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 2, 2024—9:30 AM EST] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.8% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.3%. Chinese markets were lower, with the Shanghai Composite down 1.5% from its previous close and the Shenzhen Composite down 3.0%. U.S. equity index futures are signaling a higher open.

With 218 companies having reported so far, S&P 500 earnings for Q4 are running at $56.40 per share, compared to estimates of $55.15, which is up 1.6% from Q3 2023. Of the companies that have reported thus far, 79.4% have exceeded expectations while 15.1% have fallen short of expectations.

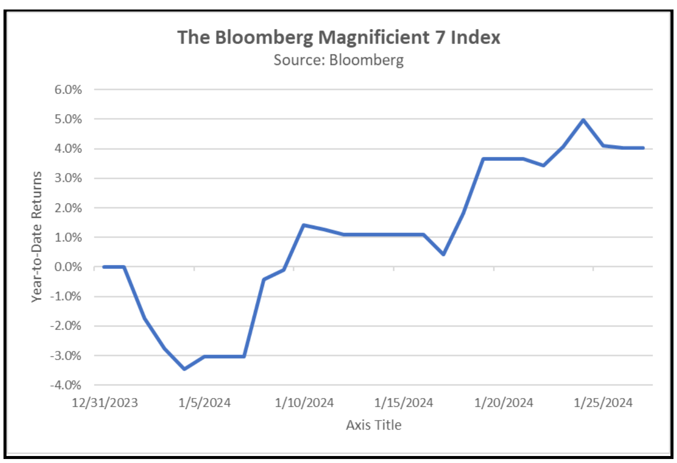
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (1/29/2024) (with associated podcast): "Introducing the U.S. Space Force"
- *Weekly Energy Update* (12/14/2023): Oil prices have been under pressure as geopolitical risk premium evaporates; COP28 ended with a deal to "shift" from fossil fuels, softer language than the "phase out" comment that was rejected by oil producers. (N.B. The *Weekly Energy Update* will go on indefinite hiatus following this report.)
- *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 Q4 2023 Rebalance Presentation* (10/30/2023): 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* (1/22/2024) (with associated podcast): "How Does Powell Define Restrictive Monetary Policy?"
- *The 2024 Outlook: Slow-Bicycle Economy* (12/18/2023) (with associated *Confluence of Ideas* podcast)

Good morning! Equities slumped and Treasury yields are up following a really strong jobs number. In other news, the GOAT of Formula One, Lewis Hamilton, will be joining the iconic Ferrari team next year. In today's *Comment* we dive into Thursday's tech earnings bonanza, explore the surging popularity of leveraged loans, and unpack recent central bank policy decisions. As always, we'll include a roundup of global and domestic economic releases.

The Train Keeps Moving: Tech giants pleasantly surprised investors with earnings that exceeded expectations, and yet the duration of this upbeat trend remains uncertain.

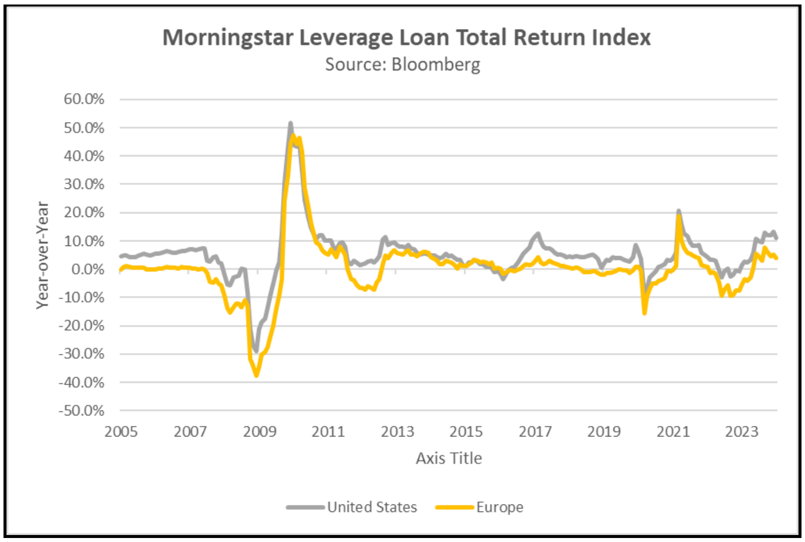
- Meta (META, $457.50) basked in the afterglow of stellar financial results and notched its highest quarterly revenue in over two years while tripling profits through strategic cost-cutting. To amplify the joy, it announced its first-ever dividend and a whopping $50 billion share buyback, grabbing headlines and investor attention. This wasn't the only good news in the tech world. Both Amazon (AMZN, $169.39) and Apple (AAPL, $180.32) delivered positive surprises. Yesterday's earnings report showed that Amazon is solidifying its dominance in cloud computing, demonstrating its significant revenue potential, while Apple defied naysayers with strong iPhone sales, proving the device's enduring appeal.
- Despite continued strong financial performance, tech firms are facing significant headwinds from geopolitical and regulatory risks. The slowdown in China, a key growth market, will likely impact overseas profits, as Apple's recent sales outlook demonstrates. Additionally, growing concerns about tech giants' influence and limited accountability are fueling regulatory scrutiny. Lawmakers like Missouri Senator Josh Hawley have publicly criticized platforms like Facebook for failing to adequately protect children from harmful content. The growing adoption of AI by tech companies is raising concerns among governments who are looking for ways to mitigate potential risks to the public.



- Tech stocks currently outperform the market, but questions linger about the sustainability of their growth. The average P/E ratio of 38, while lower than the dotcom bubble peak, is still significantly higher than historical market averages, raising concerns about future valuations. Meeting current market expectations would require unprecedented revenue growth. Additionally, regulatory hurdles pose a major potential challenge. While navigating these hurdles successfully won't guarantee smooth sailing, failing to do so could significantly impact performance and valuations. As a result, we still believe that investors could probably find better value in other places in the market.

Debt Wall Solution? As concerns rise about large amounts of maturing debt, companies are exploring options to restructure their obligations and avoid default.

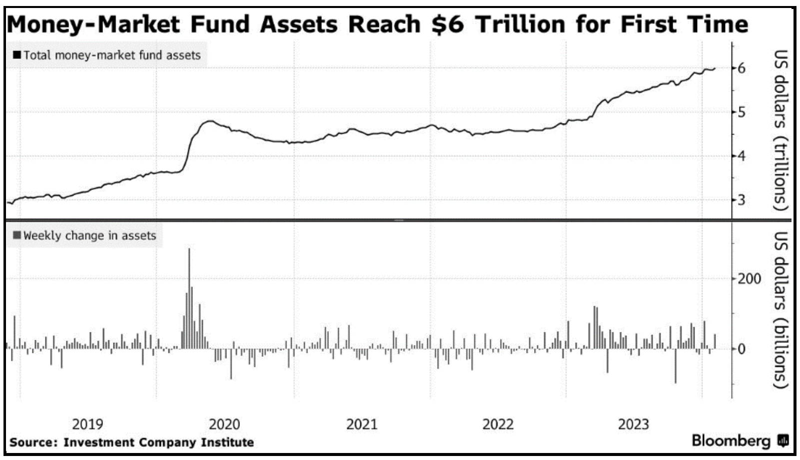
- As companies grapple with maturing debt, many are turning to private credit funds for relief, seeking lower interest rates or longer maturities. Leveraged loans offer a potential solution, allowing them to refinance existing debt with lien debt. However, this comes at the cost of potentially higher interest rates and the risk of asset seizure in case of default. While this trend offers relief from elevated interest rates, it also raises concerns about potential risks to the broader market if economic conditions worsened.
- The record-breaking issuance of U.S. leveraged loans in January ($140.1 billion) highlights the growing global appeal of this financing option, while European debt issuance in this category surged by 20.1% in 2023. This increase in issuance reflects companies seeking to manage their existing debt in a challenging economic environment, but also raises concerns about increased refinancing risk for borrowers with higher risk profiles. Notably, refinancing activity reached a record high of $50.4 billion, while repricing (renegotiating loan terms) reached $78.7 billion, suggesting a strong focus on reducing debt payments through various strategies.



- Leveraged loans offer a double-edged sword in tackling the debt maturity wall. While they can ease debt pressure and potentially mitigate the broader economic impact of rising interest rates, concerns linger about their long-term stability. This stems from the subjective valuation of underlying collateral, particularly for loans backed by volatile assets like commercial real estate. The opaqueness of private credit funds, where some of these loans reside, further complicates matters, making it difficult for investors to conduct thorough due diligence. However, if the economy remains strong and default rates stay low, these loans may not pose a systemic risk.

The Dust Settles: With central banks in the U.S., Europe, and Japan all signaling that rates are unlikely to change, the market awaits the exact timing, which remains anyone's guess.

- All G-7 rate-setting bodies opted to maintain their policy rates during their most recent meetings, affirming to the markets that they are embarking on a new phase of the monetary cycle. Among the four major central banks announcing their decisions, the Bank of Japan stood out as the sole institution contemplating a rate hike. Meanwhile, all the other institutions have signaled that interest rates will be cut sometime this year but likely not as soon as the market anticipates.
- Interest rate uncertainty could deter institutional investors from re-entering the stock market, despite the S&P 500's current proximity to all-time highs. Bank of America strategist Jill Carey Hall's research shows that institutional investors recently sold the most U.S. equities in nearly a decade, suggesting a shift towards safer assets due to economic uncertainty. The outflows were recorded in seven out of the 11 sectors, predominantly driven by sales in Technology, Consumer Discretionary, and Consumer Staples. This reluctance likely stems from a fear of being caught off guard if central banks reverse course on interest rates.

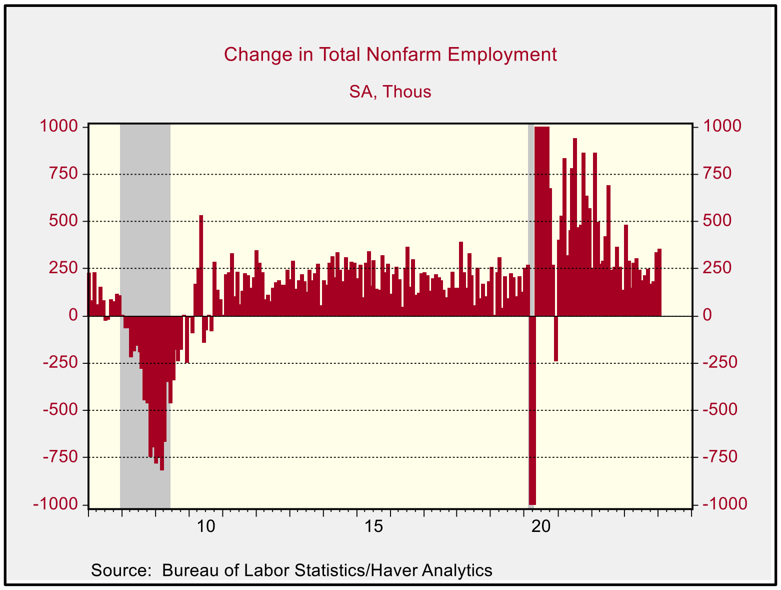


- Elevated interest rates may keep a significant amount of money parked in low-risk investments, but it could act as a potential tailwind for riskier assets once central banks start easing interest rates. This is evidenced by the record-breaking $6 trillion in U.S. money market assets. Although small and mid-cap stocks have not been able to grab headlines, these companies may be an attractive target for investors looking for a bargain. Valuations suggest that these firms provide investors with a lot of upside when risk sentiment changes.

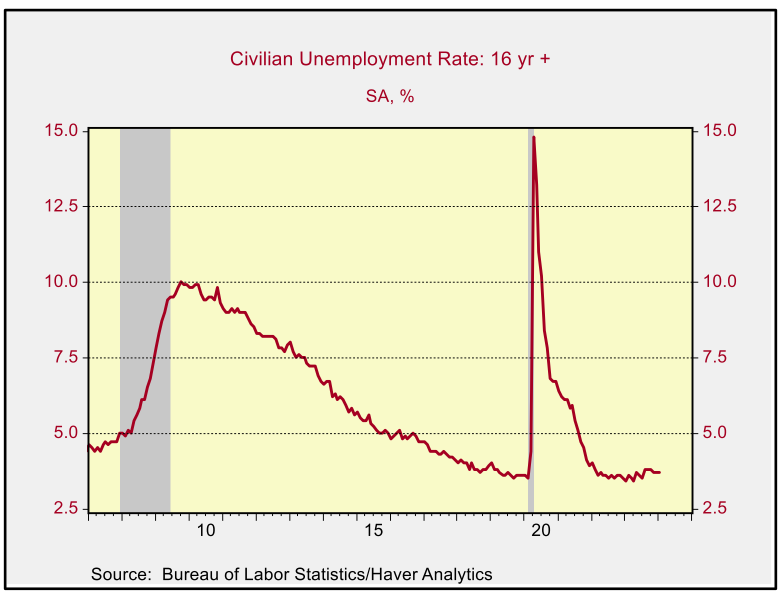
Other News: Fed Chair Jerome Powell will appear on *60 Minutes* on Sunday, sparking speculation that he may aim to clarify recent remarks interpreted by the market in unexpected ways, or possibly to address concerns about the overall health of the financial system. Tensions are rising between China and the Philippines after Beijing criticized the latter's congratulatory message to Taiwan's newly elected president. This incident highlights China's growing influence and its sensitivity towards its neighbors' formal interactions with Taiwan. Hungary is looking to play ball with the West after finally approving an aid package for Ukraine and possibly approving Sweden's NATO bid.

U.S. Economic Releases

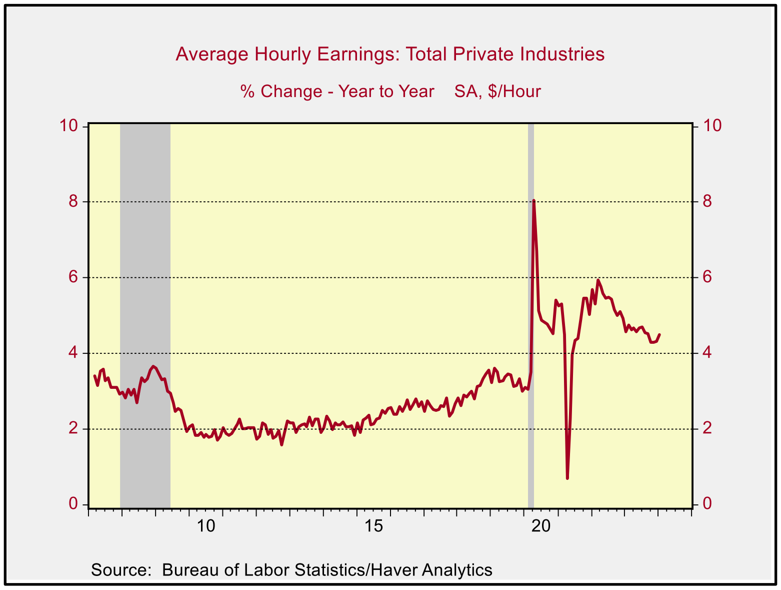
January ***nonfarm payrolls*** rose by a seasonally adjusted 353,000, nearly twice the expected gain of 185,000 and above the upwardly revised gain of 333,000 in December. Most of the job gains were in the private sector, including a good jump of 23,000 in factory positions. The chart below shows the change in nonfarm payrolls since shortly before the Great Financial Crisis.



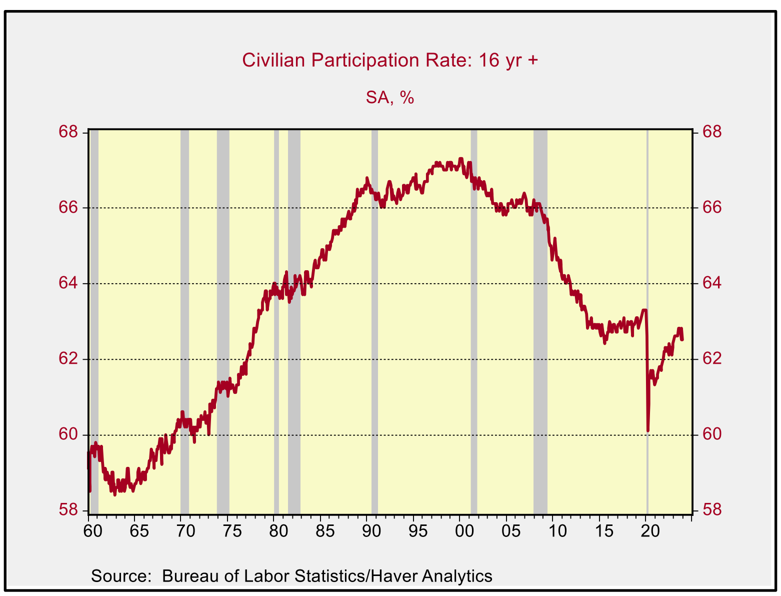
The January ***unemployment rate*** was stable at a seasonally adjusted 3.7%, rather than rising to 3.8% as surveyed economists had expected. The chart below shows how the unemployment rate has evolved since just before the GFC.



With the demand for labor high and the "inventory" of unemployed workers low, it should be no surprise that wage rates remain high. ***Average hourly earnings*** in January rose to a seasonally adjusted $34.55, up 4.5% from the same month one year earlier. That marked a significant acceleration from the revised rise of 4.3% in the year to December, which will probably be a significant concern to the Fed policymakers looking for a drop in inflation pressures. The chart below shows the year-over-year growth in average hourly earnings since just before the GFC.



A final key indicator in the monthly employment report focuses on the share of the adult, civilian, noninstitutionalized population that is either working or looking for work. Despite the strong job gain in the month, the January ***labor force participation rate (LFPR)*** held steady at a seasonally adjusted 62.5% rather than rising to 62.6% as expected. The chart below shows how the LFPR has changed over the last several decades.



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	U. of Mich. Sentiment	m/m	Jan F	78.9	78.8	***
10:00	U. of Mich. Current Conditions	m/m	Jan F	83.5	83.3	**
10:00	U. of Mich. Expectations	m/m	Jan F	76	75.9	***
10:00	U. of Mich. 1 Yr Inflation	m/m	Jan F	2.9	2.9	***
10:00	U. of Mich. 5-10 Yr Inflation	m/m	Jan F	2.8	2.8	**
10:00	Factory Orders	m/m	Dec	0.2	2.6	**
10:00	Factory Orders Ex Trans	m/m	Dec	0.2%	0.1%	*
10:00	Durable Goods Orders	m/m	Dec F	0.0	0.0	***
10:00	Durables Ex Transportation	m/m	Dec F	0.6%	0.6%	**
10:00	Cap Goods Orders Nondef Ex Air	m/m	Dec F		0.3%	**
10:00	Cap Goods Ship Nondef Ex Air	m/m	Dec F		0.1%	***
Federal Reserve						
No Fed speakers or events for the rest of today						

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	Monetary Base	y/y	Jan	4.8%	7.8%		**	Equity and bond neutral
Australia	PPI	y/y	4Q	4.1%	3.8%		**	Equity and bond neutral
New Zealand	Building Permits	m/m	Dec	3.7%	-10.6%		**	Equity bullish, bond bearish
South Korea	CPI	y/y	Jan	2.8%	3.2%	2.9%	***	Equity and bond neutral
EUROPE								
France	Industrial Production	y/y	Dec	0.9%	0.6%	0.4%	***	Equity and bond neutral
	Manufacturing Production	y/y	Dec	0.9%	-0.9%	-1.2%	**	Equity bullish, bond bearish
Russia	Money Supply, Narrow Definition	w/w	26-Jan	18.03t	18.18t		*	Equity and bond neutral
AMERICAS					c			
Canada	S&P Global Canada Manufacturing PMI	m/m	Jan	48.3	45.4	46.5	***	Equity bullish, bond bearish
Mexico	S&P Global Manufacturing PMI	m/m	Jan	50.2	52.0		***	Equity bearish, bond bullish
	Vehicle Domestic Sales	m/m	Jan	112100	142959		*	Equity and bond neutral
	Gross Fixed Investment	y/y	Nov	19.2%	25.5%	19.8%	**	Equity and bond neutral
Brazil	Industrial Production	y/y	Dec	1.0%	1.3%	-0.5%	***	Equity and bond neutral

Financial Markets

The table below highlights some of the indicators that we follow on a daily basis. 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	557	1	Down
3-mo T-bill yield (bps)	519	521	-2	Flat
U.S. Sibor/OIS spread (bps)	530	529	1	Down
U.S. Libor/OIS spread (bps)	530	529	1	Down
10-yr T-note (%)	3.88	3.88	0.00	Flat
Euribor/OIS spread (bps)	388	391	-3	Down
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Flat			Up
Yen	Down			Up
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.

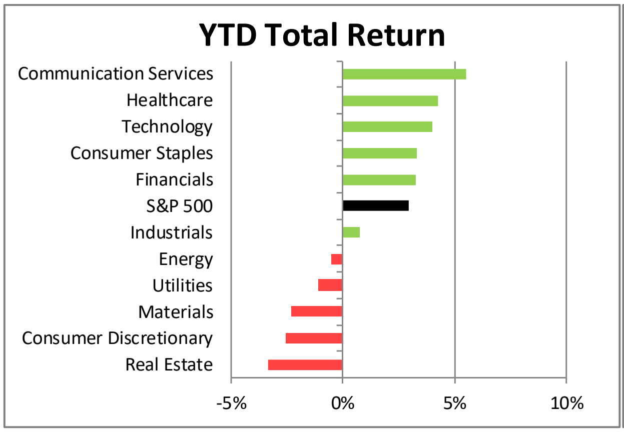
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$78.70	$78.70	0.00%	
WTI	$73.79	$73.82	-0.04%	
Natural Gas	$2.05	$2.05	0.05%	
Crack Spread	$25.14	$25.58	-1.71%	
12-mo strip crack	$24.69	$24.94	-1.00%	
Ethanol rack	$1.76	$1.77	-0.39%	
Metals				
Gold	$2,054.82	$2,054.99	-0.01%	
Silver	$23.17	$23.18	-0.04%	
Copper contract	$384.75	$385.35	-0.16%	
Grains				
Corn contract	$448.00	$447.25	0.17%	
Wheat contract	$608.25	$601.50	1.12%	
Soybeans contract	$1,207.00	$1,203.25	0.31%	
Shipping				
Baltic Dry Freight	1,388	1,398	-10	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	1.2	-1.1	2.3	
Gasoline (mb)	1.2	2.0	-0.8	
Distillates (mb)	-2.5	-1.0	-1.5	
Refinery run rates (%)	-2.6%	1.8%	-4.4%	
Natural gas (bcf)	-197	-203	6	

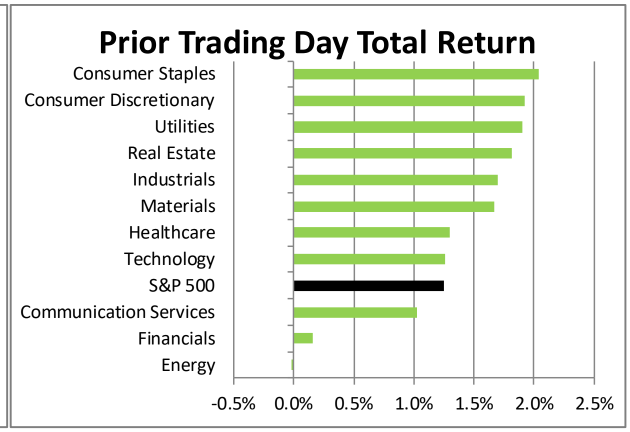
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures from the Great Plains eastward, with cooler-than-normal temperatures in the Far West. The forecasts call for wetter-than-normal conditions in the Southwest, Rocky Mountains, and Great Plains, with dry conditions in the Pacific Northwest.

Data Section

U.S. Equity Markets – (as of 2/1/2024 close)

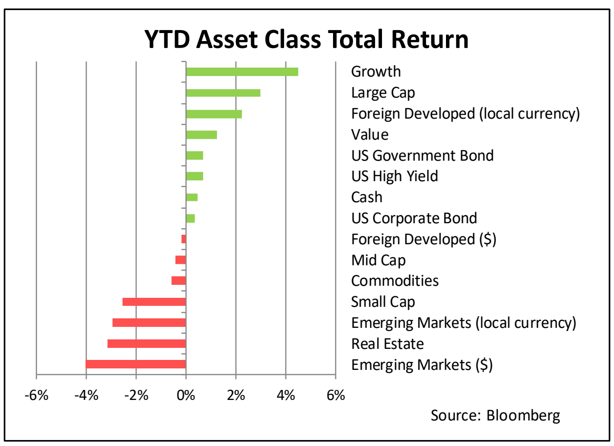




(Source: Bloomberg)

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 2/1/2024 close)

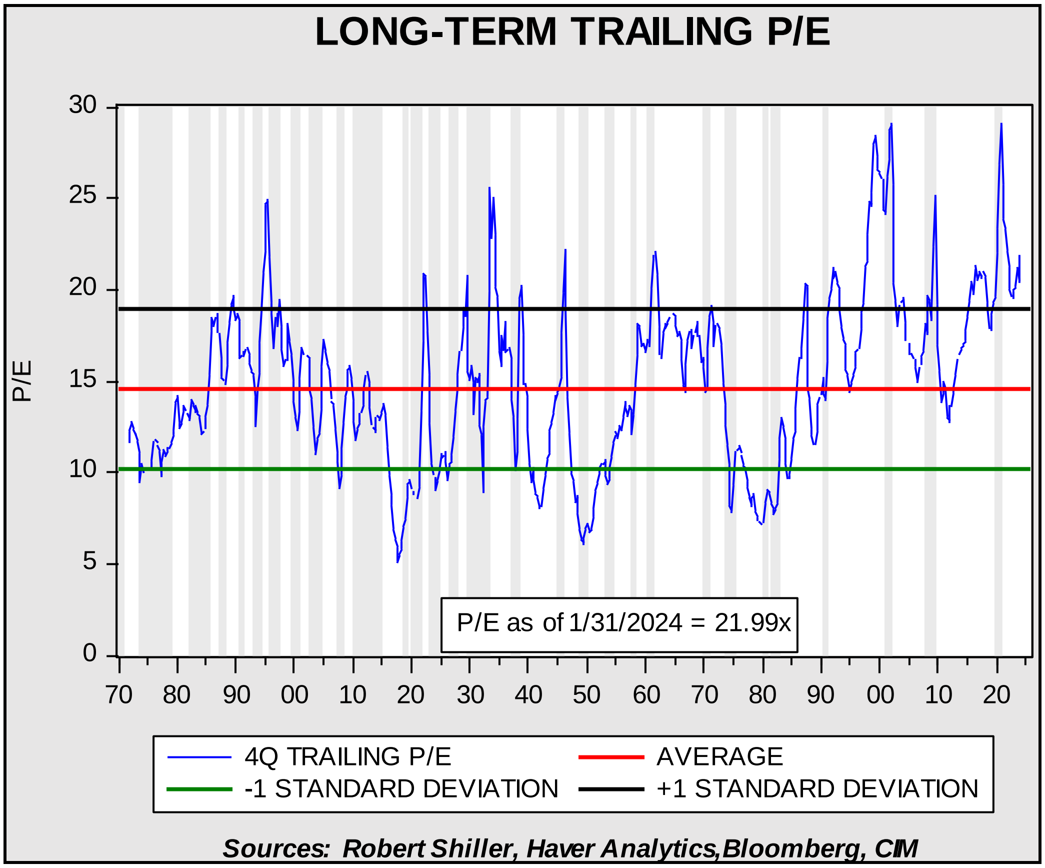


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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), U.S. Corporate Bond (iShares iBoxx $ Investment Grade Corporate Bond ETF), U.S. Government Bond (iShares 7-10 Year Treasury Bond ETF), U.S. 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 1, 2024



Based on our methodology,[1] the current P/E is 21.99x, up 0.09x from our last report. The rise in the multiple was driven primarily by an increase in the 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.