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 28, 2022—9:30 AM EST] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is currently down 0.7% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.7%. Chinese markets were also down, with the Shanghai Composite closing down 0.8% from its prior close and the Shenzhen Composite closing down 0.5%. U.S. equity index futures are signaling a lower open.

With 483 companies having reported so far, S&P 500 earnings for Q3 are running at $56.40 per share, compared to estimates of $55.45. Of the companies that have reported thus far, 69.6% have exceeded expectations while 24.4% 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 12.
- *Weekly Energy Update* (11/17/2022): In this week's report we discuss Iran's increasingly reckless behavior. We also note the upcoming changes to Europe's oil purchases from the EU on December 5. As usual, we recap major stories and last week's data. Due to the upcoming holiday, our next report will be published December 1.
- *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" Due to the upcoming holiday, our next report will be published December 5.
- *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

Our *Comment* today opens with an update on the Russia-Ukraine war, including more evidence that the Russians are expecting a robust Ukrainian counterattack on the east side of the Dnipro River. We next review a wide range of other international and U.S. developments with the potential to affect the financial markets today, including news of mass anti-government protests in China that have sparked fears of new, draconian political crackdowns and even worse headwinds for the Chinese and global economies.

Russia-Ukraine: Now that the Ukrainians have pushed the Russian invasion forces from the western side of the Dnipro River and are continuing to probe the eastern side, the Russian forces are apparently assuming that the Ukrainians will soon attack in force on the eastern side. They are therefore attempting to build trenches and other fortifications to at least delay a Ukrainian advance toward Crimea. Meanwhile, the Russians continue to attack toward the city of Bakhmut in the northeastern Donbas region of Ukraine, with little success so far.

- The Russians are continuing to stage artillery, missile, and kamikaze drone attacks against Ukraine's civilian power and water infrastructure in an apparent effort to freeze the population into submission. However, Ukrainian authorities claim they are quickly repairing much of the infrastructure and bringing it back online, raising the question of whether the Russians are wasting their dwindling ammunition supplies on a lost cause.

- Separately, the European Union on Wednesday failed to agree on the price at which to cap Russian oil sales in order to reduce the amount of funding Moscow has available to prosecute the war. Consistent with a recent G7 agreement, most EU members were prepared to cap the price at between $65 and $70 per barrel, but Poland held out for a much lower $30 per barrel to turn the screws even harder on Russia.

Global Oil Market: U.S. regulators stated that they would allow Chevron (CVX, $183.70) to resume pumping crude oil from its Venezuelan fields after the Socialist government and an opposition coalition agreed on a humanitarian relief program and continued dialogue on efforts to hold free and fair elections. Improved access to the resources and expertise of Chevron could help it modestly boost production and exports going forward, which the Biden administration hopes will help bring down prices.

European Union: EU Commission President von der Leyen issued an unexpectedly harsh judgment that Hungary has failed to adopt promised rule-of-law reforms and therefore has no right to €7.5 billion in regular EU funding and €5.8 billion in pandemic recovery grants that have been temporarily frozen over the issue. She did recommend approving Hungary's plan to spend the recovery funds if they are ultimately released, but only if Hungary now meets an expanded list of 27 reforms.

- The EU's College of Commissioners will formalize the decision next week, after which the Council of the EU (consisting of national representatives) will have to approve it by qualified majority (55% of the EU countries and 65% of its population).
- Naturally, the decision will anger Hungarian Prime Minister Viktor Orbán. As he has done in the past, he will likely retaliate by holding up EU decisions that require a unanimous vote of all countries, including votes on new sanctions against Russia. Brussels' ongoing rule-of-law disputes with Poland and Hungary threaten to undermine the EU's cohesion and hamstring its decisionmaking in the coming months.

European Union-United States: EU trade ministers meeting on Friday warned that there is a rising risk of a trans-Atlantic trade war over the U.S.'s newly passed Inflation Reduction Act, which provides some $369 billion in subsidies for domestically-made high-technology products beginning in 2023. Along with the U.S.'s better supplies of energy and labor, those subsidies have already prompted a number of major European companies to re-channel future investment plans out of the EU and into the U.S. That is further irritating European leaders who see the U.S. as profiteering from the war in Ukraine by selling immense amounts of natural gas and weaponry to EU nations.

- Some EU members, such as France, have called for Brussels to replicate the U.S. act with a "buy European" subsidy regime of its own. German Economy Minister Habeck has also suggested increased subsidies. However, EU Trade Commissioner Dombrovskis, some other EU national leaders, and many economists oppose a big subsidy program on grounds that it would be exceedingly expensive and lead to economic distortions. They also fear that competing subsidy programs would amount to a "trade war" that would hurt EU-U.S. ties.

- However, we note that the Biden administration, to date, hasn't been warning the EU against such a program. Indeed, early in November U.S. Trade Representative Tai called on the EU to step up support for its manufacturers and reduce its reliance on China for strategically important products in the process. As we reported in our *Comment* at the time, Tai suggested that Brussels should jointly develop a new industrial policy alongside the U.S. to counter China's rising geopolitical threat. This suggests that the Biden administration is actually pushing for a broad industrial policy to support key technology companies wherever they may be in the evolving U.S.-led geopolitical bloc.

Iran: As anti-government protests continue, especially in eastern Iran, the commander of the Islamic Revolutionary Guard Corps traveled to Sistan-Baluchistan's capital of Zahedan, where he threatened more crackdowns and alleged that the protesters were being manipulated by foreign powers. The protests continue to threaten social stability and the government's hold on power.

China: The latest wave of COVID-19 pushed many local governments to impose further lockdowns, sparking mass protests against the government across the country. Although it now appears that the government has taken control of the situation and suppressed the protests, there is no denying the fact that they were big enough to threaten the social stability and political power that President Xi prizes so dearly. The lockdowns and protests are also weighing heavily on stocks, commodities, and other risk assets so far this morning. Interestingly, the dollar is also down today as investors continue to focus on a hoped-for slowing in the Federal Reserve's interest-rate hikes.

- To address the weakening economy, on Friday the People's Bank of China announced a cut in the bank reserve requirement ratio to 7.8%, down 25 basis points from the previous RRR and roughly in line with expectations. The modest cut, which will take effect December 5, will mean that banks can lend roughly $70 billion more than before.
- The small boost to banks' lending capacities will probably have only a very modest positive impact on Chinese economic prospects this winter. Along with weakening foreign demand and President Xi's crackdowns on key parts of the private sector, the latest COVID-19 lockdowns and resulting protests are expected to be a big headwind to Chinese economic growth in the coming months.

United States-China: On Friday, the U.S. Federal Communications Commission voted 4-0 to ban the marketing or importing of new telecom and surveillance equipment made by several Chinese companies, based on national security concerns. The ban affects a number of Chinese telecom heavyweights that were already under restrictions, such as Huawei, ZTE (000063.SZ, CNY, 23.94), and Hangzhou Hikvision (002415.SZ, CNY, 30.90). The order doesn't require U.S. equipment buyers to remove items that they have already purchased, nor does it remove authorizations for electronics models that already exist. However, it apparently does allow the FCC to take those steps in the future.

- The FCC action is the latest U.S. move aimed at thwarting China's strategy of using advanced telecom technology to carry out mass spying on U.S. citizens, conduct secret influence campaigns in the U.S., and sabotage critical U.S. infrastructure in times of conflict. Illustrating the seriousness of the issue, the move is the first ever in which the FCC has voted to prohibit the authorization of new equipment on national security grounds.

- The FCC's move comes on the heels of the administration's draconian new restrictions on semiconductor technology exports and services to China, the recent Congressional hearings into the national security implications of Chinese social media app TikTok, and a broader range of barriers against Chinese imports that began under the Trump administration. Together, the never-ending rise of U.S. restrictions show how the U.S. government, with strong bipartisan support, is taking ever-tougher steps to constrain China's ability to compete with the U.S. and its bloc. Naturally, that presents ongoing regulatory risks for Chinese assets.

U.S. Economy: Reports suggest that the traditional kick-off to the holiday shopping season on Friday started off relatively well, with a further rebound in store traffic and continued gains in online buying. According to shopping data firm RetailNext, store visits on Black Friday were up about 7% from the previous year. However, there are also signs that consumers are exercising caution in the face of rising prices and interest rates. The same report showed in-store sales rose just 0.1%, and the average shopper spent less per visit than last year.

U.S. Housing Market: Real estate analysts report that as home prices remain high and interest rates continue to surge, more individuals who had hoped to buy are now renting single-family homes instead. The trend is creating new opportunities for larger developers and real estate funds that are pivoting toward building and buying more single-family homes to rent.

U.S. Economic Releases

There were 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**
10:30	Dallas Fed Manufacturing Activity	m/m	Jan	73.2	73.2	**
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
11:30	John Williams Speaks to The Econimic Club of New York	President of the Federal Reserve Bank of New York				
14:45	James Bullard Takes Part in MarketWatch Live Event	President of the Federal Reserve Bank of St. Louis				

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	Retail Sales	y/y	Oct	-0.2%	0.6%	5.0%	**	Equity bearish, bond bullish
China	Industrial Profits	y/y	Oct	-3.0%	-2.3%		***	Equity bearish, bond bullish
EUROPE								
Eurozone	M3 Money Supply	y/y	Oct	5.1%	6.3%	6.1%	***	Equity bearish, bond bullish
Germany	GDP NSA	y/y	Q3 F	1.2%	1.1%	1.1%	**	Equity and bond neutral
	GDP WDA	y/y	Q3 F	1.3%	1.2%	1.2%	**	Equity and bond neutral
	GfK Consumer Confidence	m/m	Dec	-40.2%	-41.9%	-39.6%	**	Equity and bond neutral
France	Consumer Confidence	m/m	Nov P	83.0	82.0	82.0	**	Equity and bond neutral
Italy	Consumer Confidence	m/m	Nov	98.1	90.1	91.0	***	Equity bullish, bond bearish
	Manufacturing Confidence	m/m	Nov	102.5	100.4	100.7	***	Equity bullish, bond bearish
	Economic Sentiment	m/m	Nov	106.4	104.5	104.7	**	Equity bullish, bond bearish
Switzerland	Domestic Sight Deposits CHF	w/w	25-Nov	523.0b	524.4b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	25-Nov	555.4b	562.1b		*	Equity and bond neutral
Russia	Money Supply, Narrow Definition	w/w	18-Nov	15.83t	15.79t		*	Equity and bond neutral
AMERICAS								
Mexico	GDP NSA	y/y	3Q F	4.3%	4.2%	4.1%	***	Equity and bond neutral
	Economic Activity IGAE	y/y	Sep	5.16%	5.59%	4.90%	**	Equity bullish, bond bearish
	Trade Balance	m/m	Oct	-$2.012b	-$895.4m	-$2.122b	**	Equity and bond neutral
Brazil	Total Outstanding Loans	m/m	Oct	5215b%	5177b	5161b	**	Equity and bond neutral
	Current Account Balance	m/m	Oct	-$4.625b	-$5.678b	-$7.120b	**	Equity and bond neutral
	Foreign Direct Investment	m/m	Oct	$5.541b	$9.185b	$6.700b	**	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)	473	474	-1	Up
3-mo T-bill yield (bps)	417	419	-2	Up
TED spread (bps)	56	55	1	Widening
U.S. Sibor/OIS spread (bps)	439	439	0	Up
U.S. Libor/OIS spread (bps)	442	442	0	Up
10-yr T-note (%)	3.68	3.68	0.00	Up
Euribor/OIS spread (bps)	192	191	1	Neutral
Currencies	**Direction**			
Dollar	Down			Down
Euro	Up			Up
Yen	Up			Flat
Pound	Down			Up
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.

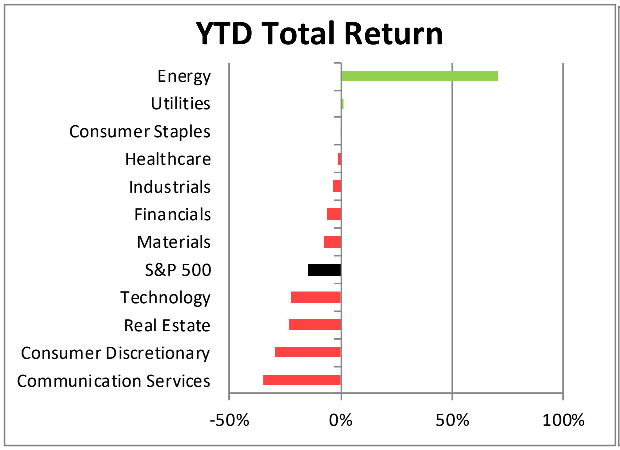
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$81.16	$83.63	-2.95%	
WTI	$74.14	$76.28	-2.81%	
Natural Gas	$6.61	$7.02	-5.88%	Supply Optimism
Crack Spread	$32.85	$31.39	4.65%	
12-mo strip crack	$30.56	$29.47	3.68%	
Ethanol rack	$2.67	$2.67	0.01%	
Metals				
Gold	$1,752.41	$1,754.93	-0.14%	
Silver	$21.33	$21.75	-1.90%	
Copper contract	$360.80	$363.05	-0.62%	
Grains				
Corn contract	$668.25	$671.25	-0.45%	
Wheat contract	$787.50	$797.00	-1.19%	
Soybeans contract	$1,433.25	$1,436.25	-0.21%	
Shipping				
Baltic Dry Freight	1,324	1,242	82	

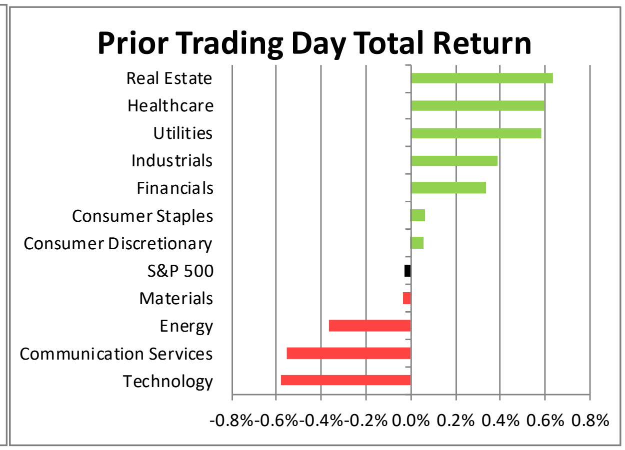
Weather

The 6-10 and 8-14 day forecasts call for cooler-than-normal temperatures expected to move from the Pacific and Rocky Mountain regions toward the Midwest, and warmer-than-normal temperatures for the rest of the country. Wet conditions are expected for most of the country, with dry conditions expected throughout Florida.

Data Section

U.S. Equity Markets – (as of 11/25/2022 close)

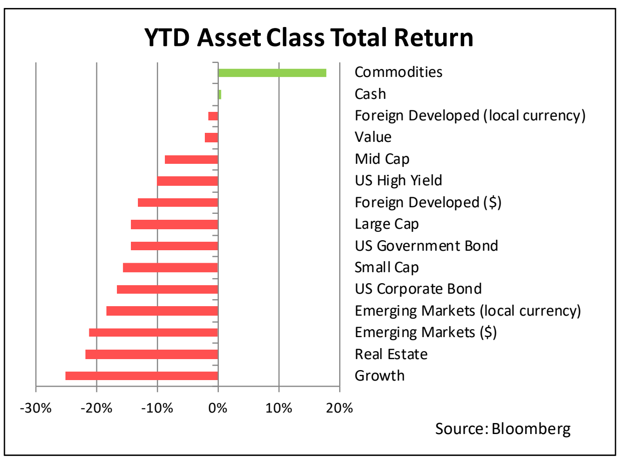




(Source: Bloomberg)

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 11/25/2022 close)

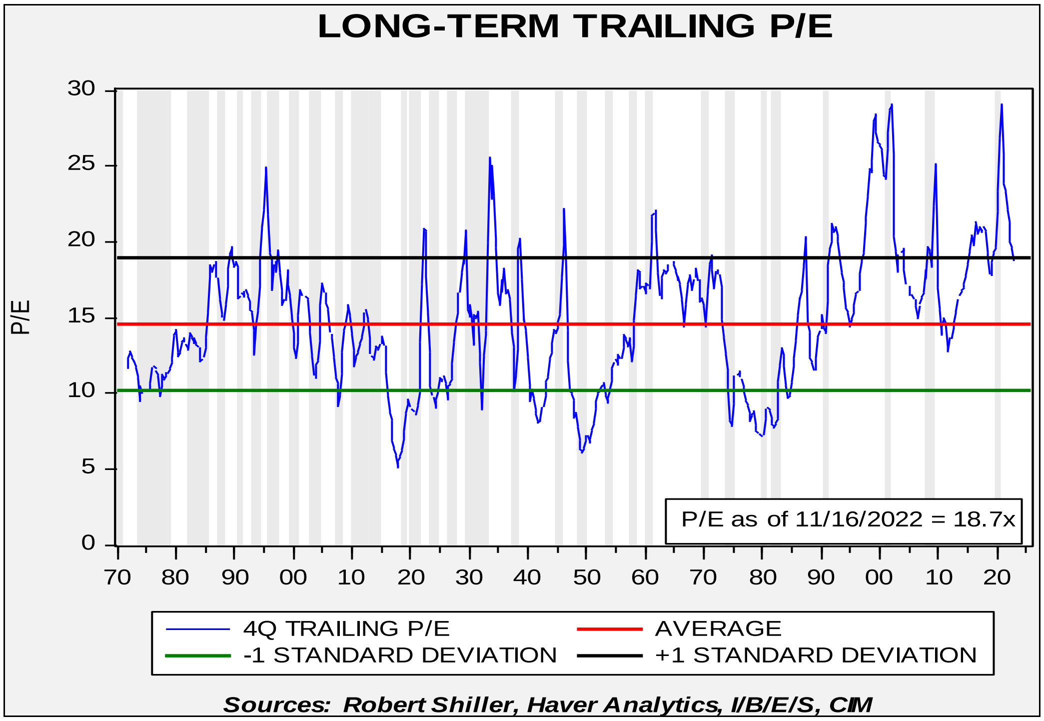


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 17, 2022



Based on our methodology,[1] the current P/E is 18.7x, up 0.7x from last week. The primary reason for the rise in the multiple is the switch from Thomson/Reuter's calculation of earnings for Q3 to that of Standard and Poor's. There are periods where the two series diverge, and this quarter was one of them.

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 three actual quarters (Q1, Q2 and Q3) and one estimate (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.