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 6, 2023—9:30 AM EDT] Global equity markets are mostly lower this morning. In Europe, the Euro Stoxx 50 is down 0.9% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.4%. Chinese markets were slightly higher, with the Shanghai and the Shenzhen Composites both up 0.1% from their previous close. 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* (8/31/2023): We take a short look at the forecasts for oil demand and note that a major oil ETF is reverting to an earlier method of managing its investment in various contract months. We also note that one reason why Iran prefers to live under sanctions is that it benefits those in power. Saudi Arabia is wooing both the U.S. and China to build nuclear power. (this week's report will be delayed until 9/8 due to the holiday)
- *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* (8/28/2023) (there will be no podcast for this report): "Examining the Rise in T-Note Yields"
- *Confluence of Ideas* podcast (8/22/2023): "The Economics of Defense in Great Power Competition"

Good morning. Risk markets are under pressure again this morning, with rising Treasury yields raising investor fears. Rising interest rates are also lifting the dollar. The JPY is challenging recent lows, and traders are watching for central bank intervention.

In today's *Comment*, we start our coverage with a roundup of economic factors. Up next is our international overview, followed by news on the war in Ukraine.

Economic Roundup: The Fed looks set to pause, and a government shutdown may be looming.

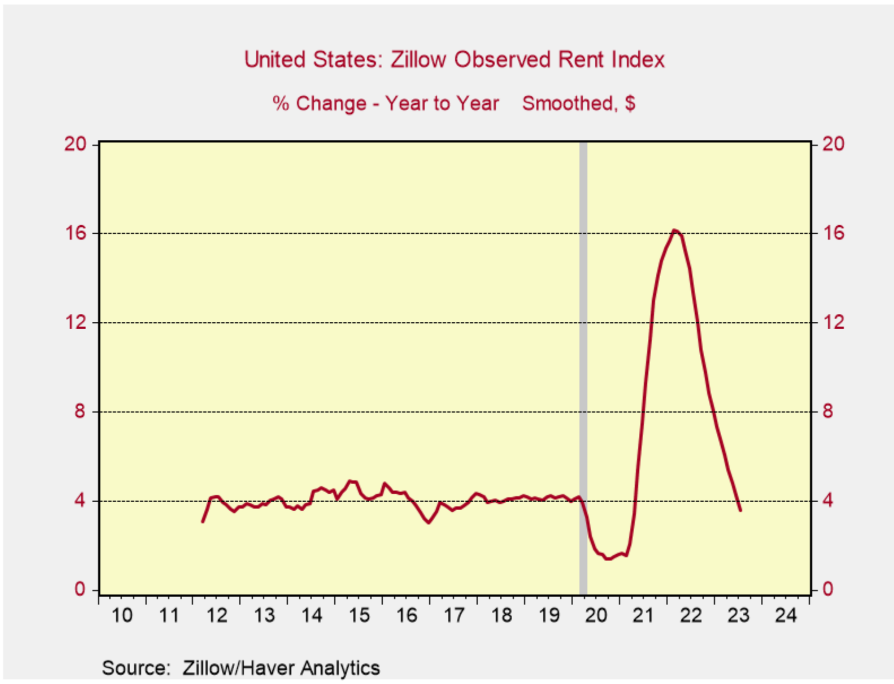
- Fed Governor Waller was on CNBC yesterday and signaled that the FOMC was likely to "proceed carefully," suggesting the committee will stand pat at the next meetings, scheduled for September 19 and 20. Currently, fed funds futures are projecting with near certainty that the policy rate will be held steady. We also note these futures are leaning toward steady policy from here, although with much less conviction. Waller tends to lean hawkish, so his remarks are probably a solid signal of steady policy.
    - Although there is ample evidence that the FOMC isn't united on the future path of policy, Chair Powell has a remarkable ability to forge a consensus on policy. In fact, he has the best track record for the fewest dissents of all the Fed chairs in the post-Treasury agreement era. The table below shows the chairs since 1951 and the number of dissents divided by the number of meetings over which each chair presided. By far and away, Powell has been able to create consensus on the FOMC when compared to his predecessors. It's hard to know his secret; it's possible that the members during his tenure have been simply less combative, although that would be hard to determine. We will have a better understanding five years from now when the full meeting transcripts are released. In general, policy dissents would be expected to increase volatility. So, in this regard, Powell is probably, in a small way, holding down market uncertainty.

MARTIN	50.9%
BURNS	62.4%
MILLER	142.1%
VOLCKER	122.7%
GREENSPAN	53.6%
BERNANKE	72.7%
YELLEN	66.7%
POWELL	23.9%

    - Congress is set to name Phillip Jefferson as vice-chair of the Federal Reserve. Although widely expected, Jefferson is likely to lean dovish and thus will give the dovish members of the FOMC more influence.
- Congress averted a shutdown last spring, but it's starting to look like it will be hard to avoid one later this month. Speaker McCarthy is struggling to move his caucus to a budget deal and probably can't pass a budget without Democratic support. McCarthy is trying to keep the government open, and hold his position as speaker, a pair of goals that is looking increasingly tenuous. Government shutdowns tend to lower bond yields as spending stops and the Treasury reduces its borrowing. However, coming on the back of recent downgrades, a shutdown now might have a different outcome.
- This has been the summer of labor unrest, as several large companies are either facing the threat of strikes or have decided to capitulate to their unions. The Biden administration finds itself in a difficult spot as these negotiations unfold. On the one hand, the president fashions himself as a friend of labor, but on the other, strikes in key industries will hurt

the economy and massive contract gains could spark inflation. The president is running for re-election and wants to avoid both a downturn and another spike in price levels. Thus, the White House is mostly staying out of the contract fights. Although this is one way to avoid the dilemma we outlined above, it won't necessarily help him with union voters.

- Although yearly apartment rental rates are in a clear downtrend, the overall number doesn't capture suburban versus city costs. Reports suggest that suburban rental rates are soaring.



- Announcements from Saudi Arabia and Russia indicating that they will maintain production cuts through year's end sent oil prices higher. The rise in oil prices, coupled with lingering logistical issues caused by the war in Ukraine, are raising diesel prices which then tend to filter into goods prices.
- As U.S. bank regulators are spinning out new regulations, especially on bank capital, American lenders are looking with envy at Europe. European regulators are taking a lighter touch with their banking system.
- As pandemic savings are exhausted, households are increasing their use of credit cards. Delinquencies on credit cards and auto loans are moving higher. The expected recession from policy tightening has been avoided so far, in part, because the economy has become less sensitive to interest rates. However, we may be starting to see evidence that elevated interest rates are having a detrimental effect.
- Japanese investors, fearful of inflation, are increasing gold purchases.
- Europe is implementing new regulations on technology platform providers. The Digital Markets Act will force tech providers to allow more competition on their platforms,

reduce data collection by the platforms, and provide companies operating on the platforms easier access to their customer's data. The tech firms are not pleased.

International Roundup: The defense industry is globalizing and there is a race to gain access to Pacific islands.

- With the growing U.S. aversion to free trade deals, there is a concern that it may be difficult for Washington to build alliances to isolate the Russia/China/Iran axis. Allowing allies to run trade surpluses with the U.S. was a key element in America's alliance system that isolated the Soviet bloc during the Cold War. Because such policies are politically untenable at present, we have been closely watching to see if policymakers can create an alternative to trade. It appears that globalizing supply chains for military spending is becoming one substitute. As nations begin to rebuild their militaries, the U.S. is "friend-shoring" production to create a broader supply chain.
- China's anti-access/area denial (A2/AD) strategy is designed to prevent the U.S from moving expensive naval assets into close proximity to a military theater. China has designed missiles and expanded its submarine force to counter U.S. aircraft carriers as part of this strategy. One way to respond to China's strategy is to put bases on islands and other land masses around China. Last week, we noted that the U.S. was recommissioning mothballed facilities in Asia for this purpose. At the same time, Beijing won't passively allow the U.S. to engage in this policy. On Monday, Vanuatu established a new government following a no-confidence vote. The new PM, Sato Kilman, replaces Ishmael Kalsakau, and is thought to be more friendly to China than his predecessor. We expect China and the U.S. to actively woo these Pacific nations for defense purposes.
- As Commerce Secretary Raimondo began her visit to China, Huawei (002502, CNY, 2.65) unveiled its new 5G smart phone, a device that apparently houses semiconductor chips that the U.S. is trying to prevent China from acquiring. The announcement was pointed, suggesting that U.S. efforts to restrict China's access had failed. In the wake of this announcement, the U.S. is "seeking information" and may add new sanctions.
- In what is being called a mistake, President Biden is not going to the ASEAN meetings next week, sending VP Harris instead as his replacement. If Washington's goal is to woo Asian nations to the U.S.'s "side," such no-shows make little sense. What hurts the optics is that the president is making visits to Vietnam and India. However, we also note that President Xi is not going to the G-20 meeting in New Delhi, so perhaps we are seeing unforced errors on both sides.
- Southern Europe is facing a deluge, with record rains causing widespread flooding.

War in Ukraine: The slow offensive may be gathering speed and Russia "woos" Cubans.

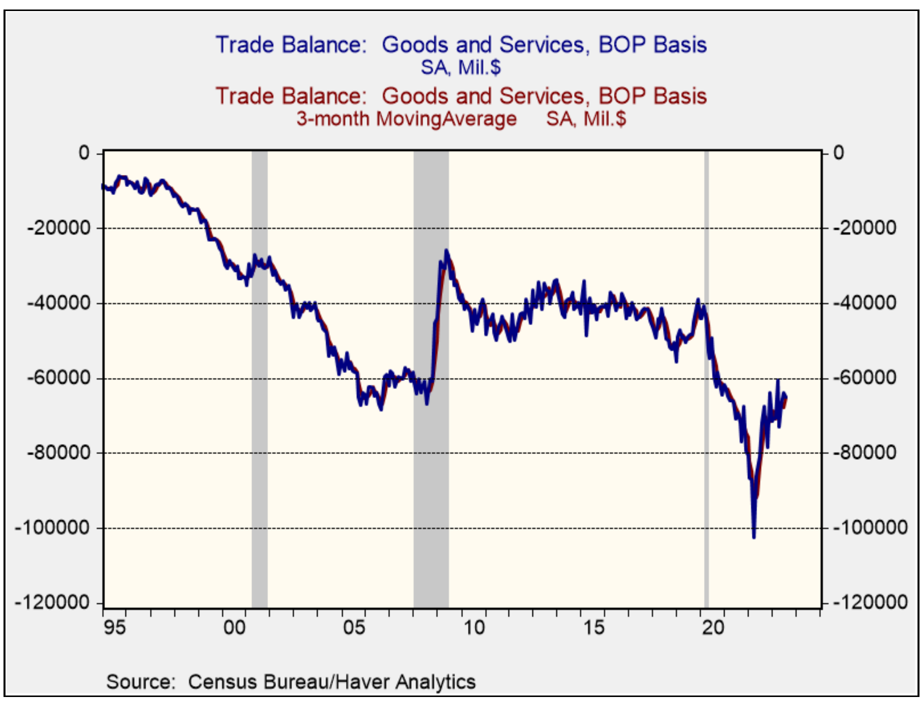
- Ukrainian sources suggest that the entrenchments the Ukrainian military is facing are not as strong as what they dealt with initially. The Russians, in anticipation of the offensive, built extensive fortifications, but these comments indicate that progress may be underway. SoS Blinken is traveling to Kyiv this week and is expected to offer an additional $1.0 billion in aid.

- Cuba has uncovered a trafficking ring, where Russians are trying to encourage Cubans to fight in Ukraine. Havana is not pleased with this development.
- Oil and gas rigs in the Black Sea are becoming targets in the conflict. Given the already tight supplies, this development is another bullish factor for oil and gas prices.
- Kim Jong-un is visiting Russia, with the expectation that Moscow wants to source military equipment from the Hermit Kingdom. Pyongyang is said to be seeking missile and nuclear warhead technology. Washington has warned North Korea that it will "pay a price" for cooperating with Russia. However, given how heavily sanctioned Pyongyang is already, it's hard to see what additional measures could be implemented.

U.S. Economic Releases

High interest rates continue to sap demand for residential loans. Mortgage applications fell 2.9% in the week ending September 1, according to an index tracked by the Mortgage Bankers Association. The drop in requests for mortgage applications is likely related to high interest rates. Despite the average 30-year fixed-rate mortgage falling 10 bps to 7.21% last week, borrowing costs are up 127 bps from a year ago. As a result, purchase applications fell 2.1% last week, its lowest level in 28 years. Meanwhile, refinancing applications fell 4.7% in the same period.

Separately, the U.S. trade deficit narrowed in July to $65.0 billion, below expectations of $68.0 billion but above the previous month's revised reading of $63.7 billion. This was due to foreign purchases outpacing foreign sales. Exports rose 1.6% to $251.7 billion, while imports increased 1.7% to $316.7 billion.



The previous chart shows the level of the trade balance in goods and services, along with its three-month moving average. In July, the moving average of the deficit decreased from $67.8 billion to $65.2 billion. This shrinking deficit is the result of a steady decline in imports, which will boost GDP growth but is also a sign of slowing consumption.

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	S&P Services PMI	m/m	Aug F	51.0	51.0	**
9:45	S&P Composite PMI	m/m	Aug F	50.4	50.4	**
10:00	ISM Services Index	m/m	Aug	52.5	52.7	**
10:00	ISM Services Prices Paid	m/m	Aug		56.8	**
10:00	ISM Services Employment	m/m	Aug		50.7	*
10:00	ISM Services New Orders	m/m	Aug		55.0	**
Federal Reserve						
No Fed speakers or events for the rest of today						
EST	Speaker or Event	District or Position				
9:00	James Bullard Speaks at NABE	Former President of the Federal Reserve Bank of St. Louis				
14:00	U.S. Federal Reserve Releases Beige Book	Federal Reserve Board				
15:00	Lorie Logan Takes Part in Community Listening Session	President of the Federal Reserve Bank of Dallas				

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								
Australia	GDP	q/q	2Q	2.1%	2.3%	2.4%	***	Equity and bond neutral
EUROPE								
Eurozone	Retail Sales	y/y	Jul	-1.0%	-1.4%	-1.0%	*	Equity and bond neutral
Germany	Factory Orders WDA	y/y	Jul	-10.5%	3.0%	3.3%	***	Equity bearish, bond bullish
	HCOB Construction PMI	m/m	Aug	41.5	41.0		***	Equity and bond neutral
UK	S&P/CIPS Construction PMI	m/m	Aug	50.8	51.7	49.8	**	Equity and bond neutral
AMERICAS								
Mexico	International Reserves Weekly	w/w	1-Sep	$203247	$203719m		*	Equity and bond neutral
Brazil	S&P Global Composite PMI	m/m	Aug	50.6	49.6		**	Equity and bond neutral
	S&P Global Services PMI	m/m	Aug	50.6	50.2		**	Equity and bond neutral
	FGV Inflation IGP-DI	y/y	Aug	-6.91%	-7.47%	-6.82%	**	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.

doe	Today	Prior	Change	Trend
3-mo Libor yield (bps)	566	566	0	Up
3-mo T-bill yield (bps)	530	527	3	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	540	540	0	Up
U.S. Libor/OIS spread (bps)	542	542	0	Up
10-yr T-note (%)	4.25	4.26	-0.01	Flat
Euribor/OIS spread (bps)	380	380	0	Up
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Up
Yen	Up			Down
Pound	Flat			Up
Franc	Flat			Up

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	$89.44	$90.04	-0.67%	
WTI	$86.20	$86.69	-0.57%	
Natural Gas	$2.59	$2.58	0.23%	
Crack Spread	$30.46	$30.86	-1.31%	
12-mo strip crack	$27.74	$28.03	-1.06%	
Ethanol rack	$2.45	$2.46	-0.15%	
Metals				
Gold	$1,925.55	$1,926.12	-0.03%	
Silver	$23.40	$23.54	-0.58%	
Copper contract	$380.90	$384.85	-1.03%	
Grains				
Corn contract	$488.75	$486.00	0.57%	
Wheat contract	$604.50	$599.25	0.88%	
Soybeans contract	$1,378.25	$1,365.00	0.97%	
Shipping				
Baltic Dry Freight	1,063	1,083	-20	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.8		
Gasoline (mb)		-0.3		
Distillates (mb)		1.3		
Refinery run rates (%)		-0.2%		
Natural gas (bcf)		29		

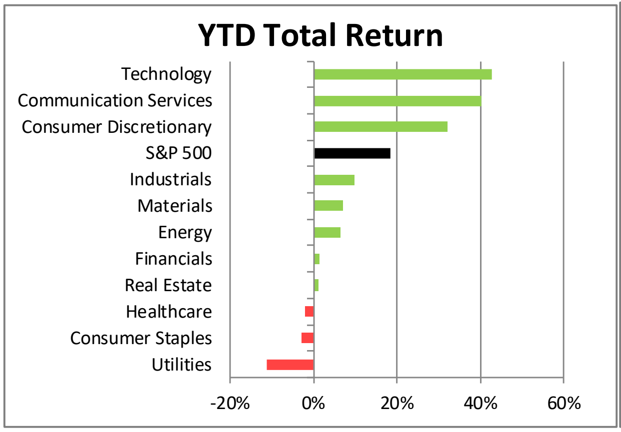
Weather

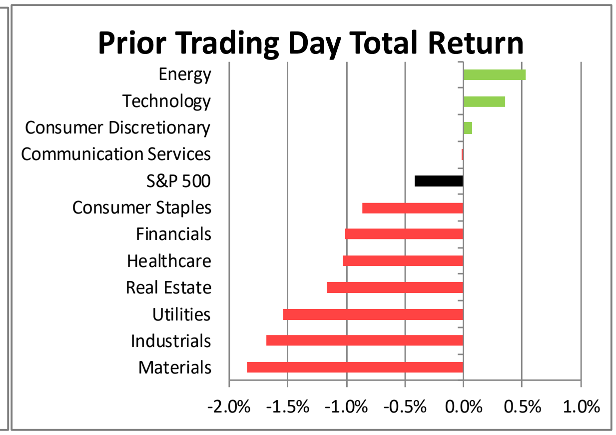
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for most of the country, with below-normal temperatures only in New England, the Midwest and parts of the Southeast. The forecasts call for wetter-than-normal conditions in most states on the East Coast and Great Plains, with dry conditions in the Midwest and Pacific Northwest.

There are currently three atmospheric disturbances in the Atlantic Ocean. One of these disturbances has already formed into a tropical storm. Tropical Storm Lee is currently located in the central Atlantic Ocean near the Leeward Islands. It is forecast to make its way to Florida over the next several days, but it is too early to say at this time how strong the storm will be when it makes landfall. The other two disturbances are unlikely to develop into cyclones within the next 48 hours.

Data Section

U.S. Equity Markets – (as of 9/5/2023 close)

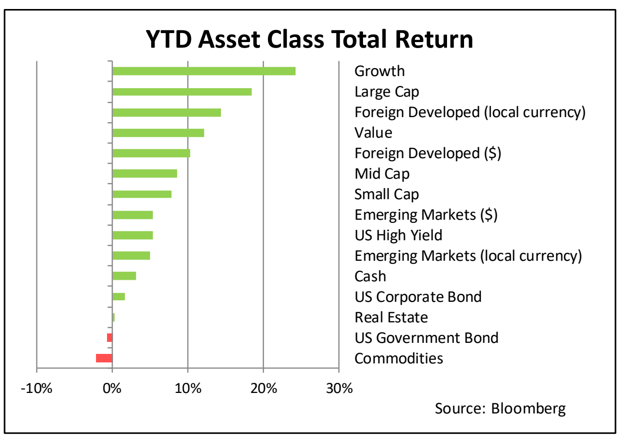




(Source: Bloomberg)

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 9/5/2023 close)

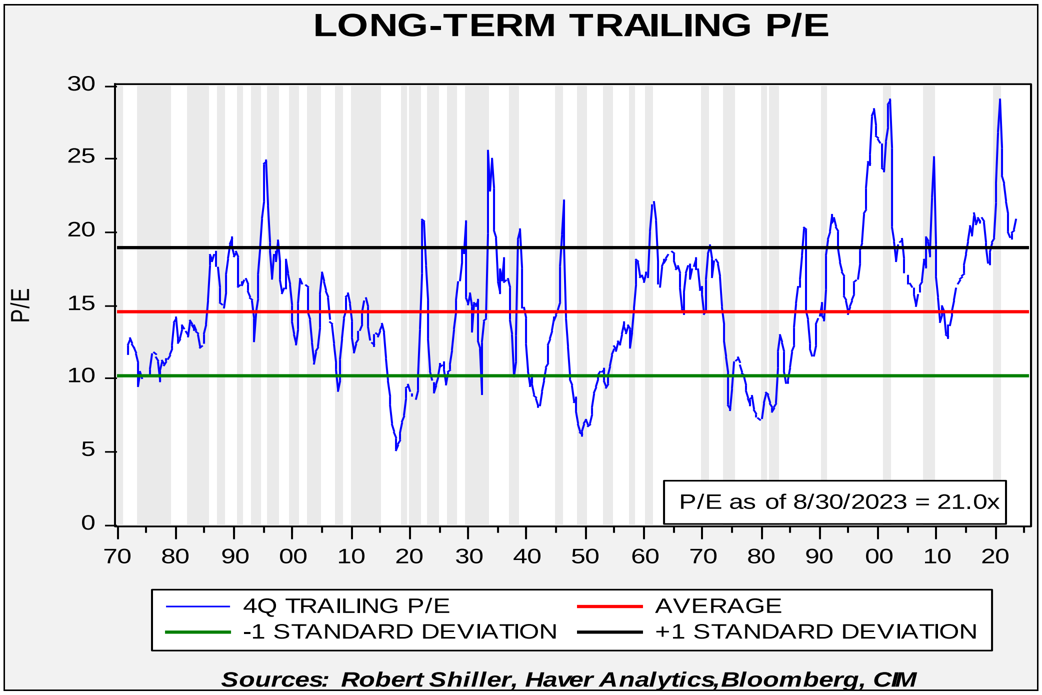


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

August 31, 2023



Based on our methodology,[1] the current P/E is 21.0x, down 0.1x from last week. Improved earnings coupled with falling index values led to the modest decline 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.