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 4, 2024—9:30 AM EST] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.1%. Chinese markets were lower, with the Shanghai Composite down 0.4% from its previous close and the Shenzhen Composite down 0.8%. 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* (12/18/2023) (with associated *Confluence of Ideas* podcast)

Good morning! Global markets hum with cautious optimism as investors dissect the latest FOMC minutes, while the European football world holds its breath for Kylian Mbappé's blockbuster transfer decision. In today's *Comment*, we delve into the Fed's policy signals, why Europe's central bank deserves a closer look, and the escalating tensions in the Red Sea. As always, our comprehensive report equips you with the latest domestic and international data releases.

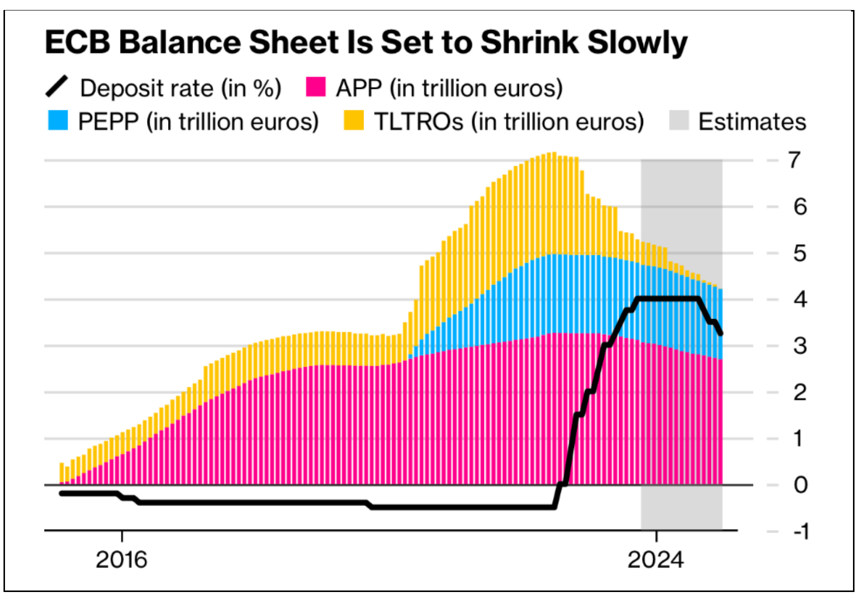
Pivot or Not? While some investors anticipate swift rate cuts, FOMC minutes suggest a more gradual and data-dependent approach, prompting concerns about unrealistic expectations in the market.

- Wednesday's minutes revealed that policymakers acknowledged potential 2024 rate cuts while stressing ongoing restrictive policy for now. Inflation progress toward the 2% target was noted, but officials demanded further proof of easing pressures before declaring victory. However, optimism was tempered by concerns from others within the committee. They flagged potential risks to inflation from global energy/food prices, geopolitical developments, a potential rebound in core goods, and effects of nearshoring. While some saw the labor market's cooling, which was further buttressed by the JOLTS report's low job vacancy figures, as evidence for dovishness, others remained cautious, emphasizing the need for comprehensive data before changing course.
- Beyond conventional economic gauges, Fed officials highlighted a potentially disruptive factor influencing their policy decisions — the looming commercial real estate debt wall. Over $117 billion of office building loans in the U.S. face maturity in 2024, according to the Mortgage Bankers Association. Issued during an era of low rates, these loans now burden properties whose value has fallen, raising concerns about potential losses and limited lender capacity for extensions. The ongoing crisis in CRE markets adds a layer of complexity to the Fed's decision-making process, as they must weigh not just inflation and employment risks but also financial stability concerns.

- The 2019 mid-cycle adjustment by the Federal Reserve serves as a reminder that an outright recession isn't always necessary for them to cut rates. Following a series of hikes to normalize monetary policy during that period, Fed Chair Jerome Powell explained the policy shift as a tactical move to mitigate the dampening effects of international developments on U.S. growth, manage downside risks to the economy, and support a symmetrical return to the Fed's 2% inflation target. However, complications within the repo market emerged as a key driving force behind the decision. With inflation exceeding its target, the central bank is likely to prioritize price stability over short-term growth concerns, potentially leading to less aggressive rate cuts than the market anticipates.

ECB Bluffing? After pulling back on bets for U.S. rate cuts, investors should consider revising their expectations for the European Central Bank as well.

- Growth expectations have taken center stage in shaping rate expectations for the European Central Bank (ECB). After a promising first half of 2023, the eurozone economy stumbled in the third quarter, with GDP contracting at an annualized rate of 0.1%. This slowdown was further underscored by the recent Purchasing Manager's Index (PMI) reading of 47.6, dipping below the 50 threshold that indicates a contraction in private sector activity. These indicators have significantly increased the possibility of the eurozone slipping into a technical recession, defined as two consecutive quarters of negative GDP growth. As a result, bets for rate hikes have faded, and speculation about potential easing measures is rising.
- Investors dismissing the ECB's commitment to a tight policy may be overlooking a hidden weapon — the lingering Pandemic Emergency Purchase Programme (PEPP). While the bank has hiked rates to record highs and started shrinking its balance sheet, PEPP's ongoing reinvestments of maturing securities suggest it hasn't fully embraced monetary tightening. Even though net purchases ceased in 2022, PEPP has continued to reinvest maturing securities. Despite its initial aim of preventing fragmentation, PEPP's ongoing presence has inadvertently provided the eurozone with a buffer against the potential negative impacts of tighter policy on its financial system.

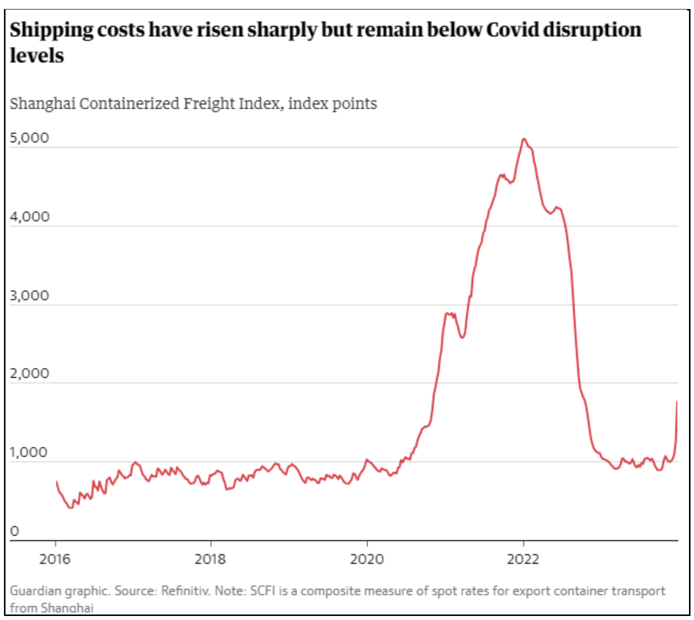


(Source: Bloomberg)

- While the eurozone's financial system is better equipped to handle rising rates compared to the U.S., a looming debt maturity wall in their junk bond market could still force cuts. The share of lower-rated firms facing debt repayments within the next three years has risen to its highest level since 2015, particularly in high-yield debt for telecom, consumer staples, and real estate. This significant vulnerability could lead policymakers to rethink monetary policy stance. As a result, we maintain that aggressive rate cuts as soon as the market expects are unlikely in the near term. However, we acknowledge that conditions may change in the future.

Middle East Uncertainty: Houthi rebel attacks on commercial vessels in the Red Sea have spooked markets, raising fears of a wider Middle Eastern conflict.

- The U.S. and its allies have threatened military action against the Houthi rebels if the group continues its attack on vessels traveling through the Red Sea. The warning comes after the Yemen-based military group carried out at least 23 attacks since the fighting broke out between Israel and Hamas. In addition to warning the rebels, the U.S. also aimed criticism toward Iran, viewed as the Houthis' primary financial backer, by warning of repercussions if Iran continues to support these attacks. Prior to the warning, the U.S. Navy was forced to use self-defense against rebel boats, killing 10 Houthis in the process.
- Simmering tensions in the Red Sea threaten a vital global trade route, raising concerns about supply disruptions and potential inflationary pressures. The vital Bab el-Mandeb Strait, nestled between the Arabian Peninsula and Africa, funnels 12% of global trade, including containerized goods and oil, towards the crucial Suez Canal. Recent attacks on shipping have forced rerouting, causing over $1 million in extra fuel costs, rising insurance premiums, and delaying deliveries. While below the chaos of the pandemic, these disruptions are no less worrying. Increased shipping costs and delays ripple through supply chains, potentially translating into higher consumer prices.

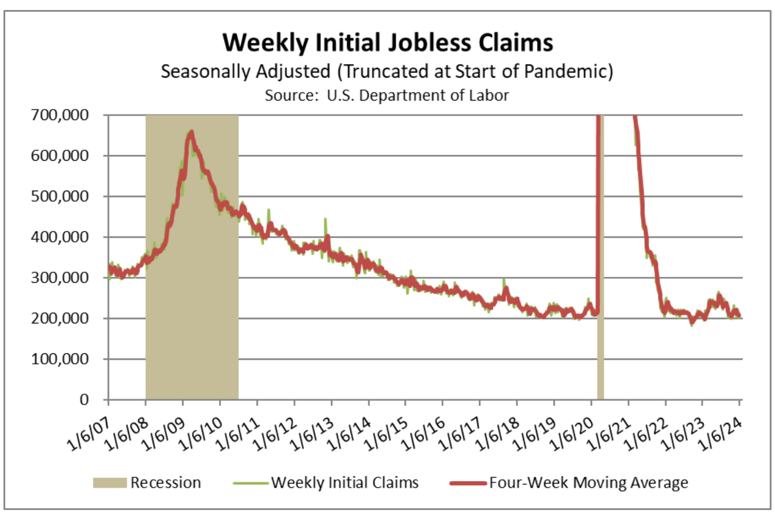


- While current oil prices and consumer spending trends haven't fueled a major inflation hike due to the conflict in the Red Sea, escalating tensions could quickly disrupt supply chains or amplify energy market volatility, triggering a more pronounced surge in price pressures. Although crude oil has seen a 6% increase recently, it remains below $80 a barrel, and slowing global demand, evident in the economic slowdown in Europe and China, could provide some downward pressure on global prices. However, the conflict's unpredictable nature keeps the inflation threat on the table, requiring close monitoring of its potential economic fallout.

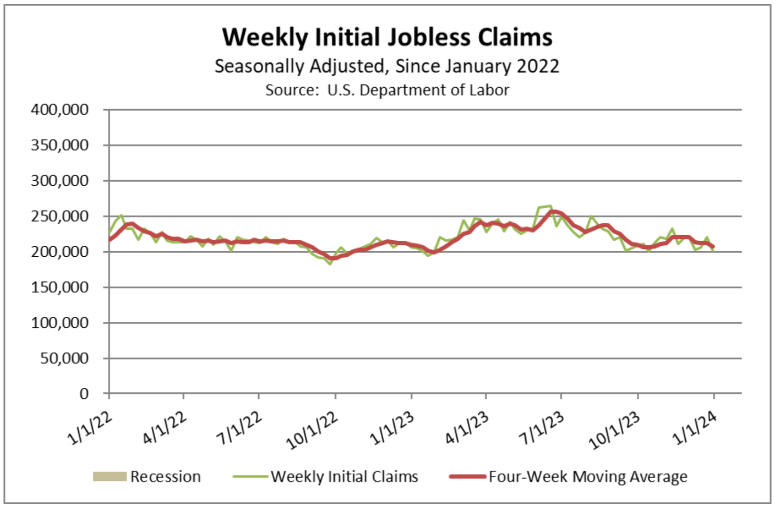
Other news: Former President Donald Trump faces a crucial legal hurdle as he pushes the Supreme Court to decide if Colorado can remove his name from its presidential ballot. The dispute reinforces our view that the outcome of this year's presidential election will be less predictable than previous contests. Meanwhile, economic cracks widen in China as the world's second-largest economy grapples with a property market slump and declining exports. Chinese provinces have been forced to pump billions into their fragile banking system, raising concerns about a prolonged slowdown and its global ripple effects.

U.S. Economic Releases

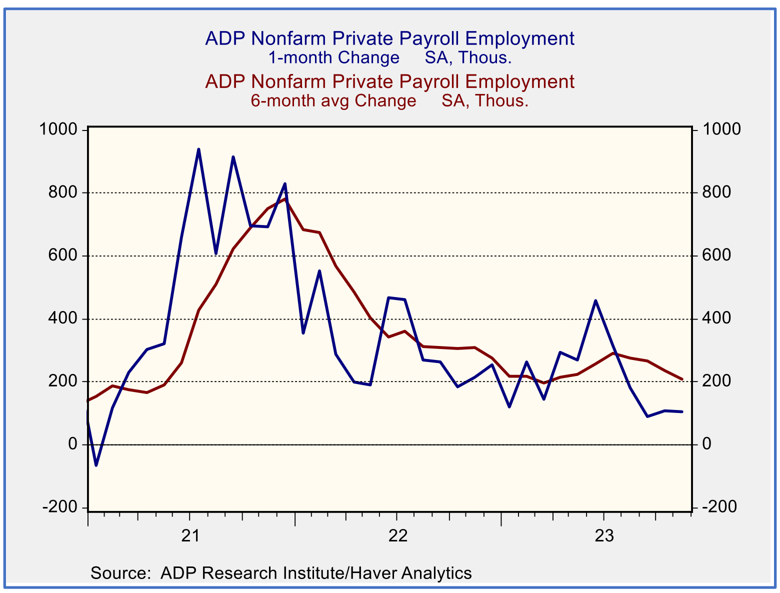
In the week ended December 30, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 202,000, lower than both the expected level of 216,000 and the previous week's revised level of 220,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to a nearly three-month low of 207,750. Meanwhile, in the week ended December 23, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) fell to 1.855 million, below the anticipated reading of 1.881 million and the prior week's revised reading of 1.886 million. The chart below shows how initial jobless claims have fluctuated since just before the Great Financial Crisis. The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



To provide more detail on recent trends, the following chart shows how initial jobless claims have changed just since the beginning of 2022.



Separately, the ADP Research Institute estimated that ***private payroll employment*** rose in December by a seasonally adjusted 164,000, beating the expected gain of 125,000 and accelerating sharply from the revised November increase of 101,000. ADP's estimate is widely seen as an indicator of what to expect when the Labor Department releases its measure of nonfarm payrolls on Friday. The chart below shows ADP's estimate of private payrolls since the beginning of 2021.



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
9:45	S&P Services PMI	m/m	Dec F	51.3	51.3	**
9:45	S&P Composite PMI	m/m	Dec F		51.0	**
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 F	47.9	47.7		***	Equity and bond neutral
South Korea	Foreign Reserves	m/m	Dec	$420.15b	$417.08b		*	Equity and bond neutral
China	Caixin Composite PMI	m/m	Dec	52.6	51.6		**	Equity and bond neutral
	Caixin Services PMI	m/m	Dec	52.9	51.5	51.6	**	Equity bullish, bond bearish
EUROPE								
Eurozone	HCOB Eurozone Services PMI	m/m	Dec F	48.8	48.1	48.1	**	Equity bullish, bond bearish
	HCOB Eurozone Composite PMI	m/m	Dec F	47.6	47.0	47.0	*	Equity bullish, bond bearish
Germany	HCOB Germany Services PMI	m/m	Dec F	49.3	48.4	48.4	**	Equity bullish, bond bearish
	HCOB Germany Composite PMI	m/m	Dec F	47.4	46.7	46.7	*	Equity bullish, bond bearish
	CPI	y/y	Dec P	3.7%	3.2%	3.7%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Dec P	3.8%	2.3%	3.9%	**	Equity and bond neutral
France	CPI, EU Harmonized	y/y	Dec P	4.1%	3.9%	4.1%	**	Equity and bond neutral
	CPI	y/y	Dec P	3.7%	3.5%	3.7%	***	Equity and bond neutral
	HCOB France Services PMI	m/m	Dec F	45.7	44.3	44.3	**	Equity bullish, bond bearish
	HCOB France Composite PMI	m/m	Dec F	44.8	43.7	43.7	*	Equity bullish, bond bearish
Italy	HCOB Italy Composite PMI	m/m	Dec	48.6	48.1	48.2	*	Equity and bond neutral
	HCOB Italy Services PMI	m/m	Dec	49.8	49.5	50.0	**	Equity and bond neutral
UK	Mortgage Approvals	m/m	Nov	50.1k	47.4k	48.5k	***	Equity and bond neutral
	S&P Global UK Services PMI	m/m	Dec F	53.4	52.7	52.7	**	Equity and bond neutral
	S&P Global UK Composite PMI	m/m	Dec F	52.1	51.7	51.7	**	Equity and bond neutral
AMERICAS								
Mexico	International Reserves Weekly	w/w	29-Dec	$212762m	$211509m		*	Equity and bond neutral
Brazil	Total Outstanding Loans	m/m	Nov	5655b	5594b	5606b	**	Equity and bond neutral
	S&P Global Brazil Composite PMI	y/y	Dec	50.0%	50.7%		***	Equity and bond neutral
	S&P Global Brazil Services PMI	m/m	Dec	50.5%	51.2%		***	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)	523	523	0	Down
U.S. Sibor/OIS spread (bps)	533	533	0	Down
U.S. Libor/OIS spread (bps)	532	532	0	Down
10-yr T-note (%)	3.95	3.92	0.03	Flat
Euribor/OIS spread (bps)	393	391	2	Down
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Down			Up
Pound	Up			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.

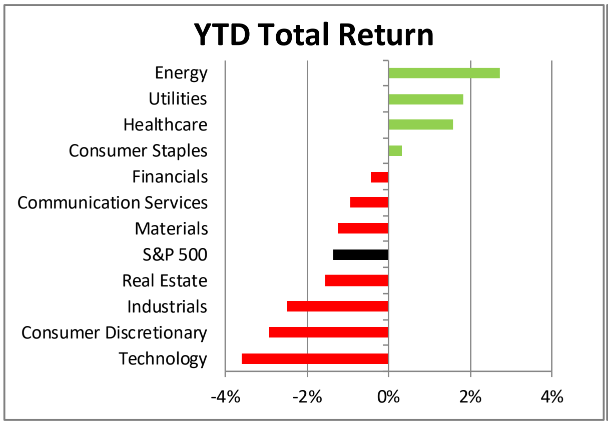
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$78.97	$78.25	0.92%	
WTI	$73.53	$72.70	1.14%	
Natural Gas	$2.78	$2.67	4.35%	Demand Optimism
Crack Spread	$23.84	$23.74	0.40%	
12-mo strip crack	$23.85	$23.86	-0.06%	
Ethanol rack	$1.72	$1.72	0.03%	
Metals				
Gold	$2,045.89	$2,041.49	0.22%	
Silver	$22.99	$22.99	-0.02%	
Copper contract	$384.15	$386.15	-0.52%	
Grains				
Corn contract	$465.25	$465.25	0.00%	
Wheat contract	$596.25	$600.25	-0.67%	
Soybeans contract	$1,274.25	$1,277.00	-0.22%	
Shipping				
Baltic Dry Freight	2,091	2,093	-2	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.0		
Gasoline (mb)		-1.7		
Distillates (mb)		-1.1		
Refinery run rates (%)		-0.4%		
Natural gas (bcf)		-35		

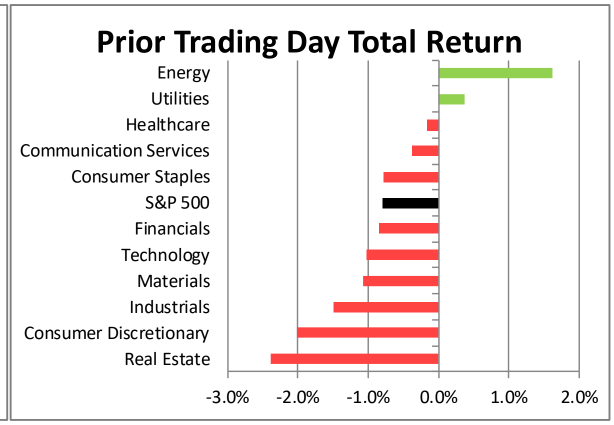
Weather

The 6-10 and 8-14 day forecasts currently call for cooler-than-normal temperatures throughout the entire country west of the Mississippi River, with warmer-than-normal temperatures in the Northeast and southern Florida. The precipitation outlook calls for wetter-than-normal conditions everywhere except California and Texas, where precipitation levels are expected to be normal.

Data Section

U.S. Equity Markets – (as of 1/3/2024 close)

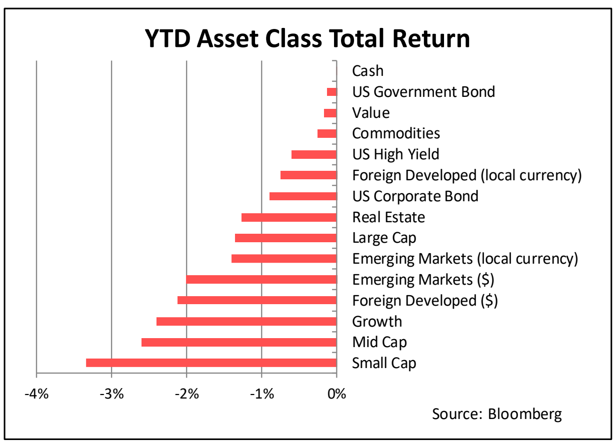




(Source: Bloomberg)

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 1/3/2024 close)

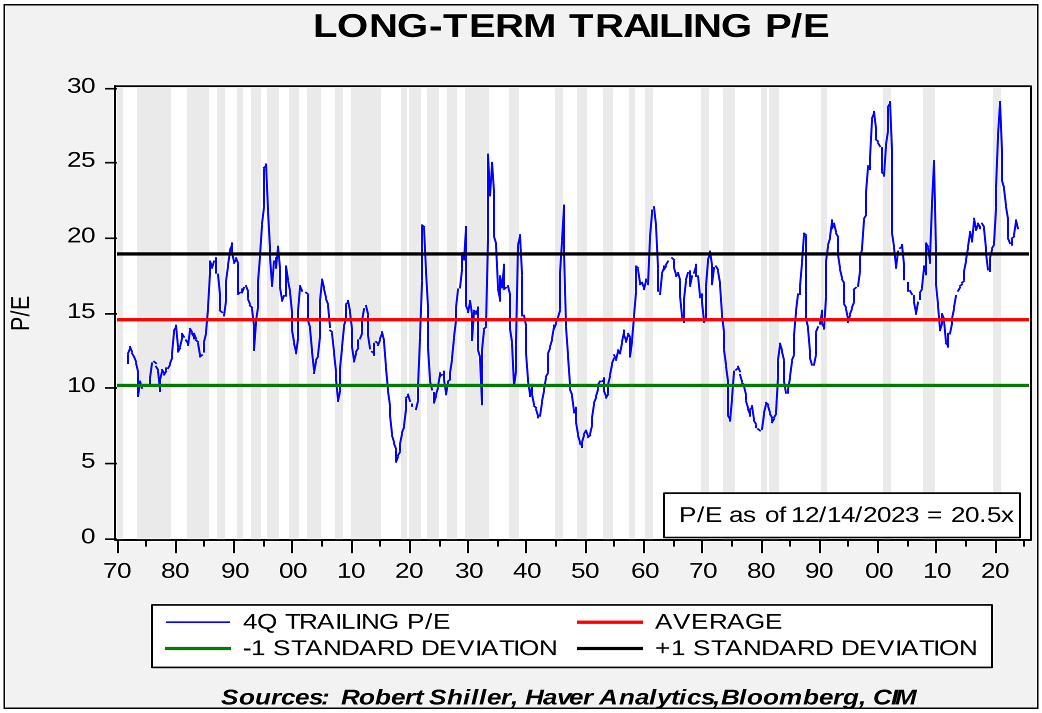


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.