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 27, 2022—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is currently up 0.5% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.6%. Chinese markets were mixed, with the Shanghai Composite down 0.1% from its prior close and the Shenzhen Composite up 0.3%. U.S. equity index futures are signaling a higher open. With 154 companies having reported, the S&P 500 Q2 2022 earnings stand at $56.10, higher than the $55.26 forecast for the quarter. The forecast reflects a 4.3% increase from Q2 2021 earnings. Thus far this quarter, 72.1% of the companies have reported earnings above forecast, while 22.7% 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* (7/18/2022) (with associated podcast): "The Pandemic's Impact on Inequality"
- *Weekly Energy Update (7/21/2022):* We take another look at trend gasoline demand (it's remarkably weak), the EU/Russian natural gas problem, and the European heat wave.
- *Asset Allocation Quarterly – Q3 2022* (7/19/2022): Discussion of our asset allocation process, Q3 2022 portfolio changes, and our outlook for the markets
- *Asset Allocation Bi-Weekly* (7/25/2022) (with associated podcast): "The Puzzle of the Labor Force"
- *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)

Our *Comment* today opens with an update on the Russia-Ukraine war, including more fallout for the world's energy and food supplies. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including new signs of labor unrest across the globe, and a preview of the Federal Reserve's latest monetary policy decision, due later today.

Russia-Ukraine: Russian forces are again seizing incremental territory in Ukraine's eastern Donbas region. They are likely to consolidate control over the region so they can hold a contrived referendum on annexation there on Russia's national election day in mid-September. The Russians also continue to launch long-range missile strikes against a variety of targets across

Ukraine, but especially in the southern region around Ukraine's grain-exporting ports. Meanwhile, Ukrainian forces continue to attack Russian ammunition depots, logistics centers, and personnel concentrations, as well as a key bridge running into Kherson, an occupied city in the country's south that Ukraine is attempting to recapture from the Russians.

- U.S. and other NATO officials continue to signal that they are shifting their position toward supplying Ukraine with advanced fighter jets and training pilots to fly them in the coming months. The changed posture stems in part from Ukraine's tenacious battlefield performance to date and a tacit understanding that Kyiv is likely to lean closer to the NATO alliance in the future.
- Meanwhile, U.S. officials are redoubling their efforts to convince China, India, and other countries that have been buying up cheap Russian crude oil to sign on to a low-price cap for the product. The plan aims to supplant the Western countries' scheduled ban on insuring tankers carrying Russian oil beginning in December, in a move U.S. officials fear would lead to a new spike in oil prices and ultimately provide more funds to Moscow.
- Separately, European natural gas prices are continuing to spike in response to Russia's latest cut in supplies. As of this writing, the European benchmark gas price is up some 12% to the equivalent of $231.17 per megawatt hour. The benchmark price has now risen approximately 37% this week alone.
    - In response to the price surge, German chemicals giant BASF (BASFY, $10.61) said it would reduce its production of ammonia, a gas-intensive product that is a key ingredient for many fertilizers.
    - The production cut is a reminder that Europe's energy crisis also feeds into the evolving world food crisis. Reduced supplies and higher prices for fertilizers are already affecting food production around the world.
- Finally, in another aspect of the Western sanction regime, the *Wall Street Journal* reports that auditors trying to avoid running afoul of the sanctions are demanding that their clients promise they have no significant connections to Russians or Russian firms. Sanctions experts and some corporate board members say the auditors are going beyond what is necessary and could be placing legal liability on their clients if authorities question their Russia connections.

Global Labor Market: In another sign that tight labor markets have emboldened workers all over the globe, several new strikes or strike announcements have popped up in recent days. Taken together, the actions illustrate how labor shortages are giving increased bargaining power to workers, raising costs for companies, and potentially signaling lower profit margins.

- In Germany, ground crew for Deutsche Lufthansa (DLAKY, $5.92) have gone on strike over a wage dispute. The action has forced the airline to cancel nearly all flights at its big hubs in Frankfurt and Munich.
- In the U.K., railroad employees have staged another massive one-day strike over pay, job security, and working conditions. The strike follows three similar one-day strikes last month.

- Finally, in the U.S., a union representing 2,500 machinists at three defense plants owned by Boeing (BA, $155.92) has voted to go on strike beginning August 1. The impending action at facilities near St. Louis aims to fight Boeing's plan to phase out its automatic contributions to the machinists' 401(k) accounts.

Italy: With polls showing right-wing parties are likely to form Italy's next government after elections in September, European Union Economics Commissioner Paolo Gentiloni warned that the EU would not renegotiate the fundamentals of its €200-billion pandemic relief plan for the country, and that Rome must stick firmly to the reform pledges made by lame duck Prime Minister Mario Draghi in order to receive the money. The statement sets up a possible conflict over the funds once a new government is in place, potentially undermining Draghi's economic reforms and depriving Italy of major financing for big infrastructure changes and other investments.

Hungary: Prime Minister Viktor Orbán, a darling of the world's growing right-wing populist movement, has touched off an international backlash over comments he made decrying Western "mixed race" nations and warning Hungarians not to intermarry with "non-Europeans." The statements are likely to further exacerbate Hungary's ties with the rest of the European Union.

Tunisia: The country's electoral commission said nearly 95% of voters approved Tunisia's new constitution in a referendum this week. The new constitution provides virtually dictatorial powers to populist President Kais Saied, essentially tearing up the democratic reforms launched in Tunisia after the Arab Spring uprising in 2011.

El Salvador: Yesterday, President Nayib Bukele announced that his country will use some of its international reserves and financing from a regional lender to buy back $1.6 billion of its sovereign debt coming due in 2023 and 2025. The plan aims to take advantage of the bonds' current low prices as investors fret about a potential default by the country. The plan also comes as El Salvador's intention to sell an exotic $1-billion bond, which bet on a rise in bitcoin's value, stalled when the crypto asset fell sharply in recent months.

United States-China: With tensions rising over House Speaker Pelosi's potential trip to Taiwan to show support for the island as it comes under increased pressure from China, the White House said President Biden and Chinese President Xi will talk by telephone tomorrow. Meanwhile, Chairman of the Joint Chiefs of Staff Gen. Mark Milley said he worried that a Pelosi trip could touch off a crisis, but that the U.S. military is always prepared to support lawmakers' trips and ensure they are safe.

U.S. Monetary Policy: The Fed today ends its latest two-day monetary policy meeting, with the decision expected to come out at 2:00 pm ET. The officials have signaled they will hike their benchmark fed funds interest rate by another 0.75% to a range of 2.25% to 2.50%, and investors widely expect further aggressive rate hikes through the end of the year before the officials reverse course sometime in 2023.

- Reflecting those expectations, the yield curve remains inverted.

- As of this morning, the yield on the 2-year Treasury note stands at 3.061%, while the yield on the 10-year Treasury stands at 2.801%.

U.S. Technology Sector: Yesterday, the Senate voted 64 to 32 to advance a $280-billion package of subsidies and research funding to boost U.S. competitiveness in semiconductors and advanced technology. A particular focus of the bill is to spur more investment in U.S. computer-chip factories, reducing the country's dependence on foreign chips. If the measure passes a final Senate vote as expected today, it will then have to be passed by the House before being signed into law.

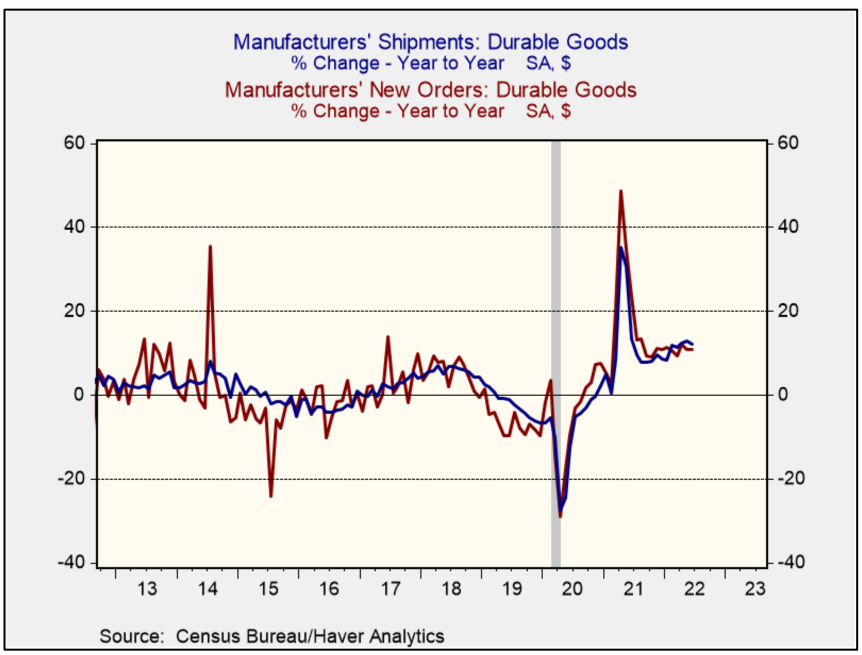
- Separately, Director of the Consumer Financial Protection Bureau Rohit Chopra warned, in an interview, that big technology companies' entry into the buy now, pay later lending business could undermine competition in the nascent sector and raise questions about the use of customer data. The statement points to a new vector for regulatory risks facing big technology firms.
- Meanwhile, technology firms Alphabet (GOOG, $105.44) and Microsoft (MSFT, $251.90) posted better-than-expected earnings last night, suggesting their post-pandemic retrenchment may not be as bad as anticipated. The results have helped give a boost to U.S. equity markets so far today.

U.S. Economic Releases

Elevated interest rates continue to dissuade potential homebuyers from applying for purchase or refinance loans. According to an index tracked by the Mortgage Bankers Association, weekly mortgage applications fell 1.8% in the week ending July 22. The index has declined for four consecutive weeks and is currently at its lowest level since February 2000. The component index that tracks purchase applications fell 0.8% from the prior week, while the refinancing application index fell 3.8%. The average 30-year fixed-rate mortgage fell 8 bps from 5.82% to 5.74%.

In a separate report today, a preliminary estimate showed the U.S. trade deficit narrowed to a seasonally adjusted $98.2 billion in June. According to the U.S. Census Bureau, total merchandise exports rose 2.5% from the prior month, while imports rose 0.5%. The chart below shows the monthly value of U.S. exports and imports since just before the previous recession.

New orders for durable goods rose unexpectedly in June, suggesting that business spending remains strong despite tightening financial conditions and slowing demand. Bookings for durable goods rose 1.9% from the prior month. The decline was above expectations of a drop of 0.4% and higher than the previous month's increase of 0.8%. Excluding transportation, durable goods orders rose 0.3% from the prior month, above expectations of a rise of 0.1%. Meanwhile, core capital goods' orders, which excludes defense goods and aircraft, rose 0.5% from the prior month, above expectations of 0.2%.



The chart above shows the annual change in durable goods orders and shipments. New shipments rose 12.2% from the prior year, while orders rose 10.9%.

The table below shows the economic releases and/or Federal Reserve events scheduled for the rest of the day.

Economic Releases						
EST	Indicator			Expected	Prior	Rating
10:00	Pending Home Sales	m/m	Jun	-1.0%	0.7%	**
10:00	Pending Home Sales NSA	y/y	Jun	-13.5%	-12.0%	***
Federal Reserve						
EST	Speaker or Event	District or Position				
14:00	FOMC Rate Decision	Federal Reserve Board				
14:30	Jerome Powell Holds a Press Conference	Chairman 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	Leading Economic Index	m/m	May F	101.2	101.4		**	Equity and bond neutral
Australia	CPI	y/y	2Q	6.1%	5.1%	6.3%	**	Equity and bond neutral
South Korea	Consumer Confidence	m/m	Jul	86.0	96.4		**	Equity bearish, bond bullish
China	Industrial Profits YTD	y/y	Jun	1.0%	1.0%		**	Equity and bond neutral
	Industrial Profits	y/y	Jun	0.8%	-6.5%		*	Equity bullish, bond bearish
EUROPE								
Eurozone	M3 Money Supply	y/y	Jun	5.7%	5.8%	5.4%	***	Equity and bond neutral
Germany	GfK Consumer Confidence	m/m	Aug	-30.6	-27.4	-28.9	*	Equity bearish, bond bullish
France	Consumer Confidence	m/m	Jul	80	82	80	**	Equity and bond neutral
Italy	Consumer Confidence	m/m	Jul	94.8	98.3	96.6	***	Equity bearish, bond bullish
	Manufacturing Confidence	m/m	Jul	106.7	110.0	108.0	***	Equity bearish, bond bullish
	Economic Sentiment	m/m	Jul	110.8	113.6		**	Equity bearish, bond bullish
AMERICAS								
Mexico	Trade Balance	m/m	Jun	-3.957t	-2.215t	-1.200t	**	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)	277	277	0	Up
3-mo T-bill yield (bps)	244	246	-2	Up
TED spread (bps)	33	31	2	Widening
U.S. Sibor/OIS spread (bps)	258	256	2	Up
U.S. Libor/OIS spread (bps)	262	260	2	Up
10-yr T-note (%)	2.80	2.81	-0.01	Up
Euribor/OIS spread (bps)	21	23	-2	Neutral
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
Yen	Up			Down
Pound	Up			Down
Franc	Up			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
FOMC Rate on Reserve Balances	0.250%	0.250%	0.250%	On Forecast
FOMC Rate Decision (Upper Bound)	1.750%	1.000%	1.500%	Above Forecast
FOMC Rate Decision (Lower Bound)	1.500%	0.750%	1.250%	Above Forecast

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	$105.26	$104.40	0.82%	
WTI	$95.88	$94.98	0.95%	
Natural Gas	$8.79	$8.99	-2.26%	
Crack Spread	$41.62	$40.67	2.34%	
12-mo strip crack	$32.21	$32.14	0.24%	
Ethanol rack	$2.81	$2.80	0.30%	
Metals				
Gold	$1,720.28	$1,717.32	0.17%	
Silver	$18.74	$18.63	0.61%	
Copper contract	$340.15	$338.45	0.50%	
Grains				
Corn contract	$603.25	$600.75	0.42%	
Wheat contract	$811.00	$803.75	0.90%	
Soybeans contract	$1,397.50	$1,383.75	0.99%	
Shipping				
Baltic Dry Freight	2,061	2,114	-53	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.5		
Gasoline (mb)		-0.1		
Distillates (mb)		-0.5		
Refinery run rates (%)		0.2%		
Natural gas (bcf)		1.0		

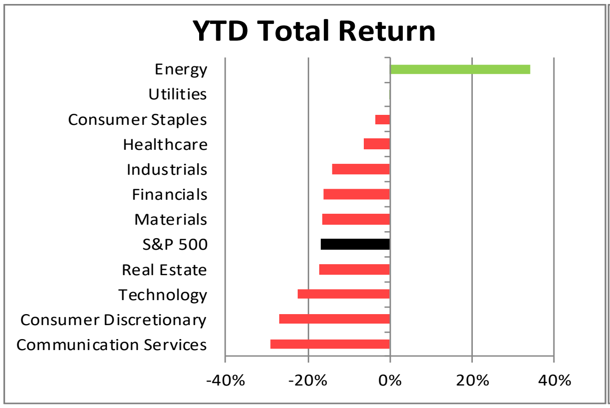
Weather

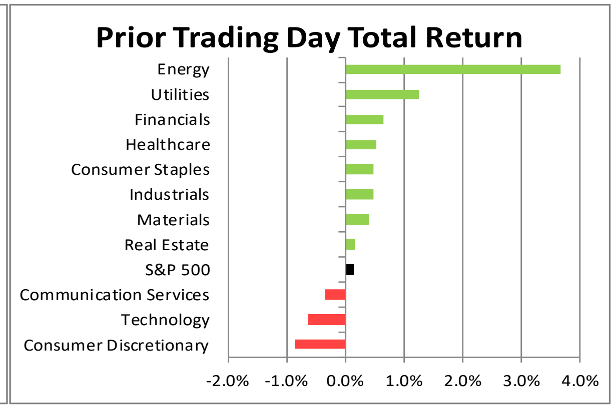
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout most of the country, with cooler-than-normal temperatures in the southern Pacific region. Wetter-than-normal conditions are expected in the Southwest and Mid-Atlantic, with dry conditions expected in the Great Plains, Midwest and New England.

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 7/26/2022 close)

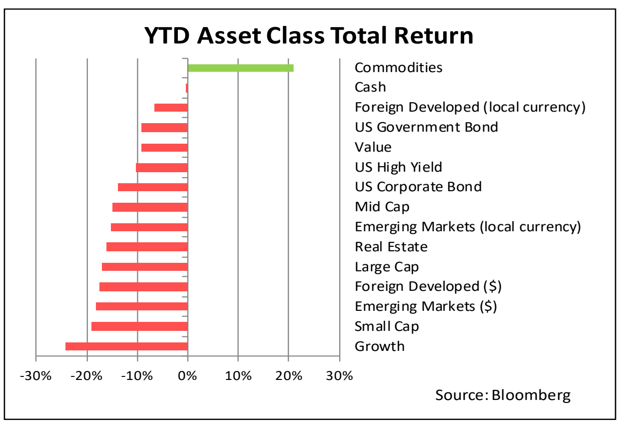




(Source: Bloomberg)

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 7/26/2022 close)

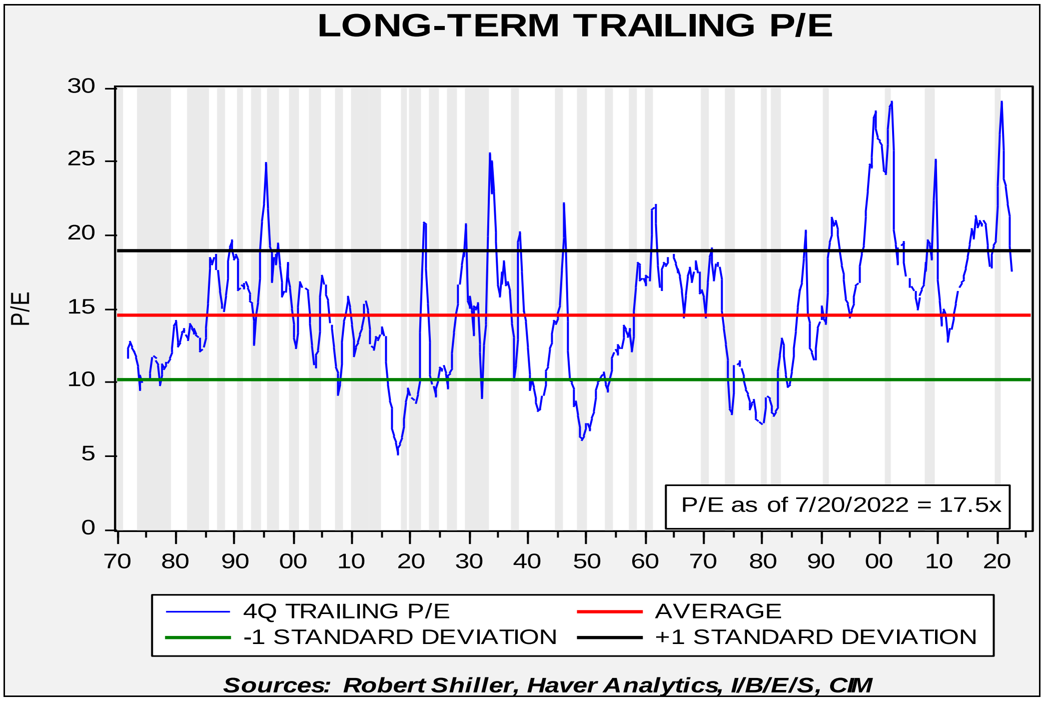


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 21, 2022



Based on our methodology,[1] the current P/E is 17.5x, up 0.1x from last week. The rise in the P/E is due a modest decline in Q3 earnings expectations.

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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.