# 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 25, 2024—9:30 AM ET]** Global equity markets are generally lower this morning. In Europe, the Euro Stoxx 50 closed down 1.6% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.0%. Chinese markets were mixed, with the Shanghai Composite down 0.5% from its previous close and the Shenzhen Composite up 0.1%. US equity index futures are signaling a lower open.

With 155 companies having reported so far, S&P 500 earnings for Q2 are running at $59.90 per share, compared to estimates of $58.94, which is up 8.0% from Q2 2023. Of the companies that have reported thus far, 78.1% have exceeded expectations while 14.2% 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* (7/22/2024) (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.

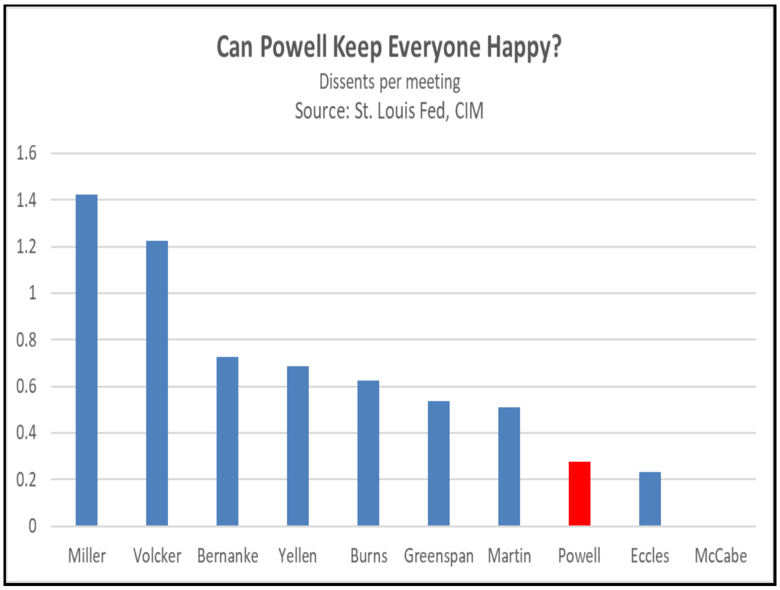
Good morning! The S&P 500 is off to a sluggish start as investors digest recent earnings reports. In sports news, Morocco's men's soccer team was almost robbed of its Olympic victory over Argentina. Today's *Comment* will explore the possibility of a Fed rate cut in July, analyze the disproportionate impact of the recent market downturn on large companies, and delve into the reasons behind the yen's recent surge. As always, our report concludes with a roundup of international and domestic economic data.

**A July Cut?** A sudden turn by a former Fed official and weak economic data fueled further speculation that the Fed may cut imminently.

- Former New York Fed President William Dudley called for an immediate interest rate cut on Wednesday, warning that the Federal Reserve may be running out of time to prevent a recession. While acknowledging the benefits of low mortgage rates and a buoyant financial market for the wealthy, Dudley emphasized the broader economy's struggles.

He argued that maintaining current interest rates unnecessarily increases recession risks. Dudley is not alone in this opinion as former PIMCO Chief Mohamed El-Erian also expressed concerns about Fed cautiousness and suggested that the Fed may be two meetings away from a mistake.

- His comments come at a time when the Federal Reserve is presenting a united front, yet also showing signs of growing divisions. During his tenure as Fed Chair, Jerome Powell has experienced the fewest dissents since Marriner Eccles held the position from 1948 to 1951. However, Fed speeches reveal significant divergence among policymakers regarding the appropriate policy path with officials making the case both for and against rate cuts. The March summary of economic projections underscored this disparity, with some members of the FOMC advocating for no rate cuts while one proposed as many as four.

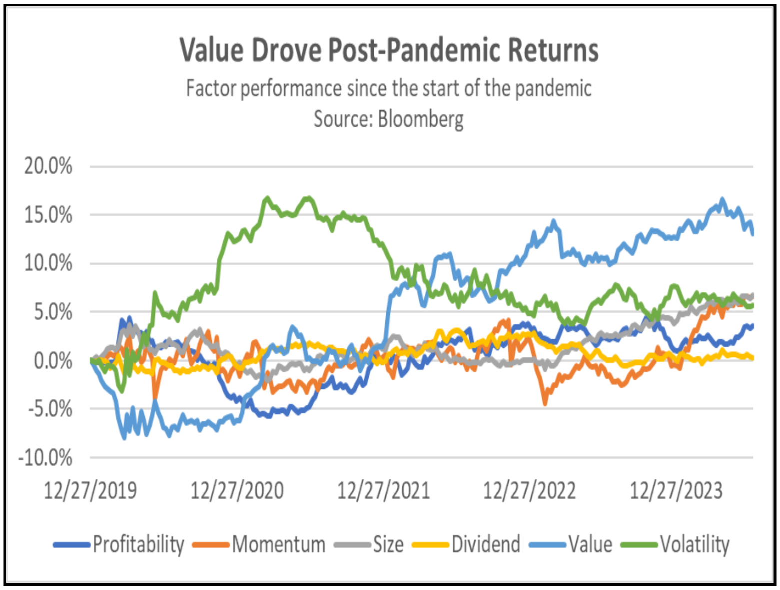



- The Fed will make its next policy rate decision next week. While not a voting member, Dudley's comments are likely to influence discussions as policymakers navigate the path forward. If inflation continues to moderate and labor market conditions worsen, the Fed may signal the potential for multiple rate cuts before year-end. However, a surprise rate cut, which can't completely be ruled out, could prompt the central bank to indicate a pause on further reductions until after the election in order to avoid perceived political bias.

**Market Friend or Foe:** The unwinding of the AI tech rally is a reminder of why it is risky to make investments based on momentum.

- The AI-related stock sell-off has gone global. The Stoxx Europe 600 Technology Index plunged 2.8% on Wednesday, fueled by steep declines in chipmakers like Netherlands-based ASML and Germany's Infineon. The rout extended to Asia, with SK Hynix, a key Nvidia supplier, plummeting 8.9% on Thursday despite reporting robust chip sales. This market downturn was triggered by Alphabet's earnings call, during which the company signaled increased expenses due to hiring and infrastructure costs, raising concerns about the ability of tech companies to improve profit margins.

- This sell-off serves as a stark reminder of the risks associated with momentum investing. While riding market trends can be profitable, it's essential to recognize that such strategies are inherently cyclical. The underperformance of momentum stocks coincided with a confluence of negative factors, including declining inflation and interest rate expectations, as well as growing pessimism about consumer spending. The reversal of these trends has led to a sharp increase in market volatility as investors plan for the next move, with value stocks emerging as an attractive option.

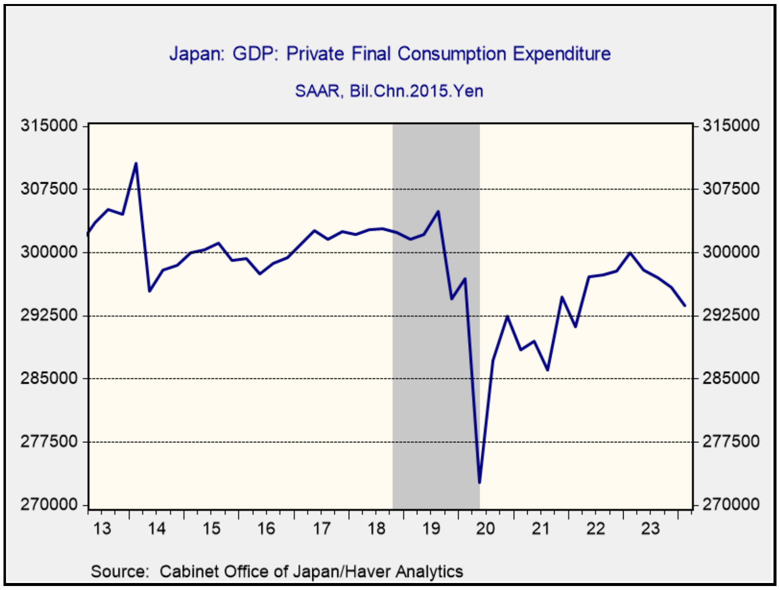



- Market fundamentals suggest a potential rotation from large-cap to small-cap stocks. However, unforeseen challenges like a more hawkish Fed stance or an economic downturn could derail this trend. Nevertheless, a bounce back for AI-related stocks cannot be ruled out entirely. A strong earnings report from Nvidia next month could potentially bolster the broader tech sector, including mega-cap companies. That said, we remain optimistic about companies that have yet to fully participate in the market rally, particularly mid- and small-cap stocks.

**The Yen's Comeback:** The Japanese yen (JPY) has strengthened as the Bank of Japan's monetary policy appears relatively more hawkish compared to its G7 counterparts.

- The JPY has strengthened 3.1% against the dollar over the past five days, surpassing the psychologically significant 152 level. This appreciation follows a series of dovish policy actions and statements from other central banks aiming to stimulate economic growth. On Wednesday, the People's Bank of China reduced its one-year medium-term lending rate by 20 basis points. Simultaneously, the Bank of Canada lowered its benchmark interest rate by 25 basis points for the second consecutive month, while the European Central Bank is mulling another cut in September.

- While global central banks lean towards easing monetary policy, the Bank of Japan (BOJ) is charting a divergent course. At their upcoming policy meeting, policymakers are expected to discuss potential steps to unwind their expansive stimulus program. BOJ officials are considering a potential rate hike and halving their bond purchase program. Their decisions will likely hinge on expectations for future consumption and inflation. While inflation has shown signs of stickiness, with the core CPI above its 2% target, domestic consumption has weakened.

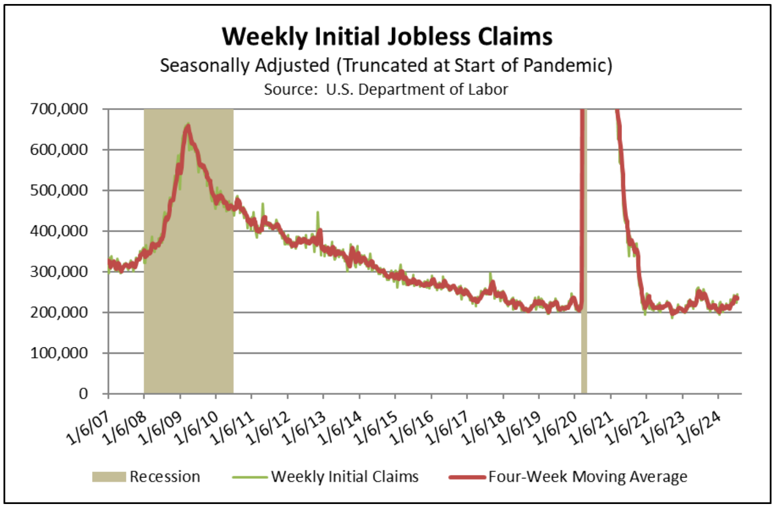



- The strengthening of the JPY is likely to be a sustained trend. For years, Japan has been signaling its intention to normalize monetary policy after a prolonged period of negative interest rates. This policy shift is expected to impact carry trades as investors may hedge their JPY exposure, which proliferated during the BOJ's ultra-loose monetary policy era. Clear communication from the BOJ regarding its policy exit should mitigate the risk of a significant market disruption. Additionally, it should provide some resistance to the USD.

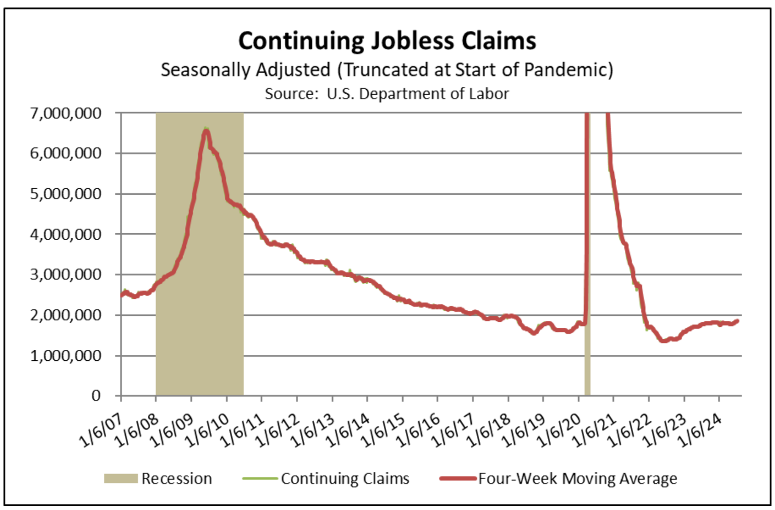
**In Other News:** Former President Trump is set to be the keynote speaker at a crypto conference in Nashville later today. Speculation is rife that he may be considering building a strategic bitcoin reserve, a move that could potentially usher in a bitcoin standard. Russia and China participated in a joint mission near Alaska in a sign that their rivalry with the West is intensifying.

**US Economic Releases**

In the week ended July 20, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 235,000, below the expected level of 238,000 and down from the prior week's revised level of 245,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 235,500. 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.

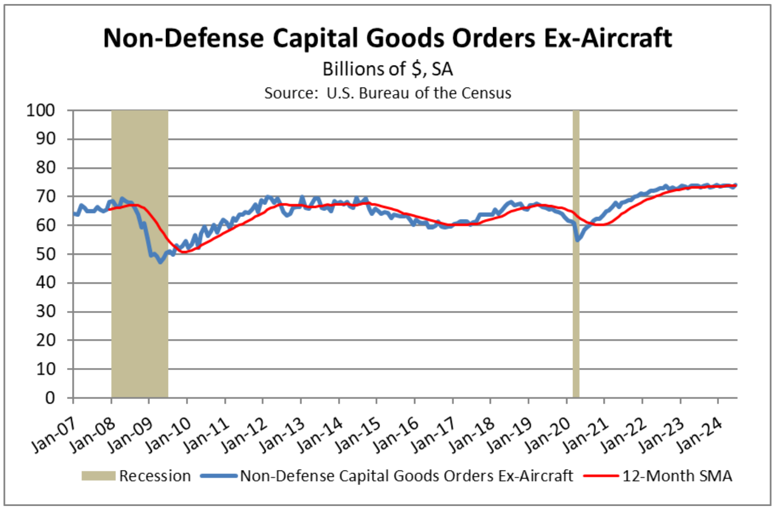



In the week ended July 13, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) fell to a seasonally adjusted 1.851 million, below the anticipated reading of 1.868 million and down from the previous week's revised reading of 1.860 million. The four-week moving average of continuing claims rose to 1,853,500, moving farther above the levels prevailing right before the coronavirus pandemic and helping to confirm that the demand for labor has cooled significantly. 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.

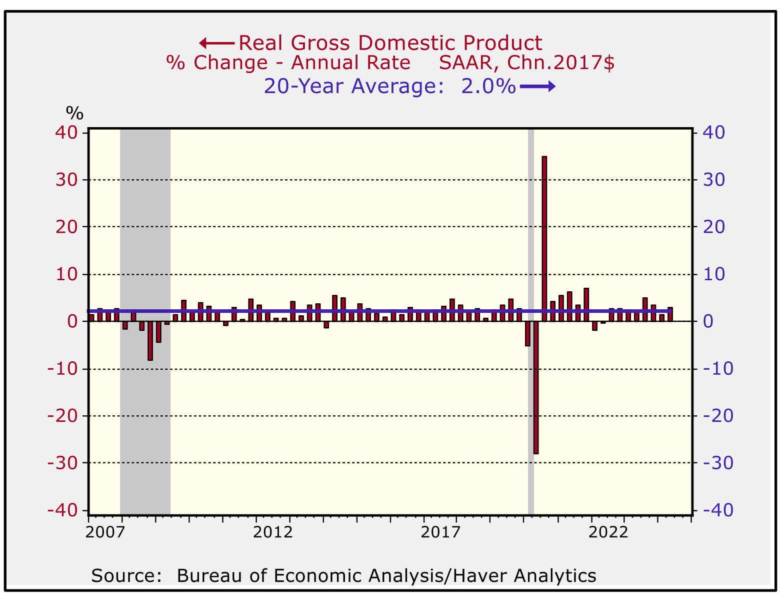



In a preliminary estimate, June ***durable goods orders*** plunged by a seasonally adjusted 6.6%, compared with the expected small rise of 0.3% and the May increase of 0.1%. Durable goods orders are often driven by transportation equipment, where just a few airliner orders can have a big impact, and that certainly seemed to be the problem last month. According to the report, June ***durable goods orders excluding transportation*** rose 0.5%, beating their anticipated rise of 0.2%

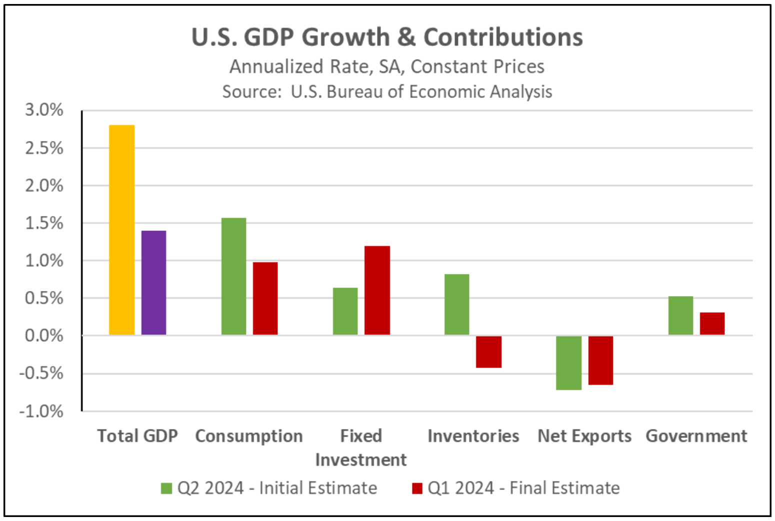
and reversing the May decline of 0.1%. Finally, the durable goods report also includes a key proxy for corporate capital investment. In June, ***nondefense capital goods orders ex-aircraft*** jumped 1.0%, beating their expected gain of 0.2% and essentially reversing their revised May decline of 0.9%. Compared with the same month one year earlier, overall durable goods orders in June were down 11.1%, while durable orders ex-transport were down 1.6%. Nondefense capital goods orders ex-aircraft were down 2.0%. The chart below shows the progression of nondefense capital goods orders ex-aircraft since just before the GFC.




Separately, the Commerce Department released its initial estimate of economic activity in the April-through-June period. After stripping out seasonal factors and price changes, second-quarter ***gross domestic product (GDP)*** rose at an annualized rate of 2.8%, far better than the expected growth rate of 2.0% and the first-quarter's growth rate of 1.4%. The chart below shows the annualized growth rate of US GDP since just before the GFC.



A close look at the details in the report shows that the main source of growth in the quarter was personal consumption spending, which accelerated from the first quarter to show a growth rate of 2.3%. A second major contributor was inventory investment. The main drag on growth was the international sector, where exports grew at a rate of 2.0% but imports surged at a rate of 6.9%. The chart below shows the contributions to the annualized growth rate in the second quarter.




The GDP report also includes the broadest measure of US price inflation. The second-quarter ***GDP Price Index*** rose at an annualized rate of 2.3%, better than the anticipated rate of 2.6% and cooler than the first quarter's rate of 3.1%.

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 |
| 11:00 | Kansas City Fed Manfacturing Index | m/m | Jul | -5 | -8 | * |
| 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 | Expected |
|---|---|---|---|---|---|---|---|---|
| ASIA-PACIFIC | | | | | | | | |
| Japan | Services PPI | y/y | Jun | 3.0% | 2.7% | 2.6% | * | Equity and bond neutral |
| | Japan Buying Foreign Stocks | w/w | 19-Jul | ¥12.1b | -¥136.3b | | * | Equity and bond neutral |
| | Foreign Buying Japan Stocks | w/w | 19-Jul | -¥49.0b | ¥227.8b | | * | Equity and bond neutral |
| | Japan Buying Foreign Bonds | w/w | 19-Jul | -¥730.4b | -¥206.0b | | * | Equity and bond neutral |
| | Foreign Buying Japan Bonds | w/w | 19-Jul | -¥352.1b | ¥774.5b | | * | Equity and bond neutral |
| | Nationwide Dept Sales | y/y | Jun | 14.00% | 14.40% | | *** | Equity and bond neutral |
| South Korea | Business Survey - Manufacturing | m/m | Aug | 72 | 75 | | ** | Equity and bond neutral |
| | Business Survey - Non-Manufacturing | m/m | Aug | 72 | 70 | | * | Equity and bond neutral |
| | GDP | q/q | 2Q A | 2.3% | 3.3% | 2.5% | ** | Equity and bond neutral |
| India | HSBC India PMI Mfg | m/m | Jul P | 585.0 | 58.3 | | *** | Equity and bond neutral |
| | HSBC India PMI Composite | m/m | Jul P | 61.1 | 60.9 | | ** | Equity and bond neutral |
| | HSBC India PMI Services | m/m | Jul P | 61.1 | 60.5 | | ** | Equity and bond neutral |
| EUROPE | | | | | | | | |
| Eurozone | M3 Money Supply | y/y | Jun | 2.2% | 1.6% | 1.5% | *** | Equity and bond neutral |
| Germany | IFO Business Climate | m/m | Jul | 87.0 | 88.6 | 89.0 | *** | Equity bearish, bond bullish |
| | IFO Current Assessment | m/m | Jul | 87.1 | 88.3 | 88.5 | ** | Equity bearish, bond bullish |
| | IFO Expectations | m/m | Jul | 86.9 | 89.0 | 89.0 | ** | Equity bearish, bond bullish |
| France | Business Confidence | m/m | Jul | 94 | 99 | 99 | ** | Equity bearish, bond bullish |
| | Manufacturing Confidence | m/m | Jul | 95 | 99 | 99 | * | Equity bearish, bond bullish |
| Russia | Industrial Production | y/y | Jun | 1.9% | 5.3% | 4.5% | *** | Equity bearish, bond bullish |
| AMERICAS | | | | | | | | |
| Brazil | FGV Consumer Confidence | m/m | Jul | 92.9 | 91.1 | | * | Equity and bond neutral |
| | Current Account Balance | m/m | Jun | -$4029m | -$2274m | -$2900m | ** | Equity and bond neutral |
| | Foreign Direct Investment | m/m | Jun | $6269m | $3023m | $3300m | ** | Equity and bond neutral |
| | IBGE Inflation IPCA-15 | m/m | Jul | 4.45% | 4.06% | 4.37% | *** | 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 | 554 | 1 | Down |
| **3-mo T-bill yield (bps)** | 516 | 517 | -1 | Down |
| **U.S. Sibor/OIS spread (bps)** | 525 | 527 | -2 | Down |
| **U.S. Libor/OIS spread (bps)** | 522 | 524 | -2 | Down |
| **10-yr T-note (%)** | 4.21 | 4.28 | -0.07 | Up |
| **Euribor/OIS spread (bps)** | 370 | 369 | 1 | Down |
| **Currencies** | **Direction** | | | |
| Dollar | Down | | | Down |
| Euro | Flat | | | Up |
| Yen | Up | | | Up |
| Pound | Down | | | Up |
| Franc | Up | | | Up |
| **Central Bank Action** | **Current** | **Prior** | **Expected** | |
| PBOC 1-Year Med-Term Lending Facility | 2.30% | 2.50% | | Above Forecast |
| PBOC 1-Year Med-Term Lending (Bil.) | 200.0b | 182.0b | | Above Forecast |
| Bank of Canada Rate Decision | 4.500% | 4.750% | 4.500% | 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 | $80.18 | $81.71 | -1.87% | |
| WTI | $76.12 | $77.59 | -1.89% | |
| Natural Gas | $2.12 | $2.12 | 0.19% | |
| 12-mo strip crack | $22.11 | $22.25 | -0.61% | |
| Ethanol rack | $2.01 | $2.02 | -0.26% | |
| **Metals** | | | | |
| Gold | $2,364.60 | $2,397.70 | -1.38% | |
| Silver | $27.54 | $28.91 | -4.74% | |
| Copper contract | $407.80 | $410.90 | -0.75% | |
| **Grains** | | | | |
| Corn contract | $418.25 | $418.00 | 0.06% | |
| Wheat contract | $542.75 | $547.00 | -0.78% | |
| Soybeans contract | $1,061.50 | $1,064.00 | -0.23% | |
| **Shipping** | | | | |
| Baltic Dry Freight | 1,864 | 1,869 | -5 | |
| **DOE Inventory Report** | | | | |
| | **Actual** | **Expected** | **Difference** | |
| Crude (mb) | -3.74 | -2.84 | -0.90 | |
| Gasoline (mb) | -5.57 | 1.00 | -6.57 | |
| Distillates (mb) | -2.75 | 1.00 | -3.75 | |
| Refinery run rates (%) | -2.1% | -0.5% | -1.6% | |
| Natural gas (bcf) | | 11 | | |

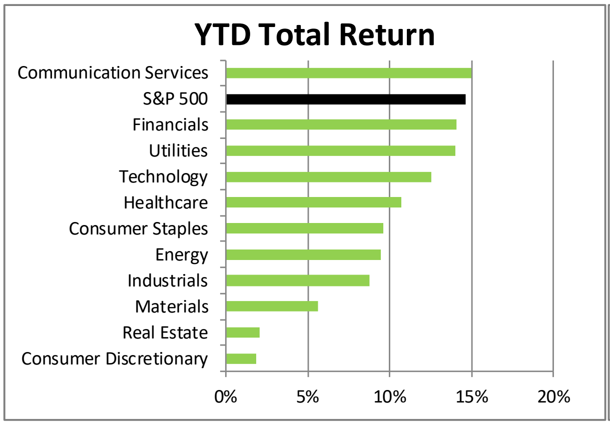
## Weather

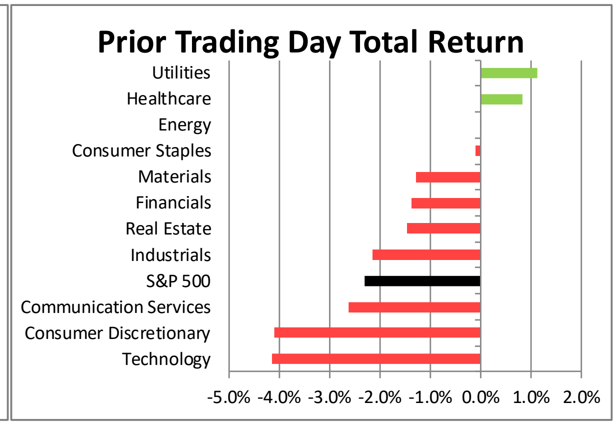
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures across the entire country except for the Pacific Northwest and southern Texas, where temperatures will be near normal. The forecasts call for wetter-than-normal conditions in the Pacific Northwest and along the East Coast, with dry conditions in the Rocky Mountains and Great Plains.

No cyclonic activity is expected in the Atlantic Ocean region within the next 48 hours.

## Data Section

**US Equity Markets** – (as of 7/24/2024 close)

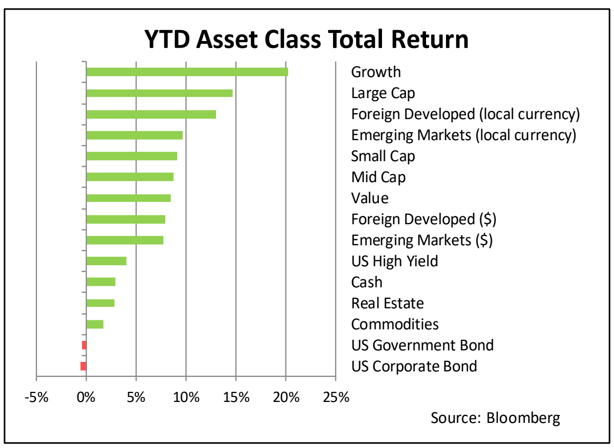



(Source: Bloomberg)

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 7/24/2024 close)

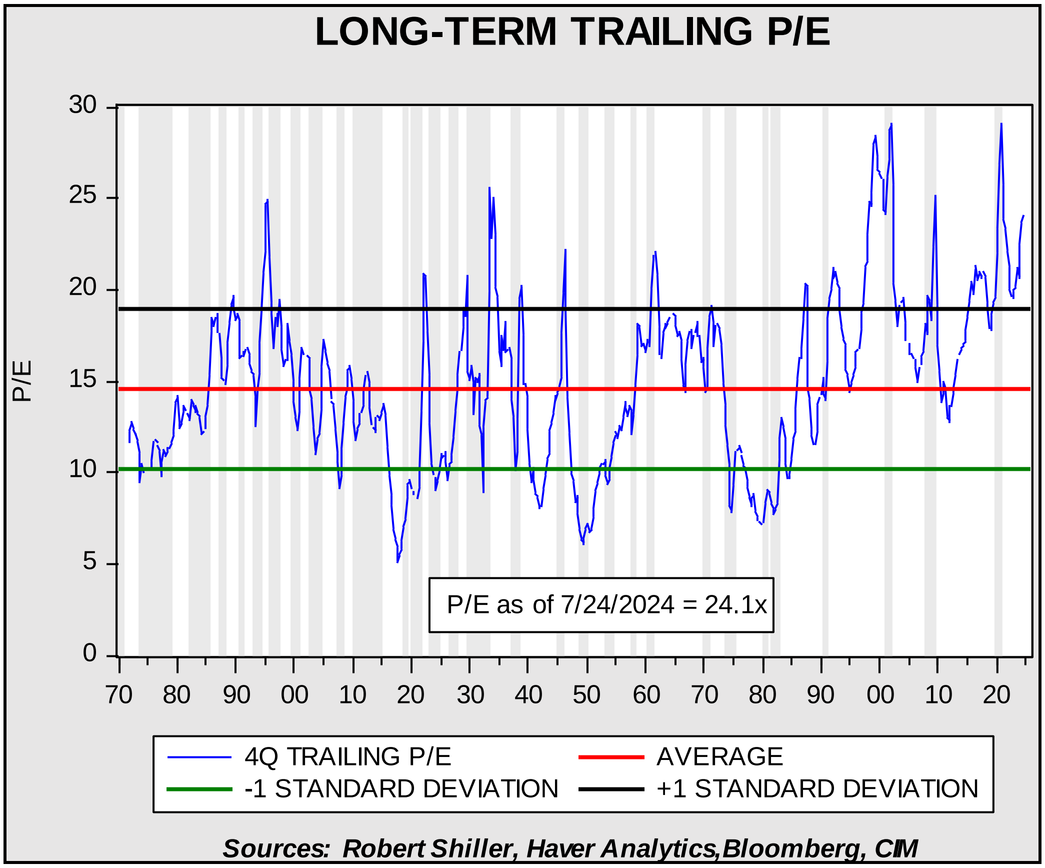



This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 25, 2024




Based on our methodology,[1] the current P/E is 24.2x, down 0.1 from our last report. The decrease in the multiple was due to a slight decrease in the stock price index and 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.