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 6, 2024 — 9:30 AM ET] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is up 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.9%. Chinese markets were higher, with the Shanghai Composite up 0.2% from its previous close and the Shenzhen Composite up 1.2%. US equity index futures are signaling a higher open.

With 384 companies having reported so far, S&P 500 earnings for Q2 are running at $61.00 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.

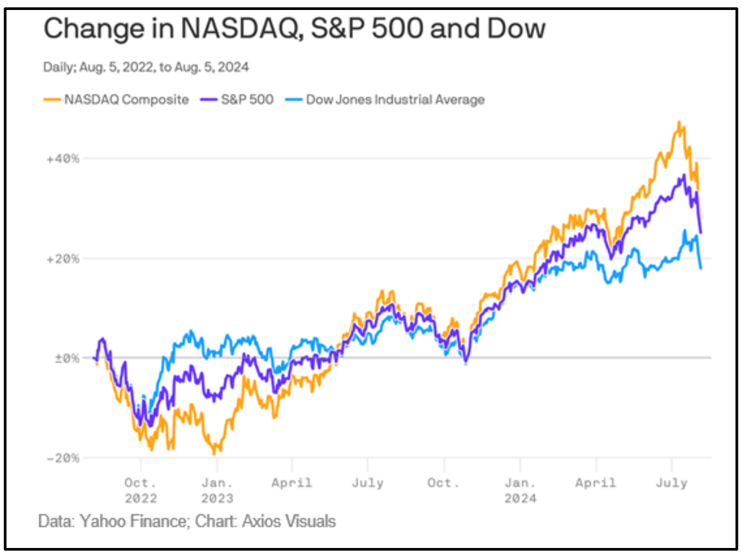
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- ***Bi-Weekly Geopolitical Report*** **(8/5/2024) (no accompanying podcast for this report): "The US Geopolitical and Economic Bloc as an Investment Region"**
- *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 a recap of the wild market swoon around the world on Monday. So far today, the markets have calmed down considerably, and the Japanese equity market regained most of the 12% decline it suffered yesterday. We next review several other international and US developments with the potential to affect the financial markets today, including a potential new point of conflict between China and the Philippines and an antitrust ruling against technology giant Google.

Global Financial Markets: The global rout in risk markets yesterday ultimately drove large-cap US stock prices down about 3.0%, with previously high-flying technology stocks and small-cap stocks faring even worse. All the same, our close read of the markets and our second look at recent economic data still suggest that the culprits were largely what we tagged in yesterday's *Comment*: an overreaction to the weak July employment report on Friday, rising Japanese interest rates, and an unwinding of yen carry trades.

- Multiple US data series suggest lower-income consumers continue to struggle with the high price inflation of recent years. Those consumers have been especially whipsawed by the way tax brackets are indexed to inflation only with a lag. Many responded by borrowing more, only to be hit with higher interest charges. On top of that, higher interest rates have cooled parts of the production sector, such as apartment developers. Weaker consumer demand and cooler business investment is now hurting the labor market.
- As we noted in our Economic and Financial Market Outlook for 2024, which we titled *"The Slow-Bicycle Economy,"* slower economic growth will make the US economy more susceptible to recession, especially if there is an exogenous shock to the system. At this point, however, such an exogenous shock is not readily apparent. It is entirely possible that the US will merely experience a period of slower growth or perhaps a mild, short recession. The silver lining is that such a situation would imply lower interest rates.
- Looking ahead to the coming days, the unwinding of yen carry trades and continued concerns about the US economy could keep the markets volatile. This volatility will likely prompt investors to reassess their expectations and valuations for certain sectors, potentially leading to a longer-lasting rotation away from recent high-flyers to down-trodden assets that may benefit from lower interest rates, such as real estate and bonds.
- In the Japanese stock market, which dropped 12.4% yesterday to get the rout going, indexes closed up about 10.4% today.



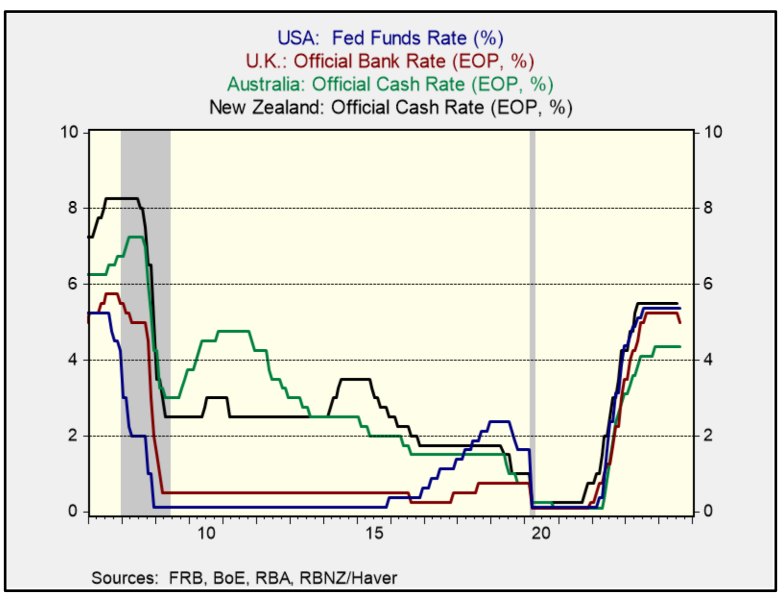
Global Oil Market: Saudi Aramco, Saudi Arabia's largely state-owned oil company and the world's biggest producer, confirmed it will pay out $124 billion in dividends this year, dwarfing the $32 billion in dividends and share buybacks expected from US oil giant ExxonMobil. More broadly, the firm warned that global oil demand is much stronger than investors realize.

- According to CEO Amin Nasser, global oil demand is "robust," especially in China, despite its economic slowdown and the broader global transition to green energy.
- If Nasser is correct, it would suggest the US and global economies are still in decent shape. In turn, that could point to ongoing upward pressure on oil prices.

China-Philippines: Yesterday's *South China Morning Post* said Manila has deployed a coast guard vessel to a new area of the South China Sea claimed by both China and the Philippines. The Philippine vessel, the *Teresa Magbanua*, has reportedly been blocking Chinese coast guard ships from interfering with boats from the Philippine Bureau of Fisheries and Aquatic Resources, which have been refueling fishing boats in the area. According to the article, Beijing has accused Manila of intentionally grounding the *Teresa Magbanua* on the disputed Sabina Shoal.

- The report comes just days after Beijing and Manila reached a deal to defuse tensions around a Philippine naval vessel, the *Sierra Madre*, which was intentionally grounded in 1999 on the disputed Second Thomas Shoal, also in the South China Sea. The *Sierra Madre* is now an outpost for Philippine marines, helping assert Philippine sovereignty over the area.
- Since the old, rusting *Sierra Madre* is now in danger of breaking up, Beijing has been pressuring Manila to stop shoring it up. Once the *Sierra Madre* breaks up and the Philippine marines have to abandon her, Chinese forces would be free to seize the Second Thomas Shoal and assert Beijing's sovereignty over the area.
- If Manila really has grounded the *Teresa Magbanua* on Sabina Shoal, right after promising not to shore up the *Sierra Madre* any further, it would mark a stunning and aggressive sleight of hand by Philippine President Ferdinand Marcos, Jr. The result would be to keep alive the increasing territorial tensions between Beijing and Manila, which could potentially draw in the US and lead to conflict in the South China Sea.

Australia: The Reserve Bank of Australia (RBA) today held its benchmark short-term interest rate unchanged at 4.35%, right where it has been since November. In its statement, the central bank said underlying inflation pressures remain too high and probably won't come down enough to support a rate cut anytime soon. That puts the RBA at odds with most other developed-country central banks, many of which have started cutting rates or are preparing to do so.



European Union-Mercosur: According to the *Financial Times*, European and South American officials have said they recently resolved some sticking points in the 20-year negotiations over an EU-Mercosur free-trade deal and could have the pact signed by the end of 2024. If signed and approved by a majority of the EU's 27 member states, the deal is expected to save EU businesses more than 4 billion EUR per year in tariffs, while opening new markets in Europe for the five Mercosur nations of Brazil, Argentina, Uruguay, Paraguay, and Bolivia.

Mexico: For the first time, Defense Secretary Gen. Luis Cresencio Sandoval has admitted that the country's drug cartels have killed some Mexican soldiers with bomb-dropping drones like those being used in the Russia-Ukraine war. In our view, the cartels' successful use of the drones illustrates why they are revolutionizing modern warfare: The drones are highly effective at killing and destroying equipment, while they are also cheap and relatively easy to use.

US Monetary Policy: After yesterday's global market selloff, as discussed above, Chicago FRB President Goolsbee vowed the Fed would "fix" any deterioration in the US economy. Separately, San Francisco FRB President Daly said the policymakers "will do what it takes" to meet their price stability and employment goals.

- The statements are far from any commitment to implement an interim interest-rate cut, a 50-basis point cut in September, or even a 25-basis point cut that month.
- However, the statements do confirm that yesterday's market action and recent soft economic data have gotten the Fed's attention, raising the probability that they will ease monetary policy this autumn more aggressively than previously planned.

US Antitrust Policy: In a ruling yesterday, a federal judge said Google violated US antitrust law by spending billions of dollars on exclusive deals to maintain a monopoly on internet searches. The judge is still deciding what remedies to impose, and the company said it plans to appeal the ruling in any case. Still, the ruling illustrates the federal government's increased focus on uncompetitive behavior by big technology firms. The question is how much that focus will hurt those firms' revenues and profitability going forward.

US Artificial Intelligence Industry: New reports say AI chip darling Nvidia and manufacturing partner Taiwan Semiconductor have suffered production snags on Nvidia's new Blackwell data center chip. The snags reportedly could delay shipments of Nvidia's key new product scheduled for later this year. The news could take further wind out of Nvidia's high-flying stock price.

US Economic Releases

The June ***trade balance*** showed a seasonally adjusted deficit of $73.1 billion. This is greater than the expected value of $72.5 billion, but less than May's revised value of $75 billion. According to the data, total ***exports*** rose 1.5%, while ***imports*** rose 0.6%. Compared with the same month one year earlier, exports in June rose 5.9%, while imports rose 7.3%. This narrowing of the deficit, the first in three months and largely due to the decrease in imports, could serve as a further sign of a decelerating overall economy and could weigh on the market. The chart below shows the monthly value of US exports and imports since just before the previous recession.

There are no economic releases and/or Fed events scheduled for the rest of the day.

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	Labor Cash Earnings	y/y	Jun	4.5%	2.0%	2.4%	**	Equity bullish, bond bearish
	Real Cash Earnings	m/m	Jun	1.1	-1.3	-0.9	*	Equity bullish, bond bearish
	Household Spending	y/y	Jun	-1.4%	-1.8%	-0.8%	**	Equity bearish, bond bullish
EUROPE								
Eurozone	Retail Sales	y/y	Jun	-0.3%	0.5%	0.1%	*	Equity and bond neutral
Germany	Factory Orders WDA	y/y	Jun	-11.8%	-8.7%	-14.2%	***	Equity bullish, bond bearish
	HCOB Germany Construction PMI	m/m	Jul	40.0	39.7		*	Equity and bond neutral
UK	S&P Global UK Construction PMI	m/m	Jul	55.3	52.2	52.5	**	Equity bullish, bond bearish
Switzerland	Unemployment Rate	m/m	Jul	2.3%	2.3%	2.3%	**	Equity and bond neutral
	Real Retail Sales	y/y	Jun	-2.2%	-0.2%		**	Equity and bond neutral
AMERICAS								
Mexico	Vehicle Production	y/y	Jul	302309	344206		*	Equity and bond neutral
Mexico	Formal Job Creation Total	m/m	Jul	12.3k	-29.6k		*	Equity and bond neutral
Brazil	S&P Global Brazil Composite PMI	m/m	Jul	56.0	54.1		***	Equity and bond neutral
Brazil	S&P Global Brazil Services PMI	m/m	Jul	56.4	54.8		***	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)	507	505	2	Down
U.S. Sibor/OIS spread (bps)	512	509	3	Down
U.S. Libor/OIS spread (bps)	510	506	4	Down
10-yr T-note (%)	3.86	3.79	0.07	Down
Euribor/OIS spread (bps)	358	362	-4	Down
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Down			Up
Pound	Down			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
RBA Cash Rate Target	4.350%	4.350%	4.350%	On Forecast

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	$76.49	$76.30	0.25%	
WTI	$73.16	$72.94	0.30%	
Natural Gas	$1.95	$1.94	0.51%	
12-mo strip crack	$21.52	$21.70	-0.84%	
Ethanol rack	$1.97	$1.97	-0.08%	
Metals				
Gold	$2,413.06	$2,410.79	0.09%	
Silver	$27.08	$27.26	-0.67%	
Copper contract	$399.60	$399.90	-0.08%	
Grains				
Corn contract	$404.50	$407.00	-0.61%	
Wheat contract	$536.75	$539.50	-0.51%	
Soybeans contract	$1,026.75	$1,040.75	-1.35%	
Shipping				
Baltic Dry Freight	1,677	1,675	2	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.10		
Gasoline (mb)		-1.29		
Distillates (mb)		-0.90		
Refinery run rates (%)		0.8%		
Natural gas (bcf)		31		

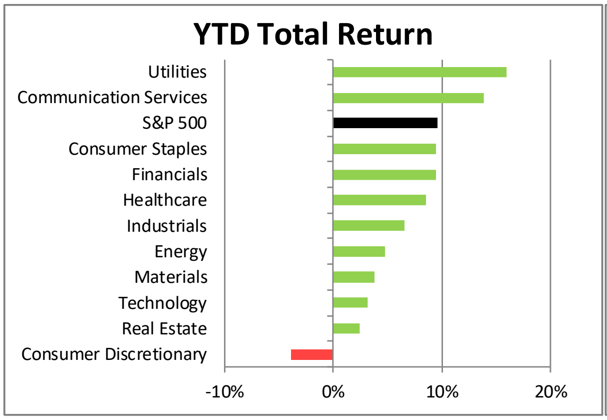
Weather

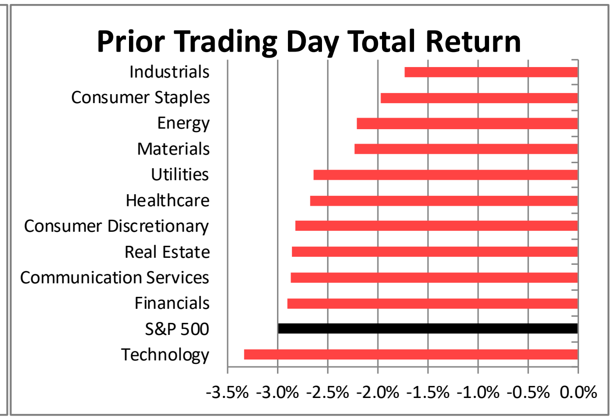
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout the South, Rocky Mountain, and Pacific Northwest regions, with cooler-than-normal temperatures in California and the Mid-Atlantic coast. The precipitation outlook calls for wet conditions in New England and the northern part of the western two thirds of the country, with dry conditions expected in the heart of Dixie and the Desert Southwest.

Hurricane Debby made landfall Monday morning in the Big Bend area of the Florida gulf coast. It is expected to track through Georgia and along the Carolina coast as the week passes, drenching the area with potentially historic rainfall, flooding, and storm surges. Another tropical disturbance has just transited the Windward Islands off the coast of Venezuela, but it poses a minimal threat, with only a 10% chance of developing into a cyclone.

Data Section

US Equity Markets – (as of 8/5/2024 close)

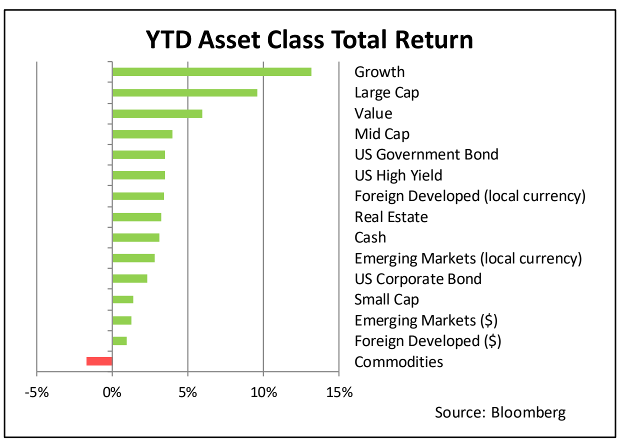




(Source: Bloomberg)

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 8/5/2024 close)

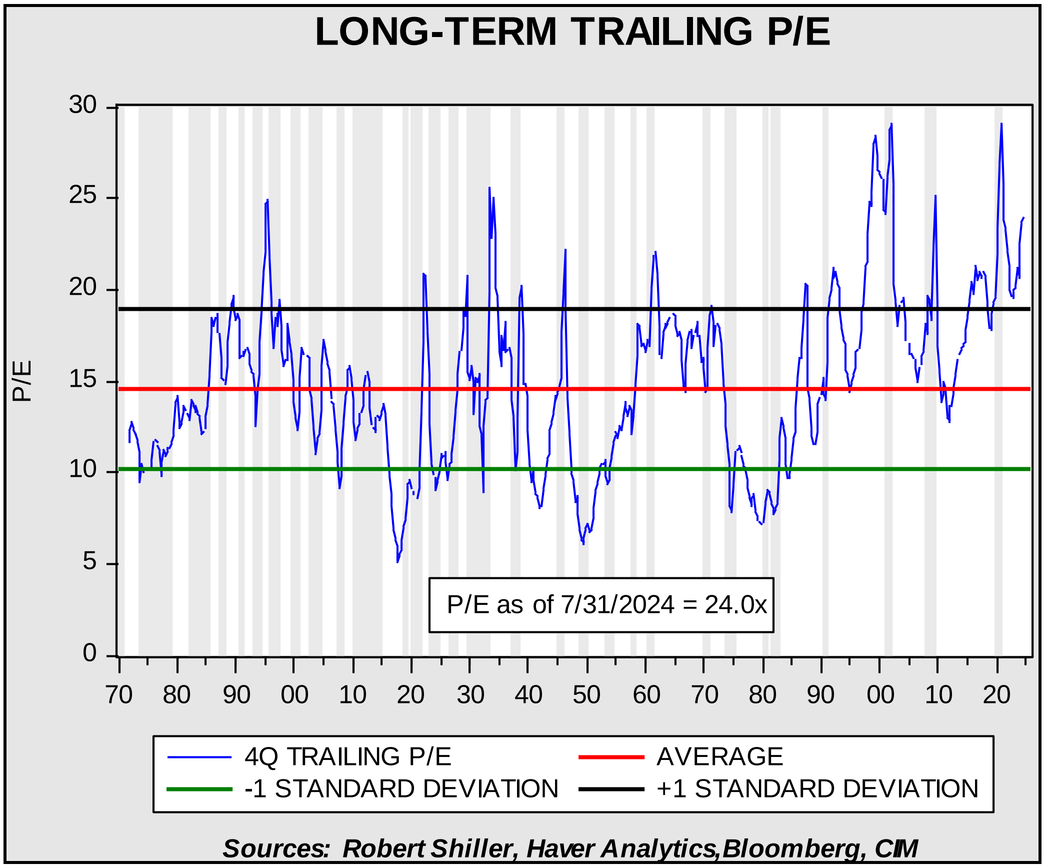


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

---

[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.