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 1, 2024—9:30 AM EST] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.5%. Chinese markets were lower, with the Shanghai Composite down 0.6% from its previous close and the Shenzhen Composite down 0.5%. U.S. equity index futures are signaling a higher open.

With 185 companies having reported so far, S&P 500 earnings for Q4 are running at $55.80 per share, compared to estimates of $55.15, which is up 1.6% from Q3 2023. Of the companies that have reported thus far, 78.9% have exceeded expectations while 15.7% have fallen short of expectations.

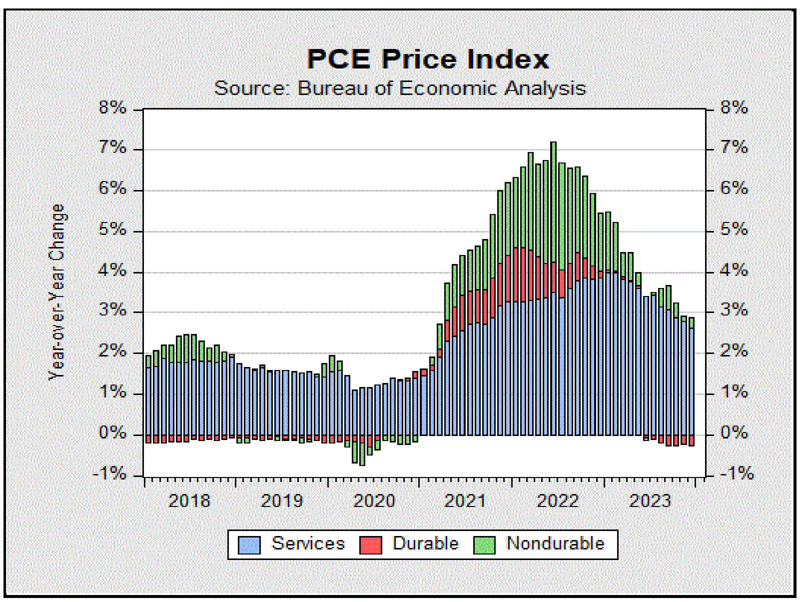
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (1/29/2024) (with associated podcast): "Introducing the U.S. Space Force"
- *Weekly Energy Update* (12/14/2023): Oil prices have been under pressure as geopolitical risk premium evaporates; COP28 ended with a deal to "shift" from fossil fuels, softer language than the "phase out" comment that was rejected by oil producers. (N.B. The *Weekly Energy Update* will go on indefinite hiatus following this report.)
- *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 Q4 2023 Rebalance Presentation* (10/30/2023): 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* (1/22/2024) (with associated podcast): "How Does Powell Define Restrictive Monetary Policy?"
- *The 2024 Outlook: Slow-Bicycle Economy* (12/18/2023) (with associated *Confluence of Ideas* podcast)

Good morning! Equities are unfazed by Powell's remarks this morning, while Caitlin Clark continues her dominant run in women's college basketball. Today's *Comment* dives into the latest Fed rate decision, explores renewed concerns about regional lenders, and examines the potential impact of China's overcapacity on other nations. As always, we'll wrap up with a summary of key international and domestic data releases.

Mission Not Accomplished: The Federal Reserve dashed hopes for a March rate cut, sending stocks plummeting and lifting bond yields from their intraday lows yesterday as investors recalibrated their expectations.

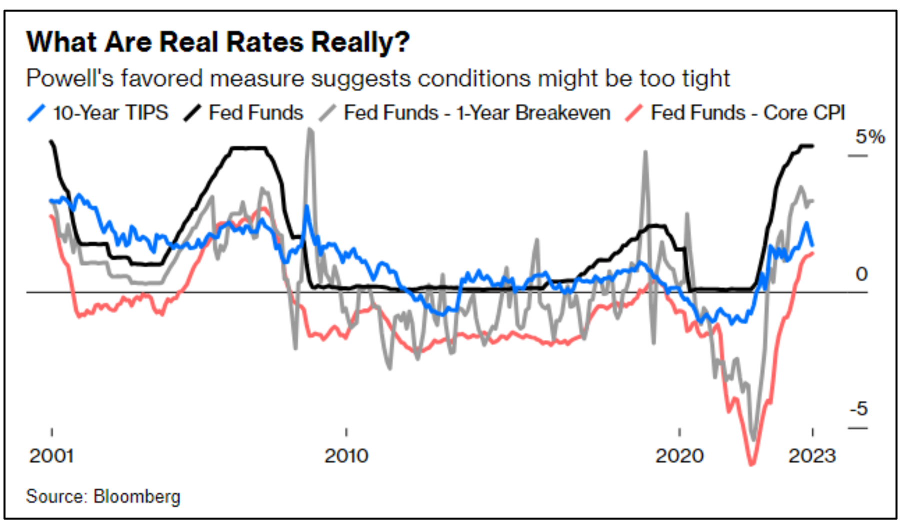
- The Federal Open Market Committee (FOMC) kept its benchmark interest rate unchanged at 5.25%-5.50% in its January meeting. While the decision was largely expected, the accompanying statement and Chair Powell's comments offered valuable insights into the Fed's future plans. The FOMC statement notably dropped any mention of further rate hikes and instead mentioned that it would consider “any adjustments” to its key policy rate. Chair Powell elaborated during the press conference, expressing the committee's confidence in the trajectory of inflation toward the 2% target. However, he emphasized the necessity for additional evidence before contemplating rate cuts, suggesting such measures are unlikely to materialize by March.
- Stronger-than-expected economic data, including a robust December jobs report and resilient consumer spending, could be behind the Federal Reserve's decision to delay rate cuts. The December jobs report smashed expectations, with the economy adding 216,000 jobs and far exceeding the forecast of 170,000. Additionally, personal consumption remains a key driver of GDP, with December discretionary spending accelerating from 6.2% to 6.5%, significantly outpacing the 10-year average of 5.0%. Despite robust data, inflation has remained largely unaffected, prompting some members of the committee to express concerns about economic conditions that could potentially hinder the attainment of the 2% inflation mandate.



- The Federal Reserve is expected to closely scrutinize economic data over the next few months, searching for signs that could justify a policy shift. Two key inflation and employment reports will be released before the Fed's next meeting, and the upcoming revisions to the Consumer Price Index (CPI) on February 9 could provide further clarity on the central bank's progress against inflation. While the Fed has ruled out interest rate cuts in March, a policy pivot within the first half of the year remains a possibility. The latest CME FedWatch Tool shows that there is a 90% chance that policymakers will vote to cut interest rates in May.

Regional Bank Worries? The surprise earnings loss reported by New York Community Bancorp fueled fears of instability in the U.S. financial system amidst fresh concerns about the U.S. commercial real estate market.

- Fourth-quarter earnings at New York Community Bancorp (NYCB, $6.47) sent shockwaves through the market with a staggering $252 million loss, primarily driven by loan losses. The bank was forced to slash its dividend by 70% and scrambled to bolster its capital reserves to comply with stricter regulations imposed on larger institutions. This news sent the stock price plummeting 37%, while the broader KBW regional bank index dipped 6% as investors feared similar challenges across the industry. The bank's weak performance comes just under a year after its acquisition of New York Signature Bank, which ultimately collapsed due to deposit flight driven by the failure of Silicon Valley Bank.
- NYCB's news ignited an initial sell-off, but deeper anxieties linger regarding broader financial health. Falling inflation has pushed real interest rates to their highest levels since the pandemic, squeezing banks' margins as they compete to retain deposits with attractive rates. While deposit flight has subsided since March, fears persist that savers may flee to higher-yielding money market accounts if rates remain elevated. The Federal Reserve's bank term lending facility, which addressed the deposit run problem in the short term, is scheduled to end in March, thus raising concerns about potential economic challenges if broader policy changes are not implemented.



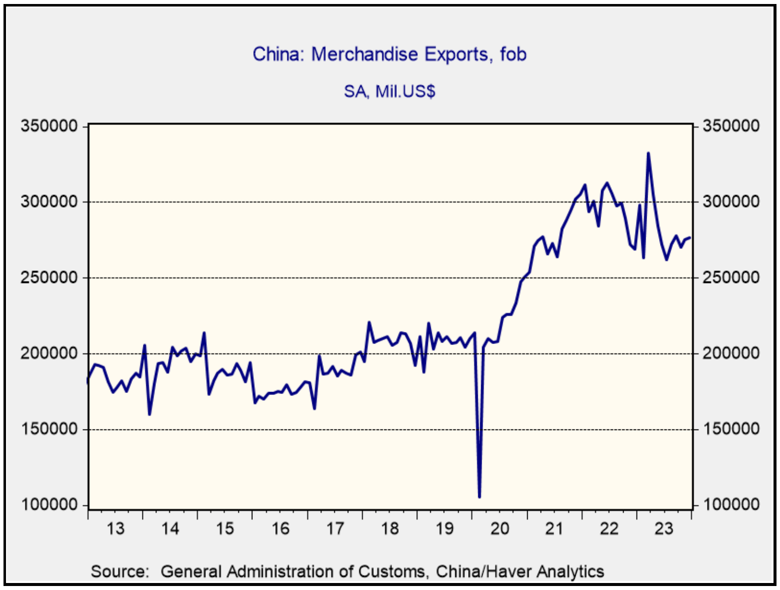
- The Federal Open Market Committee (FOMC) omitted its prior statement about the banking system being "sound and resilient," which raises concerns that policymakers are increasingly worried about financial conditions when compared to the previous meeting.

While the impact of NYCB's news on FOMC discussions surrounding the banking system remains unclear due to the absence of questions on the topic during Powell's Q&A, his suggestion of initiating discussions on balance sheet reduction in March indicates potential measures to address liquidity risk. However, the specific form this reduction will take — whether tapering quantitative tightening or complete cessation — is yet to be determined.

- The fallout from NYCB spread to other banks around the world with Tokyo-based Aozora Bank and German bank DeustchBank both reporting losses on loans on U.S. commercial properties. Such issues in real estate could likely put more pressure on central bankers to loosen monetary policy.

China's Economic Fallout: There are fears that China's economic slowdown could have spillover effects on the global economy, according to a business lobby group.

- The American Chamber of Commerce in China (AmCham China) sounded the alarm on persistent overcapacity woes, warning that Beijing's credit shift from real estate to manufacturing could exacerbate the problem. This policy change, they say, raises the specter of "dumping" lower-priced goods into global markets, especially in strategically important sectors like electric vehicles. The report coincides with growing concerns that China might resort to increased state lending and industrial subsidies to prop up its flagging manufacturing sector.
- A potential glut of Chinese goods in the global market threatens to reignite Western concerns about unfair trade practices. The European Union is actively exploring measures to curb the influx of Chinese electric vehicles (EVs) within its borders, while the U.S. is pressuring companies to diversify their reliance on Chinese-made legacy chips for their devices. Pivoting exports towards developing countries within the Belt and Road Initiative might seem like a solution for China's overcapacity woes, but the viability of this option is questionable. The global economic slowdown is expected to disproportionately impact these very countries, limiting their capacity to absorb significant amounts of additional imports.

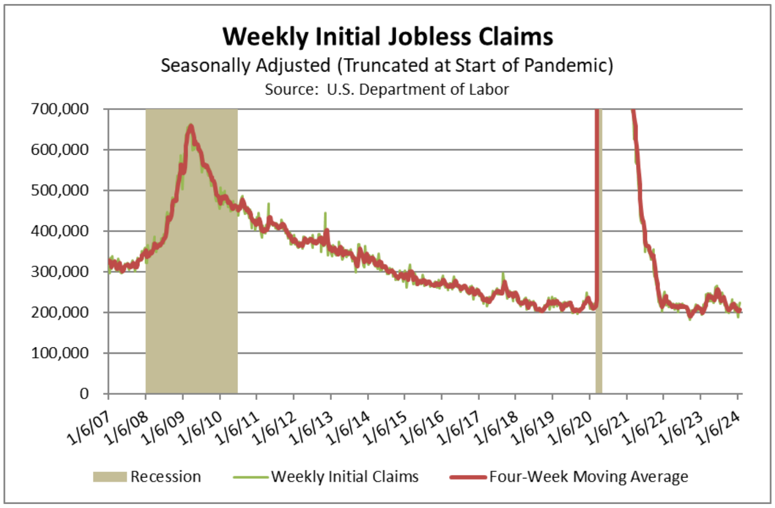


- China's bloated industrial capacity and escalating trade protectionism cast a long shadow over its fight against deindustrialization. Despite impressive recent growth, the country lacks concrete measures to unleash domestic consumption, a critical step needed to stabilize internal demand for its manufactured goods. Unfavorable demographic trends have further exacerbated this challenge and dampened consumption potential. While China's economic resilience is undeniable, a strategic shift is necessary to navigate this complex crossroads and ensure sustainable, long-term growth.

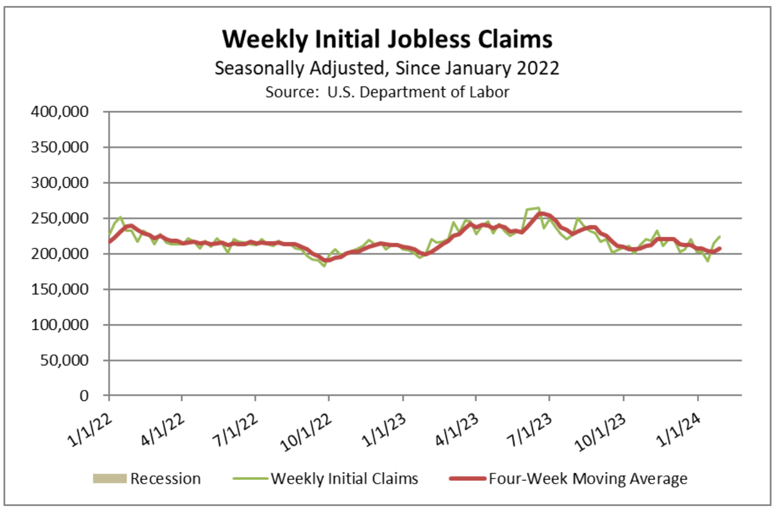
Other News: The U.S. continues launching strikes against Houthi rebels in Yemen, escalating tensions in the region amid preparations for a response to the Jordan drone attack that killed three American service members. This escalating conflict in the Red Sea raises concerns about the potential for a broader war in the Middle East. U.S. regulators have targeted Chinese chipmakers over concerns that they aided AI firms with ties to the Chinese military. This crackdown on chip manufacturers reflects the intensifying competition between the two economic giants for dominance in the field of artificial intelligence.

U.S. Economic Releases

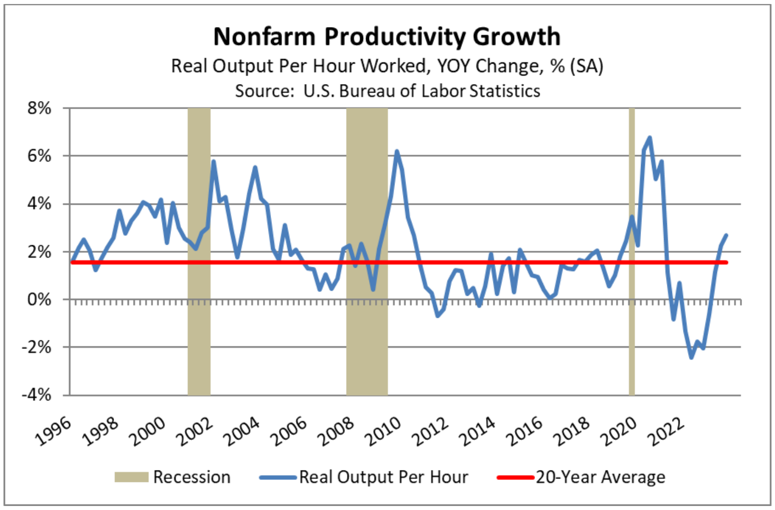
In the week ended January 27, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 224,000, higher than the expected level of 212,000 and the previous week's revised level of 215,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 207,750. Meanwhile, in the week ended January 20, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to 1.898 million, above the anticipated reading of 1.839 million and the prior week's revised reading of 1.828 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.



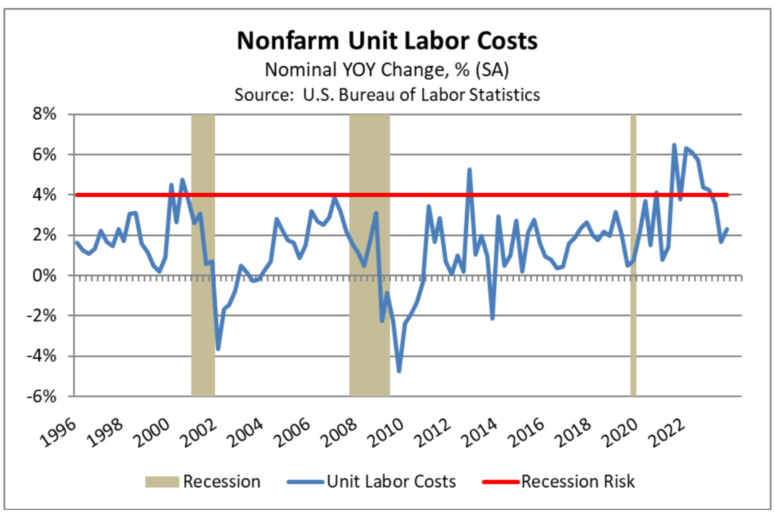
To provide more detail on recent trends, the chart below shows how initial jobless claims have changed just since the beginning of 2022.



Another report today focused on the productivity of U.S. workers, defined as the average value of output per hour worked. After stripping out price changes and normal seasonal fluctuations, fourth-quarter ***nonfarm productivity*** rose at an annualized rate of 3.2%, beating the expected growth rate of 2.5% but still weaker than the revised third-quarter rate of 4.9%. Taking account of the fluctuations in each of the last four quarters, productivity in the fourth quarter was up 2.7% from the same period one year earlier. Productivity growth is now growing again at the same healthy rate it was right before the COVID-19 pandemic. Growing output per hour is key to boosting living standards and supporting higher wages, so if anything like the current growth rate can be sustained, it would provide a substantial benefit to U.S. workers. The chart below shows the year-over-year growth in real productivity over the last quarter-century or so.



Reflecting the good gain in productivity, fourth-quarter ***unit labor costs*** rose at an annualized rate of just 0.5%, far below the anticipated rate of 1.2% and not enough to offset the third quarter's revised rate of a decline of 1.1%. Unit labor costs in the fourth quarter were up a modest 2.3% year-over-year, far below the 4.0% rise that has often been associated with a recession in the past. The chart below shows the year-over-year growth in unit labor costs since 1996.



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
9:45	S&P Global Manufacturing PMI	m/m	Jan F	50.3	50.3	***
10:00	Construction Spending MoM	m/m	Dec	0.5%	0.4%	**
10:00	ISM Manufacturing PMI - New Orders	m/m	Jan	48.2	47.1	**
10:00	ISM Manufacturing PMI - Employment	m/m	Jan	47.0	48.1	*
10:00	ISM Manufacturing PMI	m/m	Jan	47.2	47.4	**
10:00	ISM Manufacturing PMI - Prices Paid	m/m	Jan	46.9	45.2	**
	Wards Total Vehicle Sales	m/m	Jan	15.70m	15.83m	*
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								
Japan	Foreign Buying Japan Stocks	w/w	26-Jan	¥720.3b	¥286.7b	¥287.0b	*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	26-Jan	¥382.9b	-¥48.0b	-¥43.5b	*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	26-Jan	-¥207.5b	¥348.6b	¥359.9b	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	26-Jan	-¥55.2b	¥130.4b	¥130.2b	*	Equity and bond neutral
	Jibun Bank Manufacturing PMI	m/m	Jan F	48.0	48.0		***	Equity and bond neutral
Australia	NAB Business Confidence	m/m	4Q	-6	-1		**	Equity and bond neutral
	Building Approvals	m/m	Dec	-9.5%	1.6%	0.3%	***	Equity bearish, bond bullish
South Korea	Trade Balance	m/m	Jan	$300m	$4500m	$4457m	*	Equity and bond neutral
	Exports	y/y	Jan	18.0%	5.1%	5.0%	***	Equity bullish, bond bearish
	Imports	y/y	Jan	-7.8%	-10.8%	-8.1%	**	Equity and bond neutral
	S&P Global Global Manufacturing PMI	m/m	Jan	51.2	49.9		***	Equity and bond neutral
China	Caixin Manufacturing PMI	m/m	Jan	50.8	50.8	50.8	***	Equity and bond neutral
India	HSBC India PMI Manufacturing	m/m	Jan F	56.5	56.9		***	Equity and bond neutral
EUROPE								
Eurozone	HCOB Eurozone Manufacturing PMI	m/m	Jan F	46.6	46.6	46.6	***	Equity and bond neutral
	CPI	y/y	Jan	2.8%	2.9%	2.7%	***	Equity and bond neutral
	Core CPI	y/y	Jan P	3.3%	3.4%	3.2%	**	Equity and bond neutral
	Unemployment Rate	m/m	Dec	6.4%	6.4%	6.4%	**	Equity and bond neutral
Germany	HCOB Germany Manufacturing PMI	m/m	Jan F	45.5	45.4	45.4	***	Equity and bond neutral
France	HCOB France Manufacturing PMI	m/m	Jan F	43.1	43.2	43.2	***	Equity and bond neutral
Italy	HCOB Italy Manufacturing PMI	m/m	Jan	48.5	45.3	46.9	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Jan P	0.9%	0.5%	0.8%	***	Equity and bond neutral
	CPI NIC Including Tobacco	y/y	Jan P	0.8%	0.6%	0.9%	**	Equity and bond neutral
UK	S&P Global UK Manufacturing PMI	m/m	Jan F	47.0	47.3	47.3	***	Equity and bond neutral
Switzerland	Manufacturing PMI	m/m	Jan	43.1	43.0	44.5	***	Equity bearish, bond bullish
Russia	S&P Global Manufacturing PMI	m/m	Jan	52.4	54.6	53.7	***	Equity and bond neutral
	Gold and Forex Reserves	m/m	26-Jan	$587.8b	$586.7b		***	Equity and bond neutral
AMERICAS								
Canada	GDP	y/y	Nov	1.1%	0.9%	1.0%	**	Equity and bond neutral
Brazil	S&P Global Brazil Manufacturing PMI	m/m	Jan	52.8	48.4		***	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	557	0	Down
3-mo T-bill yield (bps)	519	521	-2	Flat
U.S. Sibor/OIS spread (bps)	530	531	-1	Down
U.S. Libor/OIS spread (bps)	530	531	-1	Down
10-yr T-note (%)	3.94	3.91	0.03	Flat
Euribor/OIS spread (bps)	391	390	1	Down
Currencies	**Direction**			
Dollar	Up			Down
Euro	Flat			Up
Yen	Flat			Up
Pound	Down			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
FOMC Rate Decision (Lower Bound)	5.250%	5.250%	5.250%	On Forecast
FOMC Rate Decision (Upper Bound)	5.500%	5.500%	5.500%	On Forecast
Bank of England Bank Rate	5.250%	5.250%	5.250%	On Forecast
Brazil Selic Rate	11.250%	11.750%	11.250%	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.

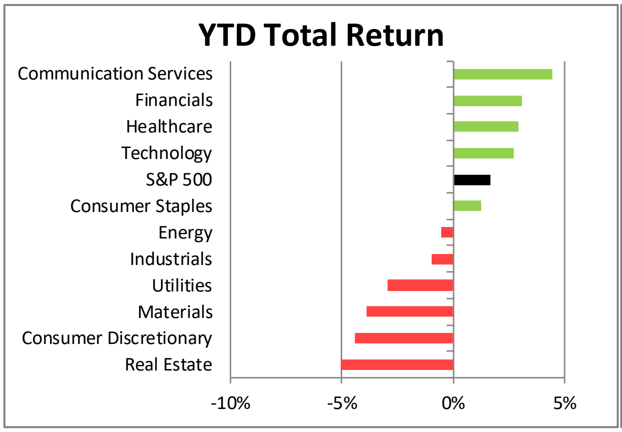
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$80.78	$80.55	0.29%	
WTI	$76.05	$75.85	0.26%	
Natural Gas	$2.12	$2.10	0.71%	
Crack Spread	$25.59	$25.63	-0.19%	
12-mo strip crack	$25.04	$25.15	-0.43%	
Ethanol rack	$1.78	$1.78	0.05%	
Metals				
Gold	$2,034.91	$2,039.52	-0.23%	
Silver	$22.66	$22.96	-1.31%	
Copper contract	$386.50	$390.60	-1.05%	
Grains				
Corn contract	$444.75	$448.25	-0.78%	
Wheat contract	$590.00	$595.25	-0.88%	
Soybeans contract	$1,212.25	$1,222.25	-0.82%	
Shipping				
Baltic Dry Freight	1,398	1,397	1	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	1.2	-1.1	2.3	
Gasoline (mb)	1.2	2.0	-0.8	
Distillates (mb)	-2.5	-1.0	-1.5	
Refinery run rates (%)	-2.6%	1.8%	-4.4%	
Natural gas (bcf)		-202		

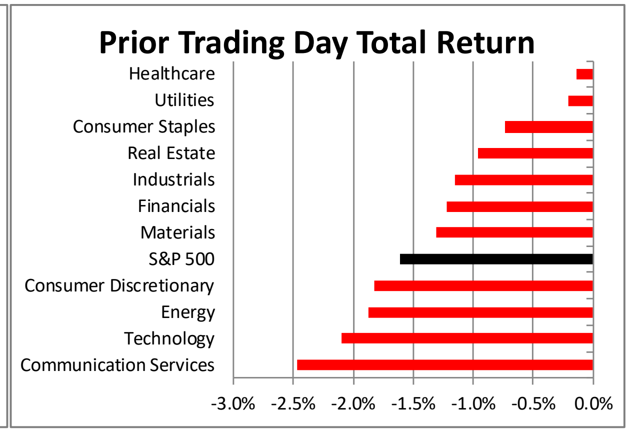
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures from the Great Plains eastward, with cooler-than-normal temperatures in the Far West. The forecasts call for wetter-than-normal conditions west of the Mississippi River, with dry conditions in New England.

Data Section

U.S. Equity Markets – (as of 1/31/2024 close)

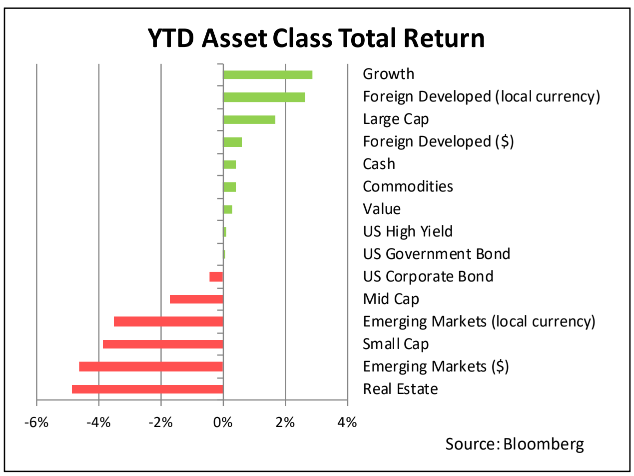




(Source: Bloomberg)

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 1/31/2024 close)

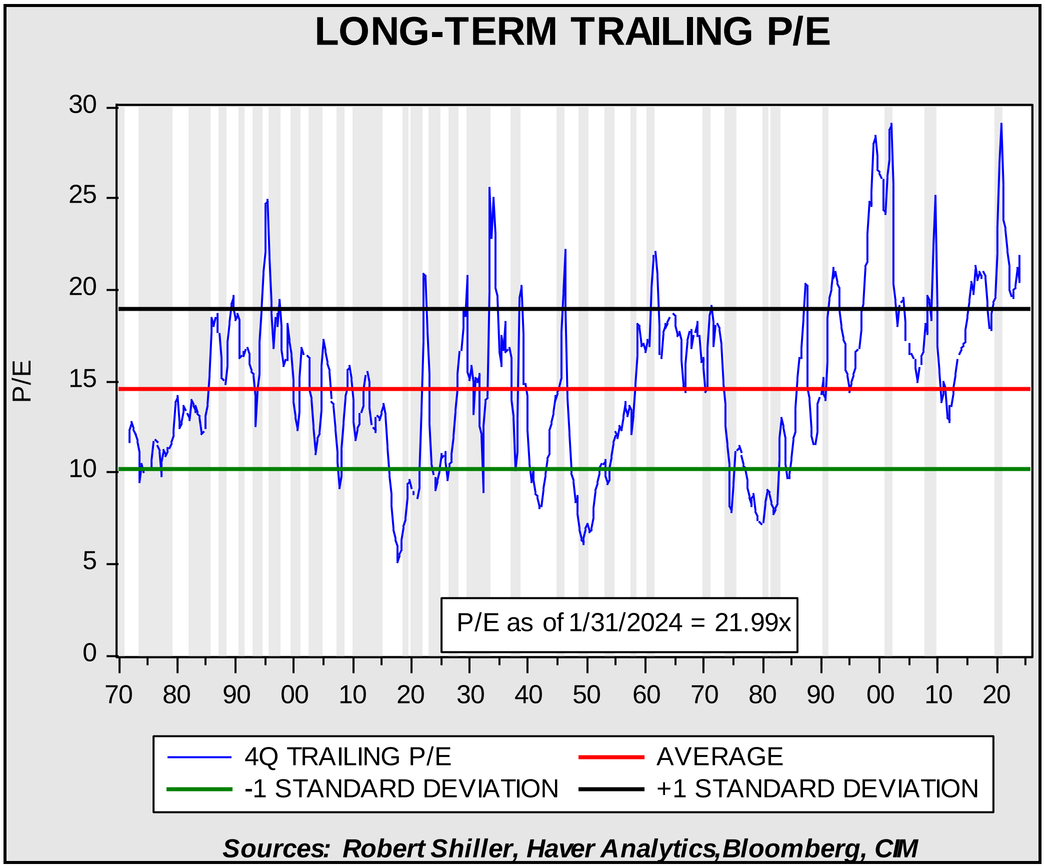


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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), U.S. Corporate Bond (iShares iBoxx $ Investment Grade Corporate Bond ETF), U.S. Government Bond (iShares 7-10 Year Treasury Bond ETF), U.S. 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 1, 2024



Based on our methodology,[1] the current P/E is 21.99x, up 0.09x 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.