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: November 7, 2022—9:30 AM EDT] Global equity markets are generally higher this morning. In Europe, the Euro Stoxx 50 is currently up 0.6% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 2.3%. Chinese markets were higher, with the Shanghai Composite closing up 0.2% from its prior close and the Shenzhen Composite closing up 0.4%. U.S. equity index futures are signaling a flat open.

With 426 companies having reported so far, S&P 500 earnings for Q3 are running at $56.30 per share, compared to estimates of $55.45. Of the companies that have reported thus far, 70.7% have exceeded expectations while 23.2% have fallen short of expectations.

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* (10/24/2022) (with associated podcast) "Defining Deglobalization"
- *Weekly Energy Update* (11/3/2022): In this week's report we include a special discussion on the distillate situation since concerns have been raised in the media and we wanted to address them in detail. We then update the natural gas market as the northern hemisphere winter approaches. We also recap major stories and last week's data.
- *Asset Allocation Quarterly – Q4 2022* (10/18/2022): Discussion of our asset allocation process, Q4 2022 portfolio changes, and our outlook for the markets
- *Asset Allocation Bi-Weekly* (10/31/2022) (with associated podcast): "The Inflation Adjustment for Social Security Benefits in 2023"

Our *Comment* today opens with an update on the Russia-Ukraine war. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including multiple reports related to China. Importantly, there are conflicting reports about China's readiness to ease its Zero-COVID policies, which have done so much to impede Chinese and global economic activity.

Russia-Ukraine: As Ukrainian forces continue to press their counteroffensives in the northeastern Donbas region and in the southern region around Kherson, Russian forces continue to strike back with air, missile, and kamikaze drone attacks against civilian infrastructure across Ukraine. The Russians are also attempting to counterattack with ground forces, but reports indicate a contingent of their Pacific Fleet Marines took heavy casualties in the Donbas recently.

At the same time, Russian financier Yevgeny Prigozhin continues to throw his Wagner Group mercenaries against the Ukrainian city of Bakhmut in the Donbas region and is reportedly close to taking the city, albeit with significant casualties. However, most Western observers that we follow believe that the capture of Bakhmut would give Russia little strategic advantage; rather, the Wagner Group attacks there appear to be designed to bolster Prigozhin's leadership credentials, perhaps for his take over as Russian defense minister or for him to eventually seize power from President Putin.

- A report in the *Wall Street Journal* stated that U.S. National Security Advisor Sullivan, in recent months, has engaged in confidential discussions with high-level Russian officials to reduce the risk of a broader conflict over Ukraine and to warn Moscow against using nuclear or other weapons of mass destruction.
- Some Western analysts dismiss the possibility out-of-hand that Russia might take steps toward using a tactical nuclear weapon in its war with Ukraine, but as President Putin

becomes increasingly backed into a corner, we would place the probability of such a move at around 25% or so.

- Sullivan's discussions with the Russian leadership confirm that the risk of such an event is not negligible.
- In any case, Sullivan's instinct to keep the lines of communication open reflects how many national security personnel in the U.S. administration are traditionalists and well-schooled in the imperatives of U.S.-Russian diplomacy and great-power rivalry.

United States-China: Just one month after the U.S. imposed a series of tough, new restrictions on sending advanced semiconductor technology, goods, or services to China, reports show Chinese tech firms such as Alibaba (BABA, $69.81) have found at least one workaround as the firms are tweaking their most advanced chip designs to reduce processing speeds, allowing them to avoid U.S. sanctions when the chips are shipped back to China after being made in Taiwan.

- With the U.S.-China geopolitical rivalry intensifying, the U.S. restrictions aim to suppress China's computing power and make it more difficult for the country to compete economically and militarily.
- China's indigenous semiconductor plants are most likely decades away from producing cutting-edge chips such as those designed by Alibaba, so the move to deliberately cut their processing speeds is likely to have a noticeable impact on Chinese firms.

China-Solomon Islands-Australia: Illustrating how some countries will likely try to play the evolving China-led geopolitical bloc against the U.S.-led bloc for their own advantage, last week the Solomon Islands took delivery of a Chinese domestic security aid package consisting of two water cannon trucks, 30 motorcycles, and 20 SUVs for its police force, just days after it took delivery from Australia of 60 short-barreled police rifles and 13 vehicles.

- In our recent study projecting which countries will end up in each of the evolving geopolitical blocs, we assigned the Solomon Islands to the "Neutral" camp. Our study projects that Australia will be a key member of the U.S.-led bloc.
- The competing Chinese and Australian donations come one year after the Solomons' Prime Minister Sogavare put down a violent uprising stemming from his efforts to switch the country's allegiance to China as he attempts to retain power.
- In the coming years, as the U.S. and Chinese blocs attempt to curry favor with other ostensibly neutral countries, such as Indonesia and Vietnam, we suspect many of the neutrals will try to play the two blocs off each other in order to take advantage of the situation and retain their room to maneuver.

Chinese COVID Policy: In a Saturday press conference, government health officials said they will continue to enforce President Xi's "dynamic Zero-COVID" policy, calling it "completely correct, most economical, and effective." Although the officials promised to continually refine the policy to minimize economic and social disruptions, the statement suggested that the Chinese economy and financial markets will continue to struggle with the economically painful policy.

However, reports based on insider accounts this morning indicate high-level officials are actually reconsidering the Zero-COVID policy but want to move slowly before abandoning it to limit any downside for public health and/or for the political position of the Communist Party. The conflicting reports have whipsawed stock equity futures over the last day.

- The headwind from the Zero-COVID policy has added to China's many other problems, such as the government's crackdown on whole swaths of the private sector, foreign clampdowns on technology and capital flows into China, and weakening foreign demand for Chinese exports. Indeed, data this morning showed that Chinese exports in October were down 0.3% year-over-year, marking their first annual decline since May 2020.
- The Zero-COVID policy and new outbreaks of the disease have also presented challenges for U.S. firms currently active in China. Yesterday, Apple (AAPL, $138.38) said global shipments of its newest high-end iPhones will be delayed after the latest lockdowns caused havoc at a factory run by a main supplier, Hon Hai Precision Technology (HNHPF, $6.22).

Chinese Finance Sector: The Communist Party announced that Fan Yifei, one of the six deputy governors of the People's Bank of China, has been detained as part of an investigation into "suspected serious violations of discipline and law." Fan, a former high-level officer at China Construction Bank (CICHY, $10.98), is the latest in a series of financial officials who have been arrested on corruption charges over the past two years.

- Foreign investors are now quite attuned to President Xi's value-destroying crackdowns on sectors such as technology and real estate development.
- Fan's arrest is a reminder that China's broader financial sector is also at risk of a regulatory crackdown. At the PBOC, Fan's responsibilities included overseeing the country's payment system and shepherding the central bank's effort to create a digital currency. His arrest signals that those two areas may now be a focus of the party's corruption police.

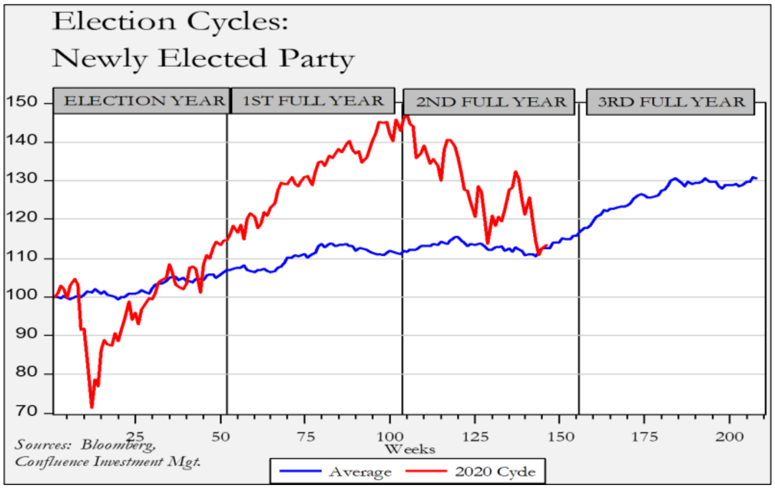
United Kingdom: When he releases his Autumn Statement at mid-month, Chancellor Hunt reportedly will call for tax increases and public spending cuts worth up to £54 billion per year to close the government's yawning fiscal deficit. Not only would the fiscal tightening reverse Former Prime Minister Truss's plans, which sparked a massive selloff in U.K. government bonds, but it would also mark a return to growth-inhibiting austerity like that of the early 2010s.

U.S. Economy: New polling suggests that almost three-quarters of U.S. consumers plan to seek less-expensive alternatives in this year's holiday shopping season, driven largely by high inflation and concerns about an economic downturn. The report is a reminder that the resilient labor market and continued high employment will not necessarily preclude a drop in consumer spending or a broader economic recession. We continue to believe a recession is likely to begin in the next few quarters.

U.S. Elections: Voters across the country will go to the polls tomorrow for mid-term elections in which all seats in the House of Representatives and one-third of the seats in the Senate will be contested. The latest polling suggests that the summer swing of voting intentions toward the

Democrats has now largely dissipated, raising the chance that the Republicans could take control of both chambers.

- For investors, perhaps the key thing to remember is that U.S. stock prices typically rebound once the mid-term elections are finished, perhaps reflecting greater clarity on which party will control policy.
- If that happens again this year, it would suggest stocks could rebound in the coming months and beyond. The chart below shows stock performance this cycle versus the average when a new party takes over the presidency (as happened in 2020).



U.S. Economic Releases

There were no economic releases prior to the publication of this report. The table below lists the economic releases and/or Federal Reserve events scheduled for the rest of the day.

Economic Releases						
EST	Indicator			Expected	Prior	Rating
15:00	Consumer Credit	m/m	Sep	$30.000b	$32.241b	*
Federal Reserve						
EST	Speaker or Event	District or Position				
15:40	Susan Collins and Loretta Mester Speak at Women in Economics Symposium	Presidents of the Federal Reserve Banks of Boston and Cleveland				
18:00	Thomas Barkin Speaks at Event on Inflation	President of the Federal Reserve Bank of Richmond				

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								
Australia	Foreign Reserves	m/m	Oct	A$83.6b	A$83.6b		*	Equity and bond neutral
China	Foreign Reserves	m/m	Apr	$3.0524t	$3.188t	$3.130t	**	Equity and bond neutral
	Exports	y/y	Apr	-0.3%	4.5%	5.7%	**	Equity bearish, bond bullish
	Imports	y/y	Apr	-0.7%	0.3%	0.0%	**	Equity and bond neutral
	Trade Balance	m/m	Apr	$85.15b	$47.38b	$49.90b	***	Equity and bond neutral
EUROPE								
Germany	Industrial Production WDA	y/y	Sep	2.6%	2.1%	1.6%	**	Equity bullish, bond bearish
	S&P Global Construction PMI	m/m	Oct	43.8	41.8		*	Equity and bond neutral
Switzerland	Unemployment Rate	m/m	Oct	1.9%	1.9%	2.0%	**	Equity and bond neutral
	Foreign Currency Reserves	m/m	Oct	817.2b	807.1b		***	Equity and bond neutral
	Domestic Sight Deposits CHF	w/w	4-Nov	532.1b	539.6b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	4-Nov	572.1b	581.7b		*	Equity and bond neutral
AMERICAS								
Mexico	Gross Fixed Investment	y/y	Aug	6.5%	2.1%	3.6%	**	Equity bullish, bond bearish

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)	455	453	2	Up
3-mo T-bill yield (bps)	399	401	-2	Up
TED spread (bps)	56	52	4	Widening
U.S. Sibor/OIS spread (bps)	421	419	2	Up
U.S. Libor/OIS spread (bps)	424	423	1	Up
10-yr T-note (%)	4.13	4.16	-0.03	Up
Euribor/OIS spread (bps)	173	173	0	Neutral
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
Yen	Flat			Down
Pound	Up			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.

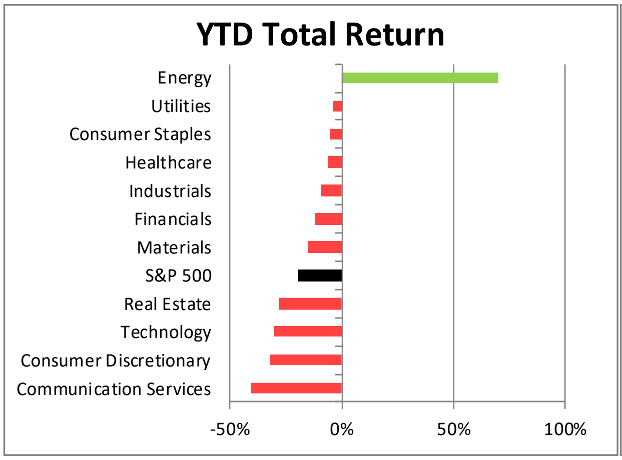
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$98.00	$98.57	-0.58%	
WTI	$91.94	$92.61	-0.72%	
Natural Gas	$7.09	$6.40	10.81%	Supply Pessimism
Crack Spread	$37.80	$38.71	-2.34%	
12-mo strip crack	$33.62	$33.90	-0.85%	
Ethanol rack	$3.03	$3.04	-0.09%	
Metals				
Gold	$1,675.76	$1,681.87	-0.36%	
Silver	$20.65	$20.86	-0.99%	
Copper contract	$361.70	$368.65	-1.89%	
Grains				
Corn contract	$679.00	$681.00	-0.29%	
Wheat contract	$842.25	$847.75	-0.65%	
Soybeans contract	$1,459.25	$1,462.25	-0.21%	
Shipping				
Baltic Dry Freight	1,323	1,290	33	

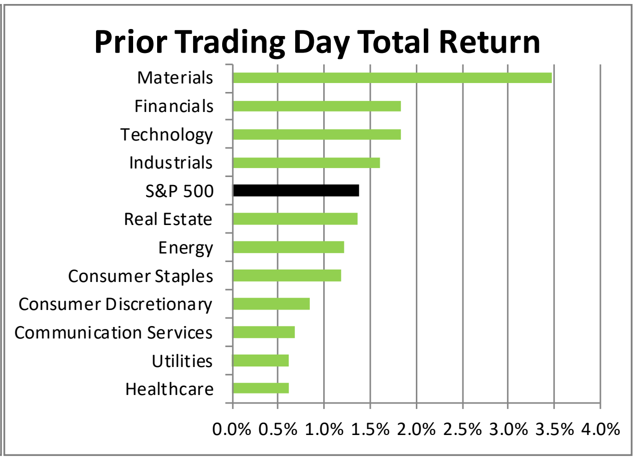
Weather

The 6-10 and 8-14 day forecasts currently call for cooler-than-normal temperatures for most of the country. Wetter-than-normal conditions are anticipated for Texas and surrounding areas, with dry conditions expected in the Southwest and the Mississippi Valley.

Data Section

U.S. Equity Markets – (as of 11/4/2022 close)

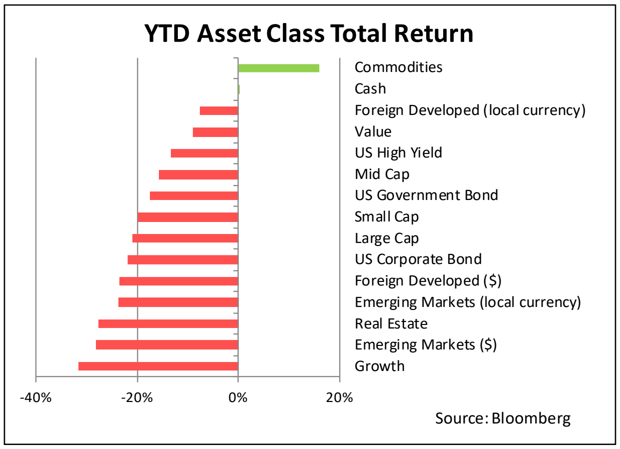




(Source: Bloomberg)

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 11/4/2022 close)

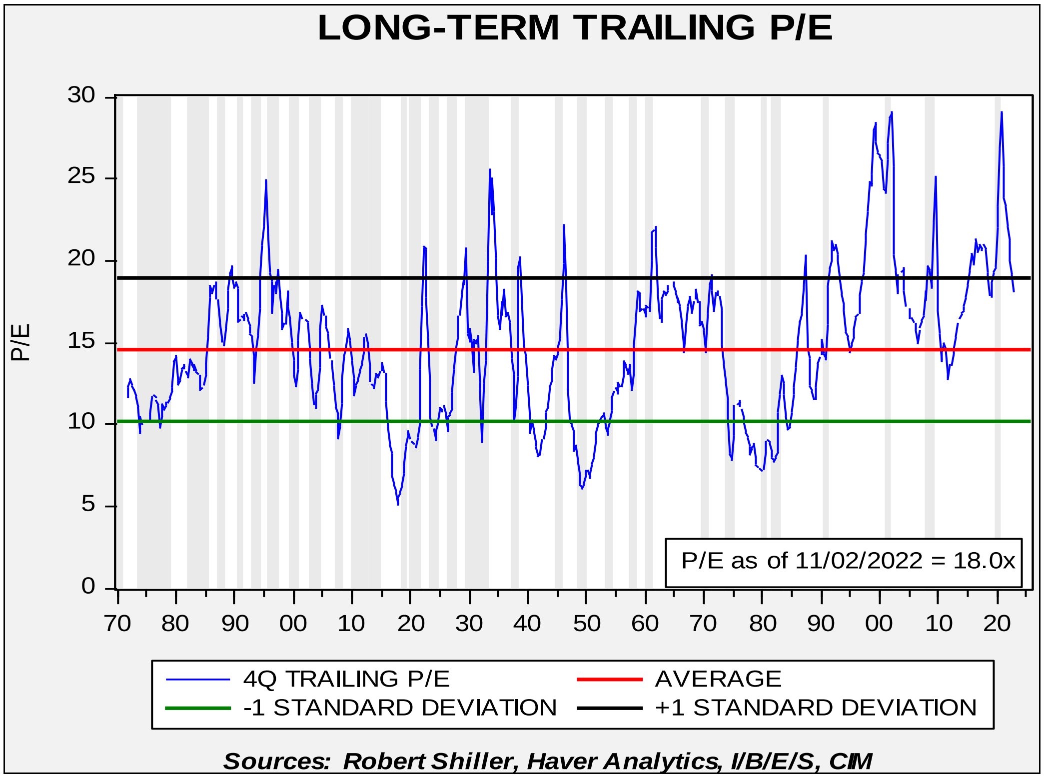


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

November 3, 2022



Based on our methodology,[1] the current P/E is 18.0x, up 0.2x from last week. Rising index values and falling earnings led to the rise in 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 (Q1 and Q2) and two estimates (Q3 and Q4). 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.