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: January 3, 2024—9:30 AM EST] Global equity markets are mostly lower this morning. In Europe, the Euro Stoxx 50 is down 1.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.8%. Chinese markets were mixed, with the Shanghai Composite up 0.2% from its previous close and the Shenzhen Composite down 0.6%. 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)

Our *Comment* today opens with recent reports suggesting U.S. and European leaders are shifting their focus from helping Ukraine expel the invading Russians to simply helping it defend the territory it still holds. We next review a range of other international and U.S. developments with the potential to affect the financial markets today, including an Israeli strike on a Hamas leader in Lebanon that raises the risk of escalation and new private-sector data confirming the recent slowdown in U.S. labor demand.

Russia-Ukraine War: Now that Russian and Ukrainian forces have fought to an apparent draw and many U.S. and European politicians staunchly oppose further aid to Kyiv, President Biden and allied leaders have reportedly begun to shift their focus toward bolstering Ukraine's ability to defend the territory it still holds, rather than pushing the Russians out of the country. Their aim is to bolster Kyiv's bargaining position when peace negotiations eventually come about.

- In our view, the U.S. and European resistance to further aid for Ukraine is essentially political and strategic, rather than economic.
    - The officials who support Ukraine are often traditional center-left or center-right establishment elites. Those who oppose more aid to Ukraine are often on the far left or the far right. U.S. and European far-right populists have been especially energized by working class anger over post-Cold War globalization, migration, de-industrialization, and income and wealth inequality. Those populist isolationists are often strongly opposed to more assistance for Ukraine.
    - Some of international relations theorists also argue that while the U.S. and Europe might face an existential threat if Ukraine lost its independence to Russia, the West wouldn't face much additional risk if Russia merely holds on to the territory it has already conquered.
- In contrast with the very real political pushback and strategic disagreements, the U.S. and European aid to Ukraine so far in the war is small from an economic standpoint. For example, the U.S.'s total assistance of $75.4 billion to date equals:
    - About 0.16% of the estimated $46.116 trillion in U.S. gross domestic product from the start of Russia's invasion until late 2023;
    - Roughly 0.65% of the U.S. government's total spending of about $11.689 trillion over the same period;
    - About 5.1% of the U.S.'s defense spending of $1.491 trillion over that period; or
    - Approximately the same amount that the U.S. spent on health research in that period, and well below what it spent on disaster relief.
- For investors, the longer-term strategic implications of reduced Western aid for Ukraine may be most important.
    - Recent research from the Institute for the Study of War notes that if the conflict is frozen with Russia retaining the almost 20% of Ukrainian territory it now holds in the east and south, President Putin would almost certainly use the freeze to rebuild his forces for a new invasion in the future.
    - That would likely require the U.S. and NATO to drastically bulk up their defenses in Europe, further bolstering our thesis of higher future defense spending and new investment opportunities in the defense sector.

Israel-Hamas Conflict: In an apparent Israeli drone strike, a top Hamas political leader and at least two of the group's military commanders were killed in an explosion in the suburbs of Beirut yesterday. Since the assassinations took place in an area dominated by the Iran-backed Hezbollah militant group, which previously warned against any Israeli strikes in Lebanon, the incident further ratchets up the risk of the conflict spreading beyond the Gaza Strip.

- Separately, the Turkish government yesterday arrested nearly three dozen people on suspicion of helping Israel's intelligence services target Palestinians living in Turkey for assassination.
- If true, it would be just the latest in a rash of aggressive — and risky — extraterritorial assassination programs carried out by countries ranging from Russia to India.

European Union: José Manuel Campa, head of the European Banking Authority, said in an interview that the regulator is launching an investigation into the relationship between banks and non-bank financial institutions (NBFIs) such as hedge funds, private equity firms, and cryptocurrency groups. The goal is to determine if there is any risk that financial stress in the NBFIs could spread to banks. Importantly, the initiative may encourage similar scrutiny in the U.S., with the possibility of new regulations down the road.

United Kingdom: According to a union leader representing the junior physicians who yesterday launched a planned seven-day strike against the National Health Service, the doctors would accept a 35% pay hike spread over several years, rather than all at once. The statement could potentially diffuse the strike, which would be the longest in NHS history. It could also help bring an end to the U.K.'s year-long labor unrest.

- Meanwhile, research firm Kantar estimated that British grocery prices have softened considerably in recent months. The firm said December grocery prices in the U.K. were up just 6.7% year-over-year, compared with 9.1% in November.
- Easing inflation could not only take the wind out of union wage demands, but it could also prompt an eventual cut in the Bank of England's benchmark interest rate.

United States-Netherlands-China: ASML (ASML, $716.92), the world's top manufacturer of fabricating equipment for advanced semiconductors, yesterday said the Dutch government has revoked some of its licenses to export deep ultraviolet lithography systems to China. Under U.S. pressure to help constrain China's ability to make advanced chips, the Dutch government already bans ASML from selling its top-of-the-line extreme ultraviolet lithography systems to China. Revoking the licenses for less advanced systems shows the U.S.-China tech war is expanding.

- The U.S.-China geopolitical rivalry, and especially the U.S. clampdown on technology flows that could help China's military, continue to present risks for investors who own Chinese assets or have positions in companies that depend on Chinese capital or markets.
- As proof of that, ASML's depository receipts in the U.S. fell 5.3% yesterday, as the loss of DUV export licenses convinced investors that even more of the company's China revenue could be at risk.

United States-China: Reflecting China's growing competitiveness in making electric vehicles, Shenzhen-based BYD (BYDDY, $53.70) for the first time delivered more all-electric cars than U.S. rival Tesla (TSLA, $248.42) in the fourth quarter of 2023. While China still lags in some advanced technology industries, in part because of Western restrictions, it continues to come on strong in EVs. As Chinese EV exports increasingly threaten other countries' auto industries, the question is whether, when, and how those countries might clamp down on the Chinese cars.

- On a related note, the *Financial Times* this morning carries an article in which top officials from General Motors (GM, $36.05) and Nissan (NSANY, $7.80) warn against former President Trump's plan to gut the Inflation Reduction Act's subsidies for EVs made substantially in the U.S.
- The officials warn that if the subsidies are revoked, the recent U.S. investment boom in EV-related factories will end, inward foreign investment will weaken, and consumers will be tempted to buy vehicles from China and elsewhere.

U.S. Energy Regulation: Oil giant Chevron (CVX, $149.48) yesterday warned that it will book impairment charges of $3.5 billion to $4.0 billion in the fourth quarter, in part to reflect the impact of tough regulations in California. The California issue is a reminder of the regulatory drag that can hit energy firms operating in the U.S. In addition, Chevron said the charges would also reflect hiccups in the disposal of certain assets in the Gulf of Mexico.

U.S. Labor Market: Recruitment site Indeed has released data showing that its total job postings at the end of 2023 were down 15% from one year earlier. However, the data shows that the pace of decline slowed in the second half of the year, and that overall postings remain more than one-quarter higher than before the pandemic. In sum, the report helps confirm that labor demand slowed markedly in 2023, especially early in the year. As we argued in our outlook, slowing momentum will leave the economy more susceptible to a recession in 2024.

U.S. Stock Market: On the year's first day of trading yesterday, the NASDAQ Composite price index dropped 1.6%, as some large, growthy technology stocks sold off sharply. The stodgier Dow Industrials rose marginally to a new record high of 37,715.04. In fact, the Dow has now risen for nine straight weeks.

- Of course, one day does not make a trend. Nevertheless, we note that recent action and yesterday's trading in particular were consistent with the arguments we made in our recent Outlook for 2024.
- In our Outlook, we argued that the run-up in large-cap tech and artificial intelligence stocks last year has left them richly priced. Going into the new year, we think investors are likely to see better opportunities in value and small-cap equities.

U.S. Economic Releases

Demand for home loans plummeted last week as potential buyers waited for borrowing costs to fall further amidst rising house prices. According to the Mortgage Bankers' Association, mortgage applications dropped 10.7% in the week ending December 29. The significant drop in loan requests reflects anticipation of further rate declines this year, fueled by the Fed's potential pivot towards an easier monetary policy. The latest average 30-year fixed mortgage rate fell 5bps from the prior week to 6.71%. That said, the MBA tracker for purchases and refinancing fell 7.6% and 18.1%, from the prior week, respectively.

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	ISM Manufacturing PMI	m/m	Dec	47.1	46.7	**
10:00	ISM Manufacturing PMI - Prices Paid	m/m	Dec	49.5	49.9	**
10:00	ISM Manufacturing PMI - Employment	m/m	Dec	46.5	45.8	*
10:00	ISM Manufacturing PMI - New Orders	m/m	Dec	49.1	48.3	**
10:00	JOLTS Job Openings	m/m	Nov	8821k	8773k	**
	Wards Total Vehicle Sales	m/m	Dec	15.5m	15.32m	*
Federal Reserve						
EST	Speaker or Event	District or Position				
14:00	FOMC Meeting Minutes	Federal Reserve Board				

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								
India	S&P Manufacturing PMI	m/m	Dec	54.9	56.0		***	Equity and bond neutral
EUROPE								
Germany	Unemployment Change	m/m	Dec	5.0k	22.0k	21.0k	***	Equity bearish, bond bullish
	Unemployment Claims Rate	m/m	Dec	5.9%	5.9%	5.8%	**	Equity and bond neutral
Switzerland	Domestic Sight Deposits CHF	w/w	29-Dec	453.2b	453.6b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	29-Dec	462.9b	462.2b		*	Equity and bond neutral
Switzerland	PMI Manufacturing	y/y	Dec	43.0	42.1	43.0	***	Equity and bond neutral
AMERICAS								
Canada	S&P Global Canada Manufacturing PMI	m/m	Dec	45.4	47.7		***	Equity bearish, bond bullish
Mexico	S&P Global Mexico Manufacturing PMI	m/m	Dec	52.0	52.5		***	Equity and bond neutral
Brazil	Current Account Balance	m/m	Nov	-$1553m	-$230m	-$39m	**	Equity and bond neutral
	Foreign Direct Investment	m/m	Nov	$7780m	$3306m	$4000m	**	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)	559	559	0	Down
3-mo T-bill yield (bps)	522	522	0	Down
U.S. Sibor/OIS spread (bps)	533	533	0	Down
U.S. Libor/OIS spread (bps)	532	531	1	Down
10-yr T-note (%)	3.97	3.93	0.04	Flat
Euribor/OIS spread (bps)	391	391	0	Down
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Down			Up
Pound	Flat			Up
Franc	Down			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.

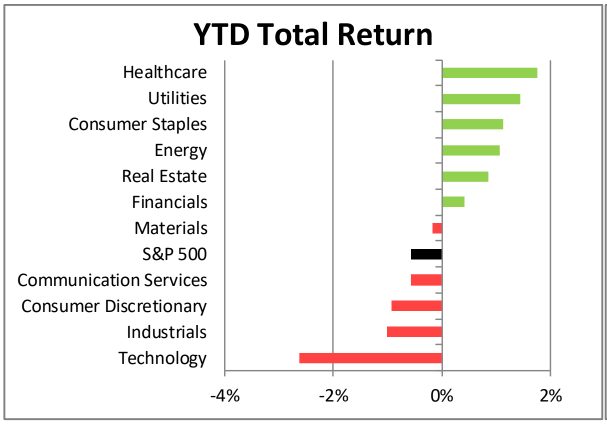
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$76.60	$75.89	0.94%	
WTI	$70.95	$70.38	0.81%	
Natural Gas	$2.61	$2.57	1.67%	
Crack Spread	$23.73	$23.61	0.49%	
12-mo strip crack	$23.72	$23.59	0.57%	
Ethanol rack	$1.71	$1.74	-1.27%	
Metals				
Gold	$2,046.26	$2,058.96	-0.62%	
Silver	$23.31	$23.66	-1.49%	
Copper contract	$384.60	$388.05	-0.89%	
Grains				
Corn contract	$464.00	$463.75	0.05%	
Wheat contract	$603.50	$606.75	-0.54%	
Soybeans contract	$1,271.75	$1,273.50	-0.14%	
Shipping				
Baltic Dry Freight	2,093	2,094	-1	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.9		
Gasoline (mb)		-0.3		
Distillates (mb)		0.0		
Refinery run rates (%)		0.1%		
Natural gas (bcf)		-79		

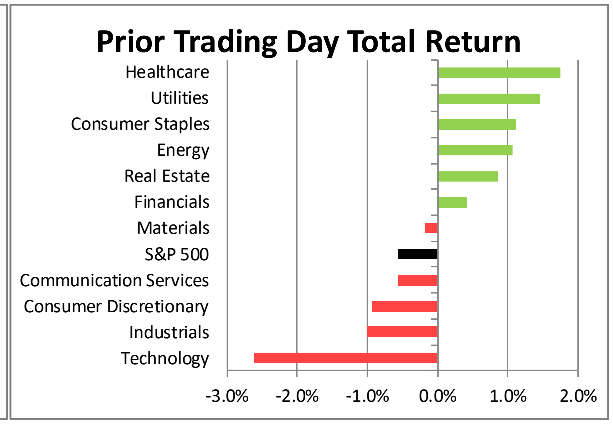
Weather

The 6-10 and 8-14 day forecasts currently call for cooler-than-normal temperatures in most of the country, with warmer-than-normal temperatures throughout the Midwest and East Coast. The precipitation outlook calls for wetter-than-normal conditions across most of the country.

Data Section

U.S. Equity Markets – (as of 1/2/2024 close)

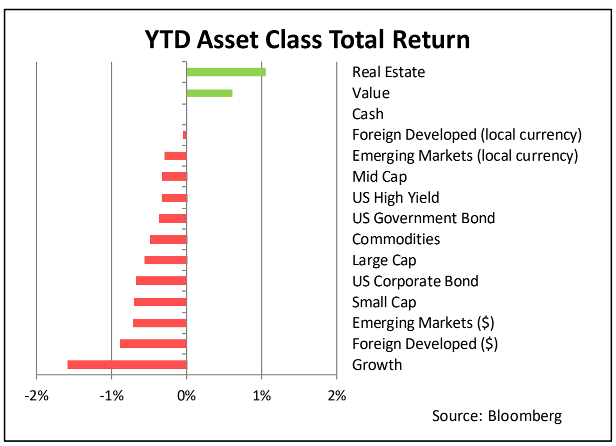




(Source: Bloomberg)

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 1/2/2024 close)

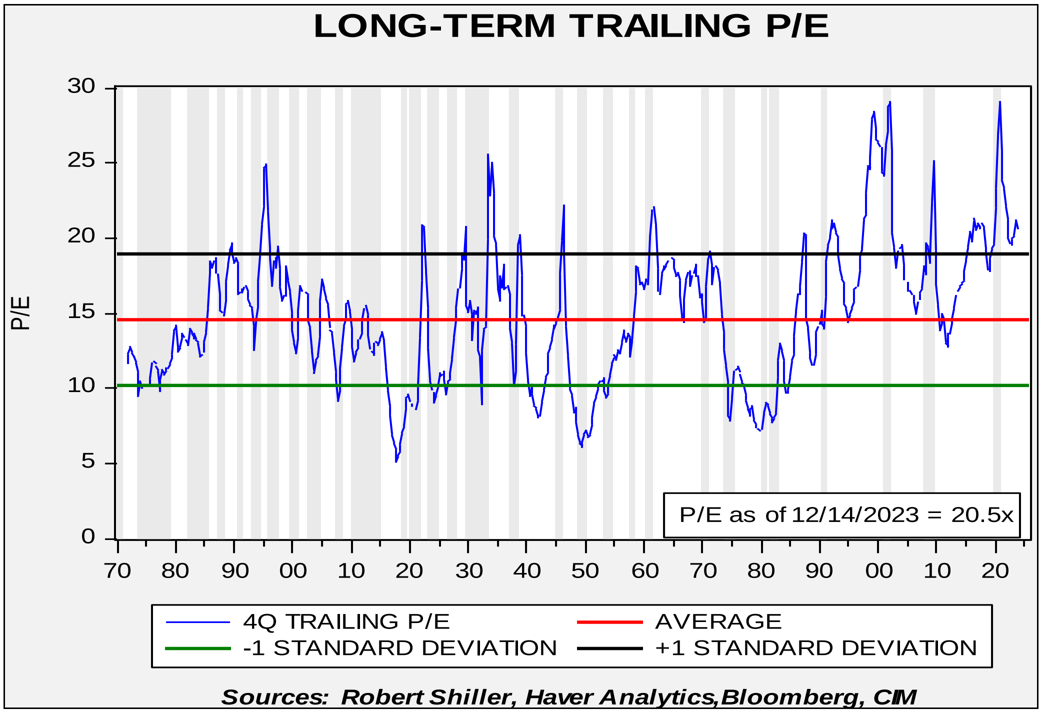


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.