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 9, 2024—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is down 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 was essentially unchanged. Chinese markets were higher, with the Shanghai Composite up 0.8% from its previous close and the Shenzhen Composite up 1.3%. US equity index futures are signaling a lower open.

With 448 companies having reported so far, S&P 500 earnings for Q1 are running at $56.20 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 17.0% 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:

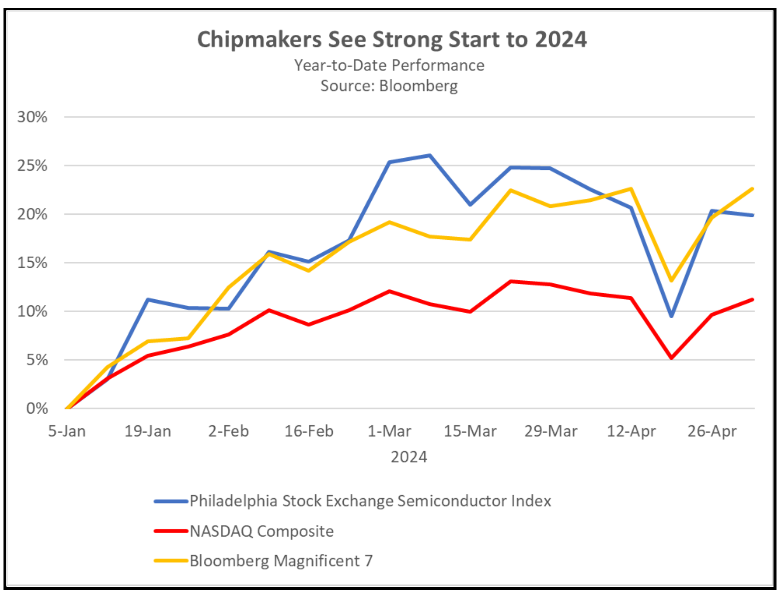
- *Bi-Weekly Geopolitical Report* (5/6/2024) (with associated podcast): "Middle East: Land of Fault Lines"
- *Asset Allocation Quarterly – Q2 2024* (4/25/2024): Discussion of our asset allocation process, Q2 2024 portfolio changes, and our outlook for the markets.
- *Asset Allocation Q2 2024 Rebalance 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* (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* (5/8/2024) "Reviewing the Asset Allocation Rebalance: Q2 2024"**

Good morning! Equities are trading lower following a weaker-than-expected bond auction on Wednesday. However, in a thrilling turn of events, Real Madrid secured a comeback victory against Bayern Munich, booking their spot in the Championship Final against Borussia Dortmund. Today's *Comment* explores how the earnings outlook from Intel reflects the US-China rivalry's impact on tech companies. We'll also examine why the Federal Reserve might hold off on further interest rate hikes and how Germany is working to lessen its dependence on

China. As usual, the report concludes with a wrap-up of international and domestic data releases.

Rubber Meets Road: Intel's earnings outlook offers a real-world example of how the shifting geopolitical landscape can harm corporate profits.

- Semiconductor giant Intel exceeded first-quarter earnings expectations but cautioned about a revenue dip due to a new US ban on chip exports to China. While Intel is maintaining its revenue forecast within its $12.5 billion to $13.5 billion range, it anticipates falling short of the midpoint. This revised outlook follows the US Commerce Department's decision to revoke the licensing rights of Huawei Technologies to purchase semiconductors from both Intel and Qualcomm. The announcement triggered stock price declines for both companies. However, Qualcomm later clarified that its business with Huawei was already limited and will likely cease entirely.
- The weak outlook comes as the US tightens the screws on China's chip access. In 2022, the Biden administration, along with allies like Japan and Europe, limited chip sales to certain Chinese companies to prevent their use in military weapons. These efforts proved inadequate, though, as Chinese firms continued to improve the quality of their semiconductors. Last month, US lawmakers were angered that Huawei's new AI laptops were powered by American-made Intel chips, leading to calls for more chip restrictions. This episode highlights the tightrope that tech companies must walk as they are caught between escalating geopolitical tensions and government policy shifts.

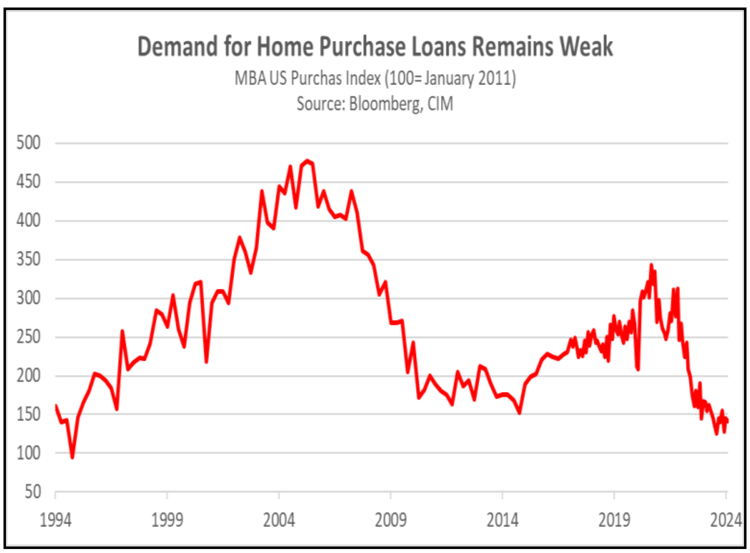


- Despite their strong start this year, semiconductor companies face potential headwinds from rising US-China tensions. This is because tech companies, as measured by the Invesco QQQ ETF, have a greater exposure to China than the broader S&P 500 index. However, there are safer alternatives to large cap tech companies. Midcap companies, with their focus on the US domestic market and strong financials, might offer a hedge against those risks due to their lower exposure to trade disputes.

Restrictive Enough: As the Consumer Price Index continues to disappoint, central bankers are increasingly concerned about whether monetary policy is sufficiently tight.

- Minneapolis Fed President Neel Kashkari weighed in on the current state of monetary policy in a Wednesday note. While acknowledging current policy is stricter than it was prior to the pandemic, Kashkari pointed to a robust housing market as evidence that more action might be necessary to get inflation back to its 2% target. This aligns with recent comments from Fed Governor Michelle Bowman. Over the weekend, she expressed concern that rising immigration might be putting upward pressure on shelter price inflation, as supply struggles to keep pace with demand.

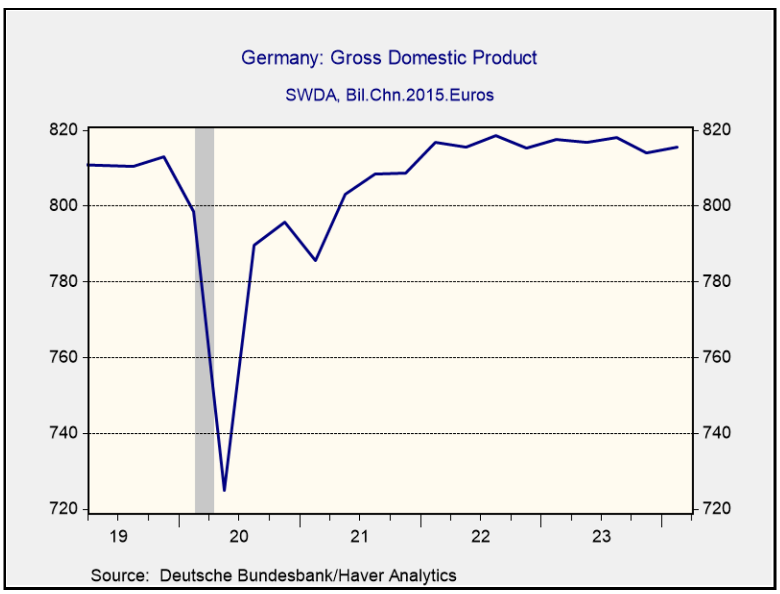
- Anxiety about tightening credit conditions is emerging despite a seemingly easier residential mortgage market. The latest Senior Loan Officer Opinion Survey (SLOOS) shows banks are indeed tightening lending standards for commercial real estate and consumer loans. However, for residential mortgages (excluding subprime), the survey indicates a slight easing in the previous quarter. This divergence suggests the Fed's policy may not be having a consistent impact across all loan sectors. It's important to note, though, that despite this easing of financial conditions, demand for home purchase loans remains well below pre-pandemic levels.



- The Federal Open Market Committee (FOMC) minutes, due to be released in two weeks, could provide key insights into the ongoing debate regarding the Fed's monetary policy stance. During the press conference following the recent decision to hold rates steady, Fed Chair Powell remained tight-lipped when questioned about the possibility of another hike. The minutes from this past meeting may reveal whether any committee members advocated for a rate increase. This, if confirmed, could significantly alter interest rate expectations, especially if the upcoming April CPI data continues the trend of high inflation as seen in the past three months.

Berlin's Shift: Germany aims to build a closer relationship with the US as it increasingly views China as a threat to its interests.

- Germany's trade winds have shifted dramatically. The US has surpassed China as Germany's top import partner for goods and services in the first quarter of 2024, ending China's eight-year reign at the top. This change reflects China's sluggish economic growth, but also likely stems from Germany's growing reservations about its reliance on Chinese imports. German businesses are facing a mounting challenge in China. Soaring compliance costs, coupled with Beijing's policies that favor domestic companies, are creating a difficult operating environment. While German Chancellor Olaf Scholz has tried to assuage these concerns, there have been few signs of success or improvement.
- In 2023, Germany formally designated China as a "partner, competitor, and systemic rival," reflecting a strategic shift meant to reduce its dependence on the Asian nation. This attitude change comes as Germany has expressed concern that Beijing may look to resolve its overcapacity problem by dumping its excess goods into Europe. Furthermore, Germans have become sharply critical of China's backing of Russia. Last week, a cyberattack, which breached emails of the Social Democratic Party, was linked to Russia. Additionally, allegations surfaced that China and Russia may have offered financial incentives to a German lawmaker in order to influence policy in their favor.

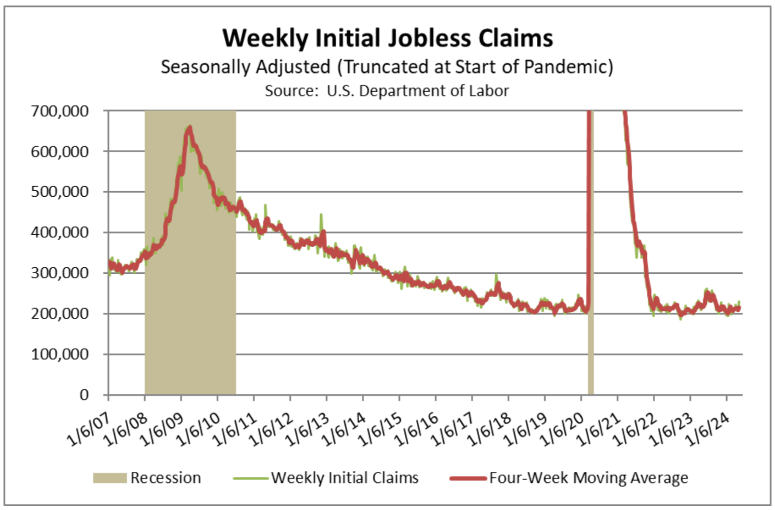


- Germany's economic slowdown has been heavily influenced by its exposure to China, and this fact could play a major role in its shift towards the US. A change could offer long-term advantages for German companies. A potential turn inward by China might prioritize domestic firms at foreigners' expense. At the same time, the US, with its strong dollar and commitment to open markets, could favor allies like Germany. However, the transition will likely be slow. German firms, especially carmakers with deep ties to China, will likely lobby their government to manage the deteriorating relationship and mitigate potential disruptions.

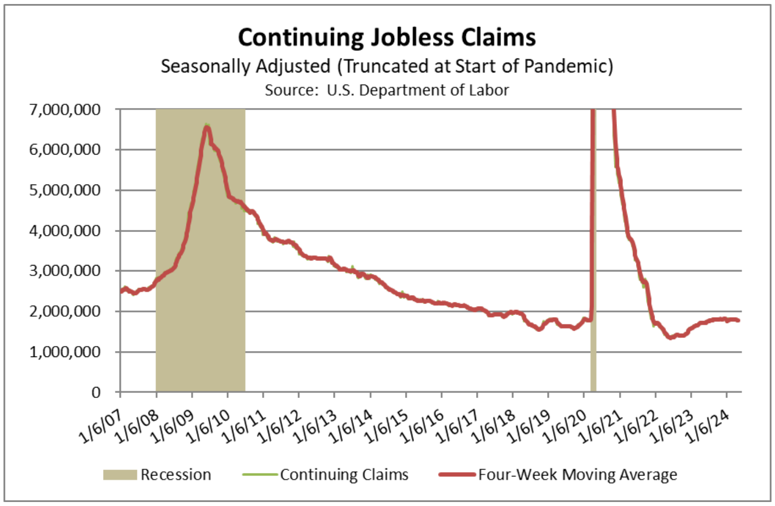
In Other News: The Bank of England signaled a potential rate cut in June following its policy meeting. This could be a sign that it believes inflation is under control and will likely lead to further weakness in the pound (GBP). Separately, President Joe Biden warned Israel that the US would halt arms sales if it invades Rafah, in a sign of growing friction between his administration and Israel. Political tensions are also on the rise in Germany, with a recent attack on a former German mayor.

US Economic Releases

In the week ended May 4, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 231,000, much higher than the expected level of 212,000 and the previous week's revised level of 209,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to a three-month high of 215,000. The chart below shows how initial jobless claims have fluctuated since just before the Great Financial Crisis. The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



In the week ended April 27, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to a seasonally adjusted 1.785 million, modestly above the anticipated reading of 1.782 million and the prior week's revised reading of 1.768 million. The four-week moving average of continuing claims fell to 1.781 million. The chart below shows how continuing claims have fluctuated since the GFC. It is also truncated during the pandemic period because of the high level of claims at the time.



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

Economic Releases		
No economic releases for the rest of today		
Federal Reserve		
EST	**Speaker or Event**	**District or Position**
14:00	Mary Daly Participates in Fireside Chat	President of the Federal Reserve Bank of San Francisco

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	Mar	0.6	1.4	1.4	**	Equity and bond neutral
	Leading Economic Index	m/m	Mar P	111.4	112.1	111.2	**	Equity and bond neutral
	Coincident Index	m/m	Mar P	113.9	111.5	114.0	*	Equity and bond neutral
South Korea	BoP Current Account Balance	m/m	Mar	$6931.4	$6858.3m		**	Equity and bond neutral
	BoP Goods Balance	m/m	Mar	$8092.6	$6607.9m		*	Equity and bond neutral
China	Exports	y/y	Apr	1.5%	-7.5%	1.3%	**	Equity bullish, bond bearish
	Imports	y/y	Apr	8.4%	-1.9%	4.7%	**	Equity bullish, bond bearish
	Trade Balance	m/m	Apr	$72.35b	$58.55b	$81.00b	***	Equity and bond neutral
EUROPE								
UK	RICS House Price Balance	m/m	Apr	-5%	-5%	-2%	**	Equity bullish, bond bearish
Russia	Official Reserve Assets	m/m	Apr	597.9b	590.4b		*	Equity and bond neutral
AMERICAS								
Mexico	CPI	y/y	Apr	4.65%	4.42%	4.63%	***	Equity and bond neutral
	Core CPI	y/y	Apr	4.37%	4.55%	4.39%	**	Equity and bond neutral
Brazil	Trade Balance	m/m	Apr	$9041m	$7228m	$9400m	**	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)	558	559	-1	Up
3-mo T-bill yield (bps)	523	525	-2	Up
U.S. Sibor/OIS spread (bps)	532	533	-1	Up
U.S. Libor/OIS spread (bps)	534	534	0	Up
10-yr T-note (%)	4.51	4.49	0.02	Down
Euribor/OIS spread (bps)	381	379	2	Down
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Down
Yen	Down			Down
Pound	Down			Down
Franc	Down			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of England Bank Rate	5.250%	5.250%	5.250%	On Forecast
Brazil Selic Rate	10.500%	10.750%	10.500%	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.

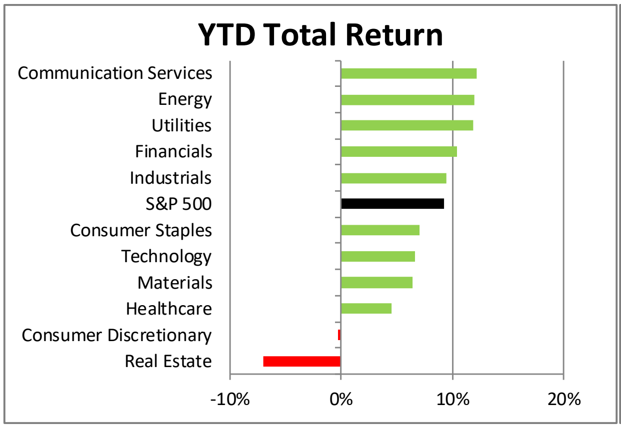
DOE Inventory Report	Price	Prior	Change	Explanation
Energy Markets				
Brent	$84.15	$83.58	0.68%	
WTI	$79.56	$78.99	0.72%	
Natural Gas	$2.16	$2.19	-1.10%	
12-mo strip crack	$23.15	$22.94	0.93%	
Ethanol rack	$1.91	$1.90	0.54%	
Metals				
Gold	$2,315.90	$2,308.85	0.31%	
Silver	$27.72	$27.33	1.41%	
Copper contract	$453.00	$454.25	-0.28%	
Grains				
Corn contract	$461.25	$458.50	0.60%	
Wheat contract	$645.75	$634.00	1.85%	
Soybeans contract	$1,233.75	$1,227.75	0.49%	
Shipping				
Baltic Dry Freight	2,203	2,083	120	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-1.4	-0.4	-1.0	
Gasoline (mb)	-0.7	0.9	-1.6	
Distillates (mb)	0.6	-0.8	1.36	
Refinery run rates (%)	1.0%	1.1%	-0.1%	
Natural gas (bcf)		87		

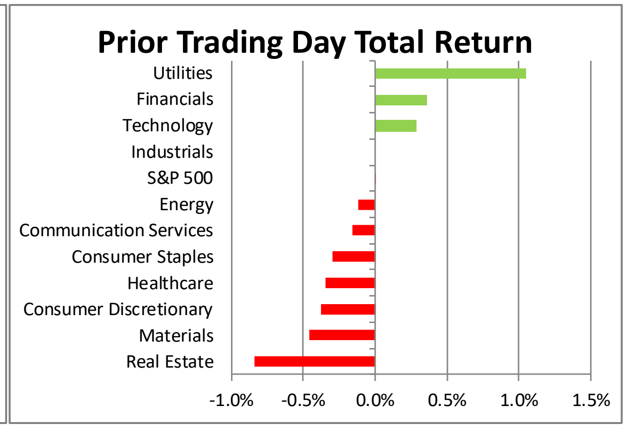
Weather

The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures throughout the entire country other than the Pacific Northwest and central Mississippi Valley regions, where temperature will be near normal. The forecasts call for wetter-than-average conditions from the Great Plains eastward, with dry conditions in the Pacific Northwest.

Data Section

US Equity Markets – (as of 5/8/2024 close)

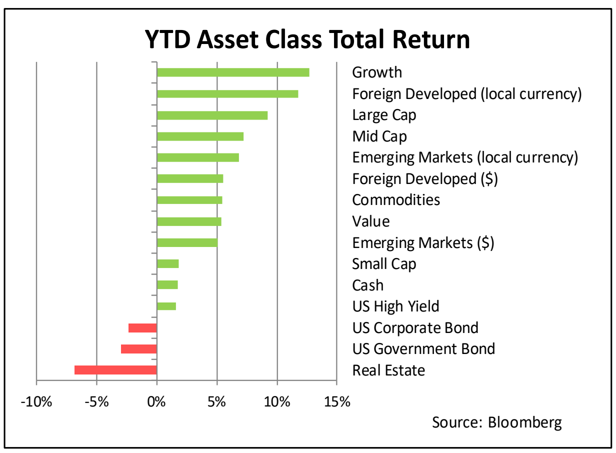




(Source: Bloomberg)

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 5/8/2024 close)

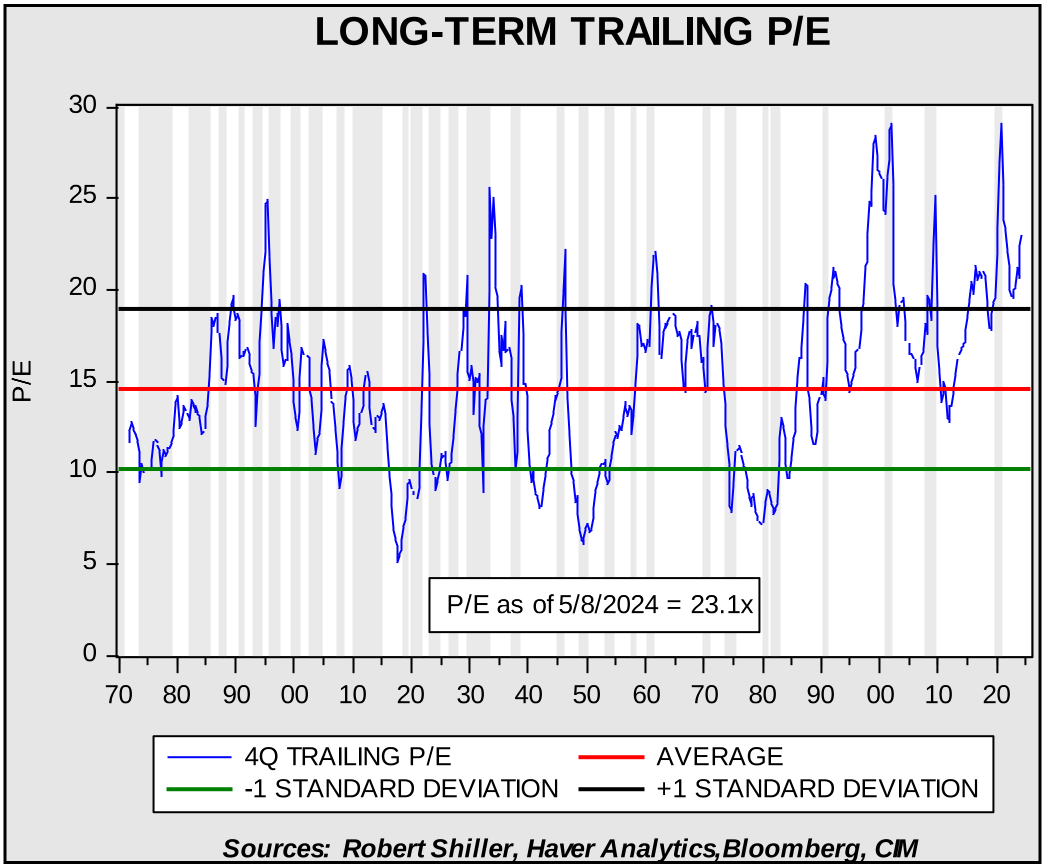


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 9, 2024



Based on our methodology,[1] the current P/E is 23.1x, up 0.1x from our last report. The increase in the multiple reflects an increase in the S&P 500 Index, outweighing 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.