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 15, 2022—9:30 AM EST] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 is currently up 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 4.3%. Chinese markets were higher, with the Shanghai Composite closing up 1.6% from its prior close and the Shenzhen Composite closing up 2.1%. U.S. equity index futures are signaling a higher open.

With 460 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, 69.1% have exceeded expectations while 24.6% 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* (11/07/2022) (with associated podcast) "Reflections on the 20th Party Congress." Due to the upcoming holiday, the next BWGR will be our 2023 Outlook published on December 12th.
- *Weekly Energy Update* (11/10/2022): In this week's report we 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* (11/14/2022) (with associated podcast): "The Impossible Trinity"
- ***Asset Allocation Q4 2022 Rebalance Presentation* (11/14/2022): Video presentation featuring the Asset Allocation Committee as they review our asset allocation strategies, recent portfolio changes, and the current macro environment**
- *Charts Worth Noting* (11/14/2022): Annual Percentage Change in CPI

Good morning to all those eight billion out there (that are growing older, btw)! Equities are trending higher this morning, interest rates are falling, and the dollar is lower. The driving factor behind the rally is primarily the meeting between President Biden and President Xi (although the better-than-expected PPI data gave another leg up to the rally), which will head up our *Comment* this morning. Up next is broader China news. Ukraine comes next, followed by our take on economics and policy. An update on the crypto situation is the next item, and we close with international news.

Biden-Xi: The leaders of China and the U.S. met yesterday for the first time since Biden has been in office. Although unusually late for the leaders of the two largest economies on earth to delay a meeting, President Xi has mostly stayed home during China's Zero-COVID policy. Expectations about the meeting were low, and for the most part, these expectations were met. The first clue that no new ground was broken was that there was no joint statement as both sides issued their own statements.

So, if the outcome was so pedestrian, why are markets surging? Mainly because relations have become so difficult, even this outcome looks quite positive. China's official media was downright gushing. Here are the key takeaways from our perspective:

- The meeting does appear to stabilize relations, which seemed to be on a downward spiral. Xi and Biden have a positive history as they met several times when both were second in command in previous administrations. The meeting does suggest that at least the two sides can begin talking.
- Our take is that China needed stabilization more than the U.S. did. China is attempting to deal with a property bubble (see next section), and its Zero-COVID policy is hurting its economy. We suspect that Beijing thought that after Trump's loss, U.S. policy to China would ease, but that didn't happen. In fact, it may have become harsher. Beijing was avoiding contact with Washington for a host of reasons, but a big one may have been to wait until after Xi was given his third term as general secretary. China's economy is still dependent on exports, and it needs to trade with the U.S. Thus, cooling tensions makes sense.
- It appears that contact will continue. Secretary of State Blinken is scheduled to visit his counterparts as a follow up. Even Australia is trying to mend relations.
- At the G-20, China also signaled it wasn't happy with the war in Ukraine. China's English language readout didn't include the quote below, but it was in the Chinese readout (translation courtesy of Bill Bishop of *Sinocism*).

> The two heads of state also exchanged views on issues such as the Ukraine crisis. Xi Jinping pointed out that China is highly concerned about the current situation in Ukraine. After the crisis broke out, I put forward the "four should," and not long ago I put forward the "four commons." In the face of a global and complex crisis such as the Ukraine crisis, there are several points that deserve serious consideration: first, there are no winners in conflicts and wars; second, there is no simple solution to complex problems; third, major power confrontation must be avoided. China has always stood on the side of peace and will continue to promote peace talks. It supports and looks forward to the resumption of peace talks between Russia and Ukraine. At the same time, China hopes that the United States, NATO, and the European Union will conduct comprehensive dialogues with Russia.

- At the same time, very large differences remain. The U.S. is more than happy to maintain the status quo in Taiwan as Washington supports a quasi-independent state without full independence. For China, this is unacceptable, but it doesn't really have a path to unify the island without setting off a war. Biden is not fully in control of policy towards China and Taiwan, as Congress is becoming increasingly hawkish toward

Beijing and toward supporting Taipei. The actions taken on semiconductors have been viewed as a major step in a costly "cold war" with China, and it would be hard to pull back politically. Much like U.S. administrations found in the Cold War, appearing "soft on communism" was a loser in elections. Thus, we would not expect a major change in policy from the U.S. side.

Overall, it's good news that the two sides are talking, but it's important not to view this meeting as some sort of turning point. The differences between the U.S. and China are great. China is envisioning a world where it is a regional hegemon and expects the U.S. to acquiesce to its role and allow that to occur. We don't see Washington ceding that outcome without a fight. The meeting does stabilize conditions, but we would not expect the U.S. to adjust its policy on trade or semiconductors. But at least with both sides talking, the risk of miscommunication is lessened.

China News: China moves to bolster its economy by easing COVID-19 restrictions and helping the real estate sector.

- Although the Zero-COVID policy remains officially in place, in practice restrictions are easing despite a steady rise in infections. Quarantine rules are being relaxed. Tracking and investigation of reported cases are being eased. Testing rules are becoming less stringent. We would not expect a major announcement from the government in rolling back rules, but at the provincial level, Beijing is allowing local governments to ease up. Although it may take a while for citizens to return to pre-pandemic behavior, this easing should boost economic activity.
- Banks are being instructed to extend deadlines, and regulations on how real estate firms handle escrow accounts are being eased. These measures are helpful, but there is increasing evidence that the sentiment towards real estate has fundamentally changed. Before, real estate was seen as a safe investment. In a country that restricted capital flows, real estate was one area where households could have a chance at a positive real return on savings. That idea is now widely seen as outdated, and real estate is seen as risky, as household saving shows signs of building.
- Global investors are shunning China bonds.

War in Ukraine: Discussions of peace talks are rising, but Russia and Ukraine appear to be in no hurry to begin serious discussions.

- One of the truisms of nuclear weapons is that a nation possessing them can never be forced into unconditional surrender. That doesn't mean nuclear powers can't lose wars, but that loss is a choice. Essentially, a nuclear power loses a war when it concludes that the costs of continuing the conflict exceed the benefits. For example, the U.S. and U.S.S.R. both lost wars in Afghanistan. They both left not because they couldn't win, but because they decided winning wasn't worth the trouble.
    - Ukraine can't force a surrender on Russia, since, as Moscow has warned, it can use nuclear weapons to avoid defeat. Thus, this conflict will end with some sort of negotiated settlement. At this juncture, Ukraine sees little reason to talk as it is enjoying battlefield success. And Russia expects Ukraine's allies to tire of the

conflict and thus sees every reason to continue to war, regardless of losses, hoping that the deprivations caused by the war will lead NATO to reduce its support of Ukraine.

  - And so, allies of the combatants are making comments about talks. General Milley recently suggested that a "window" for talks could emerge this winter. The administration has "clarified" these remarks by saying it's up to the Ukrainians to decide to talk, but the reality is that if the U.S. reduces its support, Ukraine will be forced to make a deal.
  - As noted above, China's displeasure with Russia over the war could lead Beijing to pressure the Kremlin to sue for peace.
  - At this point, we don't expect a rapid resolution to the conflict, but the war won't go on indefinitely. Outside pressure on both Russia and Ukraine can likely force some sort of ceasefire. We are not there yet as the U.S. sees value in degrading Russia's military. But the loss of Russian energy is a major problem for the EU, and China is clearly displeased with the course of the war. So, by next summer, we could see some moves toward talks.

- The U.S. is warning Russia against the use of nuclear weapons. The U.S. has also added additional sanctions on Russia.

Markets, Economics and Policy: Vice-Chair Brainard bolsters the case for slowing rate hikes, and student debt relief is in limbo.

- Although we don't expect the FOMC to stop tightening anytime soon, the pace of hikes looks poised to slow. Vice-Chair Brainard suggested she would support a slowing in the pace of tightening, worried about the lagged effects of rising rates.
- The plan to offer student debt relief has been put on hold by the Eighth Circuit Court of Appeals. It is unclear when or if the plan will be revived. In its place, the Biden administration is considering extending the current payment suspension.
- One area of concern is residential real estate. The spread between mortgage rates and Treasuries is widening, mostly because the buyers of mortgages are stepping away from the market.
- Layoff announcements are building rapidly, with tech and transportation leading the way.
- Railroad unions are continuing to reject the recent tentative agreement, raising the odds of a nationwide strike.
- Industrial metals are recovering on hopes of a China reopening.
- Martin Gruenberg will be nominated to run the FDIC; he has been acting director for several months.

Crypto: The FTX debacle continues.

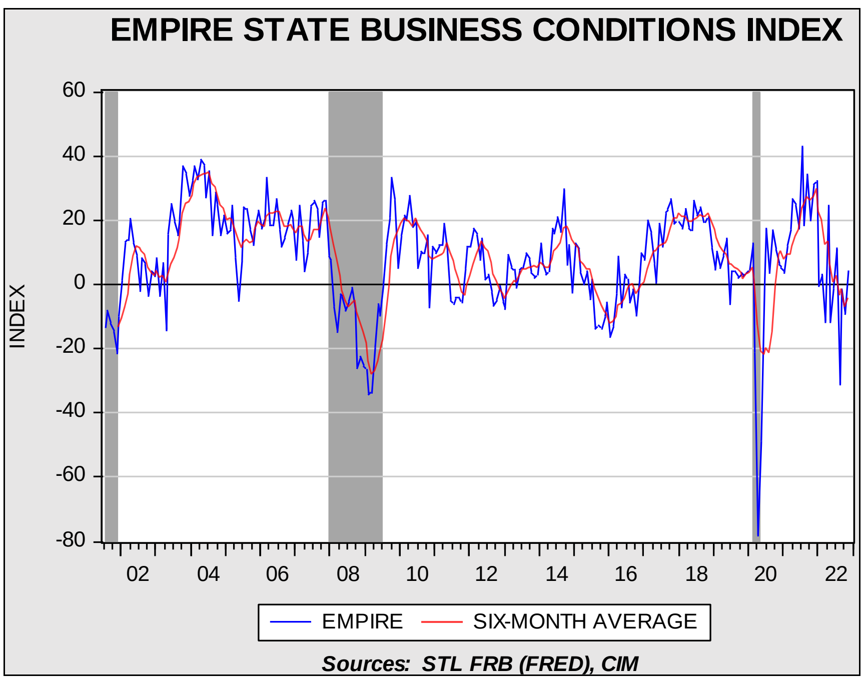
- An investigation by the *Financial Times* reveals that FTX had less than $1.0 billion in liquid assets backing $9.0 billion of liabilities. It has become clear that the company funded a large number of dubious crypto assets with little oversight, leading to lots of illiquid "assets."

- The FTX bankruptcy is in chaos, and the company could have up to one million creditors.
- The collapse of FTX has affected the regulatory agenda regarding crypto as those advocating a light touch are retreating, and it is likely that policymakers will develop a restrictive regulatory stance.
- Although there is the potential for systemic risks to the financial system, so far, we haven't seen signs of major stress.

A deal in Europe: The U.K. and France have a new arrangement to deal with migrants attempting to move to the U.K. Westminster will pay Paris $75 million to manage the migrant flows, an increase of $10 million from earlier agreements.

U.S. Economic Releases

Manufacturing activity in New York jumped unexpectedly last month. The Federal Reserve Bank of New York general business conditions index rose from -9.1 to 4.0 in November. The reading came in above consensus estimates of -6.0 and the contraction indicator of zero.

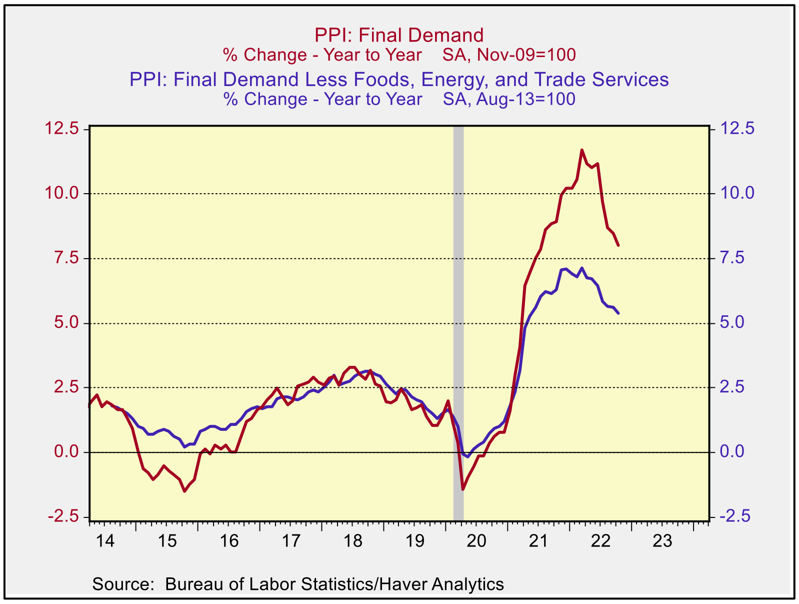


Sources: STL FRB (FRED), CIM

The chart above shows the general business conditions index and its six-month moving average. The moving average now sits at -4.58.

The increase in prices paid by producers for good and services slowed in October but remains elevated. According to an index tracked by the U.S Bureau of Labor Statistics, producer prices rose 8.0% from the previous year. The figure was below the consensus estimate of 8.3% and

September's increase of 8.5%. The elevated reading reflects the relatively high price of energy when compared to the same time last year. After excluding volatile food and energy prices, the producer price index rose 6.7% from prior year. The reading is below the consensus estimate of 7.2%.



The chart above shows the annual change in the headline and core PPI.

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

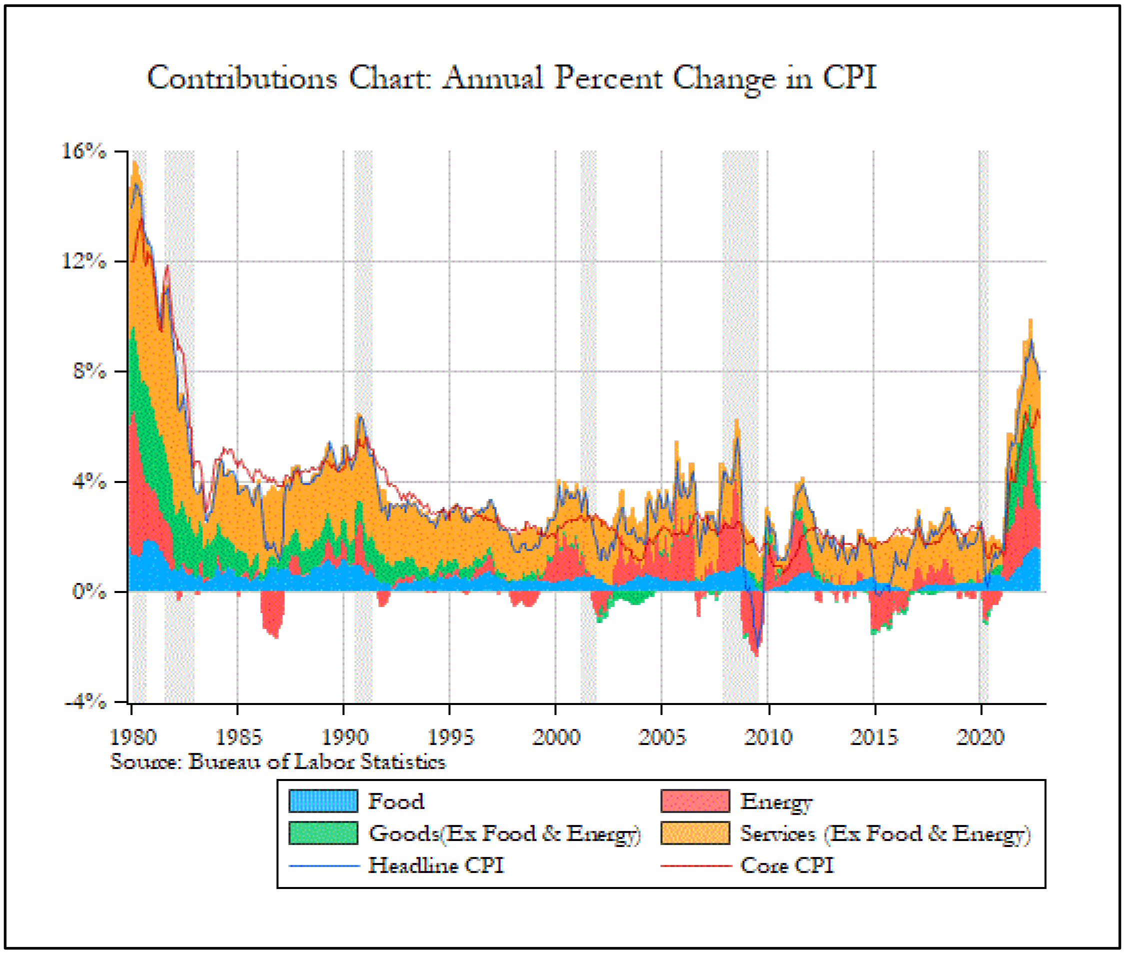
Economic Releases						
No economic releases for the rest of today						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
9:00	Patrick Harker Discusses Economic Outlook	President of the Federal Reserve Bank of Philadelphia				
9:00	Lisa Cook Discusses Post-Covid Challenges Facing Women	Member of the Board of Governors				
10:00	Michael Barr Speaks Before Senate Panel	Federal Reserve Board Vice Chair for Supervision				

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	GDP SA	q/q	3Q P	-0.3%	0.9%	1.1%	***	Equity bearish, bond bullish
	GDP Deflator	y/y	3Q P	-0.5%	-0.3%	-0.4%	***	Equity and bond neutral
	Industrial Production	y/y	Sep F	9.6%	9.8%		***	Equity and bond neutral
	Capacity Utilization	m/m	Sep	-0.4%	1.2%		**	Equity bearish, bond bullish
New Zealand	REINZ House Sales	y/y	Oct	-34.7%	-10.9%		**	Equity bearish, bond bullish
South Korea	Export Price Index	y/y	Oct	13.7%	15.2%	14.7%	*	Equity bullish, bond bearish
	Import Price Index	y/y	Oct	19.8%	24.1%	24.2%	*	Equity bullish, bond bearish
China	Industrial Production	y/y	Oct	5.0%	6.3%	5.3%	***	Equity and bond neutral
	Retail Sales	y/y	Oct	-0.5%	2.5%	0.7%	*	Equity bearish, bond bullish
India	Trade Balance	m/m	Oct	-$26.912b	-$25.710b	-$25.713b	*	Equity and bond neutral
	Exports	y/y	Oct	-16.6%	4.8%		**	Equity bearish, bond bullish
	Imports	y/y	Oct	5.7%	8.7%		**	Equity bearish, bond bullish
EUROPE								
Eurozone	GDP	y/y	3Q P	2.1%	2.1%	2.1%	***	Equity and bond neutral
	ZEW Survey Expectations	m/m	Nov	-38.7	-59.7		**	Equity bullish, bond bearish
	Trade Balance SA	m/m	Sep	-37.7b	-47.3b	-47.6b	**	Equity and bond neutral
Germany	ZEW Survey Expectations	m/m	Nov	-36.7	-59.2	-51.0	**	Equity bullish, bond bearish
	ZEW Survey Current Situation	m/m	Nov	-64.5	-72.2	-69.3	**	Equity bullish, bond bearish
France	CPI	y/y	Oct F	6.2%	6.2%	6.2%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Oct F	7.1%	7.1%	7.1%	**	Equity and bond neutral
UK	Claimant Count Rate	m/m	Oct	3.9%	3.90%		**	Equity and bond neutral
	Jobless Claims Change	m/m	Oct	3.3k	25.5k	3.9k	**	Equity and bond neutral
	Average Weekly Earnings 3M	m/m	Sep	6.0%	6.00%	6.10%	**	Equity and bond neutral
AMERICAS								
Canada	Manufacturing Sales	m/m	Sep	0.0%	-2.0%	-1.9%	**	Equity bullish, bond bearish
	Wholesale Trade Sales	m/m	Feb	0.1%	1.4%	1.9%	**	Equity bearish, bond bullish

Charts Worth Noting



The annual change in U.S. consumer prices slowed more than expected in October, raising hopes that the Fed could soon curb its tightening cycle. According to the Bureau of Labor Statistics, the overall Consumer Price Index rose 7.7% from the previous year, which is lower than the consensus estimate of 7.9% in the same period. A steep deceleration drove this decline in the inflation rate in energy and goods prices. That said, core CPI, which excludes energy and food prices, has risen 6.3% since October 2021. Although the overall price levels eased up last month, transportation and shelter prices are still accelerating. Going into the year's final month, we anticipate core inflation to fall just below 6% in December.

The sharp decline in inflation will encourage the Fed to slow the pace of its hike; however, pivot bets are likely premature. Recent remarks from Fed officials support this view. Last week, Cleveland Fed President Loretta Mester insisted that the policy rate will need to be more restrictive for longer despite a favorable CPI report. Several other Fed officials mirrored her sentiment. Although the market has priced in a 25 bps hike for December, it is still possible that the Fed will raise rates by 50 bps. Hence, the market could be hit with a negative surprise at the next Federal Open Market Committee meeting.

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)	461	465	-4	Up
3-mo T-bill yield (bps)	403	409	-6	Up
TED spread (bps)	58	56	2	Widening
U.S. Sibor/OIS spread (bps)	424	423	1	Up
U.S. Libor/OIS spread (bps)	428	427	1	Up
10-yr T-note (%)	3.81	3.86	-0.05	Up
Euribor/OIS spread (bps)	179	176	3	Neutral
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Up			Down
Pound	Up			Down
Franc	Up			Up

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.

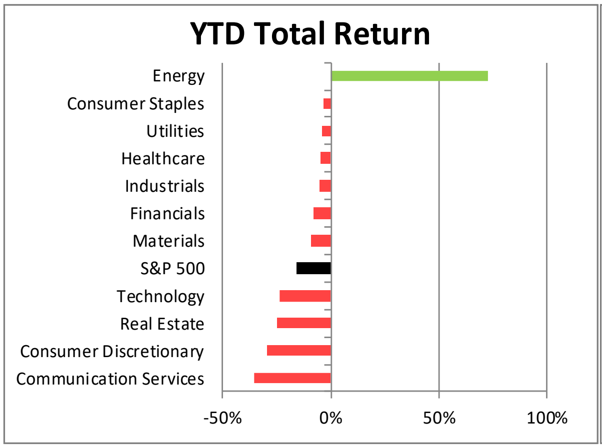
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$92.51	$93.14	-0.68%	
WTI	$85.12	$85.87	-0.87%	
Natural Gas	$6.05	$5.93	1.92%	
Crack Spread	$35.08	$35.08	0.01%	
12-mo strip crack	$32.22	$32.28	-0.20%	
Ethanol rack	$2.83	$2.85	-0.86%	
Metals				
Gold	$1,775.41	$1,771.40	0.23%	
Silver	$21.89	$21.98	-0.41%	
Copper contract	$381.90	$382.75	-0.22%	
Grains				
Corn contract	$655.75	$659.25	-0.53%	
Wheat contract	$826.25	$838.25	-1.43%	
Soybeans contract	$1,432.75	$1,440.50	-0.54%	
Shipping				
Baltic Dry Freight	1,325	1,355	-30	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.7		
Gasoline (mb)		-0.4		
Distillates (mb)		-1.0		
Refinery run rates (%)		0.3%		
Natural gas (bcf)		80		

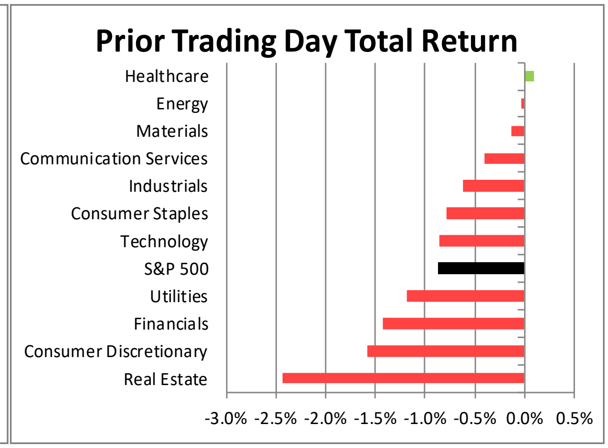
Weather

The 6-10 and 8-14 day forecasts currently call for a deep cold snap throughout the entire country, with warmer-than-normal temperatures moving in from West toward the end of the forecast period. Wetter-than-normal conditions are anticipated in the Pacific Northwest and the Southeast, with dry conditions expected in the Midwest, Southwest, and New England.

Data Section

U.S. Equity Markets – (as of 11/14/2022 close)

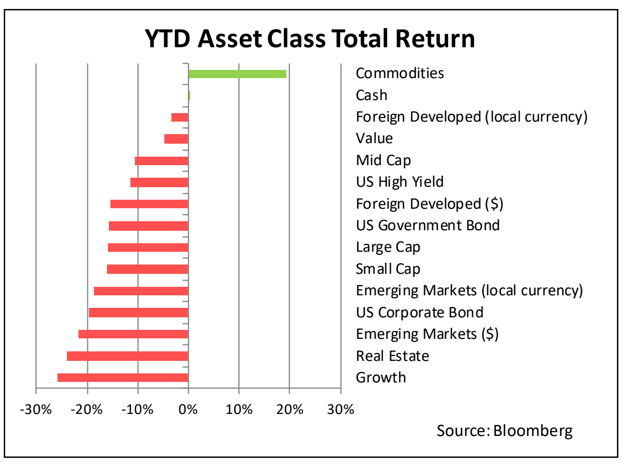




(Source: Bloomberg)

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 11/14/2022 close)

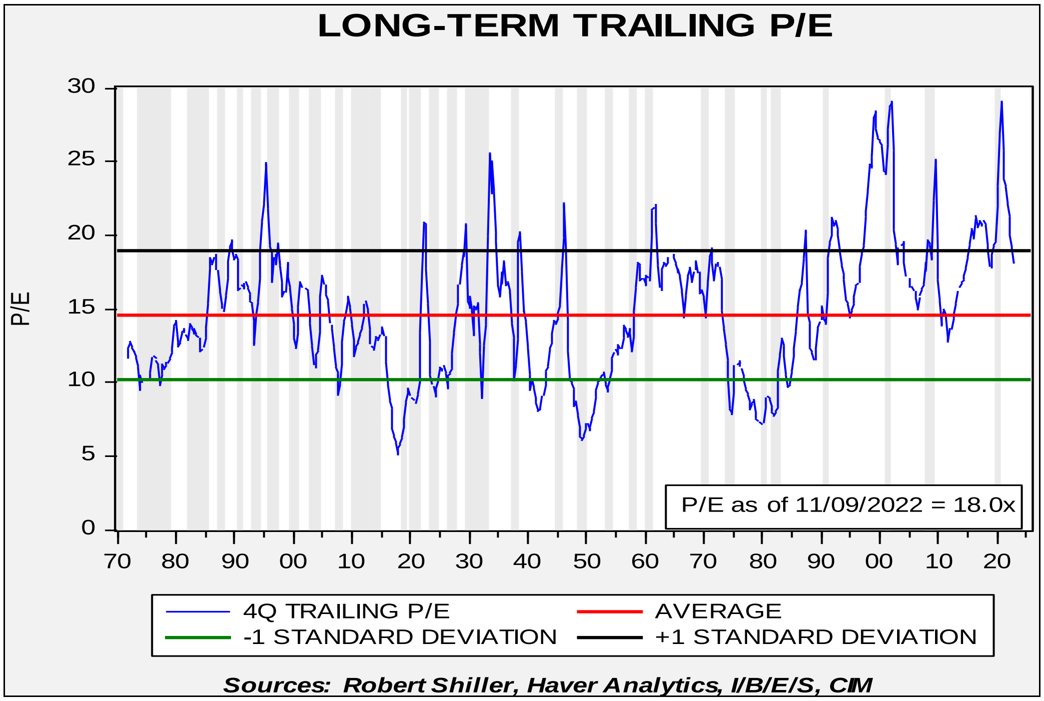


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 10, 2022



Based on our methodology,[1] the current P/E is 18.0x, unchanged 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 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.