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 6, 2023—9:30 AM EST] Global equity markets are mostly higher 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 up 0.5%. Chinese markets were mixed, with the Shanghai Composite down 0.1% from its previous close and the Shenzhen Composite up 0.6%. U.S. 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* (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 the latest on the potential for a Venezuela-Guyana crisis. We next review a wide range of other international and U.S. developments that could affect the financial markets today, including Italy's widely expected decision to pull out of China's controversial Belt and Road Initiative and several items related to U.S. monetary policy going into 2024.

Venezuela-Guyana: It still appears that domestic electoral politics were the main reason President Maduro held last weekend's referendum on taking control of the Essequibo territory of Guyana. However, new steps that he called for yesterday appear much more concrete and menacing than mere political posturing. If implemented, the steps requested by Maduro would likely lead to a serious case of territorial aggression in South America.

- The new steps called for by Maduro include the following:
    - Immediate legislative debate and approval of a bill creating a new Venezuelan state of "Guayana Esequiba" (Venezuela's term for the Guyana territory).
    - Creation of a new High Commission for the Defense of Guayana Esequiba.
    - Creation of a Guayana Esequiba Comprehensive Defense Zone, with administrative and military headquarters in Tumeremo, a town in eastern Venezuela close to the border with Guyana.
    - Designation of Maj. Gen. Alexis Rodríguez Cabello as the Sole Authority of Guayana Esequiba, with administrative and military headquarters in Tumeremo.
    - Creation of a new Essequibo Division within state-owned oil company PDVSA and state-owned mining company CVG, with exclusive administrative and operational powers for the exploitation of natural resources in Guayana Esequiba.
    - Publication of a new official map of Venezuela, including Guayana Esequiba, and ensuring it is sent to all schools, high schools, and universities in the country.
    - Development of a comprehensive social plan for the inhabitants of Guayana Esequiba, including the provision of official Venezuelan identification cards.
    - Establishment of a three-month period for the withdrawal of foreign companies/unilateral concessions in Guayana Esequiba.
    - Creation of a Special Law for the protection of Guayana Esequiba.
- Besides seeking to boost his prospects in Venezuela's planned 2024 elections, Maduro is likely hoping to wring more sanctions relief from the U.S. The Biden administration may indeed be tempted to further ease restrictions on U.S.-Venezuelan energy trade to avoid an invasion that would likely boost global energy prices ahead of the U.S. elections.
- On the other hand, if Maduro miscalculates and actually follows through on an attempt to seize Essequibo, we suspect the U.S., Brazil, and potentially other countries in the region would come to Guyana's aid. Any such move by Maduro could therefore backfire on him, but even Venezuela would see some temporary fiscal benefit from the likely spike in oil prices that would result.

Guinea: In another reminder of the mineral riches in less-developed regions like Latin America and Africa, mining giant Rio Tinto (RIO, $68.49) today said its single biggest investment over the next few years is likely to be a huge new iron ore mine in the West African country of Guinea. In partnership with Guinea's government and a Chinese firm, Rio expects to contribute about $6.2 billion to cover half the cost of developing the southern part of the projected Simandou mine, which some analysts think could eventually produce enough ore to drive down global iron and steel prices and take market share from today's leading producers, Australia and Brazil.

Argentina: Back in South America, Argentina's newly elected president, populist libertarian Javier Milei, [is making news by backing away from some of the radical economic policy changes that got him so much attention during his electoral campaign]. For example, he has fired some top economic advisers who were enlisted to help him kill the central bank and adopt the U.S. dollar as the national currency. He has also aligned with officials from a previous center-right government that he previously derided, and he has toned down his rhetoric against China.

- Ahead of his inauguration this coming Sunday, Milei is likely running head-on into the messy realities of governing, especially since some of his proposals would be socially disruptive and costly for many Argentines.
- Besides that, Milei's party has only a modest number of seats in the country's legislature, presenting challenges for getting his reforms passed into law.

European Union-United Kingdom: As part of a deal to extend tariff-free trade in electric vehicles between the EU and the U.K., the European Commission [proposed a program today offering 3 billion EUR ($3.2 billion) in subsidies to EV battery producers in the bloc]. The program would operate even as the EU continues its investigation into Chinese subsidies for its electric vehicles exported to the EU, which could ultimately lead to punitive EU tariffs against Chinese EVs.

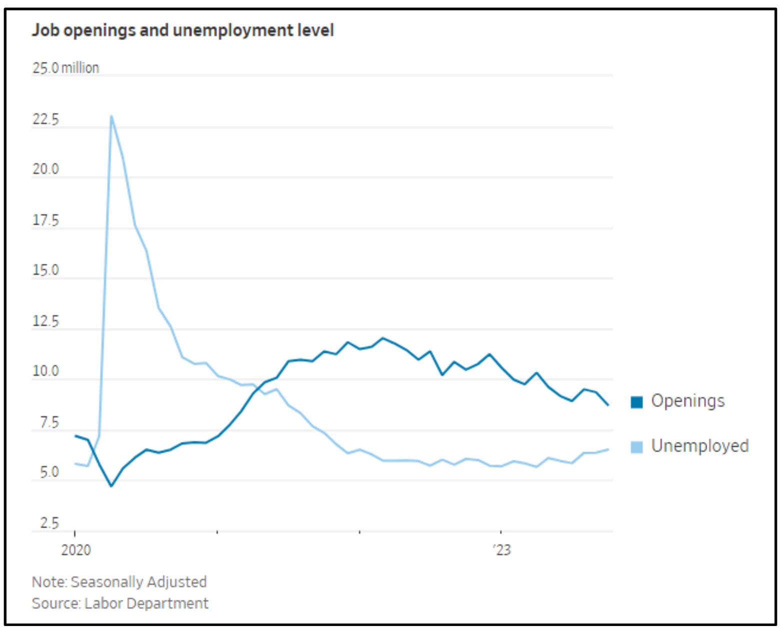
- The EU program would pale in comparison with the big subsidies provided in the U.S. under the Biden administration's Inflation Reduction Act.
- Nevertheless, the EU program is another reflection of how the world is fracturing into relatively separate geopolitical and economic blocs, and how industrial policy and more active government involvement in the economy is a part of that.

Italy-China: The Italian government today said it has formally notified China that it is pulling out of President Xi's signature Belt and Road Initiative. Under that program, China has channeled more than $1 trillion to mostly underdeveloped countries around the world to build ports, railroads, and other infrastructure aimed at easing Chinese trade.

- The BRI has been criticized as a debt trap by many officials and economists in the West. The Chinese-led projects reportedly often come with opaque and onerous loan obligations.
- Italy's move shows that the populist right-wing government of Prime Minister Meloni is now back in closer alignment with other states in the European Union, which have begun to push back against China's rising geopolitical and economic aggressiveness.

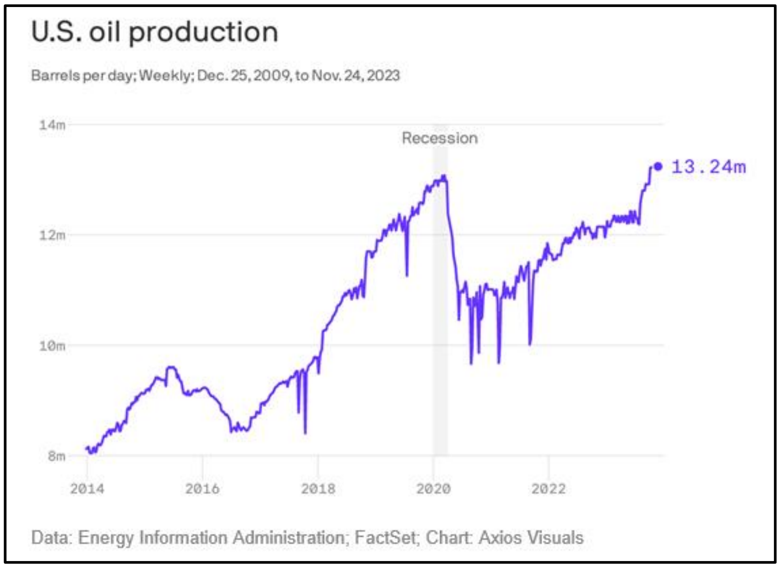
U.S. Labor Market: In a release yesterday, the monthly Job Openings and Labor Turnover report showed October job openings fell by 617,000 to a level of 8.7 million, well below the record high of 12.0 million in March 2022. The number of quits and hires also remained well below the levels reached in early 2022.

- Coupled with the recent rise in the unemployment rate and an increase in the number of people drawing jobless benefits, the data points to continued gradual weakening in the labor market.
- That will probably help keep price inflation moderating and discourage the Fed from hiking interest rates further.



U.S. Energy Industry: New data from the Energy Information Administration shows domestic oil production has now reached a new record high for the first time since the coronavirus pandemic hit. In recent years, U.S. output was held back by a decline in new exploration and development, reflecting factors such as investor insistence that drillers focus more on profits and policymakers' drive to impose new green regulations. Now, domestic supply has rebounded enough that it is helping push energy prices downward.

- On the demand side, energy prices are also being cut by weak economic growth in China and some other major markets.
- Increased use of electric vehicles around the world may also be sapping petroleum demand to some extent.



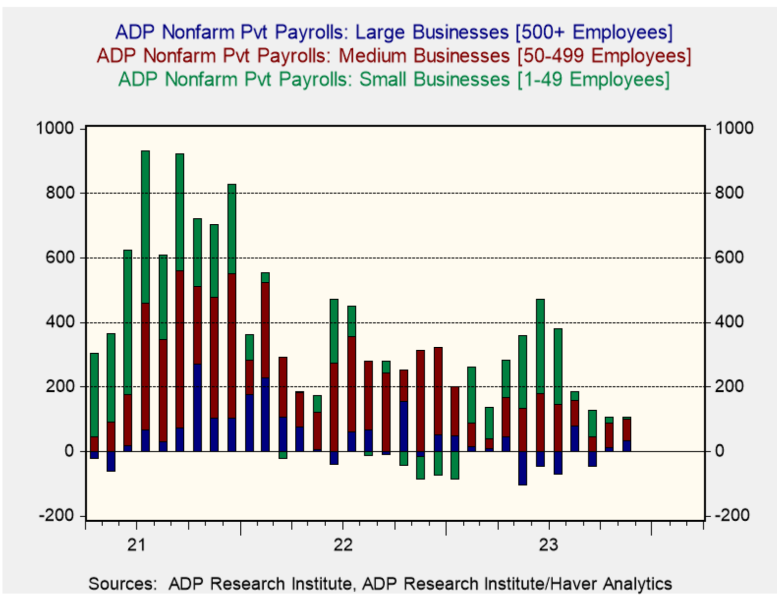
U.S. Bond Market: Reflecting the softening labor market, lower energy prices, and hopes that the Fed will cut interest rates soon, the yield on the 10-year Treasury note continues to decline. In fact, we've noted that the 10-year yield's 20-day moving average has now decisively slipped below its 50-day average. Such a cross-over, when the 50-day average is still trending upward, is often a harbinger of further declines. Nevertheless, we still think investors are overly optimistic about near-term rate cuts.

U.S. Monetary Policy: Consistent with our view that many bond investors are too optimistic about near-term interest-rate cuts, a new poll of economists by the *Financial Times* found that almost two-thirds of the respondents think the Fed won't start to cut rates until July 2024 or later. About three-quarters of the respondents expect the Fed to cut the benchmark fed funds rate by half a percentage point or less by the end of 2024.

U.S. Economic Releases

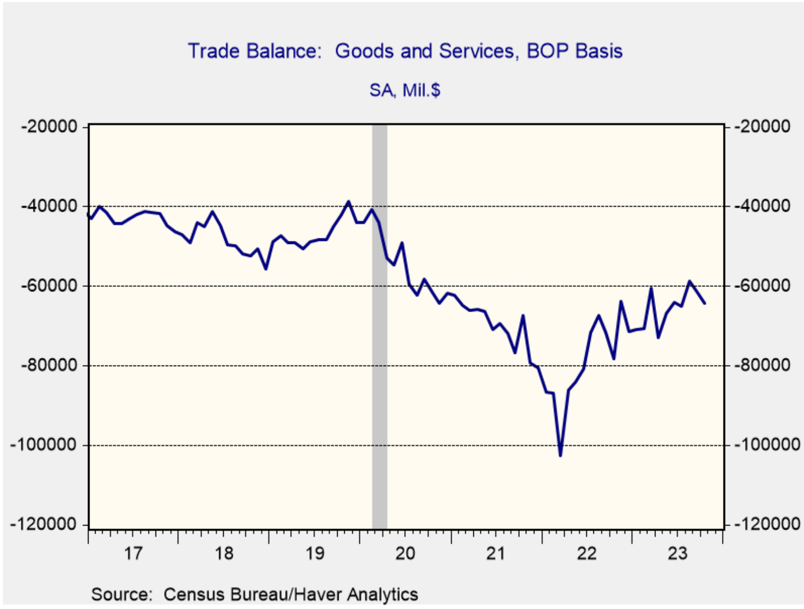
Residential loan demand surged for the third consecutive week, fueled by a drop in interest rates. The Mortgage Bankers Association's (MBA) mortgage applications index jumped 2.8% in the week ending December 1, driven by a significant decline in 30-year fixed-rate mortgages, which fell from 7.37% to 7.17%. This prompted a 13% increase in the MBA's refinancing tracker compared to the previous week, while the purchase tracker remained relatively stable.

U.S. employers added jobs at a slower-than-expected pace in November, providing further evidence that the labor market is finally starting to cool down. According to payroll company ADP, private firms increased their payrolls by 103,000 last month. The reading was slightly below the revised report of 106,000, but well below consensus expectations of 130,000.



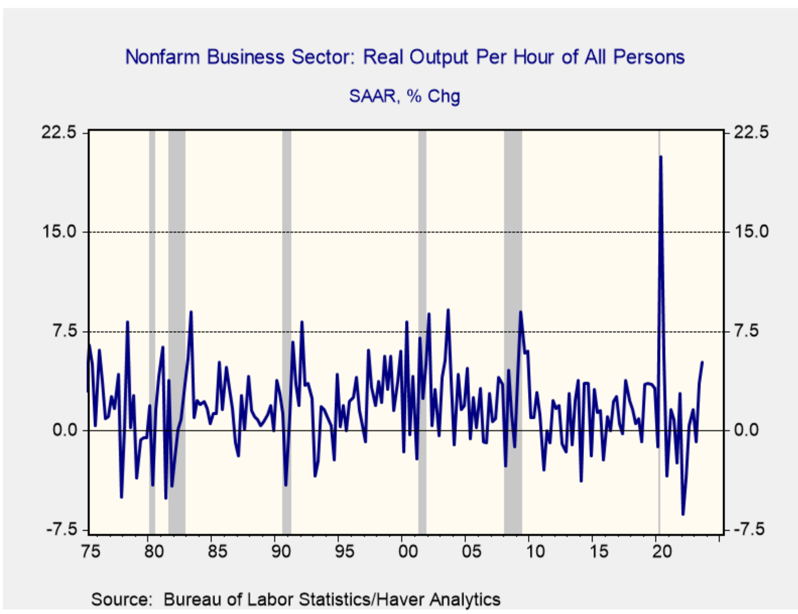
The chart above illustrates the breakdown of November hires by firm size. As depicted, medium-sized firms were the primary drivers of job growth, expanding their payrolls by 68,000. They were followed by large firms, which added 33,000 new employees, and small firms, whose workforce increased by a modest 6,000.

The U.S. trade deficit widened slightly in October, driven by a small decrease in exports. The American trade deficit increased from $61.2 billion in September to $64.3 billion in October. This increase was relatively in line with market expectations of $64.2 billion.



The chart above shows the U.S. trade balance.

Finally, U.S. productivity was revised upward for the third quarter. According to the U.S. Bureau of Economic Analysis, labor productivity increased 5.2% in third quarter, up from the previous reported rise of 3.6%. Meanwhile, unit labor costs fell at annualized pace of 1.2%, well below the preliminary estimate of 0.8%.



The chart above shows the annualized change in real output per worker. The latest reading shows that productivity accelerated at its fastest pace since 2020.

There are no economic releases or Fed events scheduled for the rest of the day.

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
EUROPE								
Eurozone	Retail Sales	y/y	Oct	-1.2%	-2.9%	-1.1%	*	Equity and bond neutral
Germany	Factory Orders WDA	y/y	Oct	-7.3%	-4.3%	-3.8%	***	Equity bearish, bond bullish
	HCOB Germany Construction PMI	m/m	Nov	36.2	38.3		*	Equity bullish, bond bearish
UK	S&P/CIPS Global Construction PMI	m/m	Nov	45.5	45.6	46.7	**	Equity and bond neutral
AMERICAS								
Canada	S&P/CIPS Global Services PMI	m/m	Nov	445.0	46.6		**	Equity and bond neutral
	S&P/CIPS Global Composite PMI	m/m	Nov	44.8	46.7		**	Equity and bond neutral
Mexico	International Reserves Weekly	w/w	1-Dec	$207120m	$206278m		*	Equity and bond neutral
Brazil	FGV Inflation IGP-DI	y/y	Nov	-3.62%	-4.27%	-3.52%	**	Equity and bond neutral
	Net Debt % GDP	m/m	Oct	60.0%	60.0%	59.9%	**	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)	562	564	-2	Down
3-mo T-bill yield (bps)	522	521	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	535	1	Down
10-yr T-note (%)	4.20	4.17	0.03	Flat
Euribor/OIS spread (bps)	396	396	0	Up
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Down			Up
Yen	Down			Up
Pound	Flat			Up
Franc	Flat			Up

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.

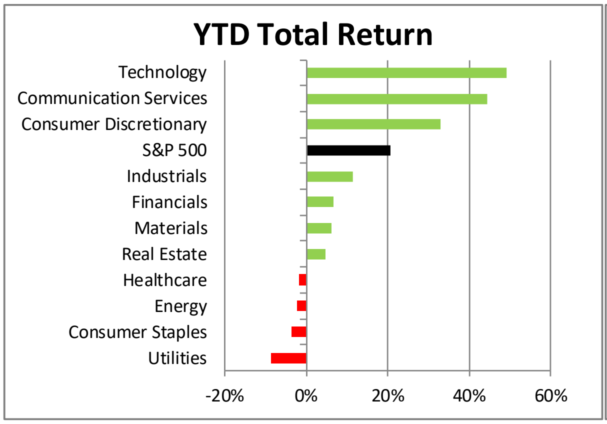
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$76.42	$77.20	-1.01%	
WTI	$71.52	$72.32	-1.11%	
Natural Gas	$2.70	$2.71	-0.22%	
Crack Spread	$23.63	$23.85	-0.92%	
12-mo strip crack	$24.03	$24.23	-0.85%	
Ethanol rack	$1.97	$1.98	-0.45%	
Metals				
Gold	$2,021.06	$2,019.36	0.08%	
Silver	$24.08	$24.16	-0.31%	
Copper contract	$380.90	$378.40	0.66%	
Grains				
Corn contract	$492.25	$490.50	0.36%	
Wheat contract	$637.75	$631.25	1.03%	
Soybeans contract	$1,311.00	$1,305.50	0.42%	
Shipping				
Baltic Dry Freight	3,143	3,346	-203	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.6		
Gasoline (mb)		1.3		
Distillates (mb)		1.1		
Refinery run rates (%)		0.7%		
Natural gas (bcf)		-109		

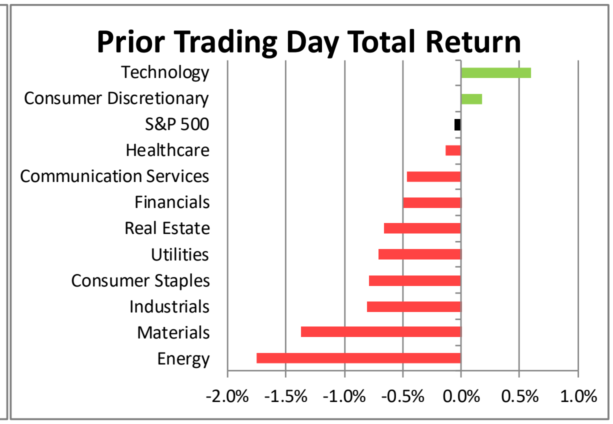
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for most of the country, with near-normal temperatures throughout the South. 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 12/5/2023 close)

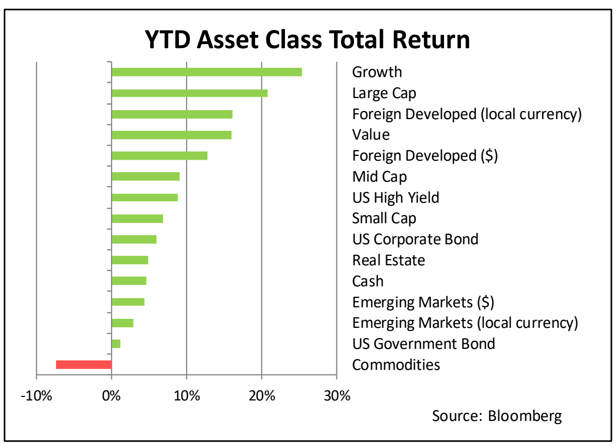




(Source: Bloomberg)

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 12/5/2023 close)

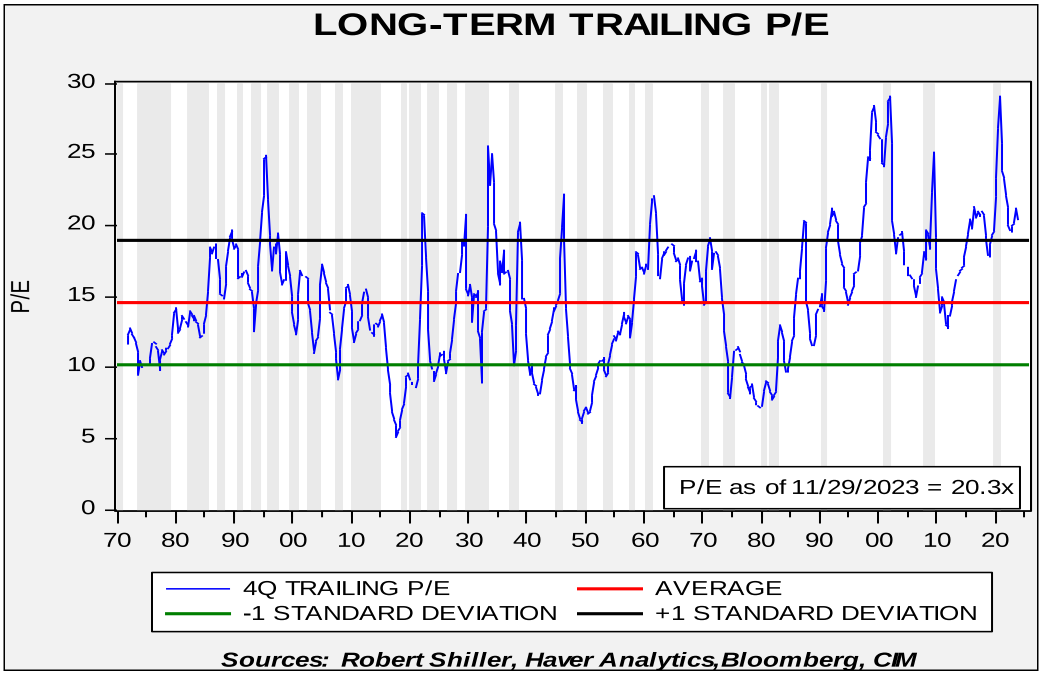


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.