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 20, 2024—9:30 AM EST] Global equity markets are mostly higher 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 0.2%. Chinese markets were higher, with the Shanghai Composite up 0.4% from its previous close and the Shenzhen Composite up 0.5%. Conversely, U.S. equity index futures are signaling a lower open.

With 396 companies having reported so far, S&P 500 earnings for Q4 are running at $57.50 per share compared to estimates of $55.15, which is up 1.6% from Q3 2023. Of the companies that have reported thus far, 78.7% 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* (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* (2/20/2024) (with associated podcast): "Who Wants US Treasurys?"**
- *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 range of news items related to continued economic and security tensions between China and the West. We next review a range of other international and US developments with the potential to affect the financial markets today, including an important Russian military victory in Ukraine and an important new effort to regulate one aspect of artificial intelligence in the US.

United States-China: Senior US Treasury officials have told the *Financial Times* that they warned Chinese Vice Premier He Lifeng that Washington and its allies will retaliate if Beijing tries to deal with its excess industrial capacity and high debt load by dumping products on the global market. The US officials said they are most concerned about possible Chinese dumping of high-technology products such as electric vehicles, lithium-ion batteries, and semiconductors.

- Like many countries that sought to develop their economies via high investment and strong exports, China held on to the strategy too long, leaving it saddled with high debt and a production base that far exceeds domestic demand.
- For countries that find themselves in that predicament, many strategies are available to bring supply back into balance with demand. For example, the US allowed a sharp depression and a dramatic write-down in asset values during the 1930s. Japan opted for a long, slow correction marked by weak asset pricing and plodding economic growth from the 1990s until very recently.
- Other countries have turned to warfare or colonialism. What Western leaders fear is massive Chinese dumping as a kind of quasi-colonialism, which would further decimate Western industries and throw legions of workers into unemployment. Increasing hints of Chinese dumping are therefore likely to further exacerbate Chinese-Western geopolitical and economic tensions, keeping alive a range of risks for investors.

European Union-China: Following on the US warning to China, the EU has opened an anti-dumping probe into Chinese state-owned locomotive and railcar maker CRRC, in what Competition Commissioner Margrethe Vestager says is a signal to domestic and foreign firms that the EU won't hesitate to use its legal tools to fight off unfair foreign competition.

- The investigation follows on a similar probe into Chinese electric vehicles launched in September.
- The new probe shows that the EU is slowly coming around to the tough US policies against Chinese subsidies and other unfair trade practices. The move raises the risk that China will retaliate against EU firms active in China or that try to export to China.

China: On Sunday, The People's Bank of China left its benchmark interest rates unchanged for a sixth straight month, disappointing investors who have been hoping for stronger economic stimulus measures from the government. The rate on the key medium-term lending facility was left at 2.5%, apparently to support the sagging renminbi (CNY).

- Despite the freeze on official central bank rates, major banks today implemented a surprisingly aggressive cut in their five-year prime lending rate from 4.20% to 3.95%. That was the biggest cut in the prime rate since it was introduced five years ago.
- The five-year prime rate is China's standard for residential mortgages, so it is likely that the government guided the banks to cut the rate as a way to provide some support for the beleaguered real estate developers.
- Since many investors had been looking for stronger measures to support the economy, Hong Kong stock prices fell to start the week, but mainland stocks gained as investors caught up from the week-long Lunar New Year holiday.

Australia: Responding to China's aggressive military buildup, the Australian government today unveiled a plan to more than double the size of the country's navy. The government now plans to spend an additional $7.2 billion on its navy, expanding the fleet to 26 warships, including 11 new frigates and six new large vessels with long-range missile capability. The Australian navy will then be at its largest size since World War II.

- The plan is consistent with our belief that rising geopolitical tensions will boost defense budgets around the world in the coming years.
- Since rising tensions will also keep fracturing the world into relatively separate geopolitical and economic blocs, we think the result will be increased investment opportunities in areas such as defense, broad industrials, basic materials, energy, and even technology firms with strong or potential defense business.

Singapore: In a potential sign that right-wing populist ideologies may be spreading to Asia, the Internal Security Department has recently detained two youths who espoused extremist views and were reportedly planning attacks on racial minorities, lesbian and gay activists, and "woke" progressives. One of the youths, an ethnic Chinese, bizarrely espoused white supremacy. If the ideology continues to spread in Asia, perhaps driven by social media, it could risk destabilizing countries throughout the region, just as it has in Europe.

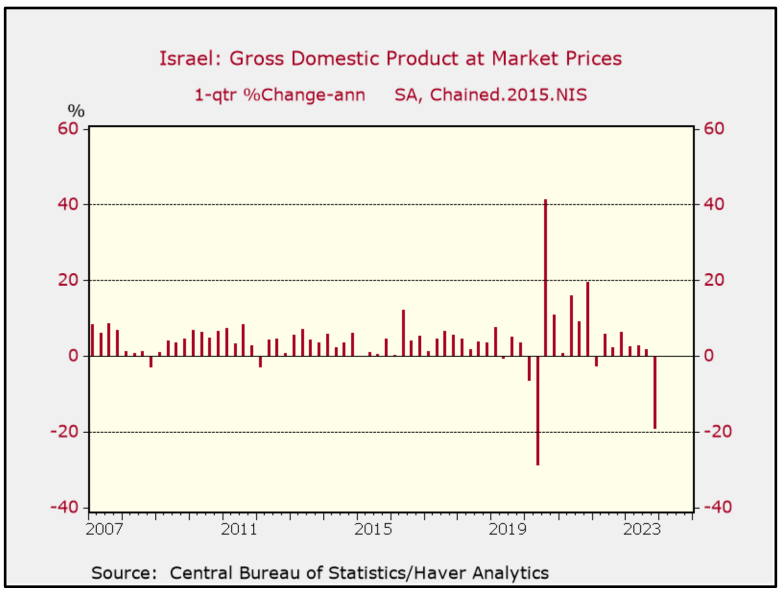
Russia-Ukraine War: Kyiv's forces on Saturday withdrew from the eastern Ukrainian city of Avdiivka, ceding it to the Russians after an intense, weeks-long siege. Reports indicate that the Ukrainians defending the city were not only overmatched by Russia's vast firepower and available personnel, but were also increasingly hampered by their shortage of ammunition and other supplies. Separately, a Russian military pilot who defected to Ukraine last year has been found murdered in Spain, illustrating the brutal vengeance of the Russian intelligence services.

- Avdiivka is Ukraine's most significant loss of territory since its unsuccessful counteroffensive last summer and the following loss of Western military aid.
- Now that the Kremlin has successfully shifted the Russian economy to a war footing, it is enjoying an increasing advantage in available equipment, ammunition, and personnel. The key question is to what extent the Russians can capitalize on their capture of Avdiivka to build momentum and start taking more Ukrainian territory.
- If the Russians successfully build on their momentum and begin to roll across Ukraine, Western politicians could potentially be galvanized to re-start their assistance to Kyiv. However, it could be too little, too late. If so, the incentive for peace talks would rise.
- In US political terms, the closer Russian forces end up from the North Atlantic Treaty Organization's southern frontier, the more those politicians who opposed aid to Ukraine may be open to criticism for allowing an increased Russian threat to NATO. That could lead to foreign policy being a bigger part of the US electoral campaign, making it more volatile going into the autumn.

NATO-Sweden: Hungarian Prime Minister Viktor Orbán's ruling Fidesz Party said it has scheduled a parliamentary vote next Monday on Sweden's accession to NATO, and it plans to vote in favor. If so, Sweden will finally have the unanimous approval of all NATO members, allowing it to join the alliance. With the inclusion of Sweden and its capable military, NATO's northern flank will be strengthened, and the Baltic Sea will become virtually a NATO lake, potentially helping to deter future Russian aggression in the north.

United Kingdom: Addressing a parliamentary committee today, Bank of England Governor Andrew Bailey said the central bank may begin to cut its benchmark interest rate even before consumer price inflation falls all the way to its target of 2%, citing encouraging signs that price pressures are falling rapidly. Despite the prospect for lower bond yields in the UK, investors appear to be encouraged by the prospect for reduced impediments on economic growth. The British pound has therefore risen 0.4% to a multi-week high of $1.2641 as of this writing.

Israel-Hamas Conflict: The Israeli government yesterday said gross domestic product in the fourth quarter fell at an annualized rate of 19.4% from the same period one year earlier, far worse than expected and almost matching the rate of decline in the midst of the COVID-19 pandemic in 2020. Israel's defense expenditure has surged since its war with the Hamas government in the Gaza Strip began on October 7, but that spending has been offset by a huge drop in personal consumption spending and private fixed investment.



US Artificial Intelligence Regulation: Late last week, the Federal Trade Commission proposed modifying a rule that already prevents the impersonation of government and business entities to also outlaw the impersonation of individuals. The proposal follows a move earlier this month by the Federal Communications Commission to ban the use of AI-generated voices in robocalls.

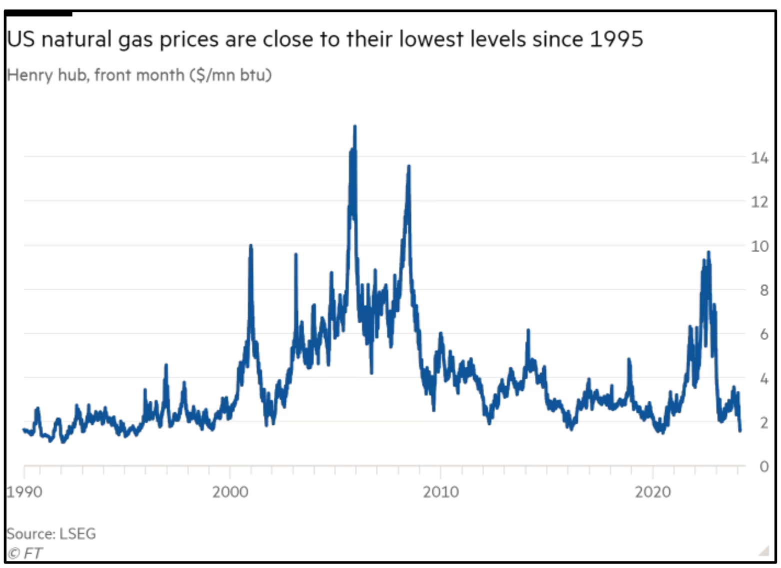
- These proposals show how government agencies are trying to address the risk of AI-driven scams and frauds via rulemaking, rather than waiting for a deeply polarized Congress to act.
- The rapid development of AI raises the risk that political operators or fraudsters could use deepfake video and voice for scams. For example, officials fear that people could be

manipulated or defrauded using AI-generated deepfakes of their family members, friends, work colleagues, or celebrities.

US Semiconductor Industry: The Commerce Department said it will provide $1.5 billion in grants to contract semiconductor maker GlobalFoundries to expand the company's production facilities in New York and Vermont. The award is the first under the CHIPS and Science Act of 2022, which set aside $52 billion in incentives for firms to expand their US chipmaking factories and shore up secure domestic supplies of semiconductors. The Commerce Department is expected to announce billions of dollars of additional awards in the coming weeks.

US Banking Industry: Based on recent regulatory filings, overdue commercial real estate loans at the six largest banks have now grown to 160% of the amounts the banks have set aside to cover losses on those loans, versus 90% one year earlier. As commercial property owners continue to struggle with high interest rates and increased vacancies, more loans are likely to go sour in the coming months. In turn, that will likely force banks to boost their loss reserves further, impinging on bank profits and weighing on bank stock prices.

US Energy Market: US natural gas prices in recent days have fallen close to their lowest levels since 1995, reflecting weak heating demand amid the country's warmest winter on record, surging US production, and possibly from the administration's recent pause on liquified natural gas exports. Near futures prices for gas this morning are down 1.5% at approximately $1.59. The decline in gas prices will likely help reduce consumer price inflation in the near term, potentially helping to convince the Federal Reserve that it can start cutting interest rates.



US Economic Releases

There were no domestic releases prior to the publication 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
10:00	Leading Economic Indicators	m/m	Jul	-0.3%	-0.1%	***
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	Core Machine Orders	y/y	Dec	-0.70%	-5.00%	-1.30%	***	Equity bullish, bond bearish
	Tokyo Condominiums for Sale	y/y	Jan	56.60%	3.80%		*	Equity and bond neutral
South Korea	Consumer Confidence	m/m	Feb	101.9	101.6		*	Equity and bond neutral
EUROPE								
Eurozone	Current Account	m/m	Dec	31.9b	24.6b	22.5b	*	Equity and bond neutral
	Construction Output	y/y	Dec	1.9%	-2.2%	-1.9%	*	Equity bullish, bond bearish
	EU27 New Car Registrations	y/y	Jan	12.1%	-3.3%		*	Equity and bond neutral
UK	Rightmove House Prices	y/y	Feb	0.1%	-0.7%		**	Equity and bond neutral
Switzerland	Domestic Sight Deposits CHF	w/w	16-Feb	468.6b	473.8b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	16-Feb	477.1b	482.3b		*	Equity and bond neutral
	Real Exports	m/m	Jan	-0.4%	1.1%		*	Equity and bond neutral
	Real Imports	m/m	Jan	-4.3%	2.3%	2.2%	*	Equity and bond neutral
AMERICAS								
Canada	Industrial Prices	m/m	Jan	-0.1%	-1.5%	-0.2%	**	Equity and bond neutral
	Raw Material Prices	m/m	Jan	1.2%	-4.9%	0.6%	*	Equity bearish, bond bullish
Brazil	Economic Activity	y/y	Dec	1.36%	2.19%	2.38%	**	Equity bearish, bond bullish

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)	558	558	0	Down
3-mo T-bill yield (bps)	522	523	-1	Up
U.S. Sibor/OIS spread (bps)	532	532	0	Down
U.S. Libor/OIS spread (bps)	533	533	0	Down
10-yr T-note (%)	4.28	4.28	0.00	Down
Euribor/OIS spread (bps)	393	393	0	Down
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
Yen	Flat			Down
Pound	Flat			Up
Franc	Flat			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
PBOC 1-Year Loan Prime Rate	3.450%	3.450%	3.400%	Above Forecast
PBOC 5-Year Loan Prime Rate	3.950%	4.200%	4.100%	Below Forecast
PBOC 1-Year Med-Term Lending Facility	2.500%	2.500%	2.500%	On Forecast
PBOC 1-Year Med-Term Lending (Bil.)	500.0b	995.0b	500.0b	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.

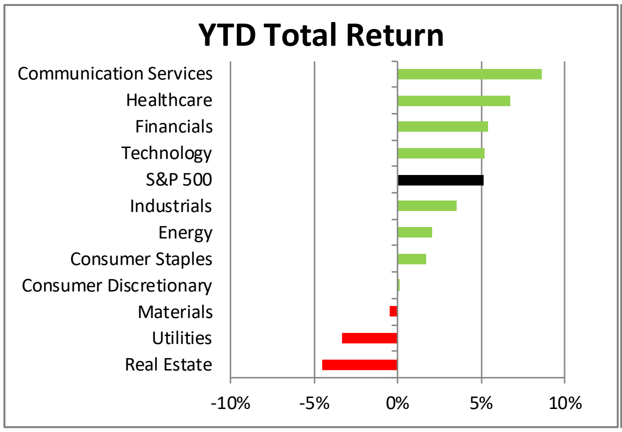
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$82.72	$83.56	-1.01%	
WTI	$78.68	$79.19	-0.64%	
Natural Gas	$1.59	$1.61	-1.37%	
Crack Spread	$24.30	$25.12	-3.27%	
12-mo strip crack	$24.89	$25.42	-2.11%	
Ethanol rack	$1.64	$1.64	0.00%	
Metals				
Gold	$2,027.19	$2,016.66	0.52%	
Silver	$23.12	$23.02	0.40%	
Copper contract	$383.55	$385.15	-0.42%	
Grains				
Corn contract	$432.50	$429.50	0.70%	
Wheat contract	$562.00	$559.00	0.54%	
Soybeans contract	$1,184.75	$1,176.25	0.72%	
Shipping				
Baltic Dry Freight	1,629	1,610	19	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.4		
Gasoline (mb)		-1.6		
Distillates (mb)		-1.7		
Refinery run rates (%)		0.1%		
Natural gas (bcf)		-66		

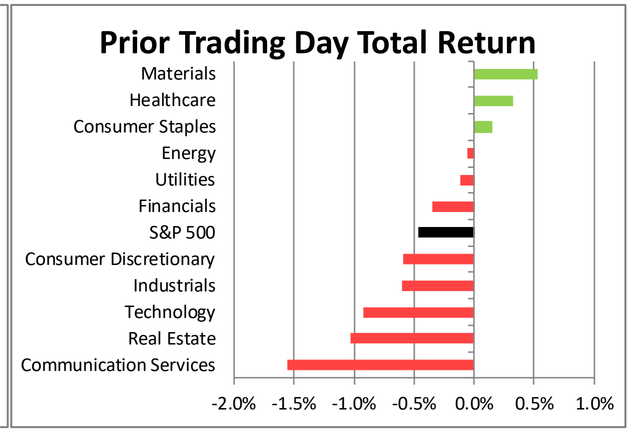
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for most of the country, with cooler temperatures in the Pacific region. Meanwhile, the precipitation outlook calls for wetter-than-normal conditions for most states north of Texas, with drier conditions expected in the Southwest region.

Data Section

US Equity Markets – (as of 2/16/2024 close)

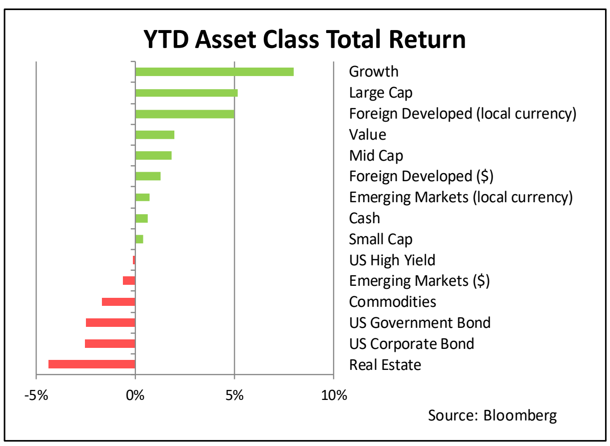




(Source: Bloomberg)

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 2/16/2024 close)

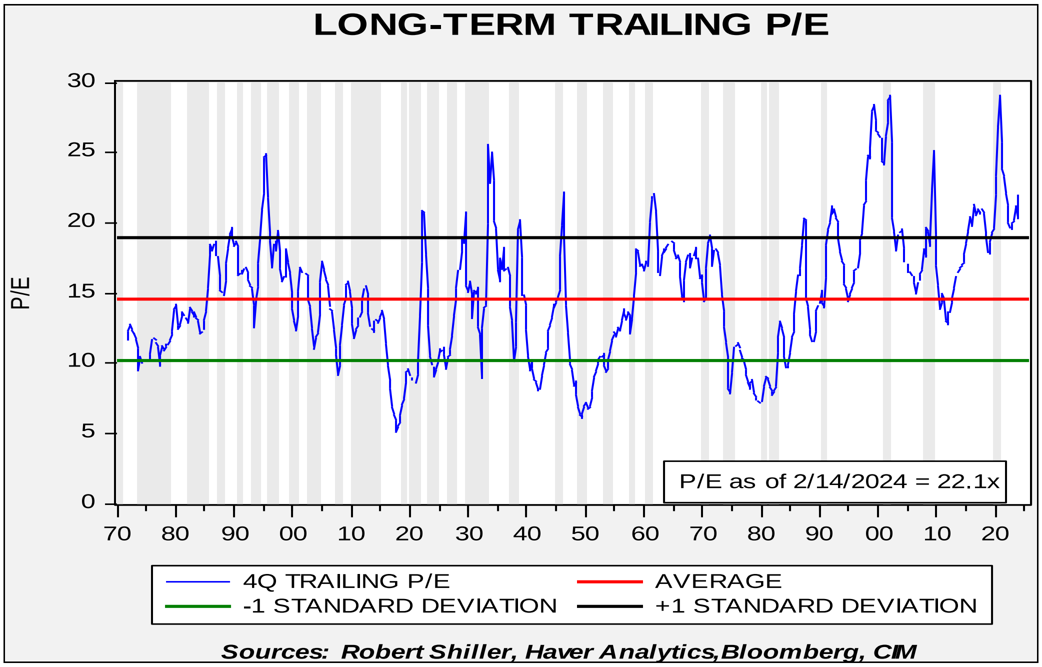


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.