improvement will depend on member states' willingness to compromise on deficits or a complete reversal in monetary policy. Such uncertainty will likely weigh on the euro as investors try to gauge what is next for the bloc.

**Shutdown Politics:** The U.S. government is on the verge of paralysis as lawmakers continue to play political brinkmanship with the nation's finances.

- Congress has until Saturday to pass a bill to keep the government open. The [House of Representatives has passed three appropriations bills] that largely maintain defense-related expenditures. However, the House still has eight remaining appropriations bills to pass to keep the government fully funded. The political standoff in Congress, which is split in both houses, is making it difficult to reach an agreement. Grandstanding from members of the GOP Freedom Caucus, in particular, is hindering progress. The Senate has already passed a short-term spending bill, but the House is not expected to call it to a vote. The standoff may not last longer than a week, but it is unclear what is needed to get the ball rolling.

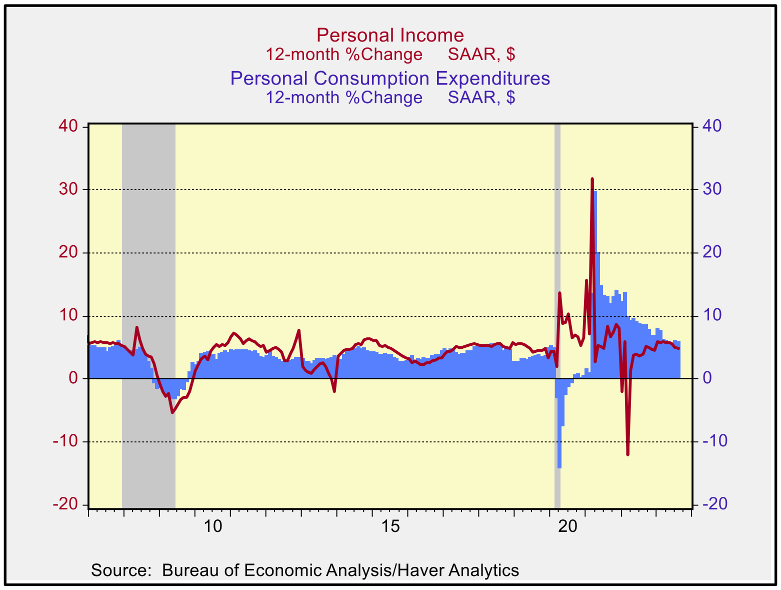
- The row over government debt continues to unnerve investors, highlighting government dysfunction. Moody's, the last of the big three credit rating agencies to give the U.S. its highest rank, has warned that the wrangling could jeopardize its stance on U.S. government debt. At the same time, Federal Reserve Chair Jerome Powell has warned that a delay in releasing data could complicate policymakers' ability to judge the economy's state, especially the heavily watched job employment numbers, which could lead to market volatility.



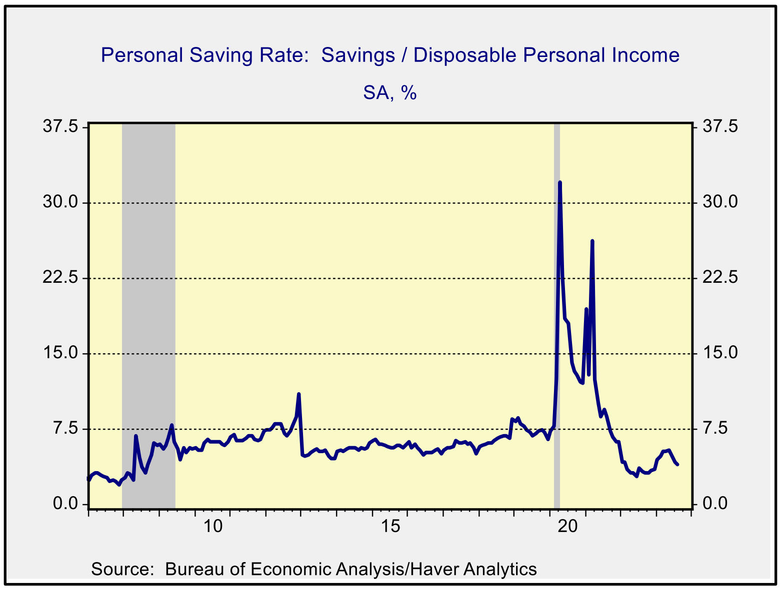

- Legislative gridlock is likely to persist over the next few years, as neither Republicans nor Democrats have been able to create a unified message for the country. This growing partisanship suggests that neither side will be able to make major changes to the economic system without the help of the court system, which typically favors conservatives. Therefore, it is unlikely that the government will be able to reach a long-term resolution on its burgeoning debt burden. While this may make investors less likely to hold U.S. Treasury securities, we do not believe that these concerns will outweigh other issues, such as inflation and economic growth.

## U.S. Economic Releases

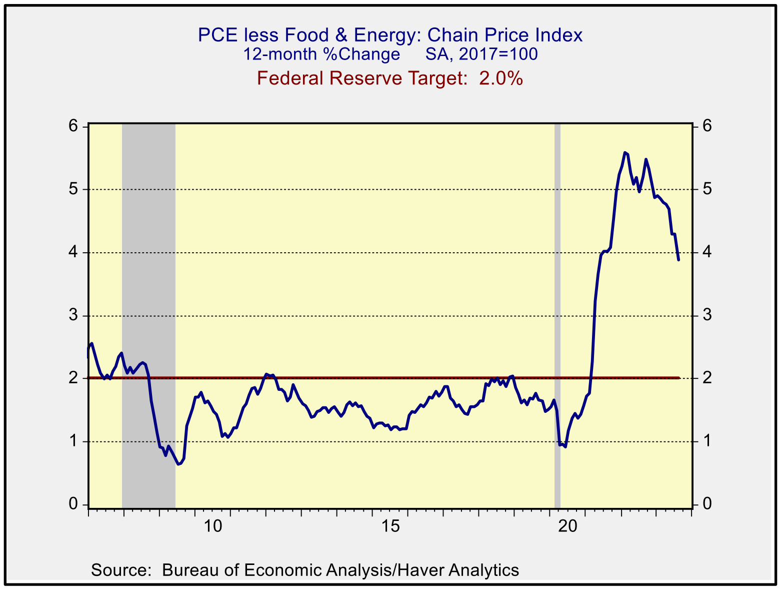
In today's most important report, August ***personal income*** rose by a seasonally adjusted 0.4%, matching expectations and accelerating from the July increase of 0.2%. As it turns out, August ***personal consumption expenditures (PCE)*** also rose 0.4%, but that was a bit shy of the anticipated increase of 0.5% and far weaker than the revised July gain of 0.9%. Personal income in August was up 4.8% from the same month one year earlier, while PCE was up 5.9%. The chart below shows the year-over-year change in personal income and PCE since just before the Great Financial Crisis.



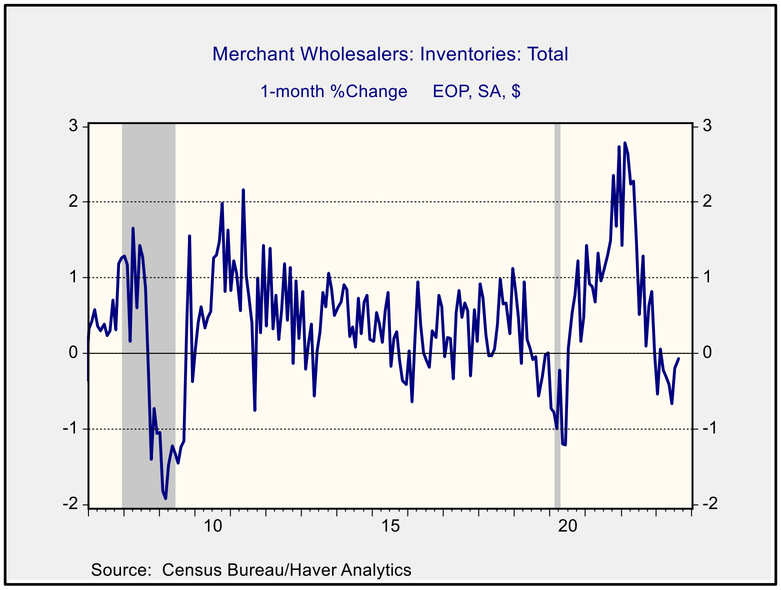

The personal income and spending report also includes a measure of personal saving, defined as disposable (after tax) income less consumption spending on goods and services. The August ***personal savings rate*** fell to a seasonally adjusted 3.9%, reaching its lowest level since last November. The chart below shows how the personal savings rate has fluctuated since just before the Great Financial Crisis.



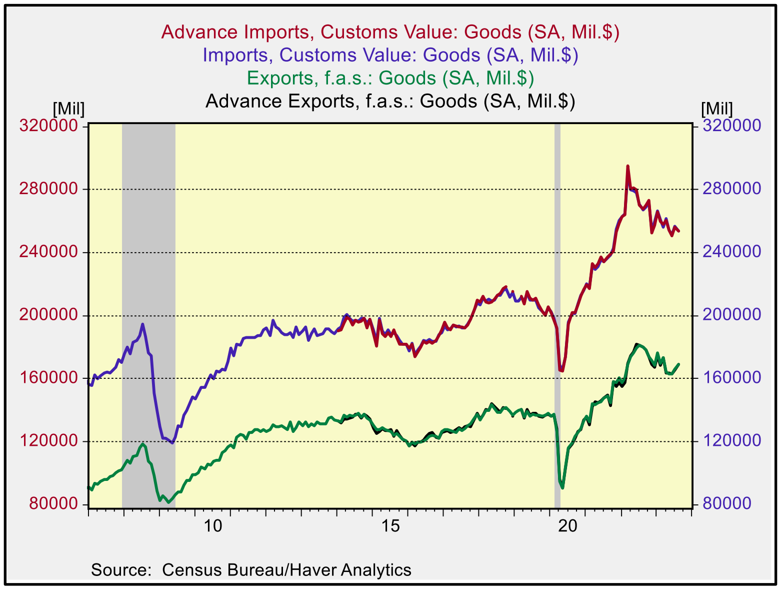

Finally, the income and spending report includes the Fed's preferred measure of consumer price inflation. Excluding the volatile food and energy components, the ***Core PCE Deflator*** for August was up just 3.9% from the same month one year earlier, matching expectations and marking a welcome deceleration from the revised gain of 4.3% in the year to July. Inflation as measured by the Core PCE Deflator is now at its lowest since May 2021. The chart below shows the year-over-year change in the Core PCE Deflator since just before the GFC.




In a separate report, August ***wholesale inventories*** declined by a seasonally adjusted 0.1%, versus expectations that they would fall 0.2%, as they did in July. Since distributors make their inventory decisions based on their unique view of both production activities and final demand, we think wholesale inventories provide an important perspective on where the economy is heading. The chart below shows the monthly change in wholesale inventories since just before the GFC.



Finally, a preliminary estimate showed the U.S. ***merchandise trade balance*** in August showed a seasonally adjusted deficit of $84.3 billion, beating the anticipated shortfall of $91.4 billion and narrowing from the revised July deficit of $90.9 billion. According to the report, merchandise exports rose 2.5% in August, while imports fell by 1.1%. Compared with the same month one year earlier, exports in August were down 4.6%, but imports were down an even sharper 6.3%. The chart below shows the monthly value of U.S. exports and imports since just before the GFC.




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 |
| 9:45 | MNI Chicago PMI | m/m | Sep | 47.6 | 48.7 | *** |
| 10:00 | U. of Michigan Consumer Sentiment | m/m | Sep F | 67.7 | 67.7 | *** |
| 10:00 | U. of Michigan Current Conditions | m/m | Sep F | 69.8 | 69.8 | ** |
| 10:00 | U. of Michigan Future Expectations | m/m | Sep F | 66.4 | 66.3 | ** |
| 10:00 | U. of Michigan 1-Year Inflation Expectation | m/m | Sep F | 3.2% | 3.1% | * |
| 10:00 | U. of Michigan 5-10 Year Inflation Expectation | m/m | Sep F | 2.8% | 2.7% | * |
| 11:00 | Kansas City Fed Services Activity | m/m | Sep | | -1 | * |
| **Federal Reserve** | | | | | | |
| EST | Speaker or Event | District or Position | | | | |
| 12:45 | John Williams to Speak on Monetary Policy | President of the Federal Reserve Bank of New York | | | | |

## 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** | Tokyo CPI | y/y | Sep | 2.8% | 2.9% | 2.7% | ** | Equity and bond neutral |
| | Tokyo CPI Ex-Fresh Food | y/y | Sep | 2.5% | 2.8% | 2.6% | *** | Equity and bond neutral |
| | Tokyo CPI Ex-Fresh Food & Energy | y/y | Sep | 3.8% | 4.0% | 3.9% | * | Equity and bond neutral |
| | Jobless Rate | m/m | Aug | 2.7% | 2.7% | 2.6% | *** | Equity and bond neutral |
| | Job-To-Applicant Ratio | m/m | Aug | 1.3% | 1.3% | 1.3% | ** | Equity and bond neutral |
| | Retail Sales | y/y | Aug | 7.0% | 6.8% | 6.6% | ** | Equity and bond neutral |
| | Depart. Store & Supermarket Sales | y/y | Aug | 6.0% | 5.5% | | * | Equity and bond neutral |
| | Industrial Production | y/y | Aug P | -3.8% | -2.3% | -4.6% | *** | Equity and bond neutral |
| | Annualized Housing Starts | y/y | Aug | 0.812m | 0.778m | 0.778m | * | Equity and bond neutral |
| | Housing Starts | y/y | Sep | -8.7% | -9.4% | -6.7% | ** | Equity bullish, bond bearish |
| **Australia** | Private Sector Credit | y/y | Aug | 5.1% | 5.3% | | ** | Equity and bond neutral |
| **New Zealand** | ANZ Consumer Confidence Index | m/m | Sep | 86.4 | 85.0 | | * | Equity and bond neutral |
| **EUROPE** | | | | | | | | |
| **Eurozone** | CPI | y/y | Sep | 4.3% | 5.2% | 4.5% | *** | Equity and bond neutral |
| | Core CPI | y/y | Sep P | 4.5% | 5.3% | 4.8% | ** | Equity and bond neutral |
| **Germany** | Import Price Index | y/y | Aug | -16.4% | -13.2% | -16.2% | ** | Equity and bond neutral |
| | Retail Sales NSA | y/y | Aug | -1.9% | -2.4% | -2.1% | * | Equity and bond neutral |
| | Unemployment Change | m/m | Sep | 10.0k | 18.0k | 20.0k | *** | Equity and bond neutral |
| | Unemployment Claims Rate | m/m | Sep | 5.7% | 5.7% | 5.7% | ** | Equity and bond neutral |
| **France** | CPI, EU Harmonized | y/y | Sep P | 5.6% | 5.7% | 5.9% | ** | Equity and bond neutral |
| | CPI | y/y | Sep P | 4.9% | 4.9% | 5.1% | *** | Equity and bond neutral |
| | PPI | y/y | Aug | -1.4% | 0.9% | | * | Equity and bond neutral |
| **Italy** | CPI, EU Harmonized | y/y | Sep P | 5.7% | 5.5% | 5.4% | *** | Equity and bond neutral |
| | CPI NIC Including Tobacco | y/y | Sep P | 5.3% | 5.5% | 5.4% | ** | Equity and bond neutral |
| | Industrial Sales WDA | y/y | Jul | -1.6% | 1.3% | -0.4% | * | Equity and bond neutral |
| **UK** | GDP | q/q | 2Q F | 0.6% | 0.4% | 0.4% | *** | Equity and bond neutral |
| | Mortgage Approvals | m/m | 2Q F | 45.4k | 49.4k | 49.5k | *** | Equity and bond neutral |
| | M4 Money Supply | y/y | Aug | 0.2% | -0.5% | -0.6% | *** | Equity bullish, bond bearish |
| **Russia** | Gold and Forex Reserves | m/m | 22-Sep | $576.0b | $576.7b | | *** | Equity and bond neutral |
| | Money Supply, Narrow Definition | w/w | 22-Sep | 18.67t | 18.74t | | * | Equity and bond neutral |
| **AMERICAS** | | | | | | | | |
| **Brazil** | Net Debt % GDP | m/m | Aug | 59.9% | 59.6% | 59.9% | ** | Equity and bond neutral |
| | National Unemployment Rate | m/m | Aug | 7.8% | 7.9% | 7.8% | * | 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) | 565 | 565 | 0 | Up |
| 3-mo T-bill yield (bps) | 530 | 532 | -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 (%) | 4.56 | 4.58 | -0.02 | Flat |
| Euribor/OIS spread (bps) | 396 | 397 | -1 | Up |
| **Currencies** | **Direction** | | | |
| Dollar | Down | | | Up |
| Euro | Up | | | Down |
| Yen | Flat | | | Down |
| Pound | Up | | | Down |
| Franc | Up | | | Down |
| **Central Bank Action** | **Current** | **Prior** | **Expected** | |
| Bank of Mexico Overnight Rate | 11.250% | 11.250% | 11.250% | 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 | $96.04 | $95.38 | 0.69% | |
| WTI | $92.79 | $91.71 | 1.18% | |
| Natural Gas | $2.92 | $2.95 | -0.85% | |
| Crack Spread | $22.94 | $23.49 | -2.33% | |
| 12-mo strip crack | $25.22 | $25.47 | -1.01% | |
| Ethanol rack | $2.50 | $2.49 | 0.23% | |
| **Metals** | | | | |
| Gold | $1,869.31 | $1,864.87 | 0.24% | |
| Silver | $23.11 | $22.62 | 2.13% | |
| Copper contract | $375.10 | $370.80 | 1.16% | |
| **Grains** | | | | |
| Corn contract | $487.00 | $488.50 | -0.31% | |
| Wheat contract | $582.25 | $578.75 | 0.60% | |
| Soybeans contract | $1,300.75 | $1,300.50 | 0.02% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 1,716 | 1,752 | -36 | |
| **DOE Inventory Report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | -2.2 | -0.9 | -1.3 | |
| Gasoline (mb) | 1.0 | -0.5 | 1.5 | |
| Distillates (mb) | 0.4 | -1.0 | 1.4 | |
| Refinery run rates (%) | -2.4% | -0.7% | -1.7% | |
| Natural gas (bcf) | 90 | 88 | 2 | |

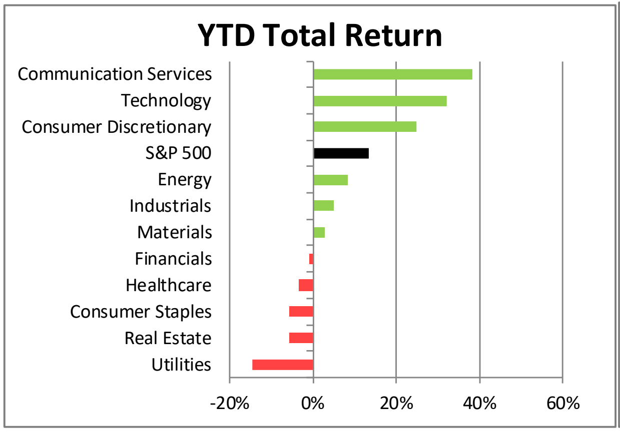
**Weather**

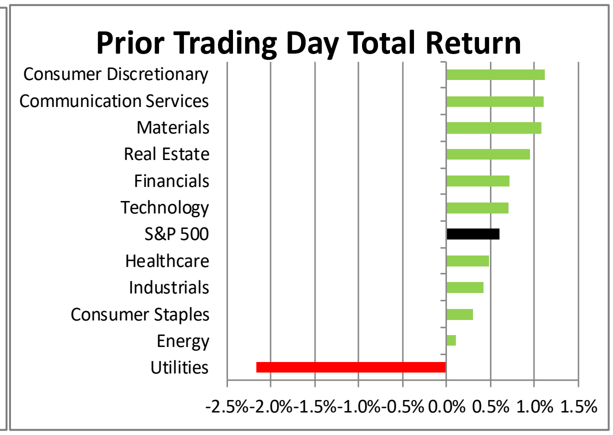
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for the entire country from the Great Plains eastward, with cooler-than-normal temperatures throughout the Far West. The forecasts call for wetter-than-normal conditions in the Pacific Northwest, the northern Rocky Mountains, and the Great Plains, with dry conditions in the Deep South and the Northeast.

Two atmospheric disturbances are now active in the Atlantic Ocean. Tropical Storm Philippe is in the central Atlantic and is now moving northward. Tropical Storm Rina is to the east of Philippe and moving to the northwest. On average, Atlantic hurricane activity peaks on September 15.

## Data Section

**U.S. Equity Markets** – (as of 9/28/2023 close)

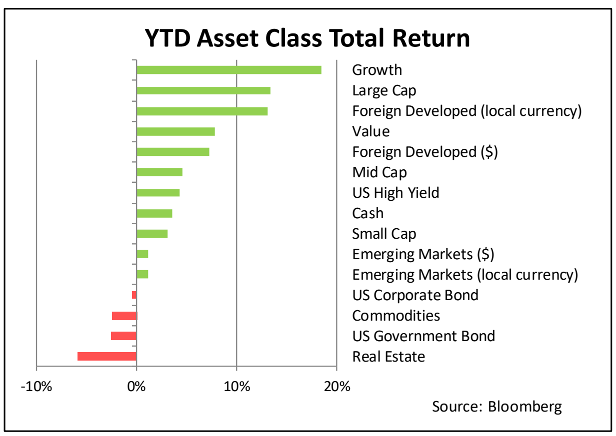



(Source: Bloomberg)

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 9/28/2023 close)

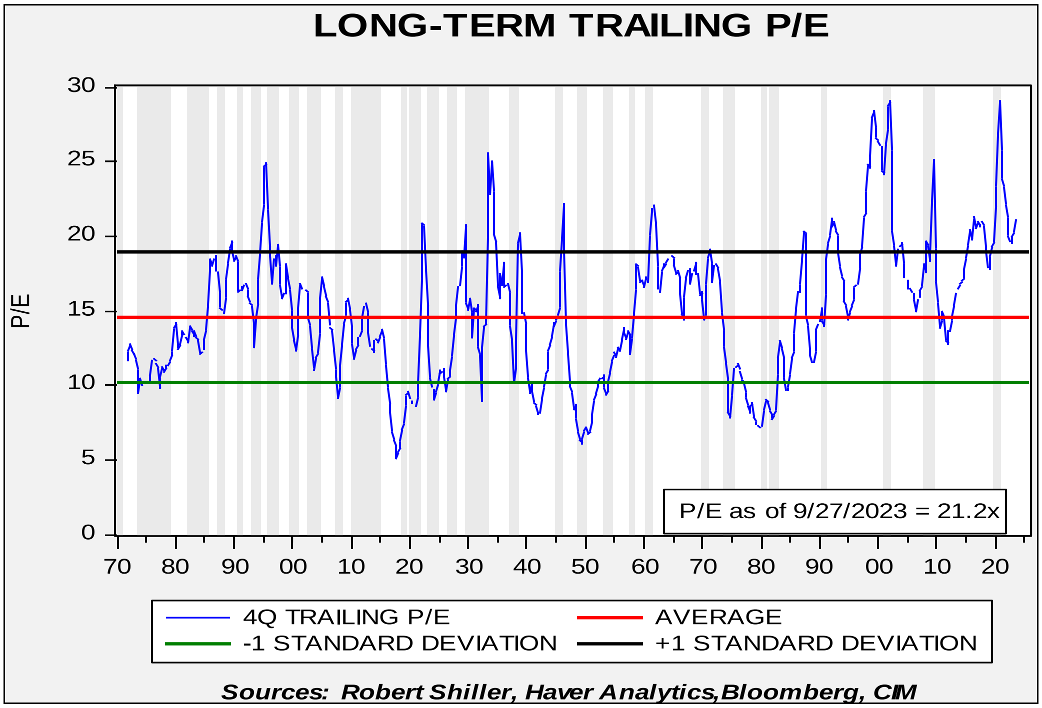



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 28, 2023




Based on our methodology,[1] the current P/E is 21.2x, 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.