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: June 5, 2024—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is up 1.4% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.3%. Chinese markets were lower, with the Shanghai Composite down 0.8% from its previous close and the Shenzhen Composite down 1.2%. 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* (6/3/2024) (with associated podcast): "The Philippines, China & Escalation in the South China Sea"
- *Asset Allocation Quarterly – Q2 2024* (4/25/2024): Discussion of our asset allocation process, Q2 2024 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q2 2024 Rebalance Presentation* (5/7/2024): Video presentation featuring the Asset Allocation Committee as they review the asset allocation strategies, recent portfolio changes, and the current macro environment.
- *Asset Allocation Bi-Weekly* (5/28/2024) (with associated podcast): "The Importance of the Federal Reserve's Inflation Target"
- *Confluence of Ideas podcast* (5/8/2024) "Reviewing the Asset Allocation Rebalance: Q2 2024"

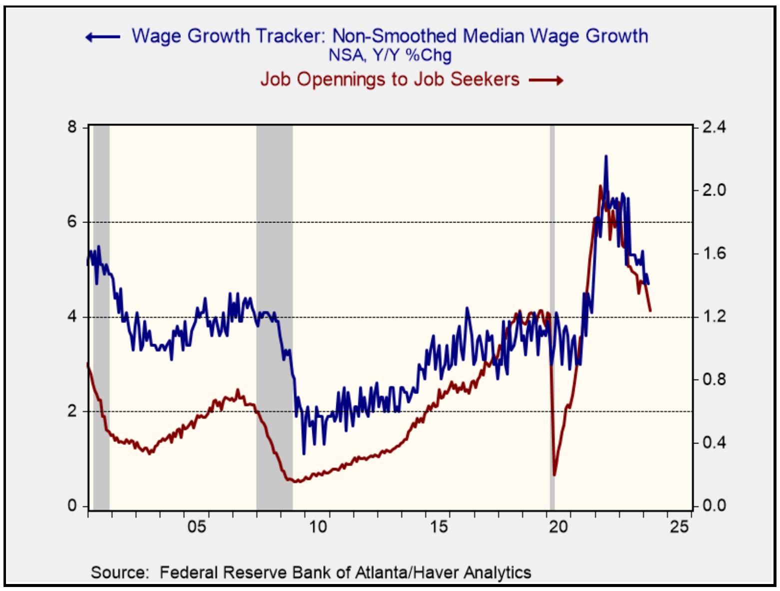
Good morning! Equities futures are off to a strong start as investors digest the latest ADP jobs data. In sports news, the US Women's National Team (USWNT) delivered a convincing victory over South Korea in their pre-Olympics preparation. Today's *Comment* will focus on why a slowdown in job openings may be good news for the market, why the regional banking system remains a point of concern, and why the UK Prime Minister debate wasn't a clear win for either candidate. As usual, our report concludes with a roundup of international and domestic data releases.

Labor Cooling: Job openings have fallen in recent months in a sign that rising interest rates may finally be impacting the US economy.

- US job openings have plunged to a three-year low, according to the Bureau of Labor Statistics. April data shows that 8.06 million jobs are available, down from 8.35 million in the previous month, which pushed the job openings rate down to 4.8% from 5.0%.

This marks the third straight month of decline and fuels speculation of an economic slowdown. The [Atlanta Fed's GDPNow forecast predicts second-quarter growth of just 1.8%](), down from last week's estimate of a 2.7% rise. This weak reading was seen as bullish for risk assets as it raised the possibility of the Federal Reserve cutting rates to prevent a recession.

- The recent jobs data offers a glimmer of hope for a soft landing. The ratio of job openings to unemployed workers is steadily declining and is now approaching pre-pandemic levels. This suggests employers are adjusting to wage pressures by scaling back on hiring, as opposed to reducing their workforce. This aligns with past comments from Fed Governor Christopher Waller. A few years ago, he suggested companies might freeze hiring rather than resorting to layoffs during an economic slowdown. This trend strengthens the case for potential rate cuts by the Fed in the latter half of the year.



- A Goldilocks scenario seems likely for the economy, with growth potentially slowing enough to tame inflation without tipping into recession. Friday's jobs report is a crucial test for this forecast. The expected gain of 190,000 jobs would be considered modest. A significantly weaker number could fuel expectations of a rate cut, possibly as early as September. If our forecast holds true, this could lead to a rise in stock prices, with small-cap and mid-cap stocks potentially outperforming their larger counterparts as investors embrace riskier assets. Additionally, US government bonds should also rally as investors look to get ahead of the Fed.

Bank Troubles: Even though some indicators suggest financial conditions are still relatively stable, regulators remain concerned about potential trouble for banks.

- The Federal Deposit Insurance Corporation (FDIC) identified an increase in bank vulnerability, with 63 banks now considered at risk. This marks a rise from 52 in the fourth quarter of 2023. The US banking system faces a growing burden of unrealized losses totaling $517 billion. This represents an 8.2% increase from the previous quarter.

Residential mortgage-backed securities are the primary culprit, accounting for 95% of the recent rise in losses. Additionally, there is an upward trend in the volume of past due and nonaccruals (PDNA), with most of the increase coming from the largest banks.

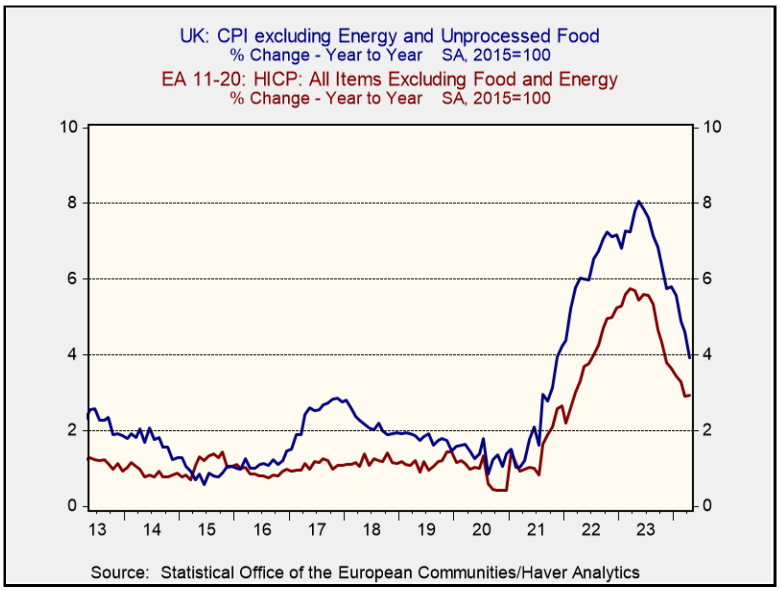
- Despite signs of vulnerability in some banks, broader financial conditions remain easy. The Chicago Fed National Financial Conditions Index reflects this disconnect, with 101 out of 105 indicators signaling looser-than-average conditions. As a result, hawkish voices within the Fed are rising. Last week, Dallas Fed President Lorie Logan, a non-voting FOMC member, emphasized the need to keep rate hikes on the table in order to prevent reigniting inflation through premature easing. She finds support from Atlanta Fed President Raphael Bostic, Minneapolis Fed President Neel Kashkari, and Fed Governor Michelle Bowman, who have also signaled openness to further tightening.

- A recent increase in banks identified as potential problems by the FDIC raises concerns. However, with only 1.2% of the system flagged, the overall health of the banking industry remains strong. This will be a key factor for policymakers as they navigate next week's rate decision. While recent economic data is unlikely to completely derail rate cuts, rising inflation concerns may prompt the Fed to scale back its plans. Instead of the previously anticipated three cuts, the Fed might opt for a more measured approach with just two reductions. Additionally, policymakers may choose to monitor the effects of slowing the balance sheet reduction before resorting to more aggressive measures to safeguard the banking system.

UK Showdown: Prime Minister Rishi Sunak clashed with his Labour counterpart Keir Starmer as he attempted to boost support for his re-election campaign.

- The debate opened with a fiery exchange, as Sunak launched a direct attack by accusing Starmer of proposing a £2,000 tax increase (roughly $2,550). Starmer countered, insisting the figure was grossly inflated and based on flawed assumptions about his policies. However, despite his pushback, Starmer struggled to deflect concerns about potential tax hikes, leaving him on the defensive throughout most of the verbal sparring. That said, Sunak struggled to defend his party's 14-year record in power, likely damaging his overall likeability rating.

- Although polls showed that Sunak was the victor of the debate, his party is still heavily favored to lose the election that is set to take place on July 4. Two of the most pressing concerns for the British are the rising cost of living and immigration. While inflation has come down from its peak, prices in the UK are still rising faster than in the eurozone. Additionally, many voters are concerned that immigration is placing a strain on housing affordability and public services. Although the country has implemented stricter immigration policies, there is still a push for lawmakers to go further.



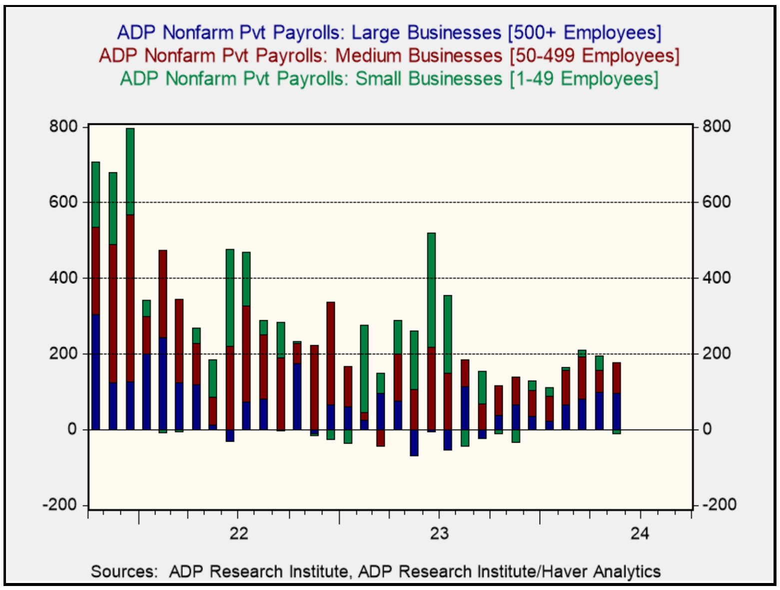
- Despite exiting the European Union more than four years ago, the UK continues to search for a clear national identity. If polls hold true, the country could be on its fourth prime minister in that timeframe. This persistent leadership change is likely to complicate efforts to predict the future course of policy, as the UK grapples with ongoing challenges. One key issue in the coming months will be the country's ability to manage its debt in order to achieve economic stability. A successful approach could attract investment, but failure could lead to investor hesitancy.

In Other News: President Biden issued an executive order to tighten restrictions on border crossings, likely in response to criticism of being too lenient on immigration. However, this move might also alienate some within his base. Meanwhile, Nvidia has surpassed Apple in market value, reflecting strong enthusiasm for AI technologies. In other news, Ukraine launched its first missile into Russia, indicating a potential escalation of the conflict beyond the current borders.

US Economic Releases

US home loan demand slowed last week as elevated borrowing costs continue to keep potential homebuyers on the sidelines. According to an index tracked by the Mortgage Bankers Association (MBA), mortgage applications fell 5.2% in the week ending May 31. Rising interest rates may have contributed to the slowdown in mortgage activity, with the average 30-year fixed-rate mortgage increasing 2 basis points to 7.07%. The MBA purchase tracker fell 4.4% from the previous week, and the refinance tracker declined by 6.8%.

Private sector hiring appears to be cooling down. ADP data shows that the US added only 152,000 jobs in May, falling short of expectations (175,000) and revising down the previous month's figure (188,000). This slowdown could fuel concerns that Friday's BLS report could also show a deceleration in job creation.



The chart above shows the number of jobs added by company size. In May, large businesses added 98,000 jobs, medium businesses added 78,000 jobs, while small businesses lost 10,000 jobs.

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

Economic Releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	S&P Global US Services PMI	m/m	May F	54.8	54.8	***
9:45	S&P Global US Composite PMI	m/m	May F	54.2	54.4	***
10:00	ISM Services Index	m/m	May	51.0	49.4	***
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	Apr	2.1%	1.0%	1.8%	**	Equity and bond neutral
	Real Cash Earnings	m/m	Apr	-0.7	-2.1	-0.9	*	Equity and bond neutral
	Jibun bank Composite PMI	m/m	May F	52.6	52.4		*	Equity and bond neutral
	Jibun Bank Services PMI	m/m	May F	53.8	53.6		**	Equity and bond neutral
Australia	GDP	q/q	1Q	1.1%	1.6%	1.2%	**	Equity and bond neutral
South Korea	Foreign Reserves	m/m	May	412.8	$413.26b		**	Equity and bond neutral
	GDP	q/q	1Q P	3.3%	3.4%	3.4%	**	Equity and bond neutral
China	Caixin Composite PMI	m/m	May	54.1	52.8		**	Equity and bond neutral
	Caixin Services PMI	m/m	May	54.0	52.5	52.5	**	Equity bullish, bond bearish
India	HSBC India PMI Composite	m/m	May F	60.5	61.7		**	Equity and bond neutral
	HSBC India PMI Services	m/m	May F	60.2	61.4		**	Equity and bond neutral
EUROPE								
Eurozone	HCOB Eurozone Services PMI	m/m	May F	53.2	53.3	53.3	**	Equity and bond neutral
	HCOB Eurozone Composite PMI	m/m	May F	52.2	52.3	52.3	*	Equity and bond neutral
	PPI	y/y	Apr	-5.7%	-7.8%	-5.3%	**	Equity and bond neutral
Germany	HCOB Germany Services PMI	m/m	May F	54.2	53.9	53.9	**	Equity and bond neutral
	HCOB Germany Composite PMI	m/m	May F	52.4	52.2	52.2	**	Equity and bond neutral
France	Industrial Production	y/y	Apr	0.9%	0.7%	0.7%	***	Equity and bond neutral
	Manufacturing Production	y/y	Apr	0.4%	-0.4%	0.3%	**	Equity and bond neutral
	HCOB France Services PMI	m/m	May F	49.3	49.4	49.4	**	Equity and bond neutral
	HCOB France Composite PMI	m/m	May F	48.9	49.1	49.1	**	Equity and bond neutral
Italy	HCOB Italy Services PMI	m/m	May	52.3	52.6	53.2	**	Equity and bond neutral
	HCOB Italy Composite PMI	m/m	May	54.2	54.3	54.5	**	Equity and bond neutral
UK	New Car Registrations	m/m	May	1.70%	1.00%		*	Equity and bond neutral
	Official Reserves Changes	m/m	May	$1647m	$13m		*	Equity and bond neutral
	S&P Global UK Services PMI	m/m	May F	52.9	52.9	52.9	**	Equity and bond neutral
	S&P Global UK Composite PMI	m/m	May F	53.0	52.8	52.8	**	Equity and bond neutral
Russia	S&P Composite PMI	m/m	May	51.4	51.9	52.5	**	Equity bearish, bond bullish
	S&P Services PMI	m/m	May	49.8	50.5	50.5	**	Equity bearish, bond bullish
AMERICAS								
Mexico	International Reserves Weekly	w/w	31-May	$218726m	$218739m		*	Equity and bond neutral
Brazil	Industrial Production	y/y	Apr	8.4%	-2.8%	8.7%	***	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)	560	560	0	Up
3-mo T-bill yield (bps)	524	524	0	Up
U.S. Sibor/OIS spread (bps)	534	534	0	Up
U.S. Libor/OIS spread (bps)	535	535	0	Up
10-yr T-note (%)	4.33	4.33	0.00	Down
Euribor/OIS spread (bps)	377	378	-1	Down
Currencies	**Direction**			
Dollar	Up			Up
Euro	Flat			Flat
Yen	Down			Down
Pound	Flat			Up
Franc	Down			Down

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.

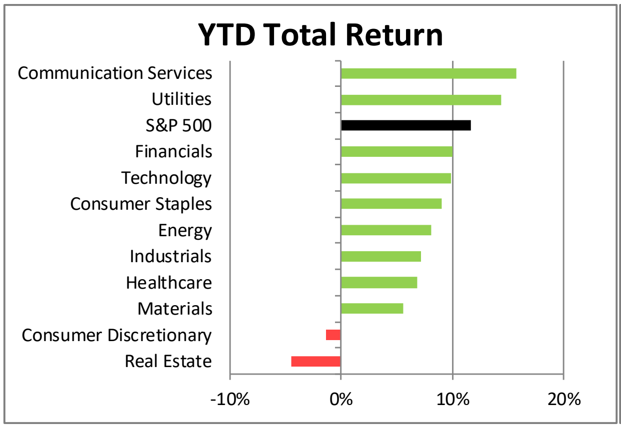
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$77.87	$77.52	0.45%	
WTI	$73.58	$73.25	0.45%	
Natural Gas	$2.63	$2.59	1.62%	
12-mo strip crack	$21.67	$21.59	0.37%	
Ethanol rack	$1.97	$1.97	0.14%	
Metals				
Gold	$2,333.67	$2,327.01	0.29%	
Silver	$29.59	$29.50	0.30%	
Copper contract	$453.65	$453.70	-0.01%	
Grains				
Corn contract	$440.25	$442.50	-0.51%	
Wheat contract	$658.25	$658.25	0.00%	
Soybeans contract	$1,181.00	$1,179.00	0.17%	
Shipping				
Baltic Dry Freight	1,813	1,808	5	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.30		
Gasoline (mb)		1.70		
Distillates (mb)		2.17		
Refinery run rates (%)		0.0%		
Natural gas (bcf)		88		

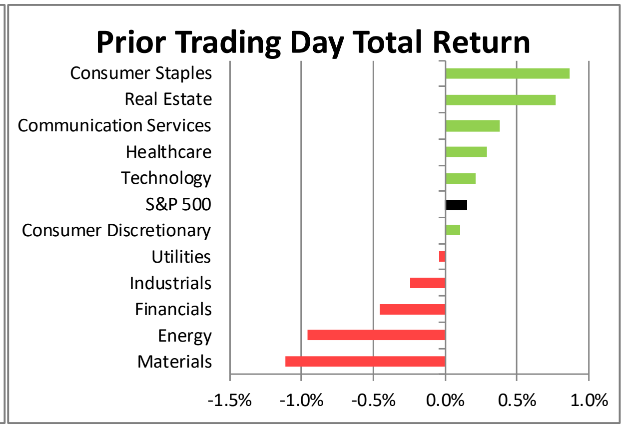
Weather

The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures for most of the country, with cooler-than-normal temperatures in the Midwest. The forecasts call for wetter-than-average conditions along the East Coast and parts of the Rocky Mountain region, with dry conditions in the Southeast.

<u>Data Section</u>

US Equity Markets – (as of 6/4/2024 close)

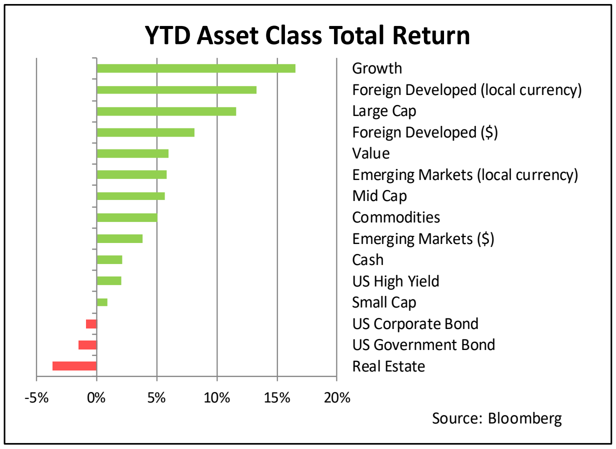




(Source: Bloomberg)

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 6/4/2024 close)

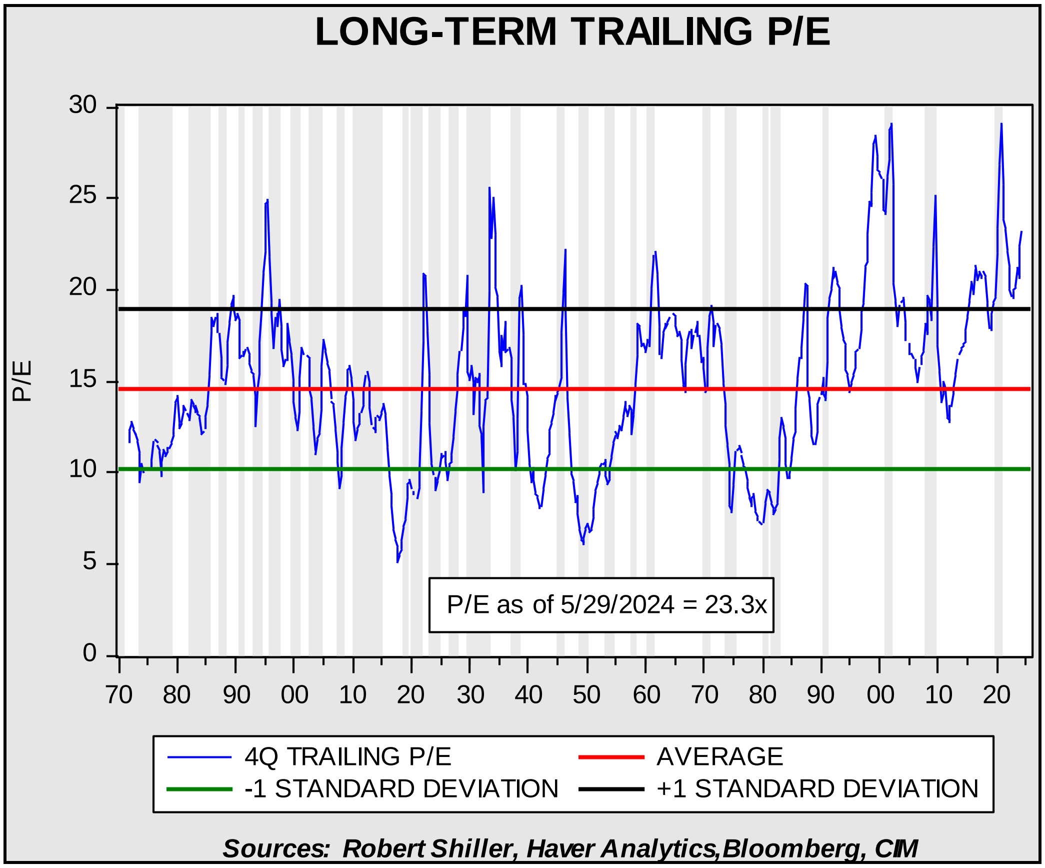


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

May 30, 2024



Based on our methodology,[1] the current P/E is 23.3x, up 0.1 from our last report. The increase in the multiple was due to an increase in the stock price index, outpacing the increase 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 (Q2, Q3 and Q4) and one estimate (Q1). 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.