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 15, 2024—9:30 AM EST] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is up 0.8% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.6%. Chinese markets were closed for the Chinese Lunar New Year. US equity index futures are signaling a higher open.

With 379 companies having reported so far, S&P 500 earnings for Q4 are running at $57.40 per share compared to estimates of $55.15, which is up 1.6% from Q3 2023. Of the companies that have reported thus far, 78.6% have exceeded expectations, while 15.6% 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)
- *Confluence of Ideas podcast* (2/13/2024) "Reviewing the Asset Allocation Rebalance: Q1 2024"

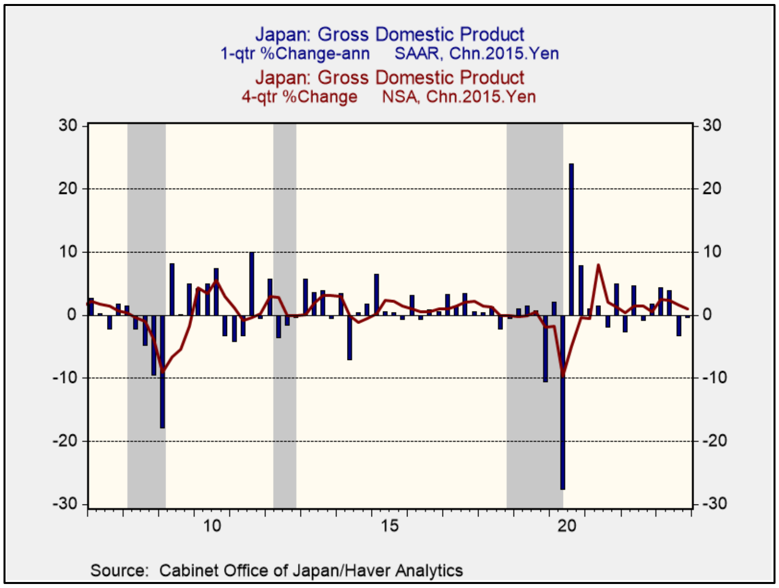
Our *Comment* today opens with a mysterious warning from Congress about a new, destabilizing military capability in Russia. We next review a range of other international and US developments with the potential to affect the financial markets today, including multiple economic reports related to key economies in Asia and Europe and notes on US fiscal policy and the economic impact of immigration.

United States-Russia: Republican Representative Mike Turner, chair of the House Intelligence Committee, issued a cryptic call for all lawmakers to visit a secure facility in the Capitol so they could review new classified intelligence regarding what he called "a destabilizing foreign military capability." Administration officials speaking on condition of anonymity said the intelligence relates to a new Russian nuclear capability that could be used against US satellites in space. The officials said the weapon is still in development and has not yet been deployed.

- Reports say Turner's committee has had the referenced intelligence for about a week, and National Security Advisor Jake Sullivan was already scheduled to brief Congressional leaders on the intelligence on Thursday. It is therefore not clear why Turner issued his unusual call yesterday.
- It's possible that Turner is simply trying to whip up anti-Russian sentiment as Congress battles over military aid to Ukraine to help it fight off Russia's invasion.
- Nevertheless, Russia is far ahead of the US in modernizing its nuclear force, and it has made progress in developing exotic new technologies, such as hypersonic missiles. As we discussed in our recent *Bi-Weekly Geopolitical Report*, space has also become a high-priority warfighting domain for today's top militaries. It would not be surprising if Russia really has leapfrogged the US in some new, destabilizing capability.
- In any case, such a development would be more evidence that the world is becoming more chaotic and risky, as we have long expected. However, while the evolving world will create headwinds for many investments, it will also likely create some investment opportunities. Here at Confluence, we continue to focus heavily on managing investments with a keen eye on both the risks and the opportunities.

Israel-Hamas Conflict: After Iran-backed Hezbollah militants apparently fired missiles from southern Lebanon into Israel yesterday, killing one Israeli soldier and wounding several others, Israel unleashed artillery and air strikes against southern Lebanon, killing and wounding both Hezbollah members and civilians. The attacks are a reminder that Israel's retaliatory war against the Hamas government in Gaza could still spread into a regional conflict, which would threaten energy and commercial supply chains critical to the global economy.

Japan: New data shows gross domestic product unexpectedly fell for a second straight quarter at the end of 2023, putting the Japanese economy in a technical recession. After stripping out price changes and seasonal effects, fourth-quarter GDP fell at an annualized rate of 0.4%, after dropping at a rate of 3.3% in the third quarter. Nevertheless, good growth earlier in 2023 meant that Japanese GDP in the full year was up 1.9%, accelerating from its growth of 1.0% in 2022 and helping confirm positive trends that have recently boosted Japan's stock market.

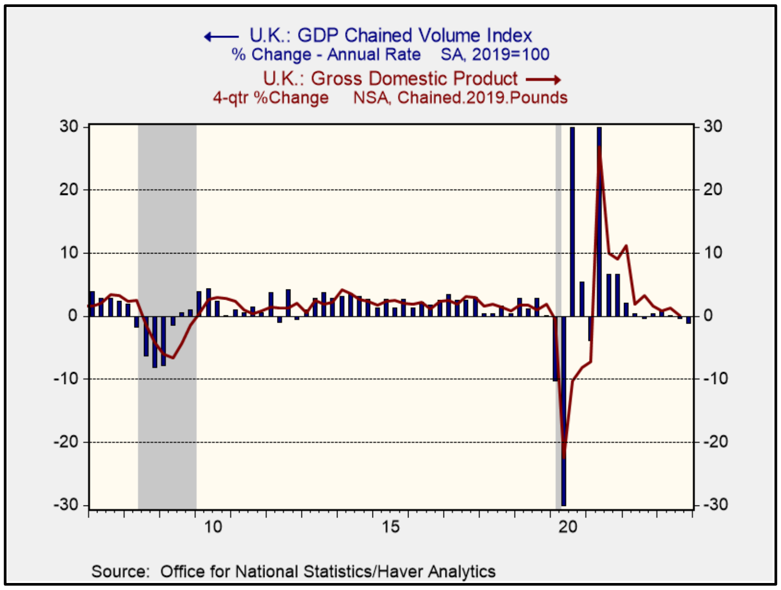


South Korea: The Financial Services Commission has launched a public-private partnership to provide the equivalent of $57 billion in low-cost loans to boost investment in targeted sectors, such as advanced semiconductors, batteries, and smaller companies. Including two state-owned lenders and five major commercial banks, the program is part of a global trend in which governments are embracing subsidies, trade barriers, and other forms of industrial policy to promote favored sectors.

- These modern industrial policies largely aim to improve economic resilience, shield the country from external supply shocks, and promote better-paid jobs at home.
- The downside is that this could further fracture and balkanize global supply chains over time, making the global economy less efficient and leaving inflation and interest rates higher than they otherwise would be.

European Union: The European Commission today cut its economic growth forecasts for the overall EU and the eurozone. The Commission now expects gross domestic product in the EU to grow a modest 0.9% in 2024, while it expects eurozone growth to come in at just 0.8%. Previously, the Commission had forecast growth of 1.3% and 1.2%, respectively. Despite recent data suggesting Europe's industrial recession could be bottoming out, the region continues to struggle with high energy prices, elevated interest rates, and weak domestic and foreign demand.

United Kingdom: Similar to the Japanese experience, British gross domestic product fell for a second straight quarter at the end of 2023, putting the country in a technical recession. After stripping out price changes and seasonal effects, fourth-quarter GDP fell at an annualized rate of 1.4%, worse than expected and far more than the 0.5% rate of decline in the third quarter. The British economy continues to struggle against a range of headwinds, including high prices, elevated interest rates, and weak demand.



United States-China: Volkswagen is reportedly holding thousands of imported Porsche, Bentley, and Audi autos on US docks after the company was informed by one of its downstream suppliers that the cars were equipped with a small electronic component from western China that might have been made with banned forced labor. Volkswagen is replacing the components at dockside, which is likely to delay US delivery of many of the autos for months.

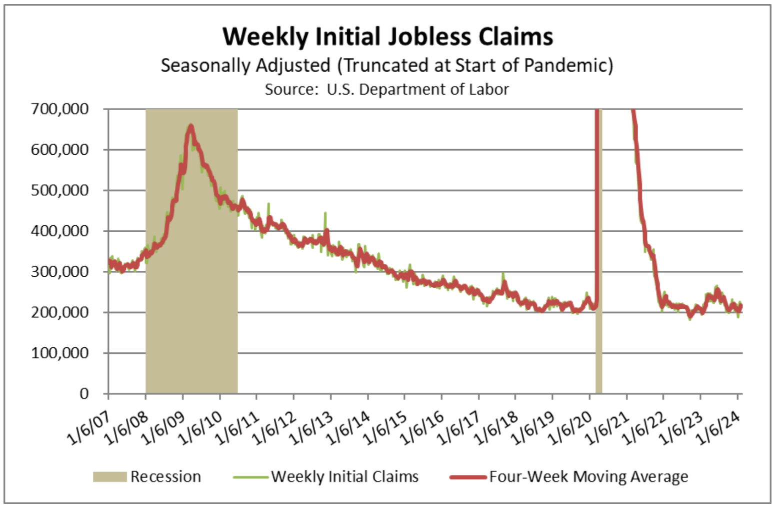
US Fiscal Policy: In an interview yesterday, Lael Brainard, director of the White House National Economic Council, argued that the ability of the US economy to keep growing despite the Federal Reserve's high interest rates and slowing inflation can be largely ascribed to the administration's stimulative fiscal policies, including its big infrastructure rebuilding law and subsidies for investments in advanced technologies.

- Those programs probably have started to pump cash into the economy, but we don't think that's necessarily the main fiscal stimulus that's boosting economic growth.
- Our recent work suggests much of the stimulus comes from expanding Social Security and Medicare outlays now that so many baby boomers retired during the COVID-19 pandemic, along with a drop in personal income tax revenues because of big, inflation-generated adjustments to tax brackets last year.

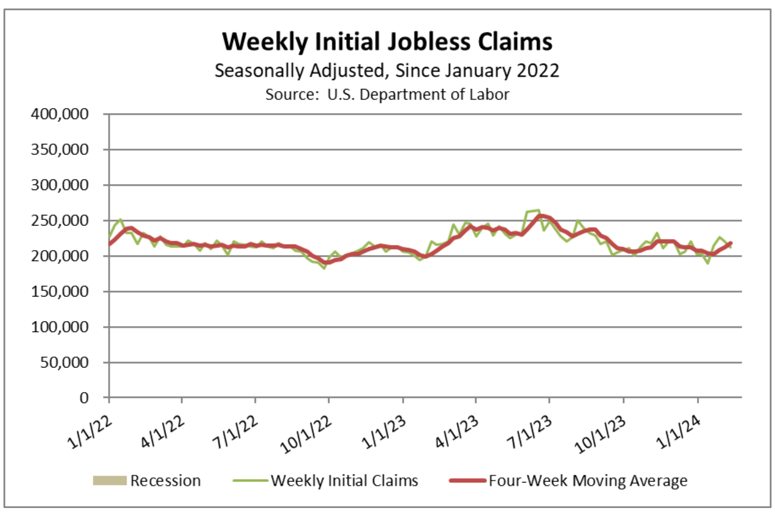
US Labor Market: Congressional researchers have estimated that the huge influx of migrants coming across the southern border in recent years will expand the labor force beyond what they previously predicted, thereby boosting future economic growth and government revenues. However, the researchers also believe the new immigrants are less educated than previous waves, meaning they could be less productive and therefore hold down wages for less-skilled job categories.

US Economic Releases

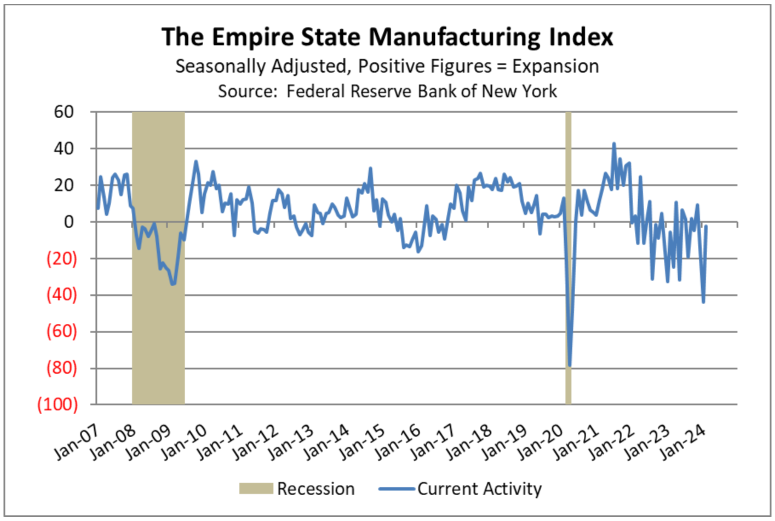
In the week ended February 10, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 212,000, rather than staying at the previous week's revised level of 220,000 as anticipated. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 218,500. Meanwhile, in the week ended February 3, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to 1.895 million, above both the expected reading of 1.880 million and the previous week's revised reading of 1.865 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.



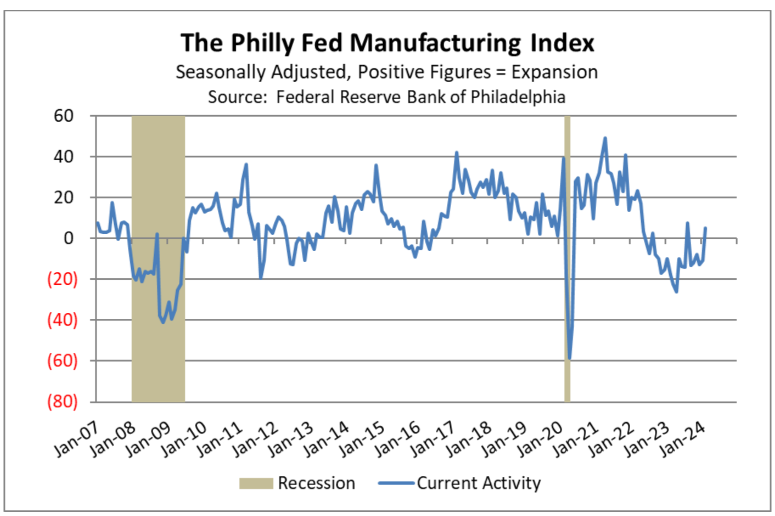
To provide more detail on recent trends, the chart below shows how initial jobless claims have changed just since the beginning of 2022.



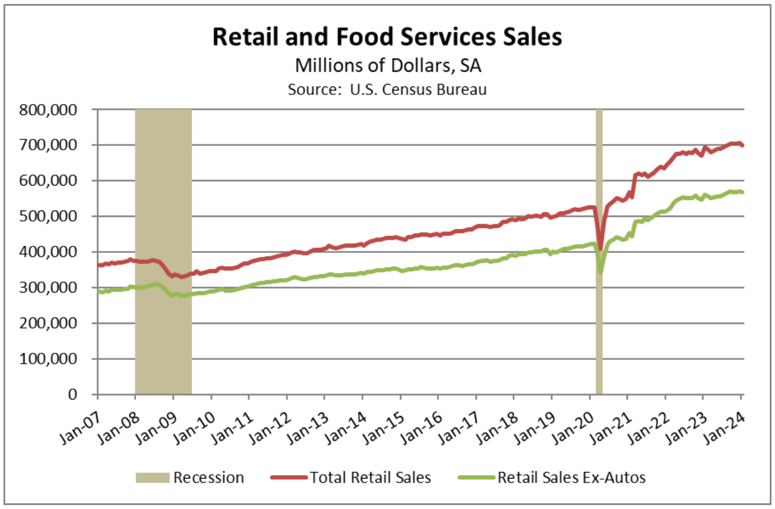
Separately, the New York FRB said its February ***Empire State Manufacturing Index*** improved to a seasonally adjusted -2.4, well above both the expected reading of -12.5 and the January reding of -43.7. This index is designed so that positive readings point to expanding factory activity in New York state. At its current level, the index suggests the state's manufacturing activity is still declining, but not nearly as fast as it was previously. The chart below shows how the index has fluctuated since just before the GFC.



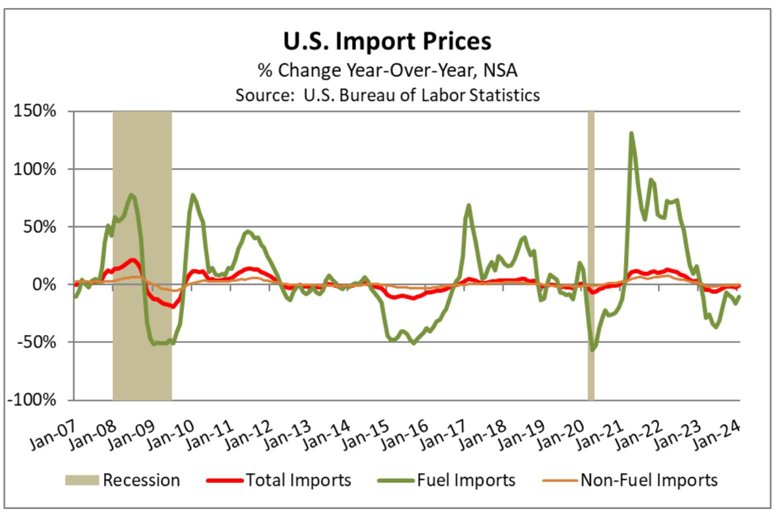
The Philadelphia FRB said its February ***Philly Fed Index*** improved to a seasonally adjusted 5.2, beating the anticipated reading of -8.1 and well above the January reading of -10.6. The index, officially designated as the Philadelphia FRB Manufacturing Activity Index, is designed so that positive readings point to expanding factory activity in the mid-Atlantic region. At its current level, the index suggests mid-Atlantic manufacturing is now growing again, albeit modestly. The chart below shows how the index has fluctuated since just before the GFC.



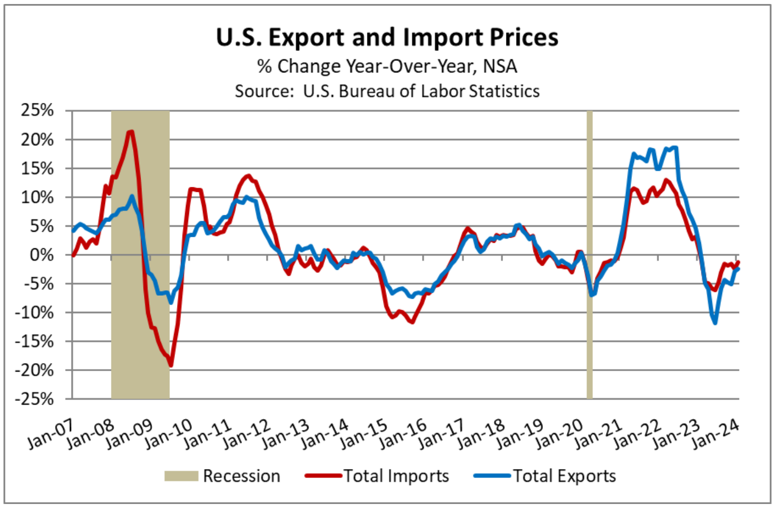
In another report today, January ***retail sales*** fell by a seasonally adjusted 0.8%, far worse than both the expected decline of 0.2% and the December gain of 0.4%. Of course, overall retail sales are often driven by the volatile auto and auto parts sector, which makes up almost one-fifth of the total. January ***retail sales excluding autos and auto parts*** were down 0.6%, versus their anticipated decline of 0.2% and their December rise of 0.4%. Overall retail sales in January were up 2.0% from the same month one year earlier, while sales excluding autos and auto parts were up 2.1%. The chart below shows how retail sales have changed since just before the GFC.



Finally, January ***import prices*** were up 0.8% from the previous month, versus expectations that they would be unchanged, just as they were in December. Of course, import prices are often driven by volatility in the petroleum fuels category. January ***import prices excluding fuels*** were up 0.6%, versus similar expectations that they would be unchanged for a second straight month. Overall import prices in January were down 1.3% year-over-year, while import prices excluding fuels were down 0.3%. The chart below shows the year-over-year change in import prices since just before the GFC.



According to the report, ***export prices*** in January were down 2.4% from one year earlier, in large part because of the key agriculture category. Comparing the annual change in export prices versus import prices provides a sense of the US "terms of trade," or the relative advantage or disadvantage the country is facing because of trends in international trade prices. The chart below compares the year-over-year change in US export and import prices since just before the GFC.



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**
9:15	Industrial Production	m/m	Jan	0.2%	0.1%	***
9:15	Capacity Utilization	m/m	Jan	78.8%	78.6%	**
10:00	Business Inventories	m/m	Dec	0.4%	-0.1%	*
10:00	NAHB Housing Market Index	m/m	Feb	46.0	44.0	**
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
13:15	Chris Waller Gives Remarks on Dollar International Role	Member of the Board of Governors				
19:00	Raphael Bostic Speaks on Outlook, Policy	President of Federal Reserve Banks 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	GDP SA	q/q	4Q P	-0.1%	-0.7%	-0.8%	***	Equity and bond neutral
	GDP Deflator	y/y	4Q P	3.8%	5.3%	5.2%	***	Equity bearish, bond bullish
	Industrial Production	y/y	Dec F	-1.0%	-0.7%		***	Equity and bond neutral
	Capacity Utilization	m/m	Dec	-0.1%	0.3%		***	Equity and bond neutral
Australia	Employment Change	m/m	Mar	0.5k	-65.1k	-62.7k	***	Equity bullish, bond bearish
	Unemployment Rate	m/m	Mar	4.1%	3.9%	4.0%	***	Equity and bond neutral
	Participation Rate	m/m	Mar	66.8%	66.4%	66.9%	**	Equity and bond neutral
India	Trade Balance	m/m	Jan	-$17490.6m	-$19803.3m	-$20000.0m	*	Equity and bond neutral
	Exports	y/y	Jan	3.1%	1.0%		**	Equity and bond neutral
	Imports	y/y	Jan	3.0%	-4.8%	-4.8%	**	Equity and bond neutral
	Wholesale Prices	y/y	Aug	0.27%	0.73%	0.58%	**	Equity and bond neutral
EUROPE								
Eurozone	Trade Balance SA	m/m	Dec	13.0b	14.8b	15.1b	**	Equity and bond neutral
UK	Industrial Production	y/y	Dec	0.6%	-0.1%	0.1%	***	Equity and bond neutral
	Manufacturing Production	y/y	Dec	2.3%	1.3%	1.9%	**	Equity and bond neutral
	Construction Output	y/y	Dec	-3.2%	0.9%	-0.7%	*	Equity and bond neutral
	Trade Balance	m/m	Dec	-£2603m	-£1408m	-£3723m	**	Equity and bond neutral
	Visible Trade Balance	m/m	Dec	-£13989m	-£14189m	-£15125m	**	Equity and bond neutral
	GDP	y/y	4Q P	-0.2%	0.3%	0.2%	***	Equity and bond neutral
	Total Business Investment	y/y	4Q P	3.7	2.3	2.6	*	Equity bullish, bond bearish
Switzerland	Producer & Import Prices	y/y	Jan	-2.3	-1.1		**	Equity and bond neutral
Russia	CPI	y/y	Jan	7.44	7.42	7.30	***	Equity and bond neutral
	Core CPI	y/y	Jan	7.15%	6.83%		*	Equity and bond neutral
	Gold and Forex Reserves	m/m	9-Feb	$580.4b	$586.4b		***	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	557	0	Down
3-mo T-bill yield (bps)	521	523	-2	Flat
U.S. Sibor/OIS spread (bps)	532	532	0	Down
U.S. Libor/OIS spread (bps)	533	533	0	Down
10-yr T-note (%)	4.23	4.26	-0.03	Down
Euribor/OIS spread (bps)	392	390	2	Down
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
Yen	Up			Up
Pound	Down			Up
Franc	Up			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.

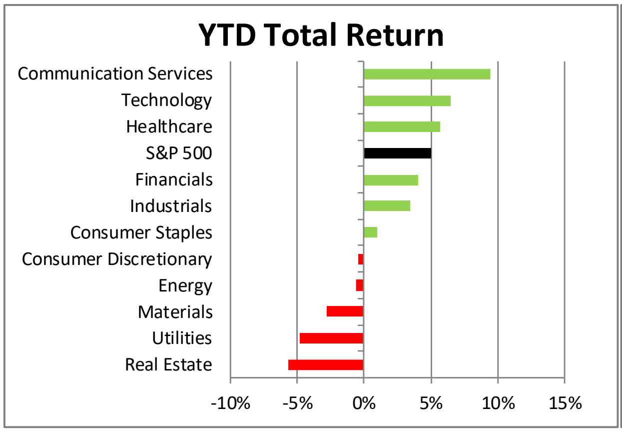
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$81.15	$81.60	-0.55%	
WTI	$76.19	$76.64	-0.59%	
Natural Gas	$1.63	$1.61	1.12%	
Crack Spread	$26.86	$27.36	-1.85%	
12-mo strip crack	$25.86	$26.34	-1.85%	
Ethanol rack	$1.67	$1.68	-0.50%	
Metals				
Gold	$1,997.99	$1,992.33	0.28%	
Silver	$22.71	$22.37	1.52%	
Copper contract	$372.70	$370.00	0.73%	
Grains				
Corn contract	$437.75	$437.25	0.11%	
Wheat contract	$579.25	$583.00	-0.64%	
Soybeans contract	$1,177.50	$1,176.25	0.11%	
Shipping				
Baltic Dry Freight	1,582	1,585	-3	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	12.0	3.4	8.7	
Gasoline (mb)	-3.7	-1.6	-2.1	
Distillates (mb)	-1.9	-1.7	-0.3	
Refinery run rates (%)	-1.8%	0.1%	-1.9%	
Natural gas (bcf)		-66		

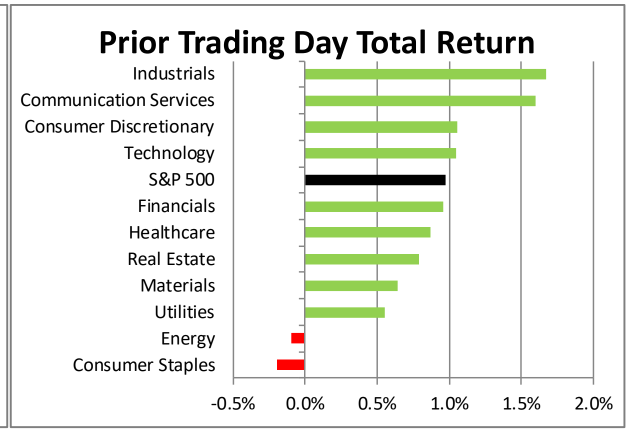
Weather

The 6-10 and 8-14 day forecasts currently call for colder-than-normal temperatures only in southern California, with warmer-than-normal temperatures in the Rocky Mountains, the Great Plains, the Midwest, and the Mississippi Valley. The forecasts call for wetter-than-normal conditions along the West Coast and in the Northeast, with dry conditions in the Southwest and southern Florida.

Data Section

US Equity Markets – (as of 2/14/2024 close)

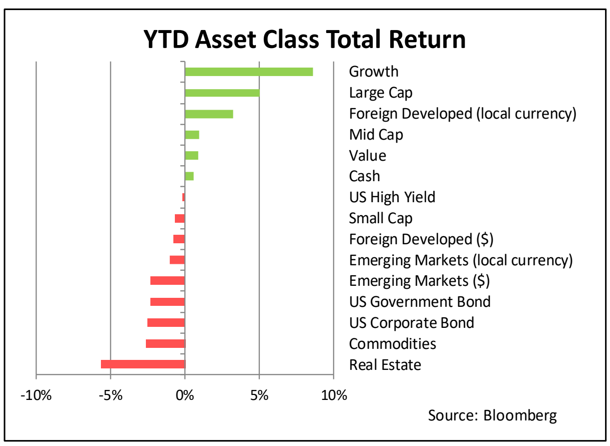




(Source: Bloomberg)

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 2/14/2024 close)

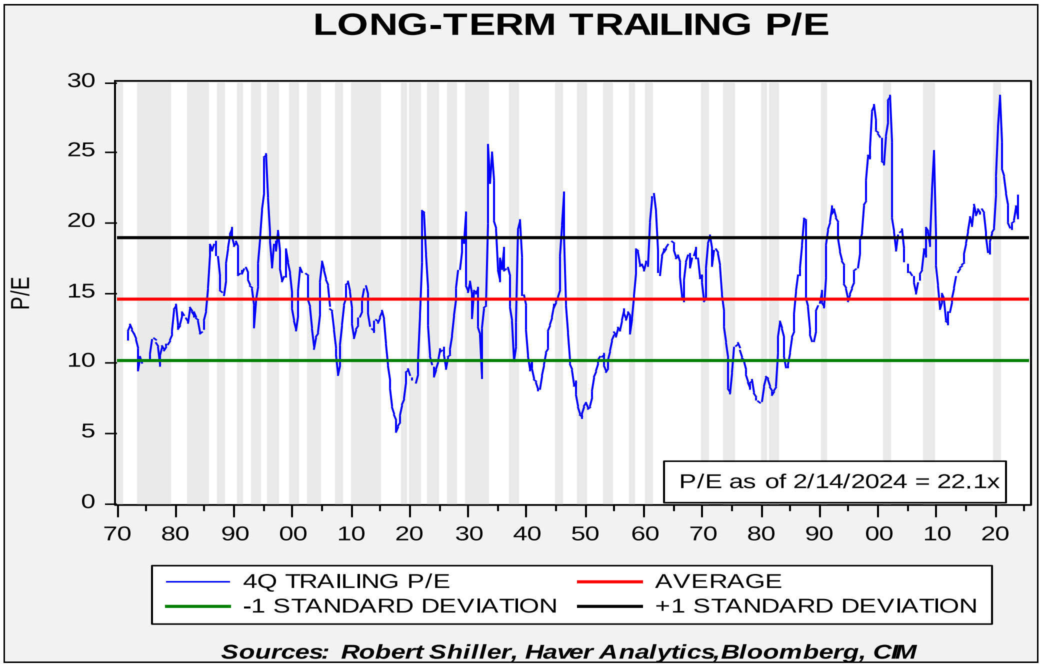


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 15, 2024



Based on our methodology,[1] the current P/E is 22.1x, down 0.1x from our last report. The modest decline in the multiple reflects improved 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.

[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.