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 7, 2023—9:30 AM EST] Global equity markets are generally lower this morning. In Europe, the Euro Stoxx 50 is down 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.7%. Chinese markets were down, with the Shanghai Composite down 0.1% from its previous close and the Shenzhen Composite down 0.3%. U.S. equity index futures are signaling a lower open.

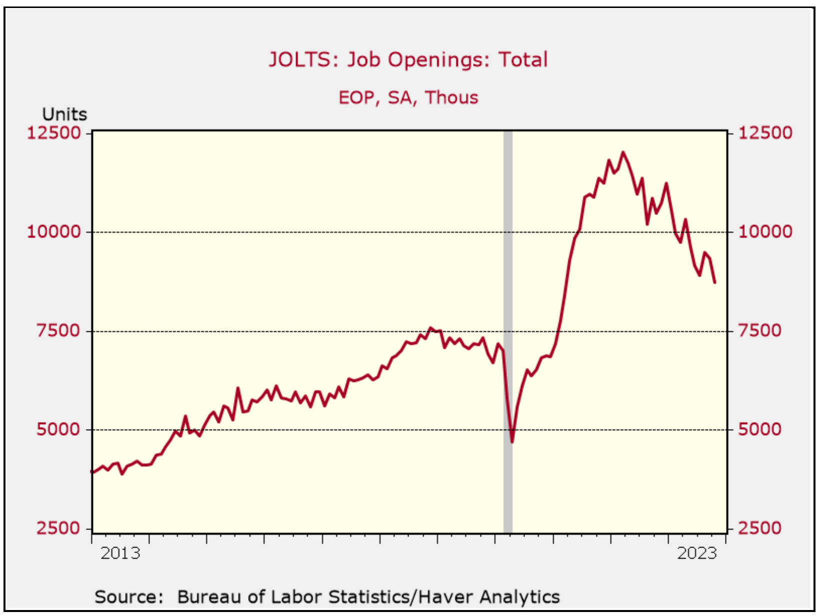
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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*** **(12/7/2023): Oil prices continue under pressure despite efforts by OPEC+ to constrain supply. This week's soft oil export data triggered selling, but the larger concern over slowing global economic growth is weighing on sentiment. We continue to monitor events in the Middle East and the brewing Guyana/Venezuela tensions**.
- *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?"

Good morning! Risk assets are enjoying a lift as investors eagerly await tomorrow's crucial jobs data. Meanwhile, former Padres' outfielder Juan Soto is making his way to the Big Apple for his next adventure. Today's *Comment* kicks off with our insights on the anticipated rate cuts for next year, then explores why banks are wary of the new Basel regulations, and finally delves into how China's economic struggles might ultimately benefit the rest of the world. As always, our comprehensive report encompasses the latest domestic and international data releases.

Are Rate Cut Bets Overdone? Investors are having second thoughts on how aggressive the Fed will be when cutting rates next year.

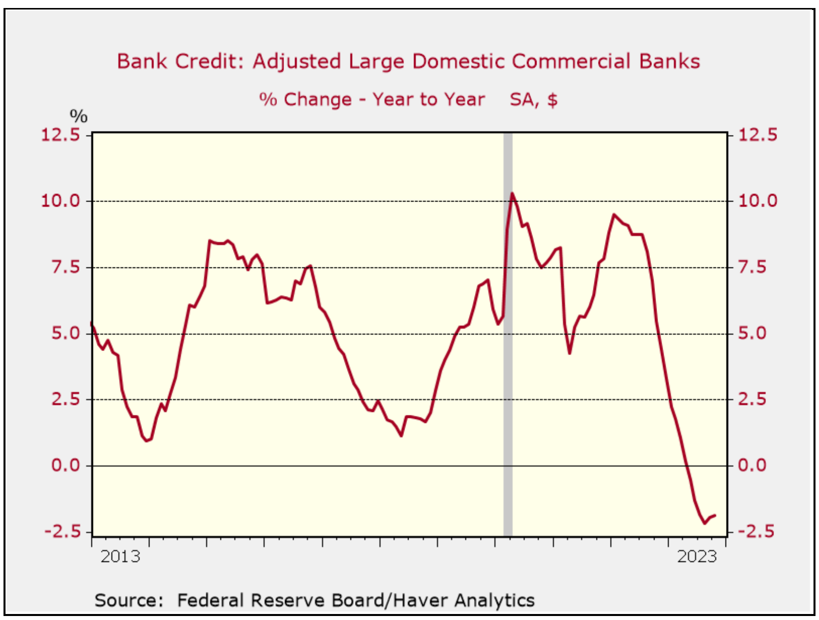
- Despite rallying nearly 9% in November, the S&P 500 has been relatively sluggish in the first week of December. This lackluster performance can partially be attributed to market participants rethinking their expectations of a Federal Reserve policy shift. Projections based on fed funds contracts show that investors are predicting a 125 basis point cut in key interest rates, while economists have offered a more pessimistic view, predicting at most a 50 basis point cut in 2024. This divergence in views has led investors to seek protection against market volatility in the form of options.
- While concerns remain, expectations for a moderating interest rate environment are not entirely unfounded. Federal Reserve Board Governor Christopher Waller, a traditionally hawkish member, recently suggested that the central bank could cut rates as early as April if inflation continues to make significant progress towards the 2% target. Additionally, signs of a cooling labor market may further incentivize action from Fed officials. Last week, data from the Bureau of Labor Statistics revealed a two-year low in job postings for October, while the latest private payroll data from ADP indicated a reduction in new hires by firms. These developments suggest a potentially more dovish stance from the Fed in the near future.



- Although inflation remains significantly above the Federal Reserve's 2% target, it is still too early to predict with certainty whether the Fed will cut rates or stand pat next year. Furthermore, aggressive cuts, as anticipated by the market, are highly unlikely without a major economic crisis. The Atlanta Fed's latest forecast projects a modest 1.3% annualized growth for the final quarter of 2023. Therefore, if we assume there will be no recession or perhaps a mild one, then any potential rate cuts in the coming year will likely be moderate.

Wall Street Woes: CEOs from major banks gathered on Capitol Hill to express their concerns about new financial regulations.

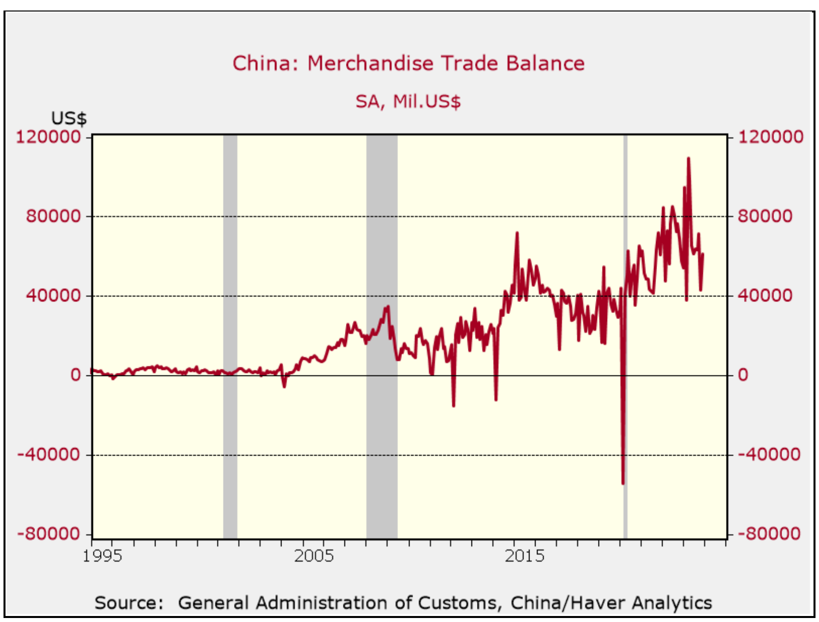
- Implementation of new banking standards dubbed the "Basel III Endgame," which are due to take effect in 2028, was the central topic of discussion. The chief executives argued that the proposed changes, which have not been finalized, are likely more burdensome than regulators realize. For example, the new capital requirements could make it harder for financial institutions to lend to households and small businesses, particularly those who already struggle to access credit. Additionally, the executives argued that the changes could push lending into less regulated sectors of the financial system. The banks' concerns about the impact of the new regulations on lending come amid a significant rise in private credit lending, which has seen a dramatic increase in recent months.
- The new rules were announced in July in response to growing concerns about the weakness within the financial system. These rules will apply to banks with holding over $100 billion in assets, exempting smaller institutions. The aim is to compel banks to adopt a more conservative and standardized approach to risk measurement, effectively requiring them to hold more capital as a buffer against losses. Regulators estimate a 19% average capital increase for globally systemically important banks (G-Sibs), although industry groups believe the actual increase could be significantly higher. Nevertheless, the stricter rules should help bring U.S. banks into compliance with international standards.



- New rules often have a good purpose, but they typically come at a cost to the overall economy. The combination of higher interest rates and regulatory scrutiny has already weighed on lending. As the chart above shows, large banks have reduced the amount of credit issued compared to the year prior. However, the new Basel rules' ability to prevent another crisis may not be as clear-cut as regulators may think, as it could lead to unforeseen consequences. For example, the rise of collateralized debt obligations (CDOs) was spawned by the first Basel Framework, highlighting the possibility of unintended side effects. That said, the proposed rules are still under development and open for public comment until January 16, 2024.

China Needs a Break: The country faces a growing number of obstacles as it seeks to expand its global reach and revitalize its struggling economy.

- China's Belt and Road Initiative has suffered a significant setback with Italy's formal withdrawal from the program. Though Italian Prime Minister Giorgia Meloni's earlier criticism of the initiative foreshadowed the decision several months ago, it will likely strain relations with China. Italy's 2019 participation in the BRI marked a historical first — the only G-7 member to join the program. However, this decision drew criticism from other EU countries and the United States, highlighting divisions within the Western alliance. Italy's withdrawal may lead to some retaliation from Chinese consumers, but the decision to leave is a further indication of Beijing's waning influence in Europe.
- U.S. ratings agency Moody's (MCO, $374.43) downgraded the outlook for eight Chinese banks, including the "Big Four" state-owned commercial banks (Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China, and China Construction Bank Corporation), from stable to negative. The negative outlook reflects Moody's earlier downgrade of China's sovereign debt rating, as the agency believes the government has less fiscal capacity to support struggling banks. Additionally, they signaled the potential downgrade of several government-backed entities supporting infrastructure. Fearing potential retaliation from the Chinese government, similar to surprise audits faced by Mintz Group, Bain & Co., and Capvision Partners earlier this year, Moody's advised its staff to work from home following the downgrade.

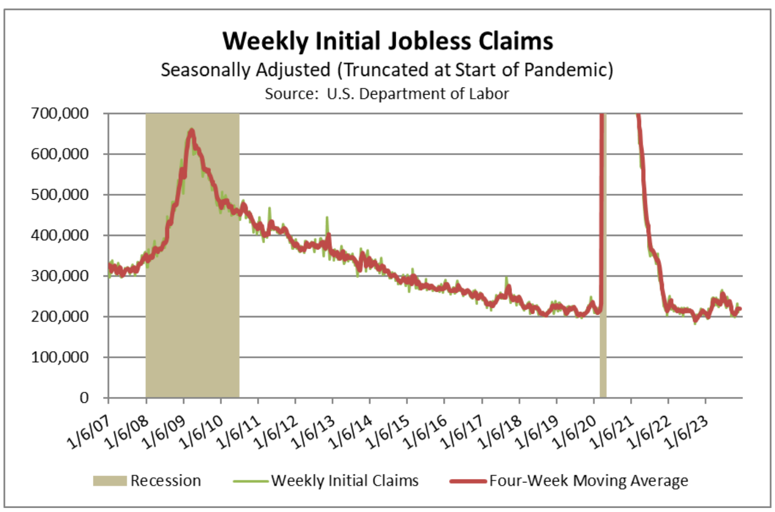


- The country's escalating economic problems will likely discourage Beijing from seeking major disruptions in its international relations in the near term. This is evidenced by Xi Jinping's recent efforts to foster warmer ties with the United States, despite President Biden's earlier remarks referring to him as a dictator. As the government seeks to manage its debt burden, promoting exports becomes an increasingly important strategy for generating growth and maintaining industrial production levels. This explains Xi Jinping's recent trip to the EU, where he aimed to convince lawmakers not to place barriers on trade. In all, China's shortcomings may lead to more stability as it may be too distracted to start a fight with the West.

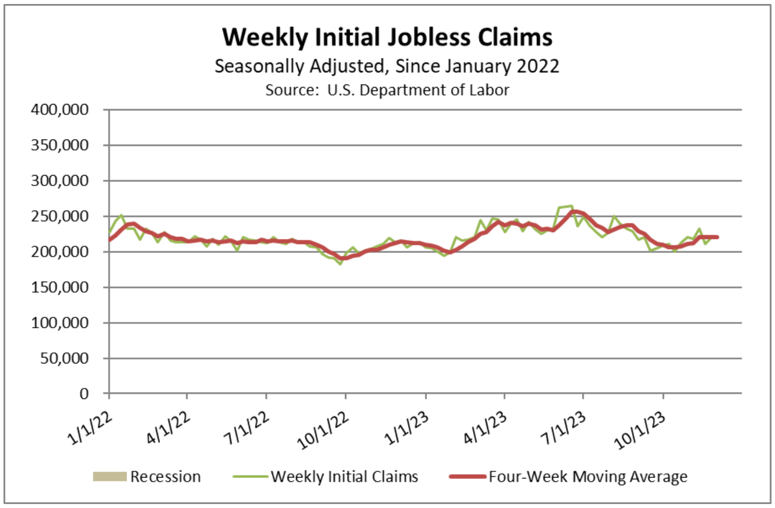
Other News: Venezuelan President Nicolás Maduro recently unveiled a controversial map claiming Guyana's Essequibo region as part of Venezuela. This action marks a significant escalation in Maduro's ongoing efforts to assert control over the eastern region. President Biden suggested that there are Democrats who could possibly defeat Trump in an election, a possible sign that he may be weighing his options. Meanwhile, the Senate's failure to pass legislation funding Ukraine due to demands for increased aid for U.S. border security highlights a growing trend of inward-focused politics as the nation grapples with its changing role in the global landscape.

U.S. Economic Releases

In the week ended December 2, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 220,000, matching expectations and coming in slightly higher than the revised level of 219,000 in the previous week. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 220,750. Meanwhile, in the week ended November 25, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) fell back to 1.861 million, below both the anticipated reading of 1.910 million and the previous week's revised reading of 1.925 million. The chart below shows how initial jobless claims have fluctuated since just before the Great Financial Crisis. The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



To provide more detail on recent trends, the chart below shows how initial jobless claims have changed just since the beginning of 2022.



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	Wholesale Inventories	m/m	Oct F	-0.2%	-0.2%	***
10:00	Wholesale Trade Sales	m/m	Oct	1.0%	2.2%	**
15:00	Consumer Credit	m/m	Oct	$8.50b	$9057b	*
Federal Reserve						
No Fed speakers or events for the rest of today						

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	Foreign Buying Japan Stocks	w/w	1-Dec	¥358.3b	¥4.2b	¥4.5b	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	1-Dec	-¥560.2b	-¥209.8b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	1-Dec	¥64.5b	-¥84.5b	-¥84.3b	*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	1-Dec	-¥710.4b	¥864.1b	¥849.2b	*	Equity and bond neutral
	Leading Economic Index	m/m	Oct P	108.7	108.9		**	Equity and bond neutral
Australia	Trade Balance	m/m	Oct	A$7129m	A$7500m	A$6184m	***	Equity and bond neutral
	Exports	m/m	Oct	0.4%	-1.4%	-1.8%	*	Equity bullish, bond bearish
	Imports	m/m	Oct	-1.9%	7.5%	8.0%	*	Equity bearish, bond bullish
	Foreign Reserves	m/m	Nov	A$92.2b	A$92.1b		*	Equity and bond neutral
China	Exports	m/m	Nov	0.5%	-6.4%	0.0%	***	Equity and bond neutral
	Imports	y/y	Nov	-0.6%	3.0%	3.9%	**	Equity bearish, bond bullish
	Trade Balance	y/y	Nov	$68.39b	$56.53b	$54.90b	**	Equity and bond neutral
	Foreign Reserves	y/y	Nov	$3171.81b	$3101.22b	$3139.50b	***	Equity and bond neutral
EUROPE								
Eurozone	GDP SA	q/q	3Q F	0.0%	0.1%	0.1%	***	Equity and bond neutral
Germany	Industrial Production WDA	y/y	Oct	-3.5%	-3.7%	-3.6%	**	Equity and bond neutral
France	Trade Balance	m/m	Oct	-£8597m	-£8917m	-£7.800b	**	Equity and bond neutral
	Current Account Balance	m/m	Oct	-2.9b	-2.5b	-2.8b	**	Equity and bond neutral
Italy	Retail Sales	y/y	Oct	0.3%	1.3%		**	Equity and bond neutral
	Industrial Production WDA	y/y	OCt	-1.1%	-1.2%	-1.4%	*	Equity and bond neutral
Switzerland	Unemployment Rate	m/m	Nov	2.1%	2.0%	2.1%	**	Equity and bond neutral
	Foreign Currency Reserves	m/m	Nov	641.7b	657.8b	657.5b	***	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	1-Dec	$592.9b	$587.5b		***	Equity and bond neutral
	Official Reserve Assets	m/m	Nov	592.4b	576.1b%	625.0b	*	Equity and bond neutral
AMERICAS								
Mexico	CPI	y/y	Nov	4.32%	4.26%	4.39%	***	Equity and bond neutral
	Core CPI	y/y	Nov	5.30%	5.50%	5.33%	**	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	562	2	Down
3-mo T-bill yield (bps)	523	525	-2	Down
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	537	537	0	Down
U.S. Libor/OIS spread (bps)	535	535	0	Down
10-yr T-note (%)	4.15	4.10	0.05	Flat
Euribor/OIS spread (bps)	395	396	-1	Up
Currencies	**Direction**			
Dollar	Down			Down
Euro	Flat			Up
Yen	Up			Up
Pound	Flat			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Canada Rate Decision	5.000%	5.000%	5.000%	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.

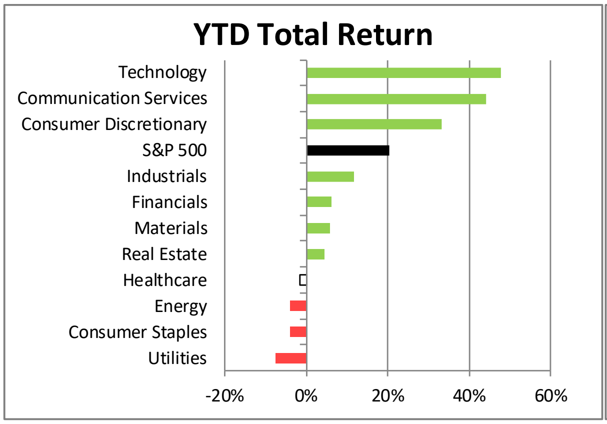
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$74.87	$74.30	0.77%	
WTI	$69.86	$69.38	0.69%	
Natural Gas	$2.51	$2.57	-2.30%	
Crack Spread	$23.73	$23.79	-0.27%	
12-mo strip crack	$23.89	$23.81	0.32%	
Ethanol rack	$1.93	$1.94	-0.61%	
Metals				
Gold	$2,032.33	$2,025.55	0.33%	
Silver	$23.90	$23.90	0.00%	
Copper contract	$375.95	$373.45	0.67%	
Grains				
Corn contract	$487.75	$484.25	0.72%	
Wheat contract	$637.50	$633.50	0.63%	
Soybeans contract	$1,305.00	$1,295.50	0.73%	
Shipping				
Baltic Dry Freight	2,848	3,143	-295	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-4.6	-1.6	-3.0	
Gasoline (mb)	5.4	1.3	4.1	
Distillates (mb)	1.3	1.1	0.2	
Refinery run rates (%)	0.7%	0.7%	0.0%	
Natural gas (bcf)		-107	107	

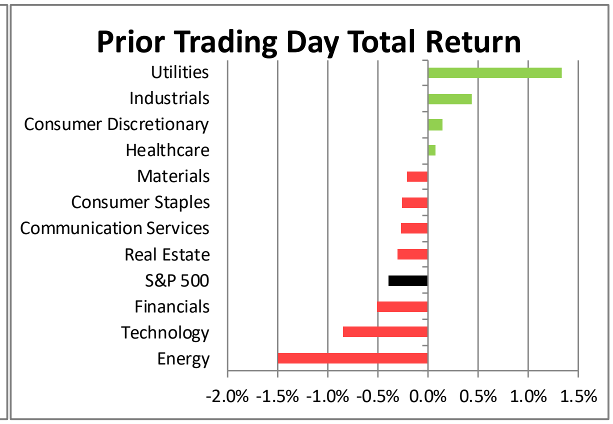
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures along the West Coast and in the northern Rocky Mountains and Great Plains regions, with cooler-than-normal temperatures along the Gulf Coast. The outlook calls for wetter-than-normal conditions in Texas and Florida, with dry conditions throughout the entire northern half of the country.

Data Section

U.S. Equity Markets – (as of 12/6/2023 close)

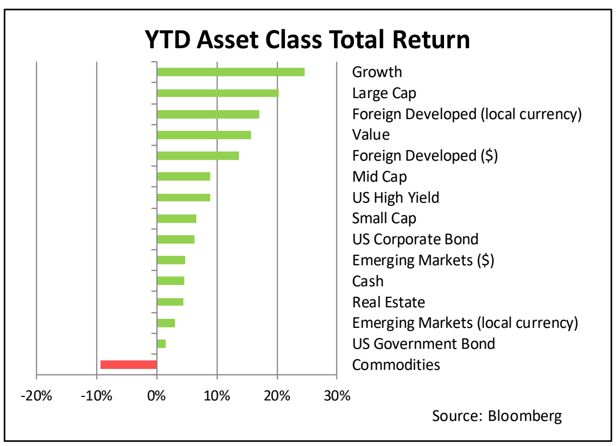




(Source: Bloomberg)

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 12/6/2023 close)

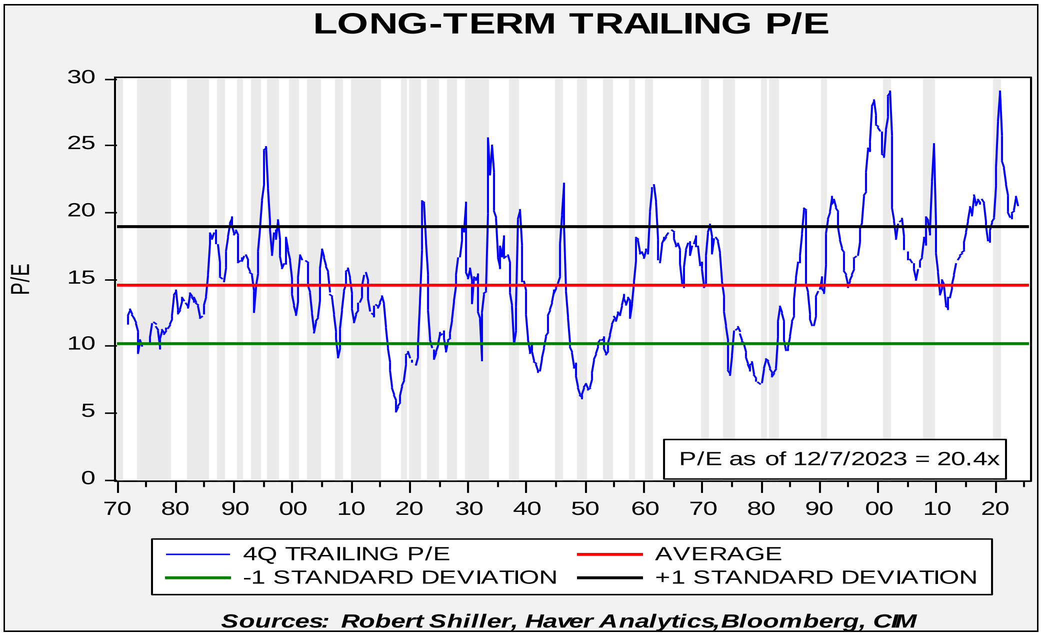


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

December 7, 2023



Based on our methodology,[1] the current P/E is 20.4x, up 0.1x from our last report. Falling earnings expectations for Q4 led to the modest expansion of the multiple despite the decline in index values.

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 (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.