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 21, 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 2.4%. Chinese markets were lower, with the Shanghai and the Shenzhen Composites both down 0.1% from their previous closes. 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:

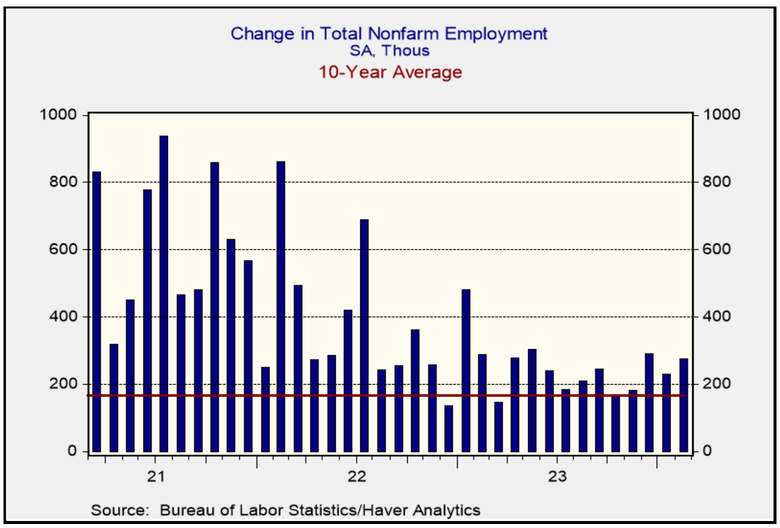
- *Bi-Weekly Geopolitical Report* (3/11/2024) (with associated podcast): "Rebirth of US Nuclear Deterrence"
- *Asset Allocation Quarterly – Q1 2024* (1/26/2024): Discussion of our asset allocation process, Q1 2024 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q1 2024 Rebalance 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* (3/18/2024) (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"

Good morning! Stocks are rallying this morning as investors remain optimistic about the Fed achieving a soft landing. In sports news, March Madness tips off today, and we're calling a win for the University of North Carolina. Today's *Comment* dives into key issues: analyzing the latest FOMC meeting, exploring the budget debates among lawmakers, and examining the recent shift towards military assertiveness by US allies. As always, we'll keep you informed with a roundup of international and domestic news.

Powell's Punt: The Federal Open Market Committee's (FOMC) decision paves the way for a potential rate cut in June; however, it may hinge on the strength of the labor market.

- Despite maintaining a cautious monetary policy, the FOMC signaled a brighter view of the US economy. In their latest decision, they opted to hold the target range for the federal funds rate between 5.25% and 5.50% and continue its balance sheet runoff. Nevertheless, a shift in their economic outlook is evident. FOMC projections show increased optimism, with GDP growth forecasts for 2024 revised upwards from 1.4% to 2.1%. Additionally, the unemployment rate is expected to dip slightly, from 4.1% to 4.0%. Notably, inflation projections remain unchanged, suggesting policymakers believe this economic uptick won't significantly impact price pressures.

- The market initially welcomed the FOMC's announcement, but a deeper analysis suggests a potentially hawkish undertone. Although the median dot plot remained flat at 4.625%, a rise in the weighted average from 4.70% to 4.80% signaled a slight shift among some policymakers. This could stem from concerns about the persistent tightness in the labor market, which might hinder progress toward the Fed's 2% inflation target. Reinforcing this, Federal Reserve Chair Jerome Powell hinted during the press conference that persistently strong employment data could lead the central bank to hold interest rates higher for a longer period than currently anticipated by the market.

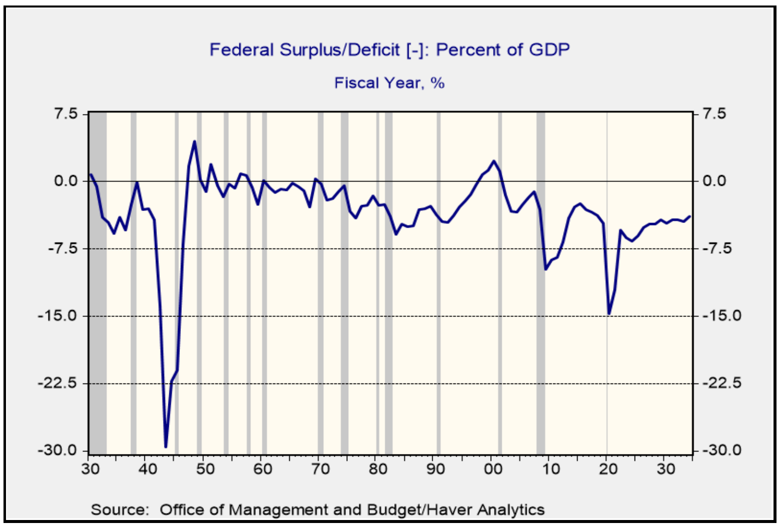


- The Fed's decision on a June rate cut remains uncertain. While they haven't committed to it, our baseline expectation is a cut if they aim to deliver on their projected three reductions this year. Thus, the strength of the employment data will be a key factor. If the US continues adding jobs at a solid pace, exceeding 180,000 per month, the Fed may delay easing policy, especially with inflation still above its target. However, to maintain political neutrality, the central bank might delay its first rate cut until July at the latest. This would keep them on track for three total reductions this year, with the other two likely occurring in the November and December meetings.

Slash Entitlements: Lawmakers are setting their sights on benefit programs as a potential area to address the government's budget deficit.

- The Republican Study Committee (RSC), a conservative group within the Republican Party, has proposed a plan to ensure the long-term solvency of social programs. This proposal includes raising the Social Security retirement age, tightening work requirements for food stamps, and capping unemployment benefits based on prevailing wages, possibly around $15 per hour. While immediate passage seems unlikely, the RSC plan reflects a growing emphasis within the Republican Party on reforming entitlement programs. This aligns with recent comments by former President Trump, who called for streamlining Social Security to address potential inefficiencies. The Republican budget proposal is expected to reduce outlays by $14 trillion over the next decade.

- This plan addresses the challenge of the national debt's sustainability through the implementation of rigorous spending controls, a matter both political parties are exploring alternative approaches to resolve. Democrats aim to reduce costs by allowing the expiration of the Trump tax cuts in 2025 and by increasing taxes on high-income individuals. President Biden has indicated his intention to raise taxes on individuals earning over $400k annually and to elevate corporate taxes from 21% to 28% should he be re-elected. This projection suggests Biden's plan could generate nearly $5 trillion in additional revenue over the next decade.

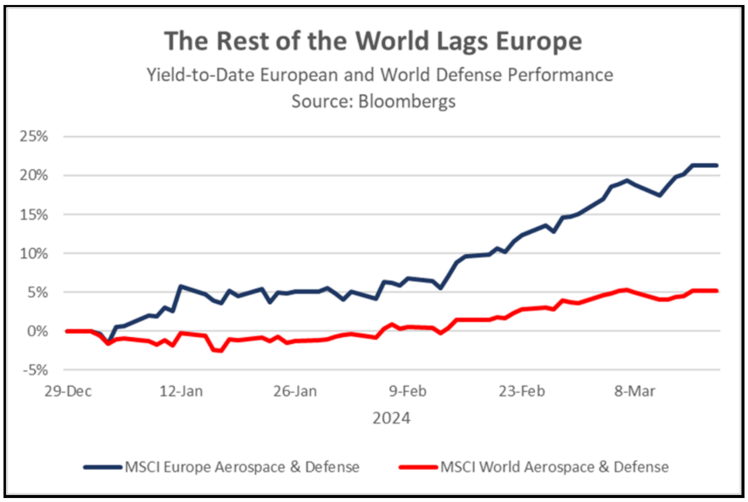


- Austerity measures, including tax hikes and cuts to social programs, could free up resources to improve the fiscal balance. However, this approach faces significant hurdles. Public spending makes up a nearly a quarter of GDP, a substantial portion. Additionally, Social Security costs are projected to rise further by 2033, and these programs are essential for many voters. Tax increases are likely to encounter resistance from lobbyists representing groups who would shoulder the burden. While we remain optimistic that the government will take the necessary steps to stabilize government spending, we also acknowledge there may be bumps along the way. That said, we remain confident that defense spending will be fairly insulated.

Foreign Defense: With growing concerns about international conflicts, key US allies are taking a harder look at their defense capabilities.

- The UK and Australia fortified their defense partnership on Thursday with a pact addressing China's growing influence in the Indo-Pacific. This agreement streamlines troop deployments, further solidifying the ties established by the 2021 AUKUS defense pact. Meanwhile, in response to Russia's escalating threat on the European continent, French President Emmanuel Macron has revived plans for EU defense bonds to bolster Europe's military capabilities. However, this proposal faces an uphill battle as Germany remains staunchly opposed. Nonetheless, these moves reflect a broader Western trend of unease over rising threats from both Russia and China.

- The Ukraine invasion in 2022 marked a turning point for Western priorities. Previously, these nations prioritized domestic spending on social programs, often neglecting defense budgets. The war has triggered a significant shift. Western powers are now demonstrably reorienting their focus towards bolstering their own defenses and supporting allies in a climate of heightened security threats. This is evident in Europe's recent surge in support for Ukraine, which has had a cascading effect, revitalizing the Continent's defense industry. European defense stocks have surged 21% year-to-date, outperforming the US defense sector which has gained 5%.

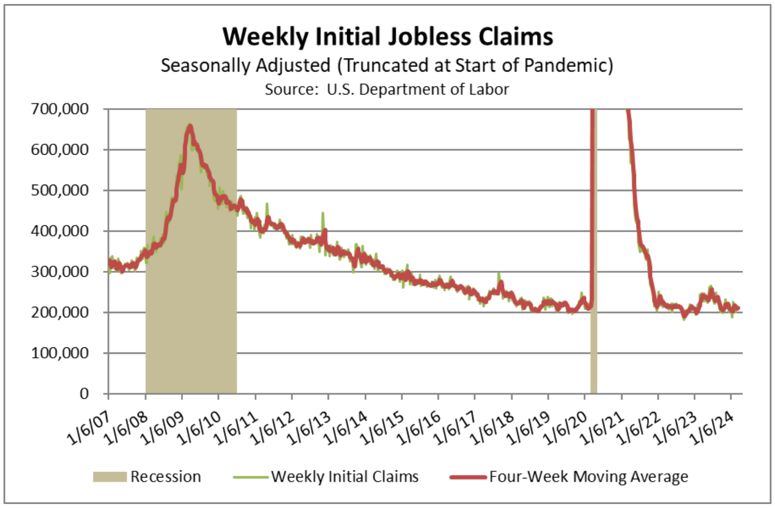


- US allies, particularly in Europe, are investing in their own defense industries. Though, established US firms like Lockheed Martin, General Dynamics, and Northrop Grumman are well-positioned to remain key partners in the near future. These giants boast a proven track record of fulfilling allies' growing demands for advanced weaponry. To capitalize on the expanding global defense market, they may look to expand through acquisitions and partnerships in other markets. This trend towards increased defense spending across the Western world bodes well for the industry as a whole.

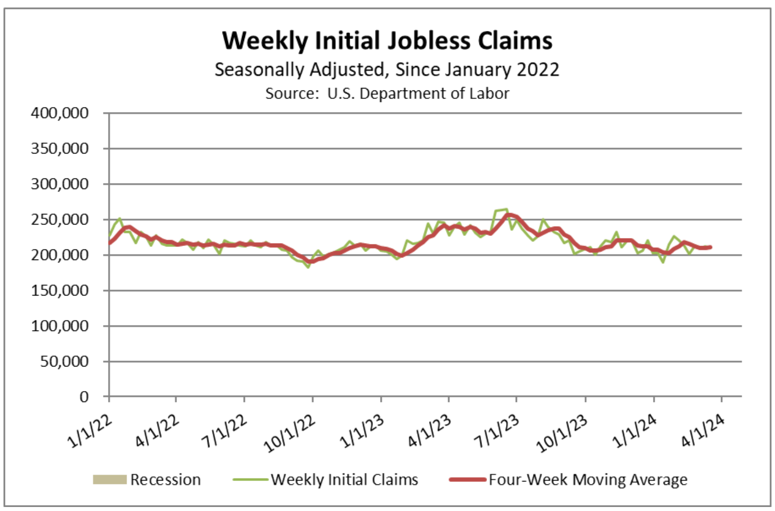
Other News: Central banks in the West are taking a dovish turn, with the Bank of England signaling a potential rate cut later this year, and the Swiss National Bank taking a surprise step by lowering rates immediately. Yemen has told Russia and China that their ships will not be targeted; the move is further evidence of Iran's growing influence on the conflict in the Red Sea. President Biden's continued focus on reducing housing costs underscores the growing political importance of affordability.

US Economic Releases

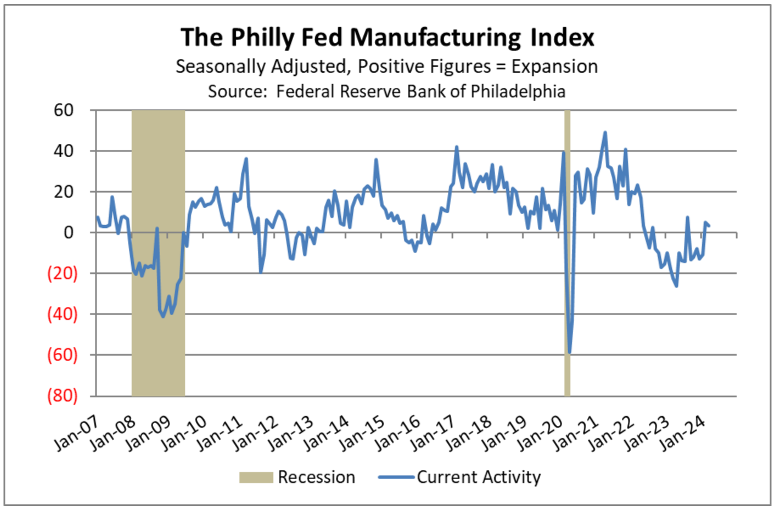
In the week ended March 16, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 210,000, slightly lower than both the expected level of 213,000 and the previous week's revised level of 212,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 211,250. Meanwhile, in the week ended March 9, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to 1.807 million, below the anticipated reading of 1.820 million but above the prior week's revised reading of 1.803 million. The chart below shows how initial jobless claims have fluctuated since just before the Great Financial Crisis. The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



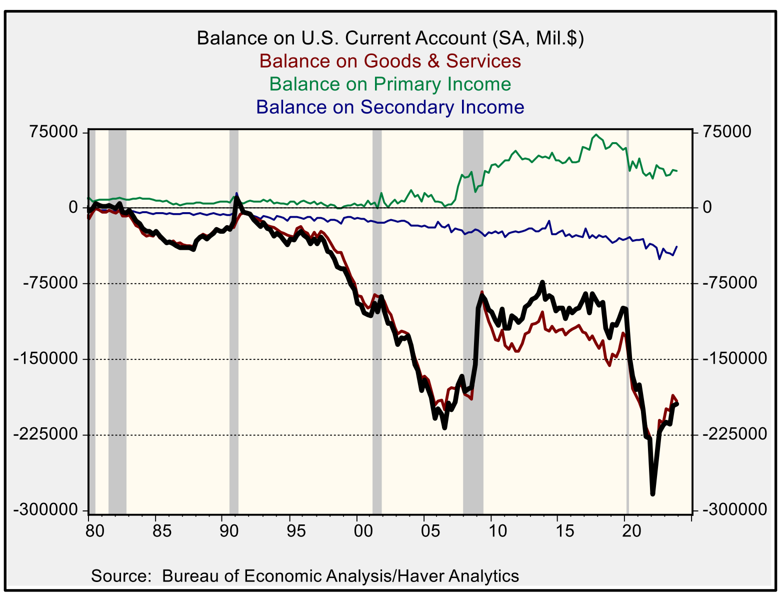
To provide more detail on recent trends, the chart below shows how initial jobless claims have changed just since the beginning of 2022.



Separately, the Philadelphia FRB said its March ***Philly Fed Index*** rose to a seasonally adjusted 3.2, beating the expected level of -2.5 but still slightly below the February level of 5.2. The index, officially designated as the Philadelphia FRB Manufacturing Activity Index, is designed so that positive readings point to expanding factory activity in the mid-Atlantic region. At its current level, the index suggests manufacturing in the region may be starting to grow again after nearly constant declines over the last two years. The chart below shows how the index has fluctuated since just before the GFC.



A final report so far today focused on the country's overall balance of international current transactions. The fourth-quarter ***current account balance*** showed a deficit of $194.8 billion, better than both the anticipated shortfall of $209.0 billion and the revised third-quarter shortfall of $196.4 billion. The overall current account balance has been in deficit almost constantly since globalization really began to take hold at the beginning of the 1980s, mostly reflecting the US trade deficit. The chart below shows the overall current account balance since 1980, along with each of its three components: the balance on trade in goods and services, primary income (mostly income on foreign investments), and secondary income (gifts, remittances, personal transfers, etc.).



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 Mnufacturing PMI	m/m	Mar P	51.8	52.2	***
9:45	S&P Global US Services PMI	m/m	Mar P	52.0	52.3	***
9:45	S&P Global US Composite PMI	m/m	Mar P	52.2	52.5	***
10:00	Leading Economic Indicators	m/m	Feb	-0.1%	0.4%	***
10:00	Existing Home Sales	m/m	Feb	3.95m	4.00m	***
Federal Reserve						
EST	Speaker or Event	District or Position				
12:00	Michael Barr Participates in Fireside Chat	U.S. Federal Reserve Vice Chair for Supervision				

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	Trade Balance	m/m	Feb	-$379.4b	-¥1760.3b	-¥785.0b	***	Equity and bond neutral
	Imports	m/m	Feb	0.5%	-9.8%	0.5%	*	Equity and bond neutral
	Exports	m/m	Feb	7.8%	11.9%	5.1%	*	Equity bullish, bond bearish
	Jibun bank Composite PMI	m/m	Mar P	52.3	50.6		*	Equity bullish, bond bearish
	Jibun Bank Manufacturing PMI	m/m	Mar P	48.2	47.2		***	Equity and bond neutral
	Jibun Bank Services PMI	m/m	Mar P	54.9	52.9		**	Equity bullish, bond bearish
	Tokyo Condominiums for Sale	y/y	Feb	-27.60%	56.60%		*	Equity and bond neutral
Australia	Employment Change	m/m	Feb	116.5k	15.3k	40.0k	***	Equity bullish, bond bearish
	Unemployment Rate	m/m	Feb	3.7%	4.1%	4.0%	***	Equity and bond neutral
	Participation Rate	m/m	Feb	66.7%	66.6%	66.8%	**	Equity and bond neutral
New Zealand	GDP	y/y	4Q	-0.3%	-0.6%	0.0%	**	Equity and bond neutral
India	HSBC India PMI Mfg	m/m	Mar P	59.2	56.9		***	Equity and bond neutral
	HSBC India PMI Composite	m/m	Mar P	61.3	60.6		**	Equity and bond neutral
	HSBC India PMI Services	m/m	Mar P	60.3	60.6		**	Equity and bond neutral
EUROPE								
Eurozone	EU27 New Car Registrations	y/y	Feb	10.1%	12.1%		***	Equity and bond neutral
	HCOB Eurozone Manufacturing PMI	m/m	Mar P	45.7	46.5	47.0	***	Equity bearish, bond bullish
	HCOB Eurozone Services PMI	m/m	Mar P	51.1	50.2	50.5	**	Equity bullish, bond bearish
	HCOB Eurozone Composite PMI	m/m	Mar P	49.9	49.2	49.7	*	Equity and bond neutral
	Current Account	m/m	Jan	39.4b	31.9b		*	Equity and bond neutral
Germany	HCOB Germany Manufacturing PMI	m/m	Mar P	41.6	42.5	43.0	***	Equity bearish, bond bullish
	HCOB Germany Services PMI	m/m	Mar P	49.8	48.3	48.8	**	Equity bullish, bond bearish
	HCOB Germany Composite PMI	m/m	Mar P	47.4	46.3	47.0	**	Equity and bond neutral
France	Business Confidence	m/m	Mar	100	98	99	**	Equity and bond neutral
	Manufacturing Confidence	m/m	Mar	102	101	100	*	Equity and bond neutral
	HCOB France Manufacturing PMI	m/m	Mar P	45.8	47.1	47.5	***	Equity bearish, bond bullish
	HCOB France Services PMI	m/m	Mar P	47.8	48.4	48.8	**	Equity bearish, bond bullish
	HCOB France Composite PMI	m/m	Mar P	47.7	48.1	47.7	**	Equity and bond neutral
UK	Public Sector Net Borowing	m/m	Feb	7.5b	-17.0b	6.4b	*	Equity and bond neutral
	PSNB ex Banking Groups	m/m	Feb	8.4b	-16.1b	6.0b	**	Equity and bond neutral
	S&P Global UK Manufacturing PMI	m/m	Mar P	49.9	47.5	47.8	***	Equity bullish, bond bearish
	S&P Global UK Services PMI	m/m	Mar P	53.4	53.8	53.8	**	Equity and bond neutral
	S&P Global UK Composite PMI	m/m	Mar P	52.9	53.0	53.1	**	Equity and bond neutral
Switzerland	M3 Money Supply	y/y	Feb	-2.8%	-2.1%		**	Equity and bond neutral
Russia	PPI	y/y	Feb	19.5%	19.4%		*	Equity and bond neutral
AMERICAS								
Mexico	International Reserves Weekly	w/w	15-Mar	$216492m	$216801m		*	Equity and bond neutral
	Retail Sales	y/y	Jan	-0.8%	-0.2%	1.2%	***	Equity bearish, bond bullish

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	523	-1	Up
U.S. Sibor/OIS spread (bps)	532	532	0	Down
U.S. Libor/OIS spread (bps)	532	532	0	Down
10-yr T-note (%)	4.23	4.27	-0.04	Down
Euribor/OIS spread (bps)	392	394	-2	Up
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Down
Yen	Up			Down
Pound	Down			Up
Franc	Down			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
FOMC Rate Decision (Lower Bound)	2.250%	5.250%	5.250%	Below Forecast
FOMC Rate Decision (Upper Bound)	5.500%	5.500%	5.500%	On Forecast
Bank of England Bank Rate	5.250%	5.250%	5.250%	On Forecast
Swiss National Bank Policy Rate	1.500%	1.750%	1.750%	Below Forecast
Brazil Selic Rate	10.750%	11.250%	10.750%	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.

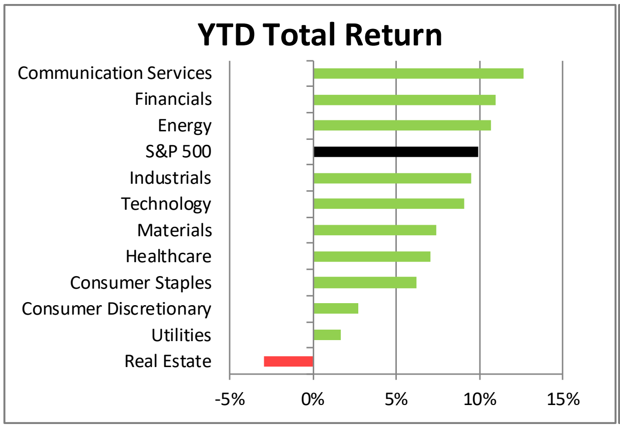
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$85.49	$85.95	-0.54%	
WTI	$80.83	$81.27	-0.54%	
Natural Gas	$1.69	$1.70	-0.41%	
Crack Spread	$31.73	$32.24	-1.58%	
12-mo strip crack	$25.14	$25.94	-3.09%	
Ethanol rack	$1.75	$1.75	-0.37%	
Metals				
Gold	$2,206.96	$2,186.39	0.94%	
Silver	$25.47	$25.58	-0.44%	
Copper contract	$407.90	$405.15	0.68%	
Grains				
Corn contract	$441.75	$439.00	0.63%	
Wheat contract	$548.75	$545.00	0.69%	
Soybeans contract	$1,215.50	$1,209.50	0.50%	
Shipping				
Baltic Dry Freight	2,284	2,392	-108	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.0	-0.2	-1.8	
Gasoline (mb)	-3.3	-2.8	-0.5	
Distillates (mb)	0.62	-0.50	1.12	
Refinery run rates (%)	1.0%	0.8%	0.2%	
Natural gas (bcf)		5		

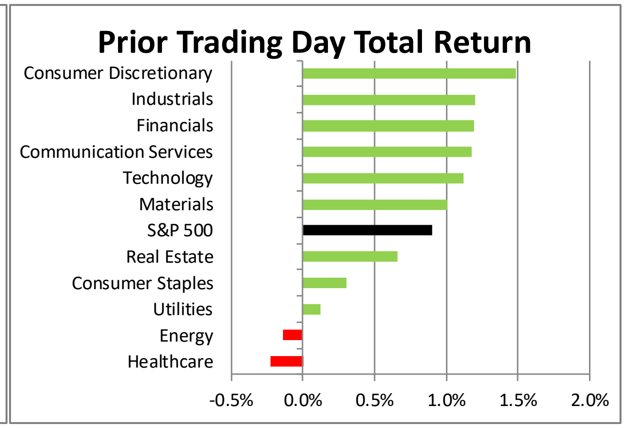
Weather

The 6-10 and 8-14 day forecasts currently call for cooler-than-normal temperatures from the Mississippi River westward, with warmer-than-normal temperatures in the Northeast. The forecasts call for wetter-than-normal conditions in virtually the entire country, with dry conditions expected only in southern Texas.

Data Section

US Equity Markets – (as of 3/20/2024 close)

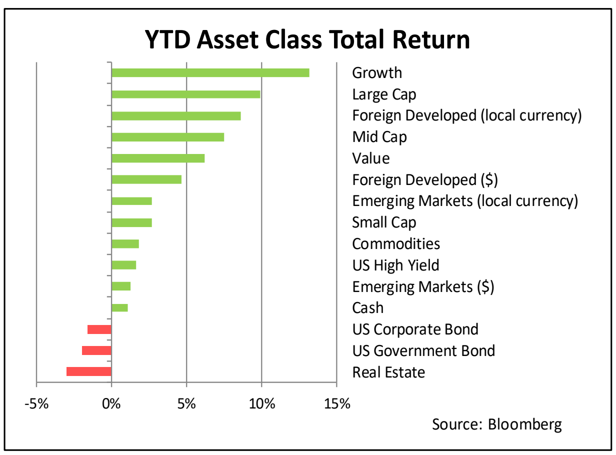




(Source: Bloomberg)

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 3/20/2024 close)

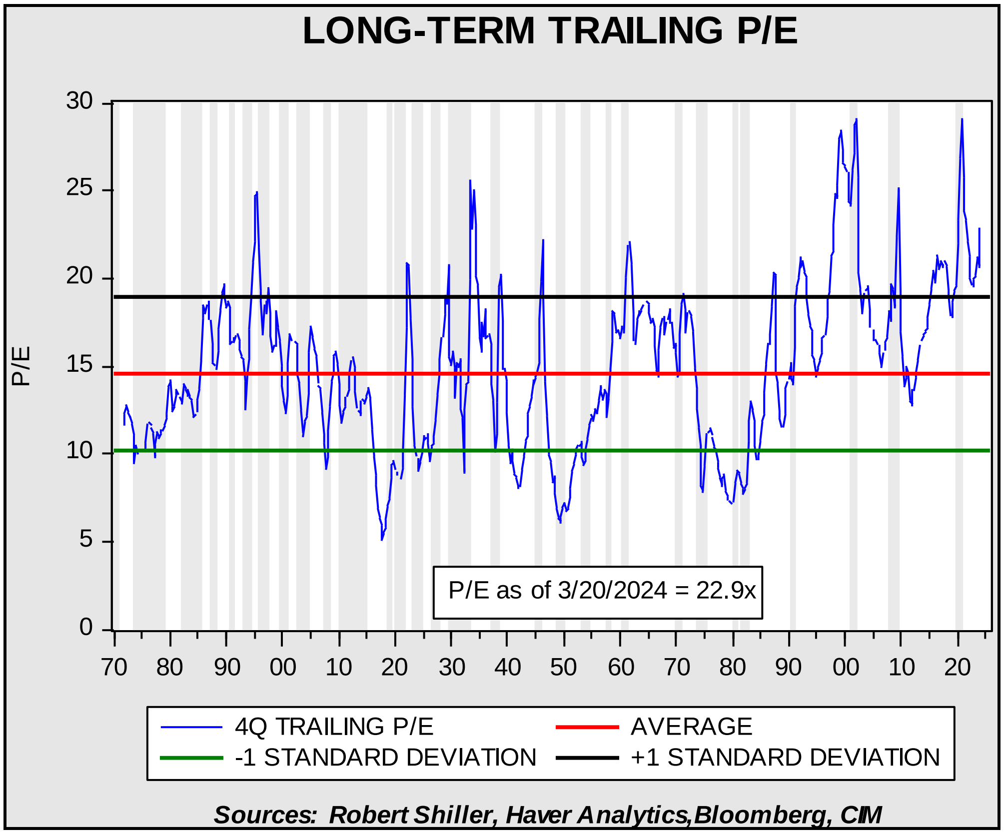


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 21, 2024



Based on our methodology,[1] the current P/E is 22.9x, up 0.5x from our last report. The improvement in the multiple reflects an increase in the stock price index, and a decrease 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 (Q2, Q3 and Q4) and one estimate (Q1). 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.