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: May 23, 2024—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 0.6% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.1%. Chinese markets were lower, with the Shanghai Composite down 1.3% from its previous close and the Shenzhen Composite down 1.7.%. US equity index futures are signaling a higher open.

With 476 companies having reported so far, S&P 500 earnings for Q1 are running at $56.50 per share compared to estimates of $54.24, which is up 0.9% from Q1 2023. Of the companies that have reported thus far, 79.0% have exceeded expectations, while 16.8% have fallen short of expectations.

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* (5/20/2024) (there is no associated podcast): "The Great COVID Labor Reform"
- *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* (5/13/2024) (with associated podcast): "The Immigration Paradox"
- *Confluence of Ideas podcast* (5/8/2024) "Reviewing the Asset Allocation Rebalance: Q2 2024"

Our *Comment* today opens with several new indicators pointing to a possible further worsening in tensions between the US bloc and the China/Russia bloc. We next review several other international and US developments with the potential to affect the financial markets today, including signs of better economic growth in Europe, a snap election in the UK, and minutes of the Federal Reserve's most recent meeting on US monetary policy.

China-Russia: Following on the UK defense minister's assertion yesterday that the US and UK have intelligence showing that China is sending or preparing to send lethal aid to Russia for its

invasion of Ukraine, US National Security Advisor Sullivan said he has not seen such evidence and would have to discuss the matter with his British counterparts. At this point, it isn't clear whether the disagreement reflects differences over how to interpret the same intelligence or perhaps is due to the Biden administration's extreme reluctance to push China or Russia too far.

- In any case, the US-UK disagreement seems to be based on some kind of intelligence showing China's support for Russia is more substantial than previously known.

- As we noted in our *Comment* yesterday, such substantial support for Russia's invasion would potentially be quite incendiary and could lead to sanctions directly against China. Obviously, broad Western sanctions against China would likely exacerbate the current spiral of tensions and present greater risks for investors.

China-Taiwan: While China draws closer to authoritarian allies such as Russia, it continues to ramp up its aggressiveness against Taiwan and other democracies. In an apparent effort to intimidate Taiwan's newly inaugurated, independence-minded president, the Chinese military today has launched large-scale exercises practicing encirclement of the island. The drills are planned to last two days and will include air, navy, ground, and rocket forces.

- According to a Chinese military spokesperson, the exercises are intended to "serve as a strong punishment for the separatist acts of 'Taiwan independence' forces and a stern warning against the interference and provocation by external forces."

- We still believe that the biggest near-term risk involving China's geopolitical aggressiveness is in the Philippines. Nevertheless, exercises such as the ones China is launching today around Taiwan raise the risk of accidental confrontation or miscalculation that could escalate into a bigger conflict and draw in the US.

China-Australia: Australian wine exports to China jumped to $10.4 million in April after removal of the tariffs Beijing imposed in 2021 to punish Australia for questioning China's role in the coronavirus pandemic. Australian wine exports to China in April were about eight times greater than in the same month one year earlier and are expected to keep growing in the near term. The improvement shows how China sometimes does back down after imposing punitive trade barriers on countries that anger it.

China-European Union: In contrast with the improved China-Australia relationship, a top Chinese auto market expert who works closely with the government said in an interview that China should hike import tariffs against foreign internal-combustion autos with large engines. With the European Commission (EC) expected to release its decision on possible import tariffs against Chinese electric vehicles in the next two weeks, the remark has been widely interpreted as a warning that Beijing is prepared for a trade war if the EU puts up barriers to Chinese EVs.

- Europe's large auto industry is a juicy target for Chinese attack in a trade war, and European nations have often proven timid when faced with threats to their sales in China.

- Nevertheless, the EC has exclusive responsibility for the region's trade policies, and its priority is to avoid another decimation of a key European industry at the hands of China. Individual countries can't block any anti-China tariffs the bureaucrats in Brussels might impose, so the risk of an EU-China trade war is rising.

- Any such trade war would further the process of global fracturing, in which countries are coalescing into relatively separate geopolitical and economic blocs. Since many large European companies are dependent on exporting to China, a trade war could weigh heavily on European stock markets.

Eurozone: The composite purchasing managers' index for May rose to a seasonally adjusted 52.3, beating expectations and improving from 51.7 in April. Like most such indexes, the eurozone's composite PMI is designed so that readings over 50 indicate expanding activity. The May data adds to the evidence that the European economy is recovering a bit from its recent contraction, which stemmed from factors such as high energy prices and rising interest rates.

United Kingdom: Prime Minister Sunak yesterday called a snap election for July 4, even though the ruling Conservative Party is trailing the leftist Labour Party by about 20 percentage points in recent opinion polls. Sunak and the Conservatives are hoping, perhaps against hope, that a string of positive data points on economic growth and price inflation will overcome voter fatigue with the Conservatives and perceptions that the party is too chaotic and divided to govern.
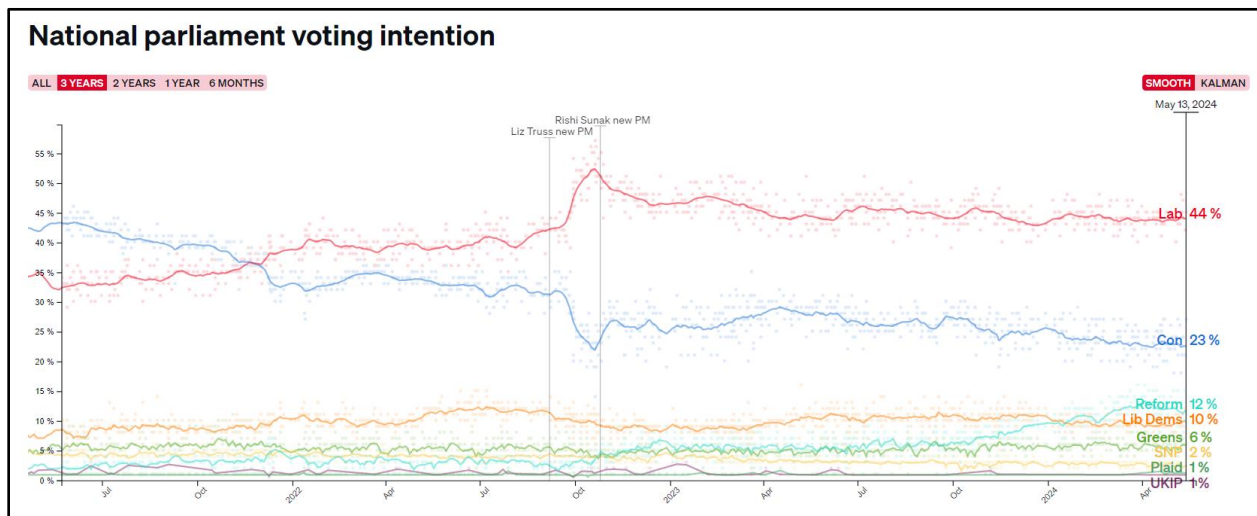
US Monetary Policy: The minutes of the Fed's April 30-May 1 policy meeting, released yesterday, show that the policymakers as a group continued to believe the benchmark fed funds interest rate is high enough to slow economic activity and bring down price pressures, but the process is likely to take longer than originally thought. Importantly, the minutes show some officials "mentioned a willingness to tighten policy further should risks to inflation materialize in a way that such action became appropriate."

- Even though Fed board member Waller said separately yesterday that the probability of rate hikes is currently "very low," the reference to potential policy tightening drove stock prices lower.

- By market close, the S&P 500 was down 0.3% to 5,307.01.

US Antitrust Policy: The Justice Department and several state governments today are expected to file an antitrust suit against entertainment ticketing giant Live Nation. Based on allegations that Live Nation has a monopoly that leads to higher ticket prices, the suit will essentially ask that the 2010 merger between Live Nation and Ticketmaster be reversed.

- The suit against Live Nation is another example of the Biden administration's effort to toughen US competition policy. To date, that effort has had a mixed record.

- Coincidentally, Bloomberg's latest "Odd Lots" podcast, published just today, carries an interview with the top DOJ economist, who explains how the department identifies and analyzes potentially uncompetitive behavior that could lead to an antitrust suit.

US Stock Market: After market close yesterday, artificial intelligence darling Nvidia said sales in its latest quarter rose to $26 billion, three times greater than one year earlier, while its net income rose to $14.88 billion, nearly 7.5 times more than in the year-earlier period. Moreover, the firm lifted its sales forecast for the current quarter, and its CEO pronounced a bullish outlook for its products in the coming years.

- The company also announced a 10-for-1 stock split effective June 7 and more than doubled its dividend.

- In after-hours trading, the stock jumped approximately 6%. So far this morning, Nvidia's stock is up about 6.7% to $1,013.40.

US Economic Releases

In the week ended May 18, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 215,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 219,800. Meanwhile, in the week ended May 18, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to 1,794,000. Although the initial claims number is slightly less than expected, the continuing claims number matches the expectation. These results are not likely to significantly impact markets. 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.

FOUR-WEEK AVERAGE OF INITIAL CLAIMS

Sources: BLS, CIM
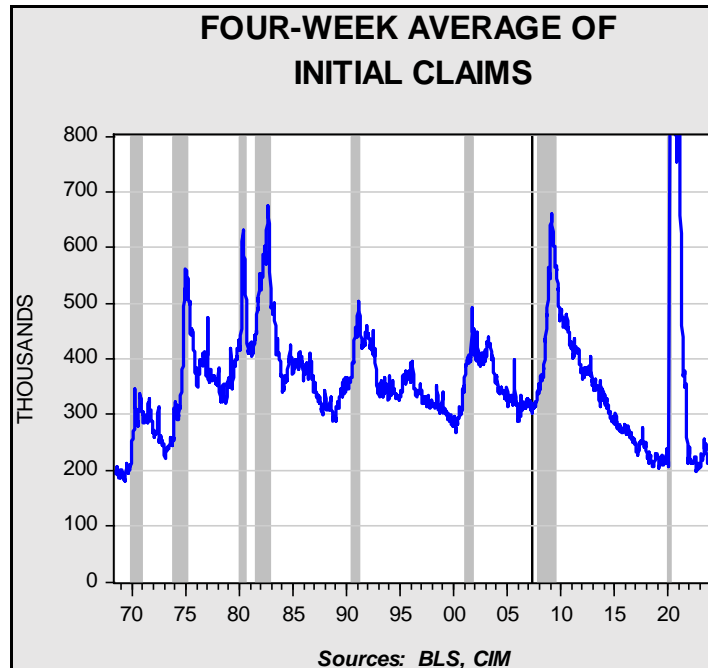
Separately, the ***Chicago Fed said its April National Activity Index (CFNAI)*** fell to -0.23, which is well below the expected value of +0.13. This deviation to the downside could prove meaningful. The CFNAI, which encompasses dozens of separate indicators to capture all aspects of current economic activity, is designed so that readings above 0.00 reflect the economy growing at trend. Our analysis shows that when the six-month moving average of the CFNAI falls below about -0.45, it indicates the economy is in recession. With the latest reading, the index suggests the economy could be losing steam, while not actually entering recession. The chart below shows how the CFNAI has fluctuated over the last several decades.

CHICAGO FRB NATIONAL ACTIVITY INDEX

LATEST DATA -0.18

CFNAI, 6-mo Avg — Recession Point

Sources: Chicago FRB, CIM
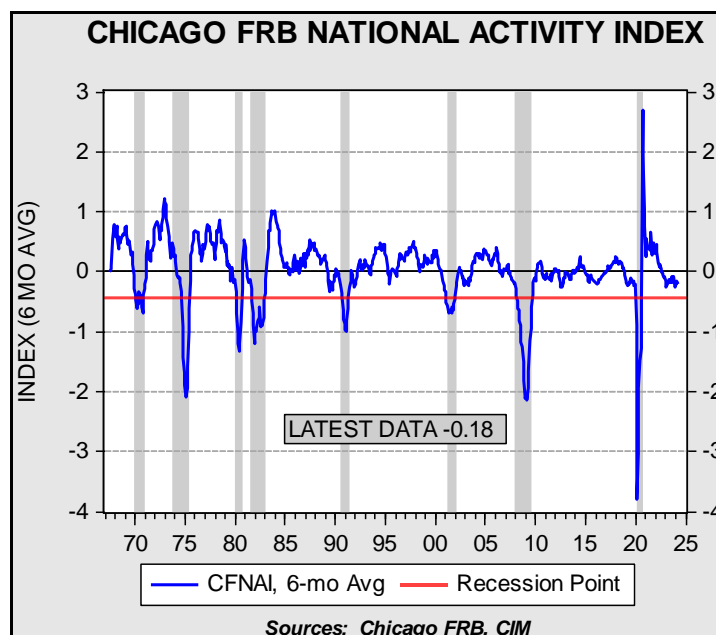
The table below lists the economic releases and/or Fed events scheduled for the rest of the day.

Economic Releases							
EST	**Indicator**				**Expected**	**Prior**	**Rating**
9:45	S&P Global US Manufacturing PMI	m/m	May P		49.9	50	***
9:45	S&P Global US Services PMI	m/m	May P		51.2	51.3	***
9:45	S&P Global US Composite PMI	m/m	May P		51.2	51.3	***
10:00	New Home Sales	m/m	Apr		678k	693k	***
10:00	New Home Sales MoM	m/m	Apr		-2.2%	8.8%	**
11:00	Kansas City Fed Manufacturing Index	m/m	May		-7	-8	*
Federal Reserve							
EST	**Speaker or Event**		**District or Position**				
15:00	Raphael Bostic Participates in Student Q&A		President of the Federal Reserve Bank of Atlanta				

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	17-May	¥528.6b	-¥390.9b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	17-May	¥248.1b	¥664.8b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	17-May	¥427.4b	¥1698.4b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	17-May	¥2192.2b	-¥390.6b		*	Equity and bond neutral
	Jibun bank Composite PMI	m/m	May P	52.4	52.3		*	Equity and bond neutral
	Jibun Bank Manufacturing PMI	m/m	May P	50.5	49.6		***	Equity and bond neutral
	Jibun Bank Services PMI	m/m	May P	53.6	54.3		**	Equity and bond neutral
	Machine tool orders	y/y	Apr F	-8.9%	-11.6%		**	Equity and bond neutral
New Zealand	Retail Sales Ex Inflation	q/q	1Q	0.50%	-1.80%	-0.30%	***	Equity bullish, bond bearish
India	HSBC India PMI Mfg	m/m	May P	58.4	58.8		***	Equity and bond neutral
	HSBC India PMI Composite	m/m	May P	61.7	61.5		**	Equity and bond neutral
	HSBC India PMI Services	m/m	May P	61.4	60.8		**	Equity and bond neutral
EUROPE								
Eurozone	HCOB Eurozone Manufacturing PMI	m/m	May P	47.4	45.7	46.1	***	Equity and bond neutral
	HCOB Eurozone Services PMI	m/m	May P	53.3	53.3	53.6	**	Equity and bond neutral
	HCOB Eurozone Composite PMI	m/m	May P	52.3	51.7	52.0	*	Equity and bond neutral
Germany	HCOB Germany Manufacturing PMI	m/m	May P	45.4	42.5	43.3	***	Equity bullish, bond bearish
	HCOB Germany Services PMI	m/m	May P	53.9	53.2	53.5	**	Equity and bond neutral
	HCOB Germany Composite PMI	m/m	May P	52.2	50.6	51.0	**	Equity bullish, bond bearish
France	HCOB France Composite PMI	m/m	May P	51.0	50.5	50.5	***	Equity bullish, bond bearish
	HCOB France Manufacturing PMI	m/m	May P	46.7	45.3	45.9	***	Equity bullish, bond bearish
	HCOB France Services PMI	m/m	May P	49.1	50.5	51.0	***	Equity bearish, bond bullish
UK	S&P/CIPS Manufacturing PMI	m/m	May P	51.3	49.1	49.5	***	Equity bullish, bond bearish
	S&P/CIPS Services PMI	m/m	May P	52.9	55.0	54.7	**	Equity bearish, bond bullish
	S&P/CIPS Composite PMI	m/m	May P	52.8	54.1	54.0	**	Equity bearish, bond bullish
Russia	PPI	y/y	Apr	18.4%	19.1%		***	Equity and bond neutral
AMERICAS								
Mexico	GDP NSA	y/y	Q1 P	1.6%	1.6%	1.6%	***	Equity and bond neutral
	Economic Activity IGAE YoY	m/m	Mar	-1.33%	4.50%	-1.03%	**	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)	559	559	0	Up
3-mo T-bill yield (bps)	524	525	-1	Up
U.S. Sibor/OIS spread (bps)	534	534	0	Flat
U.S. Libor/OIS spread (bps)	535	535	0	Flat
10-yr T-note (%)	4.42	4.42	0.00	Up
Euribor/OIS spread (bps)	382	382	0	Down
Currencies	Direction			
Dollar	Down			Up
Euro	Up			Up
Yen	Up			Down
Pound	Up			Up
Franc	Up			Down
Central Bank Action	Current	Prior	Expected	
Bank of Korea Base Rate	3.500%	3.500%	3.500%	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.
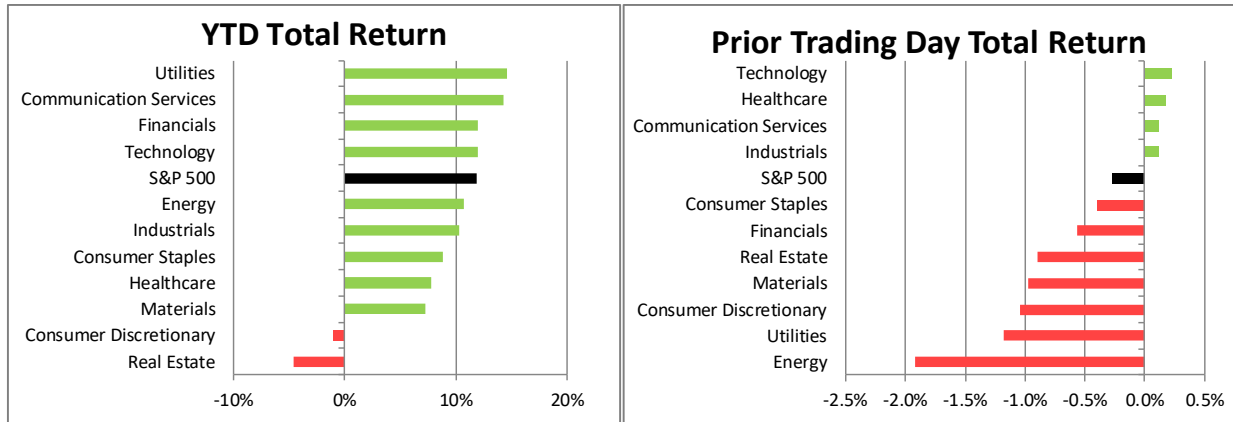
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$82.47	$81.90	0.70%	
WTI	$78.15	$77.57	0.75%	
Natural Gas	$2.82	$2.84	-0.70%	
12-mo strip crack	$22.67	$22.51	0.69%	
Ethanol rack	$1.94	$1.93	0.20%	
Metals				
Gold	$2,367.81	$2,378.85	-0.46%	
Silver	$30.62	$30.79	-0.55%	
Copper contract	$481.95	$484.85	-0.60%	
Grains				
Corn contract	$463.25	$461.25	0.43%	
Wheat contract	$692.00	$693.00	-0.14%	
Soybeans contract	$1,249.75	$1,246.25	0.28%	
Shipping				
Baltic Dry Freight	1,804	1,829	-25	
DOE Inventory Report				
	Actual	Expected	Difference	
Crude (mb)	1.83	-2.00	3.83	
Gasoline (mb)	-0.95	-1.38	0.43	
Distillates (mb)	0.38	0.30	0.08	
Refinery run rates (%)	1.3%	0.5%	0.8%	
Natural gas (bcf)		85		

Weather

The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures in the Mountain Time Zone, California, along the Gulf Coast, and in Maine, with cooler temperatures expected in the lower Ohio Valley. The forecasts call for wetter-than-average conditions in Texas, Oklahoma, Kansas, and New Mexico, with drier-than-normal conditions expected in the Rocky Mountains.
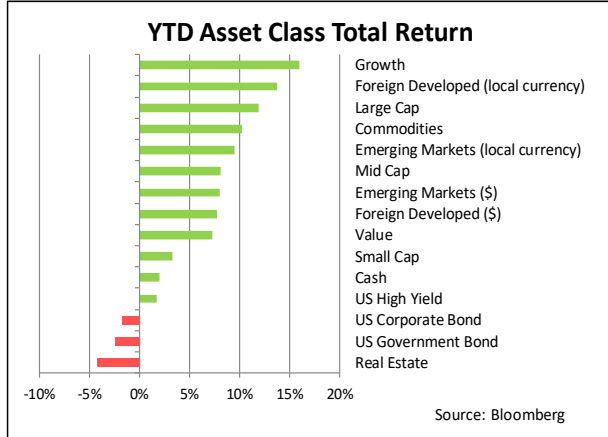
Data Section

US Equity Markets – (as of 5/22/2024 close)

YTD Total Return

Sector	
Utilities	~15%
Communication Services	~14%
Financials	~12%
Technology	~12%
S&P 500	~11% (black)
Energy	~11%
Industrials	~10%
Consumer Staples	~9%
Healthcare	~8%
Materials	~7%
Consumer Discretionary	~-2%
Real Estate	~-5%

Prior Trading Day Total Return

Sector	
Technology	~0.3%
Healthcare	~0.2%
Communication Services	~0.1%
Industrials	~0.1%
S&P 500	~-0.1% (black)
Consumer Staples	~-0.4%
Financials	~-0.6%
Real Estate	~-0.9%
Materials	~-0.9%
Consumer Discretionary	~-1.0%
Utilities	~-1.1%
Energy	~-1.9%

(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 5/22/2024 close)

YTD Asset Class Total Return

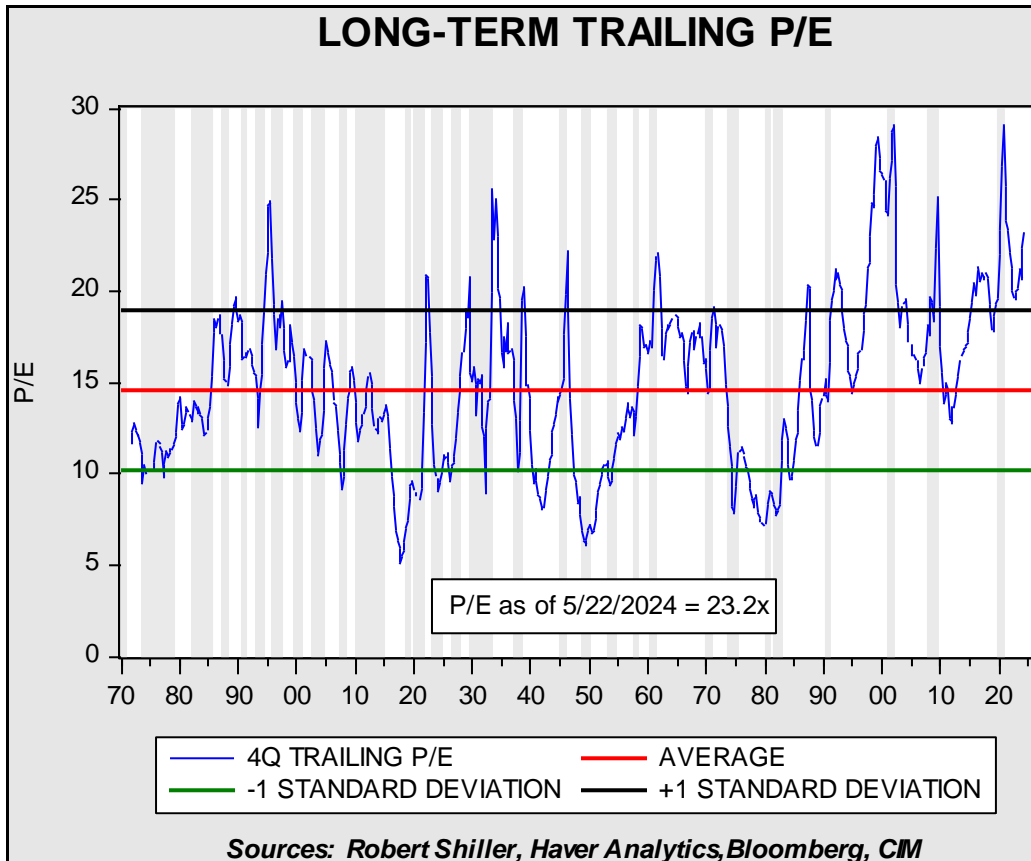| Asset Class	
Growth	~16%
Foreign Developed (local currency)	~13%
Large Cap	~11%
Commodities	~10%
Emerging Markets (local currency)	~8%
Mid Cap	~8%
Emerging Markets ($)	~7%
Foreign Developed ($)	~7%
Value	~6%
Small Cap	~2%
Cash	~2%
US High Yield	~1%
US Corporate Bond	~-1%
US Government Bond	~-2%
Real Estate	~-4%

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

May 23, 2024

LONG-TERM TRAILING P/E

P/E as of 5/22/2024 = 23.2x

Legend:
— 4Q TRAILING P/E — AVERAGE
— -1 STANDARD DEVIATION — +1 STANDARD DEVIATION

Sources: Robert Shiller, Haver Analytics, Bloomberg, CIM

Based on our methodology,[1] the current P/E is 23.2x, unchanged from our last report. Despite a rise in the stock price index, the valuation multiple remained unchanged due to a corresponding increase in company 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 (Q2, Q3 and Q4) and one estimate (Q1). 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.