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 8, 2024 — 9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is down 0.9% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.8%. Chinese markets were mixed, with the Shanghai Composite relatively unchanged from its previous close and the Shenzhen Composite down 0.1%. US equity index futures are signaling a higher open.

With 439 companies having reported so far, S&P 500 earnings for Q2 are running at $61.10 per share, compared to estimates of $58.94, which is up 8.0% from Q2 2023. Of the companies that have reported thus far, 79.5% have exceeded expectations while 15.8% have fallen short of expectations.

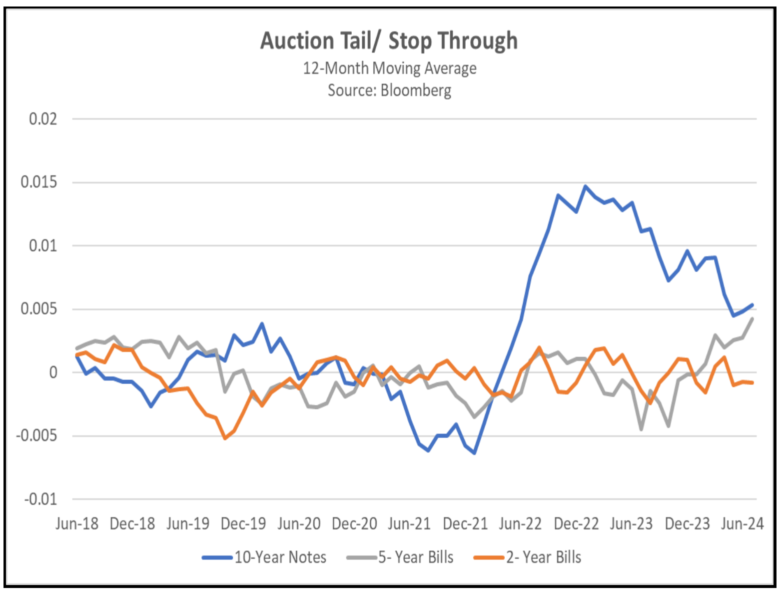
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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.
- *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! S&P 500 futures are off to a strong start to the day as data reassured investors that the country is not in recession. In sports news, US Men's Track and Field athlete Quincy Hall staged a comeback in the 400m to take gold. Today's *Comment* will discuss the market reaction to poor performance in the Treasury auctions, review the growing signs that consumption is waning, and examine Europe's decision to target the ultra-wealthy for its budgetary challenges. As usual, our report will conclude with a round up international and domestic data releases.

Auction Failure: Uncertainty over the path of interest rates continue to weigh on the equity market.

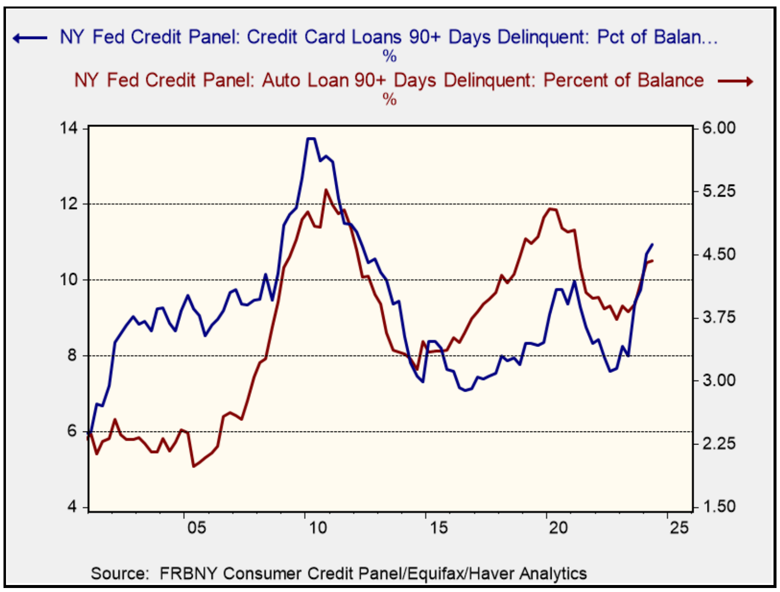
- The S&P 500's early gains evaporated Wednesday, with the index closing down 0.6% amid weak Treasury auction results. [A $42 billion sale of 10-year notes was met with tepid demand]() and ended with a yield of 3.960%, which is 3 bps higher than what investors were anticipating. While lower than the previous auction's 4.276% yield, the result highlights investors' ongoing aversion to current bond yields. The miss triggered a sell-off in equities as investors remain concerned that the Fed will fail to implement rate cuts in time to avert a hard landing.
- Treasury bond auctions have struggled since the Fed embarked on its rate-hiking campaign in 2022. The chart below illustrates escalating auction tails, signaling weak demand, which peaked in late 2023 amid expectations of an imminent shift in monetary policy. While shifting Treasury issuance towards shorter maturities has eased some pressure, it has exacerbated challenges in the five-year sector. Recent narrowing of auction tails for both 10-year and five-year Treasury bonds suggests growing investor discomfort with holding mid and long-term bonds.



- The surge in failed bond auctions indicates that the market's capacity to absorb Treasury issuance has been overwhelmed. While a potential Fed rate cut could offer temporary relief, the underlying issue is excessive government spending. The burgeoning US debt burden will be a formidable challenge for the next administration. Despite vague campaign promises of tax increases or Social Security reform, neither candidate has offered concrete plans to address the growing deficit. Consequently, a return of bond yields to pre-pandemic levels appears unlikely in the near term.

Households Holding Back: Although consumption figures remain positive, a rising chorus of corporate voices warns of potential reductions in consumer spending.

- Earnings reports continue to allude to a consumer pullback in spending. The travel and leisure industry, including key players like Airbnb and Disney, has been hit hard. Airbnb reported delayed bookings and shorter stays, suggesting a shift towards more spontaneous travel plans. Disney blamed declining consumer spending for its bleak outlook. These challenges are mirrored in the fast-food sector, with companies such as McDonald's and Domino's also reporting weaker-than-expected results. The pessimism has led shares of these stocks to fall as investors fear a broader economic slowdown.
- Economic indicators point to growing household financial strain. Auto and credit card delinquency rates have soared to levels not seen since the COVID-19 pandemic, according to the New York Fed, signaling mounting pressures on household balance sheets. Moreover, a sharp $1.7 billion decline in consumer debt — the largest since early 2021 — suggests consumers are tightening their belts amid economic challenges. This sudden weakness in the data comes nearly a week after the breach of the Sahm rule.

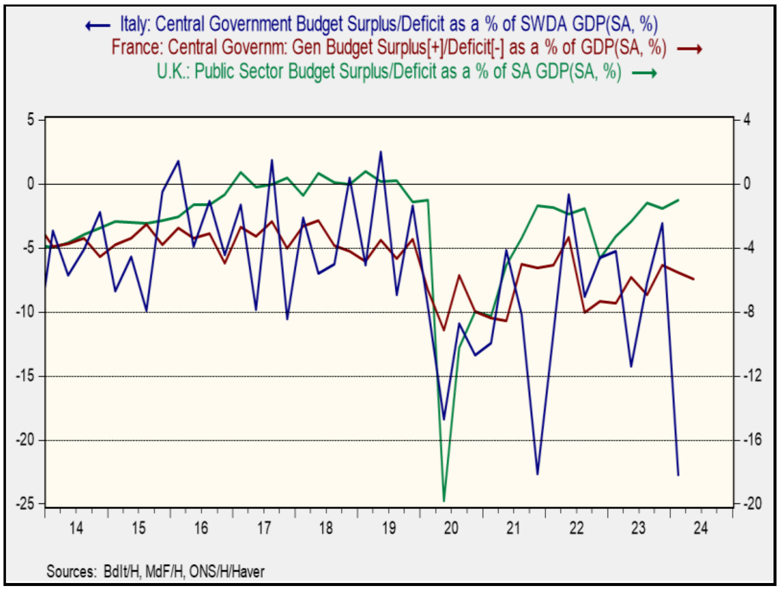


- While concerns of a looming recession persist, current economic indicators suggest a different trajectory. The Atlanta Fed's GDPNow forecast predicts a 2.9% annualized growth rate for the third quarter, an acceleration from the previous quarter's 2.8%. Historically, significant economic downturns in the past three decades were recognized following exogenous shocks like the global pandemic, the collapse of Lehman Brothers, the 9/11 attacks, or the Gulf War. In the absence of such disruptive events, like a major financial crisis or widespread conflict, the economy is likely to continue expanding.

Italy Getting Tough: Italian Prime Minister Giorgia Meloni faces the challenge of balancing the nation's need for fiscal restraint with her campaign pledge to support struggling families.

- To shield middle-class households from higher taxes, Meloni has focused on the ultra-wealthy and financial institutions. On Wednesday, her cabinet endorsed a plan to double the flat tax on foreign income for new residents from $100,000 to $200,000. Additionally, it was revealed last week that her administration has begun revisiting plans to tax banks and insurers that profited from higher interest rates. Last year, her administration was forced to walk back plans for a 40% windfall tax on excessive financial institution profits after the proposal triggered a market sell-off.

- The move underscores a growing European populist trend targeting the wealthy as countries look to balance their budget. This trend is underscored by the UK's decision to end non-domiciled tax status and the growing support for France's Left Alliance, which has promised higher taxes on billionaires and which may revive the wealth tax. This decision stems from the pressure these governments face to address their budget deficits without harming the middle class. France and Italy are currently in breach of the EU's 3% deficit limit, while the UK is struggling to meet its debt reduction target set in 2020.



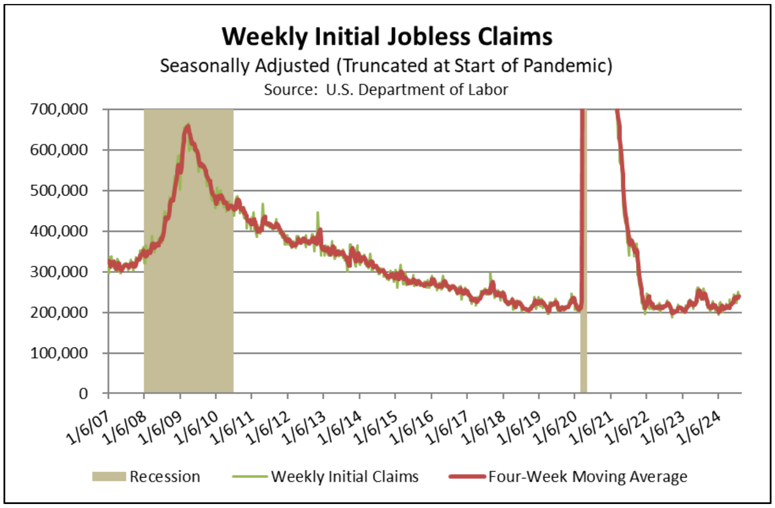
- While targeting the wealthy to address budget deficits might be politically expedient, historical evidence suggests that it's an ineffective strategy. Not only can high-net-worth individuals easily transfer assets offshore, but those in positions of power often possess the means to shape legislation in their favor. Therefore, we predict that a Robin Hood-style fiscal policy will be unsustainable in the long term. As budgetary pressures intensify, governments are likely to resort to more conventional measures, such as pension and social program reforms.

In Other News: Ukraine's surprise attack on Russia has intensified the ongoing conflict, and it shows no signs of de-escalation. Meanwhile, global economic concerns are mounting as Asian chipmakers face pressure from weakening AI demand. Adding to the uncertainty, a major earthquake struck southwest Japan, triggering tsunami fears and potentially impacting Japanese equities.

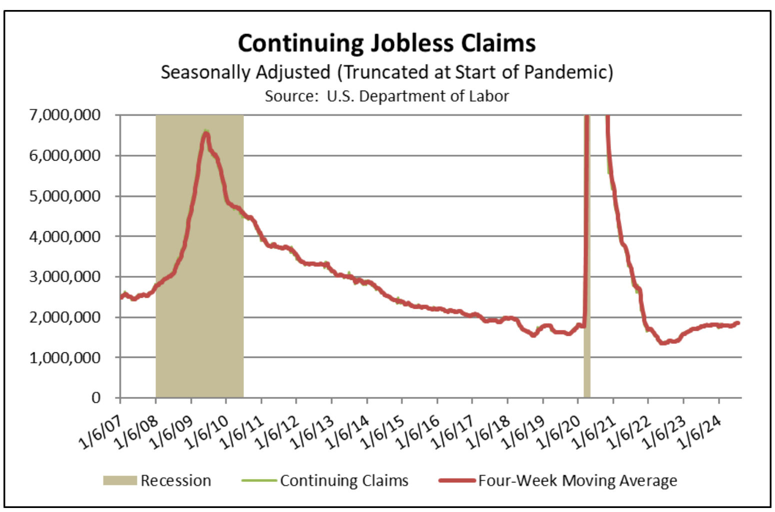
US Economic Releases

In the week ended August 3, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 233,000, below both the expected level of 240,000 and the prior week's revised level of

250,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 240,750. The chart below shows how initial jobless claims have fluctuated since just before the Great Financial Crisis. The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



In the week ended July 27, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to a seasonally adjusted 1.875 million, exactly matching the anticipated reading and up from a revised 1.869 million in the previous week. The four-week moving average of continuing claims rose to 1.862 million, reaching its highest level since November 2021 and confirming that labor demand remains soft despite the pullback in initial claims last week. The chart below shows how continuing claims have fluctuated since the GFC. It is also truncated during the pandemic period because of the high level of claims at the time.



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	Wholesale Inventories	m/m	June F	0.2%	0.2%	**
10:00	Wholesale Trade Sales	m/m	June	0.3%	0.4%	*
Federal Reserve						
ET	**Speaker or Event**	**District or Position**				
15:00	Thomas Barkin Speaks in Fireside Chat	President of the Federal Reserve Bank of Richmond				

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	Japan Buying Foreign Stocks	w/w	2-Aug	¥1290.7b	¥228.7b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	2-Aug	¥669.7b	-¥694.7b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	2-Aug	-¥641.7b	-¥612.9b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	2-Aug	-¥1160.3b	¥1211.5b		*	Equity and bond neutral
	BoP Current Account Balance	m/m	Jun	¥1533.5b	¥2849.9b	¥1865.0b	***	Equity and bond neutral
	BoP Trade Balance	m/m	Jun	¥556.3b	-¥1108.9b	¥350.7b	**	Equity and bond neutral
Australia	Foreign Reserves	m/m	Jul	A$94.4b	A$94.9b		*	Equity and bond neutral
New Zealand	2-Year Inflation Expectations	q/q	3Q	2.03%	2.33%		**	Equity and bond neutral
China	Foreign Reserves	m/m	Jul	$3256.37b	$3222.36b	$3252.00b	**	Equity and bond neutral
EUROPE								
UK	RICS House Price Balance	y/y	Jul	-19%	-17%	-11%	**	Equity and bond neutral
Russia	Official Reserve Assets	m/m	Jul	602.1b	593.5b		*	Equity and bond neutral
AMERICAS								
Mexico	CPI	y/y	Jul	5.57%	4.98%	5.53%	***	Equity and bond neutral
	Core CPI	y/y	Jul	4.05%	4.13%	4.02%	**	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)	532	539	-7	Down
3-mo T-bill yield (bps)	508	509	-1	Down
U.S. Sibor/OIS spread (bps)	510	510	0	Down
U.S. Libor/OIS spread (bps)	507	508	-1	Down
10-yr T-note (%)	3.94	3.94	0.00	Flat
Euribor/OIS spread (bps)	357	352	5	Down
Currencies	**Direction**			
Dollar	Down			Down
Euro	Flat			Up
Yen	Up			Up
Pound	Flat			Up
Franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
RBI Cash Reserve Ratio	4.500%	4.500%	4.500%	On Forecast
RBI Repurchase Rate	6.500%	6.500%	6.500%	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	$78.28	$78.33	-0.06%	
WTI	$75.27	$75.23	0.05%	
Natural Gas	$2.07	$2.11	-1.94%	
12-mo strip crack	$21.70	$21.70	-0.01%	
Ethanol rack	$1.96	$1.96	0.00%	
Metals				
Gold	$2,412.36	$2,382.92	1.24%	
Silver	$27.04	$26.61	1.63%	
Copper contract	$396.00	$395.20	0.20%	
Grains				
Corn contract	$400.00	$400.75	-0.19%	
Wheat contract	$540.75	$538.25	0.46%	
Soybeans contract	$1,016.75	$1,018.75	-0.20%	
Shipping				
Baltic Dry Freight	1,698	1,685	13	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-3.73	-1.80	-1.93	
Gasoline (mb)	1.34	-1.80	3.14	
Distillates (mb)	0.95	1.00	-0.05	
Refinery run rates (%)	4.0%	0.6%	3.4%	
Natural gas (bcf)		25		

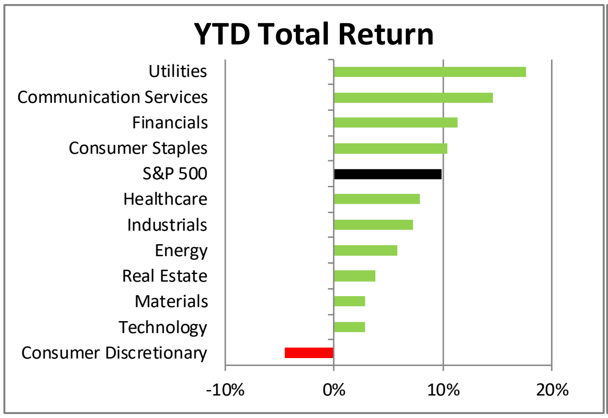
Weather

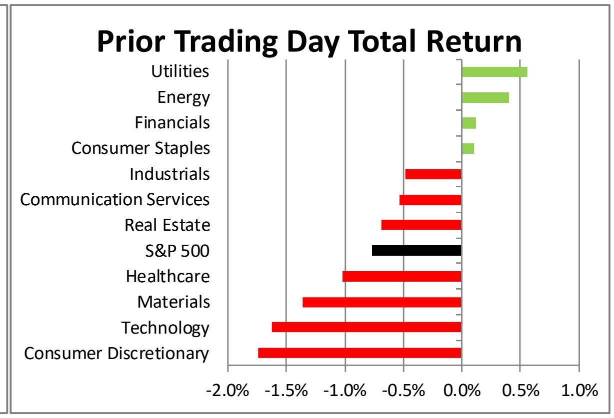
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in the Rocky Mountains, Great Plains, Midwest, and Southeast, with cooler-than-normal temperatures along the West Coast. The forecasts call for wet conditions in the Pacific Northwest, the central Rocky Mountains, and the northern Great Plains, with dry conditions in Nevada and the lower Mississippi River valley.

Tropical Storm Debby is now over the Carolinas and is expected to move up the East Coast in the coming days bringing heavy rains and a risk of flooding. There are now no other atmospheric disturbances in the Atlantic region.

Data Section

US Equity Markets – (as of 8/7/2024 close)

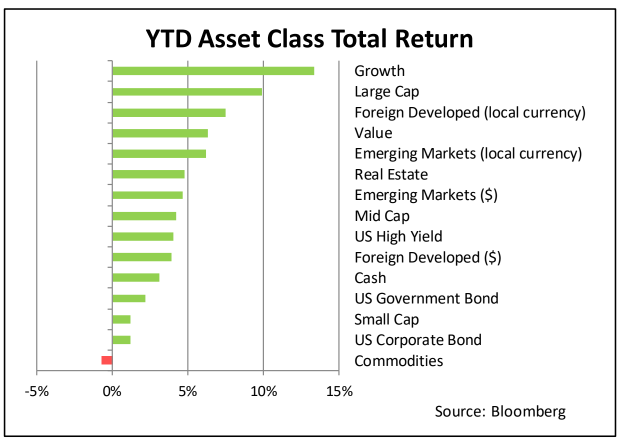




(Source: Bloomberg)

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 8/7/2024 close)

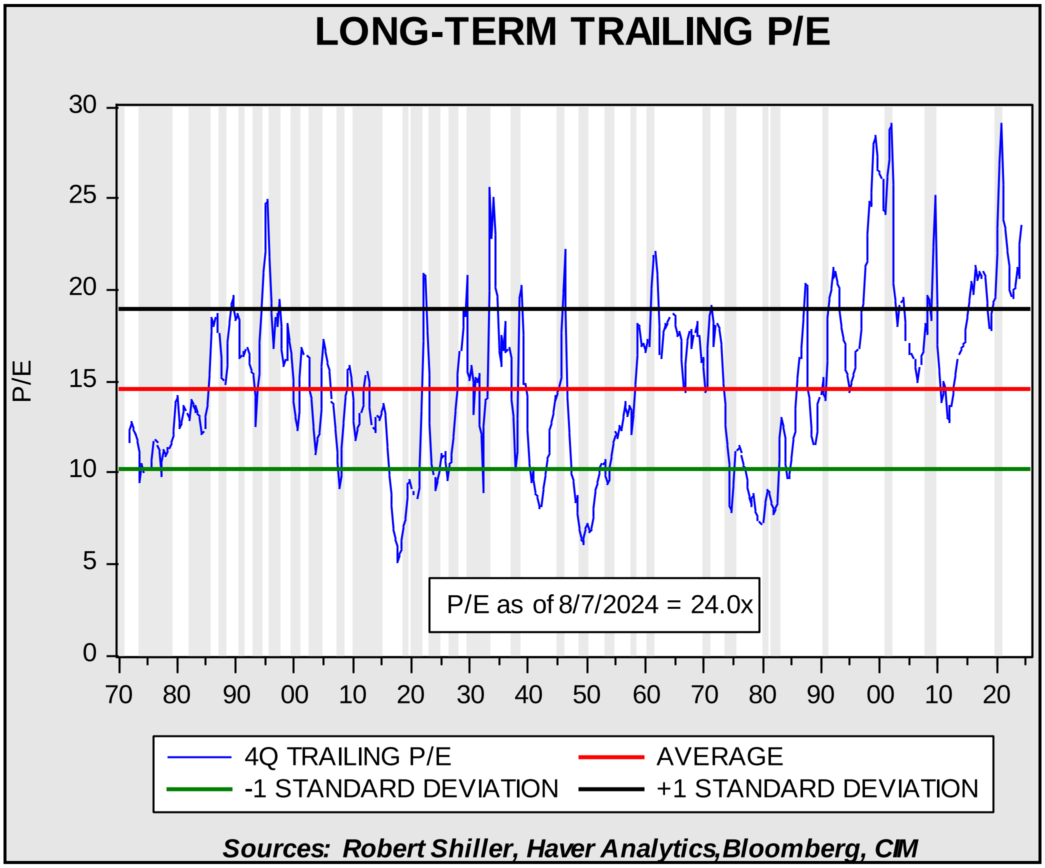


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 8, 2024



Based on our methodology,[1] the current P/E is 24.0x, unchanged from our last report. The lack of movement in the multiple was due to the decline in the stock price index, which was offset by a decline 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.