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 28, 2024—9:30 AM EST] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is down 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.7%. Chinese markets were lower, with the Shanghai Composite down 1.9% from its previous close and the Shenzhen Composites down 3.8%. U.S. equity index futures are signaling a lower open.

With 473 companies having reported so far, S&P 500 earnings for Q4 are running at $57.90 per share compared to estimates of $55.15, which is up 1.6% from Q3 2023. Of the companies that have reported thus far, 81.0% have exceeded expectations, while 14.4% 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* (2/26/2024) (with associated podcast): “Posen vs. Pettis”
- *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 new restrictions on information flows within and between the US and China, which will likely further decouple the two economies and exacerbate tensions. We next review a range of other international and US developments with the potential to affect the financial markets today, including signs of potential new British curbs on Chinese electric vehicle imports and a range of US political and policy news.

China: The government yesterday [passed amendments to its State Secrets Law that will expand the types of information that must be protected]. Importantly, the amendments establish a new category of "work secrets" at government and party bodies that aren't considered state secrets but could "cause certain adverse effects if leaked," adding a potentially broad new category of restricted information. Other provisions will restrict travel and work by people who leave sensitive positions and impose new rules on private businesses exposed to state secrets.

- Implementing rules on the work secrets category are to come at a later date. The overall package of amendments is due to take effect on May 1.
- The toughened law is only the latest example of how General Secretary Xi is actively prioritizing national security over economic growth or Chinese "soft power."
- The toughened provisions will likely add to the concerns of Western firms trying to do business in China, since they will put those companies and their employees at greater risk of running afoul of the law. In turn, that may further discourage Western investment in China, adding to the country's economic headwinds.

United States-China: In another development relating to information flows, President Biden will sign an executive order today limiting the sensitive personal data on US citizens that data brokers can sell to China and other adversarial countries. The restrictions will apply to data such as genomic, biometric, personal health, geolocation, financial, and certain types of personal identifiers. In large sets, those types of data could be used by adversaries for intelligence gathering and to facilitate illicit influence campaigns or computer hacking.

United Kingdom-China: Reporting by Politico indicates the British government is considering launching an investigation into whether the Chinese government has subsidized its burgeoning electric vehicle exports in violation of global trade rules. The probe would follow a similar action by the European Union last fall, which has angered Beijing and worsened China-EU relations.

- Now that Chinese EV makers have begun to make ultra-cheap, high-quality cars (aided by government subsidies and protection), their EV exports are rapidly rising and posing what could be an existential threat to automakers in the developed countries.
- With the threat of massive job losses in their auto sectors, the EU and the UK are therefore taking steps that will likely lead to tough restrictions against the Chinese. Along with the existing US restrictions on Chinese vehicles, that could eventually lead to excess capacity in China's EV industry, which would further weigh on Chinese economic growth in the coming years.

Russia: The *Financial Times* carries an article today describing what it says is a series of secret Russian military documents on the country's policies for when it would use tactical nuclear weapons in a conflict. The report suggests Russia's threshold for using tactical nukes is lower than previously thought, including numerical standards such as the loss of 20% of its nuclear ballistic missile submarines.

- We are still analyzing the article, so our view on its implication may still evolve. Nevertheless, it appears that the documents' scenarios for going nuclear are fundamentally defensive. For example, one scenario is if an adversary has invaded Russian territory and Russian conventional forces are unable to stop it.

- Of course, it's always useful to ask oneself: "Why is this being reported now?" It could well be that this is a leak designed to influence the current US and European debate over the future threat from Russia if it can consolidate its invasion of Ukraine.
- Regarding the war in Ukraine, we believe the stalemate that seemed to be evolving late last year is now shifting toward an advantage for the Russians. With Western aid to Kyiv faltering and Ukraine struggling to field the requisite manpower, equipment, and ammunition to fight effectively, it looks increasingly like Ukraine's defenses are becoming brittle and could soon fail, allowing the Russians to sweep westward.

United States-European Union-Russia: European Commission President von der Leyen today formally proposed that the Group of 7 countries use profits from the $300 billion or so of Russian foreign reserves that they have frozen to support Ukraine in fighting off Russia's invasion. The formal proposal, which is also supported by the US, comes despite a lack of consensus among the allies over the legality of doing so and how it could be done.

- Recent proposals have called for designating the frozen Russian assets as collateral to support G7 loans to Ukraine for its war effort and rebuilding, based on the idea that Russia will eventually owe reparations to Ukraine. The expected Ukrainian default would then result in the Russian assets being confiscated.
- Despite the machinations being considered, the confiscation of Russian assets at the end of the day would not only be a major provocation against Moscow, but it would likely accelerate the loss of the US dollar's status as the world's reserve currency. Countries in the China/Russia geopolitical bloc and any other nations worried about crossing the US would have an even greater incentive to reduce or end their use of the greenback, with unpredictable consequences for the world's financial system.

US Politics: In yesterday's Michigan presidential primary elections, former President Trump handily beat former UN Ambassador Haley again in the Republican contest, and President Biden won the Democratic one, but the protest votes on each side were large. In the Republican contest, Trump won 68.2% to Haley's 26.5%. In the Democratic ballot, Biden won 81.1% against an "uncommitted" vote of 13.3%.

- It increasingly looks like Trump and Biden will have a rematch in the November general election. Nevertheless, we still think that age and other potential issues could ultimately keep one or even both of the candidates off the ballot. On top of that, a close race exacerbated by a potential third-party candidate could throw the election into Congress, with very unpredictable consequences.
- At the end of the day, this election season is looking unusually chaotic and hard to call. It would not be a surprise if the unpredictability at some point begins to weigh on the financial markets.

US Fiscal Policy: After a meeting with President Biden at the White House yesterday, Republican and Democratic congressional leaders expressed confidence they would soon reach a new funding deal that would avert a partial shutdown of the federal government when the current stopgap law expires Friday night. However, Senate Majority Leader Schumer, a Democrat, warned that the likely solution would be yet another short-term funding package designed to give the two parties time to agree on funding for the remainder of the fiscal year.

- Despite the optimism expressed by the lawmakers yesterday, neither a short-term nor a full-year deal can be assured, especially given the existence of a large body of Republican deficit hawks in the House who seem willing to torpedo any deal that doesn't meet their aggressive goals for spending cuts.
- In any case, yet another stopgap measure and a further delay in passing funding for the rest of the fiscal year through September will impinge even more on the US military's effort to rebuild and expand to meet the growing threat from the China/Russia geopolitical bloc.

US Antitrust Policy: In another sign that the administration is trying to tighten antitrust policy, the Justice Department has reportedly opened an investigation into health insurance giant UnitedHealthcare. The probe appears to be focused on the relationship between the company's insurance operations and its Optum health-services operation. It isn't clear whether the probe will lead to an antitrust lawsuit. As we mentioned in our *Comment* yesterday, the administration has had a mixed record in antitrust because of the prevailing Bork Standard in the courts.

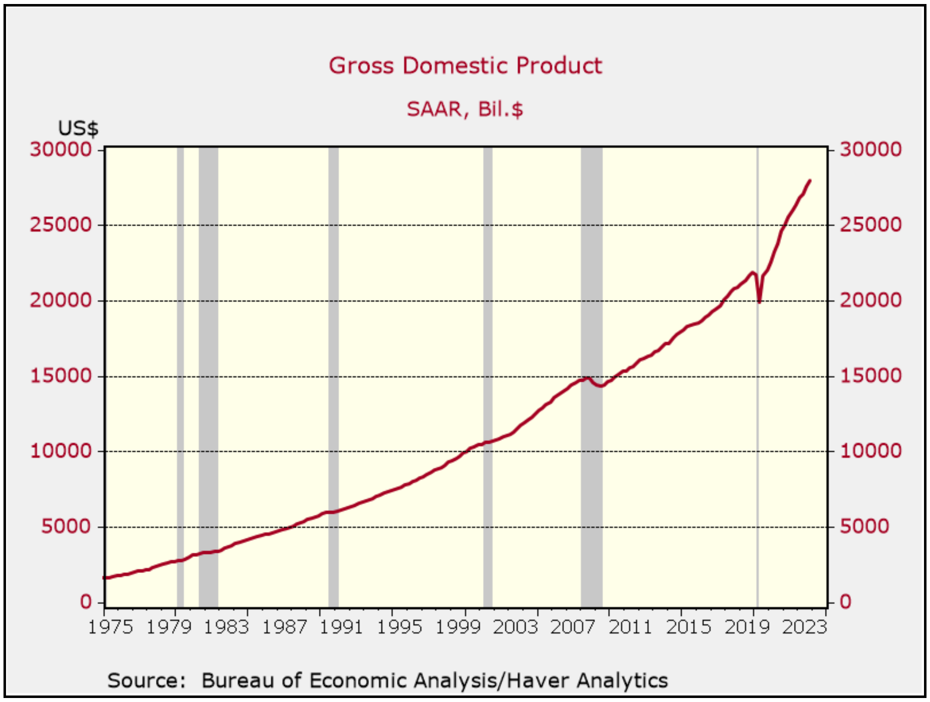
US Economic Growth: The National Association of Business Economists said its updated US economic forecasts now show gross domestic product growing 2.2% in 2024, up sharply from its December forecast of 1.3%. The improved growth would reflect better-than-expected increases in personal consumption expenditures, corporate and residential investment, and government spending. The forecasts also call for lower unemployment and price inflation, which should allow the Federal Reserve to start cutting interest rates in Q2.

US Cryptocurrency Market: Just weeks after financial firms won regulatory approval to launch exchange-traded funds holding bitcoin, reports say about 10 companies have now filed applications to offer ETFs holding ether, the second-biggest cryptocurrency. In response to the news, ether prices have surged approximately 42% so far this month. That has given a further boost to bitcoin prices, which are now up about 33% in the month to date.

US Economic Releases

Home loan demand remains weak, despite a modest decline in borrowing costs. According to an index tracked by the Mortgage Bankers Association, mortgage applications fell 5.6% in the week ending February 23. The drop in mortgage requests was related to interest rates continuing to weigh on home buyer sentiment. The average 30-year fixed-rate mortgage fell 2 bps from 7.06% to 7.04%. As a result, the MBA tracker for purchases fell 4.4% from the prior week, while the refinance tracker fell 1.5%.

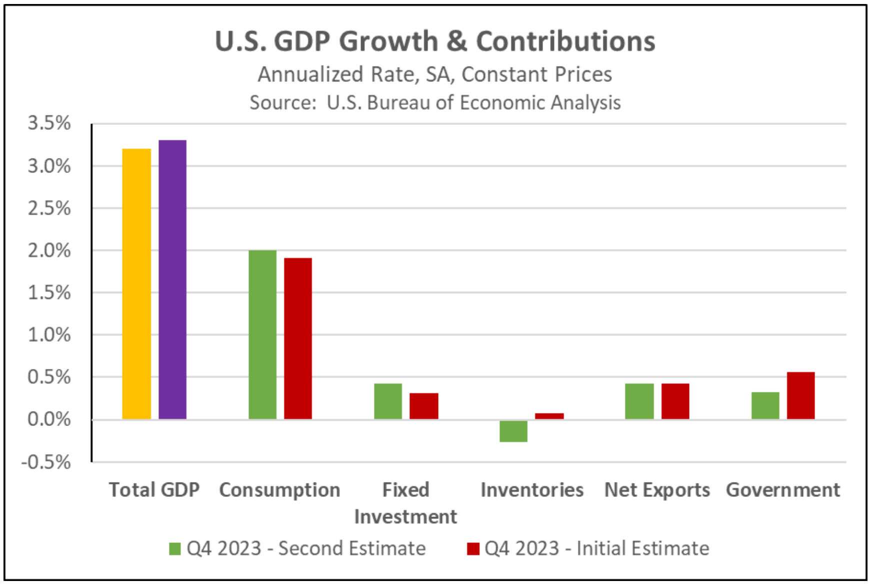
The US economy grew at a slightly slower pace than initially estimated in the third quarter. The Bureau of Economic Analysis revised down its estimate for GDP growth from 3.3% to 3.2%. However, there was positive news on the consumer front, with real consumer spending, a key driver of the economy, revised upward from 2.7% to 3.2%. Inflation also showed signs of picking up slightly, with both the GDP price index and the core PCE price index revised up by 0.1 percentage points.



The chart above shows nominal GDP. Although the economy has slowed from the previous quarter, it is clearly in expansion.

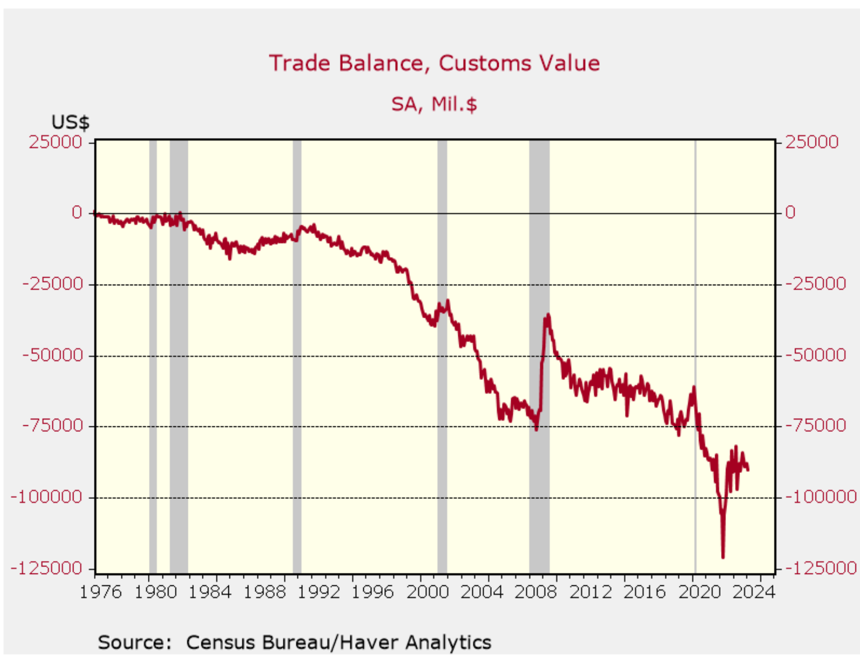
	Q4 2023 - Second Estimate	Q4 2023 - Initial Estimate	Difference
Total GDP	3.2%	3.3%	-0.1%
Consumption	2.0%	1.9%	0.1%
Fixed Investment	0.4%	0.3%	0.1%
Inventories	-0.3%	0.1%	-0.3%
Net Exports	0.4%	0.4%	0.0%
Government	0.3%	0.6%	-0.2%

The table above details the revised GDP contributions. Compared to the initial estimates, net exports and inventories were overestimated, while consumption, investment, and government spending were slightly lower in the second estimate.



The chart above shows the contributions graphically. Consumer spending remains the primary driver of GDP and should continue to support economic activity as long as the labor market remains tight.

In related news, the US trade shortfall in goods widened more than expected in January. According to the US Department of Commerce, the US goods deficit rose from $87.9 billion to $90.2 billion. The reading was above expectations of $88.5 billion. Separately, retail inventories rose 0.5% from the prior month, while wholesale inventories declined 0.1%.



The chart above shows the advanced trade balance, which has widened, reflecting an increase in imports exceeding the growth in exports. While a larger deficit can negatively impact GDP, the rise in imports might also signify stronger domestic demand for foreign goods.

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**
12:00	Raphael Bostic Participates in Fireside Chat	President of the Federal Reserve Bank of Atlanta
12:15	Susan Collins Gives Remarks, Fireside Chat	President of the Federal Reserve Bank of Boston
12:45	John Williams Delivers Keynote Remarks	President of the Federal Reserve Bank of New York

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	Leading Economic Index	m/m	Dec F	110.2	110.0		**	Equity and bond neutral
	Coincident Index	m/m	Dec F	115.9	116.2		*	Equity and bond neutral
Australia	CPI	y/y	Jan	3.4	3..4	3.6	*	Equity and bond neutral
EUROPE								
Eurozone	Consumer Confidence	m/m	Feb F	-15.5	-15.5		**	Equity and bond neutral
	Services Confidence	m/m	Feb	6.0	8.8	8.4	*	Equity bearish, bond bullish
	Industrial Confidence	m/m	Feb	-9.5	-9.4	-9.3	*	Equity and bond neutral
	Economic Confidence	m/m	Feb	95.4	96.2	96.1	**	Equity and bond neutral
Italy	Consumer Confidence	m/m	Feb	97.0	96.4		***	Equity and bond neutral
	Manufacturing Confidence	m/m	Feb	87.3	88.3	88.1	***	Equity and bond neutral
	Economic Sentiment	m/m	Feb	95.8	98.1	97.9	**	Equity bearish, bond bullish
AMERICAS								
Mexico	International Reserves Weekly	w/w	23-Feb	-$213479m	-$213061m		*	Equity and bond neutral
Brazil	FGV Inflation IGPM	y/y	Feb	-3.76%	-3.32%	-3.74%	***	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)	560	559	1	Down
3-mo T-bill yield (bps)	523	523	0	Up
U.S. Sibor/OIS spread (bps)	534	534	0	Down
U.S. Libor/OIS spread (bps)	535	535	0	Down
10-yr T-note (%)	4.28	4.30	-0.02	Down
Euribor/OIS spread (bps)	395	395	0	Flat
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Down
Yen	Flat			Down
Pound	Down			Down
Franc	Down			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
RBNZ Official Cash Rate	5.500%	5.500%	5.500%	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.

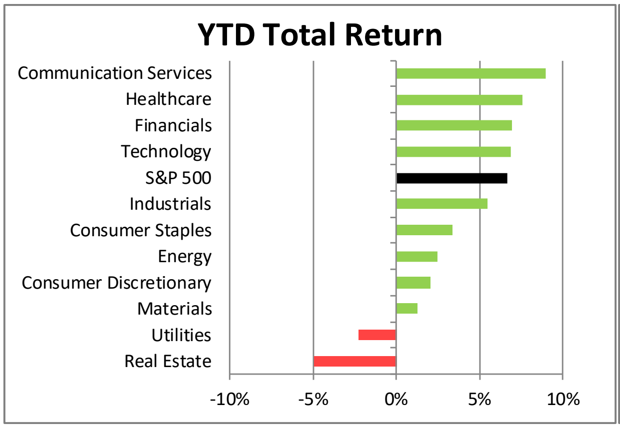
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$82.92	$83.65	-0.87%	
WTI	$78.06	$78.87	-1.03%	
Natural Gas	$1.83	$1.81	1.00%	
Crack Spread	$31.06	$31.53	-1.50%	
12-mo strip crack	$24.65	$25.10	-1.77%	
Ethanol rack	$1.60	$1.60	-0.26%	
Metals				
Gold	$2,029.56	$2,030.48	-0.05%	
Silver	$22.35	$22.46	-0.50%	
Copper contract	$382.85	$385.05	-0.57%	
Grains				
Corn contract	$423.50	$423.50	0.00%	
Wheat contract	$578.50	$584.25	-0.98%	
Soybeans contract	$1,140.50	$1,140.75	-0.02%	
Shipping				
Baltic Dry Freight	1,899	1,871	28	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.7		
Gasoline (mb)		-2.8		
Distillates (mb)		-2.0		
Refinery run rates (%)		0.5%		
Natural gas (bcf)		-84		

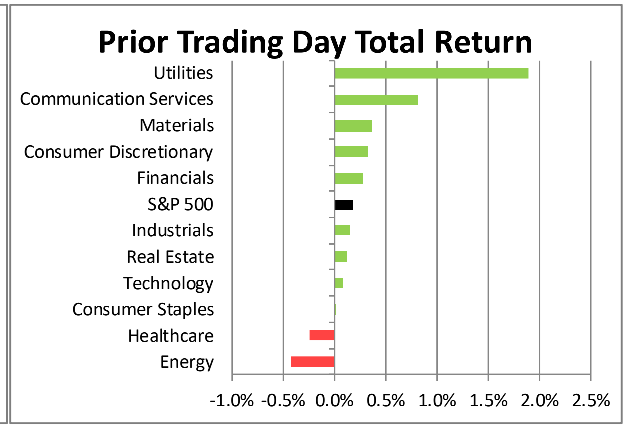
Weather

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

Data Section

US Equity Markets – (as of 2/27/2024 close)

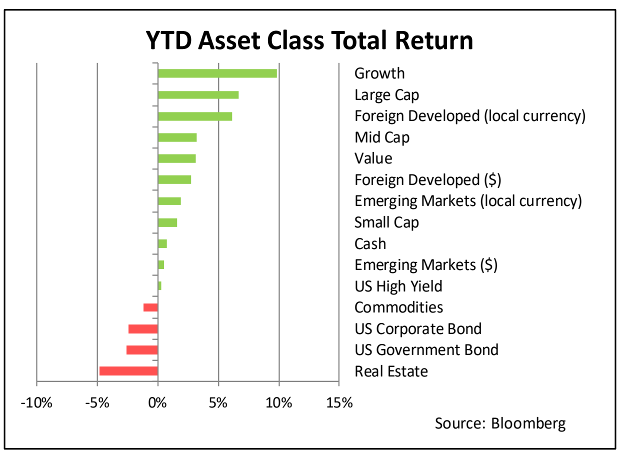




(Source: Bloomberg)

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 2/27/2024 close)

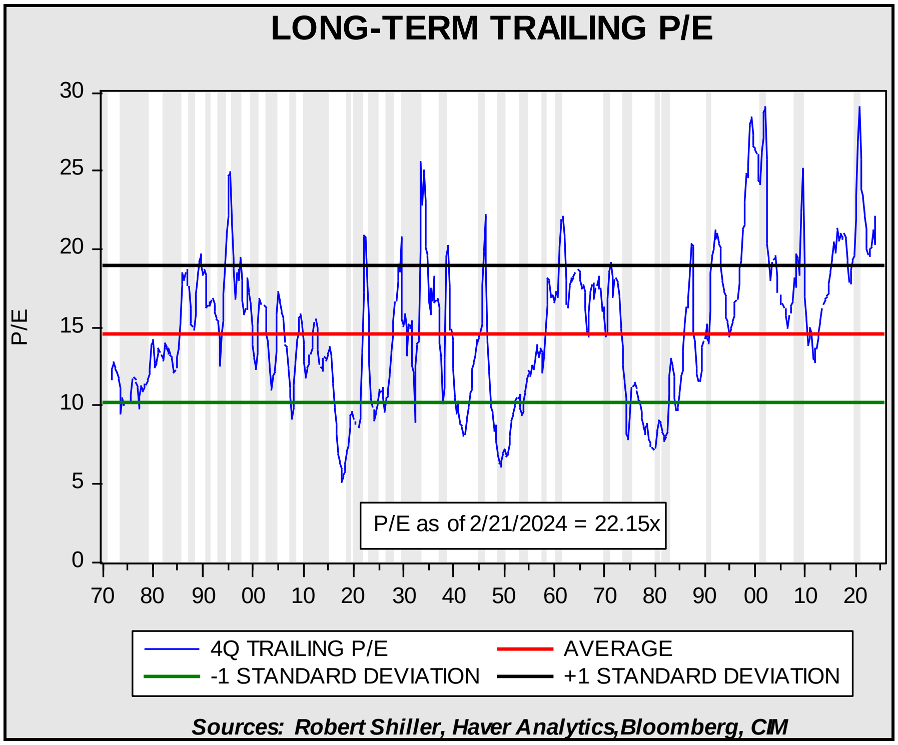


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.