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 26, 2024 — 9:30 AM ET] Global equity markets are mostly higher this morning. In Europe, the Euro Stoxx 50 is up 1.0% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.2%. Chinese markets were higher, with the Shanghai Composite up 0.1% from its previous close and the Shenzhen Composite up 1.4%. US equity index futures are signaling a higher open.

With 199 companies having reported so far, S&P 500 earnings for Q2 are running at $60.00 per share, compared to estimates of $58.94, which is up 8.0% from Q2 2023. Of the companies that have reported thus far, 79.9% 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:

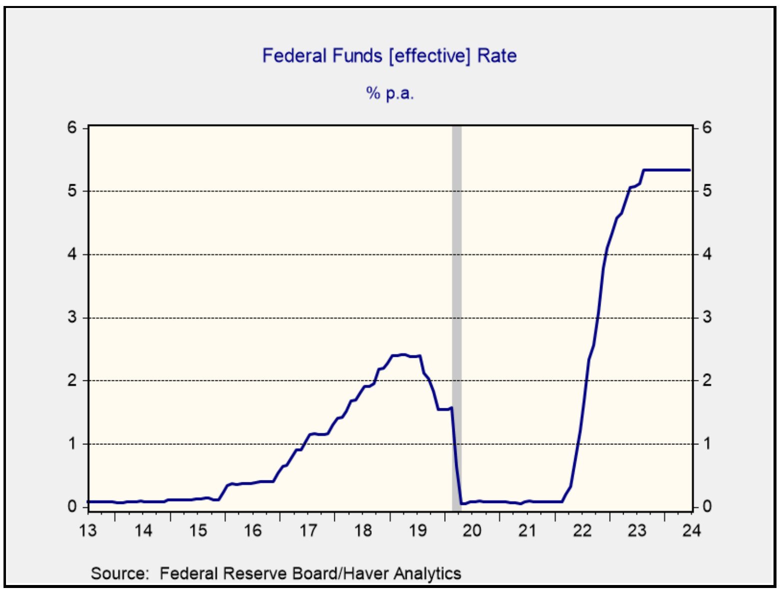
- *Bi-Weekly Geopolitical Report* (7/22/2024) (with associated podcast): "Meet Ferdinand Marcos Jr., President of the Philippines"
- *Asset Allocation Bi-Weekly* (7/15/2024) (with associated podcast): "A New Factor for Gold Prices"
- *Asset Allocation Quarterly – Q3 2024* (7/16/2024): Discussion of our asset allocation process, Q3 2024 portfolio changes, and our outlook for the markets.
- ***Business Cycle Report* (7/25/2024)**

Good morning! S&P 500 futures are higher as investors remain optimistic about a Fed pivot. The USWNT boosted spirits with a crucial victory over Zambia, keeping their Olympic quest for gold alive. Today's *Comment* will dissect the latest GDP data and its potential impact on Fed policy, explore why mega-cap stocks are offsetting gains from other companies within the S&P 500, and assess rising trade tensions between the US and Mexico. We'll conclude with a snapshot of key economic indicators.

Soft Landing? The US economy is proving remarkably resilient in the face of elevated interest rates.

- In Q2, US Gross Domestic Product (GDP) expanded at an annualized pace of 2.8%, significantly outpacing the prior period's 1.4% growth and surpassing the projection of 2.0%. This acceleration was fueled by a sharp increase in consumer spending, jumping from an annual pace of 1.5% to 2.3%. Specifically, households capitalized on declining prices by boosting purchases of automobiles and household furnishings. To address weakening demand over the past year, retailers have implemented price cuts on major appliances and motor vehicles.

- While the robust growth figures may temporarily alleviate recession concerns, they do not guarantee sustained expansion. Consumption, driven largely by big-ticket purchases, has propelled growth, but this may mask the underlying economic weaknesses faced by most households. A recent report from the Philadelphia Fed showed that credit card delinquencies have risen to their highest level in nearly 12 years. Moreover, despite a pickup in spending during the second quarter, consumption lagged the 3.0% annual pace recorded in the same period last year.

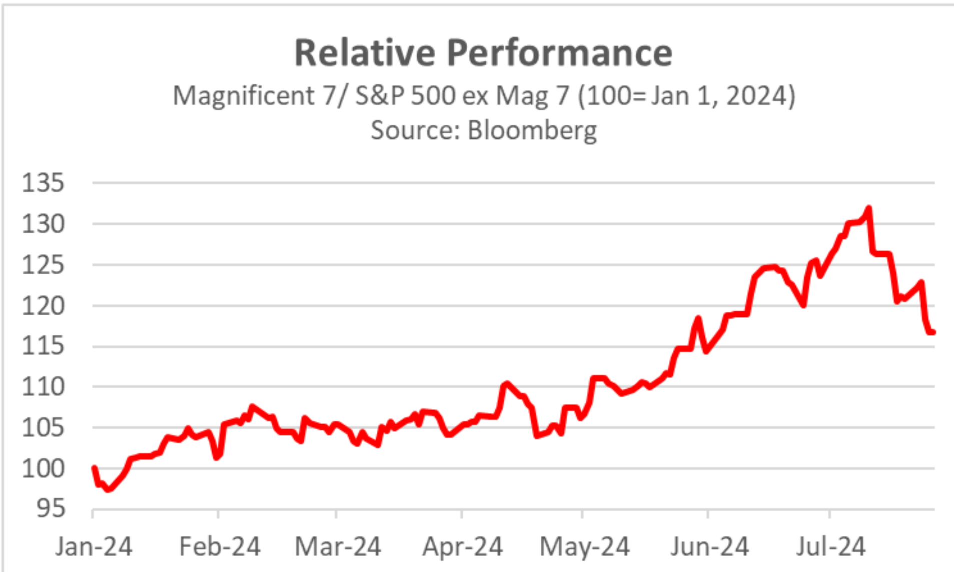


- The robust GDP figures suggest the US economy may be operating in a Goldilocks zone, balancing growth with price stability. This could embolden Fed officials to maintain their current interest rate stance to avoid the risk of prematurely loosening policy only to reverse course later. While inflationary pressures have remained surprisingly subdued in recent months, concerns persist about a potential resurgence similar to the first quarter's spike. Although a July rate cut cannot be entirely ruled out, a pause until the Fall meetings seems more probable.

The S&P 493: While the S&P 500 has declined sharply this month, most of the losses have been concentrated among the Magnificent 7 (M7).

- In July, the stock price index for the Magnificent 7 declined by 6.5%, while the remaining 493 within the S&P 500 increased by 1.2%. This divergence began in mid-July following the CPI report, which indicated that month-to-month inflation turned negative for the first time since 2020. The gap expanded over the past two weeks as investor skepticism intensified regarding the pricing of large-cap tech firms and the profitability of AI initiatives.

- The recent pullback is benefiting the broader market, which has become heavily concentrated over the past two years. Despite a decline in the index, nearly 300 S&P 500 companies have advanced, with industrial and financial services leading the way. These companies' performances were overshadowed by the dominance of the Magnificent 7, which collectively account for nearly a third of the index. The relative performance of the M7 and the other 493 companies shows that mega-cap companies have lost a lot of ground to their smaller, large-cap peers.

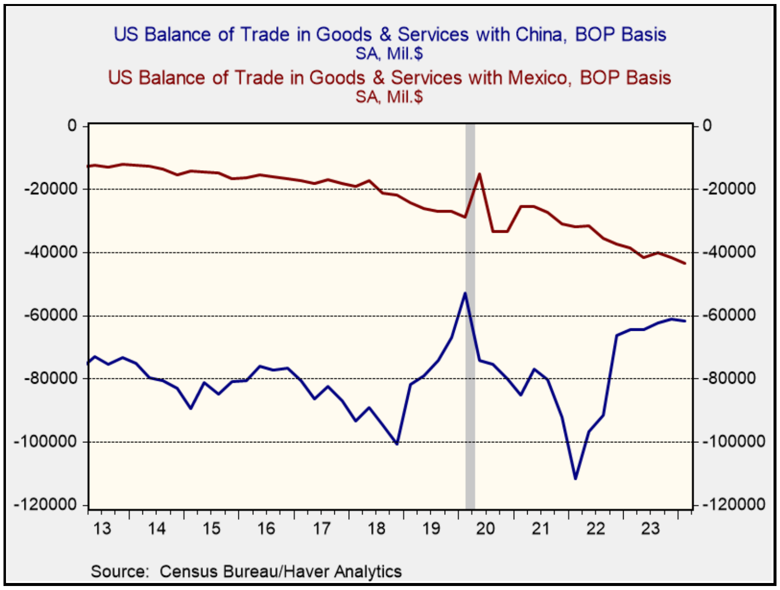


- While the recent rotation away from big tech has gained popularity, it has been anything but smooth sailing. The VIX Index, a measure of market volatility, has surged to its highest level in three months and currently hovers just below 20, indicating heightened investor anxiety. The index may begin to cool over the coming months as investors gain greater certainty about the path of interest rates and the likely winner of the presidential election. As a result, investors should be careful not to overreact to sudden changes in the market.

US vs Mexico: Concerns about a potential trade war with the US have cast doubts on Mexico's ability to capitalize on nearshoring opportunities.

- Earlier this week, Mexican President Andrés Manuel López Obrador (AMLO) dismissed threats stating that the US would consider banning cars made in Mexico. His comments followed remarks made by Tesla CEO Elon Musk, who said that his company is putting plans to build a factory in the country on hold until after the US election due to political uncertainty. Musk was referring to former President Trump's pledge to impose tariffs on Mexican-made cars due to concerns that Mexico was aiding China's efforts to evade tariffs by building factories there.
- The dispute over tariffs unfolds amid a deepening economic interdependence between the United States and Mexico. In recent years, the US has dramatically increased its reliance on Mexican goods, surpassing China as its top import source in 2022. Concurrently,

Mexico has experienced a surge in foreign direct investment (FDI), including from China, as businesses seek to establish supply chains closer to the US market to mitigate geopolitical risks. According to the United Nations Conference on Trade and Development (UNCTAD), Mexico ranked as the world's ninth largest FDI recipient.

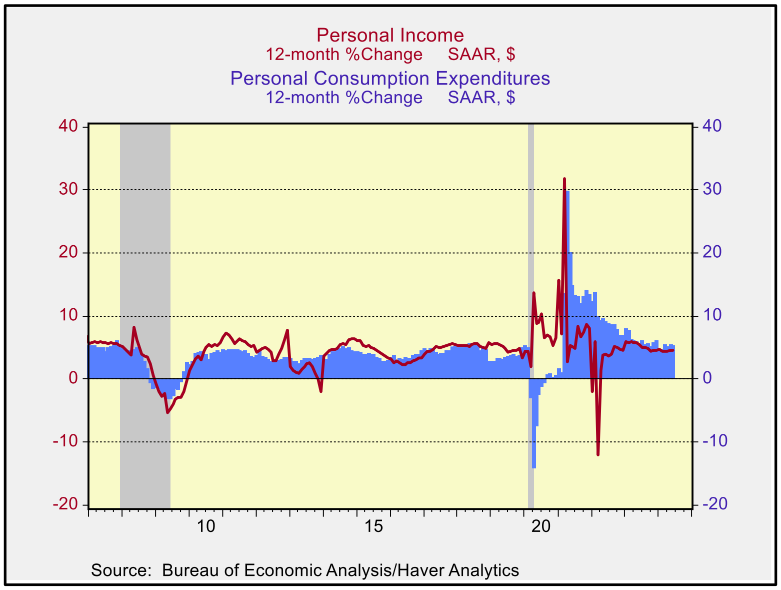


- It is important to note that Trump had a relatively good relationship with AMLO during his first term in office. Despite his initial skepticism about Mexico, Trump ultimately bridged his differences in order to play a pivotal role in renegotiating NAFTA, now known as USMCA. This collaboration suggests that there may be some validity to AMLO's claims that concerns about tariffs on Mexican cars are being overblown. Nevertheless, the dispute over China is likely to remain a significant source of tension between the US and Mexico, regardless of the November election outcome.

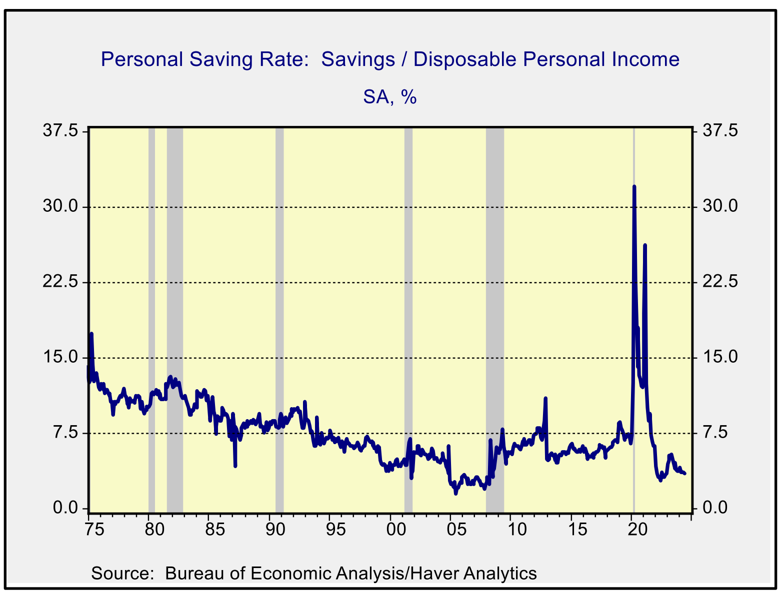
In Other News: North Korean hackers are intensifying cyberattacks targeting US military secrets amid renewed nuclear ambitions. This escalating digital threat underscores a growing risk to US national security. Separately, a cyberattack crippled France's railway system just hours before the opening ceremony of the Olympics. The attack raises concerns about other possible disruptions during the event. Barack and Michelle Obama endorsed Kamala Harris as the Democratic nominee for president, which is a further sign that the party has rallied around a candidate.

US Economic Releases

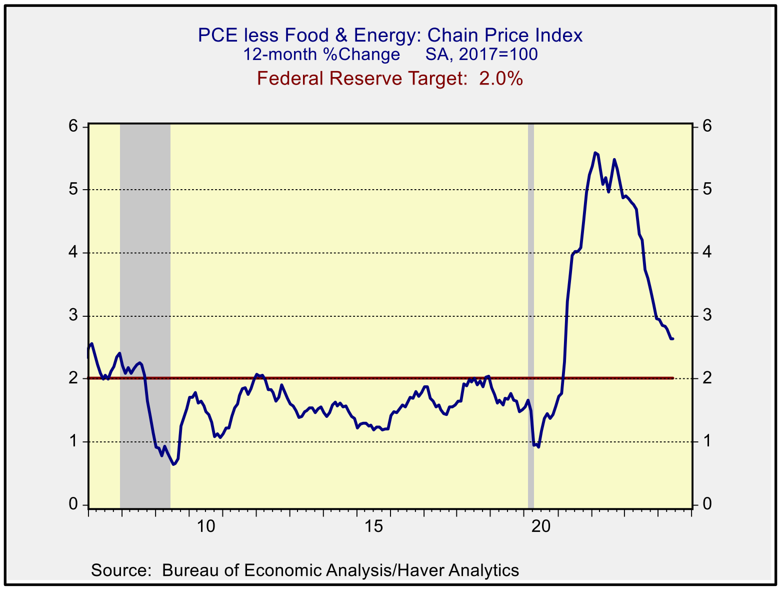
In the only major economic release so far today, June ***personal income*** rose by a seasonally adjusted 0.2%, well short of expectations that it would match May's revised increase of 0.4%. June ***personal consumption expenditures (PCE)*** rose 0.3%, matching expectations but still cooling from May's 0.4% rise. Personal income in June was up 4.5% from the same month one year earlier, but people boosted their consumption expenditures by an even greater 5.2%. The chart below shows the year-over-year change in personal income and PCE since just before the Great Financial Crisis.



The personal income and spending report also includes a measure of personal savings, defined as disposable (after tax) income less consumption spending on goods and services. The June ***personal savings rate*** fell to a seasonally adjusted 3.4%, its lowest level since late 2022. The chart below shows how the personal savings rate has fluctuated since just before the GFC.



Finally, the income and spending report includes the Fed's preferred measure of consumer price inflation. Excluding the volatile food and energy components, the ***Core PCE Deflator*** for June was up 2.6% from the same month one year earlier, matching the rise in the year to May but dashing expectations that core inflation would fall to 2.5%. The chart below shows the annual change in the Core PCE Deflator 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	U. of Michigan Consumer Sentiment	m/m	Jul F	66.4	66.0	***
10:00	U. of Michigan Current Conditions	m/m	Jul F	64.4	64.1	**
10:00	U. of Michigan Future Expectations	m/m	Jul F	67.5	67.2	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Jul F	2.90%	2.90%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Jul F	2.90%	2.90%	*
11:00	Kansas City Fed Services Index	m/m	Jul		2	*
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	Tokyo CPI	y/y	Jul	2.2%	2.3%	2.3%	**	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food	y/y	Jul	2.2%	2.1%	2.2%	***	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food & Energy	y/y	Jul	1.5%	1.8%	1.6%	*	Equity and bond neutral
	Leading Economic Index	m/m	May F	111.2	111.1		**	Equity and bond neutral
	Coincident Index	y/y	May F	117.1	116.5		**	Equity and bond neutral
New Zealand	ANZ Consumer Confidence Index	m/m	Jul	87.9	83.2		*	Equity and bond neutral
EUROPE								
France	Consumer Confidence	m/m	Jul	91.0	90.0	90.0	***	Equity and bond neutral
Italy	Consumer Confidence	m/m	Jul	98.9	98.3	98.7	***	Equity and bond neutral
	Manufacturing Confidence	m/m	Jul	87.6	86.9	87.3	***	Equity and bond neutral
	Economic Sentiment	m/m	Jul	94.2	94.5		**	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	19-Jul	$611.3b	$601.3b		***	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	19-Jul	18.39t%	18.35t		*	Equity and bond neutral
AMERICAS								
Mexico	Exports	m/m	Jun	48871m	55671m		*	Equity and bond neutral
	Imports	m/m	Jun	49908m	53680m		*	Equity and bond neutral
	Trade Balance	m/m	Jun	-1036.9m	1991.2m	663.0m	*	Equity and bond neutral
Brazil	Total Outstanding Loans	m/m	Jun	6019b	5946b		**	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)	515	517	-2	Down
U.S. Sibor/OIS spread (bps)	526	526	0	Down
U.S. Libor/OIS spread (bps)	523	523	0	Down
10-yr T-note (%)	4.23	4.24	-0.01	Down
Euribor/OIS spread (bps)	369	370	-1	Down
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Up			Up
Yen	Down			Up
Pound	Up			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Russia Key Rate	18.000%	16.000%	18.000%	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	$82.04	$82.37	-0.40%	
WTI	$78.01	$78.28	-0.34%	
Natural Gas	$2.04	$2.04	-0.24%	
12-mo strip crack	$22.66	$22.67	-0.04%	
Ethanol rack	$2.01	$2.01	0.08%	
Metals				
Gold	$2,374.67	$2,364.56	0.43%	
Silver	$27.78	$27.85	-0.26%	
Copper contract	$413.80	$412.55	0.30%	
Grains				
Corn contract	$419.00	$420.75	-0.42%	
Wheat contract	$539.25	$537.75	0.28%	
Soybeans contract	$1,073.00	$1,079.50	-0.60%	
Shipping				
Baltic Dry Freight	1,834	1,864	-30	
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)	22	11	11	

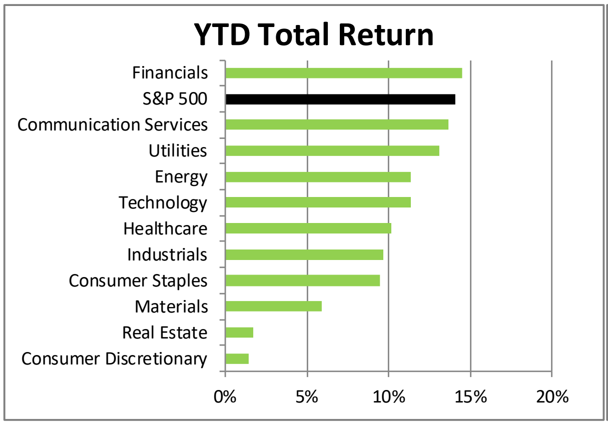
Weather

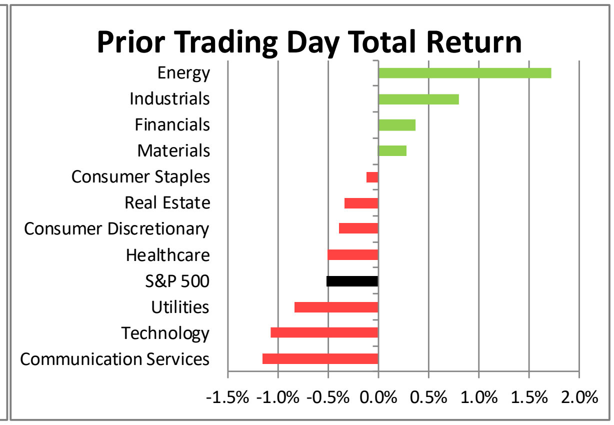
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures across the entire country except for the Pacific Northwest and southern Texas, where temperatures will be near normal. The forecasts call for wetter-than-normal conditions in Southern California and from the Mississippi River eastward, 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 7/25/2024 close)

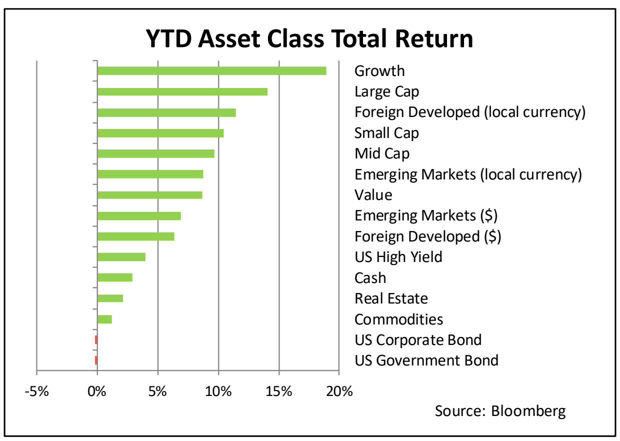




(Source: Bloomberg)

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 7/25/2024 close)

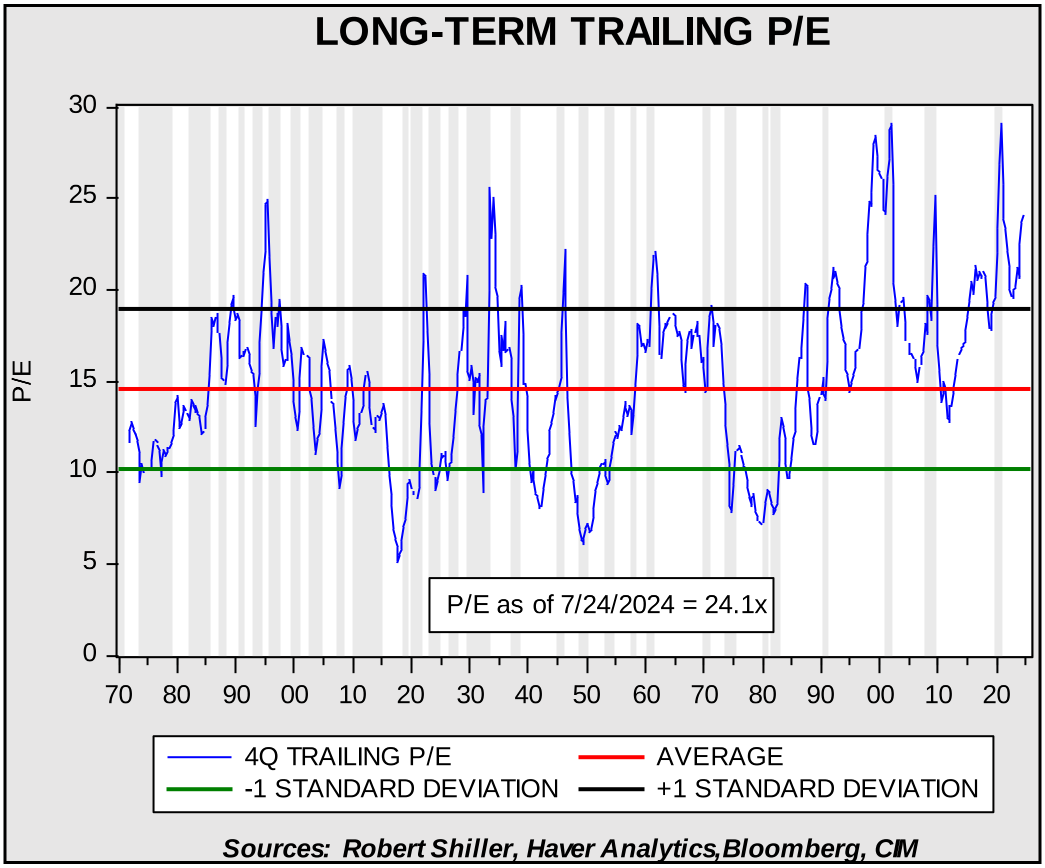


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

---

[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.