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 25, 2024—9:30 AM EST] Global equity markets are higher 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 1.3%. Chinese markets were higher, with the Shanghai Composite up 3.0% from its previous close and the Shenzhen Composite up 2.6%. U.S. equity index futures are signaling a higher open.

With 97 companies having reported so far, S&P 500 earnings for Q4 are running at $54.90 per share, compared to estimates of $55.15, which is up 1.6% from Q3 2023. Of the companies that have reported thus far, 84.1% have exceeded expectations while 14.4% have fallen short of expectations.

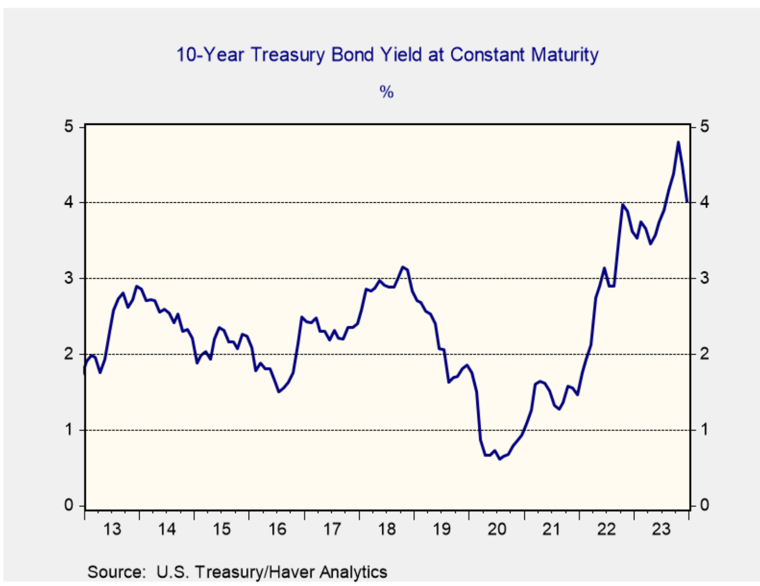
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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* (1/22/2024) (with associated podcast): "How Does Powell Define Restrictive Monetary Policy?"
- *The 2024 Outlook: Slow-Bicycle Economy* (12/18/2023) (with associated *Confluence of Ideas* podcast)

Good morning! Wall Street is evaluating the latest GDP data and Jim Harbaugh's return to coach the L.A. Chargers is expected to electrify the NFL. Today's commentary dives into the bond market's potential tantrum after another disappointing auction, discusses the ECB's recent policy decision, and explores how escalating national security anxieties may slow the rally in chip-related stocks. As usual, our report concludes with the latest international and domestic data.

Clouds on the Horizon? Another poor showing at a Treasury auction could foreshadow a drop of enthusiasm for equities.

- Yields on long-duration government securities have rebounded as growing bond issuance and doubts about rate expectations weigh on bond prices. On Wednesday, a U.S. Treasury auction of $61 million of five-year bonds failed to meet expectations. The lower-than-expected demand has led to concerns that the market is saturated with Treasuries. This comes on the heels of an announcement of a heavier borrowing schedule from February to April and expectations that the Federal Reserve may not cut rates as aggressively as the market anticipates. As a result, the 30-year yield rose to the highest rate year-to-date.
- The sluggish demand in recent government bond auctions casts doubt on the sustainability of the December 2023 plunge in bond yields. The 10-year Treasury note's yield slumped over 80 basis points since October, fueled by optimism for the easing monetary policy later in 2024. However, stronger economic data and inflation worries prompted policymakers to temper dovish talk, dampening speculation of an immediate shift. Hawkish comments sent the CME FedWatch Tool's estimate for a Q1 rate cut plummeting from above 70% to just 40% as of today.

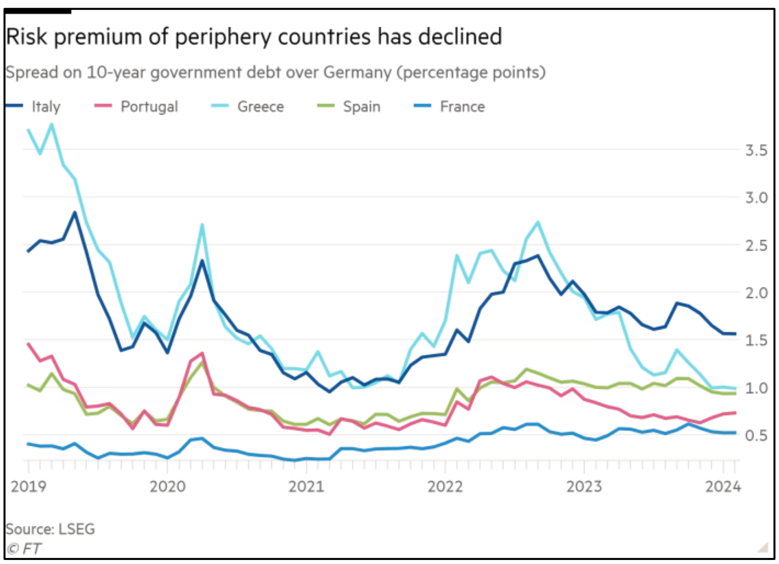


- The stock market's recent sunshine might face a harsh winter from rising interest rates. A growing supply of bonds coupled with waning demand is creating a perfect storm that may force the Fed to consider changing course sooner rather than later. While some policymakers, like Dallas Fed President Lorie Logan, have advocated for a more cautious approach, such as slowing down the pace of quantitative tightening, others on the committee seem to favor a possible cut in policy rates. This internal tug-of-war will play out in next week's FOMC meeting as Fed officials grapple with how to conduct policy going forward.

ECB Not Ready to Backdown: The European policymakers may be more willing to stick to higher-for-longer rates than the market anticipates.

- The European Central Bank left its benchmark policy rate unchanged. The decision was in line with market expectations as traders are currently pricing in the central banks' first rate cut in June. During the press conference, ECB President Christine Lagarde emphasized that the central bank is focused on achieving its 2% target. Lagarde threw cold water on market hopes for an April rate cut, suggesting the bank may wait until the summer before it pivots. However, she maintained that the committee will remain data-dependent when deciding future policy and is prepared to make changes if necessary.

- While Germany and France, Europe's largest economies, got off to a slow start this year, investors are still buying up government bonds in the region. The latest eurozone Purchasing Managers' Index (PMI) indicates that the region is currently experiencing contraction, suggesting that economic growth remains sluggish. This weakness is particularly evident in Germany and France, whose PMI readings of 45.4 and 47.1, respectively, fall well below the contraction threshold of 50. Despite ongoing concerns, a promising development emerges in the eurozone periphery. Countries like Italy and Spain, once burdened by high-risk premiums, are witnessing declining bond yields due to anticipated reductions in their debt-to-GDP ratios over the next two years.



- While April rate cuts remain widely expected from the European Central Bank, the bank retains the flexibility to delay if economic data dictates. Despite tepid regional output, fears of a deep recession lack strong evidence. The unemployment rate sits near record lows, suggesting that the slowdown has not spilled over into labor markets. Furthermore, the narrowing gap in yields between core and peripheral eurozone countries, even with the planned March end of PEPP, reduces the risk of diverging borrowing costs and financial instability within the eurozone. As a result, the ECB is better positioned to remain tighter for longer than its American counterpart.

Global Chips: The West's potential alliance against China and Russia could hinder chipmakers' ability to meet audacious earnings expectations.

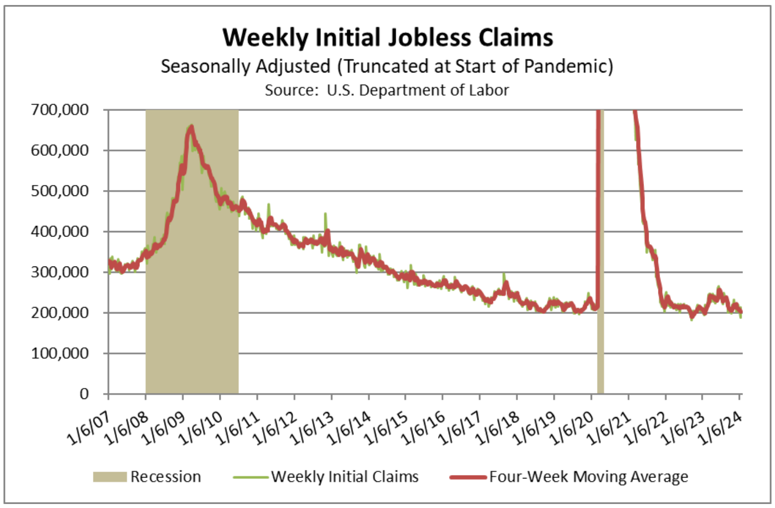
- Despite a growing effort to curtail access, the U.S. is finding it increasingly challenging to stop its rivals from obtaining high-quality chips crucial for their military and industrial development. In 2023, Russia imported over $1 billion of these strategically important components, accounting for more than half of its total chip imports, potentially fueling its war efforts in Ukraine. Adding to the concerns, Dutch lithography giant ASML (ASML, $847.31) ramped-up semiconductor equipment sales to China, in spite of an agreement between the U.S. and the Netherlands to limit shipments.
- Navigating the complexities of coordinated export controls in a fragmented world poses a growing challenge for the U.S. and its allies. Competing interests and shifting partnerships can make effective implementation difficult, even when national security concerns are at stake. This is evident in the case of leading chipmakers like Nvidia (NVDA, $613.62) and Intel (INTC, $49.09), where a quarter of their revenue originates from China. Restricting their ability to sell advanced chips in this crucial market could not only jeopardize their ambitious growth plans but also raise concerns about the effectiveness of such policies in achieving their intended strategic goals.

- Despite this policy's unsurprising failure, governments may be forced to take a tougher stance with firms, potentially through stricter regulations or financial penalties, to achieve their desired outcomes. Speaking at the Reagan National Defense Forum in California, U.S. Secretary of Commerce Gina Raimondo warned chipmakers that she would like to stop any company looking to aid China's bid to advance its own AI capabilities. Raimondo's statement underscores the potential for stricter export controls, a measure not unprecedented in history. Similar restrictions were implemented during World War II and beyond to address critical national security needs. Concerns about new restrictions on chip exports could dampen the recent euphoria surrounding domestic chipmakers.

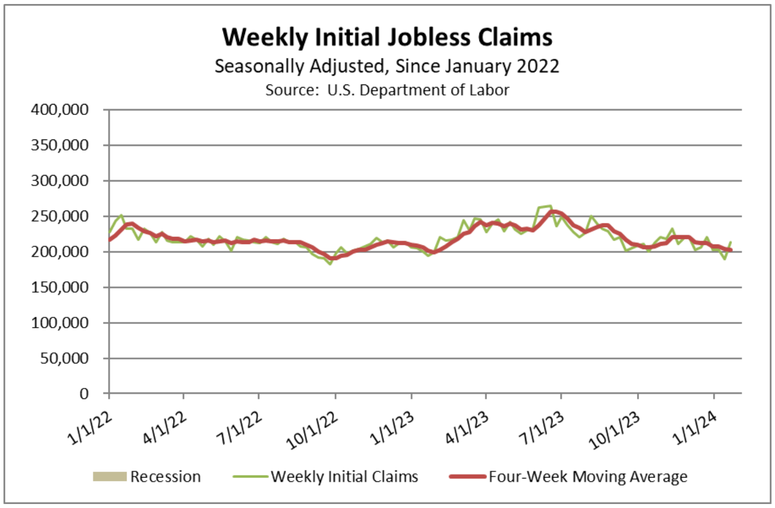
Other news: South Korean lawmaker Bae Hyun-jin was attacked on Thursday in a sign of growing political hostilities in the country. The Federal Reserve hiked rates in its Bank Term Lending Facility on Thursday as it looks to curtail arbitrage trading. The move highlights the growing concerns policymakers have about moral hazard problems when it comes to backstops.

U.S. Economic Releases

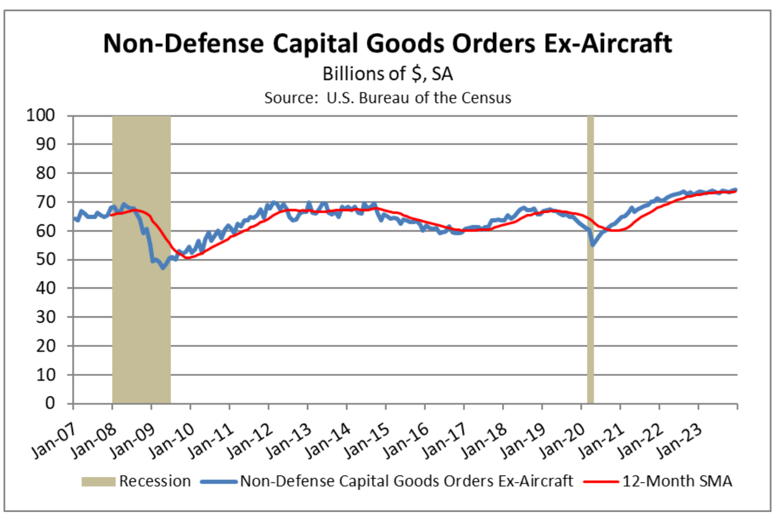
In the week ended January 20, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 214,000, well above the expected level of 200,000 and the previous week's revised level of 189,000. Nevertheless, the four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to a nearly one-year low of 202,250. In the week ended January 13, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to 1.833 million, above the anticipated reading of 1.823 million and the prior week's reading of 1.806 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.



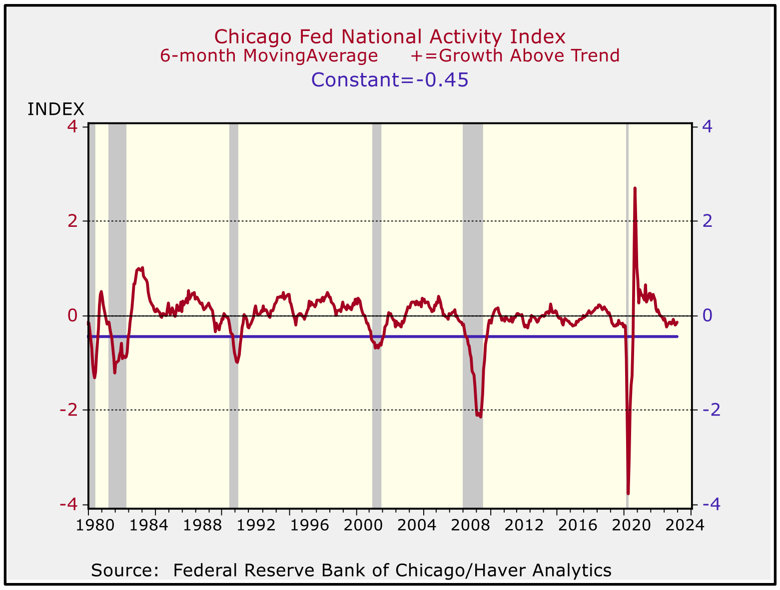
To provide more detail on recent trends, the following chart shows how initial jobless claims have changed just since the beginning of 2022.



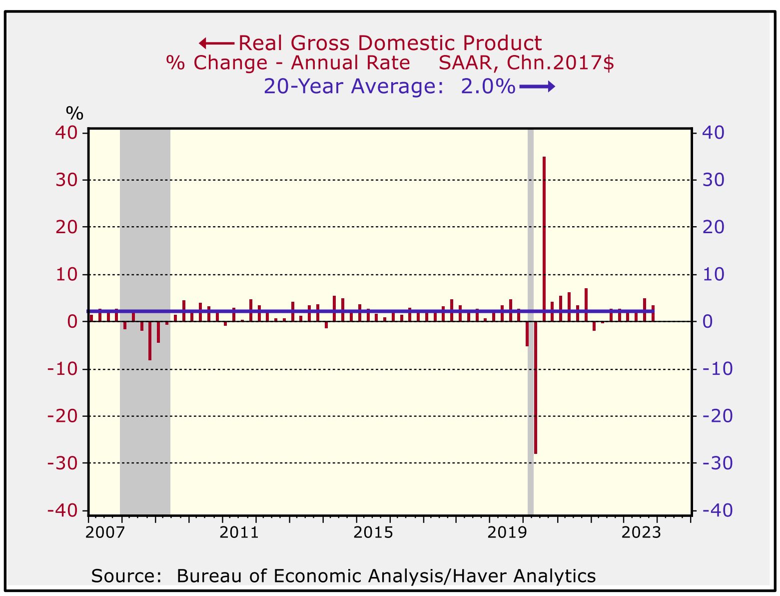
Separately, December ***durable goods orders*** were unchanged on a seasonally adjusted basis, far short of the expected rise of 1.5% and the revised November gain of 5.5%. Durable goods orders are often driven by transportation equipment, where just a few airliner orders can have a big impact. December ***durable goods orders excluding transportation*** rose 0.6%, beating the anticipated rise of 0.2% and the revised November increase of 0.5%. Finally, the durable goods report also includes a key proxy for corporate capital investment. In December, nondefense capital goods orders ex-aircraft rose 0.3%, also above their expected gain of 0.1%, but weaker than their November increase of 1.0%. Compared with the same month one year earlier, overall durable goods orders in December were up 3.7%, while durable orders ex-transport were up 1.1%. Nondefense capital goods orders ex-aircraft were up 1.2%. The chart below shows the progression of nondefense capital goods orders ex-aircraft since just before the GFC.



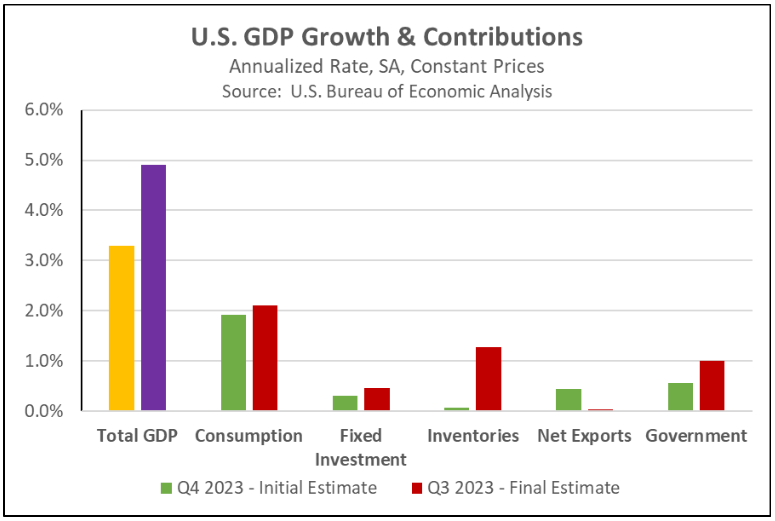
In another key report, the Chicago Fed said its December ***National Activity Index (CFNAI)*** declined to -0.15, far worse than the anticipated reading of 0.06 and below the revised November reading of 0.01. The CFNAI, which encompasses dozens of separate indicators to capture all aspects of current economic activity, is designed so that readings above 0.00 reflect the economy growing at trend. Our analysis shows that when the six-month moving average of the CFNAI falls below about -0.45, it suggests the economy is in recession. With the latest reading, the index suggests the economy has definitely lost momentum, but isn't yet in a contraction. The chart below shows how the CFNAI has fluctuated over the last several decades.



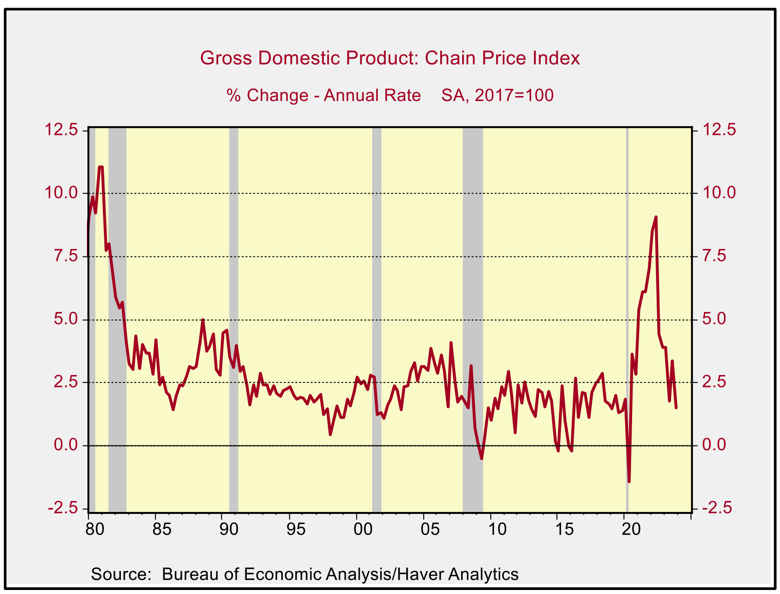
Finally, the Commerce Department today released its initial estimate of economic activity in the fourth quarter of 2023. After stripping out seasonal factors and price changes, fourth-quarter ***gross domestic product (GDP)*** rose at an annualized rate of 3.3%, handily beating the expected growth rate of 2.0% but still a slowdown from the third-quarter growth rate of 4.9%. The chart below shows the annualized growth rate of U.S. GDP since just before the GFC.



A close look at the details in the report shows that the main drag on activity in the quarter was a slowdown in inventory investment, possibly reflecting caution among business managers. On a more positive note, however, reduced inventory investment often sets the economy up for accelerated growth in the future if demand proves more resilient than expected. The chart below shows the contributions to the annualized growth rate in the fourth quarter.



The GDP report also includes the broadest measure of U.S. price inflation. The fourth-quarter's ***GDP Price Index*** rose at an annualized rate of just 1.5%, below the Fed's target of 2.0%, the anticipated rate of 2.2%, and the third-quarter's rate of 3.3%. The chart below shows the year-over-year change in the GDP Price Index over the last several decades.



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	New Home Sales - Annualized Selling Rate	m/m	Dec	10.0%	-12.2%	***
10:00	New Home Sales - Monthly Change	m/m	Dec	649k	590k	**
11:00	Kansas City Fed Manfacturing Index	m/m	Jan	-3	-1	*
Federal Reserve						
No Fed speakers or events for the rest of today						

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	Machine tool orders	y/y	Dec F	-9.6%	-9.9%		**	Equity and bond neutral
	Nationwide Dept Sales	y/y	Dec	5.4%	7.4%		***	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	19-Jan	¥286.7b	¥1202.6b	¥1202b	*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	19-Jan	¥48b	¥1642.8b	¥1689.3b	*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	19-Jan	¥348.6b	¥980.2b	¥980.3b	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	19-Jan	¥130.4b	¥783.3b		*	Equity and bond neutral
South Korea	Business Survey - Manufacturing	m/m	Feb	71	69		**	Equity and bond neutral
	Business Survey - Non-Manufacturing	m/m	Feb	68	68		*	Equity and bond neutral
	GDP	y/y	4Q A	22.2%	1.4%	2.1%	**	Equity and bond neutral
EUROPE								
Germany	IFO Business Climate	m/m	Jan	85.2	86.4	86.3	***	Equity bullish, bond bearish
	IFO Current Assessment	m/m	Jan	87.0	88.5	88.5	**	Equity and bond neutral
	IFO Expectations	m/m	Jan	83.5	84.3	84.2	**	Equity and bond neutral
France	Business Confidence	m/m	Jan	98	98	98	**	Equity and bond neutral
	Manufacturing Confidence	m/m	Jan	99	100	99	*	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	19-Jan	$586.7b	$592.6b		***	Equity and bond neutral
AMERICAS								
Mexico	Unemployment Rate NSA	m/m	Dec	2.61%	2.71%	2.61%	***	Equity and bond neutral
Brazil	FGV Consumer Confidence	y/y	Jan	90.80%	93.70%	93.20%	*	Equity bearish, bond bullish

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	558	1	Down
3-mo T-bill yield (bps)	520	521	-1	Flat
U.S. Sibor/OIS spread (bps)	532	533	-1	Down
U.S. Libor/OIS spread (bps)	531	532	-1	Down
10-yr T-note (%)	4.17	4.18	-0.01	Flat
Euribor/OIS spread (bps)	393	395	-2	Down
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Flat			Up
Yen	Flat			Up
Pound	Flat			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
ECB Main Refinancing Rate	4.500%	4.500%	4.500%	On Forecast
ECB Marginal Lending Facility	4.750%	4.750%	4.750%	On Forecast
ECB Deposit Facility Rate	4.000%	4.000%	4.000%	On Forecast
Bank of Canada Rate Decision	5.000%	5.000%	5.000%	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.

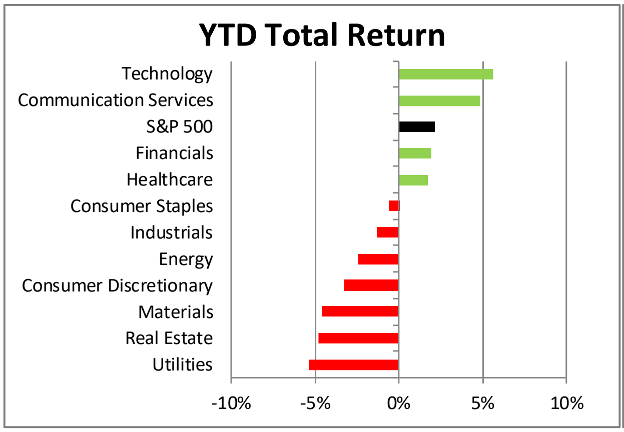
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$81.07	$80.04	1.29%	
WTI	$76.14	$75.09	1.40%	
Natural Gas	$2.77	$2.64	4.81%	
Crack Spread	$25.24	$24.86	1.54%	
12-mo strip crack	$24.77	$24.53	0.98%	
Ethanol rack	$1.76	$1.75	0.05%	
Metals				
Gold	$2,020.60	$2,013.89	0.33%	
Silver	$22.86	$22.67	0.84%	
Copper contract	$387.25	$388.60	-0.35%	
Grains				
Corn contract	$453.00	$452.25	0.17%	
Wheat contract	$612.50	$610.75	0.29%	
Soybeans contract	$1,237.00	$1,240.25	-0.26%	
Shipping				
Baltic Dry Freight	1,507	1,473	34	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-9.2	-1.4	-7.8	
Gasoline (mb)	4.9	2.0	2.9	
Distillates (mb)	-1.4	1.0	-2.4	
Refinery run rates (%)	-7.1%	-0.6%	-6.6%	
Natural gas (bcf)		-318		

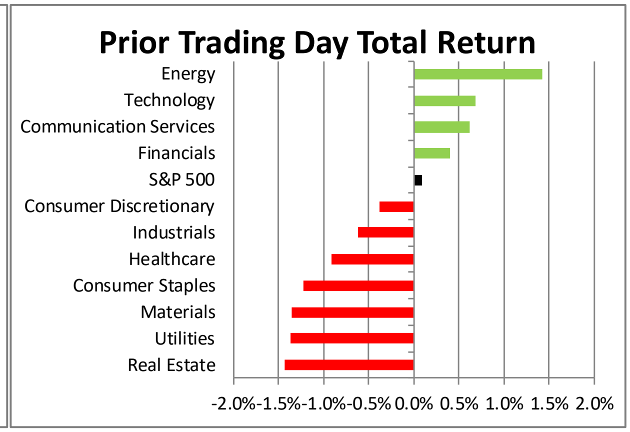
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for the entire country other than the West Coast and southern Florida, where temperatures will be near normal. The forecasts call for wetter-than-normal conditions in all parts of the country west of the Mississippi River, with dry conditions expected in New England.

Data Section

U.S. Equity Markets – (as of 1/24/2024 close)

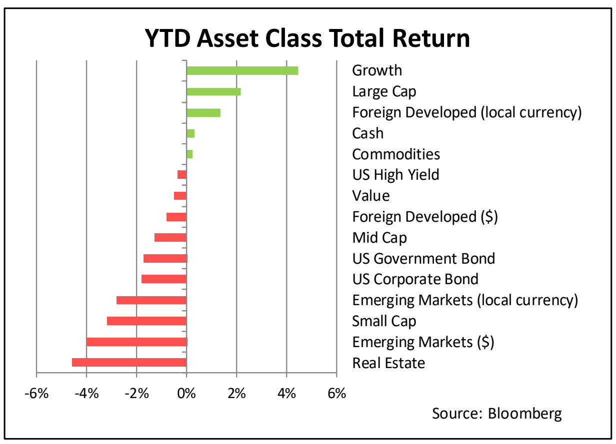




(Source: Bloomberg)

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 1/24/2024 close)

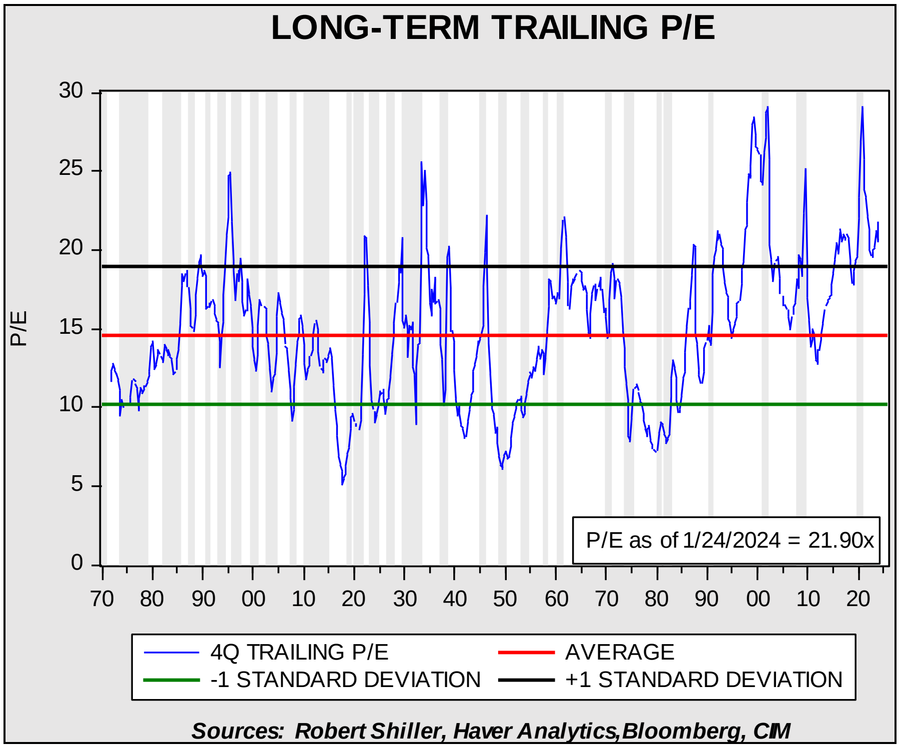


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 25, 2024



Based on our methodology,[1] the current P/E is 21.90x, up 0.12x 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.