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 24, 2024—9:30 AM ET] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 closed down 0.9% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.4%. Chinese markets were lower, with the Shanghai Composite down 0.5% from its previous close and the Shenzhen Composite down 1.3%. US equity index futures are signaling a lower open.

With 114 companies having reported so far, S&P 500 earnings for Q2 are running at $59.80 per share, compared to estimates of $58.94, which is up 8.0% from Q2 2023. Of the companies that have reported thus far, 80.7% have exceeded expectations while 14.0% 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:

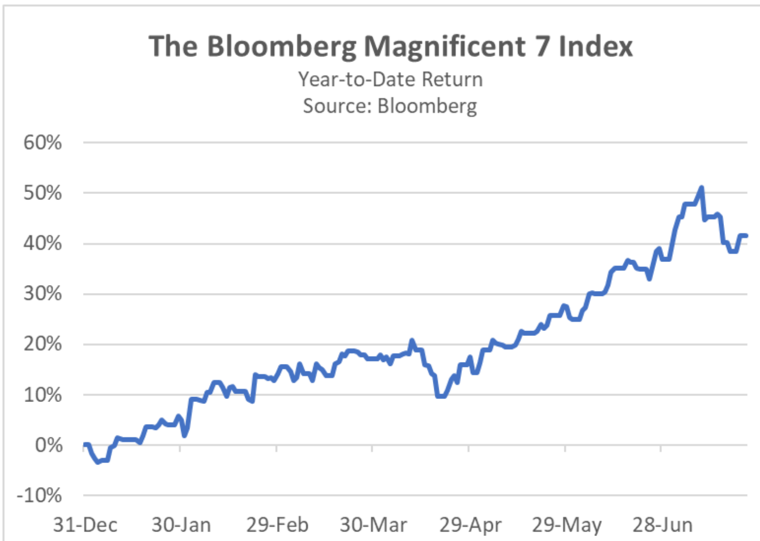
- *Bi-Weekly Geopolitical Report* (7/22/2024) (with associated podcast): "Meet Ferdinand Marcos Jr., President of the Philippines"
- *Asset Allocation Bi-Weekly* (7/15/2024) (with associated podcast): "A New Factor for Gold Prices"
- *Asset Allocation Quarterly – Q3 2024* (7/16/2024): Discussion of our asset allocation process, Q3 2024 portfolio changes, and our outlook for the markets.

Good morning! S&P 500 futures are indicating a subdued open as investors digest earnings. In sports news, Team USA's basketball team defeated Germany in its final Olympic tune-up. Today's *Comment* begins with our analysis of why the Magnificent 7 companies might be declining in popularity, followed by an explanation of why bond liquidity is becoming a big problem. We will then discuss how a potential economic slowdown in the EU could shift the central bank's focus from inflation. As usual, our report concludes with a summary of international and domestic data releases.

Big Tech Fades: Two Magnificent 7 companies have underwhelmed investors this earnings season as the market demands concrete evidence of profitability.

- Google's parent company, Alphabet, topped second-quarter earnings expectations on Tuesday, but failed to reassure investors about the impending returns on its AI investment. The company's AI spending surged to $2.2 billion, doubling the previous year and pushing back the timeline for substantial profits to 2025 or 2026. Adding to investor woes, Tesla reported disappointing earnings and pushed back the launch of its highly anticipated robotaxi by two months. These setbacks, coupled with slowing demand for electric vehicles, signal broader challenges for the company.

- The recent decline of the Magnificent 7 was anticipated. Two months ago, we highlighted that several of the companies were attempting to bolster investor confidence through dividends and buybacks to help justify their stocks' lofty valuations. While these actions temporarily lifted sentiment, they did little to alter the fundamental reality: AI remains in its early stages. Nvidia, a key beneficiary of the AI frenzy, has been under our close watch. Given the company's history of exceeding earnings expectations, a miss could lead the recent decline in the Magnificent 7 Total Return Index to deepen.

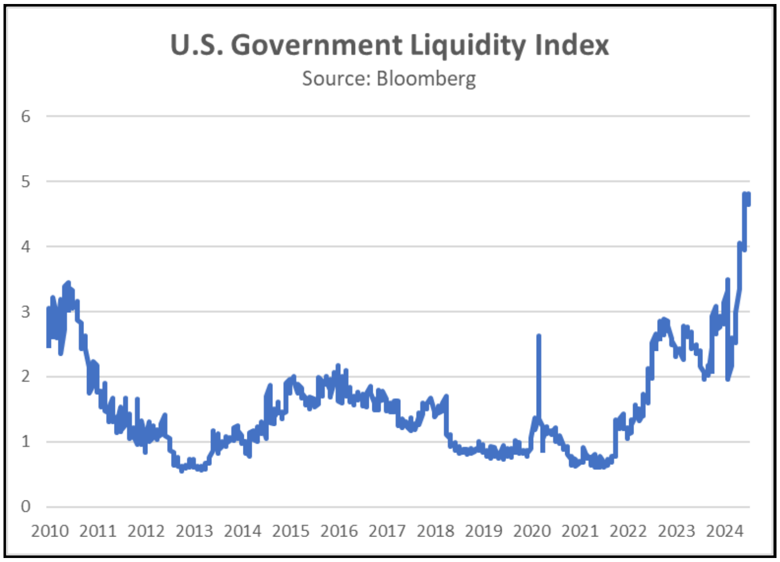


- The Magnificent 7 initially captivated investors with their scale and AI focus, propelling their stock prices to extraordinary heights over the past two years. This rally coincided with a sharp rise in interest rates on government bonds, making investors wary of smaller, riskier companies due to tighter financial conditions. However, much of these tech giants' future growth appears priced in, limiting their upside potential. While it's too early to declare a long-term trend, the outperformance of small and mid-cap stocks suggests a potential shift in investor sentiment may be underway.

Treasury Auction: The expectations of lower interest rates have helped fuel demand for US government debt, even as liquidity remains an issue.

- Tuesday's $69 billion auction of two-year Treasury notes yielded a strong result, with a yield of 4.434%, more than 2 basis points lower than the previous record-matching auction. Surprisingly, the overwhelming majority of the issuance was absorbed by just two bidders, leaving a mere 9% for primary dealers — a historic low for these buyers who are typically responsible for picking up excess supply. This robust investor demand likely reflects a desire to lock in yields ahead of the anticipated Federal Reserve rate cut in September.

- One of the most pressing questions facing the US government is how to address its ballooning deficit. While the Treasury market has historically proven to be a reliable outlet for government debt, concerns are growing about its capacity to absorb future issuances. A liquidity index that tracks US government securities is showing signs of deterioration. In fact, it suggests that liquidity conditions are now worse than both the COVID crash in 2020 and the European Debt Crisis in 2011. This erosion appears to be on track to continue as long as the government struggles to deal with its growing fiscal imbalances.

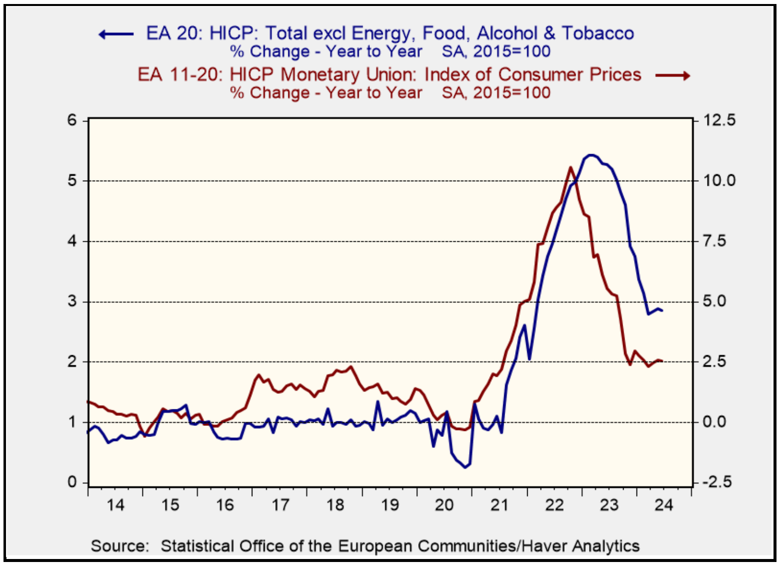


- We have long suspected a coordinated policy approach between the Federal Reserve and Treasury to manage the nation's growing debt burden. While we are skeptical of market projections for aggressive rate cuts in the near term, we acknowledge the potential for heightened Fed intervention in the Treasury market. If economic conditions deteriorate and inflation persists, the central bank may need to play a more active role to avert a crisis, which could include a sooner-than-expected end to quantitative tightening and a possible return to quantitative easing.

Europe's Growth Problem: A slowdown in economic activity could complicate efforts by the ECB to balance growth and inflation concerns.

- The S&P Global Purchasing Manager Index (PMI) for the EU fell from 45.8 to 45.6 in July. A reading below 50 is a signal of contraction. The reading was below estimates of an increase to 46.1. The problem was really pronounced in the two largest countries within the bloc. Germany's manufacturing PMI fell from 43.5 to 42.6, while France's manufacturing PMI fell from 45.4 to 44.1. Although service activity was stronger throughout the regions, (particularly in France, which has benefited from the Olympics) there does seem to be a loss of momentum.
- The slowdown in economic activity could shift the European Central Bank's (ECB) focus from solely targeting inflation toward supporting growth. Despite acknowledging progress in curbing inflation toward its 2% goal, the ECB has maintained a cautious

approach to interest rate cuts. Following a 25-basis-point reduction in June, the bank opted to hold rates steady in July, pending further evidence of sustained disinflationary trends. In June, overall inflation in the eurozone held steady at 2.9%, while core inflation was roughly unchanged at 2.6%.



- Despite economic growth concerns, the ECB is likely to delay further rate cut commitments until the Federal Reserve's monetary policy becomes clearer. Widening interest rate differentials have been a primary driver of recent currency fluctuations. This poses a challenge for the eurozone as it seeks to contain inflation, given the region's heavy reliance on dollar-priced imports. As a result, while future price cuts cannot be ruled out, we think a potential hawkish shift by Fed members could alter the path of future ECB policy.

In other news: Democratic candidate Kamala Harris has announced that she has locked up enough delegates to secure the nomination as president. The move sets up a showdown between her and former President Donald Trump. Home prices hit a new high in a sign that shelter prices may continue to be a problem for inflation. The US has become increasingly concerned about Russia and China's activities in the Arctic. This concern likely reflects the growing tensions between the West and these two nations.

US Economic Releases

The Mortgage Bankers Association today said ***mortgage applications*** in the week ended July 19 fell 2.2%, compared to last week's gain of 3.9%. Applications for home purchase mortgages fell 4.0%. Applications for refinancing mortgages rose 0.3%. According to the report, the average interest rate on a 30-year mortgage fell to 6.82%, compared to 6.87% the previous week. Although this is the lowest level since February, it is still twice as high as the level at the end of 2021. Taken together with this week's large downward movement in applications, this report suggests a need for even lower rates to stir demand, as well as a possibility for further weakness in the market for the rest of the year.

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	Jul P	51.6	51.6	***
9:45	S&P Global US Services PMI	m/m	Jul P	54.9	55.3	***
9:45	S&P Global US Composite PMI	m/m	Jul P	54.2	54.8	***
10:00	New Home Sales	m/m	Jun	640k	619k	***
10:00	New Home Sales MoM	m/m	Jun	3.4%	-11.3%	**
Federal Reserve						
ET	Speaker or Event	District or Position				
16:05	Michelle Bowman and Lorie Logan Give Opening Remarks in Dallas	Member of the Board of Governors and Dallas Fed Presidant				

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	Jibun bank Composite PMI	m/m	Jul P	52.6	49.7		*	Equity and bond neutral
	Jibun Bank Manufacturing PMI	m/m	Jul P	49.2	50.0		***	Equity and bond neutral
	Jibun Bank Services PMI	m/m	Jul P	52.6	49.4		**	Equity and bond neutral
South Korea	Consumer Confidence	m/m	Jul	103.6	100.9		*	Equity and bond neutral
India	HSBC India PMI Mfg	m/m	Jul P	58.5	58.3		***	Equity and bond neutral
	HSBC India PMI Composite	m/m	Jul P	61.4	60.9		**	Equity and bond neutral
	HSBC India PMI Services	m/m	Jul P	61.1	60.5		**	Equity and bond neutral
EUROPE								
Eurozone	Consumer Confidence	m/m	Jul P	-13.0	-14.0	-13.5	**	Equity and bond neutral
	HCOB Eurozone Manufacturing PMI	m/m	Jul P	45.6	45.8	46.1	***	Equity and bond neutral
	HCOB Eurozone Services PMI	m/m	Jul P	51.9	52.8	52.9	**	Equity bearish, bond bullish
	HCOB Eurozone Composite PMI	m/m	Jul P	50.1	50.9	50.9	*	Equity bearish, bond bullish
Germany	GfK Consumer Confidence	m/m	Aug	-18.4	-21.6	-21.0	**	Equity and bond neutral
	HCOB Germany Manufacturing PMI	m/m	Jul P	42.6	43.5	44.0	***	Equity bearish, bond bullish
	HCOB Germany Services PMI	m/m	Jul P	52.0	53.1	53.3	**	Equity bearish, bond bullish
	HCOB Germany Composite PMI	m/m	Jul P	48.7	50.4	50.6	**	Equity bearish, bond bullish
France	HCOB France Manufacturing PMI	m/m	Jul P	44.1	45.4	45.9	***	Equity bearish, bond bullish
	HCOB France Services PMI	m/m	Jul P	50.7	49.6	49.7	**	Equity bullish, bond bearish
	HCOB France Composite PMI	m/m	Jul P	49.5	48.8	48.8	**	Equity bullish, bond bearish
UK	S&P Global UK Manufacturing PMI	m/m	Jul P	51.8	50.9	51.0	***	Equity bullish, bond bearish
	S&P Global UK Services PMI	m/m	Jul P	52.4	52.1	52.5	**	Equity and bond neutral
	S&P Global UK Composite PMI	m/m	Jul P	52.7	52.3	52.6	**	Equity and bond neutral
AMERICAS								
Mexico	International Reserves Weekly	w/w	19-Jul	$221621m	$221184m		*	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)	517	518	-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 (%)	4.23	4.25	-0.02	Up
Euribor/OIS spread (bps)	371	370	1	Down
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Up			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	$81.89	$81.01	1.09%	
WTI	$77.93	$76.96	1.26%	
Natural Gas	$2.12	$2.19	-3.06%	
12-mo strip crack	$22.17	$22.05	0.52%	
Ethanol rack	$2.02	$2.03	-0.22%	
Metals				
Gold	$2,416.37	$2,409.64	0.28%	
Silver	$29.34	$29.24	0.32%	
Copper contract	$415.20	$416.05	-0.20%	
Grains				
Corn contract	$417.75	$417.25	0.12%	
Wheat contract	$543.75	$542.75	0.18%	
Soybeans contract	$1,071.25	$1,075.50	-0.40%	
Shipping				
Baltic Dry Freight	1,869	1,896	-27	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.84		
Gasoline (mb)		1.00		
Distillates (mb)		1.00		
Refinery run rates (%)		-0.5%		
Natural gas (bcf)		13		

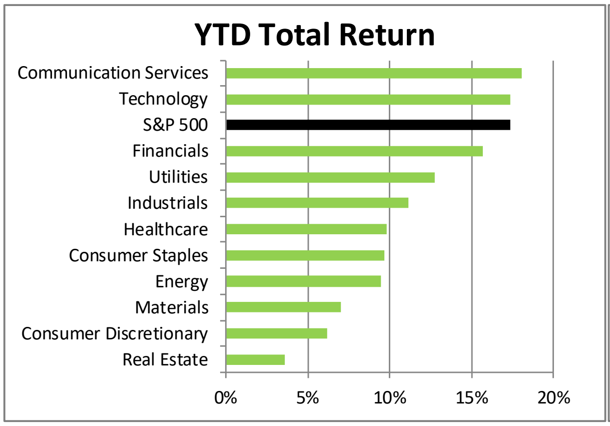
Weather

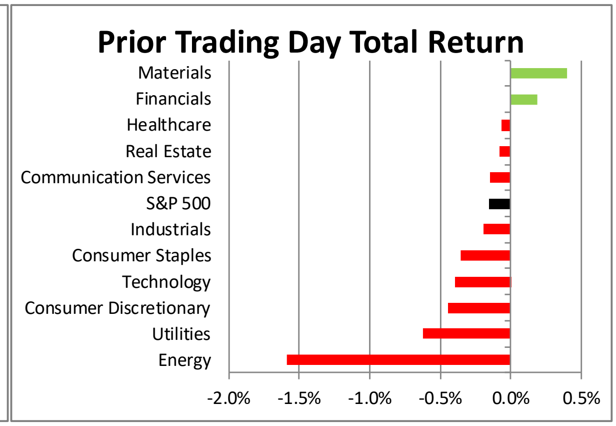
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures to prevail across all of the country except for the West Coast and a swath of the South from Texas to the Carolina coast, with cooler-than-normal temperatures in southern Texas and California. The precipitation outlook calls for wetter-than-normal conditions in the eastern third of the country from Florida through the Great Lakes to Maine, with dry conditions expected in a bubble encapsulating Nevada, the Rocky Mountains, and the 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 7/23/2024 close)

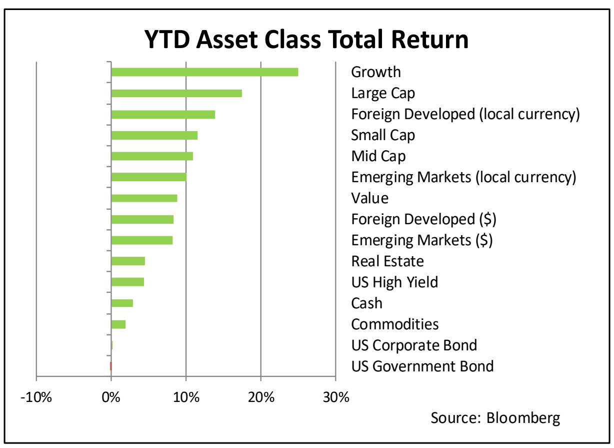




(Source: Bloomberg)

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 7/23/2024 close)

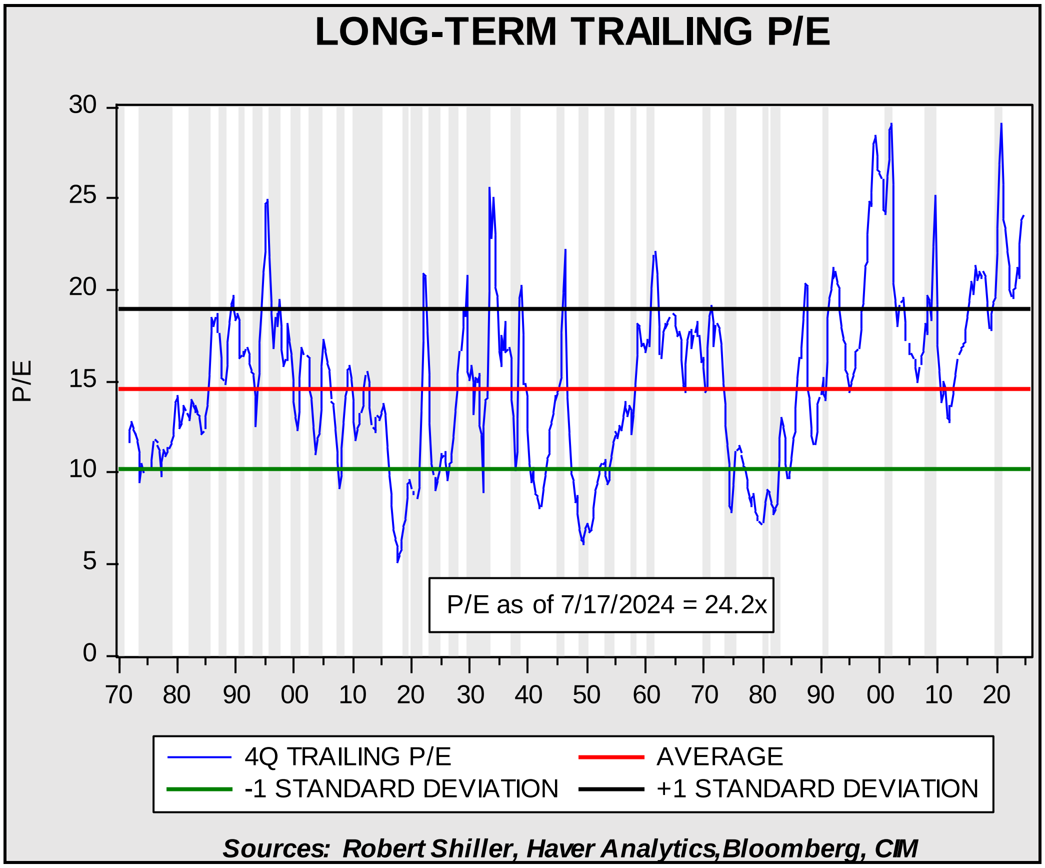


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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.