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 1, 2024—9:30 AM ET] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 closed up 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.1%. Chinese markets were higher, with the Shanghai Composite up 0.9% from its previous close and the Shenzhen Composite up 0.8%. US equity index futures are signaling a 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* (6/17/2024) (with associated podcast): "Mid-Year Geopolitical Outlook: Uncertainty Reigns"
- *Asset Allocation Quarterly – Q2 2024* (4/25/2024): Discussion of our asset allocation process, Q2 2024 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q2 2024 Rebalance Presentation* (5/7/2024): Video presentation featuring the Asset Allocation Committee as they review the asset allocation strategies, recent portfolio changes, and the current macro environment.
- *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)*
- *Confluence of Ideas podcast* (5/8/2024) "Reviewing the Asset Allocation Rebalance: Q2 2024"

Our *Comment* today opens with new details on why Philippine President Marcos is pushing back so strongly against Chinese territorial aggression in the South China Sea. We next review several other international and US developments with the potential to affect the financial markets today, including a new move by China to potentially weaponize its rare earth resources, a win by the far right in France's first-round parliamentary elections, and additional signs of a potential economic slowdown in the US.

China-Philippines: As Chinese-Philippine tensions continue to worsen, a new article in the *South China Morning Post* provides a useful historical view on how the relationship soured. The article notes the key issue is Beijing's multi-decade effort to assert its sovereignty over parts of the South China Sea claimed by Manila, which successive Philippine leaders have tried to stop with legal suits, appeasement, military investment, and alliance building — all to no avail.

However, the article also emphasizes that Philippine citizens have become incensed at Chinese "Pogo" firms.

- Approved by the previous Duterte administration under its appeasement policy, the Pogos are lightly regulated, Chinese-owned gambling venues that have spread throughout the Philippines. Not only have the Pogos brought criminality, corruption, and illegal Chinese immigration, but recent police probes suggest they have also been used by Beijing to infiltrate secret Chinese intelligence and military operatives.
- Spurred on by China's aggressiveness in the South China Sea and the revelations of the Pogo industry, almost 75% of Philippine citizens now favor the use of military force to maintain the country's sovereignty over the disputed territories.
- The strong domestic political pressure on current President Ferdinand Marcos Jr. to take a hard line against Beijing is one reason we see today's Chinese-Philippine tensions as an especially dangerous source of potential conflict. Because of the US-Philippine mutual defense treaty, any such conflict could also draw the US into a direct conflict with China.

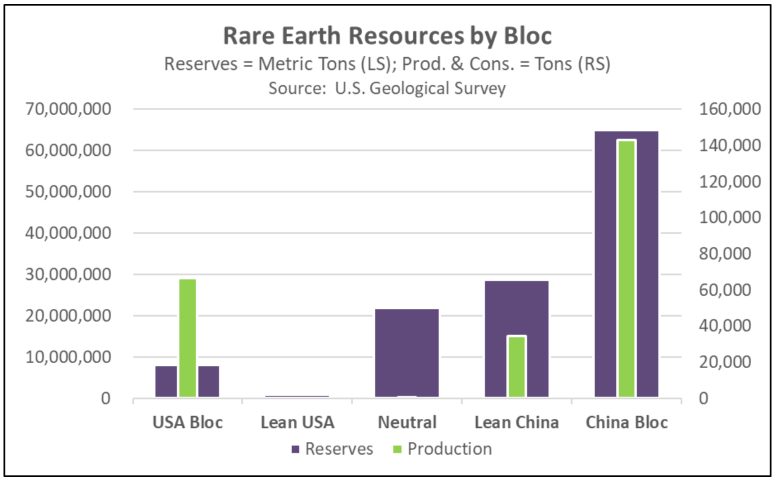
China-Southeast Asia: As widely expected, the new US and EU tariffs on Chinese electric vehicles are starting to prompt Chinese EV makers to shift toward Southeast Asian markets. BYD (which Warren Buffet's Berkshire Hathaway has invested in) and other Chinese EV makers are reportedly now spending billions of dollars to ramp up their sales and output in Indonesia, Thailand, and other countries in the region.

- Given that those countries are relatively poor, the move is expected to force the Chinese firms to cut prices, potentially weighing on their profitability.
- Of course, the invasion of Chinese EVs and any new Chinese EV factories could spark disruption in the region's auto markets, potentially raising tensions between Beijing and regional capitals.

China-Global Rare Earths Market: On Saturday, China issued a package of new rules aimed at protecting its supply of rare earths, a class of exotic minerals critical to modern electrified technologies. Although China and its geopolitical and economic bloc already dominate the world's supply and smelting of rare earths, the new rules emphasize that rare earth resources belong to the state and that the government will control the industry's development. Importantly, the rules also establish a rare earth traceability system that could aid in embargoing rare earths.

- Beijing introduced restrictions last year on the export of germanium and gallium, which are critical to the manufacturing of semiconductors. It had also already banned the export of technologies for refining rare earths and making them into magnets.
- Under the new traceability system, Chinese firms involved in the mining, refining, or export of rare earths must establish a detailed product flow record and submit the data to the government.
- Of course, having detailed information on the flow of rare earth products would allow the government to fine-tune any restrictions it might want to place on their export. That's consistent with our view that Beijing will likely try to weaponize its dominance of key

mineral commodities as tensions between the US bloc and the China/Russia bloc continue to rise.



European Union-United States: The European Commission today charged US social-media giant Meta Platforms with violating the EU's new Digital Markets Act, just as it issued charges against Apple and Microsoft last month. At issue is how Meta requires EU users of Facebook and Instagram to either pay a subscription fee or allow the firm to use their data for targeted ads. If found guilty of the infraction, Meta could be fined 10% to 20% of its global revenue. The action highlights the rising regulatory risks faced by US tech firms in the EU market.

European Union: The far-right government of Hungarian Prime Minister Viktor Orbán today takes over the presidency of the Council of the European Union, giving the nationalist firebrand a megaphone and opportunity to steer EU policy initiatives over the coming six months. Our new *Bi-Weekly Geopolitical Report*, to be published later today, explains how the Council fits into the EU's governance structure.

France: In the first round of parliamentary elections on Sunday, preliminary results suggest the far-right National Rally (RN) party came in first with 33.2% of the vote, followed by the far-left National Popular Front (NFP) with 28.0% and President Macron's centrist liberal alliance with 22.4% of the vote. That puts the far-right in position to potentially win an absolute majority in the National Assembly after the second-round voting on July 7.

- In such a situation, the far right would be in position to name the prime minister and force an uncomfortable "cohabitation" government with President Macron.
- However, the far-left NFP and Macron's centrists are reportedly in emergency talks today to coordinate and block RN from gaining a majority. The parties are negotiating a plan to withdraw the weaker of their candidates in hundreds of constituencies, with the goal of limiting how many seats RN can win. The effort has given a modest boost to French stocks and the euro so far this morning.
- In any case, the results point to a sharp shift to the right in French politics, potentially leading to populist fiscal policies and a crackdown on immigration.

Iran: In Friday's first-round presidential election, Masoud Pezeshkian, a reformist former health minister, came in first with 42% of the vote, followed by Saeed Jalili, an arch-conservative, with 38%. Since neither candidate won an absolute majority, the two will now face each other in a run-off election this coming Friday. Although the true power in Iran's government lies with conservative clerics, a win by Pezeshkian could help nudge Iran toward better relations with the West and less belligerence toward Israel and other rivals in the Middle East.

US Regulatory Policy: In a decision Friday, the Supreme Court overturned its 40-year old "Chevron deference" doctrine, under which courts hearing challenges to regulations deferred to agency legal interpretations when the statutory language passed by Congress was unclear, as long as the interpretation was reasonable. Originally seen as a bulwark against excessive regulation, the doctrine more recently had been seen as giving regulators too much power. Now that the doctrine is overturned, it should be easier for firms to challenge regulations.

- When first laid down in 1984, in *Chevron v. Natural Resources Defense Council*, the doctrine aimed to recognize the expertise that federal regulators typically have in their area of responsibility. The decision on Friday turned in large part on the fact that while agencies have a lot of technical and policy expertise, they don't necessarily have more legal expertise than the courts.
- Going forward, the decision means that a court hearing a challenge to a regulation won't necessarily defer to the agency's understanding of what it can or can't do. That should tip the scale back in favor of businesses or property owners challenging a regulation.
- The decision illustrates how the US is now in the midst of a court-driven de-regulation phase. A key question is how far that de-regulation trend will go, especially given that today's geopolitical tensions and political populism should tend to increase government power and lead to tougher regulation in some areas of the economy.

US Personal Income: In a little-noticed aspect of Friday's report on May personal income and spending, the year-over-year growth in inflation-adjusted, per-capita disposable personal income (income after taxes) has slowed dramatically every month this year. In May, it was only up 0.5% year-over-year. The slowdown largely reflects the unusual jump in disposable income in early 2023, when tax brackets were adjusted for the high consumer price inflation in 2022.

- Real per-capita personal consumption expenditures have held up better, with the figure for May up 1.9% year-over-year.
- Still, the drop in real after-tax income threatens to weigh more on personal spending in the coming months. If so, that could lead to a more material slowdown in economic growth and greater pressure on the Federal Reserve to cut interest rates.

US Lumber Market: Near lumber futures on Friday fell approximately 3% to $452.50 per thousand board feet, bringing their drop to 27% since mid-March. The unusual decline in the middle of the prime homebuilding season suggests today's high interest rates are finally starting to weigh on home construction and remodeling, despite continued high demand for new homes.

US Economic Releases

There were no domestic releases prior to the publication of this report. 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
9:45	S&P Global US Manufacturing PMI	m/m	Jun F	51.7	51.7	***
10:00	Construction Spending MoM	m/m	May	2.00%	-0.10%	*
10:00	ISM Manufacturing	m/m	Jun	49.1	48.7	**
10:00	ISM Prices Paid	m/m	Jun	55.8	57	**
10:00	ISM New Orders	m/m	Jun	49.0	45.4	**
10:00	ISM Employment	m/m	Jun	50.0	51.1	*
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	Tankan Large Manufacturing Index	q/q	2Q	13	11	11	***	Equity bullish, bond bearish
	Tankan Large Manufacturing Outlook	q/q	2Q	14	10	11	***	Equity bullish, bond bearish
	Tankan Large Non-Manufacturing Index	q/q	2Q	33	34	33	***	Equity and bond neutral
	Tankan Large Non-Manufacturing Outlook	q/q	2Q	27	27	28	***	Equity and bond neutral
	Tankan Large All-Industry Capex	q/q	2Q	11.1%	4.0%	13.9%	***	Equity bearish, bond bullish
	Jibun Bank Manufacturing PMI	m/m	Jun F	50.0	50.1		***	Equity and bond neutral
	Consumer Confidence Index	y/y	Jun	36.4%	36.2%	36.4%	**	Equity and bond neutral
Australia	Melbourne Institute Inflation	y/y	Jun	3.2%	3.1%		***	Equity and bond neutral
South Korea	Exports	y/y	Jun	5.1%	11.5%	4.4%	***	Equity and bond neutral
	Trade Balance	m/m	Jun	$7999m	$4855m	$5700m	*	Equity and bond neutral
	Imports	y/y	Jun	-7.5%	-4.7%	-4.0%	**	Equity bearish, bond bullish
	S&P Global South Korea PMI Manufacturing	m/m	Jun	52.0	51.6		***	Equity and bond neutral
China	Official Composite PMI	m/m	Jun	50.5	51.0		*	Equity and bond neutral
	Official Manufacturing PMI	m/m	Jun	49.5	49.5	49.5	***	Equity and bond neutral
	Official Services PMI	m/m	Jun	50.5	51.1	51.0	**	Equity bearish, bond bullish
	Caixin Manufacturing PMI	m/m	Jun	51.8	51.7	51.5	***	Equity and bond neutral
India	HSBC India PMI Mfg	m/m	Jun F	58.3	58.5		***	Equity and bond neutral
EUROPE								
Eurozone	HCOB Eurozone Manufacturing PMI	m/m	Jun F	45.8	45.6	45.6	***	Equity and bond neutral
Germany	HCOB Germany Manufacturing PMI	m/m	Jun F	43.5	43.4	43.4	***	Equity and bond neutral
	CPI	y/y	Jun P	2.2%	2.4%	2.3%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Jun P	2.5%	2.8%	2.5%	**	Equity and bond neutral
France	HCOB France Manufacturing PMI	m/m	Jun F	45.4	45.3	45.3	***	Equity and bond neutral
Italy	HCOB Italy Manufacturing PMI	m/m	Jun	45.7	45.6	44.3	***	Equity bullish, bond bearish
UK	Nationwide House Price Index	y/y	Jun	1.5%	1.3%	1.2%	***	Equity and bond neutral
	Net Lending Sec. on Dwellings	m/m	May	1.2b	2.2b	1.5b	*	Equity and bond neutral
	Mortgage Approvals	m/m	May	60.0k	60.8k	60.5k	***	Equity and bond neutral
	M4 Money Supply	y/y	May	-0.1%	0.1%		*	Equity and bond neutral
	S&P Global UK Manufacturing PMI	m/m	Jun F	50.9	51.4	51.4	***	Equity and bond neutral
Switzerland	Real Retail Sales	y/y	May	0.4%	2.7%	2.2%	**	Equity bearish, bond bullish
	PMI Manufacturing	m/m	Jun	43.9	46.4	45.5	***	Equity bearish, bond bullish
	PMI Services	m/m	Jun	52.0	48.8		*	Equity and bond neutral
	Domestic Sight Deposits CHF	w/w	28-Jun	443.0b	443.4b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	28-Jun	452.0b	451.8b		*	Equity and bond neutral
Russia	Current Account Balance	q/q	1Q F	22555m	25200m		**	Equity and bond neutral
	S&P Global Canada Manufacturing PMI	m/m	Jun	54.9	54.4		***	Equity and bond neutral
AMERICAS								
Canada	GDP	y/y	Apr	1.1%	0.6%	1.1%	**	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)	559	559	0	Up
3-mo T-bill yield (bps)	522	522	0	Up
U.S. Sibor/OIS spread (bps)	532	532	0	Up
U.S. Libor/OIS spread (bps)	532	532	0	Flat
10-yr T-note (%)	4.41	4.40	0.01	Up
Euribor/OIS spread (bps)	371	370	1	Down
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Flat
Yen	Down			Down
Pound	Up			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	$85.62	$85.00	0.73%	
WTI	$82.09	$81.54	0.67%	
Natural Gas	$2.57	$2.60	-1.23%	
12-mo strip crack	$22.52	$22.34	0.77%	
Ethanol rack	$2.18	$2.18	-0.04%	
Metals				
Gold	$2,336.98	$2,326.75	0.44%	
Silver	$29.31	$29.14	0.56%	
Copper contract	$442.00	$439.15	0.65%	
Grains				
Corn contract	$418.75	$420.75	-0.48%	
Wheat contract	$575.25	$573.50	0.31%	
Soybeans contract	$1,102.50	$1,104.00	-0.14%	
Shipping				
Baltic Dry Freight	2,050	2,031	19	

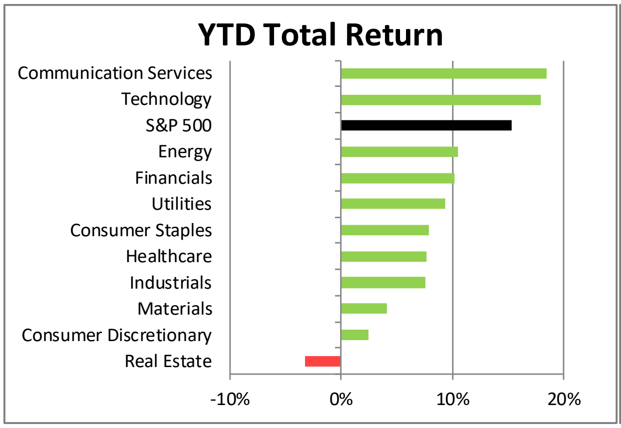
Weather

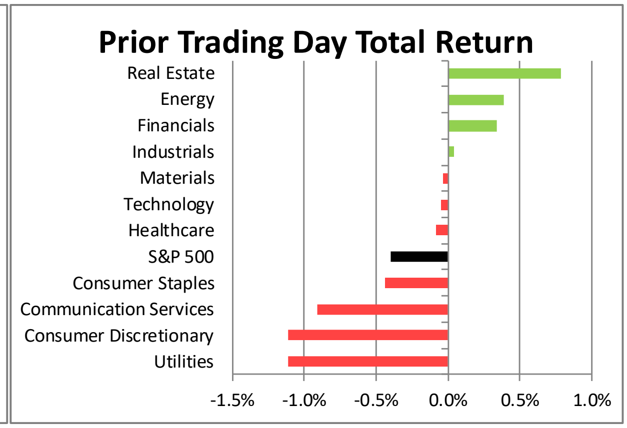
The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures throughout most of the country, with cooler-than-normal temperatures only in the North Central states. The forecasts call for wetter-than-normal conditions in most states, with dry conditions in the Pacific Northwest.

There are now three atmospheric disturbances in the Atlantic Ocean area. The first is a tropical depression that developed off the east coast of the Yucatan Peninsula. The second, Hurricane Beryl, is expected to make landfall in the Windward Islands later today before making its way into the Caribbean Sea. The third tropical disturbance, located in the Central Atlantic Ocean, is moving westward and is assessed to have a 40% chance of turning into a cyclone in the next 48 hours.

Data Section

US Equity Markets – (as of 6/28/2024 close)

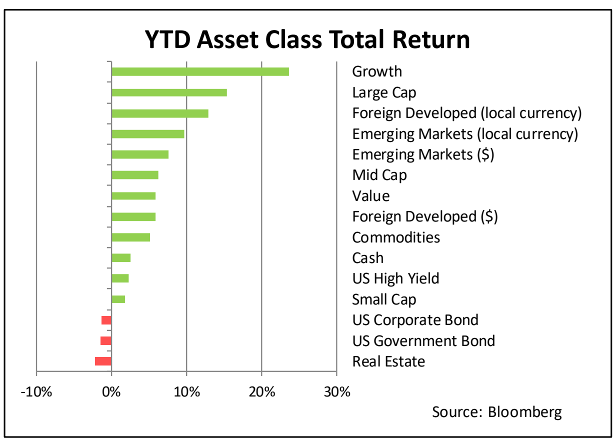




(Source: Bloomberg)

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 6/28/2024 close)

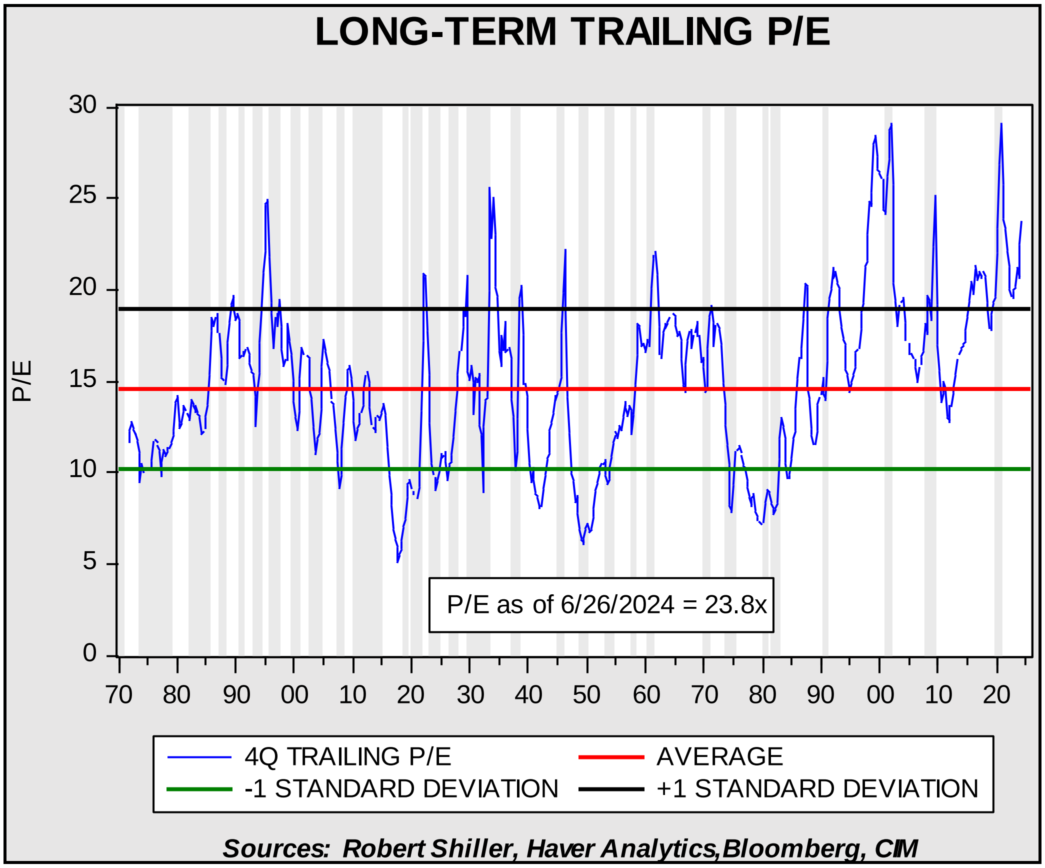


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

June 27, 2024



Based on our methodology,[1] the current P/E is 23.8x, up 0.1 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.