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 8, 2024—9:30 AM EST] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.7%. Chinese markets were higher, with the Shanghai Composite up 1.3% from its previous close and the Shenzhen Composite up 3.2%. US equity index futures are signaling a lower open.

With 301 companies having reported so far, S&P 500 earnings for Q4 are running at $57.20 per share, compared to estimates of $55.15, which is up 1.6% from Q3 2023. Of the companies that have reported thus far, 80.1% have exceeded expectations while 15.0% have fallen short of expectations.

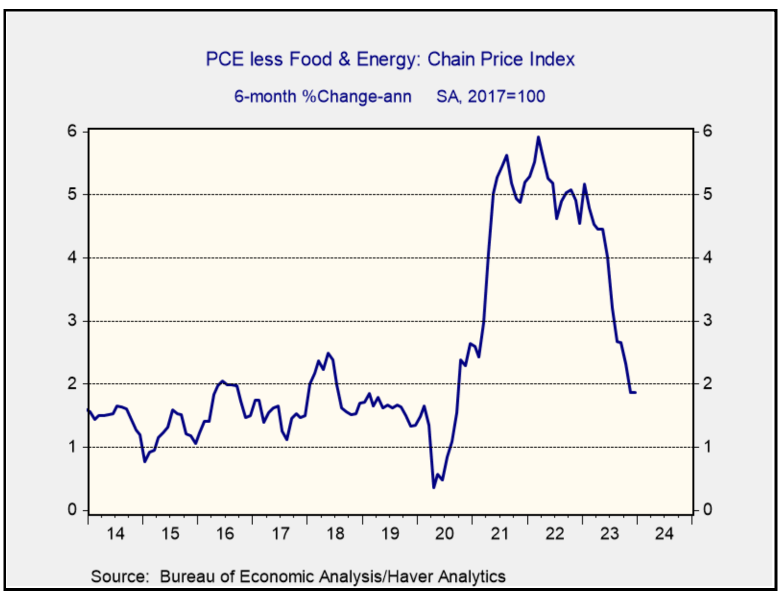
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (1/29/2024) (with associated podcast): "Introducing the US 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): "US Oil Production at a Record High"
- *The 2024 Outlook: Slow-Bicycle Economy* (12/18/2023) (with associated *Confluence of Ideas* podcast)

Good morning! Equities are holding steady, and the NBA trade deadline is expected to end with a bang. In today's *Comment*, we dive into the recent Treasury auction, explore why New York Community Bank is on investors' watchlists, and analyze the potential for a US decoupling from the EU and China. As always, we wrap up with a summary of key domestic and international economic releases.

Auction Success: The US Treasury sold a record number of bonds as investors gear up for a Fed pivot; however, policymakers aren't as confident.

- The US Treasury successfully auctioned $42 billion in 10-year notes at a slightly lower yield than anticipated, 4.093%. This strong demand marks a turnaround from recent auctions plagued by weak participation and "tail" outcomes, where low-priority buyers received bonds at significantly higher yields. The better-than-anticipated demand in the latest bond sale boosted bond prices slightly and fueled a surge in the S&P 500, pushing it closer to the 5,000 mark. This suggests growing investor confidence that the Fed might adopt a more dovish stance later in the year, but Fed officials continue to play down speculation that a policy pivot is imminent.
- Several central bank policymakers urged patience on rate cuts, emphasizing the importance of waiting for clearer signs of disinflation before considering adjustments. Fed Governor Adriana Kugler advocated for further evidence before the committee considers a rate cut. Meanwhile, Minneapolis Fed President Neel Kashkari projected the central bank could reduce rates 2-3 times this year, but acknowledged the need for inflation to remain near the 2% target for several months before action. Recent core PCE readings show that inflation dipped below the Fed's target on a six-month annualized basis, suggesting a sustained downward trend.

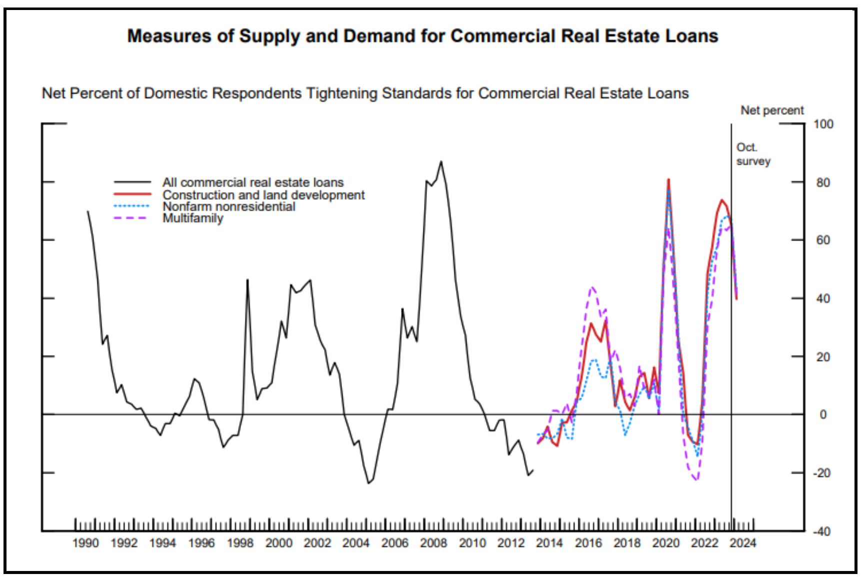


- A successful Treasury auction of $25 billion worth of 30-year bonds today could spark market optimism, but demand for these bonds in the future could hinge on expectations of a Fed pivot. Robust payroll data coupled with persistent inflation appears to be preventing policymakers from acting more aggressively. Meanwhile, Chair Powell's recent call for fiscal responsibility amplifies concerns within the Fed that Congressional inaction on the fiscal deficit debt could hinder their efforts to manage long-term interest rates. Given this uncertainty, investors should tread carefully and avoid premature exposure to duration risk, as these assets will most likely remain highly susceptible to volatility in the coming months.

Loss Provisions: Recent loan losses at New York Community Bank are fueling fears of a surge in real estate defaults this year.

- Faced with a surprise earnings loss and dividend cut, the New York lender is scrambling to regain investor trust by exploring asset sales, including offloading loans made during lower interest rates. This move reflects concerns about potential losses on real estate holdings in a challenging market. However, the firm's efforts to shore up its balance sheet may be hampered by a lack of appetite for commercial real estate (CRE). Banks are struggling to value properties due to high vacancies and borrowing costs, making potential buyers wary. As a result, concerns linger that other banks might also face difficulties in managing their CRE.

- Small and mid-sized banks face mounting concerns about CRE loans, according to the latest Senior Loan Officer Opinion Survey. While the report showed a slight easing in credit tightening for nonresidential properties, standards remain significantly stricter compared to pre-pandemic levels. Notably, large banks were less likely to tighten standards, highlighting a potential vulnerability for smaller lenders. Alongside stricter lending practices, banks are expressing growing uncertainty about the economic outlook, reduced risk tolerance, and worsening liquidity conditions, further amplifying concerns about the CRE market.

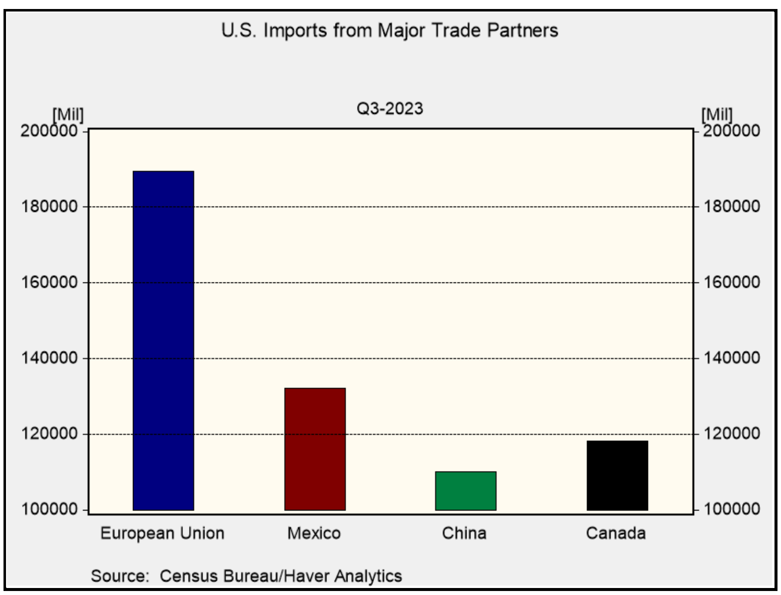


(Source: Federal Reserve)

- While historical trends show real estate crashes to be major drivers of US recessions, exemplified by the downturns in the early 90s and the Great Recession, current indicators don't necessarily point to imminent trouble. The latest Household Debt and Credit report reveals increased auto and credit card delinquencies in the final quarter of 2023, but defaults remain significantly lower than pandemic highs. Additionally, the labor market continues to show signs of tightness which is likely to make households more resilient. Hence, despite the gloom in CRE, financial markets still look good.

Trade Flow and Tension: Trade data shows that the US is steadily reducing its dependency on China; however, there are growing concerns that the European Union may be next.

- For the first time in two decades, the US imported more goods and services from Mexico than from China, marking a significant shift in global trade dynamics. This trend is primarily driven by a decline in imports from China, falling from $575 billion to $431 billion in 2023, rather than a significant increase in Mexican imports, which dipped slightly from $459 billion to $448 billion. This shift reflects not only ongoing tensions and potential decoupling between the US and China, but also the growing trend of "nearshoring" as companies and investors seek geographically closer production and supply chains.
- However, a potential shift towards regionalization could strain relations with traditional allies. The European Union has voiced concerns about potential trade disruptions if former President Donald Trump were to be re-elected. Throughout his initial term, Trump publicly criticized the EU, particularly Germany, for its perceived reluctance to adopt a firmer stance against China, as well as its long-standing trade deficit with the United States. Trump is currently considering punitive trade measures against the EU if he regains office, prompting the EU to assess its response to potential actions by the Republican front-runner should he resume power.

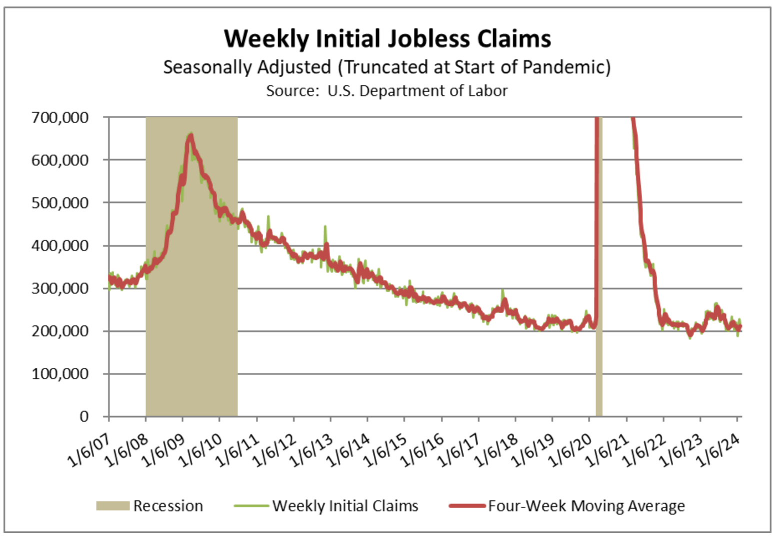


- Escalating trade tensions create a complex landscape of uncertainty, presenting both challenges and potential opportunities. Recent price data hints at post-lockdown economic struggles in China, raising questions about whether cost advantages for US companies will be sustainable in the face of trade disputes. Additionally, a potential EU-US feud could prompt the bloc to diversify its imports, particularly in commodities, potentially impacting the US energy sector. However, the EU might also need to balance this with maintaining access to the US consumer market, potentially softening its stance on American tech firms.

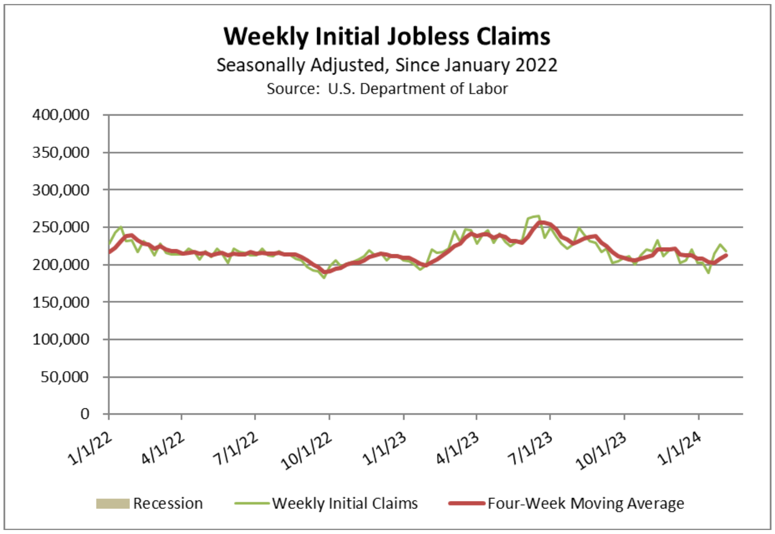
Other News: Israel's PM Benjamin Netanyahu rejected a deal to end the hostage situation, suggesting that the conflict will likely continue for the foreseeable future. The US killed the commander of an Iran-backed militia in Iraq as it looks to retaliate against those responsible for the Jordan attack in late January. The action risks a broader conflict in the Middle East. Lastly, the stock price for UK chip designer Arm surged on Thursday after it reported higher-than-expected earnings. Its strong performance reflects growing demand for AI-related technology.

US Economic Releases

In the week ended February 3, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 218,000, below both the expected level of 220,000 and the previous week's revised level of 227,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 212,250. Meanwhile, in the week ended January 27, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) fell to 1.871 million, below both the anticipated reading of 1.875 million and the prior week's revised reading of 1.894 million. The chart below shows how initial jobless claims have fluctuated since just before the Great Financial Crisis. The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



To provide more detail on recent trends, the following chart shows how initial jobless claims have changed just since the beginning of 2022.



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	Wholesale Trade Sales	m/m	Dec	0.3%	0.0%	**
10:00	Wholesale Inventories	m/m	Dec F	0.4%	0.4%	***
Federal Reserve						
EST	Speaker or Event	District or Position				
12:05	Thomas Barkin Speaks at Economic Club of New York	President of the Federal Reserve Bank of Richmond				

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								
	Coincident Index	m/m	Dec P	110.0	114.5	109.3	*	Equity and bond neutral
	Leading Economic Index	m/m	Dec P	116.2	107.7	116.1	**	Equity and bond neutral
Japan	Foreign Buying Japan Stocks	w/w	2-Feb	¥308.4b	¥720.3b	¥721.0b	*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	2-Feb	¥456.6b	¥382.9b	¥385.5b	*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	2-Feb	¥394.4b	-¥207.5b	-¥218.0b	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	2-Feb	-¥194.7b	-¥55.2b	-¥91.3b	*	Equity and bond neutral
	BoP Current Account Balance	m/m	Dec	¥744.3b	¥1925.6b	¥1138.7b	***	Equity and bond neutral
	BoP Trade Balance	m/m	Dec	¥115.5b	-¥724.1b	¥183.1b	**	Equity and bond neutral
Australia	Foreign Reserves	m/m	Jan	A$89.4b	A$93.9b		*	Equity and bond neutral
China	PPI	y/y	Jan	-2.5%	-2.7%	-2.6%	**	Equity and bond neutral
	CPI	y/y	Jan	-0.8%	-0.3%	-0.5%	***	Equity and bond neutral
	Wholesale Prices	y/y	Aug		24.2%		**	Equity and bond neutral
EUROPE								
Russia	Retail Sales Real	m/m	Dec	10.2%	10.5%	11.9%	**	Equity bearish, bond bullish
	Unemployment Rate	m/m	Dec	3.00%	2.90%	2.90%	***	Equity and bond neutral
	Gold and Forex Reserves	m/m	2-Feb	$586.4b	$587.8b		***	Equity and bond neutral
AMERICAS								
Canada	International Merchandise Trade	m/m	Dec	0.31b	1.57b	1.06b	**	Equity and bond neutral
Mexico	CPI	y/y	Jan	4.88%	4.66%	4.88%	***	Equity and bond neutral
	Core CPI	y/y	Jan	4.76%	5.09%	4.72%	**	Equity and bond neutral
	International Reserves Weekly	w/w	2-Feb	-$213464m	-$212877m		*	Equity and bond neutral
Brazil	IBGE Inflation IPCA	y/y	Jan	4.5%	4.6%	4.4%	*	Equity and bond neutral
	Exports	m/m	Jan	$27016m	$28839m	$27650m	*	Equity and bond neutral
	Imports	m/m	Jan	$20490m	$19479m	$20283m	*	Equity and bond neutral
	Trade Balance	m/m	Jan	$6527m	$9360m	$7400m	**	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	558	0	Down
3-mo T-bill yield (bps)	522	522	0	Flat
U.S. Sibor/OIS spread (bps)	531	531	0	Down
U.S. Libor/OIS spread (bps)	531	532	-1	Down
10-yr T-note (%)	4.14	4.11	0.03	Flat
Euribor/OIS spread (bps)	390	393	-3	Down
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Down			Up
Pound	Down			Up
Franc	Flat			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
RBI Cash Reserve Ratio	4.500%	4.500%	4.500%	On Forecast
RBI Repurchase Rate	6.500%	6.500%	6.500%	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.

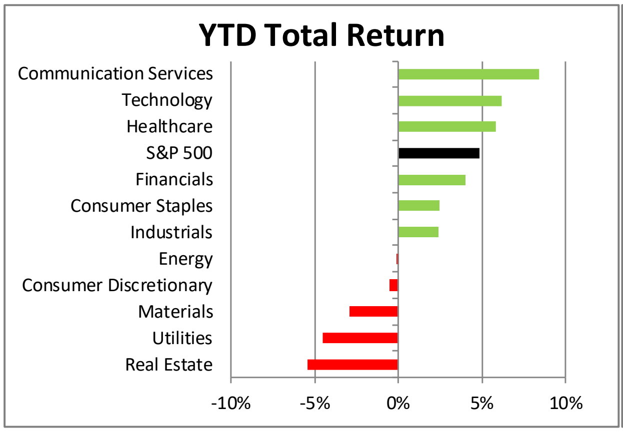
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$80.29	$79.21	1.36%	
WTI	$74.88	$73.86	1.38%	
Natural Gas	$1.97	$1.97	0.10%	
Crack Spread	$29.62	$28.99	2.17%	
12-mo strip crack	$26.92	$26.55	1.37%	
Ethanol rack	$1.72	$1.72	0.02%	
Metals				
Gold	$2,024.56	$2,035.36	-0.53%	
Silver	$22.28	$22.22	0.25%	
Copper contract	$372.65	$373.55	-0.24%	
Grains				
Corn contract	$434.25	$434.25	0.00%	
Wheat contract	$594.00	$602.00	-1.33%	
Soybeans contract	$1,194.00	$1,189.00	0.42%	
Shipping				
Baltic Dry Freight	1,487	1,516	-29	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	5.5	2.1	3.4	
Gasoline (mb)	-3.1	1.5	-4.6	
Distillates (mb)	-3.2	-2.5	-0.7	
Refinery run rates (%)	-0.5%	1.2%	-1.7%	
Natural gas (bcf)		-75		

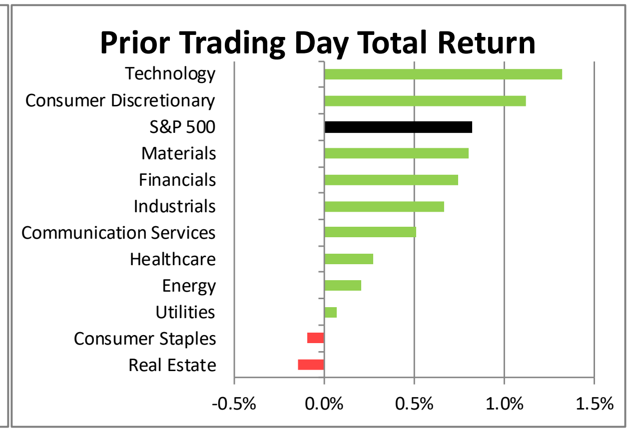
Weather

The 6-10 and 8-14 day forecasts currently call for colder-than-normal temperatures throughout the Rocky Mountain, Deep South, and East Coast regions, with warmer-than-normal temperatures along the West Coast. The forecasts call for wetter-than-normal conditions in the Southwest, with dry conditions in the Midwest and the Northeast.

Data Section

US Equity Markets – (as of 2/7/2024 close)

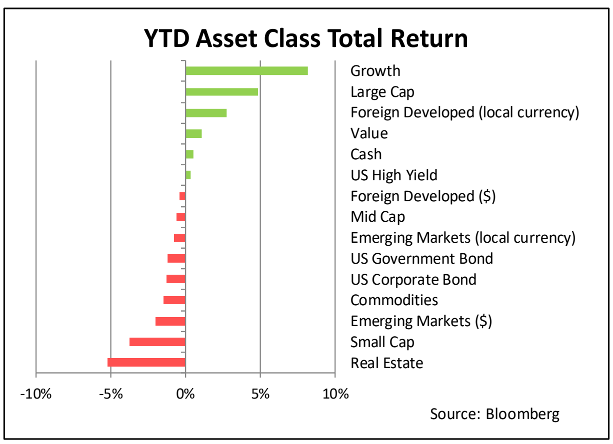




(Source: Bloomberg)

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 2/7/2024 close)

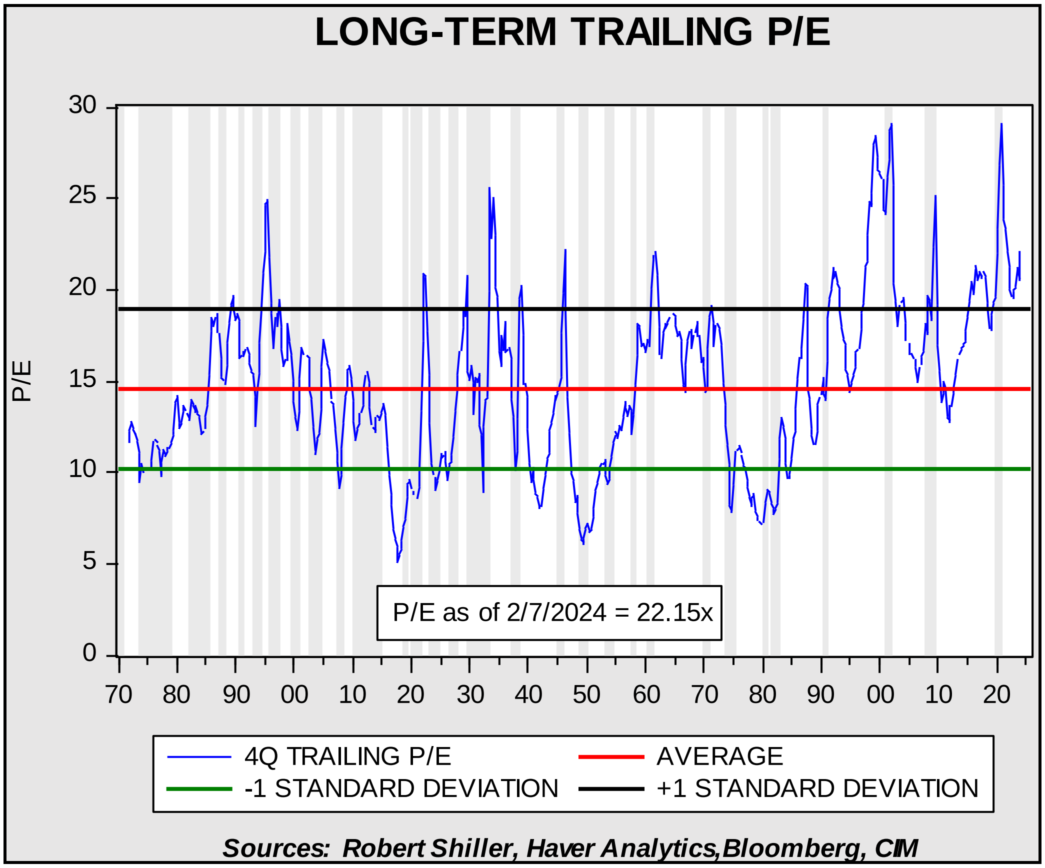


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 8, 2024



Based on our methodology,[1] the current P/E is 22.15x, up 0.16x 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.