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 17, 2024 — 9:30 AM ET] Global equity markets are mixed 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 down 0.5%. Chinese markets were lower, with the Shanghai Composite down 1.1% from its previous close and the Shenzhen Composite down 0.6%. US equity index futures are signaling a higher open.

With 55 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, 96.9% have exceeded expectations while 1.9% have fallen short of expectations.

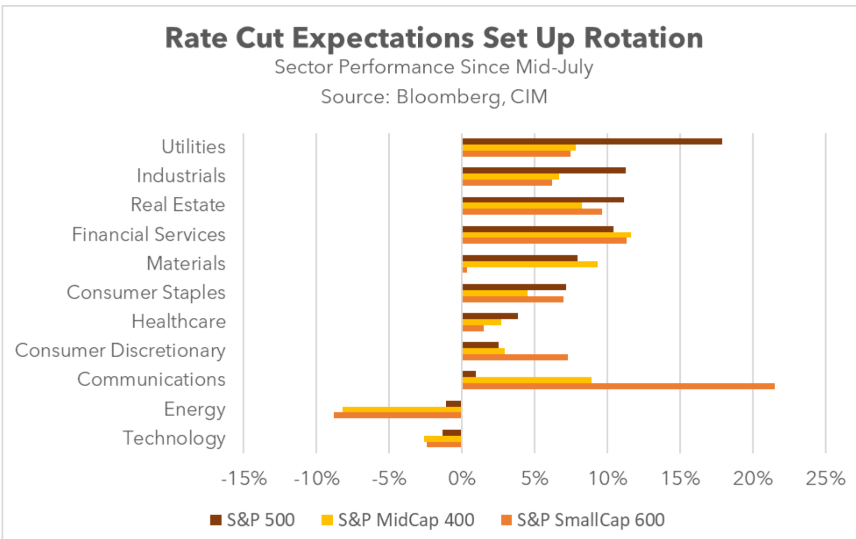
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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! The market is currently analyzing the latest retail sales data. In sports news, the New York Liberty secured a victory against the Minnesota Lynx in Game 3 of the WNBA Finals, taking a 2-1 lead in the series. Today's *Comment* will discuss why small cap stock indexes are gaining attention, explore the strategic shift toward clean energy sources, and provide an overview of North Korea's increasing assertiveness. As usual, the report will conclude with a roundup of international and domestic news releases.

The Rally Broadens: The market has changed its equity sector preference as it embraces the possibility of a soft landing.

- A broad-based rally over the past four months has pushed small cap indexes, such as the Russell 2000 and S&P SmallCap 600, close to all-time highs. Investors are increasingly willing to take risks, shifting their focus to smaller cap stocks that were often overlooked in the early half of the year. This shift in sentiment started when rising market expectations of a rate cut encouraged investors to move away from the tech sector in mid-July.
- The two best performing sectors over the past four months have been large cap utility companies and small cap communication firms. This shift comes as investors seek to maintain limited exposure to AI-related companies without incurring significant downside risk. Utility companies in the S&P 500 have gained appeal due to AI's energy demands, their relatively high dividend yields, and their negative correlation with interest rates. Meanwhile, small cap communication companies within the S&P SmallCap 600 index have attracted investors seeking bargains.

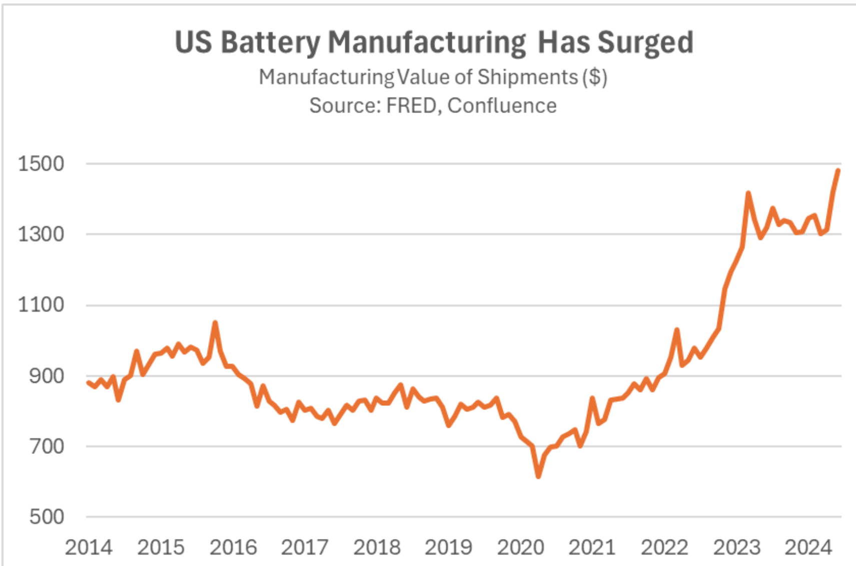


- The overall broadening of the market should continue as long as investors remain confident in a soft landing. A continued decline in inflation, which would keep the Fed on track to lower rates, should be supportive of not only the sectors outlined above but also Real Estate and Financials, which had been shunned by investors during the Fed's hiking cycle. However, any indication of a recession could lead investors to seek shelter in safer assets. At this time, we remain confident that if current conditions persist over the next few months, small cap stocks should perform relatively well.

Battery Superpower? As the US looks to build out its supply chain diversification, it is starting to focus on resources in its own backyard.

- A Silicon Valley startup, Lyten, has announced that it plans to invest over $1 billion in a lithium battery factory in Reno, Nevada. This area has become known as one of the key regions that will be used to build out the capacity of the US battery manufacturing industry. It is estimated that the state may be sitting on the largest deposit of lithium found anywhere in the world, at around 20 to 40 million metric tons.

- In recent years, the US has been ramping up its battery manufacturing capacity to diversify its energy resources. This effort is evident in the surge in the value of shipments from battery factories. A key component of this strategy involves securing critical mineral resources, which is why it has expanded investment lithium and cobalt production. Earlier this year, the US made its first major investment in Ottawa since WWII in order to gain access to its cobalt, while President Biden is scheduled to visit Angola in December to explore similar investment opportunities.



- While renewable technologies won't supplant traditional fossil fuels as the primary energy source, their increased utilization will contribute to diversifying the US energy portfolio. This shift is essential as the US seeks to reduce its dependence on energy cartels like OPEC, whose member countries may be hostile to US interests. Consequently, the development of renewable resources will be a cornerstone of America's energy strategy.

South Korea-North Korea: The two sides are feuding again as North Korea issues new threats to invade its southern neighbor.

- The new dispute arose after North Korea accused South Korean drones of flying into North Korean territory and dropping propaganda leaflets, which Pyongyang labeled as an act of war. In retaliation, North Korea destroyed parts of an unused bridge and railway connecting the two countries and warned that the escalating tensions had prompted 1.4 million people to sign up for military service. While the possibility of North Korea launching an imminent large-scale attack on its southern neighbor appears to be unlikely, the country does seem to be acting more hostile.

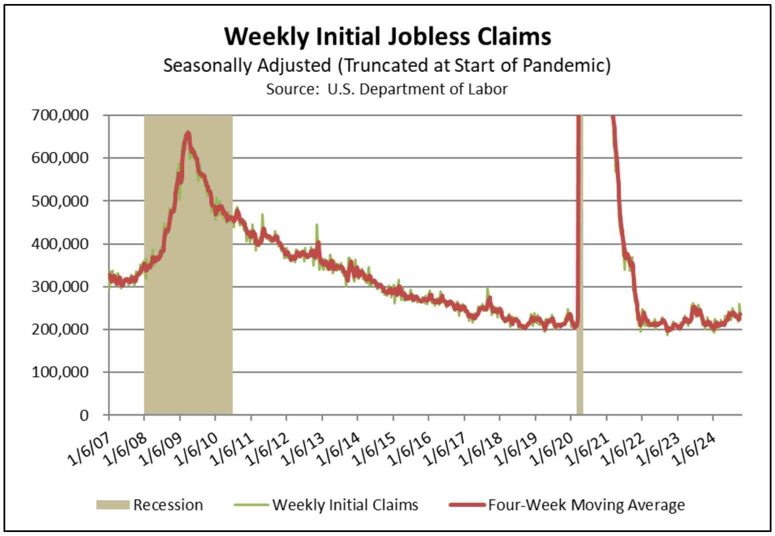
- Since the collapse of the nuclear agreement under the previous US administration, which would have lifted sanctions, North Korea has sought to strengthen its ties with some of America's rivals, namely Russia and Iran. These relationships have likely contributed to the development of North Korea's military capabilities, as the three countries have been known to exchange military expertise and weapons. Most recently, reports indicate that North Korea sent troops to assist Russia in its war against Ukraine, suggesting that its military is now gaining firsthand combat experience.

- Rising tensions on the Korean Peninsula have largely gone unnoticed as news coverage has focused primarily on the wars in Ukraine and Gaza. However, there are growing concerns that the possibility of conflict is at its highest level in recent memory. North Korea's growing ties with hostile actors such as Iran and Russia suggest that the US will need to seek greater coordination with its allies within the Indo-Pacific to deter conflict. While we do not think a war is imminent, the risk is elevated.

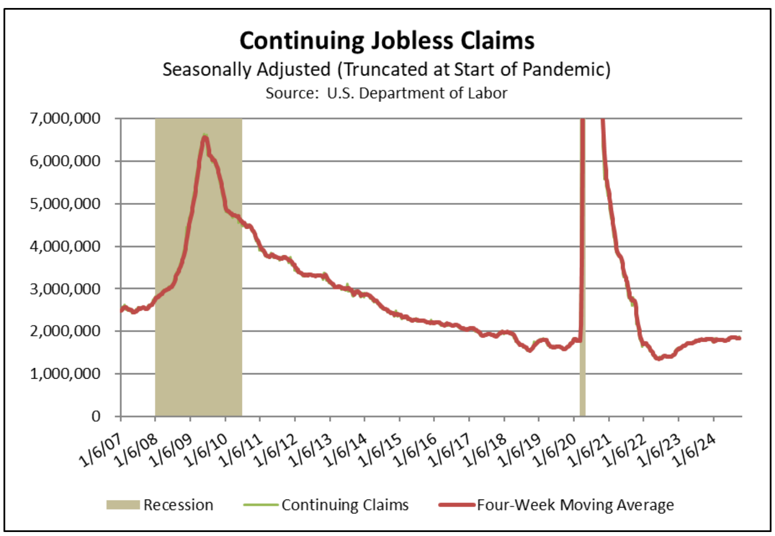
In Other News: The Mexican peso (MXN) has dropped significantly as investors continue to factor in the possibility of a Trump victory in November. Chinese President Xi Jinping has urged officials to make every effort to ensure that the country meets its 5% annual growth target. Meanwhile, Meta has laid off employees who misused its $25 meal credit, indicating that the company may be preparing for a smaller workforce. The European Central Bank cut its rate by 25 bps, which is in line with expectations, as inflation continues to move downward.

US Economic Releases

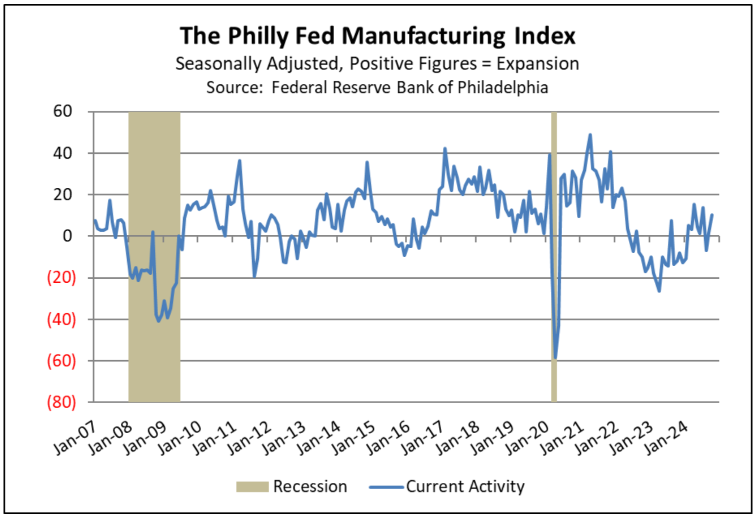
In the week ended October 12, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 241,000, comfortably below the expected level of 259,000 and down from the prior week's revised level of 260,000. Nevertheless, the four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to a two-month high of 236,250. 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.



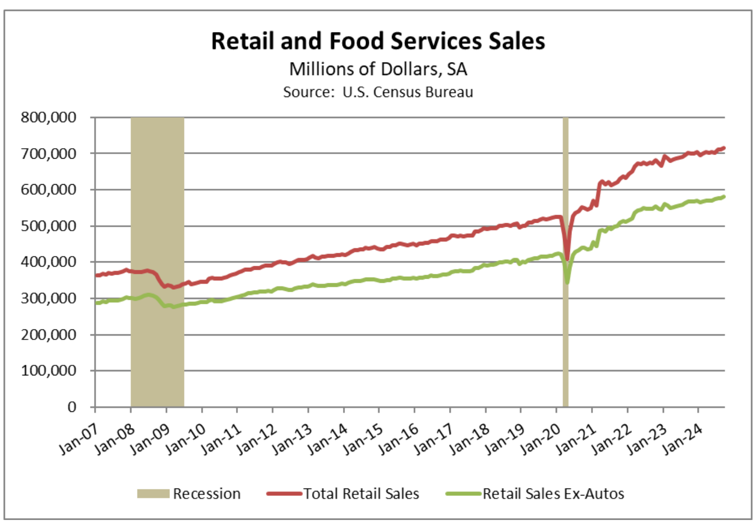
In the week ended October 5, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to a seasonally adjusted 1.867 million, above both the anticipated reading of 1.865 million and the previous week's revised reading of 1.858 million. The four-week moving average of continuing claims rose to 1,842,750. 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 Philadelphia FRB said its October ***Philly Fed Index*** rose to a seasonally adjusted 10.3, smashing past the expected reading of 3.0 and massively improving from the September reading of 1.7. The index, officially designated as the Philadelphia FRB Manufacturing Activity Index, is designed so that positive readings point to expanding factory activity in the mid-Atlantic region. At its current level, the index suggests mid-Atlantic manufacturing has accelerated sharply in recent months. The chart below shows how the index has fluctuated since just before the GFC.



Finally, September ***retail sales*** rose by a seasonally adjusted 0.4%, beating the expected increase of 0.3% and accelerating from the August increase of 0.1%. Of course, overall retail sales are often driven by the volatile auto and auto parts sector, but that wasn't the case this time. September ***retail sales excluding autos and auto parts*** were up an even stronger 0.5%, beating their anticipated rise of 0.1% and accelerating from their August increase of 0.2%. Overall retail sales in September were unchanged from the same month one year earlier, but sales excluding autos and auto parts were up 0.8%. The chart below shows how retail sales have changed since just before the GFC.



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

Economic Releases						
ET	Indicator			Expected	Prior	Rating
10:00	NAHB Housing Market Index	m/m	Oct	42	41	*
16:00	Total Net TIC Flows	m/m	Aug		$156.5b	**
16:00	Net Long-Term TIC Flows	m/m	Aug		$135.4b	**
Federal Reserve						
ET	Speaker or Event	District or Position				
11:00	Austan Goolsbee Gives Opening Remarks	President of the Federal Reserve Bank of Chicago				

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	Trade Balance	y/y	Sep	-¥294.3b	-¥703.2b	-¥316.0b	**	Equity and bond neutral
	Exports	y/y	Sep	-2%	5.5%	0.9%	*	Equity and bond neutral
	Imports	y/y	Sep	2%	2.3%	2.8%	*	Equity and bond neutral
	Tertiary Industry Index	m/m	Aug F	-1.1%	2.2%	-0.3%	***	Equity bearish, bond bullish
Australia	Employment Change	m/m	Sep	64.1k	42.6k	25.0k	***	Equity and bond neutral
	Unemployment Rate	m/m	Sep	4.1%	4.1%	4.2%	***	Equity and bond neutral
	Participation Rate	m/m	Sep	67.2%	67.1%	67.1%	**	Equity and bond neutral
EUROPE								
Eurozone	CPI	y/y	Sep F	1.7%	2.2%	1.8%	***	Equity and bond neutral
	Core CPI	y/y	Sep F	2.7%	2.7%	2.7%	**	Equity and bond neutral
	Trade Balance SA	m/m	Aug	11.0b	13.7b	17.6b	*	Equity and bond neutral
Switzerland	Real Exports	m/m	Sep	-3.5%	1.4%		*	Equity and bond neutral
	Real Imports	m/m	Sep	0.6%	-0.5%		*	Equity and bond neutral
Russia	PPI	y/y	Sep	5.6%	10.2%		***	Equity and bond neutral
AMERICAS								
Canada	Housing Starts	m/m	Sep	223.8k	213.0k	235.0k	**	Equity and bond neutral
	Manufacturing Sales	m/m	Aug	-1.3%	1.1%	-1.5%	**	Equity and bond neutral
Brazil	FGV Inflation IGP-10	m/m	Oct	1.34%	0.18%	1.36%	**	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	459	0	Down
10-yr T-note (%)	4.03	4.01	0.02	Down
Euribor/OIS spread (bps)	321	322	-1	Down
Currencies	**Direction**			
Dollar	Down			Down
Euro	Flat			Up
Yen	Up			Up
Pound	Up			Up
Franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
ECB Deposit Facility Rate	3.250%	3.500%	3.250%	On Forecast
ECB Main Refinancing Rate	3.400%	3.650%	3.400%	On Forecast
ECB Marginal Lending Facility	3.650%	3.900%	3.650%	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	$74.38	$74.22	0.22%	
WTI	$70.53	$70.39	0.20%	
Natural Gas	$2.37	$2.37	0.17%	
12-mo strip crack	$20.05	$20.18	-0.64%	
Ethanol rack	$1.69	$1.69	-0.21%	
Metals				
Gold	$2,686.72	$2,673.83	0.48%	
Silver	$31.85	$31.69	0.49%	
Copper contract	$433.55	$436.75	-0.73%	
Grains				
Corn contract	$402.75	$404.75	-0.49%	
Wheat contract	$583.25	$585.00	-0.30%	
Soybeans contract	$972.00	$980.00	-0.82%	
Shipping				
Baltic Dry Freight	1,676	1,766	-90	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.50		
Gasoline (mb)		-2.00		
Distillates (mb)		-2.50		
Refinery run rates (%)		-0.5%		
Natural gas (bcf)		80		

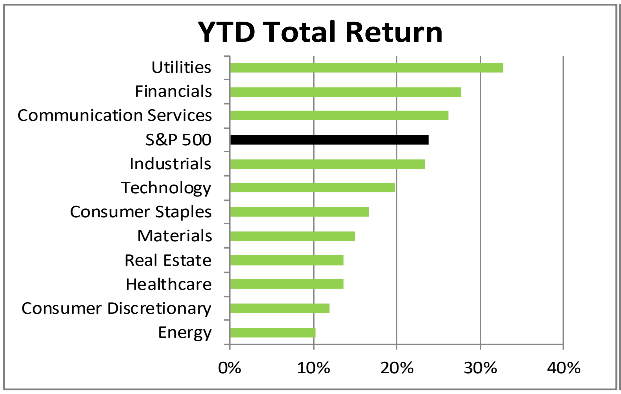
Weather

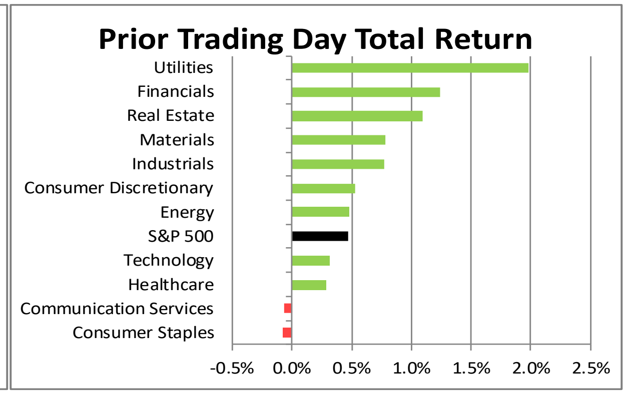
The 6-to-10-day and 8-to-14-day forecasts currently call for warmer-than-normal temperatures everywhere except the Pacific Northwest, where temperatures will be below normal. The forecasts call for wetter-than-normal conditions across the northern parts of the Far West and in the Midwest, with dry conditions in the Southwest and along the East Coast.

There are now two tropical disturbances in the Atlantic Ocean. One is located just off the coast of Honduras, while the other is in the central Atlantic to the east of the Leeward Islands. Both these disturbances are assessed to have only a 20% chance of cyclonic formation.

Data Section

US Equity Markets – (as of 10/16/2024 close)

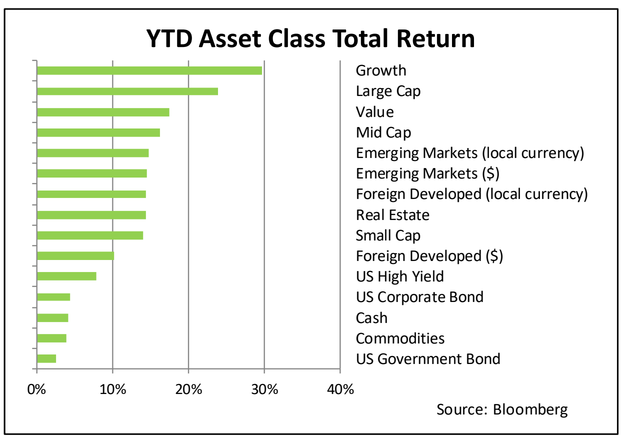




(Source: Bloomberg)

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 10/16/2024 close)

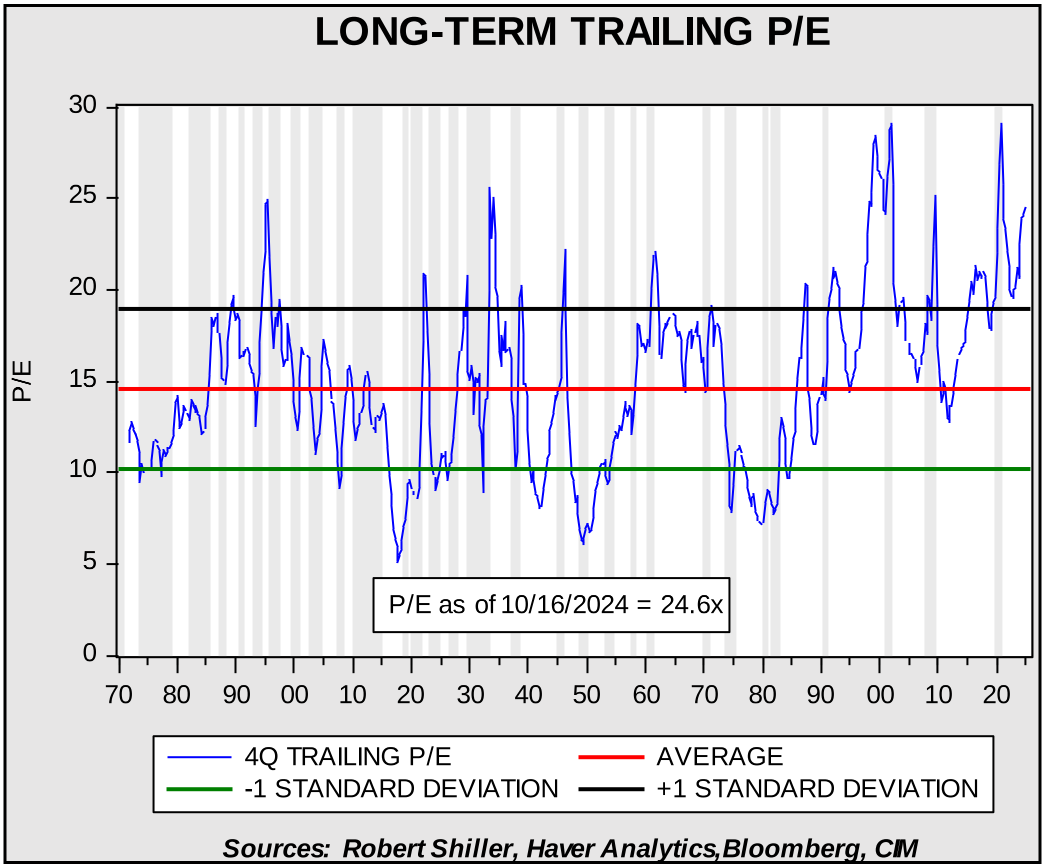


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 17, 2024



Based on our methodology,[1] the current P/E is 24.6x, up 1.0 from our last report. The stock price index increased last month, while earnings were revised downward.

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.