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 11, 2024—9:30 AM ET] Global equity markets are generally higher this morning. In Europe, the Euro Stoxx 50 closed up 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.7%. Chinese markets were higher, with the Shanghai Composite up 1.1% from its previous close and the Shenzhen Composite up 2.4%. Conversely, US equity index futures are signaling a flat 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:

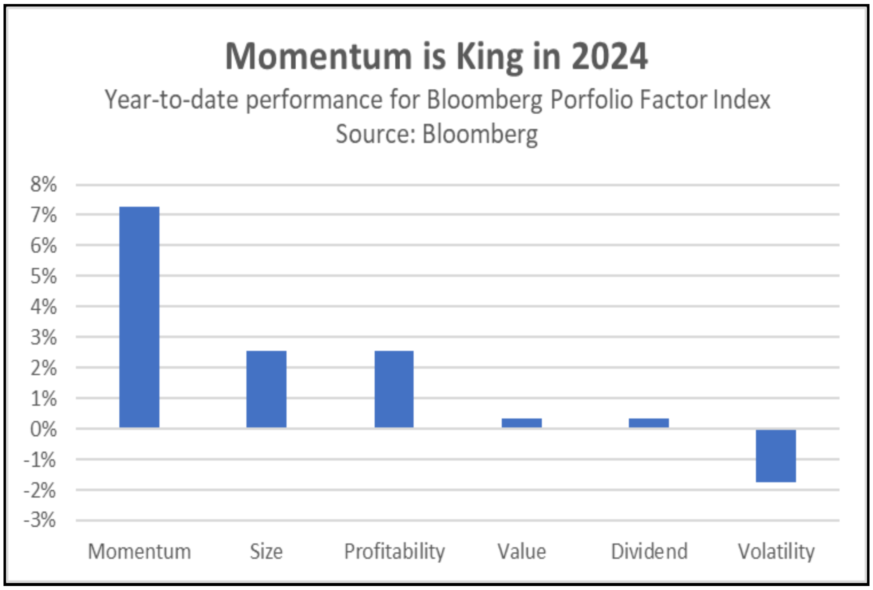
- *Bi-Weekly Geopolitical Report* (7/1/2024) (with associated podcast): “The EU Parliamentary Elections: New Strength for the Right”
- *Asset Allocation Bi-Weekly* (6/24/2024) (with associated podcast): “Small Caps and the Hope for a Soft Landing” *(Note: the next AABW report will be published 7/15/24)*

Good morning! S&P 500 futures have cooled this morning following favorable inflation data. In sports news, England defeated the Netherlands in the semifinals and will now play Spain in the Euro final. Today’s *Comment* will begin by examining the significant role that momentum has played in the market rally, followed by a discussion on why uranium remains a commodity with substantial upside potential for investors. We will also provide an update on the UK in the wake of the Labour Party's recent victory. As usual, the report will conclude with a roundup of international and domestic data releases.

Momentum Propels Large Cap: The S&P 500 leapt past 5,600 for the first time ever on Wednesday, as investors piled into large-cap stocks in anticipation of a Federal Reserve policy shift.

- The market surged following comments made by Fed Chair Powell during his second day of testimony on Capitol Hill. While speaking with lawmakers, Powell stated that although he does not believe the central bank is ready to cut interest rates, Fed officials will not wait for inflation to fall to the 2% target before making a cut and will do so regardless of the upcoming election. Risk assets rose following his remarks, with the S&P 500 climbing 1.0% on the day and the Magnificent Seven stocks increasing by 1.2%.
- The S&P 500's record high might mask a troubling truth: many underlying companies lack the fundamentals to justify the rally. Bloomberg data confirms this, showing momentum chasing and a focus on large caps have dominated investment returns in 2024.

Investors have been relentlessly buying a limited pool of large-cap stocks at any hint of good news, inflating their portfolios. In an uncertain economic climate with rising interest rates and inflation, investors are seeking stability and believe larger, established companies with growth potential will be better positioned to weather these headwinds.

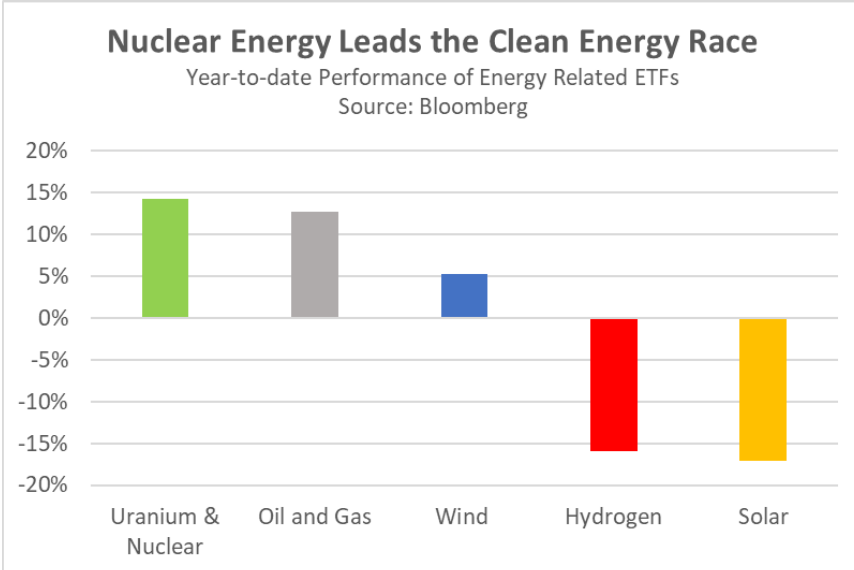


- The S&P 500's momentum dependence exposes it to steeper losses in the future. Mega-cap tech stocks, leading the large-cap surge, appear particularly inflated, making them more vulnerable if investor sentiment weakens. This concern is amplified as earnings season approaches and firms such as Nvidia are expected to meet lofty expectations. However, while we remain optimistic about equities overall, mid-cap and small-cap stocks might be better suited for this environment. They offer not only a lower correction risk but also the potential for more upside if interest rates fall.

Uranium Popularity: While renewables gain momentum, nuclear energy from uranium remains a powerful tool for countries transitioning away from fossil fuels.

- On Wednesday, President Biden signed legislation aimed at promoting the development of advanced nuclear reactors. The new law will cut licensing times and processing fees, making it easier for companies to bring these clean energy sources online. While nuclear power currently generates about 20% of US electricity, development has been hampered by cost concerns and unpredictable permitting timelines. The passage of this legislation should make it easier for firms to capitalize on clean energy incentives and offer potential solutions to concerns over the rising energy use of artificial intelligence (AI) technology.
- Fueled by the insatiable energy demands of AI, big tech giants are leading the charge in adopting nuclear power. A *Wall Street Journal* report reveals that one-third of US nuclear plant owners are in talks with tech firms to discuss the powering of data centers, with Amazon on the cusp of a deal with the nation's largest nuclear company. This surge in demand is prompting utility companies like Dominion Energy Virginia and Bill Gates'

TerraPower to develop the first of their own commercially viable small modular reactor (SMR) in the US.

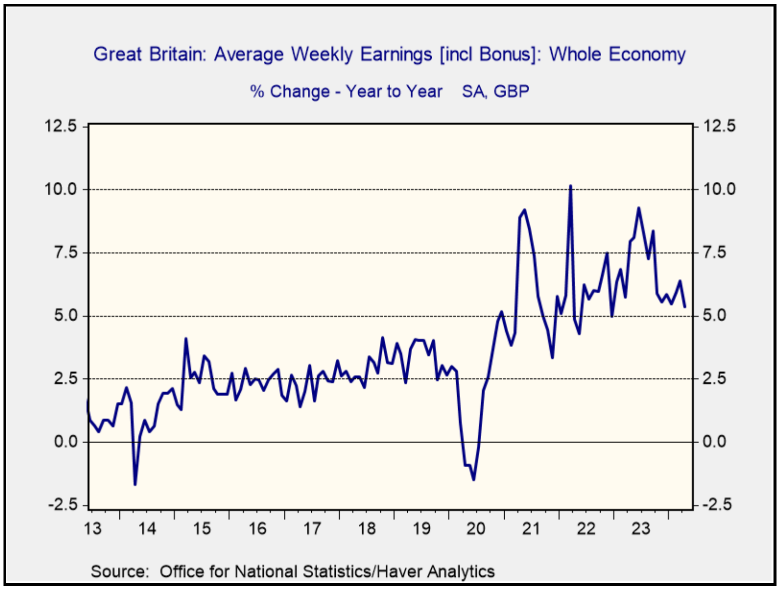


- Uranium and nuclear power stocks have skyrocketed this year, eclipsing the broader market. This surge is likely driven by a widening supply-demand gap for uranium. Booming AI and the global push for clean energy are fueling demand, while uranium production capacity lags behind. To bridge this gap, countries are expected to invest heavily in SMRs due to their lower cost and faster deployment timelines. While a near-term correction can't be ruled out, we believe nuclear companies remain a compelling long-term investment.

The UK Comeback: A surprise surge in economic growth has likely eased concerns about the UK's debt burden, but also strengthens the case for keeping interest rates high.

- The UK economy defied expectations with a robust 0.4% expansion in May. This is a significant improvement over the previous month's flat growth and double the forecasted rate for the period. The surge was fueled by a rebound in construction activity, which had been lagging for three months, and an increase in manufacturing production. This positive data strengthens the Labour Party's position as they navigate economic policy. They can potentially avoid austerity measures while still promoting growth, all within the constraints of fiscal rules that require a balanced budget.

- However, the stronger-than-expected economic data likely diminishes the prospect of an interest rate cut at the next Bank of England meeting. The central bank had previously anticipated a slowdown to 0.2% growth in the second quarter, down from 0.7% in the first. The recent data suggests the quarter will exceed the estimates. Further complicating a rate cut, some voting members, including Huw Pill, have reportedly expressed concerns about high services inflation and wage growth leading to further price pressures.

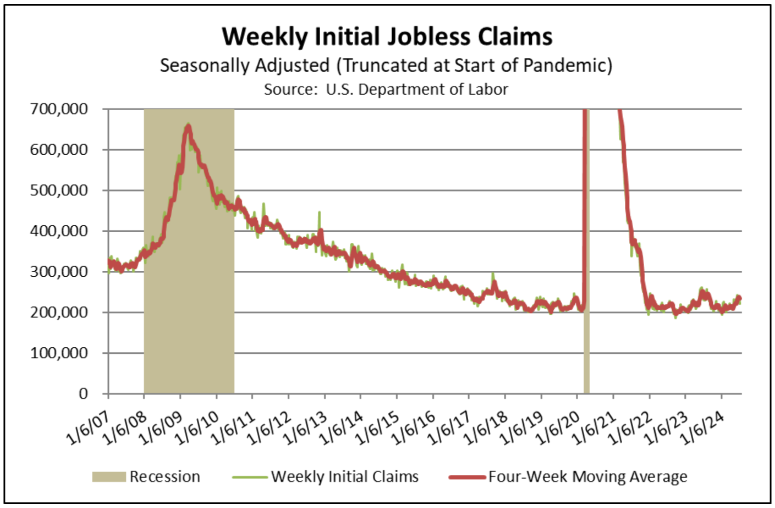


- Strong economic growth is poised to bolster the attractiveness of UK assets, especially for value investors seeking bargains. British companies currently trade at a discount compared to their US peers, presenting a potential opportunity. Furthermore, the prospect of the Bank of England maintaining higher interest rates for longer than the market anticipated at the start of the year should help stabilize the pound (GBP) against the US dollar. While we remain skeptical of the UK market due to the Labour Party's proposals, the overall sentiment towards the pound is improving.

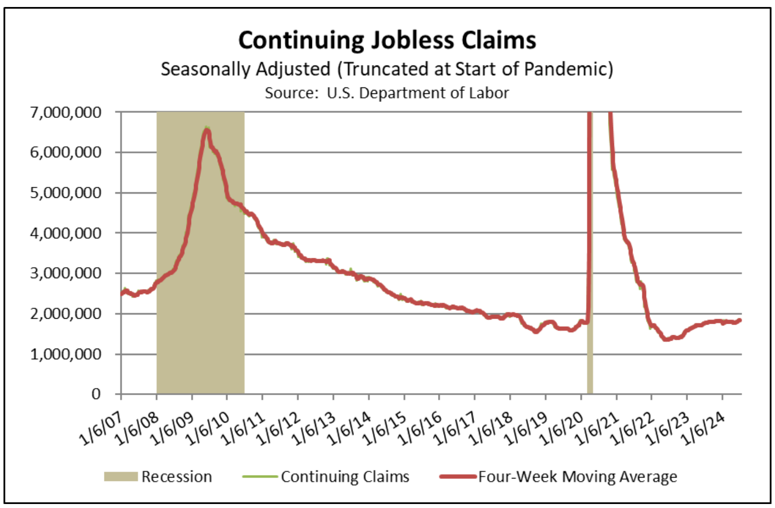
Other News: Prominent Democrats and donors continue to urge Joe Biden to step aside, highlighting ongoing uncertainty about the party's presidential nominee. In other news, Apple will not face fines from the EU after deciding to allow other providers to use its wallet technology for free. This decision underscores the impact of regulations on Big Tech earnings. Meanwhile, US officials are frustrated with India and Saudi Arabia for maintaining relationships with both sides of the conflict in Ukraine. This development illustrates how some countries can avoid aligning exclusively with either the US or China.

US Economic Releases

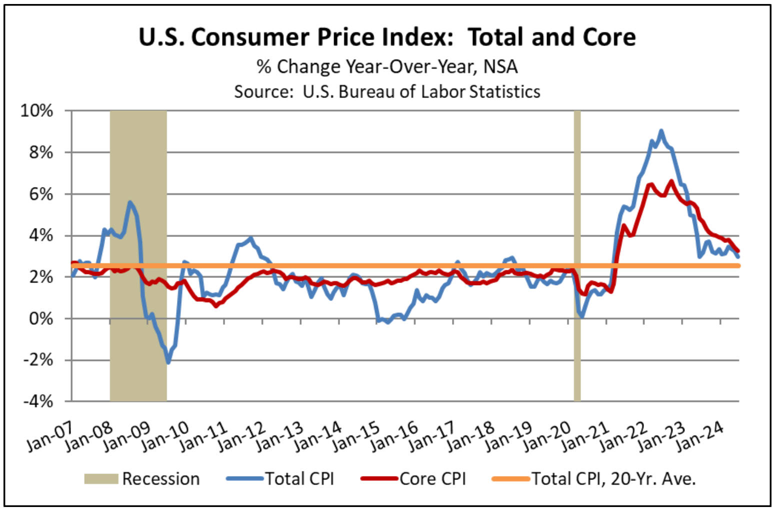
In the week ended July 6, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 222,000, below both the expected level of 235,000 and the previous week's revised level of 239,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to 233,500. However, it remains elevated compared with the readings over the last couple of years, helping confirm that labor demand in the US has cooled and potentially helping prompt the Fed to start cutting interest rates. 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 June 30, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) fell to a seasonally adjusted 1.852 million, below both the anticipated reading of 1.860 million and the prior week's revised reading of 1.856 million. The four-week moving average of continuing claims rose to 1,840,250, reaching its highest level since December 2021 and providing more evidence that the demand for labor has cooled. 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.



Separately, the June ***consumer price index (CPI)*** unexpectedly fell by a seasonally adjusted 0.1%. Not only did that mark the first outright decline in the index since May 2020, but it was also completely the opposite of the expected rise of 0.1%. The overall index had been flat in May. Excluding the volatile food and energy components, the June ***"core" CPI*** rose 0.1%, but it had been expected to rise 0.2%, just as it did in the previous month. The overall CPI in June was up just 3.0% from the same month one year earlier. The core CPI was up 3.3% on the year, posting its weakest annual gain since April 2021. The chart below shows the year-over-year change in the CPI and the core CPI since 1980.



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
14:00	Monthly Budget Statement	m/m	Jun	-$76.0b	-$347.1b	**
Federal Reserve						
ET	Speaker or Event	District or Position				
11:15	Raphael Bostic Speaks in Moderated Q&A	President of the Federal Reserve Bank of Atlanta				
13:00	Alberto Musalem Speaks in Q&A on Economy	President of the Federal Reserve Bank of St. Louis				

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	5-Jul	-¥555.6b	-¥488.8b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	5-Jul	¥603.7bb	¥185.0b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	5-Jul	-¥228.8b	-¥124.9b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	5-Jul	-¥237.7b	-¥254.2b		*	Equity and bond neutral
	Core Machine Orders	y/y	May	10.8%	0.7%	7.1%	**	Equity bullish, bond bearish
New Zealand	Food Prices	m/m	Jun	1.0%	-0.2%		***	Equity and bond neutral
EUROPE								
Germany	CPI	y/y	Jun F	2.2%	2.2%	2.2%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Jun F	2.5%	2.5%	2.5%	**	Equity and bond neutral
UK	Industrial Production	y/y	May	0.4%	-0.7%	0.6%	***	Equity and bond neutral
	Manufacturing Production	y/y	May	0.6%	-0.4%	1.2%	**	Equity bearish, bond bullish
	Construction Output YoY	m/m	May	0.8	-2.1	-1.8	*	Equity bearish, bond bullish
	Visible Trade Balance GBP/Mn	m/m	May	-£17917m	-£19442m	-£16600m	**	Equity and bond neutral
	Trade Balance GBP/Mn	m/m	May	-£4894m	-£6423m	-£2850m	**	Equity and bond neutral
AMERICAS								
Brazil	Retail Sales	y/y	May	8.2%	2.2%	4.4%	***	Equity bullish, bond bearish

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	Flat
3-mo T-bill yield (bps)	522	523	-1	Up
U.S. Sibor/OIS spread (bps)	530	530	0	Down
U.S. Libor/OIS spread (bps)	530	531	-1	Down
10-yr T-note (%)	4.29	4.29	0.00	Down
Euribor/OIS spread (bps)	370	371	-1	Down
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Flat			Down
Pound	Up			Up
Franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Korea Base Rate	3.500%	3.500%	3.500%	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	$85.24	$85.08	0.19%	
WTI	$82.17	$82.10	0.09%	
Natural Gas	$2.32	$2.33	-0.47%	
12-mo strip crack	$22.09	$22.00	0.42%	
Ethanol rack	$2.08	$2.09	-0.46%	
Metals				
Gold	$2,379.94	$2,371.26	0.37%	
Silver	$30.90	$30.82	0.29%	
Copper contract	$457.40	$460.85	-0.75%	
Grains				
Corn contract	$410.25	$407.25	0.74%	
Wheat contract	$571.75	$561.50	1.83%	
Soybeans contract	$1,072.50	$1,067.00	0.52%	
Shipping				
Baltic Dry Freight	1,939	1,894	45	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-3.44	1.00	-4.44	
Gasoline (mb)	-2.01	-1.00	-1.01	
Distillates (mb)	4.88	0.50	4.38	
Refinery run rates (%)	1.9%	-0.1%	2.0%	
Natural gas (bcf)		56		

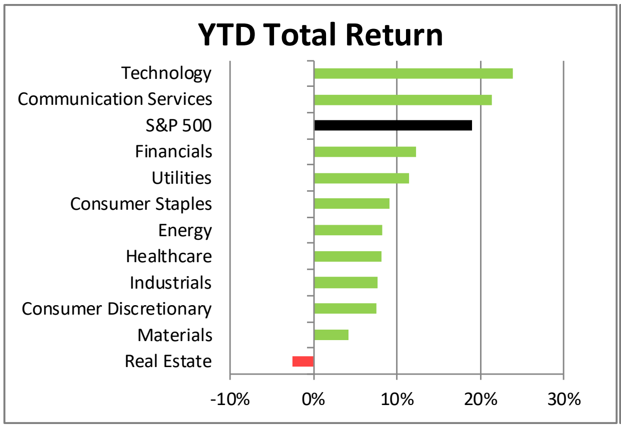
Weather

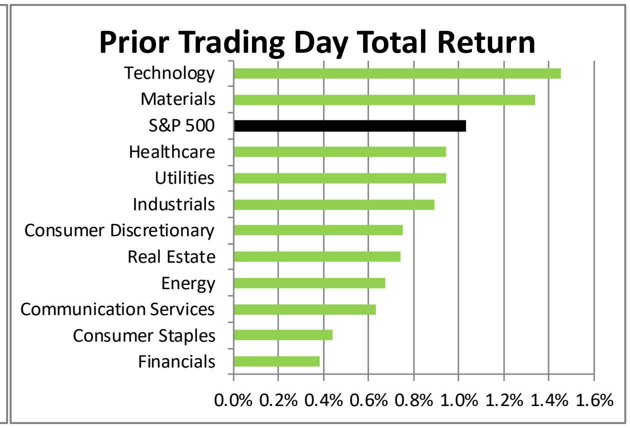
The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures across the entire country except for the Midwest and the Southwest, where temperatures will be near normal. The forecasts call for wetter-than-normal conditions in the southern Rocky Mountains, the southern Great Plains, and the Southeast, with dry conditions in the Northern Tier states.

There is currently only one atmospheric disturbance in the Atlantic Ocean area, located a few hundred miles off the coast of Georgia and Florida. It is assessed to have only a 10% chance of becoming a cyclone, but it is nonetheless expected to bring heavy rains to the Carolinas by the weekend.

Data Section

US Equity Markets – (as of 7/10/2024 close)

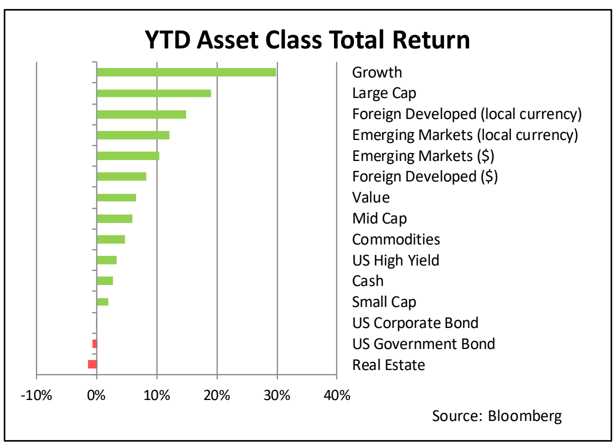




(Source: Bloomberg)

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 7/10/2024 close)

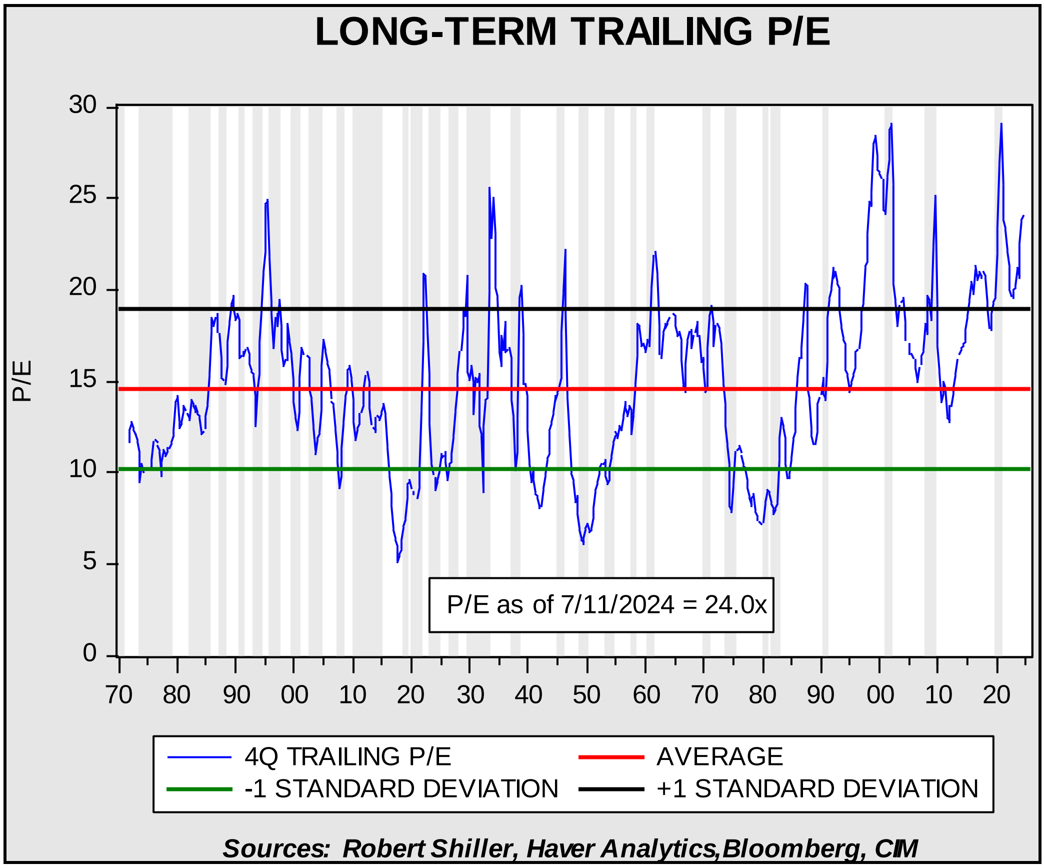


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

July 11, 2024



Based on our methodology,[1] the current P/E is 24.0x, up 0.2 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.

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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.