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: March 7, 2022—9:30 AM EST] Global equity markets are lower this morning. In Europe, the EuroStoxx 50 is currently down 3.7% from its prior close. In Asia, the MSCI Asia Apex 50 closed down 2.7%. Chinese markets were lower, with the Shanghai Composite down 2.2% from its prior close and the Shenzhen Composite down 2.7%. 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* (2/28/2022) (with associated podcast): "The Turkish Experiment"
- *Weekly Energy Update* (3/3/2022): Oil prices move definitively over $100 per barrel on supply disruptions due to the war in Ukraine.
- *Asset Allocation Quarterly - Q1 2022* (1/20/2022): Discussion of our asset allocation process, Q1 2022 portfolio changes, and our outlook for the markets
- ***Asset Allocation Bi-Weekly* (3/7/2022) (with associated podcast): "Believe It or Not, Fiscal Policy Is Tightening"**
- *Confluence of Ideas* podcast (1/20/2022): "The 2022 Outlook"
- *Current Perspectives*: "2022 Outlook: Update #1" (2/18/2022)
- ***Charts Worth Noting*: See below the "U.S. Economic Releases" section for a new featured chart. This chart covers financial conditions and Fed policy.**

Our *Comment* today opens with an update on the Russia-Ukraine War. The key developments include the U.S. and Poland looking into ways to provide Ukraine with more fighter jets (which obviously would be seen by Russia as exceedingly provocative) and the U.S. considering a ban on Russian oil imports. Those actions go far toward explaining the dramatic moves in the financial markets so far today. We also provide a brief overview of other key international and U.S. news. We wrap up with the latest developments regarding the coronavirus pandemic.

Russia-Ukraine: Over the weekend, Russia continued to attack civilian targets throughout Ukraine, killing dozens, while Chinese Foreign Minister Wang Yi stressed China's support and "everlasting friendship" for Russia. Ukrainian and Russian negotiators are scheduled to meet for their third round of cease-fire talks on Monday, but prospects for a breakthrough were uncertain as the Kremlin signaled its determination to pursue the war. Meanwhile, Ukrainian President Zelensky continued to press the U.S. and NATO to implement a no-fly zone over Ukraine, even though such an action would likely result in a direct conflict between the West and Russia. The U.S. and NATO continue to reject that option, and U.S. officials are considering a deal in which Poland would provide Soviet-era fighter jets to Ukraine so it can continue to contest its airspace with the Russians. Separately, U.S. Secretary of State Blinken said the U.S. is talking with European partners about banning imports of Russian oil, a prospect that has pushed global oil prices up to $130 per barrel or more so far this morning and pushed several European stock indexes down to bear-market levels. Natural gas, gold, wheat, nickel, and a range of other commodity prices are also surging, while the need to wean Europe off its reliance on Russian energy continues to spark discussions of accelerating the Continent's switch to renewable energy. Importantly, even U.S. Treasury yields are rising, suggesting renewed concern about inflation. Within Russia, domestic protests against the war appear to be growing. Finally, another important piece of news over the weekend was the leak of a purported letter on the crisis from an official in Russia's Federal Security Service, the successor of the KGB's domestic security operation.

- In an English translation of the letter circulating on the internet, the official claims that:
    - The war against Ukraine is a mistake equal to Russia's failed war against the Japanese in 1905.
    - Decision-making about the war was too concentrated at the top, leading to most of the Russian shortcomings so far.
    - Russia can't mobilize militarily now to get control of the situation, since mobilization plus sanctions will implode the economy.
    - Russia will soon face grave domestic instability as the population responds to the hardships brought on by the invasion and the Western sanctions.
    - Use of a tactical nuclear strike in Ukraine is possible, not for any military reason, but to scare the West.
    - Russia's foreign intelligence service is trying to plant evidence that Ukraine was developing nuclear weapons. [Note: This would explain Russia's focus on seizing the Chernobyl nuclear site, as well as the Zaporizhzhia nuclear generating station.]
    - The economic implosion from the sanctions and efforts to improve the supply situation in Ukraine will threaten the viability of Russian forces in Syria.
- While those observations are instructive, we at Confluence have our own capabilities in translating and interpreting the underlying Russian text, and our reading of the document provides several important additional findings:
    - The official who wrote this was probably involved in the Chechnya conflict. The letter refers specifically to Ramzan Kadyrov, the Russian-imposed leader of Chechnya. The letter suggests that some kind of Chechen special operations group was sent to Kyiv to assassinate Ukrainian President Zelensky, but they got decimated before they could act. This is consistent with reports over the weekend that Russia is recruiting Syrian fighters experienced in urban warfare to help counter the Ukrainians' efforts to defend major cities.
    - In any case, the translation circulating on the internet is not complete. There are several sentences and paragraphs left out, although most aren't necessarily

critical. Most of the sentences not translated merely give more color regarding how upset the writer is, and they provide a bit more detail on his view of the fiasco in Syria.

- However, at the end of the Russian document, there are several important untranslated sentences in which the writer says, "Out of cynicism, I would only add that I don't think VV Putin will cross the red line of destroying the whole world [i.e., a strategic nuclear strike]."
  - "First, there isn't just one person that takes that decision. Although one person starts the process in motion, there's a lot of people involved. It isn't a 'one-man show.'"
  - "Second, there are many doubts that all that would be successful. Experience teaches that the greater the transparency and control, the easier it is to show deficiencies. And where it's not understood who exercises control, and how, but they always flaunt outcomes, it's the opposite. I'm not sure that the nuclear system functions as advertised. After all, you have to replace nuclear warheads every ten years."
  - "Third, and this is most disgusting and sad, personally I don't believe that someone who won't even allow members of the Federation Council or his own closest representatives and ministers to get close to him would sacrifice himself. Whether it's fear of the coronavirus or fear of assassination, it's not important: If you're afraid to allow the most trustworthy people to come close to you [remember the 20-foot-long conference table], how could you decide to destroy yourself and those close to you?"

- In any case, the risk of a major miscalculation remains high. In the near term, that is likely to keep boosting prices for energy commodities, grains, and precious metals. However, if the Russian military ultimately proves to be a paper tiger and Western resolve brings an end to the crisis, or if Russian forces quickly take control of Ukraine and the situation stabilizes, equities and other risk assets may well rebound smartly.

China: Over the weekend, the Chinese government said it would target an economic growth rate of 5.5% for 2022. The target is the smallest since China began setting such benchmarks in 1994, but it is actually a much heavier lift than the 2021 target of 6%, given last year's pandemic-related statistical distortions and the mounting economic headwinds. The relatively aggressive target signals further government intervention is likely on the way, including an expected ramp-up in government infrastructure spending.

Australia: One important fallout from the Russia-Ukraine War is that the world's liberal democracies have been scared into boosting their defense capabilities. Over the weekend, the Australian government said it would build a $7.5 billion base for nuclear-powered submarines on the country's east coast.

- That comes after many other countries, such as Germany and Italy, have said they will boost their defense budgets going forward.

- Even if the Russia-Ukraine War ends soon, the liberal democracies probably won't soon forget Russia's aggression and China's support. The boost to defense spending, therefore, is likely to be long-lasting, which could prove to be an opportunity for investors.

U.S. Cryptocurrency Regulation: Even as the U.S. and other major governments look set to tighten their regulation of digital currencies, Senate Finance Committee Chairman Wyden has warned that clamping down too hard would stifle innovation and ultimately hurt the U.S. We still expect that digital currencies will face increased regulation going forward, but Wyden's statement serves as a reminder that there are political forces working in the other direction that could limit or delay some of the regulations.

U.S. Fiscal Policy: With the ongoing economic recovery boosting tax revenues, a range of state governments are enacting or considering enacting tax cuts. The states moving in that direction range from Tennessee and Mississippi to Wisconsin and Georgia. State-level tax cuts would probably not be as economically significant as federal cuts would be, but if they are widely adopted, they could help provide a boost to the national economy and stock prices as consumers face higher inflation and deplete their pandemic-related excess savings.

COVID-19: Official data show confirmed cases have risen to 446,404,737 worldwide, with 6,000,394 deaths. In the U.S., confirmed cases rose to 79,271,466, with 958,621 deaths. (For an interactive chart that allows you to compare cases and deaths among countries, scaled by population, click here.) Meanwhile, in data on the U.S. vaccination program, the number of people considered fully vaccinated now totals 216,147,515, equal to 65.1% of the total population.

Virology

- In the U.S., the seven-day average of people hospitalized with a confirmed or suspected COVID-19 fell to 38,999 yesterday, marking a 43% decline from two weeks ago.
- In Japan, the government today lifted its quasi-emergency pandemic measures in Niigata, Nagano, Fukushima, and 10 other prefectures, as new cases dip and the burden on regional medical systems comes under control.
- In contrast with trends in the U.S. and other key developed countries, China logged its highest daily total of locally transmitted infections in more than two years, with the highly transmissible Omicron variant of the coronavirus posing a fresh test to China's ability to smother outbreaks quickly.
    - The government said it detected 526 domestic infection cases yesterday, 214 of which were symptomatic.
    - Most of those who tested positive were in the eastern port cities of Qingdao and Shanghai, with others detected in the southern province of Guangdong and the northeastern province of Jilin.

Economic and Financial Market Impacts

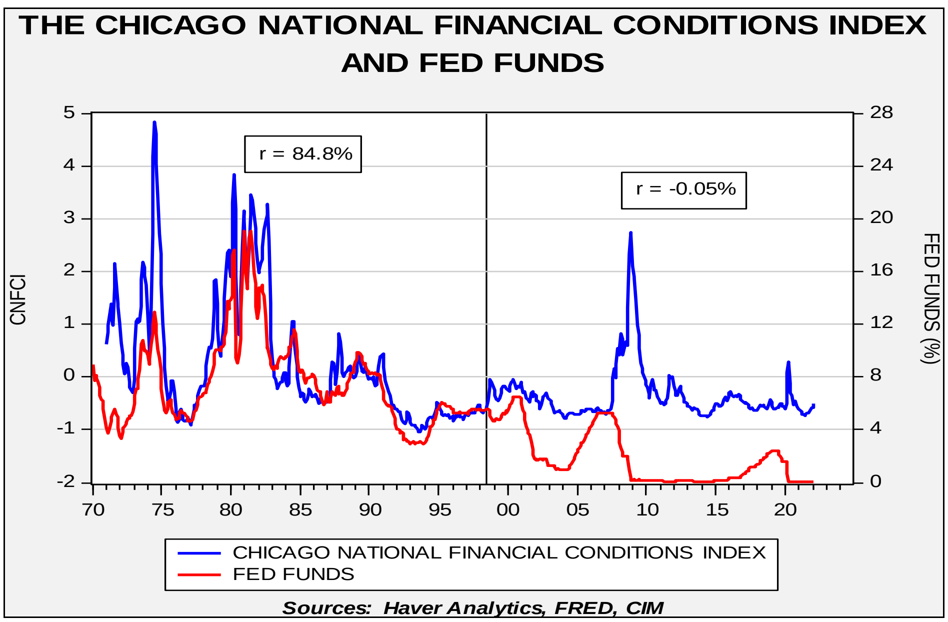
- While the U.S. press has published lots of stories about the "Great Resignation," or the big rise in people switching jobs amid the strong post-pandemic job market, the trend is now spreading to other countries, including Australia and, potentially, even Japan.

U.S. Economic Releases

There were no domestic releases prior to the publication of this report. The table below shows the economic releases scheduled for the rest of the day.

Economic Releases							
EST	**Indicator**			**Expected**	**Prior**	**Rating**
15:00	Consumer Credit	m/m	Jan	$24.500b	$18.898b	**
Fed Speakers or Events						
No Fed speakers or events today						

Charts Worth Noting



This chart shows the Chicago FRB National Financial Conditions Index (NFCI) and fed funds. The way to understand the NFCI is that when the index rises, financial conditions are deteriorating and vice versa. In general, a reading below zero suggests favorable financial conditions. Until the late 1990s, there was a tight correlation between the policy rate and financial conditions. Essentially, the policy rate acted as a force multiplier for monetary policy. When the FOMC raised rates, financial conditions deteriorated, and they improved when rates were lowered. However, since the late 1990s, the relationship between these two variables has broken down. Raising the policy rate seems to have little impact on weakening financial conditions, and when a crisis hits, radical action seems to be required to reduce stress. Given high levels of debt and leverage in the financial system, the FOMC appears to suppress stress actively. Since 1998, it has been rare for the FOMC to raise rates when the NFCI is close to zero. We believe financial stress will be the limiting factor in policy tightening; thus, investors can use this index as an indicator for the path of monetary tightening.

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								
China	Foreign Reserves	m/m	Feb	$3213.8b	$3221.63b	$3225.00b	*	Equity and bond neutral
	Trade Balance YTD	m/m	Feb	$115.95b	$103.25b	$95.00b	**	Equity bullish, bond bearish
Australia	ANZ Job Advertisements	m/m	Feb	8.4%	-0.3%		***	Equity and bond neutral
	Foreign Reserves	m/m	Feb	A$79.5b	A$81.1b		*	Equity and bond neutral
EUROPE								
Eurozone	Sentix Investor Confidence	m/m	Mar	-7.0	16.6	5.3	*	Equity bearish, bond bullish
Germany	Retail Sales	m/m	Jan	2.0%	-5.5%	1.9%	***	Equity and bond neutral
	Factory Orders	m/m	Jan	1.8%	2.8%	1.0%	***	Equity bullish, bond bearish
Switzerland	Unemployment Rate	m/m	Feb	2.5%	2.6%	2.5%	***	Equity and bond neutral
	Foreign Currency Reserves	m/m	Feb	938.3b	947.2b		*	Equity and bond neutral
	Domestic Sight Deposits CHF	w/w	4-Mar	657.6b	660.9b		***	Equity and bond neutral
	Total Sight Deposits CHF	w/w	4-Mar	725.7b	725.2b		**	Equity and bond neutral
AMERICAS								
Mexico	Consumer Confidence	m/m	Feb	43.4	43.4		**	Equity and bond neutral
Canada	Bloomberg Nanos Confidence	y/y	4-Mar	59.3	59.9		**	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)	61	58	3	Up
3-mo T-bill yield (bps)	30	32	-2	Neutral
TED spread (bps)	32	26	6	Widening
U.S. Libor/OIS spread (bps)	43	42	1	Down
10-yr T-note (%)	1.72	1.73	-0.01	Down
Euribor/OIS spread (bps)	-52	-53	1	Neutral
Currencies	**Direction**			
Dollar	Up			Neutral
Euro	Down			Up
Yen	Down			Neutral
Pound	Down			Up
Franc	Down			Neutral

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.

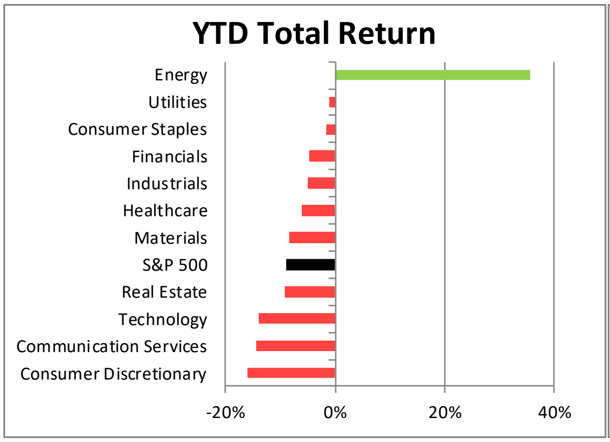
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$125.37	$118.11	6.15%	Russia-Ukraine crisis intensifying.
WTI	$122.81	$115.68	6.16%	Russia-Ukraine crisis intensifying.
Natural Gas	$5.14	$5.02	2.55%	Russia-Ukraine crisis intensifying.
Crack Spread	$37.19	$35.93	3.49%	
12-mo strip crack	$29.47	$28.25	4.33%	
Ethanol rack	$2.62	$2.61	0.38%	
Metals				
Gold	$2,001.41	$1,970.70	1.56%	
Silver	$26.01	$25.70	1.19%	
Copper contract	$498.10	$493.75	0.88%	
Grains				
Corn contract	$772.50	$754.25	2.42%	Russia-Ukraine crisis intensifying.
Wheat contract	$1,294.00	$1,209.00	7.03%	Russia-Ukraine crisis intensifying.
Soybeans contract	$1,692.00	$1,660.50	1.90%	
Shipping				
Baltic Dry Freight	2,148	2,104	44	

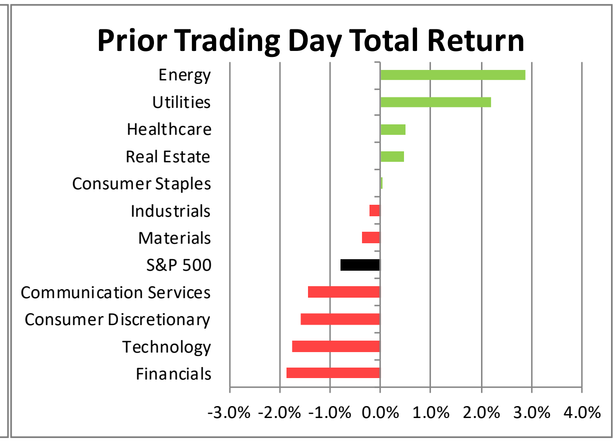
Weather

The 6-10 day and 8-14 day forecasts call for cooler-than-normal temperatures throughout the entire central portion of the country, with warmer-than-normal temperatures in California and Florida. The forecasts call for wetter-than-normal conditions in the northern Rocky Mountains and East Coast, with dry conditions in California and the Southwest.

Data Section

U.S. Equity Markets – (as of 3/4/2022 close)

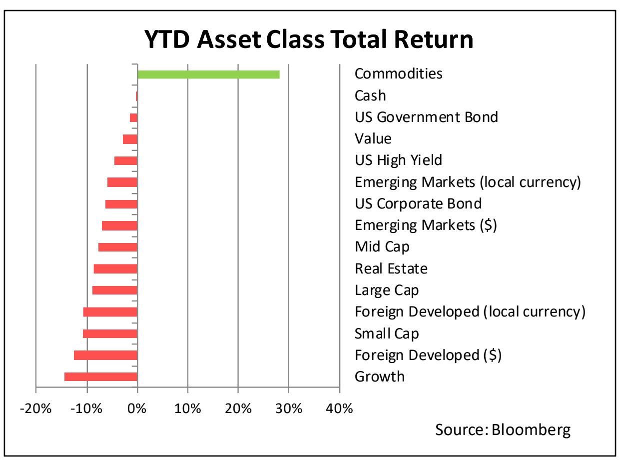




(Source: Bloomberg)

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 3/4/2022 close)

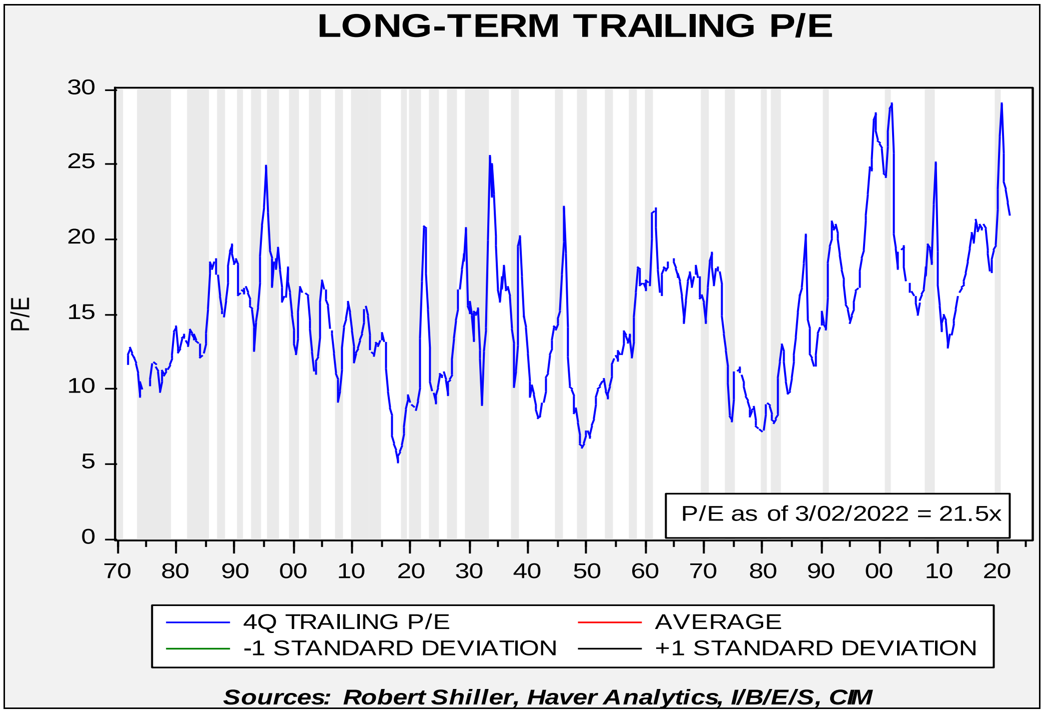


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

March 3, 2022



Based on our methodology,[1] the current P/E is 21.5x, down 0.1x from last week. The decline in the multiple is due to the decline in the index.

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 (Q2, Q3, and Q4) and one estimate (Q1). 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.