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: September 16, 2024 — 9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is down 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.5%. Chinese markets are closed in observance of the Mid-Autumn Festival. US equity index futures are signaling a mildly lower open.

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:

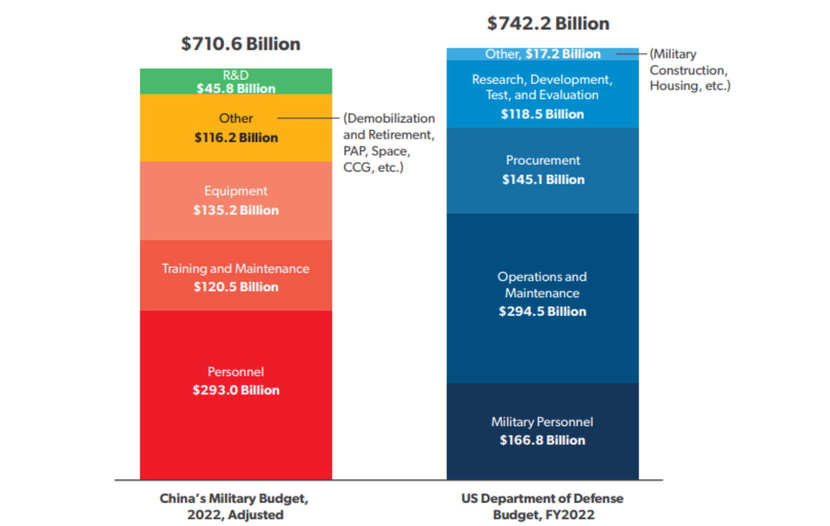
- *Bi-Weekly Geopolitical Report* (9/9/2024) (with associated podcast): "Prospects for the Dollar in a Fracturing World"
- ***Asset Allocation Bi-Weekly*** **(9/16/2024) (with associated podcast): "The Benjamin Button Dividend"**
- *Asset Allocation Quarterly – Q3 2024* (7/16/2024): Discussion of our 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"

Our *Comment* today opens with some interesting new research on how much the Chinese are spending on their military — an issue that has raised concerns about China's intensions, which helped spawn global fracturing. We next review several other international and US developments with the potential to affect the financial markets today, including signs that the Bank of Canada may be ready to embark on aggressive interest-rate cuts and new reporting on how utility-sized batteries helped the US electrical grid handle near-record demand this summer.

China: A recent study by the American Enterprise Institute (AEI) estimates that China's true military spending is about three times bigger than it admits publicly and rivals that of the US. Adjusting Beijing's published defense budget to account for hidden military outlays, defense industry subsidies, and price distortions, the study finds that China's all-in defense spending in 2022 was $710.6 billion, almost matching the US Department of Defense's budget of $742.2 billion and rivaling the US's all-in spending of $860.7 billion.

- Like the Soviet Union during the Cold War, China currently releases only minimal information on its defense spending. The few figures Beijing does release are widely seen as under-counting China's military effort.
- The AEI estimate is consistent with Congressional statements suggesting that the CIA believes China's all-in defense spending is around $700 billion per year.
- Leaders in Beijing almost certainly want to replace the US as the global hegemon eventually. For now, however, China remains more like a regional power, with a defense sphere covering roughly the eastern half of the northern hemisphere, or one-quarter of the earth's surface. If the AEI estimate is correct, China's military spending is now more than $14,000 per square mile of its defense sphere.
- The US, in contrast, is still the global hegemon, with a defense sphere covering the entire globe excluding Antarctica (which is nominally neutral). US military spending today amounts to only about $4,800 per square mile of its defense sphere.
- The enormous resources that China is pouring into its military within the East Asian region is one reason why countries around the world have become more fearful of Beijing's intentions. The Chinese military expansion is therefore a key reason why the world is fracturing into relatively separate geopolitical and economic blocs, with big implications for the global economy and financial markets.

Figure 3. When Accounting for Economic Differences and Hidden Expenditures, China's Military Spending Is Nearly Equal to the United States'



(Source: American Enterprise Institute)

China-Philippines: On Sunday, the Philippine coast guard ship *Teresa Magbanua*, which had been anchored at a disputed shoal in the South China Sea since April to assert Manila's sovereignty, returned to a Philippine port for repairs and supplies. Manila said the ship will soon return to the disputed shoal, but China is likely to swarm the area in the meantime with its own vessels, potentially setting the stage for a dangerous new crisis.

Russia-Ukraine: Russian forces today continue their counteroffensive against the Ukrainians who have seized some 1,200 square kilometers of Russia's Kursk region. However, they have apparently only taken back about 63 square kilometers. Since one key reason for the Ukrainian incursion was to gain a bargaining chip for future negotiations, the question now is how tenaciously the Ukrainians will fight to hold the area and what military resources they might lose in defending it.

France: President Macron has nominated his outgoing foreign minister, Stéphane Séjourné, to be France's next EU commissioner. The move followed a deal in which European Commission chief Ursula von der Leyen told Macron she would give France a more powerful commissioner post if Macron would sack France's previous commissioner, Thierry Breton, who is a political enemy of von der Leyen. Upon hearing of the deal, Breton resigned, opening the way for Séjourné. (A bit hardball? Yes. But this is why we love French politics.)

Canada: In an interview with the *Financial Times*, Bank of Canada Governor Tiff Macklem said his policymakers are increasingly concerned about the country's weakening labor market and the prospect for further declines in oil prices. With consumer price inflation now almost back down to the central bank's target of 2.0%, Macklem's statement sets the stage for further and/or more aggressive interest-rate cuts over the coming months.

Argentina: In a speech yesterday, President Milei proposed a 2025 budget with a primary surplus (i.e., revenues minus outlays excluding interest payments) of 1.3% of gross domestic product. Milei's austerity program produced a primary surplus of about 1.4% of GDP in the first seven months of 2024, but political and popular opposition is rising, and his 2025 goals depend on a dramatic increase in economic growth and a sharp decline in price inflation. It is not yet clear whether he can continue his reforms and rein in Argentina's destabilizing debt.

United States-China: The Biden administration on Friday proposed a rule change that would dramatically tighten up the "de minimis" tariff exemption, which allows foreign producers to ship goods directly to US customers if the shipment's value doesn't exceed $800. The exemption was used by low-cost consumer goods producers in China, such as Shein, to send about one billion tariff-free shipments to the US last year, creating competitive challenges for US producers.

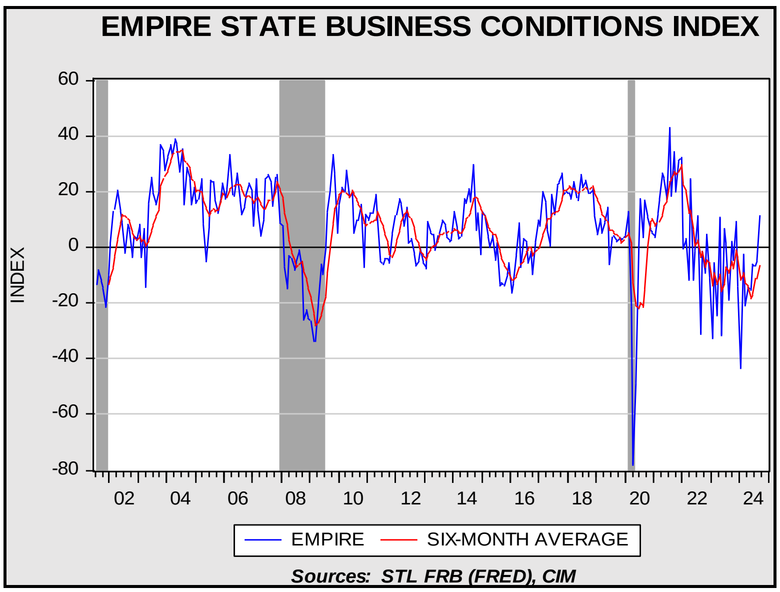
US Monetary Policy: The Fed begins its latest policy meeting tomorrow, with its decision due on Wednesday at 2:00 PM ET. The policymakers are widely expected to cut the benchmark fed funds interest rate at least 0.25% from its current range of 5.25% to 5.50%. Of course, some investors are still looking for a cut of 0.50%, but we think lingering concerns about price inflation will keep the policymakers from being that aggressive.

US Electrical Grid: Despite record-high temperatures and strong electricity demand for air conditioning this summer, a *Wall Street Journal* article today shows the US electrical grid managed to handle the load with relatively few problems. The article tags the success largely to recent investments in both renewable energy, such as solar and wind farms, and battery storage, especially in California and Texas. The surprisingly critical role played by batteries suggests investors will continue pouring funds into battery makers and battery materials.

US Technology Industry: In another article today, the *Journal* highlights a little-noticed announcement as Apple rolled out its new iPhone last week. According to the company, the Food and Drug Administration has approved use of its AirPods Pro 2 as a hearing aid. Once Apple releases the required software update this fall, an AirPod Pro 2 will be a medical device. It also could well become one of the most popular, low-cost, over-the-counter hearing aids on the market and open a whole new market for consumer tech firms.

US Economic Releases

The New York Fed's Empire Manufacturing Index surged unexpectedly to +11.5 in September, signaling a rebound in factory activity. This marked a dramatic turnaround from the previous month's -4.7 and easily outpaced the consensus forecast of -4.0. While optimism about the economy fueled this improvement, the index did reveal a slowdown in hiring.



The chart above shows the empire manufacturing index along with its six-month moving average. The moving average rose from -11.4 to -6.0.

There are no economic releases or Fed events scheduled for the rest of the day.

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								
China	Industrial Production	y/y	Aug	4.5%	5.1%	4.7%	***	Equity and bond neutral
	Retail Sales	y/y	Aug	2.1%	2.7%	2.5%	**	Equity and bond neutral
	Fixed Assets Ex Rural YTD	y/y	Aug	3.4%	3.6%	3.5%	**	Equity and bond neutral
EUROPE								
Eurozone	Trade Balance SA	m/m	Jul	15.5b	17.0b	15.0b	**	Equity and bond neutral
Germany	Retail Sales	y/y	May	-3.9%	-1.3%		*	Equity and bond neutral
Italy	CPI, EU Harmonized	y/y	Aug F	1.2%	1.3%	1.3%	***	Equity and bond neutral
UK	Rightmove House Prices	y/y	Sep	1.20%	0.80%		**	Equity and bond neutral
Switzerland	Producer & Import Prices	w/w	Aug	-1%	-2%		*	Equity and bond neutral
	Domestic Sight Deposits CHF	w/w	13-Sep	458.2b	4473b		*	Equity and bond neutral
	Total Sight Deposits CHF	y/y	13-Sep	466.8b	455.9b		**	Equity and bond neutral
Russia	GDP	y/y	2Q P	4.1%	4.0%	4.0%	**	Equity and bond neutral
AMERICAS								
Canada	Wholesale Sales ex Petroleum	m/m	Jul	0.4%	-0.5%	-1.1%	**	Equity bullish, bond bearish
	Capacity Utilization Rate	m/m	2Q	79.1%	78.6%	78.8%	**	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)	520	521	-1	Down
3-mo T-bill yield (bps)	475	476	-1	Down
U.S. Sibor/OIS spread (bps)	482	488	-6	Down
U.S. Libor/OIS spread (bps)	479	485	-6	Down
10-yr T-note (%)	3.64	3.65	-0.01	Down
Euribor/OIS spread (bps)	347	348	-1	Down
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			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	$72.05	$71.61	0.61%	
WTI	$69.18	$68.65	0.77%	
Natural Gas	$2.31	$2.31	0.04%	
12-mo strip crack	$18.25	$18.33	-0.44%	
Ethanol rack	$1.87	$1.87	-0.20%	
Metals				
Gold	$2,581.35	$2,577.70	0.14%	
Silver	$30.96	$30.72	0.78%	
Copper contract	$425.60	$423.60	0.47%	
Grains				
Corn contract	$410.25	$413.25	-0.73%	
Wheat contract	$584.50	$594.75	-1.72%	
Soybeans contract	$1,005.25	$1,006.25	-0.10%	
Shipping				
Baltic Dry Freight	1,890	1,927	-37	

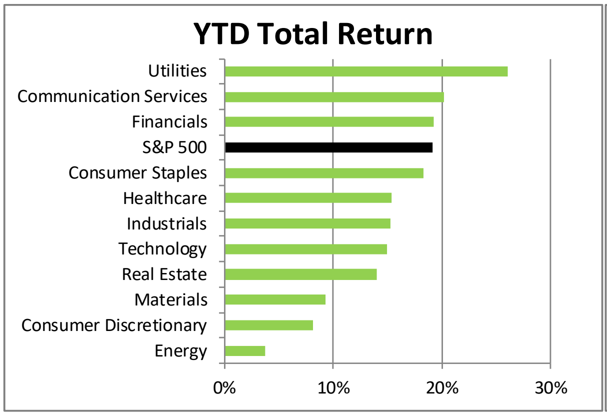
Weather

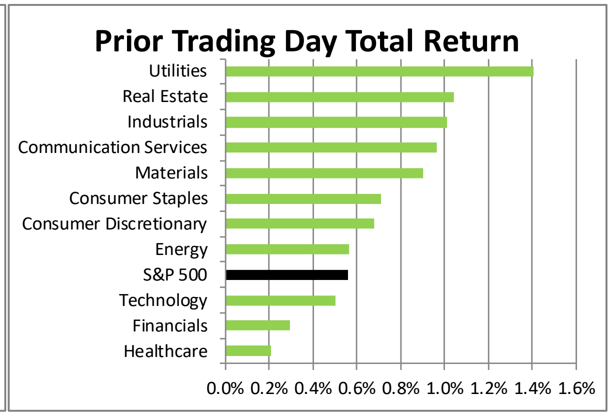
The 6-to-10-day and 8-to-14-day forecasts currently call for warmer-than-normal temperatures for most of the country. The precipitation outlook calls for wetter-than-normal conditions in states within the Rocky Mountain, Great Plains, and the Southeast, with dry conditions in the Pacific, Great Lakes, and New England regions.

Two tropical disturbances are currently active in the Atlantic Ocean. Tropical Cyclone Eight is moving near the Carolina coast, while Tropical Depression Gordon is located in the central Atlantic.

Data Section

US Equity Markets – (as of 9/13/2024 close)

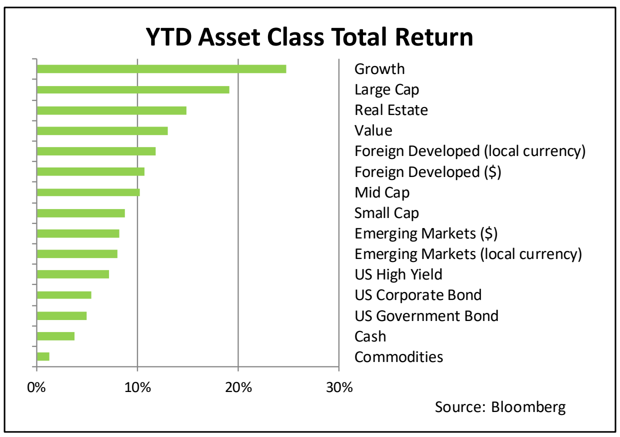




(Source: Bloomberg)

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 9/13/2024 close)

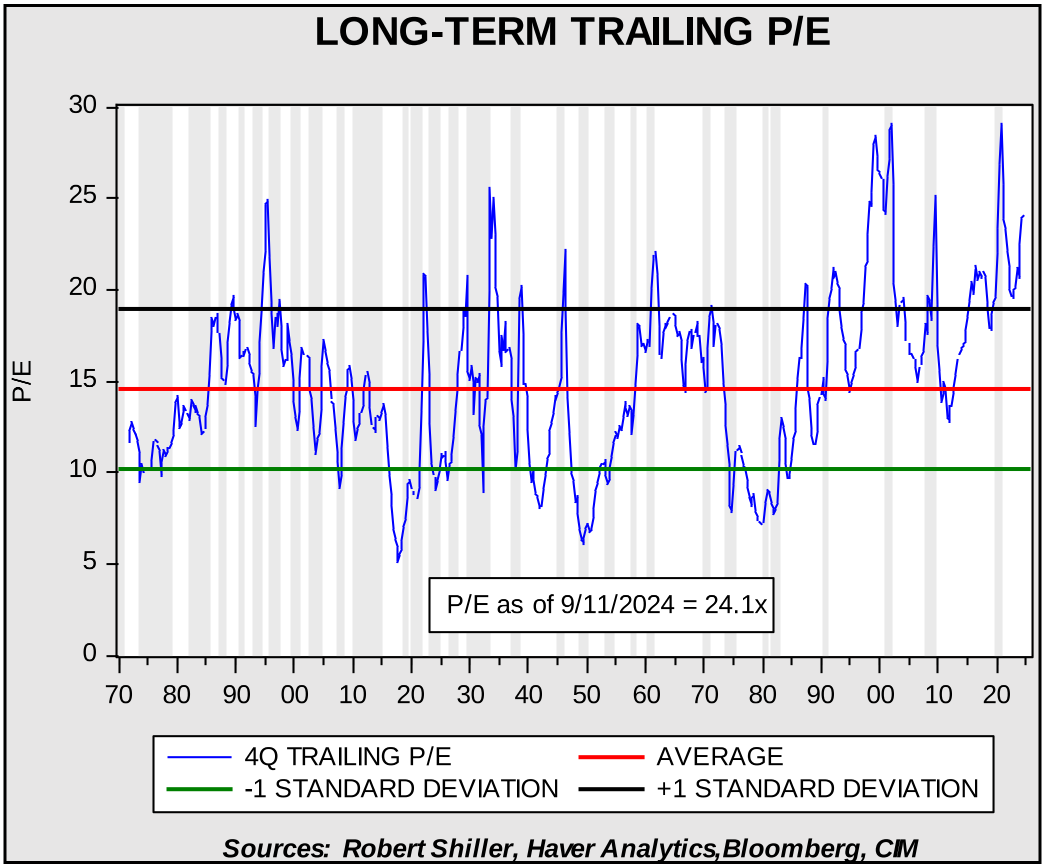


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

September 12, 2024



Based on our methodology,[1] the current P/E is 24.1x, unchanged from our last report. Both the stock price index and earnings were little changed from the previous week.

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.