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 1, 2024—9:30 AM EST] Global equity markets are generally higher 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 up 0.1%. Chinese markets were higher, with the Shanghai Composite up 0.4% from its previous close and the Shenzhen Composite up 1.1%. Conversely, US equity index futures are signaling a lower open.

With 489 companies having reported so far, S&P 500 earnings for Q4 are running at $57.90 per share compared to estimates of $55.15, which is up 1.6% from Q3 2023. Of the companies that have reported thus far, 76.0% have exceeded expectations, while 18.0% have fallen short of expectations.

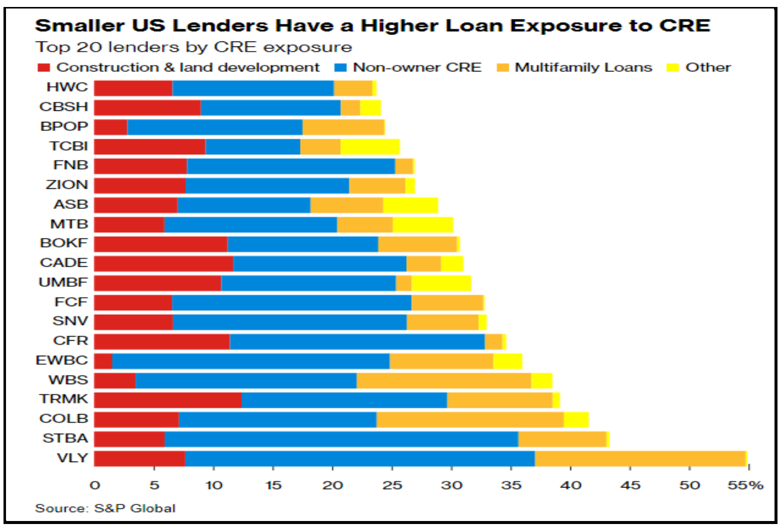
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (2/26/2024) (with associated podcast): "Posen vs. Pettis"
- *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* (2/20/2024) (with associated podcast): "Who Wants US Treasurys?"
- *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! Financial markets are off to a sluggish start today. In sports news, University of Iowa star and top WNBA prospect Caitlin Clark declared for the draft. In today's *Comment*, we delve into the impact of the NYCB turmoil, analyze the latest inflation data, and explore the possibility of tightening monetary policy at the Bank of Japan (BOJ). We conclude, as always, with a summary of recent domestic and international data.

More Regional Bank Pain: Regional banks are under increased scrutiny following turmoil at New York Community Bank, raising concerns about a potential financial crisis linked to commercial real estate.

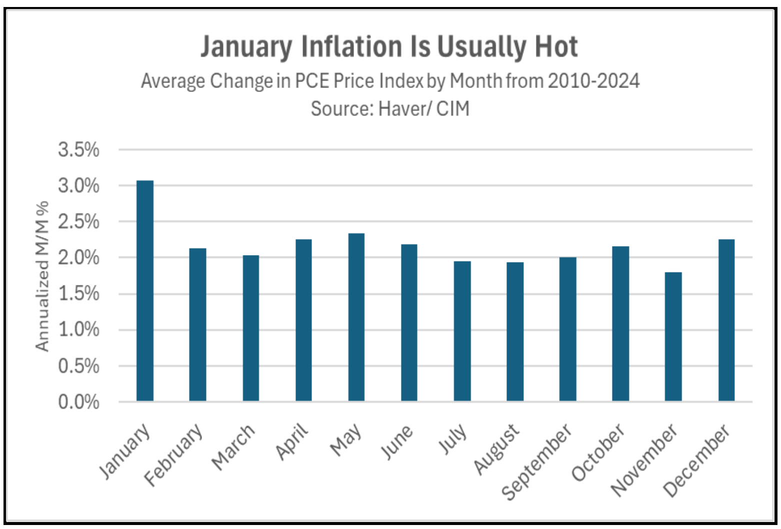
- On Thursday, NYCB announced a $2.4 billion earnings hit, citing a "material weakness" in its loan review process. The bank's CEO resigned and NYCB revealed it would miss its annual report deadline due to "ineffective oversight and risk management." This news follows a prior announcement of a $552 million loan loss provision, 10 times greater than analysts' expectations. The disclosure raises concerns about potential defaults on commercial real estate loans, sending NYCB's stock down 19% in after-hours trading and potentially sparking broader sell-offs in similarly exposed banks on Friday.
- While the commercial real estate market's vulnerabilities are widely recognized, its potential to trigger a major financial crisis remains the subject of heated debate. According to research from the American Enterprise Institute, banks have accumulated $1.5 trillion in unrealized mark-to-market interest losses on fixed income securities since September 2023. This could erode their ability to absorb potential loan losses in the event of a downturn in the commercial real estate market, adding to concerns about financial stability. However, it's important to acknowledge the Federal Reserve's ongoing efforts to collaborate with banks to address these concerns. Thus, there is also a strong possibility that the central bank has a contingency plan in case of an emergency.



- While the Federal Reserve's primary mandate prioritizes price stability and maximum employment, its historical role in preventing bank panics remains relevant in the context of rising risks within the regional banking system. The expected termination of the Fed's Banking Term Funding Program alongside these concerns could incentivize policymakers to reconsider their monetary policy stance. So far, the Fed has only hinted at potentially lowering rates, while maintaining its quantitative tightening. Based on these factors, we believe a rate reduction of at least 50 basis points could be warranted if the situation worsens, and potentially even more if a significant crisis erupts.

The January Spike: January's hot inflation raises concerns that the Federal Reserve might delay rate cuts, but historical trends suggest a wait-and-see approach is likely.

- The core Personal Consumption Expenditures (PCE) Price Index, the Federal Reserve's preferred inflation gauge, saw a notable 0.4% uptick in January. Despite this substantial rise, the year-over-year change in the price index actually dipped from 2.94% to 2.85%. While this moderation might suggest a momentary relief, it has also sparked concerns about the Fed's ability to effectively combat inflationary pressures. Policymakers seem to put little emphasis on the report. Atlanta and Chicago Fed Presidents Raphael Bostic and Austan Goolsbee suggested that the recent inflation report has not influenced their views on monetary policy.
- Policymakers' dismissal of the report might be linked to the seasonal nature of inflation data. Historically, January tends to have the highest inflation rate compared to other months, often around 3.1% as the chart below demonstrates. This sharp increase is due to what some economists refer to as "residual seasonality," in which prices increase due to changing out of contracts. This year's inflation increase notably surpassed the historical average, hitting an annualized rate of 5.2%, though it marks an improvement over the preceding two Januarys, which recorded increases of 6.2% and 5.7%, respectively.



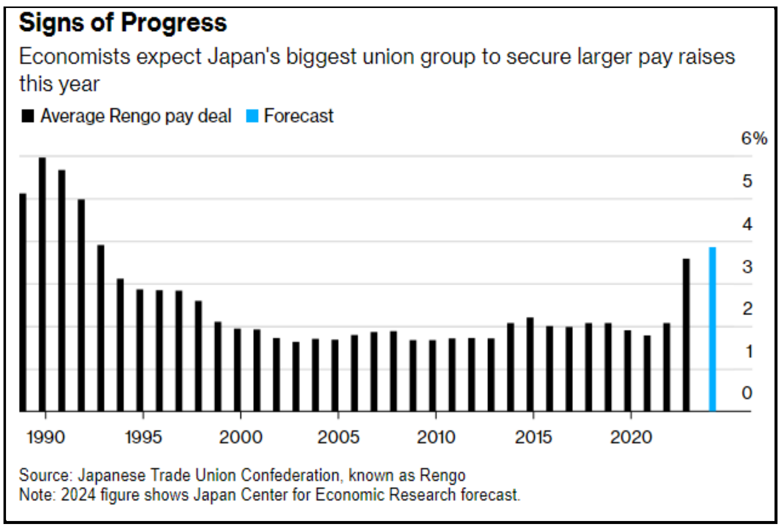
- Wages undoubtedly wield significant influence over inflation. The recent surge in strikes and a constricted labor market have empowered workers to negotiate higher earnings from employers, possibly fueling price pressures. However, there exists a trade-off between increased wages and employment levels. January witnessed a notable increase in WARN notices, which are expected to filter into employment figures over the next few months. While we anticipate most layoffs to be concentrated in finance and tech, it wouldn't be surprising to see other industries affected as well.

BOJ Ready for Lift Off: Despite the risk of recession, the Bank of Japan (BOJ) continues to signal its intent to exit its ultra-accommodative monetary policy.

- On Thursday, BOJ board member Hajime Takata declared that the central bank's price target is "finally coming into sight." His remarks add to the growing indication that

Japanese policymakers are prepared to begin phasing out negative interest rates and yield curve control. While BOJ Governor Kazuo Ueda maintains that it's premature to declare victory over deflation, he emphasized that the outcome of ongoing wage negotiations between unions and companies will be a key determinant of future inflation trends. A settlement is set to be released on March 13, a few days before policymakers start their two-day meeting on March 18-19.

- Predicting labor negotiations amidst the current economic climate and tight labor market poses significant challenges. Japan endured two consecutive quarters of economic contraction in 2023, meeting the technical definition of a recession. The downturn stemmed largely from decreased consumer and investment spending, compounded by a sharp decline in industrial output that threatens to further dampen growth prospects. Despite this, the labor market remains surprisingly strong, with a 2.4% unemployment rate — a four-year low. Additionally, surveys reveal that two-thirds of small and mid-sized firms face labor shortages, highlighting the unusual disconnect between the economy and the job market.



- That said, there is optimism that labor will be able to receive a notable bump in pay this spring. Economists are predicting that wage hikes will rise by about 3.9% from the prior year. Although lower than the 5% minimum initially sought by labor leaders, the negotiated pay increase still exceeds the previous year's three-decade high of 3.58%. A rate hike is likely to occur in March or April. This development could pressure the greenback, put upward pressure on global bond yields, and potentially drive increased investment in Japanese financial markets.

Other News: Brazil's and China's economies are showing signs of weakness, reflecting broader global economic stagnation. The slowdown in these nations underscores a worrisome trend affecting economies worldwide. Moreover, George Galloway's victory in Rochdale highlights a potential decline in the Labour Party's popularity, possibly linked to its stance on the Gaza conflict. Lastly, Tesla CEO Elon Musk is suing OpenAI and its CEO Sam Altman. This legal dispute reflects the ongoing struggle in tech for control and dominance as various entities vie to shape the trajectory of artificial intelligence development.

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						
EST	Indicator			Expected	Prior	Rating
9:45	S&P Global US Manufacturing PMI	m/m	Feb F	51.5	51.5	***
10:00	Construction Spending MoM	m/m	Jan	0.2%	0.9%	**
10:00	ISM Manufacturing	m/m	Feb	49.5	49.1	**
10:00	ISM Prices Paid	m/m	Feb	53.2	52.9	**
10:00	U. of Michigan Consumer Sentiment	m/m	Feb F	79.6	79.6	***
10:00	U. of Michigan Current Conditions	m/m	Feb F		81.5	**
10:00	U. of Michigan Future Expectations	m/m	Feb F		78.4	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Feb F	3.0%	3.0%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Feb F	2.9%	2.9%	*
	Wards Total Vehicle Sales	m/m	Feb	15.40m	15.00m	**

Federal Reserve		
EST	Speaker or Event	District or Position
10:00	Austan Goolsbee Appears on CNBC	President of Federal Reserve Banks of Chicago
10:15	Christopher Waller, Lorie Logan Discusses Paper at US Monetary Policy Forum	Member of the Board of Governors, President of the Federal Reserve Bank of Dallas
12:15	Raphael Bostic Speaks on Economic Outlook, Real Estate	President of Federal Reserve Banks of Atlanta
13:30	Mary Daly Participates in Panel Discussion w/ Fed's Schmid	President of the Federal Reserve Bank of San Francisco
15:20	Adriana Kugler Speaks on the Dual Mandate	Member of the Board of Governors
16:00	Austan Goolsbee Appears on Fox News	President of Federal Reserve Banks of Chicago

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	Jobless Rate	m/m	Jan	2.4%	2.4%	2.5%	***	Equity and bond neutral
	Job-To-Applicant Ratio	m/m	Jan	1.3%	1.27%	1.27%	**	Equity and bond neutral
	Jibun Bank Manufacturing PMI	m/m	Feb F	47.2	47.2		***	Equity and bond neutral
	Consumer Confidence Index	y/y	Feb	39.1%	38.0%	38.3%	*	Equity bullish, bond bearish
New Zealand	CoreLogic House Prices	y/y	Feb	-1.4%	-2.7%		*	Equity and bond neutral
	ANZ Consumer Confidence Index	m/m	Feb	94.5	93.6		*	Equity and bond neutral
	Building Permits	m/m	Jan	-8.8%	3.7%	3.60	***	Equity bearish, bond bullish
South Korea	Trade Balance	m/m	Feb	$4290m	$300m	$328m	*	Equity bullish, bond bearish
	Exports	y/y	Feb	4.8%	18.0%	1.4%	***	Equity bullish, bond bearish
	Imports	y/y	Feb	-13.1%	-7.8%	-7.9%	**	Equity and bond neutral
China	Official Composite PMI	m/m	Feb	50.9	50.9		*	Equity and bond neutral
	Official Manufacturing PMI	m/m	Feb	49.1	49.2	49.0	***	Equity and bond neutral
	Official Services PMI	m/m	Feb	51.4	50.7	50.7	**	Equity bullish, bond bearish
	Caixin Manufacturing PMI	m/m	Feb	50.9	50.8	50.7	***	Equity and bond neutral
India	HSBC India PMI Mfg	m/m	Feb F	56.9	56.7		***	Equity and bond neutral
EUROPE								
Eurozone	HCOB Eurozone Manufacturing PMI	m/m	Feb F	46.5	46.1	46.1	***	Equity and bond neutral
	CPI	y/y	Feb	2.6%	2.8%	2.5%	***	Equity and bond neutral
	Core CPI	y/y	Feb P	3.1%	3.3%	2.9%	**	Equity and bond neutral
	Unemployment Rate	m/m	Jan	6.4%	6.4%	6.5%	**	Equity and bond neutral
Germany	HCOB Germany Manufacturing PMI	m/m	Feb F	42.5	42.3	42.3	***	Equity and bond neutral
France	HCOB France Manufacturing PMI	m/m	Feb F	47.1	46.8	46.8	***	Equity and bond neutral
Italy	HCOB Italy Manufacturing PMI	m/m	Feb	48.7	48.5	49.1	***	Equity and bond neutral
	Unemployment Rate	m/m	Jan	7.2%	7.2%	7.2%	**	Equity and bond neutral
	CPI, EU Harmonized	y/y	Feb P	0.9%	0.9%	1.0%	***	Equity and bond neutral
	CPI NIC Including Tobacco	y/y	Feb P	0.8%	0.8%	1.0%	**	Equity and bond neutral
UK	Nationwide House Price Index	y/y	Feb	1.2%	-0.2%	0.7%	***	Equity bearish, bond bullish
	S&P Global UK Manufacturing PMI	m/m	Feb F	47.5	47.1	47.1	***	Equity and bond neutral
Switzerland	Real Retail Sales	y/y	Jan	0.3%	-0.8%	-0.1%	**	Equity and bond neutral
	PMI Manufacturing	m/m	Feb	44.0	43.1	44.3	***	Equity and bond neutral
	PMI Services	m/m	Feb	53	54.6		*	Equity and bond neutral
Russia	S&P Global Manufacturing PMI	m/m	Feb	54.7	52.4	52.0	***	Equity bullish, bond bearish
Russia	Money Supply, Narrow Definition	w/w	22-Feb	18.08t	18.09t		*	Equity and bond neutral
AMERICAS								
Canada	GDP	y/y	Dec	1.1%	1.1%	1.6%	**	Equity and bond neutral
Brazil	GDP	y/y	4Q	2.0%	2.0%	2.2%	**	Equity and bond neutral
	S&P Global Brazil Manufacturing PMI	m/m	Feb	54.1	52.8		***	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)	560	560	0	Down
3-mo T-bill yield (bps)	521	523	-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 (%)	4.24	4.25	-0.01	Down
Euribor/OIS spread (bps)	394	394	0	Down
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Flat			Down
Yen	Down			Down
Pound	Flat			Down
Franc	Down			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.

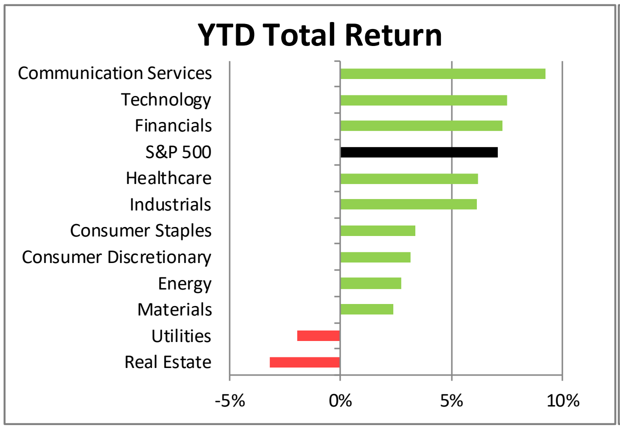
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$83.09	$81.91	1.44%	
WTI	$79.43	$78.26	1.50%	
Natural Gas	$1.85	$1.86	-0.32%	
Crack Spread	$30.86	$31.08	-0.71%	
12-mo strip crack	$24.59	$24.71	-0.49%	
Ethanol rack	$1.61	$1.61	-0.04%	
Metals				
Gold	$2,053.77	$2,044.30	0.46%	
Silver	$22.71	$22.68	0.17%	
Copper contract	$384.25	$384.70	-0.12%	
Grains				
Corn contract	$427.75	$429.50	-0.41%	
Wheat contract	$570.75	$576.25	-0.95%	
Soybeans contract	$1,146.50	$1,140.75	0.50%	
Shipping				
Baltic Dry Freight	2,111	2,041	70	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	4.2	3.7	0.5	
Gasoline (mb)	-2.8	-2.8	0.0	
Distillates (mb)	-0.5	-2.0	1.5	
Refinery run rates (%)	0.9%	0.5%	0.4%	
Natural gas (bcf)	-96	-85	-11	

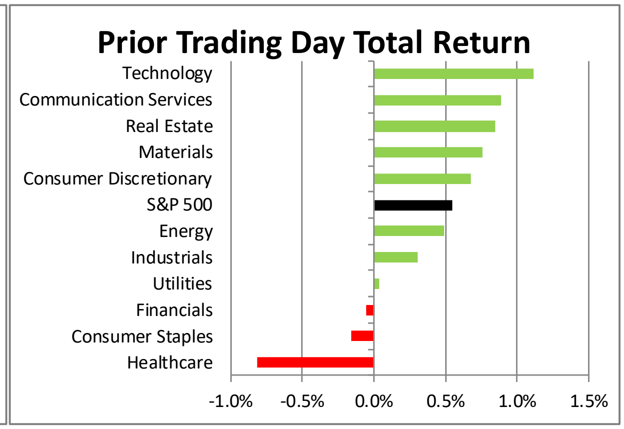
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures from the Great Plains eastward, with cooler temperatures on the West Coast and in the Rocky Mountains. The forecasts call for wetter-than-normal conditions everywhere in the country except the northern Rocky Mountains, where conditions will be drier than usual.

Data Section

US Equity Markets – (as of 2/29/2024 close)

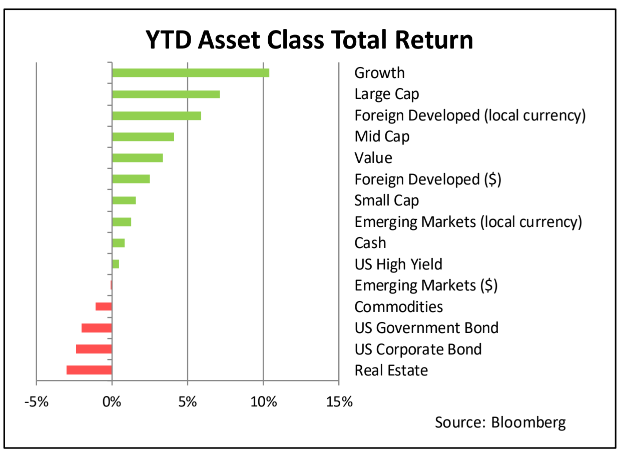




(Source: Bloomberg)

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 2/29/2024 close)

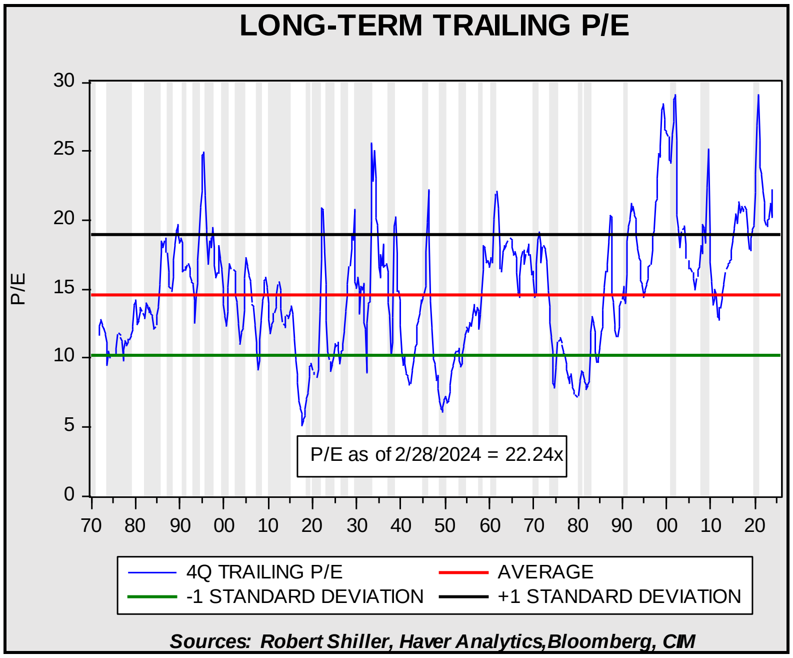


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 29, 2024



Based on our methodology,[1] the current P/E is 22.24x, up 0.09x 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.