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 19, 2024—9:30 AM EST] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.9%. Chinese markets were lower, with the Shanghai Composite down 0.5% from its previous close and the Shenzhen Composite down 0.9%. U.S. equity index futures are signaling a higher open.

With 45 companies having reported so far, S&P 500 earnings for Q4 are running at $54.80 per share, compared to estimates of $55.15, which is up 1.6% from Q3 2023. Of the companies that have reported thus far, 82.2% have exceeded expectations while 13.3% have fallen short of expectations.

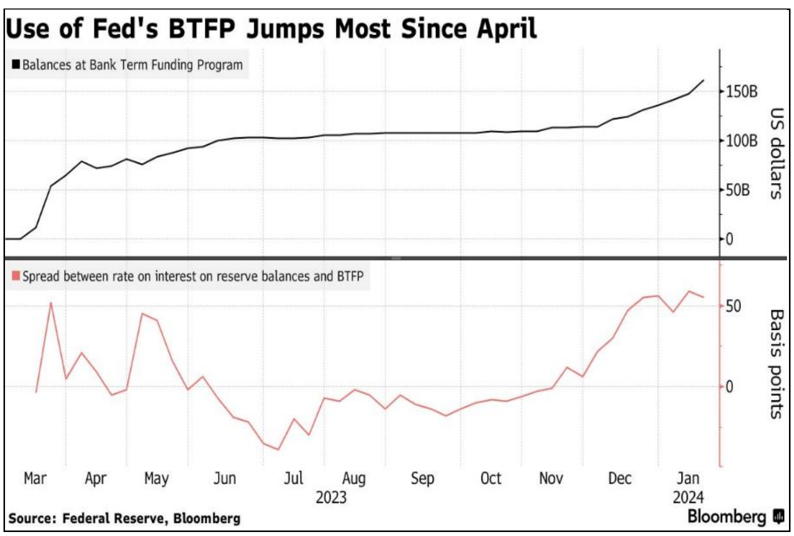
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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! Tech stocks are soaring on chip optimism, while La Liga giants Atlético Madrid and FC Barcelona are gearing up for a Copa Del Rey clash! Today's *Comment* dives deep into the Fed's rate cut whispers, the Red Sea crisis, and why U.S. oil is the crude market's kryptonite. Plus, we've got your U.S. and international data roundup.

Fed Black Out: As the Fed enters its pre-meeting quiet period, expectations for a March rate cut have dimmed, but the possibility of adjustments remains on the table.

- Atlanta Fed President Raphael Bostic was the latest member of the Federal Open Market Committee to cast doubts about a cut within the next three months. During an event hosted by the Atlanta Business Journal, Bostic stated that he suspects that the central bank will lower its benchmark rate in the third quarter but maintained that he would be persuaded to move sooner if inflation falls faster. His comments follow a group of other policymakers such as Federal Reserve Board Governor Christopher Waller and New York Fed President John Williams, who are also looking to rein in investor expectations of an imminent rate cut.
- Though the Fed insists the market is misreading its March intentions, the Bank Term Funding program (BTFP), established after the collapse of Silicon Valley and Signature Bank, may offer a different story. Set to expire on March 11, the program, which allows banks to borrow at discounted rates in exchange for discounted bonds valued at par, is unlikely to be renewed. In the lead up to the end of the program, banks have looked to ramp up their borrowings. The program's closure could force the central bank to look for alternatives to help ease some of the financial stress, which may include policy rates or possible changes to its quantitative easing program.

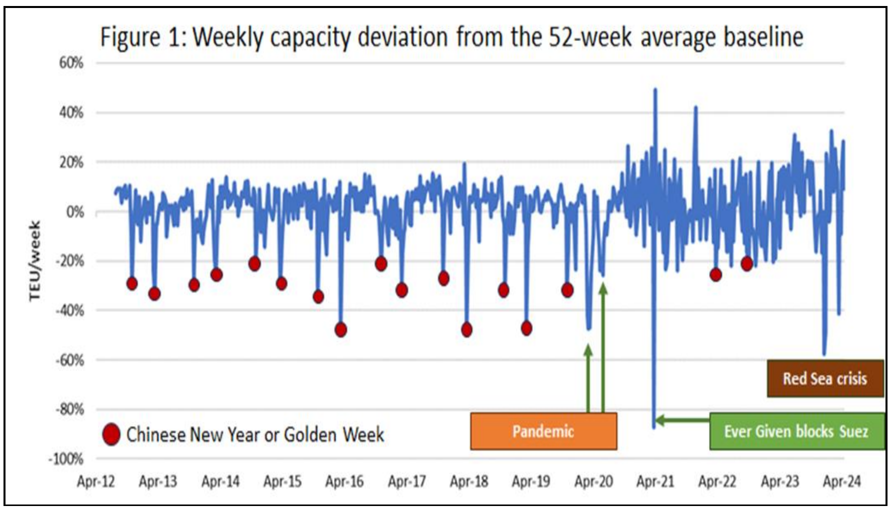


(Source: Bloomberg)

- The Federal Reserve's first meeting of the year on January 31 will be crucial in setting the stage for its 2024 policy approach. While some policymakers have hinted at further interest rate hikes, the Fed's primary focus will be on lowering rates, albeit at a pace dictated by economic conditions, inflation, and financial stability. The upcoming election adds a layer of complexity, potentially influencing the Fed's communication and policy decisions as it does not want to be seen as favoring a particular party or candidate. Nevertheless, with inflation in check, policymakers' three-cut projection could be seen as a minimum rather than a maximum.

Red Sea Escalation: Western efforts to counter Houthi rebels in Yemen raise concerns of a broader Middle East conflict and potential supply chain disruptions.

- The U.S. launched its fifth round of airstrikes against the Iranian-backed Houthis in the Red Sea on Thursday, following a drone attack near Yemen that struck a third oil tanker. White House National Security Council member John Kirby insisted the attacks would continue as long as necessary to deter further attacks on commercial shipping while acknowledging the potential for escalation in the region. While the U.S. maintains it is not seeking conflict, the continued airstrikes raise concerns about the long-term stability of the region.
- Houthi attacks and international military responses in the Red Sea, by some accounts, are causing greater shipping delays than the early COVID-19 pandemic. The chart below reveals significant fluctuations in a key indicator of global trade flows, the Trade Capacity Index, which was developed by Sea-Intelligence CEO Alan Murphy. Notably, since Houthis started attacking ships, the average weekly deviation in shipping capacity from its annual average has dropped to levels last seen when the Ever Given blocked the Suez Canal in 2021, highlighting the dire situation for global supply chains.

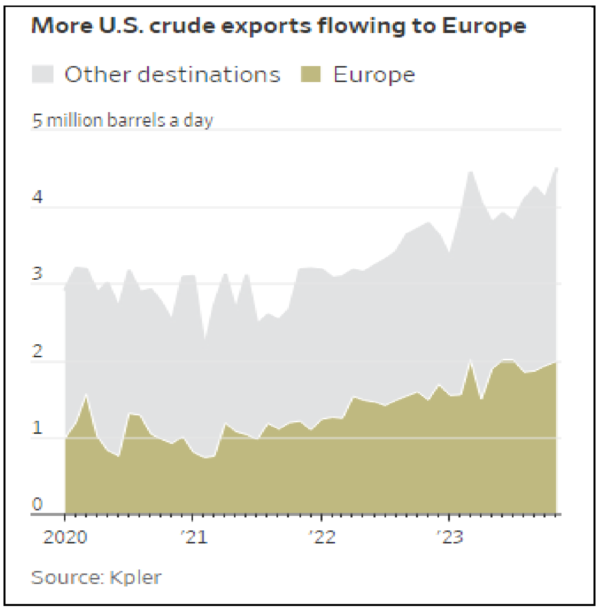


(Source: Sea-Intelligence)

- Amid escalating tensions, Arab nations are actively engaged in mediating efforts to broker a cease-fire agreement and pave the way for the establishment of an independent Palestinian state. The overarching agreement seeks not only to diffuse current tensions but also to set the stage for normalized relations between the involved Arab countries and Israel. In exchange for this normalization, there is a mutual commitment to undertake "irreversible" measures that contribute to the realization of a sovereign Palestinian state. Although it currently seems like a long shot, if successful, it could pave the way for lower commodity prices.

Shale's Comeback: Even as geopolitical tensions in the Middle East threaten to disrupt supply and drive up crude prices, U.S. shale production continues to act as a dampener, reminding us of its lasting impact on the oil market.

- The International Energy Agency predicts a global oil surplus driven by a projected surge in production from the U.S. and other non-OPEC countries despite production cuts agreed upon by OPEC. This production surge, exemplified by the U.S. surpassing Iraq's exports in November, is expected to outpace the moderating effect of OPEC cuts throughout the year. The surplus could lead to lower oil prices, impacting investments and potentially affecting energy security in countries reliant on oil imports. While OPEC's cuts may slow the initial production boom, its influence is likely to wane later in the year.
- After a shaky start following Russia's invasion of Ukraine, U.S. oil production is demonstrating impressive resilience. The U.S. Energy Information Administration (EIA) noted that the United States reached a record-breaking 13.2 million barrels per day as of October 2023, with a slight moderation later in the fourth quarter. The strong performance is expected to continue, with record production figures anticipated in both 2024 and 2025. In a recent move, Saudi Arabia lowered its crude price, likely an attempt to maintain market share in the face of rising U.S. competition.



(Source: Wall Street Journal)

- The war in Ukraine has accelerated Europe's growing reliance on the U.S. for energy, raising concerns about potential geopolitical risks. This shift comes as Russia's ostracization forces it to lean towards China and India for its own sales, potentially creating new power dynamics in the global oil market. This dominance could pave the way for a potential ceasefire in Ukraine as Russia and Europe look to find ways to strengthen their position as they try not to be overrun by the two major superpowers.

Other News: The Federal Reserve is proposing a new rule that would require banks to borrow from the discount window at least once a year. This move aims to encourage banks to become more familiar with this emergency lending facility and lessen their reliance on backstops during times of crisis. Japan [is aiming to become the fifth country to land an aircraft on the moon](). Japan's space exploration showcases its ambition to compete alongside established players.

U.S. Economic Releases

No major U.S. reports have been released so far this morning. 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	U. of Michigan Consumer Sentiment	m/m	Jan P	70.1	69.7	***
10:00	U. of Michigan Future Expectations	m/m	Jan P	67.0	67.4	**
10:00	U. of Michigan Current Conditions	m/m	Jan P	73.0	73.3	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Jan P	3.1%	3.1%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Jan P	3.0%	2.9%	*
10:00	Existing Home Sales (monthly change)	m/m	Dec	3.83m	3.82m	**
10:00	Existing Home Sales (annualized selling rate)	m/m	Dec	0.3%	0.8%	***
16:00	Total Net TIC Flows	m/m	Nov		-$83.8b	**
16:00	Net Long-Term TIC Flows	m/m	Nov		$3.3b	**
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
11:15	Fed's Daly Speaks on Fox Business	President of the Federal Reserve Bank of San Francisco				
13:00	Fed's Barr Speaks About Bank Regulation	Federal Reserve Board Vice Chair for Supervision				
16:15	Fed's Daly Speaks in Fireside Chat	President of the Federal Reserve Bank of San Francisco				

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	National CPI	y/y	Dec	2.6%	2.8%	2.5%	***	Equity and bond neutral
	National CPI Ex-Fresh Food	y/y	Dec	2.3%	2.5%	2.3%	**	Equity and bond neutral
	National CPI Ex-Fresh Food & Energy	y/y	Dec	3.7%	3.8%	3.7%	*	Equity and bond neutral
	Tertiary Industry Index	m/m	Nov	-0.7%	-0.8%	-0.2%	**	Equity and bond neutral
New Zealand	BusinessNZ Manufacturing PMI	m/m	Dec	43.1	46.7	46.5	***	Equity and bond neutral
EUROPE								
Germany	PPI	y/y	Dec	-8.6%	-7.9%	-8.0%	**	Equity and bond neutral
UK	Retail Sales	y/y	Dec	-2.4%	0.1%	0.2%	***	Equity bearish, bond bullish
	Retail Sales Ex-Auto Fuel	y/y	Dec	-2.1%	0.3%	0.5%	**	Equity bearish, bond bullish
Switzerland	Producer & Import Prices	y/y	Dec	-1.1%	-1.3%		**	Equity and bond neutral
Russia	Current Account Balance	q/q	4Q P	10700m	16261m	12900m	**	Equity and bond neutral
AMERICAS								
Mexico	Retail Sales	y/y	Nov	2.7%	3.4%	3.4%	***	Equity bearish, bond bullish
Brazil	Economic Activity Index	y/y	Nov	2.19%	1.54%	1.28%	**	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)	557	556	1	Down
3-mo T-bill yield (bps)	520	521	-1	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 (%)	4.14	4.14	0.00	Flat
Euribor/OIS spread (bps)	397	390	7	Down
Currencies	**Direction**			
Dollar	Down			Down
Euro	Flat			Up
Yen	Flat			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.

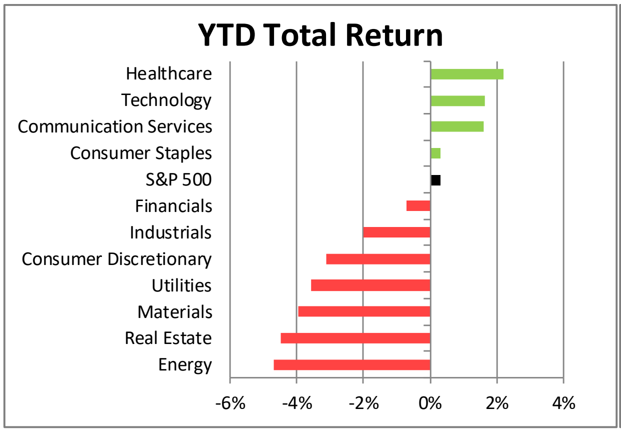
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$78.86	$79.10	-0.30%	
WTI	$73.89	$74.08	-0.26%	
Natural Gas	$2.63	$2.70	-2.37%	
Crack Spread	$24.84	$24.58	1.08%	
12-mo strip crack	$24.95	$24.85	0.44%	
Ethanol rack	$1.74	$1.75	-0.28%	
Metals				
Gold	$2,033.04	$2,023.34	0.48%	
Silver	$22.77	$22.74	0.12%	
Copper contract	$377.85	$374.50	0.89%	
Grains				
Corn contract	$445.00	$444.00	0.23%	
Wheat contract	$589.00	$585.50	0.60%	
Soybeans contract	$1,221.25	$1,213.50	0.64%	
Shipping				
Baltic Dry Freight	1,357	1,308	49	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.5	-0.9	-1.6	
Gasoline (mb)	3.1	2.5	0.6	
Distillates (mb)	2.4	1.9	0.5	
Refinery run rates (%)	-0.3%	-0.6%	0.3%	
Natural gas (bcf)	-154	-165	11	

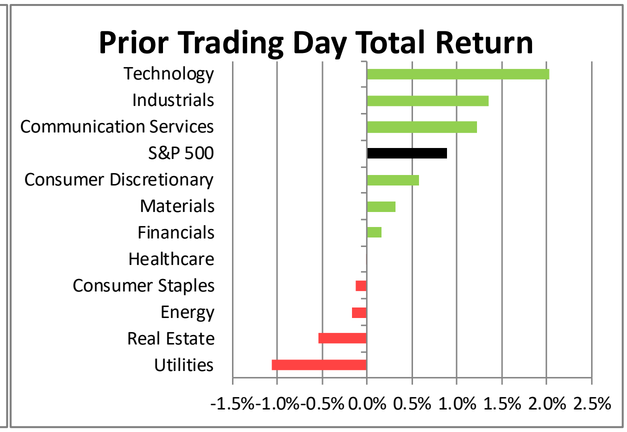
Weather

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 in the Pacific Northwest, the southern Great Plains, and east of the Mississippi, with dry conditions in the Southwest and northern Great Plains regions.

Data Section

U.S. Equity Markets – (as of 1/18/2024 close)

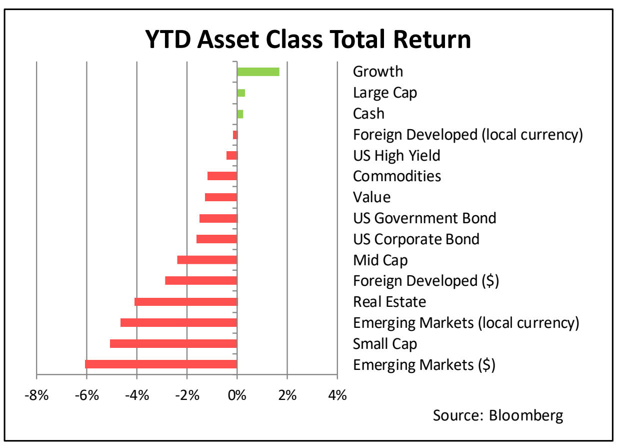




(Source: Bloomberg)

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 1/18/2024 close)

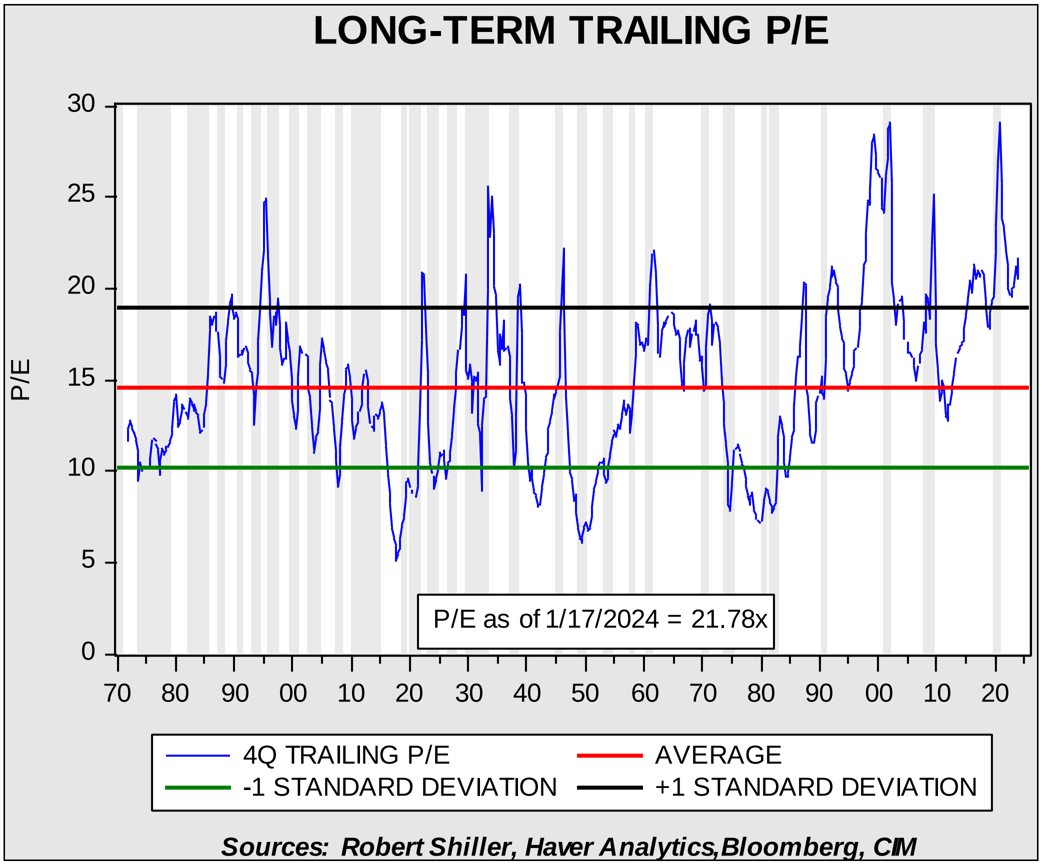


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.