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: September 22, 2022—9:30 AM EDT] Global equity markets are mostly lower this morning. In Europe, the Euro Stoxx 50 is currently down 0.9% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.5%. Chinese markets were lower, with the Shanghai Composite down 0.3% from its prior close and the Shenzhen Composite down 0.6%. In contrast, U.S. equity index futures are signaling a higher open.

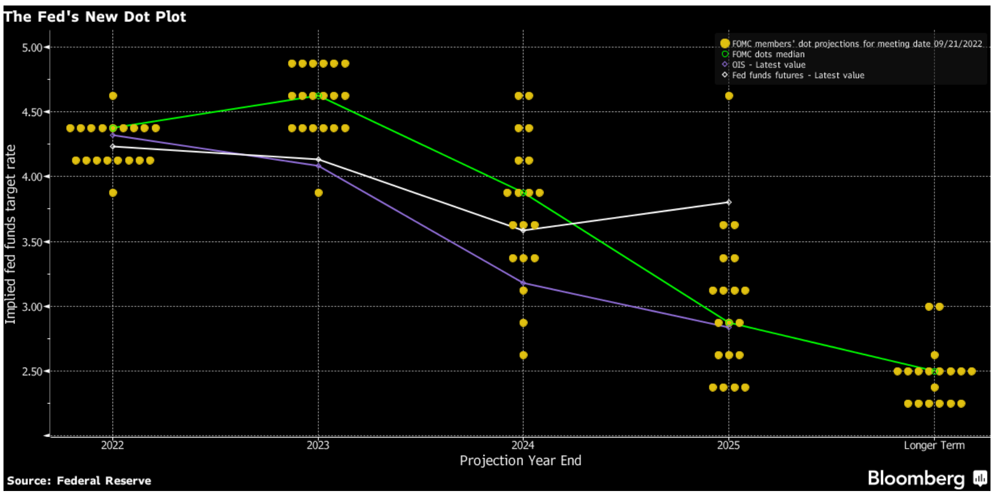
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below, with new items of the day emphasized in bold:

- *Bi-Weekly Geopolitical Report* (9/12/2022) (no associated podcast this week) "The Ukraine War at Six Months: Some Reflections"
- ***Weekly Energy Update*** **(9/22/2022): We discuss the idea that the SPR is becoming a buffer stock instead of a strategic reserve. There are comments on the weekly data and the usual look at the news affecting oil and natural gas**.
- *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* (9/19/2022) (with associated podcast): "The Federal Reserve's Big Policy Mistake"
- *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)

Good morning and buckle up! Today's *Comment* will focus exclusively on the central banks. We begin with a broad overview of the latest Federal Open Market Committee (FOMC) meeting followed by an assessment of the future path of policy hikes. Next, we cover the market reaction to the Fed's rate decision and discuss implications for the global economy. Lastly, the report summarizes how central banks responded to the Federal Reserve's rate announcement.

It Will Be Enough: The Federal Reserve raised its benchmark interest rate by 75 bps for the third meeting in a row and signaled that it has the tools necessary to corral inflation.

- In a press conference, Fed Chair Jerome Powell reaffirmed that his position is unchanged since [giving his Jackson Hole speech] three weeks ago. He reiterated the central bank's will to keep interest rates in restrictive territory until it sees compelling evidence that inflation is coming down. Although his comments were mostly hawkish, Powell signaled the Fed could slow the pace of increases at some point.
- The Fed's latest "dot plot" shows the implied year-end fed funds rate above 4.25%. Although Powell mentioned that no decision has been made on the size of the next hike, it is widely believed the Fed will raise rates 75 bps and 50 bps, respectively, at its next two meetings. The plot also shows that policymakers favor a mild hike of 50 bps for all of next year.

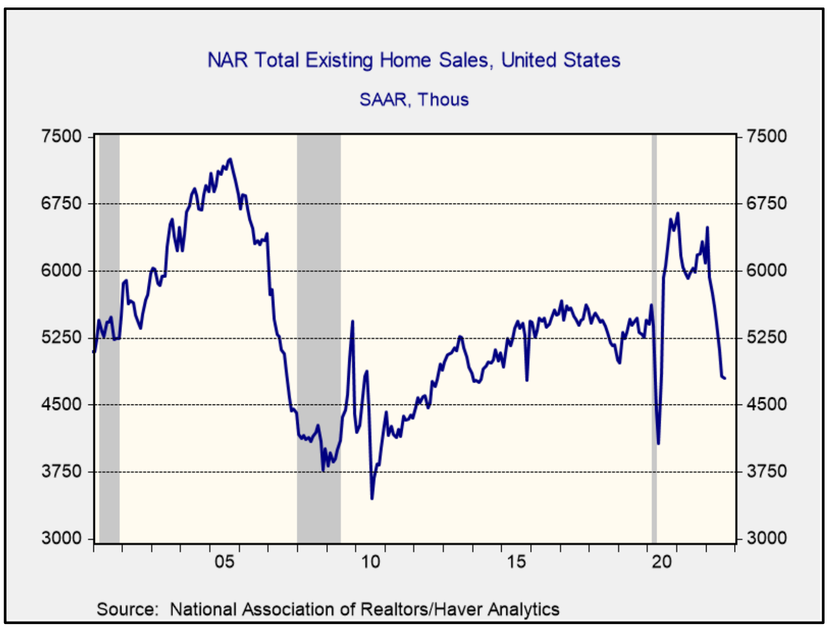


  - Although there were no dissenting votes in the Fed's rate decision, the dot plot reveals that at least one Fed member on the committee was uncomfortable lifting the fed funds rate above 4.00%. We would guess the outlier was one of the new Fed governors, either Lisa Cook or Philip Jefferson. If that is the case, future hikes could face resistance, especially if the economy falls into recession.
- The Fed's economic projection showed that the U.S. economy could expand by only 0.2% in 2022. This tepid growth forecast suggests that central bank officials are possibly factoring in a recession later this year. Although the Fed does forecast more robust growth in 2023 and 2024, the sharp increases in the policy rate imply that the central bank does not plan to reverse course if economic growth slows.

The Markets React: Equities whipsawed, major currencies tanked, and long-duration bond prices surged as investors weighed the impact of higher interest rates on financial assets.

- The central bank has been able to raise rates because the unemployment rate remains low, but policymakers will likely not be able to sustain this pace of hikes once the economy contracts. While Powell maintains the bank plans to keep rates high for as long as it takes to bring down inflation, the central bank could face political pressure as the economy weakens and labor markets soften. For example, hours after the rate announcement, Massachusetts Senator Elizabeth Warren (D-MA) [slammed the Federal Reserve for its hawkish actions] for not looking out for workers. Accordingly, the recent volatility is likely attributable to investors being unsure of whether the Fed will blink when confronted with poor economic data.

- The U.S. dollar rallied against its peers following the Fed's decision to raise rates. The euro fell further below parity, and the British pound dipped to its lowest level since 1985. The greenback's strength will exaggerate inflation in other countries as most commodities are priced in dollars. Additionally, the currency's strength encourages capital outflows, especially from emerging markets, as investors look to move away from risk assets into safe-haven assets. As a result, non-U.S. central banks will be forced to raise rates if they want to prevent their currencies from weakening, thus increasing the likelihood that the global economy will fall into recession.
- The yield curve inversion deepened as recession fears led to a plunge in long-duration yields and a spike in short-end yields. Because financial institutions like to borrow in the short term and lend in the long term, an inverted yield curve can hurt bank profitability. Thus, financial institutions may be less inclined to issue loans to potential borrowers. As a result, the potential decline in lending activity will hinder investment spending and may be already negatively impacting the housing market.



  - The number of existing home sales plummeted as the Fed’s interest rate hikes pushed up mortgage rates to their highest level since 2008. In his speech, Powell mentioned that he expects the housing market to enter correction territory.

The World Strikes Back: Central banks are altering their monetary policy to prevent a stronger dollar from hurting their respective economies.

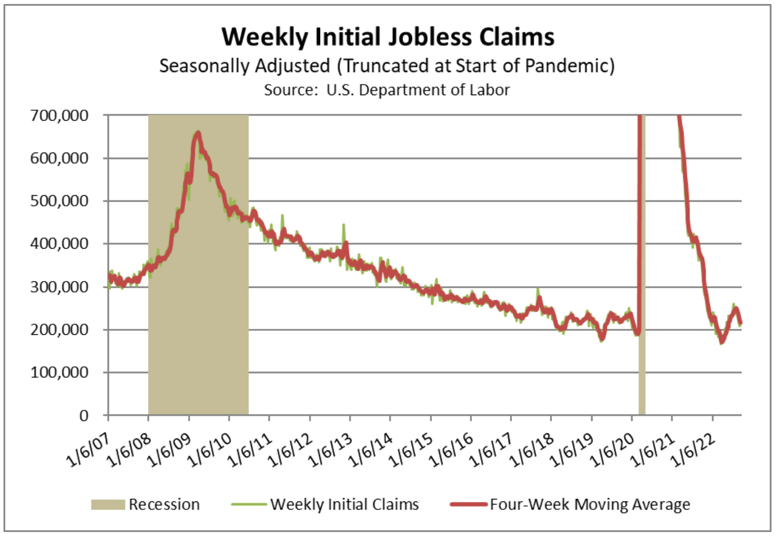
- The Bank of Japan intervened in the foreign exchange market for the first time since 1998. The move was aimed at protecting the yen from depreciation, while the central bank maintained its ultra-accommodative monetary policy. The intervention pushed the dollar down 2% to around 140.2 against the yen. However, the BOJ's action will provide limited relief for the currency as traders will still attempt to offload their yen holdings until the central bank backs away from its loose monetary policy.

  - Despite the recent central bank's action, BOJ Governor Haruhiko Kuroda maintained there would be no change in the bank's monetary policy.

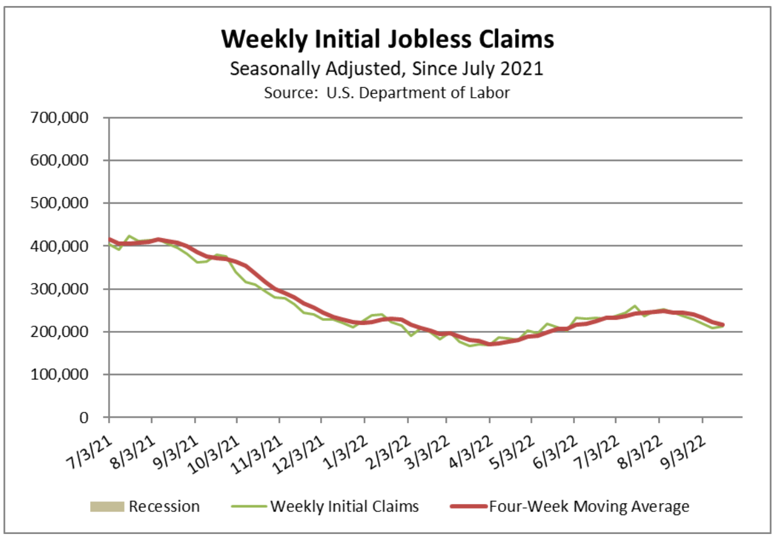
- In contrast to the BOJ, the Bank of England lifted its benchmark rate by 50 bps to 2.25%, its seventh consecutive rate hike. The bank's actions were relatively modest compared to the hikes of 75 bps from the Federal Reserve and European Central Bank. The BOE's moves are likely related to confidence that the U.K. government's plan to cap energy bills will also lower inflation. Following the hike, the pound briefly rallied above $1.13 before settling back to its 1985 lows. Although the BOE was the first major central bank to raise interest rates, we suspect it could be the first bank to pause its policy tightening as the country battles recession.
  - PM Liz Truss's new administration has advocated for pro-growth policies as she looks to jump-start the British economy. Thus, if the bank tightens policy too much and the economy contracts, the bank will likely be blamed. This dynamic should push the British pound closer to dollar parity over the next few months.
- Several other central banks also tightened their policy to slow the rise in import prices. For example, the Swiss National Bank hiked interest rates by 75 bps, bringing the country out of negative territory for the first time since 2015. Meanwhile, the Philippines and Indonesia raised rates by 50 bps each, and Taiwan hiked interest rates by a modest 12.5 bps. Import goods, especially commodities, are primarily priced in dollars; thus, a surging greenback generally adds to inflationary pressures abroad. As a result, we suspect other central banks will continue to tighten policy until the Fed ends its hiking cycle.

U.S. Economic Releases

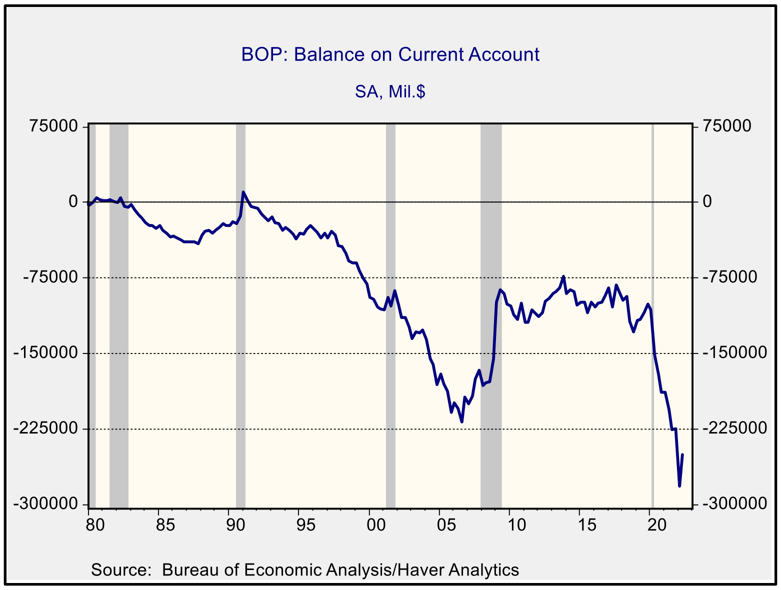
Initial applications for unemployment benefits in the week ended September 17 rose to a seasonally adjusted 213,000, not quite as bad as the expected level of 217,000 but still up from the revised level of 208,000 in the previous week. All the same, the four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to 216,750. Meanwhile, the number of people continuing to draw benefits in the week ended September 10 fell to just 1.379 million, coming in below both the expected reading of 1.418 million and the previous week's revised reading of 1.401 million. The figures continue to suggest that a modest rebound in layoffs during the summer has now reversed itself, and the labor market remains quite tight. 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.



A separate report today provided a broad overview of U.S. international transactions in the period from April through June. The second quarter current account balance showed a seasonally adjusted deficit of $251.1 billion, far better than the revised shortfall of $282.5 billion in the first quarter. The improvement largely reflects a narrower trade deficit in the second quarter. The chart below shows how the current account balance has fluctuated over the last several decades.



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**
10:00	Leading Economic Indicators	m/m	Aug	-0.1%	-0.4%	***
11:00	Kansas City Fed Manfacturing Index	m/m	Sep	5	3	*
Federal Reserve						
No Fed speakers or events 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	Nationwide Dept Store Sales	y/y	Aug	26.1%	9.6%		*	Equity bullish, bond bearish
New Zealand	Wespac Consumer Confidence	m/m	Q3	87.6	78.7		*	Equity and bond neutral
	Trade Balance NZD	m/m	Aug	-2.447b	-1.092b	-1.406b	**	Equity and bond neutral
	Exports NZD	m/m	Aug	5.48b	6.68b	6.35b	**	Equity and bond neutral
	Imports NZD	m/m	Aug	7.93b	7.77b	7.76b	**	Equity and bond neutral
EUROPE								
France	Business Confidence	m/m	Sep	102	103	104	**	Equity and bond neutral
	Manufacturing Confidence	m/m	Sep	102	104	103	*	Equity and bond neutral
Russia	PPI	y/y	Aug	3.8%	6.1%	4.0%	**	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)	360	357	3	Up
3-mo T-bill yield (bps)	317	319	-2	Up
TED spread (bps)	44	37	7	Widening
U.S. Sibor/OIS spread (bps)	352	347	5	Up
U.S. Libor/OIS spread (bps)	357	352	5	Up
10-yr T-note (%)	3.55	3.53	0.02	Up
Euribor/OIS spread (bps)	112	110	2	Neutral
Currencies	**Direction**			
Dollar	Down			Up
Euro	Up			Down
Yen	Up			Down
Pound	Up			Down
Franc	Up			Down
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of England Bank Rate	2.250%	1.750%	2.250%	On Forecast
Swiss National Bank Policy Rate	0.500%	-0.250%	0.500%	On Forecast
Bank of Japan Policy Balance Rate	-0.100%	-0.100%	-0.100%	On Forecast
Bank of Japan 10-Yr Yield Target	0.000%	0.000%	0.000%	On Forecast
Brazil Selic Rate	13.750%	13.750%	13.750%	On 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	$91.10	$89.83	1.41%	
WTI	$84.21	$82.94	1.53%	
Natural Gas	$7.69	$7.78	-1.17%	
Crack Spread	$31.28	$29.60	5.70%	
12-mo strip crack	$30.18	$29.09	3.75%	
Ethanol rack	$2.70	$2.71	-0.37%	
Metals				
Gold	$1,673.86	$1,673.89	0.00%	
Silver	$19.65	$19.57	0.41%	
Copper contract	$350.75	$346.70	1.17%	
Grains				
Corn contract	$688.25	$685.50	0.40%	
Wheat contract	$901.00	$903.75	-0.30%	
Soybeans contract	$1,467.75	$1,461.25	0.44%	
Shipping				
Baltic Dry Freight	1,746	1,729	17	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	1.1	2.2	-1.1	
Gasoline (mb)	1.6	-0.5	2.0	
Distillates (mb)	1.2	-0.5	1.7	
Refinery run rates (%)	2.1%	0.05%	2.1%	
Natural gas (bcf)		95	-95	

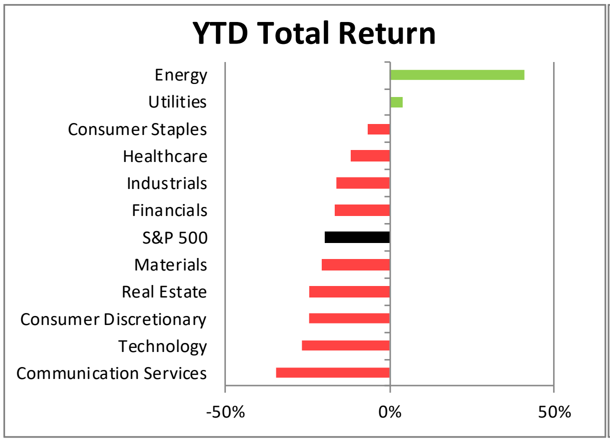
Weather

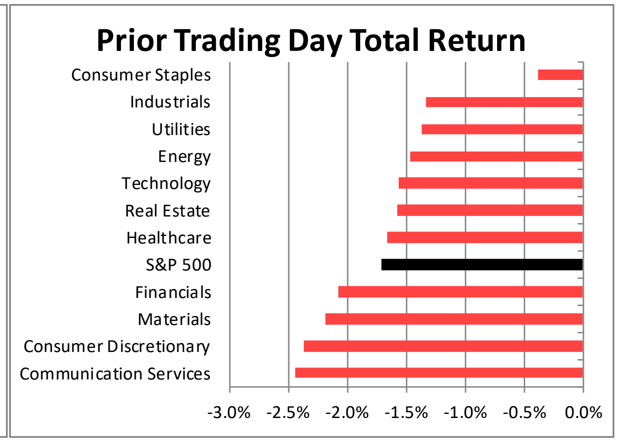
The 6-10 and 8-14 day forecasts call for warmer-than-normal temperatures throughout the entire western two-thirds of the country, with cooler-than-normal temperatures in New England. Wetter-than-normal conditions are anticipated in the Four Corners area of the Southwest and in Florida, with dry conditions expected in the Great Plains and Midwest.

Today, there are five tropical disturbances in the Gulf Coast, Caribbean, and Atlantic Ocean areas. Hurricane Fiona is making its way to Bermuda and is expected to move out into the Atlantic within the next 48 hours. In the central Atlantic Ocean, Tropical Storm Gaston is not expected to make landfall. Meanwhile, along the South American coast, there is a disturbance with a 70% chance of cyclone formation. The remaining two disturbances, which are located off the western coast of Africa, have more moderate probabilities of cyclone formation within the next 48 hours.

Data Section

U.S. Equity Markets – (as of 9/21/2022 close)

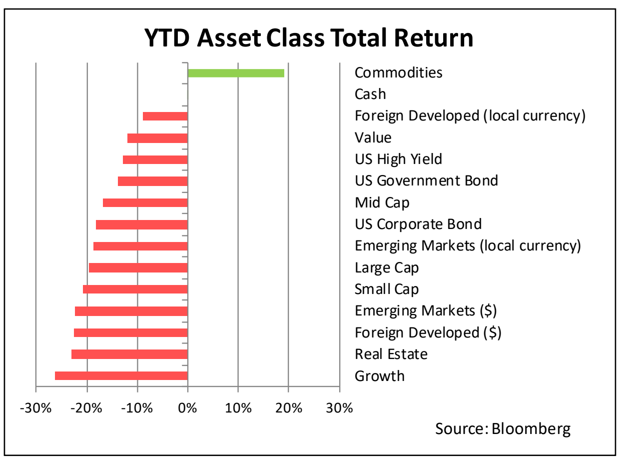




(Source: Bloomberg)

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 9/21/2022 close)

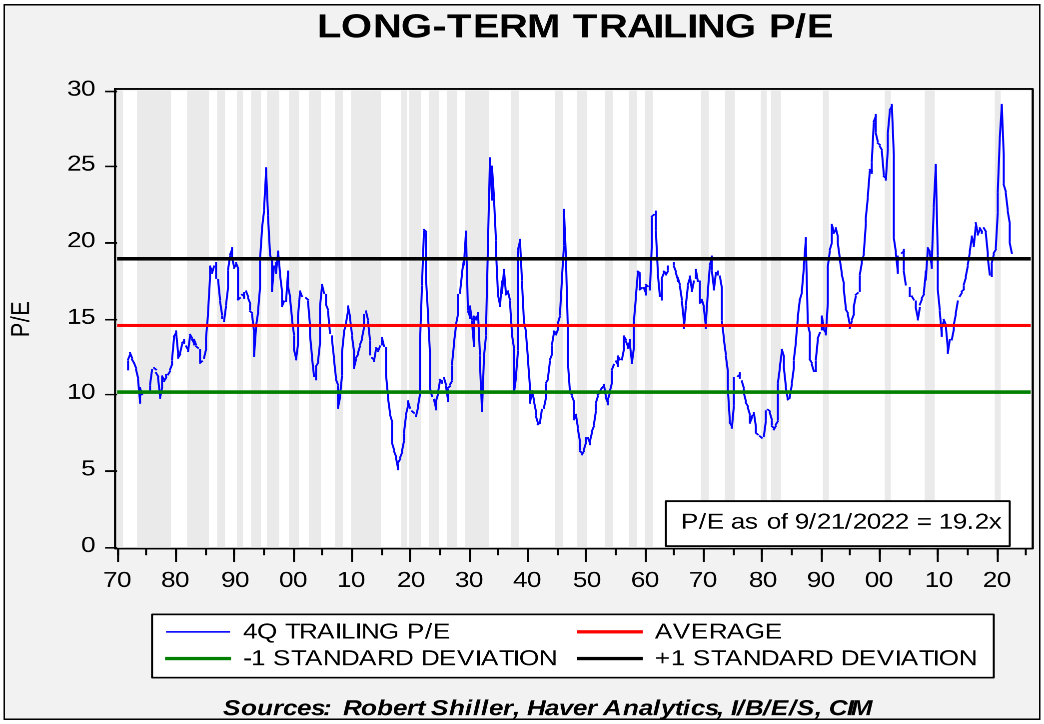


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

September 22, 2022



Based on our methodology,[1] the current P/E is 19.2x, down 0.1 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.

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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 (Q4, Q1 and Q2) and one estimate (Q3). 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.