Daily Comment

Confluence Investment Management

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[Posted: February 6, 2025 — 9:30 AM ET] Global equity markets are higher this morning. In Europe, the Euro Stoxx 50 closed up 0.8% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.6%. Chinese markets were higher, with the Shanghai Composite up 1.3% from its previous close and the Shenzhen Composite up 2.3%. US equity index futures are signaling a higher open.

With 267 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, 77.5% have exceeded expectations while 16.5% have fallen short of expectations.

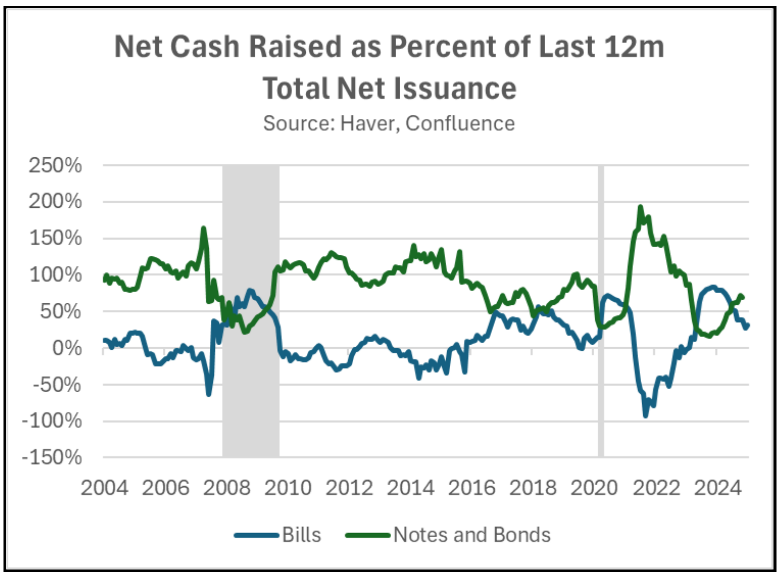
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below with new items of the day in bold:

Bi-Weekly Geopolitical Report	Asset Allocation Bi-Weekly	Asset Allocation Quarterly	Of Note
Trump and the Political Economy of Alliances (1/27/25) + podcast	*American Exceptionalism and the Markets* (2/3/25) + podcast	Q1 2025 Report	***The Case for Hard Assets: An Update***

Good morning! Markets are closely watching the latest developments from the Trump administration. In sports news, the Golden State Warriors made headlines by acquiring Miami Heat guard Jimmy Butler in a major trade. Today's commentary will focus on the Trump administration's shift toward targeting longer-term interest rates, Canada's planned response to new US tariffs, and other market-moving headlines. As always, we'll also provide a roundup of key domestic and international data releases.

Ten-Year Yield Rates Take Center Stage: US Treasury Secretary Scott Bessent reaffirmed his support for the Federal Reserve's independence on Wednesday, stating that the current administration has no intention of interfering with Fed policy. Instead, the Treasury plans to leverage its issuance strategy to target long-term interest rates, which play a more direct role in shaping borrowing costs for American households.

- His announcement comes amid growing concerns from several Federal Reserve officials about the potential inflationary impact of tariffs. Chicago Fed President Austan Goolsbee recently added his voice to the debate, cautioning that the risks to supply chains from trade policy should not be overlooked. His hesitation is particularly noteworthy given his past support for the Fed's easing measures, signaling a shift in perspective as policymakers weigh the broader economic implications of trade restrictions.
- Prior to Secretary Bessent's remarks, the Treasury Department unveiled its quarterly refunding plans, revealing that it would maintain the debt management strategy established by its predecessor, Janet Yellen. The Treasury confirmed it will continue shifting issuance away from longer-term securities, a move expected to alleviate upward pressure on 10- and 30-year Treasury yields.
- Over the next three months, the Treasury plans to utilize Treasury bills to manage fluctuations in its borrowing needs. This decision marks a notable shift for Secretary Scott Bessent, who had previously criticized the strategy, warning that it could undermine the Federal Reserve's efforts to curb inflation.



- Additionally, the Treasury's forward guidance indicated that borrowing needs would keep auction sizes unchanged for at least the next several quarters. However, this decision has been met with some skepticism, as the Treasury Borrowing Advisory Committee — a group of external advisors including dealers, fund managers, and other market participants — has warned that auction sizes may need to adjust depending on the trajectory of monetary and fiscal policy, and the broader economic outlook.

- With the Treasury now prioritizing the reduction of long-term interest rates, this shift is likely to be bullish not only for fixed-income securities but also for equities, particularly small-cap stocks. Lower long-term rates typically reduce borrowing costs and support higher valuations across asset classes. However, this move also underscores the need for the Treasury to maintain a focus on cost reduction to ensure it can sustainably fund future spending initiatives.

Canada Fights Back? Canadian sentiment toward the US has soured following the imposition of tariffs on Canadian exports and controversial remarks suggesting Canada could become the 51st state. This shift in relations has prompted many Canadians to push for a stronger response from their government.

- Nearly 82% of Canadians support implementing an export tax on oil if the US follows through with its threat to impose tariffs. This measure has gained traction as Canadian lawmakers aim to pressure the US by increasing energy costs for American consumers and businesses. Other goods being considered for export taxes include uranium and potash.
- The threat arises as the US president has opted to exclude oil from the tariffs he plans to impose on Canadian goods. It's important to note that a tariff is essentially an import tax, typically paid by the consumer, though in some cases, the cost may be shared with the supplier. Conversely, an export tariff is paid by the supplier to ship goods abroad, though this cost can also be passed on to the consumer under certain circumstances.
- The key difference between export and import tariffs lies in their impact on supply and sales. Import tariffs, or taxes, are intended to make foreign goods more expensive compared to their American counterparts, thereby reducing their sales. This, in turn, typically leads to higher prices for consumers. On the other hand, export tariffs discourage the sale of domestic goods abroad, increase domestic supply and, as a result, lower prices.
- Export taxes on Canadian goods could provide a modest boost to Canada's economy but are unlikely to prevent a recession. Conversely, reduced US imports of oil may lead to some price increases domestically, but the effect should be minimal and would not disrupt the overall economic outlook.

End of Ukraine War? The Trump administration is set to unveil its long-awaited plan to resolve the Ukraine war next week at the Munich Security Conference. The announcement will coincide with the three-year anniversary of the conflict's onset. The plan is expected to facilitate increased access to Russian energy in global markets.

- While specific details of the proposal have not been revealed, it is expected to include a freeze on the conflict, potentially allowing Russian forces to remain in occupied territories. The plan may also provide Ukraine with security guarantees against future Russian aggression, alongside provisions for new elections following a ceasefire.

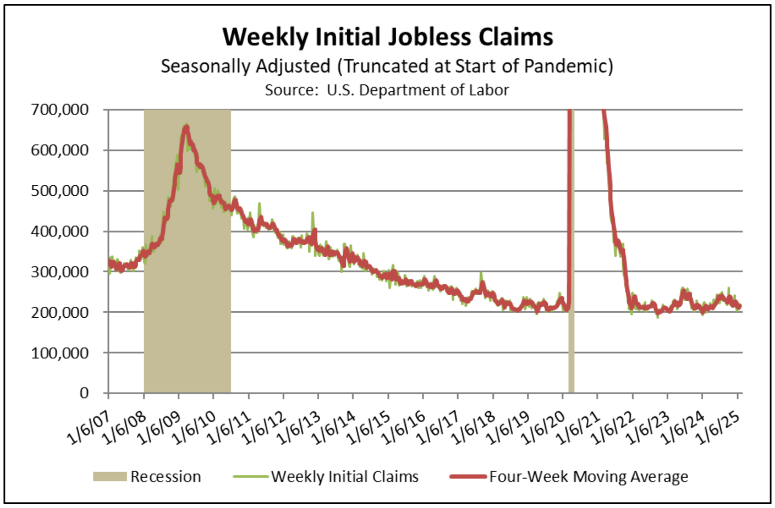
- That said, there still appears to be room for negotiation between Russia and Ukraine. Moscow believes it holds enough territorial leverage to extract concessions from Kyiv, while Kyiv views its control over parts of the Kursk region as a potential bargaining chip.
- One consistent pattern we've observed with this administration is its reluctance to make deals without securing benefits for the United States. President Trump has expressed interest in gaining access to Ukraine's rare earth minerals and has hinted at ensuring that Europe maintains its energy ties with the US. Consequently, any potential sanctions relief for Russia is likely to come with significant conditions attached.

Bank of England Lowers Rate: The UK central bank lowered its benchmark interest rate for the first time this year, reducing it from 4.75% to 4.50%, amid growing concerns about the economy's weakening strength. While the decision was widely anticipated, the downgrade in the economic outlook has dampened sentiment toward the British pound (GBP).

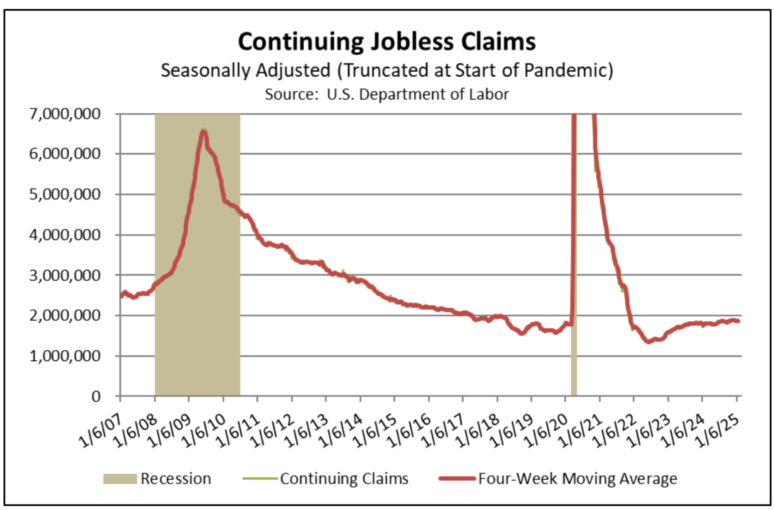
- While the Monetary Policy Committee unanimously agreed on the need for a rate cut, two members dissented, pushing for a larger decrease. Interestingly, even Catherine Mann, typically a policy hawk, advocated for a 50 basis point reduction, which would have brought the rate down to 4.25%.
- The committee signaled its openness to further rate cuts to stave off a recession. Despite a recent uptick in inflation, they anticipate it will be transitory. This apparent disregard for rising prices suggests a shift in the central bank's priority from price stability to economic stabilization.

US Economic Releases

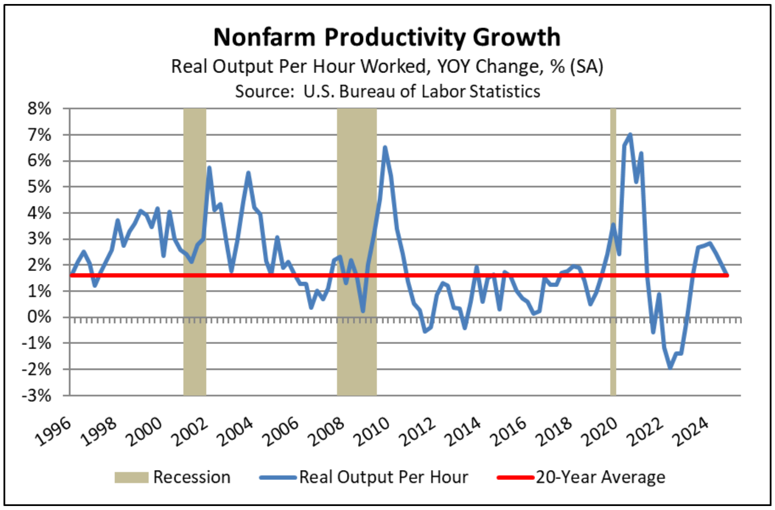
In the week ended February 1, ***initial claims for unemployment benefits*** rose to a seasonally adjusted 219,000, above both the expected level of 213,000 and the previous week's revised level of 208,000. The four-week moving average of initial claims, which helps smooth out some of the volatility in the series, rose to 216,750. Still, it's important to note that these levels are still historically low, suggesting the demand for labor remains healthy. The chart below shows how initial jobless claims have fluctuated since just before the Great Financial Crisis. The chart is truncated through much of the pandemic period because of the extremely high level of claims at that time.



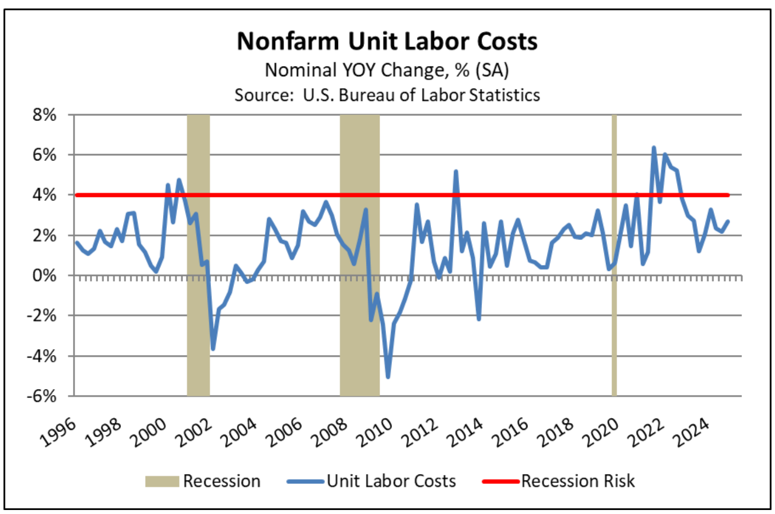
In the week ended January 25, the number of ***continuing claims for unemployment benefits*** (people continuing to draw benefits) rose to a seasonally adjusted 1.886 million, above both the anticipated reading of 1.870 million and the prior week's revised reading of 1.850 million. The four-week moving average of continuing claims rose to 1,872,250. The chart below shows how continuing claims have fluctuated since the GFC. It is also truncated during the pandemic period because of the high level of claims at the time.



Another report today focused on the productivity of US workers, defined as the average value of output per hour worked. After stripping out price changes and normal seasonal fluctuations, fourth-quarter ***nonfarm productivity*** rose at an annualized rate of 1.2%, matching expectations but still only about half the growth rate as the third quarter. Taking into account the fluctuations in each of the last four quarters, productivity in the fourth quarter was up 1.6% from the same period one year earlier, precisely matching the 20-year average. The chart below shows the year-over-year growth in real productivity over the last quarter-century or so.



Fourth-quarter ***unit labor costs*** rose at an annualized rate of 3.0%, better than the expected growth rate of 3.4% but much higher than the revised growth rate of 0.5% in the previous period. Unit labor costs in the fourth quarter were up 2.7% year-over-year, remaining below the 4.0% annual increase that has often been associated with recessions in the past. The chart below shows the year-over-year growth in unit labor costs since 1996.



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

Economic Releases		
No economic releases for the rest of today		
Federal Reserve		
EST	**Speaker or Event**	**District or Position**
14:30	Christopher Waller Speaks on future of Payments	Member of the Board of Governors
17:10	Lorie Logan Speaks o Future Challenges for Monetary Policy	President of the Federal Reserve Bank of Dallas

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	Japan Buying Foreign Bonds	w/w	31-Jan	-¥1458.4b	¥193.1b		*	Equity and bond neutral
	Japan Buying Foreign Stocks	w/w	31-Jan	¥199.2b	¥217.2b		*	Equity and bond neutral
	Foreign Buying Japan Bonds	w/w	31-Jan	-¥724.5b	¥128.3b		*	Equity and bond neutral
	Foreign Buying Japan Stocks	w/w	31-Jan	¥315.2b	¥753.0b		*	Equity and bond neutral
Australia	Trade Balance	m/m	Dec	A$65000m	A$7079m	A$6750m	***	Equity and bond neutral
	Exports	m/m	Dec	1.1%	4.2%	--	*	Equity and bond neutral
	Imports	m/m	Dec	5.9%	1.4%	--	*	Equity and bond neutral
South Korea	BoP Current Account Balance	m/m	Dec	$12367.5m	$10046.4m		**	Equity and bond neutral
	BoP Goods Balance	m/m	Dec	$10433.5m	$9876.6m		*	Equity and bond neutral
EUROPE								
Eurozone	Retail Sales	y/y	Dec	1.9%	1.6%	1.9%	*	Equity and bond neutral
Germany	Factory Orders WDA	y/y	Jan	-6.3%	-1.4%	-10.5%	***	Equity bullish, bond bearish
	HCOB Germany Construction PMI	m/m	Dec	42.5	37.8		*	Equity and bond neutral
UK	S&P Global UK Construction PMI	m/m	Jan	48.1	53.3	53.5	**	Equity bearish, bond bullish
Switzerland	Unemployment Rate	m/m	Jan	3.0%	2.8%	2.9%	**	Equity and bond neutral
Russia	Industrial Production	y/y	Dec	8.2%	3.5%	4.2%	***	Equity bullish, bond bearish
	Gold and Forex Reserves	m/m	31-Jan		$619.7b		***	Equity and bond neutral
AMERICAS								
Canada	International Merchandise Trade	m/m	Dec	0.71b	-0.99b	1.02b		Equity and bond neutral
	S&P Global Canada Services PMI	m/m	Jan F	49.0	48.2		*	Equity and bond neutral
	S&P Global Canada Composite PMI	m/m	Jan	49.5	49.0		*	Equity and bond neutral
Mexico	International Reserves Weekly	w/w	31-Jan	$230764m	$230254m		*	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)	421	422	-1	Down
U.S. Sibor/OIS spread (bps)	431	431	0	Down
U.S. Libor/OIS spread (bps)	433	433	0	Down
10-yr T-note (%)	4.45	4.42	0.03	Down
Euribor/OIS spread (bps)	253	254	-1	Down
Currencies	**Direction**			
Dollar	Up	US		Down
Euro	Down	Euro		Up
Yen	Down	Japan		Up
Pound	Down	UK		Up
Franc	Down	Switzerland		Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of England Bank Rate	4.50%	4.75%	4.50%	On Forecast

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.

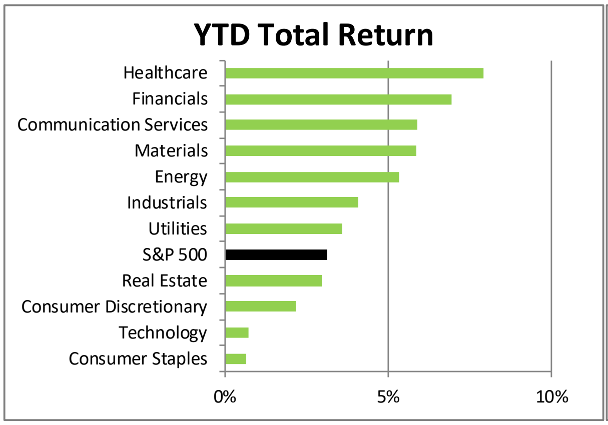
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$74.91	$74.61	0.40%	
WTI	$71.35	$71.03	0.45%	
Natural Gas	$3.39	$3.36	0.89%	
Crack Spread	$19.91	$19.67	1.25%	
12-mo strip crack	$21.84	$21.86	-0.10%	
Ethanol rack	$1.84	$1.84	-0.15%	
Metals				
Gold	$2,866.66	$2,867.24	-0.02%	
Silver	$32.06	$32.31	-0.79%	
Copper contract	$447.45	$444.40	0.69%	
Grains				
Corn contract	$494.50	$493.25	0.25%	
Wheat contract	$575.25	$572.25	0.52%	
Soybeans contract	$1,064.50	$1,057.00	0.71%	
Shipping				
Baltic Dry Freight	771	753	18	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	8.66	1.90	6.76	
Gasoline (mb)	2.23	0.21	2.02	
Distillates (mb)	-5.47	-2.07	-3.40	
Refinery run rates (%)	1.0%	-0.7%	1.7%	
Natural gas (bcf)		-171		

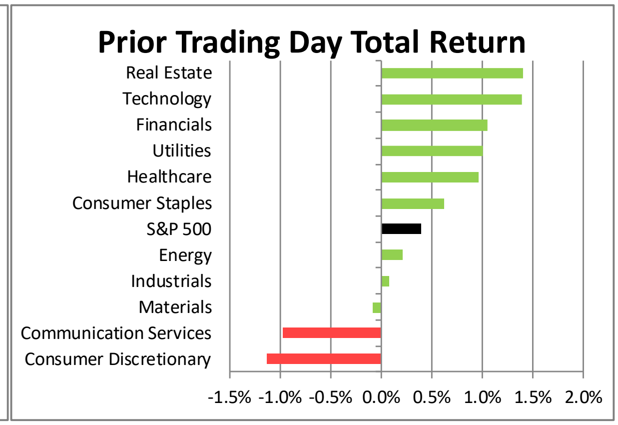
Weather

The 6-to-10-day and 8-to-14-day forecasts currently call for cooler-than-normal temperatures across the northern half of the country, with warmer-than-normal temperatures in the Southeast. The forecasts call for wetter-than-normal conditions everywhere except the southern Great Plains, with dry conditions only in western Texas.

Data Section

US Equity Markets – (as of 2/5/2025 close)

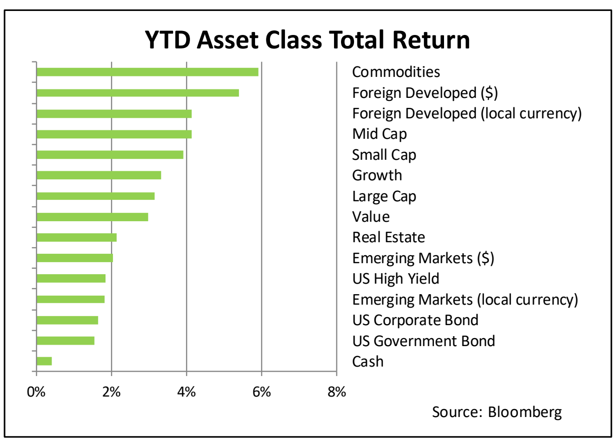




(Source: Bloomberg)

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 2/5/2025 close)

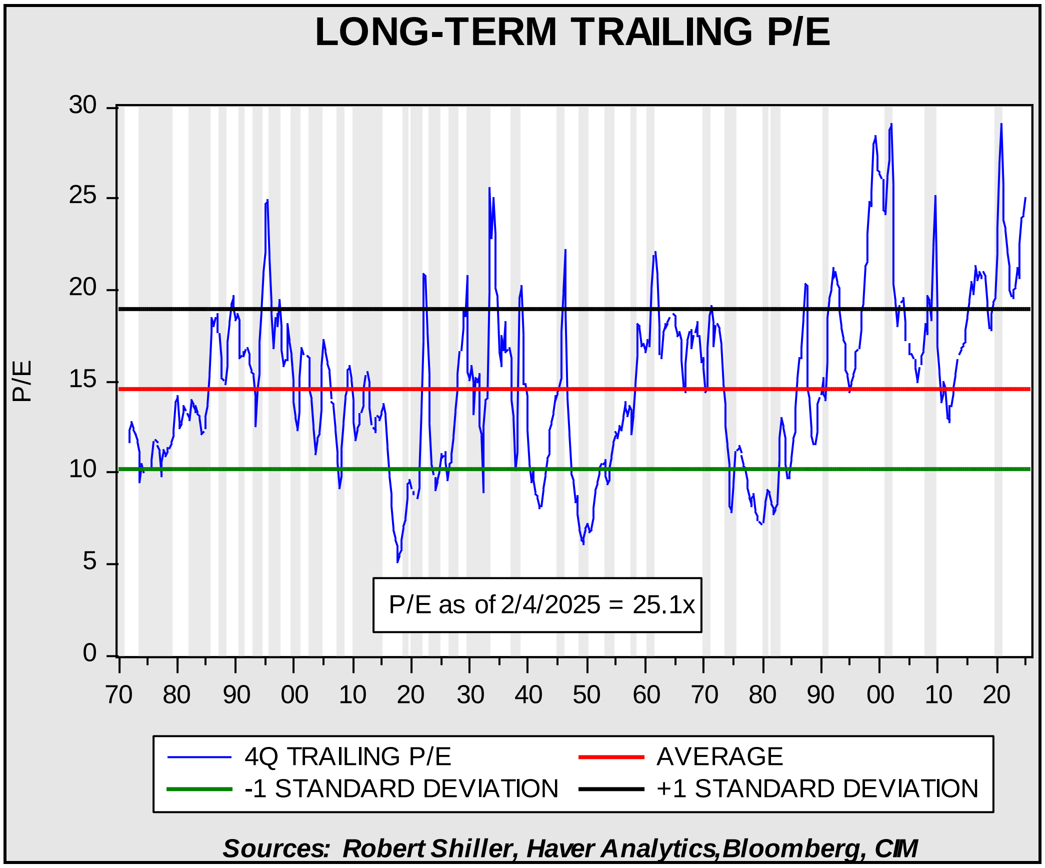


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.