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 6, 2024—9:30 AM EST] Global equity markets are generally higher this morning. In Europe, the Euro Stoxx 50 is up 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.0%. Chinese markets were mixed, with the Shanghai Composite down 0.3% from its previous close and the Shenzhen Composite 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:

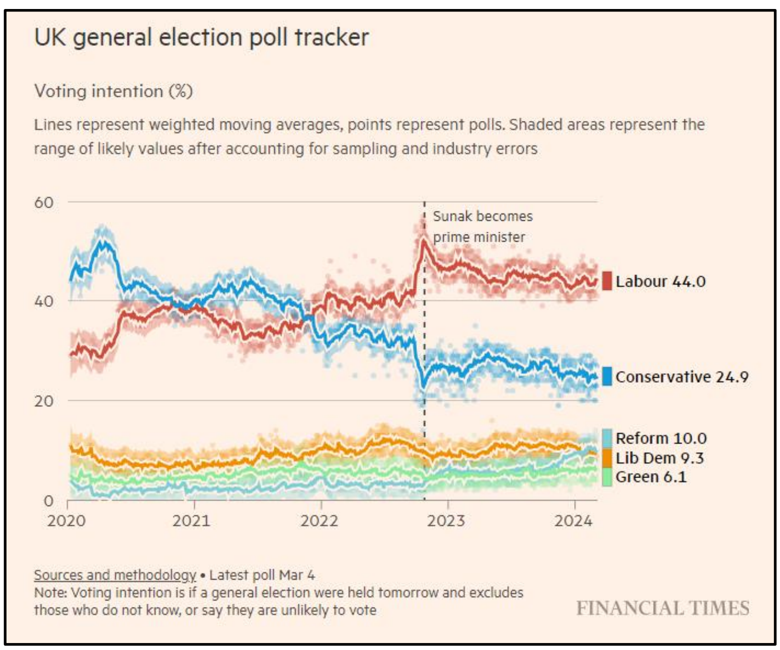
- *Bi-Weekly Geopolitical Report* (2/26/2024) (with associated podcast): "Posen vs. Pettis"
- *Asset Allocation Quarterly – Q1 2024* (1/26/2024): Discussion of our asset allocation process, Q1 2024 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q1 2024 Rebalance Presentation* (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 European Union's proposed new defense industrial strategy, which is designed to boost the region's ability to produce weapons, military equipment, and ammunition. We next review a wide range of other international and US developments with the potential to affect the financial markets today, including a surprise financial reform in debt-ridden Egypt and a preview of Federal Reserve Chair Powell's testimony before Congress today.

European Union: The European Commission yesterday released its defense industrial strategy, which constitutes its plan for shifting the EU economy to a war footing in the face of potential Russian aggression. The plan includes multiple steps aimed at expanding and shoring up the EU's defense industry base so that it can produce more military supplies. For example, the plan calls for more joint purchases of weapons and ammunition, new subsidies to expand defense industry capacity, and new authorities to compel firms to prioritize EU defense orders in crisis.

- The plan is a response not only to Russia's increasing territorial ambitions, but also to concerns that former US President Trump could stop the US from meeting its mutual defense obligations to the North Atlantic Treaty Organization if reelected in November.
- Nevertheless, it isn't clear that the plan will get the required unanimous approval of all 27 members of the EU. Many national leaders are wary of a potential power grab by Brussels and would prefer to keep defense procurement and overall policy as a national prerogative. National leaders are also wary of the potential cost of the plan.
    - The plan calls for the EU to support it with €1.5 billion (about $1.63 billion) through 2027.
    - However, EU officials have floated the possibility of eventually providing some €100 billion (about $109 billion) to finance the plan. That sum would likely require some kind of joint bond issuance and/or tax hikes.
- We would note that many EU countries are already boosting their defense budgets. As we predicted more than a year ago, the bulk of their procurement spending recently has gone to US defense contractors. One risk for those US firms is that a successful expansion of the EU defense industry base could result in a loss of sales.

United Kingdom: Chancellor Jeremy Hunt today [released the government's proposed budget for the coming fiscal year](), with multiple tax and spending initiatives designed to help the ruling Conservative Party turn around its dismal polling ahead of elections this autumn. The proposals so far include a 2% cut in required payroll contributions to the National Insurance scheme and an announcement that the government will buy land for large, new nuclear power plants and solicit bids to build small modular nuclear reactors to boost the country's energy supply.

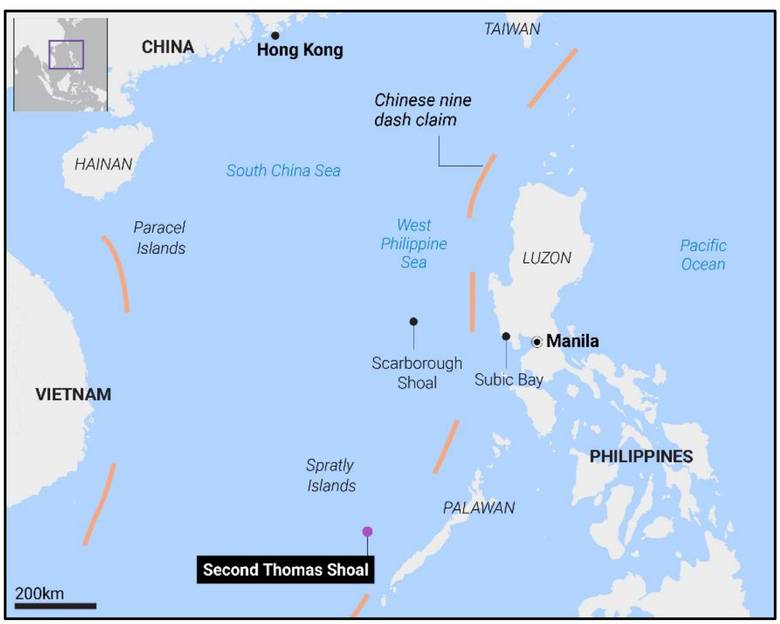


Egypt: President Al Sisi's government today unexpectedly announced a series of financial reforms long demanded by the International Monetary Fund to help the country manage its massive foreign debt. Among the key reforms, the government allowed the currency to float and hiked benchmark interest rates. The currency swiftly lost more than half its value, which will likely boost Egyptian price inflation, but the move could help unlock an IMF rescue package and avert a potential default down the line.

Venezuela: The government said it will hold a presidential election on July 28. Authoritarian President Maduro has not announced his candidacy for a new term, but he is widely expected to do so. And of course, given the government's stranglehold on political power and its practice of disqualifying any viable opposition candidates, Maduro would be expected to win. The rigging of the electoral system will likely maintain Venezuela's pariah status and continue to exacerbate tensions with the US, just as its recent territorial threats to Guyana have done.

China-Philippines: Chinese and Philippine coast guard vessels once again collided yesterday in the South China Sea around the disputed Second Thomas Shoal. In response, Beijing accused the Philippines of deliberately ramming its vessel, while Manila accused the Chinese vessel of "reckless and illegal" behavior.

- The *Wall Street Journal* today carries a fascinating article about what it's like for the crews on the Philippine ships being harassed by the Chinese. The article includes a video of how the Chinese coast guard vessels use heavy-duty water cannon to force the Philippine vessels away from the area.
- We continue to believe that the frictions between China and the Philippines are a key risk for investors, especially since any outbreak of fighting between the countries could draw in the US because of its mutual defense treaty with Manila.



(Source: South China Morning Post)

Chinese Stock Market: Sharmin Mossavar-Rahmani, the chief investment officer at Goldman Sachs Wealth Management, said in an interview with Bloomberg that she could not advise clients to buy Chinese stocks, despite the government's recent success in stabilizing stock prices and touching off a modest recovery. According to Mossavar-Rahmani, Chinese stock values are likely to be held back by structural problems such as moderating economic growth, opaque policymaking, and doubts over the authenticity of economic data.

- As our regular readers know, we think Chinese stock prices will also continue to be hurt by worsening tensions between the US and the China/Russia geopolitical blocs.
- The statement from Mossavar-Rahmani illustrates how major Wall Street investment firms and big investors are coming around to our view of the headwinds facing Chinese stocks.
- The statement also echoes a 2022 report from JPMorgan Chase that called Chinese technology stocks "uninvestable" before retracting the statement later, possibly under Chinese pressure.

US Politics: In yesterday's Super Tuesday presidential primary elections, former President Trump won in 14 of the 15 states holding Republican contests, with former UN Ambassador Haley winning in Vermont. By our calculation, Trump won about 72% of the votes in the Republican ballots, with Haley taking about 28%. Meanwhile, President Biden won in all 15 states holding Democratic contests, pulling in an average of 89% of his party's voters.

- With Trump's victories to date leaving him on the cusp of clinching the Republican nomination, Haley this morning will reportedly suspend her campaign. However, sources say Haley won't yet endorse Trump. Instead, she will at least temporarily withhold her endorsement in an effort to encourage Trump to respond to the interests and concerns of her supporters.
- While it certainly looks like Biden and Trump will be the official candidates in the November election, this campaign still has the potential to turn volatile. For example, the advanced age of each candidate alone suggests that either or both could drop out before the November balloting. We could also see the emergence of a third-party candidate (potentially even Haley). And in any case, if no candidate wins enough electoral votes, the decision could be thrown to the House of Representatives.

US Monetary Policy: Federal Reserve Chair Powell today begins his semi-annual testimony to Congress with an appearance at the House Financial Services Committee. Early indications are that he will assure lawmakers that the central bank is on track to cut interest rates this year, but it will not move until it is sufficiently confident that price pressures have fallen and won't rebound. Powell will speak before the Senate Finance Committee tomorrow.

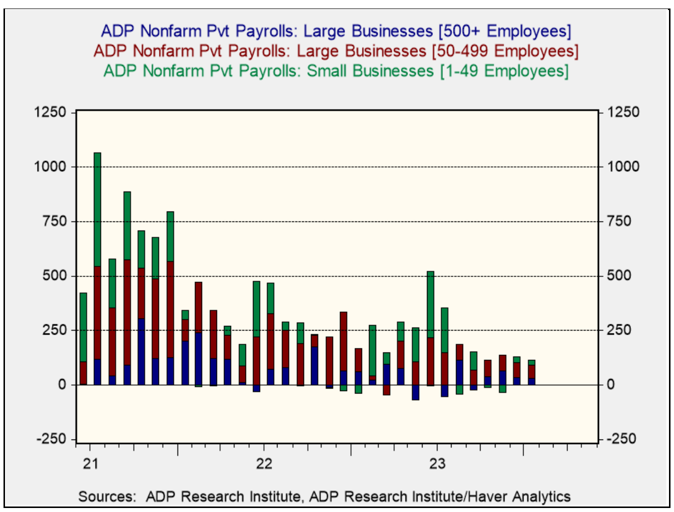
US Financial Markets: The Securities and Exchange Commission has signed off on a new type of security backed by royalty streams from songs recorded by such artists as Taylor Swift, Beyoncé, and even Stevie Wonder. The securities, offered by start-up firm JKBX and designed for everyday investors, are essentially bonds backed by the royalties from hit songs. It's not clear yet whether the new securities will be a hit with investors.

US Military: The US Air Force published images of an operational hypersonic missile, the "Air-Launched Rapid Response Weapon" (ARRW), loaded onto a B-52 bomber at Guam. The Air Force has said the ARRW is a test weapon not intended for large-scale procurement, but showing the missile deployed at one of the US's main Western Pacific bases is thought to be a message to China of US capability in this cutting-edge type of weapon. We take this as further evidence of US commitment of resources to high-tech weaponry and a broader defense build-up.

US Economic Releases

Home loan applications jumped after a months-long slump. The Mortgage Bankers Association index shows a significant 9.7% increase in applications for the week ending March 1. This surge follows a period of decline in which the index reached its lowest point since October 2023. Notably, there was a slight dip in the average 30-year fixed rate mortgage from 7.04% to 7.02%. The increase in demand is driven by a 10.6% rise in purchase applications, while refinances also saw an uptick of 8.1%.

In January, US employers demonstrated a steady expansion of their workforce. According to data from the payroll company ADP, approximately 140,000 jobs were created last month. This figure surpassed the revised reading of 111,000 from the previous month and slightly fell short of the consensus estimate of 150,000.



The chart above shows job creation by business size. Most jobs were created by mid-sized and large companies, which added 69k and 61k, respectively. The remaining 19k were created by small companies.

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	JOLTS Job Openings	m/m	Jan	8850k	9026k	**
10:00	Wholesale Inventories	m/m	Jan F	-0.1%	-0.1%	**
10:00	Wholesale Trade Sales	m/m	Jan	0.3%	0.7%	*

Federal Reserve		
EST	Speaker or Event	District or Position
10:00	Jerome Powell Testifies Before Congress	Chairman of the Board of Governors
12:00	Mary Daly to Give Keynote Address	President of the Federal Reserve Bank of San Francisco
14:00	U.S. Federal Reserve Releases Beige Book	Federal Reserve Board
16:15	Neel Kashkari Speaks at WSJ Event	President of the Federal Reserve Bank of Minneapolis

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	GDP	q/q	4Q	1.5%	2.1%	1.5%	***	Equity and bond neutral
South Korea	CPI	y/y	Feb	3.1%	2.8%	3.0%	***	Equity and bond neutral
China	Foreign Reserves	m/m	Feb	--	$3219.32b	$3221.00b	**	Equity and bond neutral
EUROPE								
Eurozone	Retail Sales	y/y	Jan	-1.0%	-0.8%	-0.5%	*	Equity and bond neutral
	PPI	y/y	Mar	-8.6%	-10.6%	-10.7%	***	Equity bullish, bond bearish
Germany	HCOB Germany Construction PMI	m/m	Feb	39.1	36.3		*	Equity and bond neutral
UK	S&P/CIPS Construction PMI	m/m	Feb	49.7	48.8	49.0	**	Equity bullish, bond bearish
AMERICAS								
Canada	S&P Global Canada Composite PMI	m/m	Feb	47.1	46.3		*	Equity bullish, bond bearish
	S&P Global Canada Services PMI	m/m	Feb	46.6	45.8		*	Equity bullish, bond bearish
Mexico	International Reserves Weekly	w/w	1-Mar	$213,903	$213479m		*	Equity and bond neutral
Brazil	Current Account Balance	m/m	Jan	-$5068m	-$5834m	-$5870m	**	Equity and bond neutral
	Foreign Direct Investment	m/m	Jan	$8741m	-$389m	$4500m	**	Equity and bond neutral
	Industrial Production	y/y	Jan	3.6%	1.0%	3.0%	***	Equity bullish, bond bearish
Brazil	S&P Global Brazil Composite PMI	m/m	Feb	55.1	53.2		***	Equity and bond neutral
	S&P Global Brazil Services PMI	m/m	Feb	54.6	53.1		**	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	559	0	Down
3-mo T-bill yield (bps)	522	521	1	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 (%)	4.16	4.15	0.01	Down
Euribor/OIS spread (bps)	393	393	0	Down
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Up			Down
Pound	Flat			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.

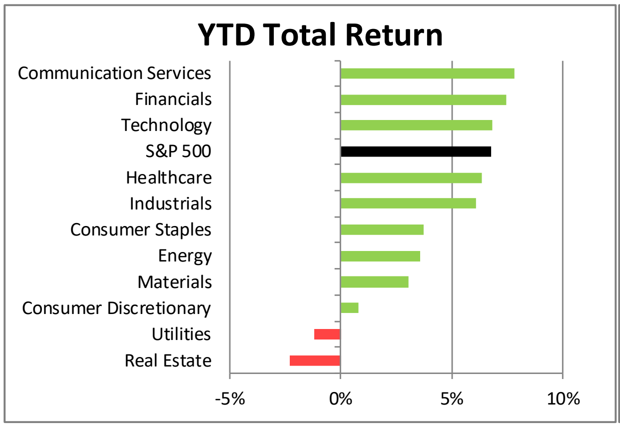
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$82.56	$82.04	0.63%	
WTI	$78.88	$78.15	0.93%	
Natural Gas	$1.95	$1.96	-0.20%	
Crack Spread	$28.71	$29.17	-1.61%	
12-mo strip crack	$23.57	$23.79	-0.93%	
Ethanol rack	$1.66	$1.66	0.18%	
Metals				
Gold	$2,132.28	$2,128.04	0.20%	
Silver	$23.77	$23.67	0.44%	
Copper contract	$386.45	$384.70	0.45%	
Grains				
Corn contract	$426.25	$426.25	0.00%	
Wheat contract	$545.00	$551.00	-1.09%	
Soybeans contract	$1,148.75	$1,149.00	-0.02%	
Shipping				
Baltic Dry Freight	2,291	2,297	-6	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.7		
Gasoline (mb)		-1.8		
Distillates (mb)		-0.7		
Refinery run rates (%)		1.1%		
Natural gas (bcf)		-40		

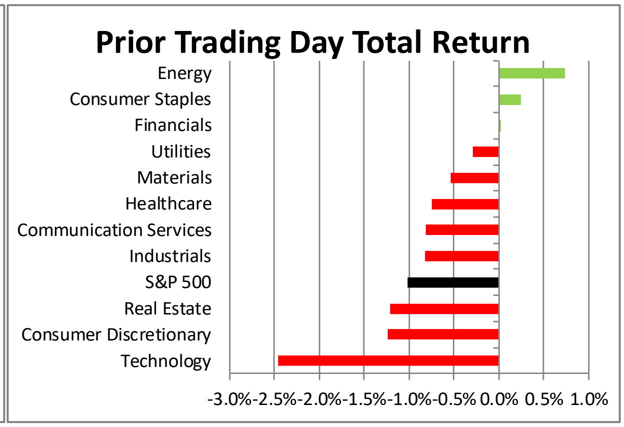
Weather

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 Central Rocky Mountain region. The precipitation outlook calls for wetter-than-normal conditions in most states west of the Rocky Mountains, and dry conditions in the Pacific region and East Coast.

Data Section

US Equity Markets – (as of 3/5/2024 close)

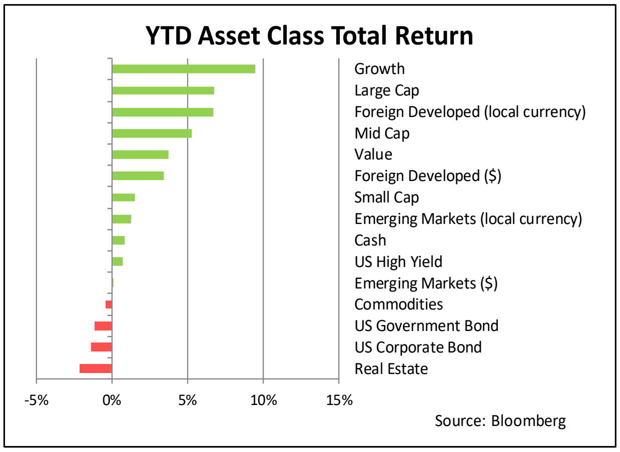




(Source: Bloomberg)

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 3/5/2024 close)

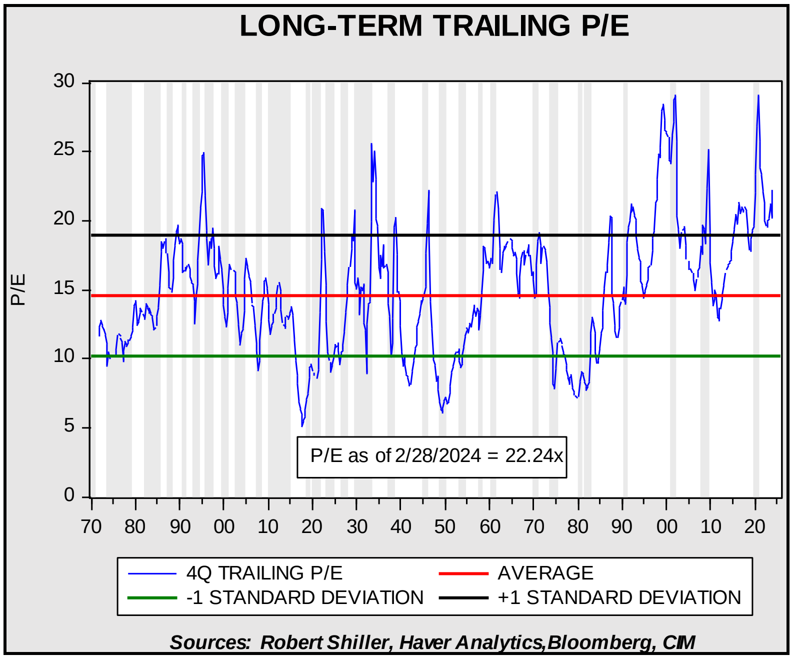


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.