Daily Comment

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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 9, 2024—9:30 AM EST] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.4%. Chinese markets were closed for the Chinese Lunar New Year. US equity index futures are signaling a higher open.

With 332 companies having reported so far, S&P 500 earnings for Q4 are running at $57.30 per share compared to estimates of $55.15, which is up 1.6% from Q3 2023. Of the companies that have reported thus far, 79.8% have exceeded expectations, while 15.1% have fallen short of expectations.

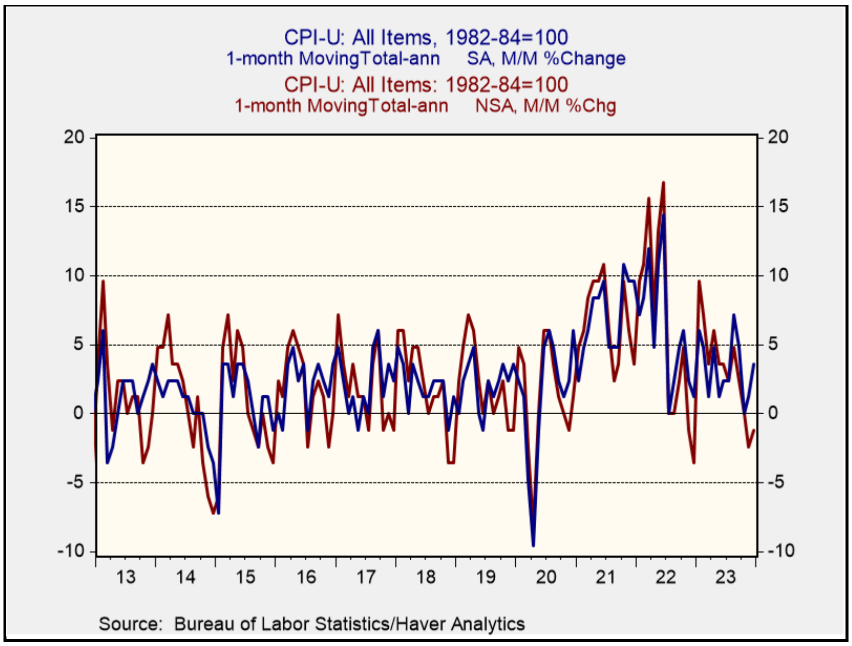
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (1/29/2024) (with associated podcast): "Introducing the US Space Force"
- *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 off to a great start, and Ravens quarterback Lamar Jackson was crowned MVP for the 2023 season. Today's *Comment* analyzes the potential impact of CPI revisions, Yellen's nonbank lender warning, and the geopolitical boost for chipmakers. Don't miss the rest of our comprehensive report that includes economic and domestic updates, with expert insights on these key trends.

CPI Revisions: A potential upward revision to the CPI might dampen expectations of a rate cut in the first half of the year.

- The Bureau of Labor Statistics will release its updated seasonal adjustment factors for monthly inflation data later today. Investors will be closely watching these changes for any hints about when the Federal Reserve might consider easing interest rates. While past revisions have typically been minor, last year's adjustments revealed that inflation hadn't cooled as quickly as initially reported, raising concerns about the Fed's policy path. Fed Governor Christopher Waller warned that another upward surprise may undermine the committee's confidence in the Fed's progress on inflation.
- However, it is quite probable that the revisions may reveal inflation to have been lower than the initial estimate suggested. Upon closer examination of the non-seasonally adjusted data, it becomes evident that while inflation experienced acceleration at the beginning of the year, prices plunged significantly into deflation by year-end. The sharp fluctuation suggests the previous year's price movements could have varied widely in both directions, signaling that revisions may not be as bad as some fear.

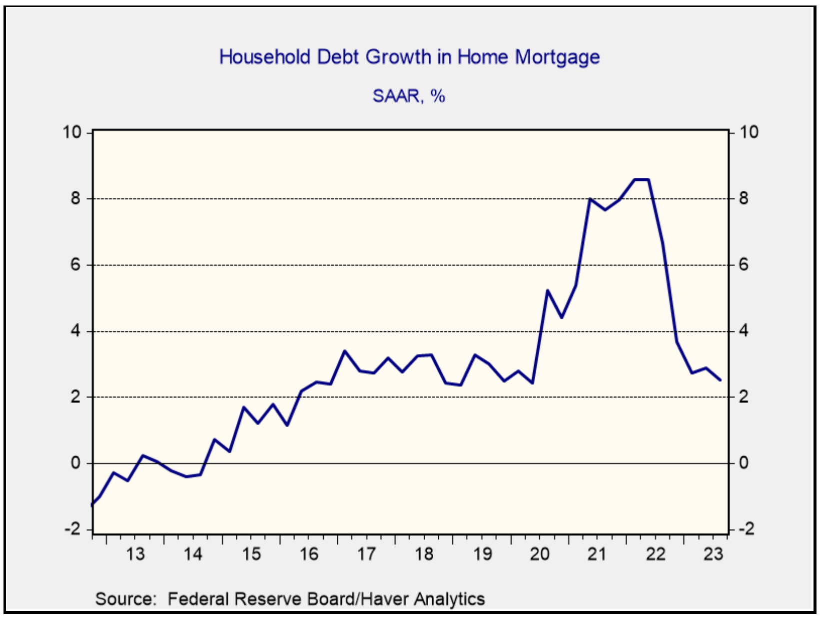


- While the CPI reigns supreme in popularity thanks to its early release, it's not without its limitations. A potential revamp would undoubtedly trigger market fluctuations, but it's crucial to acknowledge the index's shortcomings. The current methodology heavily weights shelter costs, which react slowly to economic changes, and ignores potential consumer substitutions toward cheaper alternatives. Therefore, it's important to remember that the Federal Open Market Committee (FOMC) prefers the Personal Consumption Price Index (PCE) as a more accurate inflation gauge. So, while an upward revision to the CPI might grab headlines, its impact on the FOMC's commitment might be less significant than initially perceived.

Yellen Concerns: Treasury Secretary Janet Yellen is paying close attention to the mortgage lending industry, even as she maintains a positive economic forecast.

- During her Senate Finance Committee testimony, Secretary Yellen flagged concerns about the increased vulnerability of nonbank mortgage lenders during economic downturns. She emphasized their reliance on short-term, volatile funding sources compared to traditional banks' access to stable deposits and emergency Fed facilities. This dependence, she argued, amplifies their risk of failure, potentially disrupting borrowers and destabilizing the broader financial system. Her testimony aligns with a growing effort among regulators to strengthen oversight on such institutions, aiming to mitigate the risks they pose and prevent future financial crises.

- Nonbank lenders have witnessed significant growth in recent years, partially fueled by their ability to offer loans to borrowers with lower creditworthiness, a segment often underserved by traditional banks who tightened their lending standards during the same period. This has allowed them to significantly outpace their bank and thrift counterparts in loan originations. According to Standard & Poor's Global Market Intelligence, nonbank lenders accounted for a staggering 50.9% of mortgage loans issued in 2022. However, their rapid growth and sizable market share raise concerns about potential risks to the broader financial system.



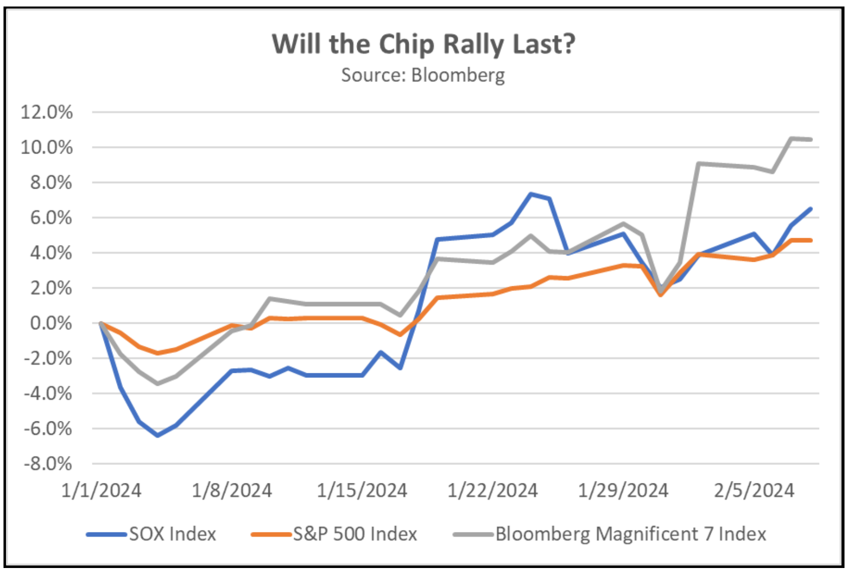
- Secretary Yellen's testimony highlights potential systemic risks beyond commercial real estate. While rising interest rates have slowed mortgage growth, they've also fueled a concerning increase in risky lending practices. Strengthening regulatory oversight of nonbank lenders could mitigate these risks, but we would expect significant resistance from these firms. While current indications suggest limited default risk among households, tightening monetary policy could elevate this risk in the future. That said, this talk about nonbank lenders is an example of how regulators are trying to extend their reach into the shadow banking market.

Global Chip War: Chipmakers are back in vogue as investors look for semiconductors to make a recovery and the US and China look to compete in the space.

- Governments are pouring money into bolstering their domestic chipmaking capabilities, spurred by geopolitical competition and supply chain concerns. The US "CHIPS and

Science Act" offers subsidies to entice companies like Intel, TSMC, Samsung, and Texas Instruments to build fabs domestically. China presses on toward self-sufficiency in advanced chipmaking, defying US export restrictions. This week, news emerged that the country's leading chipmaker is making headway in developing 5-nanometer chips. While not as miniaturized as the West's 3nm chips, this achievement underscores the potential of China's investments in the field.

- Chipmakers may find solace in intensifying competition for advanced semiconductors, after a brutal year marked by slumping sales. The Semiconductor Industry Association (SIA) predicts a potential rebound, with chip sales rising 13.1% to $595.3 billion in 2024, following an 8% dip in the previous year. This growth is fueled by the surging demand for advanced chips in artificial intelligence (AI) technology as more companies incorporate it into their products and services. The improved outlook regarding semiconductor sales has helped lift the stock price of chipmakers. So far this year, the Philadelphia Stock Exchange Semiconductor Sector Index (SOX) is currently outpacing the S&P 500.



- While intensifying competition in AI presents exciting opportunities for companies in the space, investors should proceed with caution. Similar to the S&P 500, the SOX index is concentrated, with the top three companies wielding significant influence. Additionally, the index trades at a high valuation, hovering around 30 times earnings. This suggests limited upside potential for established players within the broader index. For investors seeking exposure to AI and chip growth, consider exploring smaller companies. These companies might offer greater room for future growth, while still benefiting from the overall sector momentum.

Other News: Former Fox News host Tucker Carlson's interview with Russian President Vladimir Putin was released on X on Thursday. Some interpretations, including ours, suggest Putin's feelings of marginalization by the US were a reason for invading Ukraine. Separately, US President Joe Biden faced heightened scrutiny over his age following a special prosecutor's warning about Biden's difficulty recalling details during interrogation over classified documents found at his residence. The renewed criticism is another example of why we think this election will be less predictable than previous cycles.

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		
	No economic releases for the rest of today	
Federal Reserve		
EST	**Speaker or Event**	**District or Position**
13:30	Lorie Logan Speaks in Moderated Q&A	President of the Federal Reserve Bank of Dallas

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	Money Stock M2	y/y	Jan	2.4%	2.3%		**	Equity and bond neutral
	Money Stock M3	y/y	Jan	1.8%	1.7%		**	Equity and bond neutral
China	New Yuan Loans	m/m	Jan	4920.0b	1170.0b	1170.9b	**	Equity and bond neutral
	Money Supply M2	y/y	Jan	8.7%	9.7%	9.2%	***	Equity and bond neutral
	Money Supply M1	y/y	Jan	5.9%	1.3%	2.9%	*	Equity and bond neutral
	Aggregate Financing CNY	y/y	Jan	6500.0b	1940.0b	1940.1b	*	Equity and bond neutral
	Money Supply M0	y/y	Jan	5.9%	8.3%		*	Equity and bond neutral
EUROPE								
Germany	CPI	y/y	Jan F	2.9%	2.9%	2.9%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Jan F	3.1%	3.1%	3.1%	**	Equity and bond neutral
Italy	Industrial Production WDA	m/m	Dec	-2.1	-3.1	-2.9	***	Equity bullish, bond bearish
Russia	Money Supply, Narrow Definition	w/w	2-Feb	18.01t	18.03t		*	Equity and bond neutral
AMERICAS								
Canada	Net Change in Employment	m/m	Jan	--	0.1k	15.0k	***	Equity and bond neutral
	Unemployment Rate	m/m	Jan	--	5.8%	5.9%	***	Equity and bond neutral
Mexico	Industrial Production	y/y	Dec	0.0%	2.8%	2.9%	***	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	558	0	Down
3-mo T-bill yield (bps)	522	523	-1	Flat
U.S. Sibor/OIS spread (bps)	531	531	0	Down
U.S. Libor/OIS spread (bps)	532	531	1	Down
10-yr T-note (%)	4.17	4.16	0.01	Flat
Euribor/OIS spread (bps)	390	390	0	Down
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Flat			Up
Yen	Down			Up
Pound	Down			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Mexico Overnight Rate	11.250%	11.250%	11.250%	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.

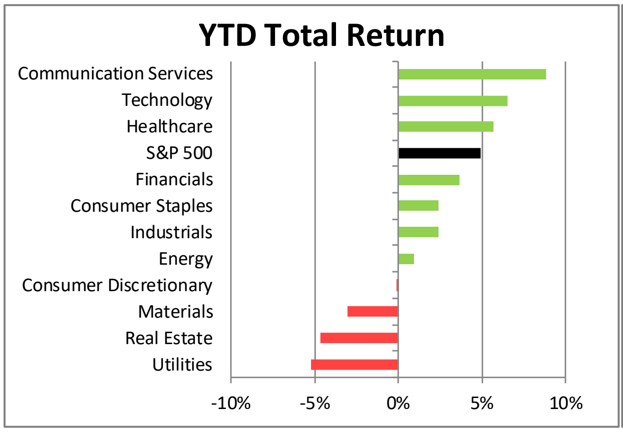
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$81.41	$81.63	-0.27%	
WTI	$76.13	$76.22	-0.12%	
Natural Gas	$1.86	$1.92	-3.23%	
Crack Spread	$29.76	$29.49	0.89%	
12-mo strip crack	$27.11	$27.14	-0.10%	
Ethanol rack	$1.73	$1.73	0.01%	
Metals				
Gold	$2,029.47	$2,034.52	-0.25%	
Silver	$22.60	$22.58	0.08%	
Copper contract	$368.65	$370.20	-0.42%	
Grains				
Corn contract	$430.25	$433.25	-0.69%	
Wheat contract	$590.25	$588.50	0.30%	
Soybeans contract	$1,182.75	$1,193.50	-0.90%	
Shipping				
Baltic Dry Freight	1,473	1,487	-14	
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	-75	0	

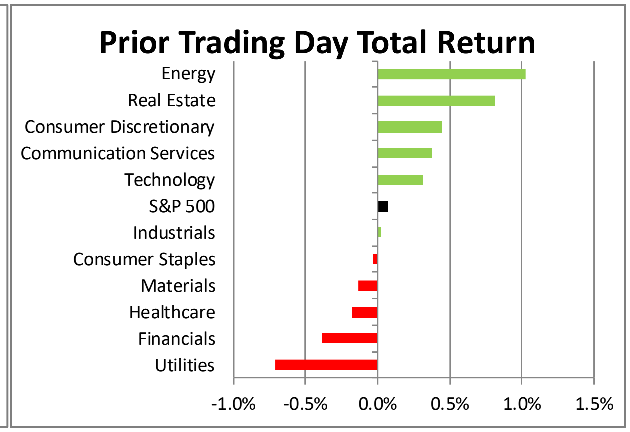
Weather

The 6-10 and 8-14 day forecasts currently call for colder-than-normal temperatures throughout the Great Plains, 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 Far West and Deep South, with dry conditions in the Midwest and the Northeast.

Data Section

US Equity Markets – (as of 2/8/2024 close)

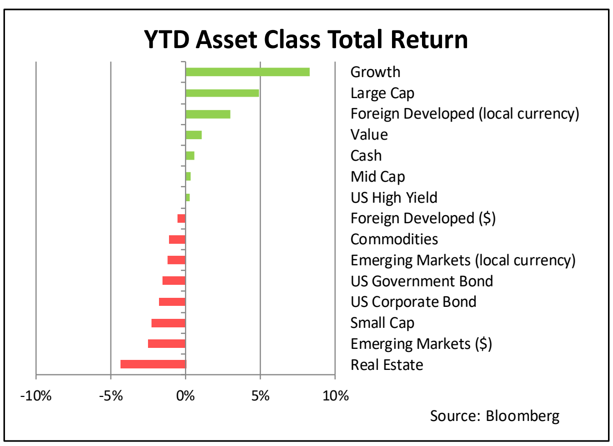




(Source: Bloomberg)

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 2/8/2024 close)

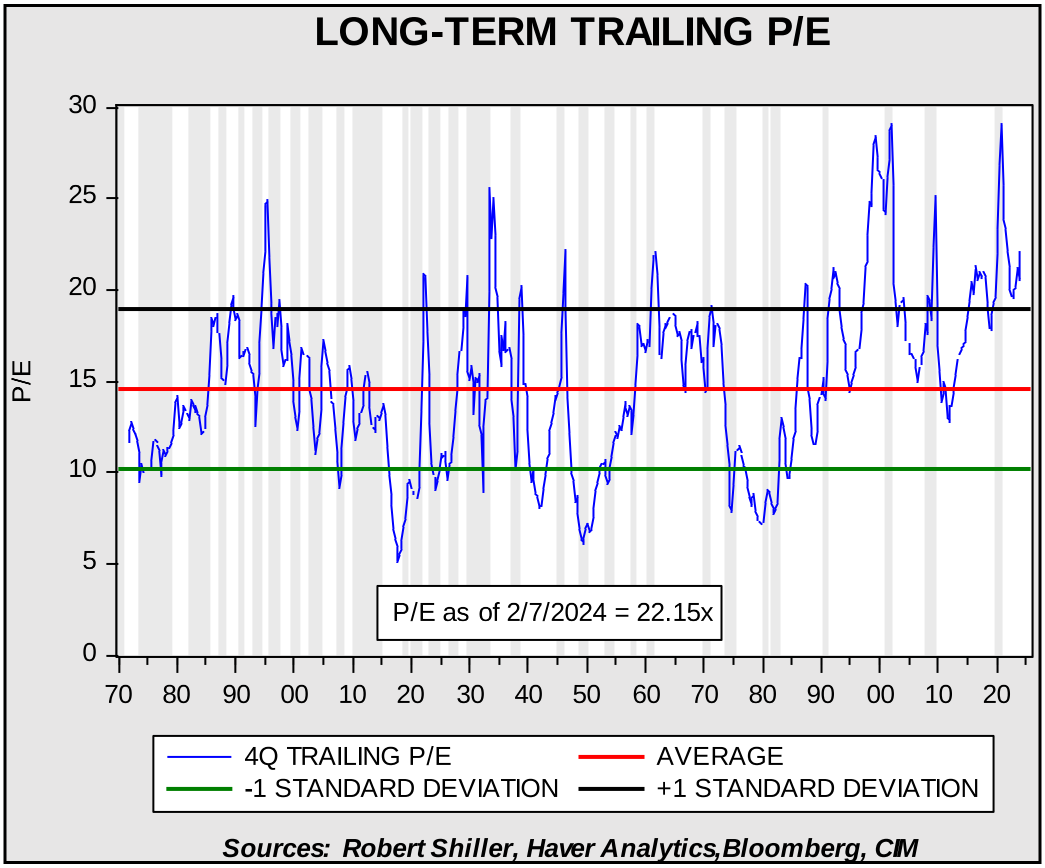


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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.