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 20, 2023—9:30 AM EST] Global equity markets are mostly lower this morning. In Europe, the Euro Stoxx 50 is down 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.6%. Chinese markets were lower, with the Shanghai Composite down 1.0% from its previous close and the Shenzhen Composite down 1.2%. U.S. equity index futures are signaling a lower 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* (12/18/2023) (with associated *Confluence of Ideas* podcast)

Note to readers: the* Daily Comment *will go on holiday after today's Comment 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 new research on the challenges facing emerging markets because of today's high interest rates and strong dollar. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including more signs of a potential future wind-down in the Israel-Hamas conflict and new data on U.S. population growth.

Global Emerging Markets: According to the World Bank's latest *International Debt Report*, the strong dollar and aggressive interest-rate hikes by advanced countries' central banks have created severe financial distress among low- and middle-income countries. For example, the report identifies 18 sovereign debt defaults by 10 different countries in the last three years, exceeding the total number in the previous two decades.

- Excluding China, the report says external debt among low- and middle-income nations now stands at 33% of gross national income, down a bit from the previous year but still much higher than the 26% of GNI one decade ago. Also excluding China, interest costs have risen to 1.06% of GNI from 0.94%, siphoning budget funds away from domestic uses and making it harder to service the debt.
- The report says that if the top central banks keep interest rates "higher for longer," as we expect, more poorer countries will face default in the coming years.

Israel-Hamas Conflict: The *Wall Street Journal* today reports that there is a growing rift between Hamas's political leaders based in Qatar, who want to end the group's war with Israel, and its administrative and military officials in Gaza, who want to keep fighting. Importantly, the Hamas political leaders have been talking with other Palestinian factions in the broader Palestine Liberation Organization about postwar governance in Gaza. The talks add to other evidence that the endgame of the war is coming closer.

China: The province of Guangdong and two of its municipal governments have set up a new $1.5-billion fund to invest in the local semiconductor industry, just as Shanghai set up a similar fund in 2016. Supplementing the central government's "Big Fund," the provincial funds illustrate how lower-level governments in China are encouraged to help achieve the goals set out by top leaders, including the rapid development, resilience, and self-reliance of the country's advanced semiconductor industry.

European Union-China: The European Commission announced today that it is launching an anti-dumping investigation into Chinese biodiesel imports. According to the Commission, EU companies have submitted evidence that biodiesel imports from China are coming into the EU at artificially low prices that local companies can't compete with. The probe further illustrates how the EU is now taking a more skeptical, confrontational approach to China, aligning it more closely with the U.S.

India-United States: In an interview with the *Financial Times*, Indian Prime Minister Modi for the first time responded to U.S. allegations that Indian agents tried to assassinate an expatriate Sikh separatist on U.S. soil. However, Modi appeared to play down the allegation, promising that his government would "look into" any evidence the U.S. provided and insisting that relations between the U.S. and India will continue to strengthen despite "a few incidents."

- Modi's nonchalant response suggests he wants U.S.-India relations to keep strengthening as both sides seek to counter China's increased geopolitical aggressiveness.
- For investors, closer relations between the U.S. and India will likely help open up opportunities in the Indian financial markets.

Colombia: The central bank cut its benchmark short-term interest rate to 13.00% yesterday, after keeping it at a nearly quarter-century high of 13.25% since May. According to Banco de la República Governor Leonardo Villar, he and five board members voted in favor of the rate cut, while two voted against. With the rate cuts, Colombia now joins other South American countries, including Brazil and Peru, that have begun to ease monetary policy.

France: The lower house of parliament yesterday approved President Macron's proposed immigration reform, but only after he toughened its restrictions enough to attract the votes of right-wing populists. The move sparked defections from scores of liberal legislators in Macron's own coalition, potentially portending political instability in France in the coming months.

- The French bill increases the government's power to deport foreigners and limits access to welfare and citizenship to dissuade asylum seekers from coming.
- More broadly, the U.K. and several other European countries are also tightening immigration restrictions as the region faces its biggest wave of migrant arrivals in years.
- Even in the U.S., right-wing populist Republicans have forced President Biden into negotiations to tighten refugee and immigrant rules as the price for his proposed bill providing more military aid to Ukraine and other U.S. allies.
- The tightened rules reflect the extent to which citizens in the developed Western countries are angry at the disruption and social change they perceive in times of mass immigration. Right-wing populists have responded to that anger throughout the West, forcing more traditional, centrist parties to tighten the rules.

United States-Mexico: Citing the need to shift personnel to handle the current wave of migrants coming across the southern border, U.S. Customs and Border Protection closed the railway bridges this week at Eagle Pass and El Paso, Texas, which respectively rank as the second and fourth busiest freight rail crossings with Mexico. Shippers and railroad industry groups warned the closures could disrupt more than one-third of U.S.-Mexican rail traffic, hitting industries from automobile manufacturing to farming.

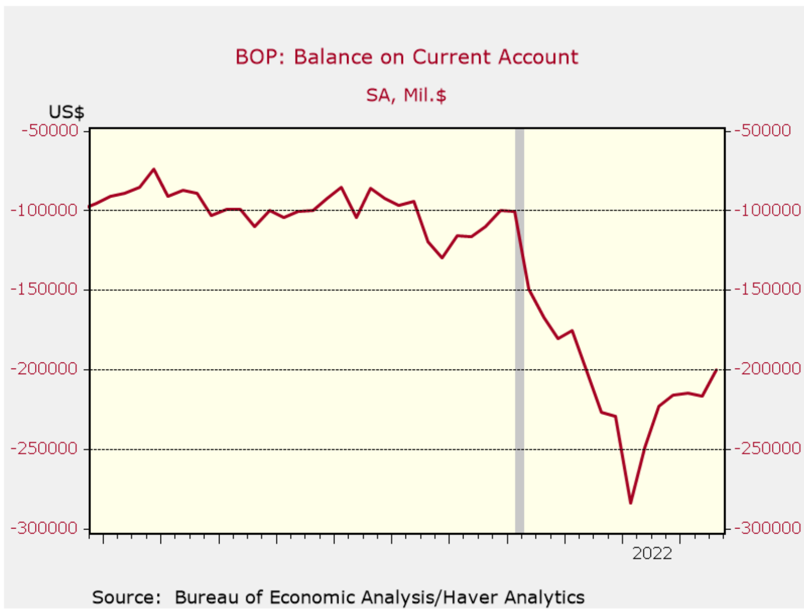
U.S. Population Growth: The Census Bureau has released an estimate that the U.S. population grew 0.5% this year, reaching 334.9 million as of June 30. The growth this year marked a slight acceleration from the 0.4% increase registered in 2022. That has helped keep the U.S. among the better-growing developed countries, many of which are seeing declines in their overall populations and work forces because of falling birth rates and higher average ages.

- Of course, the U.S. is also facing those challenges. As a result, there were only about 504,000 more births than deaths in the U.S. over the last year.
- The big difference for the U.S. is that it attracts so many immigrants. According to the Census Bureau, net migration into the U.S. came to 1.1 million over the last year. That means immigration accounted for about 70% of U.S. population growth in 2023, versus about 40% a decade ago.

U.S. Economic Releases

Demand for home loans dropped for the first time in six weeks, as interest rates falling slightly below 7% for first time since June failed to fuel a surge in applications. According to an index tracked by the Mortgage Bankers' Association (MBA), mortgage application fell 1.5% in the week ending December 15. Despite a recent dip to 6.83%, the average 30-year fixed-mortgage rate remains significantly above the sub-5% rates of 2022, dampening both refinancing and purchase activity. The MBA trackers reflect this, with refinancing applications falling 1.8% and purchase applications down 1.5% from the previous week.

Separately, the current account deficit narrowed from $216.8 billion to $200.8 billion in Q3 2023, falling short of expectations of $196.0 billion. The decline is related to weaker demand for U.S. import services, particularly in transportation and travel.



The chart above shows the balance on the current account. While import contraction is certainly a net positive for overall GDP growth, it's important to acknowledge the potential downside as it could also be a sign of weaker domestic consumption. A shrinking trade deficit fueled solely by fewer imports rather than a surge in exports, might indicate that American consumers are tightening their belts.

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	Existing Home Sales (annualized selling rate)	m/m	Nov	3.78m	3.79m	***
10:00	Existing Home Sales (monthly change)	m/m	Nov	-0.4%	-4.1%	**
10:00	Conf. Board Consumer Confidence	m/m	Dec	104.5	102.0	***
10:00	Conf. Board Present Situation	m/m	Dec	--	138.2	**
10:00	Conf. Board Expectations	m/m	Dec	--	77.8	**
Federal Reserve						
EST	Speaker or Event	District or Position				
12:00	Austan Goolsbee on WSJ Podcast	President of the Federal Reserve Bank of Chicago				
12:15	Patrick Harker Speaks in Radio Interview	President of the Federal Reserve Bank of Philadelphia				

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	Trade Balance	m/m	Nov	-¥776.9b	-¥662.5b	-¥661.0b	***	Equity and bond neutral
	Exports	m/m	Nov	-0.2%	1.6%	1.4%	*	Equity bearish, bond bullish
	Imports	m/m	Nov	-11.9%	-12.5%	-8.6%	*	Equity bearish, bond bullish
Australia	Westpac Leading Index	m/m	Nov	-0.07%	-0.03%	-0.04%	**	Equity and bond neutral
New Zealand	ANZ Consumer Confidence Index	m/m	Dec	93.1	91.9		**	Equity and bond neutral
EUROPE								
Eurozone	EU27 New Car Registrations	y/y	Nov	6.7%	14.6%		***	Equity and bond neutral
	Current Account	m/m	Oct	€33.8 b	€31.2 b		*	Equity and bond neutral
	Construction Output	y/y	Oct	-0.7%	-0.3%	0.7%	*	Equity bearish, bond bullish
Germany	PPI	y/y	Nov	-7.9%	-11.0%	-7.5%	**	Equity and bond neutral
	GfK Consumer Confidence	m/m	Jan	-25.1%	-27.8%	-27.6%	**	Equity and bond neutral
UK	CPI	y/y	Nov	3.9%	4.6%	4.3%	***	Equity bullish, bond bearish
	Core CPI	y/y	Nov	5.1%	5.7%	5.6%	***	Equity and bond neutral
	Retail Price Index	m/m	Nov	377.3	377.8	378.5	**	Equity and bond neutral
	RPI YoY	y/y	Nov	5.3%	6.1%	5.6%	**	Equity and bond neutral
AMERICAS								
Canada	CPI YoY	m/m	Nov	3.1%	3.1%	2.9%	***	Equity and bond neutral
	Industrial Prices	m/m	Nov	-0.4%	-1.0%	-0.9%	**	Equity and bond neutral
	Raw Material Prices	m/m	Nov	-4.2%	-2.5%	-2.6%	*	Equity bullish, bond bearish
Mexico	International Reserves Weekly	w/w	15-Dec	-$210888m	$209287m		*	Equity and bond neutral
	Retail Sales	y/y	Oct	3.4%	2.3%	2.0%	***	Equity bullish, bond bearish
Brazil	Economic Activity Index	y/y	Oct	1.54%	0.32%	0.09%	**	Equity bullish, bond bearish

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	563	0	Down
3-mo T-bill yield (bps)	523	521	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 (%)	3.88	3.93	-0.05	Flat
Euribor/OIS spread (bps)	392	394	-2	Down
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Up			Up
Pound	Down			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
PBOC 1-Year Loan Prime Rate	3.450%	3.450%	3.450%	On Forecast
PBOC 5-Year Loan Prime Rate	4.200%	4.200%	4.200%	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.

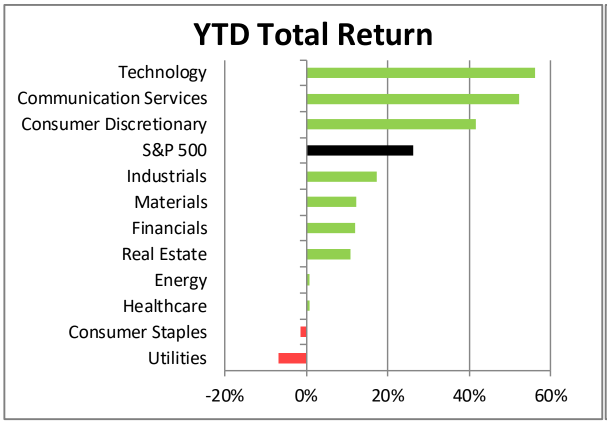
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$80.14	$79.23	1.15%	
WTI	$74.91	$73.94	1.31%	
Natural Gas	$2.48	$2.49	-0.68%	
Crack Spread	$24.93	$25.91	-3.78%	
12-mo strip crack	$24.60	$25.23	-2.47%	
Ethanol rack	$1.82	$1.83	-0.43%	
Metals				
Gold	$2,035.18	$2,040.35	-0.25%	
Silver	$24.02	$24.05	-0.13%	
Copper contract	$390.05	$389.80	0.06%	
Grains				
Corn contract	$474.00	$472.75	0.26%	
Wheat contract	$622.50	$622.75	-0.04%	
Soybeans contract	$1,324.50	$1,322.50	0.15%	
Shipping				
Baltic Dry Freight	2,219	2,288	-69	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.3		
Gasoline (mb)		1.4		
Distillates (mb)		0.7		
Refinery run rates (%)		0.3%		
Natural gas (bcf)		-82		

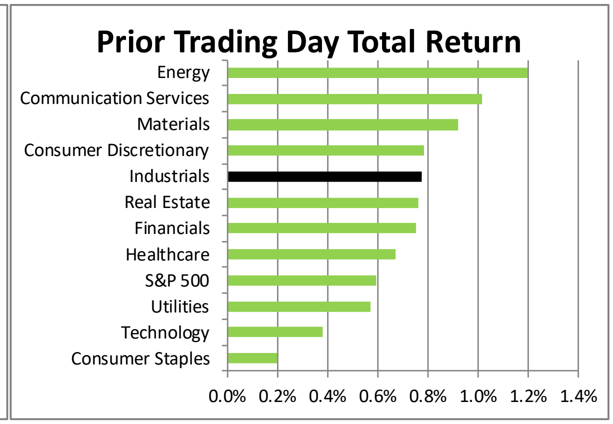
Weather

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 12/19/2023 close)

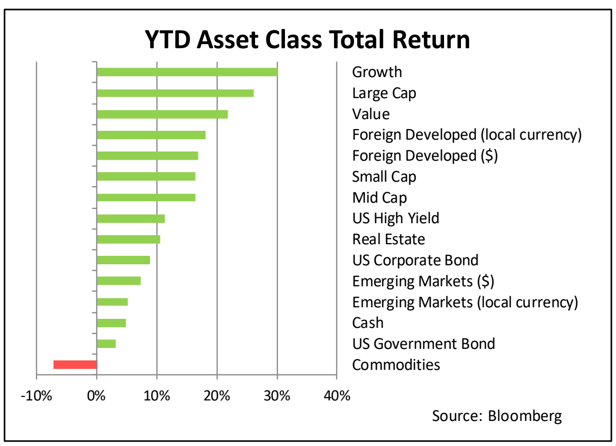




(Source: Bloomberg)

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 12/19/2023 close)

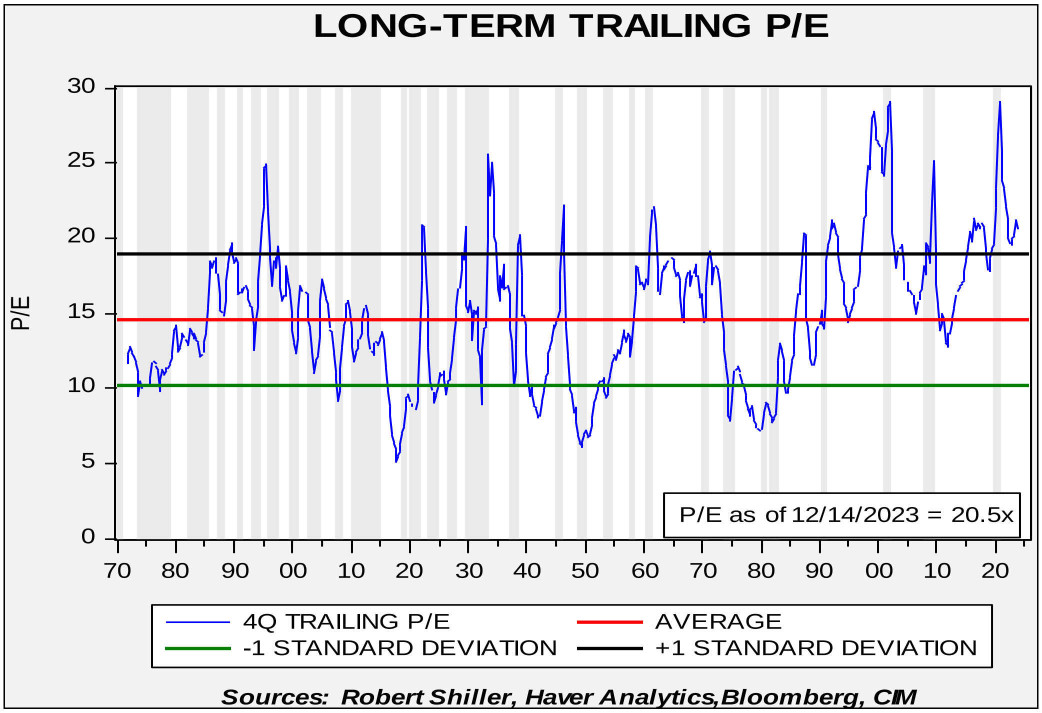


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.