# 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 12, 2024—9:30 AM ET]** Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 closed up 0.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.4%. 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 mildly 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:

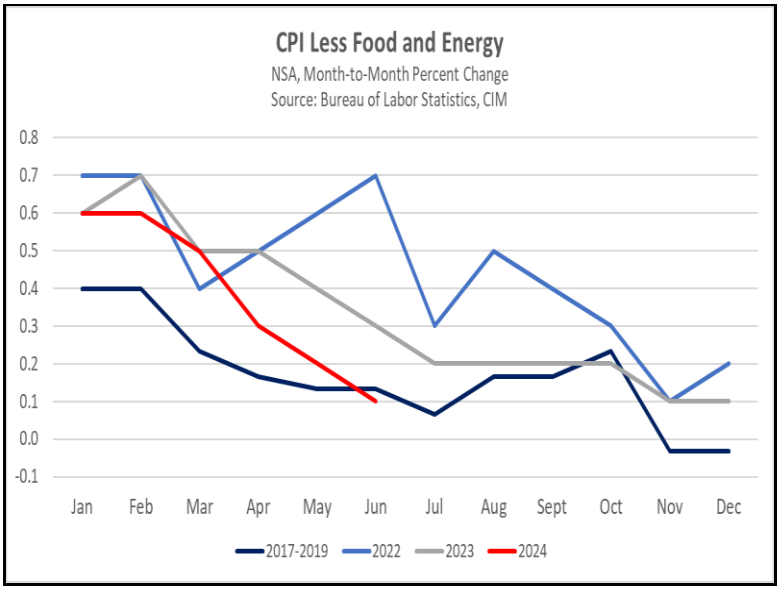
- *Bi-Weekly Geopolitical Report* (7/1/2024) (with associated podcast): "The EU Parliamentary Elections: New Strength for the Right"
- *Asset Allocation Bi-Weekly* (6/24/2024) (with associated podcast): "Small Caps and the Hope for a Soft Landing" *(Note: the next AABW report will be published 7/15/24)*

Good morning! Equities are relatively muted as investors await earnings reports. In sports news, the USMNT is looking to hire Jürgen Klopp as head coach. Today's *Comment* will begin with a discussion of the latest CPI report, then will explore why small caps are showing signs of life, and we will wrap up with a look at the challenges Russia faces in navigating a smooth exit from the war. As always, our report will include a roundup of international and domestic data releases.

**Inflation Inflection Point?** The cooler-than-expected CPI report fueled market optimism for a potential Fed rate cut in September.

- June marked the first time in nearly four years that inflation has dipped. Consumer prices fell 0.1% month-over-month, according to the Bureau of Labor Statistics. This slowdown brought the annual inflation rate down to 3.0% in June, a decrease from 3.3% in May. While energy prices led the monthly decline, the slowdown was more widespread. Core inflation, which excludes volatile food and energy, held steady at 0.1% for the month. However, annual core inflation slipped to 3.3%, a slight improvement from the previous month's increase of 3.4%.

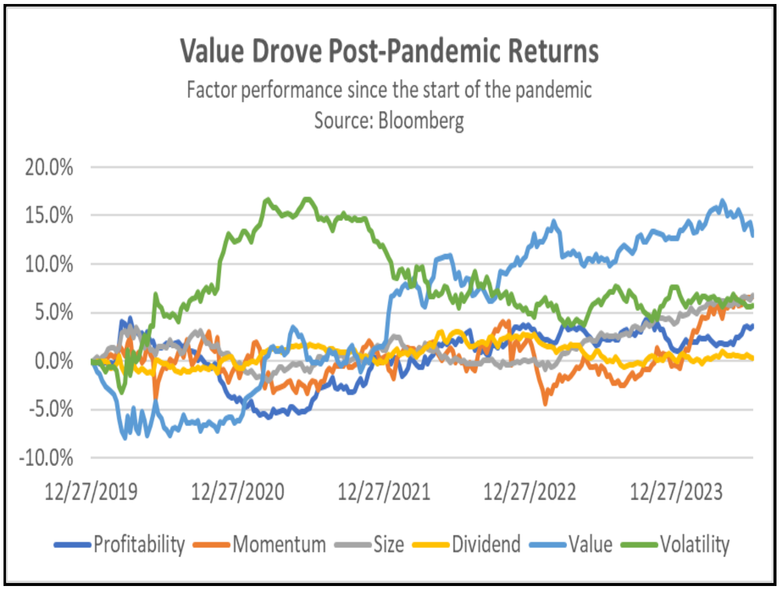
- The recent slowdown in price increases is likely to be welcomed by Federal Reserve officials. However, it may not be sufficient to prompt a rate cut at their next meeting. St. Louis Fed President Alberto Musalem commented that while the CPI data is encouraging, more evidence is needed before the central bank decides to lower interest rates. Financial markets seem to agree, pricing in only a 7% chance of a cut this month, but a much higher 94% chance by September. This cautious stance reflects concerns about overreacting to a single month of positive data.




- The coming months are critical for the Fed to build confidence in delivering multiple rate cuts this year. As the chart above shows, inflation has expanded at a slower pace than it has in the previous two years, with the latest reading falling below levels that were normal even prior to the pandemic. We will be paying particular attention to the shelter component. If it holds steady at June's 0.2% pace or declines further, inflation is likely to continue its downward trend. This could lead to two rate cuts, with a possibility of even three.

**Small Cap Has Its Moment:** Thursday's inflation surprise triggered a risk-on mood among investors, fueled by renewed confidence in a soft landing.

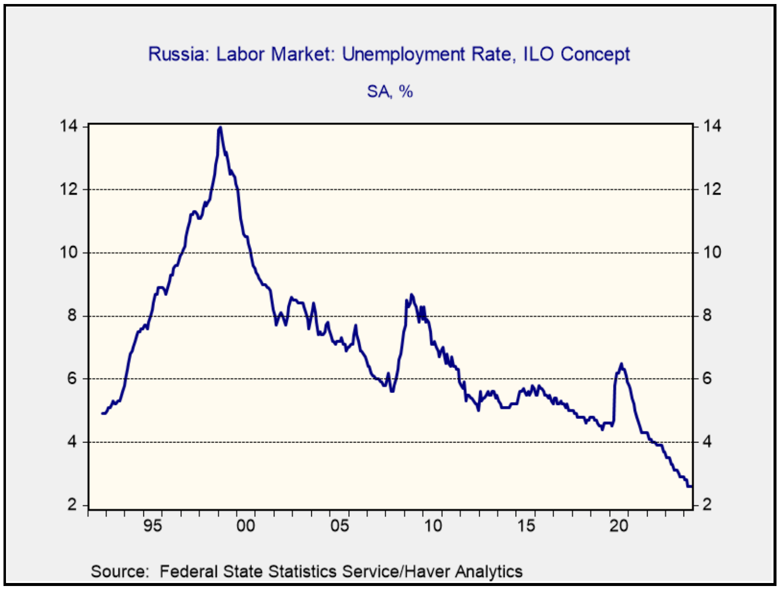
- Investors initially sought refuge in the S&P 500 after inflation data emerged. However, the trading day witnessed a significant rotation towards mid- and small-cap stocks. The large-cap index climbed as high as 1.0% midday but ultimately closed down 0.8%. Meanwhile, the S&P MidCap 400 and S&P SmallCap 600 indexes surged, gaining 2.45% and 3.31% respectively. Their strong outperformance relative to large cap was driven by investors looking for bargains as they prepare for the possibility of rate cuts.
- Our latest *Bi-Weekly Asset Allocation Report* underscores the potential for small-cap stocks to outperform in a scenario where interest rates are cut. This optimistic outlook hinges on two key factors. First, small-cap companies tend to hold a greater share of floating-rate debt, making them more responsive to interest rate reductions that directly translate to improved profitability. Second, the valuation gap between small and large caps has widened to near-historic levels. Historically, such a spread has triggered mean reversion, where undervalued assets experience a surge to close the gap.




- Momentum undeniably fueled returns in 2024, but value investing holds a proven track record for long-term outperformance. As the chart illustrates, value stocks recovered from an initial pandemic dip to become the strongest driver of returns compared to other factors. This trend should persist as long as the economy is not in recession, inflation approaches the 2% target, and the Fed implements multiple rate cuts over the next three years. While we're confident in these conditions prevailing, a worsening geopolitical climate could disrupt this scenario.

**Moscow's Poker Face:** While NATO continues to demonstrate its commitment to backing Ukraine's war effort, Moscow may not be in a rush to end the conflict.

- NATO leaders solidified a united front at their summit on Thursday, emphasizing shared concerns over territorial disputes with China and Russia. The deepening Sino-Russian relations particularly alarmed the leaders, who viewed them as a potential challenge to the established international order. Discussions also addressed accusations of China's covert support for Russia's actions in Ukraine, despite Beijing's claims of neutrality. Western leaders further warned China that its actions could force a choice between aligning with them or with Russia.
- Despite the West's commitment to Ukraine, it appears that Moscow is in the fight for the long haul. Russia's economy is performing well, as the country has mobilized to sustain its war efforts. The unemployment rate is at a 30-year low, and strong domestic consumption has pushed GDP growth, outpacing most countries within the eurozone. However, there does seem to be a problem under the surface. Russia's historically heavy reliance on exporting commodities to Europe, now restricted by sanctions, could pose a significant long-term economic threat.

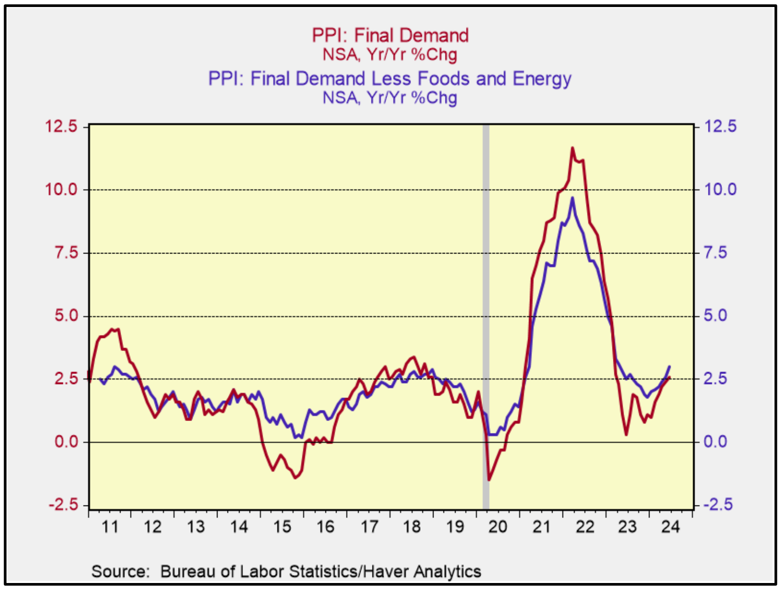



- While a desire to conclude the war might exist on both sides, ending the conflict in Ukraine appears immensely challenging. Rebuilding the country into a fully functioning state will be a long and arduous process, potentially taking decades. Even if Russia aimed to claim all or part of Ukraine, it's unlikely they possess the resources or capacity to handle such a reconstruction alone. China's own economic challenges also limit its ability to help in the transition. Faced with Western isolation and the immense challenges of rebuilding Ukraine, Russia is likely to adopt a more calculated approach in its search for an exit strategy.

**Other news:** President Biden failed to win over supporters after making several blunders during his speech at the NATO summit, raising the likelihood that he may be forced to drop out of the race. Also, US intelligence reportedly thwarted a Russian assassination attempt against the CEO of Rheinmetall, a major German arms supplier to Ukraine. This suggests Russia might be willing to escalate the conflict beyond Ukraine's borders. Meanwhile, Saudi Arabia's budget constraints have forced it to pause spending on some projects.

**US Economic Releases**

The June ***producer price index (PPI)*** rose by a seasonally adjusted 0.2%, above both the expected increase of 0.1% and the flat reading in May. Excluding the volatile food and energy components, the June ***"core" PPI*** jumped 0.4%, twice the expected increase of 0.2% and more than May's rise of 0.3%. The overall PPI in June was up 2.6% from the same month one year earlier, while the core PPI was up 3.0%. These increases will temper some of the enthusiasm generated by yesterday's good report on the consumer price index, although investors are still likely to be expecting the Fed to cut interest rates starting in September. The chart below shows the year-over-year change in the PPI and the core PPI over the last decade or so.




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** | U. of Michigan Consumer Sentiment | m/m | Jul P | 68.5 | 68.2 | *** |
| **10:00** | U. of Michigan Current Conditions | m/m | Jul P | 66.0 | 65.9 | ** |
| **10:00** | U. of Michigan Future Expectations | m/m | Jul P | 69.3 | 69.6 | ** |
| **10:00** | U. of Michigan 1-Year Inflation Expectation | m/m | Jul P | 2.9% | 3.0% | * |
| **10:00** | U. of Michigan 5-10 Year Inflation Expectation | m/m | Jul P | 3.0% | 3.0% | * |
| **Federal Reserve** | | | | | | |
| No Fed speakers or events for the rest of today | | | | | | |

## 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 | Industrial Production | y/y | May F | 1.1% | 0.3% | | *** | Equity and bond neutral |
| | Capacity Utilization | y/y | May | 4.1% | 0.3% | | ** | Equity and bond neutral |
| New Zealand | BusinessNZ Manufacturing PMI | m/m | Jun | 41.1 | 46.6 | | *** | Equity and bond neutral |
| China | Exports | y/y | Jun | 8.6% | 7.6% | 8.0% | ** | Equity and bond neutral |
| | Imports | y/y | Jun | -2.3% | 1.8% | 2.5% | ** | Equity and bond neutral |
| | Trade Balance | m/m | Jun | $99.05b | $82.62b | $85.30b | *** | Equity and bond neutral |
| China | Money Supply M2 | y/y | Jun | 6.2% | 7.0% | 6.8% | *** | Equity and bond neutral |
| | Money Supply M1 | y/y | Jun | -5.0% | -4.2% | -5.4% | * | Equity and bond neutral |
| | Money Supply M0 | y/y | Jun | 11.7% | 11.7% | -- | * | Equity and bond neutral |
| | New Yuan Loans | y/y | Jun | 13270.0b | 11136.4b | 13386.4b | * | Equity and bond neutral |
| | Aggregate Financing CNY | y/y | Jun | 18100.0b | 14801.8b | 18201.8b | * | Equity and bond neutral |
| India | CPI | y/y | Jun | 5.1% | 4.8% | 4.8% | *** | Equity and bond neutral |
| | Industrial Production | y/y | May | 5.9% | 5.0% | 4.9% | *** | Equity bullish, bond bearish |
| EUROPE | | | | | | | | |
| Germany | Wholesale Price Index | y/y | Jun | -0.6% | -0.7% | | ** | Equity and bond neutral |
| France | CPI, EU Harmonized | y/y | Jun F | 2.5% | 2.5% | 2.5% | ** | Equity and bond neutral |
| | CPI | y/y | Jun F | 2.2% | 2.1% | 2.1% | *** | Equity and bond neutral |
| | CPI Ex-Tobacco Index | q/q | Jun | 119.1% | 119.1% | 119.1% | * | Equity and bond neutral |
| Russia | Money Supply, Narrow Definition | w/w | 5-Jul | 18.22t% | 18.15t | | * | Equity and bond neutral |
| Russia | Current Account Balance | q/q | 2Q P | 18000m% | 22555m% | 15200m% | ** | Equity and bond neutral |
| | Gold and Forex Reserve | m/m | 5-Jul | $597.2b | $590.5b | | *** | Equity and bond neutral |
| AMERICAS | | | | | | | | |
| Mexico | Industrial Production | y/y | May | 1.0% | 5.9% | 1.1% | *** | Equity and bond neutral |
| Brazil | IBGE Services Volume | y/y | May | 0.8% | 5.5% | 0.0% | * | 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) | 520 | 520 | 0 | Up |
| U.S. Sibor/OIS spread (bps) | 528 | 528 | 0 | Down |
| U.S. Libor/OIS spread (bps) | 528 | 528 | 0 | Down |
| 10-yr T-note (%) | 4.21 | 4.21 | 0.00 | Down |
| Euribor/OIS spread (bps) | 369 | 370 | -1 | Down |
| **Currencies** | **Direction** | | | |
| Dollar | Down | | | Down |
| Euro | Up | | | Up |
| Yen | Flat | | | Down |
| Pound | Up | | | Up |
| Franc | Up | | | Up |

## 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 | $85.89 | $85.40 | 0.57% | |
| WTI | $83.29 | $82.62 | 0.81% | |
| Natural Gas | $2.27 | $2.27 | -0.13% | |
| 12-mo strip crack | $22.16 | $22.14 | 0.10% | |
| Ethanol rack | $2.11 | $2.10 | 0.75% | |
| **Metals** | | | | |
| Gold | $2,401.69 | $2,415.48 | -0.57% | |
| Silver | $30.73 | $31.46 | -2.34% | |
| Copper contract | $454.35 | $450.65 | 0.82% | |
| **Grains** | | | | |
| Corn contract | $407.00 | $410.75 | -0.91% | |
| Wheat contract | $562.50 | $571.25 | -1.53% | |
| Soybeans contract | $1,064.75 | $1,067.75 | -0.28% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 1,947 | 1,939 | 8 | |
| **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) | 65 | 56 | 9 | |

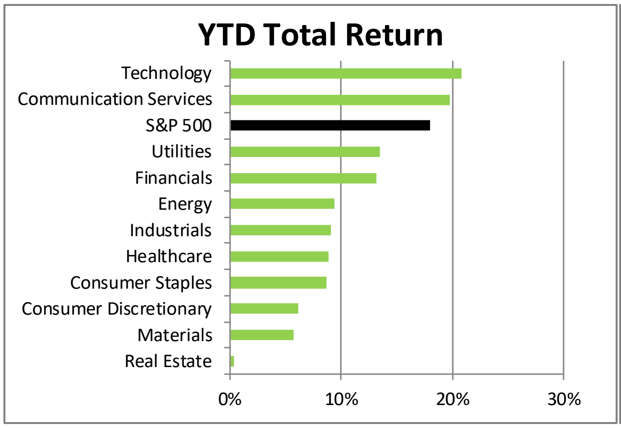
## Weather

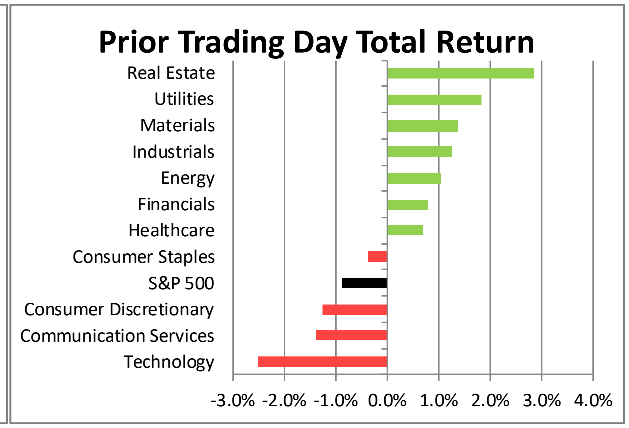
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures across the entire western half of the country, the Deep South, and New England, with cooler-than-normal temperatures in the Midwest. The forecasts are calling for wetter-than-normal conditions in the Pacific Northwest and the entire southern half of the country, with dry conditions in the Northern Tier states.

There is currently only one atmospheric disturbance in the Atlantic Ocean area, located about a hundred miles off the coast of South Carolina. It is assessed to have no chance of becoming a cyclone, but it is nonetheless expected to bring heavy rains to the Carolinas when it moves inland later today.

## Data Section

**US Equity Markets** – (as of 7/11/2024 close)

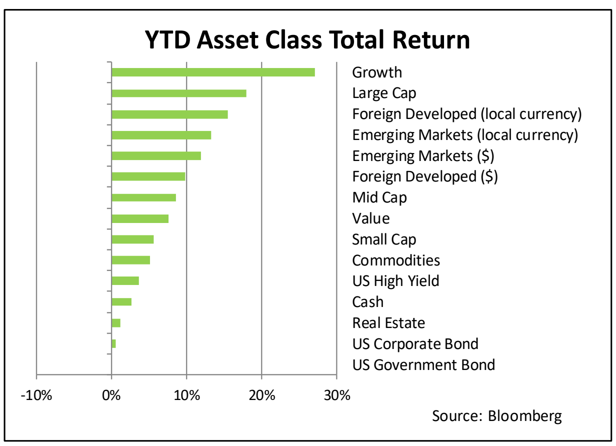



(Source: Bloomberg)

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 7/11/2024 close)

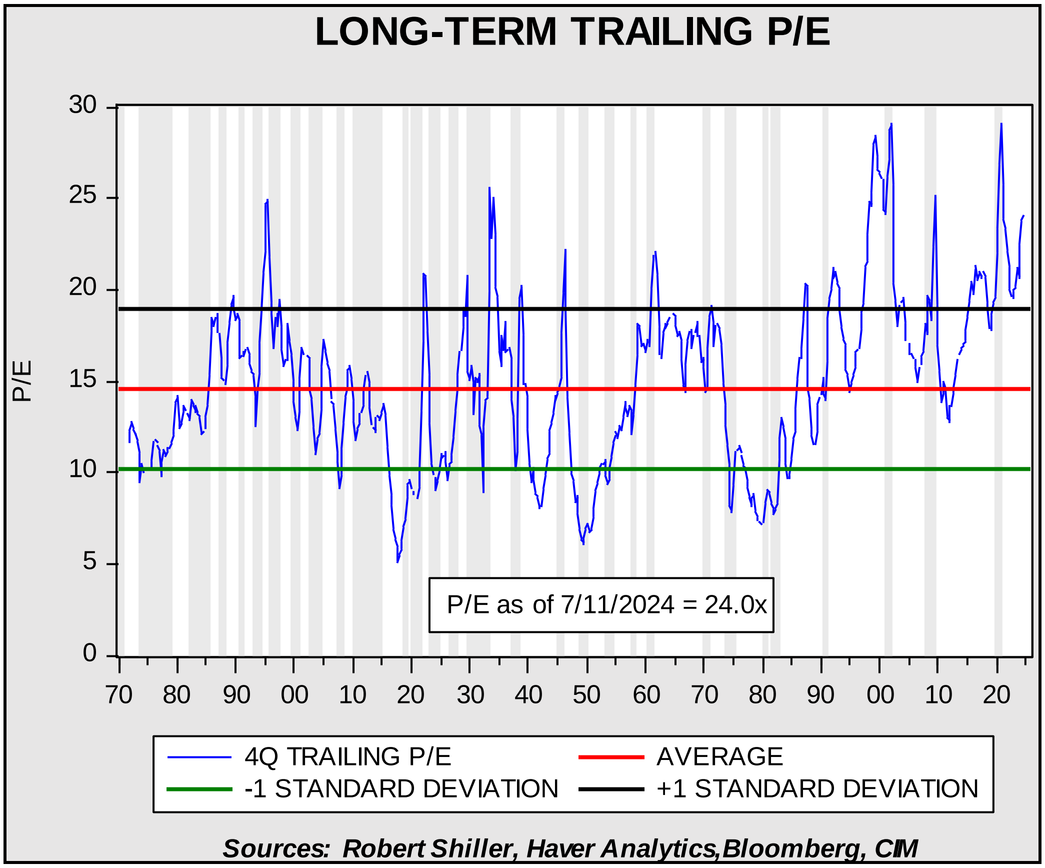



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.