Daily Comment

Confluence Investment Management

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[Posted: February 12, 2025 — 9:30 AM ET] Global equity markets are mostly higher 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 up 1.0%. Chinese markets were higher, with the Shanghai Composite up 0.9% from its previous close and the Shenzhen Composite up 1.3%. Conversely, US equity index futures are signaling a lower open.

With 332 companies having reported so far, S&P 500 earnings for Q4 are running at $64.50 per share, compared to estimates of $64.79, which is up 11.7% from Q4 2023. Of the companies that have reported thus far, 77.6% have exceeded expectations while 16.6% have fallen short of expectations.

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
Middle Eastern Stock Markets: An Overview (2/10/25) + podcast	*American Exceptionalism and the Markets* (2/3/25) + podcast	Q1 2025 Report Q1 2025 Rebalance Presentation	*The Case for Hard Assets: An Update* Value Equities Quarterly Update

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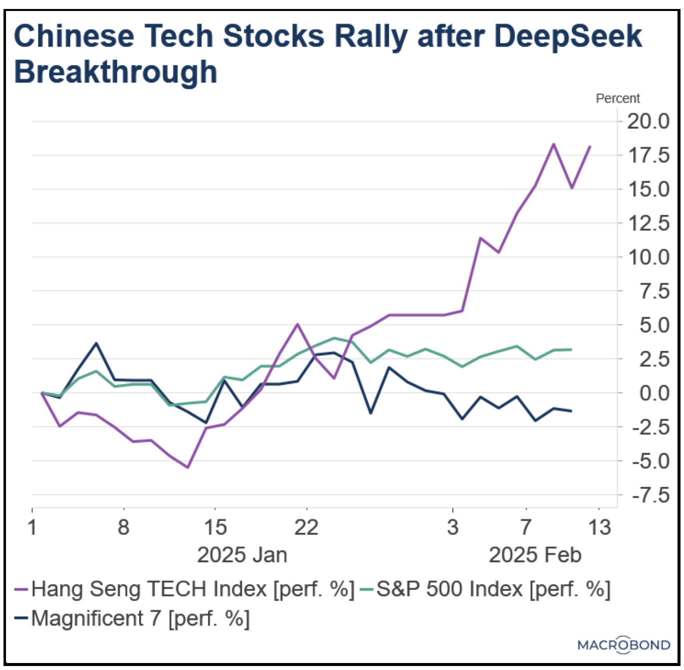
Good morning! Markets are reacting to the latest inflation figures this morning. On the sports front, Real Madrid narrowly defeated Manchester City in the first leg of their highly anticipated playoff series. Today's *Comment* will cover the increasing influence of AI, Fed Chairman Powell's testimony before Congress, and other key market developments. We'll also provide our regular roundup of the latest international and domestic economic data releases.

US AI vs Everyone Else: Vice President JD Vance declined to sign a declaration aimed at ensuring AI remains "safe, secure, and trustworthy." Instead, he asserted that the United States is committed to leading AI development and governance, and aims to set global standards and rules. While acknowledging the importance of international collaboration, Vance emphasized the US's ambition to become the global hub for AI manufacturing and innovation.

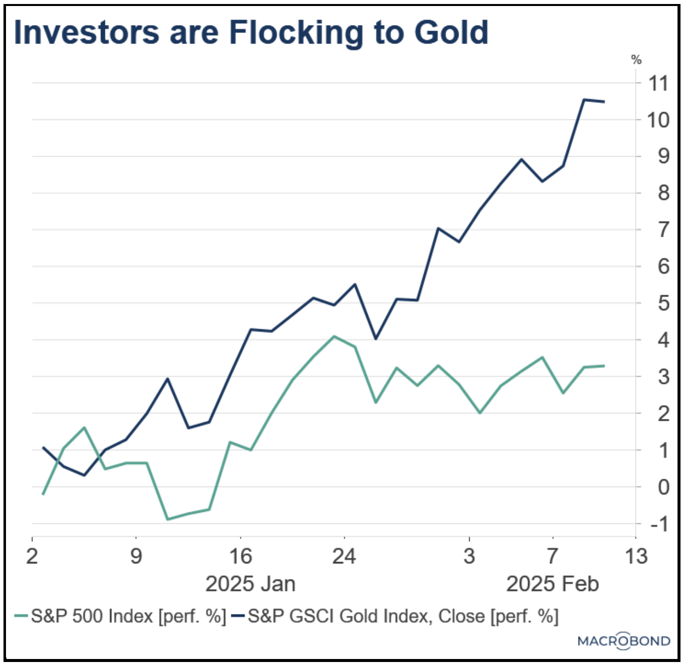
- Vance's emphasis on the US taking the lead in shaping AI rules seems to be a deliberate response to the EU's Digital Markets Act and Digital Services Act, which aim to create a more balanced competitive landscape between EU and US tech companies. The administration has made it clear that it will aggressively oppose any measures perceived as discriminatory against US firms operating abroad.
- Furthermore, his remarks suggest that the EU should take a subordinate role to the US in the global technology landscape — a stance that risks deepening tensions and complicating transatlantic cooperation. This approach appears to directly conflict with the EU's ambitions to cultivate and strengthen its own domestic tech industry.
- Vance's message comes at a pivotal moment as China continues to demonstrate its rising competitiveness in the AI sector. The recent breakthrough by DeepSeek, reportedly achieved with just $6 million and less sophisticated chips, has sent shockwaves through financial markets. This has prompted investors to increasingly turn their attention to Chinese tech companies, while casting doubt on the ability of their US counterparts to meet lofty valuations.
- Since the release of DeepSeek, Chinese stocks have surged, as investors view the breakthrough as a catalyst for revitalizing the sector and injecting new energy into the country's equity markets. While the Magnificent 7 stocks are trading below their year-start levels, the Hang Seng TECH Index, which tracks leading Chinese tech companies, has climbed nearly 20% year-to-date, underscoring the shifting momentum in global markets.



- The recent rally in Chinese tech stocks faces significant headwinds. China's economic challenges, often summarized as the ***five Ds*** — weak consumer ***demand***, excess capacity and ***high debt***, unfavorable ***demographics***, economic ***disincentives*** stemming from Communist Party market interventions, and Western ***decoupling*** — pose substantial risks.
- Moreover, the US's ability to sustain its relationship with Western allies will likely play a pivotal role in preserving its dominance in the tech sector as it looks to counter China. However, it is increasingly evident that the EU and the US could emerge as competitors in this space in the near future, potentially reshaping the dynamics of global technological leadership.

Powell Goes to Washington: Fed Chair Jerome Powell held the first of his two meetings with Congress on Wednesday. Markets showed little reaction to his testimony, as he provided no new insights into the future path of monetary policy. However, the hearing underscored the growing tension between the two parties as they continued to clash over the Department of Government Efficiency (DOGE) and how to address the budget.

- On monetary policy, Fed Chair Powell largely echoed the sentiment of his fellow colleagues stating the Fed is in no rush to cut interest rates but warned that the neutral rate was likely meaningfully higher than it was prior to the pandemic. When pushed to give his thoughts on the inflationary impact of tariffs, he resisted, and only stated that a rise in inflation was a possible outcome of new trade restrictions.
- Fiscal policy was also a key topic of discussion. Fed Chair Powell urged lawmakers to rein in spending, emphasizing that current levels are on an unsustainable trajectory. Additionally, he addressed Elon Musk's recent cost-cutting efforts at DOGE, noting that the Treasury system remains secure from any breaches and clarifying that the group has no access to its systems. Furthermore, Powell suggested that the Fed may not require staff reductions but rather hires to effectively fulfill its responsibilities.
- Investors have driven up 10-year yields in recent weeks as they react to the ongoing debate over fiscal and monetary policy. The market is increasingly pricing in the risks of higher debt and inflation, which could limit the Federal Reserve's policy options down the road. A continued rise in the yield is likely to raise borrowing costs for households and firms as well as be a source of headwinds for equities.



- Precious metals may offer a hedge against current economic uncertainty. Gold has seen a strong start to the year, rising 11.0% year-to-date and outpacing the S&P 500's 3.0% gain over the same period. This preference for gold comes as investors and institutions become skeptical of the dollar's use as a reserve asset. This trend could be further fueled by escalating trade tensions, which could weaken the dollar's position as a reserve currency.

UK Growth Concerns: British Chancellor Rachel Reeves is facing mounting pressure after a watchdog downgraded its UK GDP growth forecast. Reeves had previously cited strong economic growth as a key rationale for avoiding harsh budget cuts, but the revised outlook has cast doubt on that justification.

- Reeves is scheduled to deliver her update on the budget on March 26. If growth does not meet the fiscal rules, she will be forced to make spending cuts to public services or welfare in order to balance the books.
- Thursday's monthly UK GDP report is expected to offer valuable insights into the trajectory of the economy. If the data reveals strong growth in December, we anticipate a rally in UK bonds and equities, reflecting renewed investor confidence.

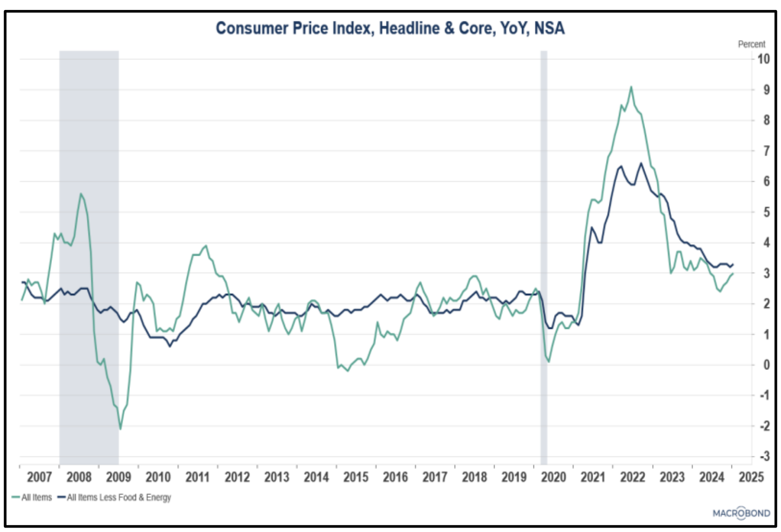
Ukraine War Update: While details of the negotiations between the US, Russia, and Ukraine to end the war remain undisclosed, it is evident that discussions are ongoing. In a recent development, a wrongfully detained teacher has been released from Russia, marking a potentially significant step amid the broader diplomatic efforts.

* Russia has intensified its attacks on Kyiv even as negotiations continue, signaling a dual strategy of military pressure and diplomacy. However, signs of economic fragility are emerging, particularly as borrowing costs rise and financial strain deepens. Meanwhile, Ukraine remains steadfast in the holding of its occupied territories, aiming to leverage them for potential negotiation swaps in the ongoing conflict.
* The likelihood of a ceasefire in the conflict has grown, but its impact on markets will largely hinge on whether Russia receives sanctions relief. This remains an open question, particularly given the Trump administration's focus on bolstering US energy companies, which could complicate any decision to ease economic pressure on Moscow.

US Economic Releases

The Mortgage Bankers Association today said ***mortgage applications*** for the week ended February 7 rose 2.3%, slightly ahead of the prior week's 2.2%. Applications for home purchase mortgages fell 2.3%, marking the third straight week of declines in this component. Applications for refinancing mortgages rose 9.6%, the second consecutive week of strong gains. Meanwhile, the average interest rate on a 30-year mortgage eased two basis points to 6.95%, continuing a slight downward trend that began with the new year.

The January ***consumer price index (CPI)*** rose by a seasonally adjusted 0.5%, notably exceeding the expected 0.3% and marking a slight acceleration from the prior month's 0.4%. Excluding the volatile food and energy components, the ***"core" CPI*** rose 0.4%. This also exceeded both the expected 0.3% and the prior month's 0.2%. The overall CPI in January rose 3.0% from the same month one year earlier, while the core CPI rose 3.3%. These figures also exceeded expectations and marked an acceleration from the previous month's readings. The chart below shows the year-over-year change in the CPI and the core CPI since just prior to the Global Financial Crisis.



The table below lists the economic releases and Fed events scheduled for the rest of the day.

Economic Releases						
EST	Indicator			Expected	Prior	Rating
14:00	Federal Budget Balance	m/m	Jan	-$94.8b	-$86.7b	**
Federal Reserve						
EST	Speaker or Event	District or Position				
10:00	Jerome Powell Testifies to House Financial Services	Chairman of the Board of Governors				
12:00	Raphael Bostic Speaks on Economic Outlook	President of the Federal Reserve Bank of Atlanta				
17:05	Christopher Waller Speaks on Stablecoins	Member of the Board of Governors				

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	Money Stock M2	y/y	Jan	1.3%	1.3%		**	Equity and bond neutral
	Money Stock M3	y/y	Jan	0.8%	0.9%		**	Equity and bond neutral
	Machine tool orders	y/y	Jan P	47.0%	12.6%		**	Equity and bond neutral
India	CPI	y/y	Jan	4.31%	5.22%	4.50%	***	Equity and bond neutral
	Industrial Production	y/y	Dec	3.2%	5.0%	3.7%	***	Equity and bond neutral
EUROPE								
Italy	Industrial Production WDA	y/y	Dec	-7.1%	-1.6%	-2.5%	***	Equity bearish, bond bullish
Russia	Trade Balance	m/m	Dec	5.6b	6.0b		**	Equity and bond neutral
	Exports	m/m	Dec	31.3b	32.0b		*	Equity and bond neutral
	Imports	m/m	Dec	25.7b	25.9b		*	Equity and bond neutral
AMERICAS								
Canada	Building Permits	m/m	Dec	11.0%	-5.6%	1.40	**	Equity bullish, bond bearish
Mexico	International Reserves Weekly	w/w	7-Feb	$231400m	$230764m		*	Equity and bond neutral
Brazil	IBGE Services Volume	y/y	Dec	2.4%	2.4%	3.5%	*	Equity bearish, bond bullish

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 T-bill yield (bps)	422	422	0	Down
U.S. Sibor/OIS spread (bps)	432	432	0	Down
U.S. Libor/OIS spread (bps)	434	434	0	Down
10-yr T-note (%)	4.55	4.54	0.01	Up
Euribor/OIS spread (bps)	254	253	1	Down
Currencies	**Direction**			
Dollar	Flat			Up
Euro	Up			Down
Yen	Down			Up
Pound	Flat			Down
Franc	Up			Down

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.

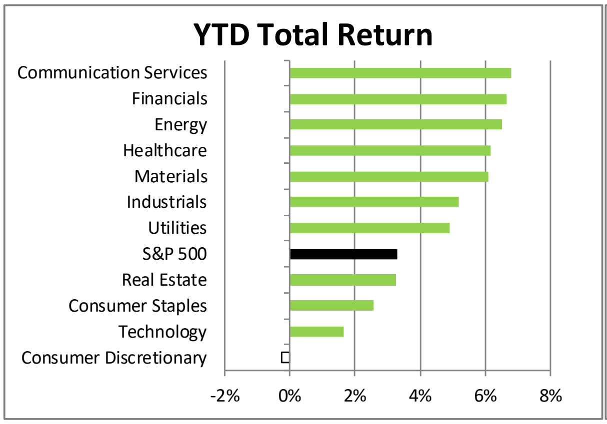
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$76.26	$77.00	-0.96%	
WTI	$72.46	$73.32	-1.17%	
Natural Gas	$3.51	$3.52	-0.31%	
Crack Spread	$22.45	$22.19	1.16%	
12-mo strip crack	$23.11	$23.06	0.22%	
Ethanol rack	$1.83	$1.83	0.02%	
Metals				
Gold	$2,882.58	$2,897.91	-0.53%	
Silver	$31.72	$31.82	-0.29%	
Copper contract	$461.50	$460.10	0.30%	
Grains				
Corn contract	$497.50	$498.00	-0.10%	
Wheat contract	$579.50	$577.00	0.43%	
Soybeans contract	$1,054.25	$1,060.25	-0.57%	
Shipping				
Baltic Dry Freight	801	809	-8	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.31		
Gasoline (mb)		1.21		
Distillates (mb)		-2.25		
Refinery run rates (%)		0.2%		
Natural gas (bcf)		-91		

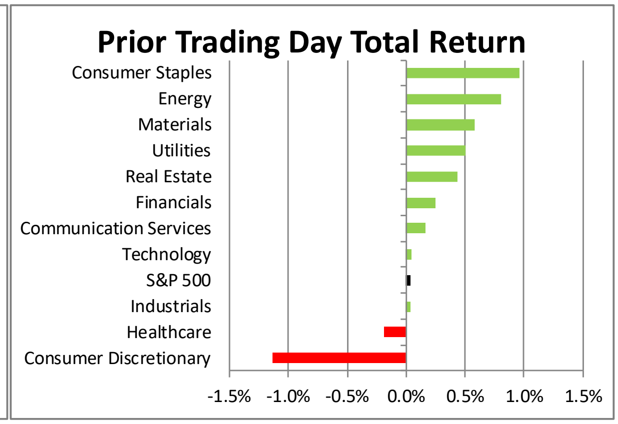
Weather

The 6-to-10-day and 8-to-14-day forecasts currently call for cooler-than-normal temperatures from the Great Plains to the East Coast, with warmer-than-normal conditions expected in the Desert Southwest. The precipitation outlook calls for wetter-than-normal conditions in the Southeast and along the East and Gulf Coasts, with dry conditions expected in the Southwest.

Data Section

US Equity Markets – (as of 2/11/2025 close)

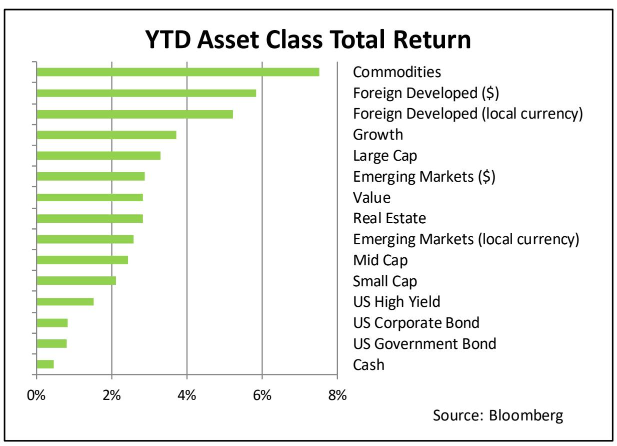




(Source: Bloomberg)

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 2/11/2025 close)

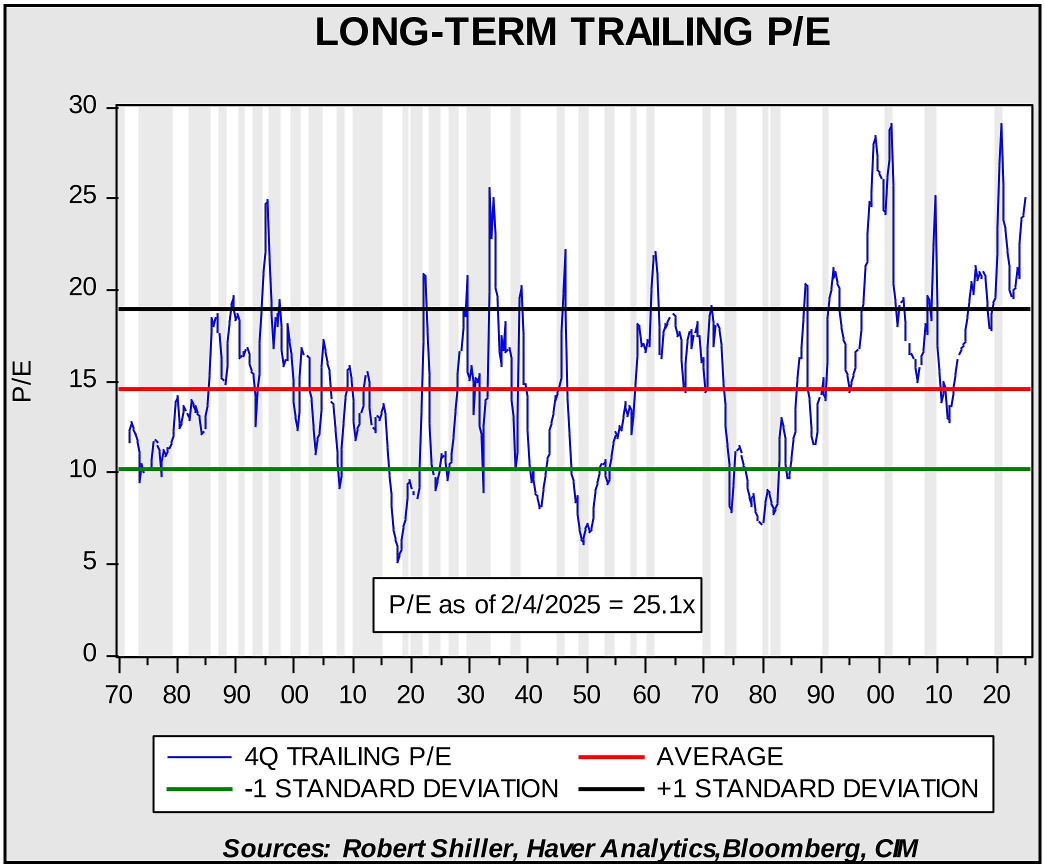


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

February 5, 2025



Based on our methodology,[1] the current P/E is 25.1x, up 0.1 from our last report. The increase was due to 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.