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 20, 2022—9:30 AM EDT] Global equity markets are mostly higher this morning. In Europe, the EuroStoxx 50 index is currently up 1.7% from its prior close. In Asia, the MSCI Asia Apex 50 index closed up 2.9%. Chinese markets were higher, with the Shanghai Composite up 1.6% and the Shenzhen Composite up 1.6% as well. U.S. equity index futures are signaling a higher open. With 473 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, 77.0% of the companies have reported earnings above forecast, while 19.9% 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* (5/19/2022): Crude oil inventories fell unexpectedly last 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 FOMC Speaks"
- *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 report begins with a brief update on the war in Ukraine. Afterward, there is a discussion on the Federal Reserve's determination to rein in inflation at all costs. Next, we look at international news, followed by economics and policy. We conclude with our COVID-19 coverage.

Russia-Ukraine: The situation in Ukraine continues to weigh on the morale of Russian forces and the general public. A lack of army reserves is hindering Moscow's war efforts. As a result, Russia is changing tactics as it looks to recover from the setbacks incurred in Kharvic. Troops are now focusing their attention on western Donetsk Oblast. An official from the Kremlin said that Russia intends to annex all of the Donetsk and Luhansk regions. Meanwhile, there is growing unrest in Russia over military mobilization. In May, there were several reports of Molotov cocktail attacks on Russian military commissariats. As the war rages on, Russia is finding it more challenging to maintain support for its invasion, while Ukraine is seeing more success and assistance from the West.

- The Biden administration is trying to provide Ukraine with anti-ship missiles to help remove Russia's naval blockade in the Black Sea. The new weapons would make the conflict more costly for Moscow, as they will likely be used to destroy Russia's Black Sea Fleet. On Thursday, Russia dismissed calls from the UN to halt its blockade that is preventing Ukraine from shipping wheat. The UN has warned that the blockade could lead to food shortages and global famine. In the meantime, the U.S. and the UN are considering transporting Ukrainian grain by railway through Belarus to Lithuania.
- Ukraine will receive more financial support from the West. Congress officially passed a $40 billion Ukraine aid package, and the bill is expected to be signed by President Biden on Friday. In addition, G-7 countries will agree to send Ukraine more than $19 billion in additional aid.
- In Europe, there seems to be waning support for Ukraine. Even though most Europeans support Ukraine as it fends off the Russians, many fear the economic costs of a prolonged war. In Italy, a transportation union went on strike on Friday to protest the government's role in providing Ukrainian forces with weapons. And Germany and France have rejected the possibility of accelerating Ukraine's admission into the European Union.

Federal Reserve: On Thursday, Fed officials reminded investors that the recent market rout would not impact its decision to tighten monetary policy. Kansas City Fed President Esther George said the Federal Reserve is not worried about the impact of higher interest rates on financial markets. Minneapolis Fed President Neel Kashkari warned that inflation would not fall without pain. Recent remarks from Fed officials reinforced the view that the central bank will attempt to rein in inflation by slowing the economy.

- Treasury Secretary Janet Yellen rejected the Fed raising its inflation target as prices rise. Although increasing the inflation target is not new—Lawrence Ball proposed raising the inflation target to four percent in 2013—the idea has circled back due to recent surges in the cost of living. The reluctance to change the inflation target is likely related to concerns that could undermine the Fed's credibility. Nevertheless, we are less optimistic about the viability of a two percent target as the world moves away from globalization and toward regionalization.

International News:

- Canada announced it would ban Chinese telecom manufacturers ZTE (763 HK, HKD, 16.10) and Huawei from its 5G network just three days after lawmakers voted to revive a special committee to study bilateral trade deals. The ban appears to be related to suspicions from Western countries that Chinese telecom companies have close ties with the Chinese military.
- Beijing is looking at alternative ways to stimulate its economy. For example, the PBOC has cut the key interest rate on five-year prime loans by a record amount to boost demand for mortgages and property. The real estate meltdown and the Zero- COVID policy have weighed heavily on the economy. *Bloomberg Economics* forecasted that the U.S. GDP growth could surpass China for the first time since 1976. If true, this would place a dark cloud over Chinese President Xi Jinping before his re-appointment for a third consecutive

term. He has long advocated that China will surpass the West; thus, slower growth would show that the economy has regressed in achieving its goal.

- The annual change in core CPI exceeded two percent in Japan for the first time in seven years. The country has been trying to increase inflation for a while, and the sharp rise will likely not impact the BOJ monetary policy. That being said, the increase in inflation suggests the yen could further depreciate against the dollar. A former BOJ official indicated the central bank might let the currency climb to 150 against the dollar before it becomes concerned. Currently, the yen is trading at 127.86.

US Economic and Policy News:

- The housing market is showing signs of a slowdown. According to the National Association of Realtors, existing-home sales fell to their slowest pace since April 2020. The sales of previously owned homes fell 5.9% from the prior year. The lack of sales is related to rising home mortgage rates and housing prices, making homes more unaffordable for buyers.
- Tether, the most widely used cryptocurrency, reports reducing its reserve of commercial paper and increasing its holding of U.S. Treasury bills. Earlier this month, the company came under scrutiny from regulators after its stablecoin USDT briefly lost its peg to the U.S. dollar. As a result, tether decided to shift its holdings to safer assets, mainly responding to criticism that investments with limited liquidity did not support its peg.
- President Biden is visiting Asia on Friday. On this trip, he is expected to try to persuade Indo-Pacific countries to build closer ties with the U.S. Additionally, Japan and the U.S. are expected to urge China to pare down its holding of nuclear weapons.

COVID-19: The number of reported cases is 524,056,687 with 6,273,624 fatalities. In the U.S., there are 83,060,981 confirmed cases with 1,001,606 deaths. For illustration purposes, the *FT* has created an interactive chart that allows one to compare cases across nations using similar scaling metrics. The CDC reports that 739,095,455 doses of the vaccine have been distributed, with 583,221,364 doses injected. The number receiving at least one dose is 258,074,668, the number of second doses is 220,811,434. The number receiving the first booster is 102,524,944, and the number receiving the second booster is 11,835,302. The *FT* has a page on global vaccine distribution.

- A Centers for Disease Control and Prevention panel recommended a booster dose of the Pfizer (PFE,$50.65) - BioNTech (BNTX, $167.87) coronavirus vaccine for children aged 5-11. The recommendation comes days after the FDA expanded authorization for that age group.

U.S. Economic Releases

There were no economic releases scheduled prior to the publication of this report nor are there any releases or Fed events scheduled for the day.

Economic Releases
No economic releases for the rest of today
Federal Reserve
No Fed speakers or events today

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	CPI	y/y	Apr	2.5%	1.2%	2.5%	***	Equity and bond neutral
	CPI Core	y/y	Apr	0.8%	-0.7%	0.7%	**	Equity bullish, bond bearish
New Zealand	Trade Balance	m/m	Apr	NZ$ .584 bn	NZ$ -.581 bn		***	Equity and bond neutral
EUROPE								
Germany	PPI	y/y	Apr	33.5%	30.9%	31.3%	*	Equity bearish, bond bullish
Eurozone	Current Account	m/m	Apr	€-1.6 bn	€15.7 bn		*	Equity bearish, bond bullish
U.K.	GfK Consumer Confidence	m/m	May	-40.0	-38.0	-39.0	**	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)	148	145	3	Up
3-mo T-bill yield (bps)	99	100	-1	Up
TED spread (bps)	49	45	4	Widening
U.S. Sibor/OIS spread (bps)	133	132	1	Up
U.S. Libor/OIS spread (bps)	138	136	2	Up
10-yr T-note (%)	2.86	2.84	0.02	Up
Euribor/OIS spread (bps)	-35	-37	2	Neutral
Currencies	**Direction**			
Dollar	up			Up
Euro	up			Down
Yen	down			Down
Pound	up			Down
Franc	up			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
PBOC 1-Yr Prime Rate	3.700%	3.700%	3.650%	Above Forecast
PBOC 5-Yr Prime Rate	4.450%	4.600%	4.550%	Below 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.

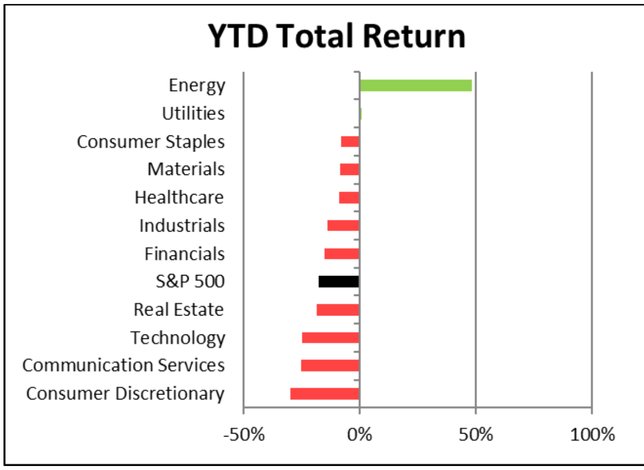
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$112.77	$112.04	0.65%	
WTI	$112.45	$112.21	0.21%	
Natural Gas	$8.01	$8.31	-3.56%	
Crack Spread	$49.22	$48.12	2.30%	
12-mo strip crack	$35.07	$34.68	1.11%	
Ethanol rack	$2.92	$2.92	-0.18%	
Metals				
Gold	$1,843.23	$1,841.85	0.07%	
Silver	$21.98	$21.93	0.23%	
Copper contract	$431.20	$428.30	0.68%	
Grains				
Corn contract	$775.75	$783.25	-0.96%	
Wheat contract	$1,188.25	$1,200.50	-1.02%	
Soybeans contract	$1,689.00	$1,690.50	-0.09%	
Shipping				
Baltic Dry Freight	3,289	3,189	100	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-3.4	1.6	-5.0	
Gasoline (mb)	-4.8	-1.0	-3.9	
Distillates (mb)	1.2	-0.8	2.0	
Refinery run rates (%)	1.8%	0.6%	1.2%	
Natural gas (bcf)	89.0	90.0	-1.0	

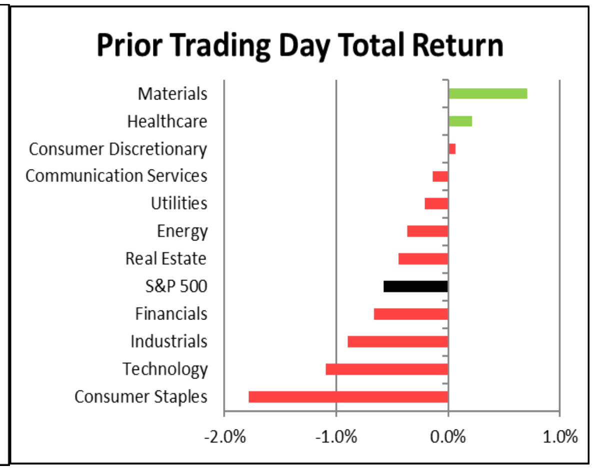
Weather

The 6-10 day forecast shows a dramatic warming trend for the western two-thirds of the nation and the east coast, with normal to below-normal temperatures for the Ohio Valley. Above-normal precipitation is forecast for the eastern third of the nation, with dry conditions persisting for the Southwest. The 8-14 day forecast shifts the hot weather to the eastern two-thirds of the country, with below-normal temps for the Pacific Northwest into Northern California. Dry conditions are expected in the Midwest and Southeast, with above-normal rain for the western border regions with Canada.

Data Section

U.S. Equity Markets – (as of 5/19/2022 close)

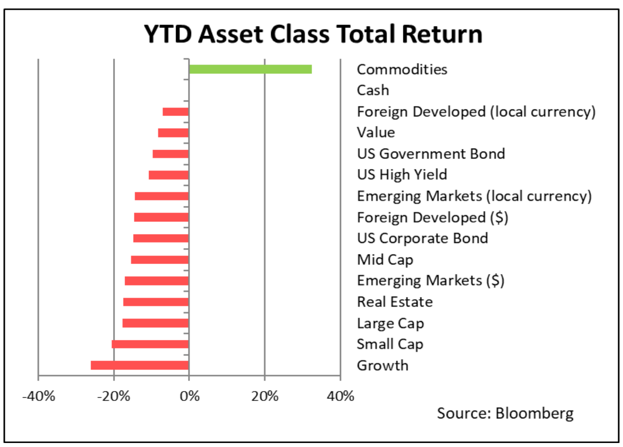




(Source: Bloomberg)

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 5/19/2022 close)

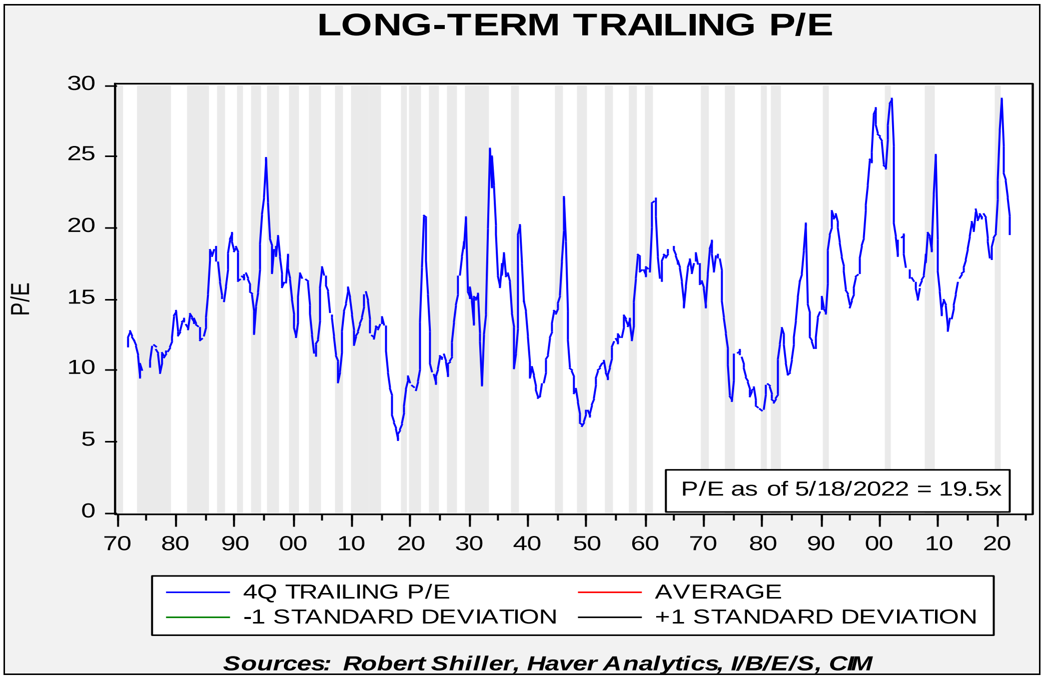


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 19, 2022



Based on our methodology,[1] the current P/E is 19.5x, down 0.2x 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.

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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 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.