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 19, 2024—9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 closed down 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 2.2%. Chinese markets were higher, with the Shanghai Composite up 0.2% from its previous close and the Shenzhen Composite up 0.3%. US equity index futures are signaling a higher open.

With 64 companies having reported so far, S&P 500 earnings for Q2 are running at $59.50 per share, compared to estimates of $58.94, which is up 8.0% from Q2 2023. Of the companies that have reported thus far, 84.4% have exceeded expectations while 14.1% 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:

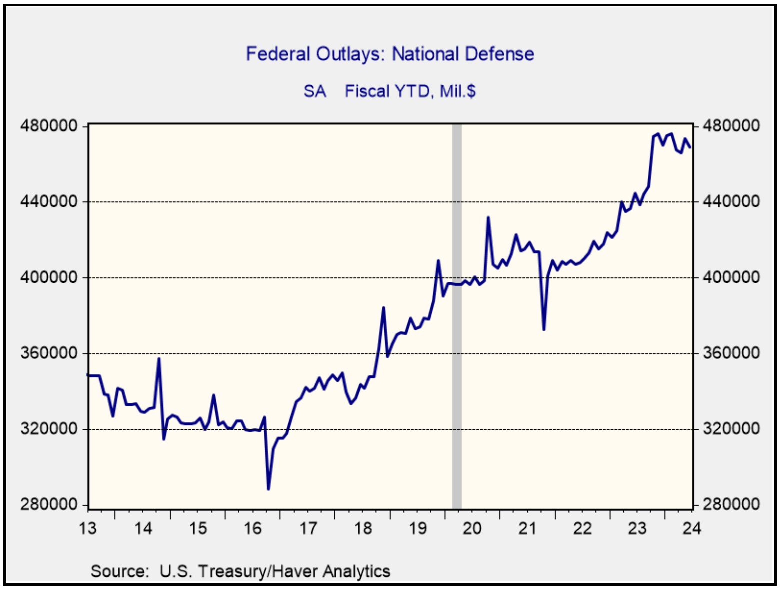
- *Bi-Weekly Geopolitical Report* (7/1/2024) (with associated podcast): "The EU Parliamentary Elections: New Strength for the Right"
- *Asset Allocation Bi-Weekly* (7/15/2024) (with associated podcast): "A New Factor for Gold Prices"
- *Asset Allocation Quarterly – Q3 2024* (7/16/2024): Discussion of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

Good morning! S&P 500 futures are off to a modest start. In sports news, Caitlin Clark broke the WNBA assist record. Today's *Comment* will discuss the recent massive tech outage, the overperformance of small caps relative to large caps, and our thoughts on China's Third Plenum. As usual, our report ends with a roundup of international and domestic economic releases.

Cybersecurity Concerns: A seemingly innocuous software update exposed serious vulnerabilities in our critical infrastructure.

- On Thursday, a massive tech outage caused IT systems around the world to shut down. The system failure impacted companies across many industries, including airlines, banks, and emergency services. The source of the disruption appears to be related to a system update by cybersecurity software company CrowdStrike. The company has since found a fix for the problem, and users of macOS and Linux were not affected. However, it is unclear when all systems will return to normal following the outage.

- Despite CrowdStrike's assurances that the outage wasn't caused by cyberwarfare, the event highlights vulnerabilities to cyberattacks. The recent surge in attacks, which picked up around 2020, has shown no signs of slowing down. The hacking of auto software provider CDK Global serves as a stark example of this growing threat. The global cost of cybercrime is expected to surge from $8.15 trillion in 2023 to over $13.8 trillion by 2028. The increase is likely to be shared by governments as they look to prepare for the new form of war that relies less on direct combat and more on sabotage.

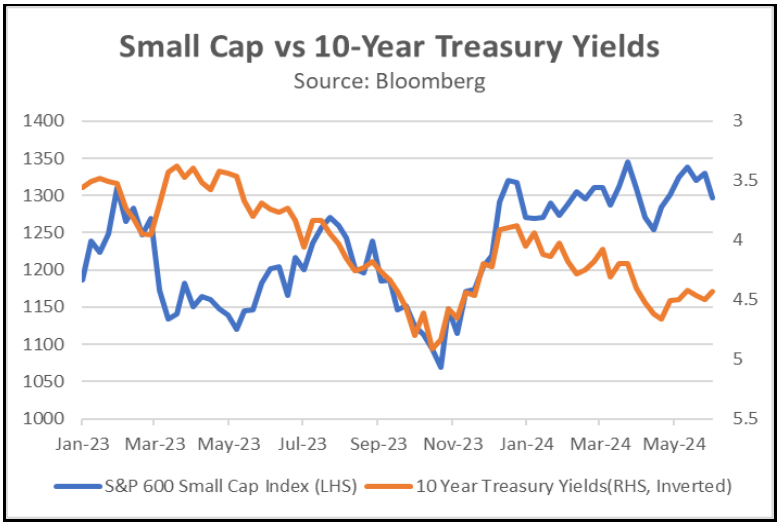


- Building on our previous analysis, we expect US government spending to increase regardless of the outcome of the 2024 election. Although Republican presidential candidate Donald Trump has mentioned cuts to foreign aid if he wins, he has consistently advocated for improving US defense spending. We anticipate that his administration could reallocate funds to provide more support for the US Department of Homeland Security. Consequently, defense companies, particularly those specializing in cybersecurity, may have significant upside potential in the coming years.

Shifting Gears: Investors are moving into small caps as the market continues to price in the possibility of a rate cut in September.

- While the S&P 500 has declined 1.0% over the last five days, the S&P SmallCap 600 Index has risen nearly 3.0%. This shift into small-cap stocks reflects investors favoring smaller companies amid expectations of a Fed pivot. Since the Fed started hiking interest rates in March 2022, investors have sought refuge in large companies because of their profitability, pricing power, and ability to absorb large changes in interest rates. Now that it appears that those rates may be moving downwards, investors are ready to go bargain hunting.
- While our views on small caps are bearing out, our concerns now rest with the longevity of the rally. The strong correlation between the S&P 600 and 10-year Treasury rates in the second half of 2023 demonstrates that even though stocks rallied during the period of

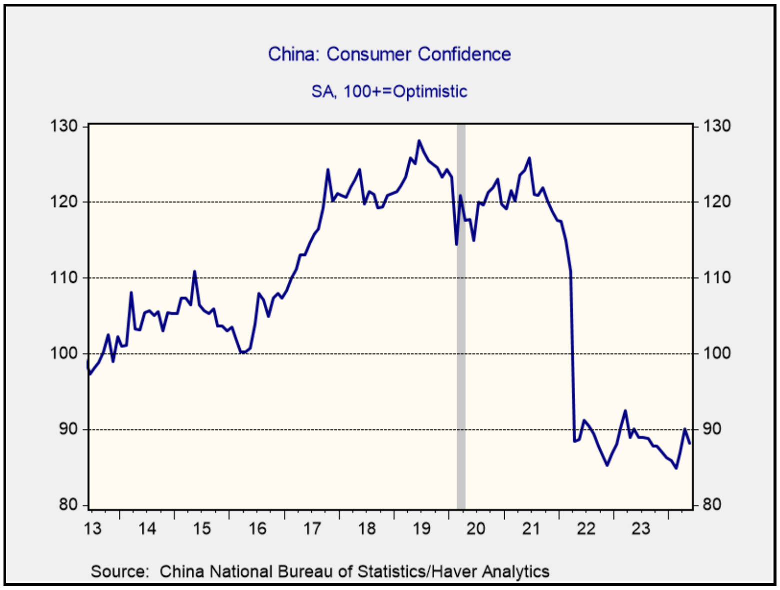
lower rates, they were unable to maintain momentum when rates reversed course. Therefore, while recent economic data has drawn investors back to small caps, their optimism likely hinges on the Fed maintaining a dovish stance on future rate policy in the form of multiple rate cuts this year.



- While monetary policy uncertainty due to high inflation presents challenges, small-cap stocks still offer attractive opportunities for investors. Our research consistently shows that value investing remains a long-term driver of performance. Since small caps boast lower P/E ratios compared to their mid- and large-cap counterparts, they possess significant upside potential relative to their peers. However, to mitigate risks, we recommend screening for quality factors like profitability, leverage, and solvency.

China's New Way: The final day of the widely expected meeting ended with a thud as the final statement failed to reassure investors that the worst was behind.

- In short, Beijing plans to continue with its state-driven economic model that focuses on balancing economic development with domestic security. Notably, the statement maintains its ambitious 5% growth target and preference toward long-term investments in technology as it looks to make itself less dependent on the West for resources. There was also a mention of the need to ensure the long-term growth by addressing potential risks associated with the property sector, local government debt, and small and mid-sized financial institutions.
- The market's reaction to the readout was negative, interpreting it as a sign of the government's reluctance to intervene and stimulate growth. While China's economy did manage a 4.7% year-over-year growth rate, this masks a concerning slowdown in domestic consumption. Retail sales have dipped modestly over the past few months and are on course to contract 1% by year-end. At the same time, consumer confidence remains near its pandemic lows, with ongoing market volatility leading households to prioritize saving over making discretionary purchases.



- China's recent remarks solidify our belief that the nation will continue to grapple with several challenges, often referred to as the ***five D's***: weak consumer **demand**, excess capacity and high **debt**, poor **demographics**, economic **disincentives** from the Communist Party's intervention in the markets, and Western **decoupling** from trade, technology, and capital flows. These factors will likely make it difficult to identify investment opportunities in China; however, a focus on companies that cater primarily to the domestic market and align with China's strategic goal could have long-term benefits.

In Other News: Israel is considering transferring control of the Rafah border to the EU, in a sign that the conflict is close to coming to an end. An ECB survey suggests that investors are growing confident that rate setters could lower rates again in September. Also, Ursula von der Leyen easily secured a second term as president of the European Commission, further cementing centrist party control over European affairs[1].

US Economic Releases

No major US data has been released so far today. 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**
10:40	John Williams Speaks on Panel on Monetary Policy	President of the Federal Reserve Bank of New York
13:00	Raphael Bostic Gives Closing Remarks	President of the Federal Reserve Bank of Atlanta

[1] Yesterday's *Comment* mistakenly stated that von der Leyen was the president of the European Parliament.

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	National CPI	y/y	Jun	2.8%	2.8%	2.9%	***	Equity and bond neutral
	National CPI Ex-Fresh Food	y/y	Jun	2.6%	2.5%	2.7%	**	Equity and bond neutral
	National CPI Ex-Fresh Food & Energy	y/y	Jun	2.2%	2.1%	2.2%	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	12-Jul	-¥136.3b	-¥569.3b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	12-Jul	¥227.6b	¥603.5b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	12-Jul	-¥208.9b	¥209.7b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	12-Jul	¥770.5b	-¥232.4b		*	Equity and bond neutral
EUROPE								
Eurozone	Current Account	m/m	May	36.7b	367b		*	Equity and bond neutral
Germany	PPI	y/y	Jun	-1.6%	-2.2%	-1.6%	**	Equity and bond neutral
Italy	Current Account Balance	m/m	May	2078m	2410m		*	Equity and bond neutral
UK	Retail Sales	y/y	Jun	-0.2%	1.7%	0.2%	***	Equity and bond neutral
	Retail Sales Ex-Auto Fuel	y/y	Jun	-0.8%	1.6%	0.2%	**	Equity bearish, bond bullish
	GfK Consumer Confidence	m/m	Jul	-13	-14	-12	***	Equity bearish, bond bullish
	Public Finances (PSNCR)	m/m	Jun	6.6b	18.8b		*	Equity and bond neutral
	Public Sector Net Borrowing	m/m	Jun	13.6b	15.6b	10.5b	*	Equity and bond neutral
	PSNB ex Banking Groups	m/m	Jun	14.5b	16.5b	11.2b	**	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	12-Jul	$601.3b	$597.2b		***	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	12-Jul	18.35t%	18.22t		*	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	554	0	Down
3-mo T-bill yield (bps)	519	520	-1	Up
U.S. Sibor/OIS spread (bps)	528	529	-1	Down
U.S. Libor/OIS spread (bps)	526	527	-1	Down
10-yr T-note (%)	4.21	4.20	0.01	Up
Euribor/OIS spread (bps)	369	368	1	Down
Currencies	**Direction**			
Dollar	Up			Down
Euro	Flat			Up
Yen	Flat			Down
Pound	Down			Up
Franc	Down			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	$84.86	$85.11	-0.29%	
WTI	$82.51	$82.82	-0.37%	
Natural Gas	$2.08	$2.13	-2.21%	
12-mo strip crack	$21.81	$21.81	0.00%	
Ethanol rack	$2.00	$2.01	-0.29%	
Metals				
Gold	$2,413.06	$2,445.08	-1.31%	
Silver	$29.20	$29.83	-2.12%	
Copper contract	$425.55	$427.95	-0.56%	
Grains				
Corn contract	$406.25	$405.00	0.31%	
Wheat contract	$542.00	$535.25	1.26%	
Soybeans contract	$1,046.00	$1,043.00	0.29%	
Shipping				
Baltic Dry Freight	1,912	1,890	22	
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)	10	26	-16	

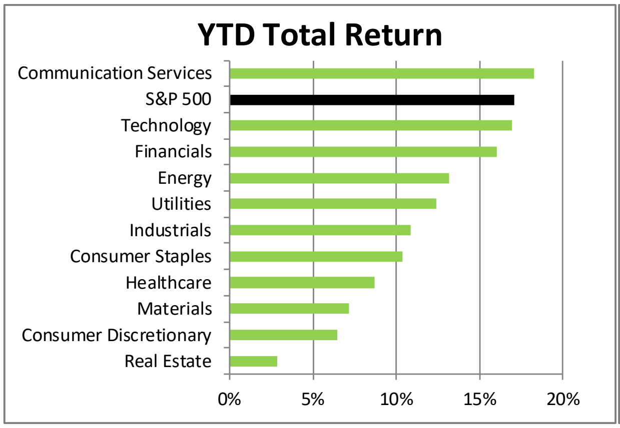
Weather

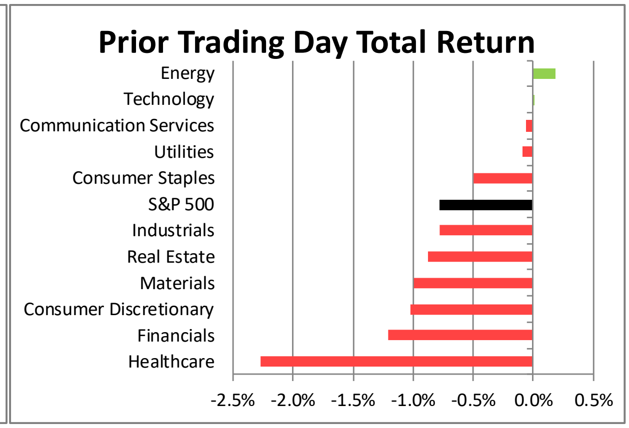
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in the Rocky Mountains, the northern Great Plains, the Upper Midwest, and along the East Coast, with cooler-than-normal temperatures in the Pacific Northwest and lower Mississippi Valley region. The forecasts call for wetter-than-normal conditions in the southern Great Plains, the Midwest, the Deep South, and the mid-Atlantic states, with dry conditions expected in Montana, the Dakotas, and Maine.

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

Data Section

US Equity Markets – (as of 7/18/2024 close)

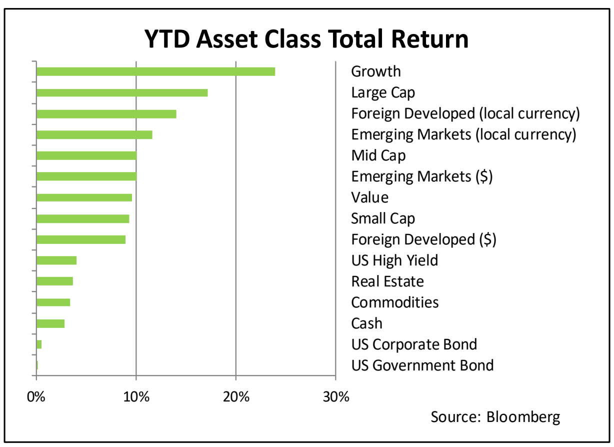




(Source: Bloomberg)

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 7/18/2024 close)

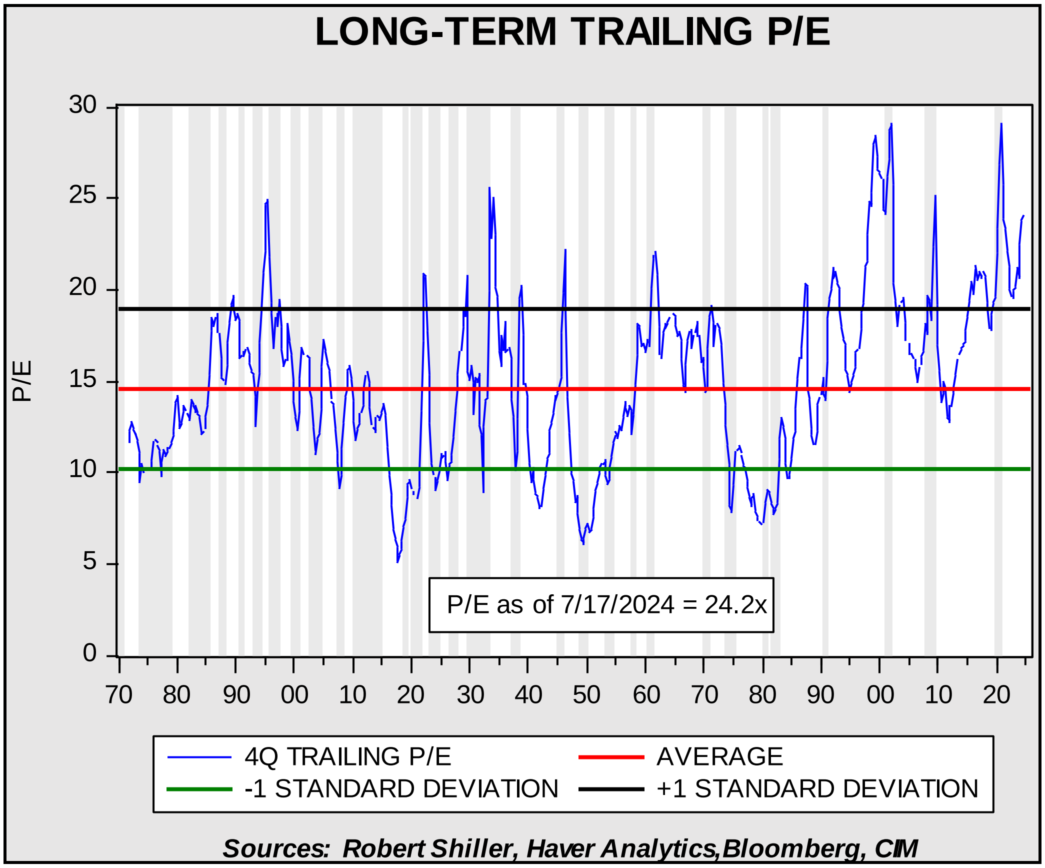


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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,[2] 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.

[2] 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.