Daily Comment

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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: April 11, 2024—9:30 AM EDT] Global equity markets are mixed 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 0.2%. Chinese markets were higher, with the Shanghai Composite up 0.2% from its previous close and the Shenzhen Composite up 0.1%. US 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:

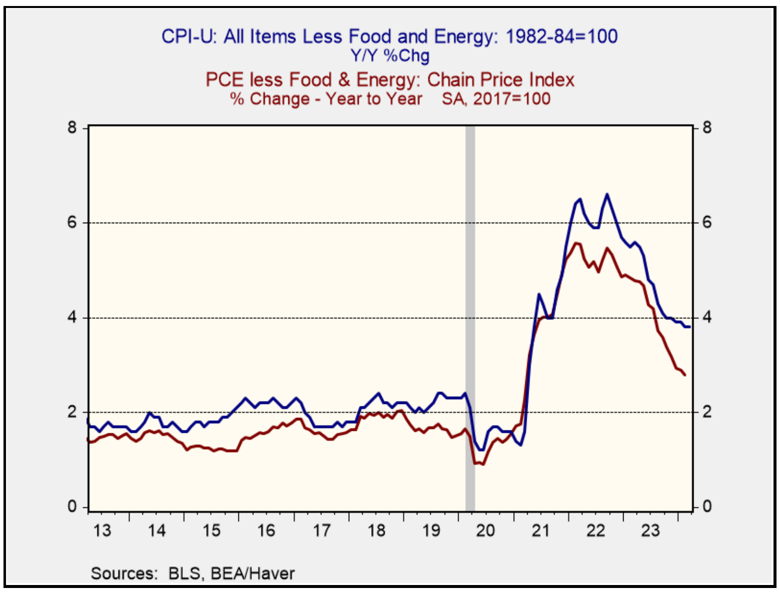
- *Bi-Weekly Geopolitical Report* (4/8/2024) (with associated podcast): "Is Japan Back?"
- *Asset Allocation Quarterly – Q1 2024* (1/26/2024): Discussion of our asset allocation process, Q1 2024 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q1 2024 Rebalance Presentation* (2/5/2024): 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* (4/1/2024) (no associated podcast for this report): "Gold, Gold Miners, and Central Banks"
- *The 2024 Outlook: Slow-Bicycle Economy* (12/18/2023) (with associated *Confluence of Ideas* podcast)
- *Confluence of Ideas podcast* (2/13/2024) "Reviewing the Asset Allocation Rebalance: Q1 2024"

Good morning! Equities are mixed after the weaker-than-expected PPI report. In a Champions League upset, Barcelona edged past PSG in Paris, and took a 1-goal lead into the return leg. Today's *Comment* examines how rising inflation (CPI) impacts interest rates, explores the increase in defense spending due to growing geopolitical tensions, and analyzes the hints of possible easing by the ECB as part of a wider trend among developed central banks.

Rate Cut Expectations: Stronger-than-expected March inflation and hawkish FOMC meetings have led to a rethink on rate cuts.

- Inflation surged in March, exceeding forecasts, and year-over-year consumer prices jumped to 3.5% (up from 3.2% in February). Core CPI, excluding volatile food and energy, also climbed to 3.8%, driven by rising costs in housing, healthcare, and car insurance. This robust report dampens hopes for the Fed achieving its 2% target, as indicated in recent meeting minutes. The minutes also reveal a divided committee, where some members fear geopolitical tensions and relaxed financial conditions could further inflate prices. In contrast, others see the potential for downward pressure from technological advancements and continued immigration.

- Recent data exposes unexpected inflation trends. Despite the Federal Reserve's anticipation of falling housing costs, shelter inflation remains stubbornly high. The three-month annualized rate rose to a worrying 7.11% in March, a significant departure from the expected disinflation. Furthermore, inflation isn't limited to housing. Core services, excluding rent, have also seen substantial increases, rising 9.3% at an annualized rate over the past three months. This unexpected increase in core services, which are sensitive to wages, suggests a tight labor market, which could fuel broader inflationary pressures.

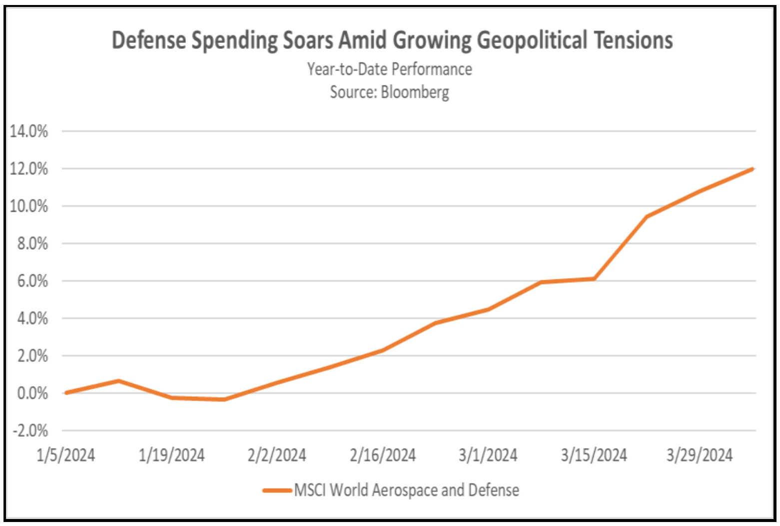


- March CPI data complicates the Fed's policy decisions. Their preferred gauge, core PCE inflation, is near their target (2.78% vs 2.50% target range). However, headline CPI inflation, the more widely followed measure, remains above 3.5%. This divergence creates a challenge. The higher CPI number suggests the Fed may now need to hold interest rates steady for a longer period than initially anticipated to avoid accusations of partisanship in an election year. Although a summer rate cut isn't entirely off the table, its likelihood has diminished significantly.

Defense Spending Splurge: Rising global tensions are prompting governments to ramp up defense spending in a bid to deter potential adversaries.

- The Middle East simmers with escalating tensions as the US and Israel ramp up collaboration on missile defense. This follows recent threats from Iran vowing retaliation after a strike in Syria killed a high-ranking Iranian general. The simmering conflict raises fears of a wider regional war, with US officials warning of potential targeted missile attacks by Iran. In a defiant move, Israel issued a stark warning, promising a forceful response on Iranian soil if its borders are breached. Adding to the regional turmoil, two major disputes threaten to ignite further chaos: Ukraine and Russia, as well as Armenia and Azerbaijan.

- While a wider Middle Eastern conflict remains a major concern, the drone revolution is another threat to global stability that shouldn't be underestimated. Iran's cheap, combat-proven drones are captivating developing nations, bolstering defenses and aiding militaries like those in Ukraine and Sudan. Their global production network, spanning South America and Central Asia (including some US parts), raises questions about the effectiveness of sanctions. Meanwhile, Ukraine's experience exposes limitations in US drone capabilities, prompting Ukraine to explore Chinese alternatives for reconnaissance. This highlights how any nation, regardless of size, can exploit niche strengths, reshaping the modern military landscape.

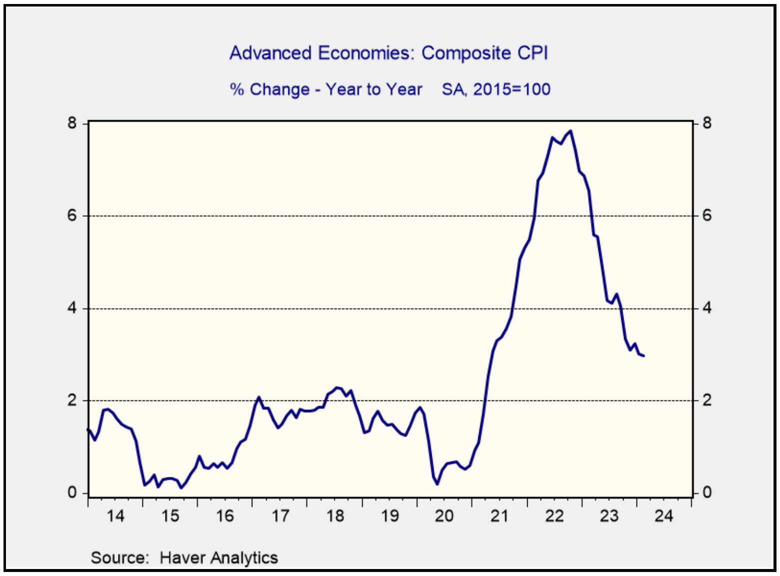


- The intensifying tensions in both the Middle East and Asia emphasize the critical importance of resilient supply chains. Recognizing the emerging alliance between Russia, China, and Iran, US allies are joining forces to bolster their military capacities, aiming to deter potential aggression. This collaborative effort is yielding early successes, as shown in the groundbreaking military drone radar developed by a notable French defense company. As geopolitical rifts deepen, the imperative for security investment grows, underscoring the importance for countries to support global defense companies in safeguarding collective defense interests.

ECB's Cautious Pivot: The European Central Bank decided to hold rates steady as it prioritizes economic growth over the inflation fight.

- The ECB Governing Council voted to hold interest rates steady for the fifth consecutive meeting. The main refinancing rate remains at 4.5%, and the deposit rate stays at 4.0%. While the central bank's updated policy statement hinted at a future easing of monetary restrictions, it provided no concrete timeline. However, there are strong indications that a rate cut could come as early as June. The ECB also plans to continue its balance sheet reduction program and will reinvest principal payments from its pandemic bond purchases until the end of 2024.

- In a sign of shifting tides, the ECB's decision to hold rates steady reflects a growing global trend towards a pause in interest rate hikes. This follows the Swiss National Bank's surprise rate cut last month, the first among G-7 central banks. Similarly, the Bank of Canada has hinted at a possible June cut as it looks to ease its rate by 100 bps by the end of the year. This cautious approach comes as inflationary pressures, which peaked in the summer 2022, have begun to show signs of moderation, and economic growth has become more of a concern.

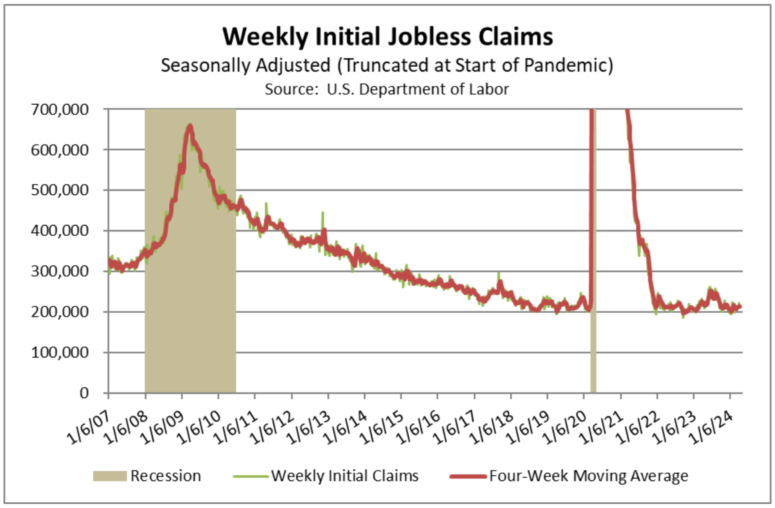


- Global monetary policy is in uncharted territory as central banks are deviating from the Federal Reserve's cautious approach. This divergence, coupled with ongoing doubts about the need for US rate cuts given its economic resilience and robust labor markets, could significantly strengthen the dollar. A stronger greenback could pose a double challenge for economies reliant on dollar-priced imports as it would exacerbate inflationary pressures, forcing them to reconsider planned rate cuts. Additionally, a robust US economy might lead their central banks to maintain higher interest rates than desired, potentially hindering domestic growth.

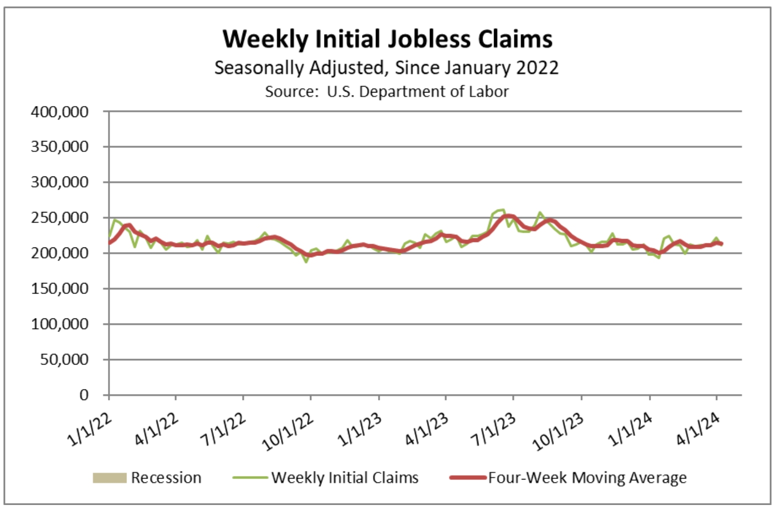
Other News: Manhattan rent dips hint at a stabilizing market, but high housing costs remain a hurdle for the central bank in achieving its 2% inflation target. Facing a persistent Russian offensive, Ukraine confronts growing challenges in maintaining momentum. Switzerland will hold a peace conference to mediate the Ukrainian/Russian crisis.

US Economic Releases

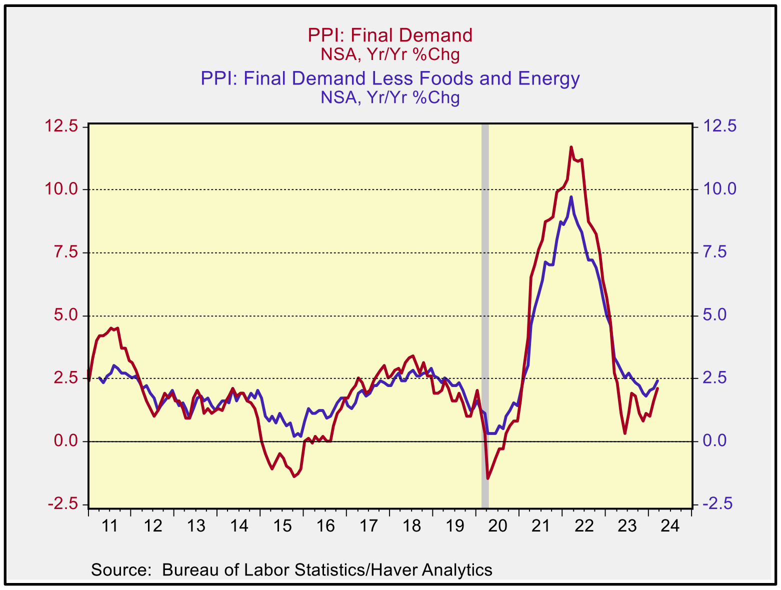
In the week ended April 6, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 211,000, below both the expected level of 215,000 and the prior week's revised level of 222,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, edged down to 214,250. Meanwhile, in the week ended March 30, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to 1.817 million, above both the anticipated reading of 1.800 million and the previous week's revised reading of 1.789 million. The chart below 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 March ***producer price index (PPI)*** rose by a seasonally adjusted 0.2%, less than the expected gain of 0.3% and far less than the February rise of 0.6%. Excluding the volatile food and energy components, the March ***"core" PPI*** also increased 0.2%, matching expectations and decelerating from February's rise of 0.3%. However, even though wholesale price gains cooled on a month-over-month basis, they accelerated on a year-over-year basis. The overall PPI in March was up 2.1% from the same month one year earlier, while the core PPI was up 2.4%. The chart below shows the year-over-year change in the PPI and the core PPI over the last decade or so.



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**
8:45	John Williams Gives Keynote Remarks	President of the Federal Reserve Bank of New York
10:00	Thomas Barkin Takes Audience Questions	President of the Federal Reserve Bank of Richmond
12:00	Susan Collins Speaks at Economic Club of New York	President of the Federal Reserve Bank of Boston
13:30	Raphael Bostic Participates in Moderated Conversation	President of the Federal Reserve Bank of Atlanta

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	Japan Buying Foreign Bonds	w/w	5-Apr	¥346.4b	-¥1660.5b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	5-Apr	-¥301.8b	-¥233.6b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	5-Apr	-¥349.0b	¥842.2b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	5-Apr	¥1764.4b	-¥441.3b		*	Equity and bond neutral
	Money Stock M2	y/y	Mar	2.5%	2.5%		**	Equity and bond neutral
	Money Stock M3	y/y	Mar	1.8%	1.8%		**	Equity and bond neutral
China	PPI	y/y	Mar	-2.8%	-2.7%	-2.8%	**	Equity and bond neutral
	CPI	y/y	Mar	0.1%	0.7%	0.4%	***	Equity and bond neutral
EUROPE								
Italy	Industrial Production	m/m	Feb	0.1%	-1.4%	0.5%	***	Equity and bond neutral
UK	RICS House Price Balance	m/m	Mar	-4.0%	-10.0%	-6.0%	**	Equity bullish, bond bearish
Russia	CPI	y/y	Mar	7.7%	7.7%	7.7%	***	Equity and bond neutral
	Core CPI	y/y	Mar	7.8%	7.6%		*	Equity and bond neutral
AMERICAS								
Canada	Building Permits	m/m	Feb	9.3%	12.9%	-4.5%	**	Equity bullish, bond bearish
Mexico	Industrial Production	y/y	Feb	3.3%	2.7%	3.1%	***	Equity and bond neutral
	Manufacturing Production	y/y	Feb	2.3%	0.1%	1.4%	*	Equity bullish, bond bearish
Brazil	Retail Sales	y/y	Feb	8.2%	4.0%	3.7%	***	Equity bullish, bond bearish

Financial Markets

The table below highlights some of the indicators that we follow daily. 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)	557	556	1	Down
3-mo T-bill yield (bps)	523	525	-2	Up
U.S. Sibor/OIS spread (bps)	533	533	0	Up
U.S. Libor/OIS spread (bps)	534	534	0	Up
10-yr T-note (%)	4.55	4.54	0.01	Up
Euribor/OIS spread (bps)	391	392	-1	Down
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Down			Down
Yen	Flat			Down
Pound	Flat			Down
Franc	Up			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
ECB Main Refinancing Rate	4.500%	4.500%	4.500%	On Forecast
ECB Marginal Lending Facility	4.750%	4.750%	4.750%	On Forecast
ECB Deposit Facility Rate	4.000%	4.000%	4.000%	On Forecast
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.

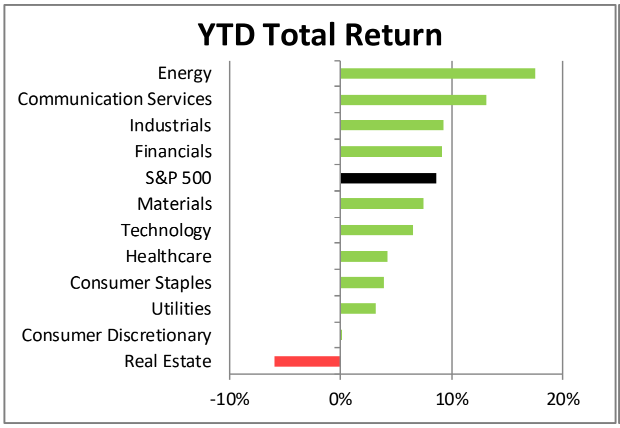
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$90.01	$90.48	-0.52%	
WTI	$85.70	$86.21	-0.59%	
Natural Gas	$1.86	$1.89	-1.11%	
Crack Spread	$29.75	$29.70	0.17%	
12-mo strip crack	$24.93	$25.11	-0.70%	
Ethanol rack	$1.83	$1.83	-0.01%	
Metals				
Gold	$2,336.46	$2,334.04	0.10%	
Silver	$27.93	$27.95	-0.08%	
Copper contract	$427.35	$428.20	-0.20%	
Grains				
Corn contract	$448.00	$445.75	0.50%	
Wheat contract	$570.75	$573.50	-0.48%	
Soybeans contract	$1,173.00	$1,178.00	-0.42%	
Shipping				
Baltic Dry Freight	1,587	1,570	17	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	5.8	0.8	5.0	
Gasoline (mb)	0.7	-2.3	3.0	
Distillates (mb)	1.7	-1.4	3.04	
Refinery run rates (%)	-0.3%	0.6%	-0.9%	
Natural gas (bcf)		13		

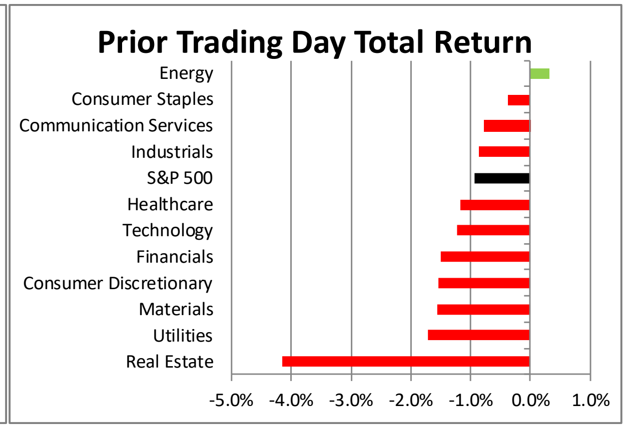
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in California, the Southwest, and from the Great Plains eastward, with cooler-than-normal temperatures in the northern Rocky Mountain region. The forecasts call for wetter-than-normal conditions from the Great Plains eastward, with dry conditions in the Far West.

<u>Data Section</u>

US Equity Markets – (as of 4/10/2024 close)

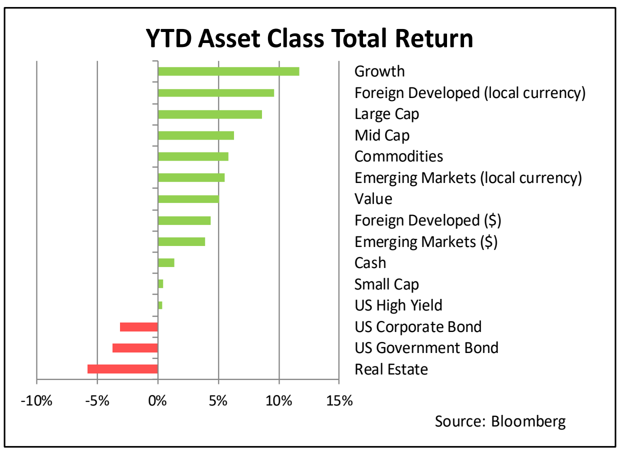




(Source: Bloomberg)

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 4/10/2024 close)

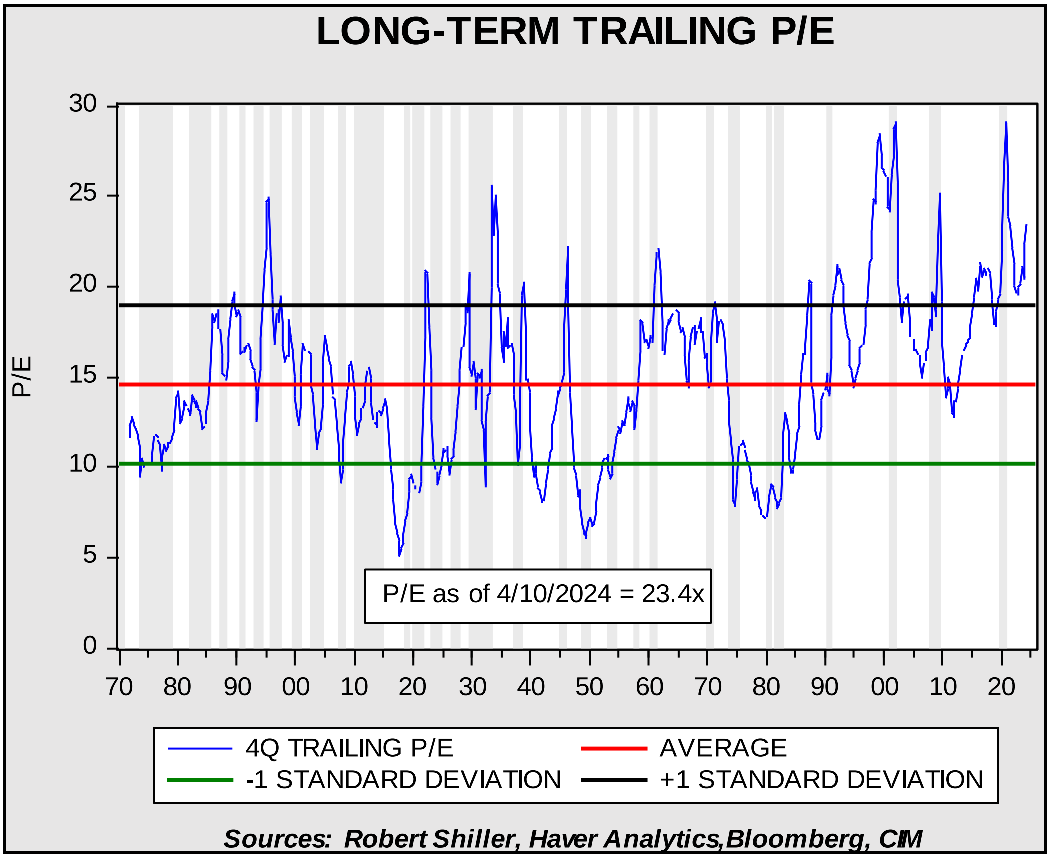


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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), US Corporate Bond (iShares iBoxx $ Investment Grade Corporate Bond ETF), US Government Bond (iShares 7-10 Year Treasury Bond ETF), US 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

April 11, 2024



Based on our methodology,[1] the current P/E is 23.4x, down 0.2x from our last report. The decline in the multiple reflects a decrease in the stock price index, and a slight increase in earnings.

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 three actual quarters (Q2, Q3 and Q4) and one estimate (Q1). 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.