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 23, 2024—9:30 AM EST] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is up 0.3% 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 0.6% from its previous close and the Shenzhen Composites up 1.2%. U.S. equity index futures are signaling a higher open.

With 448 companies having reported so far, S&P 500 earnings for Q4 are running at $57.80 per share compared to estimates of $55.15, which is up 1.6% from Q3 2023. Of the companies that have reported thus far, 76.7% have exceeded expectations, while 17.4% have fallen short of expectations.

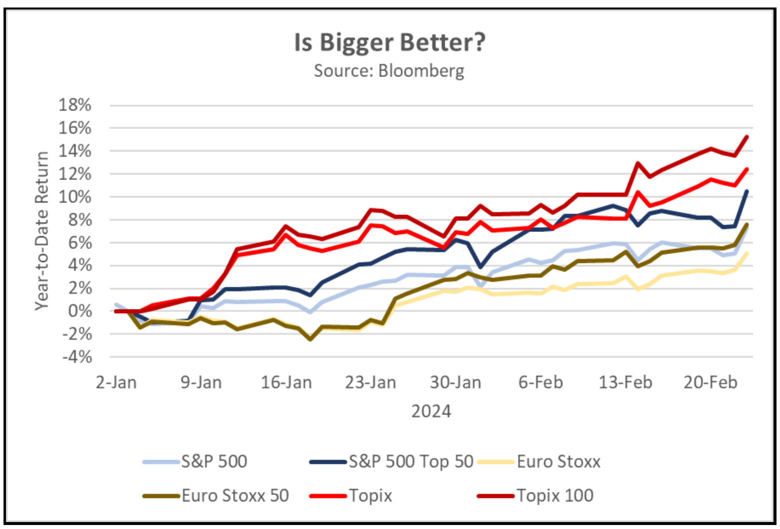
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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! Equities have simmered down since Thursday's rally. Meanwhile, prospective college football players will not have to wait long to join their teams, as official signings will occur before title games. In today's *Comment*, we delve into the reasons behind the markets' resilience amidst Europe's technical recession, explore the complexities surrounding commercial real estate issues, and offer insights into what US allies stand to gain from the ongoing chip war between the United States and China. As usual, we end our report with a summary of international and domestic releases.

What Recession? The Euro Stoxx 50 set a new record on Thursday as data showed that the regional economy is already starting to recover.

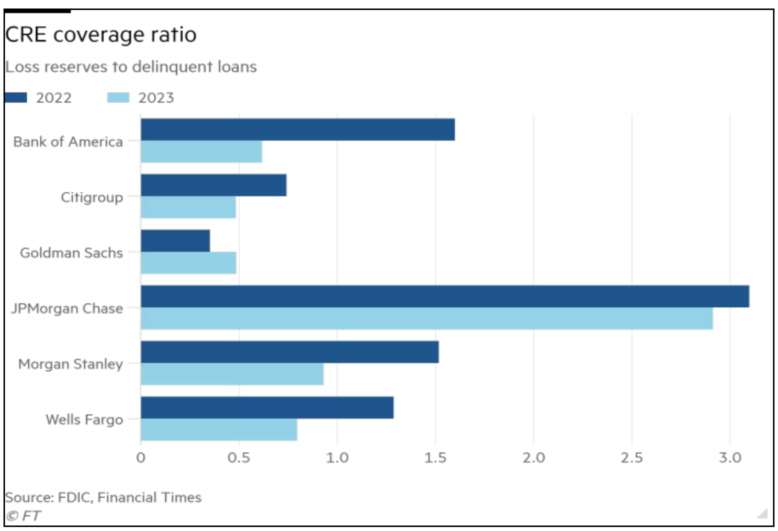
- While European economic data suggests a bumpy recovery is taking hold, the path varies across the continent. The [eurozone's composite purchasing manager index (PMI) rose from 47.9 to 48.9 in February,] exceeding expectations of 48.5, according to S&P Global. However, the picture is more nuanced. France's PMI saw a significant jump to 47.7 from 44.6, indicating expansion. Conversely, Germany's PMI unexpectedly dipped to 46.1 from 47.1, falling below the expected 47.5 and suggesting contraction. This divergence highlights how the impact of the recent economic slowdown varies significantly across countries, with some weathering the storm better than others.
- Intriguingly, markets seem to be overlooking the recent weak economic data. Even though several European nations, including Germany, entered technical recessions earlier this year, stock markets have enjoyed a strong start. The Euro Stoxx 50 Index boasts an impressive gain of almost 8% so far this year, closely trailing the S&P 500 Top 50 Index's rise of 9.5%. The apparent disconnect between economic data and European market performance is not unique to the region. Despite facing similar economic challenges, Japan's Topix 100 Index has also seen a remarkable surge of over 15% in the first quarter of this year.



- Several global stock markets are experiencing a "top-heavy" trend, with large companies driving overall gains disproportionately. This investor preference for large-cap stocks stems from their perceived stability during economic uncertainty, further fueled by mixed signals from central banks on future interest rate cuts. The persistence of this trend depends on the severity of the anticipated downturn. If the expected shallow recession in Japan and Europe materializes, the current trend might continue. However, a deeper downturn could force investors to seek "safer havens" in government bonds, potentially leading to a shift away from large-cap stocks.

CRE Problem Persists: Banks are racing against time to find solutions as hundreds of billions of dollars in office space loans approach maturity.

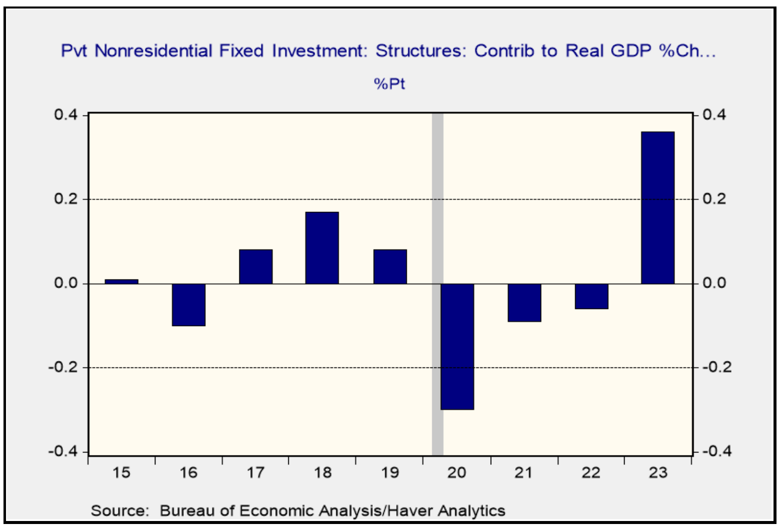
- January saw a dramatic surge in commercial real estate foreclosures, fueled by the brutal combination of high-interest rates and low occupancy rates. This "double whammy" squeezed borrowers, making it nearly impossible for many to keep up with payments, resulting in 635 foreclosures across the US. This spike highlights the significant challenges that lenders face in helping borrowers adapt to the harsh reality of higher interest rates, where the "extend and pretend" strategy is no longer viable. The increasing number of troubled CRE loans has raised concerns among regulators, with figures like Treasury Secretary Yellen and Fed Vice Chair Brainard closely monitoring the situation, fearing the potential spillover effects on the broader economy.
- A recent Barclays study revealed a significant link between bond spreads for regional banks and their risk profile. It found that 85% of the difference in bond spreads between regional banks can be explained by two factors — the weighted average rating factor (WARF), and their exposure to CRE as a percentage of their total capital. Despite their perceived stronger financial position compared to smaller banks, a recent report revealed that the bad property debts of larger banks now exceed their reserves for potential loan losses. This raises concerns about their ability to withstand potential shocks in the commercial real estate market.



- The Federal Reserve's response to this financial challenge hinges on its assessment: Is it a liquidity squeeze or a broader refinancing issue? If the Fed perceives a liquidity shortage, it might use previous measures like temporary support to prevent bank runs. Alternatively, if it sees a wider refinancing challenge, lowering interest rates could improve the negotiating power of borrowers. However, both approaches present potential drawbacks. The most recent FOMC meeting minutes showed that policymakers believe that there are ample reserves in the financial system, suggesting a potential openness to rate cuts. However, Fed officials' recent comments indicate that the committee does not plan to do so anytime soon.

Chip Wars: The US is showing that it would like to involve its allies as it battles China for AI supremacy.

- Following months of anticipation, the US government has begun allocating funds from the 2022 CHIPS and Science Act. On Thursday, South Korean semiconductor manufacturer SK Siltron secured a $544 million loan to expand its Michigan plant, marking a significant step in bolstering domestic chip production. The report comes several days after it was announced that GlobalFoundries received a $1.5 billion grant as it looks to help expand its facility in Malta, New York. It is widely expected that Taiwan Semiconductor Manufacturing Company and South Korea's Samsung will also want to take part in the program.
- Increased government funding for critical industries, like advanced manufacturing, points to a potential shift toward prioritizing domestic production. This trend is bolstered by a significant surge in investments for building and upgrading manufacturing infrastructure in 2023, marking the highest contribution to economic growth in over a decade. This push isn't limited to semiconductors; initiatives like the Inflation Reduction Act have fueled investments in electric vehicle manufacturing, further emphasizing the government's preference for producing goods that are more forward-looking as it readies to take on China.



- Despite challenges in developing its domestic electric vehicle industry, the US holds a potential advantage in semiconductors due to its long history of designing advanced chips. Recent government initiatives leverage this strength to help the US maintain its global leadership and strengthen partnerships with allied nations. This could, in turn, benefit US-aligned technology firms through increased collaboration and trade opportunities. Notably, Japan is strategically positioning itself to capitalize on this trend, as evidenced by its recent partnerships with American companies like Rapidus and Micron, aiming to revitalize its own chipmaking capabilities.

Other News: The first commercial flight to the moon landed on Thursday. This mission not only signifies the United States' triumphant return to the lunar surface after half a century, but also hints at the potential resurgence of another era of space exploration akin to a modern-day space race. The US and China are collaborating on addressing debt concerns in developing nations, showcasing a continued effort to manage tensions despite ongoing disagreements. Meanwhile, the South Carolina primary on Saturday could solidify former President Donald Trump's lead in the Republican nomination race.

US Economic Releases

No major US economic reports have been released so far today, and there are no economic releases or Fed events scheduled for the rest of the day.

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								
New Zealand	Retail Sales Ex Inflation	q/q	4Q	-1.9%	0.0%	-0.8%	**	Equity bearish, bond bullish
China	New Home Prices	m/m	Jan	-0.68%	-0.79%		*	Equity and bond neutral
EUROPE								
Germany	GDP NSA	y/y	4Q F	-0.4%	-0.4%	-0.4%	**	Equity and bond neutral
	GDP WDA	y/y	4Q F	-0.2%	-0.2%	-0.2%	**	Equity and bond neutral
	IFO Business Climate	m/m	Feb	85.5	85.2	85.5	***	Equity and bond neutral
	IFO Current Assessment	m/m	Feb	86.9	87.0	86.9	**	Equity and bond neutral
	IFO Expectations	m/m	Feb	84.1	83.5	84.0	***	Equity and bond neutral
UK	GfK Consumer Confidence	y/y	Feb	-21	-19	-18	**	Equity bearish, bond bullish
AMERICAS								
Canada	Retail Sales	m/m	Dec	0.9%	-0.2%	0.0%	**	Equity bullish, bond bearish
	Retail Sales Ex-Autos	m/m	Dec	0.6%	-0.5%	-0.4%	**	Equity bullish, bond bearish
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%	2.27%	2.32%	**	Equity bearish, bond bullish
Brazil	FGV Consumer Confidence	y/y	Feb	89.7	90.8		*	Equity and bond neutral

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	559	-1	Down
3-mo T-bill yield (bps)	524	525	-1	Up
U.S. Sibor/OIS spread (bps)	533	533	0	Down
U.S. Libor/OIS spread (bps)	534	534	0	Down
10-yr T-note (%)	4.32	4.32	0.00	Up
Euribor/OIS spread (bps)	395	395	0	Down
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Down
Yen	Flat			Down
Pound	Up			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.

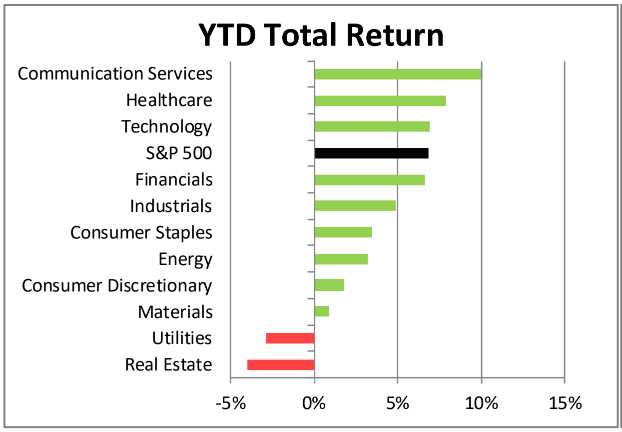
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$82.54	$83.67	-1.35%	
WTI	$77.46	$78.61	-1.46%	
Natural Gas	$1.66	$1.73	-4.04%	
Crack Spread	$31.44	$31.05	1.24%	
12-mo strip crack	$24.83	$24.75	0.31%	
Ethanol rack	$1.64	$1.65	-0.23%	
Metals				
Gold	$2,027.91	$2,024.39	0.17%	
Silver	$22.77	$22.75	0.10%	
Copper contract	$388.25	$391.50	-0.83%	
Grains				
Corn contract	$421.00	$418.50	0.60%	
Wheat contract	$585.50	$579.25	1.08%	
Soybeans contract	$1,154.50	$1,152.50	0.17%	
Shipping				
Baltic Dry Freight	1,752	1,676	76	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	3.5	3.8	-0.2	
Gasoline (mb)	-0.3	-2.6	2.3	
Distillates (mb)	-4.0	-2.1	-1.9	
Refinery run rates (%)	0.0%	0.5%	-0.5%	
Natural gas (bcf)	-60	-59	-1	

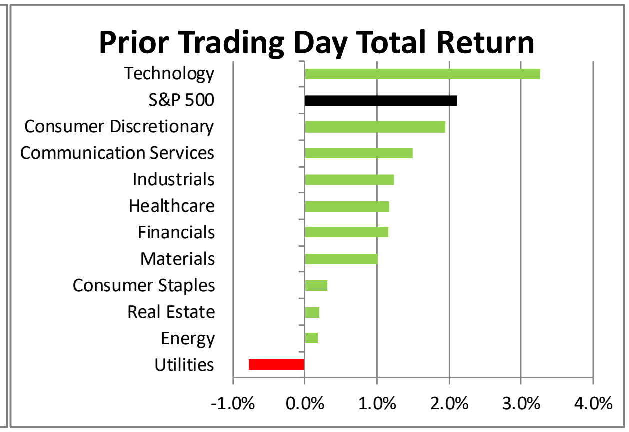
Weather

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 Great Plains and the Northeast.

Data Section

US Equity Markets – (as of 2/22/2024 close)

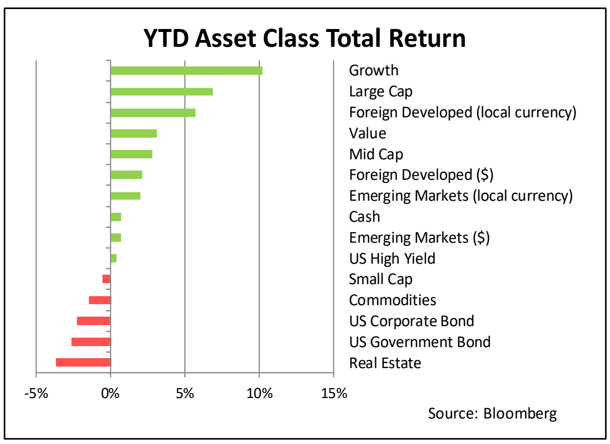




(Source: Bloomberg)

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 2/22/2024 close)

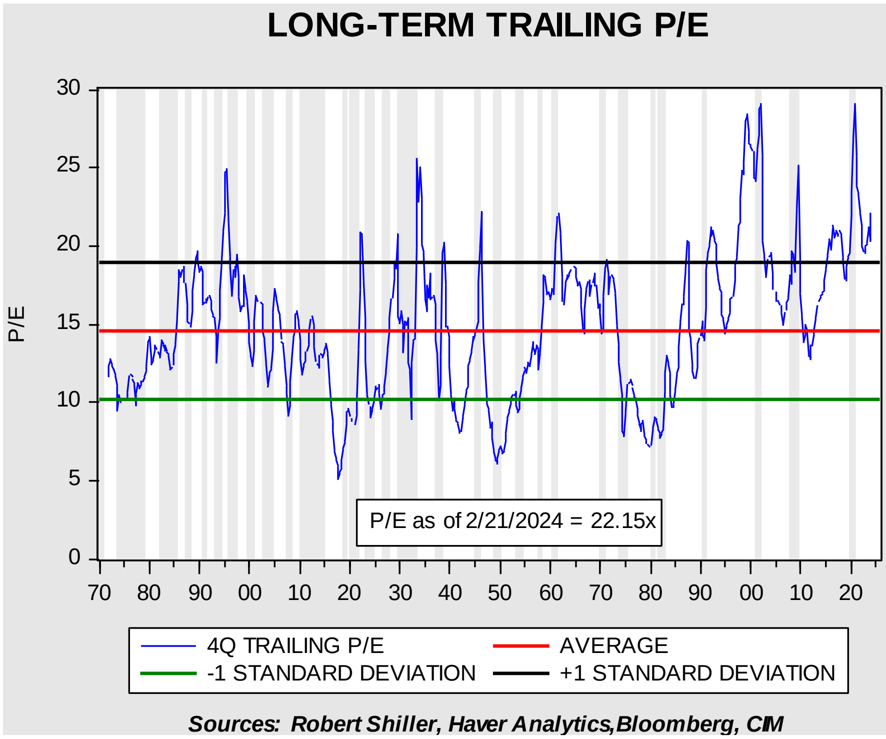


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.