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 29, 2022—9:30 AM EDT] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 is currently down 1.4% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.1%. Chinese markets were lower, with the Shanghai Composite down 0.1% from its prior close and the Shenzhen Composite also down 0.1%. U.S. equity index futures are signaling a lower 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* (9/26/2022) (with associated podcast) "Updates on Russia-Ukraine and Armenia-Azerbaijan"
- ***Weekly Energy Update* (9/29/2022): In addition to our usual update of the weekly DOE data, we also cover the apparent sabotage of the Nord Stream pipeline system and the failure of Joe Manchin's permitting bill**.
- *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! Today's *Comment* begins with our thoughts on the Bank of England's decision to purchase bonds to maintain financial stability. Next, we will discuss the Federal Reserve's role in the global economy and how its monetary choices could impact other central banks. Lastly, we review growing geopolitical risks in Europe and Asia.

BOE to the Rescue: The central bank's market intervention will benefit investors but weaken the bank's ability to fight inflation.

- The Bank of England announced that it would start purchasing long-dated government bonds to minimize risk to financial stability on Wednesday. The move was aimed at calming markets after the government released its plan to cut taxes by the most considerable amount in half a century. Before the BOE's action, the pound sank, and gilt yields surged over concerns that fiscal spending from the newly released tax plan would exacerbate inflation. Although the markets have been relatively tamed due to these actions, we cannot rule out an emergency rate hike from the central bank.

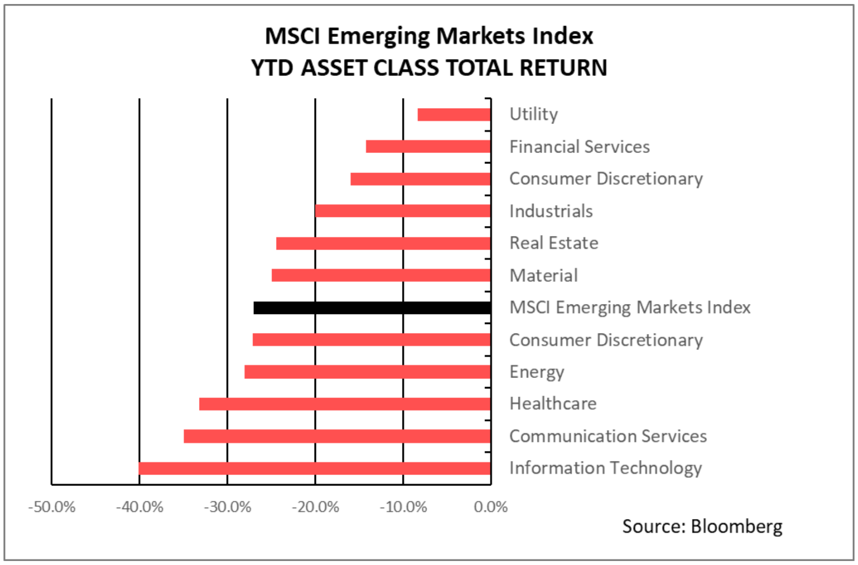
    - Despite pressure to reverse the tax plan, U.K. Prime Minister Liz Truss has vowed to stick with it.

- Financial markets initially responded positively as fixed-income investors interpreted the BOE's move as a signal that it would act in times of crisis. As a result, the pound rebounded from $1.04 on Monday to $1.08 on Wednesday. Meanwhile, the yield on 30-year gilts fell from 5.1% to 3.9% in the same period. The bank's intervention relieved market participants, such as pension funds and mortgage lenders, that were struggling to cope with higher borrowing costs. However, if the central bank holds to its word to end the bond-buying program after two weeks, we will likely see a return to market turmoil in October.
    - Despite the bank's involvement, the five-year U.K. credit default swaps spread increased to its widest level since the 2016 Brexit vote.
- The BOE's actions are evidence of a trend among central banks to maintain some level of policy accommodation as they collectively hike interest rates to counter inflation. For example, the European Central Bank and the Federal Reserve have developed similar policy tools to ensure that their respective financial markets continue to run smoothly. The bank's decision to inject cash into the market while tightening monetary policy indicates that they are not fully committed to maintaining price stability if it can lead to a financial crisis. As a result, inflation will likely be more challenging to contain, forcing banks to become more aggressive in their rate hikes.

Fed Fallout: Although much attention is paid to the BOE's solo act on Wednesday, it is essential to remember that the Fed is still the conductor of the financial orchestra.

- Non-U.S. central banks are exploring ways to protect their economies against a strengthening greenback. Over the last few months, tight Federal Reserve monetary and rising geopolitical risk in Asia and Europe pushed up the dollar's value to a twenty-year high, much to the annoyance of other countries. On Wednesday, the People's Bank of China warned investors that it would defend its currency from speculators, and Taiwan's central bank walked back claims that it would impose foreign exchange controls. In the West, calls for a 75 bps hike from the ECB officials grew louder.
- Although the recent BOE actions have led to a global bond rally, it is not likely to last. Around the world, countries are coping with elevated levels of inflation and a weaker currency. To prevent inflation from rising and capital from leaving these countries, central banks will have to implement aggressive monetary policy, especially for developing countries. Thus, tighter financial conditions will weigh on global growth.
- The push by central banks to contain the rise of the dollar could harm financial assets, particularly in developing countries. The capital flight toward safety led to a steep drop in

investment in emerging markets throughout the year. Data collected from Bloomberg showed that every asset class within the MSCI Emerging Market Index is on pace to post a negative return for 2022. The poor equity performance in these countries will likely continue as the Fed tightens and the dollar strengthens; however, investment opportunities will be available if these trends start to slow or even reverse in 2023. Although we are not forecasting an imminent change in the dollar's trajectory, we would like to remind investors that the dollar cannot rise forever or, as the saying goes, "whatever goes up must eventually come down."



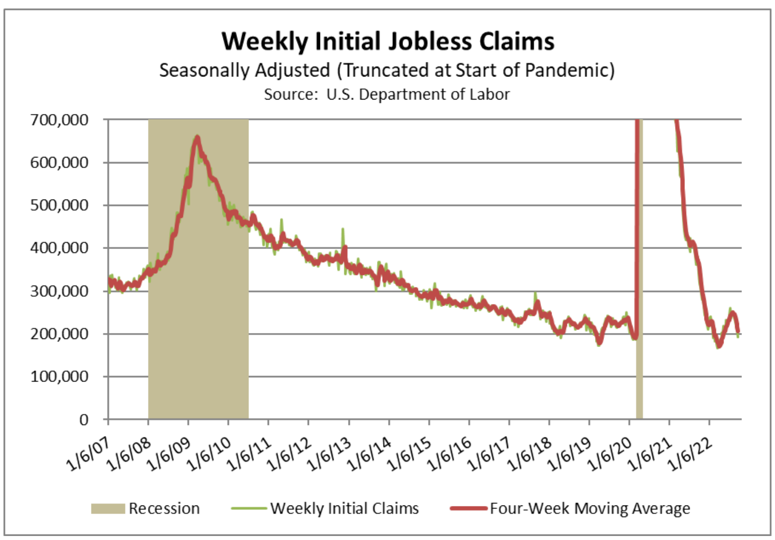
Geopolitical Turmoil: Frictions in Europe and Asia could pave the way to war.

- Abrasive actions from Moscow could pave the way for a direct confrontation between Russia and NATO. On Thursday, the Kremlin announced that it would formally annex several regions in Ukraine following the results of a referendum viewed mainly as a sham. This move by the Kremlin might be a precursor for a nuclear strike in Ukraine after Russia warned that it was willing to take extreme actions to protect its homeland. The U.S. has cautioned Russia that it would be punished if it followed through on its nuclear threat. Although it is unclear whether Moscow is bluffing, its recent setback in Ukraine and its vastly unpopular war mobilization suggest it is desperate to end the war.
    - As we mentioned in previous reports, wars are generally caused by miscalculations. Russia is more likely to use nuclear weapons if it believes that the West will not respond militarily. If Russia is wrong and uses nukes, it could lead to another intercontinental war in Europe.
- NATO warned of a collective response due to evidence that the Nord Stream Pipeline system was sabotaged. The remarks suggest that countries within the military alliance may view attacks on its infrastructure as a provocation. Although there is no evidence that the coalition plans to respond with force, it does indicate that all options are being considered. The sabotage of European pipelines is an example of the growing geopolitical instability within Europe.

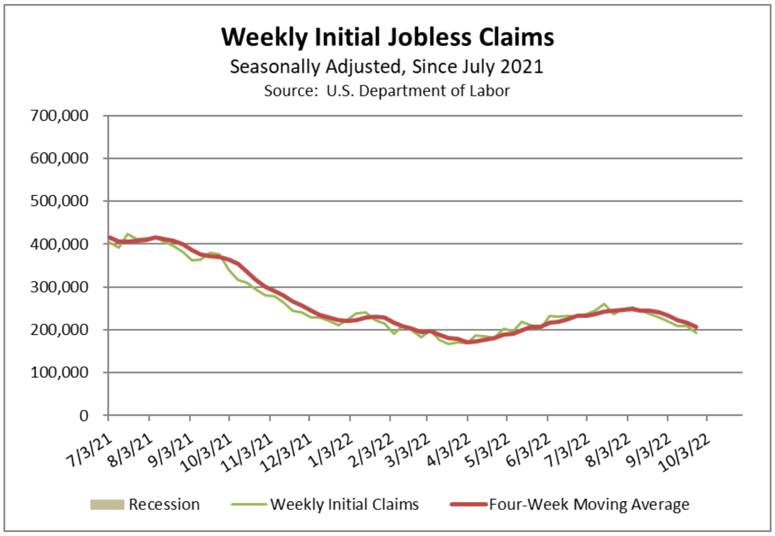
- Tensions between North Korea and the U.S. threaten the global economy. Pyongyang [fired two short-range missiles toward the East Sea](). The hermit kingdom made the provocative move one day before Vice President Kamala Harris is set to visit the peninsula's Demilitarized Zone. South Korean officials believe that North Korea will conduct another nuclear test in the coming weeks as Pyongyang has been readying its underground nuclear test tunnel. The U.S. and Japan are opposed to North Korea having nuclear weapons. Thus, the country's steady advancement in its weapons' development raises the likelihood of a preemptive attack. In the event of a conflict in the Indo-Pacific, supply chains and trade in the region will be disrupted. We will be monitoring this situation closely.

U.S. Economic Releases

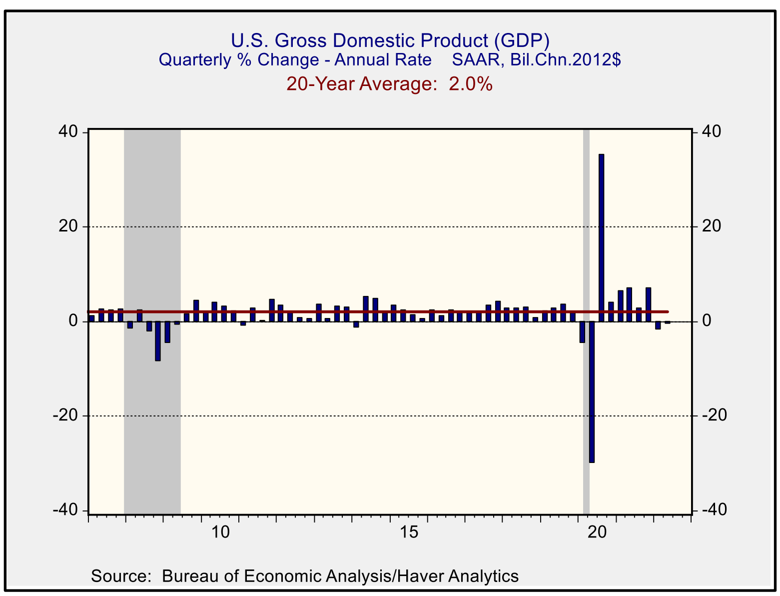
Initial applications for unemployment benefits in the week ending September 24 fell to a seasonally adjusted 193,000, much better than the expected level of 215,000 and the previous week's revised level of 209,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell to a nearly four-month low of just 207,000. Similarly, the number of people continuing to draw benefits in the week ending September 17 fell to 1.347 million, better than the anticipated reading of 1.385 million and the prior week's revised reading of 1.376 million. Taken together, these figures confirm that the modest uptick in layoffs during mid-summer has now reversed, leaving the labor market extraordinarily 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.



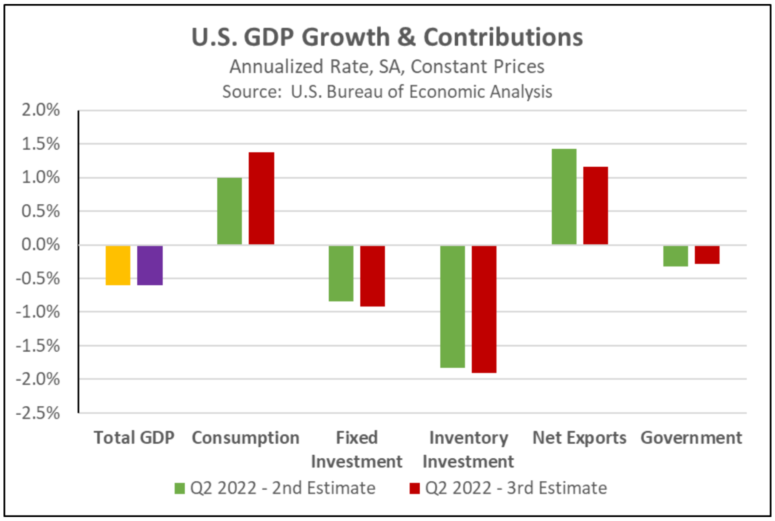
To provide more detail on recent trends, the following chart shows how initial jobless claims have changed since mid-2021.



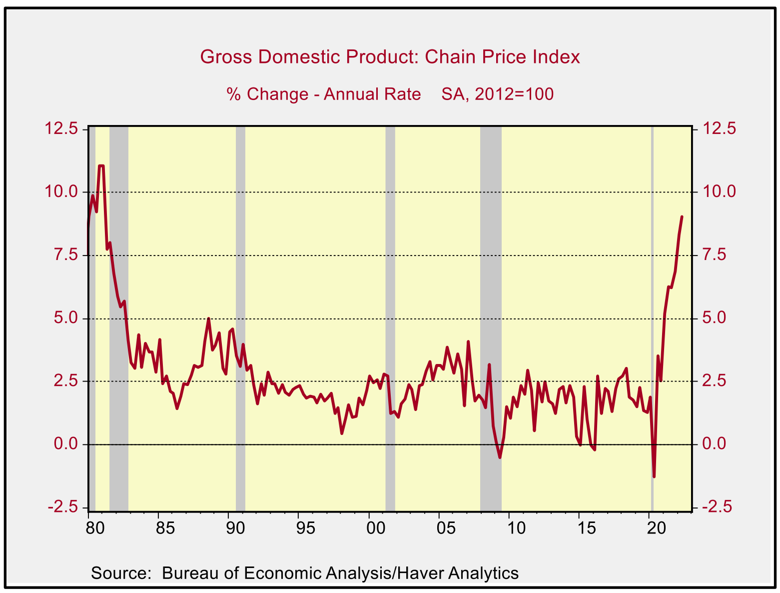
Separately, the Commerce Department released its final regular estimate of economic activity in the second quarter. After stripping out seasonal factors and price changes, second-quarter gross domestic product (GDP) declined at an annualized rate of 0.6%, matching expectations that the rate of decline would be unchanged from the previous estimate. Taking into account the regular annual corrections and revisions to the data, the drop in the second quarter was actually better than the 1.6% decline in the first quarter, although it was far weaker than the annualized growth rate of 7.0% in the final period of 2021. In fact, the revisions showed that growth was actually much stronger in 2021 than previously calculated. The chart below shows the annualized growth rate of U.S. GDP since just before the previous recession.



A close look at the details in the report shows that the main drag on activity in the quarter was a drawdown in inventories and a drop in fixed investment. The following chart shows the contributions to the annualized growth rate in the second quarter.



The GDP report also includes the broadest measure of U.S. inflation. The second-quarter GDP Price Index rose at an annualized rate of 9.0%, slightly worse than expectations that its growth rate would be unchanged at the previous estimate of 8.9%. The chart below shows the year-over-year change in the GDP Price Index 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		
No economic releases for the rest of today		
Federal Reserve		
EST	**Speaker or Event**	**District or Position**
9:30	James Bullard Discusses Economic Outlook	President of the Federal Reserve Bank of St. Louis
13:00	Loretta Mester and ECB's Lane Take Part in Policy Panel	President of the Federal Reserve Bank of Cleveland
16:45	Mary Daly Speaks at Boise State University	President of the Federal Reserve Bank of San Francisco

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	Japan Buying Foreign Bonds	w/w	23-Sep	-¥1,102.5b	-¥140.7b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	23-Sep	-¥2,862.8b	-¥2,570.5b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	16-Sep	-¥264.8b	-¥141.0b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	23-Sep	-¥1,178.9b	-¥609.7b		*	Equity and bond neutral
New Zealand	ANZ Activity Outlook	m/m	Sep	-1.8	-4.0		**	Equity bullish, bond bearish
	ANZ Business Confidence	m/m	Sep	-36.7	-47.8		**	china
South Korea	Business Survey - Manufacturing	m/m	Oct	75	82		**	Equity bearish, bond bullish
	Business Survey - Non-Manufacturing	m/m	Oct	81	82		*	Equity and bond neutral
EUROPE								
Eurozone	Economic Confidence	m/m	Sep	93.7	97.6	97.3	***	Equity bearish, bond bullish
	Industrial Confidence	m/m	Sep	-0.4	1.2	1.0	***	Equity bearish, bond bullish
	Services Confidence	m/m	Sep	4.9	8.7	8.1	**	Equity bearish, bond bullish
	Consumer Confidence	m/m	Sep F	-28.8	-28.8		**	Equity and bond neutral
Germany	CPI	y/y	Sep P	10.0%	7.9%	9.5%	***	Equity bearish, bond bearish
	CPI, EU Harmonized	y/y	Sep P	10.9%	8.8%	10.2%	**	Equity bearish, bond bearish
Italy	PPI	y/y	Aug	50.5%	45.9%		**	Equity bearish, bond bullish
Switzerland	Credit Suisse Survey Expectations	m/m	Sep	-69.2	-56.3		**	Equity and bond neutral
Russia	Industrial Production	y/y	Aug	-0.1%	-0.5%	-0.9%	***	Equity bullish, bond bearish
	Retail Sales Real	y/y	Aug	-8.8%	-8.8%	-8.7%	**	Equity and bond neutral
	Unemployment Rate	m/m	Aug	3.8%	3.9%	4.1%	**	Equity and bond neutral
AMERICAS								
Canada	GDP	y/y	Jul	4.3%	4.7%	4.6%	**	Equity bearish, bond bullish
Brazil	FGV Inflation IGPM	y/y	Sep	8.25%	8.59%	8.25%	***	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)	364	364	0	Up
3-mo T-bill yield (bps)	323	325	-2	Up
TED spread (bps)	42	39	3	Widening
U.S. Sibor/OIS spread (bps)	358	353	5	Up
U.S. Libor/OIS spread (bps)	364	359	5	Up
10-yr T-note (%)	3.83	3.73	0.10	Up
Euribor/OIS spread (bps)	119	123	-4	Neutral
Currencies	**Direction**			
Dollar	Up			Up
Euro	Flat			Down
Yen	Down			Down
Pound	Down			Down
Franc	Down			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	$89.83	$89.32	0.57%	
WTI	$82.54	$82.15	0.47%	
Natural Gas	$7.03	$6.96	1.12%	
Crack Spread	$33.53	$33.48	0.13%	
12-mo strip crack	$30.79	$30.99	-0.65%	
Ethanol rack	$2.68	$2.66	0.61%	
Metals				
Gold	$1,650.27	$1,659.97	-0.58%	
Silver	$18.73	$18.90	-0.90%	
Copper contract	$343.10	$335.85	2.16%	
Grains				
Corn contract	$674.50	$670.50	0.60%	
Wheat contract	$913.25	$903.25	1.11%	
Soybeans contract	$1,420.00	$1,408.75	0.80%	
Shipping				
Baltic Dry Freight	1,799	1,807	-8	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-0.2	2.0	-2.2	
Gasoline (mb)	-2.4	0.5	-2.9	
Distillates (mb)	-2.9	0.6	-3.5	
Refinery run rates (%)	-3.0%	-1.00%	-2.0%	
Natural gas (bcf)		96		

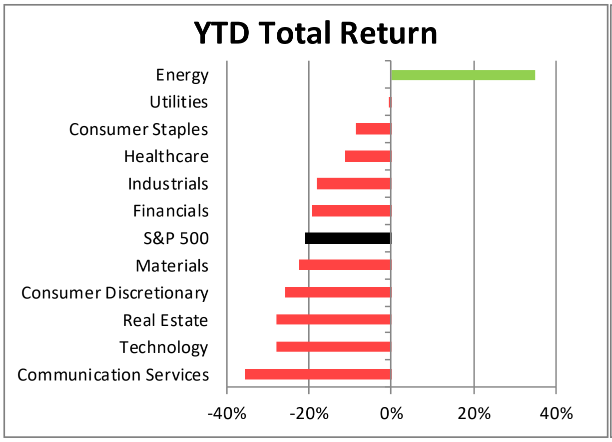
Weather

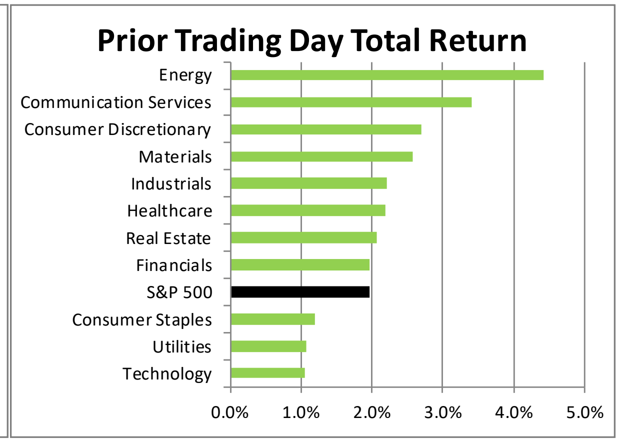
The 6-10 and 8-14 day forecasts currently call for warmer-than-normal temperatures throughout the entire western two-thirds of the country, with cooler-to-normal temperature only along the East Coast. Wetter-than-normal conditions are anticipated in the Rocky Mountain region, with dry conditions expected in the Midwest and Southeast.

There are currently two tropical disturbances in the Gulf Coast, Caribbean, and Atlantic Ocean areas. Hurricane Ian has now passed over Florida and is moving into the Atlantic Ocean as a tropical storm, but it is expected to hook back into the Carolinas by Friday and may redevelop into a hurricane. Meanwhile, Tropical Depression Eleven is moving northwest over the central Atlantic Ocean.

Data Section

U.S. Equity Markets – (as of 9/28/2022 close)

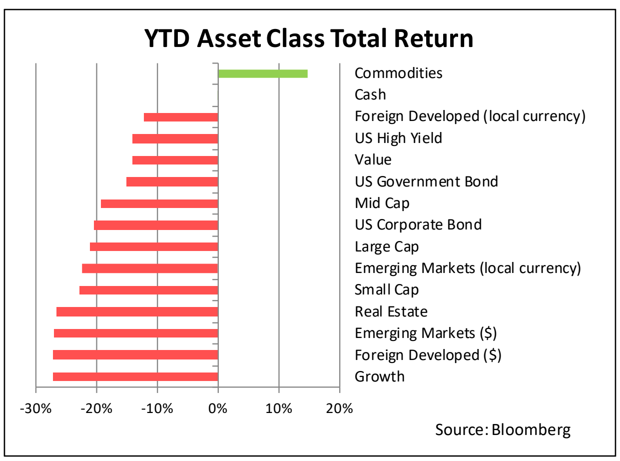




(Source: Bloomberg)

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 9/28/2022 close)

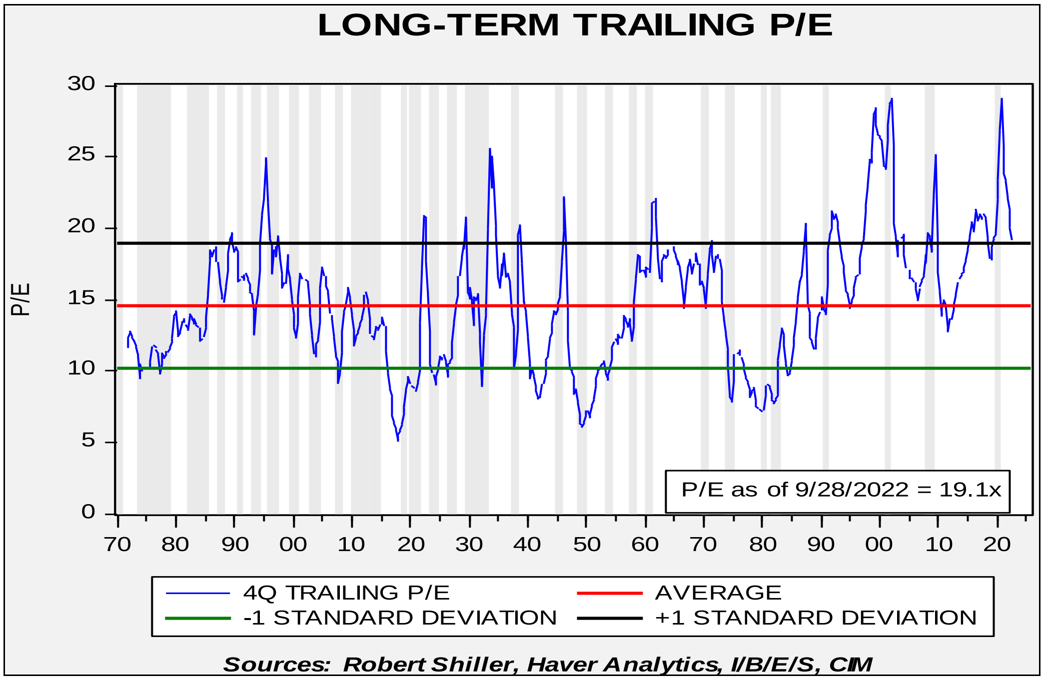


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 29, 2022



Based on our methodology,[1] the current P/E is 19.1x, 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.

[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.