Daily Comment

By Patrick Fearon-Hernandez, CFA, and Thomas Wash

[Posted: December 23, 2024 — 9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 closed down 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 1.5%. Chinese markets were lower, with the Shanghai Composite down 0.5% from its previous close and the Shenzhen Composite down 2.3%. US equity index futures are signaling a higher open.

Note to readers: the* Daily Comment *will go on hiatus after today's Comment and will return on January 6, 2025. From all of us at Confluence Investment Management, have a Happy Holiday and a Happy New Year!

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	***The 2025 Outlook: A Year of Political and Policy Change***

Our *Comment* today opens with new US trade action against China, this time setting the stage for President-elect Trump to eventually impose trade barriers and punitive tariffs against China's relatively less-expensive "legacy" computer chips. We next review several other international and US developments with the potential to affect the financial markets today, including Trump's message to European leaders that he will maintain US military aid for Ukraine in return for them hiking their defense spending to at least 5% of GDP, and some observations on the new stopgap spending bill that Congress passed over the weekend to keep the federal government funded until mid-March.

United States-China: The Biden administration today opened an investigation into China's use of "anti-competitive, non-market" measures to promote its legacy semiconductors. The probe targets China's relatively cheap, less advanced, commoditized chips of the types used heavily in the automotive, healthcare, infrastructure, aerospace, and defense industries. When the probe is completed under the new administration, President-elect Trump could be empowered to impose trade restrictions or tariffs on the Chinese chips to protect US producers.

- The new probe follows more than two years of US efforts to restrict the sale of advanced semiconductors and semiconductor technology to China. The aim of those efforts is to constrain China's military development so it would be less of a threat.
- If new restrictions are placed on importing China's legacy chips, it would be yet another example of how global supply chains are fracturing amid the US-China rivalry.
- As we've argued many times before, this global fracturing is likely to boost price inflation and interest rates over time.

United States-Europe: President-elect Trump has reportedly told European leaders that he will continue providing US military aid to Ukraine while it negotiates for a peaceful end to Russia's invasion. However, in return for that aid, he will demand that the non-US members of the North Atlantic Treaty Organization hike their defense spending to at least 5% of gross domestic product, up from the currently agreed standard of 2%. He will also demand that they provide better trade terms to the US.

- Trump's demands will be discussed during a NATO summit at the Hague in June.
- Trump's demand for enormous defense spending hikes by the non-US members of NATO is further evidence that he will seek outright cuts to the US defense budget, probably to help pay for extending the 2017 tax cuts. Any such cuts to US defense spending would likely fall heavily on the big, traditional US defense industry "primes," but they would probably favor smaller firms providing cheaper, technology-enabled defense products, such as those in the new consortium further discussed below in the Syria comments.

Iran-Jordan-Israel: Jordanian and Israeli intelligence officers reportedly held a secret meeting on Friday to coordinate efforts to stop Iran from smuggling weapons and explosives into Jordan, from which some have been smuggled to Palestinian militants in the West Bank. The meeting illustrates how Iran is still trying to leverage proxies to destabilize Israel and nearby enemies, despite the body blows it's recently suffered from Israel's military action in the region and the fall of Syrian dictator Bashar al-Assad.

- Although Iran hasn't entirely given up supporting its Middle Eastern proxies, it's failure to protect Assad, Hezbollah, and Hamas has greatly undermined its political position both internationally and domestically. The survival of the theocratic regime in Tehran is probably more in question now than it has been in decades. Whether it survives and how it might falter would have huge implications for global energy supplies and prices.
- Adding to the government's vulnerabilities, Iran is now facing an energy crisis. After years of foreign sanctions and domestic mismanagement, the energy system can't produce enough natural gas to heat homes and generate needed electricity. The government has therefore curtailed power supplies to industry, closing down factories, retail shops, and offices.

Syria: In a weekend report dissecting the Syrian government's fall, the *New York Times* said the rebels' ability to wield hundreds of strike drones against Syrian army command posts was a key military advantage. Of course, Assad's fall stemmed mostly from Russia and Iran refusing to give additional military support and Assad's army being in an advanced state of rot, while Turkey and other outside powers upped their materiel and intelligence aid to the rebels. Still, the report is more evidence of the critical role that drones have taken in modern war.

- According to other reports we've seen, even Ukraine sent a significant number of drones and more than a dozen operators to help the rebels, probably in part hoping to create a distraction for the Russian military.
- In any case, there is mounting evidence that large numbers of small, cheap, expendable drones have become a key determinant of military power. The large, expensive, "exquisite" systems that the US military specializes in (aircraft carriers, fighter jets, tanks, and the like) are still important, but countries around the world will now need to shift more resources to drones of various types, creating new winners and losers among defense industry firms.
- Indeed, the *Financial Times* yesterday scooped that more than a dozen younger, smaller US defense technology firms specializing in areas like artificial intelligence and aerospace are forming a consortium to jointly bid on Pentagon contracts and get more of the US defense budget. Top companies in the consortium include SpaceX, Palantir, and Anduril.

North Korea-Russia: While observers continue to focus on Pyongyang's provision of troops to Russia for its war against Ukraine, new satellite imagery shows North Korea has also recently ramped up its arms shipments to the country. According to the Ukrainian military, North Korea is now providing 60% of the artillery and mortar shells that Russia fires at Ukrainian forces each day, along with about 30% of the ballistic missiles it is firing. In return, North Korea has reportedly received cash, oil, food, and perhaps even fighter jets and air defense systems.

- The discovery is consistent with our view that the major countries in the China-led geopolitical bloc are increasingly cooperating, coordinating, and collaborating.
- If China, Russia, Iran, and North Korea continue to draw closer and pool their resources, they would likely become an even more formidable rival to the US-led bloc, as we outlined in our *Geopolitical Outlook for 2025*, published last week.

Japan: Major automakers Honda and Nissan today announced that they have entered formal negotiations to merge. Including Nissan's partner Mitsubishi, the resulting company would be the third-largest carmaker in the world, with more than eight million vehicles sold annually. The goal of the merger is to find cost efficiencies and help the firms compete in the face of rapidly changing technologies and increasing competition from Chinese automakers.

Germany: Auto giant Volkswagen and its union on Friday reached a deal in which the firm will keep all its German plants open and avoid any forced job cuts until at least 2030 in return for the union foregoing any further work stoppages. Under the deal, Volkswagen will only be able to cut headcount by early retirements and other "socially responsible" ways, while the union will forego wage hikes and give up certain bonuses. The deal highlights the pressures European auto firms are under from the region's slowing economic growth and rising competition from China.

United States-Panama: Signaling a possible new foreign policy issue under the incoming administration, President-elect Trump on Saturday complained that US vessels are being charged "exorbitant" fees to transit the Panama Canal and demanded that the Panamanian government either reduce the charges or return the facility to the US.

US Monetary Policy: President-elect Trump yesterday named Stephen Miran to chair his Council of Economic Advisors. Miran was a senior economic policy advisor at the Treasury Department during Trump's first term, and he is now a senior strategist at hedge fund Hudson Bay Capital Management. Importantly, Miran has also been critical of current Federal Reserve Chair Powell, potentially signaling future tensions between the White House and the Fed.

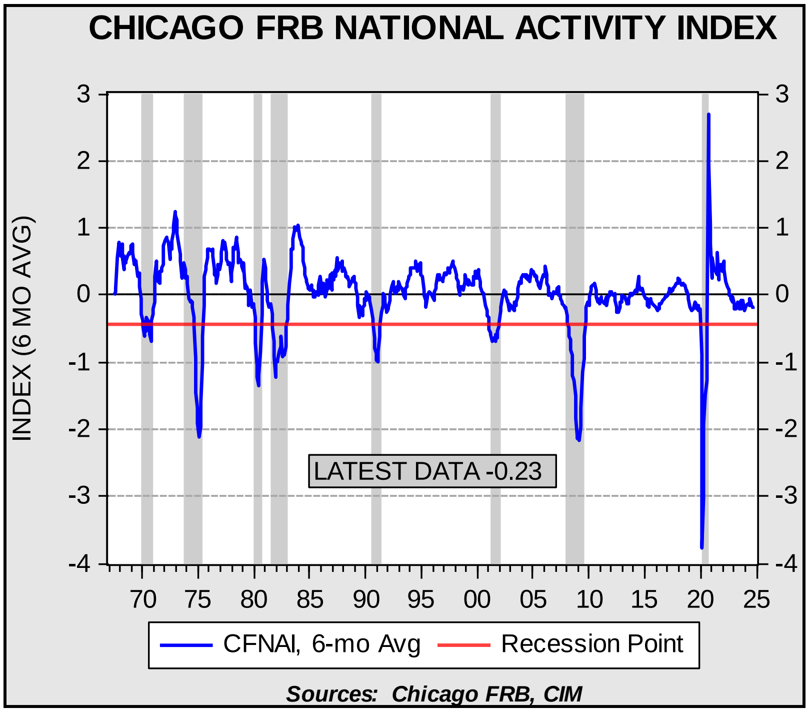
US Fiscal Policy: On Saturday, Congress passed and President Biden signed into law a new stopgap spending bill that will fund the federal government, largely at current levels, through the middle of March. Additional funding added included about $100 billion for hurricane relief and some $10 billion in aid for farmers. However, the law did not include any boost to or elimination of the federal debt ceiling that President-elect Trump demanded.

- Approval of the stopgap bill pushes off the possibility of a partial shutdown of the government for three months. Investors are likely to welcome the prospect of stable fiscal policy for the time being.

  However, Congress and the Trump administration will now face the likelihood of renewed disputes in March. This fiscal bargaining will give us a sense of how Trump intends to balance the disparate and conflicting demands from the various constituencies in his coalition, as we describe in our *2025 Outlook*.

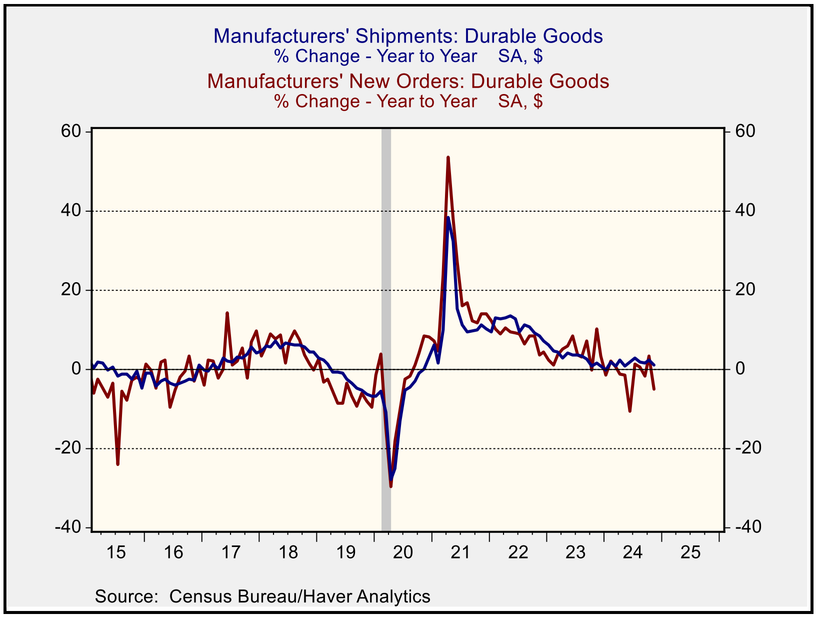
US Economic Releases

The ***Chicago Fed National Activity Index*** (CFNAI) showed economic activity remained below its historical trend in November. The index improved to -0.12 from a revised -0.50 in the previous month, slightly below the consensus estimate of -0.15. While all four major components (Production & Income, Personal Consumption & Housing, Employment, and Sales) contributed negatively to the index, Production & Income showed the most significant improvement.



The chart above shows the Chicago Fed National Activity Index along with its six-month moving average.

While overall durable goods orders declined, a key indicator of business investment showed a broad increase in spending. ***Durable goods orders*** fell 1.1% month-over-month, significantly below the expected decline of 0.3%. This drop was primarily driven by a decrease in demand for airplanes. ***Excluding transportation, durable goods orders*** still fell 0.1%, below expectations of a 0.3% increase and October's 0.2% rise. However, focusing solely on goods purchased for business operations revealed a pickup in spending. ***Capital goods orders for non-defense, excluding aircraft***, rose 0.7% month-over-month, a substantial improvement from the previous report's 0.1% decline.



The above shows the annual change in new durable goods orders and shipments. New durable goods orders increased 1.0% from the previous year, while shipments fell 5.2% in the same period.

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	New Home Sales	m/m	Nov	670k	610k	***
10:00	New Home Sales MoM	m/m	Nov	9.8%	-17.3%	**
10:00	Conference Board Consumer Confidence	m/m	Dec	113.0	111.7	***
10:00	Conference Board Present Situation	m/m	Dec		140.9	*
10:00	Conference Board Expectations	m/m	Dec		92.3	*
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								
South Korea	Depart. Store Sales	y/y	Nov	1.4%	-2.6%		*	Equity and bond neutral
	Discount Store Sales	y/y	Nov	5.7%	-3.4%		*	Equity and bond neutral
EUROPE								
Eurozone	Consumer Confidence	m/m	Dec P	-14.5	-13.7	-14.0	**	Equity and bond neutral
Germany	Import Price Index	y/y	Nov	0.6%	-0.8%	0.3%	**	Equity and bond neutral
UK	GDP	y/y	3Q F	0.9%	1.0%	1.0%	***	Equity and bond neutral
Switzerland	M3 Money Supply	y/y	Nov	1.8%	1.4%		**	Equity and bond neutral
	Domestic Sight Deposits CHF	w/w	20-Dec	448.0b	448.2b		*	Equity and bond neutral
	Total Sight Deposits CHF	w/w	20-Dec	456.5b	456.4b		*	Equity and bond neutral
AMERICAS								
Canada	Retail Sales	m/m	Oct	0.6%	0.4%	0.7%	**	Equity and bond neutral
	Retail Sales Ex-Autos	m/m	Oct	10.0%	0.9%	0.4%	**	Equity and bond neutral
Mexico	Exports	m/m	Nov	52025m	57671m		*	Equity and bond neutral
	Imports	m/m	Nov	52158m	57300m		*	Equity and bond neutral
	Trade Balance	m/m	Nov	-133.0m	370.8m	500.0m	**	Equity and bond neutral
	Economic Activity IGAE	y/y	Oct	0.72%	0.30%	0.40%	**	Equity and bond neutral
Brazil	Current Account Balance	m/m	Nov	-$3060m	-$6027m	-$3400m	**	Equity and bond neutral
	Foreign Direct Investment	m/m	Nov	$6956m	$5717m	$6000m	**	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	422	0	Down
U.S. Sibor/OIS spread (bps)	433	433	0	Down
U.S. Libor/OIS spread (bps)	433	433	0	Down
10-yr T-note (%)	4.55	4.52	0.03	Up
Euribor/OIS spread (bps)	277	284	-7	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.

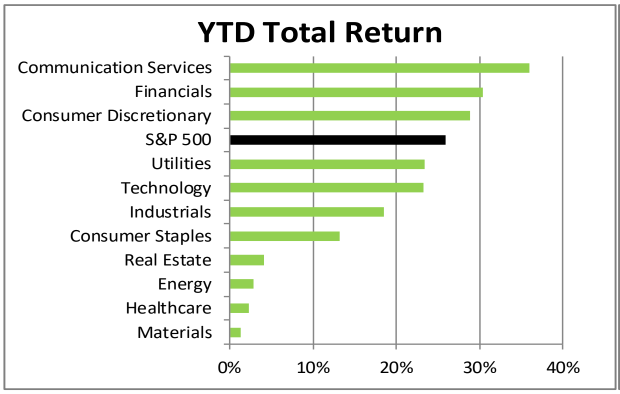
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$72.77	$72.94	-0.23%	
WTI	$69.32	$69.46	-0.20%	
Natural Gas	$3.83	$3.75	2.13%	
Crack Spread	$16.81	$16.44	2.28%	
12-mo strip crack	$19.41	$19.19	1.14%	
Ethanol rack	$1.75	$1.74	0.24%	
Metals				
Gold	$2,615.15	$2,622.91	-0.30%	
Silver	$29.64	$29.52	0.42%	
Copper contract	$410.65	$410.05	0.15%	
Grains				
Corn contract	$447.50	$446.25	0.28%	
Wheat contract	$537.00	$533.00	0.75%	
Soybeans contract	$980.50	$979.25	0.13%	
Shipping				
Baltic Dry Freight	990	976	14	

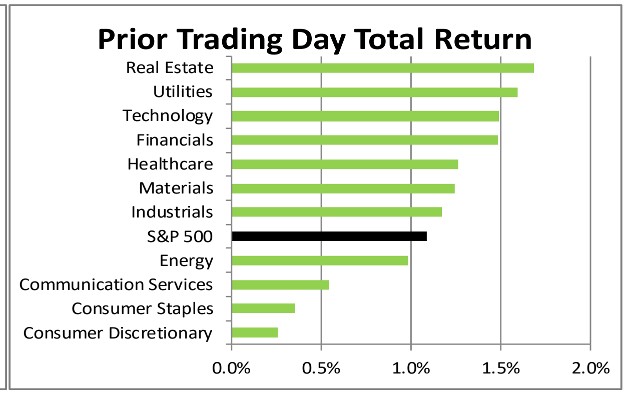
Weather

The 6-to-10-day and 8-to-14-day forecasts currently call for warmer-than-normal temperatures for the entire country. The forecasts call for wetter-than-normal conditions in all regions except the Southwest, where conditions will be dry.

Data Section

US Equity Markets – (as of 12/20/2024 close)

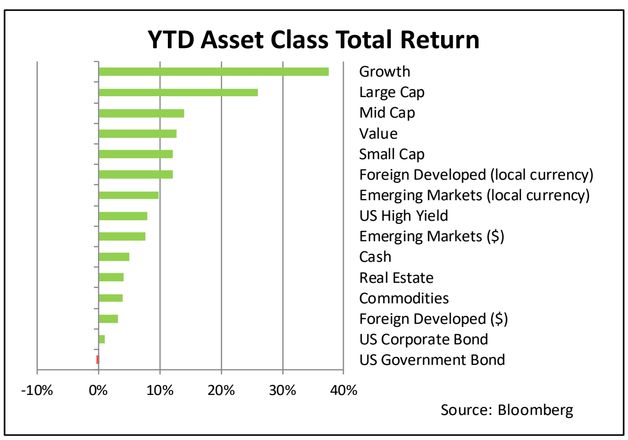




(Source: Bloomberg)

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 12/20/2024 close)

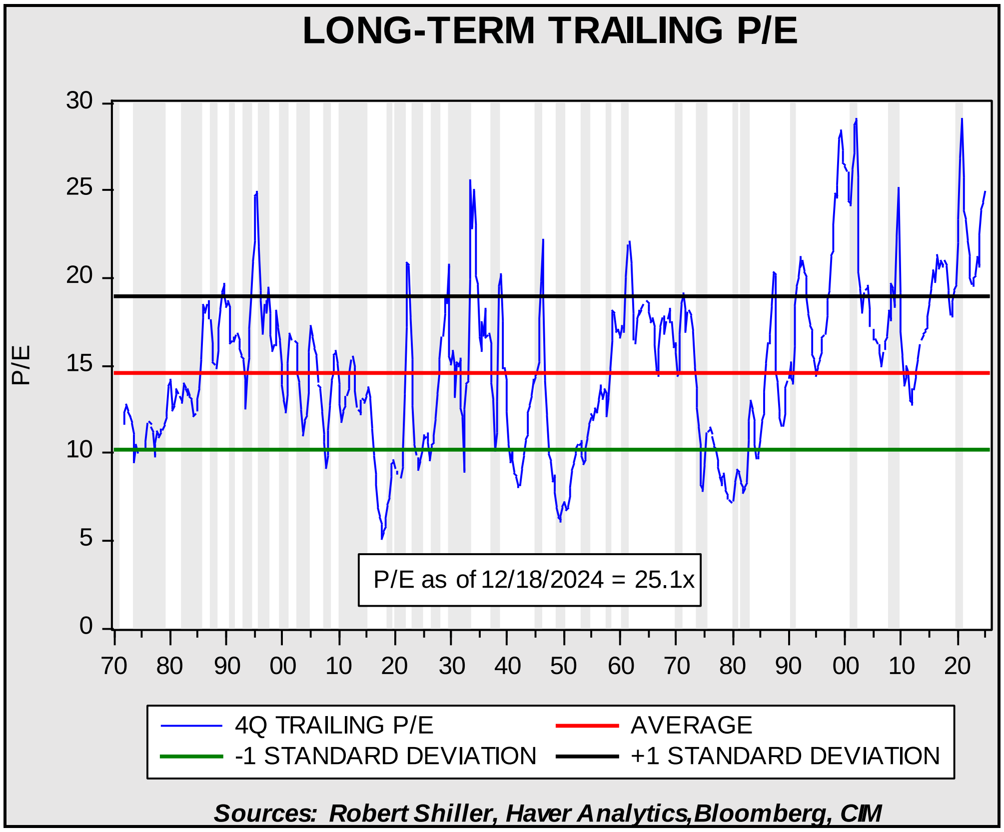


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

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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.