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: May 21, 2024—9:30 AM EDT] Global equity markets are mostly lower this morning. In Europe, the Euro Stoxx 50 is down 0.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.1%. Chinese markets were lower, with the Shanghai Composite down 0.4% from its previous close and the Shenzhen Composite down 0.8%. Conversely, US equity index futures are signaling a slightly higher open.

With 469 companies having reported so far, S&P 500 earnings for Q1 are running at $56.40 per share compared to estimates of $54.24, which is up 0.9% from Q1 2023. Of the companies that have reported thus far, 79.1% have exceeded expectations, while 16.6% have fallen short of expectations.

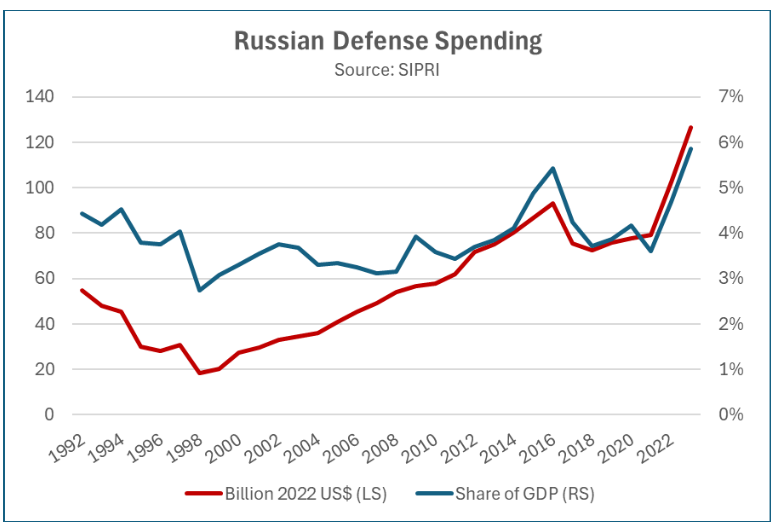
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- ***Bi-Weekly Geopolitical Report*** **(5/20/2024) (there is no associated podcast): "The Great COVID Labor Reform"**
- *Asset Allocation Quarterly – Q2 2024* (4/25/2024): Discussion of our asset allocation process, Q2 2024 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q2 2024 Rebalance Presentation* (5/7/2024): 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* (5/13/2024) (with associated podcast): "The Immigration Paradox"
- *Confluence of Ideas podcast* (5/8/2024) "Reviewing the Asset Allocation Rebalance: Q2 2024"

Our *Comment* today opens with a note on Russian President Putin's decision last week to replace his defense minister with an economist. We next review several other international and US developments with the potential to affect the financial markets today, including a major taxi driver strike in Italy and signs of change in the US labor market.

Russia: After President Putin's decision last week to replace Defense Minister Shoigu with economist Andrei Belousov, we've been hoping to see more evidence of what drove the move, but nothing concrete has shown up. All the same, we agree with the various Russia experts who think the move [probably reflects both Putin's concern about rampant corruption in the military and his realization that the war against Ukraine and its Western backers will be taxing on the Russian economy] over the long term.

- In its respected estimates of military spending, the Stockholm International Peace Research Institute (SIPRI) believes Russia boosted its military outlays to the equivalent of about $126.5 billion in 2023, some 70% higher than in the three years right before the coronavirus pandemic (excluding price inflation).
- Based on SIPRI's estimates, Russian military spending last year equaled 5.86% of gross domestic product. That's Russia's biggest "defense burden" in its modern history, and it far exceeds the current US defense burden of 3.36% of GDP.
- CIA analysis, which has been replicated by private analysts, indicates economic growth begins to falter at defense burdens above about 10% of GDP. As estimated by SIPRI, the Russian defense burden isn't quite at that level, but if Russia has large amounts of hidden defense spending like the USSR did, it could be approaching the danger zone. At the very least, even at SIPRI's calculated defense burden of 5.86% of GDP, we suspect Russia is facing resource constraints and inflation pressures.
- From this perspective, it makes sense for Putin to want an economist at the helm of the Defense Ministry. Chief of the General Staff Gerasimov will still run the war against Ukraine, but by installing an economist as defense minister, Putin is signaling that Russia will keep spending large amounts on its military into the future and will need a defense minister who can manage the defense industry's interplay with the overall economy.
- Importantly, Belousov has a reputation for favoring heavy state intervention in the economy to promote economic growth and boost particular industries. He therefore could launch a new Russian industrial policy aimed at broadening and improving the country's ability to produce high-tech weapons *en masse*. Such a move might convince Western countries to adopt similar measures to expand their defense industries.



Russia-Poland: The Polish government today said it has arrested nine Belarusian, Ukrainian, and Polish citizens for carrying out acts of intimidation and sabotage at the direction of the Russian intelligence services. According to Polish Prime Minister Tusk, the nine were also preparing to conduct sabotage in Lithuania, Latvia, and possibly Sweden. The arrests highlight how Russian intelligence is now on a war footing and aggressively operating across the West.

- Over the weekend, the Polish government also said it would spend about $2.5 billion to build fortifications against Russian attack along Poland's borders with Belarus and the Russian exclave of Kaliningrad.
- Along with other countries building fortifications, Poland's effort shows just how serious the Eastern European countries consider the military threat from Russia.

Italy: If you're heading off to Italy to begin the summer, beware of travel chaos. The country's politically powerful taxi drivers, who have already greatly limited the operations of ride-hailing apps, have launched a nationwide strike to protest a government minister's meeting with representatives from Uber. Amid consumer anger over insufficient taxi service, the meeting was taken as a sign that the government may be planning to lower restrictions on firms like Uber and Lyft.

China: A review of earnings reports from top Chinese electric vehicle makers shows they have dramatically slowed their payments to suppliers in recent quarters. For example, top EV maker BYD took an average of 275 days to settle its accounts payable in 2023, versus 219 days in 2022 and 198 days in 2021. Analysts believe the drawn-out payments reflect increasing liquidity problems as EV sales slow. Importantly, weaker domestic demand raises the risk that Chinese EV makers will dump their excess output on global markets, hiking trade tensions.

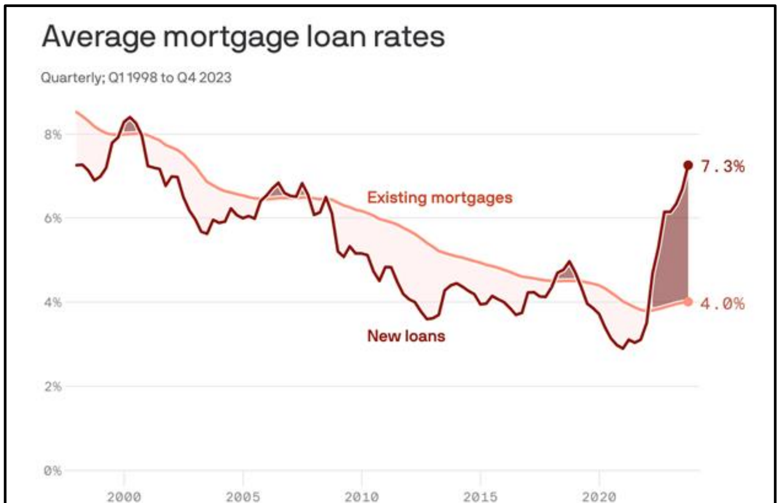
- Separately, the *Wall Street Journal* today carries an article showing Chinese mining firms are dramatically boosting their global investment and output, pushing down prices for some minerals (such as nickel) and driving some Western producers out of the market.
- The article suggests that China's tried-and-true strategy to grab global market share in manufacturing is now being used to grab market share in mining. Key elements of that strategy include making massive investments in new, modern facilities to gain scale and cut costs, leveraging cheap labor, and flooding the market with ultra-low cost output to put Western competitors out of business.
- If so, the strategy could make the West even more dependent on the China/Russia bloc for minerals critical to national defense and the new, more electrified economy of the future. That would be consistent with our often-stated belief that the China/Russia bloc will try to weaponize its mineral holdings against the West to achieve global dominance.

Australia: Ahead of elections next year, the ruling center-left Labor Party government has proposed a budget for the coming fiscal year that includes tax cuts and about $5.3 billion in energy rebates and rent subsidies to ease the cost of living for renters and mortgage borrowers. The fiscal help, along with stickier-than-expected consumer price inflation, is expected to preclude the central bank from cutting interest rates anytime soon.

Mexico: With the ruling Morena Party in the pole position to win the July presidential election, the government is reportedly considering a tax hike on banks to rein in the surging budget deficit. Such a move could have big implications for major Spanish banks, which dominate the Mexican market. For example, BBVA reportedly gets almost 50% of its profit from its Mexican operations, while Banco Santander gets about 13% of its profit there.

US Labor Market: The *Wall Street Journal* carries an article today showing a big shift in the tenor of corporate job postings aimed at new college graduates. Rather than listing a litany of responsibilities and requirements, the listings now emphasize high salaries, opportunities for professional advancement, and perks. The change is consistent with the shortage of younger, relatively lower-skilled workers that we describe in our latest *Bi-Weekly Geopolitical Report, "The Great COVID Labor Reform,"* published yesterday.

US Housing Market: Axios today carries a useful article laying out how the disparity in new versus existing mortgage rates is handcuffing home sellers. The following chart lays out the situation in stark terms.



Reproduced from NYT with data from a Federal Housing Finance Agency analysis; Note: New rates are the average predicted interest rate for fixed-rate mortgages as if they were re-originated during the quarter; Chart: Axios Visuals

US Transportation Industry: The containership that rammed Baltimore's Francis Scott Key Bridge and made it collapse in March was finally towed away from the crash site yesterday, allowing most cargo traffic in the important port to start flowing again. However, replacing the bridge will take many more months or years.

US Economic Releases

There were no domestic releases prior to the publication of this report. 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**
9:00	Thomas Barkin Gives Welcome Remarks	President of the Federal Reserve Bank of Richmond
9:00	Christopher Waller Discusses US Economy	Member of the Board of Governors
9:05	John Williams Gives Opening Remarks	President of the Federal Reserve Bank of New York
9:10	Raphael Bostic Offers Brief Welcome Remarks	President of the Federal Reserve Bank of Atlanta
11:45	Michael Barr Speaks in Fireside Chat	U.S. Federal Reserve Vice Chair for Supervision
19:00	Raphael Bostic Moderates Panel with Collins and Mester	President of the Federal Reserve Bank of Atlanta

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 Consumer Conf SA	m/m	May	-0.3%	-2.4%		**	Equity and bond neutral
	Westpac Consumer Conf Index	m/m	May	82.2	82.4		**	Equity and bond neutral
South Korea	Consumer Confidence	m/m	May	98.4	100.7		*	Equity and bond neutral
EUROPE								
Eurozone	Current Account	m/m	Mar	35.8b	28.9b		*	Equity and bond neutral
	Construction output	y/y	Mar	0.1%	-1.8%		*	Equity and bond neutral
	Trade Balance SA	m/m	Mar	24.1b	16.7b	20.0b	**	Equity bullish, bond bearish
Germany	PPI	y/y	Apr	-3.3%	-2.9%	-3.1%	**	Equity and bond neutral
Italy	Current Account Balance	m/m	Mar	1500m	2306m		*	Equity and bond neutral
Switzerland	M3 Money Supply	y/y	Apr	-1.1%	-1.5%		**	Equity and bond neutral
	Domestic Sight Deposits CHF	w/w	17-May	459.0b	460.3b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	17-May	467.4b	468.9b		*	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	Up
3-mo T-bill yield (bps)	522	524	-2	Up
U.S. Sibor/OIS spread (bps)	533	533	0	Flat
U.S. Libor/OIS spread (bps)	534	534	0	Up
10-yr T-note (%)	4.42	4.45	-0.03	Down
Euribor/OIS spread (bps)	382	383	-1	Down
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Up			Up
Yen	Flat			Down
Pound	Up			Up
Franc	Up			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.

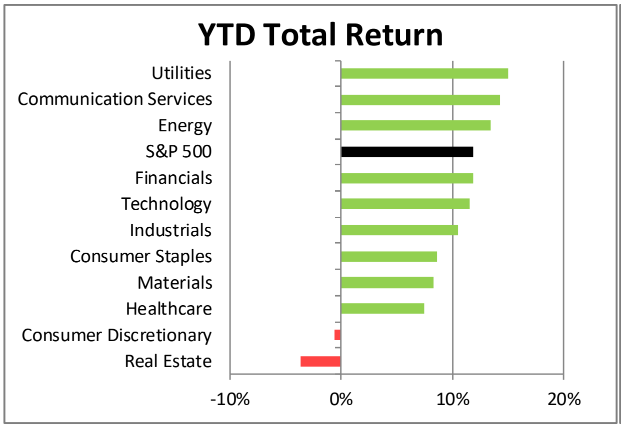
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$82.48	$83.71	-1.47%	
WTI	$78.45	$79.80	-1.69%	
Natural Gas	$2.79	$2.75	1.34%	
12-mo strip crack	$22.79	$22.98	-0.82%	
Ethanol rack	$1.93	$1.93	0.09%	
Metals				
Gold	$2,419.60	$2,425.31	-0.24%	
Silver	$31.68	$31.82	-0.44%	
Copper contract	$511.25	$507.90	0.66%	
Grains				
Corn contract	$458.25	$460.50	-0.49%	
Wheat contract	$691.00	$688.75	0.33%	
Soybeans contract	$1,239.50	$1,248.00	-0.68%	
Shipping				
Baltic Dry Freight	1,847	1,844	3	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.00		
Gasoline (mb)		-1.00		
Distillates (mb)		0.50		
Refinery run rates (%)		0.5%		
Natural gas (bcf)		77		

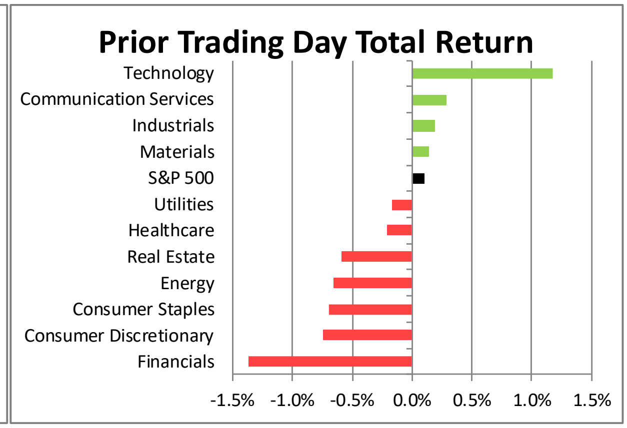
Weather

The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures throughout the Rocky Mountain, Great Plains, and the South, with cooler-than-normal temperatures in parts of the Midwest and Northern Pacific. The forecasts call for wetter-than-average conditions throughout most of the country, with drier-than-normal conditions expected in the Rocky Mountain region.

Data Section

US Equity Markets – (as of 5/20/2024 close)

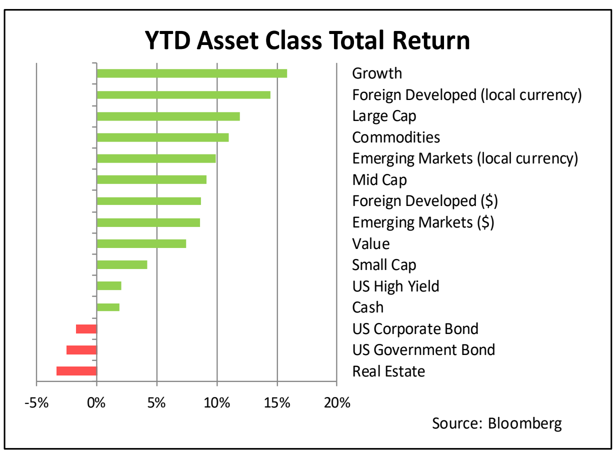




(Source: Bloomberg)

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 5/20/2024 close)

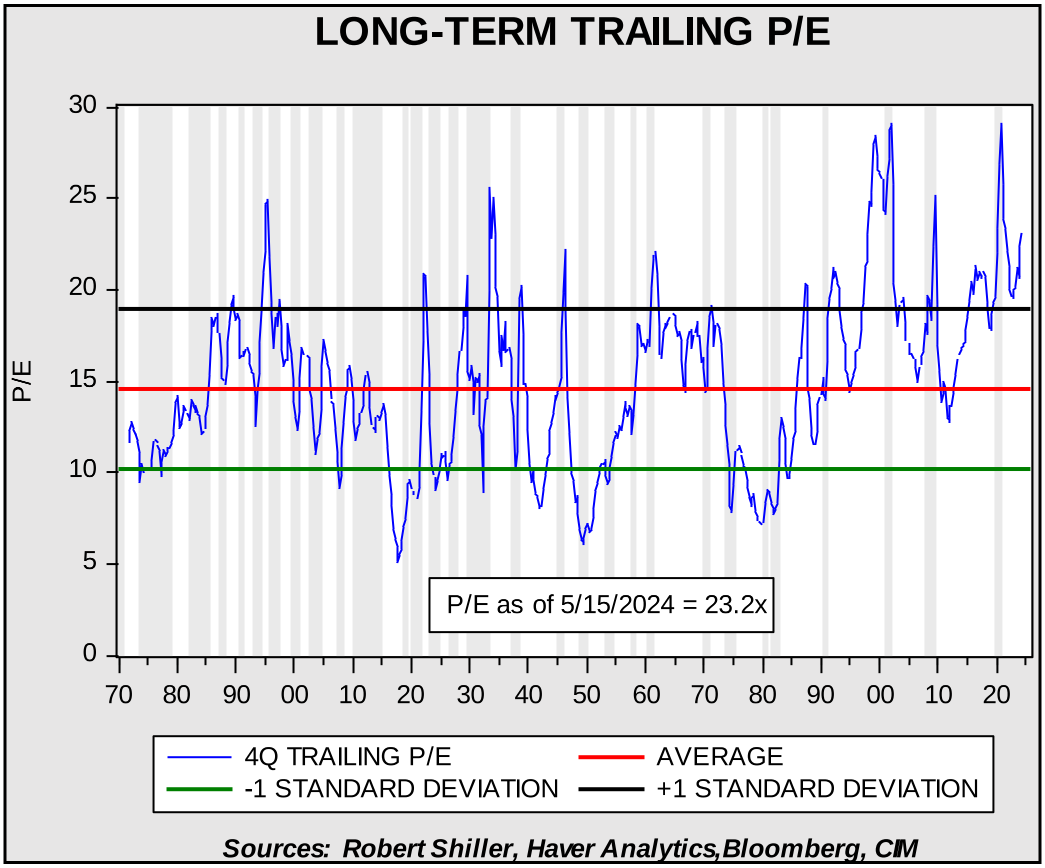


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

May 16, 2024



Based on our methodology,[1] the current P/E is 23.2x, up 0.1x from our last report. The increase in the multiple reflects an increase in the S&P 500 Index, outweighing the 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.

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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.