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 30, 2024—9:30 AM EDT] Global equity markets are generally lower this morning. In Europe, the Euro Stoxx 50 is up 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.7%. Chinese markets were lower, with the Shanghai Composite down 0.6% from its previous close and the Shenzhen Composite down 0.5%. 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:

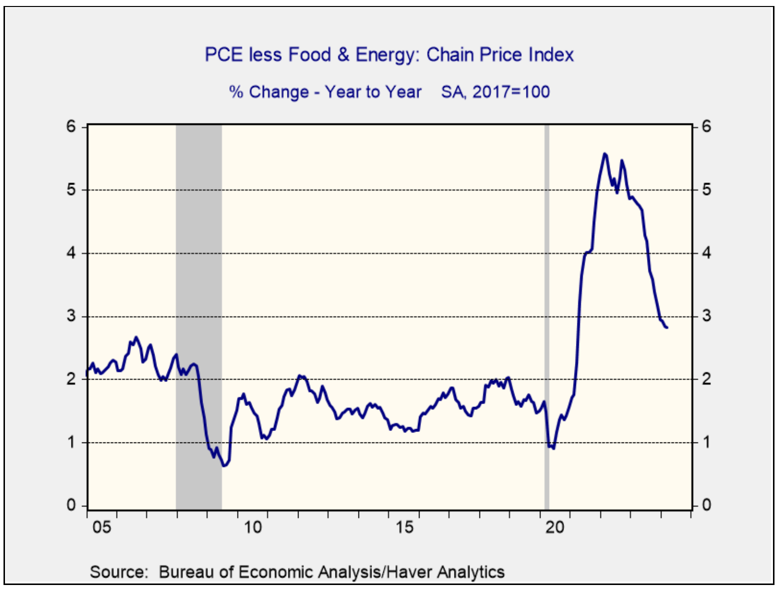
- *Bi-Weekly Geopolitical Report* (5/20/2024) (there is no associated podcast): "The Great COVID Labor Reform"
- *Asset Allocation Quarterly – Q2 2024* (4/25/2024): Discussion of our asset allocation process, Q2 2024 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q2 2024 Rebalance 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* (5/28/2024) (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, though down overall, edged higher ahead of the opening bell as downward revisions to GDP data fueled optimism about a potential policy shift by the Federal Reserve. In sports news, the Edmonton Oilers were able to keep their NHL championship hopes alive by defeating the Dallas Stars on Wednesday. Today's *Comment* will discuss the latest Beige Book and how it might impact Fed policy, why housing markets are showing early signs of troubles, and our opinion about elections in South Africa. As usual, our report will conclude with a roundup of domestic and international data releases.

Bad News on the Ground: The Federal Reserve's latest survey of its 12 districts points to a slowing economy.

- The U.S. economy saw continued slow growth in early April to mid-May according to the Federal Reserve's Beige Book. While most regions reported slight to modest expansion, some sectors showed signs of weakness. Auto sales were a particular concern, with dealerships resorting to adding more incentives to move cars. Additionally, there was a notable slowdown in hiring with the survey showing a modest increase in employment and firms reporting that they are finding it easier to fill positions. This suggests that demand is slowing, and the labor market is cooling down.

- This report is unlikely to sway policymakers to cut rates, but it should dissuade members from pushing for a rate hike. Economic data continues to show that the economy is growing at a stable pace. The latest consumer confidence report rebounded from April as households expressed more optimism about the economy, even as they worry more about rising prices. Similarly, the May Purchasing Manager Index (PMI) by S&P Global showed that output picked up in May, with services activity experiencing its best month in a year. However, the Beige Book suggests the recent slowdown in hiring and the weak Q1 GDP number might not be temporary.

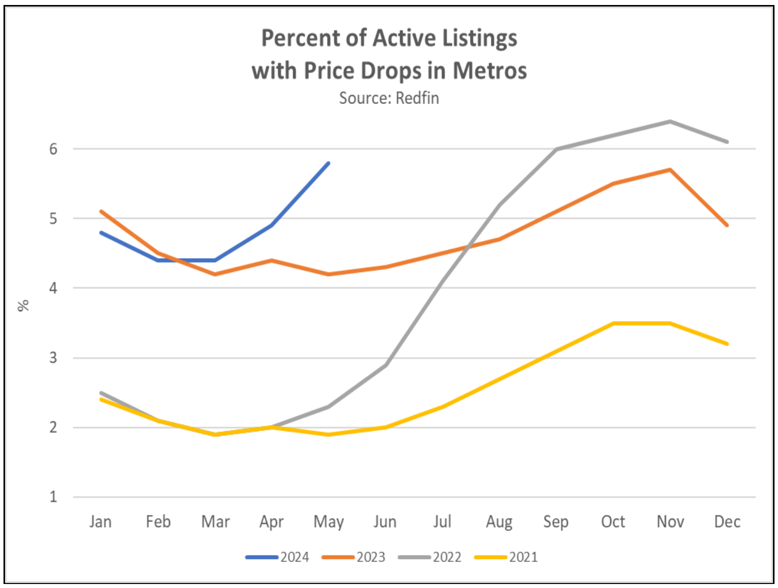


- This Friday's PCE price index, the Fed's preferred inflation gauge, is a critical indicator of progress towards its 2% target. Markets anticipate that the core index will hold steady at 0.3% growth from March and 2.8% year-over-year. A higher-than-expected reading could push back investor hopes for a rate cut to September or later. Conversely, a softer inflation reading could keep a July rate cut on the table. While we remain optimistic about one to two rate cuts this year if inflation meets the Fed's 2.6% year-end projection, the possibility of no cuts is becoming increasingly likely.

A Cool Summer: The supply of homes is starting to increase, but it appears that potential buyers are reluctant to purchase.

- Redfin data reveals a sharp increase in the number of US home sellers slashing prices to attract buyers. Nearly 6% of listings have undergone price cuts within just 12 weeks of hitting the market, a significant rise heading into the traditionally hot summer season — a time typically known for a surge in buyer demand. This data adds to growing evidence that the housing market may be losing momentum. Last week, the National Association of Realtors reported that existing home sales in April fell 1.9% year-over-year, despite expectations of a slight increase and an uptick in supply.

- Rising interest rates appear to be finally hitting the residential real estate market, as evidenced by the recent slowdown in demand. Homeowners, who locked in historically low rates during the pandemic, have been reluctant to sell. However, this trend may shift as new buyers face significantly higher borrowing costs. This could be especially impactful for a small group of homeowners who chose adjustable-rate mortgages during that period. According to a Bloomberg report, these homeowners could see a sharp rise in their monthly payments in the coming months, potentially contributing to current market headwinds.

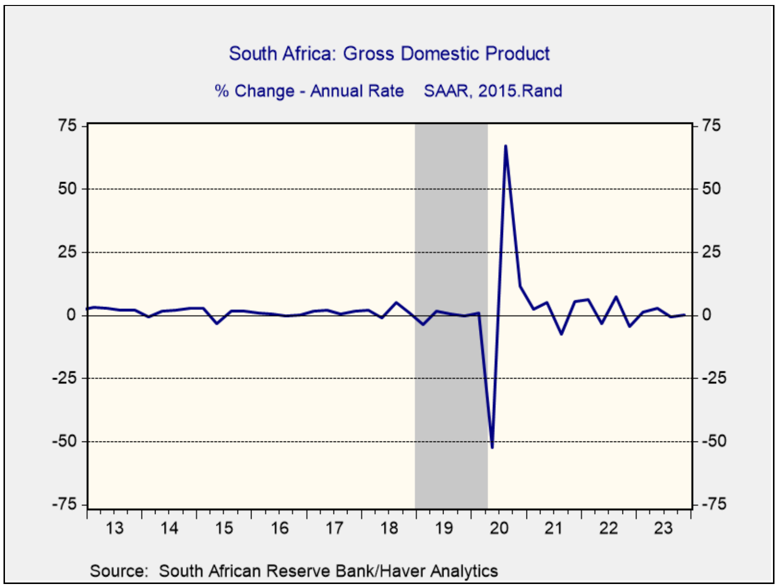


- The surge in home-price drops presents a double-edged sword for the economy. While it's welcome news for potential buyers and could lead to lower shelter price inflation (particularly rents and owner-equivalent rent), it might also dampen consumer confidence. Homeownership often represents a significant portion of a household's wealth. Falling home prices could erode this wealth, especially for those without a diversified investment portfolio. As a result of this wealth effect, consumers may start to delay major purchases like cars or appliances and look to rebuild their savings first instead.

South African Sea Change: This week's election is expected to see the ruling African National Congress (ANC) party lose its majority for the first time in 30 years.

- While the party is still expected to win the most seats, early results show that the ANC is slated to receive 42.5% of the vote. The opposition Democratic Alliance (DA) party should receive 26% of vote and the far-left Economic Freedom Fighters (EFF) will collect 8.4%. The official results won't be known for several days but must be released within a week by law. If confirmed, the ANC will be forced to form a coalition government in order to maintain control, potentially requiring them to make compromises to their platform, which could lead to political infighting.

- This year's election saw a large turnout, as voters looked to register their displeasure with the status quo. The country's job market faces a significant challenge, with unemployment rising to 32.8% in the first quarter. While this is an improvement from the pandemic peak of 35%, it remains considerably higher than the pre-COVID level of 28%. Adding to the economic woes, the country is grappling with persistent power outages due to insufficient supply of electricity. To manage the strain on the power grid, the government has implemented load shedding. While this measure has been effective in reducing the load, it has also negatively impacted economic activity.

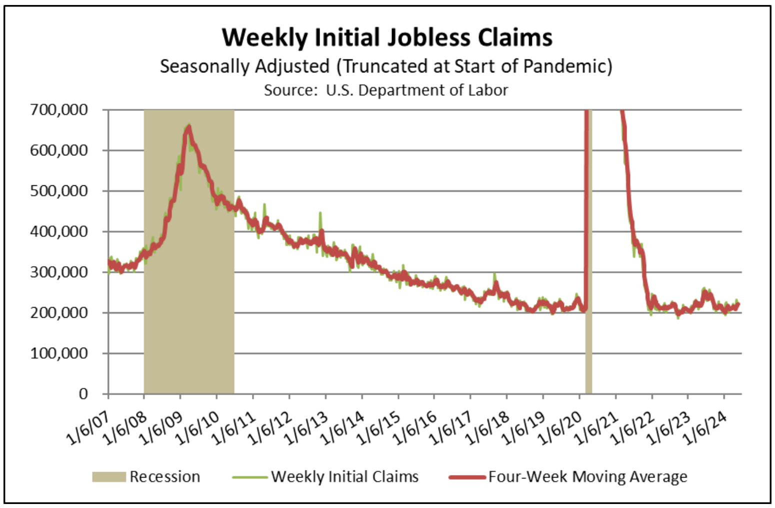


- Despite the ANC maintaining a strong plurality of seats following the election, there is still much political uncertainty. If the results hover around 40% of the vote, party members might seek to replace President Cyril Ramaphosa. Additionally, the rise of the controversial EFF could pose problems for investors. The party's leader, Julius Malema, might leverage his influence for a greater role in government. In the past, he has advocated for the nationalization of the country's gold and platinum mines and the seizure of land from white farmers.

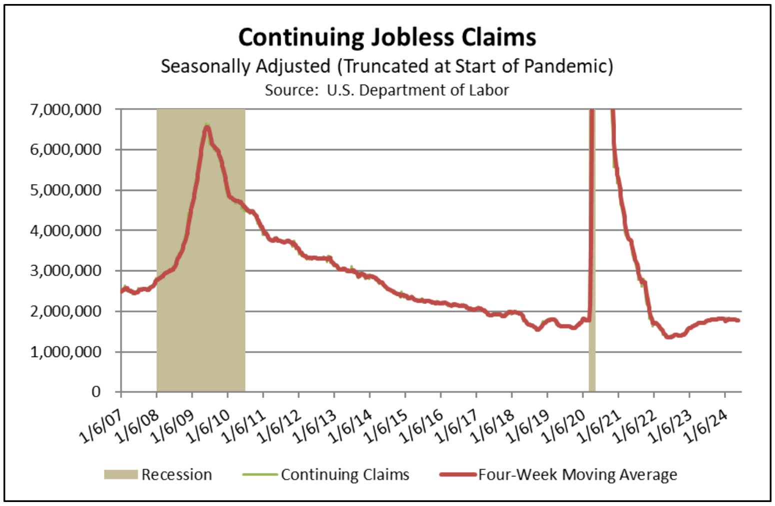
In Other News: Goldman Sachs continues to supply talent to the Federal Reserve System, with Beth Hammack set to replace Loretta Mester as the President of the Cleveland Fed. Other notable Goldman alumni include former New York Fed President William Dudley and current Minneapolis Fed President Neel Kashkari. A report revealed that NATO only has 5% of the defenses needed to protect its eastern flank, a sign that Western governments are likely to ramp up spending on security.

US Economic Releases

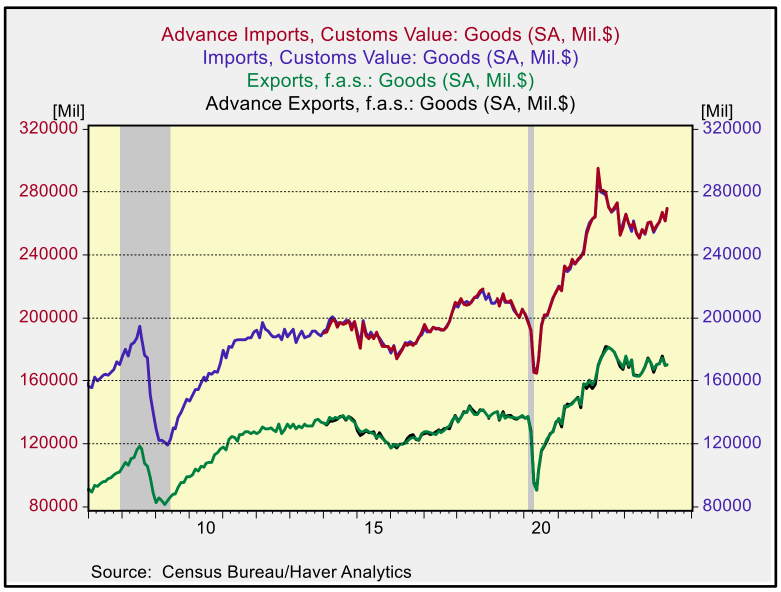
In the week ended May 25, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 219,000, slightly above both the expected level of 217,000 and the prior week's revised level of 216,000. Importantly, the four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to an eight-month high of 222,500. That could increase concern that the labor market is softening significantly, although one benefit of that would likely be reduced upward pressure on wages and consumer prices. 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.



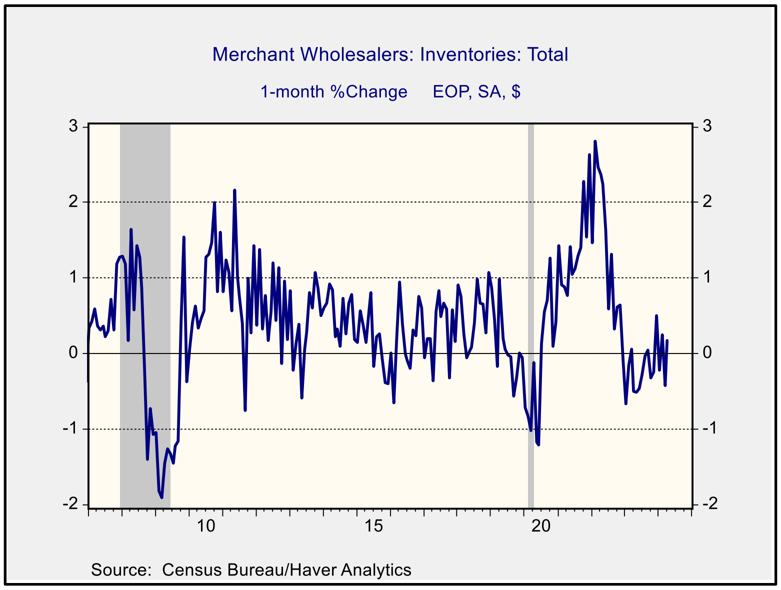
In the week ended May 18, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to a seasonally adjusted 1.791 million, below the expected reading of 1.796 million but above the previous week's revised reading of 1.787 million. The four-week moving average of continuing claims rose slightly to 1.786 million. 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.



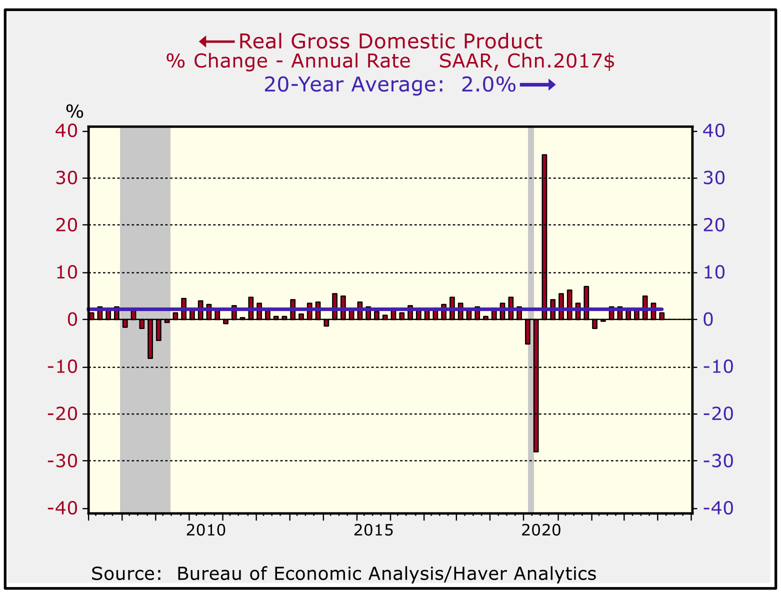
In a separate report today, a preliminary estimate showed the U.S. ***merchandise trade balance*** in April came in at a seasonally adjusted deficit of $99.4 billion, much wider than the expected shortfall of $92.4 billion and the revised March deficit of $92.3 billion. According to the data, total merchandise exports rose 0.4%, but imports jumped 3.2%. Compared with the same month one year earlier, exports in April were up 5.2%, while imports were up 8.6%. The chart below shows the monthly value of U.S. exports and imports since just before the GFC.



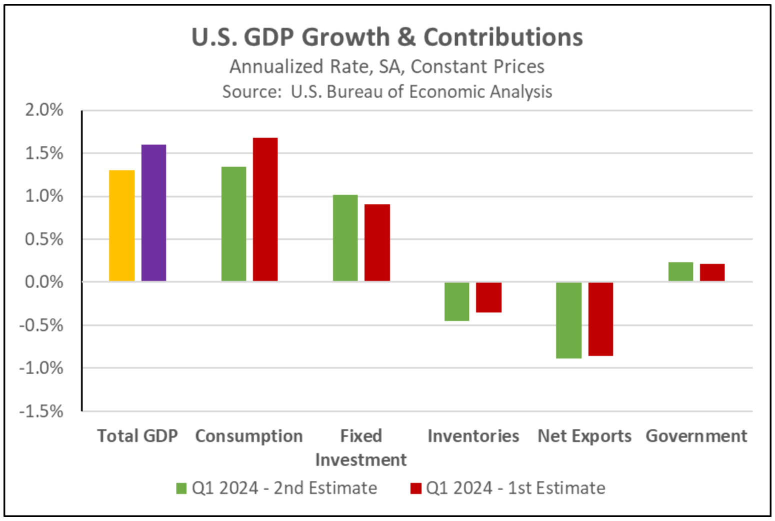
Separately, April ***wholesale inventories*** rose by a seasonally adjusted 0.2%, beating the expected increase of 0.1% and reversing part of the March decline of 0.4%. Since distributors are in a unique position to understand both production activities and final demand, we think wholesale inventories provide an important perspective on where the economy is heading. The chart below shows the monthly change in wholesale inventories since just before the GFC.



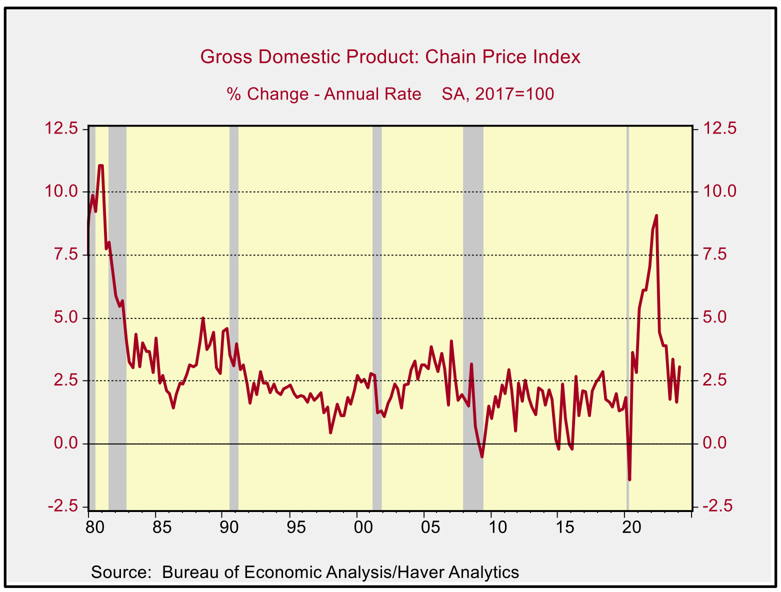
Finally, the Commerce Department released its second regular estimate of economic activity in the first quarter of the year. After stripping out seasonal factors and price changes, first-quarter ***gross domestic product (GDP)*** rose at an annualized rate of 1.3%, matching expectations but reflecting a modest downward revision from the initial estimate of a 1.6% growth rate. The chart below shows the annualized growth rate of US GDP since just before the GFC.



A close look at the details in the report shows the main reason for the downward revision in the quarter's growth estimate was that personal consumption increased more slowly than originally thought. Spending on durable goods was much weaker than first estimated. The chart below shows the contributions to the annualized growth rate in the first quarter.



The GDP report also includes the broadest measure of US price inflation. The first-quarter ***GDP Price Index*** rose at an annualized rate of 3.0%, a bit better than expectations that the growth rate would match the previous estimate of 3.1%. The chart below shows the year-over-year change in the GDP Price Index over the last several decades.



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**
10:00	Pending Home Sales	m/m	Apr	-1.0%	3.4%	**
10:00	Pending Home Sales NSA	y/y	Apr	-2.0%	-4.5%	**
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
12:05	John Williams Speaks at Economic Club of New York	President of the Federal Reserve Bank of New York				
17:00	Lorie Logan Speaks in Moderated Q&A	New York Federal Reserve Executive Vice President				

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	24-May	-¥414.6b	¥528.6b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	24-May	¥82.4b	¥248.3b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	24-May	-¥789.9b	¥424.0b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	24-May	-¥297.9b	¥2189.6b		*	Equity and bond neutral
Australia	Private Capital Expenditure	q/q	1Q	1.0%	0.9%	0.7%	**	Equity and bond neutral
	Building Approvals	m/m	Apr	-0.3%	2.7%	1.8%	***	Equity bearish, bond bullish
New Zealand	Building Permits	m/m	Apr	-1.9%	-0.2%		***	Equity and bond neutral
EUROPE								
Eurozone	Consumer Confidence	m/m	May F	-14.3	-14.3		**	Equity and bond neutral
	Services Confidence	m/m	May	6.5	6.1	6.5	**	Equity and bond neutral
	Industrial Confidence	m/m	May	-9.9	-10.4	-9.6	***	Equity and bond neutral
	Economic Confidence	m/m	May	96.0	95.6	96.1	***	Equity and bond neutral
	Unemployment Rate	m/m	Apr	6.4%	6.5%	6.5%	**	Equity and bond neutral
Italy	Unemployment Rate	m/m	Apr	6.9%	7.1%	7.3%	**	Equity and bond neutral
	PPI	y/y	Apr	-8.1%	-12.7%		**	Equity and bond neutral
Switzerland	Real Exports	m/m	Apr	9.6%	-2.2%		*	Equity and bond neutral
	Real Imports	m/m	Apr	3.2%	-1.9%		*	Equity and bond neutral
	KOF Leading Indicator	m/m	May	100.3	101.9	102.1	**	Equity and bond neutral
	GDP	y/y	1Q	0.6%	0.5%	0.7%	**	Equity and bond neutral
Russia	Industrial Production	y/y	Apr	3.9%	4.0%	4.0%	***	Equity and bond neutral
AMERICAS								
Mexico	Unemployment Rate NSA	m/m	Apr	2.61%	2.28%	2.54%	***	Equity and bond neutral
Brazil	Formal Job Creation	m/m	Apr	240033	244716	210000	**	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)	561	560	1	Flat
3-mo T-bill yield (bps)	525	525	0	Up
U.S. Sibor/OIS spread (bps)	534	534	0	Up
U.S. Libor/OIS spread (bps)	535	535	0	Up
10-yr T-note (%)	4.59	4.61	-0.02	Up
Euribor/OIS spread (bps)	379	379	0	Down
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Up
Yen	Up			Down
Pound	Up			Up
Franc	Up			Down

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.

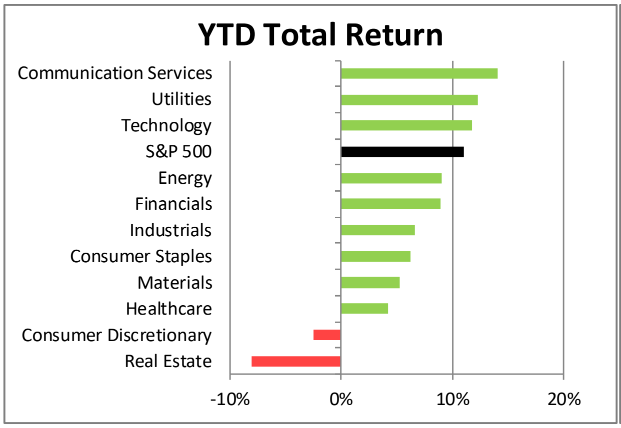
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$83.50	$83.60	-0.12%	
WTI	$79.29	$79.23	0.08%	
Natural Gas	$2.68	$2.67	0.41%	
12-mo strip crack	$21.61	$21.80	-0.87%	
Ethanol rack	$1.98	$1.97	0.32%	
Metals				
Gold	$2,338.04	$2,338.12	0.00%	
Silver	$31.35	$31.98	-1.96%	
Copper contract	$467.00	$479.10	-2.53%	
Grains				
Corn contract	$454.25	$455.25	-0.22%	
Wheat contract	$685.00	$692.75	-1.12%	
Soybeans contract	$1,213.00	$1,214.00	-0.08%	
Shipping				
Baltic Dry Freight	1,790	1,784	6	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.80		
Gasoline (mb)		-1.38		
Distillates (mb)		-0.46		
Refinery run rates (%)		0.4%		
Natural gas (bcf)		77		

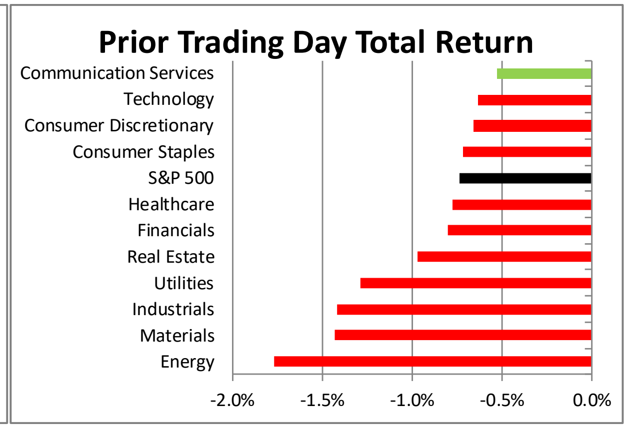
Weather

The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures west of the Mississippi River, in the Deep South, and in New England, with normal temperatures in the Midwest. The forecasts call for wetter-than-average conditions in the Southwest and the Northeast, with dry conditions in the northern Rocky Mountains and Great Plains.

Data Section

US Equity Markets – (as of 5/29/2024 close)

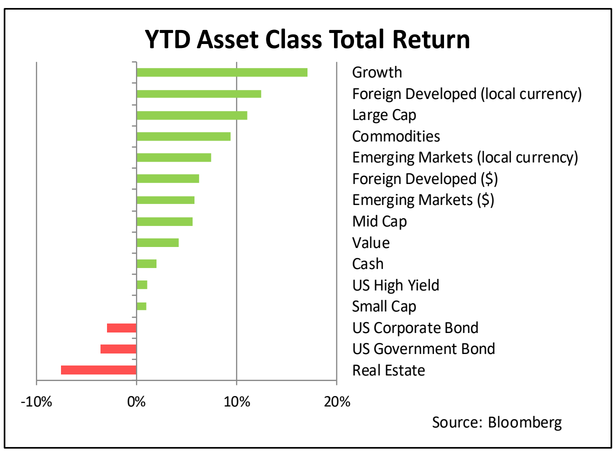




(Source: Bloomberg)

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 5/29/2024 close)

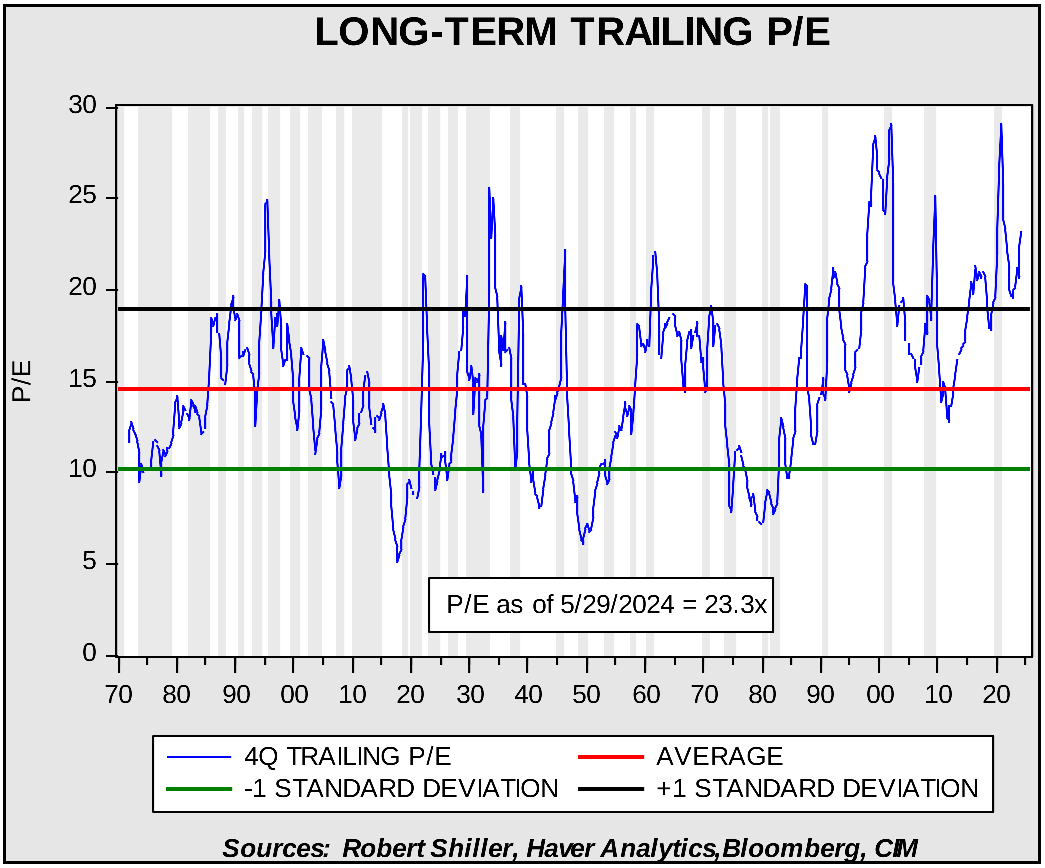


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

May 30, 2024



Based on our methodology,[1] the current P/E is 23.3x, up 0.1 from our last report. The increase in the multiple was due to an increase in the stock price index, outpacing the 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 (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.