Daily Comment

Confluence INVESTMENT MANAGEMENT

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Posted: May 16, 2025 — 9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 closed up 0.4% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed down 0.5%. Chinese markets were mixed, with the Shanghai Composite down 0.4% from its previous close and the Shenzhen Composite up 0.2%. US equity index futures are signaling a higher open.

With 462 companies having reported so far, S&P 500 earnings for Q1 are running at $63.90 per share compared to estimates of $60.75, which is up 7.3% from Q1 2024. Of the companies that have reported thus far, 77.1% have exceeded expectations, while 19.0% 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	Asset Allocation Quarterly	Of Note
"Update on the US-China Military Balance of Power" (5/12/25) + **podcast**	"US Capital Flight and the Implications for Investors" (5/5/25) + podcast	Q2 2025 Report Q2 2025 Rebalance Presentation	Confluence of Ideas Podcast Value Equity Quarterly Update

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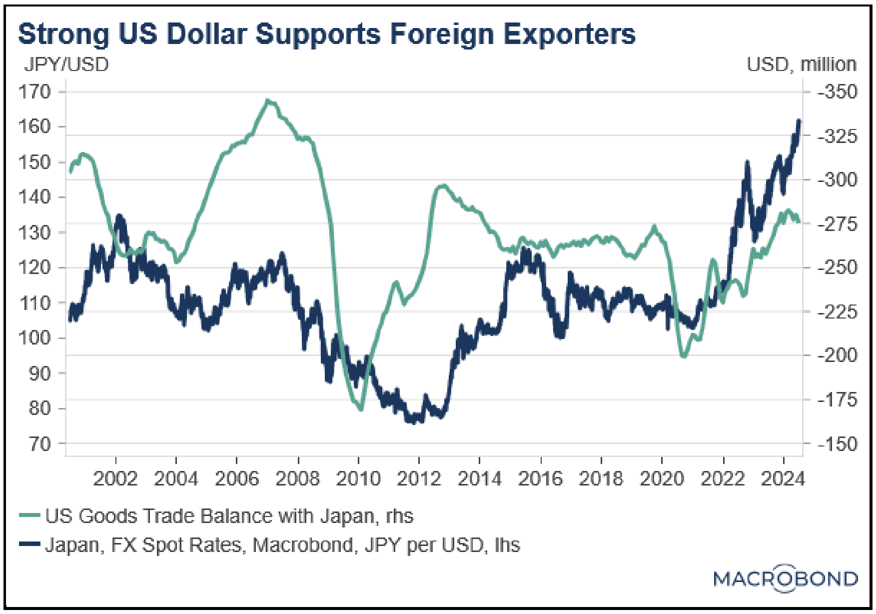
Good morning! Markets are closely tracking the president's latest trade announcement. In sports, the Carolina Hurricanes secured a victory against the Washington Capitals, advancing to the Eastern Conference Finals. Today's *Comment* will discuss the administration's recalibrating of its trade strategy, Friday's stronger-than-expected economic data that still contained worrying signals, and other market news. As always, we'll conclude with a summary of major domestic and international economic data releases.

Trump Rethinks Tariffs: The president has stated that he plans to set new tariff rates for countries due to the difficulty in securing deals with individual nations.

- The president has announced a shift away from previously set tariff rates, directing Commerce Secretary Howard Lutnick to notify trading partners of new requirements for doing business with the US. The move follows a series of deals by the Trump administration to lower tariffs from the levels set on April 2. It remains unclear whether this approach will involve eliminating some tariffs in favor of a more direct business tax or simply reducing overall tariff rates.

- The president's policy shift coincided with US-Japan trade negotiations held the same day. Reports suggested the discussions might have expanded beyond trade to include currency exchange rates. However, negotiations reached an impasse when Japanese officials demanded the complete elimination of the 25% auto tariff as a prerequisite for any agreement, a condition the Trump administration ultimately rejected.

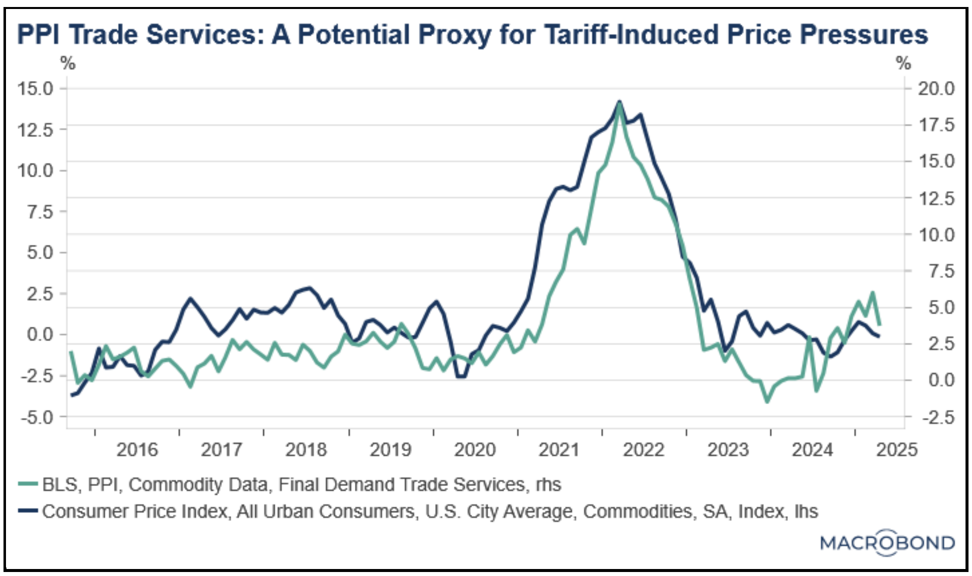


- However, his decision to reconsider tariffs offers stronger support for the "Trump put" hypothesis than market observers initially anticipated. This theory posits that the president is more likely to prioritize market performance over long-term policy goals, implying that any significant market downturn would prompt intervention to restore upward momentum.
- A notable trend in this trade war is the increasing influence of public sentiment. President Trump's trade policies have fueled recession concerns, weakening his domestic approval ratings. At the same time, foreign leaders negotiating with the US face growing political pressure to hold firm in talks to avoid appearing overly conciliatory.
- In short, the political reality of the trade war has complicated negotiations. Many Americans now fear recession and rising inflation, while foreign voters increasingly resent US economic dominance. Faced with these pressures, the administration may need to recalibrate its approach — at least until it secures passage of its tax bill.
- We expect the current market rally to persist barring any unexpected tariff escalations. Investors have largely priced in the April 2 tariffs as the likely peak, with markets now anticipating potential reductions. This baseline scenario, if correct, would mitigate recession concerns and continue supporting equity valuations. However, any deviation

from this expectation — particularly new tariff measures — could quickly reverse recent gains.

Mixed Data: The latest retail sales and PPI figures paint a mixed picture of the impact of tariffs, yet recent forecasts still point to strong GDP growth in Q2.

- While overall spending appears to be holding, there are subtle signs of weakness. Retail sales unexpectedly edged up 0.1% in April, defying forecasts of stagnation, as consumers ramped up auto purchases ahead of looming tariffs. But the headline gain masked underlying weakness as the retail sales control group (which excludes autos, gasoline, and building materials and directly feeds into GDP calculations) fell 0.2%, sharply missing expectations of a 0.3% rise.
- April's producer price index also painted a confusing picture of the economy. Defying expectations of a 0.2% gain, the headline PPI instead fell 0.5% month-over-month, a decline that reflects both moderating price pressures and businesses absorbing tariff costs. Most notably, the PPI trade services component, our key barometer for tariff impact, plummeted 1.6%, providing compelling evidence that trade intermediaries are bearing the heaviest burden from recent protectionist measures.



- Taken together, this data suggests the initial impact of tariffs on spending and prices may be less severe than anticipated. This could be attributed to firms strategically maintaining low prices to gain market share while competitors navigate adjustments. However, the sustainability of this trend remains uncertain. Even a major low-cost retailer like Walmart has indicated a willingness to raise prices in response to tariffs.
- Nevertheless, we believe this data reinforces the likelihood of a longer runway before a potential recession than many anticipate, which should support equities if this trend persists. The Atlanta Fed's latest GDPNow forecast indicates a projected 2.5% growth rate for the second quarter, suggesting economic rebound. In essence, while tariffs are

undoubtedly impacting the economy, their effects have not yet been significant enough to derail the economy's current trajectory.

Putin Says No Deal: The Russian leader's no-show for a planned meeting in Turkey aimed at securing a truce with his Ukrainian counterpart will delay a peace deal.

- The highly anticipated meeting between the leaders of the two warring nations did not unfold as planned. Originally intended to bring both sides together to finalize an agreement, the day descended into chaos instead. Putin sent a lower-level delegation instead of attending in person, and the groups landed in different cities, making face-to-face discussions nearly impossible. Although talks are expected to resume today, hopes for a final agreement remain slim.
- Putin's lack of cooperation suggests he remains confident in his dominant position at the negotiating table. Reports indicate he is pushing for discussions based on the 2022 Istanbul draft agreements, terms initially proposed as Russian forces prepared to invade Ukraine. Those demands included drastic reductions in Ukraine's military capabilities, strict limits on its armaments, and significant concessions on sovereignty — conditions that are almost certain to be rejected.
- The US maintains its mediation efforts between the warring parties, seeking to facilitate a rapid end to hostilities. President Trump has indicated he's prepared for direct talks with Putin in hopes of altering Russia's position. However, with key leaders absent from negotiations and no framework for finalizing terms, expectations remain low that the upcoming diplomatic meetings will produce substantive results.
- We remain optimistic that ongoing negotiations will ultimately produce an agreement between the two parties. Putin's decision to abstain from attending appears primarily designed to demonstrate Russia's dominant position in the talks. However, he likely understands that sanctions relief remains contingent upon reaching an arrangement. Consequently, we anticipate a settlement before year's end that should provide support for European equities while exerting downward pressure on energy prices.

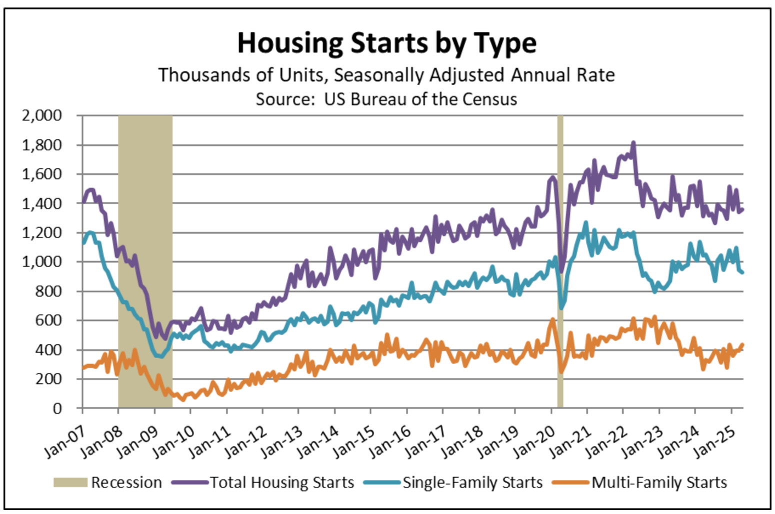
Fed Officials Reflect: The Fed is looking to change the framework that it uses to guide its policy decisions.

- Yesterday, Federal Reserve officials convened for the first day of their two-day conference to evaluate current monetary policy strategies. The discussions are part of the central bank's regular framework review, ensuring its policy tools remain aligned with the Fed's dual mandate of price stability and maximum employment. A key focus of this review will be evaluating how the pandemic has influenced the Fed's policy decisions.
- The central debate focused on the Fed's decision to prioritize maximum employment over inflation control, even as labor markets showed clear signs of tightening. Most notably, the strategy of tolerating above-target inflation to compensate for previous periods of persistently low inflation has emerged as a key area requiring revision in the upcoming policy framework.

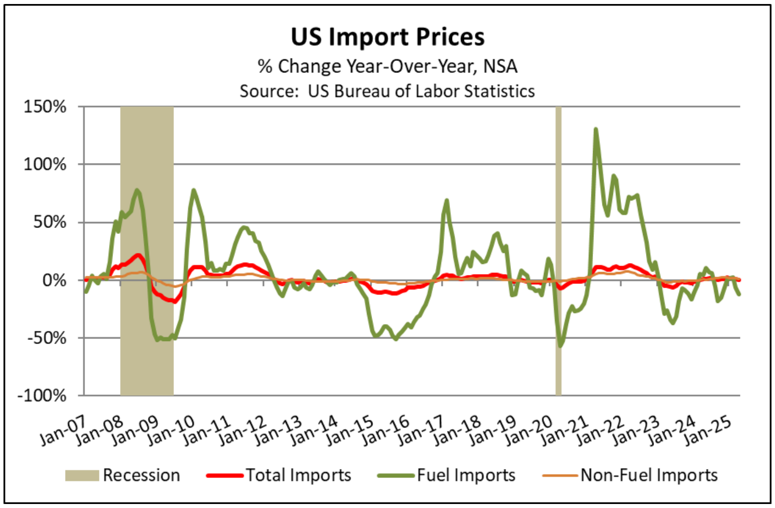
- Additionally, discussions have emerged regarding current economic conditions and their implications for monetary policy. Fed Chair Powell has indicated that he anticipates persistent supply shocks and elevated long-term yields, signaling the central bank's overall reluctance to return to the pre-pandemic normal of near zero interest rates. This shift means that bonds yields are likely to stay elevated.

US Economic Releases

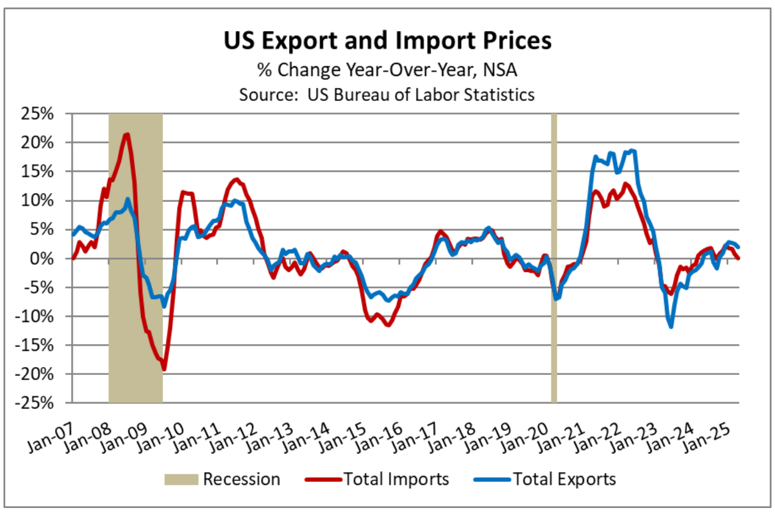
April ***housing starts*** rose to a seasonally adjusted, annualized rate of 1.361 million units, short of the expected rate of 1.364 million units but better than the revised March rate of 1.339 million units. The rate of housing starts in April was up 1.6% from the rate in the previous month. In contrast, April ***housing permits*** fell to a rate of 1.412 million units, short of both their anticipated rate of 1.450 million units and the revised March rate of 1.481 million units. Permits issued for new housing units in April were down 4.7% from the previous month. Compared with the same month one year earlier, housing starts in April were down 1.6%, while permits were down 3.5%. The chart below shows the growth in new home starts by type of property since just before the Great Financial Crisis.



Separately, April ***import prices*** were up 0.1% from the previous month, versus an expected decline of 0.3% and a revised decline of 0.4% in March. Of course, import prices are often driven by volatility in the petroleum fuels category. April ***import prices excluding fuels*** were up 0.4%, beating their expected rise of 0.1% and erasing their revised March decline of 0.2%. Overall import prices in April were up 0.1% year-over-year, while import prices excluding fuels were up 1.2%. The chart below shows the year-over-year change in import prices since just before the GFC.



According to the report, ***export prices*** in April were up 0.1% from one year earlier, in large part because of the key agriculture category. Comparing the annual change in export prices versus import prices provides a sense of the US "terms of trade," or the relative advantage or disadvantage the country is facing because of trends in international trade prices. The chart below compares the year-over-year change in US export and import prices since just before the GFC.



The table below lists the economic releases and/or 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	May P	53.5	52.2	***
10:00	U. of Michigan Current Conditions	m/m	May P	59.9	59.8	**
10:00	U. of Michigan Future Expectations	m/m	May P	48.6	47.3	**
10:00	U. of Michigan 1-Year Inflation Expectation	m/m	May P	6.5%	6.5%	*
10:00	U. of Michigan 5-10 Year Inflation Expectation	m/m	May P	4.4%	4.4%	*
16:00	Net Long-Term TIC Flows	m/m	Mar		$112.0b	**
16:00	Total Net TIC Flows	m/m	Mar		$284.7b	**
Federal Reserve						
EST	**Speaker or Event**	**District or Position**				
21:40	Mary Daly Gives Commencement Address	President of the Federal Reserve Bank of San Francisco				
	Second Thomas Laubach Research Conference	Live Broadcast at federalreserve.gov				
	Thomas Barkin Gives Commencement Speech	President of the Federal Reserve Bank of Richmond				

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	GDP Deflator	q/q	1Q P	3.30%	2.90%	3.20%	***	Equity and bond neutral
	GDP SA	q/q	1Q P	-0.20%	0.60%	-0.10%	***	Equity and bond neutral
	Industrial Production	y/y	Mar F	1.0%	-0.3%		***	Equity and bond neutral
	Capacity Utilization	y/y	Mar	-2.4%	-1.1%		**	Equity and bond neutral
New Zealand	BusinessNZ Manufacturing PMI	m/m	Apr	53.9	53.2		***	Equity and bond neutral
	Non Resident Bond Holdings	m/m	Apr	61.6%	61.9%		*	Equity and bond neutral
	2-Year Inflation Expectations	q/q	2Q	2.29%	2.06%		**	Equity and bond neutral
South Korea	Export Price Index	y/y	Apr	0.7%	6.4%		*	Equity and bond neutral
	Import Price Index	y/y	Apr	-2.3%	3.4%		*	Equity and bond neutral
India	Trade Balance	m/m	Apr	-$26424m	-$21539m	-$20500m	**	Equity and bond neutral
	Exports	y/y	Apr	9.0%	0.7%		**	Equity and bond neutral
	Imports	y/y	Apr	19.0%	11.4%		**	Equity and bond neutral
EUROPE								
Eurozone	Trade Balance SA	m/m	Mar	27.9b	22.7b		**	Equity and bond neutral
France	ILO Unemployment Rate	q/q	Q1	7.4%	7.3%	7.4%	*	Equity and bond neutral
Italy	CPI, EU Harmonized	y/y	Apr F	2.0%	2.1%	2.1%	***	Equity and bond neutral
	CPI NIC Including Tobacco	y/y	Apr F	1.9%	2.0%	2.0%	**	Equity and bond neutral
Switzerland	Industrial Output WDA	y/y	Q1	8.5%	2.1%		*	Equity and bond neutral
Russia	Gold and Forex Reserves	m/m	9-May	$687.3b	$680.2b		***	Equity and bond neutral
	Money Supply, Narrow Definition	w/w	7-May	987.3b	18.13t		*	Equity and bond neutral
AMERICAS								
Canada	Housing Starts	m/m	Apr	278.6k	214.2k	226.2k	**	Equity and bond neutral
	Manufacturing Sales	m/m	Mar	-1.4%	-0.2%	-1.9%	**	Equity and bond neutral
	Wholesale Sales ex Petroleum	m/m	Mar	0.2%	1.0%	-0.30	**	Equity bullish, bond bearish
Brazil	FGV Inflation IGP-10	m/m	May	7.54%	8.71%		**	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)	424	426	-2	Up
U.S. Sibor/OIS spread (bps)	432	432	0	Down
U.S. Libor/OIS spread (bps)	432	432	0	Down
10-yr T-note (%)	4.40	4.43	-0.03	Up
Euribor/OIS spread (bps)	213	214	-1	Down
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Up			Up
Pound	Down			Up
Franc	Down			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of Mexico Overnight Rate	8.50%	9.00%	8.50%	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.

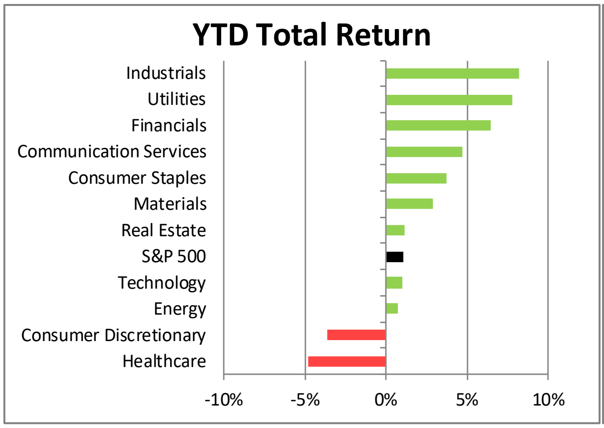
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$64.69	$64.53	0.25%	
WTI	$61.76	$61.62	0.23%	
Natural Gas	$3.33	$3.36	-1.01%	
Crack Spread	$27.85	$28.44	-2.08%	
12-mo strip crack	$22.44	$22.80	-1.57%	
Ethanol rack	$1.84	$1.84	0.38%	
Metals				
Gold	$3,175.43	$3,240.10	-2.00%	
Silver	$32.05	$32.64	-1.81%	
Copper contract	$461.70	$468.35	-1.42%	
Grains				
Corn contract	$449.00	$448.50	0.11%	
Wheat contract	$531.00	$532.75	-0.33%	
Soybeans contract	$1,053.75	$1,051.25	0.24%	
Shipping				
Baltic Dry Freight	1,305	1,267	38	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)	3.45	-2.21	5.66	
Gasoline (mb)	-1.02	-0.94	-0.08	
Distillates (mb)	-3.16	0.12	-3.28	
Refinery run rates (%)	1.2%	0.7%	0.5%	
Natural gas (bcf)	110	110	0	

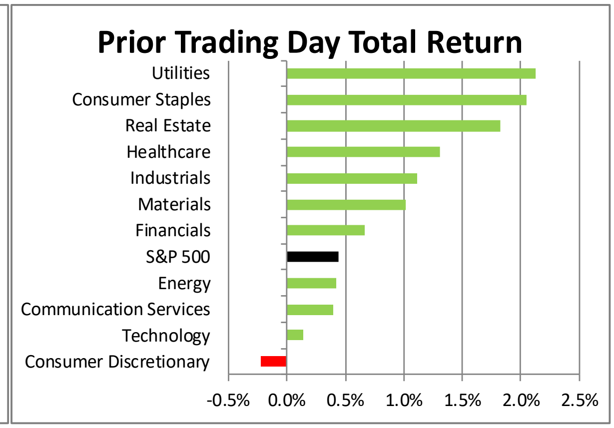
Weather

The 6-to-10 and 8-to-14-day forecasts currently call for warmer-than-normal temperatures in California, Texas, the entire Rocky Mountain region, and Florida, with cooler-than-normal temperatures in the Midwest and Northeast. The forecasts call for wetter-than-normal conditions in the Northeast, with dry conditions in California, the Rocky Mountain region, and the lower Mississippi Valley.

Data Section

US Equity Markets – (as of 5/15/2025 close)

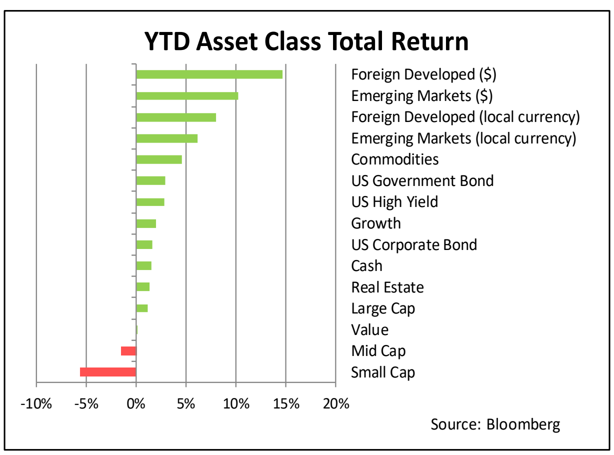




(Source: Bloomberg)

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 5/15/2025 close)

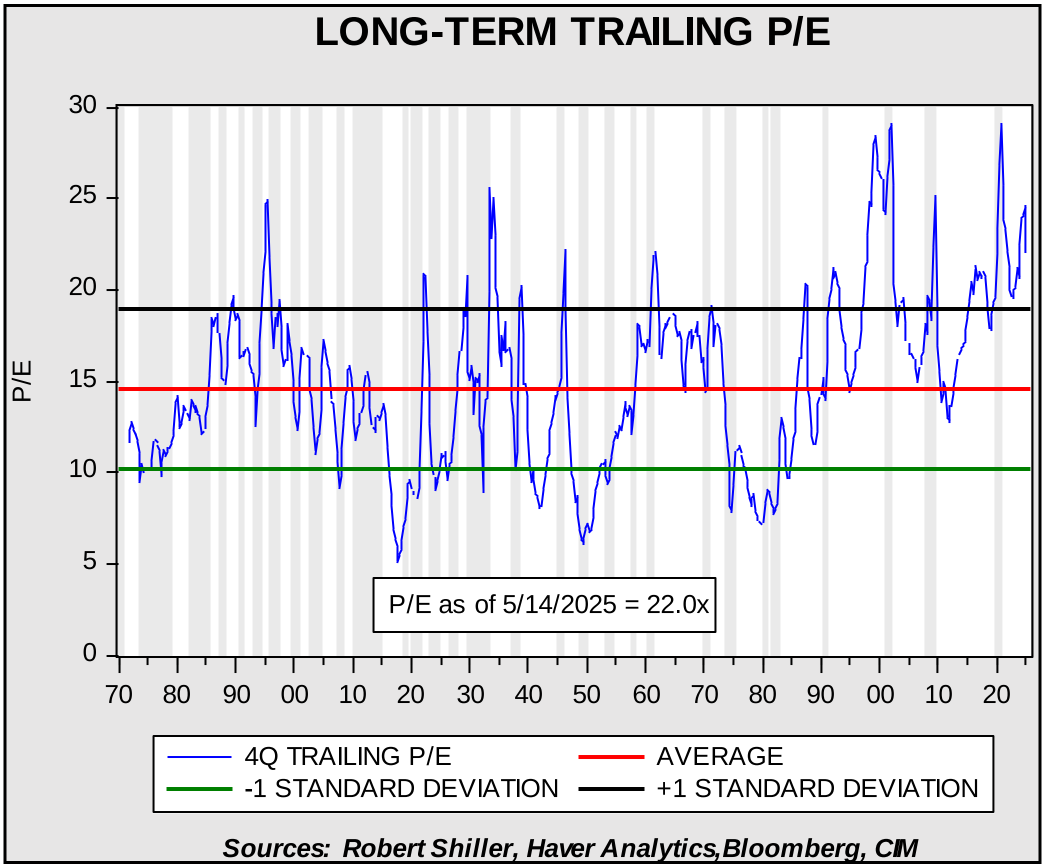


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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

May 15, 2025



Based on our methodology,[1] the current P/E is 22.0x, up 0.2 from our last report. The rise in the stock price index outweighed the increase in earnings.

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 (Q2, Q3, and Q4) and one estimate (Q1). 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.