Daily Comment

By Patrick Fearon-Hernandez, CFA, and Thomas Wash

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[Posted: October 13, 2022—9:30 AM EDT] Global equity markets were higher but those opens have reversed sharply on the U.S. CPI data (see below). In Europe, the Euro Stoxx 50 is currently down 1.9% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.1%. Chinese markets were mixed, with the Shanghai Composite down 0.3% from its prior close and the Shenzhen Composite up 0.3%. U.S. equity index futures are signaling a sharply lower open.

For Q3 S&P 500 earnings, current earnings are $56.10 per share compared to estimates of $55.45. Of the 20 companies reporting thus far, 65% have exceeded expectations while 25% have not.

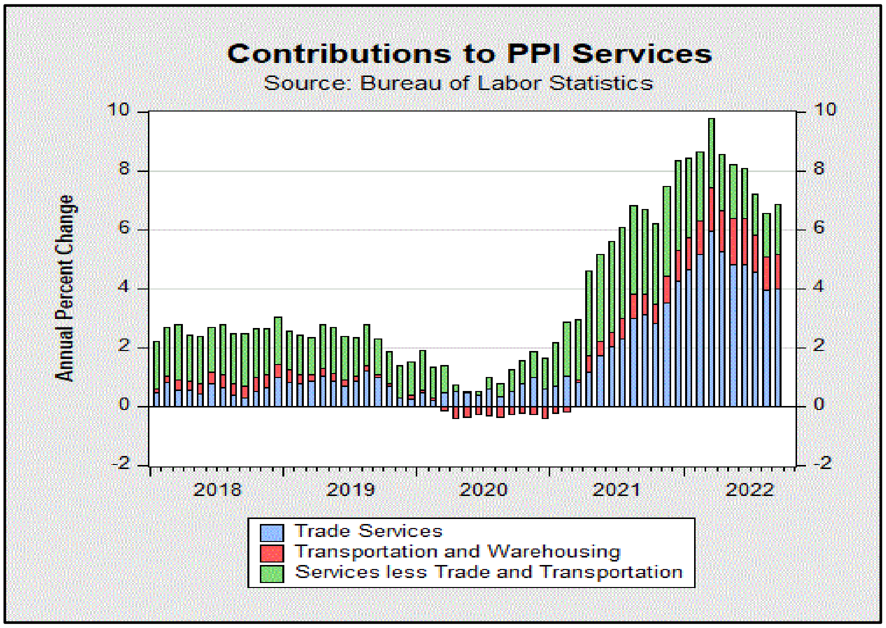
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (10/10/2022) (with associated podcast) "Europe's New Right-Wing Leaders"
- *Weekly Energy Update* (10/6/2022): **This week's report is delayed a day due to Monday's holiday. It will be published on Friday.**
- *Asset Allocation Quarterly – Q3 2022* (7/19/2022): Discussion of our asset allocation process, Q3 2022 portfolio changes, and our outlook for the markets
- *Asset Allocation Q3 2022 Rebalance Presentation* (8/4/2022): Video presentation featuring the Asset Allocation Committee as they review our asset allocation strategies, recent portfolio changes, and the current macro environment
- *Asset Allocation Bi-Weekly* (10/3/2022) (with associated podcast): "The Gold Paradox"
- *Confluence of Ideas* podcast (8/9/2022): "The 2022 Outlook: Update #2"
- *Current Perspectives*: "2022 Outlook: Update #2 – The Tails Become Fatter" (7/12/2022)
- *Charts Worth Noting (10/12/22)*: The Beveridge Curve graphs the relationship between the level of unemployment and job vacancies.

Good morning and happy CPI day! U.S. equity futures were moving higher in front of the report, and we will cover the CPI numbers in detail below, but in short, they were bad, leading to a sharp reversal in equity futures. Our coverage begins with Economics and financial news, with a deep dive into the Fed Minutes. Up next is China news as the U.S. is cracking down on technology transfers. War coverage follows and we close with the international news roundup.

Economics and Finance: The Fed Minutes offer some insight into the bank's thinking.

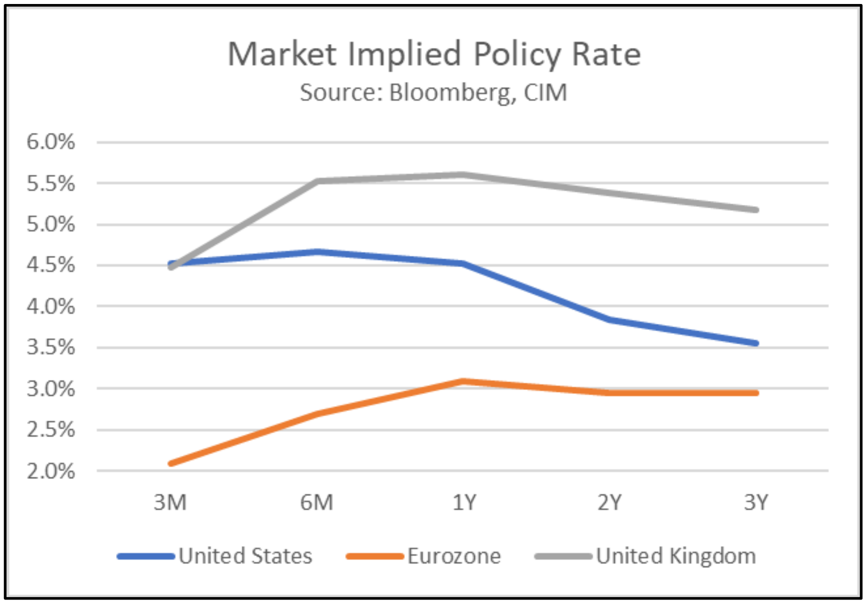
- The September FOMC minutes revealed that the Federal Reserve favors hefty rate hikes, but we are starting to see some concern emerging about overdoing it. Although the report showed that supply chains are improving, officials are worried that the pace of increases in goods prices is still elevated. The persistent pick up in goods inflation has led some members of the committee to take a look at firms' profits. Wholesale and retail margins, referred to as trade services below, is the largest contributor to producer services inflation.



- Central bankers across the world are plowing ahead with tight monetary policy regardless of the economic impact. Minnesota Fed President Neel Kashkari warned against bets in favor of a Fed pivot, stating that the bar is very high given the level of inflation. In the U.K., officials from the Bank of England signaled that rates are likely to rise sharply and announced plans to end its bond-buying program on Friday. Lastly, the European Central Bank President Christine Lagarde dismissed speculation that the EU is in recession in a sign that the bank plans to forge through with additional rate hikes. Tightening financial conditions will hurt risk assets and slow the global economy.
- One of the complicating factors for the Fed is that labor markets remain tight. A factor driving this situation could be a condition called "labor hoarding." For the past four decades, firms treated workers as expendable; the entire gig working industry is essentially built on an idea that a firm can call on labor only when needed. As the labor force growth slows, firms are finding that it has become difficult to fill positions, leading companies to hold on to workers even as economic activity slows. If the Fed doesn't take this situation into account, it may lead the FOMC to overestimate the economy's strength and overtighten.

- One way to resolve the lack of labor force growth is through immigration. We note that the U.S. is planning to issue the maximum legal level of H-2B visas.

- Hawkish central banks have added to the debt burden of emerging market countries. Most emerging markets rely on foreign debt due to their favorable interest rates. However, as the central banks have raised their benchmark interest rates, investors are pushing up borrowing costs to compensate for the additional risk. The problem will likely get worse as the global economy begins to slow. To prevent an emerging market debt crisis, the International Monetary Fund is trying to rework the debt for developing countries, but it would like China to participate in the restructuring. The risk of an emerging market debt crisis is elevated especially as Beijing continues to drag its feet on negotiations.



- Tomorrow, the BOE says it will halt its bond buying, which has led pension funds to increase selling to build liquidity. As we noted earlier in the week, central banks are facing the Tinbergen problem of not having enough policy tools for the problems they face. Specifically, if central bankers prioritize financial stability, then inflation will rise while if they instead fight inflation, then financial risks increase. We note that there are rumors that the Truss government is considering backing away from some of its fiscal expansion policy, which may be enough to give the BOE some room.

- The IMF warns that there is a 10% risk of negative global GDP growth next year.

- Although we will cover the information in more detail in tomorrow's *Weekly Energy Update*, OPEC+ has cut its global demand forecast for oil, which is probably why it made its controversial output cuts. In its monthly report, the IEA warned that OPEC+'s actions could trigger a global recession.

- Japan's bond market traded today for the first time in five days. Yield-curve control has made actual trading just about non-existent.

- Florida's orange crop is set to be the smallest since WWII. Hurricane Ian contributed to the small crop.

The Ukraine War: Sensing weakness, NATO ramps up its support for Ukraine against Russia, while Moscow gets a needed break on oil.

- Western countries pledged more military equipment to Ukraine and new penalties to curtail Russia's revenue generation. The new ammunition will allow Ukraine to defend itself from retaliatory attacks from Russia. New reports suggested that Russia has targeted 40 Ukrainian cities with missiles. Meanwhile, the new penalties will likely be an alternative way to punish Russia after OPEC+ cuts have put price caps at risk.
    - The latest developments in Ukraine suggest that the war is not close to being over; however, there does seem to be hope for de-escalation. Russian President Vladimir Putin offered to resume gas supplies through Nord-Stream 2. The plan was quickly denied by Berlin, who fears that the move would come at the expense of Ukraine.
- The IMF warned that Ukraine would need $3 billion a month in 2023 to fund its debt obligation. The war-torn country has not been able to run its government without additional aid from the West.
- Putin is pressing Belarus to join the war. We doubt President Lukashenko wants to join this war and it isn't obvious if Belarusian troops would be effective, but, it may draw some Ukrainian forces to guard its northern border.
- Winter offensives are difficult. Cold weather complicates armor operations and soldiers must fight both the weather and the enemy. Thus, there have been expectations that the pace of operations will slow as winter sets in. However, Lloyd Austin, the U.S. Secretary of Defense, indicated that the offensive would continue through the winter.
- Russia has formally blamed Ukraine for the Crimea bridge attack.

China News: The U.S. increases pressure on China's semiconductor industry.

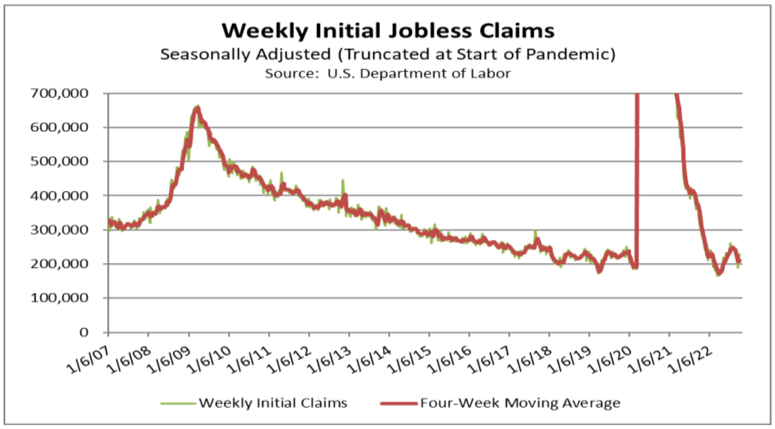
- In the wake of new U.S. restrictions on semiconductor equipment sales to China, the chip toolmakers announced the suspension of equipment sales. There have been some exemptions granted, but only for a year. We also note that the FCC is likely to ban all new sales of Huawei (002502, CNY, 3.10) and ZTE (ZTCOF, $1.79) equipment in the U.S. Although complete isolation isn't likely possible, supply chain disruption is clearly underway.
- After a long delay, the Biden administration did issue its National Security Strategy. The document makes it clear that China and Russia are its main focus.

International Roundup: There is flooding in Nigeria, and Orbán gets shunned.

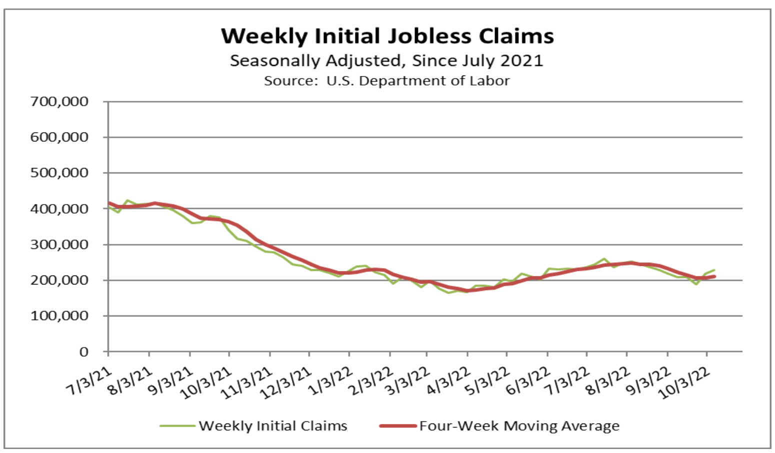
- Massive flooding in southern Nigeria has killed at least 500 and displaced 1.4 million people. Disruptions to agriculture and energy production are likely.
- Germany made it clear it isn't pleased with Hungary's actions.

U.S. Economic Releases

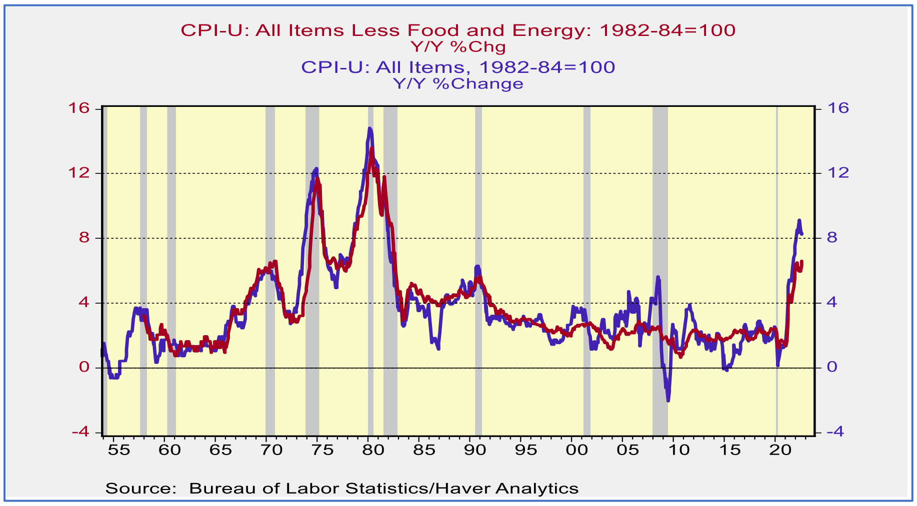
Initial applications for unemployment benefits in the week ending October 8 rose to a seasonally adjusted 228,000, somewhat above the expected level of 225,000 and significantly higher than the prior week's 219,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 211,500. The number of people continuing to draw benefits in the week ending October 1 rose to 1.368 million, above the expected level of 1.365 million, which was also the previous week's revised level. The chart below shows how initial jobless claims have fluctuated since just before the prior recession. The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



To provide more detail on recent trends, the chart below shows how initial jobless claims have changed just since mid-2021.

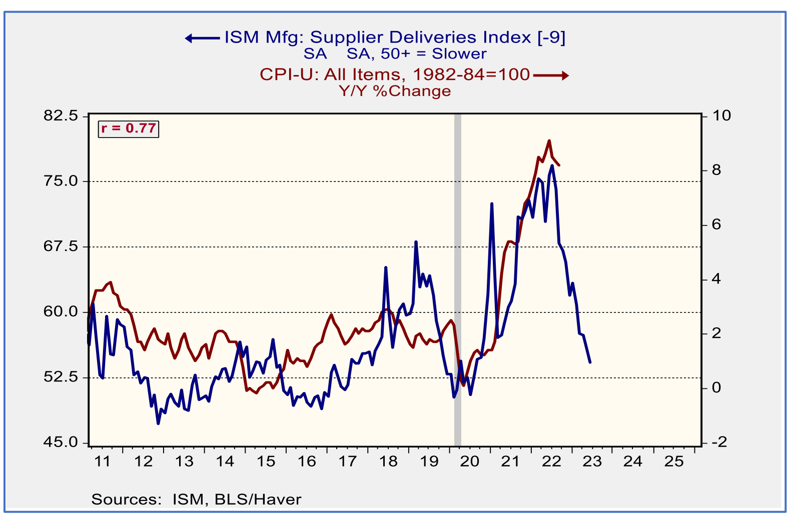


The September consumer price index (CPI) rose by a seasonally adjusted 0.4% compared to expectations of a 0.2% rise. Excluding the volatile food and energy components, the "core" CPI rose 0.6% versus expectations of a 0.4% increase. The overall CPI in September was up 8.2% from the same month one year earlier compared to an 8.1% forecast, while the core CPI was up 6.6% versus expectations of a 6.5% increase. The following chart shows the year-over-year change in the CPI and the core CPI since 1980.

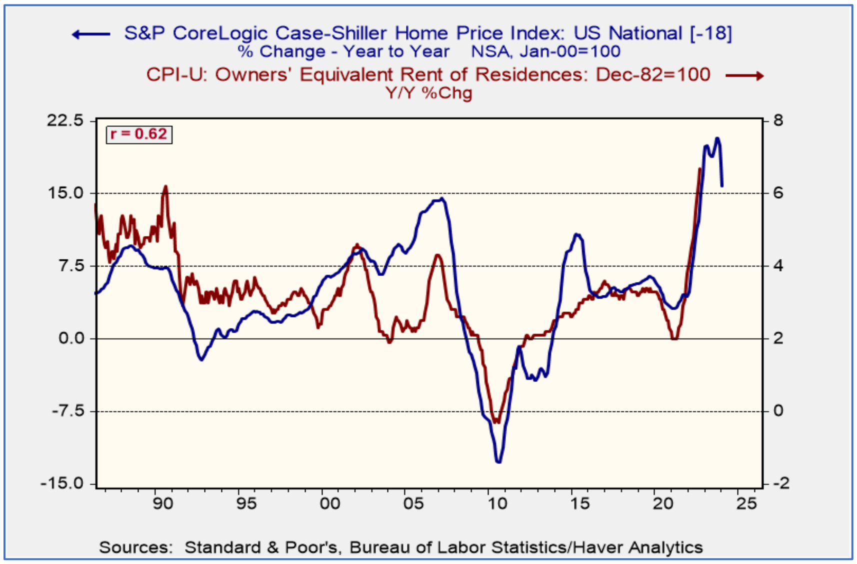


Although a case can be made that overall CPI has peaked, the rise in core is especially troubling, given that the core index is the most relevant toward monetary policy. In some of the details, food prices remain elevated, up 11.2% from last year. In terms of food, carnivores are benefiting because meat prices are up 9.0%, down from the recent peak of 14.3%. On the other hand, vegans are seeing fruit and vegetable prices up 10.4%, marking a new cycle peak. Restaurant food is continuing to tick higher, up 8.5% from last year, a new cycle high. Gasoline prices are up 18.2% from last year, but well below the 59.9% rise seen in June. Natural gas prices are up 33.1% from last year. Used car prices rose 7.2%, the smallest increase since August 2020. New car prices rose 9.4%, down from April's peak of 13.2%. Perhaps the most disturbing part of the report is shelter prices as rents are up 7.2% to a new cycle peak and owner-equivalent rent is up 6.7%, also a new cycle peak. Air fares rose 42.9%, a new cycle peak.

Is there any hope on the horizon? Some, but improvement will likely be slow. The ISM Manufacturing Supplier Delivery Index tends to lead CPI by about nine months and does suggest improvement.

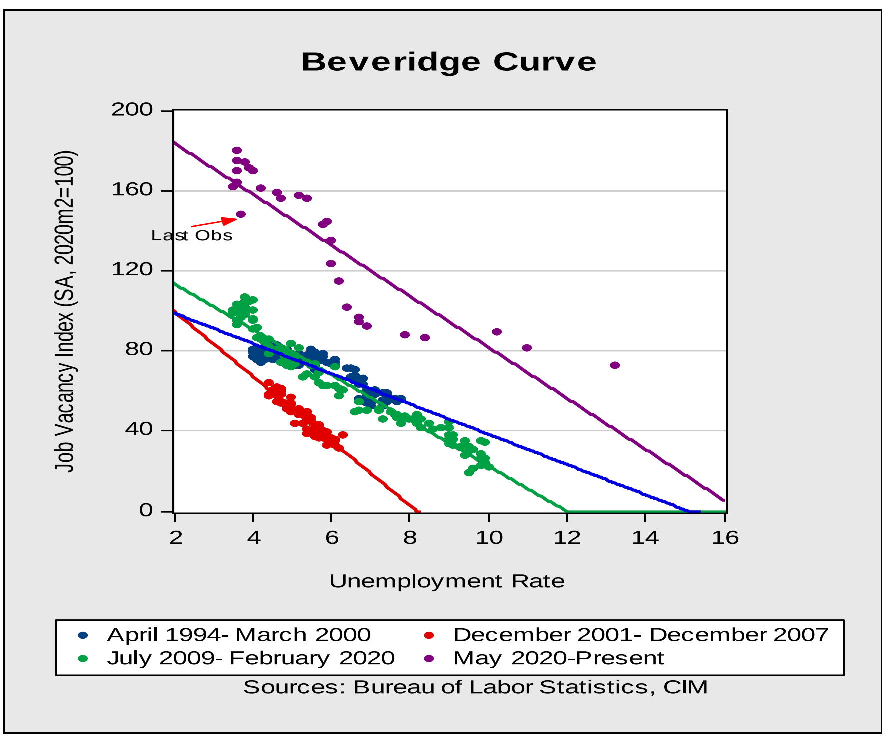


At the same time, home prices suggest that we won't see the effect of high residential real estate prices filter through for another year.



These charts suggest that the FOMC will continue to hike rates.

Charts Worth Noting



The job market may finally be showing signs of loosening up. The latest JOLTS report showed that job openings fell to their lowest level since July 2020. The significant drop in available jobs reflects firms' weakening labor demand, a desired goal of the Federal Reserve. Although it is too soon to tell whether the drop in openings represents a broader trend, the decline in hires has raised hopes for a Fed pivot.

The chart above shows the Beveridge Curve of the last four business cycles. The curves graph the relationship between the level of unemployment and job vacancies with the lines representing the underlying trend for each of the shown expansions. The points located in the upper right hand of the chart show a tight labor market, while the lower left hand represents a loose labor market. Job postings dipped below trend for the second consecutive month in August.

Fed Governor Waller has suggested that a decline in openings, rather than absolute unemployment, could ease wage pressures and eventually reduce inflation. Although the historical record does not support this assertion, there is hope that the FOMC could achieve a soft landing by a decline in openings rather than layoffs. Thus, last month's drop in openings is part of an experiment to see if openings, as opposed to unemployment, may allow the FOMC to slow the economy without a recession.

There are no further economic releases and/or Fed events scheduled for the rest of 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	Core Machine Orders	y/y	Aug	9.7%	12.8%	9.7%	**	Equity and bond neutral
	Machine Tool Orders YoY	y/y	Sep P	4.3%	10.7%		**	Equity bearish, bond bullish
New Zealand	REINZ House Sales	y/y	Sep	-10.9%	-18.3%		**	Equity bullish, bond bearish
China	New Yuan Loans	m/m	Sep	2.470t	1.250t	1.800t	**	Equity and bond neutral
	Money Supply M0	y/y	Sep	13.6%	14.3%	14.0%	*	Equity and bond neutral
	Money Supply M1	y/y	Sep	6.4%	6.1%	6.4%	*	Equity and bond neutral
	Money Supply M2	y/y	Sep	12.1%	12.2%	12.1%	***	Equity and bond neutral
India	Industrial Production	y/y	Aug	-0.8%	2.4%	1.7%	***	Equity bearish, bond bullish
	CPI	y/y	Sep	7.4%	7.0%	7.4%	***	Equity and bond neutral
EUROPE								
Eurozone	Industrial Production WDA	y/y	Aug	2.5%	-2.4%	2.5%	**	Equity and bond neutral
UK	Industrial Production	y/y	Aug	-5.2%	1.1%	-3.2%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	Aug	-6.7%	1.1%	-5.2%	**	Equity bearish, bond bullish
	Visible Trade Balance	m/m	Aug	-£19.257b	-£19.362b	-£17.594b	**	Equity and bond neutral
	Trade Balance	m/m	Aug	-£7.08b	-£7.793b	-£5.445b	**	Equity and bond neutral
Russia	Current Account Balance	q/q	3Q P	51.900b	76.691b	61.250b	**	Equity and bond neutral
AMERICAS								
Mexico	Industrial Production	y/y	Aug	3.9%	2.6%	2.9%	***	Equity bullish, bond bearish
	Manufacturing Production	y/y	Aug	8.1%	5.1%	5.6%	*	Equity bullish, bond bearish
Mexico	International Reserves Weekly	w/w	7-Oct	$196.963b	$196.918b		*	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)	394	392	2	Up
3-mo T-bill yield (bps)	352	354	-2	Up
TED spread (bps)	42	38	4	Widening
U.S. Sibor/OIS spread (bps)	385	383	2	Up
U.S. Libor/OIS spread (bps)	389	387	2	Up
10-yr T-note (%)	3.86	3.90	-0.04	Up
Euribor/OIS spread (bps)	136	134	2	Neutral
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
Yen	Up			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	$92.70	$92.45	0.27%	
WTI	$87.38	$87.27	0.13%	
Natural Gas	$6.55	$6.44	1.82%	
Crack Spread	$42.51	$40.97	3.76%	
12-mo strip crack	$33.72	$33.46	0.77%	
Ethanol rack	$2.69	$2.70	-0.19%	
Metals				
Gold	$1,681.91	$1,673.19	0.52%	
Silver	$19.30	$19.02	1.44%	
Copper contract	$344.55	$342.50	0.60%	
Grains				
Corn contract	$691.50	$693.00	-0.22%	
Wheat contract	$885.50	$882.25	0.37%	
Soybeans contract	$1,393.00	$1,396.00	-0.21%	
Shipping				
Baltic Dry Freight	1,873	1,904	-31	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		1.0		
Gasoline (mb)		-2.0		
Distillates (mb)		-2.0		
Refinery run rates (%)		-1.00%		
Natural gas (bcf)		126		

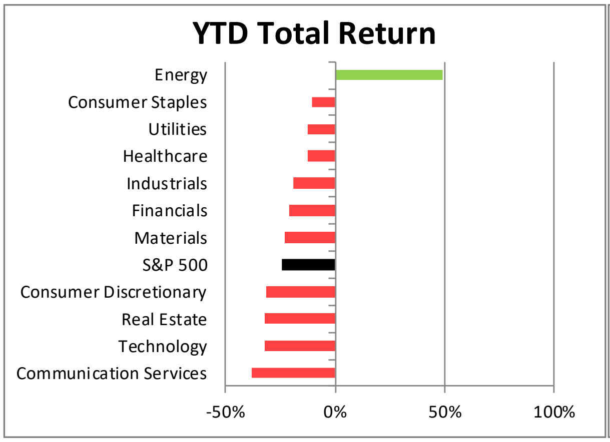
Weather

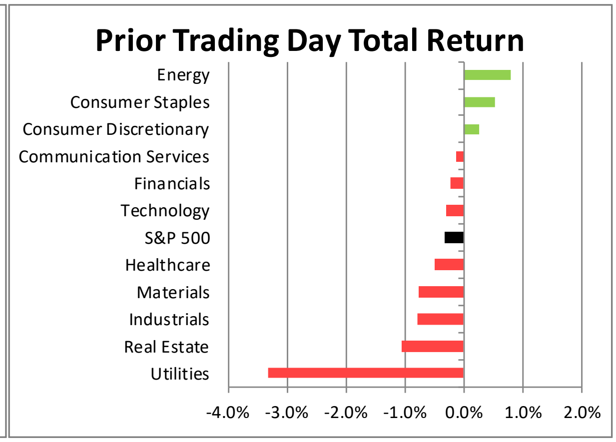
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures for the western two-thirds of the country, with much cooler-than-normal temperatures for the eastern seaboard. Wetter-than-normal conditions are anticipated for the southwest, with dry conditions expected in the Great Plains, and the Midwest.

There are currently two tropical disturbances in the Gulf Coast, Caribbean, and Atlantic Ocean areas. Tropical Storm Karl is now in the western Gulf of Mexico and is likely to bring heavy rains to the Mexican states of Veracruz and Tabasco. A disturbance has also formed off the western coast of Africa, but it is assessed to have no chance of turning into a cyclonic formation in the next 48 hours.

Data Section

U.S. Equity Markets – (as of 10/12/2022 close)

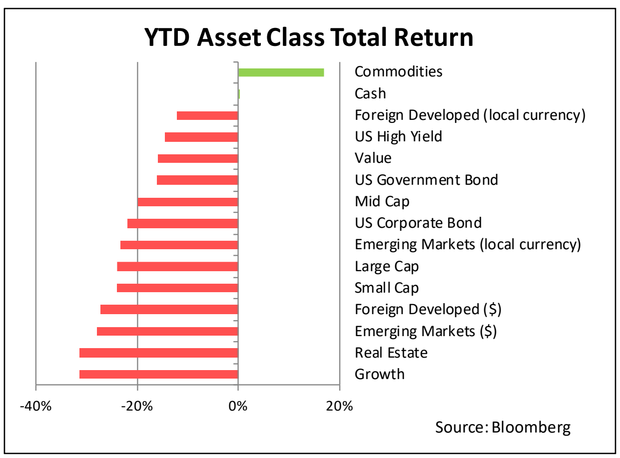




(Source: Bloomberg)

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 10/12/2022 close)

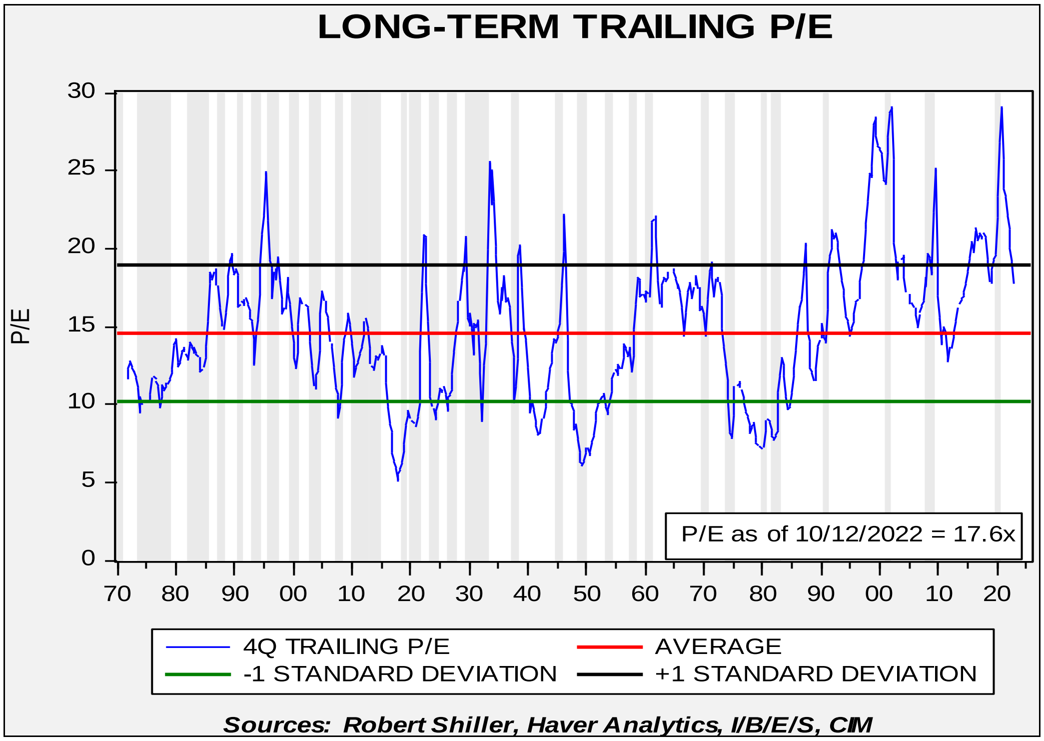


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

October 13, 2022



Based on our methodology,[1] the current P/E is 17.6x, down 0.2x from last week. Falling index values led to the decline 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.