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 31, 2024 — 9:30 AM ET] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is up 0.8% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.1%. Chinese markets were higher, with the Shanghai Composite up 2.1% from its previous close and the Shenzhen Composite up 3.3%. US equity index futures are signaling a higher open.

With 259 companies having reported so far, S&P 500 earnings for Q2 are running at $60.20 per share, compared to estimates of $58.94, which is up 8.0% from Q2 2023. Of the companies that have reported thus far, 79.8% 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:

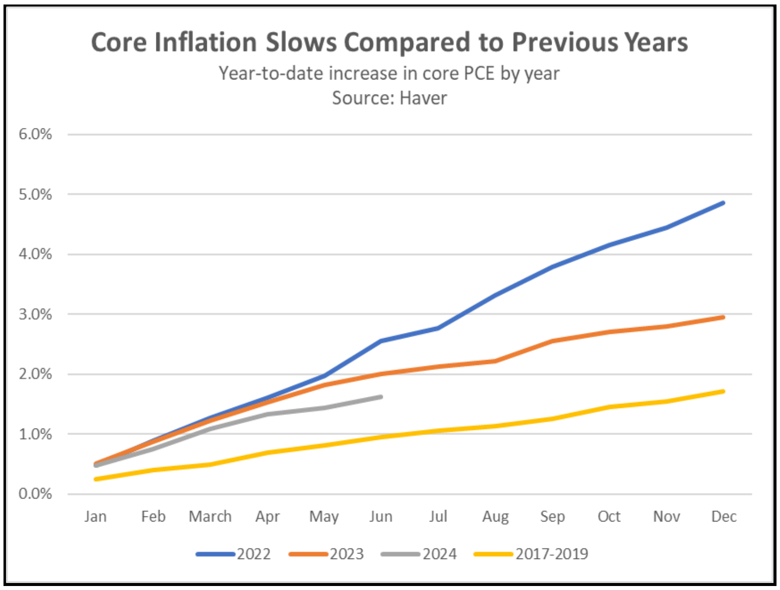
- *Bi-Weekly Geopolitical Report* (7/22/2024) (with associated podcast): "Meet Ferdinand Marcos Jr., President of the Philippines"
- *Asset Allocation Bi-Weekly* (7/29/2024) (with associated podcast): "The Price of Central Bank Independence"
- *Asset Allocation Quarterly – Q3 2024* (7/16/2024): Discussion 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 trading higher this morning as investors await the Fed's rate decision. In sports news, Simone Biles led the US women's gymnastics team to gold at the Olympics. Today's *Comment* will delve into the Federal Reserve's interest rate decision, examine the cooling AI hype, and analyze the Bank of Japan's latest policy move. We will conclude with a review of key domestic and international economic data.

Is it Pivot Time? The FOMC is set to conclude its two-day meeting today, with investors eagerly awaiting clues about potential rate cuts.

- Federal Reserve policymakers are expected to announce a shift in their focus away from inflation and toward employment to achieve greater economic balance. Concerns are growing amid four consecutive months of rising unemployment, which could trigger the Sahm Rule if the trend persists in July. This rapid labor market deterioration has prompted prominent economists, including former New York Fed President William Dudley and former PIMCO CEO Mohamed El-Erian, to push for an immediate rate reduction within the next two Fed meetings in order to avert a policy mistake.

- While Fed officials have signaled increased confidence in inflation's downward trajectory, concerns persist about the potential resurgence of price pressures. Richmond Fed President Thomas Barkin recently expressed skepticism about the current restrictive nature of interest rates, noting that inflation, though improved, remains above pre-pandemic levels. The core PCE price index rose 1.6% in the first half of 2024, a deceleration from the 2.0% pace in the same period of 2023 but still significantly higher than the 0.9% average seen in the three years preceding the pandemic.

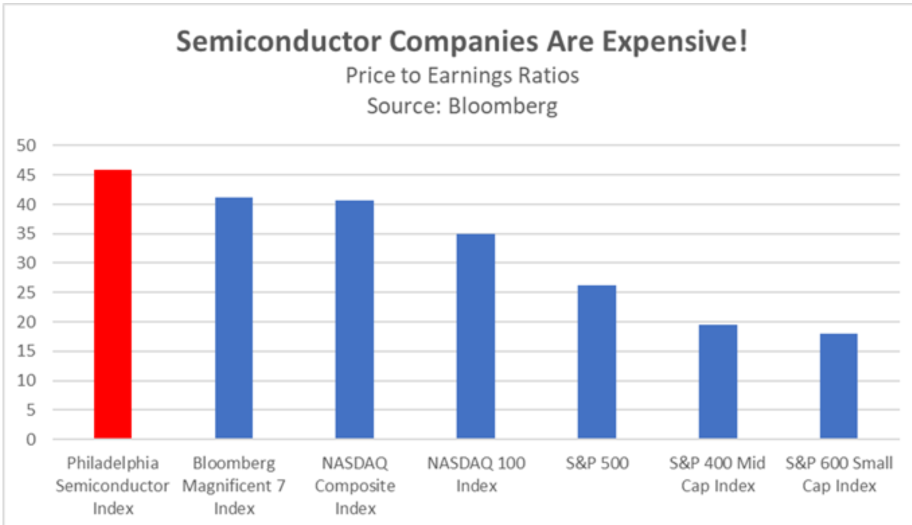


- Despite mounting pressures for an immediate rate cut, the Fed is expected to maintain its current policy stance at today's meeting. The central bank is likely wary of potential inflationary pressures during the typically quiet summer months, which would delay any rate reduction until September or beyond. Although unemployment has risen sharply, it remains within a range typically associated with economic growth. As a result, the Fed is expected to adopt a cautious approach, potentially keeping rates unchanged for an extended period. If this occurs, it could impact the rotation trade.

Magnificent 7 in Focus: Microsoft is the latest tech company to disappoint investors following its earnings reports, as investors start to question AI profit expectations.

- While Microsoft surpassed overall earnings expectations, its Intelligent Cloud division fell short. Revenue for the highly touted segment climbed 19% to $28.5 billion but missed estimates by $200 million. The company attributed the shortfall to a weak European market and capacity constraints, as it struggles to keep pace with surging AI demand. These challenges coincide with recent service outages, including CrowdStrike's software failure and a cyberattack yesterday, which will now lead to concerns about the company's overall technical infrastructure.

- Microsoft is the third of the Magnificent 7 to disappoint investors this month, following in the footsteps of Alphabet and Tesla. Their bleak outlooks have contributed to a broader tech sell-off, as investors seek more attractive valuations in other equity sectors. The S&P 500 is down 0.7% so far this month, while the NASDAQ 100 has plummeted over 5%. Hardware companies have taken the brunt of the downturn as investor are not sure whether these stocks have any more room to grow from their current valuations.

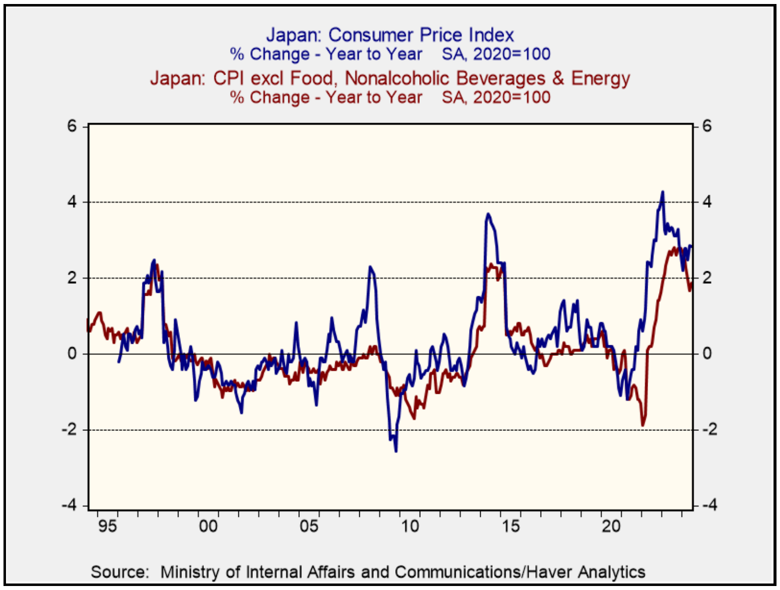


- Four Magnificent 7 companies remain, and Nvidia's August 28 report will serve as a crucial test for the AI rally. The chipmaker's triple-digit revenue growth and earnings beat have made it the index's sole standout. A disappointing result could dampen investor enthusiasm for AI and accelerate a market shift towards smaller companies, especially if the Fed maintains a dovish stance today. AMD's recent earnings report, boasting strong sales and a bullish outlook, suggests sustained spending on AI chips. This could bode well for Nvidia given the similar landscape.

Hawkish BOJ: The Bank of Japan unexpectedly raised interest rates in a sign that the central bank is looking to normalize policy after decades of policy accommodation.

- The Bank of Japan (BOJ) has raised its benchmark interest rate to 0.25%, its highest level in over 25 years, from a previous target range of 0-0.1%. This move is intended to bolster the weakening yen (JPY) and stimulate economic growth by mitigating inflationary pressures from rising import costs. Additionally, the central bank revealed that it would gradually reduce its bond purchase program by half to 3 trillion JPY a month by early 2026, or the equivalent of about $20 billion.
- The Bank of Japan's recent policy adjustments signal a determined effort to normalize monetary policy and strengthen the yen. Prior to its latest meeting, concerns mounted over Japan's economic slowdown, with GDP failing to surpass its Q2 2023 peak. Governor Ueda defended the policy shift, arguing that a stronger yen could invigorate growth by fostering consumer confidence through stable import prices. Although Japan's inflation rate has peaked, it remains a persistent issue. Headline CPI, which includes

volatile energy and food costs, continues to exceed the 2% target, amplified by the impact of dollar-denominated commodities.



- Assuming interest rate expectations remain stable, the recent policy shift is likely to contribute to dollar weakness. The Bloomberg Dollar Spot Index has already fallen by 0.4% in response to the decision by the BOJ. We anticipate a convergence of US interest rates with those of other G7 nations over the coming months. This shifting interest rate environment is expected to exert downward pressure on the dollar initially, although other factors will increasingly influence the currency's strength going forward, which include GDP growth expectations and capital flows.

In Other News: An Israeli strike on Beirut reportedly killed a top Hezbollah commander, signaling a potential escalation of tensions in the Middle East. Meanwhile, China's manufacturing sector contracted for the third consecutive month as the country grapples with declining industrial output.

US Economic Releases

The Mortgage Bankers Association today said ***mortgage applications*** in the week ended July 26 fell 3.9%, following on the previous week's decline of 2.2%. Applications for home purchase mortgages fell 2.0%, while applications for refinancing mortgages fell 7.0%. According to the report, the average interest rate on a 30-year mortgage was nearly unchanged at 6.82%.

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						
ET	Indicator			Expected	Prior	Rating
9:45	MNI Chicago PMI	m/m	Jul	45.0	47.4	***
10:00	Pending Home Sales	m/m	Jun	1.4%	-2.1%	**
10:00	Pending Home Sales NSA	y/y	Jun	-7.4%	-6.6%	**
14:00	FOMC Rate Decision (Upper Bound)	w/w	31-Jul	5.50%	5.50%	***
14:00	FOMC Rate Decision (Lower Bound)	w/w	31-Jul	5.25%	5.25%	***
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	Retail Sales	y/y	Jun	3.7%	2.8%	3.2%	**	Equity bullish, bond bearish
	Depart. Store & Supermarket	y/y	Jun	6.6%	4.1%		*	Equity and bond neutral
	Industrial Production	y/y	Jun P	-7.3%	1.1%	-6.4%	***	Equity bearish, bond bullish
	Housing Starts	y/y	Jun	-6.7%	-5.2%	-2.4%	**	Equity bearish, bond bullish
	Annualized Housing Starts	y/y	Jun	0.765m	0.813m	0.796m	*	Equity and bond neutral
	Consumer Confidence Index	m/m	Jul	36.7%	36.4%	36.6%	***	Equity and bond neutral
Australia	Retail Sales	m/m	Jun	0.5%	0.6%	0.2%	***	Equity and bond neutral
	Private Sector Credit	y/y	Jun	5.6%	5.2%		**	Equity and bond neutral
	CPI	y/y	2Q	3.8%	3.6%	3.8%	**	Equity and bond neutral
New Zealand	Building Permits	m/m	Jun	-13.8%	-1.9%		**	Equity and bond neutral
	ANZ Activity Outlook	m/m	Jul	16.3	12.2		*	Equity and bond neutral
	ANZ Business Confidence	m/m	Jul	27.1	6.1		**	Equity and bond neutral
South Korea	Industrial Production	y/y	Jun	3.8%	4.3%	2.8%	***	Equity bullish, bond bearish
China	Official Manufacturing PMI	m/m	Jul	49.4	49.5	49.3	***	Equity and bond neutral
	Official Services PMI	m/m	Jul	50.2	50.5	50.3	**	Equity and bond neutral
EUROPE								
Eurozone	CPI	y/y	Jul	2.6%	2.5%	2.5%	***	Equity and bond neutral
	Core CPI	y/y	Jul P	2.9%	2.9%	2.8%	**	Equity and bond neutral
Germany	Import Price Index	y/y	Jun	0.7%	-0.4%	0.5%	**	Equity and bond neutral
	Unemployment Change (000's)	m/m	Jul	18.0k	20.0k	15.0k	***	Equity and bond neutral
	Unemployment Claims Rate	m/m	Jul	6.0%	6.0%	6.0%	**	Equity and bond neutral
France	CPI	y/y	Jul P	2.3%	2.2%	2.4%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Jul P	2.6%	2.5%	2.8%	**	Equity and bond neutral
	PPI	y/y	Jun	-6.0%	-6.7%		*	Equity and bond neutral
Italy	Industrial Sales WDA	y/y	May	-4.8%	-2.2%		*	Equity and bond neutral
	CPI, EU Harmonized	y/y	Jul P	1.7%	0.9%	1.2%	***	Equity and bond neutral
	CPI NIC Including Tobacco	y/y	Jul P	1.3%	0.8%	1.1%	**	Equity and bond neutral
	PPI	y/y	Jun	-3.5%	-4.9%		**	Equity and bond neutral
AMERICAS								
Mexico	International Reserves Weekly	w/w	26-Jul	$221725m	$221621m		*	Equity and bond neutral
Brazil	National Unemployment Rate	m/m	Jun	6.9%	7.1%	6.9%	*	Equity and bond neutral
Brazil	Formal Job Creation	m/m	Jun	201705	139341	165000	*	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)	551	552	-1	Down
3-mo T-bill yield (bps)	513	513	0	Down
U.S. Sibor/OIS spread (bps)	525	524	1	Down
U.S. Libor/OIS spread (bps)	522	522	0	Down
10-yr T-note (%)	4.13	4.14	-0.01	Down
Euribor/OIS spread (bps)	363	364	-1	Down
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Up			Up
Pound	Flat			Up
Franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
BOJ Target Rate	0.100%	0.100%	0.100%	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	$80.82	$78.63	2.79%	
WTI	$77.40	$74.73	3.57%	
Natural Gas	$2.11	$2.13	-0.85%	
12-mo strip crack	$22.07	$21.80	1.25%	
Ethanol rack	$1.97	$1.97	-0.07%	
Metals				
Gold	$2,419.64	$2,410.78	0.37%	
Silver	$28.68	$28.39	1.04%	
Copper contract	$416.15	$408.40	1.90%	
Grains				
Corn contract	$405.25	$405.00	0.06%	
Wheat contract	$524.00	$524.00	0.00%	
Soybeans contract	$1,030.25	$1,021.25	0.88%	
Shipping				
Baltic Dry Freight	1,762	1,797	-35	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.10		
Gasoline (mb)		-1.29		
Distillates (mb)		-0.90		
Refinery run rates (%)		0.8%		
Natural gas (bcf)		29		

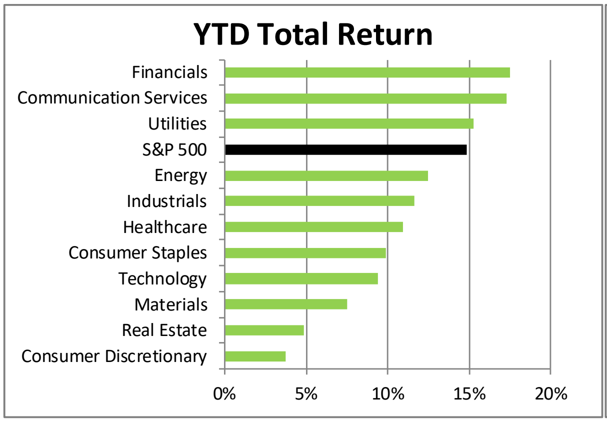
Weather

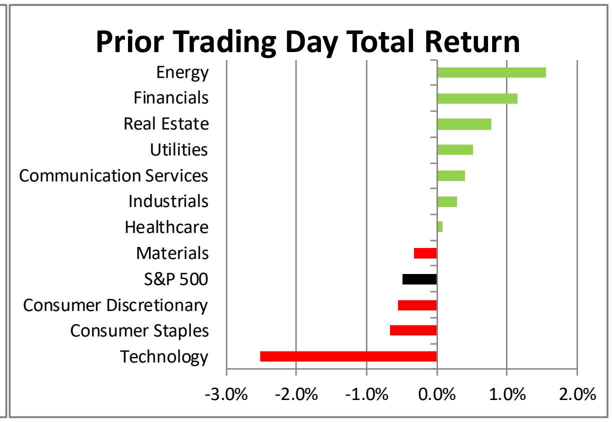
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures across the entire country, except for a patch of below normal temperatures in the northern Great Plains, Great Lakes region, and Maine. The precipitation outlook calls for wetter-than-normal conditions on the East Coast, in the upper Midwest, Great Plains, Rocky Mountains, and California, with drier-than-normal conditions on the Pacific coast of Washington and Oregon.

A strong tropical wave several hundred miles east of the Lesser Antilles, which is producing limited shower activity, has a 0% chance of forming into a cyclone in the next 48 hours and a 60% chance in the next seven days.

Data Section

US Equity Markets – (as of 7/30/2024 close)

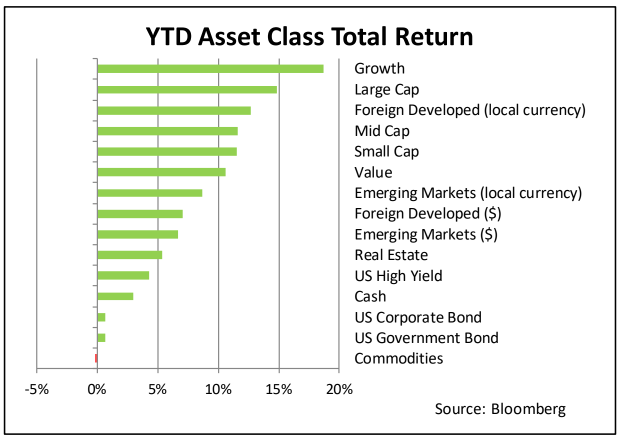




(Source: Bloomberg)

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 7/30/2024 close)

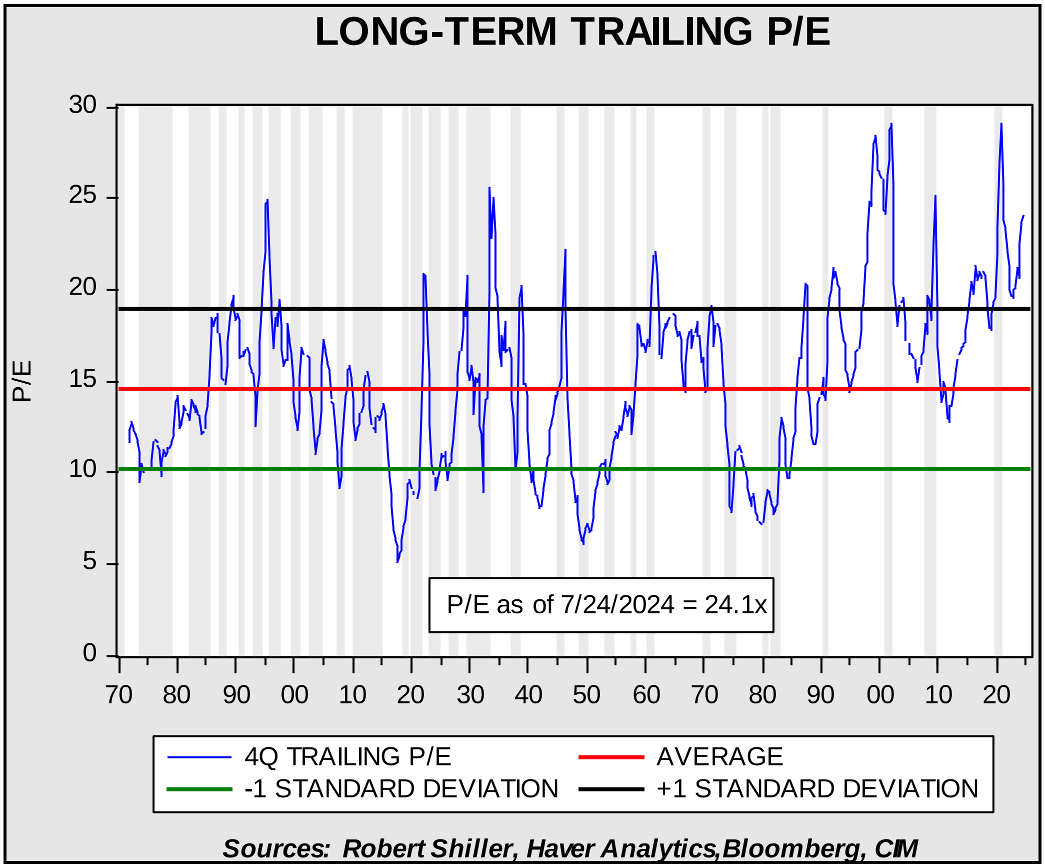


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.