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 31, 2024 — 9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 closed down 0.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.9%. Chinese markets were higher, with the Shanghai Composite up 0.4% from its previous close and the Shenzhen Composite up 0.9%. US equity index futures are signaling a lower open.

With 289 companies having reported so far, S&P 500 earnings for Q3 are running at $61.80 per share, compared to estimates of $60.44, which is up 4.2% from Q3 2023. Of the companies that have reported thus far, 72.7% have exceeded expectations while 18.3% 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:

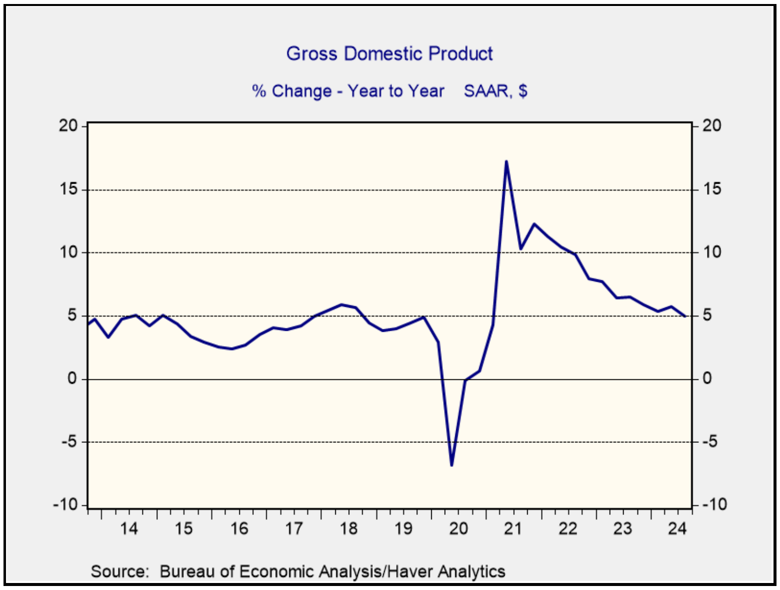
- *Bi-Weekly Geopolitical Report* (10/21/2024) (with associated podcast): "Israel's Pager Caper and Supply Chain Security"
- *Asset Allocation Bi-Weekly* (10/28/2024) (with associated podcast): "The Inflation Adjustment for Social Security Benefits in 2025"
- *Asset Allocation Quarterly – Q4 2024* (10/22/2024):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

Happy Halloween! Markets are currently digesting the latest inflation data as investors gauge the Federal Reserve's next move. In sports news, the Los Angeles Dodgers clinched a World Series victory over the New York Yankees. Today's *Comment* will delve into a detailed analysis of the recent GDP data, explore the challenges faced by Big Tech companies in scaling data center infrastructure to meet AI demands, and provide a brief overview of the UK's recent budget. As always, the report will conclude with a roundup of international and domestic data releases.

GDP Resilience: The robust economic growth observed in the third quarter has complicated the Federal Reserve's decision-making process regarding potential interest rate cuts.

- US GDP expanded at an annualized rate of 2.8% in the third quarter, marginally missing the projected 3.0%. Strong consumer spending and government expenditures were the primary growth drivers. Consumer spending accelerated from 2.8% to 3.7% annualized, led by a surge in nondurable goods purchases. Additionally, increased defense spending contributed nearly 20% to overall growth. However, investment, particularly residential spending, contracted from the previous quarter as elevated interest rates continue to act as a drag to economic output.

- While third-quarter growth was robust, its sustainability remains uncertain. Precautionary spending, likely driven by concerns over a potentially prolonged port worker strike on the East and Gulf Coasts, may have pulled forward much of the anticipated consumption for the coming quarter. Additionally, the surge in defense spending, largely driven by escalating tensions in Ukraine and the Middle East, may be a one-time event. Consequently, the latest report may still provide a complicated picture for the Fed when it is deciding whether it is appropriate to adjust policy rates.

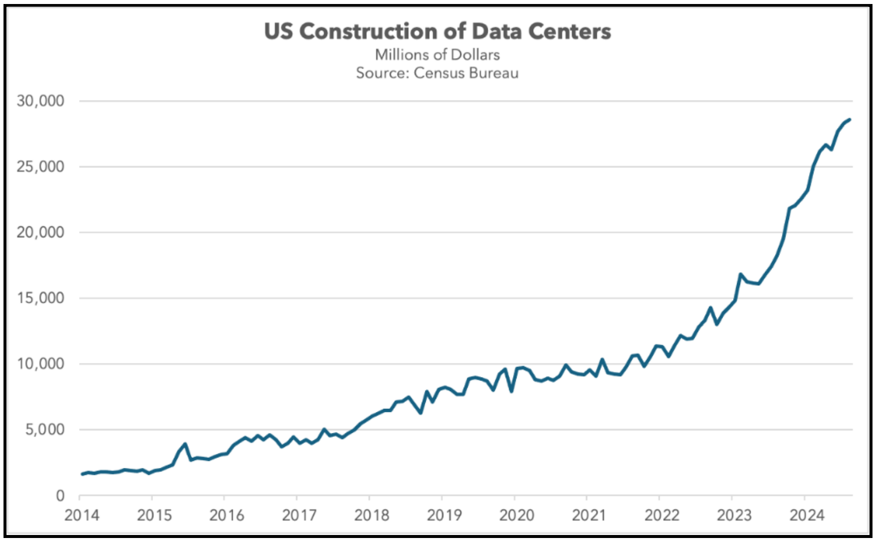


- The Federal Reserve's decision on whether to cut rates will likely hinge on Friday's jobs report. In its previous meeting, the Fed revised its year-end unemployment rate expectation upward from 4.1% to 4.4%. Given that the unemployment rate has since declined from its 2024 peak of 4.3% to 4.1%, a significant rate cut this month is highly improbable. However, a pause in rate hikes remains a distinct possibility, especially if the unemployment rate continues its downward trend, given the recent strength of economic data.

Data Centers on the Rise: The limited supply of data centers is preventing tech companies from being able to capitalize on the rising demand for AI.

- Microsoft and Meta have recently warned that their limited data center capacity could hinder revenue growth in their cloud businesses. This outlook has dampened investor sentiment towards both companies, as it implies a need for increased capital expenditures to expand their infrastructure. Consequently, both companies experienced a decline in their share prices, despite reporting relatively strong revenue growth in the third quarter. Investors are concerned about the long-term profitability of these companies, given their consistently upward revised spending forecasts that have outpaced revenue guidance.

- Building out data center capacity has proven challenging, as construction projects have faced significant pushback from local communities. These communities often cite concerns about noise pollution, land use, and limited job creation. Many towns across the country have been reluctant to approve data center construction projects. Additionally, the energy intensity of these facilities has become a concern, as utility companies struggle to build out the necessary infrastructure to meet the demand. These challenges will limit tech companies' ability to expand their data center capacity.

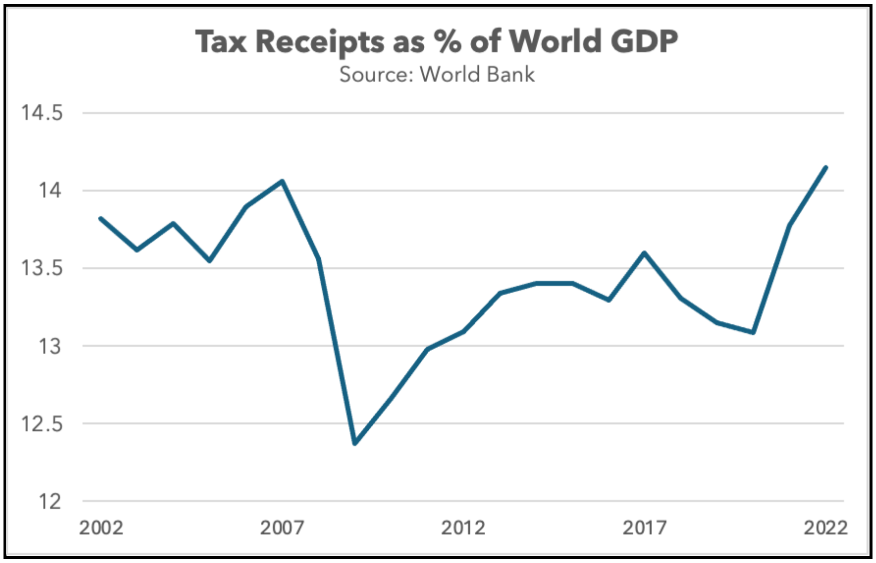


- While the demand for data centers continues to grow, the ability to build them at scale is facing significant challenges. This could hinder the growth of major tech companies as they seek to expand their infrastructure. Although this may not entirely derail revenue growth, it suggests that the path to profitability may be more arduous than many investors anticipate. Given that the future profitability of large tech companies is already largely priced into their stock prices, we believe investors may find more attractive opportunities in other sectors, particularly those with limited exposure to AI.

UK Budget: The Labour Party delivered its budget proposal to mixed fanfare.

- The new budget proposal aims to generate nearly $52 billion in additional tax revenue by the end of the decade. Over half of this revenue would come from an increase in the National Insurance payroll tax, with additional taxes levied on inheritance and capital gains. The budget also seeks to boost long-term growth through increased spending on infrastructure and research and development. While the market's initial reaction was negative, it was far from a panic. On Wednesday, the 10-year UK gilt yield rose 18 basis points, and the pound sterling (GBP) modestly weakened by 0.4% against the US dollar.

- While the recent budget averted another "Liz Truss Moment," it has raised concerns about the UK's economic growth outlook for the coming quarters. The National Insurance payroll tax levy, in particular, has drawn significant criticism. A left-leaning think tank estimates that this tax increase will limit the real weekly wage to approximately $17 higher by the end of 2028, compared to two decades ago. However, this projection assumes that businesses will pass on the tax burden to consumers and workers to protect their profit margins.

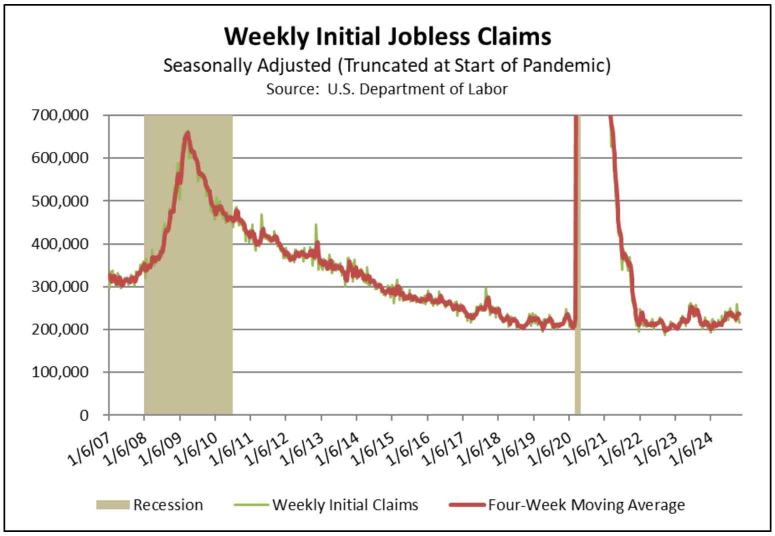


- Governments worldwide are increasingly recognizing the need to generate additional tax revenue to offset pandemic-related spending. While some countries may be able to increase funding through robust economic growth, others, like the UK, may need to rely on higher taxes to balance their budgets. The recent UK budget proposal indicates that the government does not believe that growth alone will suffice to close the fiscal gap. While we expect the new proposal to have long-term benefits, we believe that long-term bonds could present an attractive investment opportunity if the plan is successful.

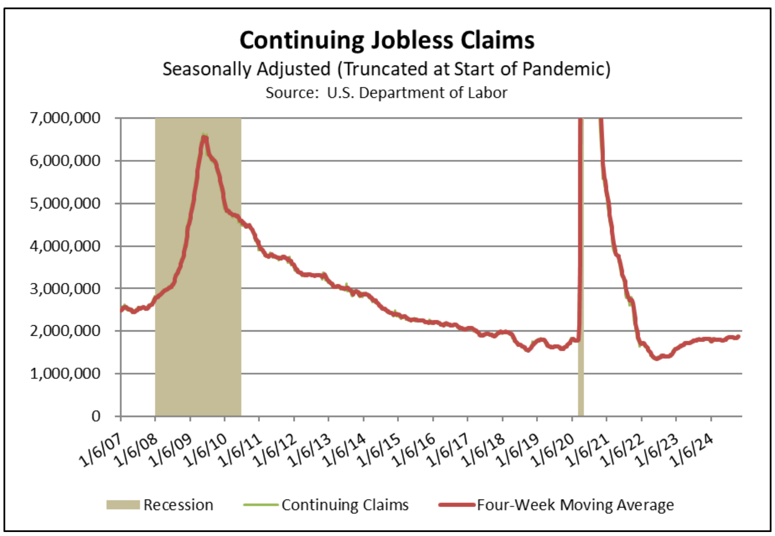
In Other News: Factory activity in China strengthened for the first time in six months, in a sign that the economy is starting to show signs of life. Volkswagen is demanding that its workers take a 10% pay cut as it looks to avoid having to make layoffs. North Korea conducted its longest ever ballistic missile test flight time in a sign that the country is looking to assert itself no matter who wins the US election in November.

US Economic Releases

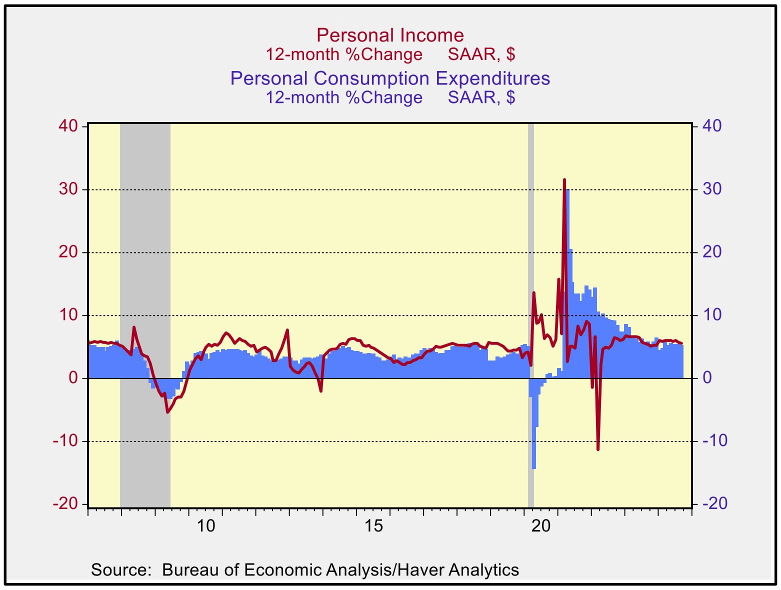
In the week ended October 26, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 216,000, well below both the expected level of 230,000 and the prior week's revised level of 228,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to a modest 236,500, helping confirm that labor demand has recently strengthened again. 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.



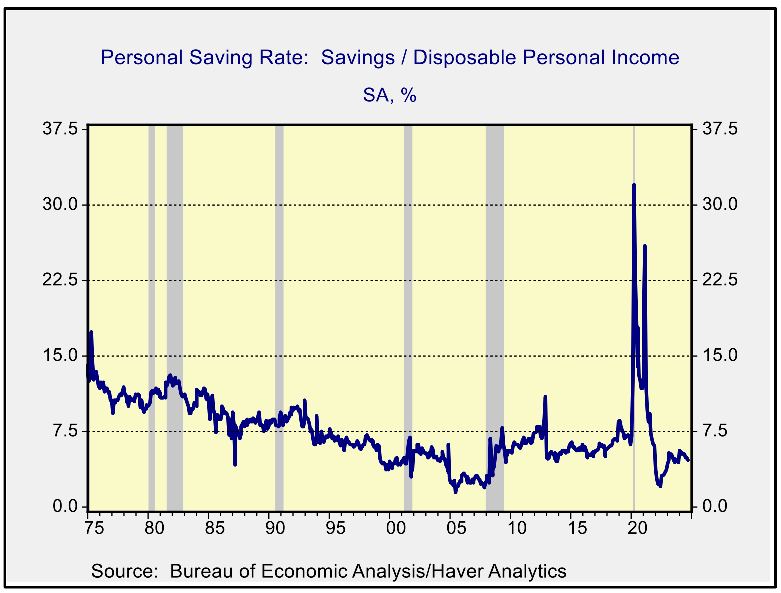
In the week ended October 19, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) fell to a seasonally adjusted 1.862 million, below both the anticipated reading of 1.880 million and the previous week's revised reading of 1.888 million. The four-week moving average of continuing claims nevertheless rose slightly to 1,869,250. 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, September ***personal income*** rose by a seasonally adjusted 0.3%, matching expectations and marking an acceleration from the 0.2% rise in August. Meanwhile, September ***personal consumption expenditures (PCE)*** rose 0.5%, exceeding their anticipated increase and accelerating from their 0.2% gain in the previous month. Personal income in September was up 5.5% from the same month one year earlier, while PCE was up 5.3%. The chart below shows the year-over-year change in personal income and PCE since just before the GFC.

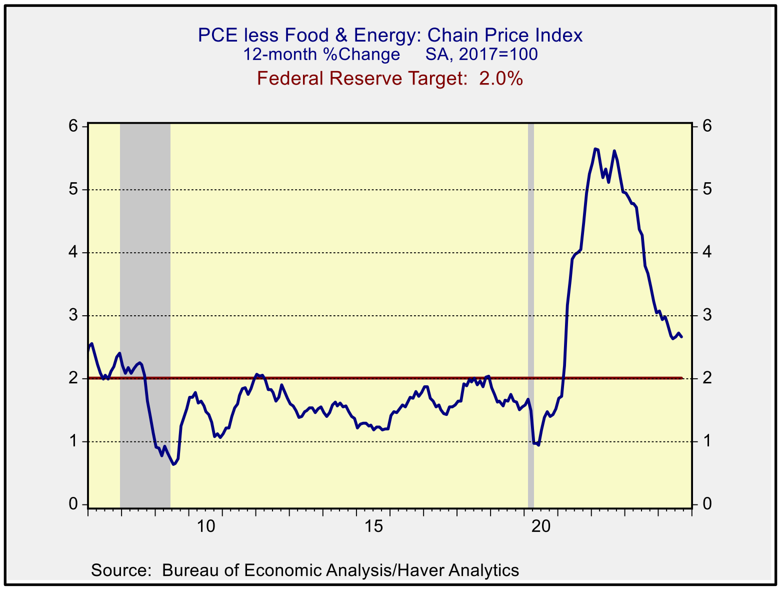


The personal income and spending report also includes a measure of personal saving, defined as disposable (after tax) income less consumption spending on goods and services. The September ***personal savings rate*** rose to a seasonally adjusted 4.6%, reaching its lowest level since last December. The chart below shows how the personal savings rate has fluctuated over the last several decades.

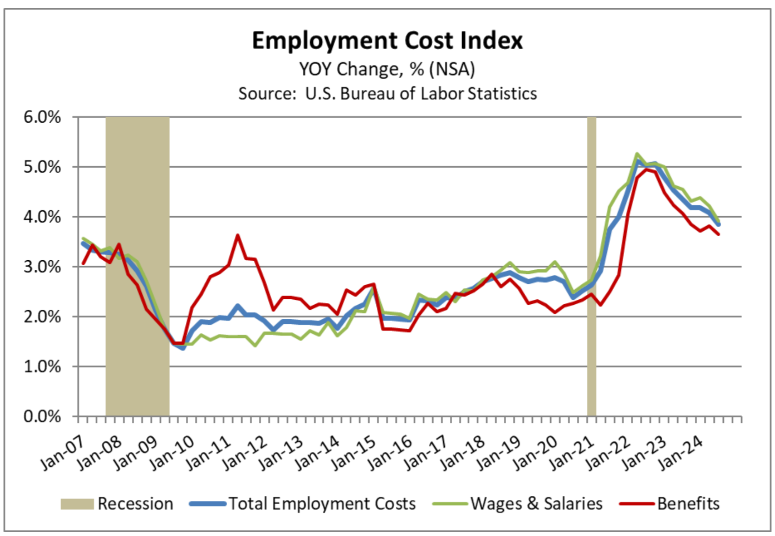


The income and spending report always includes the Federal Reserve's preferred measure of consumer price inflation. After stripping out the volatile food and energy components, the ***Core PCE Deflator*** for September was up 2.65% from the same month one year earlier, decelerating slightly from the 2.72% increase in the year to August but remaining well above the Fed's target.

The chart below shows the year-over-year change in the Core PCE Deflator since just before the GFC.



In one last report so far this morning, the third-quarter ***Employment Cost Index (ECI)*** rose by a seasonally adjusted 0.8%, slightly better than expectations that it would rise by the same 0.9% that it did in the second quarter. Both the subindex on wages and salaries and the subindex on benefits rose 0.8% as well. Compared with the same period one year earlier, the overall ECI in the third quarter was up 3.9%. The subindex on wages and salaries was up 3.9% year-over-year, while the subindex on benefits was up 3.7%. The chart below shows the year-over-year change in the ECI 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**
9:45	MNI Chicago PMI	m/m	Oct	47.0	46.6	***
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	Retail Sales	y/y	Sep	0.5%	3.1%	2.1%	**	Equity bearish, bond bullish
	Depart. Store & Supermarket Sales	y/y	Sep	1.8%	4.3%		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	25-Oct	-¥889.6b	-¥614.7b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	25-Oct	-¥397.6b	-¥384.8b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	25-Oct	¥277.9b	-¥487.1b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	25-Oct	¥8.0b	¥581.9b		*	Equity and bond neutral
	Industrial Production	y/y	Sep P	-2.8%	-4.9%	-3.2%	***	Equity bullish, bond bearish
	Housing Starts	y/y	Sep	-0.6%	-5.1%	-4.3%	**	Equity bullish, bond bearish
	Annualized Housing Starts	y/y	Sep	0.800m	0.777m	0.771m	*	Equity and bond neutral
Australia	Building Approvals	m/m	Sep	4.4%	-3.9%	2.1%	***	Equity bullish, bond bearish
	Retail Sales	m/m	Sep	0.1%	0.7%	0.3%	***	Equity and bond neutral
	Private Sector Credit	y/y	Sep	5.8%	5.7%		**	Equity and bond neutral
New Zealand	ANZ Activity Outlook	m/m	Oct	45.9	45.3		*	Equity and bond neutral
	ANZ Business Confidence	m/m	Oct	65.7	60.9		**	Equity and bond neutral
South Korea	Industrial Production	y/y	Sep	-1.3%	3.8%	0.5%	***	Equity bearish, bond bullish
China	Official Composite PMI	m/m	Oct	50.8	50.4		*	Equity and bond neutral
	Official Manufacturing PMI	m/m	Oct	50.1	49.8	49.9	***	Equity and bond neutral
	Official Services PMI	m/m	Oct	50.2	50.0	50.3	**	Equity and bond neutral
EUROPE								
Eurozone	CPI	y/y	Oct	2.0%	1.7%	1.9%	***	Equity and bond neutral
	Core CPI	y/y	Oct P	2.7%	2.7%	2.6%	**	Equity and bond neutral
	Unemployment Rate	m/m	Sep	6.3%	6.3%	6.4%	**	Equity and bond neutral
Germany	CPI	y/y	Oct P	2.0%	1.6%	1.8%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Oct P	2.4%	1.8%	2.1%	**	Equity and bond neutral
	Import Price Index	y/y	Sep	-1.3%	0.2%	-1.4%	**	Equity and bond neutral
	Retail Sales	y/y	Sep	0.9%	2.5%	1.2%	*	Equity and bond neutral
France	CPI	y/y	Oct P	1.2%	1.1%	1.1%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Oct P	1.5%	1.4%	1.5%	**	Equity and bond neutral
	PPI	y/y	Sep	-7.0%	-6.3%		*	Equity and bond neutral
Italy	Unemployment Rate	m/m	Sep	6.1%	6.1%	6.2%	**	Equity and bond neutral
	CPI, EU Harmonized	y/y	Oct P	1.0%	0.7%	0.9%	***	Equity and bond neutral
	CPI NIC Including Tobacco	y/y	Oct P	0.9%	0.7%	0.8%	**	Equity and bond neutral
	Industrial Sales WDA	y/y	Aug	-4.6%	-4.7%		*	Equity and bond neutral
Russia	Retail Sales	m/m	Sep	6.50%	5.10%	5.70%	***	Equity bullish, bond bearish
	Unemployment Rate	m/m	Sep	2.40%	2.40%	2.50%	***	Equity and bond neutral
AMERICAS								
Brazil	Formal Job Creation	m/m	Sep	247818	239113	224000	**	Equity and bond neutral
	National Unemployment Rate	m/m	Sep	6.4%	6.6%		*	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)	446	447	-1	Down
U.S. Sibor/OIS spread (bps)	456	457	-1	Down
U.S. Libor/OIS spread (bps)	453	454	-1	Down
10-yr T-note (%)	4.28	4.30	-0.02	Up
Euribor/OIS spread (bps)	306	306	0	Down
Currencies	**3 Mo**			
Dollar	Down	US		Down
Euro	Down	Euro		Up
Yen	Up	Japan		Up
Pound	Up	UK		Up
Franc	Up	Switzerland		Up
Central Bank Action	**Actual**	**Prior**	**Expected**	
BOJ Target Rate	0.250%	0.250%	0.250%	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	$72.65	$72.55	0.14%	
WTI	$68.73	$68.61	0.17%	
Natural Gas	$2.80	$2.85	-1.51%	
12-mo strip crack	$20.14	$20.19	-0.24%	
Ethanol rack	$1.73	$1.73	0.23%	
Metals				
Gold	$2,781.79	$2,787.61	-0.21%	
Silver	$33.53	$33.78	-0.73%	
Copper contract	$433.75	$435.15	-0.32%	
Grains				
Corn contract	$410.25	$411.50	-0.30%	
Wheat contract	$569.25	$573.25	-0.70%	
Soybeans contract	$994.50	$991.25	0.33%	
Shipping				
Baltic Dry Freight	1,395	1,402	-7	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-0.52	1.81	-2.32	
Gasoline (mb)	-2.71	0.60	-3.31	
Distillates (mb)	-0.98	-0.97	0.00	
Refinery run rates (%)	-0.4%	0.1%	-0.5%	
Natural gas (bcf)		85		

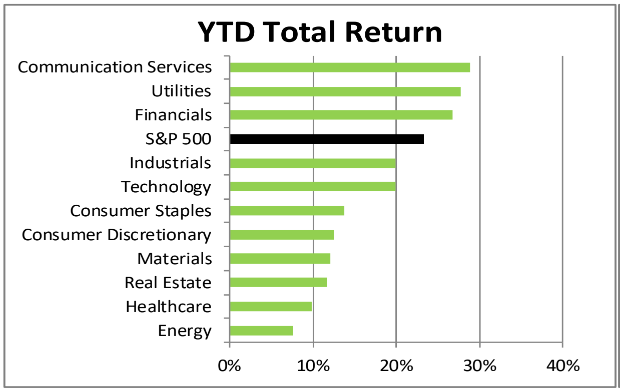
Weather

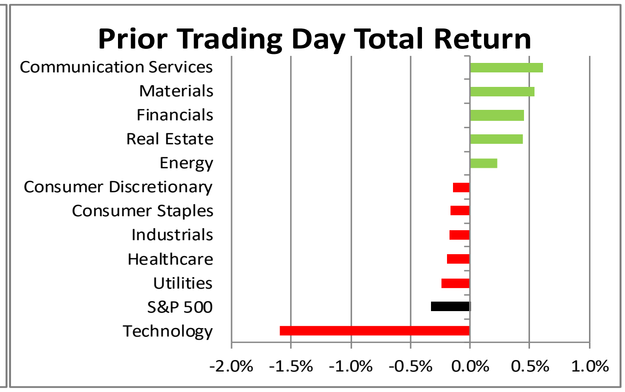
The 6-to-10-day and 8-to-14-day forecasts currently call for warmer-than-normal temperatures from the Great Plains eastward, with cooler-than-normal temperatures in the Southwest. The forecasts call for wetter-than-normal conditions in the Southwest, the southern Great Plains, and the southern stretches of the East Coast, with dry conditions in California and New England.

There are currently no tropical disturbances in the Atlantic Ocean area.

Data Section

US Equity Markets – (as of 10/30/2024 close)

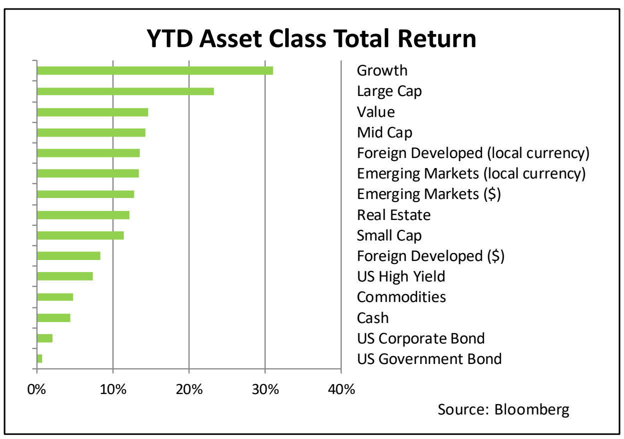




(Source: Bloomberg)

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 10/30/2024 close)

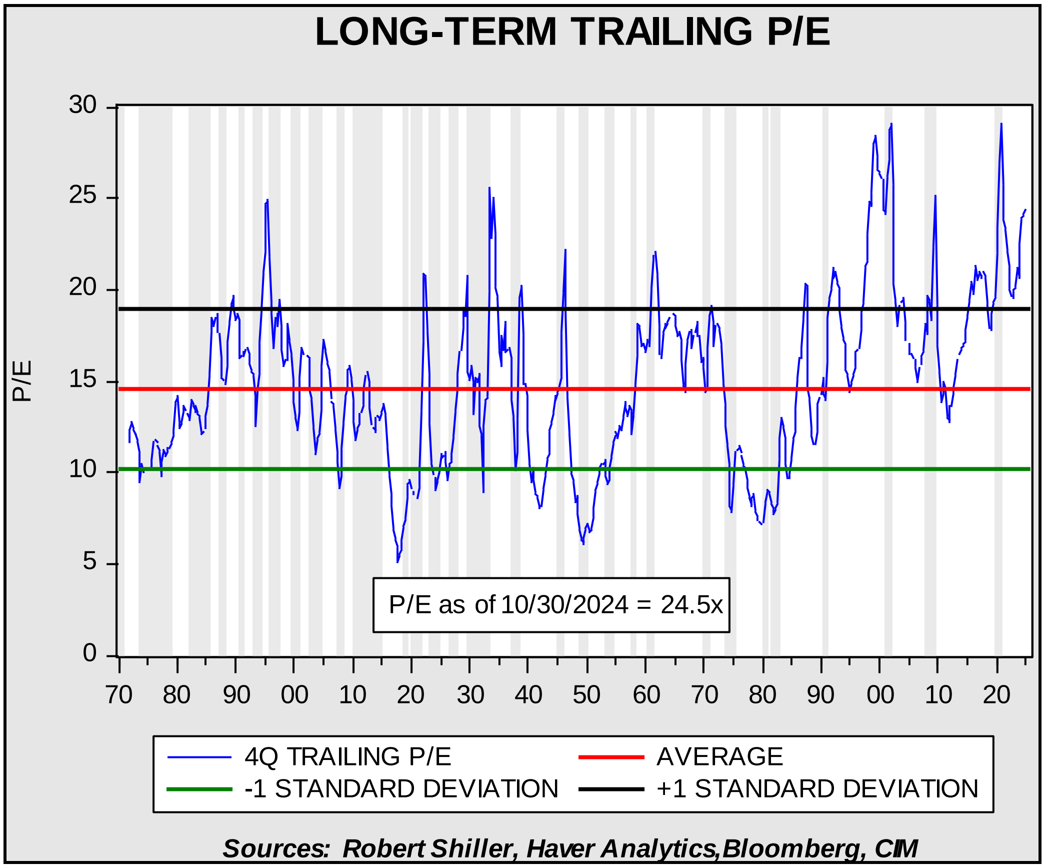


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 31, 2024



Based on our methodology,[1] the current P/E is 24.5x, down 0.1 from our last report. The stock price index increase was offset by a relatively larger 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.