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The Palos Perspective

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A Macro Market View by Hubert Marleau

The State of the U.S. Economy

Many investors are bearish because contrarian indicators show that there are too many bulls and not enough bears, and therefore too much complacency. This belief is based on the low readings of the VIX; a stretched valuation metric; and narrow yield spreads between corporate bonds versus US Treasuries. In this connection, the Skew Index has been trading at record highs for several months, fearing an imminent 5% pullback, 10% correction or 20% plunge. Citi Bank puts the bear case for the S&P 500 at 5100, stating that massive deportation of illegal immigrants and trade tariffs pose risks to economic stability. On Friday last, the benchmark was 0.6% below its record all-time high of 6090.

In the meantime, overall retail investing has not been particularly gung-ho either, but is nonetheless within the usual seasonal patterns. While I suspect that the stock market will be more volatile over the next few weeks and into the early days of the new year, I surmise that many institutional investors will rebalance their portfolios and that retail investors might cash in some of their capital gains in January, gaming the tax system.

I believe, however, that once again investors will buy the dips with accumulated dividends, in the overwhelming expectation that the S&P 500 rally will broadly continue in 2025 and reach 6600. Meanwhile, the Magnificents may appear expensive, accounting for 35% of the market capitalization of the S&P 500, but their earnings represent 30% of total earnings and are rising significantly.

Oppenheimer, the biggest bull on Wall Street, just set a 7100 target, betting that the Roaring 2020s will forge ahead in 2025 and could carry on for the rest of the decade. Tom Lee, head of research at FundStrat Global Advisors, predicted on Wednesday that the rally will continue with the S&P 500 ascending to 7000 by the middle of 2025.

A Macro Market View by Hubert Marleau

History conclusively proves that stock markets do very badly only when the central bank contracts monetary policy: interest rates rise as savings start to decline or energy is costly while a recession is due. This is not the case here. Valuation multiples is what the stock market is all about and investors are always willing to pay higher P/E and/or P/S for as long as earnings and revenue growth last, especially when interest rates don't rise. The point is the better the economic conditions, the more likely investors have confidence to make bets. Those conditions presently exist. According to the NIFB, even small businesses are very optimistic, while Main Street is certain about future business conditions, breaking a 3-year streak of record high uncertainty.

Indeed, the economy is in a good place as the Misery Index, which combines inflation with the unemployment rate, shows; and there is no reason to think the Fed should tighten monetary conditions. The policy rate (4.88%) is roughly 80 bps above the neutral rate, suggesting that there could even be 3 more interest rate cuts of 25 bps. Moreover, the Palos' Monetary Policy Index stands currently at 7.3, significantly lower than what is considered the norm.

As to that, the Palos Monetary Policy Index is the arithmetic ratio of the y/y percentage change in the CPI (2.7%) less the y/y percentage in the DXY (2.4%) divided by the unemployment rate (4.2%) less the y/y percentage change in total employment (1.4%); its purpose being to estimate the likelihood of whether the central bank's policy ought to be easier, tighter or neutral. The center point, being the norm, is 66.6.

Interestingly, the Federal Reserve Bank of the 51st U.S. state implemented a second 50-bps jumbo-sized cut in its policy rate to 3.25%, which is now only 25 bps above its neutral rate and 175 bps less than the Federal Reserve's federal funds rate. And guess what? The Loonie firmed to 70.72 U.S. cents even though the currency markets were pricing in a 70% chance of another 25 bps decline in January.

In connection with the aforementioned observations, it shouldn't be surprising that the CME FedWatch tool shows 99% odds that the FOMC will cut the policy rate by 25 bps on December 18.

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The Employment Situation

Last week's November labour report showed that the job market is softening. There was an uptick in the unemployment rate from 4.1% to 4.2% even though the labour participation rate slipped from 62.6% to 62.5%, implying that hiring is slowing down. Over the past 2 months, the job gains grew at the annual rate 0.9% versus 1.4% from a year ago. Incidentally, initial job claims rose last week to 242,000. We have not seen such a number since the height of the pandemic.

The Inflation Situation

Headline and core prints on consumer inflation were sticky in November, matching expectations, rising 0.3% m/m, and turning the consumer price index into a y/y 2.7% increase. Fortunately, the reading was not a big concern for the market because progress on bringing down inflation has not stalled.

First, the labour market as a source of inflationary pressure is receding. Unit labour cost grew 0.8% in Q3 and declined 1.1% in Q2, revised down to from 1.9% and 2.4% respectively. The Atlanta Fed's wage growth tracker was up 4.3% in November versus 4.7% in October.

Second, shelter costs have finally shown scattered signs of returning to the pre pandemic trend of 0.2% per month. Headline and core reading on consumer inflation were sticky, but matched expectations, rising 0.3% m/m respectively in November, Year-over-year the consumer price index rose 2.7%. Excluding shelter, it was up only 1.6%, having been below 2% every month since May.

The Productivity Situation

Google has a new state-of-the-art chip, named Willow, which promises to be a quantum leap in quantum computing that can outpace today's supercomputers by several orders of magnitude. Productivity is all about the "Digital Revolution" and "Energy Efficiency" processing more and more data, faster and faster, thereby pushing AI to higher and higher levels of comprehension and utilization. American dominance is not only in technology, but also in energy: U.S. energy. The share spent on energy as a percentage of N-GDP in the U.S. is 2.5%, compared to 5.5% for the rest of the world. According to rough estimates, U.S. productivity rose at an annual rate of 2.7% in Q4, even more than the imposing 2.2% and 2.5% officially recorded in Q3 and Q2 respectively. U.S. exceptionalism is productivity; and it's alive because American entrepreneurial spirit and comparative advantage is second to none, operated by a highly skilled workforce and financed by a formidably developed capital venture industry.

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$9.20	19.84%
Palos Equity Income Fund - RRSP	PAL101	$7.84	17.60%
Palos WP Growth Fund - RRSP	PAL213	$11.59	23.25%
Palos Global Small-Cap Equity Fund[2]	PAL251	$9.81	3.50%
Palos-Mitchell Alpha Fund [3]	PAL300	$11.97	18.42%
S&P TSX Composite (Total Return with dividends reinvested)			25.14%
S&P 500 (Total Return with dividends reinvested)			28.18%
S&P TSX Venture (Total Return with dividends reinvested)			11.26%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			4.23%
Canadian Government 10-Year			3.02%
Crude Oil Spot			US $68.59
Gold Spot			US $2,697.60
US Gov't10-Year/Moody BAA Corp. Spread			142 bps
USD/CAD Exchange Rate Spot			US $0.7052

[1] *Period ending December 10th, 2024. Data extracted from Bloomberg*

[2] *Fund is priced monthly*

[3] *Fund is priced weekly on Tuesdays*

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