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 14, 2022—9:30 AM EST] Global equity markets are lower this morning. In Europe, the EuroStoxx 50 is currently down 2.1% from its prior close. In Asia, the MSCI Asia Apex 50 closed down 1.8%. Chinese markets were lower, with the Shanghai Composite down 1.0% from its prior close and the Shenzhen Composite down 0.4%. U.S. equity index futures are signaling a lower open. With 359 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, 75.8% 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)

In today's *Comment*, we would love to only focus on happy news like the Super Bowl or Valentine's Day, but the world is much too tense for that. Therefore, we open with the latest developments on the Russia-Ukraine crisis. We then turn to a range of international news and U.S. developments that have the potential to affect the financial markets today. We close with a short recap of the latest news on the coronavirus pandemic.

Russia-Ukraine: Among the key developments over the last few days, President Biden had remote meetings with a large group of allied leaders on Friday, with Russian President Putin on Saturday, and with Ukrainian President Zelensky on Sunday. The most important recent development in the meetings was that Biden reportedly told the meeting with allied leaders that the U.S. has intelligence suggesting Putin has ordered his troops to prepare to launch an attack this Wednesday, February 16. Meanwhile, German Chancellor Scholz will meet with Zelensky [today in Kyiv and with Putin tomorrow in Moscow](). Since Scholz would be the last major NATO leader to have a direct or video conference with Putin, that meeting could well be the last best chance to convince Putin to take an off-ramp and diffuse the crisis.

- We continue to believe that it is somewhat more likely that Putin will back down, and the crisis will be resolved. In large part, that's because of the surprising extent to which NATO countries and the U.S. political establishment have coalesced behind a strong response to the Russian threat. In turn, that response [reflects an innovative U.S. strategy to blunt Russia's "grey zone" attacks using "information warfare."]()
    - Russian grey-zone tactics have involved cyberattacks and other activities that fall short of traditional, violent warfare and are hard to clearly attribute to the Russian military. Western leaders have, therefore, had their hands tied in taking strong action against those attacks.
    - In the current crisis, the administration is aggressively releasing U.S. intelligence on Russian preparations and grey-zone activities in order to characterize them as military aggression before they're launched. There are risks in the approach. For example, there's a chance that the U.S. releases will lead to the loss of important

intelligence sources and methods. The intelligence may also be fragmentary or otherwise unreliable, in which case it may later prove to be false.

        - Here's one example: During my days as a CIA analyst in the 1980s and 1990s, my computer search profile would typically send me 200 to 300 intelligence reports to review each day. They would include everything from raw satellite imagery and communications intercepts to "finished" intelligence reports from organizations like the State Department's intelligence group or foreign intelligence services.
        - Out of those 200 to 300 reports that would come across my computer screen, only three or four might seem reliable or connected to my "account" (Soviet/Russian military budgeting and defense industry). I would only do a deeper dive into those reports and ignore the rest.
        - Of those three or four intelligence reports that I would examine closely, many would ultimately prove meaningless. In the current crisis, the U.S. may be releasing these kinds of reports. They may merely be semi-reliable hints of what the Russians are doing or planning. While it may sound bad for the U.S. to talk up such reports, it's probably reasonable for the administration to be using a relatively low hurdle for reliability if the release of the information closes off a potential Russian avenue for attack.

- Despite the likelihood (or hopes) that the U.S. information strategy will force Putin to back down, signs continue to accumulate that sober professionals in many industries around the world are taking seriously the possibility of a major war.
    - On Sunday, one of Ukraine's main air carriers, SkyUp Airlines, said it suspended sales for flights this week after its insurers stopped covering aircraft in Ukrainian airspace because of an increased threat of a Russian invasion.
    - A day earlier, Dutch national flag carrier KLM said it had suspended its flights to Kyiv and wouldn't operate flights in Ukrainian airspace.
    - Meanwhile, energy traders are starting to price in a higher risk that a Russian invasion will lead to sanctions that curtail its oil exports. Oil prices are now approaching $100 per barrel for the first time since 2014.
    - Financial assets are also reflecting the risks. Gold and safe-haven U.S. Treasury obligations continue to appreciate. Bond yields are edging lower. Stock markets continue to weaken, especially in Europe, although we've noted relative strength in defense stocks. For the time being, we expect these trends to continue.
- Allied NATO military moves are also screaming, "This is not a drill." Among the key developments are the following:
    - The U.S. has now evacuated nearly all of its diplomatic personnel in Ukraine. It has also removed the 160 or so Florida National Guard troops who had been in the country training Ukrainian soldiers. The soldiers assigned to the 53rd Infantry Brigade Combat Team have been ordered to reposition elsewhere in Europe.

- In recent weeks, four U.S. Navy destroyers normally assigned to the East Coast were deployed to the US. 6th Fleet in the Mediterranean. Notably, the destroyers are all configured for ballistic missile defense.
- Late last week, a task force consisting of four U.S. Air Force B-52s was sent from Minot Air Force Base in North Dakota to RAF Fairford, U.K., for a notional three-week stay, during which they will exercise with NATO allies and partner nations.
- Also, late last week, U.S. Air Force fighter jets were deployed to Poland and Romania to support enhanced air policing and to reassure NATO eastern flank allies. Eight F-16s from the 52nd Fighter Squadron at Spangdahlem Air Base, Germany, deployed to Fetesti Air Base, Romania, while eight F-15s from the 48th Fighter Squadron at RAF Lakenheath, U.K., landed in Lask, Poland.
- On Saturday, U.S. F-22 fighter jets were deployed to the United Arab Emirates, ostensibly to help the UAE thwart a recent spate of air attacks by Houthi rebels in Yemen. However, we note those fighters would also be close enough to the Black Sea region to assist in any hostilities there.

Global Commodity Markets: The Russia-Ukraine crisis is happening amid low inventories for a wide range of commodities beyond just energy.

- The problems are particularly acute in metals, where spot prices of several contracts on the London Metal Exchange are trading higher than those for later delivery, as traders pay large premiums to secure immediate supply.
- Even cocoa prices are rising, driven by dry weather in Africa weighing on production and cutting into inventories. Most-actively traded cocoa futures have risen about 12% this year—and 11% in February alone—to $2,811 a metric ton, on pace for the highest monthly level since April 2018.

Canada: Police in Windsor, Ontario, yesterday arrested anti-vaccine protesters and towed vehicles to clear access to the Ambassador Bridge linking the city to Detroit. It's not entirely clear when traffic on the bridge will be back to normal, but if the flow of trucks normalizes soon, it will help ease the production stoppages that the protests caused to auto manufacturing on both sides of the border.

- The truckers' protests primarily aimed to reverse Canada's stringent pandemic rules, but we've been watching them closely for any sign that the truckers, coordinating on social media, might be tempted to use such traffic blockages as leverage to pursue other goals.
- Even as a separate truckers' protest continues in Canada's capital city of Ottawa, the dismantling of the Ambassador Bridge blockage may reflect the limits of the truckers' ability to wage economic warfare. All the same, the current labor shortage and stretched supply lines probably point to continued disruptions in other areas. In the U.S., the most important thing to watch may be the West Coast ports, where the longshoremen's contract expires this summer, possibly setting up a major strike.

European Central Bank: In an interview with the *Financial Times*, Irish central bank governor Gabriel Makhlouf pushed back against investors expecting the ECB to start hiking interest rates as early as June. According to Makhlouf, the ECB could stop its net bond purchases in June or a few months later and would only raise rates after that. His statement is consistent with efforts by ECB Chief Lagarde to walk back her recent hints of an early rate hike, which had unsettled European markets and gave a boost to the Euro.

Spain: In a regional election over the weekend, the far-right Vox party secured 18% of the vote in Castile-León, likely putting it into position to join a regional government for the first time. It also suggests that any center-right national government of the future might need to rely on the populists to govern.

U.S. Tax Policy: As Democrats in Congress try to resurrect a version of President Biden's "Build Back Better" program of social policy and climate stabilization measures, they're finding that a key stumbling block is that Senator Joe Manchin of West Virginia is pushing for increased corporate and individual income tax rates, while Senator Kyrsten Sinema of Arizona opposes them. With the Senate deadlocked 50-50 between Democrats and Republicans, both senators would need to agree for the measure to pass.

U.S. Monetary Policy: In an interview with the Wall Street Journal, Kansas City FRB President Esther George said the Fed should consider selling bonds from its $9 trillion asset portfolio to address high inflation and guard against harmful effects that can result from short-term rates rising above long-term rates.

- George's suggestion that the Fed shouldn't just stop growing its balance sheet, but should actively reduce it, is yet more evidence that monetary policymakers are panicking about inflation and the need to tighten policy.
- We have little doubt the Fed will start to tighten policy next month. However, we still suspect that the policymakers won't be able to hike interest rates as far as the market currently suggests before hitting economic or financial potholes that will force it to curtail the tightening.
- For now, the prospect of tightening monetary policy will continue to foster financial market volatility. If the Fed does curtail its tightening earlier than investors expect, however, it would likely cause a sharp rebound in bond prices.

COVID-19: Official data show confirmed cases have risen to 412,134,811 worldwide, with 5,817,819 deaths. In the U.S., confirmed cases rose to 77,740,175, with 919,697 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 are considered fully vaccinated now totals 213,869,678, equal to 64.4% of the total population.

- In the U.S., data continue to suggest that the highly transmissible Omicron mutation is in retreat. The seven-day average of people hospitalized with a confirmed or suspected

COVID-19 infection fell to 92,896 over the weekend, down some 35% from just two weeks ago.

U.S. Economic Releases

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

Economic Releases		
No economic releases today		
Fed Speakers or Events		
EST	**Speaker or Event**	**District or Position**
7:30	James Bullard speaks on CNBC	President of the Federal Reserve Bank of St. Louis

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								
India	Wholesale Price Index	y/y	Jan	13.0%	13.6%	12.7%	**	Equity and bond neutral
	CPI	y/y	Jan	6.0%	5.6%	6.0%	***	Equity and bond neutral
EUROPE								
Switzerland	Producer Prices	y/y	Jan	5.4%	5.1%		**	Equity and bond neutral
AMERICAS								
Canada	Bloomberg Nanos Confidence	w/w	11-Feb	58.9	58.6		***	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)	51	39	12	Down
3-mo T-bill yield (bps)	32	35	-3	Neutral
TED spread (bps)	18	4	14	Neutral
U.S. Libor/OIS spread (bps)	41	39	2	Down
10-yr T-note (%)	1.95	1.94	0.01	Down
Euribor/OIS spread (bps)	-52	-53	1	Neutral
Currencies	**Direction**			
Dollar	Up			Neutral
Euro	Down			Up
Yen	up			Neutral
Pound	down			Neutral
Franc	flat			Neutral

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.

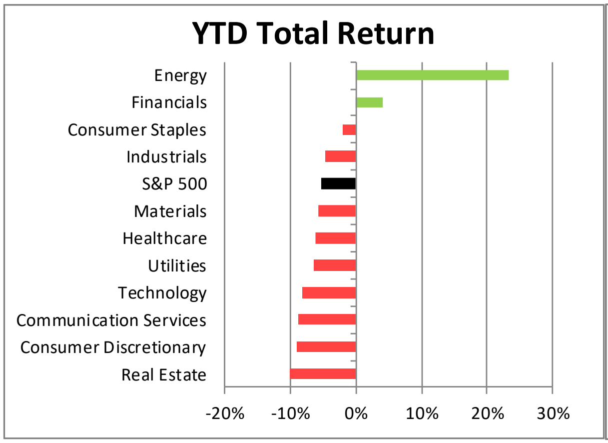
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$93.96	$94.44	-0.51%	
WTI	$92.65	$93.10	-0.48%	
Natural Gas	$4.13	$3.94	4.67%	
Crack Spread	$24.06	$24.04	0.10%	
12-mo strip crack	$24.06	$24.27	-0.89%	
Ethanol rack	$2.26	$2.24	0.79%	
Metals				
Gold	$1,853.77	$1,858.76	-0.27%	
Silver	$23.69	$23.59	0.42%	
Copper contract	$448.20	$450.95	-0.61%	
Grains				
Corn contract	$647.50	$650.50	-0.46%	
Wheat contract	$806.75	$804.00	0.34%	
Soybeans contract	$1,566.75	$1,586.25	-1.23%	
Shipping				
Baltic Dry Freight	1,977	1,940	37	

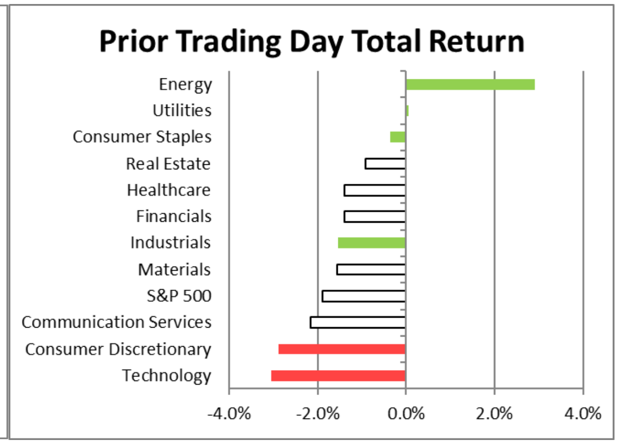
Weather

The 6-10 day forecast calls for warmer-than-normal temperatures in the nation's midsection, from Colorado to the Mid-Atlantic. Below normal temps are forecast for the upper Midwest and Pacific Northwest. The 8-14 day forecast shows the eastern half of the nation warmer to much warmer than normal, with the western half seeing below normal temps. The forecasts call for wetter-than-normal conditions throughout most of the country, with dry conditions expected along the West Coast and the Southwest.

Data Section

U.S. Equity Markets – (as of 2/11/2022 close)

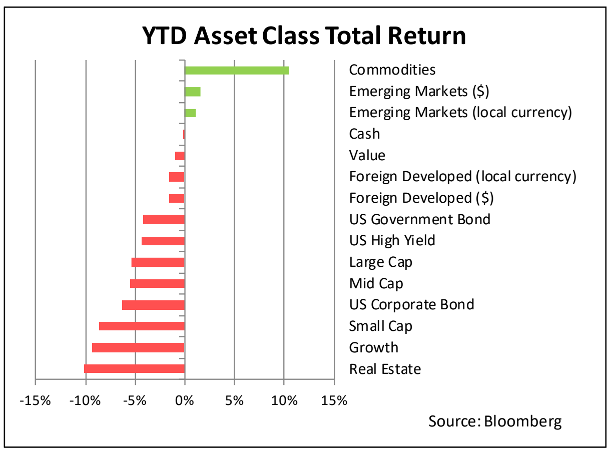




(Source: Bloomberg)

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 2/11/2022 close)

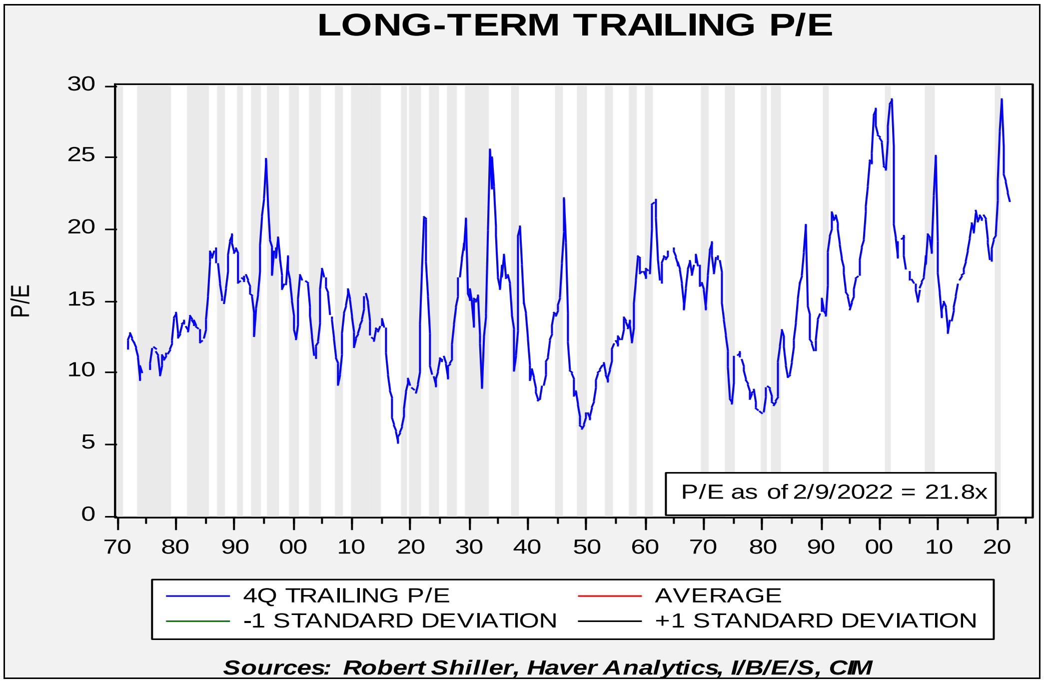


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.