

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: December 6, 2022—9:30 AM EST]** Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is down 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.8%. Chinese markets were mixed, with the Shanghai Composite closing relatively unchanged from its prior close and the Shenzhen Composite closing up 0.3%. U.S. equity index futures are signaling a flat open.

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](#) (11/07/2022) (with associated [podcast](#)) “Reflections on the 20<sup>th</sup> Party Congress.” Due to the upcoming holiday, the next BWGR will be our 2023 Outlook published on December 12.
- [Weekly Energy Update](#) (12/01/2022): In this week’s report, we highlight the recovery in distillate inventories relative to demand due to a jump in refinery operations. Total oil inventories are at 22-year lows.
- [Asset Allocation Quarterly – Q4 2022](#) (10/18/2022): Discussion of our asset allocation process, Q4 2022 portfolio changes, and our outlook for the markets
- [Asset Allocation Bi-Weekly](#) (12/05/2022) (The associated podcast that accompanies this report will be delayed until 12/12): “Forecasting Financial Stress” The AABW will go on holiday hiatus following today’s report, and our next report will be published on January 16, 2023.
- [Asset Allocation Q4 2022 Rebalance Presentation](#) (11/14/2022): Video presentation featuring the Asset Allocation Committee as they review our asset allocation strategies, recent portfolio changes, and the current macro environment
- [Confluence of Ideas podcast](#) (12/01/2022): “The November Business Cycle Report”

Good morning on the Feast of St. Nicholas! It’s actually a [rather quiet morning](#) after yesterday’s [risk-off](#) day. U.S. equity futures have been vacillating this morning, mostly trading inverse the dollar. Gold is higher this morning, but oil is trading lower. Equities have been taking on a tone of [bad news is good news](#). Yesterday’s ISM services index, coming in well above the expansion line of 50, raised fears that monetary policy won’t be as easy as hoped. We note that the WSJ’s latest “Fed whisperer,” Nick Timiraos, [published an article](#) yesterday reiterating Chair Powell’s recent comments about moving to slower rate hikes but also signaling that tightening was far

from over. Last week, when that speech occurred, the financial markets viewed the talk as dovish. The Timiraos article suggests that isn't the narrative that the FOMC preferred.

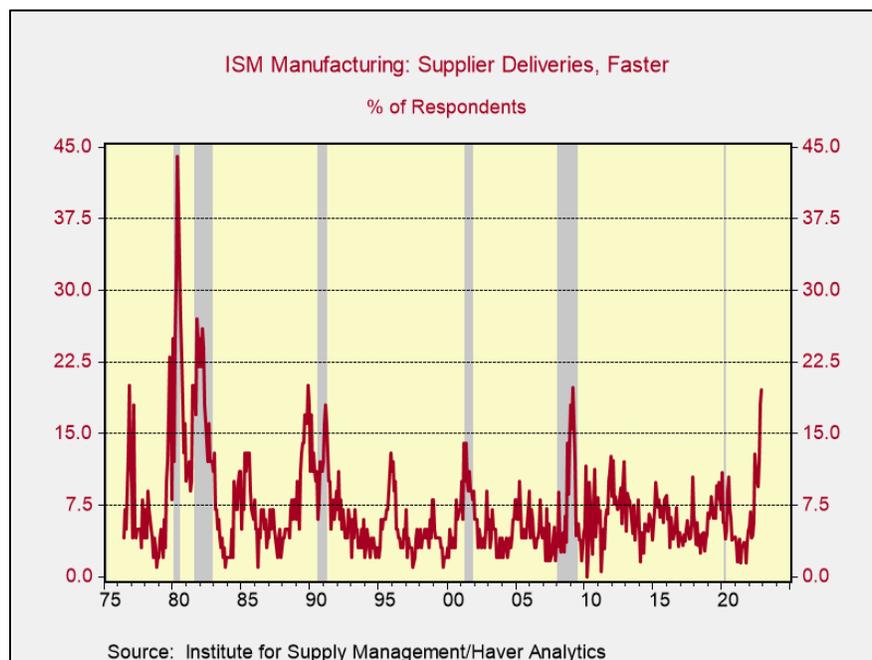
In today's *Comment*, our coverage begins with China news. Economics and policy are up next, and an update on the North Carolina substation attack follows. Our war in Ukraine briefing comes next, and we close with the international roundup.

**China News:** The [state funeral for Jiang Zemin has begun](#), as the CPC does its [best to project unity](#). We also update the COVID situation.

- It is becoming clear that China's Zero-COVID policy is evolving, but [we hesitate to call it a full reopening](#). Instead, policymakers seem to be moving along three tracks.
  - There appears to be a concerted effort to change the narrative on the disease from something to be feared [into more of an inconvenience](#). COVID has exhibited a wide array of effects with most people seeming to survive it just fine, but it is clearly a risk to the elderly and to those with several preexisting conditions. Also, the mystery of "long COVID" remains an issue. Most nations have generally developed a strategy of trying to open as much as possible while simultaneously protecting the most vulnerable. Finding that balance can be tricky.
  - As part of this narrative change, [public health authorities are said to be close to announcing less strict quarantine and testing measures](#).
  - Expanding immunizations is also being promoted. Unfortunately, [Beijing doesn't want to accept Western vaccines](#), which have proven to be more effective. Thus, immunizations may have only a limited effect on reducing risk.
  - Opening is risky, and the use of substandard vaccines coupled with a population that hasn't had much exposure to the virus further raises the risk that a bout of infection could strain the medical system. However, it has become clear, for economic and [social reasons](#), that the [Zero-COVID policy can't be maintained](#). [Beijing is adjusting, but it isn't completely certain how well this will work out](#).
- The fiscal response by the U.S. to COVID was extraordinary, and the speed that policy stimulus was deployed opened the potential for abuse. Reports of identity theft when applying for unemployment insurance and the abuses of PPP payments were widespread. Turns out the abuses were also international in nature—the [Secret Service reports that Chinese hackers clipped at least \\$20 million of COVID relief payments](#).
- As General Secretary Xi starts his third term among expectations of market-unfriendly policies expanding, we are beginning to see reports of capital flight as wealthy Chinese citizens begin moving funds offshore. [Singapore appears to be the most prominent beneficiary](#). The city-state has a large ex-pat population and is a [natural destination](#) for such funds.
- [Canada is joining other G-7 nations in conducting freedom of navigation operations](#) in the Taiwan Strait.

**Markets, Economics and Policy:** The economic picture is mixed. Business leaders are worried but still see a soft landing. Supply chains are improving, but layoffs are rising.

- Recent CEO surveys suggest that business leaders are [becoming more concerned](#) about the economy, [but still expect a soft landing](#). It's not obvious if these leaders have a great track record on forecasting the economy (to be fair, no one else is all that good either) but their attitudes likely reflect present business activity. Thus, we see it as confirmation that we are not currently in a recession.
- At long last, [supply chains appear to be improving](#). Freight rates have been easing, and we note that in the recent ISM data, there is growing evidence of improvement.



The number of purchasing managers reporting faster deliveries is rising rapidly, although history would suggest some of this improvement is likely coming from slower economic activity.

- Taiwan Semiconductor (TSMC, \$81.62) announced it is [increasing its investment in its Arizona facility](#).
- PepsiCo (PEP, \$183.12) [announced layoffs](#) from its corporate headquarters.
- For years, tech firms have been news aggregators as they give users the ability to find articles and, for a long time, avoid paying subscriptions. Clearly, this content model can't work indefinitely. If the content providers can't get paid, they will eventually stop providing the content. Congress is apparently working on legislation that would facilitate the providers' abilities to negotiate fees from the tech firms. Facebook (META, \$122.43) announced it may [stop providing news feeds on its platform](#) if the legislation passes.
- [Commercial property private REITs are seeing redemption notices](#).

- [Influenza hospitalizations are rising rapidly](#). The spike in infections may be a hangover from the COVID restrictions, which also reduced flu infections but have lowered resistance.
- [The head of the PBOC is making the argument that the dollar has peaked](#). Although we are not sure that we won't see one more recovery in the greenback, (especially if Nick Timiraos is right) we do think that we are in the very late innings of this dollar bull market.

**North Carolina:** Although authorities are not calling the weekend attack on substations in North Carolina domestic terrorism, [the actions were clearly targeted](#), suggesting that it wasn't just a random attack. Utilities are steadily bringing power back online, but it probably won't be [until Thursday](#) before [power is fully restored](#). Our worry is that if similar attacks become common, not only will it cause disruptions, but mitigation efforts (backup generators, diesel stocks, extra food, etc.) will tend to be costly and could boost inflation.

**War in Ukraine:** Ukraine strikes inside Russia which could expose divergences in goals among allies.

- Although Kyiv hasn't fully accepted responsibility, it appears that [Ukrainian drones attacked](#) three [Russian airfields](#) inside of [Russia proper](#), including one that [houses some of Russia's strategic air assets](#)<sup>1</sup>. A drone also hit a [Russian oil depot](#). [Ukraine's ability to strike inside Russia is a new development](#), and one that the U.S probably isn't pleased about. We note that the U.S. "[modified](#)" its HIMARS systems given to Ukraine to reduce its range and lessen the likelihood that Ukraine could strike within Russia.
  - This development could mark a serious escalation of the war. First, if Ukraine now has the ability to strike targets deep inside Russia, then [Putin's conduct of the war](#) will come under further scrutiny. Second, Ukraine's Western allies are mostly willing to support this war as long as it stays contained, since the West has no interest in seeing this conflict expand. Attacking Russia proper changes the nature of the war and could prompt Russia to take more aggressive steps, such as engaging tactical nuclear weapons.
  - We will wait to see the U.S./allied response. Since the drones appear to be of Ukrainian origin, the U.S. and its allies can argue that it wasn't Western arms that attacked Russia. We doubt the Kremlin will accept this argument. We look for the West to restrict weapons sales further to discourage this development.
- Meanwhile, polls show some reduction in support among Americans for "[indefinite](#)" aid to Ukraine. And [Germany is balking on sending the arms it promised earlier](#).
- As the war continues, the Kremlin is increasing its commandeering of private companies to support the war effort. This action will tend to reduce available supply; if money supply isn't restricted, then inflation will worsen.

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<sup>1</sup> In other words, it houses an element of its nuclear weapons delivery.

## International News: The EU awakens to the change in U.S. policy.

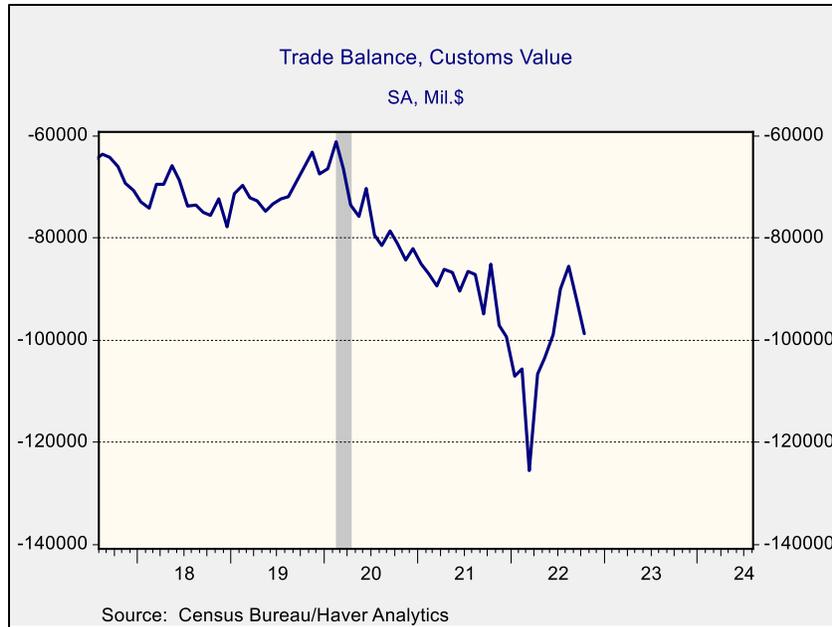
- The [Inflation Reduction Act](#), in IOHO, is the opening salvo in U.S. industrial policy designed to kick start the reindustrialization of America, but [at the expense of our trading partners, mostly Europe](#). For the Europeans, who have maintained export promotion far beyond just the recovery from WWII, [this is a massive threat](#). When French President Macron was in Washington recently, he warned that the new law could “[fragment the West](#).” Perhaps, but given that Europe can’t defend itself, it probably is better described as the U.S. subjugating Europe. The EU is expected to react, and there is talk of it creating its own energy subsidies and maybe [giving up on free trade as a policy](#)<sup>2</sup>. However, we don’t expect the U.S. to change its policies all that much, and if anything, we expect more of the same.
- Although Turkey has thrust itself into global geopolitics in a robust fashion, and is getting some economic benefits, [it still faces an ugly inflation problem](#).
- South Africa’s President Ramaphosa is facing a corruption scandal, [but it appears he will escape impeachment](#).
- Not so for Peru’s President Castillo, [who is facing a third attempt to remove him from office](#).
- [Mount Semeru has erupted in Indonesia](#). The volcano is situated on Java, where, at the other end of the island, sits the city of Jakarta. Major volcanic eruptions can cool the earth for a time, as volcanic ash spews into the upper atmosphere.
- Papua New Guinea may have [underestimated its population](#) by half.

## U.S. Economic Releases

An uptick in export services led to a smaller than expected deficit in tradeable goods and services. In October, the trade deficit increased from a revised \$74.1B to \$78.2B. The figure was below the consensus estimate of \$80.0B. The gap in the value of imports and exports was driven by a decline in foreign goods sales which fell 2.6% from the prior month, compared to a 0.9% rise in foreign goods purchases. That said, service exports increased by 2.3%.

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<sup>2</sup> Which is a bit rich, given that numerous policies, such as regulations on food, are clearly protectionist.



The chart above shows the trade balance for goods and services.

There are no economic releases and/or Fed events scheduled for the rest of today. The Fed is in its “quiet period” before its December 13-14 meeting.

### 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
<b>ASIA-PACIFIC</b>								
Japan	Household Spending	y/y	Oct	1.2%	2.3%	0.9%	**	Equity and bond neutral
	Labor Cash Earnings	y/y	Oct	1.8%	2.1%	2.0%	*	Equity and bond neutral
	Real Cash Earnings YoY	y/y	Oct	-2.6%	-1.3%	-2.2%	*	Equity and bond neutral
<b>EUROPE</b>								
Germany	S&P Construction PMI	m/m	Nov	41.5	43.8		*	Equity bearish, bond bullish
	Factory Orders WDA	y/y	Oct	-3.2%	-10.8%	-9.8%	***	Equity bullish, bond bearish
UK	S&P/CIPS Construction PMI	m/m	Nov	50.4	53.2	52.0	**	Equity bearish, bond bullish
<b>AMERICAS</b>								
Canada	International Merchandise Trade	m/m	Oct	1.21b	1.14b	0.61b	**	Equity and bond neutral
Mexico	Gross Fixed Investment	y/y	Sep	3.3%	6.5%	5.8%	**	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)	473	477	-4	Up
3-mo T-bill yield (bps)	419	422	-3	Up
TED spread (bps)	54	54	0	Widening
U.S. Sibor/OIS spread (bps)	446	445	1	Up
U.S. Libor/OIS spread (bps)	448	447	1	Up
10-yr T-note (%)	3.55	3.58	-0.03	Up
Euribor/OIS spread (bps)	198	198	0	Neutral
Currencies	Direction			
Dollar	Down			Down
Euro	Up			Up
Yen	Up			Up
Pound	Up			Up
Franc	Up			Up
Central Bank Action	Current	Prior	Expected	
RBA Cash Rate Target	3.100%	2.850%	3.100%	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.

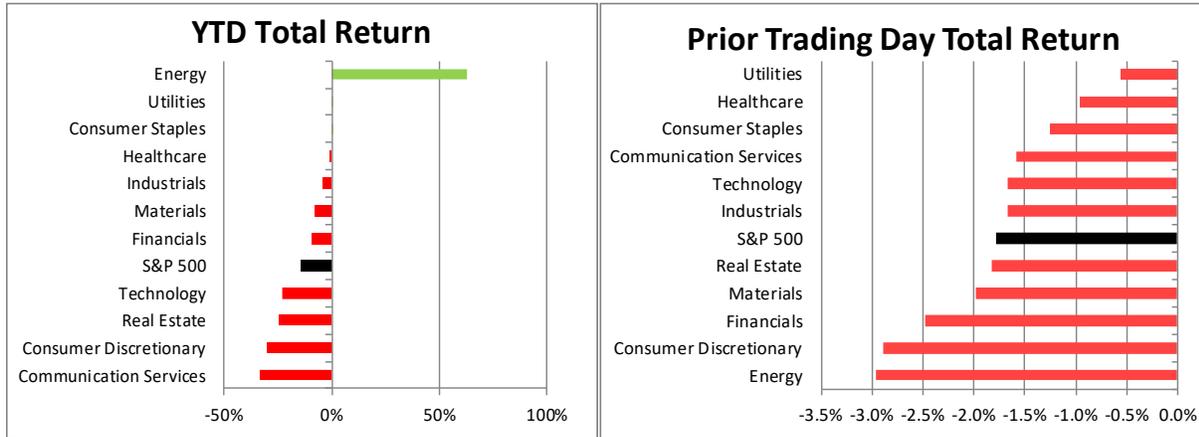
	Price	Prior	Change	Explanation
<b>Energy Markets</b>				
Brent	\$81.61	\$82.68	-1.29%	
WTI	\$76.00	\$76.93	-1.21%	
Natural Gas	\$5.48	\$5.58	-1.69%	
Crack Spread	\$26.67	\$26.82	-0.56%	
12-mo strip crack	\$26.96	\$26.97	-0.03%	
Ethanol rack	\$2.43	\$2.44	-0.52%	
<b>Metals</b>				
Gold	\$1,780.46	\$1,768.68	0.67%	
Silver	\$22.58	\$22.25	1.47%	
Copper contract	\$381.55	\$379.50	0.54%	
<b>Grains</b>				
Corn contract	\$642.75	\$640.50	0.35%	
Wheat contract	\$740.25	\$739.00	0.17%	
Soybeans contract	\$1,452.50	\$1,437.75	1.03%	
<b>Shipping</b>				
Baltic Dry Freight	1,323	1,324	-1	
<b>DOE Inventory Report</b>				
	<b>Actual</b>	<b>Expected</b>	<b>Difference</b>	
Crude (mb)		-3.9		
Gasoline (mb)		2.5		
Distillates (mb)		1.8		
Refinery run rates (%)		0.4%		
Natural gas (bcf)		-82		

## Weather

The 6-10 and 8-14 day forecasts show that warmer-than-normal temperatures in the eastern two-thirds of the country are expected to recede to the New England region. Meanwhile, the remaining areas of the country are predicted to be relatively cool over the next two weeks. Wet conditions are anticipated for most of the country but should subside toward the end of the forecasting period. [We are watching a rare subtropical storm that may develop into Tropical Storm Owen.](#)

**Data Section**

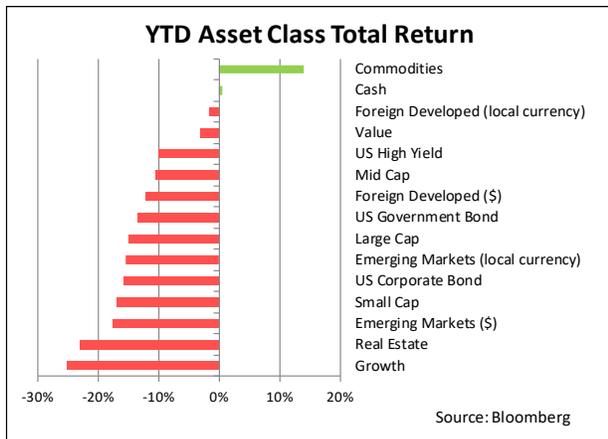
**U.S. Equity Markets – (as of 12/05/2022 close)**



(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 12/05/2022 close)**

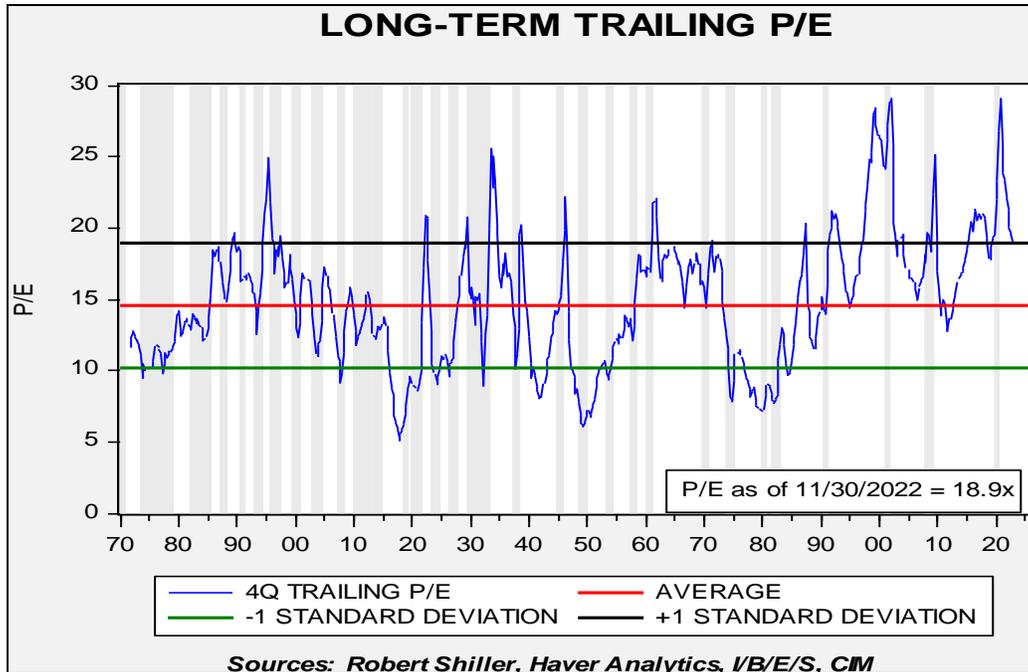


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

December 1, 2022



Based on our methodology,<sup>3</sup> the current P/E is 18.9x, up 0.2x from our last report. Falling earnings estimates and higher equity values led to the multiple rise.

*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.*

<sup>3</sup> 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 three actual quarters (Q1, Q2 and Q3) and one estimate (Q4). 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.