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 28, 2024—9:30 AM EDT] Global equity markets are mostly higher this morning. In Europe, the Euro Stoxx 50 is up 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.2%. Chinese markets were higher, with the Shanghai Composite up 0.6% from its previous close and the Shenzhen Composite up 1.7%. Conversely, 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:

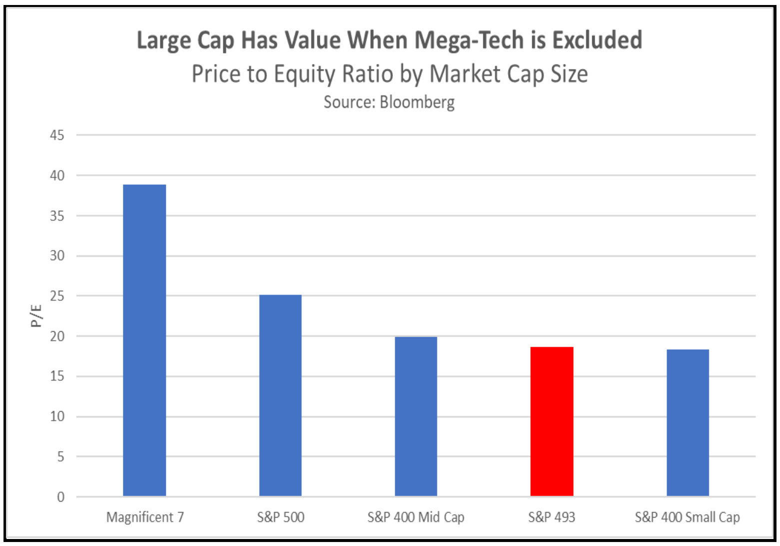
- *Bi-Weekly Geopolitical Report* (3/25/2024) (with associated podcast): "Venezuela Threatens Guyana"
- *Asset Allocation Quarterly – Q1 2024* (1/26/2024): Discussion of our asset allocation process, Q1 2024 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q1 2024 Rebalance Presentation* (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"

Note to readers: the* Daily Comment *will not be published tomorrow due to the Good Friday holiday.

Good morning! While equities are showing a muted reaction to the revised GDP figures, we are celebrating the start of the MLB season. Today's *Comment* dives into the rationale behind why investors shouldn't overlook large-cap stocks. Additionally, we explore how central bank caution has supported the dollar, while shedding light on the factors contributing to the remarkable ascent of the Mexican peso, which has emerged as one of the top-performing currencies globally. As usual, the report includes a summary of domestic and international data releases.

Not Like the Rest: Hopes for Fed rate cuts and the froth in AI stocks fueled risk-on sentiment in Q1; however, this may not carry over into next quarter.

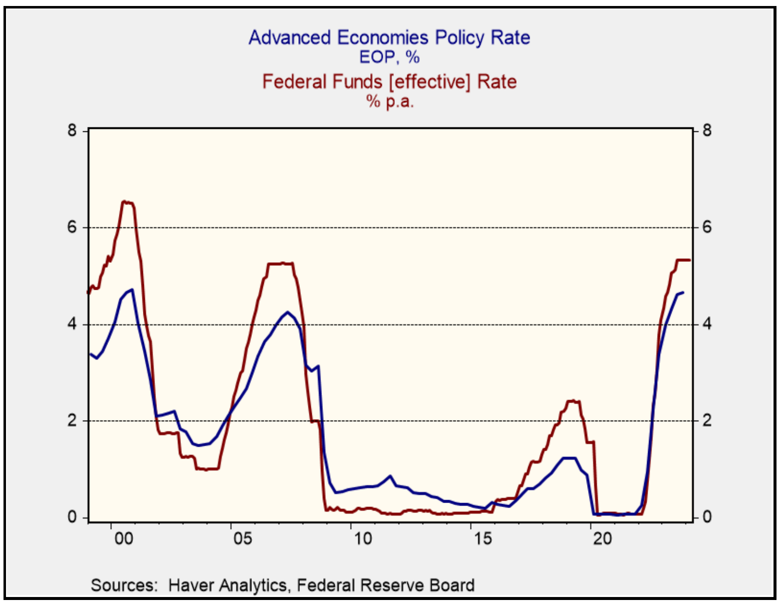
- Fueled by AI optimism and dovish monetary policy expectations, the S&P 500 surged 10% in Q1, its fastest year-to-date rise since 2019. Policymakers' promises of rate cuts and tech companies' defiance of expectations fueled this growth. However, recent headwinds threaten to stall this momentum. Fed officials, like Governor Christopher Waller, have grown cautious, downplaying the possibility of imminent cuts due to strong economic data. Additionally, concerns mount that tech valuations are stretched, potentially jeopardizing their outperformance streak. These mounting doubts raise the specter of whether these trends will be able to hold going into the next quarter.
- The market may experience volatility in the next quarter due to a confluence of factors. The Federal Reserve's monetary policy decisions will be heavily influenced by upcoming employment data. Another strong payroll report, if it exceeds expectations like the recent ones, could lead policymakers to reevaluate their plan for interest rate cuts, potentially reducing the anticipated number to just two for the year. Additionally, investor sentiment is shifting as they look beyond the Magnificent Seven (M7) stocks, whose valuations are reaching expensive territory, and seek safer alternatives.



- The narrow leadership in the market's 2024 rise suggests a Q2 pullback in momentum is more probable than a correction, absent a significant macroeconomic shock. That said, investors may be able to find value in large-cap companies outside the M7. Excluding those large-cap companies, the index has a P/E ratio of just under 19, which is right in line with historical averages. Given their size, those large-cap firms are relatively well-positioned to absorb changes in Fed policy compared to their mid- and small-cap counterparts and would likely benefit if the Fed follows through on its easing plans.

The Dollar Is Back! The greenback has roared to its strongest quarter in two years, as a shift in market expectations for central bank policy bolstered the dollar's value.

- The US dollar has surged 2.7% in Q1, according to the Bloomberg Dollar Spot Index, fueled by a shift in central bank policy expectations. Markets initially anticipated interest rates converging globally, but recent pronouncements suggest a slower pace of easing. Echoing the Fed's cautious stance, central bankers worldwide signaled a more measured approach. Bank of England Monetary Policy Committee member Jonathan Haskel indicated that the UK is a long way off from cutting rates, while ECB President Lagarde remained noncommittal on future policy easing after the ECB's expected June cut. Meanwhile, the Bank of Japan distanced itself from any tightening bias.
- Central banks' shift away from aggressive rate cuts has resonated with the market. Investors have adjusted their forecasts upward, anticipating a slower pace of rate reductions and a higher interest rate environment over the next three years. This hawkish tilt is particularly pronounced in 2025 projections, with US rates revised up by 70 bps and the UK seeing a 55-bps increase. These revisions suggest the market isn't convinced that central banks in Europe and the UK will take drastic measures to cut rates independent of the Federal Reserve's actions, despite economic weakness in those countries.

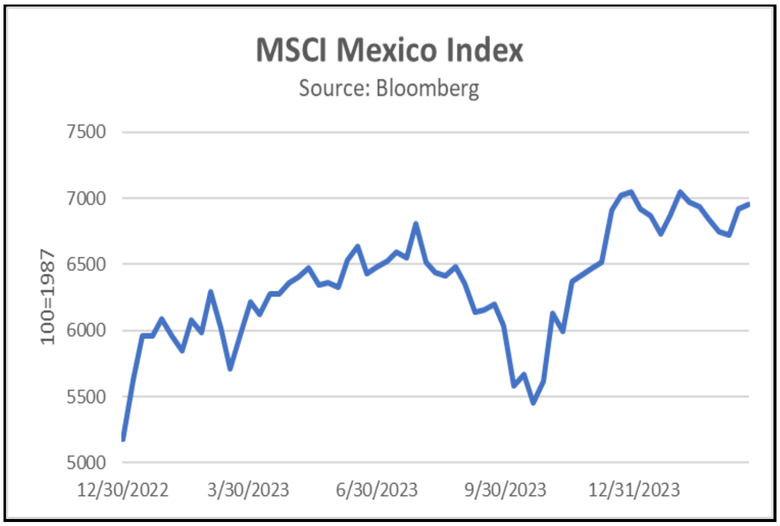


- The Fed's aggressive rate cuts, which have historically started from higher points, often result in a lower terminal rate compared to other central banks. Even if the Fed cuts this year, whether before July or after the election, the dollar's weakness would likely be temporary. However, the current combination of a strong dollar and high interest rates creates tighter global financial conditions than investors may have anticipated for 2024. This could potentially dampen global growth and make US equities more attractive relative to foreign markets.

The Super Peso: The Mexican peso (MXN) has defied expectations in 2023 by strengthening despite rate cuts and potential US tensions.

- The MXN has emerged as the world's strongest currency against the dollar this year. Two key factors fueled this stellar performance. First, despite lowering its policy rate this year, Mexico boasts one of the highest interest rates globally, making it attractive for carry-trade investors seeking to profit from interest rate differentials. These investors buy foreign currency (like the dollar) and then invest those funds into a higher-yielding currency (like the peso). Secondly, President Andrés Manuel López Obrador's (AMLO) plan to reduce government spending has helped curb national debt, bolstering investor confidence in the Mexican economy and its currency.

- Mexico's strong peso hasn't shielded its stock market from volatility in 2024. The MSCI Mexico soared nearly 30% in the final two months of 2023, but this year's performance has been choppy. This uncertainty likely stems from outgoing AMLO's late-term spending spree, which is expected to push the estimate of public debt as a percentage of GDP from 4.9% to 5.0%. Additionally, his presumed successor, Claudia Sheinbaum, has pledged to cap oil production at 1.8 million barrels per day, a slight decrease that suggests a potential move away from fossil fuels.

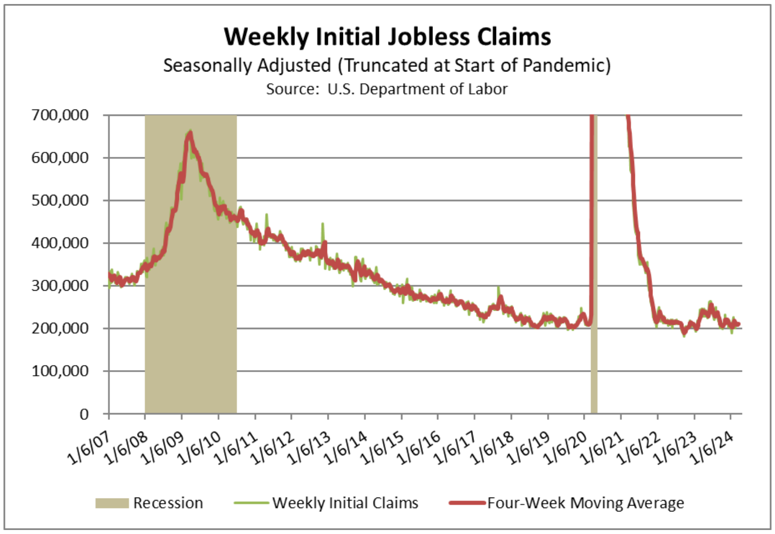


- Mexico's upcoming election looms large over its financial markets. The country's proximity to the US makes it a magnet for companies seeking North American market access. While AMLO has navigated relations with both US presidential contenders, uncertainty swirls around Claudia Sheinbaum and her ability to maintain these ties. Further complicating matters, tensions with the US are rising as Chinese firms attempt to manufacture electric vehicles in Mexico for the US market, attracting criticism from American lawmakers. Immigration, another perennial issue, adds another layer of complexity. If Sheinbaum is able to successfully avoid US hostilities, Mexican companies could present potential opportunities for investors looking for foreign exposure.

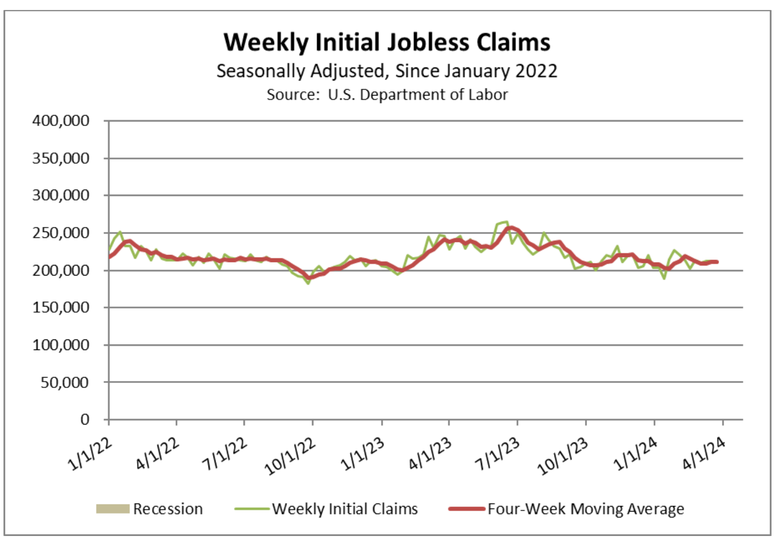
Other News: China's most senior military leader has urged Asia to take responsibility for managing its own security, indicating that despite the thaw in tensions between the world's two largest economies, significant geopolitical differences persist. The Russian propaganda machine remains active and potent, raising concerns that Moscow may attempt to influence the upcoming US election.

US Economic Releases

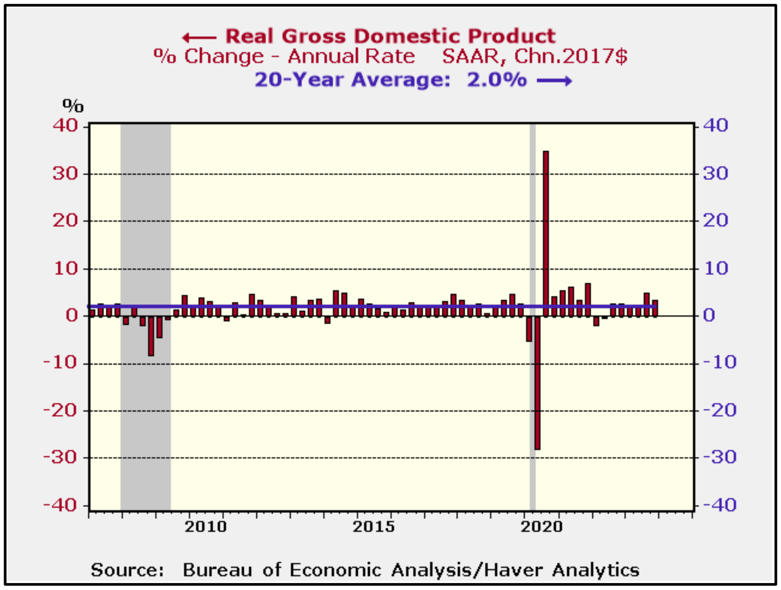
In the week ended March 23, ***initial claims for unemployment benefits*** edged down to a seasonally adjusted 210,000, better than expectations that they would remain at the previous week's revised level of 212,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to 211,000. Meanwhile, in the week ended March 16, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to 1.819 million, above both the anticipated reading of 1.815 million and the prior week's revised reading of 1.795 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.



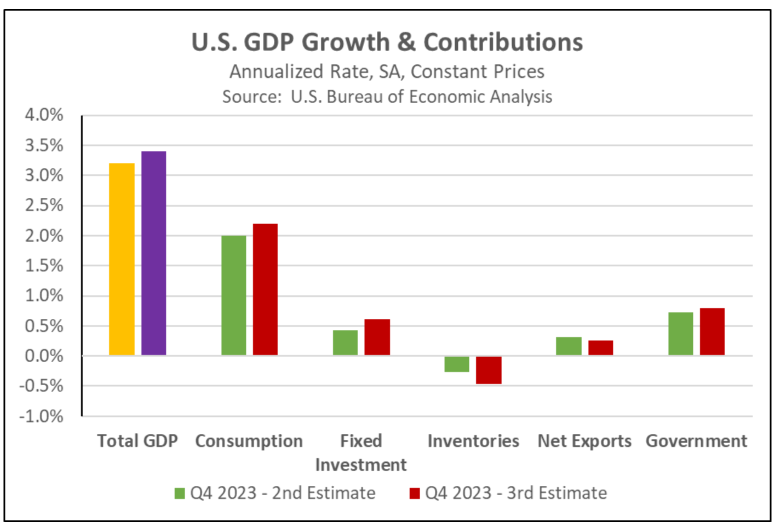
To provide more detail on recent trends, the chart below shows how initial jobless claims have changed just since the beginning of 2022.



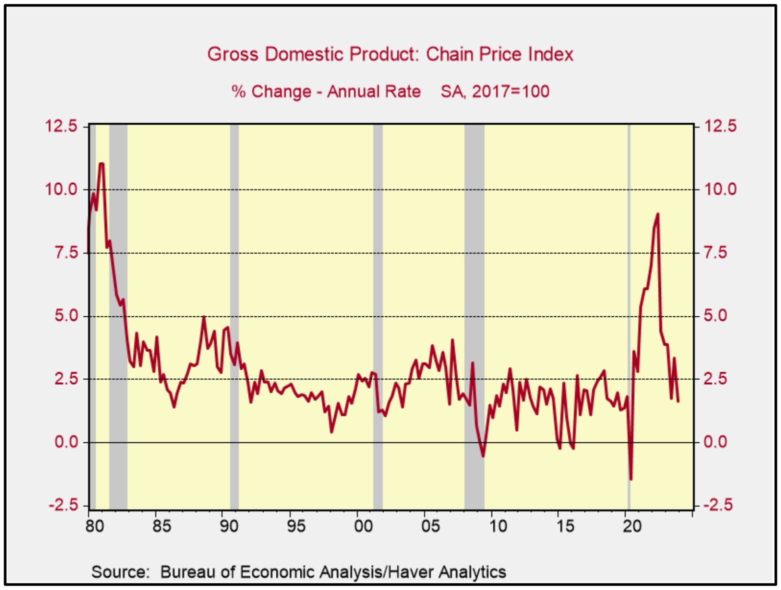
Separately, the Commerce Department released its third estimate of economic activity in the fourth quarter of 2023. After stripping out seasonal factors and price changes, fourth-quarter ***gross domestic product (GDP)*** rose at an annualized rate of 3.4%, a bit better than expectations that the estimate would be unchanged at 3.2% but still slower than the final estimate of 4.9% in the third quarter. The chart below shows the annualized growth rate of U.S. GDP since just before the previous recession.



A close look at the details in the report shows that the main source of growth in the quarter was personal consumption spending, which grew at a healthy annual rate of 3.3%, up from 3.0% in the previous estimate and 3.1% in the third quarter. The chart below shows the contributions to the annualized growth rate in the fourth quarter.



The GDP report also includes the broadest measure of U.S. price inflation. The fourth quarter ***GDP Price Index*** rose at an annualized rate of 1.6%, merely matching expectations that the broad inflation rate would be unchanged from the earlier estimate but still much slower than the final estimate of 3.3% in the third quarter. The chart below shows the year-over-year change in the GDP Price Index over the last several decades.



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	MNI Chicago PMI	m/m	Mar	46.0	44.0	***
10:00	Pending Home Sales	m/m	Feb	1.5%	-4.9%	**
10:00	Pending Home Sales NSA	y/y	Feb	--	-6.8%	**
10:00	U. of Michigan Consumer Sentiment	m/m	Mar F	76.5	76.5	***
10:00	U. of Michigan Current Conditions	m/m	Mar F	79.6	79.4	**
10:00	U. of Michigan Future Expectations	m/m	Mar F	74.7	74.6	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Mar F	3.1%	3.0%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Mar F	2.9%	2.9%	*
11:00	Kansas City Fed Manfacturing Index	m/m	Mar	-4	-4	*
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	Foreign Buying Japan Stocks	w/w	22-Mar	-¥1461.9b	-¥1461.6b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	22-Mar	-¥818.8b	-¥803.9b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	22-Mar	¥2161.6b	¥2157.7b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	22-Mar	¥81.9b	-¥522.2b		*	Equity and bond neutral
Australia	Private Sector Credit	y/y	Feb	5.0%	4.9%		**	Equity and bond neutral
	Retail Sales	m/m	Feb	0.30%	1.10%	0.40%	***	Equity and bond neutral
New Zealand	ANZ Consumer Confidence	m/m	Mar	-8.6	1.0		*	Equity bearish, bond bullish
	ANZ Business Confidence	m/m	Mar	22.9	34.7		**	Equity bearish, bond bullish
EUROPE								
Eurozone	M3 Money Supply	y/y	Feb	0.4%	0.1%	0.3%	***	Equity and bond neutral
Germany	Unemployment Change	m/m	Mar	4.0k	12.0k	10.0k	***	Equity bearish, bond bullish
	Unemployment Claims Rate	m/m	Mar	5.9%	5.9%	5.9%	**	Equity and bond neutral
Germany	Retail Sales	y/y	Feb	1.7%	-1.3%	-0.8%	*	Equity bullish, bond bearish
Italy	Consumer Confidence	m/m	Mar	96.5	97.0	97.6	***	Equity bearish, bond bullish
	Manufacturing Confidence	m/m	Mar	88.6	87.5	87.8	***	Equity and bond neutral
	Economic Sentiment	m/m	Mar	97.0	95.9		**	Equity and bond neutral
	PPI	y/y	Feb	-14.2%	-14.0%		**	Equity and bond neutral
UK	GDP	y/y	4Q F	-0.2%	-0.2%	-0.2%	***	Equity and bond neutral
	Total Business Investment YoY	y/y	4Q F	2.8%	3.7%	3.7%	***	Equity bearish, bond bullish
	Current Account Balance	q/q	4Q	-21.2b	-18.5b	-21.4b	**	Equity and bond neutral
Switzerland	KOF Leading Indicator	m/m	Mar	101.5	102.0	102.0	**	Equity and bond neutral
Russia	Industrial Production	y/y	Feb	8.5%	4.6%	5.3%	***	Equity bullish, bond bearish
AMERICAS								
Brazil	National Unemployment Rate	m/m	Feb	7.8%	7.6%	7.8%	*	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)	557	557	0	Down
3-mo T-bill yield (bps)	520	522	-2	Up
U.S. Sibor/OIS spread (bps)	531	530	1	Down
U.S. Libor/OIS spread (bps)	532	531	1	Up
10-yr T-note (%)	4.22	4.19	0.03	Down
Euribor/OIS spread (bps)	391	390	1	Down
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Down
Yen	Flat			Down
Pound	Down			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.

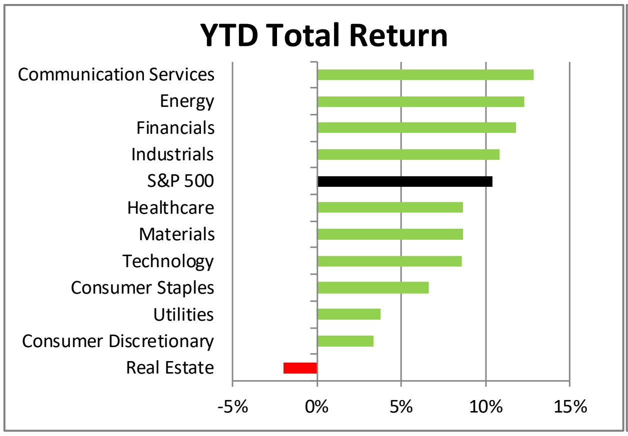
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$87.25	$86.09	1.35%	
WTI	$82.48	$81.35	1.39%	
Natural Gas	$1.70	$1.72	-1.16%	
Crack Spread	$29.60	$29.79	-0.65%	
12-mo strip crack	$24.29	$24.35	-0.24%	
Ethanol rack	$1.72	$1.73	-0.27%	
Metals				
Gold	$2,208.41	$2,194.79	0.62%	
Silver	$24.51	$24.65	-0.58%	
Copper contract	$400.05	$400.00	0.01%	
Grains				
Corn contract	$427.00	$426.75	0.06%	
Wheat contract	$549.00	$547.50	0.27%	
Soybeans contract	$1,188.50	$1,192.50	-0.34%	
Shipping				
Baltic Dry Freight	1,845	1,989	-144	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.0	-1.0	-1.0	
Gasoline (mb)	1.3	-1.7	3.0	
Distillates (mb)	-1.19	1.00	-2.19	
Refinery run rates (%)	0.9%	0.7%	0.2%	
Natural gas (bcf)		-27		

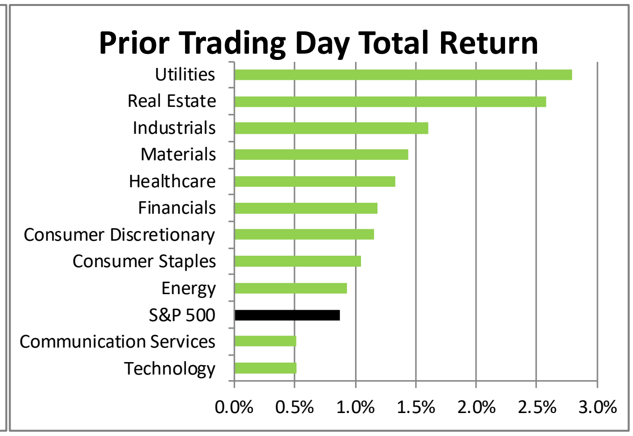
Weather

The 6-10 and 8-14 day forecasts currently call for cooler-than-normal temperatures in the southern Great Plains and the Mississippi Valley, with warmer-than-normal temperatures in the Northeast. The forecasts call for wetter-than-normal conditions in the northern and southern Rocky Mountains and the Southeast, with dry conditions in the Northeast.

Data Section

US Equity Markets – (as of 3/27/2024 close)

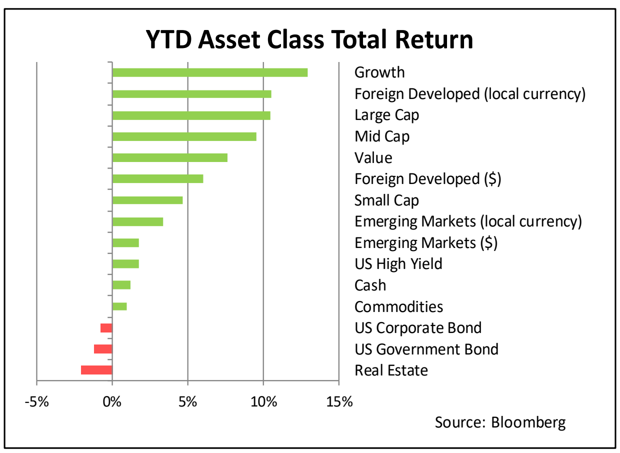




(Source: Bloomberg)

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 3/27/2024 close)

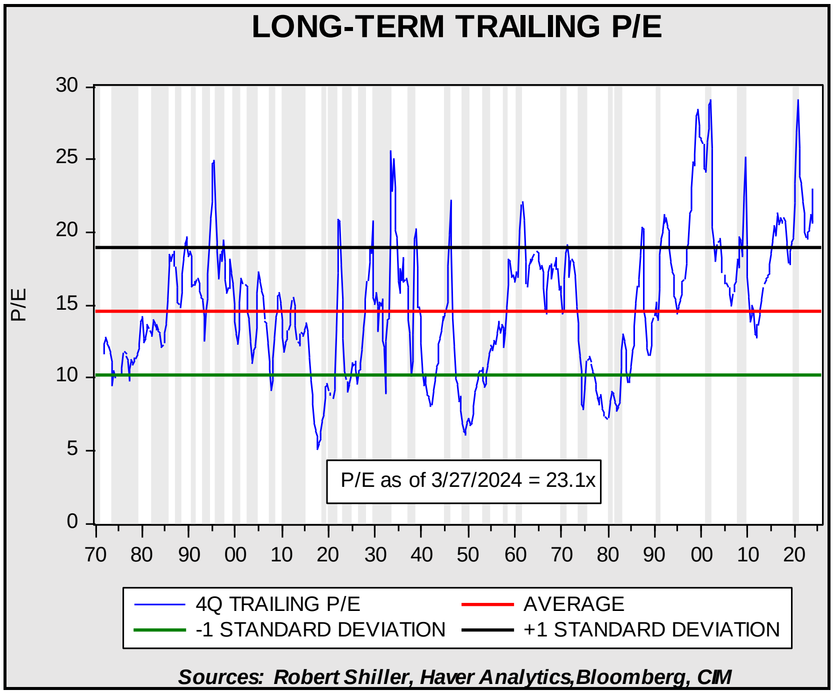


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 28, 2024



Based on our methodology,[1] the current P/E is 23.1x, up 0.2x 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.