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: January 13, 2022—9:30 AM EST] Global equity markets are mixed this morning. In Europe, the EuroStoxx 50 at present is essentially unchanged from its prior close. In Asia, the MSCI Asia Apex 50 closed unchanged. In contrast, Chinese markets were lower, with the Shanghai Composite down 1.2% from its prior close and the Shenzhen Composite down 1.7%. U.S. equity index futures are signaling a higher 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:

- *Weekly Geopolitical Report* (12/13/2021): "The 2022 Geopolitical Outlook"
- *Weekly Energy Update* (1/13/2022): ***Oil inventories fell last week; at the same time, gasoline stockpiles rose strongly but were in line with seasonal patterns***.
- *Asset Allocation Q4 2021 Rebalance Presentation* (11/4/2021): A video discussion of our asset allocation process, Q4 2021 portfolio changes, and the macro environment
- *Asset Allocation Bi-Weekly* (1/10/2022) (with associated podcast): "The Path of Monetary Policy"
- *Confluence of Ideas* podcast (12/14/2021): "The Regional Threats from the Taliban in Afghanistan"
- *Current Perspectives*: *"*2022 Outlook: The Year of Fat Tails*"* (12/16/2021)

Good morning! Today's report begins with a discussion about the recent remarks made by FOMC members. This is followed by U.S. economic and policy news a China-related story. International news is next, and we end with our pandemic coverage.

More Hikes? The Federal Reserve appears to be getting more hawkish by the week. Philadelphia Fed President Patrick Harker and San Francisco Fed President Mary Daly both signaled support for interest rate hikes starting in March. While Harker, a voting member, stated he would support "at least three" rate hikes, Daly, a non-voting member, has not been open about the number of increases she supports. Meanwhile, St. Louis Fed President James Bullard told the *WSJ* he expects to support as many four rate hikes to combat rising inflation.

In addition to the rate hikes, more members of the Fed have expressed a willingness to return inflation to its 2% target. During her testimony before the Senate Committee, Federal Reserve Governor Lael Brainard, who we view as a dove, mentioned a desire to get inflation back to its pre-pandemic norm. However, this may be easier said than done. In 2021, inflation was driven primarily by motor and energy prices. Although both product groups saw a jump in price due to stronger demand, they were constrained by a reduction in output. Retail inventories for motor vehicles are still well below their pre-pandemic levels, while the lack of investment in fossil fuels has reduced production capacity for commodities worldwide. Moreover, supply chain disruptions due to continued outbreaks of COVID-19 continue to be an issue. So, it may take a while for inflation to return to 2% even with Fed action. The hawkish comments from the Fed have made us less optimistic that it will back away from raising rates more than once this year.

Economics and policy:

- The U.S. budget deficit narrowed to its lowest level in two years in December. The deficit shrank to $21.3 billion as the rise in income and corporate profits boosted tax receipts.
- Congress expects to move forward with a bill designed to help the country's competitiveness with China. The legislation would authorize funding to bolster research and development as well as aid to the domestic semiconductor industry. Although the bill has bipartisan support, it has a narrow pathway to success. There is resistance on both sides of the aisle due to concerns that the bill may be too harsh on China.
- Senator Joe Manchin (D- WV) has expressed an openness to supporting the Build Back Better Act. Manchin, whose vote is critical to getting the bill passed, stated he would like the tax credit given to nuclear plants under the bill to expand from six years to 10 years. Extending the credit would mean the bill would have to cut costs elsewhere in order for it to meet its $2 trillion price tag.

China:

- Chinese banks have become more selective about financing real estate projects from local governments. The reluctance appears to be related to banks wanting to limit their risk exposure to the real estate sector amidst a decline in property values.

International news:

- The head of the International Energy Agency, Fatih Birol, implied that the gas crisis in Europe was deliberately caused by Russia. Birol stated Russia was holding back a third of the gas that it could send to Europe and depleted its storage facilities to give the impression of tightened supply. Additionally, Birol theorized that the gas shortage was related to Russia's ongoing tension with Ukraine. In December, Russia sent troops along the Ukraine border in what is perceived as an act of intimidation.

    - Moscow and Washington are set for additional talks. So far, discussions appear to be at a standstill after Moscow and NATO allies refused to accept each other's demands. Moscow wants guarantees that Eastern European countries will not join NATO, while Washington would like a withdrawal of troops from along the Ukraine border.

    - In the Senate, Republicans are looking to impose more sanctions on Russia over the Gazprom Nord Stream 2 gas pipeline. A vote in favor of the bill could hinder efforts of the Biden administration to come to an agreement with Moscow over the Ukraine border issue.

- U.K. Prime Minister Boris Johnson has apologized for attending a party during the first pandemic lockdown. The Prime Minister has come under pressure to resign following the release of the story.

- Taiwan Semiconductor Manufacturing Company (TSMC, $132.23) plans to spend at least $40 billion to upgrade and expand its production capacity beyond its borders. The firm is looking to establish new fabs in Japan and the U.S.

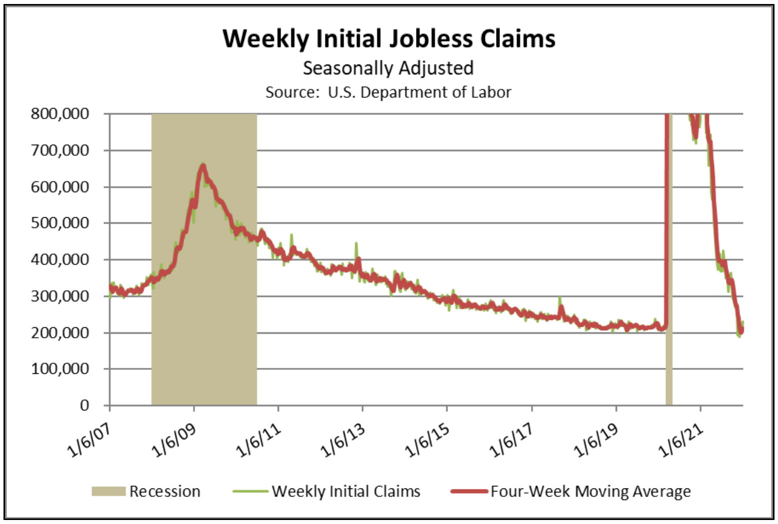
- Borrowers in Europe have rushed to debt markets in anticipation of higher rates in the future. There was $107 billion in bonds sales in the lead up to Christmas, a new record.

COVID-19: The number of reported cases is 317,289,446, with 5,515,204 fatalities. In the U.S., there are 63,203,866 confirmed cases with 844,562 deaths. For illustration purposes, the *FT* has created an interactive chart that allows one to compare cases across nations using similar scaling metrics. The *FT* has also issued an economic tracker that looks across countries with high-frequency data on various factors. The CDC reports that 644,652,095 doses of the vaccine have been distributed, with 522,482,674 doses injected. The number receiving at least one dose is 247,695,845, the number of second doses is 208,182,657, and the number of the third dose, the highest level of immunity, is 77,101,175. The *FT* has a page on global vaccine distribution.

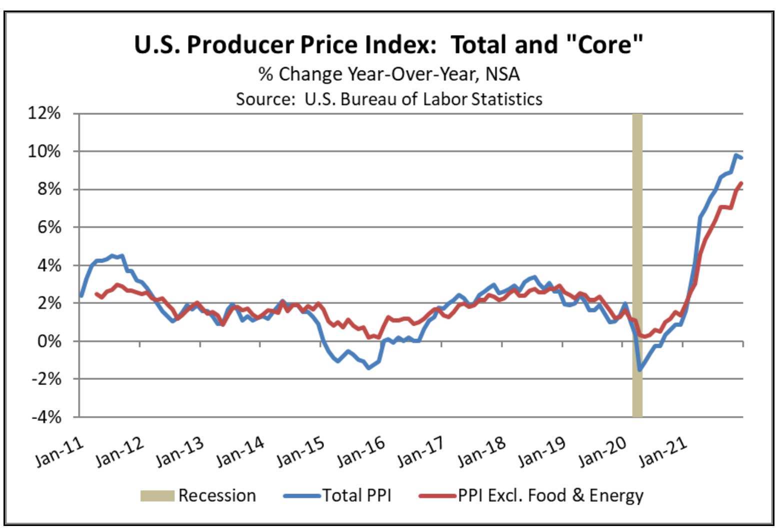
- An Omicron outbreak has been detected in another major port city in China. On Thursday, Chinese officials reported there were cases in Dalian. So far, the city is undergoing mass testing but could go into lockdown if it is discovered the virus is spreading. Dalian would be the second port city to be lockdown due to cases of COVID-19, the first being Tianjin. The spread of COVID-19 in China has already led to growing port congestion and could add to global supply chain pressures.
- AstraZeneca Plc (AZN, $58.40) has data supporting the use of its vaccine as a booster. The new research suggests that the vaccine generated antibodies against Omicron. Last year, the vaccine was sidelined by the U.S. and Europe due to a rare side effect that caused blood clots.
- The Biden Administration is set to distribute free COVID-19 tests for schools across the country. The effort is designed to keep schools open after a rise in cases has forced some schools to close due to a staff shortage.
- France expects to lift travel restrictions on the U.K. by the end of the week. The report comes after data that suggests that Omicron may have peaked in the U.K.

U.S. Economic Releases

Initial applications for unemployment benefits in the week ended January 8 rose to a seasonally adjusted 230K, significantly worse than both the expected level of 200K and the previous week's level of 207K. The four-week average of initial claims, which helps smooth out the weekly figures, rose to 210.75K, its highest level since the beginning of December. All the same, initial jobless claims remain far below the levels seen during most of the coronavirus pandemic, and they are back within range of the levels seen before the crisis. In the most positive aspect of the report, continuing claims in the previous week fell to 1.559M, far better than both the anticipated level of 1.733M and the previous week's level of 1.753M. The chart below shows how initial jobless claims have fluctuated since just before the prior recession.



Separately, the December Producer Price Index (PPI) was up by a seasonally adjusted 0.2% from November. That was much better than the anticipated rise of 0.4%, but that good news was offset by the fact that the November index was revised upward to show a jump of 1.0%. Excluding the volatile food and energy categories, the December "Core PPI" was up 0.5%, matching expectations and much more moderate than the revised rise of 0.9% in the previous month. Compared with December 2020, the overall PPI last month was up 9.7%, while the Core PPI was up 8.3%. The chart below shows the year-over-year change in the PPI and the Core PPI over the last decade.



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

Economic Releases		
No economic releases today		
Fed Speakers or Events		
EST	**Speaker or event**	**District or position**
10:00	Lael Brainard Testifies at Her Confirmation Hearing	Member of the Board of Governors
12:00	Thomas Barkin Discusses the U.S. Economic Outlook	President of the Federal Reserve Bank of Richmond
13:00	Charles Evans Discusses the Economy and Monetary Policy	President of the Federal Reserve Bank of Chicago

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.

	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
Japan	Machine Tool Orders	y/y	Dec P	40.5%	64.0%		**	Equity and bond neutral
	Bankruptcies	y/y	Dec P	-9.7%	-10.4%		*	Equity bullish, bond bearish
	Money Supply M2	y/y	Dec	3.7%	4.0%	3.8%	**	Equity and bond neutral
	Money Supply M3	y/y	Dec	3.4%	3.5%	3.5%	**	Equity and bond neutral
New Zealand	Building Permits	y/y	Nov	0.6%	-2.1%		***	Equity bullish, bond bearish
South Korea	Export Price Index	y/y	Dec	23.5%	25.5%		*	Equity and bond neutral
	Import Price Index	y/y	Dec	29.7%	35.5%	35.0%	*	Equity and bond neutral
India	Trade Balance	m/m	Dec	$21.70b	$22.91b	$21.99b	*	Equity and bond neutral
	Exports	y/y	Dec	38.9%	27.2%		***	Equity and bond neutral
	Imports	y/y	Dec	38.6%	56.6%		*	Equity and bond neutral
EUROPE								
Italy	Industrial Production WDA	y/y	Nov	6.3%	1.9%	3.7%	**	Equity bullish, bond bearish
	Industrial Production NSA	y/y	Nov	6.3%	-1.2%		*	Equity bullish, bond bearish
Russia	Gold and Forex Reserves	w/w	31-Dec	630.5b	630.6b		***	Equity and bond neutral
AMERICAS								
Brazil	IBGE Services Volume	y/y	Nov	10.0%	7.5%	6.7%	*	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)	24	24	0	Down
3-mo T-bill yield (bps)	11	12	-1	Neutral
TED spread (bps)	13	12	1	Neutral
U.S. Libor/OIS spread (bps)	17	16	1	Down
10-yr T-note (%)	1.74	1.74	0.00	Down
Euribor/OIS spread (bps)	-56	-56	0	Neutral
EUR/USD 3-mo swap (bps)	-2	-1	-1	Down
Currencies	**Direction**			
Dollar	Down			Neutral
Euro	Up			Up
Yen	Up			Neutral
Pound	Up			Neutral
Franc	Up			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.

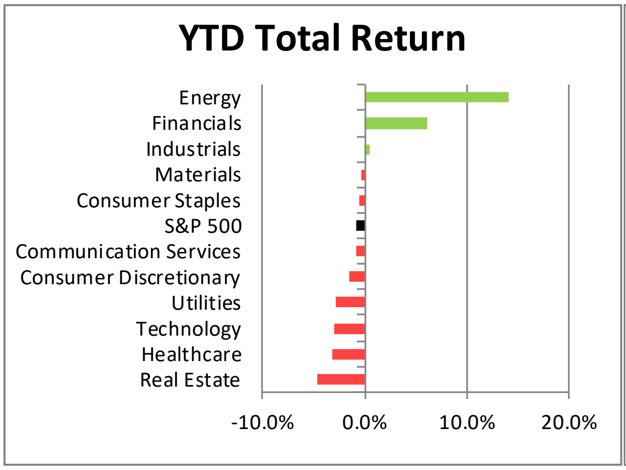
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$84.47	$84.67	-0.24%	
WTI	$82.25	$82.64	-0.47%	
Natural Gas	$4.66	$4.86	-3.99%	
Crack Spread	$20.76	$20.55	1.01%	
12-mo strip crack	$21.68	$21.81	-0.60%	
Ethanol rack	$2.27	$2.28	-0.68%	
Metals				
Gold	$1,823.30	$1,826.15	-0.16%	
Silver	$23.16	$23.14	0.06%	
Copper contract	$456.10	$457.65	-0.34%	
Grains				
Corn contract	$595.25	$599.00	-0.63%	
Wheat contract	$753.00	$757.75	-0.63%	
Soybeans contract	$1,384.75	$1,399.25	-1.04%	
Shipping				
Baltic Dry Freight	2,027	2,151	-124	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-4.6	-1.7	-2.9	
Gasoline (mb)	8.0	3.1	4.9	
Distillates (mb)	2.5	1.7	0.8	
Refinery run rates (%)	-1.40%	-0.20%	-1.20%	
Natural gas (bcf)		-31.0		

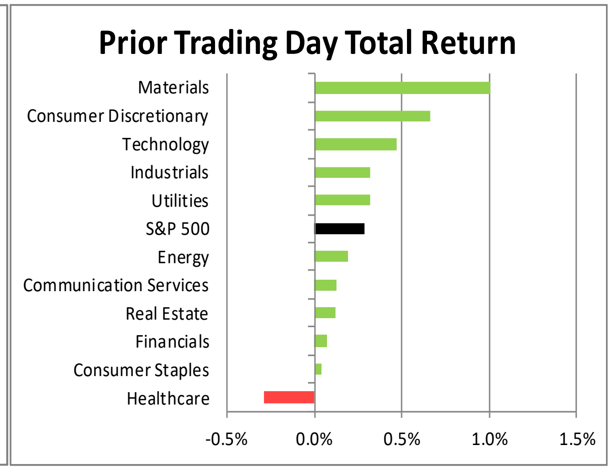
Weather

The 6-10 day and 8-14-day forecasts currently call for warmer-than-normal temperatures in Texas and the Far West, with cooler-than-normal temperatures in the Midwest and Northeast. The forecasts call for wet conditions in the Northern Great Plains and the Southeast, with dry conditions on the West Coast.

Data Section

U.S. Equity Markets – (as of 1/12/2022 close)

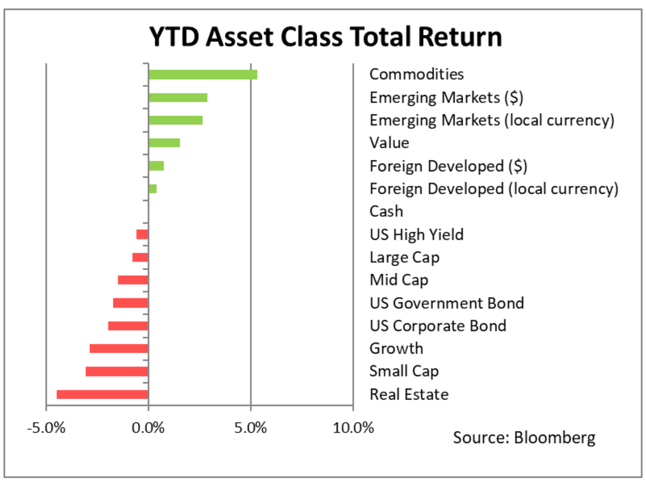




(Source: Bloomberg)

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 1/12/2022 close)

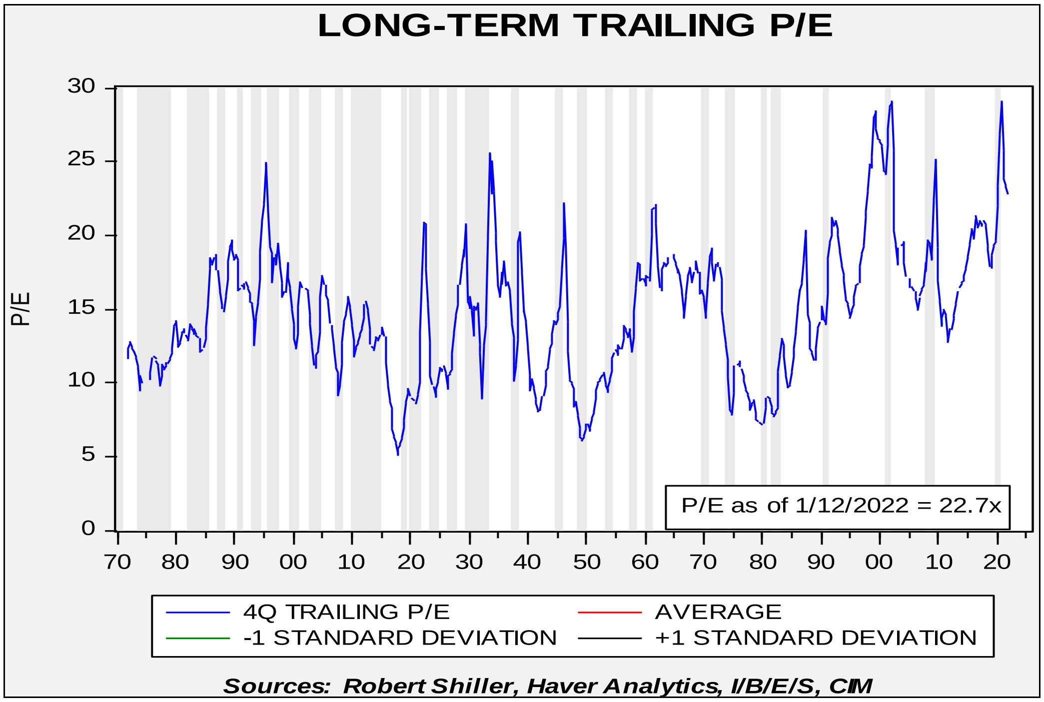


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

January 13, 2022



Based on our methodology,[1] the current P/E is 22.7x, down from last week's 23.1x. The decline in the multiple is due to lower index prices.

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.