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 28, 2024—9:30 AM ET] Global equity markets are generally higher this morning. In Europe, the Euro Stoxx 50 closed down 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.2%. Chinese markets were higher, with the Shanghai Composite up 0.7% from its previous close and the Shenzhen Composite up 0.3%. 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:

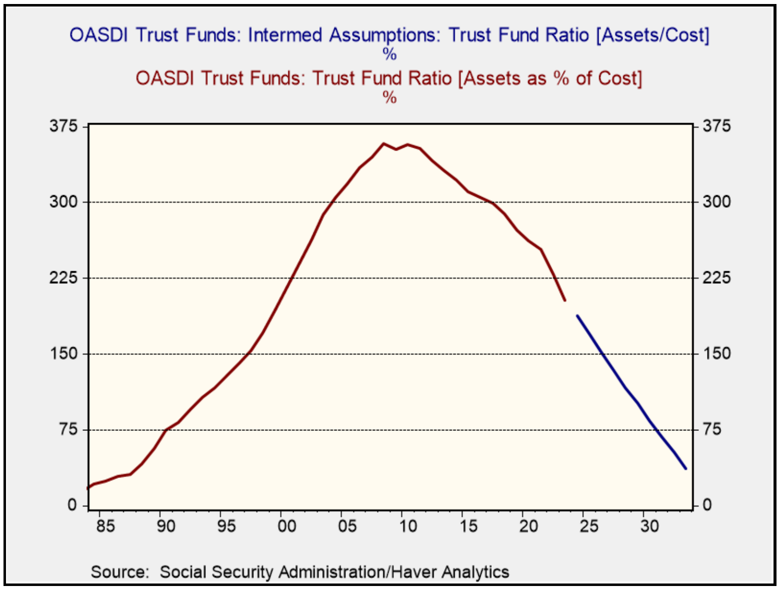
- *Bi-Weekly Geopolitical Report* (6/17/2024) (with associated podcast): "Mid-Year Geopolitical Outlook: Uncertainty Reigns"
- *Asset Allocation Quarterly – Q2 2024* (4/25/2024): Discussion of our asset allocation process, Q2 2024 portfolio changes, and our outlook for the markets.
- *Asset Allocation 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" *(Note: the next AABW report will be published 7/15/24)*
- *Confluence of Ideas podcast* (5/8/2024) "Reviewing the Asset Allocation Rebalance: Q2 2024"

Good morning! Equity futures are off to a strong start thanks to a modest inflation report. In sports news, the Los Angeles Lakers "shocked the world" by drafting NCAA standout and USC star shooting guard Bronny James in the second round. Today's *Comment* begins with a discussion about the first presidential debate, rising Treasury illiquidity, and the ongoing dispute between China and the Philippines. As usual, our report concludes with a roundup of domestic and international news.

First Presidential Debate: Although there was a clear victor in the debate, both candidates offered valuable insights into their visions for the next four years.

- Last night, both President Biden and former President Donald Trump presented their views on the state of the nation. Trump described the country as being in crisis due to rising immigration, elevated inflation, and increasing trade issues with China. In contrast, President Biden offered a more optimistic perspective, highlighting stronger job growth, progress in alleviating price pressures, and recent improvements in reducing border crossings. These contrasting viewpoints underscore how the two candidates will campaign in the coming months, each seeking to compare their records as president.

- Even though the national debt has become a pressing issue, neither candidate managed to clearly address how they plan to tackle it. While both mentioned raising revenue through tax increases, neither proposed significant spending cuts. President Trump focused on increasing tariffs, which raises the price that consumers pay for imported goods. On the other hand, President Biden advocated for raising taxes on high-income earners. Social Security benefits were a topic of discussion, but neither candidate presented a concrete plan to address the program's long-term solvency. According to the Social Security Administration, the program's assets that are available to pay benefits have been declining, while program costs are projected to rise.

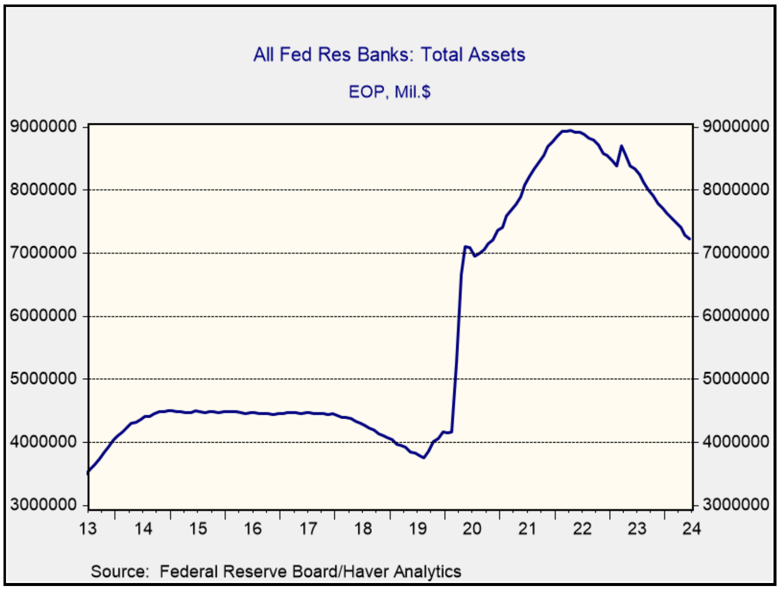


- While it's possible that neither candidate has a concrete plan yet, it's more likely they're focusing on popular policies without fully addressing the associated costs. The expiration of the 2017 tax cuts is likely to reignite debate on deficit reduction. We can expect differing approaches from the candidates. Trump will likely prioritize tax cuts and reduce spending, potentially targeting areas like climate change and social programs. Meanwhile, President Biden might advocate for letting the tax cuts expire to fund climate change initiatives.

Government Bond Liquidity: While the financial system appears stable, there are signs of financial stress bubbling beneath the surface.

- The Treasury market is flashing warning signs. Indicators like [JP Morgan's Liquidity Stress Dashboard and Bloomberg's US Government Securities Liquidity Index]() are signaling a drying up of liquidity, particularly for bonds maturing within six years. This comes despite a seemingly strong bond market, with yields on the 10-year Treasury dropping 30 basis points in the past month. However, the turbulence in the Treasury market underscores growing concerns that the economy may not be able to absorb the high level of future Treasury issuance. It also casts doubts on the Federal Reserve's ability to smoothly continue reducing its bond holdings.

- The decline in bond liquidity coincides with a shift in US debt ownership. As the Federal Reserve raises interest rates, foreign buyers, who are typically less concerned with price fluctuations (price insensitive), are reducing their purchases. This creates a gap that's being filled by domestic households, who are more sensitive to interest rates and bond prices. The lack of interest rate-insensitive buyers of US debt is important because it raises concerns about whether the government debt could be attractive at lower price yields, particularly as inflation remains elevated.

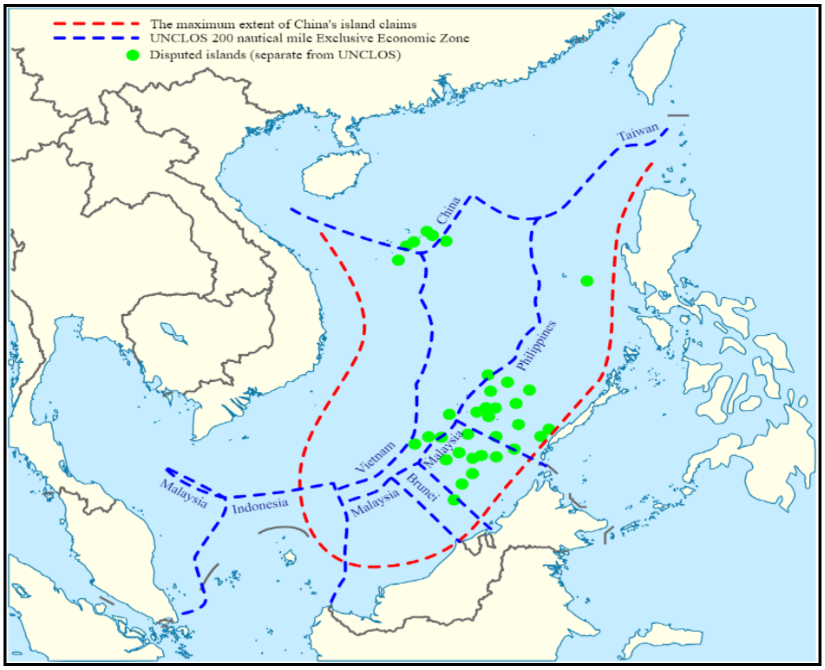


- Shifting demand for US government bonds could prompt the Fed to adjust its balance sheet normalization plans. In June, the Fed opted to slow the pace of quantitative tightening (QT), a move likely aimed at easing pressure on bond liquidity, while also allowing the Fed to continue with its drawdown. Fed officials aim to reduce bank reserves from "abundant" to a more "ample" level, though they acknowledge the exact sweet spot remains elusive. However, if these Treasury liquidity indicators are truly signaling limitations, the Fed could ultimately decide to end QT prematurely, which would likely boost bond prices.

China-Philippines: Tensions between China and the Philippines continue to escalate in a spat that may lead to US intervention.

- In response to a recent clash in the South China Sea between the Philippines and the Chinese Coast Guard, the US reaffirmed its commitment to Philippine security on Thursday. The clash, which involved the sinking of a Philippine vessel and the alleged theft of firearms, has been seen as a hostile act by China. Following the incident, the US and the Philippines are set to continue with their pre-planned joint maritime exercises in the disputed waters, and they may include other countries such as Japan and Australia.

- The tense situation between China and the Philippines in the South China Sea has unnerved neighboring countries. Vietnam, Malaysia, and Indonesia also have territorial disputes with China in the region, raising concerns of a wider conflict. Despite seeking a peaceful resolution, the Philippines plans to send another supply mission to the Sierra Madre as early as next week. While the Philippine government has insisted that it can assert its sovereignty over the contested seas without the help of a US escort, the White House is already discussing potential responses to further Chinese aggression.



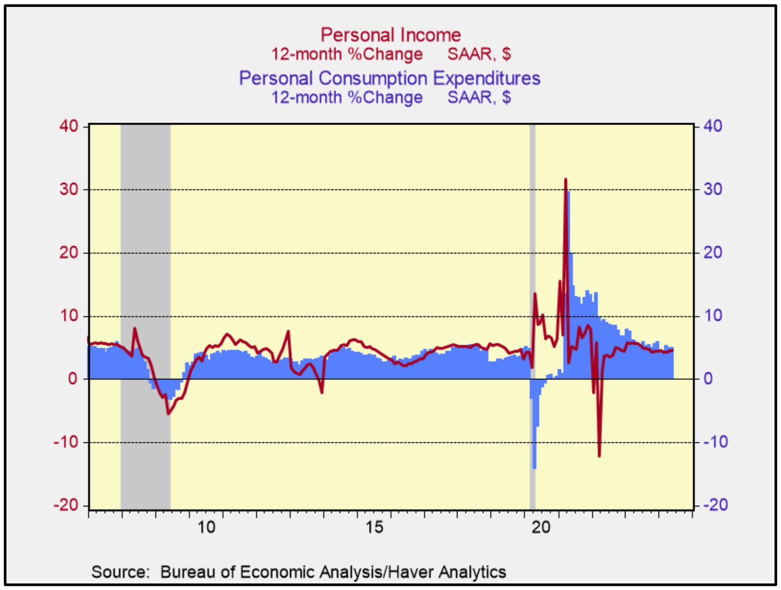
(Source: Wikipedia)

- The China-Philippines conflict in the South China Sea carries the risk of escalating into a black swan event. An attack on Philippine vessels by China could trigger the US-Philippines Mutual Defense Treaty, potentially leading to a direct military confrontation between the world's two largest economies. This event would likely lead to a dramatic shift away from risk assets as investors look for safety until the situation resolves. This should benefit risk-free assets such as US Treasurys but could also be a boon for gold.

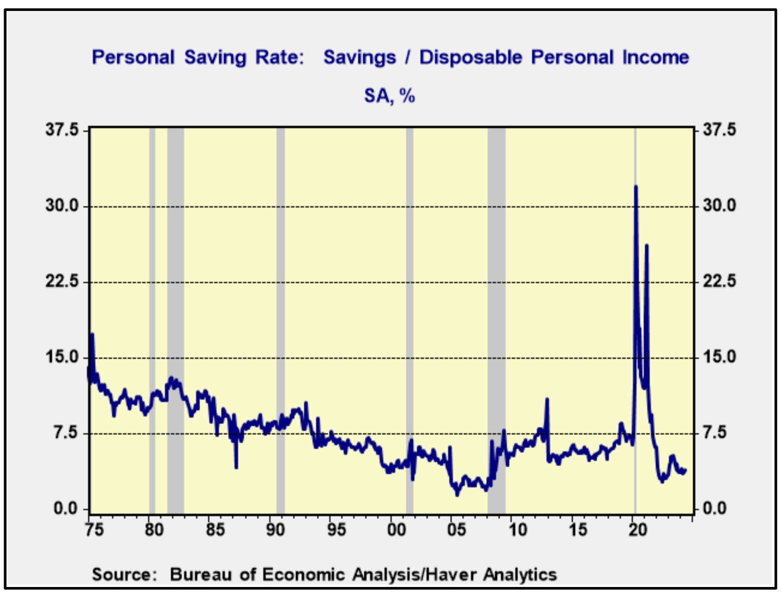
Other News: European Commission President Ursula von der Leyen was nominated for a second term, indicating that centrists still have significant influence in the European Union. French elections are set to take place next week, with polls showing that Macron’s party is likely to suffer a heavy defeat. Argentina’s President Javier Milei achieved a major victory after Congress passed his pro-business reforms, enabling the country to meet its fiscal targets.

US Economic Releases

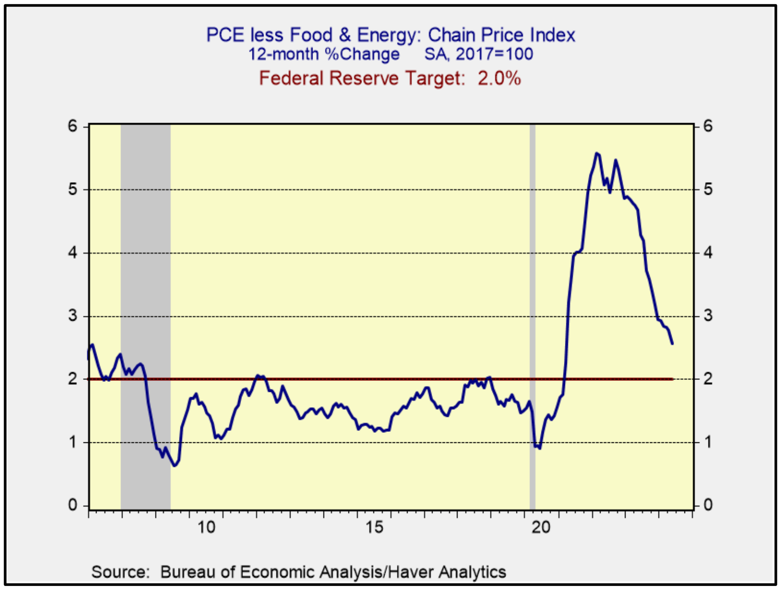
May ***personal income*** rose by a seasonally adjusted 0.5%, better than both the expected rise of 0.4% and the April increase of 0.3%. May ***personal consumption expenditures (PCE)*** rose just 0.2%, short of the anticipated increase of 0.3% but above the revised April increase of 0.1%. Personal income in May was up 4.6% from the same month one year earlier, while PCE was up 5.1%. The chart below shows the year-over-year change in personal income and PCE since just before the Great Financial Crisis.



The personal income and spending report also includes a measure of personal saving, defined as disposable (after tax) income less consumption spending on goods and services. The May ***personal savings rate*** rose to a seasonally adjusted 3.9%. The chart below shows how the personal savings rate has fluctuated since just before the GFC.



Finally, the income and spending report includes the Fed's preferred measure of consumer price inflation. After stripping out the volatile food and energy components, the ***Core PCE Deflator*** for May was up 2.6% from the same month one year earlier. That was exactly as expected, and it marked a modest slowdown from the 2.8% rise in the year to April. The chart below shows the year-over-year change in the Core PCE Deflator 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
9:45	MNI Chicago PMI	m/m	Jun	40.0	35.4	***
10:00	U. of Michigan Consumer Sentiment	m/m	Jun F	66.0	65.6	***
10:00	U. of Michigan Current Conditions	m/m	Jun F	64.0	62.5	**
10:00	U. of Michigan Future Expectations	m/m	Jun F	68.0	67.6	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Jun F	3.2%	3.3%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Jun F	3.1%	3.1%	*
Federal Reserve						
ET	Speaker or Event	District or Position				
12:00	Michelle Bowman Speaks in Moderated Q&A	Member of the Board of Governors				
12:40	Mary Daly Speaks on AI, Workforce	President of the Federal Reserve Bank of San Francisco				

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	Jobless Rate	m/m	May	2.6%	2.6%	2.6%	***	Equity and bond neutral
	Job-To-Applicant Ratio	m/m	May	1.24	1.26	1.26	***	Equity and bond neutral
	Tokyo CPI	y/y	Jun	2.3%	2.2%	2.3%	**	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food	y/y	Jun	2.1%	1.9%	2.0%	***	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food & Energy	y/y	Jun	1.8%	1.7%	1.7%	*	Equity and bond neutral
	Industrial Production	y/y	May P	0.3%	-1.8%	0.0%	***	Equity and bond neutral
	Housing Starts	y/y	May	-5.3%	13.9%	-6.1%	**	Equity bullish, bond bearish
	Annualized Housing Starts	y/y	May	0.813m	0.880m	0.805m	*	Equity and bond neutral
Australia	Private Sector Credit	y/y	May	5.2%	5.2%		**	Equity and bond neutral
South Korea	Industrial Production	y/y	May	3.5%	6.2%	3.1%	***	Equity and bond neutral
EUROPE								
Germany	Import Price Index	y/y	May	-0.4%	-1.7%	-0.3%	**	Equity and bond neutral
	Unemployment Change	m/m	Jun	19.0k	25.0k	15.0k	***	Equity and bond neutral
	Unemployment Claims Rate	m/m	Jun	6.0%	5.9%	5.9%	**	Equity and bond neutral
France	CPI, EU Harmonized	y/y	Jun P	2.5%	2.6%	2.5%	**	Equity and bond neutral
	CPI	y/y	Jun P	2.1%	2.3%	2.2%	***	Equity and bond neutral
	PPI	y/y	May	-6.7%	-6.8%		*	Equity and bond neutral
Italy	Consumer Confidence	m/m	Jun	--	96.4	97.0	***	Equity and bond neutral
	Manufacturing Confidence	m/m	Jun	--	88.4	88.6	***	Equity and bond neutral
	Economic Sentiment	m/m	Jun	--	95.1	--	**	Equity and bond neutral
	PPI	y/y	May	--	-8.1%	--	**	Equity and bond neutral
Italy	Industrial Sales WDA	y/y	Apr	-2.0%	-5.1%		*	Equity and bond neutral
	CPI, EU Harmonized	y/y	Jun P	0.9%	0.8%	0.9%	***	Equity and bond neutral
	CPI NIC Including Tobacco	y/y	Jun P	0.8%	0.8%	1.0%	**	Equity and bond neutral
UK	GDP	y/y	1Q F	0.3%	0.2%	0.2%	***	Equity and bond neutral
Switzerland	KOF Leading Indicator	m/m	Jun	102.7	102.2	101.0	**	Equity and bond neutral
Russia	Money Supply, Narrow Definition	w/w	21-Jun	18.25t%	18.29t%		*	Equity and bond neutral
	Gold and Forex Reserves	m/m	21-Jun	$593.1b	$596.2b		***	Equity and bond neutral
AMERICAS								
Brazil	Formal Job Creation	m/m	May	131811	239201	200000	**	Equity and bond neutral
	Primary Budget Balance	y/y	May	-63.9b	6.7b	-59.5b	*	Equity and bond neutral
	Net Debt % GDP	m/m	May	62.20%	61.50%	61.80%	**	Equity and bond neutral
	National Unemployment Rate	m/m	May	7.1%	7.3%	7.5%	*	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	560	0	Up
3-mo T-bill yield (bps)	522	523	-1	Up
U.S. Sibor/OIS spread (bps)	532	532	0	Up
U.S. Libor/OIS spread (bps)	532	533	-1	Up
10-yr T-note (%)	4.30	4.29	0.01	Up
Euribor/OIS spread (bps)	370	372	-2	Down
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Flat			Down
Yen	Flat			Down
Pound	Flat			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Mexico Overnight Rate	11.000%	11.000%	11.000%	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	$86.87	$86.39	0.56%	
WTI	$82.24	$81.74	0.61%	
Natural Gas	$2.74	$2.69	2.20%	
12-mo strip crack	$22.61	$22.61	-0.01%	
Ethanol rack	$2.19	$2.21	-1.13%	
Metals				
Gold	$2,334.22	$2,327.73	0.28%	
Silver	$29.32	$28.97	1.20%	
Copper contract	$440.55	$434.85	1.31%	
Grains				
Corn contract	$433.25	$433.75	-0.12%	
Wheat contract	$582.75	$579.50	0.56%	
Soybeans contract	$1,109.00	$1,104.75	0.38%	
Shipping				
Baltic Dry Freight	2,031	1,964	67	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	3.59	-2.82	6.41	
Gasoline (mb)	5.65	-1.50	7.15	
Distillates (mb)	-0.38	-1.05	0.67	
Refinery run rates (%)	-1.3%	-0.2%	-1.1%	
Natural gas (bcf)	52	54	-2	

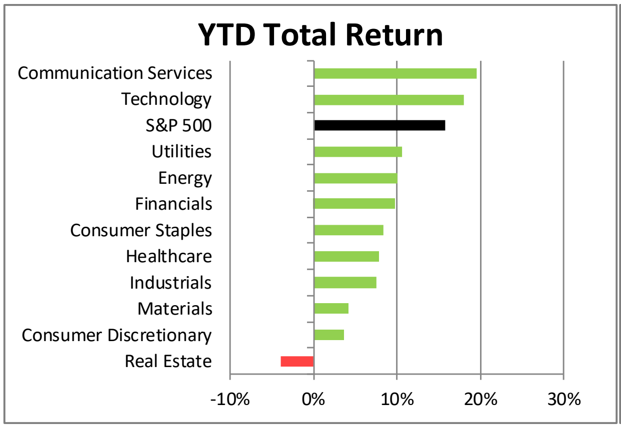
Weather

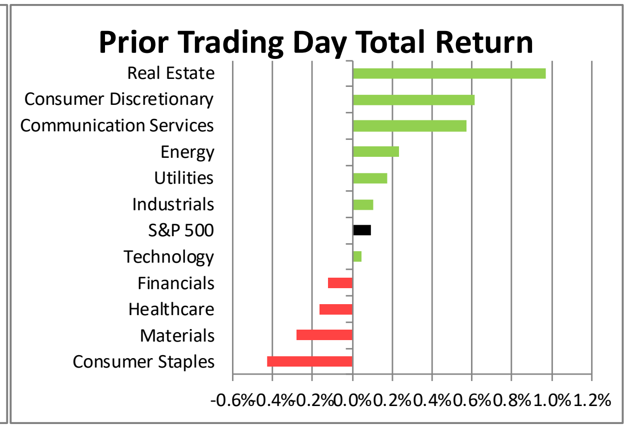
The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures throughout the entire southern half of the country, with cooler-than-normal temperatures only in North Dakota. The forecasts call for wetter-than-normal conditions in the southern Rocky Mountains, the central Great Plains, the Midwest, and the Northeast, with dry conditions in the Pacific Northwest and the southern Mississippi Valley region.

There are now three atmospheric disturbances in the Atlantic Ocean area. The first, off the east coast of the Yucatan Peninsula, is moving northwestward but is assessed to have only a 30% chance of forming a cyclone in the next 48 hours. The second, in the central Atlantic, is moving westward and is assessed to have a 90% chance of forming into a cyclone in next 48 hours. The third, off the western coast of Africa, is moving westward and is assessed to have no chance of turning into a cyclone in the next 48 hours.

Data Section

US Equity Markets – (as of 6/27/2024 close)

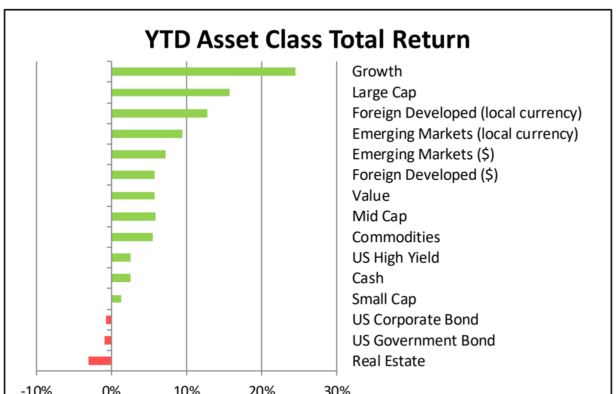




(Source: Bloomberg)

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 6/27/2024 close)



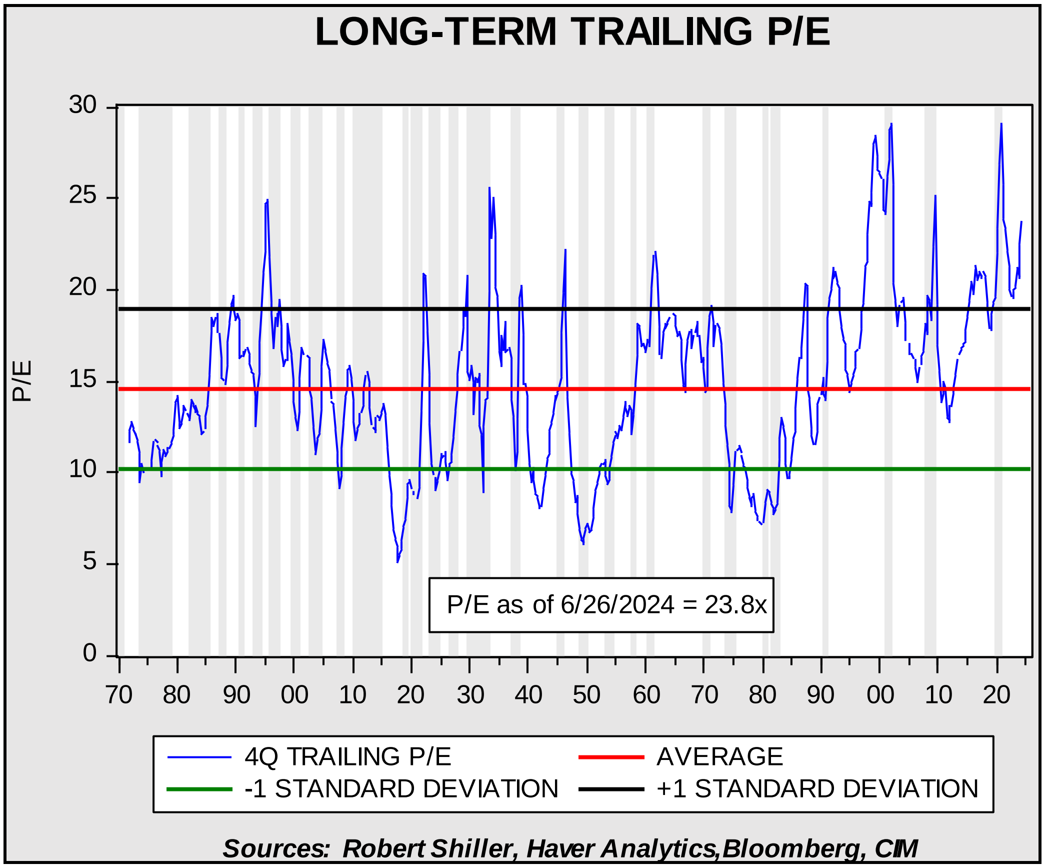
Source: Bloomberg

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.