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 12, 2024—9:30 AM EST] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.5% from its prior close. In Asia, the MSCI Asia Apex 50 Index was essentially unchanged. Chinese markets were lower, with the Shanghai Composite down 0.2% from its previous close and the Shenzhen Composite down 0.6%. 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:

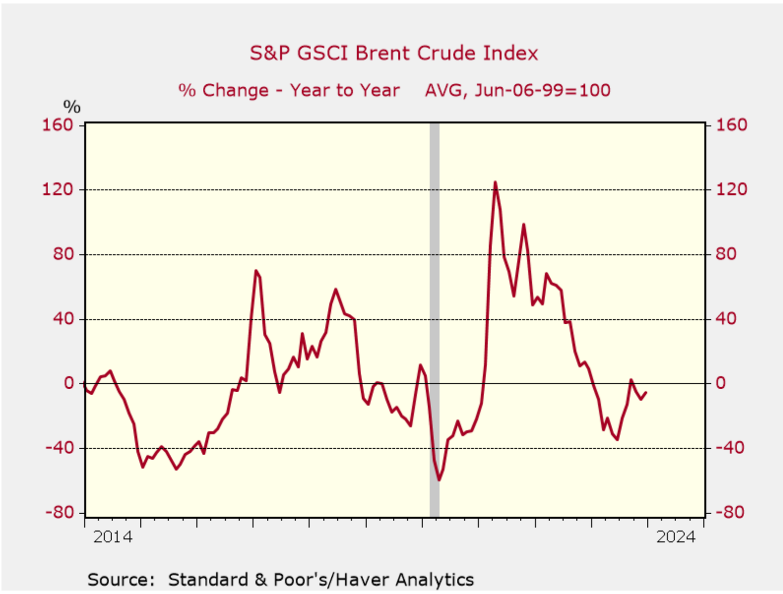
- *Bi-Weekly Geopolitical Report* (12/11/2023) (with associated *Confluence of Ideas* podcast): "The 2024 Geopolitical Outlook"
- *Weekly Energy Update* (12/14/2023): Oil prices have been under pressure as geopolitical risk premium evaporates; COP28 ended with a deal to "shift" from fossil fuels, softer 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! U.S. equities appear subdued ahead of the weekend, while Inter Miami's new game plan is clear — feed Messi! Today's *Comment* kicks off with an analysis of the potential risks of Western allies' joint action against Houthi rebels, followed by a deep dive into why traders remain confident in a March Fed rate cut. We also unpack the latest Japanese monetary policy decisions and bring you up to speed on key domestic and international data releases.

Broadening Conflict: The U.S. and U.K. launched joint airstrikes against Houthi rebels in Yemen, heightening tensions in the Middle East.

- The U.S. and U.K. launched joint airstrikes against Houthi rebel targets in Yemen, responding to their recent attacks on commercial ships in the Red Sea. They were joined by Australia, Bahrain, Canada, and the Netherlands in this operation. The coalition used precision-guided missiles to hit more than 60 targets in 16 locations in Yemen. This coordinated effort comes days after the U.S. and its allies warned Houthi rebels that continued attacks on vessels would lead to a military response. The coordinated offensive raises the likelihood of a broader conflict in the Middle East. In response to the attack, the Houthis have vowed to retaliate.

- Fighting in the region is likely to lead to volatility in oil prices. The International Association of Independent Tank Owners, a trade group representing 70% of globally traded petrochemicals, has advised its members to stay away from the highly contested Bab-el-Mandab strait. The warning comes a day after Iran seized a ship with Iraqi crude that was headed for Turkey in the Gulf of Oman. Uncertainty regarding how the next few days will play out has led to a surge in oil prices, which have risen 4% over the past two days as traders price in the potential for supply disruptions. Despite the uncertainty, oil prices remain below the previous year's levels.



- Red Sea tensions underscore the U.S.'s critical role in safeguarding economic stability through ensuring free passage in key shipping lanes. Though oil prices have been affected, swift containment of the situation should prevent long-term trade disruptions. Yet, a wider conflict which escalates military action could trigger a more sustained price shock and heighten recessionary risks, potentially sparking financial market panic due to geopolitical uncertainty. Although we remain optimistic that this will not turn into an all-out war in the Middle East, we acknowledge that risks remain elevated.

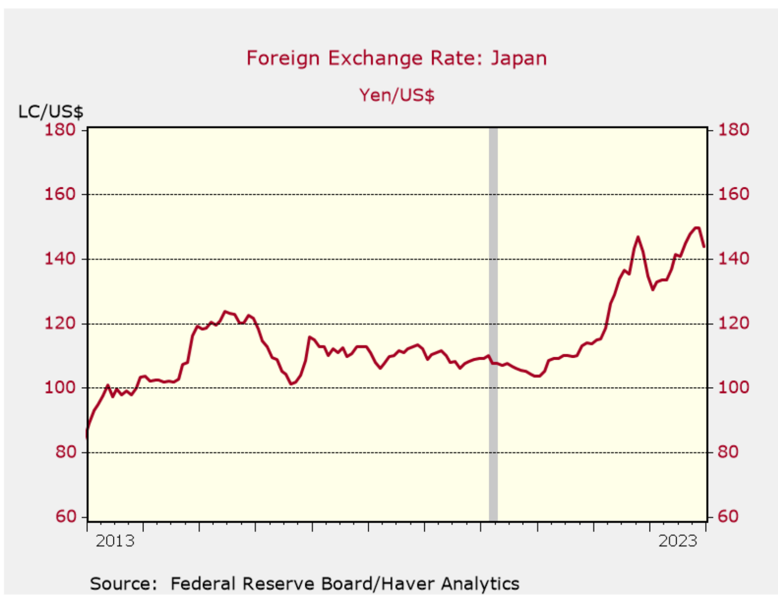
Traders Unconvinced: Market bets of rate cuts surprisingly increased even after hotter-than-expected inflation data and a reiterated commitment from Fed officials to maintaining restrictive policy.

- Central bank officials pushed back on speculation of March rate cuts but stopped short of ruling them out entirely. Hawk Loretta Mester, president of the Cleveland Fed, insisted it's too early for such a move. However, she pointed out that December's inflation uptick doesn't mean that progress has stalled. Meanwhile, both Richmond and Chicago Fed Presidents Thomas Barkin and Austan Goolsbee, refused to rule out a March rate cut, adding to the uncertainty. The lack of clarity from Fed officials prompted markets to boost their March pivot prediction by five percentage points, raising the expectation of a rate cut next spring to 70%.
- Mixed economic data fuels uncertainty around the Fed's March policy stance. December inflation hit 3.4%, exceeding both forecasts and November's reading, raising concerns about a potentiation return of price pressures. Conversely, a surprisingly strong December job market, which added 216,000 positions, suggests ongoing economic momentum. While headline figures mask nuanced trends, like a downward shift in monthly inflation and a steady increase in the number of unemployed workers throughout the year, the Fed's muted reaction indicates they're prioritizing different factors or possible embracing ambiguity. With conflicting signals and hidden depths, predicting their next move is like peering into a foggy crystal ball — a gamble fraught with uncertainty.

- Pent-up anticipation of a Fed pivot to easier policy has fueled risk appetite, with traders betting on six aggressive rate cuts this year. While this expectation reflects the perceived historical tendency of the Fed to cut rates faster than it raises them, we believe the actual easing cycle will be later and shallower than the market anticipates. If policymakers prove less dovish, the recent bond rally could face a sharp reversal. Nevertheless, even in that scenario, fixed-income securities should fare better than last year. The upcoming FOMC meeting will likely serve as the key turning point, testing market expectations and setting the tone for the year ahead.

What's Next for BOJ? The Nikkei 225 continues to rally in 2024 as investors grow concerned that the Bank of Japan won't be able to shift away from its aggressive monetary easing.

- The strength of Japan's benchmark stock index comes amid signs that nominal wage growth slowed sharply in the final months of 2023. The annual change in nominal wage growth slowed to 0.2% in November, down considerably from the previous month's rise of 1.5%. The slowdown raises concerns that BOJ Governor Ueda will see it as a sign of weak inflationary pressures, and will delay his planned pivot away from aggressive monetary easing. The wage slowdown points to firms' continued reluctance to increase labor earnings, likely due to concerns about hurting profit margins if they cannot readily pass on the costs to consumers.
- While optimism has fueled a surge in popularity for Japanese equities since 2023, concerns linger about the sustainability of the rally. The Nikkei's RSI climbed above the overbought threshold of 70, suggesting a potential loss of momentum in the coming months. Price pressures also provide a headwind. November's CPI data showed a welcome decline in annual inflation to 2.5%, down from 3.2% in October. However, government forecasts predict inflation will struggle to fall below that threshold throughout 2024, exceeding the central bank's 2% target.

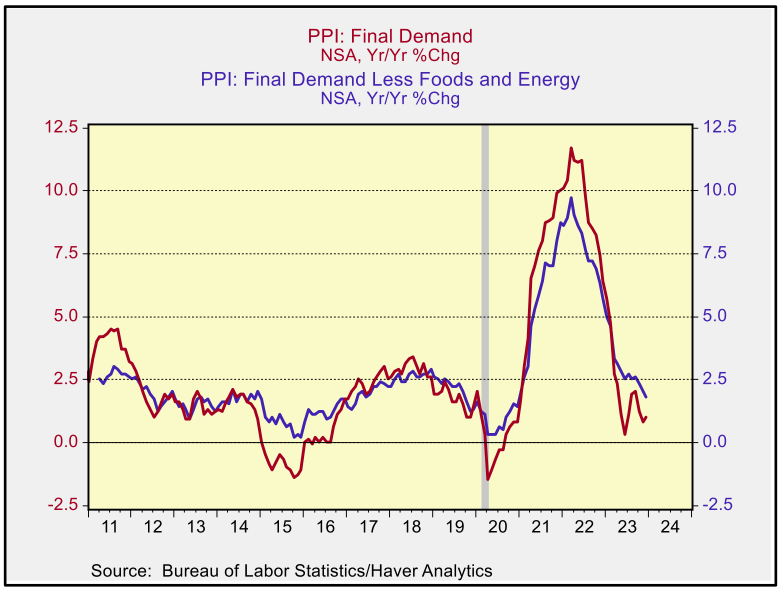


- Many economists and market analysts anticipate that the Bank of Japan will eventually pivot away from its ultra-accommodative policy, but the timing largely hinges on the outcome of the annual wage negotiations in March, known as *Shunto*. If labor unions secure significant wage increases, the central bank may feel compelled to finally raise interest rates or adjust its yield curve control policy, potentially leading to a stronger yen (JPY). This may hurt Japanese businesses due to higher borrowing costs and a less competitive currency, but we suspect the fallout could spread into global financial markets due to the preponderance of yen carry trades that are outstanding.

Other news: Taiwan's presidential elections take place this weekend, and China has issued another strong warning against any moves towards formal independence, raising concerns about a potential increase in regional tensions.

U.S. Economic Releases

The December ***producer price index (PPI)*** fell by a seasonally adjusted 0.1% for a second straight month, rather than posting the expected increase of 0.1%. Excluding the volatile food and energy components, the December ***"core" PPI*** was unchanged for a second straight month, rather than posting its expected rise of 0.2%. The overall PPI in December was up just 1.0% from the same month one year earlier, while the core PPI was up 1.8%. The relatively soft PPI figures could help offset some of the concern about the relatively firm CPI numbers released yesterday. The chart below shows the year-over-year change in the PPI and the core PPI over the last decade or so.



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**
10:00	Neel Kashkari Speaks at Regional Economic Conditions Conference	President of the Federal Reserve Bank of Minneapolis

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	Foreign Buying Japan Stocks	w/w	5-Jan	¥296.2b	-¥337.3b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	5-Jan	¥542.3b	-¥204.8b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	5-Jan	-¥402.7b	¥460.7b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	5-Jan	¥190.7b	¥40.3b		*	Equity and bond neutral
	BoP Current Account Balance	m/m	Nov	¥1925.6b	¥2582.8b	¥2385.1b	***	Equity and bond neutral
	BoP Trade Balance	m/m	Nov	-¥724.1b	-¥472.8b	-¥533.0b	**	Equity and bond neutral
China	Aggregate Financing CNY	m/m	Dec	1940.0b	2450.0b	2454.7b	*	Equity and bond neutral
China	New Yuan Loans	m/m	Dec	1170.0b	1090.0b	1088.7b	**	Equity and bond neutral
	Money Supply M2	y/y	Dec	9.7%	10.0%	10.1%	***	Equity and bond neutral
	Money Supply M1	y/y	Dec	1.3%	1.3%	1.5%	*	Equity and bond neutral
	Money Supply M0	y/y	Dec	8.3%	10.4%		*	Equity and bond neutral
	Exports	y/y	Dec	2.3%	0.5%	1.5%	**	Equity and bond neutral
	Imports	y/y	Dec	0.2%	-0.6%	-0.5%	**	Equity and bond neutral
	Trade Balance	m/m	Dec	$75.34b	$68.39b	$68.40b	***	Equity and bond neutral
	CPI	y/y	Dec	-0.3%	-0.5%	-0.4%	***	Equity and bond neutral
	PPI	y/y	Dec	-2.7%	-3.0%	-2.6%	**	Equity and bond neutral
India	Industrial Production	y/y	Nov	2.4%	11.7%	11.6%	***	Equity bearish, bond bullish
	CPI	y/y	Dec	5.6%	5.6%	5.8%	***	Equity and bond neutral
EUROPE								
France	CPI, EU Harmonized	y/y	Dec F	4.1%	4.1%	4.1%	**	Equity and bond neutral
	CPI	y/y	Dec F	3.7%	3.7%	3.7%	***	Equity and bond neutral
UK	Industrial Production	y/y	Nov	-0.1%	0.4%	-0.5%	***	Equity and bond neutral
	Manufacturing Production	y/y	Nov	1.3%	0.8%	0.2%	**	Equity and bond neutral
	Visible Trade Balance	m/m	Nov	-£14189m	-£17032m	-£15936m	**	Equity and bond neutral
	Trade Balance	m/m	Nov	-£1408m	-£4480m	-£3198m	**	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	5-Jan	598.5	593.4b		***	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)	521	522	-1	Flat
U.S. Sibor/OIS spread (bps)	531	531	0	Down
U.S. Libor/OIS spread (bps)	530	530	0	Down
10-yr T-note (%)	3.99	3.97	0.02	Flat
Euribor/OIS spread (bps)	394	394	0	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.

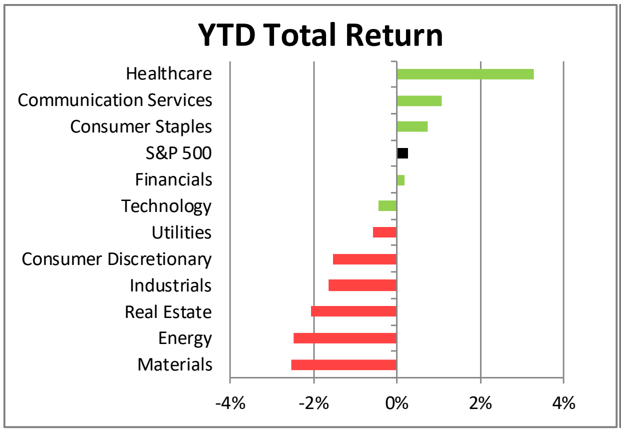
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$80.01	$77.41	3.36%	
WTI	$74.55	$72.02	3.51%	
Natural Gas	$3.19	$3.10	2.97%	
Crack Spread	$25.08	$24.63	1.81%	
12-mo strip crack	$24.46	$24.26	0.81%	
Ethanol rack	$1.74	$1.74	-0.34%	
Metals				
Gold	$2,049.10	$2,028.91	1.00%	
Silver	$23.05	$22.75	1.31%	
Copper contract	$379.05	$377.65	0.37%	
Grains				
Corn contract	$458.50	$457.75	0.16%	
Wheat contract	$607.50	$603.75	0.62%	
Soybeans contract	$1,242.75	$1,236.50	0.51%	
Shipping				
Baltic Dry Freight	1,554	1,664	-110	
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)	-140	-121	-19	

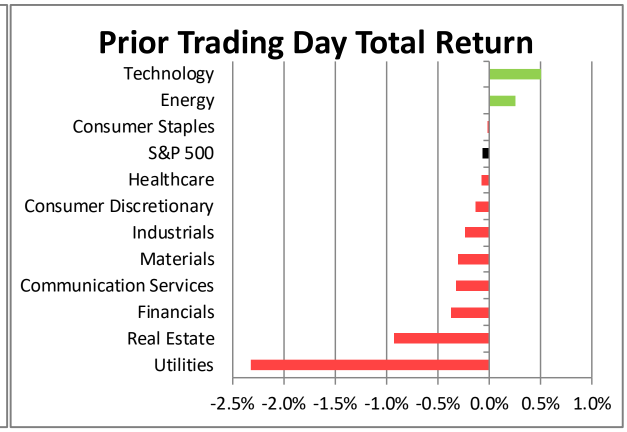
Weather

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 along the West Coast. The precipitation outlook calls for wetter-than-normal conditions in the Pacific Northwest, the Rocky Mountains, the southern Great Plains, and the Southeast, with dry conditions in the Midwest and the Mid-Atlantic states.

Data Section

U.S. Equity Markets – (as of 1/11/2024 close)

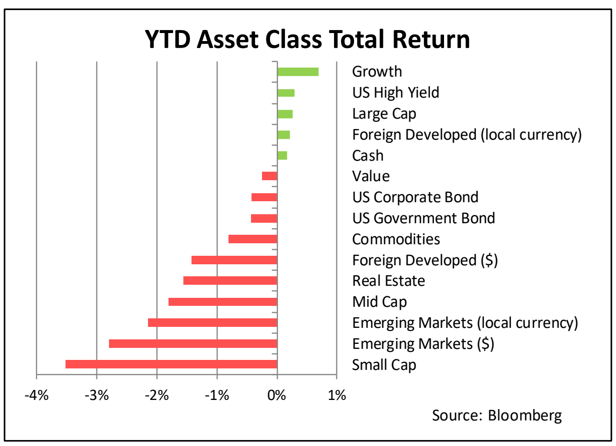




(Source: Bloomberg)

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 1/11/2024 close)

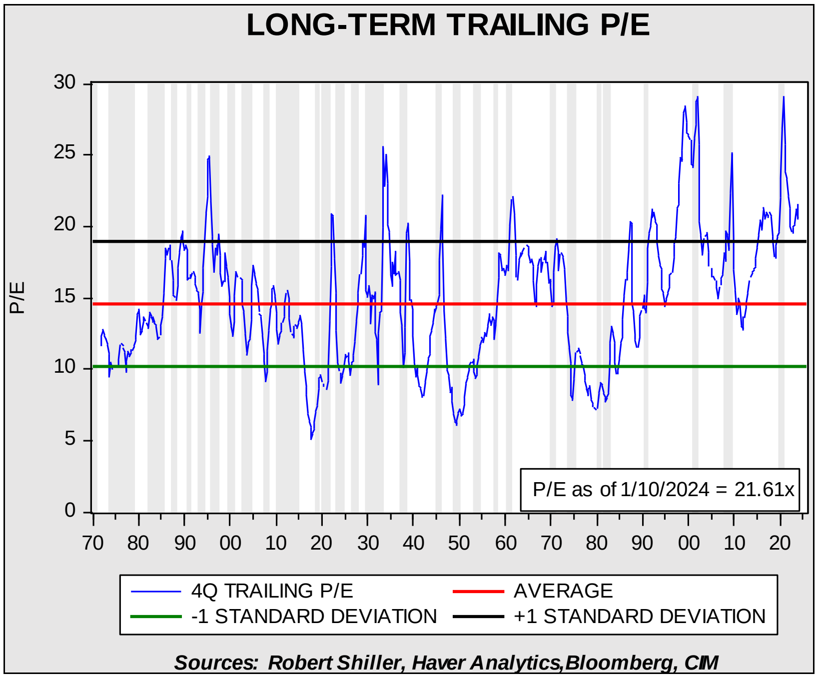


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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.