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: December 20, 2022—9:30 AM EST] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is down 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.2%. Chinese markets were lower, with the Shanghai Composite down 1.1% and the Shenzhen Composite closing down 1.6%. 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:

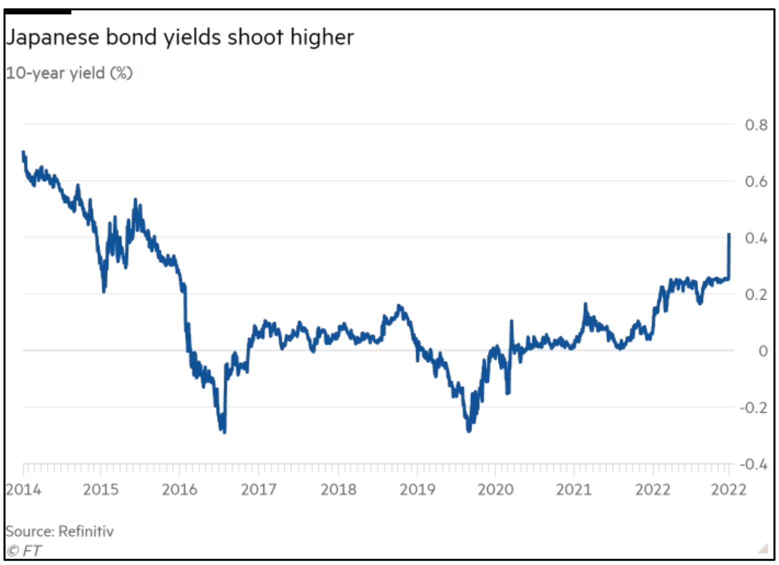
- *Bi-Weekly Geopolitical Report* (12/12/2022) **(associated podcast is available)** "The 2023 Geopolitical Outlook"
- *Weekly Energy Update* (12/15/2022): In this week's report, we discuss President Xi's visit to Saudi Arabia and mention the news on nuclear fusion.
- *Asset Allocation Quarterly – Q4 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) (with associated podcast): "Forecasting Financial Stress." *The next* AABW *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 (12/19/2022): "The 2023 Geopolitical Outlook"**

Note to readers: the* Daily Comment *will go on holiday after today's Comment and will return on January 3, 2022. From all of us at Confluence Investment Management, have a Merry Christmas and a Happy New Year!

Our *Comment* today opens with a surprising monetary tightening in Japan that has had a significant impact on global markets so far this morning. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including the release of a new U.S. spending bill for 2023 that should eliminate the risk of a partial shutdown of the federal government when the current spending authorization runs out at the end of the week.

Japan: In its latest policy decision, the Bank of Japan kept its benchmark short-term interest rate unchanged at -0.5%, but then surprised investors with a hawkish change to its yield-curve-control policy. The BOJ said that it would now allow the yield on 10-year government bonds to rise as high as 0.50%, from a limit of 0.25% previously. BOJ Governor Kuroda insisted that the change was aimed only to improve the functioning of Japan's bond market, but the move is being taken as a sign that the central bank has finally been forced to respond to rising inflation and the weak JPY.

- The decision has driven important moves in several key markets so far this morning:
  - Japanese 10-year government bond yields jumped to approximately 0.40% immediately after the decision, pushing up government bond yields in many other countries as well.
  - More importantly, the JPY so far this morning has strengthened some 3.1% to 132.59 per dollar, from about 137.00 per dollar before the decision.
  - Japanese stock values fell approximately 2.5% on the prospect of a stronger JPY and higher borrowing rates.
- It remains to be seen whether and how aggressively Japanese monetary policy will continue to tighten. Nevertheless, the reactions to today's BOJ move illustrate how sharply markets can move in response to a sudden unhinging of policy. For example, the market reaction suggests a similar big impact on the dollar if the Federal Reserve were to lift its target inflation rate above the current 2.0%.



China: After abandoning President Xi's Zero-COVID policy and with a new wave of COVID-19 infections sweeping across the country and disrupting the economy, Chinese state media has taken to describing this "exit wave" as well planned and temporary. A report in the state-run *China Daily* today promises "normalcy by spring."

China-Hong Kong: Securities regulators in China and Hong Kong have agreed to expand the scope of their "Stock Connect" program, under which investors can access mainland stock markets through the Hong Kong bourse. Northbound investments can now include stocks that have a market capitalization exceeding about $717 million or that meet certain liquidity criteria. Southbound investments can now include stocks of primary-listed foreign companies that are constituents of Hang Seng composite indices.

- The move will boost the number of mainland stocks eligible for trading via the northbound link to about 2,516, up from the current 1,458.
- Nevertheless, despite other recent signs that the Chinese government wants to ease tensions with the West in order to support its economy, we still believe the long-term geopolitical competition between China and the West will make it riskier and more difficult for U.S. investors to invest in China.

Russia-Ukraine War: Fighting continues along the front lines running from northeastern to southern Ukraine, while yesterday the Russians launched a new swarm of Iranian kamikaze drones against Kyiv. Ukrainian military officials believe that the Russians should only be able to launch three or four more rounds of missiles into Ukraine before they will deplete their available inventory, after which they will need to procure Iranian ballistic missiles, which Ukraine would have trouble defending against. Meanwhile, Russian President Putin traveled to Minsk yesterday but apparently failed to get President Lukashenko's agreement to deepen Belarus's participation in the war.

European Union: As we previewed in our *Comment* yesterday, EU energy ministers agreed to impose a price cap if month-ahead prices remain above €180 per megawatt hour on the bloc's main trading hub for three consecutive days. Prices must also be at least €35 higher than a reference level for global LNG during the same period. The new rule goes into effect on February 15. One key risk with the policy is that it could prompt shippers to divert natural gas shipments to Asia or other locales where prices may be unregulated and much higher.

United States-European Union: Facing strong pushback from the EU against its new subsidies for U.S.-made green technology, the Biden administration yesterday delayed its proposed rules for new tax incentives related to electric vehicles. Details on the battery-sourcing requirements that electric vehicles must meet in order to qualify for up to $7,500 in tax credit will now be released in March, instead of by the end of this year as earlier planned.

- The delay suggests that the administration is showing some alliance-building sensitivity to EU leaders, who worry that the U.S. subsidies will hurt the EU's green technology sector. Indeed, German Economy Minister Habeck and French Finance Minister Le Maire today issued a joint paper arguing that the U.S. and EU have a mutual interest in swiftly finding common ground on the controversy.
- All the same, it's important to remember that the U.S. administration has encouraged the EU to adopt similar subsidies as a way to reduce their economic dependence on China.

United States-Congo-Zambia: Last week, the U.S. signed a memorandum of understanding with the Democratic Republic of Congo and Zambia to provide them with the funding and technical expertise to develop their supply chains for minerals related to electric-vehicle batteries. The move shows how the U.S. is working to reverse its disadvantage in the supply of exotic minerals needed for the electrified economy of the future.

- Importantly, the U.S. move also has important geopolitical considerations. We assess that the Congo is currently a member of the evolving China-led geopolitical bloc, while Zambia is in the "leaning China" bloc.
- The U.S. move illustrates how the U.S. and China are likely to work feverishly to peel countries out of their adversary's blocs in order to ensure access to critical mineral supplies.

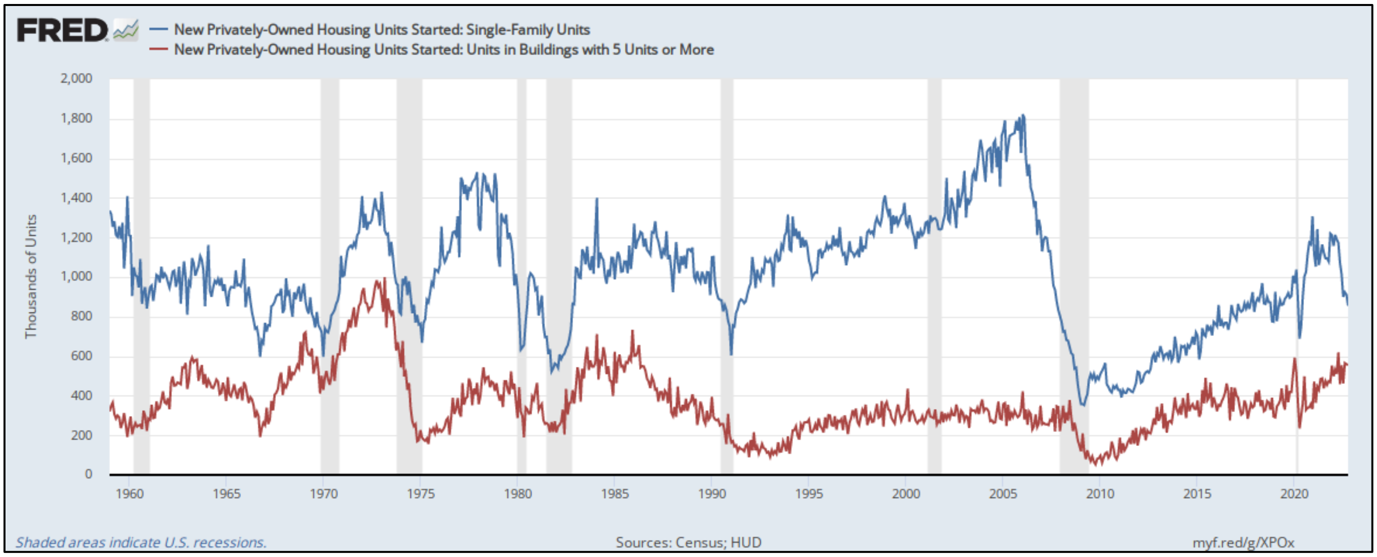
U.S. Fiscal Policy: Earlier today, congressional leaders unveiled an agreed spending bill for the remainder of the 2023 fiscal year. The bill, which must be passed and signed into law by the end of the week to avoid a partial government shutdown, includes $858 billion in military spending, or $45 billion more than President Biden had requested and up about 10% from $782 billion the prior year. It also reportedly includes $773 billion in nondefense discretionary spending, up almost 6% from $730 billion from the prior year.

U.S. Retirement Policy: The spending bill expected to be signed into law in the coming days also includes several important changes to the laws related to retirement savings. For example:

- The bill raises the age at which people are required to start withdrawing money from tax-deferred retirement accounts from 72 today to 73 beginning in 2023 and to 75 in 2033
- It also increases the catch-up contributions older workers are allowed to make to their 401(k)-style retirement accounts. In 2023, people 50 and older will be able to contribute an extra $7,500 a year to these accounts. The bill would also raise the catch-up amount to at least $11,250 a year for people 60 to 63 beginning in 2025.

U.S. Economic Releases

Homebuilders are cutting back on construction activity in a sign that economy growth is slowing. Housing starts expanded at an annualized rate of 1427k in November. The figure was slightly above expectations of 1400k, but slightly below the previous month's revised reading of 1434k. Additionally, applications for building permits slowed from an annual pace of 1510k in October to 1342k in the following month. The reading was well below expectations of 1480k.



The chart above shows the level of housing starts for multi- and single-family homes. Last month, single family homes starts expanded at an annualized rate of 856k, meanwhile multi-family home starts with 5 or more units expanded at an annual pace of 555k.

There are no economic releases and/or Fed events scheduled 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
ASIA-PACIFIC								
New Zealand	ANZ Activity Outlook	m/m	Dec	-25.6	-13.7		**	Equity and bond neutral
	ANZ Business Confidence	m/m	Dec	-70.2	-57.1		**	Equity and bond neutral
EUROPE								
Germany	PPI	y/y	Nov	28.2%	34.5%	30.0%	**	Equity bullish, bond bearish
Switzerland	Real Exports	m/m	Feb	-2.8%	-1.8%	-2.2%	*	Equity and bond neutral
	Real Imports	m/m	Feb	-0.6%	-0.8%	-0.3%	*	Equity and bond neutral
AMERICAS								
Canada	Retail Sales	m/m	Oct	1.4%	-0.5%	-0.6%	**	Equity bullish, bond bearish
	Retail Sales Ex-Autos	m/m	Oct	1.7%	-0.7%	-0.8%	**	Equity bullish, bond bearish
Mexico	Retail Sales	y/y	Oct	3.8%	3.3%	3.6%	***	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)	475	474	1	Up
3-mo T-bill yield (bps)	418	421	-3	Up
TED spread (bps)	57	53	4	Widening
U.S. Sibor/OIS spread (bps)	453	452	1	Up
U.S. Libor/OIS spread (bps)	454	454	0	Up
10-yr T-note (%)	3.66	3.59	0.07	Up
Euribor/OIS spread (bps)	206	205	1	Neutral
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Up			Up
Pound	Flat			Up
Franc	Up			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Japan Policy Balance Rate	-0.100%	-0.100%	-0.100%	On Forecast
Bank of Japan 10-Yr Yield Target	0.000%	0.000%	0.000%	On Forecast
PBOC 1-Year Loan Prime Rate	3.650%	3.650%	3.650%	On Forecast
PBOC 5-Year Loan Prime Rate	4.300%	4.300%	4.300%	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.

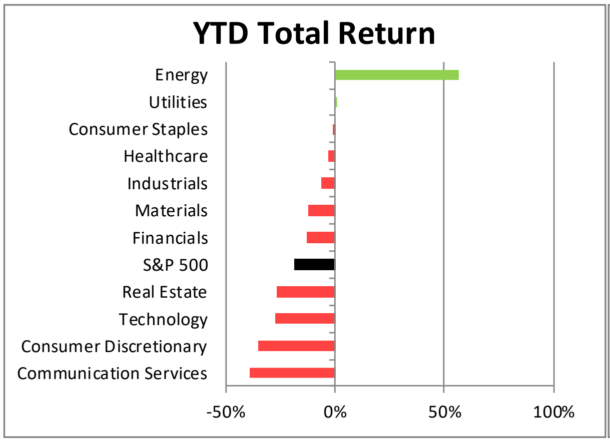
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$80.08	$79.80	0.35%	
WTI	$76.19	$75.19	1.33%	
Natural Gas	$5.67	$5.85	-3.11%	
Crack Spread	$28.61	$28.63	-0.07%	
12-mo strip crack	$27.19	$27.41	-0.78%	
Ethanol rack	$2.36	$2.35	0.17%	
Metals				
Gold	$1,805.01	$1,787.62	0.97%	
Silver	$23.68	$22.99	3.03%	
Copper contract	$378.95	$378.30	0.17%	
Grains				
Corn contract	$649.00	$647.25	0.27%	
Wheat contract	$747.25	$748.50	-0.17%	
Soybeans contract	$1,466.25	$1,463.50	0.19%	
Shipping				
Baltic Dry Freight	1,548	1,560	-12	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.5		
Gasoline (mb)		2.5		
Distillates (mb)		0.5		
Refinery run rates (%)		0.2%		
Natural gas (bcf)		-51		

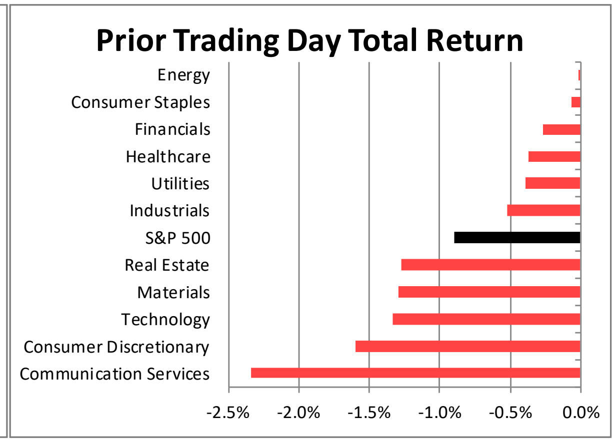
Weather

The 6-10 and 8-14 day forecasts show warmer-than-normal temperatures for the western half of the country which is expected to spread throughout the rest of the country over the next two weeks. Wet conditions are expected to spread from the Northern Pacific region throughout most of the country, with dry conditions remaining in the Southwestern states.

Data Section

U.S. Equity Markets – (as of 12/19/2022 close)

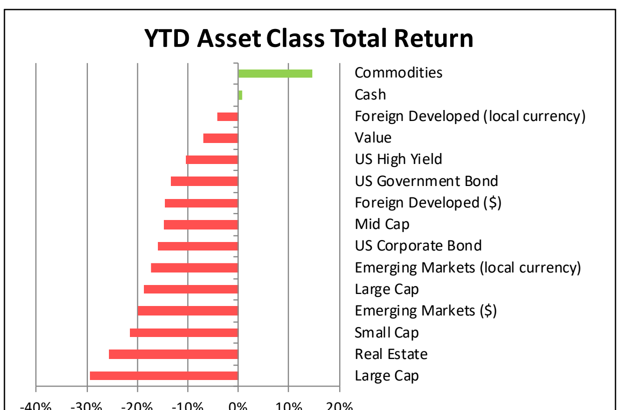




(Source: Bloomberg)

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 12/19/2022 close)



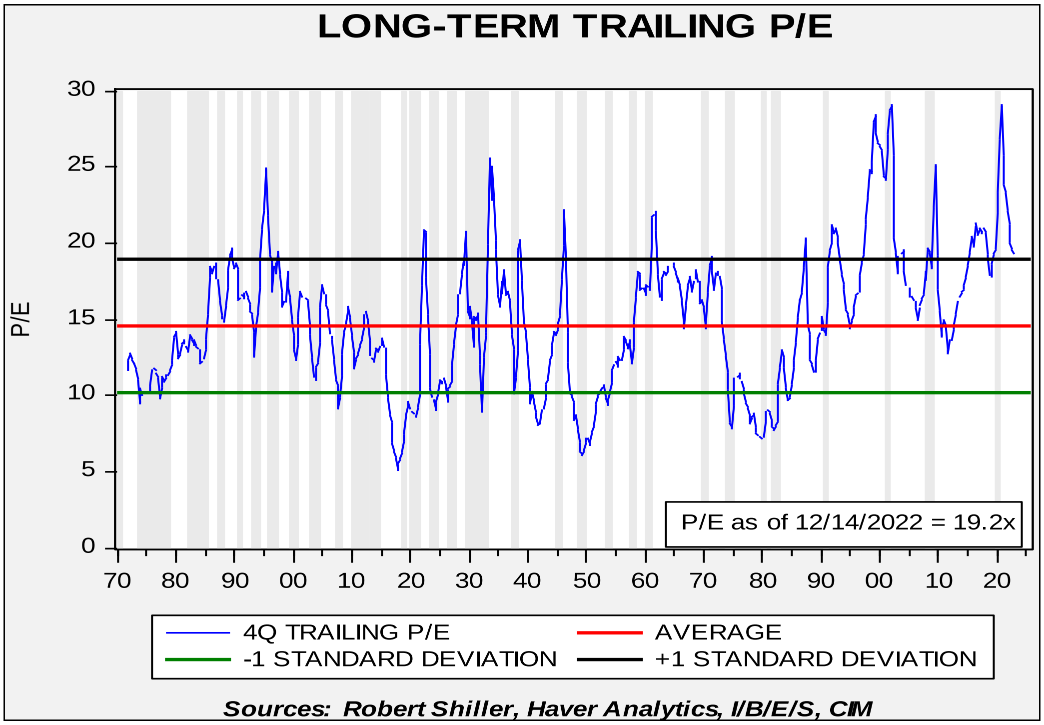
Source: Bloomberg

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 15, 2022



Based on our methodology,[1] the current P/E is 19.2x, up 0.1x from our last report. Higher equity values led to the rise in the multiple.

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 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.