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 26, 2024 — 9:30 AM ET] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is up 1.8% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 3.1%. Chinese markets were higher, with the Shanghai Composite up 3.6% from its previous close and the Shenzhen Composite up 4.0%. US equity index futures are signaling a higher 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:

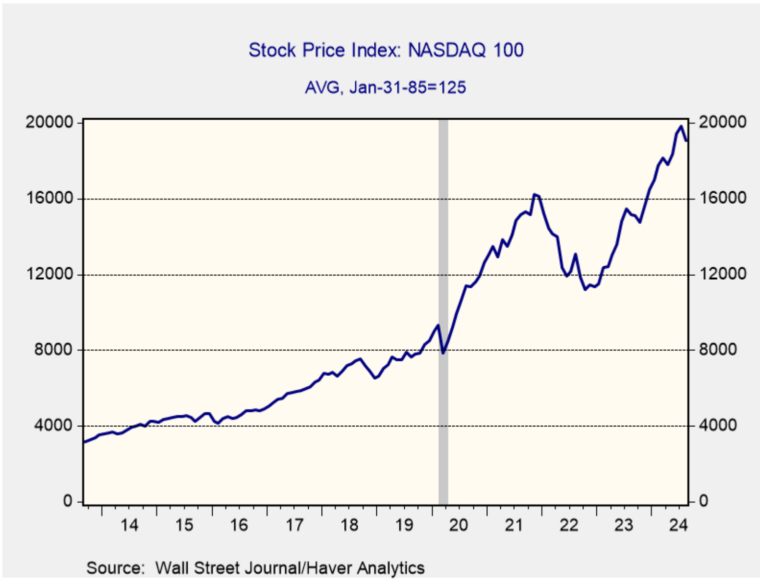
- *Bi-Weekly Geopolitical Report* (9/23/2024) (with associated podcast): "Eight Megatrends Every Investor Should Know"
- *Asset Allocation Bi-Weekly* (9/16/2024) (with associated podcast): "The Benjamin Button Dividend"
- *Asset Allocation Quarterly – Q3 2024* (7/16/2024): Discussion of our asset allocation 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"
- *Fixed Income Quarterly* (September 2024)

Good morning! Financial markets are reacting to more stimulus news from China. In sports news, the Connecticut Sun clinched a dominant sweep over the Indiana Fever, securing their place in the WNBA semifinals. Today's *Comment* will delve into the recent shake-up at OpenAI, explore the potential limitations that the Federal Reserve rate cuts will have on the housing market resurgence, and provide an update on the ongoing conflict in Israel. As always, we'll conclude with a roundup of key international and domestic data releases.

OpenAI Goes Mainstream: The brawl over the direction of the firm has taken a new turn as the company looks to take its product global.

- The developer of ChatGPT is seeking to transform from a nonprofit to a for-profit entity in order to attract greater investor interest. As part of this transition, the company is offering its current nonprofit board a reduced role in exchange for a minority stake. Following the announcement of this shift, the company's CTO, Mira Murati, and two other executives have resigned. Furthermore, the company's CEO, Sam Altman, is anticipated to receive a 7% stake upon completion of the transition. The shake-up of the company's leadership is a signal that the company is likely to alter its governance regarding AI risks.

- Since extending its partnership with Microsoft in early 2023, OpenAI has sought to integrate its technology into the global infrastructure. Altman has embarked on a world tour to encourage countries to expand their chip manufacturing facilities and data centers to facilitate the development of more powerful AI. He has even likened data centers to the essential nature of electricity. Despite the company's growing fame, its expenses have outpaced its income, leading to speculation that it might seek a public offering.

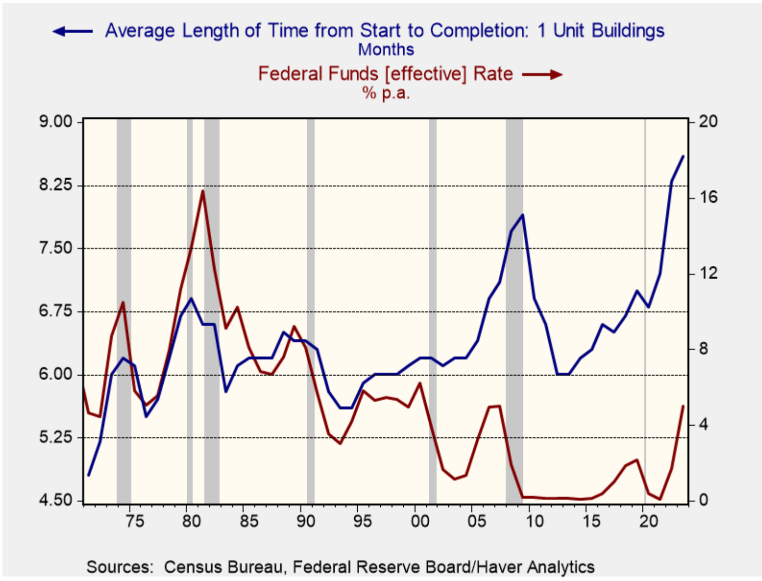


- The escalating prominence of OpenAI is anticipated to bolster the sentiment surrounding tech companies and reinforce the belief that AI technology is a permanent fixture. However, a growing concern is the increasing resistance from labor unions and workers against the widespread adoption of automation and AI as a means to replace human workers. While there is a burgeoning momentum to expand the integration of this technology, investors should be prepared for potential public backlash in response to these concerns regarding worker displacement.

The Housing Market Shrugs: While there has been optimism that a lower policy rate could boost housing demand, we suspect that accommodative policy will have a more mixed impact.

- The Fed's recent jumbo rate cut had a negligible effect on the mortgage market last week. According to the Mortgage Bankers Association, the average 30-year fixed mortgage rate fell by only 2 basis points from 6.16% to 6.14%. While loan applications experienced a surge, the majority of this increase was attributable to refinancing activity as homeowners sought to tap into their home equity. Although it's too early to gauge the full impact of the rate cut on the housing market, there's reason to believe that it may not provide the anticipated boost to home prices to which we have become accustomed.

- One reason for our doubts is the uncertainty over whether interest rates influence demand or supply more. Lower borrowing costs typically make it easier for homebuyers to secure loans, which, in theory, should drive up home prices. However, reduced rates also benefit homebuilders by lowering their costs. As shown in the chart below, a drop in the fed funds rate correlates with faster construction times for new homes, suggesting that lower rates could increase supply by bringing more homes to the market.

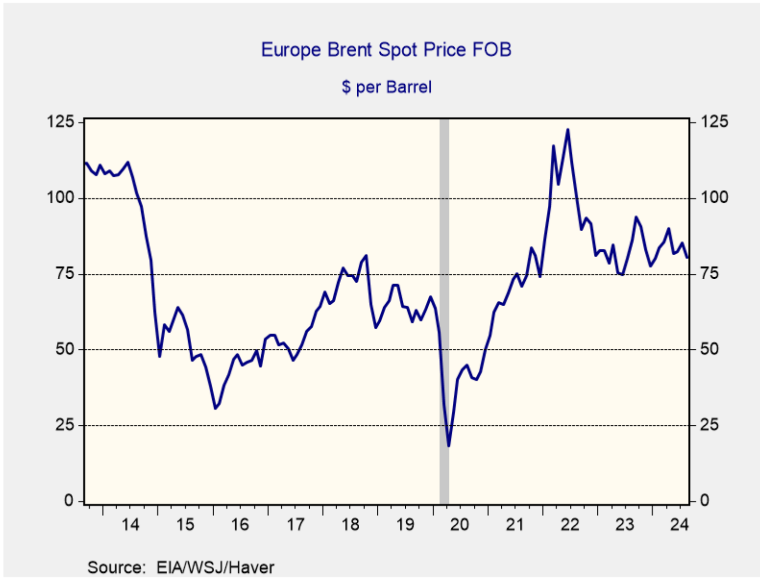


- Given the Fed's decision to cut rates during a period of continued economic expansion, the overall stimulative impact may be less pronounced than in previous easing cycles. The limited impact can be partly attributed to the fact that rate cuts have not been fully transmitted to the longer end of the yield curve. This lack of transmission is unlikely to result in mortgage rates falling to a level that significantly attracts homebuyers, but it could make it easier for homebuilders to finance new projects. Consequently, we suspect that home price increases could begin to slow down over the next few months.

Tensions in the Middle East: Israel is preparing for a potential invasion of Lebanon to counter Hezbollah's aggression; however, the oil market remains unaffected.

- Israel's decision to prepare for escalation follows the Israeli air defense's interception of a Hezbollah ballistic missile aimed at Tel Aviv. This comes after Israel warned its northern border troops that the ongoing airstrikes are meant to pave the way for a possible ground invasion. Meanwhile, US and French envoys are pushing for negotiations to broker a ceasefire and prevent a broader regional conflict, with hopes of reaching a peace agreement that could end the fighting in Gaza as well. While there remains optimism that tensions will calm, the prospect of war remains elevated.
- Despite historical links between Middle Eastern conflicts and higher oil prices, current supply dynamics seem to be preventing such a correlation. Saudi Arabia's recent announcement that it is abandoning its unofficial $100/barrel price target suggests a

strategic shift. By seeking to lower prices, the Kingdom aims to increase its market share, potentially foreshadowing another price war with US shale producers. Although the implementation of this strategy is not anticipated until December, the declaration indicates Saudi Arabia's preparedness for such a confrontation.



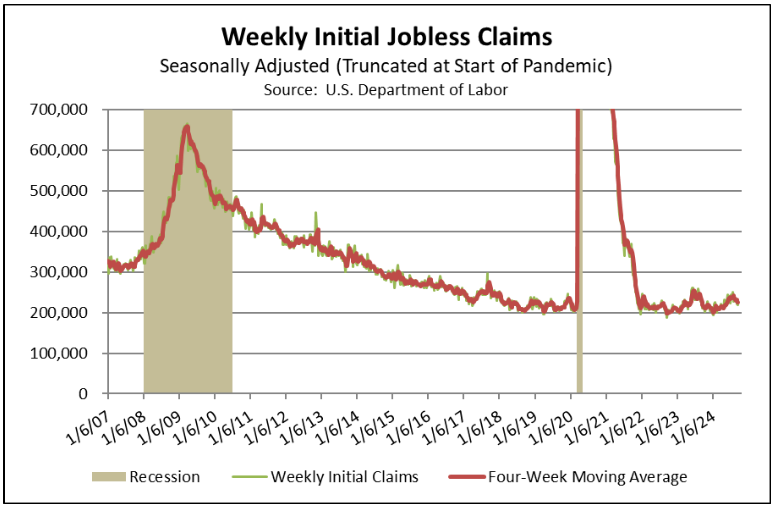
- An Israeli invasion of Lebanon would likely put upward pressure on oil prices, although the precise magnitude of this increase remains uncertain. A crucial factor influencing the situation is Iran's potential response. If Iran were to blockade the Strait of Hormuz, a vital oil shipping route, crude prices could surge dramatically. However, given Iran's recent willingness to resume nuclear negotiations with the US, the likelihood of such a blockade appears to be low. In the near term, anticipated increases in oil production by OPEC countries could help mitigate some upward pressure on prices related to conflict.

In Other News: The Chinese Politburo has committed to implementing another round of stimulus measures, signaling its determination to reignite the faltering economy. Over six years since the Brexit vote, the European Union and the United Kingdom have seemingly rekindled open dialogue, as the two sides look to reset ties. Micron's better-than-anticipated quarterly results suggest that AI-related stocks may still possess upward momentum.

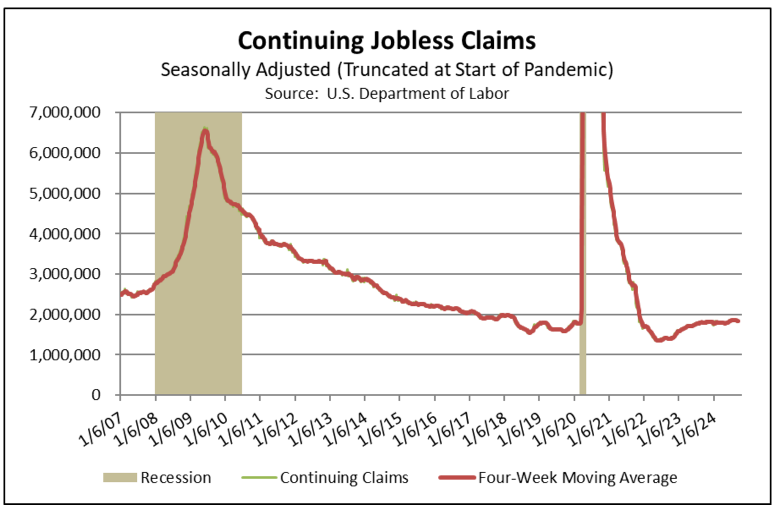
US Economic Releases

In the week ended September 21, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 218,000, lower than both the expected level of 223,000 and the prior week's revised level of 222,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to a nearly four-month low of 224,750. Together, the figures help confirm that labor demand has strengthened again from its soft spot during the summer months. 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.

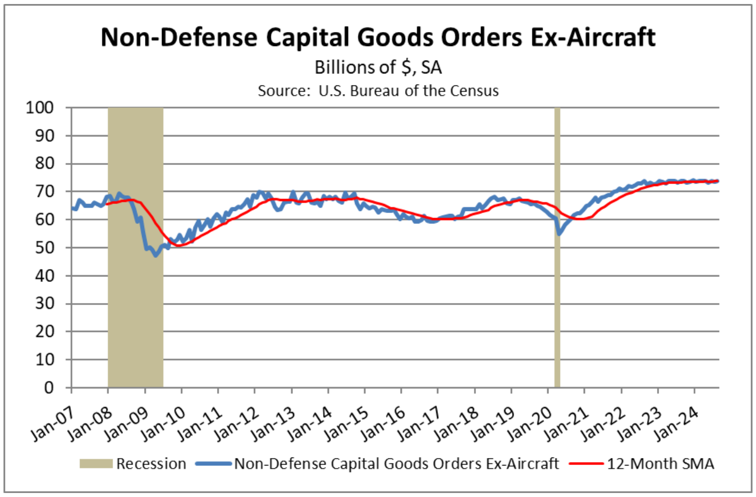


In the week ended September 14, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to a seasonally adjusted 1.834 million, above both the anticipated reading of 1.828 million and the previous week's revised reading of 1.821 million. The four-week moving average of continuing claims fell to a three-month low of 1,835,750. 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.

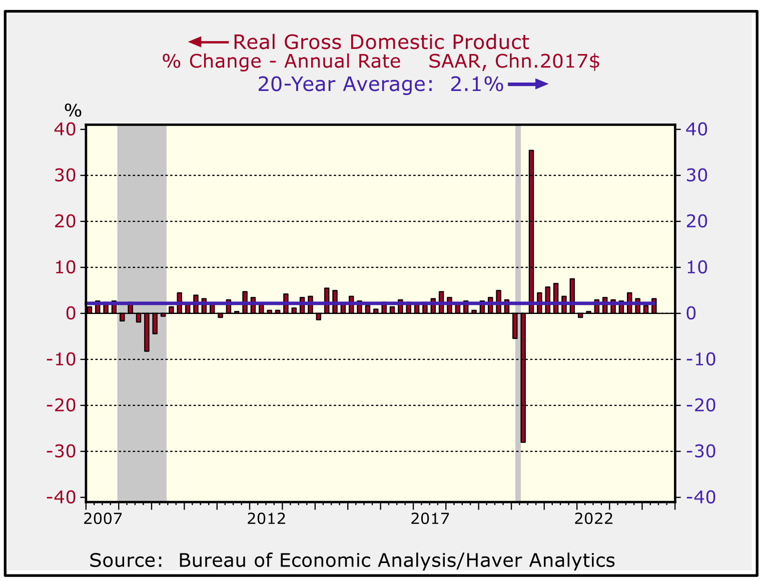


Separately, August ***durable goods orders*** were unchanged on a seasonally adjusted basis, beating the expected decline of 2.6% but still weaker than the revised July increase of 9.9%. Durable goods orders are often driven by transportation equipment, where just a few airliner orders can have a big impact. August ***durable goods orders excluding transportation*** rose 0.5%, beating their expected increase of 0.1% and more than reversing the revised July decline of 0.1%.

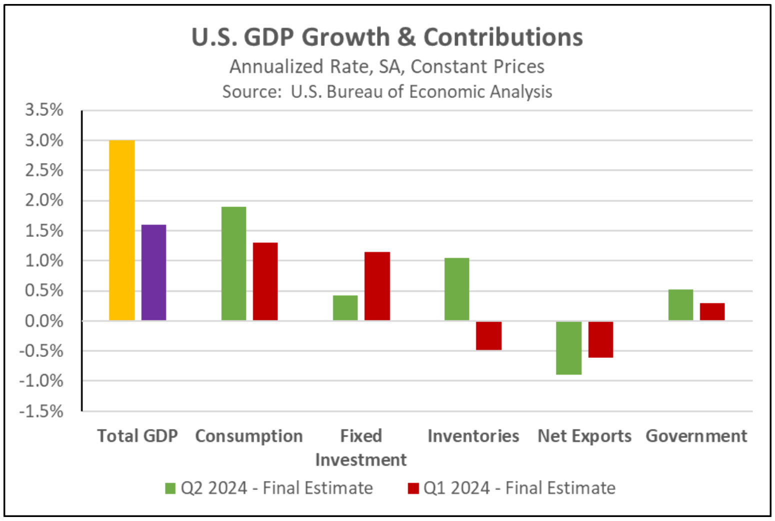
Finally, the durable goods report also includes a key proxy for corporate capital investment. In August, nondefense capital goods orders ex-aircraft rose 0.2%, beating their anticipated rise of 0.1% and just about reversing their revised July decline of 0.2%. Compared with the same month one year earlier, overall durable goods orders in August were down 0.4%, while durable orders ex-transport were down 0.3%. Nondefense capital goods orders ex-aircraft were down 1.4%. The chart below shows the progression of nondefense capital goods orders ex-aircraft since just before the previous recession.



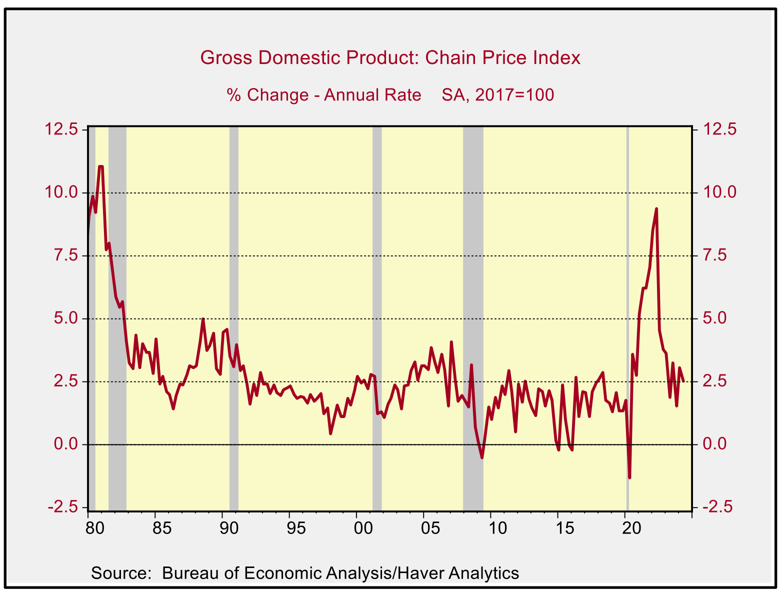
Finally, the Department of Commerce released its third and final regular estimate of economic output in the second quarter. After stripping out seasonal factors and price changes, second-quarter ***gross domestic product (GDP)*** rose at an annualized rate of 3.0%, merely matching the previous estimate but marking a big acceleration from the first-quarter growth rate of 1.6%. the second-quarter growth rate was also much higher than the average annual rate of 2.1% over the last couple of decades. The chart below shows the annualized growth rate of US GDP since just before the previous recession.



A close look at the details in the report shows personal consumption spending and inventory investment were the main sources of growth in the quarter. The chart below shows the contributions to the annualized growth rate in the second quarter versus the first quarter.



The GDP report also includes the broadest measure of US price inflation. The second-quarter ***GDP Price Index*** rose at an annualized rate of 2.5%, matching the prior estimate. The chart below shows the year-over-year change in the GDP Price Index over the last several decades.



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	Pending Home Sales	m/m	Aug	1.0%	-5.5%	**
10:00	Pending Home Sales NSA	y/y	Aug	-5.5%	-4.6%	**
11:00	Kansas City Fed Manfacturing Activity	m/m	Sep	-5	-3	*
Federal Reserve						
ET	Speaker or Event	District or Position				
9:10	Susan Collins and Adrianna Kugler Participate in Fireside Chat	President of the Federal Res Bank of Boston & Member of the Board of Governors				
9:15	Michelle Bowman Speaks on Eco Outlook at Mid-Sized Bank Coalition	Member of the Board of Governors				
9:20	Jerome Powell Gives Pre-Recorded Opening Remarks	Chairman of the Board of Governors				
9:25	John Williams Gives Remarks at Conference	President of the Federal Reserve Bank of New York				
10:30	Michael Barr Gives Remarks at Conference	U.S. Federal Reserve Vice Chair for Supervision				
10:30	Lisa Cook Joins Roundtable on AI and Workforce Develop	Member of the Board of Governors				
13:00	Neel Kashkari Hosts Fireside Chat with Michael Barr	President of the Fed Reserve Bank of Minneapolis & Fed Reserve Vice Chair for Supervision				
18:00	Lisa Cook Delivers Speech on AI and Labor Force	Member of the Board of Governors				

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	Machine tool orders	y/y	Aug F	-3.5%	-3.5%		**	Equity and bond neutral
EUROPE								
Eurozone	M3 Money Supply	y/y	Aug	2.9%	2.3%	2.5%	***	Equity and bond neutral
Germany	GfK Consumer Confidence	m/m	Oct	-21.2	-21.9	-22.5	**	Equity bullish, bond bearish
Italy	Consumer Confidence	m/m	Sep	98.3	96.1	97.0	***	Equity bullish, bond bearish
	Manufacturing Confidence	m/m	Sep	86.7	87.0	87.2	***	Equity and bond neutral
	Economic Sentiment	m/m	Sep	95.7	94.7		**	Equity and bond neutral
Russia	Industrial Production	y/y	Aug	2.7%	3.3%	1.8%	***	Equity bullish, bond bearish

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)	492	493	-1	Down
3-mo T-bill yield (bps)	448	449	-1	Down
U.S. Sibor/OIS spread (bps)	460	463	-3	Down
U.S. Libor/OIS spread (bps)	457	460	-3	Down
10-yr T-note (%)	3.77	3.79	-0.02	Up
Euribor/OIS spread (bps)	335	340	-5	Down
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Up			Up
Yen	Up			Up
Pound	Up			Up
Franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Swiss National Bank Policy Rate	1.000%	1.250%	1.000%	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	$71.60	$73.46	-2.53%	
WTI	$67.86	$69.69	-2.63%	
Natural Gas	$2.68	$2.64	1.67%	
12-mo strip crack	$19.37	$19.36	0.05%	
Ethanol rack	$1.81	$1.80	0.24%	
Metals				
Gold	$2,680.05	$2,656.89	0.87%	
Silver	$32.63	$31.81	2.57%	
Copper contract	$458.65	$448.95	2.16%	
Grains				
Corn contract	$415.00	$415.25	-0.06%	
Wheat contract	$592.00	$589.25	0.47%	
Soybeans contract	$1,058.75	$1,053.25	0.52%	
Shipping				
Baltic Dry Freight	2,016	2,014	2	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-4.47	-1.43	-3.04	
Gasoline (mb)	-1.54	0.20	-1.74	
Distillates (mb)	-2.23	-1.19	-1.04	
Refinery run rates (%)	-1.2%	-0.5%	-0.7%	
Natural gas (bcf)		52		

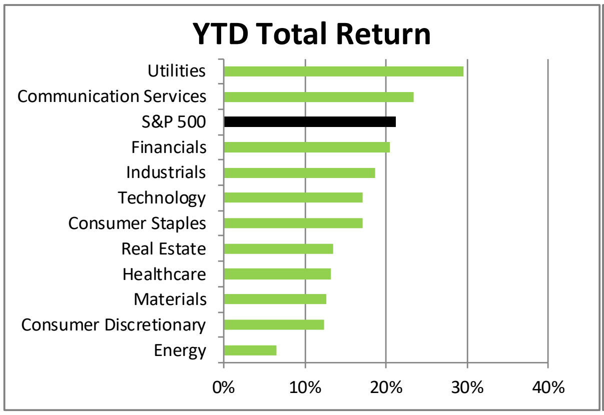
Weather

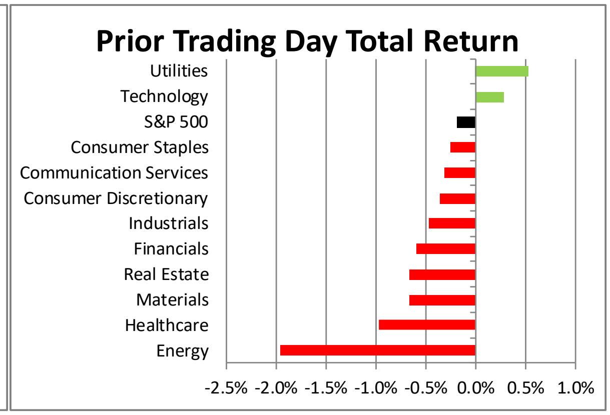
The 6-to-10-day and 8-to-14-day forecasts currently call for warmer-than-normal temperatures across the entire country except for the Pacific Northwest and the North Carolina coast, where temperatures will be near normal. The forecasts call for wetter-than-normal conditions in the Pacific Northwest, Florida, and New England, with dry conditions in the Rocky Mountains, the Great Plains, the Midwest, and the Mississippi Valley regions.

Hurricane Helene is currently off the Yucatán Peninsula and heading northward toward the Florida Panhandle, where it is expected to make landfall later today. Meanwhile, a tropical disturbance west of the Cape Verde islands continues to strengthen on a westward course with a 60% chance of cyclonic formation within the next 48 hours. A third disturbance has formed several hundred miles northeast of Bermuda, but it is assessed to have only a 10% chance of cyclonic formation within the next 48 hours.

Data Section

US Equity Markets – (as of 9/25/2024 close)

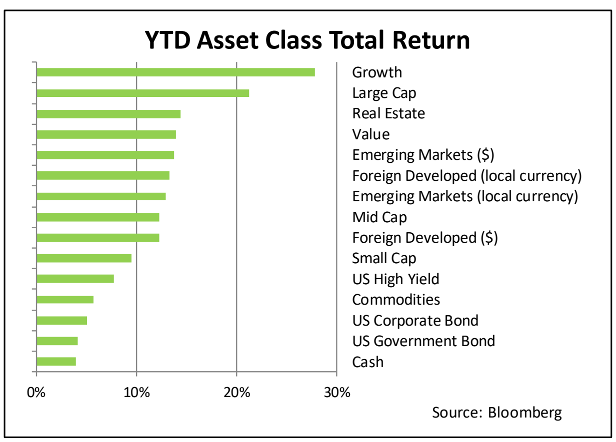




(Source: Bloomberg)

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 9/25/2024 close)

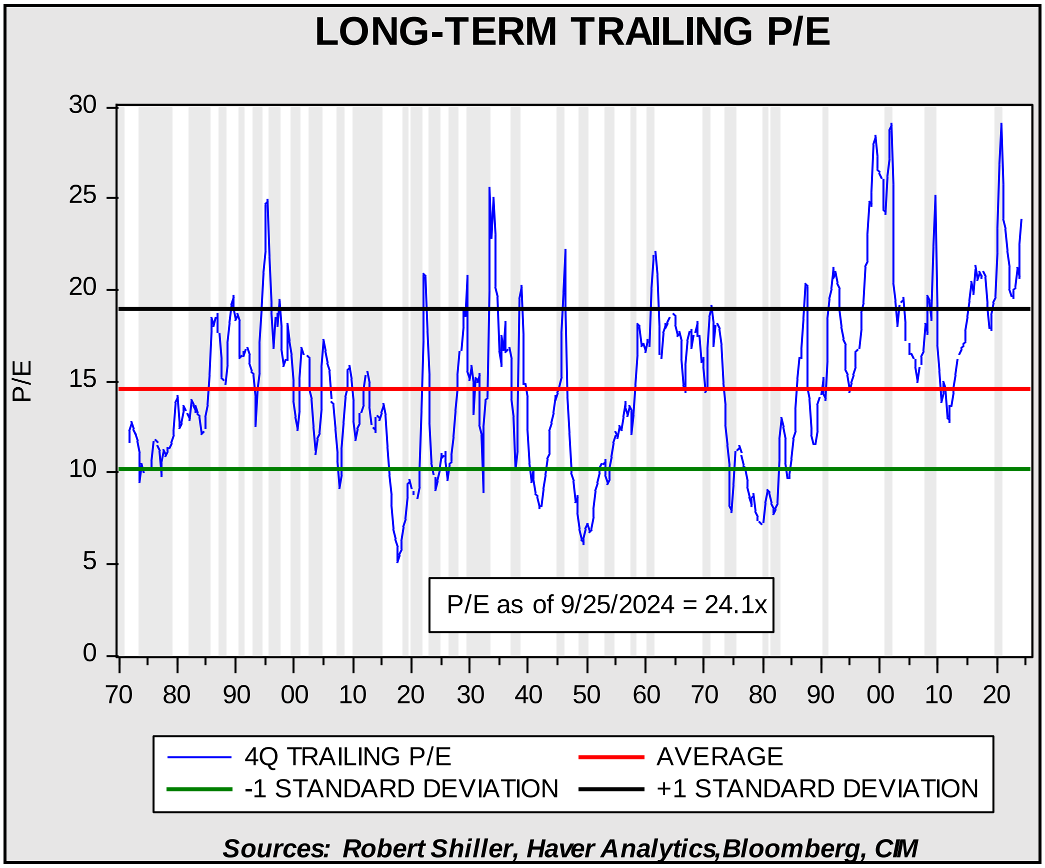


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 26, 2024



Based on our methodology,[1] the current P/E is 24.1x, unchanged from our last report. The stock price index improved slightly, while 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.