Daily Comment

Confluence INVESTMENT MANAGEMENT

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[Posted: February 7, 2025 — 9:30 AM ET] Global equity markets are mostly higher this morning. In Europe, the Euro Stoxx 50 closed down 0.2% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.9%. Chinese markets were higher, with the Shanghai Composite up 1.0% from its previous close and the Shenzhen Composite up 1.6%. US equity index futures are signaling a slightly higher open.

With 305 companies having reported so far, S&P 500 earnings for Q4 are running at $65.10 per share, compared to estimates of $64.79, which is up 11.7% from Q4 2023. Of the companies that have reported thus far, 78.0% have exceeded expectations while 16.1% have fallen short of expectations.

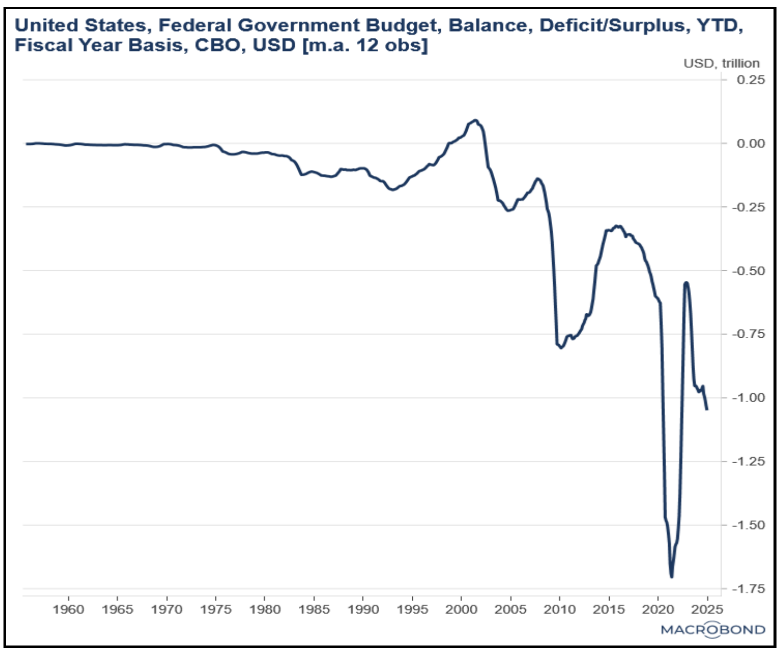
The Confluence macro team publishes a plethora of research reports and multimedia offerings on a weekly and quarterly basis, all available on our website. We highlight recent publications below with new items of the day in bold:

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 **Q1 2025 Rebalance Presentation**	*The Case for Hard Assets: An Update* **Value Equities Quarterly Update**

Good morning! The market is currently digesting the latest employment data, while in sports news, the NBA trade deadline officially passed. Today's commentary will cover the latest developments in Trump's tax plan, explore why investors are growing increasingly concerned about the spending levels of tech companies, and provide updates on other market-related news. As always, the report will also include a summary of key international and domestic data releases.

Tax Policy: The Trump administration has provided some insights into its strategy for fulfilling the president's campaign tax promises. However, it remains uncertain whether the Republican Party will rally behind a legislative measure before the impending expiration of the tax cuts at the end of the year.

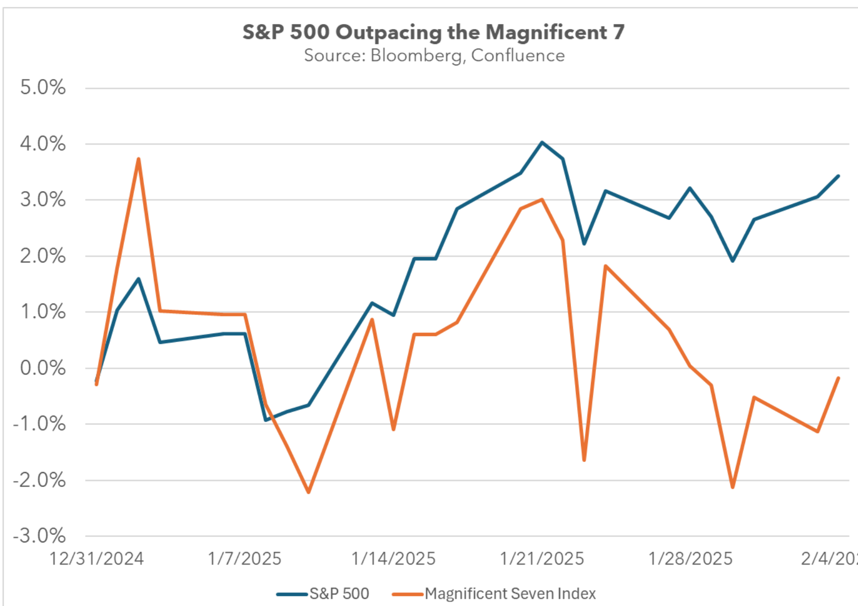
- The president has indicated his intention to eliminate tax breaks for carried interest, a loophole highly favored by private equity fund managers. He also proposed removing special tax breaks for billionaire sports team owners, which currently allow them to deduct expenses related to team purchases over a 15-year period.
- The elimination of these tax breaks is aimed at funding the president's proposed expansion of state and local tax deductions, as well as introducing new tax incentives for products manufactured in America. Additionally, there is speculation that Republicans may consider ending the tax exemption for state and local government debt.
- These cuts could lead to major savings but not enough to offset increases in spending. Repealing the carried interest tax provision, estimated to cost $12 billion over 10 years, would primarily impact private equity funds. Meanwhile, state and local tax exemptions represented $27 billion in forgone tax revenue in 2022. The potential tax savings from targeting sports team ownership is less certain, as closing this loophole could decrease the frequency of team sales.



- While the savings help offset the cost of the president's new tax plan, which includes eliminating taxes on tips, overtime pay, and Social Security, as well as lowering the corporate tax rate, additional funding will still be needed to prevent the plan from increasing the deficit. The latest estimate shows that his plan would add over $4 trillion to the deficit within the decade.

Big Tech Ramps Up Spending: Nearly two weeks after the release of DeepSeek's latest update sent shockwaves through financial markets, Silicon Valley tech companies are facing mounting pressure to enhance profitability and validate their sky-high valuations. This week, three companies have come under intense scrutiny as investors closely watch whether they can meet heightened expectations.

- Amazon reported better-than-expected fourth quarter earnings and sales on Thursday but offered a weak outlook for the coming period. This pessimism stemmed largely from unfavorable exchange rate fluctuations, as a stronger dollar typically weighs on foreign revenues. Despite the cautious outlook, Amazon plans to increase capital expenditures to $100 billion in 2025, up from $83 billion the previous year.
- Two other companies that reported earnings this week also announced plans to ramp up AI spending. Alphabet, Google's parent company, revealed that it intends to increase its capital expenditures from $57.5 billion to $75 billion. Similarly, Microsoft indicated it could spend up to $80 billion on AI data centers in the coming period.
- The focus on spending has intensified amid growing concerns that tech companies are diverting capital toward expanding AI capabilities at the expense of rewarding shareholders. These concerns were further amplified by the release of the Chinese-made DeepSeek, which was reportedly developed at a fraction of the cost and at a significantly faster pace compared to US tech companies, while still delivering comparable results.



- Growing skepticism about the already elevated valuations of mega cap tech stocks has begun to weigh on their performance this year, with the so-called Magnificent 7 underperforming the S&P 500 year-to-date. As a result, we anticipate that earnings and profitability will likely play an increasingly critical role in determining the trajectory of tech stocks for the remainder of the year.

The Indo-Pacific Seeks Assurances: The Trump administration is scheduled to meet with Asian leaders in the coming days to discuss ongoing security and economic relationships. In his first few days in office, President Trump has adopted a more assertive stance in advancing his trade agenda, signaling a shift toward a relatively expansionist foreign policy.

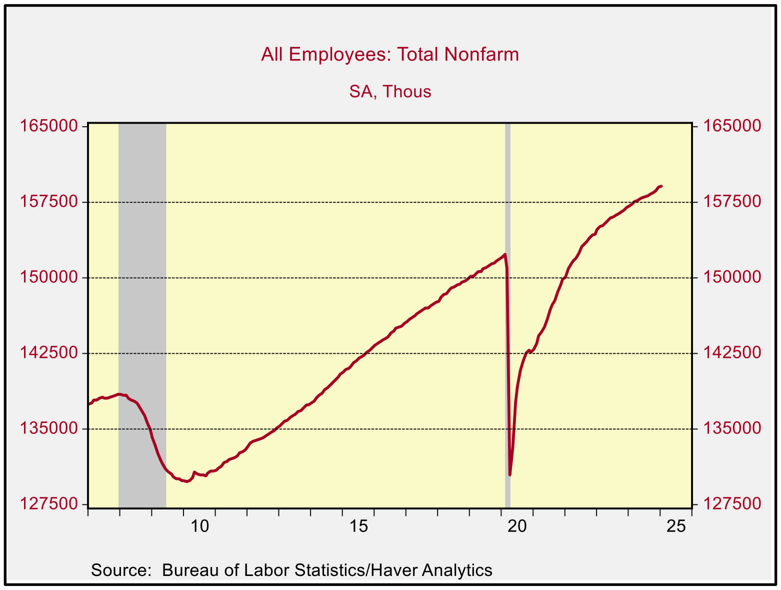
- President Trump is set to meet with Japanese Prime Minister Shigeru Ishiba on Friday. During the discussions, Japan is expected to commit to purchasing more American weapons and energy, investing in artificial intelligence, and sharing a greater portion of the defense burden. Japan's ability (as an export-oriented economy) to avoid a trade war with the US will likely provide support to its equity markets.
- On the same day, US Secretary of Defense Pete Hegseth is scheduled to meet with his Australian counterpart, Richard Marles. Ahead of the meeting, Australia made its first $500 million payment to the US as part of the AUKUS nuclear submarine deal. This payment is expected to foster goodwill, as the two leaders are likely to focus on strengthening the ongoing relationship between their nations, which are already aligned through both the QUAD and AUKUS alliances.

US Policy Close to Neutral? As the Federal Reserve prepares to review its first inflation data of the year, concerns are emerging that views within the Federal Open Market Committee (FOMC) are beginning to diverge. While some members believe the central bank could cut rates this year, others remain more skeptical.

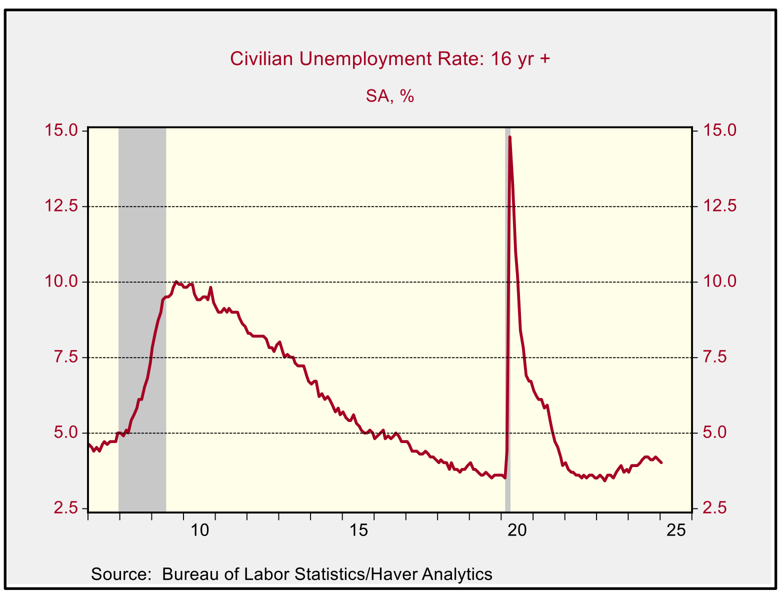
- Dallas Fed President Lorie Logan suggested that the Federal Reserve may be nearing a neutral interest rate, the point at which monetary policy is neither stimulative nor restrictive. Her comments follow similar observations from several other policymakers.
- As we have mentioned in previous reports, inflation in the first few reports of the year will likely play a major role as to whether the Fed is actually making progress toward its 2% inflation target.

US Economic Releases

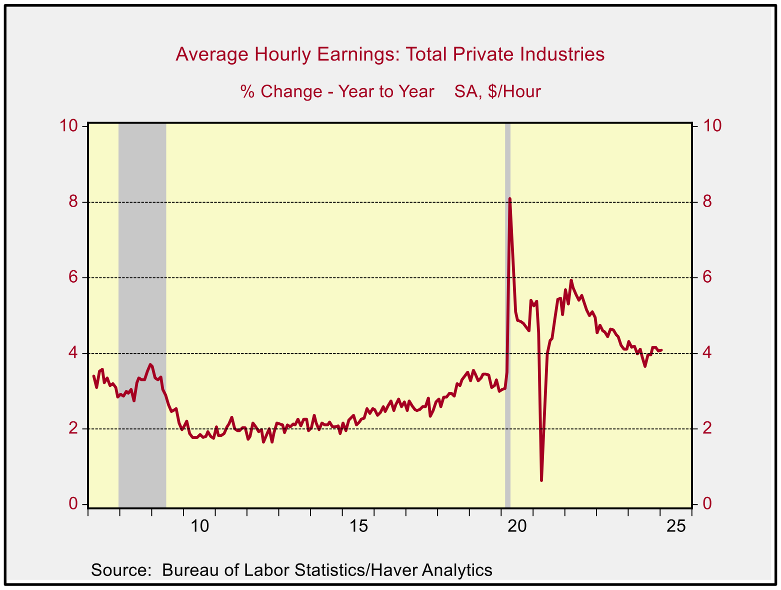
January ***nonfarm payrolls*** rose by a seasonally adjusted 143,000, well short of the expected gain of 175,000. However, the modest increase may have been the natural outcome as revisions showed big payroll increases in the previous two months. The updated estimates show job gains of 261,000 in November and 307,000 in December. The chart below shows the change in nonfarm payrolls since shortly before the Great Financial Crisis.



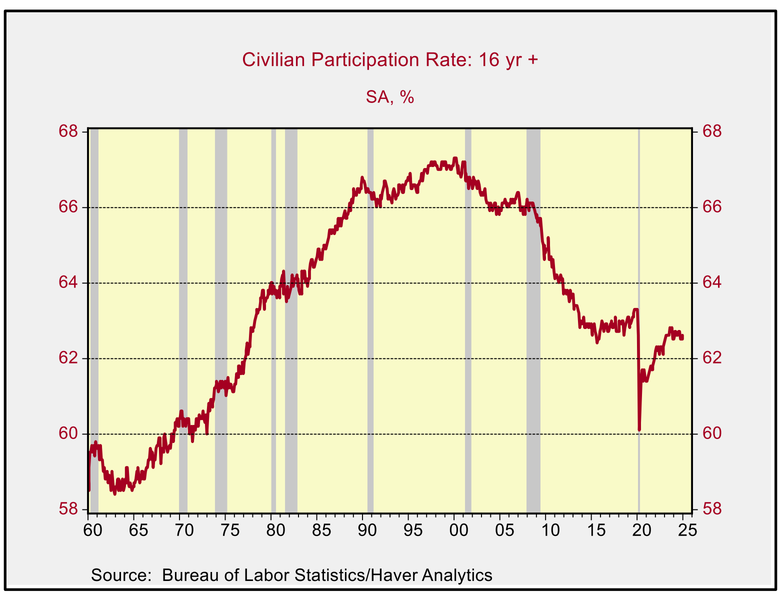
In January, the ***unemployment rate*** fell to a seasonally adjusted 4.0%, versus expectations that it would be unchanged from December's 4.1%. The chart below shows how the unemployment rate has evolved since just before the GFC.



With the demand for labor high and the "inventory" of unemployed workers low, it should be no surprise that wage rates remain high. ***Average hourly earnings*** in January rose to a seasonally adjusted $35.87, up 4.1% from the same month one year earlier. Not only was the annual increase stronger than the anticipated rise of 3.8%, but December's average earnings were revised upward to also show a year-over-year gain of 4.1%. The chart below shows the year-over-year growth in average hourly earnings since just before the GFC.



A final key indicator in the monthly employment report focuses on the share of the adult, civilian, non-institutionalized population that is either working or looking for work. The January ***labor force participation rate (LFPR)*** rose to a seasonally adjusted 62.6%, versus expectations that it would be unchanged at 62.5%. The chart below shows how the LFPR has changed over the last several decades.



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

Economic Releases							
EST	Indicator			Expected	Prior	Rating
10:00	U. of Michigan Consumer Sentiment	m/m	Feb P	71.8	71.1	***
10:00	Wholesale Inventories	m/m	Dec F	-0.5%	-0.5%	**
10:00	Wholesale Trade Sales	m/m	Dec	0.5%	0.6%	*
10:00	U. of Michigan Current Conditions	m/m	Feb P	73.7	74.0	**
10:00	U. of Michigan Future Expectations	m/m	Feb P	70.1	69.3	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	Feb P	3.3%	3.3%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	Feb P	3.2%	3.2%	*
14:00	Consumer Credit	m/m	Dec	$14.550b	$7.489b	*
Federal Reserve						
EST	Speaker or Event	District or Position				
9:25	Michelle Bowman Gives Update on Economy, Bank Regulation	Member of the Board of Governors				
12:00	Adriana Kugler Speaks on Entrepreneurship, Productivity	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	Household Spending	y/y	Dec	2.7%	-0.4%	0.5%	**	Equity bullish, bond bearish
	Leading Economic Index	m/m	Dec P	108.9	107.8	108.3	**	Equity and bond neutral
	Coincident Index	y/y	Dec P	116.8	115.4	116.6	**	Equity and bond neutral
Australia	Foreign Reserves	m/m	Jan	A$104.1b	A$102.3b		*	Equity and bond neutral
China	Foreign Reserves	m/m	Jan	$3209.04b	$3202.36b	$3192.00b	**	Equity and bond neutral
EUROPE								
Germany	Industrial Production WDA	y/y	Dec	-3.1%	-2.8%	-2.1%	**	Equity bearish, bond bullish
	Trade Balance	m/m	Dec	20.7b	19.2b	17.0b	*	Equity and bond neutral
	Exports	m/m	Dec	2.9%	2.3%	-0.5%	*	Equity bullish, bond bearish
	Imports	m/m	Dec	2.1%	-2.7%	1.9%	*	Equity and bond neutral
France	Trade Balance	y/y	Dec	-3905m	-6340m		*	Equity and bond neutral
Switzerland	Foreign Currency Reserves	m/m	Jan	736.4b	730.9b		*	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	31-Jan	$620.8b	$619.7b		***	Equity and bond neutral
Russia	Money Supply, Narrow Definition	w/w	31-Jan	18.27t	18.39t		*	Equity and bond neutral
AMERICAS								
Mexico	CPI	y/y	Jan	3.59%	4.21%	3.63%	***	Equity and bond neutral
	Core CPI	y/y	Jan	3.66%	3.65%	3.69%	**	Equity and bond neutral
Brazil	FGV Inflation IGP-DI	y/y	Jan	7.27%	6.86%	7.24%	**	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	430	1	Down
U.S. Libor/OIS spread (bps)	433	433	0	Down
10-yr T-note (%)	4.44	4.44	0.00	Down
Euribor/OIS spread (bps)	254	253	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**	
RBI Cash Reserve Ratio	4.00%	4.00%	4.00%	On Forecast
RBI Repurchase Rate	6.25%	6.50%	6.25%	On Forecast
Bank of Mexico Overnight Rate	9.50%	10.00%	9.50%	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.

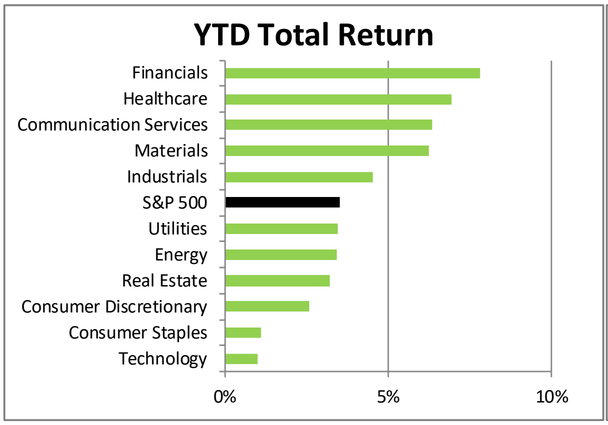
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$74.84	$74.29	0.74%	
WTI	$71.13	$70.61	0.74%	
Natural Gas	$3.42	$3.41	0.38%	
Crack Spread	$21.17	$21.22	-0.22%	
12-mo strip crack	$22.31	$22.24	0.32%	
Ethanol rack	$1.83	$1.83	-0.14%	
Metals				
Gold	$2,865.29	$2,856.28	0.32%	
Silver	$32.24	$32.18	0.21%	
Copper contract	$451.75	$446.10	1.27%	
Grains				
Corn contract	$491.75	$495.25	-0.71%	
Wheat contract	$584.00	$587.75	-0.64%	
Soybeans contract	$1,053.75	$1,060.50	-0.64%	
Shipping				
Baltic Dry Freight	793	771	22	
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)	-174	-171	-3	

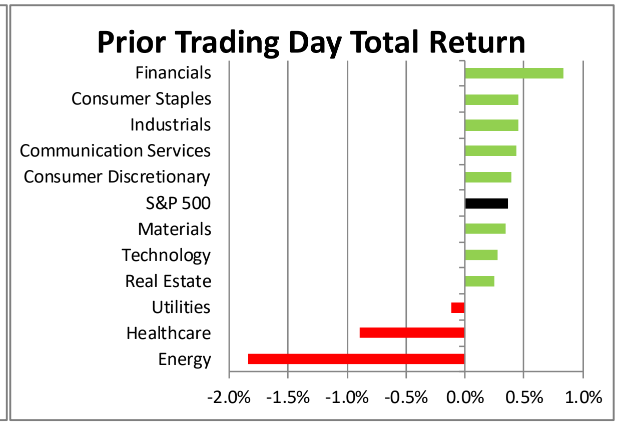
Weather

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 southern Great Plains and the Southeast. The forecasts call for wetter-than-normal conditions everywhere except western Texas and southern Florida, where conditions will be dry.

Data Section

US Equity Markets – (as of 2/6/2025 close)

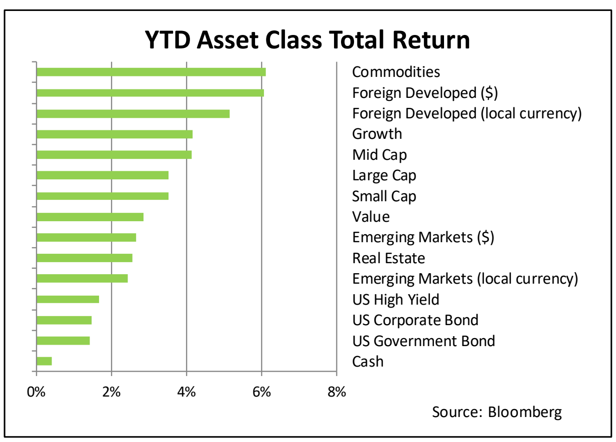




(Source: Bloomberg)

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 2/6/2025 close)

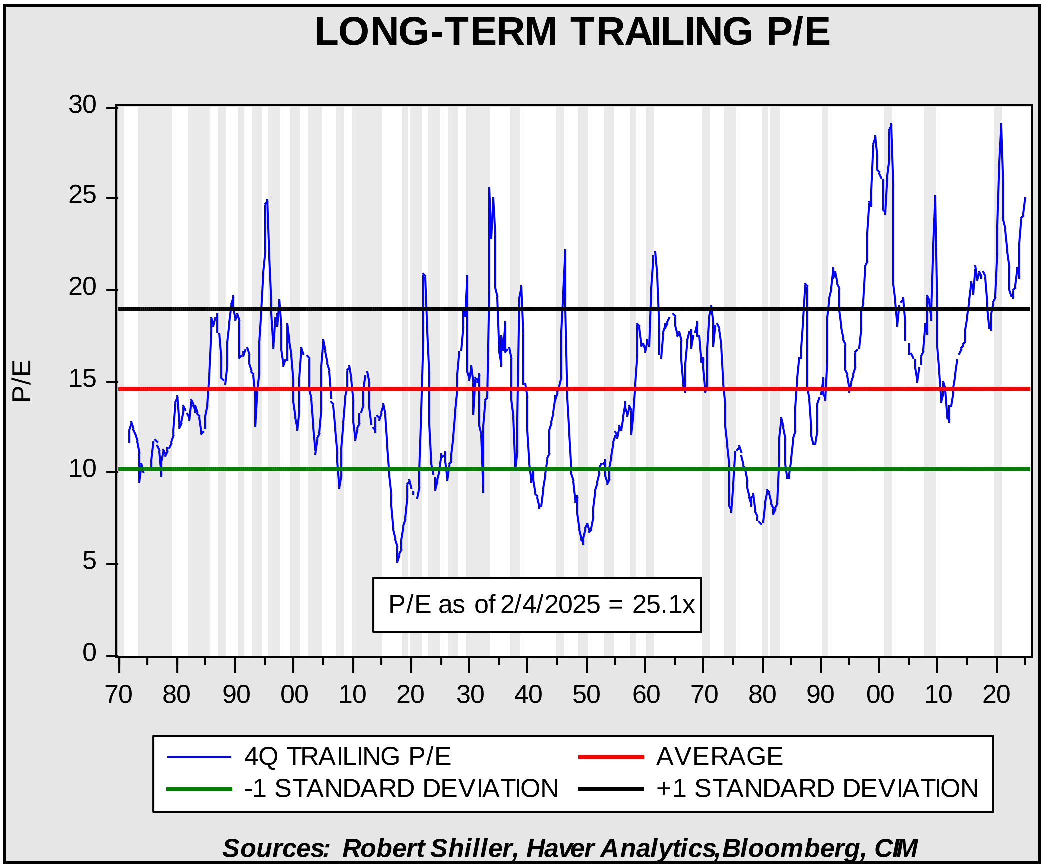


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.