Daily Comment

By Patrick Fearon-Hernandez, CFA, and Thomas Wash

[Posted: December 19, 2024 — 9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 closed down 1.4% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 1.3%. Chinese markets were mixed, with the Shanghai Composite down 0.4% from its previous close and the Shenzhen Composite up 0.4%. 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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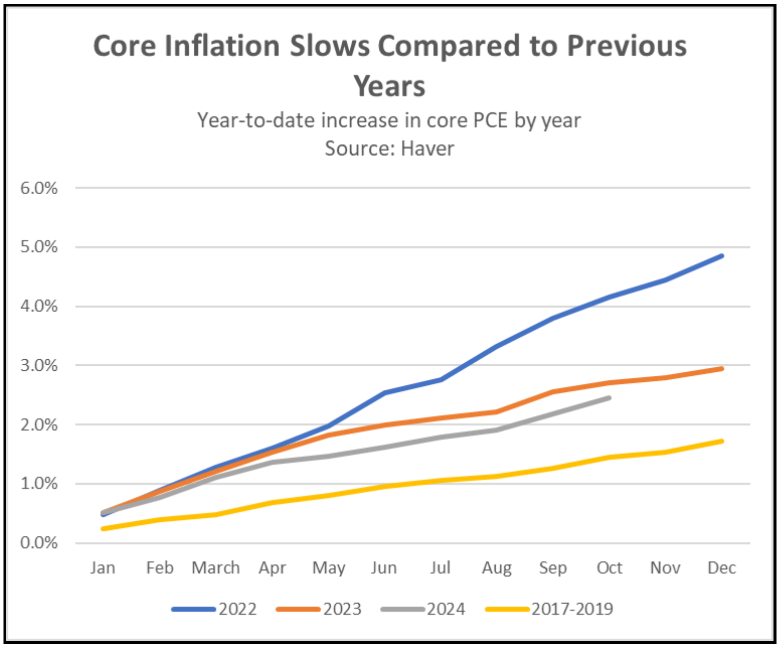
Good morning. The market is digesting the latest GDP data. In sports, Real Madrid secured its fifth trophy of the year by winning the FIFA Intercontinental Cup. In today's *Comment*, we'll analyze the Federal Reserve's latest rate decision, explore why long-term bond yields continue to rise, and review the Bank of Japan's choice to maintain its monetary policy stance. As always, the report includes a roundup of key international and domestic data releases.

Fed's Hawkish Cut: The Federal Open Market Committee voted to cut rates but also scaled back the number of projected rate cuts for 2025.

- In a widely anticipated decision, the Federal Reserve lowered its target range for the federal funds rate to 4.25%–4.50%. While most policymakers endorsed the move, Cleveland Fed President Beth Hammack dissented, advocating for no change. Alongside the rate cut, the Fed revised its economic projections, raising its 2025 inflation forecast from 2.1% to 2.5% and reducing its expected rate cuts from 100 to 50 basis points. During the press conference, Fed Chair Jerome Powell cautioned that the outlook for rate cuts could shift if inflation moderates further next year.

- The Federal Reserve's ability to lower interest rates in 2025 will depend on inflation trends during the first quarter. In the first three months of 2024, monthly inflation peaked, driven by sharp increases in financial services, insurance, and housing costs. While the preceding months have moderated, the spike complicated the Fed's efforts to meet its target inflation rate. The latest Personal Consumption Expenditure (PCE) price index indicates that while headline inflation was 2.3% year-over-year, underlying price pressures, excluding the surge from the first quarter, have moderated to an annualized rate of 1.9%.



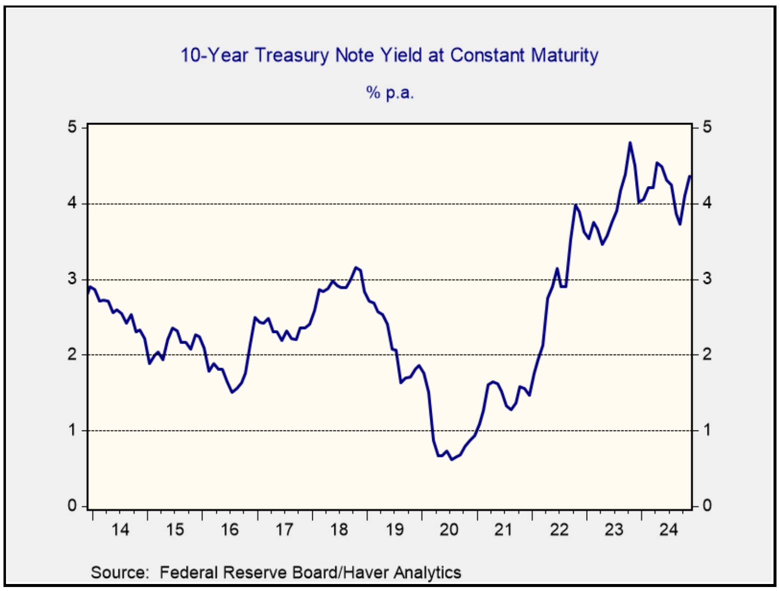
- The Federal Reserve's future policy rate decisions will hinge on inflation trends in the first quarter. If inflation moderates during this period, the Fed may adopt a more accommodative stance. Conversely, if inflation accelerates, a more restrictive policy may be necessary. This is because reducing inflation becomes more challenging after the first quarter, as spring and summer inflation trends have aligned with historical norms over the last two years. Consequently, we advise investors to remain cautious, as interest rates could move in either direction depending on how inflation unfolds.

Bond Market Roars: The 10-year Treasury yield has surged amid growing deficit worries and the Fed's less accommodative policy stance.

- On Wednesday, the 10-year Treasury yield climbed to 4.5%, a level not seen since May. This rise was primarily driven by growing uncertainty about the Federal Reserve's potential to cut interest rates in 2025. Since the Fed's rate cut in September, Treasury yields have increased by nearly 90 basis points as investors became increasingly concerned that a widening budget deficit could exacerbate inflationary pressures. The

Congressional Budget Office's recent upward revisions to its forecasts for inflation, unemployment, and long-term interest rates have further fueled these concerns.

- Uncertainty surrounding next year's policy direction, particularly the potential inflationary impact of tariffs and tax cuts, may be driving up bond yields. A recent study underscores the inflationary risks associated with these policies, estimating that a 10% tariff increase could raise the PCE price index by 0.6%, a 60% tariff on Chinese goods could add 0.4%, and a combination of both could increase it by 1%. Additionally, the proposed tax cuts, which are expected to boost aggregate demand, could further exacerbate inflationary pressures.

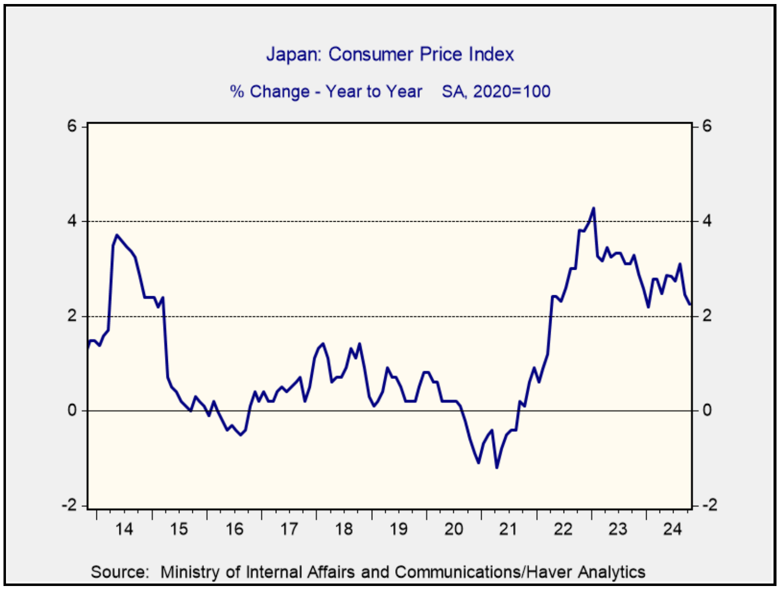


- Long-term Treasury yields are likely to be highly sensitive to fiscal policy changes in the year ahead. If the Trump administration proposes sufficient spending cuts or scales back some campaign promises, the bond market is likely to respond favorably. Moreover, tariffs, which are likely to face legal challenges, could prove less inflationary than currently anticipated. While we recognize the potential for upside risk in Treasury yields, we remain cautiously optimistic that market fears may not fully materialize.

The BOJ Holds: Japanese central bankers opted to maintain the current monetary policy stance, indicating a strategic pause before potentially implementing a third interest rate hike.

- The Bank of Japan (BoJ) held its benchmark interest rate steady at 0.25%, aligning with market expectations. However, one policymaker dissented, advocating for a rate hike to 0.5%. While policymakers expressed concerns about potential wage pressures, the decision to maintain the current rate likely reflects worries about the potential economic impact of US tariffs. During the press conference, BoJ Governor Kazuo Ueda hinted at the possibility of a future rate hike, possibly in January or March, when the central bank has a clearer understanding of wage pressures.

- Japanese policymakers' persistent adherence to accommodative monetary policy has exacerbated concerns about their ability to effectively control inflation. This sentiment was reflected in the yen's (JPY) depreciation following the central bank's decision, surpassing the key 155 JPY level against the dollar. While overall inflation appears to be moderating, core inflation, excluding volatile energy prices, remains above the 2% target, signaling persistent price pressures. Notably, service sector inflation has accelerated, indicating that businesses are increasingly capable of passing on rising labor costs to consumers.

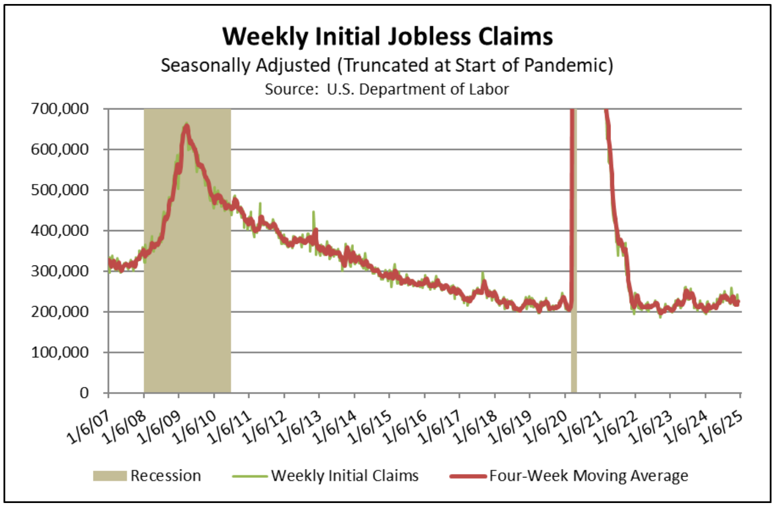


- The Bank of Japan's decision to maintain low interest rates underscores the potential for countries to employ accommodative monetary policy to mitigate the potential negative impact of tariffs. By keeping their currencies relatively weak, these countries aim to maintain export competitiveness. However, this approach may lead to higher inflation within their own economies. As tariff tensions escalate, the dollar is likely to strengthen due to increased demand for a safe-haven currency. Furthermore, a lack of progress in global inflation could boost the appeal of commodities as investments.

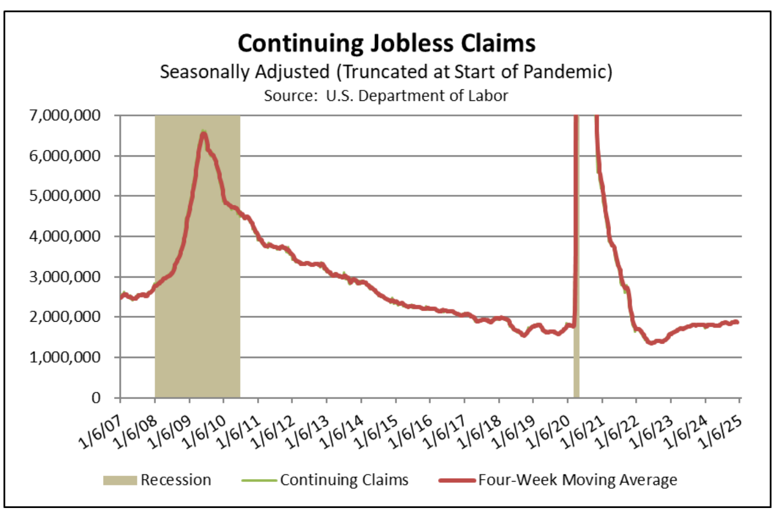
In Other News: Russian President Vladimir Putin has expressed an openness to meeting with Donald Trump, a discussion that could potentially pave the way for resolving the conflict in Ukraine. Meanwhile, the US government is facing an increased risk of a shutdown as Elon Musk and Trump oppose a continuing resolution to prevent it.

US Economic Releases

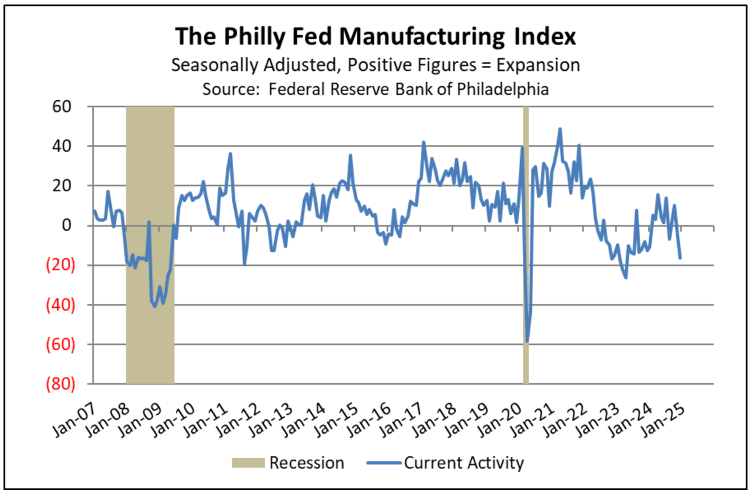
In the week ended December 14, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 220,000, below both the expected level of 230,000 and the previous week's level of 242,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 225,500. By all measures, the initial claims data still suggests the demand for labor is strong and layoffs are minimal. 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.



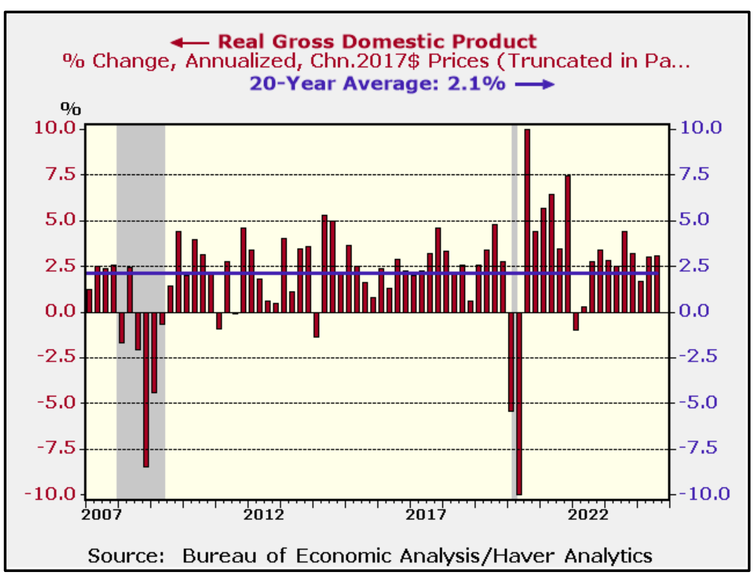
In the week ended December 7, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) fell to a seasonally adjusted 1.874 million, below both the anticipated reading of 1.892 million and the prior week's revised reading of 1.879 million. The four-week moving average of continuing claims fell to 1,880,250. 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.



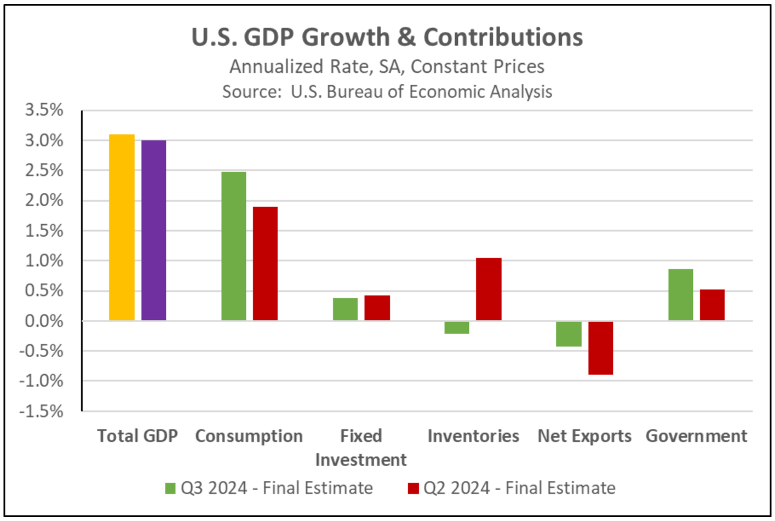
Separately, the Philadelphia FRB said its December ***Philly Fed Index*** plunged to a seasonally adjusted -16.4, dramatically missing the expected reading of 2.8 and coming in even worse than the November reading of -5.5. The index, officially called the Philadelphia FRB Manufacturing Activity Index, is designed so that positive readings point to expanding factory activity in the mid-Atlantic region. At its current level, the index suggests factory activity in the region has suffered at least a temporary pullback. The chart below shows how the index has fluctuated since just before the GFC.



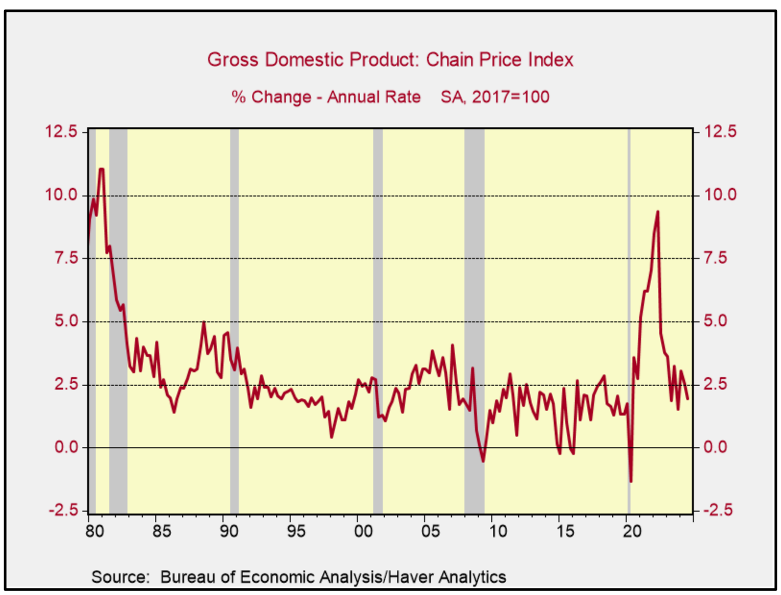
Finally, the Commerce Department released its third and final regular estimate of economic activity in the third quarter. After stripping out seasonal factors and price changes, third-quarter ***gross domestic product (GDP)*** rose at an annualized rate of 3.1%, much better than expectations that the growth rate would be unchanged from the previous estimate of 2.8%. US economic growth has now beaten its long-term average of 2.1% for two straight quarters, but only modestly so. The chart below shows the annualized growth rate of US GDP since just before the previous recession.



A close look at the details in the report shows that the main source of growth in the quarter was personal consumption spending. It accelerated to grow at a rate of 3.7%, largely because of a jump in durable goods purchases. Government spending was also a notable contributor, reflecting a big jump in defense spending. The chart below shows the contributions to the annualized growth rate in the third quarter.



The GDP report also includes the broadest measure of price inflation in the US. The third-quarter ***GDP Price Index*** rose at an annualized rate of 1.9%, matching the previous estimate as expected but decelerating from the 2.5% growth rate in the second quarter and the 3.0% growth rate in the first quarter. 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 Fed events scheduled for the rest of the day.

Economic Releases						
ET	Indicator			Expected	Prior	Rating
10:00	Leading Economic Indicators	m/m	Nov	-0.1%	-0.4%	***
10:00	Existing Home Sales	m/m	Nov	4.08m	3.96m	**
11:00	Kansas City Fed Manfacturing Index	m/m	Dec	-1	-2	*
16:00	Total Net TIC Flows	m/m	Oct		$398.4b	**
16:00	Net Long-Term TIC Flows	m/m	Oct		$216.1b	**
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	Tokyo Condominiums for Sale	y/y	Nov	-18.7%	23.4%		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	13-Dec	¥706.1b	-¥639.1b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	13-Dec	¥33.7b	-¥954.8b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	13-Dec	¥382.6b	¥999.5b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	13-Dec	-¥587.6b	¥482.9b		*	Equity and bond neutral
New Zealand	GDP	y/y	Q3	-1.5%	-0.5%	-0.4%	***	Equity bearish, bond bullish
	ANZ Activity Outlook	m/m	Dec	50.3	48.0		*	Equity and bond neutral
	ANZ Business Confidence	m/m	Dec	62.3	64.9		**	Equity and bond neutral
EUROPE								
Eurozone	EU27 New Car Registrations	y/y	Nov	-1.9%	1.1%		*	Equity and bond neutral
Germany	GfK Consumer Confidence	m/m	Jan	-21.3	-23.1	-22.5	**	Equity bullish, bond bearish
France	Business Confidence	m/m	Dec	94	96	96	**	Equity bearish, bond bullish
	Manufacturing Confidence	m/m	Dec	97	97	98	*	Equity and bond neutral
Italy	Current Account Balance	m/m	Oct	5628m	964m		*	Equity and bond neutral
Switzerland	Real Exports	m/m	Nov	-10.8%	11.4%		*	Equity and bond neutral
	Real Imports	m/m	Nov	-2.8%	0.9%		*	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	13-Dec		$614.4b		***	Equity and bond neutral
Russia	PPI	y/y	Nov	3.9%	2.7%		***	Equity and bond neutral
AMERICAS								
Mexico	Aggregate Supply and Demand	y/y	3Q	2.3%	2.1%	2.3%	*	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)	423	424	-1	Down
U.S. Sibor/OIS spread (bps)	433	435	-2	Down
U.S. Libor/OIS spread (bps)	433	434	-1	Down
10-yr T-note (%)	4.54	4.52	0.02	Up
Euribor/OIS spread (bps)	285	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**	
FOMC Rate Decision (Lower Bound)	4.250%	4.500%	4.250%	On Forecast
FOMC Rate Decision (Upper Bound)	4.500%	4.750%	4.500%	On Forecast
FOMC Rate on Reserve Balances	4.400%	4.650%	4.400%	On Forecast
BOJ Target Rate	0.250%	0.250%	0.250%	On Forecast
Bank of England Bank Rate	4.750%	4.750%	4.750%	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.

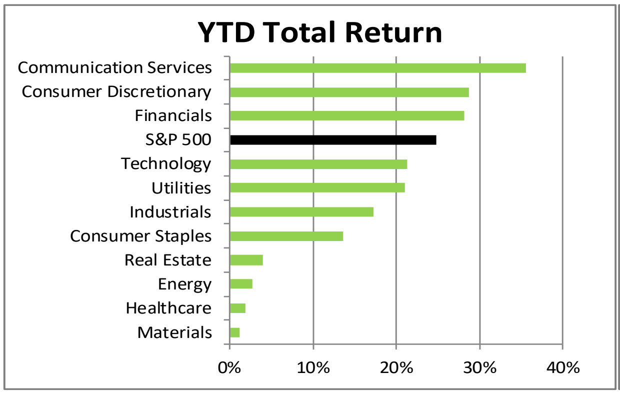
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$73.05	$73.39	-0.46%	
WTI	$70.42	$70.58	-0.23%	
Natural Gas	$3.48	$3.37	3.17%	
Crack Spread	$15.27	$15.53	-1.64%	
12-mo strip crack	$19.22	$19.34	-0.64%	
Ethanol rack	$1.72	$1.73	-0.16%	
Metals				
Gold	$2,612.75	$2,585.35	1.06%	
Silver	$29.44	$29.35	0.30%	
Copper contract	$408.85	$415.70	-1.65%	
Grains				
Corn contract	$436.25	$437.25	-0.23%	
Wheat contract	$532.25	$541.25	-1.66%	
Soybeans contract	$954.00	$953.25	0.08%	
Shipping				
Baltic Dry Freight	1,028	1,053	-25	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-0.93	-1.70	0.77	
Gasoline (mb)	2.35	2.00	0.35	
Distillates (mb)	-3.18	1.10	-4.28	
Refinery run rates (%)	-0.6%	0.0%	-0.6%	
Natural gas (bcf)		-126		

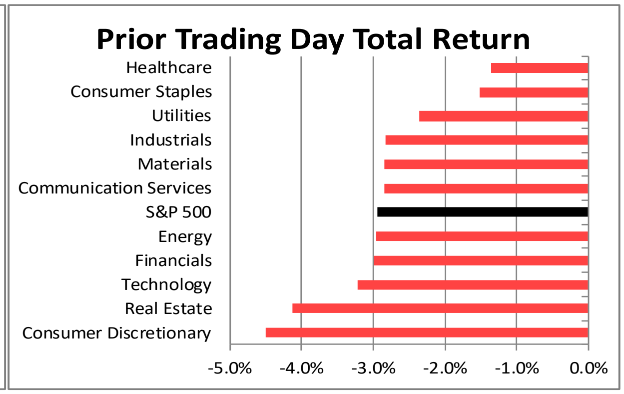
Weather

The 6-to-10-day and 8-to-14-day forecasts currently call for warmer-than-normal temperatures for almost the entire country, with normal temperatures only on the East Coast. The forecasts call for wetter-than-normal conditions in all regions except the Desert Southwest, Florida, and Maine, where conditions will be dry.

Data Section

US Equity Markets – (as of 12/18/2024 close)

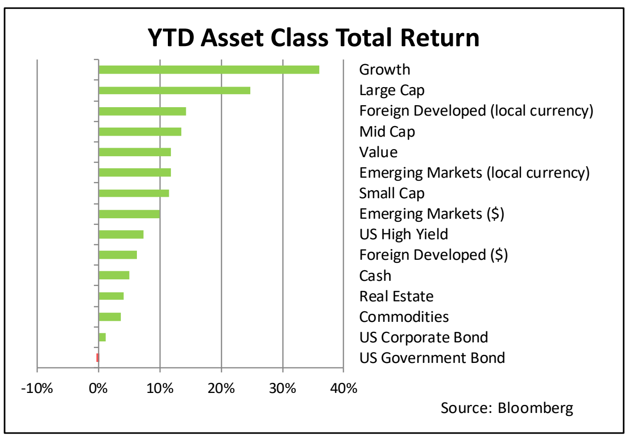




(Source: Bloomberg)

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 12/18/2024 close)

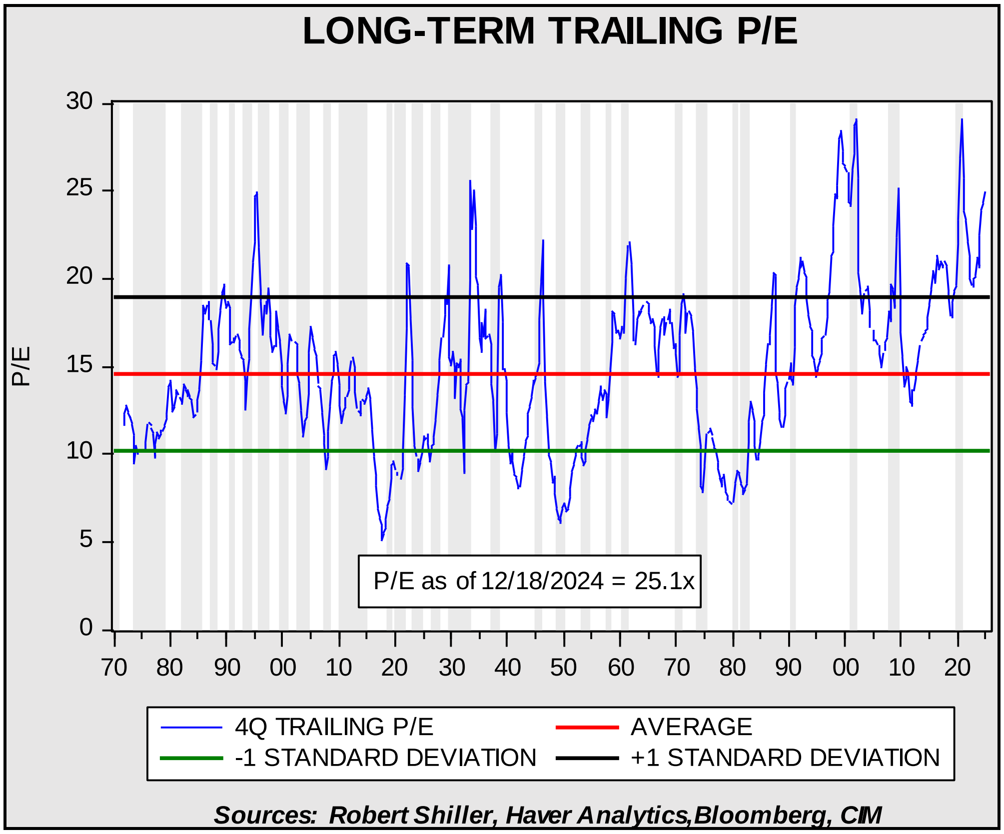


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 19, 2024



Based on our methodology,[1] the current P/E is 25.1x, up 0.3 from our last report. The increase in the multiple was due to downward revisions to Q3 earnings and a 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.