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 14, 2024—9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is down 1.5% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.2%. Chinese markets were higher, with the Shanghai Composite up 0.1% from its previous close and the Shenzhen Composite up 0.4%. US equity index futures are signaling a lower 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! Equity futures have moderated as investors await a reaction to the May inflation data from Federal Reserve officials. In sports news, the Florida Panthers have taken a commanding 3-0 lead against the Edmonton Oilers in the NHL Finals. Today's *Comment* will delve into the potential impact of letting the Saudi Arabia-US petrodollar agreement lapse, discuss what the latest PPI data tells us about consumer inflation, and examine why investors are reluctant to hold the Mexican peso. As usual, the report concludes with a summary of international and domestic economic releases.

End of the Petrodollar?: Saudi Arabia allowed the agreement with the US to price its oil exclusively in dollars lapse last Friday as the two sides work on a new defense pact.

- The decline of the petrodollar system likely signals a shift away from the dollar-based global financial regime. The agreement was the result of then President Richard Nixon's controversial decision to suspend the gold window in 1971. Upset by this move, Saudi Arabia considered pegging the price of oil to a basket of currencies, effectively severing the link to the dollar. In 1974, the US agreed to provide Saudi Arabia with military aid and weapon sales, in exchange for Riyadh's commitment to recycling its excess dollars back into the US Treasury market.

- Saudi Arabia's recent move regarding the petrodollar system can be seen as another sign of a shifting global landscape. By avoiding a definitive stance on ending the dollar's dominance in the oil trade, the kingdom appears to be strategically navigating the growing tensions between the US and China. China's rise as a major oil importer for Saudi Arabia, coupled with the US shale industry's emergence as a competitor in Europe, suggests that economic realities are driving Saudi Arabia's cautious approach. After all, China is now Saudi Arabia's second-largest customer after Russia and has shown a preference for diversifying away from holding excessive US dollars and toward holding more gold.

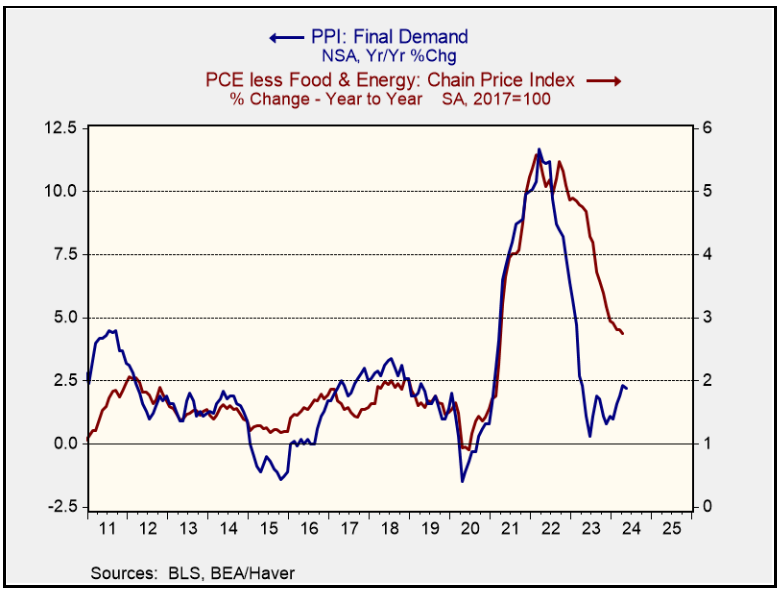
The potential end of the petrodollar system may be more calculated than it initially appeared. Earlier this year, Saudi Arabia delayed its BRICS membership bid while negotiating a potentially transformative security pact with the US. This pact, if finalized, would be more comprehensive than the previous agreement and reportedly could include a stronger US commitment to Saudi Arabia's defense. While progress has been made, details remain under discussion, but it does feel as if both sides are close to an agreement. This strategic maneuvering suggests the petrodollar's demise might be premature, as the US-Saudi relationship remains a key factor.

Another Inflation Surprise: Wholesale price inflation gave investors another reason to be optimistic that the Fed will cut more than once this year.

- Producer prices unexpectedly declined in May, marking their largest monthly drop since October 2023. The Bureau of Labor Statistics reported that the overall producer price index (PPI) fell by 0.2%, significantly lower than consensus estimates of a 0.1% increase.

This decline was widespread, with core PPI, which excludes volatile food and energy prices, holding steady compared to the previous month. Additionally, the cost of processed goods used in production, a measure of input costs, dropped 1.5%, suggesting that businesses are seeing lower costs to build their inventory.

- Following the release of the report, the 10-year Treasury yield dropped below 4.3%, as investors believe a September cut is still possible. The report provided confidence that factors within the PPI index that contribute to the Personal Consumption Expenditures (PCE) price index, the Fed's preferred inflation gauge, were relatively tame. This evidence suggests that core inflation may not reaccelerate this year as members of the Fed expect. In April, the PCE price index rose by 2.75% compared to the previous year, which was below the Fed's year-end expectation of 2.8%.

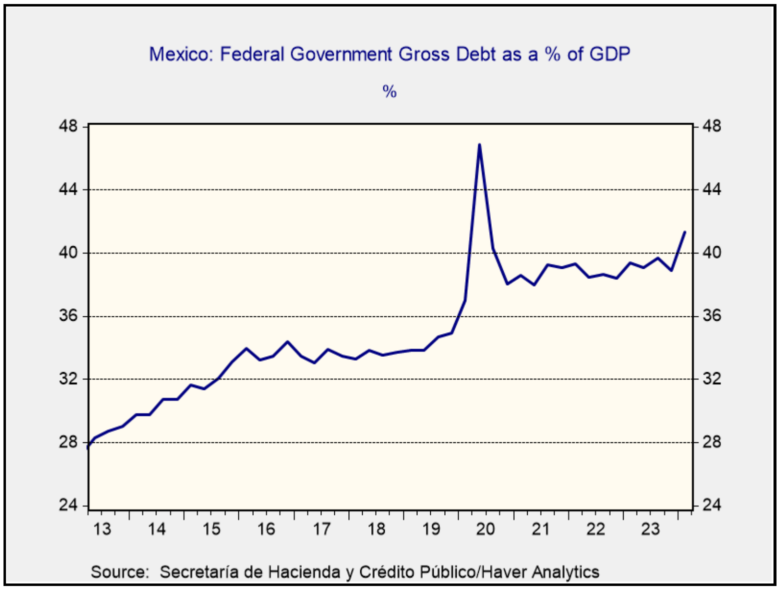


- The latest CPI and PPI reports provide evidence that inflation is on the right track. However, investors may want to wait for the latest Fed speeches before pricing in bets for additional rate cuts. The latest Fed dot plot showed that the range of rate expectations narrowed significantly from March to June, with no policymakers supporting more than three rate cuts before the end of the year, despite that being the median estimate in the previous two meetings. Any signal that current voters on the Federal Open Market Committee have become more dovish will likely be viewed favorably by markets.

Demise of the Super Peso: Mexico's currency plunged after a surprise landslide election victory, raising investor concerns about the country's economic future.

- The weakness in the currency arises from concerns that the next administration will pursue judicial reforms aimed at removing checks on the ruling Morena party. Following her victory earlier this month, President-elect Claudia Sheinbaum stated that the government should focus on reforms that would replace appointed Supreme Court judges with popularly elected ones, a move likely to undermine potential challenges to the party's agenda. While Sheinbaum mentioned that the matter should be discussed with law schools and judiciary workers, her predecessor President Andrés Manuel López Obrador (AMLO), who still holds significant influence in the party, doubled down on the necessity of this change.

- Investor uneasiness reflects concerns that the Morena party is trying to circumvent the judicial system to pass controversial legislation. Most recently, Mexico's Supreme Court struck down a proposal that would have given the state-owned electric company an unfair advantage over private competitors. The court ruled that the proposal violated constitutional guarantees of fair competition in the power sector. Additionally, the High Court clashed with AMLO by overriding legislation that aimed to restrict the power of the National Electoral Institute. This independent body safeguards elections by enforcing rules on political campaigning by public officials.

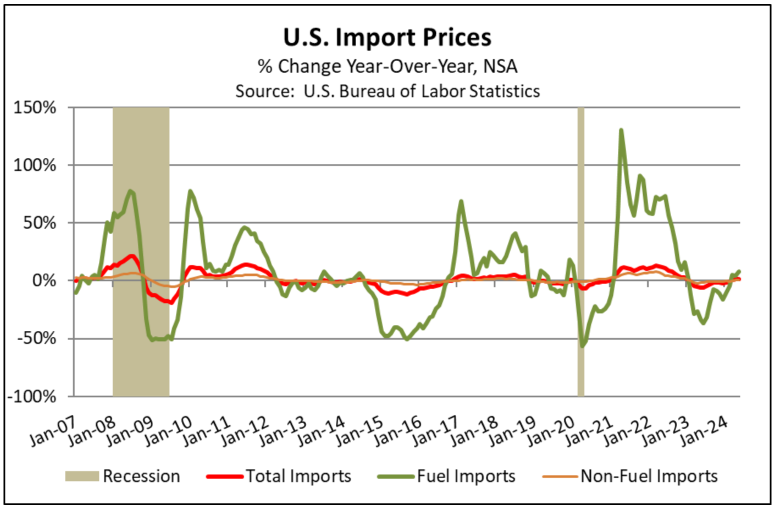


- The recent drop in the peso (MXN) suggests investors are losing faith in Mexico's ability to maintain stability. During his six-year term, AMLO did well at keeping spending in check, even as many countries were ramping up debt during the pandemic. Nevertheless, reforms favoring state-owned firms over foreign competition could create new tensions with their Western counterparts, especially if the government pursues the nationalization of key parts of its energy sector, which is a growing concern. That said, the country will likely remain a good investment opportunity as long as the High Court remains independent of the ruling party's influence.

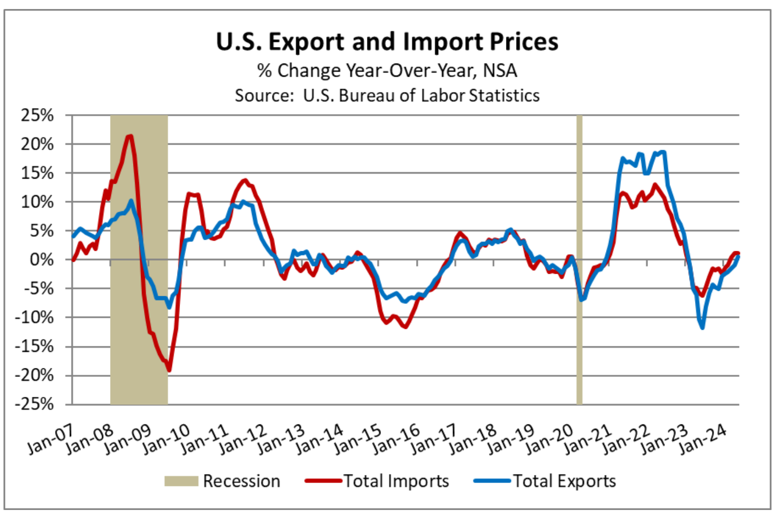
In Other News: The Bank of Japan maintained policy rates at its latest meeting but stated that it will reduce the amount of its bond purchases in a sign that the central bank is moving closer to policy normalization. Concerns over snap elections in France continue to weigh on stocks, as investors remain nervous about a potential victory for far-right candidates. Russian President Vladimir Putin proposed conditions for a possible truce, but they were rejected because they included demands for Ukrainian territory Russia doesn't currently control. Nevertheless, this proposal shows a beginning to discussions about ending the conflict.

US Economic Releases

May ***import prices*** were down 0.4% from the previous month, falling even more than the expected drop of 0.1% and reversing almost half of their April rise of 0.9%. Of course, import prices are often driven by volatility in the petroleum fuels category, but that wasn't necessarily the case this time. May ***import prices excluding fuels*** were down a similar 0.3%, versus an anticipated rise of 0.2% and April's revised rise of 0.6%. Overall import prices in May were up 1.1% year-over-year, while import prices excluding fuels were up just 0.5%. The chart below shows the year-over-year change in import prices since just before the Great Financial Crisis.



According to the report, ***export prices*** in May were up 0.6% from one year earlier. Comparing the annual change in export prices to the change in import prices provides a sense of the US "terms of trade," or the relative advantage or disadvantage the country is facing because of trends in international trade prices. The chart below compares the year-over-year change in US export and import prices 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	Jun P	72.0	69.1	***
10:00	U. of Michigan Current Conditions	m/m	Jun P	72.2	69.6	**
10:00	U. of Michigan Future Expectations	m/m	Jun P	72.0	68.8	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Jun P	3.2%	3.3%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Jun P	3.0%	3.0%	*
Federal Reserve						
ET	**Speaker or Event**	**District or Position**				
8:30	Loretta Mester Appears on CNBC	President of the Federal Reserve Bank of Cleveland				
13:00	Loretta Mester Appears on Bloomberg Television	President of the Federal Reserve Bank of Cleveland				
14:00	Austan Goolsbee Speaks in Fireside Chat	President of the Federal Reserve Bank of Chicago				
16:00	Loretta Mester Appears on CNN International	President of the Federal Reserve Bank of Cleveland				
19:00	Lisa Cook Gives Speech for AEA Summer Program	Member of the Board of Governors				

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	Tertiary Industry Index	m/m	Apr	1.9%	-2.3%	0.4%	***	Equity bullish, bond bearish
	Industrial Production	y/y	Apr F	-1.8%	-1.0%		***	Equity and bond neutral
	Capacity Utilization	y/y	Apr	0.3%	1.3%		**	Equity and bond neutral
New Zealand	BusinessNZ Manufacturing PMI	m/m	May	47.2	48.8		***	Equity and bond neutral
	Food Prices	m/m	May	-0.2%	0.6%		***	Equity and bond neutral
South Korea	Import Price Index	y/y	May	4.6%	2.9%		*	Equity and bond neutral
	Export Price Index	y/y	May	7.5%	6.5%		*	Equity and bond neutral
China	Money Supply M2	y/y	May	7.0%	7.2%	7.1%	***	Equity and bond neutral
	Money Supply M1	y/y	May	-4.2%	-1.4%	-1.6%	*	Equity bearish, bond bullish
	Money Supply M0	y/y	May	11.7%	10.8%		*	Equity and bond neutral
	New Yuan Loans	m/m	May	11140.0b	10191.2b	11310.0b	**	Equity and bond neutral
India	Wholesale Prices	m/m	May	2.61%	1.26%	22.70%	*	Equity and bond neutral
India	Imports	y/y	May	7.7%	10.3%		**	Equity and bond neutral
	Trade Balance	m/m	May	-$23782m	-$19103m	-$19500m	**	Equity and bond neutral
	Exports	y/y	May	9.1%	1.1%		**	Equity and bond neutral
EUROPE								
Eurozone	Trade Balance SA	m/m	Apr	19.4b	17.2b	17.5b	**	Equity and bond neutral
France	CPI, EU Harmonized	y/y	May F	2.6%	2.7%	2.7%	**	Equity and bond neutral
	CPI	y/y	May F	2.3%	2.2%	2.2%	***	Equity and bond neutral
	CPI Ex-Tobacco Index	q/q	May	119.05	119.01	119.01	*	Equity and bond neutral
Russia	Trade Balance	m/m	Apr	10.7b	18.9b		**	Equity and bond neutral
	Exports	m/m	Apr	33.2b	41.5b		*	Equity and bond neutral
	Imports	m/m	Apr	22.5b	22.6b		*	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	7-Jun	18.24t	18.14t		*	Equity and bond neutral
AMERICAS								
Brazil	Economic Activity Index	y/y	Apr	4.01%	-2.18%	3.90%	**	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)	561	561	0	Up
3-mo T-bill yield (bps)	523	525	-2	Up
U.S. Sibor/OIS spread (bps)	535	534	1	Up
U.S. Libor/OIS spread (bps)	534	535	-1	Flat
10-yr T-note (%)	4.19	4.25	-0.06	Down
Euribor/OIS spread (bps)	372	372	0	Down
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Down
Yen	Flat			Down
Pound	Down			Down
Franc	Up			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
BOJ Target Rate (Upper Bound)	0.100%	0.100%	0.100%	On Forecast
BOJ Target Rate (Lower Bound)	0.000%	0.000%	0.000%	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.

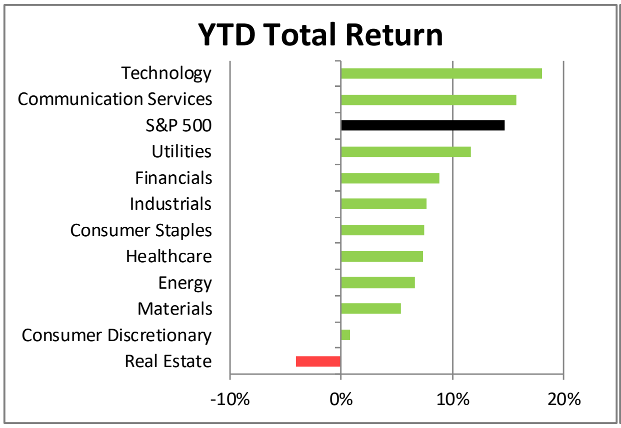
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$83.06	$82.75	0.37%	
WTI	$78.80	$78.62	0.23%	
Natural Gas	$2.98	$2.96	0.78%	
12-mo strip crack	$22.49	$22.11	1.69%	
Ethanol rack	$2.09	$2.07	0.70%	
Metals				
Gold	$2,335.03	$2,304.21	1.34%	
Silver	$29.34	$28.97	1.30%	
Copper contract	$449.05	$448.00	0.23%	
Grains				
Corn contract	$473.75	$476.00	-0.47%	
Wheat contract	$615.00	$620.00	-0.81%	
Soybeans contract	$1,152.50	$1,160.25	-0.67%	
Shipping				
Baltic Dry Freight	1,942	1,836	106	
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)	74	72	2	

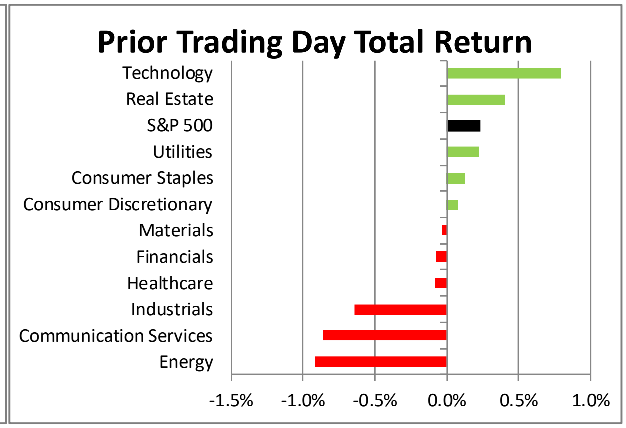
Weather

The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures throughout the entire country except for the Pacific Northwest and western Texas, with cooler-than-normal temperatures expected in the northern Rocky Mountains. The forecasts call for wetter-than-average conditions along the Northern Tier, the Midwest, New England, and the Southeast, with dry conditions in California and Nevada.

Data Section

US Equity Markets – (as of 6/13/2024 close)

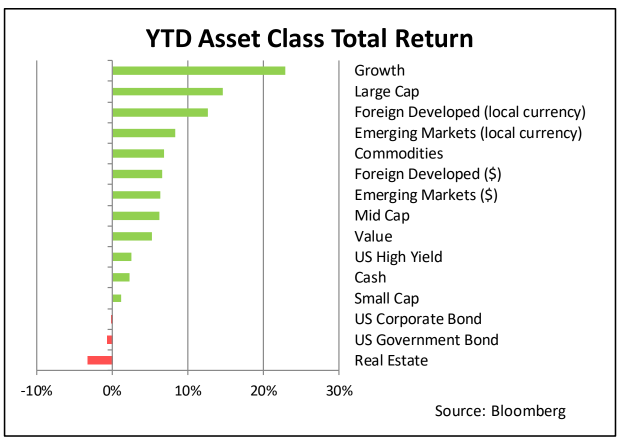




(Source: Bloomberg)

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 6/13/2024 close)

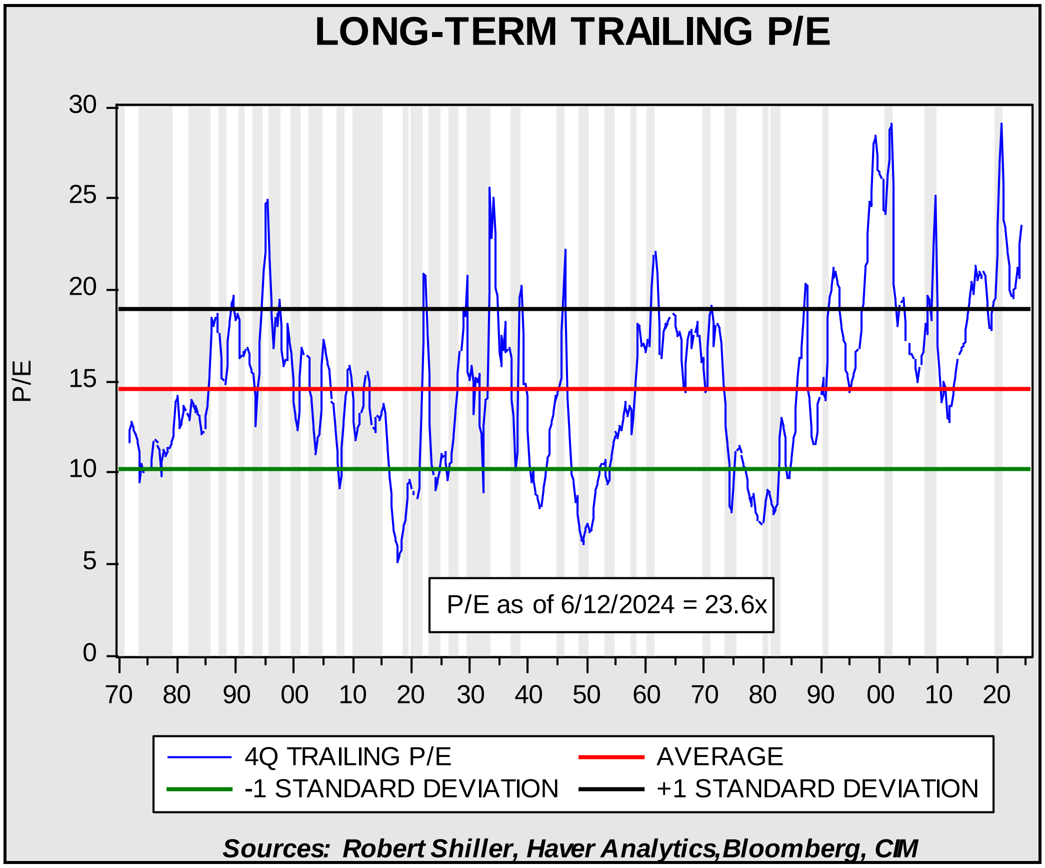


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.