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 26, 2024—9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is down 0.4% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.6%. Chinese markets were higher, with the Shanghai Composite up 0.8% from its previous close and the Shenzhen Composite up 2.0%. US equity index futures are signaling a lower open.

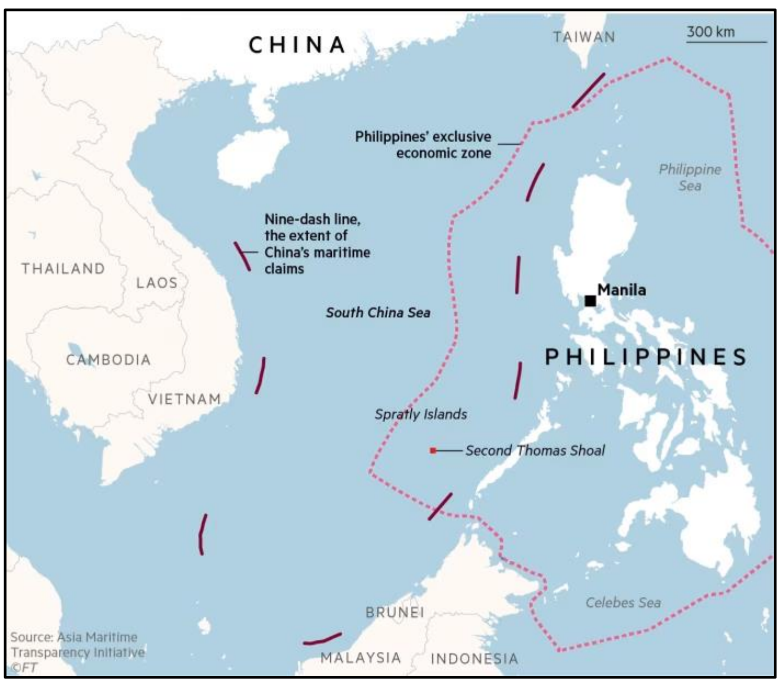
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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* (6/24/2024) (with associated podcast): "Small Caps and the Hope for a Soft Landing"
- *Confluence of Ideas podcast* (5/8/2024) "Reviewing the Asset Allocation Rebalance: Q2 2024"

Our *Comment* today opens with the latest on the simmering China-Philippines tensions in the South China Sea. We next review several other international and US developments with the potential to affect the financial markets today, including a new down-leg in the value of the Japanese yen, a bad inflation report in Australia, and, on a more positive note, signs of continued strong demand for junk-rated debt in the US.

China-Philippines: In an interview with the *Financial Times*, the Philippine Ambassador to the US warned that the China-Philippines dispute over the South China Sea's Second Thomas Shoal has now reached an incendiary phase in which it could suddenly expand into a major conflict, much as the assassination of Austrian Archduke Franz Ferdinand sparked World War I. However, according to Ambassador Jose Manuel Romualdez, this conflict would be more dangerous because it could draw in countries with nuclear weapons.

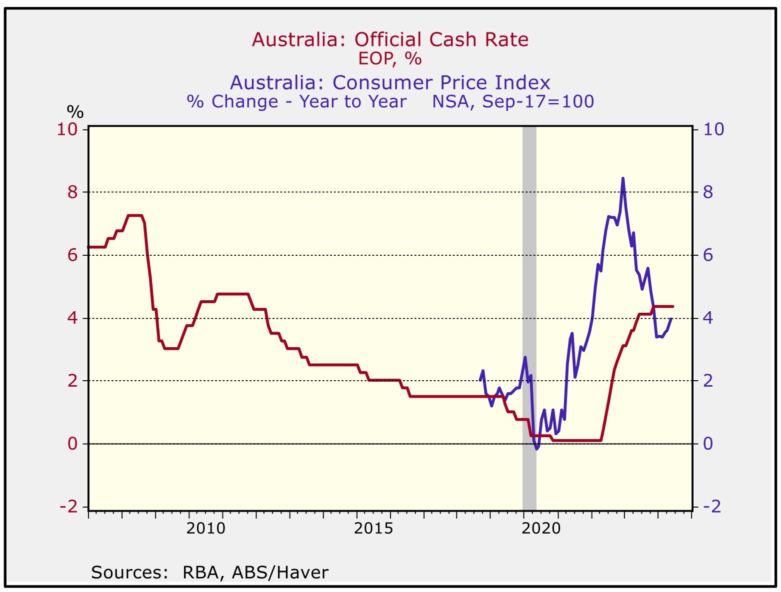
- As a reminder, our new *Mid-Year Geopolitical Outlook* identifies the China-Philippines territorial dispute in the South China Sea as the world's most dangerous geopolitical risk in the second half of 2024.
- While Beijing has deployed its coast guard and marine militia to quarantine a Philippine military outpost on the Second Thomas Shoal, using aggressive tactics to thwart resupply missions, Manila has also used provocative tactics to fight back, including by cutting Chinese fishing nets in the area and secretly delivering construction materials to shore up the outpost.
- What isn't clear is the extent to which Washington and Manila are coordinating. One concern we have is that Philippine President Ferdinand Marcos, Jr., may be trying to force the US into backing his country's sovereignty claim more forcefully.
- Since the US and the Philippines have a mutual defense treaty, which the Biden administration has repeatedly pledged to honor, Marcos may be trying to goad China into a violent action that would force the US military to make a show of force in the area. Ambassador Romualdez's interview may also be aimed at prompting the US into action. Of course, the risk is that bringing US and Chinese military forces into closer proximity in the area could push them into conflict, even if accidentally.
- With our extraordinary focus on geopolitical risks here at Confluence, we are actively considering how we can adjust our investment strategies to hedge against such risks or take advantage of any resulting opportunities.



China-United States: In a new sign that the US is military is preparing for a potential conflict with China, the Marine Corps earlier this month recertified the airstrip on the Western Pacific island of Peleliu. In a major battle during World War II, the US sent 50,000 Marines and Army soldiers to pry the island and its airstrip from 10,000 Japanese defenders, resulting in tens of thousands of casualties. As discussed in our new *Mid-Year Geopolitical Outlook*, the US is now strengthening its presence across the Indo-Pacific region in an attempt to deter further Chinese aggression.

Japan: The value of the yen (JPY) today fell to 160.36 per dollar ($0.0062), reaching its weakest level since 1986. The currency has now lost some 12.2% of its value so far this year, as investors continue to be disappointed by the Bank of Japan's slow pace of interest-rate hikes while the Federal Reserve and other major central banks keep their rates high. The new yen weakness will likely raise expectations that the Japanese government will again intervene in the currency markets to slow the currency's slide.

Australia: The May consumer price index was up 4.0% from the same month one year earlier, well above both the expected increase of 3.8% and the April rise of 3.6%. A measure of core inflation rose to 4.4%. Coming just one week before a cut in income taxes and government payments to individuals to help offset the rise in the cost of living, the data has boosted expectations that the Reserve Bank of Australia will be forced to hike interest rates again. In turn, that prospect is weighing heavily on Australian stock and bond prices so far today.

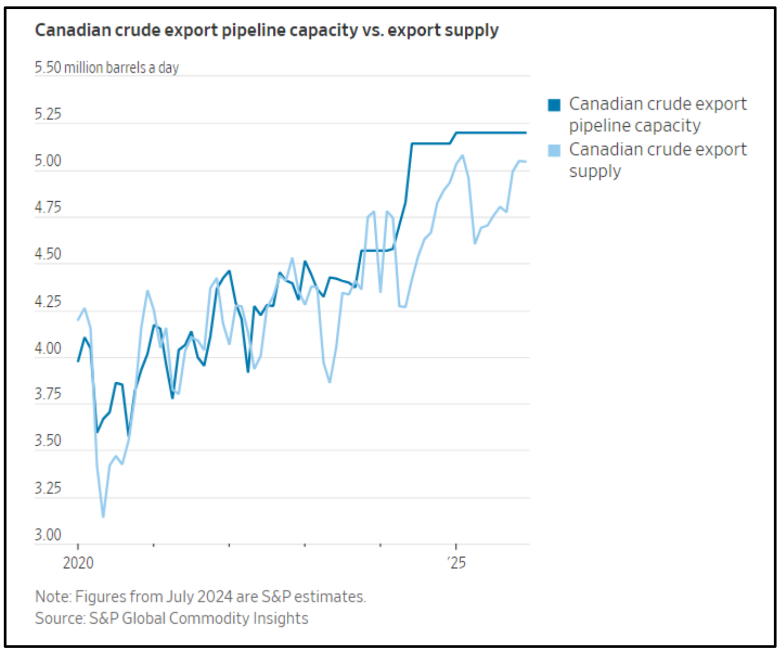


North Atlantic Treaty Organization: In other security news, NATO's member states today officially approved outgoing Dutch Prime Minister Mark Rutte as the alliance's next secretary general. Rutte is seen as a strong trans-Atlanticist who can manage NATO relations with both the US and Russia. However, he has been criticized for the Netherlands' failure to reach the NATO target of spending at least 2% of gross domestic product on defense throughout his time as prime minister. Rutte will take over the leadership of NATO on October 1.

Eurozone: The European Commission and European Central Bank today jointly announced that Bulgaria and Romania have failed to meet the economic criteria to join the eurozone, as widely expected. The countries' key shortcomings included excessively high consumer price inflation and concerns that their institutions were too saddled with corruption and money laundering. The decision means that the eurozone will continue to encompass 20 countries; the last of which to join was Croatia at the beginning of 2023.

Kenya: The mass protests against the government's new tax hikes, which we described in yesterday's *Comment*, have now turned deadly, as police opened fire yesterday on protestors who had broken into parliament. According to local rights groups and activists, at least five protesters and first responders were killed and scores were injured in the incident. The violence threatens both the political and economic stability of a major African country.

Canada: The *Wall Street Journal* today carries an interesting article on Canadian oil sand companies and their recent outperformance. After years in which the firms were held back by high costs and limited export-pipeline capacity, they have now largely completed their expensive facility build-outs and are discovering improved operating practices to cut production costs. The May 1 opening of a new export pipeline to Canada's west coast has also removed export bottlenecks. The resulting higher profits have pushed the firms' stock prices sharply upward.



US Financial Conditions: New research from Goldman Sachs shows firms with low credit ratings have repriced some $391 billion in leveraged loans into lower-interest debt so far this year, a new record for the period. According to Goldman, the benefit from the repricing has been equivalent to a 0.50% cut in the Federal Reserve's benchmark fed funds rate.

- The ability of the firms to roll their debt over into lower-interest loans stems from high investor demand for investment products that package the loans into securities.
- As illustrated by the rollover activity, burgeoning private credit funds, and the current low spreads for junk bond funds, high investor demand for yield is probably one reason

today’s high interest rates haven’t sparked a broad financial crisis or thrown the economy into recession.

US Economic Releases

Homebuyers are dipping their toes back into the market as mortgage rates cool. Mortgage applications increased for the third week in a row, according to the Mortgage Bankers Association (MBA). Applications rose 0.8% for the week ending June 21. This uptick coincides with a drop in mortgage rates to 6.93%, marking a significant decrease of 36 basis points from the 2024 peak in April. The MBA's purchase index, reflecting applications for new home purchases, rose 1.2% compared to the previous week, while the refinance index dipped slightly by 0.1%.

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	New Home Sales	m/m	May	633k	634k	***
10:00	New Home Sales MoM	m/m	May	-0.2%	-4.7%	**
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								
Australia	Westpac Leading Index	m/m	May	-0.10%	-0.03%		**	Equity and bond neutral
	CPI	y/y	May	4.0%	3.6%	3.8%	**	Equity and bond neutral
EUROPE								
Germany	GfK Consumer Confidence	m/m	Jul	-21.8	-21.0	-19.5	**	Equity and bond neutral
France	Consumer Confidence	m/m	Jun	89.0	90.0	89.0	***	Equity and bond neutral
AMERICAS								
Canada	CPI	y/y	May	2.9%	2.7%	2.6%	***	Equity and bond neutral
Mexico	International Reserves Weekly	w/w	21-Jun	$220045m	$219729m		*	Equity and bond neutral
Brazil	Total Outstanding Loans	m/m	May	5955b	5921b		**	Equity and bond neutral
	IBGE Inflation IPCA-15	m/m	May	4.06%	3.70%	4.11%	***	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)	560	561	-1	Up
3-mo T-bill yield (bps)	523	521	2	Up
U.S. Sibor/OIS spread (bps)	533	534	-1	Up
U.S. Libor/OIS spread (bps)	533	533	0	Up
10-yr T-note (%)	4.28	4.25	0.03	Up
Euribor/OIS spread (bps)	370	368	2	Down
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Down
Yen	Down			Down
Pound	Down			Flat
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	$85.46	$85.01	0.53%	
WTI	$81.36	$80.83	0.66%	
Natural Gas	$2.69	$2.76	-2.50%	
12-mo strip crack	$22.43	$22.35	0.33%	
Ethanol rack	$2.23	$2.20	1.21%	
Metals				
Gold	$2,305.06	$2,319.62	-0.63%	
Silver	$28.85	$28.91	-0.20%	
Copper contract	$436.85	$437.10	-0.06%	
Grains				
Corn contract	$444.25	$443.00	0.28%	
Wheat contract	$562.75	$560.50	0.40%	
Soybeans contract	$1,114.75	$1,111.50	0.29%	
Shipping				
Baltic Dry Freight	1,926	1,973	-47	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.82		
Gasoline (mb)		-1.50		
Distillates (mb)		-1.05		
Refinery run rates (%)		-0.2%		
Natural gas (bcf)		55		

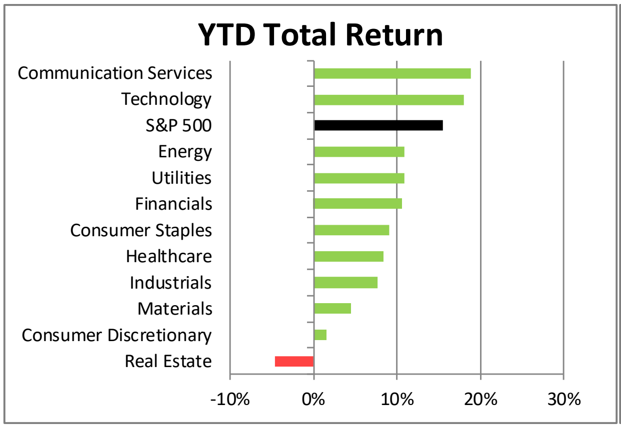
Weather

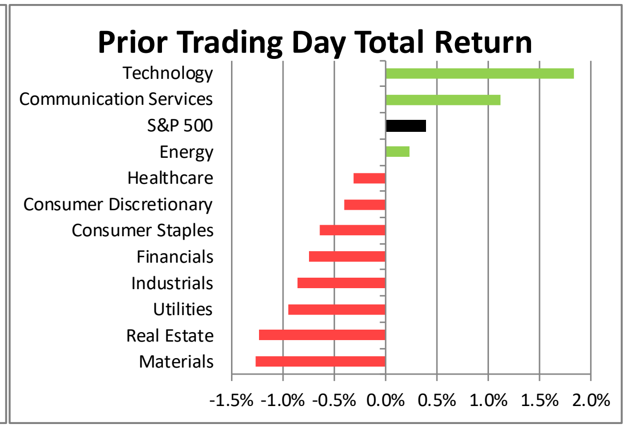
The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures throughout almost the entire country with cooler temps only in the Northern tier states. Meanwhile, the precipitation outlook projects wetter-than-normal conditions for most of the country with dry conditions expected in Northern Pacific and Southeast regions.

There are two signs of cyclone formation in the Atlantic, one in the Caribbean Sea and one near the Cabo Verde Islands. However, neither is expected to become a tropical storm within the next 48 hours.

Data Section

US Equity Markets – (as of 6/25/2024 close)

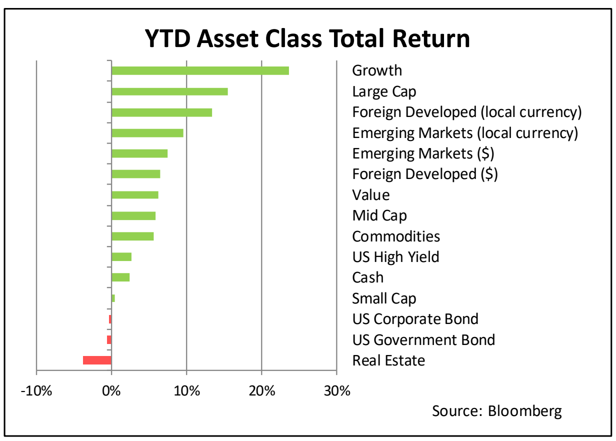




(Source: Bloomberg)

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 6/25/2024 close)

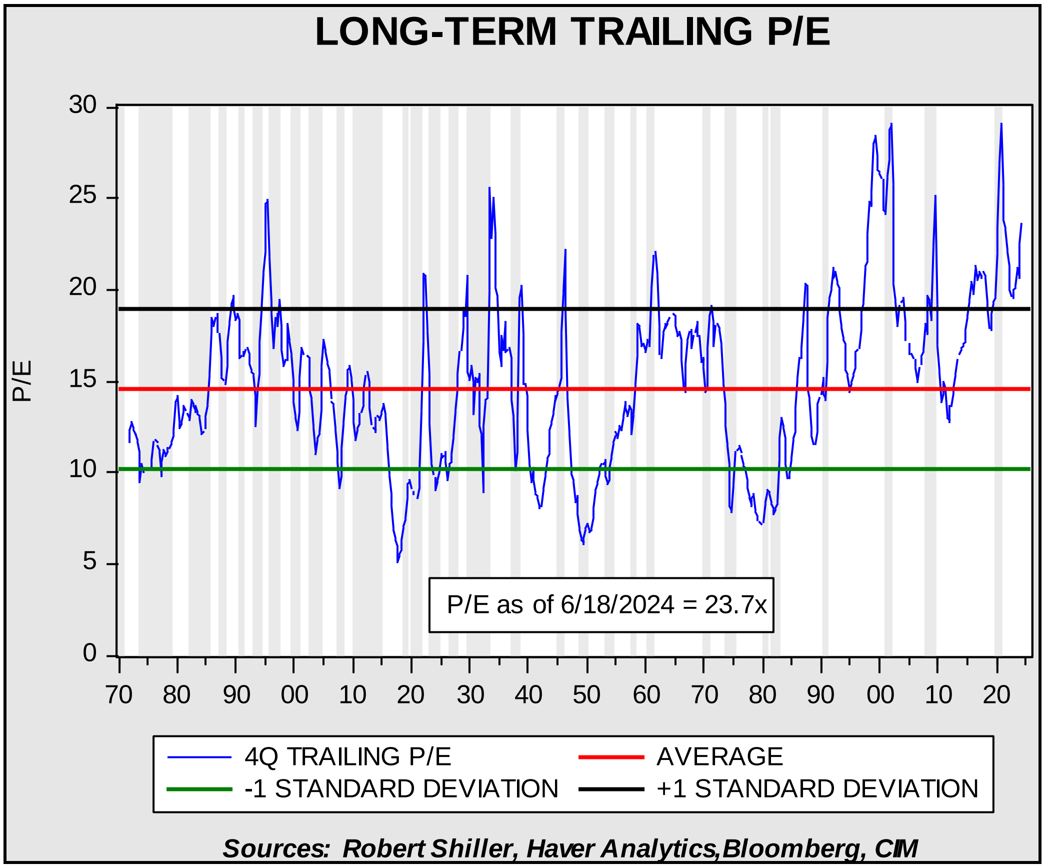


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.