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 19, 2024—9:30 AM EDT] Global equity markets are generally lower 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 1.1%. Chinese markets were lower, with the Shanghai Composite down 0.7% from its previous close and the Shenzhen Composite down 0.4%. 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* (3/18/2024) (with associated podcast): "The Fed's Other Policy Tool"
- *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 confirmation that today the Bank of Japan ended its many years of negative interest rates. We next review a range of other international and US developments with the potential to affect the financial markets, including reports that the European Union is preparing to impose punitive tariffs on grain and grain products from Russia and Belarus, and a preview of the Federal Reserve's latest policy meeting starting today.

Japan: As flagged in our *Comment* yesterday, the Bank of Japan today ended its eight-year policy of negative interest rates, dismantled its yield curve controls, and scrapped most other emergency policies it had adopted to fight the country's past economic stagnation and deflation. It set the new target for benchmark short-term interest rates at 0.0% to 0.1%. Just as important, the central bank said it will stop setting a yield target for 10-year Japanese government bonds and cease buying stocks, real estate investment trusts, and other unorthodox investments.

- Despite taking the momentous step of ending their negative interest-rate era, the policymakers insisted that overall monetary policy will remain accommodative for the time being in order to support economic growth. Indeed, the policymakers said they would continue buying Japanese government bonds.
- Since the move was well telegraphed over the last several months, today's announcement has had little impact on financial markets. Japanese stocks today appreciated modestly, and the yen (JPY) weakened 0.9% to 150.44 per dollar.

China-Hong Kong: The Hong Kong municipal government today unanimously passed a controversial new national security law to supplement the security law imposed by Beijing on the territory in 2020 and align the city's security rules with those of mainland China. Among the tough new provisions in the law, treason could be punished by life in prison, and sedition could be punished by two to seven years in jail.

- Stealing or disclosing "state secrets" could be punished by up to 10 years in jail.
- Importantly, the law broadens the definition of state secrets to include information about the economic, technological, or scientific development of Hong Kong or mainland China.
- The new law has therefore struck fear in the hearts of foreigners working in Hong Kong, who now worry that they could more easily be arrested merely for handling business data. Those concerns are likely to make the new law another point of tension between China and the West and make Hong Kong a less attractive place to do business.

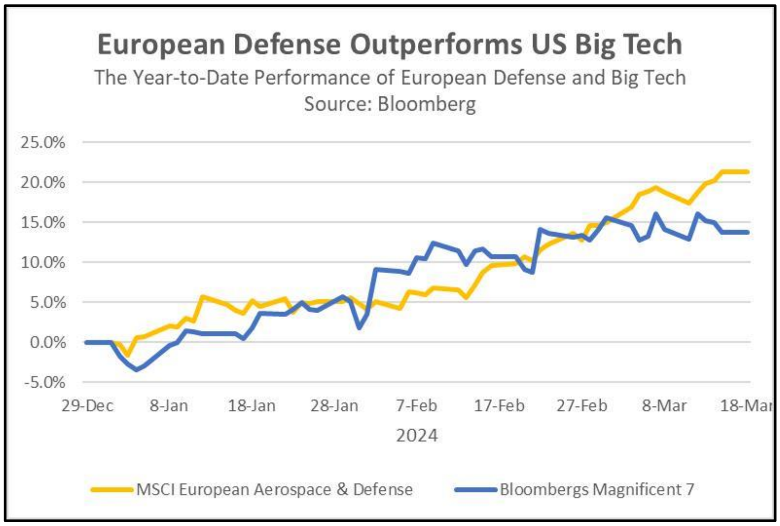
European Union-Russia-Belarus: The European Commission is reportedly preparing to impose punitive tariffs on Russian and Belarusian grain and grain products for the first time. The plans reportedly call for tariffs of 95 EUR per ton on the affected grains, which would raise their price by about 50% and effectively push them out of the EU market. The move would in large part be punishment for Russia's invasion of Ukraine and its repression at home.

- Nevertheless, the move is also apparently an effort to respond to Europe's restive farmers, who have been complaining not only about EU regulations but also about surging imports from the east amid the disruptions of the war in Ukraine.
- Even though Russian grain and grain products only account for about 1% of the EU market, the tariffs can be presented as protection for farmers' economic interests.

European Defense Industry: In a report last week, the North Atlantic Treaty Organization said 11 of the alliance's current 32 members met the NATO standard of spending at least 2% of gross domestic product on defense in 2023. As a group, the European NATO members met the 2% standard, helped by especially high defense spending in countries like Poland and Greece. The report also said two-thirds of the NATO countries should achieve the 2% standard in 2024.

- The total European NATO defense spending of $470 billion in 2023 helps explain the strong performance of European defense stocks over the last year, which we mentioned in our *Comment* yesterday.

- To help illustrate the recent strong performance of European defense stocks, the chart below shows that they have actually outperformed the US's vaunted Magnificent 7 large-cap technology stocks so far in 2024.



US Monetary Policy: The Federal Reserve's policymaking committee begins its latest meeting today, with its decision due on Wednesday at 2:00 PM EDT. The Federal Open Market Committee is widely expected to hold the benchmark fed funds interest-rate target at its current range from 5.25% to 5.50%. The first cut is now expected in June. Nevertheless, the policymakers could signal an earlier or later date for their first cut and may also announce an end to their quantitative tightening policy or other changes in their approach to policy,

US Fiscal Policy: The White House and Congressional negotiators last night resolved a last-minute dispute over border enforcement spending, setting the stage for Congress to pass the remaining six appropriations bills for the remainder of the federal fiscal year before the current stop-gap spending bill runs out on Friday. The process of getting those bills passed and signed into law could still lead to a partial shutdown of the government, but it appears any shutdown would last at most a few days and would not be very disruptive.

US Artificial Intelligence Industry: Reports yesterday said technology giants Apple and Google are in talks to include Google's generative AI system Gemini into Apple's iPhones. The news sparked significant increases in each company's stock price yesterday, based on hopes that such a deal would reinvigorate Apple's iPhone franchise and give Google added scale in the evolving AI "arms race." Nevertheless, we note that such an outcome assumes that regulators approve any such deal.

- Separately, AI chipmaker Nvidia also saw its stock price jump as it prepared to announce a new generation of AI processors that will be much faster and bigger than its current blockbuster H100 series.

- The new chips from Nvidia are expected to be available later this year, helping ease the current shortage of H100 chips.

US Nuclear Energy Industry: TerraPower, a company started by Microsoft founder Bill Gates, said it will begin building the nation's first liquid-sodium cooled nuclear reactor by June, with expectations that it will only cost half as much as a conventional water-cooled reactor and be generating electricity by 2030. The announcement shows how the US is trying to compete in building a new generation of cheaper, more efficient nuclear generating plants using innovative cooling technologies and small, modular designs to cut costs and shorten construction periods.

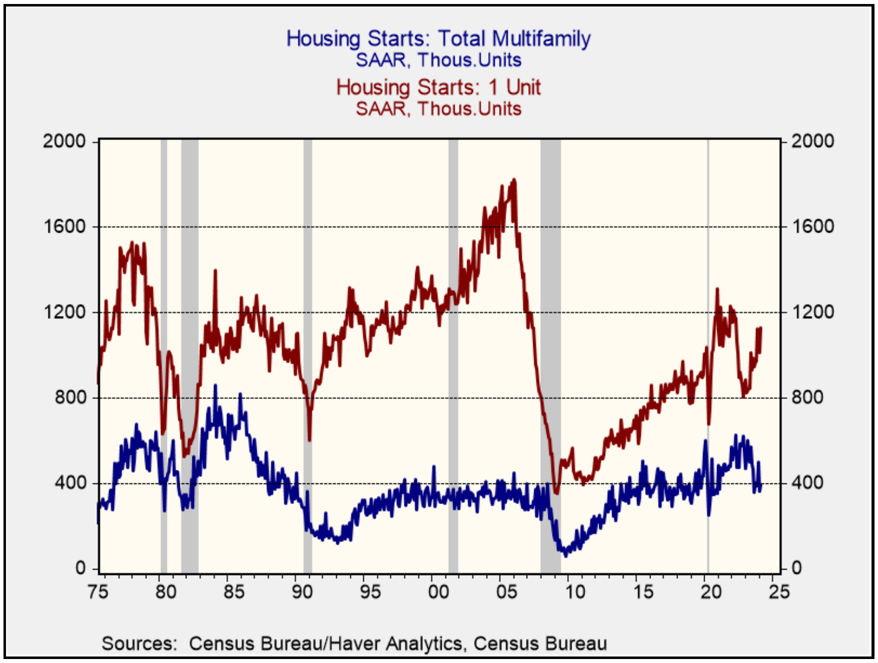
US Auto Industry: The United Auto Workers filed a petition yesterday with the National Labor Relations Board requesting a unionization vote of the 4,000 or so workers at Volkswagen's car factory in Chattanooga, Tennessee. According to the UAW, a "supermajority" of workers at the plant have signed a petition expressing an interest in joining the union. If the unionization effort is successful, it would mark the first organization of a US auto plant not affiliated with one of the Detroit Three automakers.

US Defense Industry: As the US struggles to boost its output of nuclear-powered submarines to counter rising threats from the China/Russia geopolitical bloc, Newport News Shipbuilding, a unit of defense giant Huntington Ingalls, has announced that it is trying to hire 3,000 skilled tradesmen this year and 19,000 within the next decade. Meanwhile, the Hampton Roads Workforce Council warned that the Virginia region's maritime shipbuilding vacancies could rise to 40,000 by 2030 if more workers can't be drawn into the market.

- The Newport News announcement highlights the US's rising demand for skilled tradespeople, such as welders and pipefitters. The rise in demand reflects factors such as near-shoring production within the US, increased factory construction, and rising defense budgets.
- In contrast, the decades-long advantage of college-educated workers continues to be eroded. The result is likely to be a rebalancing of opportunities in the labor market, with skilled tradesmen now enjoying more demand vis-á-vis the college educated.

US Economic Releases

Residential construction surged in February as builders capitalized on lower borrowing costs. The US Census Bureau reported that housing starts reached a seasonally adjusted annual rate of 1.52 million units last month, exceeding analyst expectations of 1.42 million and surpassing January's figure of 1.37 million. Additionally, building permits, which signal future construction activity, climbed to an annual pace of 1.52 million units, in line with market expectations.



In February, single-family home starts rose to an annualized rate of 1.03 million, while multi-family home starts reached 0.487 million.

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**
16:00	Total Net TIC Flows	m/m	Jan		$139.8b	**
16:00	Net Long-Term TIC Flows	m/m	Jan		$160.2b	**
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
10:00	FOMC Begins Two-Day Meeting	Federal Reserve Board				

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	Industrial Production	y/y	Jan F	-1.5%	-1.5%		***	Equity and bond neutral
	Capacity Utilization	m/m	Jan	-7.9%	0.2%		***	Equity and bond neutral
EUROPE								
Eurozone	ZEW Survey Expectations	m/m	Mar	33.5	25.0		**	Equity bullish, bond bearish
Germany	ZEW Survey Expectations	m/m	Mar	31.7	19.9	20.5	**	Equity bullish, bond bearish
	ZEW Survey Current Situation	m/m	Mar	-80.5	-81.7	-82.0	**	Equity bullish, bond bearish
Switzerland	Real Exports	m/m	Feb	0.2%	-0.5%		*	Equity and bond neutral
	Real Imports	m/m	Feb	3.8%	-3.9%		*	Equity bullish, bond bearish
AMERICAS								
Canada	Industrial Prices	m/m	Feb	0.7%	-0.1%	0.0%	**	Equity bullish, bond bearish
	Raw Material Prices	m/m	Feb	2.1%	1.2%	0.6%	*	Equity bearish, bond bullish
Mexico	Aggregate Supply and Demand	y/y	4Q	2.6%	2.7%	2.5%	*	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)	559	559	0	Down
3-mo T-bill yield (bps)	520	522	-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 (%)	4.32	4.33	-0.01	Up
Euribor/OIS spread (bps)	393	393	0	Down
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Down
Yen	Down			Down
Pound	Down			Down
Franc	Flat			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
BOJ Policy Balance Rate	0.100%	-0.100%	-0.100%	Above Forecast
BOJ 10-yr Yield Target	0.000%	0.000%	0.000%	On Forecast
RBA Cash Rate Target	4.350%	4.350%	4.350%	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.

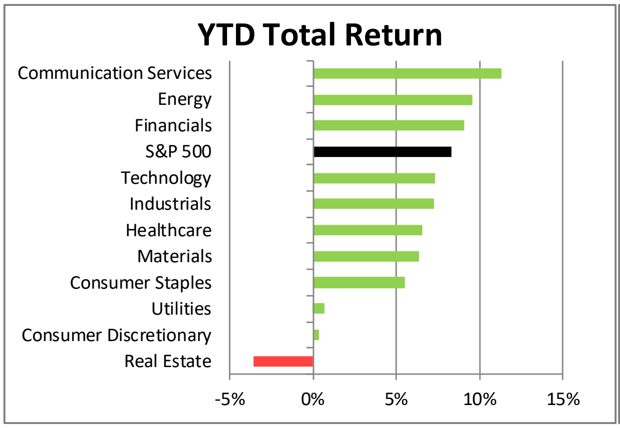
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$86.87	$86.89	-0.02%	
WTI	$82.79	$82.72	0.08%	
Natural Gas	$1.73	$1.70	1.47%	
Crack Spread	$32.91	$32.77	0.42%	
12-mo strip crack	$26.41	$26.39	0.08%	
Ethanol rack	$1.78	$1.79	-0.25%	
Metals				
Gold	$2,155.89	$2,160.36	-0.21%	
Silver	$24.96	$25.04	-0.31%	
Copper contract	$408.25	$413.00	-1.15%	
Grains				
Corn contract	$437.00	$436.00	0.23%	
Wheat contract	$543.50	$542.75	0.14%	
Soybeans contract	$1,188.25	$1,187.75	0.04%	
Shipping				
Baltic Dry Freight	2,419	2,374	45	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.5		
Gasoline (mb)		-2.0		
Distillates (mb)		-0.50		
Refinery run rates (%)		0.6%		
Natural gas (bcf)		-2		

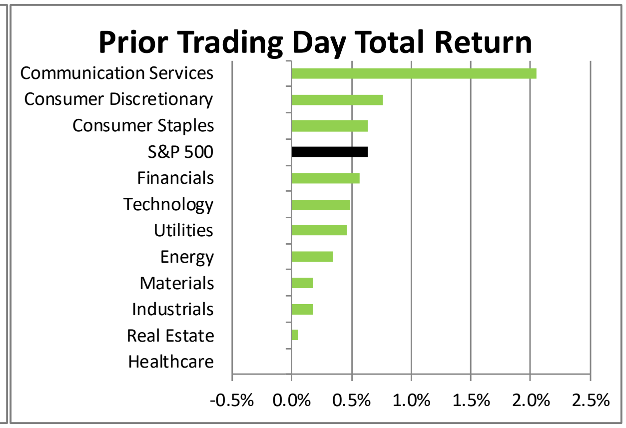
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in southern Texas and southern Florida to recede into the New England region, with cooler-than-normal temperatures expected for the rest of the country. The precipitation outlook calls for wetter-than-normal conditions throughout most of the country, with dry conditions expected in southern Texas.

Data Section

US Equity Markets – (as of 3/18/2024 close)

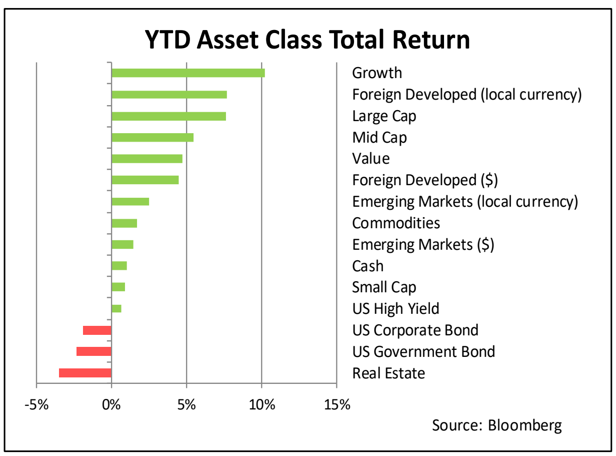




(Source: Bloomberg)

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 3/18/2024 close)

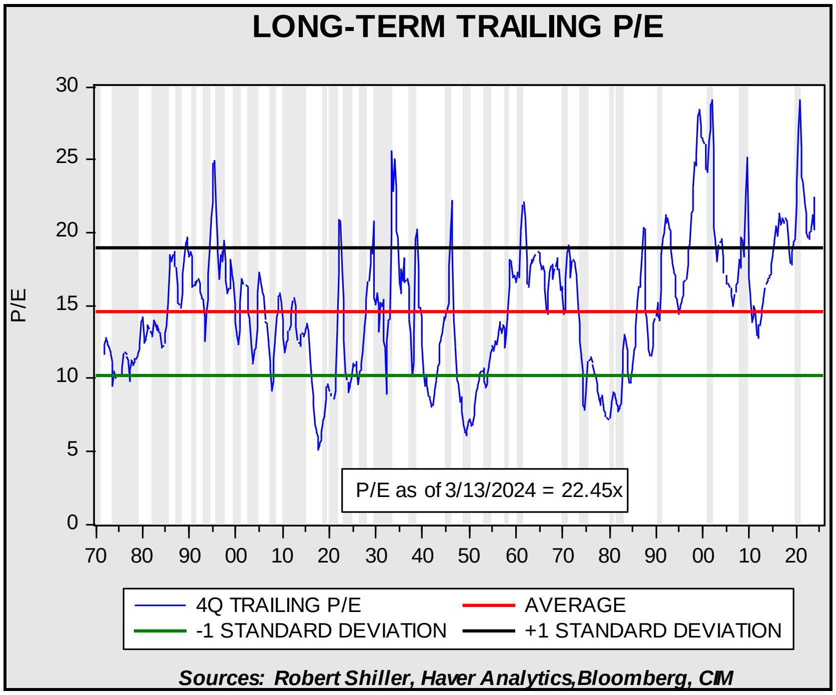


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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.