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 17, 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 2.4%. Chinese markets were lower, with the Shanghai Composite down 2.1% from its previous close and the Shenzhen Composite down 2.5%. U.S. equity index futures are signaling a lower open.

With 32 companies having reported so far, S&P 500 earnings for Q4 are running at $54.50 per share, compared to estimates of $55.15, which is up 1.6% from Q3 2023. Of the companies that have reported thus far, 87.5% have exceeded expectations while 9.4% have fallen short of expectations.

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*** **(1/16/2024) (with associated podcast): "What If Russia Wins in Ukraine?"**
- *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 new data showing slowing wage growth in major developed countries, which should eventually allow the major central banks to start cutting interest rates (though probably not as soon as many investors expect). We next review a range of other international and U.S. developments with the potential to affect the financial markets today, including the latest signs that the Middle East conflicts could broaden and worsen and increased regulatory action in the U.S. as the Biden administration gears up for the November election.

Global Labor Markets: New cross-country figures from recruiting site Indeed show average wage growth slowed markedly in major developed countries over the last six months. In the U.S., for example, the report shows advertised wages and salaries in December were up just 3.8% year-over-year, down from a peak of 9.5% year-over-year in late 2021. Advertised wages and salaries in the eurozone were also up 3.8% on the year, compared with a peak of 5.2% in 2022. Pay increases also moderated in the U.K.

- The figures from Indeed help confirm that consumer price pressure is likely to keep moderating in the near term.
- In turn, that should help encourage the major central banks to eventually start cutting interest rates, although policymakers continue to caution that any rate cuts will likely come later than investors currently seem to expect (see the latest statements in this regard in our discussions below).

Middle East Conflicts: One day after launching missile strikes against regime opponents in Syria and Iraq (including an alleged Israeli "intelligence center"), Iran's Shiite-led government said yesterday that it launched missiles and drones against a Sunni jihadist group in Pakistan. Separately, the U.S. launched a strike against Iran-backed Houthi rebels in Yemen for the third time in the last week, preemptively destroying four anti-ship ballistic missiles the rebels were preparing to launch against commercial and military ships in the Red Sea.

- The latest attacks come on top of Israel's continuing ground invasion against Hamas militants in the Gaza Strip, its effort to control rising unrest among Palestinians in the West Bank, and sympathy attacks against Israel by Iran-backed militants in Lebanon, Syria, and Iraq.
- Outside of Gaza, it appears that all these entities are trying to calibrate their attacks to sufficiently weaken or dissuade their targets without sparking an even stronger response. With so many different countries and groups launching weapons, we see an increasing risk that one of them will miscalculate and spark an even broader, more intense, and more dangerous escalation.
- It's true that even safe-haven assets such as gold and crude oil sold off today (probably on concern that interest rates won't be cut as aggressively as investors had hoped), but the growing risk of a broader conflict in the Middle East will likely keep them relatively well bid in the near term.

Chinese Economic Growth: As flagged by Premier Li Qiang in a speech yesterday, the government issued official data today showing Chinese gross domestic product rose by an inflation-adjusted 5.2% in 2023. That was slightly better than the government's target of 5.0% for the year, but excluding the extraordinary swings during the COVID-19 pandemic, it was the slowest official growth rate since 1990.

- Going forward, we expect Chinese economic growth to remain challenged by what we call the "Five Ds": Weak consumer ***demand***, high corporate and local government ***debt***, poor ***demographics***, economic ***disincentives*** from the Communist Party's increasing intrusion into the economy, and ***decoupling*** as foreign countries shift their trade, investment, and technology flows away from China.

- Since China accounts for so much of the global economy and world trade, its continued weakness is likely to weigh on output in countries around the world, retarding profit growth and presenting headwinds for financial markets.

Chinese Demographics: Highlighting China's demographic challenges, data today shows births in the country fell to slightly more than 9 million in 2023, down from more than 9.5 million in 2022 and less than half the nearly 19 million as recently as 2016 (see graph below). That means China's fertility rate — the number of children a woman has over her lifetime — has fallen to just above 1.0, far below the "replacement rate" of more than 2.0. The figures therefore portend further population declines and increasing average ages in the future.

Eurozone: At the World Economic Forum in Davos, Switzerland today, European Central Bank chief Lagarde said her institution would probably wait until summer before cutting interest rates, rather than cutting in the spring as some officials and observers expect. Coupled with a surprise acceleration in U.K. consumer price inflation announced today, Lagarde's statement is further evidence that bond investors around the world have gotten ahead of themselves in expecting near-term rate cuts. Global stock and bond prices have therefore fallen so far today.

France: In an effort to undercut the rising popularity of right-wing populists, President Macron has announced that his new cabinet will focus on law and order, easier regulations for businesses and workers, and reduced budget deficits. In theory, the pro-business policies should be attractive to investors, but it is important to remember that Macron's centrist alliance no longer has a majority in parliament, so getting the program into law will be challenging.

U.S. Monetary Policy: In a speech yesterday, Fed Governor Christopher Waller warned that the monetary policymakers want to be sure consumer price inflation has indeed been subdued, so they would "take [their] time" before cutting interest rates. With the statement, Waller appeared to be taking back the dovish views he shared last November, which helped spark the recent rally in bonds and drove yields back down to what we consider excessively low levels. In response, investors dumped bonds, and the yield on the 10-year Treasury note jumped to 4.0660%.

U.S. Energy Regulation: Under pressure from climate-change activists, the Biden administration is reportedly considering whether to review the government process for approving export terminals for liquified natural gas. Since the U.S. opened its prolific shale patch in recent years, the country has become the world's top exporter of LNG. Any eventual new regulations could throttle the growth of the industry and boost energy prices abroad, although bottling up gas in the U.S. market could bring down prices — and profits — here at home.

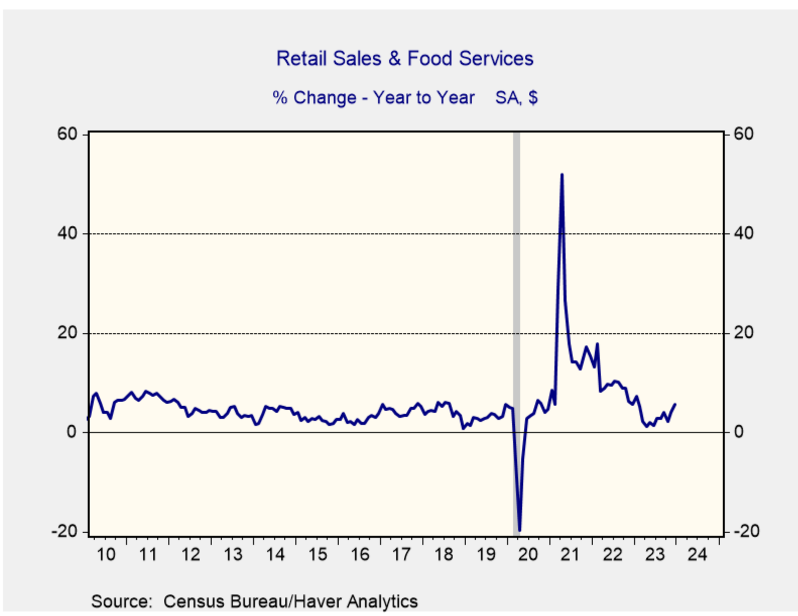
U.S. Financial Services Regulation: Stepping up the Biden administration's attack against "junk fees," the Consumer Financial Protection Bureau today is expected to propose a cap on overdraft fees at banks with $10 billion or more in assets. Reports indicate the proposed cap could be as low as $3 per instance, compared with as much as $39 today. If implemented, the cap could greatly reduce the $9 billion or so of overdraft fees that major banks pull in annually.

U.S. Artificial Intelligence Industry: Microsoft (MSFT, $390.27) announced today that it will offer new subscription-based AI tools for individuals and small businesses that would include the ability to develop custom chatbots. The move is consistent with our previously expressed view that AI would likely evolve from enormous, broad-based generative AI systems to more highly focused, customized AI tools for specific purposes or which could perhaps be trained on an organization's specific data. In any case, the announcement points to continued rapid innovation in AI.

U.S. Economic Releases

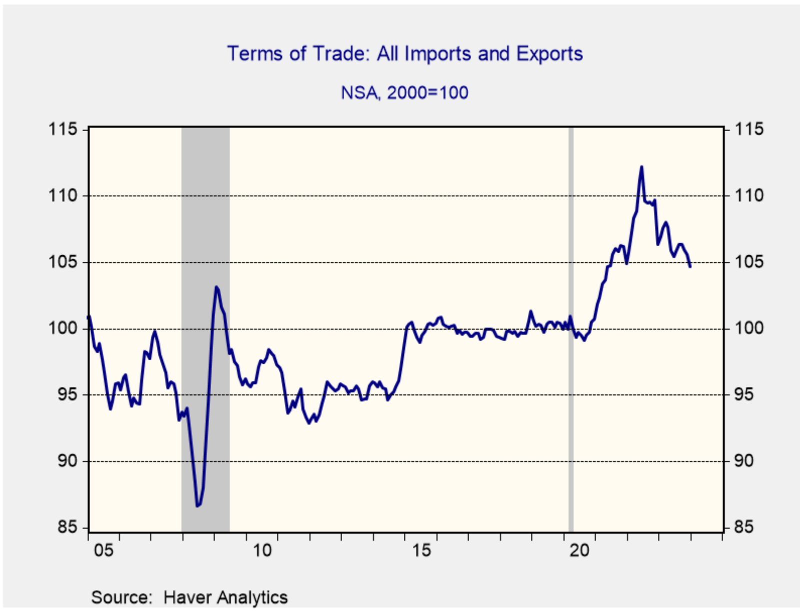
Home loan demand surged last week, fueled by lower interest rates that spurred a jump in purchases. The Mortgage Bankers' Association index tracked a 10.4% increase in mortgage applications for the week ending January 12. This rise was driven, in part, by a 6-basis-point drop in the 30-year fixed-rate mortgage, bringing it to a six-week low of 6.75%. Consequently, the MBA's purchase and refinance trackers saw impressive increases of 10.8% and 9.2%, respectively, compared to the previous week.

Consumer spending in December exceeded expectations, indicating stable demand despite economic concerns. U.S. Department of Commerce data showed headline retail sales unexpectedly surged 0.6% from the previous month, beating the forecast of 0.4%. Excluding autos, retail sales still grew 0.4% above the 0.2% expectation. Core retail sales, stripping out autos and gas, climbed 0.6%, while the retail sales control group, which also excludes building parts, saw a healthy 0.8% increase.



The chart above shows the annual change in retail sales, which rose 5.59% in December. This acceleration suggests that consumer confidence remains strong, even amidst economic uncertainties.

Lastly, trade prices continue to paint a subdued picture of global demand. Import prices remained flat despite forecasts of a 0.5% decline. Excluding petroleum, the trend remained muted at 0.0%, falling short of the anticipated increase of 0.5%. This weak picture for the global economy was furthered supported by export prices, which slipped 0.9% last month, albeit slightly worse than the expected 0.7% drop.



The above chart shows the terms of trade index which measures the relative change of export prices to import prices. In December, the index fell to its lowest level since December 2021, in a sign that global trends currently do not favor exporters.

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**
9:15	Industrial Production	m/m	Dec	-0.1%	0.2%	***
9:15	Industrial Capacity Utilization	m/m	Dec	78.7%	78.8%	**
10:00	Business Inventories	m/m	Nov	-0.1%	-0.1%	*
10:00	NAHB Housing Market Index	m/m	Jan	39.0	37.0	*
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
9:00	Michael Barr Speaks at Conference on Cyber Risk	Federal Reserve Board Vice Chair for Supervision				
9:00	Michelle Bowman Speaks About Future of Bank Capital Reform	Member of the Board of Governors				
14:00	U.S. Federal Reserve Releases Beige Book	Federal Reserve Board				
15:00	John Williams Speaks at NY Fed Event	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								
New Zealand	CoreLogic House Prices	y/y	Dec	-3.5%	-4.5%		*	Equity and bond neutral
China	Industrial Production	y/y	Dec	6.8%	6.6%	6.6%	***	Equity and bond neutral
	Retail Sales	y/y	Dec	7.4%	10.1%	8.0%	*	Equity bearish, bond bullish
	GDP	q/q	4Q	5.2	4.9	4.9	***	Equity and bond neutral
EUROPE								
Eurozone	CPI	y/y	Dec F	2.9%	2.9%	2.4%	***	Equity bearish, bond bearish
	Core CPI	y/y	Dec F	3.4%	3.4%	3.4%	**	Equity and bond neutral
UK	CPI	y/y	Dec	4.0%	3.9%	3.8%	***	Equity and bond neutral
	Core CPI	y/y	Dec	5.1%	5.1%	4.9%	***	Equity and bond neutral
	Retail Price Index	y/y	Dec	379.0	377.3	378.7	**	Equity and bond neutral
	RPI	y/y	Dec	5.2%	5.3%	5.1%	**	Equity and bond neutral
	House Price Index	y/y	Nov	-2.1%	-1.2%	-1.3%	*	Equity bearish, bond bullish
AMERICAS								
Canada	CPI	y/y	Dec	3.4%	3.1%	3.4%	***	Equity and bond neutral
Mexico	International Reserves Weekly	w/w	12-Jan	$212723m	$212408m		*	Equity and bond neutral
Brazil	FGV Inflation IGP-10	m/m	Jan	-42.00%	0.00%	0.46%	*	Equity and bond neutral
Brazil	Retail Sales	y/y	Nov	2.2%	0.2%	2.0%	***	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)	558	558	0	Down
3-mo T-bill yield (bps)	522	520	2	Flat
U.S. Sibor/OIS spread (bps)	531	531	0	Down
U.S. Libor/OIS spread (bps)	531	531	0	Down
10-yr T-note (%)	4.07	4.06	0.01	Flat
Euribor/OIS spread (bps)	389	393	-4	Down
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Flat			Up
Yen	Down			Up
Pound	Up			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.

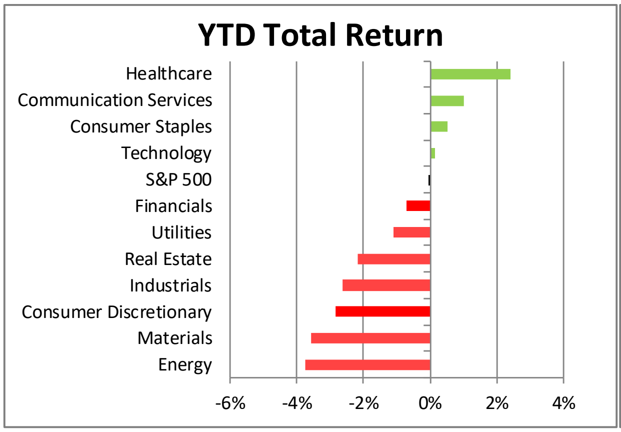
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$76.96	$78.29	-1.70%	
WTI	$70.95	$72.40	-2.00%	
Natural Gas	$2.80	$2.90	-3.48%	
Crack Spread	$24.75	$24.45	1.20%	
12-mo strip crack	$24.70	$24.47	0.94%	
Ethanol rack	$1.77	$1.76	0.83%	
Metals				
Gold	$2,026.56	$2,028.44	-0.09%	
Silver	$22.80	$22.92	-0.53%	
Copper contract	$375.80	$376.65	-0.23%	
Grains				
Corn contract	$441.25	$443.50	-0.51%	
Wheat contract	$582.75	$582.00	0.13%	
Soybeans contract	$1,218.75	$1,227.25	-0.69%	
Shipping				
Baltic Dry Freight	1,324	1,360	-36	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		0.3		
Gasoline (mb)		3.0		
Distillates (mb)		1.8		
Refinery run rates (%)		-0.6%		
Natural gas (bcf)		-165		

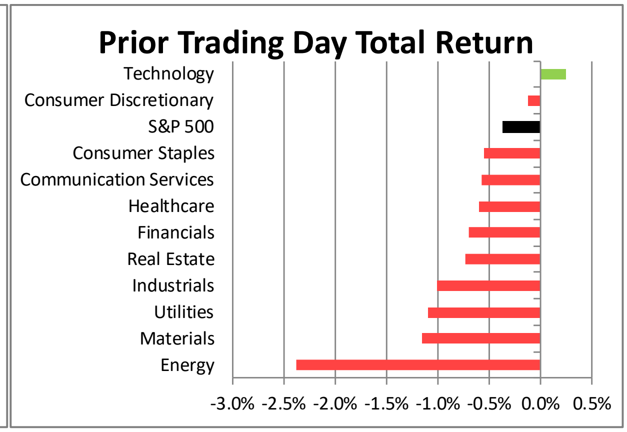
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for the entire country. Meanwhile, the precipitation outlook calls for wetter-than-normal conditions in most states, with dry conditions in the Rocky Mountain region.

Data Section

U.S. Equity Markets – (as of 1/16/2024 close)

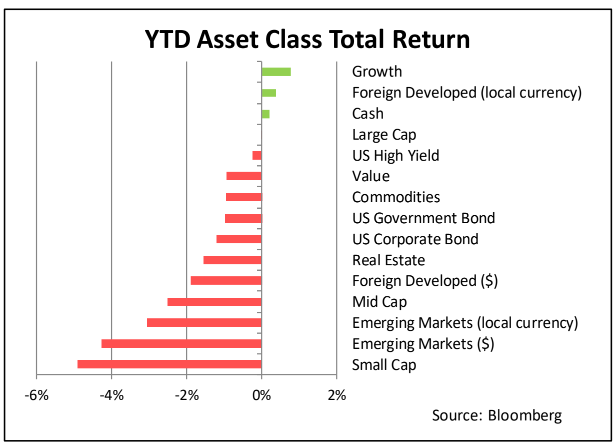




(Source: Bloomberg)

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 1/16/2024 close)

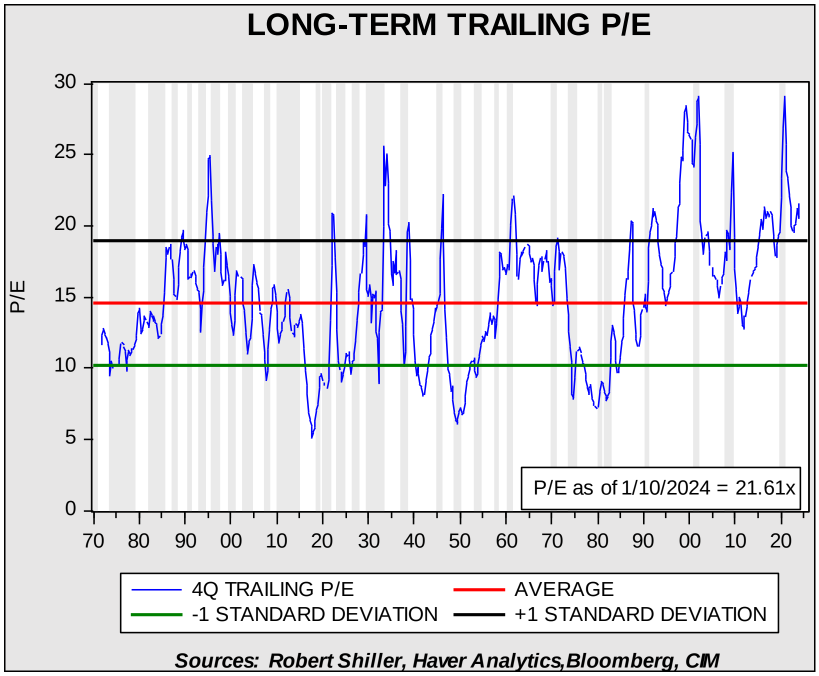


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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.