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 14, 2023—9:30 AM EST] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.8% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.4%. Chinese markets were lower, with the Shanghai Composite down 0.3% from its previous close and the Shenzhen Composite down 0.6%. U.S. equity index futures are signaling a higher open.

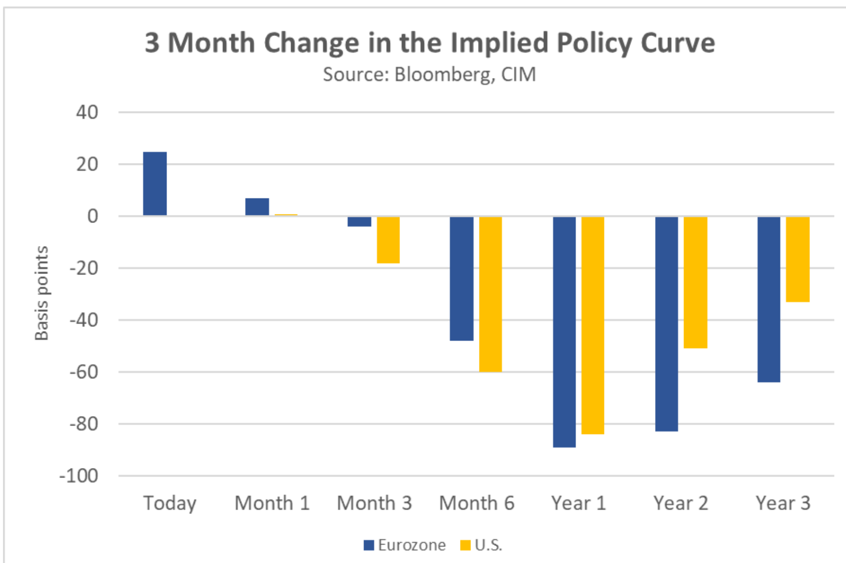
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (12/11/2023) (with associated *Confluence of Ideas* podcast): "The 2024 Geopolitical Outlook"
- ***Weekly Energy Update* (12/14/2023): Oil prices have been under pressure as geopolitical risk premium evaporates; COP28 ended with a deal to "shift" from fossil fuels, softer language than the "phase out" comment that was rejected by oil producers. N.B. The *Weekly Energy Update* will go on indefinite hiatus following this report.**
- *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 surge as investors shake off recent jitters, while Giannis Antetokounmpo lit up the court with a 60-point performance. Today's *Comment* navigates the key questions on the minds of many: Will central banks pivot soon? Are investors finally ready for risk? And how is the world's shift away from globalization shaping government priorities? As always, our comprehensive report encompasses the latest domestic and international data releases.

Higher for How Long? While the market exuberantly celebrated the end of the hiking cycle and a potential pivot, we are increasingly worried that some investors may have gotten ahead of their skis.

- Despite maintaining its hold on the target federal funds rate at 5.25%-5.50%, the Federal Open Market Committee (FOMC) issued dovish whispers, suggesting a potential pivot by the end of 2024, with the range possibly falling to 4.50%-4.75%. Fed Chair Jerome Powell's acknowledgment of committee discussions on the timing of rate cuts intensified chatter about a shift, further fueling market speculation. Ten-year yields plunged nearly 20 basis points, while the S&P 500 soared 1.4% on the day as investors strategically repositioned their portfolios for a potential shift toward lower rates.
- The European Central Bank hinted that its aggressive rate hikes might be nearing an end, but President Christine Lagarde underscored the bank's unwavering commitment to bringing inflation back to target. Despite keeping rates steady, she warned of future tightening if fiscal measures remain uncontrolled, highlighting concerns about domestic price pressures. Lagarde's veiled threat underscores the precarious balance the ECB faces—while its hawkish stance aims to tame inflation, it risks exacerbating the Eurozone's fiscal tensions, particularly as member states grapple with returning to pre-pandemic deficit rules.



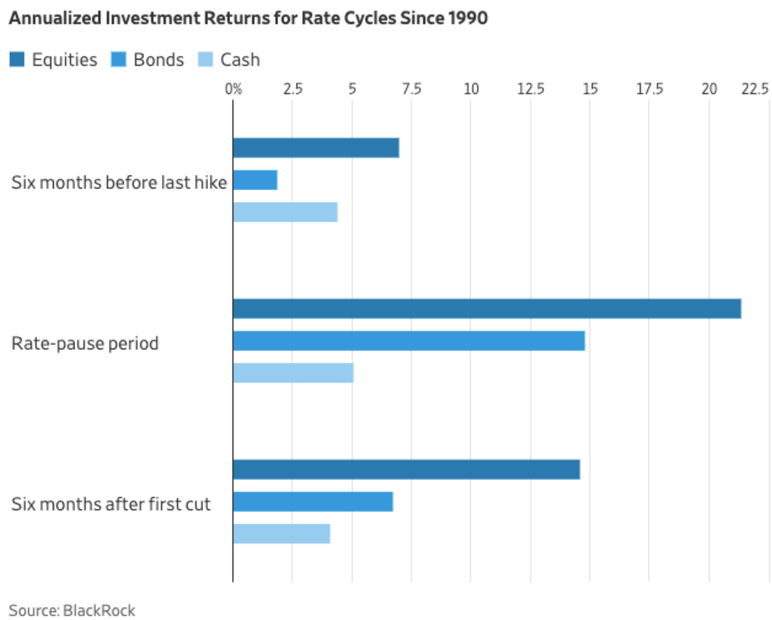
- Although policy easing may be inching closer, the pace and magnitude are unlikely to meet the aggressive expectations of many investors. The CME Fedwatch Tool predicts a potential cut of 150 bps or more in March 2024, while swap rates hint at even deeper cuts from the ECB. However, such optimism may be misplaced, ignoring lingering inflation concerns and underestimating policymakers' commitment to price stability. A significant economic downturn in the U.S., necessitated by persistent regional inflation, would be the only scenario justifying such aggressive easing. Should our assessment hold, the current market euphoria could be short-lived as policymakers may decide to rein in expectations with hawkish rhetoric.

Where Will It Go? While money market funds were all the rage during the historic rate hikes of the last two years, a potential reversal could see investors fleeing for greener pastures.

- Higher rates gave life to money market funds and savings accounts, offering investors a viable alternative to riskier assets with their suddenly competitive returns. The Crane 100

Index shows that the seven-day annualized yield currently sits at 5.19%, which surpasses the returns for a third of the S&P 500 sectors. Additionally, the funds have been a magnet for capital as they drew in more than $651 billion worth of assets in the second quarter compared to the year prior. Assuming that rates fall next year, this trend is likely to see a shift in favor of riskier assets.

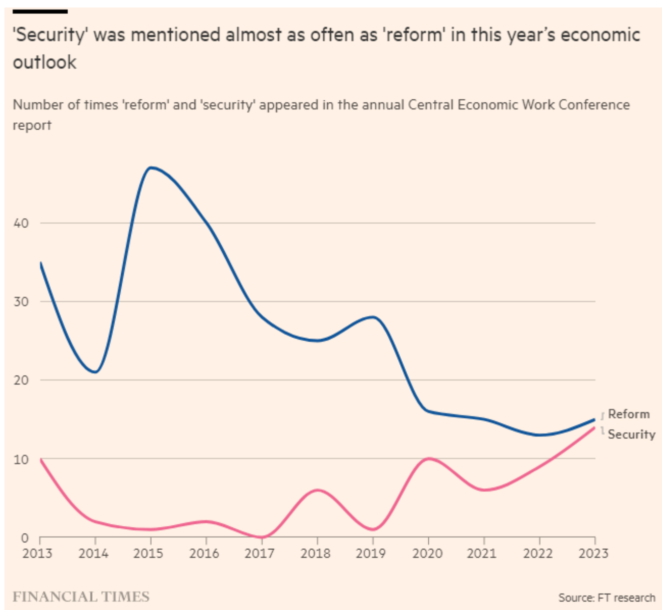
- Large cap tech stocks took investors on a wild ride in 2023, driven by FOMO surrounding AI and communication giants. But with their sky-high valuations, the "Magnificent 7" may have already priced in much of their future growth potential. This presents a golden opportunity for investors seeking diversification and hidden gems. Small and mid-cap stocks, boasting lower P/E ratios, have already attracted early birds. Since money market funds reached their peak in November, the S&P 400 and 600 indexes have skyrocketed 13.6% and 16.1%, respectively, compared to the S&P 500's 11.1% gain.



- Although the shift away from large caps might be tempting, it hinges on the U.S. maintaining its resilience, especially with inflation potentially lurking. However, worrying signs are emerging. Atlanta GDP Nowcast points to a significant slowdown in economic output compared to the previous quarter. Simultaneously, ADP data suggests small businesses, the engine of job creation, have cut back on hiring for three months straight. Adding to concerns is the looming "debt maturity wall" next year, where a massive chunk of loans come due under much tighter financial conditions than when they were issued. As a result, investors should still exercise caution and due diligence before preemptively looking to price in rate cuts.

A Smaller Peace Dividend? As the tide of globalization recedes, governments are increasingly turning their attention inward, prioritizing domestic security concerns over international cooperation.

- Western support for Ukraine faces mounting hurdles as domestic concerns and internal fissures within the bloc complicate additional aid. In the U.S., Senate wrangling centers on attaching border security measures to Ukraine funding, while within the EU, Hungary's Viktor Orban threatens to block further assistance due to concerns about alleged discrimination against Hungarians in Kyiv and his own desire for unfrozen EU funds. The persistent bickering among the countries adds pressure on Ukraine to either win decisively or be forced to compromise with Russia.
- Tensions with the West have prompted both Russia and China to flex their muscles. A recent breakdown of China's outlook for the country showed that Chinese leaders have placed more emphasis on "security" and less on "reforms" over the last three years. Meanwhile, Putin's renewed calls for "denazifying and demilitarizing" Ukraine underscore his desire to neutralize a Western ally on his doorstep. These developments suggest that neither Moscow nor Beijing is inclined to simply accept the pre-existing order dictated by the West. Consequently, their cooperation, driven by a shared desire to level the playing field with the U.S., is likely to endure for the foreseeable future.

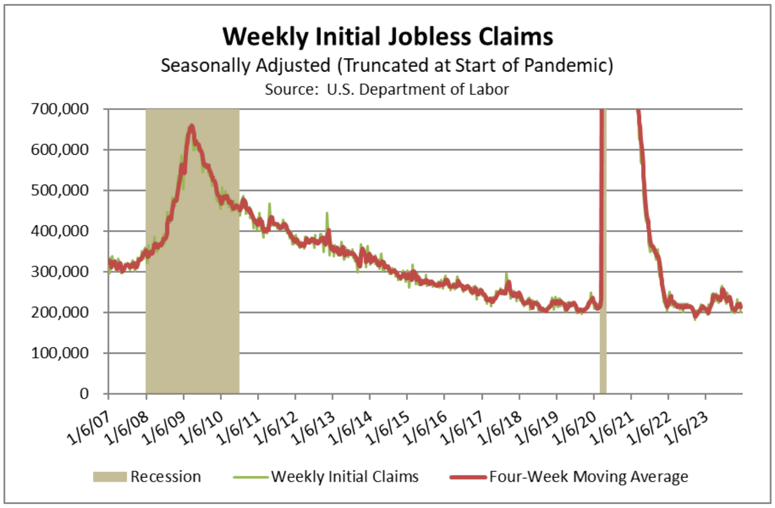


- The potential unraveling of globalization is unlikely to be smooth or swift as countries aim to mitigate sudden shocks that could erode investor and consumer confidence. China's recent re-engagement with the U.S., despite ongoing tensions, exemplifies this cautious approach to managing risk. Further reinforcing this view was Thursday's report that the top defense leaders from both countries met for the first time following an ongoing row over spying.

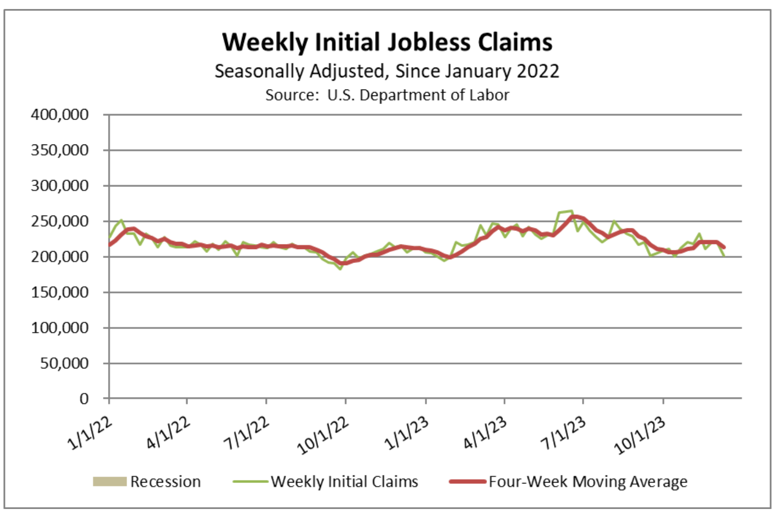
In Other News: The Senate passed a defense policy bill without much pushback. Passage of the bill highlights the ways in which the government is on the same page regarding maintaining defense spending.

U.S. Economic Releases

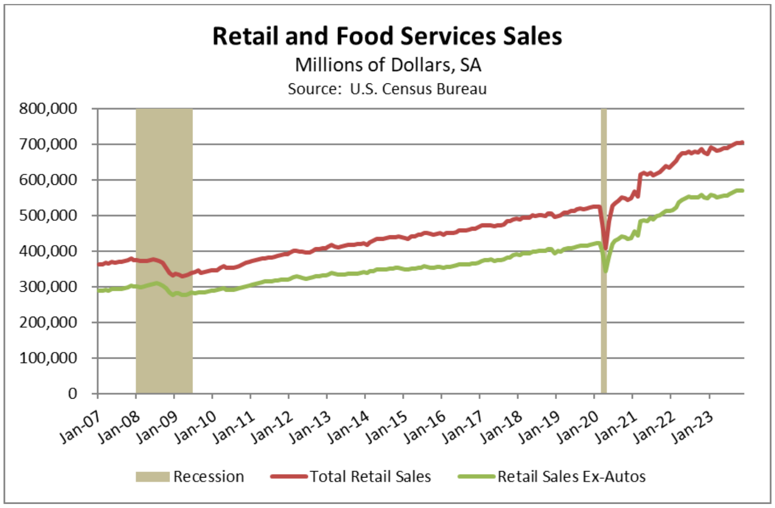
In the week ended December 9, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 202,000, well below both the expected reading of 220,000 and the prior week's revised reading of 221,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to 213,250. Meanwhile, in the week ended December 2, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to 1.876 million, not quite as bad as the anticipated 1.879 million but still up from the previous week's revised reading of 1.856 million. The chart below shows how initial jobless claims have fluctuated since just before the Great Financial Crisis (GFC). The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



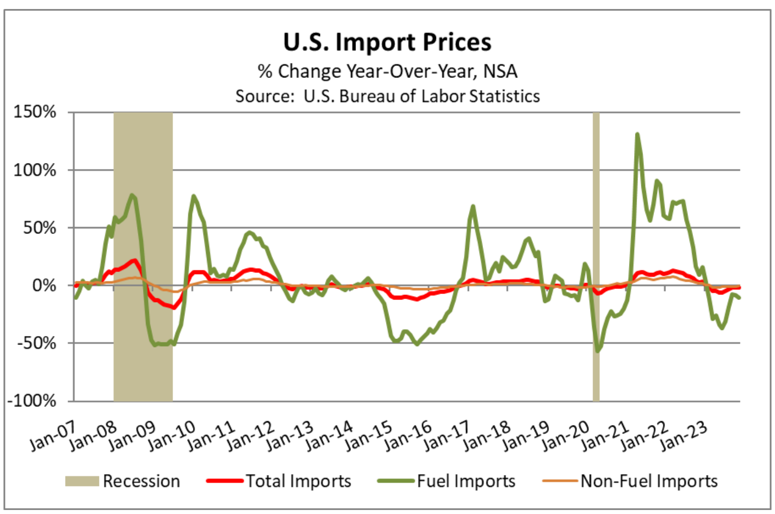
To provide more detail on recent trends, the chart below shows how initial jobless claims have changed since the beginning of 2022.



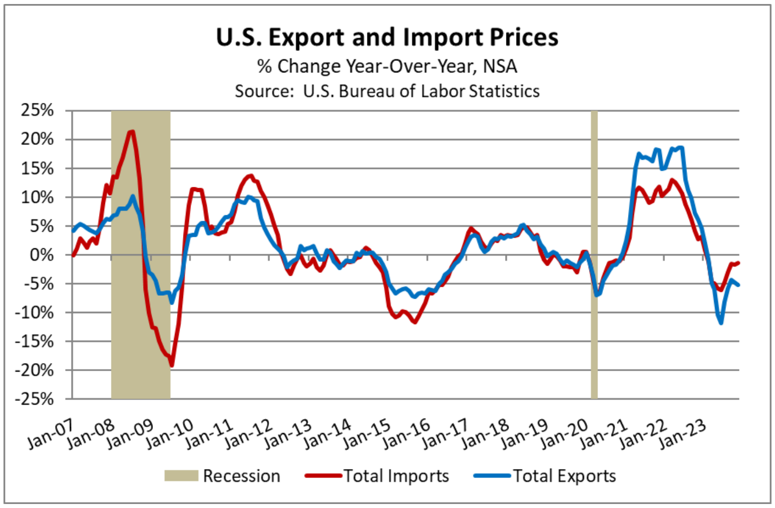
Separately, November ***retail sales*** rose by a seasonally adjusted 0.3%, much better than the expected decline of 0.1% and enough to offset October's revised decline of 0.2%. Of course, overall retail sales are often driven by the volatile auto and auto parts sector, which makes up almost one-fifth of the total. November ***retail sales excluding autos and auto parts*** were up 0.2%, beating expectations of a 0.1% decline and improving from October's flat performance. Overall retail sales in November were up 4.2% from the same month one year earlier, while sales excluding autos and auto parts were up 3.9%. The chart below shows how retail sales have changed since just before the GFC.



Finally, November ***import prices*** were down 0.4% from the previous month, not quite as good as the expected fall of 0.8% and the revised October decline of 0.6%. Of course, import prices are often driven by volatility in the petroleum fuels category, and that was the case again last month. November ***import prices excluding fuels*** were up 0.2% versus expectations that they would match the previous month's decline of 0.2%. Overall import prices in November were down 1.4% year-over-year, while import prices excluding fuels were down 0.4%. The chart below shows the year-over-year change in import prices since just before the GFC.



According to the report, ***export prices*** in November were down 5.2% from one year earlier, in large part because of the key agriculture category. Comparing the annual change in export prices versus import prices provides a sense of the U.S. "terms of trade," or the relative advantage or disadvantage the country is facing because of trends in international trade prices. The chart below compares the year-over-year change in U.S. export and import prices since just before the GFC.



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	Business Inventories	m/m	Oct	-0.1%	0.4%	*
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	Core Machine Orders	y/y	Oct	-2.2%	-2.2%	-5.6%	**	Equity bullish, bond bearish
	Foreign Buying Japan Stocks	w/w	8-Dec	-¥990.6b	-¥358.3b	-¥357.2b	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	8-Dec	-¥500.8b	-¥560.2b	-¥558.3b	*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	8-Dec	-¥1080.0b	¥64.5b	¥46.3b	*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	8-Dec	¥621.6b	-¥710.4b	-¥717.5b	*	Equity and bond neutral
	Industrial Production	y/y	Oct F	1.1%	0.9%		***	Equity and bond neutral
	Capacity Utilization	m/m	Oct	1.5%	0.4%		**	Equity and bond neutral
Australia	Employment Change	m/m	Nov	61.5k	55.0k	42.7k	***	Equity bullish, bond bearish
	Unemployment Rate	m/m	Nov	3.9%	3.7%	3.8%	***	Equity and bond neutral
	Participation Rate	m/m	Nov	67.2%	67.0%	66.9%	**	Equity bullish, bond bearish
New Zealand	GDP	y/y	3Q	-0.6%	1.8%	1.5%	**	Equity bearish, bond bullish
India	Wholesale Prices	y/y	Nov	0.26%	-0.52%	0.00%	**	Equity and bond neutral
EUROPE								
UK	RICS House Price Balance	m/m	Nov	-43.0%	-63%	-61%	**	Equity bullish, bond bearish
Switzerland	Producer & Import Prices	y/y	Nov	-1.3%	-0.9%		**	Equity and bond neutral
Russia	GDP	y/y	3Q P	5.5%	5.5%	5.5%	**	Equity and bond neutral
	Gold and Forex Reserves	m/m	8-Dec	$588.3b	$592.9b		***	Equity and bond neutral
AMERICAS								
Mexico	International Reserves Weekly	w/w	8-Dec	$209287m	$207120m		*	Equity and bond neutral
Brazil	Retail Sales	y/y	Oct	0.2%	3.3%	1.8%	***	Equity bearish, bond bullish

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)	565	564	1	Down
3-mo T-bill yield (bps)	521	523	-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)	534	535	-1	Down
10-yr T-note (%)	3.94	4.02	-0.08	Flat
Euribor/OIS spread (bps)	393	393	0	Up
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Up			Up
Pound	Up			Up
Franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
FOMC Rate Decision (Lower Bound)	5.250%	5.250%	5.250%	On Forecast
FOMC Rate Decision (Upper Bound)	5.500%	5.500%	5.500%	On Forecast
FOMC Rate on Reserve Balances	5.400%	5.400%	5.400%	On Forecast
ECB Main Refinancing Rate	4.500%	4.500%	4.500%	On Forecast
ECB Marginal Lending Facility	4.750%	4.750%	4.750%	On Forecast
ECB Deposit Facility Rate	4.000%	4.000%	4.000%	On Forecast
Bank of England Bank Rate	5.250%	5.250%	5.250%	On Forecast
Swiss National Bank Policy Rate	1.750%	1.750%	1.750%	On Forecast
Brazil Selic Rate	11.750%	12.250%	11.750%	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.

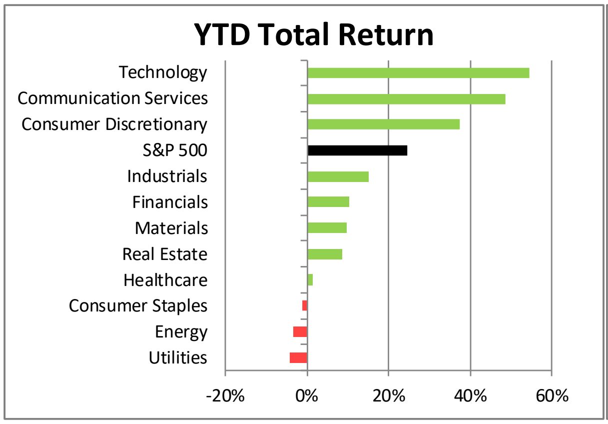
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$75.84	$74.26	2.13%	
WTI	$70.96	$69.47	2.14%	
Natural Gas	$2.36	$2.34	1.11%	
Crack Spread	$23.28	$23.15	0.58%	
12-mo strip crack	$23.66	$23.48	0.77%	
Ethanol rack	$1.86	$1.87	-0.45%	
Metals				
Gold	$2,038.30	$2,027.74	0.52%	
Silver	$24.16	$23.82	1.44%	
Copper contract	$389.45	$378.75	2.83%	
Grains				
Corn contract	$483.50	$479.50	0.83%	
Wheat contract	$614.25	$605.25	1.49%	
Soybeans contract	$1,329.50	$1,326.25	0.25%	
Shipping				
Baltic Dry Freight	2,438	2,551	-113	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-4.3	-1.8	-2.5	
Gasoline (mb)	0.4	1.9	-1.5	
Distillates (mb)	1.5	-0.2	1.7	
Refinery run rates (%)	-0.3%	0.6%	-0.9%	
Natural gas (bcf)		-55		

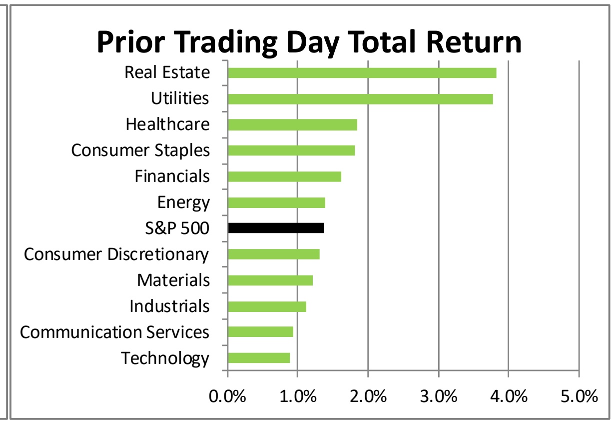
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout most of the country, with below-normal temperatures only in southern Florida. The forecasts call for wetter-than-normal conditions in California, the Southwest, and the southern Great Plains, with dry conditions in the northern Rocky Mountains and the Midwest.

Data Section

U.S. Equity Markets – (as of 12/13/2023 close)

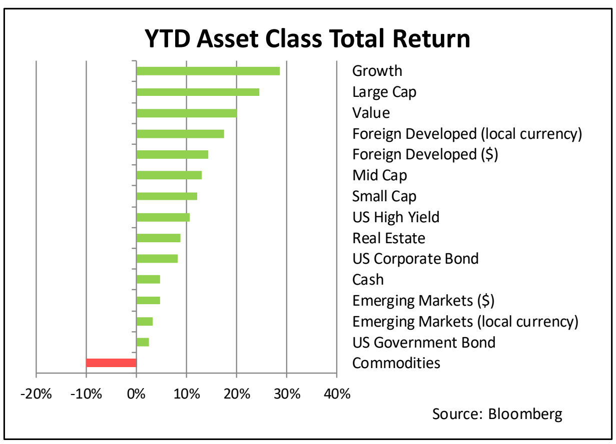




(Source: Bloomberg)

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 12/13/2023 close)

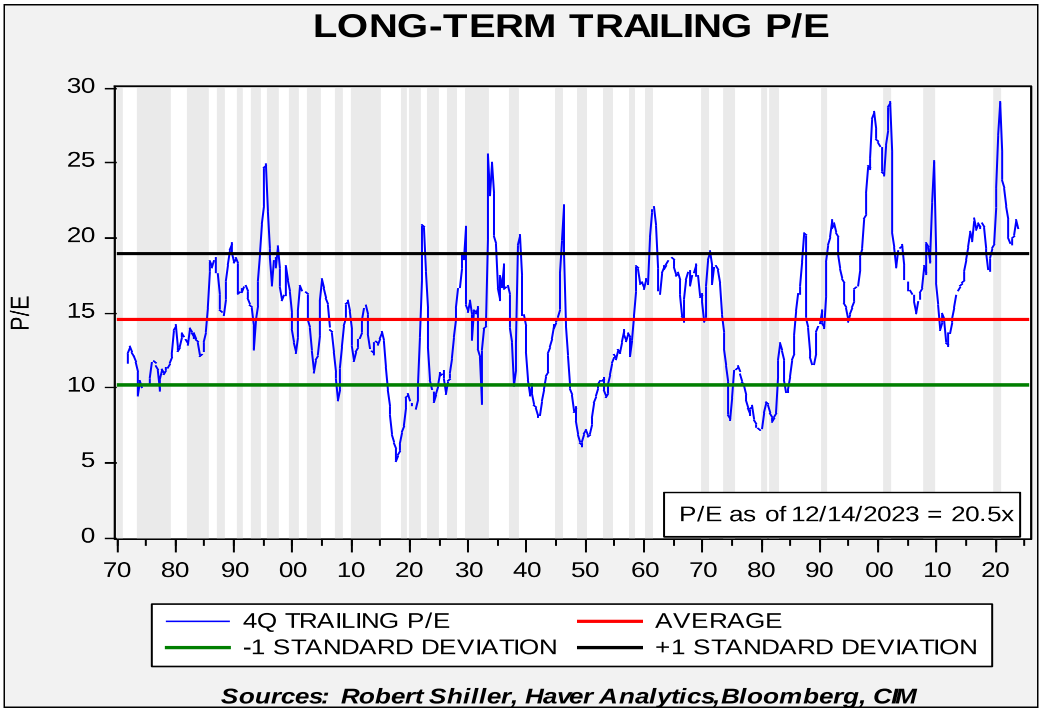


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 14, 2023



Based on our methodology,[1] the current P/E is 20.5x, up 0.1x from our last report. Rising index values lifted the multiple.

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.