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 5, 2024—9:30 AM EST] Global equity markets are generally lower this morning. In Europe, the Euro Stoxx 50 is down 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.4%. Chinese markets were mixed, with the Shanghai Composite up 0.3% from its previous close and the Shenzhen Composite down 0.6%. US equity index futures are signaling a lower open.

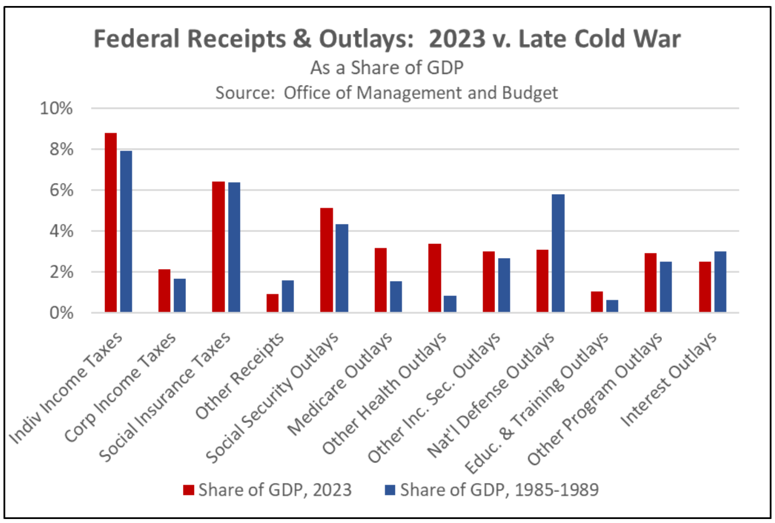
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (2/26/2024) (with associated podcast): "Posen vs. Pettis"
- *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* (3/4/2024) (with associated podcast): "Uranium Demand, Supply, and Investment Prospects"
- *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 a discussion of the fiscal challenges faced by Western governments as they look to rebuild their defenses in the face of increased threats from countries like China and Russia. We next review a wide range of other international and US developments with the potential to affect the financial markets today, including a new economic growth target in China and research pointing to more US companies tapping the convertible bond market.

Global Fiscal Policy: In a recent interview with the *Financial Times*, Danish Prime Minister Mette Frederiksen castigated European governments that slashed their defense spending after the end of the Cold War and then remained far too complacent about the growing threat from Russia in recent years. Importantly, Frederiksen warned that hiking defense budgets as necessary now will require countries to reverse the tax cuts and welfare spending hikes they funded with their post-Cold War defense budget cuts.

- As our regular readers know, we at Confluence believe the intensifying rivalry between the US and China/Russia geopolitical blocs will lead to bigger defense budgets in many countries in the coming years. To put it another way, the Western nations that cut their defense spending so dramatically following the end of the Cold War and happily spent the resulting "peace dividend" on civilian programs may now need to reverse course.
- We have argued that growing geopolitical tensions will likely lead to stronger government intervention in Western economies. Frederiksen's warning is one of the first in which a top Western leader has been willing to state the trade-offs so clearly: Hiking defense budgets as required now may well require tax hikes and civilian spending cuts.
- How would this look? To start scoping out the prospects, we conducted a quick analysis of how the US federal budget would look in an environment like the late Cold War. In the chart below, we show the Office of Management and Budget's estimated fiscal year 2023 federal receipts and outlays as a share of gross domestic product and compare them to their average shares of GDP in 1985-1989.



  - The chart clearly suggests the enormous drop in US defense spending since the Cold War has been absorbed mostly by increased outlays on Medicare, Medicaid, and other healthcare, along with Social Security retirement benefits. That likely reflects the aging of the US population and rampant healthcare price inflation.
  - If US leaders now wanted to boost the defense budget back to the late-Cold War average of 5.8% of GDP from today's 3.1% of GDP (to about $1.5 trillion from today's $815 billion), we think political considerations would likely count out any substantial cuts to Social Security, Medicare, and Medicaid outlays.
  - The problem is that other civilian outlays today are not much higher (as a share of GDP) than they were in President Reagan's second term. Even if they were cut to their share of GDP in 1985-1989, the savings would cover less than half of the required $708 billion hike in defense spending.
  - That suggests unpalatable tax hikes of some $400 billion might be needed to bring defense spending back to late-Cold War norms. And these outlay cuts and tax hikes wouldn't even address the $605 billion reduction in the deficit to bring it back in line with its average of 3.7% of GDP in 1985-1989.

European Union: The European Parliament last night gave preliminary approval to a bill that aims to reduce packaging materials for consumer products. If signed into law, for example, the bill could lead to hotel mini-toiletries and single-use plastic wraps to be banned by 2030. Many paper and cardboard packaging products were spared by intense industry lobbying, but the law will nevertheless probably become another symbol of excessive EU regulations that could be discouraging investment and growth in the region.

Chinese Economic Policy: At the formal opening of the National People's Congress today, Premier Li Qiang said the government will target economic growth of "about 5%" in 2024, helped by issuing some $139 billion of special, ultra-long-term government bonds to help relieve fiscal pressure on provincial and local governments and investing in high-priority sectors. The target for growth in gross domestic product is the same as last year's, but analysts believe the target will be harder to achieve because of China's accumulating structural headwinds.

- We tend to categorize China's intensifying headwinds as: Weak consumer ***demand***, excess capacity and ***debt***, poor ***demographics***, foreign ***decoupling***, and ***disincentives*** from the government's intrusive economic policies. We think those forces will continue to hold down Chinese growth in 2024, although the government's recent effort to boost the stock market has helped push Chinese stock prices higher for now.
- Separately, Li's economic work report also calls for China's military budget to expand by 7.2% this year, matching the increase in last year's official budget. However, Li provided no detailed breakdown of the defense spending plan, prompting the Japanese government to complain about the lack of transparency.

Chinese Economic Growth: The February Caixin purchasing managers' index for the services sector declined to a seasonally adjusted 52.5, down from 52.7 in January. Like most major PMIs, the Caixin indexes are designed so that readings over 50 point to expanding activity. Even though the February figure suggests the Chinese services sector is still growing, the number is now at its lowest since November. We believe that illustrates the continued weak momentum in the Chinese economy.

Japan: The Jibun Bank February PMI for the services sector fell to a seasonally adjusted 52.9 from 53.1 in January. Again, as with most major PMIs, the Jibun indexes are also designed so that readings over 50 indicate expanding activity. The February reading signals that Japan's services sector has now been growing for a year and a half, despite the small drop last month. In other data today, the Tokyo region's February consumer price index excluding fresh food was up 2.5% from one year earlier, accelerating from a rise of 1.8% in the year to January.

- Taken together, the data point to further strength in the Japanese economy and consumer price pressures.
- That, in turn, will likely keep the Bank of Japan on track to soon exit its negative interest rate policy.

South Korea: The government's biennial ranking of countries by technological development found that China's overall score has pulled ahead of South Korea's for the first time. Taking US development in key economic sectors as the baseline, the study put the European Union at 94.7%

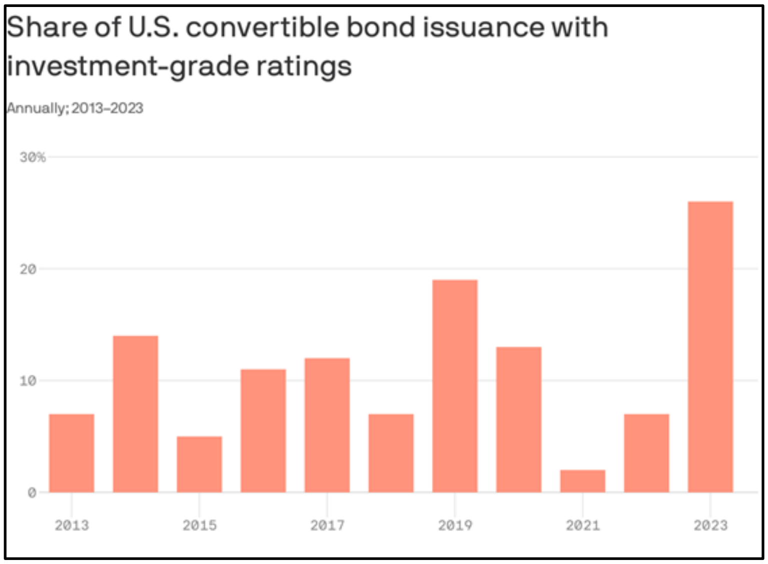
of the US level in 2022, while Japan was at 86.4%, China was at 86.2%, and South Korea was at 81.5%. Since being overtaken by China is seen as a national humiliation, the results are expected to intensify the government's US-style effort to crack down on technology flows to China.

Haiti: In what appears to be an effort to oust Prime Minister Ariel Henry, armed gangs in recent days have attacked police stations, stormed prisons, and freed about 5,000 inmates. Widespread rampages and violence are reportedly continuing today. The prime minister has been in Africa trying to secure a United Nations peacekeeping mission for the country, and his whereabouts are reportedly unknown.

US Politics: Today is Super Tuesday, with presidential primary elections and other balloting in 15 states across the country. Former President Trump is expected to win enough votes to come very close to clinching the Republican nomination, but he isn't expected to win it outright today. One key question is therefore whether Former UN Ambassador Haley will keep fighting. President Biden is naturally expected to win the vast majority of Democratic votes and eventually clinch his party's nomination.

- Separately, interesting new reporting by Axios and *The New Yorker* indicate that Biden is pushing his campaign staff for a much more aggressive approach than the traditional "Rose Garden" strategy often adopted by sitting presidents.
- Biden is reportedly pushing for a strategy in which he would actively goad and taunt Trump on a near daily basis, hoping to take advantage of Trump's perceived lack of discipline and make him "go haywire in public."
- The strategy, if implemented, would also aim to show Biden as a spirited fighter, taking some focus off his age.
- The reporting suggests that the presidential election campaigns could get nastier and more chaotic than we've seen so far.

US Bond Market: New analysis from BofA Global Research shows that the share of new convertible bonds issued by companies with investment-grade ratings has surged in the last year. Investment-grade deals made up 26% of convertible deals in 2023, up from 7% in 2022 and just 2% in 2021. Since the opportunity to convert to equity is a powerful sweetener, convertible debt typically comes with relatively low interest rates. The surge in investment-grade convertibles is a reflection of how companies are trying to cut their interest expenses in today's high-rate world.



(Sources: BofA Global Research, Axios)

US Economic Releases

No major US economic reports have been released so far today. 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 Services PMI	m/m	Feb F	51.4	51.3	***
9:45	S&P Global US Composite PMI	m/m	Feb F	51.4	51.4	***
10:00	Factory Orders	m/m	Jan	-0.03	0.002	***
10:00	Factory Orders Ex Transportation	m/m	Jan	-0.1%	0.4%	*
10:00	Durable Goods Orders	m/m	Jan F	-0.061	-0.061	***
10:00	Durables Ex Transportation	m/m	Jan F	-0.3%	-0.3%	**
10:00	Cap Goods Orders Nondef Ex Air	m/m	Jan F		0.1%	*
10:00	Cap Goods Ship Nondef Ex Air	m/m	Jan F		0.8%	*
10:00	ISM Services Index	m/m	Feb	53	53.4	**
10:00	ISM Services Prices Paid	m/m	Feb	62	64	*
10:00	ISM Services Employment	m/m	Feb		50.5	*
10:00	ISM Services New Orders	m/m	Feb		55.0	*
Federal Reserve						
EST	Speaker or Event	District or Position				
12:00	Michael Barr Speaks on Panel about CRA Modernization	U.S. Federal Reserve Vice Chair for Supervision				
12:15	Michael Barr Participates in Roundtable Listening Session	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	Tokyo CPI	y/y	Feb	2.6%	1.6%	1.8%	**	Equity bearish, bond bearish
	Tokyo CPI Ex-Fresh Food	y/y	Feb	2.5%	1.6%	1.8%	***	Equity bearish, bond bearish
	Tokyo CPI Ex-Fresh Food & Energy	y/y	Feb	3.1%	3.1%	3.3%	*	Equity and bond neutral
	Jibun bank Composite PMI	m/m	Feb F	50.6	50.3		*	Equity and bond neutral
	Jibun Bank Services PMI	m/m	Feb F	52.9	52.5		**	Equity and bond neutral
Australia	BoP Current Account Balance	m/m	4Q	A$11.8b	-A$0.2b	A$1.3b	***	Equity and bond neutral
New Zealand	ANZ Commodity Price	m/m	Feb	3.5	2.2	2.1	**	Equity bearish, bond bullish
South Korea	GDP	y/y	4Q P	2.2%	2.2%	2.2%	**	Equity and bond neutral
China	Caixin Composite PMI	m/m	Feb	52.5	52.5		**	Equity and bond neutral
	Caixin Services PMI	m/m	Feb	52.5	52.7	52.9	**	Equity and bond neutral
India	HSBC India PMI Composite	m/m	Feb F	60.6	61.5		**	Equity and bond neutral
	HSBC India PMI Services	m/m	Feb F	60.6	62.0		**	Equity and bond neutral
EUROPE								
Eurozone	HCOB Eurozone Services PMI	m/m	Feb F	50.2	50.0	50.0	**	Equity and bond neutral
	HCOB Eurozone Composite PMI	m/m	Feb F	49.2	48.9	48.9	*	Equity and bond neutral
Germany	HCOB Germany Services PMI	m/m	Feb F	48.3	48.2	48.2	**	Equity and bond neutral
	HCOB Germany Composite PMI	m/m	Feb F	46.1	46.1	46.1	**	Equity and bond neutral
France	Industrial Production	y/y	Jan	8.0%	0.9%	1.8%	***	Equity and bond neutral
	Manufacturing Production	y/y	Jan	-1.6%	0.9%		**	Equity and bond neutral
	HCOB France Services PMI	m/m	Feb F	48.4	48.0	48.0	**	Equity and bond neutral
	HCOB France Composite PMI	m/m	Feb F	48.1	47.7	47.7	**	Equity and bond neutral
Italy	HCOB Italy Composite PMI	m/m	Feb	51.1	50.7	51.5	**	Equity and bond neutral
	HCOB Italy Services PMI	m/m	Feb	52.2	51.2	52.3	**	Equity and bond neutral
	GDP WDA	y/y	4Q F	0.6%	0.5%	0.5%	**	Equity and bond neutral
UK	New Car Registrations	y/y	Feb	14.0%	8.2%		*	Equity and bond neutral
	S&P Global UK Services PMI	m/m	Feb F	53.8	54.3	54.3	**	Equity and bond neutral
	S&P Global UK Composite PMI	m/m	Feb F	53.0	53.3	53.3	**	Equity and bond neutral
Russia	S&P Global Services PMI	m/m	Feb	52.2	55.1		**	Equity bearish, bond bullish
	S&P Global Composite PMI	m/m	Feb	51.1	55.8		**	Equity bearish, bond bullish
AMERICAS								
Mexico	Gross Fixed Investment	y/y	Dec	13.4%	19.2%	15.7%	**	Equity bearish, bond bullish
	Leading Indicators	m/m	Jan	0.1	0.0	0.1	**	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)	559	560	-1	Down
3-mo T-bill yield (bps)	520	522	-2	Up
U.S. Sibor/OIS spread (bps)	533	533	0	Down
U.S. Libor/OIS spread (bps)	534	534	0	Down
10-yr T-note (%)	4.20	4.21	-0.01	Down
Euribor/OIS spread (bps)	394	394	0	Down
Currencies	Direction			
Dollar	Flat			Down
Euro	Flat			Up
Yen	Flat			Down
Pound	Down			Up
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.

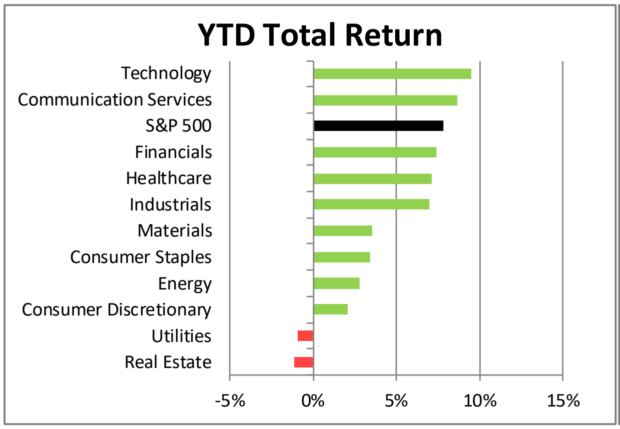
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$82.68	$82.80	-0.14%	
WTI	$78.52	$78.74	-0.28%	
Natural Gas	$1.94	$1.92	1.04%	
Crack Spread	$30.96	$30.73	0.73%	
12-mo strip crack	$24.60	$24.56	0.13%	
Ethanol rack	$1.65	$1.64	0.50%	
Metals				
Gold	$2,120.61	$2,114.48	0.29%	
Silver	$23.95	$23.89	0.28%	
Copper contract	$386.10	$385.70	0.10%	
Grains				
Corn contract	$429.75	$430.00	-0.06%	
Wheat contract	$564.00	$564.00	0.00%	
Soybeans contract	$1,151.25	$1,155.00	-0.32%	
Shipping				
Baltic Dry Freight	2,297	2,203	94	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		3.7		
Gasoline (mb)		-2.8		
Distillates (mb)		-2.0		
Refinery run rates (%)		0.5%		
Natural gas (bcf)		-85		

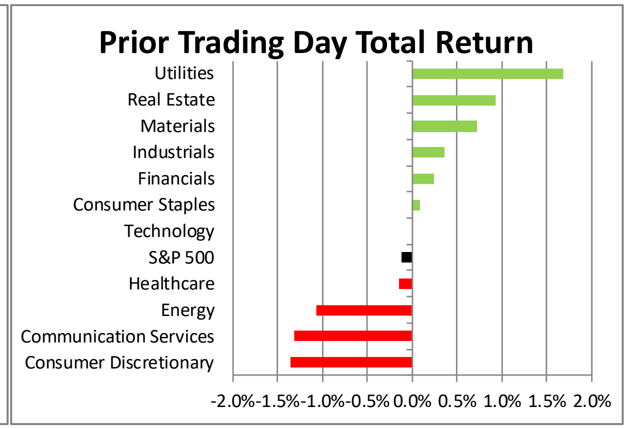
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in most of the country, with cooler temperatures in the Northern Pacific region. The precipitation outlook calls for wetter-than-normal conditions in states west of the Rocky Mountains, and dry conditions in the Southwest.

Data Section

US Equity Markets – (as of 3/4/2024 close)

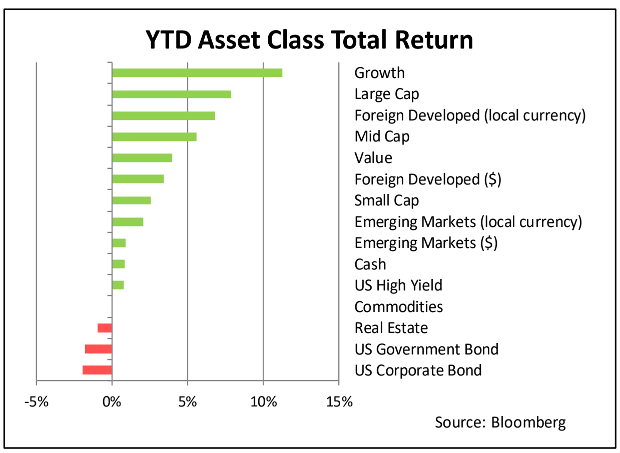




(Source: Bloomberg)

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 3/4/2024 close)

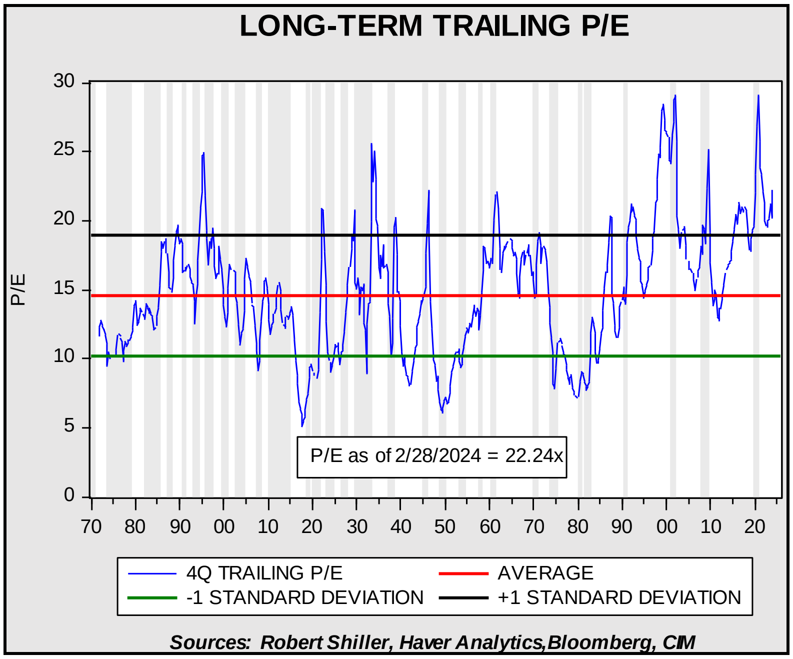


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

February 29, 2024



Based on our methodology,[1] the current P/E is 22.24x, up 0.09x 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.

[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.