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 11, 2022—9:30 AM EDT] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is currently up 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 2.4%. Chinese markets were higher, with the Shanghai Composite up 1.6% from its prior close and the Shenzhen Composite up 1.7%. U.S. equity index futures are signaling a higher open. With 453 companies having reported, the S&P 500 Q2 2022 earnings stand at $57.30, higher than the $55.26 forecast for the quarter. The forecast reflects a 4.3% increase from Q2 2021 earnings. Thus far this quarter, 75.7% of the companies have reported earnings above forecast, while 19.9% 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*** **(8/11/2022): We take a second look at the Inflation Reduction Act and continue our discussion on European weather, noting falling Rhine River levels. Also worth noting are European natural gas inventories, which are actually in good shape heading into autumn.**
- *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* (8/4/2022): 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* (8/8/2022) (with associated podcast): "The Devil Is in the Details"
- *Confluence of Ideas* podcast (8/9/2022): "The 2022 Outlook: Update #2"
- *Current Perspectives*: "2022 Outlook: Update #2 – The Tails Become Fatter" (7/12/2022)

Good morning! Today's *Comment* is divided into two main sections, starting with reactions from the market and the Fed to the latest CPI data. We include our thoughts on whether the Fed will pivot and why we are not convinced that inflation has plateaued. Next, we review international news focusing on stories that highlight rising geopolitical risks, namely, the latest developments in Ukraine, Taiwan, and Iran.

The Fed Speaks: Stocks rallied and the dollar weakened on Wednesday after the latest CPI report showed that inflation decelerated for the first time since February 2021.

- Regional Fed Presidents Neel Kashkari and Charles Evans cautioned investors not to assume that the latest CPI report will change the central bank's policy path toward higher interest rates. Chicago Fed President Evans welcomed the news about the slowdown in price increases but added that the FOMC's job is not finished. Minneapolis Fed President Kashkari further added that the Fed is far from declaring victory. The comments suggest that central bank officials view the market's reaction as premature.
- Although both officials downplayed the possibility of a Fed pivot, neither changed his end-of-year target rate. For example, Evans maintained that the central bank should raise rates to around the median year-end projection in the Fed dot plots that was released in June. Meanwhile, Kashkari, who has the highest year-end fed funds target forecast, revealed that his end-of-year projection for the policy rate has not changed. Thus, it would seem Fed officials are not placing much weight on the July CPI report.
- It is too soon to tell whether inflation has indeed hit a turning point. Much of the decline in the CPI index was due to a drop in historically volatile energy prices. Meanwhile, relatively stable shelter prices, which comprise a third of the index, continue to rise well above their long-run averages. Thus, the market could be cruising toward a bruising if it gets too confident in a Fed pause or pivot. The next FOMC meeting will be September 20-21, 2022. At this time, central bank members will have the August CPI numbers, which will play a bigger role in whether the Fed decides to change course on its policy path.
    - Declining fuel prices suggest that the August report may show further decelerating inflation. This month, gasoline prices fell below $4/gallon for the first time since March.

Despite the market's reaction over the last few days, an economic downturn will not necessarily force the Federal Reserve to end its tightening. The central bank's mandate is to maintain price stability and prevent rising unemployment. It might want to encourage growth, but it is not under any obligation to do so. Thus, the Fed will likely be open to raising rates as long as the labor market remains strong and inflation remains high. An aggressive Fed determined to bring inflation back to its 2% target and markets brewing with confidence create a fertile environment for a Fed surprise. Thus, investors should be cautious to place too much emphasis on one report.

International Risks: Rising geopolitical tensions suggest that investing abroad may remain difficult.

- The Russia-Ukraine war shows no signs of abatement. Ukraine forces are set to launch a counter-offensive to retake regions lost to Russia. Ukrainian President Volodymyr Zelensky has built up troops around the city of Kherson in preparation for a battle, while also leaving troops to fight in contested areas of the Donbas region. The war will likely be extended if Ukraine successfully regains the lost territory or can force a strategic retreat. A protracted conflict in Ukraine will make investing in Europe challenging as firms struggle to receive much-needed energy supplies. Thus, the possibility of a recession in Europe is elevated.

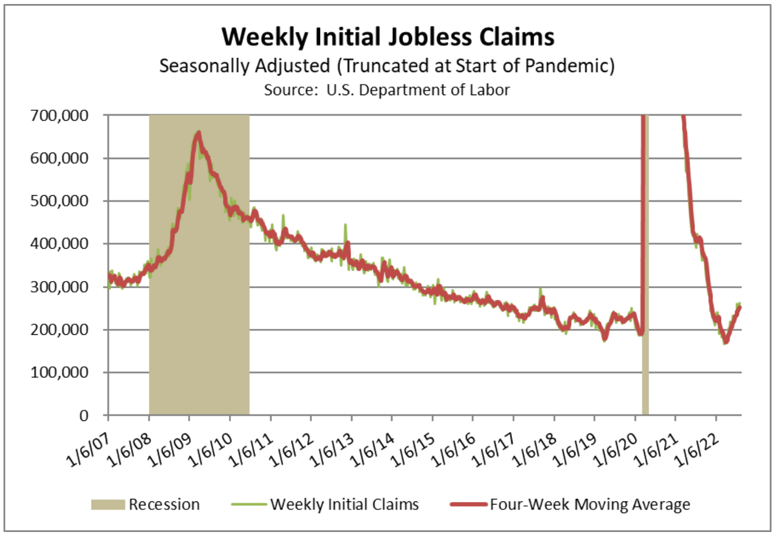
- The war will make it harder to reverse burdensome sanctions on Russia. The EU import ban on Russian coal will take effect on Thursday. Meanwhile, the International Energy Association (IEA) has projected that Russian oil output could fall by 20% by the start of next year due to the EU import ban. As a result, Russia's lack of export capacity and production will likely keep commodity prices elevated going into next year.

- Tensions between the U.S. and China have boiled over for now, but the dispute over Taiwan could still lead to conflict. On Wednesday, China ended its military drills near Taiwan. Officials from Beijing vowed to regularly send patrols across the U.S.-drawn median line in the Taiwan Strait. Additionally, China withdrew its promise never to send troops to Taiwan in the event of a takeover. As this current crisis subsides, both sides will attempt to position themselves with more leverage in subsequent disputes over the island. Accordingly, the decoupling between the U.S. and China will likely accelerate over the next few months as firms come to terms with this new reality.
    - As an example of this decoupling, Apple (AAPL, $169.24) has looked to expand its manufacturing operations into Vietnam. Meanwhile, Foxconn (2354, NT$50.60), a major Apple supplier, is building its production capacity in India. In the short term, firms will try to divest away from China by building capacity in nearby areas in Asia due to their familiarity with many of the countries in the region. Over time, however, the lack of stability and political uncertainty in small Asian countries may force forms to shift operations near the U.S. or possibly into Europe. This shift will be costly and potentially inflationary in the short and medium terms as firms will have to price in additional risks to the supply chains.
- The Biden administration's hope of securing a nuclear deal with Iran hit another roadblock. Former Secretary of State Mike Pompeo and former National Security Advisor John Bolton were targeted for assassination by affiliates of Iran's Islamic Revolutionary Guard Corps. Iran has also provided military training for Russian troops fighting in Ukraine. The Biden administration would like to secure a deal with Iran to prevent conflict in the Middle East. In the past, Israel has mentioned that it will not stand idly by while Iran develops its nuclear capacity. Thus, the likelihood of a potential conflict between Iran and Israel is elevated.

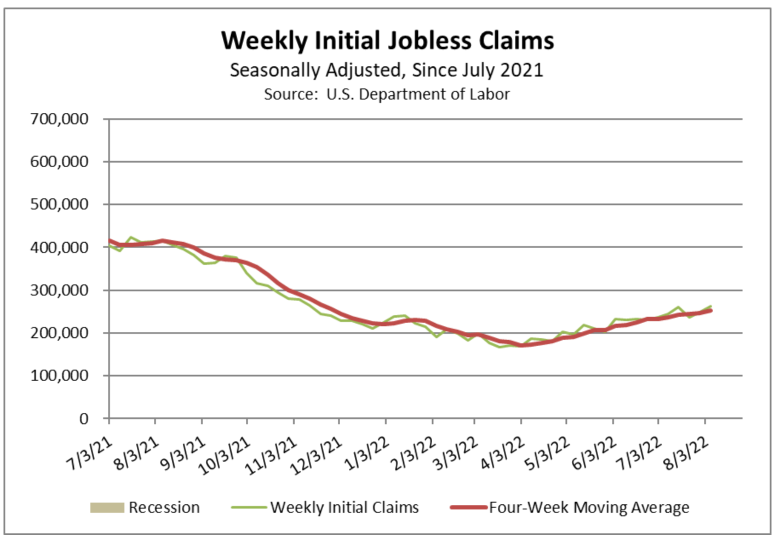
The recent slate of international news reinforces our view that global equities remain risky. A more hostile world will likely exacerbate supply chain issues and potentially slow the production of commodities. This outcome should be beneficial to energy-related assets. Additionally, as countries build up their military capabilities, industries related to aerospace and defense should also benefit.

U.S. Economic Releases

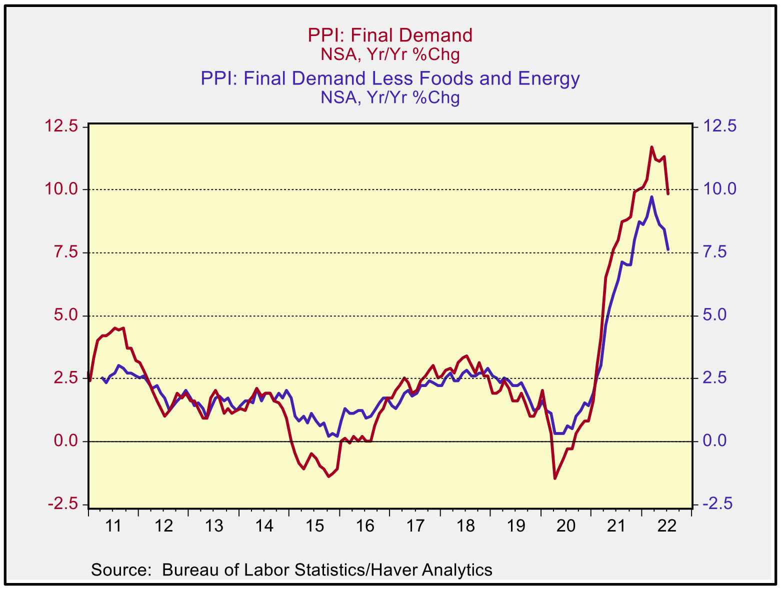
Initial applications for unemployment benefits in the week ended August 31 rose to a seasonally adjusted 262,000, not quite as bad as the expected level of 265,000 but much higher than the previous week's revised reading of 248,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 252,000, reaching its highest level since last November. Meanwhile, the number of people continuing to draw benefits in the week ended July 31 rose to 1.428 million, a bit worse than the expectations that they would remain at the previous week's revised 1.420 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.



Separately, the July producer price index (PPI) declined by a seasonally adjusted 0.5%, far better than the anticipated increase of 0.2% but not nearly enough to erase the previous month's revised gain of 1.0%. Excluding the volatile food and energy components, the "core" PPI rose 0.2%, better than the expectations calling for it to match the previous month's rise of 0.4%. The overall PPI in July was up 9.8% from the same month one year earlier, while the core PPI was up 7.6%. The chart below shows the year-over-year change in the PPI and the core PPI over the last decade or so.



The table below lists the domestic 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**
19:30	Mary Daly Interviewed on Bloomberg Television	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								
New Zealand	REINZ House Sales	y/y	Jul	-36.7%	-38.1%		**	Equity and bond neutral
EUROPE								Equity and bond neutral
UK	RICS House Price Balance	m/m	Jul	63.0%	65.0%	60.0%	**	Equity and bond neutral
Russia	CPI	y/y	Jul	15.10%	15.90%	15.30%	***	Equity and bond neutral
	Core CPI	y/y	Jul	18.40%	19.18%	18.75%	**	Equity and bond neutral
AMERICAS								Equity and bond neutral
Mexico	Industrial Production	y/y	Jun	3.8%	3.0%	3.5%	***	Equity and bond neutral

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)	292	291	1	Up
3-mo T-bill yield (bps)	252	253	-1	Up
TED spread (bps)	40	38	2	Widening
U.S. Sibor/OIS spread (bps)	270	269	1	Up
U.S. Libor/OIS spread (bps)	274	273	1	Up
10-yr T-note (%)	2.77	2.78	-0.01	Up
Euribor/OIS spread (bps)	33	32	1	Neutral
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
Yen	Up			Down
Pound	Flat			Down
Franc	Up			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.

	Price	**Prior**	**Change**	**Explanation**
Energy Markets				
Brent	$98.08	$97.40	0.70%	
WTI	$92.66	$91.93	0.79%	
Natural Gas	$8.46	$8.20	3.11%	
Crack Spread	$42.54	$41.64	2.16%	
12-mo strip crack	$31.58	$31.39	0.61%	
Ethanol rack	$2.72	$2.72	0.21%	
Metals				
Gold	$1,793.60	$1,792.38	0.07%	
Silver	$20.58	$20.59	-0.03%	
Copper contract	$368.75	$364.95	1.04%	
Grains				
Corn contract	$622.25	$618.50	0.61%	
Wheat contract	$822.75	$816.25	0.80%	
Soybeans contract	$1,439.75	$1,427.75	0.84%	
Shipping				
Baltic Dry Freight	1,592	1,564	28	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	5.5	-1.0	6.5	
Gasoline (mb)	-5.0	-1.1	-3.9	
Distillates (mb)	2.2	-1.0	3.2	
Refinery run rates (%)	3.3%	0.5%	2.8%	
Natural gas (bcf)		40.0		

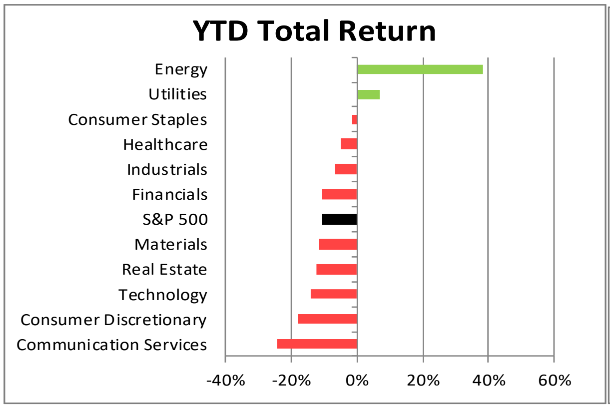
Weather

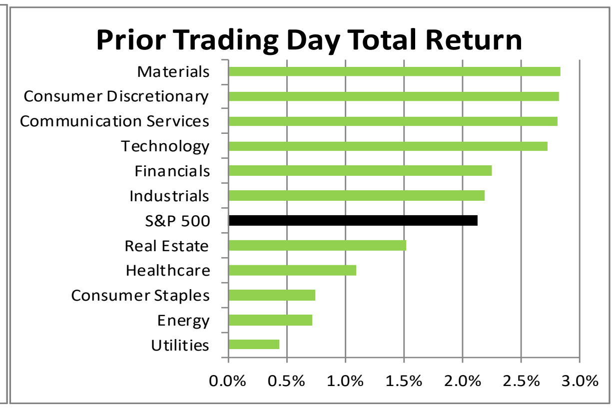
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout the West Coast, South Texas, and Florida, with cooler-than-normal temperatures concentrated in the Southwest and Midwest. Wetter-than-normal conditions are expected in the Southwest, the South, and the East Coast, with dry conditions expected in the northern Great Plains and Midwest.

In the Gulf Coast, Caribbean, and Atlantic Ocean areas, there is cyclone formation off the coast of West Africa; however, it is not expected to develop into a tropical storm.

Data Section

U.S. Equity Markets – (as of 8/10/2022 close)

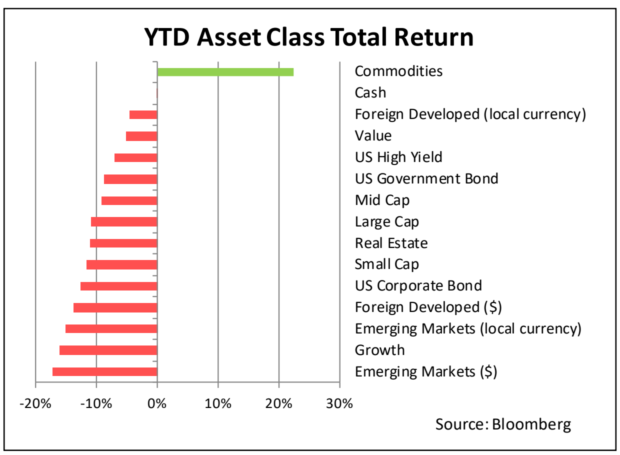




(Source: Bloomberg)

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 8/10/2022 close)

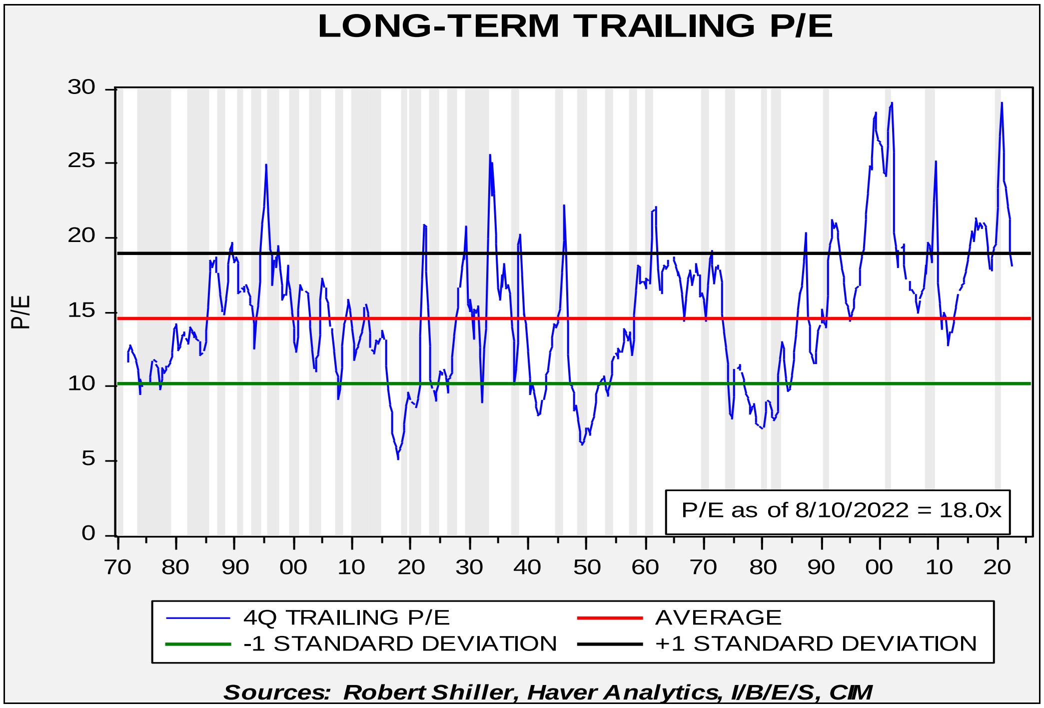


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 11, 2022



Based on our methodology,[1] the current P/E is 18.0x, up 0.1x from last week. The rise in the P/E is mostly due to the recovery in 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.

[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.