Confluence INVESTMENT MANAGEMENT

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: May 2, 2024—9:30 AM EDT] 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 0.9%. Chinese markets were closed for Labor Day. US equity index futures are signaling a higher open.

With 338 companies having reported so far, S&P 500 earnings for Q1 are running at $55.80 per share compared to estimates of $54.24, which is up 0.9% from Q1 2023. Of the companies that have reported thus far, 79.0% have exceeded expectations, while 17.5% have fallen short of expectations.

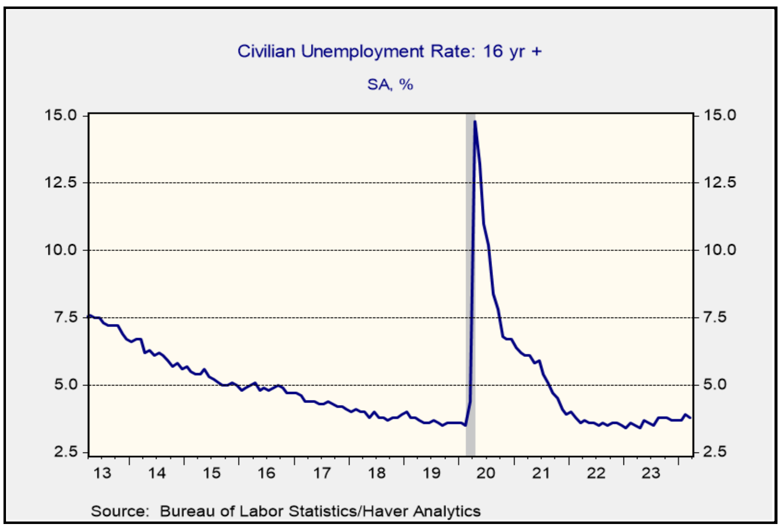
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *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) (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"
- *Keller Quarterly* (4/18/24)

Good morning! Equity futures are up today as investors embrace a less hawkish Fed. In sports news, Borussia Dortmund edged out PSG with a narrow 1-0 aggregate lead in the Champions League. In today's *Comment*, we delve into the FOMC's decision to keep rate cuts on the table, examine the disappointing trend in economic data, and discuss the impact of a possible security pact between the US and Saudi Arabia. As usual, our report concludes with a round-up of international and domestic data releases.

Less Hawkish: The Federal Reserve failed to deliver the hawkish shift markets had feared in a sign that rate cuts are likely to remain on the table for the foreseeable future.

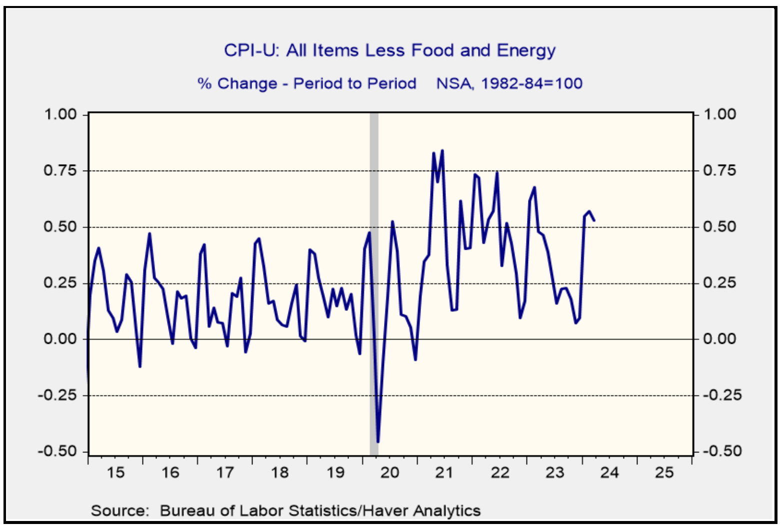
- The Federal Open Market Committee (FOMC) decided to maintain the target range for its federal funds rate at 5.25% to 5.5%. In a separate move, the FOMC announced it will slow the pace of its securities holdings runoff with a reduction in its monthly redemption cap on Treasury securities, decreasing from $60 billion to $25 billion beginning in June. At the press conference, Fed Chair Jerome Powell downplayed the prospect of an immediate rate hike aimed at further curbing inflation. However, he emphasized policymakers' heightened focus on labor market developments, suggesting their preparedness to cut rates if unemployment were to deteriorate substantially.
- Markets seem to be taking comfort in Chair Powell's cautious approach to interest rates, effectively dodging the scenario of a renewed tightening cycle. Before the decision, anxieties were mounting over whether persistent inflation would force the Fed's hand back to rate hikes in order to fully extinguish inflationary pressures. The slowdown in balance sheet reduction further underscores the committee's preference for a pause in tightening rather than new restrictions. The Fed's dovish tone has sparked investor optimism, leading to revised rate cut expectations of two reductions starting in September. We would caution, however, that this optimism may be short-lived.



- Powell's comments suggesting a dovish stance might not represent the entire committee's view, echoing a pattern from previous meetings. Notably, he sidestepped a question on whether further rate hikes were discussed if inflation worsens. This underscores the importance of studying the Fed's speeches for clues on committee sentiment before the FOMC minutes are released. That said, Powell did reiterate that the committee is ready to act if the labor market cools unexpectedly. Consequently, a payroll figure below 125,000 and an unemployment rate exceeding 4.2%, while unlikely, could keep rate cuts on the table despite high inflation.

Negative Economic Surprises: Despite headlines touting strong economic data, a recent disappointing string of data points indicates that momentum may be shifting in the wrong direction.

- Disappointing economic data emerged on Wednesday, raising concerns about a potential slowdown. Job openings reported by the BLS JOLTS survey plummeted to a three-year low in March. The decline was particularly notable in construction, which also coincided with an unexpected drop in spending for the sector in the same month. The weakness in construction activity may signal that companies are potentially facing margin pressure due to rising costs. The ISM price index surged to its highest level since June 2022, highlighting ongoing inflationary pressures despite the weakness in the manufacturing sector overall, suggesting that firms might be trying to force costs onto consumers.
- Wednesday was hardly an anomaly. Consumer confidence, as measured by the Conference Board's index, plummeted from 103.1 to 97.0 in April, defying expectations of a rise to 104.0. This unexpected decline was primarily driven by a steep drop in consumer expectations, the steepest in nearly two years. Further fueling concerns is a broader trend of emerging economic weakness. Citigroup's Economic Surprise Index has been on a downward trajectory since February, dropping from a peak of 44.1 to 15.1. While it hasn't dipped below zero yet, the sharp decline indicates a potential slowdown on the horizon.

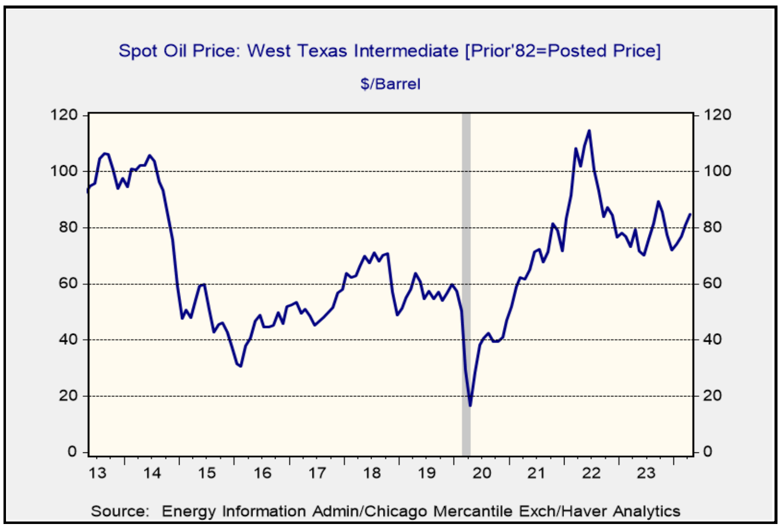


- Despite signs of a strong economy, recent data weaknesses suggest the expansion might be more fragile than previously thought. A key question remains, one that has not yet been fully addressed by the markets, regarding consumer tolerance for ongoing price increases. While businesses initially attempted to pass on these costs in early 2023, a closer look at non-seasonal data reveals they weren't able to sustain this pace throughout the year, leading to a slowdown in price hikes, particularly in the summer months. If this trend persists, as the recent data suggests, companies may be forced to address cost pressures through workforce adjustments.

Saudi Defense Pact: The US and Saudi Arabia are nearing a security guarantee agreement, potentially opening the door to normalized relations between Saudi Arabia and Israel.

- The proposed security agreement builds on discussions held before the October 7 Hamas attack on Israel. It could grant Saudi Arabia access to offensive weapons after a three-year freeze, allowing it to replenish missile stocks and potentially pursue uranium enrichment. Additionally, Riyadh would limit its purchases of Chinese technology in its key network exchange for US investment in Artificial Intelligence (AI). However, a major hurdle remains — the deal hinges on an Israeli withdrawal from Gaza and commitment to a Palestinian state, a difficult condition for Israel to accept after the recent conflict.

- The proposed US-Saudi defense agreement could reshape the security balance of the Middle East, but it faces hurdles from both Israel and the US Senate. The Biden administration hopes economic incentives and a security guarantee will win over Israel, while assuring senators that Saudi Arabia won't misuse weapons nor manipulate its oil production to harm US interests. However, navigating these challenges is difficult, especially given Israel's strengthened right wing and waning trust in US security commitments. The deal's prospects seem slim, but a potential path forward might still exist.

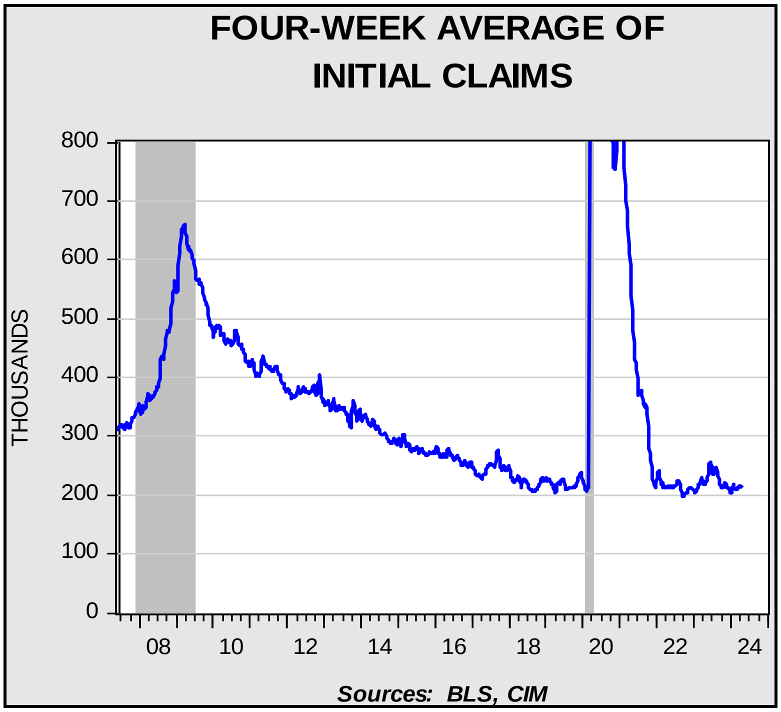


- The ability to provide a counterweight to Iran in the Middle East may play a significant factor in garnering support from all parties. There is strong suspicion that Iran provided some level of support to Hamas during its conflict with Israel. Additionally, Iran's actions since the conflict began have increased the likelihood of a broader military conflict in the region. The prospect of Iranian deterrence could incentivize Israeli Prime Minister Benjamin Netanyahu to engage in negotiations. However, a lasting agreement might necessitate strategic ambiguity from all parties regarding the Palestinian state issue, allowing for concessions without jeopardizing domestic support.

In Other News: The US is considering refilling its strategic reserves in a sign that oil prices may receive some support in the coming days. Strong speculation surrounds Japan's potential intervention in the foreign exchange market to bolster the yen. This raises the possibility of the Bank of Japan tightening monetary policy to defend its currency.

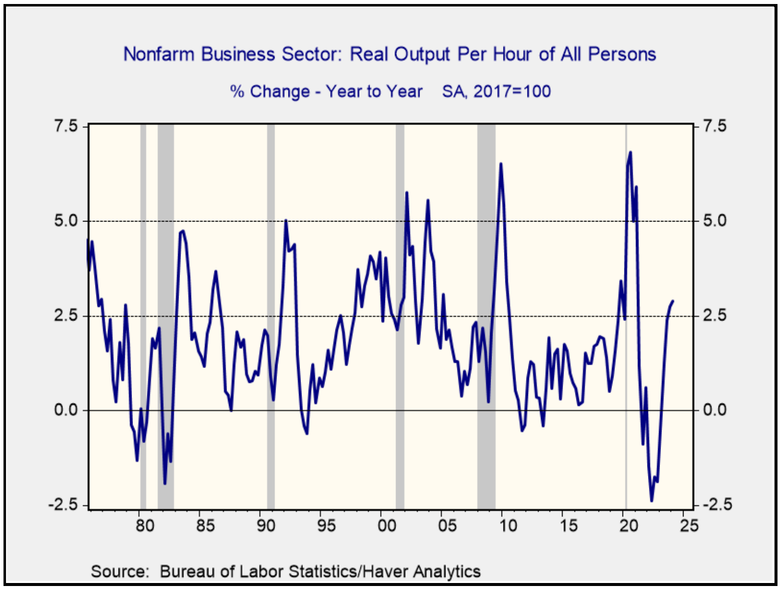
US Economic Releases

In the week ended April 27, ***initial claims for unemployment benefits*** held steady at a seasonally adjusted 208,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to 210,000. Meanwhile, in the week ended April 27, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) also held steady at 1.774 million. The chart below shows how initial jobless claims have fluctuated since just before the global Financial Crisis.

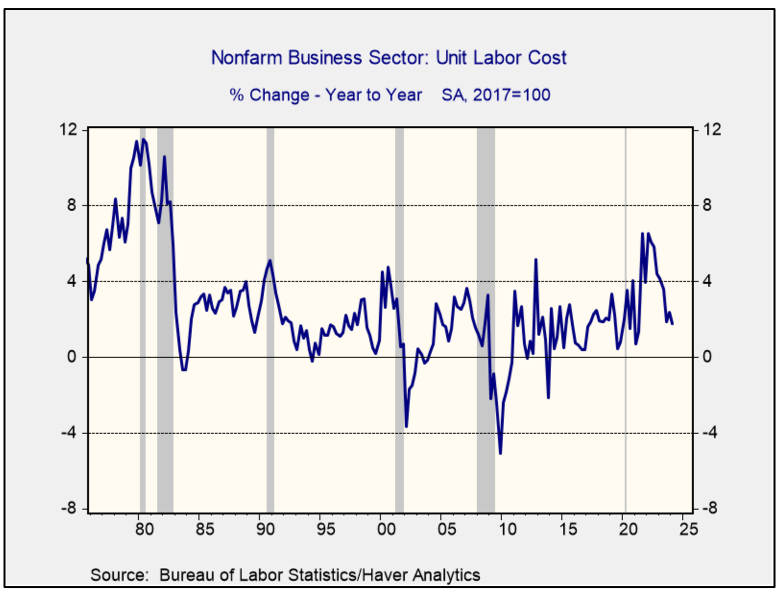


In a separate report today, the March ***trade balance*** showed a seasonally adjusted deficit of $69.4 billion, essentially the same as the $69.5 billion total for February. According to the data, total ***exports*** fell 2.02%, while ***imports*** fell 1.62%. Compared with the same month one year earlier, exports in March fell 0.03%, while imports rose 3.06%. The chart below shows the monthly value of US exports and imports since just before the previous recession.

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, first-quarter ***nonfarm productivity*** rose at an annualized rate of 0.3%. Taking into account the fluctuations in each of the last four quarters, productivity in the first quarter was up 2.9% from the same period one year earlier. The chart below shows the year-over-year growth in real productivity.



First-quarter ***unit labor costs*** rose at an annualized rate of 4.7%. Unit labor costs in the first quarter were up 1.79% year-over-year. The chart below shows the year-over-year growth in unit labor costs since 1996.



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
10:00	Factory Orders	m/m	Mar	1.6	1.4	***
10:00	Factory Orders Ex Transportation	m/m	Mar	0.2%	1.1%	**
10:00	Durable Goods Orders	m/m	Mar F	2.6%	2.6%	***
10:00	Durables Ex Transportation	m/m	Mar F	0.5%	0.2%	**
10:00	Cap Goods Orders Nondef Ex Air	m/m	Mar F		0.2%	*
10:00	Cap Goods Ship Nondef Ex Air	m/m	Mar F		0.2%	*
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	Monetary Base	y/y	Apr	2.1%	1.6%		*	Equity and bond neutral
	Consumer Confidence Index	m/m	Apr	38.3	39.5	39.8	*	Equity and bond neutral
Australia	Building Approvals	m/m	Mar	1.9%	-0.9%	3.4%	***	Equity bearish, bond bullish
	Trade Balance	m/m	Mar	A$5024m	A$6591m	A$7300m	***	Equity and bond neutral
	Exports	m/m	Mar	0.1%	-3.2%		*	Equity and bond neutral
New Zealand	Building Permits	m/m	Mar	-0.2%	15.9%		**	Equity and bond neutral
South Korea	CPI	y/y	Apr	2.9%	3.1%	3.0%	***	Equity and bond neutral
	S&P Global Global Manufacturing PMI	m/m	Apr	49.4	49.8		***	Equity and bond neutral
India	HSBC India PMI Mfg	m/m	Apr F	58.8	59.1		***	Equity and bond neutral
EUROPE								
Eurozone	HCOB Eurozone Manufacturing PMI	m/m	Apr F	45.7	45.6	45.6	***	Equity and bond neutral
Germany	HCOB Germany Manufacturing PMI	m/m	Apr F	42.5	42.2	42.2	***	Equity and bond neutral
France	HCOB France Manufacturing PMI	m/m	Apr F	45.3	44.9	44.9	***	Equity bullish, bond bearish
Italy	HCOB Italy Manufacturing PMI	m/m	Apr	47.3	50.4	50.4	***	Equity bearish, bond bullish
	PPI	y/y	Mar	-12.7%	-14.2%		*	Equity and bond neutral
Switzerland	CPI	y/y	Apr	1.4%	1.0%	1.1%	***	Equity and bond neutral
	Core CPI	y/y	Apr	1.2%	1.0%	0.9%	*	Equity and bond neutral
	Real Retail Sales	y/y	Mar	-0.1%	0.2%		**	Equity and bond neutral
	Manufacturing PMI	m/m	Apr	41.4	45.2	45.5	***	Equity bearish, bond bullish
	Services PMI	m/m	Apr	55.6	47.6		***	Equity and bond neutral
Russia	S&P Global Manufacturing PMI	m/m	Apr	54.3	55.7	54.6	***	Equity and bond neutral
AMERICAS								
Canada	S&P Global Manufacturing PMI	m/m	Apr	49.4	49.8		***	Equity and bond neutral
Brazil	Foreign Direct Investment	m/m	Mar	$9591m	$5012m	$6850m	**	Equity and bond neutral
Brazil	Current Account Balance	m/m	Mar	-$4579m	-$4513m	-$3050m	***	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)	524	526	-2	Up
U.S. Sibor/OIS spread (bps)	533	534	-1	Up
U.S. Libor/OIS spread (bps)	535	535	0	Up
10-yr T-note (%)	4.60	4.63	-0.03	Down
Euribor/OIS spread (bps)	383	384	-1	Down
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Down			Down
Yen	Down			Down
Pound	Down			Down
Franc	Up			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
FOMC Rate Decision (Lower Bound)	5.250%	5.250%	5.250%	On Forecast
FOMC Rate Decision (Upper Bound)	5.500%	5.500%	5.500%	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.

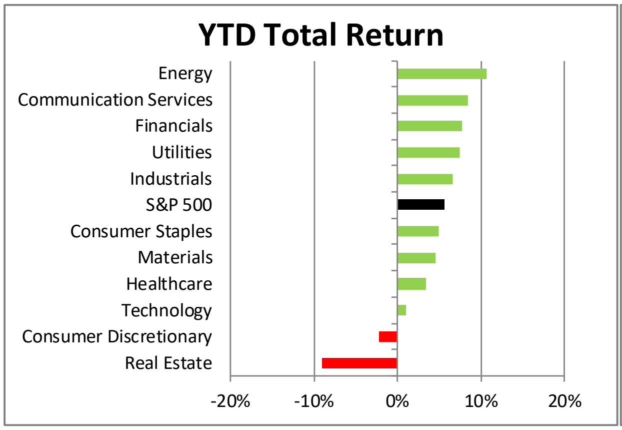
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$84.21	$83.44	0.92%	
WTI	$79.64	$79.00	0.81%	
Natural Gas	$1.97	$1.93	1.97%	
12-mo strip crack	$23.18	$23.07	0.49%	
Ethanol rack	$1.84	$1.84	-0.16%	
Metals				
Gold	$2,298.93	$2,319.56	-0.89%	
Silver	$26.27	$26.65	-1.42%	
Copper contract	$448.15	$454.60	-1.42%	
Grains				
Corn contract	$455.75	$450.75	1.11%	
Wheat contract	$608.75	$599.25	1.59%	
Soybeans contract	$1,182.50	$1,170.25	1.05%	
Shipping				
Baltic Dry Freight	1,688	1,685	3	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	7.3	-2.5	9.8	
Gasoline (mb)	0.3	-1.0	1.4	
Distillates (mb)	-0.7	1.0	-1.73	
Refinery run rates (%)	-1.0%	0.5%	-1.5%	
Natural gas (bcf)		58		

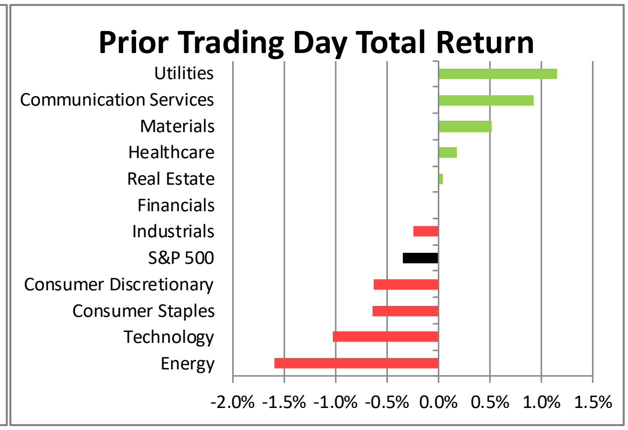
Weather

The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures southeast of a line from Texas to New Jersey, 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 Southern Florida.

Data Section

US Equity Markets – (as of 5/1/2024 close)

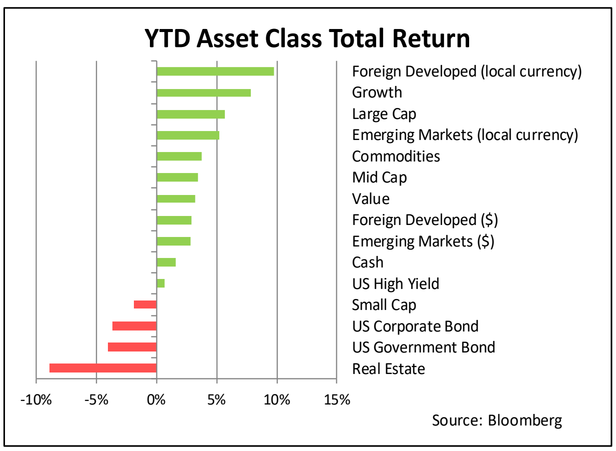




(Source: Bloomberg)

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 5/1/2024 close)

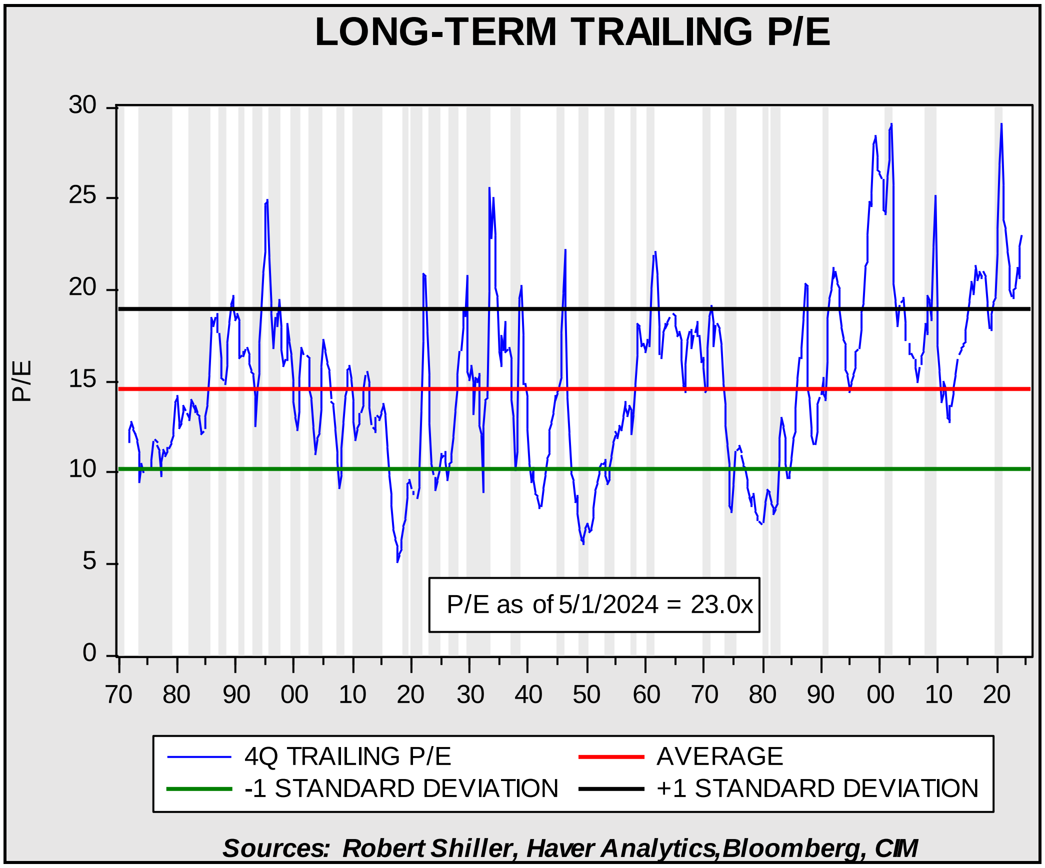


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 2, 2024



Based on our methodology,[1] the current P/E is 23.0x, down 0.2x from our last report. The decrease in the multiple reflects a decline in the S&P 500 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.