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 9, 2024 — 9:30 AM ET] Global equity markets are mixed 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 2.3%. Chinese markets were lower, with the Shanghai Composite down 0.3% from its previous close and the Shenzhen Composite down 0.7%. US equity index futures are signaling a lower open.

With 453 companies having reported so far, S&P 500 earnings for Q2 are running at $61.30 per share, compared to estimates of $58.94, which is up 8.0% from Q2 2023. Of the companies that have reported thus far, 79.6% have exceeded expectations while 15.7% have fallen short of expectations.

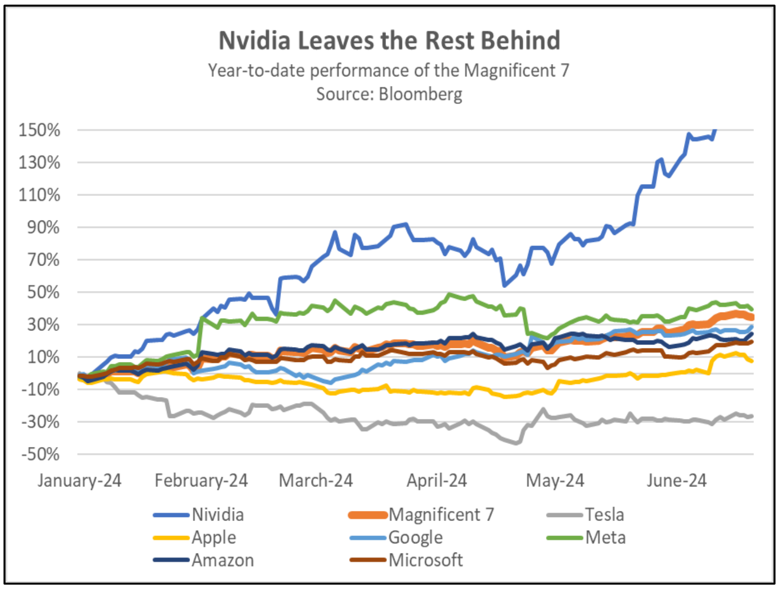
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (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! The S&P 500 is off to a slow start today as investors shrug off yesterday's rally. In sports news, the US Men's Basketball team was able to mount a comeback against Serbia in its quest for Olympic gold. Today's *Comment* will examine the factors driving investors back to large-cap stocks after the recent market downturn. We'll also delve into the reasons behind the surge in equity and bond volatility and provide an update on the conflict in the Middle East. As usual, the report will conclude with a summary of key economic indicators.

Market Rotation Trade: A week into the market meltdown, investors have reverted to old habits seeking reassurance.

- The market rallied after initial jobless claims posted their largest weekly decline since January 2023. This drop helped reassure investors that the labor market was cooling more slowly than anticipated, bolstering hopes for a Fed-engineered soft landing. Major tech companies, led by the Magnificent 7, outperformed the S&P 500 by a significant margin, rising 3.0% compared to the index's 2.0% gain. This sharp increase suggests investors are cautiously re-entering the market and are eager to gauge the sustainability of the improved sentiment.
- The S&P 500 rally may be poised to broaden beyond the tech sector, echoing a pattern observed in the weeks preceding the market downturn. While Yardeni Research indicates a slowdown in earnings growth for the Magnificent 7 in the second quarter, the remaining S&P 500 components have collectively returned to profitability. This strong performance has challenged the notion that the S&P 500 has grown over-reliant on tech companies to drive earnings and reinforce the view that mega-tech companies are running out of steam.

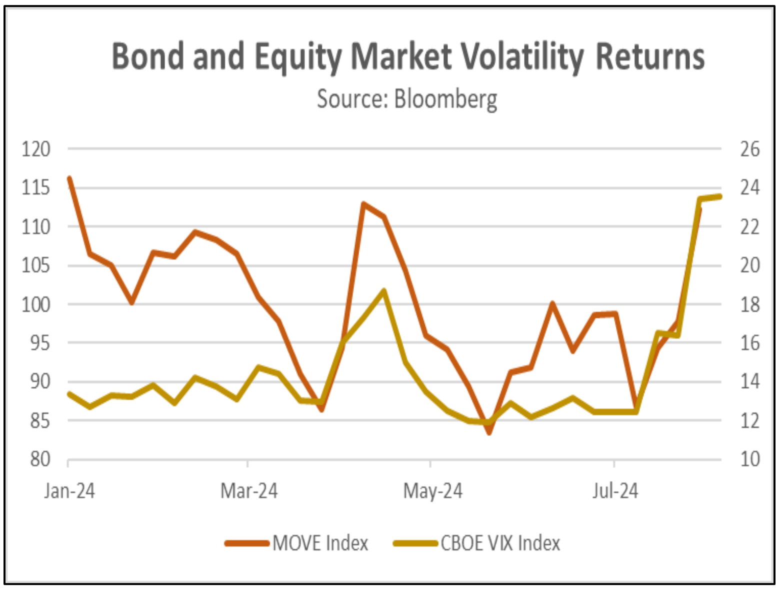


- Don't be misled by the recent surge in tech stocks. While it's tempting to get caught up in the excitement, it's crucial to remember why investors initially exited the sector. Doubts persist about tech companies' ability to justify their lofty valuations, prompting us to maintain our optimism for other S&P 500 sectors. The prospect of a rate cut has buoyed undervalued sectors like real estate and financials, while the potential for increased power consumption in AI has lifted utility stocks. As a result, we are confident that the market will broaden out once more, replicating the pattern that was seen before the recent sell-off.

Volatility Is Back: The unwinding of the carry trade highlights the unusually low equity volatility of recent months in comparison to bonds.

- For the first time in a significant period, both the VIX and MOVE indexes are signaling heightened market risk. While the MOVE index, a measure of bond market volatility, has persistently exceeded its long-term average of 95 since the Fed's 2022 rate hikes began, the VIX had remained relatively subdued, generally below its fear threshold of 20, despite prevalent inflation and recession concerns. Contrary to the prevailing view that investor sentiment explains the VIX-MOVE divergence, we believe the discrepancy is linked to carry-trade dynamics, which has artificially held down equity market volatility.

- The global trend to push interest rates higher has encouraged investors to employ leveraged carry trades. This strategy involves borrowing funds in a low-interest-rate environment, such as Japan, and investing in higher-yielding assets in countries like Mexico, Brazil, or the US. Such trades typically thrive in liquid markets that facilitate easy entry and exit and a stable currency. However, these strategies become vulnerable to sudden market disruptions, such as an unexpected interest rate hike from the Bank of Japan or fears of an imminent US recession.

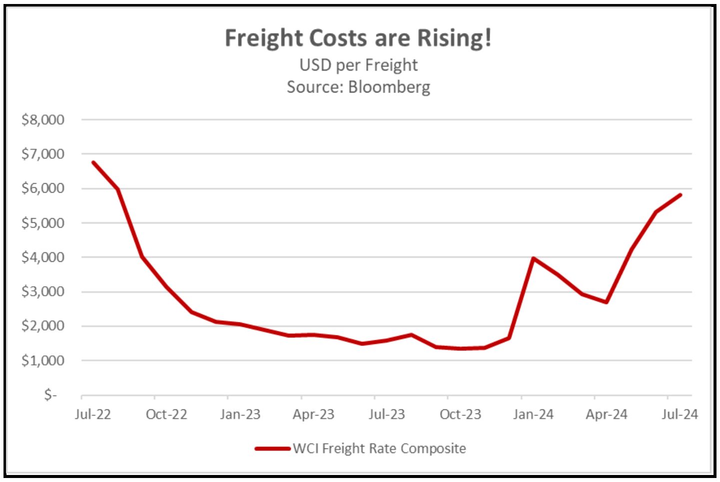


- The recent VIX spike has been partially attributed to the unwinding of carry trades as investors reevaluate positions in light of the yen's strength and the narrowing US-Japan interest rate differentials. As these positions unwind, equity volatility should gradually subside, though it will likely remain sensitive to shifts in US growth expectations. In contrast, the MOVE index, which is sensitive to interest rate expectations, is likely to remain elevated as long as the Fed remains noncommittal on the path of interest rates. This index should fall if inflation continues on its downward trajectory.

Conflict in the Middle East: Israel and its allies are preparing for a retaliatory attack from Iran and Hezbollah in the coming days, which may impact supply chains.

- Tehran is expected to retaliate for the assassinations of a Hezbollah leader in Lebanon and a top Hamas official visiting Iran. Israel has already intercepted an Iranian aerial attack but faces growing concerns about the sustainability of its defenses. The Israeli government has advised citizens to stockpile food as it prepares for potential defensive and offensive campaigns to deter future attacks. This development could escalate the conflict, drawing in additional nations and undermining recent ceasefire discussions.

- The conflict is likely to exacerbate supply chain uncertainties, potentially disrupting goods transportation through the Red Sea. Retailers have already begun stockpiling merchandise in anticipation of shipping disruptions, while Brent crude prices have increased nearly 3% over the last five days as investors assess potential repercussions. Furthermore, ocean freight costs have surged to their highest levels since 2022 as shippers bolster security measures to safeguard cargo delivery.



- The likelihood of a major Middle East conflict with significant global economic repercussions remains low, though not nonexistent. Iran has indicated a desire for retaliation without triggering a broader conflict. The US is maintaining backchannel communications to minimize the risk of unintended escalation. Presently, we remain optimistic about tensions de-escalating within the next few weeks. However, if our assessment proves incorrect, there is a realistic possibility of direct US involvement in the war. Nevertheless, this scenario remains unlikely.

In Other News: Russian President Vladimir Putin has legalized bitcoin and crypto mining, signaling the country's intent to leverage its low-cost energy to attract investors in the burgeoning digital market. If elected in November, Republican presidential nominee Donald Trump asserts that he should have a greater say in Federal Reserve policy rate decisions. His statement is likely to fuel concerns about potential threats to the Fed's independence. UK riots have shown signs of subsiding following days of protests against immigration policies.

US Economic Releases

No major economic reports have come out so far today. There are no economic releases 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	Money Stock M2	y/y	Jul	1.4%	1.5%		**	Equity and bond neutral
	Money Stock M3	y/y	Jul	0.9%	1.0%		**	Equity and bond neutral
China	PPI	y/y	Jul	-0.8%	-0.8%	-0.9%	**	Equity and bond neutral
	CPI	y/y	Jul	0.5%	0.2%	0.3%	**	Equity and bond neutral
EUROPE								
Germany	CPI	y/y	Jul F	2.3%	2.3%	2.3%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Jul F	2.6%	2.6%	2.6%	**	Equity and bond neutral
Italy	CPI, EU Harmonized	y/y	Jul F	1.6%	1.7%	1.7%	***	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	2-Aug	$606.1b	$606.7b		***	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	2-Aug	18.30t	18.31t		*	Equity and bond neutral
AMERICAS								
Mexico	Industrial Production	y/y	Jun	-0.7%	1.0%	-0.2%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	Jun	-0.9%	-5.0%	-2.0%	*	Equity bearish, bond bullish
Brazil	IBGE Inflation IPCA	y/y	Jul	4.50%	4.23%	4.47%	***	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)	537	532	5	Down
3-mo T-bill yield (bps)	507	509	-2	Down
U.S. Sibor/OIS spread (bps)	512	513	-1	Down
U.S. Libor/OIS spread (bps)	510	510	0	Down
10-yr T-note (%)	3.94	3.99	-0.05	Down
Euribor/OIS spread (bps)	358	357	1	Down
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Flat			Up
Yen	Up			Up
Pound	Flat			Up
Franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Mexico Overnight Rate	10.750%	11.000%	10.750%	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	$79.57	$79.16	0.52%	
WTI	$76.69	$76.19	0.66%	
Natural Gas	$2.15	$2.13	1.03%	
12-mo strip crack	$21.51	$21.61	-0.48%	
Ethanol rack	$1.95	$1.95	-0.30%	
Metals				
Gold	$2,425.46	$2,427.53	-0.09%	
Silver	$27.49	$27.54	-0.21%	
Copper contract	$403.25	$395.90	1.86%	
Grains				
Corn contract	$397.50	$397.00	0.13%	
Wheat contract	$546.25	$537.50	1.63%	
Soybeans contract	$1,013.00	$1,008.25	0.47%	
Shipping				
Baltic Dry Freight	1,683	1,698	-15	
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)	21	25	-4	

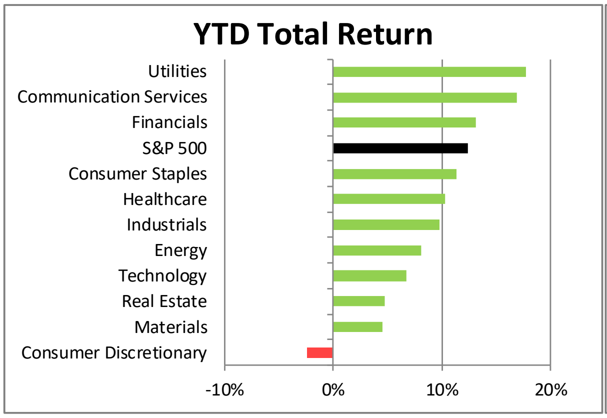
Weather

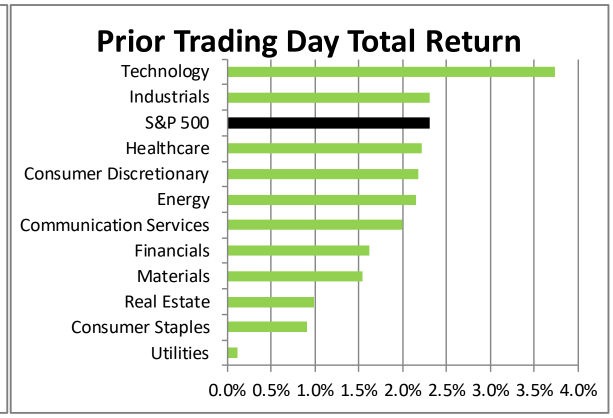
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in the Rocky Mountains, Great Plains, Midwest, and Southeast, with cooler-than-normal temperatures along the West Coast and in the mid-Atlantic states. The forecasts call for wetter-than-normal conditions in the Pacific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

Post-Tropical Cyclone 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 is also now a new atmospheric disturbance in the central Atlantic Ocean, which is moving westward toward the Caribbean Sea. However, it is assessed to have no chance of forming into a cyclone in the next 48 hours.

Data Section

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

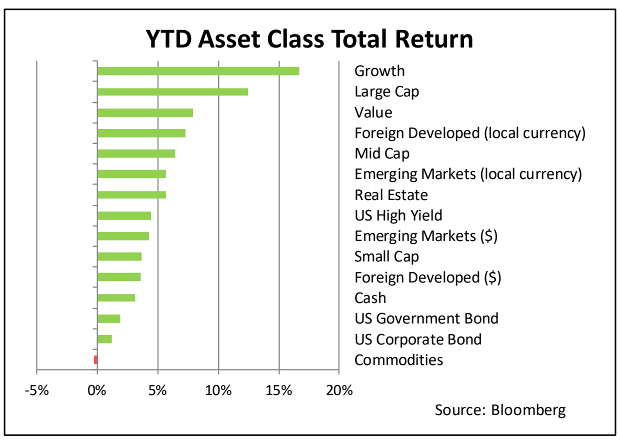




(Source: Bloomberg)

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 8/8/2024 close)

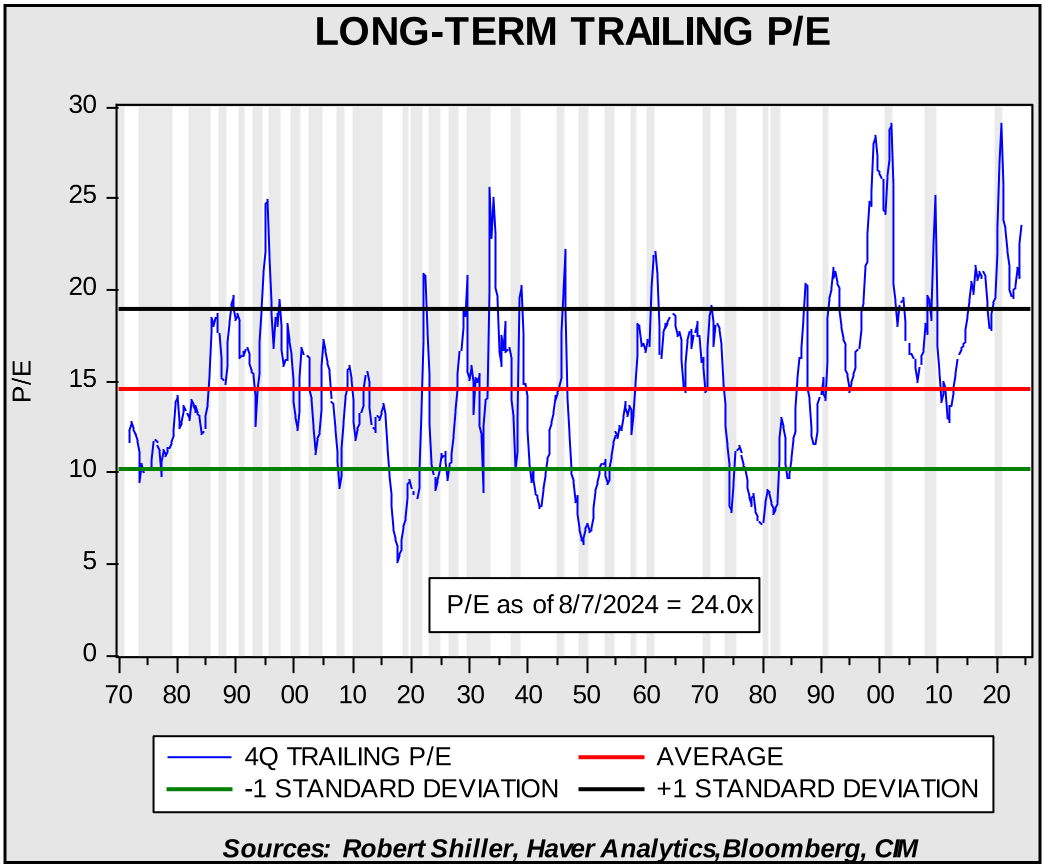


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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.