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 11, 2024—9:30 AM EST] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is up 0.4% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.1%. Chinese markets were higher, with the Shanghai Composite up 0.3% from its previous close and the Shenzhen Composite up 1.6%. U.S. equity index futures are signaling a higher open.

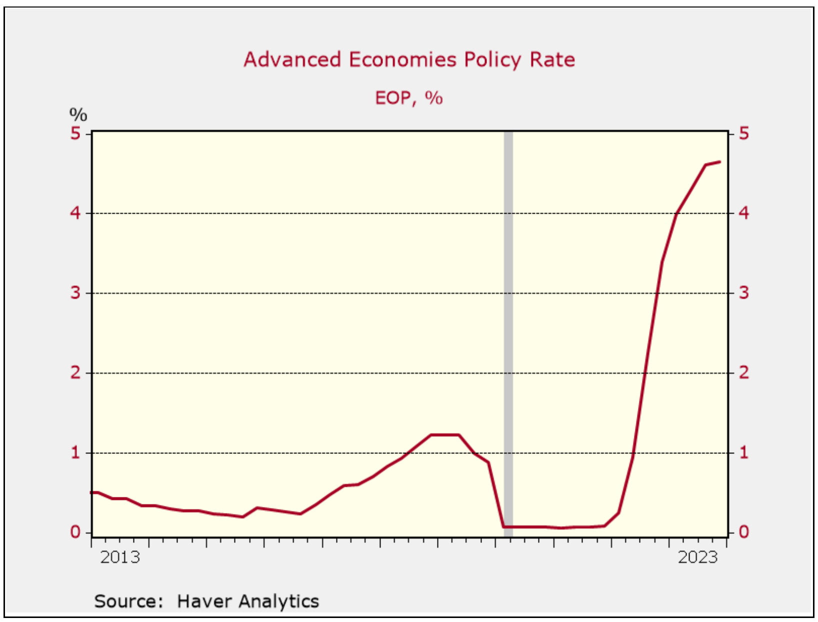
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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! Risk assets are off to a rough start as CPI failed to reinforce rate cut expectations. On the bright side, Real Madrid secured a nail-biting win over their city rivals Atlético Madrid in extra time, keeping their Supercopa dreams alive. Today's *Comment* starts with our thoughts on the resurgence of demand for fixed-income securities. We then discuss the SEC's approval of a bitcoin ETF and provide an update on the conflict in the Red Sea. As always, our report also includes an overview of the latest domestic and international data releases.

Bond Rush! Anticipation of central bank rate cuts has led investors to flock to fixed-income securities; however, policymakers continue to play their cards close to their chest.

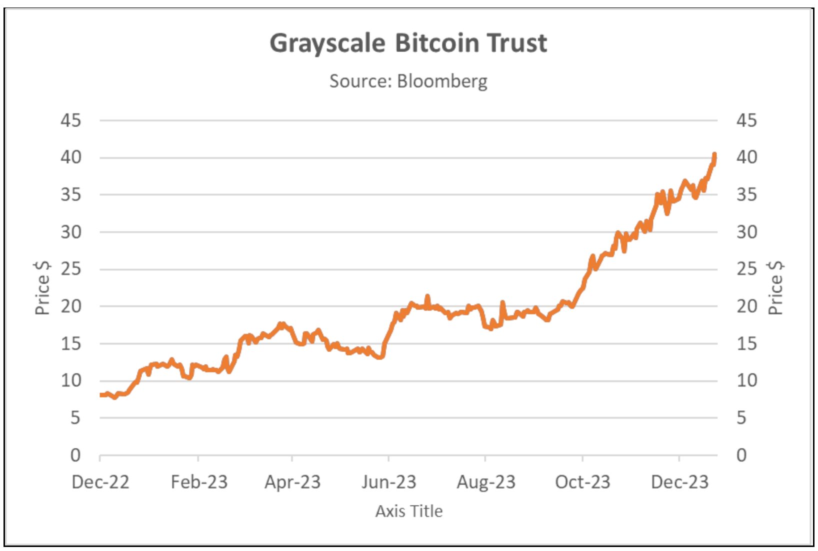
- G-7 central bankers are hinting at the end of rate hikes, but they're staying mum on potential cuts. While New York Fed President John Williams believes current rates can tame inflation, he emphasizes the need for continued evidence of a sustained cooldown before considering any easing. The European Central Bank's Isabel Schnabel and Bank of England Governor Andrew Bailey both echoed this cautious stance by warning against premature speculation due to persistently high inflation exceeding their 2% target. Although inflation has eased notably over the past year, growing concerns from economists and analysts suggest that inflation may struggle to reach the 2% target within the year due to geopolitical and supply chain risks.
- Ignoring central bank warnings of steady rates, investors drove European bond sales to a record high of 118 billion EUR ($108 billion) this week. Supranational organizations and sovereign governments fueled the surge, seeking to lock in lower rates and fund annual expenditures. This borrowing spree wasn't limited to Europe. Emerging market governments and corporations also jumped in, raising $50 billion in the first half of January to capitalize on the temporary dip in rates. This global borrowing spree reflects investor optimism in the wake of easing rate pressures, signaling potential financial relief across markets after a period of hawkish policy.



- While falling rate expectations eased borrowing costs and boosted liquidity, a long lasting ease in financial conditions will likely require actual policy changes from central banks. Despite isolated suggestions like Fed Governor Waller's hint at a March cut, no clear evidence points to an imminent pivot. Thus, the risk remains real, similar to 2023, that the current bond rally may fizzle out before it gains firm footing, revealing more risk in long-duration bonds than current pricing suggests. We recommend that investors cautiously approach the prospect of rate cuts as a deceleration in inflationary pressure may prompt policymakers to maintain current rates beyond market expectations.

SEC Approves: Crypto traders achieved a crucial victory as the Security and Exchange Commission approved the first spot Bitcoin ETFs.

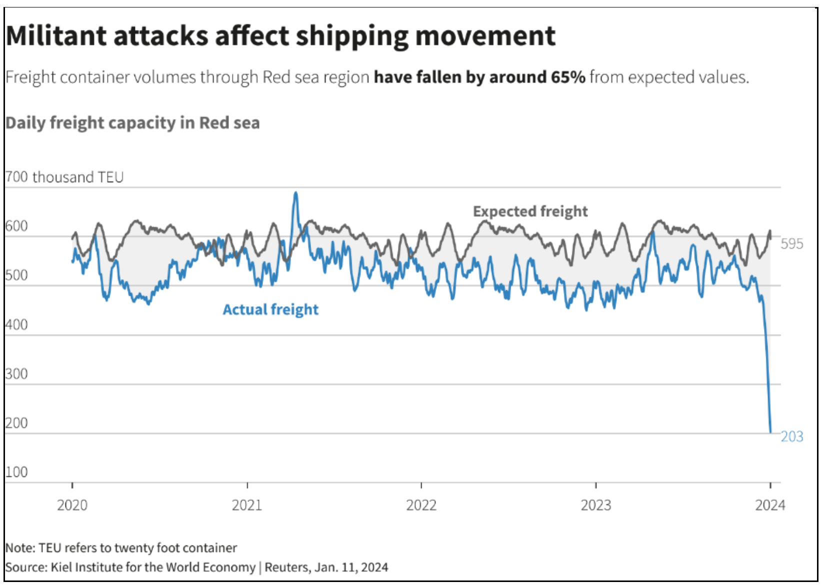
- After years of regulatory limbo, 10 crypto ETFs secured approval, marking a significant step forward for the industry. This green light follows a decade-long legal battle that culminated in the federal courts forcing the SEC to review Grayscale's Bitcoin ETF application. Despite the SEC's concerns about potential manipulation and fraud in digital assets, this decision clears the way for the first crypto ETFs to begin trading as soon as this morning. This opens the door for both retail and institutional investors to gain regulated exposure to digital assets for the first time, a move that could significantly boost adoption and legitimize the crypto market.
- Following the announcement, Bitcoin, the most widely traded currency, rose as high as 2% on the day and volume jumped to a 10-month high. This surge reflects investor excitement over the potential domino effect, paving the way for broader adoption of other digital assets. While crypto's mainstream appeal remains debatable, its dedicated fanbase is undeniable. A recent Crypto Council for Innovation survey revealed that a whopping 83% of holders favor clear regulatory guidelines from the next president, hoping they will nurture the industry's growth. Crypto may not swing elections, but its rising influence is becoming clearer.



- Although the ruling improves crypto's attractiveness, the market remains rife with regulatory uncertainty and elevated volatility. Bitcoin's $47,000 price tag faces a bumpy road ahead, with analysts predicting declines towards $28,000 by year-end, countered by some optimistic forecasts eyeing a climb above $100,000. This stark contrast underscores the inherent volatility of the asset. As a result, unless a divine power comes down to meet us at Mt. Sinai to tell us otherwise, we will remain steadfast in our belief that crypto is not a safe choice for risk-averse investors.

Conflict in the Red Sea: The Iranian-backed Houthis have continued to escalate tensions with the West by launching attacks on commercial ships entering the Red Sea.

- Frustration mounts as leaders from the United States and its allies issue stern warnings of military action in response to ongoing Houthi rebel attacks on shipping vessels in the Red Sea. This escalation comes after a recent barrage of attacks by the Houthis, which involved 18 drones, two anti-ship cruise missiles, and one anti-ship missile aimed at commercial ships traversing the crucial global trade route. The Houthis have linked their actions to the ongoing conflict between Israel and Hamas by vowing to continue their attacks until Israeli forces withdraw from Gaza. This raises concerns of a wider regional conflict.
- Houthi attacks on Red Sea shipping are worrying, but their inflationary impact remains elusive. Violence in the Red Sea has spiked freight costs, as shippers are forced to pay higher shipping costs through insurance and take longer shipping routes to transport their goods. That said, freight costs remain well below pandemic levels. Meanwhile, overall global trade dipped 1.3% in December suggesting that countries are still being impacted. The European Union, specifically, saw a sharp drop in trade with imports falling by 3% and exports declining by 2%. However, there are still no signs that the shipping problem will impact inflation.

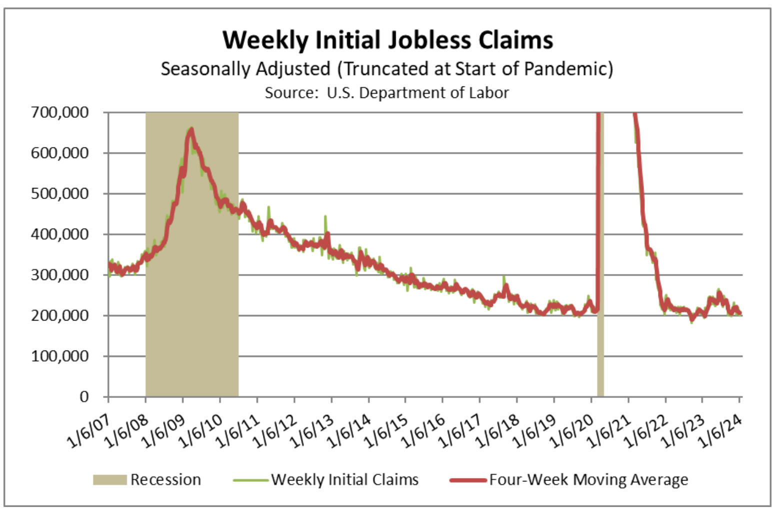


- Weak confidence and elevated rates, which dampen demand, largely shield consumers from the conflict's immediate sting. This trend is likely to hold in the next three to six months assuming that the conflict in the Middle East remains relatively contained. We foresee a broader conflict significantly impacting European inflation, more so than the U.S., while proving bullish for commodities like oil and metals. However, Western intervention remains a major headwind for financial markets as it could lead to a renewed war effort, but this remains a low probability.

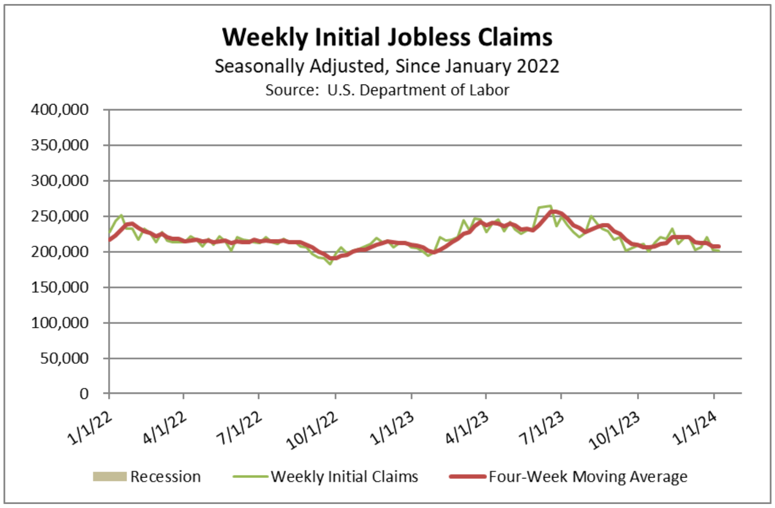
Other News: With Chris Christie suspending his presidential bid, Donald Trump is now closer to facing a one-on-one fight for the Republican nomination. While he still appears to be the frontrunner, we can't rule out an upset. China has gestured toward more cooperative U.S. ties days before Taiwan's elections, potentially reducing the risk of miscalculation regarding an island takeover if its preferred candidate loses. Alphabet Inc.'s Google (GOOG, $143,80) plans to lay off hundreds, in a sign that tech may be trying to meet earnings expectations through a smaller workforce.

U.S. Economic Releases

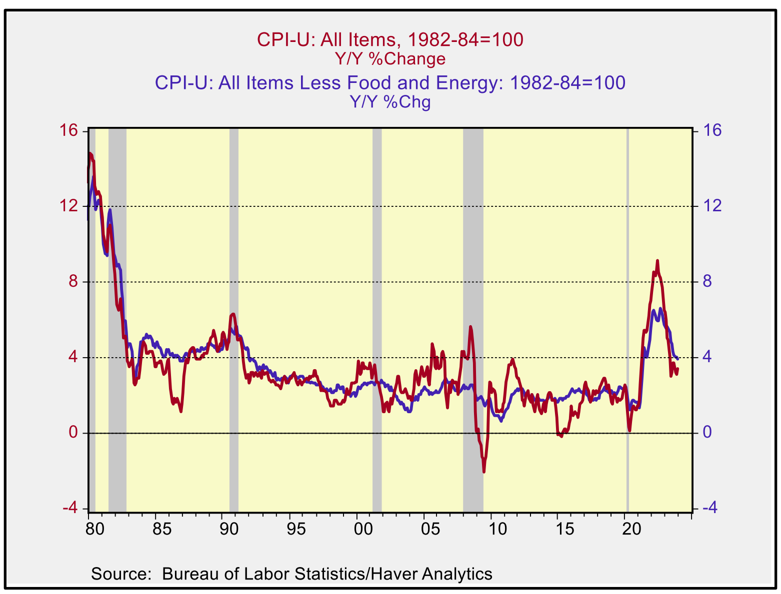
In the week ended January 6, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 202,000, significantly lower than the expected level of 210,000 and down slightly from the previous week's revised level of 203,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to a three-month low of 207,750, which will likely raise concerns that the labor market isn't cooling down enough to reduce inflation pressure and allow the Fed to start cutting interest rates. Meanwhile, in the week ended December 30, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) fell to 1.834 million, significantly lower than the anticipated reading of 1.870 million and the previous week's revised reading of 1.868 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 December ***consumer price index (CPI)*** rose by a seasonally adjusted 0.3%, more than the expected rise of 0.2% and well above the November increase of 0.1%. Excluding the volatile food and energy components, the ***"core" CPI*** rose 0.3%, matching both the anticipated rise and the increase in November. The overall CPI in December was up 3.4% from the same month one year earlier, while the core CPI was up 3.9%. The modest acceleration in the headline inflation figure may not be taken well by the market today, but it's important to note that the core year-over-year inflation rate fell to its lowest level since May 2021. The chart below shows the year-over-year change in the CPI and the core CPI since 1980.



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
14:00	Monthly Budget Statement	m/m	Dec	-$87.5b	-$85.0b	**
Federal Reserve						
	No Fed speakers or events for the rest of today					
11:40	Loretta Mester Speaks on BTV	President of the Federal Reserve Bank of Cleveland				
12:40	Thomas Barkin Speaks in Richmond	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	Leading Economic Index	m/m	Nov P	107.7	108.9	107.9	**	Equity and bond neutral
Australia	Trade Balance	m/m	Nov	A$11437m	A$7129m	A$7660m	***	Equity and bond neutral
	Exports	m/m	Nov	1.7%	0.4%	0.8%	*	Equity and bond neutral
	Imports	m/m	Nov	-7.9%	-1.9%	-2.9%	*	Equity and bond neutral
New Zealand	Building Permits	m/m	No	-10.6%	8.7%	8.50	**	Equity and bond neutral
EUROPE								
Italy	Industrial Production WDA	y/y	Nov	-3.1%	-1.1%		*	Equity and bond neutral
AMERICAS								
Mexico	Industrial Production	y/y	Nov	2.8%	5.5%	5.6%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	Nov	-0.3%	1.1%	0.5%	*	Equity bearish, bond bullish
Brazil	IBGE Inflation IPCA	y/y	Dec	4.6%	4.7%	4.6%	*	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	Flat
U.S. Sibor/OIS spread (bps)	531	532	-1	Down
U.S. Libor/OIS spread (bps)	531	532	-1	Down
10-yr T-note (%)	3.99	4.03	-0.04	Flat
Euribor/OIS spread (bps)	394	393	1	Down
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Up			Up
Pound	Up			Up
Franc	Flat			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Korea Base Rate	3.500%	3.500%	3.500%	On Forecast

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.

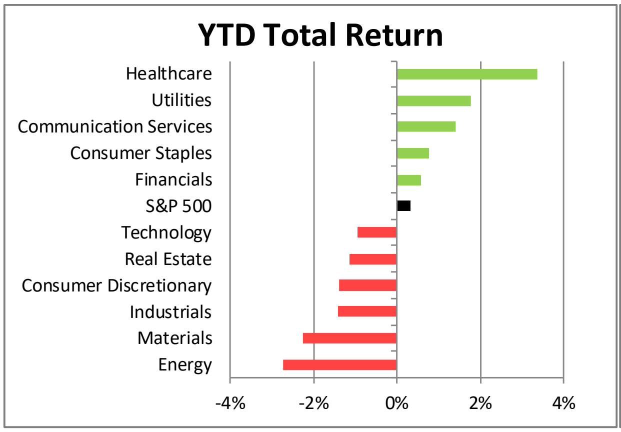
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$78.25	$76.80	1.89%	
WTI	$72.83	$71.37	2.05%	
Natural Gas	$2.97	$3.04	-2.27%	
Crack Spread	$23.54	$23.14	1.76%	
12-mo strip crack	$23.70	$23.39	1.33%	
Ethanol rack	$1.75	$1.76	-0.34%	
Metals				
Gold	$2,033.60	$2,024.41	0.45%	
Silver	$23.07	$22.90	0.76%	
Copper contract	$381.40	$378.10	0.87%	
Grains				
Corn contract	$460.00	$459.50	0.11%	
Wheat contract	$609.25	$610.75	-0.25%	
Soybeans contract	$1,244.25	$1,236.50	0.63%	
Shipping				
Baltic Dry Freight	1,664	1,875	-211	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	1.3	-0.2	1.5	
Gasoline (mb)	8.0	2.1	5.9	
Distillates (mb)	6.5	1.8	4.8	
Refinery run rates (%)	-0.6%	-0.7%	0.1%	
Natural gas (bcf)		-122		

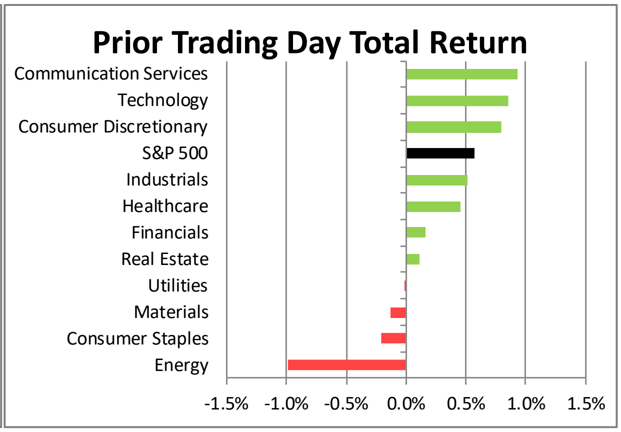
Weather

The 6-10 and 8-14 day forecasts currently call for cooler-than-normal temperatures throughout the entire country from the Rocky Mountains eastward, with warmer-than-normal temperatures only in California. The precipitation outlook calls for wetter-than-normal conditions in the Pacific Northwest, the northern Rocky Mountains, and Florida, with dry conditions in the Midwest and New England.

Data Section

U.S. Equity Markets – (as of 1/10/2024 close)

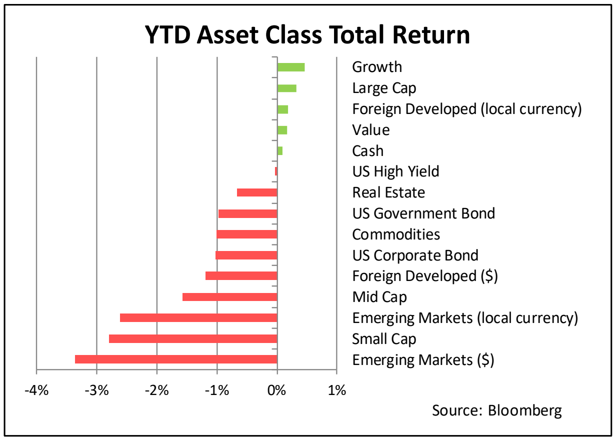




(Source: Bloomberg)

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 1/10/2024 close)

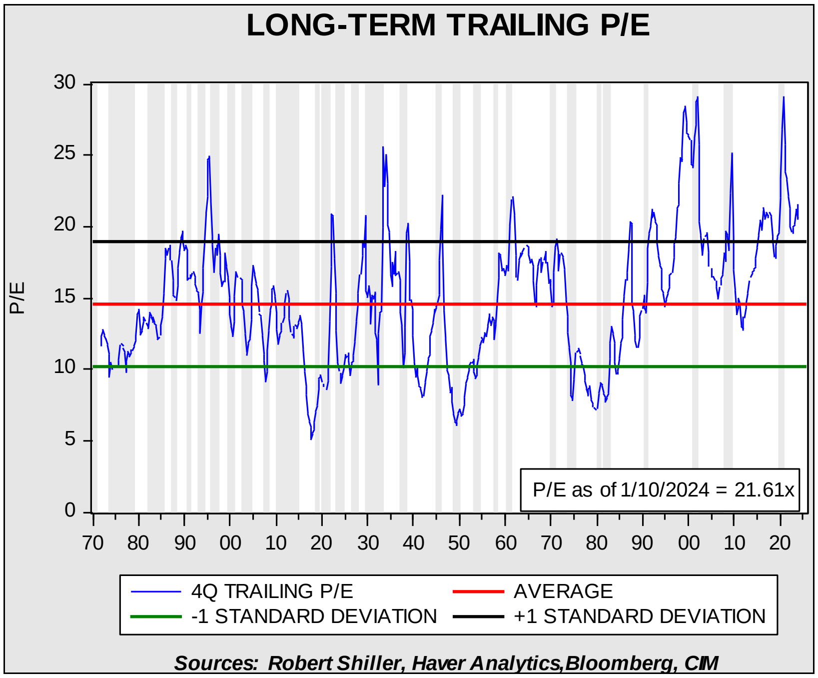


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 11, 2024



Based on our methodology,[1] the current P/E is 21.6x, up 1.2x from our last report. An increase in the price index due to a quarterly adjustment and a slight decline in earnings helped lift 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.