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: June 3, 2022—9:30 AM EDT] Global equity markets are mixed this morning. In Europe, the EuroStoxx 50 index is currently up less than 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 index closed up 0.3%. Chinese markets were higher, with the Shanghai Composite closing up 0.4% from its prior close and the Shenzhen Composite closing up 0.7%. In contrast, U.S. equity index futures are signaling a lower 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:

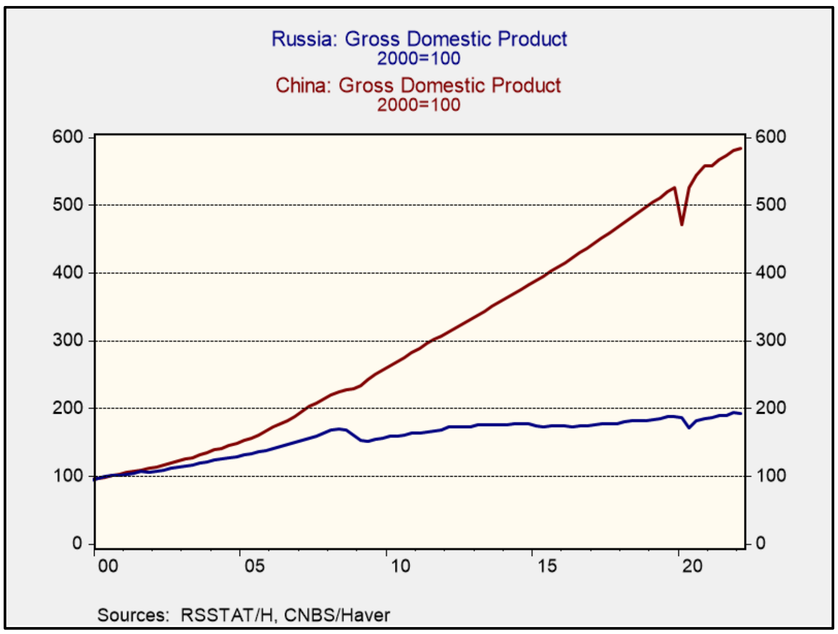
- *Bi-Weekly Geopolitical Report* (5/23/2022) (with associated podcast): "Going Nuclear with North Korea"
- ***Weekly Energy Update* *(6/2/2022): We cover the OPEC+ output increase, the EU embargo, and the concept of windfall profit taxes along with our usual recap of the energy data.***
- *Asset Allocation 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* (5/31/2022) (with associated podcast): "The Problem of Financial Conditions"
- *Confluence of Ideas* podcast (3/25/2022): "The 2022 Outlook: Update #1"
- *Current Perspectives*: *"*2022 Outlook: Update #1*"* (2/18/2022)

Good morning! Today's report begins with an update on the Russian invasion of Ukraine. Next, we discuss the latest economic and policy news, including our thoughts on recent Fed comments. Afterward, we review some international stories that could impact markets today and close with our COVID-19 coverage.

Russia-Ukraine update: As the war enters its 100th day, Moscow has more military success, but it appears to be coming at a high cost. According to Ukraine President Volodymyr Zelensky, Russian forces now control one-fifth of Ukraine and continue to make incremental gains in the eastern region. In addition, Russian troops are closer to capturing Severodonetsk and Lysychansk, two major cities in the Russian stronghold Luhansk. Despite Russian gains, Ukrainian troops have recovered much of the region it lost and still pose a significant threat in northern parts of the country. Additionally, Russian military leaders have expressed concern over the lack of forces and the low morale of many of its troops. As a result, it isn't clear whether or not Russia will be able to sustain the current momentum.

Off the battlefield, Moscow is also finding more hardship. On Thursday, the U.S. expanded its sanctions list to include individuals with ties to Russian President Vladimir Putin. Meanwhile, Russia struggles to find outside backing for its invasion of Ukraine. In the run-up to its attack, Moscow appeared confident that Beijing would support its ambitions to limit the expansion of NATO into Ukraine. However, China has been reluctant to offer any support that could make it a target of U.S. sanctions. Russian shortcomings in the war have led some members of the Chinese elite to push Beijing to abandon Moscow altogether.

It should be noted that the relationship between China and Russia is one of convenience as opposed to one of kinship. The two sides are united in their desire to limit U.S. influence worldwide but have different views on how a new world should look. China would like the international system to remain in place but with reforms. Russia would like the system replaced altogether. The difference in views stems from the fact that China has benefited from the rise in globalization while Russia has not. For example, China's GDP growth accelerated following its admission into the WTO in 2001, while Russia’s has seen only a modest rise within that same time frame.



Although both China and Russia dislike when the U.S. meddles in their respective affairs (Taiwan, Ukraine, etc.), their strategies to address these issues are different. Russia would prefer to cause chaos to tear the system down. China, on the other hand, prefers to make incremental gains, hoping it will be able to take it over. This conflicting view has become more apparent after the invasion of Ukraine. Beijing supported Russia because it believed Putin when he said it would be quick. However, since the war has gone longer and with higher costs than either side initially thought, Beijing has been reluctant to offer the support Russia desires. As a result, we do not expect China to provide any significant support in the future. If we are correct, this could mean that this war may not be as costly, which should be favorable for the global economy and financial markets.

Other Ukraine-Russia news

- Russia announced it would service its debt payments in rubles. The decision could pave the way for default, as the country is due to make a $100 billion foreign bond payment on Friday. On Wednesday, the treasury officially ended the waiver that allowed U.S. banks and individuals to receive debt payments from Russia. There is no sign that a Russian default could adversely impact the international financial system, and we are closely monitoring the situation.
- Russian natural gas supply to Europe remains stable, and there were concerns that the Ukraine war may have damaged one of the gas routes.

U.S. economic and policy news

- Federal Reserve Vice Chair Lael Brainard has dampened expectations of a possible pause in rate hikes. In an interview with MSNBC, Brainard warned that inflation would need to decelerate and demands need to cool before the Fed considers moderating its current monetary policy. Cleveland Fed President Loretta Mester, a voting member, voiced similar views in a speech. Although the Fed could pause rate hikes this year, it is unlikely to happen unless there is a recession. Rising energy and food prices will likely keep inflation above the Fed's inflation target of 2% in 2022. Furthermore, it is becoming clear the Fed is looking to see a looser job market, which may mean an unemployment rate above 4%.

International news

- OPEC agreed to boost production in July and August by an extra 650,000 barrels a day, up from the planned increase of 400,000. In addition, Saudi Arabia signaled it was willing to offset the shortages from Russia. The move comes amid pressure from Western countries for the oil cartel to ramp up production to help bring down energy prices.
- China is close to developing its most advanced aircraft carrier. The new ship will make it easier for China to expand military operations by sea. The development of these carriers suggests Beijing plans to expand its military presence throughout the Pacific.

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Interesting facts

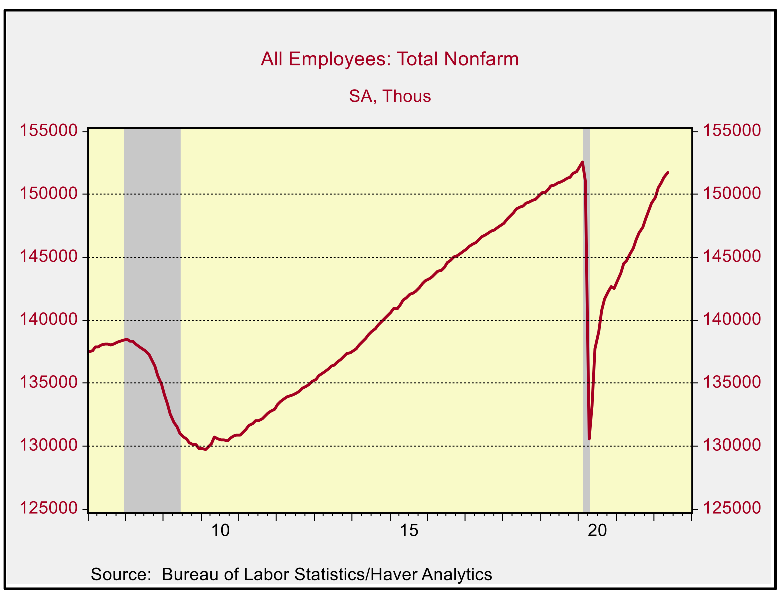
- To keep menu prices down, restaurants have started adding new surcharges to bills to cope with rising input and labor costs.

COVID-19: The number of reported cases is 530,898,846, with 6,296,311 fatalities. In the U.S., there are 84,545,537 confirmed cases with 1,008,031 deaths. For illustration purposes, the *FT* has created an interactive chart that allows one to compare cases across nations using similar scaling metrics. The CDC reports that 749,151,955 doses of the vaccine have been distributed, with 588,223,208 doses injected. The number receiving at least one dose is 258,685,370, the number of second doses is 221,406,167, the number receiving the first booster is 103,641,912, and the number receiving the second booster is 14,264,775. The *FT* has a page on global vaccine distribution.

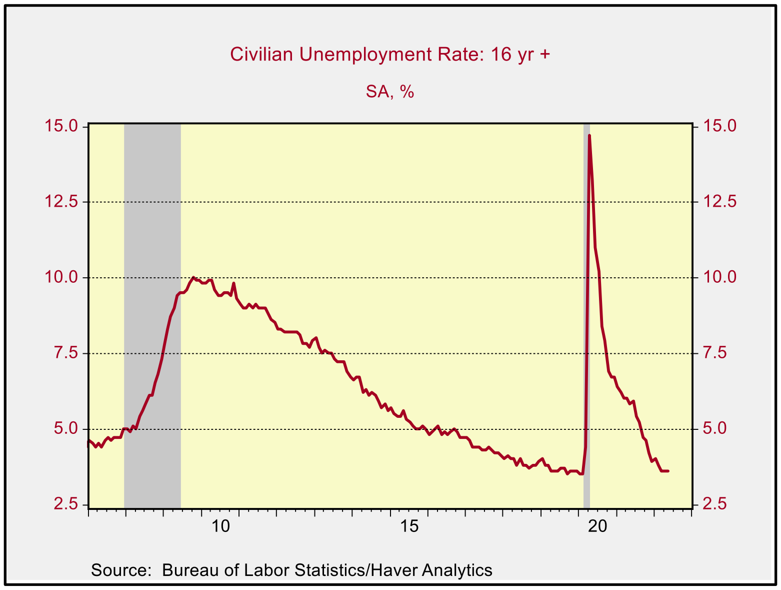
- Later this month, regulators are expected to authorize the COVID-19 vaccine for emergency use for children under 5. The decision could make it easier for the country to contain the spread of cases.
- According to the WHO, over two-thirds of the world's population has had exposure to COVID-19 through infection or vaccine. This level of exposure suggests most people have antibodies needed to fight off the virus.

U.S. Economic Releases

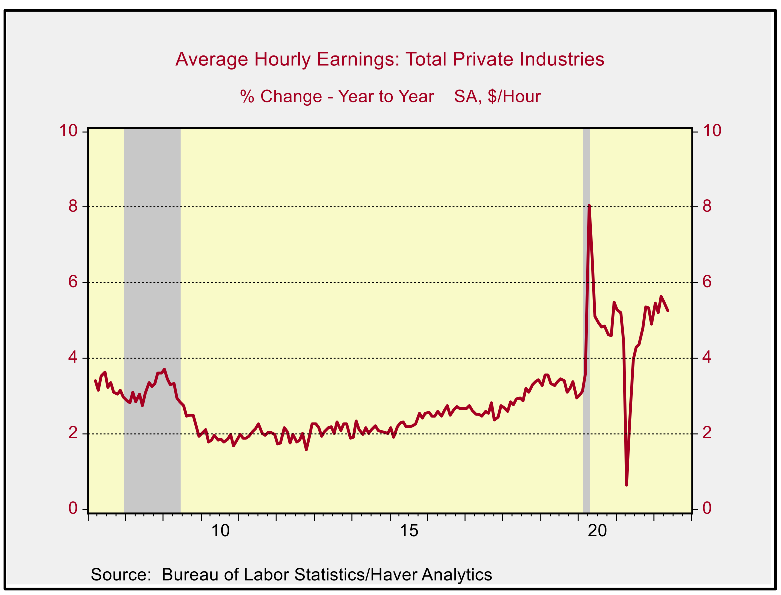
May nonfarm payrolls rose by a seasonally adjusted 390K, handily beating the consensus expectation for a rise of 318K but still weaker than the revised gain of 436K in April. Most of the job gains in May came in the private sector, but we note there was a big slowdown in factory hiring. With the increase in May, total nonfarm payrolls are now down just 0.5% from their peak right before the coronavirus pandemic hit. The chart below shows the change in nonfarm payrolls since shortly before the previous recession.



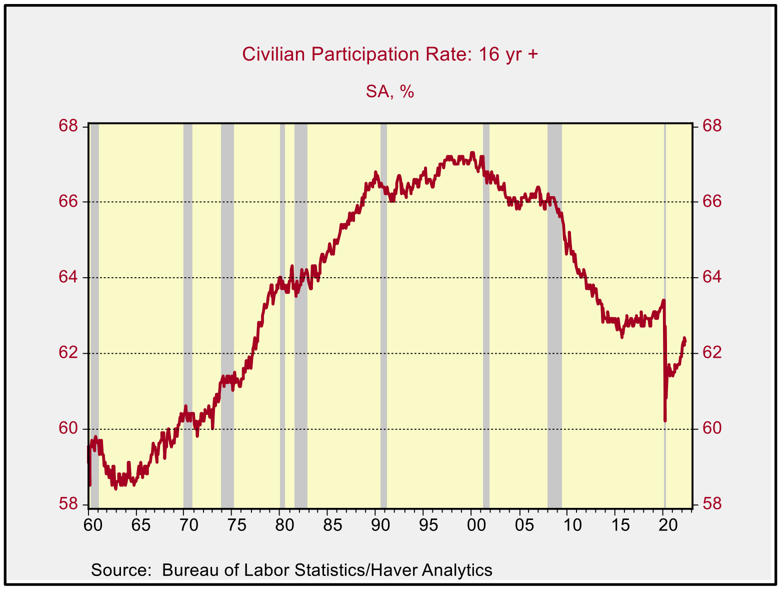
The report showed the May unemployment rate held steady at a seasonally adjusted 3.6%. The rate of joblessness remains historically low, but the figure was a bit of disappointment in the sense that it had been expected to fall to 3.5%. The chart below shows how the unemployment rate has evolved since just prior recession.



With the demand for labor high and the "inventory" of unemployed workers low, it should be no surprise that wage rates keep climbing. Average hourly earnings in May rose to a seasonally adjusted $31.95, up 5.2% from the same month one year earlier. The annual increase met expectations, but it was a bit softer than the 5.5% rise in the year to April. The figure suggests workers may be seeing somewhat slower wage growth, but that could help ease inflation pressures. The chart below shows the year-over-year growth in average hourly earnings since just before the prior recession.



A final key indicator in the monthly employment report focuses on the share of the adult, civilian, and noninstitutionalized population either working or looking for work. The May labor force participation rate (LFPR) rose slightly to a seasonally adjusted 62.3%, as anticipated, but it is still low enough to suggest there has been only a limited net influx of workers into the labor market despite the strong demand for employees and increasing wages. The chart below shows how the LFPR has changed over the last several decades.



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

Economic Releases						
EST	Indicator			Expected	Prior	Rating
9:45	S&P Services PMI	m/m	May F	53.5	53.5	**
9:45	S&P Composite PMI	m/m	May F	53.8	53.8	**
10:00	ISM Nonmanufacturing PMI	m/m	May	56.5	57.1	***
Federal Reserve						
EST	Speaker or Event	District or Position				
10:30	Lael Brainard Discusses Community Reinvestment Act	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	Jibun Bank Services PMI	m/m	May F	52.6	51.7		**	Equity bullish, bond bearish
	Jibun bank Composite PMI	m/m	May F	52.3	51.4		*	Equity bullish, bond bearish
Australia	S&P Services PMI	m/m	May F	53.2	53.0		**	Equity bullish, bond bearish
	S&P Composite PMI	m/m	May F	52.9	52.5		*	Equity bullish, bond bearish
South Korea	CPI	y/y	May	5.4%	4.8%	5.1%	***	Equity bearish, bond bearish
	Core CPI	y/y	May	4.1%	3.6%	3.7%	**	Equity bearish, bond bearish
India	S&P Services PMI	m/m	May	58.9	57.9		**	Equity bullish, bond bearish
	S&P Composite PMI	m/m	May	58.3	57.6		**	Equity bullish, bond bearish
EUROPE								
Eurozone	S&P Services PMI	m/m	May F	56.1	56.3	56.3	**	Equity bearish, bond bullish
	S&P Composite PMI	m/m	May F	54.8	54.9	54.9	*	Equity bearish, bond bullish
	Retail Sales	y/y	Apr	3.9%	1.6%	5.4%	*	Equity bearish, bond bullish
Germany	S&P Services PMI	m/m	May F	55.0	56.3	56.3	**	Equity bearish, bond bullish
	S&P Composite PMI	m/m	May F	53.7	54.6	54.6	**	Equity bearish, bond bullish
	Trade Balance	m/m	Apr	3.5b	1.9b	4.3b	**	Equity bearish, bond bullish
	Exports	m/m	Apr	4.4%	-3.0%	1.0%	*	Equity bullish, bond bearish
	Imports	m/m	Apr	3.1%	5.3%	-2.0%	*	Equity bearish, bond bullish
France	S&P Services PMI	m/m	May F	58.3	58.4	58.4	**	Equity and bond neutral
	S&P Composite PMI	m/m	May F	57.0	57.1	57.1	**	Equity and bond neutral
	Industrial Production	y/y	Apr	-0.3%	0.1%	0.0%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	Apr	0.8%	1.5%		**	Equity bearish, bond bullish
Italy	S&P Services PMI	m/m	May	53.7	55.7	54.5	**	Equity bearish, bond bullish
	S&P Composite PMI	m/m	May	52.4	54.5	53.8	**	Equity bearish, bond bullish
Russia	S&P Services PMI	m/m	May	48.5	44.5	44.8	**	Equity bullish, bond bearish
	S&P Composite PMI	m/m	May	48.2	44.4	45.5	**	Equity bullish, bond bearish
AMERICAS								
Canada	Labor Productivity	q/q	1Q	-0.5%	-0.5%		*	Equity and bond neutral
Brazil	Industrial Production	y/y	Apr	-0.5%	-2.1%	-0.7%	***	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)	163	161	2	Up
3-mo T-bill yield (bps)	110	111	-1	Up
TED spread (bps)	53	50	3	Widening
U.S. Sibor/OIS spread (bps)	147	146	1	Up
U.S. Libor/OIS spread (bps)	152	150	2	Up
10-yr T-note (%)	2.92	2.91	0.01	Up
Euribor/OIS spread (bps)	-33	-34	1	Neutral
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Down
Yen	Down			Down
Pound	Down			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	$117.37	$117.61	-0.20%	
WTI	$116.54	$116.87	-0.28%	
Natural Gas	$8.53	$8.49	0.58%	
Crack Spread	$60.82	$60.79	0.05%	
12-mo strip crack	$39.62	$39.83	-0.54%	
Ethanol rack	$2.97	$2.97	-0.01%	
Metals				
Gold	$1,865.05	$1,868.58	-0.19%	
Silver	$22.39	$22.31	0.39%	
Copper contract	$452.90	$455.25	-0.52%	
Grains				
Corn contract	$732.75	$730.25	0.34%	
Wheat contract	$1,057.75	$1,058.25	-0.05%	
Soybeans contract	$1,724.50	$1,729.25	-0.27%	
Shipping				
Baltic Dry Freight	2,633	2,566	67	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-5.1	-2.1	-3.0	
Gasoline (mb)	-0.7	-0.1	-0.6	
Distillates (mb)	-0.5	0.8	-1.3	
Refinery run rates (%)	-0.6%	0.5%	-1.1%	
Natural gas (bcf)	90.0	88.0	2.0	

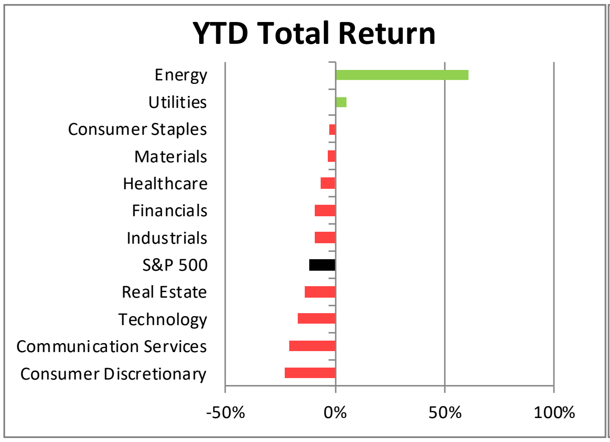
Weather

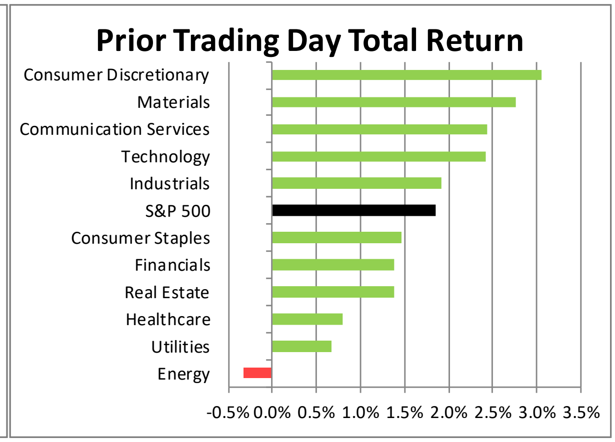
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures primarily in the Far West and the Southeast, with cooler temperatures in the northern Great Plains and Midwest. Wetter-than-normal conditions are expected in all regions from the Great Plains eastward.

Separately, we note the Atlantic hurricane season has now begun. The season runs from June 1 to November 30, although storms typically don't peak until mid-September. Currently, one storm near the coast of the Yucatan Peninsula in Mexico is expected to become cyclonic within the next 48 hours.

Data Section

U.S. Equity Markets – (as of 6/2/2022 close)

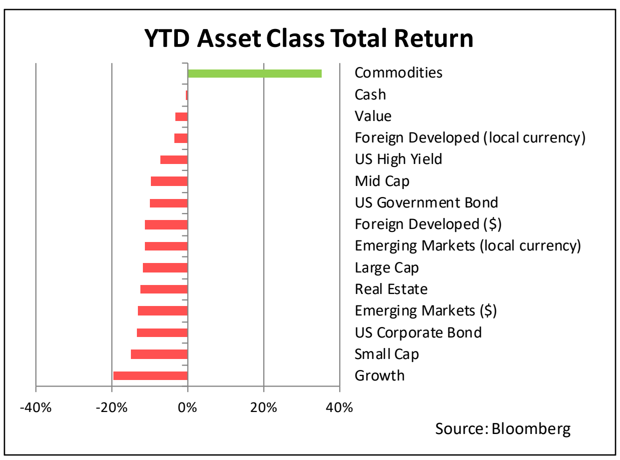




(Source: Bloomberg)

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 6/2/2022 close)

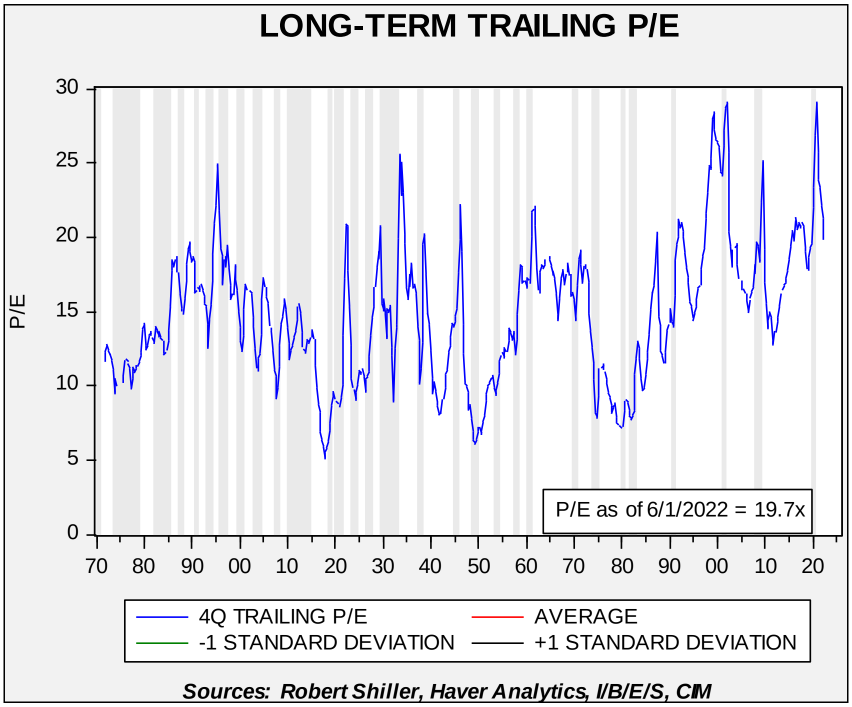


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

June 2, 2022



Based on our methodology,[1] the current P/E is 19.7x, unchanged from last week.

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 three actual quarters (Q3, Q4 and Q1) and one estimate (Q2). 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.