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 13, 2024—9:30 AM EST] Global equity markets are mostly lower this morning. In Europe, the Euro Stoxx 50 is down 0.9% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.3%. Chinese markets were closed for the Chinese Lunar New Year. US equity index futures are signaling a slightly lower open.

With 339 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, 79.9% have exceeded expectations, while 14.8% 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*** **(2/12/2024) (with associated podcast): "Thinking About Deterrence"**
- *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)

Our *Comment* today opens with several notes related to China, including changes to a key index of Chinese stocks. We next review a wide range of other international and US developments with the potential to affect the financial markets today, including a hotter-than-expected reading on British wage growth and a discussion of how artificial intelligence is affecting the US labor market.

China-Hong Kong: With the Hong Kong municipal government preparing a new national security law that would hew closer to mainland China's tough rules, US law firm Latham & Watkins said its attorneys in the city will no longer have automatic access to the firm's international databases. The lawyers will still be able to access mainland Chinese documents, but they will need special permission to see foreign information.

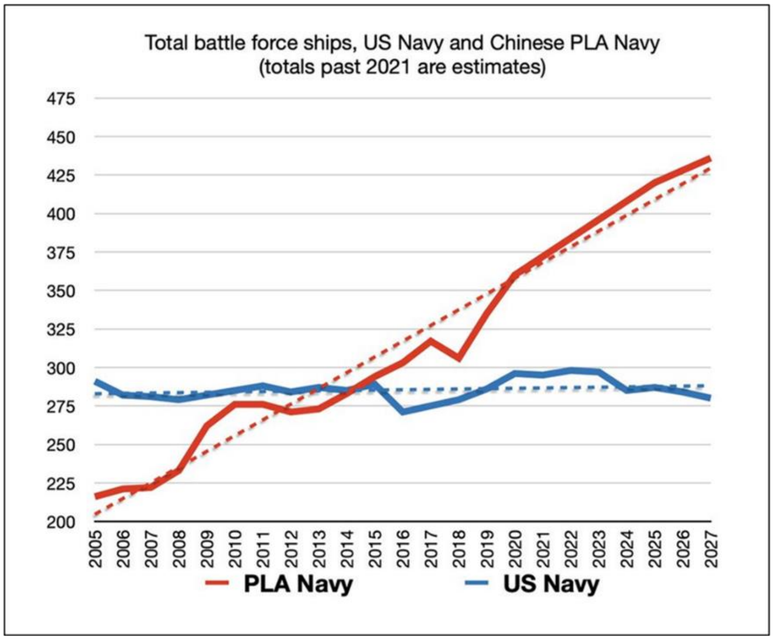
- The Latham & Watkins announcement helps confirm that cross-border information flows between China and the US geopolitical bloc will be a new arena of decoupling.
- The restrictions on Chinese-Western information flows follow years of increased barriers to trade, capital, technology, and even travel and tourism flows in each direction.
- As we have long argued, this fracturing of global markets is likely to reduce global economic efficiency and lead to higher costs, increased inflation, and elevated interest rates going forward, with particularly negative impacts on fixed-income assets.

Chinese Stock Market: Stock index compiler MSCI announced today that it will add five new names to its benchmark MSCI China Index, but it will delete 66 names that now fail to meet its standards because of China's long stock slump. The 66 deletions, which stem from MSCI's regular quarterly review, are more than in its last four quarterly adjustments combined. With the deletions, the index will now have slightly more than 700 names in total.

- Since many investors seeking to match the MSCI China Index will now have to sell out of the deleted names, those stocks are now likely to come under increased selling pressure. The deleted stocks include the likes of Weibo and China Southern Airlines.
- Currently, the MSCI China Index is down more than 7% for the year-to-date and about 27% over the last year.

Chinese Shipbuilding Industry: Based on our expectation of ever more intense Great Power competition between China and the US, we pay a lot of attention to each side's military power and defense industrial capacity. The *Wall Street Journal* today carries a good article showing how China's shipbuilding industry has surged to become the world's largest and richest, with many times more capacity to build commercial and naval ships than the US and the West.

- As we often note, China now has the world's largest navy, with more than 350 combat ships. Moreover, the Chinese navy continues to grow rapidly, while the US is basically stagnant at about 295 combat ships.
- While we continue to believe that the US and the West will keep ramping up their defense budgets in the face of increased aggressiveness by the China/Russia geopolitical bloc, the lack of shipyard capacity (including a big shortage of workers) is holding back the US military's rebuilding so far.



(Source: TheSoundingLine.com)

Russia-Estonia: The Russian government has put Estonian Prime Minister Kaja Kallas on its wanted list, along with dozens of other Baltic politicians critical of the Kremlin and its war against Ukraine. Although the move could be mere grandstanding by the Kremlin, it comes amid a surge of extraterritorial law enforcement and intelligence operations by authoritarian or authoritarian-leaning states ranging from China to India. The risks for Baltic politicians on Russia's wanted list are therefore elevated.

- Separately, the Estonian foreign intelligence service has issued a warning that the Kremlin plans to double the number of troops it has along its border with Finland and the Baltic states in preparation for a possible war in the coming years. According to the report, Russian leaders are reluctant to attack any NATO territory right now, but they calculate that they could be in a position to do so within a decade.
- Despite Russia's poor military performance early in its invasion of Ukraine, it has now ramped up its defense industrial capacity and improved its troop mobilization, leaving it in a stronger military position than many expected. With Russian President Putin intent on re-establishing the Soviet/Russian empire, further weakening of the US commitment to defending European territory would risk inviting a Russian invasion.

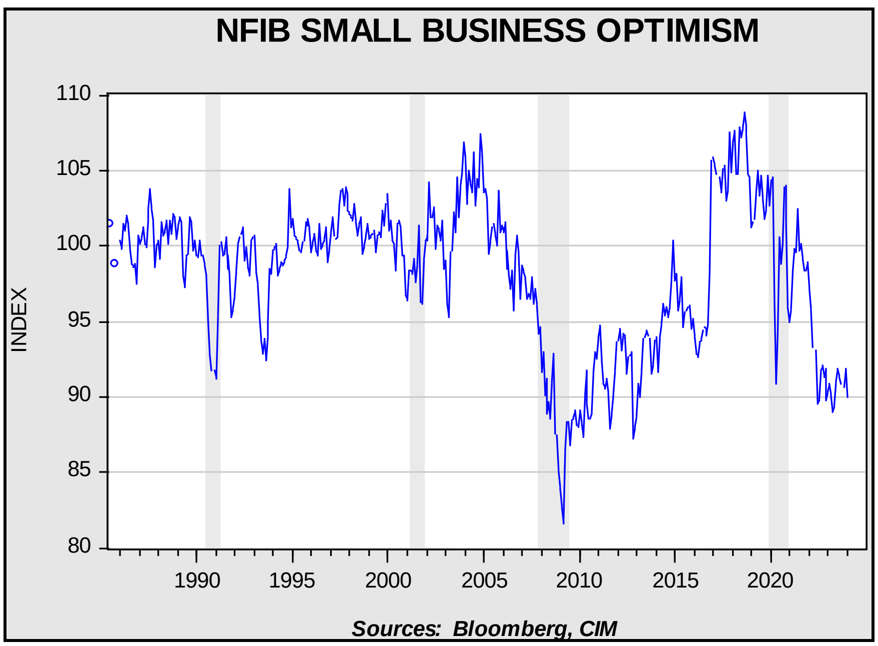
United Kingdom: Today, just as data indicated that US consumer price inflation slowed less than expected in January, a report showed UK wage growth slowed less than anticipated in October through December. The British data revealed that average weekly earnings in the period were up 5.8% from one year earlier, moderating from the annual increase of 8.5% during the summer, but the sticky wage growth will still likely discourage the Bank of England from aggressive rate cuts in the near future.

US Labor Market: New data suggests that generative artificial intelligence (AI) has already resulted in thousands of layoffs across the US economy, while more than half of all white collar "knowledge workers" report they are using the technology at least on a weekly basis. The report will likely boost concerns that generative AI will render the jobs of many affluent, college-educated knowledge workers obsolete, although we suspect it will also create many new jobs for those with skills in the technology.

US Weather: A strong nor'easter storm is lashing the Mid-Atlantic and Northeastern states today, leading to many cancelled airline flights in New York City and other major metropolitan areas. The storm won't necessarily have a noticeable impact on national economic or financial market performance, but it could certainly be disruptive for travelers today.

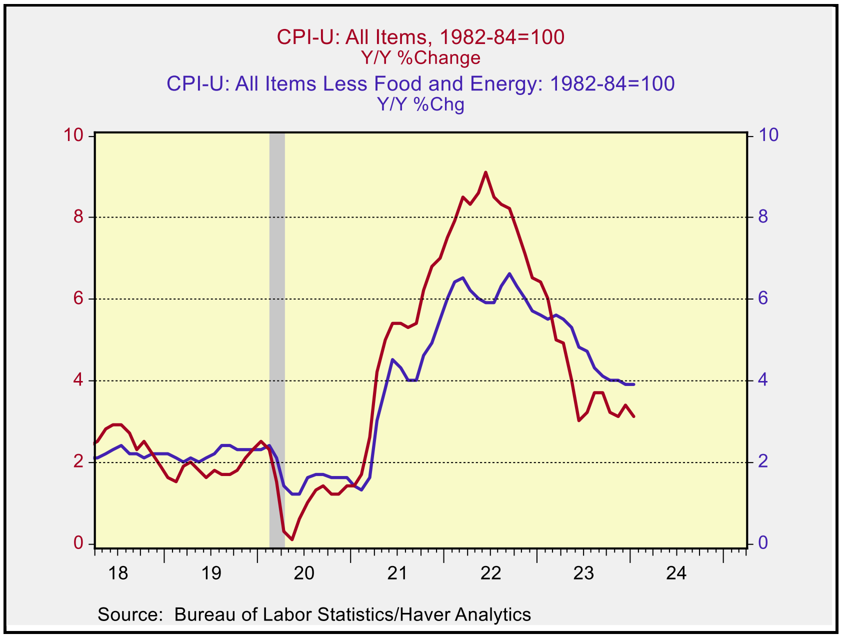
US Economic Releases

Concerns of future sales weighed on the confidence of small business owners. The National Federation of Independent Business' Small Business Optimism Index fell from 91.9 to 89.9. The reading was the lowest in eight months as owners expressed concerns about future demand. The index showed that the percent of owners expecting higher sales fell 12 points to a net negative of 16%.



The chart above shows the level of the NFIB Small Business Optimism Index. The drop in the index shows how confidence in the economy may not be as strong as the market anticipated at the start of the year.

Consumer prices rose at a faster-than-expected pace in January. The Consumer Price Index (CPI) jumped from 0.2% to 0.3%, exceeding the predicted 0.2%. Meanwhile, core CPI, which excludes volatile food and energy prices, climbed from 0.3% to 0.4% — its highest level since last May. The sharper-than-anticipated rise was driven primarily by surging new car prices and shelter costs.



The chart above shows the annual change in both headline and core CPI. Overall inflation decelerated from 3.4% to 3.1%. Meanwhile, core inflation rose 3.9% from the previous year, which is unchanged from the previous month.

There are no economic releases or Fed events scheduled for the rest of the day.

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	Machine tool orders	y/y	Jan P	-14.1%	-9.6%		**	Equity and bond neutral
	PPI	y/y	Jan	0.2%	0.0%	0.1%	***	Equity and bond neutral
Australia	Westpac Consumer Conf SA	m/m	Feb	6.2%	-1.3%		**	Equity and bond neutral
	Westpac Consumer Conf Index	m/m	Feb	86	81		**	Equity and bond neutral
	NAB Business Confidence	m/m	Jan	1	-1	0	**	Equity and bond neutral
	NAB Business Conditions	m/m	Jan	6	7	8.0%	**	Equity and bond neutral
New Zealand	2-Year Inflation Expectations	q/q	1Q	2.50%	2.76%		**	Equity and bond neutral
EUROPE								
Eurozone	ZEW Survey Expectations	m/m	Feb	25.0	22.7		**	Equity and bond neutral
Germany	ZEW Survey Expectations	y/y	Feb	19.9	15.2	17.3	**	Equity bullish, bond bearish
	ZEW Survey Current Situation	m/m	Feb	-81.7	-77.3	-79.0	**	Equity bearish, bond bullish
	Current Account Balance	m/m	Dec	--	30.8b	--	**	Equity and bond neutral
France	ILO Unemployment Rate	q/q	4Q	7.5%	7.4%	7.5%	*	Equity and bond neutral
UK	ILO Unemployment Rate	m/m	Dec	3.8%	3.9%	4.0%	***	Equity and bond neutral
	Claimant Count Rate	y/y	Jan	4.0%	4.0%		***	Equity and bond neutral
	Jobless Claims Change	y/y	Jan	14.1k	11.7k	5.5k	***	Equity bearish, bond bullish
	Average Weekly Earnings 3M/YoY	y/y	Dec	5.8%	6.5%	6.7%	**	Equity bearish, bond bullish
Switzerland	CPI	y/y	Jan	1.3%	1.7%	1.7%	***	Equity and bond neutral
	Core CPI	y/y	Jan	1.2%	1.5%	1.6%	*	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)	521	522	-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 (%)	4.16	4.18	-0.02	Flat
Euribor/OIS spread (bps)	391	389	2	Down
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Flat			Up
Pound	Up			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.

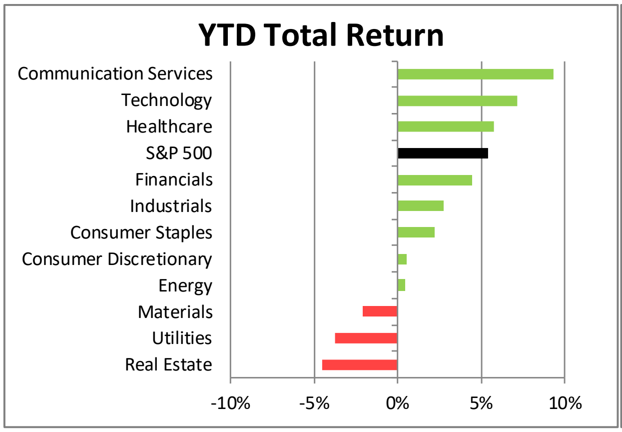
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$82.57	$82.00	0.70%	
WTI	$77.46	$76.92	0.70%	
Natural Gas	$1.76	$1.77	-0.45%	
Crack Spread	$30.36	$30.34	0.08%	
12-mo strip crack	$27.68	$27.76	-0.29%	
Ethanol rack	$1.72	$1.73	-0.28%	
Metals				
Gold	$2,028.23	$2,020.05	0.40%	
Silver	$22.88	$22.70	0.79%	
Copper contract	$373.95	$372.40	0.42%	
Grains				
Corn contract	$432.25	$430.50	0.41%	
Wheat contract	$596.75	$597.50	-0.13%	
Soybeans contract	$1,194.50	$1,193.00	0.13%	
Shipping				
Baltic Dry Freight	1,572	1,545	27	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.7		
Gasoline (mb)		-2.0		
Distillates (mb)		-2.0		
Refinery run rates (%)		-0.3%		
Natural gas (bcf)		-75		

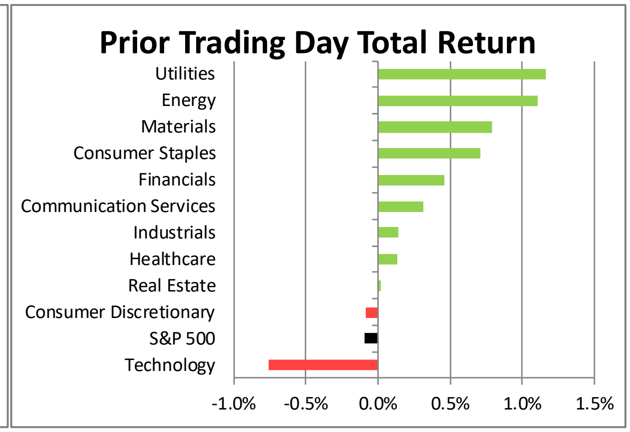
Weather

The 6-10 and 8-14 day forecasts currently call for colder-than-normal temperatures throughout the northern parts of the country and Florida, with warmer-than-normal temperatures in the Midwest and Great Plains. The precipitation outlook calls for wetter-than-normal conditions in states west of the Great Plains, and throughout most of New England and the Great Lakes with dry conditions in Texas.

Data Section

US Equity Markets – (as of 2/12/2024 close)

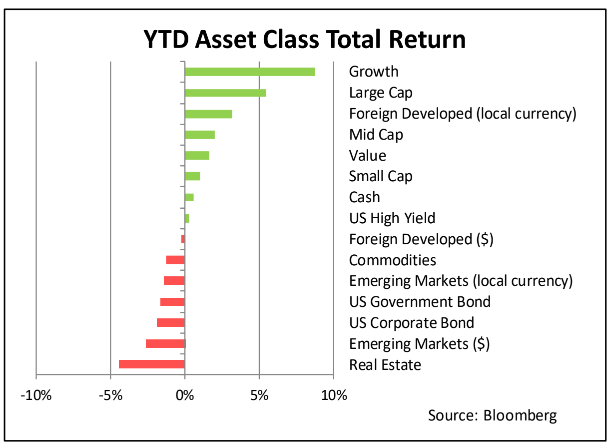




(Source: Bloomberg)

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 2/12/2024 close)

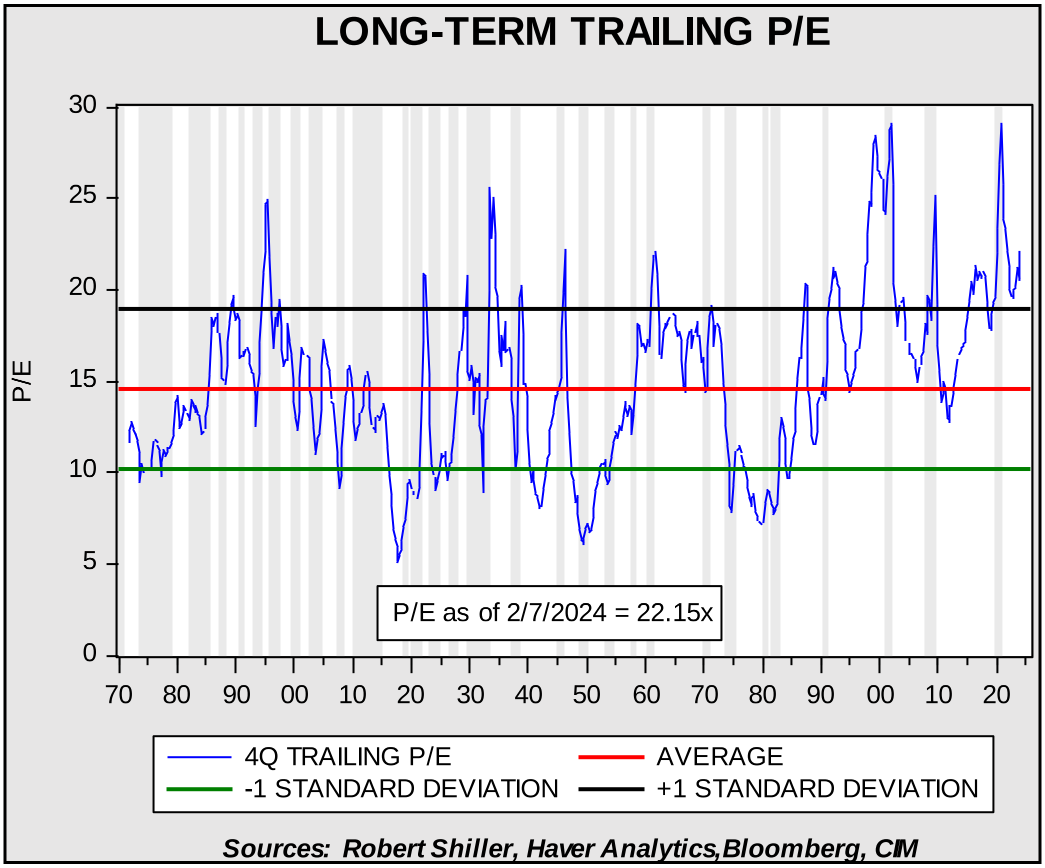


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

---

[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.