Daily Comment

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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: August 13, 2024 — 9:30 AM ET] Global equity markets are mostly higher 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 0.4%. Chinese markets were higher, with the Shanghai Composite up 0.3% from its previous close and the Shenzhen Composite up 0.5%. US equity index futures are signaling a higher open.

With 455 companies having reported so far, S&P 500 earnings for Q2 are running at $61.30 per share, compared to estimates of $58.94, which is up 8.0% from Q2 2023. Of the companies that have reported thus far, 79.7% have exceeded expectations while 15.6% 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* (8/5/2024) (no accompanying podcast for this report): "The US Geopolitical and Economic Bloc as an Investment Region"
- *Asset Allocation Bi-Weekly* (8/12/2024) (no accompanying podcast for this report): "Is the Sahm Rule Right?"
- *Asset Allocation Quarterly – Q3 2024* (7/16/2024): Discussion of our asset allocation process, Q3 2024 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q3 2024 Rebalance Presentation* (8/6/2024): Video presentation featuring the Asset Allocation Committee as they review the asset allocation strategies, recent portfolio changes, and the current macro environment.

Our *Comment* today opens with the latest forecasts for global oil demand from the Organization of the Petroleum Exporting Countries. We next review several other international and US developments with the potential to affect the financial markets today, including news of a new, advanced artificial-intelligence chip from Chinese tech giant Huawei, data showing plummeting economic optimism in Europe, and new US regulatory initiatives from the Biden administration.

Global Oil Market: The Organization of the Petroleum Exporting Countries yesterday cut its forecasts of global oil demand in 2024 and 2025, largely because of the ongoing slowdown in Chinese economic growth and the risk that high interest rates could kick the US economy into recession. The cartel now sees demand rising by 2.11 million barrels per day this year, versus its previous growth estimate of 2.25 mbpd. The new growth forecasts put total global demand at 104.3 mbpd in 2024.

- Global oil demand continues to grow faster than right before the coronavirus pandemic, but it is rapidly normalizing.
- The slowdown in demand continues to keep a lid on prices, although geopolitical tensions and the risk of supply disruptions in Eastern Europe and the Middle East have kept oil prices higher than they otherwise would be.

China: Technology giant Huawei has reportedly developed a new artificial intelligence chip to replace the advanced Nvidia chips now barred by the US government from being exported to China. The new Huawei chip, the Ascend 910C, has reportedly been provided to top Chinese internet and communications firms for testing.

- Huawei has apparently had production problems with the Ascend 910C, and it could face more such problems as the US clamps down further on exporting advanced chipmaking equipment and services to China.
- Nevertheless, the new chip illustrates how aggressively Beijing is pushing to develop China's own independent technologies, both for its own security and to dominate key global markets of the future.
- Beijing's push to develop advanced technologies such as semiconductors, solar panels, and electric vehicles (which it collectively calls "new quality productive forces") probably would have happened even without the US's recent export controls. Now that the effort is in full swing, it will likely feed into the spiral of geopolitical and economic tensions between the Beijing and Washington, presenting risks for investors.

Vietnam-China: The *Washington Post* reports Hanoi has dramatically accelerated its program to expand islands it claims in the South China Sea, putting it on track to add some 1,000 acres this year through dredging and land reclamation on existing islands and shoals. The program, which aims to thwart China's territorial claims in the area, mimics the island-building tactics that China itself used about a decade ago to assert its sovereignty in the South China Sea.

- Vietnam's effort to do the same now could worsen Chinese-Vietnamese tensions, potentially leading to conflict and/or disruptions in the area's vital shipping lanes.
- As we noted in our *Bi-Weekly Geopolitical Report* from June 3, 2024, the South China Sea is marked by multiple territorial disputes, many of which are worsening.

Germany-China: Data from the Bundesbank shows German firms' direct investment in China totaled 7.3 billion EUR in the first half of 2024, compared with 6.5 billion EUR in all of 2023. Much of the rise in foreign direct investment represented the re-investment of profits earned in China, but the acceleration this year also reflects German companies' new strategy of investing in China to serve the Chinese market, rather than for export. The figures raise concerns that German firms are again discounting geopolitical risks, as they previously did by relying on Russian energy.

Eurozone: The ZEW Economic Sentiment Indicator for the eurozone plummeted by a seasonally adjusted 25.8 points in August to just 17.9, marking its biggest drop since early in the coronavirus pandemic. The indicator for Germany alone fell 22.6 points in a month to 19.2, for its biggest decline in two years. The drops apparently reflect the European Central Bank's continued high interest rates, concerns about the US economy, and the risk of escalating war in the Middle East. They also raise the likelihood of further ECB rate cuts in the coming months.

Mexico: The government is bracing for a retaliatory war between two branches of the powerful Sinaloa drug cartel after its patriarch, Ismael "El Mayo" Zambada, last month was kidnapped and turned over to US authorities by the son of a longtime associate, Joaquín "El Chapo" Guzmán. To prepare for the conflict between the Zambada and Guzmán families, the government has deployed hundreds of special forces soldiers to the cartel's home city of Culiacán, but reports say the two families are stockpiling weapons and preparing to fight each other.

- Significant new intra-cartel violence would further worsen Mexico's reputation for insecurity. Even though Mexico is well placed to benefit from global fracturing and the "near shoring" of production closer to the US, weak rule of law and other factors have blemished Mexico's investment environment and probably reduced how much it has benefited from current global economic trends.
- Importantly, increased intra-cartel fighting could also spill over into the US, given that the cartels have operatives north of the border.

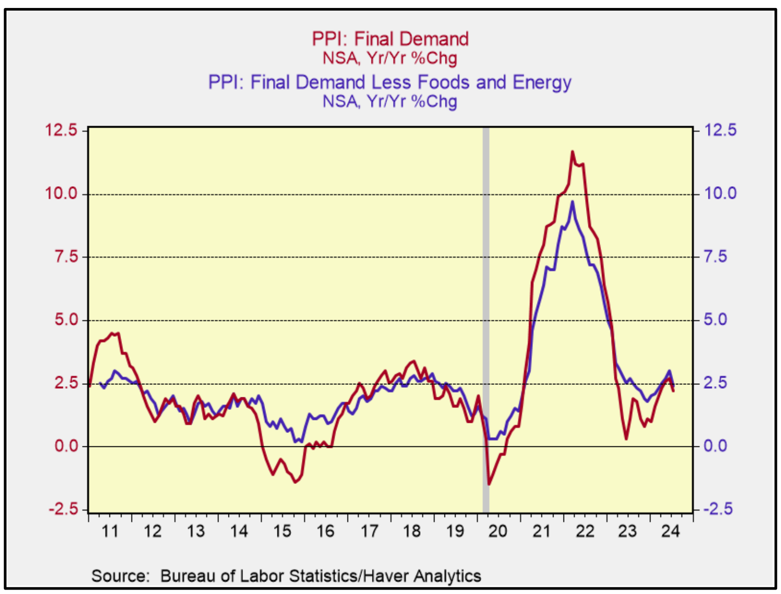
US Regulatory Policy: As part of its "war on junk fees," the Biden administration yesterday proposed several rule changes aimed at making it easier for consumers to cancel services and subscriptions. For example, a proposed rule from the Federal Trade Commission would require companies to make canceling a service or subscription as easy as signing up for one. While the proposals might play well politically, they could weigh on the profitability of some firms that rely on "sticky" client relationships.

US Stock Market: The *Wall Street Journal* today [carries an interesting article on the strong outperformance of stocks recently kicked out of the S&P 500]. According to new research by investment gurus Rob Arnott and Forrest Henslee, such stocks lose value quickly in the year before they are kicked out of the index, in part because of forced selling by index funds or index mimickers when their looming exit is announced. After they are out and that selling pressure dissipates, however, the stocks often outperform for about five years.

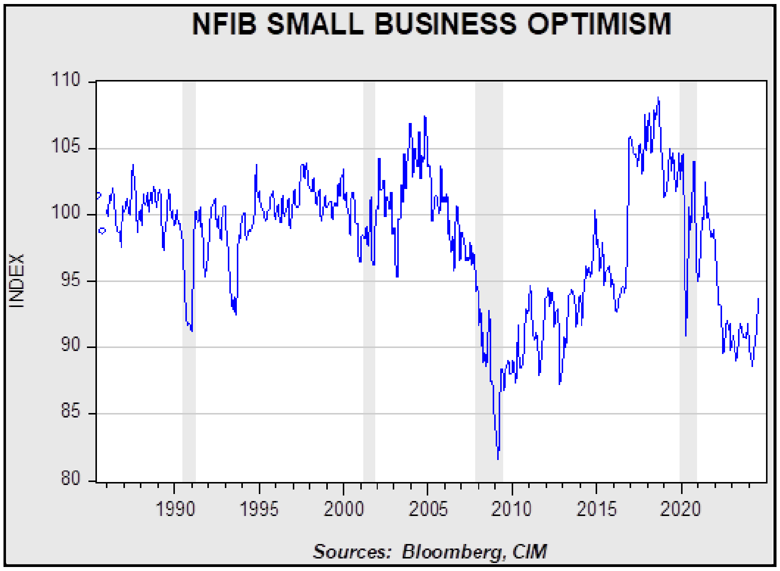
- As might be expected, Arnott and Henslee this week are launching a new index based on the strategy.
- Appropriately, the index will be called the NIXT.

US Economic Releases

The July ***producer price index (PPI)*** rose by a seasonally adjusted 0.1%, slightly less than the expected and prior-month values, which were both 0.2%. Excluding the volatile food and energy components, the July ***"core" PPI*** was unchanged, again less than the expected 0.2% and prior month's 0.3%. The overall PPI in July rose 2.2% from the same month one year earlier, while the core PPI rose 2.4%. These values were slightly less than the expected 2.3% and 2.4%, respectively, and they mark notable decelerations from the prior month's values of 2.7% and 3.0%. Taken together, these are encouraging signs of decreasing overall inflation, without portending recession, as larger declines would have suggested. The chart below shows the year-over-year change in the PPI and the core PPI over the last decade or so.



The National Federation of Independent Business' Small Business Optimism Index for July rose from 91.5 to 93.7, significantly exceeding the expectation of 91.5. Although the index remains well below its long-term average of 98 and within the downtrend that began before COVID, this marks a meaningful positive jump to its highest level since February 2022. Tempering the overall optimism of this reading, several of the index's contributing factors did not change, suggesting that business owners remain in a wait-and-see mode until the election. The following chart shows the course of the index through time.



The table below lists the economic releases and/or Fed events scheduled for the rest of the day.

Economic Releases						
ET	**Indicator**			**Expected**	**Prior**	**Rating**
11:00	NY Fed 1-Yr Inflation Expectations	m/m	Jul	--	3.02%	
14:00	Monthly Budget Statement	m/m	Jul	-$242.0b	-$66.0b	**
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	Jul P	8.4%	9.7%		**	Equity and bond neutral
	PPI	y/y	Jul	3.0%	22.9%	3.1%	***	Equity and bond neutral
Australia	Westpac Consumer Conf SA	m/m	Aug	289.0%	-1.1%		**	Equity and bond neutral
	Westpac Consumer Conf Index	m/m	Aug	85	82.7		**	Equity and bond neutral
	Wage Price Index	m/m	2Q	4.1%	4.1%	4.0%	***	Equity and bond neutral
	NAB Business Confidence	m/m	Jul	1	3		***	Equity and bond neutral
	NAB Business Conditions	m/m	Jul	6	4		***	Equity and bond neutral
South Korea	Import Price Index	y/y	Jul	9.7%	9.6%		*	Equity and bond neutral
	Export Price Index	y/y	Jul	12.9%	12.1%		*	Equity and bond neutral
China	Money Supply M2	y/y	Jul	6.3%	6.2%	6.0%	***	Equity and bond neutral
	Money Supply M1	y/y	Jul	-6.6%	-5.0%	-5.5%	*	Equity bearish, bond bullish
	Money Supply M0	y/y	Jul	12.0%	11.7%		*	Equity and bond neutral
	New Yuan Loans CNY	m/m	Jul	13530.0b	13262.1b	13689.1b	**	Equity and bond neutral
EUROPE								
Eurozone	ZEW Survey Expectations	m/m	Aug	17.9	43.7		**	Equity and bond neutral
Germany	ZEW Survey Expectations	m/m	Aug	19.2	41.8	34.0	**	Equity bearish, bond bullish
	ZEW Survey Current Situation	m/m	Aug	-77.3	-68.9	-74.5	**	Equity and bond neutral
UK	Average Weekly Earnings 3M/YoY	m/m	Jun	4.50%	5.70%	4.60%	**	Equity and bond neutral
	ILO Unemployment Rate 3Mths	m/m	Jun	4.20%	4.40%	4.50%	**	Equity and bond neutral
	Claimant Count Rate	m/m	Jul	47.00%	4.40%		**	Equity and bond neutral
	Jobless Claims Change	m/m	Jul	135.0k	32.3k	36.2k	**	Equity bearish, bond bullish
Russia	Trade Balance	m/m	Jun	11.5b	12.2b		**	Equity and bond neutral
	Exports	m/m	Jun	35.3b	36.8b		*	Equity and bond neutral
	Imports	m/m	Jun	23.8b	24.7b		*	Equity and bond neutral
AMERICAS								
Canada	Building Permits	m/m	Jun	-13.9%	-127.0%	6.00	**	Equity bearish, bond bullish
Brazil	IBGE Services Volume	y/y	Jun	1.3%	-0.1%	0.8%	*	Equity and bond neutral

Financial Markets

The table below highlights some of the indicators that we follow daily. 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)	537	536	1	Down
3-mo T-bill yield (bps)	505	505	0	Down
U.S. Sibor/OIS spread (bps)	511	513	-2	Down
U.S. Libor/OIS spread (bps)	509	510	-1	Down
10-yr T-note (%)	3.89	3.91	-0.02	Down
Euribor/OIS spread (bps)	355	356	-1	Down
Currencies	Direction			
Dollar	Flat			Down
Euro	Flat			Up
Yen	Down			Up
Pound	Up			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.

DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$81.85	$82.30	-0.55%	
WTI	$79.68	$80.06	-0.47%	
Natural Gas	$2.21	$2.19	1.05%	
12-mo strip crack	$21.36	$21.48	-0.59%	
Ethanol rack	$1.95	$1.95	-0.04%	
Metals				
Gold	$2,466.06	$2,472.90	-0.28%	
Silver	$27.82	$27.98	-0.58%	
Copper contract	$407.80	$410.40	-0.63%	
Grains				
Corn contract	$398.50	$401.50	-0.75%	
Wheat contract	$531.25	$536.75	-1.02%	
Soybeans contract	$970.50	$986.00	-1.57%	
Shipping				
Baltic Dry Freight	1,655	1,670	-15	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.80		
Gasoline (mb)		-1.80		
Distillates (mb)		1.00		
Refinery run rates (%)		0.6%		
Natural gas (bcf)		25		

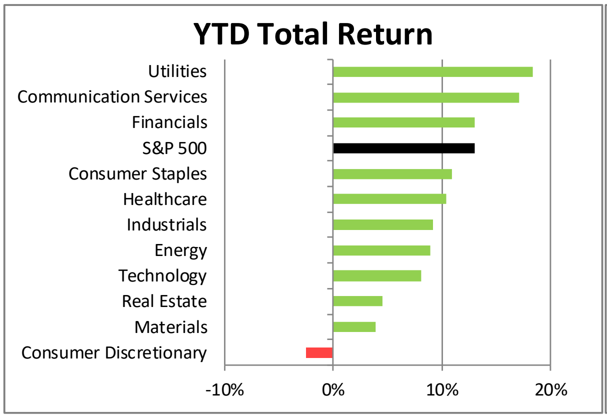
Weather

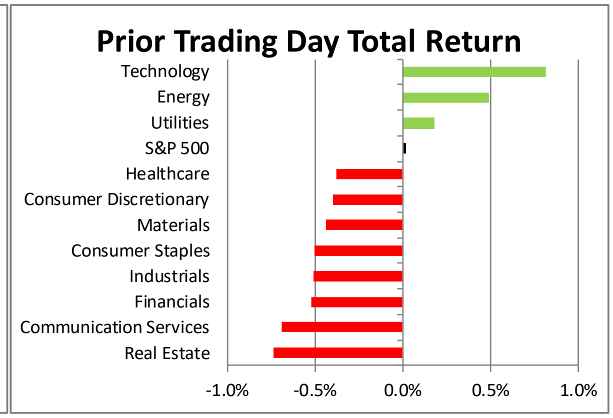
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in the Rocky Mountains, Great Plains, South, and New England, with cooler temperatures on the West Coast and in the Ohio Valley. The precipitation outlook calls for wetter-than-normal conditions in the Pacific Northwest, the southern Rocky Mountains, and New England, with dry conditions from New Mexico to Alabama and the western Great Lakes.

Tropical Storm Ernesto is transiting the Leeward Islands today, enroute to the Virgin Islands and Puerto Rico tonight and tomorrow, where it will bring heavy rain and flooding. It is then expected to veer northward into the Atlantic well east of the United States later in the week.

Data Section

US Equity Markets – (as of 8/12/2024 close)

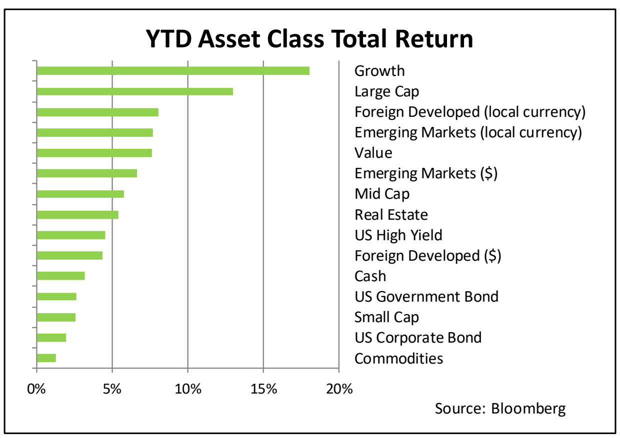




(Source: Bloomberg)

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 8/12/2024 close)

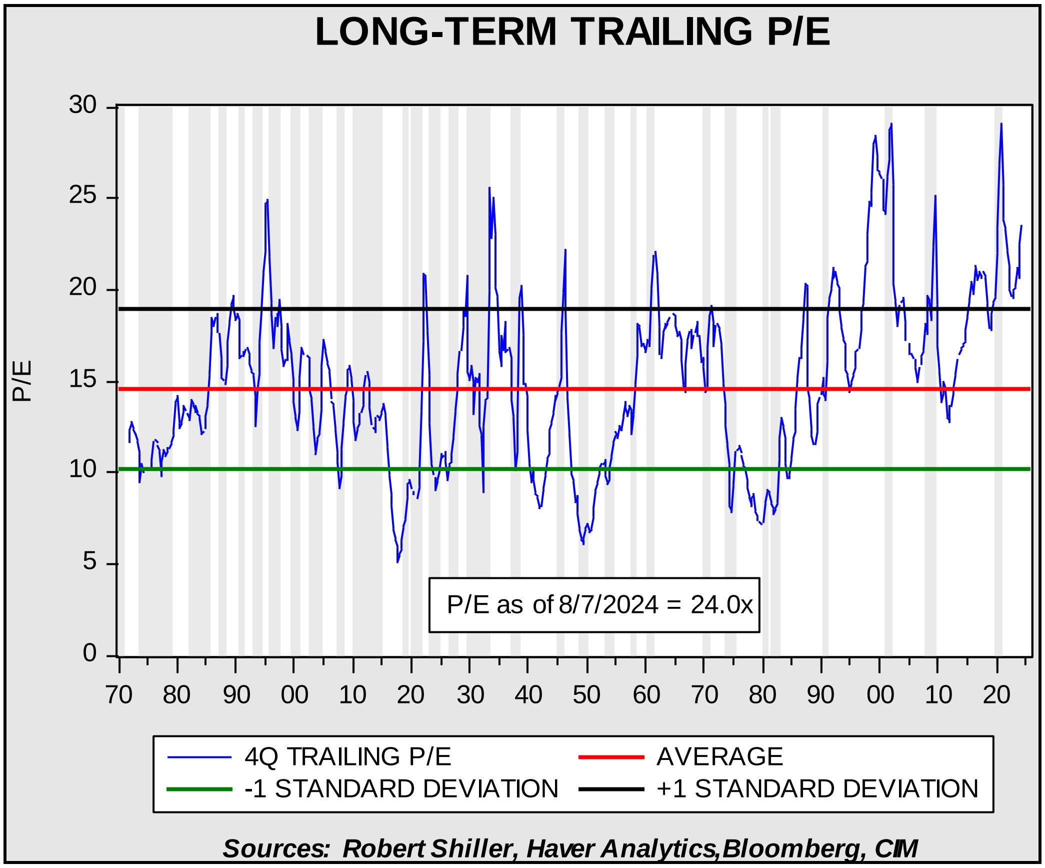


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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), US Corporate Bond (iShares iBoxx $ Investment Grade Corporate Bond ETF), US Government Bond (iShares 7-10 Year Treasury Bond ETF), US 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

August 8, 2024



Based on our methodology,[1] the current P/E is 24.0x, unchanged from our last report. The lack of movement in the multiple was due to the decline in the stock price index, which was offset by a decline in earnings.

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 (Q2). 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.