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 26, 2024—9:30 AM EDT] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is up 0.4% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.8%. Chinese markets were higher, with the Shanghai Composite up 0.2% from its previous close and the Shenzhen Composite also up 0.2%. 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:

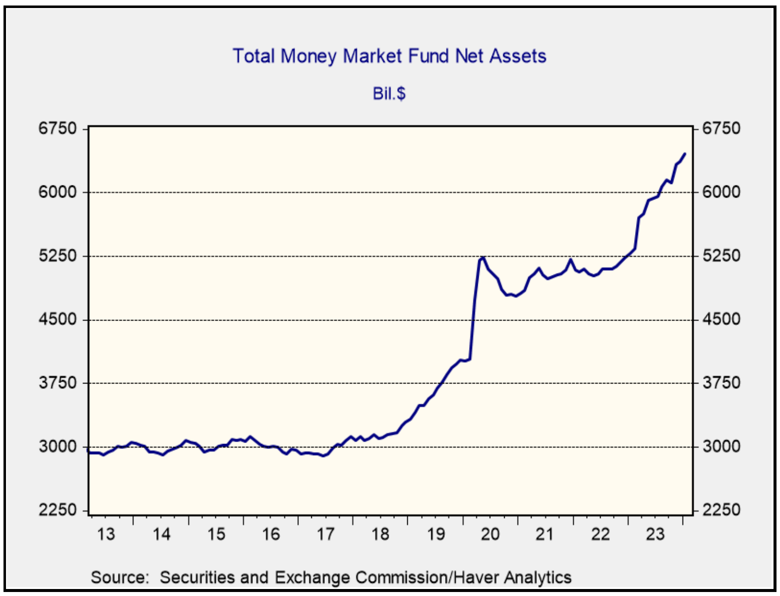
- ***Bi-Weekly Geopolitical Report* (3/25/2024) (with associated podcast): "Venezuela Threatens Guyana"**
- *Asset Allocation Quarterly – Q1 2024* (1/26/2024): Discussion of our asset allocation process, Q1 2024 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q1 2024 Rebalance 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! Despite strong economic signs like positive durable goods orders, equity futures are paring back earlier gains. On a brighter note, the University of Iowa continues to dominate the Women's NCAA tournament! Today's *Comment* dives into why rising analyst forecasts for the S&P 500 shouldn't lull investors into complacency. We'll also explore how rising housing costs might impact the Fed's policy decisions and analyze the likelihood of a slow US-China decoupling. Plus, we include our usual wrap-up of domestic and international data.

Equity Bulls on Tap: With the first quarter of 2024 nearing its close, several banks have already begun revising their year-end forecasts upwards.

- Oppenheimer Asset Management isn't alone in its bullish outlook on the S&P 500. After a stellar first quarter, it has raised its year-end target from 5,200 to 5,500. This optimism is echoed by HSBC, UBS, and Bank of America, all revising their projections upwards to around 5,400 for the index by year's end. Fueling this sentiment are the market's strong gains and surprisingly positive corporate earnings reported in the final quarter of 2023. With the S&P 500 already up 10% year-to-date, further growth is anticipated if the Fed manages a soft landing.

- A cloud of uncertainty looms over the recent stock market optimism. Positive earnings surprises stemmed from analysts significantly lowering their Q4 2023 earnings per share (EPS) estimates ahead of reporting season, reflecting concerns about a potential economic slowdown later this year. Furthermore, liquidity in the financial system is expected to tighten in the coming months due to tax payments, ongoing quantitative tightening, reduced use of the overnight reverse repo facility, and interest rates remaining higher than market expectations. These conditions will likely prevent much of the cash being held in money market funds from returning to financial markets.

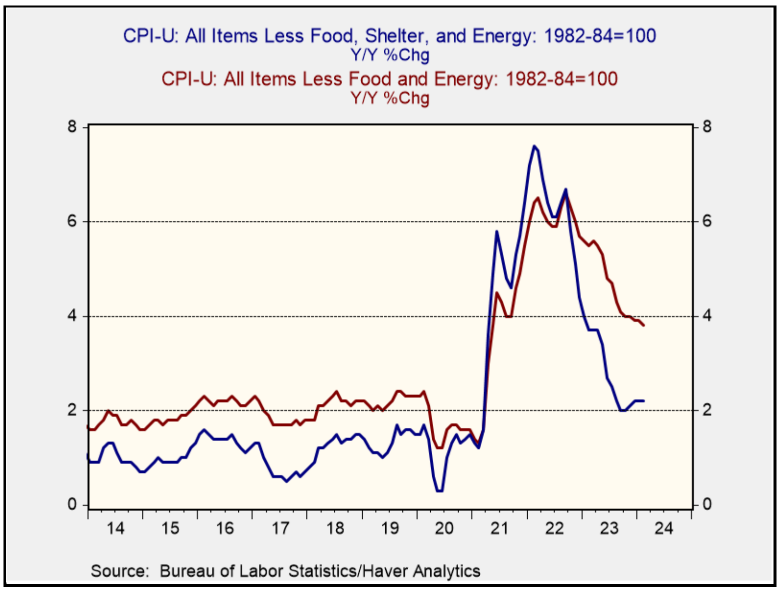


- The strength of the US economy bolsters optimism for equities, but hidden risks obscure the outlook. This is evident in the looming debt maturity wall. While leveraged loans offered companies a temporary lifeline, they've come at the cost of eroded profitability, potentially creating future solvency issues. There aren't any glaring signs of an immediate crisis, but the lack of transparency in the private credit market remains a significant concern. Given these uncertainties, investors should exercise caution before taking on excessive risk, especially with policy rates hovering above 5%.

Fed Leaning Hawkish? Rising shelter costs are dampening the Federal Reserve's optimism for three rate cuts this year, and the high home prices continue to fuel domestic inflation.

- Federal Reserve officials presented a divided front on future rate cuts this week. Voting member Raphael Bostic, President of the Atlanta Fed, pointed to stronger economic data and scaled back his forecast from two cuts to one. While Bostic expressed caution, Fed Governor Lisa Cook emphasized the potential hurdles on the path to price stability. In contrast, Chicago Fed President Austan Goolsbee held firm to his projection of three cuts, as outlined in the Fed's latest Summary of Economic Projections (SEP). These divergent views highlight the complex interplay between robust employment data and higher-than-expected inflation on policymakers' outlooks.

- Shelter costs remain a major hurdle for the Fed, delaying their shift on interest rates. While overall inflation shows signs of easing, housing prices act as a glaring outlier, driving a wedge in price trends. Excluding shelter, core CPI has held steady between 1.9% and 2.2% for the past seven months. This persistent rise in housing costs is often attributed to limited inventory and a slowdown in new construction. However, confusion clouds how this data is collected, with Fed Chair Jerome Powell himself acknowledging uncertainty about when the slowdown in housing prices will be reflected in inflation figures.

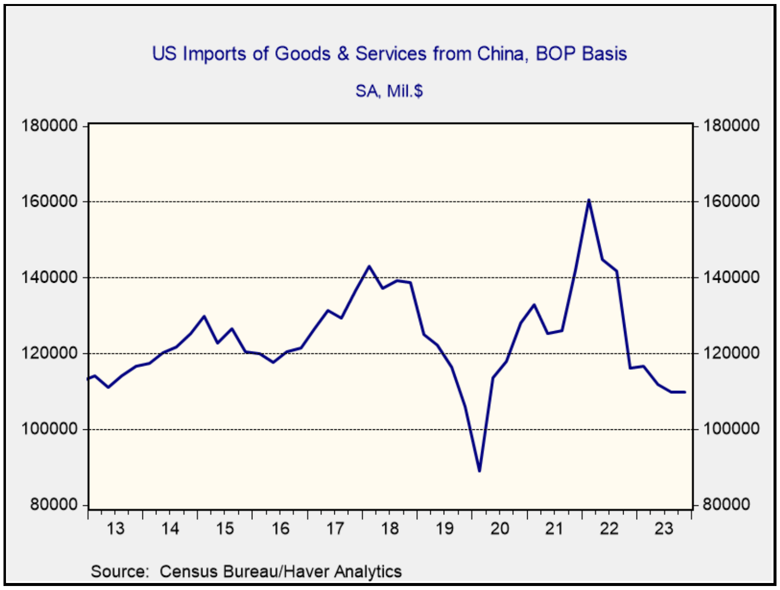


- Federal Reserve officials are signaling a cautious shift, with some openness to considering two rate cuts this year depending on economic data. While we expect the January and February inflation spikes to moderate, our confidence in the Fed achieving its target of 2% core PCE inflation by year-end has decreased. Stubbornly high shelter costs, a significant factor in inflation metrics, contribute to this hesitation. If inflation persists alongside a strong labor market, the Fed may postpone rate cuts until after the election.

Carrot and Stick Diplomacy: Despite China's push for self-sufficiency in technology, it still seeks cooperation with US business leaders to temper U.S. hostility.

- On Wednesday, a select group of US corporate executives received an esteemed invitation to meet with Chinese President Xi Jinping. Following their participation in the high-profile China Development Forum, which wrapped up on Monday, these key players will convene for an exclusive gathering, aimed at providing insights into the nation's burgeoning growth trajectory. The invitation arrives as US-China tensions escalate, fueled by policies targeting economic decoupling. With American businesses pulling back on investments in China, and Beijing planning to replace US technology, this high-level dialogue holds the key to shaping the future relationship between these economic giants.

- Despite recent tensions, a meeting between US CEOs and President Xi highlights the mutual dependence of the US and China. China's manufacturing overcapacity strains its ability to sustain growth without access to US markets. This is particularly true for the electric vehicle industry, where China faces pushback from Western countries due to its surplus. However, US firms also rely on China's vast consumer base for their own continued growth. Just look at Apple, whose sales of their flagship iPhone have dropped in China, prompting them to explore a partnership with Baidu to regain a foothold.



- High tensions simmer between the US and China, but a complete breakdown seems unlikely barring a major geopolitical crisis. Deep economic ties act as a safety net, minimizing supply chain disruptions and potentially creating space for a gradual thaw. Upcoming high-level visits, like Treasury Secretary Yellen's expected trip to China next month, highlight the ongoing communication between the two countries. This trend is likely to continue, especially as China grapples with its economic slowdown. Nevertheless, we anticipate encountering occasional obstacles as both major economies strive to maintain their economic influence.

Other News: A major bridge in Baltimore collapsed late last night after a cargo ship collided with one of its supports. While there's no indication of this being a deliberate act, authorities will likely conduct a thorough investigation in the coming months. Florida passed legislation to prevent minors under 14 from accessing social media, in another sign of the growing scrutiny of US tech companies.

US Economic Releases

February ***durable goods*** orders rose by a seasonally adjusted 1.4%. Durable goods orders are often driven by transportation equipment, where just a few airliner orders can have a big impact. February ***durable goods orders excluding transportation*** rose 0.5%. Finally, the durable goods report also includes a key proxy for corporate capital investment. In February, ***nondefense capital goods orders ex-aircraft*** rose 0.7%. Compared with the same month one year earlier, overall durable goods orders in February were up 4.69%, while durable orders ex-transport were up 4.57%. Nondefense capital goods orders ex-aircraft were up 3.04%. The chart below shows the progression of nondefense capital goods orders ex-aircraft since just before the previous recession.

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	Conf. Board Consumer Confidence	m/m	Mar	107.0	106.7	***
10:00	Richmond Fed Manufact. Index	m/m	Mar	-5	-5	**
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	Services PPI	y/y	Feb	2.1%	2.1%	2.1%	*	Equity and bond neutral
	Machine tool orders	y/y	Feb F	-8.0%	-8.0%		**	Equity and bond neutral
Australia	Westpac Consumer Conf Index	m/m	Mar	84.4	86.0		**	Equity and bond neutral
South Korea	Department Store Sales	y/y	Feb	7.2%	0.7%		*	Equity and bond neutral
	Discount Store Sales	y/y	Feb	21.0%	-9.2%		*	Equity and bond neutral
	Retail Sales	y/y	Feb	13.7%	8.2%		**	Equity and bond neutral
South Korea	Consumer Confidence	m/m	Mar	100.7	101.9		*	Equity and bond neutral
EUROPE								
Germany	GfK Consumer Confidence	m/m	Apr	-27.4	-28.8	-28	**	Equity and bond neutral
AMERICAS								
Brazil	IBGE Inflation IPCA - 15	y/y	Mar	4.1%	4.5%	4.1%	*	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)	557	558	-1	Down
3-mo T-bill yield (bps)	519	520	-1	Up
U.S. Sibor/OIS spread (bps)	531	531	0	Down
U.S. Libor/OIS spread (bps)	532	532	0	Down
10-yr T-note (%)	4.24	4.25	-0.01	Down
Euribor/OIS spread (bps)	389	390	-1	Down
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
Yen	Flat			Down
Pound	Up			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.

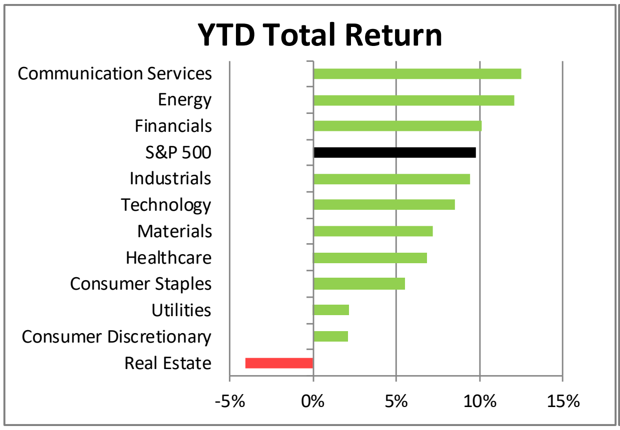
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$86.79	$86.75	0.05%	
WTI	$82.08	$81.95	0.16%	
Natural Gas	$1.63	$1.62	0.87%	
Crack Spread	$31.41	$31.72	-0.96%	
12-mo strip crack	$25.02	$25.20	-0.73%	
Ethanol rack	$1.75	$1.75	-0.17%	
Metals				
Gold	$2,195.89	$2,171.83	1.11%	
Silver	$24.77	$24.68	0.37%	
Copper contract	$402.10	$401.60	0.12%	
Grains				
Corn contract	$437.50	$437.75	-0.06%	
Wheat contract	$555.00	$555.00	0.00%	
Soybeans contract	$1,204.50	$1,209.25	-0.39%	
Shipping				
Baltic Dry Freight	2,123	2,196	-73	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.0		
Gasoline (mb)		-1.0		
Distillates (mb)		1.00		
Refinery run rates (%)		-0.1%		
Natural gas (bcf)		5		

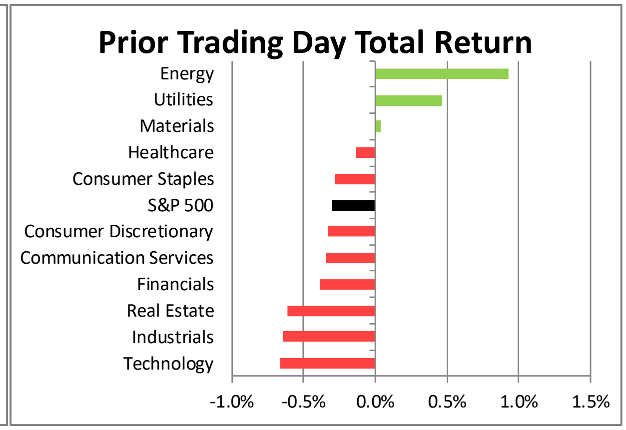
Weather

The 6-10 and 8-14 day forecasts currently call for cooler-than-normal temperatures in California and the Desert Southwest, with warmer-than-normal temperatures in the Southeast. Precipitation outlooks call for wetter-than-normal conditions in California, the preponderance of the Mountain Time Zone, the Southeast, and the Mid-Atlantic states.

Data Section

US Equity Markets – (as of 3/25/2024 close)

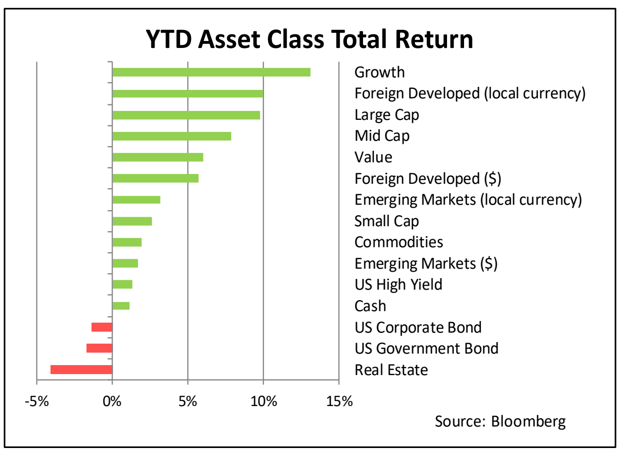




(Source: Bloomberg)

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 3/25/2024 close)

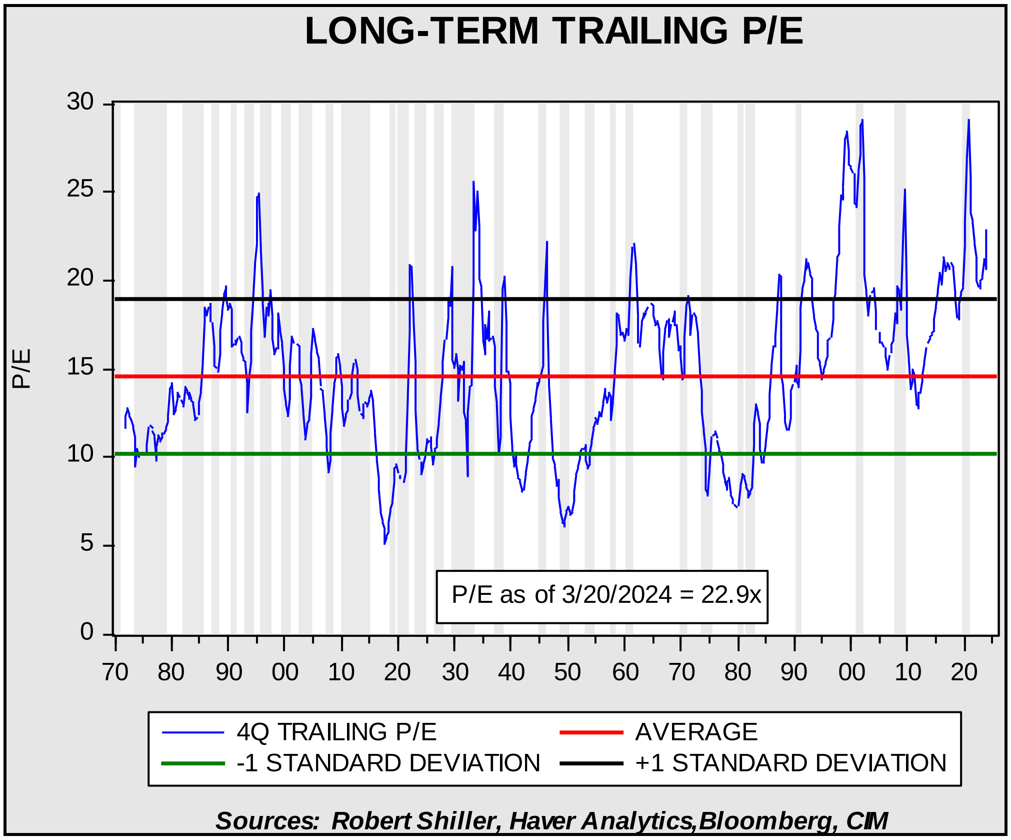


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.