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 23, 2022—9:30 AM EDT] Global equity markets are higher this morning. In Europe, the EuroStoxx 50 is currently up 0.2% 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 1.6% from its prior close and the Shenzhen Composite closing up 2.1%. 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* (6/16/2022): We discuss the natural gas market, the threats made by the White House to the Energy sector, and the upcoming presidential visit to the Middle East.
- *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* (6/13/2022) (with associated podcast): "Homebuilders Versus Apartment Builders"
- *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 coverage of Fed Chair Jerome Powell's testimony to the Senate Banking Committee. Next, we review the latest updates on the Russia-Ukraine war. We continue the report with a discussion about U.S. gas prices, China's crackdown on tech, and a potential slowdown in the European economy. Lastly, we end the report with our daily COVID-19 coverage.

Note: Because COVID-19 has become more endemic and in most countries isn't disrupting the economy or politics as much as it did previously, we will drop our dedicated COVID-19 section beginning July 1. We will continue to cover pandemic news as needed within our main text.

Jerome Speaks to the Senate: Federal Reserve Chair Jerome Powell acknowledged that a recession might be possible. This acknowledgment was the first time the central bank head conceded that rate hikes could lead to an economic downturn. He explained that although the economy can withstand monetary tightening, outside factors such as the war in Ukraine and China's Zero-COVID policy make it more difficult for the central bank to achieve a soft landing. Despite the negative outlook, the Fed chair's comment was less hawkish than investors feared. Powell neglected to mention anything about the size of future hikes leading investors to believe that in future meetings, the Fed will consider the impact that hikes will have on the economy. His comments led to an initial rally in equities and bond prices that was later pared back before the market closed on Wednesday. Jerome Powell is set to return to Capitol Hill on Thursday for the second day of testimony, where he will likely face more questions about the direction of Fed policy.

- Chicago and Philadelphia Fed Presidents Charles Evans and Patrick Harker signaled they would be open to supporting a 75bps rate hike in July if inflation remains elevated. Their comments suggest the central bank could have another big hike in July. However, both Fed officials also expressed the possibility of a pause in rate hikes by 2023. Evans stated the Fed should raise rates above three percent by the end of the year, then reassess, while Harker noted the use of quantitative tightening could make raising past three percent unnecessary. Their comments could be favorable to risk assets that have been negatively impacted by rate uncertainty.
- The job market may be cooling. Data collected by Indeed shows that job listings are starting to stagnate. Nevertheless, there are still more vacancies than the number of workers available, suggesting that the Federal Reserve may be achieving some success in relieving the demand pressures for firms.

Russia-Ukraine: Moscow continues to succeed in eastern Ukraine as Russian forces look to take over Donetsk and Luhansk oblasts. Russian troops are closing in on Lysychansk, the last major Ukrainian-controlled city in Luhansk. Ukrainian troops are prepared to defend the city, as the country remains committed to fighting a war of attrition. Meanwhile, Russia's anti-defense missile systems have decreased the effectiveness of Ukrainian drones. Using Turkish drones was a key to Ukraine's early military success. However, recent failures have forced Ukrainian forces to switch tactics. Despite Russia's advances, there is growing speculation that its momentum could slow because of a lack of resources and troops.

- Russian oil cargoes are becoming hard to track in the Atlantic Ocean. Over the last few days, at least three tankers have disappeared from the vessel-tracking system as they enter the Azores. Although it is not clear why the ships have vanished, it is suspected that the vessels went dark to conceal the prospective buyers of the oil, keeping them private to avoid sanction penalties. Other countries hit with sanctions, such as Venezuela and Iran, have also gone dark for similar reasons. The sale of Russian oil on these vessels will probably relieve some demand pressure but could also extend the war in Ukraine.
- Moscow could cut gas from Europe altogether, the head of the International Energy Agency warned. He stated Russia could make up excuses about technical difficulties to justify not supplying gas to Europe. Germany is already considering rationing its gas to consumers and businesses to rebuild its inventory for the winter months. Europe has growing concerns that the gas crisis could lead to a collapse in energy markets. Energy suppliers have been forced to take huge losses. As a result, there is a possibility that the effects could spill over to local utilities. Germany is the most vulnerable to the rise in costs, and we suspect it will become bolder in its push for Ukraine to agree to a ceasefire.

European power prices surged to their highest level since December, and prices will likely get worse.

- Russian forces have targeted wheat terminals as Moscow looks to hurt Ukraine's ability to export food. On Wednesday, it hit two North American-owned terminals with missile strikes. Russia's targeting of Ukraine wheat exports adds to concern that there could be a global food crisis this year.
- Lithuania is preparing for Russia to cut it off from the regional power grid. Moscow threatened retaliation after Lithuania blocked shipments of Russian goods to Kaliningrad. Unlike other European countries, Lithuania does not depend on Russia for its energy needs; thus, it has more flexibility to stand up to Moscow.

U.S. Gas Prices: Rising gas prices have weighed on demand as drivers have changed their consumption habits. According to energy-data provider OPIS, gas stations have declined annual sales for the 14th consecutive week. Consumers likely need this demand destruction to bring prices back into equilibrium with the supply level. Meanwhile, oil refiners are expected to meet with President Biden to discourage him from placing restrictions on exports. The Biden administration is looking at limiting the overseas sales of domestically produced oil to bring down gas prices. If the administration does ban exported oil, it will bring down fuel prices domestically but increase prices abroad.

- The rate to deliver fuel by sea has more than doubled this year to the highest level since April 2020, according to the Baltic Exchange. The increase in price is due to the war in Ukraine forcing some shippers to alter their trade routes. The rise in shipping costs might lead to an increase in inflation, as firms will look to push those costs onto consumers.

China Crackdown: Authorities in China appear to be shifting their focus away from fintech and toward online pharmaceuticals. On Thursday, Beijing approved a plan to allow online financial platforms' "healthy" development. This change indicates the investigation into financial firms like ANT could end soon, and regulators are considering banning third-party platforms from selling medication online.

- China expects to miss its growth target of 5.5% for the year. A weakening property market and the Zero-COVID policy have made it difficult for the country to expand.

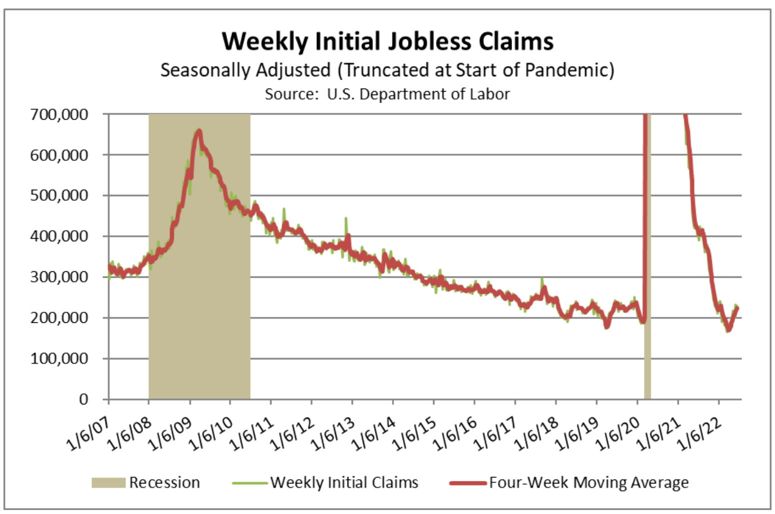
European Economy: Higher energy and food prices have started to slow economic activity in Europe as consumers have reduced their demand for other goods and services. The latest index from S&P Global shows that purchasing managers are reporting a decline in manufacturing output for the first time in two years. Additionally, the S&P Global composite PMI index, which tracks manufacturing and service activity, decreased from 54.8 in May to 51.9 in June. The reduction in output highlights the challenges Europe faces due to the war in Ukraine and raises the likelihood of a possible downturn.

COVID-19: Official data show confirmed cases have risen to 541,441,499 worldwide, with 6,324,412 deaths. The countries currently reporting the highest rates of new infections include the U.S., Taiwan, Australia, and Germany. (For an interactive chart that allows you to compare cases and deaths among countries, scaled by population, click here.) In the U.S., confirmed cases have risen to 86,636,306, with 1,014,835 deaths. In data on the U.S. vaccination program, the number of people considered fully vaccinated now totals 221,924,152, equal to 66.8% of the total population.

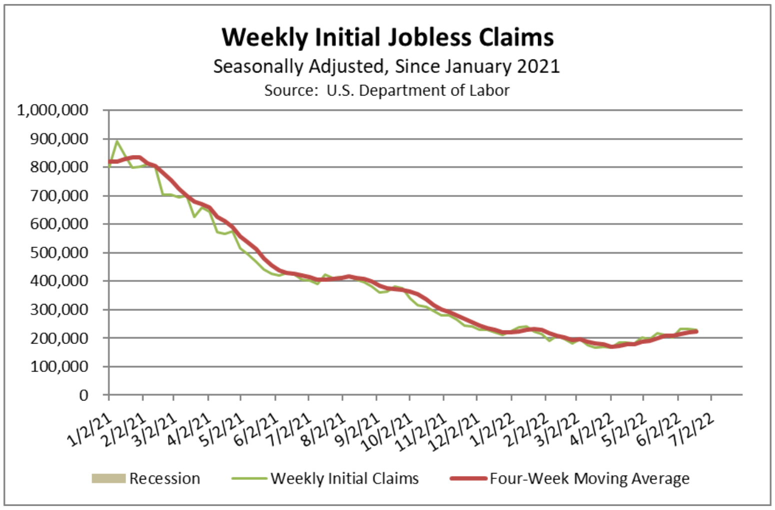
- New variants of omicron have proven to be resistant to antibodies from vaccinated and previously affected individuals. The mutation in the virus will likely increase infections; however, there is no evidence that suggests that it could lead to economic disruptions.

U.S. Economic Releases

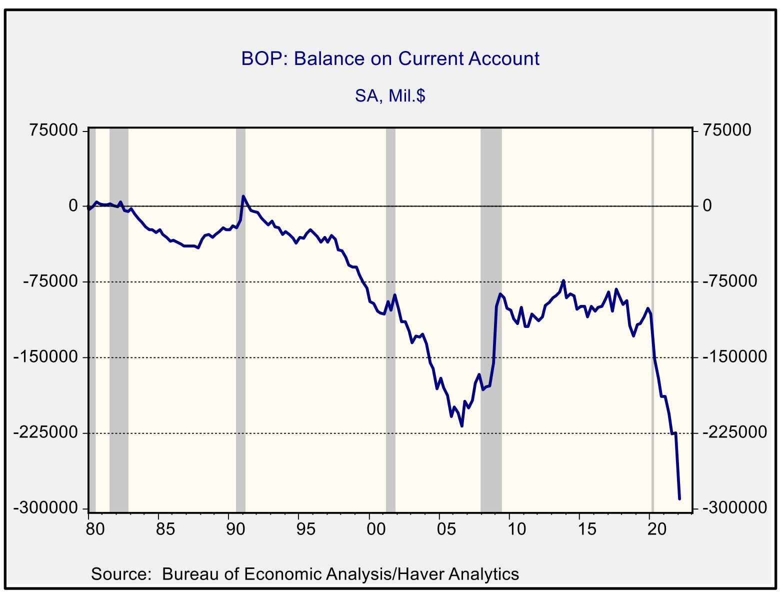
Initial applications for unemployment benefits in the week ended June 18 edged down to a seasonally adjusted 229K from a revised 231K in the previous week. However, the figure was still a bit worse than the expected reading of 226K. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 223.5K, reaching its highest level since late January. The number of people continuing to draw benefits in the week ended June 11 rose to 1.315M from a revised 1.310M in the prior week, although that was better than the expected reading of 1.320M. The recent rise in initial and continuing jobless claims is an important piece of evidence that the demand for labor may be falling and layoffs may be increasing in the face of rising interest rates, high inflation and energy prices, slowing demand growth in China, and uncertainty spawned by the war in Ukraine. 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.



Separately, the first quarter current account balance, which is a comprehensive measure of the U.S. trade balance and other near-term international transactions, showed a seasonally adjusted deficit of $291.4B, much worse than the anticipated shortfall of $275.0B and far in excess of the previous quarter's deficit of $217.9B. The widening in the deficit came mostly from the continuing surge in U.S. imports as the economy continues to recover from the pandemic, and rising commodity prices boost the bill for foreign commodities. The chart below shows how the current account balance has evolved over recent 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 Manufacturing PMI	m/m	Jun P	56.0	57.0	***
9:45	S&P Services PMI	m/m	Jun P	53.3	53.4	**
9:45	S&P Composite PMI	m/m	Jun P	53.0	53.6	**
11:00	Kansas City Fed Manfacturing Index	m/m	Jun	10	23	*
Federal Reserve						
EST	Speaker or Event	District or Position				
10:00	Jerome Powell Testifies Before House Financial Services Cmte.	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	Jibun Bank Manufacturing PMI	m/m	Jun P	52.7	53.3		***	Equity and bond neutral
	Jibun Bank Services PMI	m/m	Jun P	54.2	52.6		**	Equity and bond neutral
	Jibun Bank Composite PMI	m/m	Jun P	53.2	52.3		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	17-Jun	-¥942.5b	¥205.2b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	17-Jun	-¥4804.6b	-¥1103.0b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	17-Jun	¥9.7b	-¥137.1b		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	17-Jun	-¥496.7b	-¥862.7b		*	Equity and bond neutral
	Nationwide Department Store Sales	y/y	May	57.8%	19.0%		*	Equity and bond neutral
Australia	S&P Manufacturing PMI	m/m	Jun P	55.8	55.7		***	Equity and bond neutral
	S&P Services PMI	m/m	Jun P	52.6	53.2		**	Equity bearish, bond bullish
	S&P Composite PMI	m/m	Jun P	52.6	52.9		*	Equity bearish, bond bullish
South Korea	PPI	y/y	May	9.7%	9.7%	9.7%	**	Equity and bond neutral
EUROPE								
Eurozone	S&P Manufacturing PMI	m/m	Jun P	52.0	54.6	53.8	***	Equity bearish, bond bullish
	S&P Services PMI	m/m	Jun P	52.8	56.1	55.5	**	Equity bearish, bond bullish
	S&P Composite PMI	m/m	Jun P	51.9	54.8	54.0	*	Equity bearish, bond bullish
Germany	S&P/BME Manufacturing PMI	m/m	Jun P	52.0	54.8	54.0	***	Equity bearish, bond bullish
	S&P Services PMI	m/m	Jun P	52.4	55.0	54.5	**	Equity bearish, bond bullish
	S&P Composite PMI	m/m	Jun P	51.3	53.7	53.0	**	Equity bearish, bond bullish
France	S&P Manufacturing PMI	m/m	Jun P	51.0	54.6	54.0	***	Equity bearish, bond bullish
	S&P Services PMI	m/m	Jun P	54.4	58.3	57.5	**	Equity bearish, bond bullish
	S&P Composite PMI	m/m	Jun P	52.8	57.0	55.9	**	Equity bearish, bond bullish
	Business Confidence	m/m	Jun	104	106	105	**	Equity and bond neutral
	Manufacturing Confidence	m/m	Jun	108	106	105	*	Equity bullish, bond bearish
UK	S&P/CIPS Manufacturing PMI	m/m	Jun P	53.4	54.6	53.6	***	Equity and bond neutral
	S&P/CIPS Services PMI	m/m	Jun P	53.4	53.4	52.9	**	Equity bullish, bond bearish
	S&P/CIPS Composite PMI	m/m	Jun P	53.1	53.1	52.4	**	Equity bullish, bond bearish
	Public Sector Net Borrowing	m/m	May	13.2b	21.1b	11.5b	*	Equity and bond neutral
	PSNB Ex-Banking Groups	m/m	May	14.0b	21.9b	12.0b	**	Equity and bond neutral
AMERICAS								
Mexico	Retail Sales	y/y	Apr	4.6%	3.8%	4.3%	***	Equity bullish, bond bearish

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)	215	212	3	Up
3-mo T-bill yield (bps)	150	153	-3	Up
TED spread (bps)	65	59	6	Widening
U.S. Sibor/OIS spread (bps)	200	198	2	Up
U.S. Libor/OIS spread (bps)	210	208	2	Up
10-yr T-note (%)	3.11	3.16	-0.05	Up
Euribor/OIS spread (bps)	-17	-16	-1	Neutral
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Down
Yen	Up			Down
Pound	Down			Down
Franc	Down			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Mexico Overnight Rate		7.000%	7.750%	Below 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	$111.32	$111.74	-0.38%	
WTI	$105.65	$106.19	-0.51%	
Natural Gas	$6.72	$6.86	-2.01%	
Crack Spread	$58.44	$57.53	1.59%	
12-mo strip crack	$39.92	$39.46	1.17%	
Ethanol rack	$2.97	$2.97	0.05%	
Metals				
Gold	$1,828.33	$1,837.72	-0.51%	
Silver	$21.18	$21.42	-1.14%	
Copper contract	$387.15	$395.00	-1.99%	
Grains				
Corn contract	$675.00	$693.75	-2.70%	
Wheat contract	$973.25	$988.75	-1.57%	
Soybeans contract	$1,442.00	$1,476.50	-2.34%	
Shipping				
Baltic Dry Freight	2,349	2,484	-135	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	2.0	-1.5	3.5	
Gasoline (mb)	-0.7	-0.7	-0.1	
Distillates (mb)	0.7	-0.3	1.0	
Refinery run rates (%)	-0.5%	0.5%	-1.0%	
Natural gas (bcf)		61.0		

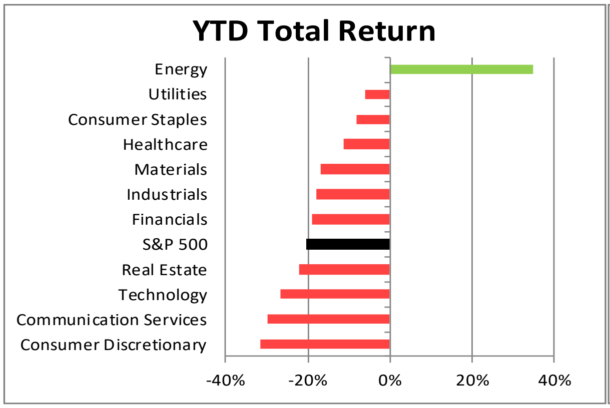
Weather

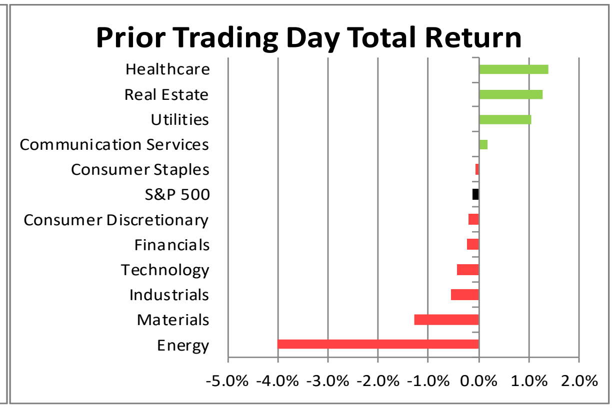
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures in Texas, the southern Great Plains, and the Deep South, with cooler-than-normal temperatures in Arizona and New Mexico. Wetter-than-normal conditions are expected in the Rocky Mountains and the Upper Midwest, with dry conditions expected in Oregon and the Ohio Valley region.

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. There is no cyclone activity expected within the next 48 hours.

Data Section

U.S. Equity Markets – (as of 6/22/2022 close)

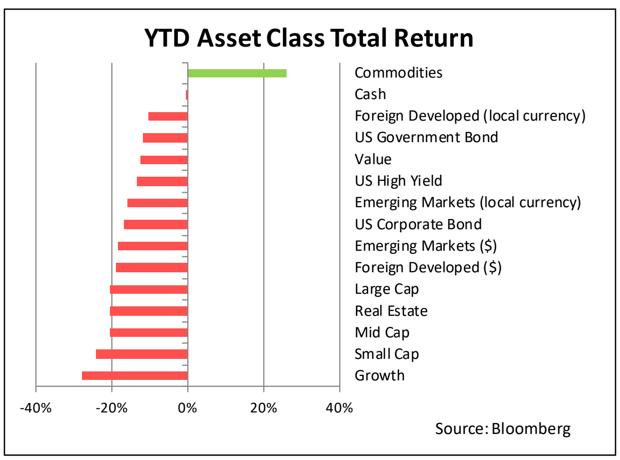




(Source: Bloomberg)

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 6/22/2022 close)

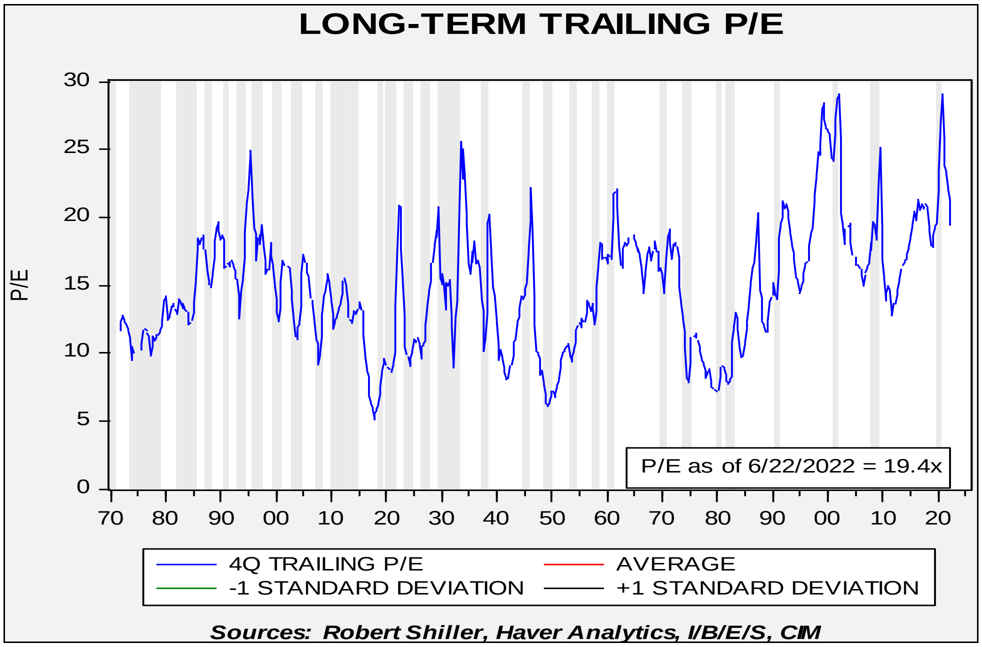


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 23, 2022



Based on our methodology,[1] the current P/E is 19.4x, down 0.1x 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.