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 28, 2022—9:30 AM EDT] Global equity markets are generally higher this morning. In Europe, the EuroStoxx 50 is currently up 0.9% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.1%. Chinese markets were higher, with the Shanghai Composite closing up 0.9% from its prior close and the Shenzhen Composite closing up 1.2%. 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* (6/27/2022) (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)

Our *Comment* opens with an update on the Russia-Ukraine war, including a discussion regarding the actions taken against Russia by leaders at the Group of Seven summit, which ended today. We next review other international and U.S. developments with the potential to affect the financial markets today, including the latest comments by European Central Bank President Lagarde. We wrap up with the latest news on the coronavirus pandemic.

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.

Russia-Ukraine: As Russian forces continue making slow, plodding progress in their effort to seize the eastern Ukrainian territory of Donbas, we have noted in recent days that they have also increased their broad, indiscriminate artillery and missile attacks on infrastructure and civilian targets throughout the country. Those attacks, including a strike on a shopping mall that killed dozens of civilians, are probably designed to taunt and intimidate Western leaders meeting this week at the G7 and NATO summits. Meanwhile, Russian military authorities continue to seek ways to replenish their increasingly exhausted force capabilities without announcing general mobilization. One U.S. defense official stated yesterday that Russian forces are likely running low on senior military leaders and are relying more heavily on retired officers and reserves to replace officer casualties.

- Press reports indicate that a U.S. precision missile system recently delivered to Ukraine killed the 56th Russian colonel to die in the conflict so far. The colonel was killed in a Ukrainian strike against a Russian command post near Izyum last Friday night. The Russian military has also lost at least 11 generals in the conflict.
- During the G7 summit yesterday, the U.S. said it would provide Ukraine with an advanced medium- to long-range surface-to-air missile-defense system and more artillery support. Other new security assistance will include additional artillery ammunition and counter-battery radars to address needs expressed by the Ukrainian military.
- The summit failed to approve a U.S. proposal to cap prices on Russian oil exports, described in our *Comment* yesterday. The final summit communique still promised that the G7 countries would keep up their efforts to impose severe economic punishments on Russia for its invasion, but officials said they still must flesh out the price-cap idea.
    - Overcoming resistance from export-dependent Germany, the G7 leaders also used their communique to confront China over its predatory economic policies and human rights abuses.
    - The text also condemned China's aggressive action in the East and South China seas, urged Beijing to respect human rights and Hong Kong's autonomy, and pressed it to work toward ending Russian aggression in Ukraine.

North Atlantic Treaty Organization: General Secretary Stoltenberg announced that a new "strategic concept" due to be approved by NATO leaders at their summit starting today would dramatically strengthen the alliance's force structure to better protect it against Russian aggression.

- Under the new plan, NATO's quick-reaction force would expand seven-fold to 300,000 troops, which would be ready to deploy quickly to specific territories on the alliance's eastern flank from the opening hours of any attack.
- The plan would also increase permanent NATO deployments close to Russia, shifting their focus from deterring any invasion to a full defense of allied territory.

Eurozone Monetary Policy: ECB President Lagarde ratcheted up her inflation-fighting rhetoric with a vow that the central bank will act in "a determined and sustained manner" to tackle surging prices in the eurozone, especially if there are signs of price expectations rising sharply among consumers and businesses. While not abandoning her preference to tighten policy gradually, Lagarde stressed it is now important to have "optionality," or the option to tighten policy more sharply if necessary.

- Despite her stronger statements regarding the severity of inflation in the Eurozone and the policymakers' determination to get prices under control, Lagarde also indicated she is sticking by her plan to boost the central bank's benchmark interest rate by just 0.25% in July before a potentially bigger move in September.
- The ECB also still plans to stop buying more bonds on Friday, which has boosted government bond yields for weaker economies like Italy relative to the yields for stronger countries like Germany.
    - The ECB has tried to limit those spreads with vague promises to develop a new "anti-fragmentation" program that would likely involve preferential ECB purchases of government bonds from Italy, Spain, Portugal, Greece, and other weaker Eurozone economies.
    - Lagarde offered no additional details on how the anti-fragmentation program would work other than insisting it would be separate from the ECB's main policy framework.
    - Even if Eurozone leaders can agree on such an anti-fragmentation program, we suspect it would essentially work at cross purposes with the ECB's tightening policy. We, therefore, think it would probably be negative for the euro.

Australia: While the world focused on the coronavirus, Australians have concentrated on a different pandemic, this time among their bees. The country has managed to contain the varroa mite, a parasite that is wiping out bee colonies around the world, but a new variant discovered in the port of Newcastle has prompted a lockdown of bee colonies reminiscent of COVID-19 restrictions to preserve the bees' availability to pollinate important food crops.

Emerging Market Currencies: Many emerging market stocks and currencies held up relatively well in early 2022 when the Russia-Ukraine war and supply disruptions boosted commodity prices. Some of those assets are now sliding sharply as investors focus on the negative impact of the strong dollar and rising interest rates. The South African rand and the Brazilian real have fallen particularly hard this month.

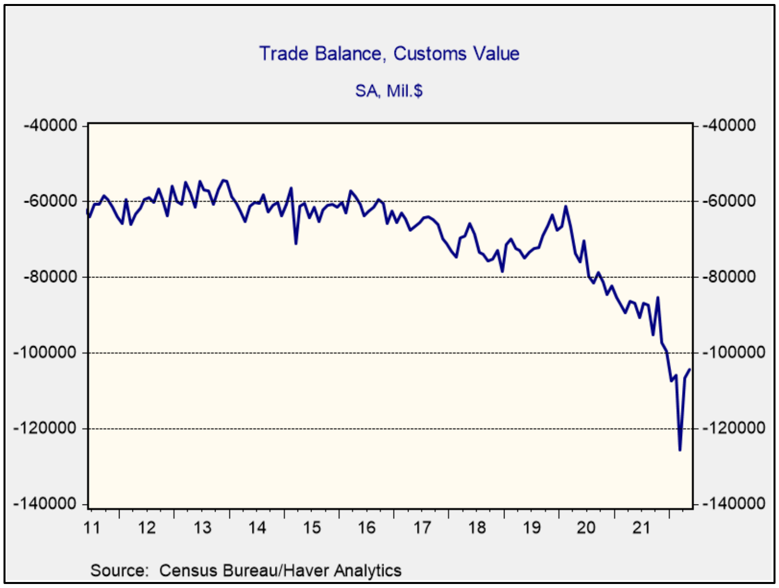
U.S. Bond Market: New data from the Municipal Securities Rulemaking Board indicates households held just 40% of outstanding municipal bonds in the first three months of the year, down from 46% in 2020. Stripping out separately managed accounts, households only hold about 20% of all munis. The data reveals that asset managers now hold the large majority of munis, potentially making the market more volatile than it was in the past.

COVID-19: Official data show confirmed cases have risen to 544,555,638 worldwide, with 6,330,745 deaths. The countries currently reporting the highest rates of new infections include the U.S., Taiwan, Germany, and France. (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 87,092,384, with 1,016,208 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.

- In the U.S., the latest wave of infections appears to be topping out, but hospitalizations are still accelerating with their usual lag. The seven-day average of newly reported cases stands at 108,215, up 1% from two weeks ago. The seven-day average of people hospitalized with confirmed or suspected COVID-19 came in at 31,720 yesterday, up 6% from two weeks earlier. New COVID-19 deaths are now averaging 333 per day, up 3% from two weeks earlier.
- In China, officials today said they would shorten their mandatory quarantine period to 10 days from 21 days for both international travelers entering the country and residents who have come into close contact with COVID-19 patients. In addition, they said they would ease testing requirements for people in quarantine.
    - By now, investors deeply understand that strict zero-COVID rules have become a drag on growth in the world's second-largest economy and threaten further disruptions in global supply chains.
    - Because of that, news of the eased requirements has given a boost to equities and commodity prices so far this morning. For example, Brent crude oil is currently trading up 1.9% to $113.02 per barrel.
    - All the same, we stress that President Xi remains committed to his strict pandemic policies, so there can be no guarantee that he won't impose new, disruptive restrictions again, even if only small outbreaks occur in China.

U.S. Economic Releases

The U.S. trade balance in goods narrowed slightly in May as imports fell due to weaker demand for foreign-made consumer merchandise. According to the Census Bureau, the U.S. trade deficit in goods fell 2.2% from the prior month to $104.3B. The latest reading came in below the consensus estimate of $105.0B. Meanwhile, inventories continue to rise at a stable pace, suggesting that firms are still investing in inventory to meet demand. Wholesale inventories rose 2.0% from the prior month, while retail inventories rose 1.1%. The build-up of inventories will likely help the economy from contracting for the second consecutive quarter.



The chart above shows the level of the Trade Balance. Last month, imports fell by $0.4B, while exports rose by $2.0B, leading to an overall improvement of $2.4B.

Home inflation continued to rise at a solid pace as the lack of housing inventory continues to buoy prices. According to the Federal Housing Finance Agency, home prices rose 1.6% from the prior month compared to expectations of 1.5%. The West South Central region (which includes Oklahoma, Arkansas, Texas, and Louisiana) has the steepest increase in prices. Meanwhile, the S&P CoreLogic shows that homes in the top-20 cities are rising at a faster pace than the rest of the country. The top-city index rose 1.8% from the prior month, while the national index rose 1.5%.

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	Conf. Board Consumer Confidence	m/m	Jun	100.0	106.4	**
10:00	Conf. Board Present Situation	m/m	Jun		149.6	**
10:00	Conf. Board Expectations	m/m	Jun		77.5	*
10:00	Richmond Fed Manufact. Index	m/m	Jun	-5	-9	**
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
12:30	Mary Daly Interviewed During LinkedIn Event	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								
South Korea	Retail Sales	y/y	May	10.1%	10.6%		**	Equity and bond neutral
	Department Store Sales	y/y	May	19.9%	19.1%		**	Equity and bond neutral
	Discount Store Sales	y/y	May	-3.0%	2.0%		**	Equity bearish, bond bullish
EUROPE								
Germany	GfK Consumer Confidence	m/m	Jul	-27.4	-26	-27.3	**	Equity and bond neutral
France	Consumer Confidence	m/m	Jun	82	86	84	***	Equity and bond neutral
Italy	Industrial Sales	m/m	Apr	2.7%	2.4%		*	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)	223	220	3	Up
3-mo T-bill yield (bps)	163	169	-6	Up
TED spread (bps)	61	51	10	Widening
U.S. Sibor/OIS spread (bps)	206	204	2	Up
U.S. Libor/OIS spread (bps)	214	213	1	Up
10-yr T-note (%)	3.23	3.20	0.03	Up
Euribor/OIS spread (bps)	-22	-22	0	Neutral
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Flat			Down
Yen	Down			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	$117.26	$115.09	1.89%	Supply Pessimism
WTI	$111.27	$109.57	1.55%	
Natural Gas	$6.48	$6.50	-0.32%	
Crack Spread	$53.34	$53.47	-0.23%	
12-mo strip crack	$38.41	$38.47	-0.17%	
Ethanol rack	$2.94	$2.95	-0.23%	
Metals				
Gold	$1,825.49	$1,822.85	0.14%	
Silver	$21.29	$21.16	0.62%	
Copper contract	$384.35	$376.60	2.06%	
Grains				
Corn contract	$665.75	$653.00	1.95%	
Wheat contract	$941.00	$917.50	2.56%	
Soybeans contract	$1,453.50	$1,432.75	1.45%	
Shipping				
Baltic Dry Freight	2,295	2,331	-36	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.5		
Gasoline (mb)		-0.7		
Distillates (mb)		-0.3		
Refinery run rates (%)		0.5%		

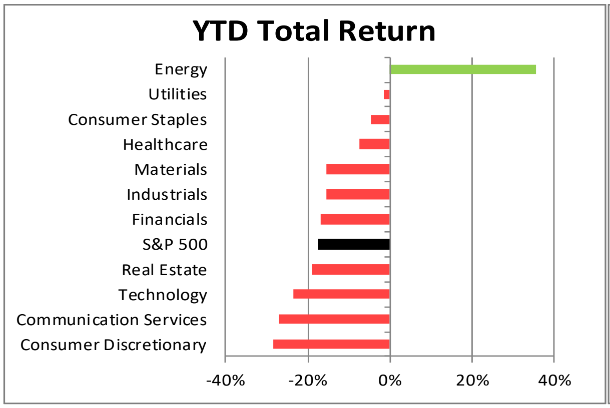
Weather

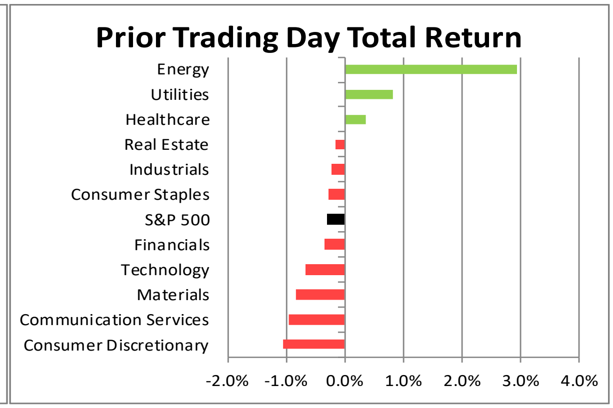
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout most of the country, with cooler-than-normal temperatures in the Pacific, Southwest, and New England regions. Meanwhile, wetter-than-normal conditions are expected in the Rocky Mountain, the Southwest, and the Great Plains, with dry conditions expected in Nevada and Texas.

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, three tropical disruptions are forming east of the U.S. In the Gulf of Mexico, there is some cyclone formation off the coast of Louisiana; however, it is not expected to develop into a tropical storm within the next 48 hours. In the Atlantic Ocean, two storms are forming, but only one is expected to develop into a tropical storm within the next 48 hours.

Data Section

U.S. Equity Markets – (as of 6/27/2022 close)

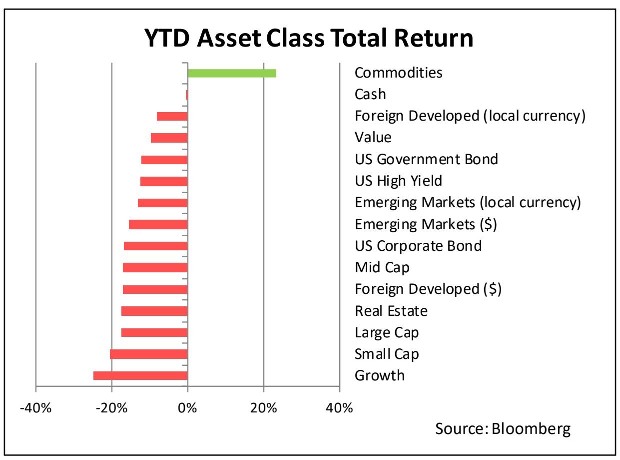




(Source: Bloomberg)

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 6/27/2022 close)

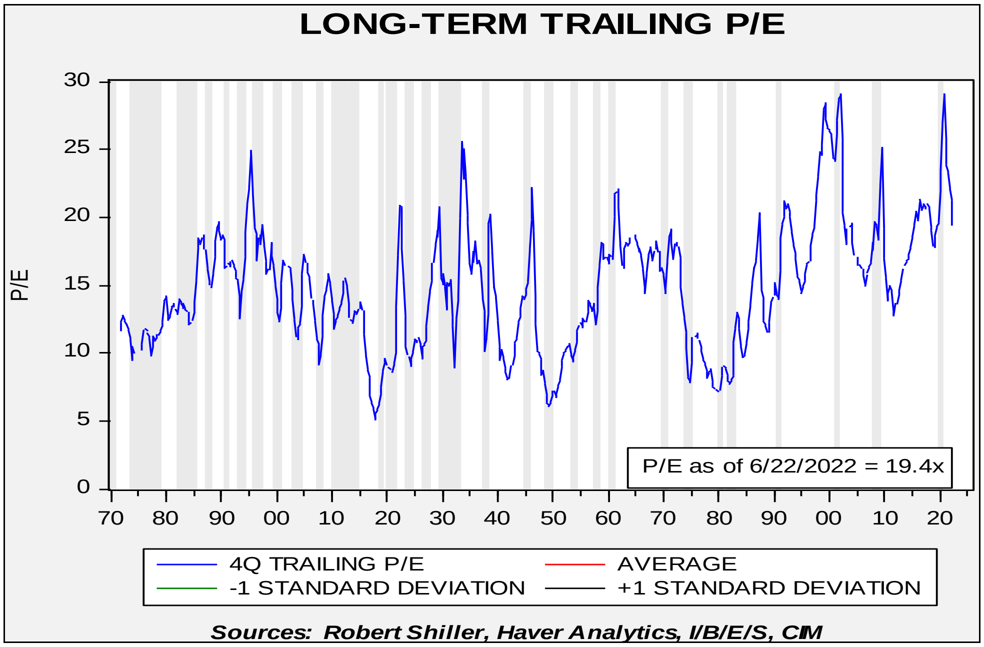


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.