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: February 12, 2024—9:30 AM EST] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.1%. Chinese markets were closed for the Chinese Lunar New Year. US equity index futures are signaling a slightly lower open.

With 334 companies having reported so far, S&P 500 earnings for Q4 are running at $57.30 per share compared to estimates of $55.15, which is up 1.6% from Q3 2023. Of the companies that have reported thus far, 79.6% have exceeded expectations, while 15.3% 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* (1/29/2024) (with associated podcast): "Introducing the US Space Force"
- *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* (2/5/2024) (with associated podcast): "US Oil Production at a Record High"
- *The 2024 Outlook: Slow-Bicycle Economy* (12/18/2023) (with associated *Confluence of Ideas* podcast)

With China and much of Asia celebrating the Lunar New Year, and with most of the US focused on yesterday's Super Bowl, it's a very slow news day, especially for economic and financial news. Our *Comment* today is therefore focused heavily on political issues, starting with former President Trump's controversial comments over the weekend about the US commitment to the North Atlantic Treaty Organization. We next review several other international and US developments with the potential to affect the financial markets today, including a disputed election in Pakistan and the retirement of a key anti-China member of congress in the US.

United States-NATO-Russia: At a campaign rally on Saturday, former President Trump [said he would "encourage" Russian leaders to do whatever they want to NATO nations that don't meet the alliance's target of spending 2%] of gross domestic product on defense. Of course, it's not clear whether the statement was mere electoral bluster or a harbinger of real policy if he is elected in November. Nevertheless, the statement is likely to spur even greater doubts in Europe about the US's commitment to defending NATO territory.

- Trump's longstanding focus on the 2% target is likely unsettling to the non-US members of NATO for several reasons.
  - For one, it suggests that a NATO member's defense budget is the key measure of its contribution to the alliance. In reality, it fails to capture the benefit that the US gets from being able to base its troops throughout Europe, extending the US defensive perimeter some 4,000 miles to the east of US shores.
  - The 2% figure is also somewhat arbitrary. To make its optimal contribution to alliance defense, a country might need to spend more than 2% of GDP, while another could make its optimal contribution with less.
  - Of course, the Europeans could also artificially boost their defense spending by rolling nominally civilian budget programs into the military budget, arguing those programs contribute to defense.
    - Another way they could game their budgeting system and inflate their defense budget would be to give their troops an enormous boost in pay, only to take it back by imposing higher income taxes on service members.
    - On average, personnel costs account for more than half the defense budget of NATO's non-US allies. Simply boosting troop pay and benefits by 50% could therefore lift a typical country's defense burden from 1.6% to the target 2.0% of GDP, with no change in troop counts or capability.
  - Even if the Europeans met the 2% target, they likely fear that Trump would raise the ante as there is no reason Trump couldn't then demand 3% or 4%. The Europeans also probably fear that he would demand outright cash transfers to the US for its "defense services," not recognizing that Europe's armed forces, military cooperation, and US basing rights also contribute to US defense. Trump could try to justify the move as a way to help cover the US budget deficit or fund tax cuts.
- Many people likely hope or believe that Trump's threat to withhold US defense support is mere posturing. However, even if it is, the real-life impact has been to undermine our European (and Asian) allies' trust in the US commitment to them. If our European and Asian allies increasingly doubt the US will stand shoulder-to-shoulder with them in a crisis, the US could face unsettling unintended consequences going forward.
  - In our latest *Bi-Weekly Geopolitical Report*, to be published later today, we note that doubts about the US commitment have already begun to spur US allies into hiking their defense budgets and starting to rebuild their armed forces to deter aggression against them. Since nuclear weapons are the gold standard for

deterrence, politicians in Europe and Asia are also starting to call for their countries to develop their own, independent nuclear arsenals.

  - In our report, we note that Beijing and Moscow likely relish the idea of the US pulling back its support from its European and Asian allies, but they may get more than they bargained for.
    - If key US allies in Europe or Asia develop their own nukes, China and Russia could find themselves surrounded by close-in nuclear powers.
    - For example, Russia could eventually face a nuclear Poland or nuclear Baltic states. China could face a nuclear Japan, South Korea, or Australia.
  - By the same token, if the US creates too much doubt about its mutual-defense commitments and prompts its allies to create their own nukes, it could face a nuclear Germany or a nuclear Japan, only a century or so after fighting each of them in World War II.

- In any case, all these developments point to an increasingly chaotic, tension-filled world, which could create headwinds for many investments, but it will also likely create some investment opportunities. Here at Confluence, we continue to focus heavily on managing investments with a keen eye on those risks and opportunities.

Finland: In national elections yesterday, former Prime Minister Alex Stubb was elected president with 52% of the vote. In Finland, the president is the commander-in-chief of the armed forces and also takes the lead on foreign policy, so Stubb will be instrumental in determining Finland's new role as a member of NATO. Given his past experience heading up Finland's finance, foreign, and trade ministries, Stubb is believed to have "safe hands" for steering the country's foreign and security policies into the future.

United States-China: Representative Mike Gallagher of Wisconsin, a former Marine Corps intelligence officer who is now the China-bashing chair of the House Select Committee on the Chinese Communist Party, said on Saturday that he will retire from Congress at the end of his current term. The announcement comes just days after Gallagher was one of only four Republican lawmakers to vote against impeaching Homeland Security Secretary Mayorkas for his handling of migration at the southern border.

- Gallagher's sudden retirement announcement suggests he may have faced punishment by the Republican Party for his vote against impeaching Mayorkas.
- In any case, Gallagher has been a persistent, forceful, articulate advocate for the US to push back against China's aggressive effort to build its power in the military, diplomatic, economic, and technology spheres. Unless Gallagher finds a new position to advocate for stronger anti-China policies, his retirement could take some of the wind out of the sails for China hawks in Congress, potentially easing US-China tensions and giving a boost to Chinese stocks.

Pakistan: The final results of last week's elections were released over the weekend, showing former Prime Minister Imran Khan's party won the most seats in parliament even though Khan has been jailed on apparently trumped-up charges. The results are being seen as a rare repudiation of the country's military and its obvious efforts to keep Khan from power and could point to an increasing risk of political strife in the country.

Israel: Moody's has cut the country's sovereign debt rating from A1 to A2, citing the possible fiscal impact of its war against the Hamas government in the Gaza Strip. Moody's also cut Israel's debt rating outlook to negative from stable out of concern that the conflict with Hamas could spread. Even though the Moody's rating is still solidly investment grade, the downgrade will likely raise some concern about Israeli stock and bond values.

US Commercial Real Estate Market: With interest rates high and vacancies making banks reluctant to roll over property-backed loans, investors who have set up funds to buy distressed properties are finally reporting that prices have come down enough for them to snap up buildings. According to data firm Preqin, global private-equity funds focused on real estate are sitting on $544 billion in cash that could be put to work on distressed properties, potentially helping prevent a crisis as bank lending to the sector dries up.

US Nuclear Energy Market: According to CEO Boris Schucht of privately held British fuel processor Urenco, a bill in Congress that would ban imports of uranium from Russia will help encourage a secure domestic supply chain for the nuclear fuel used to generate electricity. According to Schucht, the law would create enough market certainty to spur millions of dollars in new nuclear fuel capacity in the US and the rest of the West. The statement is consistent with other signs of growing interest in expanding the nuclear generation industry in the US and abroad.

US Military: Just weeks after sparking controversy by not informing the White House or the public that he was being treated in hospital, Defense Secretary Austin this morning was rushed by his security detail to Walter Reed National Military Medical Center and put in intensive care for an "emergent bladder issue."

- Coupled with the previous controversy and his recent treatment for cancer, today's incident will probably raise new calls for Austin to resign.
- If Austin does resign, he could be replaced by someone who would push for a faster military buildup and an expanded defense industrial base to counter the rising geopolitical aggressiveness of China.

US Economic Releases

There were no economic releases prior to the public 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**
14:00	Monthly Budget Statement	m/m	Jan	-$21.0b	-$129.4b	**
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
9:20	Michelle Bowman Speaks at Community Bank Conference	Member of the Board of Governors				
12:00	Thomas Barkin Speaks at Atlanta Economics Club Event	President of the Federal Reserve Bank of Richmond				
13:00	Neel Kashkari Moderates Economic Club of Minnesota Discussion	President of the Federal Reserve Bank of Minneapolis				

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								
India	Industrial Production	y/y	Dec	3.8%	2.4%	2.5%	***	Equity bullish, bond bearish
	CPI	y/y	Jan	5.1%	5.7%	5.0%	***	Equity and bond neutral
EUROPE								
Switzerland	Domestic Sight Deposits CHF	w/w	9-Feb	473.8b	470.5b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	9-Feb	482.3b	481.2b		*	Equity and bond neutral
Russia	Trade Balance	m/m	Dec	10.2b	8.7b	9.0b	**	Equity and bond neutral
	Exports	m/m	Dec	38.4b	33.4b	33.6b	*	Equity and bond neutral
	Imports	m/m	Dec	28.2b	24.7b	24.6b	*	Equity and bond neutral
AMERICAS								
Canada	Net Change in Employment	m/m	Jan	37.3k	0.1k	15.0k	***	Equity bullish, bond bearish
	Unemployment Rate	m/m	Jan	5.7%	5.8%	5.9%	***	Equity and bond neutral
	Participation Rate	m/m	Jan	65.3%	65.4%	65.4%	*	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.

Fixed Income	Today	Prior	Change	Trend
3-mo Libor yield (bps)	557	556	1	Down
3-mo T-bill yield (bps)	522	523	-1	Flat
U.S. Sibor/OIS spread (bps)	531	531	0	Down
U.S. Libor/OIS spread (bps)	532	532	0	Down
10-yr T-note (%)	4.15	4.18	-0.03	Flat
Euribor/OIS spread (bps)	389	390	-1	Down
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Down			Up
Yen	Up			Up
Pound	Down			Up
Franc	Down			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.

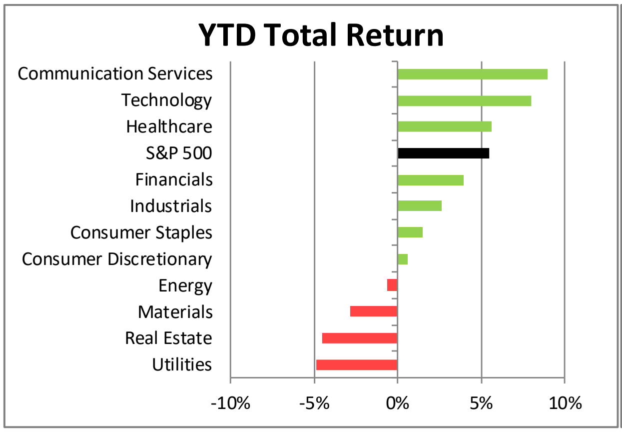
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$81.22	$82.19	-1.18%	
WTI	$75.92	$76.84	-1.20%	
Natural Gas	$1.82	$1.85	-1.25%	
Crack Spread	$30.37	$30.03	1.14%	
12-mo strip crack	$27.57	$27.37	0.73%	
Ethanol rack	$1.73	$1.73	0.20%	
Metals				
Gold	$2,021.33	$2,024.26	-0.14%	
Silver	$22.96	$22.61	1.54%	
Copper contract	$368.90	$368.15	0.20%	
Grains				
Corn contract	$431.25	$429.00	0.52%	
Wheat contract	$594.00	$596.75	-0.46%	
Soybeans contract	$1,190.75	$1,183.50	0.61%	
Shipping				
Baltic Dry Freight	1,545	1,473	72	

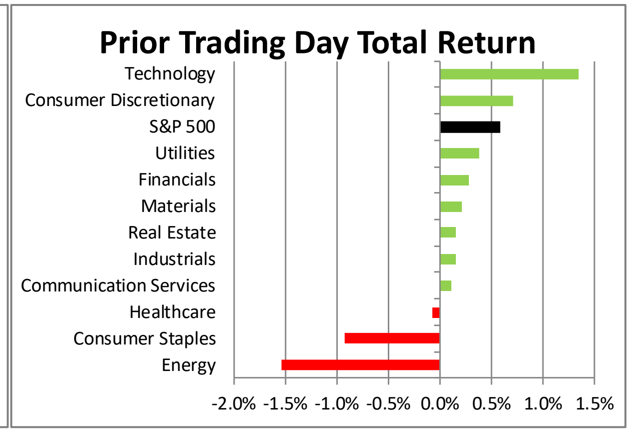
Weather

The 6-10 and 8-14 day forecasts currently call for colder-than-normal temperatures throughout most of the country, with warmer-than-normal temperatures along the Pacific region and southern Great Plains. The forecasts call for wetter-than-normal conditions in the Pacific region, Great Plains, and most of the East Coast, with dry conditions in the Great Lakes and Texas.

Data Section

US Equity Markets – (as of 2/9/2024 close)

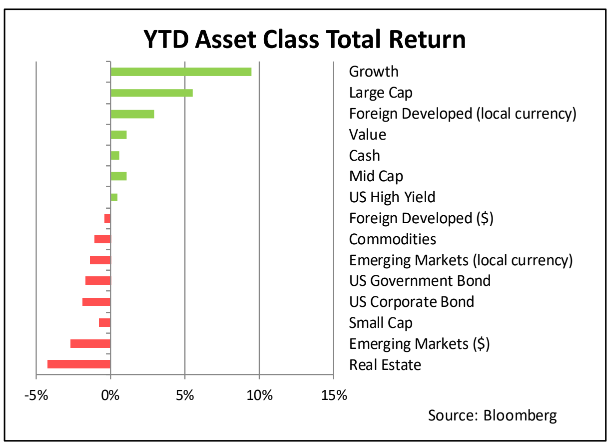




(Source: Bloomberg)

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 2/9/2024 close)

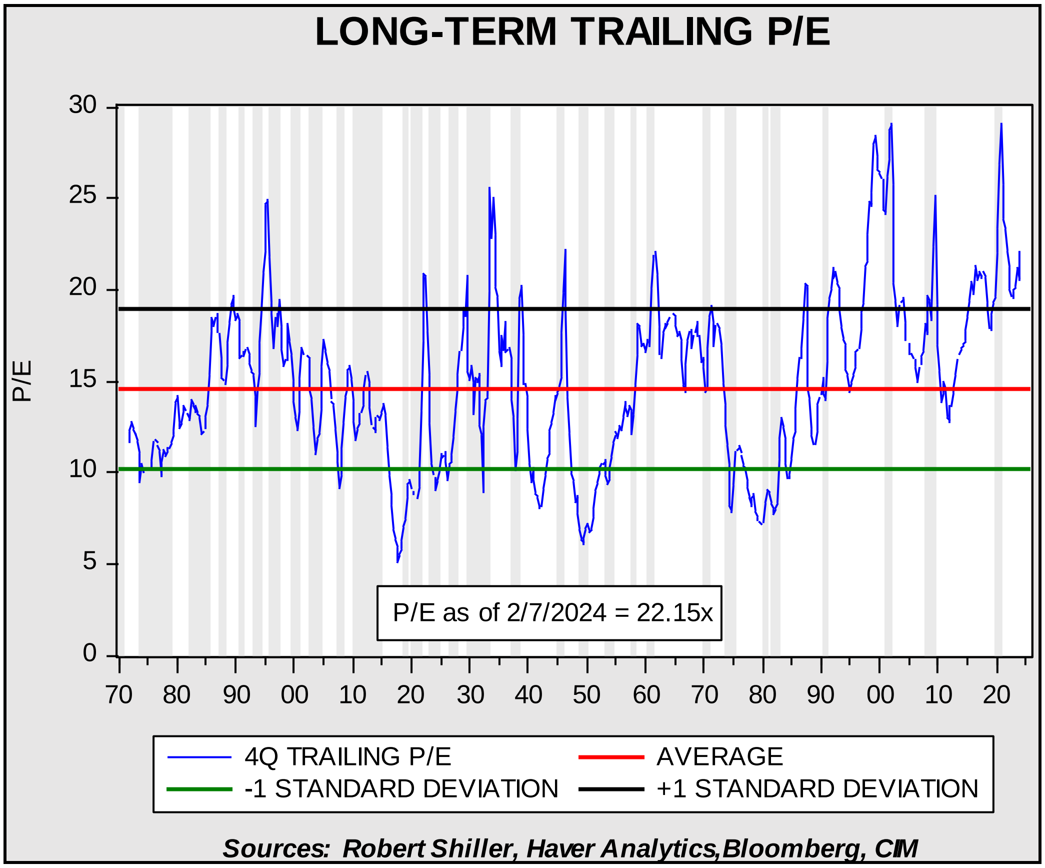


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

February 8, 2024



Based on our methodology,[1] the current P/E is 22.15x, up 0.16x from our last report. The rise in the multiple was driven primarily by an increase in the 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 (Q1, Q2 and Q3) and one estimate (Q4). 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.