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: July 19, 2022—9:30 AM EDT] Global equity markets are mostly higher this morning. In Europe, the Euro Stoxx 50 is currently unchanged from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 2.2%. Chinese markets were mostly steady, with the Shanghai Composite unchanged from its prior close and the Shenzhen Composite closing up 0.1%. U.S. equity index futures are signaling a higher open. With 41 companies having reported, the S&P 500 Q2 2022 earnings stand at $55.50, higher than the $55.26 forecast for the quarter. The forecast reflects a 4.3% increase from Q2 2021 earnings. Thus far this quarter, 65.9% of the companies have reported earnings above forecast, while 24.4% 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:

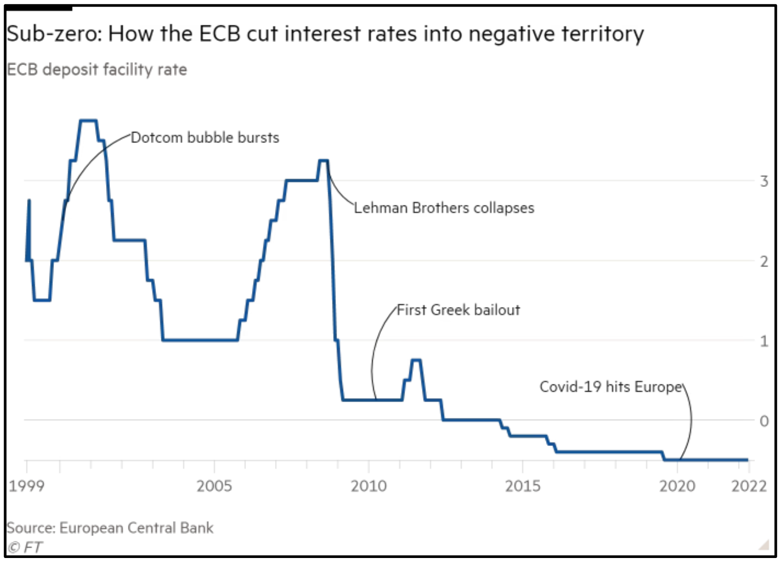
- ***Bi-Weekly Geopolitical Report*** **(7/18/2022) (with associated podcast): "The Pandemic's Impact on Inequality"**
- *Weekly Energy Update (7/14/2022): We take a look at gasoline demand, the president's trip to the Middle East, and recap the weekly data*.
- *Asset Allocation Quarterly - Q2 2022* (4/21/2022): Discussion of our asset allocation process, Q2 2022 portfolio changes, and our outlook for the markets
- *Asset Allocation Bi-Weekly* (7/11/2022) (with associated podcast): "The ECB Dilemma"
- *Confluence of Ideas* podcast (3/25/2022): "The 2022 Outlook: Update #1"
- *Current Perspectives*: *"*2022 Outlook: Update #2 – The Tails Become Fatter*"* (7/12/2022)
- ***Charts Worth Noting:*** **We look at the Annual Percentage Change in CPI which showed that the price of goods and services accelerated at its fastest pace in over four decades.**

Our *Comment* today opens with an update on the Russia-Ukraine war, including further evidence that Russia's aggression has sparked a major, long-lasting increase in global defense spending. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including a swing in investor expectations toward a view that the European Central Bank will hike its benchmark interest rate this week by more than previously anticipated.

Russia-Ukraine: Both Russian and Ukrainian forces appear to be ramping up their ground attacks, or preparing to do so, after their partial operational pauses of the last several weeks. Russian forces also continue to launch missile strikes across the country, while Ukrainian forces are reportedly concentrating and converging for what may be a counteroffensive near the southern city of Kherson. Reports also indicate that the Russian government has been forming volunteer units comprised of non-ethnic Russians, demonstrating President Putin's political reluctance to order a mass mobilization of ethnic Russians.

- By reminding government leaders that major countries can and do invade their neighbors, the Russian attack on Ukraine continues to spur greater defense spending worldwide. In the latest example, Japanese Prime Minister Kishida will allow his country's armed forces to request as much funding as they want for the coming fiscal year, while all other ministries will have their budget requests strictly capped.
    - Significantly, there have been almost no objections to the plan by opposition parties, left-leaning media or Japanese society in general.
    - Former Prime Minister Abe consistently faced strong opposition to his proposal to double defense spending to 2% of GDP, but current Prime Minister Kishida has faced no such pushback to similar plans.
- In the EU, the European Commission issued a first-ever proposal to provide financing for the joint procurement of weapons by member states to help their armies restock and improve military hardware in response to the war. The proposal seeks to channel the increase in EU defense spending toward coordinated procurement and prevent larger member states from monopolizing the continent's arms companies.
- As Germany solidifies plans for energy rationing in case Russia completely shuts off its natural gas exports to Western Europe, as European officials now expect, a fierce debate has opened up regarding whether households or industry should get priority access to limited supplies. Major firms and industry groups are pushing for protection, although political considerations probably mean consumers will be given priority.
- In a bid to encourage European countries to share gas and cap prices if necessary, the IMF warned that a full cut-off of Russian gas would trigger economic contractions of more than 5% over the next year in Italy, the Czech Republic, Hungary, and Slovakia.
    - The IMF modelling suggests that the European economy could manage with Russia curtailing supplies by 70%, but a complete cut-off would cause painful shortages.
    - In a worst-case scenario, the worst affected European countries would only be able to access 15% to 40% of their needs.

European Union: Based on new comments from ECB President Lagarde and other monetary policymakers in the Eurozone, investors have become increasingly convinced that the officials will hike their benchmark short-term interest rates on Thursday by an aggressive 50 bps, to 0.0%, rather than the 25 bps Lagarde insisted on earlier in the summer. In recent days, speculation that the ECB could end negative interest rates in the Eurozone has helped drive the euro higher after it essentially reached parity with the dollar last week.



United Kingdom: Yesterday, in the race to replace Boris Johnson as Conservative Party leader and prime minister, a vote of parliamentary party members eliminated Tom Tugendhat, chairman of the Foreign Affairs Committee. The remaining candidates include Former Chancellor Rishi Sunak (115 votes), Trade Minister Penny Mordaunt (82 votes), Foreign Minister Liz Truss (71 votes), and Former Equities Minister Kemi Badenoch (58 votes).

- Further votes are scheduled for today and tomorrow to whittle the field down to just two candidates.
- At that point, the remaining candidates will have several weeks to campaign before a poll of the broad party membership at the end of the summer.

Chinese Real Estate Sector: With dozens of real estate developers on the verge of bankruptcy and unable to finish paid-for housing units due to government efforts to rein in their debt, Beijing is scrambling to quell a move by furious homebuyers to stop making mortgage payments on undelivered homes. One government tactic has been to censor social-media posts about the crisis. More importantly, the China Banking and Insurance Regulatory Commission has instructed banks to provide credit to eligible property developers "based on market principles and in compliance with the law" to help them complete unfinished homes.

- Compared with the total amount of outstanding mortgages in China, the loans threatened by the buyers' payment strike are probably not enough to threaten the banking system.
- Rather, the government seems more focused on averting more social disruption, especially ahead of the Communist Party's 20th National Congress this autumn, at which time President Xi aims to win a precedent-breaking third term in office.
- In any case, the move by the CBIRC opens the liquidity taps to developers for the first time in almost one year. In response, Chinese developer stocks jumped sharply. The intervention also underscores the government's willingness to goose the economy in order to support growth ahead of the party conclave.

Chinese Technology Sector: The Cyberspace Administration of China is reportedly preparing to impose a fine of more than $1 billion on ride-hailing company Didi Global (DIDIY, $2.93) for data security breaches discovered last year. However, the government will also ease a ban on Didi's adding of new users to its platform and will allow the company's mobile apps to be restored to domestic app stores. Although China's tech sector remains under high regulatory risk, the move is another example of Chinese authorities easing up on firms to bolster growth ahead of the party congress.

United States-China: If you're looking for a silver lining in today's high U.S. inflation rate, you can find one in the comparison of U.S. to China gross domestic product (GDP). Such comparisons are typically calculated in nominal terms at current exchange rates, so galloping U.S. prices and a weak renminbi mean China GDP will likely lag U.S. GDP for years to come. However, when adjusted for the purchasing power of the currency, China's GDP surpassed that of the U.S. many years ago.

United States-European Union: Tomorrow, Secretary of State Blinken will hold a meeting with officials from the EU and 17 other countries to discuss ways to strengthen industrial supply chains among themselves. Besides the EU, the key countries involved will include Australia, India, Indonesia, Japan, Singapore, and South Korea. Consistent with the administration's push to increase "friend shoring," neither China nor Russia was invited.

- We have long warned that the U.S. is pulling back from its traditional role as global hegemon, contributing to deglobalization and a fracturing of the world into separate geopolitical and economic blocs. In our *Bi-Weekly Geopolitical Report* of May 9, 2022, we took a stab at forecasting which countries were likely to join each of the evolving blocs, and what that would imply for the global economy and financial markets going forward. We note that most of the countries Blinken will meet with tomorrow are in our projected U.S.-led bloc.
- To date, the Biden administration has tried to nurture the development of the U.S.-led bloc mostly by incentives and persuasion, and that will likely be the main approach at tomorrow's meeting. However, it is important to remember that the administration could eventually take a more forceful approach to building the U.S.-led bloc and sealing it off from the Chinese-led bloc, as the Trump administration did.

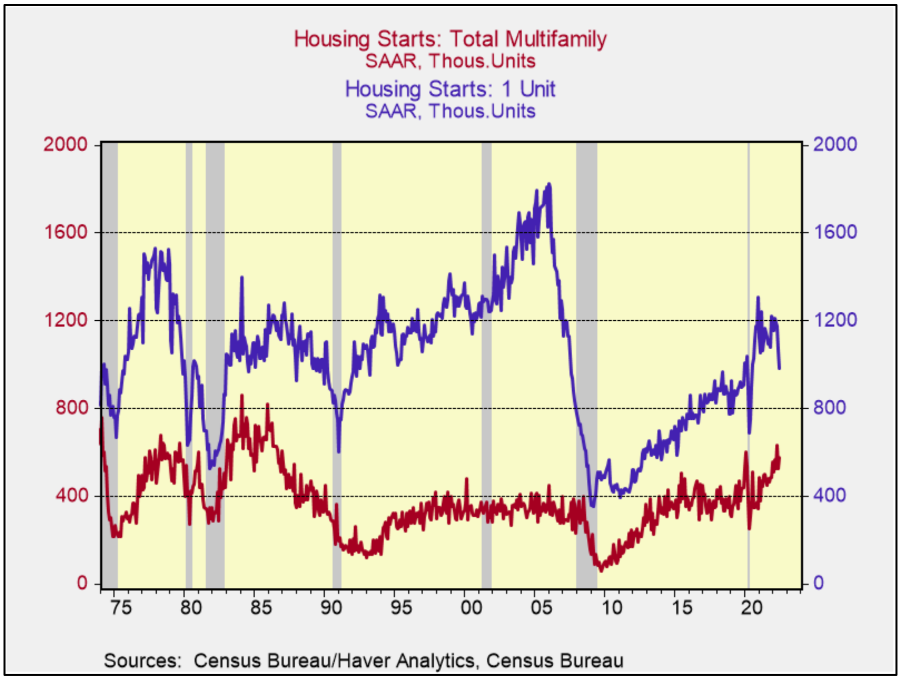
U.S. Labor Market: In a call with financial analysts yesterday, Goldman Sachs (GS, $301.26) warned it may slow hiring and eventually cut underperforming staff in response to tightening monetary conditions. Coming on top of hiring slowdowns and job cuts announced recently by major technology firms, the statement adds to concerns that U.S. economic growth and labor demand are already slowing.

U.S. Corporate Earnings: U.S. multinational firms like Johnson & Johnson (JNJ, $174.23) have begun to indicate that the strong dollar is weighing on their profits. Along with higher costs for materials and labor, the super-strong dollar suggests that large companies' margins and earnings may be set to surprise to the downside through the rest of the year.

U.S. Economic Releases

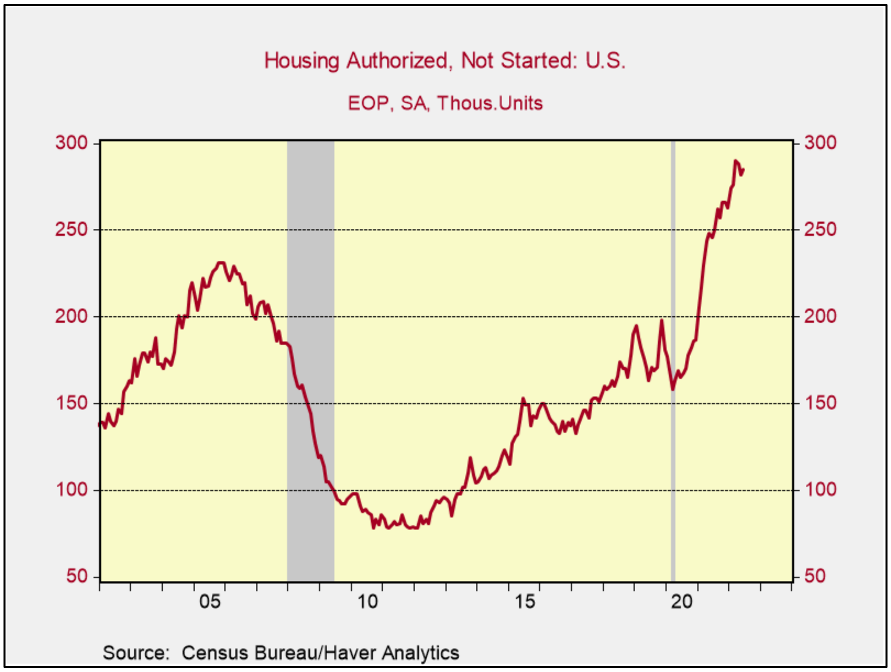
June housing starts came in weaker than expected at 1.559 million units annualized, compared to forecasts of 1.580 million units annualized. However, offsetting some of the weakness was a large upward revising to May, which was increased to 1.591 million units annualized compared to the initial report of 1.549 million units annualized. Permits were higher than forecast in June at 1.685 million units annualized compared to expectations of 1.650 million units annualized. There were no revisions to the prior month.

In the details, single family starts fell 8.1% from May, while multi-family starts rose 10.3%.



In general, the economy tends to see stronger after-purchase consumption from single-family activity, so the rapid weakness occurring in that category is concerning. In the regional breakdown, the Northeast saw a 10.6% rise in overall starts, and the West rose 3.7%. The South declined 4.8% while the Midwest slid 7.7%.

Authorized but not started remains historically elevated. This data likely reflects supply-related problems, including material and labor.

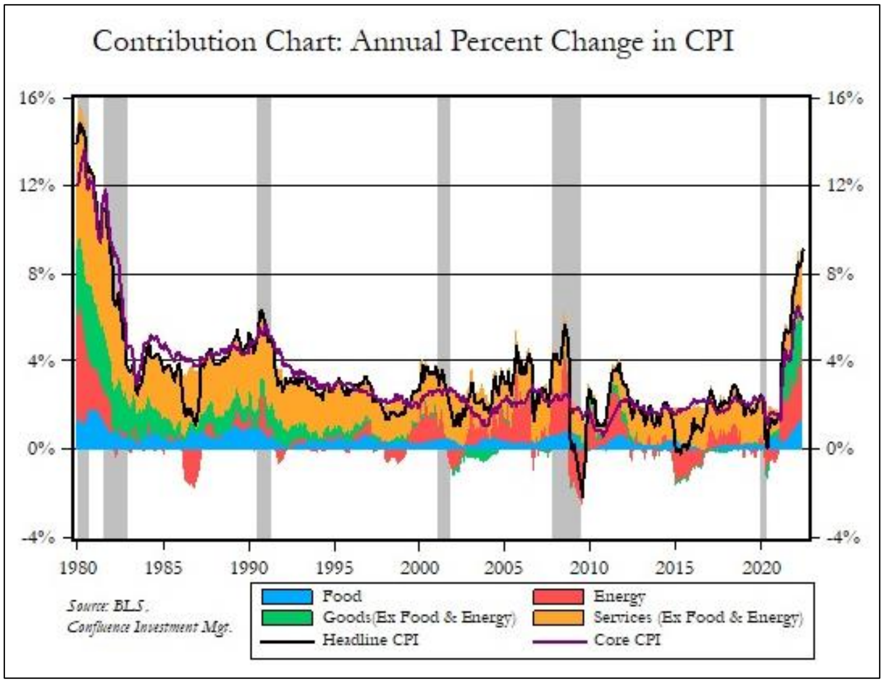


The good news from the above chart is that the pipeline of homebuilding is ample, but until the supply chain issues are resolved, the backlog will remain in place unless permitting slows. That appears to be happening, although multi-family permits rose 11.5%, single family permits have declined for five consecutive months and fell 8.0% in June. Unfortunately, we may be fixing the backlog by reducing future homebuilding.

For the rest of the day:

Economic Releases		
No economic releases for the rest of today		
Federal Reserve		
EST	**Speaker or Event**	**District or Position**
13:35	Lael Brainard Discusses Community Reinvestment Act	Vice-Chair of the Board of Governors

Charts Worth Noting



At 9.1%, the June CPI report showed that the price of goods and services accelerated at its fastest pace in over four decades. Last month, energy, food, and transportation services were the main drivers of inflation. Shelter prices, although above trend, were a drag on the overall index, rising 5.6% from the prior year in June. At the same time, we are seeing signs of inflation relief. Core goods, which exclude food and energy prices, have slowed considerably over the last few months which, given its sizeable share of CPI, should lead to lower inflation as long as the trend continues. Consequently, we could see inflation fall to around 5-4% by the end of the year as energy prices start to cool.

When the FOMC convenes on July 26-27, Fed officials will discuss whether they are prepared to take more aggressive action to tame inflation. Since the CPI report was released, officials have offered mixed signals about whether the Fed will become more aggressive in tightening monetary policy. For example, Atlanta Fed President Raphael Bostic, a traditional dove, said that "everything is in play" to bring down inflation. Meanwhile, Fed Governor Christopher Waller, a hawk, has advocated for a wait-and-see approach. Although the Fed is expected to raise rates by 75 bps at its July meeting, investors will be looking for signs as to whether the central bank will stay on its current path. The latest Fed dots plot, which the central bank uses to guide interest rate expectations, shows a median year-end projection of 3.4% for fed funds.

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								
EUROPE								
Eurozone	Construction output	y/y	May	2.9%	2.8%		*	Equity and bond neutral
	CPI	y/y	Jun F	8.6%	8.1%	8.6%	***	Equity and bond neutral
	Core CPI	y/y	Jun F	3.7%	3.7%	3.7%	**	Equity and bond neutral
UK	Claimant Count Rate	m/m	Jun	3.9%	4.0%		***	Equity and bond neutral
	Jobless Claims Change	m/m	Jun	-20.0k	-19.7k		**	Equity and bond neutral
Switzerland	Real Exports	m/m	Jun	0.9%	2.4%		*	Equity bearish, bond bullish
	Real Imports	m/m	Jun	-1.0%	7.7%		*	Equity bearish, bond bullish

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)	274	274	0	Up
3-mo T-bill yield (bps)	237	238	-1	Up
TED spread (bps)	37	36	1	Widening
U.S. Sibor/OIS spread (bps)	248	245	3	Up
U.S. Libor/OIS spread (bps)	253	251	2	Up
10-yr T-note (%)	2.98	2.99	-0.01	Up
Euribor/OIS spread (bps)	5	7	-2	Neutral
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
Yen	Up			Down
Pound	Up			Down
Franc	Up			Down

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	$104.83	$106.27	-1.36%	
WTI	$100.94	$102.60	-1.62%	
Natural Gas	$7.27	$7.48	-2.77%	
Crack Spread	$39.25	$39.85	-1.53%	
12-mo strip crack	$31.50	$31.73	-0.75%	
Ethanol rack	$2.87	$2.85	0.46%	
Metals				
Gold	$1,714.42	$1,709.22	0.30%	
Silver	$18.83	$18.70	0.72%	
Copper contract	$331.40	$334.60	-0.96%	
Grains				
Corn contract	$594.00	$610.75	-2.74%	
Wheat contract	$804.25	$812.75	-1.05%	
Soybeans contract	$1,363.50	$1,380.25	-1.21%	
Shipping				
Baltic Dry Freight	2,162	2,150	12	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.0		
Gasoline (mb)		-1.0		
Distillates (mb)		1.6		
Refinery run rates (%)		0.5%		
Natural gas (bcf)		55.0		

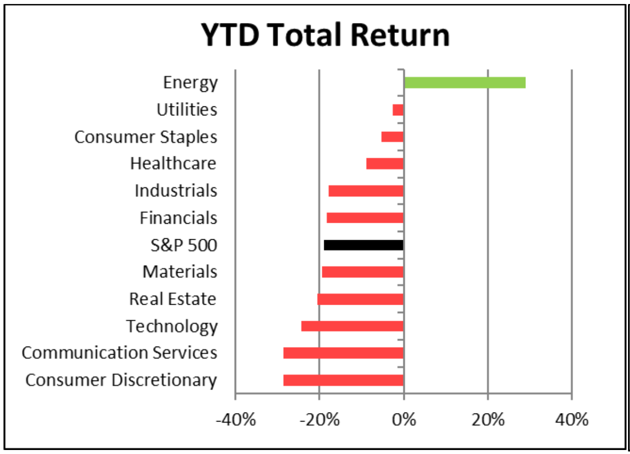
Weather

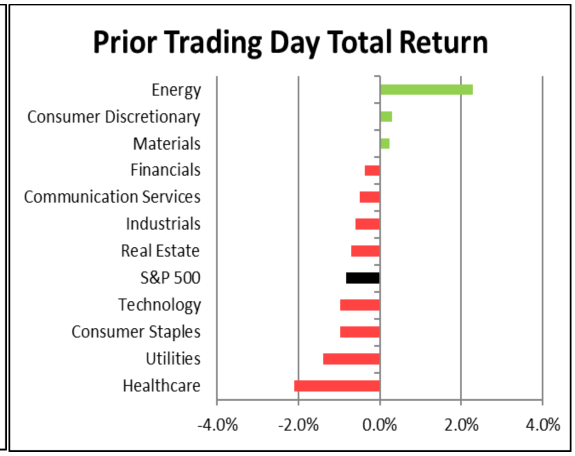
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for the entire country. Wetter-than-normal conditions are expected in the Southwest and East, with dry conditions expected in the northern Pacific, Rocky Mountains and Great Plains.

In the Gulf Coast, Caribbean, and Atlantic Ocean areas, no tropical storm activity is expected within the next 48 hours.

Data Section

U.S. Equity Markets – (as of 7/18/2022 close)

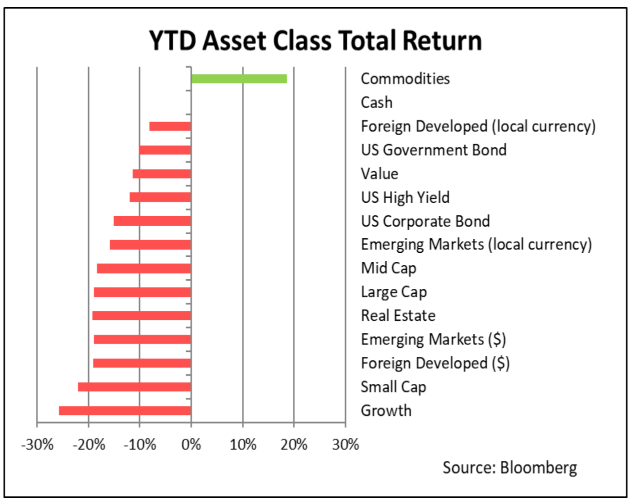




(Source: Bloomberg)

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 7/18/2022 close)

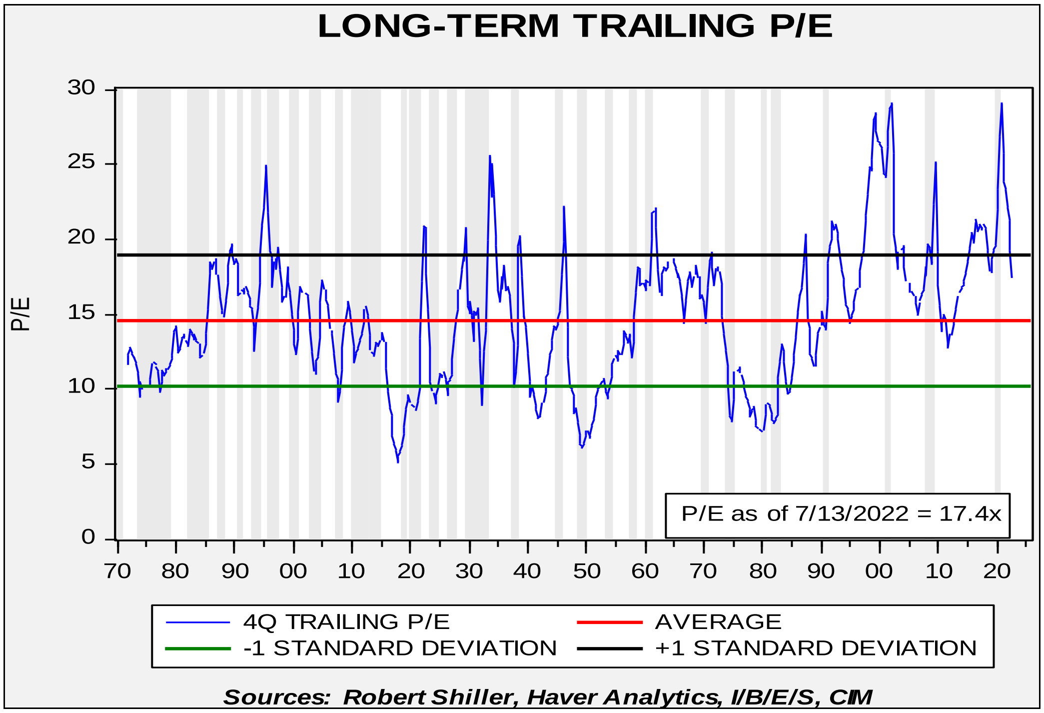


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

July 14, 2022



Based on our methodology,[1] the current P/E is 17.4x, up 0.1x from last week. The rise in the P/E is due a modest decline in Q3 earnings expectations.

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