Daily Comment

Confluence INVESTMENT MANAGEMENT

By Patrick Fearon-Hernandez, CFA, and Thomas Wash

[Posted: January 10, 2025 — 9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 closed up 0.1% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.5%. Chinese markets were mixed, with the Shanghai Composite down 1.3% from its previous close and the Shenzhen Composite down 2.2%. 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:

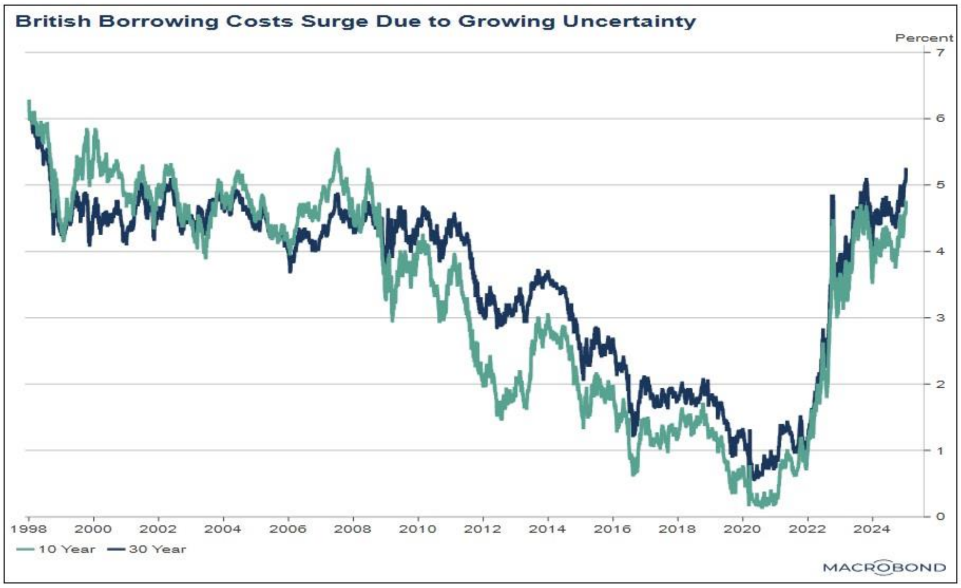
Bi-Weekly Geopolitical Report	Asset Allocation Bi-Weekly	Asset Allocation Quarterly	Of Note
The 2025 Geopolitical Outlook (12/16/24) + podcast	*Household Cash Levels and the S&P 500* (12/9/24) + podcast	Q4 2024 Report Q4 2024 Rebalance Presentation	*The 2025 Outlook: A Year of Political and Policy Change*

Good morning! The market is reacting to the latest jobs data. In sports news, Real Madrid triumphed over Mallorca to advance to the final of the Spanish Super Cup. Today's *Comment* will delve into the recent rise in UK gilt yields, explore the potential factors behind a prolonged conflict in Ukraine, and discuss other relevant market developments. As always, the report will include a summary of key international and domestic economic data releases.

Another Truss Moment? UK long-term bond yields soared to multi-decade peaks on Thursday, driven by escalating concerns about the nation's ability to manage its burgeoning debt. The 10-year gilt yield reached 4.82%, its highest level since 2008, while the 30-year gilt yield climbed to 5.38%, its most elevated point since 1998. This surge in interest rates exerted downward pressure on the pound sterling (GBP), causing it to depreciate by 0.6% on the day.

- The cause of the market sell-off remains uncertain, but a potential contributing factor could be the growing tensions between London and Washington. It has been reported that Elon Musk, a prominent figure within the Trump administration, is rumored to be trying to oust UK Prime Minister Keir Starmer before the next election.

- Despite President-elect Donald Trump not having expressed any specific criticism of the UK, concerns linger regarding potential tariffs that could impede the nation's economic growth. This anxiety emerges at a critical moment when the UK government depends on a strong economy to stave off the severe budget cuts needed to tackle the growing national debt.

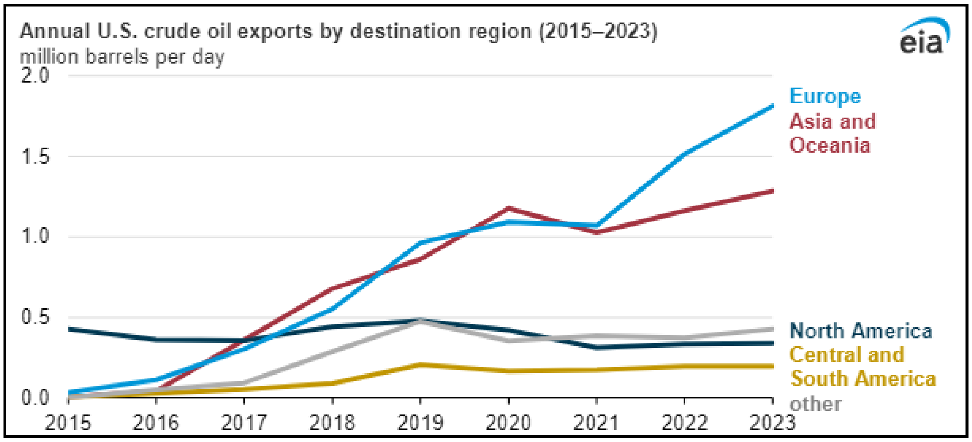


- Since the United Kingdom voted to leave the European Union in 2016, it has had six prime ministers and has seen its general government debt surpass the total of GDP for the first time in at least 50 years. Hence, the rise in yields may be driven by the possibility of growing political instability and an increase in the government deficit.
- While the recent rise in yields is concerning, its moderate pace is unlikely to trigger a market rout similar to the one that occurred in 2022 following the release of the controversial mini budget under UK PM Liz Truss. However, the increase in borrowing costs could weigh on the economic growth of the country.

Another Lifeline? President-elect Donald Trump has extended the timeline for ending the conflict in Ukraine from 24 hours after taking office to six months. This shift in strategy appears to stem from concerns within the administration that a hasty resolution could be perceived as a rushed or poorly executed decision, potentially impacting the president's public image.

- The reported U-turn also appears to be an olive branch to Europe, aimed at persuading the administration to sustain its support for Ukraine. Although the president campaigned on ending US funding for the war, he has been notably quieter on the issue since winning the election.
- In fact, just days after winning the election, Trump reportedly warned Russian President Vladimir Putin against escalating the war and reminded the Russian leader that the US "has weapons, too."

- Despite President-elect Trump's initial reluctance to end the war, discussions between the US and Russia appear to be taking shape. Trump is reportedly open to a peace deal that would allow Russia to retain control over several captured regions. However, Russian delegates have expressed dissatisfaction with the initial proposal.



- Although the end of the conflict is a positive development, investors should remain mindful that Russia remains a strong competitor to the US in the global energy market. A key takeaway from the conflict is that sanctions on Russia created new opportunities for US energy producers to capture market share in Europe. The administration's desire for Europe to increase its reliance on US energy will likely lead to heightened scrutiny by the US administration regarding any resurgence of Russian energy exports.

Japan Inflation Optimism: There are growing signs that the country may have finally escaped its deflationary spiral. The Bank of Japan is expected to upwardly revise its inflation outlook. While the recent revisions have been attributed to an increase in rice prices and the depreciation of the currency, there are also increasing signs that wages have started to pick up.

- The central bank's decision to raise its inflation forecast signals a stronger commitment to tightening monetary policy to counteract persistent price pressures and safeguard economic stability. This is likely to result in higher Japanese bond yields and a stronger yen (JPY). However, given the prevailing economic slowdown, the impact on equities may be mixed.

China's Troubles Deepen: The People's Bank of China has halted purchases of government bonds, a move widely interpreted as an attempt to dampen speculation about the country's economic growth prospects. This action could further fuel fears of a deflationary spiral in the world's second-largest economy.

- At the same time, the MSCI China Index seems poised to enter a bear market in the next few days as investors brace for escalating trade tensions between China and the US. On Friday, the index dropped by as much as 1.1%, bringing its total decline closer to 20% since its peak on October 7, 2024.

- Earlier this week, it was reported that outgoing President Joe Biden plans to announce new restrictions on AI chips as the US seeks to maintain its competitive edge over China in the sector.

- As noted in our previous reports, China is likely to face challenges stemming from the ***five Ds***: weak consumer ***demand***, overcapacity coupled with ***high debt***, unfavorable ***demographics***, economic ***disincentives*** due to the Communist Party's market interventions, and the impact of ***Western decoupling*** in trade, technology, and capital flows.

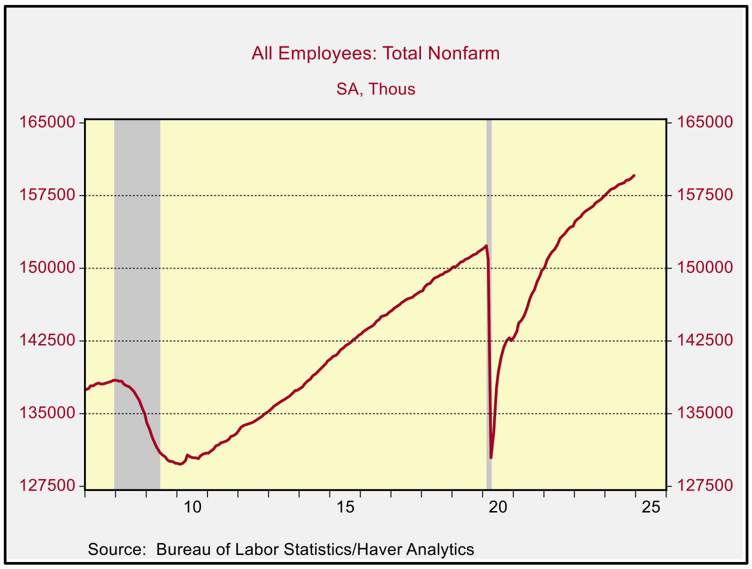
DOGE's Setback: Tesla CEO Elon Musk acknowledged on Wednesday that his newly formed Department of Government Efficiency may fall short of its ambitious goal of reducing the federal deficit by $2 trillion, potentially achieving only half of that target.

- While this news is disappointing amid the market's strong preference for fiscal restraint, investor skepticism about the feasibility of Musk's ambitious deficit reduction target was evident from the start.
- That said, we still believe that efforts to reduce government spending are likely to be bullish for bond prices.

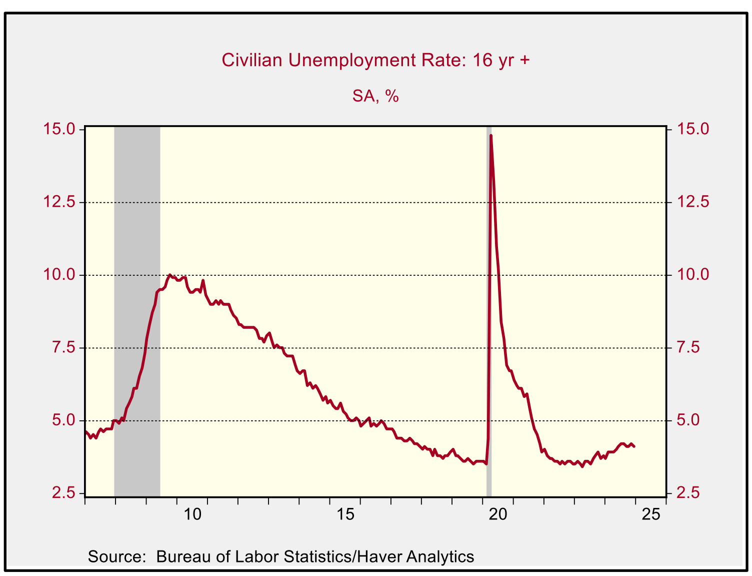
Labor Talks: US dockworkers have reached a tentative agreement with their employers, averting a potential shutdown of East and Gulf Coast ports next week. This new deal includes provisions for a framework to address the impact of automation on the workforce, aiming to protect workers' jobs as technology advances. If ratified, this agreement will have a six-year term.

US Economic Releases

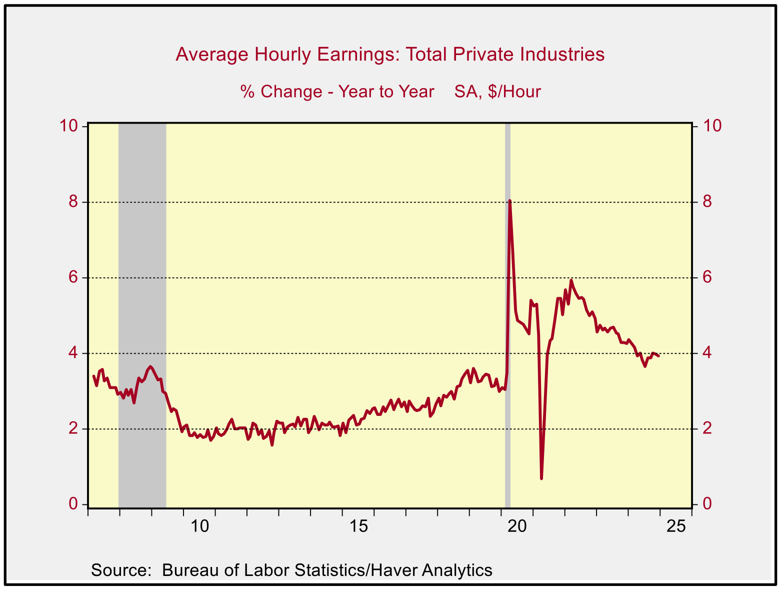
December ***nonfarm payrolls*** surged by a seasonally adjusted 256,000, well above the expected gain of 165,000. November payrolls were revised downward, but they still showed a robust gain of 212,000. The figures indicate that the demand for labor remains strong and job creation continues unabated, all of which is positive for economic growth. However, the data will likely ignite new concerns about price inflation and a possibility that the Fed won't cut interest rates further. The chart below shows the change in nonfarm payrolls since shortly before the GFC.



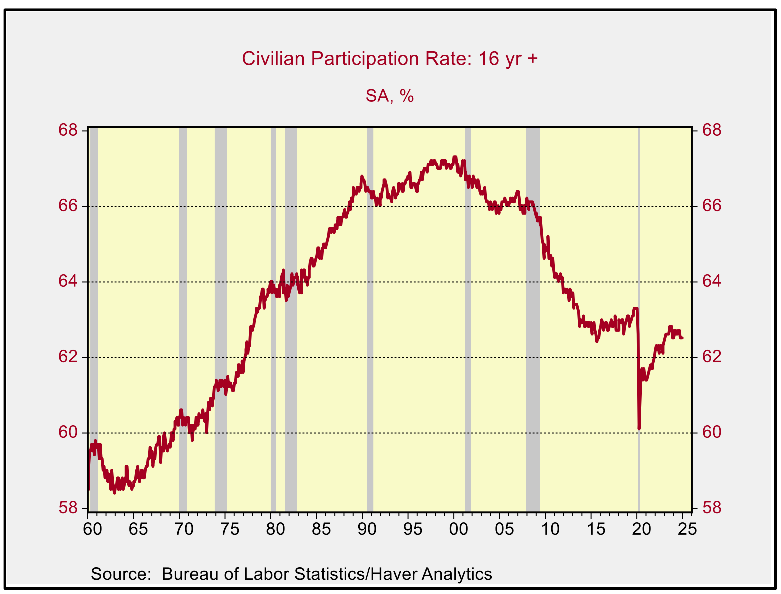
The December ***unemployment rate*** fell to a seasonally adjusted 4.1%, versus expectations that it would be unchanged from the November reading of 4.2%. The new decline in joblessness will also likely feed concerns about inflation and continued high interest rates. The chart below shows how the unemployment rate has evolved since just before the GFC.



With the demand for labor high and the "inventory" of unemployed workers low, it should be no surprise that wage rates remain high. ***Average hourly earnings*** in December rose to a seasonally adjusted $35.69, up 3.9% from the same month one year earlier. The chart below shows the year-over-year growth in average hourly earnings since just before the GFC.



A final key indicator in the monthly employment report focuses on the share of the adult, civilian, noninstitutionalized population that is either working or looking for work. The December ***labor force participation rate (LFPR)*** held steady at a seasonally adjusted 62.5%, well below the rates common right before the coronavirus pandemic. The chart below shows how the LFPR has changed 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	U. of Michigan Consumer Sentiment	m/m	Jan P	74.0	74.0	***
10:00	U. of Michigan Current Conditions	m/m	Jan P	75.1	75.1	**
10:00	U. of Michigan Future Expectations	m/m	Jan P	72.7	73.3	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Jan P	2.8%	2.8%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Jan P	3.0%	3.0%	*
Federal Reserve						
ET	Speaker or Event	District or Position				
10:04	Austan Goolsbee Appears on CNBC	President of the Federal Reserve Bank of Chicago				

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	Household Spending	y/y	Nov	-0.4%	-1.3%	-0.9%	**	Equity and bond neutral
	Coincident Index	y/y	Nov P	107.0	109.1	107.2	**	Equity and bond neutral
	Leading Economic Index	m/m	Nov P	115.3	116.8	116.8	**	Equity and bond neutral
Australia	Household Spending	m/m	Nov	2.4	3.3	2.5	*	Equity and bond neutral
India	Industrial Production	y/y	Nov	5.2%	3.7%	4.1%	***	Equity bullish, bond bearish
EUROPE								
Eurozone	Retail Sales	y/y	Nov	1.2%	2.1%	1.7%	*	Equity bearish, bond bullish
Germany	Industrial Production WDA	y/y	Nov	-2.8%	-4.2%	-4.5%	**	Equity bullish, bond bearish
France	Industrial Production	y/y	Nov	-1.1%	-0.9%	-1.3%	***	Equity and bond neutral
	Manufacturing Production	y/y	Nov	-1.5%	-1.7%		**	Equity and bond neutral
Italy	Retail Sales	y/y	Nov	1.1%	2.6%		**	Equity and bond neutral
Switzerland	Unemployment Rate	m/m	Dec	2.8%	2.6%	2.8%	**	Equity and bond neutral
Russia	Money Supply, Narrow Definition	w/w	27-Dec	18.95t	18.71t		*	Equity and bond neutral
AMERICAS								
Mexico	Industrial Production	y/y	Nov	-1.4%	-2.1%	-1.4%	***	Equity and bond neutral
	Manufacturing Production	y/y	Nov	-0.2%	0.6%	-0.6%	*	Equity and bond neutral
Brazil	IBGE Inflation IPCA	y/y	Dec	4.83%	4.87%	4.86%	***	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)	420	421	-1	Down
U.S. Sibor/OIS spread (bps)	429	429	0	Down
U.S. Libor/OIS spread (bps)	432	431	1	Down
10-yr T-note (%)	4.69	4.69	0.00	Up
Euribor/OIS spread (bps)	279	278	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.

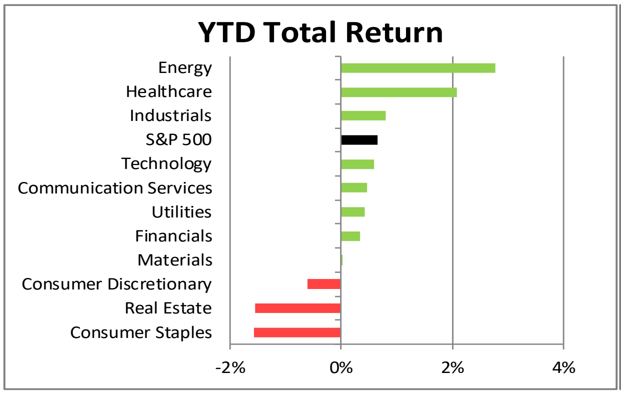
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$79.47	$76.92	3.32%	
WTI	$76.38	$73.92	3.33%	
Natural Gas	$3.85	$3.70	3.89%	
Crack Spread	$16.67	$16.25	2.58%	
12-mo strip crack	$20.24	$19.86	1.94%	
Ethanol rack	$1.73	$1.73	-0.18%	
Metals				
Gold	$2,677.48	$2,667.25	0.38%	
Silver	$30.32	$30.13	0.61%	
Copper contract	$433.25	$430.95	0.53%	
Grains				
Corn contract	$457.50	$456.00	0.33%	
Wheat contract	$533.75	$534.00	-0.05%	
Soybeans contract	$1,002.50	$999.00	0.35%	
Shipping				
Baltic Dry Freight	969	966	3	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-0.96	-2.00	1.04	
Gasoline (mb)	6.33	0.50	5.83	
Distillates (mb)	6.07	0.50	5.57	
Refinery run rates (%)	0.6%	-0.5%	1.1%	
Natural gas (bcf)	-40	-40	0	

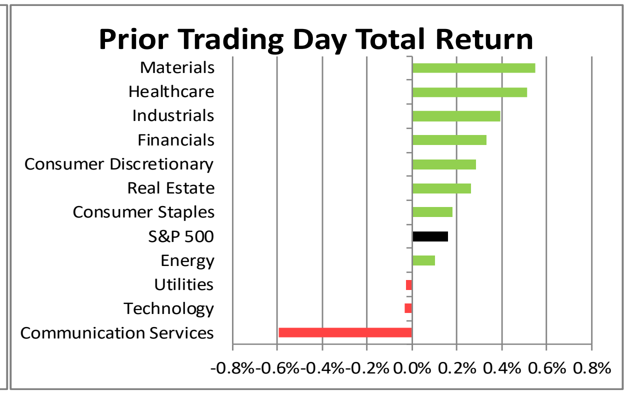
Weather

The 6-to-10-day and 8-to-14-day forecasts currently call for cooler-than-normal temperatures in the northern Rocky Mountains, the Mississippi Valley region, and along the East Coast, with warmer-than-normal temperatures in Maine. The forecasts call for wetter-than-normal conditions in the central part of the country from the Rocky Mountains through the Mississippi Valley region, with dry conditions along the West Coast.

Data Section

US Equity Markets – (as of 1/9/2025 close)

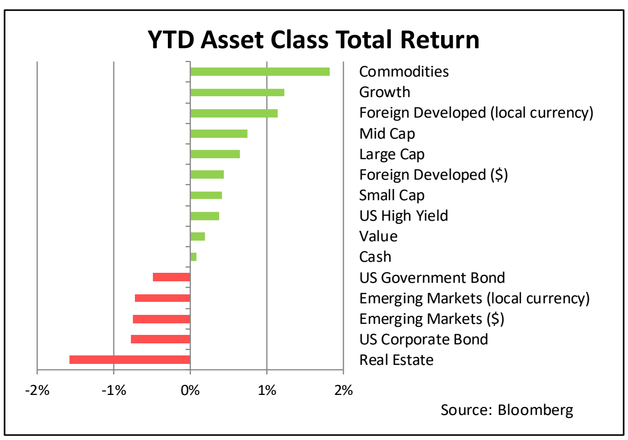




(Source: Bloomberg)

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 1/9/2025 close)

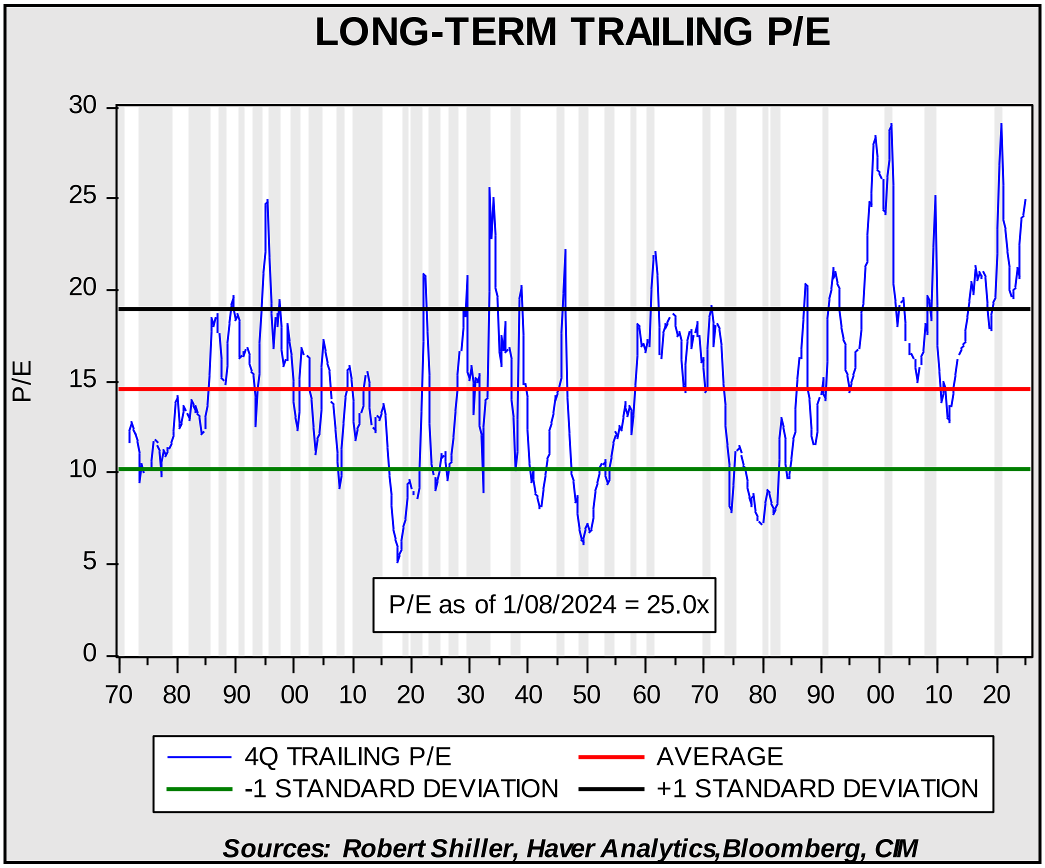


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

January 10, 2024



Based on our methodology,[1] the current P/E is 25.0x, down 0.1 from our last report. The decrease was due to a decline 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.