Daily Comment

Confluence INVESTMENT MANAGEMENT

By Patrick Fearon-Hernandez, CFA, and Thomas Wash

[Posted: January 8, 2025 — 9:30 AM ET] Global equity markets are mostly lower this morning. In Europe, the Euro Stoxx 50 closed down 0.5% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.9%. Chinese markets were mixed, with the Shanghai Composite essentially unchanged from its previous close and the Shenzhen Composite down 0.3%. 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*

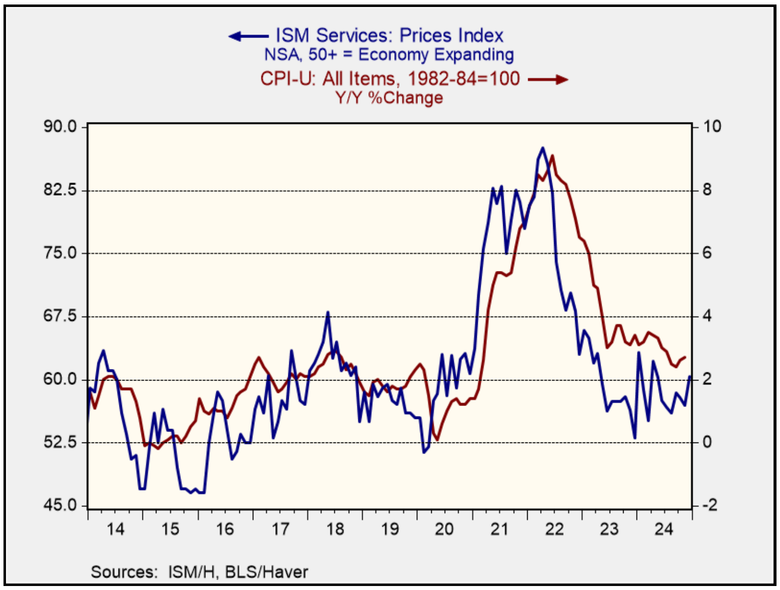
***Note: The Confluence offices will be closed tomorrow, January 9, for the Day of Mourning, and we will not publish a* Daily Comment.**

Good morning! Concerns about the deficit and inflation continue to weigh on investor sentiment. In sports news, New Orleans Pelicans forward Zion Williamson scored 22 points in a loss to the Timberwolves in his first game back from injury. Today's *Comment* will cover our perspective on the rise in 10-year Treasury yields, tensions between the US and its allies, and several other key developments. As always, the report concludes with a summary of international and domestic data releases.

Long-Term Yields Rise: Equity prices plummeted after 10-year Treasury yields rose to their highest level since October 2023. A disappointing bond sale and broader concerns about a return of inflation drove the rise in interest rates. As a result, the S&P 500 fell 1.1% on the day, while the tech-heavy NASDAQ composite closed down 1.9%.

- On Tuesday, $39 billion of Treasury securities were auctioned at a concerningly high yield of 4.68%. This yield, marginally above the initial indicated level, signaled weak investor demand. While the 10-year Treasury rates reached 5% in 2023, the auction marked the highest yield for newly issued securities in over 16 years, raising concerns about the state of the Treasury market.

- Fears of a resurgence in inflationary pressures and tightening labor market conditions may have influenced the auction's relatively weak performance. The December ISM PMI Services Index registered at 54.1, surpassing expectations of 53.3, with its sub-component prices index exceeding 60 for the first time since January 2024. Concurrently, the BLS Job Openings and Labor Turnover Survey (JOLTS) revealed a significant increase in job listings in November, rising from 7.839 million to 8.098 million.



- The weak auction and stronger-than-expected economic data will likely heighten market focus on the upcoming jobs report. The unemployment rate will be particularly scrutinized, as last year's rise from 3.7% to 4.2% significantly influenced the Fed's decision to cut rates by 100 basis points in 2024. A decline in the unemployment rate could jeopardize projected cuts unless inflation demonstrates a substantial decrease.
- The CME FedWatch Tool currently suggests only a 25-basis-point rate cut by the central bank for 2025. While this scenario seems plausible, we believe the possibility of rates remaining unchanged throughout the year remains significant, especially if inflation fails to demonstrate substantial progress, and the labor market remains tight in the coming months.

Rifts Emerge Within the Western Alliance: President-elect Donald Trump has proposed annexing Canada and Greenland, as well as renaming the Gulf of Mexico to the Gulf of America, signaling a dramatic shift in US policy. In a news conference, Trump declined to rule out the use of military or economic measures to achieve these ambitions, further raising tensions.

- Western allies have unsurprisingly dismissed Trump's attempts to acquire additional territory, warning of potential retaliation if aggression occurs. French Minister Jean-Noël Barrot stated that the EU is ready to defend the sovereignty of its members against any use of force. Similarly, Canadian PM Justin Trudeau firmly rejected the idea of being annexed by the US and implied that force would not be beneficial to either side.

- The move coincides with the incoming administration's shift away from the US's traditional role as a benevolent hegemon. This administration appears poised to adopt a more assertive, potentially even adversarial, foreign policy. Consequently, they are likely to prioritize transactional agreements that maximize national self-interest.

- Currently, financial markets seem to be discounting the risk of a significant rift between the US and its allies. Investor attention remains largely fixated on domestic concerns like inflation and the growing national debt. However, escalating tensions between the US and its allies could inject renewed uncertainty into global markets. This increased volatility could bolster demand for traditional safe-haven assets like gold and silver.
- As US global influence wanes, we anticipate a rise in demand for alternatives to the dollar. Gold and silver are likely to emerge as contenders. The current gold-to-silver ratio exceeds 80, significantly higher than the 30-year average of 67, suggesting gold's relative expensiveness compared to silver. However, this elevated ratio may now be the norm, given its consistent range between 80 and 90 over the past four years.

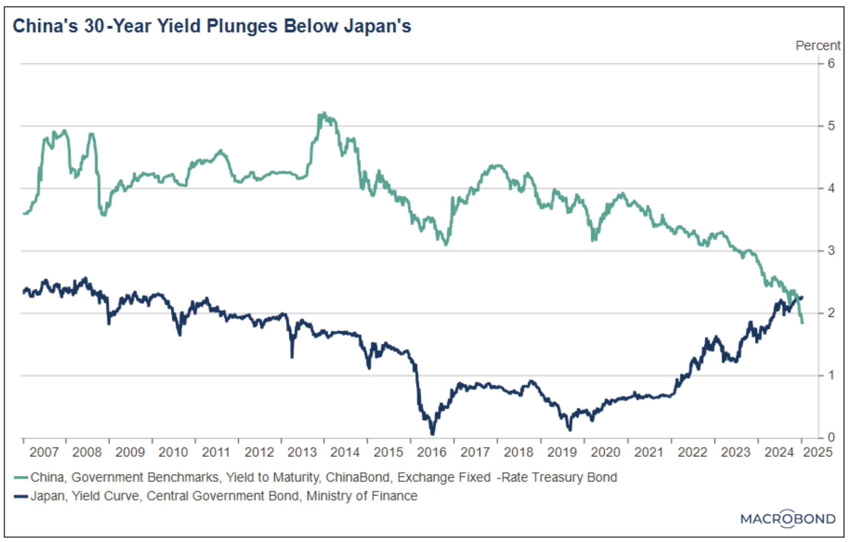
Virginia Election Races: The first political test following Donald Trump's victory brought no surprises in Virginia. Democrats retained two State House seats in left-leaning Loudoun County, while Republicans held onto their State Senate seat. The closely watched contest was seen as an early indicator of the state's political direction for when Republican Governor Glenn Youngkin's term ends next year.

Immigration Bill: The new Congress has passed its first bill of the year, the Laken Riley Act, which mandates the detention of undocumented immigrants for non-violent offenses such as theft. This legislation is likely the first in a series of measures aimed at restricting immigration.

Financial markets will closely monitor the potential impact of this crackdown on the labor market, as it could exacerbate labor shortages and push up wages for businesses.

China's Woes Continue: The country's currency fell to a 16-year low due to fears that the Trump tariffs are likely to complicate the country's growth efforts. Prior to this escalation, the country had been grappling with sluggish growth and deflation, exacerbated by waning investor and consumer confidence.

- The negative sentiment has also spread into the country's bond market with the yield on 30-year government debt falling below the psychological level of 2%, placing it below the current level in Japan.

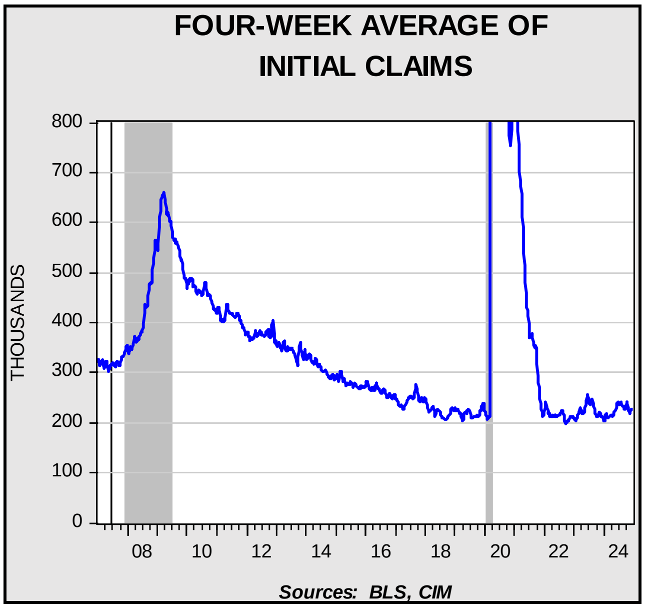


- A weakening Chinese economy poses a significant risk to global growth, as subdued consumption in the world's second-largest economy will inevitably impact global demand. While the US remains an attractive destination for equity investments, we believe that compelling opportunities exist in international markets, particularly when analyzed on a sector-specific or individual stock basis.

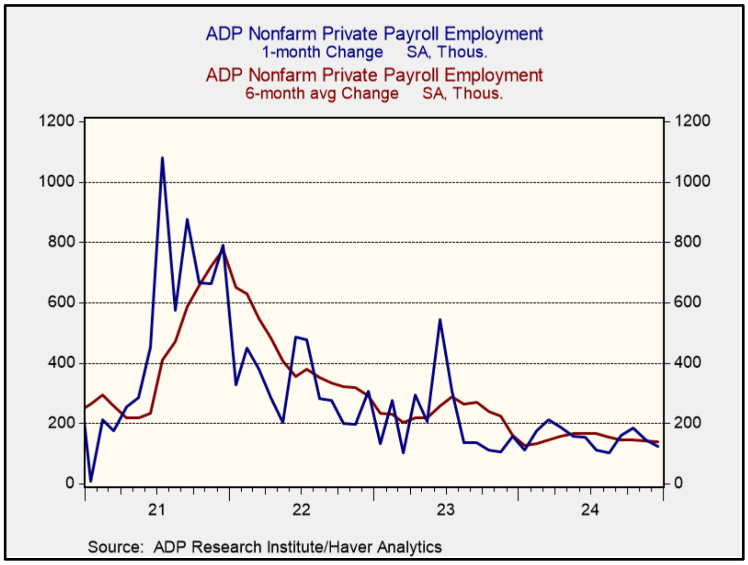
US Economic Releases

The Mortgage Bankers Association today said mortgage applications for the week ended January 3 fell 3.7%, compared to last week's decline of 12.6%. This marks the fourth consecutive weekly decline. Applications for home purchase mortgages fell 6.6%, after falling 6.8% the prior week. Meanwhile, applications for refinancing mortgages rose 1.5%, reversing the previous week's 23.4% decline. According to the report, the average interest rate on a 30-year mortgage rose 2 basis points to 6.99%.

In the week ended January 4, ***initial claims for unemployment benefits*** fell to a seasonally adjusted 201,000, less than the expected 215,000 and the prior week's 211,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, fell from 223,250 to 213,000. Meanwhile, in the week ended December 28, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to 1.867 million, slightly greater than the expected 1.860 million and the prior week's 1.834 million. 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.



Separately, the ADP Research Institute estimated that private payroll employment rose in December by a seasonally adjusted 122,000, falling short of both the expected 140,000 and the prior month's 146,000. ADP's estimate is widely seen as an indicator of what to expect when the Labor Department releases its measure of nonfarm payrolls on Friday. The chart below shows ADP's estimate of private payrolls since the beginning of 2021.



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	Wholesale Inventories	m/m	Nov F	-0.2%	-0.2%	**
10:00	Wholesale Trade Sales	m/m	Nov	0.2%	-0.1%	*
15:00	Consumer Credit	m/m	Nov	$10.500b	$19.239b	*
Federal Reserve						
ET	**Speaker or Event**	**District or Position**				
8:00	Christopher Waller Gives Speech on Economic Outlook	Member of the Board of Governors				
14:00	FOMC Meeting Minutes	Federal Reserve Board				

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	Consumer Confidence Index	m/m	Dec	36.2	36.4	36.6	*	Equity and bond neutral
Australia	CPI	y/y	Nov	2.3%	2.1%	2.2%	**	Equity and bond neutral
New Zealand	ANZ Commodity Price	m/m	Dec	0.2%	2.9%		**	Equity and bond neutral
South Korea	BoP Current Account Balance	m/m	Nov	$9299.4m	$9783.6m		**	Equity and bond neutral
	BoP Goods Balance	m/m	Nov	$9752.2m	$8118.9m		*	Equity and bond neutral
EUROPE								
Eurozone	Consumer Confidence	m/m	Dec F	-14.5	-14.5		**	Equity and bond neutral
	Services Confidence	m/m	Dec	5.9	5.3	5.7	**	Equity and bond neutral
	Industrial Confidence	m/m	Dec	-14.1	-11.4	-11.6	***	Equity bearish, bond bullish
	Economic Confidence	m/m	Dec	93.7	95.6	95.8	***	Equity and bond neutral
	PPI	y/y	Nov	-1.2%	-3.3%	-1.4%	**	Equity and bond neutral
Germany	Retail Sales	y/y	Nov	2.3%	4.8%	2.5%	*	Equity and bond neutral
	Factory Orders WDA	y/y	Nov	-1.7%	5.7%	3.0%	***	Equity bearish, bond bullish
France	Consumer Confidence	m/m	Dec	89	90	90	***	Equity and bond neutral
	Trade Balance	m/m	Nov	-7085m	-7520m		*	Equity and bond neutral
AMERICAS								
Canada	Int'l Merchandise Trade	m/m	Nov	-0.32b	-0.54b	-0.90b	**	Equity and bond neutral
Mexico	International Reserves Weekly	w/w	3-Jan	$229017m	$228789m		*	Equity and bond neutral
Brazil	FGV CPI IPC-S	y/y	7-Jan	0.34%	0.31%		**	Equity and bond neutral
	Industrial Production	y/y	Nov	1.7%	5.9%	1.4%	***	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)	430	429	1	Down
U.S. Libor/OIS spread (bps)	432	432	0	Down
10-yr T-note (%)	4.72	4.69	0.03	Up
Euribor/OIS spread (bps)	279	276	3	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.

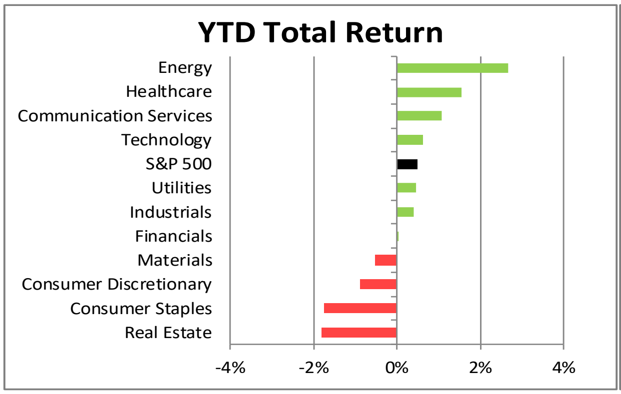
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$77.36	$77.05	0.40%	
WTI	$74.72	$74.25	0.63%	
Natural Gas	$3.62	$3.45	4.87%	
Crack Spread	$15.09	$15.56	-3.03%	
12-mo strip crack	$19.24	$19.44	-1.04%	
Ethanol rack	$1.76	$1.76	-0.38%	
Metals				
Gold	$2,649.79	$2,648.59	0.05%	
Silver	$30.07	$30.05	0.08%	
Copper contract	$417.80	$419.55	-0.42%	
Grains				
Corn contract	$457.50	$458.00	-0.11%	
Wheat contract	$540.00	$542.50	-0.46%	
Soybeans contract	$999.00	$997.25	0.18%	
Shipping				
Baltic Dry Freight	1,015	1,043	-28	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-2.00		
Gasoline (mb)		0.50		
Distillates (mb)		0.50		
Refinery run rates (%)		-0.5%		
Natural gas (bcf)		-40		

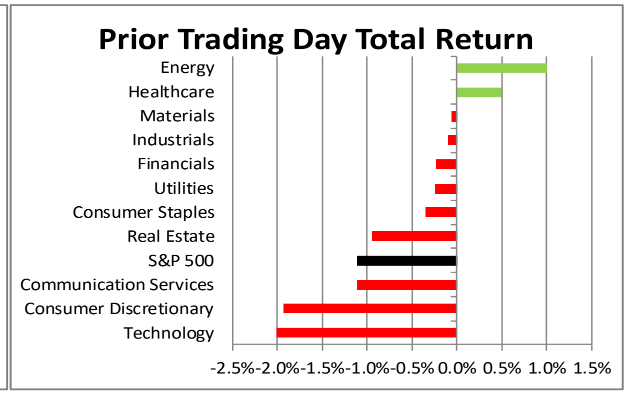
Weather

The 6-to-10-day and 8-to-14-day forecasts currently call for cooler-than-normal temperatures to prevail across most of the country from the Rocky Mountains eastward, with normal temperatures elsewhere. The precipitation outlook calls for wetter-than-normal conditions in the northern Great Plains and the Permian Basin, with dry conditions expected in a bubble surrounding Nevada and the northern half of the East Coast.

Data Section

US Equity Markets – (as of 1/7/2025 close)

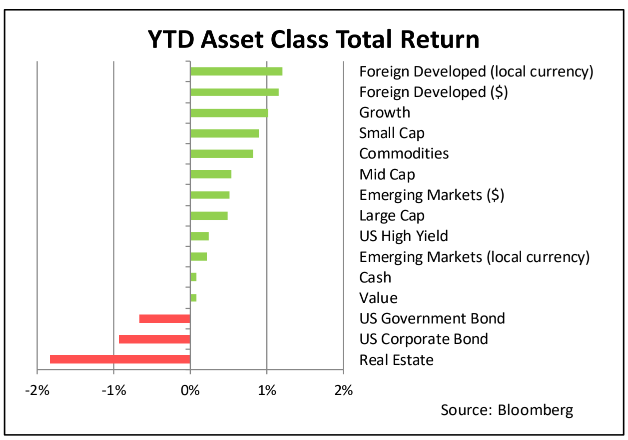




(Source: Bloomberg)

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 1/7/2025 close)

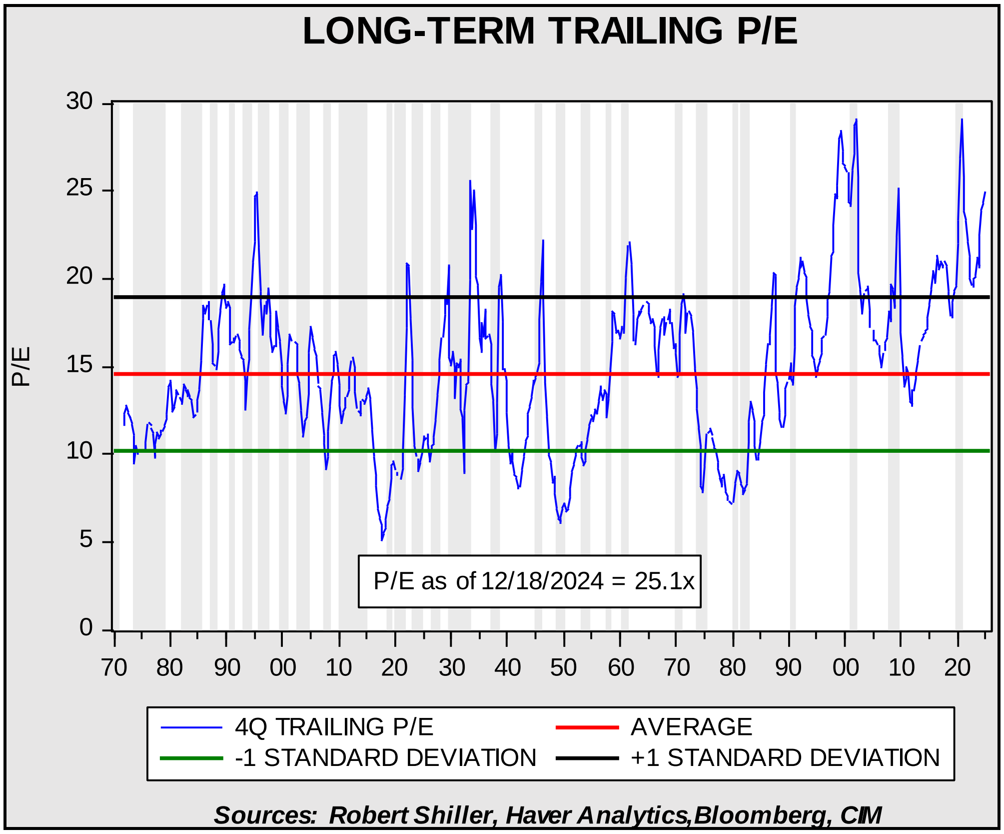


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

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.