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: March 13, 2024—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.6% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.1%. Chinese markets were lower, with the Shanghai Composite down 0.4% from its previous close and the Shenzhen Composite down 0.1%. US equity index futures are signaling a lower open.

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:

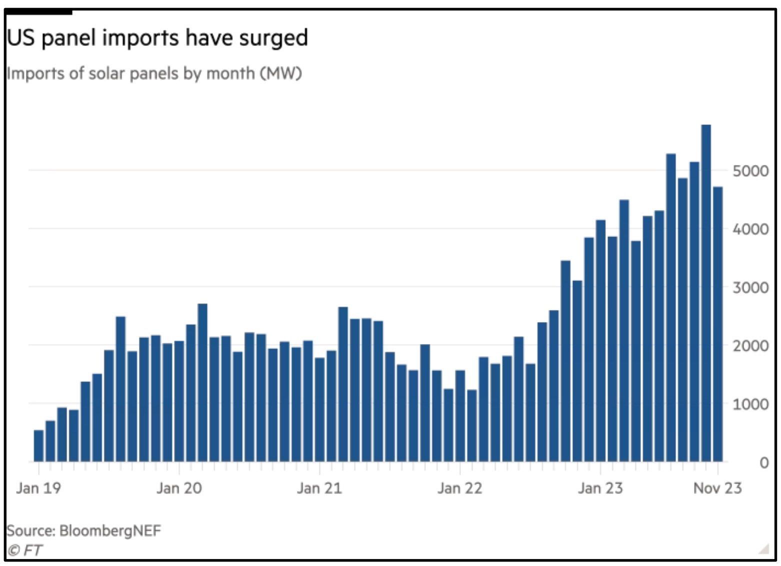
- *Bi-Weekly Geopolitical Report* (3/11/2024) (with associated podcast): "Rebirth of US Nuclear Deterrence"
- *Asset Allocation Quarterly – Q1 2024* (1/26/2024): Discussion of our asset allocation process, Q1 2024 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q1 2024 Rebalance 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* (3/4/2024) (with associated podcast): "Uranium Demand, Supply, and Investment Prospects"
- *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* opens with a discussion of today's expected congressional vote on forcing Chinese tech giant ByteDance to divest the US operations of TikTok. We next review a range of other international and US developments with the potential to affect the financial markets today, including strong wage increases in Japan that could help prompt the central bank to end its negative-interest rate policy and more detail on the Biden administration's proposed federal budget for the coming fiscal year.

US-China Espionage: The House of Representatives is set to vote on a bill today that would force Chinese tech giant ByteDance to divest the US operations of its social media app TikTok or have the app banned in the US. The move by the lawmakers stems from growing concern by intelligence officials that the app could be used to funnel data back to China for espionage or influence campaigns. The House is widely expected to approve the bill, but its fate in the Senate is less certain.

- The renewed focus on reining in TikTok will surely add another source of friction between the US and China, raising the risk that China will try to force a major US technology firm to divest its operations in China. Obvious potential targets might be Tesla or Apple.
- More broadly, the anti-TikTok bill illustrates how big, influential technology firms are being forced to choose sides in the US-China rivalry. Both Washington and Beijing are now so distrustful that they don't want their rival's companies doing business on their home turf. To the extent that they ban firms owned by their adversary from their home market, the result is basically "decoupling."
- Major US technology firms are generally very globalized, and many count China among their most important markets or their top manufacturing base. Some may try to maintain their businesses in China, but they will run the risk of increasingly brutal pressure to pull out of that market. Naturally, the resulting shift in addressable market will have a major impact on those companies' sales, profits, and stock values.

US-China Trade: New analysis shows Chinese solar panel makers have doubled their output capacity in just the last year to 1 trillion watts annually and now produce fully three times as many panels as there is global demand. The resulting glut of panels has driven global prices down some 50%, and the surge of imports into the US is threatening to put US producers out of business despite the expansion subsidies they've been offered through the Inflation Reduction Act. We therefore suspect solar panels will become another key point of US-China frictions.



China: The central government has ordered a stop to a string of big, expensive infrastructure projects in several poorer, highly indebted provinces in the country's interior. The move marks an expansion of Beijing's effort to rein in excess capacity and debt, which has tripped up the real estate development sector over the last couple of years. Importantly, the clampdown on investment and debt will likely exacerbate the Chinese economy's other structural headwinds and could make it difficult to meet the government's target of 5% economic growth this year.

Japan: In the annual "shunto" wage negotiations that mostly wrapped up today, major Japanese companies granted average pay hikes of 4% or more, marking an acceleration from last year's 3.6% increase and the biggest wage increase since 1992. The robust raise will likely help ensure that Japanese consumer prices will keep rising and encourage the Bank of Japan to finally lift its negative-interest rate policy as early as this month.

Russia-Ukraine War: The Ukrainian military has reportedly launched drone strikes against at least three oil refineries deep in Russian territory near Moscow and St. Petersburg. Sources say the strikes, which were designed to starve the invading Russian military of resources, caused "significant damage." However, we suspect that even knocking out three refineries temporarily would have only a limited impact on Russia's warmaking capability and economy.

US Politics: After winning primary elections in several states yesterday, both President Biden and former President Trump have locked up enough of their respective party convention delegates to win their nominations for president. Given the candidates' ages and other factors, there is probably still some chance that either or both could be replaced at the head of their party ticket before November, but for now, it's a Biden-Trump race until we see if a third-party candidate emerges.

US Artificial Intelligence: If you're fascinated by the new Sora artificial intelligence tool for generating videos with simple prompts, the *Wall Street Journal*'s technology editor has a story today with new examples. Like some of the Sora-generated videos already released publicly, the videos are fascinating by themselves. In addition, they suggest how difficult it's becoming to discern real videos from those that might be artificially generated to influence political opinions or defraud consumers.

US Fiscal Policy: While yesterday's *Comment* discussed President Biden's overall proposed budget for the fiscal year starting October 1, today we give more detail on the proposed budget for defense, since one of our key theses is that global defense spending is likely to rise in the coming years. The proposed budget calls for total defense spending of $926.8 billion, up just 2.1% from FY 2024 because of a deal between the White House and Congress to cap spending. That marks a big slowdown from the estimate's rise of 10.7% in defense spending this year.

- Since the nominal 2.1% rise in defense spending is below the expected rise in prices, the proposed budget actually represents a small decline in the military's purchasing power.
- The main savings in the proposed defense budget comes in weapons procurement and research, development, testing, and evaluation. Spending on those items will fall even in nominal terms.
- In contrast, the proposal calls for a 4.5% increase in troop pay, partially offset by a small decline in troop counts and shifting more of the force from active duty to reserves.

- In any case, increasing US-China geopolitical tensions and healthy Congressional support for the military will likely result in a bigger increase in funding than in the proposed budget.

US Economic Releases

Demand for home loans remained steady for the second week in a row as borrowers took advantage of a significant improvement in financial conditions. According to the Mortgage Bankers Association (MBA) index, applications rose 7.1% in the week ending March 8. This sharp increase coincided with a major drop in interest rates, with the average 30-year fixed-rate mortgage falling 18 bps to 6.84%. As a result, the MBA's purchase index rose 4.7% from the prior week, while the refinance index surged 12.2%.

There are no other economic releases or Fed events scheduled for the rest of the day.

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								
New Zealand	Food Prices	m/m	Feb	-0.6%	1.2%		***	Equity bullish, bond bearish
South Korea	Unemployment Rate	m/m	Feb	2.6%	3.0%	3.0%	**	Equity and bond neutral
EUROPE								
Eurozone	Industrial Production WDA	y/y	Jan	-6.7%	0.2%	-3.0%	**	Equity bearish, bond bullish
UK	Industrial Production	y/y	Jan	0.5%	0.6%	0.8%	***	Equity and bond neutral
	Manufacturing Production	y/y	Jan	2.0%	2.3%	2.0%	**	Equity and bond neutral
	Trade Balance	m/m	Jan	-£3129m	-£2603m	-£3000m	**	Equity and bond neutral
	Visible Trade Balance	m/m	Jan	-£14515m	-£13989m	-£15000m	**	Equity and bond neutral
AMERICAS								
Mexico	International Reserves Weekly	w/w	8-Mar	$216,801	$213903m		*	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)	558	558	0	Down
3-mo T-bill yield (bps)	523	523	0	Up
U.S. Sibor/OIS spread (bps)	533	534	-1	Down
U.S. Libor/OIS spread (bps)	534	534	0	Down
10-yr T-note (%)	4.16	4.15	0.01	Up
Euribor/OIS spread (bps)	393	393	0	Flat
Currencies	**Direction**			
Dollar	Flat			Flat
Euro	Up			Up
Yen	Down			Down
Pound	Up			Up
Franc	Flat			Down

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.

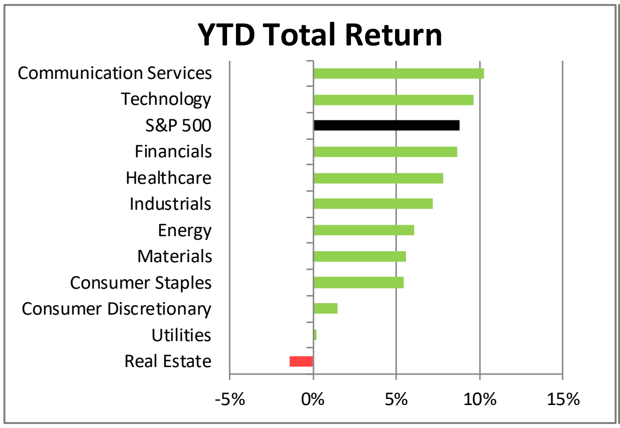
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$82.94	$81.92	1.25%	
WTI	$78.64	$77.56	1.39%	
Natural Gas	$1.68	$1.71	-2.04%	
Crack Spread	$31.98	$31.58	1.26%	
12-mo strip crack	$25.42	$25.17	0.98%	
Ethanol rack	$1.76	$1.75	0.33%	
Metals				
Gold	$2,163.04	$2,158.34	0.22%	
Silver	$24.31	$24.14	0.67%	
Copper contract	$399.80	$393.20	1.68%	
Grains				
Corn contract	$439.75	$441.75	-0.45%	
Wheat contract	$545.25	$547.50	-0.41%	
Soybeans contract	$1,184.00	$1,196.00	-1.00%	
Shipping				
Baltic Dry Freight	2,315	2,377	-62	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.0		
Gasoline (mb)		-2.2		
Distillates (mb)		-1.1		
Refinery run rates (%)		0.7%		
Natural gas (bcf)		-37		

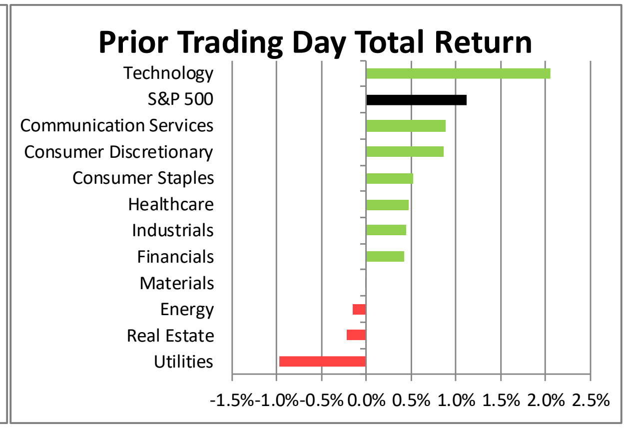
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in the northern Pacific and Great Plains region, with cooler-than-normal temperatures for the East Coast, Midwest, and Deep South. The precipitation outlook calls for wetter-than-normal conditions in the South and the Great Plains to spread throughout the rest of the country in the latter half of the forecast period.

Data Section

US Equity Markets – (as of 3/12/2024 close)

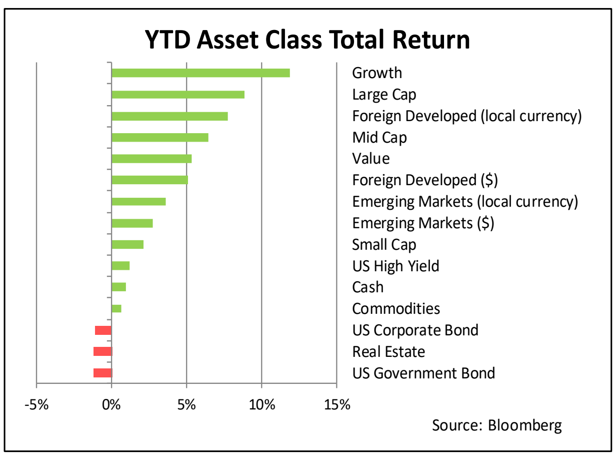




(Source: Bloomberg)

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 3/12/2024 close)

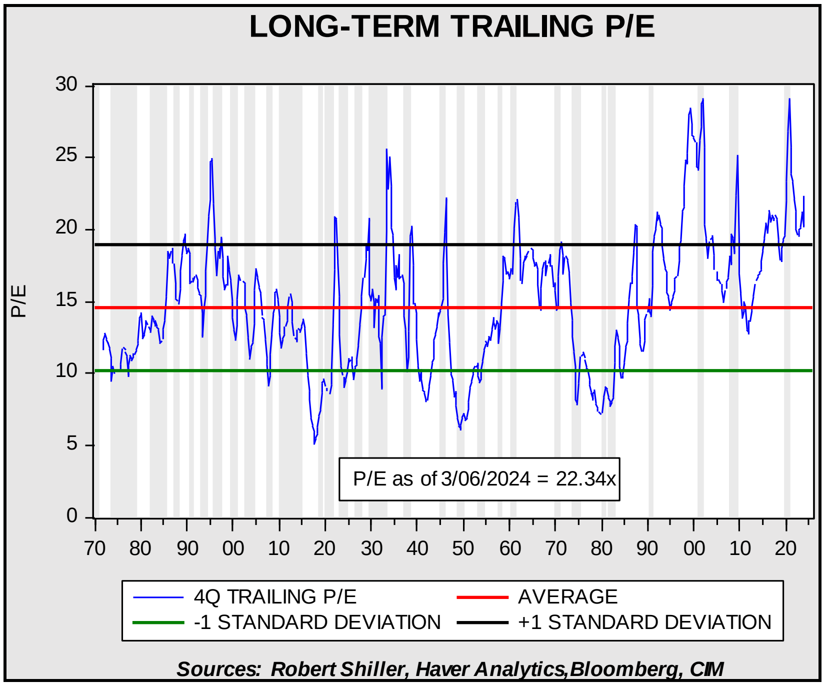


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

March 6, 2024



Based on our methodology,[1] the current P/E is 22.34x, up 0.10x from our last report. The improvement in the multiple reflects an increase in the stock price index, outweighing a modest increase in earnings.

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.