Daily Comment

By Bill O'Grady, Thomas Wash, and Patrick Fearon-Hernandez, CFA

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 7, 2021—9:30 AM EST] Global equity markets are generally higher this morning. In Europe, the EuroStoxx 50 is up 2.5% from its prior close. In Asia, the MSCI Asia Apex 50 closed up 2.3%. Chinese markets were mixed, with the Shanghai Composite up 0.2% from its prior close and the Shenzhen Composite down 0.7%. U.S. equity index futures are signaling a higher 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:

- ***Weekly Geopolitical Report* (12/6/2021): "Plunging U.S. Service Exports"**
- *Weekly Energy Update* (12/2/2021): Oil prices have tumbled on the Omicron variant and on the SPR release. We take a look at gasoline prices relative to wages.
- *Asset Allocation Q4 2021 Rebalance Presentation* (11/4/2021): A video discussion of our asset allocation process, Q4 2021 portfolio changes, and the macro environment
- *Asset Allocation Weekly* (12/3/2021) (with associated podcast): "An Update on Gold"

In today's *Comment*, we open with a range of developments touching on the U.S. relationship with other major powers, including China and Russia. We then move on to other international developments. We close with the latest news related to the coronavirus pandemic, including some positive assessments of the Omicron variant, which are giving a further boost to global risk markets today.

United States-Russia-Ukraine: In a video call scheduled for today, President Biden is expected to tell President Putin that the U.S. and its NATO allies will impose steep costs on Russia if it invades Ukraine. The U.S. intelligence community has been warning that Putin may be preparing for an invasion, although CIA Director Burns emphasizes that it hasn't definitively concluded that Putin intends to carry it out. Kremlin spokesman Dmitry Peskov told Russia's Channel One state television channel that Putin was ready to listen to Biden's proposals on settling the situation in Ukraine but cautioned against excessive expectations.

- Ukrainian entry into NATO would be a clear red line for Russia and isn't likely soon. Nevertheless, the U.S. and other NATO countries have increased their military, diplomatic, and economic support for Kiev in recent years, in what President Putin probably sees as a creeping, informal embrace of Ukraine. Putin has seemingly decided to put his foot down on the matter and is essentially fomenting a crisis in order to exact

U.S. and NATO security guarantees. It is less likely that Putin actually intends to take over more of Ukraine, although the possibility can't be entirely discounted.

- All the same, it's important to remember that anytime two great powers lock horns, there is the risk of miscalculation or accident. We note that the Biden administration has already warned that a Russian invasion of Ukraine would lead to the U.S. beefing up its troop strength and equipment deployments in Eastern Europe. At the very least, strident rhetoric or saber-rattling on either side would likely spook the financial markets and drive oil and gas prices higher, especially in Europe.

United States-Saudi Arabia: U.S. officials are considering an urgent request from Saudi Arabia to replenish its stock of antimissile munitions.
- Saudi Arabia has been facing about a dozen ballistic missile and drone attacks each week from Houthi rebels based in Yemen.
- The Saudi military has successfully fended off most of the barrages with its Patriot surface-to-air missile system, but its arsenal of interceptors—missiles used to shoot down airborne weapons—has fallen dangerously low.
- The Saudi request is likely to be approved, but the U.S. decision is being seen as a test of the Biden administration's commitment to the Middle East and its allies there.

United States-China: U.S. Air Force Secretary Frank Kendall said his service is developing a pair of classified combat drones that are designed to operate alongside fighter planes and bombers. The disclosure is the strongest indication yet that the service is banking on autonomous weapon systems to give it an edge in the increasingly fierce military competition with China. Other autonomous military equipment being developed worldwide includes drone refueling tankers, drone ships and submarines, and drone resupply transports.

China Debt Crisis: Major real estate developer Evergrande (EGRNY, $5.97) failed to make an $82.5 million interest payment on some of its international debt by the end of a grace period last night, according to bondholders. If verified, the missed payment could trigger an official default and lead to a major restructuring.
- More important, a default by Evergrande would signal the government's firm intention to rein in debt and what it sees as excessive real estate investment.
- For the last several months, the government's moves have sparked sharp volatility in Chinese markets and beyond. And official default could prompt further volatility, especially if it is handled poorly or if it opens the floodgates to other defaults. Indeed, cushioning the potential blow to markets is likely one reason Chinese regulators yesterday loosened monetary policy, which is helping support developers' shares today.
- The clampdown on real estate debt is just one of several headwinds that we see for Chinese markets going forward. Other headwinds include the government's hyper-strict "zero-COVID" policies, new energy regulations that have crimped supply, and the rising U.S.-China geopolitical rivalry, which is decoupling the two countries in terms of both information and capital flows.

Peru: Just four months into his term, radical left-wing President Pedro Castillo faces an impeachment vote in the national legislature today. Although the vote is not expected to succeed, Castillo is facing rising anger and plummeting approval ratings because of a series of scandals and chaotic leadership.
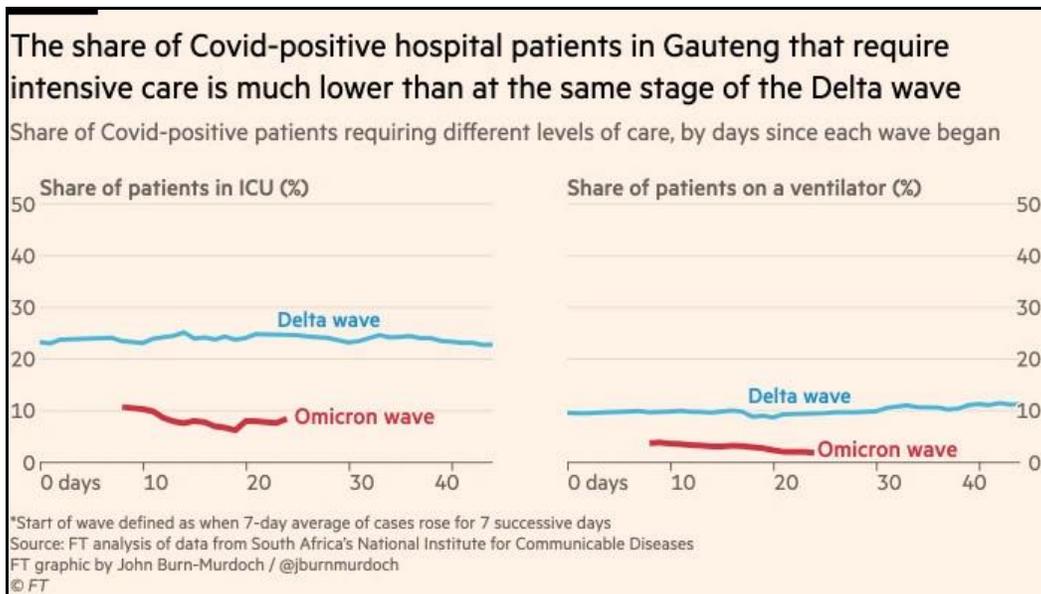
Ethiopia: With Tigrayan rebels advancing on the capital, masses of people are reportedly leaving their jobs to join the army, sparking concerns of all-out civil war and all the social and economic disruption that would likely flow from it.

United Arab Emirates: In an effort to improve the work/life balance (and better synchronize with global financial markets and business activity), the UAE government will shift the country's official workweek to Monday through noon on Friday, beginning January 1, shifting from the current Sunday through Thursday.

COVID-19: Official data show confirmed cases have risen to 266,622,610 worldwide, with 5,266,636 deaths. In the U.S., confirmed cases rose to 49,278,724, with 789,745 deaths. (For an interactive chart that allows you to compare cases and deaths among countries, scaled by population, click here.) Meanwhile, in data on the U.S. vaccination program, the number of people who have received at least their first shot totals 236,018,871 . The data show that 71.1% of the U.S. population has now received at least one dose of a vaccine, and 60.0% of the population is fully vaccinated.

Virology
- Physicians and scientists in South Africa have reported early hospital data suggesting the Omicron variant could result in less severe illness than previous waves; they also warned that higher transmission rates could still overwhelm hospitals. The good news has been a significant reason for the jump in global risk assets since yesterday. The chart below shows early data from hospitals in the key South African province of Gauteng.
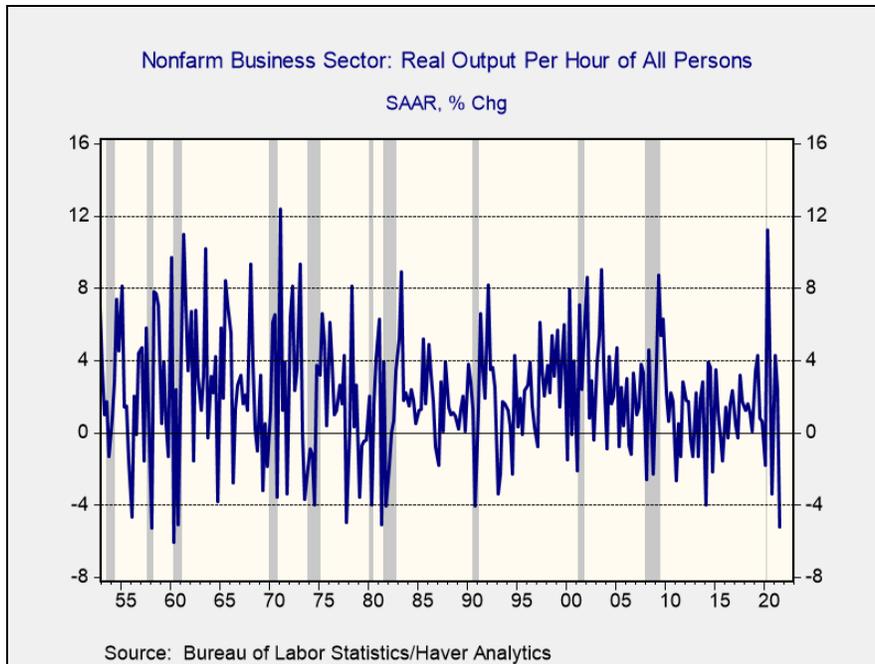

The share of Covid-positive hospital patients in Gauteng that require intensive care is much lower than at the same stage of the Delta wave

Share of Covid-positive patients requiring different levels of care, by days since each wave began

*Start of wave defined as when 7-day average of cases rose for 7 successive days
Source: FT analysis of data from South Africa's National Institute for Communicable Diseases
FT graphic by John Burn-Murdoch / @jburnmurdoch
© FT

- GlaxoSmithKline (GSK, $41.76) and Vir Biotechnology (VIR, $38.39) said their antibody treatment retained effectiveness against the Omicron variant in laboratory studies. Early data suggests similar treatments work less well against the strain, but the Glaxo/Vir statement is likely to feed into the newfound optimism regarding Omicron and will likely give further support to risk markets today.
- New data suggest the Chinese vaccines used widely in China and less developed countries are not as effective in stopping the spread of the disease as the advanced mRNA vaccines developed and used mostly in the developed countries of the West. However, they do appear to be effective in reducing the severity of an infection.
- In Brazil, which was the epicenter of the global pandemic at one point earlier this year, a mass vaccination campaign has brought daily deaths down to less than 200 per day. On a per-capita basis, that's now below the U.S., the U.K., and the EU.
- New York Mayor De Blasio yesterday issued a vaccine mandate that all private-sector employees working in person must be vaccinated by December 27, just days before he leaves office. De Blasio said more details about the rules and how they would be enforced will be released on December 15.
  - At present, it isn't clear whether incoming Mayor Eric Adams would maintain Mayor De Blasio's mandate.
  - In any case, the New York City mandate will likely be challenged in court.
- In a major policy speech opening a special session of parliament, Prime Minister Kishida vowed to accelerate the deployment of booster shots. He also announced the introduction of digital proof of vaccination using Japan's "My Number" social security system in tandem with taxation identification cards and smartphones starting December 20.

Economic and Financial Market Impacts
- European bond investors are beginning to worry more about an abrupt hawkish shift by the ECB when its policymakers meet next week. Concern is rising that the officials will be forced to abandon their previous plans to keep monetary policy loose for a prolonged period, based on the Eurozone's current high inflation, threats from the Omicron mutation, and the Fed's own recent hawkish shift.
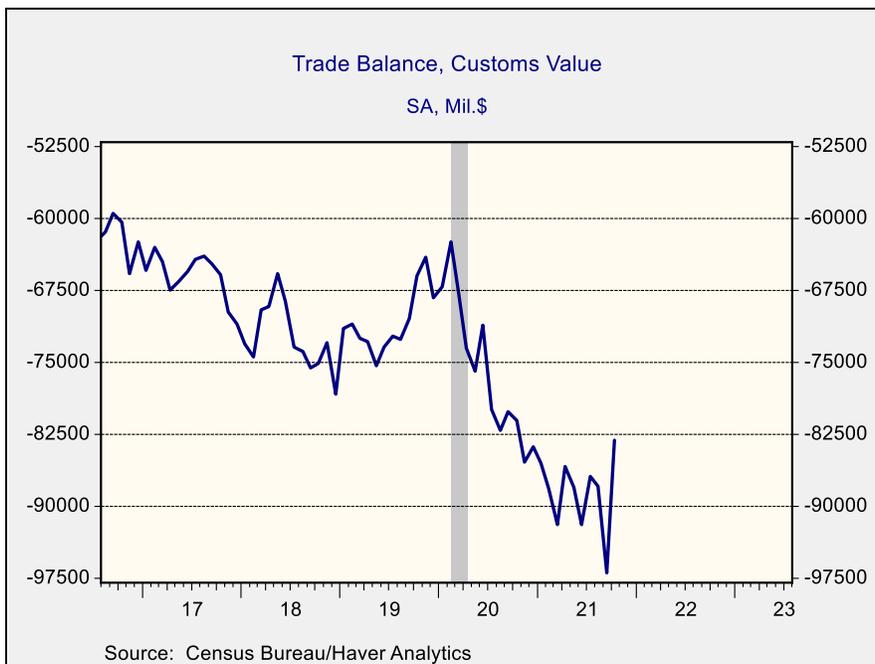
U.S. Economic Releases

Nonfarm productivity fell at its fastest pace in over 60 years, according to the Bureau Labor of Statistics. In the third quarter, nonfarm productivity fell at an annualized pace of 5.2% from the prior quarter compared to expectations of 4.9%. Meanwhile, labor costs accelerated at a much faster pace than expected. Unit labor costs rose 9.6% from the prior quarter compared to expectations of 8.3%.

Nonfarm Business Sector: Real Output Per Hour of All Persons

SAAR, % Chg

Source: Bureau of Labor Statistics/Haver Analytics

The chart above shows the annual change in nonfarm productivity.

In October, the U.S. trade gap shrank for the first time since July. The trade deficit came in at $67.1B compared to expectations of $66.8B. The prior month's trade balance was revised from $80.9B to $81.4B. The decline in the trade deficit was due to a huge spike in exports.

Trade Balance, Customs Value

SA, Mil.$

Source: Census Bureau/Haver Analytics

The chart above shows the level of the trade balance.

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

Economic Releases						Expected	Prior	Rating
EST	**Indicator**					**Expected**	**Prior**	**Rating**
15:00	Consumer Credit			m/m	Oct	$25.000b	$29.913b	**
Fed Speakers or Events								
No Fed speakers or events today								

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.

	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
China	Trade Balance	m/m	Nov	$71.72b	$84.54b	$83.60b	**	Equity and bond neutral
	Foreign Reserves	m/m	Nov	$3222.3b	$3217.61b	$3206.30b	*	Equity and bond neutral
Japan	Labor Cash Earnings	y/y	Oct	0.2%	0.2%	0.4%	**	Equity and bond neutral
	Real Cash Earnings	y/y	Oct	-0.7%	-0.6%	-0.5%	**	Equity and bond neutral
	Household Spending	y/y	Oct	-0.6%	-1.9%	-0.5%	**	Equity and bond neutral
	Leading Index CI	m/m	Oct	102.1	100.9	102.8	***	Equity and bond neutral
	Coincident Index	m/m	Oct	89.9	88.7	89.9	**	Equity and bond neutral
Australia	ANZ Roy Morgan Consumer Confidence	w/w	5-Dec	107.5	106.0		***	Equity and bond neutral
	House Price Index	y/y	3Q	21.7%	16.8%	21.7%	**	Equity and bond neutral
	Foreign Reserves	m/m	Nov	A$80.8b	A$76.0b		**	Equity and bond neutral
EUROPE								
Eurozone	Employment	y/y	3Q	2.1%	2.0%		***	Equity bullish, bond bearish
	GDP SA	y/y	3Q	3.9%	3.7%	3.7%	***	Equity bullish, bond bearish
	ZEW Survey Expectations	m/m	Dec	26.8	25.9		**	Equity bullish, bond bearish
France	Trade Balance	m/m	Oct	-7513m	-6777m	-6900m	**	Equity bearish, bond bullish
	Current Account Balance	m/m	Oct	-2.6b	-2.7b		***	Equity and bond neutral
Germany	Industrial Production SA	m/m	Oct	2.8%	-1.1%	1.0%	***	Equity bullish, bond bearish
	ZEW Survey Expectations	m/m	Dec	29.9	31.7	25.4	***	Equity bullish, bond bearish
Switzerland	Unemployment Rate	m/m	Nov	2.5%	2.5%	2.6%	***	Equity and bond neutral
	Foreign Currency Reserves	m/m	Nov	1006.4b	923.0b		**	Equity and bond neutral
AMERICAS								
Brazil	Trade Balance Weekly	w/w	5-Dec	$1075m	-$818m		**	Equity bullish, bond bearish
	FGV Inflation IGP-DI	m/m	Nov	-0.58%	1.60%	-0.51%	**	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)	19	18	1	Down
3-mo T-bill yield (bps)	4	5	-1	Neutral
TED spread (bps)	15	13	2	Neutral
U.S. Libor/OIS spread (bps)	9	8	1	Down
10-yr T-note (%)	1.44	1.44	0.00	Down
Euribor/OIS spread (bps)	-56	-56	0	Neutral
EUR/USD 3-mo swap (bps)	22	22	0	Down
Currencies	Direction			
Dollar	Flat			Neutral
Euro	Down			Up
Yen	Down			Neutral
Pound	Flat			Neutral
Franc	Flat			Neutral
Central Bank Action	Current	Prior	Expected	
RBA Cash Rate Target	0.100%	0.100%	0.100%	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
Energy Markets				
Brent	$74.95	$73.08	2.56%	Omicron fears ease
WTI	$71.57	$69.49	2.99%	
Natural Gas	$3.74	$3.66	2.35%	
Crack Spread	$18.38	$18.27	0.65%	
12-mo strip crack	$19.01	$18.84	0.89%	
Ethanol rack	$3.37	$3.43	-1.55%	
Metals				
Gold	$1,780.68	$1,778.67	0.11%	
Silver	$22.41	$22.39	0.12%	
Copper contract	$437.50	$433.75	0.86%	
Grains				
Corn contract	$584.25	$583.50	0.13%	
Wheat contract	$804.50	$806.25	-0.22%	
Soybeans contract	$1,259.00	$1,261.50	-0.20%	
Shipping				
Baltic Dry Freight	3,235	3,171	64	
DOE inventory report				
	Actual	Expected	Difference	
Crude (mb)		-1.8		
Gasoline (mb)		1.7		
Distillates (mb)		1.4		
Refinery run rates (%)		0.45%		

Weather

The 6-10 day and 8-14-day forecasts currently call for warmer-than-normal temperatures throughout the eastern two-thirds of the country, with cooler-than-normal temperatures only on the West Coast. The forecasts call for wet conditions in the Pacific and the Midwest, with dry conditions in the Southwest, Rocky Mountains, and Florida.

Data Section

U.S. Equity Markets – (as of 12/6/2021 close)
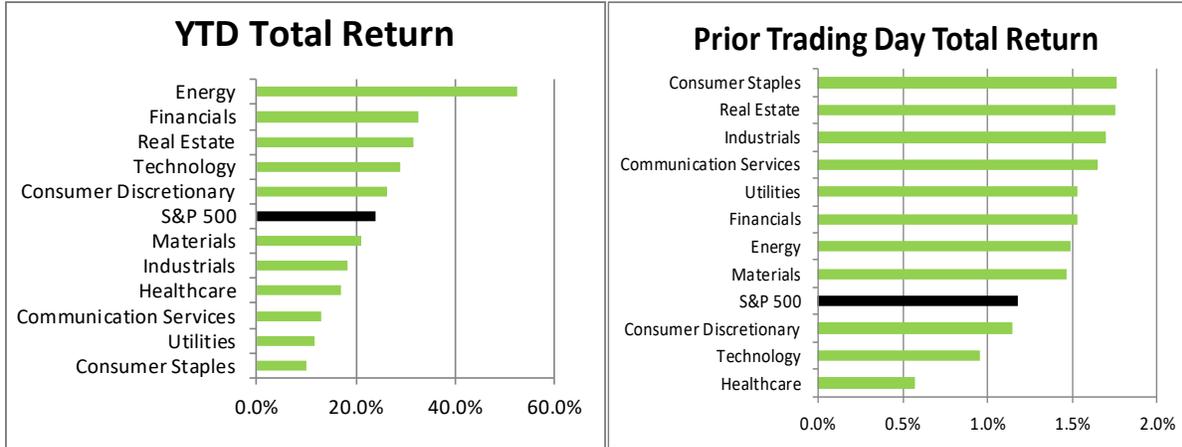
(Source: Bloomberg)

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 12/6/2021 close)
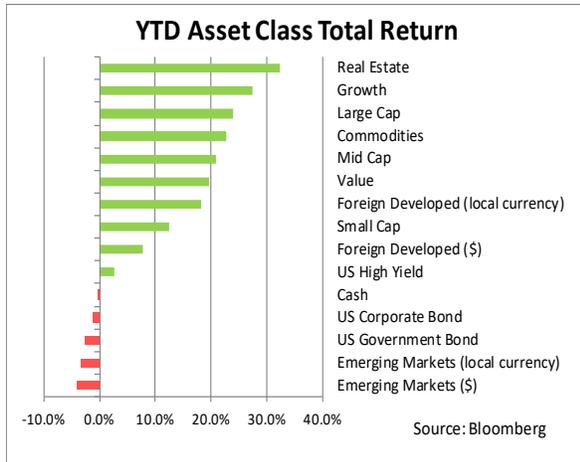
This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 2, 2021
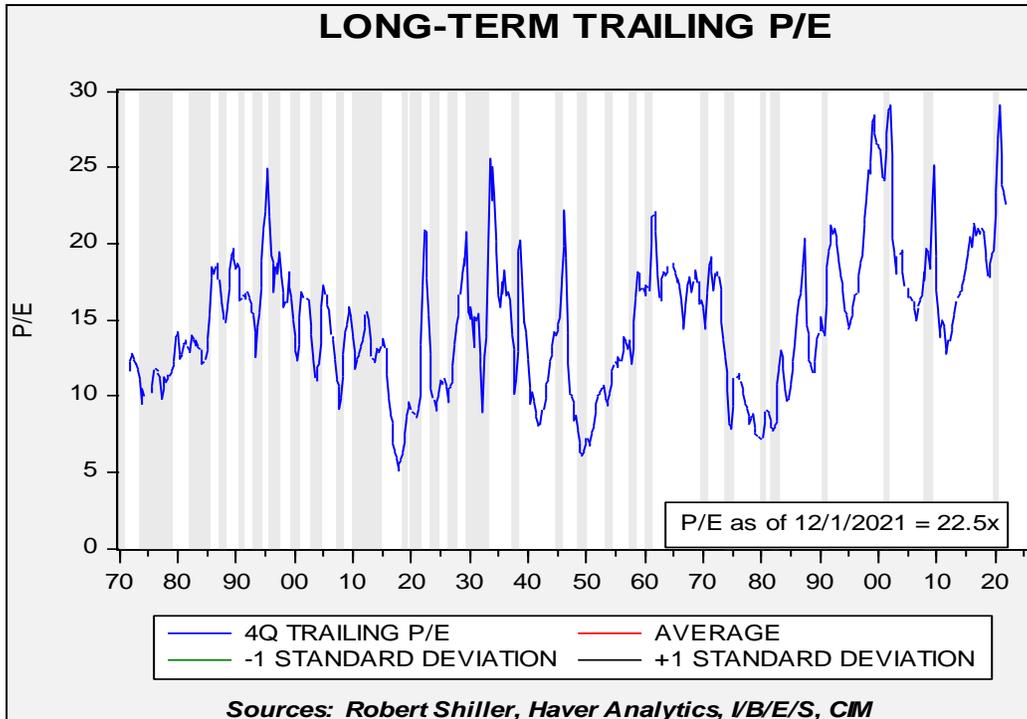
Based on our methodology,[1] the current P/E is 22.3x, up 0.3x from our last update. Some of the rise reflects the transition from Thomson/Reuters to Standard & Poor's measurement of Q3 earnings.

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 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.