Confluence INVESTMENT MANAGEMENT

Daily Comment

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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 8, 2024—9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 closed up 0.5% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.5%. Chinese markets were lower, with the Shanghai Composite down 0.9% from its previous close and the Shenzhen Composite down 1.9%. US equity index futures are signaling a mildly 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* (7/1/2024) (with associated podcast): "The EU Parliamentary Elections: New Strength for the Right"
- *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)*

Our *Comment* today opens with new data illustrating just how broadly and sharply trade tensions with China are evolving around the world. We next review several other international and US developments with the potential to affect the financial markets today, including key election results in France and the United Kingdom and the minutes from the latest Federal Reserve policy meeting.

China-Global Markets: Data from China's Ministry of Commerce show the country was hit with 64 anti-dumping probes by its trading partners in the first half of 2024, up 166% from the same period one year earlier. India alone initiated 16 of the new probes, while the US and Brazil each launched seven. The data show how Beijing's strategy to rekindle economic growth by boosting investment and exports is hitting resistance around the world, even beyond the US and EU tariffs on Chinese electric vehicles and other advanced goods that we've written so much about.

- Indeed, the new tidal wave of Chinese exports, which some economists have dubbed "China Shock 2.0," is far broader than EVs, solar panels, wind turbines, and other advanced goods.
- About 40% of the new anti-dumping probes relate to basic chemicals from China. Other major targets include non-metallic items such as glass wine bottles, iron and steel products such as steel coil, and clothing and food products.

- To the extent these anti-dumping probes lead to more tariffs and other trade barriers against China, they amount to trade de-coupling. The breadth of Chinese exports subject to this de-coupling suggests the trend will be a meaningful headwind for China's economy and Chinese companies, along with other structural problems such as excess capacity and high debt, weak consumer demand, bad demographics, and disincentives from the Communist Party's intrusion into the economy.

China: Within China, consumers also continue to shift their purchases toward domestic brands for a range of products. For example, new data show foreign brands accounted for only 43.0% of Chinese auto sales in the first six months of 2024, down from 50.5% in the same period in 2023. The loss of business to domestic competitors has left several foreign brands with excess production capacity in China. Some have pulled out of the market entirely after realizing their bet on the country was ill-placed.

Japan: In a new survey by the Japanese Chamber of Commerce and Industry, 54.8% of small and medium-sized businesses said the yen's current weakness is a big problem, up from 47.8% in a poll last November. Only 2.3% in the new poll said the weak currency was a help. While many of Japan's big, international exporters have gotten a boost from the weak yen, the poll shows that smaller firms have been hit by skyrocketing costs for fuel, raw materials, and imported components.

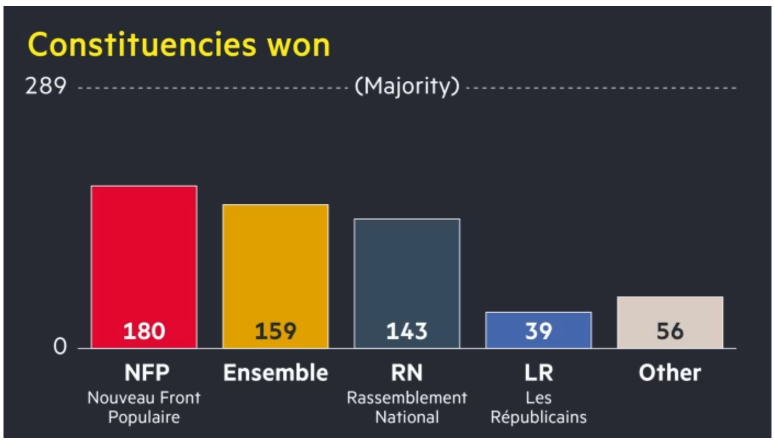
- Notably, the new survey was conducted between June 13 and June 19, when the yen was trading at an average rate of ¥157.4 to the dollar ($0.0064). So far this morning, the currency has depreciated even further, to about ¥160.8 to the dollar ($0.0062).
- The poll results may put added pressure on the government to intervene in the market again, although the yen is not likely to get much lasting relief until the Federal Reserve starts cutting US interest rates, reducing the differential between US and Japanese rates.

European Union: Although Marine Le Pen's far-right National Rally party was thwarted in France's run-off parliamentary elections yesterday (see below), it has boosted its power within the European Parliament today by allying its legislators with a new group of far-right national parties called "Patriots for Europe." With legislators from Italy's League, Hungary's Fidesz, Austria's Freedom Party, and other national parties, the group should overtake the somewhat less right-wing European Conservatives and Reformists as the parliament's third-largest group.

- As a reminder, our *Bi-Weekly Geopolitical Report* from July 1 provided a primer on the EU's governing bodies, including a discussion of the European Parliament and the major political groupings in the body at that date.
- The importance of the new Patriots of Europe group is that it will put the more radical elements of the far right ahead of the more moderate European Conservatives and Reformists. As we've noted, this should help shift the European Parliament and overall European policy toward a new set of priorities, such as more restrictive immigration and greater national autonomy.

France: In yesterday's run-off parliamentary elections, the far-left New Popular Front (NFP) unexpectedly came in first, with a projected 180 of the 577 seats in the legislature. President Macron's centrist Ensemble alliance came in second with 159 seats (doing better than expected but still losing almost 100 of the seats it previously held). The far-right National Rally (RN) came in third with 143 seats, despite being supported by the Russian government.

- The results validate last week's coordination deal between the far left and the centrists to keep RN from power. However, with no party having anything close to a majority of seats in parliament, France looks set for an extended period of political gridlock.
- Macron will be under pressure to appoint a leftist affiliated with NFP as the new prime minister as far-left politicians have argued that their strong showing means he should appoint one of their own. However, Macron could choose someone from the relatively more moderate Socialists or Greens.
- In any case, the leftists will be in position to push their priorities, such as reversing the hike in the retirement age that Macron pushed through, imposing a wealth tax, and hiking public salaries.
- Investors so far today have given a split verdict on the outcome. French stock prices at this moment are modestly higher, probably reflecting relief that the far right has been vanquished. Investors have sold off French bonds, pushing their yields modestly higher, but their spread over benchmark German bonds narrowed slightly. The euro today is roughly steady against the dollar.



Current French election results. (Source: Financial Times)

United Kingdom: In Thursday's general elections, the center-left Labour Party won in a massive landslide, taking an estimated 411 of the 650 seats in the House of Commons. The center-right Conservative Party won just 121 seats, marking the lowest total in its 190-year history and ending its 14-year lock on the government. The centrist Liberal Democratic Party rebounded from near obscurity to take 72 seats. Reflecting the results, Labour leader Keir Starmer was appointed prime minister on Friday.

- Labour now has its biggest majority since the election of Tony Blair in 1997. Starmer hasn't been specific about the policy changes he'll pursue, but many investors worry he will push through big tax hikes to fund progressive policy initiatives. All the same, relief over the end of Tory rule has helped push British stock prices higher, at least so far.
- While the results suggest the UK has bucked the recent far-right surge elsewhere in Europe, we note that Nigel Farage's far-right Reform UK Party drew millions of votes

and entered parliament for the first time, with five seats. Looking forward, a key question is whether Reform will continue to draw right-wing voters away from the Conservatives.

Iran: In the presidential run-off election on Friday, reformist Masoud Pezeshkian came out on top with about 55% of the vote. Pezeshkian has pledged to relax unpopular social restrictions and re-engage with the West to secure sanctions relief. However, since conservative clerics continue to dominate Iran's government, Pezeshkian will largely have his hands tied, so Iran's relations with the West may not improve much.

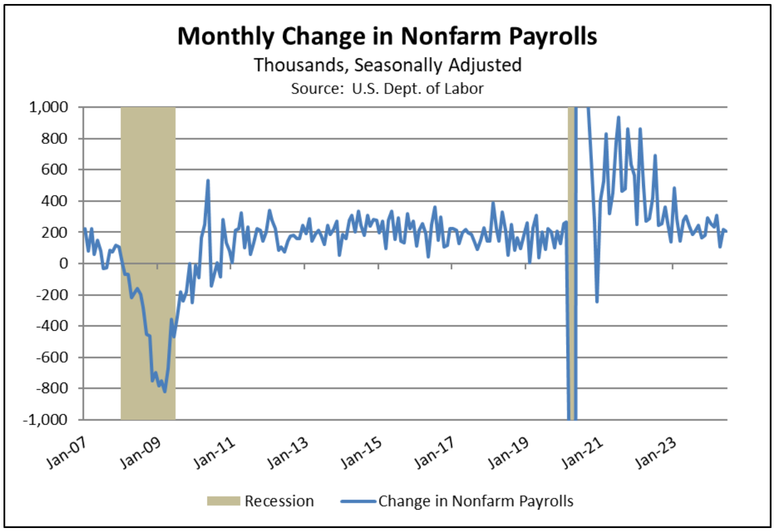
US Monetary Policy: In the minutes from the Fed's June 11-12 policy meeting, released last Wednesday, the policymakers discussed the growing financial strains on lower- and middle-income consumers due to elevated prices, high interest rates, and depleted pandemic savings. According to the minutes, the officials expressed concern that the strains could lead to a sharp drop in consumer spending.

- Those worries are consistent with other recent signs of distress among consumers with low or moderate incomes. Those concerns could eventually prompt the Fed to revisit its current "higher for longer" approach to interest rates, although there is still a risk that the Fed could cut interest rates too late to avoid a big economic slowdown.
- Of course, the economic stress on lower- and middle-income households is probably also a key reason for the weak support given to President Biden in the opinion polls, along with the concerns about his age.

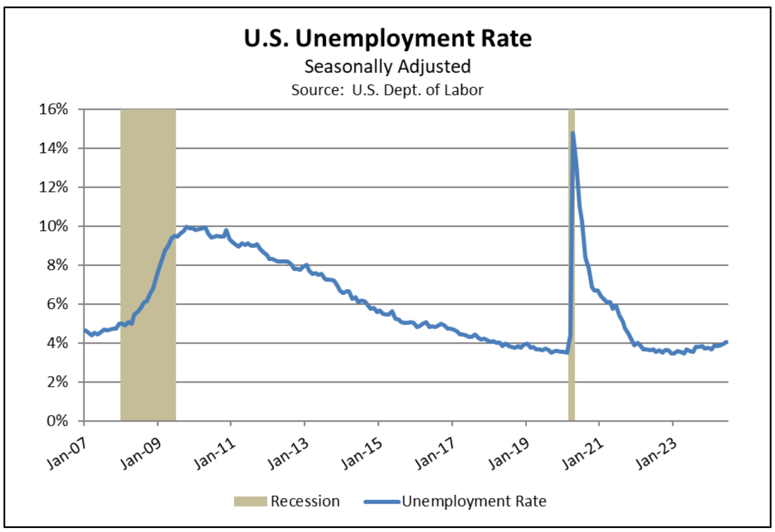
US Defense Industry: An interesting article in today's *Financial Times* discusses how the growing importance of relatively small, inexpensive, quickly modified drones is starting to disrupt the traditional defense industry. While we still believe the new era of higher defense budgets will give a boost to today's legacy defense "primes," we agree that evolving military technologies mean there will also be new opportunities for start-ups, technology firms, and the producers of goods and services with dual civilian-military uses.

US Economic Releases

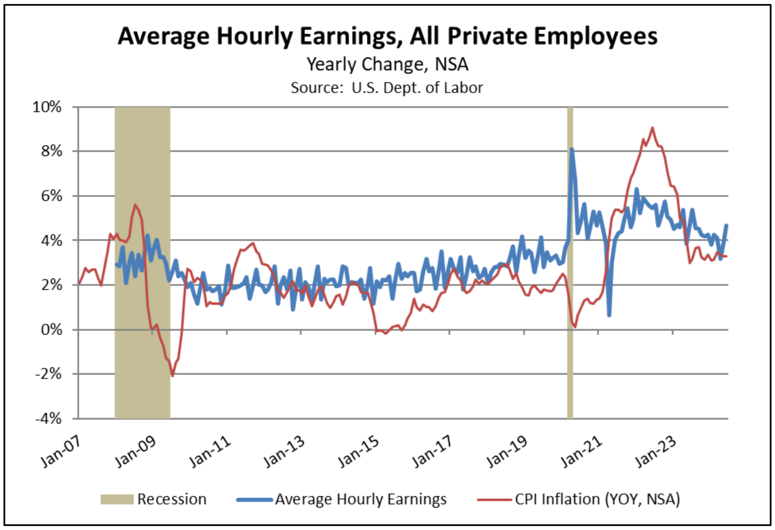
In data released over the long holiday weekend on Friday, June ***nonfarm payrolls*** rose by a seasonally adjusted 206,000, slightly beating expectations but still somewhat lower than the revised May job gain of 218,000. The job gains in April were revised down all the way to just 108,000. Together, the data confirm that the demand for labor continues to cool, potentially helping cement the case for the Fed to start cutting interest rates in the fall. The following chart shows the change in nonfarm payrolls since shortly before the Great Financial Crisis (GFC).



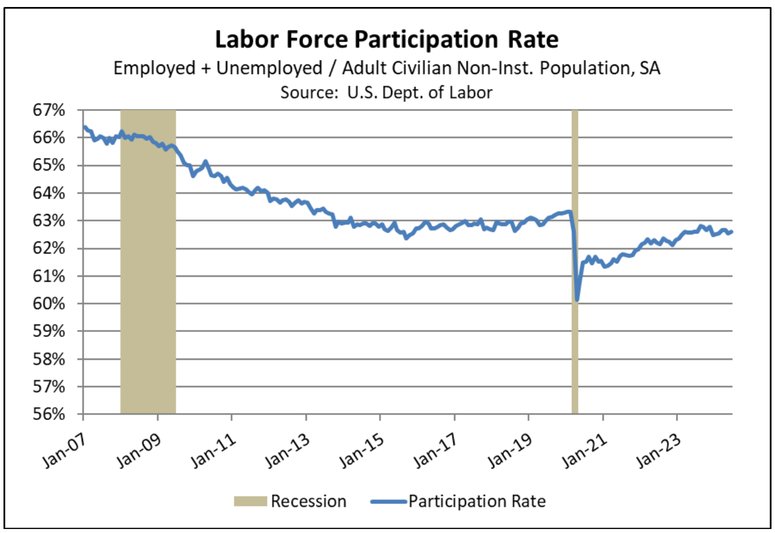
The June ***unemployment rate*** rose to a seasonally adjusted 4.1%, reaching its highest level since November 2021. The jobless rate had stood at just 3.7% at the beginning of the year. The chart below shows how the unemployment rate has evolved since just before the GFC.



Average hourly earnings in June rose to a seasonally adjusted $35.00, up 3.9% from the same month one year earlier. However, using our preferred method of calculating year-over-year changes from non-seasonally adjusted figures, the annual gain was an astounding 4.7%, well above the rate of consumer price inflation. The next chart shows the year-over-year growth in average hourly earnings since just before the GFC.



A final key indicator in the monthly employment report focuses on the share of the adult, civilian, noninstitutionalized population that is either working or looking for work. The June ***labor force participation rate (LFPR)*** rose to a seasonally adjusted 62.6%, although that did nothing to change the fact that it has stagnated in recent months, probably in part because of continued high levels of retirements. The chart below shows how the LFPR has changed over the last several decades.



There were no domestic releases today 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**
11:00	NY Fed 1-Yr Inflation Expectations	m/m	Jun		3.2%	*
15:00	Consumer Credit	m/m	May	$9.500b	$6.403b	*
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	Leading Economic Index	m/m	May P	111.1	110.9	111.0	**	Equity and bond neutral
	Coincident Index	y/y	May P	116.5	115.2	115.6	**	Equity and bond neutral
	Labor Cash Earnings	y/y	May	1.9%	1.6%	2.1%	**	Equity bearish, bond bullish
	Real Cash Earnings	m/m	May	-1.4	-1.2	-0.7	*	Equity bearish, bond bullish
	BoP Current Account Balance	m/m	May	¥2849.9b	¥2050.5b	¥2350.2b	***	Equity and bond neutral
	BoP Trade Balance	m/m	May	-¥1108.9b	-¥661.5b	-¥1186.7b	**	Equity and bond neutral
China	Foreign Reserves	m/m	Jun	$3222.36b	$3232.04b	$3225.00b	**	Equity and bond neutral
EUROPE								
Eurozone	Retail Sales	y/y	May	0.3%	0.6%	0.2%	*	Equity and bond neutral
Germany	Industrial Production WDA	y/y	May	-6.7%	-3.7%	-4.3%	**	Equity bearish, bond bullish
	Trade Balance	m/m	May	24.9b	22.2b	20.3b	*	Equity and bond neutral
	Exports	m/m	May	-3.6%	1.7%	-2.8%	*	Equity bearish, bond bullish
	Imports	m/m	May	-6.6%	1.2%	-1.0%	*	Equity bearish, bond bullish
France	Industrial Production	y/y	May	-3.1%	1.1%	-1.1%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	May	-3.9%	1.4%		**	Equity and bond neutral
	Trade Balance	m/m	May	-7987m	-7561m		*	Equity and bond neutral
Italy	Retail Sales	y/y	May	0.4%	-1.7%		**	Equity and bond neutral
Switzerland	Foreign Currency Reserves	m/m	Jun	711.5b	717.7b		***	Equity and bond neutral
	Domestic Sight Deposits CHF	w/w	5-Jul	444.4b	443.0b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	5-Jul	453.4b	452.0b		*	Equity and bond neutral
Russia	Money Supply, Narrow Definition	w/w	28-Jun	18.15t	18.25t		*	Equity and bond neutral
	Official Reserve Assets	m/m	Jun	593.5b	599.0b		*	Equity and bond neutral
	GDP	y/y	1Q F	5.4%	5.4%	5.4%	**	Equity and bond neutral
AMERICAS								
Canada	Net Change in Employment	m/m	Jun	-1.4k	26.7k	25.0k	***	Equity bearish, bond bullish
	Unemployment Rate	m/m	Jun	6.4%	6.2%	6.3%	***	Equity and bond neutral
Brazil	FGV Inflation IGP-DI	y/y	Jun	2.88%	0.88%	3.00%	**	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)	557	558	-1	Up
3-mo T-bill yield (bps)	523	523	0	Up
U.S. Sibor/OIS spread (bps)	531	530	1	Flat
U.S. Libor/OIS spread (bps)	531	531	0	Down
10-yr T-note (%)	4.31	4.28	0.03	Down
Euribor/OIS spread (bps)	371	371	0	Down
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Flat			Down
Yen	Down			Down
Pound	Up			Up
Franc	Flat			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	$86.03	$86.54	-0.59%	
WTI	$82.51	$83.16	-0.78%	
Natural Gas	$2.34	$2.32	1.08%	
12-mo strip crack	$22.61	$22.98	-1.60%	
Ethanol rack	$2.16	$2.17	-0.11%	
Metals				
Gold	$2,375.45	$2,392.16	-0.70%	
Silver	$31.09	$31.22	-0.41%	
Copper contract	$465.50	$465.20	0.06%	
Grains				
Corn contract	$418.25	$424.00	-1.36%	
Wheat contract	$581.25	$590.50	-1.57%	
Soybeans contract	$1,111.50	$1,129.75	-1.62%	
Shipping				
Baltic Dry Freight	1,966	2,021	-55	

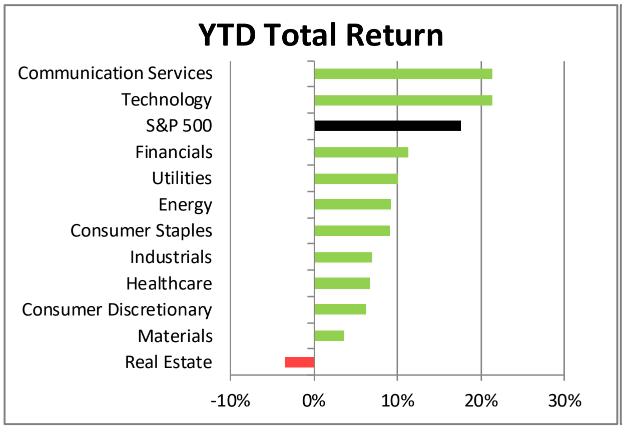
Weather

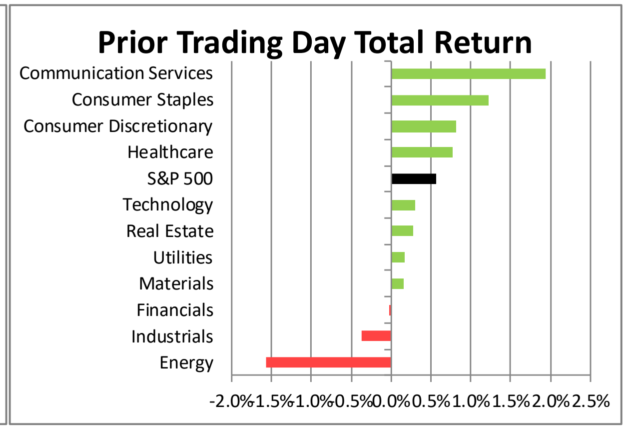
The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures throughout most of the country. The precipitation outlook calls for wetter-than-normal conditions throughout the Mid-Atlantic, South, New England and Midwest regions, with dry conditions stretching from the Pacific Northwest to parts of the Northern Great Plains.

Hurricane Beryl, the only current tropical disturbance in the Atlantic, made landfall on the Texas Gulf Coast earlier this morning. It's expected to track north through the South-Central states, reaching the Great Lakes by Thursday.

Data Section

US Equity Markets – (as of 7/5/2024 close)

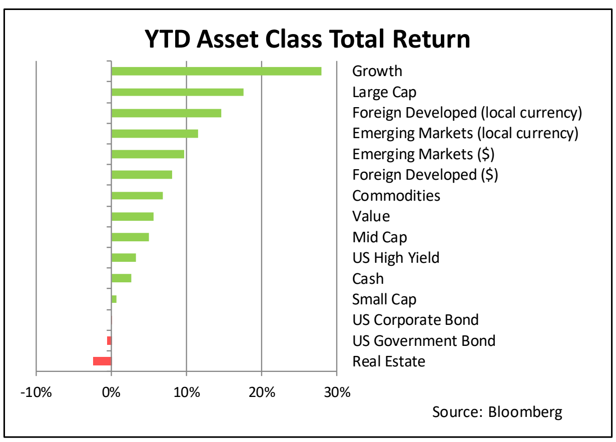




(Source: Bloomberg)

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 7/5/2024 close)

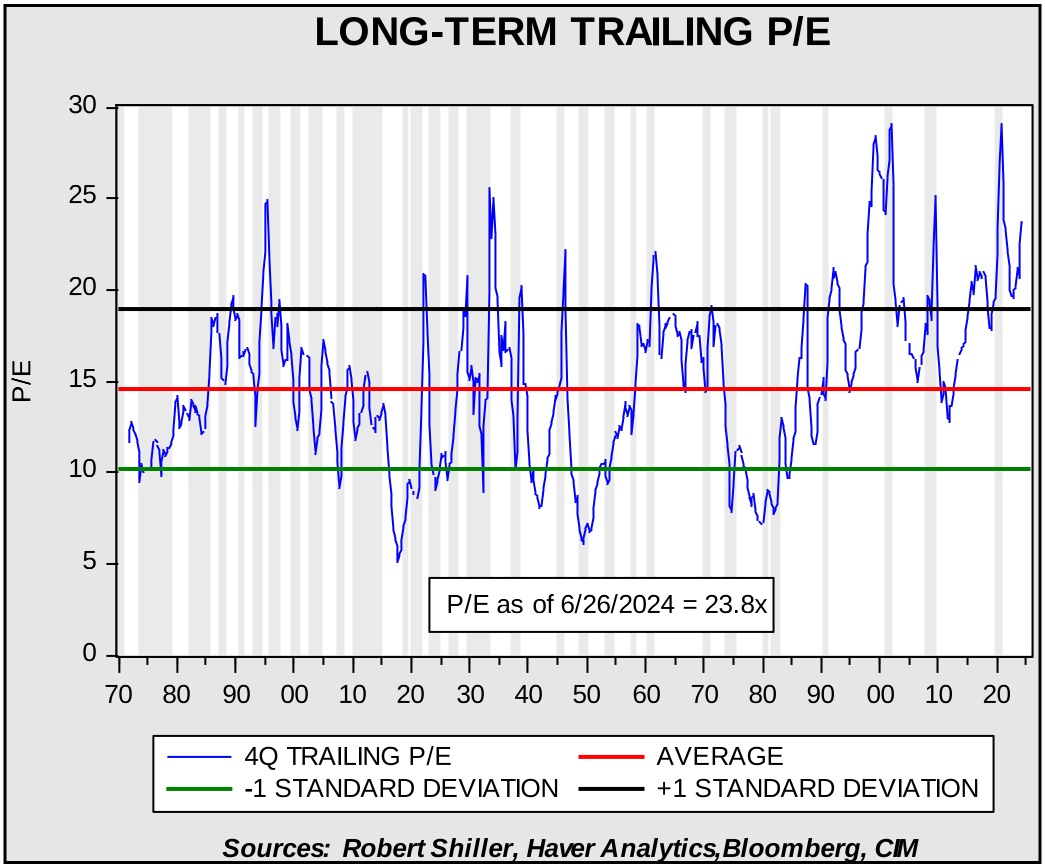


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.