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 24, 2022—9:30 AM EDT] Global equity markets are higher this morning. In Europe, the EuroStoxx 50 is currently up 1.9% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.9%. Chinese markets were higher, with the Shanghai Composite closing up 0.9% from its prior close and the Shenzhen Composite closing up 1.3%. 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* (6/24/2022): We discuss the Urals/Brents spread as an indicator of sanctions violations. We also report on Germany's natural gas situation. N.B. The DOE has a data issue, so the inventory data isn't updated. We will update the data when it becomes available.**
- *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)

Good morning. Today's *Comment* starts with an overview of Federal Reserve Chair Jerome Powell's testimony to the House Financial Services Committee. Next, we provide an update on the latest developments regarding the Russian invasion of Ukraine. Afterward, we briefly discuss the rise in home prices, commodity-related news, and the ECB's reluctance to use its new bond purchasing tool. We conclude 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: Fed Chair Jerome Powell testified for the second day on Capitol Hill. Powell reiterated his testimony that his commitment to fighting inflation is "unconditional." He added the Fed would be reluctant to cut interest rates unless there was clear evidence that inflation was coming down. The current Fed projection shows that the central bank expects to raise rates between 3.25% to 3.50% by the end of 2022. The Federal Reserve benchmark rate is currently between 1.5% and 1.75%. Powell's hawkish tone has contributed to concerns the Fed will not be able to achieve a soft landing. U.S. bond prices rallied as fears over a recession led to a flight to safety into safe-haven assets. The U.S. 10-year Treasury has dropped over 20 bps since Tuesday; investors are pricing in the possibility of a recession. Meanwhile, there was a notable shift in equities toward defensive stocks.

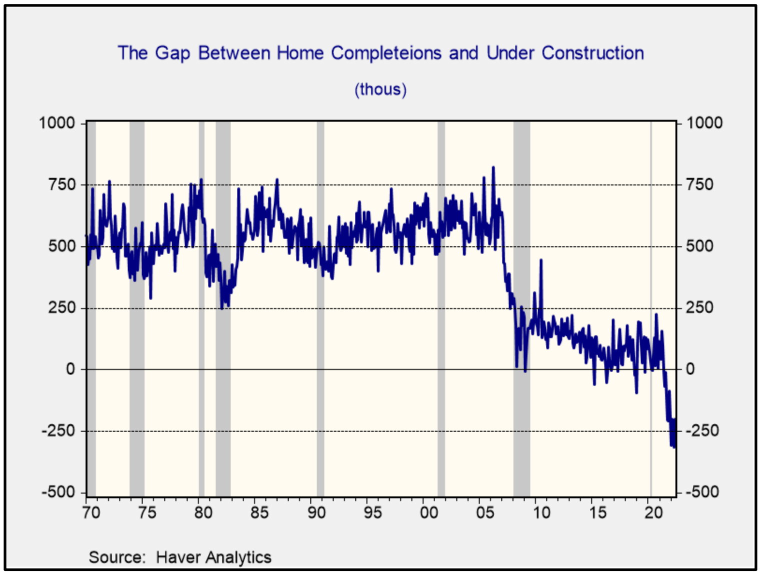
- Fed Governor Michelle Bowman signaled she might support a 75 bps rate hike in July if inflation remains elevated.
- All major banks passed the Federal Reserve financial stress test. The banks tested had to prove they had enough capital to deal with a sudden economic downturn. The financial stress test results suggest the risk of a financial crisis remains low.

Russia-Ukraine update: Russian forces continue to advance throughout eastern Ukraine, but Moscow is still looking for help from its allies. On Thursday, Ukrainian officials announced its troops in Severodonetsk would retreat, and soldiers in Lysychansk also expect orders to withdraw. Ukraine does not believe its military has enough forces to maintain the regions and will probably shift troops to other areas. The outcome is a symbolic victory for Russia, as it now has significant control over the Donbas. Moscow will probably ask that Ukraine cede the region as a requirement for any peace deal. This arrangement will likely be a nonstarter for President Zelensky, who has vowed not to give up any land to Russia. That being said, Ukraine's ability to stay in the war depends on the weapons it receives from the West. The U.S. announced Thursday that it would provide Ukraine with an additional $450 million in military aid and advanced weaponry. The extra support will help Ukraine maintain its fight against Russia.

Despite its new gains, Russia would like help from Belarus because it is running low on troops and supplies. Belarusian forces have started military exercises along the Ukrainian border. The activities appear to be an intimidation tactic, but Ukrainian officials have warned the exercises could provoke a conflict. Belarusian President Alexander Lukashenko does not have the political support to intervene in the war. A survey found that only 11 percent of Belarusians support their country getting involved in the war in Ukraine. Besides the lack of support, there is uncertainty regarding whether Belarus will significantly affect the conflict. As a result, Belarus is unlikely to get involved in the conflict, making it harder for Russia to sustain its current momentum.

- President Biden will meet with G-7 leaders on Sunday to discuss plans to deter Russia from its invasion of Ukraine. The leaders will discuss possible ways to limit Russian oil revenue and work for President Biden's new government following the midterm elections. The next Congress will be less inclined to provide Ukraine with the same level of support.

Rising home prices: Elevated prices and rising mortgage rates have made homes less affordable for many potential homebuyers. According to John Burns Real Estate Consulting, the cost of owning a home has now surpassed the cost to rent. However, the increase in the price of homes is due to demand far outpacing supply. The lack of materials and labor supply has made it difficult to finish projects. As a result, for the first time in at least 30 years, the number of homes completed exceeds that of homes under construction.



The lack of inventory has supported home prices; however, research suggests this trend will not hold for some cities. Chief Economist Mark Zandi from Moody's Analytics projects [home prices in overvalued markets will fall] over the next few months. This cooling has already shown up throughout the Sun Belt. Despite the possibility of a decline in home prices, Zandi does not believe the housing market will collapse. A drop in residential prices will affect consumer confidence, as most households derive their wealth from home values. We suspect a slowdown in housing will lead to lower levels of consumption and could add to recession fears

Commodities: Nuclear energy is making a comeback in the West. A push for cleaner energy sources and Western countries' desire to reduce their dependence on autocratic governments for fossil fuels has led governments to reconsider nuclear energy. The U.S. and France have already started working on developing nuclear reactors, while Germany is considering pausing its plan to close its three remaining plants. This shift toward nuclear will probably relieve some of the demand pressure for natural gas. Countries are struggling to expand their nuclear capacity because of a lack of knowledge and labor. We suspect nuclear energy will probably be a target for future investment as it is one of the most convenient options for countries looking to use clean energy.

- China has purchased less LNG from the U.S. because it can get better prices from Russia. As a result, U.S. natural gas providers have made up for the lack of sales to China by selling energy to Europe. The shifting trade relationship further supports our thesis that the world is breaking into regional blocks. We suspect this trend will continue as the U.S. and China decouple.

- Brazil is running out of space to store much of its corn and soybeans. The lack of storage could place inflationary pressure on food prices if the problem persists. However, news of a strong harvest in Brazil has led to a drop in corn and soybean prices.

European Central Bank: The ECB is reluctant to implement its bond-purchasing program tool as it is not sure how it will thread the needle of being transparent enough to avoid legal challenges while still being ambiguous enough to prevent speculation. The tool was designed to avert financial fragmentation as the central bank starts its tightening cycle. It will effectively prevent the spread of bond yields among Euro members by purchasing bonds from vulnerable countries like Italy. So far, the market has responded well to hearing the news that the ECB will intervene, but it isn't clear how long they can maintain this charade without actual policy action. Banks within the Eurozone region will be sensitive to this policy shift, and thus, we recommend investing with caution.

COVID-19: Official data show confirmed cases have risen to 541,972,784 worldwide, with 6,325,883 deaths. The countries currently reporting the highest rates of new infections include the U.S., Taiwan, Germany, and Brazil. (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 86,757,627, with 1,015,342 deaths. In data on the U.S. vaccination program, the number of people considered fully vaccinated now totals 222,123,223, equal to 66.9% of the total population.

- The U.K. is seeing a surge in COVID-19 cases. As of last week, 1.7 million people have contracted the virus. The recent rise in cases is related to the mutation of the Omicron virus. Despite the increase, infections remain below the all-time highs seen in March.

U.S. Economic Releases

No major U.S. releases have come out so far this morning. 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**
10:00	U. of Michigan Consumer Sentiment	m/m	Jun F	50.2	50.2	***
10:00	U. of Michigan Current Conditions	m/m	Jun F	55.4	55.4	**
10:00	U. of Michigan Future Expectations	m/m	Jun F		46.8	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Jun F	5.4%	5.4%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Jun F	3.3%	3.3%	*
10:00	New Home Sales - Annualized Selling Rate	m/m	May	590k	591k	***
10:00	New Home Sales - Monthly Change	m/m	May	-0.2%	-16.6%	**
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
13:15	Mary Daly Interviewed on Fox Business News	President of the Federal Reserve Bank of San Francisco				
16:00	Mary Daly Speaks at Shadow Open Market Conference	President of the Federal Reserve Bank of San Francisco				

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	National CPI	y/y	May	2.5%	2.5%	2.5%	***	Equity and bond neutral
	National CPI Ex-Fresh Food	y/y	May	2.1%	2.1%	2.1%	**	Equity and bond neutral
	National CPI Ex-Fresh Food & Energy	y/y	May	0.8%	0.8%	0.8%	*	Equity and bond neutral
	Services PPI	y/y	May	1.8%	1.7%	1.7%	*	Equity and bond neutral
EUROPE								
Germany	IFO Business Climate	m/m	Jun	92.3	93.0	92.8	***	Equity bearish, bond bullish
	IFO Current Assessment	m/m	Jun	99.3	99.6	99.0	**	Equity and bond neutral
	IFO Expectations	m/m	Jun	85.8	86.9	87.4	***	Equity bearish, bond bullish
Italy	Consumer Confidence	m/m	Jun	98.3	102.7	103.0	***	Equity bearish, bond bullish
	Manufacturing Confidence	m/m	Jun	110.0	109.4	108.5	***	Equity bullish, bond bearish
	Economic Sentiment	m/m	Jun	113.6	111.0		**	Equity bullish, bond bearish
UK	GfK Consumer Confidence	m/m	Jun	-41	-40	-40	**	Equity bearish, bond bullish
	Retail Sales	y/y	May	-4.7%	-5.7%	-4.5%	***	Equity bearish, bond bullish
	Retail Sales Ex-Auto Fuel	y/y	May	-5.7%	-6.9%	-5.0%	**	Equity bearish, bond bullish
AMERICAS								
Mexico	Economic Activity IGAE	y/y	Apr	1.34%	0.40%	1.30%	**	Equity bullish, bond bearish
Brazil	FGV Consumer Confidence	m/m	Jun	79.0	75.5		*	Equity bullish, bond bearish
	IBGE Inflation IPCA-15	y/y	Jun	12.04%	12.20%	12.02%	***	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)	218	215	3	Up
3-mo T-bill yield (bps)	157	157	0	Up
TED spread (bps)	61	59	2	Widening
U.S. Sibor/OIS spread (bps)	203	201	2	Up
U.S. Libor/OIS spread (bps)	212	210	2	Up
10-yr T-note (%)	3.12	3.09	0.03	Up
Euribor/OIS spread (bps)	-19	-17	-2	Neutral
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Flat			Down
Yen	Down			Down
Pound	Flat			Down
Franc	Up			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Mexico Overnight Rate	7.750%	7.000%	7.750%	On 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	$111.71	$110.05	1.51%	
WTI	$105.97	$104.27	1.63%	
Natural Gas	$6.32	$6.24	1.25%	
Crack Spread	$56.58	$56.64	-0.10%	
12-mo strip crack	$39.98	$39.99	-0.04%	
Ethanol rack	$2.93	$2.94	-0.57%	
Metals				
Gold	$1,824.80	$1,822.77	0.11%	
Silver	$20.88	$20.95	-0.36%	
Copper contract	$370.30	$374.65	-1.16%	
Grains				
Corn contract	$667.00	$655.50	1.75%	
Wheat contract	$967.50	$949.25	1.92%	
Soybeans contract	$1,421.25	$1,415.50	0.41%	
Shipping				
Baltic Dry Freight	2,354	2,349	5	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.5		
Gasoline (mb)		-0.7		
Distillates (mb)		-0.3		
Refinery run rates (%)		0.5%		
Natural gas (bcf)	74.0	61.0	13.0	

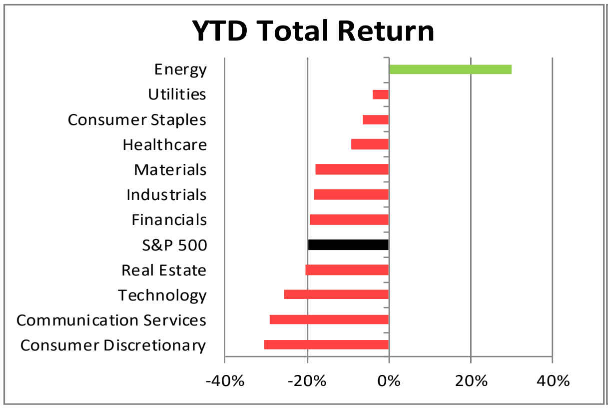
Weather

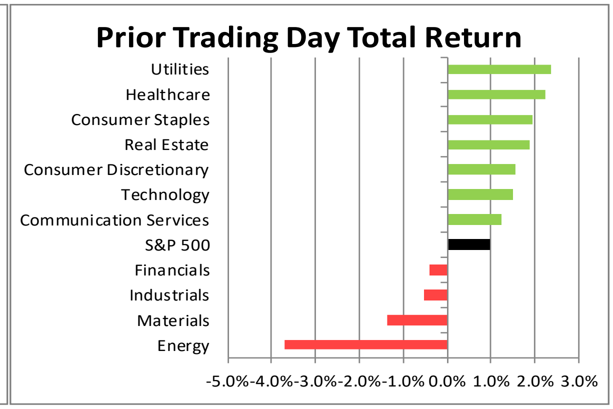
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout the Great Plains, the Mississippi Valley, and the Southeast, with cooler-than-normal temperatures on the West Coast and in the Southwest and Great Lakes regions. Meanwhile, wetter-than-normal conditions are expected in the Rocky Mountains and Great Plains, with dry conditions expected in Oregon, northern California, and northern Nevada.

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 currently a tropical disturbance far out in the Atlantic Ocean between South America and Africa, and it is assessed to have only a 20% chance of developing into a tropical depression over the next 48 hours as it moves westward.

Data Section

U.S. Equity Markets – (as of 6/23/2022 close)

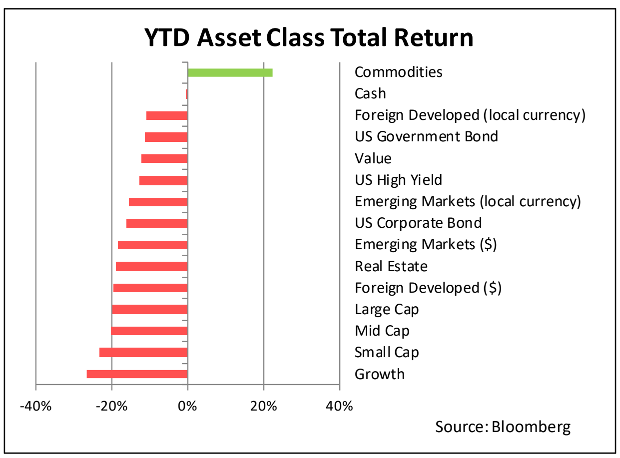




(Source: Bloomberg)

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 6/23/2022 close)

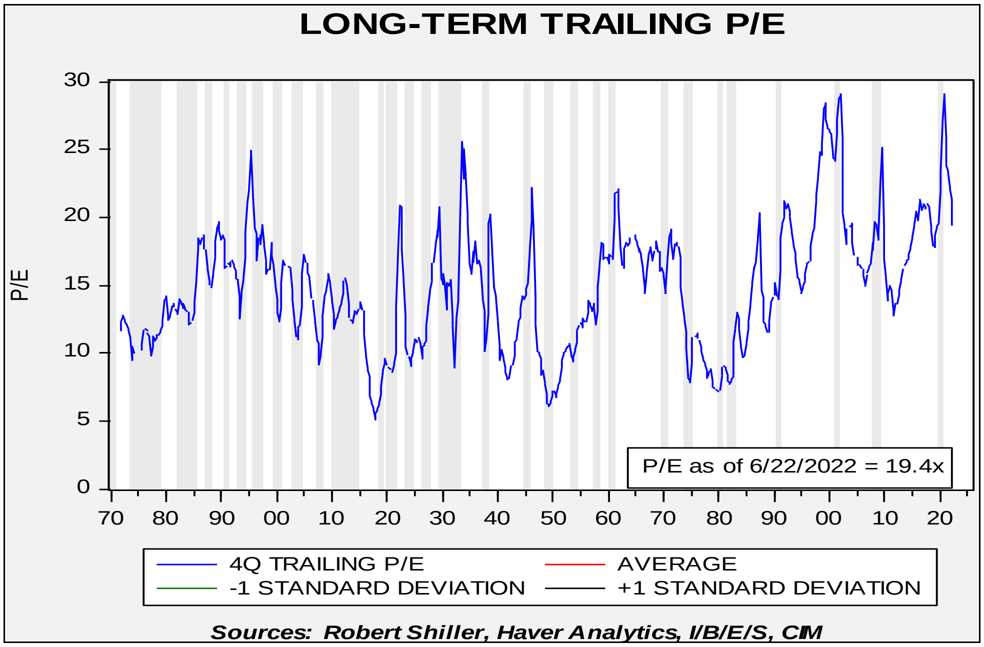


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.