MERRY CHRISTMAS

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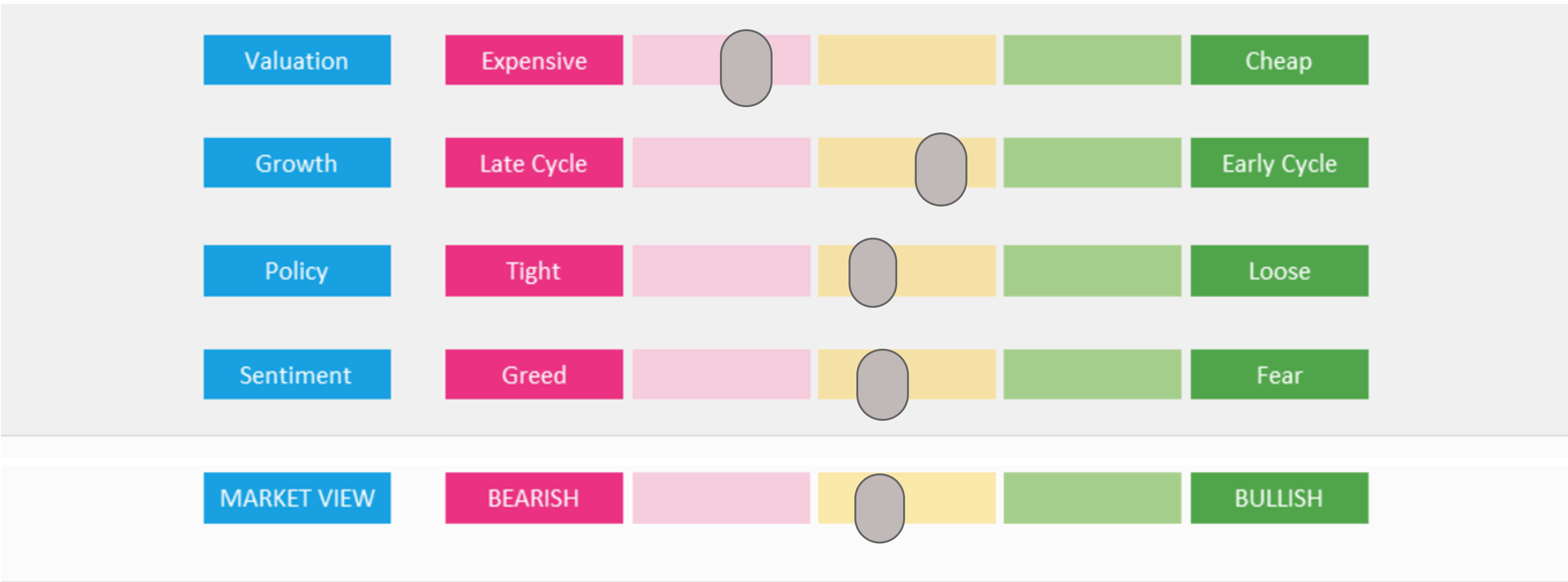
GOOD INVESTMENT

Christmas Market Barometer

Barometer

This Month
Improved
Deteriorated



Our Twelve Charts of Christmas

We are taking the opportunity of the festive period to sit back and take stock of what has been driving risk assets and what appears to be in the price.

The US stock market has only ever been more expensive than it is today twice before in the history back to 1881, on a Cyclically Adjusted PE of 38x. Those two occasions were during the TMT bubble of 2000 and at the end of the zero interest rate post pandemic period, before the rate hikes of 2022/23. Both episodes ended in substantial equity market corrections.

Against this we highlight that **expected real total returns for non-US equity markets are still very healthy**, in the mid-high single digit percent range.

And **growth momentum is very strong** both for the service sector and generally for earnings, with the incoming US administration likely to provide further support for earnings via more tax cuts and increased incentives to invest.

We are alert to four key risks:

1) Weakening earnings momentum in the Magnificent Seven / broader US equity market
2) A global trade war
3) A fiscal crisis in the US and / or Europe
4) A sharp upturn in inflation

In the meantime, **we remain risk on in portfolios**.

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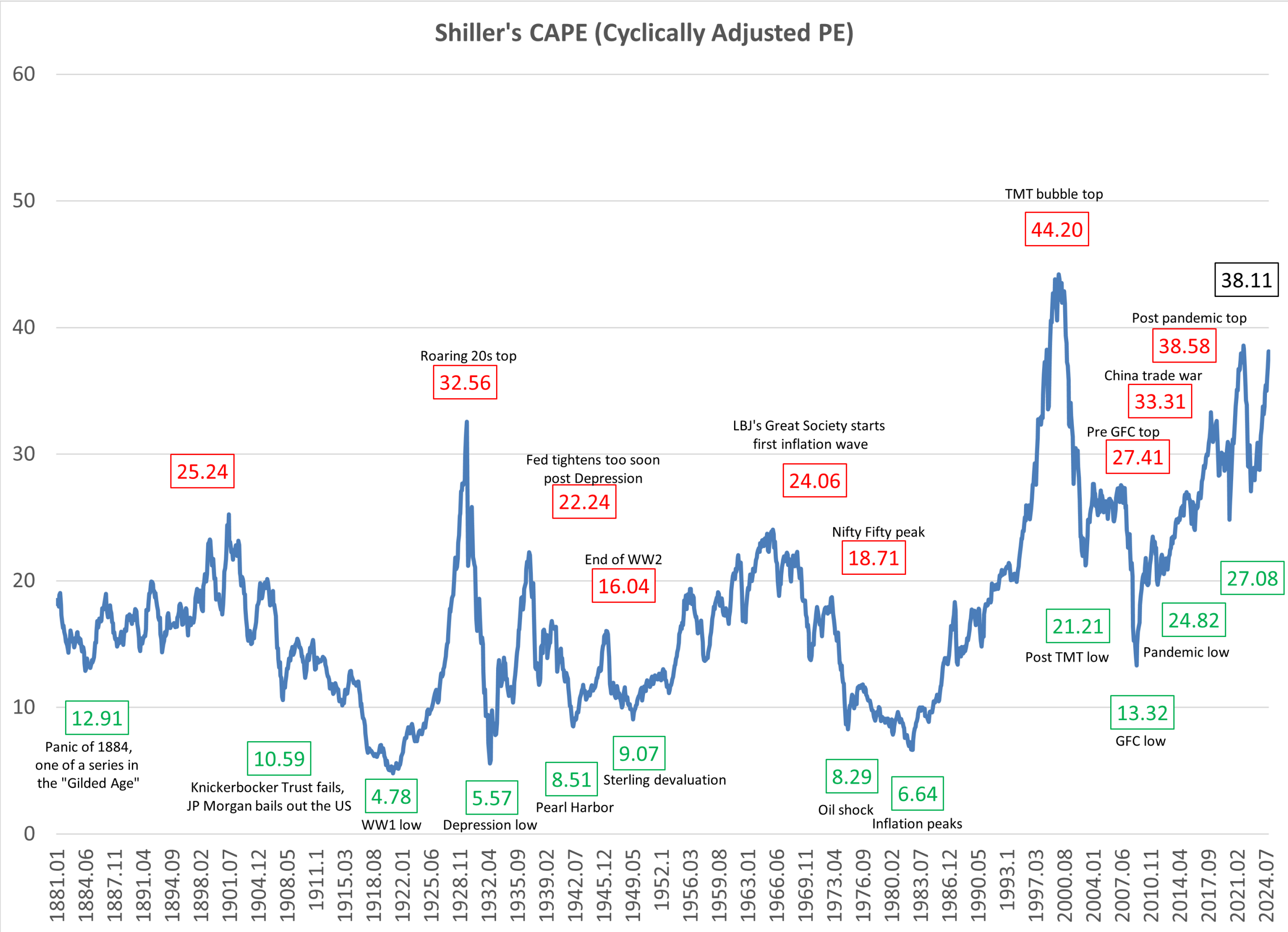
The First Chart of Christmas

Professor Robert Shiller from Yale University won the Nobel Prize in 2013 for his empirical work on asset prices. He has for many years published his Cyclically Adjusted Price Earnings (CAPE) ratio for US equities, reproduced with CCLA annotations below. The CAPE is calculated by dividing the real market price by the average of the real market earnings per share for the trailing 10 years. It is widely regarded as a more reliable valuation ratio than the "spot" PE (today's price divided by this year's earnings per share (EPS)) because EPS are so volatile from year to year.

The CAPE provides important context for the US stock market today. It has only been more expensive on this measure twice in the past 143 years. Professor Shiller also publishes a cross asset valuation measure - his Excess CAPE Yield - which compares the real earnings yield with the real bond yield, and on that measure his equity risk premium is a scant 1%. We would conclude that **earnings momentum has never been more important than it is today. Should it falter, valuations could correct considerably**.



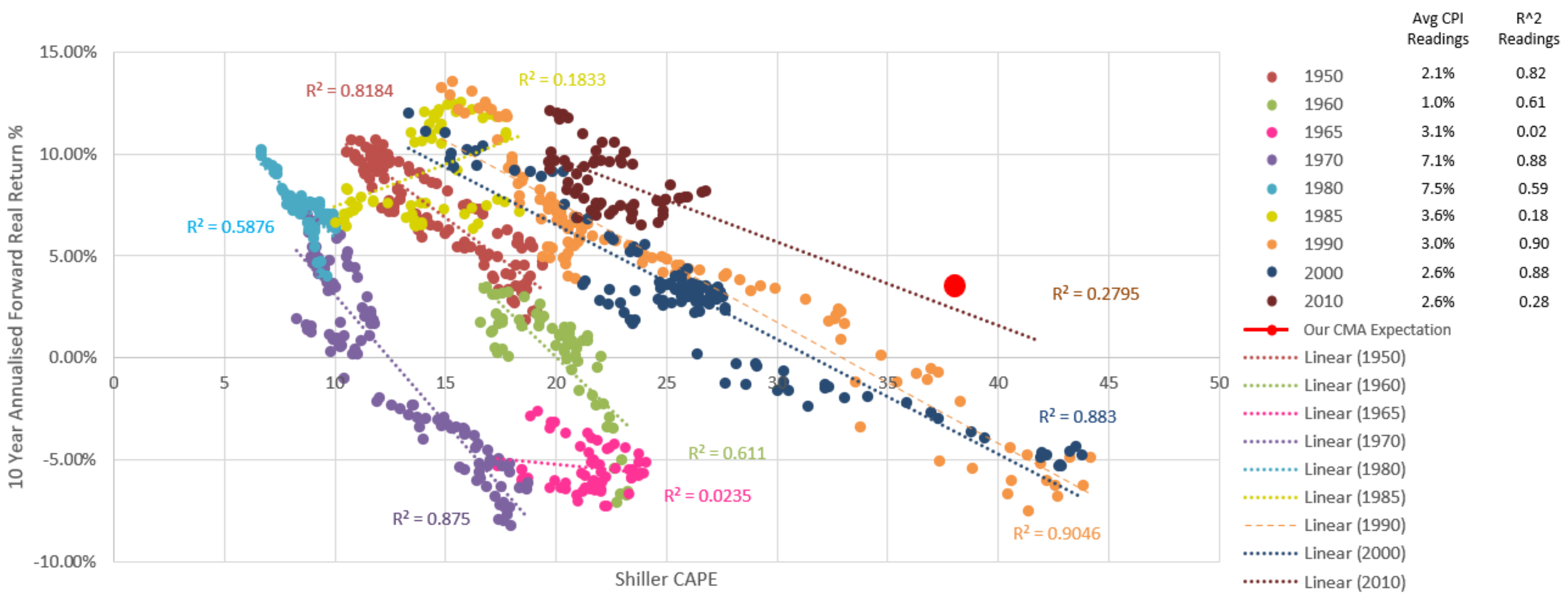
Sources | CCLA, Robert Shiller: shillerdata.com as at Dec 2024

The Second Chart of Christmas

Our second Chart of Christmas shows **the CAPE's track record at predicting market returns over the long term (10 years), which is very good**. However, the CAPE is next to useless in predicting market returns over short time horizons, say shorter than five years. So we should not panic when we see this chart, in the sense that a high or very high CAPE does not tell us anything useful about returns in the next 12-60 months, historically.

The big red dot on the chart plots the current Shiller CAPE of 38 for the US market against **our current expected 10 year real return of 3.6%**. When viewed solely through the lens of the CAPE, this **looks unlikely**. Our Capital Markets Assumption are set out on page 14 and explain how we get to our 3.6% expected return for US equity - essentially we take an average of spot Earnings Yield and Shiller earnings yield, on the expectation that earnings will not mean revert to the 10 year average.

S&P 500 - Shiller PE (x-axis) vs Subsequent 10 Year Real Annualised Total Return (y-axis)

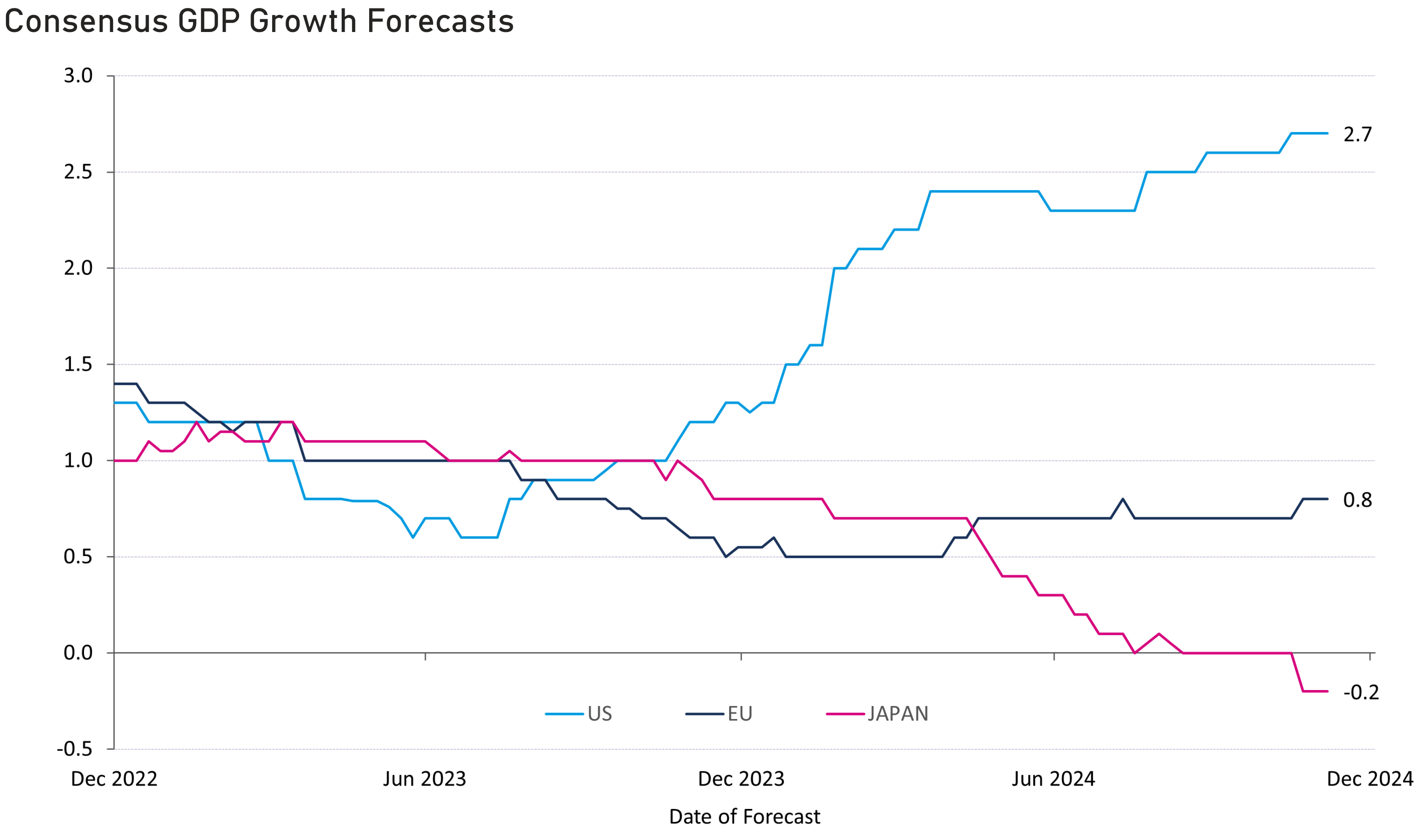


Sources | CCLA, Bloomberg as at Dec 2024

TOP OF MIND

The Third Chart of Christmas

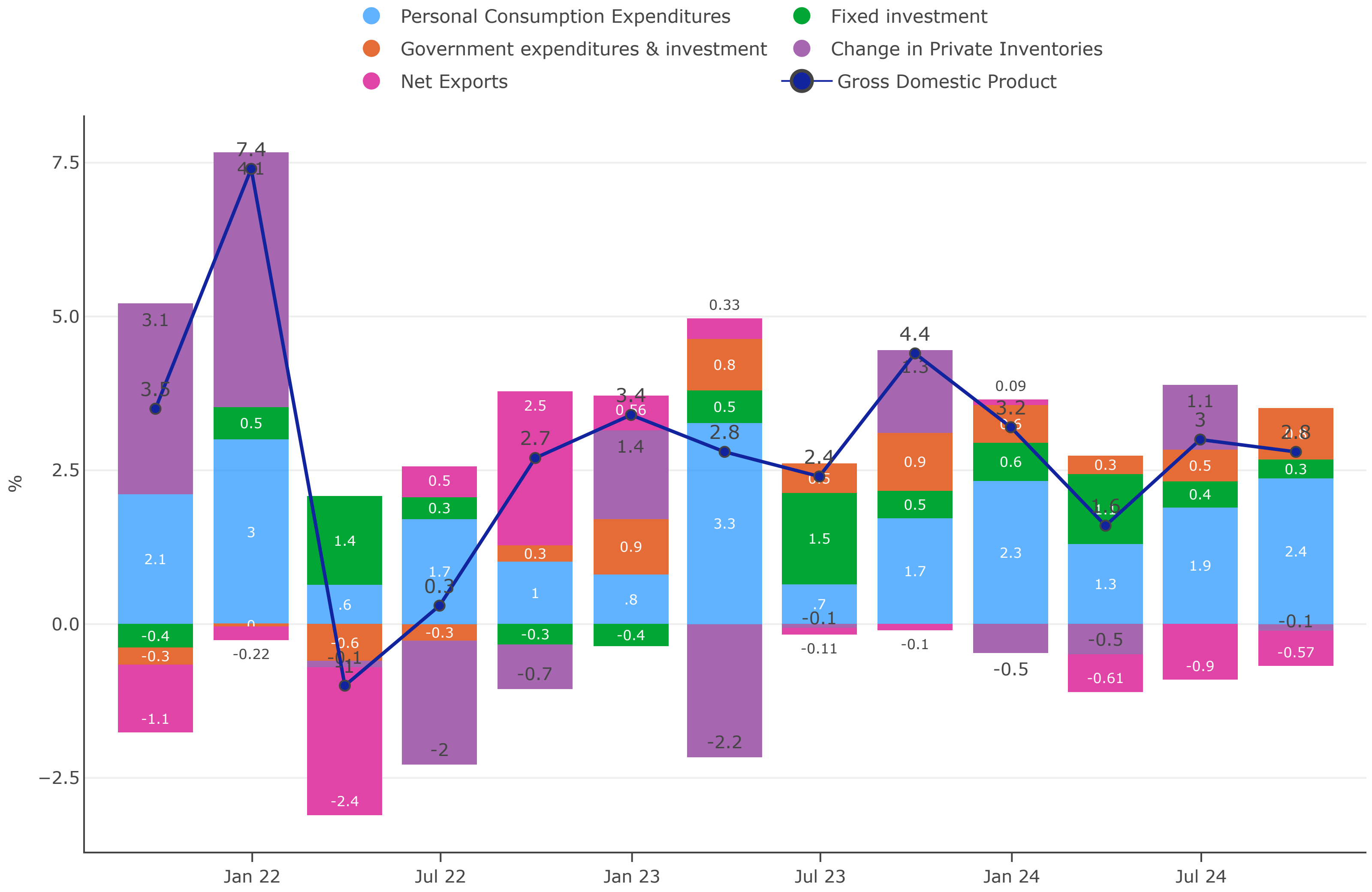
Growth rates have diverged in favour of the US. The chart shows the expectation for real GDP growth in the calendar year 2024. Consensus expectations for growth in 2025 are as follows: US 2.1%, EU 1.4%, Japan 1.2%. But has the consensus fully captured the growth-friendly tax cuts and policies to incentivise investment that Donald Trump campaigned on? It is not obvious why US growth would decelerate as much as the consensus expects. On the other hand it appears that his trade policies will specifically target the EU, especially on the car sector. **A further slowdown in already sputtering global trade will disproportionately impact the export heavy EU and Japan, while the US with its relatively closed economy has less to lose.**



Sources | CCLA, Gerard Minack as at Dec 2024

The Fourth Chart of Christmas

Never under-estimate the US consumer. With wages growing at a 3-4% annual rate depending on whether you are looking at average hourly earnings or the employment cost index, the unemployment rate low and reasonably stable at 4%, non farm payrolls growing at a 150k monthly average clip and inflation trending lower, the US consumer is in very good shape. And although it is very unevenly distributed, consumer net worth has risen 18% over the last two years to a staggering $169 trillion. The blue parts of the bars below are the personal consumption contribution to US GDP growth and are very solid. With the deficit likely to increase, government consumption (orange) should continue to contribute positively, as should fixed investment (green) under Donald Trump's America First policies. **The US economic engine should continue to purr this year.**



Sources | CCLA, Bloomberg. All data as at Dec 2024.

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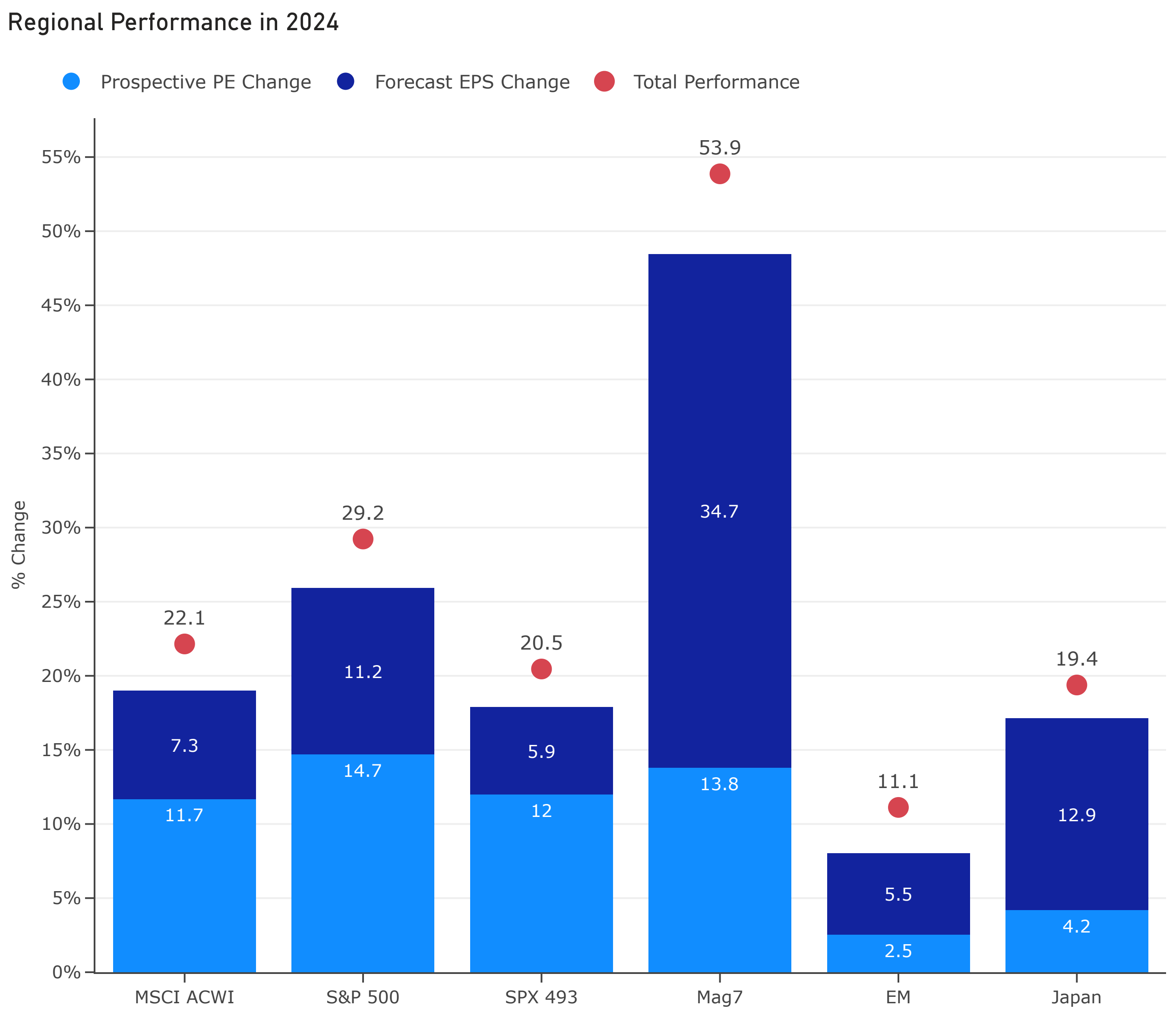
The Fifth Chart of Christmas

Growth differentials have driven the relative performance of regional equity markets. We show below the two main drivers of total return for equities over the last year (we exclude starting yields here for simplicity). PE re-rating has contributed more to US return than in other regions but what's really driven the Magnificent Seven stocks has been the 35% upgrade to earnings estimates over the last year.



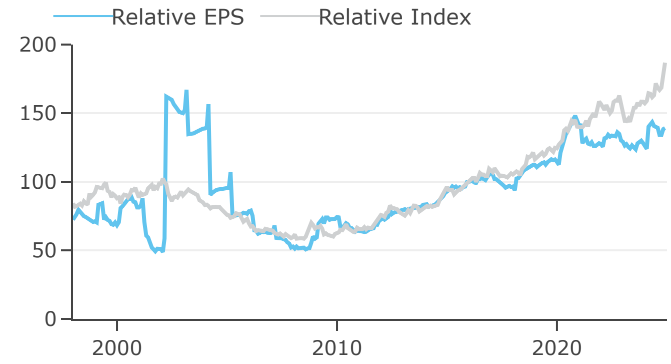
Sources | CCLA, Bloomberg, MSCI as at 12 Dec 2024

The Sixth Chart of Christmas

The primacy of US equity is well illustrated by these charts. It is the only major global market with relative earnings momentum but we should also note that the relative price line for the US has gone up faster than the relative earning line, another way of saying that US equity has re-rated relative to the rest of the world. **This is not going to be a problem until and unless the relative earnings line stops rising, we would think.**

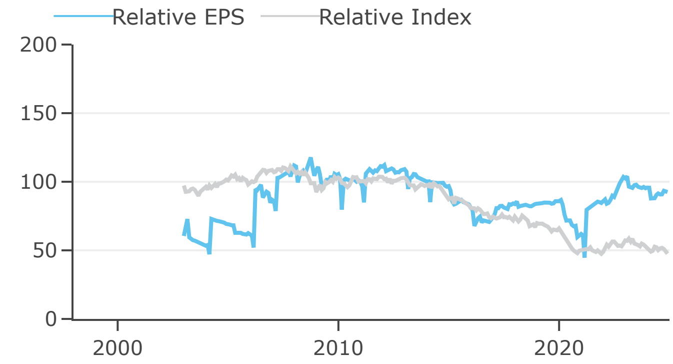
MSCI US Earnings and Price Relative To MSCI World Ex-US

(Indexed 100=Dec '15)



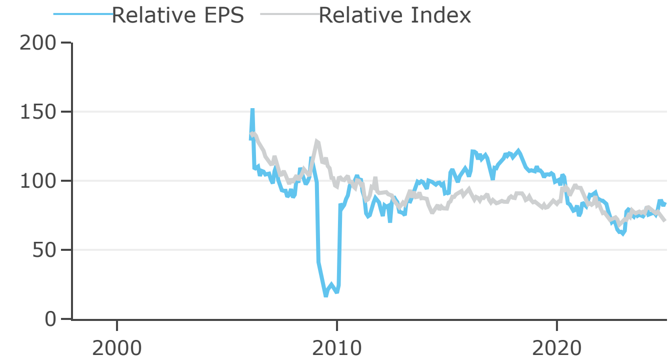
MSCI UK Earnings and Price Relative To MSCI World Ex-UK

(Indexed 100=Dec '15)



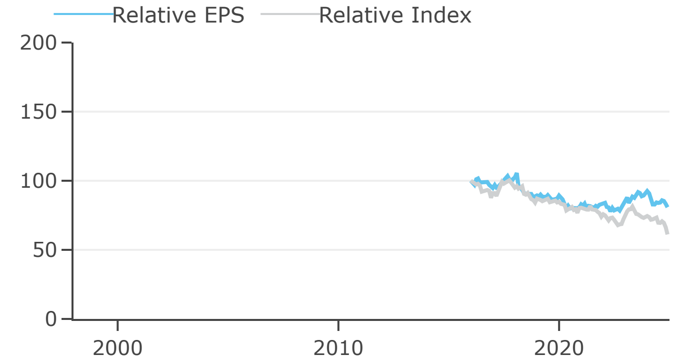
MSCI Japan Earnings and Price Relative To MSCI World Ex-Japan

(Indexed 100=Dec '15)



MSCI EU (Ex UK) Earnings and Price Relative To MSCI World Ex-EU

(Indexed 100=Dec '15)

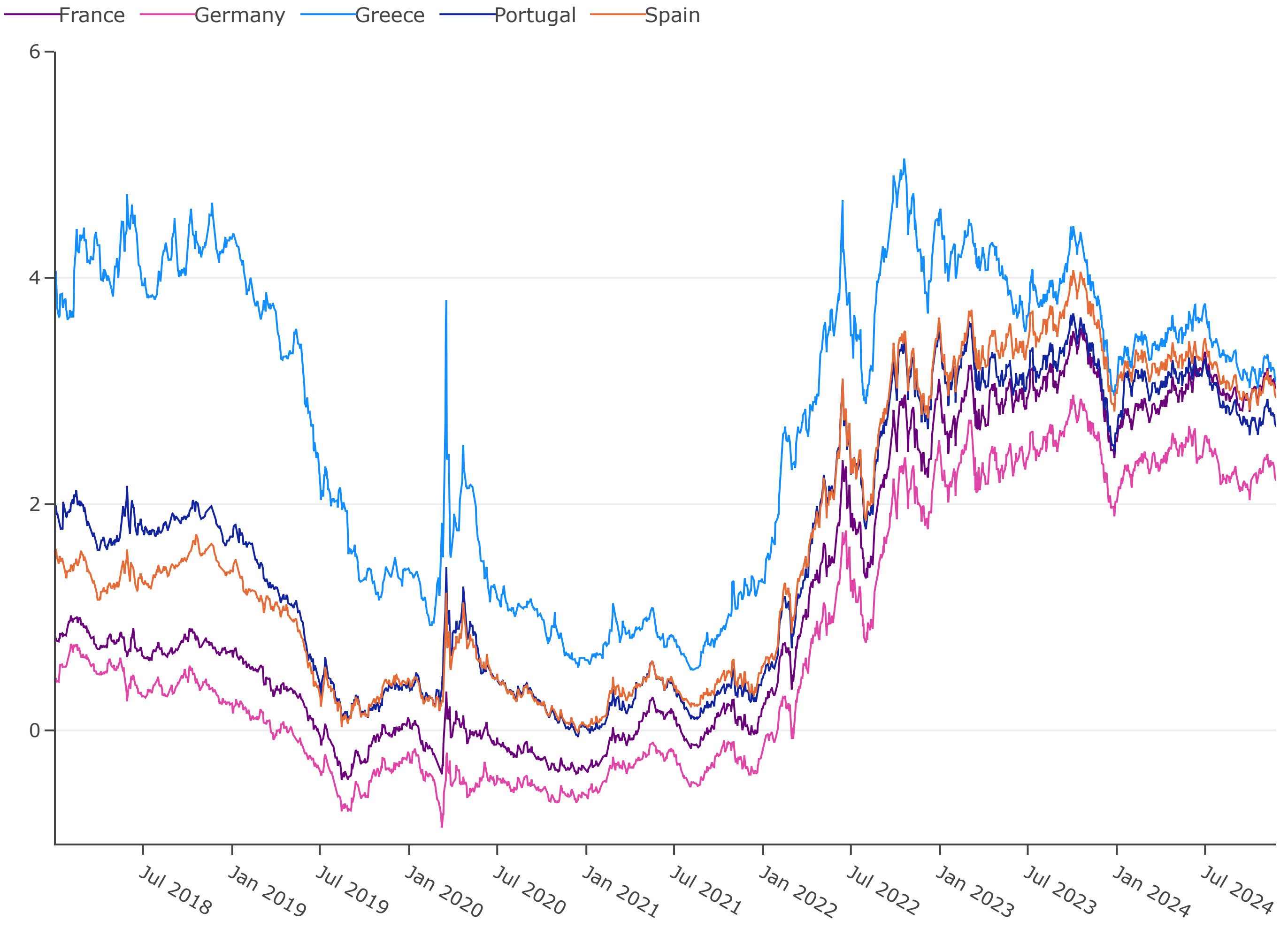


Sources | CCLA, Bloomberg, MSCI as at Dec 2024

The Seventh Chart of Christmas

The PIIGS come in from the cold as France catches a cold. In the Eurozone fiscal and debt crisis of 2010-12 the so-called PIIGS (Portugal, Italy, Ireland, Greece and Spain) saw their sovereign bond yields widen out to as much as 30% (in the case of Greece). Core Europe (Germany, France and Benelux) was intransigent in its demand that the PIIGS get their fiscal house in order. What a difference a decade makes. In the last month we have seen the Portuguese and Spanish bond yields fall below those for France. And Greece is within 6bps of France. French PM Michel Barnier lost a no-confidence vote following his budget proposal to cut the deficit, and has resigned. It remains to be seen whether France's (and for that matter the UK and US's) apparent inability to cut its deficit will evolve into a full-blown fiscal crisis, but the contrast with German bunds is increasingly stark.

European 10Y Yields %



Sources | CCLA, All data as at Nov 2024.

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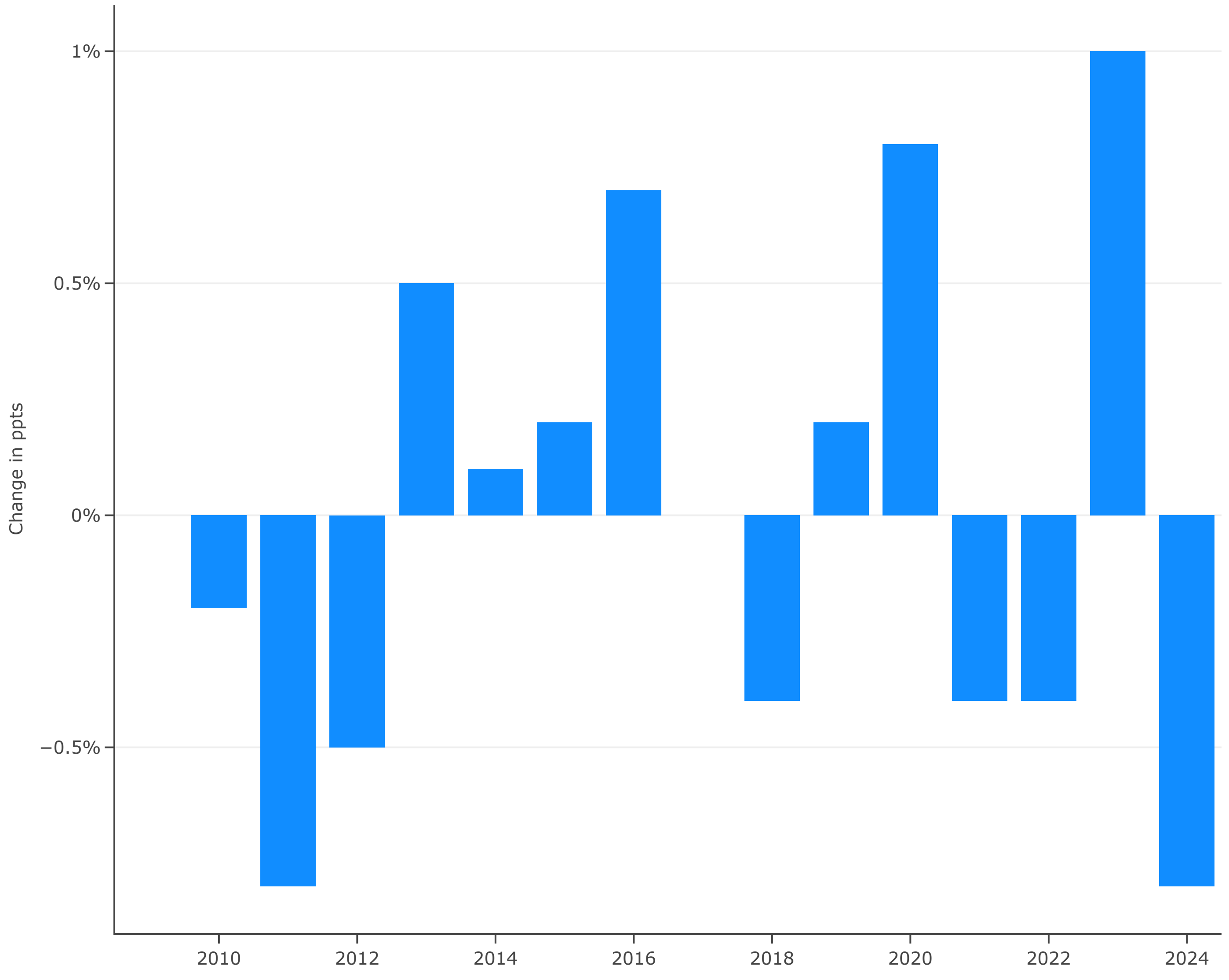
The Eighth Chart of Christmas

Will China stimulate? The chart shows the year to year change in the fiscal deficit so it's a measure of "fiscal thrust", which has actually been a headwind for growth in 2024. The A shares (onshore Chinese stocks) rallied sharply in September on hopes that the politburo was finally moving to stimulate growth, but the market has since given up over half of that September gain. If they do go all in on growth it would have positive knock-on effects in Europe too, but so far there is precious little sign of it.

China Fiscal Impulse (ppts Change in Deficit/GDP) Over Time



Sources | CCLA, National Bureau of Statistics, Bloomberg as at Dec 2024

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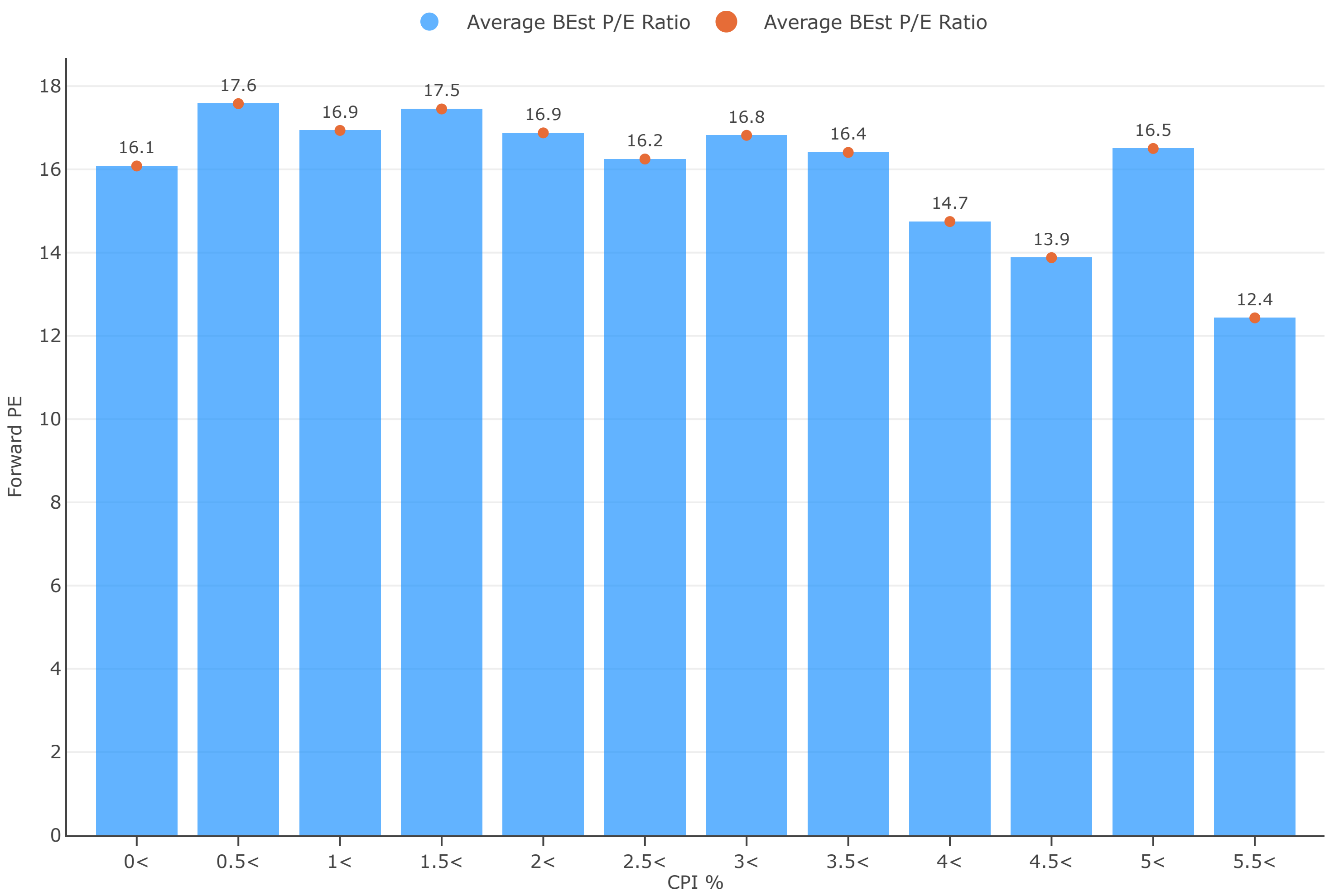
The Ninth Chart of Christmas

Equity markets like goldilocks inflation and growth - neither too hot nor too cold. This chart shows the average S&P 500 price earnings ratio in various buckets of inflation, using data from January 1990. We see that market PE is at its highest when inflation is between 1.0-3.5%. This is further corroboration of our Fire & Ice framework, which says equity market returns are best in Reflation (low and rising inflation) or Disinflation (high and falling inflation) - both of which benefit from rising PE.

Today this also highlights the risk from Trump 47, that **if he allowed inflation to acclerate we could get a de-rating of currently expensive equity markets.**

US CPI vs. S&P 500 Forward P/E



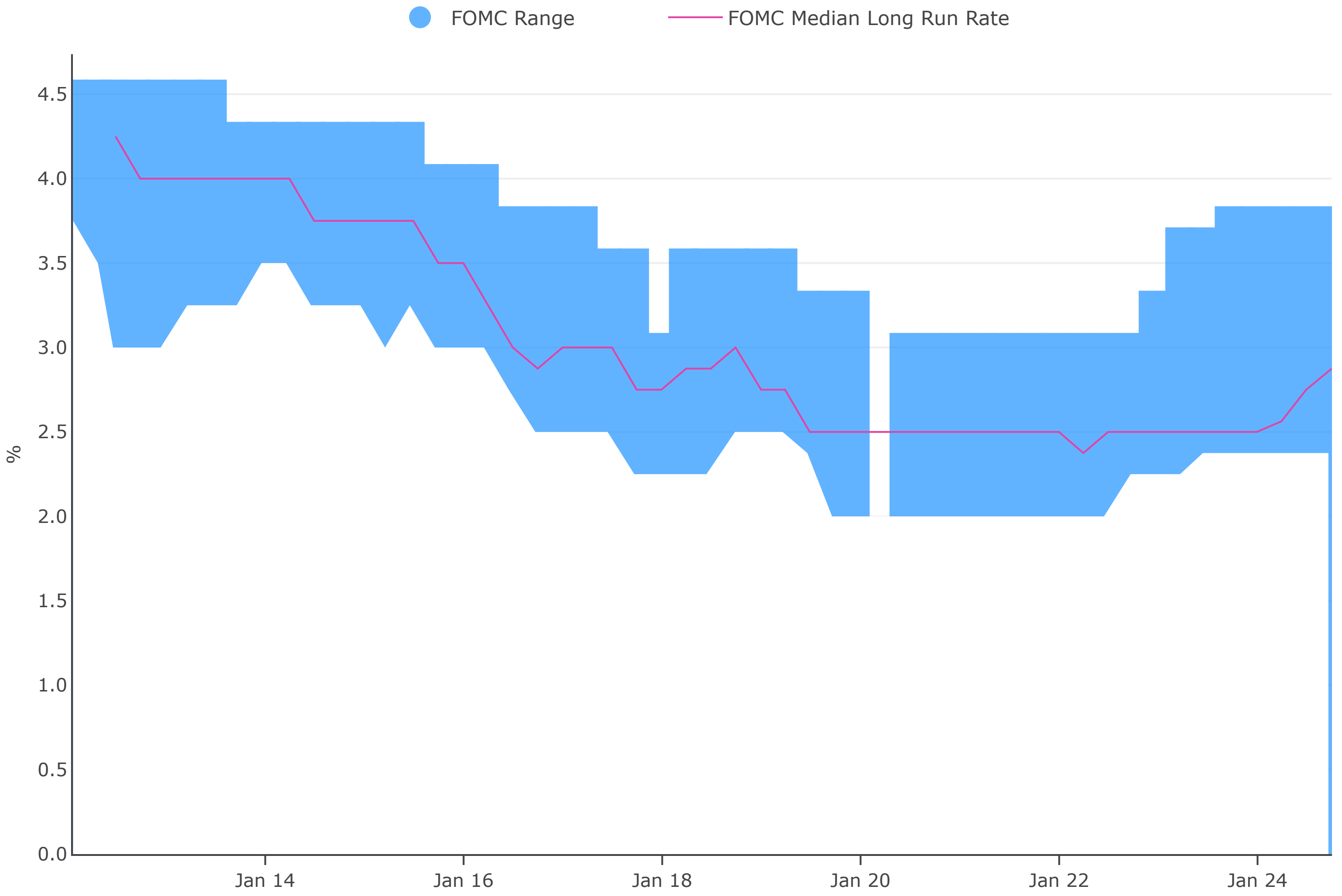
Sources | CCLA, Bloomberg as at Dec 2024

The Tenth Chart of Christmas

The Fed believes monetary policy is very tight. The so-called dot-plot is published every quarter in the Statement of Economic Projections of FOMC members. The chart shows the range and median estimate of what FOMC members believe the neutral Fed interest rate should be - currently 2.88%. Strip out their 2.0% PCE / 2.4% CPI target and you get a **neutral real interest rate of 0.5%** (the so-called r-star).

We struggle with the Fed's view! Trend real GDP growth has been 2.5% since the pandemic. But what we think doesn't matter. The Fed clearly thinks rates are too high for a trending economy so **may cut further than we think they should. To the extent they do it will further support ebullient equity markets.**

The Fed's Neutral Rate Estimate



Sources | Federal Reserve, Bloomberg. Data as at Dec 2024

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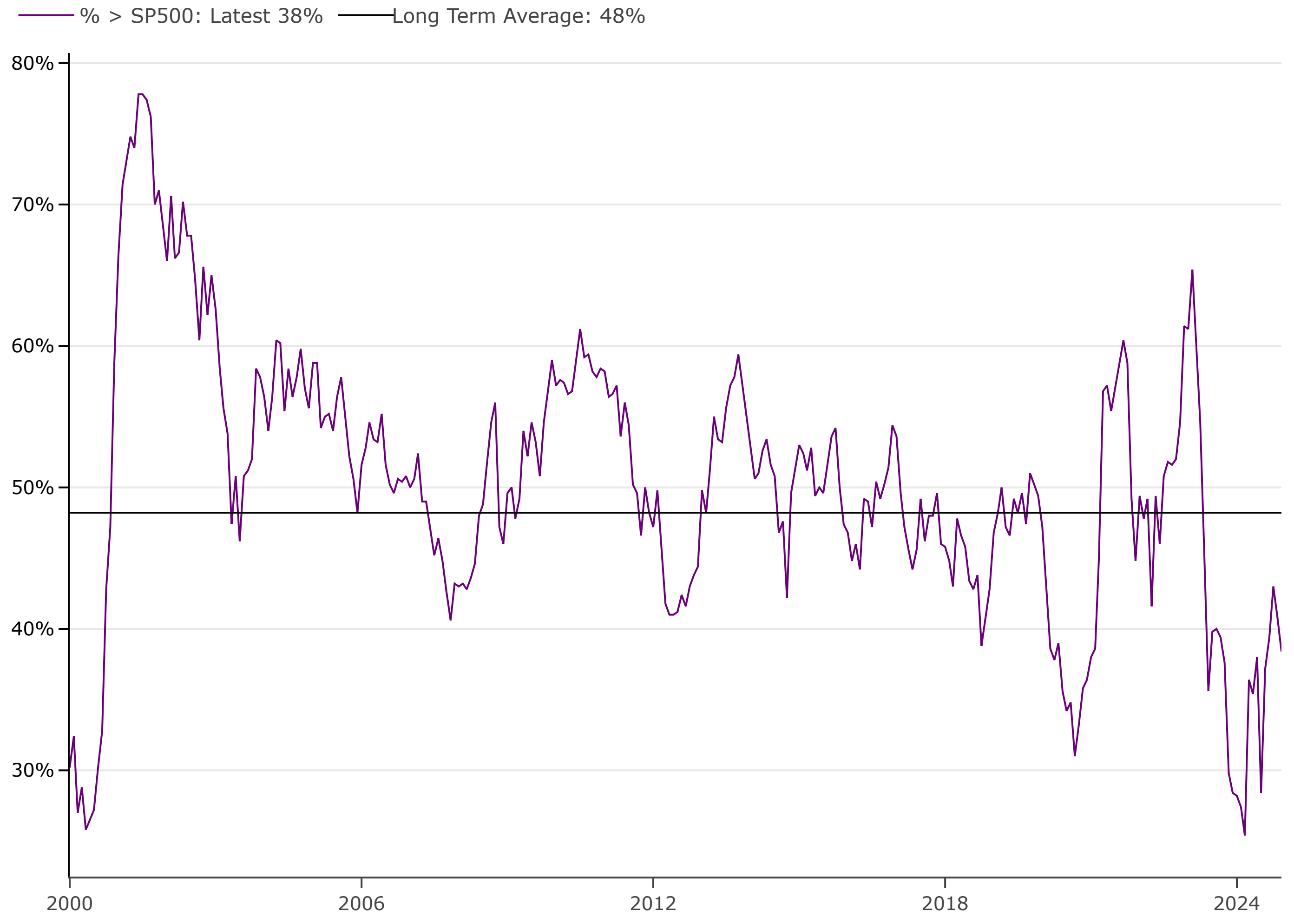
The Eleventh Chart of Christmas

Market breadth has been very poor. The chart shows the percentage of stocks in the S&P500 that have outperformed the index over a rolling 12 month period. As the market has focused on the Artificial Intelligence mega-trend, leadership has really narrowed down to a small sub-set of the index, such that in March 2024 only 25% of stocks had outperformed, far below the 48% that normally outperform.

Breadth has been as bad as it was during the last stages of the TMT bubble of 2000. What followed was three years (2001-2003) when the largest portion of stocks outperformed. If history repeats **there should be much better opportunity set for active stock pickers in coming years after the drought of the last two**.

% of Stocks in S&P 500 Outperforming the Index



Sources | CCLA, All data as at Dec 2024.

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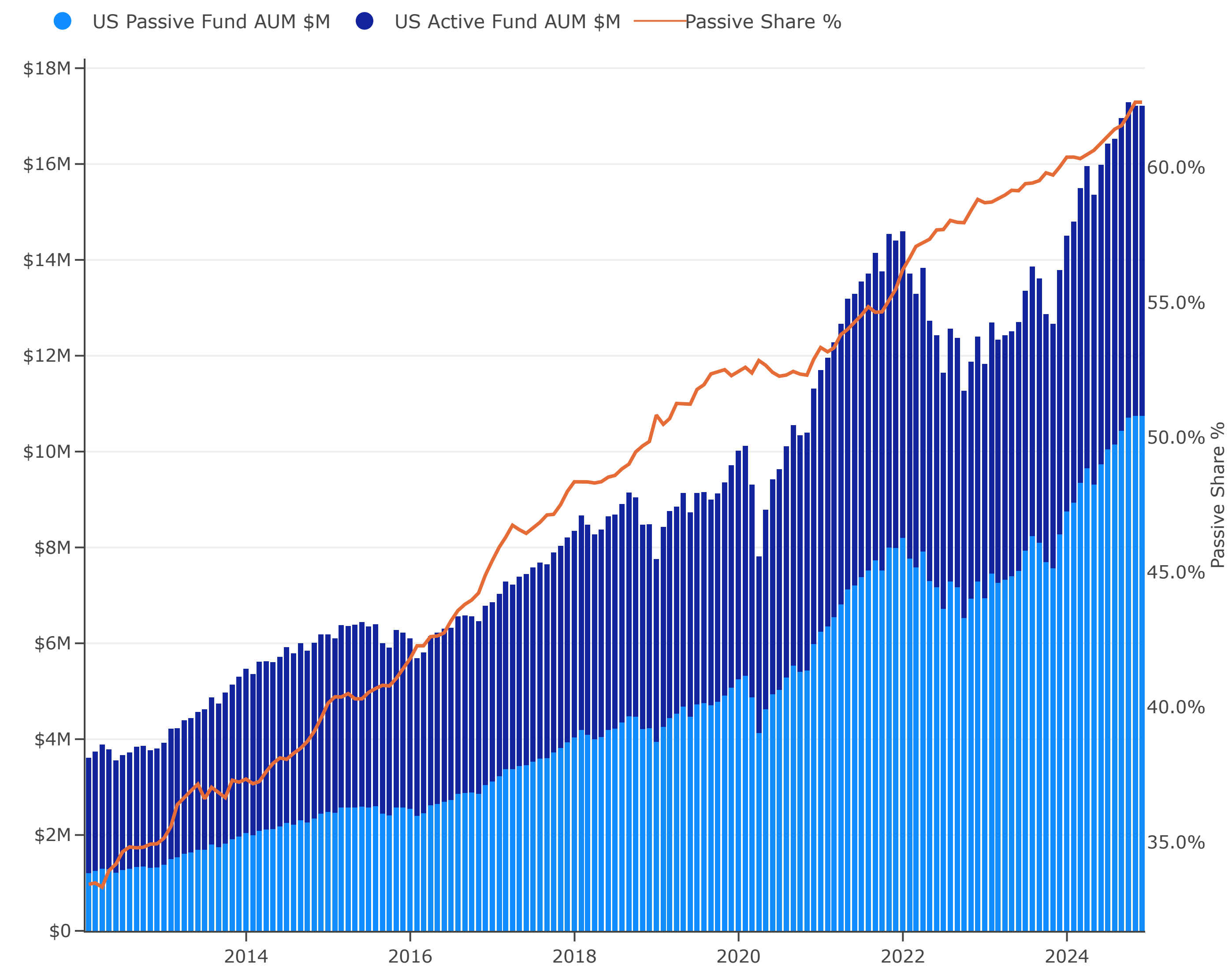
The Twelfth Chart of Christmas

The rise of passive investing marches ever onwards. The passive share of total US domestic equity funds has risen to 62% of total AUMs, according to Bloomberg. As long as net inflows continue at their currently very strong rate, momentum stocks should continue to work.

US Equity Active vs. Passive AUM Growth



Sources | CCLA, Bloomberg as at Dec 2024

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Capital Market Assumptions

And finally ... we set out our capital market assumptions for equity and sovereign bonds. We present two approaches to forecasting equity market returns but highlight that we actually use the average of the Shiller earnings yield and the spot earnings yield.

Our expected real annualised total return for global equity is 4.1%, around half the level that has been delivered over the last decade. For bonds, gilts offer the highest return but still well short of our investment objective.

If these assumptions materialise over the next 10 years we would expect our current tactical asset allocation to deliver a little more than 4% real from asset class betas alone - just around our funds' investment objective but not leaving a lot of leeway.

Global Equities

Total Return	US	Europe ex UK	UK	Japan	Emerging Markets	ACWI	World
Building Block Method (Real)	2.6%	5.0%	7.1%	3.9%	6.2%	3.5%	3.2%
Avg Shiller CAPE & Spot PE Method (Real)	3.6%	6.0%	8.1%	5.5%	8.3%	4.5%	4.1%
Average Real Return	**3.1%**	**5.5%**	**7.6%**	**4.7%**	**7.2%**	**4.0%**	**3.6%**
Inflation Expectation	2.5%	1.5%	2.5%	1.5%	3.5%	2.4%	2.2%
Average Nominal Return	**5.6%**	**7.0%**	**10.1%**	**6.2%**	**10.7%**	**6.4%**	**5.9%**

Fixed Income - Sovereigns

Inputs	US	Europe ex UK	UK	Japan	Emerging Markets
Trend Real Growth	2.0%	1.0%	1.0%	0.8%	3.7%
Term Premium	0.5%	0.5%	0.5%	0.5%	1.0%
Fair Real Yield	2.5%	1.5%	1.5%	1.3%	4.7%
Inflation Expectation	2.5%	1.5%	2.5%	1.5%	3.5%
Fair Nominal Yield	5.0%	3.0%	4.0%	2.8%	8.2%
Yield Now	4.24%	2.12%	4.31%	1.05%	2.63%
Pull To Par Annualised Return	-0.6%	-0.8%	0.3%	-1.5%	-3.9%
Total Nominal Return	4.4%	2.2%	4.3%	1.3%	4.3%

Sources | CCLA as at Dec 2024

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