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 2, 2024 — 9:30 AM ET] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is down 1.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 3.6%. Chinese markets were lower, with the Shanghai Composite down 0.9% from its previous close and the Shenzhen Composite down 1.3%. US equity index futures are signaling a lower open.

With 368 companies having reported so far, S&P 500 earnings for Q2 are running at $60.70 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 14.7% 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:

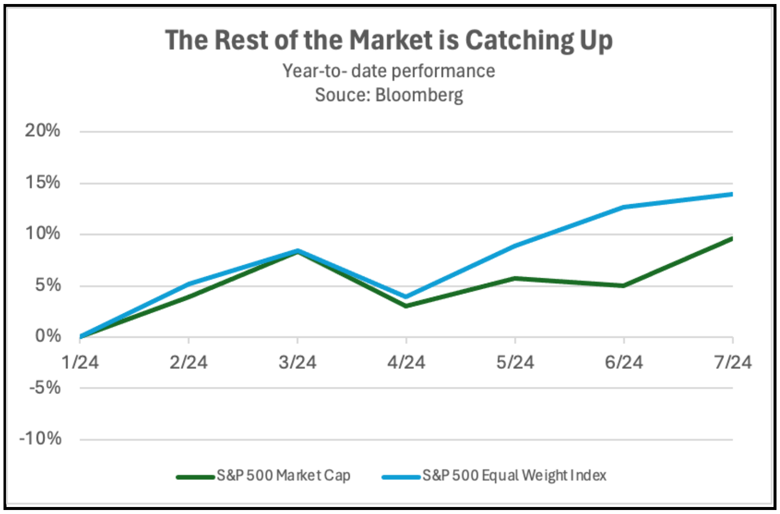
- *Bi-Weekly Geopolitical Report* (7/22/2024) (with associated podcast): "Meet Ferdinand Marcos Jr., President of the Philippines"
- *Asset Allocation Bi-Weekly* (7/29/2024) (with associated podcast): "The Price of Central Bank Independence"
- *Asset Allocation Quarterly – Q3 2024* (7/16/2024): Discussion of our asset allocation process, Q3 2024 portfolio changes, and our outlook for the markets.

Good morning! S&P 500 futures are off to a poor start today as investors fret over a possible recession. In sports news, US gymnast Simone Biles has claimed another individual all-around Olympic gold medal. Today's *Comment* will examine investor concerns over rising capital expenditures, explain how labor costs could contribute to the Fed's inflation target, and discuss China's recent decision to expand its nuclear arsenal. As usual, we will conclude with a roundup of domestic and international economic data.

The Great Reset: AI woes and Fed uncertainty keep the market on edge, with investors bracing for September's rate decision.

- The tech sector's heavy focus on AI is increasingly frustrating investors seeking immediate returns. Amazon's stock price plunged by as much as 5% on Thursday after the company issued disappointing Q3 guidance and announced plans to escalate capital expenditures on AI. Given current valuations, investors are concerned that tech companies' AI ventures may not generate profits as quickly or significantly as anticipated. The market exhibited similar reactions to comparable strategies adopted by [Alphabet, Microsoft, and Meta].

- Investor enthusiasm for highly valued tech stocks has cooled as the market anticipates interest rate cuts and analysts grow increasingly skeptical of companies prioritizing capital spending over immediate profits. Tech giants previously thrived as investors sought higher potential returns in a rising interest rate environment. However, with the prospect of declining borrowing costs, the market's focus is shifting toward sectors like Real Estate and Utilities. This market rotation has allowed the S&P 500 Equal Weight Index to gain ground on its market-cap-weighted counterpart this year.

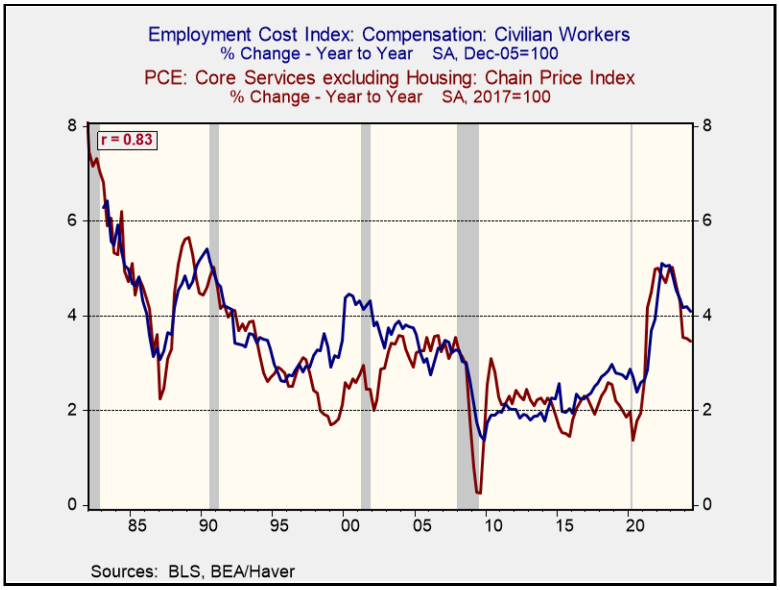


- The S&P 500's three consecutive daily swings of over 1% this week, a level of volatility unseen since January, underscore the market's fickle nature. As the Fed continues to tease a potential rate cut, we could see a shift in investor focus from growth to value stocks, which would emphasize current profitability over future earnings potential. However, investors must remain vigilant for a potential hawkish pivot by the Fed, especially if inflation unexpectedly resurges. This could cause investors to rethink their previous strategies and create even more volatility in markets.

Labor Costs and Inflation: Declining unit labor costs coupled with increased productivity further indicate easing inflationary pressures.

- Productivity, as measured by output per hour, [surged in the second quarter], while labor costs remained relatively stable. According to the Bureau of Labor Statistics, nonfarm productivity rose at an annualized pace of 2.3% in the second quarter. This was an improvement from the previous quarter's rise of 0.4%. Conversely, unit labor costs decelerated noticeably, declining from an annualized pace of 3.8% to 0.4% in the same period. This is the lowest reading in 2.5 years.
- Significant productivity gains are likely to bolster the Fed's confidence in engineering a soft landing. This sharp increase indicates the economy can sustain growth without igniting inflationary pressures. Last quarter's accelerated GDP growth from 1.4% to 2.5%

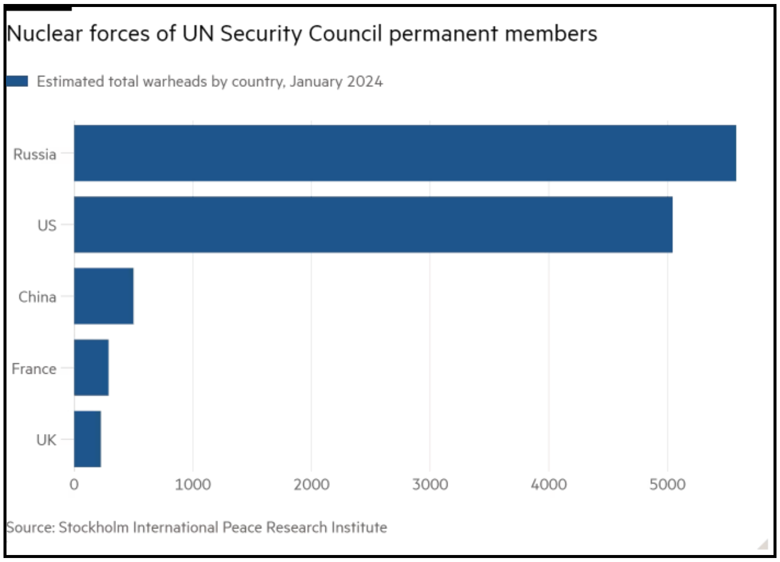
coincided with a notable decline in price pressures, as evidenced by the GDP deflator falling from 3.1% to 2.3%. Moreover, moderating wage growth will be instrumental in keeping inflation on track toward the 2% target. As the chart below illustrates, the Fed's core services index is highly correlated with employment costs.



- The Fed is confronted with the challenge of curbing inflation without precipitating a recession. Despite recent GDP growth, indicators point to a potential economic slowdown. Corporate reports of waning consumer price tolerance and a near high for the year in jobless claims amplify these concerns. While we do not share the market's pessimistic recessionary outlook, we acknowledge the possibility of economic deceleration. Notably, the current economic landscape echoes that of 2023, characterized by a summer surge in initial jobless claims followed by a subsequent normalization.

Nuclear Proliferation: China seeks to rewrite the rules of nuclear buildup as it looks to catch up to the US.

- Beijing has proposed a pledge among the five permanent UN Security Council members to refrain from using nuclear weapons first. As the sole council member to make such a proposal, China appears to be seeking a tactical advantage in the ongoing nuclear disarmament debate. This move comes in response to US-led efforts to reduce nuclear arsenals globally. Notably, China has accused the US of violating the Non-Proliferation Treaty due to its pledge to defend European allies in the event of a nuclear attack.
- Despite criticism, the motives behind China's nuclear buildup remain a subject of debate. Projections indicate that China could possess over 1,000 nuclear warheads by 2030, a substantial increase from the 200 it held in 2019. However, this pales in comparison to the US and Russia, with each estimated to have over 5,000 warheads. Due to this significant disparity, some analysts theorize that China's goal is not to achieve nuclear parity with its rivals but rather to deter potential aggression.



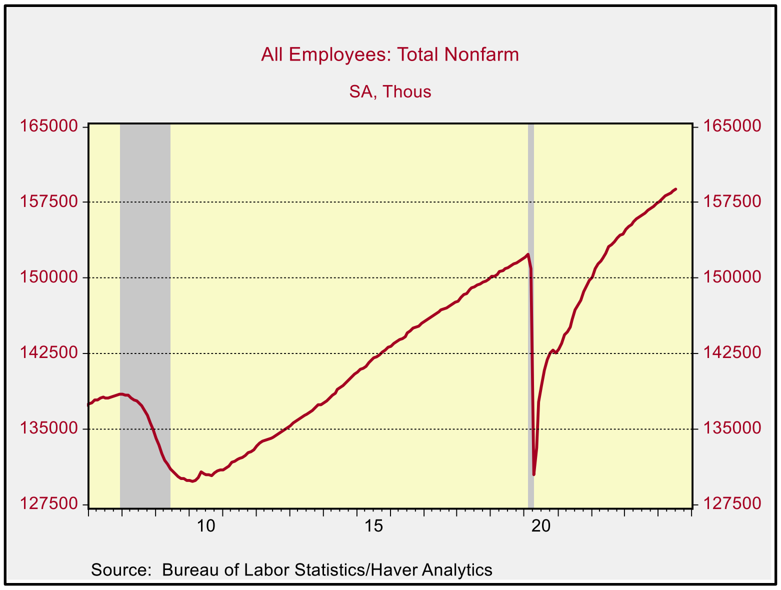
(Source: Financial Times)

- We are moving toward a more hostile world. As global geopolitical tensions rise, other nations may pursue their own nuclear deterrents. Iran and North Korea have already expanded their nuclear capabilities. Additionally, countries aligned with the US could potentially follow suit, especially if US security guarantees are perceived to have weakened. This increased demand for uranium, coupled with production constraints, could drive up uranium prices significantly over the next decade. Additionally, the potential increase in nuclear ability may raise the possibility of a miscalculation that leads to a major conflict.

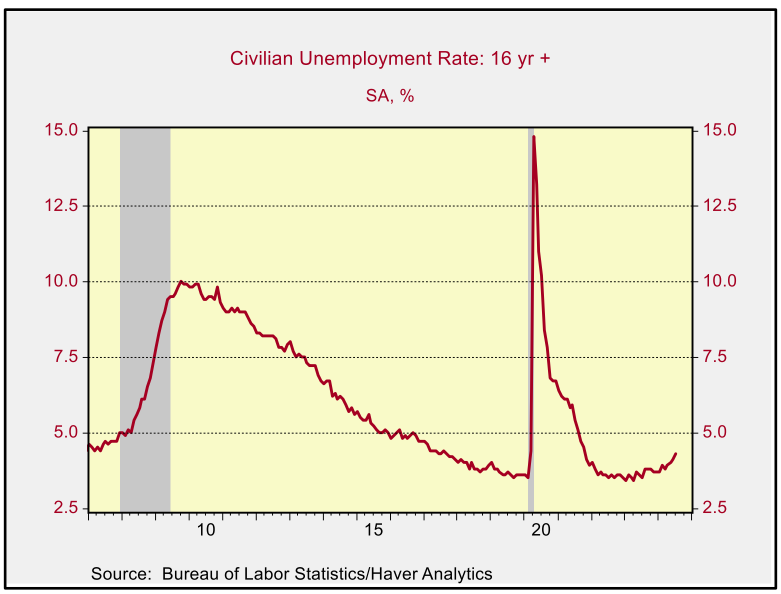
In Other News: The US has secured the largest prisoner exchange in the post-Soviet era as the president seeks to reassure critics of his administration's effectiveness. Additionally, the tech sell-off has spread to other markets, particularly Japan, as investors reassess portfolio allocations in light of shifting interest rate expectations.

US Economic Releases

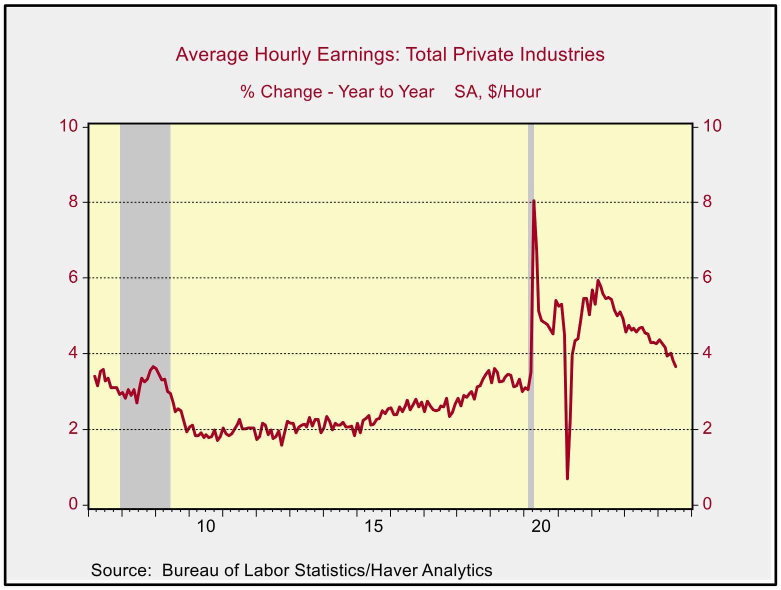
July ***nonfarm payrolls*** rose by a seasonally adjusted 114,000, far weaker than the expected gain of 175,000 and the downwardly revised June increase of 179,000. In fact, the jobs gain in July was the weakest since a short contraction during the coronavirus pandemic in December 2020. Consistent with a range of other indicators, the figures suggest that the demand for labor has cooled considerably. The chart below shows the change in nonfarm payrolls since shortly before the Great Financial Crisis.



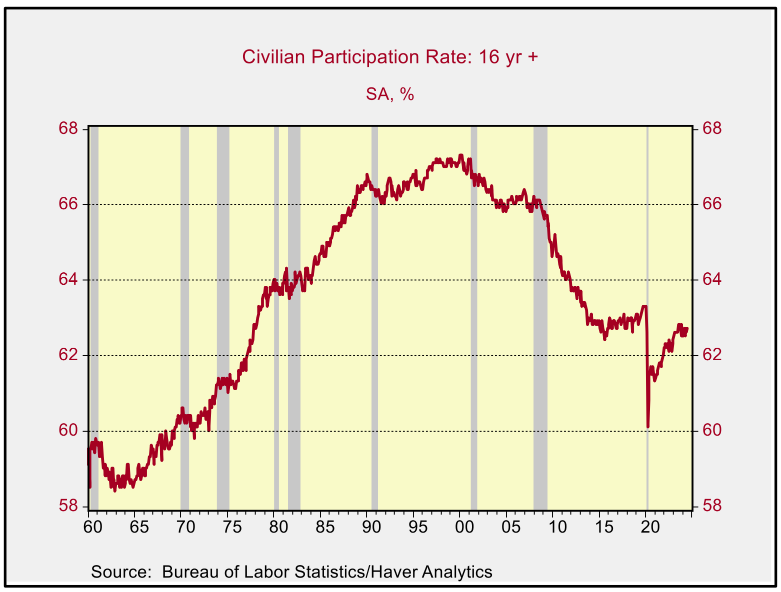
As more evidence that labor demand has weakened, the July ***unemployment rate*** rose to a seasonally adjusted 4.3%, versus expectations it would be unchanged at the 4.1% registered for June. Details in the report showed that a relatively large number of people entered the labor force in July, but in contrast with most of the last few years, only a small number of them found jobs. Importantly, the figures have triggered a popular recession indicator known as the "Sahm Rule," which says the economy is typically in recession when the three-month average of the unemployment rate is at least 0.5% above the unemployment rate's lowest level over the last year. The chart below shows how the unemployment rate has evolved since just before the GFC.



Also in the report, ***average hourly earnings*** in July rose to a seasonally adjusted $35.07, up 3.6% from the same month one year earlier. The annual increase in earnings was below both the expected rate of 3.7% and the revised June rate of 3.8%. The chart below shows the year-over-year growth in average hourly earnings since just before the GFC.



A final key indicator in the monthly employment report focuses on the share of the adult, civilian, noninstitutionalized population that is either working or looking for work. Reflecting the large cohort of people entering the labor force, the July ***labor force participation rate (LFPR)*** rose to a seasonally adjusted 62.7%, beating expectations that it would be unchanged at 62.6%. The chart below shows how the LFPR has changed over the last several decades.



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	Factory Orders	m/m	Jun	-3.2%	-0.5%	***
10:00	Factory Orders Ex Transportation	m/m	Jun		-0.7%	*
10:00	Durable Goods Orders	m/m	June F	-6.6%	-6.6%	***
10:00	Durable Goods Orders ex Transportation	m/m	June F	0.5%	0.5%	**
10:00	Cap Goods Orders Nondef Ex Air	m/m	June F	1.0%	1.0%	*
10:00	Cap Goods Ship Nondef Ex Air	m/m	June F		0.1%	*
Federal Reserve						
ET	Speaker or Event	District or Position				
12:00	Thomas Barkin Appreas on Carolina Business Review	President of the Federal Reserve Bank of Richmond				
20:30	Austan Goolsbee on Bloomberg Television	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	Monetary Base	y/y	Jul	1.0%	0.6%		**	Equity and bond neutral
	Monetary Base, End of Period	m/m	Jul	¥673.1t	¥675.4t		*	Equity and bond neutral
Australia	PPI	y/y	2Q	48.0%	4.3%		**	Equity and bond neutral
South Korea	CPI	m/m	Jul	2.6%	2.4%	2.5%	***	Equity and bond neutral
EUROPE								
France	Industrial Production	y/y	Jun	-1.6%	-3.1%	-1.1%	***	Equity and bond neutral
	Manufacturing Production	y/y	Jun	-2.0%	-3.8%		**	Equity and bond neutral
Italy	Industrial Production WDA	y/y	Jun	-2.6%	-3.3%		***	Equity and bond neutral
	Retail Sales	y/y	Jun	-1.0%	0.5%		**	Equity and bond neutral
Switzerland	CPI	y/y	Jul	1.3%	1.3%	1.3%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Jul	1.2%	1.3%		*	Equity and bond neutral
	Core CPI	y/y	Jul	1.1%	1.1%	1.1%	*	Equity and bond neutral
	PMI Manufacturing	m/m	Jul	43.5	43.9	44.5	***	Equity and bond neutral
	PMI Services	m/m	Jul	44.7	52.0		*	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	26-Jul	$616.7b	$611.3b		***	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	26-Jul	18.31t	18.39t		*	Equity and bond neutral
AMERICAS								
Canada	S&P Global Canada Manufacturing PMI	m/m	Jul	47.8	49.3		***	Equity and bond neutral
Mexico	S&P Global Mexico Manufacturing PMI	m/m	Jul	49.6	51.1		***	Equity and bond neutral
	Unemployment Rate NSA	m/m	Jun	2.78%	2.62%	2.63%	***	Equity and bond neutral
	Gross Fixed Investment	y/y	May	6.0%	18.1%	8.4%	**	Equity bearish, bond bullish
	Vehicle Domestic Sales	y/y	Jul	124761	122929		***	Equity and bond neutral
	Leading Indicators	y/y	Jun	-0.03	0.07		**	Equity and bond neutral
Brazil	S&P Global Brazil Manufacturing PMI	m/m	Jul	54.0	52.5		***	Equity and bond neutral
	Industrial Production	y/y	Jun	3.2%	-1.0%	1.6%	***	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)	550	551	-1	Down
3-mo T-bill yield (bps)	510	511	-1	Down
U.S. Sibor/OIS spread (bps)	520	521	-1	Down
U.S. Libor/OIS spread (bps)	518	518	0	Down
10-yr T-note (%)	3.94	3.98	-0.04	Down
Euribor/OIS spread (bps)	364	365	-1	Down
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Up			Up
Pound	Flat			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	$79.45	$79.52	-0.09%	
WTI	$76.26	$76.31	-0.07%	
Natural Gas	$1.98	$1.97	0.41%	
12-mo strip crack	$21.95	$22.22	-1.23%	
Ethanol rack	$1.97	$1.96	0.15%	
Metals				
Gold	$2,459.75	$2,446.26	0.55%	
Silver	$28.94	$28.52	1.46%	
Copper contract	$411.60	$408.25	0.82%	
Grains				
Corn contract	$400.25	$398.50	0.44%	
Wheat contract	$531.00	$532.00	-0.19%	
Soybeans contract	$1,029.75	$1,016.50	1.30%	
Shipping				
Baltic Dry Freight	1,668	1,708	-40	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-3.44	-1.10	-2.34	
Gasoline (mb)	-3.67	-1.29	-2.38	
Distillates (mb)	1.53	-0.90	2.43	
Refinery run rates (%)	-1.5%	0.8%	-2.3%	
Natural gas (bcf)	18	31	-13	

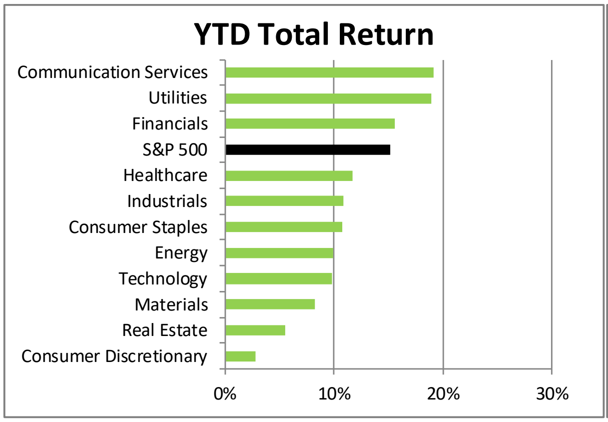
Weather

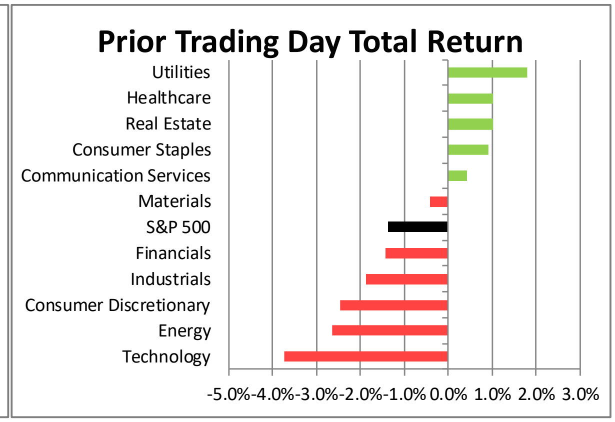
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures along the West Coast and in the southern Rocky Mountains, southern Great Plains, and Deep South, with cooler-than-normal temperatures in the northern Great Plains, the Upper Midwest, and the Northeast. The forecasts call for wet conditions in all areas except the Upper Midwest, where conditions will be drier than normal.

There is currently an atmospheric disturbance moving northwestward over Hispaniola toward the Straits of Florida. It is assessed to have a 60% chance of forming into a cyclone in the next 48 hours.

Data Section

US Equity Markets – (as of 8/1/2024 close)

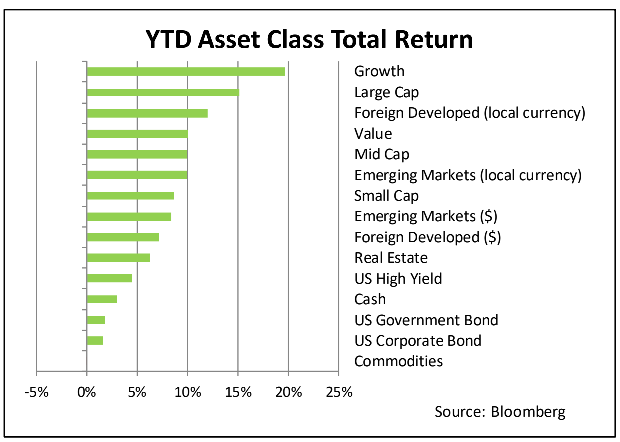




(Source: Bloomberg)

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 8/1/2024 close)

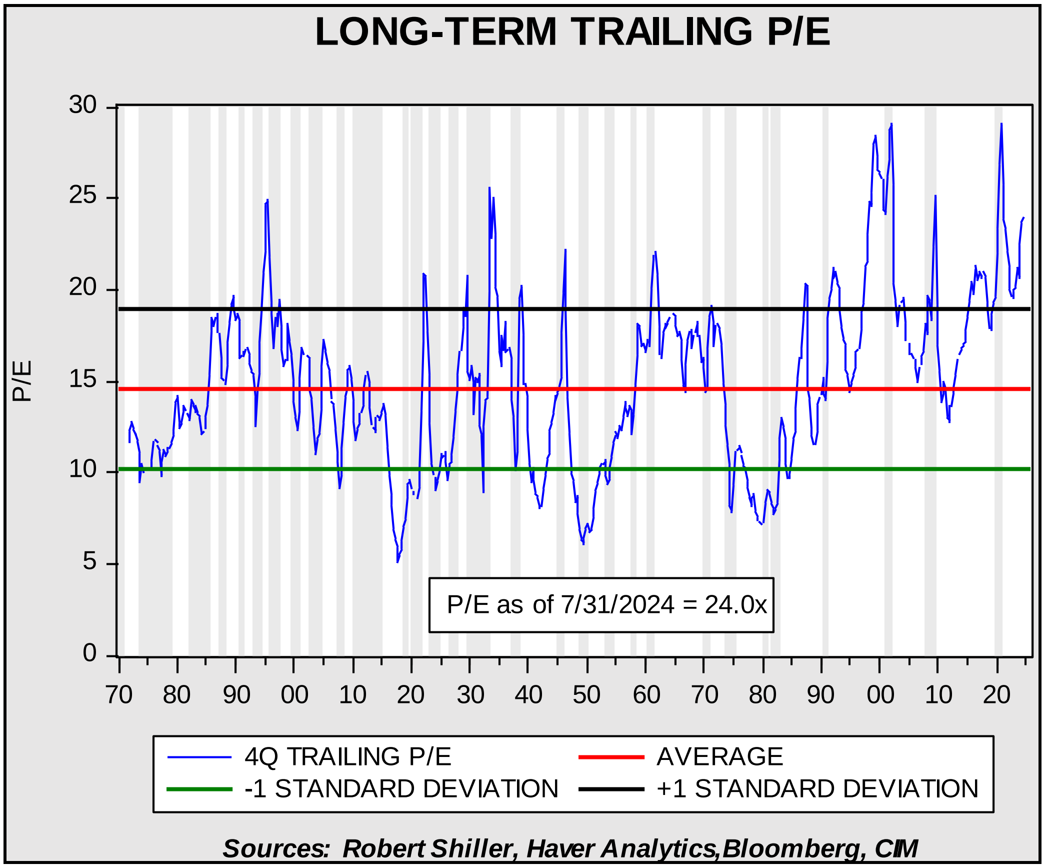


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 1, 2024



Based on our methodology,[1] the current P/E is 24.0x, down 0.2 from our last report. The decrease in the multiple was due to a slight decrease in the stock price index and an 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.