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 27, 2024 — 9:30 AM ET] Global equity markets are mostly lower this morning. In Europe, the Euro Stoxx 50 is up 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.6%. Chinese markets were lower, with the Shanghai Composite down 0.2% from its previous close and the Shenzhen Composite down 1.3%. US equity index futures are signaling a lower open.

With 477 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, 80.7% have exceeded expectations, while 14.9% 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:

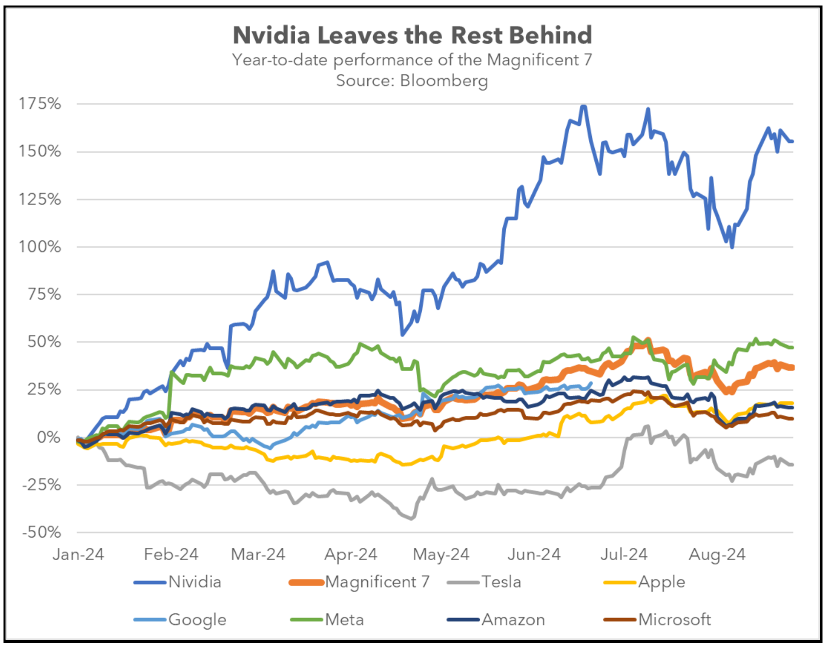
- *Bi-Weekly Geopolitical Report* (8/19/2024) (no accompanying podcast for this report): "The Recent Iranian Election: Results & Implications"
- *Asset Allocation Bi-Weekly* (8/26/2024) (with associated podcast): "Activist vs. Accommodative Treasury Issuance"
- *Asset Allocation Quarterly – Q3 2024* (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 eagerly awaiting earnings reports from several chip companies. In sports news, Dallas Cowboys' wide receiver CeeDee Lamb has signed a new multi-year contract. Today's *Comment* analyzes the influence of the Fed on equities, the impact of China's trade restrictions on the West, and why Germany's economy appears to be in the gutter. As always, the report concludes with international and domestic data releases.

Smaller is Better? A highly anticipated Fed pivot has helped boost smaller companies, but there are still many unknowns.

- Investors will closely watch the Fed for the next few weeks as it prepares to cut rates in September. While Fed officials have signaled a 25-basis-point cut at the next meeting, they have been less committed to future policy moves. On Monday, San Francisco Fed President Mary Daly advocated for rate cuts, while Richmond Fed President Thomas Barkin acknowledged inflation risks but saw no harm in a modest rate reduction. Their comments build on Fed Chair Powell's remarks at Jackson Hole on Friday, indicating a shift in the central bank's focus from inflation to safeguarding the labor market.

- Since the Jackson Hole speech, investors have adopted a more risk-tolerant stance. On Monday, the S&P small-cap and mid-cap indexes rose as high as 2.2% and 2.6%, respectively. This robust performance reflects a shift in investor preference toward factors like profitability and dividends, which have outperformed traditional metrics like size and momentum. Historically, smaller firms have offered higher dividend yields than those of their larger counterparts. Additionally, declining borrowing costs will enhance profitability for small-cap firms, which are more likely to hold floating-rate debt.

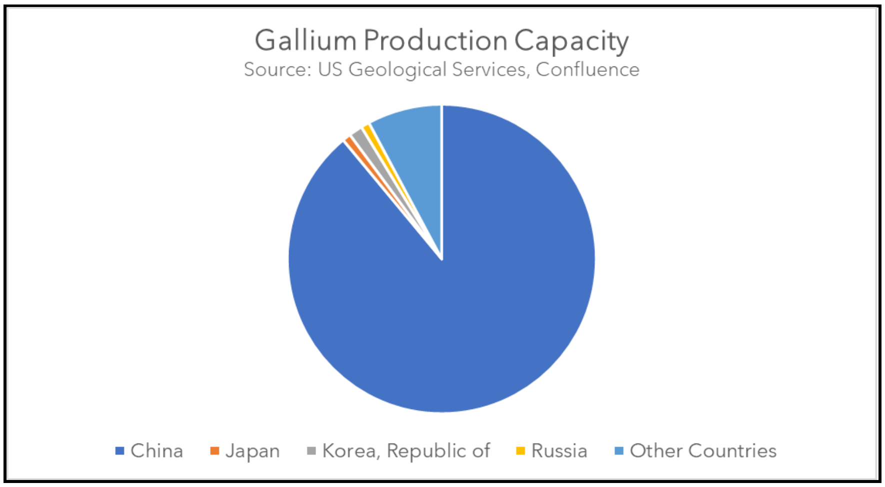


- Smaller companies have outperformed larger tech stocks, which have experienced a slight pullback despite year-to-date gains. Investors searching for undervalued opportunities have led to a shift away from mega-caps, whose stock prices have outpaced earnings growth. AI-related companies have been particularly vulnerable to this sell-off as skepticism mounts about their growth potential, given their strong performance over the last two years. Earnings from chip companies will release this week, and those, especially Nvidia's, will be a crucial test of tech's resilience in the current market.

Chip Wars: Beijing has imposed trade restrictions on critical minerals needed for chip production as trade tensions continue to escalate with the West.

- China's recent aggressive trade policies have started to worry firms with limited alternatives. Last year's export controls on gallium and germanium, both crucial for semiconductor manufacturing, have led to a surge in prices for the commodities as other countries have been forced to make up the gap. The move comes as Beijing signals that it is willing to retaliate if its companies are targeted. In two weeks, China is poised to further restrict antimony, a vital component in defense technology, such as infrared missiles, night-vision equipment, and even nuclear weapons.

- The West has struggled to counter China's strategic advantage in critical minerals. China dominates global production of gallium (over 80%), germanium (60%), and antimony (48%), while Western countries, hampered by stringent regulations, have found it difficult to develop competitive domestic industries. So far, companies have relied on existing stockpiles to maintain production. However, there are concerns about how long this can continue. Companies like Intel have continued to rely on gallium to make breakthroughs in semiconductor efficiency, even as prices have more than doubled.

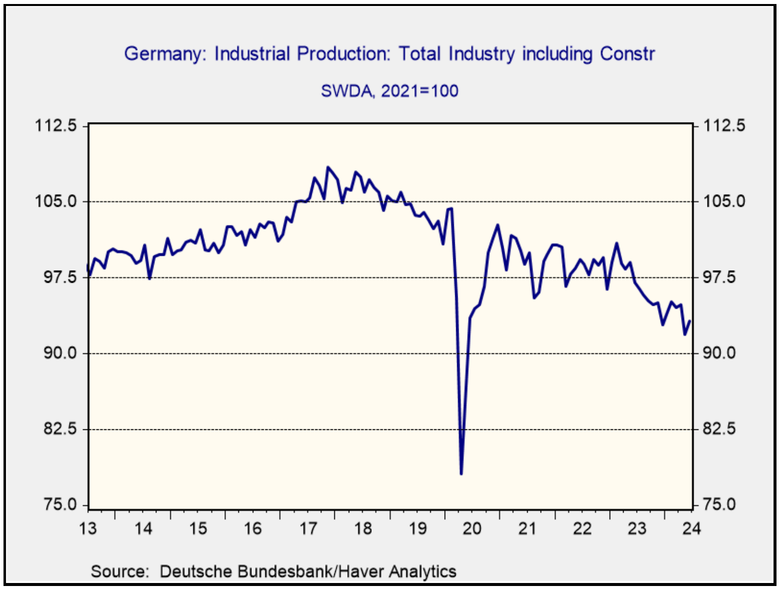


- China's market dominance is primarily due to its ability to undercut competitors' prices. By restricting the supply of resources to the rest of the world, China is likely to spur greater competition from other countries that were previously unable to compete. Since the restrictions were implemented, there have been increased discoveries of these resources in Utah and Montana. Moreover, governments are likely to leverage these restrictions as a justification for increased support of key industries as they seek to reduce their reliance on China in the future.

Germany's Industrial Crisis: There are growing concerns that industrial capacity in Europe's second largest economy will not be able to recover in the coming months.

- The German economy contracted by 0.1% in the second quarter of the year, which was primarily driven by a 2.2% decline in capital spending and a modest 0.2% drop in consumer spending. Waning consumer confidence, which was fueled by concerns about job security and a struggling manufacturing sector, contributed to these declines. The GfK Consumer Climate indicator registered a five-month low, reflecting these concerns. Meanwhile, factory output has declined for three consecutive months, raising fears of a prolonged manufacturing downturn.
- The negative report marks a setback as Germany struggles to regain its economic footing after a disappointing 2023. Despite an initial 0.2% growth in the first quarter, the overall economic activity remains relatively unchanged from the previous year. The country's

flagging industrial sector has been the primary drag on growth, with German output declining steadily since its 2017 peak. Rising competition from China and the United States, coupled with difficulties in securing cheap Russian gas, has contributed significantly to this industrial downturn.



- A significant risk to the German economy is the ongoing green energy transition. Although the government has committed to clean technology, public resistance to the associated costs has been substantial. The current economic downturn could exacerbate populist sentiment, especially as the country also confronts rising concerns about illegal immigration. Consequently, we anticipate a potential shift toward easing some of the more stringent regulations on fossil fuels in the coming years. This could help mitigate further declines in Germany's factory output.

In Other News: Canada announced that it will impose a 100% tariff on Chinese cars and a 25% tariff on Chinese steel in a sign that the West is working together to isolate China. A pivotal Mexican congressional committee sanctioned Mexican President Andrés Manuel López Obrador's restructuring of the judiciary in a move likely to incite a potential impasse with the United States and Canada regarding the existing trade arrangement. French President Emmanuel Macron ruled out the possibility of a left wing coalition as he looks to form a government with moderate politicians.

US Economic Releases

There were no economic releases today prior to the time of publication. The table below lists the economic releases and Fed events scheduled for the rest of the day.

Economic Releases						
ET	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	Conf. Board Consumer Confidence	m/m	Aug	100.9	100.3	***
10:30	Richmond Fed Manufacturing Index	m/m	Aug		-0.1	**
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	PPI Services	y/y	Jul	2.8%	3.1%	2.9%	*	Equity and bond neutral
South Korea	Retail Sales	y/y	Jul	6.3%	11.1%		**	Equity and bond neutral
	Depart. Store Sales	y/y	Jul	-6.4%	5.0%		*	Equity and bond neutral
	Discount Store Sales	y/y	Jul	-7.9%	2.1%		*	Equity and bond neutral
China	Industrial Profits	y/y	Jul	4.1%	3.6%		*	Equity and bond neutral
EUROPE								
Germany	GDP NSA	y/y	2Q F	0.3%	0.3%	0.3%	**	Equity and bond neutral
	GDP WDA	y/y	2Q F	0.0%	-0.1%	-0.1%	**	Equity and bond neutral
AMERICAS								
Mexico	Exports	m/m	Jul	54789m	48871m		*	Equity and bond neutral
	Imports	m/m	Jul	54861m	49908m		*	Equity and bond neutral
	Trade Balance	m/m	Jul	-72.0m	-1036.9m	-1705.5m	**	Equity and bond neutral
Brazil	IBGE Inflation IPCA-15	m/m	Aug	4.35%	4.45%	4.33%	***	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)	534	533	1	Down
3-mo T-bill yield (bps)	494	496	-2	Down
U.S. Sibor/OIS spread (bps)	507	507	0	Down
U.S. Libor/OIS spread (bps)	504	504	0	Down
10-yr T-note (%)	3.85	3.82	0.03	Up
Euribor/OIS spread (bps)	352	353	-1	Down
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Flat			Up
Yen	Flat			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.

	Price	Prior	Change	Explanation
Energy Markets				
Brent	$81.06	$81.43	-0.45%	
WTI	$77.01	$77.42	-0.53%	
Natural Gas	$1.94	$1.96	-1.07%	
12-mo strip crack	$19.86	$20.07	-1.08%	
Ethanol rack	$1.98	$1.97	0.21%	
Metals				
Gold	$2,511.61	$2,518.03	-0.25%	
Silver	$29.97	$29.90	0.22%	
Copper contract	$428.70	$428.10	0.14%	
Grains				
Corn contract	$385.50	$386.50	-0.26%	
Wheat contract	$521.75	$525.00	-0.62%	
Soybeans contract	$980.50	$980.75	-0.03%	
Shipping				
Baltic Dry Freight	1,762	1,768	-6	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.00		
Gasoline (mb)		-2.71		
Distillates (mb)		-1.77		
Refinery run rates (%)		0.3%		
Natural gas (bcf)		25		

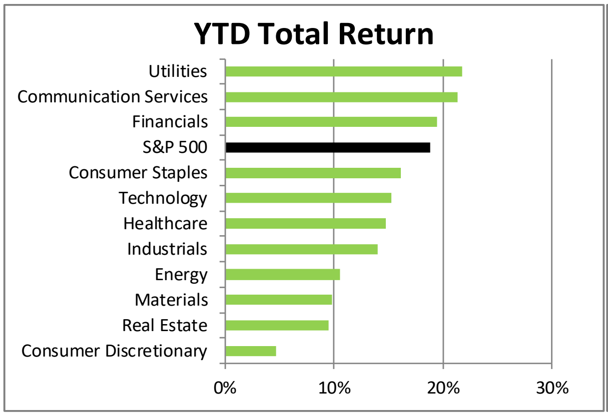
Weather

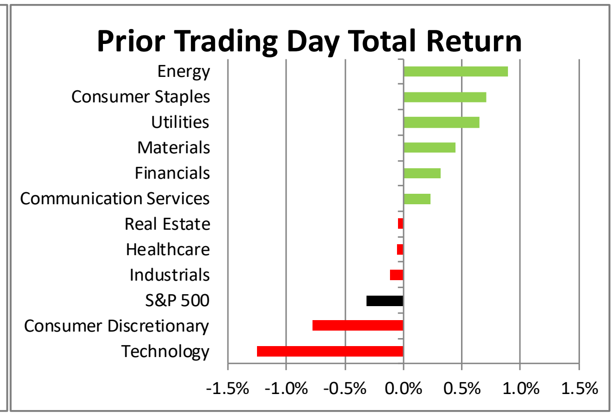
The 6-to-10-day and 8-to-14-day forecasts currently call for warmer-than-normal temperatures in the western half of the country, along the Gulf Coast, and in Florida, with cooler temperatures in the northeast. The precipitation outlooks call for wetter-than-normal conditions in the Pacific Northwest and the Southeast, with drier than normal conditions in the Desert Southwest and Great Lakes region.

There are no tropical disturbances expected in the Atlantic Ocean within the next 48 hours.

Data Section

US Equity Markets – (as of 8/26/2024 close)

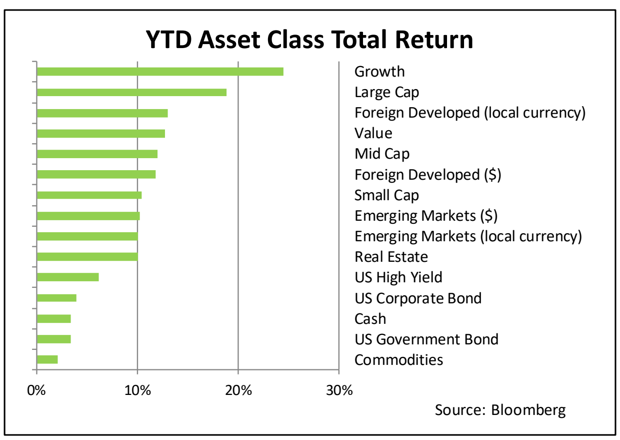




(Source: Bloomberg)

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 8/26/2024 close)

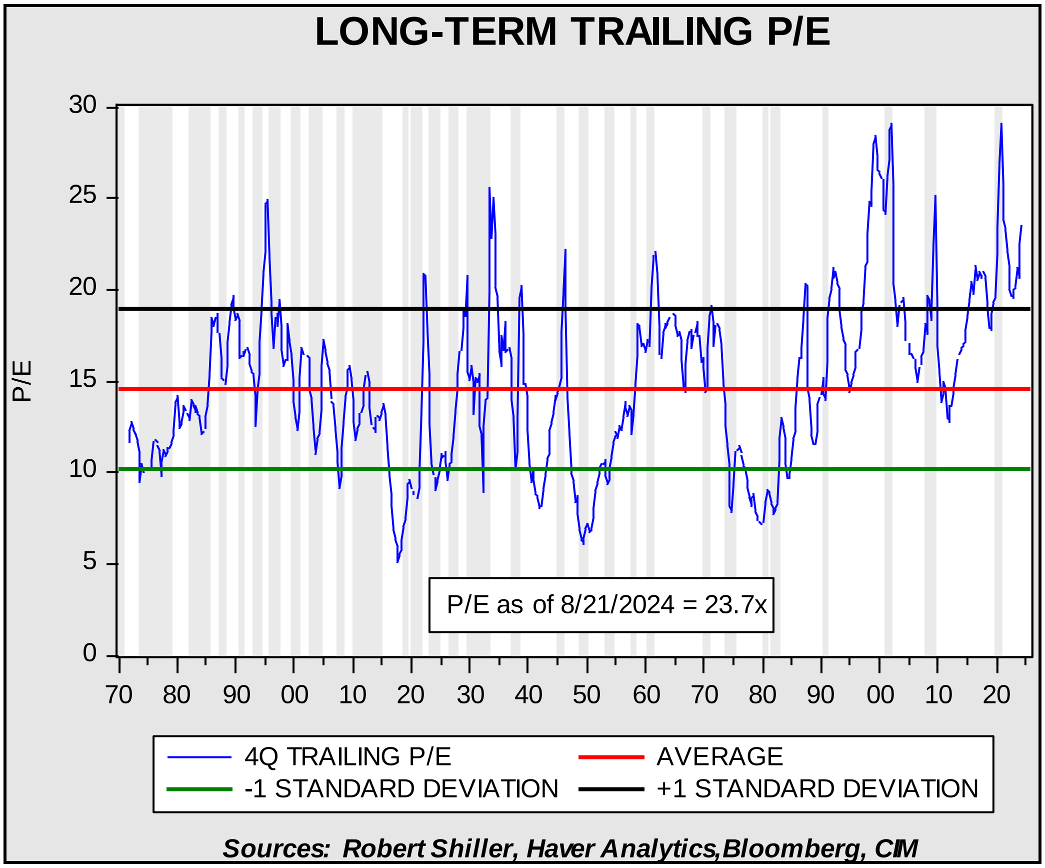


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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), 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 22, 2024



Based on our methodology,[1] the current P/E is 23.7x, up 0.1 from our last report. The increase in the multiple was due to a slight pickup in the stock 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.

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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.