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 9, 2024—9:30 AM EST] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is down 0.5% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.6%. Chinese markets were higher, with the Shanghai Composite up 0.2% from its previous close and the Shenzhen Composite up 0.3%. 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:

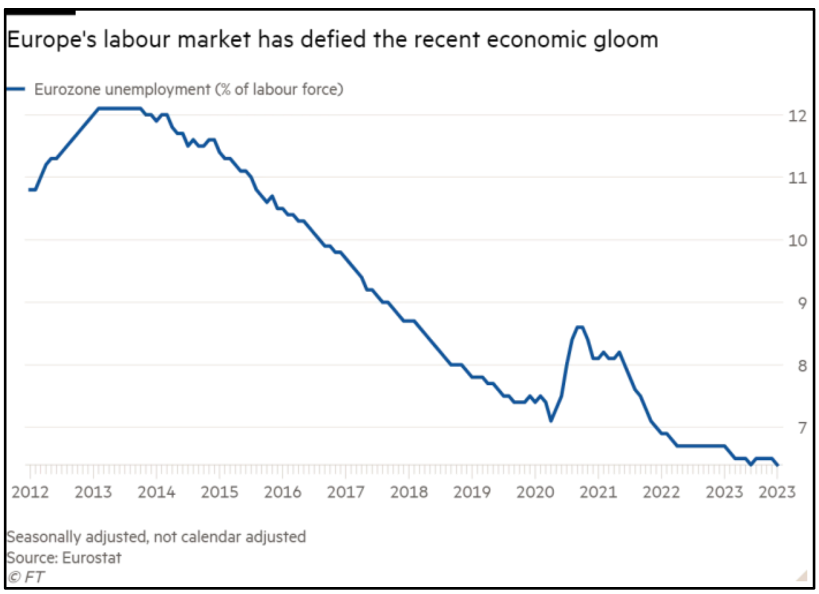
- *Bi-Weekly Geopolitical Report* (12/11/2023) (with associated *Confluence of Ideas* podcast): "The 2024 Geopolitical Outlook"
- *Weekly Energy Update* (12/14/2023): Oil prices have been under pressure as geopolitical risk premium evaporates; COP28 ended with a deal to "shift" from fossil fuels, softer 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 an observation from a high-profile investment manager about renewable energy as one element of energy security. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including a surprise fall in the eurozone's unemployment rate and further indications that the Federal Reserve is pivoting toward looser monetary policy (although still probably not as fast as many investors think).

Global Energy Market: In a short interview carried by the *Wall Street Journal* yesterday, a managing partner at infrastructure investor Brookfield Asset Management (BAM, $38.84) argued that last year's slump in many renewable energy stocks was "very overdone" and that investment and capacity growth in renewable energy continues to surprise on the upside. Importantly, the manager tied the outlook for renewables not only to a desire for clean energy and growing opposition to fossil fuels but also as a source of secure, domestic energy.

- The comment came from Jehangir Vevaina, a managing partner in Brookfield's renewable power and transition group. Vevaina touches on a theme we're seeing more often these days: With geopolitical tensions raising the risk of disruptions in global energy flows, one advantage of solar, wind, hydroelectric, and other renewables is that they can provide secure, domestically produced energy.
- Clearly, the current push for "Green Technology" has become very politicized and polarizing. The green technology push will likely lead to lots of malinvestment and underinvestment in fossil fuels. On the other hand, looking at renewables as one way to improve energy security suggests that the industry could still have a bright future even if today's environmentally driven push for renewables comes to an end.

Eurozone: The November unemployment rate fell to a seasonally adjusted 6.4%, beating expectations that it would remain at October's rate of 6.5%. With the decline in joblessness in November, the region's unemployment rate is now once again at a record low, despite a recent slowdown in economic activity due to high interest rates and other factors. In turn, the continued strong demand for labor and rising wages could encourage the European Central Bank to keep interest rates high for longer than investors expect.



France: President Macron has named his recently appointed 34-year-old, charismatic education minister, Gabriel Attal, to be his new prime minister following the resignation of Élisabeth Borne on Monday. The popular Attal will be France's youngest-ever prime minister, suggesting Macron was looking for a dramatic nominee who could breathe new life into his administration. Nevertheless, Macron's lack of a majority in parliament means he will still struggle to push his agenda forward.

Russia: According to British intelligence, the Kremlin has re-established the Stalinist counterintelligence organization known as SMERSH, an acronym for "death to spies." Made famous in Ian Fleming's James Bond spy novels, the unit aims to root out traitors and spies within the Russian government. Coming hot on the heels of increased counterintelligence efforts in China, the move may be a reaction to increased human intelligence successes by Western services that have unsettled President Putin and General Secretary Xi.

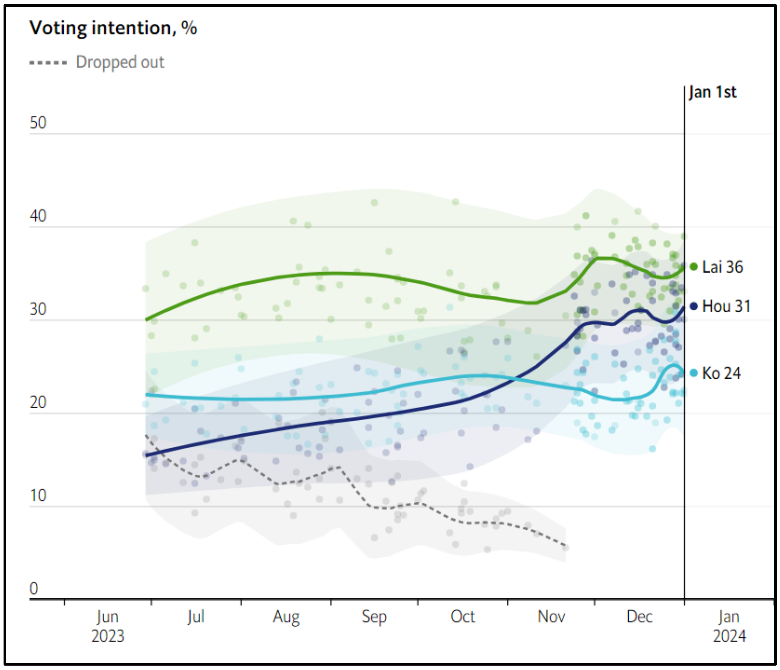
Israel-Hamas Conflict: In separate incidents yesterday, the Israeli military killed a senior figure of the Iran-backed Hezbollah militant group in southern Lebanon and another top Hamas commander in Syria. The increasingly brazen Israeli assassinations outside of the conflict zone in the Gaza Strip are keeping alive the risk that the war will broaden regionally.

China: The China Passenger Car Association today said the number of Chinese-made autos that were exported abroad rose to a record 5.26 million in 2023, putting China on track to be the world's top vehicle exporter. When Japan, the previous top exporter, reports its data in the coming weeks, it is expected to have sold less than 4.50 million vehicles abroad.

- China's surging auto exports reflect both its strong competitiveness in electric vehicles and its surging sales to Russia after that country was sanctioned by the West for its invasion of Ukraine.
- Since China's rising auto exports will threaten domestic carmakers around the world, they are likely to spur further protectionist policies, especially in Europe. In turn, efforts to hold back the Chinese export tide will likely further exacerbate today's tensions between China and the members of the U.S.-led geopolitical bloc.

China-Taiwan: Just days before the presidential election on Saturday, independence-leaning frontrunner Lai Ching-te of the ruling Democratic Progressive Party has accused China of trying to undermine his campaign. According to Lai, Beijing has used the full gamut of interference tactics, from propaganda and military intimidation to "cognitive warfare" and fake news to scare voters into casting their ballot for his opponents, especially the China-friendly Kuomintang Party's Hou Yu-ih.

- A victory by Lai could immediately raise tensions between China and Taiwan, potentially drawing in the U.S., Japan, and other Taiwan supporters.
- This portends rocky trading in the world's financial markets early next week, assuming the current opinion polls are accurate (see the latest chart by the Economist below).



(Source: *The Economist*)

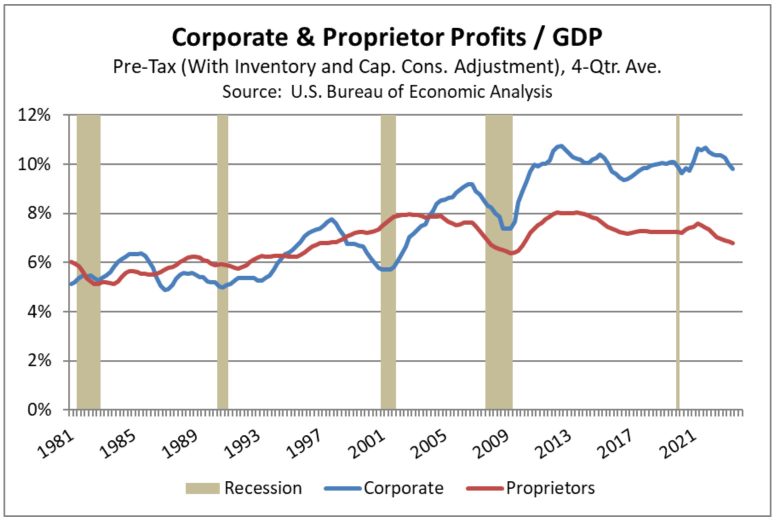
China-Argentina: The Chinese government yesterday [said it would cut import tariffs or extend tariff reductions on 143 different products from Argentina](), ranging from dried sweetcorn to infant formula and plywood. The move is being seen as an effort to curry favor with Argentina's new, radical libertarian president, Javier Milei, who has vowed to shift his country's orientation back to the U.S. and away from China.

- Our objective, quantitative methodology for predicting which geopolitical bloc a country will end up in currently places Argentina in the "Leaning China" camp, based in large part on Argentina's strong commodity exports to China.
- Nevertheless, we think the U.S. and China will actively work to draw "Leaning" countries closer and away from their rival. With Milei threatening to reorient Argentina toward the U.S., it's no surprise that Beijing has taken steps to curry favor with Milei.
- Going forward, many countries, especially those in the "Leaning" blocs, will likely be in a position to play the U.S. and China off against each other. To the extent that they can garner concessions from either of the big powers, those countries could see improved economic prospects and better stock returns.

U.S. Economic Growth: New analysis cautions that the recent strong financial results at big companies may not be indicative of the overall corporate sector. Indeed, the analysis notes that while big firms' earnings before interest, taxes, depreciation, and amortization (EBITDA) soared 18% from 2019 to the end of 2022, "middle market" companies with annual revenues between $100 million and $750 million saw their EBITDA fall 24% in the same period. That's important because middle market companies account for a huge chunk of the U.S. economy and workforce.

- A range of other measures also reflect big advantages for big firms and tough challenges for smaller ones. For example, the advantages to size also show up in disparate EBITDA margins and differing trajectories for corporate profits versus sole proprietorships (see chart below).

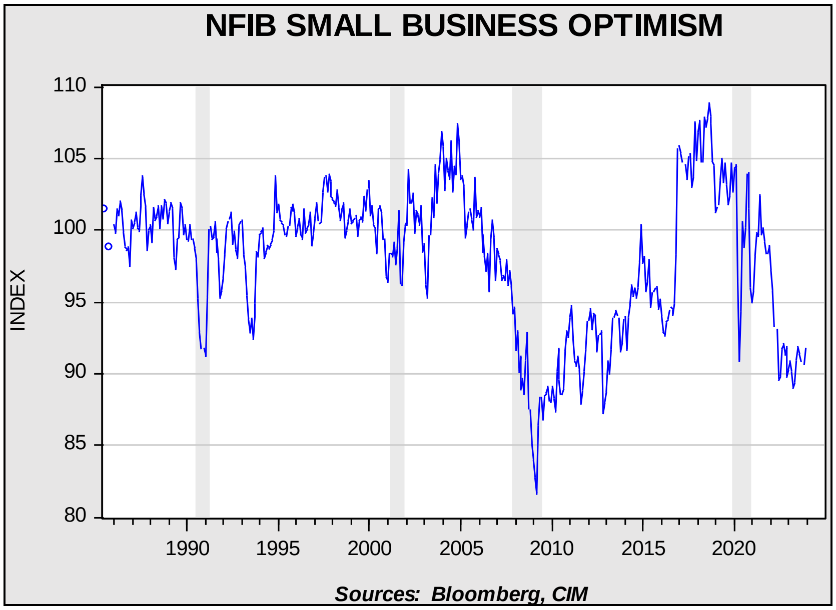
- The tougher challenges for smaller firms could eventually prompt them to cool hiring, cap wage rates, and reduce investment, leading to stronger headwinds for the economy and financial markets.



U.S. Monetary Policy: In a further sign that the Fed has pivoted toward loosening monetary policy relatively soon, Dallas FRB President Logan in recent days [delivered a speech calling for the Fed to slow its quantitative tightening program]. We still think bond investors have gotten ahead of themselves in expecting sharply looser policy in the very near term, and we still think there is a risk that bond yields will rebound at least temporarily in the coming weeks and months. Nevertheless, the signs are starting to point more strongly to looser policy later in 2024.

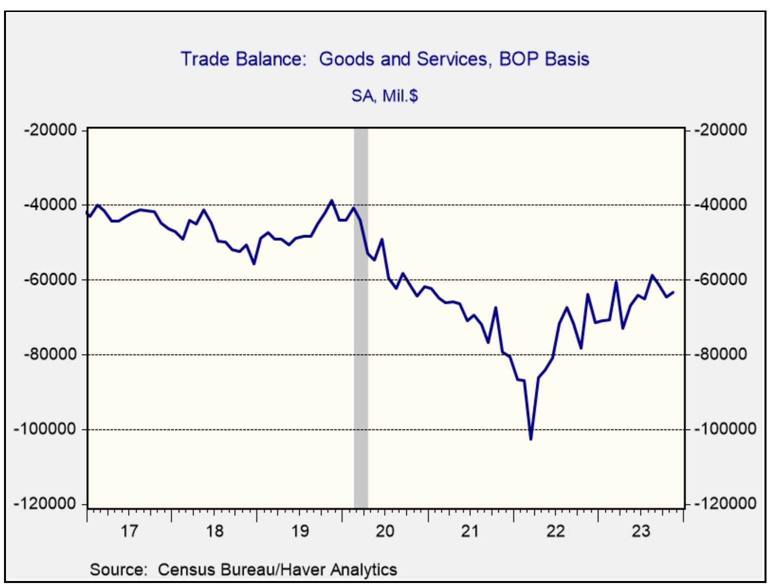
U.S. Economic Releases

Small business optimism beat expectations as an improved outlook led to higher earnings expectations. The National Federation of Independent Business Optimism Index rose from 90.6 to 91.9, above expectations of 91.0.



The chart above shows the level of the NFIB Small Business Optimism Index. December's reading rose to its highest level since July. The rise was driven by respondents' waning pessimism regarding the economy as the net percentage of those expecting a better economy rose from -42% to -36%.

The U.S trade deficit unexpectedly shrunk in December driven primarily by a drop in imports. Last month's trade gap in goods and services fell from a revised $64.3 billion to $63.2 billion. The reading was well below the consensus estimate of a deficit of $64.9 billion. U.S. foreign purchases of goods and services fell from $323.1 billion to $316.9 billion, while U.S. foreign sales of goods and services fell from $258.6 billion to $253.7 billion.



The chart above shows the U.S. trade balance. A narrowing deficit due to falling imports is a bittersweet pill. While it eases pressure on the current account and temporarily lifts GDP, it suggests a potential contraction in domestic demand, which could have broader economic consequences in the long run.

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		
Federal Reserve		
EST	**Speaker or Event**	**District or Position**
12:00	Michael Barr Speaks on Bank Regulation	Federal Reserve Board Vice Chair for Supervision

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	Tokyo CPI	y/y	Dec	2.4%	2.6%	2.7%	**	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food	y/y	Dec	2.1%	2.3%	2.1%	***	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food & Energy	y/y	Dec	3.5%	3.6%	3.5%	*	Equity and bond neutral
	Household Spending	y/y	Nov	-2.9%	-2.5%	-2.3%	*	Equity bearish, bond bullish
Australia	Retail Sales	m/m	Nov	2.0%	-0.2%	-0.4%	***	Equity bullish, bond bearish
	Building Approvals	m/m	Nov	1.6%	7.5%	7.2%	***	Equity bearish, bond bullish
South Korea	BoP Goods Balance	m/m	Nov	$7006.0m	$5351.8m		*	Equity and bond neutral
	BoP Current Account Balance	m/m	Nov	$4059.7m	$6796.1m		**	Equity and bond neutral
EUROPE								
Eurozone	Unemployment Rate	m/m	Nov	6.4%	6.5%	6.5%	**	Equity and bond neutral
Germany	Industrial Production WDA	y/y	Nov	-4.8%	-3.5%	-4.0%	**	Equity bearish, bond bullish
France	Trade Balance	m/m	Nov	-5943m	-8597m	-8455m	**	Equity and bond neutral
	Current Account Balance	m/m	Nov	-2.8b	-2.9b	-3.4b	**	Equity and bond neutral
Italy	Unemployment Rate	m/m	Nov	7.5%	7.8%	7.7%	**	Equity and bond neutral
Switzerland	Unemployment Rate	m/m	Dec	2.3%	2.1%	2.3%	**	Equity and bond neutral
	Foreign Currency Reserves	m/m	Dec	653.7b	641.7b	642.4b	***	Equity and bond neutral
AMERICAS								
Mexico	CPI	y/y	Dec	4.66%	4.32%	4.57%	***	Equity and bond neutral
	Core CPI	y/y	Dec	5.09%	5.30%	5.15%	**	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)	520	521	-1	Flat
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	4.03	0.01	Flat
Euribor/OIS spread (bps)	393	394	-1	Down
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Up			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.

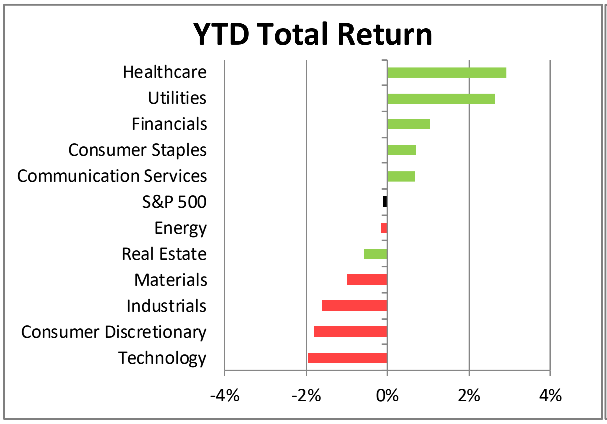
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$77.96	$76.12	2.42%	
WTI	$72.59	$70.77	2.57%	
Natural Gas	$3.07	$2.98	2.89%	
Crack Spread	$22.86	$22.43	1.90%	
12-mo strip crack	$23.53	$23.15	1.62%	
Ethanol rack	$1.74	$1.74	-0.20%	
Metals				
Gold	$2,035.52	$2,028.07	0.37%	
Silver	$23.15	$23.11	0.17%	
Copper contract	$379.90	$381.00	-0.29%	
Grains				
Corn contract	$456.25	$455.00	0.27%	
Wheat contract	$598.50	$596.25	0.38%	
Soybeans contract	$1,248.50	$1,245.50	0.24%	
Shipping				
Baltic Dry Freight	2,022	2,110	-88	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		0.3		
Gasoline (mb)		2.4		
Distillates (mb)		1.8		
Refinery run rates (%)		-0.8%		
Natural gas (bcf)		-37		

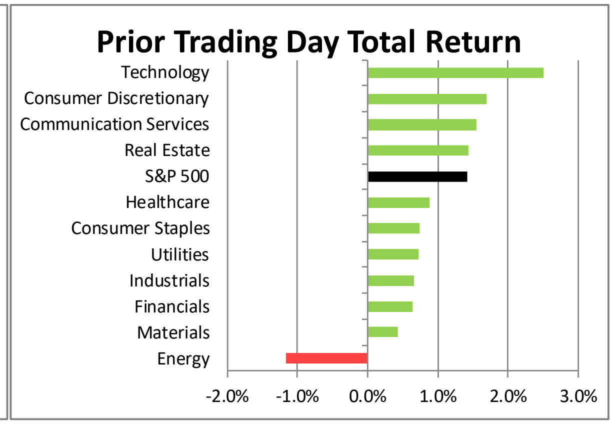
Weather

The 6-10 and 8-14 day forecasts currently call for cooler-than-normal temperatures throughout most of the country, with warmer-than-normal temperatures in the Pacific region. The precipitation outlook calls for wetter-than-normal conditions for the Pacific and Southeast regions.

Data Section

U.S. Equity Markets – (as of 1/8/2024 close)

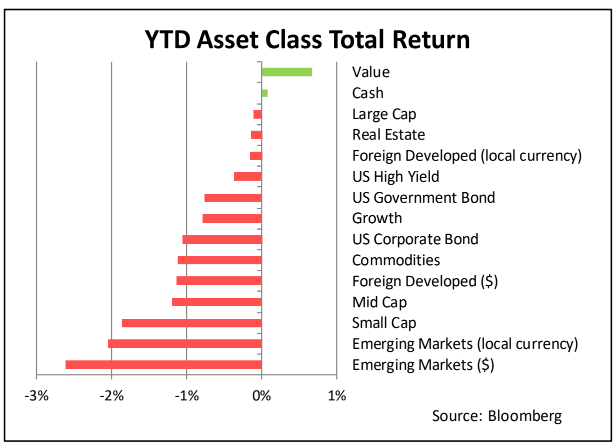




(Source: Bloomberg)

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 1/8/2024 close)

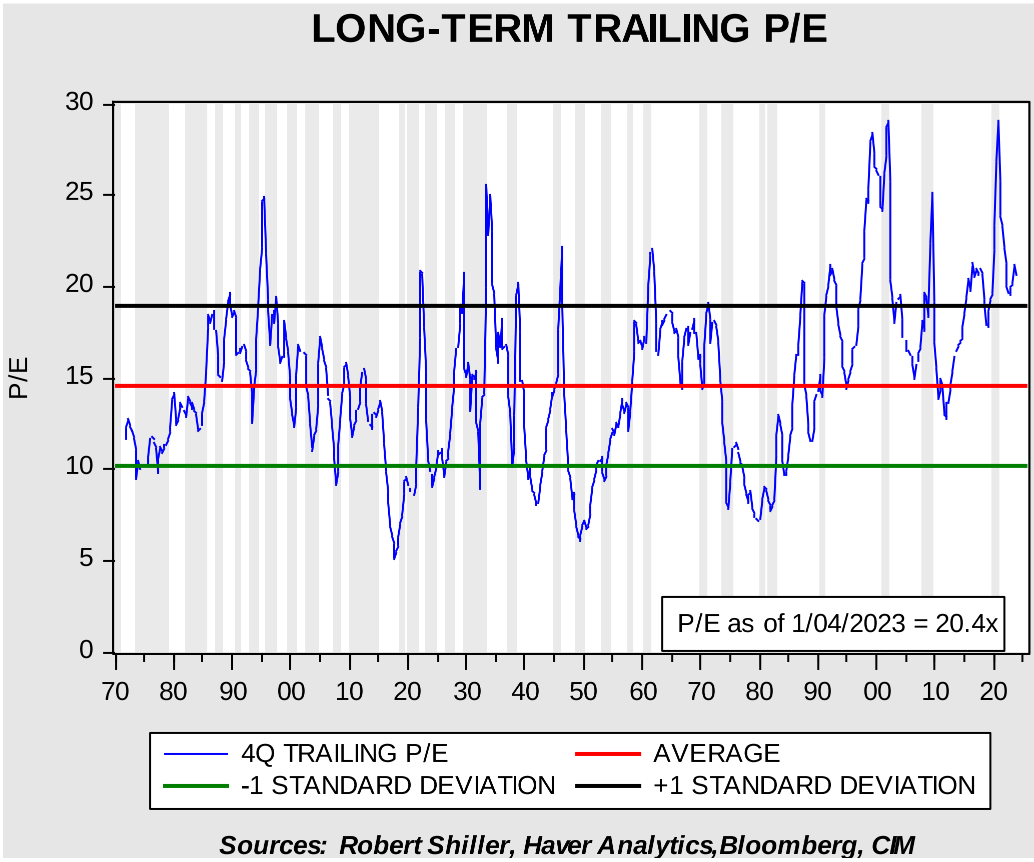


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.