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: December 5, 2023—9:30 AM EST] Global equity markets are mostly lower 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 1.7%. Chinese markets were lower, with the Shanghai Composite down 1.7% from its previous close and the Shenzhen Composite down 2.0%. U.S. 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* (11/13/2023) (with associated podcast): "The Archetypes of American Foreign Policy: A Reprise" (Note: the next BWGR will be published on 12/11/2023)
- *Weekly Energy Update* (11/30/2023): We continue to monitor the OPEC+ meeting. COP28 is underway; we expect little content to emerge. Two geopolitical items of note: Russia is struggling to manage an excess of Indian rupees and Venezuela is making threatening moves against Guyana.
- *Asset Allocation Quarterly – Q4 2023* (10/19/2023): Discussion of our asset allocation process, Q4 2023 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q4 2023 Rebalance Presentation* (10/30/2023): 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* (12/4/2023) (with associated podcast): "A Pause That Refreshes?"

Our *Comment* today opens with a downgrade in the outlook for Chinese sovereign debt. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including reports of suspicious short-selling in Israeli stocks ahead of Hamas's October 7 attacks on the country and new data on educational achievement for the future U.S. workforce.

China: Moody's (MCO, $373.94) today maintained its middling investment-grade rating of "A1" on China's long-term sovereign debt, but in a surprise decision, the firm cut its outlook on the debt from "stable" to "negative." According to Moody's, the cut in the outlook reflects a likelihood that Beijing will eventually need to bail out many of its highly indebted provincial and local governments. It also cited China's slowing economic growth in its reasoning.

- For comparison, rating firms Standard & Poor's and Fitch both currently rate Chinese debt as A+, with a stable outlook.
- While China's central government debt only amounts to about 21% of gross domestic product, total provincial and local government debt (including off-budget obligations) is estimated to be several times higher than that. Provincial and local governments are also highly dependent on land sales and other off-budget funds, which now are drying up because of Beijing's clampdown on excessive property development.
- In sum, China continues to face economic headwinds from what we call the ***Five Ds***: Weak consumer ***demand***, high corporate and local government ***debt***, poor ***demographics***, economic ***disincentives*** from the Communist Party's increasing intrusion into the economy, and ***decoupling*** as foreign countries shift their trade, investment, and technology flows away from China.

Japan: As the country returns to consistent price inflation and the Bank of Japan prepares to let interest rates rise further, commercial banks are finding that decades of deflation and ultra-low interest rates have left their staffs unprepared for the new environment. Major banks are having to retrain their staff to help them understand how to operate in an environment that is normal for most other countries!

Israel-Hamas Conflict: A draft paper by law professors at NYU and Columbia flags suspicious short-selling in Israeli stocks right before the October 7 attacks by Hamas. The professors posit that a trader or traders were informed about the planned attacks and sold Israeli stocks short in anticipation that they would decline sharply. While that seems plausible enough, it also seems to contradict the narrative that the Hamas attacks were originally meant to be relatively small scale incursion but ended up being more much extensive and successful than anticipated.

- Meanwhile, reports today say the Israel Defense Forces' retaliatory attack on Hamas in the Gaza Strip is close to encircling the last major group of Hamas fighters around the city of Khan Younis.
- Destroying that group could nearly end Hamas's conventional military capability, but it wouldn't necessarily lead to a quick end to all fighting in Gaza. Therefore, there is still a risk that the conflict could spread more broadly throughout the region.

Russia-Ukraine-NATO: In another sign of how militarized Russia is becoming, President Putin has signed an order boosting the country's total military personnel to 2.20 million, including 1.32 million troops. That's up from a total of 2.03 million, including 1.15 million troops, in the increase that was announced in August 2022. The troop levels cited appear to encompass only active-duty troops, not reservists, so the figures imply that Russia will soon have 1.98% of its military-aged population (those aged 16 to 49) under arms.

- For comparison, active-duty troops only constitute about 0.90% of the U.S. military-aged population.

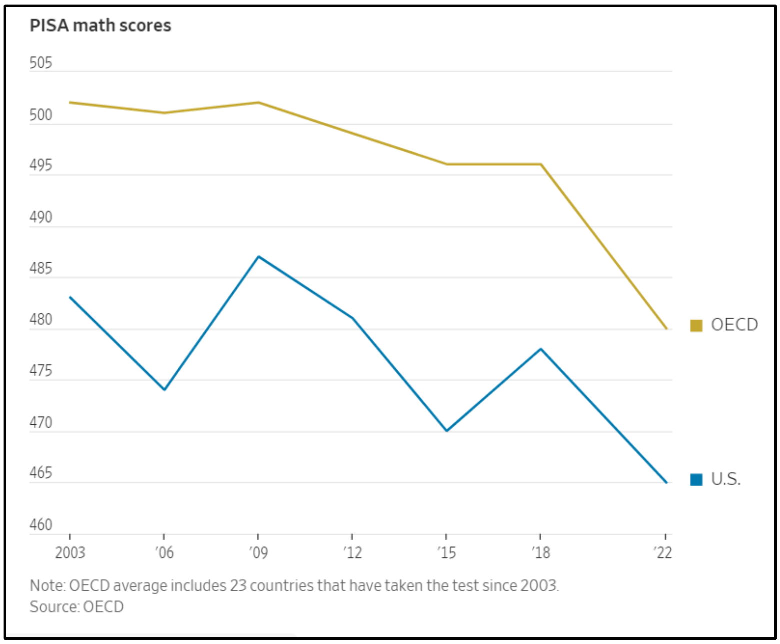
- Separately, the Stockholm International Peace Research Institute has estimated that revenue from military goods and services at the 100 global defense contractors it tracks actually fell by 3.5% in 2022, despite Western countries' rush to rebuild their defenses following Russia's invasion of Ukraine. Sales at the 42 U.S. defense firms tracked by SIPRI fell 7.9%.
    - According to SIPRI, the drop in revenues reflects problems ranging from labor shortages and soaring costs to supply chain disruptions.
    - The think tank believes Western defense firms will only see significant production, sales, and revenue increases in two or three years.
    - We continue to believe defense firms will see big, sustained increases in sales and profits over the coming decade or more as the U.S. and its allies work to rebuild their defenses, but we agree that those increases may not arrive for another couple of years.

European Union-United States: The CEO of Airbus (EADSY, $37.18) warned that the company's multi-billion euro program for replacing its aging A320 family of jets could require "some support" from European governments. The CEO may be trying to capitalize on Western governments' recent openness to using taxpayer funds to support domestic manufacturers. However, any new European support for Airbus would likely spark pushback from Boeing (BA, $234.87) and rekindle trade tensions with the U.S.

European Union-Mercosur: The Brazilian government has informed EU officials that the Mercosur trade group — Brazil, Argentina, Uruguay, and Paraguay — won't be able to sign a proposed free trade deal with the EU this week as previously planned. According to the Brazilians, the Argentines don't want to move forward until the inauguration of their newly elected President Javier Milei, who has criticized Mercosur. Coupled with resistance from France, the long-debated EU-Mercosur trade pact now looks like it could be postponed indefinitely.

United States-Cuba: Victor Manuel Rocha, a former senior U.S. diplomat who served in U.S. embassies across Latin America, was arrested by the FBI yesterday on charges of spying for Cuba over the course of decades. As bad as the case is, it likely pales in comparison to the enormous, highly aggressive espionage efforts that China continues to run against the U.S. and its allies.

U.S. Education System: In a mixed message for the future labor force, the Organization for Economic Cooperation and Development said 15-year-olds in the U.S. lost less learning during the pandemic than most of the other OECD countries. Based on tests administered under the organization's Program for International Student Assessment, U.S. students' average reading and science scores were essentially unchanged between 2018 and 2022. As shown in the chart below, U.S. students' average math score fell 13 points, versus an average decline of 15 points in the other countries tested. Unfortunately, U.S. math scores remained far weaker than in other countries.



U.S. Economic Releases

No major U.S. reports have been released so far this morning. 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	Nov F	50.8	50.8	**
9:45	S&P Global US Composite PMI	m/m	Nov F	50.7	50.7	**
10:00	JOLTS Job Openings	m/m	Oct	9300k	9553k	**
10:00	ISM Services Index	m/m	Nov	52.3	51.8	**
10:00	ISM Services Prices Paid	m/m	Nov	58.0	58.6	*
10:00	ISM Services Employment	m/m	Nov	51.4%	50.2	*
10:00	ISM Services New Orders	m/m	Nov	54.9	55.5	*
Federal Reserve						
EST	Speaker or Event	District or Position				
15:00	Michelle Bowman Gives Speech on More Inclusive Financial System	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								
Japan	Tokyo CPI	y/y	Nov	2.6%	3.3%	3.2%	**	Equity bullish, bond bearish
	Tokyo CPI Ex-Fresh Food	y/y	Nov	2.3%	2.7%	2.4%	***	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food & Energy	y/y	Nov	3.6%	3.8%	3.7%	*	Equity and bond neutral
	Jibun bank Composite PMI	m/m	Nov F	49.6	50.0		*	Equity and bond neutral
	Jibun Bank Services PMI	m/m	Nov F	50.8	51.7		**	Equity and bond neutral
Australia	BoP Current Account Balance	q/q	3Q	A-$0.2b	A$7.7b	A$7.8b	***	Equity and bond neutral
New Zealand	ANZ Commodity Price	m/m	Nov	-1.3	2.9	2.8	**	Equity and bond neutral
South Korea	CPI	y/y	Nov	3.3%	3.8%	3.5%	***	Equity and bond neutral
	GDP	y/y	3Q P	1.4%	1.4%	1.4%	**	Equity and bond neutral
	Foreign Reserves	m/m	Nov	417.1	412.9		*	Equity and bond neutral
China	Caixin Services PMI	m/m	Nov	51.5	50.4	50.5	**	Equity and bond neutral
	Caixin Composite PMI	m/m	Nov	51.6	50.0		**	Equity and bond neutral
India	S&P Services PMI	m/m	Nov	56.9	58.4		**	Equity and bond neutral
	S&P Composite PMI	m/m	Nov	57.4	58.4		**	Equity and bond neutral
EUROPE								
Eurozone	HCOB Eurozone Services PMI	m/m	Nov F	48.7	48.2	48.2	**	Equity and bond neutral
	HCOB Eurozone Composite PMI	m/m	Nov F	47.6	47.1	47.1	*	Equity and bond neutral
	PPI	y/y	Oct	-9.4%	-12.4%	-9.5%	***	Equity and bond neutral
Germany	HCOB Germany Services PMI	m/m	Nov F	49.6	48.7	48.7	**	Equity bullish, bond bearish
	HCOB Germany Composite PMI	m/m	Nov F	47.8	47.1	47.1	*	Equity bullish, bond bearish
France	Industrial Production	y/y	Oct	1.8%	-0.1%	-0.3%	***	Equity bullish, bond bearish
	Manufacturing Production	y/y	Oct	1.0%	-0.9%	-1.2%	**	Equity bullish, bond bearish
	HCOB France Services PMI	m/m	Nov F	45.4	45.3	45.3	**	Equity and bond neutral
	HCOB France Composite PMI	m/m	Nov F	44.6	44.5	44.5	*	Equity and bond neutral
Italy	HCOB Italy Services PMI	m/m	Nov F	49.5	47.7	48.3	**	Equity bullish, bond bearish
	HCOB Italy Composite PMI	m/m	Nov F	48.1	47.0	47.2	*	Equity bullish, bond bearish
UK	S&P/CIPS Global Services PMI	m/m	Nov F	50.9	50.5	50.5	**	Equity and bond neutral
	S&P/CIPS Global Composite PMI	m/m	Nov F	50.7	50.1	50.1	**	Equity and bond neutral
	New Car Registrations	y/y	Nov	9.5%	14.3%		*	Equity bearish, bond bullish
Russia	S&P/CIPS Global Services PMI	m/m	Nov	52.2	53.6	53.0	**	Equity and bond neutral
	S&P/CIPS Global Composite PMI	m/m	Nov	52.4	53.6	53.0	**	Equity and bond neutral
AMERICAS								
Brazil	Total Outstanding Loans	m/m	Oct	5594b	5576b	5586b	**	Equity and bond neutral
	GDP	y/y	3Q	2.0%	3.4%	3.5%	**	Equity bearish, bond bullish
	S&P/CIPS Global Composite PMI	m/m	Nov	50.7	50.3		**	Equity and bond neutral
	S&P/CIPS Global Services PMI	m/m	Nov	51.2	51.0		**	Equity and bond neutral

Financial Markets

The table below highlights some of the indicators that we follow on a daily basis. 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)	564	563	1	Down
3-mo T-bill yield (bps)	521	522	-1	Down
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	538	538	0	Down
U.S. Libor/OIS spread (bps)	536	536	0	Down
10-yr T-note (%)	4.23	4.25	-0.02	Flat
Euribor/OIS spread (bps)	396	396	0	Up
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Down			Up
Yen	Up			Up
Pound	Down			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
RBA Cash Rate Target	4.350%	4.350%	4.350%	On Forecast

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.

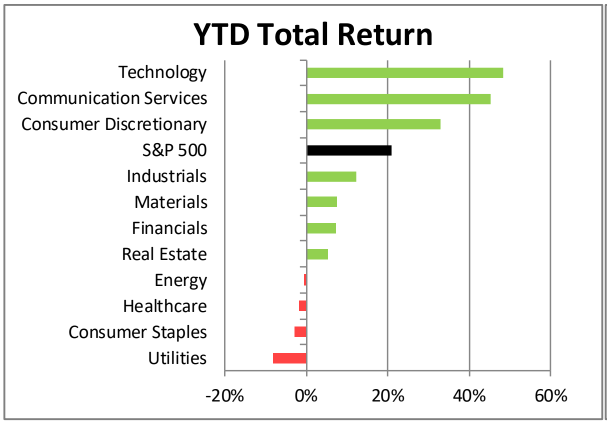
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$77.78	$78.03	-0.32%	
WTI	$72.85	$73.04	-0.26%	
Natural Gas	$2.72	$2.69	0.89%	
Crack Spread	$23.98	$24.11	-0.53%	
12-mo strip crack	$24.02	$24.24	-0.91%	
Ethanol rack	$1.99	$2.00	-0.39%	
Metals				
Gold	$2,026.92	$2,029.42	-0.12%	
Silver	$24.34	$24.51	-0.66%	
Copper contract	$379.40	$383.55	-1.08%	
Grains				
Corn contract	$485.75	$485.50	0.05%	
Wheat contract	$619.00	$620.50	-0.24%	
Soybeans contract	$1,311.75	$1,306.25	0.42%	
Shipping				
Baltic Dry Freight	3,346	3,192	154	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.0		
Gasoline (mb)		1.2		
Distillates (mb)		0.2		
Refinery run rates (%)		1.0%		
Natural gas (bcf)		-8		

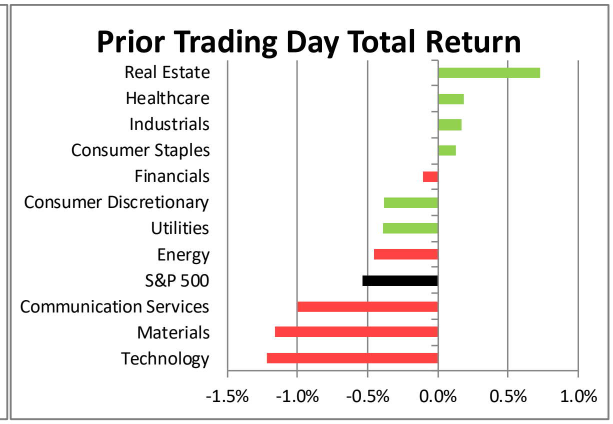
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for most of the country, with near-normal temperatures in the Southwest. The precipitation outlook calls for wetter-than-normal conditions throughout the Pacific region and in the South, with dry conditions in the Great Plains, Midwest, and East Coast regions.

Data Section

U.S. Equity Markets – (as of 12/4/2023 close)

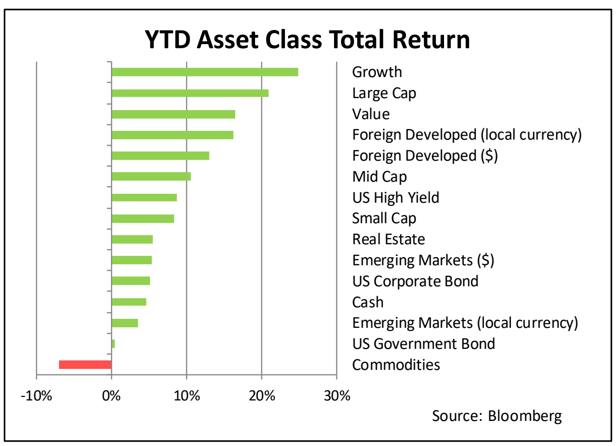




(Source: Bloomberg)

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 12/4/2023 close)

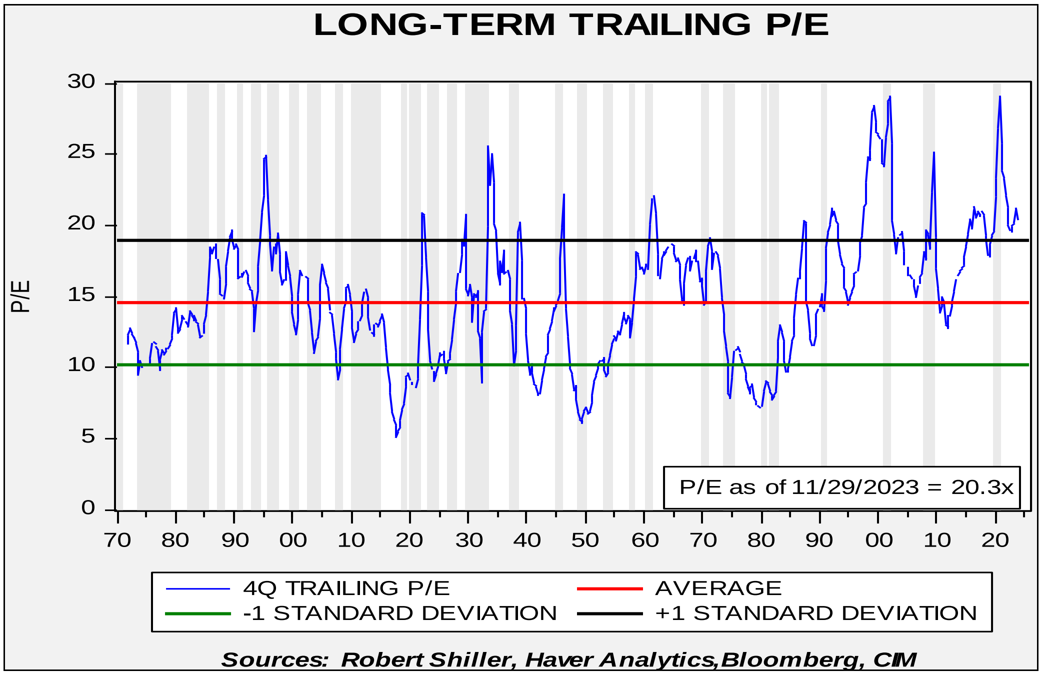


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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), U.S. Corporate Bond (iShares iBoxx $ Investment Grade Corporate Bond ETF), U.S. Government Bond (iShares 7-10 Year Treasury Bond ETF), U.S. 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

November 30, 2023



Based on our methodology,[1] the current P/E is 20.3x, up 0.9x from our last report. The large increase in the multiple is due mostly to implementing the actual earning number for Q3 from Standard and Poor's compared to the estimate from Bloomberg. This quarter's divergence was unusually large but not unprecedented. Our historical data is from Standard and Poor's; we use the Bloomberg estimated earnings data for the current and subsequent quarters. Overall, the multiple remains elevated.

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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 (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.