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: April 29, 2024—9:30 AM EDT] Global equity markets are generally higher this morning. In Europe, the Euro Stoxx 50 is down 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.7%. Chinese markets were higher, with the Shanghai Composite up 0.8% from its previous close and the Shenzhen Composite up 2.3%. US equity index futures are signaling a higher open.

With 228 companies having reported so far, S&P 500 earnings for Q1 are running at $55.60 per share, compared to estimates of $54.24, which is up 0.9% from Q1 2023. Of the companies that have reported thus far, 81.1% have exceeded expectations while 16.7% have fallen short of expectations.

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:

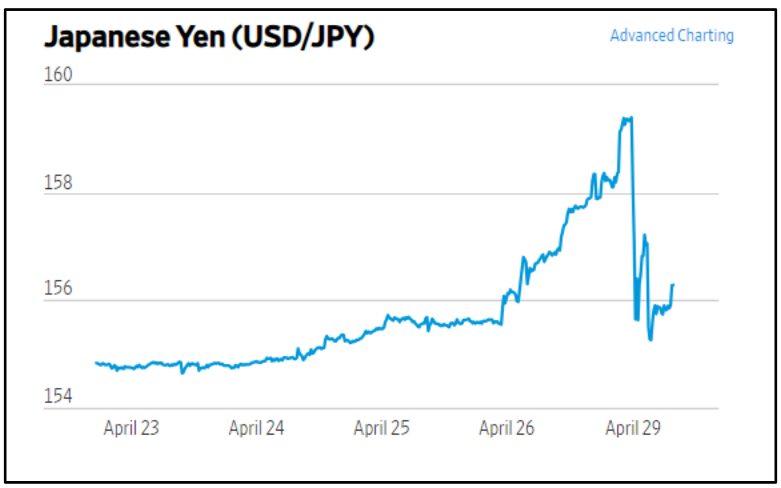
- *Bi-Weekly Geopolitical Report* (4/22/2024) (with associated podcast): "The Changing Face of War"
- *Asset Allocation Quarterly – Q2 2024* (4/25/2024): Discussion of our asset allocation process, Q2 2024 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q1 2024 Rebalance Presentation* (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* (4/29/2024) (there will be no accompanying podcast): "The Peace Dividend, Government Debt, and Yield Curve Control"**
- *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"
- *Keller Quarterly* (4/18/24)
- Business Cycle Report (4/25/24)

Our *Comment* today opens with a discussion of the latest US bank to be seized and sold by regulators as a result of today's high interest rates. We next review a range of other international and US developments with the potential to affect the financial markets today, including a UK proposal to cut long-term disability benefits due to their spiraling fiscal costs and a proposed tax increase on the wealthy in Russia to help fund its invasion of Ukraine. We also include a preview of this week's Federal Reserve policy meeting.

US Banking System: On Friday afternoon, state and federal regulators seized Philadelphia-based Republic First Bancorp and sold it to fellow regional lender Fulton Financial. Reports say the bank faced challenges similar to Silicon Valley Bank and the two other lenders that had to be seized last year: a steep drop in the value of its bond holdings as interest rates rose, along with a wave of withdrawals as large depositors sought greater security and higher yields elsewhere. Nevertheless, the seizure hasn't seemed to spark too much investor concern so far.

- The muted market reaction probably reflects the fact that Republic First had total assets of only about $6 billion at the end of 2023 and a stock-market capitalization that was closer to zero than anything else. The bank's small size, well understood problems, and orderly seizure could minimize the risk of contagion to other financial institutions.
- Nevertheless, the development underscores how continued high interest rates in the US are stressing particular firms in the financial sector and related industries, such as commercial real estate.
- Despite the economy's current positive momentum, an unexpected crisis for a big firm could still undermine confidence, spark financial contagion, and potentially put the economy into reverse. We therefore think high interest rates remain a risk for the economy and financial markets.

Japan: Continued high rates in the US also keep buoying the dollar, especially as foreign central banks hesitate to hike their rates or prepare to cut. Exemplifying the trend, the Japanese yen (JPY) today continued to depreciate, almost reaching 160 per dollar ($0.00625), a new multi-decade low. Reports indicate that the government then intervened in the market to lift the currency. As of this writing, the yen is trading at 156.26 per dollar ($0.00640).



United Kingdom: Faced with surging payments for long-term disability benefits, largely driven by mental health issues, the UK government will release proposed rules today to tighten eligibility and cut costs. The proposed rules mark a rare instance in which a Western government has been willing to suggest benefit cuts to a politically popular program as its costs increase in the face of population aging and worsening mental health conditions.

Russia: In a speech last week, President Putin said his government is exploring options for hiking taxes on wealthy companies and individuals. According to Putin, the aim is to make the tax system more progressive, with richer taxpayers obliged to pay a higher rate to fund social programs and channel more resources to the poor. Such a move would also disproportionately hit taxpayers in the rich, vibrant, liberal-leaning cities of Moscow and St. Petersburg, basically forcing them to pay more to support Russia's expensive invasion of Ukraine.

- Sources say the government is considering hiking the top corporate income-tax rate to 25% from its current rate of 20%.
- For the individual income tax, the government is mulling a boost in the top rate to 20%, versus 15% today, for those with incomes over about $54,300 per year and an increase to 15% from 13% for those with incomes over about $10,860. Individuals with incomes below that level would continue to enjoy the flat 13% rate put into place early in Putin's reign.

China-European Union: As China continues to boost its electric vehicle industry, leading to excess capacity and surging exports of ultra-low cost Chinese EVs, new research from the Rhodium Group suggests the EU would have to impose tariffs of about 50% to stem the tide and protect domestic EU producers. The report comes as Brussels continues its formal investigation into possible unfair dumping by Chinese EV firms.

- The dumping probe is widely expected to confirm that Chinese EV makers are exporting to the EU at subsidized, unfairly low prices. According to Rhodium, EU policymakers are likely to respond by imposing anti-dumping tariffs of 15% to 30%, despite the risk of angering Beijing and potentially prompting it to retaliate against European exports.
- Nevertheless, the Rhodium analysts believe many Chinese EV makers would still earn a comfortable profit at the EU's contemplated tariffs. The analysis suggests it would take tariffs of 50% or even more to make the EU market unattractive to Chinese producers.
- Of course, tariffs that high would be even more likely to anger Beijing and prompt retaliation against the EU. All the same, now that EU leaders have joined US leaders in realizing that Chinese dumping could be a mortal threat to their domestic industries, the EU is becoming increasingly aggressive in erecting barriers to Chinese trade.

China-United States: Admiral John Aquilino, the outgoing commander of all US military forces in the Indo-Pacific, has warned that China is pursuing a "boiling frog" strategy in the region. In Aquilino's analysis, Beijing is actively boosting its military strength and adopting more aggressive military behavior in the Indo-Pacific, but it is doing it so gradually that the US and its allies may not see the danger until it's too late to reverse it.

- Aquilino's analysis, which is consistent with our view of Chinese strategy, points to even more tensions or a potential crisis in the region in the future.

- As we often warn, the spiral of tensions and the potential for a future crisis will produce continued risks for investors going forward.

US Monetary Policy: The Fed holds its latest policy meeting starting tomorrow, with its decision due at 2:00 PM EDT on Wednesday. Given the continued momentum in US economic growth and persistent price pressures, the policymakers are widely expected to hold the benchmark fed funds interest-rate target unchanged at a range of 5.25% to 5.50%. Indeed, interest-rate futures trading suggests investors now expect the first rate cut — and potentially the only rate cut this year — to come around the end of summer.

- As noted above, continued high interest rates will likely put stress on certain banks, commercial real estate owners, and other players in the financial markets.
- Despite the economy's current positive momentum, high interest rates probably remain a risk for the economy and financial markets.

US Electric Vehicle Industry: Tesla has reportedly won Beijing's tentative approval to release its "full self-driving" software in vehicles sold in China. The company's FSD software is considered key to reigniting its sales growth in major markets, so the news has boosted Tesla's stock price by approximately 11% in pre-market trading. Nevertheless, given the Chinese government's massive support for domestic EV makers, we suspect that excess capacity and falling prices will remain a big challenge for Tesla.

US Economic Releases

There were no economic releases prior to the publication of this report. 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
10:30	Dallas Fed Manufacturing Activity	m/m	Apr	-11.3	-14.4	--
Federal Reserve						
No Fed speakers or events for the rest of today						

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								
South Korea	Department Store Sales	y/y	Mar	8.9%	7.2%		*	Equity and bond neutral
	Discount Store Sales	y/y	Mar	6.2%	21.0%		*	Equity and bond neutral
	Retail Sales	y/y	Mar	10.9%	13.7%		**	Equity and bond neutral
China	Industrial Profits	y/y	Mar	4.3%	10.2%		*	Equity and bond neutral
EUROPE								
Eurozone	Consumer Confidence	m/m	Apr F	-14.7	-14.7		**	Equity and bond neutral
	Services Confidence	m/m	Apr	6.0	6.4	6.9	**	Equity bearish, bond bullish
	Industrial Confidence	m/m	Apr	-10.5	-8.9	-8.5	***	Equity bearish, bond bullish
	Economic Confidence	m/m	Apr	95.6	96.2	96.7	***	Equity bearish, bond bullish
Germany	CPI	y/y	Apr P	2.2%	2.2%	2.3%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Apr P	0.5%	2.3%	2.4%	**	Equity and bond neutral
Switzerland	Domestic Sight Deposits CHF	w/w	26-Apr	467.3b	472.9b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	26-Apr	475.7b	481.3b		*	Equity and bond neutral
Russia	Retail Sales Real	m/m	Mar	11.1%	11.7%	8.6%	**	Equity bullish, bond bearish
	Unemployment Rate	m/m	Mar	2.70%	2.80%	2.80%	***	Equity and bond neutral
AMERICAS								
Brazil	FGV Inflation IGPM	y/y	Apr	-3.04%	-4.26%	-3.23%	***	Equity and bond neutral

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)	559	559	0	Up
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 (%)	4.62	4.67	-0.05	Up
Euribor/OIS spread (bps)	387	386	1	Down
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
Yen	Up			Down
Pound	Up			Down
Franc	Up			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.

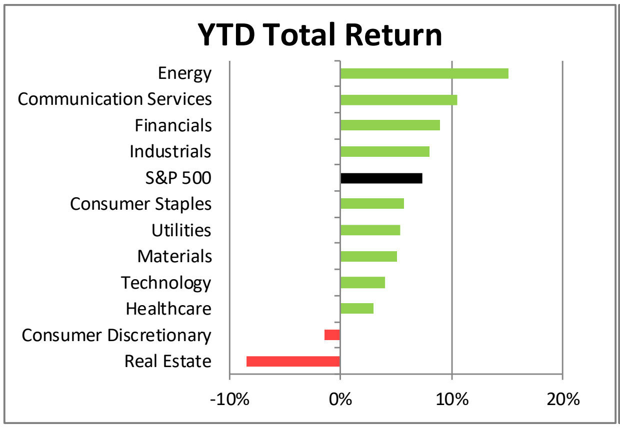
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$89.27	$89.50	-0.26%	
WTI	$83.90	$83.85	0.06%	
Natural Gas	$1.93	$1.92	0.47%	
12-mo strip crack	$24.47	$24.35	0.50%	
Ethanol rack	$1.84	$1.84	0.02%	
Metals				
Gold	$2,336.97	$2,337.96	-0.04%	
Silver	$27.33	$27.21	0.44%	
Copper contract	$461.50	$457.40	0.90%	
Grains				
Corn contract	$449.25	$450.00	-0.17%	
Wheat contract	$613.75	$622.25	-1.37%	
Soybeans contract	$1,182.25	$1,177.25	0.42%	
Shipping				
Baltic Dry Freight	1,721	1,743	-22	

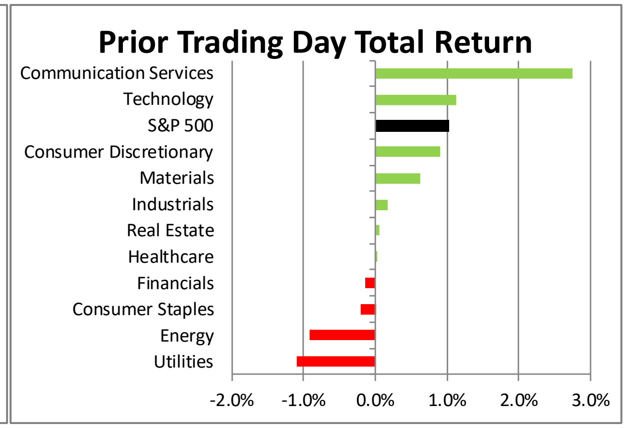
Weather

The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures across the majority of the country, with the exception of cooler-than-normal temperatures expected in the Pacific Northwest. The current precipitation forecast predicts wetter-than-average conditions across most of the country, with dry conditions expected in the Southwest and Great Lakes regions.

Data Section

US Equity Markets – (as of 4/26/2024 close)

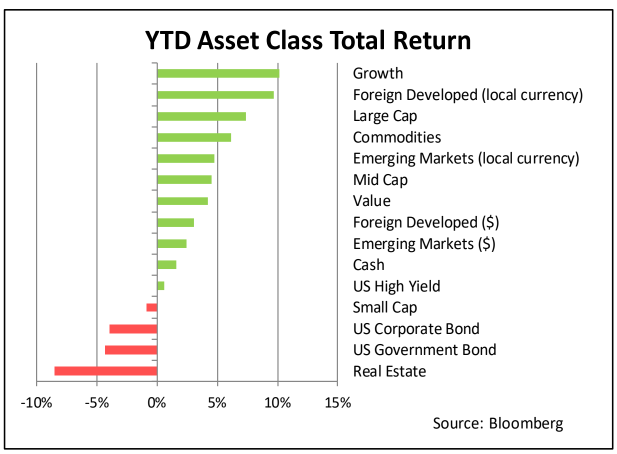




(Source: Bloomberg)

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 4/26/2024 close)

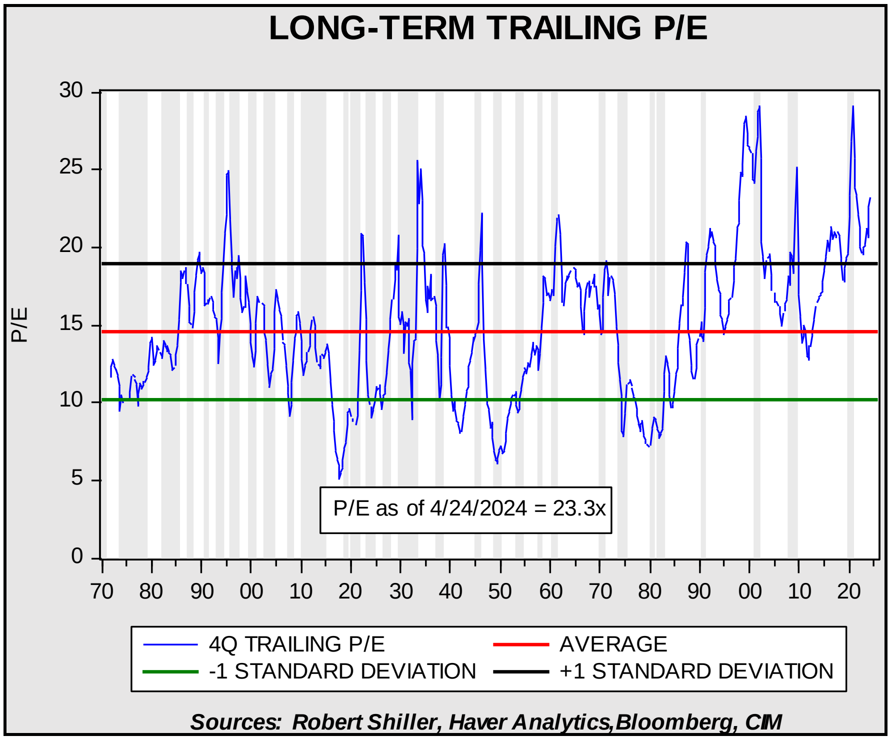


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 25, 2024



Based on our methodology,[1] the current P/E is 23.2x, up 0.2x from our last report. The decrease in the multiple reflects a slight increase in earnings and a decline in the stock price index.

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.