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 29, 2024 — 9:30 AM ET] Global equity markets are generally lower this morning. In Europe, the Euro Stoxx 50 closed up 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.1%. Chinese markets were lower, with the Shanghai Composite down 1.1% from its previous close and the Shenzhen Composite down 1.5%. US equity index futures are signaling a lower open.

With 191 companies having reported so far, S&P 500 earnings for Q3 are running at $60.50 per share, compared to estimates of $60.44, which is up 4.2% from Q3 2023. Of the companies that have reported thus far, 74.9% have exceeded expectations while 16.2% 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:

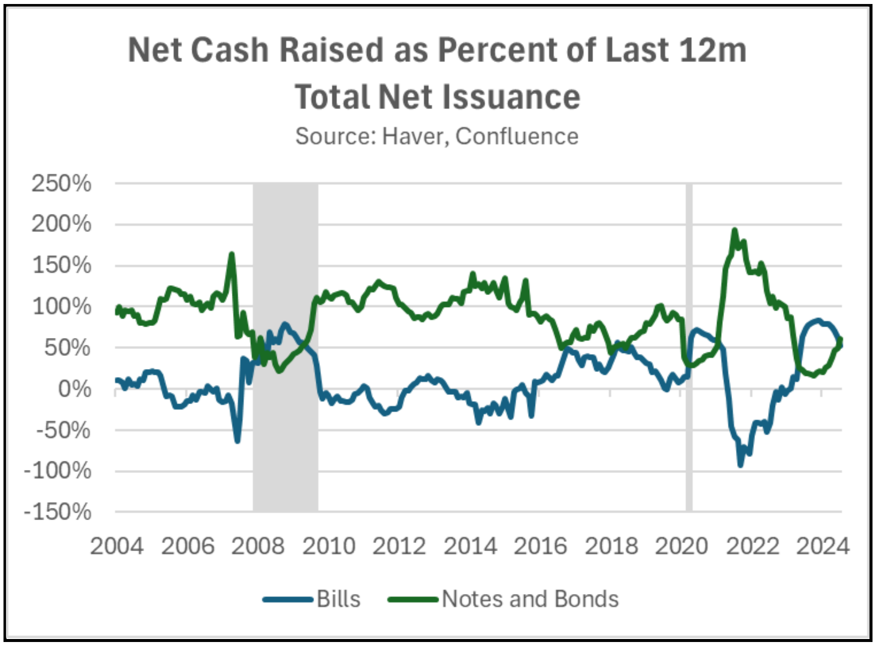
- *Bi-Weekly Geopolitical Report* (10/21/2024) (with associated podcast): "Israel's Pager Caper and Supply Chain Security"
- *Asset Allocation Bi-Weekly* (10/28/2024) (with associated podcast): "The Inflation Adjustment for Social Security Benefits in 2025"
- *Asset Allocation Quarterly – Q4 2024* (10/22/2024): Discussion of our asset allocation process, Q4 2024 portfolio changes, and our outlook for the markets.

Good morning! The market is currently awaiting the latest earnings reports from several mega-cap tech companies. In sports news, Rodri from Manchester City has been awarded the Ballon d'Or for the 2023/2024 season. Today's *Comment* will address rising concerns about financing the US deficit, explore the efforts to increase restrictions on US investments in China, and provide an update on Russia's use of North Korean troops in its war against Ukraine. As usual, our report will include a roundup of both international and domestic data releases.

Treasury Supply Unease: US bond yields have increased due to a disappointing Treasury auction and concerns about financing the federal deficit.

- The US Treasury Department forecasts borrowing $546 billion in the final quarter of the year, which is a $19 billion decrease from the previous quarter's estimate. This projection assumes a year-end cash balance of $700 billion. While the decrease in borrowing was a welcome sign, markets are still grappling with how to absorb the substantial debt. Monday's weak auctions for two- and five-year Treasurys underscore these worries as investors have started to price in the possibility of rising inflation expectations and less dovish Fed policy.

- Bond yields on Wednesday are expected to respond to the Treasury Department's guidance on debt financing for the upcoming year. Investors anticipate that the quarterly refunding announcement will indicate a need for around $125 billion, consistent with May's announcement, which maintained auction sizes for the next few quarters. With auction sizes at record highs — particularly for the 10-year Treasury — any increase above this level could drive yields higher, while a reduction might prompt a retreat. Additionally, a miss could further lead to a decline in US government bond liquidity.

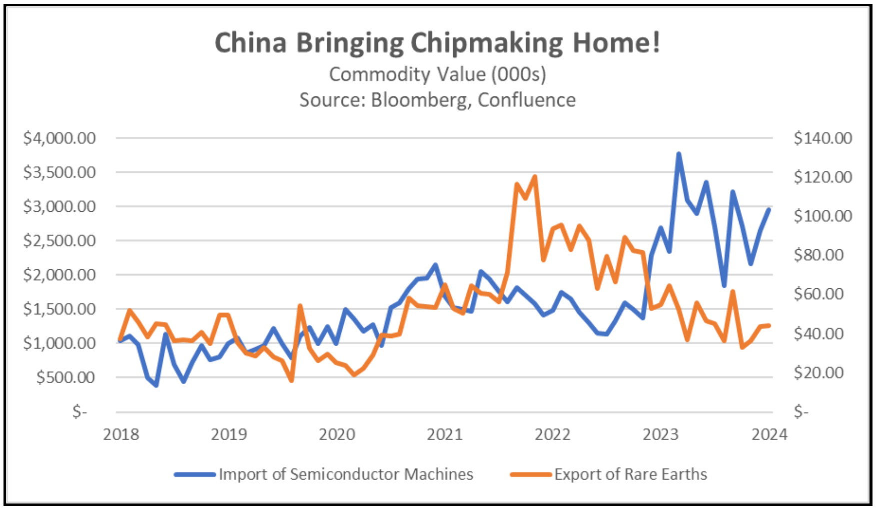


- The nation's debt remains a persistent challenge, as neither presidential candidate has offered a specific plan to tackle the deficit. Instead, their proposals rely on general and potentially contentious measures such as tax hikes and spending reductions. This absence of a clear fiscal strategy is anticipated to drive up bond yields. However, if inflation continues to moderate or the job market weakens, this upward pressure could diminish. Recent estimates from the Cleveland Fed suggest that core PCE inflation may stabilize in the near term, while unemployment rates are expected to remain at 4.1%.

Chip Wars: The White House has unveiled new restrictions on US investments in Chinese companies, aiming to curb the development of critical technologies that could potentially be used by the Chinese military.

- The new restrictions, set to take effect on January 2, will limit US investment in Chinese semiconductor and artificial intelligence companies. Additionally, investors will be required to report certain other forms of assistance to regulators. While the US has already imposed export controls on specific technologies, these new measures aim to prevent US investors from holding equity in companies with ties to the Chinese military. This move comes as a recent report revealed that American investors participated in 17% of global transactions involving Chinese AI companies.

- The restriction on US investments into China comes as Beijing looks to shore up its domestic industry. In recent years, China has aggressively sought to develop its domestic semiconductor industry through substantial investments and the acquisition of advanced manufacturing equipment. Simultaneously, China has imposed export controls on critical minerals essential for chip production, aiming to secure a reliable supply for its domestic industry and potentially limiting access for the US and other Western nations. Although China still trails the US in advanced chipmaking, it is steadily narrowing the gap.

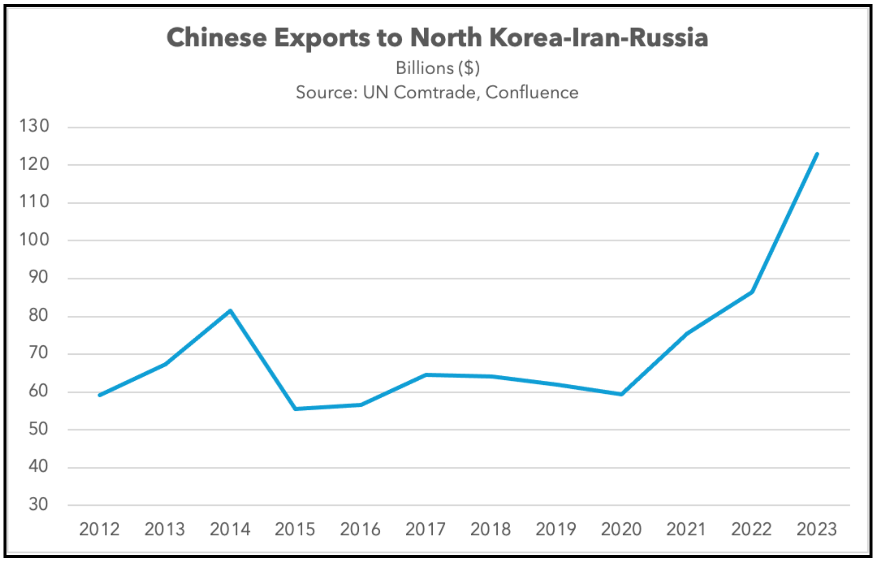


- The escalating semiconductor rivalry is creating headwinds for US tech firms. Apple, for instance, is facing obstacles in launching Apple Intelligence in China due to stringent AI regulations. This could prompt other US AI companies to form partnerships with Chinese firms, despite increased US regulatory scrutiny. To mitigate supply chain risks, Apple has invested in India to diversify its manufacturing base. However, ongoing trade tensions remain a significant challenge for mega-cap tech companies, prompting investors to consider opportunities in other sectors.

The Korea Problem: The prospect of North Korean troops being deployed in Ukraine has raised the likelihood of a broadening war.

- The Pentagon estimates that over 10,000 North Korean troops have been deployed to Russia. While it remains unclear if these soldiers have engaged in combat, US intelligence indicates a significant presence in Russia's embattled Kursk region, which borders Ukraine. In response to these reports, Ukraine has pressed Western allies to supply weapons capable of striking deep within Russia. Such a move, according to Russian President Vladimir Putin, would be seen as direct NATO involvement in the conflict.

- The potential involvement of North Korean troops in Russia's war against Ukraine has raised serious concerns about further destabilizing Europe and could have broader implications for the Indo-Pacific region. Following these reports, there have been renewed calls for deploying EU troops to Ukraine. This idea, initially suggested by French President Emmanuel Macron, was previously rejected by German Chancellor Olaf Scholz. In response to the growing threat posed by North Korea, South Korea has agreed to share intelligence with NATO to coordinate a more effective response.



- The ongoing conflict in Ukraine underscores the increasing importance of military cooperation, even as geopolitical tensions drive global decoupling. Russia's strengthened trade ties with Iran, North Korea, and China, coupled with Beijing's increased export allocation to the region, have enabled these countries to mitigate the impact of Western sanctions. This growing economic and geopolitical alliance could lead to further collaboration on initiatives beyond Ukraine, potentially including actions on the Korean Peninsula or regarding Taiwan.

In Other News: US natural gas prices plummeted 11% on Monday, driven by expectations of warmer-than-usual autumn temperatures, increased domestic production, and easing geopolitical tensions. There is growing skepticism as to whether the Fed will be able to cut rates two more times this year as the economy proves to be very resilient in spite of elevated interest rates.

US Economic Releases

There were no domestic releases prior to the publication of this report. 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	JOLTS Job Openings	m/m	Sep	8000k	8040k	**
10:00	Conference Board Consumer Confidence	m/m	Oct	99.5	98.7	*
10:00	Conference Board Present Situation	m/m	Oct		124.3	*
10:00	Conference Board Expectations	m/m	Oct		81.7	*
10:30	Dallas Fed Services Activity	m/m	Oct		-2.6	*
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	Jobless Rate	m/m	Sep	2.4%	2.5%	2.5%	***	Equity and bond neutral
	Job-To-Applicant Ratio	m/m	Sep	1.2%	1.2%	1.2%	***	Equity and bond neutral
South Korea	Retail Sales	y/y	Sep	6.7%	9.2%		**	Equity and bond neutral
	Depart. Store Sales	y/y	Sep	0.3%	4.4%		*	Equity and bond neutral
	Discount Store Sales	y/y	Sep	-6.5%	5.9%		*	Equity and bond neutral
EUROPE								
Germany	GfK Consumer Confidence	m/m	Nov	-18.3	-21	-20.5	**	Equity bullish, bond bearish
UK	Net Lending Sec. on Dwellings	m/m	Sep	2.5b	2.9b	2.8b	*	Equity and bond neutral
	Mortgage Approvals	m/m	Sep	65.6k	65.0k	64.4k	***	Equity and bond neutral
	M4 Money Supply	y/y	Sep	0.6%	-0.1%		*	Equity and bond neutral
AMERICAS								
Brazil	Current Account Balance	m/m	Sep	-$6526m	-$6899m	-$5000m	**	Equity and bond neutral
	Foreign Direct Investment	m/m	Sep	$5229m	$6104m	$5900m	**	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)	447	449	-2	Down
U.S. Sibor/OIS spread (bps)	459	459	0	Down
U.S. Libor/OIS spread (bps)	455	455	0	Down
10-yr T-note (%)	4.30	4.28	0.02	Up
Euribor/OIS spread (bps)	305	306	-1	Down
Currencies	**3 Mo**			
Dollar	Down	US		Down
Euro	Down	Euro		Up
Yen	Up	Japan		Up
Pound	Up	UK		Up
Franc	Up	Switzerland		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	$72.25	$71.42	1.16%	
WTI	$68.17	$67.38	1.17%	
Natural Gas	$2.21	$2.31	-4.42%	Slower demand and Increased Supply
12-mo strip crack	$19.63	$19.60	0.19%	
Ethanol rack	$1.71	$1.72	-0.29%	
Metals				
Gold	$2,751.66	$2,742.46	0.34%	
Silver	$34.15	$33.67	1.43%	
Copper contract	$442.30	$436.25	1.39%	
Grains				
Corn contract	$412.00	$410.75	0.30%	
Wheat contract	$563.00	$558.75	0.76%	
Soybeans contract	$989.00	$986.00	0.30%	
Shipping				
Baltic Dry Freight	1,382	1,410	-28	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.00		
Gasoline (mb)		-1.90		
Distillates (mb)		-2.01		
Refinery run rates (%)		-0.2%		
Natural gas (bcf)		68		

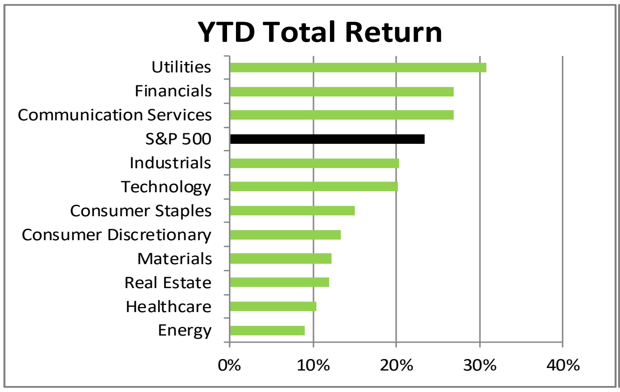
Weather

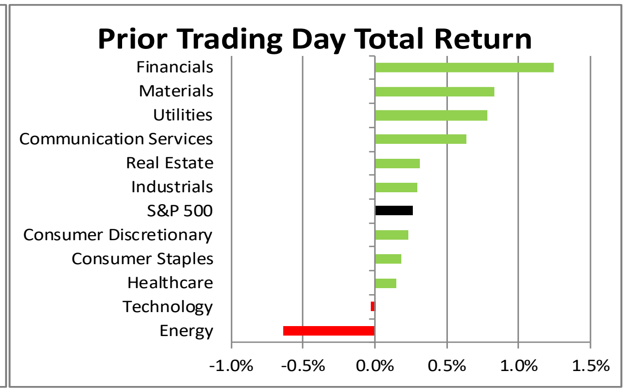
The 6-to-10-day and 8-to-14-day forecasts currently call for warmer-than-normal temperatures from the Great Plains to the East Coast, with cooler-than-normal temperatures in Arizona and New Mexico. The precipitation outlook calls for wetter-than-normal conditions in a stretch of the nation running from the entirety of the Mexican border and the Gulf Coast northeastward through the Great Lakes region and into New England, with drier conditions expected along the northern Pacific Coast stretching into Idaho and Nevada.

There are currently no tropical disturbances anticipated in the Atlantic Ocean over the next 48 hours.

Data Section

US Equity Markets – (as of 10/28/2024 close)

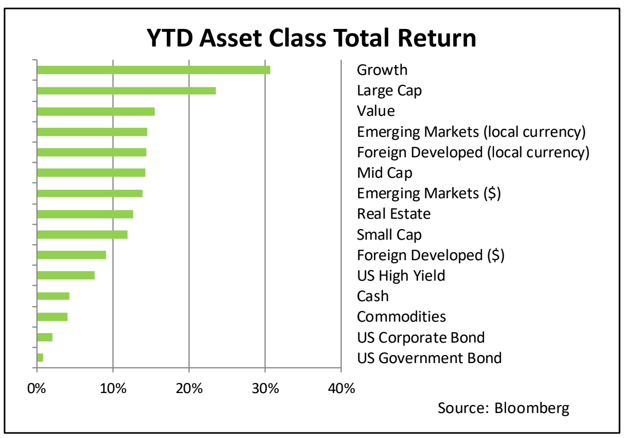




(Source: Bloomberg)

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 10/28/2024 close)

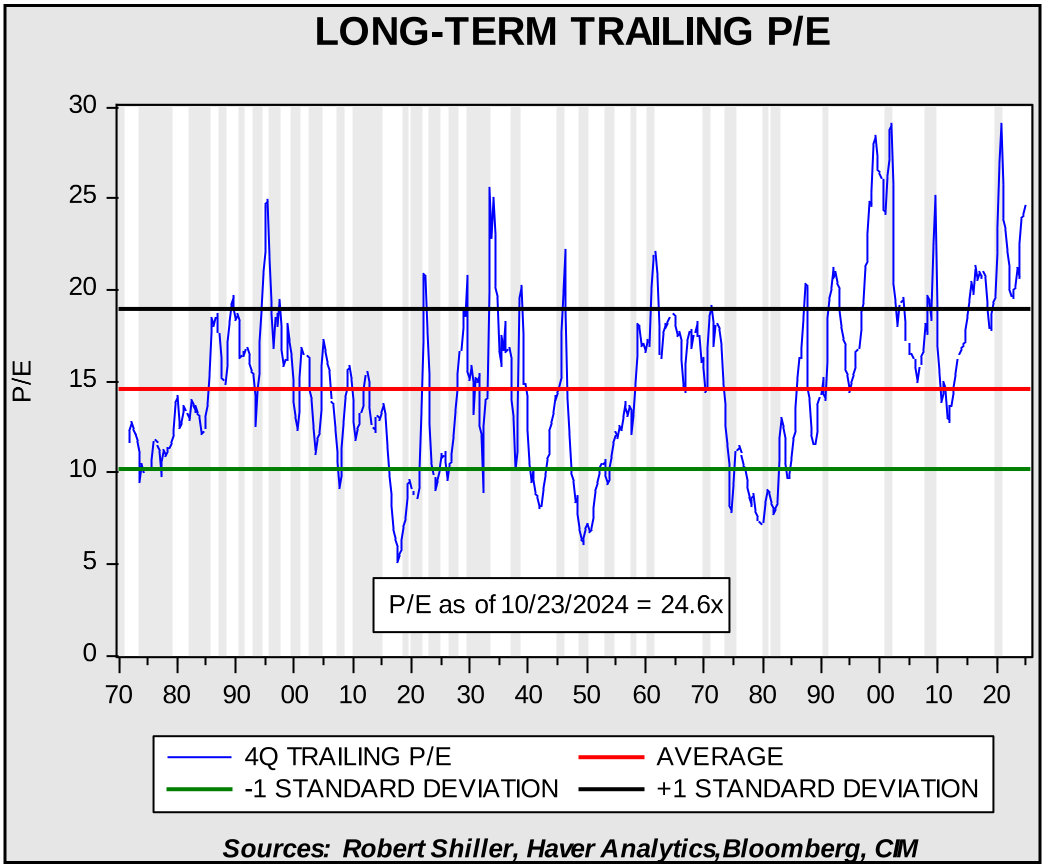


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 24, 2024



Based on our methodology,[1] the current P/E is 24.6x, unchanged from our last report. The stock price index increase was offset by an increase in earnings.

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.