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: October 10, 2024 — 9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is down 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.0%. Chinese markets were mixed, with the Shanghai Composite up 1.3% from its previous close and the Shenzhen Composite down 0.4%. 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:

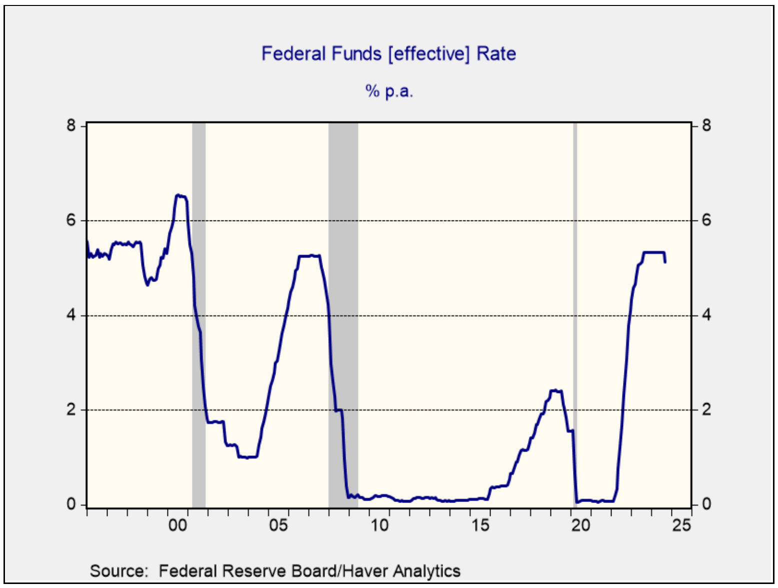
- *Bi-Weekly Geopolitical Report* (10/7/2024) (with associated podcast): "The US Presidential Election: Foreign Policy Implications"
- *Asset Allocation Bi-Weekly* (9/30/2024) (with associated podcast): "Presidential Cycles and Stock Performance"
- *Asset Allocation Quarterly – Q3 2024* (7/16/2024): Discussion of our asset allocation process, Q3 2024 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q3 2024 Rebalance Presentation* (8/6/2024): Video presentation featuring the Asset Allocation Committee as they review the asset allocation strategies, recent portfolio changes, and the current macro environment.
- *Confluence of Ideas podcast* (9/11/2024) "Reviewing the Asset Allocation Rebalance: Q3 2024"
- *Fixed Income Quarterly* (September 2024)

Good morning! The market is still processing the latest inflation data. In sports news, the New York Mets defeated the Philadelphia Phillies to move on to the NLCS. Today's *Comment* will discuss the latest FOMC meeting minutes, explain why the dollar is strengthening, and give our thoughts about Japanese elections later this month. As usual, our report will conclude with a round up international and domestic data releases.

Employment Not Inflation: The Federal Reserve cut interest rates by 50 basis points due to concerns about a weakening labor market and confidence in ongoing inflation progress.

- As detailed in the September 17-18 meeting minutes, Fed officials expressed concern about the labor market following two consecutive jobs reports that indicated a slowdown in hiring and job openings, with a rise in the unemployment rate. Additionally, the recent summer PCE price index reports, which showed that inflation rates were aligning with the 2% target, reinforced the Fed's belief that inflation was making steady strides towards its goal. As a result, the FOMC determined that the risk to its maximum employment mandate had risen to the same level as its price stability mandate.

- Although Michelle Bowman was the lone dissenter who advocated instead for a smaller rate cut, several other Fed members also expressed support for a more measured approach. Their reluctance stemmed from concerns about the reliability of the labor market data, given the influx of immigration and the frequent revisions to the payroll data. Additionally, uncertainty surrounding the determination of the neutral interest rate — the level at which the economy neither expands nor contracts — contributed to their cautious stance, as many believed it could send the wrong signal about the pace of the Fed's easing cycle.

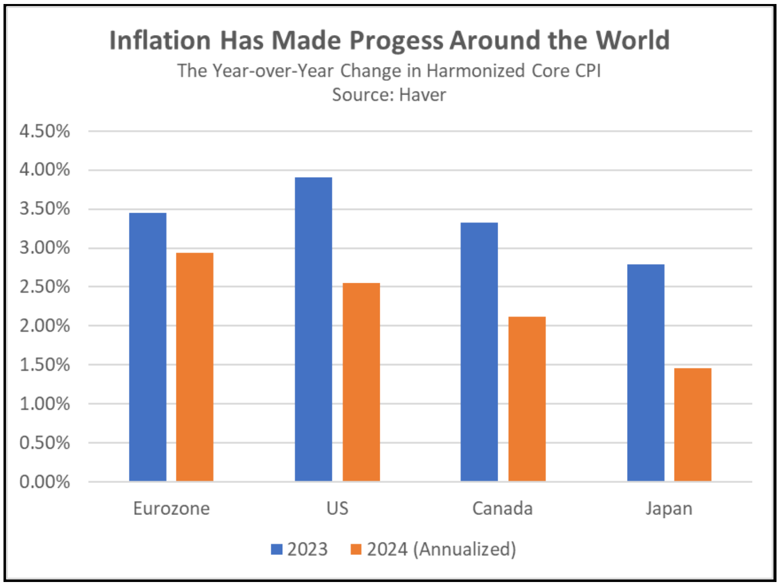


- Based on the meeting minutes, we anticipate that the Fed will gradually loosen monetary policy in the coming months, contingent upon the ongoing deceleration of inflation toward the 2% target. However, a more aggressive rate cut would likely be triggered by a deterioration in the labor market rather than by more progress toward the inflation target. As a result, we project that the Fed could decrease rates by an additional 25-50 basis points this year. This is likely not going to have a major impact on equities but could affect short to intermediate bonds.

Attitudes Are Changing: While the Fed has tapered expectations of policy easing, other central banks have gone in the opposite direction.

- The European Central Bank (ECB) is expected to cut interest rates for a third time this year at its October 17 meeting. The drop in interest rates comes as the region suffers through an economic slowdown, but inflation is still making progress toward its 2% target. Germany, the largest economy in the region, has lowered its GDP growth forecast as it braces for a deeper economic downturn in the coming months. Meanwhile, the EU's headline inflation has dropped below 2% for the first time since July 2021.

- Central banks worldwide are increasingly adopting a more accommodative monetary stance. It is anticipated that the Bank of Canada will reduce interest rates by 50 basis points in both October and December, reflecting concerns over slowing economic growth. In Japan, despite rising inflation, concerns about consumer spending have prompted the central bank to consider postponing further rate hikes until January 2025. This change in sentiment has boosted the US dollar as investors have become less confident in the narrowing of interest rate differentials with the United States.

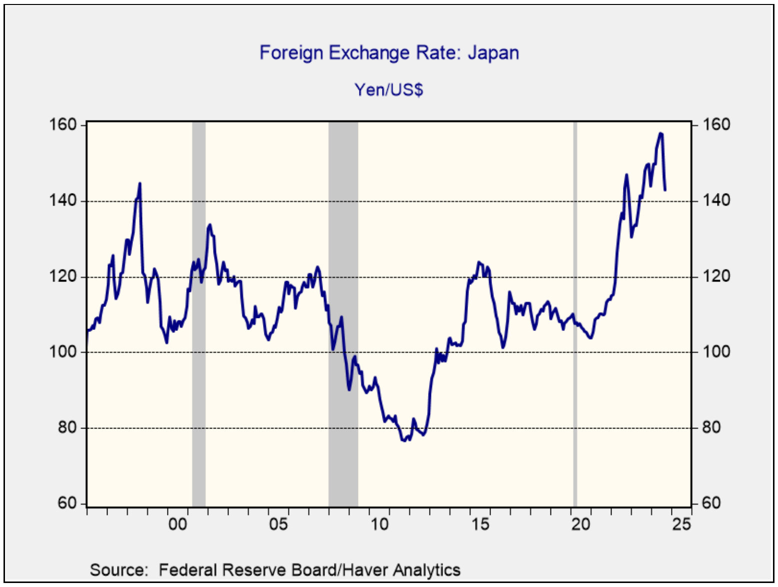


- With the initial phase of interest rate cuts behind us, central bankers are likely to prioritize the future trajectory of monetary policy. Given the current inflation rate and poor economic outlook, the ECB and the Bank of Canada are expected to implement most of their rate cuts early in this cycle. In contrast, the Bank of Japan may resume rate hikes at the beginning of the year. Assuming the Federal Reserve does not reverse course due to an unexpected rise in inflation, the US dollar is likely to weaken slightly during this monetary cycle.

Elections in Japan: A week after taking over, Prime Minister Shigeru Ishiba is already looking to consolidate his party's hold on the lower house.

- Ishiba dissolved the lower house of parliament on Wednesday, paving the way for snap elections on October 27. The swift decision aims to capitalize on a recent surge of optimism following his rise to leadership. Seen as having a cleaner image than his predecessor Fumio Kishida (who resigned after a series of political scandals), Ishiba enjoys an approval rating of around 50%, significantly higher than Kishida's, which fell below 20% in some polls. Despite the uptick in sentiment, his approval rating remains low when compared to previous leaders in Japan after taking office.
- Japan is experiencing an economic slowdown, with over a third of companies expecting to miss their first-half earnings projections, according to a Reuters survey. This downturn

aligns [with the highest number of bankruptcies since 2013], which was recorded this month. Small businesses have been hit particularly hard and are facing sluggish sales and rising costs that squeeze profit margins. In response to the economic weakness, Ishiba, known for his hawkish stance, has advised the Bank of Japan to pause any further rate hikes as households are still reluctant to spend after years of deflation.

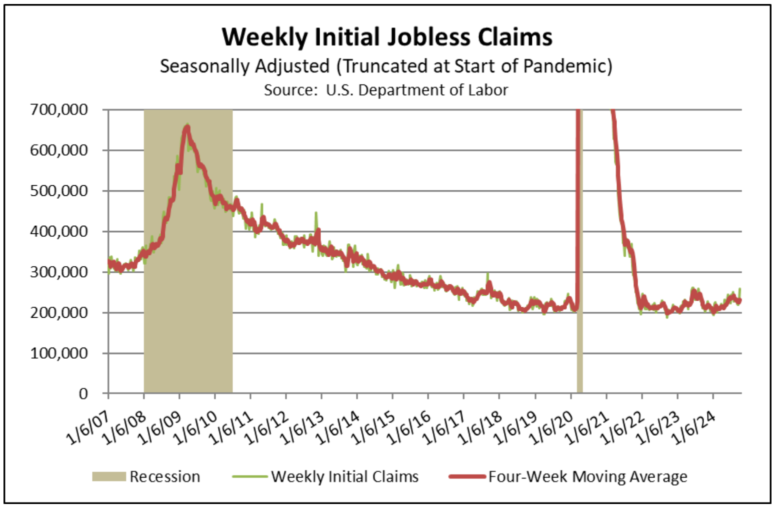


- The upcoming election this month is not expected to significantly change the composition of the lower house, but it could provide momentum for the upper house elections next year. The ruling LDP currently holds 258 seats and has a coalition with an additional 28 seats, surpassing the 233 seats needed to maintain majority in the lower house. If the party can retain its majority, it will be well-positioned to maintain power in the upcoming contests next year. Given that Ishiba is expected to carry out the mission of his predecessor, this should be favorable to markets.

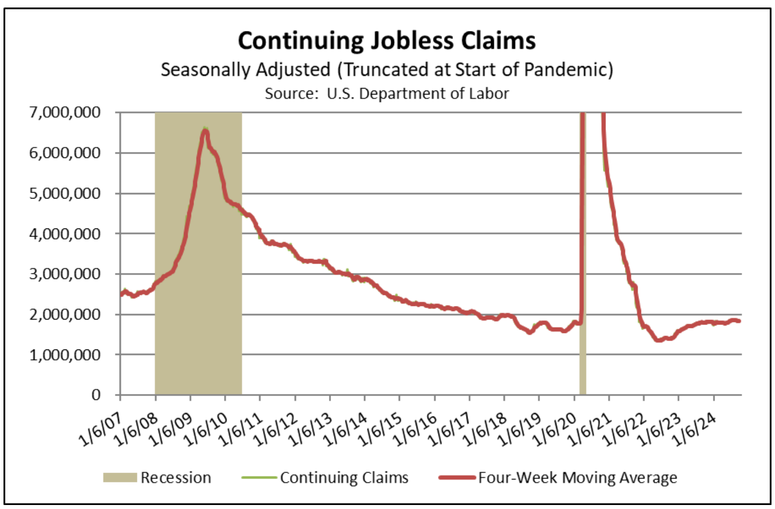
In Other News: FTC Chair Lina Khan's position will be uncertain under the next administration, as some donors push for her removal while lawmakers advocate for her to stay. In Florida, widespread blackouts followed Hurricane Milton, and the damage is expected to affect this month's payroll data. Meanwhile, former President Donald Trump has pledged to eliminate double taxation on foreign expats, signaling plans to expand his tax cut agenda if he wins the November election.

US Economic Releases

In the week ended October 5, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 258,000, much higher than both the expected level of 230,000 and the previous week's level of 225,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose more modestly to 231,000. 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.

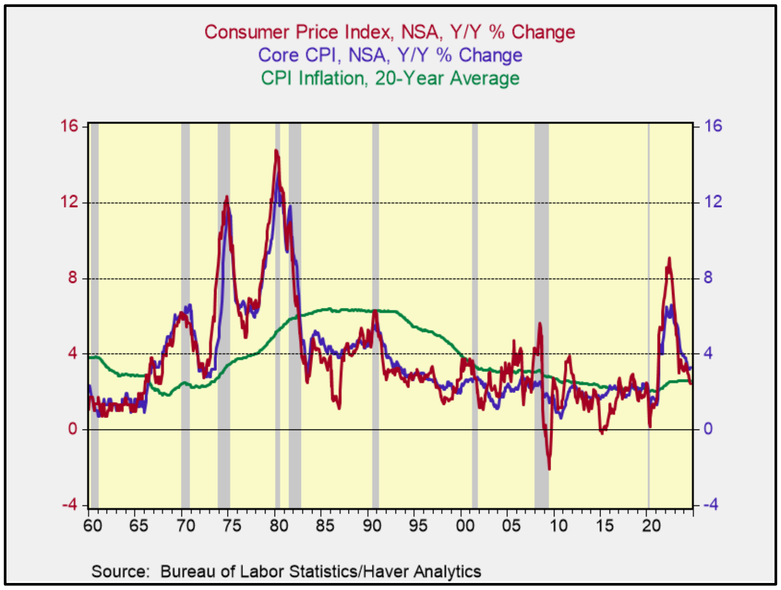


In the week ended September 28, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to a seasonally adjusted 1.861 million, above both the anticipated reading of 1.830 million and the prior week's revised reading of 1.819 million. The four-week moving average of continuing claims rose slightly to 1.832 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.



Separately, the September ***consumer price index (CPI)*** rose by a seasonally adjusted 0.2%, double the expected rise of 0.1% but matching its August increase. Excluding the volatile food and energy components, the ***"core" CPI*** rose 0.3%, above the anticipated rise of 0.2% but also matching its August increase. The unexpectedly big increases in average prices stemmed in large part from elevated housing and healthcare services costs. The overall CPI in September was up

2.4% from the same month one year earlier, cooling slightly from the 2.5% increase in the year to August. However, the core CPI was up 3.3%, accelerating from the annual rise of 3.2% in the previous month. The chart below shows the year-over-year change in the CPI and the core CPI since 1960.



Finally, now that the CPI data for the entire third quarter is available, the Social Security Administration will soon issue its cost-of-living adjustment for Social Security benefits in 2025. With today's data, we expect the COLA to be approximately 2.6%.

The following table lists the economic releases or Fed events scheduled for the rest of the day.

Economic Releases		
No economic releases for the rest of today		
Federal Reserve		
ET	**Speaker or Event**	**District or Position**
9:15	Lisa Cook Speaks on Entrepreneurship	Member of the Board of Governors
10:30	Thomas Barkin Speaks in Fireside Chat	President of the Federal Reserve Bank of Richmond
11:00	John Williams Gives Keynote Remarks	President of the Federal Reserve Bank of New York

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	PPI	y/y	Sep	2.8%	2.6%	2.3%	***	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	4-Oct	¥696.7b	-¥55.8b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	4-Oct	¥257.8b	¥16.1b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	4-Oct	¥1379.2b	¥209.6b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	4-Oct	¥919.3b	¥767.6b		*	Equity and bond neutral
EUROPE								
Germany	Retail Sales	y/y	Aug	2.4%	1.8%		*	Equity and bond neutral
Italy	Industrial Production WDA	y/y	Aug	-3.2%	-3.3%	-3.1%	***	Equity and bond neutral
UK	RICS House Price Balance	y/y	Sep	11.00%	1.00%	10.00%	**	Equity and bond neutral
AMERICAS								
Brazil	Retail Sales	y/y	Aug	5.1%	4.4%	4.2%	***	Equity bullish, bond bearish

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)	453	454	-1	Down
U.S. Sibor/OIS spread (bps)	467	468	-1	Down
U.S. Libor/OIS spread (bps)	464	465	-1	Down
10-yr T-note (%)	4.09	4.07	0.02	Up
Euribor/OIS spread (bps)	322	327	-5	Down
Currencies	**Direction**			
Dollar	Down			Down
Euro	Flat			Up
Yen	Up			Up
Pound	Up			Up
Franc	Up			Up

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	$77.51	$76.58	1.21%	
WTI	$74.17	$73.24	1.27%	
Natural Gas	$2.62	$2.66	-1.62%	
12-mo strip crack	$20.38	$20.27	0.55%	
Ethanol rack	$1.74	$1.74	-0.21%	
Metals				
Gold	$2,613.66	$2,607.77	0.23%	
Silver	$30.61	$30.50	0.36%	
Copper contract	$439.85	$439.95	-0.02%	
Grains				
Corn contract	$422.75	$421.00	0.42%	
Wheat contract	$607.25	$599.00	1.38%	
Soybeans contract	$1,018.75	$1,020.25	-0.15%	
Shipping				
Baltic Dry Freight	1,799	1,860	-61	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	5.81	1.60	4.21	
Gasoline (mb)	-6.30	-1.00	-5.30	
Distillates (mb)	3.12	-1.75	4.88	
Refinery run rates (%)	-0.9%	0.0%	-0.9%	
Natural gas (bcf)		76		

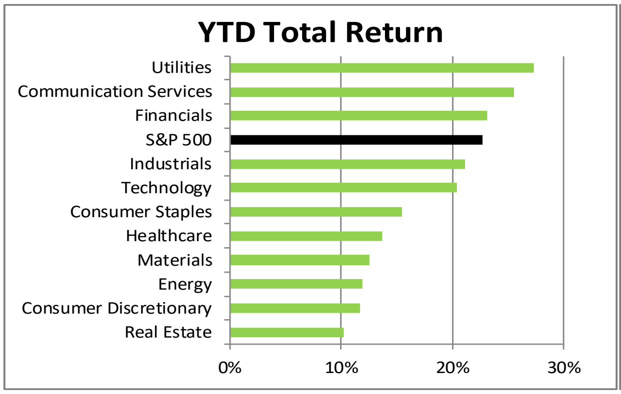
Weather

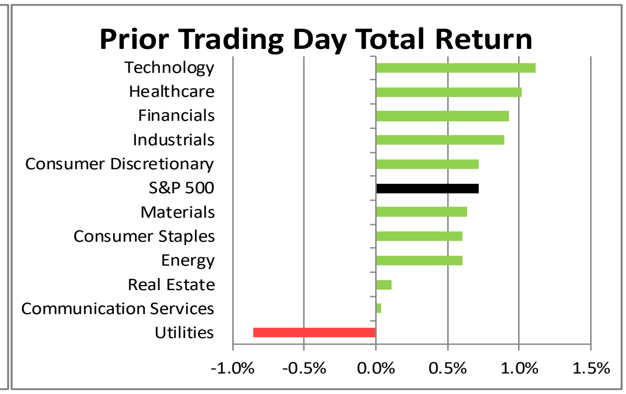
The 6-to-10-day and 8-to-14-day forecasts currently call for warmer-than-normal temperatures across the western half of the country, with near-normal temperatures in the southeast. The forecasts call for wetter-than-normal conditions in the Pacific Northwest and Florida, with dry conditions in the Mississippi Valley region, the Midwest, and the Northeast.

Hurricane Milton this morning is roaring eastward across Florida and is reportedly causing great destruction from its high winds, storm surge, and flooding. There is also a tropical disturbance in the western Atlantic Ocean south-southwest of Bermuda, and it is assessed to have a 40% chance of forming a hurricane within the next 48 hours. Finally, Hurricane Leslie is traveling northward through the central Atlantic Ocean, but it is not expected to make landfall before it dissipates.

Data Section

US Equity Markets – (as of 10/9/2024 close)

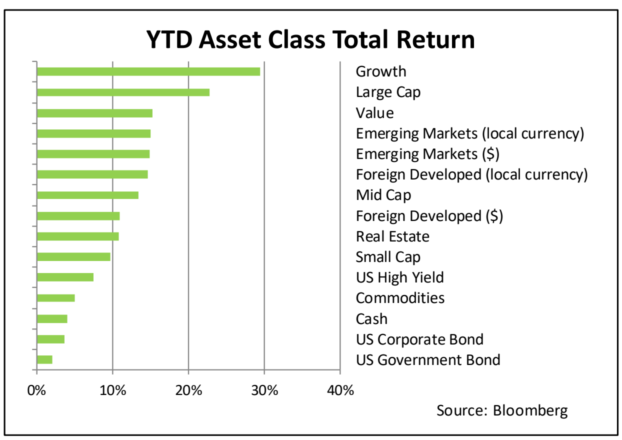




(Source: Bloomberg)

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 10/9/2024 close)

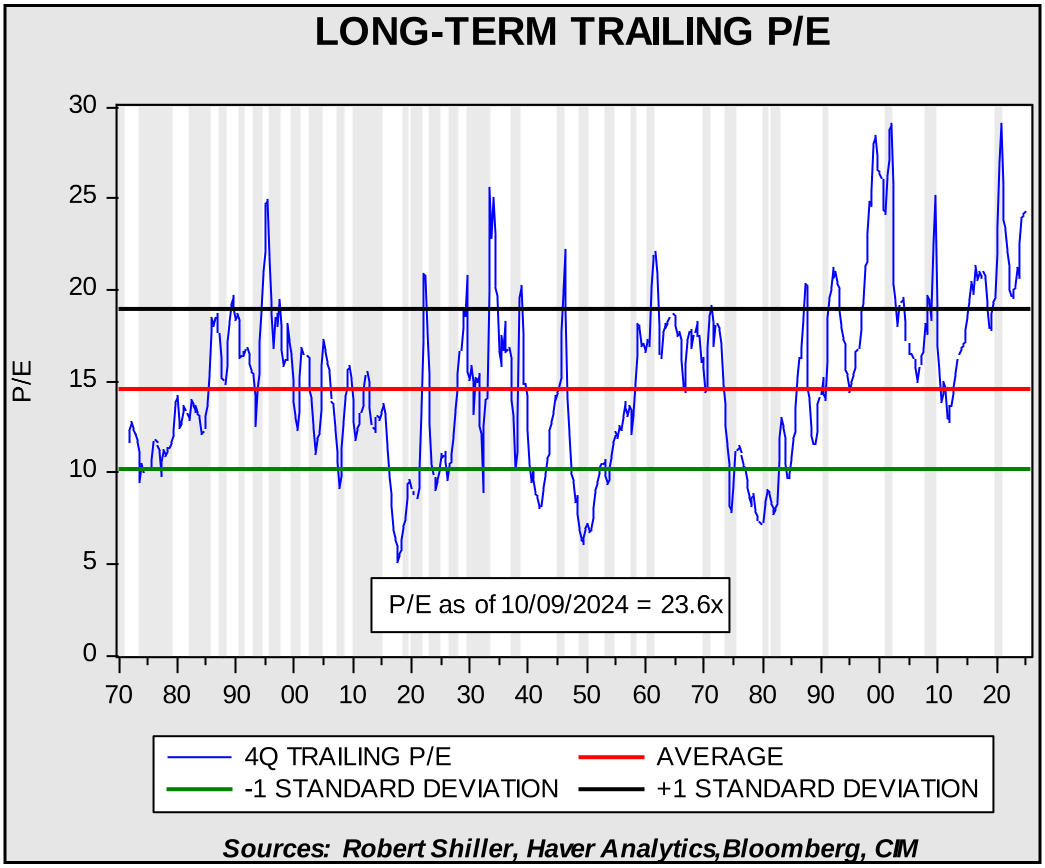


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

October 10, 2024



Based on our methodology,[1] the current P/E is 23.6x, up 0.6 from our last report. The stock price index increased slightly, while earnings were revised upward.

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.