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 15, 2024 — 9:30 AM ET] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 closed down 0.4% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.0%. Chinese markets were lower, with the Shanghai Composite down 2.5% from its previous close and the Shenzhen Composite down 2.1%. US equity index futures are signaling a slightly lower open.

With 29 companies having reported so far, S&P 500 earnings for Q3 are running at $60.70 per share, compared to estimates of $60.44, which is up 4.2% from Q3 2023. Of the companies that have reported thus far, 97.8% have exceeded expectations while 1.2% 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 emphasized in bold:

- *Bi-Weekly Geopolitical Report* (10/7/2024) (with associated podcast): "The US Presidential Election: Foreign Policy Implications"
- *Asset Allocation Bi-Weekly* (10/14/2024) (with associated podcast): "The Yield Curve Un-Inverts"
- *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)

Our *Comment* today opens with news that Israel has agreed to strike only military targets in its expected attack on Iran, sparing oil and nuclear facilities. Global oil prices have therefore fallen sharply so far today. We next review several other international and US developments with the potential to affect the financial markets today, including heightened political tensions between India and Canada and a few words about the evolving military drone industry in the US.

Israel-Iran: According to a report in the *Washington Post* late yesterday, Israeli Prime Minister Netanyahu has told the US that his forces will only launch retaliatory strikes against Iranian military targets, rather than its oil or nuclear facilities. The report also said the Israeli attack would be calibrated to avoid the perception of political interference in the US elections.

- The suggestion that Tel Aviv is willing to exercise restraint after Iran's latest missile attack has reduced the risk of a broader regional war that could cut global oil supplies.
- As a result, global oil prices so far this morning have fallen sharply. Near Brent futures are currently down 3.9% to $74.43 per barrel, while WTI futures are trading down 4.2% to $70.75 per barrel.

China-Taiwan: Despite the welcome sign of cooling tensions in the Middle East, the Chinese military yesterday conducted large-scale exercises around Taiwan to retaliate for Taiwanese President Lai's speech last week asserting the island's sovereignty. Amid the drills, the Chinese military issued a statement saying, "This is a stern warning to the secession forces advocating 'Taiwan independence.'"

- Beijing's reaction to Lai's speech shows the extent to which Taiwan's moves to assert its sovereignty could provoke a Chinese military response.
- Of course, a strong Chinese military response could ultimately draw the US into a conflict in the Western Pacific Ocean.

Russia-Germany: In another reminder of today's continuing geopolitical tensions, the head of Germany's domestic intelligence agency yesterday told parliament that increasingly aggressive Russian agents had tried to sabotage a domestic airline flight earlier this year. The agents apparently got a parcel rigged to start a fire into the cargo hold of an airliner, but it burst into flames too early and didn't cause a crash.

- The statement shows how Russian intelligence tactics are increasingly approaching the level of state-sponsored terrorism.
- The risk is that a successful attack could spark an international security crisis that would be highly disruptive to the global economy and financial markets.

Poland-European Union: Over the weekend, Polish Prime Minister Donald Tusk said his government will suspend immigrants' right to asylum, making Poland the latest EU country to unilaterally curb migration. According to Tusk, the suspension is needed because Russia and Belarus are conspiring to send waves of migrants across the border to destabilize his country. The move is also in sync with widespread popular resistance to migration among EU citizens, but it will likely set up a clash with EU officials in Brussels.

Italy: The government of right-wing populist Prime Minister Meloni is reportedly in talks with the country's banks to temporarily raise their taxes. The potential tax hikes would help cut Italy's budget deficit down to the 3% of gross domestic product required by the EU. Of the 9 billion EUR ($9.82 billion) in tax hikes or spending cuts needed to meet the EU's requirements in 2025, about one-third is expected to come from the nation's banks. However, the liberal Forza Italia party, which is a member of the coalition government, is resisting further taxes on companies.

Canada-India: Ottawa yesterday [declared six top Indian diplomats *personae non grata*] and expelled them over allegations they had collected intelligence on Canadian Sikhs and targeted them for violence. In response, the Indian government expelled six Canadian diplomats. The expulsions are the latest results of India's assassination of a Canadian Sikh separatist in British Columbia last year.

US Monetary Policy: Fed board member Christopher Waller yesterday said the monetary policymakers should exercise caution in cutting interest rates after last week's report that September consumer price inflation was higher than expected and an earlier report that labor demand in September was more robust than anticipated. The statement confirms our view that the Fed will now cut rates much more gradually than its 50-basis-point cut last month.

US Defense Industry: Since the Russia-Ukraine war has shown that small, inexpensive drones are now key military systems for reconnaissance and attack, new reports suggest the US Army will soon need to buy thousands of drones per year just for training purposes. As it tries to figure out how to best use drones in war, the Army is now testing small drones and drone-operating units in three different brigades.

- Experience to date suggests each of the Army's 59 active-duty and National Guard brigades would need at least 50 small drones, and perhaps more than 100, for training. That implies a total fleet of 3,000 to 6,000 drones. Army officials assume about 25% of those drones would be lost each year, implying annual replacement buys of 750 to 1,500. Those totals don't include the Army's purchases of bigger, heavier drones or purchases by the Navy, Marines, and Air Force.
- Of course, the Russia-Ukraine war shows that the military would need to buy multiples of those figures to prepare for a potential war. It would also need to invest in the surge capacity to produce enormous numbers of drones of various types. For comparison, Ukrainian President Zelensky recently said his country's defense industry has now developed the capacity to produce 4 million drones per year.
- We continue to believe worsening geopolitical tensions will spur increased defense budgets around the world. However, purchases of big, heavy, expensive systems such as fighter jets and tanks may be cut to fund purchases of relatively inexpensive drones. The defense budgets of the US and its allies may therefore be restructured over time.
- We still expect US spending on big, expensive, "exquisite" military systems will rise, but the growth rate will likely pale when compared with the spending hikes related to drones and other new technologies. The prime defense contractors that build the traditional systems, therefore, may not grow as fast as small defense start-ups or small companies producing high-tech products with dual civilian and military uses. As those firms eventually have their initial public offering of stock, they may be interesting investment opportunities.

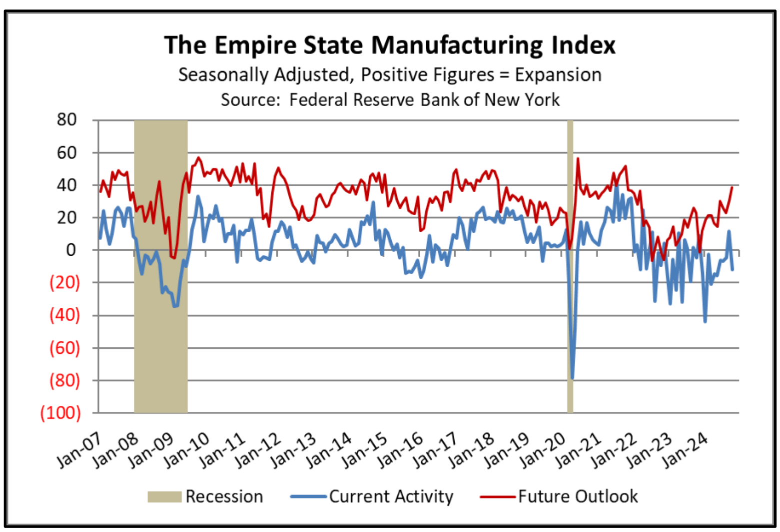
US Nuclear Energy Industry: Late yesterday, Google said it has struck a deal to back the construction of seven small, modular nuclear reactors by nuclear energy start-up Kairos Power. Under the deal, Google has committed to buy some 500 megawatts of electricity from the reactors as they come on-line between 2030 and 2035. The deal is the latest example of firms signing up for nuclear energy to power their artificial-intelligence efforts without boosting their greenhouse gas emissions.

US Property Insurance Industry: Initial estimates show last week's Hurricane Milton will lead to about $36 billion in private-sector insurance payouts, versus new estimates that Hurricane Helene will result in about $6 billion in payouts. The total estimated payouts for the two storms are significantly lower than initially feared. Reflecting the lower-than-feared payouts, major reinsurance stocks have now generally regained their prices from before the storms hit.

US Medicare Insurance Industry: The enrollment period for 2025 Medicare insurance plans opens today and will run through December 7. Because of changes by federal authorities and insurance companies, an estimated 1.5 million seniors will have their Medicare Advantage plan eliminated next year, while 3.5 million will lose their Plan D drug coverage. Many others are expected to see benefit reductions and/or deductible increases in their plans.

US Economic Releases

The New York FRB said its October ***Empire State Manufacturing Index*** fell to a seasonally adjusted -11.9, far less than the expected 3.6 and the prior month's 11.5. This index is designed so that positive readings point to expanding factory activity in New York state, so this negative reading indicates an abrupt swing into contraction. Orders and shipments in the region both weakened, consistent with the broader theme we've been observing of lackluster performance in the manufacturing sector. The chart below shows how the index has fluctuated since just before the Great Financial Crisis.



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

Economic Releases						
ET	Indicator			Expected	Prior	Rating
14:00	Monthly Budget Statement	m/m	Sep	$37.5b	$-380.10	**
Federal Reserve						
ET	Speaker or Event	District or Position				
11:30	Mary Daly Gives Keynote Remarks	President of the Federal Reserve Bank of San Francisco				
13:00	Adriana Kugler Participates in Moderated Discussion	Member of the Board of Governors				
19:00	Raphael Bostic Participates in Moderated Discussion	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	Industrial Production	y/y	Aug F	-4.9%	-4.9%	-1.3%	***	Equity bearish, bond bullish
	Capacity Utilization	y/y	Aug	-5.3%	2.5%		**	Equity and bond neutral
New Zealand	REINZ House Sales	y/y	Sep	-1.1%	5.1%		***	Equity and bond neutral
South Korea	Export Price Index	y/y	Sep	1.2%	5.5%		*	Equity and bond neutral
	Import Price Index	y/y	Sep	-3.3%	1.8%		*	Equity and bond neutral
EUROPE								
Eurozone	ZEW Survey Expectations	m/m	Oct	20.1	9.3		**	Equity and bond neutral
	Industrial Production WDA	y/y	Aug	0.1%	-2.1%	-1.0%	**	Equity bullish, bond bearish
Germany	ZEW Survey Expectations	m/m	Oct	13.1	3.6	10.0	**	Equity bullish, bond bearish
	ZEW Survey Current Situation	m/m	Oct	-86.9	-84.5	-84.0	**	Equity and bond neutral
France	CPI	y/y	Sep F	1.1%	1.2%	1.2%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Sep F	1.4%	1.5%	1.5%	**	Equity and bond neutral
	CPI Ex-Tobacco Index	q/q	Sep	118.5%	120.0%	118.6%	*	Equity and bond neutral
UK	Average Weekly Earnings 3M/YoY	m/m	Aug	3.80%	4.10%	3.70%	**	Equity and bond neutral
	ILO Unemployment Rate 3Mths	m/m	Aug	4.00%	4.10%	4.10%	**	Equity and bond neutral
	Claimant Count Rate	m/m	Sep	4.7%	4.7%	4.6%	**	Equity and bond neutral
	Jobless Claims Change	m/m	Sep	27.9k	0.3k		**	Equity and bond neutral
Russia	Trade Balance	m/m	Aug	9.3b	10.1b		**	Equity and bond neutral
	Exports	m/m	Aug	34.5b	35.1b		*	Equity and bond neutral
	Imports	m/m	Aug	25.2b	25.1b		*	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)	451	452	-1	Down
U.S. Sibor/OIS spread (bps)	466	465	1	Down
U.S. Libor/OIS spread (bps)	462	461	1	Down
10-yr T-note (%)	4.10	4.10	0.00	Up
Euribor/OIS spread (bps)	318	318	0	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	$74.59	$77.46	-3.71%	
WTI	$70.93	$73.83	-3.93%	
Natural Gas	$2.48	$2.49	-0.44%	
12-mo strip crack	$20.09	$20.14	-0.28%	
Ethanol rack	$1.71	$1.72	-0.38%	
Metals				
Gold	$2,646.80	$2,648.54	-0.07%	
Silver	$31.09	$31.20	-0.34%	
Copper contract	$435.20	$440.60	-1.23%	
Grains				
Corn contract	$406.75	$408.25	-0.37%	
Wheat contract	$584.25	$585.25	-0.17%	
Soybeans contract	$989.50	$996.00	-0.65%	
Shipping				
Baltic Dry Freight	1,814	1,809	5	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.60		
Gasoline (mb)		-1.00		
Distillates (mb)		-1.75		
Refinery run rates (%)		0.0%		
Natural gas (bcf)		76		

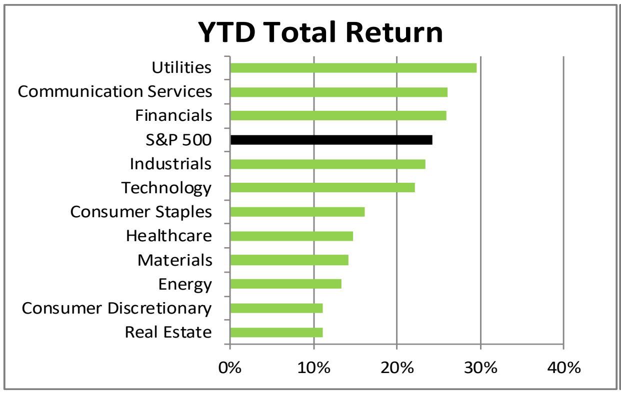
Weather

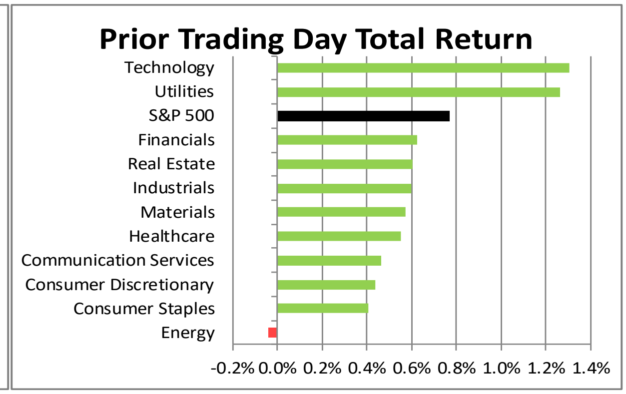
The 6-to-10-day and 8-to-14-day forecasts currently call for warmer-than-normal temperatures from the Rocky Mountains to the East Coast, with cooler-than-normal temperatures in the Pacific Northwest. The precipitation outlook calls for wetter-than-normal conditions across a northern stretch of the country from California to the Great Lakes, with dry conditions in the eastern third of the country.

A tropical disturbance midway across the Atlantic shows a 30% chance of near-term cyclonic formation.

Data Section

US Equity Markets – (as of 10/14/2024 close)

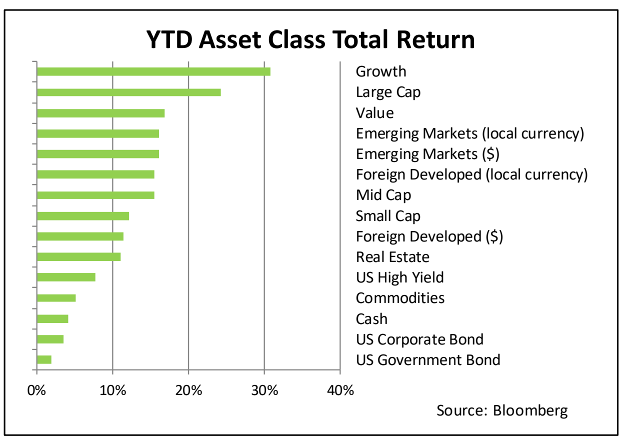




(Source: Bloomberg)

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 10/14/2024 close)

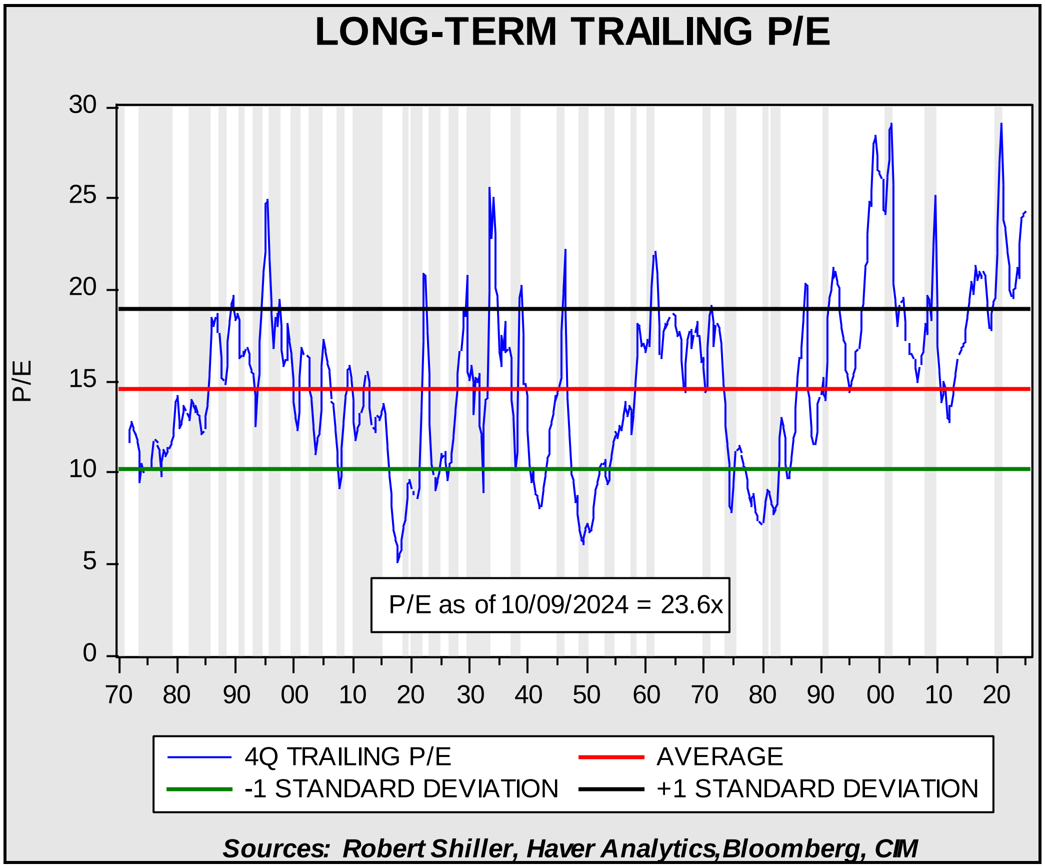


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.