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 24, 2022—9:30 AM EST] Global equity markets are sharply lower this morning. In Europe, the EuroStoxx 50 is currently down 4.8% from its prior close. In Asia, the MSCI Asia Apex 50 closed down 4.0%. Chinese markets were lower, with the Shanghai Composite down 1.7% from its prior close and the Shenzhen Composite down 2.4%. U.S. equity index futures are signaling a lower open. With 449 companies having reported, the S&P 500 Q4 2021 earnings stand at $54.90, 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 19.8% 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* (2/17/2022): Oil prices remain elevated despite continued sales from the SPR.
- *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* (2/22/2022) (with associated podcast): "The U.S. Trade Deficit and Global Prices"
- *Confluence of Ideas* podcast (1/20/2022): "The 2022 Outlook"
- *Current Perspectives*: *"*2022 Outlook: Update #1*"* (2/18/2022)

Good morning! Today's report will focus primarily on the Russian invasion of Ukraine. On this day of global crisis, we at Confluence express our gratitude to the members of the U.S. military and intelligence community who are standing by to serve and protect their fellow citizens.

Russia-Ukraine: Russian President Vladimir Putin declared a "special military operation" into Ukraine but stated that he has no plans to occupy the region. In justifying his actions, Putin blamed NATO's expansion into Eastern Europe and his position has been supported by China and Iran. Putin has demanded that Ukraine accept Russian sovereignty over Crimea and renounce its ambition to join NATO. So far, Ukraine forces have been able to hold up against the attack, but it isn't clear how long they can last. Ukraine President Volodymyr Zelensky has announced that his country will fight and has started to arm civilians. Reports suggest that both sides have seen casualties. The attack did not come as a surprise; hours before the attack, three

Russian-guided missile cruisers made their way into the Black Sea and the Mediterranean Sea. Here are our initial thoughts surrounding the invasion of Ukraine.

- When we titled our *2022 Outlook: The Year of Fat Tails*, we expected a year of outlier events. Russian belligerence was expected (the #2 risk in our *2022 Geopolitical Outlook*), but this action is far out on the risk curve. Here's why:
    - NATO has been deeply fractured. French President Macron declared it "brain dead." Given enough time, it is possible that NATO would have imploded. Invading Ukraine makes little strategic sense.
    - Now, the treaty organization has a renewed reason for existing, and states that have been historically neutral (Sweden and Finland) will almost certainly coordinate with NATO and may petition to join. The organization that Putin opposes now will likely enlarge and strengthen.
    - The actual nightmare for Russia isn't just a renewed American interest in Europe but the remilitarization of Germany. Given the behavior of the U.S. over the past decade, it would not surprise us to see Berlin conclude that it needs to protect itself.
    - We have little doubt the Russian military can defeat Ukraine's forces, but this action could very well mean winning the battle but losing the war. Opposition to Russia will almost certainly solidify.
    - Poland and other central European nations have invoked Article 4, which triggers internal meetings of NATO if a member sees an external threat to their "territorial integrity, political independence or security."
    - In addition, as the U.S. discovered in Afghanistan and Iraq, invading is one thing but controlling is something quite different. We would expect Russia to face a persistent insurgency. Moscow may overcome opposition, but it won't be costless.
- Part of the invasion was a series of cyberattacks on Ukraine. The problem with such tools is that they can be hard to contain once released. Sen. Warner (D-VA) warns that if one of these weapons "gets loose" and ends up harming a NATO member, it might trigger an Article 5[1] declaration.
- We expect the U.S. and Western reactions to center on sanctions in the short run. Most likely, the focus will be on denying Russia technology. But we also expect a surge in defense spending to fortify the region. Poland will become the new line of demarcation.
    - There are reports that Russia may use cryptocurrencies to evade Western sanctions. However, given the selloff we have seen in crypto, this might not be a good option. In addition, if crypto is suspected to be used to avoid sanctions, the full regulatory and cyber powers of the U.S. might be levied against the product.

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[1] *"The Parties agree that an armed attack against one or more of them in Europe or North America shall be considered an attack against them all and consequently they agree that, if such an armed attack occurs, each of them, in exercise of the right of individual or collective self-defence recognised by Article 51 of the Charter of the United Nations, will assist the Party or Parties so attacked by taking forthwith, individually and in concert with the other Parties, such action as it deems necessary, including the use of armed force, to restore and maintain the security of the North Atlantic area*."

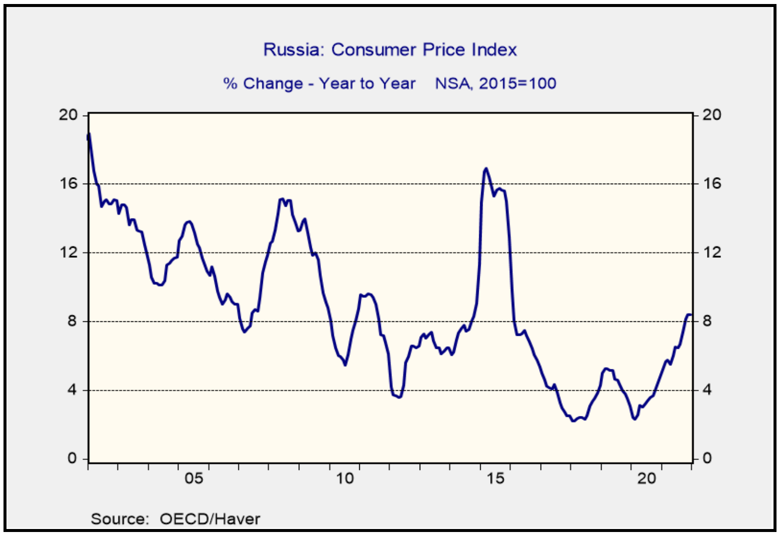
- One of the key components of this conflict is timing. Putin needs the invasion to be quick as the longer it takes to control Ukraine the more pain the Russian population is likely to feel because of the sanctions. The Russian population's willingness to support the conflict may fade in the face of damaging sanctions. Thus, this invasion could potentially backfire on Putin in a major way if not ended soon. As a result, Russia has warned media outlets to not use sources not approved by the Kremlin.
- Market reaction has been about as expected. Treasury yields fell, the dollar, yen, and Swiss franc rallied, gold lifted, and oil prices jumped. On the other hand, risk assets fell. The behavior of cryptocurrencies should end talk of them being "paper gold." Bitcoin and other currencies fell hard.

Other Russia and Ukraine-related news:

- As tensions escalate over Ukraine, the U.S. and its allies are now feeling the pressure to expand their military capabilities. We have mentioned in previous reports that China has been sympathetic to Russia over its security concerns and may be watching the Ukraine situation to see how the West might respond if it were to use similar measures to annex Taiwan. As news broke of the Russian incursion into Ukraine, China urged all sides to show restraint and pledged to resume trade with Russia.
    - China's decision to side with Russia has led many to speculate about its next moves. Taiwanese President Tsai Ing-wen called for the island to strengthen its military capabilities. Meanwhile, Admiral Mike Gilday called for increasing the U.S. fleet of ships to 500 by 2,040 to counter China if it decides to invade Taiwan. Thus, this invasion appears to be causing the U.S. to question whether it would like to forego its hegemonic role.
- Before the invasion, the European Union ratcheted up its sanctions against 23 high-ranking individuals on Wednesday as it tried to deter Russia from invading Ukraine. The list targeted banking executives, military chiefs, media officials, and a top Kremlin official. Following recent actions by Russia, the European Union will probably hit Russia with its harshest sanctions. So, neither the U.S. nor the EU is expected to cut off Russia from the SWIFT global interbank payment system, but this could potentially change.

Central Banks

- The Bank of Russia has stated that it plans to intervene to prevent a financial crisis as it prepares for a robust response from the West. The central bank has ordered brokers to stop allowing traders to short Russian stocks. Additionally, the bank announced it would intervene in the foreign-exchange market after the ruble plunged to a record-low following the invasion. A declining ruble will likely hurt Russian households as it will make imports more expensive. At 8%, annual inflation is high by U.S. standards, but it is still much lower than the level it reached following its invasion into Georgia in 2008 and Crimea in 2014.



- Ukraine's central bank has also taken measures to limit the damage the invasion will have on its financial system. It has suspended currency markets, limited cash withdrawals, and banned the issuance of foreign currency.
- In Europe, the European Central Bank is mulling whether to push back its plans to end its bond-buying stimulus program and begin rate hikes. There are concerns that the invasion could dip Europe into recession, so keeping policy easy to prevent these financial conditions may be seen as preferable to containing inflation.
- So far, the FOMC has sent no signals that it is retreating from its plans to normalize interest rates. However, we note that financial stress is rising, and over the past 30 years, the Fed has tended to avoid tighter policy when financial conditions are weakening. At the same time, with energy prices soaring, inflation worries will likely keep the pressure on to remove stimulus. So far, the 2-year deferred 3-month Eurodollar futures are still projecting at least 100 bps of tightening over the next two years.

Non-Ukraine news:

- **States export taxes?** As states grapple with ways to secure fuel supplies, the state of Washington has advanced legislation that would tax fuel shipped out of state. Washington plans to impose a six-cent-per-gallon tax on gas exported to other states. Neighboring states such as Oregon, Alaska, and Idaho have all voiced displeasure with the bill and Alaska has threatened to retaliate with an export tax of its own. That being said, the new tax would be the first of its kind in the nation and will probably be challenged in court. Washington has one of the highest gasoline prices in the country; thus, the export could be a way for the state to secure energy resources. However, the dispute over the fuel export tax may show how desperate states are becoming to rein in gasoline prices.

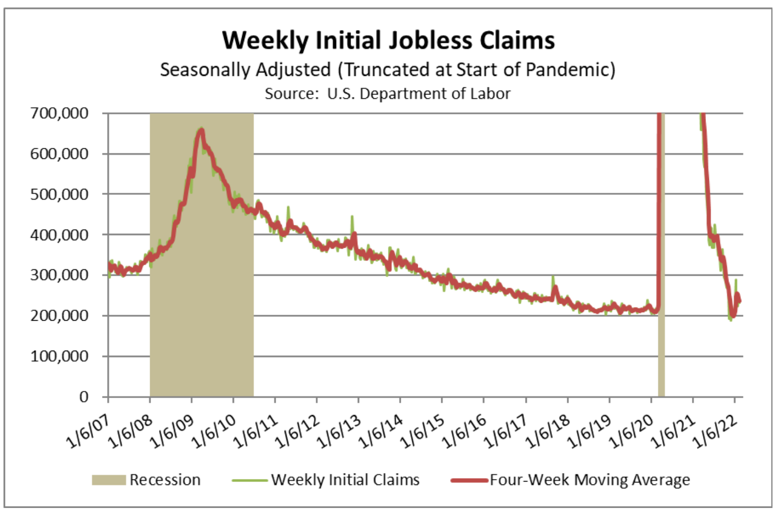
COVID-19: The number of reported cases is 430,148,646, with 5,920,054 fatalities. In the U.S., there are 78,731,240 confirmed cases with 941,909 deaths. For illustration purposes, the *FT* has created an interactive chart that allows one to compare cases across nations using similar scaling metrics. The CDC reports that 687,728,405 doses of the vaccine have been distributed with

551,372,287 doses injected. The number receiving at least one dose is 253,179,401, while the number of second doses is 215,129,430, and the number who have received the third dose, granting the highest level of immunity, is 93,428,100. The *FT* has a page on global vaccine distribution.

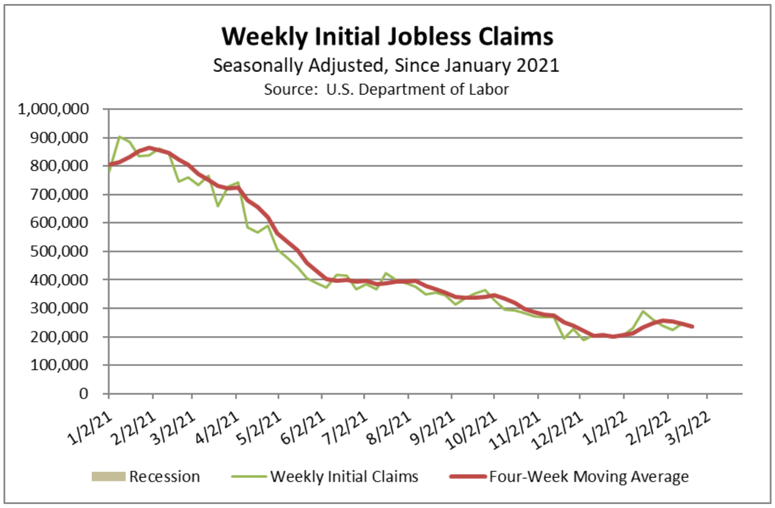
- A new vaccine developed by companies Sanofi (SNY, $52.52) and GlaxoSmithKline (GSK, $42.50) achieved 100% efficacy against severe disease and hospitalization. The shot could be an effective booster.
- South Korea has approved the Pfizer vaccine for 5- to 11-year-olds.

U.S. Economic Releases

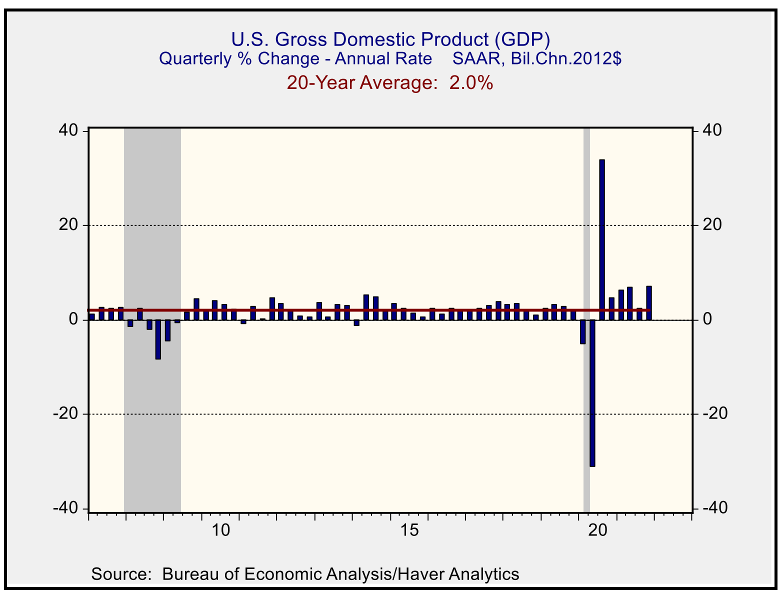
Initial applications for unemployment benefits in the week ended February 19 fell to a seasonally adjusted 232K, slightly better than both the expected level of 235K and the revised 249K in the previous week. The four-week moving average of claims, which helps smooth out some of the volatility in the series, came to 236K. The report also said that continuing jobless claims in the week ended February 12 fell to 1.476M compared with the anticipated 1.580M and the revised 1.588M in the prior week. The chart below shows how initial jobless claims have fluctuated since just before the previous recession. The chart is truncated during the period of the coronavirus pandemic because of the huge increase in claims at that time.



In order to show more detail on recent trends, the chart below shows initial jobless claims since the beginning of 2021.



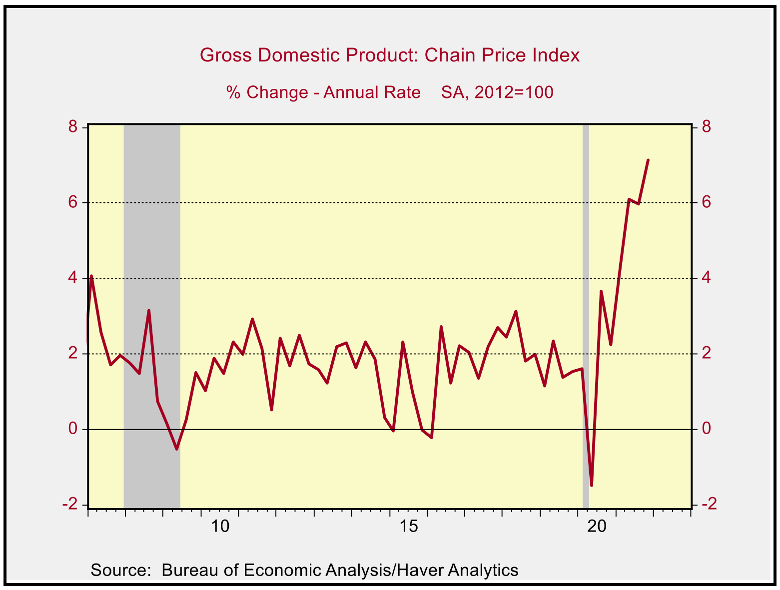
Separately, the Commerce Department issued its second regular estimate of economic growth in the final period of 2021. After stripping out seasonal impacts and price changers, fourth-quarter gross domestic product (GDP) rose at an annualized rate of 7.0%, matching expectations but slightly better than the 6.9% growth rate in the initial estimate. The fourth-quarter growth rate was also far better than the 2.3% rate of increase in the third quarter of 2021. The chart below shows the annualized rate of GDP growth each quarter since just before the previous recession.



The table below shows the contribution to growth from each of the major sources of demand, compared with the contributions in the initial estimate.

	Q4 2021 - 1st Estimate	Q4 2021 - 1st Estimate	Difference
GDP	7.0%	6.9%	0.1%
Consumption	2.1%	2.3%	-0.1%
Investment	5.4%	5.2%	0.2%
Inventories	4.9%	4.9%	0.0%
Net Exports	-0.1%	0.0%	-0.1%
Government	-0.5%	-0.5%	0.1%

The GDP report also includes the broadest measure of price inflation. The revised fourth-quarter GDP Price Index rose at a rate of 7.1%, which was somewhat worse than expectations that the rate of increase would be unrevised at 6.9%. The chart below shows how the GDP Chain Price Index has grown over time.



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

Economic Releases						
EST	Indicator			Expected	Prior	Rating
10:00	New Home Sales	m/m	Jan	802k	811k	***
10:00	New Home Sales MoM	m/m	Jan	-1.2%	11.9%	**
11:00	Kansas City Fed Manf. Index	m/m	Feb	25	24	*
Fed Speakers or Events						
EST	**Speaker or Event**	**District or Position**				
9:00	Thomas Barkin Speaks on the Economic Outlook	President of the Federal Reserve Bank of Richmond				
11:10	Raphael Bostic Discusses Banking in the Digital Era	President of the Federal Reserve Bank of Atlanta				
12:00	Loretta Mester Speaks on the Economic and Policy Outlook	President of the Federal Reserve Bank of Cleveland				
16:00	Mary Daly Takes Part in a Panel Discussion	President of the Federal Reserve Bank of San Francisco				
20:00	Chris Waller Discusses the Economic Outlook	Member of the Board of Governors				

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								
Japan	Nationwide Department Store Sales	y/y	Jan	15.6%	8.8%		**	Equity bullish, bond bearish
Australia	Private Capital Expenditure	q/q	4Q	1.10%	-1.10%	2.50%	**	Equity and bond neutral
South Korea	PPI	y/y	Jan	8.7%	9.0%		**	Equity bullish, bond bearish
EUROPE								
France	Consumer Confidence Index	m/m	Feb	98	99	100	**	Equity bearish, bond bullish
Italy	Industrial Sales WDA	y/y	Dec	14.3%	22.2%		*	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	18-Feb	643.2b	639.6b		***	Equity and bond neutral
AMERICAS								
Mexico	Bi-Weekly CPI	y/y	15-Feb	7.2%	7.0%	7.2%	**	Equity and bond neutral
	Bi-Weekly Core CPI	y/y	15-Feb	6.5%	6.3%	6.4%	*	Equity and bond neutral
	Retail Sales	y/y	Dec	4.9%	5.4%	5.9%	***	Equity bearish, bond bullish
Brazil	Total Outstanding Loans	m/m	Jan	4671b	4684b	4710b	**	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)	49	46	3	Up
3-mo T-bill yield (bps)	29	35	-6	Neutral
TED spread (bps)	20	11	9	Widening
U.S. Libor/OIS spread (bps)	40	42	-2	Down
10-yr T-note (%)	1.86	1.99	-0.13	Up
Euribor/OIS spread (bps)	-53	-53	0	Neutral
Currencies	**Direction**			
Dollar	Up			Neutral
Euro	Down			Up
Yen	Up			Neutral
Pound	Down			Up
Franc	Down			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.

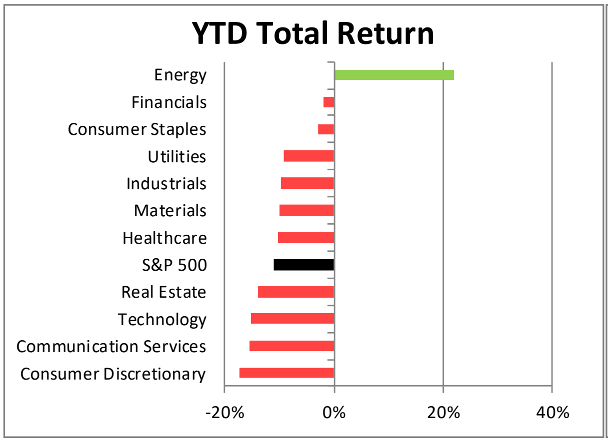
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$104.45	$96.84	7.86%	Russian invasion of Ukraine.
WTI	$98.83	$92.10	7.31%	Russian invasion of Ukraine.
Natural Gas	$4.85	$4.62	4.93%	Russian invasion of Ukraine.
Crack Spread	$28.00	$27.67	1.20%	
12-mo strip crack	$25.21	$24.56	2.63%	
Ethanol rack	$2.35	$2.33	0.48%	
Metals				
Gold	$1,962.08	$1,909.01	2.78%	Russian invasion of Ukraine.
Silver	$25.34	$24.55	3.20%	Russian invasion of Ukraine.
Copper contract	$453.20	$448.85	0.97%	
Grains				
Corn contract	$716.25	$681.25	5.14%	Russian invasion of Ukraine.
Wheat contract	$934.75	$884.75	5.65%	Russian invasion of Ukraine.
Soybeans contract	$1,711.75	$1,671.00	2.44%	
Shipping				
Baltic Dry Freight	2,244	2,148	96	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		0.0		
Gasoline (mb)		-1.5		
Distillates (mb)		-1.7		
Refinery run rates (%)		-0.4%		
Natural gas (bcf)		-129.0		

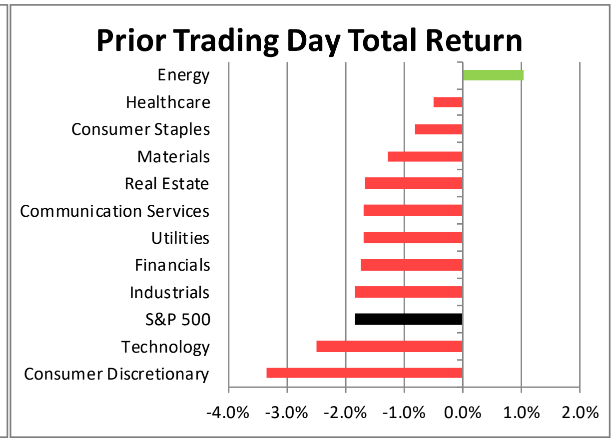
Weather

The 6-10 day and 8-14 day forecasts warmer-than-normal temperatures in a band running from the Southwest through the southern Great Plains and into the Southeast, with cooler-than-normal temperatures in the Pacific Northwest and northern New England. The forecasts currently call for wetter-than-normal temperatures in the northern Rocky Mountains and the Great Plains, with dry conditions in the Southwest and the Southeast.

Data Section

U.S. Equity Markets – (as of 2/23/2022 close)

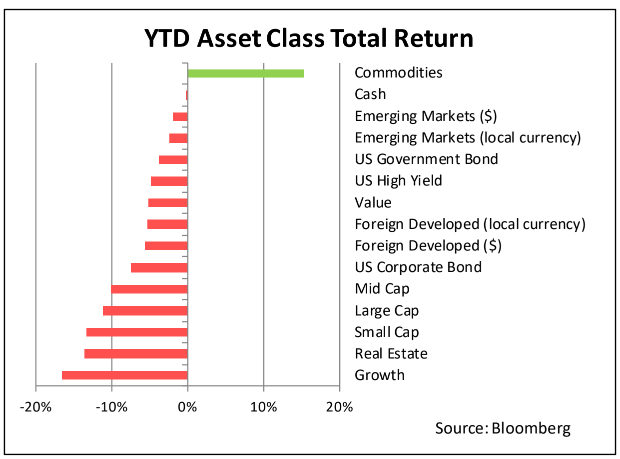




(Source: Bloomberg)

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 2/23/2022 close)

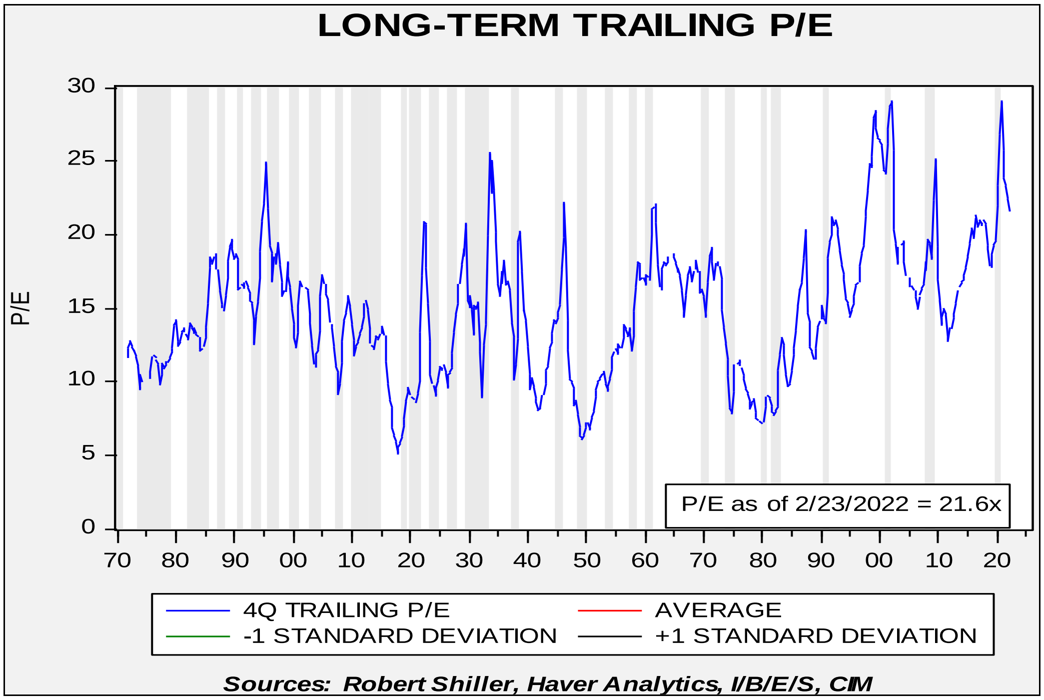


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 24, 2022



Based on our methodology,[2] the current P/E is 21.6x, down 0.1x from last week. The decline in the multiple is due to the decline in the index.

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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[2] 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.