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: July 17, 2024—9:30 AM ET] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 closed down 1.4% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.7%. Chinese markets were lower, with the Shanghai Composite down 0.5% from its previous close and the Shenzhen Composite down 0.8%. US equity index futures are signaling a lower open.

With 38 companies having reported so far, S&P 500 earnings for Q2 are running at $59.30 per share, compared to estimates of $58.94, which is up 8.0% from Q2 2023. Of the companies that have reported thus far, 84.2% have exceeded expectations while 13.2% 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* (7/1/2024) (with associated podcast): "The EU Parliamentary Elections: New Strength for the Right"
- *Asset Allocation Bi-Weekly* (7/15/2024) (with associated podcast): "A New Factor for Gold Prices"
- ***Asset Allocation Quarterly – Q3 2024* (7/16/2024): Discussion of our asset allocation process, Q3 2024 portfolio changes, and our outlook for the markets.**

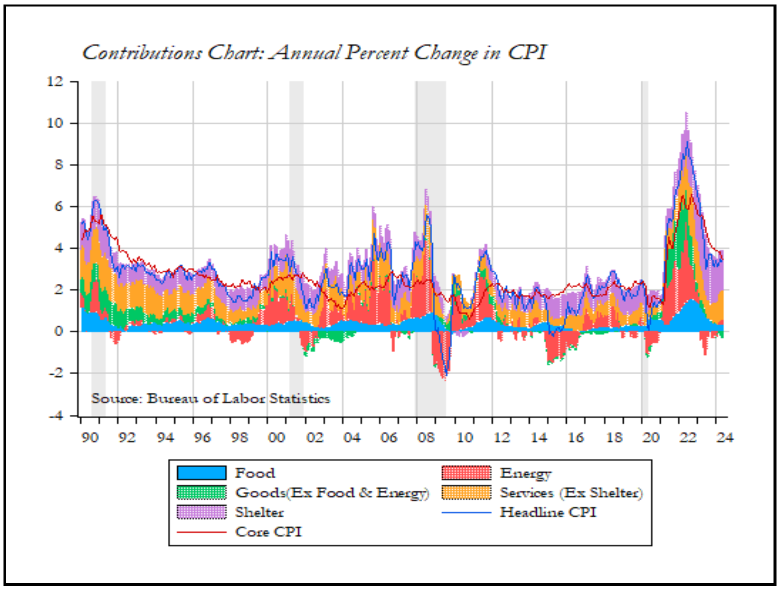
Good morning! S&P 500 futures are off to a slow start as investors look for more confidence in the data. In sports news, the players of the American League were able to beat the National League in the MLB All-Star game. Today's *Comment* starts with a summary of how former President Donald Trump and incumbent President Joe Biden are strategizing to win over supporters. We follow with discussions on the bitcoin and gold rivalry and the potential shift in US foreign policy. As always, the report concludes with a roundup of domestic and international news.

Political Re-Brand: Republican presidential candidate Donald Trump seems to be moving toward the center, while President Joe Biden has shifted further toward the left.

- During an interview with *Bloomberg Businessweek*, Trump outlined his vision for a second term. He made concessions such as allowing Fed Chair Jerome Powell to complete his term, despite previous reports suggesting he might challenge the Federal

Reserve's legal independence. Additionally, he is reportedly considering Jamie Dimon for Treasury Secretary, a position Dimon declined in 2016 but may be open to taking now that he is mulling retirement. Another newsworthy announcement was Trump's expectations that his unreleased economic agenda would be implemented quickly after his victory.

- Meanwhile, President Biden has sought support from progressives as he looks to beat back calls to drop out of the election. In an effort to address concerns about inflation impacting everyday households, he unveiled a list of re-election promises on Tuesday. These include capping rent hikes for large landlords at no more than 5%, forgiving medical debt, and raising the minimum wage. Shelter prices and costs associated with healthcare have been significant drivers of inflation throughout his term, and these proposals aim to directly target those areas.

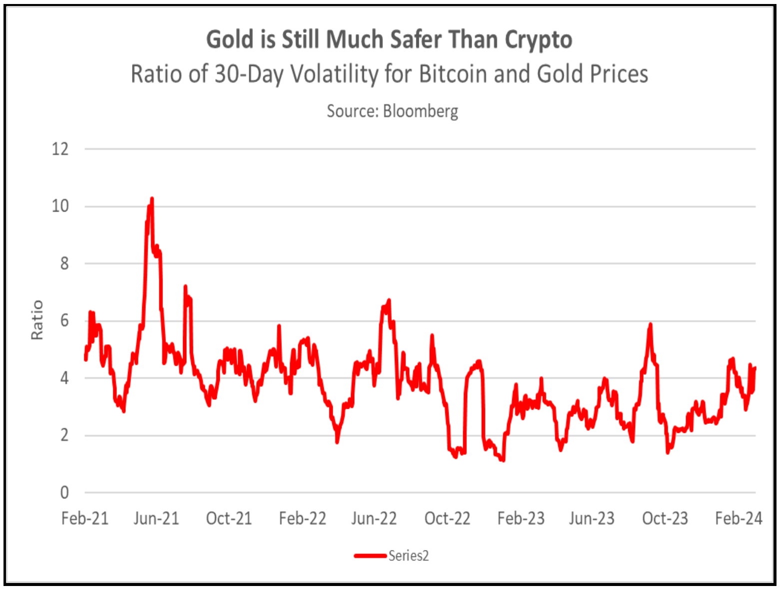


- Less than four months away from the election, betting markets show that former President Donald Trump has about a 67% chance of winning. These odds are likely to fluctuate in the coming months. While Trump's current lead is significant, he may encounter resistance from his opponents, especially if Biden unexpectedly withdraws from the race. A major point of concern is Trump's lack of a detailed economic plan, which is likely to make investors nervous given some of his positions. The uncertainty could introduce volatility into financial markets leading up to the November election.

New vs. Old School Hedges: Investor confidence in a potential Trump victory has driven a surge in gold and bitcoin prices over the past few days.

- Gold prices have skyrocketed 4% over the past week, while bitcoin has surged an even more impressive 12%. The surge in demand for these assets reflects investor concerns about the US Treasury's safe-haven status. They fear the potential deregulation of cryptocurrencies and rising government spending, leading to ballooning deficits, could weaken the attractiveness of US dollar-denominated assets. Trump recently added to those concerns after he complained that the US dollar remains too strong compared to the Japanese yen (JPY) and Chinese yuan (CNY).

- A second Trump term is likely to ramp up the competition between precious metals and cryptocurrencies. Gold's established reputation makes it a go-to for traditional investors, but younger generations are drawn to bitcoin's potential. This digital asset's allure stems partly from its innovative technology, which streamlines trading and purchases. However, its significant price swings raise concerns about its viability as a long-term store of value. As the chart illustrates, bitcoin's volatility is roughly four times higher than gold's, potentially making it a riskier option for long-term investment strategies.

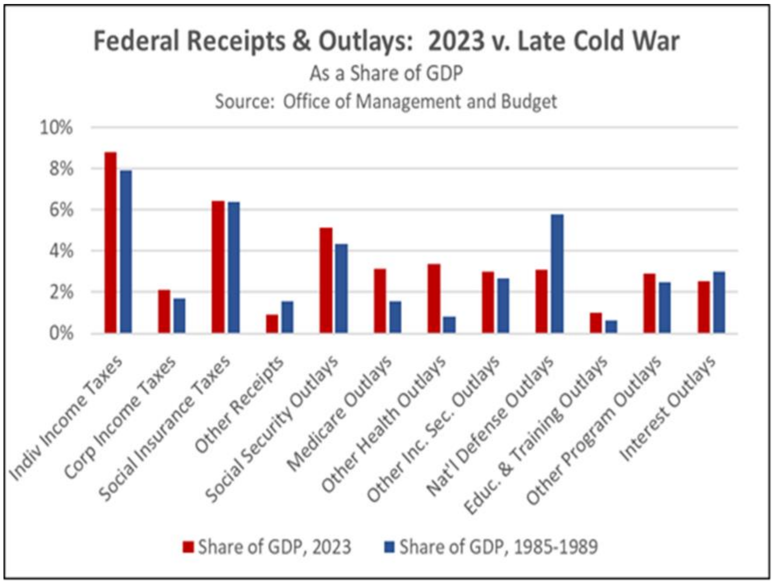


- The coming years could see high-risk investors experiment with bitcoin, but for most, gold remains a more reliable choice. Central banks' preference for gold diversification will likely bolster its value, especially as the world breaks into blocs. While bitcoin offers the potential for higher returns, its lower trading volume makes it a more volatile investment. We recommend gold for most investors due to its stability. However, bitcoin's popularity may rise as the cryptocurrency market matures. Thorough research is essential before investors enter this market.

No More Mr. Nice Guy: The Republican populist wing appears to advocate a more transactional approach to foreign policy as it looks to pivot inward.

- There are growing signals that President Trump could dramatically shake up US foreign policy in his second term. In a letter to the European Council president, Hungarian Prime Minister Viktor Orbán claimed that if reelected, Trump would force Ukraine to accept a peace deal with Russia. The comment comes after Viktor Orbán held separate in-person meetings with Russian President Vladimir Putin and Trump earlier this month to discuss the matter. In that same vein, Trump also mentioned that Taiwan should pay the US for protection in a sign that he may not be willing to deter a Chinese invasion.

- The abrupt shift in stance regarding security assistance likely represents a significant reversal in American foreign policy. Traditionally, the US has advocated shielding allies from threats posed by Russia and China; however, now it appears that these countries will have to protect themselves. This newfound hesitation to provide security guarantees, specifically to smaller allies, comes amid growing anxieties that the US needs to do more to provide security domestically. This was shown as both Trump and his running mate J.D. Vance criticized US efforts to prioritize aid to foreign conflicts over securing the southern border.



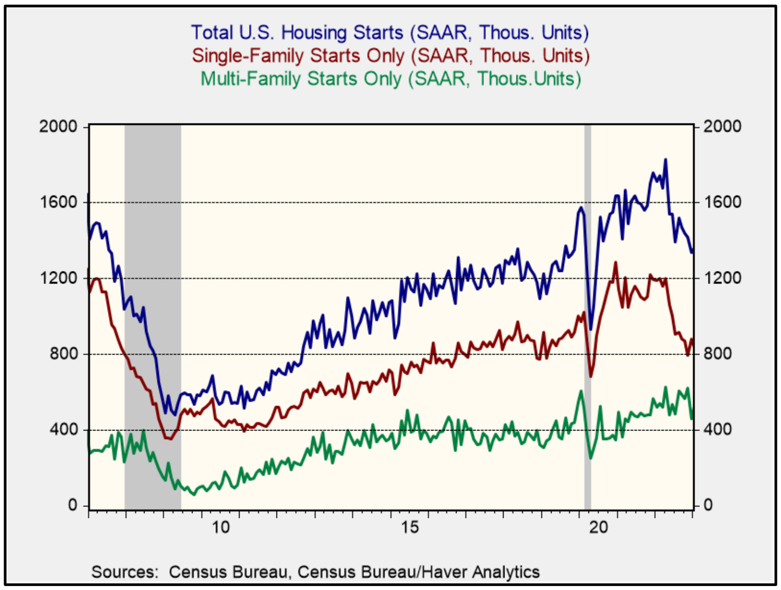
- If Trump wins the office, one of the most intriguing developments will be how he handles defense spending. Although US defense spending is at an all-time high, its share of GDP has dramatically decreased from the levels seen during the late Cold War. That said, while we expect that he will likely favor less spending abroad, we remain confident that overall spending for national security will stay at current levels or could even increase. This is due to the US's need to develop deterrents to foreign threats and enforce strict immigration policies. As a result, we believe that defense companies could perform well under his leadership.

In Other News: China's suspension of nuclear arms talks with the US further strains their already tense relationship. Meanwhile, a ceasefire agreement remains elusive in the Israel-Hamas conflict, despite hints of willingness from both sides. Additionally, there are concerns in Japan that its intervention in currency markets is becoming less effective, in a sign that the central bank may be forced hike rates soon.

US Economic Releases

The Mortgage Bankers Association today said ***mortgage applications*** in the week ended July 12 rose 3.9%, compared to last week's decline of 0.2%. This was the first rise since June 21, probably a reflection of a significant downward move in the average mortgage interest rate (see below). Applications for home purchase mortgages fell 2.7%; however, applications for refinancing mortgages rose a very robust 15.2%, after falling 2.2% in the prior week. According to the report, the average interest rate on a 30-year mortgage fell to 6.87%, compared to 7.0% the previous week.

June ***housing starts*** rose to a seasonally adjusted, annualized rate of 1.353 million units, slightly exceeding the expected rate of 1.3 million units and May's 1.314 million units. The rate of housing starts in June rose 3.0% from the previous month, exceeding the 1.8% expectation and marking a notable reversal from May's 4.6% decline. June ***residential building permits*** rose to a rate of 1.446 million units, slightly exceeding the anticipated rate of 1.4 million units and May's 1.399 million units. Permits issued for new housing units in June rose a surprisingly strong 3.4% from the previous month. The chart below shows new home starts by type of property since just before the Great Financial Crisis.



The table below lists the economic releases and/or Fed events scheduled for the rest of the day.

Economic Releases		
No economic releases for the rest of today		
Federal Reserve		
ET	**Speaker or Event**	**District or Position**
9:00	Thomas Barkin Speaks on Economy, Q&A	President of the Federal Reserve Bank of Richmond
9:35	Christopher Waller Speaks on Economic Outlook	Member of the Board of Governors
14:00	U.S. Federal Reserve Releases Beige Book	Federal Reserve Board

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								
Australia	Westpac Leading Index	m/m	Jun	0.00%	0.00%		**	Equity and bond neutral
New Zealand	CPI	y/y	2Q	3.3%	4.0%	3.4%	**	Equity and bond neutral
EUROPE								
Eurozone	CPI	y/y	Jun F	2.5%	2.6%	2.5%	***	Equity and bond neutral
	Core CPI	y/y	Jun F	2.9%	2.9%	2.9%	**	Equity and bond neutral
UK	CPI	y/y	Jun	2.0%	2.0%	1.9%	***	Equity and bond neutral
	CPI Core	y/y	Jun	3.5%	3.5%	3.4%	***	Equity and bond neutral
	Retail Price Index	m/m	Jun	387.3	386.4	387.3	**	Equity and bond neutral
	RPI	y/y	Jun	2.9%	3.0%	2.9%	**	Equity and bond neutral
	House Price Index	y/y	May	2.20%	1.30%		*	Equity and bond neutral
AMERICAS								
Canada	Housing Starts	m/m	Jun	241.7k	264.9k	254.1k	**	Equity and bond neutral
	CPI	m/m	Jun	2.7%	2.9%	2.8%	***	Equity and bond neutral
Mexico	International Reserves Weekly	w/w	12-Jul	$221184m	$220389m		**	Equity and bond neutral
Brazil	FGV Inflation IGP-10	m/m	Jul	0.45%	0.83%	0.38%	**	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)	555	555	0	Down
3-mo T-bill yield (bps)	519	519	0	Up
U.S. Sibor/OIS spread (bps)	529	528	1	Down
U.S. Libor/OIS spread (bps)	527	527	0	Down
10-yr T-note (%)	4.17	4.16	0.01	Down
Euribor/OIS spread (bps)	367	366	1	Down
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Up			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.

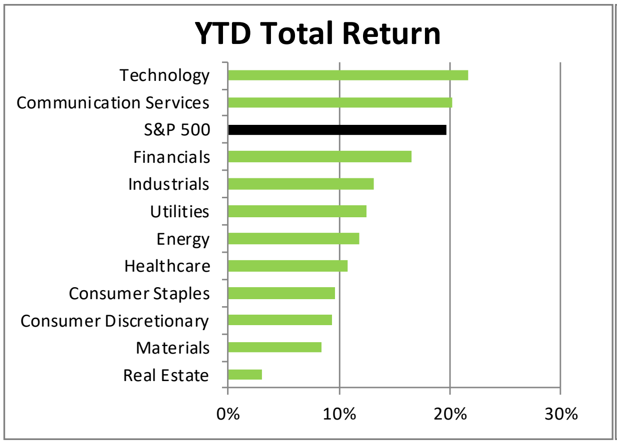
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$83.96	$83.73	0.27%	
WTI	$81.11	$80.76	0.43%	
Natural Gas	$2.21	$2.19	0.82%	
12-mo strip crack	$21.58	$21.61	-0.15%	
Ethanol rack	$2.06	$2.07	-0.65%	
Metals				
Gold	$2,472.27	$2,469.08	0.13%	
Silver	$31.03	$31.25	-0.71%	
Copper contract	$444.60	$444.95	-0.08%	
Grains				
Corn contract	$412.25	$408.75	0.86%	
Wheat contract	$538.25	$530.75	1.41%	
Soybeans contract	$1,048.75	$1,043.25	0.53%	
Shipping				
Baltic Dry Freight	1,942	1,993	-51	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.08		
Gasoline (mb)		-1.23		
Distillates (mb)		0.20		
Refinery run rates (%)		-0.9%		
Natural gas (bcf)		29		

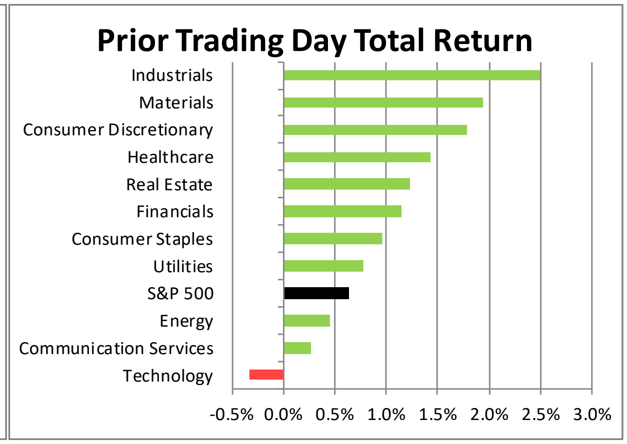
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in Florida and the western third of the country stretching from California and Arizona to the Dakotas, with colder-than-normal temperatures in in a pocket stretching from Texas and Oklahoma to southern Missouri and Tennessee. The precipitation outlook calls for wetter-than-normal conditions over roughly half of the country from New Mexico to Michigan to New Hampshire and all points south, with dry conditions expected in the Northern Great Plains. There is no cyclone activity expected in the Atlantic within the next 48 hours.

Data Section

US Equity Markets – (as of 7/16/2024 close)

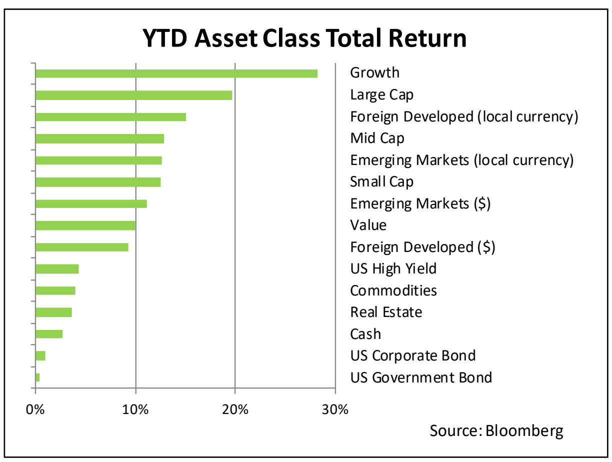




(Source: Bloomberg)

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 7/16/2024 close)

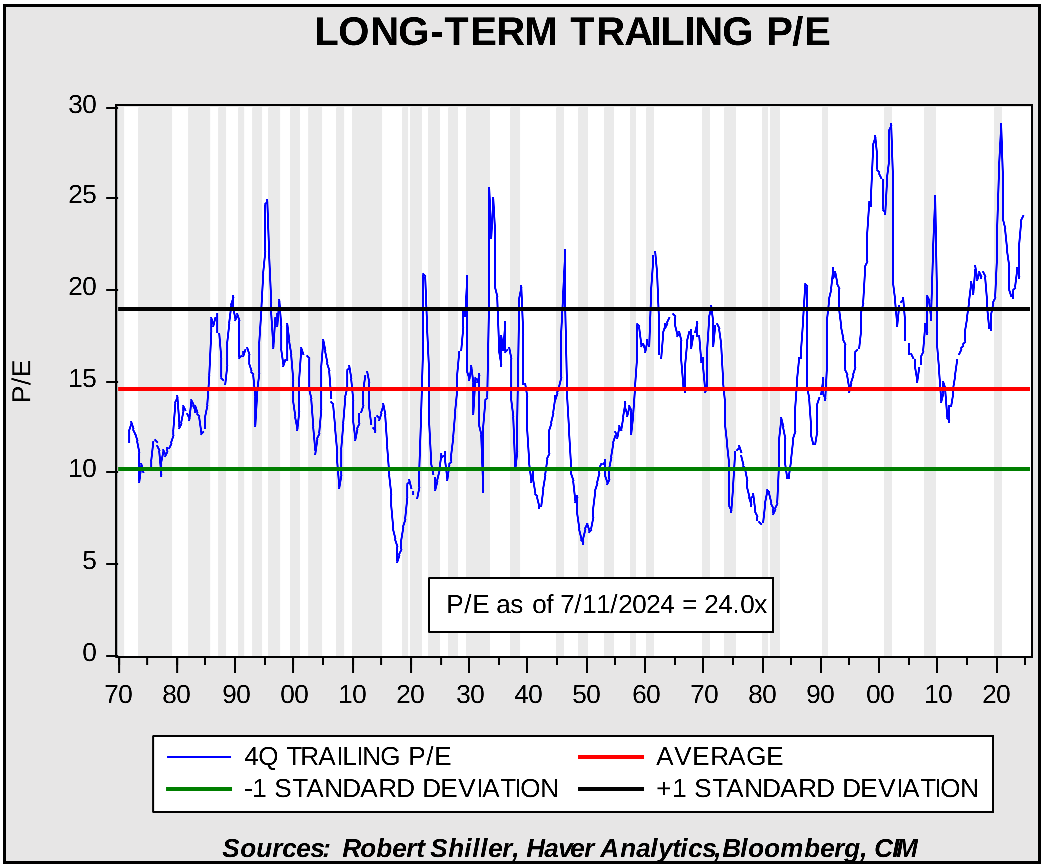


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.