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 21, 2024—9:30 AM ET] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is down 0.8% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.3%. Chinese markets were lower, with the Shanghai Composite down 0.2% from its previous close and the Shenzhen Composite down 0.1%. 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:

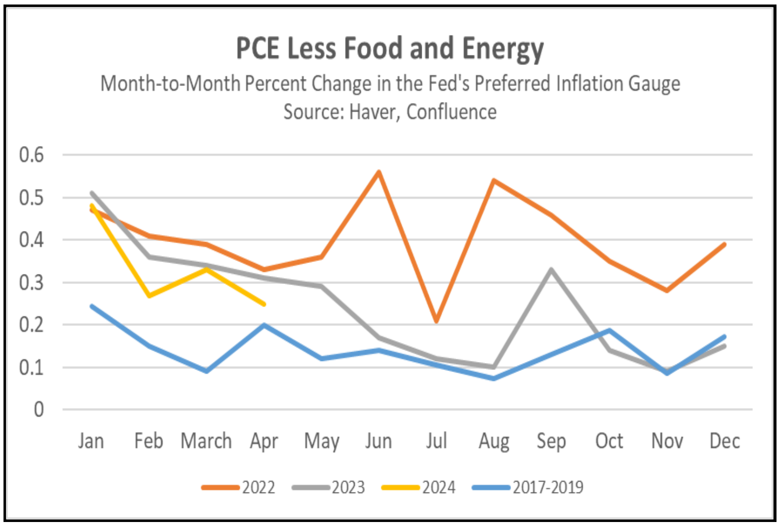
- *Bi-Weekly Geopolitical Report* (6/17/2024) (with associated podcast): "Mid-Year Geopolitical Outlook: Uncertainty Reigns"
- *Asset Allocation Quarterly – Q2 2024* (4/25/2024): Discussion of our asset allocation process, Q2 2024 portfolio changes, and our outlook for the markets.
- *Asset Allocation 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 are holding steady as investors wait for fresh economic data to guide their next move. On the sports front, Argentina emerged victorious against Canada with a 2-0 win, setting the stage for the Copa América. Today's *Comment* dives into three key topics: the persistently low bond yields, the recent restrictions on Chinese electric vehicle imports, and the performance of banks. We'll wrap up the report with a look ahead to today's domestic and international data releases.

Bonds are Back: Bond investors continue to doubt whether the Fed will hold rates steady as the economy continues to show signs of slowing.

- The yield on the 10-year US Treasury note remains stubbornly low, closing below 4.3% for the tenth consecutive day on Thursday. This defies expectations given several headwinds: the Fed's recent shift towards fewer rate cuts, stubbornly high inflation, and a ballooning Treasury supply. Investor demand for bonds seems fueled by a confluence of factors. One is the hope that inflation will continue to cool in the coming months. Additionally, economic uncertainty is driving a flight to safety, pushing investors towards the perceived security of Treasurys. Finally, a string of weak economic data has reinforced the cautious market sentiment.

- The Fed's recent slowdown in quantitative tightening, from $60 billion to $25 billion a month, might also be contributing to the decline in bond yields. This shift in policy suggests a less aggressive approach to draining liquidity from the financial system, potentially making long-duration assets more attractive to investors. While the two-year quantitative tightening program nears its final phase, the Fed plans to use the reduced pace of balance sheet reduction to ensure a smooth transition from abundant liquidity to ample liquidity. Phasing out this program will likely ease pressure on bond yields and provide support for stocks.

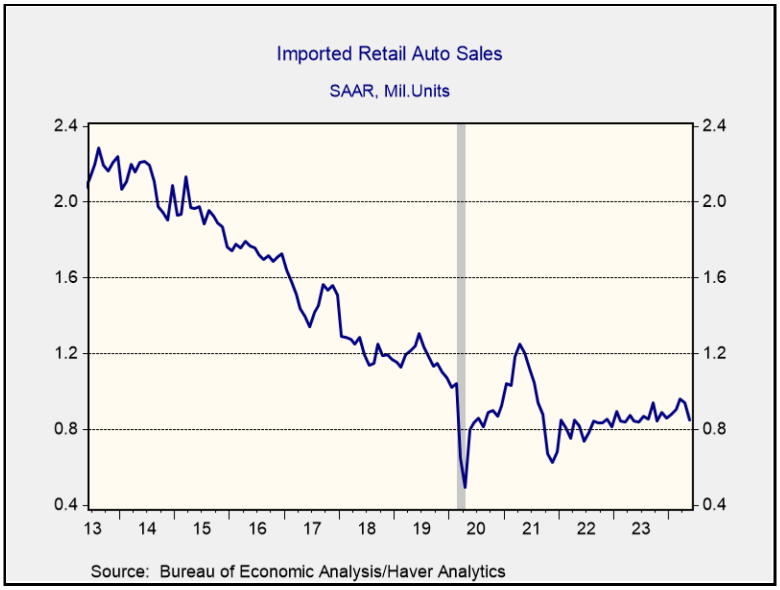


- However, further declines in Treasury yields are unlikely in the short term without clear signs of inflation subsiding. The Fed's May decision to accelerate balance sheet reduction reflects its confidence in remaining patient as inflation pressures ease. Notably, the core PCE price index, the Fed's preferred inflation measure, has shown a slower pace of increase in the first four months of this year compared to 2022 and 2023. For sustained confidence in inflation's retreat, the index should continue this trend and align with pre-pandemic levels over the next three months.

The West's EV Problem: Tensions escalate in the West-China trade dispute as Canada joins the fray.

- Canada is considering raising tariffs on electric vehicles (EVs) imported from China. This move aligns with similar actions taken by its allies such as the United States and the European Union. The concern is that China's rapid growth in EV production could harm domestic auto industries. Earlier in 2024, the US significantly increased tariffs on Chinese EVs to 102.5%, while the EU implemented tariffs as high as 38% on specific vehicles. Canada, with its current 6% tariff, is exploring raising it to match the approach of its partners. However, a final decision on Canadian tariffs remains pending.

- The proposed tariff increase on Chinese electric vehicles comes as the Western green industry faces challenges. Weak domestic demand is hindering growth, as evidenced by EV startup Fisker's recent bankruptcy after halting production. At the same, Tesla's stock price also reflects these difficulties, dropping nearly 27% this year following its announcement of a tough industry outlook. Europe shares these struggles, with a particularly sharp decline in Germany. Last month, EV sales in the Continent's largest economy plunged by 30%, while the broader European market saw a 12.5% drop.

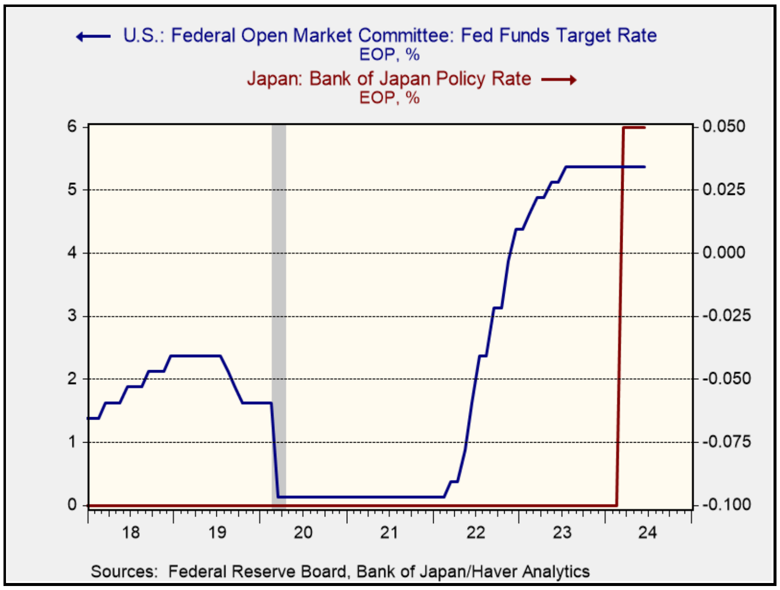


- The fight for leadership in green technology shows no signs of slowing down, even though Western nations face challenges in attracting consumers to some eco-friendly products. Affordability appears to be the biggest hurdle, with electric vehicles remaining out of reach for many households and governments becoming more selective when offering subsidies. Tariffs on Chinese EVs might not be the silver bullet. While they could limit Western sales, they might also boost demand in emerging markets. In the meantime, Western governments may need to acknowledge that consumers are not yet fully prepared to abandon their gas-powered vehicles.

Higher-for-Longer and Banks: Banks in the US and abroad are facing headwinds as they struggle to attract deposits and protect their balance sheets, but there are no signs of a crisis.

- Japan's regional banks are facing increased scrutiny as interest rates rise. Moody's rating agency warned last month that higher rates could lead to capital flight, potentially harming these banks. Similarly, S&P Global expressed concerns earlier this month that rising rates could pressure the capital ratios of regional banks, especially those with high buffers. This isn't a solely Japanese issue. US banks are also under the microscope. Moody's recently placed several American banks on watch for downgrades due to their exposure to the potentially risky commercial real estate market.

- The threat to bank profitability appears likely to persist as long as interest rates remain high. This current rate cycle has negatively impacted bank balance sheets, putting pressure on some major institutions. For example, Norinchukin Bank, a Japanese agricultural lender, announced it would unload $63 billion in low-yielding US and European government bonds. This move aims to stem losses following an unsuccessful gamble on falling interest rates. In contrast, US banks have been increasing their holdings of short-term, floating-rate collateralized mortgage obligations (CMO) backed by Ginnie Mae. This strategy aims to protect themselves from potential deposit flight if interest rates continue to rise, but exposes the banks if rates fall significantly as it could lead to a wave of refinancing.



- While rising interest rates pose challenges for the financial system, there aren't immediate signs of a crisis. This can be maintained if central banks prioritize clear and open communication about their interest rate expectations. Additionally, banks must avoid excessive risk by not over-committing to specific forecasts on Federal Reserve decisions. The pandemic highlighted the dangers of banks relying too heavily on, or outright contradicting, Fed guidance. This approach may be viable in a stable environment, but it becomes riskier during periods of high inflation volatility and geopolitical uncertainty.

In Other News: Purchasing Managers Index (PMI) surveys suggest European economies are not as robust as previously thought. This could fuel expectations of further rate cuts from the ECB. US car companies face challenges from cyberattacks, highlighting the need for further investment in cybersecurity. The Philippines' undisclosed reinforcement of a ship in the South China Sea could lead to heightened tensions with China.

US Economic Releases

No major US economic reports have been released so far today. The table below lists the economic releases and/or Fed events scheduled for the rest of the day.

Economic Releases						
EST	Indicator			Expected	Prior	Rating
9:45	S&P Global US Manufacturing PMI	m/m	Jun P	51.2	51.3	***
9:45	S&P Global US Composite PMI	m/m	Jun P	53.8	54.8	***
9:45	S&P Global US Services PMI	m/m	Jun P	--	54.5	***
10:00	Leading Economic Indicators	m/m	May	-0.3%	-0.6%	***
10:00	Existing Home Sales	m/m	May	4.05m	4.14m	**
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	National CPI	y/y	Mar	2.8%	2.5%	2.9%	***	Equity and bond neutral
	National CPI Ex-Fresh Food	y/y	Mar	2.5%	2.2%	2.6%	**	Equity and bond neutral
	National CPI Ex-Fresh Food & Energy	y/y	Mar	2.1%	2.4%	2.2%	*	Equity and bond neutral
	Jibun bank Composite PMI	m/m	Apr P	50.0	52.6		*	Equity and bond neutral
	Jibun Bank Manufacturing PMI	m/m	Apr P	50.1	50.4		***	Equity and bond neutral
	Jibun Bank Services PMI	m/m	Apr P	49.8	53.8		**	Equity and bond neutral
South Korea	PPI	y/y	May	2.9%	1.9%		**	Equity and bond neutral
India	HSBC India PMI Mfg	m/m	Jun P	58.5	57.5		***	Equity and bond neutral
	HSBC India PMI Composite	m/m	Jun P	60.9	60.5		**	Equity and bond neutral
	HSBC India PMI Services	m/m	Jun P	60.4	60.2		**	Equity and bond neutral
EUROPE								
Eurozone	HCOB Eurozone Manufacturing PMI	m/m	Jun P	45.6	47.3	47.9	***	Equity bearish, bond bullish
	HCOB Eurozone Services PMI	m/m	Jun P	52.6	53.2	53.4	**	Equity bearish, bond bullish
	HCOB Eurozone Composite PMI	m/m	Jun P	50.8	52.2	52.5	*	Equity bearish, bond bullish
	Consumer Confidence	m/m	Jun P	-14.0	-14.3	-13.8	**	Equity and bond neutral
Germany	HCOB Germany Manufacturing PMI	m/m	Jun P	43.4	45.4	46.4	***	Equity bearish, bond bullish
	HCOB Germany Services PMI	m/m	Jun P	53.5	54.2	54.4	**	Equity bearish, bond bullish
	HCOB Germany Composite PMI	m/m	Jun P	50.6	52.4	52.7	**	Equity bearish, bond bullish
France	Business Confidence	m/m	Jun	99	99	99	**	Equity and bond neutral
	Manufacturing Confidence	m/m	Jun	99	99	99	*	Equity and bond neutral
	HCOB France Manufacturing PMI	m/m	Jun P	45.3	46.4	46.8	***	Equity and bond neutral
	HCOB France Services PMI	m/m	Jun P	48.8	49.3	49.9	**	Equity and bond neutral
	HCOB France Composite PMI	m/m	Jun P	48.2	48.9	49.4	**	Equity bearish, bond bullish
UK	Retail Sales	y/y	May	1.3%	-2.7%	-0.6%	***	Equity bullish, bond bearish
	Retail Sales Ex-Auto Fuel	y/y	May	1.2%	-3.0%	-0.7%	**	Equity and bond neutral
	Public Finances (PSNCR)	m/m	May	18.1b	-5.2b		*	Equity and bond neutral
	Public Sector Net Borrowing	m/m	May	14.1b	17.5b	14.5b	*	Equity and bond neutral
	PSNB ex Banking Groups	m/m	May	15.0 b	18.4b	15.5b	**	Equity and bond neutral
	GfK Consumer Confidence	m/m	Jun	-14	-17	-16	***	Equity bullish, bond bearish
	S&P Global UK Manufacturing PMI	m/m	Jun P	51.4	51.2	51.1	***	Equity and bond neutral
	S&P Global UK Services PMI	m/m	Jun P	51.2	52.9	53.0	**	Equity bearish, bond bullish
	S&P Global UK Composite PMI	m/m	Jun P	51.7	53.0	53.2	**	Equity bearish, bond bullish
Switzerland	M3 Money Supply	y/y	May	-0.6%	-1.1%	-0.9%	**	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	14-Jun	$596.2b	$602.4b		***	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	14-Jun	18.29t%	18.24t		*	Equity and bond neutral
AMERICAS								
Mexico	Economic Activity IGAE	y/y	Apr	5.4%	-1.3%	3.5%	**	Equity bullish, bond bearish

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)	522	523	-1	Up
U.S. Sibor/OIS spread (bps)	534	535	-1	Up
U.S. Libor/OIS spread (bps)	534	534	0	Up
10-yr T-note (%)	4.23	4.26	-0.03	Up
Euribor/OIS spread (bps)	370	371	-1	Down
Currencies	Direction			
Dollar	Up			Up
Euro	Down			Down
Yen	Flat			Down
Pound	Flat			Down
Franc	Down			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	$85.60	$85.71	-0.13%	
WTI	$81.19	$81.29	-0.12%	
Natural Gas	$2.70	$2.74	-1.53%	
12-mo strip crack	$22.42	$22.13	1.32%	
Ethanol rack	$2.10	$2.11	-0.28%	
Metals				
Gold	$2,367.15	$2,360.09	0.30%	
Silver	$30.56	$30.74	-0.60%	
Copper contract	$444.90	$452.30	-1.64%	
Grains				
Corn contract	$459.00	$456.75	0.49%	
Wheat contract	$590.75	$586.00	0.81%	
Soybeans contract	$1,120.25	$1,116.75	0.31%	
Shipping				
Baltic Dry Freight	1,984	1,943	41	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.55	-2.60	0.05	
Gasoline (mb)	-2.28	1.10	-3.38	
Distillates (mb)	-1.73	1.00	-2.73	
Refinery run rates (%)	-1.5%	0.0%	-1.5%	
Natural gas (bcf)		69		

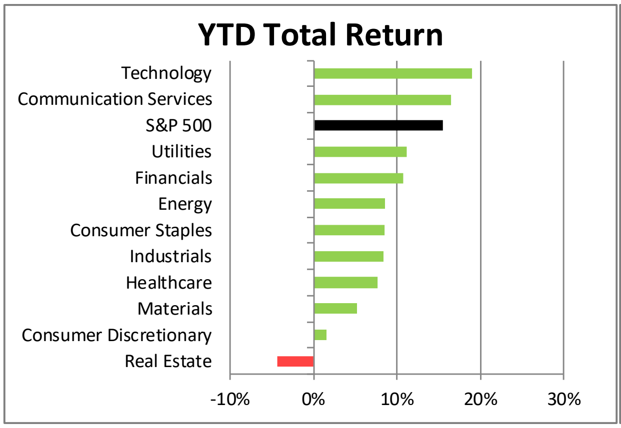
Weather

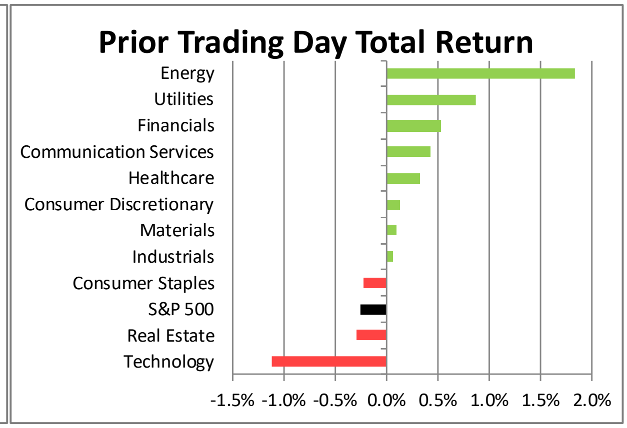
The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures throughout the entire country except for the Pacific Northwest and the Northern Tier states. The forecasts call for cooler-than-normal temperatures in the Pacific Northwest. The forecasts are also calling for wetter-than-average conditions in the Rocky Mountains, the Great Plains, and the Midwest, with dry conditions in California and Nevada.

There are currently two tropical disturbances in the Atlantic. One, located over the Yucatan Peninsula, is moving northwesterly and is assessed to have a 40% chance of turning into a cyclone. The other, off the coasts of Florida and Georgia, is moving northwesterly and is assessed to have a 50% chance of turning into a cyclone.

Data Section

US Equity Markets – (as of 6/20/2024 close)

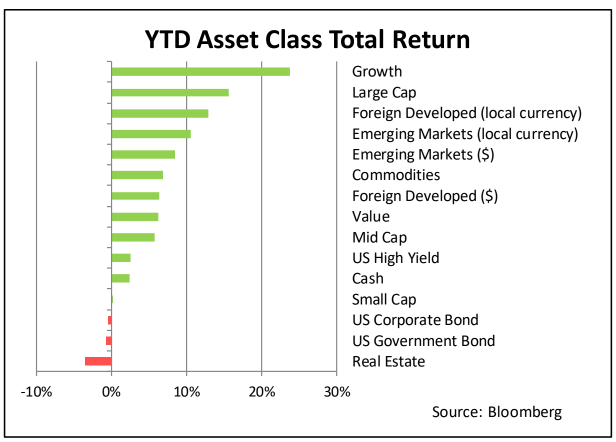




(Source: Bloomberg)

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 6/20/2024 close)

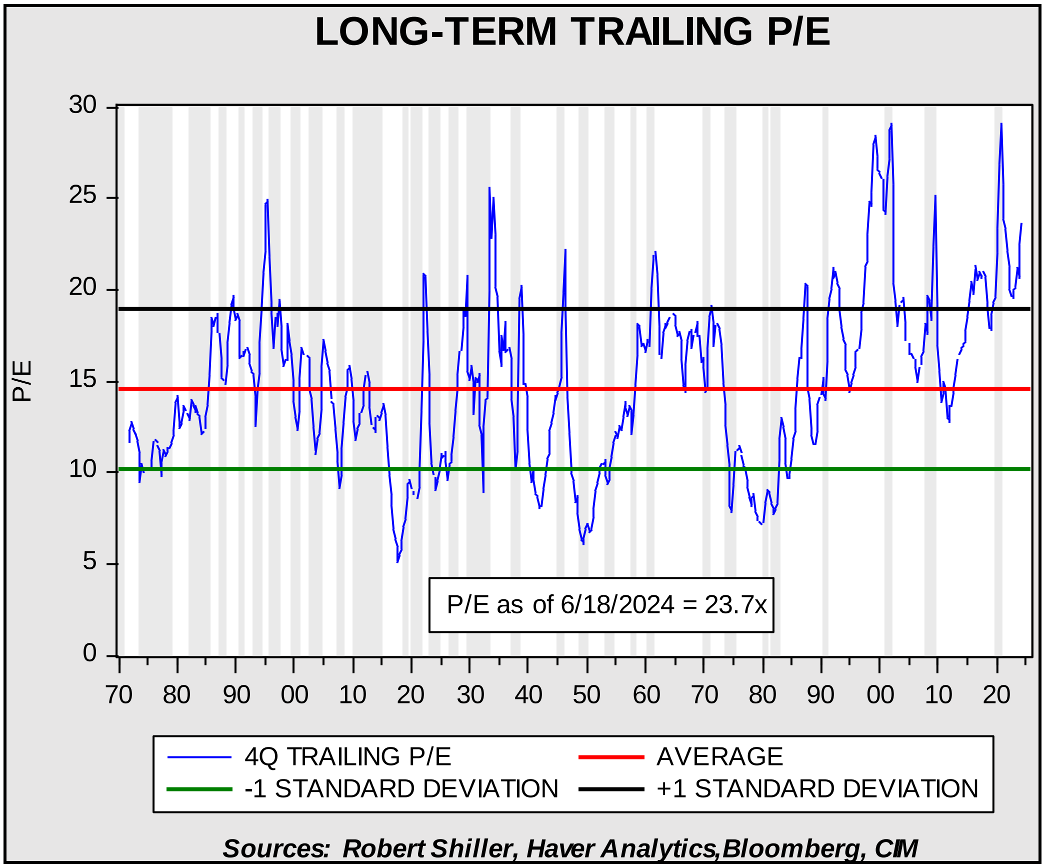


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 20, 2024



Based on our methodology,[1] the current P/E is 23.7x, 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.