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 6, 2024 — 9:30 AM ET] Global equity markets are mostly lower this morning. In Europe, the Euro Stoxx 50 is down 0.4% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.5%. Chinese markets were lower, with the Shanghai Composite down 0.8% from its previous close and the Shenzhen Composite down 1.6%. 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)

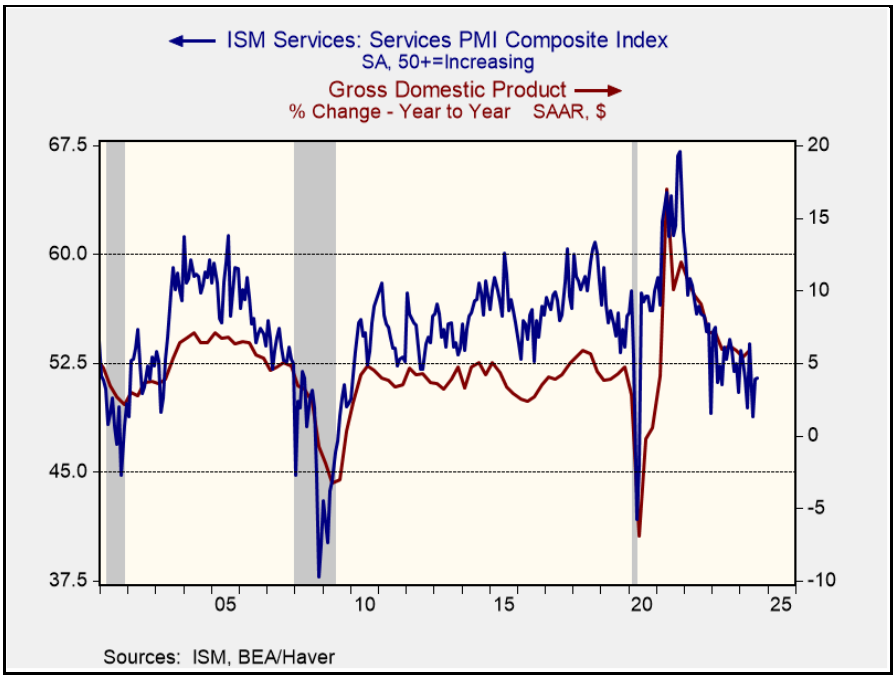
Good morning! The market is closely parsing through the latest jobs data. In sports news, Patrick Mahomes of the Kansas City Chiefs surpassed Len Dawson as the team's all-time passing leader while securing a victory over the Baltimore Ravens. In today's *Comment*, we discuss why the recent Services PMI data should relieve recession fears, consider the potential impact of the ECB's reluctance to address weak GDP figures on the dollar, and explore how the coalition collapse in Canada aligns with a broader trend of dissatisfaction with ruling parties in the West. As always, the report includes a comprehensive overview of domestic and international data.

Good News, Finally! Days after the Purchasing Managers' Index (PMI) for manufacturing raised concerns of a potential economic slowdown, the services component offered reassurance.

- Both the S&P Global and ISM Purchasing Managers' Indexes (PMIs) for August showed an increase in service sector activity, challenging the narrative of an impending recession. The S&P Global PMI rose from 55.4 to 55.7, while the ISM PMI increased slightly from

51.4 to 51.5. The stronger pace of new orders, indicating continued demand for firms' offerings, was the primary driver of the overall improvement. However, both PMIs showed declines in their employment components, reaffirming concerns about the cooling labor market.

- The rise in the PMI services index strongly indicates that the economy remains in expansion. Unlike manufacturing, service consumption represents nearly half of all economic output, making the economy particularly sensitive to shifts in this sector. The ISM services index, specifically, has proven to be a reliable economic predictor, explaining about half of the GDP variation over the past three decades. As a result, the latest reading suggests that, despite market concerns about an imminent downturn, the economy has enough momentum to avoid a recession.

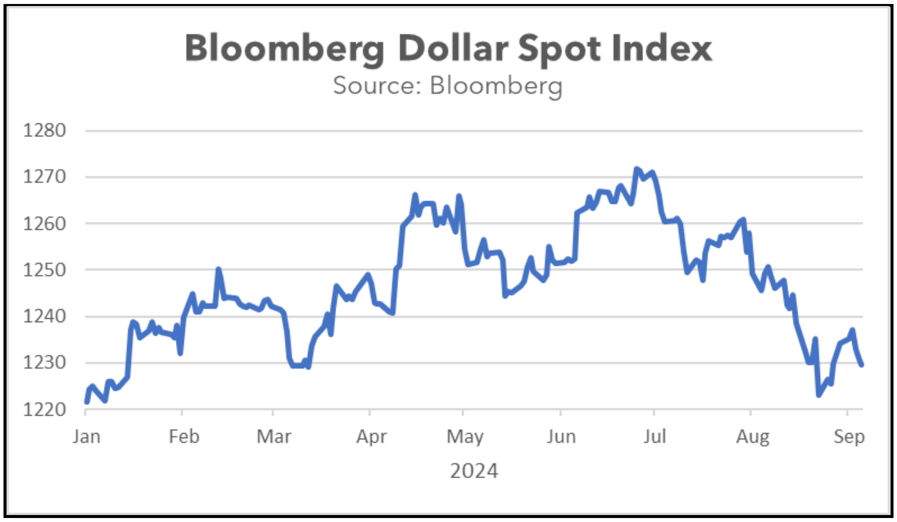


- While recent data suggests slowing growth, it's important to consider the historical context. The past four recessions were all triggered by unforeseen events: the 2020 pandemic, the 2008 Lehman Brothers collapse, the 9/11 attacks in 2001, and the Gulf War in 1990. Hence, a slowdown doesn't necessarily foreshadow an immediate downturn. While the economy faces challenges, we remain cautiously optimistic that it can weather these headwinds, absent any major disruptions such as a mass mobilization war, commodity supply shock, or pandemic.

The Flat Dollar: As the global economy anticipates a convergence in interest rate differentials, the US dollar has begun to depreciate against foreign currencies.

- The Eurozone's second quarter GDP was revised downward to 0.2% from 0.3%, indicating continued economic stagnation. This latest data is likely to fuel concerns that the region's tight monetary policy is beginning to dampen economic activity. Household consumption and investment spending both declined, with investment spending falling by a more significant 2.2%. Germany, the bloc's largest economy, contracted by 0.1% as its industrial sector remains under pressure. However, there were some bright spots: France and Italy both grew by 0.2%, and Spain's economy expanded by a robust 0.8%.

- Despite growing economic concerns, there is skepticism that recent economic data will prompt the European Central Bank (ECB) to accelerate its easing policy. A survey of economists indicates that respondents anticipate the ECB will maintain its current monetary policy stance, even in the face of weakening economic indicators. As growth slowed, the region's unemployment rate fell to a new low in July, and core inflation has shown signs of stalling. The ECB's reluctance to respond to the slowdown mirrors the Bank of Japan's decision to maintain its current policy path.



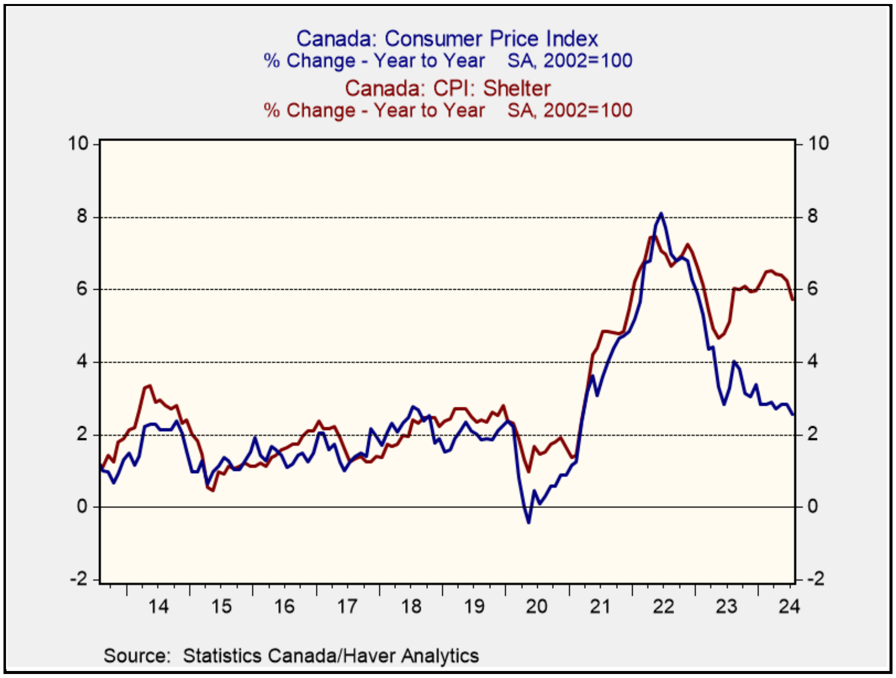
- The reluctance of central banks to respond to economic changes is likely to accelerate interest rate convergence. Historically, global developed central banks have been hesitant to follow the US Federal Reserve in raising rates and they have also been less willing to cut rates as aggressively. This narrowing interest rate differential, coupled with growing concerns about the US economy, is expected to weigh on the US dollar in the short to medium term. This trend has already begun to manifest itself this year, with the Bloomberg Dollar Spot Index falling from its 2024 peak in June to levels close to its value at the start of the year.

Trudeau in Trouble: As voters across the West express increasing discontent with incumbent leaders, the impending collapse of Trudeau's coalition threatens to end his party's nine-year reign.

- Jagmeet Singh, leader of Canada's New Democratic Party, has ended the agreement to support the minority Liberal government, raising the likelihood of snap elections. While this doesn't technically strip the Liberals of their position, his refusal to uphold the deal could leave PM Justin Trudeau vulnerable to a no-confidence vote, potentially triggering an early election. Additionally, Singh still requires his party's approval to formally withdraw from the arrangement. That said, federal elections must be held by October

2025, with current polls showing the ruling Liberals trailing the Conservatives by 17 points.

- The Liberal Party is facing increasing criticism over the rising cost of living, particularly housing. While overall inflation is 2.5%, which is within the Bank of Canada's target range of 1-3%, shelter inflation remains stubbornly high at 5.7%. Unlike in the US, where 30-year fixed mortgage rates are common, most Canadian mortgages are locked in for five years or less. This difference directly impacts inflation as mortgage interest costs account for 13% of Canada's shelter inflation. In contrast, the US removed housing costs from its CPI measure in 1983, opting instead for owner-equivalent rent.

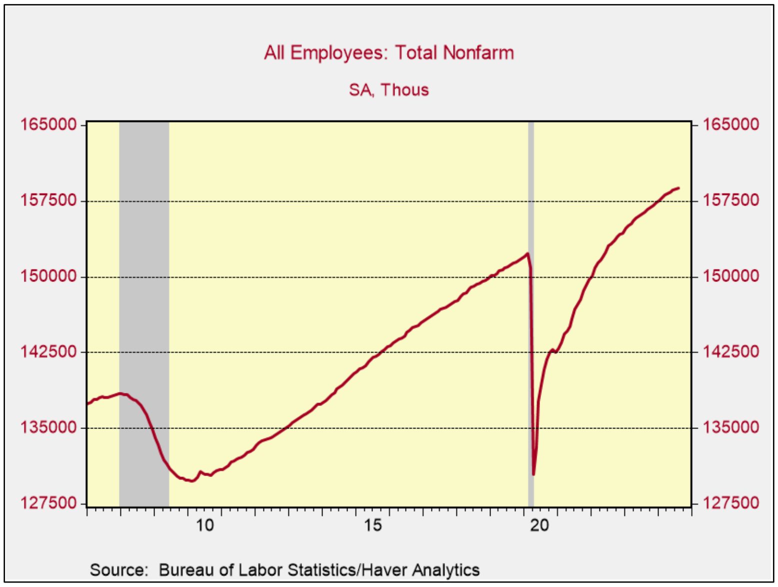


- One of the key issues facing Western nations as they approach elections in the coming months is public sentiment regarding inflation. While price increases have moderated substantially in recent years, consumers have found it challenging to adjust to current price levels as many had anticipated a decline. This dissatisfaction with prices is likely to influence election outcomes as voters may attribute the problem to their current leadership. As a result, we should not be surprised if opposition parties see a strong performance this election season.

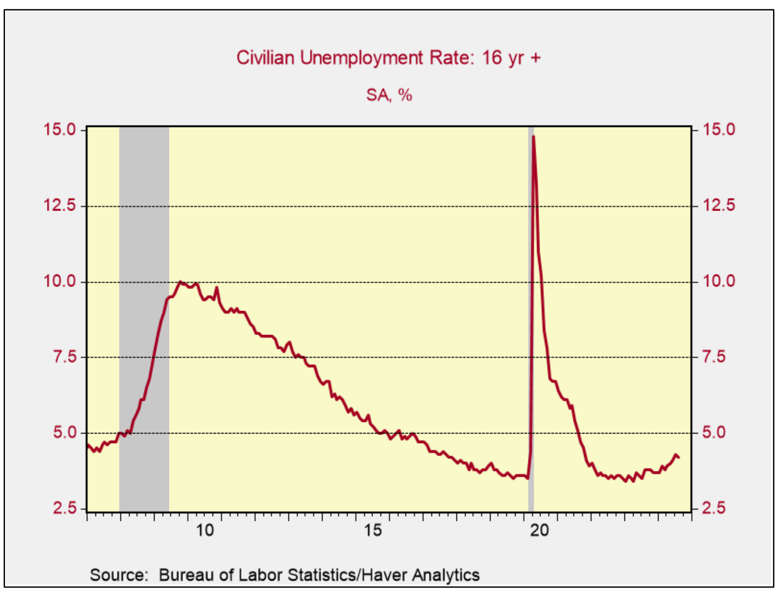
In Other News: The US is growing less confident in a Gaza peace plan and is looking for alternatives, another example of the difficulty of resolving disputes in the Middle East. Republican presidential candidate Donald Trump proposes a 15% corporate tax rate as he looks to bolster his support from big business. The pledge is another sign that neither candidate will be able to solve the deficit matter. Japanese prime minister candidate Yoshimasa Hayashi is holding out hope that the Nippon Steel acquisition of US Steel can be salvaged.

US Economic Releases

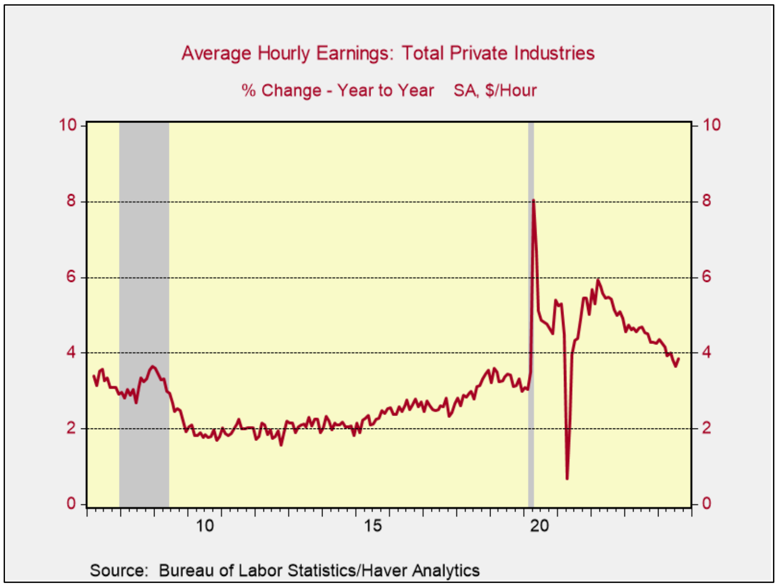
August ***nonfarm payrolls*** rose by a seasonally adjusted 142,000, weaker than the expected gain of 165,000 but much stronger than the revised July increase of 89,000. Indeed, the bigger story may be that the payroll gains in both July and June were revised sharply lower, helping confirm the recent cooling in labor demand. In line with that, August manufacturing payrolls fell sharply by 24,000, easily wiping out their gain of 6,000 jobs in the previous month. The chart below shows the change in nonfarm payrolls since shortly before the Great Financial Crisis (GFC).



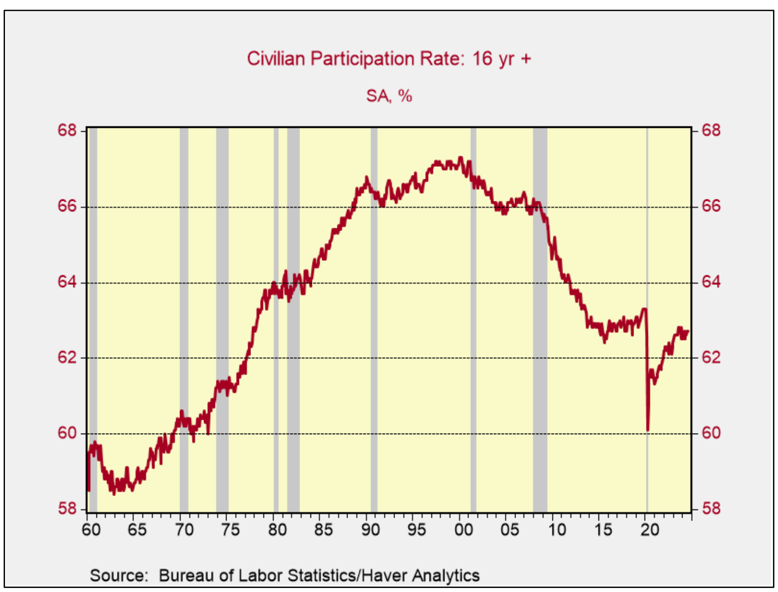
The August ***unemployment rate*** fell to a seasonally adjusted 4.2%, matching expectations and improving a bit from the 4.3% rate in July. Nevertheless, reflecting the recent cooling in labor demand, joblessness remains higher than it was before the coronavirus pandemic. The chart below shows how the unemployment rate has evolved since just before the GFC.



Also reported were ***average hourly earnings***, which rose in August to a seasonally adjusted $35.21, up 3.8% from the same month one year earlier. The annual increase in earnings was a bit stronger than the anticipated rise of 3.7% and marked an acceleration from the 3.6% gain in the year to July. Nevertheless, wage growth still appears to be weakening as labor demand cools. The chart below shows the year-over-year growth in average hourly earnings since just before the GFC.



A final key indicator in the monthly employment report focuses on the share of the adult, civilian, noninstitutionalized population that is either working or looking for work. The August ***labor force participation rate (LFPR)*** held steady at a seasonally adjusted 62.7%, as expected. The chart below shows how the LFPR has changed over the last several decades.



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

Economic Releases		
No economic releases for the rest of today		
Federal Reserve		
ET	**Speaker or Event**	**District or Position**
8:45	John Williams Gives Keynote Remarks	President of the Federal Reserve Bank of New York
11:00	Christopher Waller Gives Speech on Economic Outlook	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	Household Spending	y/y	Jul	0.1%	-1.4%	1.2%	**	Equity bearish, bond bullish
	Leading Economic Index	m/m	Jul P	109.5	109.1	109.4	**	Equity and bond neutral
	Coincident Index	y/y	Jul P	117.1	114.1	116.2	*	Equity and bond neutral
Australia	Foreign Reserves	m/m	Aug	A$96.2b	A$94.4b		*	Equity and bond neutral
South Korea	BoP Goods Balance	m/m	Jul	$8494.5mm	$11741.8m		*	Equity and bond neutral
	BoP Current Account Balance	m/m	Jul	$9131.8mm	$12563.8m		**	Equity and bond neutral
EUROPE								
Eurozone	GDP	y/y	2Q F	0.6%	0.6%	0.6%	***	Equity and bond neutral
Germany	Industrial Production WDA	y/y	Jul	-5.3%	-4.1%	-3.7%	**	Equity and bond neutral
	Trade Balance	m/m	Jul	16.8b	20.4b	20.9b	*	Equity and bond neutral
	Exports	m/m	Jul	1.7%	-3.4%	1.1%	*	Equity and bond neutral
	Imports	m/m	Jul	5.4%	0.2%	1.1%	*	Equity and bond neutral
France	Industrial Production	y/y	Jul	-2.2%	-1.7%	-0.9%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	Jul	-3.0%	-2.0%		**	Equity and bond neutral
	Current Account Balance	m/m	Jul	-1.2b	-2.6b	-2.5b	*	Equity and bond neutral
	Trade Balance	m/m	Jul	-5884m	-6088m	-5980m	*	Equity and bond neutral
Italy	Retail Sales	y/y	Jul	1.0%	-1.1%		**	Equity and bond neutral
Switzerland	Foreign Currency Reserves	m/m	Aug	693.8b	703.7b		***	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	30-Aug	$613.5b	$614.5b		***	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	31-Aug	18.30t	18.66t		*	Equity and bond neutral
AMERICAS								
Canada	S&P Global Canada Composite PMI	m/m	Aug	48.8	47.0		*	Equity and bond neutral
	S&P Global Canada Services PMI	m/m	Aug	48.8	47.3		*	Equity and bond neutral
Brazil	FGV Inflation IGP-DI	y/y	Aug	4.23%	4.16%	4.17%	**	Equity and bond neutral
	Imports Total	m/m	Aug	$24251m	$23279m	$23900m	*	Equity and bond neutral
	Exports Total	m/m	Aug	$29079m	$30919m	$29850m	*	Equity and bond neutral
	Trade Balance Monthly	m/m	Aug	$4828m	$7640m	$6100m	**	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)	526	527	-1	Down
3-mo T-bill yield (bps)	492	494	-2	Down
U.S. Sibor/OIS spread (bps)	494	495	-1	Down
U.S. Libor/OIS spread (bps)	491	492	-1	Down
10-yr T-note (%)	3.70	3.73	-0.03	Down
Euribor/OIS spread (bps)	347	345	2	Down
Currencies	**Direction**			
Dollar	Flat			Down
Euro	Flat			Up
Yen	Up			Up
Pound	Flat			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	$72.96	$72.69	0.37%	
WTI	$69.45	$69.15	0.43%	
Natural Gas	$2.26	$2.25	0.44%	
12-mo strip crack	$18.95	$18.91	0.21%	
Ethanol rack	$1.98	$1.98	-0.15%	
Metals				
Gold	$2,518.33	$2,516.76	0.06%	
Silver	$28.82	$28.82	-0.02%	
Copper contract	$415.60	$413.75	0.45%	
Grains				
Corn contract	$410.50	$410.75	-0.06%	
Wheat contract	$571.75	$574.75	-0.52%	
Soybeans contract	$1,018.75	$1,023.50	-0.46%	
Shipping				
Baltic Dry Freight	1,919	1,902	17	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-6.87	-0.30	-6.57	
Gasoline (mb)	0.85	-1.11	1.96	
Distillates (mb)	-0.37	0.41	-0.78	
Refinery run rates (%)	0.0%	-0.8%	0.8%	
Natural gas (bcf)	13	27	-14	

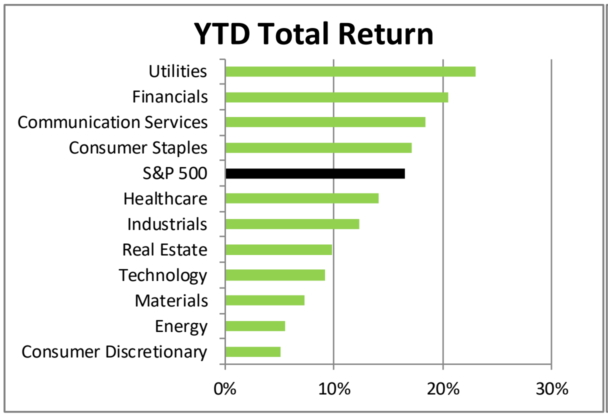
Weather

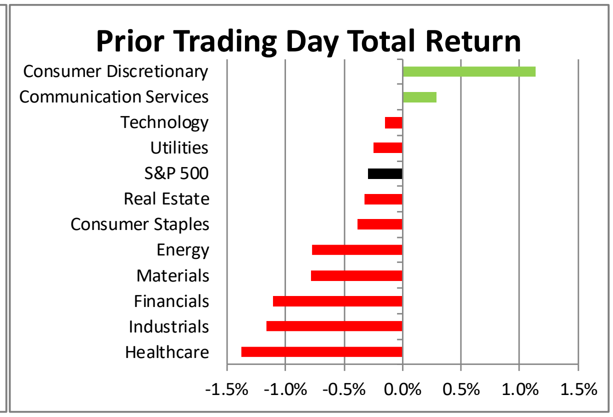
The 6-to-10-day and 8-to-14-day forecasts currently call for warmer-than-normal temperatures in the Rocky Mountains, the Great Plains, the Midwest, and the Northeast, with cooler-than-normal temperatures in the Pacific Northwest and the Deep South. The forecasts are calling for wetter-than-normal conditions in the Pacific Northwest and Southeast, with dry conditions in the Great Plains, the Midwest, and the Northeast.

There are now three tropical disturbances in the Atlantic Ocean region, including one just off the coast of Texas. However, none of these disturbances are assessed to have a significant chance of cyclone formation within the next 48 hours.

Data Section

US Equity Markets – (as of 9/5/2024 close)

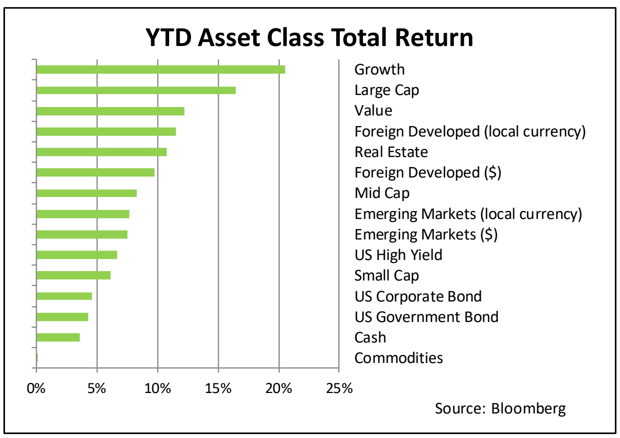




(Source: Bloomberg)

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 9/5/2024 close)

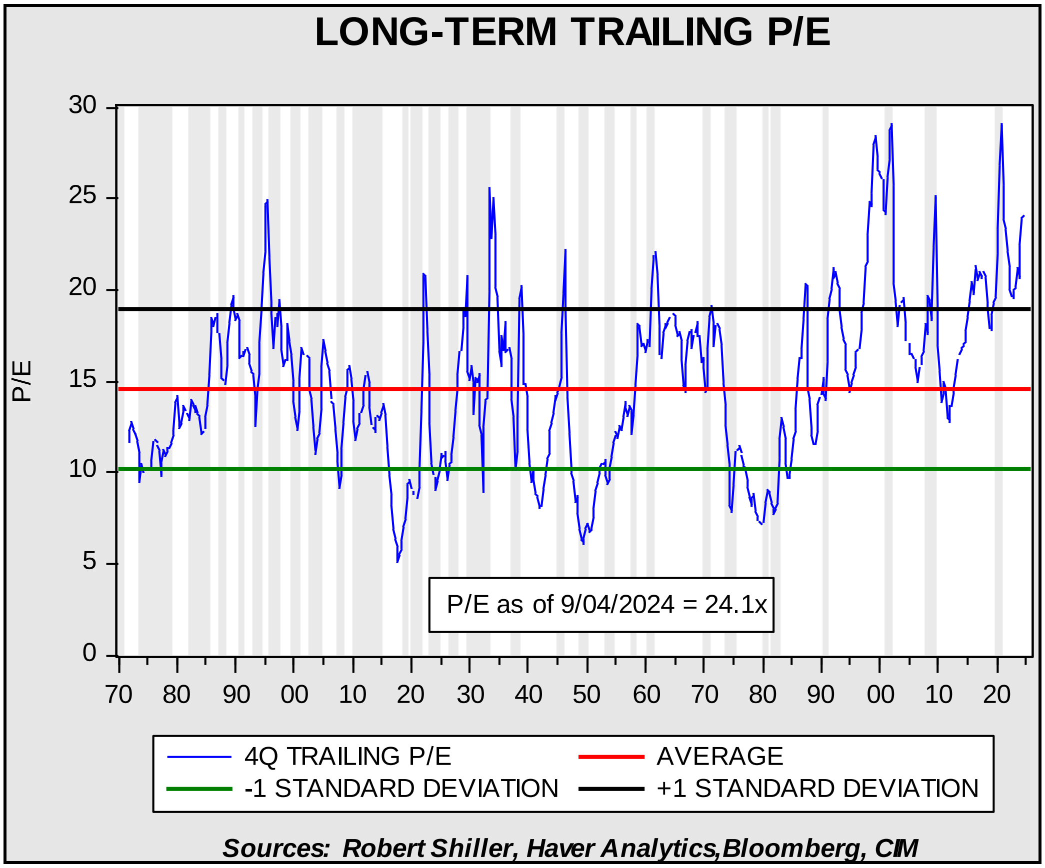


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.