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 15, 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 1.7%. Chinese markets were lower, with the Shanghai Composite down 0.6% from its previous close and the Shenzhen Composite down 0.4%. 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:

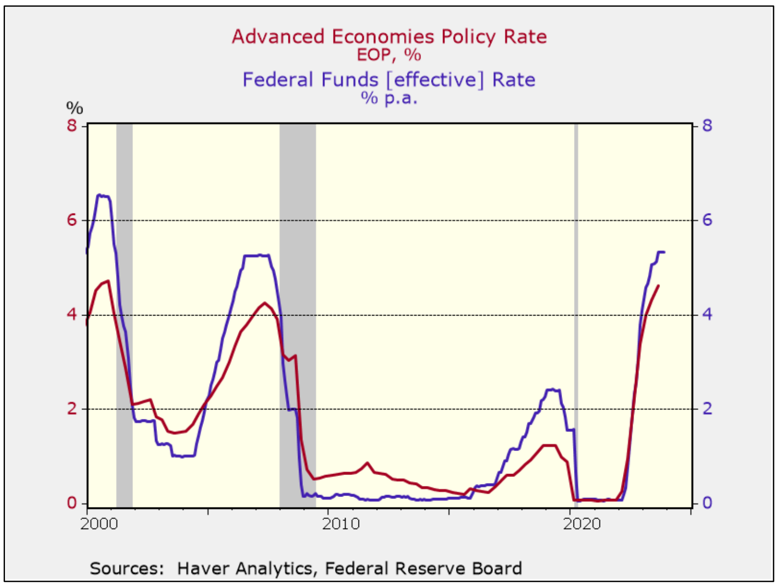
- *Bi-Weekly Geopolitical Report* (12/11/2023) (with associated *Confluence of Ideas* podcast): "The 2024 Geopolitical Outlook"
- *Weekly Energy Update* (12/14/2023): Oil prices have been under pressure as geopolitical risk premium evaporates; COP28 ended with a deal to "shift" from fossil fuels, softer 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 bullish winds sweep the market, while the Las Vegas Raiders dismantled their AFC West rivals in a dominant win. In today's *Comment*, we unpack the dollar's accelerating decline, dissect the shift away from mega-cap stocks, and delve into the unexpected delays in Ukraine funding. As always, our comprehensive report encompasses the latest domestic and international data releases.

The Greenback's Nosedive: The U.S. dollar dropped against major currencies today, likely triggered by divergent policy rate signals from the Federal Reserve and its G-7 counterparts.

- Amidst a chorus of restraint from other major central banks, the Federal Reserve stood as a lone dove, hinting at a potential policy easing in the near future. This contrasted with commitments from the European Central Bank and Bank of England to hold policy rates steady until price stability is restored. Even the Bank of Japan, long known for its ultra-accommodative stance, suggested a possible shift from quantitative easing and negative interest rates earlier this month. Following the divergent signals from U.S. policymakers and its developed counterparts, the Bloomberg Dollar Index has plunged 3% since Wednesday, reflecting investor expectations of a narrowing interest rate spread between countries. This shift has also triggered a rebound in oil prices, previously weighed down by oversupply concerns.

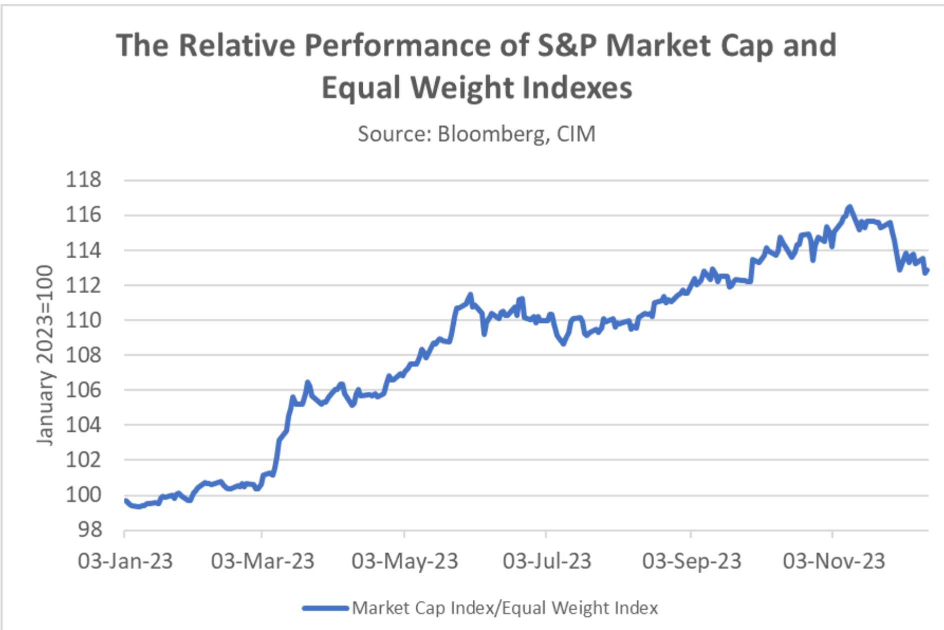
- Investors were shocked as the ECB and Bank of England unexpectedly split from the Federal Reserve. However, historical data reveals that this is not unprecedented. In past tightening cycles, the Fed has often led the charge, taking a more hawkish stance than its counterparts, followed by a more dovish pivot during periods of monetary easing. These swings likely stem from concerns about the impact that U.S. monetary policy has on other countries. High U.S. rates can lead to inflation abroad by pushing up import costs for dollar-denominated goods, while low U.S. rates can hurt the competitiveness of foreign exports, which could weaken growth. As a result, rate-setters abroad typically seek a happy medium.



- Monetary policy as mapped out by the central banks is based on a rosy outlook for next year. European policymakers' confidence in avoiding rate cuts hinges on the region sidestepping a recession, while the Fed's conditional optimism rests on inflationary pressures holding steady. A misstep by either could send investors scrambling to adjust their risk appetite and portfolio allocations. While the latest decisions from the central banks offer temporary clarity, investors should remain cautious and prepare for potential adjustments. Should central banks hold firm, the dollar's downward trajectory is likely to continue, potentially providing a boost to foreign stocks.

The Great Rebalancing: While the index approaches record territory, the current surge is a broad-based rally, fueled by a wider range of actors beyond the usual market darlings.

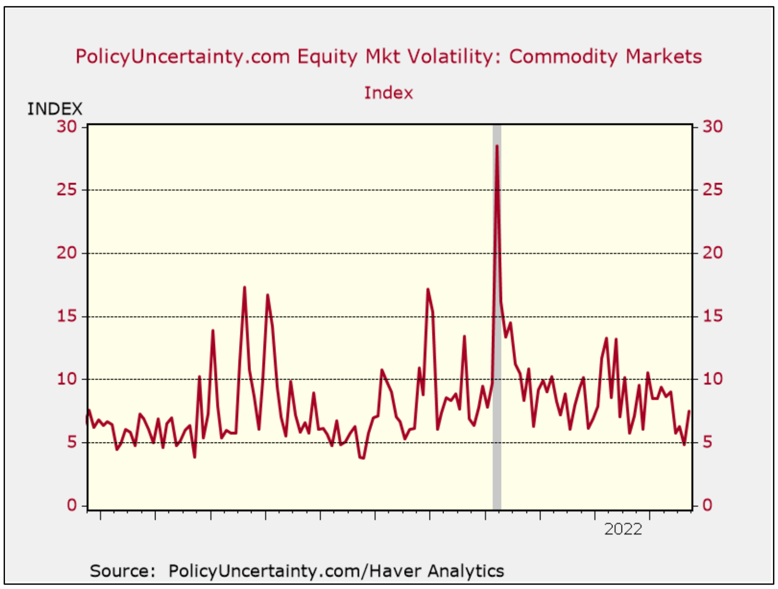
- Tech's year-long dominance is ceding ground to broader market focus, with non-tech sectors like Real Estate and Financials surging past Tech and more than doubling Communications' growth since November. This rotation suggests a potential turning point in the market as investors prepare for the Federal Reserve to start its easing cycle in 2024. The latest CME FedWatch Tool shows that investors are becoming increasingly confident that the Fed will start to cut rates in the first quarter. Meanwhile, fragility within the repo market has led investors to question how long the central bank will be able to maintain its quantitative tightening program.
- The recent rotation in investor preferences is evident in the performance gap between the S&P 500 and its equal-weight counterpart. After dominating 2023, it has lagged its equal-weight counterpart by 2% over the last two months. This shift, fueled by the equal-weight index's ability to level the playing field, exposes the true pulse of investor sentiment toward large caps. The potential for lower rates next year could fuel further rotation out of AI stocks as investors seek to capitalize on the upside potential of overlooked sectors with robust growth prospects and attractive valuations.



- After AI exuberance drove risk-taking in 2023, loosening financial conditions are poised to take center stage in the market narrative next year. During easing cycles, investors typically like to go bargain hunting as they look to cash in on companies that have been ignored. As investors rotate away from seemingly overstretched tech giants, smaller and mid-size companies with their more attractive valuations are poised to finally bask in the spotlight, particularly if economic conditions remain favorable, such as downward pressure on long-term interest rates and the abatement of producer price pressures.

Bait and Switch: As Ukraine scrambles to secure vital weapons and equipment, Kyiv battles a storm of mixed messages from the West, stoking fears of its long-term ability to sustain its war effort against Russia.

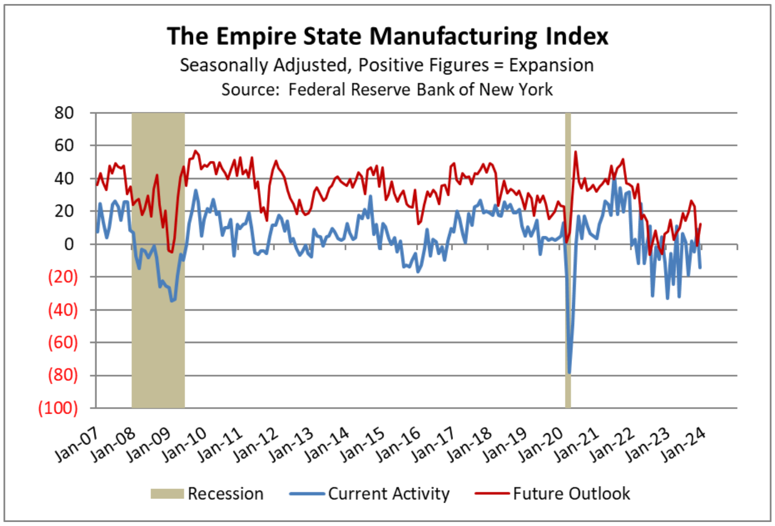
- The European Union failed to come to an agreement on €50 billion in financial aid to help Ukraine fend off Russia. Talks collapsed following the decision from Hungarian Prime Minister (and Putin ally) Victor Orban to veto the proposal. Orban's vote dealt a blow to Ukraine's immediate financial lifeline and forced the EU to scramble for alternative solutions, raising questions about the bloc's unity in supporting its embattled ally. While offering membership talks is a positive step forward, the EU must find a way to bridge the immediate financial gap and ensure Ukraine has the resources to defend itself from a potential Russian offensive.
- The EU's failure to agree on a €50 billion military aid package for Ukraine coincides with the U.S. Congress's struggle to pass a similar funding bill. The Senate has failed several times to pass military aid to help Ukraine and Israel as holdouts push for more border security funding. As of Friday, reports suggest the latest funding bill may have enough support to make it through the Senate; however, this is far from a done deal. Although the White House has warned that it was running out of money, President Biden released another round of funding for Ukraine on Tuesday.



- The emotional pull of the Ukraine-Russia conflict is undeniable, but investors must remember that the market remains indifferent to human tragedy. While a swift end to the conflict would ease supply chain pressures and stabilize commodity markets, a prolonged war significantly raises the risk of escalation, which would send shockwaves throughout the global economy and jeopardize investor confidence. Therefore, in market terms, the debate over funding would be better focused on its potential to incentivize a negotiated settlement, not based solely on achieving a decisive military victory. While Ukraine's resilience is admirable, further military aid alone seems unlikely to force a Russian withdrawal. As a result, the West may be forced to rethink its support, particularly as domestic backing for the conflict wanes and the costs escalate over the next few months.

U.S. Economic Releases

The New York FRB said its December ***Empire State Manufacturing Index*** declined to a seasonally adjusted -14.5, far worse than the expected reading of 2.0 and down from 9.1 in November. This index is designed so that positive readings point to expanding factory activity in the state of New York. At its current level, the index suggests New York factory activity remains disappointingly weak and volatile. The chart below shows how the index has fluctuated since just before the Great Financial Crisis.



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**
9:15	Industrial Production	m/m	Nov	0.3%	-0.6%	***
9:15	Industrial Capacity Utilization	m/m	Nov	79.1%	78.9%	**
9:45	S&P Global Manufacturing PMI	m/m	Dec P	49.5	49.4	***
9:45	S&P Global Services PMI	m/m	Dec P	50.7	50.8	**
9:45	S&P Global Composite PMI	m/m	Dec P	50.5	50.7	**
16:00	Net Long-term TIC Flows	m/m	Oct		-$1.7b	**
16:00	Total Net TIC Flows	m/m	Oct		-$67.4b	**
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	Jibun Bank Manufacturing PMI	m/m	Dec P	47.7	48.3		***	Equity and bond neutral
	Jibun Bank Services PMI	m/m	Dec P	52.0	50.8		**	Equity and bond neutral
	Jibun bank Composite PMI	m/m	Dec P	50.4	49.6		*	Equity and bond neutral
	Tertiary Industry Index	m/m	Oct	0.8%	1.0%	-1.2%	**	Equity bearish, bond bullish
New Zealand	BusinessNZ Manufacturing PMI	m/m	Nov	46.7	42.5	42.9	***	Equity bullish, bond bearish
China	Industrial Production	y/y	Nov	6.6%	5.7%	4.6%	***	Equity bullish, bond bearish
	Retail Sales	y/y	Nov	10.1%	7.6%	12.5%	*	Equity bullish, bond bearish
India	Trade Balance	m/m	Nov	-$20586.5m	-$31460.0m	-$24500.0m	*	Equity and bond neutral
	Exports	y/y	Nov	-2.8%	6.2%	--	**	Equity bearish, bond bullish
	Imports	y/y	Nov	-4.3%	12.3%	--	**	Equity bearish, bond bullish
EUROPE								
Eurozone	HCOB Eurozone Manufacturing PMI	m/m	Dec P	44.2	44.2	44.6	***	Equity and bond neutral
	HCOB Eurozone Services PMI	m/m	Dec P	48.1	48.7	49.0	**	Equity bearish, bond bullish
	HCOB Eurozone Composite PMI	m/m	Dec p	47.0	47.6	48.0	*	Equity bearish, bond bullish
	Trade Balance SA	m/m	Oct	10.9b	9.2b	8.7b	**	Equity and bond neutral
Germany	HCOB Germany Manufacturing PMI	m/m	Dec P	43.1	42.6	43.2	**	Equity and bond neutral
	HCOB Germany Services PMI	m/m	Dec P	48.4	49.6	49.8	**	Equity bearish, bond bullish
	HCOB Germany Composite PMI	m/m	Dec p	46.7	47.8	48.2	*	Equity bearish, bond bullish
France	HCOB France Manufacturing PMI	m/m	Dec P	42.0	42.9	43.3	**	Equity bearish, bond bullish
	HCOB France Services PMI	m/m	Dec P	44.3	45.4	46.0	**	Equity bearish, bond bullish
	HCOB France Composite PMI	m/m	Dec p	43.7	44.6	45.0	*	Equity bearish, bond bullish
	CPI	y/y	Nov F	3.5%	3.4%	3.4%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Nov F	3.9%	3.8%	3.8%	**	Equity and bond neutral
Italy	CPI, EU Harmonized	y/y	Nov F	0.6%	0.7%	0.7%	***	Equity and bond neutral
	Trade Balance Total	m/m	Oct	4699m	2346m	4393m	**	Equity and bond neutral
UK	S&P/CIPS Global Manufacturing PMI	m/m	Dec P	46.4	47.2	47.5	***	Equity bullish, bond bearish
	S&P/CIPS Global Services PMI	m/m	Dec P	52.7	50.9	51.0	**	Equity bullish, bond bearish
	S&P/CIPS Global Composite PMI	m/m	Dec p	51.7	50.7	51.0	**	Equity bullish, bond bearish
	GfK Consumer Confidence	m/m	Dec	-22	-22	-22	**	Equity and bond neutral
Russia	Money Supply, Narrow Definition	w/w	15-Dec	18.15t	18.12t		*	Equity and bond neutral
AMERICAS								
Canada	Manufacturing Sales	m/m	Oct	-2.8%	0.4%	-2.7%	**	Equity and bond neutral
Brazil	FGV Inflation IGP - 10	m/m	Dec	0.62%	0.52%	0.50%	*	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)	565	565	0	Down
3-mo T-bill yield (bps)	521	522	-1	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 (%)	3.91	3.92	-0.01	Flat
Euribor/OIS spread (bps)	393	393	0	Up
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Flat			Up
Pound	Down			Up
Franc	Flat			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Russia Key Rate	16.000%	15.000%	16.000%	On Forecast
Bank of Mexico Overnight Rate	11.250%	11.250%	11.250%	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.

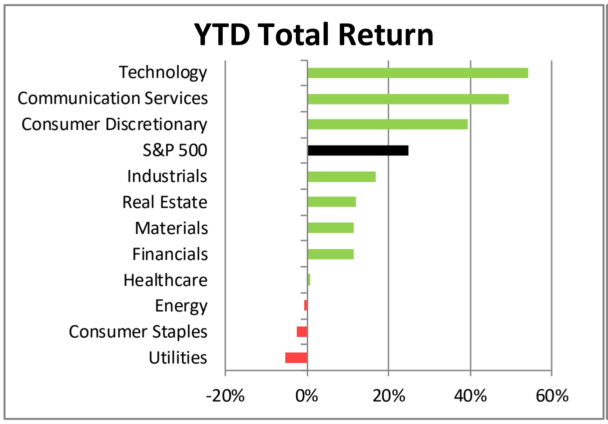
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$77.13	$76.61	0.68%	
WTI	$72.14	$71.58	0.78%	
Natural Gas	$2.42	$2.39	0.96%	
Crack Spread	$24.31	$24.03	1.17%	
12-mo strip crack	$24.08	$23.92	0.67%	
Ethanol rack	$1.85	$1.86	-0.20%	
Metals				
Gold	$2,041.01	$2,036.36	0.23%	
Silver	$24.15	$24.18	-0.12%	
Copper contract	$388.65	$389.25	-0.15%	
Grains				
Corn contract	$479.00	$479.25	-0.05%	
Wheat contract	$616.00	$615.75	0.04%	
Soybeans contract	$1,333.75	$1,332.00	0.13%	
Shipping				
Baltic Dry Freight	2,411	2,438	-27	
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)	-117	-56	-61.00	

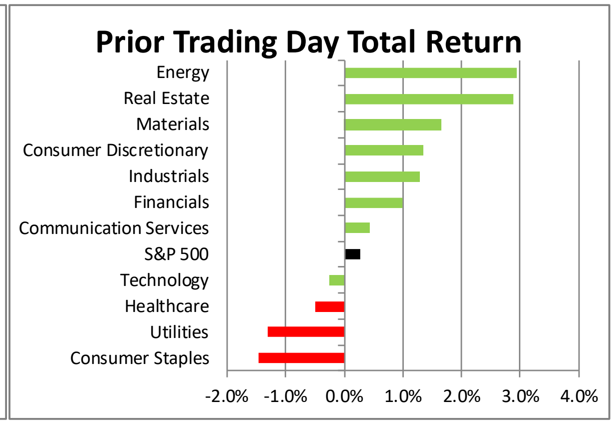
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in almost the entire country, with below-normal temperatures only in southern Florida. The forecasts call for wetter-than-normal conditions across the entire southern half of the country, with dry conditions in the northern Rocky Mountains, the Midwest, and the Northeast.

Data Section

U.S. Equity Markets – (as of 12/14/2023 close)

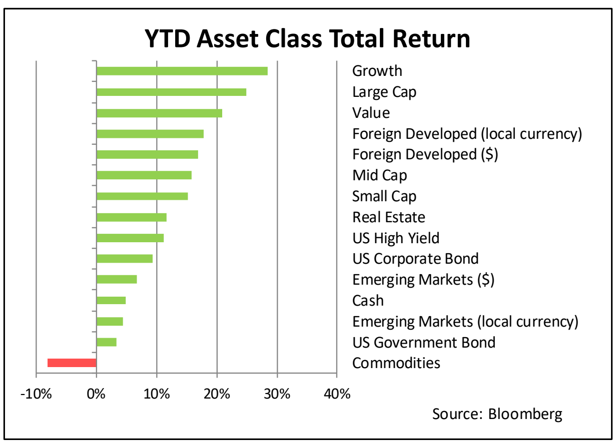




(Source: Bloomberg)

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 12/14/2023 close)

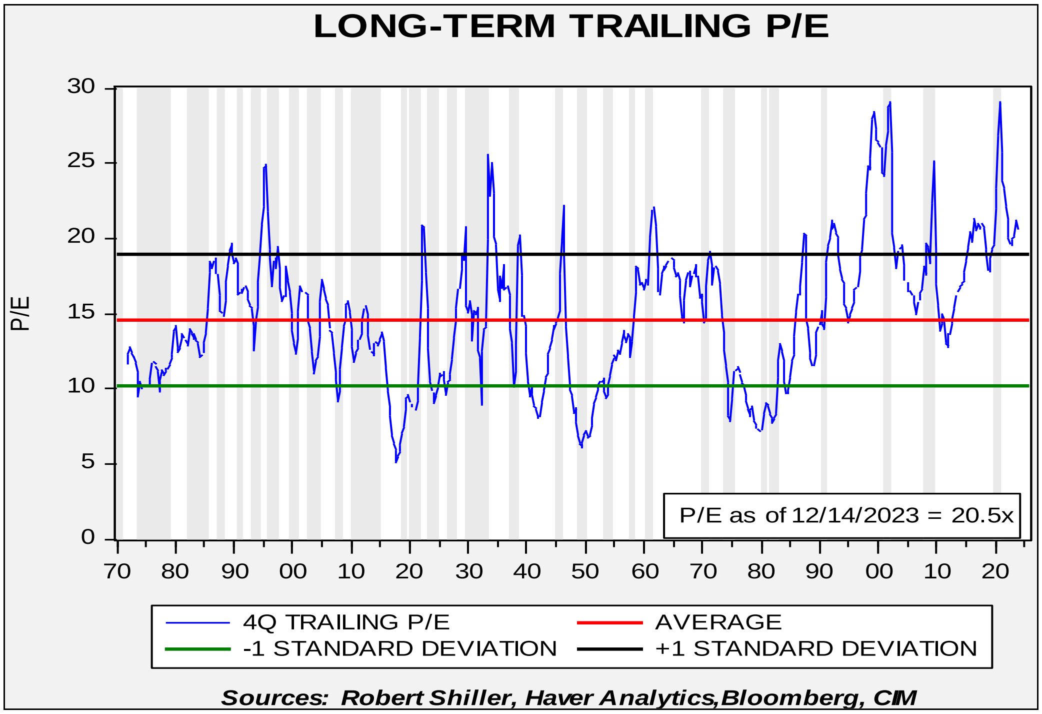


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.