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: February 11, 2022—9:30 AM EST] Global equity markets are lower this morning. In Europe, the EuroStoxx 50 is currently down 0.9% from its prior close. In Asia, the MSCI Asia Apex 50 closed down 0.5%. Chinese markets were lower, with the Shanghai Composite down 0.7% from its prior close and the Shenzhen Composite down 1.7%. U.S. equity index futures are signaling a lower open. With 343 companies having reported, the S&P 500 Q4 2021 earnings stand at $54.60, higher than the $52.34 forecast for the quarter. The forecast reflects a 21.7% increase from Q4 2020 earnings. Thus far this quarter, 75.5% of the companies have reported earnings above forecast, while 19.2% 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* (1/31/2022) (with associated podcast): "Two Power Plays in Kazakhstan"
- *Weekly Energy Update* (2/10/2022): *Oil prices have retreated from recent highs in hopes of a return to the 2015 nuclear deal with Iran.*
- *Asset Allocation Quarterly - Q1 2022* (1/20/2022): Discussion of our asset allocation process, Q1 2022 portfolio changes, and our outlook for the markets
- *Asset Allocation Bi-Weekly* (2/7/2022) (with associated podcast): "Gold: An Update of Current Conditions"
- *Confluence of Ideas* podcast (1/20/2022): "The 2022 Outlook"
- *Current Perspectives*: *"*2022 Outlook: The Year of Fat Tails*"* (12/16/2021)

Good morning! We begin today's report with a few different views about inflation, followed by an update on the Canadian trucker protest. Afterward, we give our thoughts on the Russia-Ukraine situation. International news is next, and we end with our pandemic coverage.

Inflation: The BLS reported that inflation rose 7.5% from the prior year, its fastest pace in over 40 years. Unlike previous reports, inflation was particularly broad-based, with rent, energy, and food prices all making noticeable gains. The rise in inflation has placed more pressure on the Federal Reserve to raise interest rates. The market has now started anticipating up to seven rate hikes this year, with a possible 50 bps rate hike in March. However, Fed officials have offered mixed views on the need for additional rate hikes. Richmond Fed President Thomas Barkin stated he does not see a screaming need to raise rates 50 bps in March, and San Francisco Fed

President Mary Daly said an aggressive rate hike wasn't her preference. Meanwhile, St. Louis Fed President and FOMC voting member James Bullard asserted he would like to see rate hikes reach 100 bps by July 1.

The reluctance of the Fed to put too much emphasis on the recent inflation report may be reasonable. In January, adverse weather conditions contributed to a sharp rise in electricity prices. Additionally, much of the base effects related to last year's reopening that pulled inflation upward will conceivably start to drag on inflation this year. Services such as airline fares, car rentals, and lodging away from home will probably show signs of deflation due to a drop in demand. Additionally, the rise in energy and autos may contribute less to inflation than it did in the previous year because of prices already being elevated. This does not mean inflation will return to pre-pandemic levels; that should not happen any time soon. However, it does suggest inflation is entering its peak stage. The market is expecting the Fed to raise rates up to five times this year, within a range of 1.25%-1.50%.

Trucker Protest: The trucker protest has entered its fourth day, and it appears that officials may intervene. On Thursday, the Mayor of Windsor, Ontario, which borders Detroit, stated police were prepared to remove the anti-mandate protesters by force if necessary. The Ontario government has sought an injunction to end the protest and plans to seize trucks and reopen the bridge. At least six auto plants have halted production as a result of this protest. The U.S. also expects its truckers to protest in solidarity with the Canadian drivers over Superbowl weekend. These protesters are expected to proceed to D.C. early next month.

Russia-Ukraine conflict: The U.S. has escalated its rhetoric in its attempt to dissuade Russia from invading Ukraine. In an interview with MSNBC, U.S. Deputy Secretary of State Wendy Sherman stated, "body bags will come back to Moscow" if troops enter Ukraine territory. The comment comes amid rising tensions between Russia and Ukraine and has led the country to ramp up military drills. Although talks between NATO and Russia are ongoing, there doesn't appear to be much progress. In previous reports, we mentioned the Russia-Ukraine stalemate will seemingly end without a major conflict, but Wendy Sherman's comment has made us less optimistic.

International news:

- U.K. and EU officials are scheduled to meet on Friday to discuss Northern Ireland Protocol. Following a political backlash in Northern Ireland, the new round of discussions will try to improve the trading arrangement. The protocol was put in place to prevent a resurrection of a hard border between Ireland and Northern Ireland. Since the deal was made, there has been growing opposition from Northern Ireland officials. Last week, the country's first minister, Paul Givan, resigned in protest to the rules established by the post-Brexit protocol. Negotiations have not gone well in the past, as the U.K. and EU have been unable to agree on the way goods can be transferred between Northern Ireland and mainland U.K. without border checks.
- OPEC and its allies continue to face production problems. The IEA has reported that group members have struggled to meet production pledges. The agency reports that

OECD industry oil inventories have plunged to their lowest level in seven years. Although Saudi Arabia and the United Arab Emirates, which have the sparest production capacity, could help ease oil markets, there is no sign they will. Thus, the lack of inventory could pave the way for $100 a barrel for oil.

- As the rest of the world raises rates to contain inflation, ECB President Christine Lagarde has held steadfast in her belief that higher rates are not needed at this time. She told a German publication that raising rates "would not resolve any of the current problems" and warned that it could hurt the economy and jobs. She also maintained she would only act if needed, and any moves would be gradual.

COVID-19: The number of reported cases is 406,419,929, with 5,792,240 fatalities. In the U.S., there are 77,437,156 confirmed cases with 915,618 deaths. For illustration purposes, the *FT* has created an interactive chart that allows one to compare cases across nations using similar scaling metrics. The CDC reports that 674,675,725 doses of the vaccine have been distributed with 545,477,120 doses injected. The number receiving at least one dose is 251,655,172, while the number of second doses is 213,430,434, and the number who have received the third dose, granting the highest level of immunity, is 90,852,670. The *FT* has a page on global vaccine distribution.

- Hong Kong officials have requested assistance from mainland China. The region is struggling to contain an outbreak in cases and needs an additional temporary isolation facility.
- More states are starting to end mask mandates as infection rates decline. The moves come amid growing evidence that the pandemic is headed into its final stage.

U.S. Economic Releases

There have been no significant U.S. economic releases so far today. The table below lists the releases and/or Fed events scheduled for the rest of today.

Economic Releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
10:00	U. of Michigan Consumer Sentiment	m/m	Feb P	67.0	67.2	***
10:00	U. of Michigan Current Conditions	m/m	Feb P	72.1	72.0	**
10:00	U. of Michigan Expectations	m/m	Feb P	64.5	64.1	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Feb P	5.0%	4.9%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Feb P		3.1%	*
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.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
New Zealand	BusinessNZ Manufacturing PMI	m/m	Jan	52.1	53.8		***	Equity bearish, bond bullish
	2-Year Inflation Expectation	q/q	1Q	3.27%	2.96%		**	Equity bearish, bond bearish
China	BoP Current Account Balance	q/q	4Q P	$119.4b	$73.6b		*	Equity bullish, bond bearish
India	Industrial Production	y/y	Dec	0.4%	1.3%	1.6%	***	Equity bearish, bond bullish
EUROPE								
Germany	Wholesale Price Index	y/y	Jan	16.2%	16.1%		*	Equity and bond neutral
	CPI	y/y	Jan F	4.9%	4.9%	4.9%	*	Equity and bond neutral
	CPI, EU Harmonized	y/y	Jan F	5.1%	5.1%	5.1%	*	Equity and bond neutral
UK	GDP	y/y	4Q P	6.5%	7.0%	6.4%	***	Equity and bond neutral
	Industrial Production	y/y	Dec	0.4%	-0.2%	0.6%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	Dec	1.3%	-0.1%	1.7%	***	Equity bearish, bond bullish
	Index of Services 3M/3M	m/m	Dec	1.2%	1.3%	1.2%	*	Equity and bond neutral
	Trade Balance	m/m	Dec	-£2337m	-£2586m	-£400m	**	Equity bearish, bond bullish
	Visible Trade Balance	m/m	Dec	-£12354m	-£12701m	-£12500m	**	Equity and bond neutral
Switzerland	CPI	y/y	Jan	1.6%	1.5%	1.5%	***	Equity and bond neutral
	Core CPI	y/y	Jan	0.8%	0.8%	0.7%	*	Equity and bond neutral
	CPI, EU Harmonized	y/y	Jan	1.4%	1.3%	1.2%	*	Equity and bond neutral
Russia	Money Supply, Narrow Definition	w/w	4-Feb	14.35t	14.31t		*	Equity and bond neutral
	Trade Balance	m/m	Dec	26.7b	21.1b	23.0b	**	Equity bullish, bond bearish
	Exports	m/m	Dec	57.4b	49.0b	53.5b	*	Equity bullish, bond bearish
	Imports	m/m	Dec	30.7b	27.9b	30.5b	*	Equity and bond neutral
AMERICAS								
Mexico	Industrial Production	y/y	Dec	3.0%	1.6%	2.1%	***	Equity bullish, bond bearish
	Manufacturing Production	y/y	Dec	3.8%	2.8%	3.4%	*	Equity bullish, bond bearish
Brazil	Economic Activity Index	y/y	Dec	1.30%	0.94%	1.00%	**	Equity bullish, bond bearish

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)	38	37	1	Down
3-mo T-bill yield (bps)	38	39	-1	Neutral
TED spread (bps)	0	-3	3	Neutral
U.S. Libor/OIS spread (bps)	44	46	-2	Down
10-yr T-note (%)	2.00	2.03	-0.03	Down
Euribor/OIS spread (bps)	-53	-52	-1	Neutral
Currencies	**Direction**			
Dollar	Up			Neutral
Euro	Down			Up
Yen	Flat			Neutral
Pound	Up			Neutral
Franc	Flat			Neutral
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Mexico Overnight Rate	6.000%	5.500%	6.000%	On Forecast
Bank of Russia Benchmark Rate	9.500%	8.500%	9.500%	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.

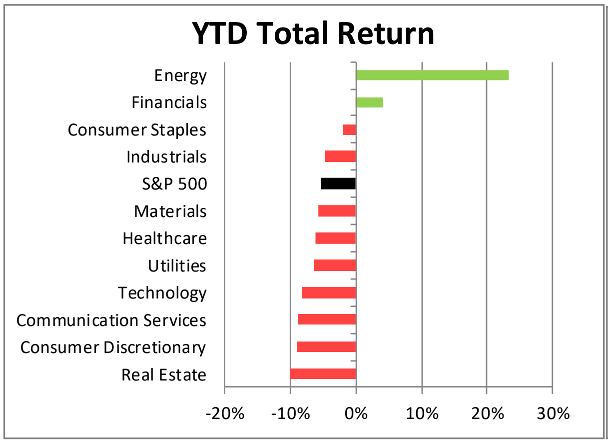
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$92.57	$91.41	1.27%	
WTI	$91.16	$89.88	1.42%	
Natural Gas	$3.96	$3.96	-0.05%	
Crack Spread	$24.07	$24.00	0.28%	
12-mo strip crack	$23.81	$23.79	0.08%	
Ethanol rack	$2.22	$2.21	0.37%	
Metals				
Gold	$1,830.98	$1,826.85	0.23%	
Silver	$22.96	$23.20	-1.03%	
Copper contract	$454.85	$465.95	-2.38%	
Grains				
Corn contract	$645.50	$640.50	0.78%	
Wheat contract	$788.25	$778.75	1.22%	
Soybeans contract	$1,589.00	$1,576.50	0.79%	
Shipping				
Baltic Dry Freight	1,940	1,711	229	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-4.8	1.4	-6.1	
Gasoline (mb)	-1.6	1.5	-3.1	
Distillates (mb)	-0.9	-1.5	0.6	
Refinery run rates (%)	1.50%	-0.40%	1.90%	
Natural gas (bcf)	-222.0	-223.0	1.0	

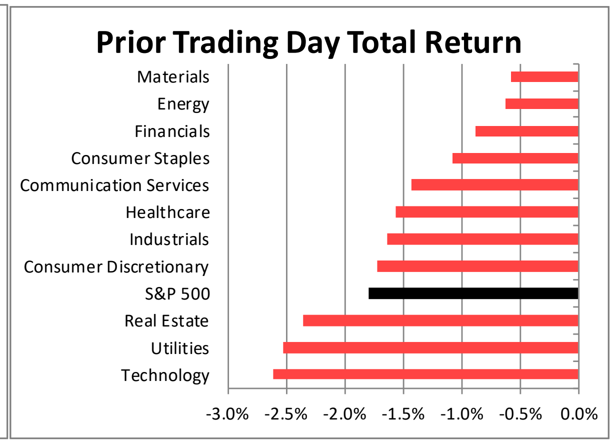
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in almost the entire country, with cooler-than-normal temperatures only along the Mexican border of Arizona, New Mexico, and Texas. The forecasts call for wetter-than-normal conditions throughout the eastern half of the country, with dry conditions expected along the West Coast and the Southwest.

<u>Data Section</u>

U.S. Equity Markets – (as of 2/10/2022 close)

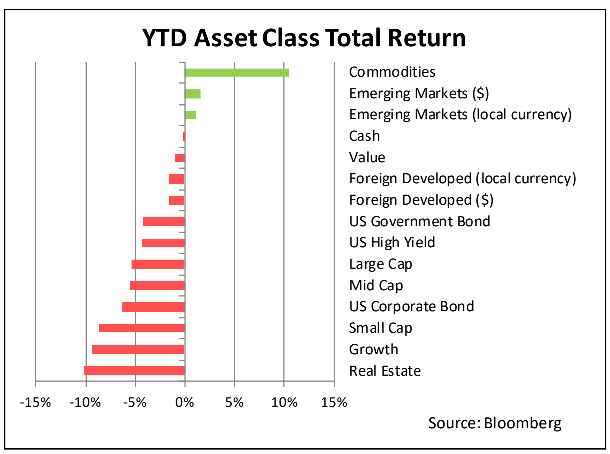




(Source: Bloomberg)

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 2/10/2022 close)

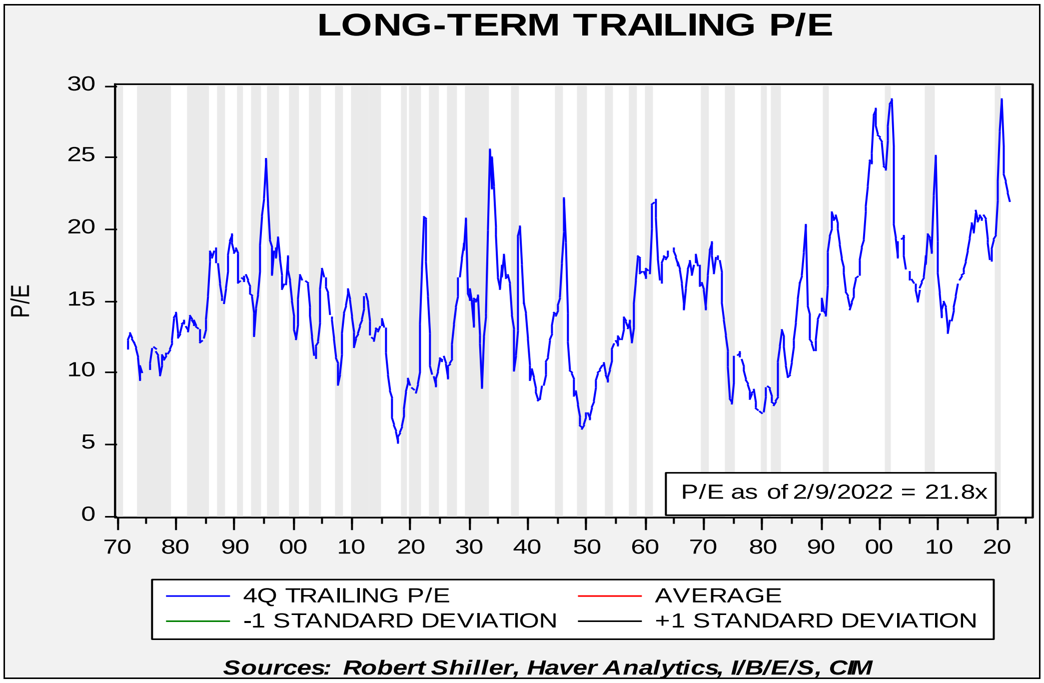


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

February 10, 2022



Based on our methodology,[1] the current P/E is 21.8x, down 0.4x from last week. The decline in the multiple is due to stronger 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.

[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 (Q2 and Q3) and two estimates (Q4 and Q1). 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.