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: June 13, 2024—9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is down 1.0% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.4%. Chinese markets were lower, with the Shanghai Composite down 0.3% from its previous close and the Shenzhen Composite down 0.6%. US equity index futures are signaling a 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* (6/3/2024) (with associated podcast): "The Philippines, China & Escalation in the South China Sea"
- *Asset Allocation Quarterly – Q2 2024* (4/25/2024): Discussion of our asset allocation process, Q2 2024 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q2 2024 Rebalance Presentation* (5/7/2024): Video presentation featuring the Asset Allocation Committee as they review the asset allocation strategies, recent portfolio changes, and the current macro environment.
- *Asset Allocation Bi-Weekly* (6/10/2024) (with associated podcast): "Copper, Gold, Treasurys, and the New World"
- *Confluence of Ideas podcast* (5/8/2024) "Reviewing the Asset Allocation Rebalance: Q2 2024"
- ***Fixed Income Quarterly*** **(June 2024)**

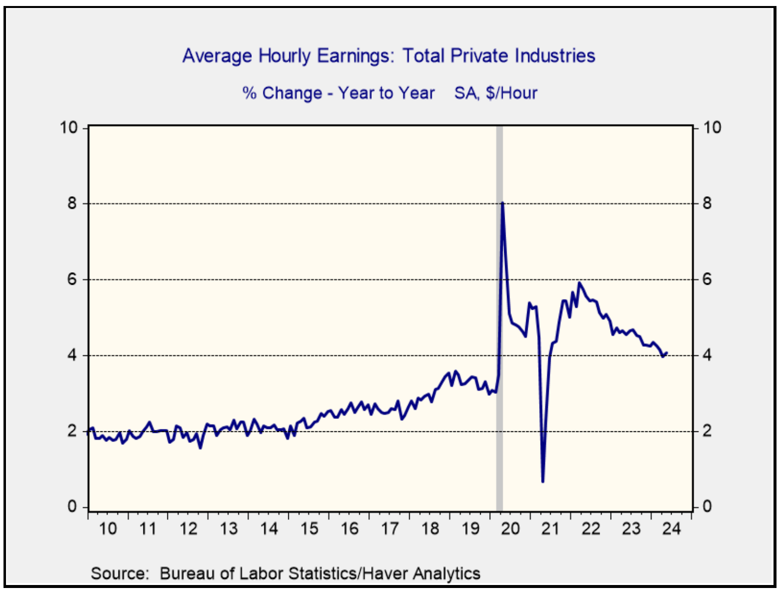
Good morning! Investors are looking past the recent Federal Open Market Committee meeting after a bullish PPI report boosted rate cut hopes. On the sports front, the US Men's National Soccer Team secured a draw against Brazil in their Copa América warmup. Today's *Comment* will analyze the FOMC meeting, explore why the CPI report offers hope of a policy shift for the Fed, and delve into the significance of the French elections. We'll also provide our usual roundup of domestic and international news.

Fed Raises Doubts: The latest FOMC move suggests that it is unlikely to feel confident enough to cut rates before the election.

- The central bank held its benchmark interest rate steady at a target range of 5.25% to 5.50%. However, it lowered its projected number of rate cuts for the year from three to one. This shift surprised market participants, as recent declines shown in the CPI and

PCE reports suggested progress toward the central bank's inflation target. A recent surge in the nonfarm payroll data, though, appears to have influenced this hawkish stance. During the press conference, the Federal Reserve Chair reassured markets that the Fed remains prepared to act if job growth weakens unexpectedly in the coming months.

- Job data has become paramount in the Fed's monetary policy decisions. Fed officials have recently signaled that a significant weakening of the labor market could prompt them to ease policy. However, recent data suggests that the labor market remains tight. Since the last Fed meeting, the unemployment rate has edged up slightly, from 3.8% to 4.0%, while nonfarm payroll jobs averaged a strong 200,000. Elevated wage pressures also remain a concern. Hourly earnings remain stubbornly above 4% annually, exceeding the level policymakers view as a sustainable long-term path, which is closer to 2.5%.

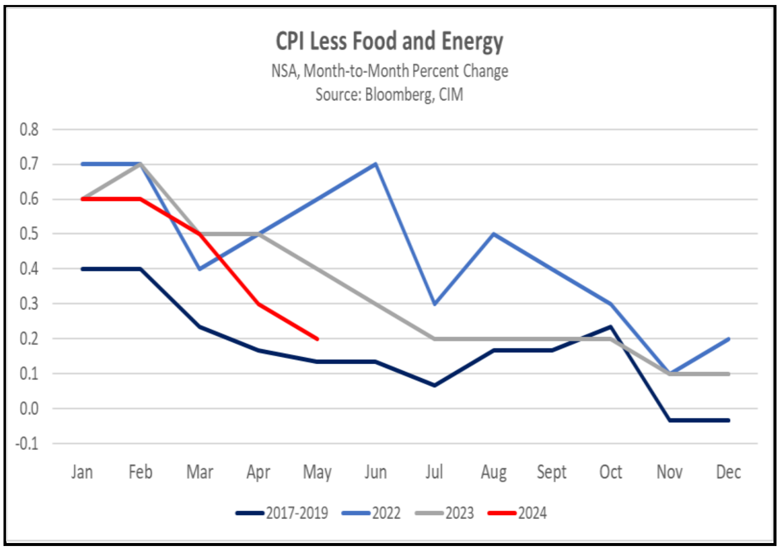


- The hawkish pivot may be related to concerns about political favoritism. Recent setbacks in inflation, as evidenced by the CPI reports during the first quarter, coupled with a relatively tight labor market, have led many commentators to question the need for any rate cuts at all. This criticism may have influenced the FOMC's decision to revise its terminal fed funds rate upward, particularly as the election nears. However, the central bank remains open to a dovish shift if labor market conditions deteriorate. Should the unemployment rate remain above the year-end projection of 4.0% (which is the current rate), it could prompt Fed officials to reassess the number of rate cuts planned for the year.

Calling the Fed's Bluff? Despite concerns from some Fed officials, inflation is rising at its slowest pace since monetary tightening began in 2022.

- Inflation eased to a three-year low in May, according to the Bureau of Labor Statistics. Consumer prices rose just 3.4% year-over-year, down from 3.6% in April. Core inflation, a more stable measure excluding food and energy, also slowed slightly to 3.3% from 3.4%. This moderation was driven by monthly price drops in airline fares, auto insurance, and new cars. Further supporting this trend, housing costs, the index's largest component, held steady for the fourth consecutive month. This cooler-than-expected report suggests that despite Fed concerns, policy rates are still helping relieve inflationary pressures.

- The 10-year Treasury yield plunged 9 basis points on the day, as the market cheered the CPI results and shrugged off the FOMC meeting. The market's reaction suggests that bond investors may be discounting the Fed's projection of a single rate cut this year, instead believing policymakers submitted their estimates prior to the release of the latest CPI figures. Data from the first five months of the year shows that non-seasonalized inflation, which is never revised, is rising at a much slower pace than in 2022 and 2023. The latest report provided even more optimism that inflation may be falling closer to its four-year average recorded before the pandemic.

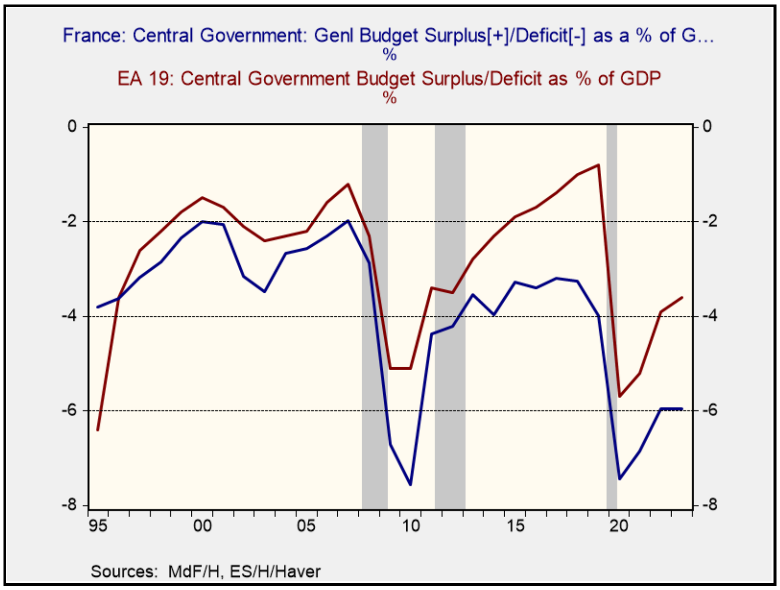


- Fed officials have consistently emphasized the need for greater confidence in falling inflation before considering rate cuts this year. The next three months, which typically see lower core CPI readings, will be a critical test for the central bank. If inflation remains below 2023 levels during this period, it would be seen as evidence of easing price pressures. The bond market's reaction reflects optimism that this will happen. However, the scenario is not without risks. A disappointing CPI report could trigger a sharp rise in bond yields in the coming months and a rethink as to whether policy rates are restrictive enough to bring down inflation.

Macron's Gamble: The French president is hoping that the market can help spook voters into reconsidering their support for far-right parties.

- The latest opinion polls indicate that the far-right conservative party is poised to make significant gains in the upcoming election on June 30. Projections suggest that the National Rally (RN) is expected to secure between 235 and 265 seats in the 577-member National Assembly. Although this would constitute a substantial increase, they are likely to fall short of achieving an outright majority. While there have been discussions about RN aligning with the center-right Republicans, significant internal opposition within both parties hinders such a partnership. Meanwhile, far-left parties are also working on forming a united front.

- The upcoming election is likely to thrust the country's ballooning deficit into the spotlight. Post-pandemic efforts to control the national debt have been unsuccessful. In 2023, the debt-to-GDP ratio remained at 6%, significantly exceeding the 3% threshold mandated by EU fiscal rules. Bond yields surged after the snap election announcement. Investors fear a potential RN victory could lead to higher government borrowing rather than debt reduction. Marine Le Pen, the party's leader, has unnerved investors with her proposed sales tax cuts and push to lower the retirement age. As a result, the spread between French and German 10-year bonds widened.



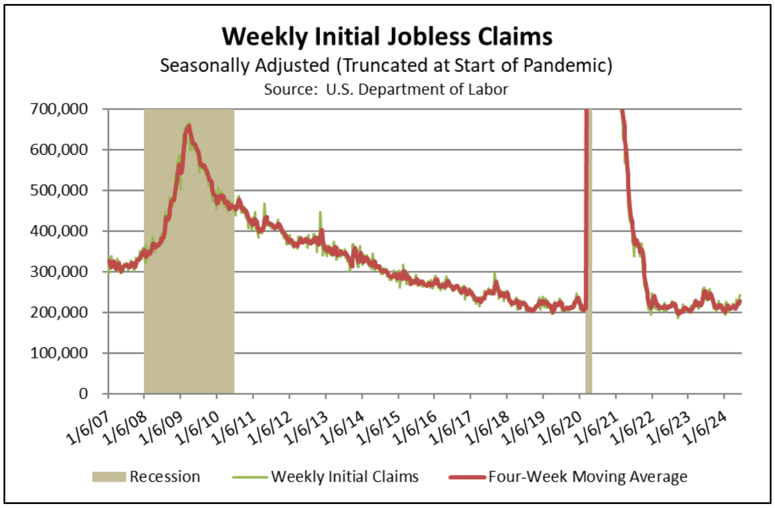
- Although RN gained momentum from the recent European parliamentary elections, its success in the upcoming elections remains uncertain. Its surge over the weekend was driven primarily by frustrated voters who were more motivated to participate in an election widely regarded as inconsequential. Voter turnout for the parliamentary election was only 50%, compared to 80% in the general election. Nonetheless, a potential defeat for RN could increase pressure on Emmanuel Macron to step down, as it would be seen as a sign that the country has lost faith in his leadership. Although a leadership change in France is not our base-case scenario, it is something we will be paying close attention to.

In Other News: In a sign that conflict in Europe will likely continue, the G-7 struck a deal to offer additional funding to Ukraine for its war efforts. South Africa inches closer to a coalition government as the African National Congress Party negotiates a power-sharing deal with the pro-business Democratic Alliance.

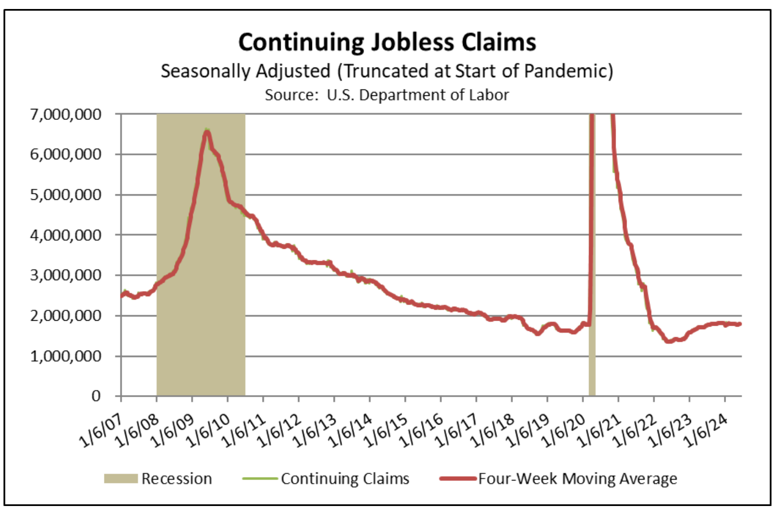
US Economic Releases

In the week ended June 8, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 242,000, much higher than both the expected level of 225,000 and the previous week's level of

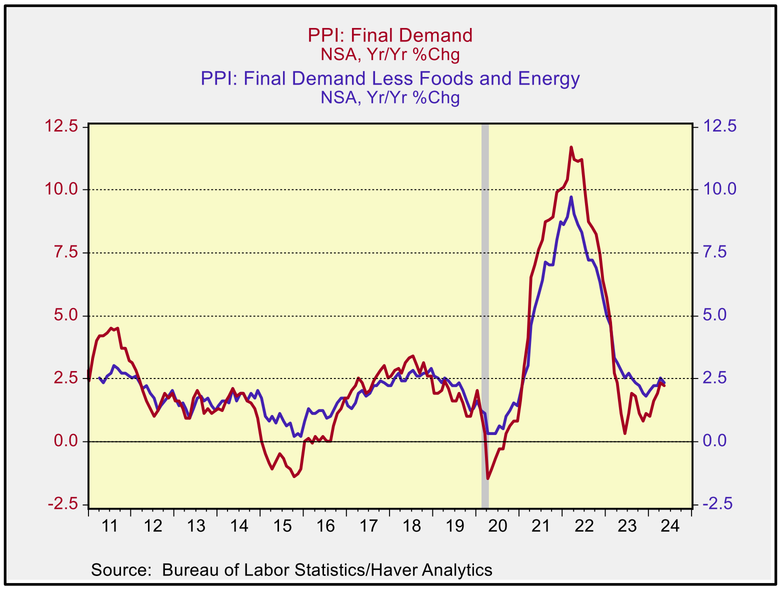
229,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to a nine-month high of 227,000. Of course, the jump in initial claims could reflect problems with the seasonal adjustment process around the Memorial Day holiday. Nevertheless, the rise does suggest there has been some softening in labor demand, which could rekindle hopes for more aggressive interest-rate cuts by the Fed. 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 June 1, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to a seasonally adjusted 1.820 million, above both the anticipated reading of 1.795 million and the prior week's revised reading of 1.790 million. The four-week moving average of continuing claims rose to 1,796,750. 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.



Separately, the May ***producer price index (PPI)*** fell by a seasonally adjusted 0.2%, much better than the expected rise of 0.1% but only enough to offset part of the 0.5% increase in April. Excluding the volatile food and energy components, the May ***"core" PPI*** was unchanged, versus an expected rise of 0.3% and April's increase of 0.5%. The overall PPI in May was up 2.2% from the same month one year earlier, while the core PPI was up 2.3%. The chart below shows the year-over-year change in the PPI and the core PPI over the last decade or so.



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		
Federal Reserve		
ET	**Speaker or Event**	**District or Position**
12:00	John Williams Interviews Treasury Secretary Yellen	President of the Federal Reserve Bank of New York

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	Japan Buying Foreign Stocks	w/w	7-Jun	-¥526.3b	-¥588.7b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	7-Jun	-¥346.6b	¥282.0b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	7-Jun	¥411.4b	¥337.4b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	7-Jun	-¥2647.6b	¥1323.4b		*	Equity and bond neutral
Australia	Employment Change	m/m	May	39.7k	37.4k	30.0k	***	Equity and bond neutral
	Unemployment Rate	m/m	May	4.0%	4.1%	4.0%	***	Equity and bond neutral
	Participation Rate	m/m	May	66.8%	66.8%	66.7%	**	Equity and bond neutral
EUROPE								
Eurozone	Industrial Production WDA	y/y	Apr	-3.0%	-1.2%	-2.0%	**	Equity bearish, bond bullish
Italy	Unemployment Rate	m/m	1Q	7.2%	7.4%		**	Equity and bond neutral
Switzerland	Producer & Import Prices	y/y	May	-1.8%	-1.8%		**	Equity and bond neutral
AMERICAS								
Brazil	Retail Sales	y/y	Apr	2.2%	5.7%	3.9%	***	Equity bearish, bond bullish

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)	561	560	1	Up
3-mo T-bill yield (bps)	524	525	-1	Up
U.S. Sibor/OIS spread (bps)	535	535	0	Up
U.S. Libor/OIS spread (bps)	535	535	0	Up
10-yr T-note (%)	4.31	4.32	-0.01	Up
Euribor/OIS spread (bps)	372	374	-2	Down
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Down
Yen	Down			Down
Pound	Down			Down
Franc	Down			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
FOMC Rate Decision (Lower Bound)	5.250%	5.250%	5.250%	On Forecast
FOMC Rate Decision (Upper Bound)	5.500%	5.500%	5.500%	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.

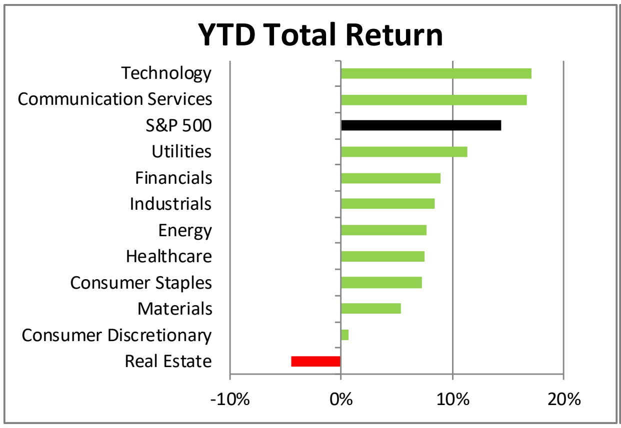
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$82.12	$82.60	-0.58%	
WTI	$77.96	$78.50	-0.69%	
Natural Gas	$2.99	$3.05	-1.94%	
12-mo strip crack	$21.26	$21.40	-0.68%	
Ethanol rack	$2.06	$2.04	1.04%	
Metals				
Gold	$2,310.30	$2,324.98	-0.63%	
Silver	$29.13	$29.73	-2.01%	
Copper contract	$452.90	$455.95	-0.67%	
Grains				
Corn contract	$458.00	$454.25	0.83%	
Wheat contract	$622.50	$617.00	0.89%	
Soybeans contract	$1,148.00	$1,147.25	0.07%	
Shipping				
Baltic Dry Freight	1,836	1,831	5	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	3.73	-1.50	5.23	
Gasoline (mb)	2.57	1.50	1.07	
Distillates (mb)	0.88	2.15	-1.27	
Refinery run rates (%)	-0.4%	-0.4%	0.0%	
Natural gas (bcf)		72		

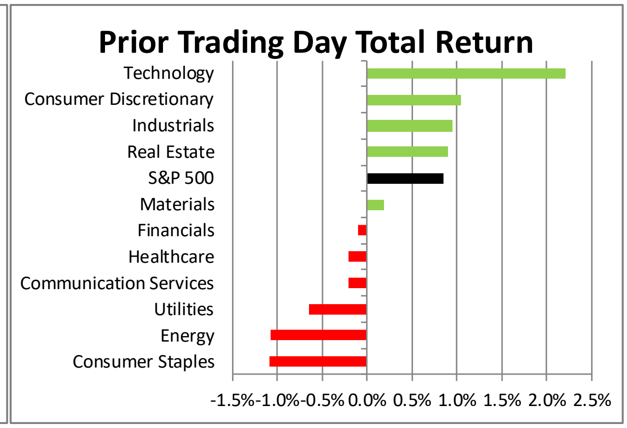
Weather

The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures from the Great Plains eastward, with cooler-than-normal temperatures in the Pacific Northwest. The forecasts call for wetter-than-average conditions along the Northern Tier and the Gulf Coast, with dry conditions in the central Great Plains.

Data Section

US Equity Markets – (as of 6/12/2024 close)

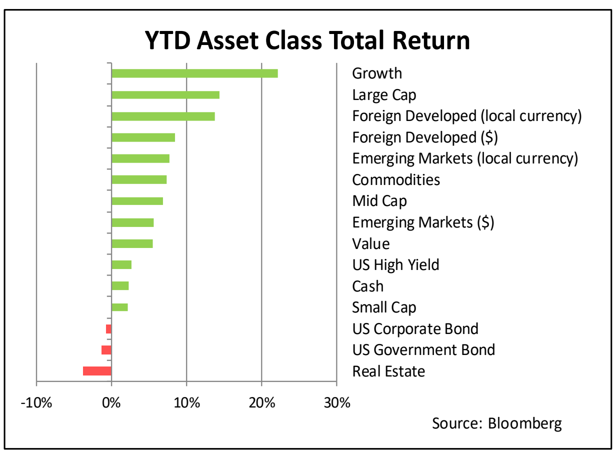




(Source: Bloomberg)

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 6/12/2024 close)

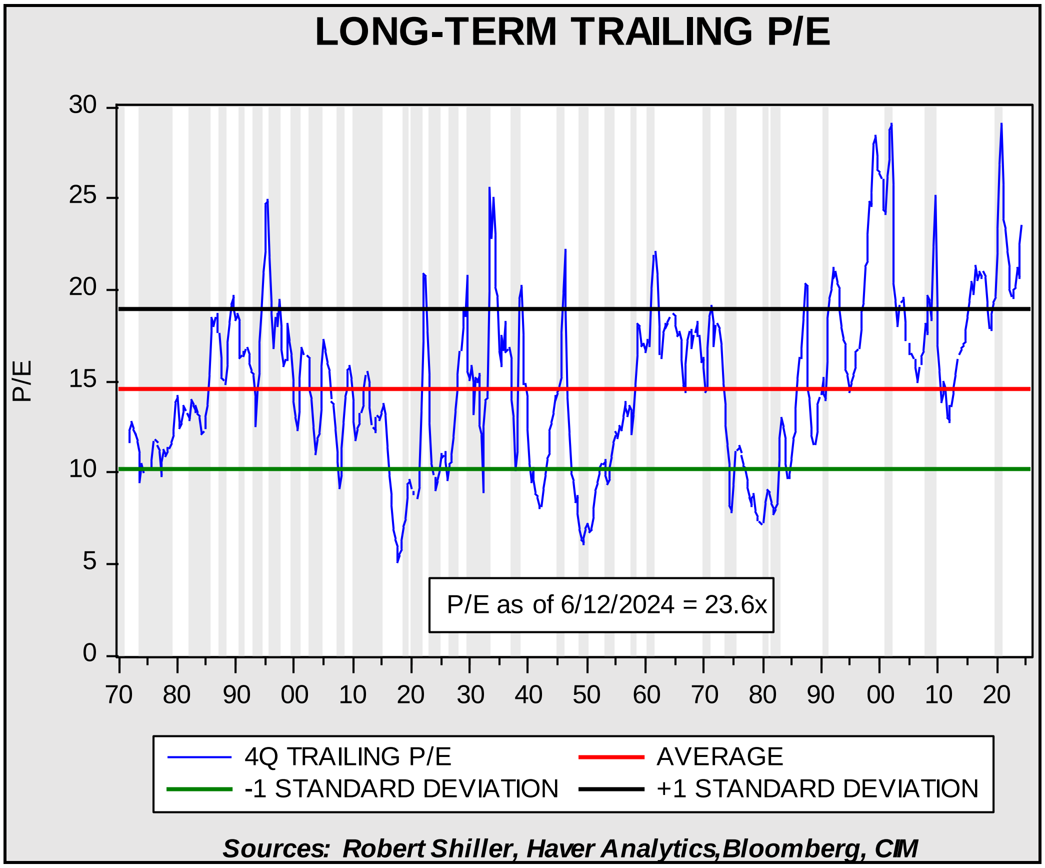


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 13, 2024



Based on our methodology,[1] the current P/E is 23.6x, up 0.1 from our last report. The increase in the multiple was due to an increase in the stock price index, and a slight decline in Q1 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.