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: August 4, 2022—9:30 AM EDT] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is currently up 0.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.4%. Chinese markets were higher, with the Shanghai Composite up 0.8% from its prior close and the Shenzhen Composite up 0.9%. U.S. equity index futures are signaling a higher open. With 379 companies having reported, the S&P 500 Q2 2022 earnings stand at $57.70, higher than the $55.26 forecast for the quarter. The forecast reflects a 4.3% increase from Q2 2021 earnings. Thus far this quarter, 75.2% of the companies have reported earnings above forecast, while 19.8% 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:

- *Bi-Weekly Geopolitical Report* (8/1/2022) (with associated podcast): "Political Crises for Top U.S. Allies"
- ***Weekly Energy Update (8/4/2022): We take a look at some of the potential effects of the inflation bill on energy and update our "gallons per hour" metric for gasoline***
- *Asset Allocation Quarterly – Q3 2022* (7/19/2022): Discussion of our asset allocation process, Q3 2022 portfolio changes, and our outlook for the markets
- ***Asset Allocation Q3 2022 Rebalance Presentation: Video presentation featuring the Asset Allocation Committee as they review our asset allocation strategies, recent portfolio changes, and the current macro environment***
- *Asset Allocation Bi-Weekly* (7/25/2022) (with associated podcast): "The Puzzle of the Labor Force"
- *Confluence of Ideas* podcast (3/25/2022): "The 2022 Outlook: Update #1"
- *Current Perspectives*: "2022 Outlook: Update #2 – The Tails Become Fatter" (7/12/2022)

Today's *Comment* begins with a discussion on the central banks' decision to raise rates despite slowing economic growth. Next, we examine how rising geopolitical risks make it more difficult for firms to rebuild their supply chains. We end the report with an update on the climate and drug bill.

Monetary Policy: Central banks in the U.S., U.K. and the Eurozone appear to be plowing ahead with tighter monetary policy even as their economies slow.

- Fed officials downplayed expectations that the central bank was close to ending its tightening cycle. Despite the disappointing economic data, regional Fed Presidents Neel Kashkari and Thomas Barkin dismissed speculation that the Fed was finished raising rates and warned of a possible recession. Meanwhile, St. Louis Fed President James Bullard, a voting member, insisted that the central bank must front load big rate hikes to cool inflation. Additionally, he revealed his desire for the Fed's policy rate to be between 3.75% and 4.00% by the end of the year.
- To keep pace with the Federal Reserve, the Bank of England raised its benchmark rate by 50 bps on Thursday. Although the increase is less than the Fed's 75 bps hike in July, the rate rise was the country's largest in 27 years. By increasing its policy rate, the BOE aims to prevents the pound from depreciating against the dollar and exacerbating the country's inflation problem. The BOE warned that the country is expected to fall into a recession and that inflation could rise as high as 13%.
- The European Central Bank appears to have used funds from maturing bonds in the portfolio of its pandemic program to purchase the debt of southern European economies. The data showed that the bank's net holdings of German, French, and Dutch bonds dropped by 18.9 billion euros in July. In the same month, statistics showed that the bank made 17.3 billion euros of net debt purchases from Italy, Spain, Portugal, and Greece. The central bank's intervention suggests it will also aggressively raise rates in its next meeting.
    - Fitch Ratings Agency expects that the ECB's new anti-fragmentation tool will allow the bank to raise rates while reducing debt sustainability risk. Fitch Ratings is one of the three most respected credit rating agencies. Thus, its analysis will likely help reassure investors that the ECB has a credible tool to fight fragmentation.

Strong U.S. economic growth and tight monetary policy have pushed the euro and British pound to near multi-decade lows against the dollar. The depreciation of the euro and pound have contributed to the inflation problem in their respective regions as it makes dollar-priced commodity imports more expensive. Unfortunately, neither the EU nor U.K. economies have expanded at the same rate as the U.S. since the pandemic started in 2020. As a result, they likely have less flexibility in raising rates. Although all three regions have elevated recession risks, the EU and U.K. are in a worse position than the U.S.

Geopolitical Risks: As the calls for a ceasefire in the Ukraine-Russia war become increasingly louder, conflicts in other parts of the world are becoming more noticeable, making it difficult for firms to return to pre-pandemic normalcy.

- European leaders are now pushing Ukraine to engage in ceasefire talks with Russia. On Wednesday, former German Chancellor Gerhard Schröder urged Kyiv to negotiate with Russia to end the conflict and modify its demands. Meanwhile, the Irish president and his wife stirred controversy after the first lady posted a letter on the presidential website pleading for world leaders to encourage ceasefire talks. The push by Putin's allies within Europe is evidence that the conflict may be headed toward a pause. Ukrainian President

Volodymyr Zelensky has also sought a meeting with Chinese President Xi Jinping to help negotiate an end to the contest. However, Xi has not replied to any of his requests to talk.

  - Although the possible end of the conflict is good news, it is foolhardy to assume that the relationship between Europe and Russia will return to normal. Russia's weaponization of its natural resources will mean Europe will still need to reduce its dependence on Russia significantly. Meanwhile, Russia's limited ability to deliver its natural gas to countries outside of Europe suggests it also needs to invest in building its pipeline capacity to new regions. Figuring out how to remove sanctions is another can of worms no one in the West wants to open. Although it is too early to determine whether the conflict will end soon, the path toward de-escalation is forming.
  - The U.S. and Italy has passed legislation that will allow Sweden and Finland to enter NATO.

- As the U.S. gears up for another round of nuclear talks, there is speculation that Iran might direct its proxies to attack American and partner targets in the region. Such an attack could lead to a crisis in the Middle East and push up the price of commodities like oil. Iran blames NATO for the recent unrest in Iraq. Over the weekend, protesters stormed the Iraqi parliament to demand new parliamentary elections. The rising tension between the West and Iran suggest that the Middle East remains politically unstable.
- China engaged in more military drills around the Taiwanese peninsula the day after U.S. Speaker of the House Nancy Pelosi visited the self-ruled island. In China's most immense provocation in 16 years, its military launched several missiles into Taiwanese waters. The drills are expected to continue until Sunday. However, possible escalation cannot be ruled out. China is in a difficult bind. Pelosi's visit undermines Beijing's argument that the U.S. views it as a threat. Meanwhile, U.S. politicians on both sides of the aisle are pushing for Washington to take a tougher stance against China. As a result, we believe that the risk of possible miscalculation leading to direct conflict is elevated.
  - The White House is attempting to rein in Congress after Pelosi's trip to Taiwan has encouraged politicians to flex their toughness on China's credentials going into the mid-terms. The Senate is currently working on legislation that would designate the sovereign island as a major non-NATO ally.

One of the trends that we are noticing is that the world is becoming increasingly hostile. Rising global tensions will make it difficult to repair supply chains and could accelerate U.S. firms' withdrawals from the rest of the world. This shift from relying on global supply chains in emerging markets will be expensive in the short term as firms look to adjust to this new normal.

Biden's Agenda: The U.S. Senate is expected to pass the Inflation Reduction Act. The bill aims to raise corporate taxes and may negatively impact corporate earnings.

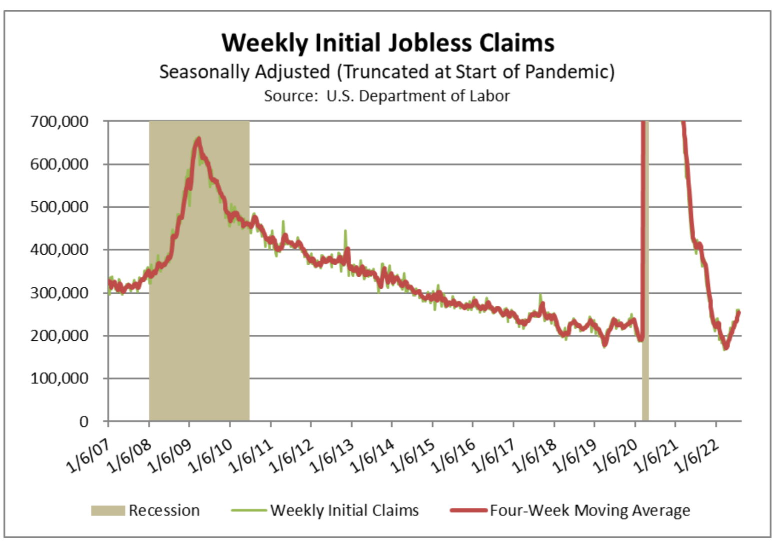
- Arizona Senator Kyrsten Sinema (D-AZ) is pushing for changes in the bill before backing it. She is a pivotal vote in getting the legislation through the Senate. She has concerns about the changes to the corporate minimum tax and has hinted at possible opposition to a carried interest tax. Additionally, she favors beefing up the amount of funding for the climate and energy portions of the bills.

- The Congressional Budget Office forecasts that [the bill will reduce the deficit by a net $101.5 billion over the next decade.] However, the CBO's estimate did not include the $204 billion tax revenue gain from the increased Internal Revenue Service enforcement. The analysis is key to getting the bill passed as Democrats are trying to make themselves look more fiscally responsible after the initial stimulus package contributed to a surge in inflation.

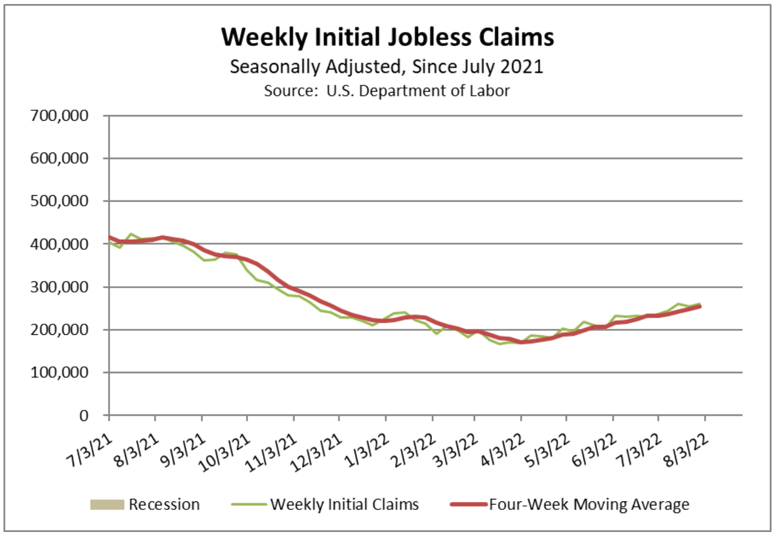
The new bill from the Democrats is austerity disguised as fiscal stimulus. The trend of reducing the government deficit will likely be a central theme going into mid-terms and could continue afterward. The lack of government spending will lead to slower economic growth.

U.S. Economic Releases

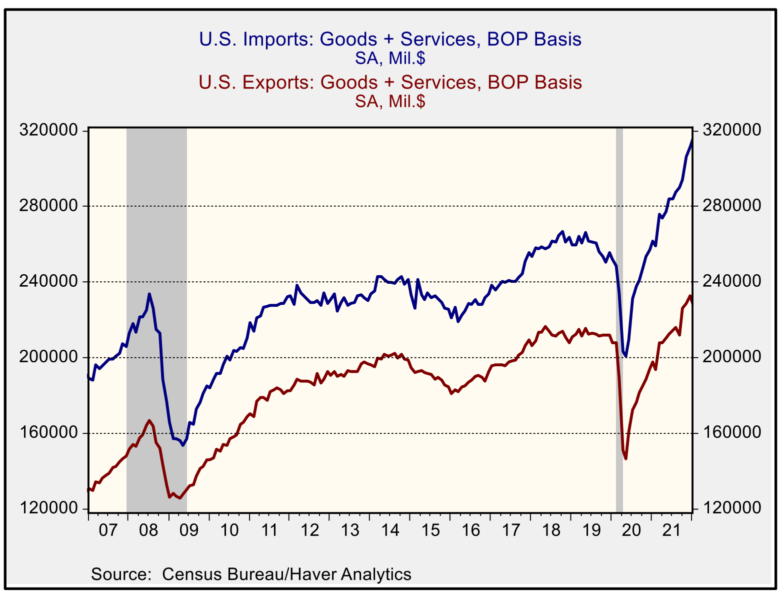
Initial applications for unemployment benefits in the week ending July 30 rose to a seasonally adjusted 260,000, matching expectations and marking a modest increase from the revised level of 254,000 in the previous week. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 254,750, its highest level since last November. Meanwhile, the number of people continuing to draw benefits in the week ending July 23 rose to 1.416 million, significantly above the expected level of 1.385 million and much higher than the previous week's revised reading of 1.368 million. The chart below shows how initial jobless claims have fluctuated since just before the prior recession. The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



To provide more detail on recent trends, the chart below shows how initial jobless claims have changed just since mid-2021.



In a separate report today, the U.S. trade deficit narrowed to a seasonally adjusted $79.6 billion in June, beating the anticipated shortfall of $80.0 billion and much better than the revised deficit of $84.9 billion in May. According to the data, U.S. exports rose 1.7% in June, while imports fell 0.3%. Compared with the same month one year earlier, exports in June were up 22.8%, while imports were up just 20.0%. The chart below shows the monthly value of U.S. exports and imports since just before the previous recession.



The table below shows the economic releases and/or Federal Reserve 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**
12:00	Loretta Mester Discusses the Economic Outlook	President of the Federal Reserve Bank of Cleveland

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	Foreign Buying Japan Stocks	w/w	29-Jul	-¥120.3b	¥298.1b	¥297.6b	*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	29-Jul	¥1.296.3t	-¥15.6b	-¥15.5b	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	29-Jul	¥336.9b	¥230.6b	¥230.3b	*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	29-Jul	¥37.1b	¥107.9b	¥112.0b	*	Equity and bond neutral
Australia	Trade Balance	m/m	Jun	A$17.670b	A$15.965b	A$15.016b	***	Equity bullish, bond bearish
EUROPE								
Germany	S&P Construction PMI	m/m	Jul	43.7	45.9		*	Equity bearish, bond bullish
	Factory Orders WDA	y/y	Jun	-9.0%	-3.1%	-3.2%	***	Equity bearish, bond bullish
UK	S&P/CIPS Construction PMI	m/m	Jul	48.9	52.6	52.0	**	Equity bearish, bond bullish
	New Car Registrations	y/y	Jul	-9.0%	-24.3%		*	Equity bullish, bond bearish
AMERICAS								
Canada	Building Permits	m/m	Jun	-1.5%	2.3%	1.6%	**	Equity bearish, bond bullish
	International Merchandise Trade	m/m	Jun	5.05b	5.32b	4.99b	***	Equity and bond neutral
Mexico	Consumer Confidence	m/m	Jul	41.3	43.6	43.6	*	Equity bearish, bond bullish
Brazil	S&P Services PMI	m/m	Jul	55.8	60.8		**	Equity bearish, bond bullish
	S&P Composite PMI	m/m	Jul	55.3	59.4		**	Equity bearish, bond bullish

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.

Fixed Income	Today	Prior	Change	Trend
3-mo Libor yield (bps)	281	280	1	Up
3-mo T-bill yield (bps)	241	243	-2	Up
TED spread (bps)	39	37	2	Widening
U.S. Sibor/OIS spread (bps)	263	261	2	Up
U.S. Libor/OIS spread (bps)	267	265	2	Up
10-yr T-note (%)	2.72	2.71	0.01	Up
Euribor/OIS spread (bps)	25	26	-1	Neutral
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
Yen	Down			Down
Pound	Down			Down
Franc	Up			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of England Bank Rate	1.750%	1.250%	1.750%	On Forecast
Brazil Selic Rate	13.750%	13.250%	13.750%	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	$96.82	$96.78	0.04%	
WTI	$91.11	$90.66	0.50%	
Natural Gas	$8.36	$8.27	1.09%	
Crack Spread	$38.31	$38.82	-1.30%	
12-mo strip crack	$29.98	$30.29	-1.03%	
Ethanol rack	$2.72	$2.74	-0.80%	
Metals				
Gold	$1,782.38	$1,765.29	0.97%	
Silver	$20.28	$20.06	1.09%	
Copper contract	$345.50	$346.70	-0.35%	
Grains				
Corn contract	$592.50	$596.25	-0.63%	
Wheat contract	$763.50	$763.75	-0.03%	
Soybeans contract	$1,367.25	$1,369.75	-0.18%	
Shipping				
Baltic Dry Freight	1,731	1,817	-86	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	4.5	-1.5	6.0	
Gasoline (mb)	0.2	-1.5	1.7	
Distillates (mb)	-2.4	1.0	-3.4	
Refinery run rates (%)	-1.2%	0.3%	-1.5%	
Natural gas (bcf)		28.0		

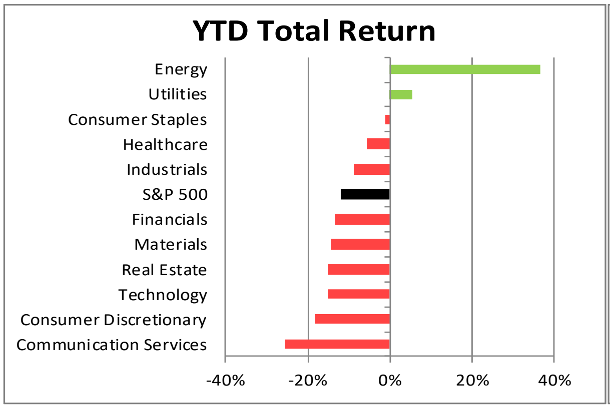
Weather

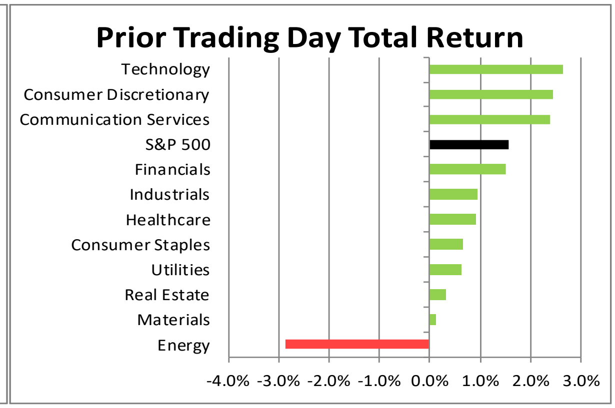
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures along the West Coast and throughout the northern Rocky Mountains and Great Plains, with cooler-than-normal temperatures in the Southwest and Mid-Atlantic states. Wetter-than-normal conditions are expected in the Rocky Mountain region, with dry conditions expected in the Great Plains and Midwest.

In the Gulf Coast, Caribbean, and Atlantic Ocean areas, no tropical storm activity is expected within the next 48 hours.

Data Section

U.S. Equity Markets – (as of 8/3/2022 close)

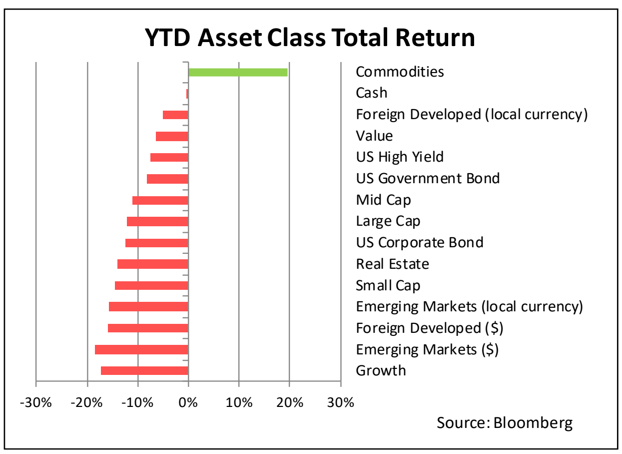




(Source: Bloomberg)

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 8/3/2022 close)

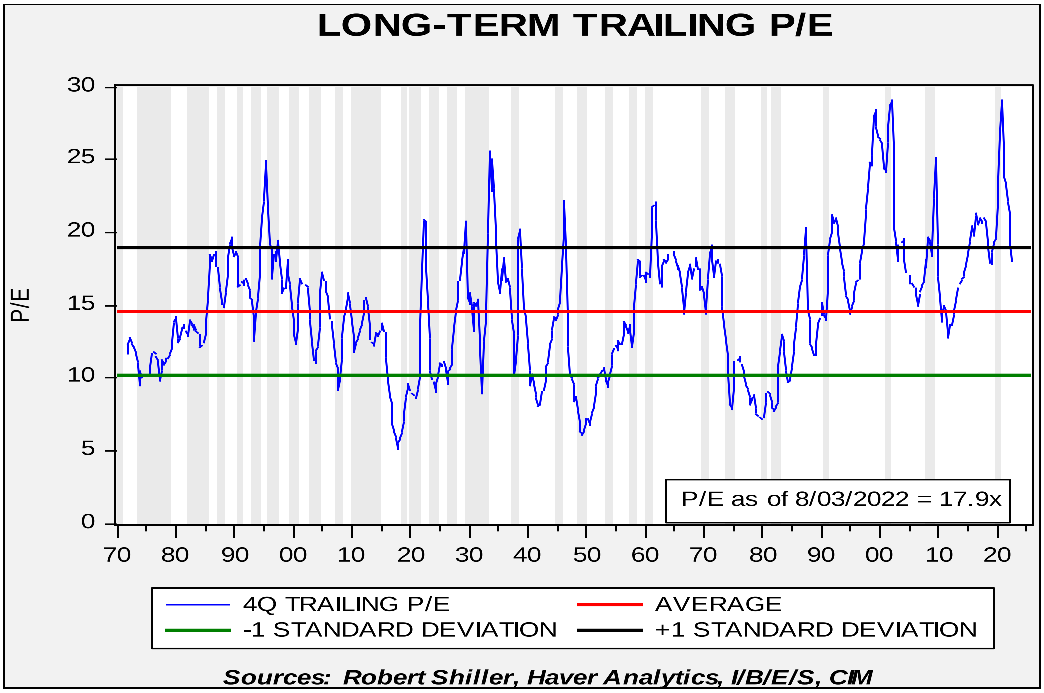


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

August 4, 2022



Based on our methodology,[1] the current P/E is 17.9x, up 0.3x from last week. The rise in the P/E is due higher equity prices.

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 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.