Confluence INVESTMENT MANAGEMENT

Daily Comment

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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 22, 2024—9:30 AM EST] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is up 1.5% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.3%. Chinese markets were higher, with the Shanghai and the Shenzhen Composites up 1.3% from the previous close. U.S. equity index futures are signaling a higher open.

With 425 companies having reported so far, S&P 500 earnings for Q4 are running at $57.70 per share compared to estimates of $55.15, which is up 1.6% from Q3 2023. Of the companies that have reported thus far, 77.4% have exceeded expectations, while 16.7% have fallen short of expectations.

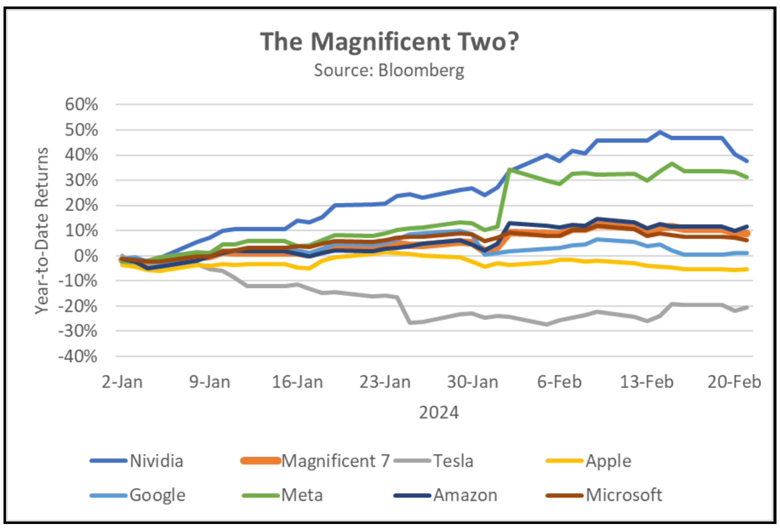
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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"

Good morning! Markets are buoyant after a stellar earnings report from Nvidia, while Messi returns to action as the reigning Ballon d'Or winner. In today's *Comment*, we discuss our reservations about the Magnificent Seven, give our reaction to the latest Fed minutes, and explain why Japan continues to capture the attention of investors. As usual, our report concludes with a summary of domestic and international data releases.

Magnificent Seven: Despite past solid performances, Big Tech valuations may face pressure as investors worry about their ability to sustain growth and meet audacious earnings targets.

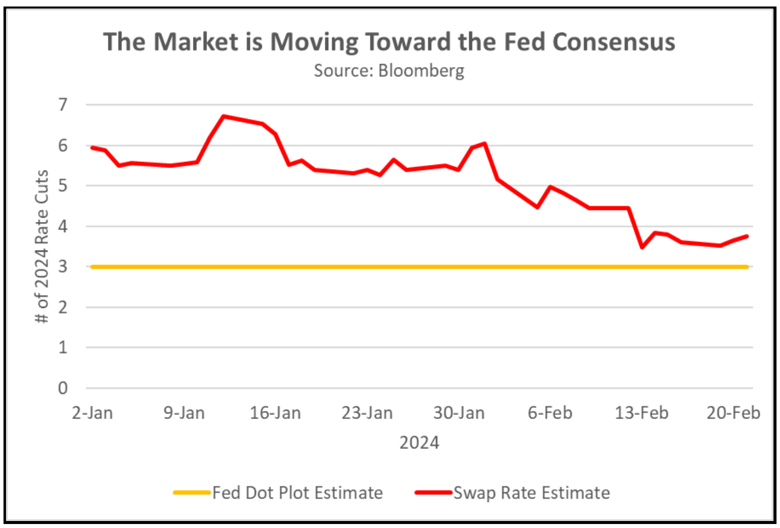
- Chipmaker Nvidia reported stronger-than-expected earnings, indicating that AI hype still has momentum. The company announced that it made $22.1 billion revenue in the three month period ending in January. This surpassed estimates by $1.7 billion and sparked optimism for a $24-billion current quarter, driven by resurgent chip demand. The news comes after a stellar year with Nvidia's stock surging 240% in 2023 and 40% year-to-date and is likely to buoy the broader tech sector as investors seek to avoid missing out on further gains made in the AI space.
- While the Magnificent Seven experienced strong overall growth to start the year, it wasn't evenly distributed, potentially fueling investor concerns. Meta and Facebook surged the most, exceeding 30% growth in the first two months, while Apple and Tesla's stock prices dipped during the same period. This disparity highlights investor skepticism towards stocks lacking robust earnings to justify their valuations. Currently, these Magnificent Seven stocks trade at a hefty 40.1 times earnings, nearly double the S&P 500 average. The high valuation suggests that these firms may not be able to sustain their current pace for the rest of the year.



- Investors may be drawn to companies with strong market positions and future growth potential, but these companies are possibly running out of steam. In the AI chip market, Nvidia holds a significant share with its H100 GPUs, and has even caused supply chain challenges for major players like Tesla, as reported by the company. However, concerns are rising about the ability of Big Tech, including Nvidia, to consistently deliver blockbuster earnings growth in the future especially given their rich valuations. This may explain why META has decided to pay out its first dividend. Nevertheless, we recommend keeping a close eye on the technology sector as broader economic factors and company-specific news could impact their valuations in the coming months.

Fed Speaks, Market Reacts: Markets have digested the Fed's reluctance for aggressive rate cuts in 2024, but uncertainty lingers due to policymakers' conflicting views on future monetary policy.

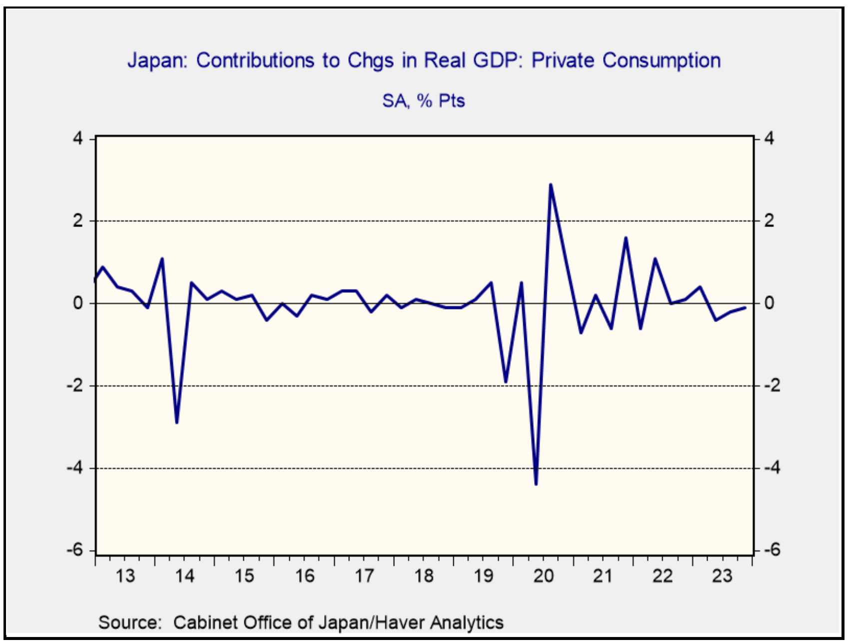
- Federal Reserve officials expressed hesitancy to cut interest rates soon unless they see more progress, according to the January 30-31 meeting minutes. While officials acknowledge inflation's move toward the 2% target, concerns about persistent economic momentum and the risk of overly restrictive policy have divided the board. Additionally, there was a broad consensus that there are enough reserves to meet bank needs. On Wednesday, Richmond Fed President Thomas Barkin and Governor Michelle Bowman reiterated their concerns, urging patience as recent economic data showed that a lot of upside inflation risk remains.
- The Fed's latest remarks significantly diminished the market's expectation of a rate cut at the upcoming March meeting. At the start of the year, investors anticipated that policymakers could slash rates up to seven times, expecting the central bank to pivot to protect the economy from slowing down. However, sentiment began to change following the Federal Reserve's January 30-31 meeting, during which Powell suggested that a rate cut in the upcoming meeting was unlikely. The latest swap rates suggest that investors believe that the Fed may cut three or four times this year, which is in line with the Fed's median projection.



- Maintaining current interest rates for an extended period could complicate the Fed's pursuit of a soft landing, as recent meeting minutes reveal. While policymakers expressed confidence in the overall economy, concerns emerged regarding the sustainability of recent growth, primarily driven by volatile factors like net exports and inventory investment. The minutes explicitly labeled these factors as "offering little signal for future growth," highlighting their limitations as economic indicators. Further, rising bank loan-loss provisions suggest potential credit deterioration later in the year. Although we do not expect a recession this year, we believe that the risk is elevated.

Japan is Back! The Nikkei 225 index hit a new high for the first time in over 34 years as investors begin to embrace the new normal.

- The recent resurgence of the Japanese stock market, once a global powerhouse in the 1980s, is fueled by a confluence of factors, including improvements in corporate governance, a shift from deflationary to moderate inflation, and a complex geopolitical landscape. The bounce began after the Tokyo Stock Exchange started its campaign to raise corporate valuations and was supported by the Bank of Japan, which has been reluctant to raise rates as a way of encouraging firms to test its pricing power. Furthermore, the lackluster performance of China's stock market has led investors seeking regional alternatives to turn to Japan.
- Echoing 2023's performance, Japan's stock market has again outpaced many of its global counterparts in the first few months of 2024. However, uncertainty remains regarding the sustainability of this trend. The Nikkei 225 index currently boasts a 16% year-to-date gain, significantly exceeding the S&P 500's 5.0% rise and even surpassing the broader MSCI World Index's 3.6% increase. While foreign investors divesting from China may have fueled some of the initial gains, their return is uncertain and contingent on China's rebound. Additionally, tepid results from upcoming union wage negotiations could challenge the narrative of Japan's shift away from deflation, especially as the country flirts with recession.

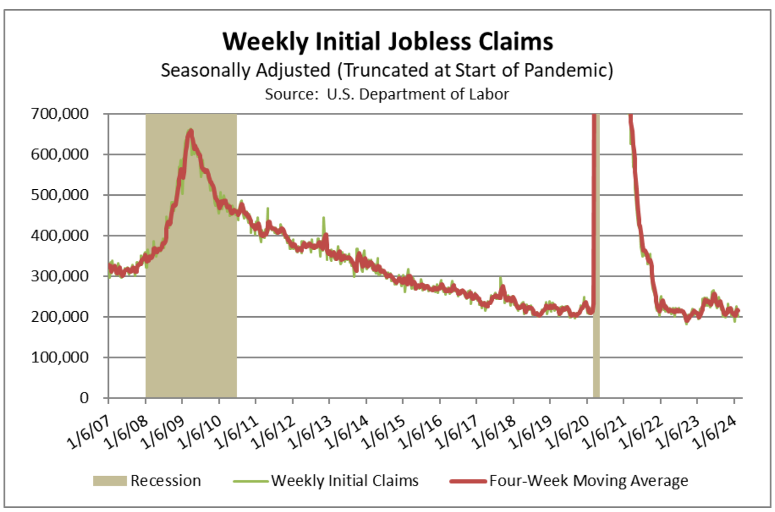


- The stock market's strong performance despite Japan's economic downturn creates a puzzling disconnect, fueling concerns about market sustainability. Weakening consumer spending, a key factor in the slump, could complicate ongoing union negotiations. Companies might resist wage increases, challenging the optimistic narrative that Japan has finally escaped its multi-decade deflationary period. This could prompt investors to re-evaluate their bullish stance. However, a relatively cheap currency presents an opportunity for Japanese exporters. If leveraged effectively, it could boost earnings and support the export-driven growth strategy, potentially mitigating concerns about sustainability in the long run.

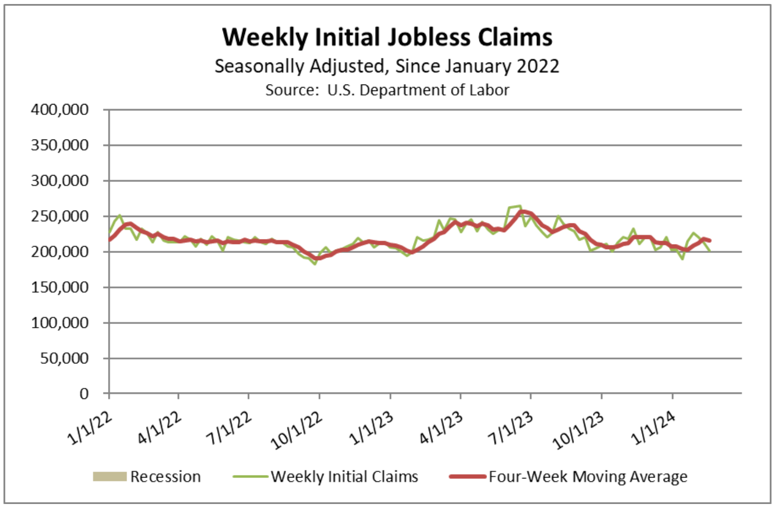
Other News: [President Trump's unveiling of his VP shortlist](#) — comprising Tim Scott, Ron DeSantis, and Vivek Ramaswamy — underscores his mounting confidence as the frontrunner for the Republican nomination, signaling a potential rematch with President Biden. In a display of bipartisan unity, [lawmakers engaged in discussions with Taiwan's President-elect](#) to reaffirm Washington's steadfast support for the sovereign island. Meanwhile, [the US government has committed billions of dollars to replace cargo cranes, previously manufactured by China](#), at ports — a significant indication of its strategic divergence from its Indo-Pacific rival.

US Economic Releases

In the week ended February 17, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 201,000, well below both the expected level of 216,000 and the previous week's revised level of 213,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to 215,250. Overall, the figures show that initial claims remain within the same low range that they've been in for more than two years. Meanwhile, in the week ended February 10, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) fell to 1.862 million, below both the anticipated reading of 1.884 million and the prior week's revised reading of 1.889 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.



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 US Manufacturing PMI	m/m	Feb P	50.7	50.7	***
9:45	S&P Global US Services PMI	m/m	Feb P	52.3	52.5	**
9:45	S&P Global US Composite PMI	m/m	Feb P	51.8	52	***
10:00	Existing Home Sales	m/m	Jan	3.97m	3.78m	***
10:00	Existing Home Sales MoM	m/m	Jan	4.9%	-1.0%	*
Federal Reserve						
EST	Speaker or Event	District or Position				
10:00	Philip Jefferson to Give Speech, Q&A	Vice-Chair of the Board of Governors				
14:00	Patrick Harker Speaks on Economic Outlook	President of the Federal Reserve Bank of Philadelphia				
17:00	Lisa Cook Speaks at Macrofinance Conference	Member of the Board of Governors				
17:00	Neel Kashkari Participates in Panel Discussion on Outlook	President of the Federal Reserve Bank of Minneapolis				
19:35	Chris Waller Speaks on Economic Outlook	Member of the Board of Governors				

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	16-Feb	¥382.0b	¥621.3b	¥621.2b	*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	16-Feb	-¥560.8b	¥1499.3b	¥1495.1b	*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	16-Feb	-¥521.6b	¥175.9b	¥176.1b	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	16-Feb	¥359.9b	¥22.1b		*	Equity and bond neutral
	Jibun Bank Japan PMI Composite	m/m	Feb P	50.3	51.5		**	Equity and bond neutral
	Jibun Bank Japan PMI Mfg	m/m	Feb P	47.2	48.0		***	Equity and bond neutral
	Jibun Bank Japan PMI Services	m/m	Feb P	52.5	53.1		**	Equity and bond neutral
	Nationwide Dept Sales YoY	m/m	Jan	0.1	0.1		*	Equity and bond neutral
New Zealand	Trade Balance NZD	m/m	Jan	-976m	-323m	-368m	**	Equity and bond neutral
	Exports NZD	m/m	Jan	4.93b	5.94b	5.85b	**	Equity and bond neutral
	Imports NZD	m/m	Jan	5.91b	6.26b	6.22b	**	Equity and bond neutral
India	HSBC India PMI Mfg	m/m	Feb P	56.7	56.5		***	Equity and bond neutral
	HSBC India PMI Composite	m/m	Feb P	61.5	61.2		**	Equity and bond neutral
	HSBC India PMI Services	m/m	Feb P	62.0	61.8		**	Equity and bond neutral
EUROPE								
Eurozone	HCOB Eurozone Manufacturing PMI	m/m	Feb P	46.1	46.6	47.0	***	Equity bearish, bond bullish
	HCOB Eurozone Services PMI	m/m	Feb P	50.0	48.4	48.8	**	Equity and bond neutral
	HCOB Eurozone Composite PMI	m/m	Feb P	48.9	47.9	48.4	*	Equity and bond neutral
Eurozone	CPI	y/y	Jan F	2.8%	2.8%	2.8%	***	Equity and bond neutral
	Core CPI	y/y	Jan F	3.3%	3.3%	3.3%	**	Equity and bond neutral
Germany	HCOB Germany Manufacturing PMI	m/m	Feb P	42.3	45.5	46.0	***	Equity bearish, bond bullish
	HCOB Germany Services PMI	m/m	Feb P	48.2	47.7	48.0	**	Equity and bond neutral
	HCOB Germany Composite PMI	m/m	Feb P	46.1	47.0	47.5	**	Equity bearish, bond bullish
France	Business Confidence	m/m	Feb	98	98	99	**	Equity and bond neutral
	Manufacturing Confidence	m/m	Feb	100	99	99	*	Equity and bond neutral
	HCOB France Manufacturing PMI	m/m	Feb P	46.8	43.1	43.5	***	Equity bullish, bond bearish
	HCOB France Services PMI	m/m	Feb P	48.0	45.4	45.6	**	Equity bullish, bond bearish
	HCOB France Composite PMI	m/m	Feb P	47.7	44.6	45.0	**	Equity bullish, bond bearish
Italy	CPI, EU Harmonized	y/y	Jan F	0.9%	0.9%	0.9%	***	Equity and bond neutral
UK	S&P Global UK Manufacturing PMI	m/m	Feb P	47.1	47.0	47.5	***	Equity and bond neutral
	S&P Global UK Services PMI	m/m	Feb P	54.3	54.3	54.1	**	Equity and bond neutral
	S&P Global UK Composite PMI	m/m	Feb P	53.3	52.9	52.9	**	Equity and bond neutral
Russia	PPI	y/y	Jan	19.4%	19.2%		*	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	16-Feb	18.09t	18.02t		*	Equity and bond neutral
	Gold and Forex Reserves	m/m	16-Feb	$573.8b	$580.4b		***	Equity and bond neutral
AMERICAS								
Mexico	GDP NSA	y/y	Q4 F	2.5%	2.4%	2.4%	***	Equity and bond neutral
	Economic Activity IGAE	y/y	Dec	1.1%	2.3%	2.3%	**	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)	559	558	1	Down
3-mo T-bill yield (bps)	523	524	-1	Flat
U.S. Sibor/OIS spread (bps)	532	533	-1	Down
U.S. Libor/OIS spread (bps)	534	534	0	Down
10-yr T-note (%)	4.33	4.32	0.01	Up
Euribor/OIS spread (bps)	395	394	1	Down
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Down
Yen	Down			Down
Pound	Flat			Up
Franc	Flat			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Korea Base Rate	3.500%	3.500%	3.500%	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.

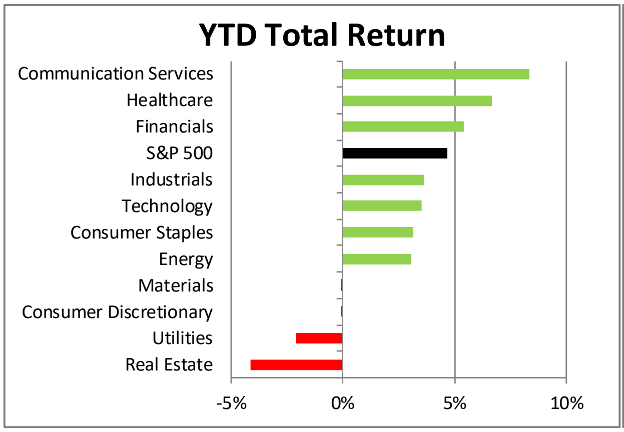
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$82.81	$83.03	-0.26%	
WTI	$77.70	$77.91	-0.27%	
Natural Gas	$1.73	$1.77	-2.48%	
Crack Spread	$29.63	$30.32	-2.26%	
12-mo strip crack	$23.75	$24.23	-1.97%	
Ethanol rack	$1.65	$1.65	0.12%	
Metals				
Gold	$2,028.64	$2,025.99	0.13%	
Silver	$23.07	$22.89	0.78%	
Copper contract	$389.40	$388.75	0.17%	
Grains				
Corn contract	$425.25	$424.25	0.24%	
Wheat contract	$584.50	$578.00	1.12%	
Soybeans contract	$1,169.50	$1,165.00	0.39%	
Shipping				
Baltic Dry Freight	1,676	1,632	44	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.8		
Gasoline (mb)		-2.6		
Distillates (mb)		-2.1		
Refinery run rates (%)		-5.0%		
Natural gas (bcf)		-58		

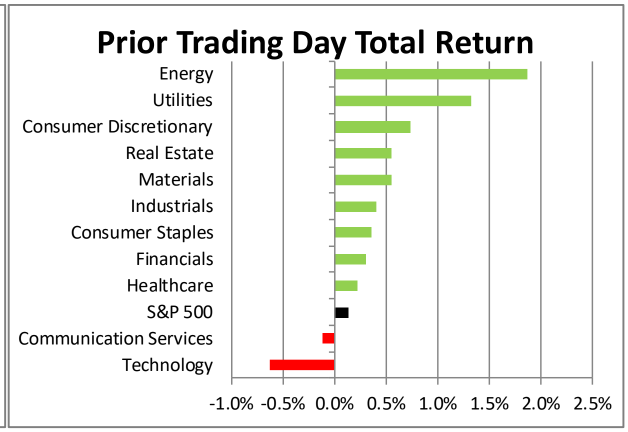
Weather

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

Data Section

US Equity Markets – (as of 2/21/2024 close)

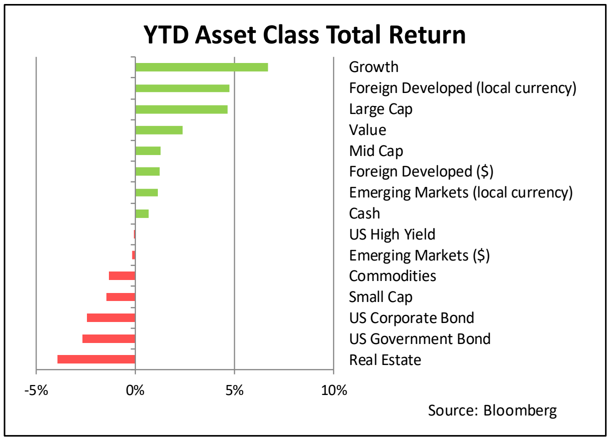




(Source: Bloomberg)

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 2/21/2024 close)

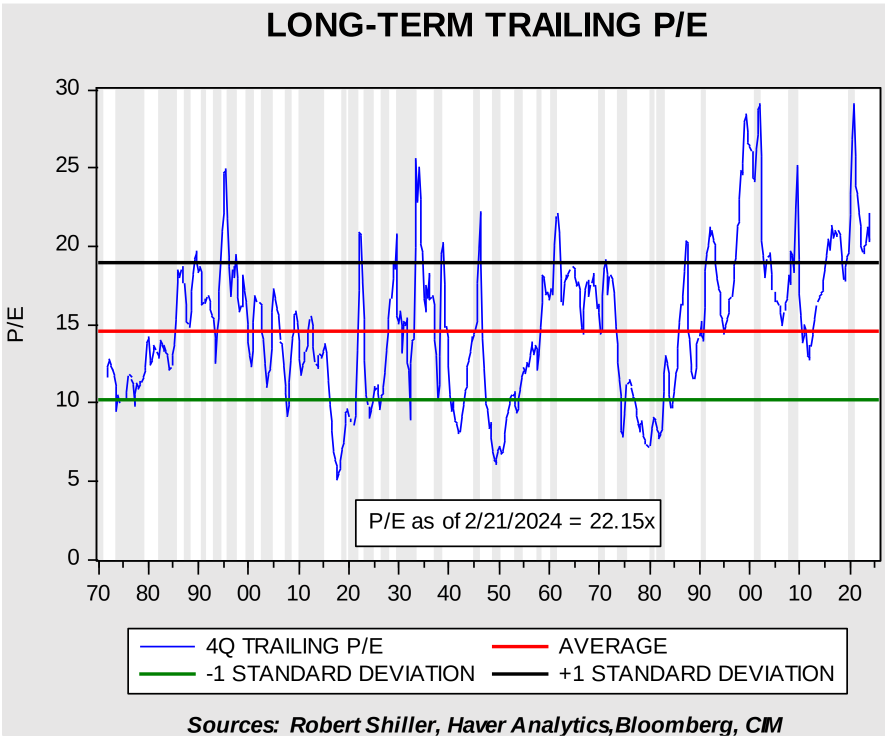


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 22, 2024



Based on our methodology,[1] the current P/E is 22.15x, up 0.05x from our last report. The modest improvement in the multiple reflects a slight increase in the stock 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.