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 29, 2024—9:30 AM EST] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is down 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.0%. Chinese markets were lower, with the Shanghai Composite down 0.9% from its previous close and the Shenzhen Composite down 2.42%. U.S. equity index futures are signaling a higher open.

With 124 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, 79.0% have exceeded expectations while 16.9% 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 – Q1 2024* (1/26/2024): Discussion of our asset allocation process, Q1 2024 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)

Our *Comment* today opens with news that an Iran-backed militant group has killed several U.S. troops in Jordan, boosting the chance that the Israeli-Hamas conflict will broaden. We next review a range of other international and U.S. developments with the potential to affect the financial markets today, including the forced liquidation of a major Chinese housing developer and a few words on the Federal Reserve's policy meeting this week.

Israel-Hamas Conflict: In sympathy for the Hamas militant government now being attacked by Israel in retaliation for its October 7 attacks, an Iran-backed militant group in Syria launched a drone strike against a U.S. military base in northern Jordan yesterday, killing three U.S. troops and injuring dozens. Iran this morning has tried to distance itself from the strike, but the casualties will surely put heavy pressure on the Biden administration to retaliate against Iranian interests, potentially broadening the Israel-Hamas war into a regional conflict.

- Separately, Israeli intelligence reports shared with the U.S. reveal that at least a dozen employees of the United Nations Relief and Work Agency participated in Hamas's October 7 attacks on Israel. Moreover, the reports indicate that UNRWA, which is the UN's organization to help Palestinian refugees, is riddled with staff members who have ties to Islamist militant groups.
- Taken together, the U.S. troop casualties and the intelligence reports have ratcheted up investor concerns about a broader Middle East conflict so far this morning. Gold and crude oil prices initially rose on the news, although oil prices are now trading slightly lower for the day.

European Union: Manfred Weber, leader of the center-right European People's Party (EPP) that is expected to place first in the European Parliament election in June, said in an interview last week that Europe needs to focus more on developing its own, independent military power outside the North Atlantic Treaty Organization, so it could defend itself even if the U.S. refused to come to its aid. Importantly, Weber even suggested that the EU develop its own nuclear weapons, perhaps under the leadership of the U.K. and France, which are already nuclear powers.

- As we have written many times, we think the most likely scenario going forward is that the growing U.S.-China rivalry fractures the world into a U.S.-led bloc consisting mostly of large, rich, highly developed liberal democracies and a few closely related emerging markets, and a China-led bloc consisting largely of authoritarian, commodity-focused emerging markets and frontier markets.
- However, if former President Trump is elected U.S. president in November, his first-term policies suggest he could renege on the U.S.'s alliance commitments, leaving the U.S. isolated and alone or scrambling to rebuild an alternative alliance structure while its former allies turn distrustful and adversaries like China and Russia keep rapidly building their armed forces. In this case, the EU, the non-U.S. NATO countries, Japan, and other former U.S. allies could be cut adrift and feel they've been left to defend themselves.
- We think leaders in the Chinese bloc hope for such an outcome, thinking they could then dominate the former U.S. allies, but Weber's statements show that such a development could backfire on the Chinese bloc. If a dismantling of the U.S. bloc prompts the EU, the U.K., Japan, South Korea, Australia, and other former allies to develop or expand their own nuclear weapons, the Chinese and Russians would suddenly feel they are surrounded by dangerous enemies. The result would likely be a global nuclear arms race.

Germany: The far-right, anti-immigrant Alternative for Germany (AfD) party unexpectedly lost a district election in the state of Thuringia, dashing the fast-rising group's hope to secure control of a local government for only the second time in its history. Mainstream voters have recently rallied against the AfD following revelations that it has explored a plan for mass deportations of German residents with foreign backgrounds, including citizens. However, the AfD could quickly recover from the Thuringia loss and continue to draw new support.

Japan: As Japanese stocks continue to perform strongly, we think the rise in prices partly reflects unexpectedly strong profits and productivity. Complementing those positive trends, new research shows that the number of Japanese companies offering stock as part of their employee compensation surged to 767 by August 2023, up from just 110 in 2015. If stock-based pay helps increase Japanese workers' engagement and incentives, the move could be an additional reason for Japanese stocks to keep rising.

China: A court in Hong Kong today ordered the liquidation of giant, highly indebted housing developer China Evergrande (3333.HK, HKD, 0.163), about two years after the company's default on its dollar bonds kicked off the financial crisis in China's real estate market. After many years of debt-fueled overbuilding, the resulting heavy debt load and market retrenchment are now a major headwind for China's economy, and, by extension, global demand.

China-Taiwan: As China continues to ramp up its military, economic, and diplomatic pressure on Taiwan to thwart any independence moves, the Taiwanese military this week inducted its first one-year draftees. To improve the quality of its troops, Taiwan in late 2022 increased its compulsory military service from just four months to one full year. The island is also trying to boost its arsenal of weapons to deter any potential Chinese invasion or blockade.

U.S. Monetary Policy: The Fed this week holds its latest policy meeting, with its decision due on Wednesday at 2:00 PM EST. The policymakers are widely expected to leave the benchmark fed funds interest-rate target unchanged at its current range of 5.25% to 5.50%. The focus for investors will be on the decision statement and Chair Powell's following press conference, either of which could provide clues as to when the Fed will finally start to cut rates and reduce its balance sheet runoff. Many investors expect those moves as early as March, but we continue to think they'll come a bit later than that.

U.S. Military: In its *2024 Index of U.S. Military Strength*, the Heritage Foundation has assessed that the country's military is "not ready to carry out its duties effectively" and that its condition has "worsened over the past two to three years." Issued last week, the report also faults U.S. leaders for not matching the renewed commitment to defense being demonstrated by allies such as Japan, Germany, Poland, and Lithuania.

- The report comes as all kinds of data also points to the increasing strength and aggressiveness of adversarial countries such as China, Russia, Iran, and North Korea.
- We continue to believe that a growing popular awareness of the global threats and the U.S. military shortcomings could prompt a stronger, more urgent effort to rebuild the

country's defense capability, with positive impacts for stocks in the industrial, technology, and other sectors that focus on selling to the military.

U.S. Military Power

	VERY WEAK	WEAK	MARGINAL	STRONG	VERY STRONG
Army			✓		
Navy		✓			
Air Force	✓				
Marine Corps				✓	
Space			✓		
Nuclear			✓		
OVERALL		✓			

(Source: Heritage Foundation, 2024)

U.S. Economic Releases

There were no economic releases prior to the publication of this report. 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**
10:30	Dallas Fed Manf. Activity	y/y	Jan	-11.8	-9.3	**
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								
New Zealand	Trade Balance NZD	m/m	Dec	-323m	-1234m	-1250m	**	Equity and bond neutral
	Exports NZD	m/m	Dec	5.94b	5.99b	5.95b	**	Equity and bond neutral
	Imports NZD	m/m	Dec	6.26b	7.23b	7.20b	**	Equity and bond neutral
China	Industrial Profits	y/y	Dec	16.8%	29.5%		*	Equity and bond neutral
EUROPE								
Switzerland	Domestic Sight Deposits CHF	w/w	26-Jan	463.2b	464.4b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	26-Jan	472.2b	473.4b		*	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)	519	521	-2	Flat
U.S. Sibor/OIS spread (bps)	531	531	0	Down
U.S. Libor/OIS spread (bps)	530	531	-1	Down
10-yr T-note (%)	4.11	4.14	-0.03	Flat
Euribor/OIS spread (bps)	389	393	-4	Down
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Up			Up
Pound	Flat			Up
Franc	Flat			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.

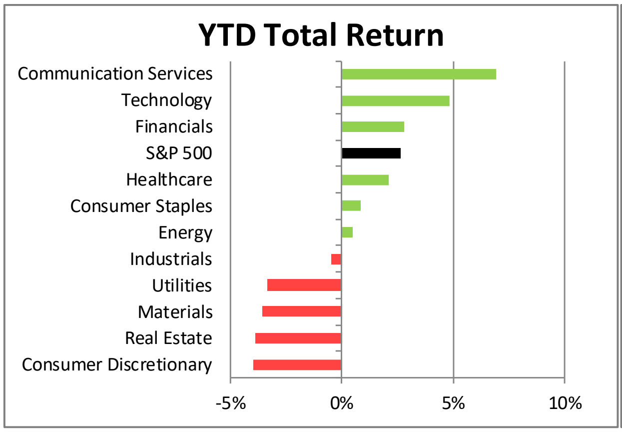
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$83.52	$83.55	-0.04%	
WTI	$78.01	$78.01	0.00%	
Natural Gas	$2.53	$2.71	-6.86%	Strong Production and higher temperatures
Crack Spread	$25.95	$26.65	-2.63%	
12-mo strip crack	$24.97	$25.50	-2.07%	
Ethanol rack	$1.75	$1.75	-0.02%	
Metals				
Gold	$2,029.48	$2,018.52	0.54%	
Silver	$23.04	$22.80	1.06%	
Copper contract	$385.15	$385.20	-0.01%	
Grains				
Corn contract	$443.00	$446.25	-0.73%	
Wheat contract	$591.75	$600.25	-1.42%	
Soybeans contract	$1,202.75	$1,209.25	-0.54%	
Shipping				
Baltic Dry Freight	1,518	1,499	19	

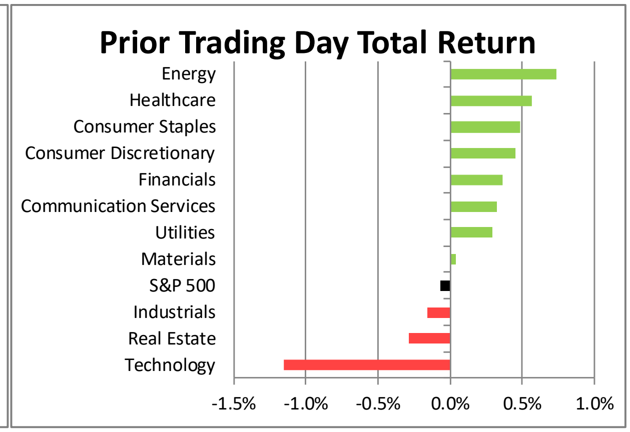
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in most states east of the Rocky Mountains, with cooler temperatures in the Pacific region and South Florida. The precipitation outlook calls for wetter-than-normal conditions for most of the country, with dry conditions in the Northeast and Midwest.

<u>Data Section</u>

U.S. Equity Markets – (as of 1/26/2024 close)

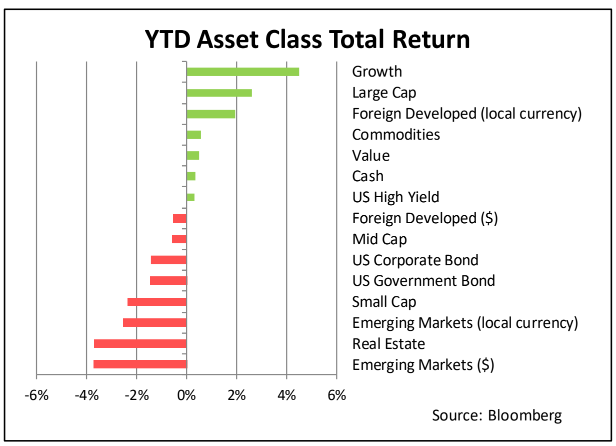




(Source: Bloomberg)

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)

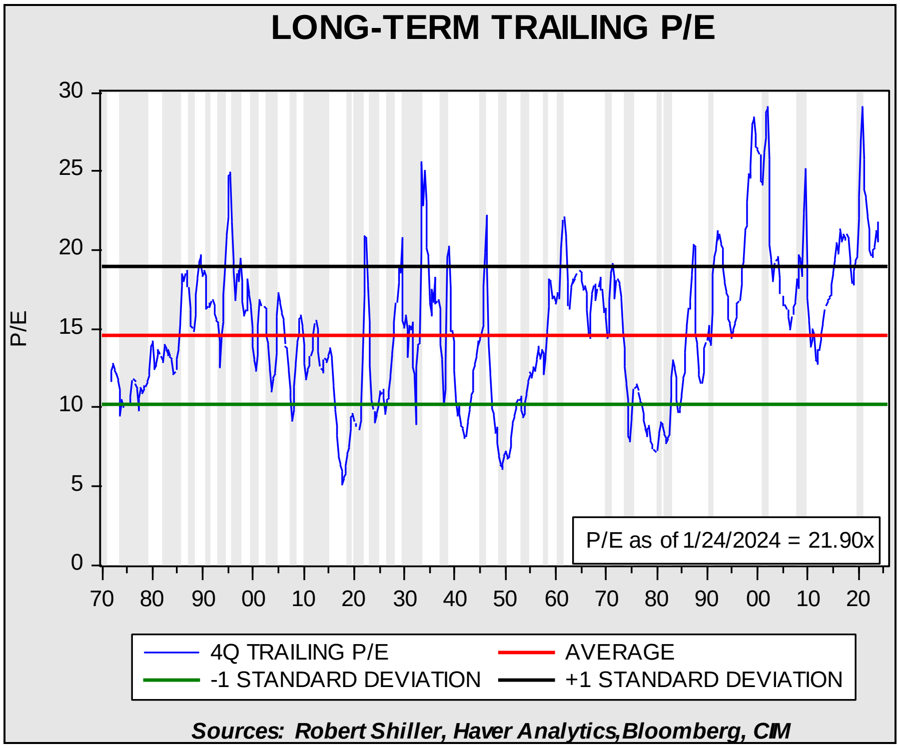


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.