Daily Comment

By Patrick Fearon-Hernandez, CFA, and Thomas Wash

[Posted: December 18, 2024 — 9:30 AM ET] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 closed up 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.7%. Chinese markets were higher, with the Shanghai Composite up 0.6% from its previous close and the Shenzhen Composite also up 0.6%. 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
***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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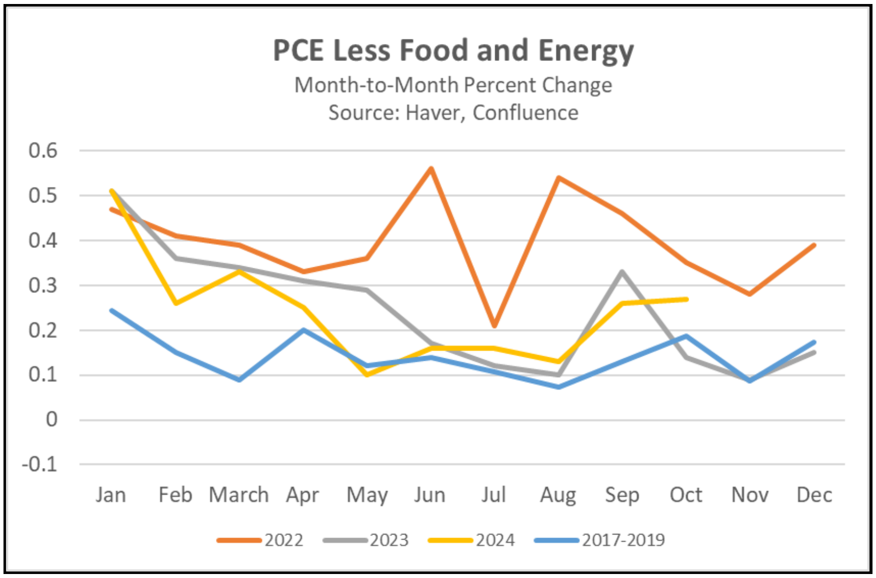
Good morning! The market is closely watching for the Federal Reserve's latest rate decision. In sports, Real Madrid's Vinícius Júnior has been awarded FIFA's The Best player, a moment many see as restoring balance to the football world. In today's *Comment*, we'll preview the Fed's decision, analyze the Dow Jones' recent slump, and provide an update on Brazil. As always, we'll conclude with a roundup of key domestic and international data releases.

Fed Decision: While the Fed is expected to cut rates today, markets will focus on the accompanying economic projections.

- The latest CME Group FedWatch Tool indicates a near-certainty of a 25 basis point rate cut today, with a 95% probability priced in. This confidence stems from reassurances from Fed officials and signs that the economic risks have become more balanced between inflation and unemployment. Earlier this month, Fed Governor Christopher Waller and Atlanta Fed President Raphael Bostic both signaled openness to a rate cut. Additionally, the November CPI inflation report, while up year-over-year, largely aligned with market expectations. At the same time, the unemployment rate has risen back to its 2024 peak level.

- While the rate cut at this meeting is widely anticipated, the market will be closely watching the number of rate cuts projected for 2025 in the updated dot plot. The September dot plot indicated that Fed officials expected to cut the federal funds rate target by a total of [100 basis points in 2025 to a range of 3.25%-3.50%.] However, stronger-than-expected economic growth and inflation's failure to reach new lows have prompted officials to call for [a slower pace of rate cuts heading into the new year]. As a result, the market now projects that the Fed could cut rates by 75 bps next year.

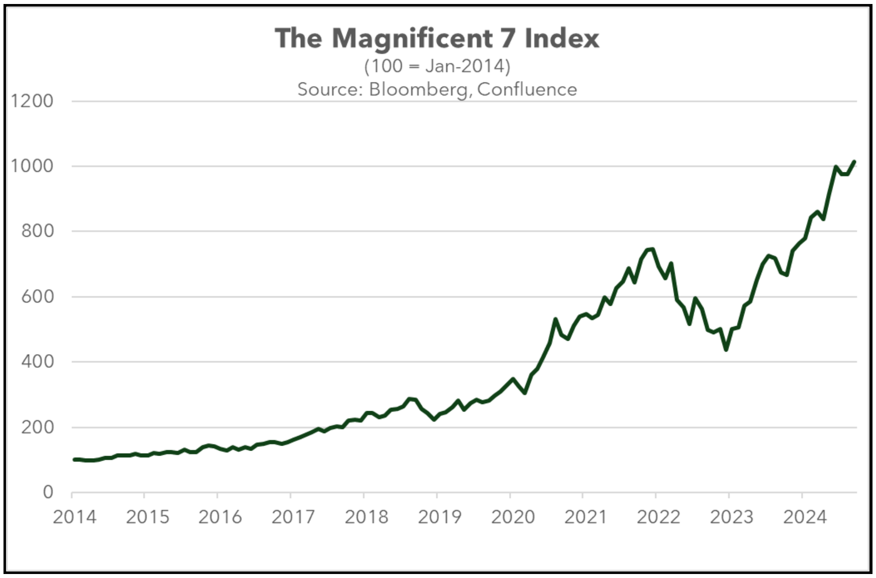


- In our view, the Fed's ability to cut rates will be determined by inflation's progress in the first three months of the year. As the chart above illustrates, the start of this year saw the widest gap between monthly PCE price inflation increases and its three-year pre-pandemic average. This divergence led several officials to question the need for rate cuts in 2025. Consequently, if inflation remains stubbornly high at the beginning of next year, the central bank may be less inclined to implement the projected rate cuts. This could mean that the Fed may end up cutting less than what the market currently expects.

Dow Jones Trouble: Recent S&P 500 and NASDAQ gains contrast the declining Dow Jones, highlighting the increasing influence of tech giants.

- The [Dow Jones Industrial Average Index extended its losing streak to nine consecutive days] on Tuesday, marking its longest downturn since the Jimmy Carter administration. The Dow Jones Index has not benefited from the rally in tech stocks, as only four of the Magnificent 7 companies (Amazon, Microsoft, Apple, and Nvidia) are included. Additionally, the index has been significantly impacted by the struggles of healthcare services following the tragic killing of the UnitedHealth CEO and the incoming administration's plans to regulate pharmacy benefit managers.
- The poor performance of the Dow Jones is another example of how concentrated equity markets have become in recent years. Tech stocks have been the primary drivers of the

S&P 500's performance this year, with the Magnificent 7 accounting for nearly 60% of the gains, which allowed them to increased their combined share of the S&P 500 to nearly 35% in the first six months of the year. This increased concentration means the overall index performance is highly sensitive to changes in sentiment toward the tech sector.



- Going into next year, we expect momentum to continue playing a major role in equity performance. As a result, we anticipate that mega cap tech companies will thrive as long as market expectations remain relatively unchanged. We believe that in 2025 many investors will flock to familiar names in search of safety amid concerns about elevated inflation and uncertainty regarding fiscal and monetary policy. However, the increased concentration of the S&P 500 suggests that the index is highly susceptible to exogenous shocks, which we will be monitoring closely in the coming months.

Brazil's Problems Deepen: Brazilian markets have plummeted as investors have sought to reduce their exposure to Latin America's largest economy due to concerns over its widening deficit.

- On Tuesday, the Brazilian real (BRL) plummeted to a record low, prompting investors to reduce their exposure to the country's debt and equities. The market turmoil was triggered by the lower house's approval of a spending package that included weakened measures to curb spending if revenue falls short of expectations. While the central bank intervened to stabilize the currency, serious concerns persist about Brazil's fiscal situation, which is likely to continue weighing on investor sentiment, especially as lawmakers prepare to pass three additional proposals.
- The country's budget deficit has reached 10% of GDP, exceeding the levels recorded during President Luiz Inácio Lula da Silva's first term. In response, Lula proposed a plan to cut annual spending by 70 billion BRL ($11.5 billion). However, the inclusion of

income tax breaks in the bill have raised concerns over the budgets' ability to rein in the deficit. Compounding the issue is the speculation that lawmakers may weaken provisions affecting social spending. Additionally, a key measure to rein in military pension expenses has been delayed until next year, further casting doubt on the plan's timely implementation.

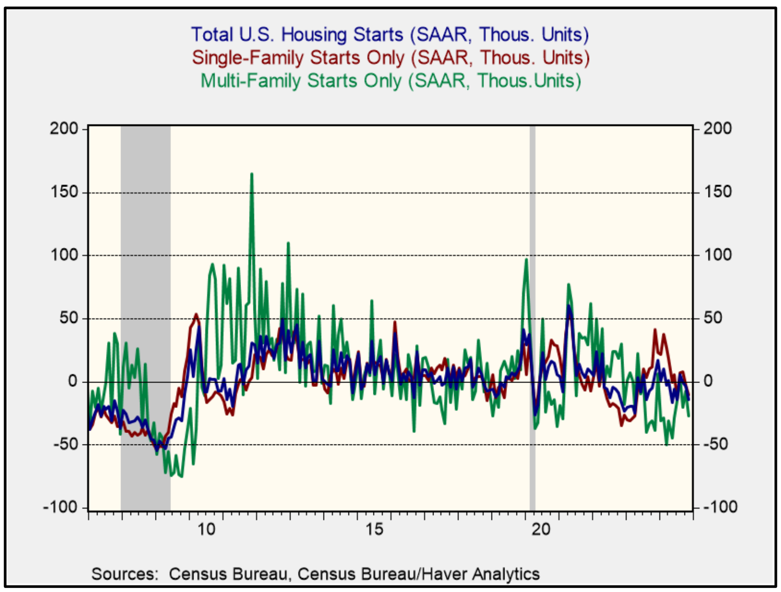
- Brazil's reluctance to make tough decisions to curb spending suggests that the central bank will likely bear the brunt of the burden. To prevent the country's widening deficit from exacerbating inflationary pressures, the Central Bank of Brazil may need to tighten financial conditions. This policy could eventually weigh on the country's GDP growth potential and negatively impact equities. However, if lawmakers adopt a stricter stance on the budget or if government revenues exceed expectations, investors may reconsider their outlook on Brazil.

In Other News: Nissan and Honda are reportedly discussing a potential merger as a strategy to increase their size and competitiveness in the automotive industry. Meanwhile, congressional lawmakers have reached an agreement to avert a government shutdown, which is expected to alleviate market uncertainty.

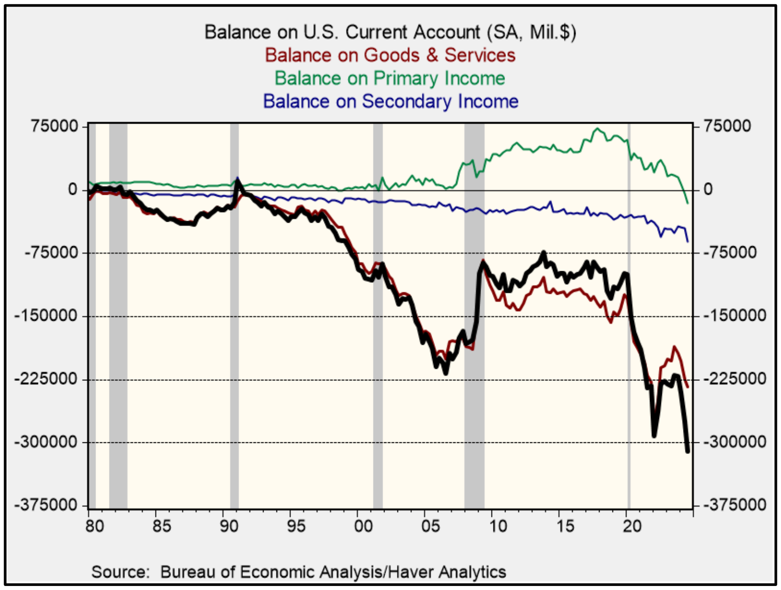
US Economic Releases

The Mortgage Bankers Association today said ***mortgage applications*** in the week ended December 14 fell 0.7%, compared to the prior week's gain of 5.4%. Applications for home purchase mortgages rose 1.4%, after falling 4.1% the prior week. Applications for refinancing mortgages fell 2.6%, after rising 27.2% the prior week. According to the report, the average interest rate on a 30-year mortgage rose 8 basis points to 6.75%.

November ***housing starts*** fell to a seasonally adjusted, annualized rate of 1.29 million units, falling short of the expected rate of 1.35 million units and the revised 1.31 from the prior month. The rate of housing starts in November fell 1.8% from the rate in the previous month, falling well short of the expected gain of 2.6%, but marking a slight deceleration of the prior month's 3.1% decline. November ***residential building permits*** rose to a rate of 1.51 million units, exceeding the expected rate of 1.43 million units and the revised 1.42 million units from the prior month. Permits issued for new housing units in November rose sharply 6.1% from the previous month, significantly exceeding the 1.0% expectation and the prior month's 0.4% decline. Compared with the same month one year earlier, housing starts in November fell 14.6%, while permits fell 0.2%. The chart below shows the growth in new home starts by type of property since just before the Global Financial Crisis.



Another report today focused on the country's overall balance of international current transactions. The third-quarter ***current account balance*** showed a deficit of $310.9 billion. The overall current account balance has been in deficit almost constantly since globalization really began to take hold at the beginning of the 1980s, mostly reflecting the US trade deficit. The chart below shows the overall current account balance since 1980, along with each of its three components: the balance on trade in goods and services, primary income (mostly income on foreign investments), and secondary income (gifts, remittances, personal transfers, etc.).



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

Economic Releases						
ET	**Indicator**			**Expected**	**Prior**	**Rating**
14:00	FOMC Rate Decision (Lower Bound)	w/w	18-Dec	4.25%	4.50%	***
14:00	FOMC Rate Decision (Upper Bound)	w/w	18-Dec	4.50%	4.75%	***
14:00	Interest on Reserve Balances Rate	w/w	19-Dec	4.40%	4.65%	**
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	Trade Balance	y/y	Nov	-¥117.6b	-¥462.1b	-¥687.9b	**	Equity and bond neutral
	Exports	y/y	Nov	3.8%	3.1%	2.5%	*	Equity and bond neutral
	Imports	y/y	Nov	-3.8%	0.4%	0.8%	*	Equity and bond neutral
Australia	Westpac Leading Index	m/m	Nov	0.05%	0.16%		**	Equity and bond neutral
New Zealand	Wespac Consumer Confidence	m/m	4Q	97.5	90.8		*	Equity and bond neutral
EUROPE								
Eurozone	Construction output	y/y	Oct	0.2%	-2.0%		*	Equity and bond neutral
	CPI	y/y	Nov F	2.2%	2.0%	2.3%	***	Equity and bond neutral
	Core CPI	y/y	Nov F	2.7%	2.7%	2.7%	**	Equity and bond neutral
UK	CPI	y/y	Nov	2.6%	2.3%	2.6%	***	Equity and bond neutral
	CPI Core	y/y	Nov	3.5%	3.3%	3.6%	***	Equity and bond neutral
	Retail Price Index	m/m	Nov	390.9	390.7	391.4	**	Equity and bond neutral
	RPI	y/y	Nov	4%	3.4%	3.7%	**	Equity and bond neutral
AMERICAS								
Canada	Int'l Securities Transactions	m/m	Oct	21.55b	29.65b		**	Equity and bond neutral
	CPI	y/y	Nov	1.9%	2.0%	2.0%	***	Equity and bond neutral
Mexico	Aggregate Supply and Demand	y/y	3Q	2.3%	2.1%	2.3%	*	Equity and bond neutral
	International Reserves Weekly	w/w	13-Dec	$228654m	$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)	424	422	2	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 (%)	4.41	4.40	0.01	Up
Euribor/OIS spread (bps)	287	286	1	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.

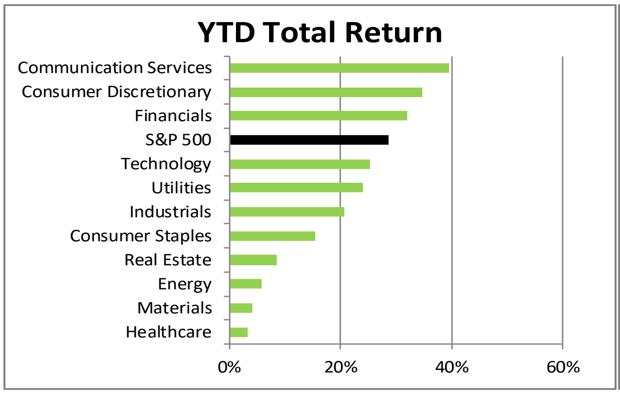
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$73.59	$73.19	0.55%	
WTI	$70.54	$70.08	0.66%	
Natural Gas	$3.37	$3.31	1.78%	
Crack Spread	$15.81	$15.63	1.17%	
12-mo strip crack	$19.47	$19.35	0.60%	
Ethanol rack	$1.73	$1.73	-0.03%	
Metals				
Gold	$2,645.73	$2,646.83	-0.04%	
Silver	$30.39	$30.54	-0.51%	
Copper contract	$415.45	$414.65	0.19%	
Grains				
Corn contract	$444.25	$443.50	0.17%	
Wheat contract	$546.75	$545.00	0.32%	
Soybeans contract	$968.00	$978.75	-1.10%	
Shipping				
Baltic Dry Freight	1,053	1,071	-18	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.70		
Gasoline (mb)		2.00		
Distillates (mb)		1.10		
Refinery run rates (%)		0.0%		
Natural gas (bcf)		-124		

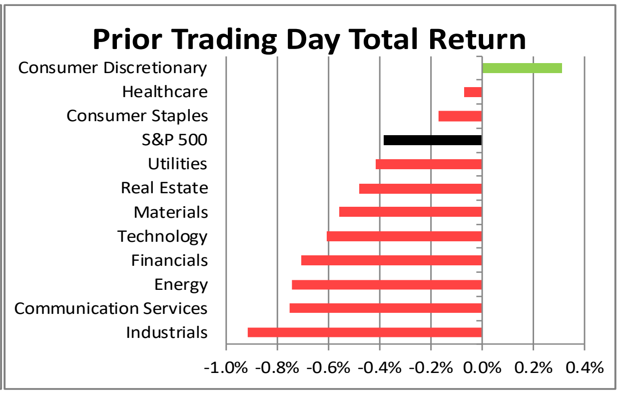
Weather

The 6-to-10-day and 8-to-14-day forecasts currently call for warmer-than-normal temperatures for the western three quarters of the country, with cooler-than-normal temperatures on the East Coast. The forecasts call for wetter-than-normal conditions across most of the country, with dry conditions in New England and the Desert Southwest.

Data Section

US Equity Markets – (as of 12/17/2024 close)

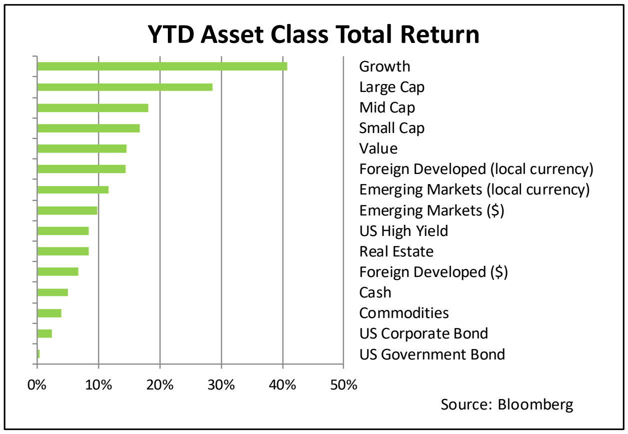




(Source: Bloomberg)

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 12/17/2024 close)

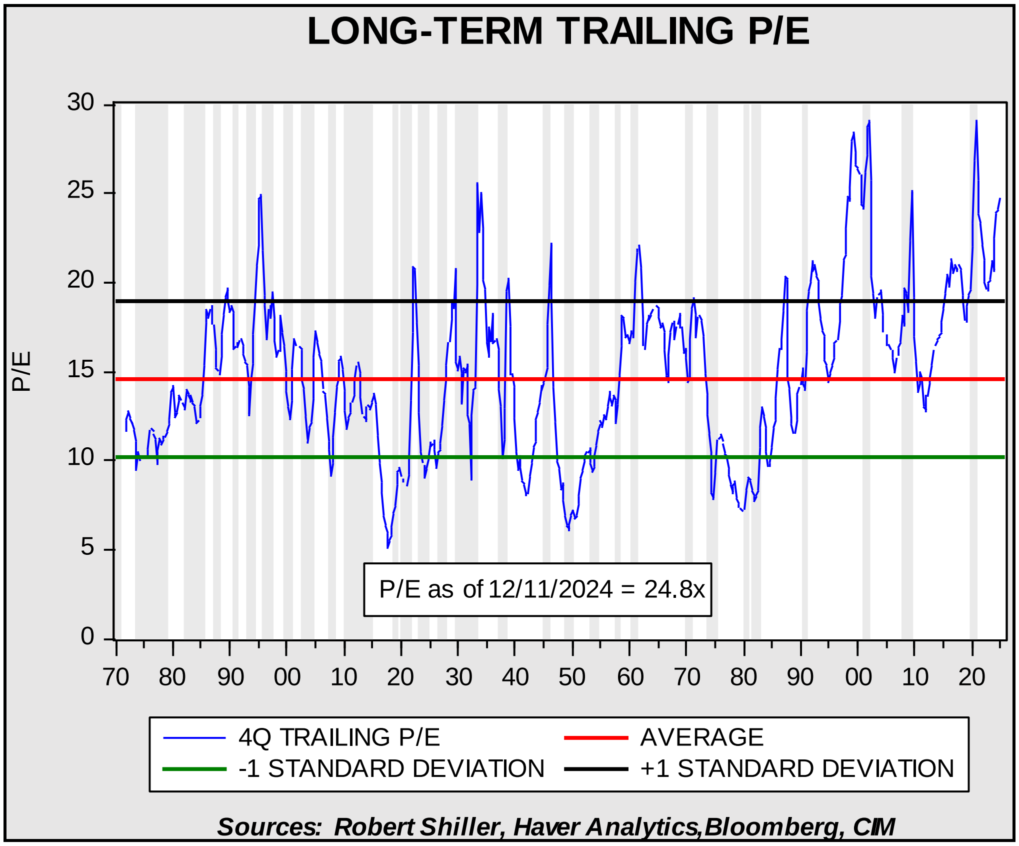


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.