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 5, 2024—9:30 AM EDT] Global equity markets are generally lower this morning. In Europe, the Euro Stoxx 50 is down 1.4% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.4%. Chinese markets were lower, with the Shanghai Composite down 0.2% from its previous close and the Shenzhen Composite down 0.7%. Conversely, US equity index futures are signaling a higher open.

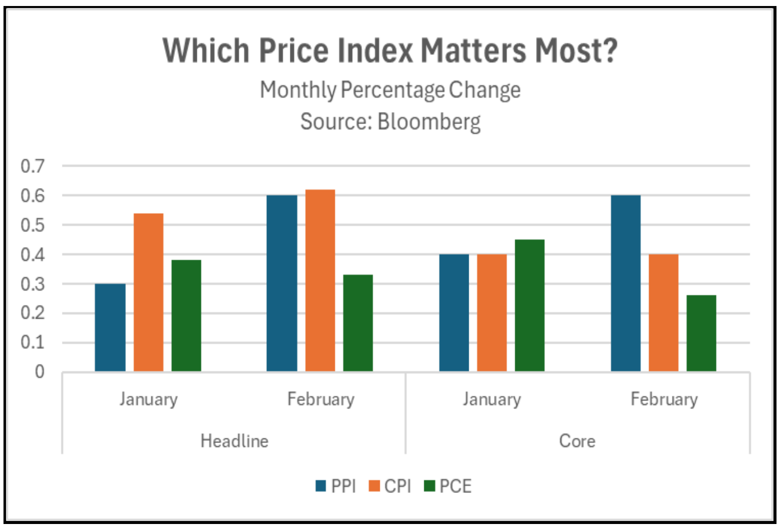
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (3/25/2024) (with associated podcast): "Venezuela Threatens Guyana"
- *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 giving back gains after a surprisingly strong jobs report. In college athletics news, Caitlin Clark, the Iowa star, secured her second straight Player of the Year award. Today's *Comment* discusses why the Fed's tolerance for inflation might be higher than investors anticipate, analyzes the surprising strength of US banks following the one-year mark of the Silicon Valley Bank collapse, and delves into the resilience of European equities despite a stagnant European economy. As usual, our report includes a roundup of international and domestic economic releases.

Not 2%, But Close Enough: The S&P 500 trimmed gains after a Fed president downplayed rate cuts, but signs suggest a Fed policy shift might still be coming.

- The Federal Reserve's monetary policy stance is in flux. In a recent LinkedIn event, Neel Kashkari, president of the Minneapolis Fed, admitted his prior projection of two rate cuts in 2024 might need to be revised. Wary of inflation proving more persistent than anticipated, Kashkari signaled a possibility that the Fed may not cut rates at all this year. This shift follows hotter-than-expected inflation data in January and February, impacting both consumer and producer prices. However, Loretta Mester, president of the Cleveland Fed, remains optimistic, believing inflation will cool enough to allow for a rate cut as planned.
- The threshold for a rate cut may be lower than most investors realize. The latest FOMC projections showed that the committee expects three rate cuts and inflation to fall to 2.5% by year-end. This suggests policymakers may be comfortable with a slower-than-expected pace of inflation reduction as long as the progress is consistent. Even so, the conflicting inflation data may complicate their decision. In February, the Consumer Price Index (CPI), a common inflation gauge, rose 3.8% from the prior year, while the Fed's preferred measure, the Personal Consumption Expenditures (PCE) price index, currently sits at 2.8%.

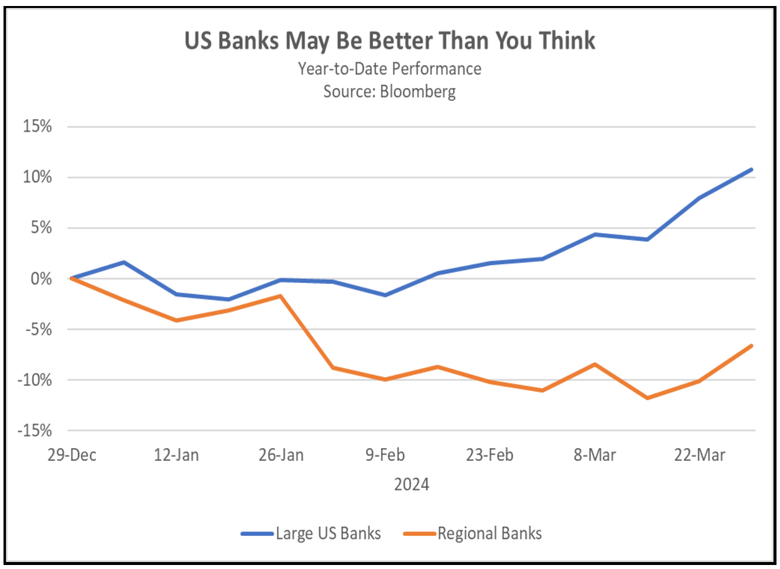


- The timing of any policy easing could hinge on which inflation indicator policymakers prioritize, or even if they consider both. Despite policymakers preferring to use core PCE as their tool to evaluate inflation, they have been known to react to changes in core CPI. This is evident in their recent references to persistent inflation, primarily based on the month-to-month change in the CPI data in March, which overshadowed a noticeable deceleration in core PCE. If they prioritize the CPI, they might hold rates for longer than expected. Conversely, if they focus on the PCE price index, they could be open to a rate cut as early as June.

Slow Moving Train: More than a year after the Silicon Valley Bank collapse, the financial system shows signs of recovery, though some skepticism lingers around regional banks.

- This week, Federal Reserve Vice Chair of Supervision Michael Barr sought to reassure the public about the financial system's health, while acknowledging potential risks in commercial real estate. At a National Community Reinvestment Coalition event, he declared banks to be "sound" and "resilient," highlighting improved liquidity. However, he balanced this optimism by acknowledging "pockets of risk" due to firms holding "significant unrealized losses" on their books and having a high concentration of commercial real estate. Instead of an immediate crisis, Barr likened the situation to a "slow-moving train" with potential problems surfacing over several years.

- Despite lingering concerns about the health of the banking system, US banks have surprised analysts with a strong start to 2024. Large-cap bank stocks have surged 11% year-to-date according to a UBS index, significantly outperforming the S&P 500's gain of just 8.5% over the same period. This robust performance can be attributed to two key factors. First, large banks capitalized on opportunities last year by acquiring struggling but profitable regional banks, which has bolstered their earnings. Second, net interest income has remained healthy due to the Federal Reserve's decision to keep interest rates elevated.



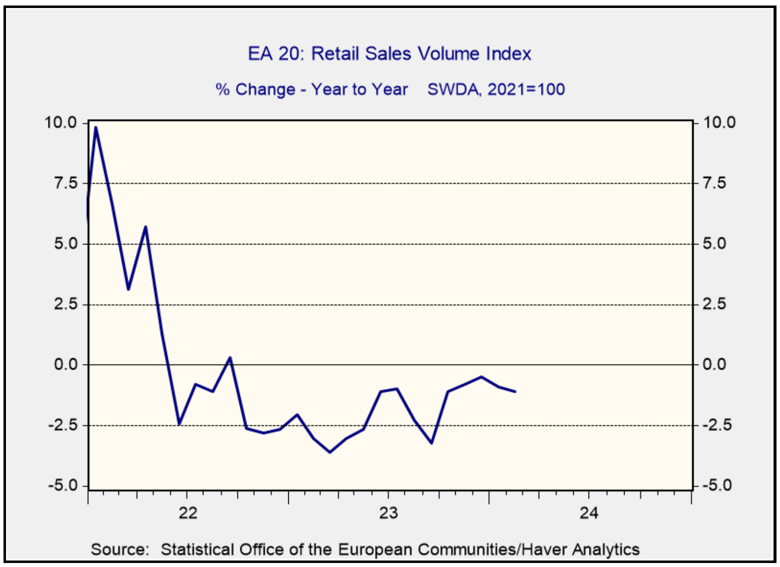
- Large banks have thrived this year, but regional banks remain a cloud of concern for investors. The KBW regional bank index is currently in negative territory, reflecting investor wariness of smaller banks due to anxieties about their commercial real estate exposure. The recent misstep at New York Community Bank further fueled these apprehensions. Still, it's important to note that the closure of the Fed's Bank Term Funding Program hasn't triggered signs of an imminent regional banking crisis. If this situation continues, it will further add to optimism that the economy may avoid a downturn this year.

Silver Lining in Europe: European equities are showcasing resilience amidst prevailing economic headwinds and Germany's weakened state.

- The STOXX Europe 600 (SXXP) has soared to new highs in 2024, fueled by a strong performance from large-cap stocks, particularly in banking and car manufacturing. The banking sector has witnessed its best showing in six years, surging 34% year-over-year.

This rise is attributed to the banks' ability to maintain financial health and capitalize on recent interest rate hikes by the European Central Bank (ECB). The recent shift by automakers away from electric vehicles due to perceived slowing demand, though, has also found favor with investors worried about declining profit margins and potentially lower sales.

- Despite a strong stock market performance, the eurozone economy faces ongoing challenges. The region narrowly averted a recession, technically defined as two consecutive quarters of economic decline. Recent data paints a concerning picture, with retail sales dropping 0.5% in February and the March purchasing managers' index indicating a further contraction in construction activity. Germany, a key eurozone player, appears particularly vulnerable. Its manufacturing sector, a traditional engine of growth, continues to drag. German industrial orders rose a meager 0.2% in February, far below expectations of 0.8%.

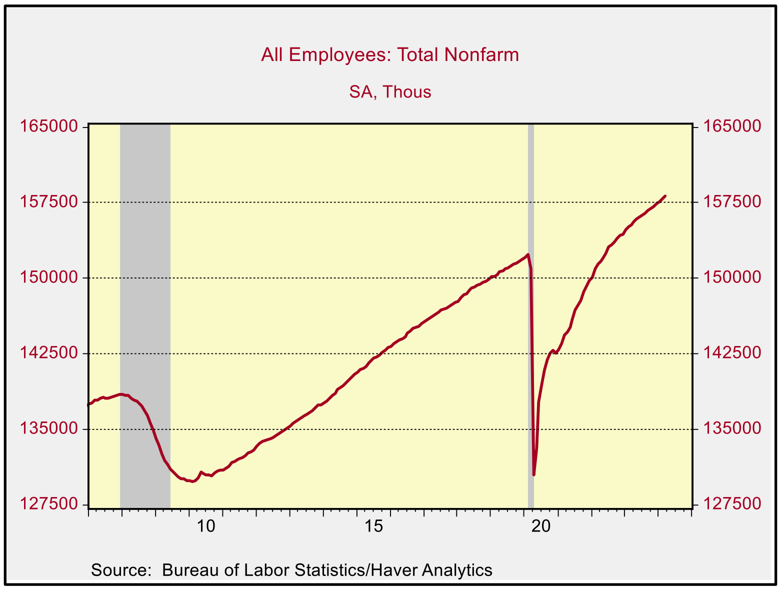


- The strong stock market performance may be short-lived if economic conditions continue to deteriorate. Downturns historically lead to credit tightening, making it harder for companies to borrow and potentially hindering their ability to remain profitable. However, the ECB's planned interest rate cut in June could help ease the situation by making credit more affordable. In the current economic climate of uncertainty, European blue-chip stocks could be a viable option for investors seeking a safe haven. These companies are resilient to major financial fluctuations, while also maintaining relatively attractive valuations compared with their US peers.

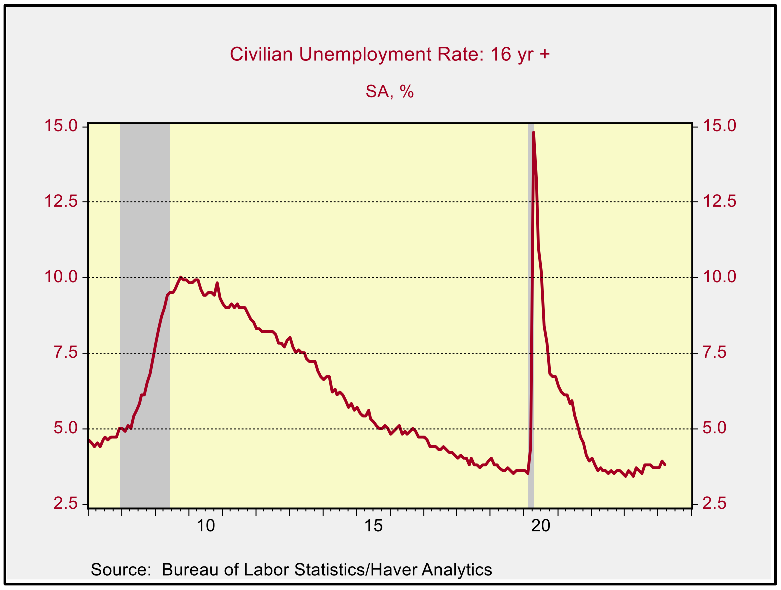
Other News: Bank of Japan Governor Kazuo Ueda signaled a possible rate hike in the second half of the year; the comment led the yen to strengthen against the dollar. Argentinian President Javier Milei seemed to retract his commitment to distancing the country from China by indicating that Beijing still wields considerable influence in South America. Treasury Secretary Janet Yellen has underscored the impracticality of the United States severing ties with China, solidifying a persistent trend of simmering tensions between the world's two largest economies.

US Economic Releases

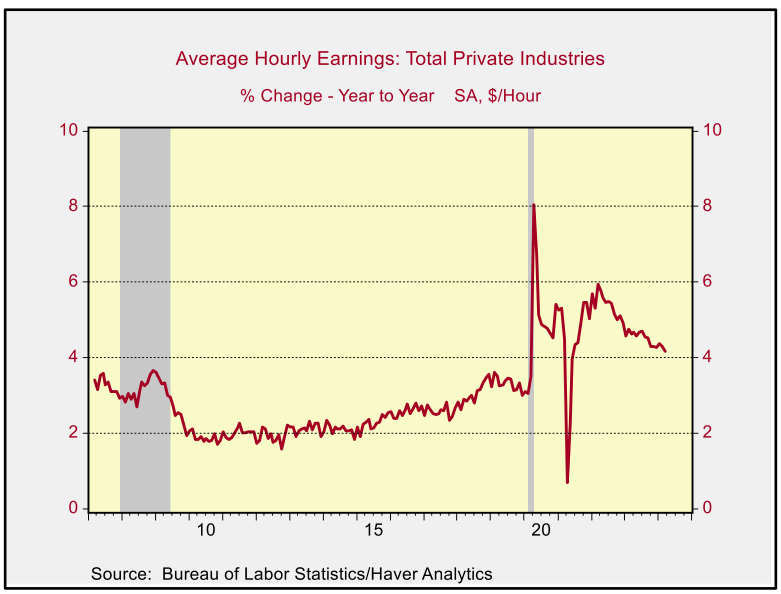
March ***nonfarm payrolls*** rose by a seasonally adjusted 303,000, surging past the expected gain of 214,000 and even higher than the revised increase of 270,000 in February. Private-sector payrolls alone rose by 232,000, accelerating from their revised increase of 207,000 in the previous month. The hot jobs number and other strong aspects of the report discussed below will likely raise concerns that price inflation will remain above the Fed's target and further delay the policymakers' plan to start cutting interest rates. The chart below shows the change in nonfarm payrolls since shortly before the Great Financial Crisis.



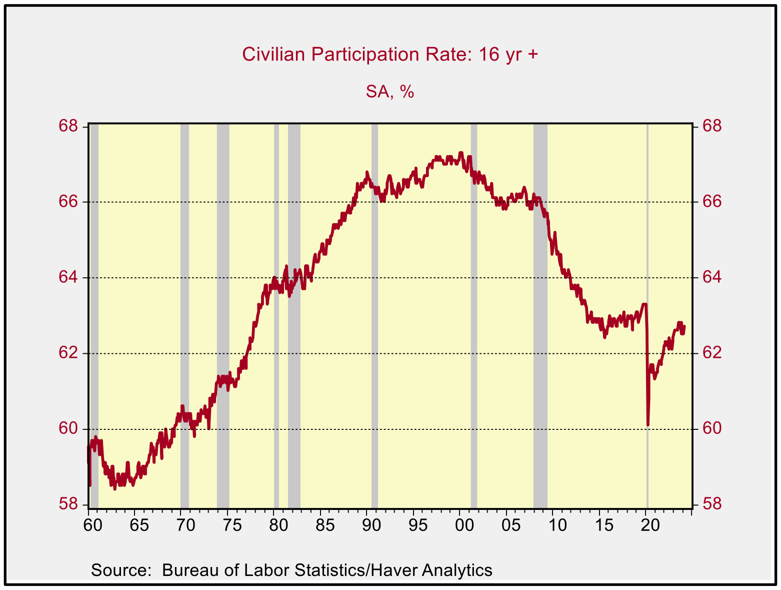
Consistent with the strong increase in jobs, the March ***unemployment rate*** fell to a seasonally adjusted 3.8% as expected, compared with 3.9% in February and 3.7% in each of the three months before that. The following chart shows how the unemployment rate has evolved since just before the GFC.



Despite the increase in jobs and decline in unemployment, ***average hourly earnings*** in March were up just 4.1% from the same month one year earlier, coming in at a seasonally adjusted $34.69. The year-over-year rise matched expectations and marked a significant slowdown from the 4.3% increase in the year to February. The chart below shows the year-over-year growth in average hourly earnings since just before the GFC.



A final key indicator in the monthly employment report focuses on the share of the adult, civilian, noninstitutionalized population that is either working or looking for work. The March ***labor force participation rate (LFPR)*** rose to a seasonally adjusted 62.7%, but it remains below the levels seen before the COVID-19 pandemic, in large part reflecting the legions of older workers who left the labor force during the health crisis. The chart below shows how the LFPR has changed over the last several decades.



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**
15:00	Consumer Credit	m/m	Feb	$15.000b	$19.495b	*
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
9:15	Thomas Barkin Speaks on Economic Outlook	President of the Federal Reserve Bank of Richmond				
11:00	Lorie Logan Speaks at Duke University	President of the Federal Reserve Bank of Dallas				
12:30	Michelle Bowman Speaks on Risks in Monetary Policy	Member of the Board of Governors				

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	Household Spending	y/y	Feb	-0.5	-6.3	-2.9	***	Equity bearish, bond bullish
Australia	Imports	m/m	Feb	4.8%	1.4%		*	Equity and bond neutral
	Trade Balance	m/m	Feb	A$7280m	A$10058m	A$10500m	***	Equity and bond neutral
	Exports	m/m	Feb	-2.2%	1.5%		*	Equity and bond neutral
South Korea	BoP Goods Balance	m/m	Feb	$6607.9m	$4240.4m		*	Equity and bond neutral
	BoP Current Account Balance	m/m	Feb	$6858.3m	$3045.7m		**	Equity and bond neutral
EUROPE								
Eurozone	Retail Sales	y/y	Feb	-0.7%	-0.9%	-0.8%	*	Equity and bond neutral
Germany	Import Price Index	y/y	Feb	-4.9%	-5.9%	-4.6%	**	Equity and bond neutral
	Factory Orders WDA	y/y	Feb	-10.6%	-6.2%	-10.1%	***	Equity and bond neutral
	HCOB Germany Construction PMI	m/m	Mar	38.3	39.1		*	Equity and bond neutral
France	Industrial Production	y/y	Feb	-0.8%	0.9%	-0.1%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	Feb	-0.3%	0.2%		**	Equity and bond neutral
UK	S&P Global UK Construction PMI	m/m	Mar	50.2	49.7	49.8	**	Equity and bond neutral
Switzerland	Foreign Currency Reserves	m/m	Mar	715.1b	677.8b		*	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	29-Mar	$589.4b	$590.1b		***	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	29-Mar	18.06t	18.12t		*	Equity and bond neutral
AMERICAS								
Canada	International Merchandise Trade	m/m	Feb	1.39b	0.61b	0.68b	**	Equity and bond neutral
Brazil	Trade Balance	m/m	Mar	$7483m	$5308m	$9.500b	**	Equity and bond neutral
	Exports	m/m	Mar	$27980m	$23494m	$31.200b	*	Equity and bond neutral
	Imports	m/m	Mar	$20498m	$18186m	$21.400b	*	Equity and bond neutral
	FGV Inflation IGP-DI	y/y	Mar	-4.00%	-4.04%	-4.06%	***	Equity and bond neutral
	Net Debt % GDP	m/m	Feb	60.9%	60.1%	60.1%	**	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)	557	557	0	Down
3-mo T-bill yield (bps)	520	520	0	Up
U.S. Sibor/OIS spread (bps)	529	528	1	Down
U.S. Libor/OIS spread (bps)	530	529	1	Down
10-yr T-note (%)	4.33	4.31	0.02	Up
Euribor/OIS spread (bps)	389	386	3	Down
Currencies	**Direction**			
Dollar	Up			Up
Euro	Flat			Down
Yen	Flat			Down
Pound	Flat			Down
Franc	Down			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
RBI Cash Reserve Ratio	4.500%	4.500%	4.500%	On Forecast
RBI Repurchase Rate	6.500%	6.500%	6.500%	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.

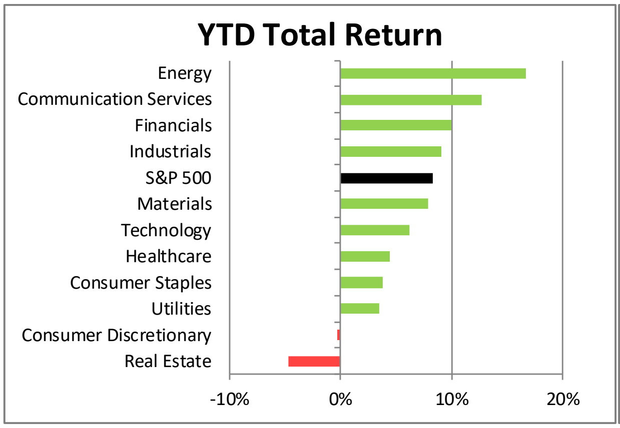
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$90.87	$90.65	0.24%	
WTI	$86.61	$86.59	0.02%	
Natural Gas	$1.79	$1.77	1.13%	
Crack Spread	$30.40	$30.18	0.71%	
12-mo strip crack	$25.48	$25.55	-0.27%	
Ethanol rack	$1.78	$1.77	0.32%	
Metals				
Gold	$2,292.34	$2,290.94	0.06%	
Silver	$26.73	$26.91	-0.69%	
Copper contract	$422.05	$424.90	-0.67%	
Grains				
Corn contract	$438.25	$435.25	0.69%	
Wheat contract	$571.25	$556.25	2.70%	
Soybeans contract	$1,183.25	$1,180.00	0.28%	
Shipping				
Baltic Dry Freight	1,669	1,711	-42	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	3.2	-1.0	4.2	
Gasoline (mb)	-4.3	0.1	-4.4	
Distillates (mb)	-1.27	-1.00	-0.27	
Refinery run rates (%)	-0.1%	0.3%	-0.4%	
Natural gas (bcf)	-37	-42	5	

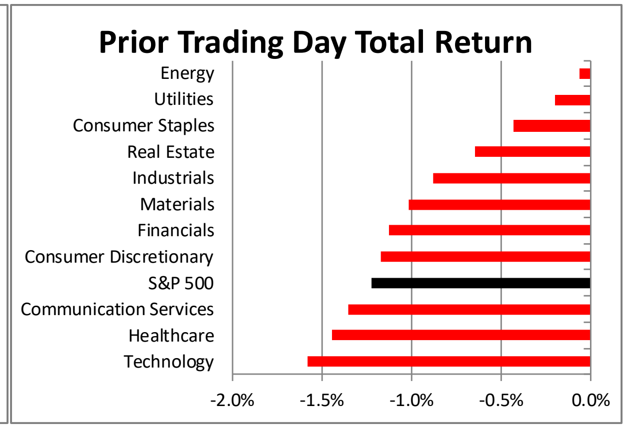
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures everywhere except the southern Great Plains, with cooler-than-normal temperatures only in southern Texas. The forecasts call for wetter-than-normal conditions in the southern Great Plains, the Southeast, and New England, with dry conditions in the central Rocky Mountains and Great Plains.

Data Section

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

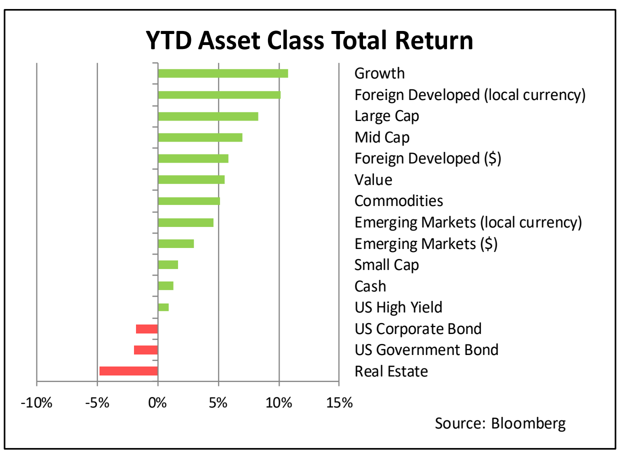




(Source: Bloomberg)

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 4/4/2024 close)

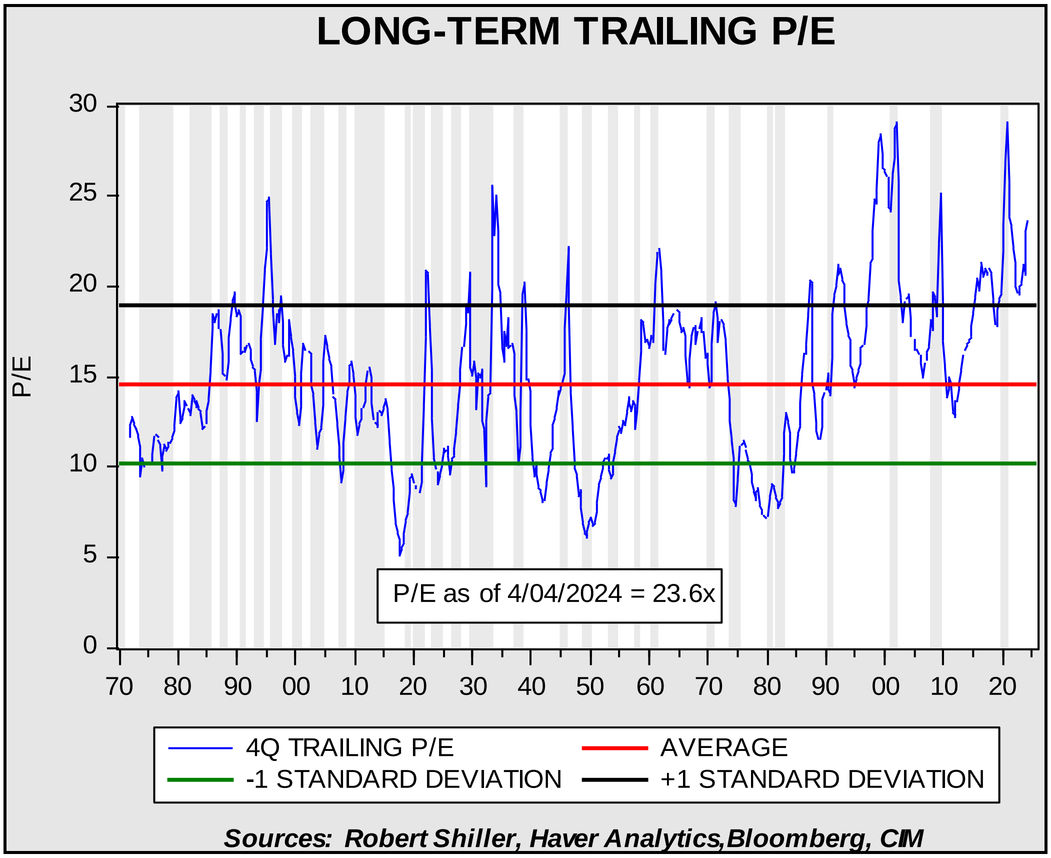


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 4, 2024



Based on our methodology,[1] the current P/E is 23.6x, up 0.5x from our last report. The improvement in the multiple reflects an increase in the stock price index due to a change in quarter, outweighing the 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.