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 7, 2023—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is down 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.1%. Chinese markets were lower, with the Shanghai Composite down 1.1% from its previous close and the Shenzhen Composite down 1.8%. 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* (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! Today's *Comment* will be broken down into three sections: 1) How the rising U.S. dollar is impacting other countries; 2) How political fracturing in Spain and Brazil is representative of a global trend; and 3) What trade and investment flow data says about the U.S.-China relationship.

Dollar Soaring: The U.S. dollar hit its highest level in six months on Wednesday in a troubling sign for global currencies.

- Investors are flocking to the dollar as a safe haven currency, attracted by the U.S. economy's resilience in the face of global economic headwinds. The latest Institute for Supply Management (ISM) non-manufacturing index unexpectedly rose from 52.7 to 54.5 in August, beating expectations of 52.5. Similarly, last week's employment data also exceeded expectations, with the U.S. economy adding 187,000 jobs in July, slightly above projections of 174,000. The better-than-expected numbers have led to speculation that the Federal Reserve will favor at least one more rate hike before the end of the year.
- In contrast, Europe and China are experiencing more signs of economic slowdown in their respective regions. Private sector surveys showed that service activity in China expanded at its slowest pace in eight months in August, while business activity in Europe fell deeper into contraction territory. The divergence in growth expectations has weighed on their respective currencies, with the EUR hitting a three-month low and the Chinese yuan (CNY) falling to its lowest against the USD since December 2007. As a result, policymakers at the European Central Bank and People's Bank of China are likely to use more aggressive policies to prevent further depreciation.

- Central bankers are in a difficult spot. The strengthening dollar is expected to worsen price pressures related to rising commodity prices. On Wednesday, oil prices hit $90 a barrel for the first time in 2023 after Saudi Arabia and Russia agreed to extend voluntary production and export cuts. The combination of a strong dollar and rising commodity prices will likely weigh on global growth by making it more expensive for governments to repay dollar-denominated debt and import energy. As a result, central bankers may be less willing to provide stimulus, which could further dampen economic activity.

Unusual Coalition: Embattled leaders in Spain and Brazil make unsavory deals to stay in power.

- Spanish Prime Minister Pedro Sánchez is considering granting amnesty to Catalan separatists in exchange for their support in forming a government, but only if they also agree to back key legislation over the next four years. Talks between the two sides have not yet begun, but Sánchez's party is working on a stability pact with the Junts per Catalunya party. If successful, this would allow Sánchez to remain in power. Still, he risks alienating some of his base who are uncomfortable with his perceived concessions to separatist groups within the country. Hence, his party popularity may take a hit.

- Brazilian President Luiz Inácio Lula da Silva reached a deal with the right-wing Progressistas (Progressive) and Republicanos (Republican) parties to secure their support for his agenda. In exchange for the support of these two parties, Lula agreed to give up two seats in his cabinet. The pact is estimated to expand Lula's support from 250 deputies to 320 out of a possible 513. The growing coalition should make it easier for him to push through difficult legislation such as tax reform. However, there is hope that conservative members of his coalition will be able to check his more radical proposals.
- Political polarization has caused gridlock in the legislatures of Spain, Brazil, and other countries around the world. This has made it difficult to pass legislation, leading to inaction on important issues and the rise of extremism. Situations such as the 2023 attack on the Brazilian Congress and the Catalan Independence referendum in 2017 are examples of how toxic politics have become over the last decade. Although markets sometimes perform well in this environment as the inertia reduces uncertainty about a sudden change in policy, the fragmentation of the electorate suggests that this is not sustainable in the long term, particularly in emerging markets.

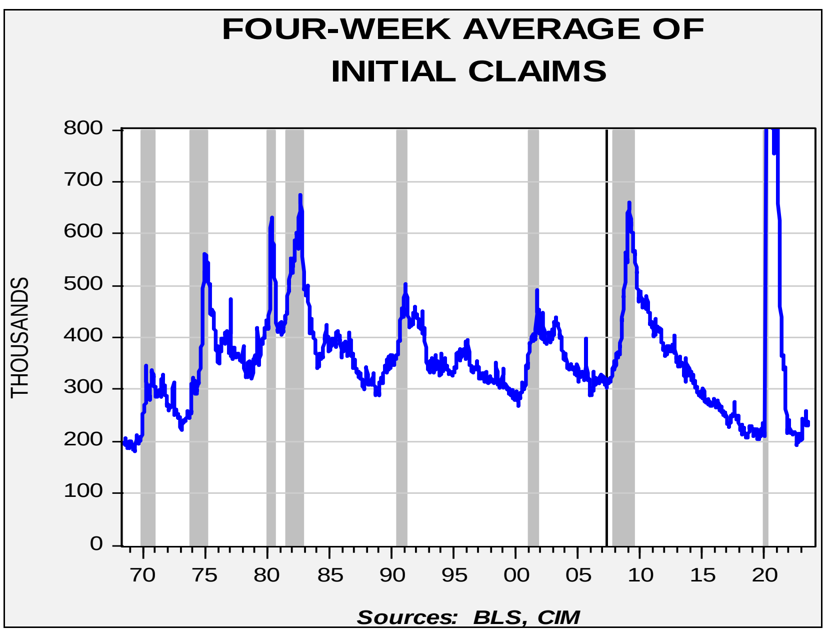
Sino-American Divorce: Economic data for the United States and China shows the two are going their separate ways.

- The latest phone developed by Huawei (002502, CNY, 2.57), the Mate 60 Pro, has led to concerns that China has been able to circumnavigate export bans. The phone caught the eye of U.S. regulators as it was able to download at faster speeds than many of the top 5G phones on the market, including the Apple's (AAPL, $177.20) iPhone 14 Pro. This has raised questions about whether Huawei has been able to obtain components from American companies in violation of the export bans, as it was widely believed that its Chinese semiconductor producer SMIC (0981, HKD, 19.82) is not known for its advanced chip-making capabilities. In an attempt to get more Chinese consumers to buy phones made domestically, Beijing has banned the use of the iPhone for Government workers.
- Frictions between the two largest economies have started to impact trade and capital flows. In July, the annual change in American imports of Chinese goods fell to its lowest since 2006. Additionally, Chinese companies have started to reduce foreign direct investment (FDI) into the U.S. and instead invest in countries with access to U.S. markets, such as South Korea and Mexico. In 2022, Chinese inflows into the U.S. fell to the lowest level since 2009. At the same time, the U.S. government is trying to restrict American investment in Chinese companies, particularly those linked with strategic ties to Beijing's military.

- The shifting trade and capital flows between China and the United States highlight the intention of the two countries to reduce their economic dependency on one another. As mentioned in previous reports, we do not expect this to happen quickly, but rather gradually over the next few years. This process will likely be beneficial for countries that have exposure to both China and the United States, such as Mexico and South Korea mentioned previously, but also could include countries such as India, Vietnam, and Indonesia.

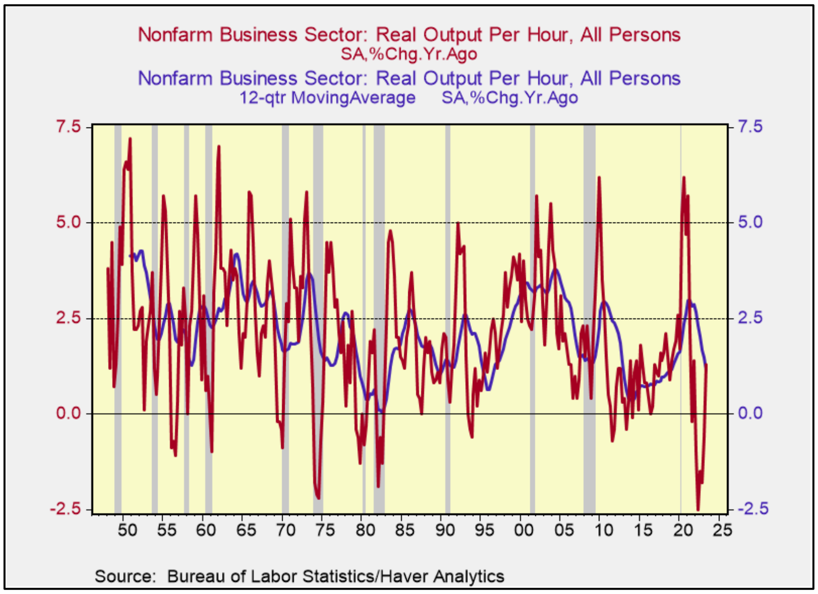
U.S. Economic Releases

Initial claims came in well below expectations, at 216k compared to expectations of 233k. The four-week average of claims fell to 229,250, down from 237,750 last week.



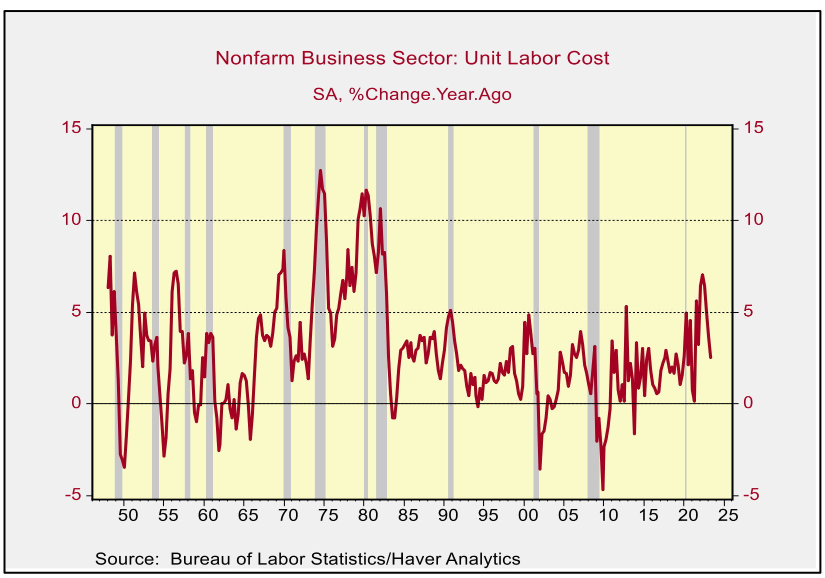
Although the claims data is strong, seasonal adjustment factors tend to be hard to gauge this time of year (when do schools reopen, auto retoolings, etc.), so we would not be shocked to see a reversal next week.

The final look at Q2 productivity and unit labor costs were released this morning. Productivity came in modestly better than forecast at +3.5% compared to expectations of +3.4%. Unit labor costs, which adjust labor costs for productivity, rose 2.2% compared to expectations of +1.9%.

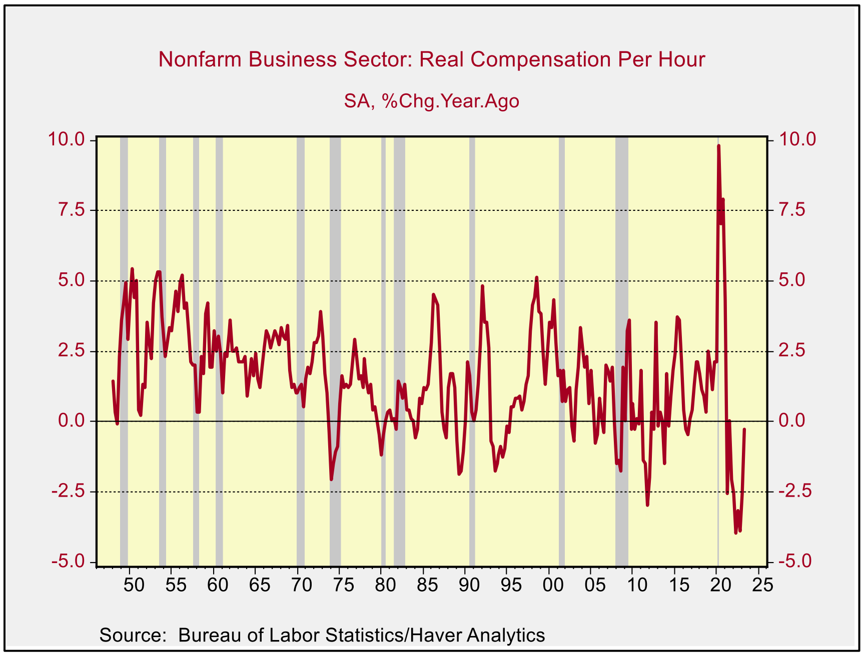


This chart shows yearly productivity growth. We are seeing some recovery in productivity which was severely affected by the pandemic. On the other hand, the three-year average suggests that trend productivity is falling.

On a yearly basis, unit labor costs are cooling.



After peaking at 7.0% in Q1 2022, costs are down to +2.5% in Q2 2023. Real compensation is rising but still shows negative growth.



Overall, we don't expect the productivity data to have much impact on markets. By the last update, the financial markets have shifted their focus, but the initial claims data will tend to lift interest rates. Although, we would caution about reading too much into a single week's data.

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**
10:00	Patrick Harker Speaks on Future of Fintech	President of the Federal Reserve Bank of Philadelphia
11:45	Austan Goolsbee Delivers Welcome Remarks at Chicago Fed	President of the Federal Reserve Bank of Chicago
14:00	St. Louis Fed Hosts Public Engagement on Presidential Search	Federal Reserve Bank of St. Louis
15:30	John Williams Speaks at Bloomberg Market Forum	President of the Federal Reserve Bank of New York
15:45	Raphael Bostic Speaks on Economic Outlook	President of the Federal Reserve Bank of Atlanta
16:55	Michelle Bowman Speaks on Panel About Future of Money	Member of the Board of Governors
19:00	Raphael Bostic Speaks on Economic Mobility	President of the Federal Reserve Bank of Atlanta
19:00	Lorie Logan Speaks on Monetary Policy in Dallas	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								
Japan	Foreign Buying Japan Bonds	w/w	1-Sep	¥926.6b	-¥551.5b	-¥534.1b	*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	1-Sep	¥90.7b	¥425.1b	¥425.3b	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	1-Sep	¥749.6b	-¥218.5b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	1-Sep	¥531.9b	-¥603.8b	-¥603.2b	*	Equity and bond neutral
	Leading Economic Index	m/m	Aug	107.6	108.9	108.8	**	Equity and bond neutral
Australia	Exports	m/m	Jul	-2.0%	-2.0%		*	Equity and bond neutral
	Imports	m/m	Jul	3.0%	-4.0%		*	Equity and bond neutral
	Trade Balance	m/m	Jul	A$8039m	A$11321m	A$10268m	***	Equity and bond neutral
New Zealand	Mfg Activity Volume	q/q	2Q	2.9%	-2.1%	-1.8	**	Equity bullish, bond bearish
	Mfg Activity SA	q/q	2Q	0.2%	-2.8%	-2.5%	*	Equity bullish, bond bearish
China	Foreign Reserves	m/m	Aug	$3160.1t	$3204.27b	$3180.00b	**	Equity and bond neutral
	Exports	y/y	Aug	-8.8%	-14.5%	-9.0%	**	Equity and bond neutral
	Imports	y/y	Aug	-7.3%	-12.4%	-9.0%	**	Equity and bond neutral
	Trade Balance	m/m	Aug	$68.36b	$80.60b	$73.90b	***	Equity and bond neutral
EUROPE								
Eurozone	GDP	y/y	2Q F	0.5%	0.6%	0.6%	***	Equity and bond neutral
Germany	Industrial Production WDA	y/y	Jul	-2.1%	-1.7%	-1.5%	**	Equity bearish, bond bullish
France	Trade Balance	m/m	Jul	-€8089m	-€6713m	-€6804m	**	Equity and bond neutral
	Current Account Balance	m/m	Jul	-€2.0b	€0.8b	€0.3b	**	Equity and bond neutral
Italy	Retail Sales	y/y	Jul	2.7%	3.6%	3.9%	**	Equity bearish, bond bullish
Switzerland	Unemployment Rate	m/m	Aug	2.0%	1.9%	1.9%	**	Equity and bond neutral
	Foreign Currency Reserves	m/m	Aug	694.3b	697.6b	698.1b	*	Equity and bond neutral
Russia	Wellbeing Fund	m/m	Aug	$142.9b	$146.3b		*	Equity and bond neutral
AMERICAS								
Canada	International Merchandise Trade	m/m	Jul	-0.99b	-3.73b	-4.92b	**	Equity bullish, bond bearish
Mexico	CPI	y/y	Aug	4.64%	4.79%	4.62%	***	Equity and bond neutral
	Core CPI	y/y	Aug	6.08%	6.64%	6.12%	**	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)	565	566	-1	Up
3-mo T-bill yield (bps)	530	531	-1	Up
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	541	540	1	Up
U.S. Libor/OIS spread (bps)	543	542	1	Up
10-yr T-note (%)	4.27	4.28	-0.01	Flat
Euribor/OIS spread (bps)	380	380	0	Up
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Flat
Yen	Up			Down
Pound	Down			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Canada Rate Decision	5.000%	5.000%	5.000%	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	$90.14	$90.60	-0.51%	
WTI	$87.00	$87.54	-0.62%	
Natural Gas	$2.54	$2.51	1.31%	
Crack Spread	$30.96	$30.73	0.74%	
12-mo strip crack	$27.95	$28.02	-0.25%	
Ethanol rack	$2.44	$2.45	-0.24%	
Metals				
Gold	$1,921.75	$1,916.56	0.27%	
Silver	$23.03	$23.17	-0.62%	
Copper contract	$374.50	$378.60	-1.08%	
Grains				
Corn contract	$486.25	$485.75	0.10%	
Wheat contract	$608.00	$609.00	-0.16%	
Soybeans contract	$1,371.25	$1,376.25	-0.36%	
Shipping				
Baltic Dry Freight	1,081	1,063	18	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.0		
Gasoline (mb)		-1.0		
Distillates (mb)		1.0		
Refinery run rates (%)		0.0%		
Natural gas (bcf)		42		

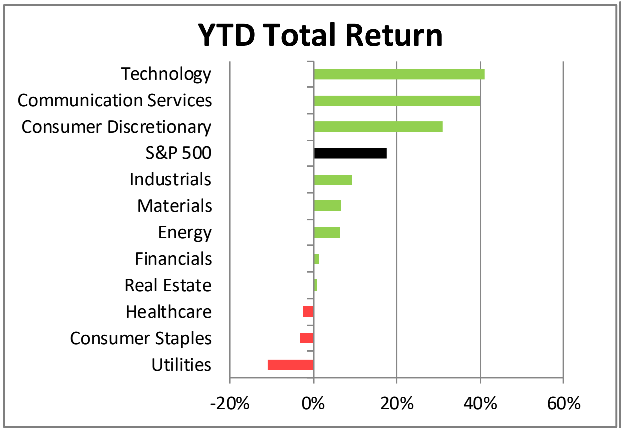
Weather

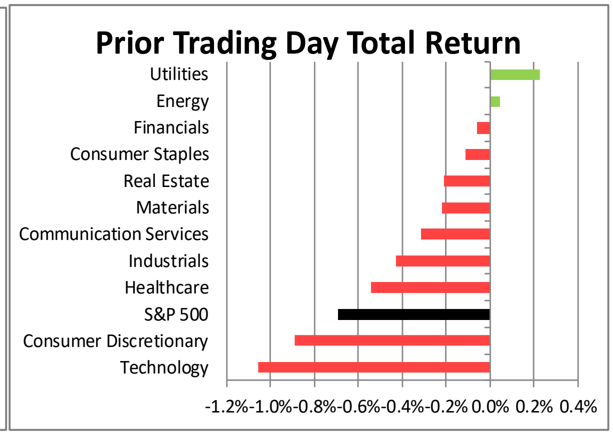
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for the western half of the country and the Gulf states, with below-normal temperatures for New England and the Midwest. The forecasts call for wetter-than-normal conditions in most states on the East Coast and Great Plains,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

There are currently two atmospheric disturbances in the Atlantic Ocean. Tropical Storm Lee is currently located about 15°N/50°W in the Atlantic Ocean. Current projections suggest it will be a major storm, hitting the Virgin Islands and Puerto Rico by the weekend and if the current path remains in place, Florida next week. It is too early to say at this time how strong the storm will be when it makes possible landfall in the U.S. The other disturbance is off the coast of Africa and is likely to develop into a cyclone later next week. We note that Atlantic hurricane activity peaks, on average, September 15.

Data Section

U.S. Equity Markets – (as of 9/6/2023 close)

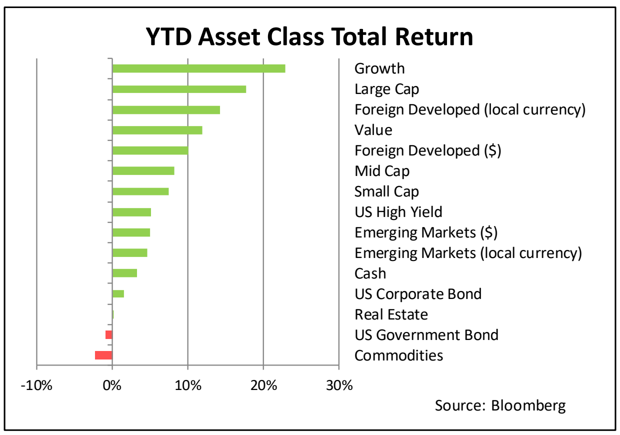




(Source: Bloomberg)

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 9/6/2023 close)

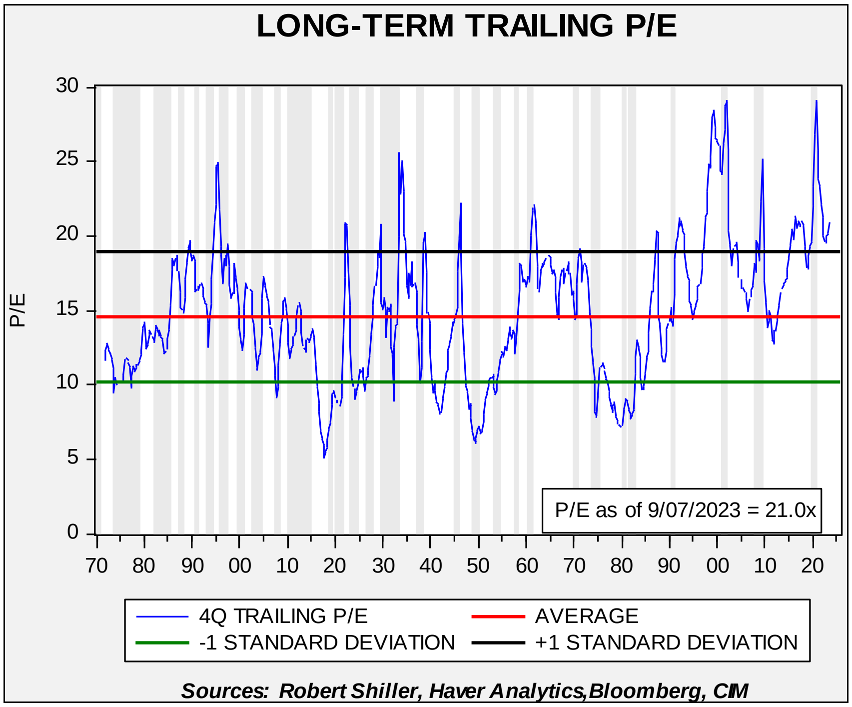


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 7, 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.

[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.