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 21, 2024—9:30 AM EST] Global equity markets are mostly higher this morning. In Europe, the Euro Stoxx 50 is up 0.4% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.4%. Chinese markets were higher, with the Shanghai and the Shenzhen Composites up 1.0% from the previous close. Conversely, U.S. equity index futures are signaling a lower open.

With 411 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, 78.0% have exceeded expectations, while 16.1% 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 an interesting development pointing to the long-term potential of hydrogen as a global fuel source. We next review a wide range of other international and US developments with the potential to affect the financial markets today, including a new Chinese threat to the developed countries' auto industries and a surge in US retirements that has driven much of the recent expansion in the country's budget deficit.

Global Energy Market: At the American Association for the Advancement of Science's annual meeting last weekend, the US Geological Survey presented unpublished data indicating as much as 5 trillion tons of hydrogen exist in underground reservoirs worldwide, potentially setting the stage for it to be a key carbon-free energy source in the future. According to the data, most of the deposits are likely inaccessible. However, if even just a few percent are recoverable, it would be enough to supply the projected demand of 500 million tons per year for centuries.

- Currently, economists and analysts are focused on nuclear, solar, and wind energy to replace fossil fuels and reduce carbon emissions in the future. There has been some focus on hydrogen, but it has been modest to date.
- The new data could potentially help shift interest toward developing hydrogen as an energy source. If technologically and economically feasible, widespread adoption of hydrogen energy would likely create new investment opportunities in the future.

Global Auto Market: Chinese electric vehicle giant BYD has announced a new version of its plug-in hybrid model, the Qin Plus DM-i, priced at the equivalent of just $11,086. The firm says its strategy with the new vehicle is to accelerate the global transition from internal-combustion vehicles to EVs. With the vehicle priced below many of today's top-selling gasoline cars, such as Toyota's Corolla, the new BYD offering highlights the threat that low-priced Chinese cars could decimate auto industries throughout developed countries.

China-United States: At the annual Munich Security Conference over the weekend, FBI Director Wray warned that the Chinese are not only still hacking the computer systems of critical infrastructure such as electricity grids to pre-position malware for use in time of conflict, but they have increased it to a "fever pitch." According to Wray, Chinese spies and hackers are increasingly inserting "offensive weapons within our critical infrastructure poised to attack whenever Beijing decides the time is right."

- Wray's comments are only the latest in a long series of FBI warnings about massive Chinese spying and hacking in the US. According to Wray, those warnings were long dismissed by corporate leaders, but they are increasingly being taken to heart as more evidence of the activity is unearthed.
- Government officials even fear that the Chinese-made cargo cranes at US ports are compromised by sensors and software that could allow Beijing to monitor or disrupt US trade. Therefore, the Biden administration will launch a maritime cybersecurity program today that will provide $20 billion from the Jobs and Infrastructure Act of 2021 to improve port security, including replacing all Chinese-made port cranes with new, US-made cranes.
- The pre-positioning of Chinese malware across US computer systems is a reminder that World War II, the last Great Power conflict, is probably not a valid template for how a potential US-China conflict would unfold. In World War II, almost all of the conflict consisted of visible, kinetic attacks: bombs being dropped, artillery being fired, etc. Much of a future US-China conflict might be invisible and non-kinetic, including electromagnetic attacks on satellites in space, malware in cyberspace, and the like.

China-Taiwan: Tensions between China and Taiwan have worsened in recent days after an incident in which two Chinese fishermen drowned while being chased out of Taiwanese waters by the island's coast guard. In response, Beijing says it will step up law enforcement around the Kinmen archipelago, a group of Taiwanese islands that sit as close as three miles from the Chinese mainland and 100 miles from Taiwan's main island. The stepped-up Chinese patrols have even included the boarding of a Taiwanese sightseeing boat this week.

- A potential Chinese effort to take control of Taiwan has long been a key geopolitical risk, as it would probably draw in the US, Japan, and other countries friendly to the island.
- In recent months, Chinese-Philippine tensions have increased sharply, to the point where we have thought they were the greater near-term risk. This week's tensions between China and Taiwan are a reminder that the Taiwan Strait remains a high source of risk for investors going forward.

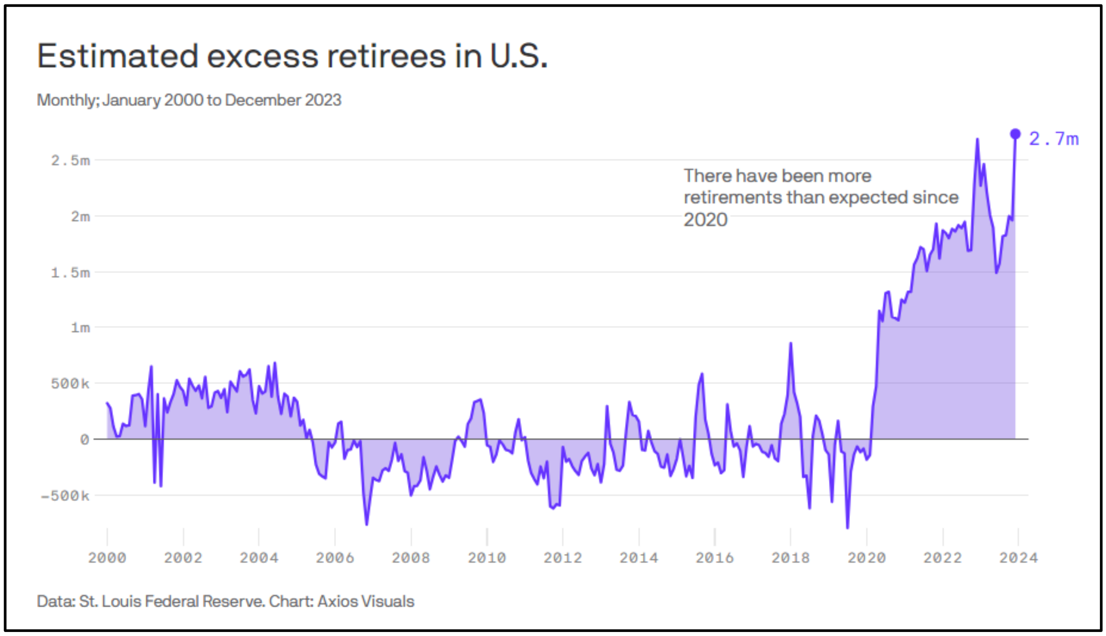
India: Government officials and farmer groups in recent days have failed to reach an agreement on the farmers' demands for fixed prices on dozens of crops and debt relief, keeping alive the farmers' threats to stage mass protests in New Delhi. Even though the popular Prime Minister Modi remains in the driver's seat ahead of this spring's parliamentary elections, the impasse and the tough choice between a budget-busting subsidy deal and mass protests is a political risk. In turn, that risk could potentially be a headwind for Indian stocks in the coming weeks.

France: After the government cut its forecast of 2024 economic growth to just 1.0% from 1.4% previously, Finance Minister Le Maire said national budget spending will be reduced by a further 10 billion EUR on top of the earlier cut of 16 billion EUR to keep the deficit at the targeted 4.4% of gross domestic product. According to Le Maire, the new cuts will come from reduced hiring and other operational expenses at government ministries, less foreign aid, and reductions in various subsidies. The spending cuts will likely be a further headwind for French GDP growth this year.

US Fiscal Policy: New analysis shows the US has about 2.7 million more retirees than predicted by a St. Louis FRB model, versus just 1.5 million excess retirees six months ago. There has also been a fiscal deficit frequently, beginning in 2008 until the onset of the COVID-19 pandemic in 2020. While the pandemic prompted millions of older workers to finally retire, this second wave of retirements was likely prompted by surging stock values. In any case, the sudden wave of new retirees is one reason why the US fiscal deficit has suddenly widened dramatically.

- The new wave of retirements has led to a sudden rise in Social Security retirement benefits and Medicare spending.
- Comparing the year ended in January 2024 to the previous year, the excess of Social Security and Medicare outlays over Social Security and Medicare gross tax receipts expanded by $672.6 billion, accounting for fully 70% of the expansion in the federal budget deficit in the period (after adjusting for the accruals related to the administration's proposed student loan forgiveness program and its subsequent reversal).
- Although politicians often claim the expanding federal budget deficit stems from profligate spending by the government, the deficit expansion primarily stems from the

aging US population and individual baby boomers finally deciding to retire and start drawing Social Security and Medicare benefits.



US Stock Market: S&P Dow Jones Indexes announced that on-line retailing giant Amazon.com will replace Walgreens Boots Alliance in the Dow Jones Industrial Average starting on Monday. While the reshuffling was prompted by Walmart's upcoming three-for-one stock split, which will reduce its weighting in the index, the move will help make the index more reflective of the broader, technology-dominated US equity market.

US Economic Releases

Home loan demand slipped following a sharp increase in interest rates. According to an index tracked by the Mortgage Bankers Association, mortgage applications fell 10.6% in the week ending February 16. The drop in loan requests is related to a sharp increase in borrowing costs as the average 30-year fixed rate rose 19 bps to 7.06% last week. As a result, the MBA tracker for refinance applications fell 11.4%, while the purchase tracker fell 10.1%.

The table below lists the economic releases and/or Fed events scheduled for the rest of the day.

Economic Releases		
No economic releases for the rest of today		
Federal Reserve		
EST	**Speaker or Event**	**District or Position**
9:10	Thomas Barkin Speaks on SiriusXM	President of the Federal Reserve Bank of Richmond
14:00	U.S. Federal Reserve Releases Meeting Minutes	Federal Reserve Board
17:30	Susan Collins Participates in Fireside Chat	President of the Federal Reserve Bank of Boston

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 F	-14.0%	-14.1%		**	Equity and bond neutral
	Trade Balance	m/m	Jan	-$¥1758.3b	¥62.1b	¥68.9b	***	Equity and bond neutral
	Exports	m/m	Jan	11.9%	9.8%	9.7%	*	Equity and bond neutral
	Imports	m/m	Jan	-9.6%	-6.8%	-6.9%	*	Equity bearish, bond bullish
Australia	Westpac Leading Index MoM	m/m	Jan	-0.08%	-0.04%	-0.03%	**	Equity and bond neutral
	Wage Price Index YoY	y/y	4Q	4.20%	4.00%	4.10%	**	Equity and bond neutral
South Korea	PPI	y/y	Jan	1.3%	1.2%		**	Equity and bond neutral
	Business Survey - Manufacturing	m/m	Mar	75	71		**	Equity and bond neutral
	Business Survey - Non-Manufacturing	m/m	Mar	70	68		*	Equity and bond neutral
EUROPE								
UK	Public Sector Net Borowing	m/m	Jan	-17.6b	6.8b	6.5b	*	Equity bearish, bond bullish
	PSNB ex Banking Groups	m/m	Jan	-16.7b	7.8b	7.4b	**	Equity bearish, bond bullish
Switzerland	M3 Money Supply	y/y	Jan	-2.0%	-2.0%		**	Equity and bond neutral
AMERICAS								
Canada	CPI	y/y	Jan	2.90%	3.40%	3.30%	***	Equity and bond neutral
Mexico	International Reserves Weekly	w/w	16-Feb	$213061m	$213177m		*	Equity and bond neutral
	Retail Sales	y/y	Dec	-0.2%	2.7%	2.4%	***	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	521	1	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 (%)	4.26	4.28	-0.02	Flat
Euribor/OIS spread (bps)	394	393	1	Down
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Flat			Down
Yen	Flat			Down
Pound	Flat			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.

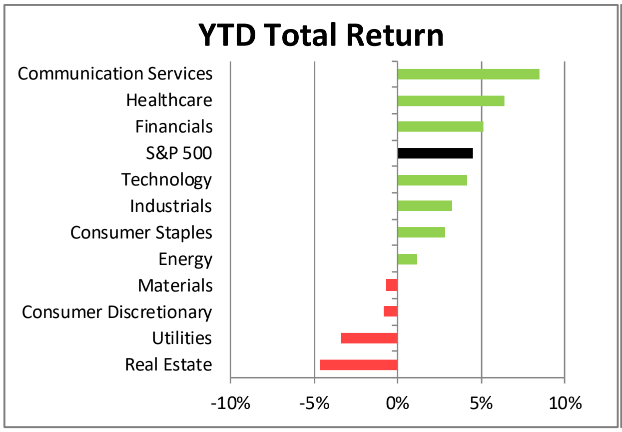
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$82.14	$82.34	-0.24%	
WTI	$76.86	$77.04	-0.23%	
Natural Gas	$1.72	$1.58	9.39%	Supply Pessimism - Production Cuts
Crack Spread	$31.12	$24.22	28.46%	Contract Roll
12-mo strip crack	$24.30	$24.71	-1.67%	
Ethanol rack	$1.65	$1.65	0.24%	
Metals				
Gold	$2,029.49	$2,024.41	0.25%	
Silver	$23.07	$23.00	0.27%	
Copper contract	$390.05	$387.55	0.65%	
Grains				
Corn contract	$429.25	$432.50	-0.75%	
Wheat contract	$575.75	$579.25	-0.60%	
Soybeans contract	$1,175.00	$1,183.50	-0.72%	
Shipping				
Baltic Dry Freight	1,632	1,629	3	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		4.8		
Gasoline (mb)		-3.4		
Distillates (mb)		-2.1		
Refinery run rates (%)		-0.1%		
Natural gas (bcf)		-66		

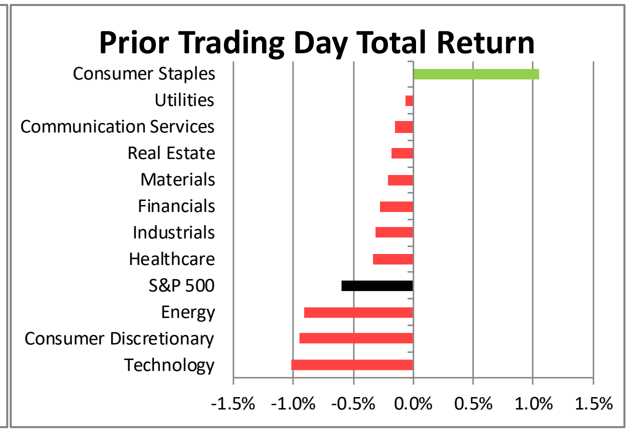
Weather

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, with drier conditions expected in Texas and Oklahoma.

Data Section

US Equity Markets – (as of 2/20/2024 close)

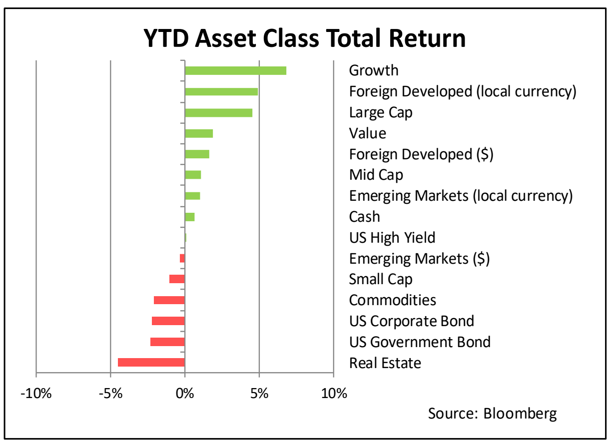




(Source: Bloomberg)

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 2/20/2024 close)

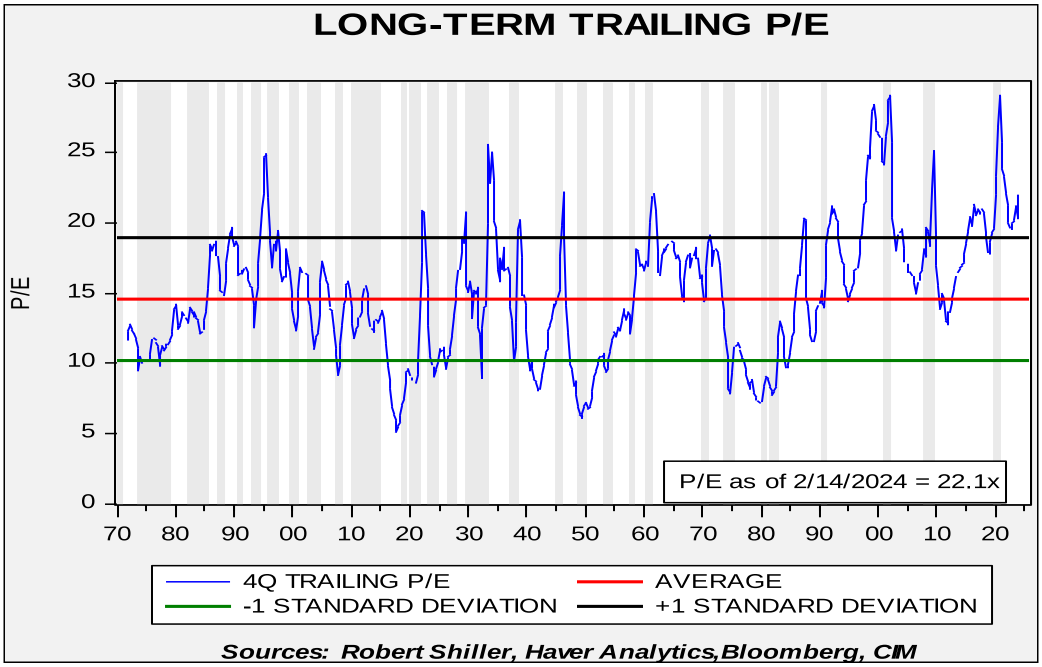


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.