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 16, 2024 — 9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.5% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 2.5%. Chinese markets were mixed, with the Shanghai Composite up 0.1% from its previous close and the Shenzhen Composite down 0.3%. US equity index futures are signaling a lower open.

With 463 companies having reported so far, S&P 500 earnings for Q2 are running at $61.40 per share, compared to estimates of $58.94, which is up 8.0% from Q2 2023. Of the companies that have reported thus far, 80.1% have exceeded expectations while 15.4% have fallen short of expectations.

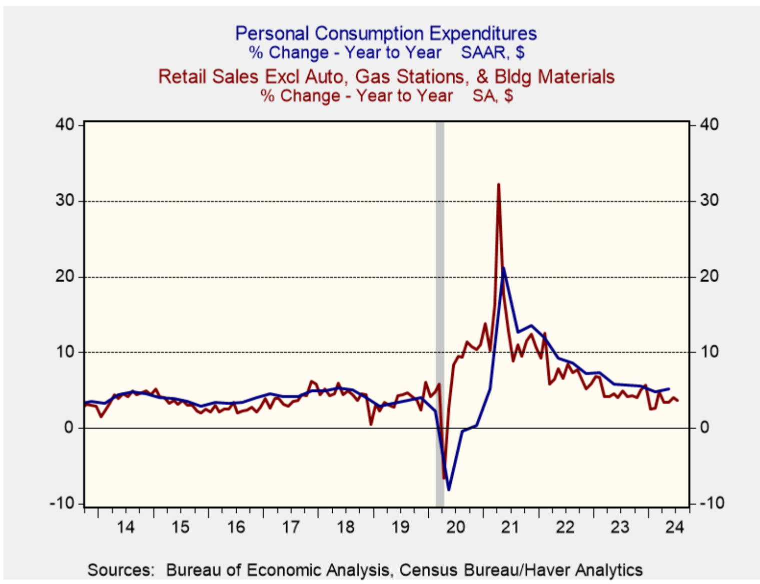
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (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! Investors are reacting to the strong economic data released on Thursday. In sports news, New York Yankee Aaron Judge became the player to hit 300 home runs the fastest in MLB history. Today's *Comment* will delve into the market's newfound optimism surrounding positive economic data, examine the factors driving gold's strong performance this year, and provide a comprehensive overview of global monetary policy. As always, the report will include a summary of key domestic and international economic indicators.

September Take Off? While a rate cut at next month's FOMC meeting appears likely, a strong economy has dampened expectations of a mega cut.

- More members of the Federal Reserve are backing a September rate cut. St. Louis Fed President Alberto Musalem reinforced this view on Thursday, endorsing a modest rate reduction as recent data suggests the economy is regaining balance. This marks a significant shift from his June stance, where he argued that rate cuts were appropriate only after several quarters, not months, of solid data. Musalem now aligns with Federal Reserve officials like Chicago and Atlanta Fed presidents Austan Goolsbee and Raphael Bostic, who also support a rate cut at the upcoming meeting.
- Strong retail sales and Walmart's upbeat outlook eased concerns that consumer demand was slowing. In July, retail sales surged at their fastest pace since January 2023, according to the Commerce Department. While the rebound in auto purchases following a crippling software attack on dealerships contributed significantly to the overall sales surge, broad-based spending growth was evident across most retail sectors. Walmart reinforced this positive trend by reporting increased spending, particularly among high-income households looking for bargains, and subsequently upgraded its company outlook for earnings.



- As September nears, market attention will likely transition from the question of whether the Fed will pivot to the timing and pace of rate cuts. A sustained period of robust economic data will probably induce a gradual approach to monetary easing from the Fed, which will be aimed at preventing a resurgence of inflation and the need for policy tightening. Conversely, signs of economic weakness, particularly a rising unemployment rate, could prompt a more aggressive easing cycle.

Gold Bulls Are Back! Bullion prices have soared to record levels as investors seek refuge in the commodity amid escalating geopolitical tensions and currency debasement.

- Gold has outperformed the S&P 500 year-to-date, surging 20.3% compared to the index's 16.8% gain. While Chinese gold purchases contributed to the metal's early-year rally, the recent price surge has been fueled by a broader range of factors. Soaring geopolitical tensions, exemplified by [the assassination of leaders associated with the war in Gaza] and [Ukraine's incursion into Russia], have intensified safe-haven demand for gold. Moreover, concerns over currency debasement, driven by nations grappling with high debt loads and potential interest rate cuts, have fueled substantial gold purchases.

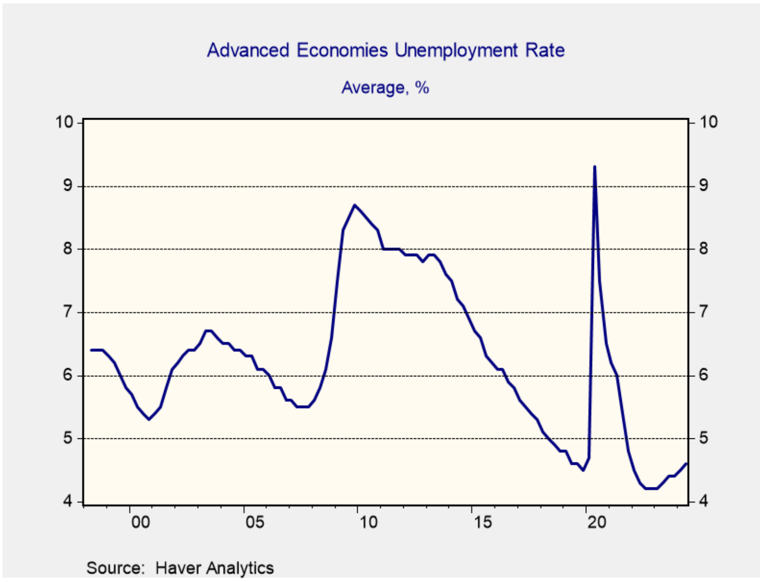
- Gold has increasingly supplanted 10-year Treasury notes as the preferred safe-haven asset. This decoupling intensified in 2022 as government spending soared and the Federal Reserve rapidly tightened monetary policy. The correlation between the two assets has weakened from a strong 88% to a more modest 75% over the past two years, primarily driven by an oversupply of Treasury bonds relative to demand. While redirecting Treasury issuance towards shorter maturities has mitigated some imbalances, the fundamental relationship between gold and 10-year Treasurys appears to be broken.

- We anticipate the negative correlation between gold and Treasury yields to persist due to escalating geopolitical tensions and the diminishing appeal of US dollar-denominated assets. As the global order fractures, a declining pool of interest rate insensitive Treasury buyers will likely contribute to higher and more volatile interest rates. While potential Treasury and emergency Federal Reserve interventions could temper extreme rate spikes, we anticipate a new interest rate environment over the next few years with persistently higher levels compared to the pre-pandemic era.

Global Rate Cut Angst: There is growing concern that central banks may not be able to continue cutting rates following setbacks in inflation.

- Central banks are adopting a more cautious tone despite a wave of policy pivots this year. Brazil, one of the first major economies to cut rates, [is now considering a reversal due to a worsening inflation outlook]. Meanwhile, [an unexpected surge in German wages] has prompted calls for the European Central Bank to exercise caution before implementing another rate cut next month. In contrast, recent market turbulence has led the [Bank of Japan to reconsider its tightening plans] to prevent further volatility.

- Central banks face a complex landscape as they navigate persistent global labor shortages and the US dollar's strength. While service sector inflation has eased, tight labor markets continue to fuel wage pressures. As the chart below shows, the unemployment rates remain notably below pre-pandemic levels. Moreover, exchange rate volatility has been a major problem, especially for countries dependent on dollar-denominated imports. The Bank of Japan's surprise rate hike last month, partly attributed to yen weakness, underscores the challenges posed by currency fluctuations.



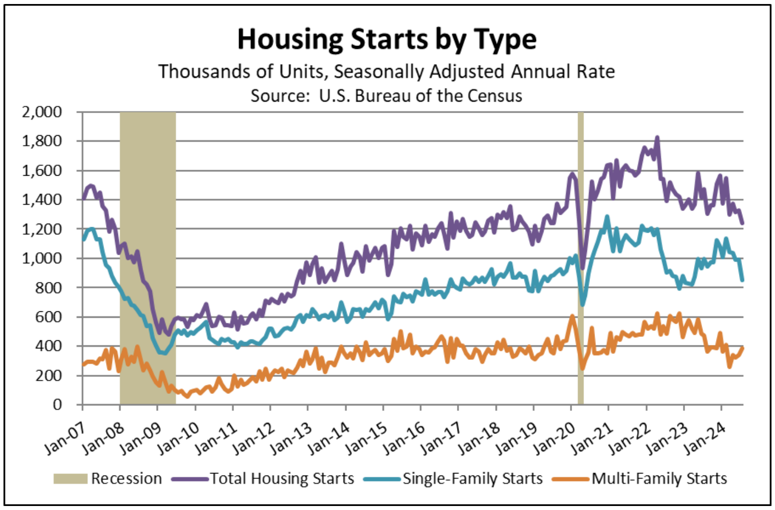
- As the global economy transitions towards policy normalization, investors should anticipate a more gradual process compared to previous cycles. Central banks are navigating an unprecedented post-pandemic landscape characterized by heightened geopolitical tensions and reduced global interconnectedness. These complexities will challenge policymakers to maintain consistent policy rate paths in either direction. Barring a catastrophic event, policy normalization is likely to proceed, albeit at a slower pace and in a more restrictive manner than the market currently anticipates.

In Other News: The Nigerian government claims diplomatic immunity after a French court ordered the seizure of three of its jets in a dispute with a Chinese company. The case is a test of tolerance for multilateralism in an increasingly fractured world. Democratic presidential candidate Kamala Harris has announced a plan to give first-time home buyers a $25,000 home tax credit. Saudi Arabia's holdings of US Treasurys rose to the highest level in history, which is another sign that the demand for Treasurys is still there for foreigners looking to play both sides of the US-China rivalry.

US Economic Releases

July ***housing starts*** fell sharply to a seasonally adjusted, annualized rate of 1.238 million units, far short of the expected rate of 1.333 million units and the revised June rate of 1.329 million units. Housing starts in July were down 6.8% from June, wiping out that month's 1.1% rise. July

housing permits fell to a rate of 1.396 million units, short of both their anticipated rate of 1.425 million units and the revised June rate of 1.454 million units. Permits issued for new housing units in July were down 4.0% from the previous month. Compared with the same month one year earlier, housing starts in July were down 14.0%, while permits were up 2.5%. The chart below shows the growth in new home starts by type of property since just before the Great Financial Crisis.



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	U. of Michigan Consumer Sentiment	m/m	Aug P	66.9	66.4	***
10:00	U. of Michigan Current Conditions	m/m	Aug P	63.3	62.7	**
10:00	U. of Michigan Future Expectations	m/m	Aug P	68.5	68.8	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Aug P	2.8%	2.9%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Aug P	2.9%	3.0%	*
Federal Reserve						
ET	**Speaker or Event**	**District or Position**				
13:25	Austan Goolsbee Speaks in Fireside Chat	President of the Federal Reserve Bank of Chicago				
16:15	Austan Goolsbee on CNN	President of the Federal Reserve Bank of Chicago				

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	Japan Buying Foreign Stocks	w/w	9-Aug	-¥328.1b	¥1288.1b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	9-Aug	¥1539.2b	¥677.7b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	9-Aug	¥521.9b	-¥643.7b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	9-Aug	¥1435.0b	-¥1160.0b		*	Equity and bond neutral
	Tertiary Industry Index	m/m	Jun	-1.30%	0.60%	0.30%	***	Equity bearish, bond bullish
New Zealand	BusinessNZ Manufacturing PMI	m/m	Jul	44.0	41.2		***	Equity and bond neutral
EUROPE								
Eurozone	Trade Balance SA	m/m	Jun	17.5b	12.4b	13.5b	**	Equity and bond neutral
UK	Retail Sales	y/y	Jul	1.4%	-0.3%	1.4%	***	Equity and bond neutral
	Retail Sales Ex-Auto Fuel	y/y	Jul	1.4%	-0.8%	1.4%	**	Equity and bond neutral
Switzerland	Industrial Output WDA	y/y	2Q	7.3%	-2.0%		*	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	9-Aug	$604.0b	$606.1b		***	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	9-Aug	18.33t	18.30t		*	Equity and bond neutral
AMERICAS								
Canada	Wholesale Sales ex Petroleum	m/m	Jun	-0.6%	-1.2%	-0.60	**	Equity and bond neutral
Brazil	FGV Inflation IGP-10	m/m	Aug	0.72%	0.45%	0.74%	**	Equity and bond neutral
	Economic Activity Index	y/y	Jun	3.18%	1.09%	2.50%	**	Equity bullish, bond bearish

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)	536	538	-2	Down
3-mo T-bill yield (bps)	507	509	-2	Down
U.S. Sibor/OIS spread (bps)	512	514	-2	Down
U.S. Libor/OIS spread (bps)	510	511	-1	Down
10-yr T-note (%)	3.87	3.91	-0.04	Down
Euribor/OIS spread (bps)	355	354	1	Down
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Up			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.

DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$79.15	$81.04	-2.33%	
WTI	$76.03	$78.16	-2.73%	
Natural Gas	$2.19	$2.20	-0.18%	
12-mo strip crack	$20.61	$20.71	-0.47%	
Ethanol rack	$1.95	$1.95	0.36%	
Metals				
Gold	$2,465.81	$2,456.79	0.37%	
Silver	$28.06	$28.35	-1.03%	
Copper contract	$414.15	$417.60	-0.83%	
Grains				
Corn contract	$393.75	$397.00	-0.82%	
Wheat contract	$551.00	$550.25	0.14%	
Soybeans contract	$960.50	$968.50	-0.83%	
Shipping				
Baltic Dry Freight	1,692	1,728	-36	
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)	-6	1	-7	

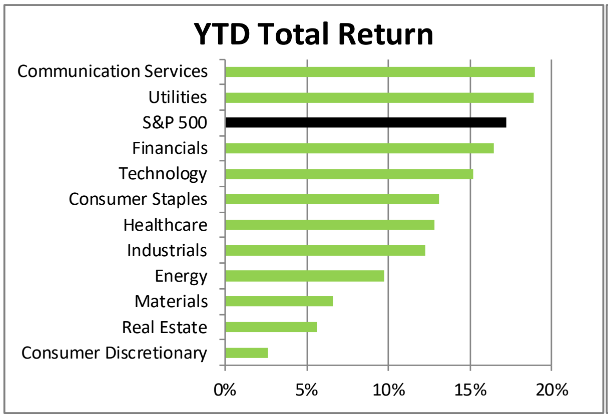
Weather

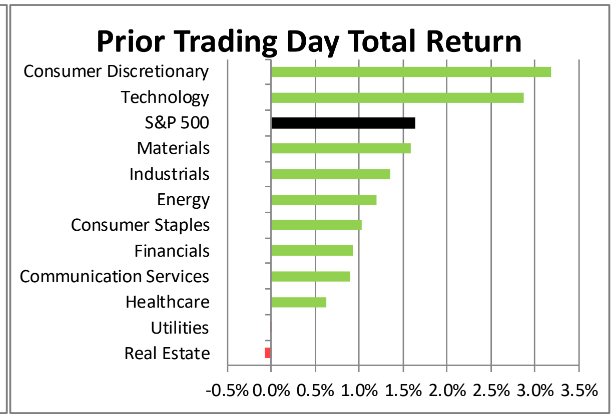
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in the Rocky Mountains, Great Plains, and the Southeast, with cooler-than-normal temperatures in Oregon, California, and the mid-Atlantic states. The forecasts call for wetter-than-normal conditions in the Pacific Northwest,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

Hurricane Ernesto is now traveling northeasterly through the Atlantic Ocean and bearing down on Bermuda, where it will bring heavy rains and winds later today and tomorrow. It is expected to stay well east of the US mainland.

Data Section

US Equity Markets – (as of 8/15/2024 close)

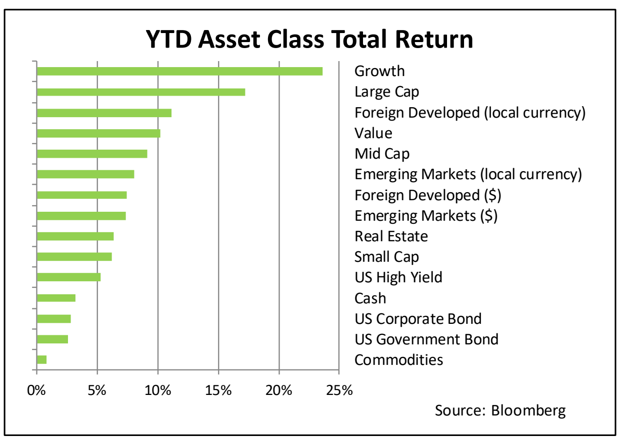




(Source: Bloomberg)

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 8/15/2024 close)

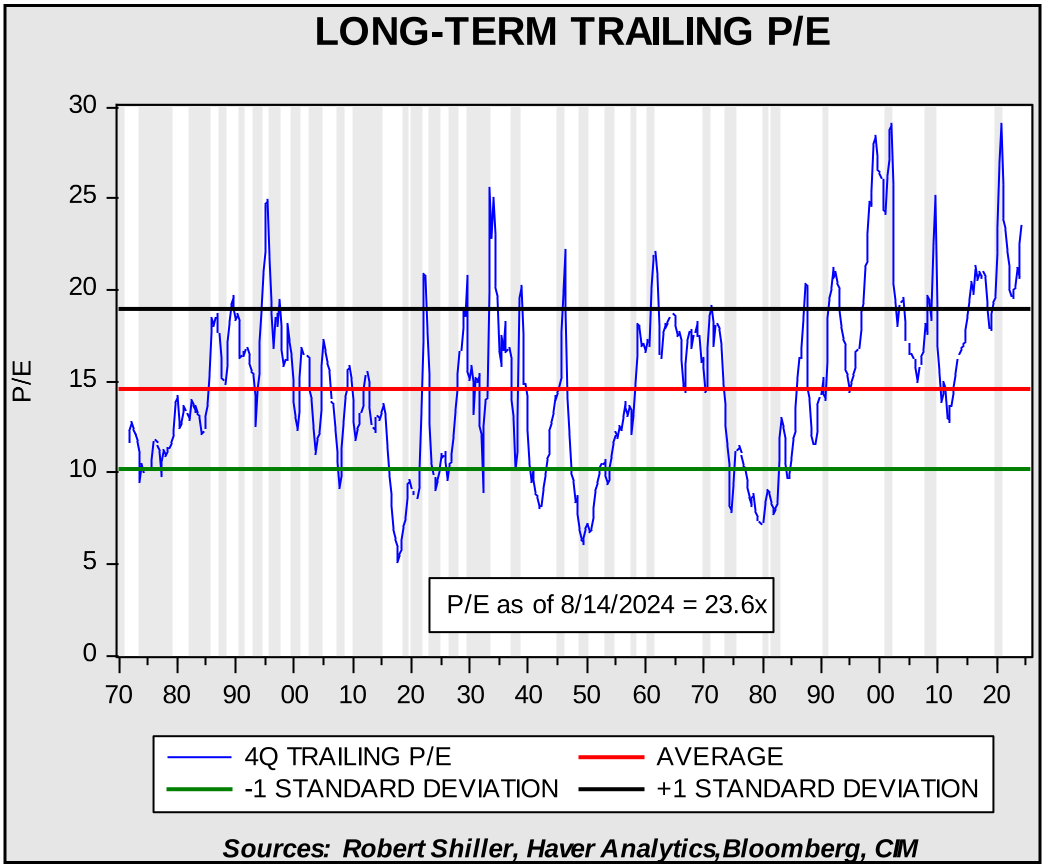


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.