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 21, 2024 — 9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.6% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.9%. Chinese markets were lower, with the Shanghai Composite down 0.4% from its previous close and the Shenzhen Composite down 0.3%. US equity index futures are signaling a higher open.

With 469 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, 80.3% have exceeded expectations while 15.2% have fallen short of expectations.

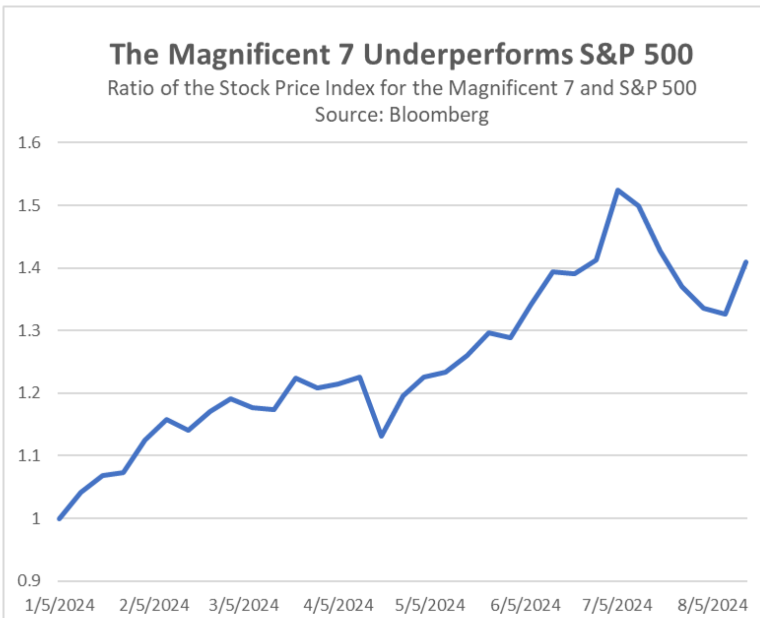
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (8/19/2024) (no accompanying podcast for this report): "The Recent Iranian Election: Results & Implications"
- *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! The market is awaiting more guidance from Fed officials as it looks for a better understanding of the path of policy rates. In sports news, Jets QB Aaron Rodgers is being pushed to his limits in training camp as he prepares for a grueling comeback attempt after an injury ended his previous season. Today's *Comment* will explore the reasons behind the market's recent broadening, analyze the implications of payroll revisions for the Fed's upcoming rate decision, and examine why investors are growing nervous about central bank independence in Brazil. As always, our report will include a comprehensive roundup of key international and domestic data releases.

The Great Rebalancing: While mega-cap companies struggle to recover from the July sell-off, smaller firms are leading the market rally.

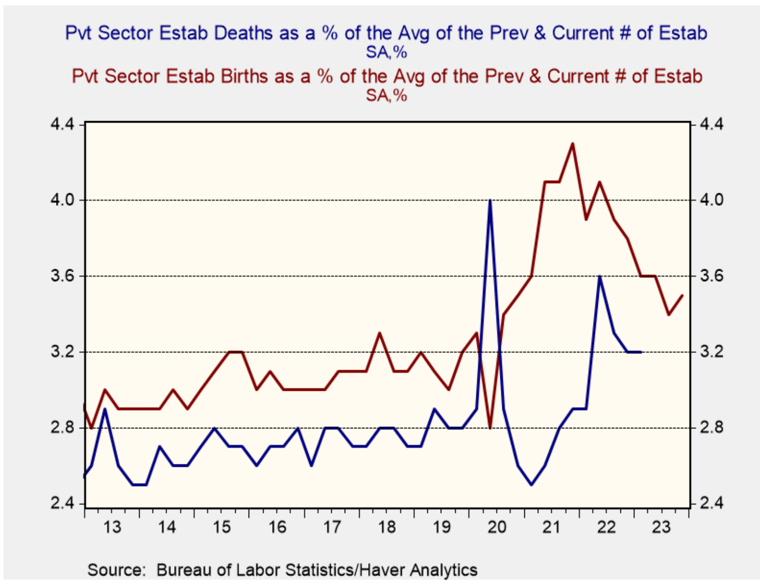
- The S&P 500 is poised for a new high this week as market uncertainty stemming from Fed rate cuts and recession worry diminishes. This surge seems to reflect strong second-quarter 2024 earnings. Over 80% of companies surpassed earnings expectations, with the overall index outperforming estimates by 13.6% compared to the anticipated 8.3%. A strong guidance also played a role as companies were relatively upbeat about future growth despite growing concerns of a looming economic slowdown.
- Surprisingly, this market rally has not been driven by the tech giants that typically dominate the S&P 500. While the Magnificent 7 Index, which once led the S&P 500's gains, is now 8% below its early July peak, the overall S&P 500 has remained relatively unchanged during the same period. In contrast, the S&P 500 Equal Weight Index, which eliminates market cap bias, has reached an all-time high. Although the mega-tech companies have regained some ground, there are signs of a potential shift in market leadership.



- This shift in market leadership is likely to be gradual and uncertain over the next few months. The upcoming election, unclear monetary policy, and economic strength will likely weigh heavily on investor sentiment. As a result, investors may be reluctant to abandon their previous winning trades in the Magnificent 7, especially given their strong performance over the past two years. This will be particularly true if Nvidia reports another strong earnings result next week. However, we are increasingly confident that the dominance of tech stocks may be nearing its end.

Gloomy Payrolls: Bureau of Labor Statistics (BLS) revisions are expected to show that the economy added less jobs than originally estimated, which is likely to place additional pressure on the Fed.

- Market expectations suggest that benchmark revisions will unveil a significant overestimation of job growth in the prior report, ranging from 400,000 to 600,000 positions. These revisions arrive amid growing criticism that the Federal Reserve may have neglected its maximum employment mandate in its singular focus on taming inflation. While the anticipated downward adjustment to job numbers is unlikely to reshape the overall economic outlook, it could exacerbate worries about a more rapid labor market cooldown than policymakers realized in its previous rate decision meetings.
- The pandemic likely contributed to the BLS's difficulty in accurately determining the number of job openings in recent years. Government stimulus and increased free time encouraged many people to start their own businesses, complicating the Fed's efforts to track hiring trends. Additionally, many of these new companies struggled to stay open in the years following the pandemic, making it challenging to assess their impact on the job market. This likely caused delays in the BLS's data collection, forcing surveyors to rely on educated guesses while awaiting more accurate information.

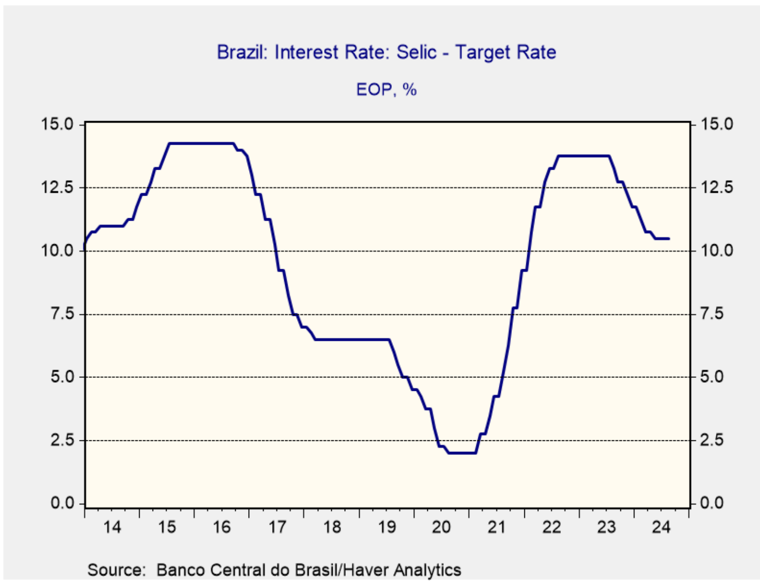


- The revisions could influence how the Fed adjusts policy rates. A larger-than-expected drop might push the central bank to take a more aggressive stance to safeguard the labor market. On the other hand, a milder revision could encourage caution, with officials gradually easing policy restrictions to prevent inflation from reaccelerating. Additionally, the upcoming jobs data will be pivotal in shaping the Fed's September decisions. While we expect the Fed to limit rate cuts to 25 bps, a surprise rise in unemployment above 4.5% could prompt stronger measures to prevent further labor market deterioration.

Brazil: While the central bank has mentioned that it will not hesitate to raise interest rates to control inflation, it appears that Brazilian President Lula da Silva has other plans.

- On Tuesday, Brazil's central bank chief, Roberto Campos Neto, appeared to downplay the possibility of raising interest rates in a newspaper interview. Specifically, he stated that he was not committed to raising interest rates and remained optimistic about inflation falling below the country's 3% target. His comments led to a sharp decline in the Brazilian real (BRL), as investors interpreted them as signaling a lack of urgency from policymakers to address rising inflation, which had increased from 3.7% in April to 4.5% in July.

- The Central Bank of Brazil, while officially independent since 2021, has struggled to maintain its autonomy amidst political pressure to adopt more expansionary monetary policies. This pressure has been particularly evident in calls for lower interest rates to stimulate economic growth from the Brazilian president. Last week, Lula attempted to deflect criticism of his involvement in monetary policy decisions by asserting that the next central bank head he appoints will need to demonstrate courage when deciding to lower or hike interest rates.



- In the coming weeks, Lula is widely expected to choose Gabriel Galipolo as his pick to take over the central bank. The central bank faces internal tension as Galipolo, set to take full control in 2025, has views more closely aligned with Lula's economic team. While Galipolo has also pushed for rate hikes, there are concerns about his loyalty. That said, the leadership announcement could spark division within the central bank and could complicate efforts to shift policy in any one direction. As a result, the September meeting will be a crucial indicator of the bank's future direction.

In Other News: A federal judge has halted the Biden administration's attempt to ban noncompete clauses, underscoring the challenges that presidents face in advancing their agendas within a highly partisan government. Meanwhile, China has countered the EU's crackdown on EV imports by launching an investigation into European dairy products, further highlighting the escalating trade tensions between China and the West. Ford is scrapping plans for a fully electric SUV due to cost concerns, in another sign that the EV market is starting to cool.

US Economic Releases

The Mortgage Bankers Association today said ***mortgage applications*** in the week ended August 16 slid to the lowest level since February, declining 10.1%, compared to last week's gain of 16.8%. Applications for home purchase mortgages fell 5.2%, after rising 2.8% the prior week. Applications for refinancing mortgages fell 15.2%, after rising 34.5% the prior week. According to the report, the average interest rate on a 30-year mortgage eased another four basis points to 6.5%, the lowest since May of last year. Despite this continuing decline, elevated housing prices are preventing a sustained increase in mortgage demand.

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

Economic Releases		
	No economic releases for the rest of today	
Federal Reserve		
ET	**Speaker or Event**	**District or Position**
14:00	FOMC Meeting Minutes	Federal Reserve Board

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	Trade Balance	y/y	Jul	-¥621.8b	¥224.0b	-¥350.0b	**	Equity and bond neutral
	Exports	y/y	Jul	10.3%	5.4%	11.5%	*	Equity and bond neutral
	Imports	y/y	Jul	16.6%	3.2%	14.6%	*	Equity bullish, bond bearish
Australia	Westpac Leading Index	m/m	Jul	-0.04%	0.01%		**	Equity and bond neutral
South Korea	PPI	y/y	Jul	2.6%	2.5%		**	Equity and bond neutral
	Business Survey - Manufacturing	m/m	Sep	73	72		**	Equity and bond neutral
	Business Survey - Non-Manufacturing	m/m	Sep	71	72		*	Equity and bond neutral
EUROPE								
UK	Public Finances (PSNCR)	m/m	Jul	19.2b	6.5b		*	Equity and bond neutral
	Public Sector Net Borrowing	m/m	Jul	2.2b	12.6b	0.4b	*	Equity and bond neutral
	PSNB ex Banking Groups	m/m	Jul	3.1b	13.5b	1.5b	**	Equity and bond neutral
Switzerland	M3 Money Supply	y/y	Jul	0.3%	0.2%		**	Equity and bond neutral
AMERICAS								
Canada	CPI	y/y	Jul	2.5%	2.7%	2..5%	***	Equity and bond neutral
Mexico	International Reserves Weekly	w/w	16-Aug	$223998m	$223233m		*	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)	539	539	0	Down
3-mo T-bill yield (bps)	503	504	-1	Down
U.S. Sibor/OIS spread (bps)	509	510	-1	Down
U.S. Libor/OIS spread (bps)	506	508	-2	Down
10-yr T-note (%)	3.81	3.81	0.00	Down
Euribor/OIS spread (bps)	354	355	-1	Down
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Down			Up
Pound	Flat			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.

	Price	Prior	Change	Explanation
Energy Markets				
Brent	$77.34	$77.20	0.18%	
WTI	$73.27	$73.17	0.14%	
Natural Gas	$2.21	$2.20	0.55%	
12-mo strip crack	$19.98	$19.91	0.32%	
Ethanol rack	$1.95	$1.96	-0.19%	
Metals				
Gold	$2,511.89	$2,513.99	-0.08%	
Silver	$29.64	$29.44	0.67%	
Copper contract	$423.30	$420.10	0.76%	
Grains				
Corn contract	$399.75	$398.00	0.44%	
Wheat contract	$556.50	$556.50	0.00%	
Soybeans contract	$982.50	$976.00	0.67%	
Shipping				
Baltic Dry Freight	1,735	1,708	27	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.20		
Gasoline (mb)		-1.80		
Distillates (mb)		-1.00		
Refinery run rates (%)		0.3%		
Natural gas (bcf)		22		

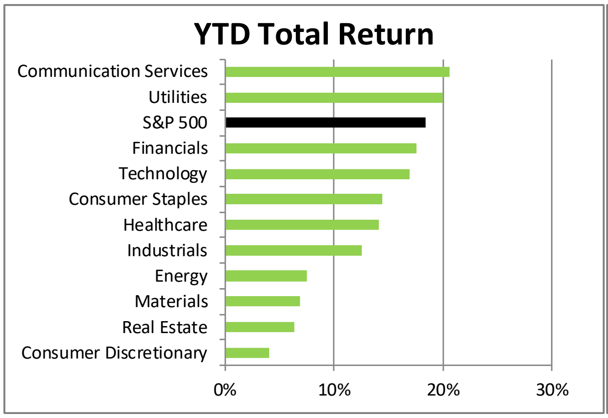
Weather

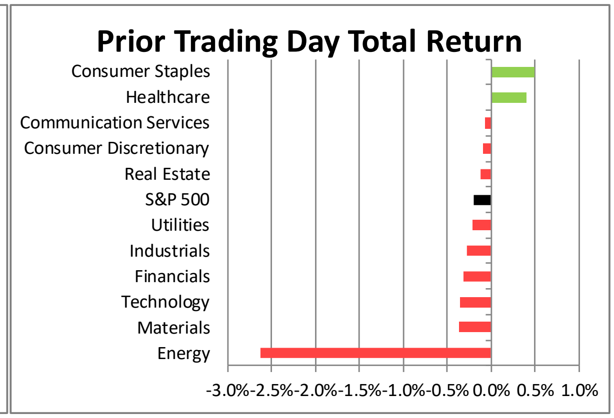
The 6-to-10-day and 8-to-14-day forecasts currently call for warmer-than-normal temperatures across most of the country, except for a patch of normal temperatures in the northern Great Plains and upper Mississippi Valley. The precipitation outlook predicts wetter-than-normal conditions in southern Florida, southern Texas, the Desert Southwest, and the extreme northern tier, with dry conditions in a bubble extending from Kansas and Oklahoma to the southern Great Lakes.

The Atlantic tropical weather scope is clean.

Data Section

US Equity Markets – (as of 8/20/2024 close)

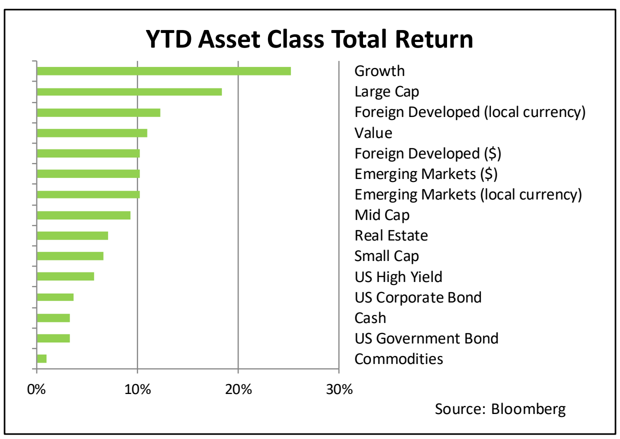




(Source: Bloomberg)

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 8/20/2024 close)

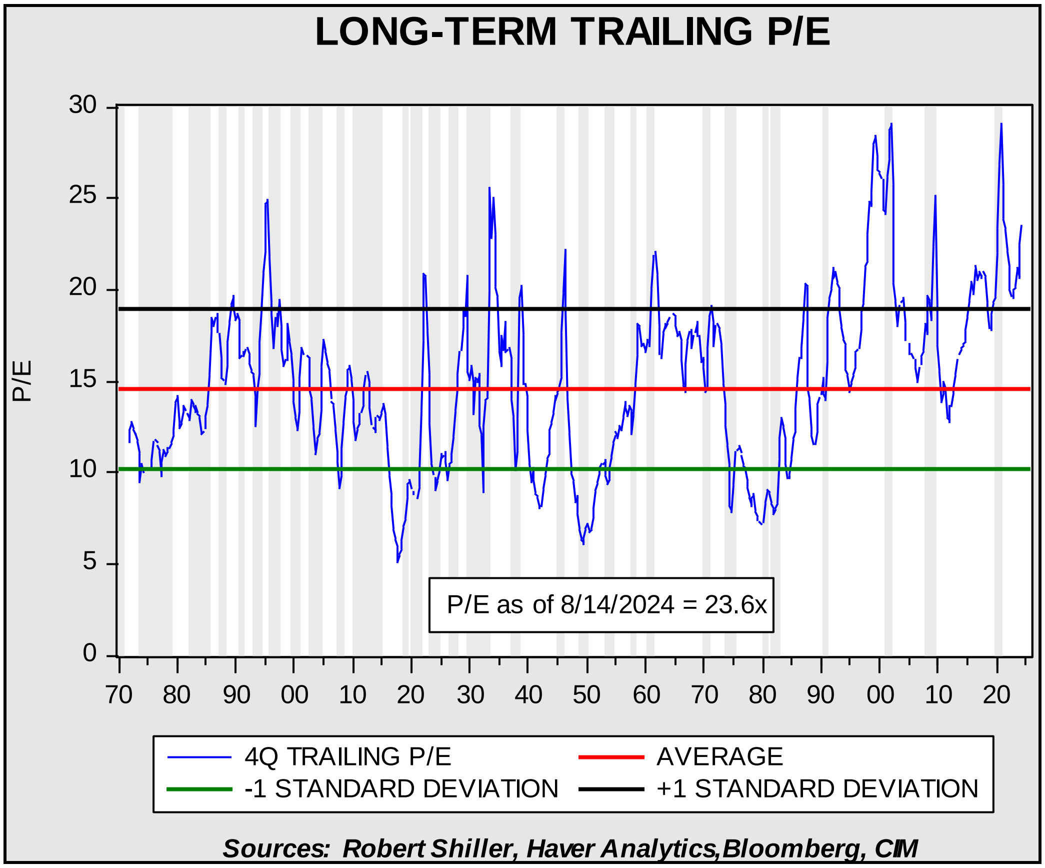


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.