Daily Comment

*By Patrick Fearon-Hernandez, CFA,
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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 19, 2023—9:30 AM EST] Global equity markets are mostly higher this morning. In Europe, the Euro Stoxx 50 is up 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.3%. Chinese markets were higher, with the Shanghai and Shenzhen Composites up 0.1% 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* (12/14/2023): 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?"
- ***The 2024 Outlook: Slow-Bicycle Economy* (12/18/23) (with associated *Confluence of Ideas* podcast)**

Note to readers: the* Daily Comment *will go on holiday after December 20, 2023, and will return on January 2, 2024. From all of us at Confluence Investment Management, have a Merry Christmas and a Happy New Year!

Our *Comment* today opens with a discussion of the potential fallout if the U.S. and its European allies stop providing military aid to Ukraine. While some observers say there would be no impact, a new study argues that it would lead to much higher costs later on. We next review a range of other international and U.S. developments with the potential to affect the financial markets today, including a decision by the Bank of Japan to hold its monetary policy unchanged and a call by one Federal Reserve policymaker for multiple U.S. interest-rate cuts in 2024.

Russia-Ukraine-United States: A new report by the Institute for the Study of War warns that if the U.S. and its European allies end their military aid to Ukraine, the country would be at risk of being overrun and conquered by Russian forces. In such an event, the Kremlin's battered but triumphant army would stand on NATO's borders from the Black Sea to the Arctic Ocean, posing a major conventional military threat to NATO for the first time since the 1990s.

- The study finds that Russia's current wartime defense industry expansion and large pool of potential military recruits would allow it to recover quickly from its steep equipment and troop losses in the Ukraine invasion to date. At the conclusion of fighting, the Russian army would also have a wealth of experienced officers and troops, effective tactics honed on the modern battlefield, and innovative new weapons.
    - The study argues that the second-worst scenario would be to freeze the conflict with Russia holding the 20% of so of Ukrainian territory it currently controls in the country's east and south. President Putin would almost certainly use such a freeze to rebuild his forces and prep them for a new invasion in the future, but at least his forces would remain far from NATO's southern frontier.
    - The best scenario for the U.S. and NATO would be to help Ukraine drive the Russians completely out of their territory. Putin would still likely respond by rebuilding his forces for a new future invasion, but those forces would then have to transverse all the territory of a potentially rebuilt Ukraine.
- If President Putin could deploy his rejuvenated army to positions along NATO's entire eastern frontier, perhaps with Chinese approval and/or prodding, the study finds that the U.S. and its allies would need to invest enormous sums to rebuild the military strength needed to deter them, even as the allies are forced into an expensive defense buildup against China in the Indo-Pacific region. The study argues that the cost of this European defense buildup would far exceed the current cost of military aid to Kyiv.
    - Such a scenario would force the U.S. to make painful trade-offs between deploying deterrence forces to Europe or to Asia.
    - In other words, allowing Russia to win in Ukraine (either in full or in part) wouldn't allow a full focus on Asia. Russia's appetite for aggression would only increase, forcing the U.S. and its allies into an expensive two-front military buildup in both Europe and Asia.
- The ISW study is therefore consistent with our thesis that rising frictions between the U.S. geopolitical bloc and the China/Russia bloc will continue to fracture international relations, creating risks for investors but also creating opportunities in sectors such as broad industrials, defense companies, defense-focused technology firms, and mining and energy firms.

United States-NATO: Speaking of NATO, one little-noticed provision of the National Defense Authorization Act passed by Congress last week prohibits any future U.S. president from pulling the country out of NATO without a two-thirds vote of approval in the Senate or separate legislation from Congress.

Israel-Hamas Conflict: As Iran-backed Houthi rebels in Yemen continue to launch retaliatory missile and drone strikes on ships in the Red Sea, the U.S. and six of its allies yesterday agreed on an expanded naval task force to protect shipping in the region. The task force will include ships from the U.S., the U.K., France, Bahrain, and several other countries to protect commercial ships and oil tankers in the region.

- Some 9 million barrels of crude oil are shipped through the Red Sea each day, representing almost one-tenth of global demand. After oil giant BP (BP, $35.12) said on Monday that it would pause its shipments through the Red Sea on security concerns, investors spooked by the prospect of supply disruptions bid up Brent oil to $77.95 per barrel, up 1.8% for the day.
- So far this morning, oil prices have given up a portion of yesterday's gain, possibly reflecting satisfaction with the expanded naval task force.

Germany-Norway: In a deal signed today, Norwegian energy giant Equinor (EQNR, $31.71) agreed to supply 129 billion cubic meters of natural gas to German state energy firm SEFE through 2039. Worth about 50 billion EUR ($54.8 billion) at today's prices, the long-term pipeline supply deal would reportedly be enough to cover one-third of Germany's industrial gas demand over the period, helping replace the cheap Russian gas shut off after the Kremlin's invasion of Ukraine.

- The deal will therefore be important in ensuring energy security for Germany, and for Europe in general, in the coming years.
- The deal is also an example of how global geopolitical fracturing will sometimes merely shift trade patterns, rather than end cross-border shipments.

United Kingdom: Bank of England Deputy Governor Ben Broadbent yesterday warned that volatile, inconsistent data on wage growth will keep the central bank from making an early judgment on whether inflation pressures are easing, which in turn will discourage it from early interest-rate cuts. The statement adds to the pushback from major central banks against investors betting on rate cuts in the near term.

- Responding to the risk that BOE policymakers could keep interest rates too high and prompt a big slowdown in the British economy next year, the chief investment officer of bond giant PIMCO said he is keeping his exposure to U.K. government bonds higher than he usually does.
- Other investors have apparently also been buying British bonds aggressively, pushing the yield on 10-year Gilts to about 3.673% recently, down approximately 100 basis points since late October.

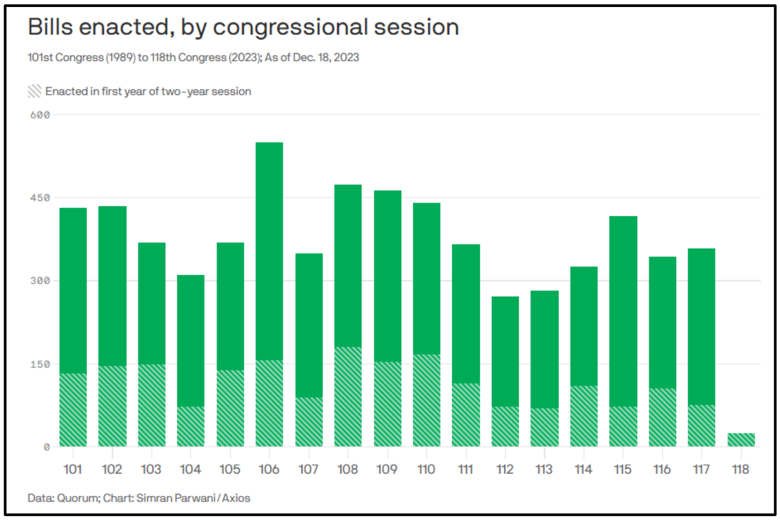
Japan: Dashing some investors' hopes for policy normalization, the Bank of Japan today held its benchmark short-term interest rate at -0.1% and made no change to its "soft" ceiling on 10-year Japanese government bond yields. In addition, BOJ chief Ueda said in his post-decision press conference that the policymakers want to see more evidence of sustained wage and price rises before ending their negative interest rates and yield curve control policies. Without even a hint of monetary normalization, the yen (JPY) today has weakened by 1.1% to 144.34 per dollar ($0.0069).

U.S. Monetary Policy: In contrast with the recent pushback against rate-cutting talk from other Fed policymakers, San Francisco FRB President Daly told the *Wall Street Journal* yesterday that cooling U.S. inflation in 2023 should prompt the policymakers to consider cutting interest rates several times in 2024. As inflation cools, Daly said it makes sense for the Fed to make sure its high interest rates don't disrupt the U.S. labor market. The statement could potentially give a further boost to risk assets in trading today.

U.S. Air Travel Industry: A recent report from the Federal Aviation Administration said the agency is struggling to find enough fully certified air-traffic controllers. With nearly all FAA facilities facing controller shortfalls, the crisis is raising concerns that the agency might have to slow flight operations around the country. Besides affecting airlines and air shippers, such a slowdown in air travel could disrupt supply chains, boost price pressures, and weigh on overall economic growth.

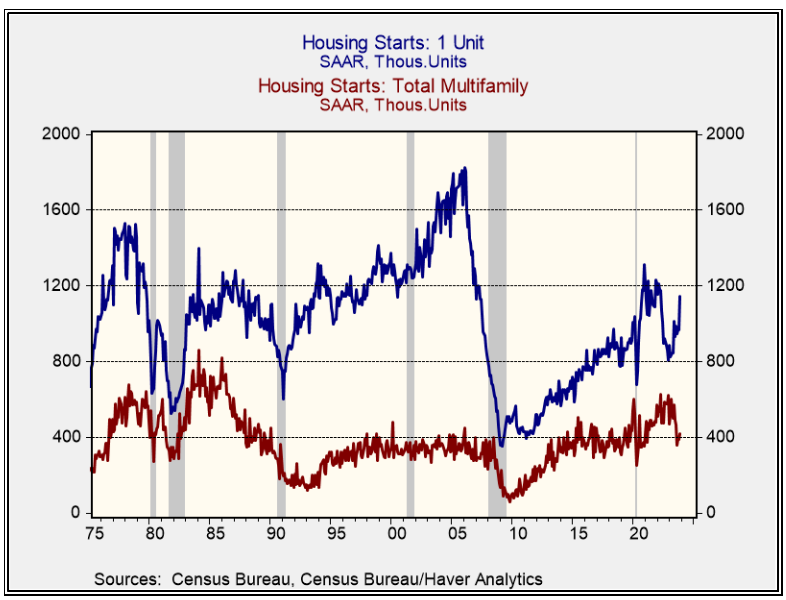
- The shortage of air-traffic controllers can be ascribed in part to mass retirements in recent years. At the same time, the tight labor market has made it harder to attract applicants.
- On a related note, the National Defense Authorization Act passed by Congress last week calls for U.S. active-duty military personnel to fall to 1.285 million by the end of fiscal 2024, down almost 64,000 from three years ago. As with the air-traffic controllers, the smaller target mostly reflects the difficulty of recruiting in a tight labor market, rather than a decline in the mission or responsibilities.

U.S. Political Dysfunction: In yet another sign of how political tensions and disdain for compromise are affecting U.S. policymaking, new analysis shows that just 20 bills have passed both chambers of Congress and been signed into law this year, with another four awaiting President Biden's signature. Most of the bills that have become laws were uncontroversial measures like naming Veterans Affairs clinics.



U.S. Economic Releases

Construction of residential property picked up in November, jumping to its highest level in six months. According to the Census Bureau, U.S. housing starts rose from a seasonally adjusted annualized rate of 1372k to 1560k last month. The reading was well above expectations of 1360k. At the same time, building permits decreased from a seasonally adjusted annualized rate of 1498k to 1460k.



The chart above depicts a steep rise in U.S. housing starts, largely driven by single-unit homes that jumped from 969k to 1,143k. Multi-family starts saw a more modest climb, ticking up from 390k to 417k. This surge in construction activity could be a sign of growing optimism in the housing market following the Fed's recent comments on the future path of monetary policy.

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
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						
EST	Speaker or Event	District or Position				
12:30	Raphael Bostic Speaks on US Economy, Business Outlook	President of the Federal Reserve Bank of Atlanta				
18:00	Austan Goolsbee on Fox News	President of the Federal Reserve Bank of Chicago				

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	Trade Balance NZD	m/m	Nov	-1234m	-1709m	-1730m	**	Equity and bond neutral
	Exports NZD	m/m	Nov	5.99b	5.40b	5.37b	**	Equity and bond neutral
	Imports NZD	m/m	Nov	7.23b	7.11b	7.10b	**	Equity and bond neutral
	ANZ Activity Outlook	m/m	Nov	29.3	7.11b		**	Equity and bond neutral
	ANZ Business Confidence	m/m	Dec	33.2	26.3		**	Equity and bond neutral
EUROPE								
Eurozone	CPI	y/y	Nov F	2.4%	2.4%	2.4%	***	Equity and bond neutral
	Core CPI	y/y	Nov F	-0.6%	-0.5%	-0.5%	**	Equity and bond neutral
Switzerland	Real Exports	m/m	Nov	1.8%	-7.2%		*	Equity and bond neutral
	Real Imports	m/m	Nov	1.7%	-3.1%	3.2%	*	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)	520	522	-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)	535	535	0	Down
10-yr T-note (%)	3.91	3.93	-0.02	Flat
Euribor/OIS spread (bps)	394	392	2	Up
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Down			Up
Pound	Up			Up
Franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
BOJ Policy Balance Rate	-0.100%	-0.100%	-0.100%	On Forecast
BOJ 10-yr Yield Target	0.000%	0.000%	0.000%	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.

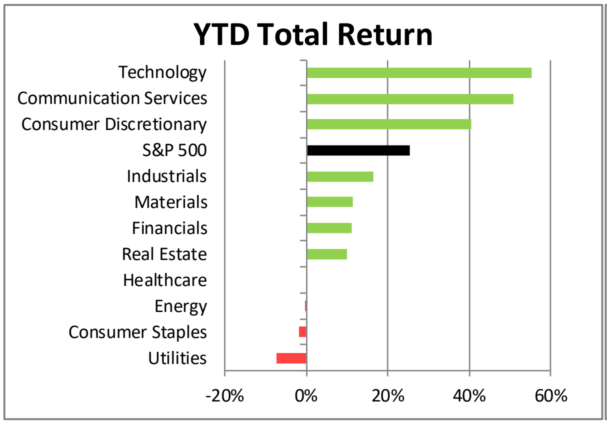
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$77.74	$77.95	-0.27%	
WTI	$72.26	$72.47	-0.29%	
Natural Gas	$2.45	$2.50	-2.24%	
Crack Spread	$25.20	$25.79	-2.32%	
12-mo strip crack	$24.77	$25.20	-1.67%	
Ethanol rack	$1.84	$1.85	-0.26%	
Metals				
Gold	$2,028.64	$2,027.19	0.07%	
Silver	$23.96	$23.80	0.66%	
Copper contract	$388.35	$385.20	0.82%	
Grains				
Corn contract	$476.25	$477.00	-0.16%	
Wheat contract	$615.50	$617.00	-0.24%	
Soybeans contract	$1,330.00	$1,340.00	-0.75%	
Shipping				
Baltic Dry Freight	2,288	2,348	-60	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.0		
Gasoline (mb)		1.0		
Distillates (mb)		1.0		
Refinery run rates (%)		0.3%		
Natural gas (bcf)		-56		

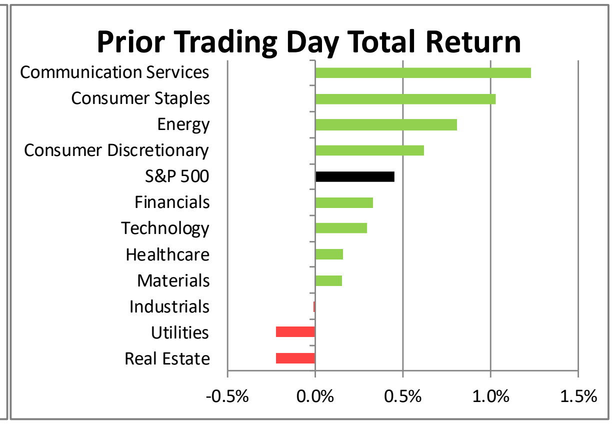
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in most of the country, with near-normal temperatures throughout the South. The precipitation outlook calls for wetter-than-normal conditions across most states that should gradually migrate towards the East and West Coasts by the end of the period. Meanwhile, dry weather is expected to spread from the Rockies into the Great Plains.

Data Section

U.S. Equity Markets – (as of 12/18/2023 close)

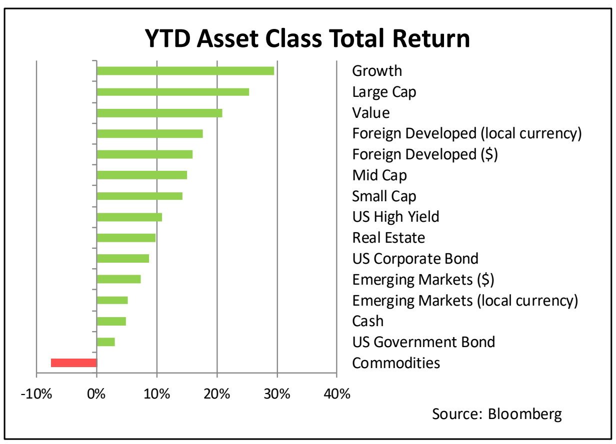




(Source: Bloomberg)

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 12/18/2023 close)

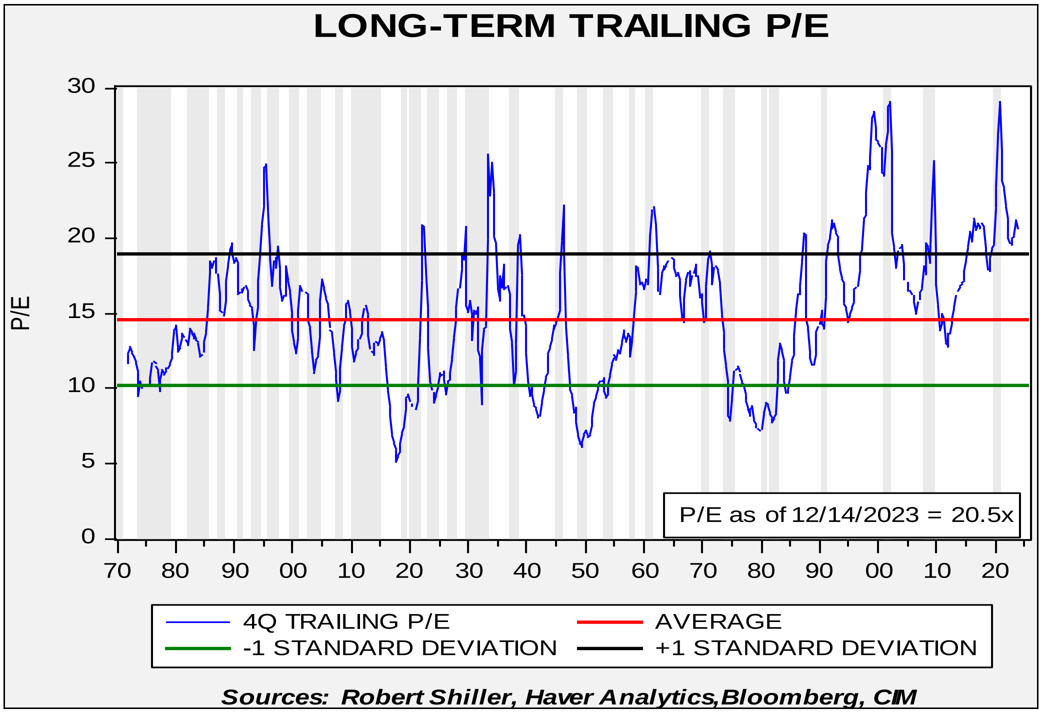


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.