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 7, 2022—9:30 AM EDT] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is currently up 1.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.3%. Chinese markets were higher, with the Shanghai Composite closing up 0.3% from its prior close and the Shenzhen Composite closing up 0.9%. 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:

- *Bi-Weekly Geopolitical Report* (6/21/2022) (with associated podcast): "The 2022 Mid-Year Geopolitical Outlook"
- *Weekly Energy Update* (6/30/2022): The DOE updated the past 2 weeks of data; we have updated our charts too. We discuss the G-7 meeting and note the SPR is not only seeing an aggressive withdrawal, but the majority of the oil sold is heavy/sour, meaning its use as a strategic stock is being compromised.
- *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* (6/27/2022) (with associated podcast): "The Selling of Austerity"
- *Confluence of Ideas* podcast (3/25/2022): "The 2022 Outlook: Update #1"
- *Current Perspectives*: *"*2022 Outlook: Update #1*"* (2/18/2022)

Today's *Comment* begins with a recap of the minutes from the FOMC meeting in June. Next, we discuss the latest events in Ukraine and other situations related to the war. Afterward, we review various stories from around the world, including developments in the European Energy Crisis, China's new stimulus, and the possibility of inflation cooling in the U.S.

Fed Meeting Minutes: The Federal Reserve reaffirmed its commitment to fighting inflation in its June meeting. The minutes from the meeting revealed that FOMC members were concerned that the central bank was at risk of losing its credibility. As a result, the members decided that a 50 or 75 bps rate hike would be appropriate for their July meeting. The market had little reaction to the minutes, as recent economic data did not convince investors that the minutes represented the Fed's current thoughts on the economy. Thus, equities closed slightly higher than open, and the two and 10-year Treasury remained inverted.

Russia-Ukraine: For the first time in 133 days, Russia has not reported any territorial gains in Ukraine. The lack of progress suggests that Moscow may be implementing a pause in its invasion. Although Russian forces are still conducting limited military offensives in Ukraine, it appears that the Kremlin is preparing for more expansive operations in the future. This assessment is supported by the Russian government adopting a new law that will give it direct control over its economy. The measure allows government officials to recall workers from vacation, reschedule their time off without consent, and force them to work weekends, holidays, and nights. This change in law will allow the government to allocate more of the country's resources toward its war effort as it seeks to take over the entirety of Ukraine. This development provides evidence that this war will probably not end soon.

- The West is continuing to look for ways to curtail the Russian invasion by targeting its energy exports. After sanctions failed to deter countries from purchasing Russian oil, the U.S. and its allies are now looking to implement price caps. The caps on the price of Russian oil will range from $40-$60 a barrel, and are designed to limit Russian export revenues. So far, it isn't clear when the caps will be imposed; however, there does seem to be some momentum for the measure. The U.S. officials are meeting with G-20 members in Bali to work out the details.
- As the Russian blockade continues to prevent Ukraine from exporting grain to the rest of the world, there is a growing push to transfer these crops via rail. On Thursday, Romania announced that it was able to reopen its railway earlier than expected to help facilitate the shipment of wheat. As a result, Ukraine can transfer its grain to countries whose ports are not blockaded. The improvement in the transportation of wheat will possibly reduce the likelihood of a global food crisis.
- Ukrainian President Volodymyr Zelensky revealed that the weapons it received from the West are helping to slow Russian advances in his country. His statement suggests that Ukraine could look to revamp efforts to retake lost territory after a noticeable lull in the conflict. This will likely mean that the stalemate between the two sides will continue as both have the weapons needed to keep the war going.

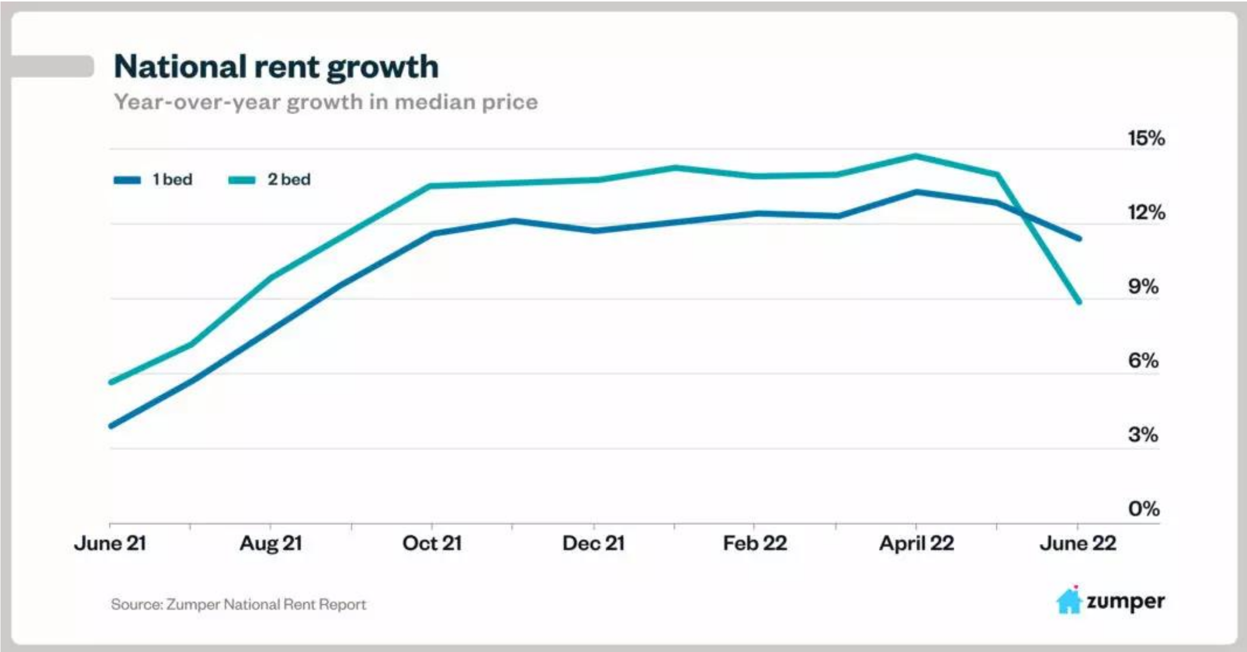
Shake-up in Europe: As the war looks to ramp up pressure on Russia, Europe is also dealing with political headaches.

- **PM Boris Johnson:** Boris Johnson was forced to resign from his post following a slew of resignations and growing calls from within his party to step down. More than 30 people have left his administration, and Johnson fired a key minister after urging his resignation. Although he plans to stay in power until a new party leader is chosen, there is growing pressure for him to step down immediately. Details of a timeline of his departure are expected to be released next week. The possibility of decreasing political uncertainty following Johnson's resignation led to a brief rally in the pound. Currently, there are several candidates to replace Johnson, but no clear front-runner.
- **European Energy Crisis:** As commodity prices rise, Europe is taking extreme action to help ensure its energy security. On Thursday, the French government agreed to nationalize nuclear energy company EDF (ECIFY, $1.74). France's decision to take it over is designed to assure the company's survival as the country prepares to secure its

energy resources moving into the winter. In a similar move, the German government bailed out energy provider Uniper (UNPRF, $10.75) on Tuesday. Recently, energy shocks due to the war in Ukraine have forced governments to make bold moves to protect the stability of energy prices. Although the EU has not altered its commitment to fight climate change, the rise in the amount of coal use and its reclassification of green energy to include natural gas and nuclear suggest it is becoming more flexible in meeting its ambitious climate standards. In the short run, this could bolster commodity prices as it appears Europe has no other alternatives to fossil fuels.

- **Draghi in trouble?** The Italian parliament is in danger of collapse as disagreement over the Ukraine war has led to fractures within the ruling government. Leader of the Five Star Movement Giuseppe Conte met Prime Minister Mario Draghi to deliver a list of demands to ensure the party's support of the coalition. The list included measures to protect the Five Star welfare payment program and raise the minimum wage. Although the Five Star Movement confirmed its commitment to supporting the current government, it is not clear how long that will last. The inter-coalition rift started when the Five Star Movement voted against offering Ukraine military support and urged the government to use more of the country's resources to improve people's lives at home. Tension within Italy has led to heightened political uncertainty risks and could have ramifications for the euro area in the long run.

Inflation cooling: As the economy shows signs of slowing, there is evidence that prices may be cooling. The latest data from Zumper suggest that rental prices are starting to slow. Meanwhile, the chipmakers are reporting quicker delivery times of semiconductors suggesting that the shortage of chips may be waning. Lastly, energy prices, one of the largest contributors to inflation, have started to decline. Brent Crude has dipped below $100 a barrel for the first time since April and declining demand could see it fall further later this year. These developments indicate that inflation may have already peaked.

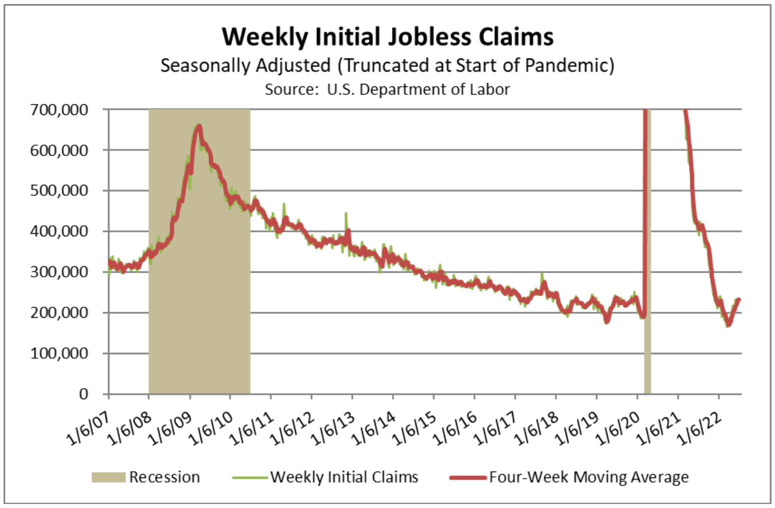


China: Although economists forecast that the Chinese government will report that its economy grew 1.5% in the second quarter, other data sources suggest that the economy shrank. The slowdown in the economy is forcing Beijing to take action to ensure that it meets its target of 5.5% growth by the end of the year. To meet its goal, China is exploring a rare mid-year sale of bonds to help fund a $220 billion stimulus package. The funds will be used to boost infrastructure and stimulate the economy.

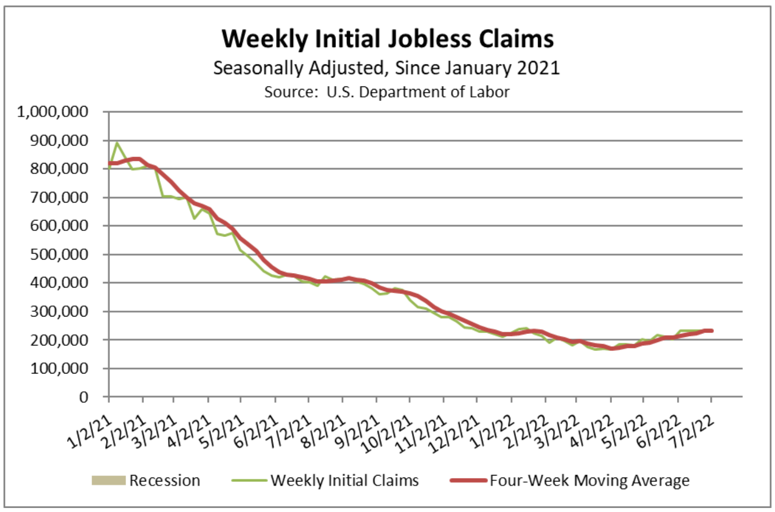
- After loosening some of its COVID restrictions and offering stimulus, Beijing may also try to help its economy by improving ties with U.S. politicians and pushing vaccinations. According to the National Counterintelligence Security Service, China plans on recruiting state and local leaders to lobby Washington on its behalf. If true, the report suggests that Beijing may not be in a rush to decouple from the U.S. as it seeks to rebound from its recent economic setback.
- New lockdowns may be imposed in Shanghai after the city reported that the number of new infections doubled on Wednesday to 54. The outcome suggests that supply chains issues may persist in China.

U.S. Economic Releases

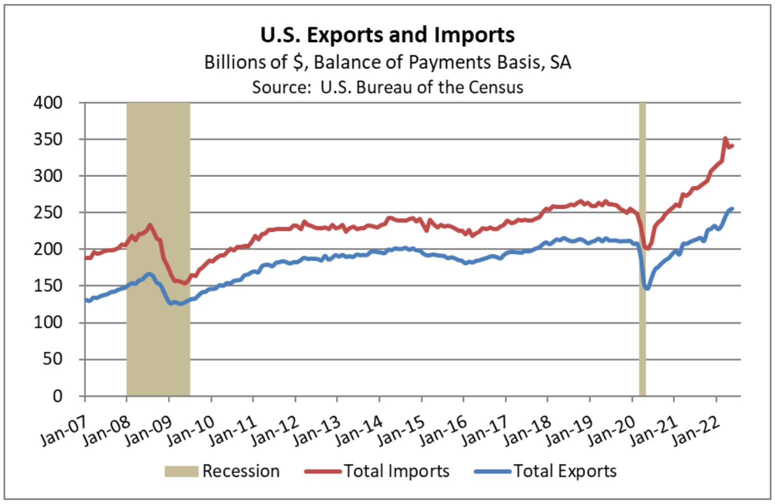
Initial applications for unemployment benefits in the week ended July 2 rose to a seasonally adjusted 235,000, higher than both the previous week's level of 231,000 and the expected level of 230,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 232,500, for its highest level since last December. Meanwhile, the number of people continuing to draw benefits in the week ended June 25 rose to 1.375 million, significantly higher than the revised reading of 1.324 million in the prior week and the anticipated reading of 1.328 million. Since the seasonal adjustment process can get distorted around major holidays like Independence Day, there is some chance that these figures have been skewed. Nevertheless, rising initial jobless claims and higher continuing claims suggest layoffs may be increasing and the labor market may be cooling as the economy slows. The chart below shows how initial jobless claims have fluctuated since just before the prior recession. The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



To provide more detail on recent trends, the chart below shows how initial jobless claims have changed just since the start of 2021.



In a separate report, the U.S. trade balance showed a seasonally adjusted deficit of $85.5 billion in May. That was narrower than the revised shortfall of $86.7 billion in April, but it wasn't quite as narrow as the expected deficit of $84.7 billion. According to the data, U.S. exports in May were 1.2% higher than in April, while imports were only up 0.6%. Compared with the same month one year earlier, exports in May were up 21.7%, while imports were up 23.3%. The chart below shows the monthly value of U.S. exports and imports since just before the previous recession.



The table below lists the economic releases and/or Fed events scheduled 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**
12:00	James Bullard Discusses U.S. Economy and Monetary Policy	President of the Federal Reserve Bank of St. Louis
12:00	Christopher Waller Interviewed During NABE Event	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	Foreign Buying Japan Stocks	w/w	1-Jul	-¥490.4b	-¥419.1b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	1-Jul	¥330.5b	¥666.9b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	1-Jul	¥1,191.7b	¥51.4b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	1-Jul	-¥1415.6b	-¥1599.3b		*	Equity and bond neutral
	Leading Economic Index	m/m	May P	101.4	102.9	101.5	**	Equity and bond neutral
Australia	Trade Balance	m/m	May	A$15.965b	A$13.248b	A$10.825b	***	Equity bullish, bond bearish
	Exports	m/m	May	9.0%	1.0%	2.0%	*	Equity bullish, bond bearish
	Imports	m/m	May	6.0%	-1.0%	3.0%	*	Equity bullish, bond bearish
South Korea	BoP Current Account Balance	m/m	May	$3.860b	-$0.079b		**	Equity bullish, bond bearish
	BoP Goods Balance	m/m	May	$2.742b	$2.948b		*	Equity and bond neutral
China	Foreign Reserves	m/m	Jun	$3.071t	$3.128t	$3.111t	**	Equity and bond neutral
EUROPE								
Germany	Industrial Production WDA	y/y	May	-3.1%	-5.3%	-5.0%	**	Equity bullish, bond bearish
Switzerland	Unemployment Rate	m/m	Jun	2.2%	2.2%	2.2%	**	Equity and bond neutral
	Foreign Currency Reserves	m/m	Jun	849.8b	925.4b		***	Equity and bond neutral
AMERICAS								
Canada	International Merchandise Trade	m/m	May	5.32b	2.17b	2.4b	***	Equity bullish, bond bearish
Mexico	CPI	y/y	Jun	7.99%	7.65%	7.98%	***	Equity and bond neutral
	Core CPI	y/y	Jun	7.49%	7.28%	7.54%	**	Equity and bond neutral
Brazil	FGV Inflation IGP-DI	y/y	Jun	11.12%	10.56%	11.10%	**	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)	235	232	3	Up
3-mo T-bill yield (bps)	181	185	-4	Up
TED spread (bps)	54	47	7	Widening
U.S. Sibor/OIS spread (bps)	222	220	2	Up
U.S. Libor/OIS spread (bps)	228	226	2	Up
10-yr T-note (%)	2.93	2.93	0.00	Up
Euribor/OIS spread (bps)	-15	-15	0	Neutral
Currencies	Direction			
Dollar	Down			Up
Euro	Flat			Down
Yen	Up			Down
Pound	Up			Down
Franc	Down			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	$101.74	$100.69	1.04%	
WTI	$99.64	$98.53	1.13%	
Natural Gas	$5.62	$5.51	1.96%	
Crack Spread	$39.62	$40.15	-1.32%	
12-mo strip crack	$31.69	$32.09	-1.25%	
Ethanol rack	$2.77	$2.78	-0.34%	
Metals				
Gold	$1,744.38	$1,738.86	0.32%	
Silver	$19.38	$19.21	0.89%	
Copper contract	$354.05	$340.80	3.89%	
Grains				
Corn contract	$599.00	$585.00	2.39%	
Wheat contract	$841.25	$804.50	4.57%	
Soybeans contract	$1,359.75	$1,322.75	2.80%	
Shipping				
Baltic Dry Freight	2,043	2,098	-55	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.6		
Gasoline (mb)		-1.1		
Distillates (mb)		1.0		
Refinery run rates (%)		0.2%		
Natural gas (bcf)		75.0		

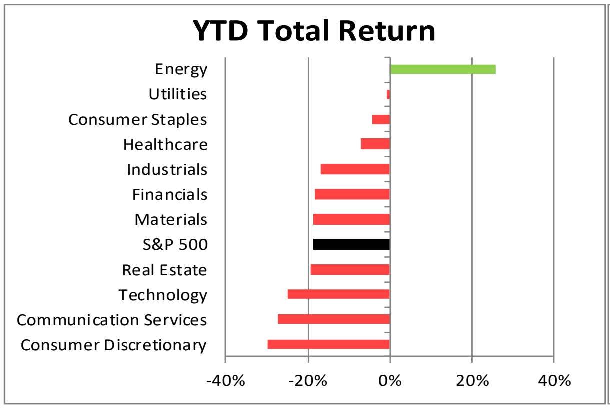
Weather

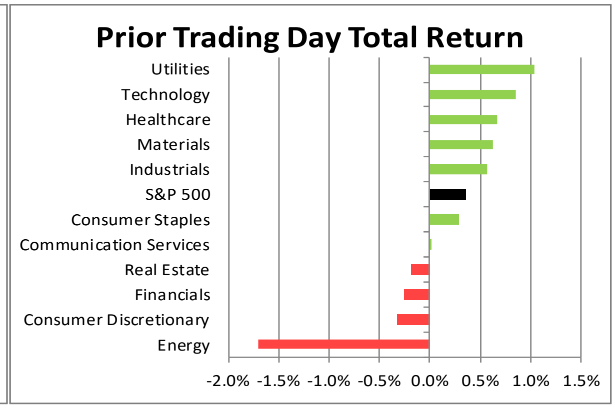
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout the entire western half of the country and the Deep South, with cooler-than-normal temperatures in the Midwest. Wetter-than-normal conditions are expected throughout the Rocky Mountains, Appalachians, and Deep South, with dry conditions expected in the Midwest.

There is no tropical cyclone activity forecasted over the next 48 hours.

Data Section

U.S. Equity Markets – (as of 7/6/2022 close)

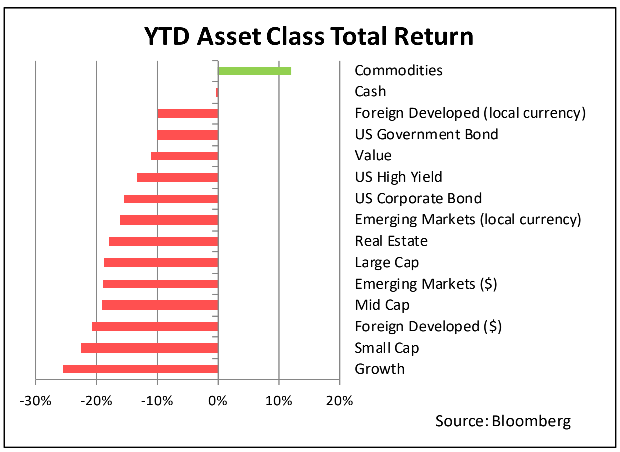




(Source: Bloomberg)

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 7/6/2022 close)

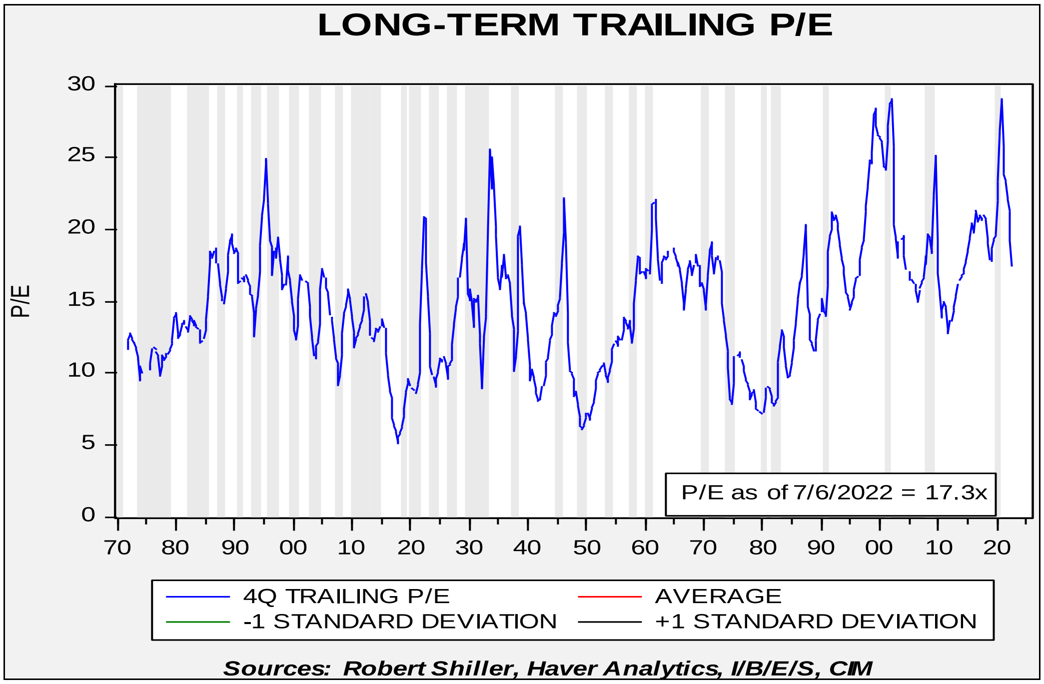


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 7, 2022



Based on our methodology,[1] the current P/E is 17.3x, down 2.0x from last week. The drop in the P/E is due to the calendar; we are now in Q3 which resets the index average and incorporates earnings estimates for Q3.

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.