

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: July 29, 2021—9:30 AM EDT] Global equity markets are higher this morning. In Europe, the EuroStoxx 50 is up 0.4% from its prior close. In Asia, the MSCI Asia Apex 50 closed up 3.0%. Chinese markets were higher, with the Shanghai Composite up 1.5% from its prior close and the Shenzhen Composite up 3.1%. U.S. equity index futures are signaling a higher open. With 195 companies having reported, the S&P 500 Q2 2021 earnings stand at \$50.00, higher than the \$45.31 forecast for the quarter. The forecast reflects a 60.0% increase from Q2 2020 earnings. Thus far this quarter, 89.7% of the companies have reported earnings above forecast, while 9.7% have reported earnings below forecast.

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:

- [Weekly Geopolitical Report](#) (7/26/2021): “The Protests in Cuba”
- [Weekly Energy Update](#) (7/29/2021): **Oil inventories decline, and iron-air batteries could bring a notable change to the attractiveness of renewable power.**
- [Asset Allocation Q2 2021 Rebalance Presentation](#) (5/20/2021): A video discussion of our asset allocation process, portfolio changes in Q2, and the macro environment
- [Asset Allocation Weekly](#) (7/23/2021) (with associated [podcast](#) and [chart book](#)): We look at the implications for investors and for the world economy of high corporate debt in China.
- [Confluence of Ideas podcast](#) (7/7/2021): “The Geopolitics of Taiwan and the Issue of Globalization”

Good morning. It's GDP day! We cover the data for Q2 below in detail, but the quick view is that the annualized growth rose 6.5%, well below expectations. [Equity markets are ticking higher](#), but we note that gold is up strongly this morning as the dollar fell, most likely on a dovish take to yesterday's FOMC meeting. There are a couple of items of note. First, the Ever Given, the vessel that was stuck in the Suez Canal, [has finally arrived at its destination in Rotterdam](#). And second, we would be remiss if not to recognize the passing of [Ron Popeil](#), the inventor of the Veg-o-Matic and other gadgets usually hawked on late-night television. He spawned a [famous parody](#) from Saturday Night Live. Our special coverage begins with a recap of the FOMC meeting. Next on the agenda, the Senate has opened a debate on the bipartisan infrastructure legislation (BIL). Starting off our ordinary coverage is China news, followed by economics and policy. The International news roundup is next, and we close with our pandemic update.

The FOMC: As expected, the [Fed didn't change monetary policy](#); QE continues at the same pace, and policy rates remained unchanged. In the press conference, Chair Powell admitted that the [economy was making progress](#), but it hadn't reached the level of "substantial." However, he also noted the committee [discussed at length the conditions required for tapering to commence](#). For obvious reasons, the Chair didn't detail what is necessary for tapering to begin, but most likely, continued improvement in the labor markets is necessary. It doesn't look like there will be a cut in mortgage securities separate from Treasuries, although the Chair left some level of flexibility. Inflation is still deemed to be transitory, meaning that policy won't be tightened yet to address it.

In what might be the most important action taken by the Fed yesterday, the central bank established a domestic and foreign repo facility. The program will allow both domestic and foreign banks to acquire liquidity for collateral at a rate 25 bps higher than the prevailing repo rate. These new facilities will act as a permanent backstop to the non-bank banking system. During the [March 2020 financial crisis](#), the inability of financial institutions to borrow short-term led to a spike in rates and caused several markets to "freeze up," meaning liquidity was nearly impossible to secure at any price. These facilities should alleviate most of these types of problems.

Infrastructure: The Senate [easily passed a measure](#) to begin debate on the [BIL](#). This action means that although the bill isn't completely written, there is enough in place to begin debate. There is still much that could derail the measure; as the bill gets debated, all the Democrats and at least 10 GOP Senators need to remain on board with the bill. It is notable that the CBO hasn't scored the bill. If it turns out to be a budget-buster, it could undermine support among centrists. And, just getting it through the Senate doesn't mean it will pass easily through the House. Left-wing populists (LWP) are worried that [centrist Democratic senators will only support this bill](#) and scuttle a much larger measure that is expected to be passed through reconciliation. The LWP in the House are [threatening to kill the BIL](#) if they don't see support for the larger second measure. Other [establishment elements in the House are not happy](#) they have had little say in the Senate bill. So, this is far from a done deal. However, getting this far is impressive and increases the odds that the \$1.2 trillion measure becomes law.

China: Policymakers try to calm markets, and flooding continues.

- After convulsing the financial markets in China over the past week, it appears that authorities are concerned about financial stress. [State media](#) have started "[jawboning](#)" the market to improve sentiment, and [regulators are trying to reassure investors](#). Banks are also being told to "[restore calm](#)." Given China's past behavior in intervening in equity markets, we could see some "bottom-fishing" activity start to occur. Still, it doesn't appear the government is finished with its intervention.
 - The [property market](#) appears to be the next target of enhanced scrutiny. Evergrande (EGRNF, USD, 0.75) continues to be a [threat to financial stability](#).
 - The context of this crackdown is important. As we are seeing in the U.S., China appears to be also implementing an [equality cycle and ending an efficiency cycle](#). This quote nails it:

- "Chinese entrepreneurs and investors must understand that the age of reckless capital expansion is over," said Alan Song, founder of private equity firm Harvest Capital. "A new era that prioritizes fairness over efficiency has begun."
 - Due to the authoritarian nature of China's government, it can move much faster on policy once a decision is in place.
 - This means the regime is likely to be more focused on equality and accept slower growth. The crackdown on wealth, the [restrictions on tutoring](#), and the [reining in of major business leaders](#) are all part of this shift.
- Although the firm denies it, Didi (DIDI, USD, 8.87) [reportedly considered going private](#) to pacify regulators and compensate shareholders after the government reacted against the company listing in the U.S.
- Ultimately, [these actions are all about protecting the CPC](#). Gaining control of data, making the tech firms less predatory toward consumers, and keeping listings in China, is all about control.
- One way China is retaliating against Chinese overseas activists is to [arrest family members](#). Increasing numbers of Chinese citizens are [seeking asylum](#) during Xi's reign.
- We have noted recent flooding in China; according to reports, [foreign journalists](#) covering the tragedy have become [targets of harassment](#), with apparent government encouragement. The typhoon that affected the Olympics has now reached the Chinese mainland and is [exacerbating recent flooding](#).
- Satellite reconnaissance shows that China is [constructing additional missile silos](#) most likely for nuclear weapons. China has generally had a smaller nuclear missile inventory than Russia and the U.S., and this recent addition won't bring parity. But, it will give China [a more formidable deterrent](#). It is worth noting that these facilities are deeper in the Chinese interior and are out of range of U.S. cruise missiles.
- China foreign minister [Wang Yi has met with the Taliban in Afghanistan](#).
- The government is [revising the population law](#) to try to increase the birth rate.
- Chinese cellphone manufacturers have [developed their own semiconductor chips](#).

Economics and policy: Semiconductor shortages continue, institutional money in single-family homes is a worry, and the poverty rate likely fell.

- Apple (APPL, USD, 144.98) and Tesla (TSLA, USD, 646.98) are the latest companies warning that the [semiconductor chip shortage](#) is affecting the production of its products. Both companies warned the shortages would slow growth.
- One item we have become concerned about is the [incursion of real estate investment into the single-family residential market](#). This buying is reducing the supply of homes available for ordinary homeowners and lifting prices. Although current homeowners clearly benefit through higher prices, housing represents the largest portion of wealth to the bottom 90% of households. Making it difficult to acquire homes at reasonable prices could become a political flashpoint in the near future.

- [GOP members of the Federal Trade Commission](#) expressed criticism of the majority Democratic Party members, arguing that changing from the Bork Standard was ill-advised. Although we understand the concern, the political winds appear to be shifting away from Bork to the neo-Brandeis position that size alone is enough to trigger antitrust concerns.
- One effect of the massive income support tied to the pandemic is a [notable drop in the poverty rate](#).
- [Coffee prices have jumped to a six-year high](#), as frost in Brazil threatens the crop.
- This year's [back-to-school season is expected to be very strong](#).
- As investors search for yield, [banks are creating securities that directly share the risk of mortgages](#). In the past, Fannie Mae (FNMA, USD, 1.305) and Freddie Mac (FMCC, USD, 1.14) acted as guarantors for investor losses. In the 2008 Financial Crisis, mortgage loan losses overwhelmed these two entities, causing the government to effectively nationalize them. These bonds, a common feature of financial engineering, are structured to allow investors to accept various levels of risk. The point here is that, as a consequence of low yields, the industry is creating instruments with more yield but have higher levels of risk.
- The *Economist* magazine's [Big Mac index](#) confirms the dollar is overvalued.

International roundup: The Eurozone economy continues to recover, and Crimean water may be the next problem in Ukraine.

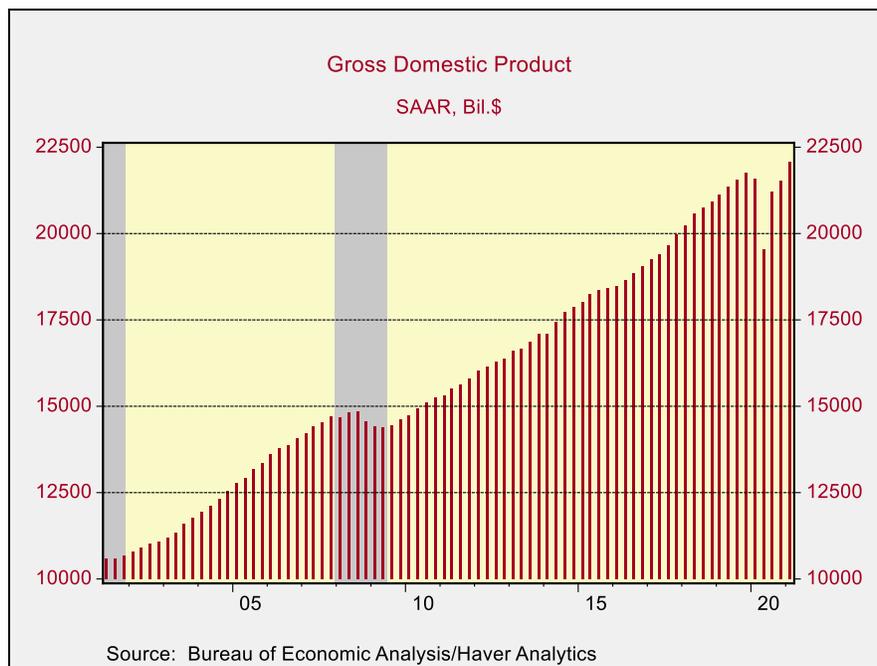
- [Eurozone economic sentiment hit a record high in July](#), although the pace of improvement is slowing.
- [The latest flashpoint in Ukraine is over the water supply in Crimea](#). Ukraine has blocked a canal that provides 85% of the peninsula's fresh water, and there are concerns that Russia will use military force to reopen the canal.
- In the wake of massive flooding in Germany and Belgium, [the cleanup is now underway](#).
- Russia and the U.S. are [holding talks on nuclear missile inventories](#).
- The U.S. has [sanctioned members of the Assad regime](#) in Syria over alleged human rights violations.
- The fallout from Nord Stream 2 continues; [GOP senators are holding up Treasury nominees in retaliation](#).

COVID-19: The [number of reported cases](#) is 196,095,694 with 4,189,011 fatalities. In the U.S., there are 34,677,412 confirmed cases with 611,809 deaths. For illustration purposes, the *FT* has created an [interactive chart](#) that allows one to compare cases across nations using similar scaling metrics. The *FT* has also issued an [economic tracker](#) that looks across countries with high-frequency data on various factors. The [CDC reports](#) that 395,974,515 doses of the vaccine have been distributed, with 343,361,524 doses injected. The number receiving at least one dose is 189,494,180, while the number of second doses, which would grant the highest level of immunity, is 163,588,042. The *FT* has a page on [global vaccine distribution](#).

- [China is seeing a strong rise in cases in Jiangsu province.](#) The city has closed the airport after tourists are thought to have brought new infections to the area, which is considered a tourist destination in China.
- Steadily, [we are seeing governments around the world learn to live with COVID-19.](#) Although mask recommendations and mandates have increased in the U.S. and other parts of the world, mass lockdowns appear to be out. Even though vaccine distribution has stalled, the [combination of vaccines and infections](#) does appear to be [giving populations some degree of immunity](#). Unfortunately, vaccines and infections don't seem to grant sterilizing immunity, but both seem to prevent more serious cases of the disease. The move away from lockdowns should support continued economic recovery.
- Unfortunately, the [current dominant strain of the virus is much more contagious](#) than earlier versions.

U.S. Economic Releases

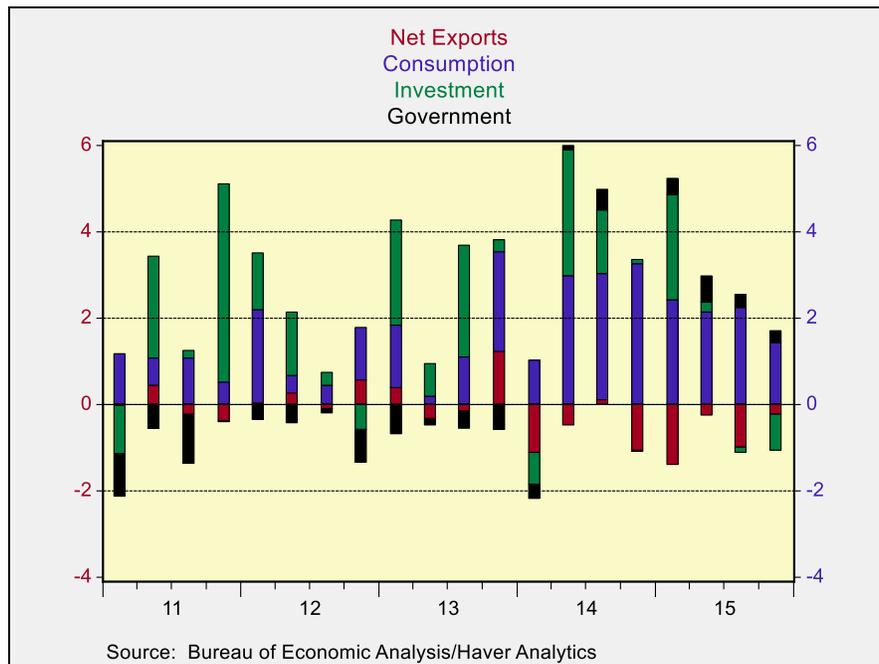
In the second quarter, GDP expanded at an annualized pace of 6.5% from the prior quarter, below expectations of 8.4%. Personal consumption expanded at an annualized pace of 11.8% from the prior quarter compared to expectations of 10.5%. The GDP Price Index and the Core PCE Index rose at an annualized pace of 6.0% and 6.1%, respectively.



The chart above shows GDP in current dollars. GDP currently sits at \$22.723 trillion.

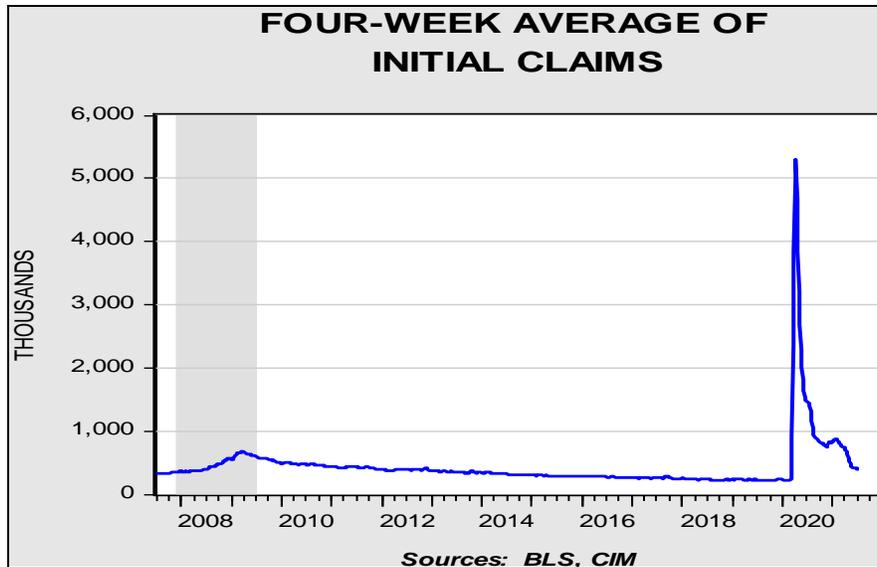
	Q2 2021 Prelim Reading	Q1 2021 Third Reading	Difference
GDP	6.4%	6.3%	0.1%
Consumption	7.8%	7.4%	0.3%
Investment	-0.6%	-0.4%	-0.2%
Inventories	-1.1%	-2.6%	1.5%
Net Exports	-0.4%	-1.6%	1.1%
Government	-0.3%	0.8%	-1.0%

The table above shows the contribution to GDP in Q2. Consumption was the primary driver of GDP, while investment and net exports were the biggest drags.



The chart above shows the contribution chart graphically.

Jobless claims fell from the previous month but remain above market expectations. For the week ending July 24, initial claims came in at 400K compared to expectations of 385K. The previous report was revised from 419K to 424K. For the week ending July 17, continuing claims came in at 3,269K compared to expectations of 3,183K. The prior report was revised from 3,236K to 3,262K.



The chart above shows the four-week moving average of initial claims. The moving average rose from 386.5K to 394.5K.

The table below shows the domestic releases scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Langer Consumer Comfort	w/w	25-Jul	51.5		***
10:00	Pending Home Sales	m/m	Jun	8.0%	0.2%	**
10:00	Pending Home Sales NSA	m/m	Jun	13.9%	-3.3%	**
Fed Speakers or Events						
No Fed speakers or events 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								
New Zealand	ANZ Activity Outlook	m/m	Jul	26.3	31.6		**	Equity and bond neutral
	ANZ Business Confidence	m/m	Jul	-3.8	-0.6		**	Equity bearish, bond bullish
EUROPE								
Eurozone	Consumer Confidence	m/m	Jul	-4.4	-4.4		***	Equity and bond neutral
	Economic Confidence	m/m	Jul	119.0	117.9	118.2	***	Equity bullish, bond bearish
Germany	Unemployment Change (000's)	m/m	Jul	-91.0k	-38.0k	-29.0k	***	Equity bearish, bond bullish
	Unemployment Claims Rate SA	m/m	Jul	5.7%	5.9%	5.8%	***	Equity and bond neutral
France	PPI	y/y	Jun	7.5%	7.2%		**	Equity and bond neutral
Italy	Hourly Wages	y/y	Jun	0.6%	0.6%		**	Equity and bond neutral
	PPI	m/m	Jun	1.7%	1.3%		**	Equity and bond neutral
UK	Net Consumer Credit	m/m	Jun	0.3b	0.3b	0.5b	**	Equity and bond neutral
	Consumer Credit	y/y	Jun	-2.2%	-3.2%		**	Equity and bond neutral
Russia	Unemployment Rate	m/m	Jun	4.8%	4.9%	4.8%	***	Equity and bond neutral
	Retail Sales Real	y/y	Jun	10.9%	27.2%	11.9%	**	Equity bearish, bond bullish
	Real Wages	y/y	May	3.3%	7.8%	5.0%	**	Equity bearish, bond bullish
	CPI Weekly YTD	w/w	26-Jul	4.6%	4.6%		***	Equity and bond neutral
AMERICAS								
Brazil	PPI Manufacturing	y/y	Jun	32.9%	32.5%		**	Equity and bond neutral
	Total Outstanding Loans	m/m	Jun	4214b	4178b	4212b	**	Equity and bond neutral
	Personal Loan Default Rate	m/m	Jun	4.0%	4.1%	4.2%	**	Equity and bond neutral
	Federal Debt Total	m/m	Jun	5330b	5171b		**	Equity and bond neutral
Canada	CPI	y/y	Jun	3.1%	3.6%	3.2%	**	Equity and bond neutral

Financial Markets

The table below highlights some of the indicators that we follow on a daily basis. 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.

	Today	Prior	Change	Trend
3-mo Libor yield (bps)	13	13	0	Down
3-mo T-bill yield (bps)	4	5	-1	Neutral
TED spread (bps)	9	8	1	Neutral
U.S. Libor/OIS spread (bps)	9	9	0	Up
10-yr T-note (%)	1.27	1.23	0.04	down
Euribor/OIS spread (bps)	-55	-54	-1	Neutral
EUR/USD 3-mo swap (bps)	5	5	0	Down
Currencies	Direction			
dollar	Down			Down
euro	Up			Up
yen	Flat			Up
pound	Down			Up
franc	Up			Up
Central Bank Action	Current	Prior	Expected	
FOMC Rate Decision (Lower Bound)	0.000%	0.000%	0.000%	On forecast
FOMC Rate Decision (Upper Bound)	0.250%	0.250%	0.250%	On forecast
Interest on Reserve Balances Rate	0.150%	0.150%	0.150%	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.

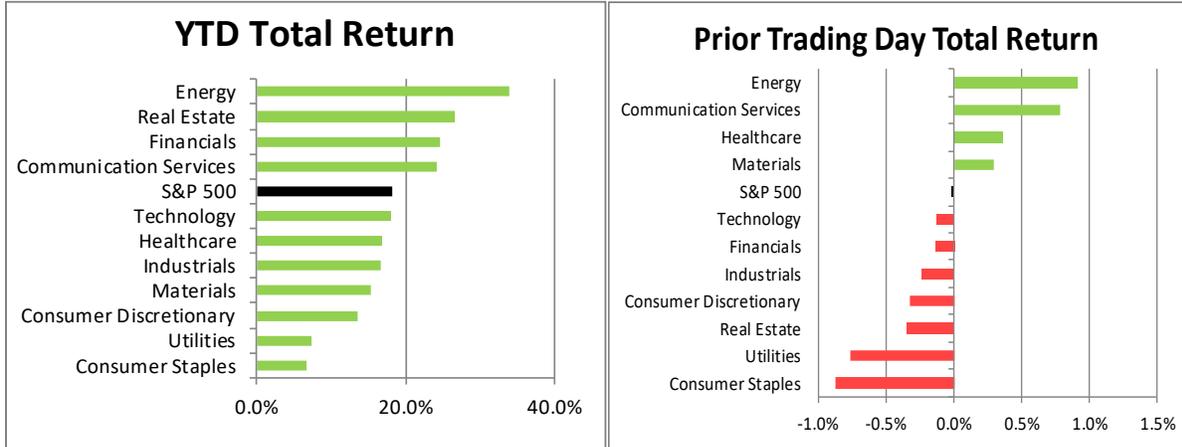
	Price	Prior	Change	Explanation
Energy Markets				
Brent	\$75.03	\$74.74	0.39%	
WTI	\$72.81	\$72.39	0.58%	
Natural Gas	\$3.95	\$3.97	-0.38%	
Crack Spread	\$21.60	\$21.68	-0.39%	
12-mo strip crack	\$20.14	\$20.28	-0.69%	
Ethanol rack	\$2.41	\$2.40	0.18%	
Metals				
Gold	\$1,822.77	\$1,807.11	0.87%	
Silver	\$25.50	\$24.96	2.13%	
Copper contract	\$453.90	\$448.20	1.27%	
Grains				
Corn contract	\$ 552.50	\$ 549.00	0.64%	
Wheat contract	\$ 697.25	\$ 688.75	1.23%	
Soybeans contract	\$ 1,370.00	\$ 1,361.00	0.66%	
Shipping				
Baltic Dry Freight	3154	3166	-12	
DOE inventory report				
	Actual	Expected	Difference	
Crude (mb)	-4.1	-2.1	-2.0	
Gasoline (mb)	-2.3	-1.0	-1.3	
Distillates (mb)	-3.0	-0.3	-2.7	
Refinery run rates (%)	-0.30%	0.45%	-0.75%	

Weather

The 6-10 day and 8-14 day forecasts currently call for warmer-than-normal temperatures for the Pacific and Rocky Mountain regions, with cooler temperatures throughout most of the country. The forecast calls for wetter-than-normal conditions in the Southeast region as well as Washington state and its surrounding areas, with dry conditions for most of the country. There is no tropical cyclone activity expected over the next 48 hours.

Data Section

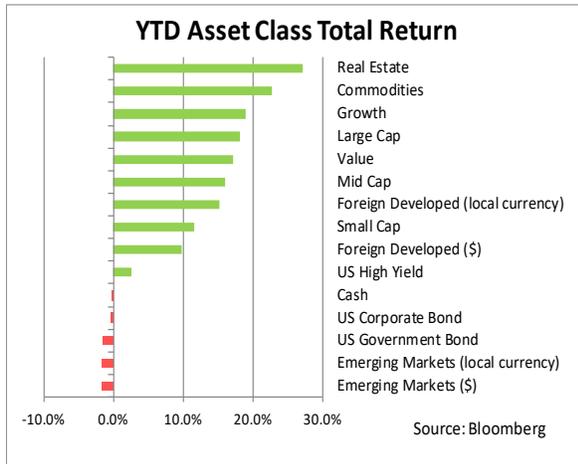
U.S. Equity Markets – (as of 7/28/2021 close)



(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 7/28/2021 close)

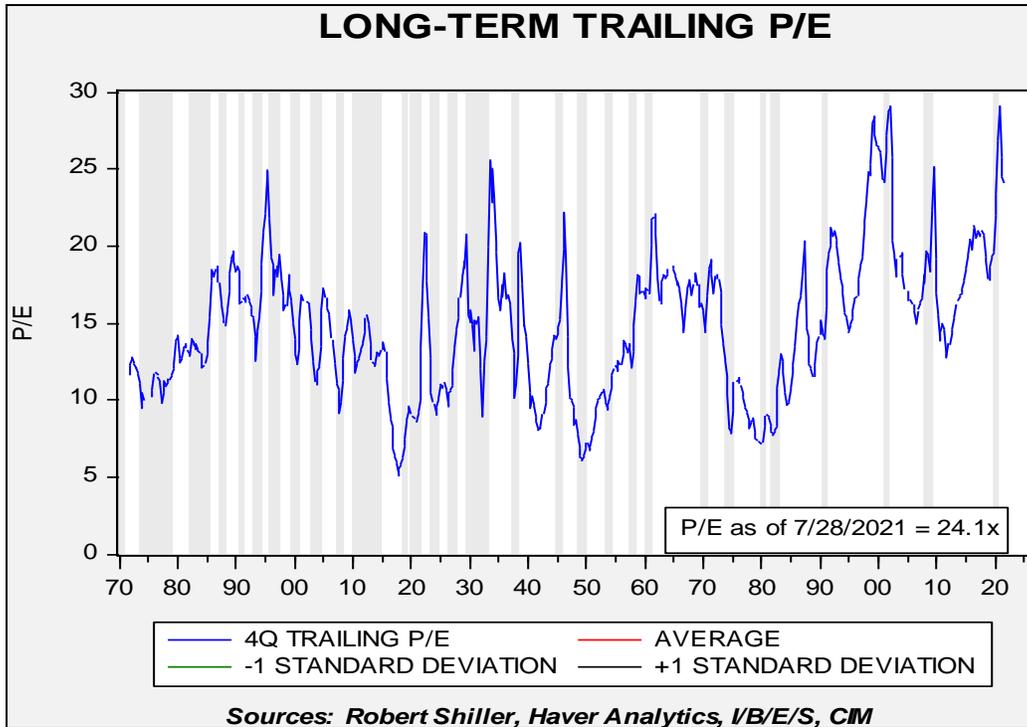


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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), U.S. Corporate Bond (iShares iBoxx \$ Investment Grade Corporate Bond ETF), U.S. Government Bond (iShares 7-10 Year Treasury Bond ETF), U.S. 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

July 29, 2021



Based on our methodology,¹ the current P/E is 24.1x, -0.1x from last week. Rising earnings and steady index values led to the decline in the multiple.

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.

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 I/B/E/S estimates which are updated regularly throughout the quarter; currently, the four-quarter earnings sum includes two actual quarters (Q4 and Q1) and two estimates (Q2 and Q3). 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.