

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, 2022—9:30 AM EST]** Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is down 0.6% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 2.2%. Chinese markets were mixed, with the Shanghai Composite closing down 0.4% from its prior close and the Shenzhen Composite closing up 0.2%. 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 this [81<sup>st</sup> anniversary of the surprise attack on Pearl Harbor](#). Only a few surviving servicemen will visit this site today, a reflection of the aging of the WWII generation. A 17-year-old serviceman in 1941 would be 98 today. In the markets it is another rather quiet morning. Earlier this morning, [U.S. equity futures and oil were lower](#) but have turned higher in the past hour while the dollar is mixed.

In today's *Comment*, our coverage begins with China news. International news comes next, and our update on the war in Ukraine follows. Coverage of economic and market news is next in line, and we close with a roundup of U.S. news.

**China News:** China is moving rapidly to ease COVID restrictions and there is some evidence of a thaw in U.S./China tech relations.

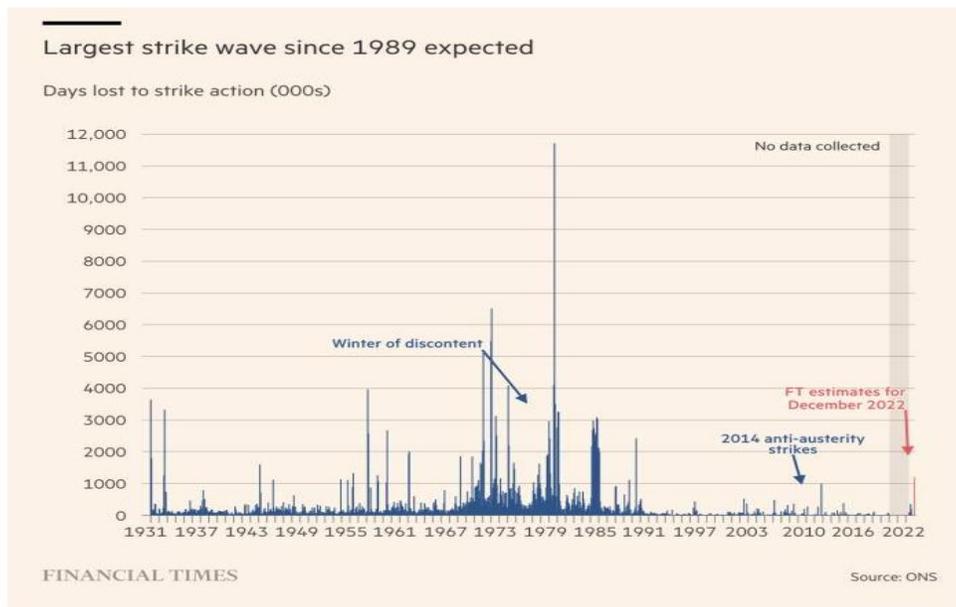
- So far, there has been no national announcement of an end to Zero-COVID policies, but we are seeing a [rapid dismantling](#) of the restrictions. Here are some of the changes:
  - The Beijing Capital Airport has [dropped its negative test requirement](#) to enter terminals. If this becomes adopted broadly, it should dramatically ease air travel in China.
  - Instead of sending [infected patients to quarantine centers](#), [those afflicted can now convalesce at home](#). Unfortunately, because there have been no national guidelines issued, local government reactions have been varied. Some podcasts we monitor on China report that local officials sometimes weld rebar on doors to ensure that those with the virus don't venture out. In other areas, citizens are self-policing.
  - [Testing requirements](#) are ending in most areas.
- An important element of the adjustment to policy is expanded vaccinations. A key worry is the low level of immunizations found among the elderly, who are especially vulnerable to COVID. China is facing [strong resistance](#) to vaccination among its older population.
- This opening brings risks with some models suggesting up to [one million deaths could result](#). But with rising social unrest and a soft economy, Beijing likely feels it has little option but to ease restrictions. As we noted yesterday, the narrative around the Omicron variant is that it isn't as deadly as earlier strains. Although there is some data to support that idea, it is also true that in the West, by the time Omicron was circulating, vaccinations and widespread infections were already in place and resistance was therefore elevated. In China, with fewer vaccinations and infections, the fast-spreading variant could be a problem.
- A surge in infections could not just overburden the health system, [it could expose health workers to the virus](#).
- The recent actions to thwart China's efforts to acquire advanced semiconductor chips and the tools to build them is leading to some adjustments. Corporate America is generally opposing the turn against China and their lobbying efforts are leading [Congress to ease restrictions](#). On China's side, Beijing is [allowing U.S. officials to enforce export controls](#) to ensure that chips don't end up in the hands of the military. We don't think these measures will change the trajectory of policy, but it does show how hard it is to enforce economic restrictions on a country like China, who is deeply enmeshed in the global economy.
  - Another sign of the thaw are [moves by Chinese regulators to allow real estate firms to service foreign debt](#). Throughout the real estate crisis, China has focused on domestic interests, mostly allowing foreigners to bear the brunt of the

adjustment. However, it appears that Chinese officials have concluded that harming foreign investors may weaken their economy in the long run.

- TikTok continues to be a problem for U.S. security officials. The government remains worried that China will use the platform [not only to collect data](#) but to execute [influence operations](#).

**International News:** Germany uncovers a right-wing coup plot, and Argentina’s vice-president has been found guilty of fraud.

- [Twenty-five people were arrested](#) from three countries on suspicion of a coup to [overthrow the German government](#). Among those detained is a [former AfD lawmaker, and a member of Germany’s special forces](#). It isn’t obvious if the plot was gaining traction or close to operational capacity. Some members did contact Russian intelligence, but there isn’t any evidence that the Russians were involved. Germany has a neo-Nazi undercurrent that resurfaces on occasion. During the 1970s, left-wing groups associated with communist factions, [such as the Baader-Meinhof Gang](#), were prevalent. None, so far, have seriously threatened the government.
- Cristina Fernández de Kirchner, the current vice-president, a former president, and the wife of a late president, [was convicted of fraud by an Argentine court](#). She was [sentenced to six-years in prison](#) and barred from public office for steering public works funding to a family associate while she was president and first lady. In the short run, nothing will change. She will appeal her conviction and during the appeal process, she will remain in office. Her term ends next December, so it is likely she will leave office without the case being resolved. The Kirchners are polarizing figures in Argentina; though, if the conviction sticks, it may mean the end of her family’s influence in the country.
- The U.K. is facing a wave of labor discontent. PM Sunak is [considering anti-strike legislation](#) to stem the tide.



**War in Ukraine:** More on the Ukraine strikes inside Russia, and Hungary blocks aid.

- The recent drone attacks (apparently on [three airfields](#)) carried out by Ukraine have [put the U.S. in a delicate position](#). Washington does not want to see this war escalate, and thus, isn't supportive of these attacks. However, it is also aware that Russia has been attacking Ukrainian infrastructure, so it can't really tell Kyiv not to attack Russia proper. One goal of Ukraine was to force Russia to [expend resources to defend these airfields](#). That [goal has apparently been met](#).
- The EU and Hungary have been at loggerheads over a number of issues, including immigration and social policy. In response, the EU has blocked funds to Hungary, and this decision led [Hungary to veto aid to Ukraine](#). The EU is looking for ways to [circumvent the veto](#).
- Although there have been steady calls for peace talks, the head of NATO suggests conditions for those talks are "[not there now](#)."

**Markets, Economics and Policy:** Lumber futures rise, and supply chain issues slow arms sales.

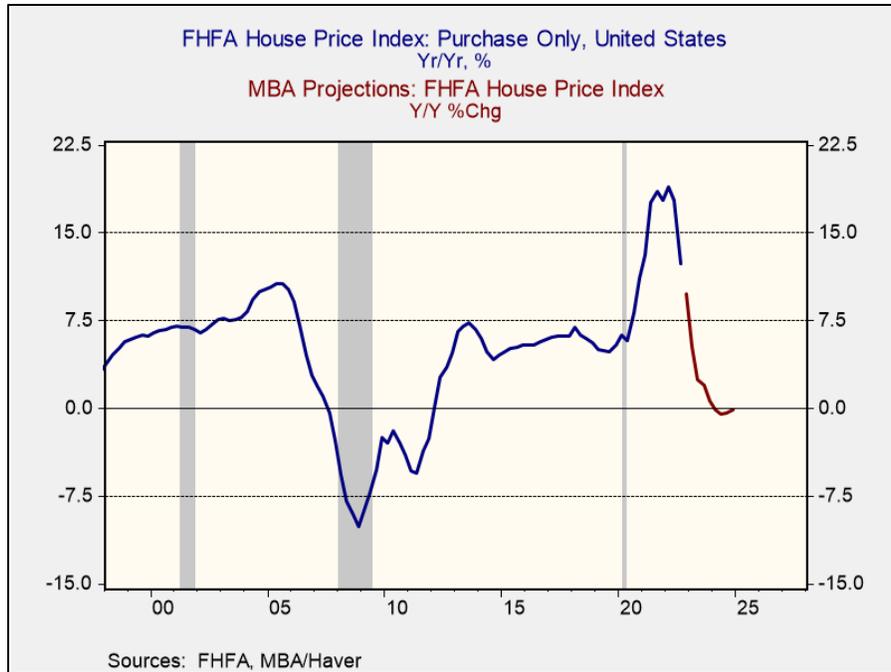
- Lumber prices soared during the pandemic, as there was a lift in housing and remodeling. However, the rally failed as time passed, and prices slid. Although prices remain well below pandemic highs, [prices jumped to their daily futures limit](#) on reports that Canfor (CFPZF, \$17.20) has cut mill output due to the falling demand.
- Arms demand is elevated due to the war in Ukraine and the general rebuilding of defense. However, [supply chain issues and rising costs have cut sales](#) over the past few months.

**U.S. News:** Part of North Carolina remains without power, and the Georgia Senate seat remains with Democrats.

- [Utilities are struggling to fix the sabotaged substations in North Carolina](#). It is still uncertain who was behind the attacks, but the event highlights the need for redundancies. It would be prohibitively expensive to defend all infrastructure, but holding inventory of critical parts would likely speed recovery. Of course, inventory costs money and reduces efficiency.
- Raphael Warnock (D-GA) [won a new six-year term](#) by defeating Hershel Walker. This gives the Democrats a 51-49 advantage in the Senate.
- Rackspace Technology (RXT, \$3.95) reported a [massive ransomware attack](#). The company hosts emails and cloud computing, mostly for business.

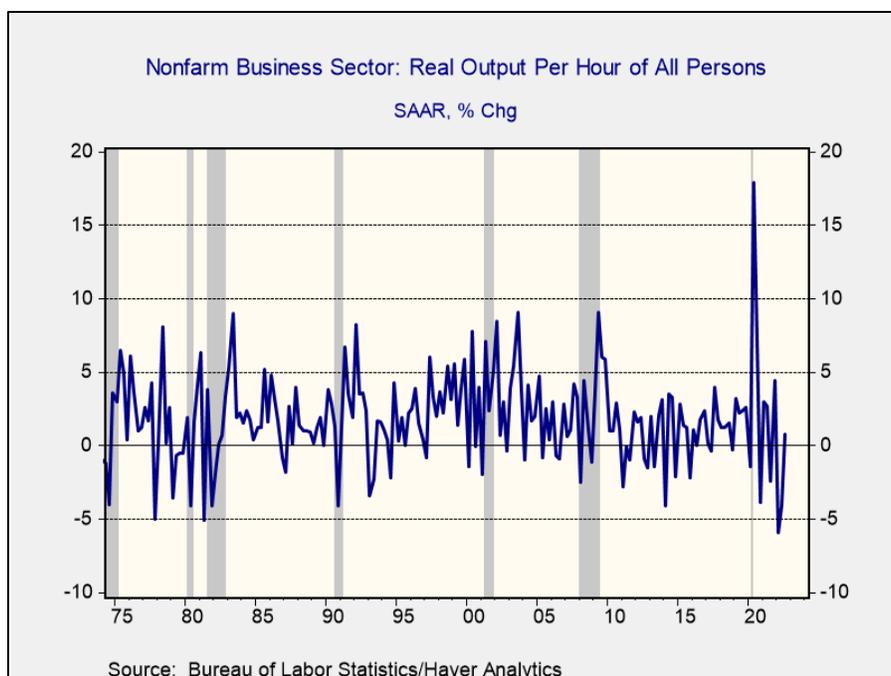
## U.S. Economic Releases

Despite lower interest rates, people are still hesitant to return to the housing market. According to an index tracked by the Mortgage Bankers Associations, mortgage applications fell 1.9% in the week ending December 2. The drop in applications is likely related to potential buyers waiting to see if home prices will decline. MBA projections of the FHFA House Price Index show that the U.S. is a little over a year away from an annual decline in property values.



That said, lower borrowing costs made withdrawing equity from property more attractive for homeowners but did little to improve housing affordability. Last week, the 30-year fixed-rate mortgage fell 8 bps from 6.49% to 6.41%. As a result, the MBA tracker for purchases fell 3.0% from the week prior, while the refinance tracker rose 4.7% in the same period.

A slight increase in employee production efficiency helped offset some of the rise in labor costs in the previous quarter. According to the Bureau of Labor Statistics, worker productivity, as measured by output per hour, increased at a 0.8% annual rate in the third quarter. The reading is above the previous reading of 0.3% and consensus estimate of 0.6%. The rise in productivity suggests that firms are getting more bang for their buck. As a result of the increase in productivity, unit labor costs were revised downward from a 3.5% annual rate to 2.4%.



The chart above shows the annualized change in U.S. nonfarm productivity. A rise in productivity should make it easier for firms to absorb rising costs thus leading to a reduction in price pressures.

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

Economic Releases						
EST	Indicator			Expected	Prior	Rating
15:00	Consumer Credit	m/m	Oct	\$28.000b	2497.6%	*
Federal Reserve						
No Fed speakers or events for the rest of 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.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
<b>ASIA-PACIFIC</b>								
Japan	Leading Economic Index	m/m	Oct P	99.0	97.5	98.3	**	Equity and bond neutral
Australia	GDP	y/y	3Q F	5.9%	3.6%	3.2%	**	Equity bullish, bond bearish
China	Foreign Reserves	m/m	Nov	\$3.117b	\$3.052t	\$3.102t	**	Equity and bond neutral
	Trade Balance	m/m	Nov	\$69.84b	\$85.15b	\$78.10b	***	Equity and bond neutral
	Exports	y/y	Nov	-8.7%	-0.3%	-3.9%	**	Equity bearish, bond bullish
	Imports	y/y	Nov	-10.6%	-0.7%	-7.1%	**	Equity bearish, bond bullish
<b>EUROPE</b>								
Eurozone	GDP	y/y	3Q F	2.3%	2.1%	2.1%	***	Equity and bond neutral
Germany	Industrial Production WDA	y/y	Oct	0.0%	2.3%	3.1%	**	Equity bearish, bond bullish
France	Trade Balance	m/m	Oct	-12.150b	-17.487b	-15.971b	**	Equity and bond neutral
	Current Account Balance	m/m	Oct	-3.8b	-7.3b		**	Equity and bond neutral
Italy	Retail Sales	y/y	Oct	1.3%	4.1%	4.0%	**	Equity bearish, bond bullish
Switzerland	Unemployment Rate	m/m	Nov	2.0%	1.9%	2.1%	**	Equity and bond neutral
	Foreign Currency Reserves	m/m	Nov	790.0b	817.2b	816.9b	***	Equity and bond neutral
Russia	Official Reserve Assets	m/m	Nov	567.3b	547.2b		*	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)	472	473	-1	Up
3-mo T-bill yield (bps)	421	420	1	Up
TED spread (bps)	51	53	-2	Widening
U.S. Sibor/OIS spread (bps)	447	445	2	Up
U.S. Libor/OIS spread (bps)	449	448	1	Up
10-yr T-note (%)	3.55	3.53	0.02	Up
Euribor/OIS spread (bps)	199	198	1	Neutral
<b>Currencies</b>	<b>Direction</b>			
Dollar	Down			Down
Euro	Up			Up
Yen	Down			Up
Pound	Up			Up
Franc	Flat			Up
<b>Central Bank Action</b>	<b>Current</b>	<b>Prior</b>	<b>6.25</b>	
RBI Repurchase Rate	6.250%	5.900%	6.250%	On Forecast
RBI Cash Reserve Ratio	4.500%	4.500%	4.500%	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.

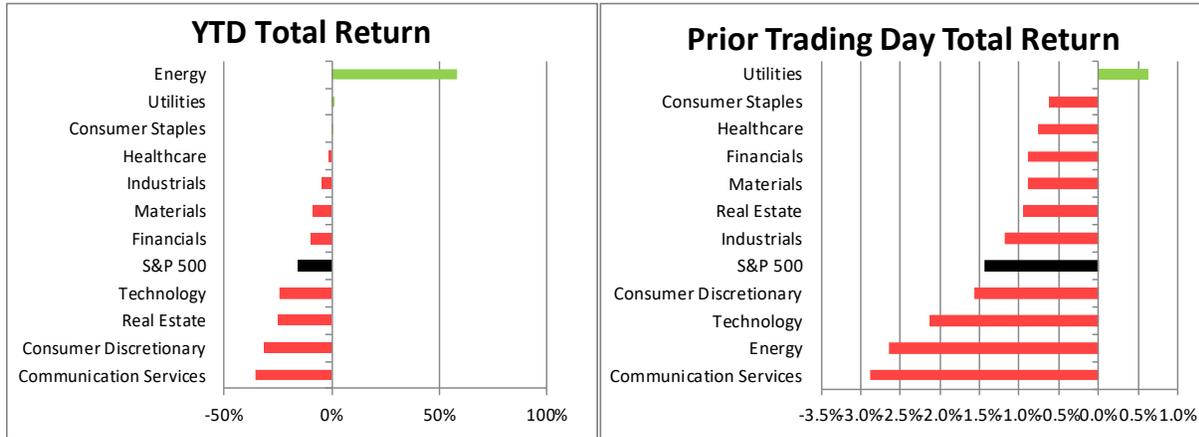
	Price	Prior	Change	Explanation
<b>Energy Markets</b>				
Brent	\$79.44	\$79.35	0.11%	
WTI	\$74.39	\$74.25	0.19%	
Natural Gas	\$5.67	\$5.47	3.69%	Supply Pessimism
Crack Spread	\$26.67	\$26.71	-0.14%	
12-mo strip crack	\$27.15	\$27.15	0.00%	
Ethanol rack	\$2.41	\$2.42	-0.24%	
<b>Metals</b>				
Gold	\$1,771.75	\$1,771.04	0.04%	
Silver	\$22.33	\$22.19	0.64%	
Copper contract	\$379.70	\$381.80	-0.55%	
<b>Grains</b>				
Corn contract	\$636.25	\$637.25	-0.16%	
Wheat contract	\$736.75	\$729.00	1.06%	
Soybeans contract	\$1,461.00	\$1,455.00	0.41%	
<b>Shipping</b>				
Baltic Dry Freight	1,340	1,323	17	
<b>DOE Inventory Report</b>				
	<b>Actual</b>	<b>Expected</b>	<b>Difference</b>	
Crude (mb)		-3.4		
Gasoline (mb)		2.5		
Distillates (mb)		2.4		
Refinery run rates (%)		0.3%		
Natural gas (bcf)		-38		

## Weather

The 6-10 and 8-14 day forecasts show that warmer-than-normal temperatures in the eastern half of the country are expected to recede to the East Coast. 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 throughout the forecasting period. We are watching a rare subtropical storm that may develop into Tropical Storm Owen. Currently the storm is located in the middle of the Atlantic Ocean and has a 50% chance of cyclone formation within the next 48 hours.

**Data Section**

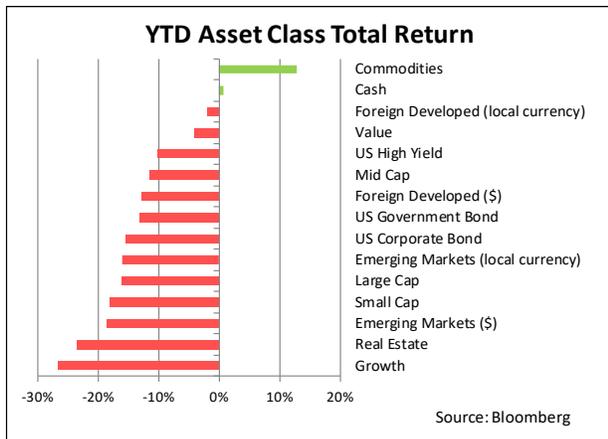
**U.S. Equity Markets – (as of 12/06/2022 close)**



(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 12/06/2022 close)**

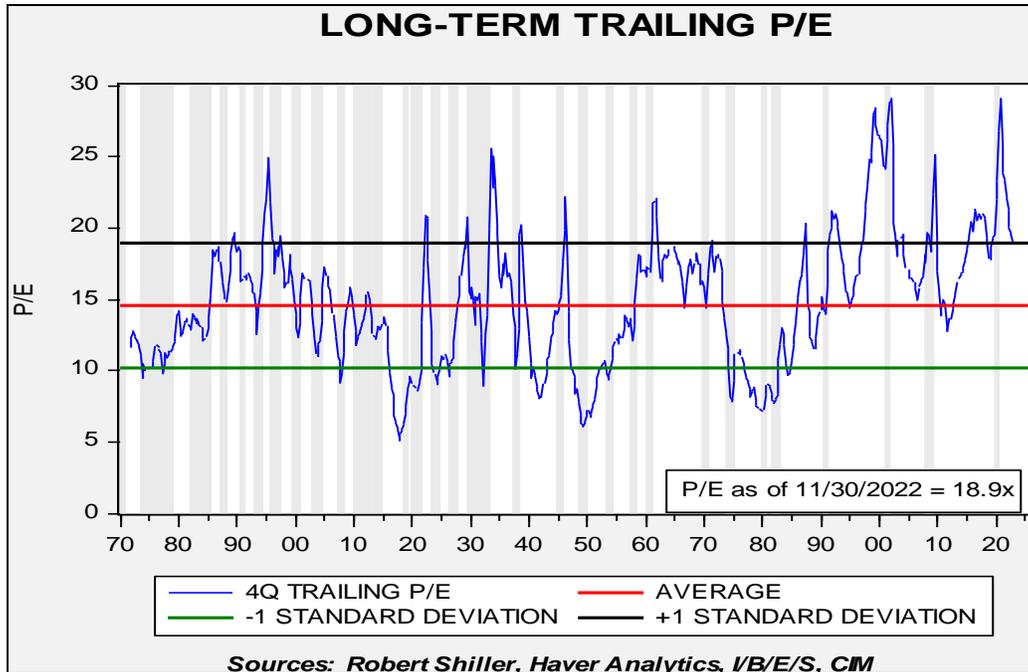


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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>1</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>1</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.