Daily Comment

By Patrick Fearon-Hernandez, CFA, and Thomas Wash

[Posted: December 17, 2024 — 9:30 AM ET] Global equity markets are lower this morning. In Europe, the Euro Stoxx 50 closed essentially unchanged from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.7%. Chinese markets were lower, with the Shanghai Composite down 0.7% from its previous close and the Shenzhen Composite down 1.7%. 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
The 2025 Geopolitical Outlook **(12/16/24)** + **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 new developments in Japanese monetary and energy policy. We next review several other international and US developments with the potential to affect the financial markets today, including a shock resignation by Canada's finance minister and signs that President-elect Trump wants to reduce the US defense budget to help pay for extending his 2017 tax cuts.

Japanese Monetary Policy: As investors focus on the Fed's monetary policy decision tomorrow (see below), the Bank of Japan will be holding its latest policy meeting on Thursday. Based on current futures trading, investor opinion is basically split on whether the BOJ will hike its benchmark interest rate or hold it steady at the current level of 0.25%. BOJ policymakers remain keen to normalize Japan's interest rates if inflation and economic growth meet expectations, but government officials want rates to remain low to boost growth rates.

Japanese Energy Policy: The government has released a new study showing nuclear power will be Japan's cheapest baseload electricity in 2040, at 12.50 JPY ($0.08) per kilowatt-hour. In its prior long-term forecast, the government said natural gas would be Japan's cheapest baseload electricity in 2030, but the new study shows that emissions mitigation requirements would push its all-in cost above that of nuclear over the longer term. The findings support the government's plan to double down on nuclear power in Japan's long-term energy mix.

- Notably, the study also showed that the all-in cost of solar-generated electricity would exceed that of nuclear power in the long run. According to the study, that's due to the need for batteries and other equipment to make up for solar energy's intermittent nature.
- The findings are consistent with our expectation for increased nuclear energy investment around the world in the coming years. That, along with China's program to boost its arsenal of nuclear weapons, will likely buoy uranium prices in the coming years as well.

China: Illustrating how China is prioritizing its effort to dominate the world's electric-vehicle market, the Foreign Ministry has reportedly begun recruiting science and technology graduates to serve in embassies around the world. As part of the recruitment process, the candidates were tested on their knowledge of Communist Party ideology and their understanding of EVs. Once hired, the candidates will presumably use their embassy positions to help open those local markets to Chinese EVs.

United Kingdom-China: The Labour Party government of Prime Minister Starmer has reportedly decided to downgrade its promised in-depth study of UK-China relations and the security and economic risks they entail. According to the sources, the decision to opt for a quicker, more cursory, less critical review was made to avoid spoiling Starmer's effort to repair the UK-China trade relationship.

- Starmer is desperately trying to re-ignite the UK economy, which has been in a funk ever since Brexit and the coronavirus pandemic. One problem has been a loss of trade with the European Union since Brexit and the UK's failure to coax the US into a free-trade deal to replace it. With the US now so isolationist and protectionist, Starmer is turning to China for new trade opportunities and potentially better growth.
- The situation illustrates the geopolitical risks the US faces as it adopts more isolationist and protectionist policies, including potential new tariffs and other trade barriers against even its core allies. As noted in our new *Geopolitical Outlook for 2025*, those policies could weaken the cohesion of the US geopolitical bloc. In a worst-case scenario, they could even incentivize US allies to draw closer to adversary countries such as China, Russia, Iran, or North Korea.

Turkey-Syria: According to US officials, Turkey and its militia partners are building up troop levels on the Syrian border in apparent preparation for a large-scale incursion into the country. Ankara's most likely goal would be to seize Syrian territory populated by US-backed ethnic Kurds before President-elect Trump takes office again in the US.

- The Syrian Kurds and their brethren in Turkey dream of forming a Kurdish republic on territory taken from both Turkey and Syria. To press the issue, a Kurdish terrorist group has long staged attacks in Turkey. Therefore, Ankara has a strong incentive to take control of the Kurds' territory while the Syrian government is largely dysfunctional following the fall of President Assad last week.

- Turkey's move would come as Israel continues to attack Syrian military sites to keep Assad's chemical weapons and other advanced arms away from the new Syrian government or terrorists.
- The possible Turkish incursion is a reminder that the fall of Assad doesn't necessarily mean a quick return to peace and stability in Syria or the broader region. The volatility means the region's globally important energy resources will remain at risk of disruption in the near term.

Argentina: New data shows that gross domestic product grew by a seasonally adjusted 3.9% in the third quarter, marking an end to the sharp recession that began in late 2023. The growth came largely from rebounding consumer spending and corporate investment as Argentines adjusted to the Milei government's sharp budget cuts and deregulation program. In response, the yield spread between Argentine and US government bonds fell to 677 basis points, versus more than 2,000 basis points one year ago.

Canada: Finance Minister Chrystia Freeland, who had been one of Prime Minister Trudeau's most loyal and trusted aides, abruptly tendered her resignation yesterday and released a blistering letter attacking Trudeau's plan to release fiscal stimulus ahead of US President-elect Trump's threatened import tariffs. Instead, Freeland argued that Canada should keep its fiscal powder dry to address any fallout from US policy in the future.

- In the latest opinion polls, support for Trudeau and his center-left Liberal Party is far below that of the center-right Conservative Party. Freeland's resignation will therefore add to the enormous pressure on Trudeau to resign. However, Trudeau has steadfastly refused to give up and said he intends to campaign for re-election next year.
- On top of Trump's threatened tariffs against Canada, the increasing political and policy uncertainty in the country is likely to discourage new investment and consumer spending. That will probably weigh on both economic growth and Canada's financial markets well into 2025.

US Monetary Policy: The Federal Reserve begins its latest monetary policy meeting today, with its decision due tomorrow at 2:00 PM ET. Based on current futures trading, the policymakers are widely expected to cut the benchmark fed funds interest rate by 25 basis points to a range of 4.25% to 4.50%. The bigger question is what their updated economic and financial market forecasts will look like.

- In their September projections, the policymakers stated that they expected to cut the fed funds rate by another 1.00% over 2025, to a range of 3.25% to 3.50% by year's end. They expect perhaps another couple of small rate cuts in 2026.
- Given the US economy's continued growth and sticky price pressures, we would not be surprised if the new projections this week call for fewer future rate cuts and a terminal rate higher than what investors currently expect. That could set the stage for some financial market volatility when the decision is released on tomorrow.

US Defense Budget: According to Axios, President-elect Trump has told former Fox News commentator Pete Hegseth, his nominee for defense secretary, to prepare for a smaller US military budget. The report quotes Trump as telling Hegseth, "I expect you to do more with less. They're spending too much money, and we're not getting anything for all that money." The report is the clearest sign yet that Trump may not follow the traditional Republican playbook of hiking defense spending to support a "peace through strength" foreign policy.

- We continue to believe that today's increasing international tensions and greater assertiveness by the China/Russia geopolitical bloc will lead to bigger defense budgets worldwide in the coming years. Indeed, that's already happening in much of Europe and Asia. However, we've also noted that US political polarization, isolationism, and "America First" sentiment have held the Pentagon's budget in check. Trump's statement is a warning that the US defense budget could face outright cuts.
- We suspect that Trump wants to find savings in the defense budget to help pay for his tax cuts and other promised initiatives.
- Against this backdrop, the major defense firms in Europe and Asia may have better prospects than the major US defense contractors, which would likely face reduced funding for the big, expensive, "exquisite" weapons systems they specialize in.
- On the other hand, some of the US's savings will likely be channeled toward smaller, more innovative start-ups or young companies with defense-related technology, such as drone makers and artificial intelligence software providers. Those small, innovative defense firms could eventually become great growth stories.
- To reiterate, though, this scenario is probably not yet set in stone. President-elect Trump's coalition includes many traditional defense hawks who want to boost the defense budget to counter China and its bloc. For example, the Republicans' former Senate Majority Leader, Mitch McConnell, has a new article for *Foreign Affairs* magazine arguing for building a stronger US military rather than cutting it.

US Industrial Policy: The Department of Energy has granted a $755 million loan to Australian firm Novonix to build the US's first large-scale synthetic graphite plant in Chattanooga, Tennessee. The investment aims to break the US's dependency on China for the graphite needed in electric-vehicle battery production. It's also another example of how growing US-China frictions are fracturing global supply chains and prompting re-industrialization in the US.

US Economic Releases

November ***retail sales*** rose by a seasonally adjusted 0.7%, compared with an expected rise of 0.6% and October's gain of 0.5%. Of course, overall retail sales are often driven by the volatile auto and auto parts sector, which makes up almost one-fifth of the total. November ***retail sales excluding autos and auto parts*** rose 0.2%, compared to an expected rise of 0.4% and October's gain of 0.2%. Overall retail sales in November were up 4.0% from the same month one year earlier, while sales excluding autos and auto parts were up 3.3%. The chart below shows how retail sales have changed since just before the Global Financial Crisis.

The table below lists the economic releases and Fed events scheduled for the rest of the day.

Economic Releases						
ET	Indicator			Expected	Prior	Rating
10:00	Business Inventories	m/m	Oct	0.1%	0.1%	*
10:00	NAHB Housing Market Index	m/m	Dec	47.0	46.0	*
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								
Australia	Westpac Consumer Conf Index	m/m	Dec	-2	94.6		**	Equity and bond neutral
	Westpac Consumer Conf SA	m/m	Dec	92.8%	5.3%		**	Equity and bond neutral
New Zealand	Non Resident Bond Holdings	m/m	Nov	61.2	62.0		*	Equity and bond neutral
EUROPE								
Eurozone	ZEW Survey Expectations	m/m	Dec	17.0	12.5		**	Equity and bond neutral
	Trade Balance SA	m/m	Oct	6.1b	12.6b	11.6b	**	Equity and bond neutral
Germany	IFO Business Climate	m/m	Dec	84.7	85.6	85.5	***	Equity and bond neutral
	IFO Current Assessment	m/m	Dec	85.1	84.3	84.0	**	Equity and bond neutral
	IFO Expectations	m/m	Dec	84.4	87.0	87.5	**	Equity bearish, bond bullish
	ZEW Survey Expectations	m/m	Dec	15.7	7.4	6.9	**	Equity bullish, bond bearish
	ZEW Survey Current Situation	m/m	Dec	-93.1	-91.4	-92.6	**	Equity bearish, bond bullish
UK	Average Weekly Earnings 3M/YoY	m/m	Oct	5.20%	4.40%	4.60%	**	Equity bullish, bond bearish
	ILO Unemployment Rate 3Mths	m/m	Oct	4.30%	4.30%	4.30%	**	Equity and bond neutral
	Claimant Count Rate	m/m	Nov	4.60%	4.60%		**	Equity and bond neutral
	Jobless Claims Change	m/m	Nov	0.3k	-10.9k		**	Equity and bond neutral
AMERICAS								
Canada	Housing Starts	m/m	Nov	262.4k	242.2k	245.1k	**	Equity and bond neutral
Mexico	Retail Sales	y/y	Oct	-1.2%	-1.5%	0.2%	***	Equity bearish, bond bullish
	International Reserves Weekly	w/w	13-Dec		$228753m		*	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)	422	421	1	Down
U.S. Sibor/OIS spread (bps)	436	436	0	Down
U.S. Libor/OIS spread (bps)	434	434	0	Down
10-yr T-note (%)	4.43	4.40	0.03	Up
Euribor/OIS spread (bps)	286	284	2	Down
Currencies	**Direction**			
Dollar	Up	US		Down
Euro	Down	Euro		Up
Yen	Down	Japan		Up
Pound	Down	UK		Up
Franc	Down	Switzerland		Up

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.

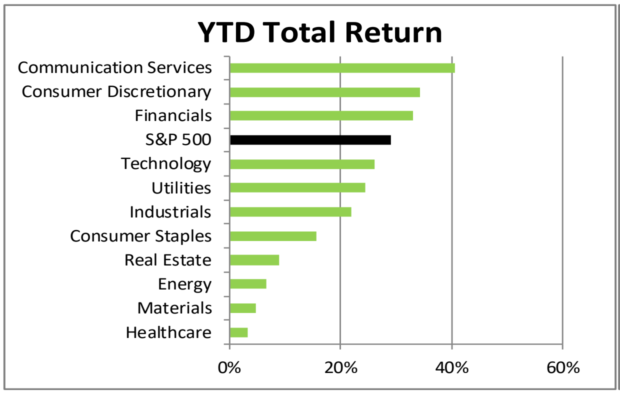
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$73.24	$73.91	-0.91%	
WTI	$69.98	$70.71	-1.03%	
Natural Gas	$3.23	$3.21	0.44%	
Crack Spread	$16.10	$16.32	-1.36%	
12-mo strip crack	$19.53	$19.72	-0.92%	
Ethanol rack	$1.73	$1.74	-0.12%	
Metals				
Gold	$2,642.57	$2,652.72	-0.38%	
Silver	$30.30	$30.55	-0.82%	
Copper contract	$414.65	$419.10	-1.06%	
Grains				
Corn contract	$445.50	$445.00	0.11%	
Wheat contract	$551.75	$550.00	0.32%	
Soybeans contract	$985.25	$986.00	-0.08%	
Shipping				
Baltic Dry Freight	1,071	1,051	20	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.70		
Gasoline (mb)		2.00		
Distillates (mb)		1.00		
Refinery run rates (%)		0.5%		
Natural gas (bcf)		-172		

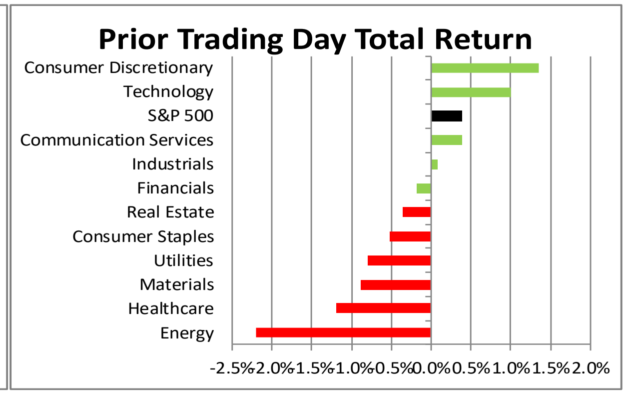
Weather

The 6-to-10-day and 8-to-14-day forecasts currently call for warmer-than-normal temperatures for the western two thirds of the country, with cooler-than-normal temperatures on the East Coast. The forecasts call for wetter-than-normal conditions in the Pacific Northwest, Texas, and Arkansas, with dry conditions in New England and the Desert Southwest.

Data Section

US Equity Markets – (as of 12/16/2024 close)

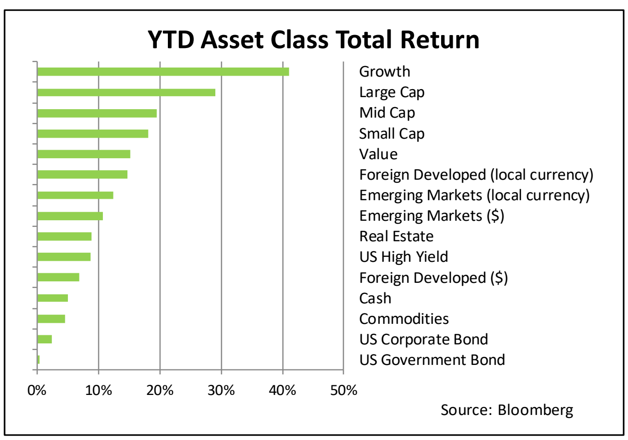




(Source: Bloomberg)

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 12/16/2024 close)

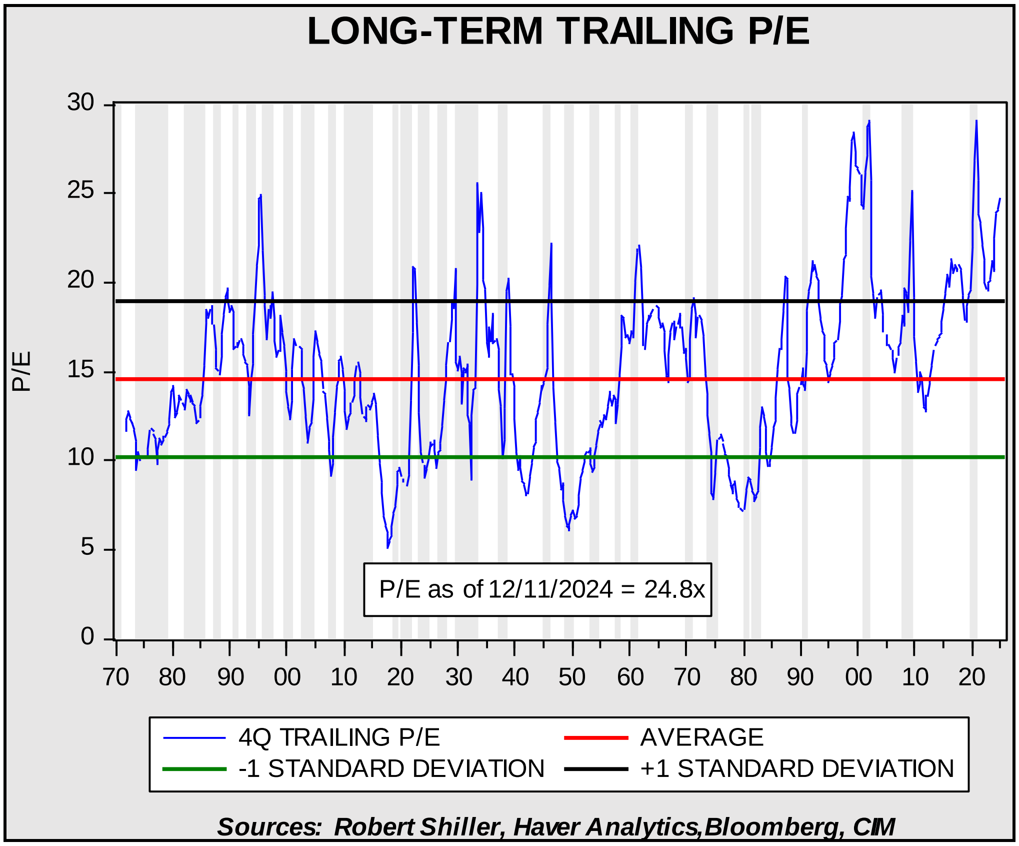


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

[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.