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 29, 2022—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is currently up 1.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.2%. Chinese markets were lower, with the Shanghai Composite down 0.9% from its prior close and the Shenzhen Composite down 1.0%. U.S. equity index futures are signaling a higher open. With 265 companies having reported, the S&P 500 Q2 2022 earnings stand at $56.90, higher than the $55.26 forecast for the quarter. The forecast reflects a 4.3% increase from Q2 2021 earnings. Thus far this quarter, 74.0% of the companies have reported earnings above forecast, while 21.1% have reported earnings below forecast.

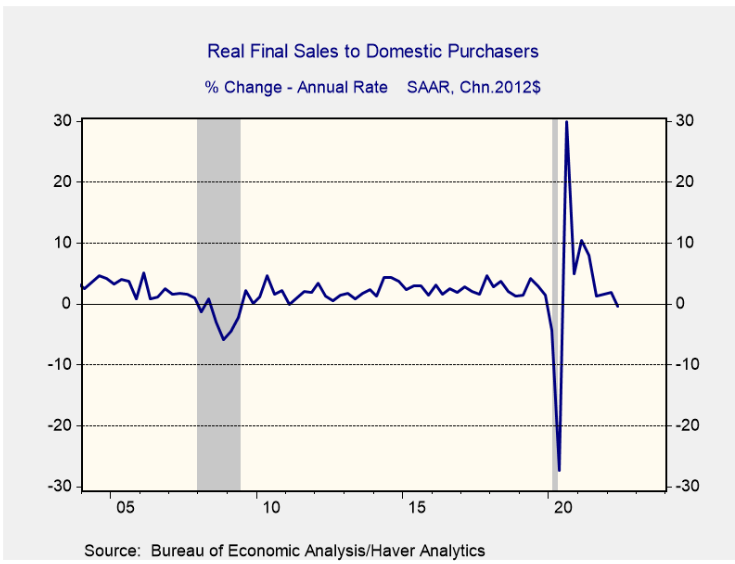
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (7/18/2022) (with associated podcast): "The Pandemic's Impact on Inequality"
- *Weekly Energy Update* (7/28/2022)*:* We take a look at the number of licensed drivers in the U.S. and comment on the new EU plan to restrain natural gas demand. We also update weather events, including usually heavy rainfall here in St. Louis this week.
- *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)
- ***Charts Worth Noting*:** **The Eurodollar futures markets are now discounting policy easing.**

Good morning! Today's *Comment* will begin with a discussion of a broad macroeconomic outlook focusing on the central bank transition away from forward guidance, the U.S. GDP contraction in Q2, and a surge in Eurozone inflation. Next, we discuss U.S.-China relations. Finally, we examine how the Russia-Ukraine war has led to greater cooperation among Western countries.

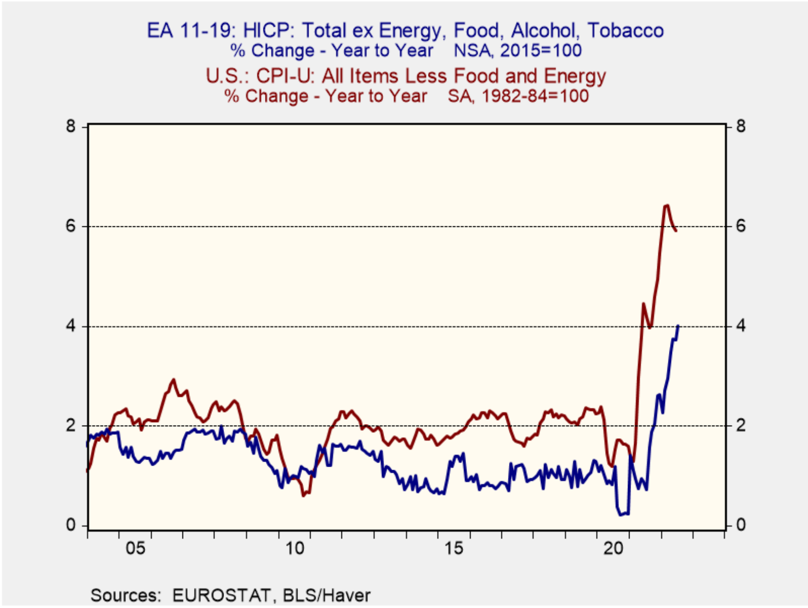
Macroeconomic Outlook: The U.S. economy has contracted two quarters in a row, but it is still too soon to call it a recession. Calls for the end of the Fed's tightening cycle may be premature as the lack of forward guidance raises the likelihood of a market surprise, and elevated inflation in the Eurozone pressures the European Central Bank to raise rates more aggressively.

- **Recession?** The economy shrank an annualized 0.9% in the second quarter. Back-to-back contractions in Q1 and Q2 have led to concerns that the country may be in a recession. Although consecutive contractions are typically associated with a recession, the NBER officially makes that call. The group looks at various measures of economic activity at the general and micro levels. As a result, the group takes a very long time before officially confirming that the economy is in recession. For example, the group waited 15 months after the Great Recession ended to announce that the economy was in recovery, and therefore, it is essential not to put too much weight on the latest GDP report. In our view, the economy is not in recession as Final Sales to Domestic Purchases, which excludes volatile elements of GDP, has contracted in one quarter but is still subject to revision.



- **Farwell, Forward Guidance:** Central banks may be transitioning from forward guidance as economies slow, and inflation remains elevated. The ECB was the first of the major central banks to ditch forward guidance, and the Federal Reserve followed suit a week later. When inflation was low, forward guidance reassured investors that the central bank policy would not change in the future. However, consistently higher than expected inflation and economic deceleration have led banks to value policy flexibility over market clarity. The shift away from forward guidance will make speeches from voting members and central bankers even more critical.

- **Eurozone inflation:** The flash estimate of the Eurozone Consumer Price Index jumped 8.9% from the year prior, setting a new record. Although inflation remains lower than in the U.S., the core CPI suggests that the momentum of the price increases continues to build in Europe. The strong reading will pressure the European Central Bank to become more aggressive in its tightening cycle in order to tame inflation. Before the report, Governing Council Member Martins Kazaks hinted at the possibility of a significant rate hike at the next ECB meeting in September. Although there is speculation that the central bank may raise rates by 50 bps, there is a strong possibility that the planned hike could be higher.



In short, the unpredictability of economic data has made it difficult for central bankers to make predictions about upcoming monetary policy. Therefore, the lack of guidance may mean the ECB and Federal Reserve could surprise markets in their next meeting depending on the latest inflation data. Although it is tempting to view a decline in GDP as a sign that the Fed could implement a pause, it is worth noting that the ECB and the Fed are mandated to maintain price stability. As a result, inflation will likely be their top focus when determining future monetary policy. When the central banks hold their respective meetings in September, they will be determining policy based on the August inflation numbers, so investors should take the July reports with a grain of salt.

China: President Biden and Chinese President Xi discussed Taiwan on Thursday, China hints at a possible slowdown in its economy, and Beijing tries to use TikTok to send propaganda to the West.

- **The phone call:** Yesterday, President Biden and Chinese President Xi Jinping had their long-awaited phone call. As usual, both sides offered each other reassurances that the status quo should remain intact. Although the call allowed the two to clear the air, tensions between the countries persist. There is still no word on whether Speaker of the House Pelosi will travel to Taiwan next month; however, she is still set to leave for her trip to Asia on Friday. Pelosi may be pressured to travel to Taiwan to avoid looking like she is kowtowing to Beijing. In that event, China may be forced to retaliate. As a result, we believe that the trip has the potential to lead to direct conflict between the U.S. and China.

- **China slowdown:** Leaders in Beijing signaled that China might miss its goal of a 5.5% expansion of GDP this year. This downbeat assessment reflects the negative impact of the property market crash and the country's controversial Zero-COVID Policy on the economy. The candidness should not be a surprise as the rest of the world is currently distracted by talks about whether the U.S. is in recession. As the economy continues to show weakness, China may inject stimulus to boost growth.

- **China propaganda:** U.S. lawmakers have consistently labeled TikTok as a national security threat due to its supposed ties to the Chinese government. On Thursday, a Bloomberg report revealed that a state entity related to public relations tried to create an account to target Western audiences with propaganda. Although TikTok executives supposedly pushed back on the report, the company's association with Chinese government officials will likely unnerve U.S. politicians that feel that the social media platform may act as an arm of Beijing. Over the last few years, governments have weaponized social media to destabilize rival countries. As a result, we believe this report will not only lead to a more significant push from U.S. officials to have TikTok removed from app stores, but also lead to more regulatory oversight with how these companies manage their users' data. Hence, this report may also have ramifications for the broader tech sector.

As we have warned in our *2022 Mid-Year Geopolitical Outlook*, China is likely to push its narrative of a "rising China, falling West" going into the 20th National Congress of the Chinese Communist Party. Therefore, it will likely view any move by the U.S. to recognize Taiwan as an independent nation as a direct threat to its national sovereignty.

Russia-Ukraine Update: The war in Ukraine continues to force the West to build closer ties with each other as it looks to respond to Russian aggression.

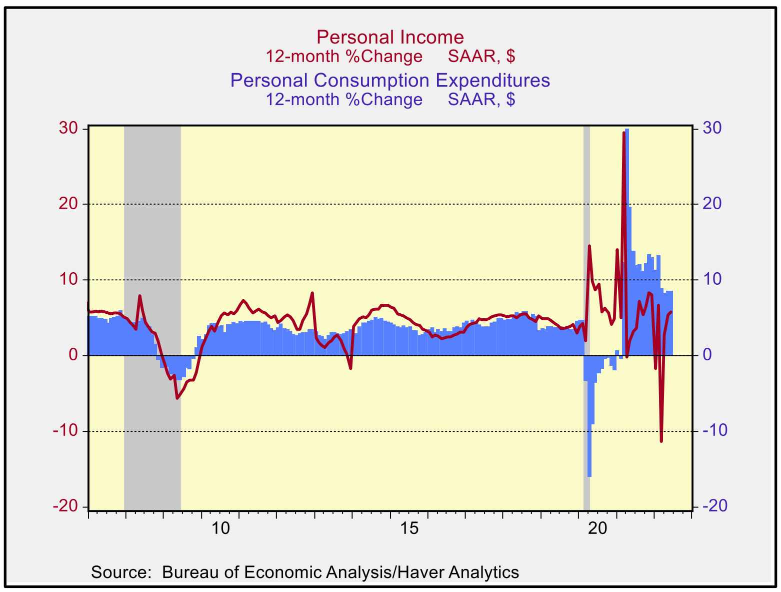
- **Preventing a crisis:** The European Union aims to diversify its energy sources to ensure it has ample supply in the winter months. France and Belgium have turned to nuclear energy, Italy has explored Algeria as its new natural gas provider, and Spain has offered to deliver some of its reserves to other countries within the bloc. The sudden change in reducing their energy consumption may not successfully solve the EU's supply needs by winter, but it will likely position the bloc to make a long-term shift away from using Russian energy in the future. In addition, the EU is planning investments to build pipelines from alternative sources, such as Algeria, Nigeria, Niger and Azerbaijan. As a result, we view the move away from Russian energy as a reflection of a long-term trend of countries looking to sever ties with unfriendly nations.

- **Arms sales:** The U.S. approved $8.4 billion in arms sales to Germany. The purchase of U.S. weapons signals Russia's invasion of Ukraine has strengthened the NATO alliance. The trading of weapons among allies reflects a closer military cooperation among Western allies. Over the next few years, NATO allies will ramp up purchases with each other as they look to ensure their security from outside threats. U.S. defense companies should benefit from this push initially; however, nascent European companies could also profit from the increase in defense spending.

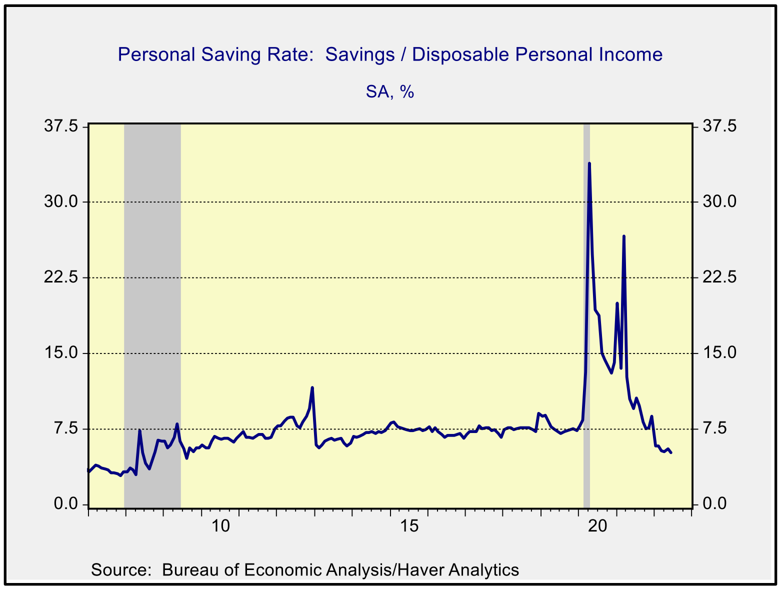
As the war continues, we believe the world will begin to break into regional blocs. Thus, the recent moves by the European Union to diversify away from Russia reflect the West's need not to rely too heavily on a single country outside of its bloc.

U.S. Economic Releases

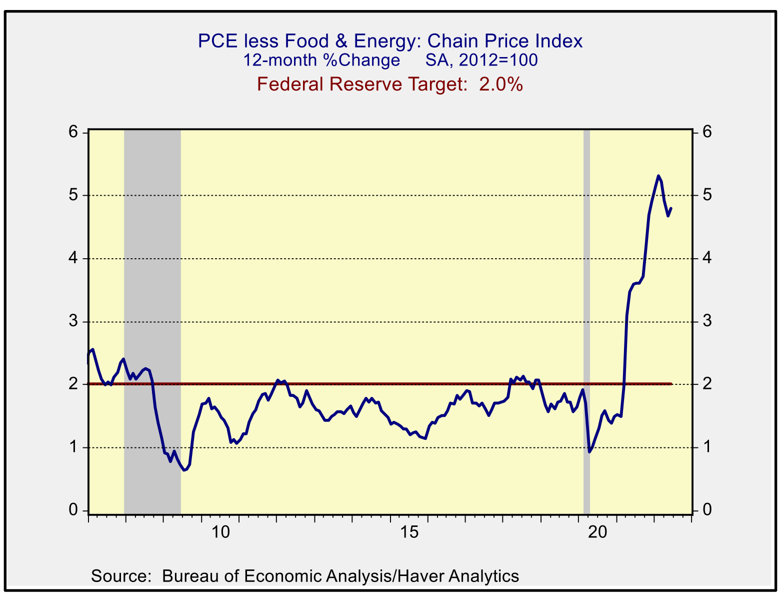
June personal income rose by a seasonally adjusted 0.6%, matching the revised gain in May and beating expectations that it would only rise 0.5%. Meanwhile, June personal consumption expenditures (PCE) rose 1.1%, beating the expected increase of 1.0% and accelerating sharply from the revised increase of 0.3% in the previous month. Personal income in June was up 5.7% from the same month one year earlier, while PCE was up 8.4%. The chart below shows the year-over-year change in personal income and PCE since just before the prior recession.



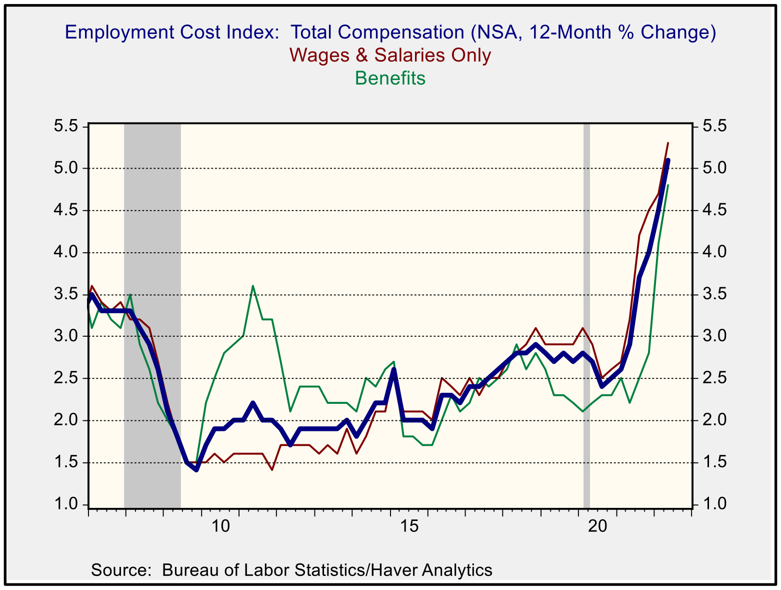
The personal income and spending report also includes a measure of personal saving, defined as disposable (after tax) income less consumption spending on goods and services. The June personal savings rate fell to a seasonally adjusted 5.1%, marking its lowest level since mid-2009. The chart below shows how the personal savings rate has fluctuated since just before the previous recession.



Finally, the income and spending report includes the Federal Reserve's preferred measure of consumer price inflation. After stripping out the volatile food and energy components, the Core PCE Deflator for June was up 4.8% from the same month one year earlier. That was only a bit worse than expectations that it would match the gain of 4.7% in the year to May, and it remained comfortably below its most recent peak of 5.3% in February. Nevertheless, Core PCE inflation remains far above the Fed's target of 2.0%. The chart below shows the year-over-year change in the Core PCE Deflator since just before the prior recession.



Separately, the second-quarter Employment Cost Index (ECI) rose by a seasonally adjusted 1.3%, slightly worse than the anticipated rise of 1.2% but still slightly better than the previous quarter's 1.4% increase. The subindex on wages and salaries accelerated to a rise of 1.4%, while the subindex on benefits cooled down to rise just 1.2%. Compared with the same period one year earlier, the overall ECI was up 5.1%, while the subindex on wages and salaries was up 5.3% and the subindex on benefits was up 4.8%. The chart below shows the year-over-year change in the ECI since just before the prior recession.

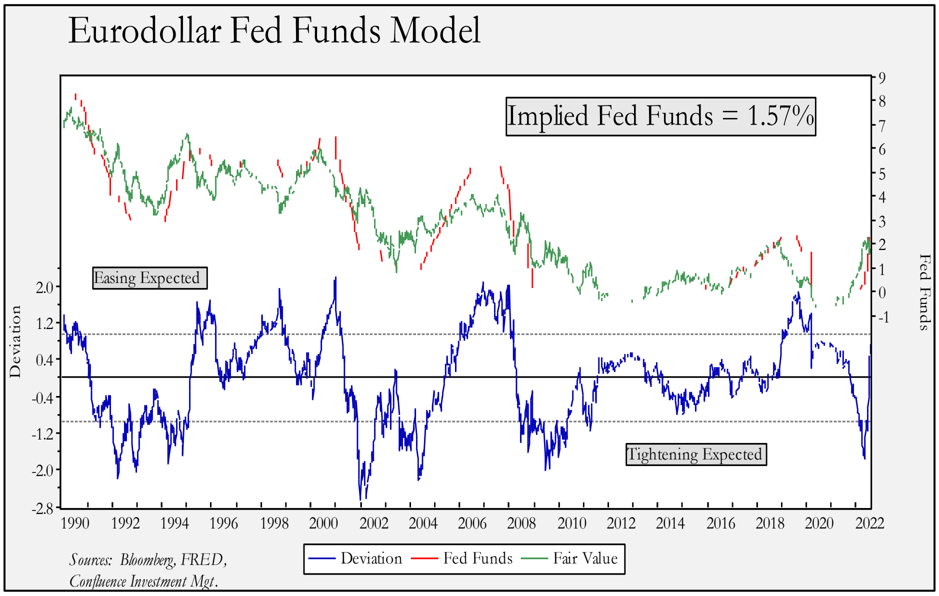


The table below shows the economic releases and/or Federal Reserve events scheduled for the rest of the day.

Economic Releases						
EST	Indicator			Expected	Prior	Rating
9:45	MNI Chicago PMI	m/m	Jul	55.0	56.0	***
10:00	U. of Michigan Consumer Sentiment	m/m	Jul F	51.1	51.1	***
10:00	U. of Michigan Current Conditions	m/m	Jul F	57.1	57.1	**
10:00	U. of Michigan Future Expectations	m/m	Jul F	47.5	47.3	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Jul F	5.2%	5.2%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Jul F	2.8%	2.8%	*
Federal Reserve						
No Fed speakers or events for the rest of today						

Charts Worth Noting

We use the implied LIBOR three-month rate from the sixth deferred quarterly contract of the Eurodollar futures to gain insights into the market's expectations surrounding monetary policy. Beginning in early July, we began to see a shift in the market's expectations to policy easing; those expectations accelerated after the recent FOMC meeting.



In April, the Eurodollar futures were suggesting that the FOMC was expected to raise rates. Even as the policy rate rose steadily, the financial markets were expecting further tightening. But no more; in early July, the Eurodollar futures began building in an end to tightening. That projecting has increased, and the market is now expecting an easing of approximately 75 bp to 100 bp.

We don't know for sure if the financial markets have gotten this right. The FOMC usually doesn't end a tightening cycle without the target rate exceeding the inflation rate. But part of the rally seen in equities, Treasuries, gold, and the weakness seen in the dollar is tied to projections that the FOMC is close to ending this tightening cycle. If the committee surprises the markets by tightening more than expected a reversal in recent trends is likely.

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	Tokyo CPI	y/y	Jun	2.5%	2.3%	2.4%	**	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food	y/y	Jun	2.3%	2.1%	2.2%	***	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food & Energy	y/y	Jun	1.2%	1.0%	1.1%	*	Equity and bond neutral
	Jobless Rate	m/m	May	2.6%	2.6%	2.5%	***	Equity and bond neutral
	Job/Applicant Ratio	m/m	May	1.27	1.24	1.25	***	Equity and bond neutral
	Retail Sales	y/y	Jun	1.5%	3.6%	3.7%	**	Equity bearish, bond bullish
	Industrial Production	y/y	May P	-3.1%	-3.1%	-7.1%	***	Equity bullish, bond bearish
	Housing Starts	y/y	May	-2.2%	-4.3%	-1.4%	**	Equity bearish, bond bullish
	Annualized Housing Starts	y/y	May	0.845m	0.828m	0.850m	*	Equity and bond neutral
Australia	Private Sector Credit	y/y	Jun	9.1%	9.0%	9.1%	**	Equity and bond neutral
	PPI	y/y	Q2	5.6%	4.9%		**	Equity and bond neutral
South Korea	Industrial Production	y/y	Jun	1.4%	7.3%	7.4%	***	Equity bearish, bond bullish
EUROPE								
Eurozone	CPI	y/y	Jul	8.9%	8.6%	8.7%	***	Equity bearish, bond bearish
	Core CPI	y/y	Jul P	4.0%	3.7%	3.9%	**	Equity bearish, bond bearish
	GDP	y/y	2Q A	4.0%	5.4%	3.4%	***	Equity bullish, bond bearish
Germany	GDP NSA	y/y	2Q P	1.5%	4.0%	3.9%	**	Equity bearish, bond bullish
	GDP WDA	y/y	2Q P	1.4%	3.8%	3.6%	**	Equity bearish, bond bullish
	Unemployment Change	m/m	Jun	48.0k	133.0k	132.0k	***	Equity bullish, bond bearish
	Unemployment Claims Rate	m/m	Jun	5.4%	5.3%	5.4%	**	Equity and bond neutral
	Import Price Index	y/y	Jun	29.9%	30.6%	29.9%	**	Equity and bond neutral
France	CPI	y/y	Jul P	6.1%	5.8%	6.0%	***	Equity bearish, bond bearish
	CPI, EU Harmonized	y/y	Jul P	6.8%	6.5%	6.7%	**	Equity bearish, bond bearish
	Consumer Spending	y/y	Jun	-4.4%	-3.4%	-3.6%	*	Equity bearish, bond bullish
	GDP	y/y	2Q P	4.2%	4.5%	4.8%	**	Equity bearish, bond bullish
Italy	CPI, EU Harmonized	y/y	Jul P	8.4%	8.5%	8.8%	***	Equity and bond neutral
	CPI NIC Including Tobacco	y/y	Jul P	7.9%	8.0%	8.1%	**	Equity and bond neutral
	GDP WDA	y/y	2Q P	4.6%	6.2%	3.7%	**	Equity and bond neutral
	PPI	y/y	Jun	41.9%	42.7%		*	Equity and bond neutral
UK	Mortgage Approvals	m/m	Jun	63.7k	66.2k	65.7k	***	Equity and bond neutral
	M4 Money Supply	y/y	Jun	4.1%	5.1%		**	Equity and bond neutral
Switzerland	KOF Leading Indicator	m/m	Mar	90.1	96.9	95.2	**	Equity bearish, bond bullish
	Retail Sales Real	y/y	Jul	1.2%	-1.6%	-1.3%	**	Equity bullish, bond bearish
Russia	Money Supply, Narrow Definition	w/w	22-Jul	14.36t	14.40t		*	Equity and bond neutral
	Gold and Forex Reserves	m/m	22-Jul	567.0b	565.3b		***	Equity and bond neutral
AMERICAS								
Canada	GDP	y/y	May	5.6%	5.0%	5.1%	**	Equity bullish, bond bearish
Mexico	GDP NSA	q/q	2Q P	2.1%	1.8%	1.5%	***	Equity bullish, bond bearish
Brazil	National Unemployment Rate	m/m	May	9.3%	9.8%	9.3%	*	Equity and bond neutral
	Net Debt% GDP	m/m	May	58.8%	57.9%	58.3%	**	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)	281	279	2	Up
3-mo T-bill yield (bps)	227	232	-5	Up
TED spread (bps)	53	48	5	Widening
U.S. Sibor/OIS spread (bps)	254	254	0	Up
U.S. Libor/OIS spread (bps)	259	259	0	Up
10-yr T-note (%)	2.70	2.68	0.02	Up
Euribor/OIS spread (bps)	27	24	3	Neutral
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
Yen	Up			Down
Pound	Flat			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.

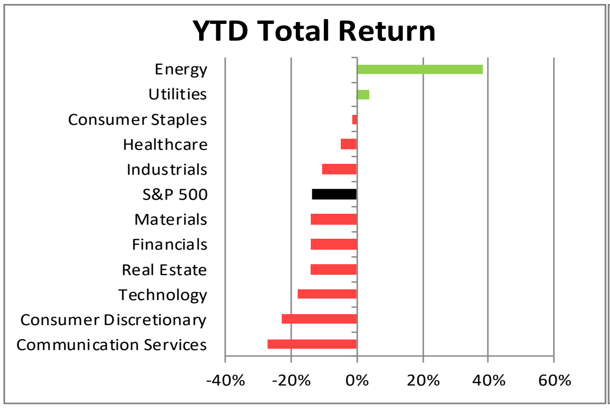
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$109.25	$107.14	1.97%	
WTI	$98.49	$96.42	2.15%	
Natural Gas	$8.15	$8.13	0.14%	
Crack Spread	$39.57	$41.00	-3.49%	
12-mo strip crack	$31.93	$32.47	-1.68%	
Ethanol rack	$2.85	$2.83	0.72%	
Metals				
Gold	$1,760.24	$1,755.84	0.25%	
Silver	$20.02	$20.01	0.02%	
Copper contract	$350.90	$347.45	0.99%	
Grains				
Corn contract	$628.50	$619.00	1.53%	
Wheat contract	$838.50	$817.00	2.63%	
Soybeans contract	$1,461.25	$1,440.50	1.44%	
Shipping				
Baltic Dry Freight	1,945	2,007	-62	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-4.5	-1.5	-3.0	
Gasoline (mb)	-3.3	-0.1	-3.2	
Distillates (mb)	-0.8	-0.5	-0.3	
Refinery run rates (%)	-1.5%	0.2%	-1.7%	
Natural gas (bcf)	15.0	18.0	-3.0	

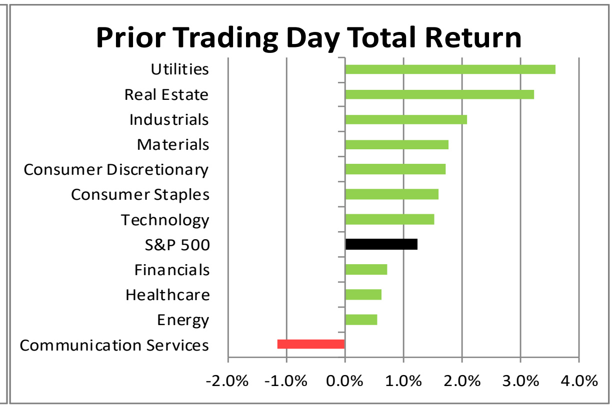
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout the entire eastern two-thirds of the country, with cooler-than-normal temperatures only in the Pacific Northwest and Southwest. Wetter-than-normal conditions are expected throughout the Rocky Mountain region, with dry conditions expected in the Great Plains and Midwest.
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 7/28/2022 close)

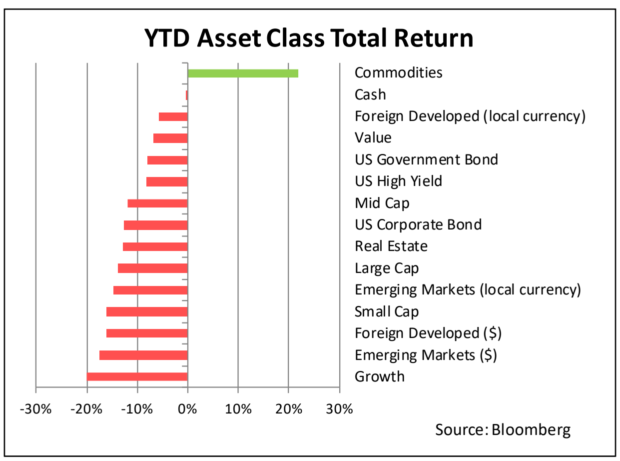




(Source: Bloomberg)

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 7/28/2022 close)

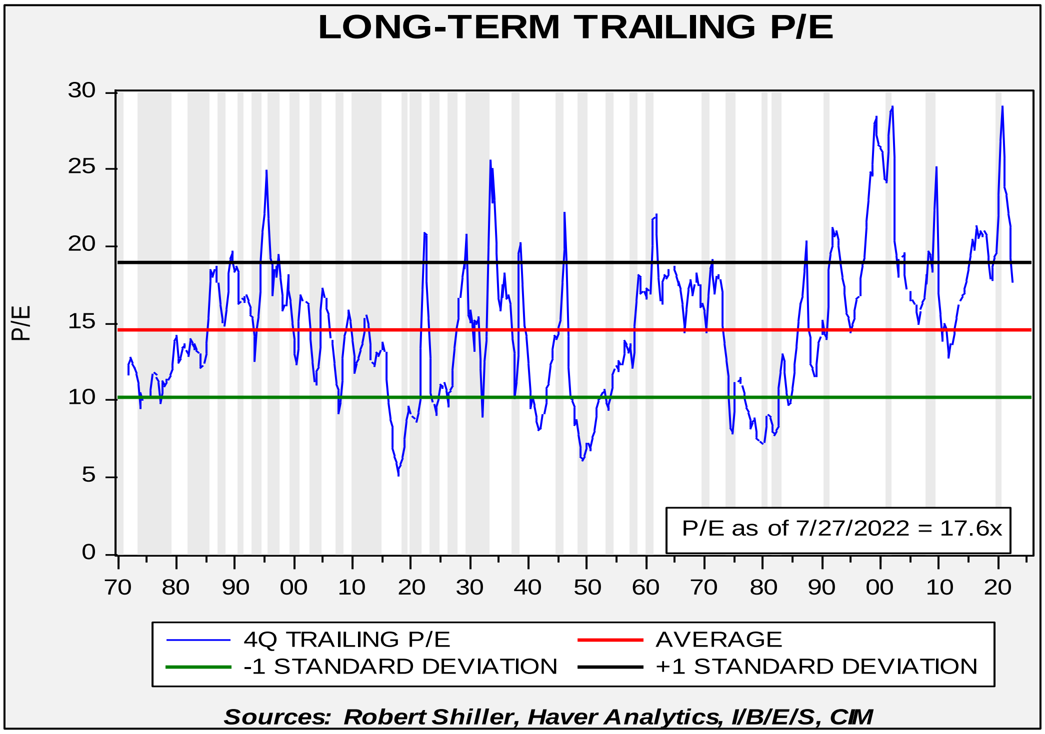


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 28, 2022



Based on our methodology,[1] the current P/E is 17.6x, up 0.1x from last week. The rise in the P/E is due higher equity prices.

[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.