Daily Comment

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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 16, 2022—9:30 AM EST] Global equity markets are mixed this morning. In Europe, the EuroStoxx 50 is currently down 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 closed up 1.7%. Chinese markets were higher, with the Shanghai Composite up 0.6% from its prior close and the Shenzhen Composite up 0.6%. U.S. equity index futures are signaling a lower open. With 380 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, 75.3% of the companies have reported earnings above forecast, while 19.7% 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* (2/14/2022) (with associated podcast): "Ukraine: Key Questions"
- *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 open with an update on the Russia-Ukraine crisis, where there still seems to be no concrete evidence that Russia is really pulling back its troops. We next cover several developments in U.S. economic policy, including a statement by the Biden administration that it is open to temporarily suspending the federal gas tax in order to reduce inflation. We then discuss a few international developments. We close with the latest news on the coronavirus pandemic.

Russia-Ukraine: Following the Russian government's statements yesterday and today that it had withdrawn a small number of troops from the Ukrainian border, U.S. and European officials said they have seen no evidence of a significant pullback. Indeed, NATO Secretary General Stoltenberg today said alliance intelligence indicates Russia is still building up its forces close to Ukraine, and President Biden yesterday warned that an invasion is still "distinctly possible."

Officials in Ukraine voiced skepticism that Russia's position was softening and said it was unclear what signals Moscow intended to send. As if to justify the continued caution, yesterday, the Russian parliament passed a resolution urging President Putin to recognize two Russian-backed separatist republics in eastern Ukraine as independent states. And, the Ukrainian government said a suspected cyberattack hit the country's Defense Ministry and two state banks.

- Although it's still not clear that Putin really is backing down, he will soon be constrained by the calendar. The Russian way of war emphasizes heavy armor, and as the weather starts to warm and the Ukrainian soil begins to thaw, Russian vehicles will find it hard to travel. If you have any doubt of that, check out this video of Russian tanks stuck in the mud during exercises just north of the Ukrainian border.
- Until there is concrete evidence one way or the other regarding any Russian de-escalation, global financial markets will be caught in limbo. We continue to monitor a wide range of information sources to gauge where the crisis might be headed.

U.S. Fiscal Policy: The White House yesterday said it is open to temporarily suspending the federal gas tax after a high-profile group of Democratic lawmakers proposed scrapping the levy until at least next year in an effort to curb inflation. According to a White House press secretary, "Every tool is on the table to reduce prices." The openness to the idea comes as the Biden administration continues to have no luck trying to convince Saudi Arabia to pump more oil in order to bring down prices.

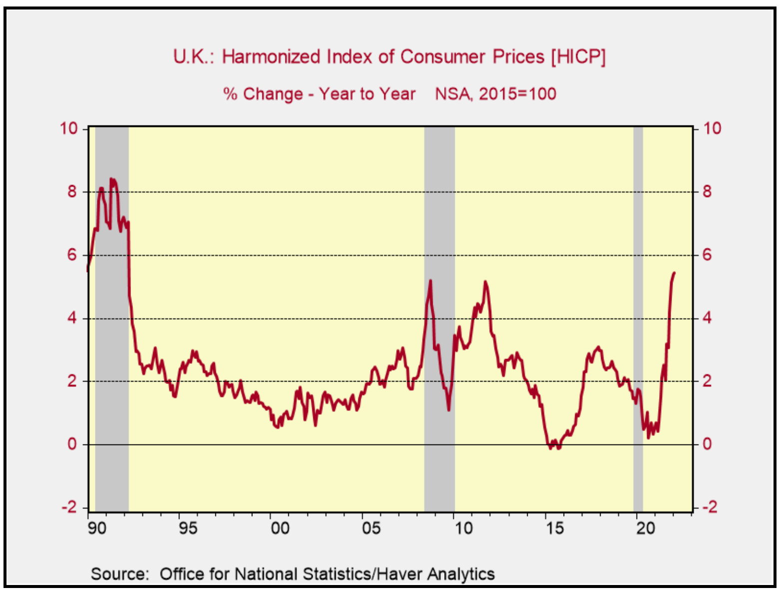
- With gasoline prices currently averaging approximately $3.50 per gallon, eliminating the federal gas tax of 18.4 cents per gallon would amount to a price cut of about 8%.
- However, gas station operators may not pass all the savings on to their customers. While gas prices are highly visible to consumers, explaining the political benefit of reducing them, they are also just one part of the typical household budget. The overall impact on inflation would probably be only modest.
- Of course, there is also a political downside to the administration's efforts to lower the price of gasoline. Those efforts directly contradict the administration's commitment to reduce U.S. global warming emissions. Indeed, the gas-tax proposal is already generating pushback from both Congressional Republicans and some Democrats.

U.S. Monetary Policy: Republicans in the Senate yesterday refused to attend a committee vote on President Biden's nominees to the Federal Reserve, delaying the reconfirmation of Chair Powell and the initial approval of all four of the other picks.

- The Republicans said they still have concerns about Sarah Bloom Raskin, the nominee for Fed Vice Chair for Supervision, primarily because of her past comments that bank regulators should promote the transition away from fossil fuels.
- At this point, it isn't clear how long the dispute will delay confirmation of the officials or if Bloom Raskin or any of the other nominees will have to give up. In any case, we would still expect the Fed to start raising its benchmark short-term interest rate in March, although we continue to believe rates won't ultimately be raised as fast or as far as most investors currently seem to think.

European Monetary Policy: In an interview with the *Financial Times*, ECB executive board member Isabel Schnabel said the central bank must consider the "unprecedented" rise in European house prices when assessing the high level of inflation and deciding how fast to tighten monetary policy.

- Unlike the U.S., the Eurozone does not include the cost of owner-occupied housing in its consumer price index. According to Schnabel, including it would have added 0.6% to the Eurozone's third-quarter core inflation of 1.4%.
- Schnabel is an influential hawk on the ECB board, so her arguments are likely to bolster the minority of board members who are pushing for faster monetary tightening. If and when the Russia-Ukraine crisis recedes, investors would likely return their attention to the prospect of tightening monetary policy in the Eurozone and beyond. In other words, financial markets could well remain volatile even with peace in Ukraine.
- Separately, the Bank of England is likely to face continued pressure to keep raising its benchmark interest rate after the U.K.'s January Consumer Price Index (CPI) showed a year-over-year increase of 5.5%. As shown in the chart below, that marks the country's highest inflation rate in almost three decades.



European Union Politics: The European Court of Justice approved a new EU budget mechanism that allows Brussels to withhold funds from member countries that don't meet EU legal standards. Brussels will now be free to use the mechanism to punish Poland and Hungary for their violations of EU rule-of-law principles.

Global Digital Currencies: The Financial Stability Board, which makes recommendations to the G20 nations on financial rules, today warned that cryptocurrencies are a growing risk to global financial stability. The report argued that policymakers must act quickly in crafting rules covering the digital asset market, given the tightening link with the traditional financial system.

COVID-19: Official data show confirmed cases have risen to 415,769,578 worldwide, with 5,839,809 deaths. In the U.S., confirmed cases rose to 78,039,888, with 925,560 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 214,104,148, equal to 64.5% of the total population.

- In the U.S., data continues 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 85,086 yesterday, down some 38% from just two weeks earlier.
- The Biden administration yesterday asked Congress for an additional $30 billion to fund its coronavirus response. The request includes $17.9 billion for medical countermeasures like antivirals, $4.9 billion for testing capacity, and $2.7 billion to combat future variants.
- In San Francisco, voters seem to have ousted three of the city's school board members in a recall election yesterday. Recall organizers began the effort in part out of frustration over the 13-month closure of city schools during the pandemic, arguing that the board had given priority to social-justice issues over a safe return to classrooms for the district's 51,000 students.
- As the Omicron wave starts to overwhelm Hong Kong's hospitals, Chinese President Xi ordered the city government to "mobilize all possible forces and resources" to protect the health of residents and maintain social stability.
    - Ominously, Xi's directive explicitly indicates that controlling the outbreak should "take priority over everything else."
    - The directive raises concerns about even more draconian measures that could hammer the Hong Kong economy and affect its financial markets. Those measures could also be a harbinger of how Xi would react to a worsening outbreak in mainland China.
- In contrast, things appear to be moving in a better direction in Japan, allowing the government to plan for further restriction easing. The government will shorten the quarantine period for all international arrivals—both Japanese and foreign nationals—from the current seven days to three days, starting in March when it opens the border for travelers other than tourists. For some arrivals, the government is considering dropping the quarantine period entirely.

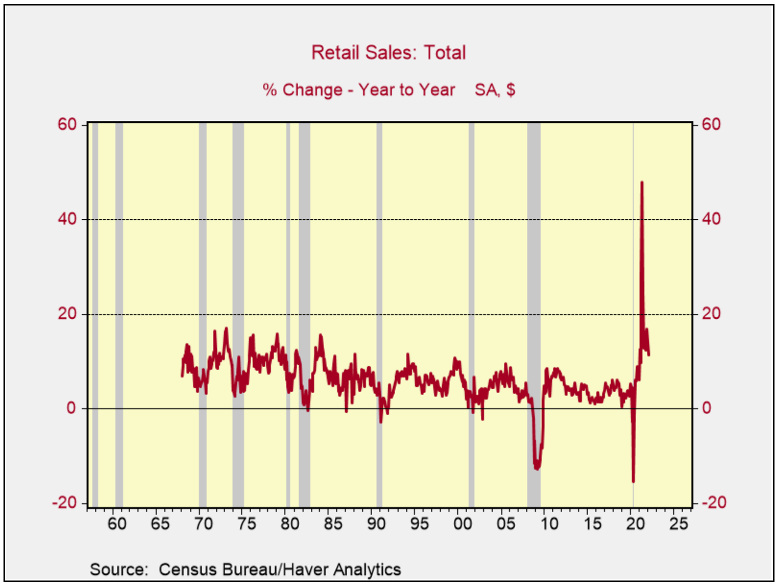
U.S. Economic Releases

The MBA weekly mortgage data showed all applications fell 5.4% for the week ending February 11. Purchases were down a modest 1.2% while refinancing activity declined 8.9%. The average 30-year fixed mortgage rate is 4.05%.

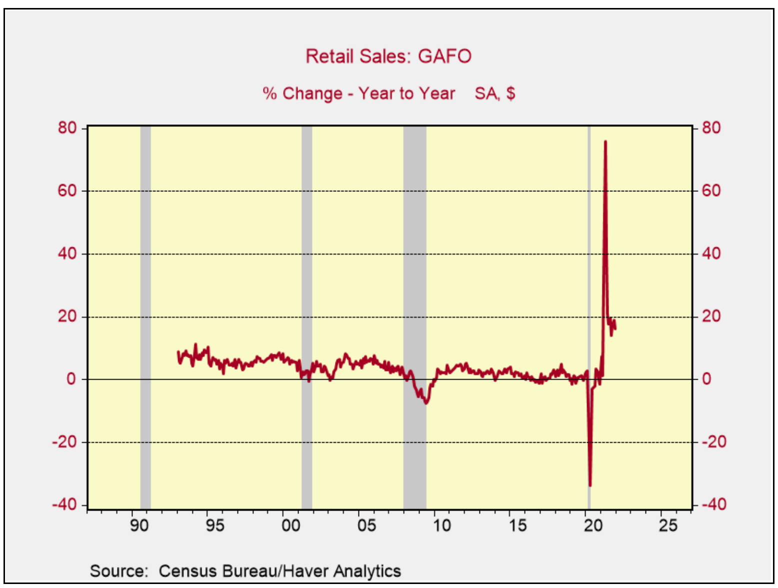
Advanced January retail sales (RTS) came in stronger than expected, rising 3.8%, exceeding expectations of a 2.0% rise. However, we note that December sales were revised lower, to -2.5%

from the initial report of -1.9%. Ex-autos, sales rose 3.3%, much better than the 1.0% forecast, but again, there was a downward revision to the prior month, to -2.8% from -2.5%. The control group, which is applied to GDP, was up a whopping 4.8% compared to an expected rise of 1.3%. The prior month was revised to -4.0% from the initial report of -3.1%.

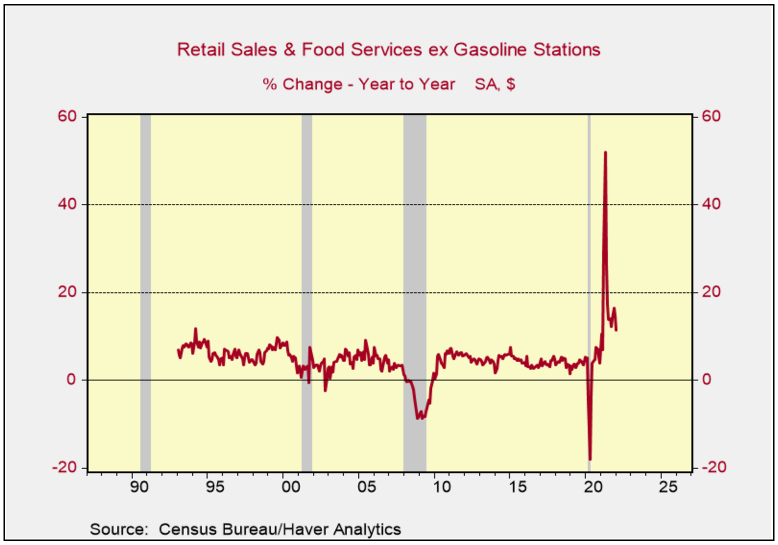
Compared to last year, RTS momentum continues to be strong. As the chart below shows, RTS remains historically strong.



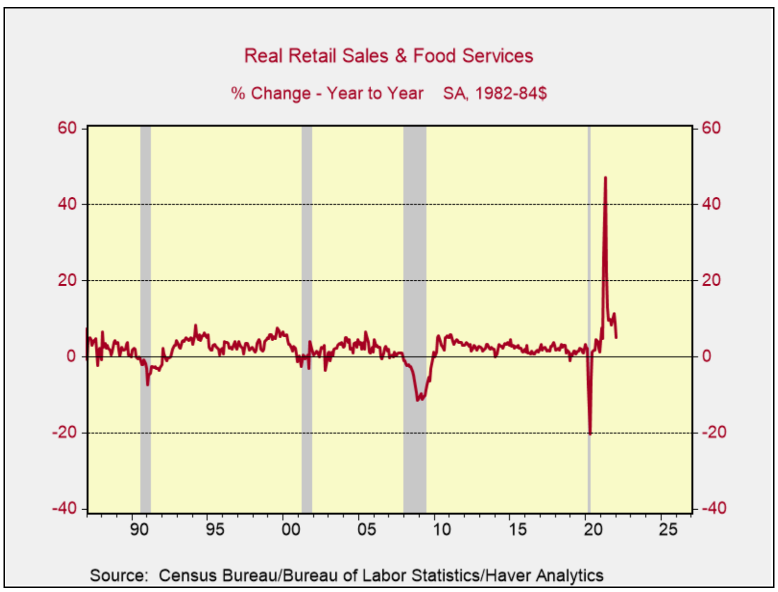
Control group sales are up 16.2% from last year.



Excluding gasoline station sales, momentum remains strong, suggesting that households are not reducing their buying, despite high gasoline prices.

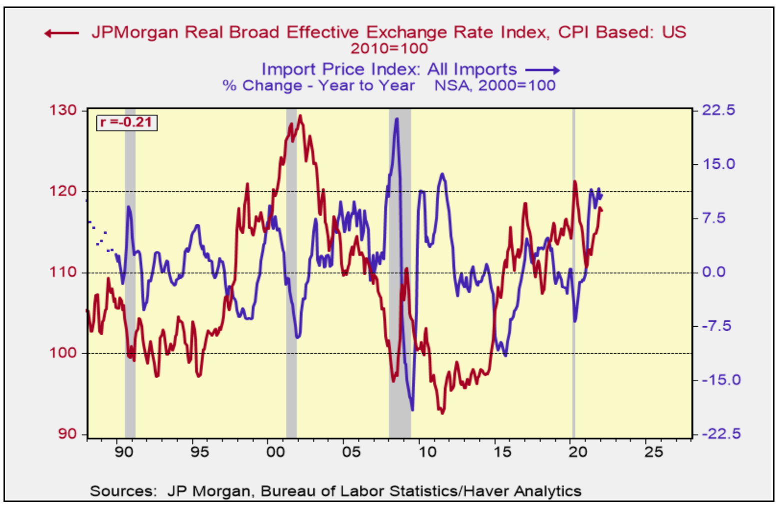


Inflation-adjusted RTS for January rose 5.1% from last year. We note that on a real basis, RTS momentum is slowing, suggesting that inflation is driving some of the RTS growth.



January import prices from last year rose 10.8%, above the 10% forecast. There was a modest downward revision to last month, to 10.2% from 10.4%. Export prices rose 15.1% from last year, well above the 13.1% forecast. The revisions were *de minimis*.

One factor that affects import prices is the dollar's exchange rate. In general, a stronger dollar often will depress import prices. Although the dollar has been considered "strong," compared to import prices, the problem is that the dollar isn't strong enough to depress import costs.



Market reaction to the data has been modestly bearish. Although the strength in RTS could weigh on bond prices, in reality, the revisions do ease some of the bearishness. The import and export price data are mostly in line with recent trends. For the most part, financial markets are much more concerned about the situation in Ukraine.

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

Economic Releases							
No economic releases today							
EST	Indicator			Expected	Prior	Rating
9:15	Industrial production	m/m	Dec	0.5%	-0.1%	***
9:15	Capacity Utilization	m/m	Dec	76.8%	76.5%	**
10:00	Business Inventories	m/m	Dec	2.1%	1.3%	*
10:00	NAHB Housing Market Index	m/m	Feb	82.0	83.0	**
Fed Speakers or Events						
10:00	Neel Kashkari hosts a town hall at United Natural Foods	President of the Federal Reserve Bank of Minneapolis				
13:00	Fed Minutes					

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.

Japan	Tertiary Industry index	m/m	Dec	0.4%	0.4%	0.3%	***	Equity and bond neutral
Australia	Westpac LEI	m/m	Jan	0.1%	-0.3%		**	Equity and bond neutral
	PPI	y/y	Jan	9.5%	10.3%	9.5%	***	Equity and bond neutral
	CPI	y/y	Jan	1.0%	1.5%	1.0%	***	Equity and bond neutral
EUROPE								
Eurozone	Industrial production	y/y	Dec	1.6%	2.3%	-0.5%	**	Equity bullish, bond bearish
UK	CPI	y/y	Jan	5.5%	5.4%	5.4%	***	Equity bearish, bond bearish
	CPI core	y/y	Jan	4.4%	4.2%	4.3%	***	Equity bearish, bond bearish
	PPI Output	y/y	Jan	9.9%	9.3%	9.1%	*	Equity bearish, bond bearish
	PPI Input	y/y	Jan	13.6%	13.5%	13.4%	*	Equity bearish, bond bearish
	House price index	y/y	Dec	10.8%	10.0%	9.4%	*	Equity bullish, bond bearish
AMERICAS								
Canada	CPI	m/m	Jan	5.1%	4.8%	4.8%	***	Equity bearish, bond bearish
	CPI core	m/m	Jan	2.2%	2.1%	2.2%	***	Equity and bond neutral
	Housing Starts	m/m	Jan	230.8k	236.1k	245.0k	***	Equity bearish, bond bullish
	Existing home sales	m/m	Jan	1.0%	20.0%	-1.5%	*	Equity and bond neutral
	Manufacturing sales	m/m	Dec	0.7%	2.6%	0.8%	**	Equity and bond neutral
	Wholesale sales	m/m	Dec	0.6%	3.5%	0.0%	**	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)	46	51	-5	Up
3-mo T-bill yield (bps)	39	40	-1	Neutral
TED spread (bps)	7	11	-4	Neutral
U.S. Libor/OIS spread (bps)	41	40	1	Down
10-yr T-note (%)	2.04	2.05	-0.01	Up
Euribor/OIS spread (bps)	-52	-52	0	Neutral
Currencies	**Direction**			
Dollar	down			Neutral
Euro	Down			Up
Yen	up			Neutral
Pound	down			Up
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.

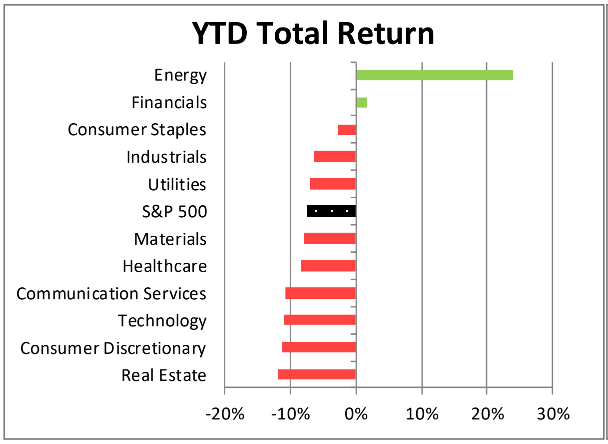
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$94.65	$93.28	1.47%	
WTI	$93.28	$92.07	1.31%	
Natural Gas	$4.54	$4.31	5.41%	
Crack Spread	$22.46	$22.95	-2.15%	
12-mo strip crack	$24.13	$24.12	0.04%	
Ethanol rack	$2.26	$2.27	-0.24%	
Metals				
Gold	$1,853.44	$1,853.61	-0.01%	
Silver	$23.43	$23.36	0.29%	
Copper contract	$456.65	$453.60	0.67%	
Grains				
Corn contract	$642.00	$637.50	0.71%	
Wheat contract	$787.75	$785.75	0.25%	
Soybeans contract	$1,572.25	$1,555.75	1.06%	
Shipping				
Baltic Dry Freight	1,968	1,984	-16	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.9		
Gasoline (mb)		0.3		
Distillates (mb)		-1.5		
Refinery run rates (%)		-0.2%		
Natural gas (bcf)		-189.0		

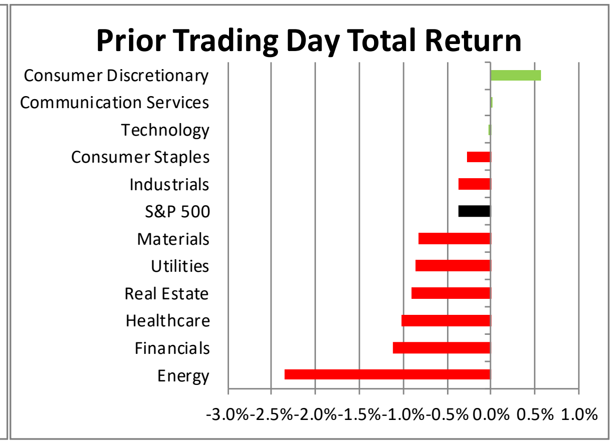
Weather

The 6-10 day and 8-14 day forecasts call for the eastern half of the nation to be 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.

Data Section

U.S. Equity Markets – (as of 2/15/2022 close)

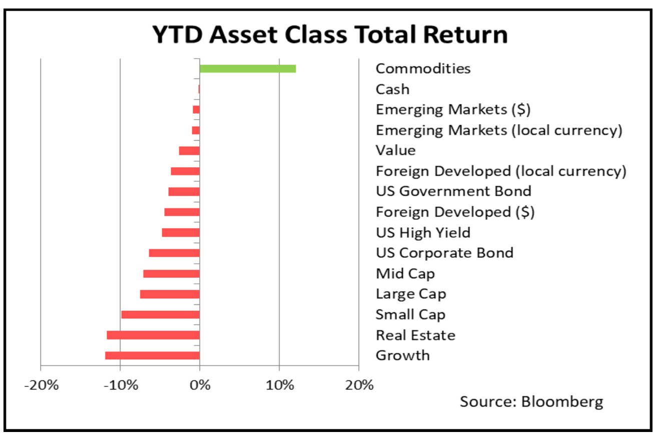




(Source: Bloomberg)

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 2/15/2022 close)

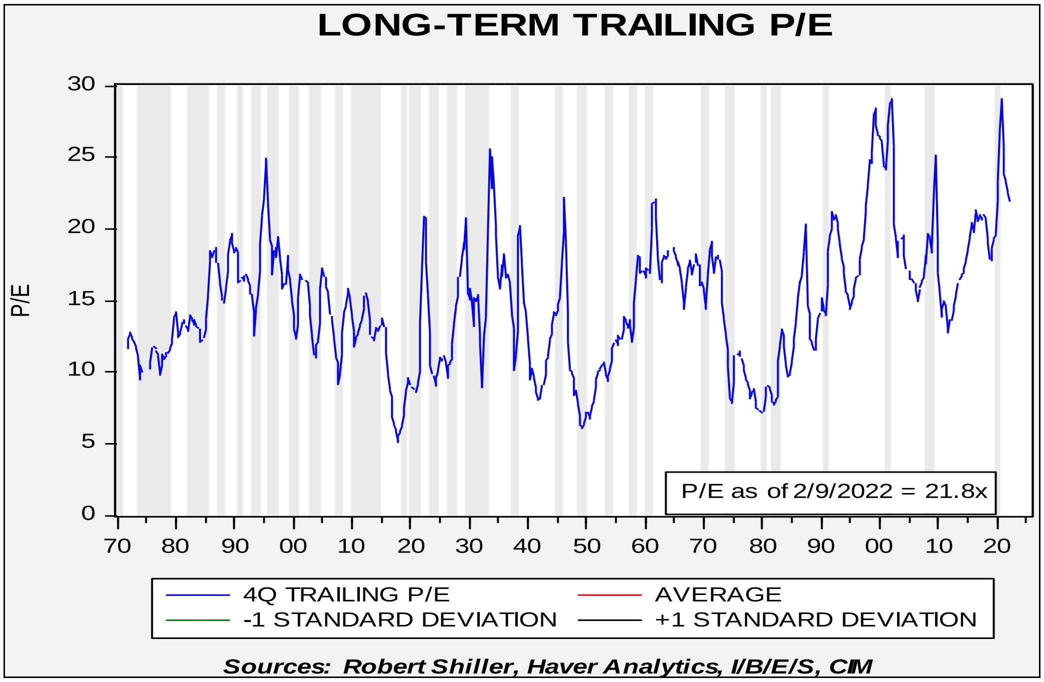


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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 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.