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 16, 2024 — 9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 closed down 0.6% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.1%. Chinese markets were mixed, with the Shanghai Composite up 0.1% from its previous close and the Shenzhen Composite down 0.5%. US equity index futures are signaling a higher open.

With 42 companies having reported so far, S&P 500 earnings for Q3 are running at $60.20 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.

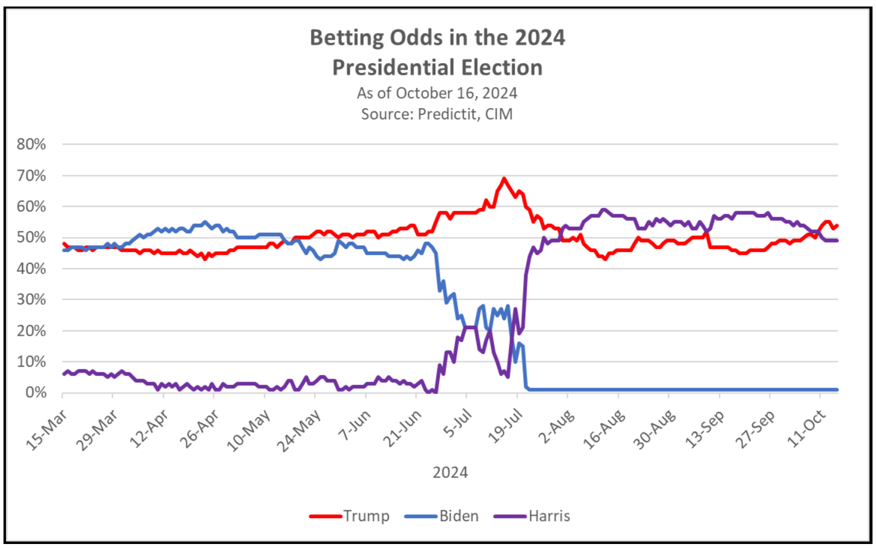
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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)

Good morning! Investors are eagerly awaiting more earnings reports to assess the underlying strength of the financial markets. In sports news, Argentine midfielder Lionel Messi scored a hat trick against Bolivia as he prepares for retirement. Today's *Comment* will delve into our takeaways from the latest Trump interview with Bloomberg, our thoughts on how government restrictions can impact earnings for chip-related companies, and an explanation of why the Bank of England's rate decision will affect the UK pound sterling. As usual, the report includes both domestic and international data releases.

Trump's Agenda: Republican candidate and former President Donald Trump has conducted another interview outlining his plans if elected.

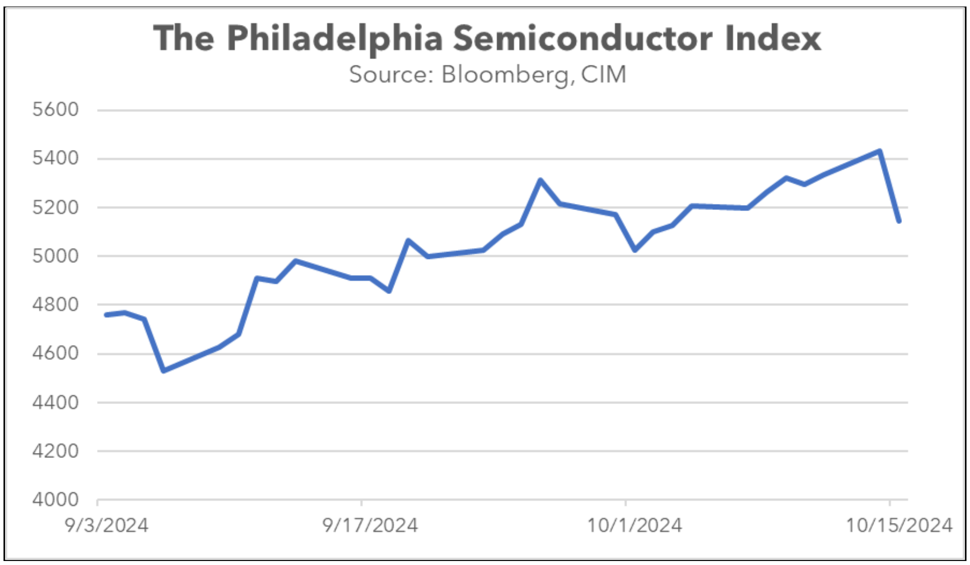
- In a one-hour interview, [Trump championed his economic policies, touting their benefits for small businesses and workers]. He stood firm in his belief that he should have a say in monetary policy and asserted that new tariffs would incentivize companies to reshore jobs lost to globalization. Additionally, he argued that his crackdown on illegal immigration would be counterbalanced by an influx of legal, documented workers. While the audience seemed to largely support his views, the interviewer raised concerns about potential negative economic consequences, as highlighted by economists.
- While theoretical criticisms hold weight, their real-world impact is contingent on various factors. For instance, a stronger dollar could mitigate many of the inflationary pressures from tariffs. Moreover, price elasticity, which measures consumer sensitivity to price changes, may compel foreign firms to absorb a portion of the increased costs. Also, although the Fed is independent, policy coordination with the executive branch is not unusual. Finally, while the crackdown on immigration could reduce the labor supply, it should also alleviate pressure on public resources.



- Betting markets currently favor President Trump to win in November, but polls indicate that the race remains close. Investors should instead focus on broader trends rather than individual candidates. Both Trump and Vice President Harris agree on reshoring manufacturing jobs. But while Trump supports tariffs to limit imports, Harris favors stimulus packages to boost domestic competitiveness. Still, assuming these efforts achieve their long-term objective of raising wages for US workers, we would expect higher inflation and higher interest rates on long-term bonds no matter the victor.

Chip Wars! Chipmakers have been impacted by increasing concerns about weak demand in China.

- ASML Holding, a leading chip equipment maker, had its worst day in 26 years after the company reported a significant decline in orders and lowered its 2025 guidance. While the specific reasons for this miss weren't explicitly stated, increasing concerns are mounting that global chip restrictions on sales to China are negatively impacting the company's earnings. Last month, the Netherlands mandated that ASML obtain export licenses to sell older machines and provide repair and maintenance services to China. This further highlights the challenges posed by these restrictions.
- The uncertainty surrounding ASML has sent shockwaves through the broader semiconductor industry, as other companies grapple with similar headwinds. The Philadelphia Semiconductor Index plummeted by 5.3% on the day, far outpacing the S&P 500's modest decline of 0.8%. Investors are reevaluating the earnings potential of these firms, driven by growing concerns over their ability to sell to China, a critical market for chips and related products. ASML is particularly exposed to these restrictions, with 47% of its quarterly sales tied to the country.

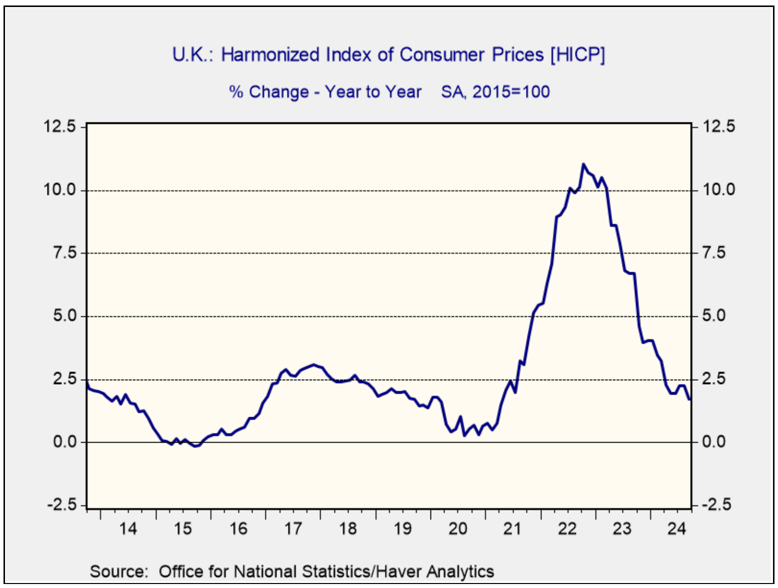


- Chipmakers and related equipment manufacturers are likely to face headwinds as these regulations will complicate their efforts to expand into foreign markets. While China will be a strong focus, other countries may also be included. The Biden administration is currently considering implementing export controls for Nvidia and AMD chips on a case-by-case basis, targeting specific countries. While many of these firms are expected to adapt to the regulatory environment, their high valuations suggest that there may be better investment opportunities in other sectors.

Dovish BOE: The British currency has hit a near two-month low amid market expectations that the central bank will implement more aggressive monetary easing than previously anticipated.

- UK inflation fell below 2% for the first time in 3.5 years. In September, the Consumer Price Index (CPI) rose 1.7% from the previous month, much lower than the prior month's increase of 2.2% and the consensus forecast of 1.9%. Meanwhile, core inflation moderated from an increase of 3.6% to 3.2%, and services inflation, a particular concern for policymakers, fell from 5.6% to 4.9%. However, not all the news was positive, as the core measure of services inflation (excluding volatile elements like airfares, packaged holidays, and education) indicated that underlying pressures persist.

- A lower-than-expected inflation report has paved the way for the Bank of England to potentially implement its second, and possibly third, interest rate cuts this year. While the central bank previously signaled a cautious approach to rate cuts following its initial cut in August, BOE Governor Andrew Bailey suggested earlier this month that the central bank could become more aggressive if inflation cooled more than anticipated. Nevertheless, the latest inflation reading has likely secured another 25-basis-point cut for November and increased the likelihood of another cut the following month.



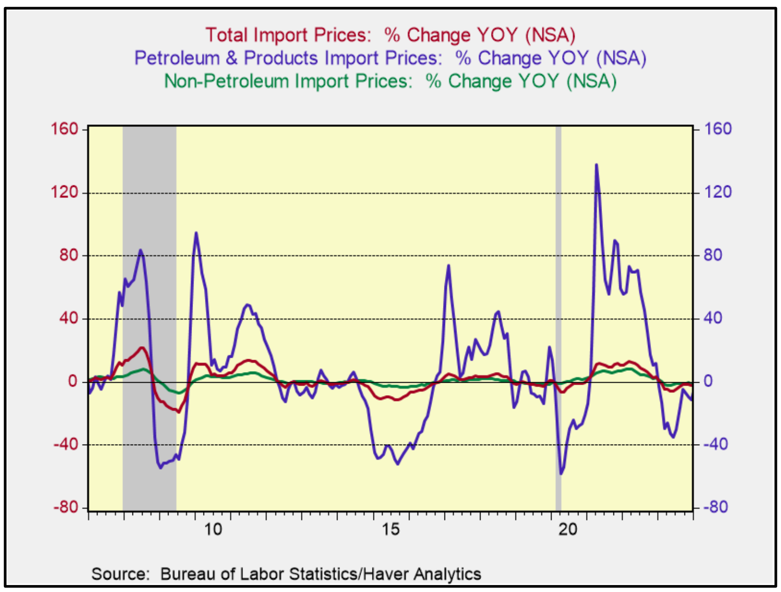
- While the inflation report is encouraging, investors should closely monitor exchange rates, as rising import prices could offset some of the progress. The narrowing interest rate differential between the US and UK is likely to put downward pressure on the pound sterling (GBP), as the two central banks pursue divergent monetary policies. The Federal Reserve's focus on the labor market means that a strong US jobs report in October could further weaken the case for another Fed rate cut. If this were to happen, the GBP could sink further relative to the dollar and push up the price of energy imports.

In Other News: The UK is considering imposing sanctions on Israel over its conduct in Gaza, indicating that other countries are seeking an end to the conflict. Ukrainian President Volodymyr Zelensky has shared his "Victory Plan" with EU officials as he seeks to reassure Western allies that he understands the war cannot continue indefinitely. Financial firms are starting off the earning's season strong, with Morgan Stanley continuing the streak of Wall Street banks posting better-than-expected revenue.

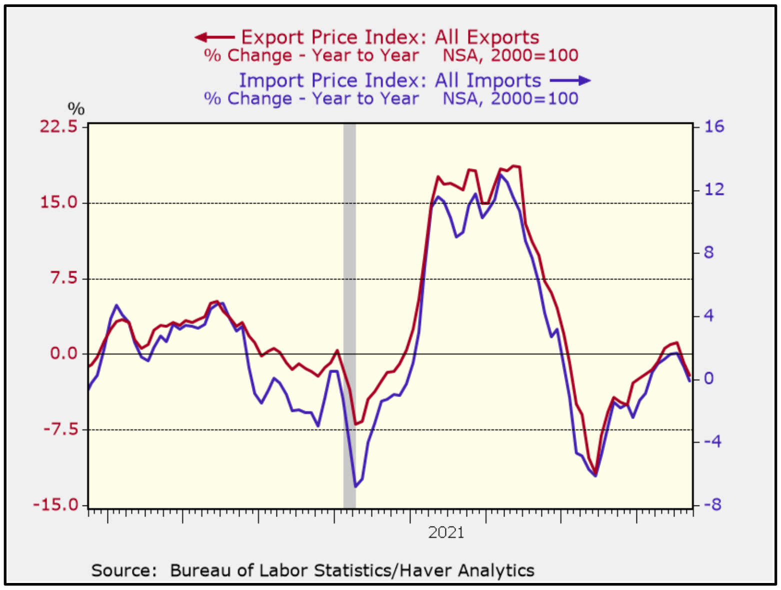
US Economic Releases

The Mortgage Bankers Association today said ***mortgage applications*** in the week ended October 11 fell 17%, compared to last week's decline of 5.1%. Applications for home purchase mortgages fell 7.2%, the most since mid-February. Applications for refinancing mortgages fell 26%, the largest decline since March 2020. According to the report, the average interest rate on a 30-year mortgage rose 16 basis points to 6.52%. In the last two weeks, the rate has climbed 38 basis points, the largest two-week rise since February 2023.

September ***import prices*** fell 0.4% from the previous month, slightly more than the expected decline of 0.3% and a further decrease from August's 0.2% decline. Of course, import prices are often driven by volatility in the petroleum fuels category. September ***import prices excluding fuels*** rose 0.2%, slightly ahead of the expected 0.1% and an acceleration from August's 0.0%. Overall import prices in September fell 0.1% year-over-year, while import prices excluding fuels rose 1.8%. The chart below shows the year-over-year change in import prices since just before the Global Financial Crisis.



According to the report, ***export prices*** in September fell 0.7% from one year earlier, steeper than the expected 0.4% decline. Comparing the annual change in export prices versus import prices provides a sense of the US "terms of trade," or the relative advantage or disadvantage the country is facing because of trends in international trade prices. The chart below compares the year-over-year change in US export and import prices 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						
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	Core Machine Orders	y/y	Aug F	-3.4%	8.7%	3.8%	**	Equity bearish, bond bullish
Australia	Westpac Leading Index	m/m	Sep	0.03%	-0.01%		**	Equity and bond neutral
New Zealand	CPI	y/y	Q3	2.2%	3.3%	2.2%	**	Equity and bond neutral
South Korea	Unemployment Rate	m/m	Sep	2.5%	2.4%	2.6%	***	Equity and bond neutral
India	Trade Balance	m/m	Sep	-$20780m	-$29643m	-$24637m	**	Equity and bond neutral
	Exports	y/y	Sep	0.5%	-9.3%		**	Equity and bond neutral
	Imports	y/y	Sep	1.6%	3.3%		**	Equity and bond neutral
EUROPE								
Italy	CPI, EU Harmonized	y/y	Sep F	0.7%	0.8%	0.8%	***	Equity and bond neutral
UK	CPI	y/y	Sep	1.7%	2.2%	1.9%	***	Equity and bond neutral
	CPI Core	y/y	Sep	3.2%	3.6%	3.4%	***	Equity and bond neutral
	Retail Price Index	m/m	Sep	388.6	389.9	390.2	**	Equity and bond neutral
	RPI	y/y	Sep	2.7%	3.5%	3.1%	**	Equity and bond neutral
AMERICAS								
Canada	CPI	y/y	Sep	1.6%	2.0%	1.8%	***	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)	450	451	-1	Down
U.S. Sibor/OIS spread (bps)	462	463	-1	Down
U.S. Libor/OIS spread (bps)	459	460	-1	Down
10-yr T-note (%)	4.00	4.03	-0.03	Down
Euribor/OIS spread (bps)	322	321	1	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	$73.97	$74.25	-0.38%	
WTI	$70.34	$70.58	-0.34%	
Natural Gas	$2.47	$2.50	-1.32%	
12-mo strip crack	$20.06	$20.07	-0.07%	
Ethanol rack	$1.69	$1.70	-0.24%	
Metals				
Gold	$2,678.93	$2,662.58	0.61%	
Silver	$31.87	$31.50	1.18%	
Copper contract	$438.40	$433.75	1.07%	
Grains				
Corn contract	$403.50	$401.25	0.56%	
Wheat contract	$576.75	$579.50	-0.47%	
Soybeans contract	$998.00	$991.00	0.71%	
Shipping				
Baltic Dry Freight	1,766	1,814	-48	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.75		
Gasoline (mb)		-2.50		
Distillates (mb)		-2.75		
Refinery run rates (%)		-0.5%		
Natural gas (bcf)		76		

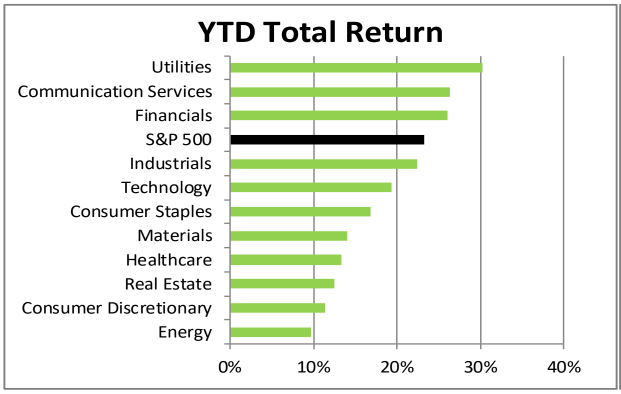
Weather

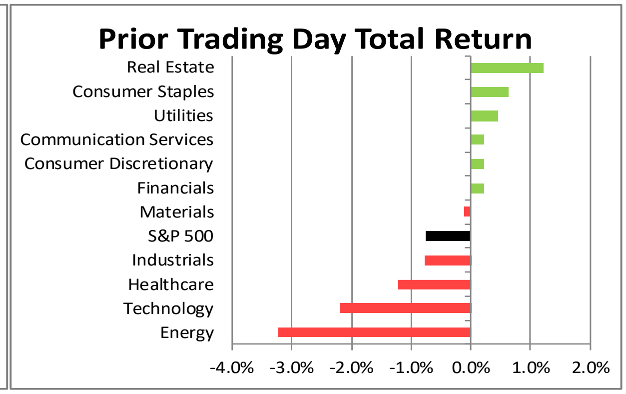
The 6-to-10-day and 8-to-14-day forecasts currently call for warmer-than-normal temperatures from the Rocky Mountains to the East Coast, with cooler-than-normal temperatures in the Pacific Northwest. The precipitation outlook calls for wetter-than-normal conditions across a northern stretch of the country 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. Meanwhile, a second disturbance has just formed off the coast of Panama with a 10% chance of cyclonic formation.

<u>Data Section</u>

US Equity Markets – (as of 10/15/2024 close)

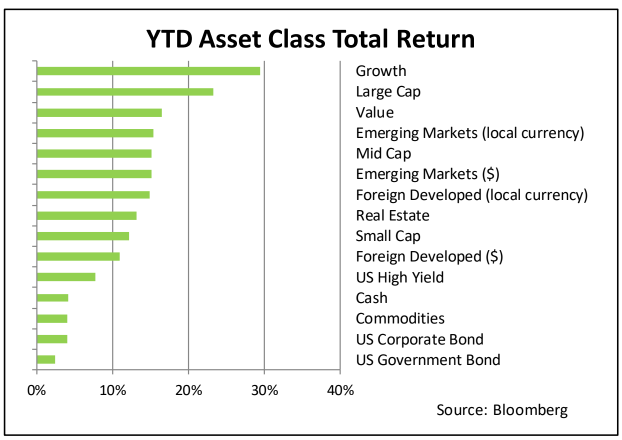




(Source: Bloomberg)

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 10/15/2024 close)

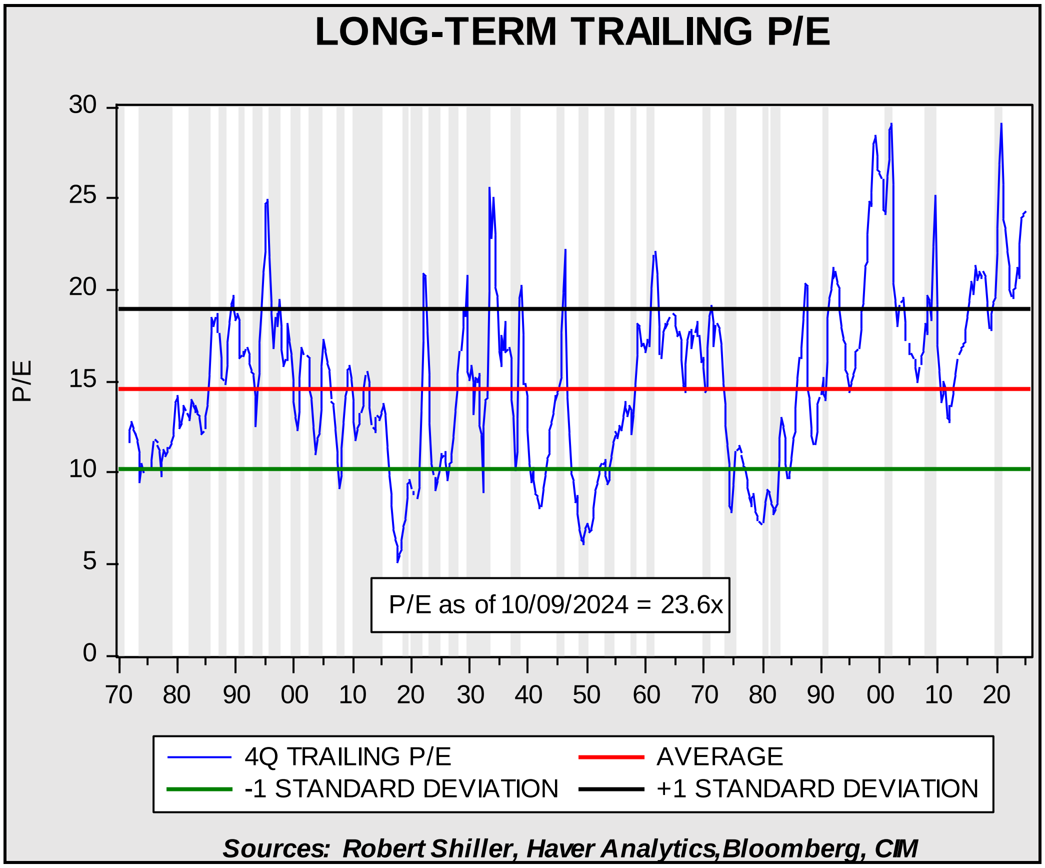


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

---

[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.