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: May 10, 2022—9:30 AM EDT] Global equity markets are generally higher this morning. In Europe, the EuroStoxx 50 index is currently up 1.2% from its prior close. In Asia, the MSCI Asia Apex 50 index closed down 1.2%. Chinese markets were higher, with both the Shanghai Composite up 1.1% and the Shenzhen Composite up 1.5%. U.S. equity index futures are signaling a higher open. With 444 companies having reported, the S&P 500 Q1 2022 earnings stand at $54.40, lower than the $54.70 forecast for the quarter. The forecast reflects a 4.7% increase from Q1 2021 earnings. Thus far this quarter, 78.2% of the companies have reported earnings above forecast, while 18.7% have reported earnings below forecast.

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*** **(5/9/2022) (with associated podcast): "Parsing the World's New Geopolitical Blocs"**
- *Weekly Energy Update* (5/5/2022): We recap the weekly data and discuss energy news from the week
- *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* (5/2/2022) (with associated podcast): "The Tale of Two Surveys"
- *Confluence of Ideas* podcast (3/25/2022): "The 2022 Outlook: Update #1"
- *Current Perspectives*: *"*2022 Outlook: Update #1*"* (2/18/2022)
- *Charts Worth Noting*: We look at housing affordability compared to the average weekly income for a non-supervisory worker.

Today's *Comment* opens with an update on the Russia-Ukraine war. Russian forces remain bogged down in the face of strong Ukrainian resistance and their own poor planning, weak execution, low morale, and resource shortages. We next review a range of international and U.S. developments with the potential to affect the financial markets today, including a trading issue in a key digital currency that probably contributed to yesterday's sharp market declines. We close with the latest news on the coronavirus pandemic.

Russia-Ukraine: Russian forces continue to make very little progress in their efforts to seize more territory in eastern and southern Ukraine, although they are consolidating their control over areas they already hold. A senior U.S. defense official said Russian forces facing tough Ukrainian resistance are exhibiting extraordinarily poor discipline and morale. Many Russian troops are reportedly refusing to obey orders, frequently abuse alcohol, and shoot at their own vehicles to avoid going to the frontline. Russia also continues to face serious force generation problems. In his Victory Day speech yesterday, President Putin failed to announce the kind of general mobilization that could eventually provide a substantial boost to Russian manpower. Reports suggest young Russians are receiving draft notices under a "covert mobilization," but those notices could merely represent the ongoing spring draft, which in ordinary times would run from April 1 to July 15. We have also seen one document pointing to the call-up of reserves, but under the Russian personnel system, the pool of soldiers available in the reserves is very limited. In sum, the Russian military is not only suffering from poor planning and amateurish operations but also from growing shortfalls in military equipment, supplies, and personnel.

- The EU effort to ban Russian oil imports continues to face resistance from several Eastern European members that are particularly dependent on Russian energy. European Commission President von der Leyen yesterday traveled to Hungary in an effort to sell the ban to Prime Minister Orbán, who has been the principal obstacle to a deal but reportedly had no success.
    - The EU is reportedly offering to let Hungary, Slovakia, and the Czech Republic phase in the import ban over the next two years or more.
    - Even if the Eastern European countries get to keep importing Russian oil, for the time being, any import ban implemented by the major EU economies will keep the demand for non-Russian oil high. It will tend to buoy prices despite the recent downdraft as investors fret about weakening economic growth in China.
- Separately, reports this morning say Brussels has shelved its plans to ban the EU shipping industry from carrying Russian crude oil. That plan had faced hard pushback from Greece and Malta, which together account for more than half of EU-flagged tonnage.
- Despite the delay in new EU sanctions on Russia, the Ukrainian government is becoming increasingly confident and ambitious in its war aims. According to Foreign Minister Kuleba, the government has upgraded its war aims and is now looking to push Russian forces out of the country entirely, as long as western allies rapidly deliver promised heavy weaponry.
    - Kuleba particularly noted the importance of pushing the Russians out of the Kherson region of southeastern Ukraine and regaining control over the country's coast.
    - According to Kuleba, that would allow Ukraine to neutralize Russia's Black Sea Fleet and restart exports through the country's southeastern ports.

European Union-Ukraine: In a development that would be as important for the EU as it would be for Ukraine, EU officials are planning an issue of €15 billion in joint debt to fund financial aid to Ukraine over the coming three months. Although the debt issue wouldn't be nearly as large as the groundbreaking mutual debt issued to fund the EU's massive pandemic relief program, it could point to a certain normalization of joint debt backed equally by all members of the EU.

United Kingdom: In the House of Lords today, Prince Charles, as heir to the throne, for the first time stood in for his mother to deliver the Queen's Speech, laying out the government's legislative priorities for the coming year. It was the first time since 1963 that Queen Elizabeth had not delivered the speech herself.

South Korea-North Korea: In his inauguration speech yesterday, conservative South Korean President Yoon Suk-yeol offered economic aid to North Korea if it suspends its nuclear weapons program and starts to denuclearize. The offer marked a pivot away from his campaign promise to emphasize military deterrence to reduce the threat from Pyongyang.

Iran: As the Russia-Ukraine war and other factors drive up global food prices, President Raisi said Iran would cut back and reform the country's bread subsidy system. Starting in about two months, the government will offer citizens digital coupons, allowing them access to a limited amount of bread at subsidized prices, while the rest will be available at market rates.

- The scheme will later include other goods such as chicken, cheese, and vegetable oil.
- Cutting back on food subsidies is a risky move because it could spark mass protests.
- As we have noted in the past, rising food costs have often sparked periods of political instability in emerging markets.

Philippines: As expected, Ferdinand Marcos, Jr., the son of the former dictator, yesterday cruised to a landslide victory in the country's presidential election. His opponents fear he could use his power to wage political battles against his family's adversaries, shield allies from scrutiny, and enrich his associates like his father did before an uprising ousted him 36 years ago.

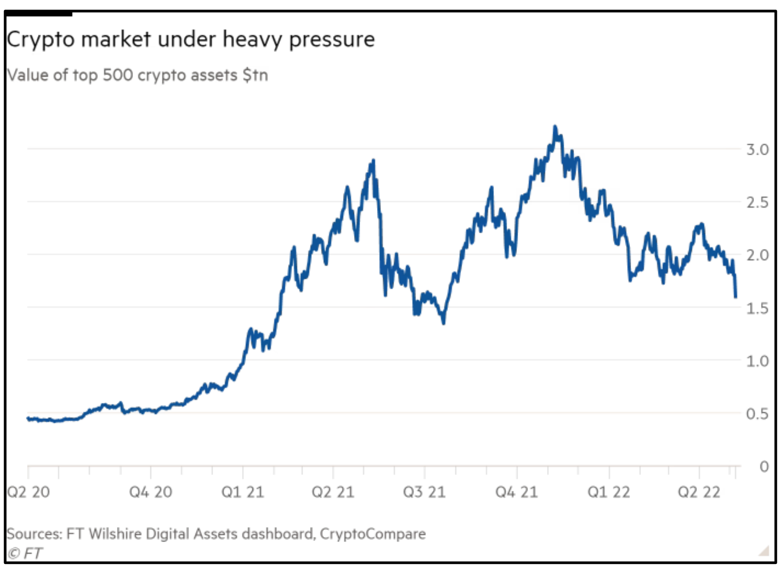
Sri Lanka: Prime Minister Mahinda Rajapaksa resigned after months of mass protests against his government's handling of an economic crisis marked by high inflation and acute shortages of fuel and medicines. It is not yet clear whether the prime minister's resignation has been accepted by his younger brother, President Gotabaya Rajapaksa.

- The prime minister's resignation points to continued political and economic disruptions in the country.
- While Sri Lanka isn't a major economy or investment destination, it has been a high-profile recipient of Chinese investment under President Xi's "Belt and Road" initiative. The continued political and economic problems in Sri Lanka could therefore weaken China's effort to build alliances and counter U.S. influence through trade and investment.

U.S. Financial Market: Amid the widespread carnage in the financial markets yesterday, we took note that the TerraUSD stablecoin, a type of cryptocurrency whose value is supposedly pegged to $1.00, traded as low as $0.94. The drop in value triggered a wave of selling, which likely contributed to yesterday's substantial drop in the broad cryptocurrency market.

- As of last weekend, Terra was the third-largest stablecoin. Unlike traditional stablecoins, Terra is strictly algorithmic, i.e., it isn't necessarily backed by any assets at all.
    - Instead, algorithmic stablecoins rely on financial engineering to maintain their link to the dollar. Such designs have been criticized as risky because they rely on

traders to push the value back to $1.00 rather than having assets that continuously support the price.
    - Once Terra "broke the buck" yesterday, at least some traders panicked and rolled into more traditional asset-backed stablecoins. At the same time, algorithmic rules prompted others to sell stablecoins such as ether and bitcoin in an effort to drive up the price of Terra again.
- We have long posited that the Wild West development of the cryptocurrency markets could pose risks for the traditional financial markets, especially as the Federal Reserve pushes up interest rates. At this point, it's not clear what sparked the loss of confidence in Terra, but we note a couple of important points:
    - The downdraft in stablecoin prices looked very much like "contagion" in the traditional financial markets.
    - To the extent that any of these assets have been pledged as collateral, the volatility in their values potentially could spark further selling and broader contagion. We remain on the lookout for any such broader financial risks.
- More broadly, the Fed warned in its semiannual Financial Stability Report yesterday that the sharp upside surprises in inflation or interest rates "could lead to higher volatility, stresses to market liquidity and a large correction in prices of risky assets, potentially causing losses at a range of financial intermediaries."

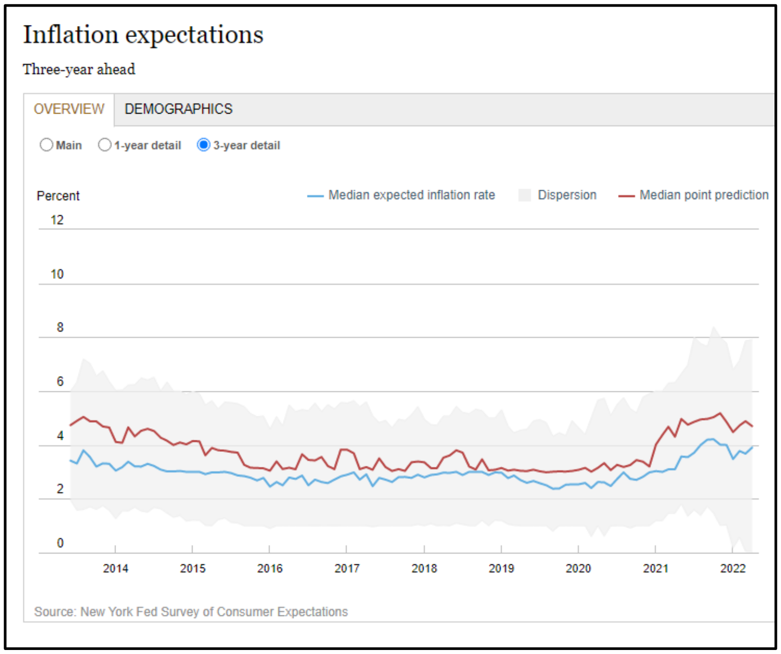


U.S. Labor Market: With the tight labor market driving up wage rates, teens are now working in greater numbers than any other time since the Great Financial Crisis of 2008-2009. Federal data show that about one-third of young people aged 16 to 19 are currently working, potentially helping keep some lower-paying firms in business.

U.S. Inflation: In its April survey of inflation expectations, the New York FRB said respondents saw prices rising at an annual rate of 3.9% three years from now, versus 3.7% in its

March survey. However, those figures remain below the three-year forward expectation of 4.2% registered in the survey last autumn.

- When the April consumer price index (CPI) is released on Wednesday, we expect base effects will finally start to reduce the calculated inflation rate on a year-over-year basis.
- As of this writing, the April CPI is expected to be up 8.1% year-over-year, versus 8.5% for the March CPI.



COVID-19: Official data show confirmed cases have risen to 518,073,573 worldwide, with 6,253,752 deaths. The countries currently reporting the highest rates of new infections include Germany, France, South Korea, and the U.S. (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 rose to 81,973,693, with 998,041 deaths. In data on the U.S. vaccination program, the number of people considered fully vaccinated now totals 220,163,884, equal to 66.3% of the total population.

Virology

- The seven-day average of people hospitalized with confirmed or suspected COVID-19 in the U.S. came in at 19,009 yesterday. The tally of people hospitalized for COVID-19 is now up 20% from two weeks earlier, although it remains relatively low.
- Just days after President Xi reiterated his "zero-COVID" policy, authorities in Shanghai are reportedly tightening the city's lockdown. New cases have been declining in the city, and officials haven't formally announced tighter restrictions. In recent days, however, residents have reported more forced quarantines at centralized facilities and halted deliveries of nonessential items, including medicines.

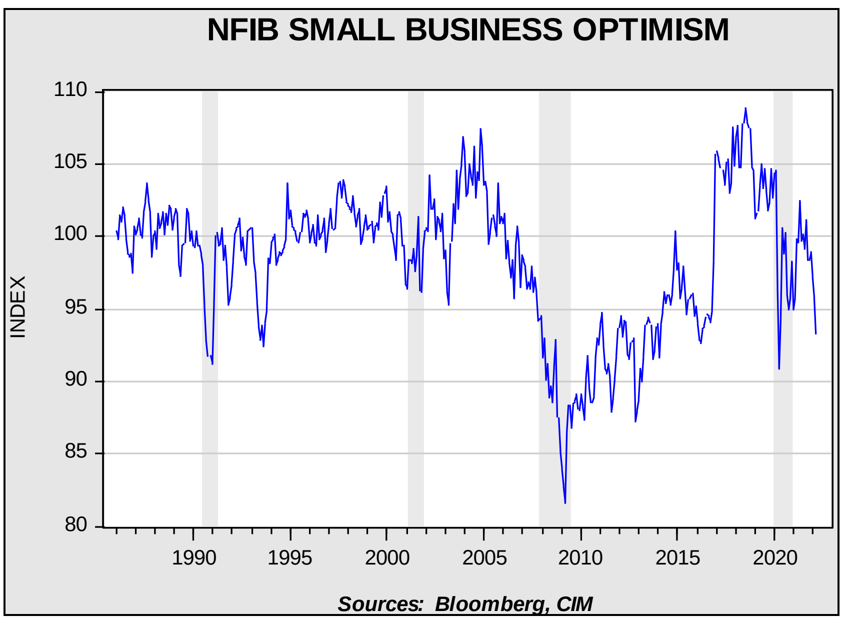
- Other local and provincial governments are likely to follow Shanghai's lead regarding redoubling their pandemic restrictions. As a result, nascent popular protests against the policies could widen and intensify.
- Just as important, any further tightening of China's pandemic restrictions threatens to slow the economy further, creating additional headwinds for the global economy and financial markets.

Economic and Financial Market Impacts

- Reflecting how badly China's lockdowns are hurting its economy, the China Passenger Car Association yesterday said April auto sales were down 36% year-over-year. Production was down even more sharply, by 41% year-over-year.

U.S. Economic Releases

Optimism among small business owners held steady from the prior month but remains at post-recession lows. The NFIB Small Optimism Index came in at 93.2 compared to expectations of 92.9.

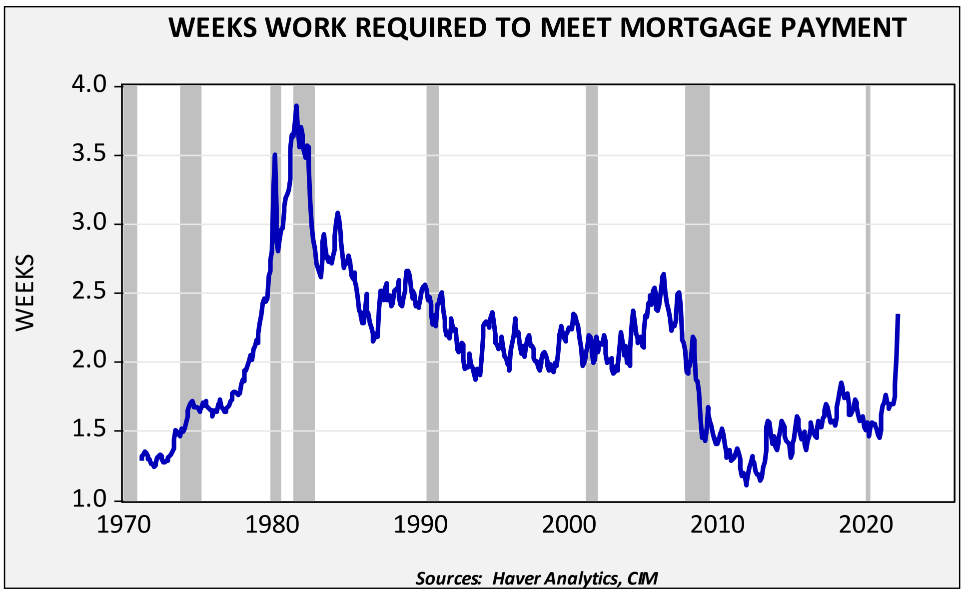


The chart above shows the levels of the NFIB Small Business Optimism Index.

The table below lists the U.S. economic releases and/or Federal Reserve events scheduled for the rest of today.

Economic Releases						
EST	Indicator			Expected	Prior	Rating
10:00	NFIB Small Business Optimism	m/m	Mar	93.2	92.9	**
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
7:40	John Williams Gives Speech at NABE/Bundesbank Symposium	President of the Federal Reserve Bank of New York				
9:15	Thomas Barkin Discusses Inflation	President of the Federal Reserve Bank of Richmond				
13:00	Chris Waller and Neel Kashkari Speaks to Economics Club of MN	Member of the Board of Governors				
15:00	Loretta Mester Takes Part in Panel Discussion	President of the Federal Reserve Bank of Cleveland				
19:00	Raphael Bostic Discusses Monetary Policy and the Economy	President of the Federal Reserve Bank of Atlanta				

Charts Worth Noting: Residential real estate is critical to the path of the economy. For the bottom 90% of households, a home is their largest asset, and even slowing home price growth can weaken the wealth effect. Existing home sales prices have averaged +5.7% since the late 1960s and rarely do we experience falling yearly price growth. A yearly decline of 2% or more usually coincides with a recession. In 2009, home prices plunged over 15% as part of the Great Financial Crisis.



This chart measures the number of weeks a person earning the average weekly wage for a non-supervisory worker would need to work to pay the mortgage on an existing home at the median sales price and the prevailing mortgage rate. At the peak of the housing bubble, it took 2.6 weeks to make the mortgage. After the crisis, housing became much more affordable, but in the past few months, the combination of rising mortgage rates and home prices has overwhelmed rising wages. Crossing 2.5 weeks would be a warning that the housing market is vulnerable to a period of stagnation or worse and increase the chances of a recession.

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	Household Spending	y/y	Mar	-2.3%	1.1%	-3.3%	**	Equity and bond neutral
Australia	CBA Household Spending	m/m	Apr	-3.8%	9.2%		**	Equity bearish, bond bullish
	ANZ Roy Morgan Consumer Confidence	w/w	8-May	90.5	90.7		**	Equity and bond neutral
	NAB Business Conditions	m/m	Apr	20	18		**	Equity and bond neutral
	NAB Business Confidence	m/m	Apr	10	16		**	Equity and bond neutral
	Retail Sales Ex Inflation	q/q	1Q	1.2%	8.2%	1.0%	**	Equity bullish, bond bearish
New Zealand	ANZ Truckometer Heavy	m/m	Apr	2.3%	1.8%		**	Equity bullish, bond bearish
	Card Spending Retail	m/m	Apr	7.0%	-1.3%		**	Equity bullish, bond bearish
	Card Spending Total	m/m	Apr	7.0%	1.6%		**	Equity bullish, bond bearish
South Korea	BoP Current Account Balance	m/m	Mar	$6729.4m	$6419.4m		***	Equity and bond neutral
	BoP Goods Balance	m/m	Mar	$5309.5m	$4273.3m		**	Equity and bond neutral
EUROPE								
Eurozone	ZEW Survey Expectations	m/m	May	-29.5	-43.0		***	Equity and bond neutral
Germany	ZEW Survey Expectations	m/m	May	-34.3	-41.0	-43.5	***	Equity and bond neutral
	ZEW Survey Current Situation	m/m	May	-36.5	-30.8	-35.0	**	Equity and bond neutral
Italy	Industrial Production	m/m	Mar	0.0%	4.0%	-1.5%	***	Equity bullish, bond bearish
AMERICAS								
Brazil	FIPE CPI - Weekly	w/w	7-May	1.3%	1.7%	1.5%	***	Equity and bond neutral
	Retail Sales	y/y	Mar	4.0%	1.3%	2.40%	**	Equity and bond neutral
	Retail Sales Broad	y/y	Mar	0.7%	0.3%	2.8%	***	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)	140	137	3	Up
3-mo T-bill yield (bps)	83	88	-5	Neutral
TED spread (bps)	57	49	8	Widening
U.S. Sibor/OIS spread (bps)	119	118	1	Up
U.S. Libor/OIS spread (bps)	124	123	1	Up
10-yr T-note (%)	3.01	3.04	-0.03	Up
Euribor/OIS spread (bps)	-40	-43	3	Neutral
Currencies	**Direction**			
Dollar	Up			Up
Euro	Down			Down
Yen	Flat			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.

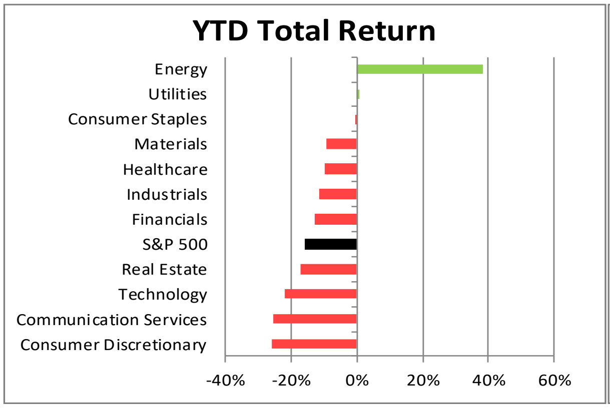
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$104.06	$105.94	-1.77%	Pessimism on the global economy
WTI	$101.39	$103.09	-1.65%	
Natural Gas	$6.91	$7.03	-1.69%	
Crack Spread	$52.50	$52.31	0.37%	
12-mo strip crack	$36.06	$36.20	-0.38%	
Ethanol rack	$2.88	$2.88	-0.04%	
Metals				
Gold	$1,857.69	$1,854.17	0.19%	
Silver	$21.81	$21.80	0.03%	
Copper contract	$419.30	$419.35	-0.01%	
Grains				
Corn contract	$774.50	$772.00	0.32%	
Wheat contract	$1,099.50	$1,092.75	0.62%	
Soybeans contract	$1,592.50	$1,585.25	0.46%	
Shipping				
Baltic Dry Freight	2,831	2,718	113	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.0		
Gasoline (mb)		-1.8		
Distillates (mb)		-1.2		
Refinery run rates (%)		0.6%		

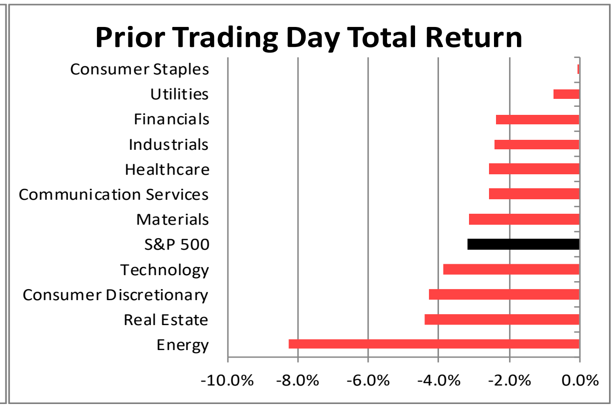
Weather

The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for most of the country, with cooler-than-normal temperatures in the Rocky Mountain and Northern Pacific regions. The forecasts call for wetter-than-normal conditions in the Northeast and Northern Pacific regions, with dry conditions for most of the Southern and Great Plains regions.

Data Section

U.S. Equity Markets – (as of 5/9/2022 close)

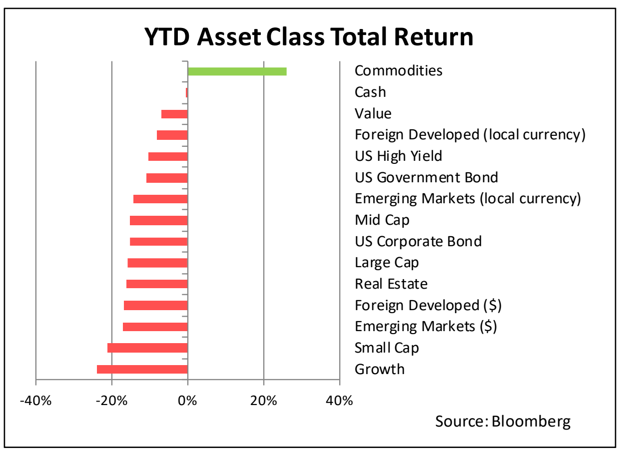




(Source: Bloomberg)

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 5/9/2022 close)

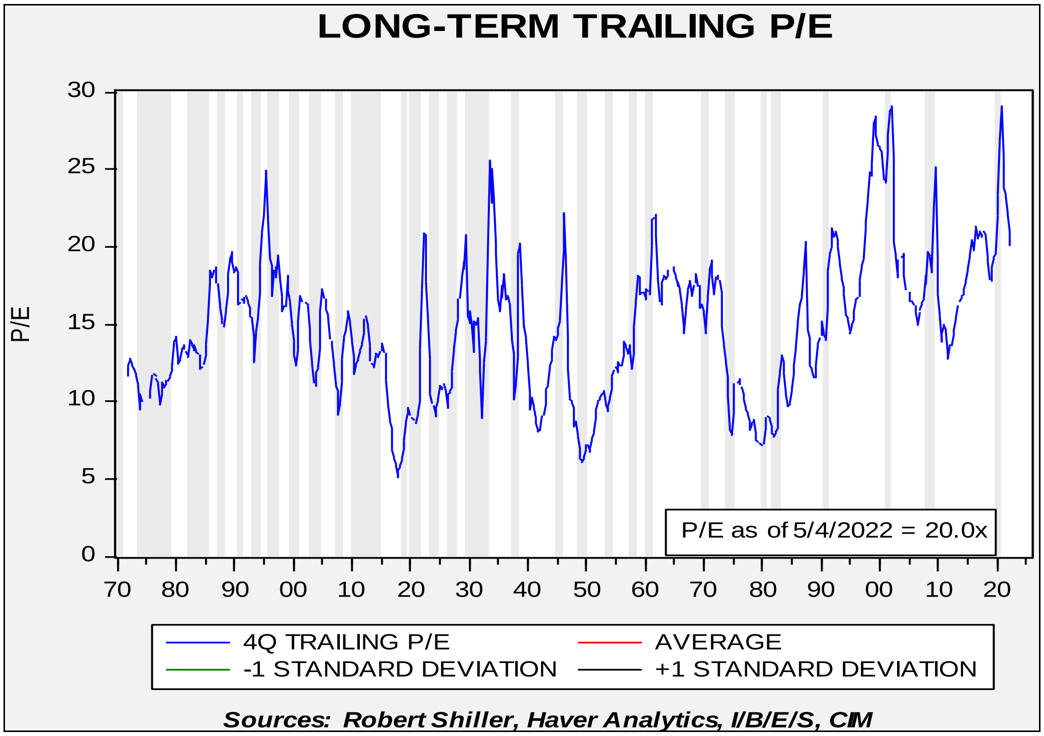


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

May 5, 2022



Based on our methodology,[1] the current P/E is 20.0x, down 0.4x from last week. Lower index values and higher earnings lowered the multiple.

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 two actual quarters (Q3, and Q4) and two estimates (Q1 and 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.