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 23, 2022—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is currently up 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.7%. Chinese markets were flat, with the Shanghai Composite and the Shenzhen Composite relatively unchanged from their prior close. U.S. equity index futures are signaling a slightly higher open. With 476 companies having reported, the S&P 500 Q2 2022 earnings stand at $57.40, higher than the $55.26 forecast for the quarter. The forecast reflects a 4.3% increase from Q2 2021 earnings. Thus far this quarter, 76.1% of the companies have reported earnings above forecast, while 19.7% 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* (8/15/2022) (with associated podcast): "*The End of the World is Just the Beginning*: A Book Review"
- *Weekly Energy Update* (8/18/2022): *We update the latest on the Iran nuclear deal and its potential ramifications. The weekly data showed a surprising draw in crude oil as exports rose. Hot weather isn't just an inconvenience; it's also affecting factory production in Europe and China.*
- *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* (8/22/2022) (with associated podcast): "The Inflation Surprise"
- *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)

Our *Comment* today opens with an update on the Russia-Ukraine war, where military operations remain relatively quiet. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including more evidence of financial volatility and economic weakness in Europe.

Russia-Ukraine: Russian forces continue to make only the most limited of territorial gains in Ukraine's eastern Donbas region, and some observers suggest those gains have only been possible because the Ukrainians are thinning out their lines in the region in order to move more troops to the Kherson area. The Ukrainians continue to suggest they will launch a counteroffensive to retake the city of Kherson and surrounding areas from their Russian occupiers, and in recent weeks they have taken some steps toward preparing for that counteroffensive. Lately, however, we have seen very little sign of the counteroffensive ramping up in earnest, suggesting the Ukrainians may have changed their plans.

- Since tomorrow is Ukraine's national Independence Day, the U.S. warned that Russia could use the occasion to increase its artillery and missile strikes against civilian areas. Wednesday also marks the sixth month since the start of the war.
- Russia now says the assassin who killed nationalist commentator Daria Dugina in a car bombing over the weekend has fled to Estonia. That accusation could be used as an excuse to threaten the Baltics, and there is probably some chance that the bombing was a false flag attack expressly for that purpose. However, we suspect it could also reflect Russia's own rough-and-tumble internal politics.
- As the U.S. and other Western allies continue to provide more advanced weapons to the Ukrainians, the momentum in the war appears to be shifting slightly in their favor. We continue to see reporting that suggests that Western governments are secretly sending more advanced weaponry than they have publicly acknowledged.

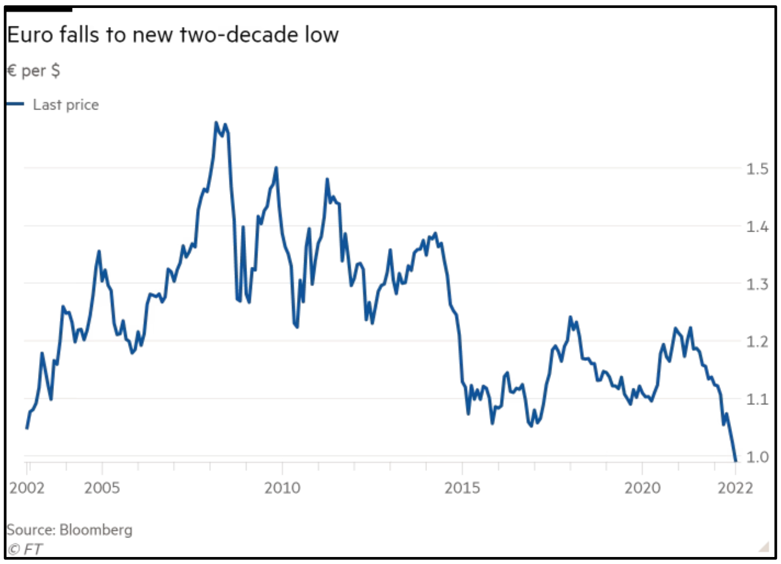
Global Energy Markets: Saudi Arabia Energy Minister Prince Abdulaziz bin Salman has warned that OPEC and its Russia-led allies may cut their crude oil production because of the recent volatility in futures markets. In response, global oil prices have jumped almost 1.4% so far this morning, with Brent now trading at $97.82 per barrel.

- We would note that key members of the OPEC+ alliance haven't been able to meet their production targets. Most importantly, some analysts have questioned how much spare capacity Saudi Arabia really has. An announced production cut might, therefore, have relatively little impact on actual supply. The energy minister's statement could well have been geared merely to reverse the recent softening in oil prices as investors grew more concerned about weakening economic growth across the globe.
- Meanwhile, Russia's latest announced "maintenance" shutdown of the Nord Stream 1 natural gas pipeline to Europe and high demand for air conditioning in Europe's heatwave continue to buoy gas prices. U.S. natural gas futures have reached $10.00 per BTU, up some 20% over the last month and equal to their highest level in 14 years.
- Reflecting the difficulties and long lead-time likely required to secure Europe's energy security, Belgium Prime Minister Alexander De Croo has warned that the Continent's next "five to ten winters will be difficult."

Eurozone Financial Markets: While the major central banks' monetary tightening has affected financial markets all over the world, there is increasing evidence that the ECB's reduced bond buying has stoked volatility in the Eurozone's bond market. For example, German government bond yields have recently been more volatile than at any other time in the last decade, and spreads between German and Italian yields are reaching concerning levels again. Fears of a looming recession and Europe's usual summer trading lull have also sapped liquidity.

Eurozone Economy: As shown in the Foreign Releases section below, S&P Global's flash composite purchasing managers' index for August fell to 49.2, as compared with 49.9 in July. As with most major PMIs, the index is designed so that readings below 50 signal contracting economic activity. Now that the index has been below that mark for two straight months, it's becoming clearer that the European economy is indeed slowing and could be on the verge of the recession many analysts are already expecting.

- The news has helped push the euro down even farther so far this morning.
- The currency is currently trading at $0.9920, its lowest level in some 20 years.



Hong Kong: The municipal government reported 6,617 new cases of COVID-19 yesterday, marking the sixth straight day in which the tally topped 6,000. Officials have also said the city now has multiple transmission chains, raising the prospects of a sharp clampdown under President Xi's Zero-COVID policy.

U.S. Labor Market: Teachers at the Columbus School District, the largest in Ohio, have voted to strike over a wide range of issues including classroom sizes, teacher pay, caps on the number of class periods in the day, and heating and air conditioning availability in school buildings. As we've noted before, falling labor force participation and fast economic growth have tightened labor markets in many countries, giving workers the leverage to demand better pay and working conditions. If the wave of strikes drives up labor costs enough, it would help keep inflation high and erode corporate profit margins.

U.S. Apartment Market: New details show that some 420,000 apartment units are due to be completed in the U.S. this year, marking the highest rate of completions in 50 years. Initially, many of those new units will likely be snapped up by people shut out of the single-family home market by soaring prices and high interest rates. Eventually, however, the new units could help bring down rents and inflation rates.

U.S. Military: As we've mentioned previously, U.S. military forces have been facing huge challenges in recruiting new members, with the Army likely to end up with far fewer troops than planned in the next year or two. Now, it turns out that applications to West Point and the other highly selective, prestigious service academies are down 10% to 30% from last year. The shortfalls reflect problems ranging from the strong labor market, declining interest in the military after the long U.S. wars in Iraq and Afghanistan, and restrictions on in-person recruiting during much of the pandemic.

U.S. Economic Releases

There were no domestic releases scheduled prior to the publication of this report.

Economic Releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
8:45	S&P Global US Manufacturing PMI	m/m	Aug P	51.8	52.2	***
8:45	S&P Global US Services PMI	m/m	Aug P	49.8	47.3	***
8:45	S&P Global US Composite PMI	m/m	Aug P		47.7	***
10:00	Richmond Fed Manufact. Index	m/m	Aug	-4	0	**
10:00	New Home Sales	m/m	Jul	575k	590k	***
10:00	New Home Sales MoM	m/m	Jul	-2.5%	-8.1%	**
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
19:00	Neel Kashkari Speaks in Q&A	President of the Federal Reserve Bank of Minneapolis				

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	Aug P	51.0	52.1		***	Equity bearish, bond bullish
	Jibun Bank Services PMI	m/m	Aug P	49.2	50.3		**	Equity bearish, bond bullish
	Jibun bank Composite PMI	m/m	Aug P	48.9	50.2		*	Equity bearish, bond bullish
Australia	S&P Manufacturing PMI	m/m	Aug P	54.5	55.7		***	Equity bearish, bond bullish
	S&P Services PMI	m/m	Aug P	49.6	50.9		**	Equity bearish, bond bullish
	S&P Composite PMI	m/m	Aug P	49.8	51.1		*	Equity bearish, bond bullish
EUROPE								
Eurozone	S&P Manufacturing PMI	m/m	Aug P	49.7	49.8	49.0	***	Equity and bond neutral
	S&P Services PMI	m/m	Aug P	50.2	51.2	50.5	**	Equity and bond neutral
	S&P Composite PMI	m/m	Aug P	49.2	49.9	49.0	*	Equity and bond neutral
Germany	S&P/BME Manufacturing PMI	m/m	Aug P	49.8	48.0	49.3	***	Equity and bond neutral
	S&P Services PMI	m/m	Aug P	48.2	49.0	49.7	**	Equity and bond neutral
	S&P Composite PMI	m/m	Aug P	47.6	47.3	48.1	**	Equity and bond neutral
France	S&P Manufacturing PMI	m/m	Aug P	49.0	49.5	49.5	***	Equity and bond neutral
	S&P Services PMI	m/m	Aug P	51.0	53.2	53.2	**	Equity bearish, bond bullish
	S&P Composite PMI	m/m	Aug P	49.8	51.7	51.7	**	Equity bearish, bond bullish
UK	S&P/CIPS Manufacturing PMI	m/m	Aug P	46.0	52.1	52.1	***	Equity bearish, bond bullish
	S&P/CIPS Services PMI	m/m	Aug P	52.5	52.6	52.6	**	Equity and bond neutral
	S&P/CIPS Composite PMI	m/m	Aug P	50.9	52.1	52.1	**	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)	296	298	-2	Up
3-mo T-bill yield (bps)	262	268	-6	Up
TED spread (bps)	34	30	4	Widening
U.S. Sibor/OIS spread (bps)	284	283	1	Up
U.S. Libor/OIS spread (bps)	289	288	1	Up
10-yr T-note (%)	3.02	3.02	0.00	Up
Euribor/OIS spread (bps)	45	43	2	Neutral
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Down			Down
Yen	Flat			Up
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	$98.00	$96.48	1.58%	
WTI	$92.02	$90.36	1.84%	
Natural Gas	$9.85	$9.68	1.75%	
Crack Spread	$36.37	$42.69	-14.81%	
12-mo strip crack	$32.84	$33.74	-2.67%	
Ethanol rack	$2.86	$2.85	0.38%	
Metals				
Gold	$1,738.07	$1,736.30	0.10%	
Silver	$19.00	$18.99	0.08%	
Copper contract	$366.30	$365.35	0.26%	
Grains				
Corn contract	$645.50	$629.00	2.62%	
Wheat contract	$801.25	$788.25	1.65%	
Soybeans contract	$1,446.75	$1,435.25	0.80%	
Shipping				
Baltic Dry Freight	1,270	1,279	-9	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-3.0		
Gasoline (mb)		-2.1		
Distillates (mb)		0.3		
Refinery run rates (%)		-0.5%		
Natural gas (bcf)		31		

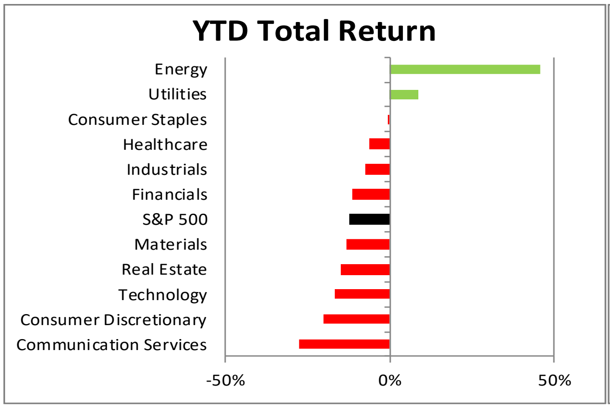
Weather

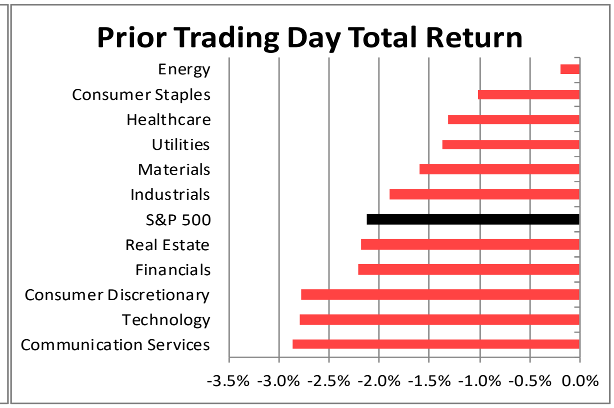
The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures for most of the country, with cooler-than-normal temperatures in the Southwest. Wetter-than-normal conditions are expected throughout the Southwest, Midwest and East Coast, with dry conditions expected in the northern Great Plains.

In the Gulf Coast, Caribbean, and Atlantic Ocean areas, there is a tropical disturbance west of the Cabo Verde Islands, but it is unlikely to develop into a cyclone within the next 48 hours.

Data Section

U.S. Equity Markets – (as of 8/22/2022 close)

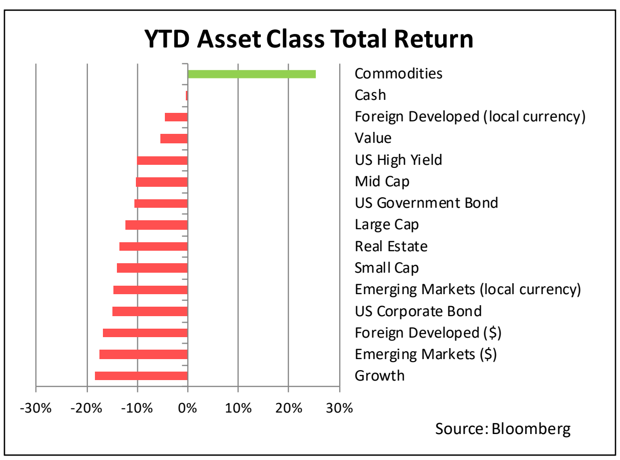




(Source: Bloomberg)

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 8/22/2022 close)

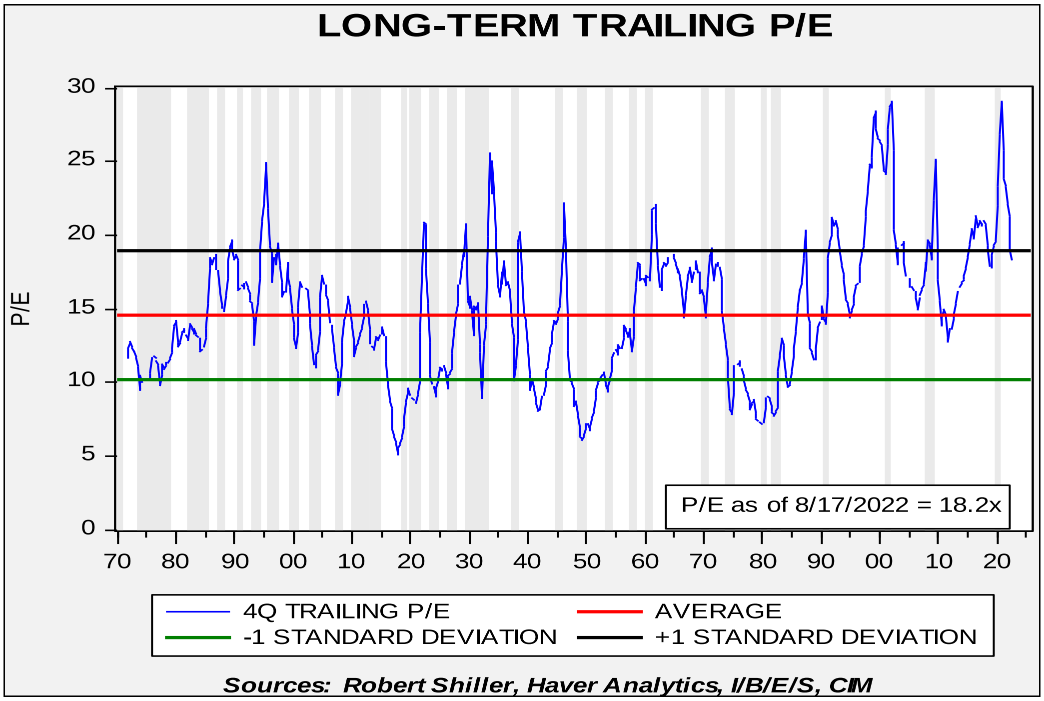


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 18, 2022



Based on our methodology,[1] the current P/E is 18.2x, up 0.2x from last week. The rise in the P/E is mostly due to the recovery in equity prices, offsetting solid Q2 earnings.

[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.