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The Palos Perspective

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CONTENTS

A Macro Market View by Hubert Marleau

Recalibration Is Complete Now that the Policy Rate is Neutral

The Federal Reserve cut its policy rate by 25bps on Wednesday, as widely expected, taking the midpoint of the target range to 4.375%. The decision was not unanimous, as 4 participants were not in favour of the decision. Powell said, however: "From here, it's a new phase, and we're going to be cautious about further cuts," suggesting the official cost of money is closing in on the neutral rate. The reason is because the monetary authorities expect inflation to be stickier and economic growth stronger than previously believed. The estimate for real economic growth in Q4 is 3.2% (saar) and the outlook for 2025 is set around 2.5%, while core inflation, which is currently running at an annual rate of 2.8%, is expected to cling around 2.5% throughout 2025.

Assuming that 5-year Treasury yields are a good proxy of the so-called neutral rate of interest (4.39%), then the official cost of money is now exactly where it ought to be if impartiality is what the Fed wants: a policy rate that is neither hot nor cold, neither slows nor gooses growth, and is neither bullish nor bearish for financial markets.

Traders in interest-rate futures markets see officials standing pat for at least two more meetings. In other words, the recalibration phase is completely over. From hereon, the Fed will simply respond to incoming data, which can be either good or bad when the economy stands right in the middle. Complicated, indeed. On the one hand, the incoming administration has made promises that it will impose tariffs and deport illegal immigrants which could boost inflation and/or impair growth; and on the other hand, it gave assurance that it would decrease corporate taxes and ease regulations. With this in mind, however,the situation becomes difficult to square, confounding the Fed and, in turn, discombobulating investors. But one thing is sure, the era of ultralow levels of interest rates is done.

Consequently, the markets freaked out over everything as Wall Street 's fear gauge - the CBOE Volatility Index - soared 75% after the Fed Meeting., with five big things occurring.

First, the 10-year Treasury bond yield jumped to 4.51%: a staggering increase of 11 bps. This yield is 88 bps from the bottom of 3.63% registered on September 16 when the Fed started its easing process. That is probably it for now, given that 4.50% is a reasonable level under current circumstances.

Second, The US dollar index (DXY) surged to 108.12, up 8.0% since it bottomed at 100.80 at the end of last September.

Third, both physical and digital gold were slammed down. The price of gold fell $67 to $2600, while bitcoins were whacked $5000, to end the day at $101,381.

And finally, the S&P 500 plunged 2.9%, off 3.6% from the all-time high of 6090 and erasing most of the gains since November 6. Importantly, this key index fell below its 50-day moving average, but still close to 10% above its 200-day moving average. This technical position could flush out whatever remaining excess there is in the market.

Wednesday investor behavior seems irrational, since some calmness did return to the markets on Thursday and Friday, pausing the tantrum. Speculators who tend to be dip-buyers stepped in, judging that overreactions of traders to the Fed's message may have been too harsh. The S&P 500 convalesced on Thursday, the tick down falling only 5 points.

Although an expenditure bill backed by Trump that would have allowed increased spending and suspended the debt limit for 2 years failed to get through Congress because Republicans refused to support it, jeopardizing his tax plans did not shake the market even though $6.6 trillions in options were expiring on Friday. Triple witching events can be very cruel. Fortunately, the Fed's favourite inflation gauge saves the day, offering hope that its monetary stance is on the right path. The PCE inflation index rose only 0.1% in November, below expectations. Thus, in spite of a huge wave of option activity hitting the market on Friday that were either exercised or terminated, the S&P 500 rose 64 points to end the week at 5931, but still booked a weekly loss of 1.9%.

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Assuming that a nasty trade war and wholesale deportations are avoided, the probabilities are good that the ongoing productivity boom should support the bull run and push the benchmark to 6850 by the end of 2025. Interestingly, according to McQuarrie's database, the chances that stocks will rise in 2025 is 72%: good odds, indeed.

P.S. 1 Canada may soon offer a lucrative investment opportunity in the new year. Assuming that it will not be subjected to Trump's tariff threats, the cheap Canadian dollar could bring extra profits to many publicly traded Canadian businesses that have big investments in the US and/or sell a lot of goods and services there. They could benefit handsomely from foreign exchange translations on assets and higher revenues on sales.

P.S. 2 In the early hours of Saturday Americans got good news: the US Congress approved a revised plan to keep the government open, extending federal funding into March, providing disaster relief and aid to farmers, but left out a debt-ceiling demanded by Trump.

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$9.07	18.16%
Palos Equity Income Fund - RRSP	PAL101	$7.73	15.86%
Palos WP Growth Fund - RRSP	PAL213	$11.27	19.83%
Palos Global Small-Cap Equity Fund[2]	PAL251	$9.81	3.50%
Palos-Mitchell Alpha Fund[3]	PAL300	$11.91	17.82%
S&P TSX Composite (Total Return with dividends reinvested)			19.94%
S&P 500 (Total Return with dividends reinvested)			24.65%
S&P TSX Venture (Total Return with dividends reinvested)			5.81%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			4.40%
Canadian Government 10-Year			3.14%
Crude Oil Spot			US $70.08
Gold Spot			US $2,592.20
US Gov't10-Year/Moody BAA Corp. Spread			141 bps
USD/CAD Exchange Rate Spot			US $0.6988

[1] *Period ending December 17th, 2024. Data extracted from Bloomberg*
[2] *Fund is priced monthly*
[3] *Fund is priced weekly on Tuesdays*

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