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 18, 2024 — 9:30 AM ET] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 closed up 0.6% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 2.62%. Chinese markets were higher, with the Shanghai Composite up 2.9% from its previous close and the Shenzhen Composite up 4.1%. US equity index futures are signaling a higher open.

With 66 companies having reported so far, S&P 500 earnings for Q3 are running at $60.30 per share, compared to estimates of $60.44, which is up 4.2% from Q3 2023. Of the companies that have reported thus far, 96.6% have exceeded expectations while 2.2% have fallen short of expectations.

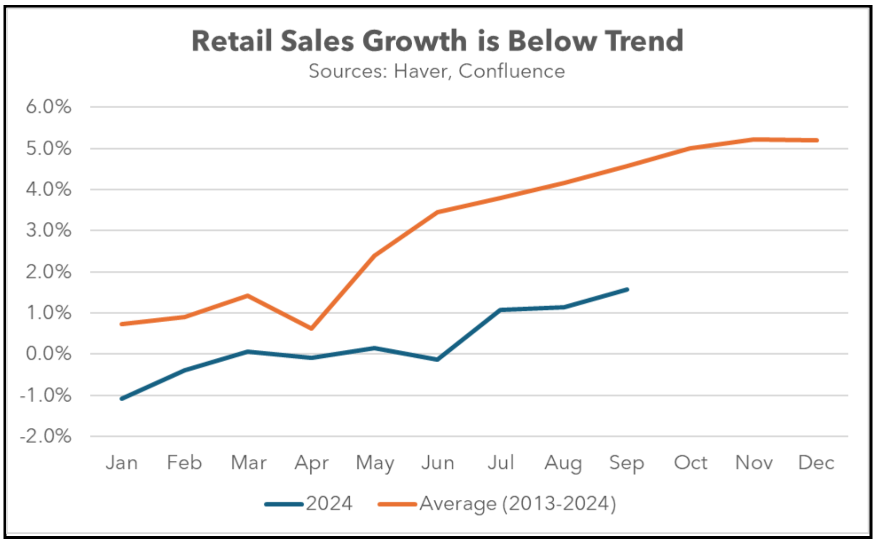
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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)

The market is currently processing the recent GDP data from China. In sports news, the Cleveland Guardians stunned the New York Yankees with a 10th-inning home run to win Game 3 of the ALCS. Today's *Comment* will discuss why consumer spending has remained resilient, the essential role of drones in modern warfare, and our thoughts on the European Central Bank's latest rate decision. As usual, our report includes a roundup of domestic and international data releases.

The Strong US Consumer: Despite concerns over rising prices, households are still managing to increase their spending on everyday goods and services.

- Retail sales for September exceeded all expectations, surging from a 0.1% increase in August to a robust 0.4% the following month. Consumer spending has surged, particularly in the Retail Sales Control group, which excludes food services, autos, gasoline, and building materials. This category, which feeds into the GDP numbers, increased from 0.3% to 0.7%, marking the fastest growth in three months. This strong report boosted the Atlanta GDPNow forecast for the third quarter, projecting an annualized rate of 3.6%, a significant increase from the previous quarter's rise of 3.0%.
- Despite the positive headline, the underlying data suggests growing consumer frugality. Households have shifted their spending towards everyday essentials while curtailing major purchases. Grocery stores, online retailers, and miscellaneous retailers like florists and pet stores were the biggest contributors to the strong retail sales figures. In contrast, big-ticket items, such as vehicles, have experienced muted sales, and home furnishing sales have declined for two consecutive months. Additionally, sales seem to be rising below their historical pace.



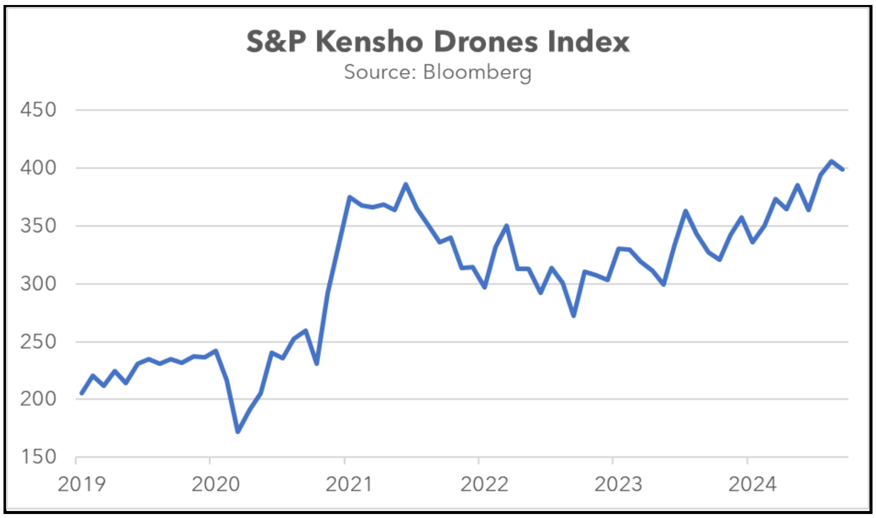
- The resilient labor market has enabled consumers to maintain spending despite rising inflation. As long as employment remains robust, consumer spending will likely continue to support the economy. The recent positive retail sales data reinforces the expectation that the Federal Reserve will either cut interest rates by 25 basis points at its next meeting or pause until economic indicators weaken. However, concerns about a potential resurgence of inflation may provide a floor in 10-year Treasury yields at 4% in the coming weeks.

The Rise of the Drone: The use of drones has become increasingly valuable in modern warfare as countries aim to reduce costs and yet remain effective in taking on larger rivals.

- The wars in Ukraine and Lebanon have demonstrated the crucial role of drones in modern warfare, particularly for smaller militaries. In its conflict with Russia, Ukraine has successfully developed a domestic drone industry that rivals imported models from the

United States, bolstering its ability to strike Russian targets. Meanwhile, Hezbollah has employed drones to defend against Israeli attacks. These examples underscore the strategic importance of drone technology in contemporary combat.

- The drone revolution is a threat to global stability that shouldn't be underestimated. Iran's cheap, combat-proven drones are captivating developing nations, bolstering defenses, and aiding militaries like those in Ukraine and Sudan. The global production network of drones, spanning South America and Central Asia (including some US parts), raises questions about the effectiveness of sanctions. Meanwhile, Ukraine's experience exposes limitations in US drone capabilities, prompting them, in some cases, to explore Chinese alternatives for reconnaissance. This highlights how any nation, regardless of size, can exploit niche strengths, reshaping the modern military landscape.

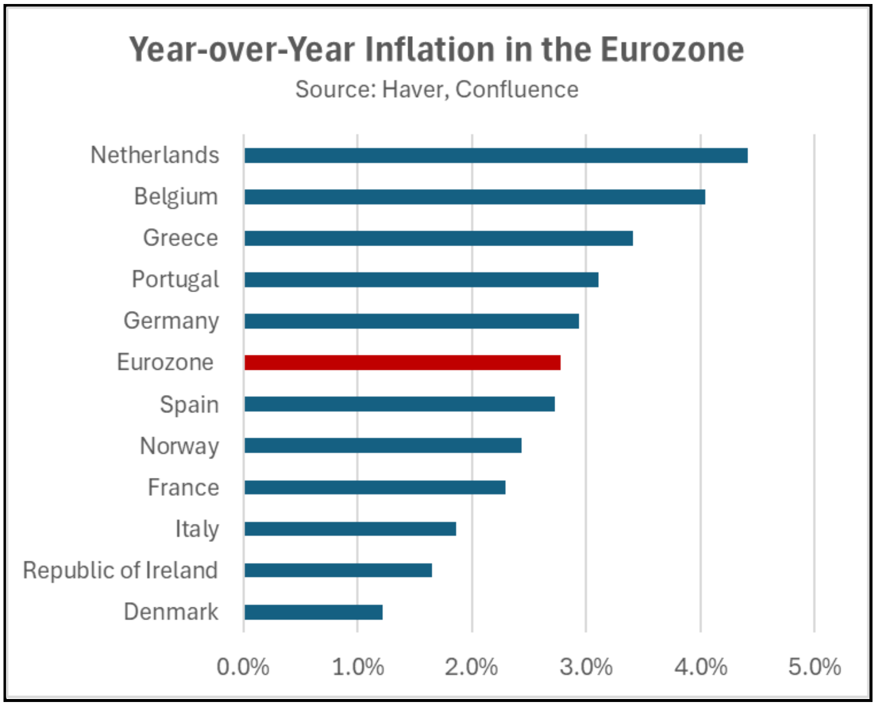


- The changing face of warfare favors smaller, stealthier equipment over traditional, heavy-duty hardware. This shift offers a strategic opportunity for the United States. By capitalizing on its advanced semiconductor industry, the US can not only improve drone performance but also develop counter-drone measures. This technological pivot could potentially reduce military expenditures, addressing budgetary concerns amidst a rising fiscal deficit. Moreover, these investments will likely stimulate growth in tech and defense companies with close ties to the government.

The Dovish Tilt: The European Central Bank (ECB) has reiterated its desire to ease policy as it looks to boost its flagging economy.

- On Thursday, the ECB lowered its benchmark policy rate by 25 basis points for the third time this year. Following the rate decision, the central bank observed that inflation was moving in the right direction, but it had growing concerns about the economy. This combination gave it the confidence to lower rates further. While there was no indication of future policy actions for December, it is speculated that they may reduce rates at the next meeting if inflation continues to decline and economic conditions deteriorate.

- Despite a general easing of eurozone inflation, several countries continue to face stubbornly high rates. In September, harmonized core inflation for the eurozone rose to 2.8%, significantly lower than the Netherlands and Belgium, where rates remain above 4% year-over-year. Greece's rate was also notably higher. This discrepancy is primarily due to increased demand for services and the end of energy price control measures. As the price control information is phased out of the data, these countries could experience even more intense inflation in the coming months due to base effect changes.

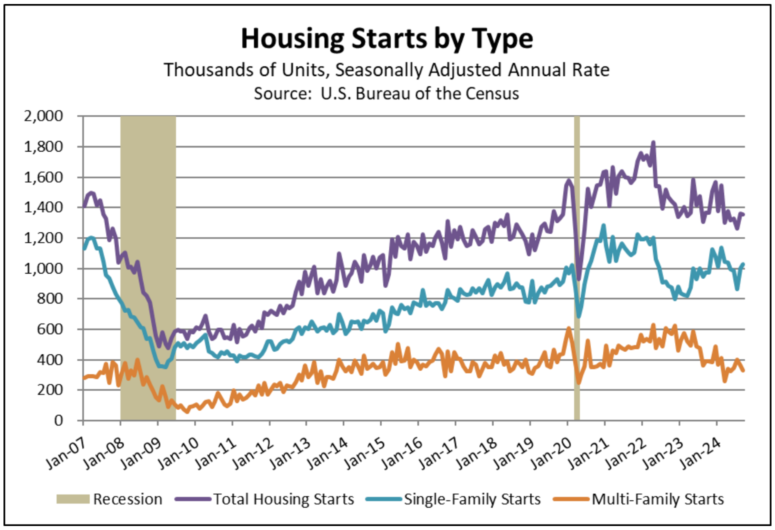


- The ECB's aggressive interest rate cuts are focused more on preventing a recession than a display of confidence that it has achieved its price stability objective. That said, while additional monetary easing is expected to continue into 2025, policymakers may slow the pace of cuts as signs of economic growth and rising inflation emerge. In the short to medium term, the ECB's dovish stance could bolster the US dollar, especially as robust US economic data reinforces the Fed's cautious approach to future rate cuts.

In Other News: Hamas leader Yahya Sinwar was killed on Thursday by Israel; his death has likely added pressure for an end to the conflict in Gaza. The US has eased restrictions on space technology exports as it looks to expand its foot print in the industry. China's GDP growth increased 4.6% from the previous year, aligning with market expectations but marking its slowest rate of growth since Q1 2023.

US Economic Releases

September ***housing starts*** fell to a seasonally adjusted, annualized rate of 1.354 million units, beating their expected rate of 1.350 million units but still short of the revised 1.361 million rate in August. The rate of housing starts in September was down 0.5% from the rate in the previous month. September ***housing permits*** dropped to a rate of 1.428 million units, short of both their anticipated rate of 1.460 million units and the revised 1.470 million rate in August. Permits issued for new housing units in September were down 2.9% from the previous month. Compared with the same month one year earlier, housing starts in September were down 0.6%, while permits were down 5.9%. The chart below shows the growth in new home starts by type of property 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		
No economic releases for the rest of today		
Federal Reserve		
ET	**Speaker or Event**	**District or Position**
9:30	Raphael Bostic Presents to High School Students	President of the Federal Reserve Bank of Atlanta
10:00	Neel Kashkari Moderates Panel Event	President of the Federal Reserve Bank of Minneapolis
12:10	Christopher Waller Speaks on Decentralized Finance	Member of the Board of Governors
12:30	Raphael Bostic Participates in Moderated Conversation	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	National CPI	y/y	Sep	2.5%	3.0%	2.5%	***	Equity and bond neutral
	National CPI Ex-Fresh Food	y/y	Sep	2.4%	2.8%	2.3%	**	Equity and bond neutral
	National CPI Ex-Fresh Food & Energy	y/y	Sep	2.1%	2.0%	2.0%	*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	11-Oct	-¥363.1b	¥699..2b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	11-Oct	-¥142.5b	¥257.8b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	11-Oct	¥719.4b	¥1379.4b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	11-Oct	¥968.4b	¥910.1b		*	Equity and bond neutral
China	GDP	y/y	3Q	4.6%	4.7%	4.5%	***	Equity and bond neutral
	Industrial Production	y/y	Sep	5.4%	4.5%	4.6%	***	Equity bullish, bond bearish
	Retail Sales	y/y	Sep	3.2%	2.1%	2.5%	***	Equity bullish, bond bearish
	Fixed Assets Ex Rural YTD	y/y	Sep	3.4%	3.4%	3.3%	**	Equity and bond neutral
EUROPE								
Eurozone	ECB Current Account SA	m/m	Aug	€31.5b	€40.8b		*	Equity and bond neutral
	Construction output	y/y	Aug	-2.5%	-2.3%		*	Equity and bond neutral
UK	Retail Sales	y/y	Sep	3.9%	2.3%	3.2%	***	Equity bullish, bond bearish
	Retail Sales Ex-Auto Fuel	y/y	Sep	4.0%	2.2%	3.1%	**	Equity bullish, bond bearish
Russia	Gold and Forex Reserves	m/m	11-Oct	$622.3b	$629.9b		***	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	11-Oct	18.43t	18.35t		*	Equity and bond neutral
AMERICAS								
Canada	Int'l Securities Transactions	m/m	Aug	9.97b%	10.97b	--	**	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)	452	453	-1	Down
U.S. Sibor/OIS spread (bps)	463	464	-1	Down
U.S. Libor/OIS spread (bps)	459	460	-1	Down
10-yr T-note (%)	4.10	4.09	0.01	Flat
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	$74.06	$74.45	-0.52%	
WTI	$70.33	$70.67	-0.48%	
Natural Gas	$2.34	$2.35	-0.34%	
12-mo strip crack	$20.08	$20.14	-0.30%	
Ethanol rack	$1.70	$1.70	0.10%	
Metals				
Gold	$2,711.72	$2,692.71	0.71%	
Silver	$32.13	$31.70	1.36%	
Copper contract	$438.90	$432.50	1.48%	
Grains				
Corn contract	$408.75	$406.75	0.49%	
Wheat contract	$588.25	$589.50	-0.21%	
Soybeans contract	$990.75	$988.75	0.20%	
Shipping				
Baltic Dry Freight	1,594	1,676	-82	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.19	1.50	-3.69	
Gasoline (mb)	-2.20	-2.00	-0.20	
Distillates (mb)	-3.53	-2.50	-1.03	
Refinery run rates (%)	1.0%	-0.5%	1.5%	
Natural gas (bcf)	76	80	-4	

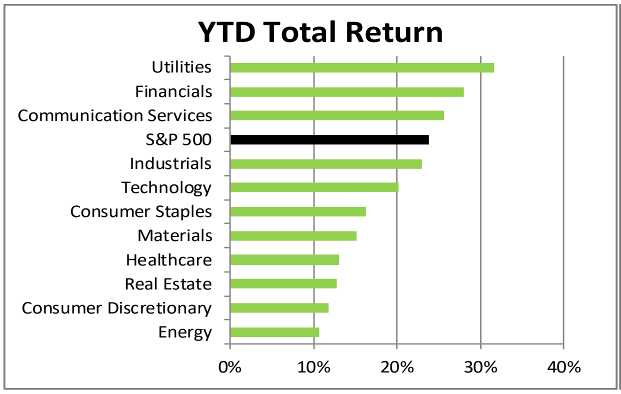
Weather

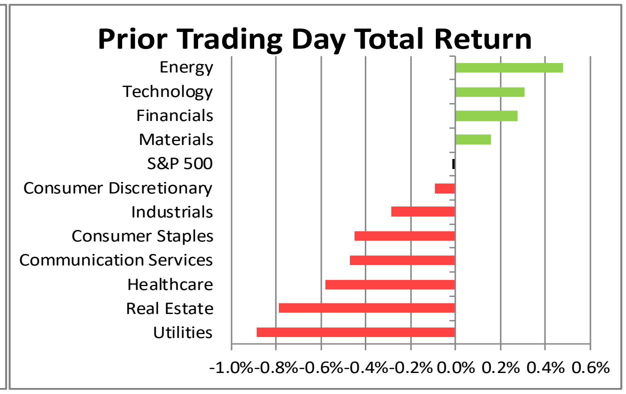
The 6-to-10-day and 8-to-14-day forecasts currently call for warmer-than-normal temperatures everywhere except the Pacific Northwest, where temperatures will be below normal. The forecasts call for wetter-than-normal conditions in the Pacific Northwest, with dry conditions in the Southwest and along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

There are now two tropical disturbances in the Atlantic Ocean. One is located just off the coast of Honduras and is assessed to have a 50% chance of cyclonic formation within the next 48 hours. The other is just to the northeast of Puerto Rico; it is assessed to have only a 10% chance of cyclonic formation in the next 48 hours.

Data Section

US Equity Markets – (as of 10/17/2024 close)

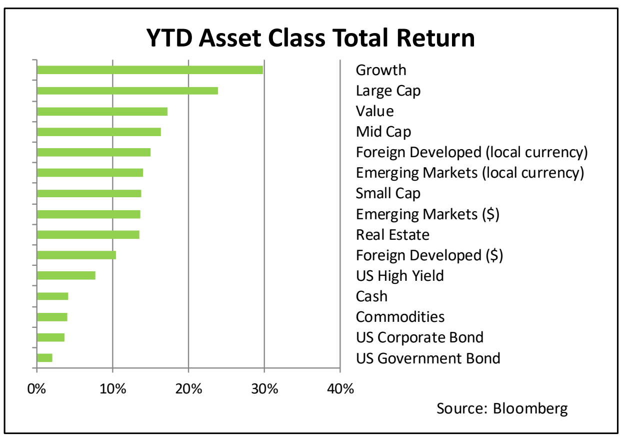




(Source: Bloomberg)

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 10/17/2024 close)

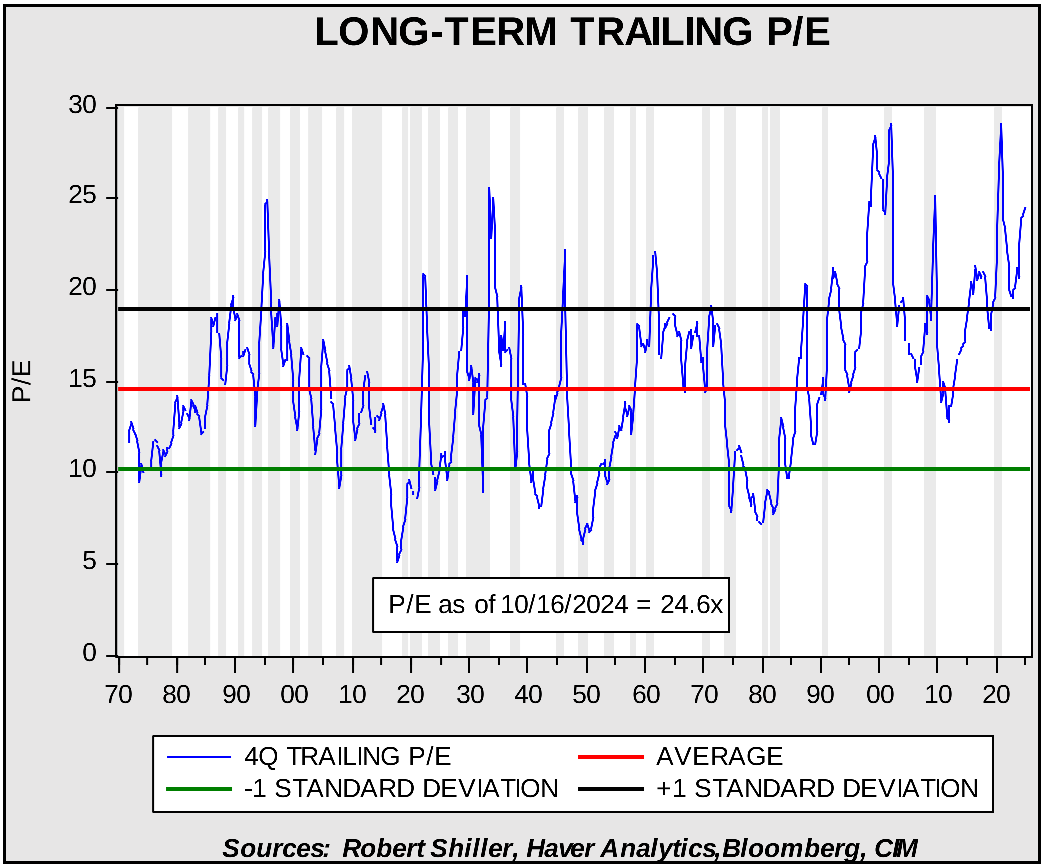


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.