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 11, 2023—9:30 AM EST] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.5%. Chinese markets were higher, with the Shanghai Composite up 0.7% from its previous close and the Shenzhen Composite up 1.0%. 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* (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?"

Our *Comment* today opens with tantalizing signs that the Israel-Hamas conflict could be inching closer to its end game. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including new tensions between China and the Philippines, the surging market capitalization of India's stock market, and various points on the U.S. economy.

Israel-Hamas Conflict: As the Israeli Defense Forces continue to press their attacks against Hamas fighters in southern Gaza, evidence over the weekend suggested Hamas may be starting to collapse politically and militarily. Arab television networks Al-Arabiya and Al-Jazeera aired interviews with Palestinians in Gaza who criticized Hamas and its leaders over the dire situation

there, and Israeli television showed large numbers of Palestinian men surrendering in northern Gaza. IDF officials confirmed that Hamas's military organization is starting to collapse.

- To accelerate a Hamas military collapse, the IDF is now redoubling its effort to find and kill the group's leaders, who are believed to be hiding in the group's tunnels in the south. If the IDF can take out the Hamas leadership, Israel's offensive could end relatively soon.

- As long as major combat operations continue, there will still be a risk of the conflict spreading to other parts of the region and threatening oil supplies.

  o Since Hamas touched off the conflict with its October 7 attacks on Israel, Brent crude oil has fallen from roughly $90 per barrel to about $75 per barrel, reflecting rebounding output from the U.S. and elsewhere and weakening demand as global economic growth moderates.

  o Nevertheless, those prices probably include some risk premium to account for the chance that the Israel-Hamas conflict could spread. When and if the conflict ends and that risk premium goes away, near-term oil prices could fall further.
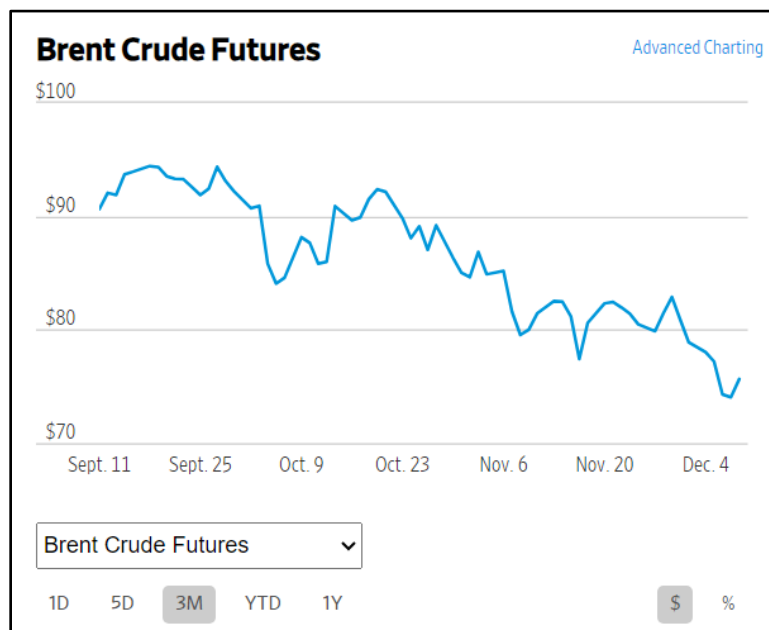
(Source: Wall Street Journal)

China-Philippines: In at least two incidents over the weekend, Chinese coast guard vessels again harassed Philippine coast guard and civilian supply vessels operating near disputed shoals in the South China Sea. In the confrontations, the Chinese once again apparently used acoustic weapons to disorient the Philippine sailors, fired water cannon at them, and collided with at least one of the Philippine vessels.

- China continues to aggressively assert its expansive territorial claims from the Himalayas to Taiwan and throughout the East China and South China seas. According to General Secretary Xi, taking control over the disputed areas is a key part of his goal to achieve "the great rejuvenation of the Chinese people."

- Given the mutual defense treaty between the U.S. and the Philippines, Beijing's increased aggressiveness in the South China Sea is especially risky as the sinking of a Philippine vessel or the killing of Philippine sailors could potentially require the U.S. to confront China.

North Korea: Security officials in South Korea last week said they are increasingly considering the possibility that top North Korean leader Kim Jong-Un is grooming his 10-year-old daughter, Kim Ju-ae, to be his eventual successor. The assessment is based on the girl's increasingly flattering coverage in North Korean state media and apparent efforts to make her look older than her age. Since North Korea is a highly conservative and patriarchal society, analysts think Kim would prefer a male heir, but if Kim has a son, he hasn't shown any public preference for him.
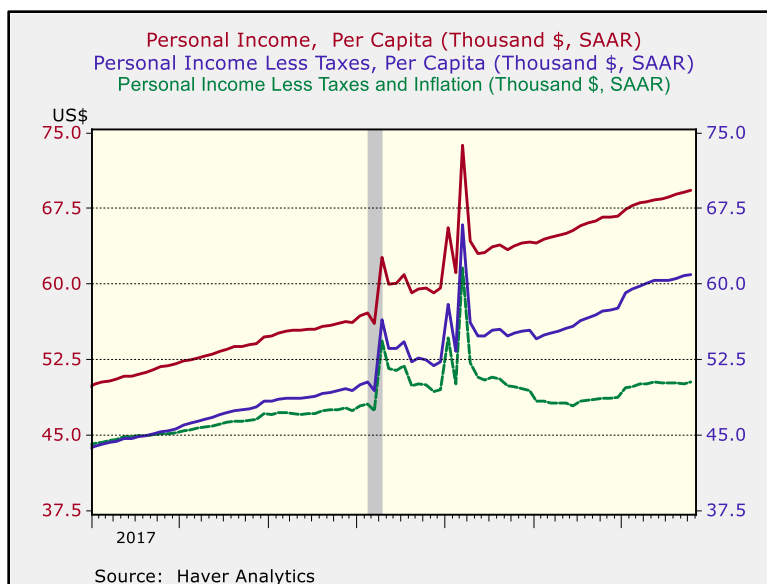
India: The World Federation of Exchanges said the Indian stock market at the end of October had total capitalization of $3.7 trillion, putting it on track to soon overtake Hong Kong, currently the world's seventh-largest market with capitalization of $3.9 trillion. We think India's stocks will keep benefitting from the country's good economic growth and warming relations with the U.S., but investors continue to sour on Chinese-related investments amid geopolitical and economic concerns.

Argentina: After his official inauguration as Argentina's president yesterday, populist libertarian firebrand Javier Milei reiterated his general goal of rebuilding the country's economy and slashing government involvement in it. However, it appears that the only concrete detail he offered was a promise to cut government spending by 5%. He is expected to offer further detailed proposals in the coming days.

U.S. Monetary Policy: The Federal Reserve will open its latest policy meeting tomorrow, with its decision due on Wednesday at 2:00 pm ET. The policymakers are widely expected to keep their benchmark fed funds interest rate at today's range of 5.25% to 5.50%. The question is what they'll say about future policy moves. While many investors are hoping for a signal of near-term rate cuts, we think officials remain focused on rebuilding their inflation-fighting credentials and are more likely to repeat their "higher for longer" mantra.
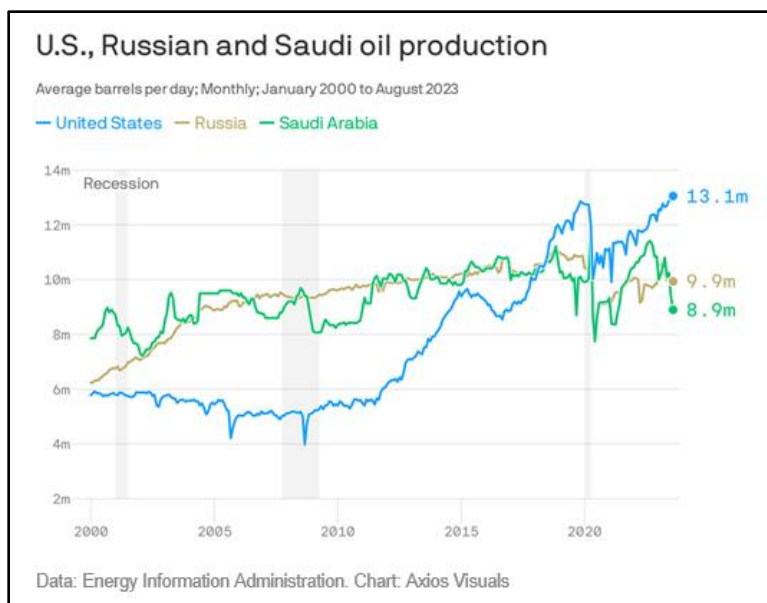
U.S. Financial Markets: The Treasury will issue a combined $108 billion of three-year, 10-year, and 30-year bonds today and tomorrow along with $213 billion of shorter-term bills. Since the 30-year bonds issued in early November were so poorly received, investors will likely focus heavily on this week's auctions. If the supply again appears to overwhelm the demand for new U.S. obligations, the result could be a rebound in yields and volatility across asset classes.

U.S. Consumer Spending: As we look out to 2024 and try to forecast where the economy and financial markets will go, we're paying close attention to consumer spending—by far the biggest driver of U.S. economic growth over the last few years. We find the chart below to be especially instructive.

Personal Income, Per Capita (Thousand $, SAAR)
Personal Income Less Taxes, Per Capita (Thousand $, SAAR)
Personal Income Less Taxes and Inflation (Thousand $, SAAR)

Source: Haver Analytics

- The top line, in red, tracks overall personal income on a per-capita, annualized basis over the last several years. The next line, in blue, tracks per-capita disposable personal income (personal income less taxes) on an annualized basis. Both measures have been trending up smartly, suggesting consumers have had a lot of buying firepower.

- However, we think the dashed bottom line, in green, is more instructive. It shows how personal income has grown after stripping out both taxes and price inflation. Essentially, it captures consumer purchasing power from income (excluding borrowing and dipping into savings). The line shows the big jump in consumer purchasing power when the government released trillions of dollars of stimulus in the middle of the coronavirus pandemic. However, the line clearly shows how purchasing power fell once price inflation took hold and has only partially recovered since then. Overall, per-capita purchasing power is flat-to-down since the start of 2021.

  o In 2017 prices, disposable income stands at $50,169 per person. If real disposable income per capita had continued to increase at its growth rate from mid-2017 to the end of 2019, it would now stand at $50,462.

  o The relative shortfall in per-capita purchasing power goes far toward explaining consumer pessimism about the economy and low opinion of President Biden. Since spending has continued to increase, the figures also suggest consumers have been borrowing or spending down their savings to buy. There is likely a limit to how far they can take that strategy, which suggests consumer demand and the economy could well slow in 2024.

U.S. Oil Industry: Following up on a chart we included in a *Comment* last week, we couldn't resist the version below, which shows that not only has U.S. oil production now risen to a record high, but it's done so while mighty Saudia Arabia and Russia have seen their output decline. As mentioned above, rising U.S. production and slowing economic growth around the world are key reasons for the recent decline in global oil prices.

U.S., Russian and Saudi oil production
Average barrels per day; Monthly; January 2000 to August 2023
— United States — Russia — Saudi Arabia

Data: Energy Information Administration. Chart: Axios Visuals

U.S. Economic Releases

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
ASIA-PACIFIC								
Japan	Money Stock M2	y/y	Nov	2.3%	2.4%		**	Equity and bond neutral
	Money Stock M3	y/y	Nov	1.7%	1.8%		**	Equity and bond neutral
	Machine tool orders	y/y	Nov P	-13.6%	-20.6%		**	Equity and bond neutral
China	CPI	y/y	Nov	-0.5%	-0.2%	-0.2%	***	Equity and bond neutral
	PPI	y/y	Nov	-3.0%	-2.6%	-2.8%	**	Equity and bond neutral
EUROPE								
UK	Rightmove House Prices	y/y	Dec	-1.10%	-1.30%		**	Equity and bond neutral
Switzerland	Domestic Sight Deposits CHF	w/w	8-Dec	463.2b	474.1b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	8-Dec	471.7b	464.1b		*	Equity and bond neutral
Russia	CPI	y/y	Nov	7.5%	6.7%	7.5%	***	Equity and bond neutral
	Core CPI	y/y	Nov	6.4%	5.5%	6.3%	***	Equity and bond neutral
AMERICAS								
Canada	Capacity Utilization	q/q	3Q	79.7%	81.4%	79.6%	**	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)	563	563	0	Down
3-mo T-bill yield (bps)	523	523	0	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 (%)	4.26	4.23	0.03	Flat
Euribor/OIS spread (bps)	395	397	-2	Up
Currencies	Direction			
Dollar	Flat			Down
Euro	Flat			Up
Yen	Down			Up
Pound	Up			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	$75.56	$75.84	-0.37%	
WTI	$70.90	$71.23	-0.46%	
Natural Gas	$2.38	$2.58	-7.71%	Supply Optimism and Mild Temperatures
Crack Spread	$22.55	$22.56	-0.06%	
12-mo strip crack	$23.18	$23.34	-0.66%	
Ethanol rack	$1.91	$1.92	-0.26%	
Metals				
Gold	$1,996.30	$2,004.67	-0.42%	
Silver	$22.95	$23.00	-0.21%	
Copper contract	$379.85	$383.05	-0.84%	
Grains				
Corn contract	$484.50	$485.50	-0.21%	
Wheat contract	$623.50	$631.75	-1.31%	
Soybeans contract	$1,310.50	$1,304.00	0.50%	
Shipping				
Baltic Dry Freight	2,483	2,495	-12	

Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout most of the country, with near-normal temperatures in Florida. The precipitation outlook calls for wetter-than-normal conditions in California to spread throughout the Great Plains and Southwest regions, with dry conditions in the Rocky Mountains and the Midwest.

Data Section

U.S. Equity Markets – (as of 12/8/2023 close)
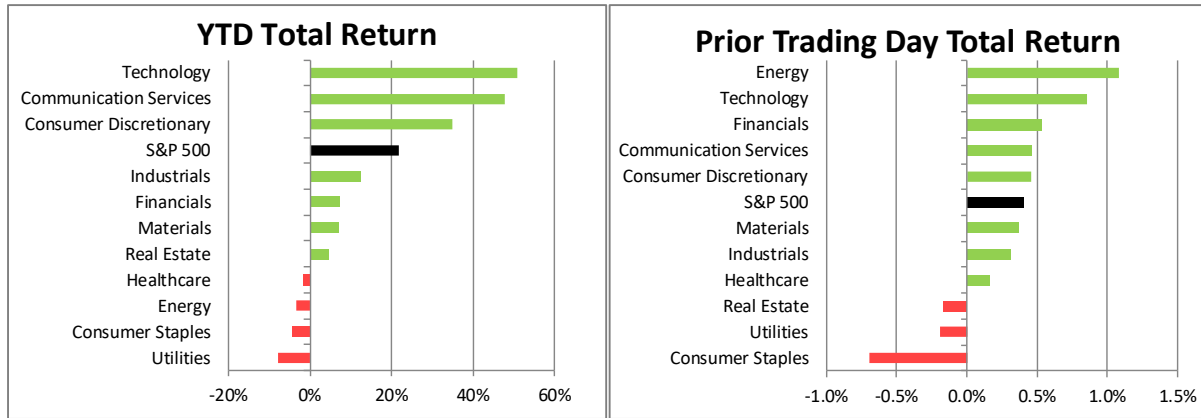
(Source: Bloomberg)

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.

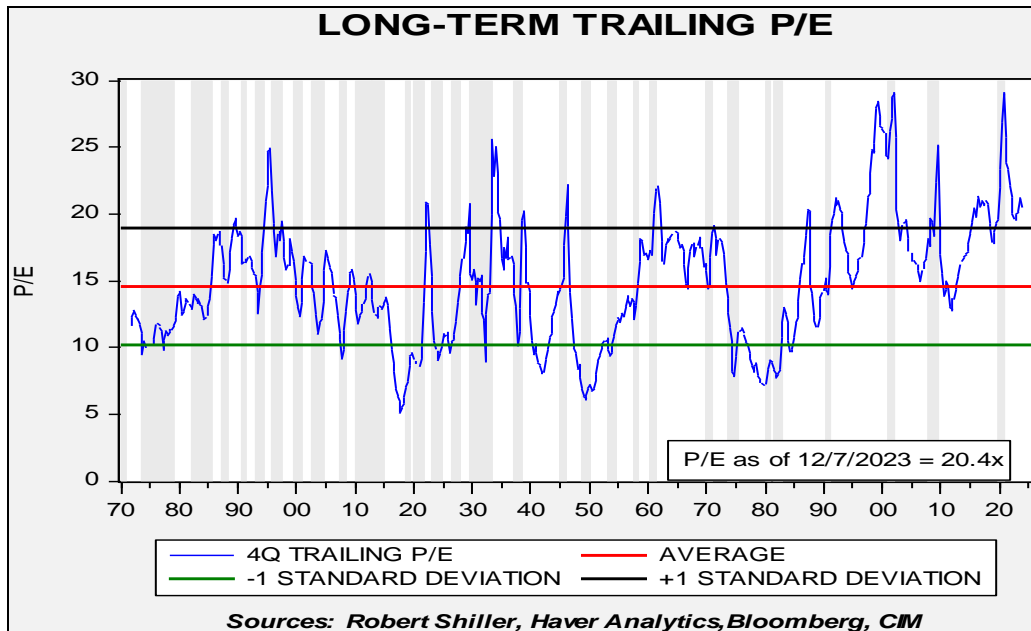**Asset Class Performance** – (as of 12/8/2023 close)
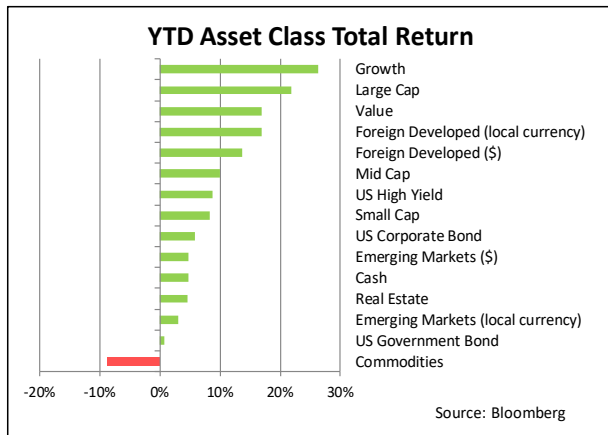
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

LONG-TERM TRAILING P/E

P/E as of 12/7/2023 = 20.4x

Legend: 4Q TRAILING P/E — AVERAGE — -1 STANDARD DEVIATION — +1 STANDARD DEVIATION

Sources: Robert Shiller, Haver Analytics, Bloomberg, CIM

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.