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 27, 2024—9:30 AM EDT] Global equity markets are mixed 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 down 0.5%. Chinese markets were lower, with the Shanghai Composite down 1.3% from its previous close and the Shenzhen Composite down 2.8%. 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:

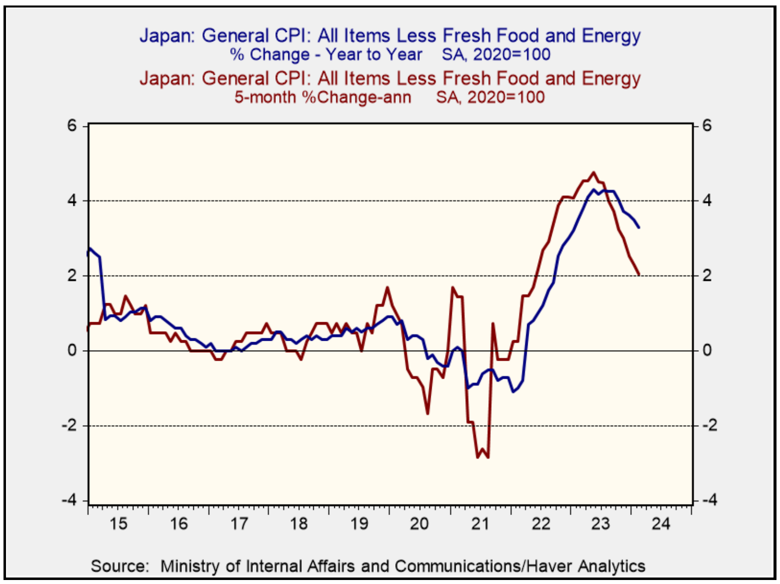
- *Bi-Weekly Geopolitical Report* (3/25/2024) (with associated podcast): "Venezuela Threatens Guyana"
- *Asset Allocation Quarterly – Q1 2024* (1/26/2024): Discussion of our asset allocation process, Q1 2024 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q1 2024 Rebalance Presentation* (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! Equity markets are off to a strong start today. In sports news, the NFL has announced a rule change to its kickoff format, making it similar to the format used by its competitor, the XFL. Today's *Comment* dives into the nuanced reasons behind the Bank of Japan's cautious approach toward significant shifts in monetary policy, explores consumer apprehensions surrounding the upcoming election, and examines the burgeoning AI frenzy making its way across Asia. As usual, we include a round of international and domestic news.

Yen Worries Continue: The Japanese yen (JPY) weakens as the Bank of Japan indicates it will refrain from additional interest rate hikes, despite inflation exceeding its 2% target.

- The Bank of Japan threatened currency intervention to halt speculation, driving down the JPY. Earlier today, the currency plunged to a 34-year low of 151.97 per dollar, alarming policymakers. This sharp depreciation follows the central bank's recent decision to end negative interest rates and to signal a pause in further tightening. However, Governor Kazuo Ueda's dovish stance — suggesting the BOJ won't raise rates aggressively until inflation expectations reach 2% — has spooked investors. Consequently, they're dumping yen holdings in anticipation of other central banks, like the Federal Reserve and the European Central Bank, maintaining higher rates for a longer period than the market anticipated at the start of the year.

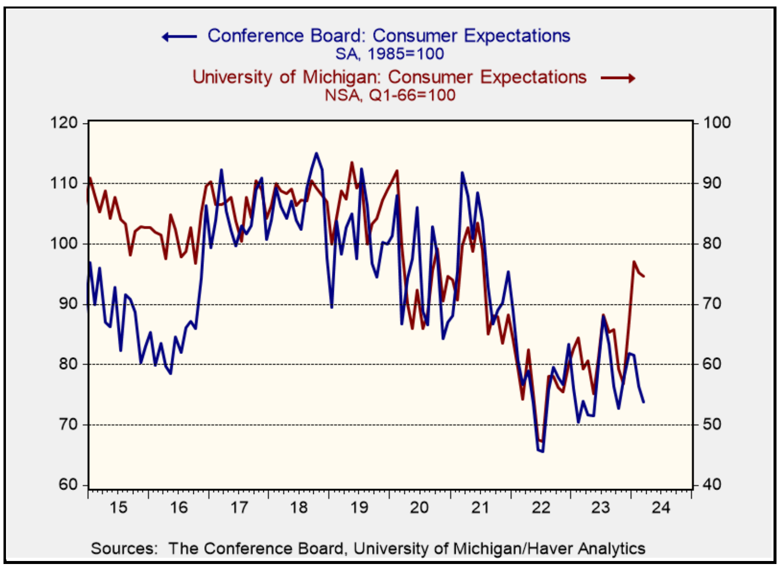
- Recent inflation data strengthens the Bank of Japan's case for maintaining its dovish stance. Headline inflation rose 2.8% year-over-year, but this increase hasn't translated to core inflation. The core index has remained flat since October 2023, suggesting underlying inflationary pressures are subdued. Furthermore, core inflation shows signs of further moderation, rising at an annualized pace of only 2.1% over the past five months, significantly lower than the 3.3% annual change observed in February. The setback in inflation has likely led policymakers to question whether the country has truly turned a corner in its fight against deflation.



- In a shift from past policy, central banks, including the Bank of Japan, are prioritizing a cautious approach to monetary policy. Their primary concern is to avoid triggering unintended economic downturns that would necessitate future policy reversals. This cautious stance extends even to central banks who have traditionally been seen as more hawkish, as evidenced by similar concerns about interest rate adjustments voiced by members of the European Central Bank and the Federal Reserve. This cautious approach by central banks is likely to keep the interest rate differential between the US and its peers stable or even widen it, potentially strengthening the dollar.

Election Concerns: Anxiety is rising among American households about the country's direction, fueled in part by the potential for a rematch between President Biden and his predecessor, Donald Trump.

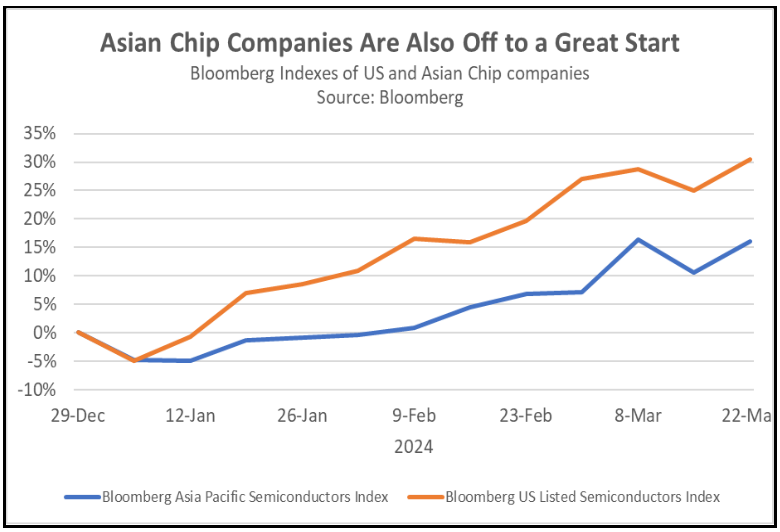
- Recent surveys paint a complex picture of consumer sentiment. While headline figures from the Conference Board and the University of Michigan suggest stability, a closer look reveals a growing unease about the future. This is evidenced by a decline in consumer expectations in the Conference Board's March survey, with the six-month outlook dropping to its lowest point in six months (73.8, down from 76.3). The University of Michigan Sentiment Index echoes this trend, dipping slightly from 75.2 to 74.6. Notably, this weakening confidence emerges despite positive signs in the labor market and significant progress on inflation reduction from its highs in 2022.
- The forthcoming election appears to be a significant factor in the growing disparity between consumer sentiment and favorable economic indicators. According to the latest findings from the University of Michigan, the survey shows a downturn in sentiment among independent voters, while partisan optimism is on the rise among the two major parties. The Conference Board's observations underscore a rising trend of write-in responses concerning the political climate. This coincides with a noticeable generational divergence among respondents. Individuals under 55 exhibit a considerable decline in enthusiasm, while those aged 55 and above demonstrate greater optimism.



- While the election may influence consumer sentiment, it likely won't significantly impact short-term spending. This disconnect suggests voters perceive that neither candidate is offering solutions to improve daily living standards. A deeper reason could be the growing acceptance of a new economic reality: Low borrowing costs are likely gone. Tighter monetary policy and ballooning deficits are expected to keep long-term interest rates above 4% for the foreseeable future. This shift may force consumers who missed the window of easy credit to increase savings to maintain their desired financial stability. In the long run, this could stifle economic growth as households tighten their belts and reduce spending in order to adapt to the shifting economic landscape.

Emerging Tech: With tech stock valuations reaching lofty heights, investors are increasingly turning their attention to Asian countries to capitalize on the burgeoning growth in artificial intelligence (AI).

- US tech giants Meta, Nvidia, Microsoft, and Amazon have been driving the S&P 500's returns this year, accounting for 55% of its gains so far. This surge is likely due to the increasing popularity of AI and the corresponding demand for semiconductors, which are crucial components in AI hardware. While some of the excitement may carry over from last year, Nvidia's strong sales figures in Q4 have bolstered investor confidence that these companies can continue to deliver above-average returns in the future. That said, their high valuations have led investors to begin seeking cheaper alternatives.
- Fueled by the Asian tech boom, India, South Korea, and Taiwan have emerged as attractive destinations for investors seeking to diversify their tech holdings beyond the US. ETF flow data from Bloomberg shows that India is leading the way with $197 million in inflows year-to-date, followed by South Korea at $181 million, and Taiwan at $112 million. These countries are all well-positioned to benefit from the growth of key technologies like AI and semiconductors and are attracting investors seeking exposure to these trends. The rising inflow also reflects a growing investor preference for geographically balanced portfolios, with a focus on countries with strong economic ties to the US or those maintaining neutrality.



- Risk appetite is currently high, likely fueled by market expectations that central banks will begin easing monetary policy within the next six months. While US mega-cap tech stocks have been in the spotlight for years, their dominance seems to be fading. This is evident in the recent broad-based gains across the S&P 500. Investors seeking to capitalize on the AI boom might find opportunities abroad. Foreign AI firms have experienced impressive growth over the past year and currently trade at lower valuations compared to the well-established "Magnificent Seven" US tech giants.

Other News: Protests have broken out in Hungary after Prime Minister Viktor Orbán was implicated in a graft probe. The Bank of England has warned that a boom in private equity may negatively impact the country, elevating the potential for financial mishap. The Congressional Budget Office Director, Phillip Swagel, has warned of a "Liz Truss-style market shock" if the US government does not get its fiscal house in order.

US Economic Releases

The Mortgage Bankers Association reported that ***mortgage applications*** in the week ended March 22 fell 0.7%, compared to the previous week's fall of 1.6%. Applications for home purchase mortgages fell 0.2%, compared to the previous week's fall of 1.2%. Applications for refinancing mortgages fell 1.6%, compared to the previous week's fall of 2.5%. According to the report, the average interest rate on a 30-year mortgage fell to 6.93%, from 6.97%.

The table below lists the economic releases and/or Fed events scheduled for the rest of the day.

Economic Releases		
No economic releases for the rest of today		
Federal Reserve		
EST	**Speaker or Event**	**District or Position**
18:00	Christopher Waller Speaks on Economic Outlook	Member of the Board of Governors

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								
Australia	Westpac Leading Index MoM	m/m	Feb	0.80%	-0.08%		**	Equity and bond neutral
	CPI	y/y	Feb	3.40%	3.40%	3.50%	***	Equity and bond neutral
South Korea	Business Survey - Manufacturing	m/m	Apr	73	75		**	Equity and bond neutral
	Business Survey - Non-Manufacturing	m/m	Apr	69	70		*	Equity and bond neutral
China	Industrial Profits	y/y	Feb	10.2%	-2.3%		*	Equity and bond neutral
EUROPE								
Eurozone	Consumer Confidence	m/m	Mar F	-14.9	-14.9		**	Equity and bond neutral
	Services Confidence	m/m	Mar	6.3	6.0	7.7	*	Equity bearish, bond bullish
	Industrial Confidence	m/m	Mar	-8.8	-9.4	-9.5	*	Equity bullish, bond bearish
	Economic Confidence	m/m	Mar	96.3	95.5	96.2	*	Equity and bond neutral
France	Consumer Confidence	m/m	mar	91.0	90.0	90.0	**	Equity and bond neutral
AMERICAS								
Mexico	International Reserves Weekly	w/w	22-Mar	$216903m	$216492m		*	Equity and bond neutral
	Unemployment Rate NSA	m/m	Feb	2.45%	2.85%	2.80%	***	Equity bullish, bond bearish
	Trade Balance	m/m	Feb	-584.7m	-4314.7m	-4314.7m	**	Equity and bond neutral
Brazil	FGV Inflation IGPM MoM	m/m	Mar	-0.47%	-0.52%	-0.22%	***	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	557	0	Down
3-mo T-bill yield (bps)	521	521	0	Up
U.S. Sibor/OIS spread (bps)	530	531	-1	Down
U.S. Libor/OIS spread (bps)	531	531	0	Flat
10-yr T-note (%)	4.22	4.23	-0.01	Down
Euribor/OIS spread (bps)	390	389	1	Down
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Flat			Down
Yen	Up			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.

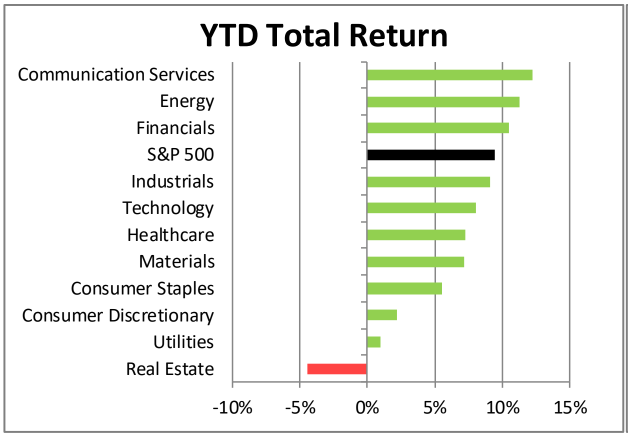
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$85.71	$86.25	-0.63%	
WTI	$81.14	$81.62	-0.59%	
Natural Gas	$1.76	$1.79	-1.79%	
Crack Spread	$30.25	$30.21	0.13%	
12-mo strip crack	$24.34	$24.42	-0.32%	
Ethanol rack	$1.74	$1.74	-0.26%	
Metals				
Gold	$2,197.21	$2,178.80	0.84%	
Silver	$24.63	$24.46	0.70%	
Copper contract	$399.90	$400.85	-0.24%	
Grains				
Corn contract	$427.75	$432.50	-1.10%	
Wheat contract	$541.00	$543.50	-0.46%	
Soybeans contract	$1,192.75	$1,199.00	-0.52%	
Shipping				
Baltic Dry Freight	1,989	2,123	-134	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.0		
Gasoline (mb)		-1.7		
Distillates (mb)		1.00		
Refinery run rates (%)		0.7%		
Natural gas (bcf)		-25		

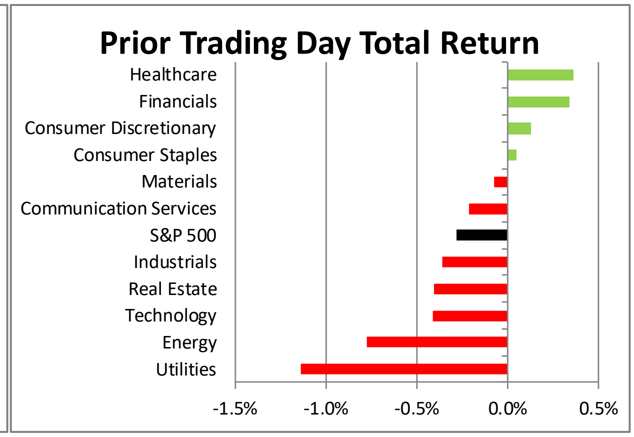
Weather

The 6-10 and 8-14 day forecasts currently call for cooler-than-normal temperatures in Southern California and the Mountain Time Zone, with warmer-than-normal temperatures in South Florida. Precipitation outlooks call for wetter-than-normal conditions in Southern California, the Mountain Time Zone, and the Southeast.

Data Section

US Equity Markets – (as of 3/26/2024 close)

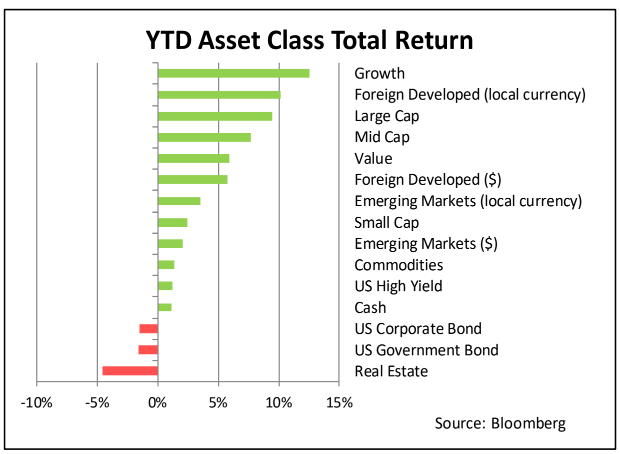




(Source: Bloomberg)

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 3/26/2024 close)

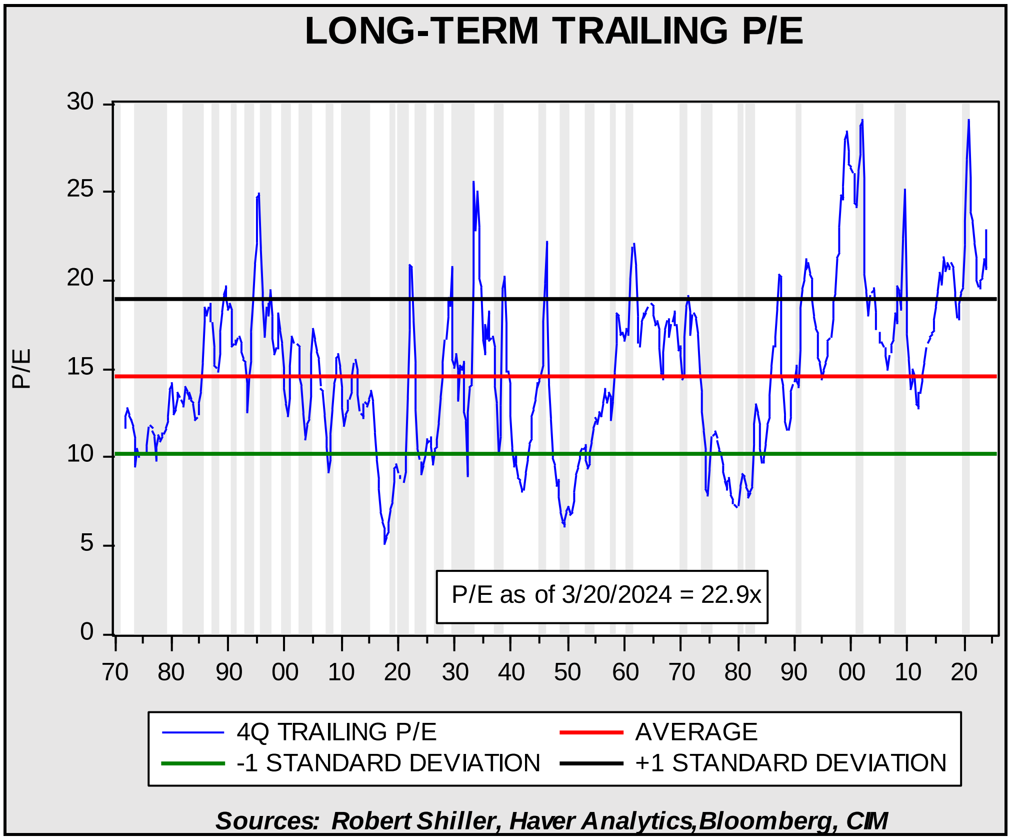


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.