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 7, 2024—9:30 AM EST] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is essentially unchanged from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.1%. Chinese markets were higher, with the Shanghai Composite up 1.4% from its previous close and the Shenzhen Composite up 1.5%. U.S. equity index futures are signaling a higher open.

With 276 companies having reported so far, S&P 500 earnings for Q4 are running at $56.80 per share, compared to estimates of $55.15, which is up 1.6% from Q3 2023. Of the companies that have reported thus far, 79.0% have exceeded expectations while 15.6% 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* (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 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* (2/5/2024) (with associated podcast): "U.S. Oil Production at a Record High"
- *The 2024 Outlook: Slow-Bicycle Economy* (12/18/2023) (with associated *Confluence of Ideas* podcast)

Our *Comment* today opens with our thoughts on a troubling new approach to providing aid to Ukraine that Western policymakers are now considering. We next review a range of other international and US developments with the potential to affect the financial markets today, including further weak industrial data out of Germany and a few thoughts about what the troubles at New York Community Bancorp might mean for the broader US financial system.

Russia-Ukraine War: With far-right, populist politicians in the US and Europe opposing more military aid to Ukraine as it tries to fight off Russia's invasion, one thing we've been watching closely is a proposal to channel frozen Russian assets in the West to Ukraine's war effort. The latest iteration of the idea is a proposal to use the frozen Russian assets as collateral for new allied borrowing to fund additional assistance to Ukraine. Officials say the idea is now the leading option to provide further aid to Kyiv.

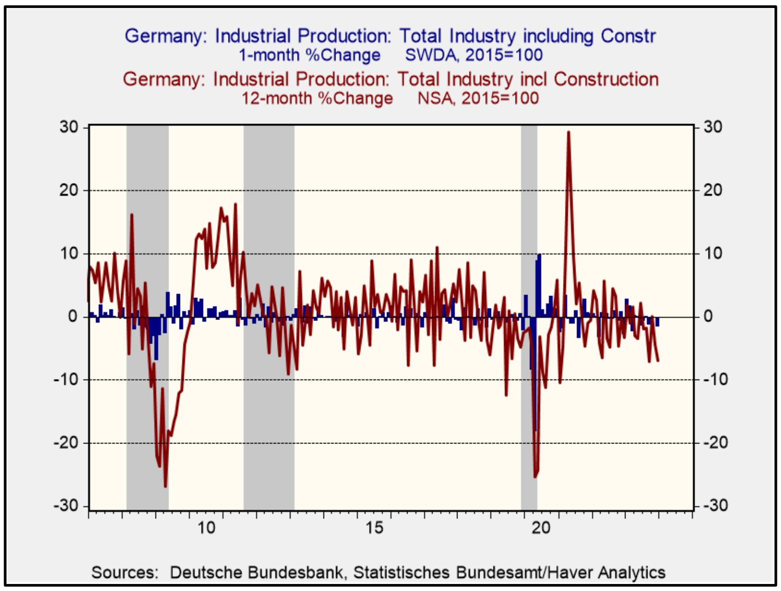
- The new proposal clearly stems from a perspective that enabling Ukraine to keep fighting off the Russians is so important that it offsets any negative effects from such a policy. However, we suspect that using frozen Russian assets as collateral for Western borrowing would dramatically increase tensions between the evolving US geopolitical bloc and the China/Russia bloc. When push comes to shove, there would be a high likelihood that Western borrowers would renege on such debt, allowing creditors to confiscate the assets.
- As we've written before, tensions between the US bloc and the China/Russia bloc are in a self-reinforcing spiral. Unilaterally pledging Russian assets to Western creditors would almost certainly prompt Beijing, Moscow, and other governments in the China/Russia bloc to further sever their financial ties with the West.
- In such a scenario, we think China, Russia, Iran, and other members of Beijing's bloc would accelerate their efforts to exit the dollar system and sell off their dollar holdings.
- If the world disintegrates into competing geopolitical, economic, and financial blocs as we think, the loss of efficiency and market competition would likely boost consumer price inflation and inflation volatility, as well as interest rates and interest-rate volatility. As we've written before, such an outcome would be especially negative for fixed-income assets. In contrast, equities and commodities would probably provide higher total returns going forward.

China-South China Sea: Illustrating the increasingly belligerent attitudes of some Chinese strategists and academics, a new article by maritime strategy expert Wu Shicun calls for Beijing to stop relying on "restraint and forbearance" in its territorial disputes in the South China Sea. Instead, Wu calls for China to "show our swords when necessary," essentially declaring that Beijing should threaten military force to counter any pushback against its expansive territorial ambitions.

China: Following Tuesday's government directive for the "national team" of major financial firms to buy Chinese stocks in an effort to buoy the market, trading prices and volumes continue to surge today. The benchmark CSI index of large, liquid stocks is now up more than 4% for the month, after falling some 6% in January. Separately, General Secretary Xi has replaced the chief of the China Securities Regulatory Commission, further signaling his intent to buoy the market.

Japan: Workers' nominal cash earnings in December were up 1.0% year-over-year, in part reflecting strong year-end bonuses. That was weaker than the expected rise of 1.4%, but analysts considered it sufficiently strong to support the Bank of Japan's plan to soon exit its longstanding policy of negative interest rates.

Germany: December industrial production fell by a seasonally adjusted 1.6%, several times worse than the expected decline and far worse than the revised fall of 0.2% in November. With the decline in December, Germany's industrial output has now fallen for seven straight months, leaving it down 6.9% year-over-year. The declines largely reflect Europe's current high interest rates and German policies that have crimped energy supplies. Since Germany is Europe's manufacturing powerhouse, its industrial decline is a big hurdle for the region's economy.

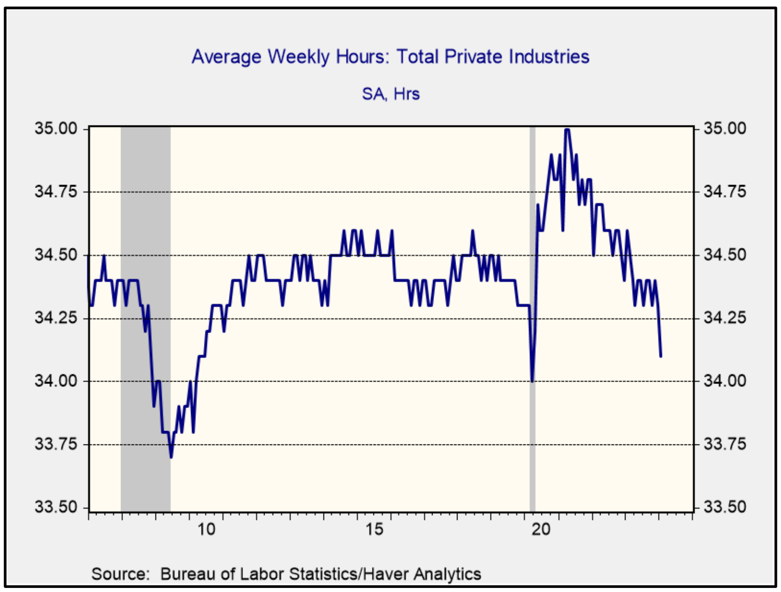


Argentina: Radical libertarian President Javier Milei and his La Libertad Avanza coalition have pulled their big, omnibus economic reform bill from the floor of the lower house of Congress after accusing opposition lawmakers of reneging on plans to approve the bill. With opposition support, the bill was approved on a first reading last week, but now opposition lawmakers have been voting down key sections in the second reading. Since Milei's coalition only has a small number of seats, the voting calls into question his ability to push through the reform program.

United States-Guyana-Venezuela: With the Venezuelan government continuing to threaten military force to seize more than half the territory of Guyana, the US this week committed to sell the Guyanese additional fixed-wing aircraft, helicopters, drones, and radar systems. As of this writing, the dollar value of the deal has not yet been made public.

US Monetary Policy: At an event yesterday, Cleveland FRB President Mester said the strong headline numbers in last week's January employment report masked other signs of moderation in the data and wouldn't derail the Fed's plans to cut interest rates gradually over the course of 2024. Mester said she supported the policymakers' expectations to cut rates three times, leaving the benchmark fed funds rate at 4.50% to 4.75% by year's end.

- We agree that the details in the January report showed more moderation than suggested by the massive gain of 353,000 in nonfarm payrolls or the year-over-year rise of 4.5% in seasonally adjusted average hourly earnings.
- For example, we note that the standard approach of using seasonally adjusted figures for year-over-year calculations is prone to distortion, since both the current month's figure and the year-earlier figure could have bad adjustments. Where possible, we prefer to use non-seasonally adjusted data for year-over-year comparisons.
    - Our approach suggests average hourly earnings in January were up just 3.9% on the year, moderating from a rise of 4.3% in the year to December.
    - Using our approach, annual wage growth is now at its weakest since last May.
- In addition, the report showed that the average workweek plunged to just 34.1 hours in January, down from 34.3 hours in December and 34.4 hours in November.



US Banking System: Following New York Community Bancorp's announcement last week of a surprisingly large loss, and in the wake of a dramatic selloff of its shares, Moody's yesterday cut the firm's debt to junk status. Moody's now rates NYCB's debt at Ba2, versus Baa3 previously. Nevertheless, it currently appears that the bank's problem is limited to profitability, rather than the falling bond values and deposit flight that marked the banking crisis last spring. For now, that suggests the situation at NYCB does not portend another crisis like last year.

- After acquiring Signature Bank during last year's crisis and a separate bank in 2022, NYCB surpassed the $100 billion in assets that require greater regulatory scrutiny and higher capital standards. NYCB had noted that working through those acquisitions would require it to shore up its balance sheet, and its recent loan write-offs appear to be part of that effort.

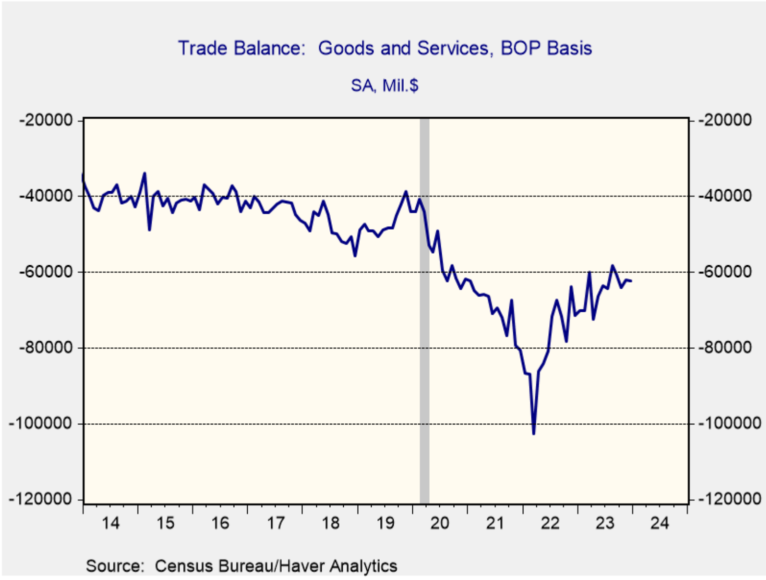
- At the same time, NYCB has reported that its deposits have been largely stable, down just 2% during the fourth quarter of 2023. Its share of insured deposits is also much higher than the banks that saw deposit flight last year.
- On the New York Stock Exchange yesterday, NYCB closed at $4.20 per share, down 22.2% for the day and approximately 60% from its level just before the announced loss. Other regional bank stocks were also down yesterday, but not nearly as sharply as NYCB.

US Housing Market: While some private data providers say overall apartment rents have stabilized or have even started to fall, new analysis from Yardi Matrix suggests the reversal in rent inflation has been mostly in the luxury segment, where most of the new supply has come. While overall rent costs grew by just 0.3% in 2023, Yardi says rents for lower- and middle-tier apartments rose 2.0%. Continued increases in apartment rents may be one reason President Biden is struggling to retain the support of working-class voters as he campaigns for re-election.

U.S. Economic Releases

US demand for home loans rose last week as homeowners took advantage of the recent dip in borrowing costs. According to an index tracked by the Mortgage Bankers Association, mortgage applications rose 3.7% in the week ending February 2. The increase is the result of a jump in refinancing as borrowers look to lock in relatively low mortgage rates. The average 30-year fixed-rate mortgage rose 2 bps to 6.80% last week. As a result, the MBA tracker for refinancing rose 12.3% from the previous week, while the purchase tracker fell 0.6%.

The US trade deficit grew slightly in December but remained near year-end expectations. Data from the Commerce Department shows a rise from $61.9 billion to $62.2 billion. Notably, both imports and exports increased compared to November — imports rose from $316.2 billion to $318.3 billion, while exports climbed from $254.3 billion to $258.2 billion.



The chart above shows the level of the trade balance. In a sign of the growing trade tensions between the two largest economies, the U.S. imported more goods from Mexico than China last year.

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
15:00	Consumer Credit	m/m	Dec	$16.000b	$23.751b	*
Federal Reserve						
	No Fed speakers or events for the rest of today					
EST	Speaker or Event	District or Position				
11:00	Adriana Kugler Speaks at Brookings Event	Member of the Board of Governors				
11:30	Susan Collins Speaks at Boston Economic Club	President of the Federal Reserve Bank of Boston				
12:30	Thomas Barkin Speaks on Outlook, Regional Economy	President of the Federal Reserve Bank of Richmond				
14:00	Michelle Bowman Speaks on Supporting Small Businesses	Member of the Board of Governors				
15:15	Julie Remache Delivers Keynote Remarks at NY Fed Conference	Deputy SOMA Manager Federal Reserve Bank of New York				
16:30	Anna Nordstrom Speaks at NY Fed Conference	Head of Domestic and International Market Functions, 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 P	110.0	107.6	108.1	**	Equity and bond neutral
	Coincident Index	m/m	Dec P	116.2	114.6	116.1	*	Equity and bond neutral
New Zealand	Employment Change	m/m	4Q	2.4	2.4	2.7	*	Equity and bond neutral
	Unemployment Rate	q/q	4Q	4.0%	3.9%	4.3	**	Equity and bond neutral
	Employment Change	q/q	4Q	0.4%	-0.2%	-0.1%	*	Equity and bond neutral
South Korea	BoP Goods Balance	m/m	Dec	$8037.4m	$7006.0m	$6878.2m	*	Equity and bond neutral
	BoP Current Account Balance	m/m	Dec	$7414.6m	$4059.7m	$3890.7m	**	Equity and bond neutral
China	Foreign Reserves	m/m	Jan	$3219.32b	$3237.98b	$32220b	**	Equity and bond neutral
EUROPE								
Germany	Industrial Production WDA	y/y	Dec	-3.0%	-4.8%	-4.3%	**	Equity bullish, bond bearish
France	Trade Balance	m/m	Dec	-6829m	-5943m	-5939m	**	Equity and bond neutral
	Current Account Balance	m/m	Dec	-0.7b	-2.8b	-2.9b	**	Equity and bond neutral
Italy	Retail Sales	y/y	Dec	0.3%	1.5%	1.40%	**	Equity bearish, bond bullish
Switzerland	Unemployment Rate	m/m	Jan	2.5%	2.3%	2.5%	**	Equity and bond neutral
	Foreign Currency Reserves	m/m	Jan	662.4b	653.7b	654.2b	***	Equity and bond neutral
Russia	Official Reserve Assets	m/m	Jan	585.4b	598.6b		*	Equity and bond neutral
AMERICAS								
Canada	Building Permits	m/m	Dec	-14.0%	-3.9%	2.0%	**	Equity bearish, bond bullish
Brazil	Net Debt % GDP	y/y	Dec	60.8%	59.5%	60.0%	**	Equity and bond neutral
	Retail Sales	y/y	Dec	1.3%	2.2%	2.5%	***	Equity bearish, bond bullish

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	555	3	Down
3-mo T-bill yield (bps)	521	522	-1	Flat
U.S. Sibor/OIS spread (bps)	531	532	-1	Down
U.S. Libor/OIS spread (bps)	532	532	0	Down
10-yr T-note (%)	4.13	4.10	0.03	Flat
Euribor/OIS spread (bps)	393	392	1	Down
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Down			Up
Pound	Up			Up
Franc	Down			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.

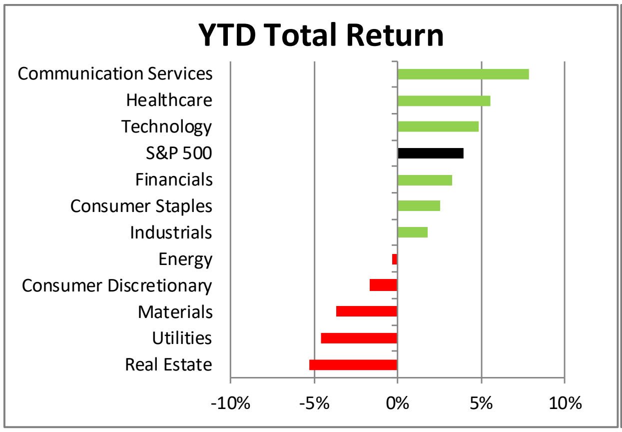
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$79.15	$78.59	0.71%	
WTI	$73.86	$73.31	0.75%	
Natural Gas	$2.01	$2.01	0.25%	
Crack Spread	$27.75	$27.22	1.97%	
12-mo strip crack	$26.17	$25.89	1.07%	
Ethanol rack	$1.73	$1.73	0.00%	
Metals				
Gold	$2,033.04	$2,036.14	-0.15%	
Silver	$22.25	$22.43	-0.77%	
Copper contract	$378.10	$378.10	0.00%	
Grains				
Corn contract	$434.25	$438.75	-1.03%	
Wheat contract	$593.00	$595.00	-0.34%	
Soybeans contract	$1,184.25	$1,199.50	-1.27%	
Shipping				
Baltic Dry Freight	1,516	1,436	80	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.1		
Gasoline (mb)		1.5		
Distillates (mb)		-2.5		
Refinery run rates (%)		1.2%		
Natural gas (bcf)		-75		

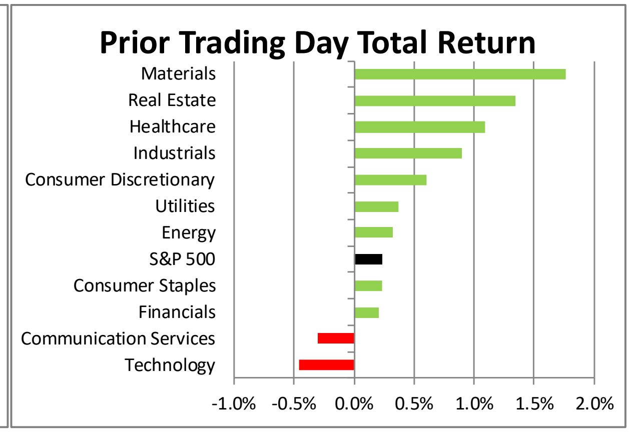
Weather

The 6-10 and 8-14 day forecasts predict a shift in temperatures across the US. Cooler-than-normal temperatures are expected to move from the Pacific region into the South and East, while warmer-than-average temperatures are anticipated on the West Coast. The precipitation outlook calls for wetter-than-normal conditions to recede to the Southern states, with dry conditions remaining throughout the rest of the country.

Data Section

U.S. Equity Markets – (as of 2/6/2024 close)

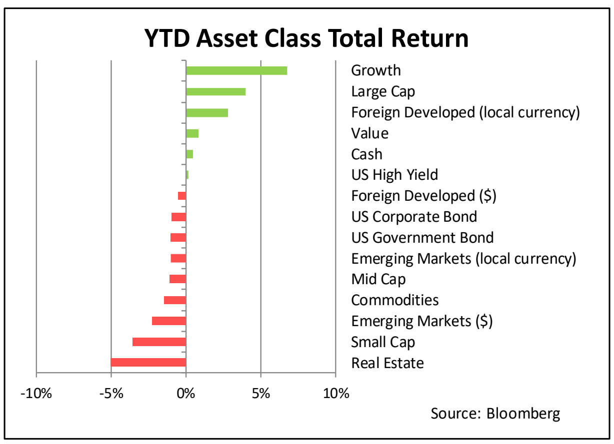




(Source: Bloomberg)

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 2/6/2024 close)

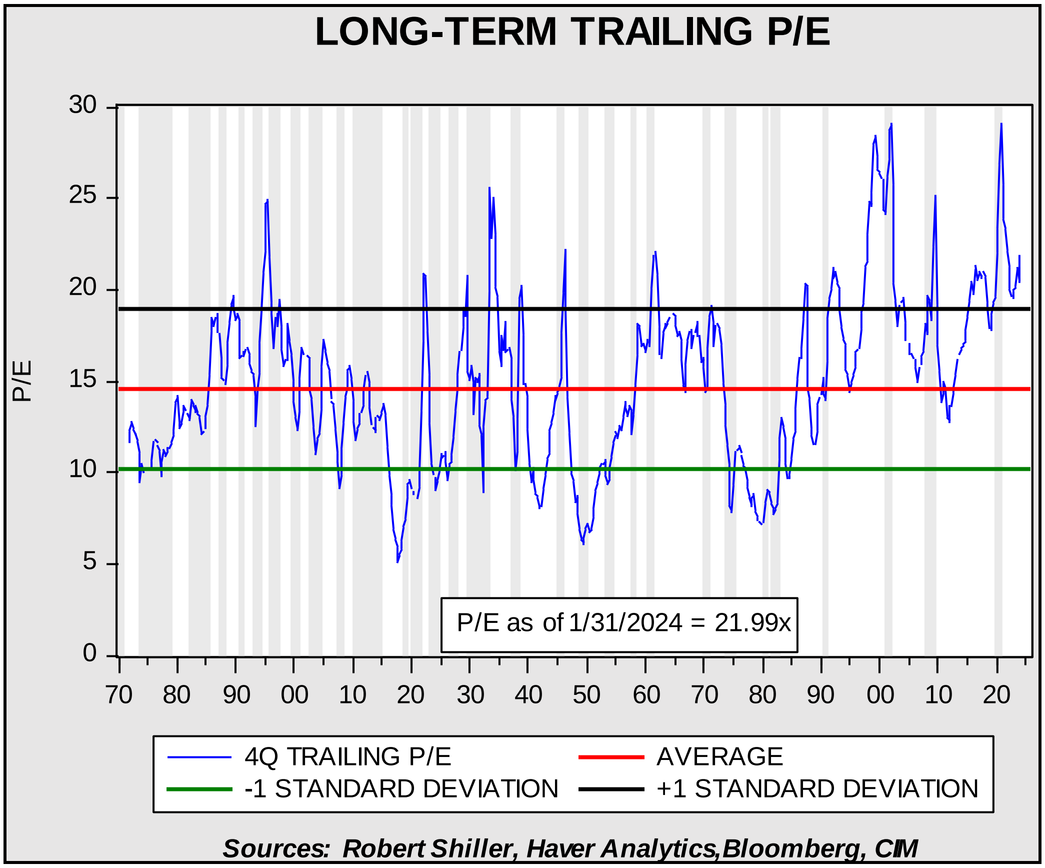


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.