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 20, 2024—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is down 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.3%. Chinese markets were higher, with the Shanghai and the Shenzhen Composites both up 0.6% from their previous closes. 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* today opens with the latest statement by a high-ranking European official warning of a possible war with Russia. We next review a range of other foreign and US developments with the potential to affect the financial markets, including a new EU plan to finance weapons and ammunition for Ukraine in a way that could further bolster gold prices and another big subsidy to a major semiconductor firm to help it fund new factories and expansion projects here in the US.

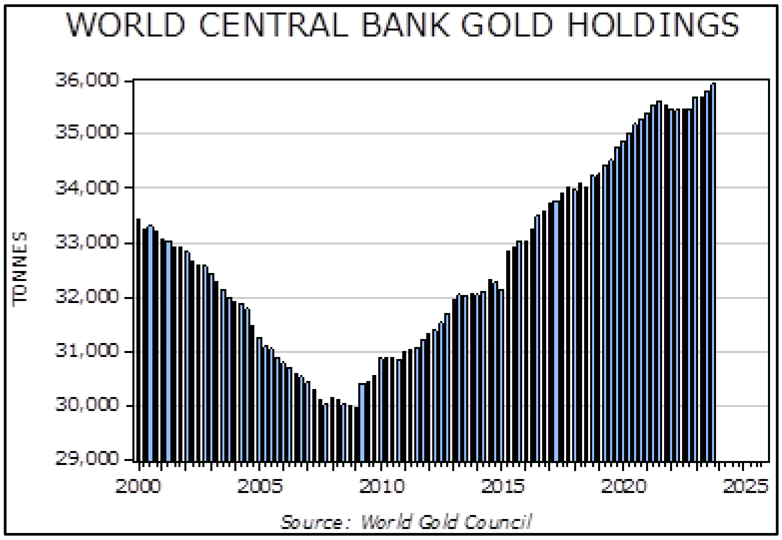
European Union-Russia: In an opinion piece in top European newspapers, European Council President Charles Michel added his voice to those warning that Western Europe is on the road to war with Russia. In his article, Michel argues that no matter what territorial gains Russian dictator Vladimir Putin achieves in Ukraine, he will not stop there. Rather, he will continue trying to grab territory in Eastern Europe. Since the US may not come to Europe's aid, despite its obvious interest in doing so, Michel argues that Europe must prepare to defend itself.

- According to Michel, "If we do not get the EU's response right and do not give Ukraine enough support to stop Russia, we are next. If we want peace, we must prepare for war."
- More to the point, Michel argued that Europe must rapidly shift to a "war economy" to deter further Russian aggression and prepare for hostilities.
- We agree that Putin's apparent goal of re-establishing the Russian Empire would imply additional territorial grabs in Europe. So long as Ukraine continues to resist Moscow's invasion, the Russian military is likely to have its hands full and may not directly threaten targets in Western Europe. The threat to the West would likely come when and if Ukraine stops fighting. At that point, the Russian military is likely to regroup and prepare for a renewed assault on Ukraine and/or Western Europe.
    - With the Russian military preoccupied and largely depleted as an offensive force in Ukraine, a future Russian assault on Western Europe may not involve a broad, multi-front attack on numerous countries simultaneously.
    - Rather, a near-term Russian offensive may well focus on specific, bite-sized territorial objectives, just as Nazi Germany initially focused on remilitarizing the Rhineland in March 1936, acquiring Austria in the Anschluss of March 1938, and then demanding and receiving the Sudetenland region of Czechoslovakia in September 1938.
- Initial Russian territorial claims following a victory in Ukraine might include taking control over Moldova and/or Georgia, where the Kremlin already has troops. Russia might also seek to take control over areas of Eastern Europe where the population has a lot of Russian speakers, or where Putin perceives European military vulnerabilities.

European Union-Russia-Ukraine: The European Commission today unveiled a plan to help buy weapons for Ukraine by using the earnings on seized Russian assets. Under the plan, 90% of the earnings on those assets would be diverted to the European Peace Facility, the main EU fund used to supply Ukraine with weapons, equipment, and ammunition. The remaining 10% of earnings would go to the general EU budget to help Ukraine rebuild and expand its defense industry. To come into effect, the plan will have to be approved by all EU member countries.

- If approved and implemented, the plan is expected to channel about 3 billion EUR ($3.25 billion) to Ukraine in 2024.
- US officials have supported using Russian assets seized as punishment for Moscow's invasion, likely enticed by the poetic justice of making Russia itself pay for the damage it has caused. The risk, however, is that the US and EU moves to seize their adversaries' sovereign assets will likely further fracture the global financial system, encouraging potential adversaries (especially countries in the China/Russia geopolitical bloc) to cut their use of the dollar or other Western currencies.
- In response to US seizures of Afghan and Russian assets in recent years, we think potential adversary governments are already directing their central banks to reduce their

exposure to the greenback. One reflection of that is the recent jump in central bank gold purchases, which our analysis suggests is a key reason why gold prices have recently hit record highs. If the new EU program is implemented, potential adversary governments will likely order their central banks to buy even more gold, boosting gold prices further.



Eurozone: European Central Bank President Lagarde today said the ECB could cut its benchmark interest rate as early as June, but it can't commit to a specific path of future rate cuts. According to Lagarde, continued price pressures for services mean the central bank will have to stay flexible and data dependent as it loosens monetary policy going forward. The statement suggests that both the Federal Reserve and the ECB want to maintain their room to maneuver and keep investors guessing as they cut rates in the coming months.

China: Not only is the European Union shifting its economy to a war footing, but new research by the Center for Strategic and International Studies shows China has already shifted its economy to essentially the same status. For example, the study shows that Chinese shipbuilding capacity is now approximately 230x current US capacity. In contrast, the study assesses that the US defense industrial base is still operating at a peacetime pace.

US Monetary Policy: The Federal Reserve's policymaking committee wraps up its latest meeting today, with its decision and new economic projections due at 2:00 PM EDT. The committee is widely expected to hold the benchmark fed funds interest-rate target at 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 Military: The *Wall Street Journal* carries a video today explaining the challenges faced by the US military as it replaces its Minuteman III strategic nuclear missiles with a more modern arsenal. The video is a nice complement to our *Bi-Weekly Geopolitical Report* from March 11, in which we explored the US's overall effort to modernize its nuclear deterrent and what the program means for investors. (Clearly, we at Confluence remain a step or two ahead of the *Journal*!)

US Semiconductor Industry: The Commerce Department said it has awarded $8.5 billion to microprocessor giant Intel to help fund new computer chip plants and expansion projects in Arizona, Oregon, New Mexico, and Ohio. The award is part of the roughly $50 billion provided for in the CHIPS and Science Act of 2022 to help bring more chip manufacturing back to the US and ensure secure supplies of the products.

US Economic Releases

Demand for home loans slowed last week as rising rates deterred potential borrowers. According to a survey tracked by the Mortgage Bankers Association, mortgage applications fell 1.8% in the week ending March 15. Higher borrowing costs likely contributed to a reduction in loan requests, as the 30-year fixed-rate mortgage surged 13 basis points to 6.97%. This translated to a 1.2% decline in the MBA purchase tracker and a 2.5% drop in the refinance tracker compared to the prior week.

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
14:00	FOMC Rate Decision (Lower Bound)	w/w	20-Mar	5.25%	5.25%	***
14:00	FOMC Rate Decision (Upper Bound)	w/w	20-Mar	5.50%	5.50%	***
14:00	Interest on Reserve Balances Rate	w/w	21-Mar	5.40%	5.40%	**
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
EUROPE								
Eurozone	Construction output	y/y	Jan	0.8%	2.8%		*	Equity and bond neutral
Germany	PPI	y/y	Feb	-4.1%	-4.4%	-3.8%	**	Equity and bond neutral
Italy	Industrial Production	m/m	Jan	-1.2%	1.2%	-0.5%	***	Equity bearish, bond bullish
UK	CPI	y/y	Feb	3.4%	4.0%	3.5%	***	Equity and bond neutral
	Core CPI	y/y	Feb	4.5%	5.1%	4.6%	***	Equity and bond neutral
	Retail Price Index	y/y	Feb	381.0	378.0	381.0	**	Equity and bond neutral
	RPI YoY	y/y	Feb	4.5%	4.9%	4.4%	**	Equity and bond neutral
AMERICAS								
Canada	CPI	y/y	Feb	2.80%	2.90%	3.10%	***	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)	523	523	0	Up
U.S. Sibor/OIS spread (bps)	533	533	0	Down
U.S. Libor/OIS spread (bps)	533	534	-1	Down
10-yr T-note (%)	4.29	4.29	0.00	Up
Euribor/OIS spread (bps)	394	393	1	Up
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Down
Yen	Down			Down
Pound	Down			Up
Franc	Down			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
PBOC 1-Year Loan Prime Rate	3.450%	3.450%	3.450%	On Forecast
PBOC 5-Year Loan Prime Rate	3.950%	3.950%	3.950%	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.

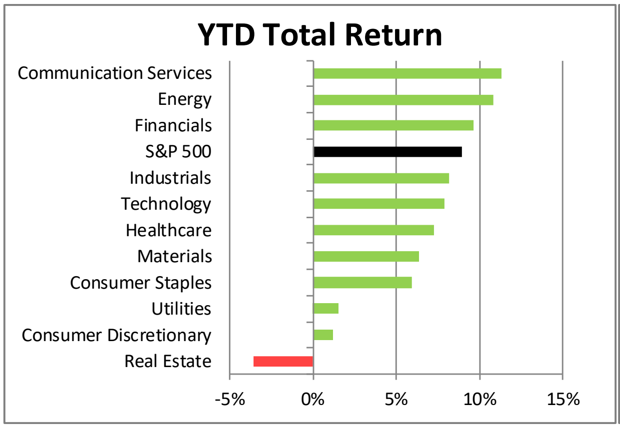
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$86.37	$87.38	-1.16%	
WTI	$82.27	$83.47	-1.44%	
Natural Gas	$1.75	$1.74	0.17%	
Crack Spread	$31.42	$32.28	-2.66%	
12-mo strip crack	$25.57	$26.14	-2.18%	
Ethanol rack	$1.76	$1.77	-0.62%	
Metals				
Gold	$2,153.83	$2,157.59	-0.17%	
Silver	$24.84	$24.91	-0.28%	
Copper contract	$404.05	$407.45	-0.83%	
Grains				
Corn contract	$437.50	$439.50	-0.46%	
Wheat contract	$544.00	$552.50	-1.54%	
Soybeans contract	$1,191.00	$1,185.50	0.46%	
Shipping				
Baltic Dry Freight	2,392	2,419	-27	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.0		
Gasoline (mb)		-2.6		
Distillates (mb)		-0.50		
Refinery run rates (%)		0.7%		
Natural gas (bcf)		6		

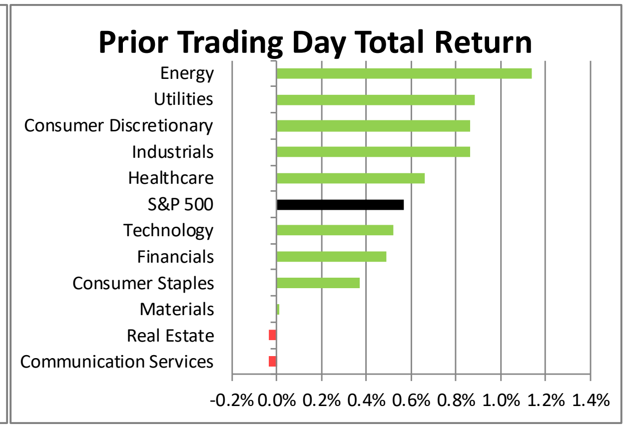
Weather

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 3/19/2024 close)

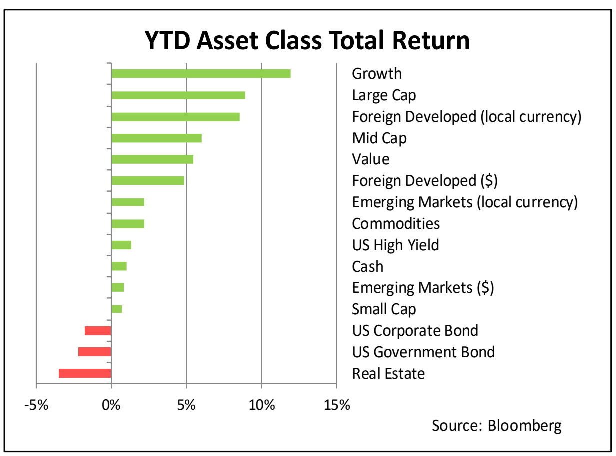




(Source: Bloomberg)

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 3/19/2024 close)

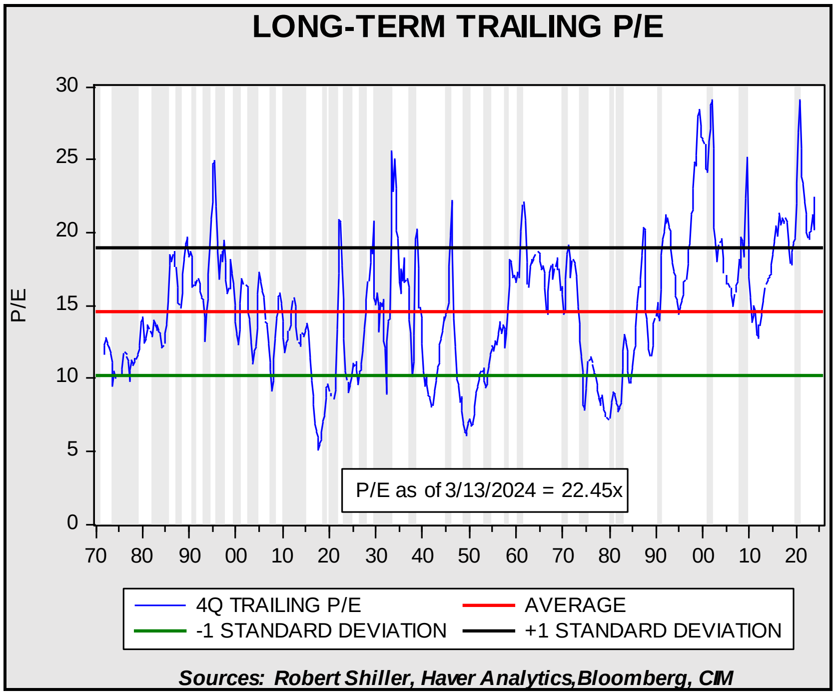


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.