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 5, 2024—9:30 AM EST] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is down 0.9% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.7%. Chinese markets were lower, with the Shanghai Composite down 0.9% from its previous close and the Shenzhen Composite down 1.34%. U.S. equity index futures are signaling a lower open.

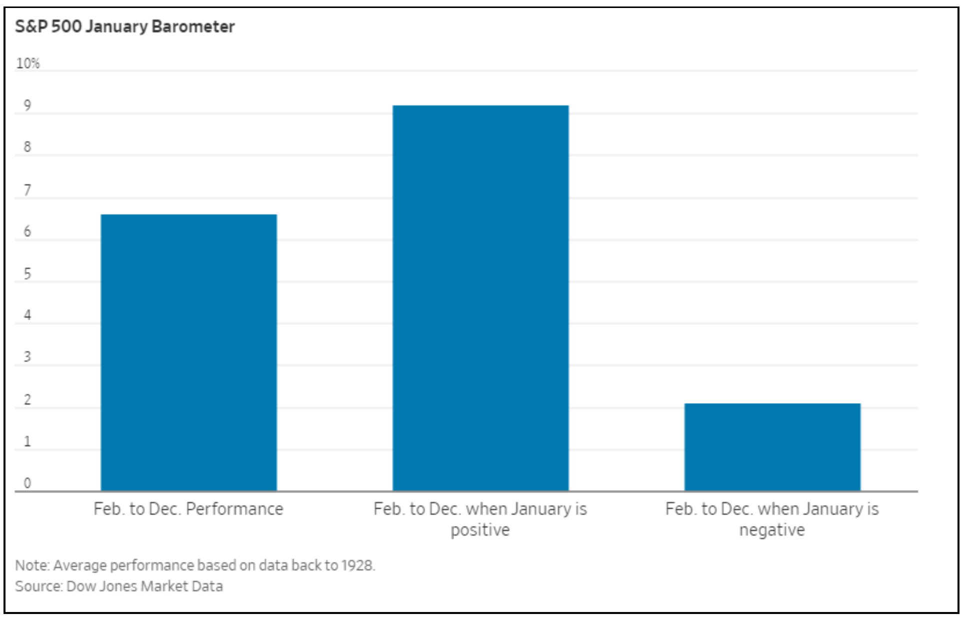
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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)

Good morning! December jobs bury the bull market's hopes, while Crosby and Bedard steal the NHL All-Star spotlight. In today's *Comment*, we dive deep into the mysteries of the January Barometer, explore why the Magnificent Seven's reign may be nearing its end, and analyze how Ukraine war fatigue might pave the way for de-escalation in Europe. As always, our comprehensive report encompasses the latest domestic and international data releases.

January Gloom: Equity prices are on track to finish the week down in a bad omen for financial markets.

- The weak start to January raises concerns about the rest of the year. Data from 1954 to 2023 reveals an unsettling pattern — in 11 out of the last 17 occurrences when January saw declines in both the first week and month as a whole, the S&P 500 finished the year lower. Rising interest rate concerns, fueled by mixed economic data, are driving this bearish sentiment. While the latest JOLTS report signaled that firms are slowing their hiring, both initial claims and ADP's private payroll data suggest workers are having no trouble finding new work. Fueling anxieties further are the ongoing conflicts in the Middle East that threaten to disrupt energy supplies and exacerbate pre-existing inflationary pressures.
- This early-year phenomenon likely reflects investors' tendencies to anchor expectations to limited data, seeking early signs for dominant themes. While the S&P 500 started 2023 with a decline in its first week, Microsoft's (MSFT, $367.94) extended partnership with OpenAI, a leading artificial intelligence (AI) company, buoyed the index to a 6.3% gain by month's end. Hopes for monetary easing have gripped investors since the last Fed meeting in December, where officials hinted at potential rate cuts in 2024, but these hopes have faced a sharp reality check. Investor expectations of a March rate reduction have drastically contracted, with the CME FedWatch Tool probability plummeting from 73.4% a week ago to 60.9% today.

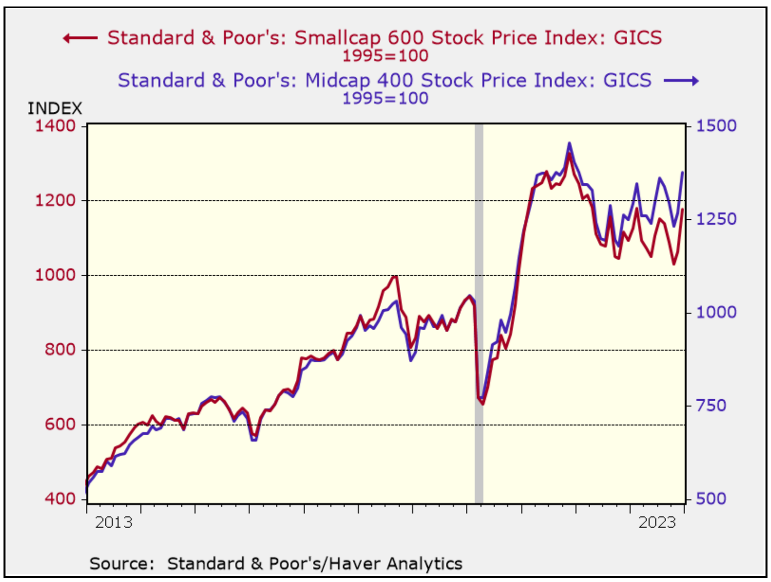


- Just like in the lead-up to the climax of the classic romantic comedy *When Harry Met Sally,* investors will spend 2024 analyzing every move of the FOMC, trying to decipher the next step in their rate-cut tango. Will it be a graceful glide to lower rates or a clumsy stumble into recession? Prepare for a comedy full of "mumbling with great incoherence," with investors caught between hope and frustration as the Fed navigates the economic tightrope. But remember, while monetary policy takes center stage, don't forget the political circus happening backstage. Half of the world will be voting, and these elections could redraw the global economic map, which is also likely to have a major impact on financial markets.

Tech Rally Over? Lower rates threaten the Magnificent Seven's market dominance. Prepare for a changing of the guard.

- In an environment of high-interest rates and cautious investor sentiment, firms with significant growth potential and limited downside risk became particularly attractive investment targets. Large companies with exposure to AI technology, a field perceived to hold immense future potential, were among the most sought-after. Investors were drawn to these companies because the firms have the ability to grab market share in an industry that is expected to play a significant role in reshaping the economy. Consequently, the excitement over AI has led investors to neglect other sectors offering opportunities.

- The prospect of lower rates has helped shift investor attention toward stocks with a better value proposition. With a hefty P/E above 20, the S&P 500 looms large over its smaller rivals. Mid-cap companies, long overshadowed by big-name hype, finally saw their alluring P/E ratios attract renewed investor attention. Though initially buffeted by a 6.5% headwind in the first 10 months of 2023, the S&P 400 Mid Cap Index roared back with a vengeance, finishing the year an impressive 11.5% higher. At the same time, small-cap companies have had a similar performance, rising 13.9% to the end of the year.

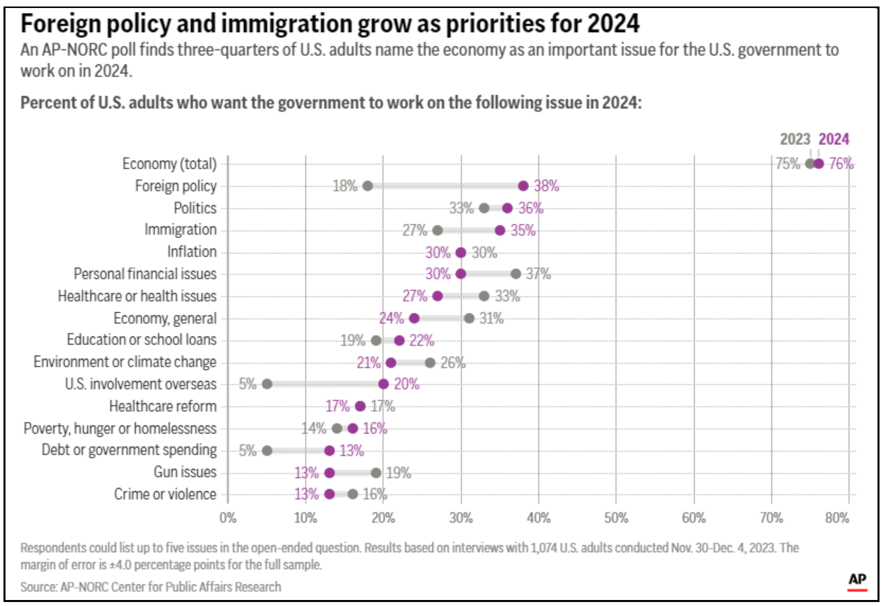


- Market fundamentals favor a potential shift from large caps to smaller peers, but unforeseen headwinds like recession or rising rates could slam the brakes on the trend, dampening risk appetite and prompting caution. So far, all signs suggest that the Fed will be able to navigate a soft landing. The Atlanta GDPNow forecasts continued economic resilience [with the economy expected to expand at a 2.5% annual rate in the fourth quarter](). At the same time, Cleveland Fed data suggests the year-over-year change in [core PCE inflation could dip below 3% this month](), offering a glimmer of hope for risk-averse investors and potentially accelerating the shift towards smaller companies.

Fresh Ukraine Worries: The growing difficulty in supplying Ukraine with military equipment has fueled anxieties among Eastern European nations bordering Russia, who fear it could leave them more vulnerable to Russian aggression.

- Amidst the ongoing war in Ukraine, Latvian Foreign Minister Krišjānis Kariņš sounded the alarm, warning that Russia's ambitions likely extend beyond Ukrainian borders and could pose a broader threat to Eastern European nations. He is pushing for the West to develop a longer-term strategy that will contain the ostracized country. His concerns come on the same day that the Pentagon stated that it had no funds left to replace weapons sent to Ukraine. Although there was $4.2 billion left for aid, it warned that the lack of additional funding may force the U.S. to pause its support

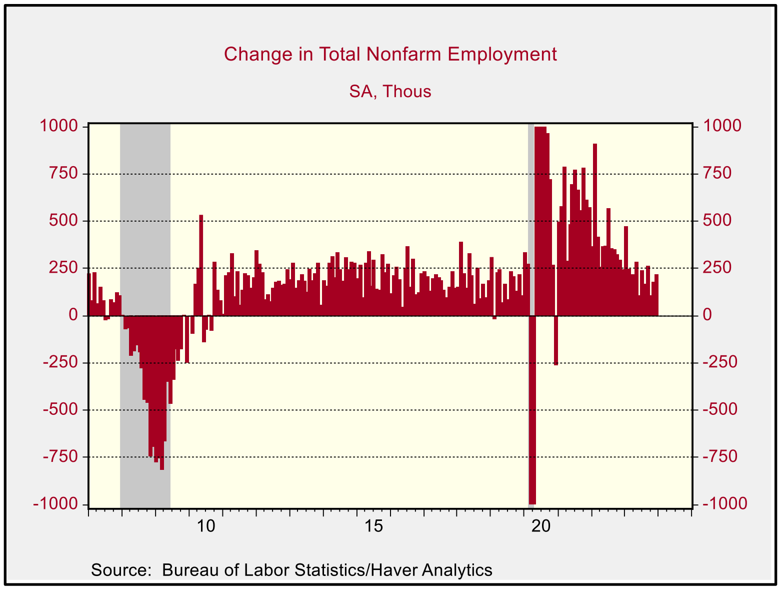
- With brutal new bombardments engulfing Ukrainian cities and Ukrainian counteroffensives pushing outwards, the need for further aid hangs precariously in the balance, shrouded in the uncertainty of allied agreement on a new spending package. The ongoing Congressional debate in the U.S., balancing domestic security concerns with foreign commitments, further clouds the picture. Meanwhile, Europe gropes anxiously for alternative solutions that don't hinge on Hungarian approval, adding another layer of complexity to the already precarious situation. Ukraine's stark assertion that no plan B exists beyond securing Western funding underscores the gravity of the situation and amplifies the pressure on allies to reach a decision.



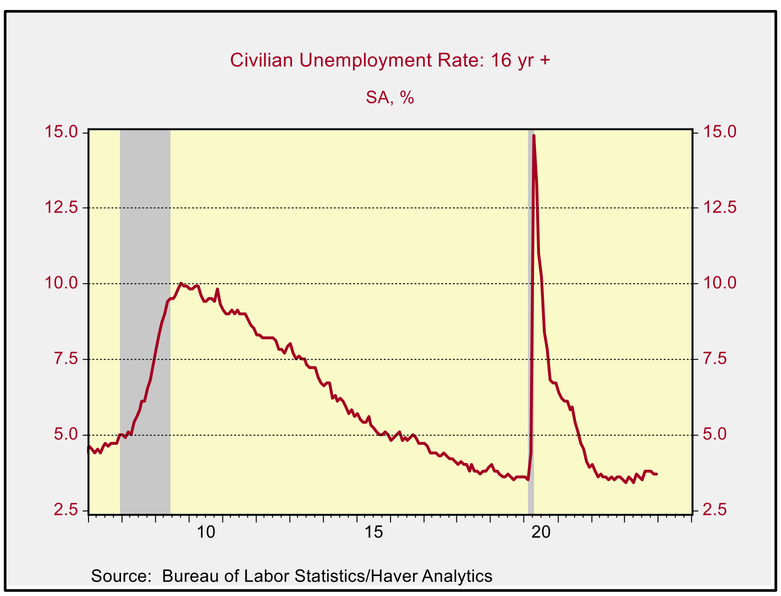
- Though further Western aid for Ukraine does seem likely, its long-term sustainability remains on shaky ground, influenced by rising American anxieties about both securing their own borders and the escalating tensions in the Middle East. While America's foreign policy focus is sharply rising, with four in 10 now saying it should be a top government priority — double the sentiment from a year ago — this change in attitude doesn't translate directly to unwavering support for Ukraine. In fact, America's focus on the war has dipped slightly from 6% to 5%. This shift in priorities could potentially make the West more receptive to a quicker peace deal.

U.S. Economic Releases

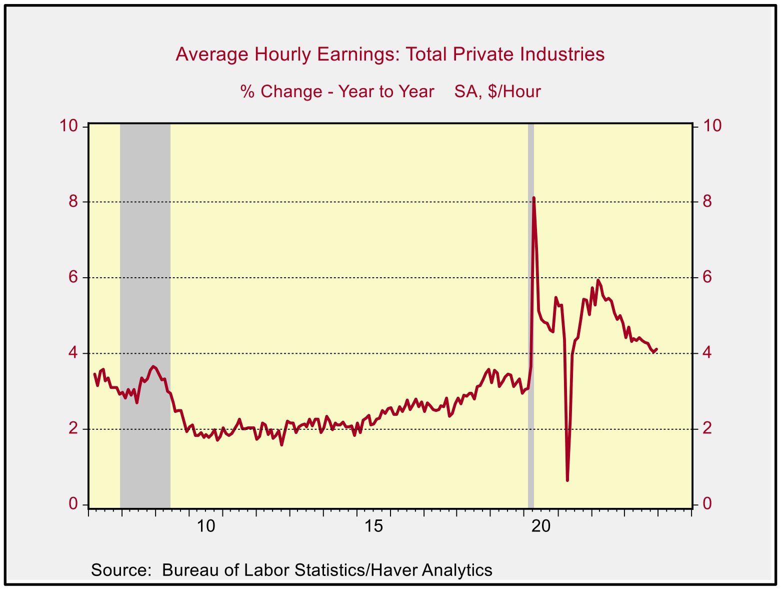
December ***nonfarm payrolls*** rose by a seasonally adjusted 216,000, above both the expected increase of 175,000 and the downwardly revised November gain of 173,000. However, among key sectors, manufacturing payrolls rose by just 6,000, after an increase of 26,000 in the previous month. In fact, despite the upside surprise in December, overall payroll growth remains on a downtrend as labor demand cools. The chart below shows the change in nonfarm payrolls since shortly before the Great Financial Crisis.



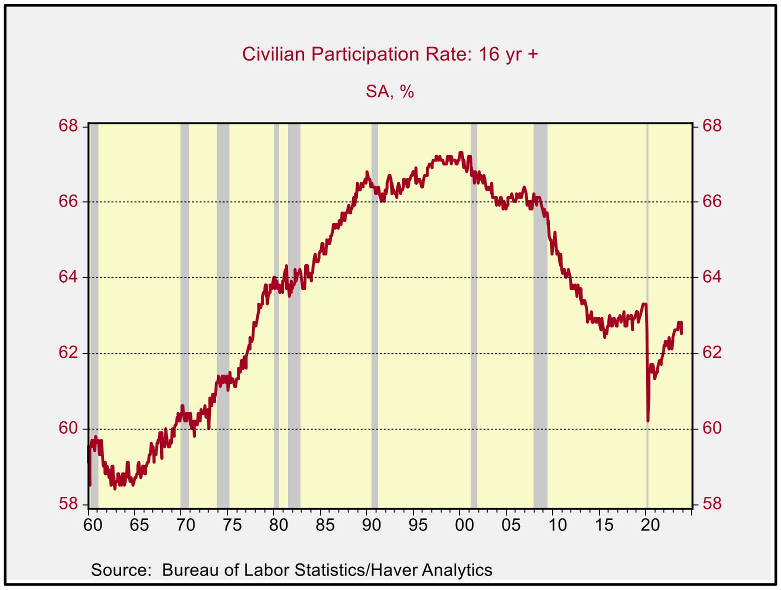
In another relatively strong aspect of the report, the December ***unemployment rate*** held steady at a seasonally adjusted 3.7%, rather than rising to 3.8% as anticipated. The chart below shows how the unemployment rate has evolved since just before the GFC.



In another unexpectedly strong data point, ***average hourly earnings*** in December increased to a seasonally adjusted $34.27, up 4.1% from the same month one year earlier. The chart below shows the year-over-year growth in average hourly earnings since just before the GFC.



A final key indicator in the monthly employment report focuses on the share of the adult, civilian, noninstitutionalized population that is either working or looking for work. The December ***labor force participation rate (LFPR)*** declined significantly to a seasonally adjusted 62.5%, rather than holding steady at 62.8% as expected. The overall LFPR remains far short of the level it reached right before the coronavirus pandemic, largely reflecting the mass retirement of baby boomers, although the resulting labor shortages have pushed the LFPR for prime-aged workers 16 to 64 well above that cohort's participation rate before the pandemic. The chart below shows how the LFPR has changed over the last several decades.



The table below lists the economic releases and/or Fed events scheduled for the rest of the day.

Economic Releases						
No economic releases for the rest of today						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Factory Orders	m/m	Nov	2.4%	-3.6%	***
10:00	Factory Orders Ex Transportation	m/m	Nov	-0.1%	-1.2%	**
10:00	Durable Goods Orders	m/m	Nov F	5.4%	5.4%	***
10:00	Durable Goods Orders Ex Transportation	m/m	Nov F	0.5%	0.5%	**
10:00	Cap Goods Orders Nondef Ex Air	m/m	Nov F	--	0.8%	*
10:00	Cap Goods Ship Nondef Ex Air	m/m	Nov F	--	-0.1%	*
10:00	ISM Services Index	m/m	Dec	52.5	52.7	**
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
13:30	Thomas Barkin Speaks to Maryland Bankers Association	President of the Federal Reserve Bank of Richmond				

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	Monetary Base	y/y	Dec	7.8%	8.9%		**	Equity and bond neutral
	Monetary Base, End of Period	m/m	Dec	¥673.0t	¥669.8t		*	Equity and bond neutral
	Jibun bank Composite PMI	m/m	Dec F	50.0	50.4		*	Equity and bond neutral
	Jibun Bank Services PMI	m/m	Dec F	51.5	52.0		**	Equity and bond neutral
India	S&P Global HSBC Composite PMI	m/m	Dec	58.5	57.4		**	Equity and bond neutral
	S&P Global HSBC Services PMI	m/m	Dec	59.0	56.9		**	Equity and bond neutral
EUROPE								
Eurozone	CPI	y/y	Dec	2.9%	2.4%	2.9%	***	Equity and bond neutral
	Core CPI	y/y	Dec P	3.4%	3.6%	3.4%	**	Equity and bond neutral
	PPI	y/y	Nov	-8.8%	-9.4%	-8.6%	**	Equity and bond neutral
Germany	Retail Sales	y/y	Nov	-2.0%	-0.1%	0.2%	*	Equity bearish, bond bullish
	HCOB Germany Construction PMI	m/m	Dec	37.0	36.2		*	Equity and bond neutral
Italy	CPI, EU Harmonized	y/y	Dec P	0.5%	0.6%	0.5%	***	Equity and bond neutral
	CPI NIC Including Tobacco	y/y	Dec P	0.6%	0.8%	0.7%	**	Equity and bond neutral
UK	New Car Registrations	y/y	Dec	9.8%	9.5%		*	Equity and bond neutral
	S&P Global UK Construction PMI	m/m	Dec	46.8	45.5	46.1	**	Equity bullish, bond bearish
AMERICAS								
Brazil	FGV Inflation IGP-DI	y/y	Dec	-3.30%	-3.62%	-3.27%	**	Equity and bond neutral
	Net Debt % GDP	y/y	Nov	59.50%	60.00%	59.20%	***	Equity and bond neutral
	Industrial Production	y/y	Nov	1.3%	1.2%	1.1%	***	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	523	-1	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 (%)	4.04	4.00	0.04	Flat
Euribor/OIS spread (bps)	392	393	-1	Down
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Down			Up
Pound	Down			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.

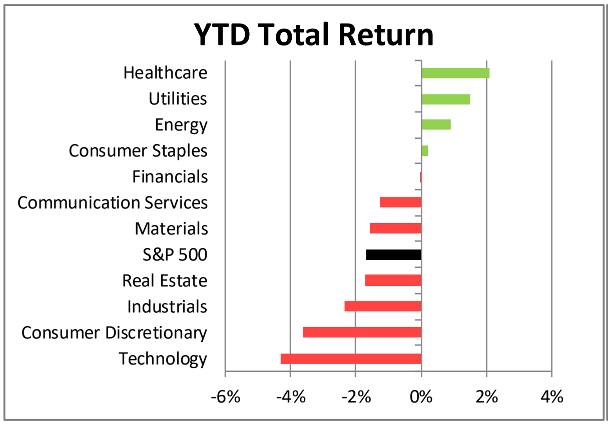
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$78.12	$77.59	0.68%	
WTI	$72.92	$72.19	1.01%	
Natural Gas	$2.77	$2.82	-1.91%	
Crack Spread	$22.68	$23.13	-1.96%	
12-mo strip crack	$23.27	$23.51	-1.05%	
Ethanol rack	$1.73	$1.73	0.21%	
Metals				
Gold	$2,040.74	$2,043.65	-0.14%	
Silver	$23.04	$23.01	0.11%	
Copper contract	$383.25	$384.40	-0.30%	
Grains				
Corn contract	$466.00	$466.50	-0.11%	
Wheat contract	$616.50	$613.50	0.49%	
Soybeans contract	$1,265.25	$1,267.50	-0.18%	
Shipping				
Baltic Dry Freight	2,086	2,091	-5	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-5.5	-3.0	-2.5	
Gasoline (mb)	10.9	-1.7	12.6	
Distillates (mb)	10.1	-1.1	11.2	
Refinery run rates (%)	0.9%	-0.4%	1.3%	
Natural gas (bcf)	-14	-37	23	

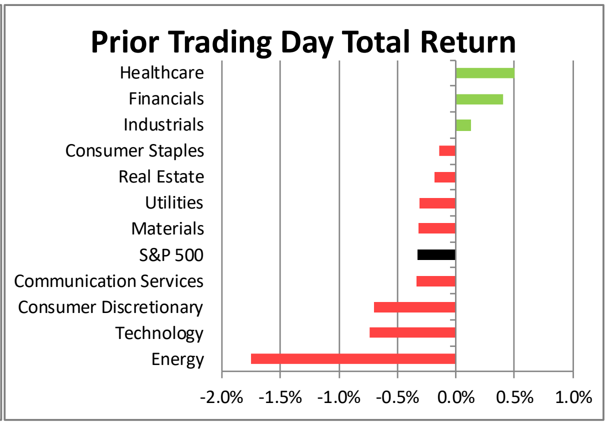
Weather

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 the southern Great Plains, where precipitation levels are expected to be normal.

Data Section

U.S. Equity Markets – (as of 1/4/2024 close)

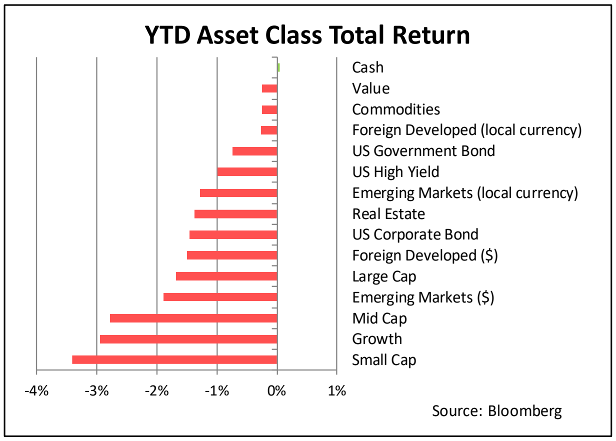




(Source: Bloomberg)

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 1/4/2024 close)

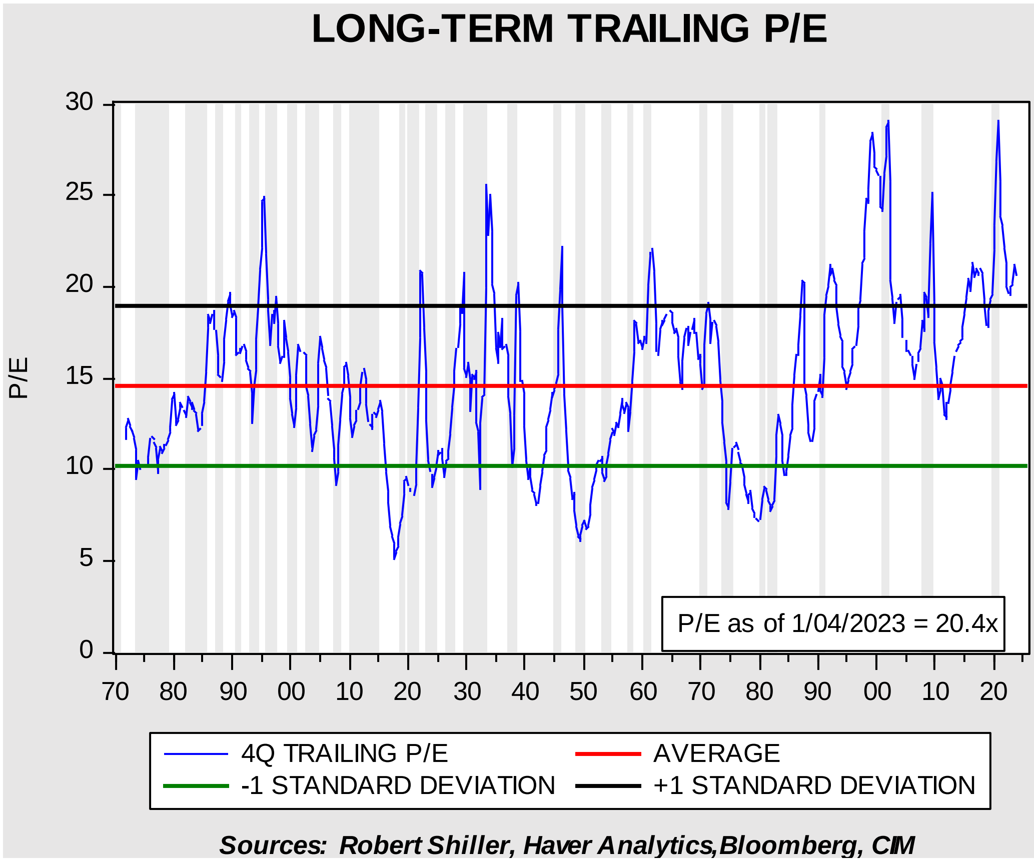


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

January 4, 2024



Based on our methodology,[1] the current P/E is 20.4x, down 0.1x from our last report. A slight increase in earnings weighed on 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.