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 26, 2024—9:30 AM EST] Global equity markets are generally lower this morning. In Europe, the Euro Stoxx 50 is down 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.4%. Chinese markets were mixed, with the Shanghai Composite down 0.9% from its previous close and the Shenzhen Composites up 0.4%. U.S. equity index futures are signaling a lower open.

With 449 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, 76.6% have exceeded expectations, while 17.6% 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 the state of play between the US and China in the important new industry of generative artificial intelligence (AI). We next review a range of other international and US news with the potential to affect the financial markets today, including developments touching on global nickel and natural gas markets and some notes on the US financial markets.

China: Just a week after US generative AI firm OpenAI released its Sora text-to-video product, Chinese leaders and technology researchers are reportedly panicking over the realization that China has fallen years behind the US in the technology, rather than being the global leader as previously thought. In a sign of the panic, the government has already ordered 10 state-owned firms to serve as "national champions" to push forward Chinese progress in generative AI, although it has not yet released the names of those firms.

- Chinese researchers had long thought that the country's vast trove of available data, engineering talent, and government support would give it a leg up in developing the large language models that underlie generative AI.
- It now appears that Western firms also have sufficient data and talent to make strides in the technology. Perhaps just as important, reports suggest the US government's clampdowns on selling advanced semiconductors and other technology tools to China for national security purposes have also been impeding Chinese progress.
- Beijing's frustration at falling behind in the AI race and facing ever more restrictions on US technology will likely continue to fuel US-China geopolitical tensions, with negative long-term consequences for firms doing business in China or trying to sell to China.
- Nevertheless, the growing US clampdown on sending advanced technology to China is having a positive impact for some companies in the near term. As the US clampdown is expected to further crimp the sale of semiconductor manufacturing equipment to China, it appears that Chinese firms are ramping up their purchases of chipmaking machinery, driving strong revenue and profit growth at companies like Dutch giant ASML and Japan's Tokyo Electron.

Indonesia: The chief executive of French miner Eramet, Christel Bories, has warned that Indonesia's low-cost nickel producers will wipe out their global rivals in the next few years, cementing the country as the world's dominant producer of the metal, which is vital to electric car batteries. Importantly, Bories said Indonesia's low costs, which in part reflect government policies, will lead to mines elsewhere being shut down and/or governments having to offer subsidies to keep them open and ensure alternative supply sources.

Qatar: Complementing recently announced investments aimed at increasing the country's natural gas production, on Sunday the government announced new investments in its liquified natural gas export infrastructure. Taken together, the government said the investments will boost Qatar's total LNG output capacity by some 85% by the end of the decade.

- The new export capacity mostly aims to feed the growing Asian market, where countries are shifting away from coal for electricity generation because of environmental concerns.
- Amid signs the US may cap its LNG export potential to bottle up fuel supplies and keep domestic prices low, Qatar's new capacity cut has positioned it to boost its global market share in the lucrative trade in the future.

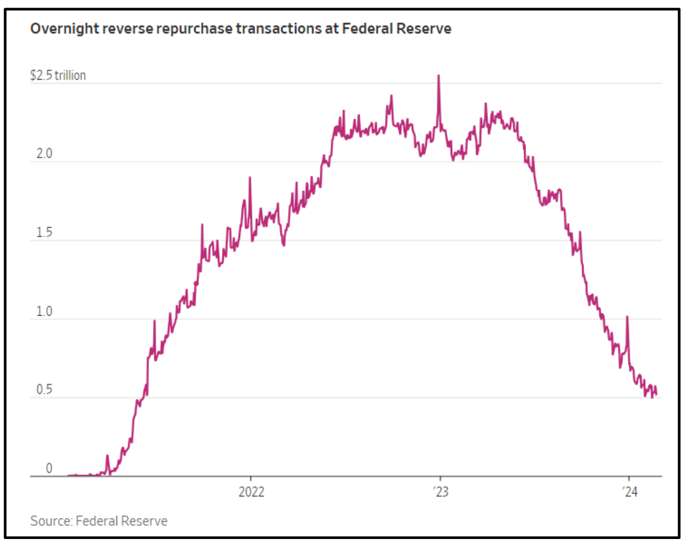
Israel: To fund the massive military spending associated with its war against Hamas in Gaza, the Israeli government has announced it will issue about $60 billion in sovereign bonds this year, freeze government hiring, and increase taxes. However, those numbers assume that the 300,000 or so troops mobilized at the start of the war last year will continue to be demobilized and can return to their civilian jobs. According to Finance Minister Rothenberg, the number of mobilized troops still serving has fallen to about 60,000 and should decline to 40,000 or less by late March.

- As we have argued frequently in the past, rising geopolitical tensions are likely to boost defense budgets around the world in the years to come. That process is already happening, albeit rather slowly.
- If tensions escalate further, as we think is possible, higher defense spending will require tradeoffs. For example, governments around the world will likely have to consider slashing civilian budget programs. Israel's increased borrowing, hiring freeze, and tax hikes suggest those kinds of initiatives are also likely to be considered in other countries.

European Union: Thousands of farmers from Belgium and beyond have converged on Brussels today in a mass demonstration seeking more support from the EU. The protests, which have included blocking major streets and roads with farm equipment, have gotten enough attention that European Commission ministers are recommending an increase in funding for the EU's Common Agricultural Policy subsidy program, which already costs some 60 billion EUR per year.

US Politics: In the Republicans' South Carolina presidential primary election on Saturday, former President Trump handily beat former UN Ambassador and former South Carolina Governor Nikki Haley by approximately 60% to 40%. Based on those results, Trump takes all the state's delegates to the Republican National Convention in the summer. Nevertheless, Haley vowed to stay in the race. The next primary is in Michigan on Tuesday.

US Bond Market: An article in the *Wall Street Journal* today highlights just how sharply financial companies have pulled back from parking overnight funds in the Federal Reserve's reverse repo facility. After hitting a peak of more than $2.5 trillion around the beginning of 2023, total positions have recently receded to only about $500 billion. The volume of funds parked in reverse repo is considered a ready pool of money available to buy Treasury bills, so the decline in participation has raised concern about waning bill demand and rising interest rates.



US Stock Market: As a reminder, Amazon.com joins the Dow Jones Industrial Average today, in a move precipitated by Walmart's implementation of a 3:1 stock split to make its shares more accessible to small investors. The Walmart stock split will also happen today.

US Economic Releases

No major US economic reports have been released so far today. 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	New Home Sales	m/m	Jan	684k	664k	***
10:00	New Home Sales MoM	m/m	Jan	3.0%	8.0%	*
10:30	Dallas Fed Manufacturing Activity	m/m	Feb	-15.0	-27.4	**
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
19:40	Jeff Schmid Gives Speech on Economy, Monetary Policy Outlook	President of Federal Reserve Banks of Kansas City				

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	PPI Services	y/y	Jan	2.1%	2.4%	2.4%	*	Equity and bond neutral
EUROPE								
Switzerland	Domestic Sight Deposits CHF	w/w	23-Feb	471.4b	468.6b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	23-Feb	480.5b	477.1b		*	Equity and bond neutral
AMERICAS								
Mexico	Current Account Balance	y/y	4Q	$11662m	$2628m	$908m	*	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)	559	559	0	Down
3-mo T-bill yield (bps)	524	525	-1	Flat
U.S. Sibor/OIS spread (bps)	534	534	0	Down
U.S. Libor/OIS spread (bps)	535	535	0	Down
10-yr T-note (%)	4.24	4.25	-0.01	Down
Euribor/OIS spread (bps)	393	395	-2	Down
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
Yen	Flat			Down
Pound	Up			Up
Franc	Up			Flat

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.

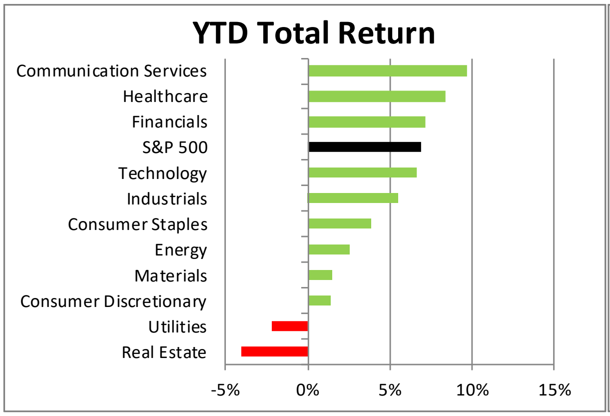
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$81.19	$81.62	-0.53%	
WTI	$76.11	$76.49	-0.50%	
Natural Gas	$1.67	$1.60	4.43%	
Crack Spread	$31.37	$30.61	2.49%	
12-mo strip crack	$24.59	$24.17	1.72%	
Ethanol rack	$1.63	$1.64	-0.28%	
Metals				
Gold	$2,032.30	$2,035.40	-0.15%	
Silver	$22.56	$22.95	-1.71%	
Copper contract	$385.00	$390.05	-1.29%	
Grains				
Corn contract	$410.50	$413.50	-0.73%	
Wheat contract	$564.00	$569.00	-0.88%	
Soybeans contract	$1,140.50	$1,141.75	-0.11%	
Shipping				
Baltic Dry Freight	1,866	1,752	114	

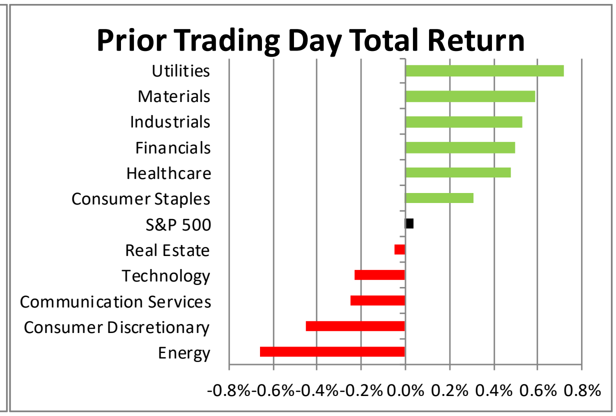
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures east of the Mississippi River, with cooler temperatures in the Pacific and Great Plains regions. The precipitation outlook calls for wetter-than-normal conditions for most of the country, with dry conditions in the northern Great Plains region.

Data Section

US Equity Markets – (as of 2/23/2024 close)

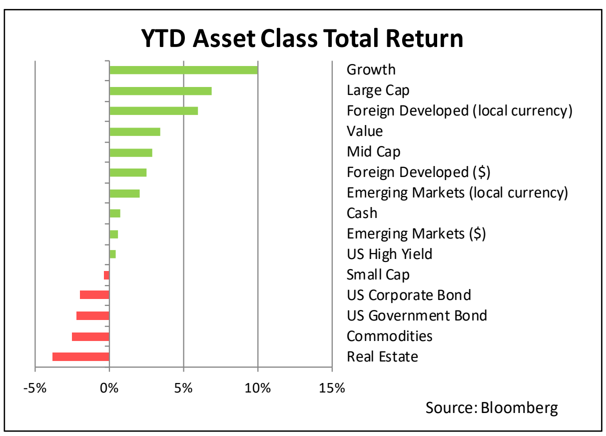




(Source: Bloomberg)

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 2/23/2024 close)

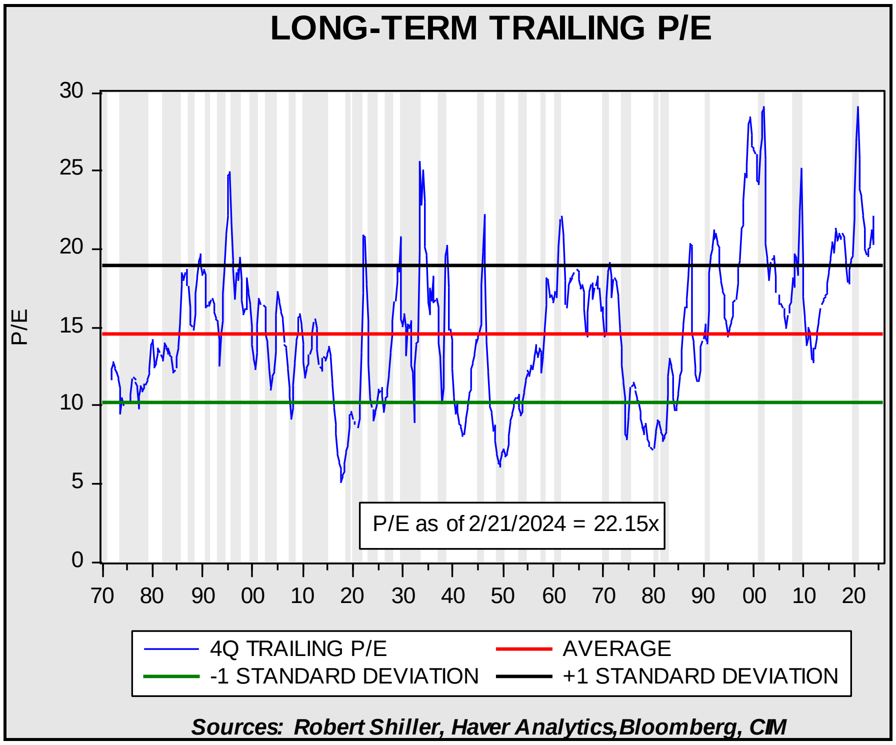


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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[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.