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: August 15, 2024 — 9:30 AM ET] Global equity markets are mostly higher this morning. In Europe, the Euro Stoxx 50 is up 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.3%. Chinese markets were higher, with the Shanghai Composite up 0.9% from its previous close and the Shenzhen Composite up 0.8%. US equity index futures are signaling a higher open.

With 458 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, 79.9% have exceeded expectations while 15.5% have fallen short of expectations.

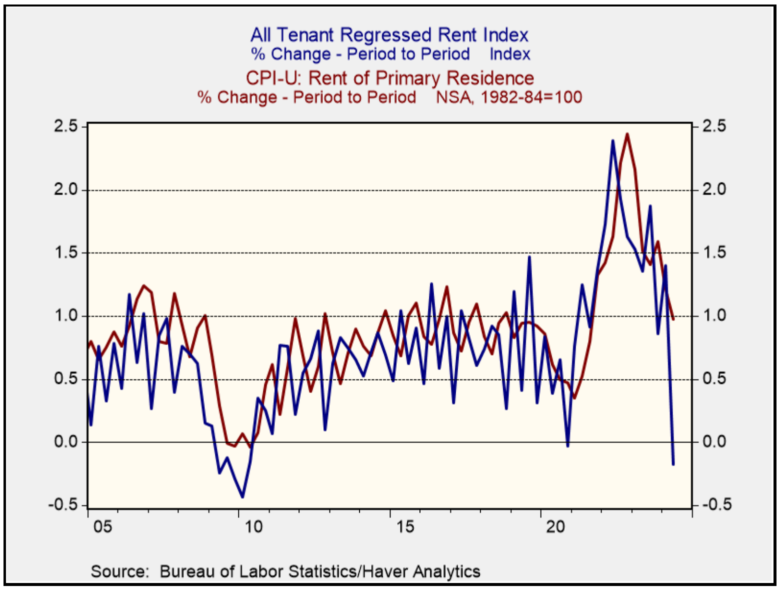
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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.

Good morning! Markets are in a risk-on mode today after yesterday's robust inflation data. In sports news, Real Madrid kicked off their 2024/25 season with a triumphant UEFA Super Cup victory, and now set their sights on defending both their Champions League and La Liga titles. Today's *Comment* examines the Fed's challenges in taming lingering inflation, the mounting regulatory pressures on tech companies, and the evolving Chinese economic landscape. As always, we conclude with a comprehensive overview of domestic and international news.

Inflation Pressures Ease: The July CPI report fueled optimism among investors that the Federal Reserve will lower interest rates in September, but questions persist regarding the size of the cut.

- Inflation eased to a three-year low last month, according to the Bureau of Labor Statistics. The headline Consumer Price Index (CPI) decelerated from 3.0% to 2.9%, while the core CPI, which excludes volatile food and energy prices, softened to 3.2% from 3.3%. These figures aligned with market forecasts and increased expectations for a potential interest rate cut in September. However, despite the positive report, market expectations for a rate cut have moderated, with odds of a 25 basis-point reduction now favored over a 50 basis-point cut, according to the CME FedWatch Tool.
- A primary driver of the shift in market expectations was the unexpected resurgence of housing inflation. Shelter costs accelerated from a month-over-month increase of 0.2% to 0.4%, challenging the notion that housing inflation, especially rental prices, had begun to cool. Fed officials have long anticipated the incorporation of market rent data into CPI figures, but technical issues, such as the timing of pandemic-related eviction moratorium expirations, have complicated the pass-through effects.

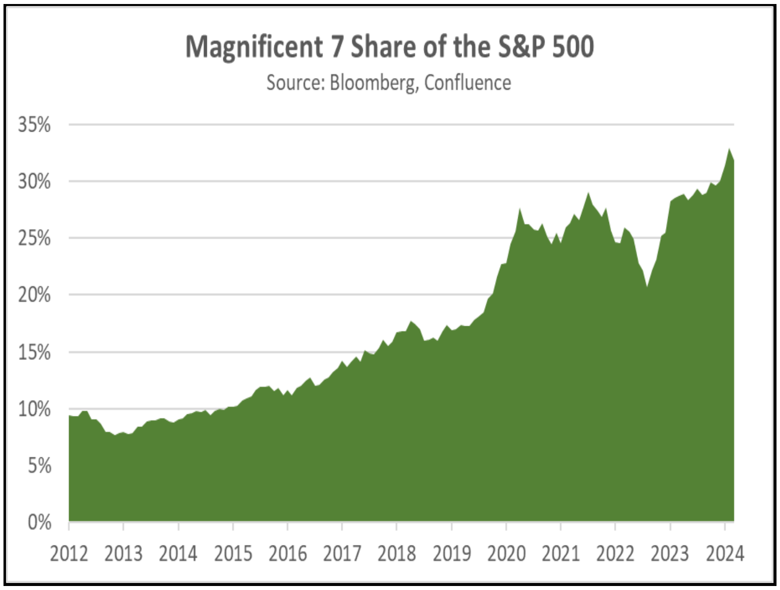


- With one CPI and one PCE price report to go before the next Fed meeting, the central bank is likely to lean toward a rate cut if inflation continues on its current trajectory. However, the size of any potential rate cut will hinge primarily on the upcoming jobs report. Several Fed officials have signaled that an unexpected increase in unemployment could pave the way for Fed action. Given the Fed's most recent projections with the most pessimistic scenario forecasting a 4.4% unemployment rate by year-end, any reading above this level would likely necessitate a more aggressive policy response.

Trust Busting?: Tech giants are increasingly resembling the monopolistic power of Standard Oil as governments intensify scrutiny of their market dominance.

- A federal court ruling has found Google guilty of illegally monopolizing the search engine and search text ad markets. As a result, the Department of Justice (DOJ) is considering breaking up the tech giant. The court determined that Google's $26 billion payments to make its search engine the default on smartphones and web browsers effectively blocked competition. While Google plans to appeal the decision, the judge has ordered both parties to explore remedies to restore competition. Potential consequences of a breakup include the divestiture of Alphabet's Android, AdWords, and Chrome.

- The recent ruling against Google is part of a broader global effort to curb the power of tech giants. The DOJ is also targeting Apple for alleged anti-competitive behavior in the smartphone market. Simultaneously, the Federal Trade Commission (FTC) is challenging Amazon's practices that restrict sellers from offering lower prices on other platforms. Overseas, European regulators have accused Meta of violating the bloc's Digital Markets Act with its pay or consent advertising model. The decision to go after major tech companies has occurred as the equity market has become more concentrated.

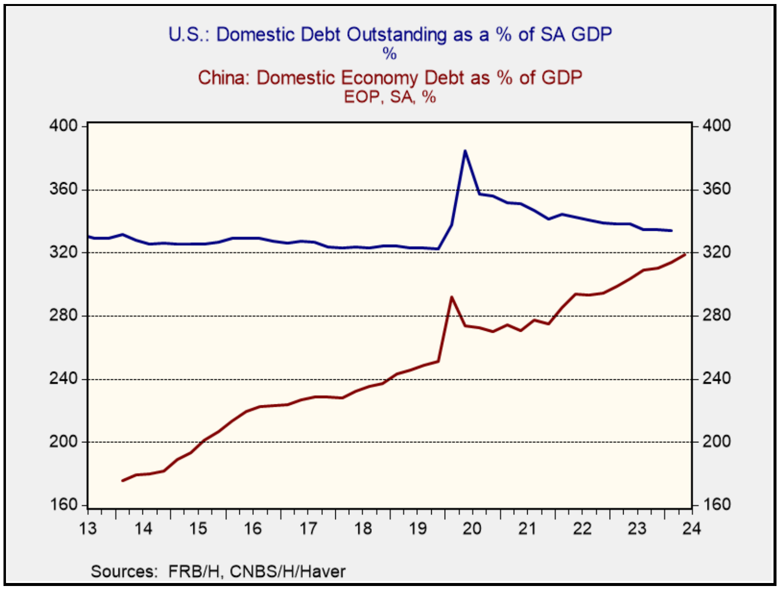


- It's important to note that despite regulatory pressures, tech companies have yet to be forced to break up their businesses. In fact, the last major company breakup occurred in the 1980s with AT&T, but a similar attempt to dismantle Microsoft in 2001 was unsuccessful. Despite these challenges, tech giants may be forced to relinquish some of their market dominance as they look to appease regulators. The increased competition and diminished pricing power of these firms will erode their profitability, leading to a broader market concentration over the next decade.

China's Economic Woes Continue: China's economic slowdown, exacerbated by trade disputes and debt, casts a long shadow over the global economy.

- New economic data has led to concerns about the current state of the Chinese economy. China's industrial output slowed to its weakest pace in four months in July, expanding at a rate below expectations. Meanwhile, the unemployment rate edged up from 5.0% to 5.2%. The real estate market remains a significant concern for policymakers, with the home price index falling even deeper into contraction territory. Home prices dropped 4.9% year-over-year in July, compared to a decrease of 4.5% in the previous month.

- Weak economic indicators are likely to increase pressure on Beijing to bolster growth. The government has been cautious about deploying significant fiscal stimulus due to mounting debt concerns. Unlike its major economic peers, which have sought to stabilize their debt levels, China has continued to accumulate debt. Its total debt-to-GDP ratio, comprising household, corporate, and government liabilities, has exceeded 300% and is on course to outstrip the US's ratio within the next few quarters. This rapid debt accumulation has intensified fears of a debt trap as China strives to maintain its growth trajectory.

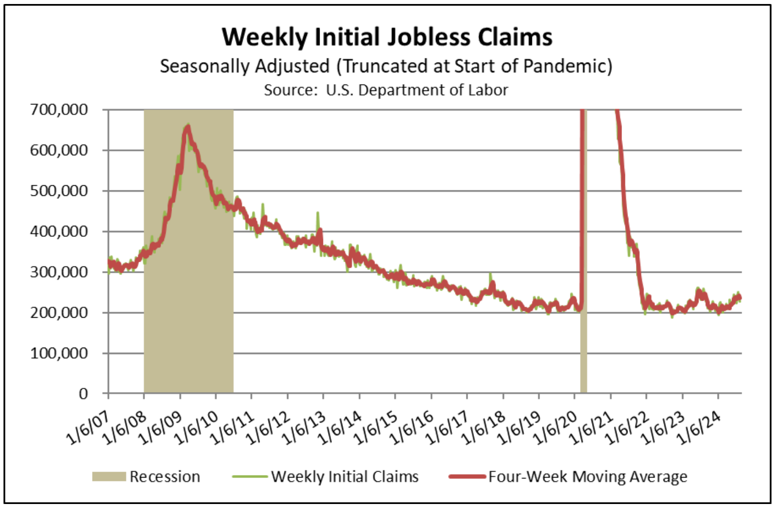


- While elevated debt levels pose risks to economic expansion, a prudent approach to debt management can strengthen investor confidence. By carefully calibrating stimulus measures and avoiding fiscal excess, the government can sustain growth while gradually addressing its debt burden. Although this strategy may not swiftly resolve the debt challenge, it can mitigate the risk of a severe economic downturn. Consequently, while we don't expect growth to be strong, we still see a lot of investable opportunities in the region.

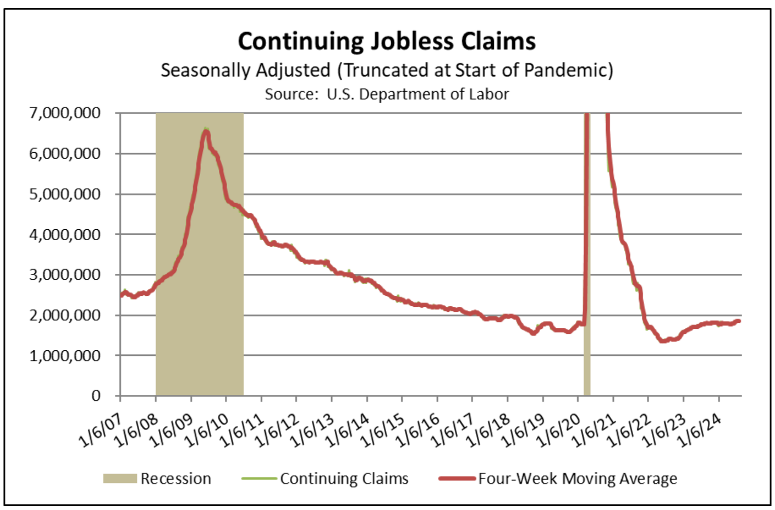
In Other News: Google reports that members of the Trump, Biden, and Harris teams were all targets of a phishing campaign from Iran. The hack highlights the growing prevalence of cyberwarfare. Vice presidential candidate Tim Walz agreed to debate JD Vance on October 1. The showdown will likely be used to win over swing voters in the Rust Belt.

US Economic Releases

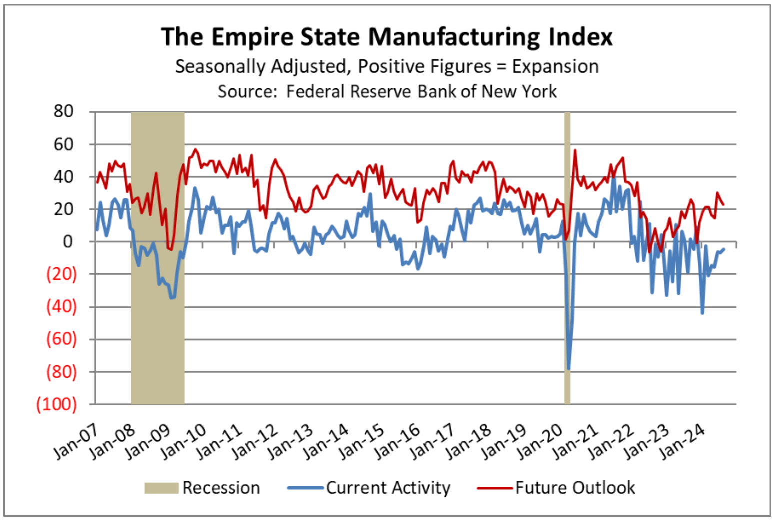
In the week ended August 10, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 227,000, below both the expected level of 235,000 and the previous week's revised level of 234,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to 236,500. 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.



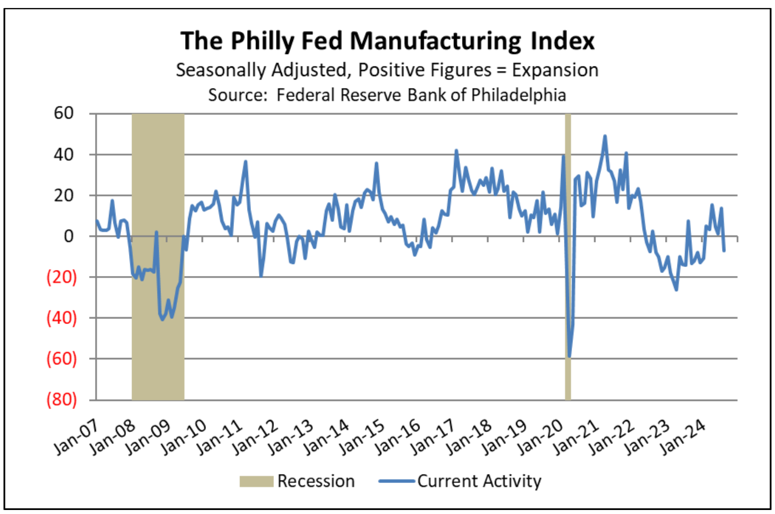
In the week ended August 3, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) fell to a seasonally adjusted 1.864 million, below both the anticipated reading of 1.870 million and the prior week's revised reading of 1.871 million. The four-week moving average of continuing claims rose to 1.862 million, moving farther above the levels seen before the coronavirus pandemic and confirming that the demand for labor has softened. The chart below shows how continuing claims have fluctuated since the GFC. It is also truncated during the pandemic period because of the high level of claims at the time.



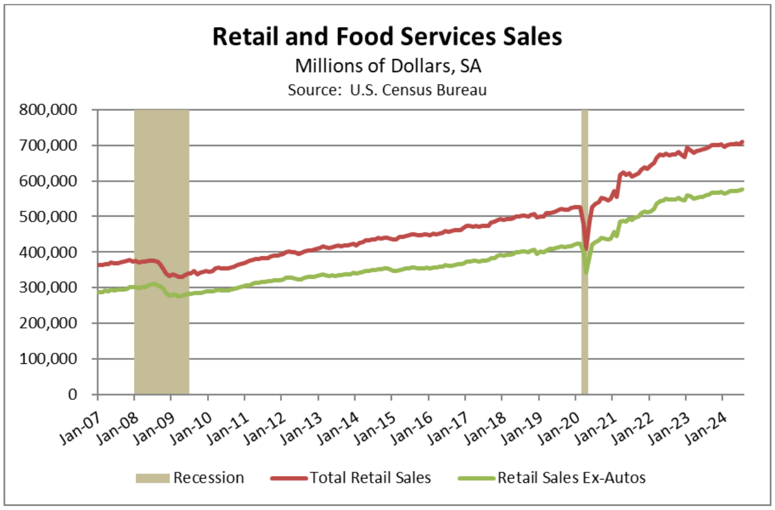
Separately, the New York FRB said its August ***Empire State Manufacturing Index*** improved to a seasonally adjusted -4.7, beating its expected reading of -6.0 and the July reading of -6.6. This index is designed so that positive readings point to expanding factory activity in New York state. At its current level, the index suggests New York manufacturing is still declining, but at a more gradual rate. The chart below shows how the index has fluctuated since just before the GFC.



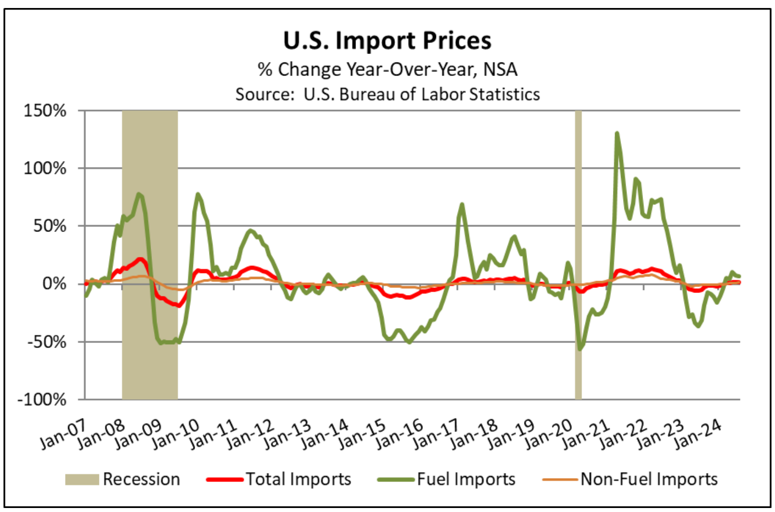
In contrast, the Philadelphia FRB said its August ***Philly Fed Index*** plunged to a seasonally adjusted -7.0, compared with its anticipated reading of 5.2 and the July reading of 13.9. The index, officially designated as the Philadelphia FRB Manufacturing Activity Index, is designed so that positive readings point to expanding factory activity in the mid-Atlantic region. At its current level, the index suggests mid-Atlantic manufacturing has entered at least a short-term contraction. The chart below shows how the index has fluctuated since just before the GFC.



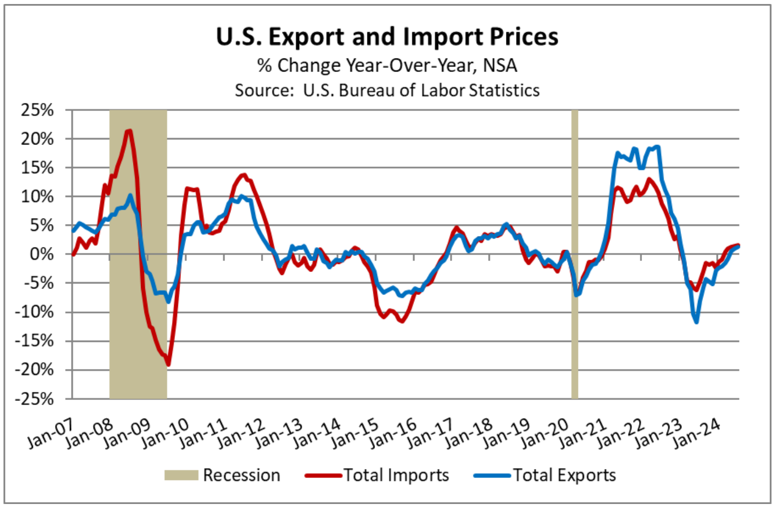
In another report today, July ***retail sales*** rose by a seasonally adjusted 1.0%, beating their expected gain of 0.4% and easily reversing the revised decline of 0.2% in June. Of course, overall retail sales are often driven by the volatile auto and auto parts sector, which makes up almost one-fifth of the total. July ***retail sales excluding autos and auto parts*** were up 0.4%, compared with their anticipated rise of 0.1% and the revised June increase of 0.5%. Overall retail sales in July were up 4.0% from the same month one year earlier, while sales excluding autos and auto parts were up 4.2%. The chart below shows how retail sales have changed since just before the GFC.



Finally, July ***import prices*** were up 0.1% from the previous month, compared with their expected decline of 0.1% and their flat performance in June. Of course, import prices are often driven by volatility in the petroleum fuels category. July ***import prices excluding fuels*** were up 0.2%, more than the anticipated rise of 0.1% but matching the rise in the prior month. Overall import prices in July were up 1.6% year-over-year, while import prices excluding fuels were up 1.2%. The chart below shows the year-over-year change in import prices since just before the GFC.



Also in the report, ***export prices*** in July were up 1.4% from one year earlier, in large part because of the key agriculture category. Comparing the annual change in export prices versus import prices provides a sense of the US "terms of trade," or the relative advantage or disadvantage the country is facing because of trends in international trade prices. The chart below compares the year-over-year change in US export and import prices 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						
ET	Indicator			Expected	Prior	Rating
10:00	Business Inventories	m/m	Jun	0.3%	0.5%	*
10:00	NAHB Housing Market Index	m/m	Aug	43.0	42.0	*
16:00	Total Net TIC Flows	m/m	Jun		$15.8b	**
16:00	Net Long-Term TIC Flows	m/m	Jun		-$54.6b	**
Federal Reserve						
ET	Speaker or Event	District or Position				
9:10	Patrick Harker Speaks on Gives Speech on Center at Philadelphia	President of the Federal Reserve Bank of Philadelphia				
1:10	Alberto Musalem Speaks on Economy, Policy	President of the Federal Reserve Bank of St. Louis				

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	GDP SA	q/q	2Q P	3.10%	-2.30%	2.30%	***	Equity and bond neutral
	GDP Deflator	q/q	2Q P	3.00%	3.40%	2.60%	***	Equity and bond neutral
	Capacity Utilization	y/y	Jun	-3.1%	4.1%		**	Equity and bond neutral
	Industrial Production	y/y	Jun F	-7.9%	-7.3%		***	Equity and bond neutral
Australia	Employment Change	m/m	Jul	58.2k	52.3k	20.0k	***	Equity and bond neutral
	Unemployment Rate	m/m	Jul	4.2%	4.1%	4.1%	***	Equity and bond neutral
	Participation Rate	m/m	Jul	67.1%	66.9%	66.9%	**	Equity and bond neutral
New Zealand	Food Prices	m/m	Jul	0.4%	1.0%		***	Equity and bond neutral
China	Industrial Production	y/y	Jul	5.1%	5.3%	5.2%	***	Equity and bond neutral
	Retail Sales	y/y	Jul	2.7%	2.0%	2.6%	**	Equity and bond neutral
China	Fixed Assets Ex Rural YTD	y/y	Jul	3.6%	3.9%	3.9%	**	Equity and bond neutral
India	Trade Balance	m/m	Jul	$23497m	-$20977m	-$21500m	**	Equity and bond neutral
	Exports	y/y	Jul	-1.5%	2.6%		**	Equity and bond neutral
	Imports	y/y	Jul	7.5%	5.0%		**	Equity and bond neutral
EUROPE								
UK	GDP	y/y	2Q P	0.9%	30.0%	0.9%	***	Equity and bond neutral
	Industrial Production	y/y	Jun	-1.4%	0.4%	-2.1%	***	Equity and bond neutral
UK	Construction Output	y/y	Jun	-1.70%	0.60%	-2.10%	**	Equity and bond neutral
	Index of Services	m/m	Jun	-0.1%	0.3%	0.1%	*	Equity and bond neutral
	Visible Trade Balance GBP	m/m	Jun	-£18894m	-£18593m	-£15900m	*	Equity and bond neutral
	Trade Balance GBP	m/m	Jun	-£5324m	-£5770m	-£3500m	*	Equity and bond neutral
Switzerland	Producer & Import Prices	y/y	Jul	-1.7%	-1.9%		**	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)	538	538	0	Down
3-mo T-bill yield (bps)	506	507	-1	Down
U.S. Sibor/OIS spread (bps)	511	512	-1	Down
U.S. Libor/OIS spread (bps)	508	510	-2	Down
10-yr T-note (%)	3.85	3.84	0.01	Down
Euribor/OIS spread (bps)	354	354	0	Down
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Flat			Up
Yen	Flat			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	$80.51	$79.76	0.94%	
WTI	$77.80	$76.98	1.07%	
Natural Gas	$2.22	$2.22	-0.09%	
12-mo strip crack	$20.72	$20.75	-0.15%	
Ethanol rack	$1.94	$1.93	0.12%	
Metals				
Gold	$2,469.89	$2,447.85	0.90%	
Silver	$28.43	$27.57	3.11%	
Copper contract	$415.20	$407.35	1.93%	
Grains				
Corn contract	$401.00	$400.75	0.06%	
Wheat contract	$560.75	$556.25	0.81%	
Soybeans contract	$972.50	$968.50	0.41%	
Shipping				
Baltic Dry Freight	1,728	1,670	58	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	1.36	-2.00	3.36	
Gasoline (mb)	-2.89	-1.42	-1.47	
Distillates (mb)	-1.67	0.25	-1.92	
Refinery run rates (%)	1.0%	-0.1%	1.1%	
Natural gas (bcf)		1		

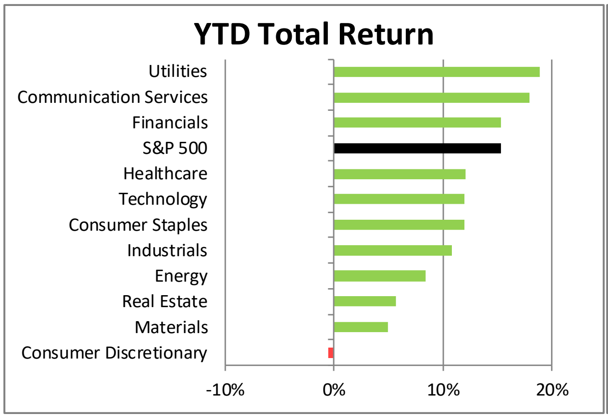
Weather

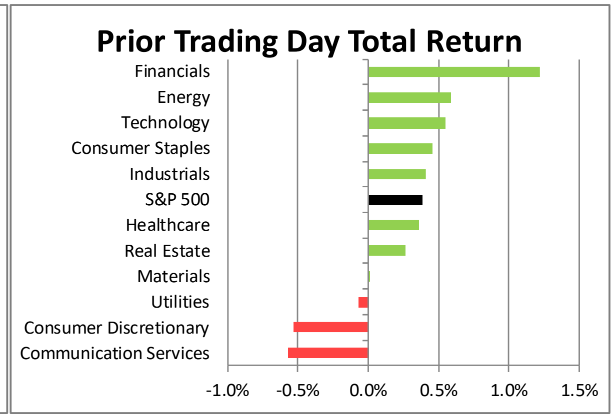
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in the Rocky Mountains, Great Plains, and the Southeast, with cooler-than-normal temperatures in the Midwest. The forecasts call for wetter-than-normal conditions in the Pacific Northwest, the central Rocky Mountains, the East Coast, with dry conditions in the Great Plains, the Midwest, and the lower Mississippi Valley.

Hurricane Ernesto has now passed Puerto Rico and is heading north toward Bermuda. It is expected to stay well east of the US mainland.

Data Section

US Equity Markets – (as of 8/14/2024 close)

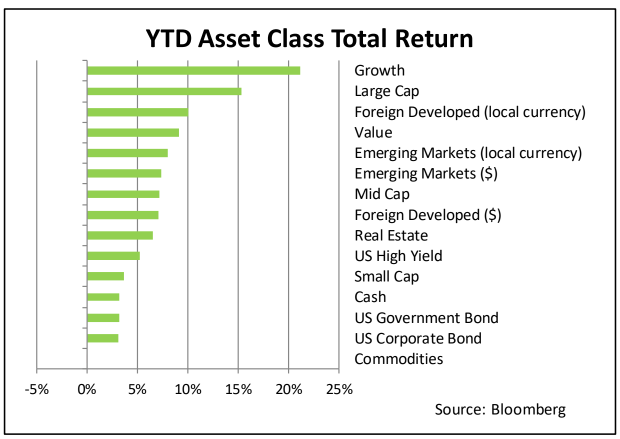




(Source: Bloomberg)

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 8/14/2024 close)

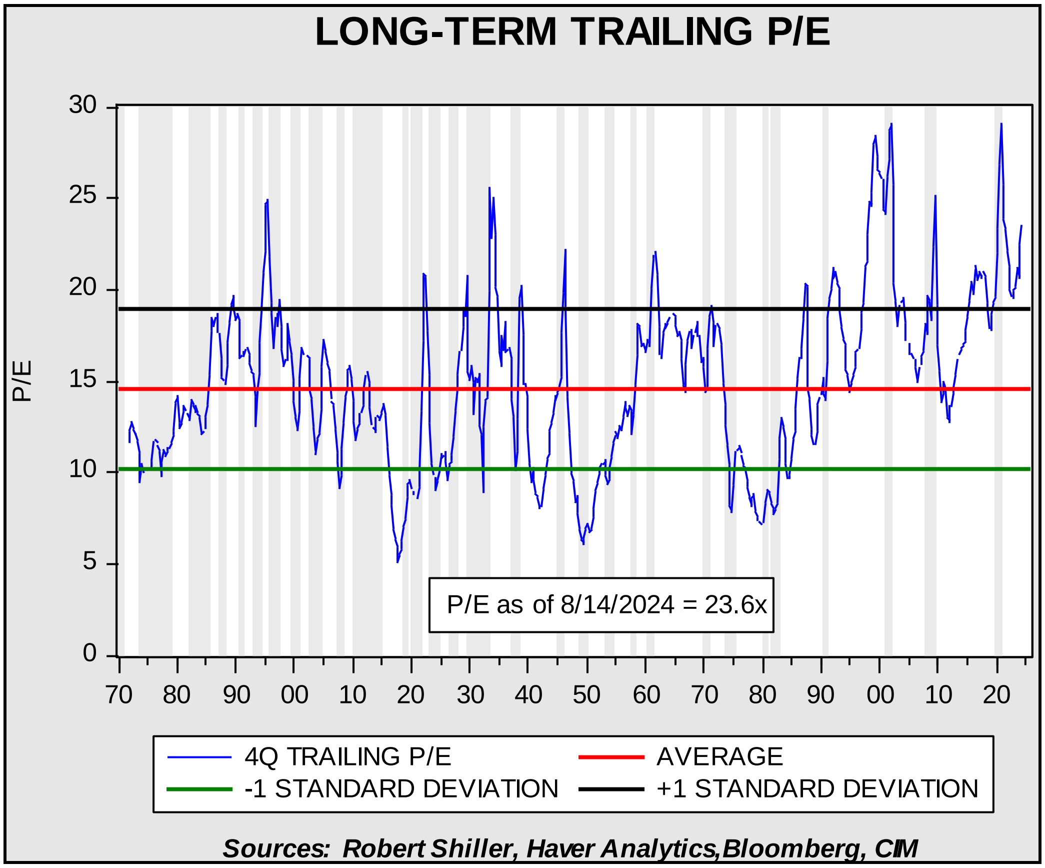


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 15, 2024



Based on our methodology,[1] the current P/E is 23.6x, down 0.4 from our last report. The drop in the multiple was due to a decrease in the stock price index, and a minor increase 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.