Daily Comment

Confluence INVESTMENT MANAGEMENT

By Patrick Fearon-Hernandez, CFA, and Thomas Wash

[Posted: February 28, 2025 — 9:30 AM ET] Global equity markets are mostly lower this morning. In Europe, the Euro Stoxx 50 closed down 0.8% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 2.6%. Chinese markets were lower, with the Shanghai Composite down 2.0% from its previous close and the Shenzhen Composite down 3.2%. Conversely, US equity index futures are signaling a higher open.

With 484 companies having reported so far, S&P 500 earnings for Q4 are running at $65.50 per share compared to estimates of $64.79, which is up 11.7% from Q4 2023. Of the companies that have reported thus far, 74.3% have exceeded expectations, while 19.3% 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:

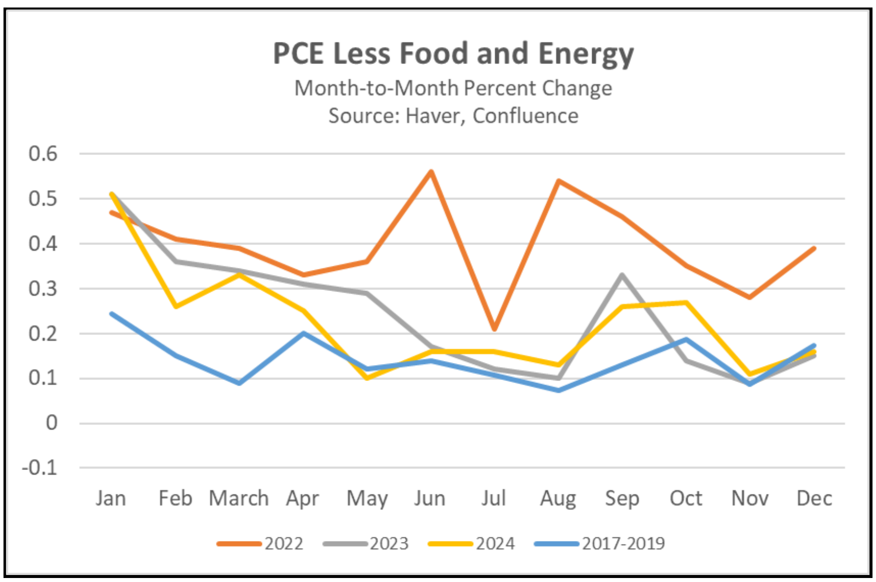
Bi-Weekly Geopolitical Report	Asset Allocation Bi-Weekly	Asset Allocation Quarterly	Of Note
"Sanctions as an Investment Risk" (2/24/25) + podcast	"Our Take on the Initial Trump Tariffs" (2/18/25) + podcast	Q1 2025 Report Q1 2025 Rebalance Presentation	The Confluence of Ideas podcast **Business Cycle Report**

Good morning! Markets are reacting to the latest inflation data. In sports, Steph Curry joined Wilt Chamberlain and Elgin Baylor as the only players with 45+ point games on the same date. Today's *Comment* explores the factors behind the Fed's aggressive policy shift, the strategic importance of a US-UK trade agreement, and other market-moving events. Plus, we'll provide a comprehensive overview of today's key economic data releases.

Close to Neutral? On Thursday, two Federal Reserve officials offered contrasting perspectives on the tightness of monetary policy, underscoring the persistent uncertainty surrounding the path to the neutral interest rate. Despite their differing views, both officials agreed that the Fed should maintain current interest rates for the time being.

- Cleveland Fed President Beth Hammack has indicated that the Fed's policy rate is no longer meaningfully "restrictive," suggesting that the central bank may be approaching its neutral rate — the level at which monetary policy neither stimulates nor constrains economic growth. Her comments mark one of the first signals that some Fed officials are growing comfortable with the idea of concluding the current easing cycle by the end of the year.

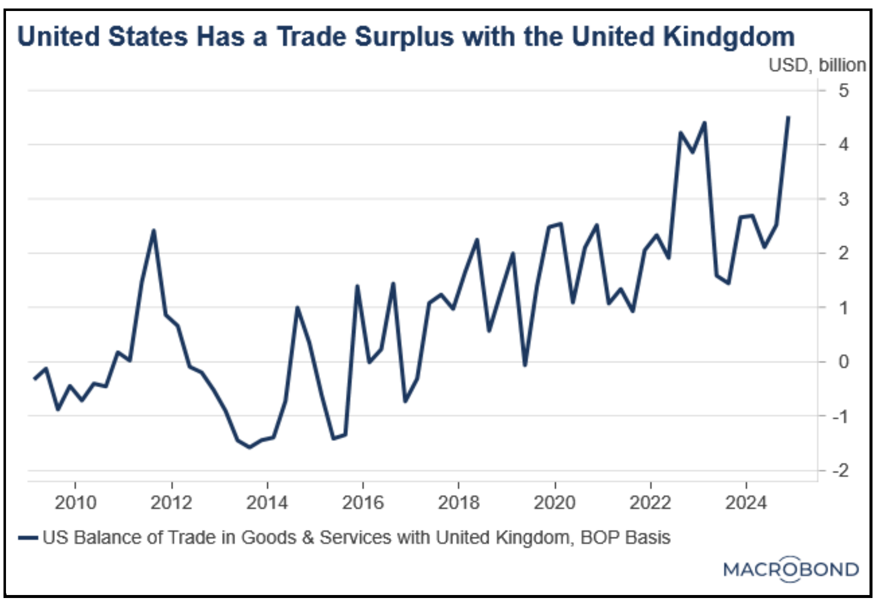
- On the same day, Philadelphia Fed President Patrick Harker noted that he believes the current policy rate remains sufficiently restrictive to maintain downward pressure on inflation over the long term. While these remarks do not indicate how many rate cuts he expects for the year, it does suggest that he may not agree that the Fed is close to finishing its easing cycle.
- Although both officials still support keeping rates steady at the upcoming meeting and neither has pushed for a near-term rate hike, the widening divergence in their views highlights a growing hawkish tilt among committee members in recent months. This shift signals that the Fed may be closer to ending its easing cycle than markets initially expected at the start of the year.
- Market expectations have shifted significantly. Before the latest inflation data, Fed futures contracts showed that many participants had largely dismissed the possibility of 50 bps of rate cuts this year. As of now, the likelihood of a rate hike has surpassed that of a cut. Current pricing suggests a 35% probability that rates will remain unchanged by the end of 2025, a 25.2% chance of a 25 bps increase, and a 23.1% chance of a 25 bps cut.



- As we have emphasized over the past few months, the Fed will be closely monitoring inflation data early in the year. The first few months present the best opportunity for the Fed to make progress toward its 2% target, given that inflation readings during this period have historically been elevated compared to their long-term average. While a sudden rate hike is not currently the base case scenario, it remains a potential unexpected headwind for risk assets.

UK Trade Deal: UK Prime Minister Keir Starmer visited Washington this week to discuss strengthening trade ties between the two nations. While no final agreement was announced, both sides expressed a commitment to maintaining positive relations. The potential US-UK trade deal is expected to serve as a benchmark for what allies can achieve when they align closely with US interests.

- Following the discussion, President Trump announced that his administration had begun working on a deal with the UK, which could help both nations avoid being swept into a trade war. The deal was a welcome development for Starmer, as his country has been seeking a breakthrough amid recent budget cuts and unpopular tax reforms. However, it appears that Trump may have a broader strategy in mind.
- The president's decision to pursue a trade deal with the UK may signal to other countries considering breaking away from the EU that they, too, could negotiate their own agreements with the US. Under current EU rules, individual member states are not permitted to negotiate independent trade deals. Additionally, the president has mentioned that he prefers bilateral trade deals with countries as opposed to multilateral agreements.
- That said, this is not the first time the president has expressed interest in working on a trade deal with the UK. In 2019, his administration was actively negotiating an agreement, but progress stalled due to the pandemic. This time may differ slightly, as the administration appears to have a clearer vision of its objectives. However, it's important to note that trade agreements typically require years of negotiation to finalize.



- One advantage the UK holds is that it currently runs a trade deficit with the US, meaning — by the President Trump's metric — it is not exploiting the system. As a result, the UK may become an attractive destination for those seeking to avoid countries that could be negatively impacted by a trade war with the US.

Open AI Strikes Back: The latest version of Open AI's model has been released, aiming to reassure investors that it remains on track following DeepSeek's recent breakthrough. This new technology marks a significant shift for the company as it moves away from language learning models (LLMs) that rely on chain-of-reasoning approaches.

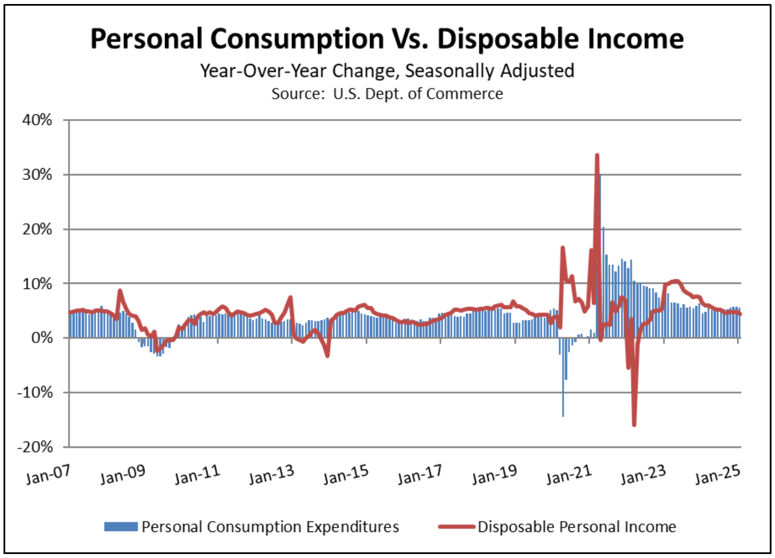
- The new GPT-4.5 is different from its predecessor models in that it is able to engage with users more naturally, therefore creating a more improved customer experience. The update is unlikely to create the same level of buzz as GPT-4 did when it was released in 2022, but it does show the focus of AI research has started to shift.
- When the technology was first introduced, it faced criticism for its capability to solve only straightforward problems while struggling with more complex ones. As a result, generative AI models have proven to be valuable tools for experts with a strong grasp of a subject, aiding them in completing tasks more efficiently. However, their unreliability in handling nuanced or intricate challenges has made them less suitable for beginners or those starting from scratch.
- Improvements in these models are expected to enhance AI's ability to tackle more complex tasks, potentially boosting overall economic productivity. However, this advancement could, over time, undermine worker bargaining power as AI becomes increasingly capable of performing roles traditionally held by humans. Consequently, while the technology holds immense promise, it may also face significant political resistance as its broader societal and economic implications come to the forefront.

China Vows Response: Beijing has responded to President Trump's threat to raise tariffs on Chinese goods, stating that it will take necessary measures if additional tariffs are imposed. This follows Trump's announcement of a planned 10% tariff increase on Chinese imports, set to take effect on March 4.

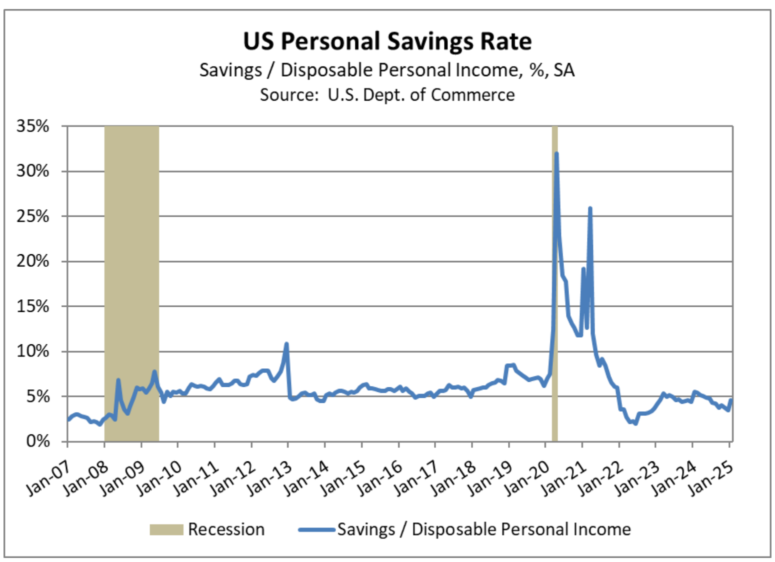
- While Beijing has avoided detailing specific measures, its response signals a readiness to counter US threats. Export growth has been a bright spot for the Chinese economy, providing momentum as it seeks to break out of its current slowdown.
- That said, any response is likely to be measured, as both leaders are expected to meet soon to negotiate a trade agreement, making an aggressive reaction improbable.

US Economic Releases

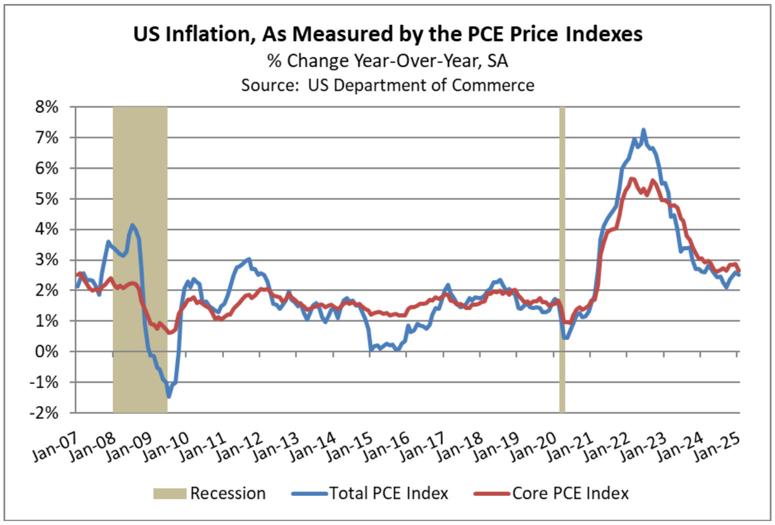
January ***personal income*** jumped by a seasonally adjusted 0.9%, smashing through expectations that it would rise just 0.4%, as it did in December. The increase should have allowed for a rise in spending as well, but January ***personal consumption expenditures (PCE)*** declined 0.2%, missing expectations for an increase of 0.2% after December's revised increase of 0.8%. The pullback in spending during January will likely be taken as a sign that President Trump's government personnel cuts are leading to a pullback in consumption activity, but it's probably too early to say that. After all, the California wildfires also may have held back outlays last month. In any case, personal income in January was up 4.6% from the same month one year earlier, while PCE was up 5.6%. The chart below shows the year-over-year change in personal income and PCE since just before the Great Financial Crisis.



The personal income and spending report also includes a measure of personal saving, defined as disposable (after tax) income less consumption spending on goods and services. The January ***personal savings rate*** rose to a seasonally adjusted 4.6%, reaching its highest level since June. The chart below shows how the personal savings rate has fluctuated since just before the GFC.



Finally, the income and spending report includes the Fed's preferred measure of price inflation. After stripping out the volatile food and energy components, the ***Core PCE Deflator*** for January was up 2.6% from the same month one year earlier, significantly better than the 2.9% rise in the year to December. However, the rise in the year to January was a bit hotter than anticipated, and it remained above the Fed's target of 2.0%. The chart below shows the year-over-year change in the Core PCE Deflator since just before the GFC.



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

Economic Releases						
EST	**Indicator**			**Expected**	**Prior**	**Rating**
9:45	MNI Chicago PMI	m/m	Feb	40.8	39.5	***
11:00	Kansas City Fed Manfacturing Index	m/m	Feb		-4	*
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
16:30	Austan Goolsbee Appears on CNBC	President of the Federal Reserve Bank of Chicago				
22:15	Austan Goolsbee Speaks in Moderated Q&A	President of the Federal Reserve Bank of Chicago				

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	Tokyo CPI	y/y	Feb	2.9%	3.4%	3.2%	**	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food	y/y	Feb	2.2%	2.5%	2.3%	***	Equity and bond neutral
	Tokyo CPI Ex-Fresh Food & Energy	y/y	Feb	1.9%	1.9%	2.0%	*	Equity and bond neutral
	Retail Sales	y/y	Jan	3.9%	3.5%	3.9%	**	Equity and bond neutral
	Industrial Production	y/y	Jan P	2.6%	-1.6%	2.8%	***	Equity and bond neutral
	Depart. Store & Supermarket Sales	y/y	Jan	2.9%	2.9%		*	Equity and bond neutral
	Japan Buying Foreign Bonds	w/w	21-Feb	-¥200.8b	¥239.6b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	21-Feb	¥19.7b	¥345.4b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	21-Feb	¥438.0b	¥789.0b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	21-Feb	-¥1038.0b	-¥351.9b		*	Equity and bond neutral
	Housing Starts	y/y	Jan	-4.6%	-2.5%	-2.7%	**	Equity bearish, bond bullish
	Annualized Housing Starts	y/y	Jan	0.774m%	0.783m	0.781m	*	Equity and bond neutral
Australia	Private Sector Credit	y/y	Jan	6.5%	6.5%		**	Equity and bond neutral
New Zealand	ANZ Consumer Confidence Index	m/m	Feb	96.6	96.0	--	*	Equity and bond neutral
India	GDP	y/y	4Q	6.2%	5.6%	6.2%	*	Equity and bond neutral
EUROPE								
Germany	Import Price Index	y/y	Jan	3.1%	2.0%	2.7%	**	Equity and bond neutral
	Retail Sales	y/y	Jan	3.5%	2.0%	1.7%	*	Equity bullish, bond bearish
	Unemployment Change	m/m	Feb	5.0k	11.0k	14.0k	***	Equity bullish, bond bearish
	Unemployment Claims Rate	m/m	Feb	6.2%	6.2%	6.2%	**	Equity and bond neutral
	CPI	y/y	Feb P	2.3%	2.3%	2.3%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Feb P	2.8%	2.8%	2.7%	**	Equity and bond neutral
France	CPI	y/y	Feb P	0.8%	1.7%	1.0%	***	Equity and bond neutral
	CPI, EU Harmonized	y/y	Feb P	0.9%	1.8%	1.1%	**	Equity and bond neutral
	GDP	y/y	4Q F	6.0%	0.7%	0.7%	**	Equity and bond neutral
Italy	CPI, EU Harmonized	y/y	Feb P	1.7%	1.7%	1.8%	***	Equity and bond neutral
	CPI NIC Including Tobacco	y/y	Feb P	1.7%	1.5%	1.6%	**	Equity and bond neutral
UK	Nationwide House Price Index	y/y	Feb	3.9%	4.1%	3.4%	***	Equity and bond neutral
Switzerland	Real Retail Sales	y/y	Jan	1.3%	2.1%		**	Equity and bond neutral
	KOF Leading Indicator	m/m	Feb	101.7	103.0	102.0	*	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	21-Feb	$634.6b	$628.5b		***	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	21-Feb	18.23t	18.29t		*	Equity and bond neutral
AMERICAS								
Canada	Current Account Balance	m/m	4Q	-$4.99b	-$3.62b	-$3.10b	**	Equity and bond neutral
Mexico	Unemployment Rate NSA	m/m	Jan	2.70%	2.43%	2.70%	***	Equity and bond neutral
	Trade Balance	m/m	Jan	-4558.0m	2566.8m	-3808.0m	**	Equity and bond neutral
	Exports	m/m	Jan	44446m	51687m		*	Equity and bond neutral
	Imports	m/m	Jan	49004m	49120m		*	Equity and bond neutral
Brazil	Central Govt Budget Balance	m/m	Jan	94.9b	12.4b	88.1b	*	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 T-bill yield (bps)	419	420	-1	Down
U.S. Sibor/OIS spread (bps)	431	432	-1	Down
U.S. Libor/OIS spread (bps)	432	433	-1	Down
10-yr T-note (%)	4.25	4.26	-0.01	Down
Euribor/OIS spread (bps)	249	250	-1	Down
Currencies	**3 Mo**			
Dollar	Up	US		Up
Euro	Down	Euro		Down
Yen	Up	Japan		Down
Pound	Down	UK		Down
Franc	Down	Switzerland		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.

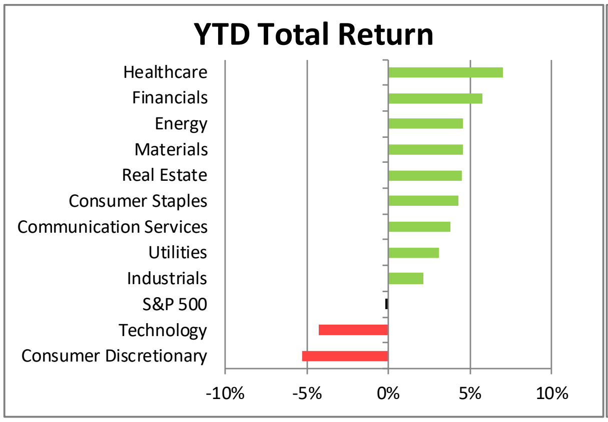
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$73.07	$74.04	-1.31%	
WTI	$69.34	$70.35	-1.44%	
Natural Gas	$3.89	$3.93	-1.09%	
Crack Spread	$25.59	$25.51	0.33%	
12-mo strip crack	$21.38	$21.45	-0.34%	
Ethanol rack	$1.80	$1.81	-0.41%	
Metals				
Gold	$2,856.98	$2,877.52	-0.71%	
Silver	$31.05	$31.28	-0.72%	
Copper contract	$456.85	$461.85	-1.08%	
Grains				
Corn contract	$481.25	$481.00	0.05%	
Wheat contract	$566.00	$562.50	0.62%	
Soybeans contract	$1,039.25	$1,037.25	0.19%	
Shipping				
Baltic Dry Freight	1,159	1,112	47	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	-2.33	2.40	-4.73	
Gasoline (mb)	0.37	-1.40	1.77	
Distillates (mb)	3.91	-2.76	6.67	
Refinery run rates (%)	1.6%	-0.2%	1.8%	
Natural gas (bcf)	-261	-271	10	

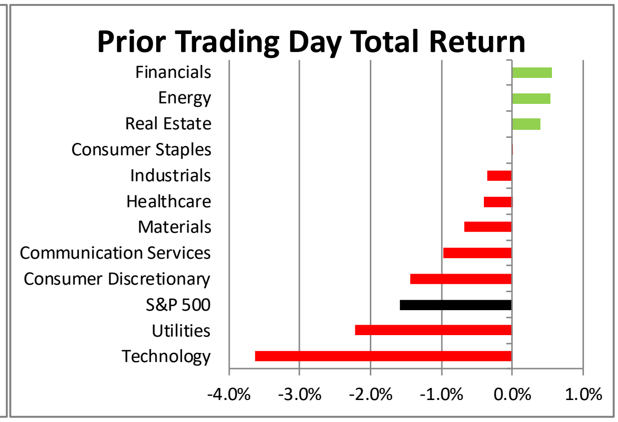
Weather

The 6-to-10 and 8-to-14 day forecasts call for cooler-than-normal temperatures in California, with warmer-than-normal temperatures across the Great Plains and Midwest. The forecasts call for wetter-than-normal conditions in the Far West and along the East Coast from central Florida northward, with dry conditions in western Texas.

Data Section

US Equity Markets – (as of 2/27/2025 close)

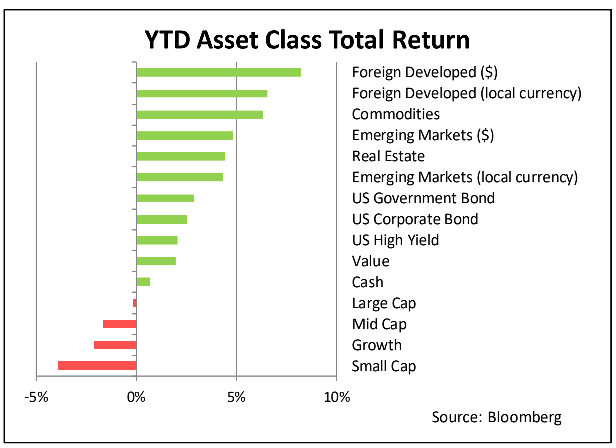




(Source: Bloomberg)

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 2/27/2025 close)

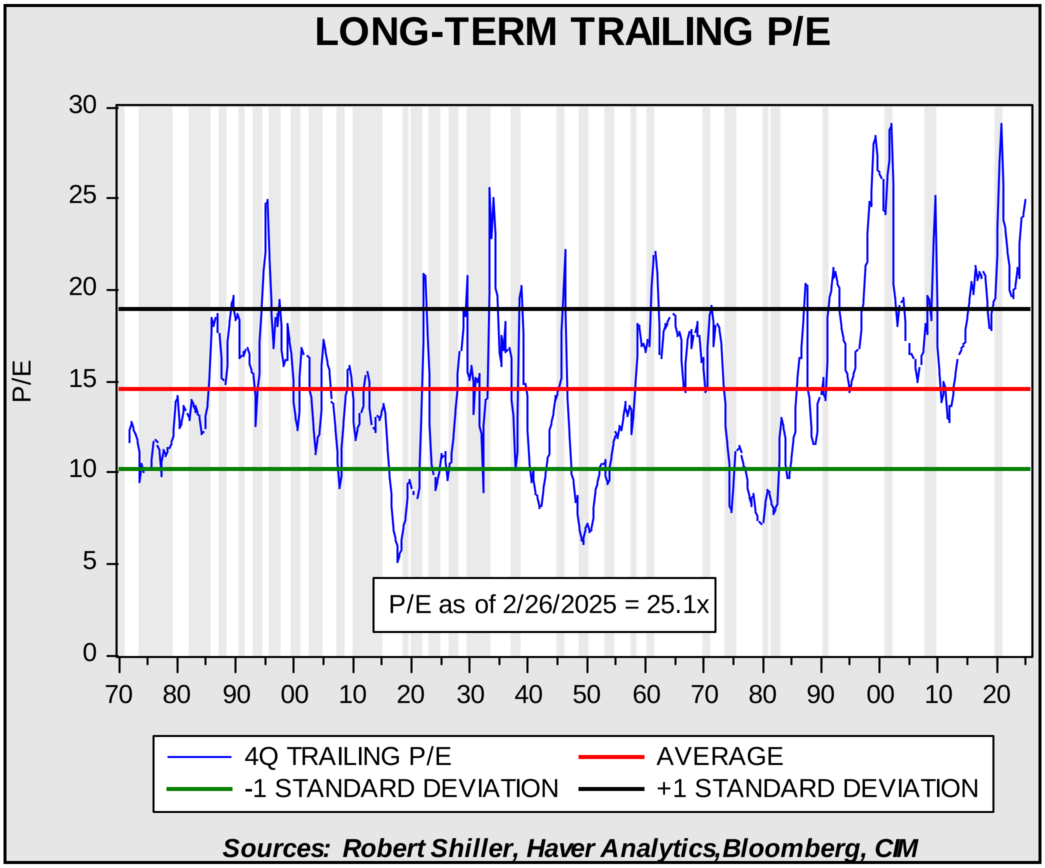


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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 27, 2025



Based on our methodology,[1] the current P/E is 25.1x, unchanged from our last report. There was minimal change in the index and earnings from the previous week.

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.