Confluence Investment Management

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 5, 2024 — 9:30 AM ET] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is down 2.8% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 4.9%. Chinese markets were lower, with the Shanghai Composite down 1.5% from its previous close and the Shenzhen Composite down 2.1%. US equity index futures are signaling a lower open.

With 376 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, 80.5% have exceeded expectations while 14.9% have fallen short of expectations.

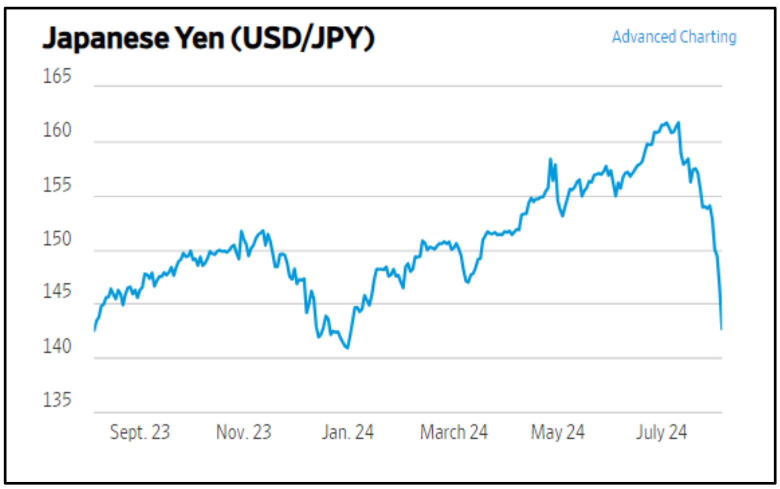
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (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.

Our *Comment* today opens with an overview of the sharp declines in global financial markets today. Given the recent weak economic data out of the US and the surging value of the yen, the volatility could stay with us in the near term. We next review several other international and US developments with the potential to affect the financial markets today, including new signs that Iran is about to launch an attack on Israel and additional notes on Friday's weak US labor market report.

Japan: Responding to Friday's weak US labor market data, rising Japanese interest rates, and the surging yen (JPY), the country's benchmark Nikkei stock market index plunged 12.4% today, for its worst decline since 1987. The plunging Japanese market pulled down stock values across the region, with the South Korean and Taiwanese markets both falling more than 8%. European equities are also weaker today, and as noted above, current futures trading suggests US stock prices will fall sharply at the open.

- The weak US employment data on Friday has rattled investors worldwide. To complement the quick first take that we provided in our *Comment* on Friday, we provide a bit more detail later in today's publication. We also note that today's upcoming business-sector data from S&P Global and ISM could help calm the markets if they are strong enough.
- The Bank of Japan's shift toward higher interest rates has also upset the years-long habit among some investors to borrow at ultra-low Japanese rates to fund aggressive bets around the world. With Japanese rates now rising, investors have begun to unwind those trades, taking air out of many high-flying stocks and pushing the JPY higher as they bring their funds back home. The resulting upward pressure on the yen then prompts even more unwinding.
- After weakening some 12.2% against the dollar in the first half of 2024, the yen has reversed almost all of that change in just the last five weeks. As of this writing, the currency is trading at 142.68 per dollar ($0.00701), down just 1.3% from the exchange rate of 140.85 ($0.00710) at the end of 2023. If the JPY continues to strengthen, the global market volatility seen today could continue for a while yet.



Japan-Philippines: In another sign that key US allies in the Indo-Pacific region are increasingly cooperating to thwart Chinese geopolitical aggressiveness, Japan and the Philippines [held their first-ever joint naval exercise] in the South China Sea on Friday. The drill came just weeks after Tokyo and Manila signed a deal allowing them to deploy troops on each other's territory in time of conflict. Separately, the German and Philippine defense ministers [met yesterday to work on a new defense cooperation deal expected to be signed later this year].

China: The *Wall Street Journal* on Saturday [carried an interesting article on the enormous scale of Beijing's support for Chinese manufacturers]. For example, the article says Beijing channels almost 5% of national income to support the factory sector, six times the share provided by the second-biggest spender, South Korea. Just as important, the article notes that 99% of China's publicly listed companies report some kind of direct government subsidy. In 2023, the top recipient was battery maker CATL, which got about $790 million.

- The Chinese Communist Party has long maintained an investment-driven economic model marked by high spending on infrastructure, housing, and factories. Since the prior emphasis on housing left that sector with enormous excess capacity and debt, the party is now emphasizing factory investment and competitiveness.
- Along with the outright cash subsidies, Chinese manufacturers receive tax breaks, cheap loans from state-owned banks, low-priced land from provincial and local governments, preferential pricing for raw materials and energy from state-owned producers, and even inexpensive equity financing by government-run investment companies. Beijing also provides valuable non-monetary support, such as discriminatory rules against foreign firms operating in the country and low regulation on Chinese firms.
- Within China's domestic economy, channeling so many resources to manufacturers leaves much less available for service firms and consumers. Even when Beijing vows to boost consumer spending, the strategy is often underwhelming. Over the weekend, for example, the State Council released a plan to boost consumer spending by increasing support for nursing care and "low altitude tourism," i.e., hot air balloons.
- Internationally, the resulting excess capacity and low domestic prices have prompted Chinese manufacturers to dramatically ramp up their exports, which threatens to hurt manufacturers and manufacturing workers in the US, other developed countries, and even many emerging markets. As a result, we expect those countries to continue slapping Chinese firms with anti-dumping tariffs and other trade barriers, which will further worsen China-Western tensions.

Malaysia: Government officials, academics, and business managers say the number of Chinese citizens moving to Malaysia has surged in response to China's slowing economic growth and oppressive Communist Party intrusions. According to the report, the surge is driven largely by students and investors. The number of Chinese citizens living in Malaysia may now be as high as 200,000, up from just 82,000 in 2022. The influx may help goose the Malaysian economy and stocks, although it could also spark social tensions.

European Union: Even though Ursula von der Leyen secured a second term as president of the European Commission earlier this summer, with support from both the EU member states and the European Parliament, she has faced an embarrassing threat to her authority as she works to fill the 27 commissioner posts in the EU's executive body. For each country that is not just renominating its existing commissioner, von der Leyen has requested both a male and a female nominee. However, at least six countries have simply nominated a man.

- Under EU law, each member state has the right to nominate one commissioner. Then, von der Leyen gets to decide which portfolio each commissioner gets.
- Von der Leyen has promised to build a gender-balanced college of commissioners, but she has no authority to require both a male and a female nominee from each member state. Most returning commissioners are likely to be men, so without more female nominees, the new college of commissioners will likely be male dominated.

United Kingdom: Rioting by far-right activists spread to more cities over the weekend, as a follow-on to the anti-immigrant riots sparked last week by a stabbing attack that killed three children in the city of Southport. Prime Minister Starmer held an emergency meeting with his top ministers on Saturday and declared the government's full support for police trying to control the violence. Nevertheless, the rioting threatens to disrupt economic activity and tarnish the UK's reputation as a safe place for business and investment.

Iran-Israel: Tehran today issued a warning for pilots and aviation authorities to consider Iranian airspace off-limits, in what is likely an indication that it will soon launch its expected strike on Israel. Meanwhile, US Secretary of State Blinken yesterday told the Group of 7's foreign ministers that he expects Iran to attack in the next 24 to 48 hours. Given that world financial markets are already facing economic jitters, an unexpectedly large, dangerous attack that threatens escalation could spark additional market volatility.

United States-Vietnam: In an annual review, the US Commerce Department on Friday unexpectedly maintained its designation of Vietnam as a "non-market economy," keeping it in the same category as countries like China and Russia. The designation means Vietnamese imports into the US will continue to face special anti-dumping and anti-subsidy scrutiny and higher tariffs.

- The US decision comes despite Hanoi's recent economic reforms and increased US investment in Vietnam. At first glance, it also seems inconsistent with the US's recent pressure on Western firms to shift production from China to other countries in the region.
- On the other hand, it's important to remember that Chinese companies have been looking to set up shop in Vietnam, Mexico, and other countries to get around US tariffs on Chinese products. Keeping Hanoi's non-market designation may give the US more leeway to impede Chinese goods being routed through Vietnam.

US Defense Policy: Faced with growing threats from China, Russia, and North Korea, a senior Defense Department official said at a conference last week that the military's current strategic review is exploring an increase in the US arsenal of nuclear weapons and launchers. The statement suggests the Biden administration may already be stepping back from its 2022 Nuclear Posture Review, which some defense analysts considered too dovish. If so, it could portend even more pressure to increase the US defense budget in the coming years.

US Labor Market: Finally, as a follow-up to our quick take on the weak July employment report in our *Comment* on Friday, we note that much of the issue was that new job creation finally fell sharply below the number of new entrants into the labor market. Our analysis shows most of the weakness came in the private sector, where the net employment gain in July was just 97,000, down 42.3% from the monthly average of 168,000 over the previous year. In the public sector, the jobs gain was 17,000, down 63.9% from 47,000 over the prior year.

- In the private goods-producing sector, net hiring in July was a bit stronger than in the prior year. The problem was in the private services sector, where net hiring weakened to 77,000, down 51.8% from the average of 149,000 in the previous year. In large part, that reflected weaker hiring in ambulatory healthcare offices and professional services, along with payroll declines in industries such as publishing and other information services.

- In the public sector, the weak hiring primarily reflected employment declines in state and local governments outside of education.
- While we're still working to deeply understand what's going on in the labor market, the weak labor demand in professional and information services may mean firms over-hired in those areas in the post-pandemic boom. Potentially, it could also point to some shifts related to artificial intelligence. Finally, the weakness in governments' non-education hiring could reflect continued strong retirements in that relatively older sector.
- In any case, if the weak July figures aren't reversed in the August report, the Fed policymakers certainly could become more amenable to a 50-basis point cut in the benchmark fed funds rate in September, as many investors now expect.

US Economic Releases

There were no domestic releases prior to the publication of this report. 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**
9:45	S&P Global US Services PMI	m/m	July F	56.0	56.0	***
9:45	S&P Global US Composite PMI	m/m	July F		55.0	***
10:00	ISM Services Index	m/m	July	51.0	48.8	***
Federal Reserve						
ET	**Speaker or Event**	**District or Position**				
14:00	Senior Loan Officer Opinion Survey on Bank Lending Practies	Federal Reserve Board of Governors				
17:00	Mary Daly Speaks in Moderated Discussion	President of the Federal Reserve Bank of San Francisco				

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	Jibun bank Composite PMI	m/m	Jul F	52.5	52.6		*	Equity and bond neutral
	Jibun Bank Services PMI	m/m	Jul F	53.4	53.9		**	Equity and bond neutral
Australia	Melbourne Institute Inflation	y/y	Jul	0.4%	3.2%		***	Equity and bond neutral
New Zealand	ANZ Commodity Price	m/m	Jul	-1.7%	1.5%		**	Equity and bond neutral
South Korea	Foreign Reserves	m/m	Jul	$413.51b	$412.21b		**	Equity and bond neutral
China	Caixin Composite PMI	m/m	Jul	51.2	52.8		**	Equity and bond neutral
	Caixin Services PMI	m/m	Jul	52.1	51.2	51.5	**	Equity and bond neutral
India	HSBC India PMI Composite	m/m	Jul F	60.7	61.4		**	Equity and bond neutral
	HSBC India PMI Services	m/m	Jul F	60.3	61.1		**	Equity and bond neutral
EUROPE								
Eurozone	HCOB Eurozone Services PMI	m/m	Jul F	51.9	51.9	51.9	**	Equity and bond neutral
	HCOB Eurozone Composite PMI	m/m	Jul F	50.2	50.1	50.1	*	Equity and bond neutral
	PPI	y/y	Jun	-3.2%	-4.1%	-8.0%	**	Equity bullish, bond bearish
Germany	HCOB Germany Services PMI	m/m	Jul F	52.5	52.0	52.0	**	Equity and bond neutral
	HCOB Germany Composite PMI	m/m	Jul F	49.1	48.7	48.7	**	Equity and bond neutral
France	HCOB France Services PMI	m/m	Jul F	50.1	50.7	50.7	**	Equity and bond neutral
	HCOB France Composite PMI	m/m	Jul F	49.1	49.5	49.5	**	Equity and bond neutral
Italy	HCOB Italy Manufacturing PMI	m/m	Jul	50.3	51.3	50.9	***	Equity bearish, bond bullish
	HCOB Italy Services PMI	m/m	Jul	51.7	53.7	52.9	**	Equity bearish, bond bullish
UK	New Car Registrations	y/y	Jul	2.5%	1.1%		*	Equity and bond neutral
	Official Reserves Changes	m/m	Jul	$1080m	-$136m		*	Equity and bond neutral
	S&P Global UK Services PMI	m/m	Jul F	52.5	52.4	52.4	**	Equity and bond neutral
	S&P Global UK Composite PMI	m/m	Jul F	52.8	52.7	52.7	**	Equity and bond neutral
Switzerland	Domestic Sight Deposits CHF	w/w	2-Aug	445.5b	449.5b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	2-Aug	453.9b	458.2b		*	Equity and bond neutral
Russia	S&P Global Russia Composite PMI	m/m	Jul	51.9	49.8	50.0	**	Equity and bond neutral
	S&P Global Russia Services PMI	m/m	Jul	51.1	47.6	48.5	**	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)	549	550	-1	Down
3-mo T-bill yield (bps)	495	503	-8	Down
U.S. Sibor/OIS spread (bps)	504	513	-9	Down
U.S. Libor/OIS spread (bps)	501	511	-10	Down
10-yr T-note (%)	3.72	3.79	-0.07	Down
Euribor/OIS spread (bps)	362	364	-2	Down
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Up			Up
Pound	Down			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	$75.47	$76.81	-1.74%	
WTI	$72.05	$73.52	-2.00%	
Natural Gas	$1.90	$1.97	-3.41%	
12-mo strip crack	$21.06	$21.65	-2.74%	
Ethanol rack	$1.98	$1.98	0.32%	
Metals				
Gold	$2,385.26	$2,443.24	-2.37%	
Silver	$26.65	$28.56	-6.67%	Market volatility, strong dollar, investor sentiment
Copper contract	$394.50	$410.30	-3.85%	
Grains				
Corn contract	$397.25	$403.25	-1.49%	
Wheat contract	$524.50	$539.00	-2.69%	
Soybeans contract	$1,018.75	$1,027.25	-0.83%	
Shipping				
Baltic Dry Freight	1,675	1,668	7	

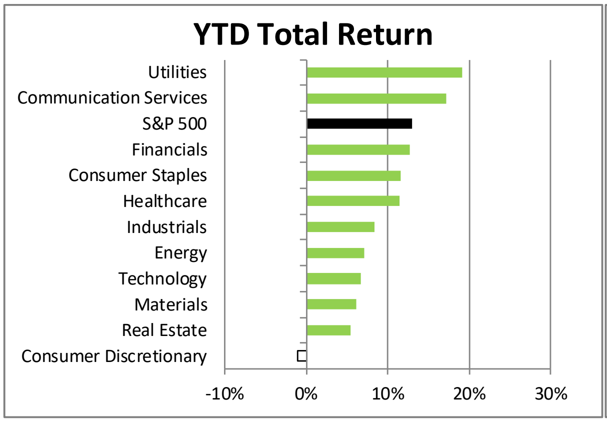
Weather

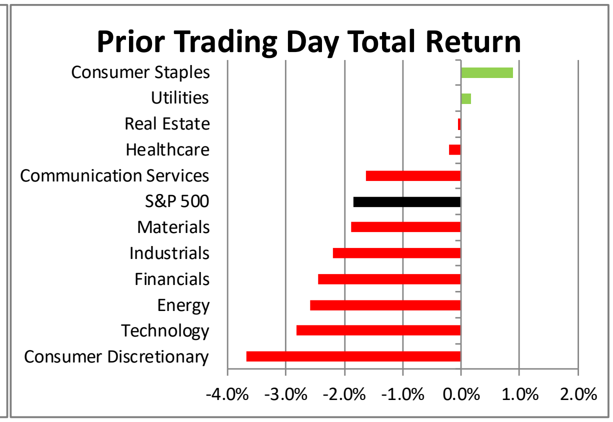
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout the South and Pacific regions, with cooler-than-normal temperatures for the rest of the country. The precipitation outlook calls for wet conditions on the East Coast and all areas west of the Mississippi River, with dry conditions expected in parts of the Midwest.

Two atmospheric disturbances are currently developing in the Atlantic Ocean. Hurricane Debby, the more concerning of the two, has just made landfall in the Florida Panhandle and is projected to move northward towards Georgia, bringing potentially historic levels of rainfall. The other disturbance, near the Windward Islands, poses a minimal threat with only a 10% chance of developing into a cyclone.

Data Section

US Equity Markets – (as of 8/3/2024 close)

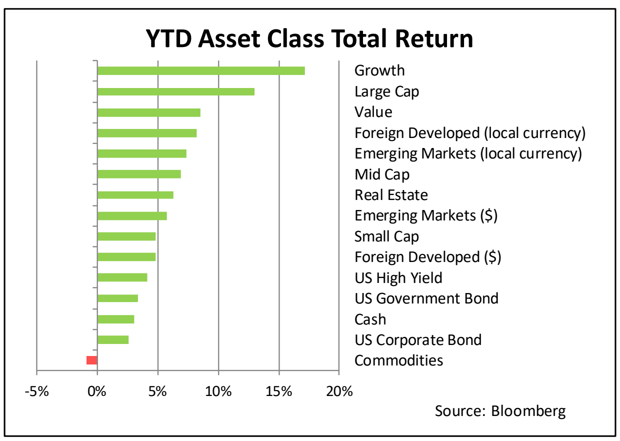




(Source: Bloomberg)

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 8/3/2024 close)

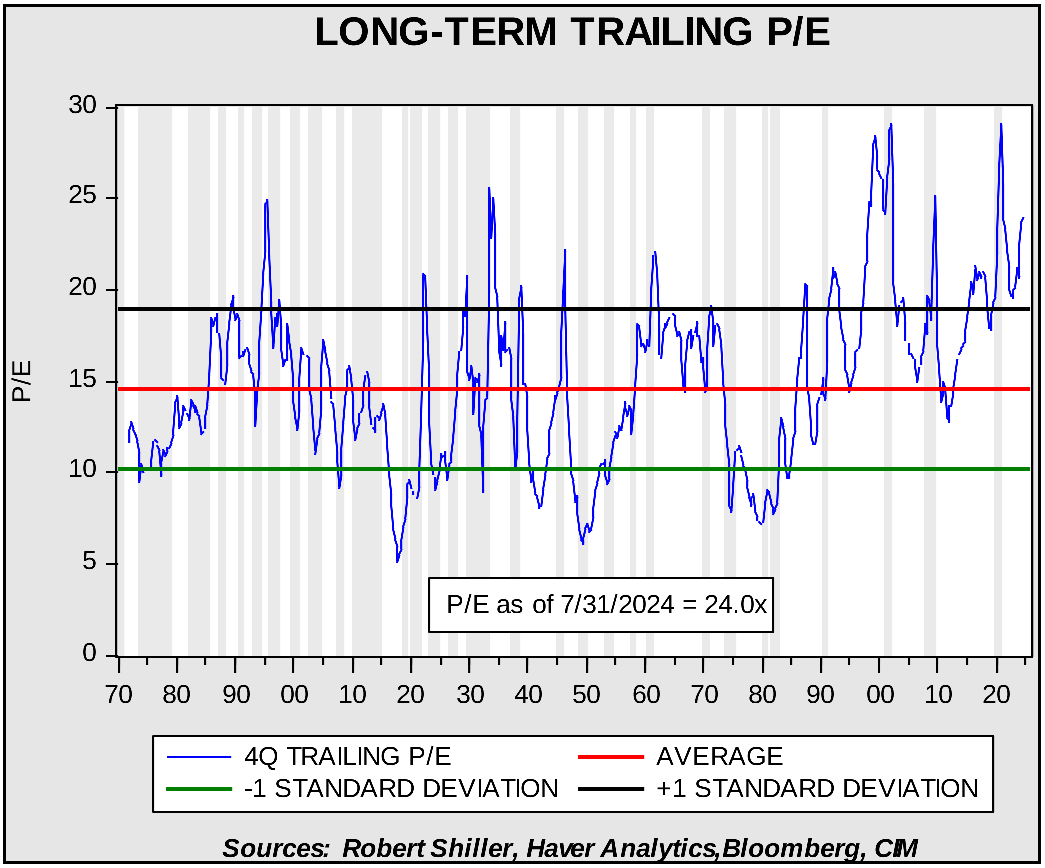


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.