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 12, 2023—9:30 AM EST] Global equity markets are higher 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 up 0.8%. Chinese markets were higher, with the Shanghai Composite up 0.4% from its previous close and the Shenzhen Composite up 0.2%. 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*** **(12/11/2023) (with associated *Confluence of Ideas* podcast): "The 2024 Geopolitical Outlook"**
- *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 a disagreement at the big COP28 climate change conference over whether to call for an eventual phase-out of fossil fuels. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including an Israeli threat to widen its conflict with Hamas to include attacks on Hezbollah militants in Lebanon and new evidence of weaker white-collar labor demand in the U.S.

COP28 Climate Change Conference: At the ongoing United Nations climate change conference in Dubai, officials have released a controversial draft communique that drops any reference to phasing out the use of fossil fuels such as oil, natural gas, and coal. The draft statement has sparked outrage aimed at Saudi Arabia, host-nation UAE, and other major oil-producing countries, which are accused of using their influence to water down the document.

- Although several European and other countries are still working to amend the draft with required cuts in the use of fossil fuels, the document as currently written illustrates what we see as rising political pushback against onerous climate-change rules.
- Even if the communique is toughened before it is ultimately adopted by the conference, global fossil fuel companies don't seem at risk of being pushed out of business anytime soon. Indeed, since capital discipline and environmental restrictions to date have held down investment in new exploration and development in recent years, future supply is likely to fall short of demand, pushing up prices and profits.

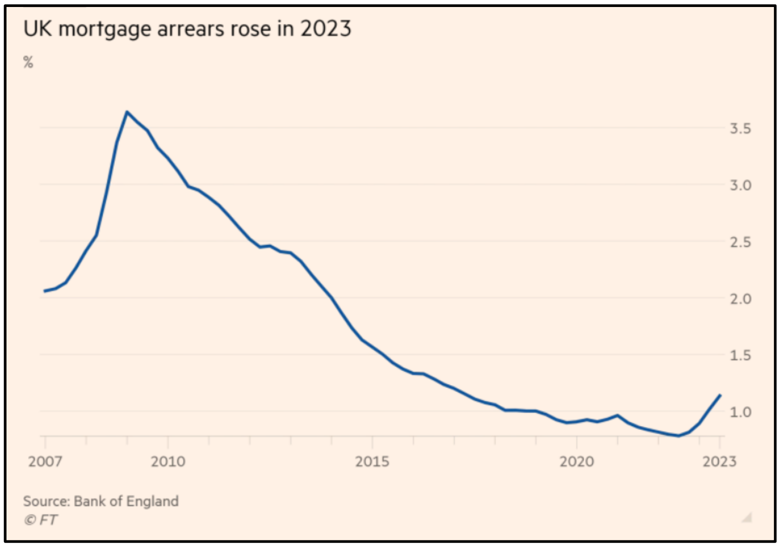
Israel-Hamas Conflict: As Iran-backed Hezbollah militants in southern Lebanon continue to fire rockets into Israel in response to Tel Aviv's offensive against Hamas in the Gaza Strip, the head of Israel's National Security Council has warned that Israel might also be forced to launch ground attacks against Hezbollah. Despite some signs that Hamas military forces in Gaza may be starting to disintegrate, an Israeli infantry offensive into Lebanon is just one way that the conflict could still spread.

Russia: Top opposition leader and anticorruption activist Alexey Navalny, who was jailed by the Kremlin and has been kept in a penal colony, has apparently been moved by the authorities to an unknown location. According to his spokeswoman and U.S. officials, he fell out of contact about a week ago after complaining of health problems, and Russian officials claim they don't know where he is.

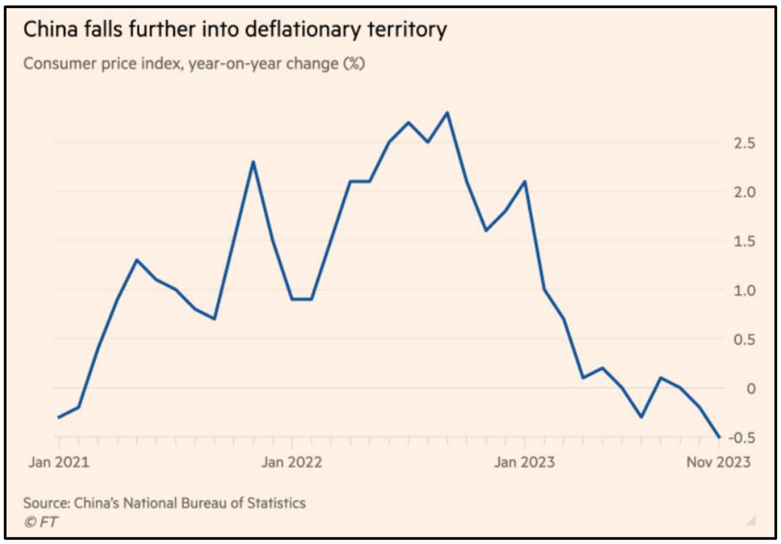
- The news comes just days after President Putin said he would run for another term in the March 2024 election.
- Putin probably still judges that it would be too politically risky for Navalny to be killed outright, as so many other Putin critics have been. At the very least, however, Putin would probably like to keep Navalny from making any public statements until after the election is concluded.

United Kingdom: The share of residential mortgages in arrears rose to a six-year high of 1.14% in the third quarter versus 1.02% in the second quarter. The rise appears to reflect both the impact of punishing inflation in the U.K. over the last couple of years and the impact of aggressive interest rate hikes by the Bank of England.

- The rise in mortgage delinquencies illustrates how homeowners in the U.K. and Europe have less access to U.S.-style fixed rate mortgages and are therefore more exposed to their central banks' rate-hiking campaigns.
- The fact that their homeowners are relatively less insulated from rate hikes compared to U.S. homeowners is probably a key reason why the U.K. and EU economies are currently growing so poorly and are at greater risk of recession or are already in recession.



China: The November consumer price index was down 0.5% from the same month one year earlier, worse than expectations that the CPI would decline 0.2% as it did in the year to October. The November producer price index was down an even sharper 3.0%. The figures are further evidence that the Chinese economy is continuing to losing steam in the face of problems such as weak consumer demand, high debt, poor demographics, disincentives from government policies, and de-coupling by foreign countries—all of which bode poorly for the global economy.



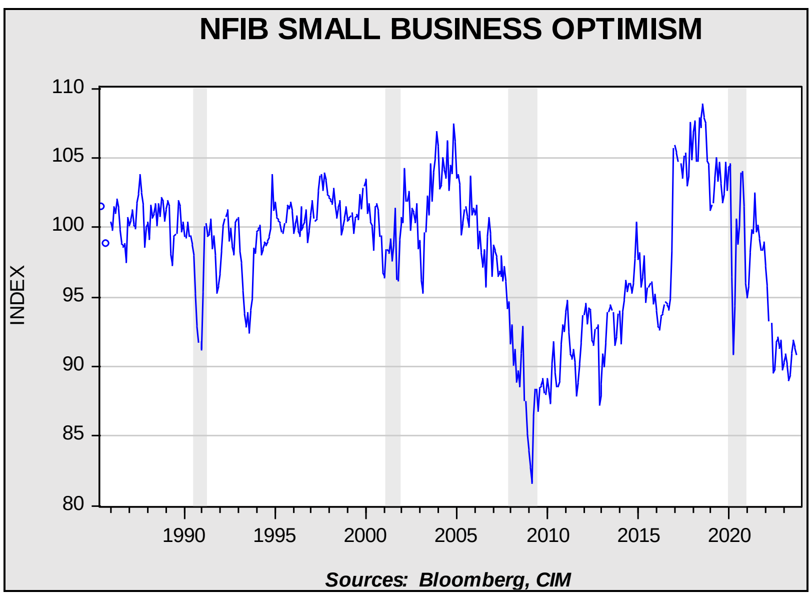
India: With parliamentary elections expected in spring 2024, officials in recent days have banned onion exports, restricted the use of sugar for ethanol production, and cut the size of wheat stocks that traders and retailers are allowed to hold. The moves are apparently aimed at ensuring robust domestic supplies and low prices to keep voters happy with Prime Minister Modi. However, the moves have also roiled some international commodity markets, such as the market for sugar.

U.S. Monetary Policy: The Federal Reserve opens its latest policy meeting today, 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. Economic Growth: Accounting and consulting giant Ernst & Young is reportedly laying off dozens of highly paid partners across all its businesses in response to a failed merger earlier in the year and weakening demand from companies as U.S. economic growth slows. The job cuts follow a previous big round in April and are seen as larger than the usual annual cull of relatively underperforming professionals. The layoffs provide further evidence of moderating economic activity in the U.S., which puts the economy at greater risk of recession in 2024.

U.S. Economic Releases

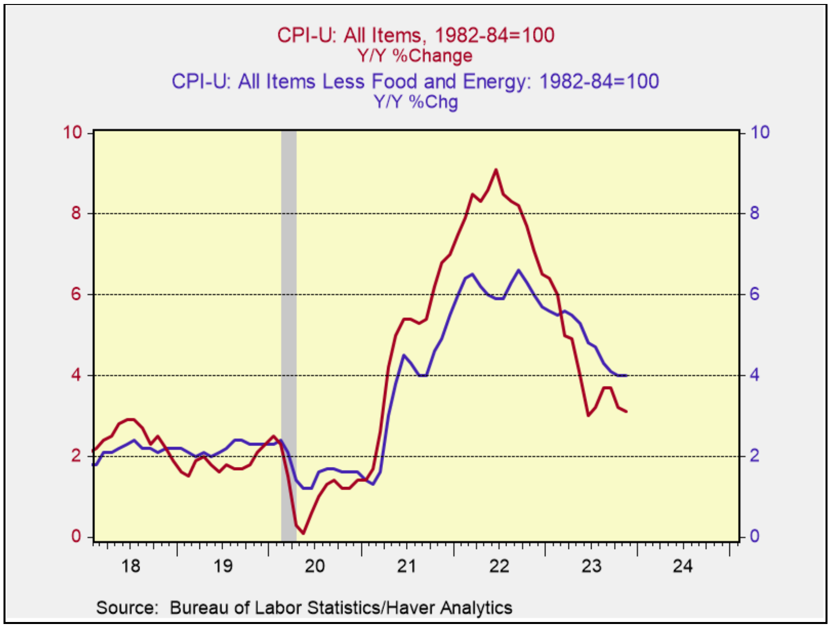
The outlook from small businesses has been relatively unchanged over the last three months despite ongoing concerns about inflation and job vacancies. The sentiment index tracked by the National Federation of Independent Business (NFIB) remained stable at 90.6 in November, a slight decline from 90.7 in October.



The low reading is a reflection of business owners' concerns over future economic conditions. A net negative 17% of owners reported higher nominal sales compared to last year. While the outlook for real sales (accounting for inflation) improved by 2 points from last month, it remains negative at 8%. The pessimism regarding sales suggests that owners are concerned about the state of the economy.

Consumer prices showed some signs of heating up in November but remain relatively tame. The consumer price index rose 0.1% from the prior month, according to the Bureau of Labor

Statistics. The reading was above the previous month's report of 0.0% but slightly below the consensus estimate of a 0.3% rise. Excluding volatile elements food and energy, the index rose 0.3% since October 2022, slightly above the previous month's rise of 0.2% and roughly in line with consensus expectations.



Although inflation remains well above the Federal Reserve's 2% target, it is still on track to fall within that range sometime in 2024. As shown in the chart above, the year-over-year change in the headline and core consumer price indexes (CPI) rose 3.1% and 4.0%, respectively. However, if inflation continues to rise at the same pace as the last six months, headline CPI could fall below 2% as early as May 2024, while core CPI could reach around 2.3%.

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
14:00	Monthly Budget Statement	m/m	Nov	-$317.0b	-$248.5b	**
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	PPI	y/y	Nov	0.3%	0.8%	0.9%	***	Equity bearish, bond bullish
Australia	Westpac Consumer Conf SA	m/m	Dec	2.7%	-2.6%		**	Equity and bond neutral
	Westpac Consumer Conf Index	m/m	Dec	82.1	79.9		**	Equity and bond neutral
	NAB Business Confidence	m/m	Nov	-9	-2	-3	**	Equity bearish, bond bullish
	NAB Business Conditions	m/m	Nov	9	13		**	Equity and bond neutral
India	Industrial Production	y/y	Oct	11.7%	5.8%	6.2%	***	Equity bullish, bond bearish
	CPI	y/y	Nov	5.55%	4.87%	5.78%	**	Equity and bond neutral
EUROPE								
Eurozone	ZEW Survey Expectations	m/m	Dec	23.0%	13.8		**	Equity bullish, bond bearish
Germany	ZEW Survey Expectations	m/m	Dec	12.8%	9.8	9.5%	**	Equity bullish, bond bearish
	ZEW Survey Current Situation	m/m	Dec	-77.1	-79.8	-76.0	**	Equity and bond neutral
UK	Claimant Count Rate	m/m	Nov	4.0%	4.0%		***	Equity and bond neutral
	Jobless Claims Change	m/m	Nov	16.0k	18.8k	8.9k	***	Equity bearish, bond bullish
	Average Weekly Earnings 3M/YoY	m/m	Oct	7.2%	7.9%	8.0%	**	Equity bearish, bond bullish
Russia	Trade Balance	m/m	Oct	9.4b	15.3b	15.7b	**	Equity and bond neutral
	Exports	m/m	Oct	33.0b	40.0b	40.4b	*	Equity and bond neutral
	Imports	m/m	Oct	23.5b	24.7b	24.5b	*	Equity and bond neutral
AMERICAS								
Mexico	Industrial Production	y/y	Oct	5.5%	3.9%	4.0%	***	Equity bullish, bond bearish
	Manufacturing Production	y/y	Oct	1.1%	0.8%	0.9%	*	Equity and bond neutral
Brazil	IBGE Inflation IPCA	y/y	Nov	4.68%	4.82%	4.70%	*	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)	521	521	0	Down
TED spread (bps)	LIBOR and the TED Spread have been discontinued.			
U.S. Sibor/OIS spread (bps)	539	538	1	Down
U.S. Libor/OIS spread (bps)	536	536	0	Down
10-yr T-note (%)	4.19	4.23	-0.04	Flat
Euribor/OIS spread (bps)	396	395	1	Up
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Up			Up
Pound	Up			Up
Franc	Up			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.

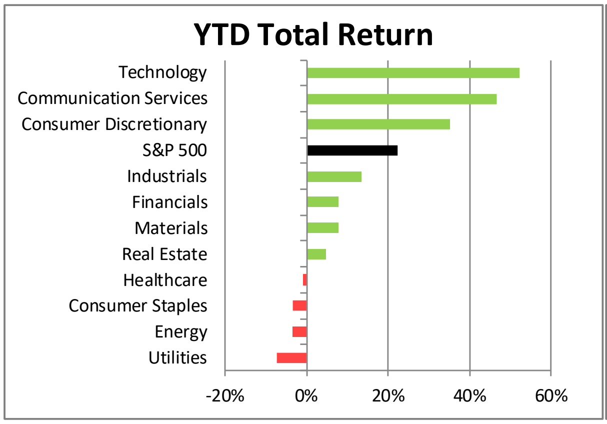
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$75.41	$76.03	-0.82%	
WTI	$70.76	$71.32	-0.79%	
Natural Gas	$2.44	$2.43	0.16%	
Crack Spread	$22.34	$22.48	-0.62%	
12-mo strip crack	$22.91	$23.14	-1.01%	
Ethanol rack	$1.90	$1.91	-0.49%	
Metals				
Gold	$1,988.26	$1,981.95	0.32%	
Silver	$23.01	$22.82	0.83%	
Copper contract	$380.15	$378.05	0.56%	
Grains				
Corn contract	$483.75	$481.50	0.47%	
Wheat contract	$613.25	$609.50	0.62%	
Soybeans contract	$1,354.50	$1,353.25	0.09%	
Shipping				
Baltic Dry Freight	2,509	2,483	26	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.0		
Gasoline (mb)		2.0		
Distillates (mb)		1.0		
Refinery run rates (%)		0.5%		
Natural gas (bcf)		-107		

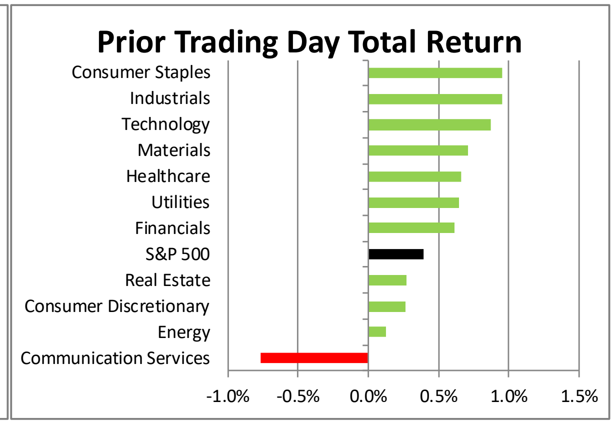
Weather

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 the Southeast. The precipitation outlook calls for wetter-than-normal conditions in California to spread throughout the Great Plains and Southwest regions, with dry conditions expected for the rest of the country.

Data Section

U.S. Equity Markets – (as of 12/11/2023 close)

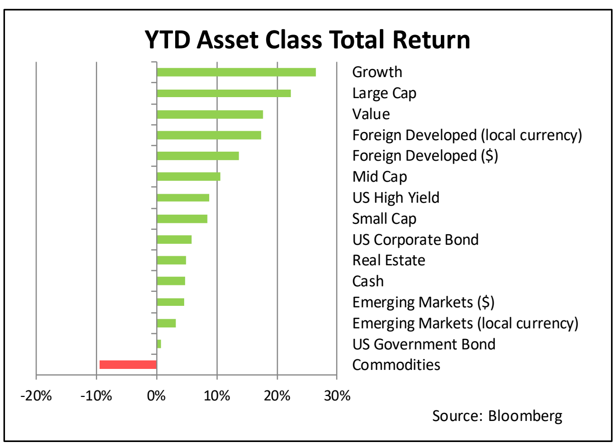




(Source: Bloomberg)

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 12/11/2023 close)

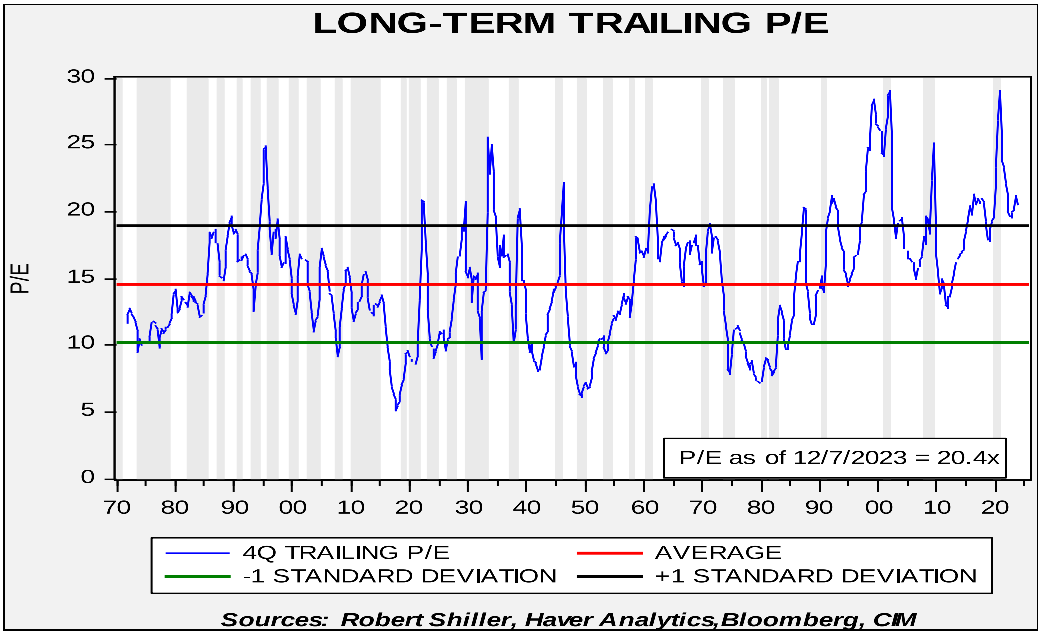


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.