Daily Comment

By Patrick Fearon-Hernandez, CFA, and Thomas Wash

[Posted: December 12, 2024 — 9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 is essentially unchanged from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.2%. Chinese markets were higher, with the Shanghai Composite up 0.9% from its previous close and the Shenzhen Composite up 1.1%. US 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 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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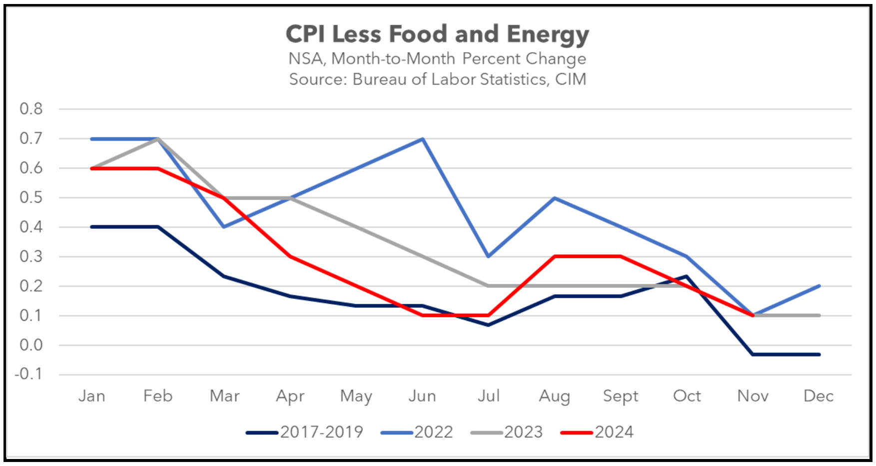
Good morning! The market is analyzing the latest PPI data to gauge the Fed's next move. In sports news, former New England Patriots coach Bill Belichick has agreed to lead the University of North Carolina's football team. Today's *Comment* will explore why Fed policymakers remain concerned about inflation, provide an update on the government's efforts to avoid a shutdown, and share insights on Canada's monetary policy. As always, we'll summarize key domestic and international data releases.

Inflation in Line: The CPI report did not disappoint, but there are still concerns about the future path of inflation.

- According to the Bureau of Labor Statistics, the overall consumer price index accelerated slightly in October. The year-over-year change rose from 2.6% to 2.7%, while the core index, which excludes volatile food and energy, rose 3.3%, roughly in line with the previous month. The rise in inflation was driven by a few components, including transportation and food prices, which both showed signs of acceleration. That said, the report was likely good enough for policymakers to cut rates next week; however, there are still questions concerning the path of monetary policy for 2025.

- Fed officials will remain vigilant for signs of renewed inflationary pressures, especially at the beginning of the year. In the first quarter of 2024, core CPI surged well above its pre-pandemic trend, mainly driven by unexpected spikes in financial services and shelter costs. While price pressures eventually eased throughout the year, this early surge led the Fed to doubt its progress and delay rate cuts until September when a 50-basis-point reduction was implemented. If a similar scenario unfolds in 2025, the Fed could signal an indefinite pause on rate cuts for the year.

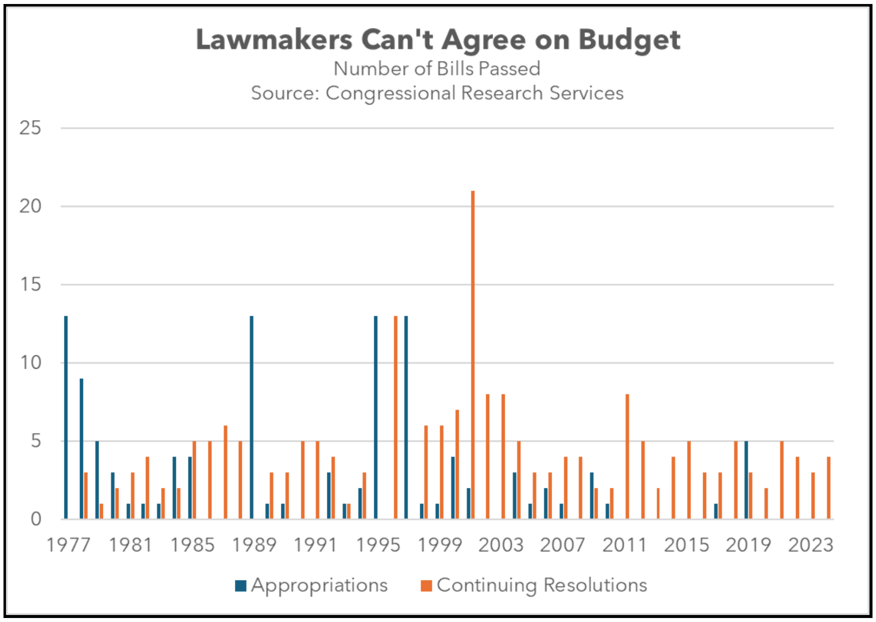


- Our primary concern is the potential resurgence of goods inflation driven by tariffs, which could reverse recent progress in moderating price pressures. The last time tariffs were implemented there was a significant increase in durable goods prices, particularly for home appliances. While this didn't have a major impact on overall inflation then, it could diminish a key driver of disinflation this time. Although we don't expect this to influence policy decisions at next week's meeting, it could prompt Federal Reserve officials to adopt a more hawkish stance in 2025.

Spending Gap Bill: Lawmakers are working together to put together a stop gap spending bill to prevent the government from shutting down on December 20.

- The House of Representatives passed an $895 billion defense spending bill on Wednesday, the first of several appropriations bills needed to fund the government. While this bill garnered bipartisan support, upcoming appropriations are expected to be more contentious. Lawmakers face disagreements over the scale of disaster relief for Hurricanes Milton and Helene and whether to increase funding for agencies like the DOE and the EPA. Despite these challenges, there's hope for a short-term funding agreement to keep the government open until the new year.
- In the post-financial crisis era, political infighting has forced lawmakers to repeatedly extend government funding with temporary measures known as continuing resolutions. Only once since 2009 has more than one appropriations bill been passed before the October 1 deadline. These stopgaps prevent government shutdowns but also prolong the appropriations process and contribute to the ballooning budget deficit. The government

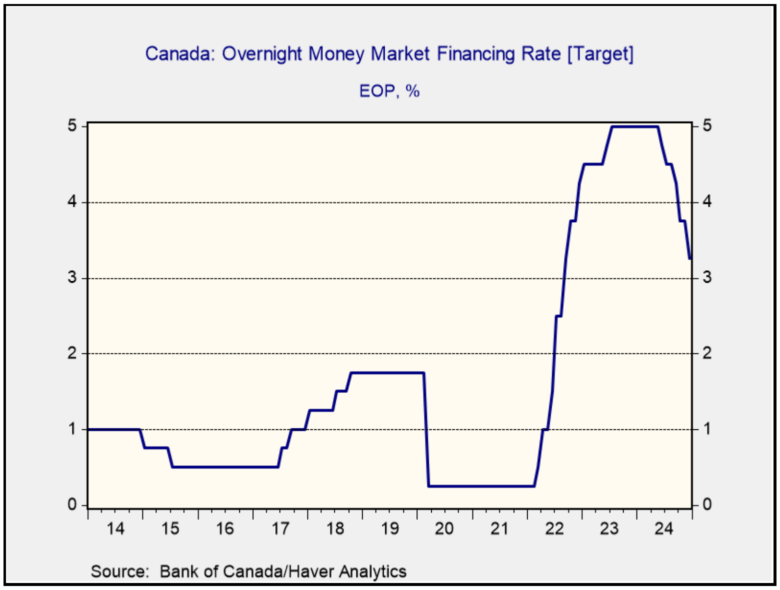
has already relied on five continuing resolutions this year, [which has helped push the deficit to nearly $2.0 trillion this fiscal year]. This puts it on track to be the largest deficit outside the pandemic era.



- The dispute over the budget will set up a showdown regarding how to raise the debt ceiling, which expires January 1. The ongoing political infighting over the budget is likely to raise investor concerns about the US government's ability to address its fiscal challenges. The two major rating agencies have already downgraded the US credit rating, citing concerns about partisan gridlock, which could prevent a bipartisan agreement to reduce the deficit. As a result, we anticipate that continued political bickering over the debt will likely impact long-term interest rates in the future.

BOC and Tariff Threats: The Bank of Canada slashed rates by 50 basis points to stimulate its economy but warned of economic risks due to trade tensions with the US.

- The central bank lowered its policy rate to 3.25%, its lowest level since September 2022. Following the reduction, the central bank signaled a more gradual approach to future rate cuts. This shift in tone suggests that larger rate cuts may be less likely, and the central bank could adopt a more modest approach to its guidance as it seeks to stimulate the economy. During the press conference, Bank of Canada Governor Tiff Macklem warned that the economic outlook has deteriorated due to the threat of tariffs against Canada.
- The threat of tariffs poses a significant risk to the Canadian economy, which is already facing a slowdown. In the third quarter of 2024, GDP growth decelerated from an annualized pace of 2.2% to 1.0%. This slowdown was primarily driven by a decline in investment spending, which has been a drag on GDP for five of the last six quarters. The threat of a trade war could intensify business uncertainty, making it harder for companies to justify capital expenditures and job creation in Canada.

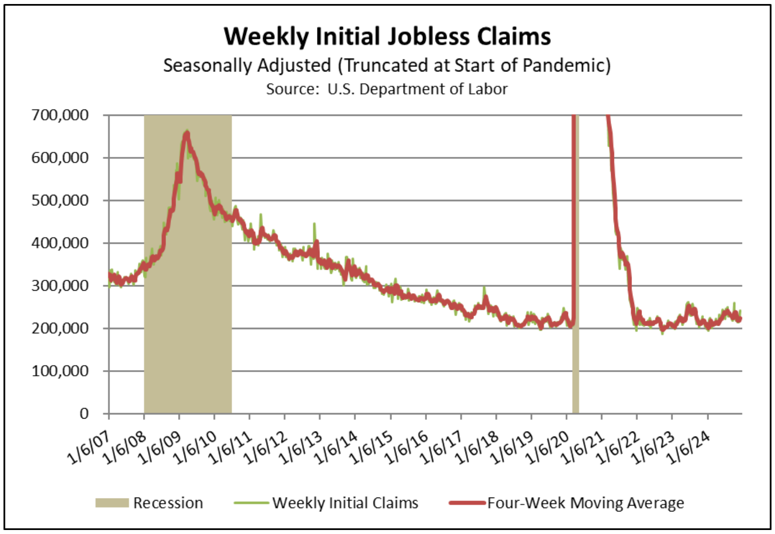


- A potential trade war with the US could significantly harm Canada's economy, as roughly 20% of its GDP is tied to trade with its southern neighbor. To mitigate the negative impact of potential tariffs, the Bank of Canada is likely to ease monetary policy further to make it easier for households and firms to borrow. This could lead to a depreciation of the Canadian dollar relative to the US dollar, but it could also make Canadian exports more competitive globally.

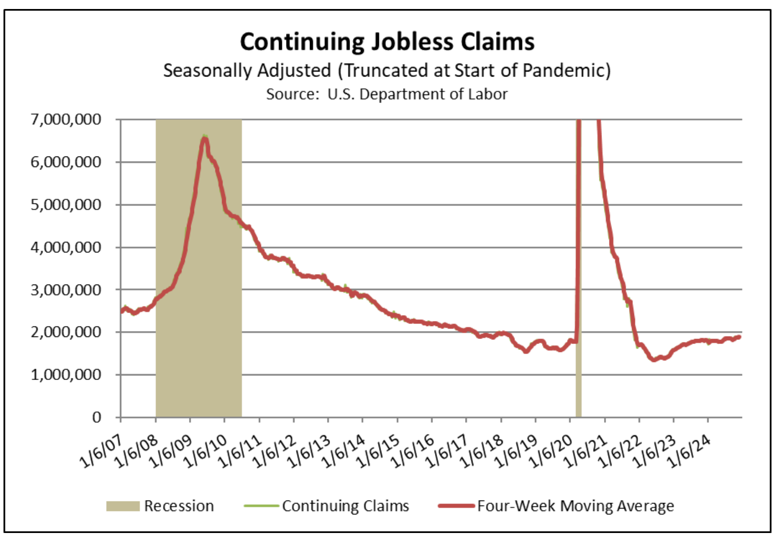
In Other News: President-elect Trump has asked Chinese President Xi Jinping to join him at his inauguration as a possible olive branch. This move suggests a possible easing of tensions between the two sides. Microsoft shareholders voted down a measure that would allow the company to add bitcoin to its balance sheet, indicating that crypto is becoming more widely accepted. The European Central Bank voted to cut its benchmark policy rate by 25 bps to 3.00%.

US Economic Releases

In the week ended December 7, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 242,000, well above both the expected level of 220,00 and the previous week's revised level of 225,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 224,250. However, all these figures remain low enough to suggest labor demand remains robust. The chart below shows how initial jobless claims have fluctuated since just before the Great Financial Crisis. The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.

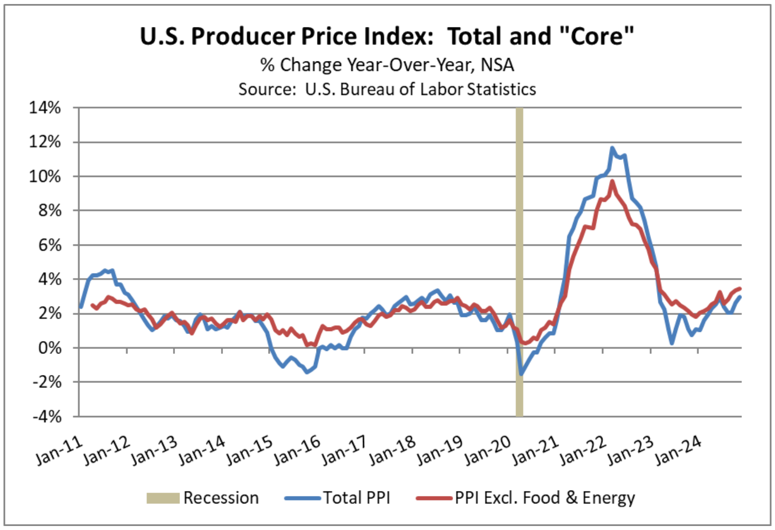


In the week ended November 30, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to a seasonally adjusted 1.886 million, above both the anticipated reading of 1.877 million and the prior week's 1.871 million. The four-week moving average of continuing claims rose to 1.888 million. The chart below shows how continuing claims have fluctuated since the GFC. It is also truncated during the pandemic period because of the high level of claims at the time.



Separately, the November ***producer price index (PPI)*** jumped by a seasonally adjusted 0.4%, twice the expected rise of 0.2% and more than the revised October increase of 0.3%. However, excluding the volatile food and energy components, the November ***"core" PPI*** rose just 0.2%, matching expectations and decelerating from its October gain of 0.3%. The overall PPI in November was up 3.0% from the same month one year earlier, while the core PPI was up 3.4%.

The chart below shows the year-over-year change in the PPI and the core PPI over the last decade or so.



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	Japan Buying Foreign Bonds	w/w	6-Dec	-¥640.8b	¥922.4b	--	*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	6-Dec	-¥954.8b	-¥544.7b	--	*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	6-Dec	¥1006.4b	¥176.1b	--	*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	6-Dec	¥482.3b	-¥607.7b	--	*	Equity and bond neutral
Australia	Employment Change	m/m	Nov	35.6k	12.1k	25.0k	***	Equity and bond neutral
	Unemployment Rate	m/m	Nov	3.9%	4.1%	4.2%	***	Equity and bond neutral
	Participation Rate	m/m	Nov	67.0%	67.1%	67.1%	**	Equity and bond neutral
India	CPI	y/y	Nov	5.5%	6.2%	5.5%	***	Equity and bond neutral
	Industrial Production	y/y	Oct	3.5%	3.1%	3.6%	***	Equity and bond neutral
EUROPE								
UK	RICS House Price Balance	y/y	Nov	25.0%	16.0%	19.0%	**	Equity bearish, bond bullish
Russia	CPI	y/y	Nov	8.9%	8.5%	8.9%	***	Equity and bond neutral
	Core CPI	y/y	Nov	8.3%	8.2%	8.4%	**	Equity and bond neutral
	Gold and Forex Reserves	m/m	6-Dec	$64.4b	$614.1b		***	Equity and bond neutral
	Trade Balance	m/m	Oct	9.1b	12.4b		**	Equity and bond neutral
	Exports	m/m	Oct	36.6b	39.1b		*	Equity and bond neutral
	Imports	m/m	Oct	27.5b	26.8b		*	Equity and bond neutral
AMERICAS								
Mexico	Industrial Production	y/y	Oct	-2.2%	-0.3%	-0.6%	***	Equity bearish, bond bullish
	Manufacturing Production	y/y	Oct	0.5%	0.8%	2.1%	*	Equity bearish, bond bullish
Brazil	Retail Sales	y/y	Oct	6.5%	2.3%	4.8%	***	Equity bullish, bond bearish

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)	425	426	-1	Down
U.S. Sibor/OIS spread (bps)	436	437	-1	Down
U.S. Libor/OIS spread (bps)	434	435	-1	Down
10-yr T-note (%)	4.30	4.27	0.03	Up
Euribor/OIS spread (bps)	289	287	2	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**	
ECB Deposit Facility Rate	3.000%	3.250%	3.000%	On Forecast
ECB Main Refinancing Rate	3.150%	3.400%	3.150%	On Forecast
ECB Marginal Lending Facility	3.400%	3.650%	3.400%	On Forecast
Swiss National Bank Policy Rate	0.500%	1.000%	0.750%	Below Forecast
Bank of Canada Rate Decision	3.250%	3.750%	3.250%	On Forecast
Brazil Selic Rate	12.250%	11.250%	12.000%	Above 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.

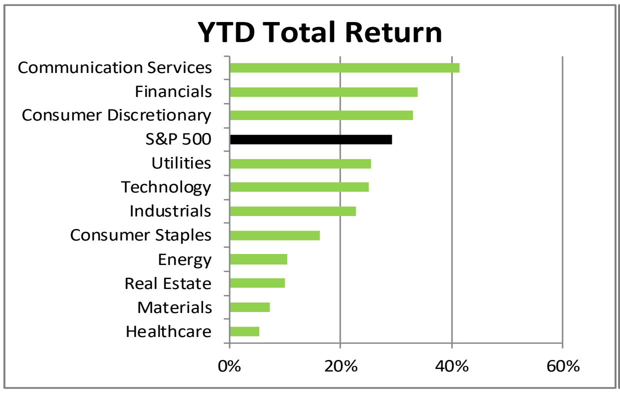
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$73.48	$73.52	-0.05%	
WTI	$70.37	$70.29	0.11%	
Natural Gas	$3.37	$3.38	-0.38%	
Crack Spread	$16.55	$16.59	-0.23%	
12-mo strip crack	$19.91	$19.97	-0.28%	
Ethanol rack	$1.75	$1.75	-0.01%	
Metals				
Gold	$2,709.73	$2,718.23	-0.31%	
Silver	$31.82	$31.90	-0.24%	
Copper contract	$428.35	$426.35	0.47%	
Grains				
Corn contract	$447.25	$448.25	-0.22%	
Wheat contract	$563.75	$563.25	0.09%	
Soybeans contract	$1,004.00	$1,002.75	0.12%	
Shipping				
Baltic Dry Freight	1,106	1,156	-50	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-1.43	-1.10	-0.33	
Gasoline (mb)	5.09	1.20	3.89	
Distillates (mb)	3.24	1.00	2.24	
Refinery run rates (%)	-0.9%	-0.1%	-0.8%	
Natural gas (bcf)		-172		

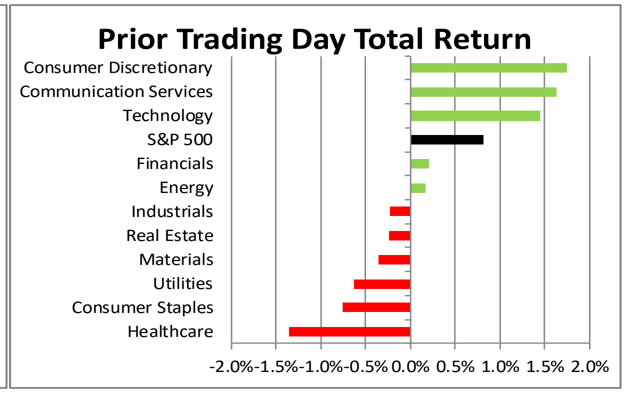
Weather

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 Upper Midwest. The forecasts call for wetter-than-normal conditions in the Pacific Northwest, southern Texas, and East Coast regions, with dry conditions in the Rocky Mountains and Great Plains.

Data Section

US Equity Markets – (as of 12/11/2024 close)

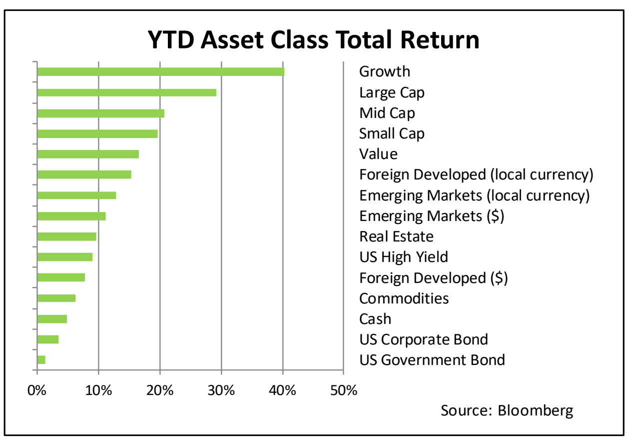




(Source: Bloomberg)

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 12/11/2024 close)

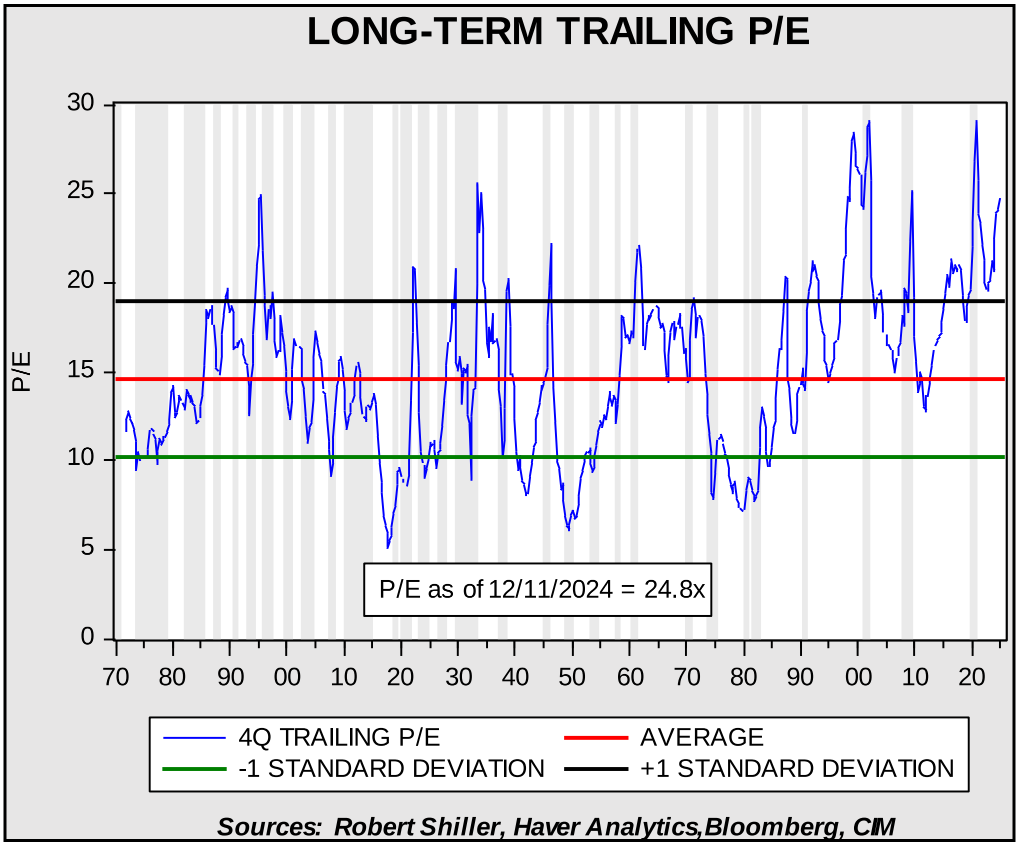


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 12, 2024



Based on our methodology,[1] the current P/E is 24.8x, down 0.1 from our last report. The decrease in the multiple was driven by an increase in earnings offsetting the 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.