Daily Comment

By Patrick Fearon-Hernandez, CFA, and Thomas Wash

[Posted: November 7, 2024 — 9:30 AM ET] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 closed up 0.8% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.2%. Chinese markets were higher, with the Shanghai Composite up 2.6% from its previous close and the Shenzhen Composite up 2.5%. US equity index futures are signaling a higher open.

With 414 companies having reported so far, S&P 500 earnings for Q3 are running at $62.50 per share, compared to estimates of $60.44, which is up 4.2% from Q3 2023. Of the companies that have reported thus far, 74.6% have exceeded expectations, while 18.2% 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 in bold:

Bi-Weekly Geopolitical Report	Asset Allocation Bi-Weekly	Asset Allocation Quarterly	Of Note
Rising US & Global Debt: A Perspective Check	The Inflation Adjustment for Social Security Benefits in 2025	Q4 2024	Asset Allocation Rebalance Presentation

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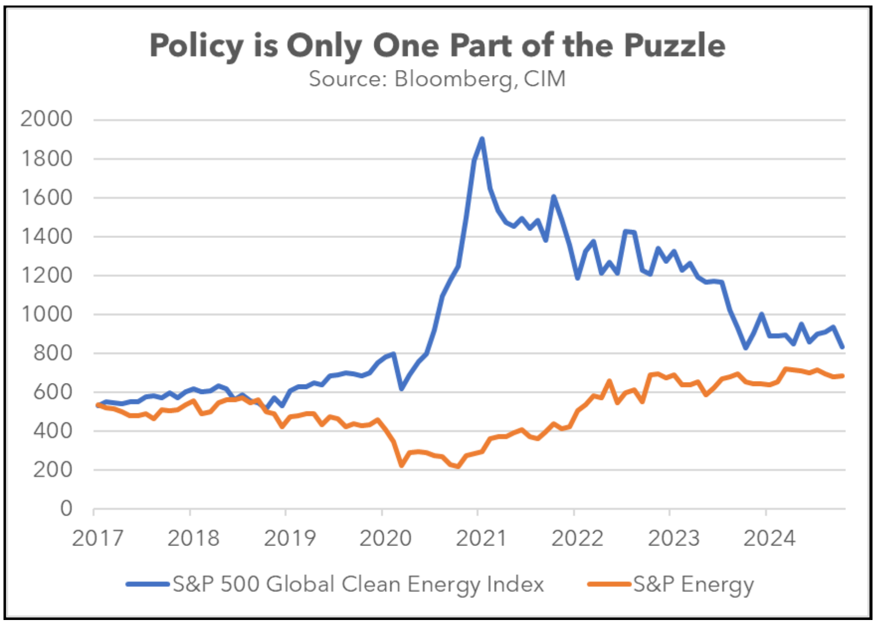
Good morning! The market is refocusing its attention on the Fed's rate decision later today. In sports news, the Golden State Warriors defeated the Boston Celtics. Today's *Comment* will discuss why investors should not be overly focused on policy agenda. We will also take a deep dive into why small cap stocks have been outperforming the overall market and explore the possibility of snap elections in Germany. As usual, the report will conclude with a roundup of international and domestic data releases.

Red Wave: The S&P 500 had its best post-election rise in history as investors prepare for a Republican takeover of the executive and legislative branches of government.

- Republicans are projected to secure 53 Senate seats and possibly exceed the 218-seat threshold needed to control the House. This anticipated shift has caught investors' attention, as control over both chambers of Congress means that lawmakers will face fewer obstacles in pushing through pro-growth measures such as tax cuts and the removal of regulations. Financials and Energy outperformed, as both sectors are expected to be big winners. Additionally, there is increasing optimism that AI will face less oversight, potentially boosting research and development in the tech space.

- While policy agendas can be influential, they don't always drive market returns. As JP Morgan Global Market Strategist Meera Pandit highlights, during Trump's first term, the S&P Global Clean Energy Index outperformed the S&P Energy Index, rising 275% compared to -40%, respectively. Conversely, under Biden, the overall energy index outperformed clean energy, returning 211% versus -54%, respectively. This happened despite Trump's pro-fossil-fuel stance and Biden's focus on clean energy. This contrast underscores the importance of looking beyond policy rhetoric to understand broader market forces.

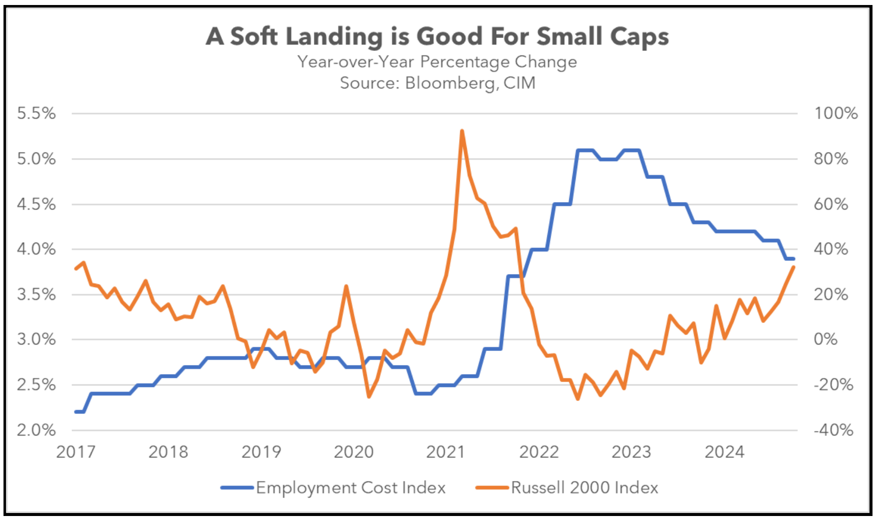


- A key risk during this period of policy optimism is that unfavorable market conditions could undermine the effectiveness of certain policies. While tax cuts will help boost earnings and consumption, the effects of policy changes are less clear. In short, although Republican influence on policy decisions is noteworthy, external factors such as trade relations, economic trends, and geopolitical tensions are likely to have a greater impact on sector returns. Therefore, investors should exercise some caution before participating in the current rally.

The Small Cap Rise: The Russell 2000 surged ahead of its larger peers as markets anticipate pro-growth policies from Trump's win.

- The day after Trump's victory, the Russell 2000 index surged nearly 6%, marking its largest post-election gain since the index began in 1978. This strong performance was no anomaly; the second-largest gain followed Trump's surprise win in 2016. The rally was fueled by expectations that Trump would push through tax cuts and remove restrictions that would help drive growth and boost corporate profits. Consequently, investors showed a heightened risk appetite, focusing on small cap Communication Services and Financials as the sectors are relatively cheap compared to its peers.

- A key difference between Trump's initial term and now is the changing macroeconomic landscape. While recent indicators show improvement, small cap companies still face strong headwinds, including high labor and borrowing costs and persistent inflation — all of which have pressured earnings growth. Continued market confidence in small cap stocks will largely depend on the Fed's ability to engineer a soft landing and achieve economic growth alongside declining inflation. This would likely boost revenues and reduce borrowing costs, thereby improving profitability.

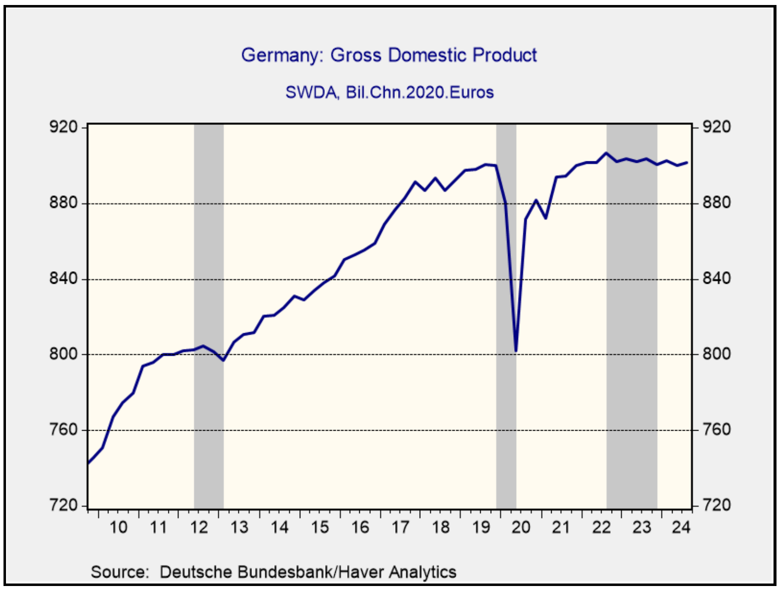


- While some initial optimism may wane in the coming weeks as investors seek further clarity from the administration, the long-term outlook for small cap stocks appears to be improving. Assuming the administration avoids more extreme policy actions, such as challenging the Fed's independence, the market is likely to view the election as a positive catalyst. This positive sentiment is expected to persist throughout much of 2025, as the Republican-led government is likely to hit the ground running by removing burdensome regulations and implementing tax cuts.

Germany on the Cusp: The German government teeters on the edge of collapse as the ruling coalition's deep divisions are proving to be insurmountable.

- On Wednesday, German Chancellor Olaf Scholz dismissed Finance Minister Christian Lindner over disagreements on spending and economic reforms. This decision effectively removes the fiscally conservative Free Democrat Party from the coalition and paves the way for a no-confidence vote scheduled for mid-January. If Scholz loses, which is highly probable, then there would likely be snap elections in March. Polls show that the right-wing [Christian Democrats (CDU) and the anti-immigration Alternative for Germany (AfD)] are the two most popular parties, with the Social Democratic Party (SPD) in third.

- The collapse of the coalition government coincides with a period of significant economic weakness. [Industrial production has stagnated since 2017], and annual GDP growth is on track to fall for the second consecutive year. Factory activity has notably plummeted, with key sectors like automotive, chemical, and engineering experiencing sharp declines. These issues have been exacerbated by high energy costs, elevated labor expenses, and insufficient infrastructure investment. While consumer sentiment has improved due to easing inflationary pressures, it remains relatively low.

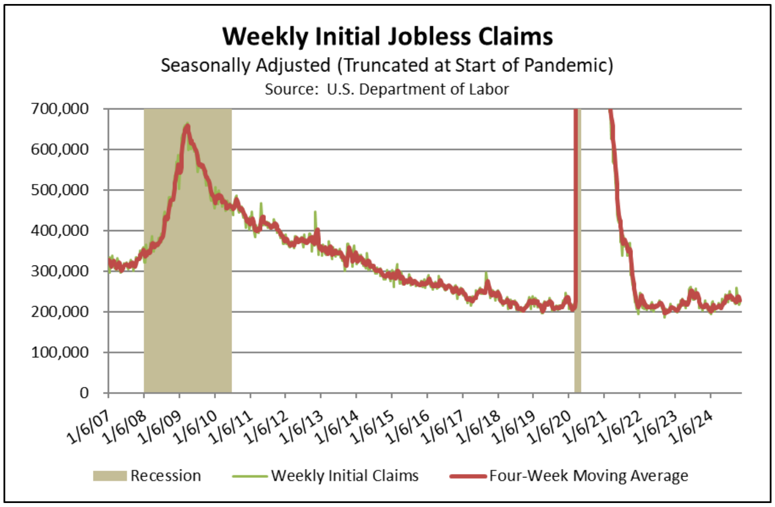


- New elections could boost right-wing parties, but their ability to form a government remains uncertain. The center-right CDU's refusal to ally with the far-right AfD means it would need significant support and partnerships with smaller parties to secure a majority. Alternatively, a coalition could emerge between the Social Democratic Party and the rising left-wing alliance led by Sahra Wagenknecht. The composition of Germany's next government will impact equities, with a CDU-led government generally viewed as the most market-friendly outcome.

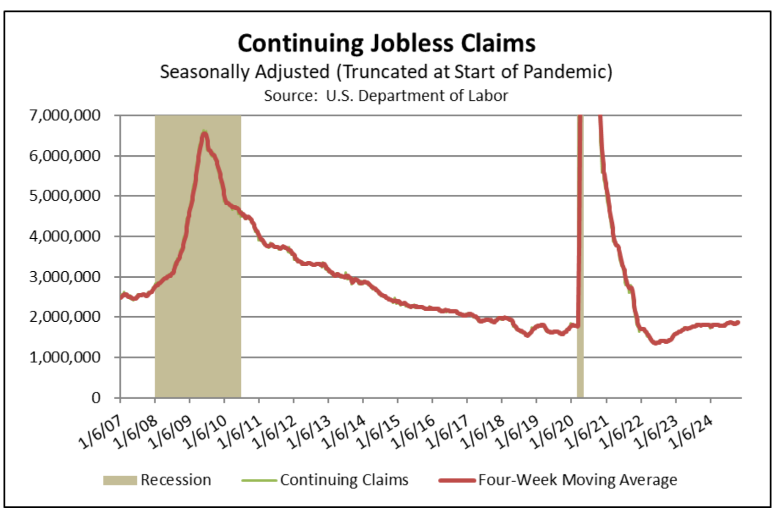
In Other News: Mitch McConnell has [expressed his belief that the filibuster will remain in place if the GOP takes control] of both the House and the Senate. The Bank of England [has cut its policy rate by 25 basis points] but did not indicate any further rate changes for this year. In October, [Chinese exports grew by 12.7% year-over-year,] marking the fastest pace of growth since 2022.

US Economic Releases

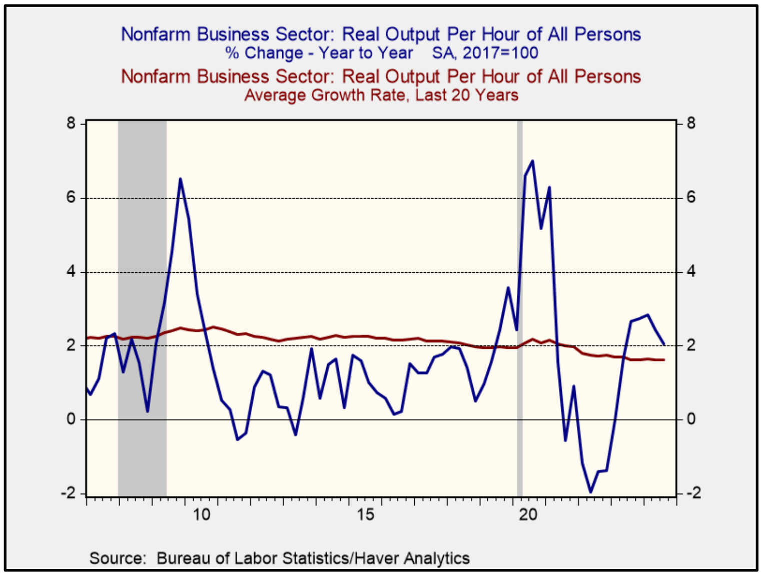
In the week ended November 2, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 221,000 from the previous week's 218,000 and virtually matching the expected 222,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to 227,250. 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.



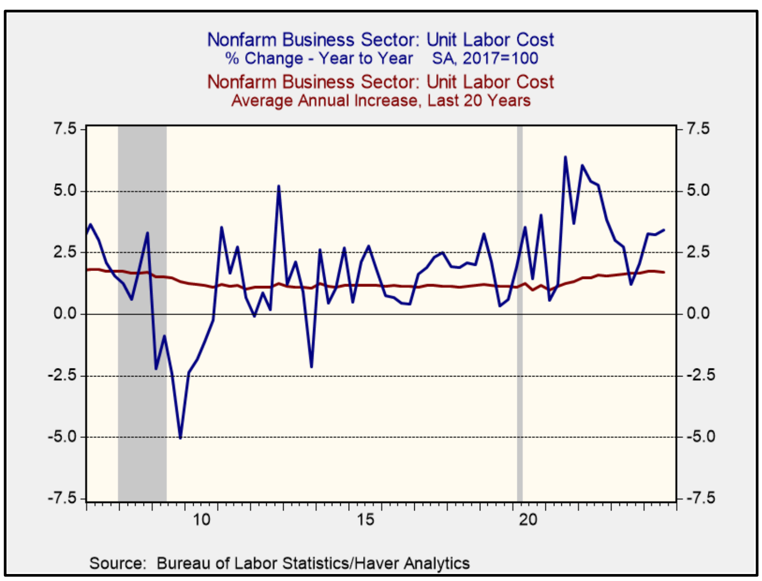
In the week ended October 26, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to a seasonally adjusted 1.892 million from the previous week's 1.853 million and exceeding the expected 1.873 million. The four-week moving average of continuing claims fell to 1.875 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.



Another 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, third quarter ***nonfarm productivity*** rose at an annualized rate of 2.2%, slightly faster than last quarter's 2.1% but falling short of the expected 2.5%. Taking into account the fluctuations in each of the last four quarters, productivity in the third quarter rose 2.05% from the same period one year earlier. The chart below shows the year-over-year growth in real productivity over the last 25 years or so.



Third quarter ***unit labor costs*** rose at an annualized rate of 1.9%, decelerating from the previous quarter's 2.4% but exceeding the expected 1.0% increase. Unit labor costs in the third quarter rose 3.41% year-over-year. The chart below shows the year-over-year growth in unit labor costs since just before the Global Financial Crisis.



The table below lists the economic releases and Fed events scheduled for the rest of the day.

Economic Releases						
ET	Indicator			Expected	Prior	Rating
10:00	Wholesale Inventories	m/m	Sep F	-0.1%	-0.1%	**
10:00	Wholesale Trade Sales	m/m	Sep	0.1%	-0.1%	*
14:00	Consumer Credit	m/m	Jul	$12.173b	$8.929b	*
14:00	FOMC Rate Decision (Lower Bound)	w/w	7-Nov	4.5%	4.8%	***
14:00	FOMC Rate Decision (Upper Bound)	w/w	7-Nov	4.8%	5.0%	***
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								
Japan	Labor Cash Earnings	y/y	Sep	2.8%	2.8%	3.0%	**	Equity and bond neutral
	Real Cash Earnings	m/m	Sep	-0.1	-0.8	0.1	*	Equity and bond neutral
Australia	Trade Balance	m/m	Sep	A$4609m	A$5284m	A$5274m	***	Equity and bond neutral
	Exports	m/m	Sep	-4.3%	-0.6%		*	Equity bearish, bond bullish
	Imports	m/m	Sep	-3.1%	-0.2%		*	Equity and bond neutral
South Korea	BoP Current Account Balance	m/m	Spe	$11124.4m	6517.6m		**	Equity and bond neutral
	BoP Goods Balance	m/m	Sep	$10670.2m	$6516.1m		*	Equity and bond neutral
China	Exports	y/y	Oct	12.7%	2.4%	5.0%	**	Equity bullish, bond bearish
	Imports	y/y	Oct	-2.3%	0.3%	-2.0%	**	Equity and bond neutral
	Trade Balance	m/m	Oct	$95.72b	$81.71b	$75.00b	***	Equity and bond neutral
	Foreign Reserves	m/m	Oct	$3261.05b	$3316.37b	$3286.00b	**	Equity and bond neutral
EUROPE								
Eurozone	Retail Sales	y/y	Sep	2.9%	2.4%	1.3%	*	Equity bullish, bond bearish
Germany	Industrial Production WDA	y/y	Sep	-4.6%	-3.0%	-3.0%	**	Equity bearish, bond bullish
	Trade Balance	m/m	Sep	17.0b	21.4b	20.9b	*	Equity and bond neutral
	Exports	m/m	Sep	-1.7%	1.2%	-2.4%	*	Equity bullish, bond bearish
	Imports	m/m	Sep	2.1%	-2.6%	0.6%	*	Equity bullish, bond bearish
	HCOB Germany Construction PMI	m/m	Oct	40.2	41.7		*	Equity and bond neutral
Switzerland	Foreign Currency Reserves	m/m	Oct	718.8b	715.7b		*	Equity and bond neutral
AMERICAS								
Mexico	CPI	y/y	Oct	4.76%	4.58%	4.74%	***	Equity and bond neutral
	Core CPI	y/y	Oct	3.80%	3.91%	3.85%	**	Equity and bond neutral
Brazil	Trade Balance	m/m	Oct	$4343m	$5023m	$4600m	**	Equity and bond neutral
	Exports	m/m	Oct	$29462m	$28423m	$30400m	*	Equity and bond neutral
	Imports	m/m	Oct	$25119m	$23400m	$25700m	*	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)	485	485	0	Down
3-mo T-bill yield (bps)	442	443	-1	Down
U.S. Sibor/OIS spread (bps)	451	452	-1	Down
U.S. Libor/OIS spread (bps)	448	450	-2	Down
10-yr T-note (%)	4.42	4.43	-0.01	UP
Euribor/OIS spread (bps)	305	306	-1	Down
Currencies	**3 Mo**			
Dollar	Down	US		Down
Euro	Down	Euro		Up
Yen	Up	Japan		Up
Pound	Up	UK		Up
Franc	Up	Switzerland		Up
Central Bank Action	**Actual**	**Prior**	**Expected**	
Bank of England Bank Rate	4.750%	5.000%	4.750%	On Forecast
Brazil Selic Rate	11.250%	10.750%	11.250%	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.

	Price	Prior	Change	Explanation
Energy Markets				
Brent	$74.36	$74.92	-0.75%	
WTI	$70.96	$71.69	-1.02%	
Natural Gas	$2.77	$2.75	0.80%	
12-mo strip crack	$20.25	$20.29	-0.20%	
Ethanol rack	$1.75	$1.75	0.03%	
Metals				
Gold	$2,672.79	$2,659.06	0.52%	
Silver	$31.28	$31.18	0.33%	
Copper contract	$434.30	$424.60	2.28%	
Grains				
Corn contract	$427.00	$426.25	0.18%	
Wheat contract	$576.00	$573.25	0.48%	
Soybeans contract	$1,013.50	$1,003.75	0.97%	
Shipping				
Baltic Dry Freight	1,427	1,405	22	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	2.15	-0.09	2.24	
Gasoline (mb)	0.41	-0.52	0.93	
Distillates (mb)	2.95	-0.50	3.44	
Refinery run rates (%)	1.4%	0.6%	0.9%	
Natural gas (bcf)		68		

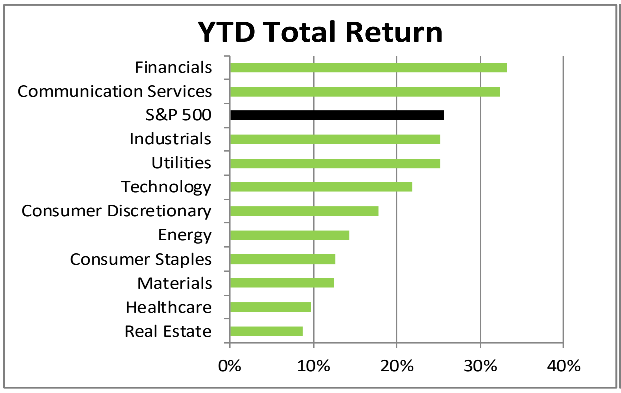
Weather

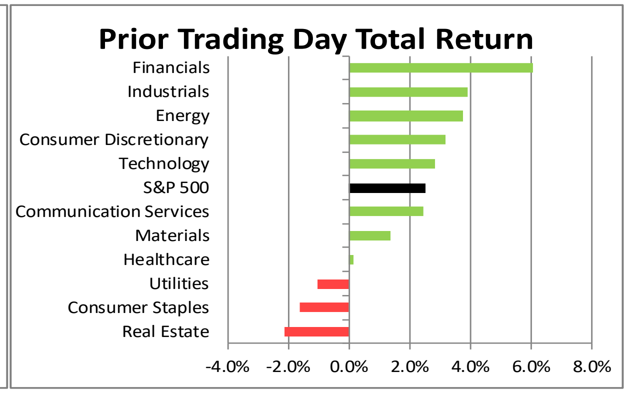
The 6-to-10-day and 8-to-14-day forecasts currently call for warmer-than-normal temperatures from the Great Plains to the East Coast, with cooler-than-normal temperatures in the Pacific and Rocky Mountain regions. The precipitation outlook calls for wetter-than-normal conditions throughout most states with normal conditions in Texas, New England, and the upper Atlantic Coast.

Hurricane Rafael has transited Cuba and is entering the Gulf of Mexico. The system is slowly meandering westward in the general direction of Mexico. Meanwhile, a second tropical disturbance has formed just west of the Leeward Islands and has a 20% chance of cyclonic formation within the next 48 hours.

Data Section

US Equity Markets – (as of 11/6/2024 close)

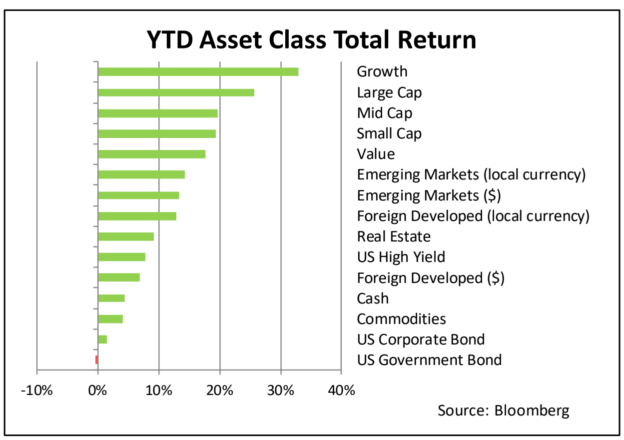




(Source: Bloomberg)

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 11/6/2024 close)

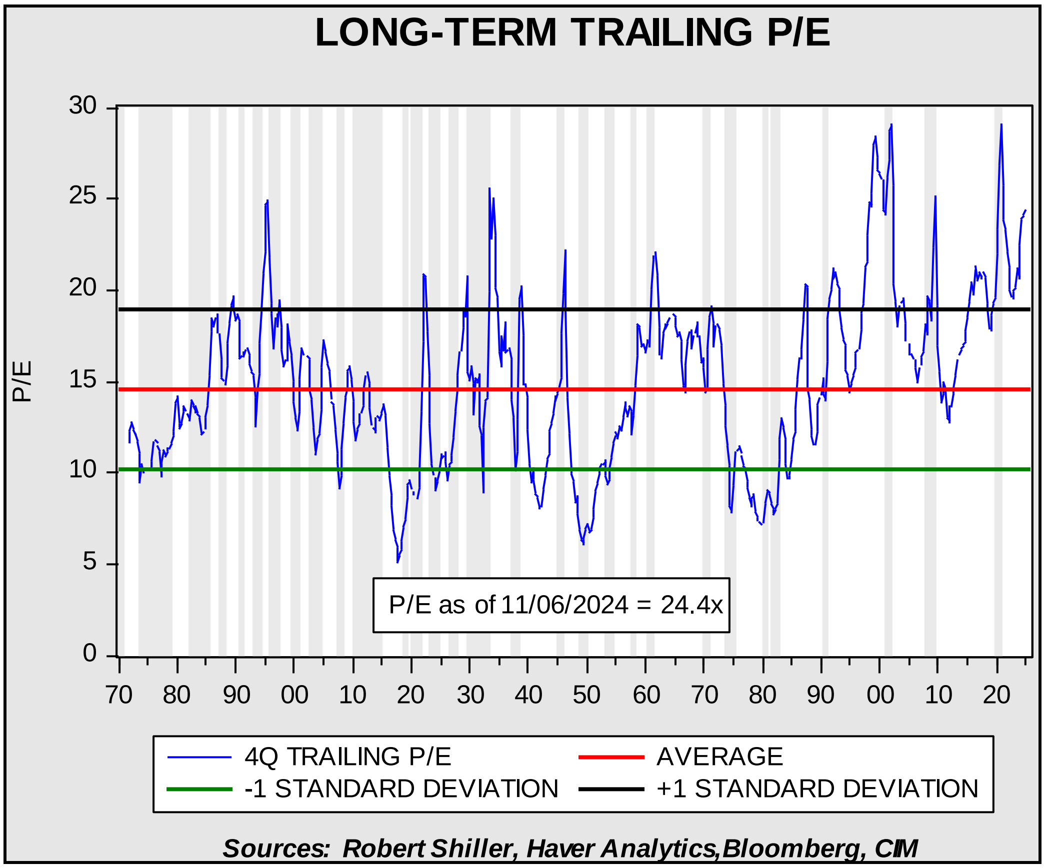


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

November 7, 2024



Based on our methodology,[1] the current P/E is 24.4x, down 0.1 from our last report. The stock price index increase was offset by a relatively larger 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.