Daily Comment

Confluence INVESTMENT MANAGEMENT

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[Posted: December 10, 2024 — 9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 closed down 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.3%. Chinese markets were higher, with the Shanghai Composite up 0.6% from its previous close and the Shenzhen Composite up 0.9%. US 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 in bold:

Bi-Weekly Geopolitical Report	Asset Allocation Bi-Weekly	Asset Allocation Quarterly	Of Note
Implications of North Korean Soldiers in the Ukraine War (11/18/24) + podcast	*Household Cash Levels and the S&P 500* (12/9/24) + podcast	Q4 2024 Report Q4 2024 Rebalance Presentation	Business Cycle Report

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Our *Comment* today opens with more signs that European countries intend to keep boosting their defense spending to counter the rising threat from Russia. We next review several other international and US developments with the potential to affect the financial markets today, including moves by China to cut off the US from its drone exports and a major bond manager's move to reduce exposure to long-term US government debt.

European Union: The European Commission's new Defense and Space chief, former Lithuanian Prime Minister Andrius Kubilius, said he will seek about 100 billion EUR ($105 billion) for weaponry in the EU's next seven-year budget to help prepare the bloc for possible aggression by Russia. That would mark a dramatic increase from the current budget's 10 billion EUR ($10.5 billion) for defense and defense industry spending. Kubilius also said he would support excluding member states' own defense outlays from EU limits on fiscal deficits and public debt totals.

- Spread out over seven years, the 100 billion EUR that Kubilius is seeking wouldn't account for a large share of European defense spending. Most military outlays in the region would still come from EU member states' own budgets.

- Nevertheless, the statement illustrates how top EU leaders are increasingly looking to boost their defense rebuilding efforts. We continue to think the result will be higher revenues, profits, and stock prices for European defense contractors.
- Now that France has dropped its previous insistence that all common EU defense funds be spent only within the bloc, it is likely that some of the EU's new spending will also benefit US defense firms. However, the US firms may see relatively weaker stock performance because of the incoming Trump administration's plan to extend the 2017 tax cuts, rein in government spending, and re-channel some funds toward smaller, cheaper weapons systems such as drones.

Russia-North Korea: During the weekend, the commander of US forces in the Indo-Pacific region, Adm. Samuel Paparo, said he has seen intelligence that Russia plans to send advanced Su-27 and Su-29 fighter jets to North Korea. The jets would presumably be partial payment for North Korea sending some 12,000 troops to Russia to help in its war against Ukraine, along with the cash, food, fuel, and air defense systems that Russia has also reportedly sent. If true, the deal is more evidence of increasing cooperation in the China/Russia geopolitical bloc.

China-Taiwan: Military officials in Taiwan today said they see evidence that China is planning what could be its largest naval exercise in the Western Pacific since 1996. The Chinese military has closed the airspace near Taiwan and is reportedly massing dozens of navy and coastguard vessels to the west and east of the island.

- The impending exercise (if that's all it is) likely aims to express Beijing's anger over Taiwanese President Lai Ching-te's recent visit to Hawaii and Guam as part of his first official international trip.
- The deployment of Chinese navy and coastguard ships to both the east and west of Taiwan is probably a signal to the US and its Western Pacific allies that Beijing has the ability to blockade the island and prevent outside forces from intervening.

Syria: To start forming a transition government, rebel leader Abu Mohammed al-Jawlani, whose HTS fighters led the toppling of dictator Bashar al-Assad over the weekend, has convened a meeting with Assad's prime minister and Mohammed al-Bashir, the head of a de facto government that HTS backed for years in Syria's rebel-held northwest. Al-Jawlani's forces have also reportedly worked to impose order on Damascus. Nevertheless, it will probably still be weeks before the contours of a transition government are laid out.

Brazil: President Lula da Silva, who is 79 years old, this morning is in intensive care after surgery for a brain hemorrhage related to a fall in October. Lula was reportedly complaining of severe headaches, which led doctors to discover the injury. According to doctors, the surgery went "well," and government officials say Lula is awake, alert, and on the road to recovery.

El Salvador: The government of cryptocurrency supporter President Nayib Bukele is reportedly close to clinching a deal with the International Monetary Fund for a new $1.3-billion loan program. However, the deal will require El Salvador to change its laws so that firms are no longer required to accept cryptocurrency as legal tender. The IMF insists on making acceptance of cryptocurrency voluntary to reduce the risk of financial instability.

China-United States: Less than a week after Beijing banned direct or indirect exports of key minerals with military applications to the US, Bloomberg yesterday said multiple Chinese firms have stopped or limited their sales of aerial drone components to the US and Europe. The firms are reportedly trying to get ahead of formal government curbs on the export of motors, batteries, and flight controllers expected to be in place in 2025.

- The Chinese curbs on drone parts would likely crimp US and European drone production, including both civilian and military drones. Since drones have become a critical new technology for defense, the moves are likely to spur further decoupling from China and stronger efforts to develop complete drone supply chains in the US and Europe.
- On a related note, US lawmakers in the House of Representatives have put language in the annual National Defense Authorization Act that would stop China-based DJI and Autel Robotics from selling new drones in the US unless a national defense agency specifically authorizes the sales. If the provision is still in the bill when it is ultimately signed into law, it would further decouple the US from the Chinese drone industry.

Canada-United States: Canadian Prime Minister Trudeau told a chamber of commerce event in Nova Scotia yesterday that his government would retaliate with its own tariffs on US goods if President-elect Trump follows through with his threat to impose 25% tariffs on imports from Canada. Trudeau reminded his audience that his government also retaliated with tariffs when President Trump imposed duties on Canadian goods during his first administration.

- Trudeau's statement serves as a reminder that a disruptive US-Canada trade war remains a possibility, despite Trudeau's recent meeting with Trump to head it off.
- Due to the complexities of how import tariffs can affect an economy, it still isn't possible to gauge exactly how Trump's threatened duties would affect the US, although there is probably a high chance that they would boost consumer price inflation, at least temporarily. In contrast, since Canada is so dependent on exporting to the US, the threatened tariffs would almost certainly have a negative impact on Canada's economy and financial markets.

US Workforce Quality: In the latest International Assessment of Adult Competencies, a test given to 160,000 workers around the world to assess their basic reasoning and problem-solving skills, the US ranked a lowly 14th in reading, 15th in adaptive problem solving, and 24th in numeracy. The countries scoring the highest in the three categories in 2023 included Japan, Norway, Sweden, Finland, Estonia, Belgium, the Netherlands, and Denmark.

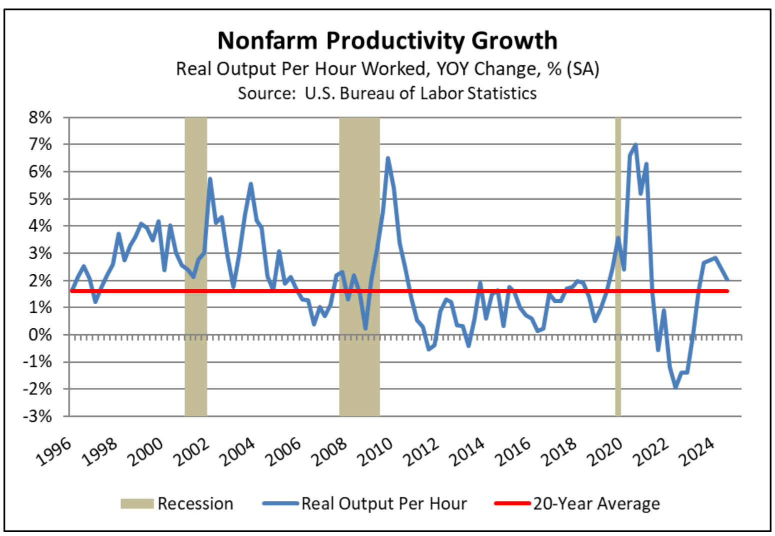
- Worryingly, while the best-educated US workers continue to score higher in each iteration of the test, the least-educated have been scoring lower. In 2023, the share of US test-takers whose math skills didn't surpass those expected of a primary-school student rose to 34% of the population from 29% in 2017, the last time the test was administered.

- The results are consistent with other studies suggesting low workforce skills are likely holding down US productivity, competitiveness, and economic growth prospects.

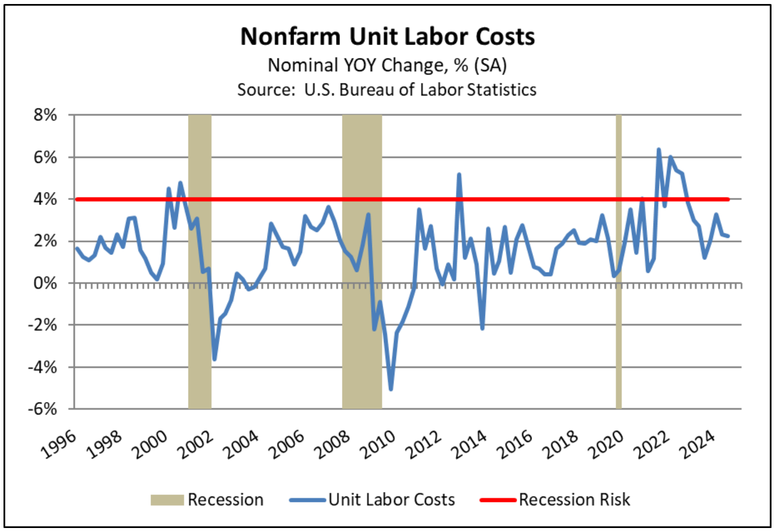
US Bond Market: Giant bond-fund manager Pimco yesterday said it is cutting its exposure to long-term US debt because of the country's big fiscal deficit and rising obligations. Instead, the firm said it has begun favoring shorter-term notes "where investors can find attractive yields without taking greater interest rate risk." Pimco's stance is consistent with our view that US debt is likely to keep rising, leading to questions about sustainability and increasing the chance of eventual financial repression (government efforts to artificially hold down interest rates).

US Economic Releases

The key report so far today focused on the productivity of US workers, defined as the average value of output per hour worked. After stripping out price changes and seasonal fluctuations, final third-quarter ***nonfarm productivity*** rose at a revised annual rate of 2.2%, matching expectations and accelerating slightly from the growth rate of 2.1% in the second quarter. Taking into account the fluctuations in each of the last four quarters, productivity in the third quarter was up 2.0% from the same period one year earlier, slightly better than the 20-year average growth rate of 1.6%. Productivity growth is key to boosting living standards and supporting higher wages, so the report is modestly positive for US workers and businesses. The chart below shows the year-over-year growth in real productivity over the last quarter-century or so.



Reflecting the growth in productivity, final third-quarter ***unit labor costs*** rose at an annualized rate of just 0.8%, far below the anticipated growth rate of 1.3% and not enough to offset the 1.1% rate of decline in the previous period. Unit labor costs in the third quarter were up 2.2% year-over-year, far below the increase of 4.0% or so that has often been a harbinger of recession in the past. The chart below shows the year-over-year growth in unit labor costs since 1996.



There are no economic releases or Fed events scheduled for the rest of the day.

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	Money Stock M2	y/y	Nov	1.2%	1.2%		**	Equity and bond neutral
	Money Stock M3	y/y	Nov	0.7%	0.7%		**	Equity and bond neutral
	Machine tool orders	y/y	Nov P	3.0%	9.4%		**	Equity and bond neutral
Australia	NAB Business Confidence	m/m	Nov	-3	5		***	Equity and bond neutral
	NAB Business Conditions	m/m	Nov	2	7		***	Equity and bond neutral
China	Trade Balance	m/m	Nov	$97.44b	$95.72b	$93.50b	***	Equity and bond neutral
	Exports	y/y	Nov	6.7%	12.7%	8.7%	**	Equity bearish, bond bullish
	Imports	y/y	Nov	-3.9%	-2.3%	0.9%	**	Equity bearish, bond bullish
EUROPE								
Germany	CPI	y/y	Nov F	2.2%	2.2%	2.2%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Nov F	2.4%	2.4%	2.4%	**	Equity and bond neutral
Italy	Industrial Production WDA	y/y	Oct	-3.6%	-3.9%	-3.5%	***	Equity and bond neutral
AMERICAS								
	Consumer Confidence	m/m	Nov	47.7	49.5	48	*	Equity bearish, bond bullish
Brazil	IBGE Inflation IPCA	y/y	Nov	4.87%	4.76%	4.86%	***	Equity and bond neutral

Financial Markets

The table below highlights some of the indicators that we follow daily. 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)	485	485	0	Down
3-mo T-bill yield (bps)	428	428	0	Down
U.S. Sibor/OIS spread (bps)	440	440	0	Down
U.S. Libor/OIS spread (bps)	438	438	0	Down
10-yr T-note (%)	4.23	4.20	0.03	Up
Euribor/OIS spread (bps)	286	287	-1	Down
Currencies	**Direction**			
Dollar	Up	US		Down
Euro	Down	Euro		Up
Yen	Down	Japan		Up
Pound	Down	UK		Up
Franc	Down	Switzerland		Up
Central Bank Action	**Current**	**Prior**	**Expected**	
RBA Cash Rate Target	4.350%	4.350%	4.350%	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.

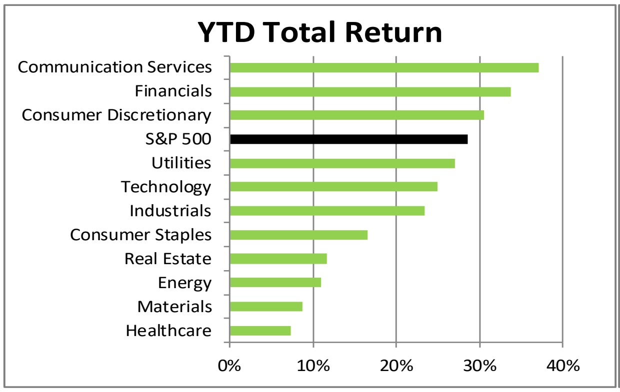
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$71.75	$72.14	-0.54%	
WTI	$67.99	$68.37	-0.56%	
Natural Gas	$3.12	$3.18	-1.98%	
Crack Spread	$17.08	$16.80	1.68%	
12-mo strip crack	$20.07	$19.96	0.55%	
Ethanol rack	$1.75	$1.75	-0.20%	
Metals				
Gold	$2,675.47	$2,660.30	0.57%	
Silver	$31.85	$31.84	0.03%	
Copper contract	$424.50	$427.55	-0.71%	
Grains				
Corn contract	$441.00	$441.75	-0.17%	
Wheat contract	$554.75	$558.75	-0.72%	
Soybeans contract	$992.00	$990.00	0.20%	
Shipping				
Baltic Dry Freight	1,168	1,167	1	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.10		
Gasoline (mb)		-1.63		
Distillates (mb)		0.79		
Refinery run rates (%)		-1.5%		
Natural gas (bcf)		-36		

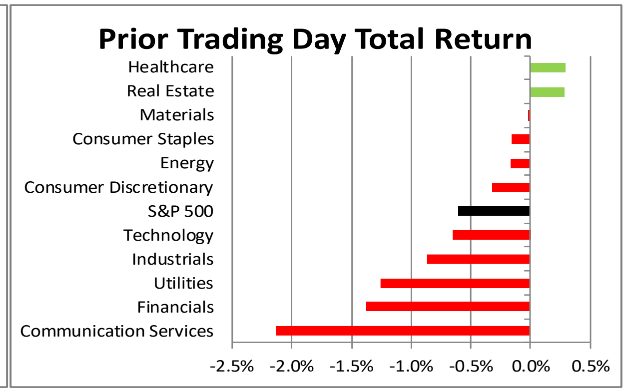
Weather

The 6-to-10-day and 8-to-14-day forecasts currently call for warmer-than-normal temperatures throughout the entire country except for the southern East Coast. The forecasts call for wetter-than-normal conditions in the Pacific Northwest and southern Texas, with dry conditions in the Southwest and the Southeast.

Data Section

US Equity Markets – (as of 12/9/2024 close)

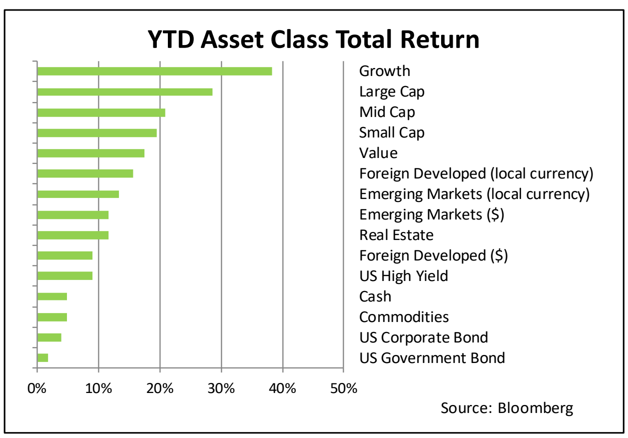




(Source: Bloomberg)

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 12/9/2024 close)

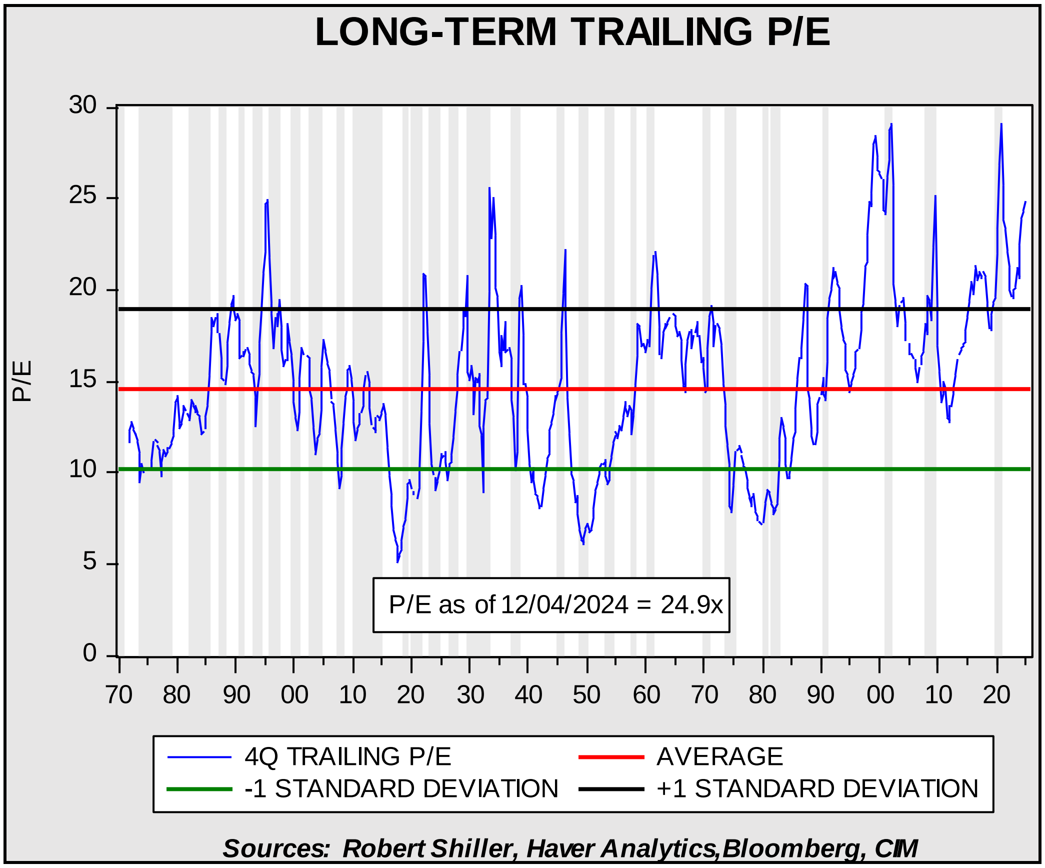


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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), US Corporate Bond (iShares iBoxx $ Investment Grade Corporate Bond ETF), US Government Bond (iShares 7-10 Year Treasury Bond ETF), US 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

December 5, 2024



Based on our methodology,[1] the current P/E is 24.9x, up 0.3 from our last report. The increase in the multiple was driven by a decrease in earnings and a slight rise in the stock price index.

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 Bloomberg 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 (Q2). 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.