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 8, 2023—9:30 AM EST] Global equity markets are mixed 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 0.9%. Chinese markets were mixed, with the Shanghai Composite up 0.1% from its previous close and the Shenzhen Composite down 0.1%. U.S. equity index futures are signaling a lower open.

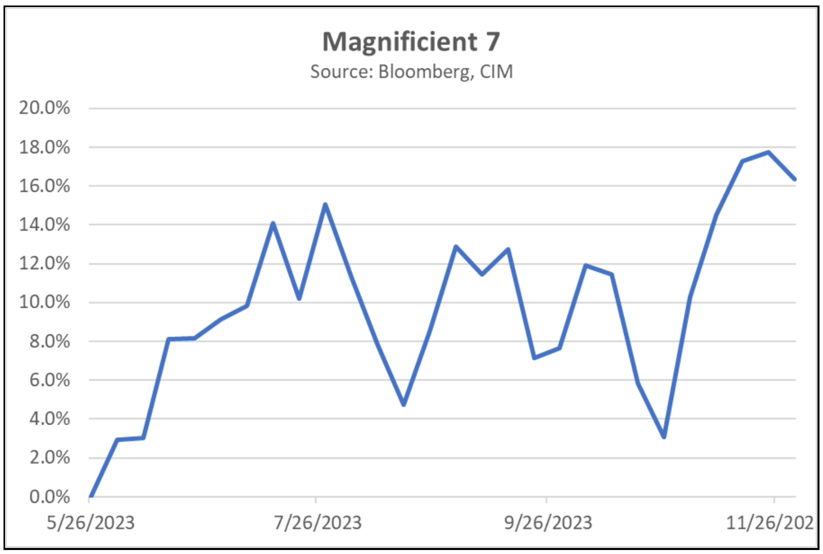
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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 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 down following stronger-than-expected jobs data. Meanwhile, the Los Angeles Lakers and Indiana Pacers have secured their spots in the NBA In-Season Tournament championship game. Today's *Comment* kicks off with our insights on the latest craze in artificial intelligence followed by an analysis of why investors suspect the Bank of Japan may soon abandon negative interest rates and a discussion on Saudi Arabia, which continues to work with both the U.S. and Russia to achieve its aims. As always, our comprehensive report encompasses the latest domestic and international data releases.

AI's Last Hoorah: Fear of missing out has led investors to pile into tech companies after each new development, but there are doubts about how long this can last.

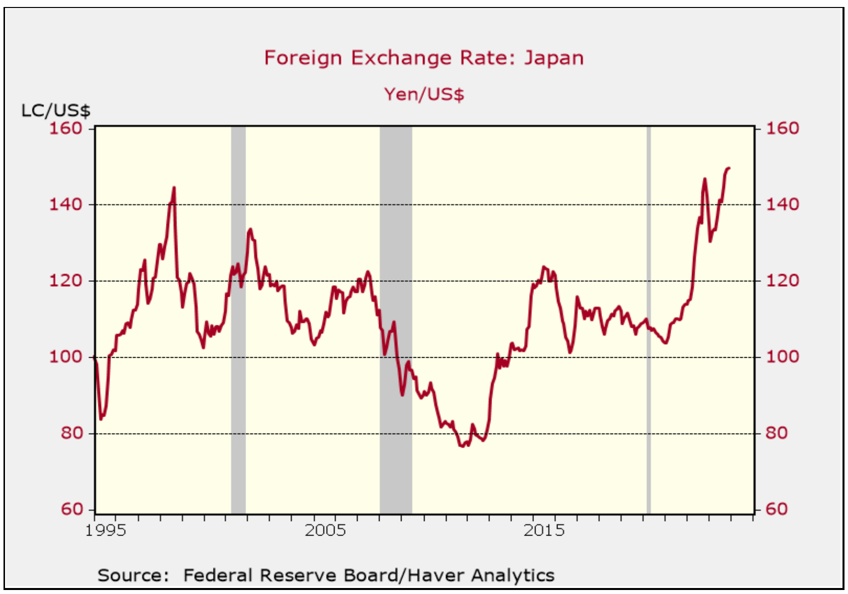
- Alphabet subsidiary Google (GOOGL, $138.10) [unveiled its highly anticipated answer to OpenAI's technology on Wednesday]. The company's new artificial intelligence, dubbed Gemini, boasts capabilities exceeding anything currently available. Gemini can process information from audio, video, and text, which should expand the customer's use. Additionally, it is believed to possess advanced reasoning and understanding abilities [and was able to outperform the latest OpenAI on a range of industry benchmarks]. So far, Gemini has been released in limited markets as Google would like to test the technology before releasing it early next year.
- Google's answer to OpenAI is a reflection of the ongoing turf war for dominance in the AI space, which has also expanded to the chip market. [Advanced Micro Devices Inc. (AMD, $127.69) unveiled its new MI300 accelerator chip,] a direct challenge to Nvidia's (NVDA, $464.22) dominance in the semiconductor market. This powerful new graphics processor boasts greater memory bandwidth and capacity compared to Nvidia's H100 chip, positioning it as a compelling and potentially cheaper alternative. Major tech players, including [Meta (META, $327.06), OpenAI, and Microsoft (MSFT, $370.75), have already expressed interest in acquiring the newly developed chip], indicating its potential to disrupt the current market landscape.



- While the excitement surrounding AI technology continues, its path to widespread adoption faces significant challenges in 2024. Intense competition within the space threatens to squeeze profitability as companies engage in price wars, potentially hindering their ability to meet ambitious earnings targets and justify their high valuations. Furthermore, lingering regulatory uncertainty surrounding AI, fueled by concerns about privacy and societal risks expressed by policymakers, poses a further obstacle. As a result, investors should exercise caution and recognize that today's industry leaders may not remain so in the future. Focusing on undervalued companies outside the AI sector may offer greater potential for long-term returns.

BOJ Regime Shift: The Japanese yen (JPY) has jumped following speculation that the Bank of Japan will move away from its ultra-accommodative monetary policy.

- BOJ Governor Kazuo Ueda hinted at potential policy adjustments in remarks to Japanese lawmakers on Thursday, stating that the central bank has "several options" available once short-term interest rates rise above zero. These comments followed Deputy Governor Ryozo Himino's remarks the previous day, which suggested that a measured transition toward a more restrictive monetary policy could benefit the overall economy. The combined statements fueled speculation among traders that a significant policy announcement might be imminent at the BOJ's upcoming meeting on December 18. This speculation contributed to a surge in the Japanese yen, reaching a peak of 4% appreciation against the dollar (141.71 yen per dollar) on Thursday, reflecting a decline in bearish sentiment toward the currency.
- The recent surge in price increases, driven by a departure from traditional corporate pricing and compensation strategies, suggests a significant shift in Japanese business culture. This has propelled inflation above the central bank's 2% target for 19 consecutive months, boosting the BOJ's confidence that deflation may be fading. However, a seamless transition to a hawkish monetary policy remains elusive. The latest GDP figures reveal a contraction of 2.9% in the third quarter of 2023 and a 2.5% decline in household spending since October 2022, suggesting the central bank's tightening might not be as swift as investors anticipate.

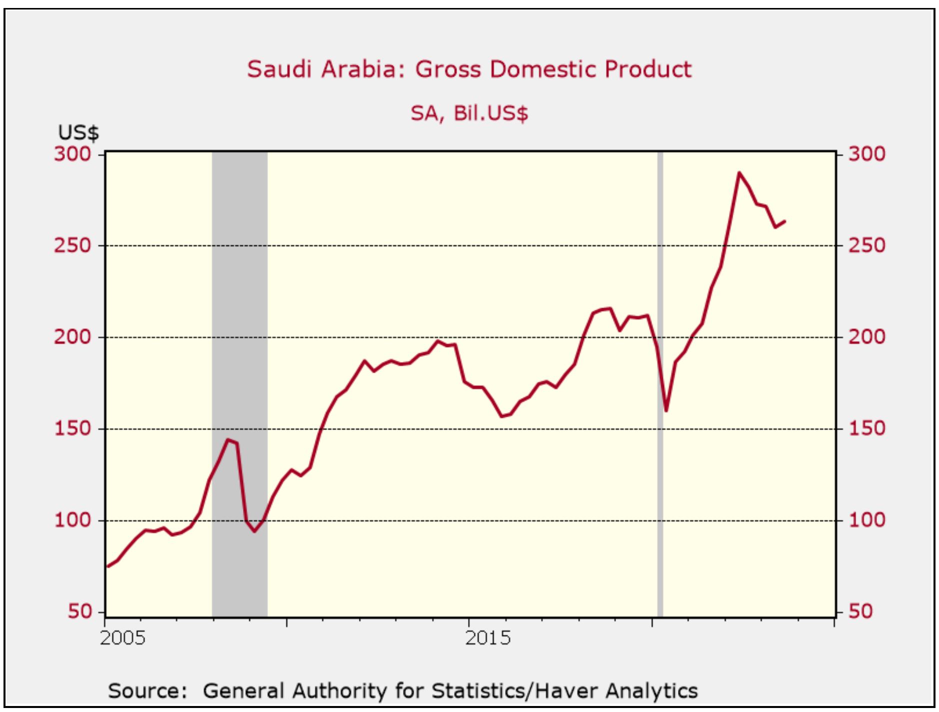


- Higher yields on Japanese government bonds (JGBs) may entice foreign investors, reversing the country's sizable net outflows and transforming them into inflows. This could lead to capital appreciation for foreign investors with exposure to Japan, driven by a strengthening JPY. Additionally, global bond yields may rise as Japanese buyers, incentivized to hold more domestic debt, exert less downward pressure on international yields. However, the change could also lead to an increase in servicing costs for traders who profited from the yen carry trade. It shouldn't be a problem as long as those traders are able to make payments on their loans. However, if they are unable to do so, it could lead to another financial crisis.

Saudi Arabia Weighs Its Options: The ongoing conflict between Israel and Hamas highlights Riyadh's cautious approach to picking sides between regional rivals.

- Washington continues its efforts to facilitate the normalization of relations between Saudi Arabia and Israel. U.S. officials remain cautiously optimistic that both parties are receptive to restarting negotiations, which were paused following the escalation of violence between Israel and Hamas. While Saudi Arabia has not explicitly called for renewed talks, its recent appeals to the U.S. to exercise restraint in response to Houthi rebel attacks on ships in the Red Sea suggest a broader regional commitment to peace. Currently, there are no plans for the countries to engage in discussions while conflicts persist in Gaza.

- On a separate note, Saudi Arabia's Crown Prince Mohammed bin Salman hosted Russian President Vladimir Putin in Riyadh for talks centered on oil production cuts. This meeting served as a stark reminder that Moscow retains significant influence in the Middle East, despite Western efforts to isolate it following the invasion of Ukraine. Putin, facing a looming re-election campaign and a struggling Russian economy heavily reliant on energy revenue, prioritized the meeting, demonstrating his deep concern about the impact of low oil prices. Following their discussion, both leaders called on other OPEC members to strictly adhere to the production targets set at the previous meeting. Notably, Iran, with whom Putin met on Thursday, remains the biggest holdout.

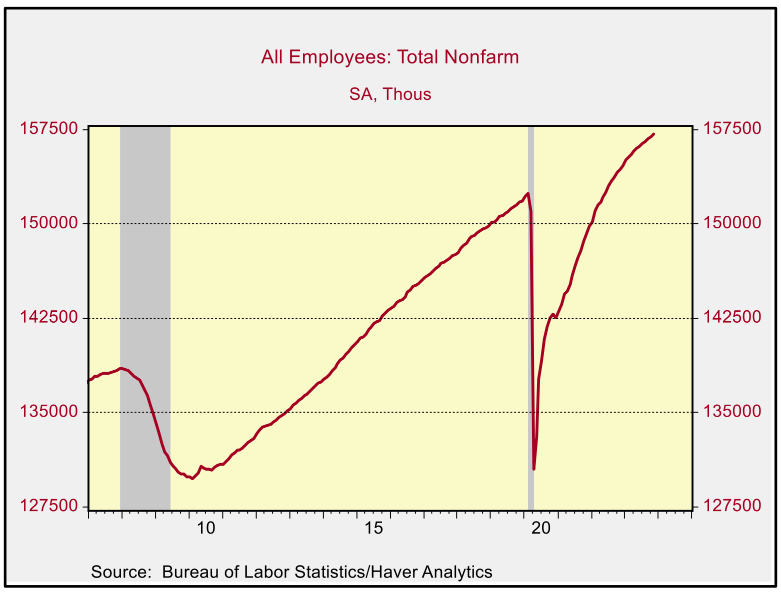


- Despite being the world's largest exporter of crude oil, Saudi Arabia is currently struggling to diversify its economy. Its attempts to branch out into different fields beyond energy have yielded weak results so far. On Thursday, the Kingdom announced a delay in its ambitious 2030 Vision due to concerns over growing budget deficits. The recent drop in oil prices, which has slowed down the global economy, has likely exacerbated these problems. To attract foreign investment, Saudi Arabia has announced a 30-year tax exemption for any company willing to relocate its headquarters to the country.

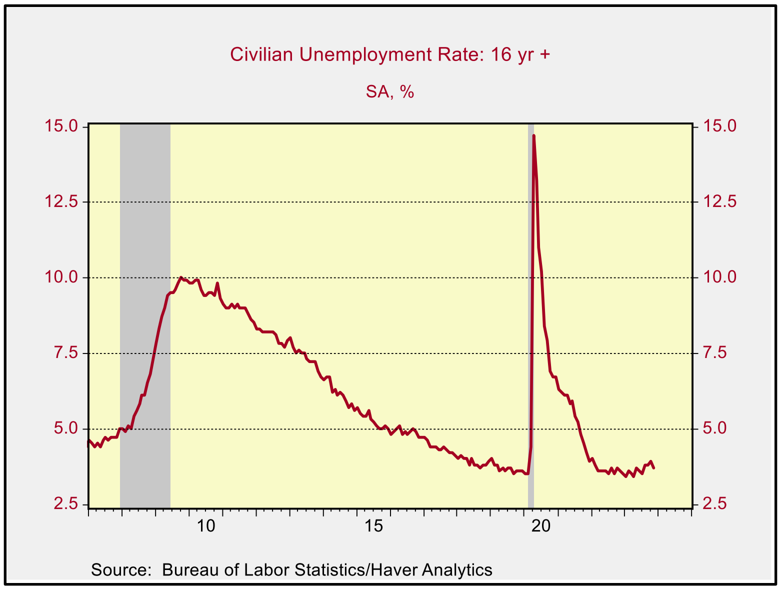
In Other News: The European Union [is considering challenging U.S. steel tariffs with the World Trade Organization](). The move highlights growing concerns that the Western alliance may be weakened following the next presidential election.

U.S. Economic Releases

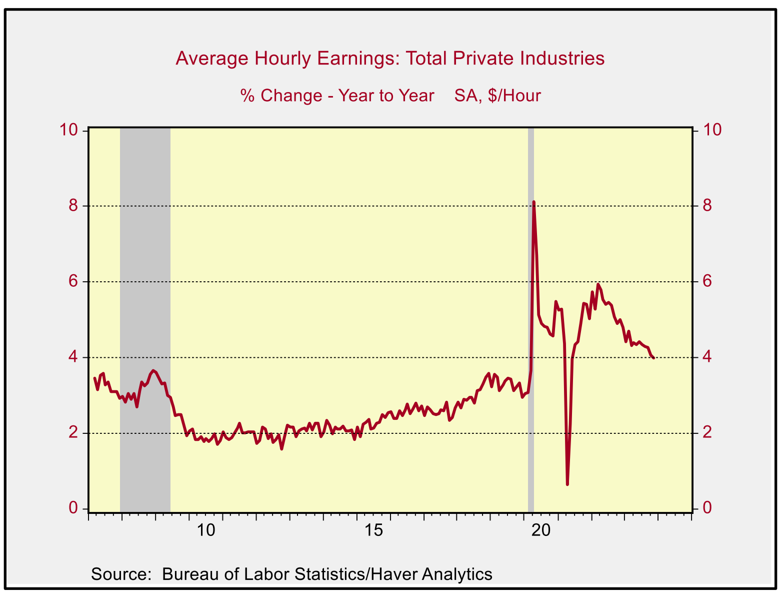
November ***nonfarm payrolls*** rose by a seasonally adjusted 199,000, only modestly beating the expected increase of 185,000 but accelerating substantially from October's increase of 150,000. Job creation has certainly slowed in the year to date. After payrolls increased by an average of 399,420 per month in 2022, they've averaged just 232,000 per month so far in 2023. All the same, job creation remains healthy enough to keep wage rates rising and potentially discourage the Fed from cutting interest rates just yet. The chart below shows the change in nonfarm payrolls since shortly before the Great Financial Crisis of 2008-2009.



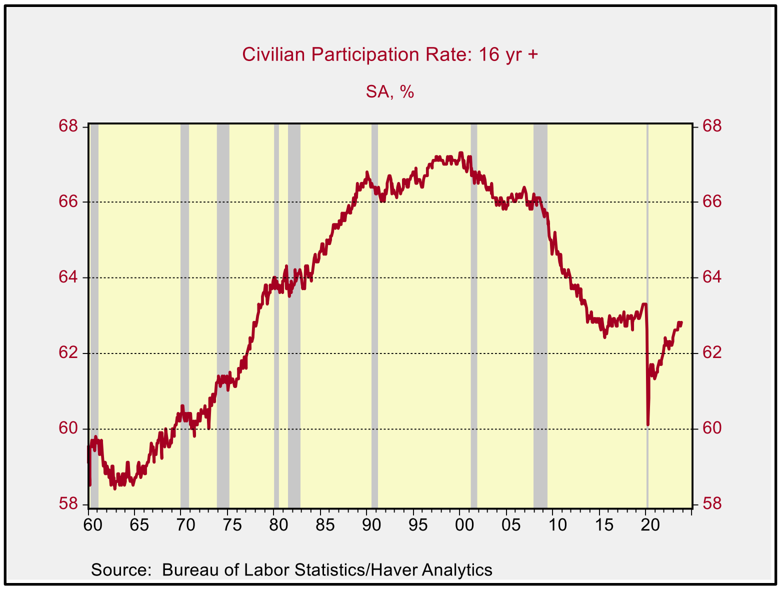
The November ***unemployment rate*** fell to a seasonally adjusted 3.7%, beating expectations that it would remain at the 3.9% level reached in October. The rate of joblessness is now at its lowest level since July. The chart below shows how the unemployment rate has evolved since just before the GFC.



With the demand for labor high and the "inventory" of unemployed workers low, it should be no surprise that wage rates remain high. ***Average hourly earnings*** in November rose to a seasonally adjusted $34.10, up 4.0% from the same month one year earlier, as anticipated. The chart below shows the year-over-year growth in average hourly earnings since just before the GFC.



A final key indicator in the monthly employment report focuses on the share of the adult, civilian, noninstitutionalized population that is either working or looking for work. The November ***labor force participation rate (LFPR)*** rose to a seasonally adjusted 62.8%, beating expectations that it would remain at 62.7% in October but still short of the 63.3% reached just before the coronavirus pandemic. The chart below shows how the LFPR has changed over the last several decades.



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	U. of Michigan Consumer Sentiment	m/m	Dec P	62.0	61.3	***
10:00	U. of Michigan Current Conditions	m/m	Dec P	68.5	68.3	**
10:00	U. of Michigan Future Expectations	m/m	Dec P	57.0	56.8	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Dec P	4.3%	4.5%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Dec P	3.1%	3.2%	*
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	Labor Cash Earnings YoY	q/q	Oct	1.5%	1.2%	1.0%	***	Equity bullish, bond bearish
	Household Spending YoY	y/y	Oct	-2.5%	-2.8%	-2.9%	***	Equity and bond neutral
	GDP SA	q/q	3Q F	-0.7%	-0.5%	-0.5%	***	Equity and bond neutral
	GDP Deflator	y/y	3Q F	5.3%	5.1%	5.1%	***	Equity and bond neutral
	BoP Current Account Balance	m/m	Oct	¥2585.8b	¥2723.6b	¥1689.3b	***	Equity and bond neutral
	BoP Trade Balance	m/m	Oct	-¥472.8b	¥341.2b	-¥372.2b	**	Equity and bond neutral
Australia	Foreign Reserves	m/m	Nov	A$92.2b	A$92.1b		***	Equity and bond neutral
South Korea	BoP Current Account Balance	m/m	Oct	$6796.1m	$5420.7		**	Equity and bond neutral
	BoP Goods Balance	m/m	Oct	$5351.8m	$7419.3		*	Equity and bond neutral
EUROPE								
Germany	CPI	y/y	Nov F	3.2%	3.2%	3.2%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Nov F	2.3%	2.3%	2.3%	**	Equity and bond neutral
France	Trade Balance	m/m	Oct	-£8917	-£8917m	-£7.800b	**	Equity and bond neutral
	Current Account Balance	m/m	Oct	-2.5b	-2.5b	-2.8b	**	Equity and bond neutral
Russia	Money Supply, Narrow Definition	w/w	1-Dec	18.12t	18.22t		*	Equity and bond neutral
AMERICAS								
Canada	Building Permits	m/m	Oct	2.3%	-6.5%	2.1%	**	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	564	0	Down
3-mo T-bill yield (bps)	522	524	-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 (%)	4.18	4.15	0.03	Flat
Euribor/OIS spread (bps)	397	395	2	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Down			Up
Pound	Down			Up
Franc	Flat			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
RBI Cash Reserve Ratio	4.500%	4.500%	4.500%	On Forecast
RBI Repurchase Rate	6.500%	6.500%	6.500%	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.

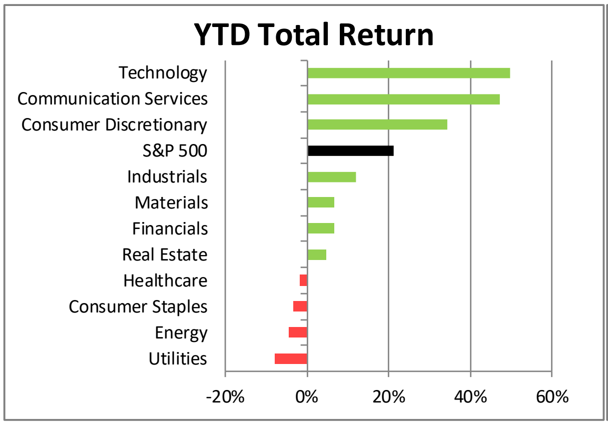
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$75.42	$74.05	1.85%	
WTI	$70.59	$69.34	1.80%	
Natural Gas	$2.60	$2.59	0.54%	
Crack Spread	$23.03	$22.46	2.56%	
12-mo strip crack	$23.57	$23.12	1.93%	
Ethanol rack	$1.92	$1.93	-0.30%	
Metals				
Gold	$2,030.13	$2,028.47	0.08%	
Silver	$23.79	$23.80	-0.03%	
Copper contract	$382.80	$379.75	0.80%	
Grains				
Corn contract	$488.50	$488.00	0.10%	
Wheat contract	$637.25	$642.25	-0.78%	
Soybeans contract	$1,315.75	$1,311.75	0.30%	
Shipping				
Baltic Dry Freight	2,495	2,848	-353	
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)	-117	-107	-10	

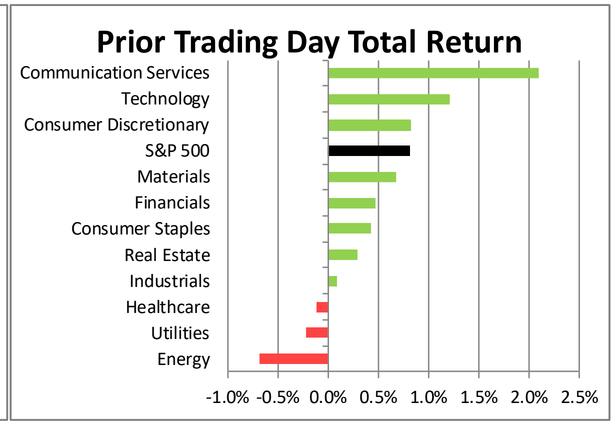
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout the Far West, the northern Great Plains, and the Midwest, with cooler-than-normal temperatures only in the Carolinas. The outlook calls for wetter-than-normal conditions in Texas and Florida, with dry conditions in the Rocky Mountains and the Midwest.

Data Section

U.S. Equity Markets – (as of 12/7/2023 close)

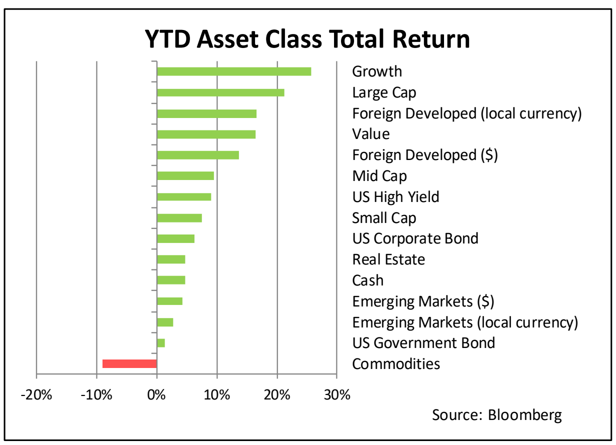




(Source: Bloomberg)

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 12/7/2023 close)

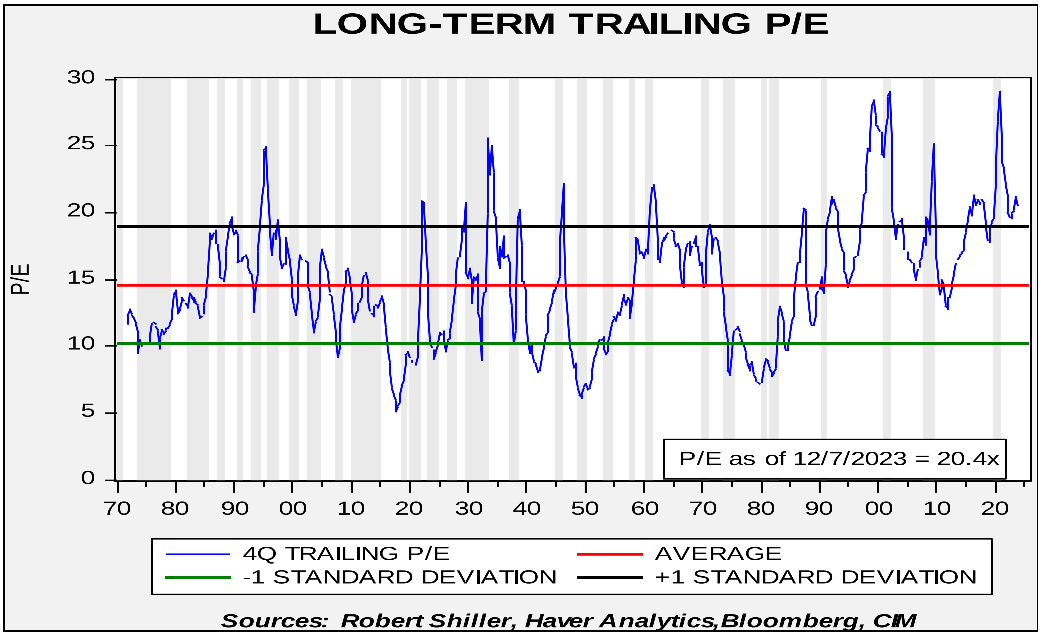


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.