Daily Comment

Confluence INVESTMENT MANAGEMENT

By Patrick Fearon-Hernandez, CFA, and Thomas Wash

[Posted: January 29, 2025 — 9:30 AM ET] Global equity markets are mostly lower 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 down 0.1% Chinese markets were closed for the Chinese Lunar New Year. US equity index futures are signaling a lower open.

With 100 companies having reported so far, S&P 500 earnings for Q4 are running at $62.20 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 16.0% 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	Outlook	Of Note
Trump and the Political Economy of Alliances (1/27/25) + podcast	*Magnificent 7 to the Rescue!* (1/21/25) + podcast	*The 2025 Outlook: A Year of Political and Policy Change*	*Keller Quarterly* January 2025

Our *Comment* today opens with new developments related to Chinese artificial-intelligence firm DeepSeek and its market-disrupting new AI model. Importantly, new evidence suggests that DeepSeek's success may have depended on stolen intellectual property from the US's top AI developer. We next review several other international and US developments with the potential to affect the financial markets today, including political pressure on the Japanese government to provide more tax breaks and new developments on the Trump administration's effort to pause federal grants and loans.

DeepSeek and Global Semiconductor Industry: As investors continue to digest the implications of the cheap, powerful new artificial-intelligence model from Chinese firm DeepSeek, the CEO of Dutch semiconductor-equipment giant ASML insisted the development would be positive for chip makers because it would lead to even more demand for their products.

The statement has boosted ASML's stock price by about 8.8% so far this morning, and other European tech stocks have rallied as well.

- The all-in cost of DeepSeek's new model was almost certainly much higher than reported. Nevertheless, the company's success does suggest that the future AI industry won't necessarily involve the super expensive advanced chips and huge electricity requirements that Western firms had been banking on. Thus, much of their AI-related investment to date may not pay off.

- On the other hand, cheaper and easily accessible AI models probably would lead to wider adoption of the technology, increasing the demand for basic chips and potentially boosting productivity across a wide range of industries.

DeepSeek and US-China Relations: OpenAI, maker of the US's advanced ChatGPT AI model, said it has evidence that Chinese firm DeepSeek used the US company's proprietary models to cheaply train its own open-source model, in violation of ChatGPT's terms of service. The Trump administration's AI czar, David Sacks, had also raised concerns earlier that DeepSeek's apparent success relied on intellectual property theft from the US, as so many other Chinese technological advancements have.

- If true, DeepSeek's ability to leverage ChatGPT's model illustrates how hard it may be for cutting-edge AI firms to maintain their advantage.

- In any case, if DeepSeek illegally used ChatGPT's intellectual property to gain its edge and wipe hundreds of billions of dollars off the value of key US technology firms, it seems certain that the development will further worsen US-China tensions. For one thing, it would likely encourage the Trump administration to be even more aggressive on imposing trade barriers with China.

Japan: Key opposition parties are reportedly demanding expensive new tax breaks to support Prime Minister Ishiba's budget for the fiscal year beginning April 1. The Democratic Party for the People is demanding a hike in the amount of income exempt from tax, while the Japan Innovation Party is asking for free elementary and secondary education. The disputes could potentially undermine the minority Liberal Democratic Party/Komeito government's prospects in the elections expected this summer and/or further worsen Japan's budget deficit.

United Kingdom: As part of its drive to boost British economic growth, the government of Prime Minister Starmer has announced a series of infrastructure investments, including support for a third runway to ease severe capacity constraints at Heathrow Airport, the country's largest. The new runway will likely face a long planning period and litigation, but it is expected to boost UK economic growth by more than 0.4% per year when it is finally completed.

United States-Greenland-Denmark: In the first survey of Greenlanders since President Trump expressed his interest in buying the autonomous island from Denmark, some 85% of respondents said they didn't want to become part of the US. About 9% were undecided, and only 6% wanted

Greenland to be bought by the US. The results echo the view of Greenlandic Prime Minister Múte Egede, who has also said his citizens reject the idea of a US takeover.

US Monetary Policy: The Fed will wrap up its latest policy meeting today, with the decision due at 2:00 PM ET. The policymakers are widely expected to hold the benchmark fed funds interest rate unchanged at its current range of 4.25% to 4.50%, but surprises are possible given that the annual rotation of committee members will bring new officials to the panel. Investors will be looking to Chair Powell's post-meeting news conference for guidance on the future path of rates and for his reaction to President Trump's demand for rate cuts.

US Fiscal Policy: A federal judge late yesterday afternoon temporarily blocked the Trump administration's order to freeze the disbursement of federal grants, loans, and other aid, which we described in our *Comment* yesterday. The injunction lasts until Monday, when an in-depth hearing is scheduled. A key legal issue is whether the president can stop the disbursement of funds appropriated by Congress, which has the power of the purse under the Constitution.

- Separately, to ensure all federal workers are on board with Trump's back-to-the-office mandate, the administration has offered buyout packages to every full-time job holder. Under the buyout, workers who don't want to give up remote work and resign by February 6 would be paid through the end of the fiscal year on September 30, with benefits.
- The buyout offer applies to all full-time federal employees except for military personnel, the Postal Service, and those working in immigration enforcement or national security.
- If implemented, the administration expects 5% to 10% of the federal workforce to quit, saving the federal government around $100 billion per year. Of course, the result would likely be a degradation of government services, especially if the offer is taken up disproportionately by the most capable and productive workers, who may have the best prospects in the private sector.
- In any case, if the program is implemented, it could potentially cause at least temporary distortions in the labor market and economic data.

US Labor Market: The National Assessment of Educational Progress from the Department of Education showed that only 67% of US eighth graders were reading at a "basic" or better competency for their grade level in 2024. Only 60% of fourth graders were at that standard. Math scores were flat to slightly better but the nearly continuous slide in reading scores over the last decade raises concern about the quality of the US workforce in the coming years.

US Economic Releases

The Mortgage Bankers Association today said ***mortgage applications*** for the week ended January 24 fell 2.0%, reversing the prior week's 0.1% gain. Applications for home purchase mortgages also fell 0.4%, versus the prior week's 0.6% gain. Applications for refinancing mortgages fell a more pronounced 6.8%, extending the prior week's fall of 2.9%. Meanwhile, the average interest rate on a 30-year mortgage held steady at 7.02%.

In a separate report today, a preliminary estimate showed the US ***merchandise trade balance*** in December widened to a seasonally adjusted deficit of $122.1 billion, setting a record. This exceeds the expected $105.5 billion and November's $103.5 billion deficit. Both sides of the ledger contributed to the record gap: According to the data, total merchandise exports fell 4.5%, while imports rose 3.9%. Compared with the same month one year earlier, exports in December fell 1.6%, while imports rose 12.4%. The following chart shows the monthly value of US exports and imports since just before the Global Financial Crisis.

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

Economic Releases						
ET	**Indicator**			**Expected**	**Prior**	**Rating**
14:00	FOMC Rate Decision (Lower Bound)	w/w	29-Jan	4.25%	4.25%	***
14:00	FOMC Rate Decision (Upper Bound)	w/w	29-Jan	4.50%	4.50%	***
14:00	Interest on Reserve Balances Rate	w/w	27-Jan	4.40%	4.40%	**
Federal Reserve						
No Fed speakers or events for the rest of today						

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	Consumer Confidence Index	m/m	Jan	35.2	36.2	36.5	*	Equity bearish, bond bullish
Australia	CPI	y/y	Dec	2.5%	2.3%	2.5%	**	Equity and bond neutral
EUROPE								
Eurozone	M3 Money Supply	y/y	Dec	3.5%	3.8%	3.9%	***	Equity and bond neutral
Germany	GfK Consumer Confidence	m/m	Feb	-22.4	-21.4		**	Equity and bond neutral
Italy	Consumer Confidence	m/m	Jan	98.2	96.3	96.5	***	Equity and bond neutral
	Manufacturing Confidence	m/m	jan	86.8	85.9	85.8	***	Equity and bond neutral
	Economic Sentiment	m/m	May	95.7	95.3		**	Equity and bond neutral
AMERICAS								
Mexico	International Reserves Weekly	w/w	24-Jan	$230254m	$229505m		*	Equity and bond neutral
	Unemployment Rate NSA	m/m	Dec	2.43%	2.64%	2.54%	***	Equity bullish, bond bearish

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	419	0	Down
U.S. Sibor/OIS spread (bps)	429	429	0	Down
U.S. Libor/OIS spread (bps)	431	431	0	Down
10-yr T-note (%)	4.52	4.53	-0.01	Down
Euribor/OIS spread (bps)	262	264	-2	Down
Currencies	**Direction**			
Dollar	Up	US		Down
Euro	Down	Euro		Up
Yen	Down	Japan		Up
Pound	Down	UK		Up
Franc	Down	Switzerland		Up

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.

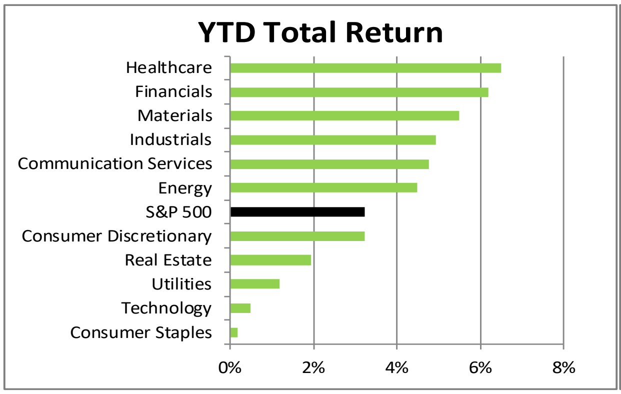
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$77.12	$77.49	-0.48%	
WTI	$73.45	$73.77	-0.43%	
Natural Gas	$3.41	$3.47	-1.70%	
Crack Spread	$17.84	$17.67	0.96%	
12-mo strip crack	$21.22	$21.15	0.31%	
Ethanol rack	$1.81	$1.80	0.22%	
Metals				
Gold	$2,757.02	$2,763.51	-0.23%	
Silver	$30.48	$30.42	0.18%	
Copper contract	$424.75	$424.65	0.02%	
Grains				
Corn contract	$491.00	$485.25	1.18%	
Wheat contract	$550.25	$545.25	0.92%	
Soybeans contract	$1,053.75	$1,045.00	0.84%	
Shipping				
Baltic Dry Freight	746	761	-15	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		2.19		
Gasoline (mb)		0.25		
Distillates (mb)		-2.30		
Refinery run rates (%)		-0.8%		
Natural gas (bcf)		-319		

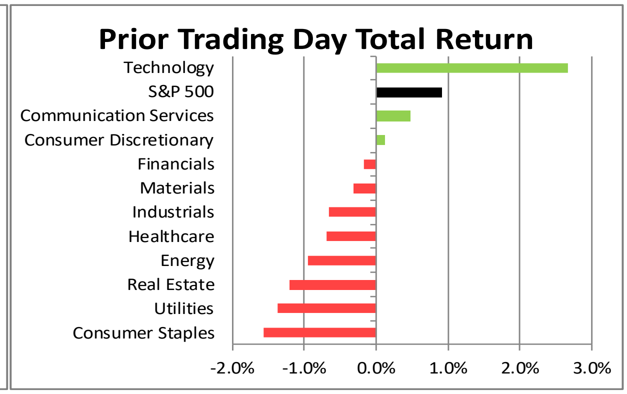
Weather

The 6-to-10-day and 8-to-14-day forecasts currently call for warmer-than-normal temperatures in the southern half of the country from the Four Corners region to the East Coast, with cooler-than-normal temperatures on the northern West Coast and along the northern tier as far east as the Great Lakes. The forecasts call for wetter-than-normal conditions across most of the country, with dry conditions in the Desert Southwest and the Gulf Coast.

Data Section

US Equity Markets – (as of 1/28/2025 close)

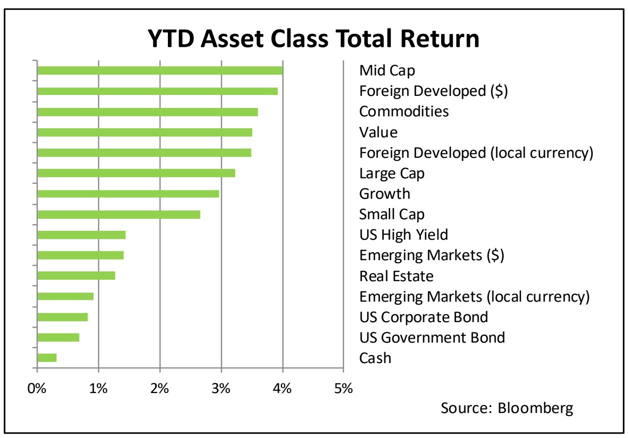




(Source: Bloomberg)

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 1/28/2025 close)

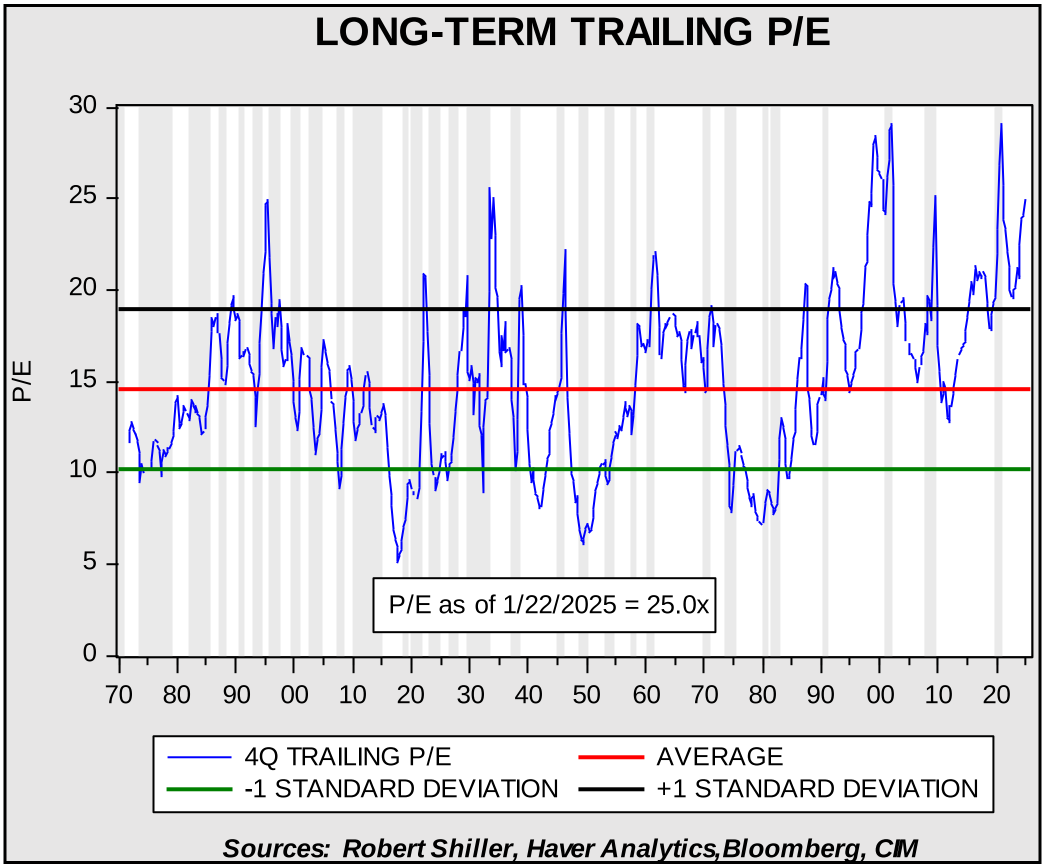


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

January 23, 2025



Based on our methodology,[1] the current P/E is 25.0x, 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.