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 6, 2024—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.8% 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 0.5% from its previous close and the Shenzhen Composite down 1.7%. 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:

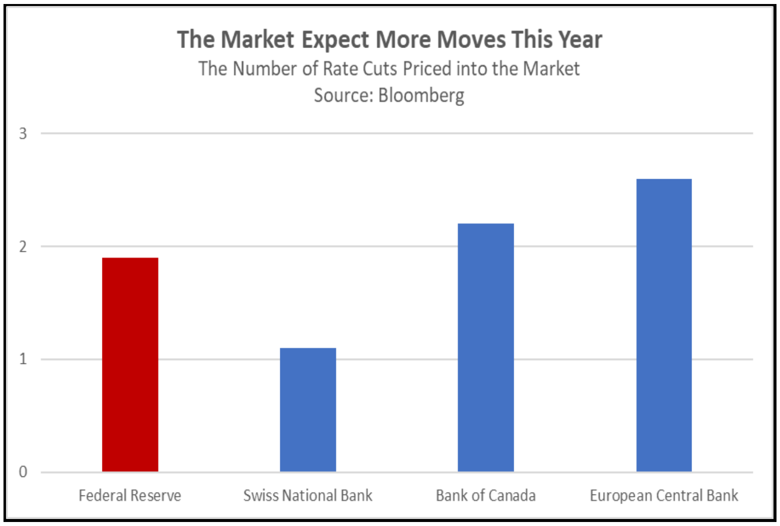
- *Bi-Weekly Geopolitical Report* (6/3/2024) (with associated podcast): "The Philippines, China & Escalation in the South China Sea"
- *Asset Allocation Quarterly – Q2 2024* (4/25/2024): Discussion of our asset allocation process, Q2 2024 portfolio changes, and our outlook for the markets.
- *Asset Allocation 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* (5/28/2024) (with associated podcast): "The Importance of the Federal Reserve's Inflation Target"
- *Confluence of Ideas podcast* (5/8/2024) "Reviewing the Asset Allocation Rebalance: Q2 2024"

Good morning! Equity futures are off to a modest start as investors eye Friday's jobs data. In sports news, the Lakers are looking at hiring UConn Coach Dan Hurley to take over the team. Today's *Comment* explains the potential reasons other central banks may be waiting on the Federal Reserve before making future rate decisions. We also explore whether Nvidia can sustain its current momentum and discuss the implications of the disappointing election results for Modi's new government. As always, our report will include a roundup of international and domestic data releases.

Rate Cuts in the West: Despite policy pivots by the European Central Bank (ECB) and Bank of Canada, the dollar's strength against major currencies may persist in the near term as other central banks await Fed action.

- The ECB became the latest central bank to cut interest rates, lowering them for the first time since 2019. This move aims to stimulate the eurozone economy, which has seen a series of quarters with subpar growth. The ECB's decision comes as annual inflation has dipped from a peak of nearly 6% in 2023 to under 3% a year later, suggesting a need to balance GDP growth and price stability. The ECB follows similar recent rate cuts by the Bank of Canada and the Swiss National Bank.

- Central banks are likely to tread carefully on further rate cuts despite the market's positive reaction. A wider gap between their policy rates and the Fed's rate could strengthen the dollar, making imports more expensive, especially for dollar-priced commodities. While there is optimism that the Fed might cut rates later this year, it's far from certain. Before their blackout period, several Fed officials emphasized the need for more data before easing monetary policy. Adding to the complexity, the euro area is also experiencing a rise in price and wage pressures.

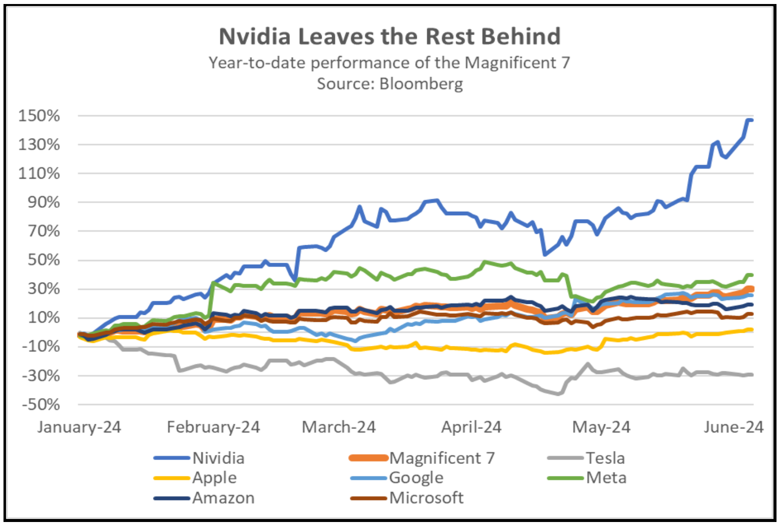


- Central bank flexibility hinges on the Fed's ability to deliver on its planned rate cuts this year. Next Wednesday's release of the Summary of Economic Projections will be a key indicator. Recent data weakness suggests a high likelihood of 1-2 cuts, aligning with market expectations. If the Fed delivers, other central banks are likely to follow suit with similar cuts to maintain parity, potentially easing pressure on the US dollar. However, a Fed decision to hold rates steady could see other banks stand pat, lending support to the dollar.

Nvidia Takes Over: The biggest mover of the Magnificent Seven is soaring, but its rapid rise could be masking a hidden weakness.

- So far in 2024, US chip designer Nvidia has surged to become the world's second-most valuable company, boasting a market valuation exceeding $3 trillion and surpassing Apple. This remarkable rise follows a period of strong demand for their graphics processing units (GPU), particularly after the company strategically pivoted to develop advanced artificial intelligence (AI) capabilities. While Nvidia faces competition from Intel and AMD, its dominance in AI is undeniable. The company holds a staggering 70% to 95% market share for AI accelerators, solidifying its position as a leader in this rapidly growing field. This strategic shift toward AI has fueled consistent, impressive earnings reports, making Nvidia a major driver of growth within the S&P 500.

- Despite its dominance in AI and high-performance computing, some analysts view Nvidia's valuation as riskier compared to the established Magnificent Seven tech giants. While the AI market holds immense potential, its relative youth raises questions about Nvidia's long-term sustainability if the AI boom falters. Unlike its more diversified peers, it's heavy reliance on AI could expose it to a significant correction if market demand cools. This lack of diversification is a familiar concern for companies reliant on a single hot trend. Tesla exemplifies this as their recent stock price decline has coincided with a slowdown in electric vehicle demand.

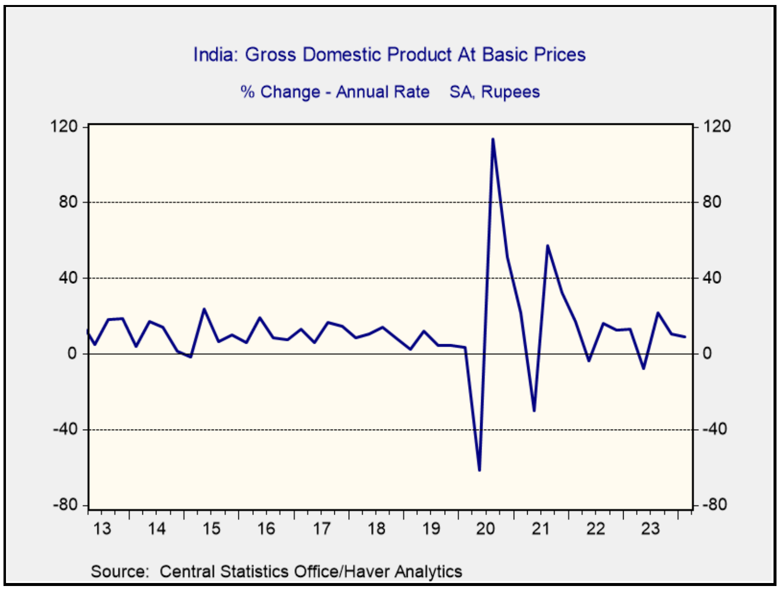


- Nvidia's momentum could be amplified by its upcoming stock split on June 7. The lower share price might attract more retail investors, potentially mirroring past trends. Historically, Bank of America research suggests companies outperform the market over the next year (25% vs. 12%) following a stock split. However, it's crucial to remember that past performance doesn't guarantee future results. Investors should consider both Nvidia's long-term prospects and its ability to meet current market expectations. Focusing on the company's valuation fundamentals alongside short-term momentum can be a wise approach for building a well-rounded portfolio.

The New India: Prime Minister Narendra Modi failed to attain a demanding victory in the election, calling into question his longer-term ambitions.

- Modi was formally named the Prime Minister of India for the third consecutive time on Wednesday despite his party's disappointing performance at the polls. The ruling [Bharatiya Janata Party (BJP) won 240 out of the 543 seats in parliament], falling short of a majority and [necessitating a coalition to maintain power]. This result signifies a weaker mandate for Modi. Throughout his tenure, Modi has been a strong advocate for Hindu nationalism and has sought to amend the country's secular constitution, a move that would require approval from two-thirds of the parliament.

- Modi’s hold on power, albeit with a reduced majority, has reassured investors by signaling continuity in market reforms. Throughout his tenure, Modi has set an ambitious agenda, aiming to propel India to developed nation status by 2047. In pursuit of this goal, his party has pushed pro-market reforms to enhance India's attractiveness to investors and boost its overall competitiveness. He's expected to leverage his new term to address labor and land regulations, which have faced significant resistance. Notably, farmer protests in 2022 forced the government to repeal three laws intended to deregulate the agricultural sector.

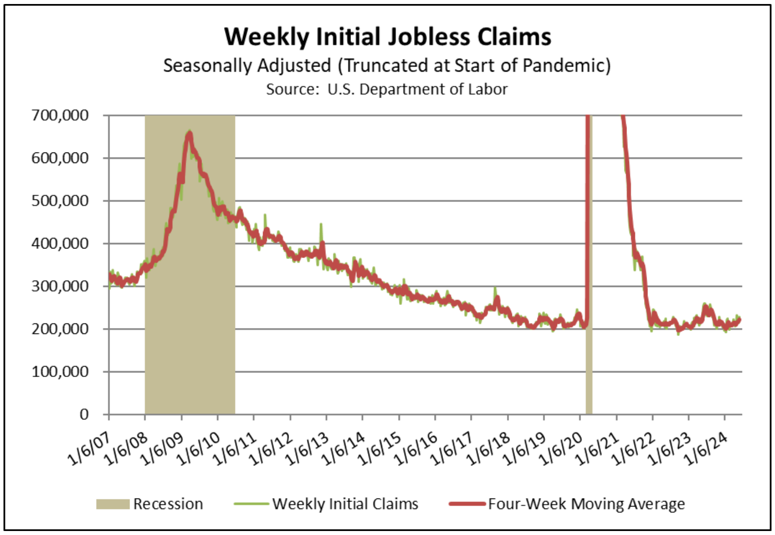


- One source of concern is that Modi, who is 73, is widely believed to be considering retirement in a couple of years. Although his party has downplayed this speculation, retiring at that age would be consistent with previous Indian leaders. His successor is widely expected to be his right-hand man, Amit Shah, whose views are highly nationalist. Given the likely negative impact Hindu nationalism had on the outcome of this election, the party could face significant challenges if Modi decides to step down. While optimism prevails due to recent reforms in India, we'll be closely monitoring any political developments.

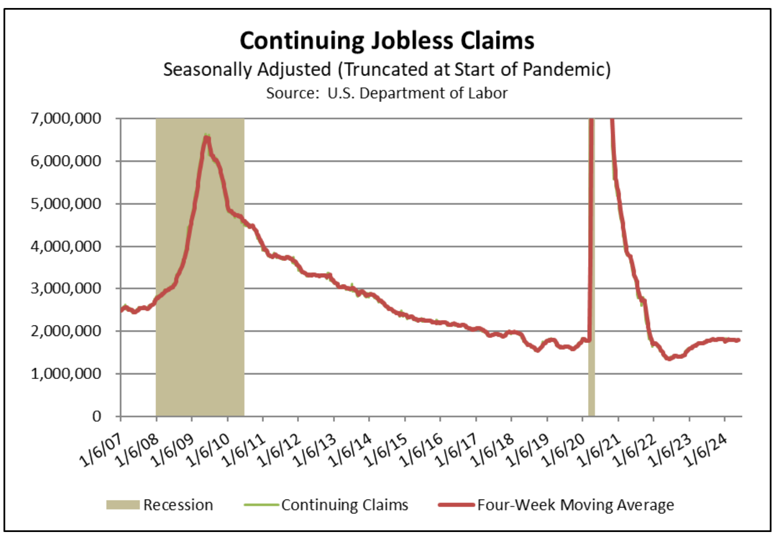
In Other News: The Federal Trade Commission has opened an investigation into the Microsoft AI deal, in another demonstration of the regulatory risks facing Big Tech. Boeing Starliner reached orbit in a sign that the company is looking to take on Musk’s SpaceX in the space race.

US Economic Releases

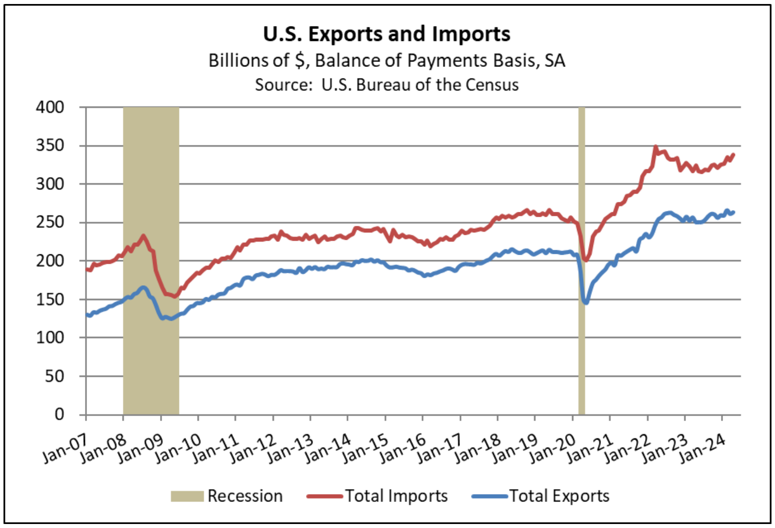
In the week ended June 1, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 229,000, above both the expected level of 220,000 and the prior week’s revised level of 221,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to 222,250. 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.



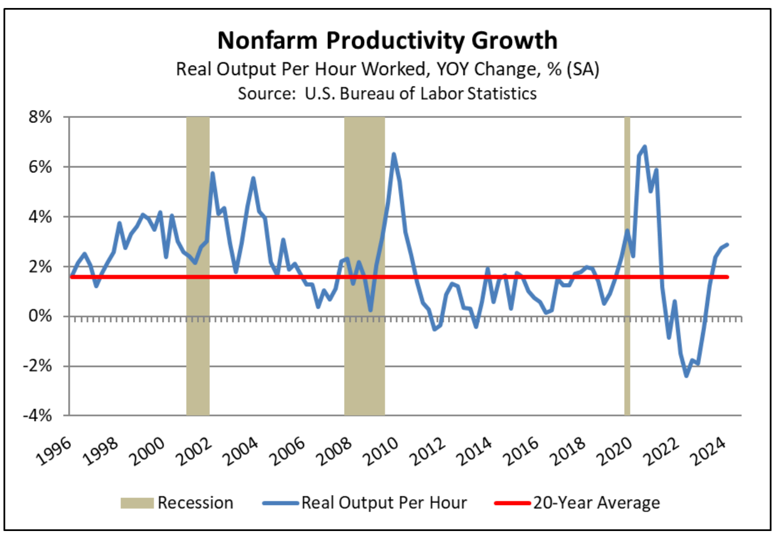
In the week ended May 25, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to 1.792 million, slightly worse than expectations that the reading would be unchanged from the prior week's revised 1.790 million. The four-week moving average of continuing claims rose to 1,788,750. 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.



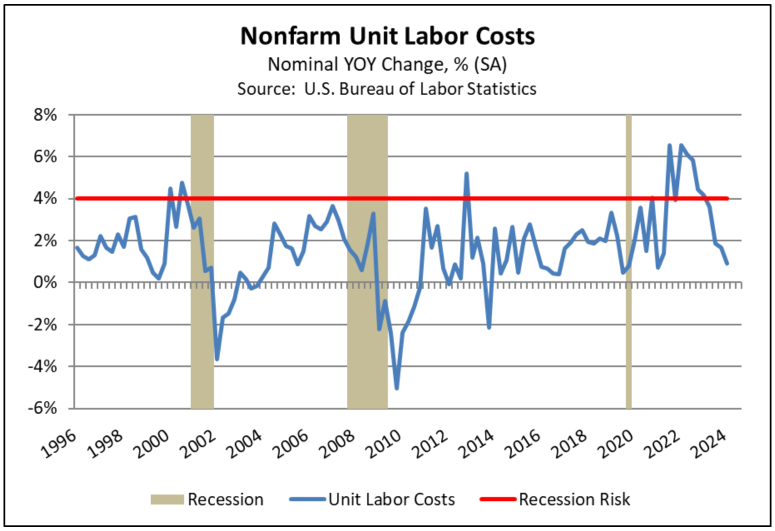
Separately, the April ***trade balance*** showed a seasonally adjusted deficit of $74.6 billion, not quite as bad as the anticipated deficit of $76.5 billion but still much wider than the revised March deficit of $68.6 billion. According to the data, total ***exports*** rose 0.8%, but ***imports*** rose 2.4%. Compared with the same month one year earlier, exports in April were up 5.1%, while imports were up 4.5%. The chart below shows the monthly value of US exports and imports since just before the GFC.



A final report today focused on the productivity of US workers, defined as the average value of output per hour worked. After stripping out price changes and normal seasonal fluctuations, revised first-quarter ***nonfarm productivity*** rose at an annualized rate of 0.2%. That was better than expectations that productivity would be flat, but it was still worse than the prior estimate of 0.3%. Taking into account the good growth in the previous three quarters, productivity in the first quarter was up a healthy 2.9% from the same period one year earlier. The chart below shows the year-over-year growth in real productivity over the last quarter-century or so.



Revised first-quarter ***unit labor costs*** rose at an annualized rate of 4.0%. While that figure is historically high, it was still much better than the expected growth rate of 4.9% and the prior estimate of 4.7%. Our research shows that recession risks are greater when unit labor costs are 4.0% or more above their level one year earlier. Happily, after taking into account the much better-behaved costs in recent quarters, unit labor costs in the first quarter were up just 0.9% year-over-year. The chart below shows the year-over-year growth in unit labor costs since 1996.



There are no economic releases or Fed events scheduled for the rest of the day.

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	31-May	-¥588.7b	-¥433.3b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	31-May	¥282.0b	¥82.4b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	31-May	¥337.4b	-¥789.0b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	31-May	¥1323.4b	-¥310.4b		*	Equity and bond neutral
Australia	Trade Balance	m/m	Apr	A$6548m	A$4841m	A$6548m	***	Equity and bond neutral
	Exports	m/m	Apr	-2.5%	-0.6%		*	Equity and bond neutral
	Imports	m/m	Apr	-7.2%	4.2%		*	Equity and bond neutral
New Zealand	ANZ Commodity Price	m/m	May	1.1%	0.5%		**	Equity and bond neutral
EUROPE								
Eurozone	Retail Sales	y/y	Apr	0.0%	0.7%	0.2%	*	Equity and bond neutral
Germany	Factory Orders WDA	y/y	Apr	-1.6%	-2.4%	0.6%	***	Equity bearish, bond bullish
	HCOB Germany Construction PMI	m/m	May	38.5	37.5		*	Equity and bond neutral
Italy	Retail Sales	y/y	Apr	-1.9%	1.9%		**	Equity and bond neutral
UK	S&P/CIPS Construction PMI	m/m	May	54.7	53.0	52.5	**	Equity bullish, bond bearish
Switzerland	Unemployment Rate	m/m	May	2.3%	2.3%	2.3%	**	Equity and bond neutral
Russia	Retail Sales	m/m	Apr	8.3%	11.1%	10.3%	***	Equity and bond neutral
	Unemployment Rate	m/m	Apr	2.6%	2.7%	2.7%	***	Equity and bond neutral
AMERICAS								
Canada	S&P Global Canada Composite PMI	m/m	May	50.6	49.3		*	Equity and bond neutral
	S&P Global Canada Services PMI	m/m	May	51.1	49.3		*	Equity and bond neutral
Brazil	S&P Global Brazil Composite PMI	m/m	May	54.0	54.8		***	Equity and bond neutral
	S&P Global Brazil Services PMI	m/m	May	55.3	53.7		***	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)	523	525	-2	Up
U.S. Sibor/OIS spread (bps)	533	534	-1	Up
U.S. Libor/OIS spread (bps)	534	534	0	Flat
10-yr T-note (%)	4.30	4.28	0.02	Down
Euribor/OIS spread (bps)	375	377	-2	Down
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Flat			Down
Yen	Flat			Down
Pound	Flat			Up
Franc	Up			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
ECB Main Refinancing Rate	4.250%	4.500%	4.500%	Below Forecast
ECB Marginal Lending Facility	4.500%	4.750%	4.750%	Below Forecast
ECB Deposit Facility Rate	3.750%	4.000%	4.000%	Below Forecast
Bank of Canada Rate Decision	4.750%	5.000%	7.750%	Below 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.

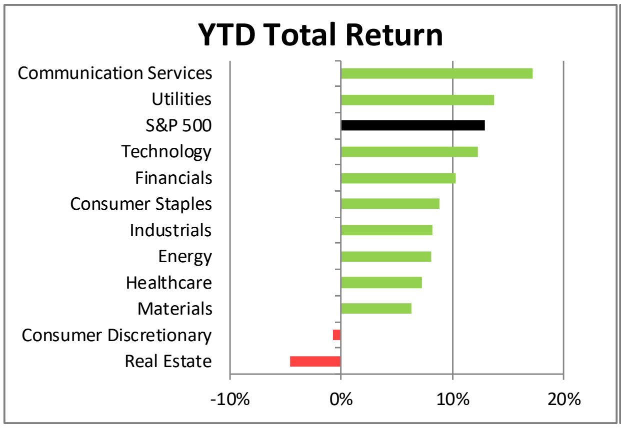
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$78.99	$78.41	0.74%	
WTI	$74.69	$74.07	0.84%	
Natural Gas	$2.78	$2.76	0.69%	
12-mo strip crack	$21.66	$21.81	-0.67%	
Ethanol rack	$1.96	$1.96	-0.12%	
Metals				
Gold	$2,360.93	$2,355.32	0.24%	
Silver	$30.32	$30.01	1.01%	
Copper contract	$464.70	$460.60	0.89%	
Grains				
Corn contract	$445.00	$439.25	1.31%	
Wheat contract	$647.25	$646.75	0.08%	
Soybeans contract	$1,184.75	$1,177.25	0.64%	
Shipping				
Baltic Dry Freight	1,852	1,813	39	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	1.23	-2.30	3.53	
Gasoline (mb)	2.10	1.70	0.40	
Distillates (mb)	3.20	2.17	1.03	
Refinery run rates (%)	1.1%	0.0%	1.1%	
Natural gas (bcf)		92		

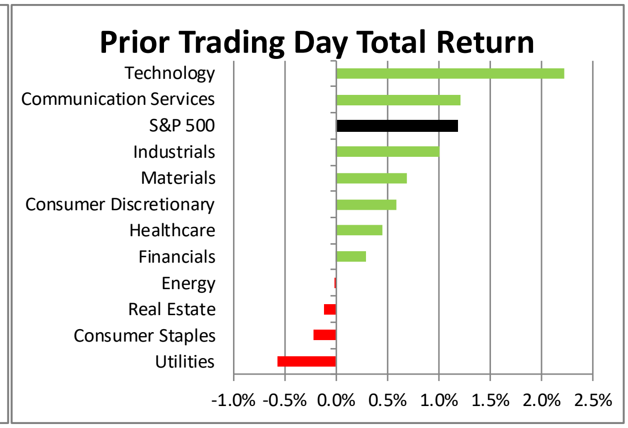
Weather

The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures throughout the entire country except for the Pacific Northwest, where temperatures will be cooler than normal. The forecasts call for wetter-than-average conditions in the Rocky Mountains and the Southeast, with dry conditions in the Mississippi and Ohio Valley regions.

Data Section

US Equity Markets – (as of 6/5/2024 close)

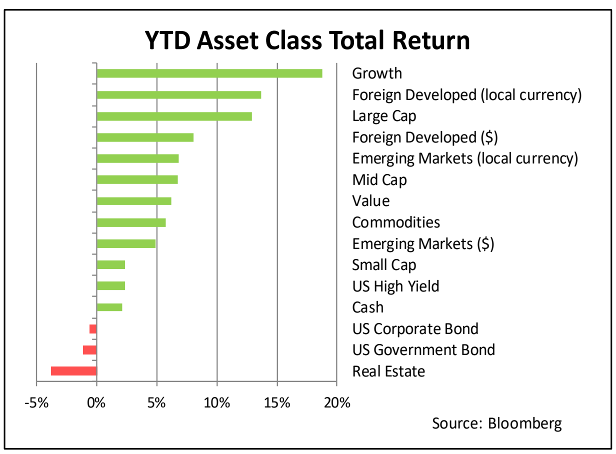




(Source: Bloomberg)

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 6/5/2024 close)

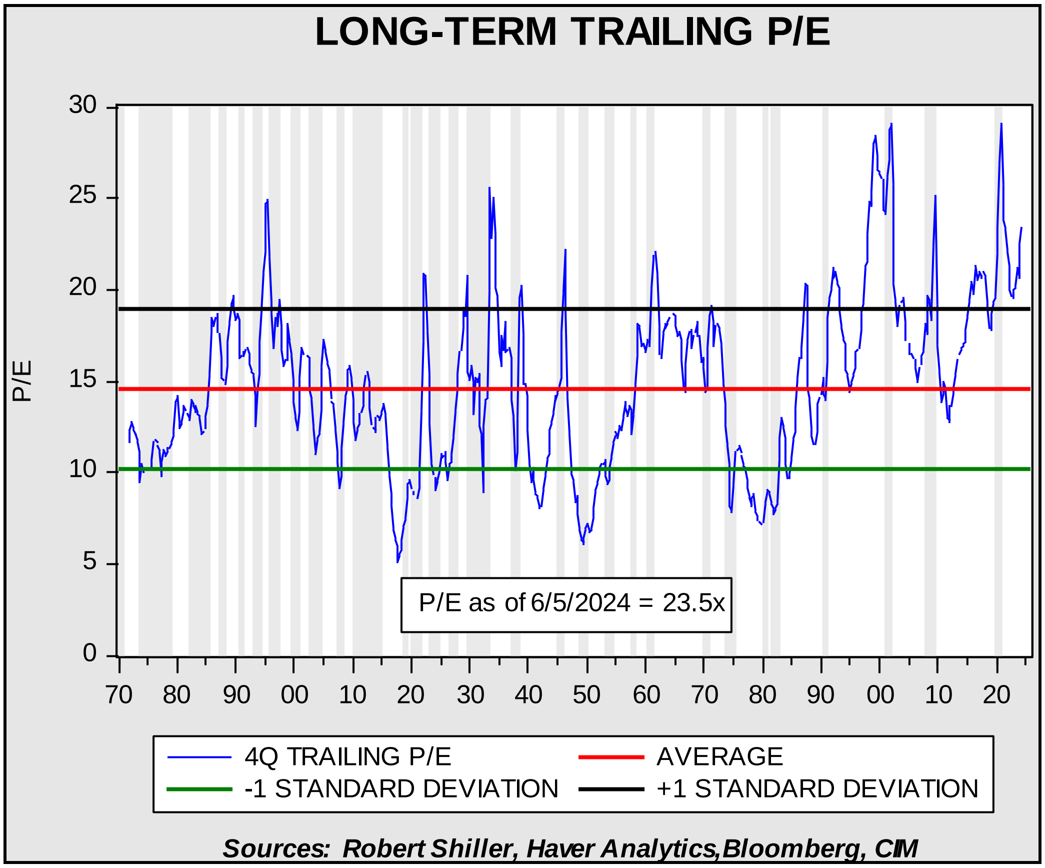


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 6, 2024



Based on our methodology,[1] the current P/E is 23.5x, up 0.2 from our last report. The increase in the multiple was due to an increase in the stock price index, and a downward revision 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.