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: July 10, 2024—9:30 AM ET] Global equity markets are mostly higher this morning. In Europe, the Euro Stoxx 50 closed up 0.6% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.1%. Chinese markets were lower, with the Shanghai Composite down 0.7% from its previous close and the Shenzhen Composite down 0.4%. US equity index futures are signaling a higher open.

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:

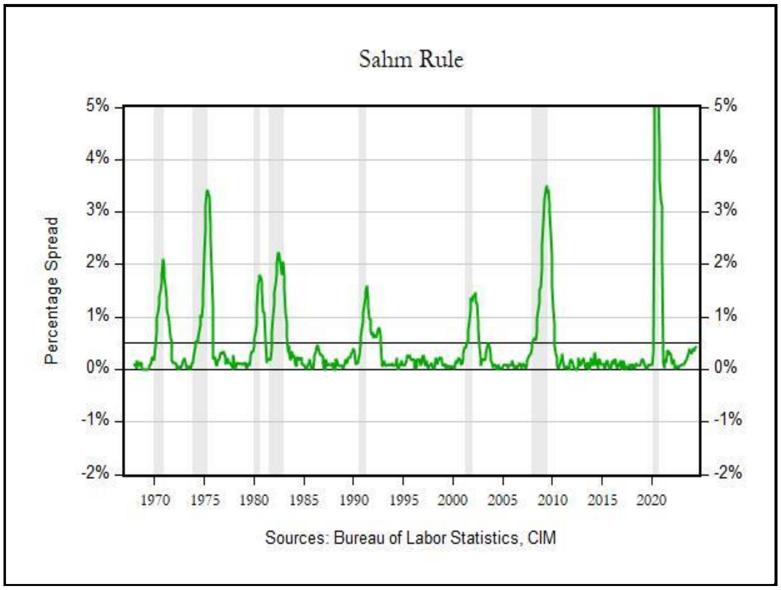
- *Bi-Weekly Geopolitical Report* (7/1/2024) (with associated podcast): "The EU Parliamentary Elections: New Strength for the Right"
- *Asset Allocation Bi-Weekly* (6/24/2024) (with associated podcast): "Small Caps and the Hope for a Soft Landing" *(Note: the next AABW report will be published 7/15/24)*

Good morning! Equity futures are off to a great start ahead of Federal Reserve Chair Powell's second day of testimony. In sports news, Spain has successfully knocked out France in the Euro semifinal. Today's *Comment* discusses how Powell has opened the door for a policy shift, the reasons emerging markets are likely to continue building up their gold reserves, and why Brazilian President Lula may be forced to make uncomfortable decisions to protect the country's currency. As usual, the report includes a roundup of international and domestic news.

Powell Talks to Congress: The Fed Chair mostly stuck to the script during his testimony, but he gave subtle hints that the central bank might be considering goals beyond its inflation mandate.

- Fed Chair Jerome Powell expressed growing concern about the labor market for the first time on Tuesday. During his testimony, he mentioned that recent employment data prompted him to reconsider his views on the economy, as unemployment rose to 4.1% in June, slightly above the median year-end estimate outlined in the Fed's summary of economic projections. While he acknowledged that further measures are necessary to achieve the Fed's 2% inflation target, he cautioned that an excessive focus on inflation could negatively impact the economy.
- While Powell did not specify a timeline, the market still anticipates a rate cut from the central bank in September. The latest CME Fedwatch tool shows that investors believe there is a 75% chance the central bank will lower interest rates before the election. This is a sharp increase from over a month ago, when the indicator suggested a less than 50%

chance. The boost in confidence appears to be a response to a string of weaker-than-expected economic data over the last couple of months. In addition to a rising unemployment rate, retail sales and personal consumption have also been disappointing.



- Powell's testimony before Congress reinforces our earlier view from May that the Fed is preparing for a rate cut based on labor market conditions rather than inflation. Since we made that call, the unemployment rate has risen for the fourth consecutive month and is now approaching the Sahm Rule threshold, an indicator of recession. The Sahm Rule is triggered when the three-month moving average of the unemployment rate climbs 0.5% above the lowest rate of the past 12 months. If the unemployment rate reaches 4.2% within the next two months, it may be sufficient to prompt a rate cut.

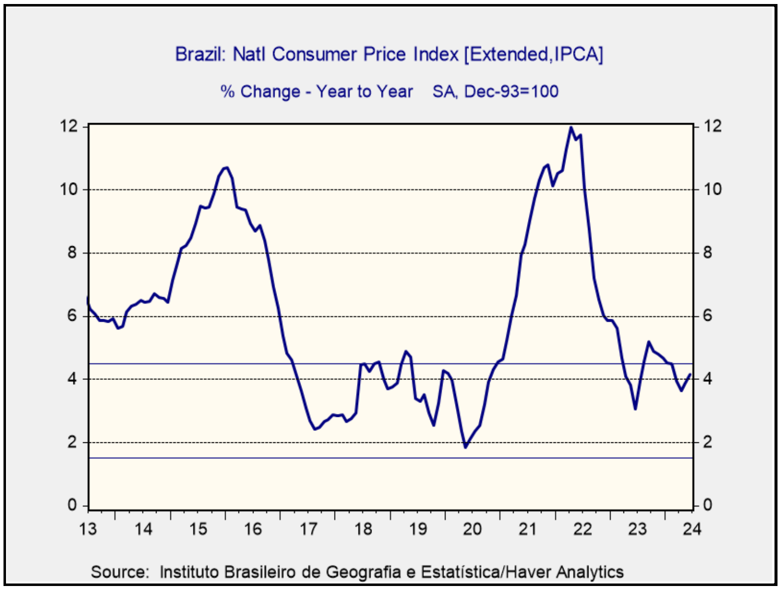
Bullion on the Rise: More emerging market countries are showing a preference for holding gold as they look to diversify their reserve holdings.

- Nigerian lawmakers are drafting legislation that would empower the Central Bank of Nigeria to hold a larger share of its reserves in gold. The bill prioritizes domestically produced gold for acquisition and proposes raising the minimum gold reserves from 4% to at least 30% of total external reserves. The decision to ramp up the holdings comes as the country struggles to contain its inflation and repay its debts, since a rising US dollar has made imports more expensive and interest payments more burdensome.
- Emerging markets are increasingly diversifying their foreign reserves, reflecting concerns about the West's use of the dollar as a financial weapon after Russia's invasion of Ukraine. This trend is likely to continue as these countries aim to increase their gold holdings, which currently represent only 6% of their reserves, roughly half the level in developed markets. Notably, India repatriated 100 tons of gold from the UK just before its recent elections, and China had been actively accumulating gold for 18 months, adding 300 tons before pausing purchases in May.

- While Nigeria's actions alone might not significantly impact global markets, emerging markets as a whole have the potential to do so. Their increasing holdings of reserve currencies reflect a broader trend likely to be followed by other central banks in these economies. However, the People's Bank of China (PBoC) will likely be the most watched central bank during this transition as it seeks to reduce its reliance on the US dollar. As a result, we expect gold prices could be on the verge of an upward trend over the next few years.

Lula and the Currency: Brazilian President Luiz Inácio Lula da Silva's plan to deliver renewed economic prosperity is under threat as the Brazil real continues to plummet against the dollar.

- On Tuesday, Gabriel Galipolo, the overseer of currency intervention in Brazil, stated that he does not plan to prop up the currency without the full support of the central bank board. His comments come as the currency has fallen 10% since the start of the year, making it the second-worst-performing currency in Latin America behind only the Argentine peso. While he has the power to use over 2.5% of the country's international reserves to protect the currency, his reluctance appears to be driven by concerns that the market could undermine his efforts.
- The currency's weakness stems from concerns about the country's fiscal and monetary future. Earlier this year, Brazil relaxed its fiscal target for 2025, aiming for a balanced primary budget, which excludes interest payments, instead of the previous year's goal of achieving a surplus. Additionally, there are concerns that Lula will replace the current central bank head, Roberto Campos Neto, with the aforementioned Galipolo. Although inflation remains within the 1.5% tolerance range of the 3% target, there are fears that Galipolo might cut rates prematurely to help boost growth.



- The attractiveness of Brazilian assets hinges on Lula's ability to convince investors of his commitment to central bank independence and fiscal responsibility. His past criticism of the central bank has undermined its credibility as an independent institution. Additionally, a higher-than-expected increase in public spending has fueled concerns about his adherence to budget goals. In the short term, this trend is unlikely to change. However, a shift toward central bank independence and fiscal discipline could make Brazil a more attractive investment destination.

In Other News: Colorado Senator Michael Bennet has officially requested President Joe Biden to end his bid for re-election. This shows that Biden is still facing intense pressure to pass the torch. BP raised its outlook on demand for oil and gas as it sees a moderation in the clean energy transition. This could lead to higher energy prices.

US Economic Releases

The Mortgage Bankers Association today said ***mortgage applications*** in the week ended July 5 fell 0.2% compared to last week's decline of 2.6%. Applications for home purchase mortgages rose 1.0%, constituting a reversal of last week's 3.3% decline. Meanwhile, applications for refinancing mortgages fell 2.2%, extending last week's decline of 1.5%. According to the report, the average interest rate on a 30-year mortgage essentially held steady at 7.0% compared to 7.03% the previous week. These numbers indicate a bit of churn in the market without revealing any new trend.

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 Trade Sales	m/m	May	0.3%	0.1%	*
10:00	Wholesale Inventories	m/m	May F	0.6%	0.6%	**
Federal Reserve						
ET	Speaker or Event	District or Position				
10:00	Jerome Powell Testifies to House Financial Services	Chairman of the Board of Governors				
12:45	Austan Goolsbee & Michelle Bowman Give Opening Remarks at Childcare Event	President of the Federal Reserve Bank of Chicago & FED Governor				
9:10	Lisa Cook Speaks on Global Inflation, Monetary Policy	Member of the Board of Governors				

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	PPI	y/y	Jun	2.9%	2.6%	2.9%	***	Equity and bond neutral
South Korea	Unemployment Rate	m/m	Jun	2.8%	2.8%	2.8%	***	Equity and bond neutral
China	PPI	y/y	Jun	-0.8%	-1.4%	-0.8%	**	Equity and bond neutral
China	CPI	y/y	Jun	0.2%	0.3%	0.4%	**	Equity and bond neutral
EUROPE								
Italy	Industrial Production	y/y	May	-3.3%	-3.0%		***	Equity and bond neutral
AMERICAS								
Mexico	International Reserves Weekly	w/w	5-Jul	$220389m	$219997m	--	*	Equity and bond neutral
Brazil	IBGE Inflation IPCA	y/y	Jun	4.23%	3.93%	4.32%	***	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)	557	557	0	Up
3-mo T-bill yield (bps)	522	521	1	Up
U.S. Sibor/OIS spread (bps)	530	531	-1	Down
U.S. Libor/OIS spread (bps)	530	531	-1	Down
10-yr T-note (%)	4.27	4.30	-0.03	Down
Euribor/OIS spread (bps)	371	370	1	Down
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Up			Up
Yen	Flat			Down
Pound	Up			Up
Franc	Flat			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
RBNZ Official Cash Rate	5.500%	5.500%	5.500%	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	$84.40	$84.66	-0.31%	
WTI	$81.20	$81.41	-0.26%	
Natural Gas	$2.36	$2.34	0.55%	
12-mo strip crack	$22.24	$22.52	-1.27%	
Ethanol rack	$2.10	$2.12	-1.17%	
Metals				
Gold	$2,378.32	$2,364.09	0.60%	
Silver	$31.06	$30.80	0.84%	
Copper contract	$460.00	$457.75	0.49%	
Grains				
Corn contract	$406.25	$408.50	-0.55%	
Wheat contract	$568.00	$572.00	-0.70%	
Soybeans contract	$1,078.75	$1,080.00	-0.12%	
Shipping				
Baltic Dry Freight	1,894	1,940	-46	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.00		
Gasoline (mb)		-1.00		
Distillates (mb)		5.00		
Refinery run rates (%)		-0.1%		
Natural gas (bcf)		55		

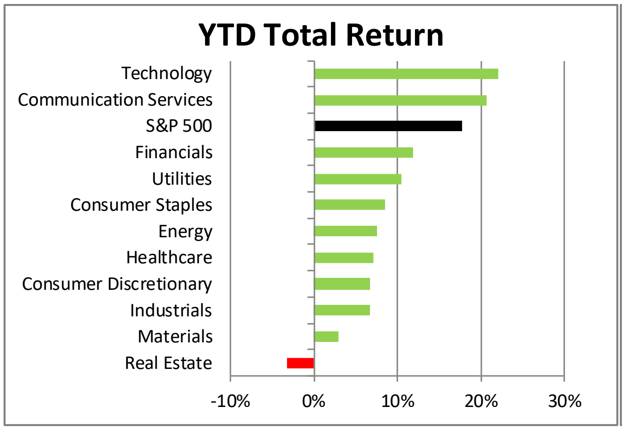
Weather

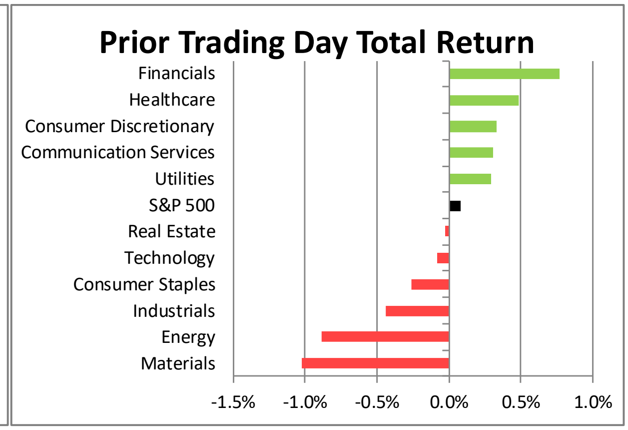
The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures across the entire continental United States. The precipitation outlook calls for wetter-than-normal conditions in the southern half of the East Coast, Texas, and the Desert Southwest, with dry conditions in Montana.

The remnants of Hurricane Beryl will continue to bring rain to the Ohio Valley over the course of the week. Meanwhile, a broad trough of low pressure has formed off the coast roughly parallel to Jacksonville, Florida. While expected to move inland over the next few days with heavy showers in tow, conditions do not favor cyclonic development.

Data Section

US Equity Markets – (as of 7/9/2024 close)

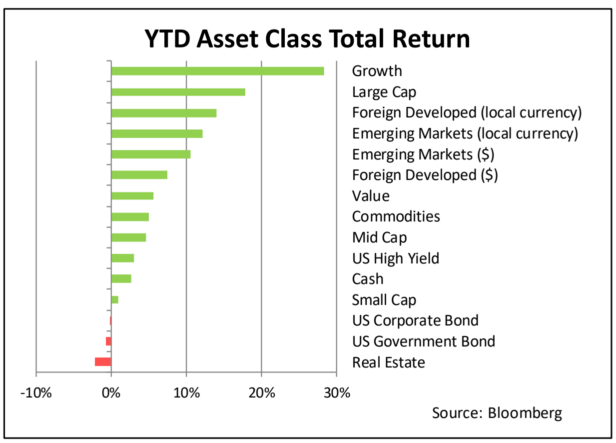




(Source: Bloomberg)

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 7/9/2024 close)

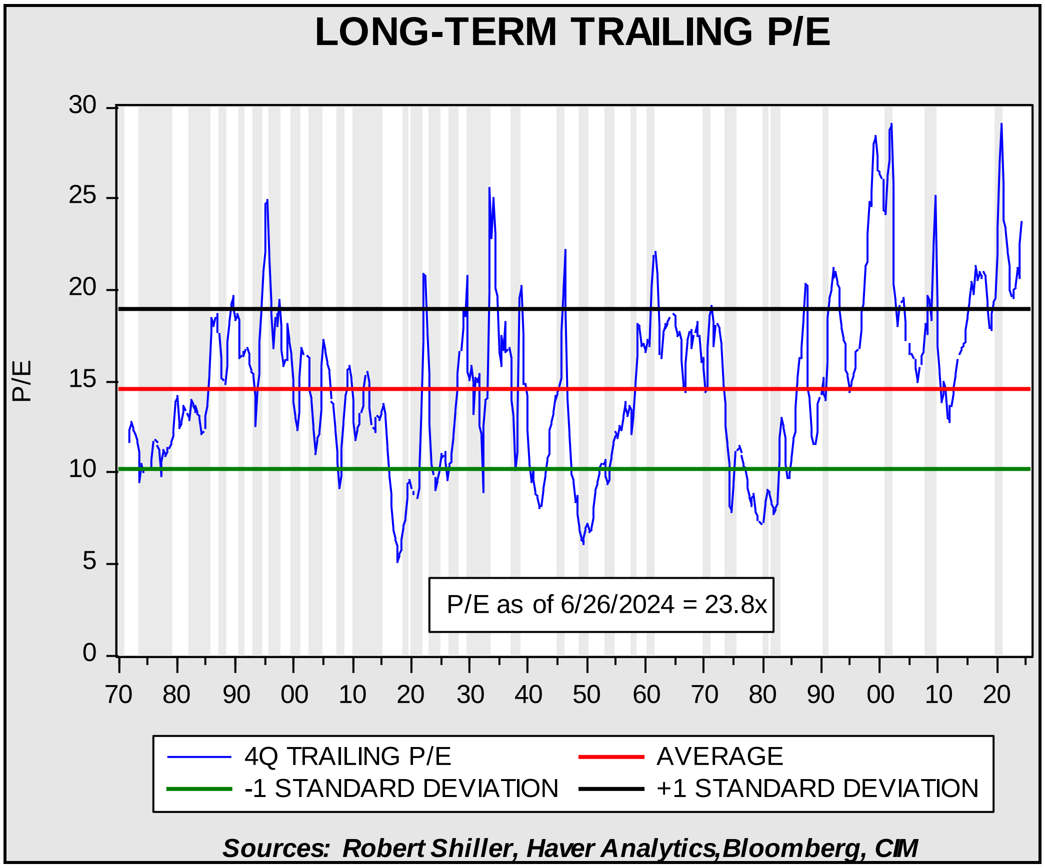


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

June 27, 2024



Based on our methodology,[1] the current P/E is 23.8x, up 0.1 from our last report. The increase in the multiple was due to an increase in the stock price index offsetting a slight 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.