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 5, 2024 — 9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is down 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.3%. Chinese markets were higher, with the Shanghai Composite up 0.1% from its previous close and the Shenzhen Composite up 0.5%. US equity index futures are signaling a 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* (8/19/2024) (no accompanying podcast for this report): "The Recent Iranian Election: Results & Implications" (the next report will be published on 9/9/2024)
- *Asset Allocation Bi-Weekly* (8/26/2024) (with associated podcast): "Activist vs. Accommodative Treasury Issuance"
- *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.
- *Business Cycle Report* (8/29/24)

Good morning! The market is eagerly awaiting the services PMI data, seeking signs that the economy remains resilient. In sports, Cristiano Ronaldo and Lionel Messi have both been left off the Ballon d'Or shortlist for the first time since 2003. Today's *Comment* will cover the latest jobs data and its implications for the Fed, why we remain optimistic that the economy is not in recession, and what Michael Barnier's rise in France reveals about immigration trends in the West. As always, we conclude with a roundup of international and domestic news.

Labor Cooling: The latest employment data reinforced the view that firms are starting to slow down hiring.

- The July Job Openings and Labor Turnover Survey (JOLTS) from the Bureau of Labor Statistics reported a sharp decline in job openings, reaching their lowest level since January 2021. Listings dropped from a revised 7.910 million to 7.673 million, suggesting a potential cooling of the labor market. In response to the report, Atlanta Fed President

Raphael Bostic stated that the risks of inflation and unemployment are now balanced, likely signaling his full support for a rate cut at the FOMC's September meeting.

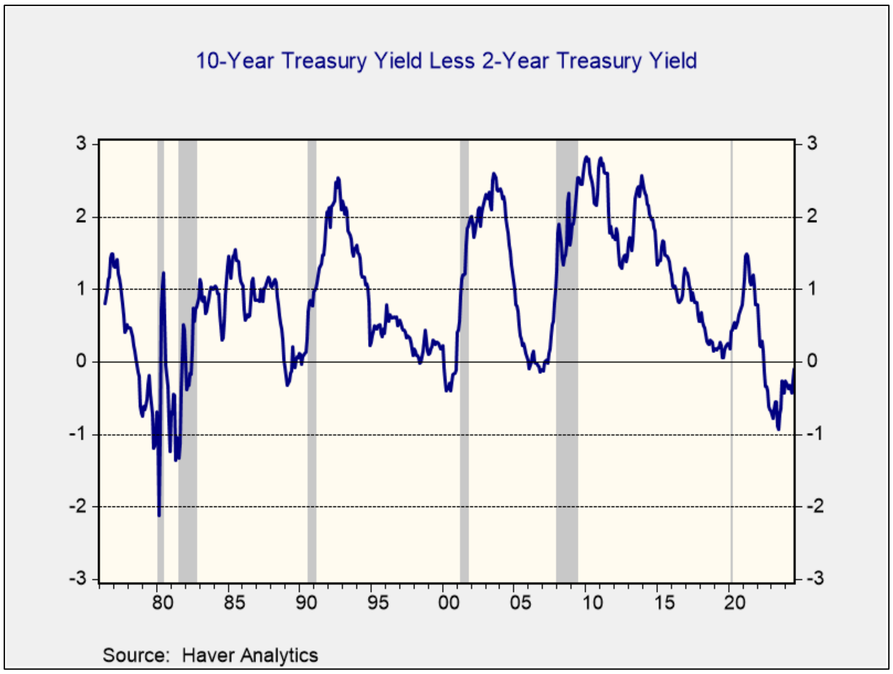
- The weakening JOLTS data has intensified concerns that the central bank may have kept rates too high for too long. The ratio of job openings to unemployed workers has now dipped below pre-pandemic levels, with approximately one job opening for every unemployed individual. Although the ratio itself remains historically high, its significant decline from the peak of nearly two job postings for every available worker further cements the shift in attitudes about the labor market following last month's triggering of the Sahm Rule.

- While the JOLTS data is disappointing, it is likely to be overshadowed by Friday's jobs report, which is expected to show a sizeable increase in payrolls from 114,000 to 160,000 and a slight decline in the unemployment rate from 4.3% to 4.2%. A stronger-than-expected jobs report could undermine expectations for an aggressive easing cycle as it may signal that July's job losses were a one-time occurrence due to Hurricane Beryl. Assuming the economy maintains its resilience, we anticipate the Fed will cut rates one to two times this year.

Disinversion: Growing concerns about the economy caused short-term rates to briefly rise above long-term rates as the market anticipates a strong response from the Fed.

- The Federal Reserve's Beige Book revealed that the country is starting to feel the weight of tight monetary policy, with the number of districts reporting flat or declining activity increasing from five to nine. In response to the slowdown in business activity, firms indicated a preference for reducing hours, cutting shifts, and slowing hiring rather than implementing layoffs. Despite these measures, firms expressed optimism about a potential economic recovery in the near future. Additionally, the report revealed a moderate increase in both prices and wages.

- Weak jobs data and a gloomy Fed outlook caused the market to reassess its policy rate expectations. On Wednesday, the yield curve briefly disinverted, with the two-year Treasury rate ending the day a tad lower than the 10-year. The recent upward slope of the yield curve indicates that investors believe the Federal Reserve will need to significantly lower interest rates to stimulate the economy. The latest CME FedWatch tool reflects this sentiment, indicating a 44% chance of a 50-basis-point rate cut in September, up from 34% last week but still below the peak of 85% seen a month ago.

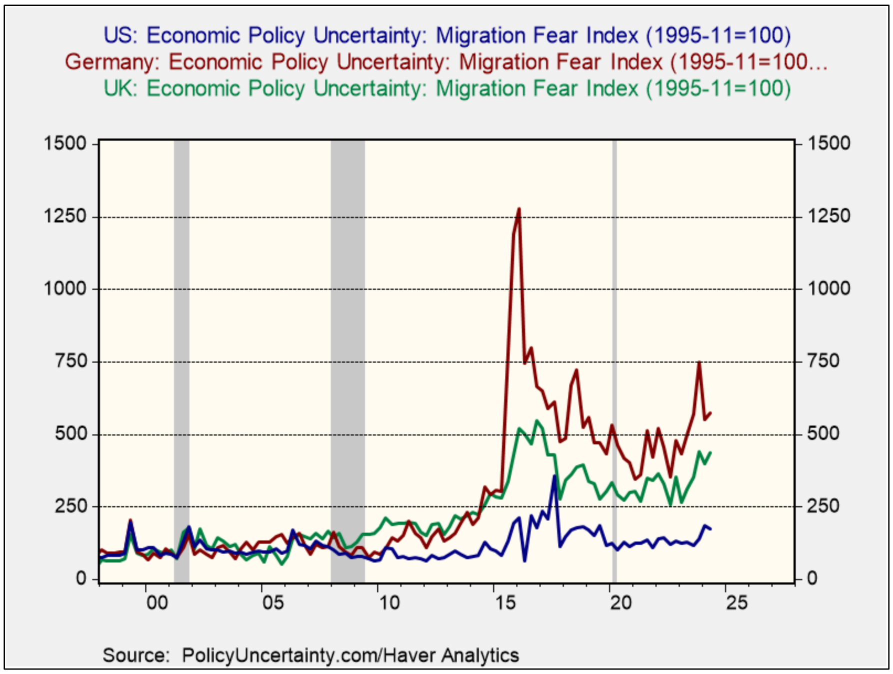


- While traditional wisdom suggests that yield curve inversions are a reliable precursor to economic downturns, data suggests that the disinversion of the curve might be a better indicator, as the chart above shows. Historically, the normalization of the yield curve has been followed by economic downturns. However, it's important to note that previous disinversions were often driven by the Federal Reserve's response to something breaking in the financial system. At this time, we see little evidence of market distress and we remain confident that the economy will demonstrate its resiliency over the next few months.

Immigration Fears Rise: A new French prime minister has been selected, and he's likely to steer the French parliament further to the right.

- Michael Barnier, conservative leader and former EU Brexit negotiator, has been appointed as France's next prime minister. Speculation about his potential nomination surged after conservative Xavier Bertrand and former socialist Prime Minister Bernard Cazeneuve fell out of favor. Barnier, who kept a low profile after failing to secure his party's 2022 presidential nomination, had taken a hardline stance on immigration during that campaign, proposing a three-to-five-year moratorium on non-EU arrivals.

- Barnier's selection likely reflects the growing prominence of immigration as a political issue across the West. While conservative parties lacked parliamentary seats to show it, they won the popular vote in France's July legislative elections, with a significant share going to Marine Le Pen's anti-immigration National Rally. This trend has been evident elsewhere, such as in Germany, where a far-right party recently won a state election for the first time since WWII, and in the UK's decision to leave the EU. Even in the US, both presidential candidates have adopted increasingly restrictive stances on immigration.

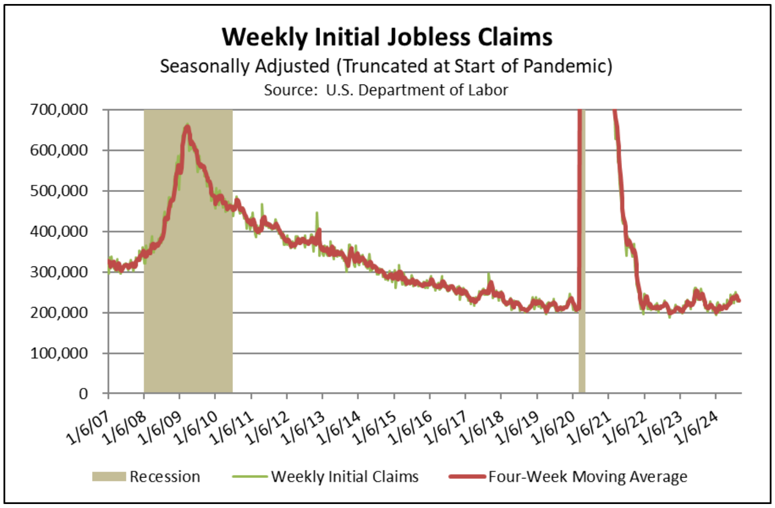


- Tougher immigration policies could hinder efforts to combat inflation. The influx of foreign workers has played a crucial role in mitigating wage pressures, which have contributed to elevated inflation. A slowdown in the growth of foreign workers could require firms to rely more heavily on productivity improvements to maintain costs. While this is achievable, the timing and nature of such technological shifts are uncertain. However, it's highly probable that service inflation would remain elevated due to this policy change.

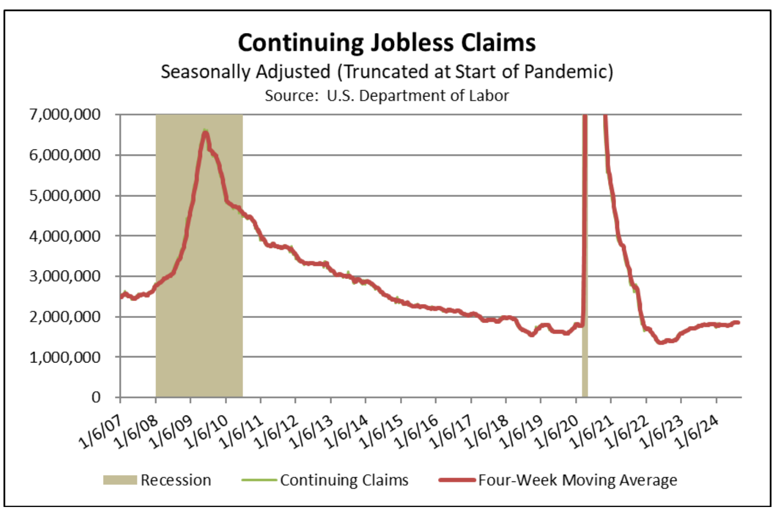
In Other News: President Joe Biden is expected to block Nippon Steel's takeover of US Steel, underscoring the commitment to protecting domestic industries in the US. Meanwhile, Elon Musk's Starlink has agreed to restrict access to X in Brazil, reflecting a growing trend of governments tightening control over tech companies. The Bank of Canada lowered its policy rate by 25 bps for a third consecutive meeting in a sign that global financial conditions are loosening.

US Economic Releases

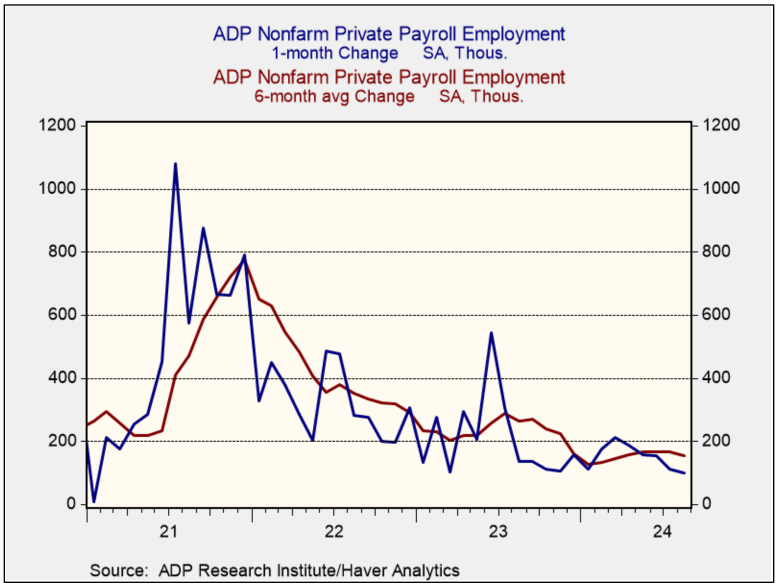
In the week ended August 31, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 227,000, below both the expected level of 230,000 and the prior week's revised level of 232,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to a three-month low of 230,000. The chart below shows how initial jobless claims have fluctuated since just before the Great Financial Crisis (GFC). The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



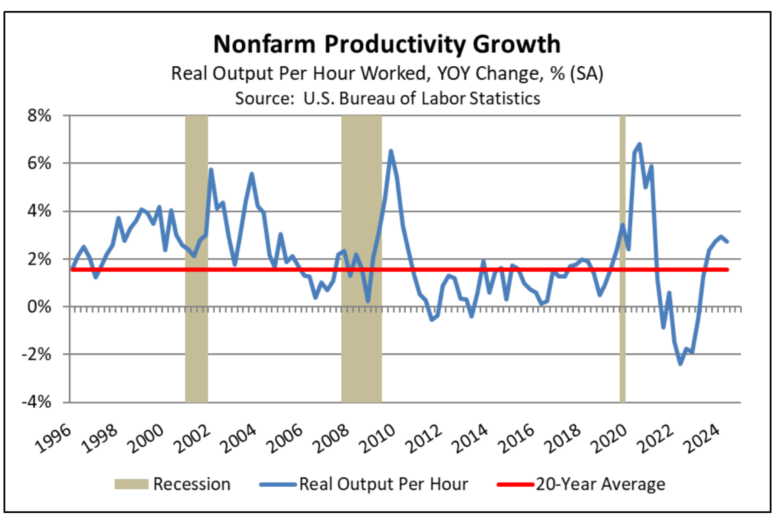
In the week ended August 24, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) fell to a seasonally adjusted 1.838 million, below both the anticipated reading of 1.867 million and the previous week's revised reading of 1.860 million. The four-week moving average of continuing claims fell to 1.853 million for its lowest level since mid-July. 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.



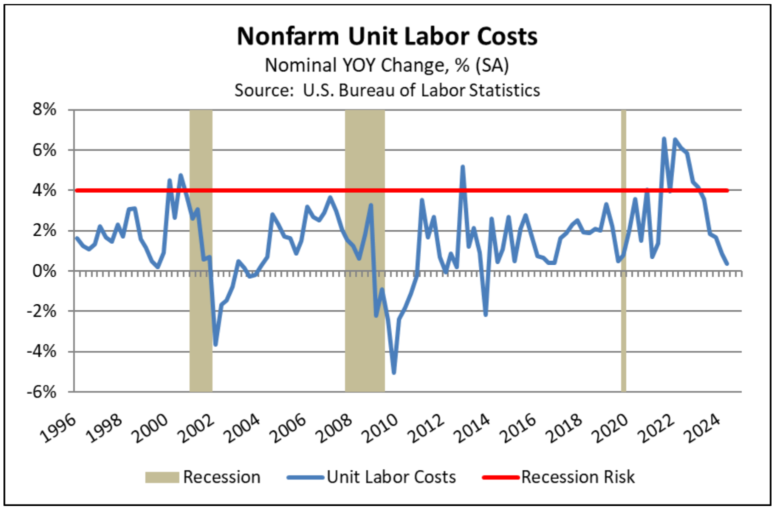
Despite the good claims data, the ADP Research Institute estimated ***private payroll employment*** rose in August by a seasonally adjusted 99,000, far short of the expected gain of 145,000 and weaker than the revised July estimate of 111,000. ADP's estimate is widely seen as an indicator of what to expect when the Labor Department releases its measure of nonfarm payrolls on Friday. The chart below shows ADP's estimate of private payrolls since the beginning of 2021.



Another report today focused on the productivity of US workers, defined as the average value of output per hour worked. After stripping out price changes and normal seasonal fluctuations, revised second quarter ***nonfarm productivity*** rose at an annualized rate of 2.5%, matching expectations and up from 2.3% in the original estimate. Taking into account the fluctuations in each of the last four quarters, productivity in the second quarter was up a healthy 2.7% from the same period one year earlier. Productivity growth is key to boosting living standards and supporting higher wages, so the recent surge in productivity bodes well for US workers. The chart below shows the year-over-year growth in real productivity since 1996.



Also in the report, second quarter ***unit labor costs*** rose at an annualized rate of just 0.4%, only half the anticipated increase of 0.8% and less than half the original estimate of 0.9%. Unit labor costs in the second quarter were up a very mild 0.3% year-over-year, which should help confirm that consumer price pressures will keep easing. Also, the annual growth in unit labor costs is now well below the 4.0% or so that is often associated with higher recession risks. The chart below shows the year-over-year growth in unit labor costs since 1996.



The table below lists the economic releases and Fed events scheduled for the rest of the day.

ET	Indicator			Expected	Prior	Rating
Economic Releases						
No economic releases for the rest of today						
ET	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	S&P Global US Services PMI	m/m	Aug F	55.1	55.2	***
9:45	S&P Global US Composite PMI	m/m	Aug F	54.0	54.1	***
10:00	ISM Services Index	m/m	Aug	51.4	51.4	***
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	Labor Cash Earnings	y/y	Jul	3.6%	4.5%	2.9%	**	Equity and bond neutral
	Real Cash Earnings	m/m	Jul	0.0	0.0	0.0	*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	30-Aug	¥1640.5b	¥1542.9b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	30-Aug	¥384.7b	¥898.8b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	30-Aug	-¥1398.5b	¥859.4b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	30-Aug	-¥824.4b	-¥438.3b		*	Equity and bond neutral
Australia	Trade Balance	m/m	Jul	A$6009m	A$5425m	A$5000m	***	Equity and bond neutral
	Exports	m/m	Jul	0.7%	1.4%		*	Equity and bond neutral
	Imports	m/m	Jul	-0.8%	0.4%		*	Equity and bond neutral
South Korea	GDP	q/q	2Q P	2.3%	2.3%	2.3%	**	Equity and bond neutral
EUROPE								
Eurozone	Retail Sales	y/y	Jul	-0.1%	-0.4%	0.2%	*	Equity and bond neutral
Germany	Factory Orders WDA	y/y	Jul	3.7%	-11.2%	-1.9%	***	Equity bullish, bond bearish
	HCOB Germany Construction PMI	m/m	Aug	38.9	40.0		*	Equity and bond neutral
UK	New Car Registrations	y/y	Aug	-1.3%	2.5%		*	Equity and bond neutral
	S&P/CIPS Construction PMI	m/m	Aug	53.6	55.3	54.5	**	Equity bearish, bond bullish
Switzerland	Unemployment Rate	m/m	Aug	2.4%	2.3%	2.4%	**	Equity and bond neutral
AMERICAS								
Canada	International Merchandise Trade	m/m	Jul	0.68b	-0.18b	0.65b	**	Equity and bond neutral
Mexico	Vehicle Domestic Sales	y/y	Aug	127684	125024		***	Equity and bond neutral
	Leading Indicators	y/y	Jul	-0.06	-0.05		**	Equity and bond neutral
Brazil	S&P Global Brazil Composite PMI	m/m	Aug	52.9	56.0		***	Equity and bond neutral
	S&P Global Brazil Services PMI	m/m	Aug	54.2	56.4		***	Equity and bond neutral
	Industrial Production	y/y	Jul	6.1%	3.2%	6.7%	***	Equity bearish, bond bullish

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)	527	528	-1	Down
3-mo T-bill yield (bps)	494	495	-1	Down
U.S. Sibor/OIS spread (bps)	495	496	-1	Down
U.S. Libor/OIS spread (bps)	492	493	-1	Down
10-yr T-note (%)	3.77	3.76	0.01	Down
Euribor/OIS spread (bps)	345	346	-1	Down
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Up			Up
Pound	Up			Up
Franc	Flat			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Canada Rate Decision	4.250%	4.500%	4.250%	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	$73.10	$72.70	0.55%	
WTI	$69.47	$69.20	0.39%	
Natural Gas	$2.15	$2.15	0.09%	
12-mo strip crack	$19.22	$19.19	0.19%	
Ethanol rack	$1.98	$1.99	-0.52%	
Metals				
Gold	$2,516.03	$2,495.72	0.81%	
Silver	$28.71	$28.27	1.55%	
Copper contract	$410.55	$407.90	0.65%	
Grains				
Corn contract	$410.50	$412.75	-0.55%	
Wheat contract	$573.50	$580.75	-1.25%	
Soybeans contract	$1,011.25	$1,021.50	-1.00%	
Shipping				
Baltic Dry Freight	1,902	1,947	-45	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.00		
Gasoline (mb)		-1.11		
Distillates (mb)		0.41		
Refinery run rates (%)		-0.8%		
Natural gas (bcf)		27		

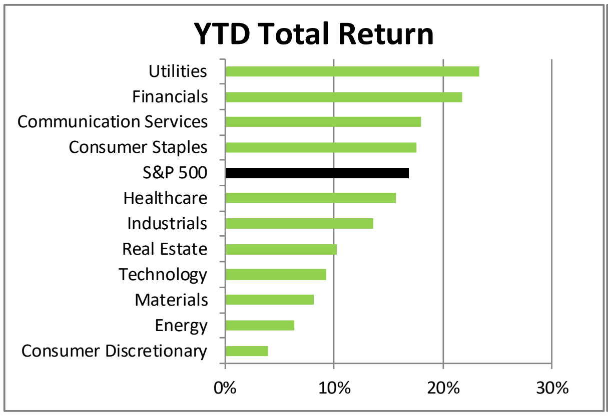
Weather

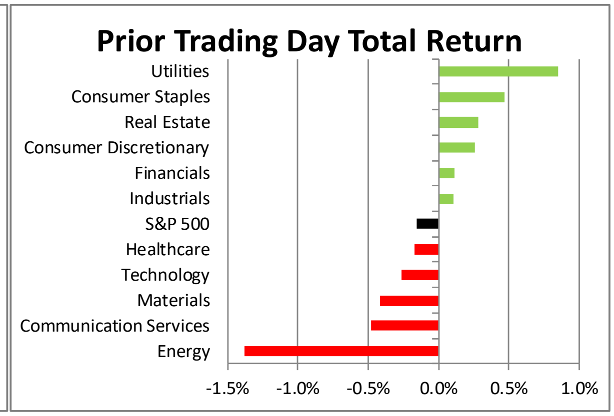
The 6-to-10-day and 8-to-14-day forecasts currently call for warmer-than-normal temperatures in the Rocky Mountains, the northern Great Plains, the Midwest, and southern Florida, with normal temperatures elsewhere. The precipitation outlooks call for wetter-than-normal conditions in the Far West and Southeast, with dry conditions in the Great Plains, the Midwest, and the Northeast.

No fewer than five tropical disturbances are now developing in the Atlantic Ocean region, including one just off the coast of Texas and one farther out in the Atlantic off North Carolina. However, none of these disturbances are assessed to have a significant chance of cyclone formation within the next 48 hours.

<u>Data Section</u>

US Equity Markets – (as of 9/4/2024 close)

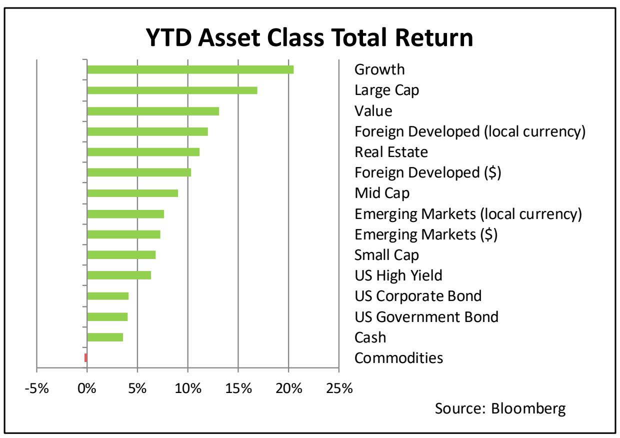




(Source: Bloomberg)

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 9/4/2024 close)

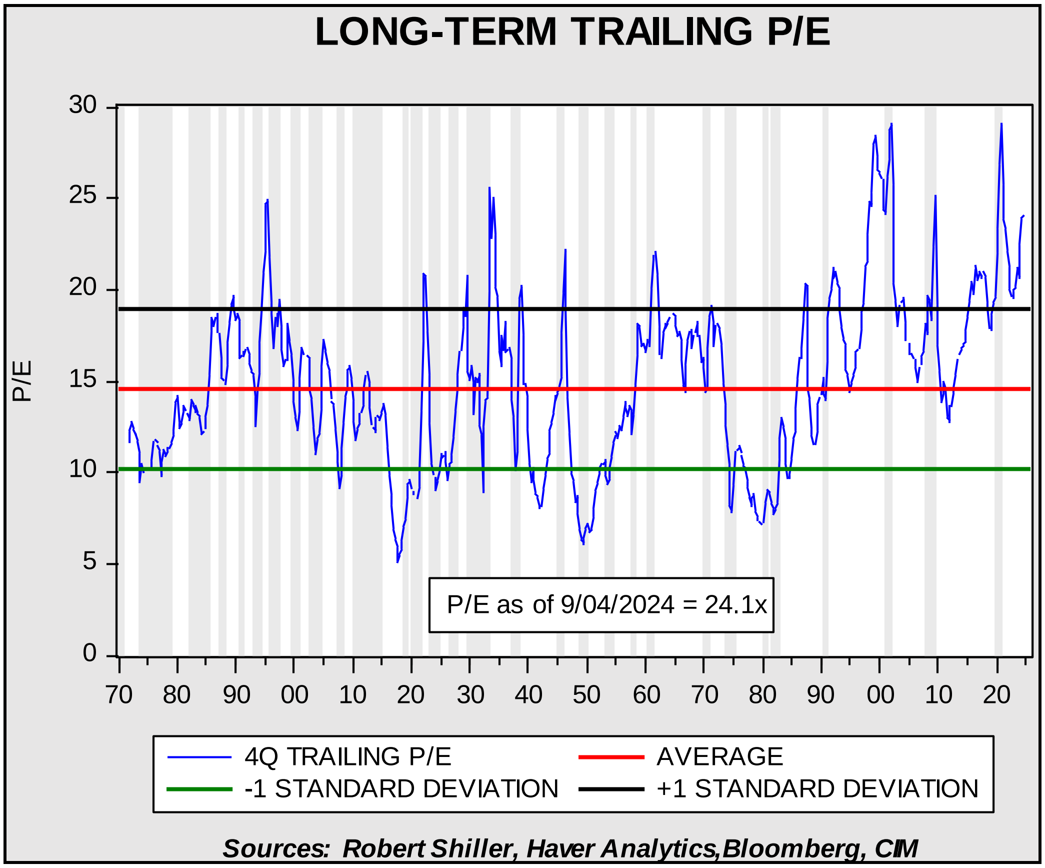


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 5, 2024



Based on our methodology,[1] the current P/E is 24.1x, rising 0.4 from our last report. The increase in the multiple was due to an increase in the stock price index and a decline 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.