# 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 18, 2024—9:30 AM EST]** Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is up 1.0% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.9%. Chinese markets were higher, with the Shanghai Composite up 0.4% from its previous close and the Shenzhen Composite up 0.2%. U.S. equity index futures are signaling a higher open.

With 38 companies having reported so far, S&P 500 earnings for Q4 are running at $54.40 per share, compared to estimates of $55.15, which is up 1.6% from Q3 2023. Of the companies that have reported thus far, 81.6% have exceeded expectations while 13.2% 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)

Good morning! Chip optimism is electrifying the market, while a potential trade could heat up the Pacers' playoff hopes. In today's *Comment*, we dive into the latest topics: the semiconductor surge, the central bank pivot, and the Basel III Endgame controversy. Plus, we provide our usual roundup of global and domestic economic data.

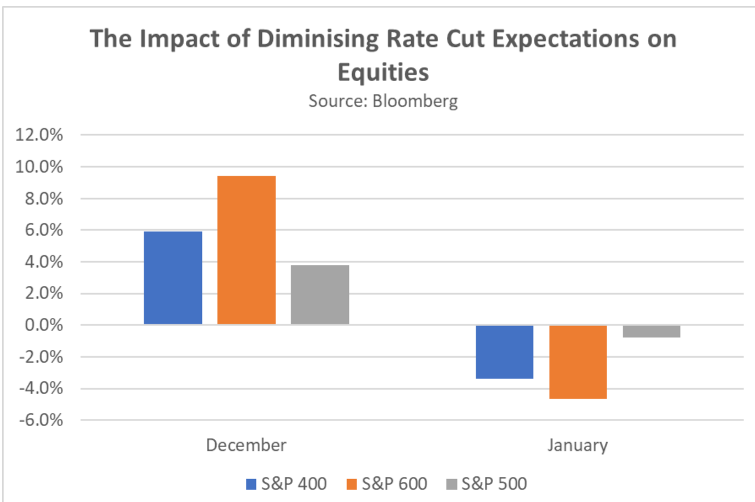
**Chips Making a Comeback?** Despite the waning enthusiasm for AI-related services, semiconductors are blazing back, rebounding from their 2023 lows.

- Taiwan Semiconductor Manufacturing Company (TSM, $111.71)), the main manufacturer of chips for Apple (AAPL, $186.80) and Nvidia (NVDA, $571.99), expects to have a strong first quarter in 2024 and plans to raise its capital expenditure. The optimistic outlook suggests that the company is confident that demand for smartphones and computing should rebound from the previous year and anticipates that its revenue will increase by at least 20%. Additionally, according to data collected by the Semiconductor Industry Association, chip sales rebounded toward the end of 2023.
- Throughout 2023, fueled by AI ambitions, software ruled the tech world. Investors flocked to companies promising the next big algorithm, leaving chipmakers in the dust. However, the tide may be turning. The "Magnificent 7" (AMD, Nvidia, and their peers) have surged in 2023, outpacing the PHLX Semiconductor Sector by nearly tenfold. This recent surge suggests a renewed interest in hardware, the very foundation on which software thrives. While the broader market remains cautious, the two indexes are now roughly in tandem, hinting at a potentially strong year for chipmakers.


- The surge in chip stocks signals a broader market tilt, with investors on the hunt for hidden gems. Predicting the top dog is still a crapshoot, but last year's champions could face a reckoning. Lofty valuations hinge on major tech companies meeting ambitious earnings projections, and any stumbles could leave them vulnerable to a sell-off. However, falling interest rates could be a boon for companies with strong fundamentals, potentially giving mid- and small-caps, last year's neglected stars, their moment in the spotlight.

**Market Takes a Breather:** Uncertainty over global rates has spooked investors, but guarded risk appetite could offer pockets of opportunity.

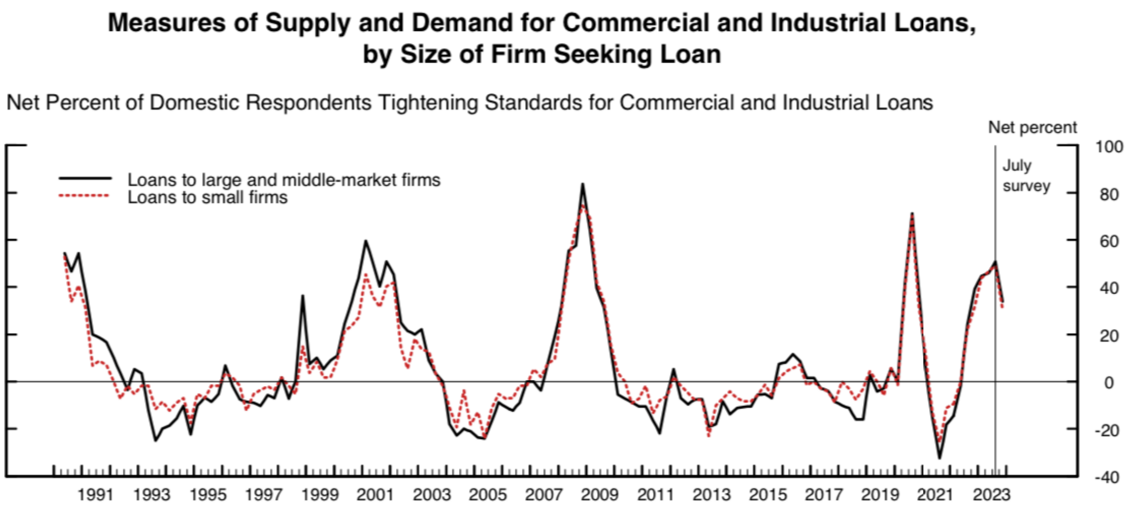
- Central bankers have looked to rein in investor expectations of interest rate cut expectations. On Wednesday, European Central Bank President Christine Lagarde ruled out the possibility of a pivot in the spring in favor of summer. Meanwhile, officials from the Federal Reserve have cautioned the market that this easing cycle will not be as aggressive as previous cycles. Their skepticism was reinforced by incoming data that showed that the headline in inflation in the U.S. and the European Union accelerated in December. Although market expectations show that traders do not expect the ECB to cut in the spring, that is not true for the Fed. Implied overnight swaps suggest there is a 56% chance that U.S. policymaker will lower rates in March, down from 83% a week ago.
- As interest rate expectations shifted recently from anticipating six Fed rate cuts by year-end to a more modest stance due to push back from several Fed officials, investors rushed to unwind their earlier bullish positions in small- and mid-cap stocks. These companies had previously attracted significant inflows as investors sought higher returns in anticipation of a dovish Fed-fueled rally. However, a change in rate expectations has led investors to position their portfolios to protect against the possibility that policymakers may be preparing to hold rates at their current levels for a longer-than-expected period.




- Over the last thirty years, the Fed hiked rates gradually but cut them aggressively. Recent comments suggest a different approach this time. While a March cut is still possible, recent comments from Fed policymakers indicate a less aggressive pace than markets anticipate. This shift could be due to concerns about inflation or financial stability. A slower pace of cuts might delay investor's shift toward stocks with more value. That said, the ECB's lower relative rates give it room to wait before following the Fed's eventual cut. Thus, it is likely that European policymakers may be more patient before they decide to lower their benchmark rates.

**Regulatory End Game:** U.S. federal banking regulators closed public comment on the Basel III Endgame framework this week as they reconsider a key provision related to capital requirements.

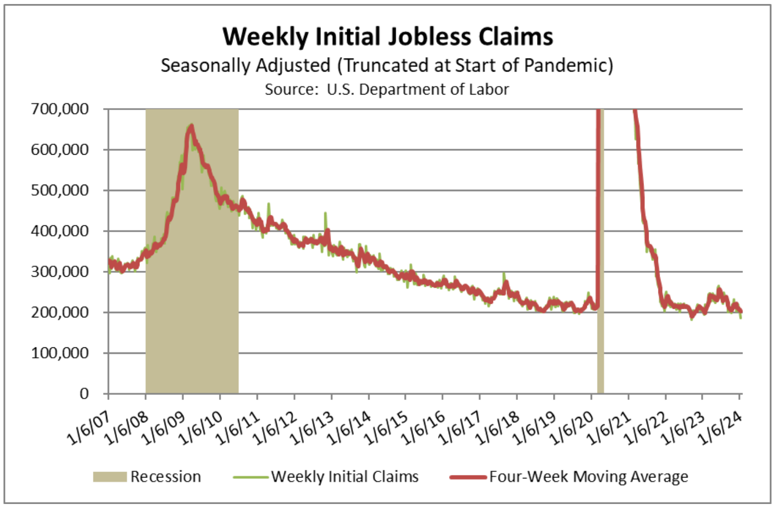
- The proposed capital requirements remain a major sticking point in the wake of the Silicon Valley Bank and Signature Bank collapses. These rules would force banks with over $100 million in assets to boost their capital cushion by 16%, aiming to protect against future financial crunches. However, Federal Reserve Governor Michelle Bowman warns that the current requirement miscalculates the actual cost of new capital and could push lending activity to the riskier shadow banking system. In a sign of potential compromise, Vice Chair of Supervision Michael Barr acknowledged the need for changes and his openness to industry feedback.
- Looming regulatory changes cast a dark cloud over financial stocks. New regulations threaten to handcuff major banks, forcing them to ditch risky bets and hoard more cash than they'd like. This could stifle lending, especially for riskier borrowers, as early signs are already suggesting. American banks could face a competitive disadvantage compared to their British and European counterparts who have less stringent rules.



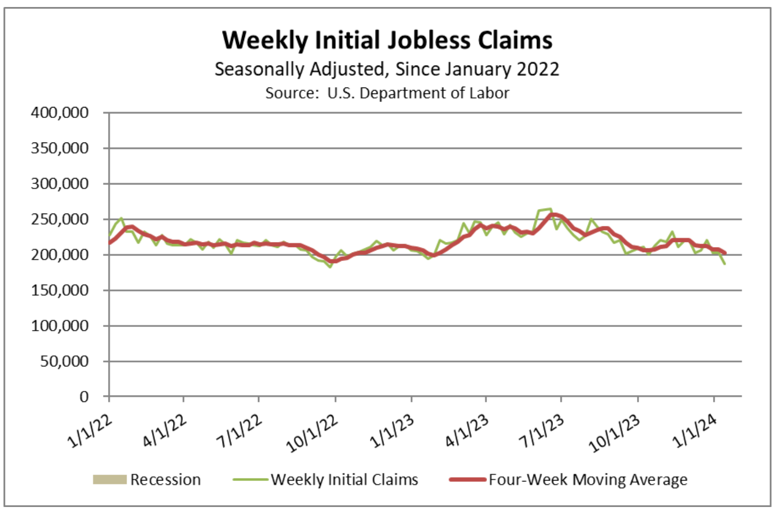

- Despite the anticipation of watered-down regulations, banks are already tightening credit, casting a shadow on future economic growth. The Senior Loan Officer Survey reveals that banks are already starting to reduce loans due to perceived economic headwinds. This year could see even tighter credit, as banks bolster capital reserves to weather the still-distant regulatory storm of late 2025. While the full impact won't be immediate, this preemptive tightening casts a long shadow on economic activity.

## U.S. Economic Releases

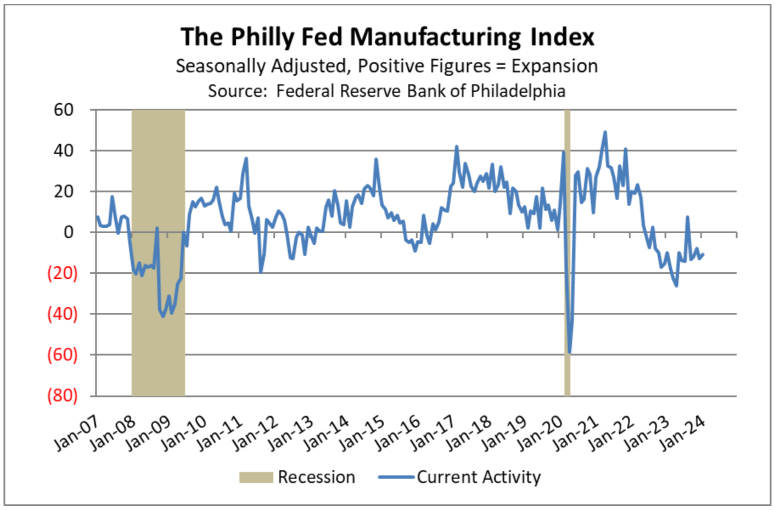
In the week ended January 13, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 187,000, far below the expected level of 205,000 and the previous week's revised level of 203,000. The four-week moving average of initial claims, which helps smooth some of the volatility in the series, fell to an 11-1/2 month low of 203,250. In the week ended January 6, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) declined to 1.806 million, far below the anticipated reading of 1.840 million and the prior week's revised reading of 1.832 million. Although the claims data can be distorted around the holidays, these extraordinarily low figures are likely to raise concerns about rebounding labor demand, a re-acceleration in wage growth, continued upward pressure on consumer prices, and continued high interest rates. 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.



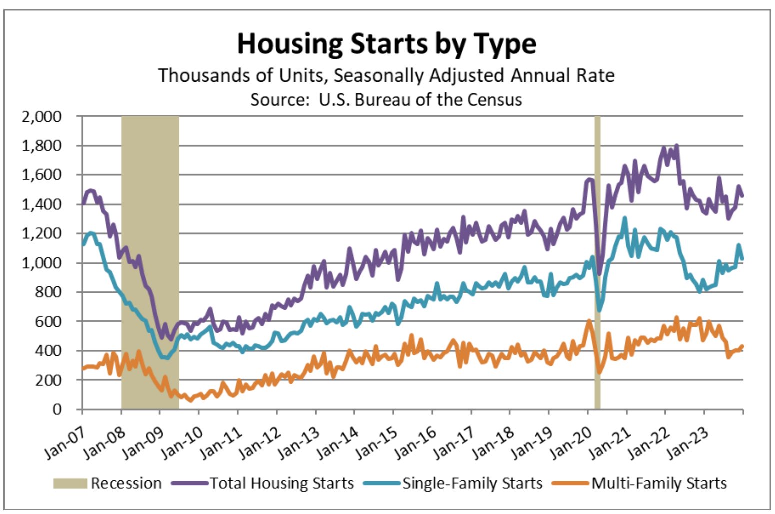

To provide more detail on recent trends, the chart below shows how initial jobless claims have changed just since the beginning of 2022.




Separately, the Philadelphia FRB said its January ***Philly Fed Index*** rose to a seasonally adjusted -10.6, not quite as good as the expected reading of -6.5 but better than the downwardly revised December reading of -12.8. The index, officially called the Philadelphia FRB Manufacturing Activity Index, is designed so that positive readings point to expanding factory activity in the mid-Atlantic region. At its current level, the index suggests the region's manufacturing sector remains in a deep slump. The chart below shows how the index has fluctuated since just before the GFC.




Finally, December ***housing starts*** fell to a seasonally adjusted, annualized rate of 1.460 million units, beating the expected rate of 1.425 million units but sharply lower than the revised November rate of 1.525 million units. The rate of housing starts in December was down 4.3% from the rate in the previous month. On a more positive note, December ***housing permits*** rose to a rate of 1.495 million units, beating both their anticipated rate of 1.477 million units and the revised November rate of 1.467 million units. Permits issued for new housing units in December were up 1.9% from the previous month. Housing starts in December were up 6.9% from the same month one year earlier, driven by groundbreakings for single-family homes. Permits in December were down 2.2% year-over-year, as a big jump in single-family permitting was offset by a decline in multi-family approvals. The chart below shows the growth in new home starts by type of property since just before the GFC.



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** | | |
| | No Fed speakers or events for the rest of today | |
| **EST** | **Speaker or Event** | **District or Position** |
| **12:05** | Raphael Bostic Speaks on Economic Outlook | President of the Federal Reserve Bank of Atlanta |

## 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 | 12-Jan | ¥1202.6b | ¥296.2b | ¥296.8b | * | Equity and bond neutral |
| | Japan Buying Foreign Bonds | w/w | 12-Jan | ¥1642.8b | ¥542.3b | ¥545.2b | * | Equity and bond neutral |
| | Foreign Buying Japan Bonds | w/w | 12-Jan | ¥980.2b | -¥402.7b | -¥401.6b | * | Equity and bond neutral |
| | Japan Buying Foreign Stocks | w/w | 12-Jan | ¥783.3b | ¥190.7b | | * | Equity and bond neutral |
| | Core Machine Orders | m/m | Nov | -5.0% | -2.2% | 0.1% | *** | Equity bearish, bond bullish |
| | Industrial Production | y/y | Nov F | -1.4% | -1.4% | | *** | Equity and bond neutral |
| | Capacity Utilization | m/m | Nov | 0.3 | 1.5 | | ** | Equity bearish, bond bullish |
| **Australia** | Employment Change | m/m | Dec | -65.1k | 61.5k | 72.6k | *** | Equity bearish, bond bullish |
| | Unemployment Rate | m/m | Dec | 3.9% | 3.9% | 3.9% | *** | Equity and bond neutral |
| | Participation Rate | m/m | Dec | 66.8% | 67.2% | 67.3% | ** | Equity and bond neutral |
| **New Zealand** | REINZ House Sales | y/y | Dec | 14.1% | 12.2% | | ** | Equity bullish, bond bearish |
| | Food Prices | m/m | Dec | -0.1% | -0.2% | | *** | Equity and bond neutral |
| **EUROPE** | | | | | | | | |
| **Eurozone** | Current Account | m/m | Jan | €24.6bn | €33.8bn | €32.3bn | * | Equity and bond neutral |
| | Construction Output | y/y | Nov | -2.2% | -0.7% | | * | Equity and bond neutral |
| | EU27 New Car Registrations | y/y | Dec | -3.3% | 6.7% | | * | Equity and bond neutral |
| **Russia** | Trade Balance | m/m | Nov | 8.7b | 9.4b | | ** | Equity and bond neutral |
| | Exports | m/m | Nov | 33.4b | 33.0b | | * | Equity and bond neutral |
| | Imports | m/m | Nov | 24.7b | 23.5b | | * | Equity and bond neutral |
| | Gold and Forex Reserves | m/m | 12-Jan | $592.6b | $598.5b | | *** | Equity and bond neutral |
| **AMERICAS** | | | | | | | | |
| **Canada** | Int'l Securities Transactions | m/m | Nov | 11.43b | -15.75b | | ** | Equity and bond neutral |
| | Industrial Product Price MoM | m/m | Dec | -1.5% | -0.4% | -0.5% | ** | Equity bearish, bond bullish |
| | Raw Material Prices | m/m | Dec | -4.9% | -4.2% | -1.6% | * | Equity bullish, bond bearish |

## 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)** | 556 | 558 | -2 | Down |
| **3-mo T-bill yield (bps)** | 520 | 522 | -2 | Flat |
| **U.S. Sibor/OIS spread (bps)** | 531 | 532 | -1 | Down |
| **U.S. Libor/OIS spread (bps)** | 531 | 531 | 0 | Down |
| **10-yr T-note (%)** | 4.09 | 4.10 | -0.01 | Flat |
| **Euribor/OIS spread (bps)** | 390 | 389 | 1 | Down |
| **Currencies** | **Direction** | | | |
| Dollar | Flat | | | Down |
| Euro | Flat | | | Up |
| Yen | Up | | | Up |
| Pound | Flat | | | 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.

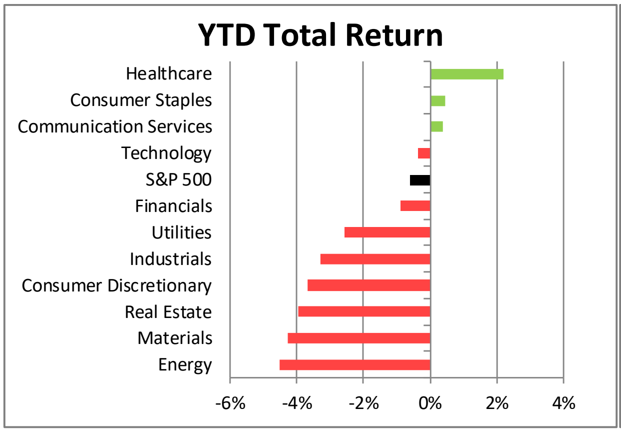
| | Price | Prior | Change | Explanation |
|---|---|---|---|---|
| **Energy Markets** | | | | |
| Brent | $77.80 | $77.88 | -0.10% | |
| WTI | $72.61 | $72.56 | 0.07% | |
| Natural Gas | $2.82 | $2.87 | -1.92% | |
| Crack Spread | $24.06 | $24.06 | 0.02% | |
| 12-mo strip crack | $24.50 | $24.53 | -0.10% | |
| Ethanol rack | $1.74 | $1.75 | -0.48% | |
| **Metals** | | | | |
| Gold | $2,014.04 | $2,006.25 | 0.39% | |
| Silver | $22.61 | $22.56 | 0.23% | |
| Copper contract | $373.00 | $373.30 | -0.08% | |
| **Grains** | | | | |
| Corn contract | $442.50 | $442.25 | 0.06% | |
| Wheat contract | $580.00 | $582.50 | -0.43% | |
| Soybeans contract | $1,211.75 | $1,205.75 | 0.50% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 1,308 | 1,324 | -16 | |
| **DOE Inventory Report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | | -0.9 | | |
| Gasoline (mb) | | 2.5 | | |
| Distillates (mb) | | 1.9 | | |
| Refinery run rates (%) | | -0.6% | | |
| Natural gas (bcf) | | -165 | | |

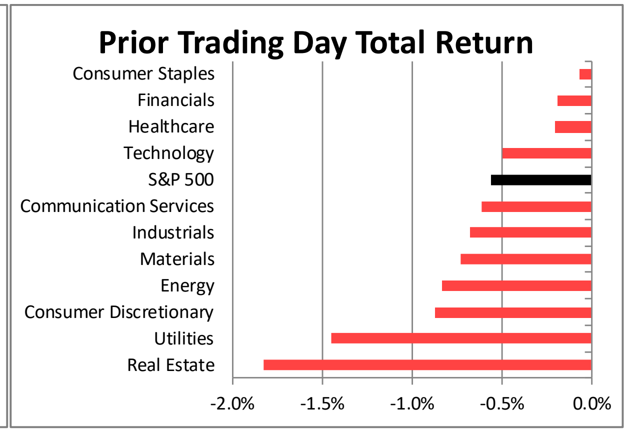
## Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for the entire country, with temperatures especially high east of the Mississippi River. The forecasts call for wetter-than-normal conditions east of the Mississippi, with dry conditions in the northern Great Plains region.

## Data Section

**U.S. Equity Markets** – (as of 1/17/2024 close)

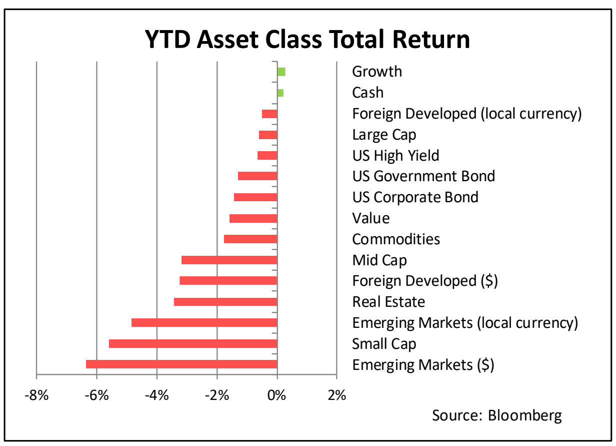



(Source: Bloomberg)

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 1/17/2024 close)

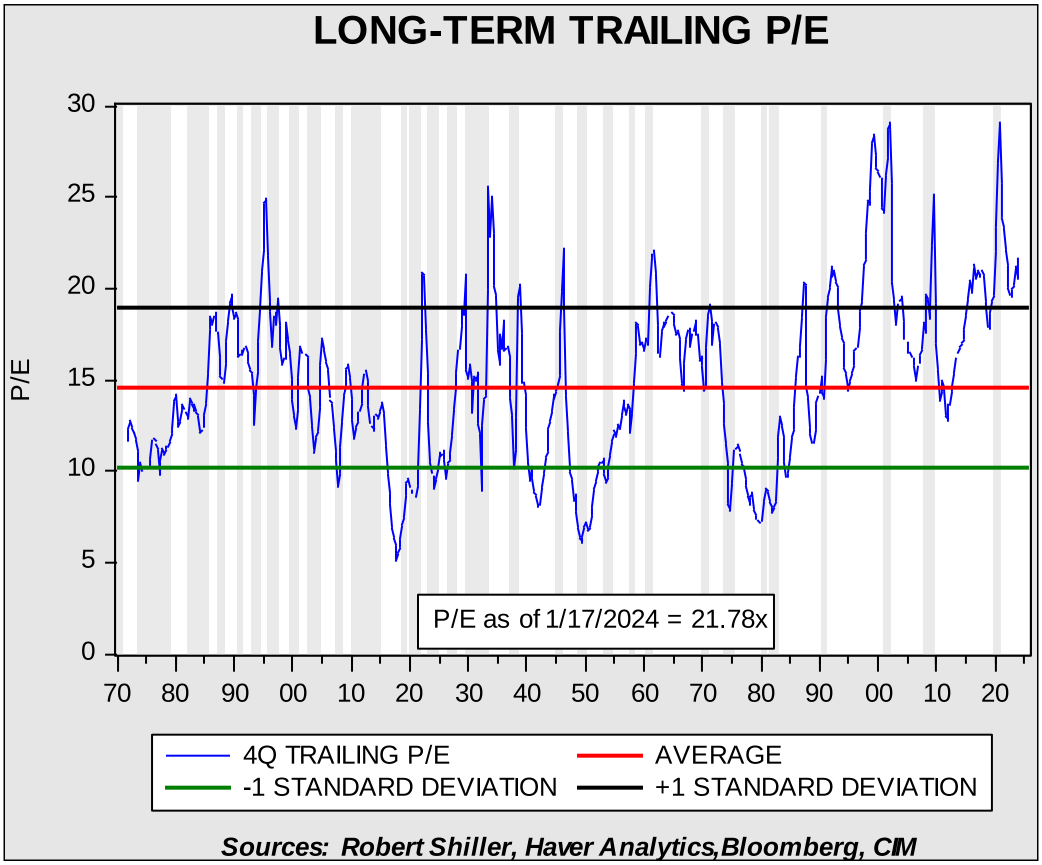



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 18, 2024




Based on our methodology,[1] the current P/E is 21.78x, up 0.17x from our last report. The rise in the multiple was driven primarily by an increase in the price index.

*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.