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 29, 2022—9:30 AM EDT] Global equity markets are generally lower this morning. In Europe, the EuroStoxx 50 is currently down 1.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.9%. Chinese markets were lower, with the Shanghai Composite closing down 1.4% from its prior close and the Shenzhen Composite closing down 2.2%. 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* (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* today opens with an update on the Russia-Ukraine war. We next review other international and U.S. developments with the potential to affect the financial markets today. 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 slowly gain enough territory to threaten the last major concentration of Ukrainian forces in the eastern Donbas region, in and around the city of Lysychansk, reports indicate the Ukrainians have begun a fighting retreat designed to make the

Russians pay dearly for any territory they seize. Meanwhile, the Ukrainians continue to pin down Russian forces in the southern part of the country along the Black Sea coast. Both sides continue to face steep losses of personnel and equipment, although it appears the Russians will ultimately have the more difficult time replacing them with combat-competent forces.

- Separately, the Biden administration has placed five little-known Chinese companies on an export blacklist for violating sanctions by allegedly providing support to Russia's military and defense companies before and during the invasion of Ukraine. The action essentially prohibits U.S. firms from exporting to the companies.
- In a new sign that President Putin's energy warfare is putting cracks in European unity, the U.K. government is testing an emergency energy plan that would cut off natural gas exports to mainland Europe in the event of a major shortage, such as the type that would be caused by a bigger Russian embargo. European officials are warning that the plan could backfire by triggering a cutoff of gas exports to the U.K. when it typically needs them in the dead of winter.
- All the same, even if the Western allies tire of the conflict and put pressure on Ukrainian President Zelensky to cede land and reach a deal with the Russians, new polling suggests he would keep fighting. The poll, by *The Wall Street Journal*-NORC, indicates that 89% of Ukrainians think it would be unacceptable to reach a peace deal with Moscow by ceding Ukrainian territory that Russian forces have seized in their invasion this year. The poll also found that 78% of Ukrainians support Zelensky's management of the war so far.

NATO Summit: In one of the most important outcomes of the NATO summit so far, the Turkish government yesterday dropped its opposition to Sweden and Finland joining the alliance, clearing a path for the two Nordic countries to become members in the coming months. The accession of Sweden and Finland will vastly expand NATO's territory right up to the Russian border and transform the Baltic Sea into a virtual NATO lake, illustrating how badly President Putin's invasion of Ukraine has backfired on him.

- President Biden today also outlined specific steps the U.S. would take to help strengthen NATO in accordance with its updated "strategic concept," which we described in our *Comment* yesterday. The new U.S. commitment will include a permanent headquarters for the U.S. Army V Corps in Poland, additional troops, and additional air, air defense, and naval assets in several countries.
- Other NATO leaders will announce their additional commitments later today.

Eurozone: In a speech this morning, ECB chief Lagarde is expected to provide more details on the central bank's evolving "anti-fragmentation" program aimed at capping government bond spreads in the Eurozone as the ECB stops buying new assets. As we mentioned in our *Comment* yesterday, the program would likely involve preferential ECB purchases of government bonds from Italy, Spain, Portugal, Greece, and other weaker Eurozone economies.

- In an interview this week, Lagarde offered no new details on how the program would work, other than insisting it will be separate from the ECB's main policy framework.

- Even if Eurozone leaders can agree on such a 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.

United Kingdom: Scottish leader Nicola Sturgeon announced plans aimed at holding a fresh referendum on independence in October 2023. The new effort follows a failed referendum in 2014, which Prime Minister Johnson says is the last word on the matter. The new effort reflects intense dissatisfaction with Brexit throughout Scotland and could create a sense of political uncertainty in the U.K., which would likely be a further headwind for its economy and financial markets.

- Under the plan, the Scottish government has simultaneously asked Prime Minister Johnson to approve the referendum and requested that the U.K. Supreme Court decide whether it can proceed even without that approval.
- If the court rules that the Scottish Parliament can't proceed with a referendum without the British government's permission, or if it declines to accept the case, then Sturgeon's Scottish National Party would contest the next U.K.-wide elections on the question whether Scotland should be independent.

China-United States: According to a cybersecurity firm, a pro-Chinese government group called Dragonbridge has been impersonating environmental protectionists on social media to undermine the U.S.'s effort to build a domestic rare earths production capability. Specifically, the group has been targeting a government-funded rare earths refinery being built in Texas that aims to cut U.S. reliance on Chinese rare earths. The fake accounts argue that the facility would "expose the area to irreversible environmental damage" and "radioactive contamination."

United States-Taiwan: In another move by the Biden administration to blunt Chinese economic influence, Deputy U.S. Trade Representative and Taiwanese Minister John Deng this week held an initial round of talks aimed at boosting trade ties. Since domestic politics in the U.S. preclude any consideration of traditional market-access provisions like tariff cuts, the talks merely center on trade facilitation, regulatory practices, agriculture, anti-corruption, small- and medium-sized enterprises, digital trade, labor, environment, standards, state-owned enterprises, and non-market policies and practices.

U.S. Monetary Policy: In a *Financial Times* commentary today, bond guru Mohamed El-Erian warns that the Federal Reserve has become too reactive to economic developments, creating a risk of disruptive "stop-go" policymaking like that of the 1970s and 1980s.

- El-Erian argues that a "well-informed Fed with a credible vision for the future" would minimize the risk of disruptive financial market overshoots, strengthen the potency of forward guidance on policy, and provide an anchor of stability that would foster productive physical investment.
- In contrast, he argues that volatile, unpredictable policymaking that whipsaws between fighting inflation and boosting growth risks yet another round of undue economic damage, financial volatility, and greater inequality.

- El-Erian also says that investors are right in worrying about a near-term recession in the U.S. As we have written, we agree that there is an increasing risk of recession, most likely in 2023.

U.S. Labor Market: Electric vehicle maker Tesla (TSLA, 697.99) announced it will lay off about 200 workers in conjunction with closing one of its California offices to cut costs. The layoffs are tiny compared with the overall labor market, but since Tesla is such a high-profile company, the news is likely to raise concerns that the economy is slowing rapidly in response to factors like high labor and material costs and rising interest rates.

COVID-19: Official data show confirmed cases have risen to 545,530,847 worldwide, with 6,332,788 deaths. The countries currently reporting the highest rates of new infections include the U.S., Germany, Taiwan, 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 87,221,842, with 1,016,766 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.

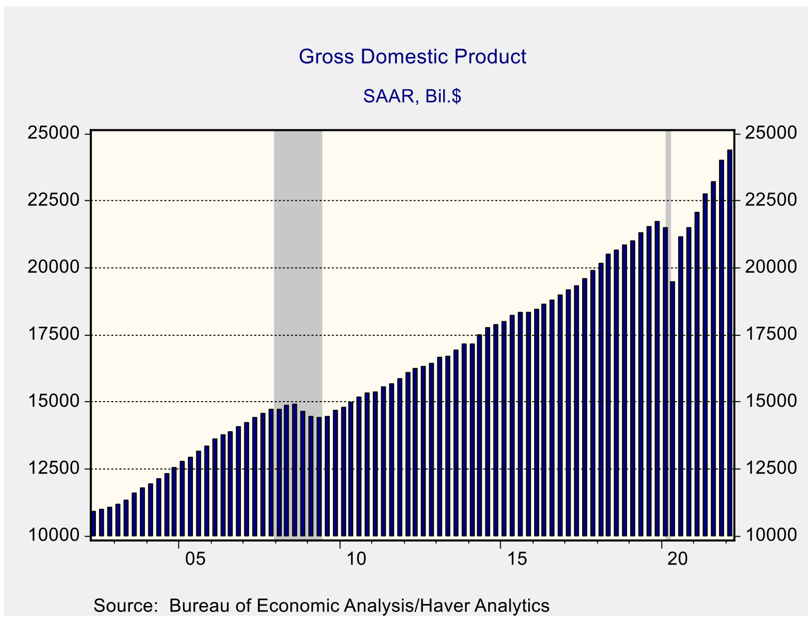
Virology

- 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 108,963, up 3% from two weeks ago. The seven-day average of people hospitalized with confirmed or suspected COVID-19 came in at 32,148 yesterday, up 7% from two weeks earlier. New COVID-19 deaths are now averaging 377 per day, up 17% from two weeks earlier.
- Separately, the Biden administration has warned Congress that the government could soon deplete its supply of a key antibody drug for treating nonhospitalized patients if pandemic funding isn't renewed. Should the federal government be unable to procure more doses, the drug's manufacturer would need to sell the drug to hospitals and states directly for the treatment to remain available.
- Following yesterday's news that officials in mainland China are easing their pandemic quarantine rules, Hong Kong's incoming health minister said his city is also looking to ease restrictions. As we reported in conjunction with the mainland easing yesterday, easier restrictions could remove one of the headwinds facing the overall Chinese and Hong Kong economies, although they would remain vulnerable to strict new lockdowns in the future.

U.S. Economic Releases

The applications for mortgages rose for the third consecutive week, according to an index tracked by the Mortgage Bankers Association. In the week ending June 17, the MBA applications index rose 0.7% from the prior week. The applications for home purchases rose 0.1% from the preceding week, while the refinancing applications rose 1.9%. The increase in demand for mortgage applications may be related to homeowners looking to borrow against their homes before interest rates rise again. Last week, the average 30-year fixed-rate fell 14 bps from 5.98% to 5.84%.

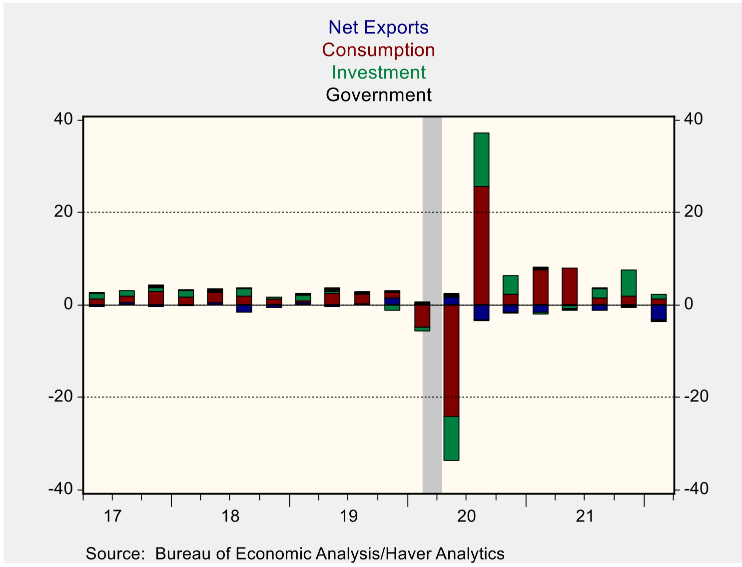
The third revision of GDP shows little change from the previous month's reading. In the first quarter of 2022, GDP contracted at an annualized pace of 1.6% of the prior quarter. The latest figure was slightly below the previous month's reading and the consensus estimate of a 1.5% decline in Q1. Personal consumption was revised downward from the previous quarter from an annualized increase of 3.1% from the prior quarter to 1.8%. The downward revision was well below the consensus estimate of 3.1%. Meanwhile, Core PCE, which excludes food and energy consumption, was little changed from the previous report, showing an annualized 5.2% gain compared to a 5.1% increase reported in the last reading.



The chart above shows the level of nominal GDP. In Q1 2022, total U.S. economic output was $24.386 trillion.

	Q1 2022 - 3rd Estimate	Q1 2022 - 2nd Estimate	Difference
Total GDP	-1.6%	-1.5%	-0.1%
Consumption	1.2%	2.1%	-0.9%
Investment	0.9%	0.1%	0.8%
Inventories	-0.4%	-1.1%	0.7%
Net Exports	-3.2%	-3.2%	0.0%
Government	-0.5%	-0.5%	0.0%

The table above shows the contributions to GDP. The sharp decline in consumption was offset by an increase in investment spending and inventories.



The chart above shows the contribution visually. Despite the revisions, the latest report still showed that government spending and net exports were a drag on the U.S. economy in Q1 of 2022.

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**
9:00	Lagarde, Powell, Bailey, Carstens speak in Sintra	Heads of central banks in the ECB, US, UK, and Mexico
11:30	Loretta Mester Speaks on Panel at ECB Forum in Sintra	President of the Federal Reserve Bank of Cleveland
13:05	James Bullard Makes Introductory Remarks	President of the Federal Reserve Bank of St. Louis

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	Retail Sales	y/y	May	3.6%	2.9%	4.0%	**	Equity and bond neutral
	Dept. Store, Supermarket Sales	y/y	May	8.5%	4.0%	4.9%	**	Equity bullish, bond bearish
	Consumer Confidence Index	m/m	Jun	32.1	34.1	34.8	***	Equity and bond neutral
Australia	Retail Sales	m/m	May	0.9%	0.9%	0.4%	**	Equity and bond neutral
South Korea	Consumer Confidence	m/m	Jun	96.4	102.6		**	Equity bearish, bond bearish
EUROPE								
Eurozone	M3 Money Supply	y/y	May	5.6%	6.0%	5.8%	**	Equity and bond neutral
	Economic Confidence	m/m	Jun	104	105	103	***	Equity and bond neutral
	Industrial Confidence	m/m	Jun	7.4	6.3	4.8	**	Equity bullish, bond bearish
	Services Confidence	m/m	Jun	14.8	14	12.8	**	Equity bullish, bond bearish
	Consumer Confidence	m/m	Jun	-23.6	-23.6		**	Equity and bond neutral
Switzerland	Credit Suisse Survey Expectations	m/m	Jun	-72.7	-52.6		***	Equity and bond neutral
AMERICAS								
Brazil	Formal Job Creation Total	m/m	May	277018	196966	181250	**	Equity and bond neutral
	Federal Debt Total	m/m	May	5702b			**	Equity and bond neutral
Mexico	International Reserves Weekly	w/w	24-Jun	$198507m	$198194m		**	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	223	0	Up
3-mo T-bill yield (bps)	170	171	-1	Up
TED spread (bps)	54	53	1	Widening
U.S. Sibor/OIS spread (bps)	208	205	3	Up
U.S. Libor/OIS spread (bps)	215	212	3	Up
10-yr T-note (%)	3.17	3.17	0.00	Up
Euribor/OIS spread (bps)	-21	-22	1	Neutral
Currencies	**Direction**			
Dollar	Up			Up
Euro	Flat			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	$118.23	$117.98	0.21%	
WTI	$112.31	$111.76	0.49%	
Natural Gas	$6.78	$6.57	3.15%	
Crack Spread	$50.86	$51.62	-1.48%	
12-mo strip crack	$36.60	$36.88	-0.78%	
Ethanol rack	$2.92	$2.93	-0.11%	
Metals				
Gold	$1,817.76	$1,820.01	-0.12%	
Silver	$20.81	$20.84	-0.13%	
Copper contract	$377.30	$378.00	-0.19%	
Grains				
Corn contract	$660.00	$659.25	0.11%	
Wheat contract	$952.50	$936.00	1.76%	
Soybeans contract	$1,470.25	$1,462.50	0.53%	
Shipping				
Baltic Dry Freight	2,204	2,295	-91	
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		

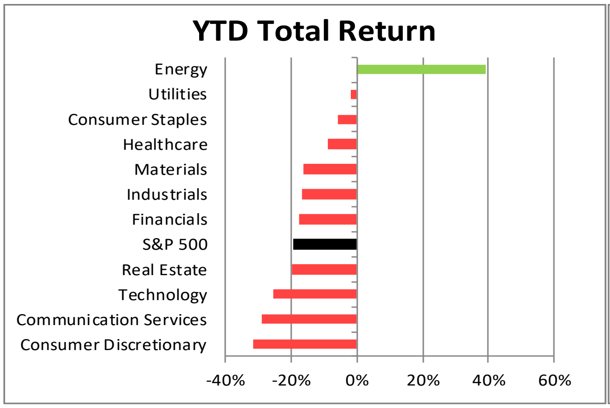
Weather

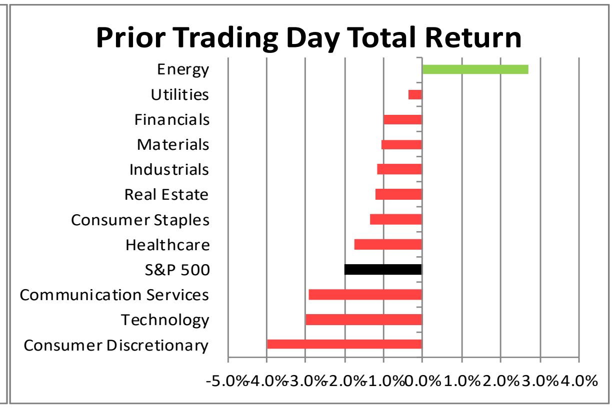
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout most of the country, with cooler-than-normal temperatures in the Pacific, Southwest, and New England regions. Meanwhile, wetter-than-normal conditions are expected in the Rocky Mountain, the Southwest, and the Great Plains regions, with dry conditions expected in the Central Pacific region 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. There is some cyclone formation in the Gulf of Mexico; 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 6/28/2022 close)

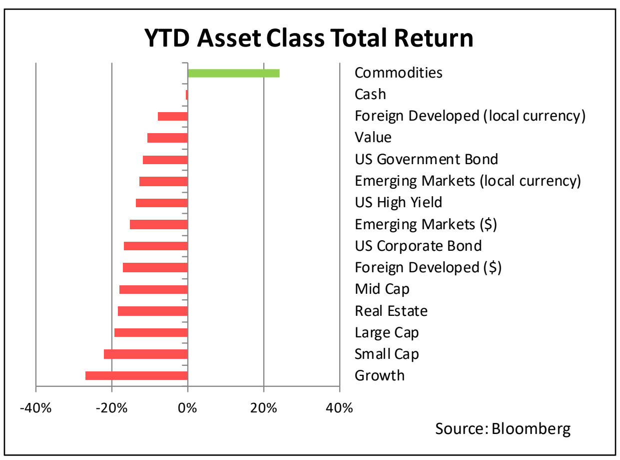




(Source: Bloomberg)

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 6/28/2022 close)

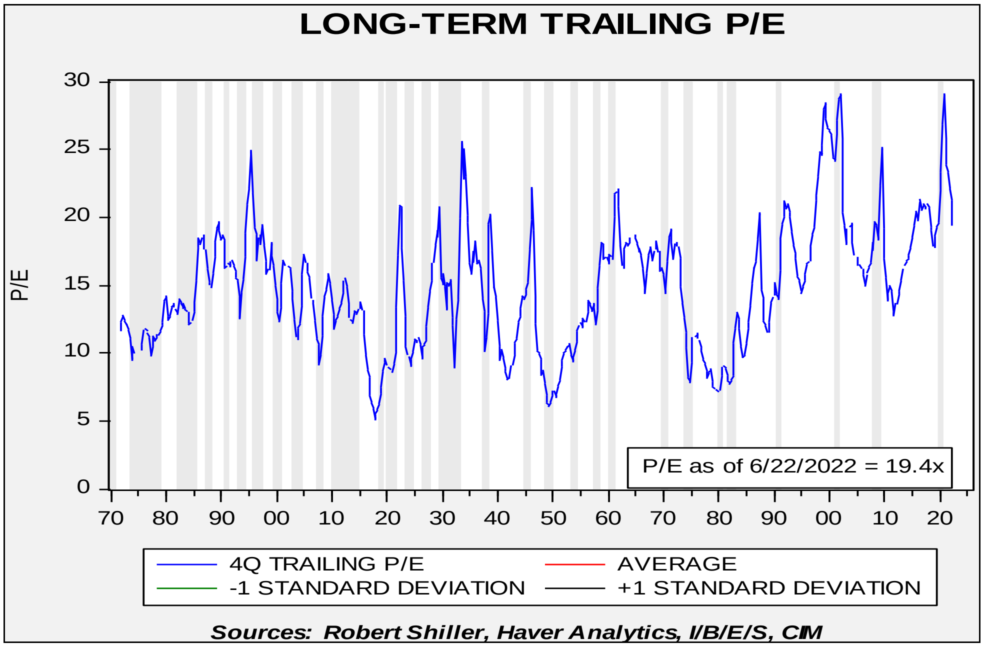


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.