Daily Comment

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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: May 1, 2024—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is down 1.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.3%. Chinese markets were lower, with the Shanghai Composite down 0.3% from its previous close and the Shenzhen Composite down 0.7%. US equity index futures are signaling a lower open.

With 287 companies having reported so far, S&P 500 earnings for Q1 are running at $55.60 per share, compared to estimates of $54.24, which is up 0.9% from Q1 2023. Of the companies that have reported thus far, 80.5% have exceeded expectations while 16.4% have fallen short of expectations.

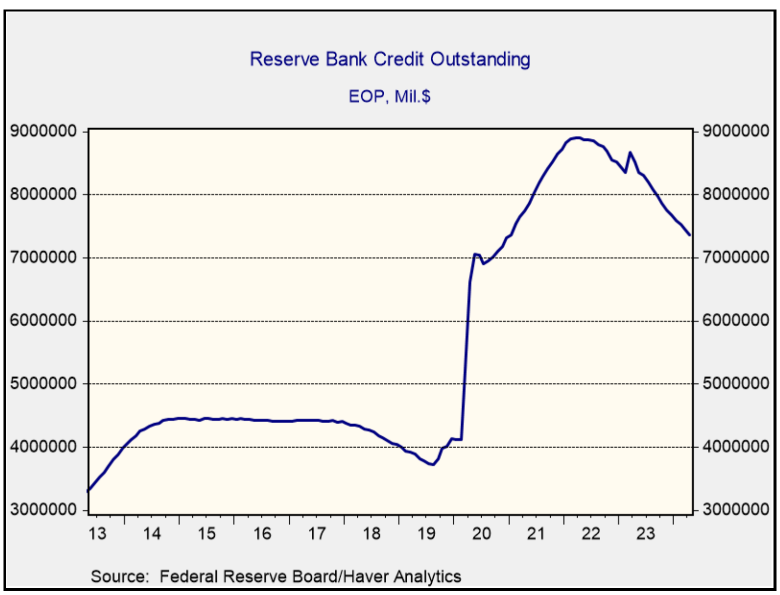
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (4/22/2024) (with associated podcast): "The Changing Face of War"
- *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 Q1 2024 Rebalance Presentation* (2/5/2024): 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* (4/29/2024) (there will be no accompanying podcast): "The Peace Dividend, Government Debt, and Yield Curve Control"
- *The 2024 Outlook: Slow-Bicycle Economy* (12/18/2023) (with associated *Confluence of Ideas* podcast)
- *Confluence of Ideas podcast* (2/13/2024) "Reviewing the Asset Allocation Rebalance: Q1 2024"

Good morning! Equities are down as investors await the Federal Reserve's policy decision. In sports news, Real Madrid showed their fighting spirit again, securing a draw against Bayern Munich in a thrilling Champions League match. Today's Comment examines our views on monetary policy, where we believe the market should be less focused on rate cuts and more on balance sheet reduction. We also discuss how investors are paying closer attention to earnings and whether China may look to stimulate its economy over the next few months. The report concludes with a summary of domestic and international data releases.

No Cut, No Problem: The market anticipates a hawkish stance from the Federal Open Market Committee (FOMC) after its meeting, but the Fed's balance sheet plans shouldn't be overlooked.

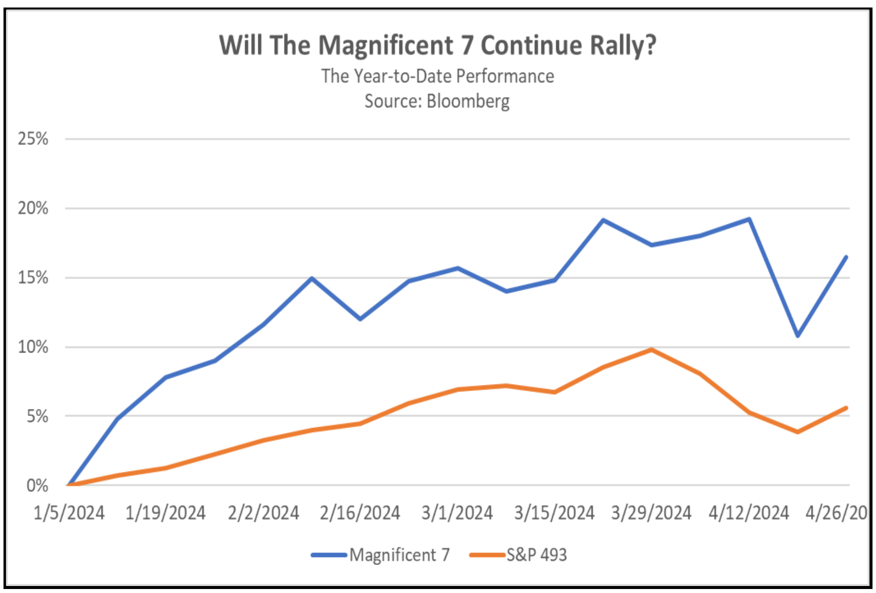
- Strong economic data has cast doubts on the Federal Reserve's plan to cut rates three times this year, as initially outlined in their economic projections. The CME FedWatch Tool now reflects a more cautious approach, suggesting one or two cuts are more likely. This shift aligns with the Fed's wait for clearer signs of inflation subsiding. Tuesday's employment cost index, showing a jump in wages and benefits from 0.9% to 1.2% in Q1, is a prime example. The data highlights persistent wage pressures, particularly for unionized workers whose compensation rose 6.3% compared to 4.1% for non-union workers.
- Despite the economic data, the Fed might prioritize easing financial conditions through other means. Minutes from the March FOMC meeting showed that a majority of policymakers favored a measured slowdown in quantitative tightening (QT), specifically by reducing the pace of US Treasury drawdown while maintaining the current pace of runoff of mortgage-backed securities. The FOMC minutes didn't provide a specific timeframe, but policymakers expressed a preference for a "fairly soon" implementation, likely indicating this summer or even this month. This move could help anchor Treasury yields and alleviate the risk of funding pressures in the repo market.



- While a rate cut delivers a more direct economic boost, slowing the pace of QT could still offer some market relief. Unlike rate cuts, a measured slowdown in balance sheet reduction is unlikely to significantly impact consumer spending. This signals the Fed's consideration of a less restrictive policy stance. However, we don't expect it to completely rule out rate cuts in 2024. Instead, it will likely signal less confidence in its ability to lower rates moving forward. Given persistent inflation, our current forecast is for a maximum of two rate cuts this year, with a strong possibility of none at all.

Investors Not Deterred: Investors have shifted their focus to corporate earnings, scrutinizing the ability of companies to maintain profitability amidst tightening financial conditions.

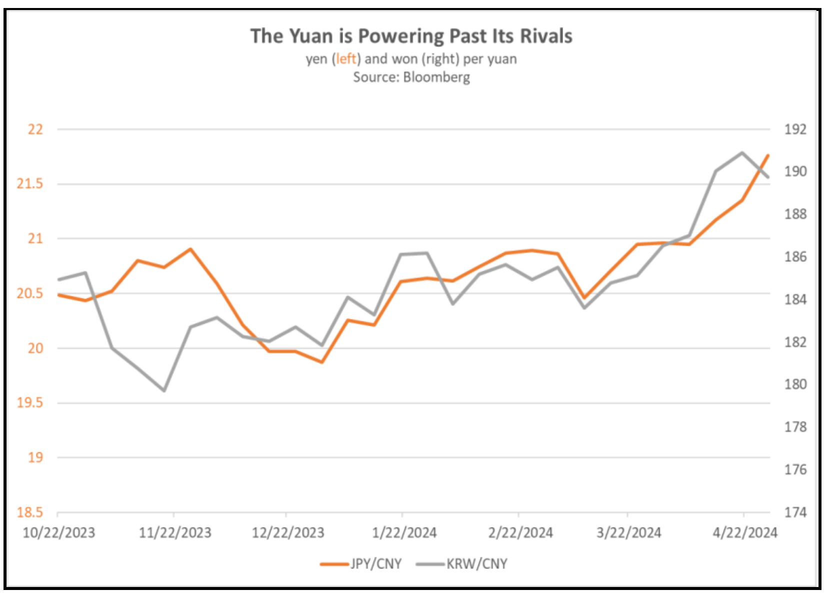
- Early signs from earnings season are positive. Over 80% of the nearly 300 companies that have reported have exceeded analyst expectations, defying concerns as the country continues to experience strong consumer spending growth. The S&P 500 has seen earnings growth of 5.6%, handily surpassing Bloomberg's estimate of 3.8%. This strong performance is broad-based, with some companies reporting positive surprises exceeding 8% in earnings growth. This robust corporate performance appears to be a bright spot in the market as investors adjust to the possibility of fewer rate cuts from the Fed.
- The focus of tech earnings this week shifts to the "Magnificent Seven," a group of high-valuation tech companies. Investors are eager to see if these companies can justify their lofty stock prices. So far, the tech sector has shown mixed results. Disappointing outlooks from Meta and weak sales from Apple have dampened investor enthusiasm. However, a surprise dividend from Alphabet and robust cloud performances by Amazon and Microsoft have offered some relief. A strong earnings report from Nvidia later this month could give the Magnificent Seven a much-needed boost. However, considering the recent reports from fellow chipmakers AMD and Supermicro, such a performance might be unlikely.



- Maintaining their stellar start to the year is proving difficult for major tech companies, suggesting much of their potential for growth is already reflected in their stock prices. This could explain the recent dividend announcements from companies like Meta and Alphabet, potentially aimed at appeasing investors seeking returns to offset the higher risks associated with tech stocks. However, such payouts are unlikely to become the norm, as tech companies prioritize reinvesting most of their earnings into research for the competitive AI landscape. This shift in focus could benefit less-favored sectors, particularly mid and small caps, which often boast stronger fundamentals.

China on the Move: Beijing is expected to announce new measures to help improve the country's economic situation, while it struggles to deal with a struggling currency and slow growth.

- The Politburo met on Tuesday and set a date in July 2024 for the long-delayed Third Plenum. The postponement of the meeting, originally expected in late 2023 (a year after President Xi Jinping secured an unprecedented third term), has sparked speculation about internal discussions within the party leadership regarding China's economic challenges. The focus of the July Plenum is expected to be economic reforms aimed at modernizing the country. Additionally, the Politburo indicated a willingness to support the struggling economy through measures such as bolstering the property market and potentially reducing interest rates.
- China's rising yuan (CNY) is raising concerns about export competitiveness. While the yuan is loosely pegged to the dollar, it has appreciated against other Asian currencies — 6% against the Japanese yen (JPY) and nearly 3% against the Korean won (KRW) — sparking speculation of a devaluation. Although a weaker yuan might boost exports, it could also trigger capital flight, similar to what happened after the 2015 devaluation. This could harm financial assets and erode investor confidence. Despite these drawbacks, the People's Bank of China's ongoing warnings against speculators suggest currency intervention remains a possibility.



- The delay of China's Third Plenum sparks questions, but it could also indicate that the government believes there is a modestly improved economic situation when compared to a few months ago. The lead-up to the meeting may buoy Chinese stock markets as the government highlights the country's growth prospects. While a currency devaluation is a lingering concern, it's unlikely unless China faces significant economic pressure.

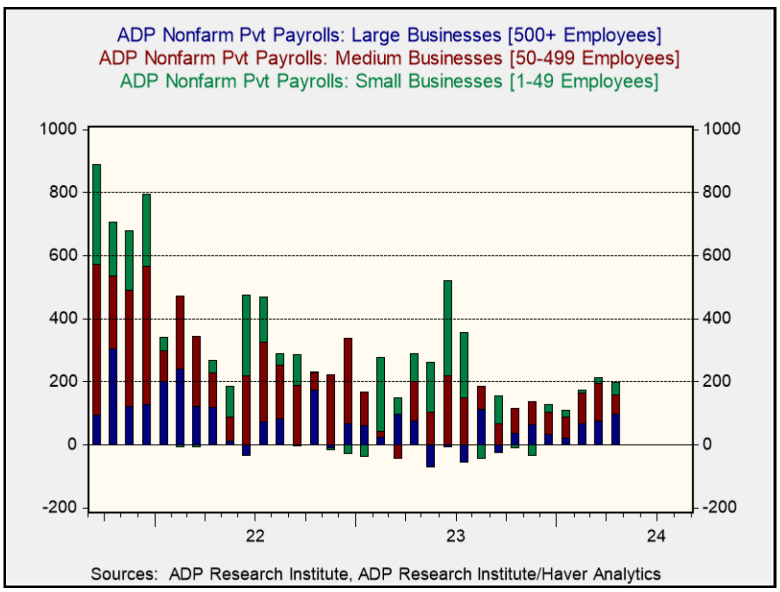
However, despite tentative signs of progress, investors should remain cautious due to persistent geopolitical and regulatory risks.

In Other News: The Department of Justice's plan to reclassify marijuana as a less dangerous drug has led to a surge in the WEED ETF. The US Senate passed legislation banning the import of enriched uranium from Russia in another sign that the ties between the country remain severed.

US Economic Releases

Home loan demand dipped last week as rising interest rates continue to sideline potential buyers. According to the Mortgage Bankers Association (MBA), mortgage application approvals fell to 2.6% in the week ending April 26. This decline coincided with an increase in the average 30-year fixed-rate mortgage, which rose 5 basis points to 7.29%. As a result, the MBA's purchase and refinance indexes fell 1.7% and 3.3%, respectively.

Private sector data shows job growth has slowed but remains positive. According to ADP, payrolls for the private sector increased by 192,000 in April, down slightly from the prior month's gain of 208,000 but exceeding expectations of 183,000.



The chart above shows the number of jobs by firm size. Large firms led hiring last month, adding 98,000 workers. Medium-sized firms followed with 62,000 new hires, and small firms brought on 38,000 workers.

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 Manufacturing PMI	m/m	Apr F	49.9	49.9	***
10:00	Construction Spending MoM	m/m	Mar	0.30%	-0.30%	**
10:00	JOLTS Job Openings	m/m	Mar	8680k	8756k	**
10:00	ISM Manufacturing	m/m	Apr	50.0	50.3	**
10:00	ISM Prices Paid	m/m	Apr	55.4	55.8	**
10:00	ISM New Orders	m/m	Apr	51	51.4	*
10:00	ISM Employment	m/m	Apr	48.2	47.4	*
14:00	FOMC Rate Decision (Lower Bound)	w/w	1-May	5.25%	5.25%	***
14:00	FOMC Rate Decision (Upper Bound)	w/w	1-May	5.50%	5.50%	***
14:00	Interest on Reserve Balances Rate	w/w	2-May	5.40%	5.40%	**
	Wards Domestic Vehicle Sales	m/m	Apr	15.70m	15.49m	*
Federal Reserve						
EST	Speaker or Event	District or Position				
14:00	FOMC Ends Two-Day Meeting	Federal Reserve Board				
14:30	Fed Chair Jerome Powell Holds Post-Meeting Press Conference	Chairman 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	Jibun Bank Manufacturing PMI	m/m	Apr F	49.6	49.9		***	Equity and bond neutral
New Zealand	Employment Change YoY	y/y	1Q	1.20%	2.70%	1.60%	***	Equity and bond neutral
	Unemployment Rate	y/y	1Q	4.30%	4.00%	4.20%	**	Equity and bond neutral
	Participation Rate	y/y	1Q	71.50%	71.90%	71.90%	*	Equity and bond neutral
South Korea	Trade Balance	m/m	Apr	$1500m	$4291m	$1000m	*	Equity and bond neutral
	Exports	y/y	Apr	13.8%	3.1%	15.0%	***	Equity and bond neutral
	Imports	y/y	Apr	5.4%	-12.3%	6.8%	**	Equity and bond neutral
EUROPE								
UK	Nationwide House Price Index	y/y	Apr	0.6%	1.6%	1.2%	***	Equity bullish, bond bearish
	S&P Global UK Manufacturing PMI	m/m	Apr F	49.1	48.7	48.7	***	Equity and bond neutral
AMERICAS								
Canada	GDP	y/y	Feb	0.8%	0.9%	1.1%	**	Equity and bond neutral
Mexico	International Reserves Weekly	w/w	26-Apr	$217248m	$217261m		*	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)	559	559	0	Up
3-mo T-bill yield (bps)	525	524	1	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 (%)	4.68	4.68	0.00	Up
Euribor/OIS spread (bps)	383	384	-1	Down
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Flat			Down
Yen	Flat			Down
Pound	Flat			Down
Franc	Flat			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.

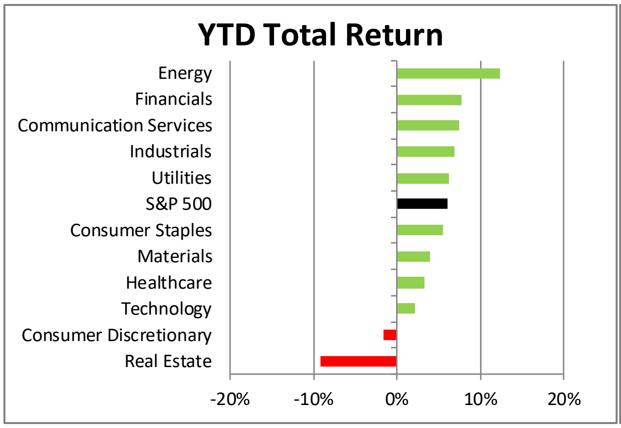
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$85.09	$86.33	-1.44%	
WTI	$80.60	$81.93	-1.62%	
Natural Gas	$1.93	$1.99	-3.01%	
12-mo strip crack	$23.97	$24.07	-0.43%	
Ethanol rack	$1.84	$1.84	-0.16%	
Metals				
Gold	$2,294.73	$2,286.25	0.37%	
Silver	$26.47	$26.29	0.66%	
Copper contract	$453.10	$456.45	-0.73%	
Grains				
Corn contract	$445.00	$446.75	-0.39%	
Wheat contract	$604.25	$603.25	0.17%	
Soybeans contract	$1,157.25	$1,163.00	-0.49%	
Shipping				
Baltic Dry Freight	1,685	1,684	1	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.5		
Gasoline (mb)		-1.0		
Distillates (mb)		1.0		
Refinery run rates (%)		0.5%		
Natural gas (bcf)		67		

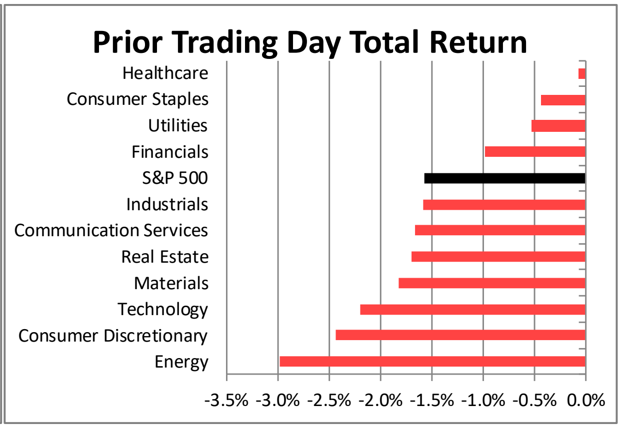
Weather

The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures southeast of a line stretching from Texas to Maine, with cooler-than-normal temperatures expected in the Rocky Mountains. The current precipitation forecast predicts wetter-than-average conditions across the northern half of the country, with dry conditions expected in New Mexico and Florida.

Data Section

US Equity Markets – (as of 4/30/2024 close)

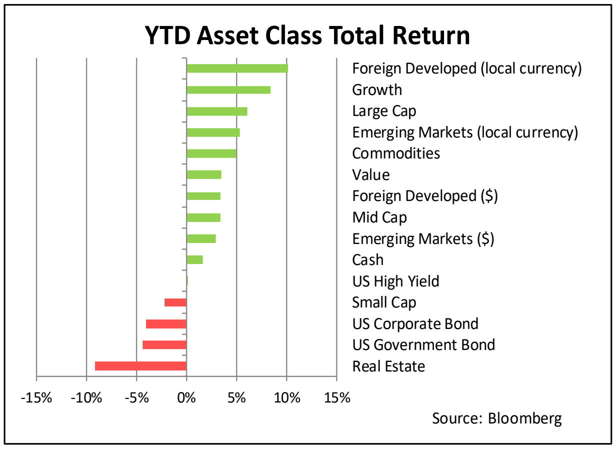




(Source: Bloomberg)

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 4/30/2024 close)

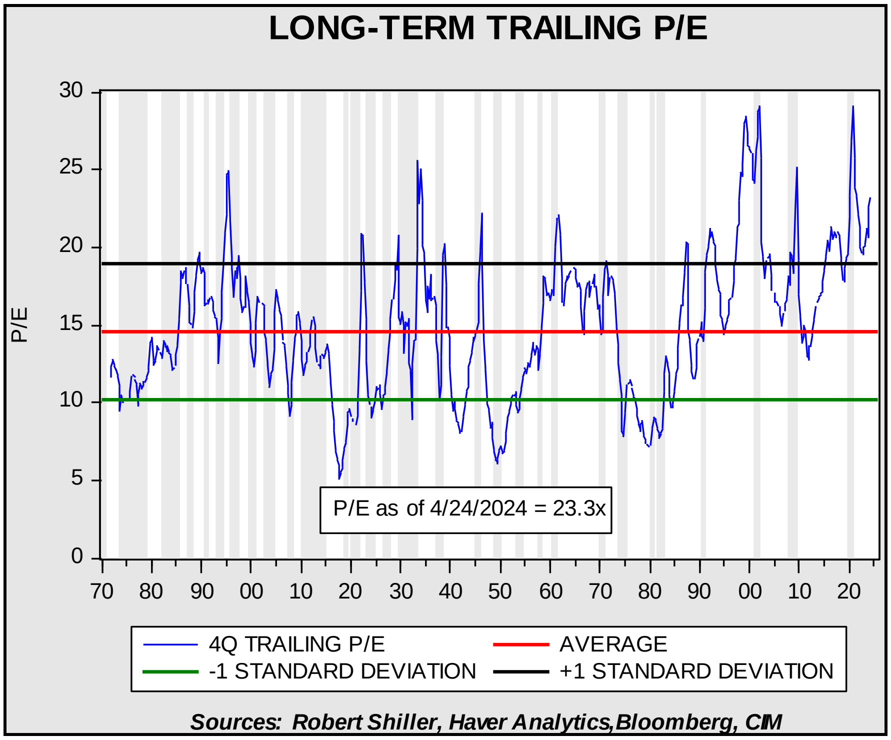


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

April 25, 2024



Based on our methodology,[1] the current P/E is 23.2x, up 0.2x from our last report. The decrease in the multiple reflects a slight increase in earnings and a decline in the stock price index.

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.