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 10, 2024—9:30 AM EST] Global equity markets are 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 down 0.7%. Chinese markets were lower, with the Shanghai Composite down 0.5% from its previous close and the Shenzhen Composite down 0.8%. U.S. equity index futures are signaling a slightly lower open.

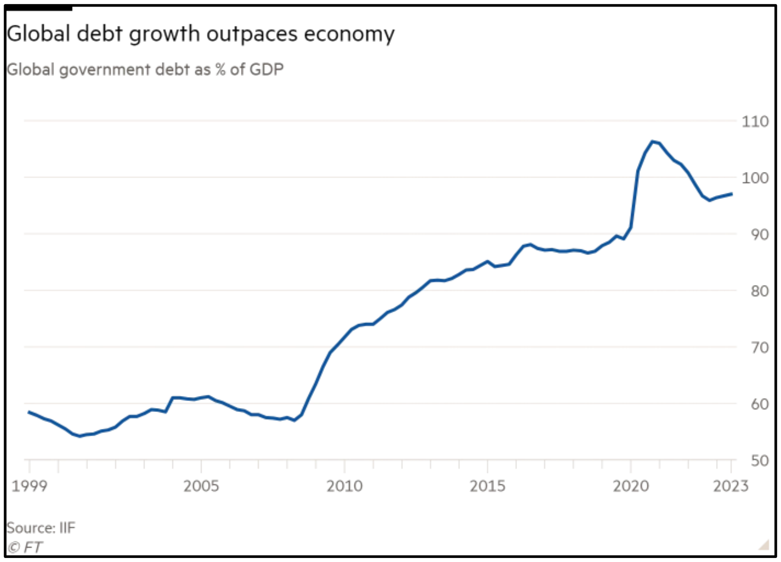
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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 a warning about high government debt levels from the Institute of International Finance. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including a dramatic example of violence in Ecuador and the latest on fiscal policy negotiations in the U.S.

Global Government Debt: The Institute of International Finance has issued a report warning that the "unmoored" level of public debt around the world is raising the risk of a bond-market backlash. The report indicates that government debt isn't just a problem in the U.S., the U.K., and other developed countries, but is also a problem in many emerging markets.

- Our analysis suggests much of the problem in the U.S. can be traced to the lingering effects of the COVID-19 pandemic, which pushed legions of baby boomers into retirement (replacing Social Security contributions with Social Security withdrawals), boosted price inflation, and prompted generous new entitlement benefits.
- In theory, policymakers could attack some of those issues, say by bringing down inflation and curtailing benefits. On the other hand, other issues will generate continued spending pressures, such as further population aging and new geopolitical tensions that will require higher defense budgets.



Eurozone: Luis de Guindos, vice president of the European Central Bank, warned in a speech today that even though the eurozone economy is likely to enter another downturn this year, persistent inflation pressures could keep the monetary policymakers from cutting interest rates as aggressively as market participants expect. The statement illustrates how bond investors in Europe are probably too optimistic about near-term interest rate cuts, just as they are in the U.S.

United Kingdom: Former defense officials have gone public with complaints that the Ministry of Defense is trying to cover up data showing a serious shortfall in skilled personnel for the armed forces. The lack of skilled sailors has reportedly prompted the early retirement of at least two navy vessels. Meanwhile, *The Telegraph* reports that total U.K. armed forces personnel has fallen to 184,865, the lowest number since the end of the Napoleonic Wars in 1815.

Ecuador: Armed gang members yesterday staged attacks across the country, including breaking into a public television station and temporarily interrupting a live show while they brandished guns and grenades. The gang violence appeared to be a warning against President Noboa's plan to crack down on the gangs and bring them under control. The violence highlights the growing power and violence of drug cartels, which threatens to destabilize governments, imped investment, and drive more migrants to the U.S.

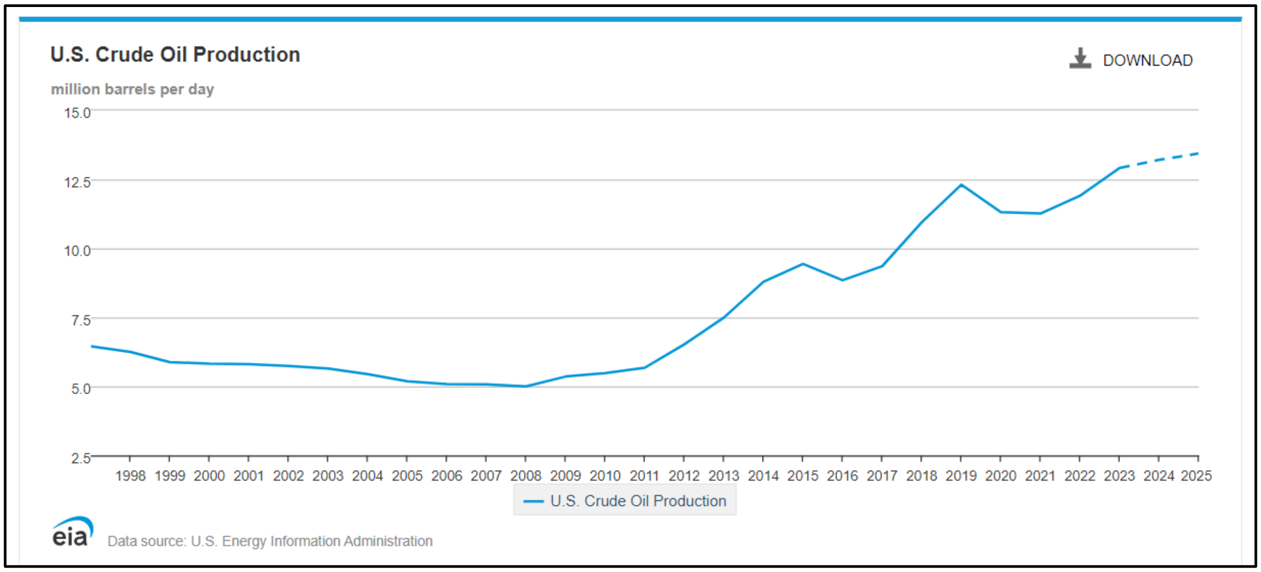
United States-China: As more evidence that the U.S. military is preparing for a potential future conflict with China, an important Air Force intelligence unit is reportedly urging its Arabic- and Pashto-speaking cryptologic linguists to learn Mandarin. The move by the 70th Intelligence, Surveillance, and Reconnaissance Wing comes as the U.S. Marine Corp is completely restructuring to fight a war in the Indo-Pacific region, while the U.S. Army has reinstituted jungle warfare training, and the U.S. Navy is broadening its submarine efforts with Australia.

U.S. Fiscal Policy: Even though lawmakers have reached an agreement on the top-line budget parameters for the current fiscal year, Senate Minority Leader Mitchell yesterday advised that there won't be enough time to pass all the specific appropriations bills needed to finance the government when the current stopgap funding law expires beginning in about two weeks. In other words, Congress may have to pass yet another stopgap to avoid a partial government shutdown until the appropriations bills are finished. Stay tuned for more budget chaos.

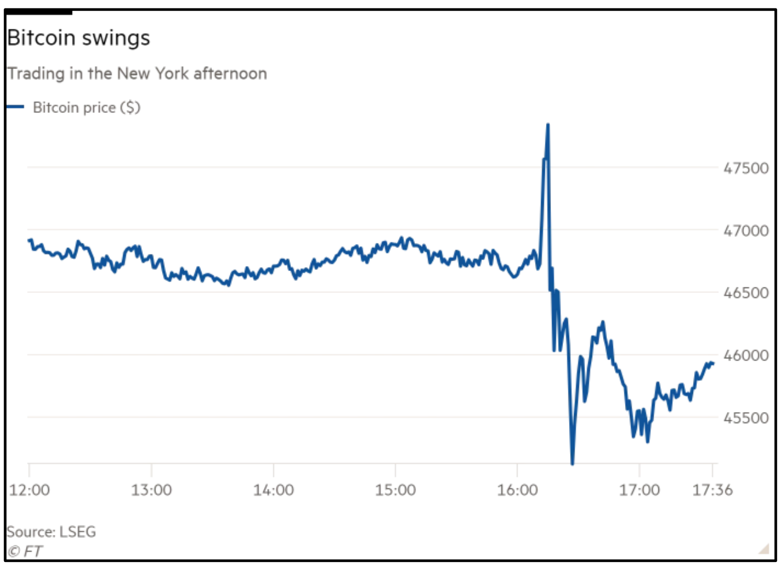
- Separately, lawmakers who are working on separate tax legislation are reportedly considering curbing the controversial pandemic-era Employee Retention Credit (ERC). That law, passed in 2020, gives employers a lucrative tax break for retaining employees during the pandemic shutdowns, but it has been wracked by fraud and an overly long availability until 2025.
- Curbing the eligibility for that credit or cracking down on spurious claims could help generate funds for other priorities the lawmakers are discussing, such as reversing the requirement in the Trump tax package of 2017 that corporate research deductions be spread out over five years instead of being expensed immediately.

U.S. Energy Market: A new outlook from the Energy Information Administration forecasts that U.S. oil production will rise further from the record high of 12.9 million barrels per day in 2023 to further new record highs of 13.2 million bpd in 2024 and 13.4 million bpd in 2025. The agency also projects that U.S. output of natural gas will also rise to new records this year and next year. The figures underscore how the U.S. has become an energy powerhouse since the arrival of new technologies such as hydraulic fracturing and horizontal drilling.

- While "green" policies and investor demands for capital discipline did discourage new exploration and development for much of the last decade, drillers more recently have boosted output.
- Along with weakening demand growth in China and other markets, the surge in U.S. energy output has helped push down prices in recent months, helping bring down the overall rate of consumer price inflation.
- If the U.S. economy slows too much and slips into recession, the further loss of demand would likely weigh even more heavily on global oil and gas prices.
- Nevertheless, we think the hesitant drilling in recent years and increased geopolitical tension will buoy oil and gas prices again over the longer term.



U.S. Cryptocurrency Market: Bitcoin (BTC, $45,108.20) and other cryptocurrencies swung wildly in price yesterday after a hacker took control of the Securities and Exchange Commission's social media account and falsely announced that the agency had approved the U.S.'s first-ever cryptocurrency ETFs. Crypto prices surged, only to fall sharply within minutes when the SEC disclaimed the report. Nevertheless, the SEC is widely expected to announce its official decision on crypto ETFs either today or tomorrow.



U.S. Economic Releases

Despite a recent uptick in borrowing costs, home loan demand surged in the first week of 2024. According to an index tracked by the Mortgage Bankers Association, mortgage applications rose 9.9% in the week ending January 5. The surge in applications came as homeowners sought to refinance and potential buyers aimed to lock in relatively low rates before they potentially climb further. As a result, the MBA tracker for refinancing rose 18.8% from the previous week, while the purchase tracker rose 5.6% in the same period. The increase in demand pushed the average 30-year fixed-rate mortgage up 5 bps to 6.81%.

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	Wholesale Inventories	m/m	Nov F	-0.2%	-0.2%	***
10:00	Wholesale Trade Sales	m/m	Nov	0.4%	-1.3%	**
Federal Reserve						
No Fed speakers or events for the rest of today						
EST	Speaker or Event	District or Position				
15:15	John Williams gives Speech on 2024 Economic Outlook	President of the Federal Reserve Bank of New York				

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	Labor Cash Earnings	y/y	Nov	0.2%	1.5%	1.5%	**	Equity and bond neutral
Australia	CPI	y/y	Nov	4.3%	4.9%	4.4%	**	Equity and bond neutral
New Zealand	ANZ Commodity Price	m/m	Dec	2.4%	-1.3%	-1.2%	**	Equity and bond neutral
South Korea	Unemployment Rate	m/m	Dec	3.3%	2.8%	2.9%	**	Equity and bond neutral
EUROPE								
France	Industrial Production	y/y	Nov	0.5%	1.8%	2.0%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	Nov	-0.9%	1.0%	1.2%	**	Equity bearish, bond bullish
Italy	Retail Sales	y/y	Nov	1.5%	0.3%	0.5	**	Equity bullish, bond bearish
AMERICAS								
Canada	Building Permits	m/m	Nov	-3.9%	2.3%	3.0%	**	Equity and bond neutral
Canada	Int'l Merchandise Transactions	m/m	Nov	1.57b	2.97b	2.0b	*	Equity and bond neutral
Mexico	International Reserves Weekly	w/w	5-Jan	$212408m	$212762m		*	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	Flat
U.S. Sibor/OIS spread (bps)	532	532	0	Down
U.S. Libor/OIS spread (bps)	531	532	-1	Down
10-yr T-note (%)	3.99	4.01	-0.02	Flat
Euribor/OIS spread (bps)	393	393	0	Down
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Up			Up
Yen	Down			Up
Pound	Up			Up
Franc	Flat			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.

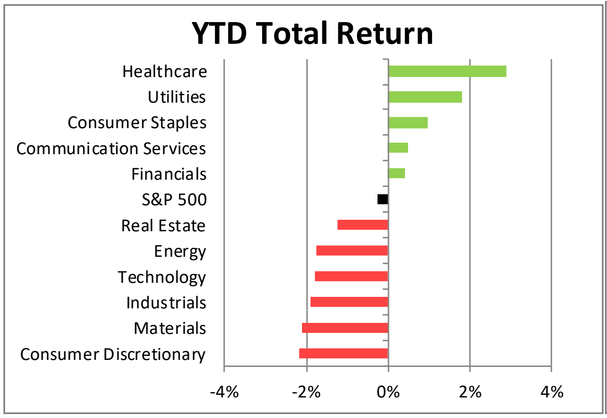
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$78.49	$77.59	1.16%	
WTI	$73.27	$72.24	1.43%	
Natural Gas	$3.13	$3.19	-1.85%	
Crack Spread	$24.19	$23.08	4.78%	
12-mo strip crack	$24.15	$23.39	3.25%	
Ethanol rack	$1.77	$1.76	0.78%	
Metals				
Gold	$2,032.03	$2,030.20	0.09%	
Silver	$22.98	$22.98	-0.03%	
Copper contract	$379.00	$375.85	0.84%	
Grains				
Corn contract	$457.00	$459.25	-0.49%	
Wheat contract	$609.00	$610.00	-0.16%	
Soybeans contract	$1,242.25	$1,248.50	-0.50%	
Shipping				
Baltic Dry Freight	1,875	2,022	-147	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-0.2		
Gasoline (mb)		-2.1		
Distillates (mb)		1.8		
Refinery run rates (%)		-0.7%		
Natural gas (bcf)		-121		

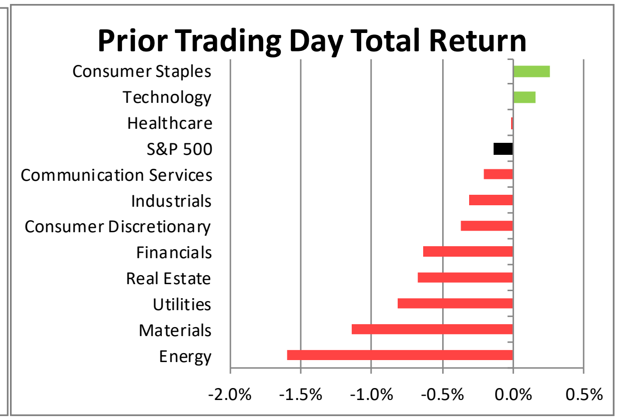
Weather

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 and Southwest regions. The precipitation outlook calls for wetter-than-normal conditions for the Pacific and Southeast regions, with dry conditions in the Mid-Atlantic, Midwest, and New England regions.

Data Section

U.S. Equity Markets – (as of 1/9/2024 close)

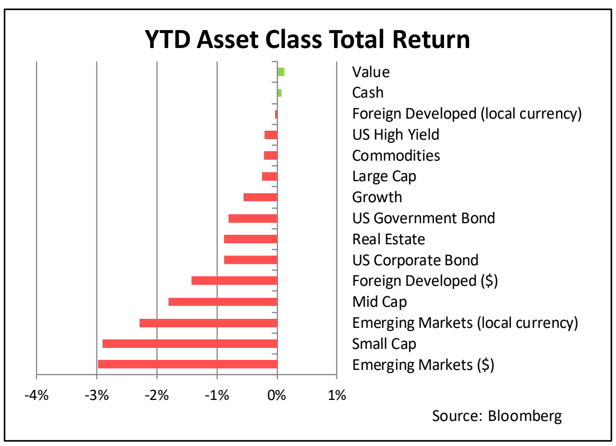




(Source: Bloomberg)

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 1/9/2024 close)

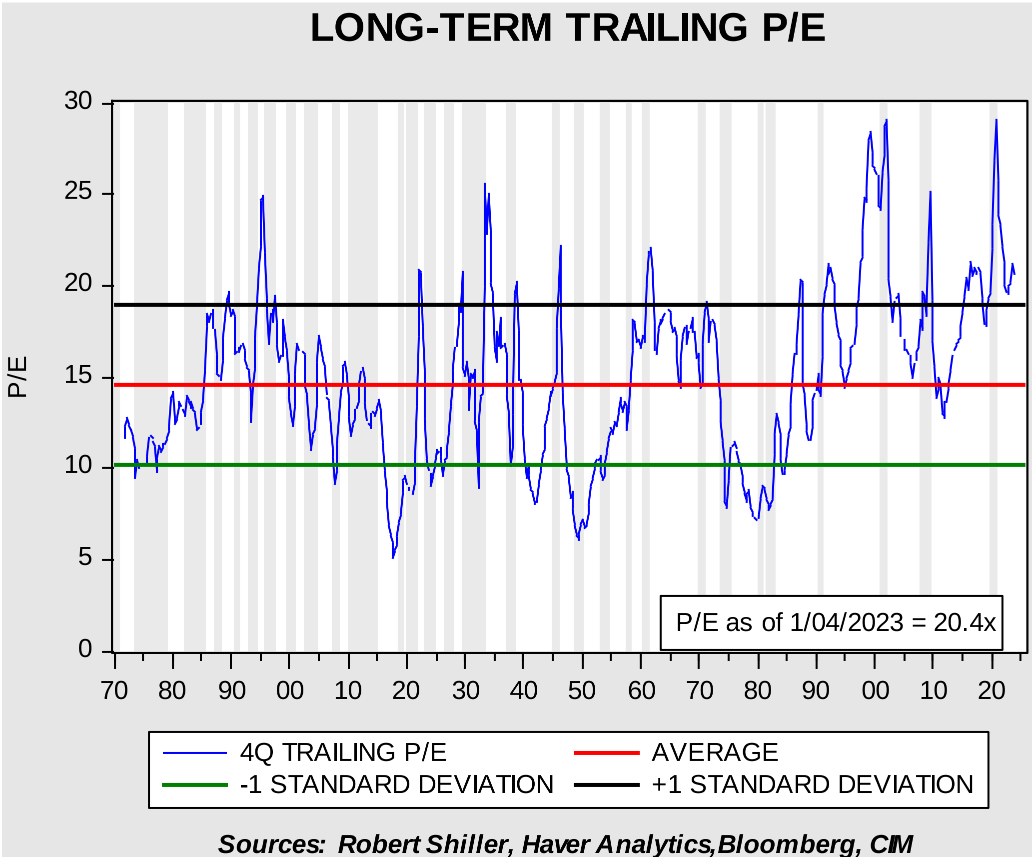


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.