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 18, 2023—9:30 AM EST] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is down 0.5% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.5%. Chinese markets were lower, with the Shanghai Composite down 0.4% from its previous close and the Shenzhen Composite down 1.3%. In contrast, 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?"

Our *Comment* today opens with several items related to the U.S.-China geopolitical rivalry and what it means for investors. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including more bad economic data out of Europe, a growing risk that Japan's prime minister may be forced to resign, and new warnings from Federal Reserve officials that U.S. investors are being too optimistic about early cuts in interest rates.

U.S.-China Technology Flows: A new report from the Chinese Academy of Sciences warns that China is at risk of falling into a "middle technology trap" because of the recent U.S.-led curbs on sending advanced technologies with potential military applications to the country. The report defines such a trap as a situation where a developing country partially industrializes via technology importation, imitation, absorption, and tracking, but fails to join the top tier of rich, advanced countries because it can't produce its own innovative technologies.

- The report confirms that one of the major challenges for the Chinese economy these days is the U.S. geopolitical bloc's clampdown on trade, investment, technology, and even human capital and tourism flows with China, as countries in the bloc belatedly work to reduce their vulnerability to China's military and economic power.
- In 2024, we believe China will continue to face economic headwinds from what we call the "Five Ds": weak consumer ***demand***, high corporate and local government ***debt***, poor ***demographics***, economic ***disincentives*** from the Communist Party's increasing intrusion into the economy, and ***decoupling*** by foreign countries.
- These challenges have prompted General Secretary Xi to seek an easing of tensions with the West, and we think he'll remain focused on détente in 2024, at least in diplomatic and economic relations. That could spark a temporary rebound in Chinese asset prices, but we think the Five Ds will still limit the returns available in China in the near term.

U.S.-China-Mexico Trade Relations: To get around the broader U.S. tariffs and other trade barriers against Chinese imports, the *Financial Times* says at least three of China's electric vehicle makers and one of its EV battery producers are looking to set up factories in Mexico. Because of the U.S.-Mexico-Canada trade agreement, producing in Mexico would potentially give the companies tariff-free access to the U.S. market, while also spurring new investment and economic growth in Mexico.

U.S.-China Military Relations: While we write a lot on the growing U.S.-China geopolitical rivalry and what it will mean for investors, sometimes it's the small operational changes in the military that best illustrate the situation. On that score, the *New York Times* on Friday had an article on how the U.S. Army is again ramping up its jungle training school in Hawaii. After two decades focused on fighting in dry, desert locations like Iraq and Afghanistan, the Army is trying to prepare its troops for a potential war with China in the jungles of the Indo-Pacific region.

- The effort to re-introduce U.S. troops to jungle warfare comes as the U.S. Marine Corps has embarked on a controversial re-design that will transform its Pacific expeditionary forces into light, highly mobile ship killers who, in time of conflict, could deploy to islands throughout the region with powerful anti-ship missiles to wreak havoc on the Chinese navy.
- For those of us who travel often and see lots of soldiers in desert camouflage in the airport terminals, the shift in geopolitical tensions toward the Indo-Pacific and Europe may really hit home when we notice more and more of those soldiers in dark-green jungle or woodland camouflage.
- On the Chinese side, provincial civilian officials have begun appearing at public events in military uniforms, in an effort to show their support for the military and military-civilian coordination.

Israel-Hamas Conflict: As Israeli troops continue their attacks on Hamas fighters in Gaza, Iran-backed Houthi rebels in Yemen continue to launch retaliatory missile and drone strikes on ships in the Red Sea. In response, oil giant BP (BP, $34.81) said today that it is temporarily pausing all its tanker transits through the area. Shipping majors A.P. Moller-Maersk (AMKBY, $8.58) and Hapag-Lloyd (HPGLY, $68.88) on Friday also curbed operations in the Red Sea after attacks on their vessels. The moves reflect the conflict's risk to world oil supplies and commerce.

- Separately, the Israel Defense Force admitted over the weekend that its soldiers mistakenly shot and killed three Israeli hostages during a chaotic combat operation, even though the hostages were waving a white flag and shouting in Hebrew.
- True to character, Prime Minister Netanyahu was slow to acknowledge the mistake or take responsibility for it, drawing further anger from Israelis who see him as having allowed the Hamas attacks on Israel on October 7 and then risking the hostages and Israel's reputation with the IDF's attack on Gaza.

Japan: After the ruling Liberal Democratic Party's spiraling illegal fundraising scandal forced Prime Minister Kishida to sack four of his ministers last week, government and party officials are now openly discussing the possibility that Kishida may soon be forced to resign as party chief. Since elections aren't required until 2025, another LDP official would likely take Kishida's place as prime minister. The risk for investors is that increased political chaos could undermine confidence and short-circuit the Japanese stock market's recent strong run.

Germany: The IFO Institute's December business climate index fell to a seasonally adjusted 86.4, well short of expectations that it would rise slightly from the November reading of 87.2. Along with a decline in the December purchasing managers' indexes published last week, the findings suggest the German economy is limping to the end of the year with declining activity. Because of the German economy's large size, its weakness is likely to weigh on other European economies and asset prices.

Serbia: In parliamentary elections yesterday, right-wing populist President Aleksandar Vučić's ruling Serbian Progressive Party won 47% of the vote, which will allow it to govern without relying on any coalition partners. Vučić had already been accused of building an authoritarian state modelled largely on Viktor Orbán's Hungary, and opposition leaders immediately complained that his win yesterday reflected electoral fraud.

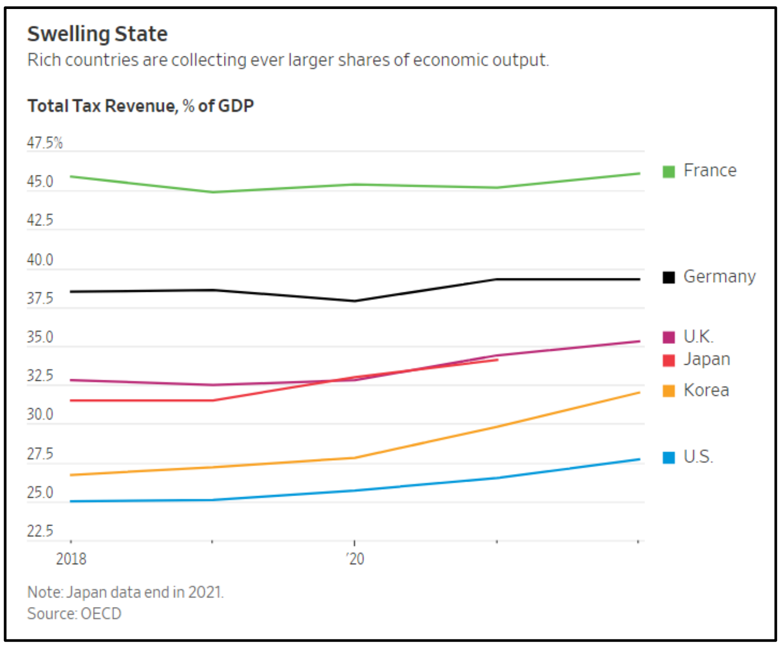
Chile: In a ballot yesterday, Chileans voted 56% to 44% against a new constitution that would have shifted policy decidedly to the right. The rejection came about a year after voters strongly rejected a radical leftist constitution and four years after the widespread rioting and protests that kicked off the effort. For now, the result will leave in place the pro-business constitution passed under the Pinochet dictatorship in 1980.

U.S. Monetary Policy: In a speech today, Cleveland FRB President Mester warned that investors have gotten ahead of themselves by pushing up asset prices in anticipation of early interest-rate cuts by the central bank. Her comments align with similar warnings on Friday from New York FRB President Williams and Atlanta FRB President Bostic. They also align with our view that Fed policymakers are so intent on rebuilding their reputation as inflation fighters that investors should take them at their word when they say rates will stay "higher for longer."

- In her comments, Mester said, "The next phase is not when to reduce rates, even though that's where the markets are at. It's about how long do we need monetary policy to remain restrictive in order to be assured that inflation is on that sustainable and timely path back to 2%."
- More to the point, she also added that, "The markets are a little bit ahead. They jumped to the end part, which is 'We're going to normalize quickly,' and I don't see that."

U.S. Fiscal Policy: Data from the Organization for Economic Cooperation and Development shows government revenue as a share of gross domestic product has risen noticeably in the U.S. and other major developed countries in recent years. According to the analysis, the rise generally hasn't come from newly legislated tax hikes. Rather, the increase has come from price and wage inflation, which can push taxpayers into higher tax brackets.

- In the U.S., tax receipts at all levels of government rose to almost 28% of GDP last year, up from 25% in 2019 and one of the highest levels in decades.
- While the higher tax take can impede consumer spending and entrepreneurship, the new resources will also be available to help fund new initiatives, such as infrastructure rebuilding and increased defense spending.



U.S. Corporate Finances: An updated review of bankruptcy filings shows business failures in the U.S. in the year ended in September were up 30% from the previous year. The data shows that bankruptcies in several other key countries have also climbed by a similar amount. The research suggests that the rise in bankruptcies can be attributed to higher costs, rising interest rates, and the continued withdrawal of pandemic relief funds by governments.

U.S. Energy Industry: New [forecasts from the Energy Information Agency]() project that solar and wind-generated electricity will surpass coal-generated electricity in the U.S. energy mix for the first time in 2024. The report [shows natural gas will remain the top source of electricity](), accounting for 42% of the nation's total, while all renewables will account for 24% and nuclear will stand at 19%. Coal is projected to provide only 15% of U.S. electricity in the coming year.

Short-Term Energy Outlook

Overview

U.S. energy market indicators	2022	2023	2024
Brent crude oil spot price (dollars per barrel)	$101	$82	$83
Retail gasoline price (dollars per gallon)	$3.97	$3.53	$3.36
U.S. crude oil production (million barrels per day)	11.91	12.93	13.11
Natural gas price at Henry Hub (dollars per million British thermal units)	$6.42	$2.56	$2.79
U.S. liquefied natural gas gross exports (billion cubic feet per day)	10.6	11.8	12.4
Shares of U.S. electricity generation			
Natural gas	39%	42%	42%
Coal	20%	17%	15%
Renewables	21%	22%	24%
Nuclear	19%	19%	19%
U.S. GDP (percentage change)	1.9%	2.4%	1.3%
U.S. CO_2 emissions (billion metric tons)	4.94	4.80	4.75

Data source: U.S. Energy Information Administration, *Short-Term Energy Outlook*, December 2023

U.S. Economic Releases

There were no economic releases prior to the publication of this report. 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	NAHB Housing Market Index	m/m	Dec	37	34	**
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								
New Zealand	Wespac Consumer Confidence	m/m	4Q	88.9	80.2		*	Equity and bond neutral
EUROPE								
Germany	IFO Business Climate	m/m	Dec	86.4	87.3	87.2	***	Equity bearish, bond bullish
	IFO Current Assessment	m/m	Dec	88.5	89.4	89.5	**	Equity bearish, bond bullish
	IFO Expectations	m/m	Dec	84.3	85.2	85.1	***	Equity and bond neutral
Switzerland	Domestic Sight Deposits CHF	w/w	15-Dec	453.8b	463.2b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	15-Dec	462.6b	471.7b		*	Equity and bond neutral
AMERICAS								
Canada	Housing Starts	m/m	Nov	212.6k	274.7k	212.3k	**	Equity and bond neutral
	Wholesale Sales ex Petroleum	m/m	Oct	-0.5%	0.4%	-0.6%	**	Equity and bond neutral
	Int'l Securities Transactions	m/m	Oct	-15.75b	-15.09b	-15.06b	*	Equity and bond neutral
Mexico	Aggregate Supply and Demand	y/y	3Q	2.7%	4.8%	3.8%	*	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)	563	564	-1	Down
3-mo T-bill yield (bps)	522	523	-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	3.91	0.00	Flat
Euribor/OIS spread (bps)	392	393	-1	Up
Currencies	Direction			
Dollar	Flat			Down
Euro	Up			Up
Yen	Down			Up
Pound	Down			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.

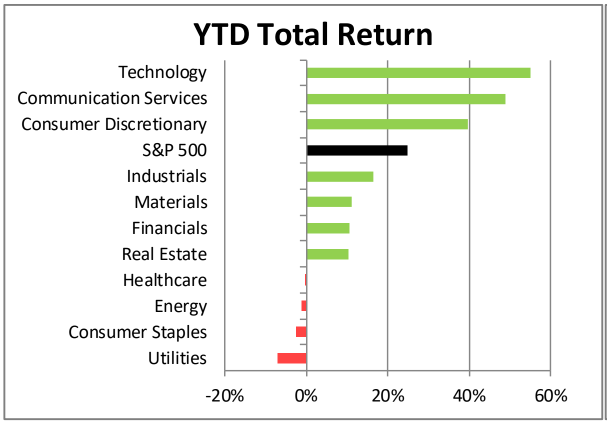
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$77.37	$76.55	1.07%	
WTI	$72.10	$71.43	0.94%	
Natural Gas	$2.58	$2.49	3.37%	
Crack Spread	$25.31	$24.79	2.09%	
12-mo strip crack	$24.79	$24.34	1.85%	
Ethanol rack	$1.86	$1.86	0.05%	
Metals				
Gold	$2,023.69	$2,019.62	0.20%	
Silver	$23.92	$23.86	0.26%	
Copper contract	$387.50	$389.05	-0.40%	
Grains				
Corn contract	$481.25	$483.00	-0.36%	
Wheat contract	$622.25	$629.25	-1.11%	
Soybeans contract	$1,329.25	$1,331.50	-0.17%	
Shipping				
Baltic Dry Freight	2,348	2,411	-63	

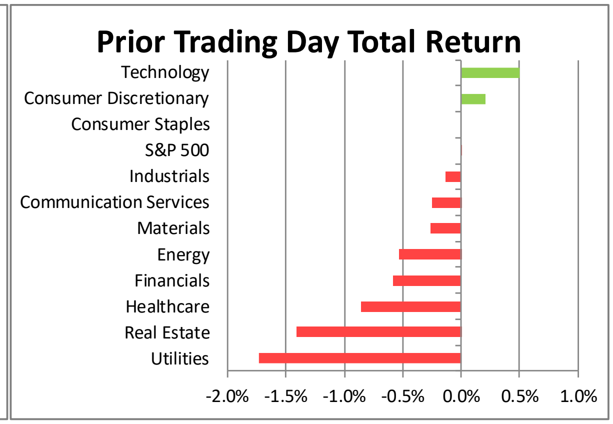
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in most of the country, with near-normal temperatures only in southern Florida. The precipitation outlook calls for wetter-than-normal conditions across most states, with dry conditions expected in the Rocky Mountains.

Data Section

U.S. Equity Markets – (as of 12/15/2023 close)

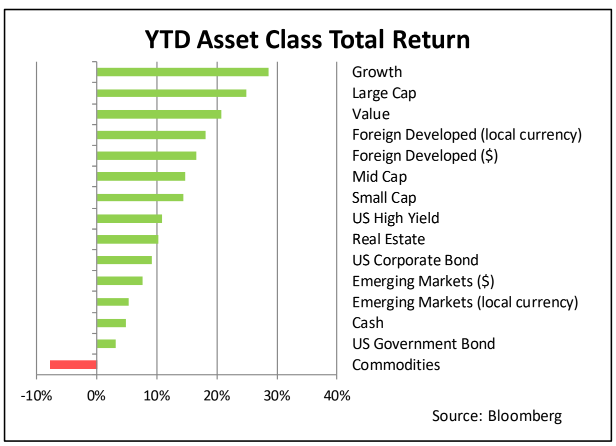




(Source: Bloomberg)

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 12/15/2023 close)

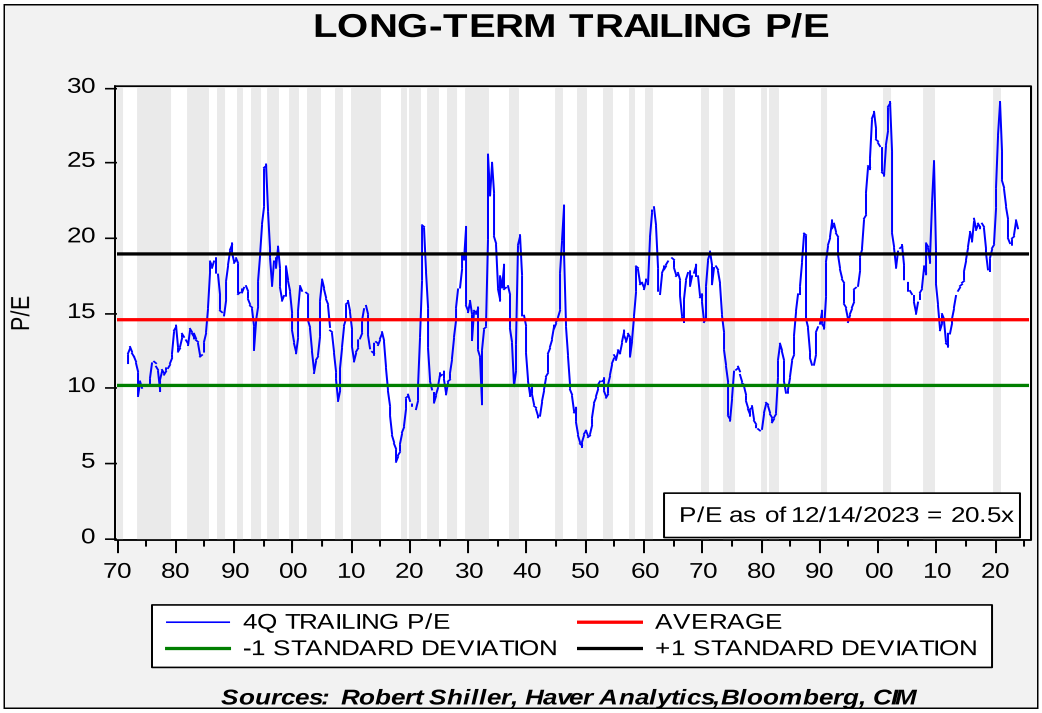


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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.