Daily Comment

Confluence INVESTMENT MANAGEMENT

By Patrick Fearon-Hernandez, CFA, and Thomas Wash

Posted: May 21, 2025 — 9:30 AM ET] Global equity markets are mixed this morning. In Europe, the Euro Stoxx 50 closed down 0.3% from its prior close. In Asia, the MSCI Asia Apex 50 Index closed up 0.9%. Chinese markets were mixed, with the Shanghai Composite up 0.2% from its previous close and the Shenzhen Composite unchanged. US equity index futures are signaling a lower open.

With 465 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, 77.0% have exceeded expectations, while 19.1% 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
"Update on the US-China Military Balance of Power" (5/12/25) + podcast	"The Looming Battle for US Monetary Policy" (5/19/25) + podcast	Q2 2025 Report Q2 2025 Rebalance Presentation	Confluence of Ideas Podcast Value Equity Quarterly Update

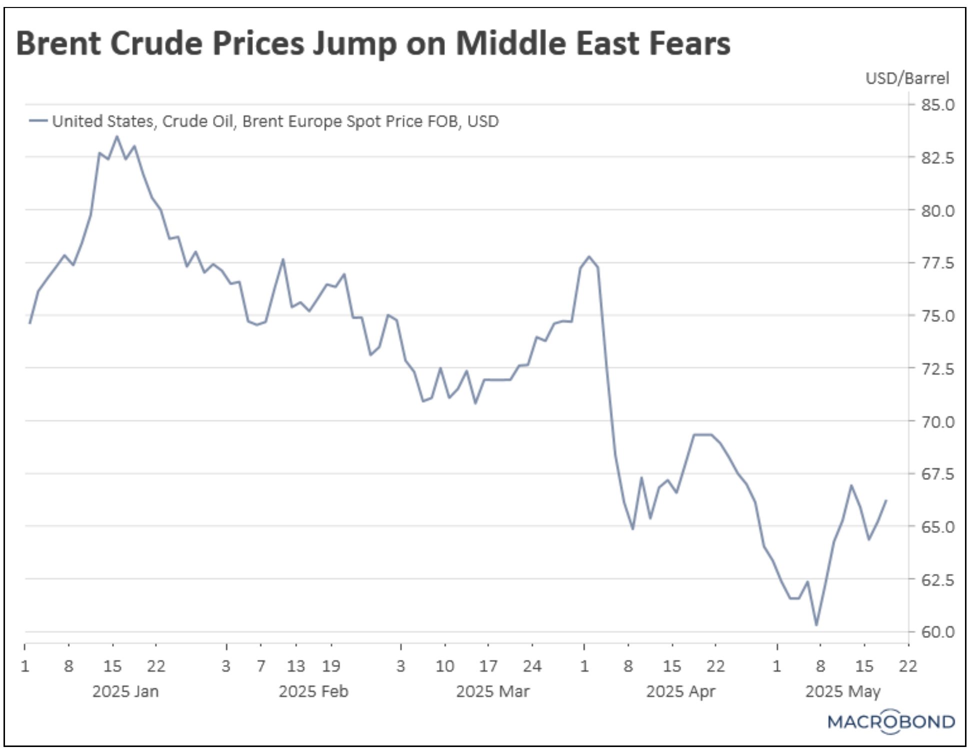
---

Good morning! Markets remain cautious as investors weigh fiscal concerns amid the tax bill's progress through Congress. In sports, the Oklahoma City Thunder claimed Game 1 against the Minnesota Timberwolves in the Western Conference finals. Today's *Comment* will address renewed tensions in the Middle East, the Fed's patient approach to rate cuts, and other market-moving developments. As usual, the report will include a summary of key domestic and international economic data releases.

Middle Eastern Tensions Rise: Israel has adopted a more assertive stance amid stalled US negotiations with Iran and escalating hostilities from Houthi rebels.

- US intelligence indicates Israel may be preparing to strike Iranian nuclear facilities. While no final decision to execute such an attack has been confirmed, Israeli officials have reportedly been weighing this option for months and military preparations appear to be intensifying recently. These developments suggest Israel may be losing confidence in the White House's ability to diplomatically curb Iran's nuclear program through diplomacy.

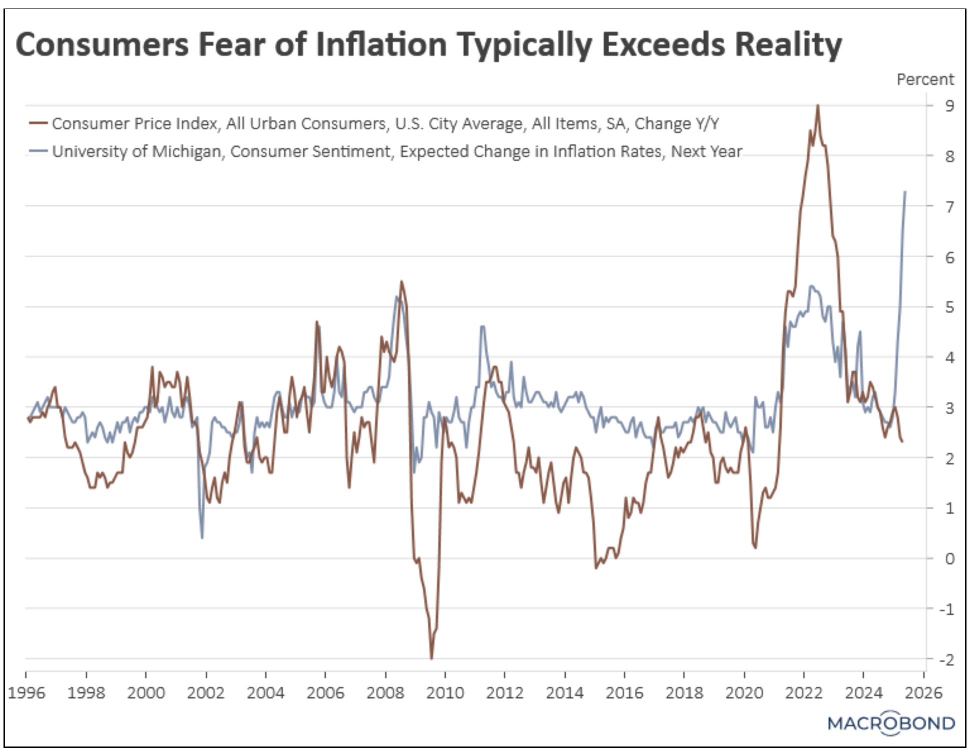
- The heightened tensions have emerged as US-Iran nuclear negotiations reached an impasse. Recent weeks saw active White House efforts to curb Iran's nuclear program, with the US president noting last week that Iran had "sort of agreed to terms." However, Iran's Supreme Leader Ayatollah Ali Khamenei has rejected this optimism, declaring the talks "unlikely to succeed" and labeling US demands as "outrageous." His ominous conclusion, "whatever happens will happen," signals a dangerous hardening of Iran's position.
- Israel's increasingly aggressive posture toward Iran follows a dangerous escalation by Tehran-backed Houthi rebels. On Sunday, the group launched missile attacks against an Israeli airport, all intercepted by defense systems, while imposing a naval blockade on Israel's Haifa port. The coordinated provocations prompted immediate retaliation, with Israel expanding its Gaza ground operations.



- While an immediate attack appears unlikely, escalating tensions in the Middle East have already begun driving up energy prices due to supply concerns. Brent crude has risen 3.5% following recent developments, trading above $66 a barrel. We believe Israel's threats against Iran may partly be a negotiating tactic to pressure Tehran into accepting previous terms, though this strategy could backfire if Iran perceives it as offering no tangible benefits. A war in the Middle East will likely weigh on global risk assets.

Wait and See Approach: Fed officials are consistently trying to dampen expectations for rate cuts this year.

- Two Federal Reserve officials emphasized the need for policy patience during Tuesday's remarks. San Francisco Fed President Mary Daly cautioned that policymakers still lack sufficient data to justify easing monetary policy. Separately, Cleveland Fed President Beth Hammack highlighted ongoing analysis of whether recent tariffs will produce only temporary inflationary effects or more persistent price pressures, noting that clearer insights should emerge in coming months.
- Their comments coincide with shifting market expectations for Fed rate cuts this year. Just a month ago, investors anticipated aggressive easing, potentially beginning as early as June with up to 100 basis points of cuts by year's end amid fears of an economic slowdown. However, receding trade tensions and stronger-than-expected data have since led forecasters to revise projections, now pricing in just 50 basis points of cuts, likely starting in September.
- The Fed's focus on cutting interest rates appears to be driven by rising inflation expectations. The latest Michigan Consumer Sentiment Survey revealed that households expect inflation to rise 7.3% next year — the highest expected level since the 1980s. While inflation expectations are not typically a reliable indicator of future price pressures, these concerns likely explain the Fed's decision to prioritize inflation over economic growth.



- So far, there is little evidence of broad-based inflation outside a few raw material intensive sectors. As we noted last week, many firms, including Home Depot, seem willing to absorb some tariff-related cost increases. While this could pressure earnings, it may also delay or mitigate the broader inflationary effects of tariffs. This dynamic could give the Fed room to cut rates once or even twice by year's end, assuming the economy avoids a recession.

Trump Gets Involved: President Trump is pressuring Republican lawmakers to fall in line and is determined to push through his signature tax plan before year's end.

- The president's decision to personally lobby lawmakers reflects growing uncertainty about whether his tax legislation can secure enough votes to pass. The bill faces resistance from fiscal conservatives and SALT deduction supporters. Fiscal conservatives insist on larger social spending cuts to control the deficit and enhance fiscal sustainability. On the other side, SALT advocates are working to secure tax breaks for states most impacted by the potential expiration of the previous tax cuts.
- Despite some opposition, Republican lawmakers are fast-tracking a bill in the House this week. The current iteration proposes raising the SALT deduction cap to $40,000 for individuals earning up to $500,000, with a 1% annual income phase-in before making the deduction permanent. Concurrently, fiscal conservatives are advocating for an accelerated implementation of Medicaid work requirements, moving up the original 2029 timeline, which is likely to neutralize potential political fallout ahead of the election.
- While the Trump tax bill is expected to partially offset the tariffs' economic impact, most analysts agree it won't fully neutralize the drag. Economists now project import taxes could slow 2025 GDP growth to 1.4%, avoiding outright downturn but marking a sharp slowdown from previous years. This growth floor, however, may support equity markets. If the economy avoids recession, firms could maintain margins by passing some tariff costs through to consumers.

Buy European: The EU is starting to embrace more populist elements as it looks to protect its companies from foreign competitors.

- Brussels is urging EU member states to restrict foreign bidders from public procurement contracts as part of a broader strategy to strengthen economic sovereignty. This push comes alongside significant investments to bolster the bloc's defense industry and reduce dependence on foreign technology. By nurturing homegrown companies, the EU aims to decrease its reliance on the US and China for critical technologies and essential raw materials while building domestic industrial resilience.
- The EU has similarly announced measures to curb the influx of small packages from China, aiming to avoid becoming an alternative destination for Chinese firms circumventing US tariffs. Under the new policy, e-commerce shipments will face a 2 GBP fee for direct-to-consumer deliveries and a 0.50 GBP charge for warehouse-bound packages. This tiered fee structure is designed to incentivize bulk shipments and distribution from warehouses within the EU.
- We believe these measures should marginally improve the attractiveness of companies within the region. However, the primary concern remains the regulatory framework

around climate change. If the bloc moderates some of its green initiatives, we anticipate a stronger and more sustainable rally in European equities.

US Economic Releases

The Mortgage Bankers Association today said ***mortgage applications*** for the week ended May 16 fell 5.1% after rising 1.1% the previous week. Applications for home purchase mortgages fell 5.2% after rising 2.3% the previous week. Applications for refinancing mortgages also fell 5.0% after falling 0.4% the previous week. Meanwhile, the average interest rate on a 30-year mortgage rose 6 basis points to 6.92%.

The table below lists the economic releases and/or 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**
12:15	Thomas Barkin and Michelle Bowman Participate in Fed Listens	President of the Federal Reserve Bank of Richmond and Fed Governor

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	Trade Balance	y/y	Apr	-¥115.8b	¥599.4b	¥215.3b	**	Equity and bond neutral
	Exports	y/y	Apr	2.0%	4.0%	2.5%	*	Equity and bond neutral
	Imports	y/y	Apr	-2.2%	1.8%	1.8%	*	Equity and bond neutral
Australia	Westpac Leading Index	m/m	Apr	-0.10%	-0.15%		**	Equity and bond neutral
New Zealand	Trade Balance NZD	m/m	Apr	1426m	794m		**	Equity and bond neutral
	Exports NZD	m/m	Apr	7.84b	7.41b		**	Equity and bond neutral
	Imports NZD	m/m	Apr	6.42b	6.61b		**	Equity and bond neutral
EUROPE								
UK	CPI	y/y	Apr	3.5%	2.6%	3.3%	***	Equity and bond neutral
	CPI Core	y/y	Apr	3.8%	3.4%	3.6%	***	Equity and bond neutral
	Retail Price Index	m/m	Apr	402.2	395.3	401.2	**	Equity and bond neutral
	RPI	y/y	Apr	4.5%	3.2%	4.2%	**	Equity and bond neutral
	RPI Ex Mort Int.Payments	m/m	Apr	4.20%	2.80%		*	Equity and bond neutral
	House Price Index	m/m	Mar	6.40%	5.50%		*	Equity and bond neutral
Switzerland	M3 Money Supply	y/y	Apr	2.9%	2.9%		**	Equity and bond neutral
AMERICAS								
Canada	CPI	y/y	Apr	1.7%	2.3%	1.6%	***	Equity and bond neutral
Mexico	Retail Sales	y/y	Mar	4.3%	-1.1%	2.2%	***	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)	424	422	2	Up
U.S. Sibor/OIS spread (bps)	433	433	0	Up
U.S. Libor/OIS spread (bps)	433	433	0	Flat
10-yr T-note (%)	4.54	4.49	0.05	Flat
Euribor/OIS spread (bps)	206	208	-2	Down
Currencies	**Direction**			
Dollar	Up			Down
Euro	Down			Up
Yen	Up			Up
Pound	Down			Up
Franc	Down			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.

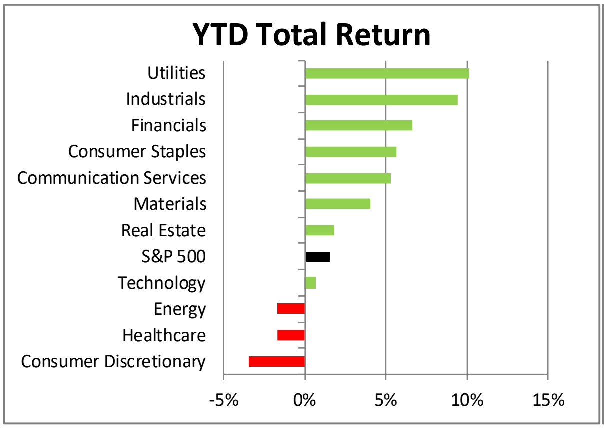
	Price	Prior	Change	Explanation
Energy Markets				
Brent	$65.81	$65.38	0.66%	
WTI	$62.49	$62.03	0.74%	
Natural Gas	$3.49	$3.43	1.78%	
Crack Spread	$26.32	$27.30	-3.60%	
12-mo strip crack	$22.29	$22.44	-0.68%	
Ethanol rack	$1.88	$1.88	0.44%	
Metals				
Gold	$3,310.91	$3,290.13	0.63%	
Silver	$33.14	$33.08	0.16%	
Copper contract	$469.10	$465.40	0.80%	
Grains				
Corn contract	$454.75	$454.50	0.06%	
Wheat contract	$549.50	$546.00	0.64%	
Soybeans contract	$1,059.75	$1,053.00	0.64%	
Shipping				
Baltic Dry Freight	1,340	1,347	-7	
DOE Inventory Report				
	Actual	**Expected**	**Difference**	
Crude (mb)		-1.10		
Gasoline (mb)		-2.00		
Distillates (mb)		-1.40		
Refinery run rates (%)		-0.7%		
Natural gas (bcf)		120		

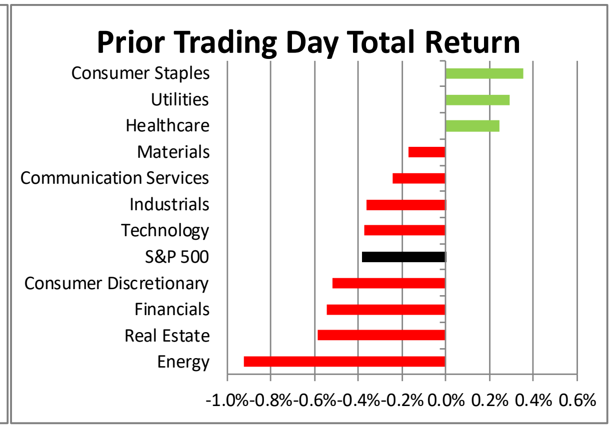
Weather

The 6-to-10 and 8-to-14-day forecasts currently call for warmer-than-normal temperatures for the western third of the country and Florida, with cooler-than-normal temperatures in Texas and the lower Mississippi and Ohio Valleys. The forecasts call for wetter-than-normal conditions in the southern half of the country from the Four Corners region to the East Coast, the Northeast, and the Pacific Northwest, with drier-than-normal conditions in California, Nevada, and the northern Rocky Mountains and Great Plains.

Data Section

US Equity Markets – (as of 5/20/2025 close)

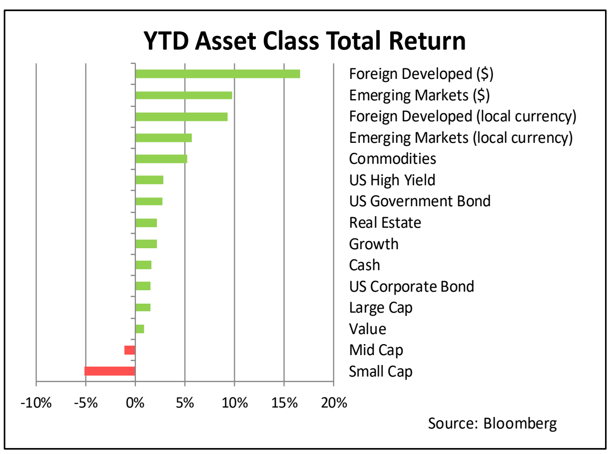




(Source: Bloomberg)

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 5/20/2025 close)

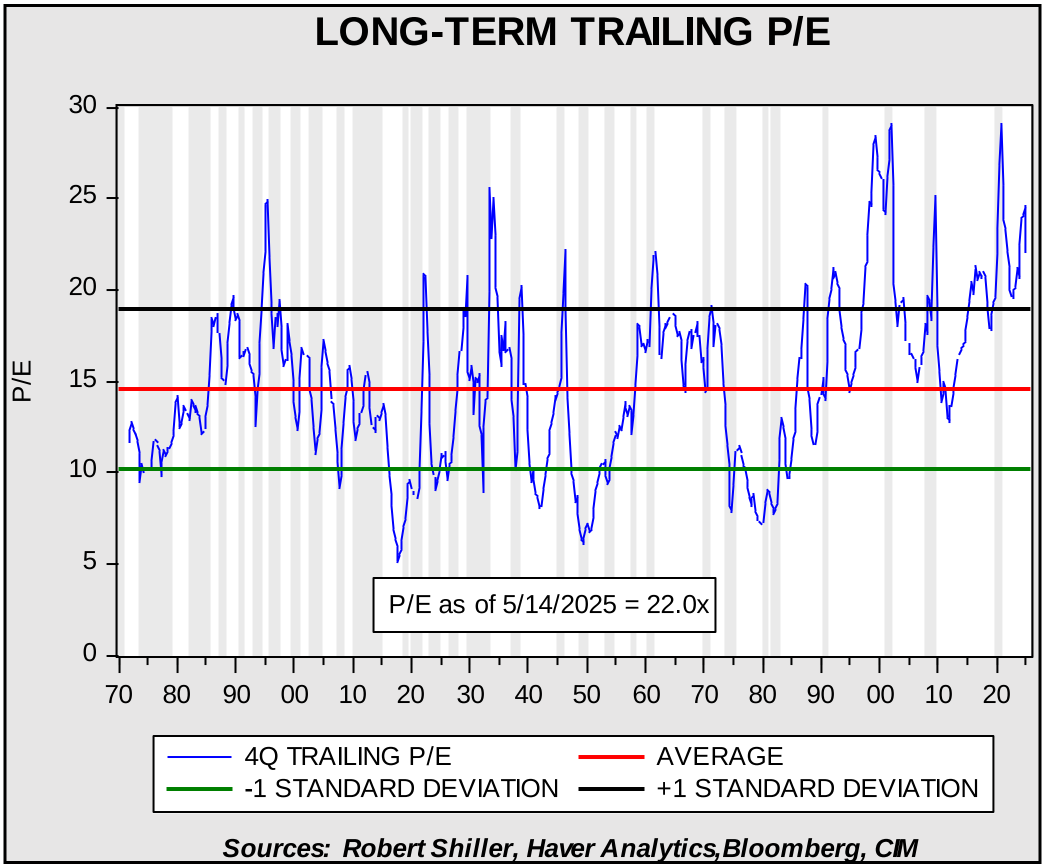


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

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.

---

[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.