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 18, 2024—9:30 AM ET] Global equity markets are mostly higher this morning. In Europe, the Euro Stoxx 50 closed up 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.0%. Chinese markets were higher, with the Shanghai Composite up 0.5% from its previous close and the Shenzhen Composite up 0.3%. US equity index futures are signaling a higher open.

With 51 companies having reported so far, S&P 500 earnings for Q2 are running at $59.40 per share, compared to estimates of $58.94, which is up 8.0% from Q2 2023. Of the companies that have reported thus far, 84.3% have exceeded expectations while 13.7% 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:

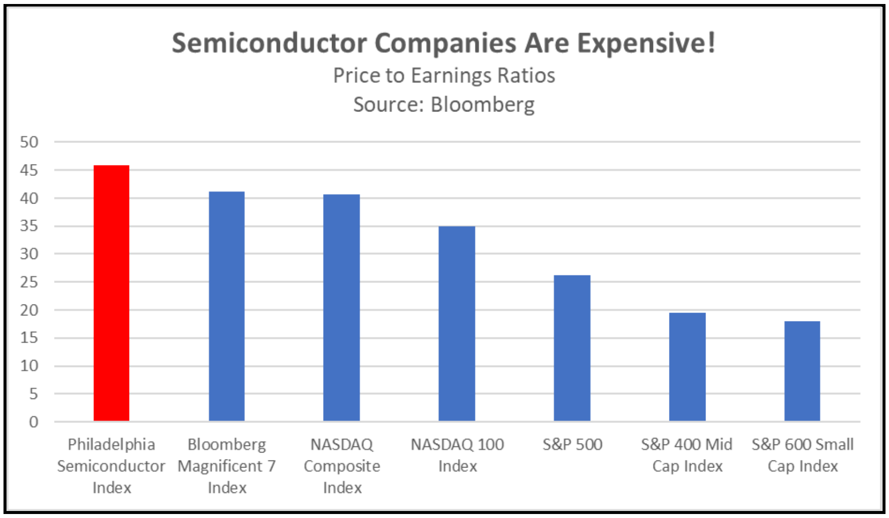
- *Bi-Weekly Geopolitical Report* (7/1/2024) (with associated podcast): "The EU Parliamentary Elections: New Strength for the Right"
- *Asset Allocation Bi-Weekly* (7/15/2024) (with associated podcast): "A New Factor for Gold Prices"
- *Asset Allocation Quarterly – Q3 2024* (7/16/2024): Discussion of our asset allocation process, Q3 2024 portfolio changes, and our outlook for the markets.

Good morning! S&P 500 futures are improved from yesterday following TSMC's outlook. In sports news, Team USA crushed Serbia in an exhibition game, just 11 days before their Olympic opener. Today's *Comment* dives into three key topics: the growing rivalry between the West and China over semiconductors, the market's growing belief in a Federal Reserve policy shift, and the enduring power of centrist parties in the EU. We'll also cover the usual roundup of international and domestic data releases.

Chip War to Trade War: Semiconductors are a flashpoint in the technological rivalry between the West and China, as both powers vie for supremacy in this critical industry.

- The US is looking for ways to undermine China's semiconductor industry. Earlier this week, the Biden administration announced that it might implement the Foreign Direct Product Rule to prevent companies from selling chip-related technology to China. This rule allows the US to control foreign-made goods containing even minimal American technology. The clampdown is not only limited to sales, as the US has also pushed a top Dutch technical university into not accepting Chinese students.

- The European Union has also taken steps to counter China's semiconductor industry. On Tuesday, it launched an anti-dumping investigation into imports of low-tech chips (also called legacy chips) from China. EU regulators suspect Beijing of unfairly undercutting prices to gain an advantage in the European automotive market. The investigation comes amidst concerns that China could use its overcapacity to flood foreign markets to the detriment of its competitors. The probe will likely open the door for tariffs, which is likely to further strain the EU trade relationship with Beijing.

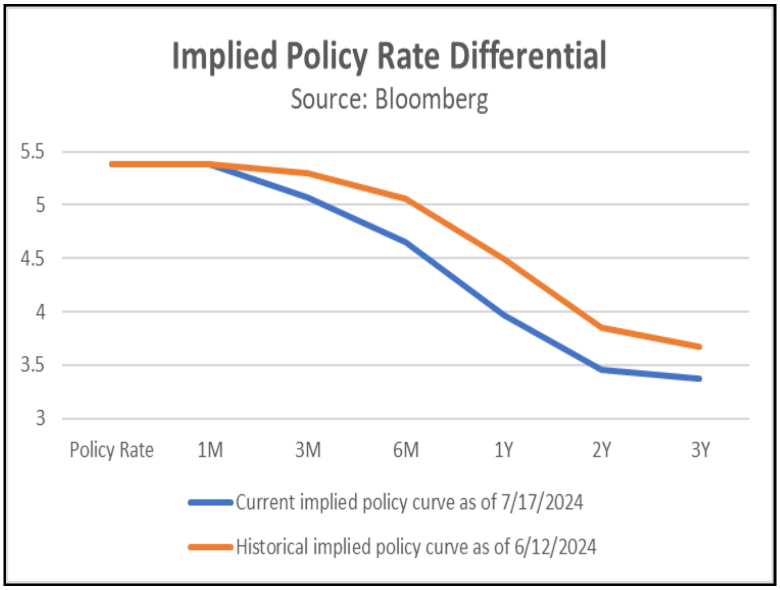


- The US and Europe's recent moves, though in early stages, signal a growing trend of coordinated action to counter rivals in the chip industry. This will likely intensify regulatory scrutiny for chip companies as Western regulators look to close ranks. While TSMC's latest revenue outlook suggests that firms are confident that they can navigate these headwinds, investors may turn their focus to whether Nvidia can maintain its streak of exceeding earnings expectations. In general, the current lofty valuations of chip companies, especially when compared to peers, suggests that the market rally for chip companies may lose momentum over the coming months.

Fed Soft Landing Near? A potential rate cut appears more likely, with the latest Beige Book and Fed comments offering some dovish hints.

- The July 17 Beige Book, a summary of economic conditions across the Fed's 12 districts, indicates a slowdown in the economy. According to the report, five districts are experiencing muted or declining economic activity, an increase of three compared to the previous report. This is likely to strengthen the Fed's case that inflation is cooling, and that it should shift its focus toward protecting economic growth. On Wednesday, Richmond Fed President Thomas Barkin hinted that Fed officials may drop their assessment that inflation is elevated and suggested that a 25 bp cut may be inconsequential.

- Investors are betting heavily on a September rate cut, with the CME FedWatch Tool indicating a near-certain likelihood at 99%. However, the prospect of additional cuts remains unclear. While the latest economic projections suggest that the Fed will only cut its policy rate once this year, it appears that the estimate was heavily influenced by the acceleration in inflation in the first quarter. In contrast, traders project that the recent rise in the unemployment rate and persistent disinflationary pressures may persuade Fed officials to cut rates 2-3 times this year.

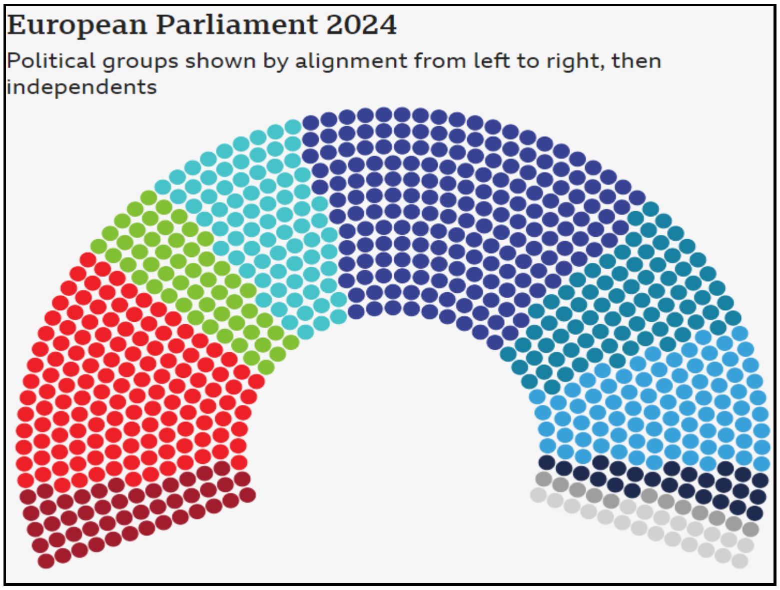


- There has been a significant shift in the expectations for rate cuts following the Fed's hawkish turn at its June 11-12 meeting. The implied policy rate curve, which tracks expectations for up to three years ahead, now suggests that the Fed could lower rates to as low as 3.5% by 2026. This level implies policymakers are expected to bring interest rates down to a neutral zone, neither tightening nor loosening the economic grip. If this holds true, it suggests the market, despite recessionary fears, remains confident in a soft landing. This bodes well for value stocks, which should outperform in such a scenario.

European Centrists Fight On: As right-wing populists gain ground, European centrists still have the edge in gaining power.

- Today, the European Commission is set to hold a vote on who will lead as president. The front-runner appears to be current head Ursula von der Leyen, and there does not seem to be anyone standing in her way. However, because the vote is done in secret, it gives party members the ability to vote against party lines. She has attempted to mediate tensions by appealing across party lines and vowing to push prosperity and security throughout the bloc. She will need 361 of 720 votes to win another five-year term.
- Her potential victory would likely be viewed as a triumph for centrist parties after the recent parliamentary elections. Earlier this month, far-right parties saw a major increase in seats, with their share growing from 14.8% to 26.0%. However, they were unable to secure enough seats to take power. Recent elections in France also suggest that these

groups are not necessarily making significant inroads domestically. Despite their growing influence, their lack of success suggests they will struggle to enact meaningful changes to European policies.

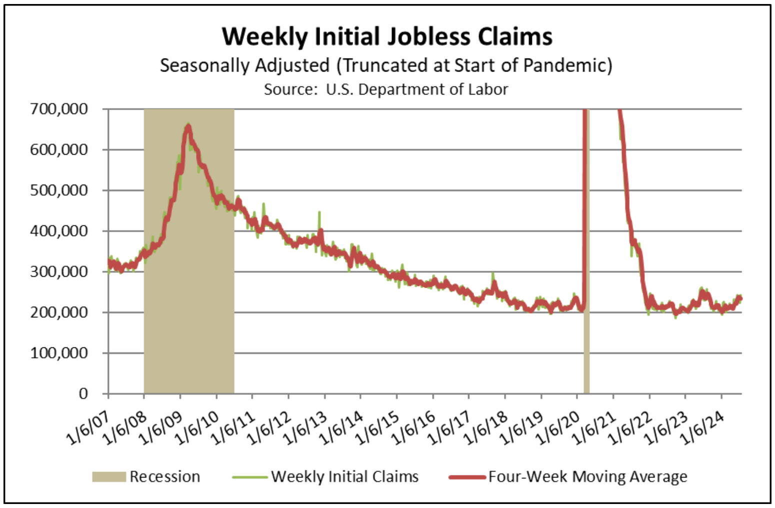


- That said, even though the far right doesn't sit in the driver's seat, they still have a hand on the wheel. This victory will likely give these groups a larger platform to voice their concerns, which could potentially lessen some of the anti-establishment resentment. Roberta Metsola's landslide victory for president of the European People's Party illustrates the continued dominance of centrist forces in the European Parliament. As a result, this could lead to a somewhat more favorable environment for investment in Europe, particularly since centrists seem likely to retain control.

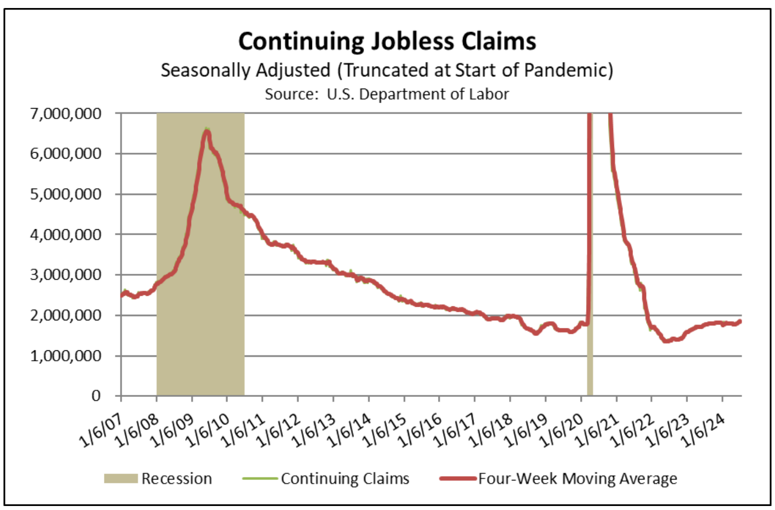
In Other News: The Democratic National Convention's decision to delay the procedural roll call for the party nominee is yet another indication that the party apparatus is losing confidence in President Biden's ability to win in November. The European Central Bank opted to hold interest rates steady at its recent meeting, a cautious move reflecting its concern about lingering inflationary pressures. Meanwhile, UK Chancellor Rachel Reeves hinted at tough choices ahead, suggesting the country is gearing up for debt control measures.

US Economic Releases

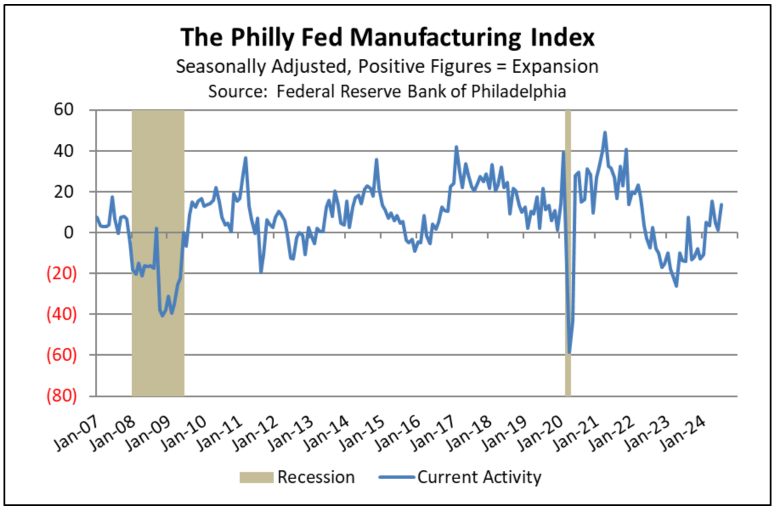
In the week ended July 13, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 243,000, far above both the expected level of 229,000 and the prior week's revised level of 223,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 234,750, clearly pointing to cooler labor demand. 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 July 6, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to a seasonally adjusted 1.867 million, above both the anticipated reading of 1.856 million and the previous week's revised reading of 1.847 million. The four-week moving average of continuing claims rose to 1,850,500, reaching its highest level since December 2021 and providing further evidence that the unemployed are finding it harder to land a job. 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 Philadelphia FRB said its July ***Philly Fed Index*** rose to a seasonally adjusted 13.9, much better than the expected reading of 2.9 and the June reading of 1.3. The index, officially designated as the Philadelphia FRB Manufacturing Activity Index, is designed so that positive readings point to expanding factory activity in the mid-Atlantic region. At its current level, the index suggests mid-Atlantic manufacturing is now expanding solidly again after its contraction from late 2022 to early 2024. The chart below shows how the index has fluctuated since just before the GFC.



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	Leading Economic Indicators	m/m	Jun	-3.0%	-0.5%	***
16:00	Total Net TIC Flows	m/m	May		$66.2b	**
16:00	Net Long-Term TIC Flows	m/m	May		$123.1b	**
Federal Reserve						
ET	**Speaker or Event**	**District or Position**				
10:00	Austan Goolsbee on Yahoo Finance	President of the Federal Reserve Bank of Chicago				
13:00	Lorie Logan Gives Opening Remarks	President of the Federal Reserve Bank of Dallas				
18:00	Mary Daly Participates in Fireside Chat	President of the Federal Reserve Bank of San Francisco				
19:00	Michelle Bowman Gives Keynote Address	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	Trade Balance	y/y	Jun	¥224.0b	-¥1220.1b	-¥185.7b	**	Equity and bond neutral
	Exports	y/y	Jun	5.4%	13.5%	7.2%	*	Equity bearish, bond bullish
	Imports	y/y	Jun	3.2%	9.5%	9.6%	*	Equity bearish, bond bullish
Australia	Employment Change	m/m	Jun	50.2k	39.5k	20.0k	***	Equity and bond neutral
	Unemployment Rate	m/m	Jun	4.1%	4.0%	4.1%	***	Equity and bond neutral
	Participation Rate	m/m	Jun	66.9%	66.8%	66.8%	**	Equity and bond neutral
EUROPE								
Eurozone	EU27 New Car Registrations	y/y	Jun	4.3%	-3.0%		***	Equity and bond neutral
	Construction Output	y/y	May	-2.4%	-1.5%		*	Equity and bond neutral
UK	Average Weekly Earnings 3M/YoY	m/m	May	5.70%	5.90%	5.70%	**	Equity and bond neutral
	ILO Unemployment Rate 3Mths	m/m	May	4.40%	4.40%	4.40%	**	Equity and bond neutral
	Claimant Count Rate	m/m	Jun	4.40%	4.30%		**	Equity and bond neutral
	Jobless Claims Change	m/m	Jun	32.3k	51.9k		**	Equity and bond neutral
Switzerland	Real Exports	m/m	Jun	-0.3%	-3.0%		*	Equity and bond neutral
	Real Imports	m/m	Jun	1.0%	-4.0%		*	Equity and bond neutral
Russia	PPI	y/y	Jun	14.0%	16.2%		***	Equity and bond neutral
AMERICAS								
Canada	Int'l Securities Transactions	m/m	May	20.89b	41.05b		**	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)	554	555	-1	Down
3-mo T-bill yield (bps)	519	520	-1	Up
U.S. Sibor/OIS spread (bps)	529	529	0	Down
U.S. Libor/OIS spread (bps)	527	527	0	Down
10-yr T-note (%)	4.19	4.16	0.03	Down
Euribor/OIS spread (bps)	368	367	1	Down
Currencies	Direction			
Dollar	Flat			Down
Euro	Flat			Up
Yen	Down			Down
Pound	Down			Up
Franc	Down			Up
Central Bank Action	Current	Prior	Expected	
ECB Main Refinancing Rate	4.250%	4.250%	4.250%	On Forecast
ECB Marginal Lending Facility	4.500%	4.500%	4.500%	On Forecast
ECB Deposit Facility Rate	3.750%	3.750%	3.750%	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	$84.93	$85.08	-0.18%	
WTI	$82.77	$82.85	-0.10%	
Natural Gas	$2.06	$2.04	1.03%	
12-mo strip crack	$21.62	$21.70	-0.39%	
Ethanol rack	$2.01	$2.03	-0.61%	
Metals				
Gold	$2,464.98	$2,458.79	0.25%	
Silver	$30.41	$30.30	0.36%	
Copper contract	$434.00	$440.85	-1.55%	
Grains				
Corn contract	$409.50	$411.75	-0.55%	
Wheat contract	$540.00	$539.25	0.14%	
Soybeans contract	$1,035.75	$1,041.00	-0.50%	
Shipping				
Baltic Dry Freight	1,890	1,942	-52	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-4.87	-1.08	-3.79	
Gasoline (mb)	3.33	-1.23	4.56	
Distillates (mb)	3.45	0.20	3.25	
Refinery run rates (%)	-1.7%	-0.9%	-0.8%	
Natural gas (bcf)		27		

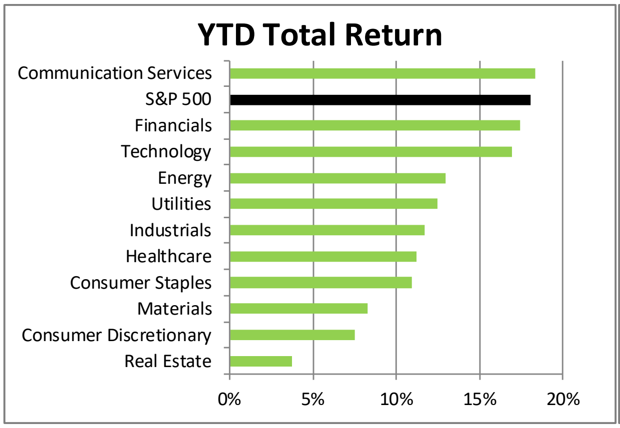
Weather

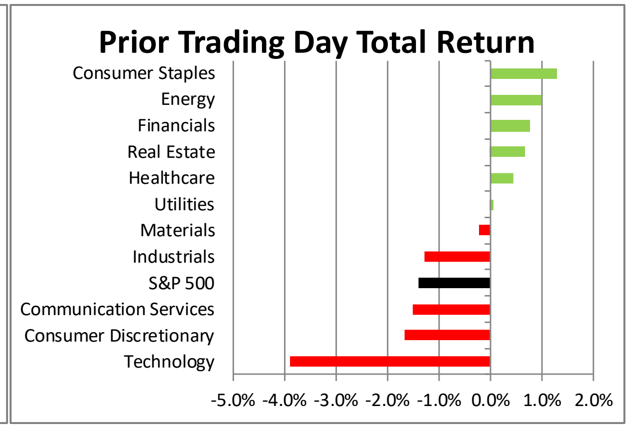
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in most of the Far West and along the East Coast, with colder-than-normal temperatures in the southern Great Plains and lower Mississippi Valley region. The forecasts call for wetter-than-normal conditions in the Southwest, the southern Great Plains, and all areas east of the Mississippi River, with dry conditions expected in the northern Great Plains.

There is no cyclone activity expected in the Atlantic Ocean region within the next 48 hours.

Data Section

US Equity Markets – (as of 7/17/2024 close)

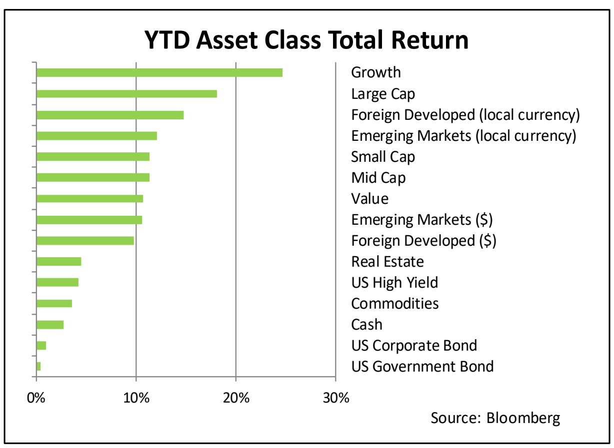




(Source: Bloomberg)

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 7/17/2024 close)

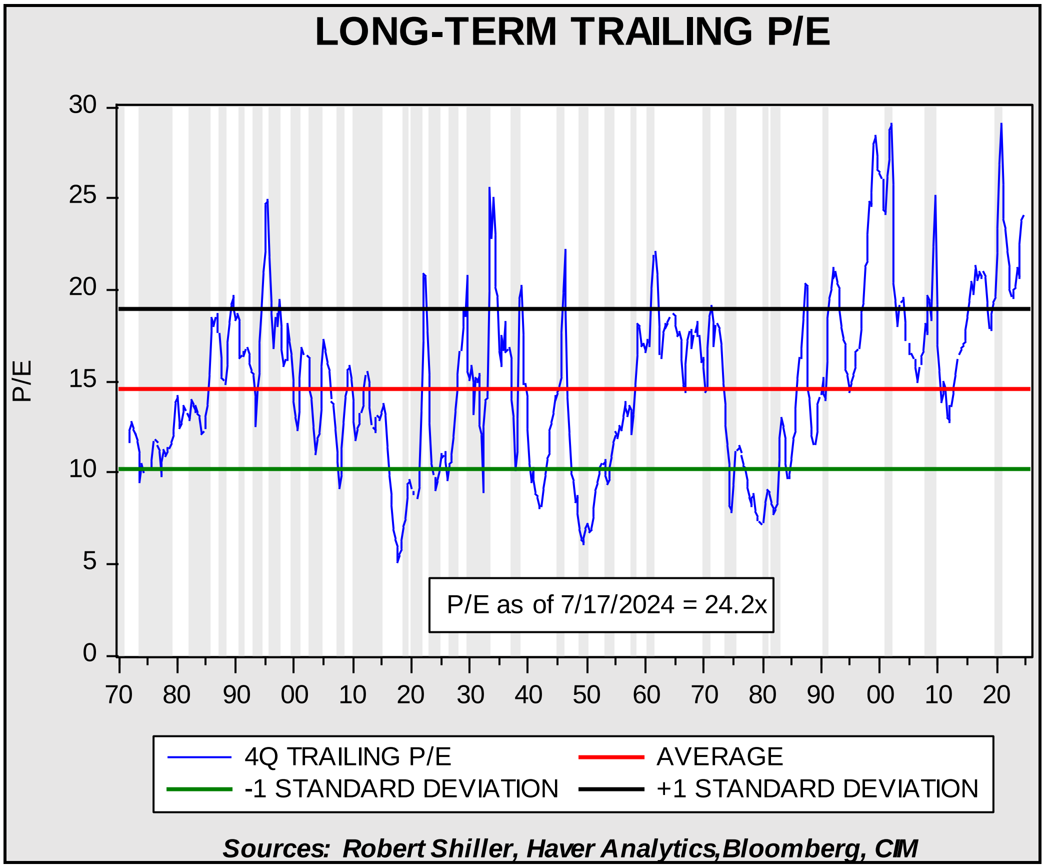


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 18, 2024



Based on our methodology,[1] the current P/E is 24.2x, up 0.2 from our last report. The increase in the multiple was due to an increase in the stock price index and a slight decrease 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.