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 13, 2023—9:30 AM EST] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.7%. Chinese markets were lower, with the Shanghai and Shenzhen Composites down 1.2% from the previous close. 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 some notes on a major Communist Party economic conference in China. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including some new details on Argentina's economic reforms under newly inaugurated libertarian President Milei and a preview of the Federal Reserve's likely action as it wraps up its latest policy meeting today.

China: Wrapping up their annual economic work conference yesterday, Communist Party officials said they would launch additional growth-enhancing initiatives and work to ensure economic stability. Echoing a statement from the Politburo on Friday, the officials vowed to focus on "establishing the new before abolishing the old," which is widely interpreted as easing up on the recent rules limiting property developers' debt.

- The summary statement is pretty opaque, but most observers seem to be reading it as a sign that Chinese economic policy will become only modestly more stimulative in 2024 as General Secretary Xi continues to resist the Party's traditional policy of debt-fueled investment.
- The problem is that China's various structural economic headwinds are probably too strong for modest stimulus to make much of a difference. If policy remains too weak to spur growth, global economic growth and financial markets could struggle in 2024.

European Union-China: Trade chief Valdis Dombrovskis yesterday announced that the European Commission in January will propose a set of rules designed to de-risk the EU's trade and investment ties with potential adversaries, such as China. The rules will include restrictions on outbound investment to ensure that key technologies and know-how aren't available to an adversary's defense and intelligence suppliers. They will also call for screening inbound direct investment to prevent critical assets from being bought by hostile or monopolistic forces.

- While the EU remains behind the U.S. in limiting trade and investment ties with the China/Russia bloc, the rules coming in January will help get it on the same page with Washington.
- The EU's coming rules are another example of how China's rising power and aggressive geopolitical moves are fracturing the world into relatively separate blocs and imposing significant limits on cross-bloc trade, investment, technology, and travel flows.
- As we have argued many times before, the resulting de-globalized supply chains will be relatively less efficient, leading to higher average inflation and interest rates.

Japan: Prime Minister Kishida, who had already been dealing with abysmally low polling support, now appears likely to be implicated in a fundraising scandal engulfing the long-ruling Liberal Democratic Party. The scandal involves unreported political fundraising by several government and party officials, including some in Kishida's parliamentary faction. A key risk is that increased political turmoil could undermine the Japanese stock market's recent big uptrend.

Australia: To combat sky-high home prices, the government has unveiled new measures aimed at cutting immigration by 14% from what otherwise would be expected over the coming four years. The move comes after the country of 26 million people absorbed about 510,000 net new immigrants in the latest fiscal year. Despite global concerns about slowing birth rates, declining populations, and rising average ages, anti-immigration voters in countries ranging from Australia and the U.K. to the U.S. continue to drive policy toward less immigration rather than more.

Israel-Hamas Conflict: Illustrating another way the Israeli-Hamas fighting could broaden, Iranian-backed Houthi rebels in Yemen, who support Hamas and Palestinians in the Gaza strip, have continued to launch retaliatory missile and drone strikes at ships in the Red Sea. At least one missile struck a Norwegian-flagged tanker carrying palm oil to Italy, setting it ablaze. When a French frigate positioned herself between the Yemeni coastline and the stricken tanker to protect it, the frigate was forced to shoot down two incoming drones.

- Meanwhile, the Israel Defense Forces have reportedly begun pumping water from the Mediterranean Sea to flood Hamas's extensive underground tunnel network under Gaza, hoping to flush out the group's fighters and destroy any military equipment there.
- One key risk for Prime Minister Netanyahu is that the flooding could kill Israeli hostages if they are being held in the tunnels.

Argentina: Just days after radical libertarian Javier Milei was inaugurated as president, his economy minister, Luis Caputo, yesterday outlined key economic initiatives aimed at bringing down inflation, cutting the budget deficit, and averting a debt crisis. According to Caputo, the government will devalue the peso by about half, slash government spending, and reduce energy and transportation subsidies.

- Now that the Milei government seems to be putting some of his policies into place, investors have been driving Argentine stocks higher.
- The Global X MSCI Argentina ETF (ARGT, 51.31) has appreciated approximately 23.5% since Milei was elected in mid-November. It is currently posting a total return of 52.0% year to date.

COP28 Climate Change Conference: As the annual United Nations climate change conference came to an end in Dubai today, the delegates issued a compromise statement that calls for "transitioning away from fossil fuels in energy systems, in a just, orderly, and equitable manner." That's tougher than the draft statement we discussed in our *Comment* yesterday, which, under pressure from major oil producers, omitted any reference to phasing out fossil fuels such as oil, natural gas, and coal. Nevertheless, the politicking on the issue at the conference and in national capitols recently still seems to reflect growing pushback to climate change rules.

U.S. Monetary Policy: The Fed today wraps up its latest policy meeting, with its decision due at 2:00 pm ET. The policymakers are widely expected to keep their benchmark fed funds interest rate at the current range of 5.25% to 5.50%. The question is what they'll say about future policy moves. Many investors are hoping for a signal of near-term rate cuts, but as we've stated before, we think officials remain focused on rebuilding their inflation-fighting credentials and are more likely to repeat their "higher for longer" mantra.

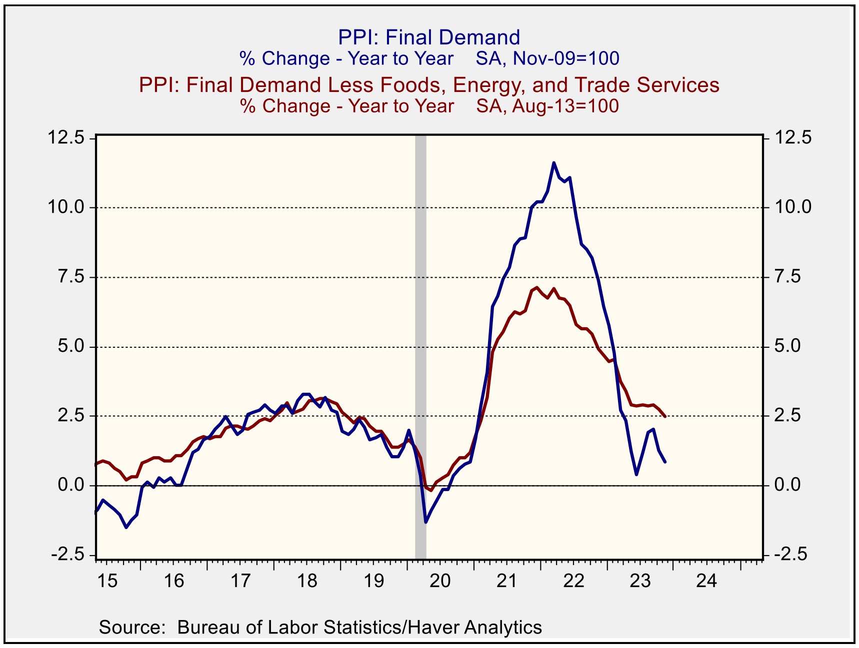
U.S. Financial Regulation: Yesterday, the House Committee on the Chinese Communist Party released a report suggesting the Fed should stress test U.S. banks' ability to "withstand a potential sudden loss of market access to China." The report said the Fed should also assess how U.S. financial markets might be affected by potential sanctions against Chinese firms in the event of a conflict between the U.S. and China. As we have written before, the growing U.S.-China geopolitical rivalry will likely lead to stronger state intervention in each country's economy.

U.S. Economic Releases

Declining borrowing costs continue to boost demand for residential loans. According to an index tracked by the Mortgage Bankers Association, mortgage applications rose 7.4% in the week ending December 8. The sharp increase was related to the drop in the average 30-year fixed-rate mortgage, which has fallen nearly 80 basis points from its peak in October to 7.07%.

As a result, the MBA tracker for refinancing jumped 19.4% from the prior week, while the purchase tracker rose 3.5%.

Producer prices held steady, indicating supply price pressures remain under control. The Bureau of Labor Statistics reported that final demand PPI was unchanged in November, meeting market expectations. Excluding volatile food, energy, and trade, PPI also remained flat compared to the October report.



The chart above depicts the year-over-year change in the Producer Price Index (PPI), showing both the headline and core rates. The overall PPI index increased by 1.0% compared to the previous year, while core PPI, which excludes volatile food and energy prices, experienced a stronger 2.5% growth. This suggests that supply-side pressures, although present, are unlikely to significantly impact consumer inflation in the near future.

The table below lists the economic releases and/or Fed events scheduled for the rest of the day.

Economic Releases						
	No economic releases for the rest of today					
EST	Indicator			Expected	Prior	Rating
14:00	FOMC Rate Decision (Lower Bound)	w/w	26-Jan	5.25%	5.25%	***
14:00	FOMC Rate Decision (Upper Bound)	w/w	26-Jan	5.50%	5.50%	***
14:00	Interest on Reserve Balances Rate	w/w	27-Jan	5.40%	5.40%	**
Federal Reserve						
	No Fed speakers or events for the rest of today					
EST	Speaker or Event	District or Position				
14:30	Jerome Powell Holds Press Conference Following FOMC meeting	Chair of the Board of Governors				

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	Tankan Large Manufacturing Index	q/q	4Q	12	9	10	***	Equity and bond neutral
	Tankan Large Non-Manufacturing Index	q/q	4Q	30	27	27	***	Equity and bond neutral
	Tankan Large Manufacturing Outlook	q/q	4Q	8	10	9	***	Equity and bond neutral
	Tankan Large Non-Manufacturing Outlook	q/q	4Q	24	21	25	***	Equity and bond neutral
	Tankan Large All-Industry Capex	q/q	4Q	13.5%	13.6%	12.7%	***	Equity bullish, bond bearish
New Zealand	REINZ House Sales	y/y	Nov	12.2%	8.0%		**	Equity bullish, bond bearish
	Food Prices	m/m	Nov	-0.2%	-0.9%		***	Equity and bond neutral
	BoP Current Account Balance NZD	q/q	3Q	-11.465b	-4.208b	-4.652b	**	Equity and bond neutral
South Korea	Import Price Index	y/y	Nov	-8.5%	-10.2%	-9.9%	*	Equity and bond neutral
	Export Price Index	y/y	Nov	-7.2%	-9.5%	-9.3%	*	Equity and bond neutral
	Unemployment Rate	m/m	Nov	2.8%	2.5%	2.6%	**	Equity and bond neutral
China	Aggregate Financing CNY	m/m	Nov	2450.0b	1850.0b	1845.2b	**	Equity and bond neutral
	Money Supply M2	y/y	Nov	10.0%	10.3%	10.0%	***	Equity and bond neutral
	Money Supply M1	y/y	Nov	1.3%	1.9%	2.0%	*	Equity and bond neutral
	Money Supply M0	y/y	Nov	10.4%	10.2%		*	Equity and bond neutral
	New Yuan Loans	m/m	Nov	1090.0b	738.4b	1300.0b	**	Equity and bond neutral
EUROPE								
Eurozone	Industrial Production WDA	y/y	Oct	-6.6%	-6.9%	-6.8%	**	Equity and bond neutral
UK	Industrial Production	y/y	Oct	0.4%	1.5%	1.1%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	Oct	0.8%	3.0%	1.9%	**	Equity bearish, bond bullish
	Visible Trade Balance GBP	m/m	Oct	-£17032m	-£14288m	-£14350m	**	Equity and bond neutral
	Trade Balance GBP	m/m	Oct	-£4480m	-£1574m	-£2150m	**	Equity and bond neutral
AMERICAS								
Brazil	IBGE Services Volume	y/y	Oct	-0.4%	-1.2%	-1.1%	*	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	563	1	Down
3-mo T-bill yield (bps)	524	523	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	536	0	Down
10-yr T-note (%)	4.18	4.20	-0.02	Flat
Euribor/OIS spread (bps)	393	396	-3	Up
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Flat			Up
Yen	Down			Up
Pound	Down			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.

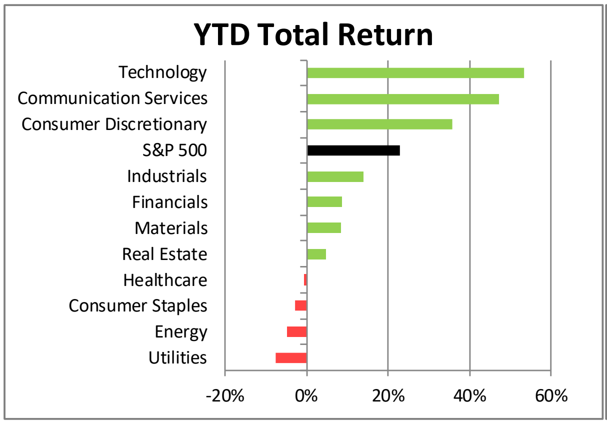
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$73.52	$73.24	0.38%	
WTI	$68.90	$68.61	0.42%	
Natural Gas	$2.31	$2.31	0.00%	
Crack Spread	$22.26	$22.22	0.18%	
12-mo strip crack	$22.86	$22.81	0.20%	
Ethanol rack	$1.89	$1.89	-0.14%	
Metals				
Gold	$1,981.91	$1,979.54	0.12%	
Silver	$22.71	$22.77	-0.28%	
Copper contract	$377.00	$378.75	-0.46%	
Grains				
Corn contract	$482.25	$485.25	-0.62%	
Wheat contract	$615.50	$625.50	-1.60%	
Soybeans contract	$1,334.50	$1,342.75	-0.61%	
Shipping				
Baltic Dry Freight	2,551	2,509	42	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.8		
Gasoline (mb)		1.9		
Distillates (mb)		-0.2		
Refinery run rates (%)		0.6%		
Natural gas (bcf)		-55		

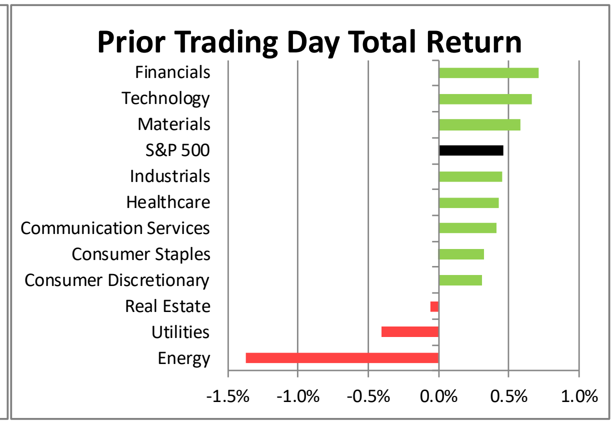
Weather

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 the Pacific to move eastward into the Midwest, with dry conditions in the Mid-Atlantic and New England regions.

Data Section

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

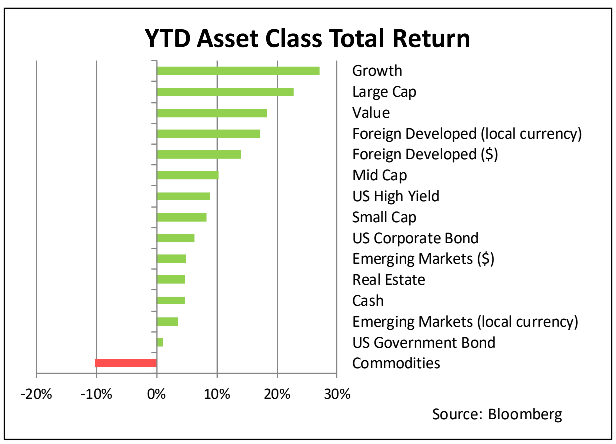




(Source: Bloomberg)

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 12/12/2023 close)

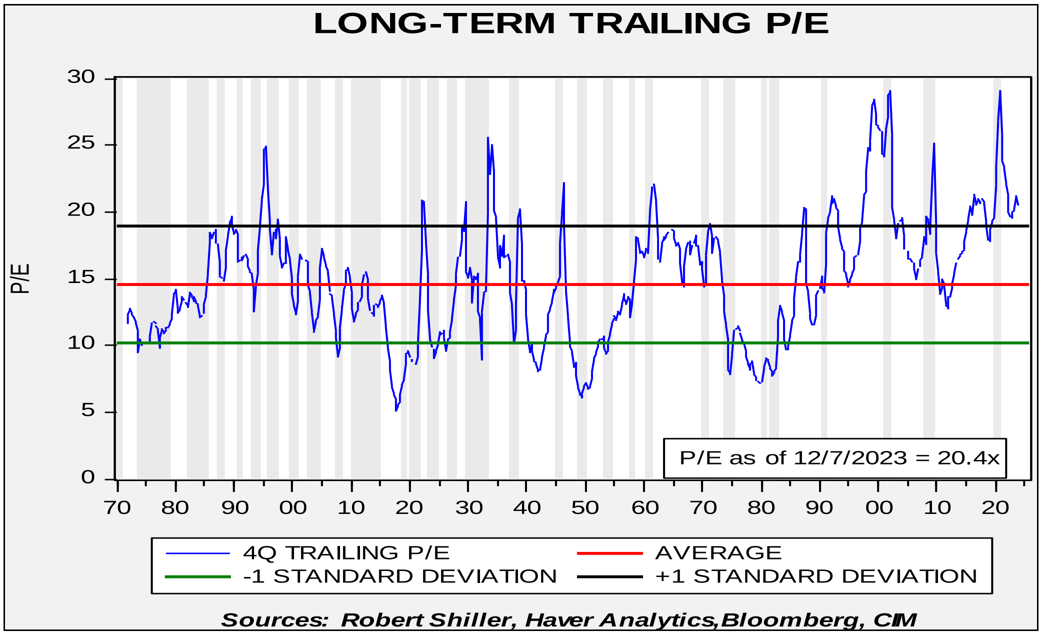


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.