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The Palos Perspective

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A Macro Market View by Hubert Marleau

Good News is Good News for the Markets

The S&P 500 rose 3.2% this week, benefiting from solid earnings reports, cooler inflation prints and incoming pro-growth policies. The benchmark would have performed even better if it hadn't been for the dragging effect of big tech, the sharp rally having stemmed more from traders covering their short positions than investors making new purchases. Nonetheless, a sense of relief filled the air, keeping the risk appetite among investors intact.

Disinflation will Continue:

Contrary to market fears, all inflation readings were milder than expected. Producer, consumer and export prices only inched up in December, registering yearly increases of 3.3%, 2.9% and 2.2% respectively. A jump in energy prices drove about half of the 0.4% m/m increase in CPI.

The bond market took all these numbers well, 10-year Treasuries bullishly tumbling 18 bps to 4.60%. Although the core CPI remains above 3.0%, ex-shelter it was only 1.93%, the 7th consecutive month below 2.0%. Thus the disinflation narrative that price increases are heading down towards target remains, raising the odds for a July interest rate cut after all. This may have given some assurance to professional traders that the market may have overreacted too bearishly in the past month. Nonetheless, the NY Fed revealed in its most recent report that we are not yet in a stable equilibrium because of median inflation expectations, which seemed well anchored at 3.0%. This will likely keep the Fed on pause for the time being.

Using the latest data, estimates abound that the Fed's 2% preferred core inflation gauge will measure 0.2% month-over-month in December. As a matter of fact, inflation uncertainties are not connected to the underlying performance of the economy, but related to how the incoming Trump administration's proposals, fiscal policies, and geopolitics will unfold and impact international money flows and global liquidity, and in turn growth and inflation. We will know more about these known unknowns on Monday when the new President will deliver his inaugural address. Again, watch the dollar for reactions and clues.

Corporate Profits Will Trend Up:

The other big news was the outstanding performance of bank earnings. And that goes for JPMorgan, Goldman Sachs, Wells Fargo, Black Rock, Morgan Stanley, Bank of America, etc. Wall Street expects S&P 500 earnings will increase between 8% and 13% in 2025 because productivity, consumer spending, operating margins, and volume growth should all hold. According to FactSet's analysis, the earnings growth rate has, on average, come in around 5.0 percentage points ahead of expectations.

The Atlanta Fed's economic tracker has an estimate of 3.0% for GDP growth in Q4. Meanwhile, the more conservative NY Fed Staff Nowcast for Q1/2025 is 3.0%. This 3% growth factor will likely continue into 2025 because the growth of the US money supply and the Federal budget deficit have accelerated in the latter months of 2014; plus, quantitative tightening (QT) may end soon. The Bank of Canada may again take the lead here, announcing that it will end in 2025.

Moreover, the Trump administration, under the auspices and support of Treasury Secretary Scott Bessent, will prioritize productive investment, deregulations, and productivity policies to grow the economy, along with tariffs to fund government spending and ensure that the US dollar remains the world's reserve currency.

The JPMorgan's Chief said: "Businesses are more optimistic about the future and are encouraged by expectations for a more pro-growth agenda and improved collaboration between government and industry," while Wells Fargo's Chief said: "We feel optimistic about where we are going into 2025 both because of where the economy is and the strength that has existed, as well as the business-friendly approach from the incoming administration."

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The Biggest Risks in 2025:

The top five quotes from this year's dense World Economic Forum on global risks are:

1. "Perceptions of the overall economic outlook for 2025 remain fairly pessimistic across all age groups surveyed";
2. "A loss of support for and faith in the role of international organizations in conflict prevention and resolution has opened the door to more unilateralist moves";
3. "Deeper decoupling of trade between West and East would have worldwide repercussions";
4. "Pension crises will start to bite over the next decade in in super-ageing societies"; and
5. "Environmental risks have consistently topped the 10-year ranking"

While these are legitimate concerns, they are nonetheless just gloomy vibes because they tend to be much more catastrophizing than what the facts justify.

Pro-Growth Policies:

Yet there is one thing that merits close scrutiny: the US dollar. American exceptionalism is very much related to the recent surge in U.S. productivity. Labour productivity grew at an annual rate of 2.2% in Q3 and perhaps as fast as 2.6% in Q4, while productivity growth has averaged an impressive quarterly increase of 2.7% in the past 7 quarters compared to only 1.4% for the 5 years before the pandemic. Unfortunately, this productivity boom risks being squeezed out by the enormous amount of capital needed to finance the huge fiscal deficit, if for any given reason private savings from the rest of the world were to stop servicing the stock of debt, fund budget deficits and feed the thirst for investment capital. Acknowledging that foreign investors are considerably more sensitive than foreign central banks when it comes to dispensing their funds, the US must preserve its status as a reserve currency with attractive interest differentials, remain global innovator and stay profitable. So far so good. For example, Canadian investors bought $17.8 billion worth of foreign securities in November alone, of which $8.8 billion were US dollar denominated.

Thank God, captain Scott Bessent understands that Trump's 2017 tax cuts must be extended and that the maintenance of the greenback as a reserve currency is crucial. Nonetheless, Trump pledged on Friday to create a huge sovereign wealth fund in the hope of mobilizing hundreds of billions from Wall Street, perhaps partially explaining why he wants to institutionalize foreign capital rather than leave it as the mercy of individual foreign investors.

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) [1]	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	$8.70	-1.15%
Palos Equity Income Fund - RRSP	PAL101	$7.42	-1.05%
Palos WP Growth Fund - RRSP	PAL213	$11.70	-0.64%
Palos Global Small-Cap Equity Fund[2]	PAL251	$9.81	0.00%
Palos-Mitchell Alpha Fund[3]	PAL300	$11.49	1.44%
S&P TSX Composite (Total Return with dividends reinvested)			-0.47%
S&P 500 (Total Return with dividends reinvested)			-0.62%
S&P TSX Venture (Total Return with dividends reinvested)			0.95%
Chart 2: Market Data [1]			**Value**
US Government 10-Year			4.79%
Canadian Government 10-Year			3.54%
Crude Oil Spot			US $77.50
Gold Spot			US $2,682.30
US Gov't10-Year/Moody BAA Corp. Spread			145 bps
USD/CAD Exchange Rate Spot			US $0.6969

[1] *Period ending January 14th, 2025. Data extracted from Bloomberg*

[2] *Fund is priced monthly*

[3] *Fund is priced weekly on Tuesdays*

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