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 15, 2024—9:30 AM EDT] Global equity markets are mostly higher 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 down 2.1%. Chinese markets were higher, with the Shanghai Composite up 0.5% from its previous close and the Shenzhen Composite up 0.9%. US equity index futures are signaling a higher open.

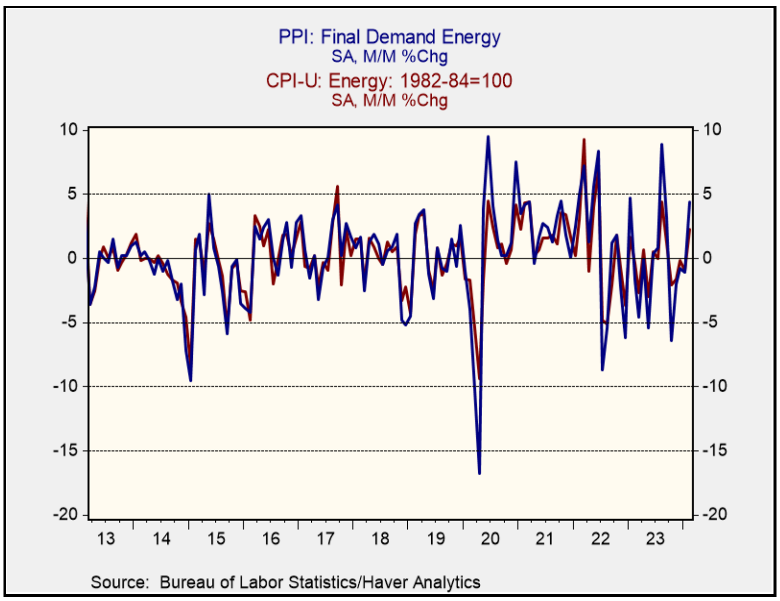
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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"

Good morning! Equities are off to a so-so start as investors brace for next week's FOMC meeting. In sports news, the Champions League matchups are set, with a highly anticipated clash between Real Madrid and Manchester City in the quarterfinals. Today's *Comment* delves into our analysis of the recent inflation reports, examines the potential impact of overnight reverse repo rates on the FOMC's policy deliberations, and provides an overview of the upcoming Russian elections scheduled for the weekend. We also include, as always, a roundup of domestic and international data.

Double Dose of Inflation Trouble: Despite a negative market reaction to the latest inflation report, a closer look at the data reveals a more nuanced picture.

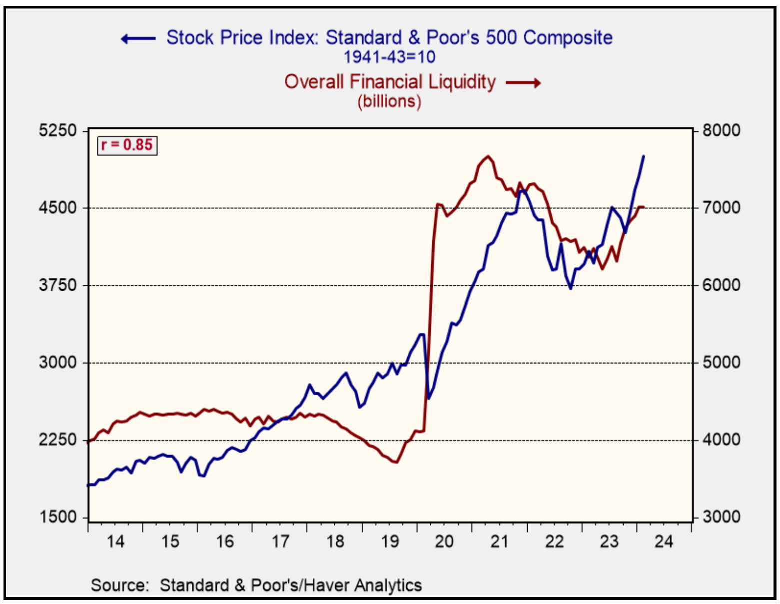
- February's faster-than-expected rise in wholesale prices is another indication that inflationary pressures remain stubbornly persistent. The producer price index (PPI) in February increased more than expected, jumping from 0.3% to 0.6%, according to the Bureau of Labor Statistics. This aligns with concerns about inflation after the consumer price index (CPI) also rose faster than anticipated earlier this week. Similar to the PPI, the CPI climbed from 0.3% in January to 0.4% in February. Following the PPI report, the 10-year Treasury yield rose 10 bps, while the stock market dipped with the S&P 500 and NASDAQ both falling about 0.7%.
- Concerns in the market about resurgent inflation might be exaggerated. Recent data suggests that inflationary pressures are mainly driven by temporary factors, most notably the significant increase in energy prices. In February, the PPI witnessed a 4.4% surge in energy prices while the CPI reported a 2.3% rise, highlighting the importance of this trend. Additionally, the rise in fuel prices also resulted in higher transportation costs, which further contributed to the unusual increase in both price indexes. In essence, the factors that inflated prices were largely one-time events and may not signal sustained price pressures.



- The hotter-than-expected inflation report likely strengthens the case for the Fed to delay a rate cut. Futures markets currently predict rate cuts in either June or July, which aligns somewhat with Atlanta Fed President Raphael Bostic's recent comments. The upcoming FOMC meeting in April, with its updated economic projections, will provide a clearer picture of the committee's policy path for the rest of the year. We expect them to either maintain their current forecast of three rate cuts this year or potentially revise it down to two.

Liquidity and the Stock Market: While a recent cash injection will bolster the financial system, it's unlikely to prevent a potential liquidity crisis later in the year.

- The Federal Reserve's overnight reverse repo (ON RRP) facility balance has surged to $521.7 billion. This increase is likely temporary, but it gives policymakers some breathing room to decide when to slow down quantitative tightening (QT). The surge reflects investors who are seeking safe, short-term parking for their cash due to a temporary pause in Treasury settlements. However, with more attractive options now available in other investments like [money market fund repos, banks have been diverting funds away from the facility](). At the current pace, it is expected that ON RRP will run out of cash by midyear.
- Overnight funding levels are a critical gauge of excess reserves in the banking system. A significant drop can signal potential market stress. As the chart below illustrates, the recent liquidity surge has likely buoyed risk assets. However, the FOMC is grappling with the optimal level of reserves, as it directly impacts the timing of QT unwinding. Governor Christopher Waller downplayed concerns about the zero-balance ON RRP, while Dallas Fed President Lorie Logan expressed anxieties about potential future liquidity issues.

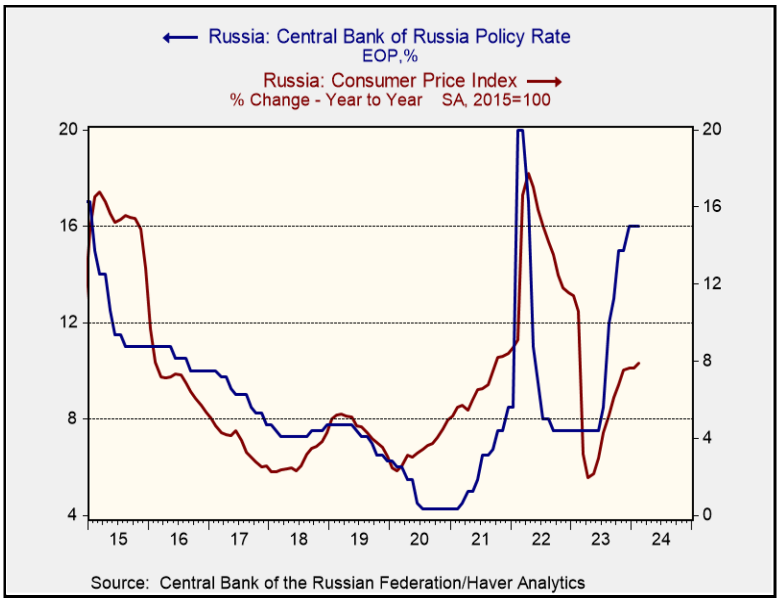


- The Federal Reserve is expected to discuss winding down its QT program at its upcoming meeting, even before the ON RRP facility is drained completely. However, the specific details of this shift remain unclear. While the expectation is for rate hikes to end before QT stops altogether, there's a possibility the meeting could lead to a slowdown in the pace of tightening from the current maximum of $60 billion in Treasuries and $35 billion in mortgage-backed securities per month. This slowdown could alleviate some market liquidity concerns and potentially boost stock prices.

Russian Elections: While Russia's upcoming presidential election is likely a formality, the outcome could reveal the true impact of the war in Ukraine on Putin's domestic standing.

- Russian President Vladimir Putin is poised to secure a fifth consecutive term without encountering significant challenges to his leadership, prompting the Kremlin to anticipate a resounding victory. Recent polls indicate a remarkable 86% approval rating for Putin, marking the highest level since 2016. However, despite his widespread popularity, there are concerns that some segments of the populace may seek to express discontent with the Russian leader. A common strategy among voters is to converge at the polls on Sunday and collectively support opposition candidates by casting their ballots simultaneously, aiming solely to spotlight their opposition stance.

- These elections occur amidst a critical juncture in the war in Ukraine. With potential territorial gains, Putin seems intent on exploiting his perceived advantage to solidify his position. Earlier this week, Putin hinted at a willingness to negotiate an end to the conflict in Ukraine in return for security assurances. Russia's resilient economy is nonetheless being strained by the war's escalating costs, particularly with declining oil revenues. This fiscal pressure likely explains the Kremlin's consideration of tax hikes, in a move that could face pushback given the country's already high borrowing costs and elevated inflation.

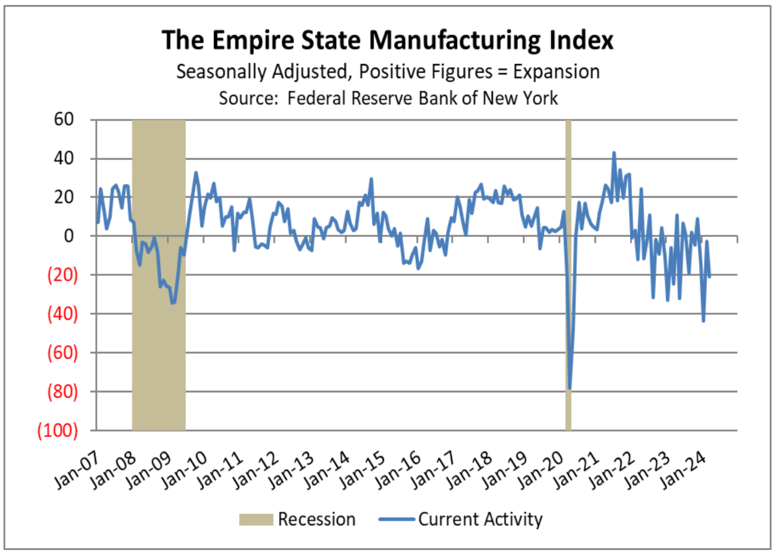


- Another electoral victory for Putin may not startle the markets, but his post-election decisions are expected to draw significant attention. In remarks made on Wednesday, Putin stated that while he currently views the deployment of tactical nuclear weapons as unnecessary, Russia maintains readiness to employ them if it senses a threat to its sovereignty. This highlights the growing importance of nuclear deterrence in national security, especially with recent calls for a stronger European defense in response to Russia. Consequently, we expect continued high demand for uranium and related materials in the coming years.

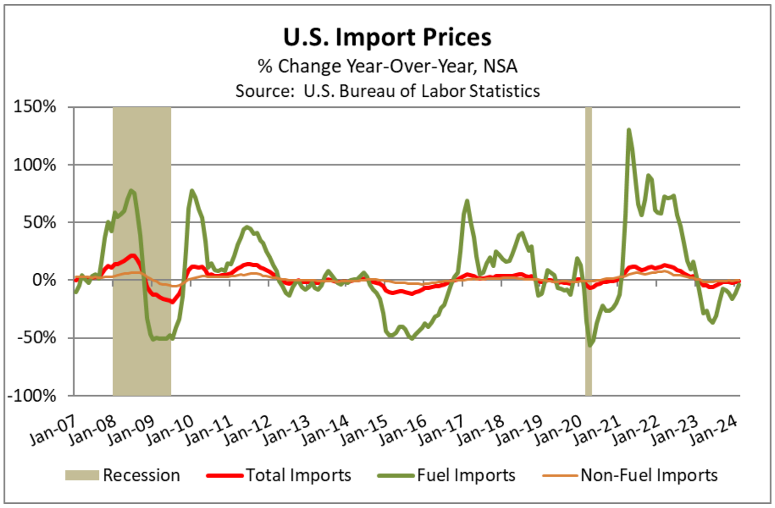
Other News: China is looking to stimulate its economy by boosting its tourism sector. This move suggests the country may be seeking to improve relations with the West as it grapples with an economic slowdown. Supporters of free-market principles have backed Nippon Steel's acquisition of US Steel, but the controversy surrounding the deal highlights growing populist sentiment in the United States. [Senate Majority Leader Chuck Schumer (D-NY) has pushed for new elections in Israel](), signaling mounting impatience in the US with Israeli President Benjamin Netanyahu's management of the conflict.

US Economic Releases

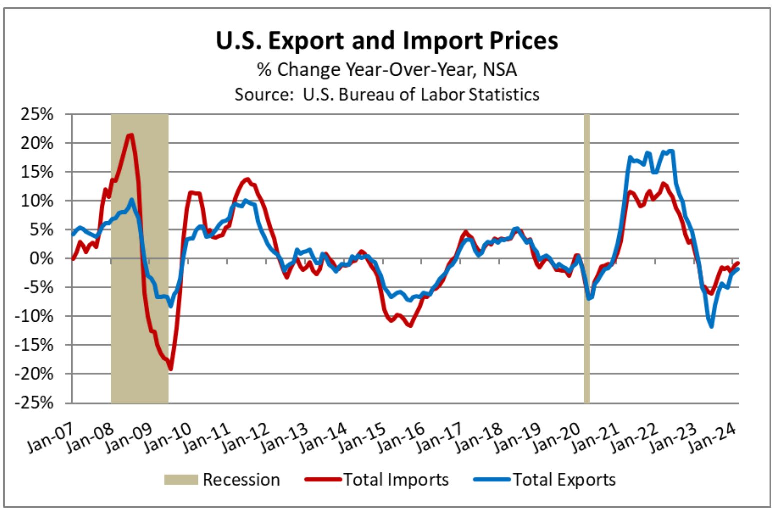
The New York FRB said its March ***Empire State Manufacturing Index*** fell to a seasonally adjusted -20.9, far worse than the expected reading of -7.0 and the February reading of -2.4. This index is designed so that positive readings point to expanding factory activity in New York state. At its current level, the index suggests New York manufacturing is still contracting. The chart below shows how the index has fluctuated since just before the Great Financial Crisis.



Separately, February ***import prices*** were up 0.3% from the previous month, matching expectations and marking a welcome slowdown from the 0.8% increase in January. Of course, import prices are often driven by volatility in the petroleum fuels category, and that was the case last month, too. February ***import prices excluding fuels*** were up a more moderate 0.2%. That was at odds with an anticipated decline of 0.2%, but it was slower than the 0.6% rise in the previous month. Overall import prices in February were down 0.8% year-over-year, while import prices excluding fuels were down 0.5%. The following chart shows the year-over-year change in import prices since just before the GFC.



According to the report, ***export prices*** in February were down 1.8% from one year earlier, in large part because of the key agriculture category. Comparing the annual change in export prices versus import prices provides a sense of the U.S. "terms of trade," or the relative advantage or disadvantage the country is facing because of trends in international trade prices. The chart below compares the year-over-year change in U.S. export and import prices since just before the GFC.



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 Michigan Consumer Sentiment	m/m	Mar P	77.1	76.9	***
10:00	U. of Michigan Current Conditions	m/m	Mar P	79.7	79.4	**
10:00	U. of Michigan Future Expectations	m/m	Mar P	75.1	75.2	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Mar P	3.1%	3.0%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Mar P	2.9%	2.9%	*
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	Tertiary Industry Index	m/m	Jan	0.3%	0.5%	0.1%	**	Equity and bond neutral
New Zealand	BusinessNZ Manufacturing PMI	m/m	Feb	49.3	47.3	47.5	***	Equity bullish, bond bearish
South Korea	Export Price Index	y/y	Feb	4.2%	3.6%		*	Equity and bond neutral
	Import Price Index	y/y	Feb	0.2%	0.5%		*	Equity and bond neutral
China	New Yuan Loans	m/m	Feb	6370.0b	4920.0b		**	Equity and bond neutral
	Money Supply M2	y/y	Feb	8.7%	8.7%	8.8%	***	Equity and bond neutral
	Money Supply M1	y/y	Feb	1.2%	5.9%	2.0%	*	Equity and bond neutral
	Aggregate Financing CNY	m/m	Feb	8060.0b	6501.7b		**	Equity and bond neutral
India	Trade Balance	m/m	Feb	-$18710m	-$17491m	-$18650m	*	Equity and bond neutral
	Exports	y/y	Feb	11.9%	3.1%		**	Equity and bond neutral
	Imports	y/y	Feb	12.2%	3.0%		**	Equity and bond neutral
EUROPE								
Germany	Current Account Balance	m/m	Jan	29.7b	31.6b		**	Equity and bond neutral
France	CPI	y/y	Feb F	3.0%	2.9%	2.9%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Feb F	3.2%	3.1%	3.1%	**	Equity and bond neutral
Italy	CPI, EU Harmonized	y/y	Feb F	0.8%	0.9%	0.9%	***	Equity and bond neutral
	Retail Sales	y/y	Jan	1.0%	0.2%		**	Equity bullish, bond bearish
Russia	Money Supply, Narrow Definition	w/w	8-Mar	18.06t	17.98t		*	Equity and bond neutral
	Gold and Forex Reserves	m/m	7-Mar	$591.2b	$581.1b		***	Equity and bond neutral
AMERICAS								
Canada	Manufacturing Sales	m/m	Jan	0.2%	-1.1%	0.4%	**	Equity and bond neutral
Brazil	IBGE Services Volume	y/y	Jan	4.5%	-1.9%	1.8%	*	Equity bullish, bond bearish

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)	559	559	0	Down
3-mo T-bill yield (bps)	522	524	-2	Up
U.S. Sibor/OIS spread (bps)	533	533	0	Down
U.S. Libor/OIS spread (bps)	534	534	0	Down
10-yr T-note (%)	4.27	4.29	-0.02	Up
Euribor/OIS spread (bps)	393	394	-1	Down
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Up			Flat
Yen	Down			Down
Pound	Flat			Up
Franc	Up			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
PBOC 1-Year Med-Term Lending Facility	2.500%	2.500%	2.500%	On Forecast
PBOC 1-Year Med-Term Lending (Bil.)	387.0b	500.0b	550.0b	Below 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.

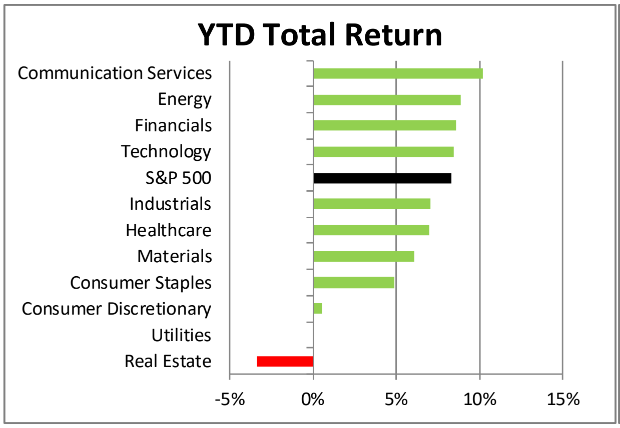
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$84.96	$85.42	-0.54%	
WTI	$80.79	$81.26	-0.58%	
Natural Gas	$1.76	$1.74	1.26%	
Crack Spread	$32.42	$32.29	0.42%	
12-mo strip crack	$26.01	$26.10	-0.36%	
Ethanol rack	$1.80	$1.80	0.13%	
Metals				
Gold	$2,166.92	$2,162.19	0.22%	
Silver	$25.15	$24.82	1.34%	
Copper contract	$409.55	$404.55	1.24%	
Grains				
Corn contract	$433.50	$433.75	-0.06%	
Wheat contract	$535.25	$532.25	0.56%	
Soybeans contract	$1,188.50	$1,195.25	-0.56%	
Shipping				
Baltic Dry Freight	2,350	2,370	-20	
DOE Inventory Report				
	Actu-9al	**Expected**	**Difference**	
Crude (mb)	-1.5	1.0	-2.5	
Gasoline (mb)	-5.7	-2.2	-3.5	
Distillates (mb)	0.89	-1.05	1.94	
Refinery run rates (%)	1.9%	0.7%	1.2%	
Natural gas (bcf)	-9	-2	-7	

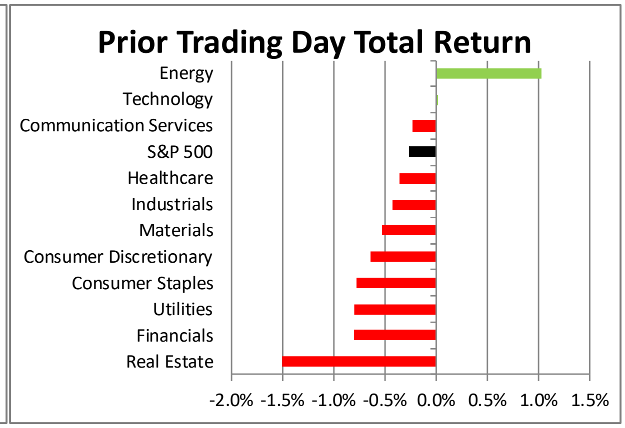
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in southern Texas and southern Florida, with cooler-than-normal temperatures in the Northern Tier states. The precipitation outlook calls for wetter-than-normal conditions in virtually the entire country.

Data Section

US Equity Markets – (as of 3/14/2024 close)

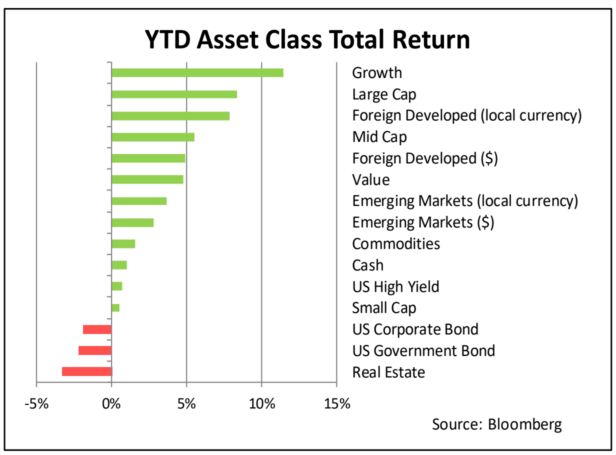




(Source: Bloomberg)

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 3/14/2024 close)

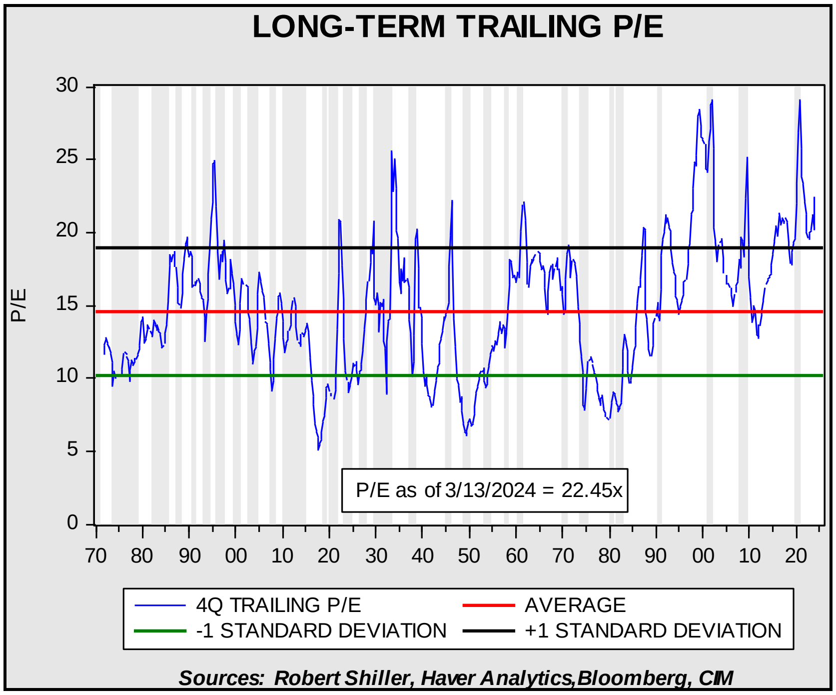


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 14, 2024



Based on our methodology,[1] the current P/E is 22.45x, up 0.11x 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.