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 26, 2024—9:30 AM EST] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 1.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.8%. Chinese markets were mixed, with the Shanghai Composite up 0.1% from its previous close and the Shenzhen Composite down 0.7%. U.S. equity index futures are signaling a lower open.

With 121 companies having reported so far, S&P 500 earnings for Q4 are running at $55.00 per share, compared to estimates of $55.15, which is up 1.6% from Q3 2023. Of the companies that have reported thus far, 80.2% have exceeded expectations while 15.7% 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:

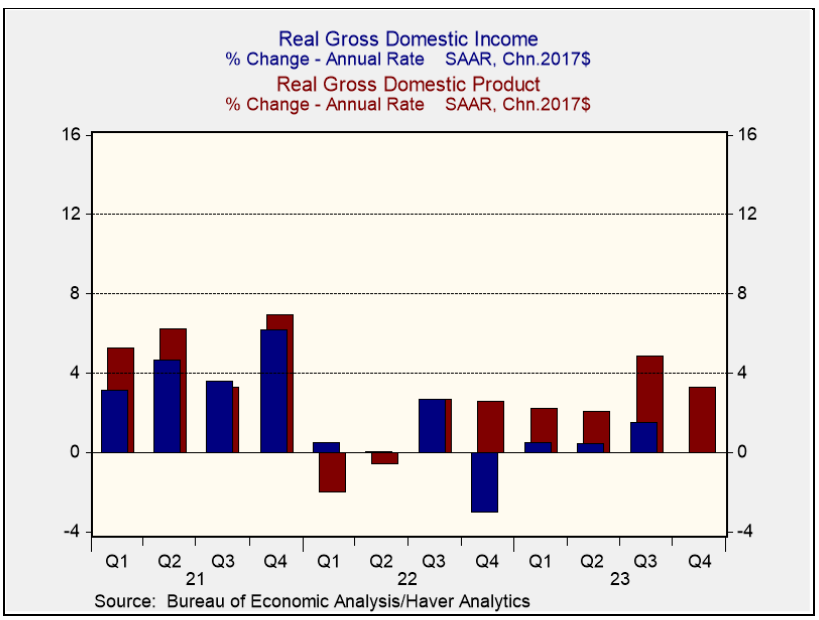
- *Bi-Weekly Geopolitical Report* (1/16/2024) (with associated podcast): "What If Russia Wins in Ukraine?"
- *Weekly Energy Update* (12/14/2023): Oil prices have been under pressure as geopolitical risk premium evaporates; COP28 ended with a deal to "shift" from fossil fuels, softer language than the "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)
- **Business Cycle Report (1/25/2024)**

Good morning! Wall Street cheers better-than-expected inflation news. Meanwhile, Novak Djokovic's perfect streak in the Australian Open came to an abrupt end. In our *Comment*, we explain why optimism should be measured. We also delve into the regulatory storm clouds over

Big Tech and dissect the ongoing move toward rate hikes by the Bank of Japan. Plus, we include your usual data for a well-rounded start to your day.

Recession to Paradise? Defying expectations, the economy not only remained in expansion territory in 2023, but it actually accelerated.

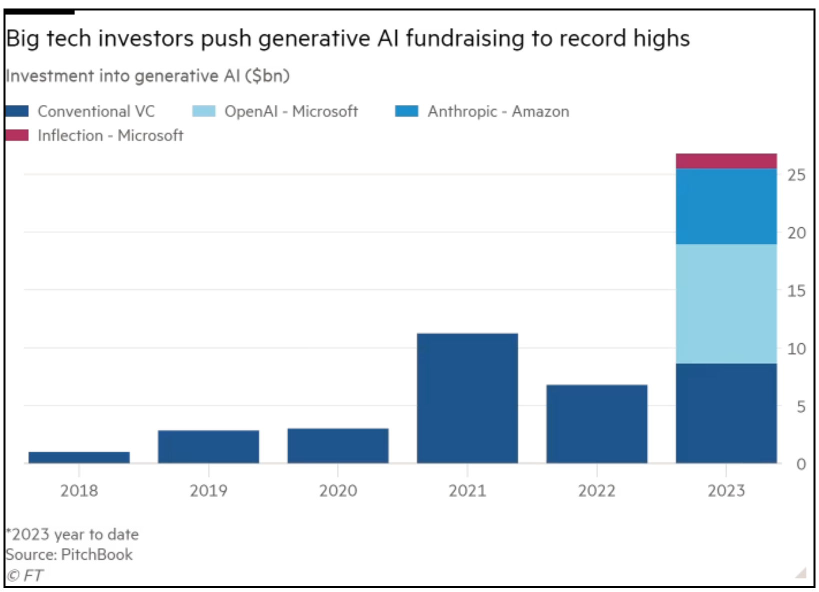
- U.S. GDP surged 2.54% in 2023, exceeding analysts' forecasts and comfortably surpassing the previous year's 1.9% rise. This robust performance, fueled by strong consumer spending and business investment, has defied fears of recession and has demonstrated the economy's resilience in the face of tighter monetary policy. Sustained growth coupled with falling inflation have revived hopes for a soft landing, even as geopolitical and trade uncertainties linger. This brighter outlook has fueled a surge in stock prices and expectations for lower interest rates, which have provided a boost to risk assets.
- Thursday's figures have given investors plenty to cheer about, but beneath the surface, there are still signs that the economy isn't humming along as smoothly as it might appear. Despite strong job growth headlines, in 2023 revisions lowered payrolls in all but one month, raising concerns about data accuracy. Further casting doubts on the economy's health, regional Fed data like the Chicago National Activity Index and New York Fed Empire Manufacturing Index revealed weak economic activity. Moreover, Gross Domestic Income, another measure of growth, has consistently lagged behind Gross Domestic Product, suggesting potential underlying issues.



- Recessions can arise unexpectedly, even in the presence of positive indicators. A prime example is the 1973 downturn, which became the third-longest on record, when the U.S. economy added 313,000 jobs during the first month. Similarly, there was positive economic data leading up to the 2008 recession. We anticipate a slowdown in the U.S. economy rather than a full-blown downturn, and we remain optimistic about the potential for equities, particularly small and mid-caps. While recent economic data has been encouraging, it is important for investors to exercise caution and not become overly optimistic.

Regulators Take On AI: Concerns over market dominance have prompted regulators to launch an investigation into the AI practices of major tech firms.

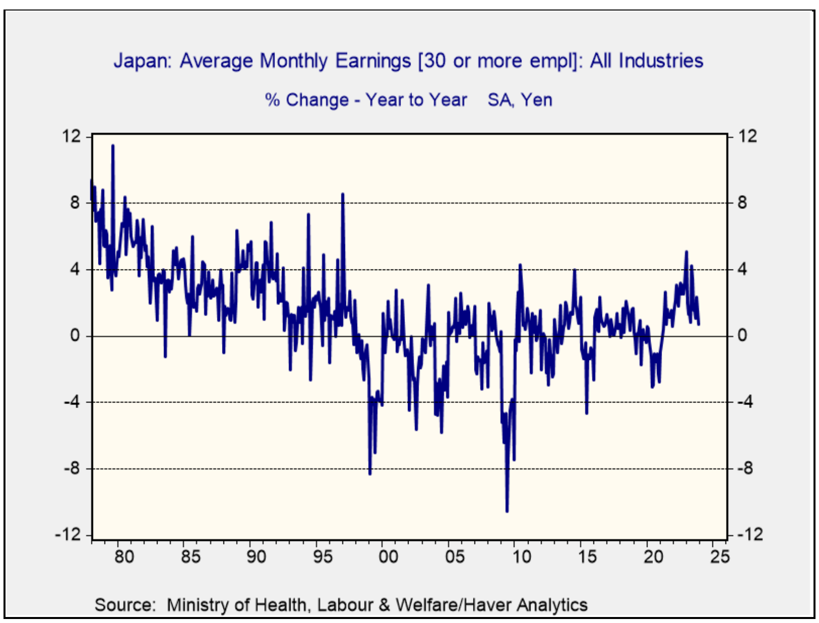
- The FTC has initiated an inquiry into Big Tech's aggressive acquisition practices concerning smaller AI firms. This investigation will scrutinize how industry giants like Microsoft (MSFT, $404.87), Alphabet (GOOG, $153.64), and Amazon (AMZN, $157.75) exploit their market dominance to procure smaller AI competitors, raising concerns about potential consumer harm and innovation suppression. The agency's heightened attention to AI aligns with similar probes opened by U.K. and EU regulators, reflecting a growing chorus of concern about the tech giants' tightening grip on the rapidly evolving AI landscape.
- Emerging language-learning startups, heavily reliant on Microsoft, Alphabet, and Amazon for crucial infrastructure, face an alarming vulnerability to hostile takeovers. These tech giants controlled two-thirds of the funding for AI firms in 2023, according to Pitchfork data, giving them immense leverage over fledgling companies. Big Tech's control over cloud computing further intensifies the takeover risk for AI startups who heavily rely on these services for their core operations. A study by Deloitte revealed that 70% of companies derive their AI capabilities from cloud-based software, while 65% utilize cloud services to construct AI applications.



- Amidst the prevailing optimism surrounding AI-related enterprises, the outlook may be considerably more nuanced than initially perceived by investors. As major tech companies brace for heightened government scrutiny, with regulatory bodies collaborating to enhance oversight, the impact on tech-stock valuations remains uncertain. While acknowledging the market's anticipation of potential upside in these stocks over the next few years, we believe that much of this optimism is already priced in. Consequently, while these companies may still present opportunities for capital gains, we foresee other sectors offering potentially superior relative returns in the future.

BOJ's Hawkish Turn: While most developed central banks are looking to pivot toward dovish policy, the Bank of Japan hints that it may be going in the other direction.

- The Bank of Japan's latest minutes hint at a possible turning point in monetary policy, as members debated the terms of exiting their ultra-loose quantitative easing (QE) program. Although disagreement persists, growing optimism about hitting their inflation target suggests a shift might be closer than previously thought. While some committee members proposed raising short-term rates and leaving long-term borrowing costs low, others urged caution, citing concerns about market turbulence if the bank stops buying risky assets. This split opinion suggests a gradual exit from QE might be more likely than a sudden shift.
- That said, recent Japanese price data offers mixed signals about the future path of inflation. Tokyo's core Consumer Price Index (CPI) rose 1.8% year-over-year, well below the central bank's target of 2.0%. Meanwhile, the annual increase in producer prices reached 2.4% in December, matching the previous month's nearly nine-year high. With mixed economic signals swirling, policymakers are putting extra weight on sustainable wage increases as a potential indicator of lasting inflation. Ongoing negotiations with Rengo, Japan's largest union, could be the tipping point. If they secure their sought-after 5% wage hike, then this could be enough to convince policymakers that inflation has truly found its footing.

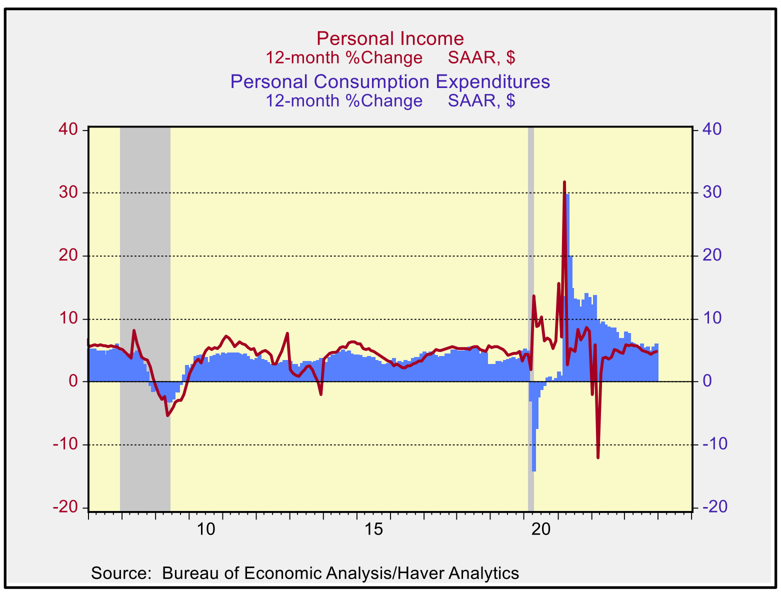


- Japanese investors, major players in the U.S. and European bond markets, face potential asset relocation if the Bank of Japan tightens monetary policy. This could trigger a domino effect in global debt markets with rising yields and currency fluctuations. However, the BOJ's delay in this shift offers welcome news for the yen (JPY), potentially strengthening it and boosting returns for dollar-based investors who hold Japanese assets. The April timeline may be etched in market forecasts, but we see a different picture. Our conviction is that the BOJ will postpone its tightening path until summer, giving ample time for domestic data to solidify.

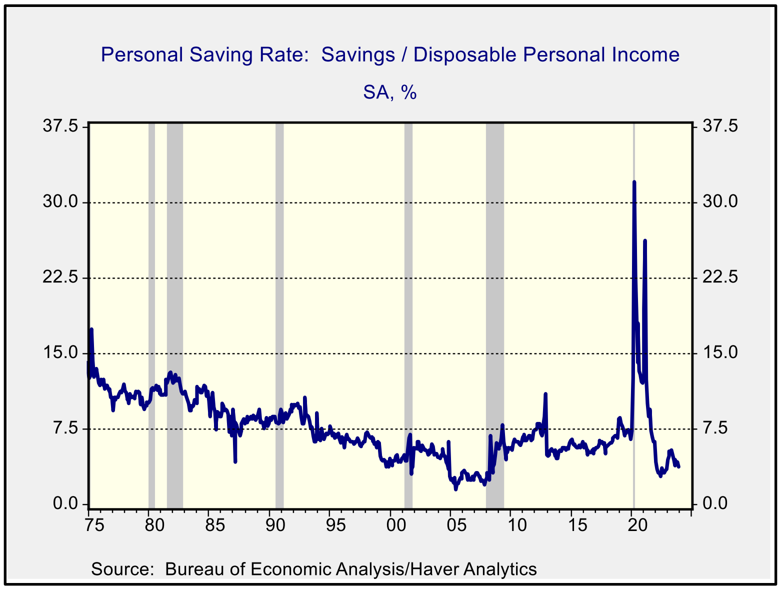
Other News: Despite growing skepticism from U.S. officials, Russian President Putin has hinted at a possible shift toward peace talks with Ukraine. This cautiously optimistic development follows a recent U.S.-China collaboration on AI regulation and Red Sea issues, suggesting a potential thaw in tensions. Meanwhile, Brazil is mediating a territorial dispute between Guyana and Venezuela, offering hope for further conflict reduction in South America. In short, geopolitical risks are starting to ease.

U.S. Economic Releases

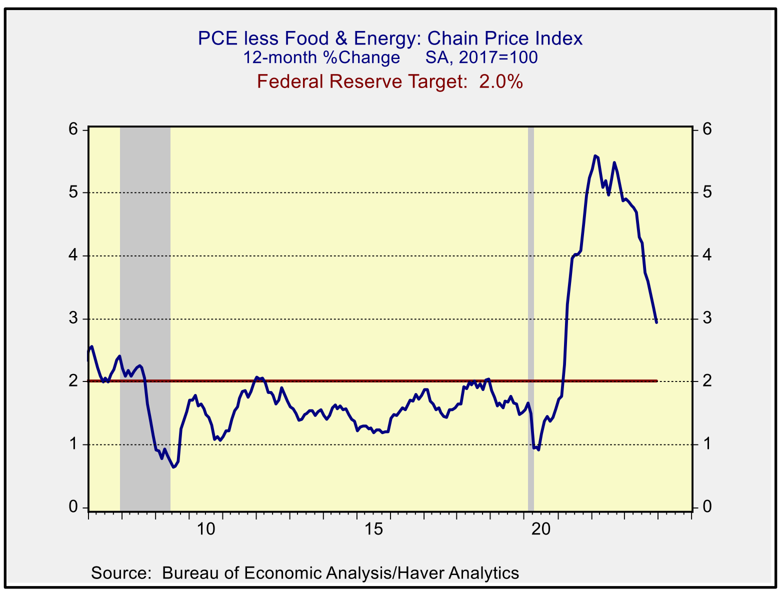
December ***personal income*** rose by a seasonally adjusted 0.3%, matching expectations but marking a modest deceleration from the November gain of 0.4%. Meanwhile, December ***personal consumption expenditures (PCE)*** rose 0.7%, beating the anticipated rise of 0.5% and accelerating from their November increase of 0.4%. Personal income in December was up 4.7% from the same month one year earlier, while PCE was up 5.9%. The chart below shows the year-over-year change in personal income and PCE since just before the Great Financial Crisis.



The personal income and spending report also includes a measure of personal saving, defined as disposable (after tax) income less consumption spending on goods and services. With consumer spending continuing to rise faster than incomes, December ***personal savings rate*** fell back to seasonally adjusted 3.7%. That marked the lowest savings rate in a year and will likely increase concern that consumers can't keep spending so robustly. The chart below shows how the personal savings rate has fluctuated since just before the GFC.



Finally, the income and spending report includes the Fed's preferred measure of consumer price inflation. After stripping out the volatile food and energy components, the ***Core PCE Deflator*** for December was up 2.9% from the same month one year earlier. That was slightly better than the expected rate of 3.0%, but it was still far above the Fed's target of 2.0%. The chart below shows the year-over-year change in the Core PCE Deflator 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						
EST	Indicator			Expected	Prior	Rating
10:00	Pending Home Sales	m/m	Dec	0.0%	2.0%	**
10:00	Pending Home Sales NSA	y/y	Dec	-5.1%	--	**
11:00	Kansas City Fed Services Activity	m/m	Jan	-10	--	*
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	Tokyo CPI	y/y	Jan	1.6%	2.4%	2.0%	**	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food	y/y	Jan	1.6%	2.1%	1.9%	***	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food & Energy	y/y	Jan	3.1%	3.5%	3.4%	*	Equity and bond neutral
	PPI Services	y/y	Dec	2.4%	2.3%	2.4%	*	Equity and bond neutral
	Coincident Index	m/m	Nov F	114.6	114.5		*	Equity and bond neutral
	Leading Economic Index	m/m	Nov F	107.6	107.7		**	Equity and bond neutral
EUROPE								
Eurozone	M3 Money Supply	y/y	Dec	0.1%	-0.9%	-0.7%	***	Equity and bond neutral
Germany	GfK Consumer Confidence	m/m	Feb	-29.7	-25.1	-25.4	**	Equity bearish, bond bullish
France	Consumer Confidence	m/m	Jan	91.0	89.0	90.0	**	Equity and bond neutral
Russia	Money Supply, Narrow Definition	w/w	19-Jan	18.1t	18.26t		*	Equity and bond neutral
AMERICAS								
Mexico	Trade Balance	m/m	Dec	4242.4m	629.9m	1836.5m	**	Equity and bond neutral
Brazil	IBGE Inflation IPCA - 15	y/y	Jan	4.5%	4.7%	4.6%	*	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)	519	520	-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 (%)	4.13	4.12	0.01	Flat
Euribor/OIS spread (bps)	393	393	0	Down
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Flat			Up
Pound	Up			Up
Franc	Up			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.

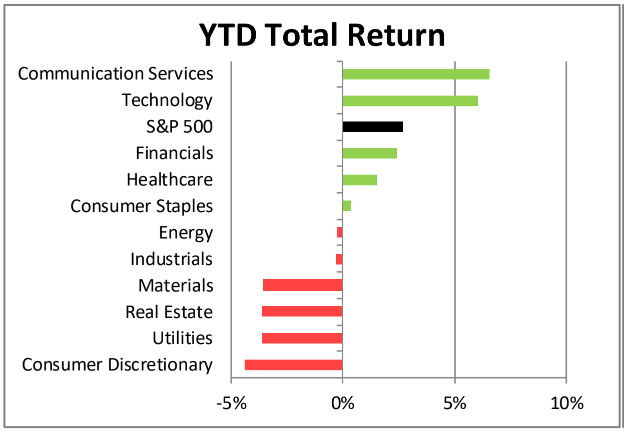
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$81.86	$82.43	-0.69%	
WTI	$76.58	$77.36	-1.01%	
Natural Gas	$2.55	$2.57	-0.70%	
Crack Spread	$25.62	$25.56	0.26%	
12-mo strip crack	$24.78	$24.86	-0.32%	
Ethanol rack	$1.74	$1.74	-0.35%	
Metals				
Gold	$2,021.30	$2,020.84	0.02%	
Silver	$22.82	$22.91	-0.43%	
Copper contract	$387.05	$386.90	0.04%	
Grains				
Corn contract	$446.75	$451.75	-1.11%	
Wheat contract	$606.25	$612.25	-0.98%	
Soybeans contract	$1,212.00	$1,223.00	-0.90%	
Shipping				
Baltic Dry Freight	1,499	1,507	-8	
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)	-326	-318	-8	

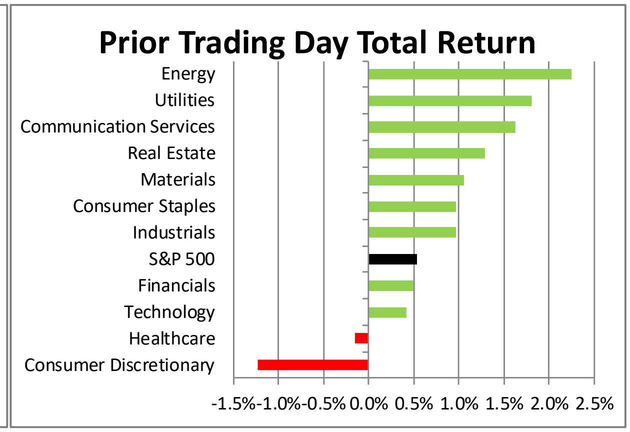
Weather

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 lower than normal. The forecasts call for wetter-than-normal conditions west of the Mississippi River, with heavy rains in California. The forecasts call for expected dry conditions in the Northeast.

<u>Data Section</u>

U.S. Equity Markets – (as of 1/25/2024 close)

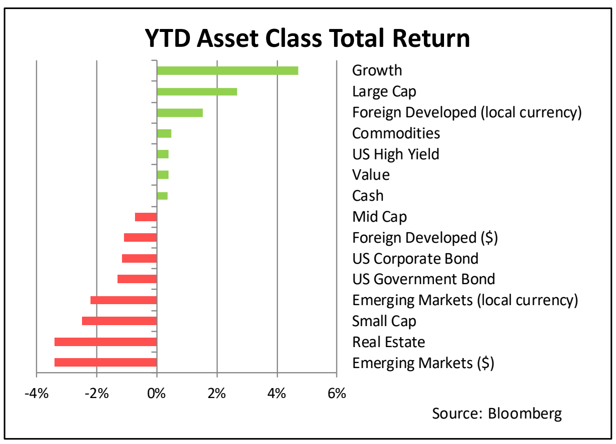




(Source: Bloomberg)

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 1/26/2024 close)

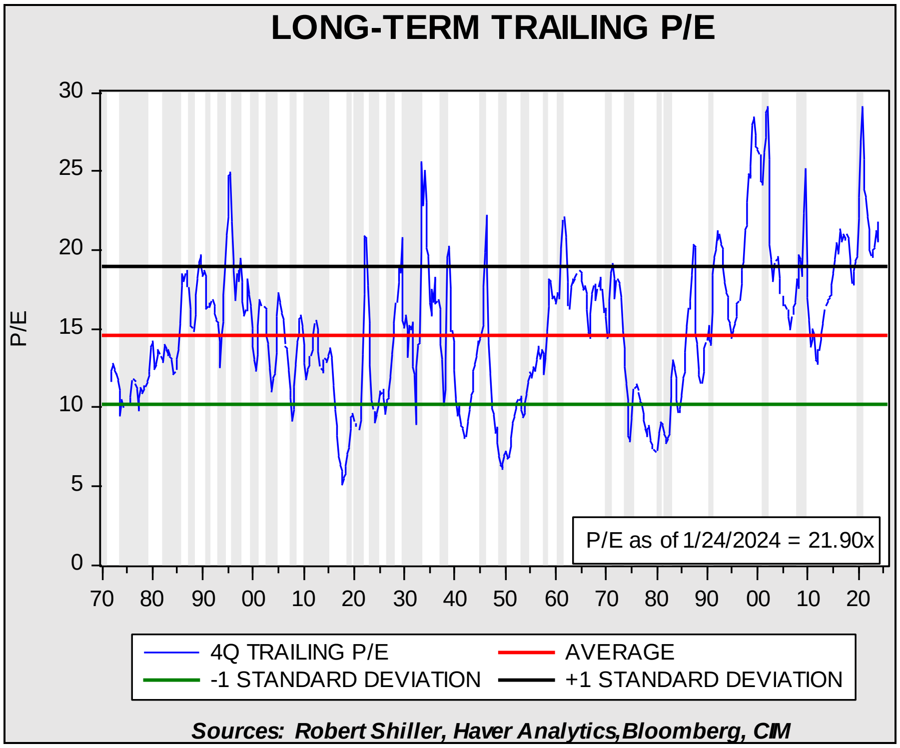


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.